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The Texas Way

Armed with a 'premier list' of real estate fund managers, the private markets team of the Teacher Retirement System of Texas, led by Steve LeBlanc, spoke about its vision for the portfolio and how it could be even tougher to get through its doors in the future.

Posted - 03 Jun 2011 17:55 GMT CET
updated - 03 Jun 2011 18:05 GMT CET

Steve LeBlanc is not afraid to speak his mind. Whether it be a conversation about asset allocations, strategic investments, general partners or just about lunch, the head of the Teacher Retirement System of Texas' private markets group is absolutely clear about what he wants to achieve and how he needs to express himself in order to get there. It is due, he says, to the need for "clarity" in business as he helps the $110 billion pension plan become one of the most "efficient" institutional investors in the alternatives space. "Clarity," he argues, "equals productivity," and perhaps that is part of the reason why Texas Teachers is the top performing US pension plan with greater than $10 billion in total assets, according to the Wilshire Trust Universe Comparison Services.

Steve LeBlanc

LeBlanc, though, is by no means alone in speaking his mind. Even before arriving in Austin to interview LeBlanc and the private markets group of the Teacher Retirement System (TRS), *PERE* was told how forthright the team could be. We were not disappointed.

Eric Lang, managing director for real assets, stresses that institutional investors need to have "candid, honest conversations" with their general partners if the relationship is to truly work. "If you think it's a bad idea, say 'We think it's a bad idea and we're not going to invest,' instead of saying we'll think about it." This philosophy extends well beyond GP dealings, he says, adding: "We are very candid and upfront and believe in transparency and communication."

It would be fair to argue, therefore, that TRS' private markets group – with a total of $34.5 billion in assets, including $20.2 billion of private equity and real asset investments and an additional $14.3 billion of dry powder on hand – is not what you'd call "quiet money." Some professionals have suggested it has something to do with the Lone Star state's renowned attitude, which hails all the way back to Davy Crockett, Sam Houston and Texas' battle for independence from Mexico. Perhaps there is a hint of that, but it fails to explain the deliberateness in the way TRS and the private markets group approach investing and how the team has become one of the most influential LPs in the private equity and real estate arenas today.

LeBlanc, together with Lang and Rich Hall, who heads up the private market group's private equity and principal investments, call their method of investing "The Texas Way." At its heart is a "premier list" of private equity, real estate and real asset fund managers that TRS has pre-scrutinised and pre-certified as being top quartile – among the best in their class – and to whom the bulk of TRS' private markets capital will be allocated.
Still, the Texas Way is more than just a list. It also is a culture, a way of doing business and a way of executing an investment vision. As LeBlanc says: "It's all about execution. A vision without execution is just a hallucination."

By invitation
As a 27-year veteran of the public and private real estate markets, LeBlanc joined TRS in September 2008 as the pension plan was starting to significantly increase its exposure to alternatives. Under chief investment officer Britton Harris, who joined the pension in 2007, TRS moved from being a "sleepy Southern giant," as media reports at the time dubbed it, to one with a "bolder" investment thesis that sought to increase allocations to both private equity and real assets from roughly 3 percent each to 10 percent and 15 percent, respectively.

It was under this programme that the idea of a "premier list" of managers was first envisioned. The list was intended to focus TRS' attention on a narrow universe of top-quartile managers with whom the pension could have very deep, long-term relationships by formalising the selection, due diligence, review and investment process. Starting from a relatively low allocation to private equity and real estate, the list developed as TRS made commitments to commingled funds and joint ventures.

The Teacher Retirement System of Texas' private markets group

Working with consultants The Townsend Group, Hamilton Lane and Altius, TRS looked at the performance, track record, strategy and team composition of a "substantial" number of fund managers and how those GPs and their strategies fit into the pension's allocation models for each asset class. However, in producing a premier list of GPs, which includes private equity, real asset and other real asset managers, the pension also had to be more disciplined over who was – and was not – included, according to LeBlanc. It wasn't just a matter of finding the top-quartile managers that fit with TRS' own portfolio needs, but it also was about finding GPs that the pension could trust and build a future with, he says.

