INREV RESEARCH & MARKET INFORMATION

RE-EVALUATING THE CASE FOR INVESTING IN NON-LISTED REAL ESTATE FUNDS POST-CRISIS

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INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to improve the accessibility of non-listed real estate funds for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

As a pan European body, INREV represents an excellent platform for the sharing and dissemination of knowledge on the non-listed real estate funds market. The association's primary focus is on institutional investors, although other market participants such as fund managers, investment banks, lawyers and other advisors provide additional support.

CONTENTS

EXECUTIVE SUMMARY

This paper re-evaluates the case for investing in non-listed real estate funds in the aftermath of the financial crisis and synchronised downturn in real estate markets. The research addresses the performance of the sector relative to other real estate investing options and re-visits the key components underlying the rationale for investing in the sector. In addition, the findings of structured interviews are used to examine those areas undergoing change. Key issues which have arisen out of the downturn are considered over both the short- and long-term. The paper concludes that the place of the non-listed sector within real estate investing options remains robust, although there are a number of specific areas that require strengthening.

Key findings of the research are:

- Although the sector has delivered a very weak performance since 2007 this is not limited to non-listed real estate. Across alternative real estate investing options the sector compares favourably when considered on a like-with-like, ungeared basis.
- The misuse of leverage in the absence of explicit debt strategies has had a detrimental impact on fund performance. While the severity of its effect is not to be diminished, the long negative skew of the INREV Index suggests that it is clear that such misuse is limited to a sizeable minority of funds.
- The key components underlying the rationale for investing in non-listed real estate funds remain intact, including economies of scale, access to expert management, access to new markets and sectors and diversification benefits. However, certain factors such as ease of investment have proved less durable as the importance of due diligence and the on-going responsibility of investors to monitor their representatives is evident post-crisis.
- The behaviour of certain fund managers who failed to fully exercise their fiduciary duty to investors has resulted in a breakdown of trust in the industry. This has led to a strengthening of the alignment of interest between fund managers and their investors, further increased by new and proposed legislation. In the short-term this has resulted in a shift in the basis of management fees, the structure of performance fees, as well as greater use of key man clauses and co-investment. In the medium and longer term a more holistic approach to debt strategy, co-investment and the realignment of fee structures and remuneration policies to better reflect the longer term characteristics of the asset class.
- Differences in the investment horizons and key objectives of investors has seen alignment of interest across the investor pool emerge as a key issue. This is manifesting itself in a classification of funds by investor objectives, with institutional investors preferring to invest alongside other long-term investors. Indeed, the largest investors have either shifted to alternative investing options such as separate accounts, direct or joint ventures, or are taking a lead role from the inception of funds.
- While larger investors may continue to retain control into the medium-term, smaller and medium sized investors will need to trade homogeneity of the investor base for enhanced diversification attainable through greater scale. Moreover, the greater liquidity promised through open ended real estate models and the emergence of a secondary market proved a false dawn. To this end, participating investors and fund managers will all recognise and accept the longer term characteristics of the asset class, with funds putting in place safeguards in regard to investors with a limited track record.
- Over the medium- to long-term we anticipate that large investors will continue to find their voice and utilise the power of their capital commitments to shape and strengthen the industry.

1 INTRODUCTION

The rapid growth of the non-listed real estate fund sector from the turn of the millennium to 2007 occurred during a period of strong economic growth and an explosion in debt markets. During this time the structure of the industry in terms of the fund model and relationships between and across actors in the industry developed organically. The rationale for investing in the sector was clear.

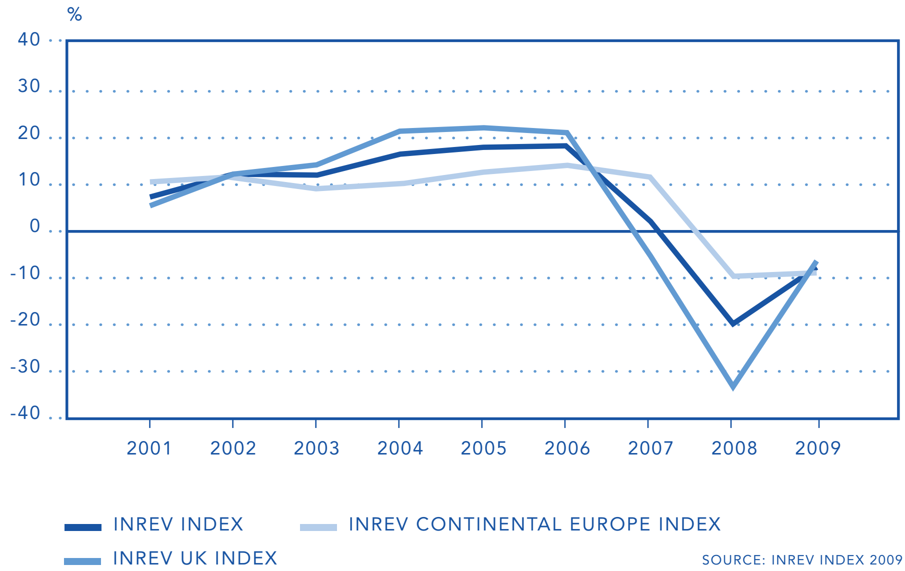
This paper re-evaluates the case for investing in non-listed real estate funds post financial crisis. First, it considers the performance of non-listed real estate funds and assesses such performance relative to other real estate investing options. Second, it reviews the key components underpinning the rationale for investing in the non-listed funds sector and examines how the relative importance of certain factors has shifted since the financial downturn.

Third, utilising the findings of twenty-two structured interviews undertaken with fund managers and investors, the changing structure of the non-listed model is evaluated. Interviewees included thirteen fund managers and nine investors, of which three were fund of funds managers. The findings reveal which aspects of the fund model remain robust post financial crisis, which could be improved and which aspects are subject to change, whether the result of market participant behaviour or due to legislative change. Finally, the paper evaluates the case for investing in non-listed real estate vehicles and draws conclusions as to the short- and longer term impact of the financial crisis on the structure of the sector.

2 PERFORMANCE OF NON-LISTED REAL ESTATE FUND VEHICLES

Prior to re-evaluating the structural characteristics that together form the rationale for investing in non-listed real estate funds, it is first necessary to consider the performance of real estate funds over the past decade. Following a period of strong performance from 2001 to 2006, the INREV Index began a period of sharp decline in 2007. This weak performance was intensified by the high weighting of the more volatile UK real estate market, which masked more stable returns for continental Europe. As the impact of the financial market crisis deepened, it manifested itself across all real estate markets in 2008. UK markets deteriorated yet further while in continental Europe, capital growth shifted into negative territory. By the end of 2009, markets had begun to stabilise, notably in the UK market driven by greater liquidity.

FIGURE 01 / RETURNS FOR NON-LISTED REAL ESTATE FUNDS 2001 – 2009, LOCAL CURRENCY



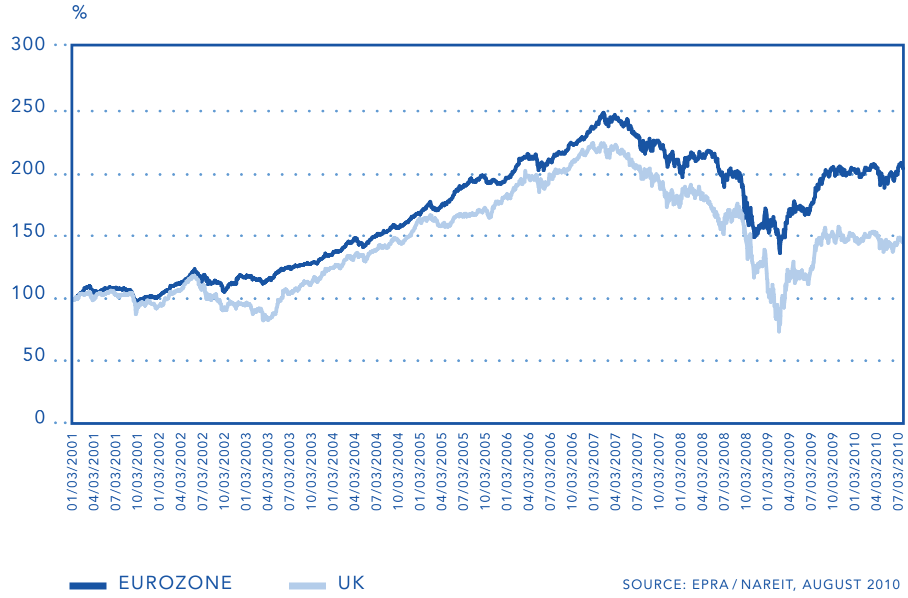
SOURCE: INREV INDEX 2009

Of course, this sharp decline in asset values has been experienced across wider financial markets and across other modes of real estate investing. Given this, in addition to examining the absolute performance of non-listed real estate funds, it is necessary to consider its performance in the context of the wider real estate investment universe.

2.1 Comparison of the performance of real estate investing options

There are three principle options for private real estate investing. In addition to the non-listed sector there are two further established modes, namely; direct real estate and listed real estate securities funds. Each comprises a distinct set of risk return characteristics that may be aligned to different investment objectives. Both direct and non-listed investing share private real estate assets as their investment base. In contrast, listed real estate securities funds represent investments in operating companies, not merely the underlying real estate. As such they sit on the boundary of investing in equities and investing in real estate as an alternative asset class. While offering greater liquidity important for shorter term investment duration objectives than direct or non-listed, such characteristics increase the risk and volatility associated with this real estate investing option (Figure 02, page 06). Relative to the non-listed and direct real estate sectors, the listed sector offers limited opportunity for fund managers to influence the underlying real estate strategy at either a portfolio or asset level.

FIGURE 02 / INDEX OF RETURNS OF LISTED REAL ESTATE SECURITIES 2001 – 2010, LOCAL CURRENCY (JANUARY 2001=100)



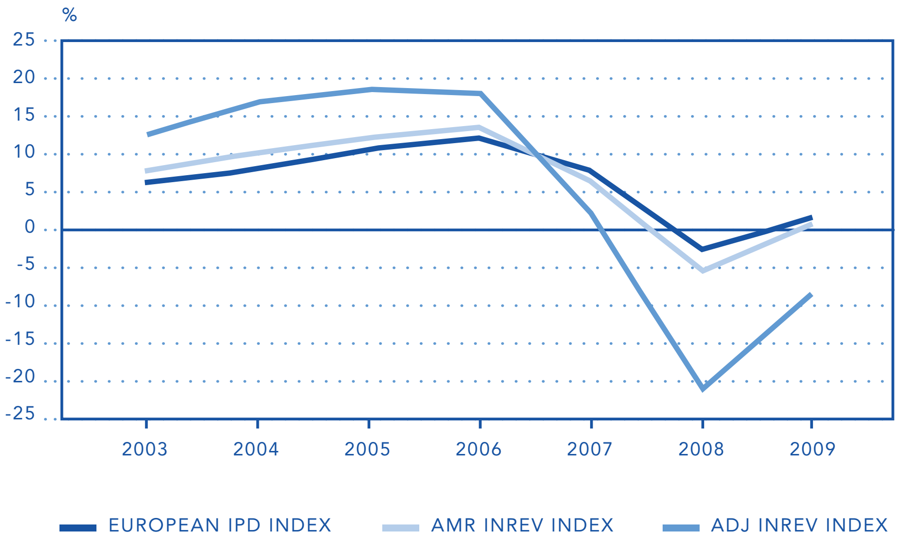
SOURCE: EPRA / NAREIT, AUGUST 2010

Arguably, sharing an underlying asset base, it is more appropriate to compare the performance of the non-listed sector against direct real estate investing. However, it is difficult to make a direct comparison between Investment Property Databank (IPD) indices of direct investing with the established non-listed real estate fund INREV Index due to a number of important differences in construction. These are detailed in full in Appendix 1. Most importantly, IPD indices measure ungeared market returns of individual properties and are valuation based. The INREV Index reflects the NAV of non-listed real estate funds and amongst other factors fully reflects any gearing impact, capital placement, fund management fees and associated costs. Of course, these factors are not the sole preserve of non-listed real estate funds, on a NAV basis direct returns would also be affected by any gearing impact, asset management fees and associated costs. There are also considerable differences in their geographic reach.

