Consolidation in the Real Estate Consulting Industry

PREPARED AUGUST 2005

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One of the participants in today's institutional real estate investment industry is the consultant. [1]Over the past two decades the institutional real estate asset class has expanded and matured, and the role of the real estate consultant has evolved accordingly. At one point, approximately a dozen firms offered some form of institutional real estate consulting services. Within the last 15 years, we have seen a consolidation within the institutional real estate consulting industry. Today, there are six nationally known firms which provide these services to the bulk of the US pension funds and other institutional investors. [2]Three of these firms provide these services exclusively, while three are engaged in a broader general consulting or management practice.

It may seem ironic that the number of real estate consultants has shrunk at the same time the asset class dramatically expanded. Upon closer review, however, I argue that the expansion of the asset class has been the primary driver of consolidation: the resources required by the consultant have increased substantially in order to be informed about this increasingly sophisticated and growing universe. A second and important driver of the consolidation is economics; this is related to the compensation structure for real estate consulting (fixed rate retainers) and the fact that such compensation is a low margin business. Combined, these have resulted in fewer firms providing services in this industry. I would argue that the industry as a whole benefits from the development of strong real estate consulting firms that are better staffed with experienced professionals who are prepared for future evolution of our dynamic asset class.

Evolution of Institutional Real Estate Investment

To understand the reasons for the consolidation of the institutional real estate consulting industry, one must follow the evolution of the institutional investment in real estate and the corresponding role of the consultant.

[1] As defined in this paper, the institutional real estate consultant is a firm that provides to pension funds and other investors the services of strategy development, investment and manager selection, investment oversight, performance measurement and other portfolio services (advice on valuation, budget, leverage, risk management, etc.) This is distinguished from the fairly sizable class of firms, mostly local in nature, who provide consulting advice at the property level to the owner or operator on how to improve operations, manage the tenant profile or reposition/redevelop an asset.

[2] The Townsend Group; Courtland Partners; ORG; PCA; Russell; Callan Associates. A few other smaller firms provide services to institutional investors but are not generally considered active in this business.

<u>A Simple Beginning</u>

The rise of the real estate consultant is fairly recent, mirroring the growth of real estate as an institutional asset class. Institutional ownership of commercial real estate did not take

its present form until the early 1970s, with the creation of Prudential PRISA, an open-end core commingled fund. It was greatly boosted by the passage of the Employee Retirement Income Security Act ("ERISA") in 1973, which required that plan fiduciaries prudently diversify their portfolios. The nascent real estate investment management industry responded by adding real estate managers and products to allow pension plans to diversify their assets.

The initial investments in the newly formed asset class were typically open-end or closed-end commingled funds, and for larger investors, the creation of what was called a separate account. In the 1970s through most of the 1980s, most of the investments available to pension funds were core oriented separate accounts and funds which invested in operating, substantially leased office, retail and industrial properties located in the United States. A few pension funds invested in commercial mortgages, although the bulk of that capital was supplied by insurance companies and commercial banks, as few pension funds invested directly in commercial mortgages.

These commingled funds often were either larger diversified funds (e.g., Prime Property Fund) or were differentiated by a focus on a particular property type (e.g., malls) or region (e.g., the West). However, fundamentally there was little differentiation in the underlying strategies of these funds: they were comprised of core, domestic, unleveraged commercial property types (office, retail and industrial). Multifamily properties were not a mainstream property type until the mid-to-late 1980s, as a result of the passage of tax reform in 1986. The real estate investment management industry was fairly concentrated, as a small number of managers (about 10) controlled approximately half of the pension fund capital invested, and the top 20 managers controlled more than 75% of the pension fund market.

<u>Role of the Real Estate Consultant</u>

In the early environment, the role of a real estate consultant was fairly straight forward. It primarily provided three services:

- The consultant provided an independent source of information. Real estate was a new asset class, and many investors were unfamiliar with its attributes and investment characteristics. The available information often was fragmented and inconsistent, and much of it was produced by research departments of the investment managers. The consultant offered an efficient, independent and cost effective way for investors to access underlying fundamental data about properties and the property markets.

