The Impact of Real Estate Investment Manager Mergers

Growing industry concentration brings benefits and creates problems.

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In 1995, *Pensions & Investment* surveyed 84 real estate investment management firms that managed tax-exempt pension fund assets.[1] Only 11 had assets greater than $4 billion and 38 had assets greater than $1 billion. Over half of the firms had assets below $1 billion, which is the amount often considered the minimum for profitable operations in this industry.

Exhibit 1 shows the number of investment advisors managing tax-exempt assets, stratified by asset size, including debt and equity. By the measure of the value of assets, there is a high degree of concentration among a few managers. Some of the concentration is the by-product of internal growth within the successful firms. However, some concentration is the result of management firm mergers.

This article probes the concentration of large amounts of assets among a small number of investment management firms. It examines the forces bringing about this pattern, and the concerns that pension plan sponsors might have whenever a merger affects one of its managers. Finally, it explores what the near future might hold for investment management firms and how plan sponsors might respond as what was once a stable business relationship now becomes increasingly uncertain.

The Concentration of Activity in Relatively Few Firms

Pension plan sponsors are aware of the consolidation taking place among the managers of real assets. In 1994 in particular, some very large real estate managers merged. Examples are: Heitman and JMB Institutional, and LaSalle and ABKB. According to one knowledgeable observer,[2] there have been 25 mergers and acquisitions within real estate investment managers since 1989. He concedes that there may have been others that he failed to notice.

Although this activity concentrated larger amounts of assets within fewer managers, the only observations have been anecdotal. Because the data are imprecise and do not go back very far in time, it is impossible to specify how much concentration has taken place.

The current concentration graphically portrayed in Exhibit 2, which shows total value of real estate tax-exempt assets managed by the 84 managers in the latest *Pensions & Investment* survey. The managers are ranked by size. The graph shows two lines: the higher one is for all debt and equity assets and the lower line is for equity assets only. Because real estate debt controlled by real estate investment managers is such a small part of the overall business, the spread between the two lines is relatively small. However, because the amount of real estate debt actually is large relative to equity, it appears obvious that the pension plans either handle the bulk of securitized

[1] *Pensions & Investment*, October 2, 1995.

[2] Conversation with Geoffrey Dohrmann of the “Institutional Real Estate Letter.”

real estate debt directly or they assign that responsibility to other than those that *Pensions & Investment* considers to be the real estate investment advisory community.

Exhibit 3 focuses on the top 35 firms by size of managed assets. It measures for 1993, 1994, and 1995 the concentration of those assets in the top 10 and top 20 firms, tabulating the percent of the equity and the percent of the equity plus debt managed for tax-exempt institutions by firms in each of these categories. (Thirty-five firms were chosen to make possible comparisons in the next section to other industries that also have large numbers of participating firms.)

The top 10 real estate investment management firms account for nearly 60% of the tax-exempt assets of the largest 35 firms; the top 20 firms control better than 80% of tax-exempt assets of the largest 35 firms. Looking at equity-only assets , we find that concentration of assets in the top 10 and 20 firms is slightly higher in the three years surveyed, indicating that smaller firms control a slightly higher ratio of debt to equity assets than do larger firms.

Exhibit 4 plots the cumulative percentage of total tax-exempt real estate assets managed by all 84 real estate investment advisors in *P&I*'s 1995 survey against the rank order of the advisor in both the combined debt and equity and equity-only categories. Once again, there is somewhat more concentration among advisors when equity assets are the only yardstick. Thirty-eight of the 84 firms account for 90% of the combined debt and equity real estate assets managed; thirty-three of the 84 firms account for 90% of the equity-only real estate assets managed.

Comparisons to Other Business Sectors

The real estate investment management business was born in the mid-1970s and is therefore in its adolescence when it is compared to other domestic industries. Despite its relative youth, the real estate investment management business has become nearly as concentrated among a few firms as have older, more established industries that tend to concentration.

Exhibit 5 compares concentration in terms of total revenues. It compares the percentage concentration of the top 10 and 20 firms among the top 35 firms in various domestic industries reported by *Fortune Magazine*.[3] While this is a seemingly disparate collection of business sectors, the degree of concentration among the top firms is remarkably similar, especially among the top 20. If real estate investment management becomes as concentrated as other industries, the evidence suggests that more concentration might be in store for the top 10 firms rather than the next lowest tier.