To provide for a more like-with-like comparison it is first necessary to narrow the sample base of the INREV Index to those markets covered by IPD (Adj INREV Index). Second, an index that reflects valuation based market returns rather than NAV returns is required. Using IPD country returns as a proxy an adjusted market return INREV Index (AMR INREV) is constructed. to mirror the geographical composition of the Adj INREV Index (see Appendix 2). Figure 03 illustrates the strong alignment of European IPD and AMR INREV return indices. Although the AMR INREV Index appears to marginally outperform to 2007 and underperform subsequently, it is important to note that while the geographic reach is the same, there are significant differences between the country weightings of the IPD and AMR INREV Index (see Appendix 1). In particular, the AMR INREV Index has a much higher weighting to the distressed markets of Southern Europe and to the UK which corrected earlier and more sharply than other European markets. In contrast, the European IPD Index has a stronger weighting to the less volatile German market. The latter tends to drag the performance of the IPD Index up to 2007 and boost it thereafter.

Figure 03 further demonstrates the impact of gearing, fees and costs on the Adj INREV fund performance in relation to both the AMR INREV return and European IPD return. Clearly, leverage has a considerable impact on absolute returns. The level of gearing as a proportion of gross asset value (GAV) increased over the period peaking in 2006. Yet interestingly, the analysis suggests that the Adj INREV Index fund returns did not increase proportionately to the AMR INREV Index, rather the incremental benefit of gearing slowed.

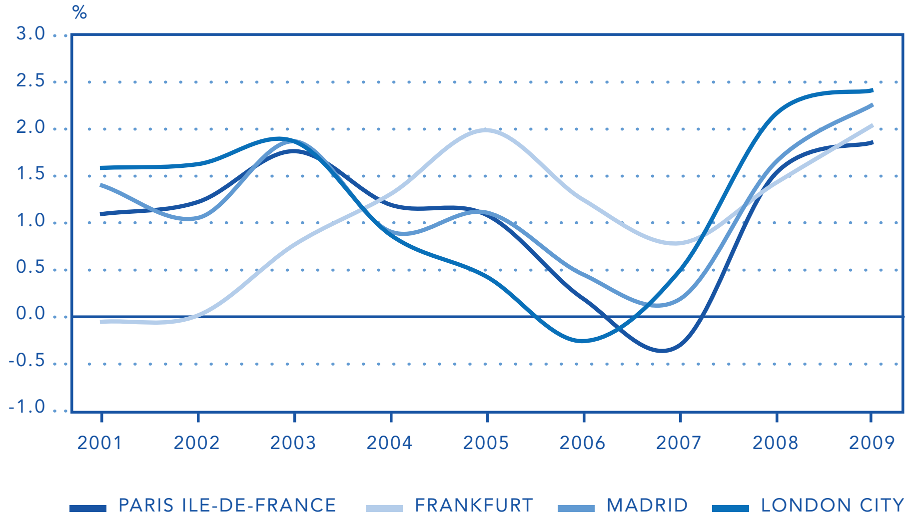
FIGURE 03 / COMPARISON OF INREV INDEX WITH AMR INREV AND EUROPEAN IPD DIRECT RETURNS 2003 – 2009



SOURCE: INREV INDEX 2009; EUROPEAN IPD INDEX 2009; RHL STRATEGIC SOLUTIONS 2010

In part, this reflects the gradual erosion of the spread between the cost of debt and returns from real estate impacting on new fund launches, as well as new acquisitions within existing funds. Yields fell to historically low levels in many markets as the weight of capital, in part fuelled by increased gearing levels, resulted in competitive pricing. Performance also reduced due to the rising fee basis of real estate funds. Fund management fees increased in percentage terms and being generally based on GAV, in volume too. In a more competitive market, acquisition costs also rose along with dead deal costs. In addition, new layers of fund management fees were introduced including but not limited to placement and subscription fees.

FIGURE 04 / SPREAD BETWEEN LONG-TERM INTEREST RATES AND PRIME YIELDS 2001 Q1 – 2010 Q2



SOURCE: CBRE Q2 2010; EUROSTAT 2010

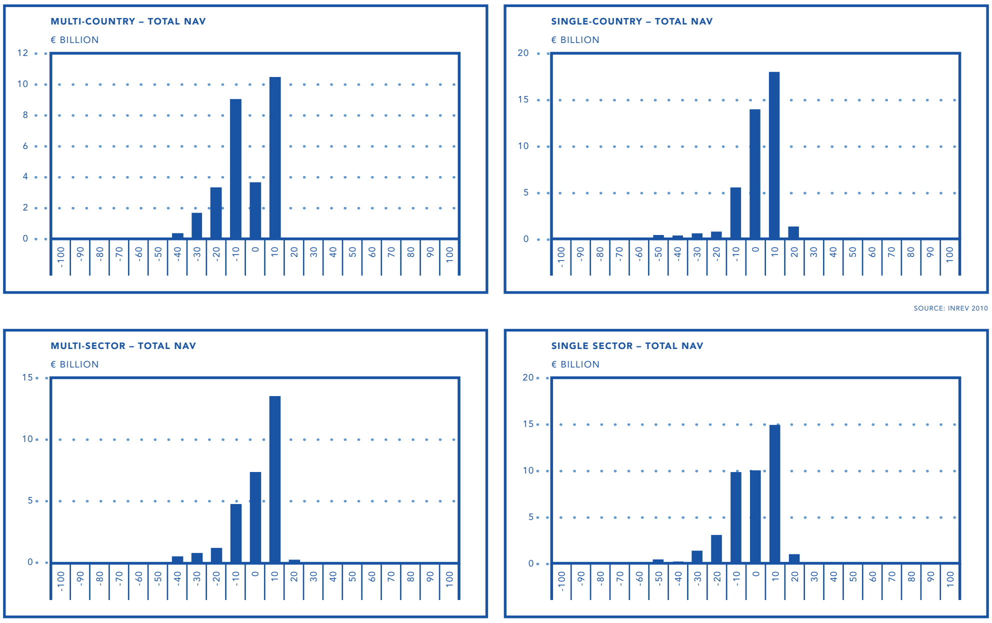
Given that absolute return expectations started to decline at the same time as gearing levels accelerated to their peak, on a risk-adjusted basis, returns were diminishing even more rapidly as ever greater risk was taken for lower returns. Somewhat ironically, the greatest leverage risk was applied to the narrowest yield gaps as the growing bandwagon of debt-fuelled investors blew the bubble to bursting point. As the debt market crisis deepened, risks were reassessed. Positive yield gaps reversed sharply as inflated real estate markets entered a period of re-adjustment and on occasion over adjustment. Interest rate terms rose despite all time low official interest rates. Gearing demonstrated its asymmetric risk for real estate, dragging down already weak returns.

2.2 Skewed impact of highly geared funds on the INREV Index

The impact of gearing on returns is not a straight line equation. Its effect accelerates as the proportion of leverage in the capital base increases. Analysis of the INREV database indicates that on average, leverage levels by size of fund are marginally higher for smaller funds. Differences in gearing levels are however, much more pronounced by style. As higher risk strategies adopt greater levels of leverage the impact of negative gearing has been more acute for opportunity and value added funds.

While opportunity funds are not included within the INREV Index, highly leveraged value added funds are. Such funds are characterised by higher risk assets that have experienced much sharper value deterioration than the prime income secure assets usually associated with core funds. This exacerbates the negative returns associated with such highly-leveraged funds. Value added funds form a smaller proportion of the non-listed real estate funds universe comprising the INREV Index. However, the combined impact of negative gearing alongside the sharp re-pricing of non-prime assets results in a long negative skew to the distribution of non-listed returns (Figure 05). This is evident across all categories of funds, with single country, multi-country, single sector and multi-sector distributions of fund returns all characterised by a negative tail. This has a marked effect on the mean performance of funds at the aggregate level, disproportionately dragging the INREV Index down.