"The fact is, deeper, stronger relationships with your general partner make you a much better investor," adds LeBlanc. "First, we know exactly what that GP is thinking, how they look at things and what their analysis is, and they know exactly what we are trying to achieve in our portfolio and the returns and risks we are seeking." That meant TRS was looking for managers who would be with them not just over the life of one or two funds, but – depending on the execution of their strategy – managers who would be with them over the next 20, 30 or even 50 years and could put sizeable amounts of capital to work while being able to think outside the box when it comes to dealing with the public pension.

The list's primary benefit, of course, is trying to avoid what LeBlanc dubs the "Kabuki dance," where GPs spend their time trying to tell LPs how smart they are and LPs challenge GPs to prove it. "We've established those relationships already, and we don't have to go through this every time we look at a different investment," he says. "We've already established that we trust the GP, and we've established that the manager has a good team, that they have a good track record and that they know what they are doing in this space." Instead, the managers should be spending their time anticipating the future and looking for opportunities on behalf of TRS, he says.

That doesn't mean there's no movement on and off the premier list, or that TRS focuses solely on approved list managers to the exclusion of all others. Over the course of the past four years, a handful of managers have been removed – and new ones added – during the pension's semi-annual review of its managers and funds. LeBlanc cites a number of reasons for exclusion, including "lying, cheating or stealing," GP and fund performance, team turnover, the need for TRS to realign its own portfolio and "just because."

"There will be managers who don't perform because of the economic regime," says LeBlanc. "We are committed for the long term, and we'll stay with them and understand. But when a GP doesn't perform from an execution standpoint, when they have underperformed the market when their investment style should have done well, then we have to replace the GP." That process isn't entered into lightly, he adds. "Managers need to know we are committed to their success. We often give them the benefit of the doubt, but they know before us when they're not serving our public school employees."

Focused diversity
As would be expected, one of the most common questions LeBlanc, Lang and Hall get asked is: how do we get on the premier list? The selection process is in-depth, involving collaborative reviews with its consultants, investment screenings, strategy reviews, key man reference calls and track record reviews, but most importantly it's about TRS' own needs.

LeBlanc says one of the frustrations of being an LP is when GPs fail to understand their investors' portfolio needs. "You can have managers who have $1 billion or so of your dollars and if you ask them what the whole portfolio looks like, you get the deer-in-the-headlights look. I want to know how a GP's product fits into our portfolio and serves the need of Texas teachers."

The list, LeBlanc says, acts almost like a TRS pitchbook so that managers – both on and off the list – understand the portfolio. "Clarity equals productivity, and we want to make it efficient so we don't waste their time or ours," he explains. "We are saying this is exactly what we are looking for and asking them upfront how their product fits our needs."

LeBlanc concedes that, as the list has developed over the years, the movement of real estate managers on and off of it has declined. And, he notes, it could get even harder to get on the premier list in the future as the private markets group considers further narrowing the field of GPs to just 25 each for private equity and real assets.
In restricting its play list to an even smaller universe of fund managers, it can be argued that TRS is limiting the benefits of diversification within its portfolios. Not so according to LeBlanc. Arguing that most LPs are vastly over-diversified, he says "the ability to have such a deep level of understanding, communication and clarity outperforms the increased diversification."


Rich Hall

It is something Hall echoes, asking whether an LP needs exposure to all the largest global buyout funds in its portfolio. "These firms all fish from the same pond, so chances are you are going to get a trout. It might be one trout or another, but the type of deal, the size of the deal and the return streams you are going to get within that group of six or seven or 10 managers tend to be quite similar." An LP's job, he says, is about selecting the managers with whom you "have the highest conviction, the best relationships – the guys who really want to work with us and are excited to work with us – and where we as limited partners can add value."

