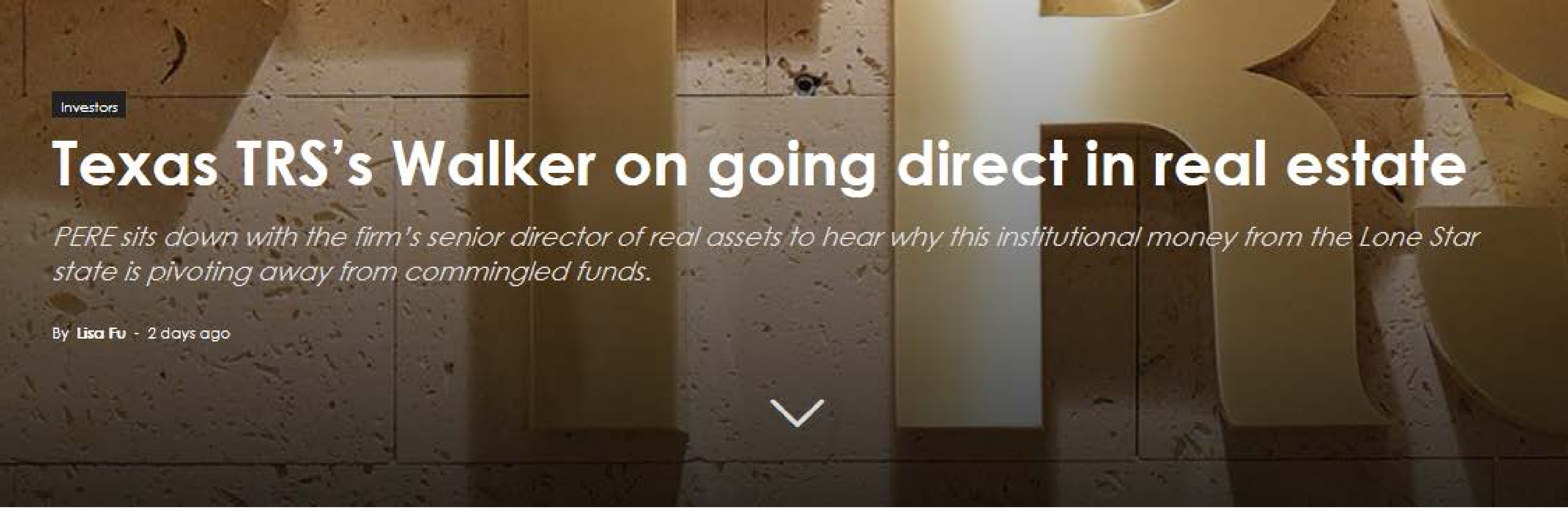

Investors

Texas TRS's Walker on going direct in real estate

PERE sits down with the firm's senior director of real assets to hear why this institutional money from the Lone Star state is pivoting away from commingled funds.

By **Lisa Fu** - 2 days ago

Managing around $19 billion in real estate net asset value, the **Teacher Retirement System of Texas** is already one of the larger US private real estate investors. It wants more.

The pension system is trying to bulk up its real estate team to help it pivot towards principal investments over commingled funds. With an allocation target of 14 percent, Texas TRS is certainly more bullish on real estate investments than some of its peers.

It wants to be more progressive, too, pushing forward its emerging manager program to identify talent ahead of time. In April, the pension system announced that it will commit another $3 billion to emerging managers across asset classes over the next three to five years.

It also hosted its annual Emerging Mangers Conference once again. At the conference, held last month, PERE sat down with Texas TRS senior director of real assets Grant Walker for an exclusive interview to discuss these items, today's competitive market for investors, term negotiations and how the system is generally developing its investment strategy. Here is an abridged transcript of the conversation:

PERE: A lot of investors are choosing to re-up with just a handful of large private real estate mangers. Why is Texas TRS taking a chance on emerging managers?

Grant Walker: Larger managers have been successful, but part of our goal is to find new managers that may have something that can be additive for us once they get larger. We get to know these managers and make smaller commitments of $15 million-$20 million, maybe $30 million initially. Then, we find out who's been performing the best and how they can be additive to our overall portfolio. In the past, we have had two specific examples that started out in the emerging manager program and that have graduated to our team: Harrison Street and DivcoWest. We now commit to both of those groups directly in fund formats and also consider co-invest, principal-type investments with them.

PERE: What are the economic advantages to picking out these managers early? Do you get more favorable terms – for instance, co-invest rights?

Texas Teachers: wants to build the team to do more co-investments

GW: It's tough because with some of the smaller ones, we don't want to make the terms so advantageous to us that they can't run their business. They've got to be able to run their business. But we also want to prepare them for when they do graduate to have an expectation of what we think is standard for larger firms. Co-invest opportunities are great if they can provide that to us, and that is one of the main factors we consider when selecting managers.

PERE: Texas TRS is a huge system. Couldn't you just acquire an emerging manager and take it in-house instead?