The Forces That Encourage Mergers & Acquisitions

Mergers and acquisitions (M&A) of businesses have been going on for a long time. Because real estate investment management firms are relatively new forms of businesses, they do not have a long history of M&A activity, but the pace appears to be quickening. It is useful to examine the motivations behind the push toward consolidation.

The Profit Motive

The search for profits is an obvious cause of mergers, but that does not mean that all mergers are profitable. Small firms often indicate that their small size makes them nimble on their feet and quick to respond to both opportunity and danger. Had the shrew written a survival plan in the days of the dinosaur, it undoubtedly would have used a similar argument. But, all other things

[3] *Fortune Magazine*, May 15, 1995.

being equal, the simple truth is that being big is a superior strategy for long-term survival. It remains to be seen whether the shrew and its descendants will be as successful as the dinosaurs that ruled the earth for hundreds of millions of years.

Size , Resources, and Efficiency

Size brings resources of all kinds: people, capital assets, market share, clients, prestige, and expertise.

Economies of scale often drive mergers, and economies of scale often translate into having each person in the organization do more. The surviving entity typically either engages in personnel reductions or does a lot more with relatively few additional people. Real savings and efficiency result from elimination of duplicate activities, although the patterns of change depend on the specialties of the two firms and the locations and types of their assets, .

Generally, larger real estate investment management firms are vertically integrated. They are able to deal effectively with real estate assets throughout the investment life cycle and to produce a steady stream of information and direct personal contact that has become a trademark of real estate investment practice today.

Moreover, successful investment management requires more skills than merely acquisitions and asset management. The full-service real estate firms today must include the following services internally or through third parties: marketing, portfolio management, property management, client reporting, fund accounting, research, information technology, dispositions, risk management, engineering, legal, mortgage underwriting, and securities. The dominant firms have demonstrated a preference for taking in house as many of these services as possible.

Scale-Expanding Activity

A merger or acquisition can be “scale-expanding.” It can broaden the scope of investment services or capture new segments of the real estate investment business. For example, in three recent consolidations, the acquiring company added securities expertise that it otherwise would have had to be built from scratch. RREEF did so, by acquiring Kim G. Redding & Associates; Heitman, by merging with JMB Institutional; and LaSalle, by acquiring ABKB. Each of the acquiring firms took on the other firm’s publicly-traded securities business.

Scale-expanding activities permit advisory firms to gain market share quickly and efficiently in one or more of the “four quadrants” of investment (private equity, public equity, private debt, and public debt). Indeed, one firm has already declared that it is open for business in all six “quadrants!”

The Need for Research and Reporting Capacity

Some observers assert that plan sponsors discover that they must devote 80 to 90% of their time and attention to just the 5 to 10% of their investments that are in real estate. The essentially private nature of real estate investments causes pension plans to ask more questions and to demand more information about specific investments or fund holdings than they require when they deal with other investment types.

Additionally, plan sponsors, consultants, and academics have become extremely vocal, and clamor for more and more information. Because they are client-oriented and having survival instincts, investment management firms have responded by producing more and more information, competing with other managers’ research departments for recognition.

Consequently, investment managers have created full service organizations and have put in place sets of systems to respond in a timely manner to information requests. Sometimes these staffs are not fully engaged, but they must be available for a deluge of questions when the occasion arises.

The Need for Capital

Sometimes plan sponsors and consultants suggest their management companies to become co-investors as a mechanism for aligning the pecuniary interests of both parties. This might seem like a good idea, but it requires considerably more capital than most managers have available and, if these relationships become common, they would effectively preclude otherwise excellent managers from the participating in the investment management business.

To the extent that managers are persuaded to co-invest with plan sponsors, they need access to debt or equity capital. The most successful business entity for the purpose of financing new activities is the corporation. Few advisors today are organized as corporations, but it seams reasonable that, given these pressures, some firms will seek broader ownership, perhaps the corporate form, perhaps public listing on a major stock exchange or with publicly-traded debt.

The Concerns of the Plan Sponsor

The consolidation of two real estate investment management firms into a single organization is a significant event that affects the future business relations of the new entity. Plan sponsors that have business relations with the merged firms should ask questions and get answers before deciding whether to terminate or reaffirming those relationships . Following are some of the concerns that plan sponsors should address when their real estate advisor merges.

- Continuity of personal relationships;
- The effect on the plan sponsor's diversification plan;
- Disruptive effects, if any;
- Possible changes in strategic or tactical plans;
- Culture clashes; and
- Quality of the acquired firms.

The personal touch.

Some plans might conclude that after a merger, they will become smaller fish in the manager's bigger pond. Such plans have good reason to question whether the quality and quantity of service they have experienced will continue.

