Divided loyalty?

How will GEM Realty Capital manage interest alignment as it deploys GEM Realty Fund VI, GEM Realty Evergreen Fund?

Key points:

- GEM Realty Capital, a private equity real estate manager, is in the process of raising GEM Real Estate Fund VI, its newest non-core real estate fund.

- In late 2015, GEM also launched the GEM Realty Evergreen Fund, which seeks to make “long-term investments in real estate properties in the United States.”

- GEM Realty Evergreen Fund was 29% owned by GEM insiders as of March 2016, versus just 4.3% for GEM Realty Fund V.

- This will be the first time GEM has sought to deploy two real estate funds at the same time, raising questions about how the manager will manage interest alignment in allocating investment opportunities between the two funds.

- GEM’s 2016 Form ADV brochure leaves open the possibility that the manager may “cross-trade” assets between funds – i.e. sell assets from one private equity fund (e.g. GEM Realty Fund V, GEM Realty Fund VI) to another (e.g. GEM Realty Evergreen Fund).
Questions:

- What property-types, strategies will the GEM Realty Evergreen Fund invest in?
- Do GEM principals have an incentive to allocate better investments to the more insider-owned GEM Realty Evergreen Fund?
- Has GEM Realty Capital disclosed any exclusivity provisions of the Evergreen Fund to potential Fund VI investors?
- What types of investments does GEM Realty Fund VI have exclusivity over?
- How will GEM Realty Capital disclose decisions on investment allocation to investors? Will GEM Realty Fund VI investors be informed of investment opportunities allocated to the Evergreen Fund?
- Given its outsize (29%) insider ownership, will GEM Realty Capital hold off on making investments from the GEM Realty Evergreen Fund until the close of the GEM Realty Fund VI investment period?

Chicago-based private equity real estate manager GEM Realty Capital has raised a series of real estate funds, GEM Realty Fund I–VI.

In late 2015, in addition to its flagship funds, GEM launched an evergreen real estate fund to make long-term investments in real estate properties.

Given that GEM has historically focused exclusively on its non-core real estate funds, how will the manager balance the interests of different investor groups in terms of allocating investment opportunities and staff time?

**GEM Realty Fund VI**

In April 2015, GEM Realty launched fundraising for its new non-core real estate fund, GEM Realty Fund VI, seeking as much as $1 billion from investors.¹

GEM Realty Fund VI will invest in a mix of properties and debt, according to Pensions & Investments.²

While it is not known exactly what GEM Realty Fund VI’s strategy will be, GEM’s predecessor fund, GEM Realty Fund V, targeted "an 18% net return for investors with moderate leverage and a focus on principal preservation," according to minutes of an investment board meeting. At the time (July 2013), GEM principal Norm Geller reported that he believed the "greatest opportunities are in value-add investing."³
GEM Realty launched its GEM Realty Evergreen Fund in late 2015, based on an SEC Form D.\(^4\)

While GEM did not at that point disclose the size of the Evergreen Fund, as of March 30, 2016 the Evergreen Fund had 71 beneficial owners.\(^5\) The Evergreen Fund does not appear to have drawn or deployed capital as of the end of March 2016.\(^6\)

GEM Realty disclosed the Evergreen Fund in its 2016 SEC Form ADV part 2A brochure, describing it as "a Private Equity Fund that primarily makes long-term investments in real estate properties in the United States through an evergreen structure."

GEM Realty insiders owned 29% of the Evergreen Fund as of March 2016.\(^8\)

By comparison, GEM Realty Capital insiders have accounted for a much smaller share of GEM’s past non-core real estate funds. Indeed, the GP share of past GEM Realty Capital funds has been declining with each subsequent fund, from 8% of GEM Realty Capital Fund III to just 4.3% of GEM Realty Capital Fund V, based on the manager's 2016 SEC Form ADV.\(^9\) It is unknown what portion of GEM Realty Capital Fund VI will come from GEM insiders.

This could raise interest alignment questions for potential investors in GEM Realty Fund VI.

Multiple funds and interest alignment

Historically, GEM Realty Capital has raised a series of real estate funds, deploying one fund at a time. Balancing investor interests in allocating investments among multiple funds may be a new experience for GEM.

For example, the firm’s March 2015 SEC Form ADV brochure noted:

Typically only one Private Equity Fund is actively investing capital at any given time, so GEM does not need to allocate Private Equity Fund investments between multiple Funds.\(^10\)
GEM updated this language significantly in its 2016 Form ADV, noting:

