Status and influence of corporate governance on the non-listed real estate industry **2015**

Research | Academic Paper

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.

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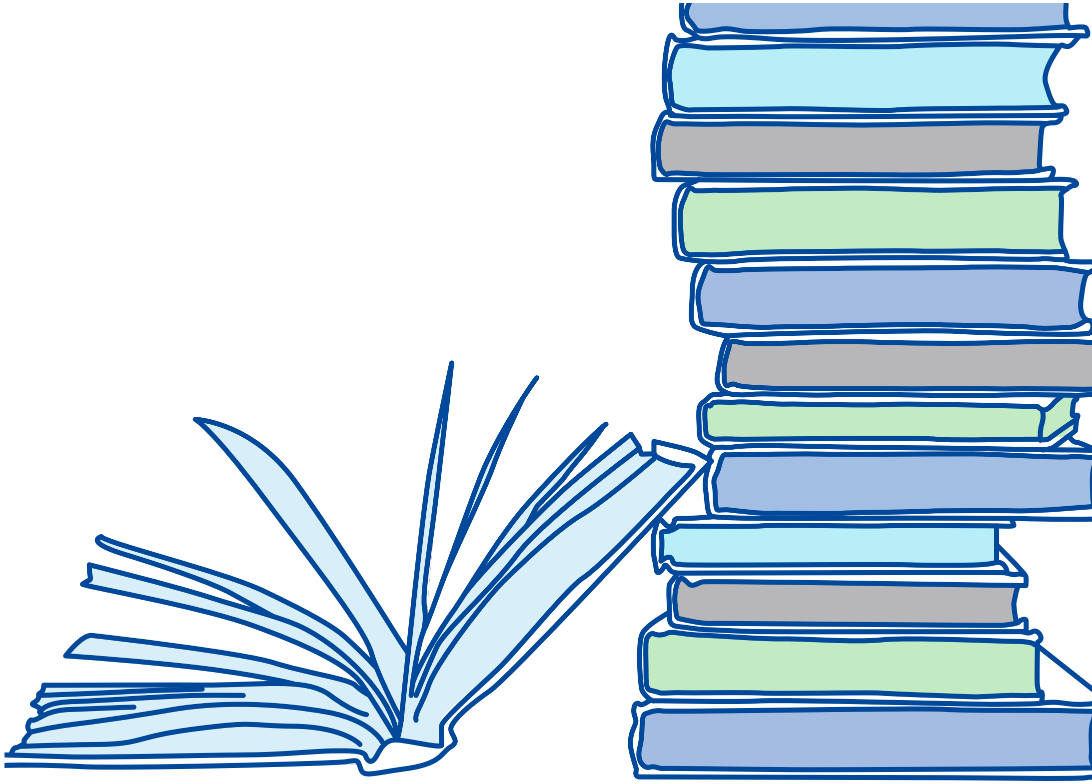

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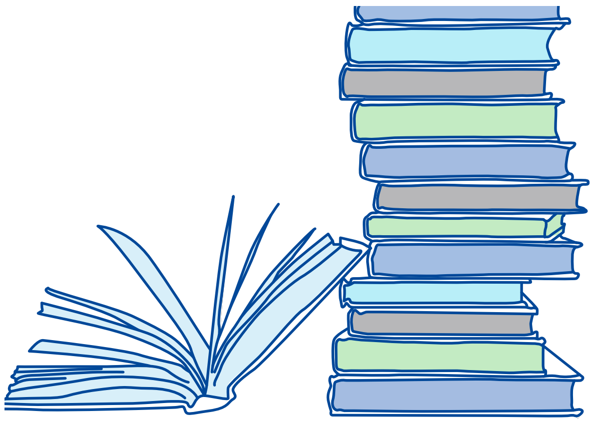

Executive summary

Financial crises and individual misconducts have often led to increased regulation and the heightened importance of corporate governance. Even though the role of corporate governance in the non-listed real estate fund industry underwent major changes as a result of the recent financial crisis its importance is still developing. The fact that its importance is high in prominence is particularly impressive given that the non-listed real estate sector can still be considered a young industry relative to other sectors.

The common held perception, as highlighted in published research literature, is that strong corporate governance contributes to less volatile corporate results since it makes businesses safer and less exposed to external or management risks. Companies known for weak governance practices often face reputational risks and can be interpreted by investors as acting without transparency and accountability.

> ‘Weak governance practices can be interpreted by investors as acting without transparency and accountability’

This study identifies the views of real estate fund managers - that are INREV members - on the key components of corporate governance and investigates the influence of corporate governance on volatility, performance, risk and capital raising ability. The primary basis of this study is the seven main governance principles as identified in the INREV corporate governance guidelines. We measured attitudes to corporate governance principles among fund managers by surveying 75 managers and analysed its implications for the industry.

The study found that corporate governance issues are dynamic and fund managers are continuously adapting to new conditions. In particular governance has been highly influenced in recent years by the introduction of new European regulation applying to alternative investment fund managers such as the Alternative Investment Fund Managers Directive (AIFMD).

It is important for the real estate industry to continuously improve corporate governance standards and understand how new developments affect the industry in order to properly react to the changes and challenges ahead. Far from being viewed as an onerous imposition or a restrictive set of prescriptive guidelines, corporate governance should be seen as a business opportunity where fund managers that have high standards of corporate governance will be noticed by investors and rewarded with successful capital raisings.

In addition, the study found that the industry takes corporate governance very seriously and acknowledges the direct relationship between good corporate governance

> ‘Corporate governance issues are dynamic and fund managers are continuously adapting to new conditions’

standards and manager performance. Fund managers believe that through good corporate governance, volatility and risk can be reduced, while performance and capital raising ability can be increased. This further emphasises the importance of corporate governance in the non-listed real estate sector.

The three main findings and recommendations identified by the study are listed below:

1) Corporate governance has a positive impact on reducing volatility, increasing performance, reducing risk and increasing capital raising ability.

   Governance standards are improving and INREV's efforts in developing and supporting best practice in corporate governance should be welcomed by fund managers. For their part managers should actively continue to improve their own standards of governance.

   Implementing higher levels of corporate governance principles should lead to positive effects for fund managers in the industry. As investors improve their ability to measure and integrate corporate governance risk into their investment decision making process in a more systematic way, governance standards will likely play an increasing role in fund manager selection.

   Smaller and medium-sized fund managers might be able to compete with their larger counterparts by tailoring their operating processes within the INREV corporate governance principles to meet investors' requirements. This will help them to differentiate themselves from others in the market.

2) Implementation of AIFMD is the main trigger for a corporate governance review. Increased regulation leads to increased operational costs which can be particularly onerous especially for small fund managers. Though market consolidation is expected, small and medium-sized fund managers might need to adapt their governance strategy to their resources.

3) The majority of managers intend to review their corporate governance during the next two years. The study findings are that the INREV corporate governance self-assessment tool supports fund managers in doing their review very well. Fund managers should provide necessary resources required to conduct their corporate governance review. Those fund managers not planning a corporate governance review should consider doing so in order to ensure that they will not lag in the future.

The results outlined above highlight the importance of corporate governance for the non-listed real estate industry. The implementation of such not only constitutes business opportunities for individual fund managers, but also contributes to the overall stability of the non-listed real estate industry.

Section 1

Introduction

Introduction

The research objective of this study is to examine the current status and the influence of corporate governance on the volatility and returns of non-listed real estate funds, and seeks to address the following questions:

- How has corporate governance for the non-listed industry changed over the last twenty years?
- How does corporate governance affect fund performance, risk, volatility and capital raising ability?

The non-listed real estate industry has grown considerably over the last decade and with it the interests and needs of market participants. One important field of activity is corporate governance.

A reasonably concise definition of corporate governance is the system by which companies are directed and controlled, and how relationships between shareholders, stakeholders and the company are formed (European Commission, 2011). Companies typically interpret this as the promotion of corporate fairness, transparency and accountability.

For non-listed real estate investors, corporate governance is crucial for ensuring that they get a good return on their investments. This definition aptly recognises corporate governance as integral to their investment selection process.

When looking at corporate governance this study's approach is different to many other studies on the non-listed real estate industry, which to date have mainly focused on performance drivers and risk factors. With our approach we have sought to identify and reveal fund managers' opinions on corporate governance principles, providing in our view an interesting insight into governance practices and managers' views.

In section 2 of this study a brief overview is given of how corporate governance principles have evolved over the last two decades. This section also presents current literature relating to the importance of corporate governance in the non-listed real estate industry. Section 3 outlines the research approach and methodology and presents the survey carried out by INREV fund manager members, including survey design, sample description and methodology, as well as the objective of the interviews.

Section 4 discusses the results from section 3 in context with the implications from literature and elaborates on the influence of corporate governance, while highlighting and summarising key takeaways.

We conclude the paper in section 5 with recommendations and highlight future research questions that we have come across within this study.