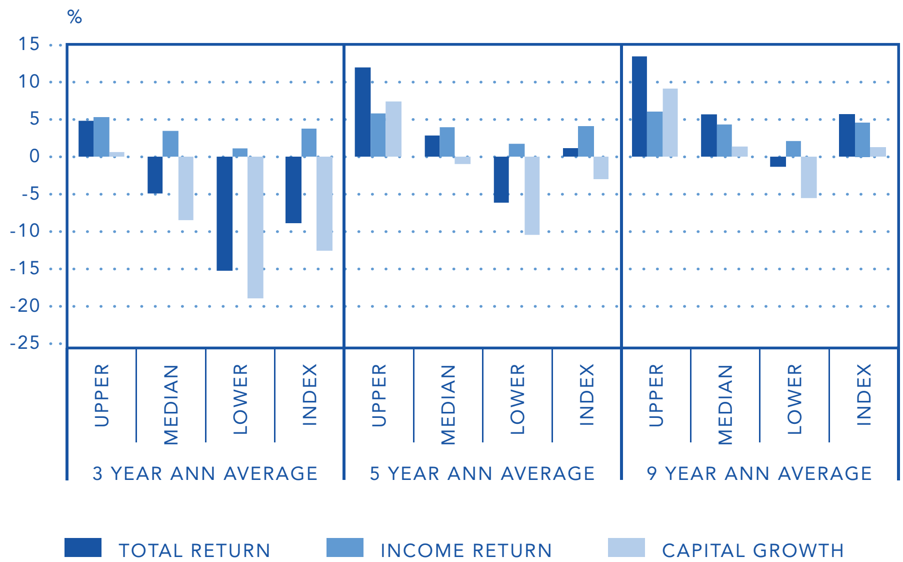
FIGURE 05 / DISTRIBUTION OF RETURNS BY % OF NAV AND TYPE OF FUND



SOURCE: INREV 2010

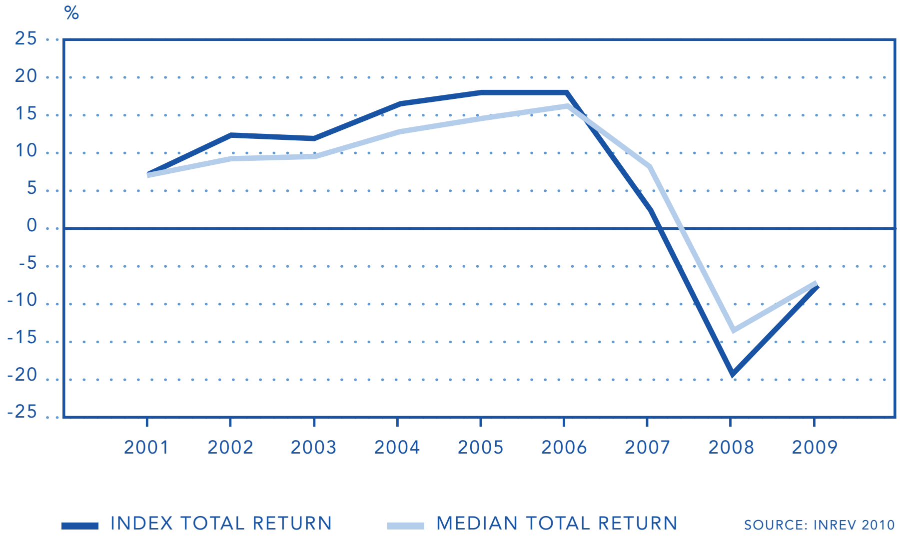
Indeed, comparison of quartile returns demonstrates this negative tail on the performance of the INREV Index (Figure 06). Over a three, five and nine year horizon, annual median returns have been much better than the average mean returns reported in the Index. Over a three-year horizon, at -8.9%, mean returns are significantly weaker than the median of -4.9%. Similarly, over five years the median return of 2.7% delivers a stronger performance than the mean return of 1.0%. Over a longer term, the mean and median converge to deliver a 5.6% return. Over the same horizon, the difference between mean and median income returns is not merely much narrower, it is inverted. In contrast, differences in the magnitude of capital growth have a much stronger negative skew. Again, this illustrates that the negative impact of higher leverage funds is disproportionate to their actual value weighting within the INREV Index.

FIGURE 06 / COMPARISON OF COMPONENTS OF RETURN BY QUARTILE AND MEAN (INDEX), 2001 – 2009



SOURCE: INREV 2010

FIGURE 07 / COMPARISON OF MEAN AND MEDIAN INREV INDEX RETURNS 2001 – 2009



SOURCE: INREV 2010

Figure 07 illustrates this gap between the average and median returns. It highlights the negative skew to the distribution of returns since 2007, dragged down by those with excessive gearing levels. Prior to this, the impact is evident in a positive skew as higher leverage delivered stronger absolute (but not risk-adjusted) returns. It is likely that the spread between mean and median returns also reflects the activity of funds that chased the yield gap over quality, acquiring secondary assets to benefit from gearing. Subsequently, while rising yields and cost of debt eroded value across all assets, this was most acute for secondary real estate.

3 RATIONAL FOR INVESTING IN NON-LISTED REAL ESTATE FUNDS

Previous research undertaken by INREV prior to the downturn in real estate markets identified the range of factors underlying the rationale for investing in non-listed private real estate vehicles. These may be divided into a range of factors pushing investors towards and pulling investors away from non-listed investing. Given the strength of the downturn in real estate markets, their relevance requires a post-crisis reassessment.

3.1 Push factors

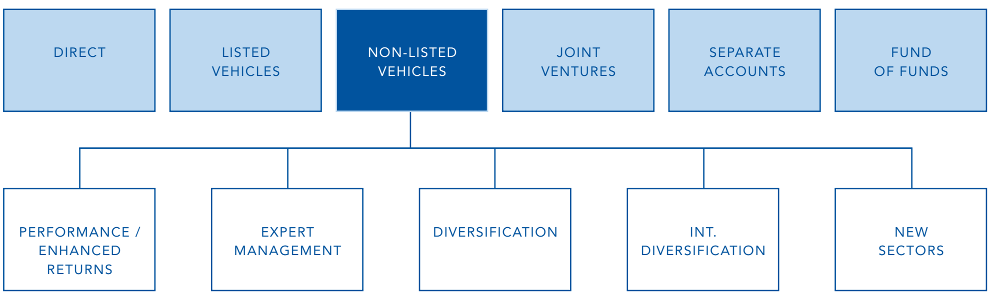
Push factors encompass a range of positive investment drivers including enhanced performance, access to expert management, diversification, cross border diversification and investing in new sectors. Such factors are inter-related.

Investing through non-listed real estate vehicles relative to direct real estate investment should deliver enhanced returns for a number of reasons. First, the benefits of accessing expert management should deliver higher returns due to the greater market penetration and relationships it offers, thereby providing access to a greater range and quality of product. Such management should enable investors to benefit from highly skilled fund management including active asset management, tax and debt management among other services.

The like-with-like comparison of direct and non-listed performance above suggests that until the downturn, non-listed real estate vehicles delivered outperformance based on market returns. Post crisis, the reverse is evident with the AMR INREV Index marginally underperforming the IPD Index of direct returns until 2009 when the indices converge (Figure 02).

As shown previously, the INREV Index demonstrates a strong negative skew, with median performance being considerably stronger than the mean average reported in the INREV Index. This is not merely due to gearing, it also reflects the sharper value deterioration of higher risk assets. This suggests that even on an ungeared basis, the majority of funds experienced performance in excess of the IPD direct real estate index, thereby delivering outperformance. In addition, as discussed previously, differences between the country weightings of the indices suggest that the direct European IPD Index benefits from greater exposure to the less volatile German market. In contrast, the INREV Index reflects its greater exposure to the more volatile Southern European and UK markets (see Appendix 2).

PUSH: WHY INVEST IN NON-LISTED REAL ESTATE?
(OVER AND ABOVE PERCEIVED MARKET OPPORTUNITY)

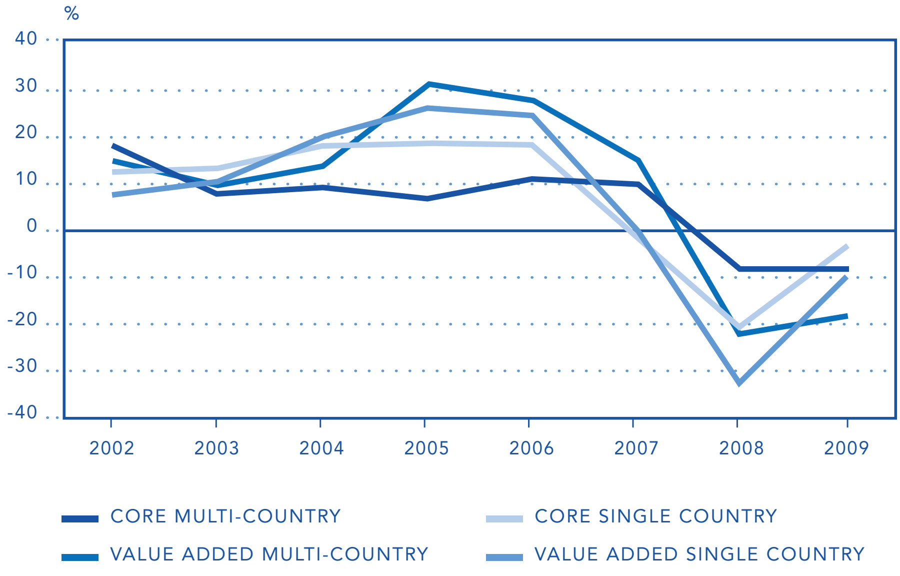


A second benefit for investors keen to expand their investment base into new sectors and international markets in which they have limited experience, is the access to expert management offered. Perceiving strong markets outside their traditional investment base, they were also keen to derive the benefits of portfolio diversification to lower risk and deliver a more stable return over the long-term.

In addition to accessing expertise, non-listed real estate funds offered a number of other advantages. The critical mass generated from investing in a pooled vehicle provided for economies of scale and operating efficiencies as the greater capital base enabled the construction of a portfolio of larger assets across a greater number of markets and/or sectors. This reduces risk yet further and is particularly attractive to smaller and medium sized investors as a means of lowering both market and specific risk, allowing access to greater diversification and better quality assets than might otherwise be possible.

The financial crisis signalled an unprecedented synchronisation in the collapse of real estate markets, eroding some diversification benefits over the short-term. However, over the medium-and long-term the importance of such diversification benefits remain an important benefit of investing in pooled real estate vehicles. Indeed, analysis of the INREV Index by style and single country v multi-country funds demonstrates the greater stability of core multi-country returns (Figure 08). Although single country core funds provide a lower level of volatility than value added funds, their performance has a stronger correlation with value added than with core multi-country. This demonstrates the benefits of diversification.

FIGURE 08 / COMPARISON OF RETURNS BY TYPE OF FUND DEMONSTRATES DIVERSIFICATION BENEFITS OF MULTI-COUNTRY FUNDS



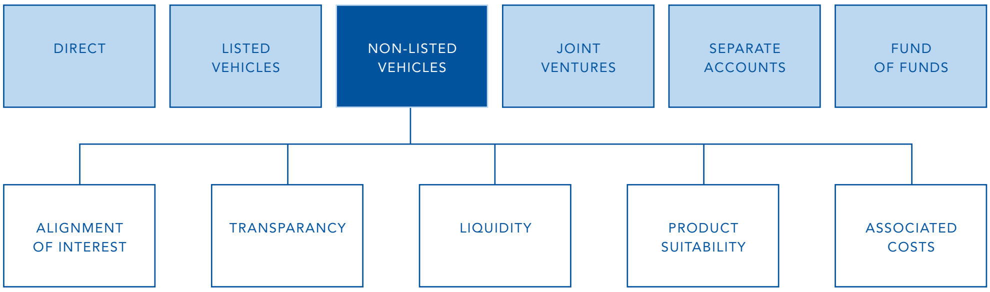
SOURCE: INREV 2010

3.2 Pull Factors

There are also a number of disadvantages associated with non-listed real estate vehicles that can act as deterrents to investing. Many of these factors such as transparency, liquidity, product suitability and associated costs are not limited to pooled funds, but are relevant to real estate as an asset class. However, the relative degree of risk of some factors is considered to be higher for non-listed real estate funds than for certain other investing options, such as direct real estate and to a lesser extent, the listed sector.

PULL: WHY NOT INVEST IN NON-LISTED REAL ESTATE?