- The consultant measured and monitored the performance of managers. Investors could obtain performance data from each manager, but rarely could they do so in a consistent and comparable manner. The real estate consulting industry developed the specialized reporting capabilities that allowed investors to independently collect and measure the performance of their managers and assets. Rudimentary analysis permitted some deeper assessment of the drivers of performance, although few consultants were able to make comparisons beyond the NCREIF Property Index, the primary index for private market institutional core investing.

- The consultant was involved in manager and investment selection. In an environment when most funds or managers were executing a similar strategy, the primary task was for the consultant to identify the managers who offered superior skills in buying and managing core properties. A secondary task was to assess the role of the manager as an operator of the underlying properties, as many of the real estate managers were vertically integrated and manager selection was intimately tied execution at the property level in terms of operations, leasing and property management.[3]

In that relatively simple early environment, a number of general consulting firms added real estate capabilities to their asset classes. Some of the early general consultants with real estate capabilities included Callan, Frank Russell Company, Wilshire, Mercer, Karp and SEI, to name a few. Since real estate still represented a small portion of most clients' portfolios, the general consultants tended to respond to this demand by adding one or two dedicated real estate professionals. This worked relatively well in an environment of relatively few significant managers and fund products and little differentiation by underlying strategy.

As the real estate markets grew in the 1980s, it became a bit more complex and the industry witnessed the rise of the specialty real estate consultants. In part this development occurred in response to demand from larger public pension funds, which sought greater levels of specialized services than was available from their general consultant. The new firms often were formed to focus on just real estate, either exclusively (firms such as Townsend, IPC or PRA) or as a component of a broader consulting practice (PCA, Cambridge). These specialist consultants dedicated more resources to the real estate practice, hiring experts in real estate, finance, law, performance reporting and other disciplines in order to address the growing needs of pension funds and other investors in the asset class.

The consulting industry was fairly fragmented through the early 1990s, with institutional clients spread across the spectrum of general consultants and specialized real estate consultants, with up to a dozen firms in the business. No single firm dominated the industry. New growth occurred in the industry as a whole, largely as the number of pension funds seeking expert advice multiplied. There was little change in market share occurring among the firms competing for new business.

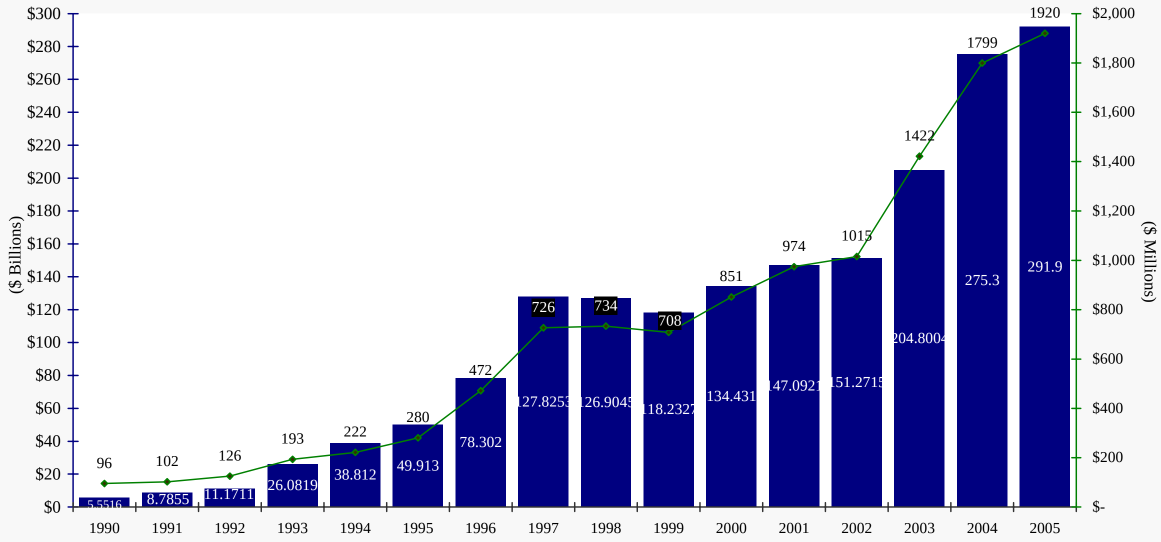
The Expansion of the Real Estate Universe

The institutional real estate industry began to change dramatically in the 1990s, driven primarily by the tumultuous real estate depression experienced in 1990 to 1992. While this period of history was painful to both investors and managers, it gave rise to two of the factors that reshaped institutional real estate then and continue to do so today: the creation of the public real estate markets, both equity (the REIT industry modern era begins in 1991) and debt (the creation of the CMBS market by the RTC and eventual privatization of the issuance of CMBS securities), and the rise of pools of risk capital in the form of opportunity funds that invested in different types of investments, both domestically and on a global basis.