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Section 2

Corporate governance and the European non-listed real estate industry

Corporate governance and the European non-listed real estate industry

Institutional background

When investing in a fund, investors are choosing to delegate real estate investment capacity to an external fund manager, selected for its investment ability and expertise. Therefore in these cases, most investment decisions and the running of a fund are usually taken by a fund manager, and investors often have limited control.

This separation of ownership from management can potentially lead to conflicts of interest between investors and fund managers which can be detrimental to fund performance. This source of agency problem is not specific to the real estate industry, but can also be found as a source of agency problems for other corporations (Laffont & Martimort, 2009).

In non-listed real estate funds the agency problem can rise from the fee structures being based on assets under management. On top of the base fee, some fund managers charge additional fees for transactional activities, such as acquisitions and disposals.

Another potential conflict that could arise in the non-listed real estate fund industry, and occurs in other industries, is a moral hazard problem. A moral hazard problem refers to the situation when one party deviates from the terms of the agreement and is usually acting at the expense of the other parties.

Corporate governance has been viewed as an effective monitoring device that is established to alleviate agency problems. It also refers to the set of mechanisms that helps to align the interest of fund managers with the interest of investors.

With a growing significance of the non-listed real estate industry, stronger corporate governance will help to increase the transparency of this industry, thereby providing consistency in corporate governance practices. Therefore corporate governance is one of the most important mechanisms to mitigate risk and help investors in their investment decisions, being:

- how much they invest
- the timing of the vehicle, or the mechanism for termination
- changes to the investment strategy and financing strategy
- asset acquisition or disposal outside the investment strategy of the vehicle
- changes to the legal structure of the vehicle
- changes affecting the liquidity mechanism
- the identity of the manager, the replacement/removal of the manager or the change of control of the management company
- how the manager is remunerated through its fee structure

Development of corporate governance codes in Europe

There has been continuous development of corporate governance principles over the past two decades (Table 1). Common law has influenced this development and in particular guidelines from the UK. Studies by Zattoni & Cuomo (2008) show, that common law countries have a leading role in implementing new standards and *"it is […] likely that the UK will become the 'norm leader' for further stewardship guidelines within Europe"* (Lütz, Eberle, & Lauter, 2011). Also there is *"a global convergence of standards among the traditionally divergent national corporate governance systems"* (Lütz, Eberle, & Lauter, 2011).

The development and changes were also mainly driven by policy requirements which have often been triggered by major economic crises or financial misconduct. For example, The Cadbury Report (1992), which can be seen as a milestone in the evolution of corporate governance codes in the past 25 years, arose from a number of major events including Black Monday in 1987 when stock markets around the world crashed and the collapse of Bank of Credit and Commerce International in 1991 due to the money laundering scandal.

A key criticism to fund managers generally has been that they are subject to either only modest regulation or no regulation at all (Dobrauz & Schnee, 2012). In fact, most corporate governance codes established prior to the global financial crisis remain voluntary. Though self-regulation allows the focus to be on the needs of a single company and provides flexibility to changes in market situation, it might not generate the same impact as mandatory regulation.

It is not until after the financial crisis between 2007 and 2009 that there has been much stronger demand and a push for more standardised regulation. The introduction of the Alternative Investment Fund Managers Directive (AIFMD) in 2011 led to a shift from optional corporate governance to mandatory law.

The AIFMD was enacted to create comparable standards all over Europe which was a welcome harmonisation for the markets. The AIFMD requires Alternative Investment Fund Managers (AIFMs) to establish a well-documented organisational structure that clearly assigns responsibilities, defines control mechanisms and ensures a good flow of information between all parties involved.

> 'There has been stronger demand for more standardised regulation after the financial crisis'

A number of organisational requirements and the set-up of control functions are specified in the Directive. The two core functions of an AIFM specified by the Directive are risk and portfolio management. In addition, the Directive covers other functions such as compliance, valuation and internal audit.

Literature review

A number of studies have shown that good corporate governance is an important element in terms of cost, performance and risk, by providing transparency and additional rules (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 2000; Cumming, Hou and Wu, 2014; Andreou, Louca and Panayides, 2014).

With good corporate governance, a firm would be able to set guidelines on how investments decisions are made that are disclosed to shareholders. These measures amongst others will create more transparency with regards to what sort of investment a firm makes and that should translate to lower fund performance volatility.

Besides lowering performance volatility, a firm would also be able to reduce corporate risks, primarily covering reputational and other indirect financial risk. This is because strong corporate governance makes businesses safer and less exposed to external or management risks.

> 'Introduction of AIFMD led to a shift from optional corporate governance to mandatory law'

Additionally, firms with weak corporate governance practices often face reputational risks and can be interpreted by investors as acting without transparency and accountability (Kirkpatrick, 2009).

Corporate governance is also shown to be an effective tool to improve transparency and mitigate investment risk. This should translate to good corporate governance boosting capital raising abilities.

Moreover, studies found that in addition to the quality of the legal system of the respective country, a good reputation as a consequence of good corporate governance will also help companies to raise funds easier and at better conditions (International Finance Corporation, 2014; Shleifer & Vishny, 1997; OECD, 2014; Klapper & Love, 2004).

Table 1: Development of corporate governance over the last 25 years

Year	Corporate governance code	Focus	Outcomes
1992	Cadbury Report	Board of Directors, Audit Committee, Remuneration Committee	1. Separation of CEO and Chairman 2. Board composition with a majority of outside directors 3. Remuneration committees for board members with majority of Non-Executive Directors 4. Audit committee should include at least three Non-Executive Directors
1995	Greenbury Report	Directors' remuneration	Executive director remuneration should be disclosed
1998	Hampel Report	Deal with criticisms of previous reports	Consolidation in a combined code
1998	UK Corporate Governance Code	Flexible principles	Flexible principles instead of static corporate governance rules
1999	Turnbull Report	Risk management	Director's obligation to review their companies' internal control and risk management systems
2003	The Higgs Report	Board of Directors, Board meeting, Shareholders active involvement	1. Non-Executive Directors should meet at least once a year 2. Independent senior director appointment as shareholders' contact person 3. Diversity in board members' background
2003	Smith Report	Audit Committee	Independence of Audit Committee members
2009	Walker Report	Risk Management, Shareholders active involvement	1. Non-Executive Directors should focus on risk management headed by a dedicated Chief Risk Officer 2. Shareholders must take their responsibility of active engagement 3. Remuneration committees should cover the remuneration of all authorising employees to ensure best alignment with long term risk
2011	EU Corporate Governance Framework	Board of Directors, Shareholders active involvement, Risk management	1. Board of Directors: separation of functions and duties, gender balance, remuneration policy 2. Shareholders: boost long term focus on investors and shareholder cooporations 3. Regulate the industry in terms of transparency and disclosure of risk 4. Monitoring of corporate governance: alternative solutions
2013	AIFMD	Alternative Investment Fund Manager	1. Well documented organisation structure 2. Clear assigned responsibilities 3. Defined control mechanisms 4. Good flow of information between all parties involved

Section 3

Research approach and methodology

Research approach and methodology

The research was conducted in two stages, by a survey and by interviews, in order to determine how corporate governance is applied in practice and to determine the hypotheses set out. The survey is based on the INREV corporate governance self-assessment tool and was sent to all fund manager companies that are members of INREV. This section hence includes the description of the survey, the survey design, the sample as well as the methodology of the survey.

Survey design

The survey consists of three parts: The description of the participants and company details (I), the influence of corporate governance (II) and corporate governance and the INREV self-assessment tool (III). Each part will be described in the following paragraphs.

I Description of participants and company details

This part contains the description of the participants to determine whether the sample is a fair representation of the population, as well as to aggregate different sub-groups for further analysis. It consists of questions concerning real estate assets under management (AUM), the region, the investment style, products, the investment segment and the clients. The analysis of this part is shown later in the report.

II Influence of corporate governance

With this part of the survey the attitude of the fund managers concerning influence of corporate governance has been examined with a 7-level Likert-scale (see Figure 1) on the following topics:

1. Volatility: It is a statistical measure of the dispersion of returns (standard deviation of performances).
2. Performance: Performance of non-listed real estate funds.
3. Risk (corporate risk): Refers to any risk (e.g. strategic, operational, reputational, etc.) a company faces, excluding performance risk.
4. Capital raising ability: Ability to raise the required amount of capital for the funds.

Figure 1: An example of four Likert-items with a 7-level Likert-scale

Please evaluate: The influence of ‘compliance with institutional terms’ on... is...

	Strongly positive	Positive	Moderately positive	No influence	Moderately negative	Negative	Strongly negative
Volatitlity	◯	◯	◯	◯	◯	◯	◯
Performance	◯	◯	◯	◯	◯	◯	◯
Risk	◯	◯	◯	◯	◯	◯	◯
Capital raising ability	◯	◯	◯	◯	◯	◯	◯

In order to avoid problems with interpretation of terms, Floyd (2014) recommends specifying definitions of potentially unclear terms. Therefore the influence has been defined as follows:

Volatility:

Positive influence means: A higher level of corporate governance leads to lower volatility. Negative influence means: A higher level of corporate governance leads to higher volatility.