(OVER AND ABOVE PERCEPTION OF MARKET OPPORTUNITY)

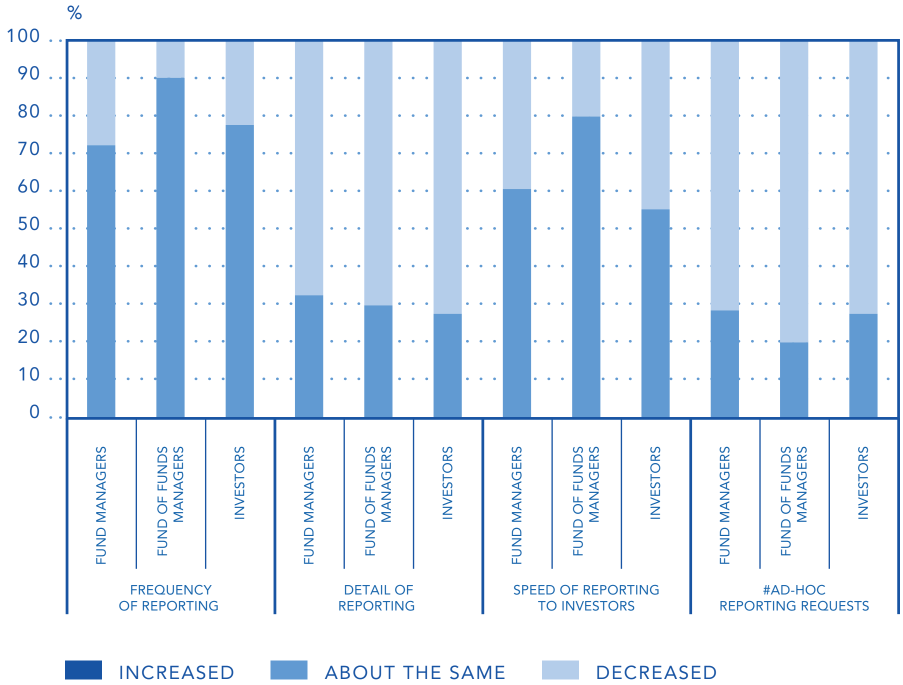


As a consequence, much consideration has been given to the structure of funds. Usually arranged on a general and limited partnership basis, the fund manager and investor both benefit from positive performance. However, the market downturn exposed the asymmetric risk of fund structures with fund managers facing little downside risk if they did not meaningfully co-invest. In addition, many fund managers benefitted from various layers of management fees over and above the cost of such management. Being based on GAV and often in the absence of an explicit debt strategy, fund managers were effectively incentivised to use leverage to increase the capital base. Some were equally driven by the erroneous pursuit of ever higher returns and building higher levels of diversification. While it is true that some

investors pushed for such outperformance, it is clear that there was a breakdown in alignment of interest. At its extreme, the lack of a clear division between investment management and asset management functions gave rise to a conflict of interest whereby some managers derived greater fees from arranging and securitising bundles of debt secured on assets than from the management of the fund itself.

In comparison to direct investing, transparency and liquidity concerns are greater. The level of transparency achieved is dependent on the terms of the fund and the level of openness in communication between fund managers and their investors. Previous research undertaken by INREV indicates that the depth and frequency of reporting is increasing as investors demand more detailed information regarding both fund and asset performance (Figure 09, page 14).

FIGURE 09 / INCREASING IMPORTANCE OF COMMUNICATION AND TRANSPARANCY



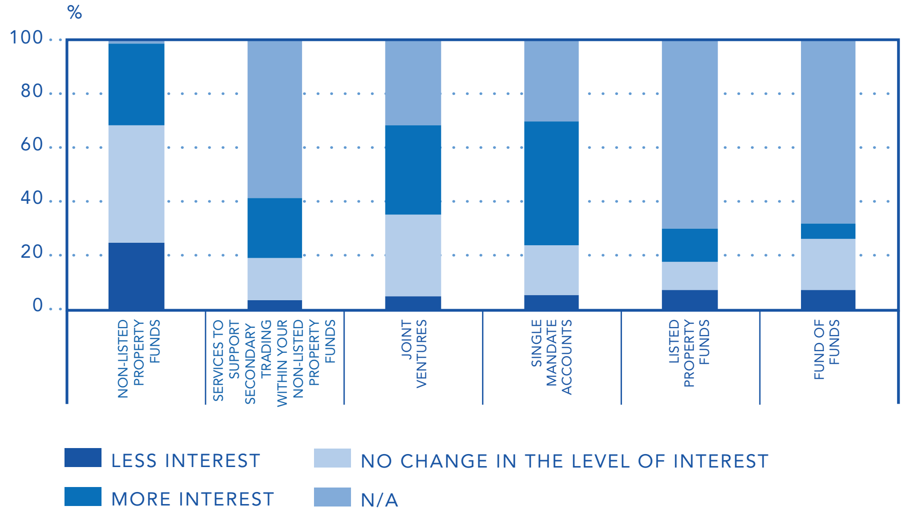
SOURCE: MARKET ACTIVITY SURVEY, INREV 2009

The application of the open end fund model was considered to provide a solution to real estate liquidity issues, in particular, concerns with the indivisibility of assets associated with direct investing. The emergence of a secondary trading market suggested the ability to trade units on demand and in this regard non-listed was perceived to have a lower liquidity risk than direct. However, issues of valuation and pricing particularly in inert markets illustrated that real estate remains a relatively illiquid asset regardless of the manner in which it is held. Indeed, direct investing proved to have a lower liquidity risk as investors are free to accept any price, whereas non-listed is subject to fund control as regards the timing of disposals and what is deemed an acceptable price level. This suggests that investors in non-listed real estate funds require a liquidity premium compared to direct real estate investments.

Accessing expert management through non-listed vehicle structures is often at the cost of control. Limited partners must trust the general partner to exercise their fiduciary duty and acquire appropriate real estate assets on their behalf. While the experience over the downturn has shaken this trust, the previous analysis indicates that as regards the underlying real estate, the performance of ungeared returns for pooled fund vehicles mirrors that of direct. Moreover, the majority of funds delivered returns in excess of direct returns.

The costs associated with indirect investing are both a pull and a push factor depending on the scale of the investor. For small and medium sized investors, cross border or multi-sector expansion of their investment bases would be prohibitively expensive were it not for the availability and economies of scale offered by non-listed real estate funds. For large investors there is a trade off between loss of control and efficiency gains from investing across a range of fund vehicles, increasing diversification yet further. However, in the aftermath of the downturn many investors are reassessing the efficiency gains alongside the cost of fees in the light of the low performance of some funds and/or the quantum of the distributed return post management and performance fees. This particularly relates to those funds launched late cycle. Investors are questioning whether they would have reduced losses had they been in the driving seat. Consequently, while non-listed real estate funds remains an important investing option across investors, some large investors are refocusing on direct, separate account and joint ventures (Figure 10). However, the cost associated with establishing a platform to manage such investing is not to be underestimated.

FIGURE 10 / INTEREST IN ALTERNATIVE MODES OF REAL ESTATE INVESTING RISE IN 2009



SOURCE: MARKET ACTIVITY SURVEY, INREV 2009

3.3 Why invest in non-listed real estate fund vehicles?

The factors underlying investment in non-listed real estate vehicles have been considered in INREV's Investment Intentions survey since its inception in 2005. Analysis of the results from 2006 to 2010 indicates that two of the top three primary push factors for investing in pooled funds as perceived by investors remain robust, namely, access to expert management and multi-sector benefits. While international diversification benefits remain important, their ranking as a rationale for investing in non-listed real estate vehicles has declined. As investors lower their risk appetite, they are refocusing on home and known markets.

TABLE 01 / CHANGING CONSENSUS ON BENEFITS OF NON-LISTED

INVESTOR			**FUND MANAGER**	
2010	2006		2006	**2010**
1	1	ACCESS TO EXPERT MANAGEMENT	1	**1**
▲ **4**	2	DIVERSIFICATION BENEFITS (DOMESTIC)	2	**6** ▲
3	3	DIVERSIFICATION BENEFITS (MULTI-SECTOR)	4	**2** ▼
▲ **6**	4	EASIER IMPLEMENTATION COMPARED TO DIRECT	3	**4** ▲
▲ **7**	5	ACCESS TO NEW MARKETS	5	**7** ▲
▼ **2**	6	ACCESS TO SPECIFIC SECTORS	6	**3** ▼
▼ **4**	7	ENHANCED RETURNS	7	**4** ▼
8	8	ACCESS TO LEVERAGED INVESTORS	8	**7** ▼

Interestingly, while access to expert management increases in its importance as a factor the perception of the ease of such investments declines. This reflects the increased level of due diligence being undertaken by investors on assets in existing and seeded funds, but also into the investment strategy, quality of the platform, its individuals and that of co-investors. In regard to push factors, alignment of interest has increased in its level of importance sharply since 2006, reflecting the significance of this issue for the industry. The availability of suitable products has remained stable, while the importance of other investors has turned sharply upwards. While at 20% it remains a lower priority to investors in this earlier survey than other issues, more recently it has emerged as a topical issue.

FIGURE 11 / SHIFTING IMPORTANCE OF PUSH AND PULL COMPONENTS FOR INVESTING IN NON-LISTED REAL ESTATE 2006 – 2010

SOURCE: INREV INVESTMENT INTENTIONS SURVEY 2005 – 2010

This analysis indicates that the rationale for investing in non-listed real estate vehicles has altered, but remains robust. The downturn has exposed weaknesses in the established non-listed model. Investors have placed such areas under the spotlight and are reassessing the terms of real estate funds and the relationships between parties. Equally, fund managers recognise the breakdown in trust between general and limited partners and across limited partners. It is fundamental to the future of the investment sector that such trust is rebuilt. National and supranational governing bodies are also considering the terms of agreements and management of funds, particularly where their misalignment or mismanagement may lead to wider systemic risk. Those most relevant to non-listed real estate funds are the Proposed EU Directive for Alternative Investment Fund Managers (AIFM); the EU Capital Requirements Directive III (CRD III) and the Proposed EU Directive Solvency II (solvency II). These three elements are altering the structure of the non-listed real estate vehicle industry.

4 KEY COMPONENTS OF TRUSTED RELATIONSHIPS

Adaptations to the structure of non-listed real estate vehicles and the issues underlying such change require evaluation. To this end, structured interviews were undertaken with a total of twenty-two respondents representing thirteen fund managers and nine investors, of which three were fund of funds managers. The aim of the interviews is to identify which aspects of the fund model remain robust post financial crisis, which could be improved and which aspects require change. In addition, the impact of recent legislative change on the key issues arising is considered.

The discussions centred upon, but were not limited to, a number of pre-defined issues. These included relationships between fund managers and investors, and across investors, alignment of interest and fee structures, debt strategy and consideration of risk and return. The discussions revealed strong consensus among investors and fund managers. Where differences persist, these are not a simple polarisation of fund manager and investor perspectives. Rather, given differing objectives, divergence of views are further evident across fund managers and across different types of investor.

4.1 Improving fund manager and investor relationships

Across both fund managers and investors there is recognition that the failure to exercise a fiduciary duty to investors' by what remains a minority of fund managers, has led to a breakdown of trust between actors in the private real estate vehicle industry. Investors are focusing on establishing fund agreements that best protect their investment This is manifesting itself in a number of ways including a shift in the mode of accessing real estate investment; re-emphasis and expansion of corporate governance, and generation of greater alignment of interest between GPs and LPs, and amongst LPs.