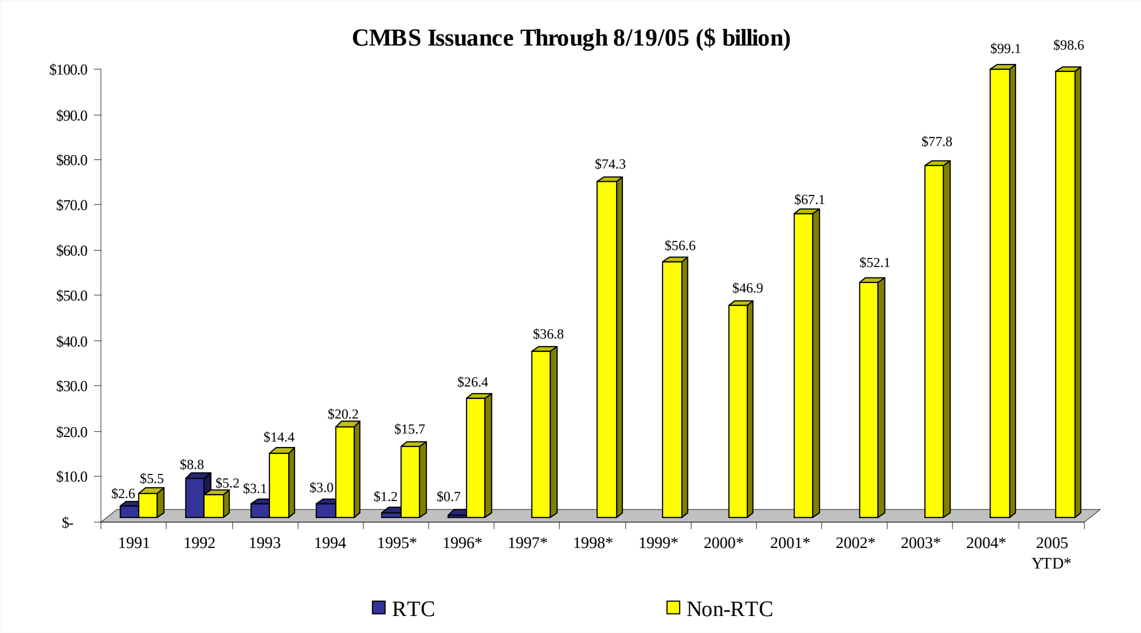
[3] This operating capability assessment was one of the factors in manager selection that differed from that used by the general consultants. Most general consultants evaluated managers but focused on the capital allocation decision (e.g., how they managed large capitalization securities relative to an index) but did not evaluate the underlying operating businesses invested in by the manager (e.g., GM versus Ford). The latter was the manager's job, not the general consultants. In real estate, the consultant needed to evaluate both aspects of allocation (by property type and region) and operating capabilities.

The public markets have seen a fairly strong growth in terms of market size since 1991, as shown in the two charts below. The first chart tracks the increase in the public REIT market as measured by the market capitalization of the NAREIT Equity Index.

