

Generalists vs. specialists

While vertically integrated operators do not grab the same headlines and attention as do large, diversified generalist allocators, these sector specialists offer investors depth of knowledge, nimbleness and consistency.

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Which of the following characterizations would sound more appealing to an investor: ‘a mile wide and an inch deep’ or ‘an inch wide and a mile deep?’ The answer is not always obvious. Specialization has clear advantages and benefits. Some people put all their eggs into one basket, striving to master a niche endeavor, dedicating all resources and energies to one narrow pursuit without distraction. Others choose to spread their efforts across numerous undertakings and pastimes, content to be good, but not great, in many areas.

Is it better to develop unmatched skills in a more obscure specialty (for example, an ace reliever in baseball, a celebrated pastry chef at fine dining restaurants, a beloved but typecast character actor), or is it preferable to be a five-tool player, a chef de cuisine or a leading man/woman, even if you never achieve the heights of your profession, such as the league MVP, a Michelin star or an Oscar? The specialist runs the risk of being pigeonholed, whereas the generalist may end up being a highly competent jack-of-all-trades, but master of none.

Two operational models

The real estate investment management business has evolved along similar lines. The jack-of-all-trades equivalent is the large, diversified allocator that offers investors exposure to multiple property types and geographies, usually benchmarked against a diversified index or peer returns. They outsource leasing, property management, development and value-add renovation work to third-party managers, agents and operators. They tend to be incubated within large private equity firms, investment banks, insurance companies or real estate brokerage companies.

The equivalent of the specialist is the vertically integrated operator which tends to focus on a single property type and controls all aspects of the real estate investment and asset management value chain in-house. They tend to have grown up as founder-driven private developers and operators, and tend to be as passionate about their chosen property type as they are knowledgeable.

Allocators have dominated the industry in terms of capital aggregation and are unlikely to relinquish that crown anytime soon. The best of the class have





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demonstrated over time that they have the market wisdom to make smart portfolio bets across a variety of property types and geographies, and the ability to skillfully underwrite, structure and finance transactions at the highest level. Theoretically, they have the flexibility to shift exposures between sectors at different points in the cycle, although that can sometimes prove challenging given the illiquidity of real assets and the tendency for market sentiment to shift in lockstep with economic trends.

With success and growth come the benefits of scale. The largest managers can be models of operational and financial efficiency, especially those that delegate much of the portfolio management, asset management and/or development management activities to operating partners. With no need to directly employ thousands of leasing agents, property managers, designers, architects, procurement officers and construction specialists, these firms can operate with AUM and revenue per head ratios that would make any operator jealous. Scale also can afford the ability to invest meaningfully in state-of-the-art support functions such as ESG teams,

data scientists and engineers, research groups, capital raising and marketing teams, and legal and compliance groups.

The rise of the operator

'If you want it done right, do it yourself' would be an apt mantra for many of the operators in today's real estate investment management business. With vertically integrated firms, it is their own employees providing customer service as they interact directly with residents or tenants. It is both a blessing and a curse in that it is these employees designing and building space, providing maintenance services, setting rents and negotiating leases; there is no third party to blame for poor customer service, faulty execution, or underwhelming NOI or IRR performance. But, ultimately, there is the opportunity to implement true consistency and differentiation in branding, service and design across a portfolio.

Private developers and value-add managers typically grew up 'smiling and dialing' for capital to fund one-off projects from friends and family. When they reached some scale, they moved on to family offices and, subsequently, formed joint ventures (JV) with sophisticated institutional investors and generalist allocators looking to outsource expertise in their target property types. To allocators, operators bring deep levels of specific market knowledge and relationships in their chosen milieu, as well as granular execution capabilities that are nearly impossible to replicate in a generalist's platform.

Gradually, these operators grew weary of smiling and dialing and also saw that much of the fruits of their labors were generating attractive fee streams for their allocator JV partners.

This caused some to begin to try to go straight to the source and launch their own sector-specific funds. Some operators have succeeded greatly, but all have learned that along with the holy grail of fully discretionary, commingled fund capital comes new institutional requirements and challenges, ranging from registering with the Securities and Exchange Commission as investment advisers and complying with regulations, to learning to navigate the consultant and limited partner (LP) universes. Many new vertically integrated operators are now looking to institutionalize their organization and their capital base.