Is there a limit to the size to which an investment manager might grow beyond which service to its clients is impaired? Size is not the issue so much as organizational structure. Investment managers should be able create organizational structures that deliver proper attention to their clients regardless of the size of the particular manager.

The sponsor's diversification strategy.

Pension plan sponsors should react to mergers and acquisitions among advisory firms just like they react to any other substantial management changes within one of their advisors. A merger may matter a lot, a little, or not at all.

The use of a number of advisors to gain the benefits of diversification is prudent and advisable for all but the smallest pension plans. By combining the varying talents of different managers, a pension plan may reduce its overall portfolio risk. Diversification among managers recognizes the special skills needed in various aspects of the business that are difficult to find in any one manager. Mergers can upset this diversification strategy. Pension plans should therefore determine whether the merger of two of its managers or the absorption of one of its managers into another firm will impair the plan's manager-level diversification strategy.

Disruptive effects of a merger.

The most troubling aspects of a merger may not even be apparent to senior executives who negotiated the consolidation. Basic organizational structures, like communication systems that worked fine before the consolidation, might malfunction when new people are connected. Computers and software of two newly joined firms may not be compatible. Unfortunately, the typical MIS staff is not trained to integrate disparate systems. The complication of consolidating different systems must be factored into the time and capital budget of any merger.

More basic types of disruption are also possible. When a firm takes on additional debt or equity capital to acquire other firms, the financial burdens may adversely affect the strategy, tactics, or focus of the manager. Some debt or equity agreements impose controls on the borrower that could prove detrimental in an economic downturn. There have been some cases in which the lender or investor, to protect its interests, made changes in a management firm's operations, to the detriment of the manager's clients.

Possibility that the consolidated firm might change its strategic and tactical plans.

As a consolidated management team works through the changes that follow a merger, it may change the firm’s strategies or day-to-day operations substantially. The firm may gradually alter its stances or approach. Consequently, affected plan sponsors usually should wait a year or more before making any decision to terminate or reaffirm the relationship.

Culture clashes within the merged firm.

Sometimes the personalities of the personnel within the merged firms clash and talented people leave, disrupting the everyday business and adversely affecting investment performance. Plan sponsors should follow those changes and perhaps consider termination. Of course, corrective action is possible only if the plan sponsor has an option to cancel the relationship and, most important, if the plan sponsor can find an acceptable replacement manager within the asset class.

Quality of the acquired firms.

The plan sponsor may have had poor relations with one of the acquired or merged firms, and it may not wish to have the people, policies, or activities of that firm in its stable of investment managers. Indeed, the plan sponsor may have already rejected the acquired or merged advisor in a recent Request for Proposal (RFP).

On a positive note for investment managers, some plan sponsors stipulate that no more than a certain percentage of an advisor's asset base (say 20% to 25%) can be under the control or authority of a single client. Thus, the consolidation of two managers that have no or few common clients might diminish the proportion held by a single large client and enable the combined management firm to compete for business where it was previously excluded.

The Future of Management Firm Mergers

Merger activity is likely to continue as the real estate investment advisory business matures. This is a natural progression for successful industries in this country. Less successful firms are often into more successful ones, and the new entity seeks profits by doing more with the same capital and labor or by trimming the labor component with perhaps some additional increment of capital investment.

The firm being absorbed may have experienced declining fortunes in the months and years just prior to merger. Loss of major accounts, loss of key personnel, loss of profitability, lack of resources to compete, and failure to adapt or grow are all problems that have been evident in firms that have been swallowed by others.

Profit: The Cost of Staying in Business

As the number of small firms decreases, merger and acquisition activity will decline. Nonetheless, for the next five years, a merger pace of two or three per year appears likely. The economic incentives remain strong. Plan sponsors expect a high level of service from their real estate investment managers. As indicated previously, the requisite service takes money and administration that only the largest, best capitalized management firms can afford.

Earlier we cited the general rule that $1 billion in equity real estate assets under management is the minimum threshold for a full service investment advisor. This level of activity implies that the advisor earns annual revenues of $5 to $10 million. Given the reasonable assumption that the average professional earns $100,000 per year, the revenues would permit a company size of 50 to 100 professionals, enough staff to offer plan sponsors a broad range of services and to give the principals the profits to continue its activities.

Barriers to Entry

Concentration implies not only a climate favorable to mergers but the existence of barriers to entry. A substantial barrier to possible new entrants in the investment management business is articulated in another general rule. Big has a tendency to favor big, but it does not follow that small likes small. As pension plans grow, they have a tendency to favor investment managers that are similarly large and growing within their market segment.

