A Conversation with Hawkeye Partners

Hawkeye Partners, a boutique real estate private equity firm based in Austin, Texas — has made a name for itself among institutional investors as a matchmaker of sorts. Through its first tailor-made investment program, Scout Fund I, the company works to facilitate relationships between institutional investors looking for new opportunities and new managers looking to earn their stripes among the major players. ***Claudia Faust*** *and* ***Scott McArtor****, co-founders and managing partners of Hawkeye, recently spoke with* The Institutional Real Estate Letter *editor* **Rachel Speirs,** *about their company, their services for investors and their outlook on the market.*

Hawkeye's Scout Fund I raised approximately $700 million from institutional investors. Can you tell me about the program and its goals?

Scott McArtor: Our company was founded to creatively meet the underserved needs of large institutional investors, predominantly state plans and sovereign wealth funds. Our first investment program, Scout Fund I, was created on behalf of eight of our large institutional relationships. The mandate is to source, underwrite and incubate the next generation of real estate investment managers that can work directly with our large investors.

What investment styles do you look for?

McArtor: Scout is a talent-driven program that looks at all investment styles and product types. However, our initial focus has been predominantly on groups that currently execute value-added and opportunistic strategies. Our belief is that many of these groups will be able to migrate over time to invest across the whole risk spectrum with the support of our investors and Hawkeye.

Our first two managers invest in what we view as defensive sectors, multifamily and industrial. Phoenix-based Alliance Residential is one of the largest multifamily developers in the country with an extremely strong and cycle-tested management team. And the second is Panattoni Development Co., which is arguably the largest and most successful private industrial developer in the world. For our last two managers, we are focused on groups executing more opportunistic strategies. We think that's what's more appropriate for today's market, and the quality, depth and breadth of groups we have seen is appealing.

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Claudia Faust: Ideally, we'd like to see the managers grow to be able to invest in different strategies over time. Obviously they each have a core competency, but there is a natural evolution whereby they can and will grow into other strategies and risk positions around that core competency. Large institutions are very relationship oriented, and it's very helpful for an investor to be able to go to one group and have a variety of needs met.

Although the first two groups in the Scout Program are large developer/operators, the program is also suitable for other types of new managers. For example, we expect one of our remaining slots to be filled by what we call a lift-out group, which is people or teams who worked for opportunity funds or financial institutions that have recently gone out on their own. Another type of group could be a financial services firm or company interested in developing or expanding a real estate investment management platform.

So the goal, as you say, is to have these new managers graduate into full-fledged institutional-grade management teams. How do you evaluate their performance and determine if they're ready?

Faust: We obviously spend a whole lot of time evaluating and vetting them before they ever make it into the program. Once in, the program involves a very high level of monitoring and transparency. We make sure they perform as expected in the strategy that we've given them capital for, they do what they said they would do, and that they follow the processes and procedures that we mutually agreed upon. If they do this, they will earn the Hawkeye stamp of approval, and the whole market will know they can operate at a best-in-class level.

Another critical aspect of the program is that we make sure these groups develop the infrastructure necessary to manage institutional capital on a stand-alone basis with discretion. This means by the time they spend the capital that we have given them, and maybe even some sidecar capital that we can provide, they are ready to receive allocations directly from institutional investors.

However, the program is not overly burdensome, but more prescriptive in nature. Basically, we assess their current level of operations and identify areas that need improvement or are not there at all. Then we design a program that will help them get there over time. That's a very, very important thing for us. We will not pick groups that we don't think can get there in the first place.

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We also make sure the market environment is favorable to recommend additional allocations to our new managers and that what they're doing is an interesting and attractive investment opportunity for our investors.

Do you consider your operation a fund of funds model?

Faust: We don't consider ourselves a fund of funds. Let me explain why. We don't invest in existing funds. Instead, our strategy is to find sectors we like, find the best talent within those sectors and create new fund managers. As part of that process we're giving them an allocation of capital, so they can develop a discretionary track record. We call their first programs funds, but in many ways they are more like separate accounts.

