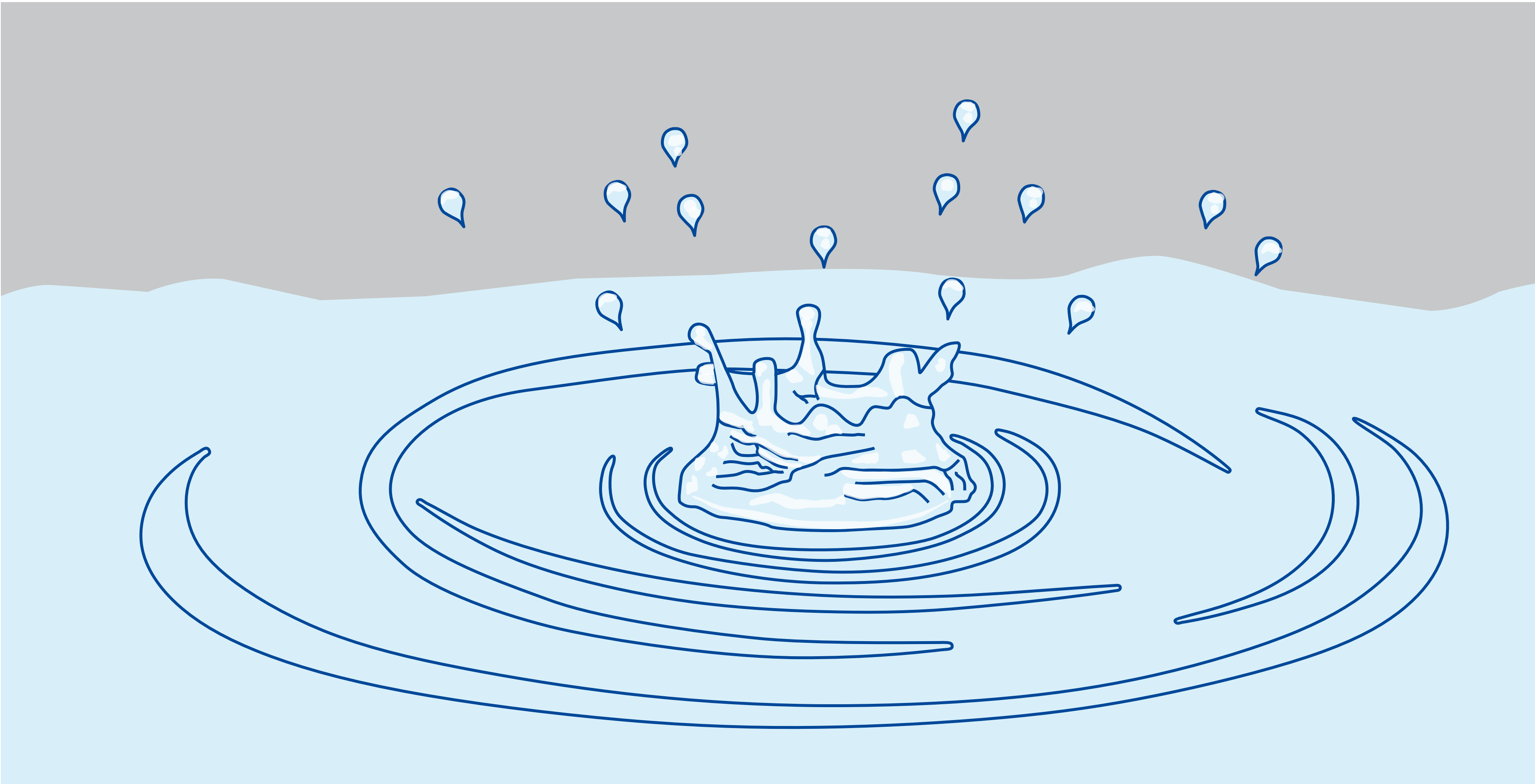


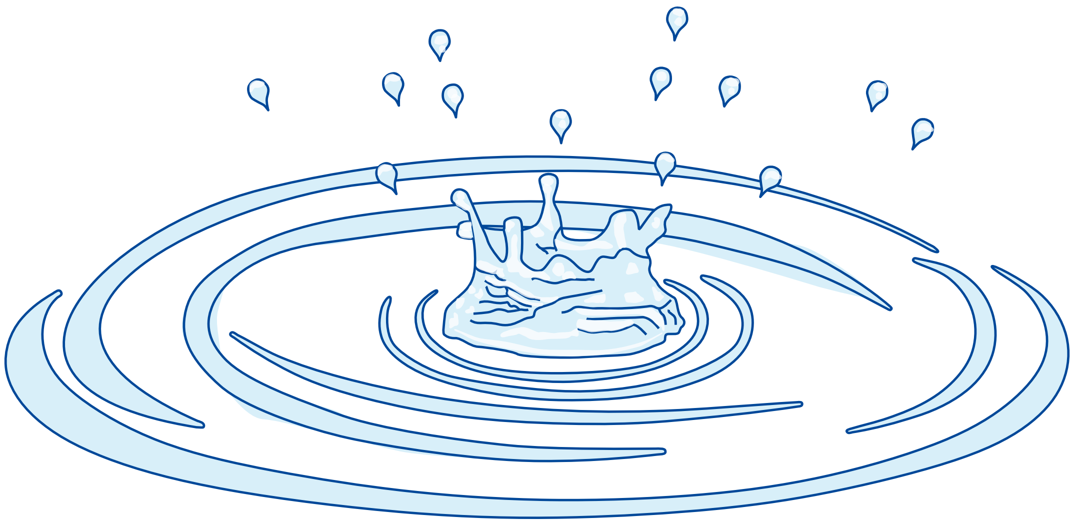
Investor Perspectives on Indirect Real Estate Liquidity
2015

Research

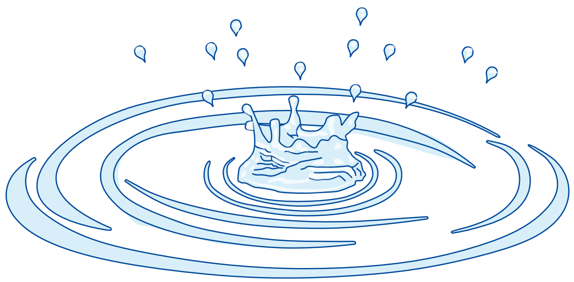
INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to improve the accessibility of non-listed real estate vehicles for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

As a pan European body, INREV represents an excellent platform for the sharing and dissemination of knowledge on the non-listed real estate industry.

INREV
Strawinskylaan 631
1077 XX Amsterdam, The Netherlands
+31 (0)20 799 39 76 | research@inrev.org | www.inrev.org



Contents



Executive summary

As the global financial crisis recedes, are investors seeking greater liquidity from indirect real estate or would altering a fundamental characteristic of the sector ultimately make it a less attractive portfolio diversifier and thus provide less reason to invest in the asset class?

Distinct from direct real estate, the liquidity of indirect real estate is dependent not only on the liquidity profile of the underlying direct assets, but is also influenced by indirect vehicle and market specific features. These include:

i) Vehicle structure and documentation provisions
ii) Portfolio construction and performance expectations
iii) Fund manager reputation
iv) Secondary market investor risk appetite and trading volumes
v) The length of commitment and redemption queues

> 'Investors consider timing and pricing to be the two key aspects of liquidity'

In the construction of a multi-asset portfolio, any allocation to indirect real estate is undertaken with the acceptance of the inherent illiquidity of the asset class. Once the indirect real estate allocation has been made, the relative illiquidity of the sector is therefore a less important consideration to investors than the potential for portfolio diversification and return generation.

Despite this, approximately half of all investors would like the ability to trade in or out of an indirect position within 12 months of deciding to do so. The ability to increase or decrease indirect real estate exposure within this time frame is seen as a valuable risk management tool. The link between liquidity and risk management has been influenced by negative investor experiences during the recent global financial crisis, where the inability to obtain indirect real estate liquidity was a detractor on returns. For some investors, liquidity provides an opportunity to tactically trade between indirect real estate vehicles in order to generate enhanced returns.

Investors consider timing and pricing to be the two key aspects of liquidity. A trade-off occurs between the two aspects, with investors being more time sensitive during period of distress and more price sensitive in stable or positive environments.

There is widespread agreement amongst investors that not all open end funds can provide their intended liquidity in all market conditions, specifically during periods of market distress. This has negative implications for those investors who are reliant on the liquidity provisions of open end funds. The impact is significantly lessened for those open end investors with long term investment horizons, who are able to withstand temporary periods of decreased fund liquidity.

> 'The ability to increase or decrease indirect real estate exposure within a given time frame is seen as a valuable risk management tool'

In order to improve indirect real estate market liquidity, investors mentioned increased transparency, document standardisation and increased indirect real estate market size as the three most important factors.

Transparency relates to the availability and completeness of information such as portfolio construction and performance data. Standardisation of fund and transfer documents is seen by investors as an important step towards expediting the transaction process. Increasing indirect real estate market size relates not only to a greater number of primary market fund raises (thus increasing the overall pool size of indirect holdings that could theoretically be traded) but also increasing the number participants in the secondary market, along with secondary market transaction volumes.

Section 1

Introduction

Introduction

This study focuses on the liquidity needs and requirements of investors who invest in indirect real estate.

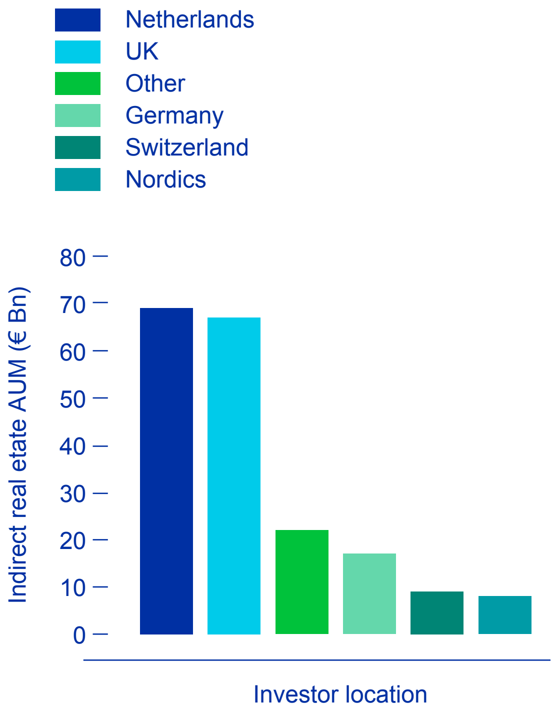
Indirect real estate is defined as any investment in a fund, separate account or other vehicle which is managed by a third party, rather than by investors themselves. Such indirect investments may have as their underlying collateral any combination of debt or equity investments, including listed or non-listed real estate.

The aims of the study are to identify how investors define liquidity, discover the importance they ascribe to liquidity when compared to other investment considerations and explore the factors that influence their liquidity needs. Furthermore, the study examines investor views on the drivers of indirect real estate liquidity and their perspectives on the liquidity of indirect real estate vehicles, with a particular focus on closed end and open end real estate funds. Preferred secondary market transaction methodologies are also examined. Finally, investor suggestions for changes to the indirect real estate market which could enhance liquidity are discussed.

The research was conducted in two stages. Firstly, respondents completed a 24 question online questionnaire, a template of which can be found in the appendix. Secondly, a one on one interview was conducted with each respondent. The questions asked during the interview stage sought to explore the questionnaire responses in more depth to gain greater insight from the respondents. These insights are contained within this report in the form of anonymised investor quotations.

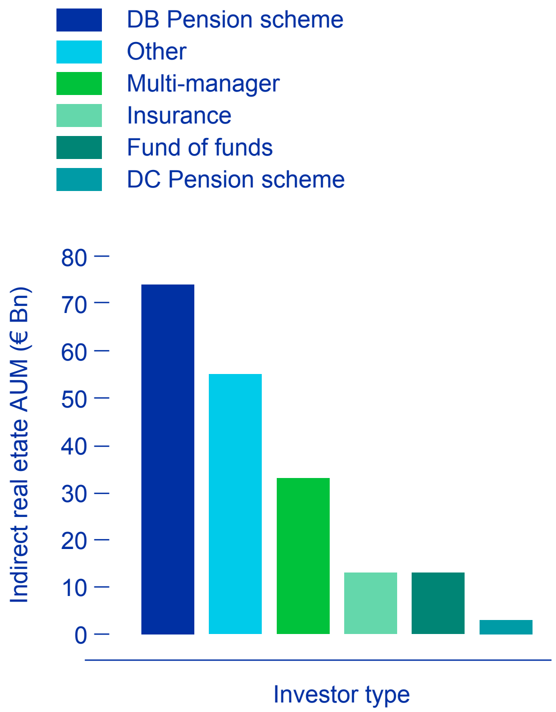
A total of 66 investors from 10 different countries took part in the research, spanning a diverse range of industries, including fund of funds, insurance companies, multi-managers, pension schemes, secondary market specialists and sovereign wealth funds. These investors are collectively responsible for the management of €191 billion of indirect real estate.

Figure 1: Indirect real estate assets under management by investor location



Note: The other category comprises investors from Luxembourg, United Arab Emirates and United States

Figure 2: Indirect real estate assets under management by investor type



Note: The other category comprises corporate balance sheet investors, charities, investment consultants, secondary investment specialists and sovereign wealth funds

This research report has been commissioned by INREV and authored by Richard Urban, Independent Non-Executive Director, with support from the project focus group:

- Marcus Cieleback, Group Head of Research, Patrizia
- Michael Clarke, Head of Investor Services EMEA, CBRE Global Investors
- Annisa Dian Prima, Senior Research Manager, INREV
- Alistair Dryer, Senior Fund Manager, Global Real Estate Multi-Manager, Aviva Investors
- Anne Koeman, Associate Director, LaSalle Investment Management
- Simon Mallinson, Executive Managing Director, Real Capital Analytics
- Henri Vuong, Director of Research and Market Information, INREV

The author would also like to extend his gratitude to the investors who took part in the research and the members of the INREV Research Committee and the INREV Secondary Market Committee.

