

**opc**

**Liquidity and private property  
vehicles: where next?**



**The University of Reading and Oxford Property  
Consultants**

**October 2001**

**A Report for Invesco Real Estate Advisers,  
Grosvenor and the Investment Property Forum  
Educational Trust**



**GROSVENOR**





With thanks to Arthur Andersen, who provided advice on tax and accounting issues.

Any errors or omissions remain the authors' responsibility, but no liability is accepted for any decisions made using information found in this report. There is no substitute for professional advice.

# Liquidity and private property vehicles: where next?

## Research Results

### Contents

#### Preface

#### Summary

#### **Part 1: Introduction** **Page 1**

- 1.1 Background
- 1.2 Vehicles
  - 1.2.1 Limited partnerships
  - 1.2.2 Property Unit Trusts
  - 1.2.3 Managed funds
  - 1.2.4 Other vehicles
- 1.3 Players
  - 1.3.1 Fund managers
  - 1.3.2 Property companies
  - 1.3.3 Property consultants
  - 1.3.4 Capital sources
- 1.4 The research
  - 1.4.1 Method
  - 1.4.2 The report

#### **Part 2: The PPV market, size and growth** **Page 9**

- 2.1 Limited Partnerships
- 2.2 Property Unit Trusts
- 2.3 Managed Funds
- 2.4 Property Investment Trusts
- 2.5 Privatised property companies
- 2.6 Sub-sector sizes

#### **Part 3: General** **Page 14**

- 3.1 What interest do you have in private property vehicles?
- 3.2 Do you think there is a 'natural' investor for the current vehicles – who, and why?
- 3.3 What attributes would you see as crucially important in limited partnerships and other private property vehicles? Can you rank the main advantages/crucial attributes of the current vehicles?

- 3.4 What are the key reasons why this market has grown so rapidly in recent years? What are the key drivers?
- 3.5 What will drive the future growth of this market?
- 3.6 Can you rank the main disadvantages of the current investment vehicles available?
- 3.7 What are your main concerns regarding private property vehicles?

#### **Part 4: Details**

**Page 25**

- 4.1 Do you generally prefer LPs, PUTs (on- or off-shore) or other structures?
- 4.2 Are fee levels too high? Are performance fees standard and how do they work?
- 4.3 Does the fund manager always co-invest?
- 4.4 Is gearing preferable? Essential? At what level?
- 4.5 Are these vehicles tax-efficient? How does the tax efficiency of private property assets, shares in pooled vehicles (PUTs, LPs) and shares in quoted companies compare?
- 4.6 At what rate does stamp duty apply on transfer? How will increasing stamp duty costs impact the liquidity of the market?
- 4.7 UK institutions appear willing to invest in UK vehicles investing in UK property assets. However, they seem more reluctant to invest in pan-European private property vehicles. Why is this?
- 4.8 How is the life of a LP normally extended?
- 4.9 Will limited liability partnerships make a difference?
- 4.10 What is current practice in performance and management reporting from operators? Is there much difference between different operators? What would be the ideal level of reporting?

#### **Part 5: Liquidity**

**Page 43**

- 5.1 How does the primary market work – how is capital raised?
- 5.2 How many investors are preferable in a LP?
- 5.3 Are LP pre-emption rights typical? Are they desirable?
- 5.4 Are LPs strictly limited life products?
- 5.5 Are shares in these products liquid compared to direct property investments and shares in quoted companies?
- 5.6 Do you believe that improved liquidity would be desirable? If so, how might such liquidity be introduced? Is there a secondary market? Is there demand for a more active secondary market in property funds?

- 5.7 Do you see benefits in having a standardised structure and process for limited partnerships and other private property vehicles and what would these be?
- 5.8 How much will investors value transparency in property information, and what information will they value most?
- 5.9 What other information will investors need to encourage participation?
- 5.10 What is the value of an LP/PPV share? How should a share in an LP be valued?

<b>Appendix 1: Interviewees</b>	<b>Page 58</b>
<b>Appendix 2: Typical LP and PUT structures</b>	<b>Page 60</b>
<b>Appendix 3: References</b>	<b>Page 62</b>
<b>Appendix 4: Investment vehicles: summary of taxation treatment</b>	<b>Page 63</b>

## **Preface**

Despite a clear need for more information there is little available UK research describing the views of investors, managers and advisors concerning the market for private property vehicles, including limited partnerships, property unit trusts and other unquoted collective investment schemes.

This is the first major study of its type. Commissioned and funded by Grosvenor, Invesco Real Estate Advisers and the Investment Property Forum Educational Trust, the research was undertaken by the University of Reading and Oxford Property Consultants between January and October 2001.

Assistance was received from 48 interviewees, whose contribution is much appreciated, and from Arthur Andersen, whose contribution has greatly improved the quality of much of the technical information include in this report. Any comments made do not cover the full range of tax consequences of investing in private property vehicles, but are intended to provide an indication of some of the main tax considerations.

For further information, please contact Andrew Baum at the University of Reading (0118 987 5123) or Jane Fear at Oxford Property Consultants (0118 958 5848).

## Summary

### Market size

Indirect property investment vehicles have greatly increased in popularity in recent years. The UK private property vehicle market has seen rapid growth to reach a market capitalisation of £23 billion in 2001. Limited partnerships alone have grown over the period 1996 to 2001 from just over £1 billion gross assets to over £13 billion. There is over £3 billion of capital in the top 10 limited partnerships and over £4 billion in the top 10 unauthorised PUTs.

As a comparison, a total of £35 billion was invested by UK private equity firms between 1984 and 1999.

There are now around 100 LPs that can be described as collective investment schemes. Many more LPs are not collective investment schemes as such but convenient ways of sharing property ownership (joint ventures).

PUTs are worth just over £9 billion, approx 5% of the direct institutional market. The unauthorised property unit trust market contains 40 trusts. Roughly 75% are based onshore in the UK, with the remaining ten being offshore trusts. The onshore-based UPUT market has a current market capitalisation of £6.8 billion, in comparison to the offshore market, which is less than one third the size at £2.1 billion.

Insurance managed funds are worth in excess of £3 billion.

### Favoured attributes of LPs

Specialist and expert management and access to large or rarely available stock are clearly seen as the key attributes for a successful LP. Transparency of information and an easily apparent alignment of interest, tax transparency and access to gearing were also commonly quoted. Many participants in this market clearly feel that the LP format can be an excellent means of structuring co-mingled property investment with appropriate separation of (and remuneration for) the roles of the parties involved.

### What has driven PPV growth?

Specialist management (and the perceived out-performance that goes with specialisation) was seen as the key driver of growth in the PPV market. Fee-push factors were also seen as dominant, alongside industry consolidation and tax efficiency and transparency. There was a divided view about likely future growth: evidence suggests the market may have peaked and attained saturation; others believe this is the beginning of a transformation of the market to vehicle format. Our research suggests some room for further PPV growth.

### Disadvantages

The concern which united participants was the lack of liquidity and the issues this may cause in a market downturn. Advisors worried about the aptitude of certain managers to be in the business; investors worried about retaining the motivation of the individual managers they liked; and managers worried about a lack of understanding and information, which limits the size of the investor market.

## PUTs v LPs

The LP is the vehicle of fashion; PUTs have suffered some bad publicity and performance as a result of their open-ended nature and high redemption rates in a poor market in the early 1990s. But PUTs offer many of the advantages that LP operators and investors are seeking from the LP format, and it may be that the PUT offers a more appropriate vehicle for the long term fund.

## Fees

Most managers felt that fee levels are too low for both LPs and PUTs, while the great majority of investors thought, without qualification, that fees were too high. Advisors thought that this was a complex issue, with a trade-off between running fees and performance fees, and an investor group which, while sensitive to fees, is able to judge value for money. Some (perhaps understandably) make the point that the work required is enormous.

Performance fees are standard, charged on both valuation and realisation bases. The market has not yet developed to the point where fee structures for long life and short life funds are clearly differentiated.

## Co-investment

Co-investment is standard, but likely to become less important. Some successful specialists have very small equity commitments and increasingly 'pure' fund management may sit alongside 'pure' co-investment as alternative attractive models for LP investment.

## Gearing

Gearing is not seen as essential, but is attractive to most LP participants to enhance returns above basic market returns, with 50% a typical level. Gearing may also be justified for operational management and to provide working capital.

## Tax efficiency and transparency

The majority of those questioned regarded all private property vehicles as tax efficient, although some preferred the term tax transparent, with PPVs having a clear advantage over property company shares (which are not tax transparent). Some suggested that for tax-exempt pension funds in particular this factor was over-rated.

There was very limited knowledge concerning the relative tax efficiency of the LP and offshore PUT vehicle. A small number of investors had formed the view that offshore PUTS offer equivalent tax transparency to LPs, but the offshore PUT has not been promoted to the same extent as LPs. There is a perceived potential to change the tax treatment of offshore PUTs, which renders their investors somewhat more vulnerable than LP investors.

For some, LPs are seen as 'properly' tax-transparent while off-shore PUTs are 'effectively' tax-transparent. The tax treatment of a PUT differs between exempt, non-exempt and offshore PUTs.

Two tax differences were commonly mentioned. First, there is a deemed disposal for all existing partners every time a new partner comes into an LP. This can be especially problematic for UK Life Funds.

Second, there may be an annual tax charge based on the net increase/decrease in the value of the assets held in the year spread over 7 years for life funds in an offshore vehicle (including offshore PUTs). This creates an acceleration rather than an increase of tax, and this is not regarded as much of an issue unless the fund increases in value over a period and then plummets. In this case investors will have to pay tax on unrealised gains. However, the tax rates on life companies are reasonably low, and this provision may be beneficial in some circumstances.

### Stamp duty

The interviewees were hung over the importance of stamp duty in explaining the growth in LPs and the extent to which the vehicle can help to avoid this tax. Many of those questioned felt that it was obvious that stamp duty has increased the appeal of LPs, and that continued increase in stamp duty would further strengthen the popularity of the vehicle.

Equally, many felt that this is a red herring: most investors, however, accepted that stamp duty has focused attention on the PPV, either due to perceived stamp duty effectiveness or to actual stamp duty savings.

### UK v overseas property

The overwhelming opinion was that the relative popularity to date of UK property is not to do with structures: it is to do with the lack of interest shown to date by UK investors in overseas property. This appears set to change.

### LP life extension

There was widespread agreement about LP extension provisions. There is usually a mechanism to extend the life of a vehicle for 1 or 2 years post the stated termination date, the vote often being taken two years before expiry. This will be by unanimous vote or, more commonly, by majority (usually 75%, with a range of 66% to 85%) agreement. There will be provision for the minority to be bought out by the majority in these cases.

### Will limited liability partnerships make a difference?

During the course of this research the government indicated that limited liability partnerships would not be tax effective for exempt funds. Hence the interviewees were unanimous in their view that LLPs are of no interest as alternative structures.

### Performance reporting

There is widespread confusion regarding the way in which PPVs are and should be measured for performance purposes. IPD currently measures the performance of a share in an LP as if it were a single property investment, making no distinction between a long life collective investment scheme and a two-owner joint venture. The growing importance of AIMR's GIPS (Global Investment Performance Standards) initiative will clearly begin to directly affect PPVs.

### Capital raising

Where small numbers of parties join together in a joint venture, there will be no need to raise capital, and a private agreement is reached to share ownership of an existing or target building. This partnership may be put together principal to principal, or through an agent operating quietly 'off-market'. Where external capital is to be raised by the originator

of the concept, two models exist: either the originator will raise capital by producing a concept memo, arranging and delivering pre-marketing presentations to 'warm contacts', and then producing an information memorandum verified by lawyers that may be distributed more widely. Alternatively, external capital raisers (usually agents) will be appointed.

### Number of investors

There is no ideal number, but the market is beginning to see the fundamental difference between a limited life JV or club investment (3-5) and a true collective investment scheme (as many as possible).

### Pre-emption

On balance, pre-emption rights have become unpopular with the majority of players as evidence shows that secondary market interest and pricing may be inhibited. The distinction between the JV or club and the true co-mingled product is again relevant: joint venture type LPs need pre-emption rights; 'fund' type LPs do not.

### Life

The view of the majority was a preference for LPs to be long life products. While many are sceptical, managers in particular would like to see acceptance of the LP as a long life product.

### Liquidity

Advisors, investors and managers all agree that presently PPVs (especially LPs) are less liquid than buildings. There is no established secondary market for LP shares, with 10 or so trades so far recorded; investors feel the need to undertake double due diligence, examining both manager/vehicle issues as well as property issues; and pre-emption rights, still prevalent, inhibit the willingness of new investors to expend time and money in pursuing shares in LPs which are likely to be bought by existing partners. In addition, fee levels can be slightly higher on the sale of an LP share than when selling buildings.

