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Small but mighty: How emerging managers navigate the COVID-19 environment

BY ANDREA ZANDER

Investors and consultants continually look for new talent with innovative ideas and long-term, successful, diverse strategies. And they are increasingly recognizing the benefits of partnering with small and diverse emerging managers, and launching emerging-manager programs.

Emerging managers are highly motivated to perform well for their investors. And emerging-manager programs or partnerships have achieved goals by attaining proposed target returns, providing investment strategy diversity and offering improved alignment of interest.

The spread of COVID-19 and current events have made investors uneasy, especially regarding investing new capital outside current investments. Are these emerging-manager programs finding it harder to develop new business against bigger household names — especially given the challenges around in-person meetings and due diligence? Or is having the reputation of being a “smaller firm” benefiting investors during these times of uncertainty?

Small, but highly motivated

Many emerging-manager platforms are designed to explore opportunities to drive alpha with managers that need to prove their credibility in the institutional community, utilize market inefficiencies and establish their track records. And these smaller emerging-manager partners tend to outperform their larger counterparts.

“The premise is that an emerging manager is completely unburdened by distractions associated with being part of a larger, and perhaps multi-missioned, platform — that their business is purely focused on an investment thesis and the core elements required to execute on it. As a result, performance is stronger,” confirms Frank Scavone, a managing partner at New York City–based Trawler Capital Management.

Scavone continues, “You need seed investment capital. Then you need to access appropriate investments within the context of your mandate. To consistently deliver strong performance through market cycles, you’ll need to employ a set of underwriting methodologies and processes designed to affect good judgment. Then you need to constantly measure the performance of the assets at the base collateral level. This last step allows you to best preempt any performance problems, as well as provide robust and timely reporting to your investor base. From there, it is somewhat self-fulfilling. Do all of this well, tell your story, establish trust, and you will ultimately be rewarded with more capital.”

For investors, diversity, equity and inclusion are of increasing importance and focus. Both parties benefit from loyalty and additional transparency, which bode well for the longevity of the relationships.

“We believe that many investors who engage in the emerging-manager space are seeking to access a universe of investments that larger institutions, like many pension funds, typically do not have the internal resources to source and manage,” says Maria Stamolis, a co-head of real estate investments and director of asset management at Canyon Partners Real Estate. “Canyon’s emerging-manager program seeks to identify high-performing emerging managers with specific product-type expertise in targeted geographies; compile a diversified portfolio of assets for our investor; and create a supportive ecosystem for emerging managers via long-term programmatic partnerships, Canyon’s customized mentorship, and peer engagement. The ultimate measure of success for our program is whether we have supported the development of fiduciary-minded investors with the capability of managing institutional capital independently.”

The Canyon Catalyst program has been highly successful not only from the perspective of portfolio performance, but also in terms of emerging-manager growth and development. Canyon’s Catalyst platform has grown from $200 million at its inception to $1.4 billion. Its emerging-manager partners have increased headcount by more than two times, on average, throughout the life of the partnership.

“This growth has resulted in one of our emerging-manager partners successfully raising institutional capital directly — the ultimate measure of success to us, given how much time and effort we spend on helping these businesses evolve,” says Stamolis.

Artemis Real Estate Partners, one of the first and largest majority women-owned real estate private equity firms in the United States, has been building what is now a nearly $3 billion business investing with diverse and emerging managers. Since inception, more than half of the firm’s investments, across the risk spectrum, have been made with emerging and diverse operating partners.

The firm was inspired to create the Artemis Emerging Manager program. Even today, of nearly 1,000 real estate firms in the industry, women-owned firms manage only 0.8 percent of assets, and minority-owned firms manage 1.2 percent. Raising Artemis Fund I took two years and 225 meetings to secure 11 investors, and only one public pension plan emerging-manager program invested in the final closing.

“It was evident how challenging the process would be for firms that did not have a realized fund track record, nor the significant seed equity required to build out their team and invest the meaningful GP capital commitment expected," says Gina Baker Chambers, a principal and portfolio manager at Artemis. "That was the impetus for its emerging-manager program with New York Common, a core-plus programmatic joint venture program for diverse and emerging operating partners. That program was designed to open the door to a universe of highly qualified, diverse, and emerging firms, many of which did not have access to institutional capital. They have partnered with 28 emerging and diverse firms in our core-plus emerging-manager program."