The Investment Committee will allocate investment opportunities among the Clients with available capital in a fair and equitable manner (and consistent with the obligations contained in the governing documents or other agreements for the relevant Client) taking into account the investment strategies of each Client. An investment opportunity will first be allocated to the Private Equity Fund, if any, whose governing documents or other agreement require or otherwise contemplate exclusivity (an “Exclusive Fund”) with respect to such investment opportunity, as determined by the Investment Committee in its sole discretion (an “Exclusive Investment”). The Investment Committee will allocate an investment opportunity that is not an Exclusive Investment among the Private Equity Funds (other than any Exclusive Fund(s)) based on the investment opportunity’s characteristics and the investment strategies of the other Private Equity Funds; provided, however, in no event shall an investment opportunity be allocated among more than one Private Equity Fund. Most investment opportunities will be suitable for only one Private Equity Fund, since the investment strategies of the series of Private Equity Funds and the evergreen Private Equity Fund are sufficiently differentiated to avoid conflicts of allocation. To the extent that the characteristics of an investment opportunity make it clearly suitable for only one Private Equity Fund, in the sole determination of the Investment Committee, it will be allocated to that Private Equity Fund. Despite differentiated investment strategies, occasions may arise where an investment opportunity is suitable for more than one Private Equity Fund (a “Conflict Investment”). In such circumstances, the Investment Committee shall allocate the Conflict Investment first to the current Exclusive Fund and then among the other Private Equity Funds based on the suitability of the investment opportunity for the Private Equity Funds’ investment strategies (in the sole determination of the Investment Committee); provided, however, in no event shall an investment opportunity be allocated among more than one Private Equity Fund. If a Private Equity Fund rejects or otherwise passes on the opportunity to pursue an Exclusive Investment or a Conflict Investment, or the transaction is later determined to not be appropriate for the Private Equity Fund’s investment strategy, the Investment Committee may reallocate such investment opportunity to another Private Equity Fund based on the suitability of the investment opportunity for the remaining Private Equity Funds’ investment strategies, in the sole determination of the Investment Committee, provided, however, in no event shall an investment opportunity be allocated among more than one Private Equity Fund.

While wordy and complex, it is important to note that the 2016 policy leaves all decision-making authority on the allocation of investments to GEM Realty Capital’s Investment Committee. GEM insiders’ outsize (29%) share of the GEM Realty Evergreen Fund raises questions about whether that Investment Committee can be a neutral arbiter of allocation of investment opportunities. Further, the policy falls to spell out how Investment Committee decisions regarding investment allocation will be reported to limited partners.
Does GEM Realty Evergreen Fund have exclusivity over any types of investments?

Based on the language in GEM's 2016 policy for allocating investments among multiple funds, the scope of what GEM Realty Fund VI can invest in could be limited in ways that are not clear to investors.

For example, if GEM Realty Evergreen Fund were deemed to be exclusive fund for investments in industrial properties, then all potential industrial property investments would automatically be offered to GEM Realty Evergreen Fund first. If and only if the Investment Committee passed on that opportunity for the Evergreen Fund would the opportunity be offered to GEM Realty Fund VI. Again, this raises particular concern in light of the 29% of the Evergreen Fund held by GEM Realty insiders. The Evergreen Fund (being “evergreen”) will presumably have an investment period that outlasts that of GEM Realty Fund VI, meaning investment types deemed exclusive for the GEM Realty Evergreen Fund may never be offered to GEM Realty Fund VI.

Has GEM Realty Capital disclosed any exclusivity provisions of the Evergreen Fund to potential Fund VI investors?

What types of investments does GEM Realty Fund VI have exclusivity over?

Cross trades between funds a possibility

GEM’s 2016 Form ADV brochure leaves open the possibility that the manager may “cross-trade” assets between funds – i.e. sell assets from one private equity fund (e.g. GEM Realty Fund V, GEM Realty Fund VI) to another (e.g. GEM Realty Evergreen Fund).

GEM’s brochure notes that “cross transactions may be effectuated by GEM as long as such trade is expected to result in the best price and execution for both accounts.”

Yet with the Evergreen Fund so heavily owned by GEM insiders, a cross trade between it and one of the private equity funds would seem to raise conflict-of-interest questions.
Questions:

• What property-types, strategies will the GEM Realty Evergreen Fund invest in?

• Do GEM principals have an incentive to allocate better investments to the more insider-owned GEM Realty Evergreen Fund?

• Has GEM Realty Capital disclosed any exclusivity provisions of the Evergreen Fund to potential Fund VI investors?

• What types of investments does GEM Realty Fund VI have exclusivity over?

• How will GEM Realty Capital disclose decisions on investment allocation to investors? Will GEM Realty Fund VI investors be informed of investment opportunities allocated to the Evergreen Fund?

• Given its outsize (29%) insider ownership, will GEM Realty Capital hold off on making investments from the GEM Realty Evergreen Fund until the close of the GEM Realty Fund VI investment period?

Endnotes

1 GEM Realty Fund VI SEC Form D, Apr 14, 2016.
3 Rhode Island State Investment Commission minutes, July 24, 2013.
5 GEM Capital SEC Form ADV, March 30, 2016.
6 Based on a Gross Asset Value of $0, GEM Capital SEC Form ADV, March 30, 2016.
7 GEM Capital SEC Form ADV brochure, March 30, 2016.
8 GEM Capital SEC Form ADV, March 30, 2016.
9 GEM Capital SEC Form ADV, March 30, 2016.
10 GEM Capital SEC Form ADV brochure, March 2015.