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Riding the Wave of Capital:

A Perspective On the Open-End Commingled Funds



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Open-end commingled funds (OECFs) have been part of the investment landscape now for more than 30 years and have become a widely accepted vehicle for investors to access private equity real estate. The real estate asset class has been the beneficiary of record capital inflows, and nowhere has this been more evident than in the OECFs. The last five years have seen the number of available funds double and the total assets under management more than quadruple. Over this same time period, investor appetite has continued to exceed the existing capacity, and as a result, investors have had to wait in lengthy contribution/deposit queues to get new money invested. As we enter a period of uncertainty for the real estate asset class, this article attempts to address the question of whether the deposit queues that exemplified the middle of this decade are sustainable or whether record inflows will be replaced by outflows and a return to the redemption queues of the early 1990s. First we will define the universe and provide some historical context before evaluating capital flows today and what they mean for investors and the future of the OECFs.

Defining the Universe

The legal structures that govern the operation of the OECFs differ, although each of the offerings exhibits several of the same key characteristics. First, there is typically a perpetual term. Second, a methodology is established that provides for investor liquidity based on the availability of capital and, subject to other limitations, permits new capital to be invested in the fund. Finally, to facilitate the liquidity provisions, a routine and independent valuation of the portfolio of assets occurs in order to establish an accepted net asset value. At the end of 2003, the universe of funds that Townsend classified as open-ended numbered fewer than 15 and had a market value of approximately \$26 billion. Today, that universe has expanded to more than 30 funds with a market value in excess of \$100 billion. Over time, the universe has evolved from a primarily core focus to include higher risk strategies and funds targeting only specific property types. For the purpose of this article, we will examine the universe today under the following categorizations:

- **Core diversified**—diversified by property type and geographic region. Real estate assets are defined as operating and substantially leased with limited value enhancement activities and less than 30% leverage. There are 16 total funds with a market value exceeding \$82 billion. Fourteen of the funds constitute the NCREIF Open End Diversified Core Equity (ODCE) fund index.

■ **Value diversified**—diversified by property type and geography with leverage generally at or above 50%. Real estate assets exhibit moderate additional risk through leasing, redevelopment, and repositioning strategies. There are limited amounts of ground-up development. Ten funds are included in this category with a current market value exceeding \$15 billion.

■ **Specialty**—property-type-specific funds. These funds utilize varying degrees of leverage, generally 30% to 50%, and target multiple property life cycle strategies. There are five funds accounting for \$6 billion in current market value.

The OEFCs promise investors liquidity, generally on a quarterly basis; however, the liquidity is always subject to prevailing capital market conditions. At any one time, there may be an imbalance in supply and demand, resulting in the queuing of capital. Redemption queues have formed historically during downturns in the real estate market when investors seek to reduce their positions to avoid moderating or negative returns, but investors must wait several quarters for assets to be liquidated so that their requests can be fully honored. The opposite is true with a deposit queue. In an upward-trending market, demand by investors to achieve real estate exposure outpaces the acquisition capacity of fund managers. The last two decades have seen the existence of both types of queues.

Historical Perspective

Two meaningful downturns have occurred in the last 20 years during which data exist for the OEFCs. The first and most severe downturn occurred in the early 1990s. Existing funds entered 1991 with a market value of approximately \$11 billion only to begin a steady decline to just over \$8 billion by 1995. During this time, the real estate markets were in correction. Aggregate fund performance was negative for a total of nine consecutive quarters starting in the first half of 1991. Much like today, there was limited or no activity in the transaction market, and investors sought liquidity from the OEFCs only to be forced to wait in lengthy redemption queues. Almost all the funds in existence during that period had a redemption queue that constituted a significant percentage of assets under management, in some cases 25% to 30% of net asset value. Redemption queues varied in length from as short as one year to as long as five years before the full amount of the requests were honored. In addition to poor performance, fund managers were faced with issues of transparency and valuation with many hard lessons learned. Several funds during the period were overwhelmed by redemptions and were forced to liquidate.



The last five years
have seen the number
of available funds
double and the
total assets under
management more
than quadruple.