Performance:

Positive influence means: A higher level of corporate governance leads to improved performance. Negative influence means: A higher level of corporate governance leads to lower levels of performance.

Risk (corporate risk):

Positive influence means: A higher level of corporate governance leads to lower risk. Negative influence means: A higher level of corporate governance leads to higher risk.

Capital raising ability:

Positive influence means: A higher level of corporate governance increases fund manager's ability to raise capital. Negative influence means: A higher level of corporate governance decreases the ability to raise capital.

The results of this part are shown in section 4.

III Corporate governance and the self-assessment tool

This part was created to check the actual status of the review of corporate governance, the importance of the different principles and the usability of the INREV corporate governance self-assessment tool. It consists of the following questions:

1. When are you planning your next major review of corporate governance (select the most appropriate)?
2. What has been the main trigger to review your corporate governance (multiple selections possible)?
3. Please rank the INREV Corporate Governance Principles.
4. Have you ever used the INREV corporate governance self-assessment tool?
5. Is the INREV corporate governance self-assessment tool useful for you?
6. Do you think the self-assessment's results give a complete picture of your company's corporate governance?

The results of this part can be found in section 4.

The INREV Corporate Governance Principles and Guidelines

Due to the limited studies on the corporate governance of non-listed real estate funds, this study uses the INREV corporate governance self-assessment tool as a proxy of a corporate governance framework to test the research hypotheses. This tool was introduced in 2007 by INREV and consists of seven principles as an integrated set of guidelines for the non-listed real estate industry. These principles are regularly reviewed and revised accordingly.

The explanation of each principle is set out as follows[1]:

Principle 1. Compliance with the law: The investment vehicle and its manager should always comply with the relevant legislation and regulations applicable in the jurisdiction in which it is established.

Principle 2. Compliance with constitutional terms: The vehicle's constitutional terms should clearly articulate the key corporate governance principles which should always be applied.

Principle 3. Skill, care, diligence and integrity: Investors, investor representatives, non-executive officers and managers should manage the protection of investors' interests

[1] For more details please go to: https://www.inrev.org/guidelines-tool/corporate-governance-self-assessmentquestionaire.php

and their investments, with due skill, care, diligence and integrity, and should ensure adequate levels of human, financial and operational resources.

Principle 4. Accountability: Managers, non-executive officers, investor representatives and investors, and those they have delegated to, should always be accountable for their actions.

Principle 5. Transparency: All relevant information relating to the vehicle should be communicated in a way which is clear, fair, complete, timely and not misleading.

Principle 6. Acting in investors' interests: including alignment of interests and conflicts of interest. Vehicles should be run in the interests of all investors. Where they arise, conflicts of interest should be managed fairly between investors, vehicles and managers; the alignment of interests between investors and managers can reduce the risk of such conflicts.

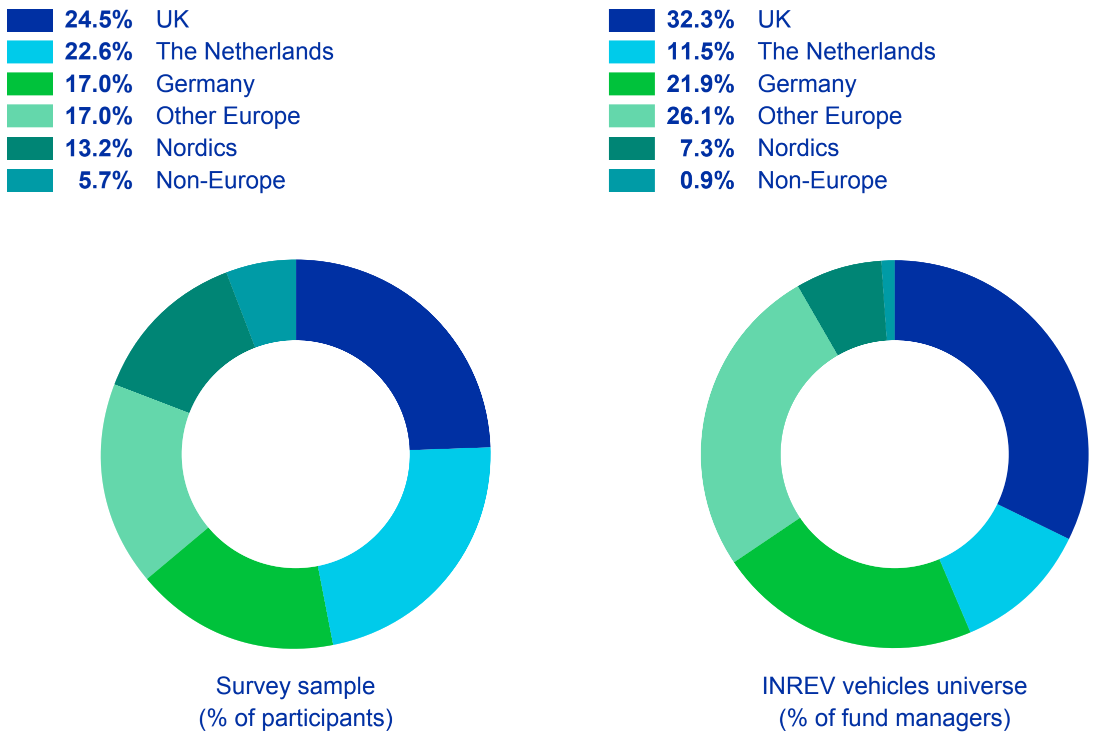
Principle 7. Confidentiality: Information regarding vehicles and investors' interests in vehicles which is not publicly available should always be treated confidentially.

The survey sample

The survey was sent to 222 fund manager members of INREV. In order to be able to draw conclusions from the sample, which are valid for the whole population of INREV fund managers, the sample and population need to have a similar characteristics. Therefore we subsequently compare some characteristics of our sample with data from the INREV vehicles database (INREV, 2015d), such as country of headquarter and investment style.

As 75 fund managers took part in the survey, the total response rate was 33.8%. 53 of them fully completed the survey representing a total of €511.5 billion total real estate AUM. The remaining 22 fund managers did not complete the survey fully. The distribution of the sample by country of headquarter is as follows (see Figure 2). The full list of participants and interviewees can be found in appendices 1 and 2 respectively.

Figure 2: Fund manager domicile: survey sample versus INREV vehicles universe



Note: The % is based on the number of fund managers

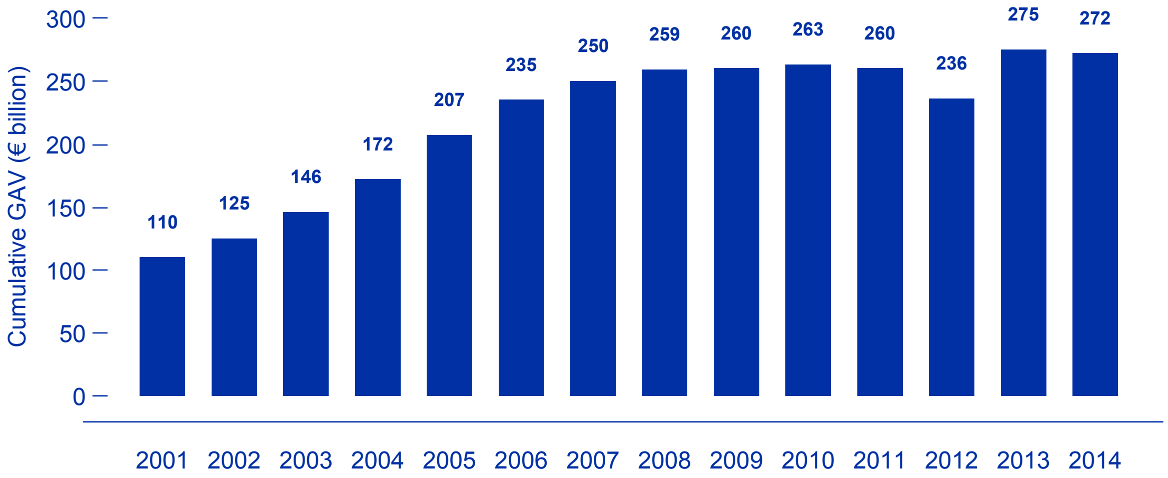
The UK (13 / 53 = 24.5%), the Netherlands (12 / 53 = 22.6%) and Germany (9 / 53 = 17.0%) have nearly the same fraction as in the population. Altogether 94.3% (50) of participants have their headquarters in Europe. With this result, the sample is quite similar with the population regarding the headquarters.

