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Operating outside the box

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Few real estate managers are quite like Related– and that's helped drive the growth of its fund management business. PERE Magazine, April 2015 issue

Related Companies isn't like most operators in private equity real estate. The New York-based firm, which has been in business for more than four decades, is known as one of the top developers in the US, and is the name behind some of the most high profile, large-scale projects in the US. Famed for bringing the Time Warner Center to New York City in the early 2000s, Related continues to make headlines as the developer of the city's Hudson Yards, the biggest real estate development in US history. At present, it owns and operates a $20 billion property portfolio that includes multifamily, retail, office and affordable housing, and employs more than 2,700 people across the globe.

Yet as a fund manager, Related is a relative newbie, essentially the David to its Goliath-like development business. Its US-focused funds management platform is just five years old, has a 40-person team and approximately $3 billion in assets under management. Like other operators, the firm keeps all of its development and construction, property management and leasing, sales and marketing operations in-house, although few other operators have the national presence that Related does, with eight US offices in New York, Boston, Chicago, Los Angeles, Miami, San Francisco, Dallas and Aspen, Colorado.

That dichotomy has become a major differentiator for Related. Most other national real estate managers are allocator funds, which typically work with local operating partners to source and execute on deals in markets or property types where they have less expertise. Limited partners in those funds, however, are required to pay a promote to both the fund manager and its operating partner. A growing sensitivity among investors to fees in recent years, however, has led to an increasing interest in operator funds.

“I think our pitch is: you know us, you know who’s going to do the work, and you only pay for it one time,” said Justin Metz, managing principal of Related Fund Management. “And then you get the entire scale of our company.”

Starting small

Although the two businesses work together, the main distinction between Related’s fund management and development platforms is that the former does virtually no ground-up development. Additionally, while the company’s development projects tend to be multi-billion dollar endeavors, its fund investments are much more modest in size, typically in the $30 million to $60 million range.

Related launched its fund management business during the global financial crisis, as the company began to encounter a number of distressed investment opportunities. Shortly after hiring Metz, previously the global head of real estate alternatives at Goldman Sachs, to head up the new business in 2009, the company made its first foray into real estate funds through a rather ingenious move.

The initial venture was Related UBC Opportunity Fund, a construction loan fund that was backed by a $100 million commitment from the United Brotherhood of Carpenters – many of whose members then were out of work because of project cancellations or delays during the global financial crisis. The vehicle originated approximately $250 million in loans for projects across the US, with one restriction: all developments that received financing from the fund had to use Carpenters labor.

“At that time in the market, it was very difficult to get construction financing,” said Metz. “Banks were scarred, ending up with projects that they never intended to own. They weren’t making loans, so we saw an opportunity and went into the construction lending business.”

Related followed up the construction loan fund with the purchase of a 25 percent stake in a real estate-owned apartment portfolio from Fannie Mae. The company funded the acquisition with $500 million in commitments from private investors.

Road to Recovery

Related’s flagship fund, however, was the Related Real Estate Recovery Fund. In 2008 and 2009, the firm was getting many calls from banks that were saddled with troubled construction loans on developments that were left half-built as a result of the downturn.

“We thought there was a business there around accessing these deals, where somebody controls real estate but doesn’t have the operating, construction or development ability to access the value of the asset for themselves,” Metz explained. “What we found ourselves doing when we started the funds business was partnering with those banks on those failed development deals.”

Related’s strategy for the aborted developments was to gain control of the unfinished real estate assets, and using its real estate and development expertise, complete the stalled projects and business plans. The firm would not only invest in non-performing and sub-performing loans held by lenders, but also buy distressed assets directly from sellers at a substantial discount to replacement costs.

To be able to execute on those deals, however, Related needed a different source of capital than its development business, which capitalized projects over a three- or four-year process. The company historically would acquire land on its balance sheet, and after making improvements on the land, would bring in a development partner when it was ready to build on the site.

“The difference is that the types of deals that we were looking at in 2009 and 2010, we needed capital immediately,” said Metz. “Banks needed to trade quickly, quietly and with certainty. We needed a different source of capital, one that we could draw down in effectively 10 days’ notice. So that’s how we migrated toward this model.”

Raising capital for the Recovery Fund, however, wasn’t easy. The firm launched the vehicle, originally called Related Distressed Opportunity Fund I, in 2009, according to filings from the US Securities and Exchange Commission (SEC). Related held a first close of $170 million for the fund in January 2011, and by the following September, had raised $410.6 million, according to the SEC documents. The firm ultimately closed the fund on commitments of $825 million, exceeding an equity goal of $750 million, in late 2011. Limited partners included The University of Michigan Regents and multimanager Siguler Guff, according to documents from those institutions.

