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In this Memo

Direct investment in real estate has grown in popularity amongst private investors. Rockstreet reviews some of the reasons for the trend, and offers some critical perspective on its risks.

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A Client Memorandum from Rockstreet Partners

A Closer Look at Direct Investing

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By John Turner

In March 2015, Rockstreet published a white paper entitled *Effective Direct Real Estate Investment* that offered suggestions on how family offices might approach the goal of setting up a direct real estate investing arm. Since then we've had some additional thoughts on the issue and wanted to share them in this memo.

The impetus to revisit this subject was a recent meeting I had with a family office that controlled over a quarter billion of investable capital and wanted a more firmly defined real estate investing strategy. The question they wrestled with: Do we make their real estate allocations through a dedicated investment manager, like Rockstreet, or just do it ourselves?

Towards the meeting's end, I asked the group why they wanted to pursue a direct strategy. The response: **"We don't want to pay a double promote on our real estate investments."** They also mentioned wanting greater control over the investments, but this had the feeling of an afterthought. The clear reason was cost reduction.

This investor was not alone. Many private investors share those sentiments about the so-called "double promote"—whereby both the investment manager and its joint venture partner, or sponsor, take a share of the profits. Eliminating it is probably the most common reason we hear from private investors who directly invest in real estate. It is an understandable position: What investor wouldn't want to have an effective direct real estate investment platform? None. Everyone would welcome more control and lower fees over their investments.

Problem is the narrow focus tends to simplify something that is anything but simple. Many private investors, particularly the largest family offices, are well served by handling their real estate investments internally. But not all are; and in our opinion **far too many private investors we meet are going the direct route for the wrong reasons**. The distinction between those who should and should not directly invest seemed like a good topic for a memo, so here we go.

AN ACKNOWLEDGMENT

Before we get started, I should be candid about my interest in this topic. Because Rockstreet is a real estate invesment manager who invests in joint ventures, **it could fairly be said that our comments about this topic are self-serving,** especially to the extent it would urge an investor to use a manager such as us. I cannot ignore or explain away that accusation. Rather, I would say only that what is being shared is our honest thoughts on this trend—one that we believe has as strong likelihood to underperform for many investors who travel its path. Of course, you may contest our rationales, and reject our conclusions; we only hope, however, that you accept the spirit of good faith in which we share them.

UNPACKING THE OBJECTION

We start the discussion by stating an opinion: <u>Eliminating the double promote should not be your primary rationale for becoming a direct investor</u>. Call this opinion self-serving if you want (agin, I cannot prove that its not); but we firmly believe there is far more that should go into the decision. Yet, time and again, we hear from private investors that the double promote is the #1 reason they don't invest with real estate managers (followed closely by a manager's use of a closed-end, non-discretiuonary funds to marshall capital).

I've often tried to unpack why some private investors feel so strongly about the double promote. Here are the two best rationales I've consistently heard:

- *Opportunity for Direct Investment.* Real estate investment opportunities are ubiquitous. Private real estate investment is the most readily accessible of alternative investment class. We'd add a bit of caution here by saying that truly exception deals are rare, but we won't deny that family offices are frequently approached by developers looking for an equity partner.

- *Ease of Understanding.* Real estate is a comparatively easier asset class to understand. Unlike, say, venture capital, the business inputs to uderstanding real estate investment are relatively consistent. In short, it is a practical asset class where investors easily gain comfort.

Despite their logic, however, I don't believe those explanations tell the full story. While they explain some of the objections to using a dedicated real estate manager, the objection is often so strong that something deeper must be lurking at the core of certain investors' objection to a double promote. For example, is anyone truly bothered by paying a promote if the investment performs better than expectations? Maybe some; but I think **most investors appreciate excellence and don't mind compensating a manager who delivers superior performance.** If the net return meets or exceeds the investors return targets, the goal is accomplished—wealth was created to the projected (or better) degree.

When viewed this way, **there really isn't anything conceptually wrong with a double promote, provided the investors feel it was earned**. And while I don't know for sure, my guess investors feel promotes are earned whenever a manager provides above-average returns, but undeserved when the manager does not (as so many do). Hence my conclusion: <u>The ultimate origin to the objection of the double promote is a lack of perceived value from many managers who charge them</u>.

And you know something? They are right.

Superior means something that is higher in quality. There cannot be many real estate managers who provide superior performance—the definition just won't allow it. Most managers won't beat the benchmarks, yet they still rake out a promote (albeit smaller). It follows, therefore, that **most managers are charging a promote for investments in which its limited partners see little value-added from the manager. Given this, the issue at the core of the objection is that** <u>**most managers rake out promotes for average (or worse) investment performance**</u>**.** Faced with these realities, many investors have elected to go direct—with thinking along the lines of: "Most managers will not

deliver above-average returns, so why not eliminate the fees/costs and do it ourselves?"