COVID can't stop me

One benefit of being a small firm is the ability to pivot quickly and efficiently amid the COVID-19 pandemic.

"The challenges are no different for emerging managers than they are for established managers — real estate is a physical asset, and seeing assets cannot be replaced by technology, regardless of how inventive it is. Digesting and reacting to the constantly changing market dynamics are a challenge for everyone. But the drive and resourcefulness we see exhibited by our emerging-manager partners is very encouraging, and we believe they have what it takes to manage through this with our guidance," says Vernon Chin, a managing director at Canyon Partners Real Estate.

Chin continues, "We have certainly seen this anecdotally translate into a preference for known quantities and incumbent managers, which of course is an added hurdle for emerging managers. But emerging managers often focus on a less-trafficked subset of the market, and those with the right capabilities can still attract capital. We have spent extra time and effort as part of our mentorship program on the capital raising and due diligence process this year, given COVID-19-related challenges."

Many emerging-manager partner firms have not slowed down in seeking and evaluating emerging-manager relationships, and although property tours take longer, they are happening.

"On the investments front, once an investment is in late-stage diligence or post closing, we are performing our own site visits, like we normally do, but have invited certain investors to participate via Zoom in the form of virtual guided property tours," says Nicolas Ibanez, president and co-founder of Drake Real Estate Partners, a minority-owned, value-add real estate manager that targets undervalued assets in high-growth secondary U.S. markets — typically niche, "under the radar" opportunities.

Overall, virtual due diligence will be more prevalent, and investors may need to rely on consultants or placement agents more heavily for internal and operational due diligence. "Specific to fundraising, strong capital introduction and fund placement counterparties are more important than ever to bridge the initial trust gap created by virtual-only meetings," says Ibanez.

The markets have changed, and tech adaption may never be able to replicate the benefits of meeting face-to-face.

"It's possible that you can underwrite investments from your living room, but in order to truly understand how a property compares to the other space options in that submarket, you need boots on the ground. Also, markets have changed. You do not know Madison Avenue retail if you haven't walked down Madison Avenue in the past three months," explains Scavone.

Alliance Global Advisors is a women-owned business launched in April 2020 that partners with investment-management organizations to provide an independent perspective on strategic planning, business and operations, so executive-management teams can focus on what matters most: diligently managing client capital, creating value and delivering exceptional returns in a performance-driven market.

The firm's leadership has spoken with several limited partners regarding the topic of emerging managers. "We found that many investors are looking forward to face-to-face interactions once travel restrictions subside; however, investors also recognize the importance of embracing technology as a useful tool to stay connected to managers," says Jennifer Stevens, co-founder and managing partner of Alliance Global Advisors.

Emerging-manager programs will continue to deliver through the crisis.

“We believe that investors who have thought about diversifying their portfolios should take the opportunity to do so now. Access to capital for diverse and emerging firms is transformational, and those investors who step up can truly be force multipliers for performance and purpose. We believe it is more important now than ever to accelerate the growth of diverse and emerging firms in our industry and give them the opportunity to perform. Our support of diverse and emerging operating partners remains cycle agnostic, and we will continue to seek to be their capital provider of choice,” says Chambers.

Emerging managers are still trying to establish themselves with new investors. It continues to be a challenge that, when committing new capital during the current crisis, most investors have stuck to follow-on commitments with existing managers.

“Overall, we believe this is a more difficult fundraising climate for all managers — and for emerging managers, in particular,” says Ibanez. “Investors have voiced their opinion since March that follow-on and re-up investments are the favorable play at the moment. Nonetheless, we believe there is a place for emerging managers in the current environment, especially those with a niche focus. If an emerging manager can articulate this niche, combined with their ability and ‘edge’ in execution, this post-pandemic period is certainly an opportunity to highlight a more differentiated, hands-on approach to investing.”

Given the difficulties accessing capital without face-to-face meetings, emerging managers should be laying the groundwork now and preparing for a post-COVID environment.

Scavone adds, “Our priority is to remain highly focused on the investments in our portfolio while watching the world unfold. As part of our portfolio risk-management framework, we constructed a quarterly COVID-19 impact assessment designed to measure property operations, borrower staying power and downside protection. In the event we need to navigate bigger seas, we are running a liquidity protocol of approximately 56 percent. Thankfully, our credit processes seem to have served us well, but we believe we are well prepared to protect our investments. If all continues to go well, we will deploy that capital offensively into post-pandemic opportunities."