Exhibit 1: Historical Deposit Queues

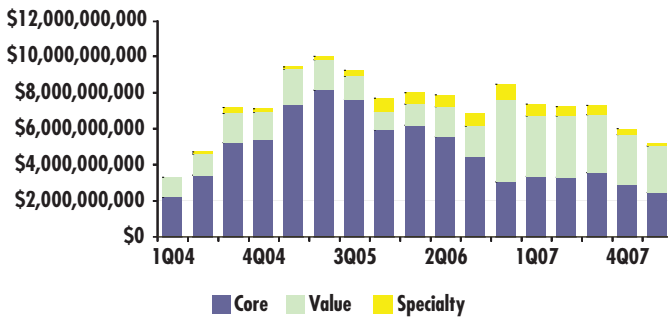
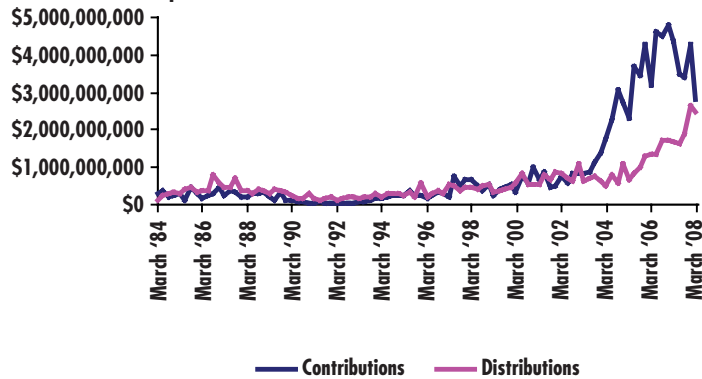


Exhibit 2: OECF Capital Flows



The second major downturn was experienced earlier in the 2000s as real estate was impacted by the tech wreck and the subsequent economic recession. During this period, fund performance moderated, although it never produced a negative quarterly return. The growth in the OECFs slowed, but there was never a reversal in capital flows. No redemption queues formed, and new funds were initiated during this time, capitalizing on a better pricing environment. Over the three-year period starting in 2001, the OECFs still added more than \$4 billion through growth and contributions.

Record Capital Inflows

The last five-year period has seen the most substantial growth in the OECFs. Coming out of the downturn in 2003, real estate began to attract more investor interest. By the beginning of 2004, modest queues had formed, concentrated primarily in several of the largest core funds. Exhibit 1 shows the progression of the deposit queues over time. Queues grew rapidly starting at the end of 2003, peaking in the second quarter of 2005 at just over \$10 billion. On average, investors were waiting from a year to two years to get capital invested. The core funds dominated the deposit queues, with several individual funds exhibiting queues in excess of \$1.5 billion each.

As fast as the queues formed, fund managers were meeting the increasing demand by acquiring new properties and calling capital. New contributions topped \$1 billion in a single quarter for the first time in the third quarter 2003 and rapidly reached more than \$4 billion a quarter by 2006. For historical comparisons, the prior ten years had seen average quarterly inflows of approximately \$440 million. New contributions have averaged approximately \$11 billion over the past five years annually, peaking in 2006 at \$16 billion. In aggregate, more than \$62 billion of new capital made its way into the OECFs in the last five years.

As shown in Exhibit 2, capital inflows have slowed but have not yet reversed. Approximately \$2.7 billion of new capital was contributed to the OECFs during the first quarter of 2008. Total distributions (attributed to income, capital return, and redemptions) added up to just under \$2.4 billion. The deposit queues began to slowly retreat from the peak in 2005, although they still remain above \$5 billion today. Just over \$2 billion is committed to seven core funds and \$800 million to two start-up funds. The value space has grown to be an increasing share of the queue dollars as a result of two distinct capital raises, accounting for almost \$3 billion in equity. Despite the recent capital raises, deposit queues are expected to trend downward as capital is placed in the market and inflows slow.

Return of the Redemption Queue

The question for investors today is, What will the next five years hold for the OECFs and the real estate asset class? Will 2008 most resemble 1991, 2001, or neither? Performance has begun to moderate. The NCREIF ODCE returned just under 1.4% for the first quarter 2008 after delivering a full-year 2007 return of 16%. Removing the one-time impact of changes in debt mark-to-market policies reduces the first-quarter return to just 1.0%, or an annualized return of 4.1%.

Transaction activity has fallen off dramatically and continues to remain muted in the market, specifically with respect to the OECFs. Most buyers and fund investors remain on the sidelines, waiting for a clearer indication of where new market pricing will settle. Current valuations have yet to provide a reliable indication of future pricing. With limited transaction activity, appraisers are still finding it difficult to justify value adjustments despite the general consensus that pricing has changed. At the same time, fund return expectations for 2008 continue to be revised downward based on the outlook for pricing and declining fundamental assumptions used to support values.