Possibly the subject of greatest interest in the PPV market is the potential for secondary market trading of LPs and other private property vehicles. To date, there appear to have been few secondary market deals, with 5 regularly discussed (UK Prime, Whitgift, Cheshire Oaks, MWB and Lend Lease Retail Partnership) and a possible total of 10-15 trades. There is an enormous demand for more liquidity, but scepticism as to whether this is achievable.

### Standardisation

While many LPs are specialist vehicles, so that standardisation cannot be expected, long and idiosyncratic documentation can inhibit liquidity. Participants see potential benefits in standard LP structures.

### Transparency

Most managers were very clear that the market would benefit from the making public of more information. The market needs to be expanded, and liquidity would be enhanced by the making public of more information about the available vehicles. Some expressed reservations about the need to make private data available.

## Valuation

Valuation of LP shares is an increasingly large issue. Nobody appears to be valuing shares in LPs *qua* shares; valuations are typically of gross property asset value divided by the percentage share owned. Few appear to be comfortable with this, and at the same time there is little agreement regarding potential premiums and discounts. Recent concerns over valuations for performance measurement was directly relevant to PUTs and could easily spill over to the LP market, where a lack of valuation transparency will damage liquidity. Hence others believe that a wholly different, transparent and cash flow-based valuation process will inevitably develop for LPs, and thereby challenge the traditional valuation basis for the property market in general.

## **Part 1: Introduction**

### **1.1 Background**

In 2000, property was easily the best performing mainstream institutional asset class and net institutional investment in property attained record levels. Office of National Statistics (ONS) figures revealed that insurance companies and pension funds increased their exposure to commercial property by nearly £2.4bn in the third quarter of the year, surpassing any other quarter. Pension funds were the largest investors in property in 2000, first year since 1994 in which property out-performed gilts and equities, supporting the long term place of property in diversified investment portfolios.

While many larger investors choose to invest by assembling portfolios of buildings (segregated portfolios) or by appointing managers to do the same (separate accounts), smaller investors may choose indirect investment in property through the purchase of property shares or by participating in pooled property vehicles.

Investing in property shares has tended to deliver performance which is linked to the performance of the stock market and fails to provide the diversification advantages of property. Recent work by ABN-Amro also suggests that returns have been very similar as for direct property investment, but for much greater risk. Hence this means of investing in property has become less popular in recent years.

Attention has focussed instead on private property vehicles (PPVs), especially limited partnerships (LPs) and to a lesser extent property unit trusts (PUTs), private corporate vehicles and offshore corporate structures. The management of PPVs is shared between property consultants/chartered surveying practices, fund managers and property companies.

Estimates suggest that this market has recently dominated the market: as much as 50% of all trading in 1999 and 2000 is said to have been PPV-related.

### **1.2 Vehicles**

#### 1.2.1 Limited Partnerships

Conceived by the Limited Partnership Act of 1907, this vehicle has been in common usage in other investment markets and industries, but has only been regularly heard of in the UK property market since the 1990s. The limited partnership enables a pool of investors to invest together in one or more assets. The number of partners is limited to twenty, (although it is possible to side-step this limit by having successive layers of partnerships), and while at least one, the general partner, must have unlimited liability the other partners may be limited. The investment is, therefore, passive and, importantly, the investment vehicle itself is tax transparent.

It is common practice that limited partnerships have a predetermined lifespan, usually varying between six and ten years. There is a statement of intent, when the partnerships are established, that at the end of the period the partnership will be wound up and the assets disposed of, although this need not be the case if the partners vote to extend the vehicle life.

LPs can be complex in their management structures, but a simplified description of a typical structure is as follows. A general partner (GP) will usually be created by the

originator of the concept and/or will act as lead investor. The GP may be a special purpose company owned by more than one lead investor, and will have unlimited liability in respect of the partnership. The GP will usually appoint an operator, required by the Financial Services Act (FSA) of 1986 to be an FSA regulated body, which will be responsible for a defined set of administrative functions.

In establishing the pool of capital required, the GP may appoint a promoter to raise capital from LPs; in some cases, the promoter may be the originator of the concept and seek a GP to act as lead investor.

Limited partners will contribute capital and may form an advisory board, but cannot be seen to be making decisions without losing their limited liability status. In rare examples, LPs may contribute non-executives to the GP.

The GP will also appoint an investment manager or an asset manager; in turn, the investment or asset manager may appoint a property manager. The relationships of promoter, operator, GP and asset manager can be subtly or obviously connected: in some cases, the same financial services group will provide all of these functions.

See Appendix 2 for an illustration of a typical LP structure.

### 1.2.2 Property Unit Trusts

#### *General*

In practice, PUTs fall into four categories: exempt, non-exempt unauthorised UK trusts, authorised PUTs and offshore trusts. The most common form, exempt unauthorised PUTs, are exempt from capital gains tax, unauthorised and available only to pension funds and other tax-exempt UK resident entities.

The Association of Property Unit Trusts was founded in the early 1970s and formalised in 1986. Membership is open to unitised property funds. There are currently 27 members and the total net assets of the Association's membership are in excess of £6 billion. Participating PUTs are bound by the APUT voluntary code of conduct.

The largest PUT is the Schroder Exempt Property Unit Trust, established in 1971, with a property portfolio currently valued at in excess of £1.1bn.

#### *Authorised or unauthorised?*

As stated above, property unit trusts can either be authorised or unauthorised. Authorised PUTs are designed primarily for retail investors. The much more common unauthorised PUTs are unregulated unit trust schemes and may only be offered to institutional investors. There is an exemption from capital gains tax where all issued units are held by investors who are themselves wholly exempt from capital gains tax or corporation tax (primarily pension funds and charities). The requirement is that units are held only by *“pension funds, charity or other investors which are exempt approved or treated as approved under chapter 1, part XIV of the Incomes and Corporation Taxes Act 1988 or otherwise permitted by the Inland Revenue to hold units without prejudicing the exemption of the trust from tax on capital gains under Section 100(2) of the Taxation of Chargeable Gains Act 1992”*.

Investors in unauthorised PUTs tend to be professional investors. While the Operator/Manager of the fund will be regulated by IMRO, the fund itself will not be subject to the regulations set down by the FSA. Accordingly, the fund may be run with more flexible

investment objectives and restrictions to meet the investment needs of more sophisticated investors. These objectives and restrictions will in some cases be the responsibility of a supervisory board representing the interests of investors.

The Financial Services (Regulated Schemes) Regulations 1991 led to the authorisation of unit trusts as property funds. The authorised property unit trusts (APUTs) were designed primarily for retail investors, giving them a medium whereby they could invest in units of a collective property fund offering exemption from capital gains tax on disposals of investments in the fund, with income taxable in the fund at 20%. On distributions from the fund there is no further tax liability for corporate or exempt investors, but no credit of the tax paid in the fund is available. This structure is therefore less attractive to exempt funds as there is an absolute tax cost, which can be avoided by investing through an unauthorised unit trust. Given this, and the restrictions placed on investment and liquidity, the structure has had very limited impact, evidenced by there being only two present in the market today.

In order to be available to retail investors, a PUT must be authorised and set up to comply with requirements for the constitution, management and operation of the fund, including investment restrictions, set out in regulations issued by the Financial Services Authority ("FSA").

#### *Open or closed ended?*

While some offshore property unit trusts are closed ended, a property unit trust (PUT) is typically an open-ended property investment vehicle which enables subscribers to participate by acquiring units. The open-ended nature of the majority of these vehicles means that managers will offer to buy units from investors and issue new units to investors. Managers will quote an 'offer' price at which units will be issued or sold, and a 'bid' price at which units will be bought back. The difference between the two – the bid-offer spread – may closely and quite reasonably resemble the round trip dealing costs of buying and selling a property.

The total initial subscriptions form a fund for investment by professional fund managers on behalf of trustees, who own the investments for the benefit of unit holders. Units will be issued and redeemed by the manager, who will regularly quote buying and selling prices for units; alternatively units may be traded on the secondary market. The secondary market is quite limited, HSBC being the predominant orchestrator, with matched bargains sometimes achieved at 'mid' price. Both buyer and seller will usually be better off buying and selling at 'mid'.

#### *Exempt or non-exempt?*

Non-exempt UK unit trusts, subject to restrictions on marketing to the public, are open to all investors. In particular, these are used by non-exempt UK resident institutional investors and non-resident investors. These vehicles are subject to tax on their income and gains, although tax paid by the trust is fully creditable to investors if the vehicles follow a full distribution policy and manage the responsibility for payment of non-allowable fund expenditure. One of the disadvantages of this vehicle is a potential double charge to tax on gains, once on the sale of the asset, and again on the sale of the units, the value of which reflects the capital appreciation.

### *Balanced or specialist?*

Balanced PUTs generally hold a wide mix of property assets, by type and location. Much less common specialist PUTs focus upon particular types of property, or on particular geographic regions. For no particular reason, specialist PUTs are often established offshore.

### *Onshore or offshore?*

Offshore PUTs offer greater flexibility, as they are tax effective for a greater range of UK and international investors. The vehicle can be more efficient for both tax exempt and taxable institutions. Non-resident PUTs which are structured to give unit holders immediate entitlement to any income are tax transparent for income - thereby giving a cash flow advantage and preventing possible tax leakages – and are also exempt from capital gains tax at the level of the PUT by virtue of non-residence. In addition, these vehicles are less heavily regulated.

### *Management*

PUT structures can be complex. A supervisory board may be appointed to represent what is usually a larger pool of investors than represented in an LP; the Lend Lease Retail Partnership, the LP with the largest number of investors, has 19 investors; The Schroder Exempt Property Unit Trust, the largest PUT, has over 600. The supervisory board will appoint a trustee to operate the fund, and an investment manager to buy and sell assets and act as issuer and redeemer of units. The promoter or originator of a PUT will usually be the investment manager, who will then appoint the supervisory board and effectively appoint the trustee; but there have been recent examples of supervisory boards terminating their investment manager's contract and appointing a new manager. This is different from the LP model. The GP, which cannot usually be removed, appoints the asset manager, often a connected company.

See Appendix 2 for an illustration of a typical PUT structure.

### 1.2.3 Managed funds

Managed funds (life managed property pension funds) are the insurance companies' equivalent of the pension funds' property unit trust. They are usually managed by insurance-based fund managers. The performance of nine managed funds (together with that of a larger number of contributing PUTs) is tracked in regular reports issued by HSBC and the Association of Property Unit Trusts (APUT); over 30 are covered by CAPS.

Managed funds are unit-linked funds. Some are sold to retail clients; some are sold only to institutional investors. The same fund may have both investor types, and charge different fees based on the source of capital. In return for an investment in a managed fund, a life policy is issued by the life company to the pension fund. This are held in the name of the pension fund and not by a nominee. No certificate is issued.

Managed funds are governed by DETR regulations, and (while some funds claim to be able to invest) most are in practice prevented from investing in some asset types, including limited partnerships. (PUTs can invest in whatever they like subject only to the trust deed.) Managed funds can gear, but this is problematic in actuarial terms and none do in practice.

Some managed funds were created by life-company based fund managers as a means for balanced mandate to gain property exposure; others are for segregated money. Some are mixed.

Managed funds are accumulation funds: there is no distribution of income. As a result, redemption periods can be shorter than for PUTs, as income can be used to finance redemption. 7-14 days is not uncommon.

Managed funds are usually, like many PUTs, valued monthly. Some use rotation, which can lead to smoothing.

To achieve secondary market trading, investors have to deal direct with the manager because of the life policy assignment. The bid-offer spread is the same as for PUTs, but some managed funds are 'single priced'. Bid – the price at which investors disinvest– will be NAV less 1.75%; offer will be NAV plus 5.75%, with no spread on cash and distortions created by gearing (which can disguise true bid-offer spreads). The bigger spread on geared funds can be policy or the result of gearing distortion.

Where single priced, the investor will serve notice on a blind basis. If the balance of sales over purchases on that day is positive, the pricing basis for a buyer will be bid. Matched bargains are made at mid price; all trades have to be at that same price on the day of trade.

PUTs are more typically used for defined benefit pensions; managed funds are more suitable for defined contribution schemes. Some segregated accounts invest across a range of PUTs and managed funds.

#### 1.2.4 Other vehicles

Investment Trusts are generally restricted regarding the proportion of their assets that can be held in property. As a result, despite industry demands for the liquidity that a quoted vehicle provides, this has not been a popular format for holding property. The TR Property Investment Trust is a rare example of a large property investment trust. These are not private vehicles.