GW: We have a law in Texas where we can't own direct real estate titles; we must invest in securities. So we take these limited partnership positions in funds. Any time that we want to invest directly, we always need a fiduciary in place, one of these general partners. The venture holds the title. I think there's a lot of confusion in the market about what direct investing means. Everybody defines it a little bit differently. For us, we will always have a fiduciary, but we can go out and underwrite a specific building and use that fiduciary – one of our general partners – as a sponsor to underwrite alongside us, and then do the portfolio management, asset management on growth order basis.

GW: We've thought about it. That would take a lot of work to structure and set up from a legal standpoint. To go more to that Canadian model, we'd have to have more resources, and that's something that we're trying to do. We want to build up our team so we can do more of these co-investments, principal investment type structures. Right now, about half the portfolio is a typical commingled fund, the other half is what we call principal investments, which can be a sidecar along a fund, a club fund, a separate account, or a direct deal with a manager. That half of the portfolio is where we've earned a lot of our alpha and outperformed. We are trying to pivot to do more of that, which requires more resources. We hired three new people last year on the team and may hire at least one, maybe more this year.

PERE: How big would you have to be to have that kind of real estate arm?

GW: It depends. I know some of those Canadians, they have hundreds. I don't think we'll ever get to that point, but maybe we can get somewhere in between – a kind of a hybrid where we can still do the funds with the main general partners because that is our source of co-investments. We need to keep making those investments and staying in the market because part of the goal is to be relevant to them. We want to be a manager's first call when they have an opportunity.

PERE: Something we like to talk about is the constant push and pull in relationships between investors and their managers. What are the negotiations for terms like with your managers currently?

GW: If we're a large investor in the fund, or we invest early, we typically get a discount compared with what's published in the PPM. If we've got a long-time relationship with them, we hope to have better fees and terms than some of our peers. On the co-investment side, if we do some kind of sidecar or principal investment, it's typically about half-fee and half-promote compared with what a fund would be. We try to make it advantageous enough for it to be worthwhile. Partners have to make money. You want to have proper alignment where they're motivated to perform as well.

> *"We want to be a manager's first call when they have an opportunity"*
>
> *– Texas TRS senior director of real assets Grant Walker*

PERE: When you are an anchor investor and able to negotiate a fee discount, how much is that discount?

GW: Sometimes it may be only 5-10 basis points, or it can be more. It all depends on the size of our commitment relative to the overall fund, the size of our commitment relative to our peers. If we've been in four, five or six prior funds and really helped the firm get off the ground and put them in business, that's important as well.

PERE: How are negotiations on terms changing at this point in the cycle versus prior years?

GW: Well, there's a lot of capital out there now, and we try to make sure that we have something that's comparable or better than our peers. The exception could be if some sovereign wealth fund comes in and commits twice as much as we do. Then, we realize it's harder for the GP to give us the same deal as them. But we also want them to factor in the length of the relationship and how much have we supported them before. If we've been in their past four, five or six funds, we feel like we should get the same, or better, deal than someone who just swooped in for the first time.

PERE: Where are we in the cycle?

GW: Who knows? We don't hear anyone saying there's going to be a correction this year, for example. Most of our partners that look at this daily say sometime in the next year to two. But there could be geopolitical events that change that timeline. We are a little more defensive and focused a bit more on cashflow-oriented investments. Two or three years ago, we may have done more equity. Now, if we're looking at a particular investment, we may not want to be in the equity position. We may want to be doing mezzanine lending or preferred equity somewhere in the 50-70 percent part of the capital stack where we've got some cushion.

PERE: Are you moving away from core investments and toward value-add?

GW: We've been doing that for the past two to three years. We haven't been committing to new open-ended core funds. We've been doing more value-add and opportunistic. The thought there is: cap rates on core are so low right now with so much capital and being so competitive. We don't like to buy at, or above, replacement cost. In the value-add or opportunistic strategies, we've been doing some build-to-core with multifamily and industrial where we feel we can buy an industrial warehouse at a five-cap, for example. But if we have a great development partner that's identified a great location, we can build and that yield from developing might be 6.5-7 percent. We feel that's a great position to be in versus buying a 15-20-year-old product right now at a lower cap rate. When the opportunity is available to do develop-to-core, we will start out in our opportunistic or value-add part of our portfolio. Once we build it and see the asset stabilize, we transfer it over to core and position it over for a longer-term hold.

PERE: Do you feel like you are holding your investments longer these days?

GW: Somewhat, yes. We don't want to get married to an asset and hold it, because if someone wants to put some crazy offer out there, we'll sell. In the past two to three years, we've done some developmental warehouses where the projection was to sell in x number of years at some target price once it was fully leased and stabilized. Then we received offers during development or before leasing with the pricing we thought we'd get two to three years down the road after lease-up. In those cases, we'll take that price and money. It depends on the structure and what our intentions were. Sometimes, we will hold long-term if it is a great cash-flowing asset with low risk.

PERE: How do you execute a transfer like that?

GW: We've had some scenarios where we had a value-add fund in multifamily. We went through the typical holding period, and the market outlook for multifamily was still great. We were nearing the end of the initial targeted fund life, but we didn't want to sell because we would have had to go out and replace those assets. So, we extended the life of the fund and made a slight adjustment to fees and how it was structured so that it became a long-term hold vehicle. And we have held those assets and have been able to benefit from the appreciation.