Style Classification refined to provide industry with a more robust, workable and enduring model.

➤ Provides a further layer of information on core funds.

➤ Reflects realties faced in industry.

➤ Forms a basis for investors and fund managers to distinguish between different investment strategies.

The INREV Style Classification released in March 2011 was a major step forward in providing the industry with a robust classification and a consistent basis to understand and compare risk in funds. Response from the industry was on the whole positive however feedback from some members indicated that the 40% maximum leverage boundary for core funds was too rigid due to currency hedging and tax structuring reasons.

The model is based on three variables, one of which is leverage. These variables were the result of a long period of theoretical work, which demonstrated that leverage is the key risk factor when it comes to style, and therefore made it an important component of the model. For core funds there is an additional variable (see figure 1). However, in practically applying the results of the theory to the market via the Style Classification model, the 40% boundary between core and value added proved to be too easy a tipping point. This resulted in a large proportion of funds being defined value added on a basis of their leverage whilst they were evidently core when the three other operational variables were considered.

STYLE REFINED

The refined version of the model takes this sensitivity to leverage into account and allows fund managers to classify their funds to be core based on the three operational variables without the maximum loan-to-value ratios. Instead, INREV has set the parameters on leverage for core to be less than or equal to 40% or more than 40%. Therefore, a core fund can be defined as such using the three variables and then classify itself as core less than or equal to 40% or core more than 40%.

This solution provides a further layer of information around core funds for investors when assessing funds in the market and brings clarity on the leverage issue.

STYLE CLASSIFICATION EXPLAINED

INREV developed its first style framework in 2004. It used the two measures of leverage and return to classify non-listed property funds as core, value added or opportunity. It was seen as a first step toward guidance at that time, but the increasing sophistication of the industry and more data available on live funds have made a more comprehensive

Figure 1: INREV Style Classification Parameters*

	CORE ≤ 40%	CORE >40%	VALUE ADDED	OPPORTUNITY
Target percentage non-income producing investments	≤ 15%		15%> - ≤40%	> 40%
Target percentage of (re)development exposure	≤ 5%		> 5% - ≤25%	> 25%
Target return derived from income	≥ 60%			
Maximum LTV	≤ 40%	>40%	> 40% - ≤ 60%	> 60%

*** To be applied to newly launched funds from 2011 onwards.**

approach possible that is workable, robust and enduring.

After an extensive research and development process, INREV developed the next generation INREV Style Classification. These are based on an entirely new approach to the classification methodology and are designed only to be applied to funds launched in 2011 and later. In addition an online Style Classification Guide Tool was developed (see box below).

The methodology for this style classification is based on the notion that style is the result of a bundle of risks, while return is the outcome of the investment process and is not part of the style classification. Many risks factors impact the non-listed real estate funds market as a result of the heterogeneity of real estate assets and the variety of management strategies employed. However, the INREV Style Classification focuses only on the three factors that were found to be the key determinants of fund style. The new style classification, while using risk variables to determine a fund's style, is not simply a label of risk.

These three factors are: target non-income producing investments; target annual development exposure as a percentage of fund GAV; and maximum allowable leverage as a percentage of fund GAV. In addition, a core fund must target most of its return from income.

A fund is required to meet all the boundaries of a particular style. If one of the boundaries is crossed, the fund will be classified to the next style in order, value added or opportunity. A fund style classification is based on its objectives/targets at launch. Style is frozen at that point and reclassification should be regarded as an exceptional event.

The Style Classification supplemented by the Style Guide Tool creates a classification that is workable, robust and enduring because it is based on measurable, quantitative factors, while being a clear model that leads the market. The new classification methodology will be applied to newly launched funds from 2011 onward. The INREV Benchmarking Committee will review how to incorporate the new classification in the INREV Index.

ABOUT STYLE CLASSIFICATION ON-LINE GUIDE TOOL

The use of fixed numerical bands to classify styles may create boundary challenges for funds that are on the borderline of the bandings. The Style Classification Guide Tool was therefore added to provide a further level of sophistication to the classification analysis but does not override the classification parameters.

Rather than using the boundaries the tool weighs each of the three classification factors and then combines them to determine the probability of a fund belonging to one of the three styles. The Style Classification Guide Tool measures the impact of each of the three risk variables. The higher the probability of belonging to a particular style by looking at a large sample of the funds, the more confidence there will be in assigning a fund to it.

The tool is available on www.inrev.org

The full report is available to members at www.inrev.org
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