For a variety of reasons connected with financing, accounting and tax many corporate vehicles have been created as special purpose vehicles for holding property assets off balance sheet. In addition, some property funds have been created in offshore corporate form, but usually for the purpose of holding overseas assets in a tax-efficient way. Formerly public quoted property companies such as MEPC and Hemingway now form part of the portfolios of institutional investors as private companies, a form of PPV.

The success of the Real Estate Investment Trust in the US has prompted many investors and managers to encourage the creation of a similar quoted, tax transparent product in the UK. Unfortunately, the UK government has made it clear that it regards such a development as tax negative and therefore not permissible. As a result the future appears to hold much promise for the limited partnership and property unit trust, both onshore and offshore, and other non-UK structures.

Examples of offshore structures include Delaware Limited Liability Partnerships and Limited Liability Companies; Luxembourg SICAFs; and others.

## **1.3 Players**

### 1.3.1 Fund managers

The ownership and management of institutional investment property is becoming increasingly concentrated, and the last two years has seen a major shake-up of insurance companies who invest in property.

Consolidation has occurred due to rationalisation in financial services provision and the resulting economies of scale available to fund management groups. Most institutions with less than £200m of property have effectively closed down their direct property activities, and either sold the portfolio or out-sourced the responsibility to another fund manager.

In large institutions, for managerial and regulatory reasons there has been an increasing tendency to separate out fund management as a business in its own right, even where the resulting business manages assets solely or mainly for the parent or sister company's own policy holders. Increasingly, insurance-based fund management businesses are responsible for a variety of funds (a life fund, their own group pension fund, a unit-linked fund and one or two limited partnerships). Examples of the largest insurance-based players include Aberdeen, Henderson Global Investors, Morley, AXA, Prudential Property Investment Managers, Threadneedle, Standard Life and Scottish Widows.

### 1.3.2 Property companies

The poor performance of property companies in the 1990s left the majority trading at a discount to net asset value in early 2000. The result was the taking private of several large companies, including MEPC, and a drive to diversify activity out of asset accumulation towards an income-based business whose valuation might be less punitive. Pressure grew to add more fee income through asset management without extending the capital invested in order to increase IRR and EVA: this naturally led to property companies seeing the promotion of LPs as an attractive alternative to value-destructive equity-raising. Hence a group of property companies has entered the fund management business through the LP explosion.

### 1.3.3 Property consultants

The chartered surveying partnership went through significant change in the 1980s and 1990s: financial services regulations forced the separation of some corporate finance arms in the late 1980s, and globalisation and resulting transfers of ownership from partnerships to multi-national corporations created more flexible and multi-faceted property consultancies in the mid to late 1990s. Naturally, these businesses (largely excluded from direct involvement in the corporate finance activities of the public quoted property sector) have also taken part in the PPV market, especially in capital raising and promotion.

### 1.3.4 Capital sources

Much confusion exists concerning the ultimate source of capital for investment in property in general and PPVs in particular. This has been partly the result of the re-structuring of property fund managers, which may themselves be owned by what used to be insurance companies and are now financial services groups, and may invest 'in-house' funds as well as externally sourced capital.

Our research located over 350 UK pension and insurance funds, of which 186 replied to our questionnaire survey. 76% of those surveyed invested in property, with a surprisingly

high mean exposure of over 9% (selection bias is likely to mean that those with no property did not reply to the survey: mean exposure then would be between 4.5% and 9%). DTZ's *Money into Property* 2001 survey suggests a typical weight of 7.7%, 7.1% for pension funds and 8.1% for life funds, but again suffered selection bias: more commonly accepted mean weights are between 3 and 5%.

48% of those funds surveyed invested in private property vehicles. While some unit-linked funds are not permitted to invest in collective investment schemes, we found that for pension and insurance funds in general any limit in exposure to PPVs is largely (85%) self-imposed. The mean limit is around 11%; where funds have a target exposure, this also is around 11%. Extrapolating these values across the whole institutional market produces an estimate of some £10 billion available to invest in PPVs, with the sector's current gross asset value approaching £23 billion. Growth in the sector is possible, but this would imply higher gearing than the present average, the use of overseas capital or an extension of UK funds' appetite for PPVs.

Suggesting this is an under-estimate of the capital available, DTZ/Royal Sun Alliance (2001) estimate that £11.3 billion of total pension fund property assets (around 23% of an estimated £50 billion) are held in indirect vehicles, around £6.1bn in PUTs and the remainder in other indirect vehicles. Pension fund exposure to LPs is in the region of £2.5 billion.

Summarising, if somewhere between 11% and 23% of around £100bn of institutional property assets find their way into PPVs, gearing and overseas involvement will allow some considerable growth in the sector beyond the current £23 billion.

## **1.4 The research**

Despite a clear need for more information there is little available UK research describing the view of investors, manager and advisors concerning the PPV market. This is the first major study of its type. Commissioned and funded by Grosvenor, Invesco Real Estate Advisers and the Investment Property Forum Educational Trust, the research was undertaken by the University of Reading and Oxford Property Consultants between January and October 2001.

The subject matter is the private property vehicle, its growth, its attractions and dangers, typical detailed terms and the market's need (or otherwise) for liquidity. Given the popularity of the LP recent capital raising exercises, where the vehicle is not specified PPV should be assumed to be synonymous with LP.

### 1.4.1 Method

A literature search was undertaken, and 48 interviews were undertaken between February and July 2001. The format was a semi-structured face-to-face interview, always involving one or both of two senior researchers, often with a further researcher present. The interviewees and their organisations are shown in Appendix 1.

The interviewees can be divided into advisors, investors and managers. Of ten advisors interviewed, four were property advisors, two were lawyers, two were accountants, and two were investment consultants/actuaries. Of 13 investors interviewed, eight were pension funds, one was a charity, and four were insurance companies. Of 25 managers/investors interviewed, seven were property companies, 15 were institutional fund managers and three were specialists.

The questions asked fell into three categories. The first group of questions concerned the interviewees' general feelings about private property vehicles; the second group of questions dealt with specific issues to do with the terms of a private property vehicle agreement, and the final group of questions were concerned with the way in which capital is raised through primary and secondary markets, liquidity and transparency.

#### 1.4.2 The report

Following this introduction, the report is divided into four further sections followed by a bullet-point summary. Section 2 describes the literature search and deals primarily with PPV growth. Section 3 deals with interviewees' general views of the attractions of the PPV market. Section 4 covers the details of LP and other PPV agreements. Section 5 deals with liquidity.

## **Part 2: The PPV market, size and growth**

Indirect property investment vehicles have greatly increased in popularity in recent years. This is not a phenomenon unique to the UK: the US Opportunity Fund market soared in market capitalisation from 1993 to 2000 to reach a market capitalisation conservatively estimated at \$142 billion at end 2000.

The UK private property vehicle market has seen growth at a similar rate over similar period to reach a market capitalisation of £23 billion. There is over £3 billion of capital in the top 10 limited partnerships and over £4 billion in the top 10 unauthorised PUTs.

As a comparison, £35 billion was invested by UK private equity firms between 1984 and 1999 (BCVA, 2001).

This section endeavours to illustrate the present size of the indirect property investment market and the rate at which the PPV market has been growing.

### **2.1 Limited Partnerships**

Although the legislation for limited partnerships has been in existence since the passing of the Limited Partnership Act of 1907, conspicuously few were established as a vehicle for property prior to 1997. Following a model established by Dusco for the UK Prime LP in 1992, there has been a proliferation in their number to the extent that they are now a well-established and significant part of the UK investment market. Over £5 billion was invested in LPs in the 1997-1999 period alone.

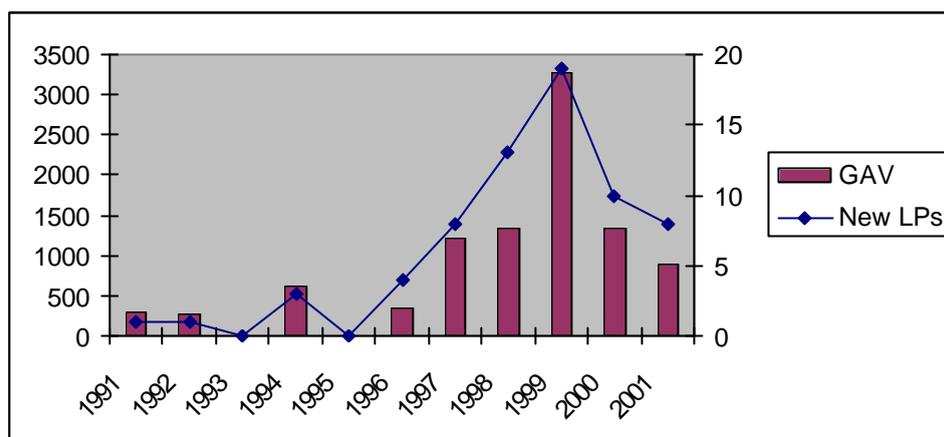
Freeman's Guide to the Property Industry for 2000 shows 47 registered LPs in June 2000. DTZ's Money into Property 2000 report identified more than 60 LPs by the end of 2000, representing a combined gross asset value (GAV) exceeding £9 billion.

Our findings have discovered a total number of around 100 limited partnerships that appear to be collective investment schemes. It should be stated that there are many more LPs, most of which are not collective investment schemes (CIS) as such, but convenient ways of sharing property ownership (joint ventures, JV). The distinction between a CIS and a JV is not always clear at the outset, and a judgement has to be made.

If fully represented in the universe, LPs would have grown from 1% to 13% of the IPD universe market in 5 years. The GAV of all the Limited Partnerships presently equates to approximately £13 billion. There is over £3.6 billion of capital in the top 10 funds.

Figure 1 shows the growth in new LP issuance over the period 1991 to 2000, suggesting a market peak in 1999.

**Figure 1: New LP issuance**



Source: OPC

**Table 1: Top 10 Limited Partnerships (GAV, £m)**

Triton Property Fund	553
Lend Lease Retail Partnership	520
Industrial Property Investment Fund	450
GMetro	400
Arkle Fund	300
Basingstoke Investment Partnership	300
UK Prime Property Partnership	300
Victoria Centre Partnership	270
Charterhouse London Residential Property	250
Electra Fairmile Property Partners	250
<b>Total</b>	<b>3600</b>

Source: Freeman Publishing

The GAV of LP funds would appear to range from very small numbers (£35 million in the Pelmore Limited Partnership, managed by REIT Asset Management) up to a projected £1bn for the Birmingham Alliance, an amalgamation of three LPs, including Bull Ring, Martineau and Martineau Galleries owned by Hammerson, Henderson Global Investors and Land Securities.

Limited Partnerships do not appear to favour particular types of property over others, but a key theme is that in many cases a fund will often be sharply focused on a single specialist property type. Examples include Airport Hotels Partnership, Apreit V Nursing Homes and MWB's leisure funds. Some are more similar to PUTs, diversified partnerships including the Lionbrook Property Partnership (an LP structure incorporating three PUTs) and the Threadneedle Tandem Property Fund.

The life span of Limited Partnership vehicles appears in many cases to be between 5 and 10 years; however, many have the built in option of being extended for additional periods. An extension is usually only possible where there is a majority vote of 75% or more by the partners.

Recent performance appears to have been better than the IPD universe. Specialist funds in the universe include LPs, and specialist funds have out-performed each year for the last four years.

DTZ suggests that three-quarters of insurance companies and a third of pension funds have invested in real estate through Limited Partnerships. *“Typically, the proportion of property assets held in LP’s was 6%, although the range varies markedly. It is well known that a number of institutions including Equitable Life and Barclays Property Investment (now Aberdeen) hold more than a quarter of their property assets in LPs”.*

## 2.2 Property Unit Trusts

Property Unit Trusts and Managed Funds are pooled funds which allow smaller insurance companies and pension funds to achieve portfolio diversification without the high cost of holding direct property. The market is worth just over £9 billion, approximately 9% of the institutional market.

The unauthorised property unit trust (UPUT) market has been in existence since the 1960s and at present contains 40 trusts. 75% are based ‘onshore’ in the UK, with the remaining ten being offshore trusts (located principally in Jersey) for taxation benefits.

The onshore-based UPUT market has a current market capitalisation of £6.8 billion, in comparison to the offshore market, which is less than one third the size at £2.1 billion. The onshore UPUT market includes one or two specialist funds (The Electricity Supply Pension Scheme UK Forestry Fund) but is mainly balanced, the market leader being the Schroder Exempt Property Unit Trust, with a gross asset value of £1.2 billion.