Section 2

Investors’ definitions of liquidity

Investors' definitions of liquidity

Key aspects of liquidity: timing and pricing

Investors were asked to identify up to three aspects of liquidity which are important to them. The objective was to ascertain how investors define the concept of liquidity. This is separate from whether or not investors require liquidity from indirect real estate (which is discussed in Section 4.

The two key aspects of liquidity were identified as timing (mentioned by 77% of investors) and pricing (mentioned by 53% of investors) , and the interaction which occurs between the two. Timing relates to the time taken to transact indirect real estate when either deploying capital or seeking to exit a non-listed real estate investment through secondary market sale or open end fund redemption. Pricing relates to the price paid at purchase or achieved upon sale or redemption.

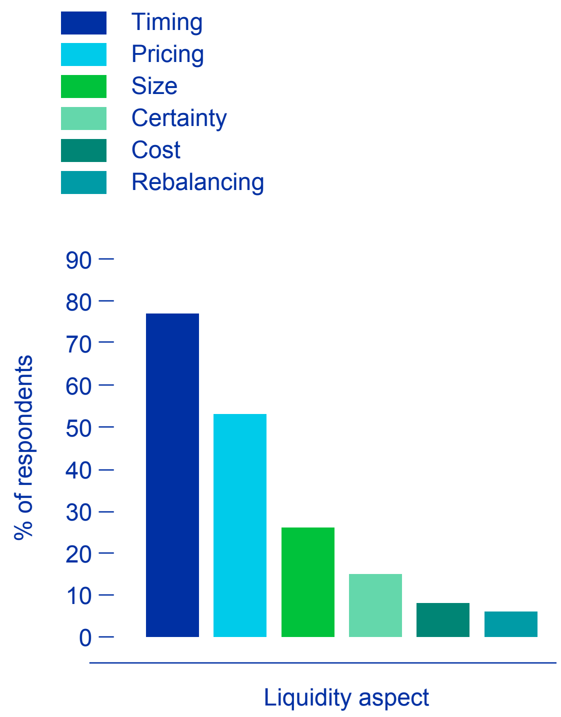
The ability to time entry and exit in the indirect real estate market is constrained by a number of factors. Entry timing is constrained by the time it takes to underwrite an investment in a non-listed vehicle, capital queues in popular commingled funds and the pace of deployment of capital of closed end funds. Exit timing is impacted by the lock up periods of closed end funds and the ability of open end funds to meet or suspend redemptions.

Thus, the structural features of the real estate market and investment vehicles, together with investor psychology (for example, a herd mentality) mean that accurate timing of entry and exit can be difficult. This is especially true in times of large capital deployments or in periods of significant market distress.

Investors' perception on the importance of timing and pricing fluctuates over time. During periods of economic distress, the requirement for cash increases and thus investors prioritise timing and become less price sensitive. As one investor surmised, '*In different parts of the cycle, either pricing or timing becomes more important*'. A second investor linked the prioritisation of timing to a detrimental effect on price, commenting '*If the market perceives liquidity issues are behind the reason for sale of indirect real estate, pricing will be negatively impacted*'. In essence, this indicates a trade-off between timing and pricing, with pricing being sacrificed for timing and vice versa in some instances.

This lowering of price sensitivity is distinguished from complete price insensitivity; rather it is an indication that at particular points in the macroeconomic and property market cycle, the need for cash in the short term overrides the importance of delaying a transaction in the hope for a more positive price outcome.

Figure 3: The most important aspects of liquidity according to indirect real estate investors



Liquidity defined by market size, certainty and cost

As the economic and property markets have healed, the need for short term cash has abated and thus investors have become more price sensitive than during the downturn. Highlighting this, a Swiss investor remarked '*Timing is now less important, so pricing is the greater element*.' Expanding on this, a UK investor opined '*In 2009, sellers took whatever was on the table but now motivations have changed. Sellers have become more price sensitive and so are now more patient*'. Seeking to provide evidence of the increased importance of pricing, a German investor shared his observations of the secondary market. He remarked, '*Discounts to net asset value have diminished and now sometimes premiums are paid for the best funds*'. Investor observations on secondary market pricing are discussed more fully in Section 4.

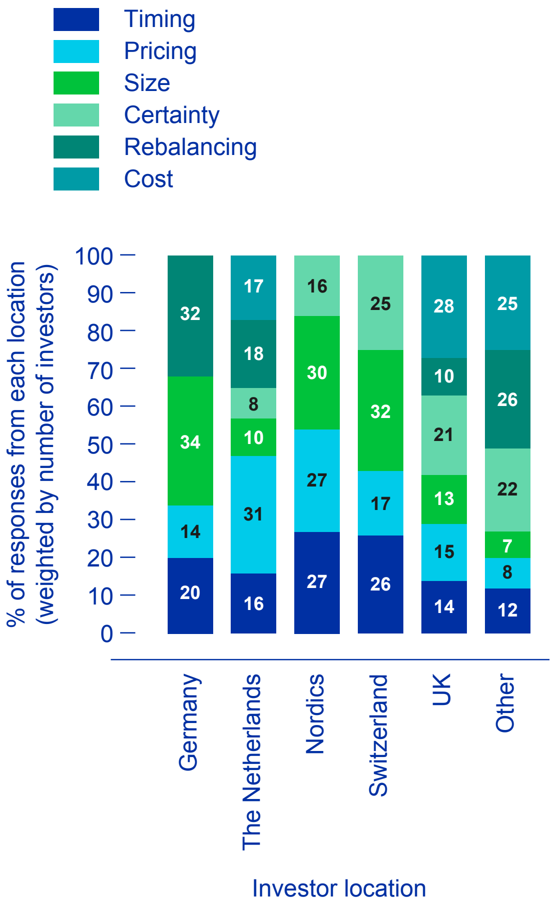
Market size is the third most important element to investors, with 26% of investors nominating that aspect. Market size includes a number of features such as fund size, the number of primary fund raises that occur, the size of primary and secondary market investor pool and the volume of trading on the secondary market. The view amongst investors is that the greater each of these underlying features becomes, the more liquid the indirect real estate market will become. German investors are the most concerned with market size, accounting for 60% of those investors which ranked the size as the most important aspect of liquidity. Their response is born by their experience and observations of the open end fund industry. One German investor commented '*Smaller funds have obvious problems when numerous investors want to redeem*'. A second elaborated '*The number of investors is important because if one or two investors with large holdings have a change in strategy and decide to redeem, the fund may be forced to sell significant assets*'.

Certainty is an aspect which combines both pricing and timing, with investors expressing the view that a certain price and time is preferable either (or both) of the elements being unknown. A UK investor explained '*Knowing that we have access to capital on a fixed date or even within a specific window is useful*'.

Investors also identified the ability to rebalance their portfolio as a useful feature of liquidity. One Nordic investor commented '*Liquidity allows us to tilt the portfolio and manage country and sector exposure*'.

In addition to any transaction fees that may be payable, undertaking due diligence on indirect real estate holdings may require significant staff time commitment and involve the engagement of third party professionals. This can mean that the cost of undertaking due diligence can be large.

Figure 4: The most important aspects of liqudity by investor location



Section 3

Investors’ indirect liquidity needs and requirements

Investors' indirect liquidity needs and requirements

Investment considerations: liquidity in context

Investors identify that liquidity is a consideration at three different levels of portfolio construction:

Firstly, liquidity is a consideration during construction of the multi-asset portfolio, where liquidity is typically achieved through the bond and equity components of the portfolio, rather than via real estate. The ability to trade bond and equities daily in very large volumes and at low cost means that they offer investors the opportunity to swiftly and inexpensively increase or decrease exposure. On this topic one investor commented: '*If we want liquidity we sell treasuries or corporate bonds*', whilst another investor added 'We have over half our exposure in gilts which we use to achieve liquidity'.

Secondly, liquidity is a consideration at the real estate portfolio level, where investments are made into direct assets and/or in one or more different types of indirect real estate vehicles. Thirdly, investors take the liquidity of the underlying assets held by such indirect vehicles into account.

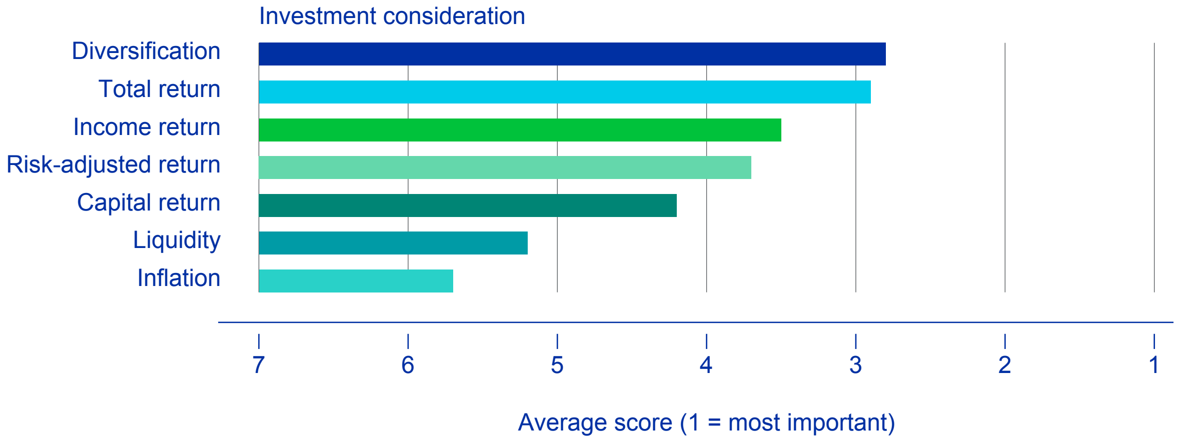
Investors unanimously acknowledged direct real estate to be illiquid on a relative basis versus bonds and equities, citing the time to transact, the cost of transacting and the information opacity as contributors to illiquidity. Indirect real estate is also illiquid, being a function of both the illiquidity of the underlying assets (which itself varies by sector and location) together with the additional complexity of trading heterogeneous indirect holdings in a market which is smaller than the direct real estate market in terms of transaction volume.

The decision to invest in indirect real estate therefore indicates an acceptance of the asset class' inherent illiquidity. The key drivers behind that decision are to gain access to specialist expertise which investors do not have in house and to provide portfolio diversification from a sector and country perspective.

Once the real estate allocation decision has been made, the relative illiquidity of indirect real estate is therefore a less important consideration to investors than the return generation and portfolio diversification that indirect real estate investments can provide. This can be seen in Figure 5, which demonstrates that across all investors, total return and diversification are the leading investment considerations. Income return, risk adjusted return and capital return considerations also all rank ahead of liquidity.

In order to explore how liquidity ranks against other investment considerations, investors were asked to rank the following seven factors in order. A score of 1 indicates the most important consideration while a score of 7 indicates the least important consideration.

Figure 5: The most important investment considerations ranked in order of importance



Diversification is the primary consideration for investors choosing to invest indirectly, with one investor summarising the general view thus: '*Our focus has been on diversifying internationally, the liquidity component is very much secondary to diversification*'. Investors had a range of views regarding diversification, some of which stepped outside the traditional sector and region diversification rationales.

The speed of achieving diversification through indirect investing was mentioned, with one investor commenting '*Our motivation to invest indirectly is to quickly obtain international exposure*'. A second investor mentioned that instead of seeking geographic diversification, they see diversification by manager and investment year as an important risk management tool, stating '*We are focussed geographically, so we seek diversification in terms of fund vintages and manager exposure*'. A third investor captured the range of views stating '*Our aim is to diversify by manager, region and vehicle structure*'.

'UK investors and multi-managers rank liquidity as more important than investors from any other location or type'

Liquidity ranks sixth out of the seven considerations, lagged only by inflation hedging. Although the inflation hedging characteristics are championed by some within the real estate arena, the vast majority of inflation hedging takes place using liquid options, which are outside the remit of the respondents. It is therefore unsurprising that inflation hedging ranked lowest.

