| REAL ESTATE

Morgan Stanley Makes a Comeback in Real Estate

New global fund draws $1.7 billion, marking a recovery from downturn

Morgan Stanley led a venture that purchased one of the tallest office buildings in Vienna, Millennium Tower, for €320 million ($353.9 million). *PHOTO: BARBARA GINDL/EUROPEAN PRESSPHOTO AGENCY*

At Morgan Stanley, real estate is back.

Amid an otherwise dismal third quarter, the New York investment firm enjoyed a bit of good news from a unit whose staggering losses during the property bust were viewed as an emblem of the era's excesses.

Morgan Stanley wrapped up fundraising over the summer for its first higher-risk real-estate fund since 2007, a sign that it has finally recovered from the downturn. The new global fund has attracted $1.7 billion in commitments from investors such as CIC and Australia's sovereign-wealth fund, according to people familiar with the matter.

Morgan Stanley's success comes as commercial real-estate values are hitting record levels in some markets and deal activity is rising. Some big investors, like Sam Zell, are taking advantage of higher prices by selling. Many pension funds and other institutional investors, meanwhile, have a renewed appetite for risk.

The new Morgan Stanley fund is smaller than those the firm raised in the years leading up to the bust. Still, it represents a triumph after many in the real-estate industry were predicting the demise of the unit's high-risk fund business due to its high-profile losses.

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"The market is insanely competitive right now," said John Klopp, co-chief executive of the real-estate unit at Morgan Stanley with Olivier de Poulpiquet. They joined Morgan Stanley in 2010 to co-head the unit and quell a near investor rebellion. "There's a ton of capital chasing real estate in every market in every nook and cranny."

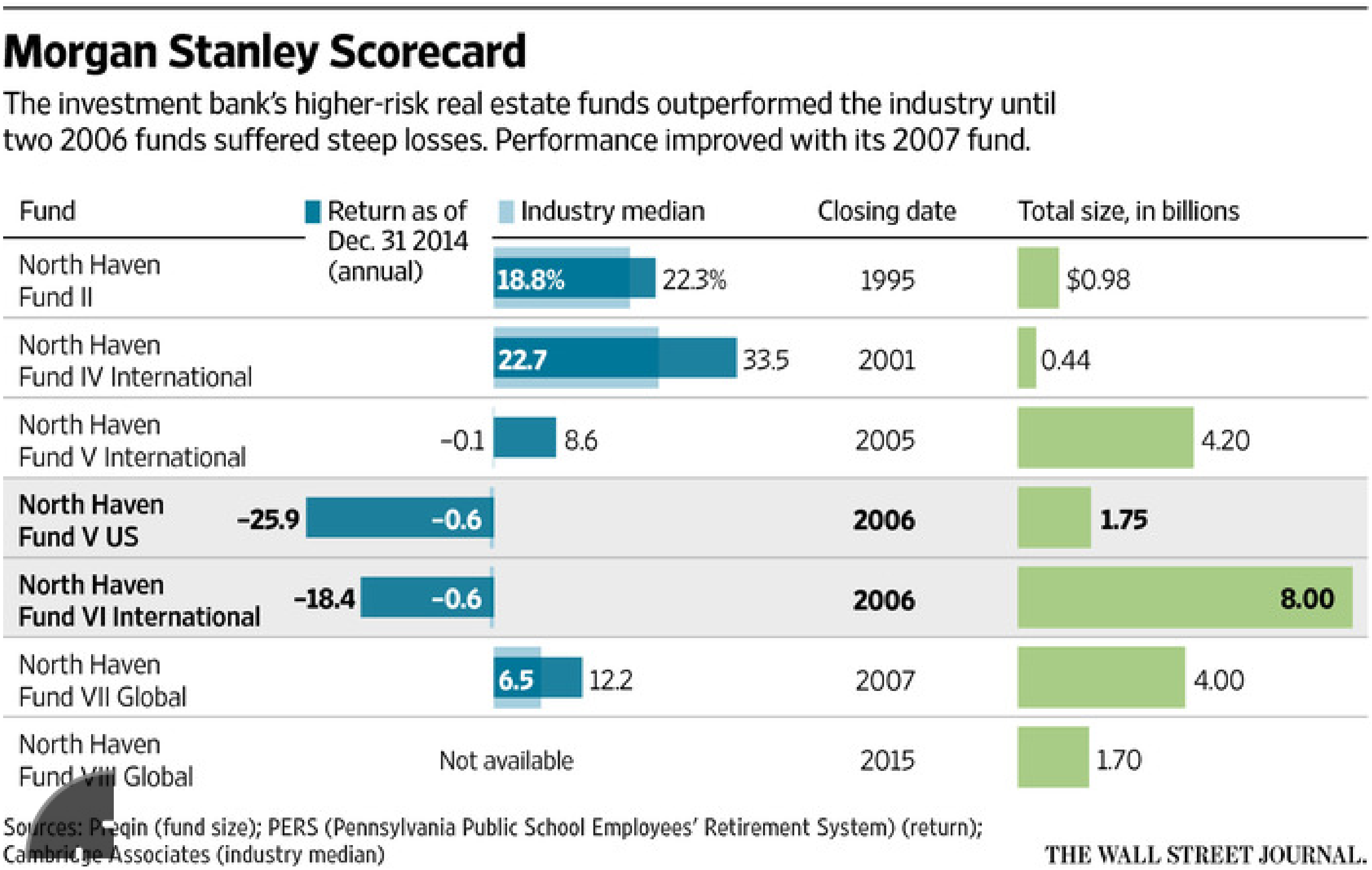
During the early years of the recovery, much of the unit's focus was on raising money for buying fully leased buildings in great locations and other "core" properties. About 55% of the unit's $32 billion in assets under management are currently in such core funds.