Declining fees caused by lower property net incomes and values in the last few years and by active competition among managers for new business have affected the overall profitability of investment managers. These conditions also raise the barriers to entry by new firms and push the minimum amount of assets under management for economic break-even to ever higher level.

Plan Sponsor Preferences Are Changing

Continuing mergers have some negative implications. Following a merger of one of their real estate investment managers, plan sponsors experience feelings of uncertainty. A natural response to uncertainty is an effort to gain control of those events that are difficult, if not impossible, to predict. An earlier section discussed sponsor relationships with the merged entity. But sponsors may also decide to gain control by moving more of their real estate allocation to securitized forms of real estate. They may opt for liquidity and increased freedom of action to stay or to move on.

Conclusion

Recent consolidations in the institutional real estate investment management business have created a false impression that soon only a few large firms would remain. A comparison of real estate and other industries indicates that the degree of concentration among advisory firms is about the same as concentration in a wide range of industries, from financial services to food to manufacturing. Admittedly, the data are scarce, but the tendencies are clear.

The forces leading to consolidations are predominantly economic. As the industry expands and as clients' needs increase or delve into new areas, investment service providers must reach a certain size to cover a broader area with the same or improved service. This argues for increasing manager size, a wider range of professional specialties, and a larger capital base on which to fund these activities.

Experience has shown that consolidations are seldom painless or simple for the merging firms or their clients. Thus, plan sponsors are prudent to scrutinize the pros and cons of any consolidation among their investment service providers. Some consolidations may prove beneficial, but only careful analysis will determine the proper path for a plan sponsor to follow: whether to stay with the incumbent manager or to seek a new one.

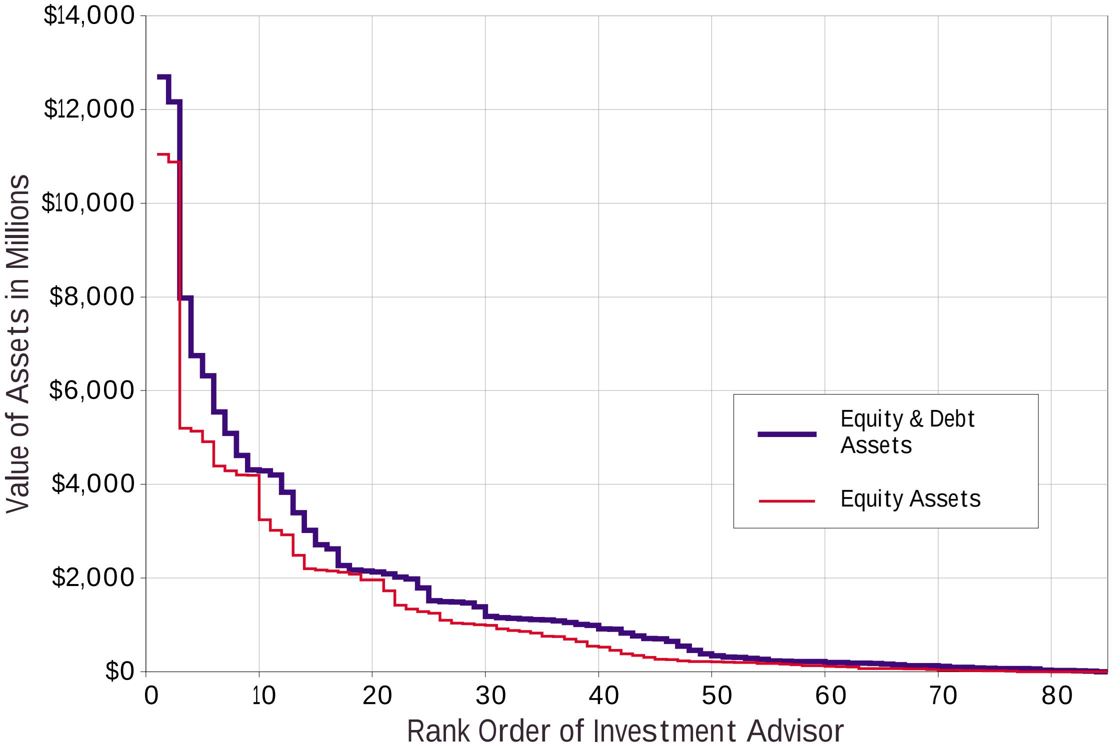
Exhibit 1

Investment Advisors by Amount of Tax-Exempt Assets Managed
June 1995

	Number	Cumulative
More than $10 billion	2	2
$5 to 10 billion	5	7
$4 to 5 billion	4	11
$3 to 4 billion	3	14
$2 to 3 billion	8	22
$1 to 2 billion	16	38
$500 million to $1 billion	9	47