Public REIT Market Capitalization



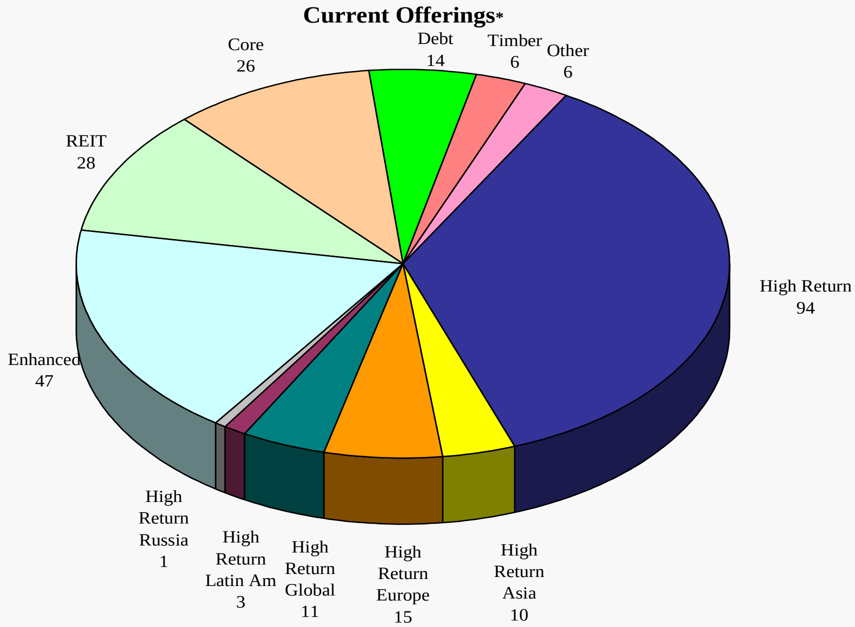
The chart below shows the history of issuance of CMBS market; note that it plots only the domestic CMBS; one of the most significant recent trends has been the explosion of international CMBS offerings since 2002.



* Excludes International CMBS Issuance

Although the growth is not as dramatic as shown above, the amount of capital raised and invested by so-called “opportunity funds” has also increased significantly during the last 15 years. For example, in 1996 our firm tracked 27 opportunity funds with a market value of $8.4 billion; today, we are tracking 97 funds with a market value of $28.4 billion.

The explosion of new offerings is evident in the universe we track for investors today. As of July 31, 2005, we are tracking more than 260 funds open for investment of all types, as shown below.



Note that the majority of fund offerings are in the higher risk, higher return segment of the market: 94 domestically oriented high return funds and 40 global or international funds, or 134 of 260 or 51% of all funds. If the 47 domestically oriented value added or Enhanced Return funds are added to this total, approximately 70% of the current universe of funds available for investment falls in the value added or higher segments of the market. Neither sector existed 15 years ago!

The pie chart only hints at the breadth of the current universe. Investors today may invest in core funds (including specialized funds), debt oriented funds (including commercial mortgages, below investment grade CMBS and mezzanine loans/B notes), REIT funds (including REIT hedge funds and specialized strategies), timber funds and other funds (e.g., agriculture). Within the Enhanced and High Return segments, the strategies include development, redevelopment/ renovation, small capitalization properties and/or secondary markets, funds focused on particular property types (e.g., hospitality, office), brown fields, and other strategies. In the international/global sector, the current universe includes funds focused on Europe, Asia, Latin America and select other markets.

The universe of investment managers and fund sponsors has grown as dramatically as the underlying products. How has this universe changed? A few facts will help illustrate:

- In 1992, our firm tracked investments in 145 commingled funds. Today, we track investments in more than 460 commingled funds.

- In 1992, we tracked investments in properties in 32 separate accounts; today, we are tracking over 80 active separate accounts, and cumulatively we have tracked over 150 separate accounts.

- We currently monitor 160 firms who provide real estate services in private equity real estate, plus another 40 firms that provide services in pub licly traded REITs and/or CMBS investments.

- While the core manager universe has remained somewhat consolidated (the top 30 firms manage more than $128 billion in assets), the overall universe has grown dramatically and remains somewhat fragmented and very few firms have more than a 5% market share.

- The firms involved included investment banks, private equity firms, real estate operators, public REITs and recently a surge in small, newly established firms staffed by very experienced professionals who are departing their larger (successful) firms and seek a more entrepreneurial environment.

Expanded Role of the Real Estate Consultant

In the current environment, the role of the real estate consultant has expanded along with the asset class. As the universe of institutional real estate investments has dramatically grown in size and complexity, these changes have empowered the institutional investor with the ability to create greater value from the top down. *Strategy is now the most important element in constructing a portfolio.* An investor today has more tools and options than ever to create a real estate program that meets its specific needs: it now can build a program that is domestic or global; private and/or public; equity or debt; core, value, opportunistic or specialized; in pooled funds, separate accounts or joint ventures. This expansion also has burdened the institutional investor with the duty to be more informed. This has helped fuel the demand for real estate consulting services.