4.1.1 ACCESSING REAL ESTATE INVESTMENT

First, there has been a sharp increase in the number of joint ventures, club deals and separate accounts. However, it is accepted that the scale of capital required limits the approach to a small number of very large investors. Within these structures, large investors are often able to exercise discretion. In the case of separate accounts, meaningful levels of co-investment provide greater assurances as to the alignment of interest between parties.

However, a number of fund managers questioned how the structure of joint ventures and in particular, club deals differed markedly from fund structures once the number of parties exceeds two. They highlighted that greater risk control may be false as such structures require participating investors to acquire highly skilled employees across all areas of fund management. Ultimately, the structure mirrors that of a fund, but with potentially even greater risk. Should the objectives of participants become less aligned there is no established platform to mediate between the parties or reaffirm the agreed strategy.

Perhaps in recognition of such limitations, certain large investors have pursued a third way. To varying degrees, they have developed their business' to mirror many functions within strong fund management platforms, notably within due diligence, investment strategy, tax structures and debt management. Such investors pre-determine the strategy they wish to pursue and subsequently cherry pick a fund manager to implement, operate and manage the fund on their behalf. These large investors are capitalising on the scale and scarcity of their capital commitments, while fund managers can profit from their ability to prudently execute and manage the fund strategy. After initial setup, such funds are open to other investors, but participation is effectively as second close investors. The fund manager has discretion within the agreed fund strategy, although in some instances partner investors have reserved the right to veto certain decisions.

As identified in INREV's Investment Intentions survey early in 2010, investors have shifted away from pan-European funds towards single country, sub regional and sector funds. The interviews reveal the rationale underpinning this behaviour. First, investors are exercising greater control over strategic investment decision-making. To this end they are effectively retaining discretion as to country and sector allocation, and in this regard, to market risk. Second, investors and many fund managers commented that the ability of any one fund manager to have the same detailed local market knowledge, depth of relationships, access to product and scale of platform across all markets at a pan-European scale is unrealistic. Consequently, there is a re-emphasis on single sector, country and sub regional multi-country funds.

Yet, retaining control over market risk comes at a cost. To derive diversification benefits which are a key component of performance requires appropriate risk and portfolio management of what is in effect, a self-managed fund of funds strategy. Any one investor will require the capacity to develop strategy, effectively research, underwrite and where appointed, monitor the performance characteristics of a large universe of funds. While a number of large investors will have the capacity to develop such a platform, for most it will not prove viable. Of course, this provides an opportunity for the growth of intermediaries with additional management roles such as capital placement firms and separate account, fund of fund managers. Being fee based, such services will reduce net returns.

4.1.2 ACCOUNTABILITY AND CORPORATE GOVERNANCE

Investors are seeking greater manager accountability in future fund agreements. Importantly, most investors are not seeking to take discretion within managed real estate vehicles. Rather, investors argue that they are simply implementing best practice already established in many existing funds that have strong corporate governance and risk control. Indeed, for many well governed funds there may be no noticeable change in investor participation. Across fund managers, experience of where discretion is sought, is either within those funds which culturally have a long tradition of non-discretionary mandates, for example the German Spezialfonds or, in structures outside the non-listed real estate fund model. A number of the issues raised by interviewees are central to the recent INREV review of corporate governance practice. Key areas of emphasis are:

(I) REPORTING AND COMMUNICATION

Interviewees commented on the lack of communication and transparency that pervaded as the debt crisis worsened and real estate values declined. More pro-active fund, managers began a process of re-underwriting assets to re-establish the fund base. However, many fund managers weren't well-equipped to deliver bad news. For funds lacking a regular and established reporting procedure, investors had to force information flow. Somewhat counter intuitively given resources, investors indicated that smaller platforms provided greater transparency of information. There were a limited number of extreme cases where no provision for reporting is detailed in the fund agreement and fund managers resisted appeals from investors to attain such information. Investors acknowledge that at the height of the boom they failed to ensure the accountability of fund managers, especially in regard to detailing the investment strategy and in reporting requirements. As a result, investors are keen to redress this balance.

This issue is considered within the proposed AIFM legislation. Minimum disclosure requirements are outlined and include; annual reporting of financial accounts and activity; any material changes to investment strategy; risk profile and risk management; disclosure of debt profile and strategy; and, remuneration policies.

(II) ADVISORY BOARDS

Investors are keen to establish more effective and participative advisory boards. Fund managers tend to confuse this with loss of discretion. However, investors are seeking manager accountability, not discretion. An important element relates to investment strategy. Investors are now seeking a more detailed and precise investment strategy, within which, the fund manager has full discretion. It is acknowledged that given greater precision, the need for tactical adjustments is likely to increase. Interviewees reported that many investors are seeking annual advisory board meetings to approve any tactical revisions to the investment strategy. Indeed, this is an example of established best practice within both discretionary and non-discretionary German institutional closed end funds. Frustrations around the effectiveness of advisory boards tend to focus on investor to investor relationships and are discussed in greater detail below.

(III) NON-EXECUTIVE DIRECTORS

Interestingly, support for the role of non-executive directors is lukewarm, particularly in respect of positions on investment committees or advisory boards. It was argued that such appointments bring additional costs, yet evidence of their efficacy is muted, with non-executives rarely challenging fund manager decisions. However, there was broader support for the role of non-executives directors as mediators within advisory boards and in particular, as chair of investor meetings. Moreover, in some countries national legislation prohibits the appointment of non-executive directors to investment committees for certain types of fund, for example, German law prohibits non-executive roles within Spezialfonds.

(IV) NO FAULT DIVORCE

A recent study by INREV examining corporate governance highlighted that although the majority of existing funds included a clause for the removal of a manager with cause, in practice it is very difficult to implement such clauses. Many require a court order and often no forfeiture of fees or carry. Indeed, the cost of exercising no fault removal clauses which are included in a fifth of funds within the study, are often prohibitively expensive. Given wide variation in fund management and the exercise of fiduciary duty experienced during recent market turmoil, investors are keen to use the shift in the balance of power to ensure the efficient removal of a non-performing manager. Fund managers are accepting of this change, recognising that it is a response to what remains a minority of fund managers who failed to act in the best interests of clients.

4.1.3 ALIGNMENT OF INTEREST

It is accepted across investors and fund managers that behavioural issues are central to the breakdown of trust. A number of areas of misalignment of interest have been identified, particularly in relation to fee structures that may have influenced fund manager behaviour and ultimately exacerbated the impact of the downturn. In order to repair such components, much attention has focused on generating a much closer alignment of interest. Issues are centred on the structure of fees, the basis of fees, co-investment and retention of team.

(I) STRUCTURE OF FEES As the popularity of investing in non-listed real estate vehicles accelerated from 2003, many fund managers introduced new fee layers. Fee structures became increasingly complex and difficult to look through and ultimately, reduced the proportion of returns due to investors to unsustainable levels. The findings of the interviews suggest a move towards greater standardisation and simplification of fee structures. This is hand in glove with a move towards greater sophistication in the relevance of fee structures across types of investment strategy. One interviewee stated that of a sample of

150 funds he had analysed at the height of the boom, no two had the same fee structure. Indeed, one manager released five funds with five different fee structures on one day. Presently, there is a shift towards a basic frame of a low management fee to cover costs, with performance fees linked to hurdle rates and deferred or back ended. There is some variation by style, with opportunity funds tending to retain an introductory or capital commitment fee, with performance fees remaining back-ended and including a catch up clause. In contrast, introductory fees are not a feature of core funds and while performance fees are back ended, the longer life of such funds often results in a deferred three or four year rolling performance fee structure. Catch-up provisions for core funds are disappearing with many respondents indicating that for core funds they may encourage inappropriate risk taking.

(II) BASIS OF FEES

Arguably, the most widely spread change in the basis of fees has been in the shift from GAV to NAV for management fees. In the aftermath of the crisis, it became apparent that having management fees based on GAV incentivised managers to leverage portfolios to the maximum permitted in order to generate additional fee income. Anecdotally, many respondents spoke of trophy assets owned by some managers that delivered a management fee in excess of the equity committed. The use of NAV as a basis ensures the manager is primarily focused on the real estate performance of assets, rather than that simply due to a yield gap. However, it was also argued that in the current market the effect of leverage has resulted in negative NAVs. While some investors and fund managers expressed the view that managers should not be paid for non-performance, other investors and fund managers suggested that managers needed to be incentivised to work assets out. Although it is accepted that retaining the client relationship is incentive in itself it was agreed that there are circumstances where the manager/investor relationship is beyond repair. Importantly, with the absence of fees and associated remuneration it was considered that the most skilled members of the platform might leave. Such situations were considered fund specific by interviewees and subject to special arrangements. Using NAV as a means of aligning investor and manager behaviour was considered by most investors and fund managers as being a more important objective. However, a number of fund managers and investors suggested that the issue of GAV versus NAV is a superficial response to the broader issue of debt management and its explicit consideration with the fund agreement. It is noteworthy that the AIFM legislation is silent on fees, but makes explicit proposals regarding debt management (see Leverage and Debt Strategy).

Again, there is marked variation by investment style with opportunity funds tending towards a management fee based upon committed capital while for core and opportunity funds with a strong income component of target returns, management and/or performance fees based upon income returns are emerging.

(III) CO-INVESTMENT

Both investors and fund managers suggest that co-investment leads to greater alignment of the parties. However, one investor suggests that unless the co-investment represents a significant proportion of the fund, the fund manager should not consider itself a partner to investors. In contrast, another argues that the level of investment isn't important, but that it is meaningful to the individual is. What both require is that fund managers recognise their role as a service provider and act upon their fiduciary duty to investors. Appropriate co-investment levels are considered within the AIFM proposals which suggest fund managers should provide 0.02% of the GAV in excess of €250 million for external managers and €300 million for internally managed funds. They propose to limit such co-investment to a maximum of €10 million. The source of such investment is not considered in the proposed legislation, yet an important requirement for some investors is that such investment is made by those individuals responsible for the fund and not from the wider organisation. It was accepted by investors and fund managers that smaller fund managers tend to have a higher degree of personal co-investment in their platforms, while for the largest platforms it can be difficult to distinguish between organisational, organisation-sponsored and personal co-investment. For such large platforms, additional measures and controls to secure alignment of interest are considered, with a much greater emphasis on key man clauses, remuneration and the role of investment committees.

(IV) RETAINING THE TEAM

Continuity of key personnel involved in the management of the fund and the execution of its strategy is of rising importance for investors and those fund managers seeking to retain and acquire new clients. In a market that is competitive in terms of its highly skilled labour force, developing longevity is difficult. Within smaller platforms, the level of co-investment in the fund and equity in the fund management business tends towards greater stability of the team. In addition, investors may require key man provision. This is generally of greater importance to medium and large fund manager platforms where co-investment is often less personally committed, even when provided by individuals. However, some fund managers questioned whether it is appropriate to place a key man provision on team members where the duration of the fund is in excess of five years, particularly in larger platforms where it would be normal for many team members to progress. Consequently, there has been a greater emphasis on securing the key role, rather than a key person as ensuring there is dedication is paramount. In addition, placing an emphasis on retaining such members within the organisation is considered more appropriate, thereby retaining the asset and fund history.