“From my perspective, to launch a fund business from scratch is very difficult,” said Metz. “There was a lot of start-up work at first, and I think having relationships with large key investors, both my own personal relationships and the company’s relationships, certainly helped to get us started.”

While the company’s decades-long track record helped to get investors on board, so did its previous experience serving as a fiduciary to institutional capital. Beginning in the 1990s, Related managed capital on behalf of several large institutions, including the State Teachers Retirement System of Ohio, GM Pension Fund, MEPT and CalPERS, CreditRE and CertRE via separate accounts. The company also has formed ventures with Credit-Suisse and Zurich Financial.

New strategies

Related has continued to attract capital for various strategies since the final close of the Recovery Fund. In 2013, the company launched a new real estate credit investment platform, forming a joint venture with Highbridge Principal Strategies to jointly invest $800 million in first lien mortgages, mezzanine loans and preferred equity positions in transactions involving land deals and non-stabilized assets in gateway cities such as New York, Boston, Chicago, Washington DC, Los Angeles, San Francisco, Miami and select secondary markets. The venture has invested approximately two-thirds of its capital to date.

Also in 2013, the company established a separate account with the five New York City pension funds, to invest in real estate in areas affected by Superstorm Sandy. The pension plans committed $300 million to their investment program with Related, which has focused on acquiring workforce housing properties in the Bronx.

Metz has declined to comment on fundraising, but public documents show that the company currently is raising capital for two new funds. One offering is the Related Energy Focused Real Estate Fund, which will target property investments in US shale oil markets. Through the vehicle, which has a $300 million equity goal, the company is said to be planning to buy and build up to 6,000 multifamily properties, primarily in North Dakota’s Bakken Shale and Texas’ Permian Basin and Eagle Ford Shale. According to people familiar with the fund, investments would involve a mix of acquisitions and upgrades of existing multifamily properties and new development. Related collected $108.07 million during the fund’s first close last August, according to SEC filings.

One potential challenge with an energy-related strategy, however, is the sharp drop in oil prices that occurred during the second half of 2014 and has continued into 2015. “I think there will be some negative effects in the energy markets,” said Metz. “There has to be when you have job loss, but they haven’t shown up as of yet,” since real estate demand generally lags any changes in the economy.

One major energy-related deal that the company struck last year was the acquisition of a portfolio of 21 multifamily properties totaling 3,000 units in Midland and Odessa, Texas, on behalf of the Recovery Fund. Overall, however, Related to date has only invested a small amount of capital in energy-related real estate. “We haven’t been investing capital, because we’re not really sure where the bottom is,” he said. “There’s a huge correlation between the price of the commodity and the success of the real estate strategy. They’re very coupled together, and so until we feel comfortable with the pricing of that commodity and the stabilization of that price and maybe even the upward trend of that price, we’re just going to watch and monitor.”

Follow up to Recovery

The other new strategy is the successor to the Recovery Fund, Related Real Estate Fund II. According to documents from the Teachers’ Retirement System of Louisiana, the fund, which has an $850 million target, will be similar in strategy to its predecessor in that it will focus on underperforming assets in need of operational or development improvement; recapitalizations of assets or real estate; foreclosed residential assets and special situations such as corporate and entity-level investments.

The firm has been marketing Fund II since at least last June and raised $127.15 million during the initial closing in December, according to the Louisiana Teachers documents and SEC filings. Among the limited partners are the Texas County & District Retirement System, which earmarked $40 million to the fund in December, and Louisiana Teachers, which committed $35 million in January, according to documents from those investors.

In its presentation to Louisiana Teachers' investment committee, real estate consultant Hamilton Lane noted that one of main reasons for committing to the fund was the strong performance of Related's fund management platform, both for Fund I and pre-Fund I. The firm was generating a gross internal rate of return (IRR) of 48 percent on realized pre-Fund I investments as of last January, and 26.2 percent on realized Fund I investments as of last June, the presentation said. Moreover, Fund I was yielding a net IRR of 20.7 percent, with $337.4 million in distributed capital.

One of the biggest contributors to the fund's returns thus far has been 111 West Wacker in Chicago. Originally planned as a 90-story hotel and condominium tower, the project stalled in 2008, after 26 stories had been built. Through the fund, Related partnered with several trade contractors that had filed $90 million in liens against the project and took joint ownership of the asset in 2011. The venture went on to change the business plan to build a 50-story, 504-unit apartment building, which had a cost basis of $180 million and required an equity commitment of $30.9 million from the fund. In January, Related sold the property, now known as OneEleven, for a record $328 million – the highest amount ever paid for an apartment building in Chicago.