While real estate remains a local business, and bottom-up asset selection is also important to success, the fact remains that top down strategic decisions can drive a program. For example, over the last five years publicly traded REITs have produced an annual average return of 20%; this compares to private unleveraged equity real estate (as measured by the NPI) of 10.6%. Obviously an investor which included public REITs would have had superior absolute performance over the past five years. To stay in the private markets, an index comprised of the open-end commingled funds generated a 10.5% return over the last five years; over the same period, the Enhanced and High Return fund indices we track generated a return of 11.5% and 16.0%, respectively. How an investor chooses to access these segments and structure its program will have a lot more to do with success than if it selects the correct property type. Within the higher risk and return sectors, manager selection is increasingly important, as the spread between the to performing High Return fund and the lowest performing fund is approximately 5,000 basis points!

One of the primary roles today is for the real estate consultant to provide advice on the structure of a program, the development of the underlying investment strategy and the allocation of resources. These changes have obligated the real estate consultant to be expert in a much larger discipline of knowledge, and required them to have more resources and greater sophistication. In addition, the past 20 years have shown that real estate consulting is a fundamentally different service than general consulting. The real estate consultant is asked to make investment decisions (e.g., should I buy this property?), and it operates in an opaque asset class in which access to information and experienced judgment provides significant competitive advantages.

<u>Greater Resources are Required to Succeed</u>

A successful real estate consulting firm today and in the future will be expected to dedicate greater resources to understand the much broader global investment universe. To do so in any meaningful way, a consultant will need a large staff of professionals with a variety of backgrounds to permit the development of expertise in many areas. On any given day, it may be asked to provide advice on development/redevelopment, financial structuring and leverage, the various global regions, REITs, CMBS, timber and specialized property types. For example, in order to maintain a perspective on investments in Europe, Asia and the United States, a real estate consultant needs to have access to, and then scrub and evaluate, data from various parts of Europe, Asia and the other parts of the global universe. That data and information relates to the underlying fundamentals (supply, demand, rent growth, occupancy, etc.), the capital markets and pricing, the number and nature of the investment opportunities available to investors, and issues such as legal constraints, taxes and hedging. This requires more resources to monitor and maintain current information and expertise.

The real estate consultant also is required to dedicate a more resources to track, evaluate, underwrite, and monitor the investment universe. The current universe has over 260 funds available for investment at present, in a variety of strategies and on a global basis, and typically at least 100 new funds added each year. It is unlikely that a small number of professionals, even if they are very smart, well organized and efficient, can adequately cover this ever growing universe, let alone ensure they have the time and resources to find and select the *best* of the managers and offerings for their clients.

Even performance measurement has evolved significantly. What investors demand today, in addition to performance measurement services, is more insight as to why they have these results, and greater relevant comparisons to similar investments. For example, very few pension funds today invest only in US core real estate in the four primary property types. Thus, finding a benchmark beyond the NCREIF Property Index is a typical issue for most pension fund investors. This is driving the need for robust and detailed databases to allow the creation of proprietary indices for better benchmarking and comparisons. To do so, the consultant needs to make continuous investments in technology and infrastructure to allow it to efficiently collect, manage and manipulate that data.

How does the general consultant model fare in this environment? It is a difficult challenge, as the current real estate asset class does not fit neatly into the general consulting model. Private market real estate remains inefficient in comparison to their other asset classes, and the data is limited and less robust; combined, these factors mean limited value can be derived from sophisticated analytics. Judgment and experience can be as important, if not more so. Real estate also remains a small portion of the overall pension fund portfolio and does not justify a significant cost to staff up to meet client real estate needs. Thus, the general consultant model does not work as well for the real estate services as it does for more efficient public market asset classes. As a result, many general consultants have eliminated their capability in this area and their clients have sought specialized real estate consulting expertise to fill the gap.

How does the specialist real estate consultant fare in this environment? It would appear the old model does not work well; it is unrealistic to expect that one or two smart, talented individuals can become experts in all of the areas noted above that real estate consultants are required to advise their clients today. Over the longer term, smaller firms will not have the resources to maintain such information and expertise. The evolution of real estate consulting firms may follow the path of law firms and accounting firms: real estate consultants will be forced to develop internal expertise in the major investment and service areas, or they will face elimination from the firms that do invest in their infrastructure. For firms that do not expand, they may survive if they become even more specialized (e.g., the provide services only to discretionary clients or only to one segment of the market, such as endowments or Taft-Hartley plans). In this model they fall into an even narrower band within an already specialized asset class, and will be limited in terms of their client base and scale.