FRAMING THE QUESTION

Many private investors we know, particularly family offices, wrestle with that question. Before turning to our answer, let's set some parameters for our inquiry:

1. **A direct investor's net return should be better than what the average manager can consistently deliver.** It doesn't make much sense the expend the resources to invest directly only to end up with a return that you could have had simply through outsourcing. You want to do better. Therefore, a direct real estate investor should generate higher returns than the net return (after fees and promote) the average manager can deliver. Anything less is probably a misuse of resources.

2. **To accomplish #1, the investor must make the <u>same caliber investments</u> as the dedicated managers.** True, by forming their own joint ventures, direct investors eliminate an extra layer of costs; but eliminating those costs, alone, will not provide better returns. At best, it will give you a few hundred basis points of return to work with. This means a direct investor can do deals that generate slightly lower overall returns and still do about the same, but they won't do <u>better</u>. *To make its overall net return better to what he had investing with the manager, the direct investor must invest in the <u>same caliber</u> of project.* Simply stated, a 20% IRR deal with a promote still delivers a higher net return than a17% IRR deal without a promote.

As you may have noticed, the two guiding points to Rockstreet's analysis of the "direct question" are return based. First, the goal is to earn higher returns, not the same return, than what you could generate through outsourcing. Second, to earn higher net returns the investor must select real estate projects of a similar caliber as the managers. Eliminating the managers expenses helps raise returns, but they only do better if they select the same caliber of deals.

With those rules of engagement established, here is Rockstreet's recommendation: **if you're deal flow is about as good as the average manager, then do it yourself.** Becoming a direct investor should offer you some additional return. That added buffer makes selection slightly less challenging on average—i.e., you can select projects that do slightly worse than the average manager and still earn slightly better net returns. And if you're deal flow is about as good as the managers (and you can separate the wheat from the chaff), then you should see your net returns improve.

THE LIMITS OF DIRECT CAPITAL

Indeed, many private investors have concluded: "Yes, I can do this better myself." Part of the reason it may be so easy to reach that decision at this point is that everything up till now was theoretical. There was no questioning the market realities in which many private investors will find themselves. That is the subject to which we now turn.

To frame the discussion, let's assume there is an investment manager with about $400 million of assets under management. The firm is called Direct Capital, because it does not use third-party managers. Instead, it allocates 50% of its capital directly across a range of public markets and the other half towards alternative asset classes—direct lending, private equity, real estate and venture capital—that it believes it understands at least as well as third-party specialists. By investing in this manner, Direct Capital eliminates third-party fees and double promotes. For all of this, Direct Capital charges its investors a fee that averages about 1% on committed capital.

From above, we know that the first thing Direct Capital must do to beat the dedicated managers is consistently sourcing investments that are of a similar caliber. How does Direct Capital attract that deal flow? Our prescription in Effective Direct Investment boiled down to this: **investors seeking a direct investment platform "must commit a portion of capital large enough to attract and retain an on-going relationship with the best [operating partners]".** Simple point, but one that is often overlooked.

Commitment of capital drives deal flow. An investor with capital who rarely pulls the trigger is not much different from one without capital. **When it comes to attracting deal flow, the rule is: <u>Its not how much investable capital you have, its how much capital you deploy</u>.**

The reason for this is the environment in which the real estate specialists with whom direct investors joint venture operate. Theirs is a highly pressurized existence, a point that Effective Direct Investment addressed as follows:

> Real estate Sponsors operate in a highly competitive and fluid environment, where speed of execution and certainty of close are paramount. They expend considerable time and money performing diligence, securing deals and lender commitments, and obtaining regulatory approvals before ever breaking ground or securing an acquisition. A Sponsor's ability to focus on these critical prefatory tasks, much less actually taking a project to close, is dependent upon having a stable of reliable joint venture equity partners. They must know at least one of those relationships is highly likely to invest on agreeable terms and structure.

That assurance for the sponsor is having relationships with joint venture equity partners who are consistently active. For equity providers, such as Rockstreet or any investor who wishes to invest directly, this requires a significant and on-going commitment of investment capital that can serve as a reliable source of joint venture funds. Lacking that commitment will set you back, because **top sponsors are unlikely to seriously engage with capital sources of limited or irregular appetite.**

To illustrate this point, let's return to the example of Direct Capital. The firm believes it has great deal flow, and tells you how it repeatedly sources, structures and underwrites real estate deals. The team at Direct Capital is highly competent, and can undoubtedly underwrite an opportunity well. However, Direct Capital allocates just $40 million (a fifth) of its $200 million alternative allocation to real estate, and prefers to invest no more than $4 million in a single transaction. With deals averaging hold periods of 3 to 5 years, Direct Capital is unlikely to commit more than $15 million to the space in any given year.