**Table 2: Top 10 UPUTs**

Schroder Exempt Property Unit Trust	1184
Merrill Lynch Property Fund	853
Electricity Supply Pension Scheme UK Property Fund	680
Hermes Property Unit Trust	442
Deutsche UK Managed Property Fund	416
Hanover Property Unit Trust	257
Industrial Trust	150
Local Authorities Property Fund	126
Sackville Property Unit Trust	108
Falcon Property Trust	74

Source: APUT, OPC

The offshore UPUT market on the other hand contains a much greater proportion of funds specialising in one particular area of real estate like the Chiswick Park Unit Trust, Deutsche’s UK Industrial fund or the Schroder Retail Park Unit Trust.

The Norwich and Liberty APUTs have a combined value approaching £400 million.

## 2.3 Managed Funds

There is no complete listing of managed funds. There may be many small and unmarketed examples, as some do not want to raise external money. This research found over 30 managed funds, but only nine list their performance in the HSBC and the Association of Property Unit Trusts (APUT) reports. These and one or two other leading funds have a total combined capital value of in excess of £3 billion.

The funds within the market range in size from £12 million to £800 million. The total market capitalisation is somewhere between one-third and a half of that of the PUT sector.

## 2.4 Property Investment Trusts

Property investment trusts (PITs) are listed investment trust companies which specialise in property investment, primarily by holding portfolios of listed property shares. As such, they are not private property vehicles: they are referred to here for comparative purposes.

PITs do have the ability to invest directly in property, but direct investment is restricted in order to retain the investment trust status of the fund for tax purposes.

There are presently only three PITs in existence in the UK: TR Property, Wigmore and Trust of Property Shares. Their combined gross assets at May 2001 were around £400 million.

## 2.5 Privatised Property Companies

In 1999 and 2000, the pressure on share prices and the arbitrage made available by the discount to NAV resulted in no less than 16 public quoted property companies being taken private. High profile examples include MEPC, now owned by a special purpose vehicle owned by Hermes and GE Capital, Hemingway, now owned by PRICOA and others, and Burford. In 2001, Bradford Property Trust and others went private and the drift continued. A full list to end 2000 is provided in Table 3.

## 2.6 Sub-sector sizes

The five main PPV sub-sectors – LPs, PUTs, authorised PUTs, managed funds, and newly privatised property companies - have a total value of around £56bn. £45 billion is held in true collective investment schemes (LPs, PUTs and managed funds), which would represent 46% of the £97bn (at end 2000) IPD annual universe of institutional property investment. (Not all vehicles are represented in the universe: these values are for comparison only.) Table 4 shows this breakdown.

**Table 3: Privatised Property Companies**

<b>Company</b>	<b>New Owner</b>	<b>Equity Value</b>	<b>GAV</b>
Evans	Taken private by family	164	294
Greycoat	Merrill Lynch	282	400
Chesterfield	Quintain	139	382
Hemingway	Pricoa	119	269
Milner	Delancey (Ritblat link)	169	330
Allied London	JER with management	135	280
Scottish Met	Rodamco UK	153	247
MEPC	Leconport: Hermes/GE	1924	3488

Eskmuir	Laing Family	144	306
Raglan	Management	51	85
Dencora	Knowle Hill	58	109
Prestbury	Liquidation		
Capital Shop	Liberty buying minority	389	
Wates	Pillar/CLOUT	373	600
Frogmore	Management/Trefick/Rbos	293	440
Burford	Management/Lehmans	498	950
<b>Total</b>		<b>4891</b>	<b>8180</b>

Source: Merrill Lynch

**Table 4: PPV sub-sectors**

Sub-sector	Value (£m)	Number
Quoted property companies	22400	48
Limited partnerships	13000	97
Privatised property companies	9827	15
UPUTs	7886	39
Managed funds	3000	12+
APUTs	480	2

Source: HSBC, OPC

The gross asset value (GAV) of private UK vehicles excluding privatised property companies now exceeds the market capitalisation of UK quoted vehicles. Limited partnerships, property unit trusts and managed funds now have a combined value of over £23bn; this exceeds the quoted sector's capitalisation of £22.4bn.

In addition, the GAV of limited partnerships appears for the first time in 2001 to be greater than the GAV of PUTs and managed funds: however, the equity invested is less, as gearing levels in PUTs are typically much lower than in limited partnerships.

## **Part 3: General**

In this section, we address the interviewees' views concerning the attractions and otherwise of PPVs, with particular attention paid to the LP. Who are the natural investors? What will drive the future growth of this market? Is specialisation important? Is out-sourcing the key driver? Is the market supply-led (fee-driven) or demand-led?

Where we have significant differences between the views of advisors, investors and managers, we report them separately. In some cases we attempt to summarise the consensus.

### **3.1 What interest do you have in private property vehicles?**

#### ***Advisors***

The roles of the advisors interviewed were usually to do with advising the manager or sell side. This role included developing the attractiveness and tax effectiveness of the general offer; advising on the detailed terms of the offer, acting as promoters in raising capital and administering limited partnerships and offshore property unit trusts as FSA registered operators. Sometimes the advisory role developed from general advice concerning the acquisition or disposal of all or part of an asset.

The buy-side advisors advised corporate pension schemes concerning their allocations to property, much of which are invested in private property vehicles. *"In many cases, a client comes to us to ask how to get assets off of their balance sheet, diversify their holdings or realise an investment. We advise the client on what to do with the asset(s)."*

#### ***Investors***

It is revealing that the investor group, defined as those not currently promoting vehicles in which they have a fee-related interest, was harder to locate than the promoter group, which was considerably larger than the former.

The investor group (a majority of which were pension funds) included only one pension fund which had never invested in a private property vehicle and lacked a mandate to do so; the majority were pension funds who were current investors in PPVs.

Eight of the group of 13 claimed no interest in promoting their own vehicle, but three funds (both pension and life funds) were currently working on promotion of a PPV or would consider doing so.

#### ***Managers***

The managers usually acted as operators or significant owners of the general partners of LPs, but the key activity is the strategic investment management role delegated by the GP. Two managers used agents to promote the vehicles; all others promoted their own vehicle. Two (different) managers used the corporate finance subsidiaries of agents to operate the LP; all others appointed an IMRO or FSA-registered subsidiary of the manager as the operator. No manager saw this as anything other than a low reward activity, suggesting ease of control and lack of alternative choices as the main reason for keeping the function in-house.

Two managers stated that they would only invest in their 'own' vehicles; most would consider investing in others.

One manager had recently been appointed as a manager of managers, the brief allowing up to 15% of the investments to go into the manager's 'own' vehicles.

### **3.2 Do you think there is a 'natural' investor for the current vehicles – who, and why?**

*This question was asked of the investor group only.*

The split of interviewees between advisors, investors and managers suggests a simple answer to this question. Pension funds are the dominant group in the investor sample but none appear in the manager sample. These form the 'natural' investor non-manager group. The managers who also invest are the insurance-based fund managers. Those who do not invest other than in their own products are the property companies and specialist fund managers.

The investor group considered natural investors to be those institutions with small teams looking for specialised market sectors. Smaller life funds and pension funds may need to access certain parts of the market (or overseas markets) through some form of indirect product.

For larger funds, indirect vehicles enable access to markets that would be unwieldy to administer such as residential or small retail. For these investors, limited term exposure to a sub-sector can be achieved without hiring a specialist team. In addition, PUTs can be used to assist in asset allocation, offering a means to adjust the property allocation at reasonably short notice.

One investor considered that there is no 'natural investor', and the PPV simply appeals to fund managers who are under pressure to put money into the market.

Some Dutch pension funds are clearly 'natural' investors: investing overseas alongside the manager has clear appeal to an investor group which has found direct exposure painful in the past.

### **3.3 What attributes would you see as crucially important in limited partnerships and other private property vehicles? Can you rank the main advantages/crucial attributes of the current vehicles?**

#### ***Advisors***

Four advisors mentioned the need for a sector-specific vehicle, providing access to large, otherwise unavailable product.

Four advisors identified access to specialist and excellent management expertise (significantly, all examples of excellence quoted were property companies).

Two advisors suggested alignment of interest and transparent fees were important, while two considered that the vehicle is less important than the underlying property product and business plan.

Tax efficiency was mentioned by one advisor (a tax expert).

## **Investors**

Several investors expressed the view that the vehicle format of an LP is naturally attractive and aligns interests neatly. The structure works naturally as a means of a group of investors sharing information with a motivated general partner. There is a clear and natural differentiation of roles.

If the documentation is successful, the investors all have a relatively common aim and a common time horizon. LPs enable investors to have some influence over the fund, even though a 'managing partner' technically manages it.

Eight investors (the great majority) mentioned specialist management and access to niche sectors and to niche expertise as the key factors.

Transparency of information and motivation was also seen as key by six investors. Investors wanted to see permanence in management and needed to observe transparent incentivisation that encouraged this. The fund managers' track records should be transparent. Generally, more simplification and transparency of information, including good reporting, good information regarding the underlying assets, quarterly cash flow reporting and quarterly valuations were in strong demand.

Four investors mentioned the appeal of access to attractive stock that would otherwise be unavailable and/or the lack of appeal of a blind pool.

Three investors found the indirect management offered by an LP attractive *per se*, as it can permit an investor to access a sector with no direct exposure to political issues (for example, residential) or to 'messy' sectors (high yielding management intensive properties).

For three investors tax transparency and stamp duty mitigation were factors working in favour of PPVs.

In the words of two investors, principal investment can be an advantage and the manager/promoters of the LPs must have their own money invested. Two investors found PPVs attractive simply as a means of providing pure property performance (unlike property shares) and getting money into the market (when individual property stock might be unavailable). Two investors mentioned the use of PPVs to improve returns through leverage when gearing cannot be introduced directly. Two investors mentioned unitisation, with PPVs providing the ability to sell down parts of large investments and a PUT in particular providing the advantage of a potential sale of units.

## **Managers**

Focus and specialisation was mentioned eight times: this included exposure to properties or property styles which are difficult to access otherwise, including emerging sectors, management skills, specialist product, and a way to hand off difficult properties and sectors.

Six managers identified stock as key. This might mean access to large lot sizes and a way for investors to avoid specific risk; also included in this group were those making more general comments regarding the need for a good property proposition/good quality assets/interesting stock.

For four managers, the ability of the manager to out-perform a target or benchmark (and to demonstrate this) was seen as very important. Tax transparency and perceived stamp duty savings were mentioned by four managers. The need for general transparency of information regarding fees and costs in order to judge true alignment of interest was also identified by four managers.

Three managers felt that marketing was a vital input: a well thought out pre-marketing campaign and launch process, a well-communicated and focussed strategy, and the appropriate staff to accomplish the mission were vital factors in achieving success.

LPs as a route to gearing through the back door was mentioned by two managers. One property company admitted that the LP enabled the company to get assets off the balance sheet, and to share its risk in holding non-core (smaller) assets. Another manager identified the importance of good corporate governance, setting up structures that are actually implemented, and appointing a GP which is responsible concerning its fiduciary responsibility.

### ***Consensus***

Specialist and expert management and access to large or rarely available stock are clearly seen as the key attributes for a successful LP. Transparency of information and an easily apparent alignment of interest, tax efficiency and access to gearing were also commonly quoted. Many participants in this market clearly feel that the LP format can be an excellent means of structuring co-mingled property investment with appropriate separation of (and remuneration for) the roles of the parties involved.

### **3.4 What are the key reasons why this market has grown so rapidly in recent years? What are the key drivers?**

#### ***Advisors***

Many advisors were sceptical about the reasons for growth of the LP format. Many pointed to the obvious bandwagon effect, while some suggested excessive use of the structure in the wrong circumstances. Going further, the great majority of advisors suggested a supply-push effect contrasting with a less obvious natural demand from investors to grow this market. The market appears to have been fuelled by only a few investors – at core only 5 to 10 - and has limited breadth.

Several suggested that fees have driven promoters to create vehicles, and that there are more promoters than investors; that the market has grown too wide due largely to fee takes; and that property companies in particular need to find ways of recognising the value of their management.

The LP structure is particularly effective, as it separates capital invested from management, creates a fee income and increases the efficiency of the property team while enabling capital to focus on the core activity. It also enables the property company to take holdings off its balance sheet; to realise development profits and to raise cash.

On the other hand, specialisation has been increasingly recognised as a source of out-performance. Both IPD in the direct market and property share analysts in the quoted sector have produced supporting evidence for this. One advisor suggested that unique assets and unique manager skills are a good reason for creating LPs, and another held the view that some institutions have realised that the management expertise they need to

manage different types of property in many different sectors is so specialised that it cannot be provided in a 5-10 man in-house team.