Investors have taken this time to focus on their current portfolios and mitigate additional long-term risk factors. As we enter fourth quarter 2020, many investors are meeting with new managers virtually. Still, the consensus is investors prefer to wait until they can meet in person to actually commit capital to a new manager, says Heather Fernstrom Border, co-founder and managing partner of Alliance Global Advisors.

"Despite the disruptive operating environment, we believe our diverse and emerging manager program will continue to perform, specifically because we seek to partner with top-quality, local product experts that we believe can be nimble and responsive," says Chambers. "Our partners are still bringing us deal flow, and we have continued to invest in assets that are squarely on-strategy. Investor interest in the program has accelerated, which we hope is a sign of a broader realization among investors and asset managers that support for diverse firms is an urgent industry imperative."

Chambers continues, "As for emerging managers seeking new investors, I would not be surprised to hear that this crisis rhymes with previous downturns. Artemis was founded at the bottom of the great financial crisis, and we saw firsthand how challenging raising capital can be amidst crisis before confidence has returned, particularly discretionary, commingled fund capital. What is different today is the existence of programs like ours that have the capital, the mandate, and that are actively evaluating new opportunities. We continue to believe that diverse and emerging managers will not only deliver risk-adjusted returns, but we believe that they may generate outperformance at the bottom of the cycle."

Smaller firm, bigger picture

This is not an easy time to invest, but many can express a sense of accomplishment for navigating through this year.

"We're not going to change our investment strategy at all. We are going to remain in lower-risk positions and use the performance of our portfolio to win the trust of new limited partners and grow our business," says Scavone. "I am very proud that we didn't have to lay anybody off, and everyone stayed busy on pre-emptive asset-management activities the past six months. Everyone on the team feels a great sense of accomplishment and purpose in navigating the challenges of 2020, and as a result, we are closer knit and better investors because of it. 2020 was hard, and I certainly feel older, but there were many unexpected blessings."

"Our new and existing investors have proven their resiliency through the pandemic; while investors overall were hesitant to make drastic moves earlier this year, they have refined their approach in response to the pandemic and — we believe — have put a finer point on their allocation processes by evaluating not only the historical track record of new managers, but also the 'fit' of the manager's strategy with the opportunity set," says David Cotterman, co-founder and CIO of Drake Real Estate Partners. "This fit, we believe, has been evidenced in the $220 million–plus commitments we have received toward our second institutional fund, comprised of approximately 40 percent new investors."

And this period may offer the industry the opportunity to foster even better practices.

"At Alliance, our No. 1 priority is enhancing best practices throughout our community. We believe this current environment creates an opportunity for managers to become better versions of themselves by offering unique and innovative strategies, services and execution avenues for investors," says Stevens. "Alliance will continue to work alongside motivated leaders to improve strategy, enhance operations, and accelerate business and product development initiatives. In 2021, we will help managers focus on important areas, such as reporting, succession planning, terms and conditions, ESG and DEI, all while leveraging third-party educational tools and providing professional development opportunities for our partners."

Artemis' goal is to achieve attractive risk-adjusted performance, and to facilitate transformational access to capital for emerging and diverse firms. "We will continue to implement defensive and proactive asset management across our existing portfolio. For new acquisitions, we learned coming out of the great financial crisis that core and core-plus investments can outperform at the bottom of the cycle, in our view, and we believe those opportunities will re-emerge in the post-COVID environment for our core-plus emerging-manager capital," says Chambers. "Additionally, in 2021 we remain committed to facilitating transformational access to capital for both diverse and emerging managers during a market-cycle correction. We consider it a privilege to do our part to widen the circle of opportunity, and a responsibility to share our experience navigating periods of economic disruption."

Canyon expressed the same motivation for finding more opportunities next year. "We expect to manage our portfolio with creativity and flexibility in mind, while seeking to identify new opportunities that may come from the current market dislocation. We expect to continue investing new capital opportunistically in value-add real estate opportunities in the western markets of California, Phoenix, Portland, Seattle and Denver," said Stamolis.

Emerging-manager partners are living up to their large reputations.

Andrea Zander is web content editor of Institutional Real Estate, Inc.