As an example, LeBlanc notes that when TRS assessed its early private equity investments, it found it was invested in 70 percent of all M&A deals over $1 billion. "That's not very diverse, that's beta. If we keep that up, we are going to get market returns and we want above-market returns." Although real estate is somewhat different, allowing for greater specialisation and having fewer global allocators around today, the principle certainly carries over the asset classes.

The road ahead
After investing almost $5 billion in equity in real assets, including real estate, last year alone, TRS sees its principal investment activities as one of the most exciting means of deploying capital in the near term. The co-investments, or single LP and fund-of-two vehicles as TRS calls them, are done directly by the pension plan and led by Hall, although TRS also has two dedicated vehicles targeting co-investments run by LaSalle Investment Management and BlackRock. Principal investments are expected to grow to as much as 20 percent (or up to $5 billion) of the entire private markets portfolio, with investments presented by the premier list of managers expected to make up the majority of the deals.


Eric Lang

"The most attractive investments tend to be what we're seeing from our premier list managers," says Lang. He cites the pension plan's June 2009 acquisition of a portfolio of ProLogis properties as a case in point. Teaming up with a premier list manager, Stockbridge Real Estate Funds, TRS acquired 9.6 million square feet of core industrial space from the Denver-based developer and fund manager at a time when few GPs, let alone LPs, were doing deals. Investing $401 million of TRS equity in the single-LP vehicle, TLF Logisitics, the deal saw Stockbridge and TRS select 90 properties across 11 US markets from a wider offering, acquiring them at a roughly 30 percent discount to replacement cost.

Lang admits that, at the time of the deal, TRS was criticised for paying too much for the assets, in part because "no-one was doing anything and the world was still falling apart." The actual returns on the deal were 14.2 percent net, as of the end of March. In April, TRS made a follow-on investment with Stockbridge of $250 million into an unseeded venture, TLF Logistics II, which is expected to target core and highly-stable industrial assets in major US markets.

Hall says such co-investments offer TRS "deeper insights into managers" because the pension is working alongside them and seeing the underwriting. "We don't step in and try to be the GP – we're riding shot gun as opposed to driving the bus – but the principal investments allow us to add some tactical tilt to the portfolio where we see interesting opportunities," he adds.

Describing a recent co-investment targeting multifamily development, Hall talks about TRS' attempt to get exposure to the sector at a time when pricing for stabilised assets didn't make sense. "We needed exposure, but it was difficult to generate outsize returns [buying stabilised assets]," he says. "So we decided to go the other direction and support a development programme with a high-quality manager we know."

Of the 10 sites that TRS and the multifamily manager identified, eight are under construction and one is complete. "We are so far ahead of the vast majority of the market, that we will have those assets stablised and sold while others are still figuring out their money," adds Hall, who goes on to talk with equal fluency about TRS' investment in the 2010 recapitalisation of the bankrupt mall REIT, General Growth Properties (GGP).

And that, perhaps, is one of the surprising things when talking to Lang and Hall: the ability of the two to switch conversations about their respective asset classes and the closeness of the entire private markets team. "We are all in the same office together and have some of the same GPs, so it just makes good sense to integrate the two areas," says Lang, noting that the worlds of private equity and real estate often overlap, not least in the hospitality sector. "We are invested in one hotel business that is in both private equity and real estate funds, so it's important to keep the group together," he adds.

Ahead of the elephants
In getting its capital out into the market, there are two overriding issues for TRS' private market group: being ahead of the crowd and being able to shoot the "elephant."

In talking about TRS' investments in ProLogis and GGP, Lang and Hall continually stress the need to be significantly ahead of the masses, if not first. "[In core real estate today], there are 10 buyers for every transaction and we don't like that," says Lang. "We like to be one of a few buyers, finding something that has hair on it or something that people just don't understand."


