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An emerging group: A roundtable of LPs and GPs discuss investing with and by emerging managers

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Some studies have found a correlation between early-stage funds and investment outperformance, and investors are looking for ways to tap into emerging manager talent. And while that talent remains raw and, by definition, somewhat untried, a number of institutional investors have launched emerging manager programs. Institutional Real Estate, Inc. collected perspectives from limited partners, multi-managers and emerging managers about some of the challenges that face the industry, as well as some of the benefits of working with new talent.

On the pension fund side, participants include **Amy Cureton,** portfolio manager, and **Bob Sessa,** director of real estate, of the $26.5 billion Employees Retirement System of Texas, as well as **Thomas DiNapoli,** comptroller of the state of New York, whose office oversees the $184.5 billion New York State Common Retirement Fund. Both NYSCRF and Texas ERS have programs targeting emerging manager firms.

On the investment management side, participants include **David Butler** and **Andrew Stewart,** managing partners of Argosy Real Estate Partners; **Deborah Harmon,** co-founder and CEO of Artemis Real Estate Partners; **Greg Parsons,** CEO and head of the investment committee at Semper Capital Management; **Neville Rhone,** co-founder and managing partner of Arc Capital Partners; and **Maria Stamolis,** co-head of real estate investments and director of asset management at Canyon Partners Real Estate.

What do emerging managers bring to the table that sets them apart from larger, established firms?

David Butler: Emerging managers generally bring more focus and hands-on management to the execution of real estate investment strategies. The teams have greater involvement from senior management in all aspects of the business. Given the generally smaller fund sizes of emerging managers, they typically pursue smaller-sized transactions in the middle market, where there is less competition and greater inefficiency. Since fee income for smaller emerging manager funds is lower on a relative basis to that of the larger, established firms, there is greater motivation to generate outsized returns since carried interest is more important to the economics of the principals. Emerging managers also tend to bring an entrepreneurial mindset to investments. Combining this entrepreneurial mentality with a return-focused approach, emerging managers can be well-positioned to generate fund returns that are attractive relative to those of larger firms.

Greg Parsons: Emerging managers provide a distinct set of experiences and perspectives that can help shape and differentiate their product offerings from the larger, established firms. Emerging managers are also often able to blend institutional presence and capabilities with a more opportunistic, nimble approach, allowing them to take advantage of opportunities their larger competitors can't execute on.

Deborah Harmon: Emerging managers have an unparalleled will to succeed — failure is just not an option. They often possess deep local knowledge and relationships, as they typically focus on concentrated geographic areas and product type, or they have a very strong realized track record as an operator or fund manager at a previous firm. Investing with diverse emerging managers fosters job growth, generates wealth creation — often in underserved markets — and improves the bottom line. Diverse emerging managers outperformed the Cambridge Real Estate Fund benchmark by an average of 600 basis points from 2009 to 2013.

Maria Stamolis: In our experience with the Canyon Catalyst Fund, we have found emerging managers employ niche investment strategies and can often capitalize on opportunities that are not easily accessed by traditional investment managers. They also tend to be operators and managers with specific product-type and submarket expertise, which can afford them an advantage in their micromarkets. Catalyst is designed to identify high-quality emerging managers and support them in the context of a "mentoring" investment manager model.

Neville Rhone: We believe emerging managers are far more innovative than larger, established firms since the founders and key principals are typically directly involved in key investment decisions. Not surprisingly — but certainly to our advantage — we have seen much larger firms miss compelling opportunities due to slower, bureaucratic decision-making processes. We also believe that seasoned emerging managers are better equipped to identify and execute niche strategies that larger, established firms would not — or could not — pursue. Interestingly, rather than solely increasing allocations to larger firms, investors can achieve portfolio diversification over the long term with emerging managers.

How do investor organizations define emerging manager? What criteria are important in the definition?

Thomas DiNapoli: With regard to the real estate asset class, there are three criteria that define an emerging manager. First, the emerging manager must have less than $1 billion in equity capital under management; second, the emerging manager must have 12 years or less real estate investing experience; and lastly, the emerging manager must have raised fewer than four institutional funds. Overall, the emerging manager must be committed to diversity, integrity and transparency.

Bob Sessa: The technical definition as suggested by the state of Texas for all asset classes is a firm with less than $2 billion in assets under management. However, for the real estate, we feel a firm with less than $500 million in AUM and on their third or less institutional fund would probably be a better representation of this universe.

Harmon: Artemis Real Estate Partners has multiple investors with different emerging-manager definitions, each of which is driven by the investor's unique requirements or objectives. For example, some investors define emerging mangers using assets under management thresholds, while others have a statutory requirement to identify firms with 51 percent ownership by women, minority and persons with disabilities. At Artemis, all of our emerging managers share the following characteristics: integrity and transparency, successful and proven track record in a targeted niche strategy, proprietary deal flow and off-market opportunities, local market expertise, and relationships with tenants, brokers and government officials.