(V) REMUNERATION AND BONUS STRUCTURE

Investors, keen to ensure that the wider acquisition and asset management teams are retained and stay focused are attempting to influence the distribution of deferred carry. While investors are seeking co-investment to ensure that key individuals with responsibility for the fund are exposed to downside risk, they are equally keen that remuneration policies promote collegiate behaviour with potential upside from performance fees being widely distributed. Preferences tend towards fund and organisational bonus pools as a means of ensuring broad accountability and interest in fund performance. While investors are keen to ensure that performance related fees are structured at appropriate levels,, deferred and/or based on realised returns, they are unconcerned as to the level of remuneration.

Although remuneration is considered within AIFM proposals, the umbrella of the CRD III directive captures the non-listed funds sector. This legislation, enforceable retrospectively from January 2011, contains specific clauses as to the structure, amount and timing of remuneration. Bonuses should not exceed 50% of fixed salary and 40% to 60% should be deferred for a minimum of three to five years. Cash may make up no more than 30% of any bonus. In addition, claw back provisions can apply. This legislation is likely to have important implications and assuming skilled labour doesn't migrate en masse, is likely to result in greater skills retention by managers and an increased focus on longer term performance.

(V) INVESTMENT COMMITTEES

The structure, operation and effectiveness of investment committees is an area that has received scant discussion. INREV's Corporate Governance Best Practice Review indicates that the majority of funds (73%) have established an investment committee. Within non-discretionary funds, the investor committee provides approval. For discretionary funds the structure and operation of the investment committee may be specific to an individual fund, or operate across funds. For larger funds which may lack the alignment of interest through meaningful and personal co-investment, the com-position and operation of investment committees is considered an area where increased Corporate Governance might assist risk management. Interestingly, investors are less focused on this issue than fund managers, perhaps reflecting the lack of transparency as to their operation.

However, the issue has been considered within the proposed AIFM legislation, albeit loosely, with a requirement for fund managers to separate risk management from portfolio management.

Fund managers are polarised on the issue. Investment committees will usually comprise senior representatives from across the fund management business, including at least one senior representative from within the acquisition team. There is strong potential for conflict of interest where an individual leading a proposed acquisition may be both presenting an investment to the committee and voting on it. It is argued that there should be a split between decision-makers and originators as a means of controlling risk within larger platforms where it is more difficult to secure alignment of interest through co-investment. It would be necessary to ensure that at least one senior member of the platform had a transactional background, but should not be active in this role. Other fund managers suggest that it is unrealistic to divide roles in this manner and that it is important to have experienced deal makers involved in steering complex acquisitions. They suggest that where an investment committee member is conflicted, they lose voting rights. It was further suggested that non-executive committee members could assist in ensuring investment committees exercised their duty of care. Indeed, by undertaking a chairing role it is suggested that they might also ensure that all important issues are raised and that no one individual dominates proceedings.

(VI) SEPARATION OF FUNCTIONS

It was considered that the nesting of fund management within investment banks lay at the heart of the financial crisis. There was a major conflict of interest between fees that could be generated from securitising and selling down debt, and the exercising of fiduciary duties towards investors through prudent acquisition and management of assets. Both investors and managers foresee a separation of investment banking and investment management.

4.1.4 CAPITAL PLACEMENT

A key behavioural issue lies in the deployment of capital through the cycle. Investors accept that during the real estate boom, great emphasis was placed on the speed of capital placement in selecting fund managers. Once allocated, capital left lying in cash reserves was considered to have a negative pull on returns. Such pressure to place capital resulted in an acceleration of risk relative to return as the weight of capital exceeded supply. This suggests that investors need to provide for deferred investment strategies. Strict asset allocation within institutional funds in particular is based on the premise that capital allocations are invested immediately. For more illiquid and smaller capital markets such as real estate a provision to allow for prudence over speed, especially when capital commitments to the asset class are high, is required. Indeed, one fund manager suggested that the industry develop a simple metric to measure the strength of real estate capital markets based on the ratio of capital commitments to market size.

Similarly, fund manager placement of capital also reflected some behavioural issues. Recognising that speed to market was an important attribute, expedience in the placement of capital became more important than prudence in its deployment. In addition, as the markets began to turn and capital allocations froze, some fund managers continued to drawdown capital and invest. While some investors failed to recognise the severity of the financial crisis, fees continued to present an incentive to invest and more worryingly, some fund managers' primary focus was on retaining their platform by keeping employees active. Similarly, for open ended funds, capital was reinvested from realised assets. As a result, some investors are trying to place limits on fund manager discretion as to the amount of capital that may be deployed in any one year. This is likely to prove a rather counter-productive and short-term reaction. Promoting an even distribution of capital across time in what remains a cyclical market does not engender best practice. Rather, greater emphasis should be placed on developing and applying appropriate risk adjusted return measures, in tandem with the ability to exercise a deferred investment programme.

4.2 Investor to investor relationships

Diversity of investor objectives and its impact on investor relationships has arguably led to the greatest breakdown in trust within the fund model. As financial turmoil manifested itself in the real estate market, it rapidly became evident that the investor base of non-listed real estate funds is heterogeneous in terms of its objectives, level of sophistication and culture. Consequently, investors are exercising much greater caution as to the types of limited partners they are prepared to invest alongside and under which circumstances. This change is expected to have significant implications for the structure of the industry, but also for its maturation and future development, especially in respect of secondary trading. The key areas of contention arise from differences in investment duration, scale and capability, and passivity versus activism.

4.2.1 INVESTMENT HORIZONS AND LIQUIDITY

Traditionally, real estate investment has been dominated by long-term institutional, sovereign wealth, endowment and legacy investors. Previous to the boom, high net worth individuals (HNWI) and shorter term investors needing greater capital liquidity tended to avoid real estate due to its bulky capital commitment characteristics. However, the growth in real estate vehicles and particularly open ended funds were put forward as the solution to real estate illiquidity. In response, the asset class attracted a wave of new investors with short- to medium-term investment horizons, keen to participate in the sectors strong returns. While such investors comprise a broad group, HNWI represent a large proportion. As well as investing directly, such investors commonly used the conduit of fund of funds to access the market. As the real estate market moved into its downward cycle and real estate values began to fall, it became clear that real estate remained illiquid regardless of the open ended fund wrapper. Indeed, it can be argued that direct real estate is more liquid than indirect as the owner has discretion as to assessing its value and its disposal.
The open ended fund model and emergence of a secondary trading market promised greater flexibility and market transparency. However, real estate assets remain bulky, broadly indivisible and impossible to transact in a market where the only certainty regarding values is that they are falling. In this respect, short- to medium-term investors misunderstood the characteristics of the asset class.

Such investors were often keen to liquidate assets, often requiring the capital for broader commitments. Their investing alongside long-term sovereign wealth and institutional investors resulted in a mismatch of desired outcomes. Institutional investors sought to work through the issues and continue to hold investments long-term. Worse still, as such investors were often highly leveraged they faced personal liquidity issues and certain of such investors began to default on capital draw-downs. Consequently, institutional investors are now focusing on closed-end funds, with a limited number of more homogenous institutional investors (not exceeding 10).

This has a number of implications. First, the scale of funds may reduce due to a smaller number of investors together with reduced leverage, unless institutional investors increase the average size of capital commitments. Indeed, Solvency II adopted in May 2010, may impact upon investments made by certain institutional investors. Designed to harmonise capital adequacy and solvency requirements of European insurance providers, it promotes investment in safer, less volatile and more liquid investments. While allowing for flexibility within its "prudent person principle", it is likely to result in lower risk real estate allocations, if made to real estate at all. Second, with a shift back towards closed end funds, the liquidity and transparency of the market is reduced. This increases the risk premia associated with real estate over the long-term and stalls its development into a mature asset class. Thus, the current approach may prove disadvantageous in the long-term.

An alternative is to restructure the terms of open ended funds to safeguard their longer term objectives. First, limits are set on the exercise of annual redemptions to circa 10% per annum. Second, such limits must be mirrored in the agreement between client and fund of fund manager. Third, capital commitments from HNWI, fund of fund managers and any first time investor must be provided at fund launch, with appropriate cash management.

While it is understandable that investors are keen to safeguard future investment it is worth remembering that those investors requiring liquidity have either withdrawn, or are accepting longer term commitments and illiquidity in regard to any real estate investment. Many of the funds of funds that remain represent long-term, institutional investors. What sets them apart is scale.

4.2.2 SCALE, CAPABILITY AND SOPHISTICATION

The crisis has resulted in a polarisation between investors with differing objectives. At the extremities are active, well-resourced large investors and passive, poorly resourced small investors. Well resourced large and medium sized platforms expressed frustration with their smaller counterparties in funds for failing to resource funds in crisis, either with financial or human capital. They argued that the larger investors were left to resource the fund and dedicate time, people and capital to working through solutions. Again, fund of funds were identified as a particular source of frustration, particularly where they had taken a position on an advisory board, but failed to exercise their responsibilities on it, for example attending investor meetings and advisory boards. Of course, there are a number of well resourced fund of fund managers that have proved the exception to the rule.

The interviewees acknowledge that smaller and sometimes medium sized investors are also dissatisfied with large investors. They consider their own investment objectives are often railroaded by large investors who work behind the scenes with fund managers to construct solutions that are acceptable to the large investor, and that this is then presented for approval by wider investors as the only solution.

The role of investor meetings, advisory boards and non-executive meetings is to provide a forum for airing such grievances, as well as for discussing key issues and reaching consensus as to the way forward. However, larger investors suggested that smaller investors had limited resource and often lacked the investment sophistication to understand the complexity of issues being discussed, tending to support the fund manager by default. As discussed above, this has resulted in large investors shifting towards separate accounts, club deals, joint ventures or taking an active role in launching new funds. Similarly, many smaller and medium sized investors are reluctant to invest in funds with one, large dominant investor as they anticipate their objectives will be subordinate to the larger investor. This is resulting in further stratification of the market by type of investor.

However, with the exception of perhaps the largest investors for whom other limited partners are not essential, the solution is rather short-term and fundamentally flawed. Seasoned fund managers in particular were keen to point out that over a medium-term horizon, many of the individuals representing investors who negotiated either a club deal, joint venture or fund will change. Organisations shift objectives, outlook and ultimately, strategy. Merger and acquisition activity often changes the people, objectives and scale of resourcing of an organisation. A longer term solution would be to ensure an active, participative investor forum to (I) achieve consensus on an investor charter, be that activism or passivity; (II) acknowledge the potential value and sophistication that larger investors can bring and recognise it through leadership roles; (III) appoint non-executives to chair and mediate meetings and contentious issues.

Interestingly, proposed amendments to Italian Tax law are running counter trend. To benefit from tax efficient structures the definition of what constitutes a fund will require a plurality of investors, thereby failing to recognise funds that have a small number of investors. Moreover, to achieve recognition for exemption from income and capital gains tax, such funds must have full independence from any investor interference, including investor advisory boards or committees.