Almost all of those questioned suggested that investors are less worried about entering an unknown sector if they are co-mingling, and this is the only way to access certain sectors. Investors want to access professional management in areas where they do not have in-house expertise, and benchmarks have driven investors to access certain new sectors through this route. This effect is connected with consolidation of the fund management industry, which has not typically expanded the areas of sector specialisation within each business but has instead created less diversity within the new giant fund managers.

Three advisors pointed out that assets are key drivers: as lot sizes have been rising so more investors need partners whose interests are clearly aligned. Again, consolidation is relevant here. The insurance-based fund managers have suffered from perceived conflicts of interest arising from the distinction between the 'in-house' insurance and pension funds they manage and the pure external business some of them have and most of them chase. Co-investment in a fund with clients is a way of overcoming these perceived conflicts.

LPs are seen as tax-efficient, and this vehicle has provided access to gearing for institutions (effectively achieving a debt swap between the property company and institutional sectors).

### ***Investors***

Three major drivers were cited by the majority of investor group. These were the attractions of specialist sectors and assets; perceived performance; and, more negatively, a fee-driven market that has achieved critical mass and a herd or bandwagon effect.

One investor thought that the LP format is a good way of accessing certain parts of the market and enables smaller funds to invest in assets that would otherwise be too large. Bluewater was most often quoted as an example of this. Indirect does enable some institutions to invest in areas of the market where they have no exposure, and for some funds it is seen as a quick way into the market. LPs provide access to specialist stock and specialist management skills, providing efficient diversification, and the opportunity to sub-contract to specialist management.

While few investors have a brief to move between the quoted property sector and the PPV, the under-performance of property companies has clearly contributed to interest in the private vehicle, which is regarded as a potential out-performer due to specialisation and gearing. The PPV is seen as a way of increasing running yield through gearing. Some, but not all, investors have enjoyed great performance from LPs, which have been geared during a sustained period of double digit property performance, low interest rates and (often) running yields in excess of the debt charge. For many funds which cannot access gearing directly, this has been the only means of using gearing to enhance returns in a benign environment.

The bandwagon effect is seen as a less rational argument for the sector's growth. Momentum has been building since the early 1990s, during which time tax transparent vehicles have effectively been vetoed by government and the quoted sector has suffered a severe decline. The result is that PPVs are seen by some as 'poor man's or 'back-door' REITs'. At the same time, the investor group is highly sceptical about the motivation of many promoters and managers of LPs.

The variation in fees charged and the perceived high rates of fees in some cases have clearly inhibited investor interest. Several investors expressed disquiet about high fee charges where the assets involved are not management-intensive.

*“A 1.0% fee is not so bad if the property offer is something like a serviced office fund or a European fund where we are getting some management expertise. But in many cases, like a retail warehouse fund where everything is on 25 year leases, we don’t need any management expertise so why should we pay away the fees? Otherwise we feel we should invest directly”.*

Reductions in headcount amongst some investors is again seen by some as a driver, especially when coupled with the demands of globalisation. One international investor formerly employed 100 people to manage 2bn euros of domestic and international real estate; it now employs 10 people to manage 4.5bn euros. Efficient local and specialist management has become more popular, and co-investment by overseas investors has been made possible by the PPV.

### **Managers**

While positive market conditions over the period 1996-2001 clearly encouraged the growth of this sector, the major driver of the PPV market was seen to be **specialisation**. 75% of those managers interviewed mentioned this factor.

The underlying property offer was seen by some managers to be key, and the attractiveness of specialisation is its perceived potential for out-performance. LPs provide exposure to asset classes that investors could not access directly. Assets are larger, and often too large, and specialist asset management skills are increasingly necessary.

One of the main purposes LPs serve is to spread risk for investors. They allow investors to invest across a wide spectrum of property sectors that they would not otherwise have access to. LPs also enable investors to gain exposure to specialist areas of the market with expert management. This enables them to take exposure to sectors that are unfamiliar to the in-house managers.

While LPs and offshore PUTs may not be perfect structures, and a UK REIT would be preferred by many, PPVs are seen to be the next best thing, with the great advantage of being immediately achievable. The growth of PPVs has been highly correlated with transfers out of the quoted sector, and there is often a direct linkage (for example, the privatisation of MEPC, now a PPV). The quoted sector is criticised as lacking transparency, which is therefore a key factor required of a PPV, and damaged by changes to ACT regulations which do not affect largely tax-transparent PPVs.

The lack of suitable alternative structures, fund management consolidation and gearing were the next most mentioned factors, all by around 40% of the manager survey.

**Consolidation in the fund management industry** has led to the creation of a limited number of large fund managers. At the same time, globalisation has stretched the resources of investors and fund managers, so that extensions of expertise and activity beyond national boundaries has often been at the cost of expanding domestic expertise. Finally, the pressure to reduce overheads which has affected all service businesses has increased the attractiveness of out-sourcing and delegation.

Pressure on costs has reduced specialist expertise in fund managers. Specialism and entrepreneurial flair may not be accessible within the salary structure of institutional fund

managers. As a result, there has been a change in funds' attitudes. They cannot do everything and value specialists. Contraction in the fund management industry and pressure to perform has made geared specialist vehicles irresistible.

Some domestic investors have gone international and a process of elimination (retaining direct property returns, co-mingling interests) naturally leads to the LP structure.

There is a general advantage in passing on liability for some peripheral operational issues when risk averse managers might otherwise feel very responsible. The PPV can provide access to scarce stock, or stock which is too messy to handle (such as residential).

**Gearing** is attractive to investors who are not permitted to directly introduce debt into life or pension funds but who (like most) are under relative performance pressure. Investors want to enhance returns and LPs provide higher gearing/ risk/reward opportunities. To place debt off balance sheet means that investors can avoid liability for the debt of the vehicle.

A related issue is the suggestion that with average gearing levels of up to 50% there may not have been quite the explosion of equity investment that gross asset values in the PPV sector suggest.

**Access to large assets for small investors** has supported PPV expansion. Reductions in specific risk without exclusion from sectors dominated by large lot sizes is a clear attraction of the collective property investment scheme. There is less clarity regarding the possible premiums paid for scarcity: some large assets are rarely available on the market and may attract high prices, so that the divisible ownership offered by a PPV may reduce that value, but this did not appear to be an express concern.

**Fee push:** four managers were prepared to admit that the LP market has largely been driven by promoters, supported by the bandwagon effect among investors. Some use the market to partially disinvest from properties already owned while retaining fee income; some to grow fund management businesses.

**Liquidity:** three managers suggested that improved liquidity was a factor working in favour of LPs. Because the sector involves a wide range of players in the market (insurance funds, pension funds, fund managers, agents, international investors) there is potentially greater liquidity than direct investment. (It has to be said that set against this is the limited range of pure investors evidenced above).

Factors adding to the liquidity of the LP are thought to be the guaranteed exit and the fact that investors gain comfort from being part of a group of partners. Some investors believe that one can divest of holdings at par or even a premium, unlike listed property companies which typically trade at a discount to NAV. (This positive view is challenged in part 5).

A further factor mentioned by three managers was the access provided to large assets: big buildings have been best-performing, so the LP structure is essential, and assets have become larger, especially in retail. Also mentioned by three managers was performance: *"we have been in a rising market where it has paid to take risk and these vehicles offer opportunities not otherwise available"*. Fund managers with poor performance have looked for enhanced performance to protect their positions, and pressure to perform has led some managers to invest in other vehicles because this can be seen as defensive (where other managers are seen as best in their field).

**Tax transparency** was cited by two managers, who felt that LPs and offshore vehicles provided tax transparency especially for overseas investors.

**Business development** was an interesting final motivation: PPVs give institutions insights into ways that other fund managers operate. *“And it’s interesting – a release from the day-to-day plain vanilla tasks. It has provided the opportunity for managers to do things they could not otherwise do.”*

### **Consensus**

Among the group of 40 interviewees, specialist management (and the perceived out-performance that goes with specialisation) was seen as the key driver of growth in the PPV market. Fee-push factors were also seen as dominant, alongside industry consolidation and tax transparency.

### **3.5 What will drive the future growth of this market?**

This question was dealt with by a limited number of investors and promoters. There were positive and negative views. There was a divided view about likely future growth: evidence suggests the market may have peaked and attained saturation; others believe this is the beginning of a transformation of the market to vehicle format.

The positive views were as follows: LPs will become increasingly specific with lots of single property LPs that have just a few partners, and most interest is in this area at present. The same applies for offshore and onshore PUTS. There is a growing awareness and acceptance of these funds in the market. There will be a clear demonstration of increasing liquidity in the market, perhaps through a growing secondary market. LPs are good enough to meet most of the criteria that investors look for in an indirect vehicle (tax transparency, trading at or close to NAV, specialist management). The market should continue to widen, particularly if liquidity can be enhanced.

On the negative side: it may be that demand for LPs is correlated to general investment market performance. 2000 was an exceptional year for property and it would not be surprising to see the market cooling. If and when the market performs poorly, LPs will be more negatively impacted because of their specialisation. Some investors may continue to resist LPs if fees do not fall. There is already evidence of a slowdown in new issuance. There is a natural limit on the number of investors that can be attracted and the amount they can invest in PPVs. Have we attained saturation point?

### **3.6 Can you rank the main disadvantages of the current investment vehicles available?**

Investors were asked about their perceptions about the weaknesses of the current structures. These were mainly to do with lack of liquidity, the long term commitment needed, the lack of critical mass and secondary market, and uncertainty over how units should be valued.

Neither PUT nor LP format are ideal in this respect: *“with a PUT, investors have the ability to move in and out at different times. This can cause disposals at times that would not suit us if we were a major investor. With LPs, the problem is lack of flexibility. If you want to liquidate your holding you have to go out and find a buyer”.*

Lack of investor influence, fee levels, and the risk associated with being geared into a downturn were also mentioned more than once.

Several investors complained about the bespoke nature of vehicles and their documentation.

They are seen to be too slow and too costly to set up. The commitment period can be too long and allocations to property are then difficult to manage in this context.

### **3.7 What are your main concerns regarding private property vehicles?**

#### **Advisors**

The great majority of concerns expressed by advisors were to do with the liquidity of the PPV (especially the LP) vehicle in a market downturn. Typical comments are as follows:

*“(The market) is largely confined to professional investors but there is no experience of operating in a downturn.”*

*“What will happen in a downturn? Not many have come to an end and there is potential for real difficulties in a falling market”.*

*“You have to wonder what will happen if they unwind at a time of recession. There has been a long period of consistent growth. The first LPs are coming toward their wind-up dates and they have been very successful. Market conditions could be very different when some of the more recently launched LPs approach their wind up dates - and then we will see if these vehicles can stand the test of time.”*

*“ The buoyant state of the market blinds participants to potential problems on exit.”*

Secondly, the market is not yet seen as providing a healthy balance between demand and supply. There are too many operators/managers in what is and has been an attractive market. Is the market growing through fee-driven managers or the needs of investors?

Are fund managers always the appropriate specialists? And should property asset managers make currency decisions and complex financing decisions within the vehicle?

What happens if there is an insolvency? The new Financial Services and Markets Act is not regarded as LP friendly.

While advisors think that there can be too much work in setting up an LP, fee levels will continue to be an issue.

#### **Investors**

Three issues concerned the investor group. Concerns about liquidity and marketability at full value in a market downturn were again to the fore, exacerbated by what is seen to be a thin investor base. Participation has widened somewhat recently, but there is still a concern about over-supply: *“Many investors must be nearing their capacity to take on exposure”.*

However, and interestingly, a new concern was equally common. Will the managers stay in place? What happens if returns do not trigger performance fees and carried interest and the managers become unhappy? It is important that the fund manager has a sizeable stake so that interests are aligned, but how can this be guaranteed if market performance is poor?

*“With an LP, if they raise the capital and then buy the properties, you are effectively investing in the individual manager.”*

Fees are also a concern, and some investors feel that interests are not necessarily aligned. Carried interest, performance fees on valuations and a lack of downside participation creates divisions. Who appoints valuers?

Double fees deter investment in vehicles: it is difficult for the client/manager to accept that fees are going elsewhere in addition to the in-house team.

Potential changes in the tax treatment of LPs is a concern – a few investors worry that the government could change the rules so that they are no longer tax-transparent.

## **Managers**

The overwhelming concerns of managers were to do with a lack of a broad investor base, an insufficient understanding of the vehicles in the market and consequent concerns about the liquidity of assets in a market downturn.

*“There is insufficient regulation, and the downturn will provide some testing problems. There is an insufficiently broad investor base. There is not enough secondary market activity.”*

Related concerns were to do with the value of LP units in a secondary market: will they trade at NAV? Why does an investment trust such as TRPIT trade at a discount when LPs do not? How do you value a share in a LP – if it is less liquid, why is there no discount?