The total value of real estate AUM (listed and non-listed) of the respondents sum up to €511.5 billion. The INREV vehicles universe is a collective of non-listed real estate vehicles only, which cumulatively have a gross asset value (GAV) of €272 billion, therefore is not directly comparable with the survey results. As corporate governance usually is a company wide policy this is not considered to be a drawback. Hence the sample is representing the cumulative assets under management quite well.

The main investment style of the participants is core (€374 billion / €511 billion = 73.2%). The other fund managers investing style are opportunity and value add (€137 billion / €511 billion = 26.8%, see source: INREV, 2015d). This fits quite well with the data from the INREV vehicles universe (INREV, 2015d) as could be seen in source: INREV, 2015d.

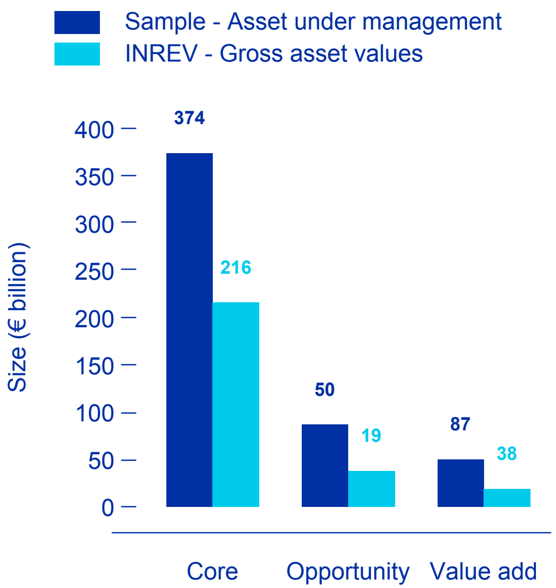
In summary it can be said that the sample is quite similar to the population regarding domicile, AUM and investment style. As a qualitative result it can be stated that the sample reflects the INREV fund manager population rather well.

Figure 3: Size of the European non-listed real estate industry



Source: INREV, 2015d

Figure 4: Investment style composition: survey sample versus INREV vehicles universe



Source: INREV, 2015d

Methodology

Working with small sample sizes can be a statistical challenge, because it is difficult to identify if the sample data is normally distributed. Normally distributed sample data is a requirement of many statistical analyses. According to Shier (2004a) it is required in such cases to apply a statistical test that does not require data to be normally distributed, such as a non-parametric test.

To analyse the 7-level Likert-items, the non-parametric sign-test has been used to check the null-hypotheses which are defined as follows:

H0.1: Fund manager expects that corporate governance will have no influence on volatility.

H0.2: Fund manager expects that corporate governance will have no influence on risk.

H0.3: Fund manager expects that corporate governance will have no influence on performance.

H0.4: Fund manager expect that corporate governance will have no influence on capital raising ability.

The objective in testing these null-hypotheses is to reject the null-hypotheses, which indicates that with a high level of statistical confidence the effect is confirmed. The null-hypotheses are also targeting the main research area for the survey, which is to find out whether principles of corporate governance are perceived to have a significant influence on volatility, performance, risk and capital raising ability.

The sign-test is used to test “the null hypothesis that the median of a distribution is equal to some value” (Shier, 2004a).

Furthermore, the Mann-Whitney U-test is applied to check whether there are significant differences between sub-groups of the participants (see appendix 3).

The data is analysed using non-parametric tests.

Section 4

Results and implications

Results and implications

Within the following sections the results and its implications will be demonstrated. First we will look at the influence of the corporate governance principles. Then we analyse several sub-groups to identify differences in the medians. The results are also analysed with focus on the INREV self-assessment tool. On this basis three takeaways are developed as a part of the conclusion to the study.

Influence of corporate governance

The second part of the survey has been created to examine the influence of corporate governance on volatility, risk, performance and capital raising ability. For the analysis semantic differentials have been used to present the results. The semantic differential has been invented by the psychologists Osgood, Suci & Tannenbaum (1957) to determine the attitude from someone to something.

In general corporate governance has a positive influence. But let us see the different effects in detail. In literature we found that the exchanges with shareholders, as well as remuneration structures create more transparency and therefore the average aberration from the expected development will be reduced.

Corporate governance and volatility

In order to review the opinion among INREV fund managers regarding corporate governance (volatility) hypothesis 0.1 is determined as follows:

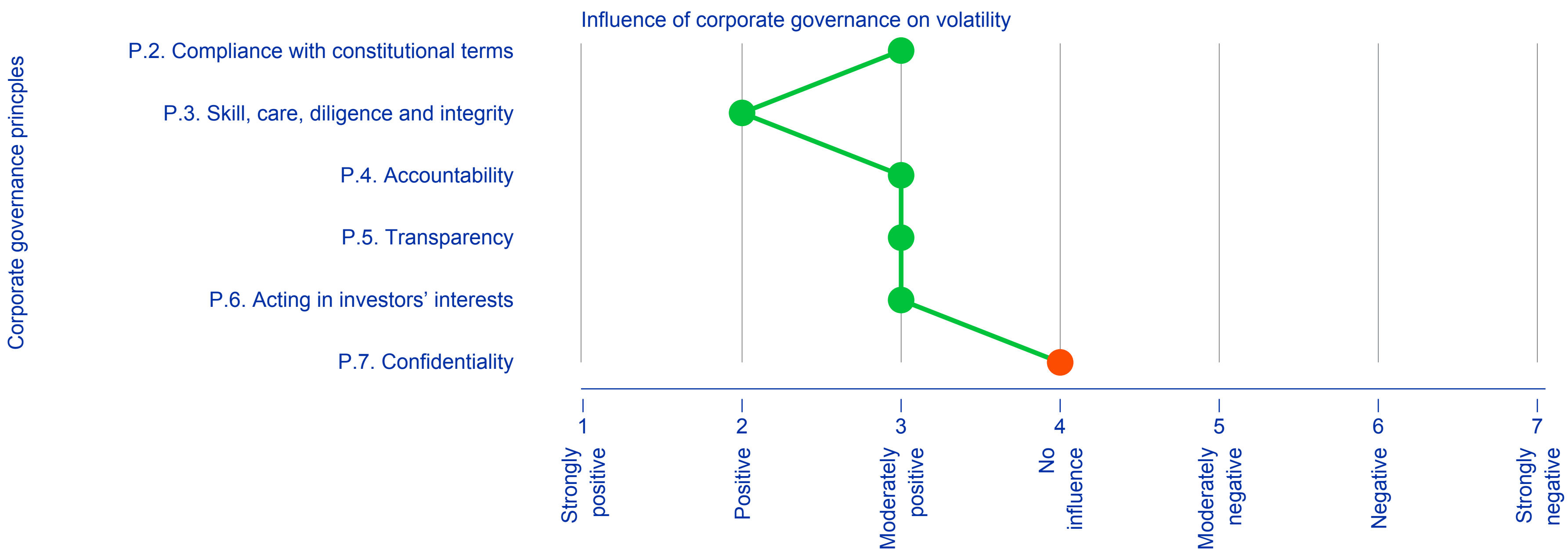
H0.1: Fund managers expect that corporate governance will have no influence on volatility.

The results are illustrated in Figure 5.

The null hypothesis could be rejected with a 95 % confidence for principle 2. compliance with constitutional terms to principle 6. acting in investors' interest. Hence the corporate governance principles 2 to 6 have a statistically significant (moderately) positive impact that reduces volatility according to the fund managers' opinion. With confidentiality (principle 7) the analysis could not confirm such influence on volatility. We do not have a final explanation for this from literature or the collected data, but it could be possible that confidentiality is not related to volatility.

Conclusion: Fund managers believe that good corporate governance can reduce volatility.