'Very innovative'

Indeed, the firm's ability and capacity to take on complex deals involving distressed real estate assets such as 111 Wacker has been a strong selling point for Related's fund management business. "What they did in Fund I, none of it was easy," said Jim Corl, head of real estate investments at Siguler Guff, which committed a total of $140 million to the vehicle in September 2011. Deals such as 111 Wacker "were a degree of difficulty that was 9.5 on a scale of 10."

Related's expertise as a ground-up developer has been a major asset in tackling "busted development deals" on behalf of its funds, he added. Calling the firm "very innovative," he said that very few firms would be able to take on such complicated transactions. "Their skillset enables them to look at something that other people would walk away from," Corl added. "They can see value creation opportunities that others wouldn't see or mitigate risks that others wouldn't be able to mitigate."

Related also has found other ways to leverage its development business to its advantage in fund management. Take the company's relationship with the Kuwait Investment Authority (KIA), which began in 2009 when the sovereign wealth fund acquired a minority stake in the company through a number of equity and debt investments. "The whole purpose was to get access to projects and to be preferred partners for projects they're going to do," explained Farouk Bastaki, executive director of the alternative investment sector at KIA.

While KIA has traditionally made core property investments on its own, the sovereign wealth fund has partnered with real estate managers on value-add strategies. “There are some special situations that require certain types of work that you wouldn’t have expertise to do overseas,” said Bastaki. “So you need a partner or fund manager to do that. We thought Related had that expertise.”

The sovereign wealth fund then became part of a group of institutional investors that helped Related and its partner, Oxford Properties Group, to fund the first two buildings at Hudson Yards – the South Tower, a 1.7 million-square-foot office tower that will serve as the new headquarters of Coach, as well as a residential high-rise building, both of which are anticipated to be completed within the year.

As an operator, Related stood out for its wide-ranging capabilities. “There are a lot of developers who can do development, but they need someone to find tenants and rent the building,” said Bastaki. “It’s difficult to find someone like Related who can do everything.”

In 2011, KIA added a third prong to its investment approach with Related: investing $75 million in the Recovery Fund, largely because of the company’s strength as a developer. “We didn’t know how they would do in the fund business,” said Bastaki. “But we knew they were very capable as developer, and they could use their development knowledge to help the fund and provide opportunities for the fund, especially with a lot of distressed situations.”

The sovereign wealth fund is now considering a follow-on investment with Fund II, partly because of the predecessor fund’s strong performance, delivering both a high IRR and a high multiple on investments. But there’s also another significant reason: “It’s a great opportunity to invest with someone that you know and that you trust,” said Bastaki.

Hands-on approach

Institutions like KIA see a place in their property portfolios for both operator and allocator funds. Indeed, Metz himself acknowledges the advantages and disadvantages of both. He noted that allocators often are able to draw from a larger pool of operators and in theory, should see more deal flow from those partners. “The downside is, they don’t necessarily have control over those deals,” he said. “It’s a local operator who really has control, who really knows what’s going on. I would say we know exactly what’s going on with all of our deals at all times because we’re doing it. Having that said, we probably have a smaller universe of opportunities to look at.”

On the flip side, the biggest challenge for operators overall is scale, he said. Particularly for operators that are focused on one market and one property type outside of New York City, “the challenge for them is scaling their business,” he said. “You have to do a lot of $40 million deals to have an institutional-type fund. I think that’s the struggle that a lot of local operators have. And that’s why a lot of them aren’t in the fund business.” Most operators would rather receive capital from an allocator fund than spend 18 months raising a fund, Metz added. He estimated that there were only 10 funds in market sponsored by national operators that invest across multiple property types.

While Metz said that Related's main competitors are other operators, the company's national footprint gives it a competitive edge over many such firms. "The advantage brought by a national firm is the ability to see different markets and emphasize the markets with promise while deemphasizing the markets with less promise," observed John Haggerty, director of private markets investments at Meketa Investment Group, a Westwood, Massachusetts-based investment consulting and advisory firm. A national operator would be able to avoid investing in a market that has become overpriced, unlike a local firm that is focused only on that one particular market, he said.

But despite its broader geographic reach, the company has maintained a very hands-on approach to its fund investments, he added. "Related gets very involved with their properties," Haggerty said.

International expansion

Unlike its development business, Related's fund management platform has focused exclusively on the US to date. That could change, however, in the next few years.

In Metz's view, the company is best off establishing a presence in another market before making any investments through its fund management business. Currently, Related has overseas offices in the Middle East, China and London and has invested capital in other markets such as Brazil. But he anticipates that Related Fund Management will make its first international investment in the next three years.