Untying the structures on termination could be a problem. In a small group of investors, each can have a significant negative influence. There is a problem for owners who will be reluctant to sell units in the early years as undiluted set up costs will have a damaging effect on performance; equally, buyers will be reluctant to go through due diligence when there are only two years to run if it appears likely that the fund will be wound up.

The US experience was cited by some: this market experienced massive disaffection in a downturn (examples are JMB’s Cadillac Fairview fund and Heitman’s problems in the mid 1990s).

Related to the lack of market depth is a perceived lack of disclosure and a general lack of information and education. This leads to a doubt over the marketability of smaller shares in less attractive or well known products, and the potential lack of a broker for these assets. Who has access to all the necessary information?

*“The market does not yet fully understand the mechanics of these vehicles. Risk is often higher than recognised – gearing is too easily agreed to and the risk implications inadequately modelled.”*

*“There is a lack of understanding in the market. These vehicles are capital markets/property hybrids requiring more expertise than either market offers.”*

*“The format is untested in the courts and in a downturn. The wind-up is not yet proven, and there may be a bulge in re-financing at the wrong time. Players are inexperienced and inadequately informed.”*

*“Everyone is a promoter. There hasn’t been a shake-out yet. US failures changed perceptions and structures in the US, and this cleaning up process has not yet taken place here.”*

There were subsidiary concerns over possible changes in tax legislation (for example, recent changes in Holland) and some managers damaging the reputation of LPs by using them as a dumping ground for poor quality stock. There is a perceived lack of professionalism in some managers and *“too many half-hearted attempts at LPs causing a potential glut in the market”*. There is some concern that vehicles are too dependent upon individuals.

### **Consensus**

The only issue of concern which united all three participant groups was the lack of liquidity and the issues this may cause in a market downturn. This was a concern for the great majority of the 40 interviewees. Advisors worried about the aptitude of certain managers to be in the business; investors worried about retaining the motivation of the individual managers they liked; and managers worried about a lack of understanding and information, which limits the size of the investor market.

## Part 4: Details

Many of the questions asked and views offered concerned the differences between LPs and PUTs, details of LP agreements and structures, including fee levels, gearing and tax efficiency.

### 4.1 Do you generally prefer LPs, PUTs (on- or off-shore) or other structures?

#### *Advisors*

The advisors interviewed were all familiar with LPs; and most had also recently dealt with PUTs. Less were familiar with continental European PPVs, and one interviewee wondered why efforts were not being made to provide an appropriate and common structure for pan-European investment.

Differences in the levels of control exercised by the manager and investors was consistently referred to. There is less control of a PUT by the fund manager: this is the key difference. The GP/manager controls an LP, but the investors control a PUT through the supervisory board or similar structure. General partners cannot typically be removed for under-performance, and there is no record of this having happened in the UK. On the other hand, the manager of a PUT can be replaced, and there have been two high-profile examples in the UK in recent years.

LPs allow more involvement on the part of the investor partner, but this is largely a function of the limited number of investors, as partnership law does not allow decision making by limited partners.

Another common difference referred to was tax treatment. LPs are seen as 'properly' tax-transparent while PUTs can be 'effectively' tax-transparent (the difference being referred to as subtle but material). The tax treatment of a PUT differs between exempt, non-exempt and offshore PUTs.

Two tax differences were commonly mentioned. First, there is a deemed disposal for all existing partners every time a new partner comes into an LP. For capital gains purposes, this deemed disposal is treated as being for nil gain nil loss provided that the partners whose fractional shares change do not receive any proceeds directly, and provided that assets have not been revalued in the Limited Partnership but there will be a shift in base cost to the new partner, such that the eventual gain on sale for the existing partners may be increased. Second, there may be an annual imputed tax charge, aggregated and spread over 7 years for life funds in an offshore vehicle including PUTs. This creates an acceleration rather than an increase of tax as the aim of the legislation is to ensure that life funds cannot avoid tax by not disposing of their interest. Therefore the increases and decreases in the value of their interest is taxed/allowed by deeming that the life fund disposes of, and reacquires at market value, its interest annually. This is not usually regarded as much of an issue unless the fund increases in value over a period and then plummets. In this case investors will have to pay tax on unrealised gains, although they may be able to carry back and offset against this any future unrealised losses, such that the only effect is in terms of cashflow. However, the tax rates on life companies are reasonably low, and this provision may be beneficial in some circumstances.

There are clear differences between LPs and PUTs in the mechanisms established for secondary market transactions. PUTs are regarded as more transparent and more easily and accurately priced due to the absence of complex debt arrangements, generally clean fee agreements, and well understood transaction costs and procedures. According to one

advisor, offshore PUTs have an unlimited investor universe and more liquidity. There have been signs of recent shifts in popularity away from the LP and towards the PUT: as an example, a new industrial fund and an existing retail warehouse vehicle each changed from an LP structure to an onshore unauthorised PUT in 2001.

Other advisors see unauthorised offshore PUTs as strong competition for LPs. This is a more transparent and wide market (there are many more potential investors in this format). Nonetheless, exempt PUTs work for charities and pension funds only, which is too narrow; non-exempt on-shore PUTs are not transparent, and can lead to double taxation on chargeable gains; authorised onshore PUTs are seen to have failed; and the offshore structure is therefore regarded as the most promising.

Admission of fresh capital is easier into a PUT, which is seen as a semi-private and semi-liquid vehicle compared to the wholly private and generally illiquid share in an LP.

Other issues mentioned were as follows: PUTs are usually diversified, while LPs are usually specialist; incentive structures are different and charges/fees are different; and protection levels for investors are different (APUT acts as a supervisor of the PUT industry, and there is no LP equivalent; PUT Supervisory Boards add regulation and transparency).

### **Investors**

Of nine investors offering a view, four were more familiar with LPs and either regarded offshore structures with suspicion or were unfamiliar with PUTs; three had no preference (insufficient knowledge?); and two had a preference for open-ended PUTs, one specifically suggesting that the offshore PUT structure is preferred.

### **Managers**

Managers were concerned by a range of issues related to the differences between PUTs and LPs. Around 10 seemingly different points were regularly made, with liquidity and tax transparency most often mentioned. Arguably, a subtle but coherent picture emerges.

Some managers have come to a view to the effect that offshore PUTs are poorly understood but superior vehicles to LPs.

*“Starting from scratch, I’m off to Jersey”*, stated one manager, who had established LPs that he would now see as offshore PUTs. LPs are seen by these managers as only appropriate for investment clubs, and as alternatives to Trusts for Sale; otherwise offshore PUTs are much more appropriate. These managers believe that many LPs may well evolve into PUTs or similar formats (although conversion to PUTs creates a transaction for stamp purposes).

On the other hand, several managers identified the bandwagon effect in favour of LPs: some had never been involved in PUTs, and suggested that offshore PUTs are not widely understood. *“LPs are fashionable, PUTs are old hat.”*

One manager suggested that LPs should be strictly limited life products only, and so-called ‘vulture funds’ are appropriate for the LP format, while the PUT is entirely open-ended and has an infinite life.

Others were concerned about the offshore nature of the most flexible PUT format. For some, it is not yet clear that there are many advantages in going offshore, although there is less regulation. Others thought that the offshore PUT structure should be used more, but

that offshore vehicles are off-putting to investors. Offshore PUTs can be seen to be aggressive in Inland Revenue terms, and some investors cannot be seen to be aggressive. One manager suggested that as time goes by there is and will continue to be less of a stigma about going offshore, but to balance this there is thought by some to be a danger that government will close down the advantages of offshore vehicles.

### Regulation and flexibility

LPs are less regulated, according to six managers: and this is appealing to them. PUTs are thought to be more regulated, so that there is more flexibility in managing a LP; more thoughtful managers saw LPs as a safe form of less accountable investment for managers, whereby property companies and property service providers can avoid the rigours of the investment industry. Running a PUT is a more responsible endeavour.

Under the typical LP agreement, the general partner can be sacked for incompetence or misconduct but not for poor performance. This is not true of PUTs. In addition, more work is involved in both setting up and running the PUT vehicle. Where there is a limited number of investors, it may not be thought to be worth the extra costs of setting up a PUT structure, and it is not surprising that LPs have become more fashionable among managers.

An interesting demarcation dispute separates LPs and PUTs. The LP structure, based as it is on the joint venture, is seen primarily as a property investment vehicle. In a JV, investors need to carry out due diligence at the property level, and this has become standard for investors in a LP. On the other hand, PUTs are regarded as co-mingled investment products, which should leave the manager free to exercise his/her discretion.

PUTs have generally developed a style, management philosophy and a relative performance orientation. LPs are more property-specific driven and manager performance records are less likely to be compared. Onshore PUT operators are always IMRO registered, but this not always necessary for LPs. The implication is a danger that LPs might be less professionally managed and regulated than PUTs.

### Tax transparency

Both vehicles are seen as compromises which try to get around the same problems. Managers would ideally like to use a tax-transparent vehicle that is liquid and can be sold to retail as well as institutional investors. LPs do not succeed in the latter respects.

Pure tax transparency is less for PUTs, and managers were agreed that the LP is entirely tax transparent. Nonetheless two problems remain: first, the partial disposal implied by the introduction of new capital presents an issue for life funds; second, withholding tax might be impossible to avoid for the overseas investor in some LPs.

*“To clarify the tax problem, when you have 5 partners with 20% each in a £250m LP, if a 6<sup>th</sup> partner comes in with £50m (same as original 5) the share of the original partners drops to 1/6 of the fund from 1/5. This is deemed to be a part disposal for tax purposes, even though the fund has grown. This is not the case with offshore trusts. However, life companies face a 1/7 deemed disposal per annum in offshore PUTs. They are paying tax that they will have to pay anyway, but it is a timing issue. Pension funds do not have to pay tax so it is not an issue.”*

If the offshore PUT became attractive to LP managers, as some indicated, the transfer of an LP to PUT format would be complicated because a stampable transaction may occur in the absence of planning to mitigate the duty.

## Liquidity

Liquidity, or the potential for it, is seen as greater for PUTs by most managers. The number of investors in a PUT is unlimited whereas an LP is limited to 20 investors. Transparency is also regarded as greater for PUTs, because the pool of potential investors is wider than for LPs. Units in these vehicles are also easier to trade on the secondary market, where an established mechanism exists both over the counter and through the manager. Open-ended funds can attract more investors and PUTs are accepted by a wider range of potential participants. It is easier to sell units in a PUT than part interests in an LP.

One or two managers have the opposite view, specifically that the investor pool is wider for LPs and offshore PUTs, with PUTs limited to pension funds. There is no significant liquidity advantage in PUTs, despite greater set-up costs. Investor recognition is the key driver: it is easy to bolt on flexible sub-structures to an LP, and investors are comfortable with the LP format.

The experience of investors in Rodamco, forced to convert to closed ended status, PFPUT and other open-ended vehicles in the early 1990s also lingers in the memory of many. In certain market conditions, the apparent liquidity advantage of a PUT can disappear.

## Specialisation

LPs usually provide greater specialisation than most PUTS. It is typical to get real specialist expertise and an incentivised management (through the fee structure). PUTS, on the other hand, have been around a long time and suffer from being 'just another fund' run by a fund manager. There is rarely the specialist focus that is common in LPs and investors cannot always tell what they are buying (there is no clear focus or style). PUTs are generally regarded as balanced, LPs specialist. There appears to be no good reason why this is the case, and several specialist offshore PUTs have recently been created.

## Volatility and gearing

There is thought among a small number of managers to be a danger of volatility in the unit pricing of specialist and non-diversified PUTs, hence the case for LPs. The open-ended nature of PUTs and the possible pressure for redemptions is a disadvantage. High gearing levels – 200% in some LPs - are not regarded as appropriate for PUTs.

### **4.2 Are fee levels too high? Are performance fees standard and how do they work?**

#### ***Advisors***

##### Level of fees

The advisor group was by no means unanimous in its views of fee levels. Three thought that fees were too high; but the remainder thought that this was a complex issue, with a trade-off between running fees and performance fees, and an investor group which, while sensitive to fees, is able to judge value for money. Some (perhaps understandably) make the point that the work required is enormous.