Now, place yourself in the shoes of a top sponsor. Your average investment likely requires many millions—perhaps tens of millions—in equity. The yellow pages are full of real estate funds looking to deploy hundreds of millions of dollars. If you have a track record of success that can get an investor's attention, are you going to spend your valuable time reaching out to Direct Capital when its dry powder is comparatively small? Maybe you will sometimes, but you're unlikely to do it for long and you're rarely to approach them as your first choice. Direct Capital simply cannot scale a sponsor's business as deeply as the dedicated managers can. Remember that, in a sponsor's mind, an investor with capital who rarely invest is not much different from one without capital.

The implications of this are clear: **If an equity investor is unlikely to be a first choice, then they must realize that many of the opportunities they do see were rejected by the investors who were** (or they were one of many who receive a "blast", which is virtually unheard of from quality sponsors). In real estate, every deal is unique—there is only one property located at a specific address. Unlike the amateur stock picker who can have the exact same portfolio as Warren Buffett, the real estate investor must choose from only those options he uncovers—he cannot replicate a portfolio that is identical to Blackstone's. To draw out the analogy, it would be as if our amateur stock picker could only buy stocks like (but not the same as) the ones owned by Mr. Buffett. By itself, this doesn't mean the investor won't uncover quality stocks; he likely will, just fewer. This raises the selection stakes, because **Direct Capital will see relatively fewer opportunities that are of the <u>same caliber</u> as the dedicated managers**.

In our view, this is the challenge most private investors will face when they attempt to invest directly in real estate. To secure a continuous stream of quality deal flow, a real estate equity investor must deploy capital. All but the largest private investors will lack the capital necessary to make themselves a consistent presence in the JV equity market. A lack of presence impacts

an investor's opportunity set—fewer deals are presented, and the ones that are were probably rejected by others. From what is presented, Direct Capital will see most of the poor deals, but relatively fewer investments of the same caliber as those the managers selected. With a smaller proportion of above-average deals from which to choose, Direct Capital must make very wise selections.

It is not enough for Direct Capital (or the average family office) to say it has a large deal flow. It may see a large volume of transactions, but fewer of them will be of the same caliber investments as was presented to the dedicated managers. They can still succeed and outperform the specialist, its just that, like the amateur stock picker in the alternate universe, Direct Capital must be better at picking deals if it wants net return to be better than what the average manager can consistently deliver. Call us skeptical (or self-serving), but there seems to be far more risk in Direct Capital's approach than at first meets the eye.

GOOD MANAGERS EARN THEIR PROMOTE

Prior to the 2008 crash, only from the largest family offices, those whose fortunes numbered in the many billions, were routinely investing directly investing in real estate. That has changed in the years since, and **today there are (in our opinion) too many private investors allocating money to real estate just like Direct Capital.** They feel good about reducing fees and gaining control, but they often lack the full appreciation of why they will seldom be the top equity choice for the best opportunities.

Years ago, I had the pleasure of working with a gentleman from Louisiana who managed the investments for a single family with a considerable fortune. At his disposal was more than enough capital to directly invest in anything he wanted. When I asked him why he didn't, he said: "My job is to find the very best at their craft and evaluate them. I want to manage my managers, not compete with them." I took my friend's point to be this: **Superior managers deliver above-average returns. Weak managers deliver average (or worse) performance. Superior managers earn promotes, weak managers don't.**

Many dedicated managers are staffed with talented people who care deeply about their performance and take their fiduciary responsibilities seriously. They think creatively about their strategy and the opportunity set it provides. As a result, they provide above-average net results. Of course, there are not many of them. As we noted earlier, superior performance can only be delivered by a relatively small few. This often makes them harder to locate, harder to engage—and you must expend considerable time to find, monitor and evaluate them. **Delivering above-average returns isn't easy, nor is finding those who can.**

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Near the conclusion of the meeting I mentioned at the beginning of this memo, I posed this question: **"Which do you think is the more difficult task: locating talented real estate managers who can consistently perform or beating them at their own game?"** As we have seen, it all depends on who is asking the question; if its Bill Gates then the answer is the latter, if you're Direct Capital its probably the former. **At the end of the day, many private investors who devote resources to direct investments could likely achieve the same (or better) results by devoting fewer resources to locating superior managers.**

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