Figure 5: Impact of corporate governance on volatility by a semantic differential



Corporate governance and risk (any risk a company faces, excluding performance risk)

One important milestone in corporate governance history was the separation of power to impede deliberate misconduct. In addition an assessment of directors and dedicated risk management has been suggested. Our second research hypothesis regarding corporate governance (risk) hence is:

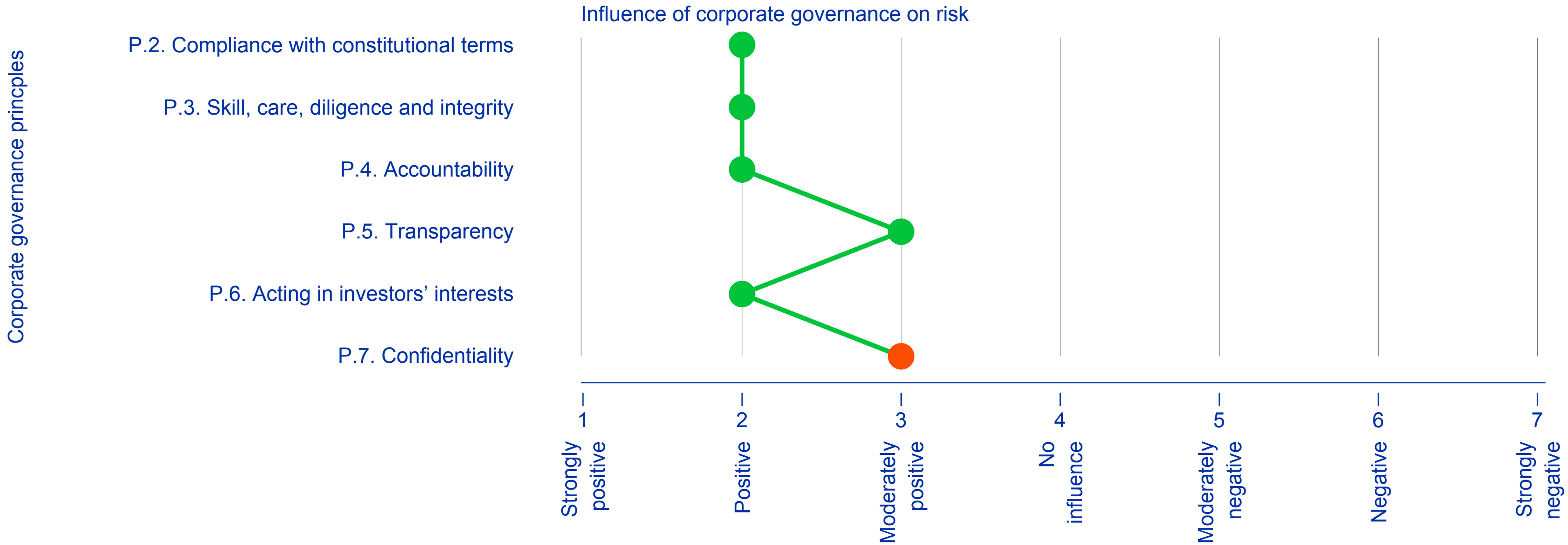
H0.2: Fund managers expect that corporate governance will have no influence on risk.

The results are illustrated in Figure 6.

The null hypothesis for risk could be rejected for all principles with a 95 % confidence. Hence all corporate governance principles have a statistically significant (moderately) positive impact to reduce risk according to the fund manager's point of view. This implies that corporate governance is considered to be an effective measure for good stewardship and therefore should be developed further with assiduity.

Conclusion: Fund managers believe that good corporate governance reduces risk.

Figure 6: Impact of corporate governance on risk by a semantic differential



Corporate governance and performance

Our literature review showed that several authors were able to verify a positive influence of corporate governance on performance and valuation. Therefore the third hypothesis regarding corporate governance (performance) is:

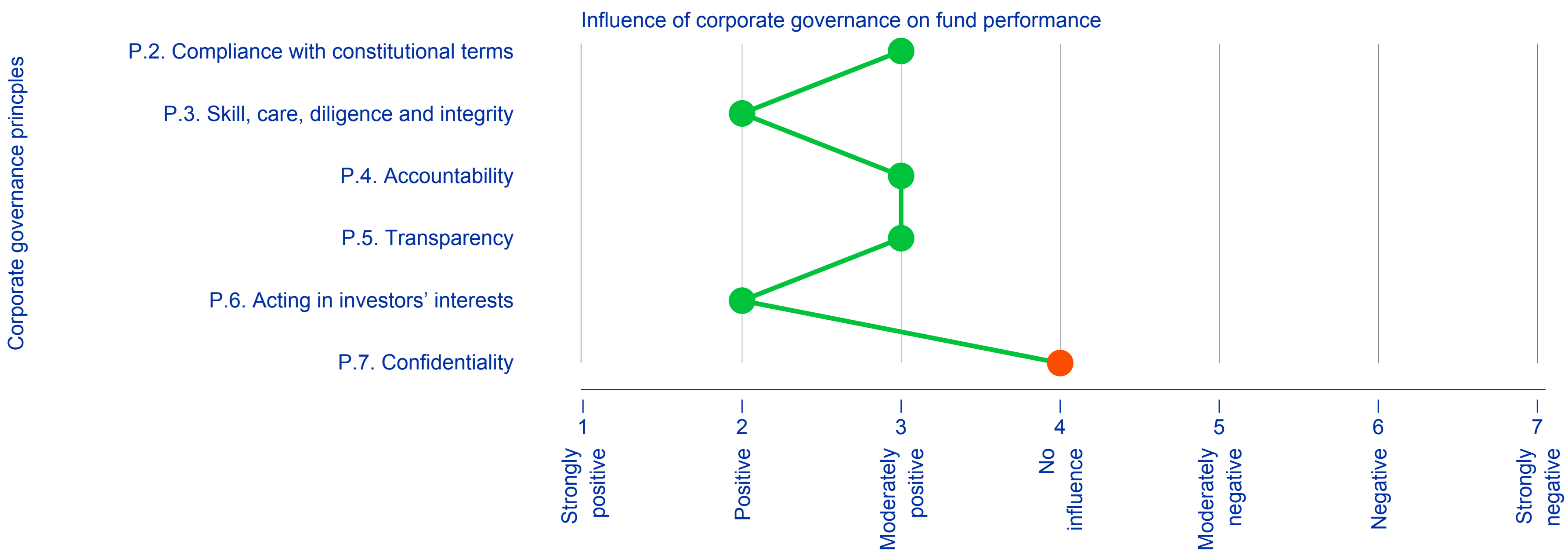
H0.3: Fund managers expect that corporate governance will have no influence on performance.

The results are illustrated in Figure 7.

Similar to volatility, the null hypothesis could be rejected for principles 2 (compliance with constitutional terms) to 6 (acting in investors' interest) with a 95 % confidence for performance. Hence the corporate governance principles 2 (compliance with constitutional terms) to 6 (acting in investors' interest) have a statistically significant (moderately) positive impact to increase performance according to the fund manager's opinion. Only confidentiality (principle 7) is not influencing performance. Again we do not have a final explanation for this from literature or the collected data, but it could be possible that confidentiality is not related to performance.

Conclusion: The overall results confirm that fund managers believe in a positive impact of good corporate governance on performance.

Figure 7: Impact of corporate governance on performance by a semantic differential



Corporate governance and capital raising ability

Literature implies that corporate governance might be an effective tool to improve transparency and mitigate investment risk. The fourth research hypothesis regarding corporate governance (capital raising ability) therefore is:

H0.4: Fund managers expect that corporate governance will have no influence on capital raising ability.

The results are illustrated in Figure 8.

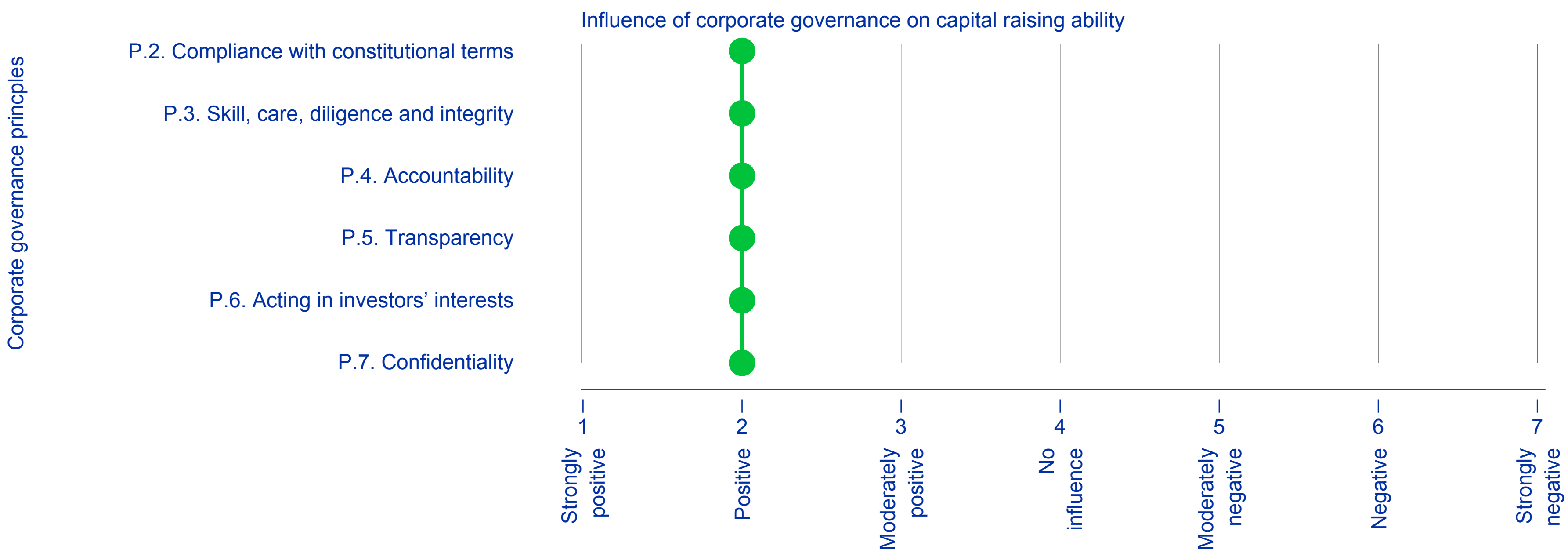
Similar to risk (any risk a company faces, excluding performance risk), the null hypothesis for capital raising ability could be rejected for all principles with a 95 % confidence. Hence all INREV corporate governance principles have a significant positive impact on increasing capital raising ability according to the fund manager's point of view.

