Understanding the Merits of Open-Ended Credit Fund Structures

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Simply put, it is the job of the CRE credit fund manager to originate or buy debt instruments, monitor and collect payments through the term, and then seek a full repayment on the maturity date. If the debt instrument does not pay off, the best case is that you are in a negotiation and the worst case, assuming the possibility of principal preservation, is a legal fight, followed by the ownership and repositioning of a distressed real estate property.

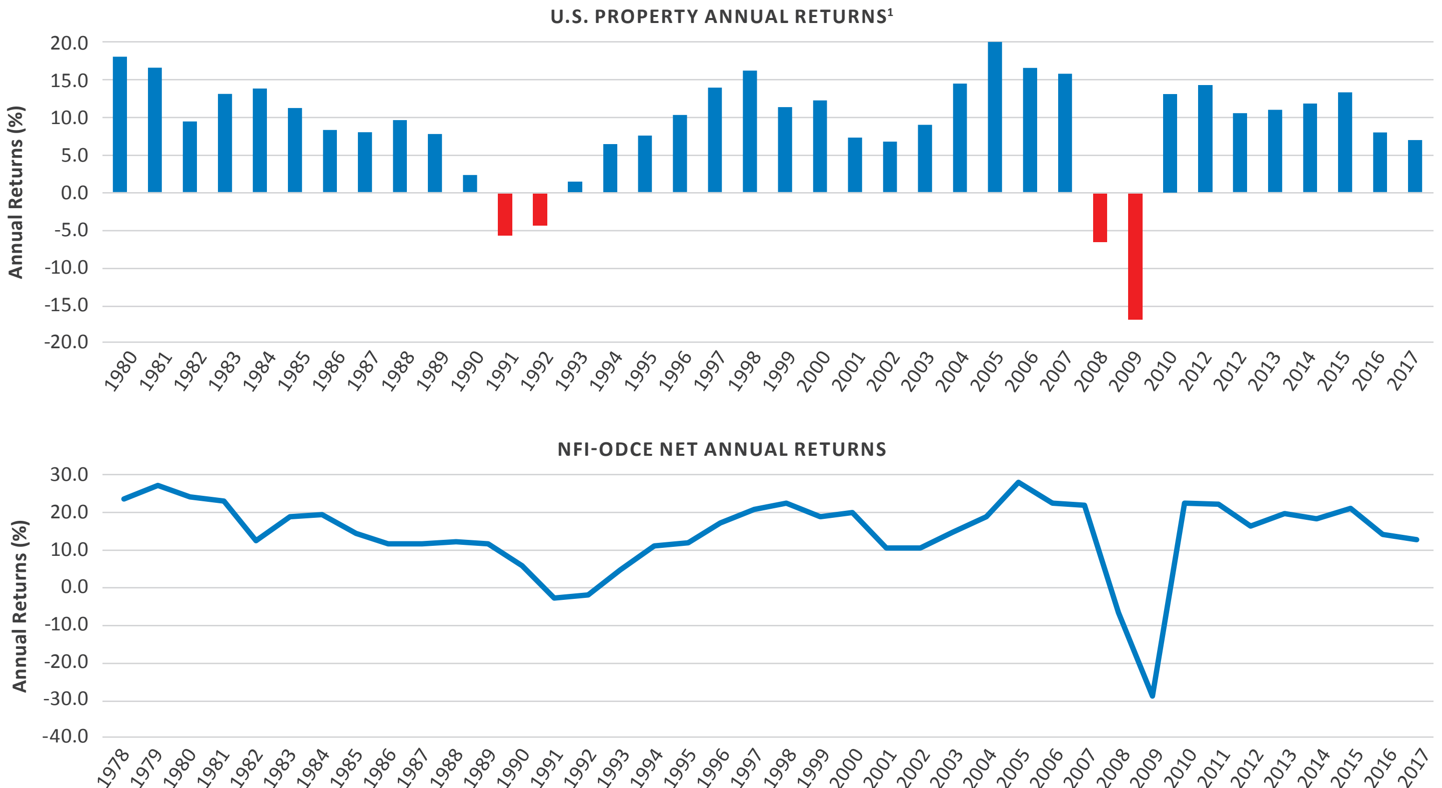
Our last white paper focused broadly on the various risks associated with CRE credit investment. This white paper is a bit more granular as it focuses on the question of which type of CRE credit fund structure, open or closed-ended, is better designed to drive performance over the long term. Fully weighed, both operational issues and protective LP provisions should be considered. Addressed in this discussion are, among other things, proper alignment of GP/LP interests, enhanced liquidity, the competitive benefits of maintaining a continuous market presence, investment term flexibility and diversification. Finally, this discussion would not be complete without consideration as to which structure may be nimbler and more effective in navigating the inevitable road bumps that may arise along the way. Accordingly, this piece considers some of the practicalities of default scenarios to best understand which fund structure may be better equipped to maximize principal recovery.