4.2.3 CULTURE CLASH

A number of investors commented on the attraction of club deals being less about control of the fund strategy and more concerned with retaining control over co-investors. Those investing across a number of funds have identified those organisation that share similar investment objectives and a similar culture in implementing them. As noted above, such seemingly cultural compatibility is dependent on organisation and individuals within them remaining constant over time. However, individuals get promoted, change companies, retire and fall under the proverbial bus. Similarly organisations expand horizontally, laterally, merge, de-merge etc. To this end, cultural compatibility of organisations and their employees will shift due to business change and the natural progression of individuals and their responsibilities over the lifetime of what remains a long-term investment in real estate.

However, a number of interviewees commented on the cultural differences between US and European investors, rooted in the historical background of fund managers that results in a culture clash as regards investor behaviour, participation and ethos. Essentially, this may be summarised as activism versus passivity. Within Europe, most institutional investors in non-listed real estate vehicles have their roots in direct real estate investment. In this respect they have a strong understanding of the asset class, the acquisition process, asset management and fund management in the guise of portfolio management. Given their knowledge and understanding of the market place, this predisposes such investors to being activists. In contrast, US investors in European real estate vehicles have tended to approach the sector from a different perspective. Such investors tend to represent the trustees of institutional investors of which real estate is one allocation. They use fund vehicles as a means of accessing not merely product, but also real estate investment expertise. Given this backdrop, many US investors take a passive role in funds, although they require detailed reporting. In appointing fund managers, the trustees and their representative undertake detailed due diligence in selecting the fund manager. Given this, they expect their GP to execute fund strategy unfettered by LPs and are therefore averse to activists in discretionary funds. However, even with this culture a number of large investors have taken a more activist stance, especially post financial crisis.

4.3 Leverage and debt strategy

The explosion in the use of leverage within real estate during the boom has had a major impact on fund performance since the collapse of debt markets and real estate values. Both fund managers and investors comment that it wasn't irrational to use debt given the yield gap. Rather, the irrational exuberance lay in the failure to plan for paying down that debt as and when the real estate and /or debt markets turned. Errors arose with the failure to relate debt to income. Indeed, the strategies using the highest level of leverage often had an absence of income return. Some fund managers used debt as a means of expanding the AUM and as discussed earlier, management fees. There was an absence of risk control and little consideration was given as to what sort of debt should be used and how such debt might be repaid under different scenarios. In short, there was often an absence of an explicit debt strategy within fund agreements beyond a debt ceiling. Post-crisis, investors have focused on changing the fee basis to dis-incentivise leverage.

Presently, low interest rates suggest that prudent use of leverage is both rational and beneficial, especially in relation to core assets with strong income cover. Therefore, it may be more meaningful to develop an explicit debt strategy as a means of controlling risk while maximising risk adjusted returns. Indeed, the issue is considered within AIFM proposed legislation which requires fund managers to disclose an explicit debt strategy including levels, sources, duration and any collateralisation agreements in relation to debt. The findings of the structured interviews go even further in considering the scope of an explicit debt strategy.

4.3.1 SCALE AND LINKAGE

The debt strategy should be clear about the aggregate level of debt permissible at the fund level and for any individual asset. Clearly this will vary across investment styles. The level of debt should be related to income cover. For prudence, loan to values could make reference to fair value rather than a spot price. Such fair value would be referenced each year to the average market value estimated for each of the preceding 3, 5, 7 or 10 years, as appropriate to individual assets and funds. Equally, the leverage test should be capable of being applied over the life of the fund rather than at one point in time, for example, the end of the investment period.

4.3.2 SOURCING AND DURATION

The underlying source of debt and its maturity will carry different risk profiles. The debt strategy should detail whether debt sources will be on balance sheet, syndicated or securitised. It should further detail the maturity of debt cover in relation to the life of the fund, or for open ended funds, the holding period of the asset. If short- and medium-term durations are used, or rates are variable, the debt strategy should detail the hedging policy. Indeed, as the debt crisis escalated it became apparent that certain funds had failed to hedge appropriately. This resulted even in some core funds being exposed to escalating costs of debt as debt margins rose rapidly. Some investors commented that hedging capability is a major focus of due diligence on fund managers and products.

4.3.3 CROSS COLLATERALISATION

The issue of cross collateralisation has proved one of the most contentious issues across fund managers and between fund managers and investors. Many existing fund documents allow or are silent on cross collateralisation. Investors have been rudely awakened to the use of the pooled fund assets as collateral for debt arrangement on a single asset. This results in the contagion of non-performance of a single asset across a fund. Such cross collateralisation is likely to have reduced the cost of debt, but carried greater risk.

In addition, the triangulation of investor, fund manager and debt provider relationships has led some investors to suggest that there is a conflict of interest and that fund managers are placing their relationship with debt providers above their relationship and fiduciary duty towards investors. Investors maintain that there are three risk bearing interests in any asset; investors, fund managers and debt providers, and that together they should work as professionals to find solutions. They consider debt provides to have been unwilling to accept their share of risk and that fund managers have bowed too easily to their pressure to recapitalise, often using cross collateralisation to safeguard their own relationships. Despite the tripartite agreement, investors suggest that they are left to carry the downside risk and losses.

A majority of fund managers argue that securing long-term relationships with debt providers across their platforms is important for all investors as it impacts on the availability and cost of debt to the fund manager. Moreover, it is argued that this may have further implications for individual investors as debt providers are now undertaking due diligence on investors within a fund prior to granting facilities. Thus, the last resort of handing back the keys is not an option.

In contrast, one fund manager disputes the contention that long-term relationships are damaged or debt availability is put at risk and agrees that many fund managers have given way too easily to debt providers demands. It is stressed that investors' interests must come first. It is argued that professionalism is key and that it is the duty of both fund manager and investors to work hard towards finding a solution with the debt provider. However, in circumstances where all attempts have failed, debt providers need to accept that they carry the risk of holding a non-performing asset. In this fund manager's experience of handing back keys following a professional, but ultimately unsuccessful work out period, no long-term repercussions had been experienced.

4.4 Refocus on risk and return

Many interviewees commented that underlying the downturn in real estate values is an economic and in turn, real estate cycle. Both investors and fund managers consider that as the markets accelerated investors pushed fund managers to generate ever higher returns, encouraging higher leverage. It is acknowledged that both parties failed to consider the steepening downside risk associated with ever increasing levels of gearing. Indeed, many investors and fund managers commented that risk adjusted returns fell sharply over the cycle, as the risk curve was climbed. That is, on a risk adjusted basis, core investment provided a higher return at the peak of the market than opportunistic investing. Fund managers and investors are now focused on developing appropriate risk metrics.

In assessing the risk associated with a fund management platform both investors and fund managers are keen to stress that being a good asset manager is not synonymous with being a good fund manager. While real estate fundamentals associated with investments and the skills to effectively asset manage them are primary, they must be augmented by a strong skill set in managing debt, currency and tax mitigation as well as good corporate governance, with clear reporting and fee structures of the fund. Investors are underwriting teams, not merely fund products.

In assessing both the market risk and the specific risk associated with assets, fund managers and investors have refocused on developing qualitative frameworks. These enable the qualitative assessment of risk adjusted returns, utilising risk premia and hurdle rates. Specific risk is scrutinised and in particular, investors are seeking regular updates on tenancy risk.

5 CONCLUSION

In considering the case for non-listed real estate vehicles in the aftermath of the financial crisis and downturn in European real estate markets it is clear that they will retain their place in the spectrum of real estate investing options. Comparative analysis of the performance of alternative options for real estate investment indicates that on an ungeared basis, non-listed returns mirror those of direct market returns. Indeed, on an ungeared basis, non-listed returns may have marginally out performed when differences in the composition of the indices are considered. In comparing geared and ungeared INREV returns, the negative impact of leverage on performance post-crisis is clear. The mis-management of debt within portfolios and its damaging effect on the industry as well as performance is not to be trivialised. However, it is clear that within the INREV Index universe a small number of funds in terms of both quantity and value have had a strong negative skew on the average index return in recent years, indicating that the majority of non-listed real estate funds delivered performance in excess of the Index.

The favourable investment characteristics of non-listed real estate vehicles have largely remained resilient throughout the cycle, although investors have reconsidered the relative importance of certain characteristics. Access to expertise and economies of scale continue to be considered as valuable benefits of investing in the non-listed sector. However, it is no longer viewed as the easy option with investors recognising the importance of detailed due diligence prior to fund selection and the ongoing monitoring and management of such investments. Currently, investors are retrenching to domestic or core markets in which they have experience and greater comfort, resulting in a focus on single country, sector or sub regional country funds. While the view that no single manager can truly have the required expertise across all markets and sectors on a truly pan-European basis is perhaps valid, the current emphasis is likely to weaken diversification benefits and therefore be short-term for small to medium scale investors. For large investors with the requisite expertise and critical mass to deliver diversification from investing across a range of funds, this retention of what is essentially managing market risk through asset allocation strategy may prove more durable. Despite the unprecedented synchronisation of the real estate downturn across both geography and sectors, the benefits of diversification remain with core, multi-country funds delivering more stable returns. In the medium-term we expect regional funds to re-emerge but with greater specificity in their strategies as to the markets, sectors and risk profile permissible.

As regards greater liquidity, it is clear that non-listed funds are not a panacea to real estate illiquidity issues. While the open ended fund model and emergence of a secondary trading market promised greater flexibility and market transparency, it failed to deliver during the crisis. Ultimately, real estate assets remain bulky, broadly indivisible and impossible to transact sharply declining markets. Many of the short- to medium-term investors attracted by the false dawn of real estate liquidity are likely to withdraw from the market, while others who have enjoyed the experience will accept the longer-term investment horizon required.

While the rationale for investing in non-listed real estate remains robust, the crisis exposed weaknesses in the established model. This is resulting in a number of changes in the construct of fund manager and investor relationships which are manifesting themselves in product development. Certain of these changes will prove short-term, while others represent more structural shifts in the non-listed real estate industry. For example, while the switch from management fees based on GAV to NAV does remove the benefit of widening the asset base through the use of leverage, it doesn't necessarily dis-incentivise mis-use of debt. Would it negate the extreme example of investment managers generating greater fees from the issuance and securitisation of debt than from fund management itself? The development of an explicit debt management strategy that details the level, sources, duration and allowable collateralisation of debt is more prudent and effective. Both the short-term and more structural trends are summarised in Table 02, page 30.

