



Transparency defined and delivered

J.P. Morgan explores why those general partners who embrace the true meaning of transparency may achieve the most successful funds.

By **Bonnie Novella**

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LET’S FACE IT: “TRANSPARENCY” – THE WORD UTTERED IN nearly every discussion and most financial articles about investment risks – is the new normal. It is a hot topic, with regulators suggesting that transparency is one of the key variables to mitigating future losses.

Although virtually everyone is talking about transparency, what does the term actually mean when applied by real estate fund investment teams? What are stakeholders looking to expose? And finally, how should the focus on underlying details change the behavior of fund sponsors?

Transparency is just another way of describing insight into the underlying asset’s performance. The trending of that performance provides information to both investors and fund sponsors. While the investors leverage this insight to manage risks, the fund sponsors use performance indicators to adjust asset-level strategy.

Only a few years ago, a veritable information veil was drawn between funds and their investors. Minimal reports were provided to limited partner investors (LPs) by their general partners (GPs), and there were few details provided beyond fund returns. GPs had little need to open the fund books and records or shine a light on their operations. When real estate valuations were high and returns were strong, this state of affairs satisfied most industry participants.

However, the veil has definitely been lifted. Due to tumultuous markets, infamous fund fraud schemes and shifting risk allocations, investment committees now demand that GPs provide LPs a much more granular view

into a fund. This is not just to garner a commitment, but also to satisfy the new investment oversight behavior that GPs can expect for the life of the fund. LPs now want to scrutinize leverage ratios, deal pipeline, team activities, fund fees and typical fund performance reports.

This affords GPs a rare opportunity. From the first discussion with an investor, GPs can now demonstrate their willingness, ability and desire to meet investor transparency needs. GPs that fully embrace this may not only have stronger investor relationships, but they also may realize better fund performance as a result.

Staying ahead of the regulatory curve

As the worst of the market turmoil subsides and real estate valuations begin to stabilize, a new investment culture has emerged. While regulations are being finalized with the goal of mitigating risk, investors are in actuality well ahead of the rule writers in demanding changes in their investment monitoring. In fact, it is the new investor need for information that has been the catalyst for risk mitigation and the move to greater organizational transparency.

Consider this example: it is not only Wall Street reform (aka the Dodd-Frank Act) that has expanded investor diligence in evaluating a fund manager; it is the recognition among LP investment committees that the lack of insight into asset performance was a key factor in yesterday's losses.

As a result, GP teams confront this level of new diligence during fund-raising. They are careful to outline their team, experience, strategy, deal pipeline, fee methodology and other details. It is worth noting that, regardless of whether a fund sponsor is a registered investment advisor (RIA), investors today typically follow the same due diligence standards for any fund manager who requests their capital.

The plain truth is that investor demands for greater transparency preceded regulatory reform and, as a result, regulation is less relevant to the new dynamics between GPs and LPs than one may think. While Dodd-Frank compliance does place more demands on RIAs to report to the SEC, the reporting requirements overlap with those already defined by investors. Even if new regulatory exemptions were granted in the future to private equity real estate funds, the culture of transparency that is yielding more detailed reporting from GPs to LPs is likely here to stay.

Go long

Investors generally have increased their allocations to real estate assets classes and, according to *PERE Connect*, have more than 332 funds seeking an aggregate target of \$150 billion in commitments from which to choose. What differentiates one real estate fund from another during the request for capital? More importantly, what will differentiate the returns of those funds over their entire life?

Consider that LPs look at real estate investments as long-term diversity plays that diminish correlation to equity and fixed-income investments, thus maximizing their total portfolio returns. To achieve this, LPs seek optimal fund returns realized by good asset selection at the right price, followed by superior long-term asset management by a GP that truly understands the real estate asset class.

GP market acumen is vital to achieve desired optimal returns. Since excessive deal competition is making it very difficult to find undervalued institutional-class real estate, higher returns will be derived from this skill. While the front-office and deal teams of the GP are important, so too are the critical skills of the team that will oversee the management of the asset while it is owned by the fund.

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A transparency checklist

To mitigate risks and project fund returns, investors expect transparency into fund activities. GPs must prepare for detailed discussions about many areas, including:

- Fund expenses
- Deal pipeline and activities
- Leverage ratios
- Tenant health (by industry code, by tenant)
- Property capital projects
- Market lease assumptions
- Trending of occupancy and leasing activities
- Valuations and calculation methods
- Material variations in net operating income (budget to date, pro-forma)

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Mastery of this skill derives from accurately projecting property performance and adjusting strategy as needed, but it also comes from possessing a keen sense for market timing for the disposition of each asset. This requires a polished “middle-office” team with a thorough knowledge of the local valuation trending, as well as fluent command of the real estate narrative. Transparency in the middle office means that this team must be armed for detailed discussions about debt, capital projects, tenant health, market lease assumptions and other factors that affect the projected cash flow of the asset.

The most diligent GP also is prepared to outline how their back-office team stacks up to meet investor demands during the long life of the fund. LPs want timely, accurate and auditable information in customized report formats. While some GPs are equipped to provide this without difficulty, others may elect to use a third-party fund administrator to complement their own people. As a cooperative unit, this becomes the GP’s back office.

A quality third-party fund administrator should not only provide expert people, processes and technology to track the fund’s books (and those of related entities), but it also should serve investors’ reporting needs. Ideally, the books and records are tracked using controlled, auditable systems with minimal use of offline spreadsheets. This way, transparency into underlying details is tied to strong audit trails and good governance over the separation of duties.

When a GP has assembled the right team for their fund, the execution of a long-term fund strategy should be seamless. Properties owned by the fund should trend toward full occupancy, streamlined operations and maximum rents. The GP that can achieve this with skilled front-, middle- and back-office teams, each prepared to provide transparency in their specific area, is better positioned to improve fund performance.

A win for all stakeholders

The new culture of transparency is likely here to stay, as LPs will continue to monitor key performance indicators and asset trends. GPs that embrace this transparency culture and meet new LP demands stand to gain an optimized operation, more efficient audits and better fund performance.

At some point, the risk-return appetite will again shift toward opportunistic investments and GPs will be ready to launch new funds with new strategies. By then, transparency will be the standard best practice and diligent GPs will have won LPs’ confidence and approval, making it a *little bit* easier to raise capital. □

About the Author:

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Novella: promoting transparency across GP operations

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