CREatures of Habit

At the onset, it's worth noting my belief that the great majority of CRE debt funds, 88% according to Preqin, are organized as closed-ended because that's what LP's from equity funds were most familiar with. Immediately post the Great Financial Crisis, GPs attempting to convince LPs to redirect CRE equity allocations into debt, were already rowing against the tide (and to a lesser extent still are). Generally stated and according to Preqin, since 2008, less than one of every five dollars allocated to US CRE investment funds was targeted towards debt investment. In 2018, the ratio only improved to less than one in four. Simultaneously attempting to reorient LPs from closed to open-ended structures would only add complexity to the challenge. Conveniently, and while catering to the comfort of their LP relationships, CRE closed-end equity fund managers (many who jumped into the debt space with increasing frequency as equity cap rates compressed), also preferred the closed-end structure as their operating, accounting, and compensation mechanics were already geared around a closed-end structure. Accordingly, the LP's and GP's mutual familiarity with conventional closed-ended structures, as opposed to any thoughtful projection of the probable benefits of each structure, seems to be the primary driver of the current 88% to 12% imbalance.

Alignment of Interests between GP Team & LPs

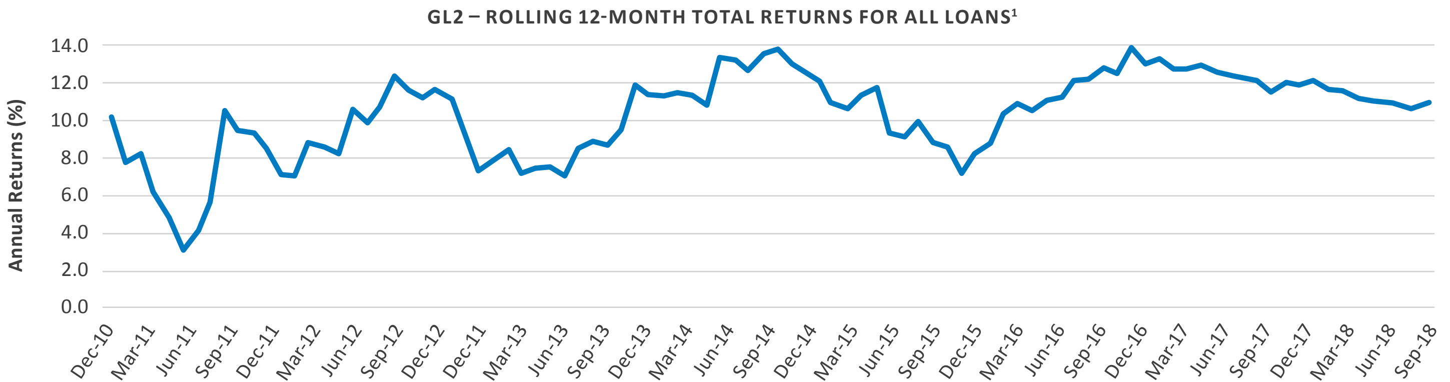
The primary challenge of running a CRE debt investment strategy is attracting creditworthy, fairly-priced, transaction flow as the market cycle progresses. While I'm confident this is an obvious problem for any given sector, the impact of cycle timing on CRE equity investment is highly apparent in both the NCREIF NPI and ODCE performance statistics.



