Managers Emerging from the Market Uncertainty

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On the back of social and macroeconomic shifts resulting from the global COVID-19 pandemic, new dynamics in the capital market space, such as the rapid rise in interest rates, the banking crisis, and the ongoing asset value adjustment process, have led both real estate fund managers and their underlying investors to take a cautious approach, as evidenced by a significant slowdown in transaction activity.

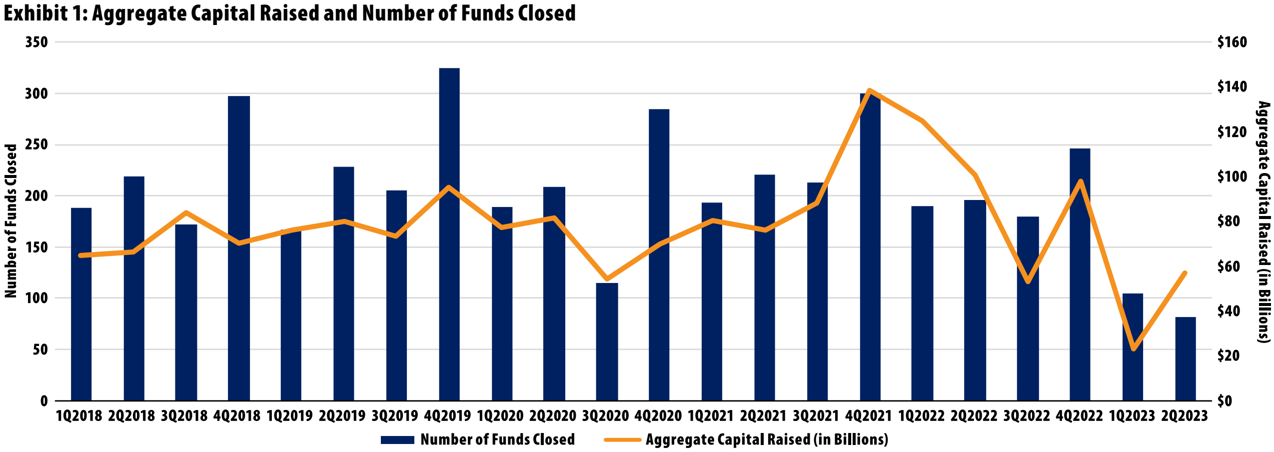
Although this news is not new, it has continued to play out in recent quarters with elongated fundraising timelines for many real estate funds, fewer real estate funds holding final closings, and an increased percentage of real estate funds holding final closings below their target fund sizes.

As of May 2023, a record number of real estate funds were in the market; Preqin tracked 2,035 real estate funds seeking a total of $547.5 billion, compared to 1,779 real estate funds seeking $512 billion at the start of the year.[1] Further, 1Q2023 had the lowest quarterly total of funds holding final closings since 1Q2013, with 92 funds closing, raising an aggregate $22.9 billion.[2] Although real estate capital raising did bounce back to $57 billion in the second quarter of 2023, above the $46 billion quarterly average achieved since 2018, the number of funds holding final closings still continued to fall, marking the second consecutive quarterly drop of funds closed (Exhibit 1).[3]

Moreover, in 2023, the average percentage of target fund size achieved at final close dipped below 100% for the first time in three years. This is contrary to 2021 and 2022, in which actual capital closed at 5% greater than that targeted by funds in the market, indicating certain real estate managers were exceeding their fundraising targets in 2021 and 2022 and some are failing to meet these targets in 2023.[4]

With these market dynamics and their ripple effects on fundraising and transaction activity, many real estate fund managers and industry professionals believe the coming years will present an opportune moment to capitalize on investment opportunities arising from current and expected capital market dislocations.

Exhibit 1: Aggregate Capital Raised and Number of Funds Closed



Source: "Real Estate Q2 2023: Preqin Quarterly Update," Preqin, July 2023

1. Grant Murgatroyd, "Private Equity Real Estate Funds in Market Swell to Record Level," Preqin, May 15, 2023.
2. Murgatroyd, "Private Equity."
3. Henry Lam, "Real Estate Q2 2023: Preqin Quarterly Update," Preqin, July 27, 2023.
4. Lam, "Real Estate."

Further, certain sectors within the industry, such as industrial, multifamily, and data centers, have continued to prove resilient, bolstered by secular tailwinds and/or continued liquidity through equity dry powder and available financing within that market segment.

Under the pretense of this unique investment environment, the backlog of new fund commitments, and an increased number of funds open for investment, investors are assessing where they see the most opportunity in today's market, the ways in which they can access that opportunity, and who provides the best access to the opportunity at hand.