With challenges in recent years besetting the retail and then the office sectors — historically the two most heavily invested sectors for institutional investors — allocators in particular have sought enhanced deal flow from operators with 'boots on the ground' in chosen sectors, further spurring the rapid growth of residential and industrial operators with institutional fund offerings.

The investors' view

One of the tectonic shifts in the private real estate landscape that has happened in recent years is the 'barbellization' of investor appetites. This has led to increasingly large and diversified allocators at one end of the barbell and a new breed of increasingly institutionalized operator investment managers at the other end. Anecdotally, it has been said for some time that institutional investors preferred to invest either with category-killer generalist allocators or with smaller, focused, vertically integrated operators — theoretically leaving out smaller generalists.

Cortland's experience

In the multifamily sector in which we operate, having the luxury of being able to fully control our brand and the consistent roll out of resident-targeted technologies, community and amenity programs, as well as sustainability initiatives across a large portfolio, without relying on varying approaches and degrees of quality across a range of third parties cannot be overstated.

Returning to the 'inch wide, mile deep' analogy, being an operator focused on a sector — especially as we increase scale — affords firms such as ours a market presence, depth of knowledge and nimble execution capabilities that are hard to replicate. We believe we have a competitive advantage when we own and manage close to 50 apartment buildings in a single market, as Cortland does in Dallas-Fort Worth, and have a team of locally based investment, operations and construction professionals responsible for managing all of those assets, as well as sourcing and underwriting new value-add and core-plus acquisition opportunities.

As we have built proprietary rent growth models for every market we target and have intimate, first-hand local knowledge of the costs of operating and renovating assets, we believe that our integrated underwriting process allows us to underwrite any asset in our markets across the country with a high degree of granularity, precision and speed. Given the efficiency and the level of conviction around the assumptions that we input into any underwriting — not relying on the seller's, the selling broker's or even a partner's views — we have been able to find attractive investments at all points of the cycle, even staying very active during the early days of Covid-19.

We have also built a network of joint venture partners over the years, including many of the aforementioned who's who of the largest and most respected allocators, with whom we partner on complex development projects, large assets that strain our funds' concentrations to single assets or markets, or large portfolios or privatizations that are simply too big for a specialist to swallow. These partner relationships and the yin and yang of what they bring to the table across a consistent track record of successful investments demonstrate that, far from being polar opposites or rivals on the far ends of the barbell, allocators and operators are able to work harmoniously to deliver the best of what each model can provide to the full range of investors in the market today.

For decades, public REIT investors voted with their capital in preference of single property type, internally managed and vertically integrated real estate managers. They were skeptical that any manager could simultaneously be best in class at acquiring and managing office buildings, retail malls, residential communities and industrial warehouses.

The story on the private real estate fund manager side has been the exact

opposite, with the largest aggregators of capital having diverse portfolios worldwide. These juggernauts have benefitted from ever-increasing scale; balance sheet strength; institutional and retail capital distribution networks; and strategic relationships with banks, lawyers and other service providers. They have also attracted and developed some of the best intellectual capital in the industry, all leading to sustainably strong investment performance.

There will always be the need for generalist allocators with a bird's-eye view to provide all things to all people for their LPs. However, with increasing investor sophistication and willingness to choose sharpshooters in desired verticals, making specific commitments to these operators is one way investors can more actively manage their own property type and geographic exposure as they see fit.

Often, investing with specialists in the sectors that match investors' specific risk/return appetites is likely the only way to achieve an actual zero allocation to the sectors they wish to avoid. Such funds tend to appeal to the consultant community, which often finds, analyzes and recommends emerging managers with deep and specific expertise, instead of recommending diversified managers.

Given the increasing focus on fee leakage, it is also advantageous for investors to go directly with an operator and pay them market value-add fund or development fees, without the material additional layer of acquisition, asset management and/or incentive fees that an allocator must layer on top. Moreover, the laser focus of operators means they tend to have fewer allocation issues between overlapping capital sources, which can be a source of angst for some investors.

At the end of the day, what matters most is delivering returns to investors, and so it remains incumbent upon operator investment managers to fully capitalize on the competitive advantages and efficiencies that their specialization and focus affords them. ♦

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