1. Source: National Council of Real Estate Investment Fiduciaries.

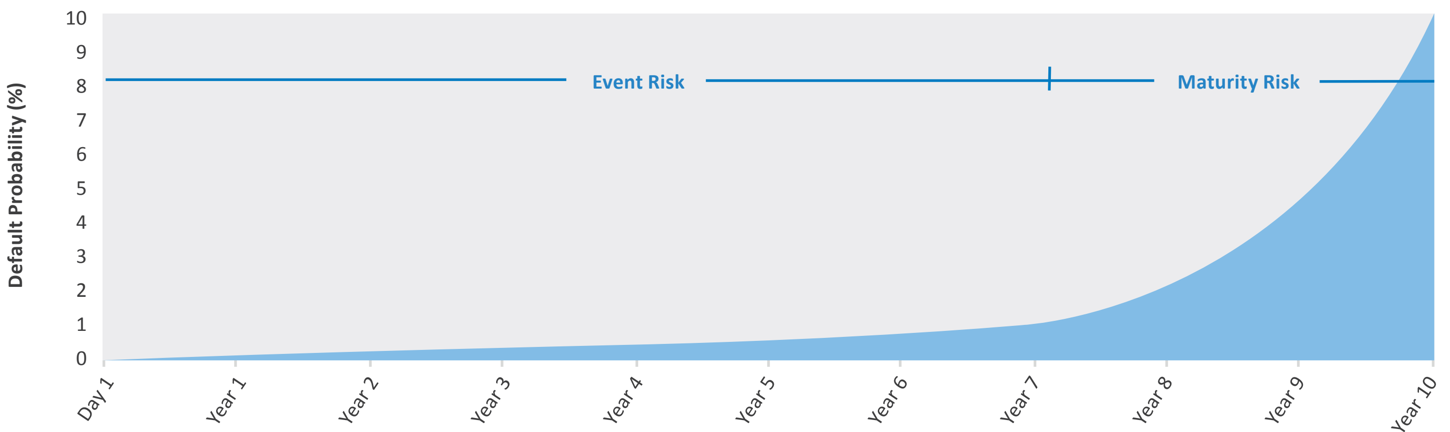
The newly developed GL2 high yield CRE debt index has not yet tracked a full cycle, thus quarterly yield volatility reflected in the chart below is likely the result of fair value fluctuations and the materialization of idiosyncratic event risk. We expect that following dislocation or economic contraction, short term performance will reflect broader materialization of event risk on bridge/transitional and development loans over the following 24-36-month period and the materialization of maturity risk, particularly for the later valuation cycle 2016-2018 vintage loans.

GL2 – ROLLING 12-MONTH TOTAL RETURNS FOR ALL LOANS[1]



EVENT AND MATURITY RISK

For reference, this illustration is designed to show the general magnitude and timing of both event and maturity related cumulative defaults on a hypothetical CRE loan portfolio.



Regardless of cycle timing, investment managers must organize their businesses to operate on a continuum. This, of course, requires recruiting and retaining a team of CRE debt professionals to invest, manage and report on the portfolio.

Team alignment with positive performance for LPs is paramount and team compensation is a key tool in aligning such interests. In a typical closed-ended fund, team members are, in large part, compensated on the success of the fund via a participation in the performance fees. Further, different team members may, as the investment firm evolves, participate to greater or lesser degrees in the performance fees of subsequent fund vintages.

By way of example, assume closed-end Fund I is on track to be a huge success. Also assume that the weighted average life of the investments in this fund is seven years, and that a senior team member has a participation in the performance fees with an expected value of $2 million dollars upon full realization. Now assume this same senior team member also has a participation in the performance fees of a later vintage Fund IV, but that in year six of the life of Fund I, it becomes apparent that Fund IV will suffer losses and no performance compensation will likely ever be earned. In years six and seven, the senior team member is obviously financially motivated to focus his or her attention on successfully completing the harvesting of Fund I, and perhaps will even switch jobs after doing so, as there is no projected upside in sticking around to clean up the mess of Fund IV. Looking at this scenario from a different perspective, what quality level professional would be willing to join the firm in year four, only to receive performance fee participation in a later (riskier) vintage year fund?

1. Source: Giliberto-Levy Index. Last observation: September 2018. G-L 2 covers investments such as mezzanine loans, B notes, leveraged senior loans and preferred equity. The index includes fixed and floating-rate debt on stabilized and value-add assets.

! **Key takeaway #1** – Operating a series of closed-ended funds may result in selective focus of employees and lower quality employees being assigned to later vintage funds. Quite differently, in an open-ended structure, there are no vintage years. Everyone typically participates each year in the success of the one portfolio. Further, participation in performance fees are not permanently assigned or portable (yes – I learned this lesson the hard way), and in fact can be reshuffled from year to year. This is a key driver in the Managing Partner's ability to maintain a meritocracy.

! **Key takeaway #2** – It is much easier to attract new high-quality team members into an existing fund with a well (or at least transparently) performing collection of assets. It is also easier to manage down the deployment of new capital across all team members during more risky periods in the cycle (more on this point in a moment). Further, senior investment officers are less inclined to introduce more risky assets into the portfolio as a default may offset imbedded performance fees on existing successful investments.