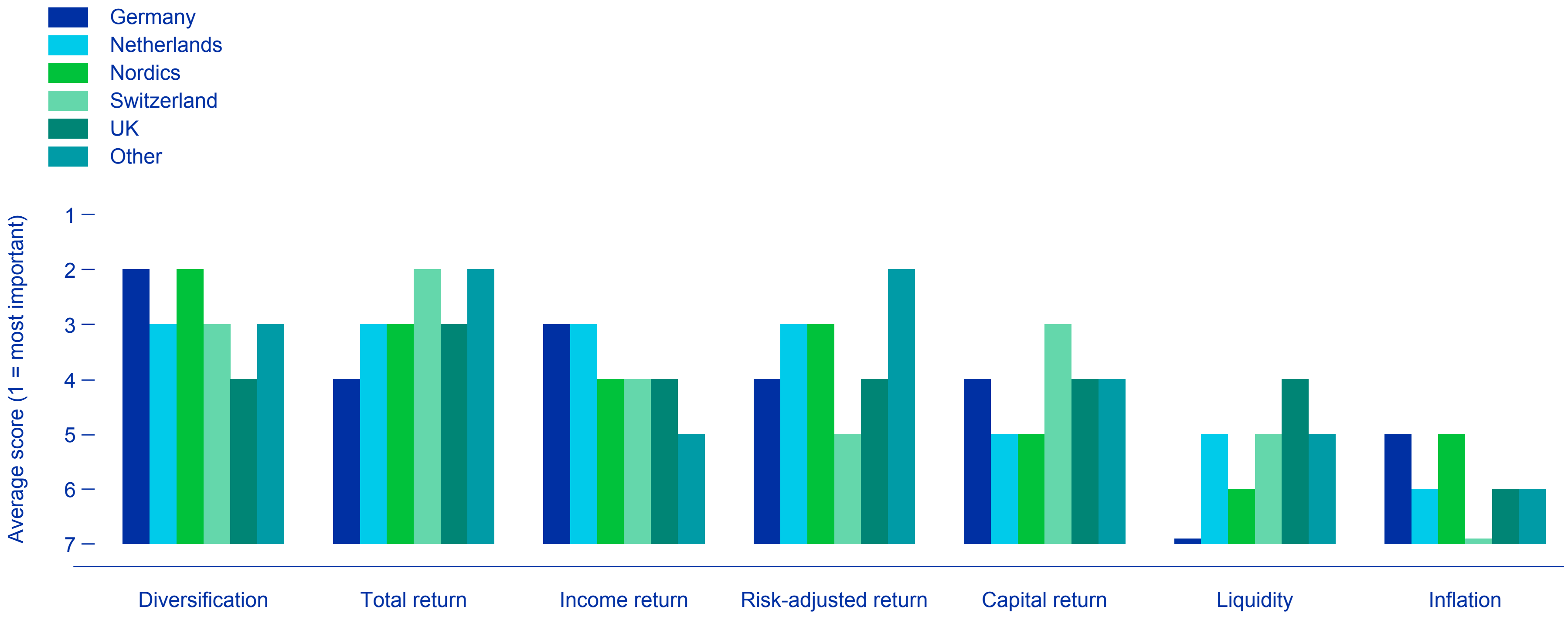
As indicated by the average scores for liquidity, UK investors and multi-managers rank liquidity as more important than investors from any other location or type. Since all multi-manager respondents are located in the UK, they exert significant influence on the collective UK investor view on liquidity. The multi-managers have significant exposure to UK core funds for which there is an active secondary trading market. One investor commented on this, remarking '*We are actively trading UK core funds every quarter'. A second investor added 'In our opinion, the trading of UK core funds is dominated by multi-managers*'.

German investors, which are predominantly comprised of insurance companies and DB pension schemes, are the least focussed on liquidity but place the greatest emphasis on income return. This is because these investors typically have very long term investment horizons. As one investor commented '*We seek long term, low volatility income*', whilst another added '*We accept real estate is illiquid because we are focussed on long term income*'.

'Multi-managers have significant exposure to UK core funds for which there is an active secondary trading market'

DB and DC pension investors are the most focussed on inflation hedging, given that they have significant inflation linked liabilities to meet. One DB pension investor summarised the position as follows: '*We need capital to pay benefits and collateral for inflation and interest rate hedging*'.

Figure 6: Importance of investment considerations by investor location



Influences on investor liquidity needs

Investors' own requirements (and where respondents are managers of third party capital, the requirements of their investors) are the biggest determinant of their liquidity needs. The interviews revealed that these requirements can be defined by the fact that investors understand and accept the illiquid nature of indirect real estate because it is typically held over the medium to long term and acts as a diversifier in a mixed asset portfolio. Therefore events that impact liquidity can disrupt asset management plans at the underlying asset level.

Capturing the essence of the view on liquidity, one insurance investor mentioned: '*Liquidity is an illusion, I consider indirect real estate to be an illiquid investment form*' whilst a UK investor commented '*Liquidity is not a paramount concern, our objective is to hold long term until fund maturity*'. A fund of funds investor noted the impact a liquidity event can have on a vehicle, stating '*I want indirect real estate investments to be illiquid because I don't want liquidity events impacting development or asset management plans*'.

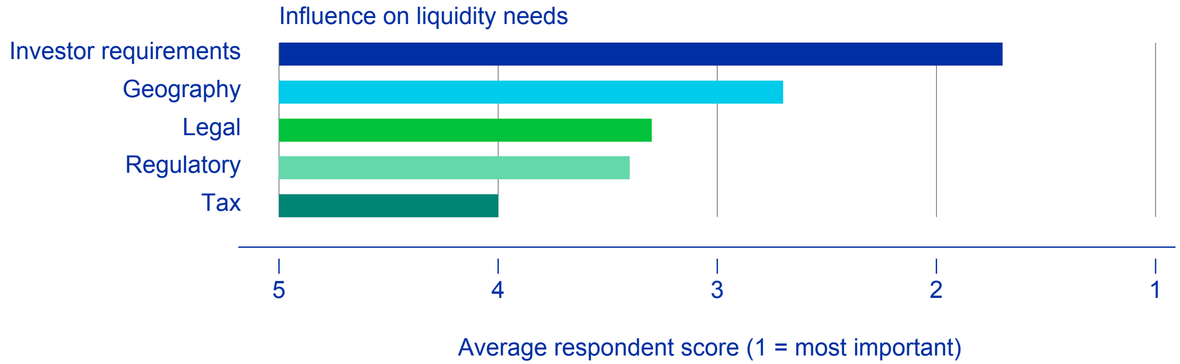
Investment geography also has a key role to play in influencing liquidity needs, with one Dutch investor summarising '*There is a strong relationship between geography and liquidity*'. The point was elaborated on by other respondents who noted that liquidity of direct assets in different geographies has a key impact on the liquidity of indirect vehicles, with one German investor noting that '*We prefer exposure to gateway cities in Western Europe as they are the most liquid*'. A UK investor mentioned '*Different valuation frequencies across geographies can impact indirect liquidity since longer intervals between valuations lead to greater subjectivity on the value of the indirect holding*'.

A fund of funds investor made the link between geography and fund terms which can impact liquidity, quoting one respondent '*In our experience Continental European funds more frequently incorporate pre-emption rights than those in the UK and these can cause delays to transactions*'.

A Dutch investor highlighted the link between geography and transparency, noting '*Liquidity is different from country to country, for example the US is much more transparent than Asia*'. Whilst a UK investor highlighted '*Fund documentation is less standardised in Europe than in the UK and the various different tax regimes mean that it can be time consuming to fully understand a pan-European investment*'. This is particularly true if an investor is intending to invest in a new geography where existing familiarity with local taxation issues is limited.

Investors were asked to rank the following five factors in terms of which had the strongest influence on their liquidity needs. A score of 1 indicates the most important influence while a score of 5 indicates the least important influence.

Figure 7: Influences on indirect real estate investor liquidity needs ranked in order of importance



Geographic variation influencing factors

Although investors highlighted that different geographies have different liquidity profiles, they generally do not apply an explicit illiquidity premium which reflects this. One UK investor summarised the general view thus; '*We don't have an explicit illiquidity premium but we do take liquidity into account when we consider risk premiums*'.

In constructing risk premiums, investors therefore take a number of regional factors (including illiquidity) into account. These additional factors include political and economic risk, property market outlook and views on currency movements. Theoretically composite risk premiums should be able to be deconstructed to their constituent parts to reveal the illiquidity premium, but being more art than science, investors could not provide such deconstructions.

When considering return targets, investors therefore have different approaches. Some investors make comparisons to fixed income. One insurance investor explained '*We seek a 1.5% premium over the equivalent gilt duration*'. A Dutch investor added, '*We use 2% over 10 year government bonds*'. Other investors are more absolute return focussed. One UK investor mentioned '*Given its illiquidity, real estate has to earn its way into our portfolio. We typically seek low to mid-teens type returns*', whilst a Swiss investor said '*We generally seek total net returns in excess of 12% p.a. to compensate for illiquidity*'.

Regulatory impact on liquidity

Investors did not strongly distinguish between the impact on liquidity of legal, regulatory and tax regimes. It was highlighted that investing in the US can be problematic due to negative tax implications, with Foreign Investment in Real Property Tax Act (FIRPTA) being punitive to non-US based investors. FIRPTA levies tax on property income and capital gains and whilst there are fund structuring options which can lessen the impact, it cannot be removed entirely.

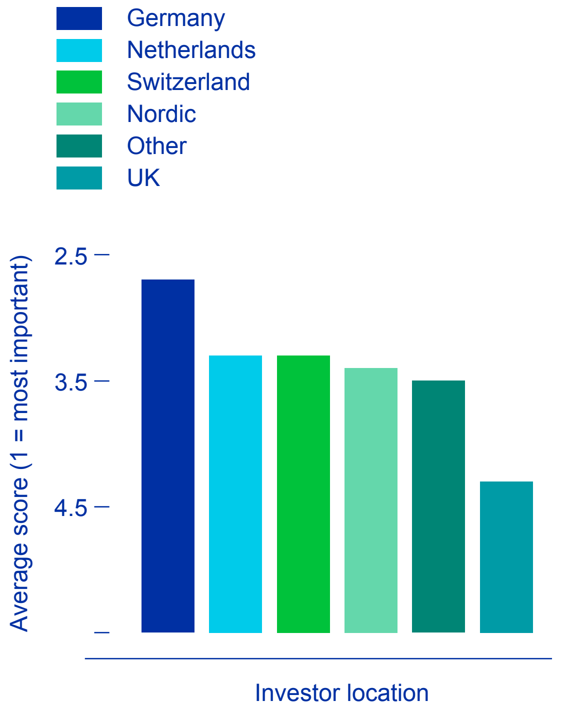
Regulatory impact was ranked fourth out of the five categories. Given the proliferation of regulations across Europe, it is surprising that the impact of regulation did not feature more prominently amongst investors influencing factors.

Although AIFMD and national regulatory bodies such as DNB (Netherlands) and FINMA (Switzerland) were mentioned during the interviews, a clear theme emerged that it is the German investors who are most focussed on regulation, rating it the second most important influence on liquidity.

The reason for this is twofold. Firstly, a number of the German investors are insurance companies. By investor type, insurance companies indicated that they are most influenced by regulation, citing the impact of Solvency II. Secondly, the German financial regulator (BaFin) has significant influence over the way that German insurance companies and pension funds invest.

Investors were asked to rank how strongly regulations influenced their liquidity needs. A score of 1 indicates the most important influence and a score of 5 indicates the least important influence.

Figure 8: The importance of regulation as an influence on liquidity needs



BaFin stipulates how much real estate exposure (including indirect exposure) investors can have and also provides strict criteria regarding what constitutes a real estate investment, putting limitations on geographic exposures and how much property development can be undertaken.

Solvency II aims to implement a more risk focussed approach to investing amongst insurers, with the ultimate objective of increasing the probability that obligations of policyholders are met.

Insurers must therefore demonstrate that they are able to meet these obligations as well as set aside capital to absorb any negative shocks to their investment portfolio. Insurers typically have multi-asset portfolios and each asset class is treated differently under the regulations, with equities considered the most volatile and thus having the highest capital charge and EU sovereign bonds the least.

The treatment of indirect real estate under Solvency II is dependent on whether an insurer uses the standard model for determining its solvency capital requirements or whether it develops an internal model that is tailored to the demonstrated volatility of its own portfolio. Internal models, however, must be approved by BaFin. Under one internal model option for determining solvency capital charges for non-listed real estate investment, the amount of leverage that is incorporated in the vehicle influences the regulatory capital requirements. Beyond certain thresholds, the use of leverage incurs higher capital charges, so that under this option, funds with higher leverage are treated more punitively than those with low levels of debt.

Some insurance respondents therefore reported that there is an increasing incentive to invest in vehicles which have low or no leverage as such vehicles generally have lower volatility and this reduces the capital charge which flows from the real estate component of the portfolio. Commenting on this, one German investor mentioned, '*Due to capital requirements under Solvency II, we need to find ways to invest in real estate that use low leverage*'. A second added, '*We need to focus on conservative fund managers and strategies*'.

There was a mixed response amongst investors about the implications regarding the imposition of restrictions. Referencing the fact that certain indirect real estate vehicles, especially listed vehicles and securitised commercial real estate debt, can no longer be accessed without capital charge penalties, one investor commented, '*The reduced choice of vehicles could become a problem for us*'. Another counteracted this view, stating, '*This could be an opportunity to develop new product types which seek to attract investors bound by Solvency II*'. This latter comment highlights the fact that increased regulation can lead to innovations in product development.

The expectation is that the treatment of real estate debt under Solvency II will be more favourable for some insurers than bricks and mortar and, in addition, it provides the stable, medium to long term income that is attractive to insurance investors. As one investor commented, 'A*s an alternative to seeking non-listed funds with low LTV's we can increase exposure to real estate debt, which in some circumstances has better treatment under Solvency II*'.

Section 4

Investors' liquidity desire and views on indirect real estate market liquidity

Investors’ liquidity desire and views on indirect real estate market liquidity

Investors’ desire for liquidity

Having already ascertained how investors define the concept of liquidity, the question of whether or not investors require liquidity from indirect real estate was explored.

Given that indirect real estate liquidity ranked so low in comparison to other investment considerations, it was unsurprising that first reactions to the question of liquidity in indirect real estate can be typified by the following quotes: ‘*Liquidity is not unimportant but real estate is not liquid by definition*’, ‘*Real estate is a long term illiquid investment and we are comfortable with that*’ and ‘*Liquidity is not a decision criteria for us*’.

Despite respondents being in agreement that liquidity is not a pre-requisite for investment into indirect real estate, 47% of investors indicated that the ability to trade in or out of an indirect position within 12 months was desirable. As one UK investor mentioned ‘*Indirect real estate liquidity is not necessarily needed, but it is nice to have*’.

Achieving liquidity within 12 months is seen as a valuable by option by some investors because it provides flexibility to allow portfolio rebalancing which can be used as an effective risk management tool. Multi-managers view liquidity as providing an opportunity to enhance returns by tactically trading between indirect real estate vehicles.