Other contradictory views can be identified: one advisor considered that while pure asset management fees are too high at 1% property in general has a low fee regime, which does

not help perceptions. Another suggested a benchmark might be 0.3% plus performance fees or carry. Another compared property to private equity: *“Private equity fees are high, and the same format is being used for property, with the result that some fees are huge for a lower return asset. Private equity is 1% of assets and is specialist, deserving higher fees; but property is 10% (of assets). Fees are too high.”*

Another advisor suggested market immaturity: fee levels tend to be the same irrespective of the quality that is provided. There is a tendency to overcharge for mediocre performance. Some property portfolios approach private equity and take a great deal of management time (development portfolios); others do not. Fees should be more sensitive to these issues, and to the manager’s liability when mistakes are made.

Fees may be linked to rent collected, not to asset values. This may be more relevant for management-intensive portfolios.

### Performance fees

Performance fees (and/or carried interest) are regarded by investors as standard, although one or two vehicles are free of performance fees. The issues raised concern the basis of the fee: charging on a realisation or valuation basis. There is some caution regarding valuation-based fees. In the words of one interviewee *“Performance fees must be paid on realisation, not valuation”*.

This may be a naïve view. *“There is a general problem with performance fees – how do you pay them? On what pool of cash? People do not like paying performance fees on the basis of a valuation and disposal is the only accurate way to determine performance. But how do you do this if the fund is on-going?”*

There may be a compromise: where performance fees are rolled up to the end of the fund’s life, a proportion of fees may be taken out at a halfway point.

Valuation-based carried interest can place pressure on valuers, and the appropriate benchmark for performance fees can be problematic.

### Transparency of fees

Some fees are hidden, and some are opaque (difficult to anticipate accurately). Hidden fees include insurance for properties where the fund manager receives a commission; opaque fees include fees for arranging further financing. Some investors will have to borrow the money to pay performance fees, and managers may arrange this on their behalf and charge them a fee.

Some managers take asset management fees based on net asset value, some on gross. In the view of one advisor, either may be appropriate depending on gearing arrangements.

## **Investors**

### Level

The great majority of investors thought, without qualification, that fees were too high, although there is some differentiation: *“fee structures have been all over the place. We have been comfortable with some and others seem ludicrously generous to the manager”*.

*“The last two LPs I looked at in some detail both had high fees which they tried to justify by claiming management intensity was high – but I was not impressed with this argument. My shopping centre funds are management intensive and their base fees are half of what these two wanted. I did not go into either of the LPs because of the high fees.”*

Others do make qualifications: *“They are not too high if they turn in a superb performance for us”; and “Fees need to be reasonable to retain the motivation of managers. But opportunity fund fees are too high, and asset management fees should be limited so that the icing on the cake is performance driven”.*

Fees are usually based on asset values and appear to range from 0.20 to 1.5% per annum.

*“An investment of £25m is costing £70,000-£100,000 as a base fee per annum plus carried interest.”*

*“Base fees are .25-.50%, except in cases where assets are intensively managed. The latter tend to be around 1.0%.”*

*“Usually LPs seem to charge 0.5%-1.0% of capital value or 0.33% plus an introductory fee.”*

*“They have fallen into the range 20bps to 150 bps.”*

*“Base fees seem to be going up. They used to be around 0.3% but lately they seem to average 0.5% and I have seen one that is 0.6%.”*

*“Fees are coming down.”*

*“Promoters always expect a negotiation, so opening fee gambits are always too high. A good reputation can protect and justify fee levels.”*

Other individual comments included the following: fees in LPs seem on the high side relative to PUTs; fees should be taken from rents receivable and not based on asset value; fees on committed capital cannot be right – fees should be paid as capital is invested; and specialist vehicles can command higher fees.

### Performance fees

Investors are agreed that performance fees are a general feature. One investor suggested that if the manager is taking equity risk he feels more comfortable with them taking a larger ‘kicker’. A typical performance fee is to retain 25% of returns above 12%: *“But I don’t know that there is a norm. There have been no studies and nobody knows what the market norm is.”*

Another accepts: *“It is difficult for the manager to strike the right balance between the minimum fee level in the early stages so that they are reasonably rewarded for the costs they are incurring without it being a real dilution of the income distribution at a later stage.”*

Performance fees may be earned with reference to a benchmark or to market performance. A specific benchmark is likely to be preferred. Valuation-based fees are common, and split investor opinion.

*“Fees are usually partially based on valuations through the life of the vehicle with the balance based on return at the end of the life of the LP. As long as one is comfortable with the valuation end of the industry, we see no problem in valuation based fees.”*

*“Valuation-based fees are acceptable.”*

*“ Performance fees are standard and not always fair. Valuation-based performance fees are sometimes attempted. But performance fees should be realisation-based.”*

*“Performance fees are standard, but investor must get his money back before performance fees are paid out. Valuation-based fees are not acceptable.”*

Performance fees may be calculated based on market returns, or on RPI and IRR based targets. These may be based on geared returns measured against an ungeared benchmark. In the words of one investor: *“many investors do not really know how carried interest is calculated.”* Returns may be measured on a portfolio basis, or measured property by property, with a clawback if a fee has been paid and later performance is disappointing.

The use of preferred returns is becoming standard among certain US investors in opportunity funds. 9% (for example) may be guaranteed as a first cut. Returns may then be shared 50:50, then allocated 80:20 in favour of the investor above 20%.

## **Managers**

### Level

*“There is a perceived market norm emerging of around 0.35% p.a. plus a performance related fee. Whether that is too high or too low depends on what the fund is aiming to do. Fees should relate to the amount of management required.”* *“A typical base fee is 0.5% – 0.6% of asset value”.* The fee level most regularly quoted was 0.5%, although *“1 to 1.5% is not uncommon plus a performance fee”.*

In addition, start up fees may be charged. These are controversial. Anecdotal evidence indicates these are often around 1.0% of capital invested or committed. Other fees charged can include introduction fees for bringing new partners in.

15 managers felt that fee levels are too low for both LPs and PUTs, and should be maintained or increased to allow professional managers to do a professional job. The opinion was expressed that fee pressure comes from agents and property companies who are prepared to offer poor products for low fees. UK asset management fees are low in a global context, while agency and property management fees are too high. Fee levels should depend on the product and what the manager is offering. Fees for any co-mingled vehicle should be higher than those charged for separate accounts to cover the additional responsibilities involved. Fees for actively managed assets should be higher than fees for passively managed single-tenant properties.

Six managers felt fees were too high. This may appear surprising, but there was some correlation between this tendency and the extent to which the managers invested in other managers' products. Some expressed a concern that fees were too variable and higher for LPs than for PUTs and other pooled pension products. *“This is still a venture capital/property hybrid, and fee structures reflect this immaturity.”*

Some felt that fees charged on gross assets can lead to inappropriate behaviour, especially high gearing and a reluctance to sell assets. Others felt that fees should be charged as proportion of rent collected.

### Performance fees

Managers were agreed that performance fees are standard, with a great majority promoting the use of valuation-based fees *“because managers should not be forced to sell buildings or close funds to attain performance fees”*. *“Longer life vehicles investing in large properties need to charge valuation-based performance fees.”*

A 3-year rolling IPD-related valuation-based fee is typical. Clawback may be necessary, sometimes cumulative.

A minority of managers charge transaction-based performance fees.

Three managers expressed the opinion that performance fees should be charged on ungeared returns, and rolled up to the end of the fund life. *“We often see LPs with fees of 1% p.a. plus carried interest of 20% of everything over 10%. On a geared play this is a one way bet. They still get the fee if performance is bad, and if it is good they get the kicker from the gearing while the investors are taking all the risk”*.

There is confusion in the market regarding IPD’s role with regard to LPs, and suggestions made to the effect that IPD will have to measure the performance of the vehicle.

### **4.3 Does the fund manager always co-invest?**

Alignment of interest is a key driver of the recent surge in LP popularity. This can appear to be achieved in a variety of ways: the manager may invest alongside the limited partners; he may take performance-based fee; or he may have a carried interest, where he retains cash in excess of a target or hurdle return.

The promoter or investment manager almost always co-invests, but in rare cases (especially where agents are involved) he may not. The general partner and operator are normally connected, but the operator needs to be FSA regulated to run the partnership and cannot invest. Hence different corporate bodies within the same business may be involved in operation and management.

Some LP agreements will link the asset management fee to a continued capital commitment by the manager, and may allow dismissal if his proportionate holding falls below a certain level. Sometimes, manager bonuses may be rolled into a co-investment plan. *“Sometimes individual fund managers have stakes in the vehicle, and this is especially persuasive.”* On the other hand, there may be a contradiction between co-investment and the interests of the limited partners who may wish to replace an under-performing manager.

Comments were made to suggest that there have been occasions where the terms under which the originator of the fund co-invests are not side by side with the other investors. They may have a greater interest in some properties than others, for example. The market is likely to be especially uninterested in funds that exhibit any such cherry-picking.

It is difficult to achieve true alignment of interest when the manager takes a fee from the limited partners. The closest example of true alignment might be a property company-

managed LP where the only fee taken is a property management fee assessed as a percentage of rent collected. Elsewhere, alignment is usually distorted in some way.

Co-investment by the manager can disguise conflicts. The investment manager may, for example, be primarily motivated to earn fees from fund management but at the same time manage in-house insurance or pension funds. Where these funds seed new LPs or PPVs, the amount of investment relative to the potential scale of the fees charged may be revealing. *“They must (co-invest), with a full exposure relative to their asset base (this may mean a small investment for a small manager, large for large).”*

In addition, disinvestment can be, or appear to be, co-investment. Where an owner ‘sells down’ a partial interest in a development by creating a single property LP, what is the primary motivation?

The above issues appear to have affected some interviewees’ attitudes to co-investment, which is likely to become less important. Some successful specialists have very small equity commitments, as low as £200,000 in one case and 2-5% of the initial equity in others. Increasingly, ‘pure’ fund management may sit alongside ‘pure’ co-investment as alternative attractive models for LP investment.

#### **4.4 Is gearing preferable? Essential? At what level?**

##### ***Advisors***

The majority of advisors suggested that gearing is either essential or attractive in LPs to enhance returns above basic market returns, with 50% a typical level.

Gearing may also be justified for operational management and to provide working capital. *“If you do not have gearing, the manager of a development portfolio has to hold investors’ cash and many investors want to be fully invested from the start.”*

The minority view was negative. Pooled vehicles such as PUTs tend not to gear, and three advisors suggested that gearing may be prohibited by some trust agreements and inadvisable for risk-averse investors.

##### ***Investors***

Half the investor sample sought gearing as a matter of preference, with 50% being a typical target. *“In this market gearing is preferable. It is part and parcel of investing in these vehicles.”* *“We do not gear our direct investments and, actuarially, gearing is frowned on for asset allocation reasons. Indirect effectively provides gearing through the back door for us, although the exposure is noted and understood. There is not much point in these vehicles if they do not have substantial gearing (20-30% would be pointless). But we would not want to go beyond 70-80%.”*

The other half were circumspect. Gearing was not sought as a matter of principle. 50-70% maximums were permitted depending on circumstances, sometimes in an opportunity fund only.

*“We have no preference. We look at the un-g geared returns and if they meet our investment criteria we do not care whether there is gearing or not. However for pension funds, gearing has implications for overall asset allocation. If the fund has an allocation to cash, the gearing will dilute this exposure.”*

*"It depends if you are an optimist or a pessimist. Gearing is preferable in a rising market. I suppose gearing is preferable if it is going to improve returns and we would look at something with low gearing (say 5%). We cannot gear our direct investment."*

*"Gearing is not the main attraction for us but the ability to gear is helpful, depending on the market conditions. We do have a fear of things getting out of control so we would not want to see gearing above 50%."*

*"This is probably helpful, but is not essential. Ungear performance is key."*

## **Managers**

The manager sample was also split by this issue. Eight managers considered gearing to be essential, while the remaining 12 thought that gearing was not essential, or depended on circumstances. Typical levels quoted were 40-60%.

*"Gearing is essential. With 13% yields, and 75-80% gearing, much of the performance comes from gearing."*

Gearing is thought preferable for higher returns, and for tax efficiency in some cases. But some pension fund rules do not permit gearing, while some insurance funds choose not to gear directly for actuarial reasons (a decision to hold cash can be damaged by gearing other assets. *"It is certainly preferable. It is part of the attraction of doing these things. It is gearing through the back door as it is off balance sheet, non-recourse. All things being equal it should enhance returns. We can gear directly, but it impacts asset allocation. If you gear property directly you reduce the size of your fixed interest book as you must net off your borrowing from what you lend to others (bonds). The thinking behind this stems from looking at the liabilities that these assets are trying to match. With LPs the gearing is invisible because it is off balance sheet - you only see the property exposure."*

*"Some investors want gearing, others no. The split is about 50/50. Our fund has only 10% gearing allowed and this is solely to provide working capital. The market will eventually differentiate between geared and ungeared vehicles. The LP should provide what the investor wants. At the moment most LPs seem to be geared."*

*"Gearing is not preferable. It is often used to disguise the fees charged with insufficient recognition of the effect on risk."*

*"Gearing is of secondary interest. The ability of the operator to out-perform is more important. Gearing did not help in 2000. Gearing will damage immature funds buying assets with high set up costs."*

*"This is not essential – it depends on the objectives of the investors and manager. The management of gearing is a skill set that only some managers have, and high gearing is only natural in a LP."*

#### **4.5 Are these vehicles tax-efficient? How does the tax efficiency of private property assets, shares in pooled vehicles (PUTs, LPs) and shares in quoted companies compare?**

##### General

The majority of those questioned regarded all private property vehicles as tax efficient, although some preferred the term tax transparent, with PPVs having a clear advantage over property company shares (which are not tax transparent).