A good fiduciary in the leadership position should be able to manage through these issues regardless of structure, but the alignment of interests associated with the open-ended structure should result in a far more natural tendency towards the desired outcome.

Two other important alignment of interest factors for consideration are the pace of capital deployment and compensation mechanics.

Less "Forced Deployment" and Capital Overhang Risk

Closed-ended funds raise capital at the front end of the fund's life cycle and then are under internal and external pressure to quickly put the capital to work. This is likely to influence investment decisions for even the most disciplined of managers and can manifest itself in the form of more risky transactions with greater loss severity and ultimately lower yields. I should note that in speaking with allocators of capital, their single biggest concern after credit loss is intelligent deployment velocity, and they frequently recount instances where they committed capital that was extremely slow to deploy.

"…open-ended funds raise capital on a continuum and can manage the pace at which new commitments are sought and accepted."

By contrast, open-ended funds raise capital on a continuum and can manage the pace at which new commitments are sought and accepted. As a result, in periods where suitable investments are difficult to secure, the manager can slow down marketing efforts and their entire team lives or dies by the results of their prior credit decisions. Now that's a "collective" focus!

Compensation on Realization

In comparing closed-ended funds to traditional open-ended structures, and with regard to the payment of incentive compensation, closed-ended funds appear to hold an advantage for the LP. In closed-ended structures, performance fees are generally paid after the majority of the portfolio has been realized, whereas some open-ended funds (think hedge funds) are paid on "marked" unrealized appreciation. Managers may argue that this is a fair tradeoff given the greater liquidity of hedge funds, but this does not hold true for CRE debt funds given the generally illiquid holdings (despite the existence of a viable secondary market for CRE debt positions). The simple fix to this issue is the modification of the open-ended structure to require that performance fees are only paid on realized distributions to LPs and subject to achievement of minimum hurdle requirements in the subject "compensation year". Such modification, in combination with a high integrity valuation process designed to identify and incorporate impairments, protects LPs from compensating managers on performing transactions while the credit quality of other assets in the portfolio is eroding.

Market Presence Continuity

Another advantage related to successfully attracting creditworthy, fairly-priced, transaction flow is continuous market presence. Debt investments are sourced primarily through the mortgage banking community and large real estate owners. "Mezzanine" positions are often sourced through CMBS and other lenders which control the first mortgage lending opportunity. In each of these cases, market participants are continually in the market and, without question, cultivate relationships with reliable, ever present sources of capital. Managers that invest through a series of closed-ended funds, must compensate for the disruption of their market presence during the completion of investment activity for the previous fund and the raising of capital for the next fund.

With the advent of CMBS in the early 90s, capital market's culture materially changed the CRE lending business. Unlike equity investment, debt investment is a high velocity process where the best deals are circulated to "first call" relationships and sometimes awarded within hours, subject to a predictable due diligence and documentation process. If a participant is not continuously present and earnestly transacting in the market, staying on the "first call" list becomes difficult.

While, as demonstrated, not impossible, managing market presence for a series of closed-end structures is far more disjointed than the mission of an open-ended fund designed to exist on a continuum. This is without even contemplating the reality that the next fund's investment mandate may change due to the preference of a new investor or perception of near-to-medium term opportunities (think for example, a new large LP that does not want hospitality exposure). To the sourcing community being marketed a fund's lending program, this "no hotels" mandate modification comes across as a disruptive product offering change.

Flexibility on Investment Term and Enhanced & Dynamic Diversification

Because open-ended funds redeploy capital upon loan maturity, they have an inherent advantage over closed-ended funds that are dissuaded from both very short and very long- term investments. *Commercial Mortgage Alert* publishes an annual "High Yield" lender survey. While difficult to precisely ascertain due to limited reported information regarding fund investment mandates, of the capital raised by closed-ended, "U.S. only" debt funds roughly 75% is targeted for mid-term or liquid investments (think bridge loans, development, distressed loans and structured B pieces). At first glance one might assume this is to achieve higher yields, but based on the reported targeted yields this is not the case on a risk adjusted and often absolute basis. The more likely reason for this is that

three- to five-year investment terms fit neatly into the five-year GP compensation format, as opposed to putting money to work for less than three years and giving it back to LPs, or waiting 10 years to get paid incentive compensation. Whatever the case, the flexibility that open-ended funds have around term, allows them to pursue the most attractive risk reward investment profiles without "investment term" driven constraints.