The point is illustrated by the fact that of those investors who desire annual liquidity, 40% are from pension funds and 25% are from insurance companies. This is despite the fact that such investors are long term holders of real estate and have large allocations to liquid bonds and equities.

Investors responses on this apparently contradictory position included: ‘*We get liquid exposure from other asset classes but would like to have annual liquidity from real estate*’. ‘*We recognise the illiquidity of real estate but we would like to be able to liquidate part of our portfolio within a year*’ and ‘*We’d like the ability to be able to make portfolio changes over the course of a year, even though it not a criteria that we do so*’.

It is noteworthy that despite investors identifying timing as a key aspect of liquidity, that approximately half of all respondents are willing to wait for one year or more for liquidity. This is explained by the fact that although they recognise timing is an important feature in liquidity; their portfolio management approach does not call for liquidity over the short term.

Figure 9: Time period over which investors desire liquidity from indirect real estate investments

32% I do not require liquidity from real estate
30% Annual
15% 3 to 6 months
14% 3 years
8% 5 years
2% Monthly or less

The most notable aspect to emerge from this assessment was that the desire for short term liquidity was predominantly driven by one investor type, multi-managers. This section explores the reasons why this investor group leads the desire for short term liquidity over 3 to 6 months.

Multi-managers lead the desire for short term liquidity

UK multi-managers hold a range of UK non-listed core funds which are actively traded on the secondary market. The reasons for trading are manifold, with one multi-manager commenting '*We actively trade in indirect holdings because we are able to gain immediate exposure to portfolios, which is a key advantage if there is a capital commitment queue*'. A second remarked '*Portfolio rebalancing, reinvestment of income and exploitation of arbitrage opportunities are all reasons why we actively trade*'. A third multi-manager investor added '*We look across all the comparable funds and will actively trade them based on where we see the best relative value*'.

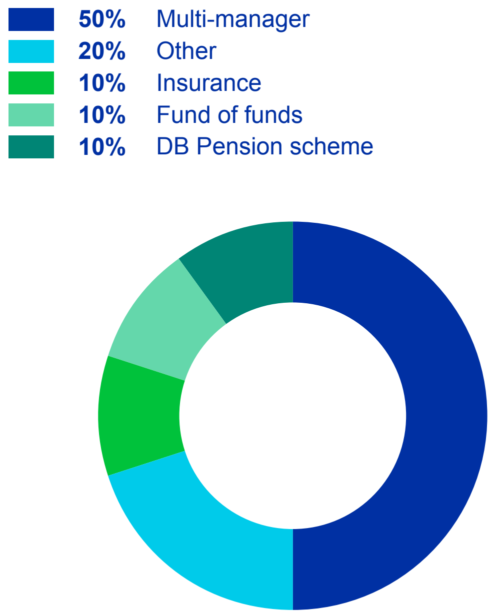
The points regarding exploitation of arbitrage and seeking best relative value refer to the fact that multi-managers seek to enhance returns by trading in and out of indirect real estate holdings. In such cases, the decision to buy or sell a non-listed fund is based on their assumptions of relative performance expectations between funds and is a key driver behind the comparatively frequent trading and their desire for liquidity over 3 to 6 months.

Multi-manager accounts often have annual performance targets which are typically set at MSCI (formerly Investment Property Databank) returns plus a low single digit percentage point margin. Reporting performance quarterly, multi-managers are keen to ensure that they can demonstrate to clients a consistent performance across the quarters and that they are able to be responsive to market conditions. As one multi-manager investor mentioned '*It's a competitive environment, clients scrutinise our performance reports and we need to meet our return target. We don't want to be reporting an underperformance and trading between funds can help guard against that*'.

One multi-manager investor remarked how transparency is key to the decision making process '*We have regular meetings with the fund managers and good information flow, so we are able to make decisions about how a fund will fare against its peers*'.

A different multi-manager attributed their liquidity desire in part down to their own investment vehicle structure. They commented '*We operate some structures with short term liquidity provisions, meaning that we have to seek out underlying indirect investments which have matching or better liquidity*'.

Figure 10: Preference for 3 to 6 month liquidity by investor type



Changes in investors' perception of liquidity

Approximately two thirds of investors perceive that liquidity in the indirect market has increased over the past five years. Investors identified two key reasons for this:

The first is a change in attitude amongst market participants. During the recent global financial crisis the need for short term cash prevailed and this, together with bleak performance outlooks for many indirect vehicles led numerous indirect real estate investors to seek redemptions of open end funds and sales of closed end holdings which they had previously intended to hold until vehicle maturity. Some open end funds suspended redemptions and many potential buyers of indirect holdings had withdrawn from the market, leading to a supply-demand imbalance between sellers and buyers.

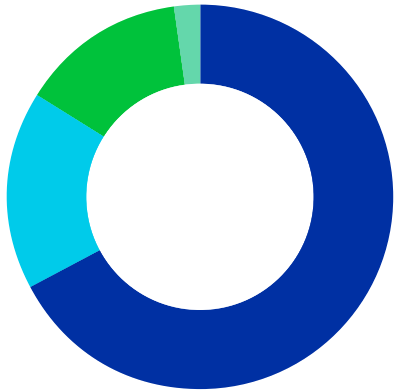
This imbalance meant that those investors who were well capitalised were able to purchase indirect holdings at often large discounts to their net asset value (NAV). During this time, an impression was formed within the indirect real estate market that those who sought liquidity from indirect real estate were distressed sellers and those that bought were opportunistically driven vulture buyers. Thus, some potential market participants refrained from seeking indirect liquidity for fear that their organisation would be seen as distressed.

As macroeconomic and property markets have recovered, a change in mind set is occurring which is helping to improve indirect liquidity. On this topic one US investor stated '*The biggest take away for me has been a change in market conditions and investor psychology*'. A Swiss investor remarked '*Market psychology is evolving. It's no longer just liquidity that is driving sellers, it's simply portfolio management reasons*' Whilst a pension fund investor added '*Indirect real estate trading is no longer about distress, it's about portfolio management*'.

Investors are thus coming to the realisation that transacting indirect real estate can be a useful tool which is used to increase or decrease exposures, it need not be the domain of distressed sellers or highly opportunistic buyers. As we have already seen with UK multi-managers, this is not a revolutionary concept to some investor groups, but to others it is. Contrasting these views, one investor noted '*Many investors now understand that secondaries are a legitimate way of transacting without distress*' whilst another stated '*Some investors have taken a while to embrace what liquidity means in an otherwise illiquid market. Highly institutional organisations are now accepting that trading indirect vehicles has benefits and there are no longer any perception ramifications*'.

Figure 11: How investors' perception of indirect real estate liquidity haschanged over the past 5 years

68%	Increased
17%	Sector or geography dependent
14%	Unchanged
2%	Decreased



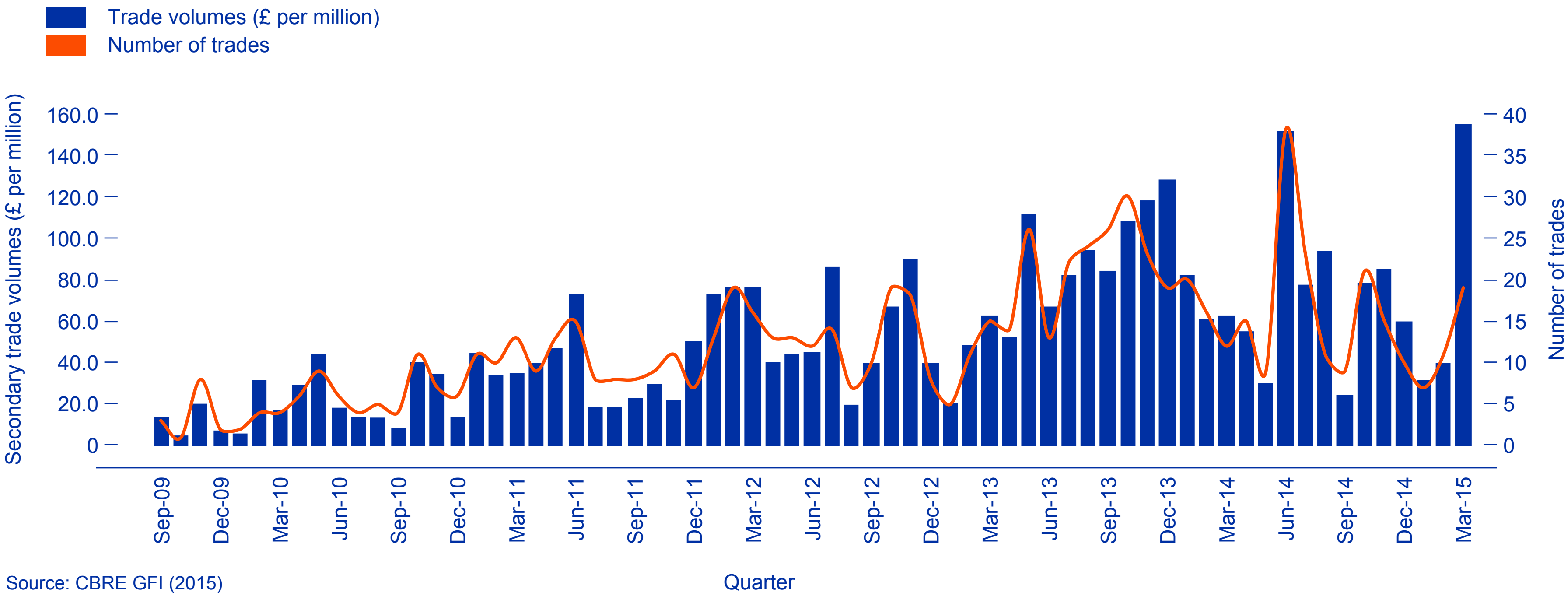
Portfolio rebalancing can also reduce operational burden, since indirect real estate investments can be time consuming to monitor, even if they are a relatively small proportion of the overall portfolio. As a fund of funds investor noted '*There is a different motivation. It's not about being desperate to sell, its more about asset allocation and retreating from small holdings which take effort to monitor*'. A UK investor added '*One motivation for trading is to manage out those tail positions*'. Thus through transacting, operational efficiency can be enhanced and this acts as another attraction to investors.

The second key reason for the perception of liquidity of indirect real estate increasing was that trading volumes had increased substantially over the past 5 years. Figure 12 shows that over £154 million traded in 19 transactions compared with less than £18 million traded in just 4 transactions in March 2010.

Pricing in Europe has also evolved, with the range of prices paid narrowing over time. Commenting on this market movement, one investor stated '*We are seeing a wider variety of sellers and NAVs have become more realistic*'. One reason for this is that during the global financial crisis, valuation of indirect real estate vehicles were impacted by the valuation frequency and methodology of the underlying assets. For those assets which were valued infrequently, there could be widespread disagreement between buyer and seller on their true market value. Furthermore, valuers who employed comparables to determine rents and yields faced difficulties due to low transaction volumes. As such, investors could not have much certainty on true valuations. As one investor mentioned '*My perception is that sellers in the past had to accept big discounts. Things are generally now more mark to market, valuation issues have cleared up and markets are healthier so there is more clarity on pricing*'.

Other reasons given for a rise in liquidity amongst indirect vehicles was the role of third party brokers. One investor mentioned '*5 years ago liquidity was zero but has picked up with the introduction of secondary market brokers and greater interest from buyers*' whilst a Dutch investor added '*I think there is more secondary market selling than 10 years ago, brokers are acting as market makers*'.

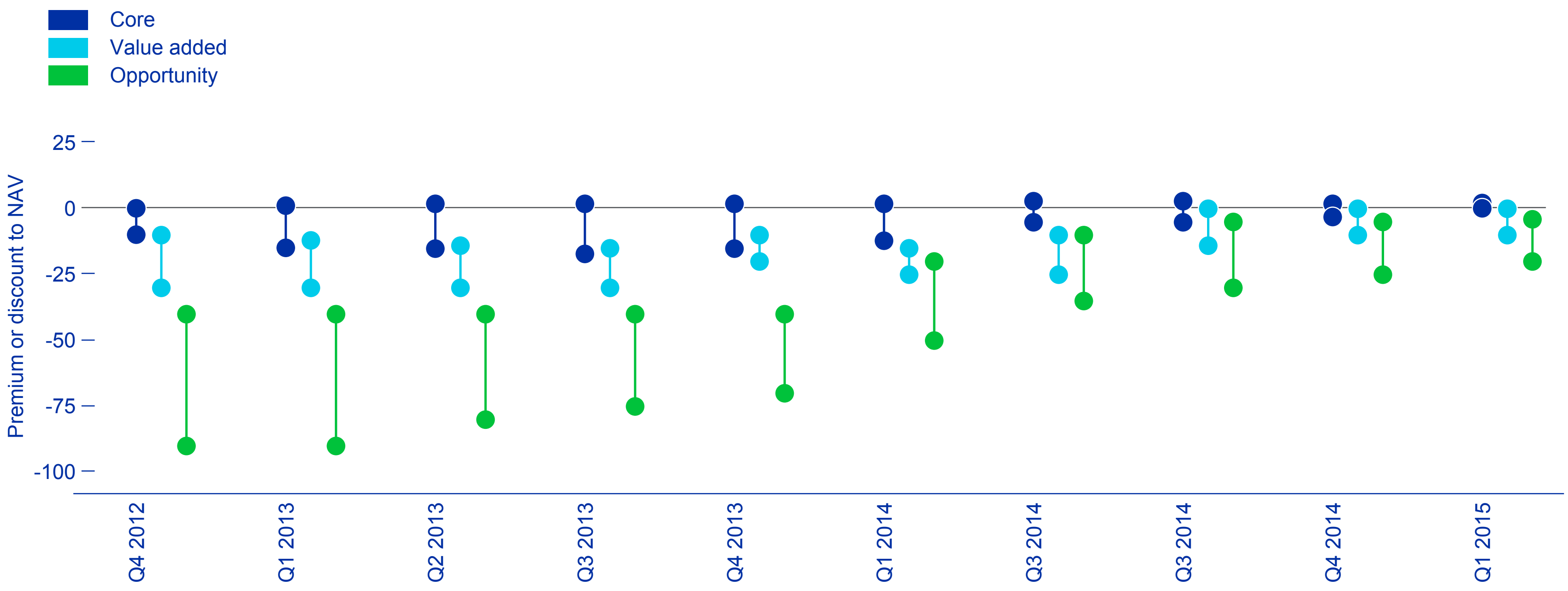
Figure 12: Secondary market trade volumes and values



Source: CBRE GFI (2015)

Figure 13 shows how pricing of different real estate fund strategies has changed over time and how pricing has changed in relation to NAV (which is represented by the 0% line). For each fund type, the range of prices (as indicated by the vertical bars) has narrowed over time and discounts to NAV have decreased across all strategy types.