One interviewee commented that better corporate governance is beginning to have an impact on capital raising ability for his company.

Conclusion: Fund managers believe that good corporate governance improves their capital raising ability.

Generally it can be stated that fund managers rated corporate governance to have a positive influence on volatility, performance, risk and capital raising ability. But it has to be kept in mind, that these are results from qualitative analysis. Therefore an exact interpretation of the results is rather difficult and could be addressed in future research.

Figure 8: Impact of corporate governance on capital raising ability by a semantic differential



Differences in sub-groups

To examine differences between sub-groups of the sample, a clustering has been done according to Table 2. These clusters (1 - 10) are explained as follows.

As corporate governance can differ between countries, the fund managers headquarter has been examined within subgroups for the three most represented countries Germany, United Kingdom and the Netherlands (cluster No. 1 - 3).

Size such as AUM could also be a reason for different attitudes of fund managers towards corporate governance. Therefore the two sub-groups “very big AUM (> € 10 billion) versus the rest” and “more than the mean (> € 3.45 billion)” have been created.

Finally “Real estate only”, “Europe only”, “core only” and “closed end funds only” have been examined by sub-groups (Cluster No. 7 - 10). These sub-groups have been chosen because there could be differences according to the product a fund manager looks after.

It can be stated that within all the sub-groups nearly no statistical differences in the medians could be found (see appendix 4). Based on these findings this infers that the opinions among fund managers within the sub-groups are very homogeneous concerning corporate governance and its influence on volatility, performance, risk and capital raising ability.

Table 2: Clustering into sub-groups

Cluster number	Sub-group 1 (p)	n=	Sub-group 2 (q)	n=
1	Germany HQ	9	Rest	44
2	UK HQ	13	Rest	40
3	The Netherlands HQ	12	Rest	41
4	Very big AUM (> € 10 billion)	14	Smaller AUM	39
5	Big AUM (> € 3,45 billion (Mean))	24	Smaller AUM	29
6	Real Estate only	44	More than real estate	9
7	Europe only	33	Europe and other countries	20
8	Core only	14	Core and other categories	39
9	Closed end funds only	20	Closed end and other funds	33

Corporate governance and the self-assessment tool

This part was created to check the actual status of corporate governance. The questions and results are described as follows.

1. *When are you planning your next major review of corporate governance (select the most appropriate)?*

Most of the respondents are currently reviewing (29.2 %) or planning a review of corporate governance within the next year (40.3 %, see Figure 9).

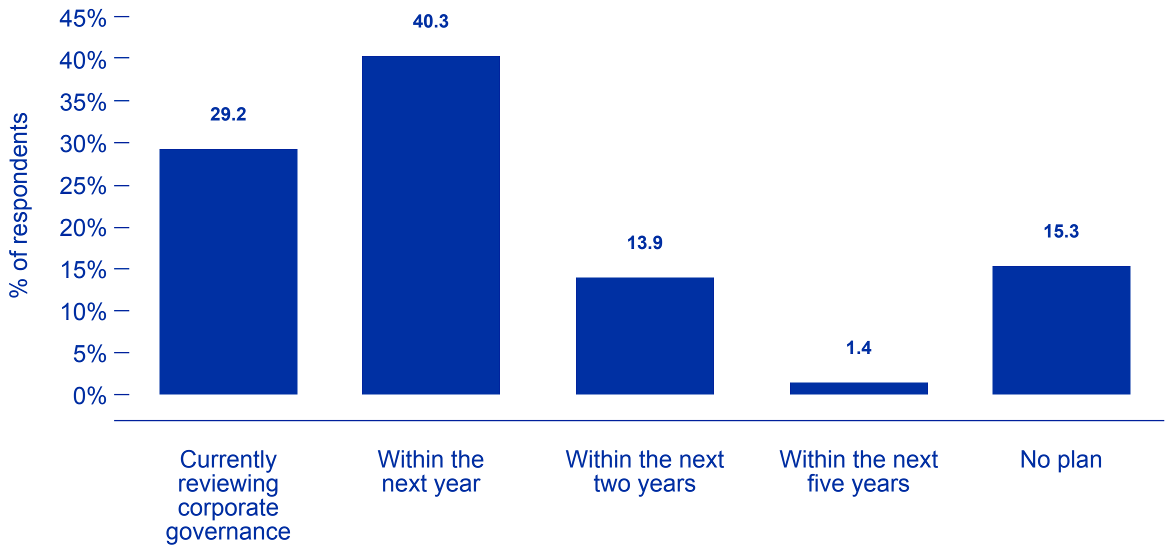
Another 13.9 % will review their corporate governance framework within two years and a minority of 1.4 % within the next five years. It is surprising that 15.3 % of the respondents have no plans to review their corporate governance within the next five years.

Dr Beyerle (Interview Beyerle, Catella, 2015) argued that in his opinion *“corporate governance has not yet reached the broad market of non-listed real estate. The big companies however have done their homework”*. He expects amendments for the smaller and medium-sized fund managers within the next two years.

This opinion matches pretty well with the result of nearly 70 % reviewing their corporate governance until the end of next year according to the survey.

Another interview partner stated (Interview Barris, Peakside Capital, 2015) that *“right now the situation is just like in 2005 to 2007. There is a huge rush of money into real estate combined with a reduced attention to corporate governance”*. But he also states that *“AIFMD forces people to deal with corporate governance”*.

Figure 9: Next major review of corporate governance



‘AIFMD forces people to deal with corporate governance’

2. *What has been the main trigger to review your corporate governance (multiple selections possible)?*

The main trigger to review corporate governance was the introduction of AIFMD (49 / 73 = 67.1 %). Mergers of companies (8 %), introduction of Solvency II (7 %), new management (12 %) and a new strategy (19 %) are playing a minor role.

In the free comment box some of the respondents (7 / 73 = 9.6%) further said, that corporate governance is annually or continuously reviewed in their company and accordingly there is no main trigger.

This result is not very surprising, as the key requirements of AIFMD partly match the corporate governance principles of INREV, e.g. transparency, conflict of interest & valuation (INREV, 2013).

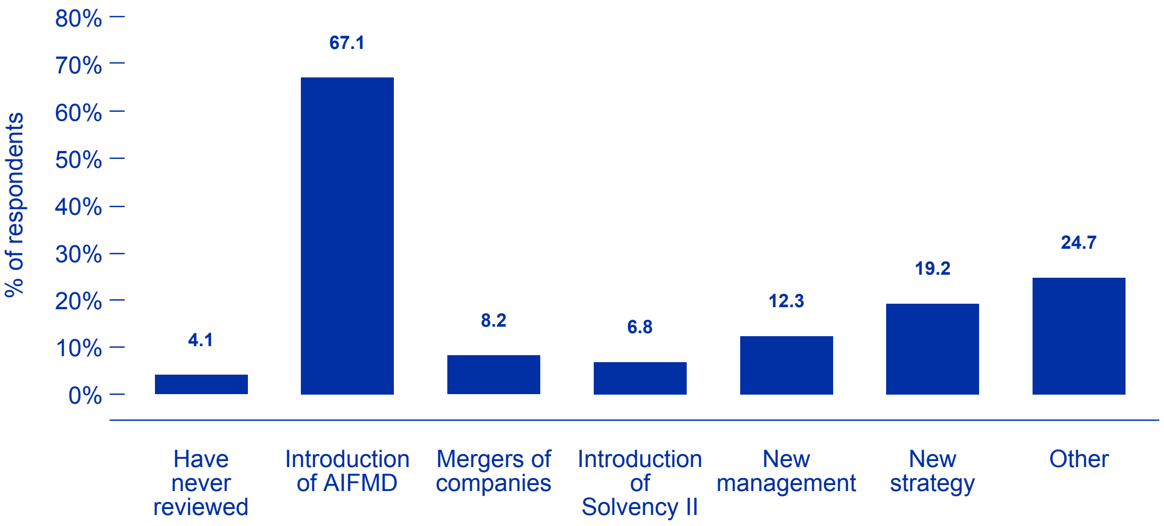
The influence of regulation on alternative investments is also confirmed by some interview partners. One of the interviewees said: *"What we are beginning to see is that some of those investors and consultants are changing their perspectives, because they have come to the view that these smaller managers just don't have the resources to provide the level of corporate governance quality and timely reporting of information etc. that they want and need. So it is beginning to have an impact on our capital raising ability"*.