(l to r) Rich Hall, Steve LeBlanc, Eric Lang

Trying to be first requires speed and flexibility, something that Hall argues GGP was a prime example of. After being on the losing side of the bidding to take over the troubled REIT with Simon Property Group and Paulson & Co, the pension plan sought to capitalise on its diligence and find a different avenue into the transaction. Unable to fit within Brookfield Asset Management's winning recapitalisation partnership, the TRS team approached GGP directly to offer up their equity. "Steve called the chief executive officer [Adam Metz] and said, 'We know the story, we like the story and can you help us find a way in'."

Within three weeks, TRS had negotiated and approved a $500 million investment in the REIT, subject to GGP's ability to source cheaper credit elsewhere. As GGP emerged from bankruptcy this past November and re-listed on the New York Stock Exchange, it ultimately scaled down TRS' investment to $250 million. The investment currently is valued at close to $400 million.

Despite the success of the deal, the GGP investment is expected to only boost returns in the group's REIT portfolio by 15 basis points. That is precisely why LeBlanc insists that TRS needs to "shoot elephants" – deals needing between $400 million and $1 billion of equity – and why there are no "slow maybes" from the team. "A GP would rather have a quick no for a very objective reason than a slow maybe, maybe, maybe," he says.

LeBlanc adds: "Keep in mind, it is our job to find managers to invest our capital, who have a good thought process and whom we trust. We make it known to those managers that, if they can get an elephant in their sights that needs a substantial amount of capital, needs someone to move quickly and will generate an above-market rate of return, we are there to talk about it."

Although it's not all about elephants, the size of the deal is a crucial consideration for the $110 billion pension fund. Eyeing minimum investments of $200 million in equity and looking for fund investments ideally between $200 million and $500 million, TRS must pass on many of the opportunities that come its way.

"A lot of people call us with ideas, and many of them are too small," says Hall. With a team of eight real asset and six private equity investment professionals, TRS "doesn't have the resources to evaluate every small investment that comes along," but the team is happy to "air-traffic control" interesting ideas to managers that do hold its money.

Lang adds that one co-investment opportunity, which is in the process of being signed off, resulted from such a deal. "One of our managers sourced an excellent principal investment, but we couldn't directly participate because of the small amount. So we referred them to another manager of ours and they ended up doing a deal."

That one deal is just a small example of why the premier list has become so important for TRS, according to LeBlanc. By selecting a narrow band of premier managers with which it invests the bulk of its capital, TRS benefits from much deeper relationships with its managers that allow the pension to generate the alpha it needs to stay in the "forever business" of providing pensions to the 1.3 million public and higher education employees and retirees in Texas, he explains.

"We have been very fortunate, and I give a lot of credit to being at the right place at the right time," says LeBlanc. But he adds: "We make our own luck. When the market is fearful, we want to invest, and when the market is not fearful, we will not invest. We want to be a leader in the industry, not a follower, and you will see us constantly being ahead of the curve."

Making the grade
The pension plan's premier list of managers includes some of the largest names in the private equity real estate business, as well as smaller niche players.

Perhaps it's no surprise that The Blackstone Group features prominently on the premier list of real asset managers at the Teacher Retirement System of Texas. Indeed, the $110 billion pension plan has invested in the firm's third European real estate fund, as well as its two global vehicles, Blackstone Real Estate Partners V and VI, according to pension documents.

Some of the other real estate specialists on the TRS premier list, however, may or may not be as obvious of a choice. Private real estate firms among the premier list real asset managers include: AMB Property; ARA Asset Management; Brockton Capital; the Carlyle Group; Colony Capital; Five Mile Capital Partners; Forum Partners; Iron Point Real Estate Partners; LaSalle Investment Management; PCCP; Principal Real Estate Investors; Prudential Real Estate Investors; Square Mile Capital Management; Thayer Lodging Group; Walton Street Capital; and Westbrook Partners.