Figure 13: European secondary market pricing for different fund strategies



Source: JLL Corporate Finance (2015)

Drivers of indirect real estate liquidity

Investors believe that performance expectations are the most important factor which determine the liquidity of indirect vehicles, as one investor summarised '*Performance expectations are the most important, they are the key figure*'. The ability to sell a position is substantially enhanced when it is expected to generate attractive future cash flows and this is directly linked to the quality and performance prospects of the underlying assets. Conversely, it is incredibly difficult to find a buyer for those vehicles which are facing performance challenges. Hence, performance expectations have a very strong link to the liquidity of an indirect holding.

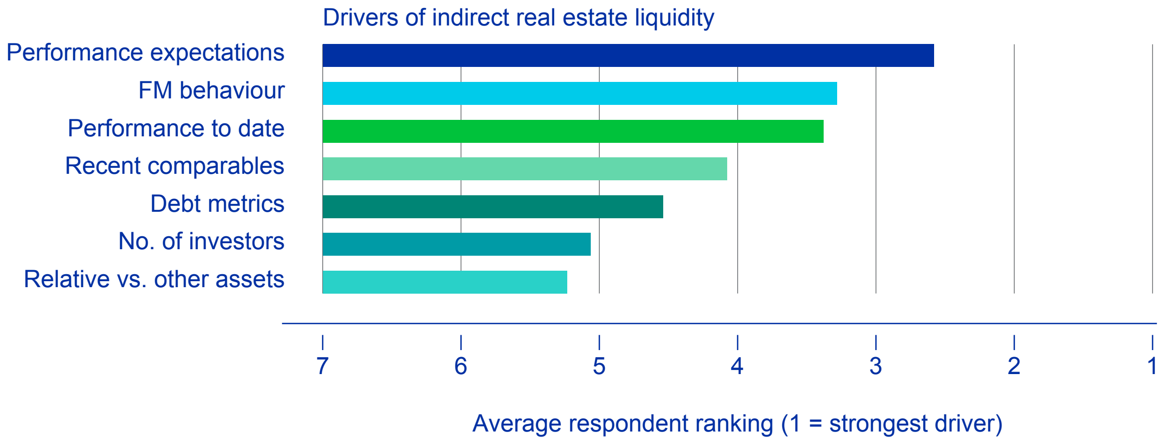
Transparency is key when assessing performance expectations, with one UK investor noting '*On occasion it's difficult to get information, not all funds have comprehensive reporting systems*' Another investor added '*Some managers are quite cautious at providing information, which is not helpful to the transaction process*'. A Swiss investor related opacity to price reduction, stating '*A lack of information makes it much harder to transact. The less information I have, the more guessing I need to do and the higher the discount to NAV*'.

Fund manager behaviour and reputation is a key component of liquidity. As one investor commented '*It is easier to trade when a manager is respected and has good corporate governance. Funds run by the best managers remain the most liquid*'. Two investors noted that the investor-fund manager relationship could be one of a long term partnership since when buying on the secondary market an investor is entering a fund part way through its term and there may be 5 years or more remaining until fund maturity. Fund managers with tarnished reputations are less likely to attract new capital, both in the primary and secondary markets. Poor manager reputation is due in part to poor past performance but can also be related to a lack of transparency with investors. As a Swiss investor commented 'A *reason not to invest is lack of transparency from the fund manager*'.

Fund manager behaviour also impacts indirect real estate in another way, as the supportiveness of a fund manager to trading in their fund can vary depending on their business strategy. As one UK investor commented '*Our experience has been varied. We have found trading core funds quite straightforward, because managers have bought into the process but opportunistic managers have different motivations.*'

Investors were asked to rank the following seven factors in terms of which were the strongest drivers of indirect real estate liquidity. A score of 1 indicates the most important driver and a score of 7 indicates the least important driver.

Figure 14: Drivers of indirect real estate liquidity ranked in order of importance



Continuing on the theme of fund manager behaviour, it is important to understand the context with which managers approach investor relationships.

Those managers with opportunistic strategies typically undertake capital raising for new non-listed vehicles every few years, as the investment period of the prior vehicle is nearing its end. They are dependent on raising subsequent funds for the future of their business and thus investor loyalty is a priority for them. As one UK investor noted '*Opportunistic managers want a particular investor base which will stick with them through successive funds. Therefore, they are less supportive of a trading mentality amongst investors*'. A second investor put a nuance on this point, stating '*It's a private fund industry and some fund managers do not want information disseminated widely but they can be co-operative with a select few investors*'. This highlights the tension between investors requiring more transparency and some fund managers being reluctant to provide it.

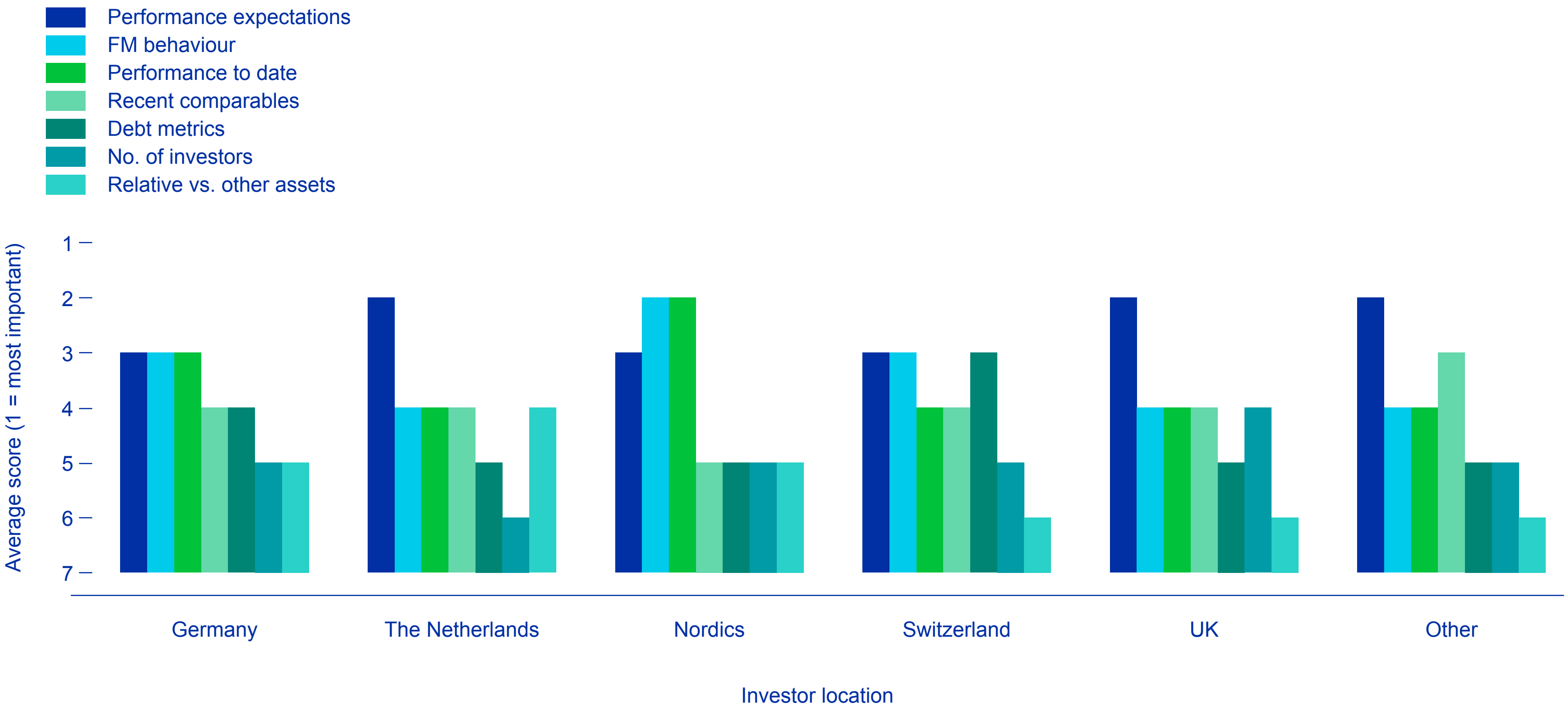
Performance to date is the third most important factor to investors, as they believe it is a good indicator of a fund manager's capability to succeed (or fail) in a given economic environment. Though investors are cautious of using past performance to project future returns, they do use it as a guide when assessing the quality of the management team.

A Swiss investor summarised thus '*We use past performance as an indicator to decide whether to look closer at an opportunity, it's a useful screening metric*'. A German investor who preferred to use past performance as a guide noted '*Expected performance is always influenced by whoever is constructing the model, it's too subjective. Past performance is the real indicator of capability*'. Meanwhile, a multi-manager investor was critical of using past performance, stating '*A lot of investors look at past performance, but it is not a guide to how well the fund will perform in the future*'.

The respondents recognised that liquidity of indirect vehicles is closely linked to the liquidity of the assets which those vehicles invest in. All other things being equal, vehicles with well located assets let on long leases to good covenants and with low leverage were deemed by investors to be the most liquid. Commenting on this, one fund of funds investor noted '*Those funds with higher risk profiles which are more focussed on capital return rather than income return are more difficult to forecast, so tend to trade less frequently and at higher discounts to NAV*'.

'Performance expectations are the most important factor to determine the liquidity of indirect vehicles'

Figure 15: The importance of different drivers of indirect real estate liquidity by investor location



Secondary market transactions

Investors have a range of options when seeking to trade on the secondary market. Third party brokers act as agents in the buying and selling of indirect real estate, helping to connect buyers and sellers.

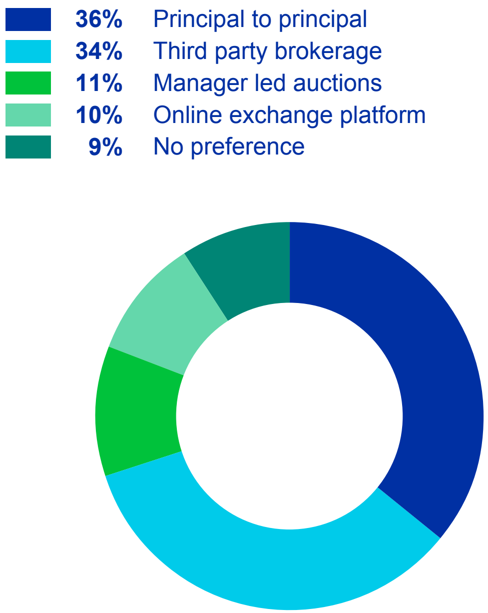
Principal to principal involves two investors dealing directly with each other. Manager auctions involve a fund manager seeking to sell an investor's holding to other existing investors in the fund, or in some cases investors who have shown an interest in allocating capital to the fund. Online exchange platforms seek to facilitate secondary market trading through providing an online portal. Principal to principal is the favoured method of transacting on the secondary market, attracting 36% of total responses. Principal to principal often allows prospective buyers an increased amount of time to underwrite the target vehicle. This is a key component of what makes the method so attractive, as greater familiarity with the purchase target means more accurate pricing. One UK investor commented '*If we have more time to diligence the assets, there is potential for the seller to generate a higher price because if we have a lack of understanding, we will reflect that with a lower bid*'. Principal to principal is also attractive due to the lack of broker fees, as another investor commented '*Principal to principal is attractive to us because it reduces the overall transaction cost*'.

From a vendor's perspective, principal to principal can be a discrete way of divesting and so is advantageous to those vendors who do not wish to alert the wider market of a pending sale and the potential impact it may have on pricing.

However, some respondents expressed concern that principal to principal would not allow the sale price to reach a true market level if the pool of potential purchasers was limited. One investor mentioned 'We prefer widely marketed transactions in order to increase competition and the number of prospective buyers, which can give us the best chance of finding the highest possible price'.

Third party brokerage was the second most favoured option amongst respondents. The fact brokers are able to widely market positions is a key benefit, as one investor remarked '*Marketing positions through brokers allows for price discovery and overall fairer pricing*' A second investor commented 'I *prefer to demonstrate best execution, which principal to principal doesn't offer*' A fund of funds investor highlighted an additional benefit of using brokers, mentioning '*Brokers help make sense of information and they have the best view on the market*'.

Figure 16: Prefered indirect real estate transaction methods



The fact that brokerages have good contact networks and market coverage was also mentioned by investors, with one stating '*It's easier to source a deal when using a third party broke*'. As a counterpoint one investor mentioned '*Dealing with brokers you often don't know who the counterparty is until after the trade, it would be good to know who you are transacting with*'.