Next-Generation Managers

This point in the cycle, together with the market backdrop described above, may serve as a catalyst in the real estate manager space, with "next-generation" principals spinning off to form their own real estate investment management businesses. These next-generation principals may seek to capitalize on a sector-specific opportunity in which they have previous experience or capitalize on a trend in a specific set of markets in which they have invested in for years. With real estate valuations in flux and the corresponding potential effect on a fund manager's promote, principals could be more inclined to establish their own firms where they control more of their future incentives.

These spin-off firms often fall under the umbrella of "emerging managers" within the investment manager universe, although the actual definition of *emerging manager* varies significantly, as shown in the specific mandates certain investors maintain. Real estate fund managers classified as emerging managers often include those in early stages of their life cycle, such as fund managers raising a first, second, or third fund; managers who have raised a series of smaller (sub $500 million) funds with targeted strategies (whether by sector or market); or managers whose businesses are minority- or women-owned. Certain investors maintain specific defined thresholds for emerging managers, such as by assets under management (AUM), number of funds managed, or percentage of management- and firm-level diversity. Finally, some investors take a broader view of emerging managers, including investment managers at an inflection

point in their company history, transitioning from deal-by-deal financing to a committed-fund structure.

Emerging managers have often been credited with outperformance relative to their larger, established peers, and despite the perceived nascency of emerging managers, many are led by cycle-tested teams that have spent significant time working together at prior firms, executing investment strategies similar to what their new firms will pursue.

At the "gross" level, outperformance can be credited to emerging managers' ability to be flexible and nimble compared with larger investment managers and with access to unique deal flows relative to larger funds. Within a specific sector, these managers can access middle- to lower-market real estate transactions efficiently given their smaller fund size. These smaller investments can prove to be a fruitful way to execute on pockets of dislocation within a broader sector. With a market-level focus, emerging managers have been credited with taking advantage of inefficiency within

specific submarkets. This is often a result of "boots on the ground" within a smaller set of specific target markets, providing access to deal flow and limiting a double layer of fees that many global allocators are often subject to when executing on their investment strategies with local operating partners. Gaining access to more localized or niche investment strategies may also provide diversification to an investor's overall real estate allocation.

In executing their investment strategies, emerging managers are credited with having increased alignment with their underlying investors. These smaller fund managers typically have a larger portion of their net worth and personal capital tied to the performance of a specific fund through their general partner commitment. The lower level of fee-earning AUM relative to that of their larger peers can often mean that an increased proportion of their compensation is tied directly to the performance of the fund via promote payments.

At the "net" level, fund investors can benefit further from partnering with emerging managers. These managers have typically shown an increased willingness to offer favorable terms for the potential to secure an institutional capital commitment, especially if the commitment can serve as an anchor to their fund, benefiting the balance of the fundraising. These incentives can come in the form of modifications to a fund's fee structure, such as a management fee discount or alteration to a fund's marketed waterfall structure. Further, at the smaller fund size, emerging managers may have an increased opportunity to offer to coinvest alongside the fund. Coinvesting can help reduce an investor's fee load to a fund manager as coinvesting is offered at more favorable terms than a traditional fund commitment.

Despite the benefits partnering with emerging managers can offer, investor appetite has remained muted relative to larger, established investment managers with increasing fund sizes. A greater concentration of capital being raised by a smaller universe of larger real estate managers has been evident in recent years, most recently with Blackstone Real Estate Partners X, which closed at $30.4 billion in 2Q2023, accounting for 42% of total capital raised in 1H2023. Per *PERE*, a single fund had never claimed this significant of a portion of the equity raised during a given time period since *PERE* began tracking this data in 2008. Muted interest can be attributable to the increased difficulty in identifying emerging managers operating within a segment or a difficulty in diligence of that manager through evaluation of a team's prior track record (especially if the manager doesn't have attribution rights from the prior firm) or less institutional back-office capability (given the nascency of a firm).

Conclusion

Looking ahead, both the pace and amount of real estate fundraising activity is likely to resume as investors maintain annual allocation planning and look to take advantage of opportunities arising from the current environment.

At this point in the cycle and following the slowdown in real estate fundraising and transaction activity, an increase in next-generation principals forming new businesses is also likely. These businesses, often classified as emerging managers within investor allocation planning, have seen relatively lower investor appetite than established investment managers.

That said, some emerging managers have demonstrated continued outperformance compared to their larger peers and provide a unique opportunity for investors to establish new relationships.

At a time when fund managers and investors are looking to generate alpha, partnering with emerging fund managers can provide investors a way to take advantage of anticipated market dislocation in the areas where they see the greatest opportunity. ■

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5. Christie Ou, "Three Ways Fundraising Looks Different Without BREP X," PERE, July 27, 2023.
6. Ou, "Three Ways."