In order to fulfill these expanded responsibilities, the real estate consultant is required to bring to bear relatively expensive resources. Since this remains a relatively inefficient and opaque asset class, particularly when considering global investments, the real estate consultant needs talented and experienced personnel. There is no institutional real estate training program in the leading real estate schools; the current consultants have learned from on the job training with appropriate oversight and support. There is no substitute for experience and judgment in this asset class. This means generally more expensive talent is required, as most clients will not accept advice in this area from inexperienced professionals fresh from an MBA program.

Scale is important to finance the resources required. In the real estate consulting business, similar to the general consulting business, most client relationships are on a fixed fee, retainer basis. That structure has evolved over time to assure that the consultant will remain independent and objective in its advice, as it will not be paid more (or less) depending upon the type of investment or how that investment performs. While some investors are willing to include a form of incentive compensation in a real estate consultant fee, it is rare today. The industry also prices discretionary consulting services slightly differently, more along the lines of a fee based upon the total allocation to real estate (or on invested capital). However, that still remains a small segment of the total real estate consulting market.

Under the traditional revenue model for real estate consultants, the margin on traditional consulting retainers is relatively low. Unlike investment management fees, where investors will pay up to 500 basis points for superior performance, a typical traditional real estate consulting retainer fee typically falls in the range of 5 basis points or less of the value of the real estate allocation being advised. For larger accounts, it often falls below 2 basis points, as there is little scaling of fees in the traditional real estate consulting model. No single client can bear the incremental costs to add these resources. Thus, the revenue stream does not support the necessary increase in resources unless it is spread over a much larger number of clients so that each bears only a small portion of that cost.

Thus, when one objectively evaluates (i) the increasing demands placed on real estate consultants in this complex global environment, and (ii) the revenue structure of the traditional real estate consulting model, it is not surprising that fewer firms are providing that service today. As noted above, it is unlikely that general consultants will be able to routinely and effectively compete against the specialists firms that have focused their resources on this asset class. In our discussions with general consultants, their revenue stream does not allow them to economically expand their real estate staffing to meet these increased demands. Hence, many general consultants have departed this business and focus on the more efficient public market asset classes and overall asset allocation.

Within the specialist consulting firms, the pension fund and institutional market appears to have embraced the view that more, and not fewer, resources are required to meet the level of sophisticated expertise demanded in a global real estate environment. Thus, over the past ten years the specialist firms have expanded their capabilities by organic growth or have done so by mergers. It would appear that the old model of having one or two experienced, sophisticated individuals will not be effective in a global investment environment, unless those smaller firms or teams intend to focus on niches within the industry (e.g., the way small law firm can focus on complex litigation or a small accounting firm can focus on taxes).

Is the industry better served as a result of this consolidation? I would argue yes.

- The smaller base of specialized real estate consulting firms is able to supply its increasingly sophisticated investor with the necessary information and perspective to evaluate the full range of options in developing a program. This evolution has been timely given the recent explosion of interest in global investments, as well as the development of specialized investments as investor look for any advantage in today's capital rich environment.

- Investors today still have very low cost access to this information and expertise, notwithstanding the consolidation of this industry. That is in part a direct result of the scale of the business available under a smaller number of consulting service providers. It also stems from the historical pricing of this service, although that could change on the margin as more investors seek non-traditional alternative means to access consulting advice, such as through discretionary consulting or possibly funds of funds (in the future, such as in hedge funds or private equity areas today).

- The proof is in the results: the specialists firms have experience the greatest growth in their businesses in the first half of this decade, and some of the general consulting firms have either focused on a niche (e.g., discretionary consulting) or are not effectively growing their practice.

- Finally, I would argue that investors which embrace the use of today's real estate consultants are generally obtaining better access to investments (particularly important in this capital rich environment), and are obtaining better results in their investment programs. Smaller investors in particular benefit from the scale that is provided by today's larger real estate consulting firms. They would not normally have access to certain investments, nor be able to do so on advantageous terms, as they do when they are part of a larger client base that provides the leverage to the consultant to negotiate fees and other terms. While this third point is based on limited data (within our client base), we believe it to be true.