Stamolis: Canyon's emerging manager platform … defines "emerging manager" as an investment adviser that has less than $1 billion of assets under management and no more than three institutional commingled funds or separate accounts at the time of initial evaluation. In addition to a track record of success and demonstrated deep expertise in their asset class, emerging manager candidates need to show aligned interests with their investors through a meaningful co-investment of capital.

For the LPs, how has working with real estate emerging managers been beneficial for your organization?

DiNapoli: The program is performing above expectations. The program has 25 approved emerging managers, with nearly $500 million committed in 41 transactions. One of the first women-owned managers in the program successfully realized their program commitment, executing their business plan in a shorter time period than anticipated and substantially exceeding target returns. With regard to diversity, 83 percent of the capital invested to date is with diverse managers, and approved emerging managers have directed $74 million of third-party service provider dollars to women- and minority-owned firms.

Amy Cureton: Emerging managers offer a diversifying element to our overall portfolio, and we have found them to be great alpha generators. They typically invest in smaller asset sizes and usually in markets where we may not have a significant presence with other investments. Since they are trying to establish themselves, we have also found them to be very focused investors, usually generating attractive risk-adjusted returns.

Research shows real estate fund managers outperform in their first through third funds. Why would that be?

Rhone: While we are somewhat biased as an emerging manager, we believe that size is the enemy of performance for a number of reasons. First, earlier funds tend to focus on smaller, highly fragmented opportunities that can be less competitively priced and provide stronger risk-adjusted returns as compared to larger opportunities. Second, emerging managers are extremely focused on generating the highest absolute returns as quickly as possible since asset-management fees generated by early funds usually do not result in profitability for their firms. Third, typically, the sizes of later funds dwarf the size of earlier successful funds and force managers to divert focus to larger mainstream transactions rather than the niche strategies that led to their earlier successes.

Andrew Stewart: It is possible that some real estate managers outgrow the "emerging manager" mindset after several funds. Many managers grow fund sizes significantly from fund to fund, increasing their fee stream, and potentially losing their drive and motivation to generate outsized returns. The amount of fee income generated from earlier, generally smaller, funds is usually insufficient to provide for a high level of compensation for principals of the firm; therefore, there is greater incentive to generate outsized investment returns in early funds since carried interest is the primary economic motivator.

Harmon: One, earlier-stage, smaller managers tend to have smaller fund sizes; therefore, they can be more nimble, focus on smaller transactions typically under the radar screen of larger, more competitively priced deals. Two, newer firms are extremely motivated to succeed. If a manager's first fund does not achieve its target performance, emerging managers could effectively be out of business. The starkness of this reality translates to a strong respect for risk and an aversion to strategy creep, both of which can negatively impact more established funds but will not be business killers.

Butler: The manager consolidation trend has resulted in a greater majority of capital being allocated to larger funds run by a smaller number of firms. These larger funds, therefore, have more competition targeting more sizable transactions and, therefore, potentially have greater difficulty in sourcing attractive opportunities. Emerging managers overseeing their earlier, smaller-sized funds tend to have greater capability to generate alpha in the execution of their real estate business strategies. There typically is a lot more inefficiency in the middle market, where emerging managers can capitalize on more favorable acquisition opportunities and the generally less-complex execution strategies associated with smaller assets.

What advice do you have for emerging managers in the private equity real estate space?

Harmon: There is no one-size-fits-all approach. Emerging managers must have clarity of vision for their firm and investment thesis. It is also imperative to have a realized, verifiable investment track record for their proposed investment strategy. The process requires persistence and determination, and emerging managers need to pursue multiple capital sources and capital strategies while continuing to build their transaction track record and demonstrate access to attractive investment opportunities. Discretionary fund capital is not always the Holy Grail. With it comes the highest standards of fiduciary responsibility and organizational requirements that can be overwhelming to first-time firms or first-time funds.

DiNapoli: Have a compelling investment thesis and detailed execution plan that offers an opportunity not readily available from known, established investment managers. Have in place processes that demonstrate adherence to well-defined underwriting and due diligence policies and procedures. Have a successful track record in the specific strategy being pursued, either as part of the current organization or as part of a previous organization. Understand what it means to be a fiduciary.

Stamolis: We often find emerging manager candidates try to "sell" their strategy to an investor without having a complete or thorough understanding of whether it suits that prospective LP's interest, appetite or mandate. Canyon counsels emerging managers to thoroughly understand the infrastructure that is required by their investor when managing institutional capital. We educate our emerging managers to properly execute their fiduciary responsibilities, which include regular communication, robust underwriting, and institutional asset management and reporting.

Sessa: We have noticed it takes a lot of patience, perseverance and being humble to break through. Differentiating your firm from the competition and demonstrating your uniqueness is important. Highlight how you might have an edge in sourcing, underwriting, picking markets or vision for an asset, etc., to show the LPs your expertise.

Where do real estate emerging managers need to improve?

