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## Next Shoe to Drop - Rescuing Capital

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### *Prescription for Limited Partners in Faltering Real Estate Funds*

By Mark Antonic

Two years ago pension funds and other institutional investors were investing in a crowded real estate opportunity fund market which targeted 20% plus returns. Major investment banks, various investment managers, and a slew of boutique firms sponsored funds and raised many tens of billions of dollars. The general theme pursued investments in a cap rate compression environment, leading to heavily weighted IRR-driven investments which exploited cheap debt and leverage up to 80% or even 90% LTV. In many cases, strategies anticipated buyers would keep bidding up prices while the economy just chugged along. Well, we all know what happened.

With prospects for outsized returns dashed in the ongoing market collapse, limited partners in many of these funds confront a host of issues and should be gauging how to protect what's left of their investments. The scenarios are potentially nightmarish. Some general partner sponsors have already shown signs of stress; others are headed in that discomfiting direction. Although some fund managers can navigate extremely choppy waters, others are financial engineers, capable of structuring highly complicated financings, but out of their depths in asset-managing troubled properties in falling markets. Some GPs have lost any opportunity to make their promote fees and some are ready to bail on their investors without any profit incentives to keep going. The rumor mill is rife with stories of GPs going silent on limited partners, banks getting back the keys on properties, and mounting losses. LPs may face imminent capital

calls, property refinancings at much less favorable terms, GP workout or even replacement issues, and disputes among themselves. It's a complex mess waiting to happen.

#### **Be Proactive**

So what should an LP do now? For starters, it's no time for complacency.

Obviously many general partners are financially sound and staffed to manage through the difficult period—they won't deliver originally promised returns, but they'll husband as much value as possible under the circumstances to sustain their franchises and reputations into the next business cycle. These managers probably communicate well with their limiteds and keep them updated. Even in these circumstances, it behooves investors to ask GPs key questions about potential exposure to refinancing issues and capital calls, as well as to insist on frequent updates about individual property performance. Don't accept spoon-fed answers at face value under any circumstances.

The more difficult situations occur when GPs start to falter. The red flags include: key personnel leave, firm fiscal viability seems shaky, fund operating partners fail, and investor communications turn sketchy. When it's hard to get straight answers or worse yet GPs don't return calls, the odds grow dramatically that bad news lurks ahead. Then it's imperative for LPs to anticipate taking greater control, preferably banding together, and potentially exercising rights to replace the GP.

## Focus on Fundamentals

If GP experience weights to financial structuring and capital market expertise rather than real estate fundamentals, asset management and workout knowledge, LPs should grow more circumspect. The next two years will require ample skill sets in property operations, leasing, and negotiations with lenders. At the very least, GPs may need to hire asset management talent and gray-haired experience to help manage through the downturn. If the GP appears over its head and balks, LPs may need to move the firm aside and bring in their own manager, partnership agreements permitting.

In circumstances where the GP needs to be moved aside or abandons ship, it won't be unusual for limited partners to find themselves at loggerheads—they typically will have different agendas, varied stakes, and trouble coordinating. Some investors are prepared to fund capital calls, while others don't have the means or the desire to take the risk on further losses. They may bow out and that may require strategic decisions to create value and liquefy their positions in the fund. But often LPs are severely staff-constrained in analyzing best approaches and executing game plans. They should not delay hiring real estate and legal counsels, especially when lenders may be positioned to foreclose on fund assets. If debt positions can be stabilized, then investors should be able to ride out the slump and possibly recoup investments in a market recovery.

## Experience Counts

LPs may fall back on the very consultants who advised initially to invest in the funds, to help identify alternative investment managers to replace general partners. The LPs may also work together to find a new investment manager to salvage fund capital and performance. Not surprisingly many real estate companies and managers have reoriented their platforms to undertake workout and asset management assignments, anticipating the looming carnage. Investors in troubled funds may get inundated by pitches offering solutions from these firms. Assessing who to hire could create its own contention and conundrums.

Investors would be well-advised to choose tested investment firms with portfolio and asset managers who have navigated past real estate downturns and are grounded in underwriting fundamentals. Crisis situations aren't well-suited for on-the-job training and start-ups. Complicated debt-equity structures will need attention from executives who not only can negotiate loan workouts and issues like debtor-in-possession financing, but also have property level experience and can oversee leasing strategies and building operations. Be careful of "workout firms" distracted by legacy fund issues—their own problems will get primary focus and attention. And better to hire firms that operate in fiduciary frameworks familiar with standards of prudence and institutional legal strictures.

Under any circumstances, don't get caught flat-footed—preservation of capital is at stake.

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