The key is finding the right deal to be the platform's debut overseas investment. "We want to be really successful on the first one we do, and the deals that we've looked at so far, it's not clear to me that we've been the first call," he said. "We'll wait until we're more established in those markets, and we're seeing the opportunity first. I think that's when it's priced best."

The most likely location for the fund management business' overseas expansion is London, where Related already has been active for more than a year on the development side. Last month, Related announced a joint venture with UK developer Argent to develop large-scale projects in London and other UK markets. "If we were to be presented an opportunity there that we felt really good about, that's where we'd go," said Metz.

Staying small

A potential international expansion aside, however, Related isn't actively pursuing the growth of its fund management business. Metz is confident that three years from now, the platform, whether in terms of staff or AUM, won't be double the size of what it is today. In fact, the company prefers to remain small enough to be able to continue to execute on deals that are in the $30 million to $60 million equity range – too small for larger institutional investors and too large for the local entrepreneurial firms.

Deals such as 111 Wacker "are really, really hard to do, so if we have the right amount of capital to do 20 or 25 deals over three to four years, that's exactly the size that we want to be," said Metz. "We may have to raise capital more frequently, because we raise smaller funds, but it gets easier to raise that capital if you've done what you said you were going to do.”

Also, given the fact that the company, as an operator, is highly detail-oriented and does everything in-house, it doesn’t necessarily make sense for Related to significantly grow its fund management business. “People assume bigger is better, but it’s only better when the market’s perfect,” he added. “When the market’s not as perfect, and it’s harder to find opportunities, sometimes being smaller and nimbler is better, and that’s the path we’ve chosen to take.”

Likewise, Related wants to manage the growth of its fund management team. “We’re only as good as our people, so we don’t want to make any hiring mistakes,” he said. “One bad deal could sink your entire fund.” The firm has been very careful about who they’ve hired, and typically have recruited people with whom they’ve had a relationship for an extended period of time. A potential danger for a fund manager is a need to staff up quickly, Metz observed. “When you’re in growth mode and you need people and you need bodies, sometimes if you’re hiring 10 people, you may get one wrong,” he said. “We may hire two people a year. We can’t afford to be wrong.”

SIDEBAR

Activist deal

While Related typically takes on complex deals on behalf of its fund management platform, the company deviated from its usual investment strategy of private market, asset-level investments with its activist deal regarding CommonWealth REIT, an office real estate investment trust. On February 26, 2013, Related and New York-based hedge fund Corvex Management announced that they had jointly acquired 9.8 percent of the REIT’s outstanding common shares.

In a letter to CommonWealth’s board of trustees, the two parties stated that they had assessed, through a property-by property valuation analysis, the net asset value of CommonWealth was significantly higher than what was then the current per share price of $15.85. “We believe the company’s real estate assets are significantly undervalued due to the misalignment of incentives between the company and its externally advised management structure, and track record of underperformance,” they wrote. The external manager skewed incentives and reduced the REIT’s

cash flow through excessive fees, ultimately hampering CommonWealth’s valuation as a company, they said.

Over an 18-month court and arbitration process, Related and Corvex were able to gather enough shareholder votes to remove the contract that the external manager had with CommonWealth and replace the REIT’s entire board of directors. As nominated by Related and Corvex, the new board – led by chairman Sam Zell – was elected by approximately 85 percent of the outstanding shareholders on May 2014. The REIT, which was renamed Equity Commonwealth, was trading at $25.68 as of press time.

“We would never do it again,” said Metz of the transaction, with a laugh. Normally, Related has control over what occurs between the time it acquires an asset and the time it realizes the value on that investment. With CommonWealth, however, the company was subject to litigation by the previous board and also had to get the approval of the other shareholders to remove the existing board. “There were just a lot of difficulties and roadblocks that made it beyond our control,” he said. “And so while we knew we would ultimately get there, the process to getting there is not one that I ever want to go through again.”

Although the fund management business primarily is focused on private markets opportunities, the company pursued the Commonwealth deal because “we thought we were buying something at what we thought was a 60 percent discount, and that’s what got us excited,” Metz said. “Even though private markets are inefficient, you generally can’t buy at that big of a discount. This happened to be a unique situation.”

The deal “represented some very outside-the-box thinking,” according to Siguler Guff’s Corl, who also was elected to the REIT’s new board. Related “demonstrated that they were able to leverage their skillset into a new and different way to realize value.”

INFO BOX

Related Companies

HQ: New York

Number of offices: 11

Chairman and founder: Stephen Ross

Chief executive officer: Jeff Blau

Head of fund management: Justin Metz

Total number of employees: 3,000

Number of fund management employees: 40

Total assets under management: $23 billion

Total third-party AUM: $3 billion