CAPITAL IDEAS

JESSICA POTHERING REPORTS ON LAUNCHING A NEW FUND IN TODAY'S MARKET

When Brian Malliet launched BKM Capital Partners to raise his first independent first real estate fund management business in 2013, it seemed like the fundraising environment was not on his side.

Close to 450 private real estate funds were actively raising capital at the time and in spite of a more successful fundraising year by dollar amount, the number of funds that successfully reached their targets by year-end had dropped dramatically from the year before. Investor capital was becoming more concentrated among a smaller number of experienced managers: only 7% of all the real estate capital raised in 2013 went to new fund managers, compared to the 45% that went to managers who had raised at least nine funds in the past. It seemed the chances of success would be slim.

Malliet, a 25-year industry veteran, spent most of his career with Voit Real Estate Services, dedicating 13 years to the brokerage side of the business then moving into development, and eventually into asset management and operation as co-owner of the platform. In all, he has raised and invested more than $850 million in industrial properties over his career. Malliet felt he had what investors value most in a fund manager – track record – he just had to prove it.

Two years on, BKM – a boutique industrial real estate fund management firm – has invested $95 million in five properties covering close to one million square feet, which BKM expects will generate a 20% internal rate of return. It is in the midst of raising a $200-300 million fund. The company said it is in advanced stages of negotiation with investors for about half that amount, and aims to reach its first close this summer and fully close before year end.

Getting to this stage, Malliet has spent a lot of time doing his homework. He knew new funds do not happen overnight; rather, some take years beyond the average 18 months of fundraising to close, while most do not close at all. Constructing a precise strategy was a critical first step – next would be proving it.

For two years, Malliet aggressively worked the conference circuit, trying to understand investors' real estate mindset and studying which funds were successful and why others were not. He subscribed to all of the industry trade publications, following new fund launches, their strategies and who was appointed to their boards.

"What I saw as a commonality among successful funds was a niche-focused strategy. A lot of the new ones that didn't get funded were generalist funds and were competing with the big guys. I knew first time funds have to be niche," Malliet explained. BKM is very niche: multi-tenant industrial business parks in the Western United States.

With Voit, Malliet spent over three years in the downturn helping the firm manage its existing portfolio and watching the market for signs of recovery. When he finally decided to go out on his own in 2013, he felt the fundamentals in the multi-tenant industrial sector were starting to turn. But rather than shooting straight for a traditional new fund approach of developing an investment thesis and taking it to market, Malliet and his partner Nima Taghavi took a page from the Silicon Valley tech-start up scene and decided to prove their strategy by seeding the company themselves.

"We did it backwards. We funded a 'startup' company with a couple million dollars from our GP's, we raised a friends and family round, we spent time proving that the niche product opportunity was there and that it could be scaled. We put an execution team in place, put an impressive board together," – which includes former ceo of Morgan Stanley John Mack, and Jeff Gehl, managing director of private equity fund of funds manger RCP Advisors. "A year after we launched the company, we started buying value-added assets," Malliet recalled.

"We had decided it's not if we can do this, but when we can get this done. The message to future investors was that we are going ahead in any case."

Demonstrating pipeline is important for new fund managers because unlike 2005-2007 when it was much easier for new funds to raise capital, investors remain cautious since the downturn and see new funds as exceedingly high risk today, according to Nancy Lashine, managing partner of Park Madison Partners, a placement agency based in New York. Indeed, more than

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60% of institutional investors say they will not invest in new funds outright, according to data firm Preqin's latest investor survey.

"We strongly advise new funds and potential funds to have assets already in their portfolio or lined up before marketing their funds. It sends a whole different message to investors. It says the fund is live and they can get deals done," Lashine explained. It also gives investors something too look at – a chance to tangibly understand they kinds of assets a manager is targeting and how their underwriting works.

Even with a ready portfolio and demonstrated pipeline, raising a fund is an uphill battle for most new managers. There has been a clear trend since the downturn of investors narrowing the range of fund managers they work with, choosing to commit more capital to a smaller number of large managers, rather than spreading their allocations across a wider pool. Roughly a third of institutional investors plan to invest in only one real estate fund in 2015, according to Preqin's latest investor survey, while an additional 30% intend to invest in two only.

"Just choosing a small corner of the market is not a guarantee," said Paul Murphy, director of private funds with EY's Real Estate Corporate Finance group. "Successful new fund managers should focus on a niche, but they have to be able to prove that niche is scalable, and that they can get deals done in order to attract institutional capital."

First quarter fund raising data makes no mystery of who is winning the lion's share of real estate commitments: global platforms. Blackstone Group's broke its own record for the largest private fund ever raised in March, raking in $14.5 billion at lightning speed – reportedly less than four months after launch – shredding the industry average of 18 months. The fund amounted to exactly 50% of the total commercial real estate capital raised across the private fund sector for 2015's first quarter. Starwood Capital and CIM Group's new funds accounted for an additional $8 billion for the quarter, while the other 21 funds that successfully closed by March 31 added up to only 25% of the total.

"It's almost a buyers market for investors. The fundraising market is very crowded – investors can pretty much pick and choose who they want to work with and where to put their capital," explained Lashine. "And when you're running a large portfolio, adding a new fund may not be the most important thing you have to do."

For Malliet and his team, it was understood that strong relationships would be the other key to success. For this reason, the young company spent a year carefully building its board and identifying a placement agent – Mercury Capital Advisors – to help BKM efficiently execute a formal fundraising plan and get in front of investors. While Malliet is confident that a first close is imminent, it has nevertheless taken upwards of 50 investor meetings to get to this point.

"For those who have decided not to invest with us, the main reason they give is that they are not a first closer in a new fund," Malliet explains. Some appear to be interested in testing the waters via a separate account agreement, which Malliet believes could translate to future fund investments.

Yet, while running a fund and separate accounts concurrently may be a necessary step to kick into the fund management space as a new manager, it is not a long-term goal to engage in multiple investment strategies.

"When we started, the goal was to have a fund strategy built around an operator model because it is the most effective way to put capital to work and get involved in the real estate. It's important to investors that managers have a laser-focused strategy. We are committed to a niche, so we have to stay narrow," Malliet concluded.