The fourth quarter of 2007 was the first time since the mid-1990s that the OECFs have experienced redemption

queues. Reports of new requests for redemptions have increased but not yet to levels that indicate fear or a movement out of the real estate asset class. The total amount of redemptions outstanding and not paid as of the first quarter 2008 was just under \$2.5 billion. Ten funds have now developed redemption queues. Approximately 78% of the outstanding requests were observed in the core funds. The average queue size was approximately \$248 million although heavily influenced by one fund with a \$1.1 billion queue that accounts for nearly half the total requested redemptions. Only five of the ten funds have queues that exceed \$100 million. As such, the issue of redemptions is not yet pervasive. Further, our observations have indicated that the majority of capital outflows are the result of clients' reducing their overall positions versus redeeming entirely from a fund or the asset class. There is no indication of investors' allocating away from the real estate asset class. In fact, new allocations or increases in existing allocations continue to be announced.

What Does It Mean for Investors?

Plan sponsors are under pressure from several directions. First, several quarters of poor performance in the equities market have had an impact on the denominator of plan assets and have increased the relative weighting of real estate. Second, strong performance over the past five years has led to imbalances in sector weightings within the real estate portfolio. Finally, expectations of moderating performance are leading investors to seek new alpha strategies in their real estate portfolios. Although we have not seen a substantial level of redemption activity, all these pressures are likely to lead to further outflows from the OEFCs.

Valuable lessons were learned from past downturns, and funds are better structured today to accommodate redemption requests in a fair and timely manner. Redemption policies that rewarded investors first in the queue by receiving the first payouts have been abolished in favor of pro rata policies. The implementation of a pro rata queue reduces the chances of seeing a crippling run on the bank. Investors do need to be aware of the nuances in the implementation of redemption policies that differ from fund to fund. The universe is divided among pro rata queues that calculate redemptions based on overall percentage interest in the funds versus others that calculate it on percentage interest in the queues. Investors should also know whether a fund can make new acquisitions while having a redemption queue, whether there is a threshold at which a forced liquidation occurs, and whether all the available cash is or must be distributed. It is time for investors to brush the dust off the documents and revisit the redemption policies of funds.

Despite an anemic transaction market, liquidity is still favorable relative to historical measures. The size of the fund universe has grown to more than \$100 billion today versus \$11 billion at the beginning of the '90s. Current income alone generates almost \$5 billion in cash annually. Financing on a secured and unsecured basis still remains available. The transition of many funds to certain private REIT structures has opened up the universe of potential investors to include foreign sources, high net worth individuals, and non-qualified plans. There is still a larger queue to enter the funds than there is to pull money out. And new mandates continue to be awarded, although voluntary funding has led to a temporary mismatch, with investors on the sidelines waiting for further transparency in pricing.

Both fund managers and investors learned from the experiences of the 1990s. Prior to the 1990s, investors sought OEFCs for liquidity and then learned that the liquidity was only as great as the liquidity in the underlying real estate markets. Today, investors seek the funds for immediate access to a diversified portfolio of quality properties not available elsewhere. Closed-end funds are no longer offered for core. The evolution of global and high-return mandates means U.S. core and value constitute a smaller percentage of programs, thus precluding separate accounts for many. As a result, OEFCs serve as the primary source of beta exposure for many investors. And liquidity is understood to be limited and available only when the underlying markets are healthy.

Conclusion

Today's market correction is different. At the outset of the 1990s, we had serious fundamental issues with oversupply and weak demand fueled by a recession. A credit crisis existed in the savings and loan industry that caused a secular exit from the debt markets. We certainly have a credit crisis today, but it is moving only from unbridled liquidity to rational pricing, and we have diverse capital sources (opportunity funds, debt funds, public markets, and global lenders) to address any dislocations in the debt or equity markets. This should reduce the depth of any trough created by a dislocation. Demand will certainly weaken, but absent a global meltdown, it will be less challenging than the 1990s and follow the current economic slowing.

In the early 1990s, real estate as an asset class was viewed with some skepticism. Today, real estate is viewed more as an established asset class. It has had a long period of healthy returns, and investors are better positioned to weather weaker returns without running from the sector. The continuing evolution in the perspective of real estate and the established role of the OEFCs will likely mitigate the risk of a return to a 1990s-like redemption queue scenario. ■

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