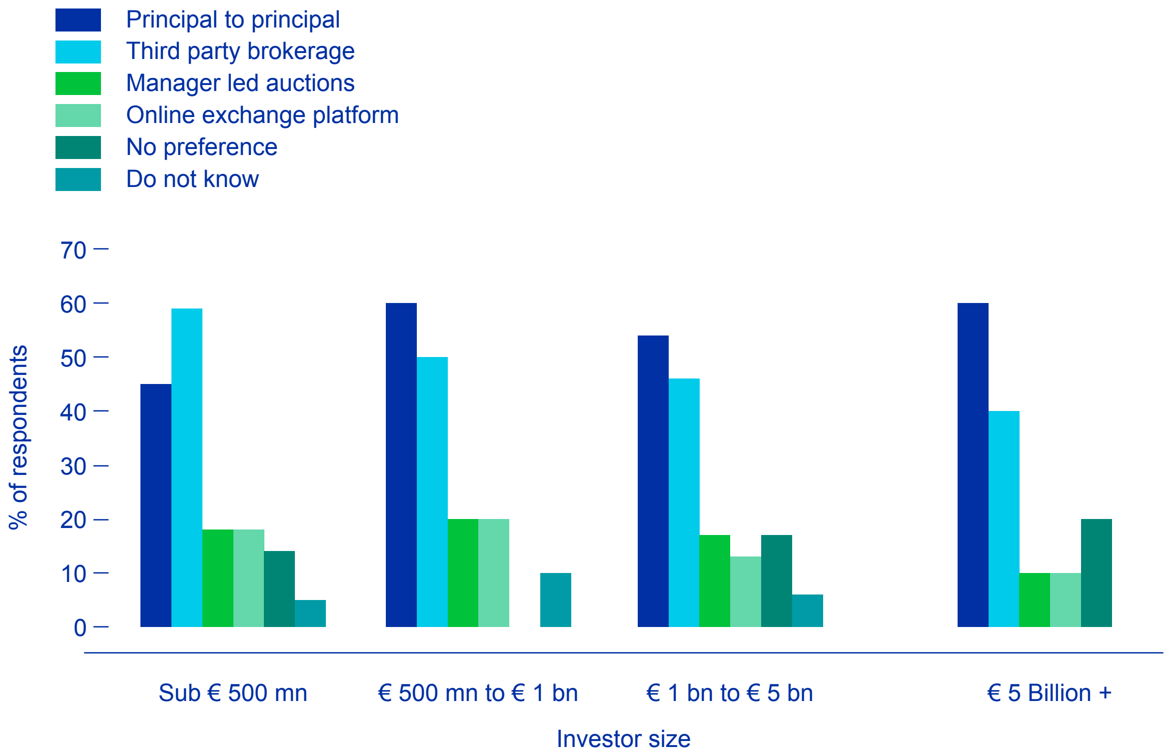
Several (9%) of investors declared that they have no set preference regarding methodology and instead prefer to assess each secondary sale on its own merits. In particular, some investors noted that they would prefer a principal to principal methodology if they were buying, but a more widely marketed broker method if they were vendors.

Those investors that preferred manager led auctions highlighted the information advantage of purchasing an indirect holding where they were already invested in the vehicle. One investor mentioned '*It's hard to succeed buying a secondary without knowing the manager and the portfolio well*' with another investor adding '*Wherever possible we like to have an existing investment relationship with the manager before acquisition*'. Notably those investors who take this stance tend to invest in non-listed vehicles which employ complex strategies with high leverage. Such non-listed vehicles are less frequently traded than, for example, UK core funds and also have a significantly higher risk profile, which puts extra onus on the investor to accurately underwrite.

Referring to market coverage, one investor commented '*I prefer third party broking over managed auctions because it's a much wider coverage with an extensive network of buyers and sellers*' and a second investor mentioned '*Manager auctions might be useful if selling one position, but not when I want to sell a portfolio*'.

The smaller the assets under management (AUM), the more an investor is reliant on third party brokerage and online exchange platforms. This is because such investors trade at relatively small volumes and therefore less likely to be given a considerable amount of time and information by a prospective seller. Indeed, the principal to principal methodology is least preferred amongst investors with less than €500 million AUM. In contrast, it is the preferred method amongst the very largest investors. Given the large transaction sizes that they undertake, they also typically require more time to fully underwrite the portfolios. Furthermore, the largest investor category includes some multi-managers who are used to trading frequently and thus are comfortable transacting without broker assistance.

Figure 17: Preferred secondary market transaction methods by investor size



Section 5

Indirect real estate investment vehicle liquidity

Indirect real estate investment vehicle liquidity

Investors access real estate utilising a variety of indirect vehicle types, with non-listed funds being by far the most popular choice across investor type and location.

Liquidity of open end funds

Open end funds differ from closed end funds in two distinct ways:

i) Open end funds typically have no set maturity date. By contrast, closed end funds typically have maturities seven to ten years from inception.

ii) Open end fund allow investors to exit the fund by redeeming their capital commitment, whereas closed end funds do not.

By offering the ability to redeem capital, open end funds are therefore promising liquidity to investors.

> 'Open end funds are vulnerable to herd instinct so can't work in all environments'

During the global financial crisis, redemptions increased as investors sought to convert their assets into cash in part to avoid large anticipated declines in NAV. Many open end funds faced redemption requests greater than they could service with their cash and income. Where permitted by their documentation, some fund managers chose to suspend redemptions entirely whilst others were forced to sell assets to raise capital. In a market with declining values, assets were being sold below their latest NAV.

As a result, many investors in open end funds were forced to wait in a redemption queue until the fund was able to meet their redemption requests.

Given this backdrop, investors were asked if open end funds can actually provide the liquidity that they profess to offer. Just 3% of investors were in agreement, whilst the remaining investors either answered no (39%) or cycle dependent (58%). The cycle dependent category indicates that the respondent felt that open end funds could provide liquidity in certain parts of the macroeconomic and property market cycles but not in others

In the absence of large capital inflows or market distress, liquidity is available. However, if investment inflows become too great, capital deployment is delayed until sufficient stock can be sourced, which may take some time in a competitive buying environment. If market distress is present, return of capital can be delayed as open end fund managers are unable to divest assets within the required timescale and therefore suspend redemptions.

The reduction of open end fund liquidity during periods of market distress was highlighted as a key weakness of the concept, since the requirement for cash over the short term is increased. Opining on this, one Swiss investor noted '*Open end funds do not provide liquidity when investors most need it*'. A UK investor added '*Open end funds are vulnerable to herd instinct so can't work in all environments*'.

A fund of funds investor highlighted the liquidity mismatch of the fund terms and the underlying assets as a reason for the illiquidity, stating '*Open end funds use liquidity as a marketing tool but how can they offer liquidity if the underlying assets are illiquid?*' whilst a Nordic investor mentioned '*The liquidity of open end funds correlates with direct property liquidity*'.

Investors also noted that smaller, less diversified open end funds were likely to be less liquid than their larger counterparts. One Dutch investor commented '*The US funds are huge and offer good liquidity. In comparison, European funds are smaller and there are fewer investors*'. Another added '*In our experience the smaller open end funds were only liquid on paper; we couldn't get liquidity when we needed it*'. An insurance investor noted '*Larger open end funds are more likely to be able to offer liquidity*'.

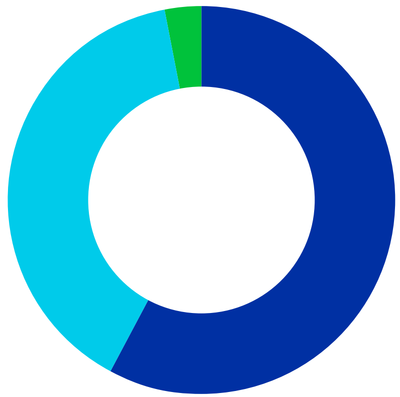
Not all investors utilise open end funds for liquidity reasons. The open end fund structure can be less of a consideration than the manager quality and/or the operation of a strategy which provides access to sectors and/or regions that investors seek access to.

A German investor explained, '*Our decision to invest in open end funds is driven mainly by their strategy, though the flexibility of reallocation they provide can be a benefit*'. In essence, the structure type is not a material driver of the investment decision in such situations. Agreeing with this stance, a Dutch investor commented '*I'm sceptical about the liquidity that open end funds offer so for me it's more about liking the strategy and the manager*'. Furthermore, for those investors with longer term investment horizons who are more focussed on income and diversification, the lack of liquidity of open end funds is less of an issue. As a Swiss investor explained '*Longer duration investors can sit out periods of illiquidity and don't mind a lack of redemptions in difficult markets.*'

As a reason for not investing in open end funds, one investor noted '*We like to have controlling stakes; it's the net exposure which is important to us. We can be diluted in an open end fund so that doesn't match with our philosophy*'. Highlighting the fact that open end funds tend to operate core strategies with a focus on income, one investor mentioned '*We haven't invested in an open end fund. We have a distressed or opportunistic investment mandate and we haven't found an open end fund that matches our return or strategy requirements*'.

Figure 18: Do open end funds offer the liquidity they profess to provide?

58% Cycle dependent
39% No
3% Yes



Despite the acknowledgment of the liquidity limitations of open end funds, investors reported that they remain a viable investment option as they do function as intended in normal market environments, i.e. in the absence of distress or glut of capital. On this topic one investor noted '*We have one open end fund investment and the driver behind making the investment was liquidity. It's a lower risk strategy, so we see it as the closest proxy to a bond in our portfolio*.' Another added '*We like to use the open end funds for liquidity*'.

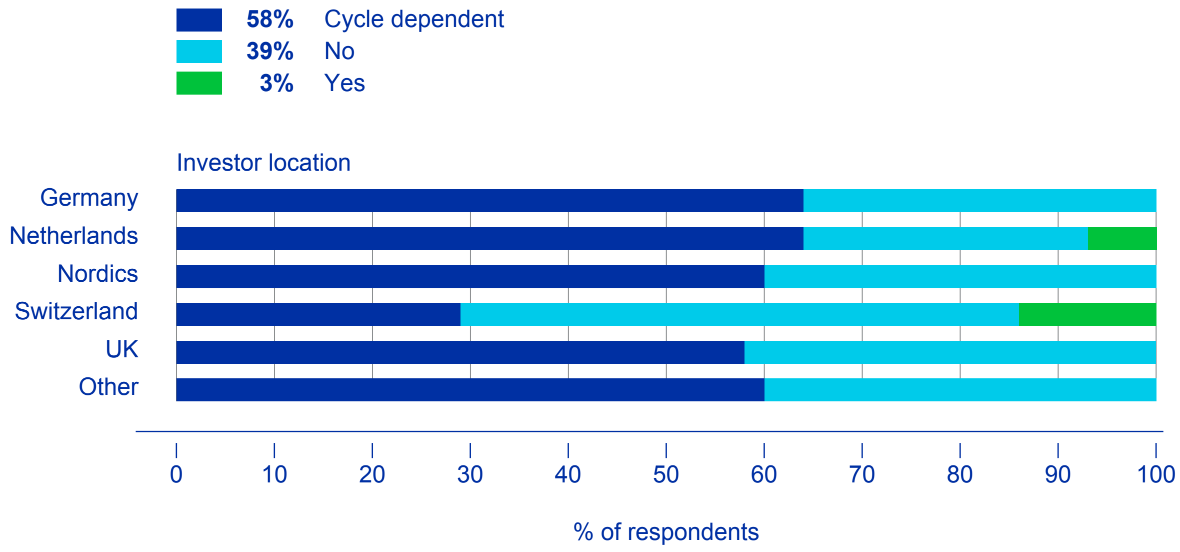
A third investor highlighted that a different structural feature was attractive for him 'I *like open end structures because they provide long term real estate income exposure without the need to liquidate in 5 to 7 years*', thus highlighting one weakness with the closed end fund model. Investors also commented that certain highly diversified funds have open end structures and in order to gain access to such high quality diversified portfolios, it was necessary to invest in an open end structure. As one Dutch investor mentioned '*If you want to get diversified exposure relatively quickly, open end funds are a good way of doing it*'.

Of those investors that voted yes, one respondent mentioned that the fact that open end funds offer some liquidity is a benefit over closed end funds, so by comparison they are liquid. Another mentioned that in his experience, investing in the large US open end funds had been very efficient from a liquidity perspective.

No secondary market specialists, multi-manager or fund of funds investors hold the view that open end funds offer liquidity in all environments. These investor types have very wide ranging exposures to a variety of underlying indirect vehicles and many had first hand experience of redemptions being suspended during the global financial crisis.

A number of investors expressed the view that open end fund liquidity had improved in recent years, with one German investor summarising '*There are much less redemptions in the market now than during the crisis*' and a Dutch investor adding '*There's no problem redeeming from open end funds now, it's much easier than during the downturn*'. However, a fund of funds investor added a note of caution about the cyclicality of real estate, stating '*As market conditions have improved, redemptions have reversed but the open end structures will be tested again during the next downturn*'.

Figure 19: Do open end funds offer the liquidity they profess to provide by investor location



Liquidity of closed end funds

Entry liquidity into closed end funds (from a primary, rather than a secondary perspective) is governed by two key factors.

The first is the ability to invest into a particular fund. Funds typically have minimum commitment sizes, which small investors may not be able to meet. Conversely, many fund managers limit the maximum aggregate amount of capital that they will accept for a fund raise. If the fund is popular amongst investors, the fund manager may decide to decline a prospective commitment or downsize it, either of which can lead to investor disappointment.