Sessa: Every manager will have their own strengths and weaknesses. First, this is not a get-rich-quick scheme, so they need to be flexible with terms and don't feel entitled to getting the excessive payments this industry has made the norm. Reporting seems to be an area that could be enhanced, as well as investment memos. Providing enough information and in a format that is easy to digest is extremely helpful, as we are all stretched for time.

DiNapoli: Emerging managers must prioritize improving their infrastructure. Oftentimes emerging manager candidates are great at sourcing and executing the business plan of a transaction but less equipped to provide the reporting and analysis of the investment opportunity in the format and on the schedule to which we are accustomed, because they have fewer resources.

Harmon: From the depth of senior talent required, key man insurance, seed equity, GP capital commitment, SEC registration, placement agent or in-house marketing talent, one must be aware it is as much the organizational business risks as it is their investment capacity that an emerging manager must address. Oftentimes emerging managers need to improve the back-office functionality of their business; if it is too early to hire reporting and accounting infrastructure, then it is important to find a strong firm to outsource those functions. For example, Artemis is the largest client of Great Falls Advisors. Great Falls Advisors is an independent service provider that offers third-party back-office support services, such as managerial and fund accounting, human resources support, and information technology management and insurance brokerage to emerging managers.

Cureton: Emerging managers also need to be thoughtful about how they manage the growth of their firm. Growing too quickly, expanding the scope of investing — such as launching a core-plus vehicle or expanding the geographic footprint — may not be appropriate for all managers. Not every firm should be managing $500 million plus in AUM.

What challenges do emerging managers face in the market? Is raising capital more difficult? Is it harder to source investments?

Parsons: Emerging managers face a number of obstacles in finding opportunities to showcase and deploy their skills. The market's perspective on limited scale, lack of brand recognition and desire to "play it safe" with known entities often limits emerging managers' ability to get in front of opportunities.

Harmon: Artemis is a real-time example of the challenges facing an emerging manager. We encountered a very high bar for investors to hand over discretionary capital to a first-time fund — much less a first-time firm. In March of 2010, Artemis set out to raise capital for a value-add/opportunistic fund focused on distressed situations across product and geography in the U.S. We secured seed equity sufficient to fund a 13-person senior team that had a successful track record buying distressed assets over multiple cycles. We invested $50 million in GP equity day one and offered favorable pricing and investor-friendly terms. Because we were among the first women-owned real estate private equity firms, we hoped that we might appeal to public pension plans with emerging manager mandates. It turned out that only one official emerging-manager program invested with Artemis Fund I. It took us 22 months to complete the capital raising from start to finish. This included 238 in-person meetings, 114 formal phone calls, 352 marketing investor pitches, and 20 on-site, all-day due diligence meetings. All of this work resulted in 11 institutional investors who committed to Fund I. That's a yield of roughly 3 percent. When people ask me what it takes to raise capital for a first-time fund or as an emerging manager, I have two words: persistence and stamina.

Stewart: Capital raising is more difficult for emerging managers. Many institutions typically do not want to be the first limited partner to commit capital to a new manager. Additionally, institutional fund commitment sizes are often too large for smaller funds, given their desire to not be too large of a percentage of a single fund. Furthermore, the track record of the emerging manager is generally limited since the team may be managing their first discretionary fund, even though the investment professionals may have significant historical experience working for other firms. For these reasons, it generally takes a long time for emerging managers to raise funds.

Stamolis: Capital raising is one of the most difficult tasks for emerging managers. Investors question a host of issues, including the emerging manager's ability to deploy capital, to manage existing investments, and to provide appropriate back-office infrastructure with a small staff. In addition, emerging managers are often overlooked, as they lack a long track record. Many new managers have successful track records at other firms that may be difficult to attribute to the new emerging-manager executive team. Institutional LPs have very high standards for reporting and compliance and work to ensure their own fiduciary responsibilities to shareholders. Successful emerging-manager candidates understand, appreciate and plan for this. When dedicated capital from a programmatic relationship is established, we find emerging managers can more easily overcome these challenges.

Butler: Another significant challenge with emerging managers involves the start-up capital required to put a team together, invest in the necessary infrastructure — i.e., back office — and launch a new fund management platform. The fee structures for smaller funds usually do not immediately cover the necessary fixed operating costs of a fund management company, so it can be capital intensive to get an emerging manager platform off the ground. Emerging manager platforms run by principals with strong deal-sourcing relationships and good reputations in the marketplace generally have access to a large number of attractive investment opportunities. When these principals are provided with access to discretionary capital, these emerging manager platforms have the potential to produce outsized returns, especially given the relative lack of capital in the marketplace chasing smaller investment sizes.

Rhone: Challenges in capital raising and sourcing investments are not unique to seasoned emerging managers and can be navigated with the right team. However, emerging managers are under significant upward cost pressure in order to perform to institutional-quality standards, yet often do not receive enough asset-management fees to be profitable as a firm. While there are a number of ways to mitigate this operating risk, we raised strategic capital with a large family office and are focused on programmatic joint ventures to build our real estate portfolio in a patient, disciplined manner until we achieve strong profitability.