TABLE 02 /SUMMARY OF SHORT- AND LONG-TERM CHANGE TO THE STRUCTURE OF NON-LISTED REAL ESTATE FUNDS

	SHORT-TERM	LONG-TERM
GEOGRAPHICAL AND SECTOR DIVERSIFICATION	Investors have refocused on single country and single sector funds as a means of controlling market risk exposure. However, excepting a few large investors with the requisite expertise and capital, this approach may heighten risk as it neglects the benefits of diversification.	Recognising the need for diversification, investors will reawaken to the benefits of multi-country funds. However, investment will be permissible only in those countries in which an investor can demonstrate depth and reach. This may lead to some consolidation in the industry and see broad European regional funds offered by a limited number of managers. This will be augmented by a range of sub-regional funds, with fund managers specialising in local sub-regional geographies. Large investors with the required capability and capacity, may continue to manage their market risk through selection of single country and sector funds.
MODE OF INVESTMENT	Those investors with the critical mass to invest in separate accounts, club deals and joint ventures have favoured this mode of investing over non-listed as suposedly it delivers greater control.	Large investors may continue to pursue separate accounts. However, over the medium term the resource required to implement joint ventures and club deals, together with shifts in partner objectives are likely to fail to deliver on lowering investment risk. Such investors, keen to avoid spending time and resource on asset and property management will return to the non-listed sector. However, they are likely to use the power of their capital commitments to shape strategy and fund terms at the outset.
ALIGNMENT OF INTEREST	Given the breakdown in trust, some investors have been seeking to retain control through narrowing strategies and limiting capital placement. While they will continue to require better communication, they will provide greater flexibility over the medium term to ensure they do not impede effective investment decision-making.	The stronger alignment of interest through the structure of fees, co-investment and remuneration will be durable. Advisory boards will hold investors to account and in turn, be accountable to the broader investor pool.
INVESTOR RELATIONSHIPS	Investors are seeking homogeneity in the investor base by limiting both the type and number of investors in a fund. There is a reluctance by institutional, sovereign wealth and other long term investors, to invest alongside smaller investors, HNWI and funds of funds.	Given the requirement for diversification in addition to a lower leverage environment, funds will need to increase their investor base to achieve scale. Fund documents will explicitly set out the long term objectives of the fund. Virgin and intermediary investors will be required to give safeguards as regards capital commitments at the outset.
REFOCUS OF RISK	Many efforts to control risk have been knee-jerk and piecemeal. For example the switch to NAV over GAV fails to address the underlying issue of exercise of fiduciary duty and debt management.	Establishment of higher barriers to entry to the sector. Greater emphasis on risk management, strategy and capability including an explicit debt and hedging strategy.

Greater alignment of interest is also being secured through the restructuring of management and performance fees to better reflect the long-term investment horizon of assets. Fee structures are being simplified and management fees scaled back to cover the operational cost rather than an additional source of profit for some managers. Performance fees are back-ended and for funds with longer horizons are based on a deferred rolling average of values. New legislation marries this to remuneration, with a large proportion of bonus income being both deferred and linked to performance criteria.

Perhaps one of the most surprising findings of the research is the rising importance of alignment of interest across different types of investor which has resulted in a number of trends, both short and long-term. First, the largest investors are recognising both the power and scale of their capital commitments and the knowledge and expertise embedded within their own organisations. Many are keen to regain control of portfolios and are switching into alternative real estate investing options, especially joint ventures, separate accounts and club deals. Others are using their power to initiate fund strategy internally so that the strategy is optimised prior to selecting a fund manager to market, operate and manage the fund as part of the managers platform. Given the greater influence and often expertise of large investors, in the medium-term we expect this trend to continue and their role within the industry to grow in importance as they increasingly voice issues of concern.

Medium and small investors are equally focused on generating greater alignment of interest between investors. To this end, the number of investors in any one fund is decreasing. However, the combination of lower leverage and a smaller pool of investors is reducing the scale of funds, the quality of assets they can invest in, while reducing diversification benefits. Ultimately, the approach increases market and specific risk and is therefore unlikely to prove viable in the longer term.

Although there is likely to be a more identifiable typology of funds by investor base, fund agreements will begin to address issues of cohesion more explicitly in their terms to safeguard longer term objectives. These might include limits on annual redemptions, with assurance of the repetition of such agreements to feeder and capital commitments at fund launch from investors with a limited track record. The long-term objectives of the fund will be clear as will the responsibilities of the investor pool. Moreover, to ameliorate concerns and to build trust across investor pools, an investor forum will achieve consensus on an investor charter at the outset, acknowledge the potential value and sophistication that larger investors can bring and appoint non-executives to chair and mediate meetings on contentious issues.

The non-listed real estate model has proved its durability. Post crisis the structure of the industry and relationships within it are undergoing a process of change that will strengthen the approach moving forward. At the heart of this is a much stronger alignment of interest between fund managers and investors and, across investors.

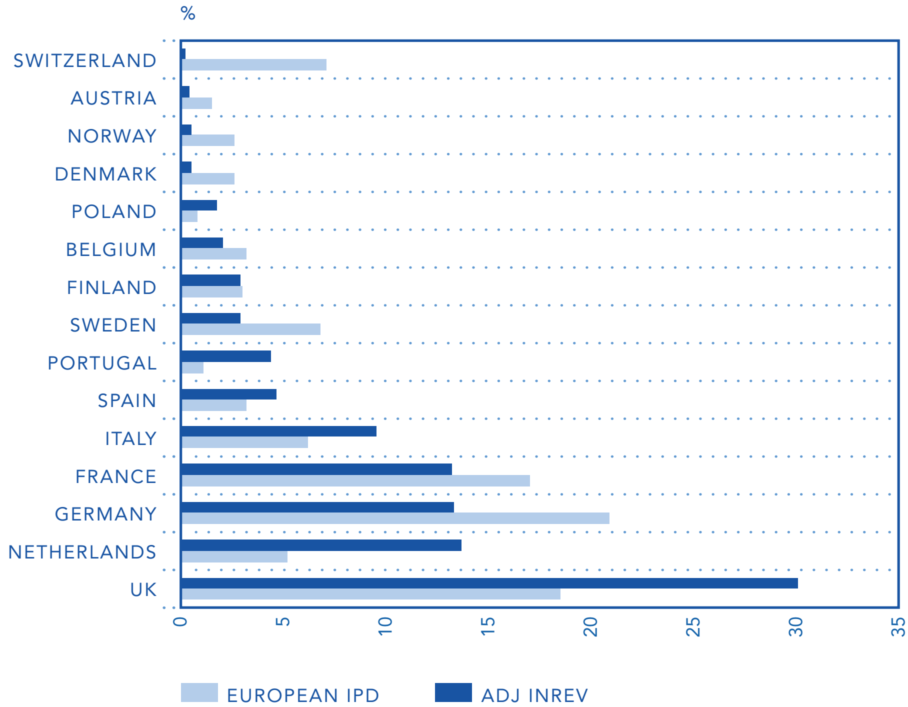
APPENDIX 1: COMPARISON OF TECHNICAL CONSTRUCTION OF EUROPEAN IPD AND INREV INDICES

There are a number of technical and geographical differences between the construction of the European IPD indices and that of the INREV Index. Most importantly, direct indices measure ungeared market returns of individual properties and are valuation based. The INREV Index reflects the net asset value (NAV) of non-listed real estate funds and among other factors, reflects any gearing impact, fund management fees and associated costs.

There are also technical differences in the calculation of the indices. IPD is a time-weighted annual return, based on an index of monthly total return calculations. In contrast the INREV Index is based on annual Total Returns.

The geographical reach of the European IPD and INREV Index differ substantially. The INREV Index includes funds that have at least 90% of their target allocation in Europe and therefore includes a low percentage of non-European assets. The European IPD Index is limited to those mature and maturing markets for which it has a country index and while this is extensive, it does not include many of the smaller accession countries.

CHART 01 / COMPARISON OF COUNTRY ALLOCATION OF EUROPEAN IPD AND AMR INREV INDEX



APPENDIX 2: DEVELOPING A PROXY MARKET VALUE BASED INREV INDEX

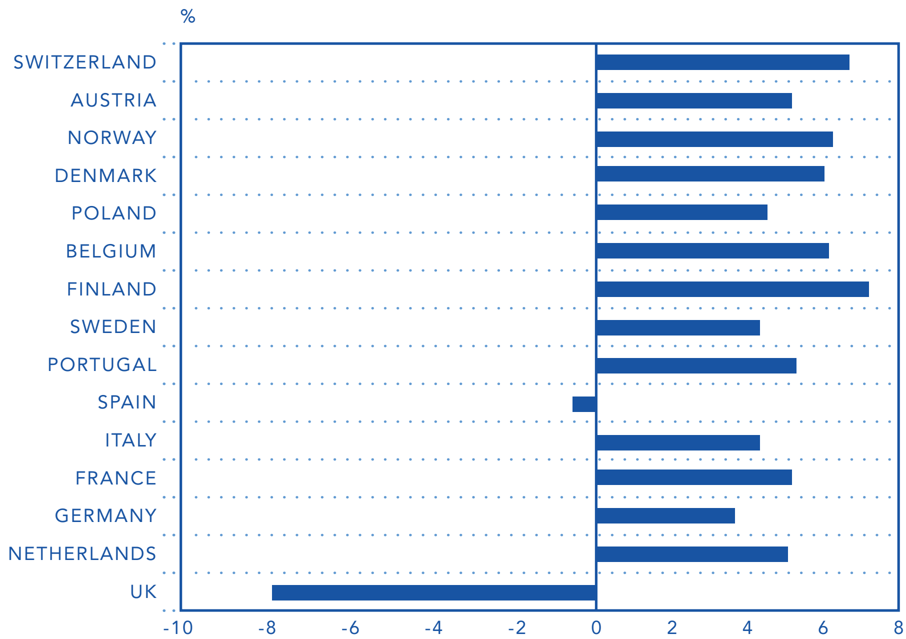
To enable meaningful comparison between the performance of non-listed and direct real estate it is necessary to consider them on a like-with-like basis. Therefore a proxy index is created to provide a market value based index that better reflects the geographical cove-rage of the INREV Index. There are three key steps:

1. Using the INREV analysis system, a sample INREV Index comparable in reach to the direct real estate European IPD Index is constructed (Adj INREV Index).

2. As the IPD Index includes a small weighting to Ireland which is not covered by the Adj INREV Index, it is eliminated from the aggregate European IPD, with the index country allocations re-weighted. Due to the effect of Monthly time weighted annual returns, there is a margin of error in this calculation but given the low allocation to Ireland, this is minimal.

3. Using the performance of IPD country indices as a proxy for market based returns, market return INREV Index (AMR INREV Index) is constructed using the Adj INREV Index country weightings. These differ substantially from those comprising the European IPD Index (Chart 01). In particular, the Adj INREV Index has a much higher weighting to the UK, Netherlands, Poland and Southern European markets and a lower weighting to Germany, Belgium and the Nordics. This provides a more meaningful comparison of INREV NAV fund returns, with the AMR INREV valuation based index.

CHART 02 / DIFFERENTIAL TOTAL RETURN PERFORMANCE OF EUROPEAN MARKETS, ANNUALISED END 2007 TO END 2009 (LOCAL CURRENCY)



4. Given strong variation in performance across markets and country weightings, comparison between the European IPD Index and the AMR INREV Index are distorted (Chart 02, page 33). In particular, the AMR INREV Index is dragged down by its exposure to the more volatile UK market as well as Iberia and Poland. In contrast, in recent years the IPD Index has been bolstered by its greater exposure to the less volatile German market.