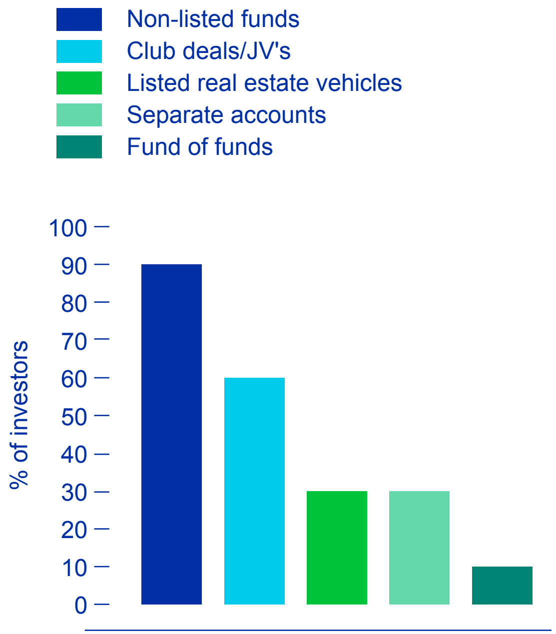
The second key aspect for entry liquidity is the pace at which an investor gains real estate exposure. Investors' capital commitments are drawn down pro-rata amongst investors over an investment period, which is typically two to four years. However, the pace of draw down is at the fund managers discretion and thus once an investor has committed capital to a fund, the speed with which they gain real estate exposure can vary considerably.

Exit liquidity is governed by the structure of the fund. Closed end funds typically have a set term of seven to ten years and may also have optional extensions, which can further extend the life of the fund. Typically these extension options must be agreed to by investors when fund managers make a request to enact them. During the financial crisis, managers sought to exercise extension options to prevent the need to sell assets into a challenging market and to allow time for stalled asset management plans to be reinvigorated.

Since closed end funds offer no right for capital to be redeemed, investors need to take into account that their capital will be locked in the fund for a specified length of time. This is one of the key features which makes indirect real estate illiquid.

As already documented, there is a secondary trading market for non-listed funds which can provide some liquidity to investors. However, some funds may prohibit or restrict transfers, limiting their liquidity. Where transfers are permitted, liquidity varies from fund to fund and is dependent on a range of fund specific and market wide factors. Whilst some funds are actively traded, not all funds have a buoyant secondary market and some positions may hold no attraction for purchasers whatsoever.

Figure 20: Percentage of investors that invest in each vehicle type



Liquidity of separate accounts and joint ventures

There are additional liquidity related benefits to investing in separate accounts and club deals/joint ventures (JVs).

These are:

- Ability to identify and underwrite underlying assets prior to investment, leading to greater certainty regarding portfolio construction and the ability to undertake a more accurate assessment of potential exit liquidity of the underlying asset(s).

- Enhancement of entry liquidity through potential for rapid capital deployment. This mitigates the effect of negative cash flows in the early years of the non-listed vehicles life which are created by the two to four year capital deployment period.

- Alignment with like-minded investors, which can improve decision making and information sharing and reduces the potential for conflict which can arise when investors with disparate philosophies are brought together.

The point regarding investor co-operation is key when considering liquidity. During the global financial crisis many commingled funds faced significant challenges, including failing business plans, overleveraged assets and in some cases repossession of assets by lending banks. Not only were investors tasked with voting on certain key issues, such as extending fund maturity or selling major components of portfolios but were on occasion asked to recapitalise funds with additional equity. In these instances, investor interests were not always aligned, meaning that a particular course of action designed to create exit liquidity which was attractive to one or more investors could be prevented from occurring by other investors.

Noting this, a UK investor mentioned '*The number of different investors in funds means that there is sometimes a misalignment of interests in the investor base. Strategy and timelines are not always aligned*.' A German investor added '*We are attracted to club deals where other investors have the same mind set. We prefer not to get involved in funds with lots of investors unless the biggest investors are able to work together*.'

Across the different vehicle types, entry and exit liquidity will be governed to a large extent by the liquidity of the underlying assets. For example, whilst an investor with a separate account may have discretion to instruct the manager to sell part or whole of the underlying portfolio, the time taken to realisation and the price achieved will depend to a large extent on the prevailing market environment in the sectors and regions to which the manager has exposure.

Whilst managed accounts are typically run on behalf of a single investor, JVs bring two or more investors together, so create a different dynamic. Here it not only necessary for investor philosophies to be aligned but also for the consideration of exit liquidity in the event that one or more of the investors wish to exit the JV.

> 'The number of different investors in funds means that there is sometimes a misalignment of interests in the investor base'

Exit liquidity can be generated in two ways. The first is to sell one or more of the underlying assets in order to redeem the departing investor. However, this could lead to asset selection bias and potential disagreements, with the departing investor being dispassionate about which assets(s) are sold whilst the remaining investor(s) are keen not to be left with a lower quality portfolio. In cases where the JV has been formed around a single asset, then the option is removed entirely unless an agreement can be made to sell that asset.

The second method of generating exit liquidity is a sale of the indirect holding. Typically these are governed by incorporating 'drag along, tag along' rights into the documents. In the event that liquidity is required by one of the parties, the others have the right to purchase their interest and if they decline to do so, they also have the right to declare that they want to sell their interest. As a Dutch investor commented '*Drag along tag along rights creates opportunity for an exit*'. An insurance company investor added '*Liquidity in JVs can be hampered by the inability to sell the underlying asset. Drag along tag along rights help increase the liquidity*'.

Since JVs have far fewer investors than commingled funds and commonly have a much more concentrated portfolio, there can be difficulty in achieving exit liquidity. Commenting on this a Nordic investor mentioned '*Pooled funds can be more liquid than JVs*' whilst a UK investor added '*We undertake a lot of investments with JV partners, we think that 3 years is an acceptable timescale to extricate ourselves f or a JV situation*'.

Listed investments have considerably greater liquidity than the non-listed sector, with daily liquidity being available for many holdings, though exiting from poorer quality positions can take substantially longer. Whilst the liquidity of the listed sector provides an opportunity to rebalance portfolios over a short time frame, listed investments can add substantial volatility to portfolios.

The entry and exit liquidity of fund of funds varies depending on whether they are structured as a closed end or open end vehicle. For those structured as a closed end vehicle, the lock up period can be substantial. For example, an investment made in year four of the investment period into an underlying fund with a ten year maturity will mean that fourteen years will have elapsed from investor capital commitment to realisation. For open end fund of funds, their liquidity will depend on the liquidity of the underlying investments, as well as their own commitment and redemption queues.

Liquidity and indirect real estate vehicles: investor influence on documentation

Although closed end funds grant delegated powers to the fund manager, those investors who commit a significant amount of capital to the fund are able to exert influence on the fund documentation and obtain co-investment rights. A Dutch investor remarked '*Liquidity is important especially when you have a substantial stake. We like to insert liquidity clauses in the documentation, for example to allow investors to instruct the manager to sell a part or whole of the portfolio*'. A German investor added '*We like to have control over the purchase and sales of significant assets*' whilst a third investor added '*We like to have control over major decisions and undertake a lot of co-investments alongside the funds*'.

Due to their smaller commitment sizes, smaller investors are less able to exert influence on the fund documentation and are unlikely to be able to command a seat on the advisory board, and must thus abide by the governance structure which is agreed between the manager and the larger investors.

The liquidity characteristics of open end funds are discussed at length in the prior section titled Liquidity of Open End Funds but it is noteworthy that due to limitations on entry liquidity in some funds (due to large capital commitment queues) secondary market trading may occur in open end funds. In such cases a prospective investor is able not only to reduce the time taken to gain access to the fund but may also be able to purchase at a more attractive price than the current offer price of the fund. As a UK investor explained '*We actively trade in the secondary market, it gives immediate access to the funds which is a key advantage if there is a commitment queue. There can ultimately be better pricing too*'.

Although larger investors are able to negotiate more favourable terms when investing in commingled non-listed vehicles, their significant financial capital allows them to work with managers to create bespoke investment vehicles in the form of separate accounts. These vehicles typically grant the investor control rights over key decisions such as asset purchase, disposal and major asset management decisions.

Such control rights allow investors to feel that they have increased proximity to the underlying assets, which in turn enhances their perception of liquidity. This perception is driven by the view that they are in full control of the decision to sell and what price to accept.

'*We actively trade in the secondary market; it gives immediate access to the funds which is a key advantage if there is a commitment queue. There can ultimately be better pricing too*'.

Section 6

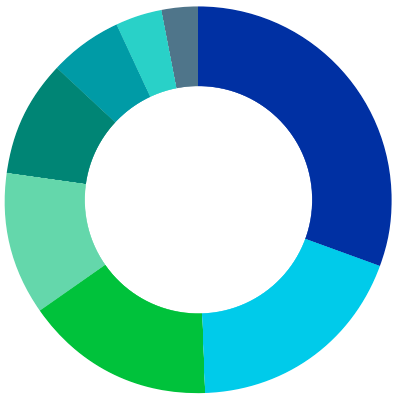
The future of liquidity in non-listed real estate vehicles

The future of liquidity in non-listed real estate vehicles

Investors mentioned increased transparency (31%), document standardisation (19%) and increased market size (16%) as the top 3 factors which would enhance the liquidity of the indirect real estate market.

Figure 21: Most popular investor suggestions for improvements that would increase indirect real estate liquidity

31%	Transparency
19%	Standardisation
16%	Increased size
12%	Fund structure
10%	Valaution
6%	Exchange
4%	Communication
3%	Pre-emption



Transparency

Transparency in this context means an availability of information. In particular, an inability to access fund documentation, portfolio and performance data hampered their ability to underwrite potential purchase targets. In addition, there is often no readily available recent pricing comparable which investors can use to aid them in their decision making process. In cases where data is incomplete and is not forthcoming from seller or fund manager, the potential purchaser will either factor in the unknown elements by decreasing the price which they are willing to pay or decide to walk away from the transaction altogether. Both scenarios can be frustrating for buyer and seller alike, especially if significant time and resource has already been committed to the process. One investor explained '*Transparency is key. Greater transparency on portfolio construction and performance means investors can make better decisions*'.

A lack of transparency was also highlighted as acting as a barrier to entry for new investors, discouraging liquidity by negatively impacting the ability of the market to grow in size. One insurance investor remarked '*Transparency helps attract investors to the sector*', whilst a Dutch investor noted 'T*ransparency is linked to liquidity and it's really important for the secondary market*'.

A small proportion of investors mentioned improved communication could aid liquidity and this is part of the same theme of increased transparency. There is a general sense that buyer, seller and fund manager can work more closely together, information share (within the boundaries of client confidentiality) and achieve a suitable outcome for all parties. As one UK investor noted '*Less unnecessary confidentiality amongst managers would be a benefit*'.

Document standardisation

Document standardisation was the second most frequently cited improvement that could be made. Mentioning standardisation and transparency, one Nordic investor said '*The greatest positive impacts would be the lessening of fund document diversity and improving transparency*'. Investors highlighted the fact that there is little harmonisation between fund terms and transfer documents. One investor remarked '*Standardising fund terms would be hugely beneficial. It's a huge demand on due diligence*'. A second investor added '*Different funds have different documentation which can be time consuming to digest*'; whilst a third noted the cost implications that additional time commitments can have '*A standard transfer agreement would be useful because it would reduce on time and expense*'.

Regarding particular clauses in documentation, a small proportion of investors specifically mentioned the need to standardise or remove pre-emption rights as these can cause delays to transactions. Noting the potential for delays one pension investor mentioned '*Pre-emption rights are a hindrance*', whilst a UK investor noted the need for a balance, stating '*I'd like the best of both worlds, pre-emptions can be useful when already invested in a fund but it would be good to standardise, simplify and reduce the time that the process takes*'.

Furthermore, investors felt that standardisation of transfer documents could also help smooth the transaction process and would also allow third party service providers such as administrators become more conversant with secondary market trades, decreasing delays. One multi-manager investor mentioned '*It's crucial that third parties like administrators and custodians are familiar with the process*' whilst a second investor agreed, saying '*Fund managers need to embrace the secondary market and third parties like administrators need to be well drilled in the process*'.

> 'It would be good to focus on enhancing the level of understanding of the secondary market amongst investors that should improve levels of comfort and participation'

One UK investor's solution to the diversity of transfer documentation is to use their own transfer agreement. They explained '*We use a proprietary transfer agreement in addition to any that might be specified in the fund documents because we like to have standardisation across all our transactions*'. One investor had a counterview to standardisation, mentioning '*Every fund manager is entitled to use their own documentation, so harmonisation of documents is not possible. The biggest thing is actually the evolution of investor mind set in the secondary market*'.

Increased market size

Increased market size was the third most popular option amongst investors, which is unsurprising given that respondents had previously linked market size to liquidity. Once again, market size has a number of components, including number of funds in the primary market (since secondary markets are a derivative of the primary market), the size of funds and a continued increase in investor participation. A German investor mentioned '*Increasing the overall market size would be a positive*' whilst a Swiss investor added '*Ultimately primaries need to grow and then secondaries will grow*'. A UK investor focussed on the education aspect to market growth, stating '*It would be good to focus on enhancing the level of understanding of the secondary market amongst investors that should improve levels of comfort and participation*'.

Harmonisation of valuation approach

Harmonisation of valuation methodologies was mentioned by a number of investors, with a desire to adopt the mark to market valuation technique commonly used in the UK, rather than the sustainable value methodology frequently used in Germany. It was felt that whilst market to market (MTM) valuations have their inherent weaknesses (such as lag and subjectivity) they are more useful in determining current value than the alternative methodology. Indeed, the change to valuation methodology towards a mark to market approach was most frequently suggested by German investors. Regarding valuation, one Dutch investor noted '*Greater valuation frequency allows us to track the portfolio more closely, I strongly believe it's a benefit to liquidity*' whilst a UK investor added '*Mark to market valuations would be much better than the German approach, they improve confidence and understanding*' and a German investor stated '*Standardisation of valuation to MTM would be good*'.

The less frequently cited improvements included changes to fund structures to allow for more liquidity and the formation of a central exchange which would be designed to boost transparency and availability of information. The suggestion of the former is somewhat surprising given the widespread acknowledgement amongst investors of the limitations of open end funds. However, a minority did feel that having some option to redeem is better than none at all.