How has the real estate downturn affected your business?

Faust: We have been extremely — I should say painfully — disciplined. We received our capital beginning in 2007, and shortly thereafter the market reached its peak, we think in February, around the time of the EOP transaction. The market was just really out of whack. Pricing was crazy. People asked for various terms and conditions to partner on that just didn't make sense for what we were trying to do. We told our investors that we would continue to look, but we didn't feel comfortable until some event occurred to change the situation. We didn't know when it would occur, but we knew it couldn't continue like that. And certainly in the summer it did start to shift.

McArtor: Since the premise of Scout is to find the next generation of managers our investors can invest with over time, we can't just rush in and transact because everyone else is throwing capital into the marketplace. We didn't know exactly when or to what extent, but we clearly anticipated the current downturn, and I think keeping our powder dry until now has turned out to be a really positive thing for us.

Where do you see the next big opportunities coming from?

Faust: It's really hard to tell what the future will hold, but every time we've had a bubble like this — we had one in the late '80s and early '90s — there was always a need for fresh talent, as investors figure out which of their managers did the right thing and which, ones kept eating just to grow AUM when they should have pushed away from the table. For a variety of reasons, the barriers of entry for new groups has never been higher. So we think it is going to be very important, for a lot of reasons, for investors to have the opportunity to work with new groups through programs like Scout.

We're going through a period of transition, but at some point in time things will start to reprice, and I think that will be a very good time to pick up some bargains. The debt markets have been interesting for a whole host of reasons; there's a level of distress going on, and it will continue to go on. But there's still an opportunity to provide capital to the market.

Many large institutional investors have indicated they are favoring larger allocations to fewer investment managers. What implication does the consolidation of managers and consultants have on smaller firms?

McArtor: Most of the large institutional investors have indicated that they're trying to limit their number of relationships; they want a smaller number of more meaningful relationships because it's more efficient for them to allocate larger sums of capital and monitor their relationships. Unfortunately, as the existing managers get much larger, they tend to focus on their recurring fees driven off AUM versus the profits in the real estate, and a misalignment of interest occurs.

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The whole situation creates a bit of a Catch-22, if you will, for bringing a new group in. Smaller firms may not be able to handle as much capital as an investor might want to give them, so a real barrier is created. Further, I think as you get consolidation within the consultants and they get spread across more and more clients, it gets increasingly difficult for them to work with new managers. We see the Scout program as a real benefit to the consultants and the investors they serve by providing them with more choices.

How has Hawkeye dealt with those barriers to entry?

Faust: We've built a very large infrastructure to be able to go out and dig deep into the marketplace to find the right groups. We were very pleased that consultants like Townsend and others have been extremely supportive from the start, as it is very difficult to break into the business if you don't get sign-off from a few of them.

To some extent, consultants are not rewarded to take on the potential risks associated with working with new groups. We have been told by some that they look to us to try out new groups, and if they like them then they will invest with them in the future. And that's been really positive for us.

How do you see the market shaking out in 2009?

Faust: We think the market will start to improve sometime in late 2009. We've just really hit the tip of the iceberg. There's a lot of deleveraging and repricing that needs to go on, and I think next year will continue to be a difficult year. Then the market will get better sometime in 2010. We've got a difficult road ahead. Out of that will come some opportunities but we need to be cautious.

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McArtor: A lot of people anticipated that there was going to be some kind of market correction. We believed there would be, and we've been going with the premise that we're trying to position the right players in the market at the right time now, so that as the market corrects in 2010 or so we'll be there.

The number of players will be limited by things like access to debt or just the lending environment in general, or interest rates, performance, etc.

We intend to deliver groups that came up with interesting opportunities during this time but, in particular, lay the groundwork for future relationships with our investors. As the markets turn, they will have proven that they can handle discretionary capital. ❖