Source: *Pensions & Investment*, October 2, 1995

Exhibit 2
Value of Tax-Exempt Real Estate Assets under Management
by Real Estate Investment Advisors — 1995



Source: Pensions & Investment, October 1995

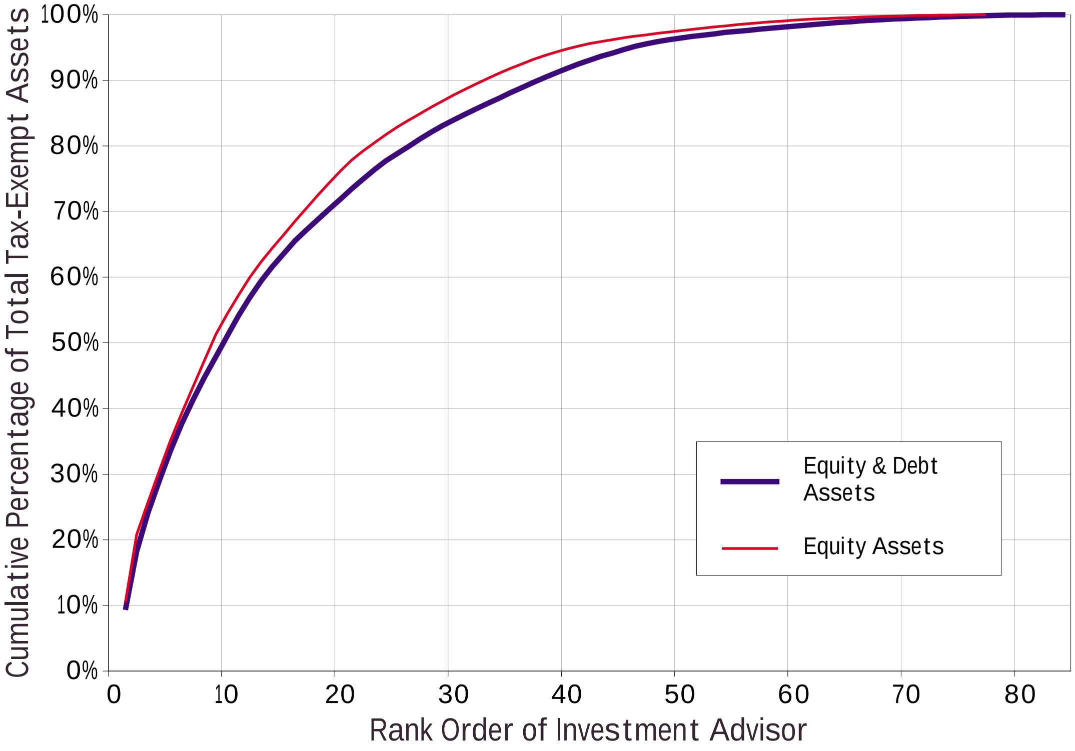
Exhibit 3

Concentration in Real Estate Investment Management
among Top 35 Firms Based on Tax-Exempt Assets

	Top 10 Firms	Top 20 Firms	Top 35 Firms
Equity and Debt Assets			
1995	58%	82%	100%
1994	54	81	100
1993	59	83	100
Equity Assets			
1995	59%	83%	100%
1994	60	84	100
1993	62	85	100

Source: *Pensions & Investment*

Exhibit 4
Cumulative Percentage of Total Tax-Exempt Real Estate Assets
Managed by Real Estate Investment Advisors — 1995



Source: Pensions & Investment, October 1995

Exhibit 5

Concentration in Domestic Industries
among Top 35 Firms Based on Revenues

	Top 10 Firms	Top 20 Firms
Commercial Banks	60%	82%
Electric & Gas Utilities	46	72
Electronics & Elec. Equip.	76	90
Food	69	91
Food & Drug Stores	68	87
Forest & Paper Products	65	89
Industrial & Farm Equip.	66	85
Insurance (Stock Companies)	63	84
Insurance (Mutual Companies)	77	92
Insurance (Stock & Mutual)	62	83
Specialist Retailers	61	84
Wholesalers	59	82

Source: *Fortune Magazine*, May 15, 1995