AIFMD is expected to increase governance cost. "*This is especially a problem for smaller and medium funds (managers)*" (Interview Barris, Peakside Capital, 2015) and another interviewee said that AIFMD *"could lead to a consolidation within the non-listed real estate industry"*.

However a significant difference between bigger and smaller companies (limit: €10 billion AUM) could not be found within the sample. The selection of AIFMD as a main trigger within the survey is evenly distributed.

'AIFMD could lead to consolidation within the non-listed real estate industry'

Figure 10: Main trigger to review corporate governance

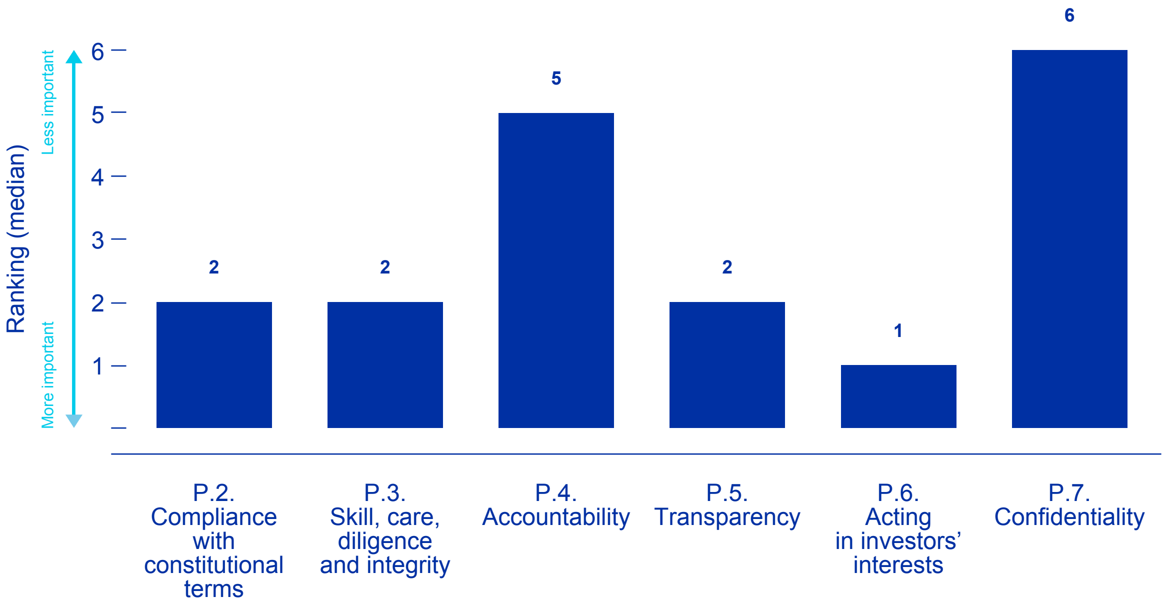


3. Please rank the INREV Corporate Governance Principles.

The fund managers have been asked about the importance of the different INREV corporate governance principles. It was expected that the principles are of equal importance. In fact, one participant wrote as a free comment *"Please note, these six issues are of equal importance and it is difficult to rank them from 1 to 6"*.

The most important criterion for the fund managers according to the survey is the principle 6. acting in investors' interest (rank 1), transparency (principle 5), skill/care/diligence and integrity (principle 3), as well as compliance (principle 2) are regarding the median of equal importance on rank 2. They are followed by accountability (principle 4) and confidentiality (principle 7) on rank 5 and 6.

Figure 11: Rankings of INREV corporate governance principles



4 - 6. *INREV corporate governance self-assessment tool.*

The INREV corporate governance self-assessment tool offers an instrument to benchmark one's corporate governance against industry best practices. The outcome helps to identify strengths and weaknesses in the framework to which investor reporting should be tailored.

Questions 4 to 6 of the questionnaire aim to check the utilisation and the usefulness of the corporate governance self-assessment tool. Only 26 respondents (34.7 %) had previously used the self-assessment tool.

As the evaluation of the tool makes sense only for respondents that used the tool, questions 5 and 6 focus on this sub-group (n = 26 or 34.7 %).

> 'The INREV self-assessment tool offers an instrument to benchmark one's corporate governance against industry best practices'

An amount of 23 respondents (23 / 26 = 88.5 %) found the tool to be useful.
18 respondents found that the tool gives a complete picture of their company's corporate governance. With this it can be stated that for participants, who have used the tool, it is useful and gives a complete picture of the company's corporate governance.

Buscemi (2014, p. 172) summarises that the use of this tool is a must in his opinion and agrees with this positive rating with other interview partners. Barris (Interview Barris, Peakside Capital, 2015) indicates that *"the tool might not be very well known in the industry and that INREV maybe should improve marketing of the tool"*.

The survey results imply that an increased usage of the tool could be expected within the next two years. According to Beyerle (Interview Beyerle, Catella, 2015) *"it is important that the correct person uses the tool, like CEOs, risk, or compliance officers, because corporate governance is a leadership topic"*.

> 'Corporate governance is a leadership topic'

The yearly INREV membership survey underlines this positive outcome with appraising the self-assessment tool as one of INREV's favourite products over the last years.

One of the respondents expressed in the comments that he would appreciate a short explanation of why a certain answer does not fall in a good category. Another one left the comment, that the tool is not applicable enough for real estate debt.

Key takeaways

- Corporate governance has a positive impact on volatility, performance, risk and capital raising ability
- Introduction of AIFMD is the main trigger for a corporate governance review
- The majority is reviewing their corporate governance within the next two years

The findings from literature, the survey analysis, as well as the interviews with industry experts delivered interesting aspects on the status and influence of corporate governance on volatility, performance, risk and capital raising ability. Based on these findings three takeaways are derived.

Takeaway 1: Corporate governance has a positive impact on volatility, performance, risk and capital raising ability.

Corporate governance has a positive impact on volatility, performance, risk and capital raising ability. Governance standards are improving and INREV's efforts in developing and improving corporate governance should be welcomed by fund managers. For their part managers should actively continue to improve their own standards of governance.

‘Governance standards will likely play an increasing role in determining successful fund managers’

Implementing higher levels of corporate governance principles should lead to positive effects for fund managers in the industry. As investors improve their ability to measure and integrate corporate governance risk and volatility into their investment decision-making process in a more systematic way, governance standards will likely play an increasing role in determining successful fund managers.

Smaller and medium-sized fund managers might be able to compete with their larger counterparts by tailoring their operating processes within the INREV corporate governance principles to meet investors' requirements. This will help to differentiate themselves from others in the market.

Takeaway 2: Introduction of AIFMD is the main trigger for a corporate governance review.

The introduction of AIFMD has been identified as one of the main triggers for a corporate governance review. The distinguished meaning of AIFMD was also confirmed by an interview partner, who said that corporate governance has become a hot topic in the market due to AIFMD. Rodrigues (interview Rodrigues, CMS Cameron McKenna, 2015) indicated *“the trend - resulting from the global financial crisis - of institutional investors seeking higher standards of corporate governance when committing into funds as well as regulators introducing legislation like AIFMD aimed at greater investor protection.”*

In literature the concern has been stated, that the introduction of AIFMD might considerably increase costs in the real estate market, which would especially menace the businesses of smaller and private funds and might lead to an undesirable consolidation of the market (van Pelt, 2015). It is further asserted, that the rise in cost could lead to a displacement of investments from real estate into other asset categories, as it might reduce performance.

Correspondingly not all fund managers are quite agreeable to AIFMD. Roger Barris (Interview Rodrigues, CMS Cameron McKenna, 2015) said, that from his point of view *“AIFMD is too bureaucratic. It would have been much better to keep corporate governance up to negotiation of private parties.”*

Other commentators are critical of the AIFMD operational costs, though Rodrigues (Interview Rodrigues, CMS Cameron McKenna, 2015) highlighted *“that such costs need to be balanced against the greater transparency, disclosure and other AIFMD benefits afforded to investors.”*

Especially for larger companies many elements of AIFMD will already be implemented in terms of corporate governance. So it should not have a massive effect on their corporate governance. One interviewee remarked *"AIFMD is much more impacting the way of doing business, for example by the introduction of passporting"*.

Takeaway 3: The majority is reviewing their corporate governance within the next two years.

Most of the participants are reviewing their corporate governance within the next two years. The INREV corporate governance self-assessment tool, which was revised in 2014, can provide the industry with a tool to support the review process.

The tool should be extended with a more specific tool guide and it should also be taken into consideration, if the tool can be extended to specific areas such as real estate debt.

The ones that are not planning to review their corporate governance should consider doing so as they might be left behind the market or the regulatory requirements otherwise.