"For an open-ended fund…diversification constantly improves and the manager can dynamically rebalance the portfolio…"

In the comparison of open vs. closed, the topic of portfolio diversification is a simple conversation. Assume, based again on *Commercial Mortgage Alert,* that the average closed-end, U.S. only CRE debt fund is $500M in size. Further assume an average size loan of $20M (remember that we are speaking only about the subordinate "High Yield" portion of the capital stack). This means that the typical closed-ended debt fund holds 25 investments, on average representing just over 4% of the entire portfolio. This is perhaps a bit high, but within a reasonable range for diversification. For an open-ended fund, as the fund grows, diversification is constantly improving, and the manager can dynamically rebalance the portfolio across geographic, property type, and demand generator concentrations, or even "throttle back" deployment based on market conditions and cycle timing.

Enhanced Liquidity

Closed-ended funds do not generally contemplate periodic liquidity. Open-ended funds do contemplate periodic liquidity; however, it is generally subject to constraints related to available cash levels. This "available cash" constraint is structural in nature and is designed to eliminate the risk that redemptions can force liquidations into "fire sale" results. Again, this is part of the fund's intended design and is not subject to a decision to "gate" LPs by the manager. Further, available cash should include new capital raised, as it is unfair for a manager to grow their platform while certain LPs are in the redemption queue. Properly structured, liquidity for an open-ended fund, best case is immediate, base case is quarterly as new capital is raised, and worst case (in periods of complete market dislocation) is upon the sequential maturity/payoff of the portfolio investments.

Time & Resources to Minimize Loss Severity on Defaulted Loans

There are both psychological and practical realities associated with recovering the underlying collateral for a commercial real estate loan and minimizing loss severity. Historically, embedded in the mindset of borrowers was an underlying belief that their lenders were less than willing (or perhaps prepared) to foreclose on their property and therefore were motivated to do everything possible in "workout" solutions. Assume a borrower knows that their lender is a closed-ended fund coming to the end of its lifecycle. Further assume that their property is slightly over leveraged and will have trouble refinancing at maturity. If this loan is the last in the fund's portfolio, a protracted foreclosure repositioning and sale will take months, if not years, and may hold up the realization of 5 years' worth of carried interest for the entire management team. What are the chances that the borrower doesn't consider exploiting this? More importantly, what are the chances the Fund manager doesn't consider some concession?

Now consider an open-ended fund manager. While a default should impact returns if properly marked as an impairment, it would not necessarily delay the realization of earned annual incentive compensation on the overall portfolio. Further, the open-ended fund has revolving capital via new commitments and loan maturities, which can be utilized to address cash needs or recover and reposition underlying collateral. In fact, this process is quite naturally anticipated by the open-ended structure. In closed-ended funds, while mechanically permitted, managers may be less motivated to make a late stage capital call to infuse new capital into a distressed asset. These fund structure realities are not lost on the borrower. Many borrowers understand that the open-ended manager has both time and revolving resources with which to address defaults and thus may be far less likely to manage down recovery perceptions, posture or negotiate.

The Next Evolution of CRE Finance

In closing, a few words on the future. Dodd Frank and risk retention set the stage for the shift away from CMBS lending to fund based lending. Accordingly, in our very first investment thesis presentation dated November 2016, we predicted that the investment bank role in CRE finance would be narrowed to bond distribution. As is frequently the case with market disruptions, the convergence of two advancements, as opposed to the occurrence of one, acts as the catalyst. The evolving comfort with CLO structures, particularly the recent proliferation of "managed" vs "static" collateral pools, is the crucial second element. The next evolutionary step may well be the acceptance of an evergreen and expandable CLO (the "ECLO") where capital, and bond issuance, is issued on a continuum. A manager, of what I refer to as the ECLO, would be able to originate loans on an ongoing basis and subject to certain eligibility criteria, periodically issue bonds. This will eliminate the need to aggregate loans in a chunky capital-intensive fashion for securitization. Instead, loans will be originated and contributed on an efficient flow basis, the most important end result of which should be a lower cost of capital for consumers of such capital – i.e., borrowers. As soon as the market takes this step, it will be realized that open-ended funds are quite well positioned as the CLO equity. Finally, and in the true spirit of risk retention (the basic premise of which I happen to agree with), fund-based lenders will hold the hot potatoes they bake until maturity, and harvest (or not) the fruits of their credit practices.

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