Those investors that suggested the formation of a central exchange recognised that the inherent characteristics of the market meant that while of some benefit to investors, it would fall short of what those in the equity markets are used to. One investor stated ‘*An exchange with set trading rules and documentation would be a real benefit to liquidity*’.

Despite the suggestion of improvements, some investors sounded cautionary notes about improving indirect real estate liquidity. One investor noted ‘*More liquidity of real estate may mean it behaves ore like equities, which is undesirable*’ A second added ‘*Investors should be careful what they wish for. Improving liquidity makes real estate closer to equities and bonds and the less reason to distinguish it from other assets, the less reason to invest in it*’. A third investor stated ‘*I have bought into the concept of indirect real estate being illiquid so I don’t wish it to be more liquid*’.

‘Greater valuation frequency allows us to track the portfolio more closely; I strongly believe it’s a benefit to liquidity’

Conclusion

Compared with bonds and equities, indirect real estate is an illiquid asset class because the time taken to transact can be lengthy, the pricing may be uncertain and there are can be considerable costs involved. Despite this, it remains attractive to investors who are seeking to increase the diversification and return generating potential of their portfolios.

By investing indirectly, investors are able to gain access to experienced third party fund managers and can thus benefit from the local knowledge and experience which are necessary to enact a successful real estate strategy across different locations.

Investment geography has a major influence on liquidity as the liquidity of indirect real estate is influenced not only by the liquidity of the underlying assets but also the prevailing legal and tax regimes. Regulation has varying impact depending on investor type and location. Whilst regulation can be a constraining factor to strategy it can also lead to greater demand for certain product types and in underserved markets, this can lead to product innovation.

> ‘Information transparency, document standardisation and increased market size are three most important drivers of increased liquidity’

Although illiquidity of indirect real estate is accepted by investors, a large proportion of investors desire to trade real estate within one year of deciding to do so. This can be for portfolio rebalancing, risk reduction (or increase) or return generation reasons.

Principal to principal and third party brokerage are the most popular methodologies for transacting indirect real estate. Principal to principal offers the advantage of a close working relationship between buyer and seller and the potential for increased transparency during the sales process. Third party brokers are perceived to have good market coverage and are recognised as having the ability to access a wide range of investors, which is particularly useful when selling holdings.

Due to the illiquidity of the underlying assets and a herd mentality amongst market participants, the liquidity of open end funds can decrease during times of severe market distress. Despite this, and in the absence of market distress, open end funds remain attractive to long term investors, to those who benefit from the portfolio rebalancing option and to those that are seeking to invest in particular sectors or geographies which open end funds have exposure to.

The future of indirect real estate liquidity

Information transparency, document standardisation and increased indirect real estate market size are identified as the three most important drivers to increasing indirect real estate liquidity. These three factors are interlinked, a more transparent market which is easier to transact in will aid in increasing investor participation and transaction volumes.

Looking to the future of the indirect real estate market, there are a number of ways which the investor sentiment expressed in this study may manifest. As part of a standardisation and simplification process, restrictions on transfer may become less common and where existent, the pre-emption rights process could be redesigned in such a way as to negate any lengthy delays to a transfer process.
A standardised transfer document may also be adopted by the market which could take the form of an agreed template with predefined sections which can be excluded or included dependent on the wishes of the counterparties.

Managers may have legitimate concerns regarding the sharing of sensitive information, however these must be balanced against the wishes of existing and prospective investors who wish to undertake transactions. As investors demand greater transparency we may also see increased acceptance from fund managers that the provision of information and assisting investors in secondary market trading will enhance their reputations, rather than act as a destabilising factor to their long term business plans.

Manager led auctions may become more commonplace, with a match bargaining process being allowed for in the fund documentation, in the anticipation that certain investors may want some liquidity in the future. Indeed, this could also act as a benefit to a manager who then has the opportunity to replace a disengaged investor with one that is very supportive of the platform.

Whilst open end funds continue to remain an attractive investment option, improvements may be made which lessen the impact that difficult market conditions have on the fund. If standardisation of terms cannot be achieved then at least transparency and clarity on liquidity provisions and redemption suspensions for each fund would improve the ability of investors to more accurately assess the liquidity impact during different environments. Different share classes with variable liquidity provisions may also be introduced, which would allow the fund manager greater clarity in terms of forward planning for redemptions. In terms of corporate governance enhancement, major decisions such as managing capital inflows and redemption suspensions could be referred to an independent board, to ensure there is no conflict of interest between manager and investors.

The evolution of investor mind set, with seller motivations changing from distress to prudent portfolio management has been noted. It will be interesting to monitor if this evolution will continue and if so, will the pace remain consistent or will momentum increase. One determinant of the pace of evolution is education and improved understanding. Therefore, there is an opportunity for industry participants to enhance indirect real estate liquidity by acting as educators in the market place.

The continuation of a variety of indirect vehicle structures seems inevitable. Non-listed funds appeal not only to smaller investors who lack the capital required for managed accounts but also to larger investors who are seeking for country or sector diversification. Meanwhile managed accounts and JVs will continue to appeal to those investors who feel their structural benefits warrant inclusion in the portfolio.

‘There is an opportunity for industry participants to enhance indirect real estate liquidity by acting as educators in the market place’

Appendix 1

Questionnaire

Questionnaire

Introduction

This research project is being undertaken by Richard Urban, on behalf of INREV.

Research project background
The consideration of liquidity plays an important role in investment decision making. Since the global financial crisis, many investors have given greater focus to the liquidity of their investments and the level of control they are able to exercise over them. Regulations have also changed in many countries and many of these changes have had material impact on the liquidity mechanisms permitted in indirect structures.

Objective
The objective of this project is to obtain a greater understanding of the needs and requirements of investors who invest into indirect real estate.

For the purpose of this project, 'Indirect' is defined as any investment in a fund, managed account or other vehicle which is managed by a third party, rather than by the investor themselves. Such indirect investments may have as their underlying collateral any combination of real estate debt or equity investments (including listed investments).

INREV background
INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Its 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.

Richard Urban background
Richard is an independent non-executive director for funds which invest in real estate and other asset classes. A former investment manager with cross capital structure investment and fund governance experience, Richard is an industry award judge, regular conference speaker and has contributed extensively to investment management and pension industry press articles.

Richard is regulated by the Jersey Financial Services Commission and is a Member of the Institute of Directors and the Royal Institution of Chartered Surveyors (RICS). He is also an RICS professional examinations assessor. Richard holds a BSc in Investment and Finance in Property from the University of Reading.

Important information
No information provided will be released into the public domain in a way which can be attributed to you.

Your contribution to this research is most valued. By way of thanks you will receive a complimentary copy of the research report upon its publication, even if your organisation is not a member of INREV.

Thank you for your participation.

1. Your contact information (for internal purposes only, this information will not be published)

Name ______

Company ______

Email address ______

Phone number ______

2. Please select the investor type category which most closely describes your organisation

- ☐ DB Pension scheme
- ☐ DC Pension scheme
- ☐ Family office
- ☐ Fund of funds (client capital is pooled together)
- ☐ Insurance company
- ☐ Multi-manager (client capital remains segregated in one or more separate accounts)
- ☐ Sovereign wealth fund
- ☐ Other (please specify)

______

3. Please select your location

- ☐ Denmark
- ☐ Finland
- ☐ France
- ☐ Germany
- ☐ Luxembourg
- ☐ The Netherlands
- ☐ Sweden
- ☐ Switzerland
- ☐ United Kingdom
- ☐ United States
- ☐ Other (please specify)

______

4. Please state your current AUM for direct, indirect real estate and other sectors (EUR millions)

Current direct real estate AUM (EUR millions) ______

Current indirect real estate AUM (EUR millions) ______

Current other asset classes AUM (EUR millions) ______

5. Please state your target (in 3 years) AUM for direct, indirect real estate and other sectors (EUR millions)

Target direct real estate AUM (EUR Millions) ______

Target indirect real estate AUM (EUR Millions) ______

Target other asset classes AUM (EUR Millions) ______

6. Please state your current and target exposures for direct and indirect real estate by location

	Current exposure (% of total AUM)	Target exposure in 3 years time (% of total AUM)
Domestic Indirect		
International Indirect		

7. Regarding your indirect real estate investments, please state your current and target exposure by vehicle type:

For the purpose of this project, 'Indirect' is defined as any investment in a fund, managed account or other vehicle which is managed by a third party, rather than by the investor themselves. Such indirect investments may have as their underlying collateral any combination of real estate debt or equity investments (including listed investments).

	Current exposure (% of indirect real estate AUM)	Target exposure in 3 years time (% of indirect real estate AUM)
Funds of funds		
Non-listed funds/ commingled funds/ private REITs		

8. Which of the following real estate sectors do you invest in indirectly? (tick all that apply)

- ☐ Bricks and mortar
- ☐ Non-listed funds
- ☐ Performing senior debt
- ☐ Performing non-senior debt
- ☐ Non-performing loans/distressed debt
- ☐ CMBS and/or RMBS
- ☐ Real estate equities
- ☐ Real estate derivatives
- ☐ Other (please specify)

9. From the list below, please rank the following considerations which you take into account when constructing your indirect investment strategy in order of importance (1 = most important, you may drag and drop the option boxes)

- ☐ Diversification benefits
- ☐ N/A

- ☐ Capital return
- ☐ N/A

- ☐ Income return
- ☐ N/A

- ☐ Inflation hedging
- ☐ N/A

- ☐ Liquidity
- ☐ N/A

- ☐ Risk adjusted performance over other asset classes
- ☐ N/A

- ☐ Total return
- ☐ N/A

- ☐ Other
- ☐ N/A

10. What is your definition of liquidity?

11. What are the three most important aspects of liquidity to you? (e.g. timing). Please rank in order of importance.

1 ______________________________

2 ______________________________

3 ______________________________

12. If you require your indirect real estate holdings to be liquid, over what time period do you require liquidity?

- ☐ N/A, I do not require liquidity from indirect real estate
- ☐ Daily liquidity
- ☐ Monthly liquidity
- ☐ Annual liquidity
- ☐ 3 years
- ☐ 5 years
- ☐ Other (please specify)

____

____

____

13. From the list below, please rank the drivers of indirect real estate liquidity in order of importance (1= most important, you may drag and drop the option boxes)

☐ Behaviour/reputation of the fund manager
☐ N/A

☐ Debt metrics (LTV, DSCR/ICR)
☐ N/A

☐ Number of current investors in the vehicle
☐ N/A

☐ Performance to date
☐ N/A

☐ Performance expectations
☐ N/A

☐ Relative attractiveness of real estate vs. other asset classes
☐ N/A

☐ Recent comparable evidence of fund pricing
☐ N/A

☐ Other
☐ N/A

14. From the list below, please rank the most important factors which influence your liquidity needs in order of importance (1 = most important, you may drag and drop the option boxes)

- ☐ Investment geography
- ☐ N/A

- ☐ Investor requirements
- ☐ N/A

- ☐ Legal systems
- ☐ N/A

- ☐ Regulatory regimes
- ☐ N/A

- ☐ Tax requirements
- ☐ N/A

- ☐ Other
- ☐ N/A

15. Which regulations are having the greatest impact on your liquidity requirements?

____

____

____

16. Please provide details of any illiquidity premium you adopt when investing indirectly in real estate:

Do you adopt an illiquidity premium when investing indirectly in real estate?

____

____

____

What is your iliquidity premium for domestic indirect real estate? (if any, basis points)

____

____

____

Please specify your liquid proxy (e.g. 10 year gilts), if any

____

____

____

17. If you invest across sectors, how do the illiquidity premiums across those sectors differ from your domestic indirect real estate premium?

Illiquidity premium or discount vs. domestic indirect real estate (basis points)

Fixed income ______________________

Private equity ______________________

Other (please specify)

____

____

____

18. If you invest internationally in indirect real estate, how do the illiquidity premiums you require in those countries compare with the illiquidity premium you desire in your domestic market?

International real estate illiquidity premium vs. domestic illiquidity premium (basis points)

Western Europe excluding Nordics, ______________________

Southern Europe and UK ______________________

Nordics (Denmark, Finland, Norway, Sweden) ______________________

Asia Pacific ______________________

Americas excluding US ______________________

Other (please specify)

____

____

____

19. How has your perception of real estate vehicle liquidity changed over the past 5 years (if at all)?

20. Which measure do you use to assess liquidity risk when making indirect real estate investments (e.g. assume holdings are completely illiquid)

21. Do you consider open end funds to offer the liquidity they profess to provide? If so, why is that the case and if not, why not?

22. Is the secondary market an efficient way of achieving liquidity of indirect real estate? (please explain your answer)

23. In terms of transacting holdings on the secondary market, which methodology do you prefer and why?

- ☐ Manager led auctions
- ☐ Online exchange platforms
- ☐ Principal to principal
- ☐ Third party brokerages
- ☐ Other (please specify)

Please comment on why you prefer this option

24. In order of importance, list the three changes to indirect real estate vehicles which would have the greatest positive impact on liquidity

1.
2.
3.

Appendix 2

List of participants

List of participants

A total of 66 investors took part in the research.

The following list of investors, fund of funds managers and multi-managers participated in the research and gave permission for their company names to be published.

Abu Dhabi Investment Authority
ASR
Aviva Investors
Bouwinvest
CBRE Global Investors
DTZ Investors
ImmofinRE Group
Kames Capital
Landmark Partners
Madison International Realty
Partners Group
PFA Pension
Pramerica Real Estate Investors
Siguler Guff
Syntrus Achmea Real Estate and Finance
TKP Investments

CORPORATE

RESEARCH

INDUSTRY DATA

PUBLIC AFFAIRS

PROFESSIONAL STANDARDS

www.inrev.org