Lately, however, investors have been gravitating toward riskier "opportunity funds" that buy into new developments, land and fixer-upper buildings, reaching for returns of 20% and above. In 2015, these funds have raised $47.7 billion, a postrecession record but still below the $74.2 billion in 2008, according to early October statistics from data firm Preqin.

The new Morgan Stanley fund already has committed about a third of its equity, with 10 closed deals and another seven in the pipeline. With competition for commercial real estate intense in cities such as London and New York, the fund has been looking for property in cities like Tokyo, Vienna and Honolulu. For example, it led a venture that purchased one of the tallest office buildings in Vienna, Millennium Tower, for €320 million ($353.9 million).

"I admire what Klopp has done. He came in and cleaned house," said Nori Gerardo Lietz, partner with Areté Capital, a real-estate firm that advises institutional investors. She added that Morgan Stanley also was helped in its fundraising efforts by the fact that institutional investors "have a very short memory."

The comeback of Morgan Stanley's high-risk real-estate fund business marks the latest chapter in the history of one of the biggest names in commercial property investment over the past quarter century.



During the 1990s and early 2000s, the company's opportunity funds were considered the gold standard by many investors and participated in many of the biggest deals around the world. But they suffered bigger losses than most of their peers when the downturn hit. When Messrs. Klopp and de Poulpiquet took over five years ago, an $8 billion fund that Morgan Stanley closed in 2006 was reporting losses over 70%.

Messrs. Klopp and de Poulpiquet managed to calm investor dissent partly by agreeing to cut back on the ambitions of a 2007 fund that raised $4.7 billion but had only spent about $2.5 billion. In 2011, they agreed to allow investors to get off the hook on $700 million worth of commitments. In exchange, they received a green light to keep investing the rest.

That proved to be a good deal for both investors and Morgan Stanley. Taking advantage of low prices after the crash, the 2007 fund chalked up a 12.16% annual return as of the end of 2014, according to data reported by the Pennsylvania Public School Employees Retirement System, one of its investors. In comparison, the median annual return for 2007 vintage funds is 6.48%, according to Cambridge Associates, a firm that tracks private-equity fund performance. Meanwhile, the 2006 fund pared its losses to 26% as of the end of 2014.

“It was an attractive time to be investing,” Mr. Klopp said.

Still, persuading investors to put up new money wasn’t easy. Morgan Stanley did this partly by changing its fee structure so that investors get 100% of their capital and a preferred return before Morgan Stanley gets a “promote,” or a cut of the profit above the usual management fees.

Before the crash, Morgan Stanley, along with many private-equity firms, would collect a promote on a property-by-property basis. That structure can occasionally create “anomalies” in which the interests of the investors and fund managers aren’t aligned, Mr. Klopp said. The new structure avoids situations in which “the investors don’t make money but you do,” he added.

Messrs. Klopp and de Poulpiquet also have centralized decision making within the Morgan Stanley real-estate unit. Under the old guard, decisions to buy property often were made with limited input from headquarters. Today any major capital commitment has to go through an investment committee that uses a consistent approach to balance risk and reward.

Mr. Klopp agreed there is a danger of decision-making all being done at headquarters. He said he is aware of the trade-off between centralized management and the need in real estate to stay nimble and understand local markets.

“The art form is combining local market presence with centralized control and that’s a very hard balance to achieve,” he said.

Write to Peter Grant at peter.grant@wsj.com

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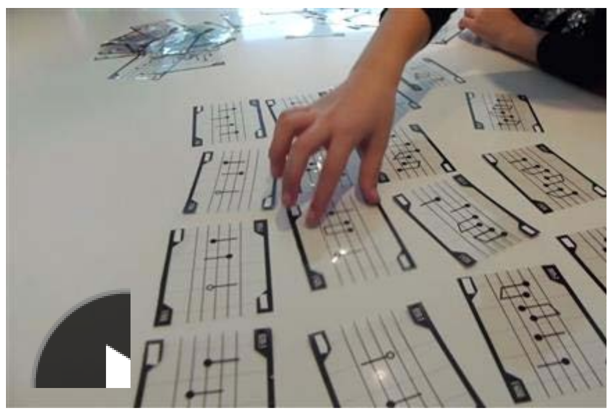

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