Section 5

Conclusion

Conclusion

In the previous section implications have been developed from the findings of the survey. In this section we derive recommendations from these findings:

A. As many respondents will be reviewing their corporate governance within the next two years, fund managers should make sure that they have the necessary resources required to complete this work. On the one hand, this requires internal manpower, knowledge, and time. On the other hand, the fund managers will at the most need external support. This process should be started early.

B. Those fund managers not planning a corporate governance review should consider doing so, so that they will not lag the market in the future.

   In our survey results the self-assessment tool had been rated useful by most of its users. We previously highlighted the potential risk of rising costs resulting from new requirements from AIFMD. However, as AIFMD is mostly country specific, a platform could be created, where country specific information on AIFMD can be shared among market participants to help facilitate an exchange between them.

C. In terms of the expected market consolidation which was addressed in the interviews, smaller and medium-sized fund managers should re-evaluate their strategy and also examine, if mergers with other small or medium-sized fund managers could be an option to strengthen their market position by building strategic alliances. If so, potential merger partners should be identified in time. By finding equivalent partners, the small fund managers should be able to maintain large parts of their autonomy when merged.

D. Implementing higher levels of corporate governance should lead to positive effects for fund manager companies in the industry. The success formula lies within the balance of standardised regulation and tailored guidelines for the individual needs of each fund manager.

   Smaller and medium-sized fund managers might be able to tailor their operating processes within the INREV corporate governance principles to meet investors' requirements. This will help them to differentiate themselves from others in the market.

'Higher levels of corporate governance should lead to positive effects for fund managers'

Section 6

Future research

Future research

This paper also came across new research questions, which could not be answered within the scope of the study. However these questions could be a valuable impulse for future research.

A. One interesting finding from theory and our study results was that there is a positive impact of good corporate governance on performance, risk, volatility and capital raising ability according to fund manager's point of view. At the same time our results also show that regulation is expected to have a negative effect on performance and cost. As we have learned, regulation such as AIFMD contains many elements of good corporate governance. It might be interesting to explore, how these rather conflictive statements collude.

B. In addition to the fund manager's point of view it would be interesting to examine what investors think about corporate governance and its specific influence.

C. The statistical analysis could not confirm an influence of confidentiality on risk or volatility. Based on the collected data, as well as the literature and interviews at hand, it was not possible to deliver a conclusive explanation. Therefore it is up to future research to further investigate market participants understanding of confidentiality.

D. Literature and several of our interview partners highlight, that 'one-size-fits-all' corporate governance provisions might lead to inefficient businesses in characteristic industries such as the real estate industry.

   However with AIFMD taking effect just recently it is unlikely that this trend will turn anytime soon. Therefore it might be profitable to research approaches and identify best practices, by which funds are still able to tailor their operating processes within the INREV corporate governance principles and accommodate industry characteristics.

   Furthermore it would be informative to investigate, how corporate governance is applied in the various sectors of the finance industry, what best practices have been established in these sectors, whether they have had a positive/negative effect and how they vary from best practice in the real estate industry.

E. Our survey could not identify significant differences in the opinion of the various sub-groups (see section 4). This finding was rather surprising, as we expected some variation regarding country, size, preferred investment style and focus of the fund manager company. Future research should further investigate this with a bigger sample size.

'It would be interesting to examine what investors think about corporate governance and its specific influence'

Appendix 1

List of participants

List of participants

The following list of fund managers participated in the survey and gave permission for their company names to be published:

AltaFund
Altera Vastgoed N.V.
Amstar Global Partners, Ltd
Amvest
Apollo Zorgvastgoed BV
AREIM AB
Art-Invest Real Estate Funds GmbH
ASR Real Estate Investment Management
BNP Paribas REIM
Bouwfonds Investment Management
Bouwinvest REIM
CAERUS Debt Investments AG
Catalyst Capital LLP
CBRE Global Investors
Clarion Partners
Composition Capital Partners
Cornerstone Real Estate Advisers
Corpus Sireo Investment Management Sarl
Credit Suisse
Deutsche Asset & Wealth Management
Diener Syz Real Estate
DNB Real Estate Investment Management
Eurindustrial N.V.
Europa Capital LLP
Fabrica Immobiliare SGR
Frogmore
Genesta
Goodman
Grainger plc
Grosvenor Fund Management
HAHN Fonds Management GmbH
Hannover Leasing Investment GmbH
Harbert Management Corporation
Heitman LLC
Hunter Real Estate Investment Managers Limited
Invesco Real Estate Europe
Jamestown US - Immobilien GmbH
KGAL GmbH & Co. KG
Kristensen Properties
M&G Real Estate
Niam AB
Nordic Real Estate Partners
Northern Horizon Capital A/S
PATRIZIA Immobilien AG
Peakside Capital
Prologis
Revcap
Rockspring
Sonae Sierra SGPS
Standard Life Investments Limited
Union Investment
USAA Real Estate Company
Vesteda Investment Management BV

Appendix 2

List of interviewees

List of interviewees

The following people participated in the study and gave permission for their names to be published:

Appendix 2: List of interviewees

Name	Position	Company
Dominic von Felten	Head of Business Development	UBS
Doris Pittlinger	Managing Director	Invesco Real Estate
Dr. Thomas Beyerle	Managing Director	Catella Property Valuation GmbH
Melville Rodrigues	Partner	CMS Cameron McKenna LLP
Roger Barris	Founding Partner	Peakside Capital
Ulrich Kaluscha	Managing Director	4iP

Appendix 3

Statistical tests

Statistical tests

The sign-test

The sign test is used to test "the null hypothesis that the median of a distribution is equal to some value" (Shier, 2004a).

According to Whitley & Ball (2002) the sign test assigns an either positive or negative sign to each data value, depending on whether the value is above or below an assumed expected value. Data values being identical to the expected value are dropped from the sample. The sign-test then evaluates, if the sample data is substantially different from contingency by calculating an exact P-value that is based on a binominal distribution.

Appendix 3.1 shows the required steps for the sign test (Whitley & Ball, 2002).

Appendix 3.1: Steps required in performing the sign-test

Step	Detail
1	Define the null hypothesis and a certain value for comparison
2	Allocate a sign (+ or -) to each observation according to whether it is greater or smaller than the hypothesized value. (Observations exactly equal to the hypothesised value are dropped from the analysis)
3	Determine: N+ = the number of observations greater than the certain value N- = the number of observations less than the hypothesized value S = the smaller of N+ and N-
4	Calculate an appropriate P-value

The Mann-Whitney U-test

The Mann-Whitney U-test (Mann & Whitney, 1947) is “used to test the null hypothesis that two samples come from the same population (i.e. have the same median) or, alternatively, whether observations in one sample tend to be larger than observations in the other” (Shier, 2004b).

The test statistic is “defined as

$$U = n_1 n_2 + \frac{n_2(n_2+1)}{2} - \sum_{i=n_1+1}^{n_2} R_i$$

where samples of size n1 and n2 are pooled and Ri are the ranks” (Statsdirect, 2015).

The assumptions of the Mann-Whitney test are random samples from populations, independence within samples and mutual independence between samples and that the measurement scale is at least ordinal (Statsdirect, 2015). Appendix 3.2 shows the required steps for the Mann-Whitney U-test (Whitley & Ball, 2002).

Appendix 3.2: Steps required in performing the sign-test

Step	Detail
1	Rank all observations in increasing order of magnitude, ignoring which group they come from. If two observations have the same magnitude, regardless of group, then they are given an average ranking
2	Add up the ranks in the smaller of the two groups (S). If the two groups are of equal size then either one can be chosen
3	Calculate an appropriate P-value

Appendix 4

Significant differences between sub-groups

Significant differences between sub-groups

Appendix 4: Significant differences between sub-groups

Cluster number	Principle	Item	Mann-Whitney-U	Median of influence		
				All	Sub-group 1	Sub-group 2
1	P.2.	Performance	Significant	**3**	**4**	**3**
1	P.6.	Performance	Significant	2	3	2
1	P.7.	Risk	Significant	**3**	**4**	**3**
2	P.4.	Volatility	Significant	3	2	3
2	P.4.	Performance	Significant	3	2	3
2	P.6.	Risk	Significant	2	1	2
3	P.2.	Risk	Significant	2	2,5	2
3	P.6.	Risk	Significant	2	2,5	2
3	P.6.	Capital raising	Significant	2	2	1
4	P.3.	Performance	Significant	2	3	2
4	P.4.	Performance	Significant	3	3	2
4	P.5.	Capital raising	Significant	2	2	1
4	P.6.	Capital raising	Significant	2	2	1
5	No differences in median					
6	No differences in median					
7	P.4.	Volatility	Significant	3	3	2
7	P.5.	Risk	Significant	**3**	**3**	**4**
7	P.7.	Performance	Not significant	**4**	**3**	**4**
8	No differences in median					
9	P.5.	Risk	Significant	3	2	3
10	P.7.	Capital raising	Significant	2	2	3

Appendix 5

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