(Tax efficiency is not the same as tax transparency. While these two terms may have the same effect in practice, they are different technically. For example, for a corporate investor, a limited partnership is tax transparent, meaning that the partnership is disregarded for tax purposes, and all income and gains are taxed to the UK corporate investor as if he owned his share directly. Therefore, in this situation, investment through a limited partnership is no more tax efficient for a UK company than owning property directly, or investing in shares in a property owning company (as dividends from UK companies to UK companies are outside the scope of UK corporation tax).)

Some suggested that for tax-exempt pension funds in particular this factor was over-rated.

*"It is not the structure of these vehicles but the underlying assets that drive our interest. Having decided we like the assets and/or the management, we then ask ourselves if we can live with the vehicle."*

A smaller group expressed stronger doubts, and suggested that the tax efficiency of the vehicle depends on the investor.

##### LP v PUT

There was very limited knowledge concerning the relative tax efficiency of the LP and offshore PUT vehicle. A small number of investors had formed the view that offshore PUTs offer equivalent tax transparency to LPs, but the offshore PUT has not been promoted to the same extent as LPs. There is a perceived potential to change the tax treatment of offshore PUTs, which renders their investors somewhat more vulnerable than LP investors.

For some, LPs are seen as 'properly' tax-transparent while offshore PUTs are 'effectively' tax-transparent. The tax treatment of a PUT differs between exempt, non-exempt and offshore PUTs.

Two tax differences were commonly mentioned. First, there is a deemed disposal for all existing partners every time a new partner comes into an LP (although see above). This can be especially problematic for UK Life Funds.

Second, there may be a annual phantom tax charge based on assumed disposal spread over 7 years for life funds in an offshore vehicle (including offshore PUTs) (see section 4.1).

##### UK charities

Dutch tax laws do not recognise UK charity fund status. For charities, offshore PUTs are equally as attractive as LPs, however, alternative Dutch-based offshore structures are not as attractive as UK charity status is not recognised.

## Overseas investors

Raising local (UK) debt against rental income is key to the tax efficiency of a UK limited partnership for an overseas investor, as this can reduce or extinguish liability to UK income tax, payable on UK source income. This liability is met, unless the overseas investor obtains clearance under the Non-Resident Landlord's Scheme, by withholding tax at the basic rate of income tax on rent. If clearance is obtained, the liability is met through the income tax self-assessment regime. This may make non income-producing developments difficult to finance in this way and raises the required running yield. There is also a threat that this device may lose its effect, in which case moving offshore would be logical.

### Exempt funds and trading

UK PUTs can be 'exempt', meaning available only to tax exempt funds such as pension fund and charities. Pension funds and charitable foundations are required to behave as investors and cannot be seen to trade (engage in excessive buying and selling activity) in order to maintain their exempt status.

One can churn investments in an offshore PUT but not in an exempt PUT or LP without breaking the tax exempt status of the gross funds (this is effectively the downside of an LP's tax transparency). As an example, one particular manager has created two successful LPs, but their third fund (which is a trading vehicle) became an offshore PUT.

### Operating revenues from service companies

The operating profit from service-based properties such as hotels may be taxable at the corporate level.

#### **4.6 At what rate does stamp duty apply on transfer? How will increasing stamp duty costs impact the liquidity of the market?**

There is confusion in the market concerning the impact of stamp duty on PPVs. Is stamp duty charged on equity or gross assets? Is the effective rate on transfer of a share in a vehicle 4% (the rate for property valued at £500,000 or more ) or 0.5% (the flat rate for securities)? Is stamp duty relevant in explaining the growth in the market?

The interviewees were hung over the importance of stamp duty in explaining the growth in LPs and the extent to which the vehicle can help to avoid this tax. Many of those questioned felt that it was obvious that stamp duty has increased the appeal of LPs, and that continued increases in stamp duty would further strengthen the popularity of the vehicle. *"In a highly geared vehicle, the impact of stamp duty can be enormous as a proportion of the investor's equity. PPVs and corporate deals through SPVs will continue to become more popular."*

Equally, many felt that this is a red herring: *"Stamp duty has no effect on the attractiveness of the vehicle, because the fund has to pay stamp duty when it buys a building."* *"Even if vehicles are apparently efficient in terms of stamp duty, it will all come out in the wash as the vehicles themselves will have to suffer high duty on acquisitions."*

Most investors, however, accepted that stamp duty has focused attention on the PPV, either due to perceived stamp duty effectiveness or to actual stamp duty savings.

*"Stamp duty has concentrated investors' minds on LPs."* *"Arguably, stamp duty has enabled the market to exist."* *"Rising stamp duty has probably been a modest spur to the*

*market, but eventually the government is likely to plug the loopholes. Since stamp duty has risen, the lives of LPs have lengthened.”*

Some are more sceptical. *“This is all to do with perception. As trading costs increase there is an implication if not a fact that vehicles are more efficient.”* *“LPs would have happened without stamp duty rises. But stamp has created a focus on vehicles despite the lack of obvious stamp duty savings.”*

The stamp duty efficiency of PPVs needs to be examined more carefully. Three alternative situations arise. First, what happens if investors club together, combine capital into an LP, and the LP then buys properties? Second, how does the situation change if existing properties are placed in an LP by a general partner, who then raises capital from more limited partners? Third, what happens when a share in a LP is transferred? Fourth, how is the situation different for offshore PUTs?

#### Primary market: raising capital

A small number of interviewees confirmed that new money going in does not attract stamp duty. But as soon as the vehicle purchases a building in the UK, it will pay stamp duty like any purchaser.

If the transaction is executed offshore, stamp duty does arise, but as penalties for late payment only begin to accrue 30 days after the document is brought back into the UK, stamp duty is effectively deferred.

#### Primary market: existing buildings split between more investors

Investors were agreed that if an LP already owns properties then this is advantageous in respect of stamp duty when new investors are introduced. Devices include splitting and not selling legal title, passing beneficial interest and leaving the legal title behind; ‘resting on contract’, with no completion, using 100% non-refundable deposits; and offshore transactions.

However, it is not clear that there is anything special about an LP in these respects. While some of the avoidance schemes clearly require the introduction of a second owner, with an LP being an obvious structure, offshore transactions are equally efficient for the sale of an individual asset. *“The key point is that a single property transaction is less likely to be dealt with in this way because the parties do not share an interest. In a JV or LP several parties can have the same interest, and where property is swapped into an LP these interests can be equal. In addition, the trouble taken to avoid stamp duty works so much better if properties are bundled together in the same tax efficient LP wrapper.”*

There is a view that HM Treasury is aware of the loopholes and that these may be subject to action at some point.

#### Secondary market

*“I am not sure I know at the moment. We started off thinking LPs would be stamp duty free, then it looked like it might be the full 4%. At present it is unclear. This is a huge issue. Stamp duty is killing the property investment industry.”*

There is great confusion in the market over this point. On later sales of LP shares, it is not at all clear at first sight what the situation is: some investors believe stamp duty can be reduced to 0.5% on subsequent transactions of LP shares; some believe the full 4% is

payable; some believe no stamp duty is payable; and the more experienced group are aware that the incidence of stamp duty on purchases of limited partnership shares depends on the structure.

Stamp duty may in some circumstances be avoided by the existing LP relinquishing units, the partnership borrowing money and the incoming party taking up new units although this needs careful planning to ensure the saving is effective. In addition, offshore exchanges of units and LP shares defers stamp duty until such time as the documents are brought back onshore. *“An offshore transfer with documentation staying offshore attracts no stamp duty. Proof of title can be provided by the GP and an advert in the London Gazette.”*

*“Buyers paid 4% on the (fund name 1) transfer, but this should be 0.5% on (fund name 2), which is more carefully structured. If stamp duty rises there will be more interest in LPs, because the tax-saving structure does work.”*

*“Some investors are forced into structures in which the full 4% is unavoidable.”*

#### LPs v PUTs

The simple answer appears to be that there is a 4% stamp duty charge on the sale of an LP interest as an interest in an LP is not a chargeable security, and 0.5% on sale of units in an on-shore PUT (from 6 February 2000). Transactions in an offshore PUT can avoid stamp duty on transfer, just as offshore LP transactions can be effective. The advantage of the offshore PUT seems clear: once the administrative effort has been applied to setting up the offshore structure, tax- and stamp-efficient capital raising and secondary market transfers can be more easily undertaken.

#### **4.7 UK institutions appear willing to invest in UK vehicles investing in UK property assets. However, they seem more reluctant to invest in pan-European private property vehicles. Why is this?**

The overwhelming view of those advisors, investors and managers questioned was that this issue is not to do with structures: it is to do with the lack of interest shown by UK investors in overseas property:

*“UK institutions tend to stick to the UK property market because it more closely pertains to their liabilities.”*

*“We did a survey and found that most managers still were not interested in overseas investing. It comes back to the asset/liability problem. How are you going to compare your performance if you invest overseas? What is your benchmark?”*

More harshly, it is also due (in the opinion of some) to the unprofessional attitude of many investors.

*“The reliance of UK investors on benchmarks is unbelievable and has cost them much in return.”*

*“UK institutions have not done their homework.”*

*“This is due to an incredible lack of research by UK institutions. Not enough background work has been done.”*

The key issues here are as follows. First, there is widespread agreement that the best way to enter non-UK market as a UK investor is certainly through a co-mingled vehicle, and overseas (including Dutch) investors coming into the UK agree. Second, investors have been hurt in the past when investing overseas, and need to see a long and successful track record of investment by the manager in the chosen markets(s). This does not yet typically exist. Third, and related to this, there is a limited number of suitable vehicles on offer. Fourth, the dominance of benchmarking is a clear drag on innovation. Fifth, liability matching is also a hindrance. Sixth, tax is country specific, so these ownership structures have to be country-specific, probably under some umbrella ownership, adding to complexity and due diligence costs.

As the popularity of the PPV structure has increased, most are agreed that in time this will help to send much higher levels of UK capital overseas. There are now several successful or attractive non-UK PPVs. The market seems set for a deep and long term change of attitude, and PPVs will help this to happen.

*“Historically there has always been a geographical approach to asset allocation and the home market is considered first. Foreign investment entails taking many additional factors into account such as currency risk. There is also a lack of familiarity as to what is available outside the UK. This is changing and foreign investment is growing – but only slowly. We have not pushed our clients to invest in foreign property. Property is only a small part of their portfolios.”*

*“I don’t know much about European structures, but the important point is whether one wants to access these markets at all. Until we are comfortable that we understand a market and we are capable of researching it, have enough data, and that there are robust indices, we don’t want to access a market - directly or indirectly. We have not decided how we will access Europe. There are probably certain markets that we’ll want to access indirectly or in partnerships.”*

*“If we were going to invest overseas we would almost certainly do it through indirect vehicles. If there were more overseas invested indirect vehicles there would be more choice and more interest in this type of investment.”*

*“Non-UK property may simply be of less interest to UK investors. But international investment clearly works best through vehicles.”*

*“This is not an LP specific problem. If you decide to invest in Europe, partnerships are probably the best way. Otherwise you need to invest in enormous new infrastructure.”*

*“No one has a feel for these markets as yet, and no one wants to invest blind. However, we would look at a European fund. We haven’t yet but we could. If someone had a great 10 year track record we would listen.”*

*“We have been actively looking for a Pan-European LP. There is not the supply. We would be looking for sector-based pan-European funds. We want expert management with a track record.”*

#### **4.8 How is the life of a LP normally extended?**

There was widespread agreement about LP extension provisions. There is usually a mechanism to extend the life of a vehicle for one or two years post the stated termination date, the vote often being taken two years before expiry. This will be by unanimous vote

or, more commonly, by majority (usually 75%, with a range of 66% to 85%) agreement. There will be provision for the minority to be bought out by the majority in these cases.

The extension may sometimes be repeatable or even roll on indefinitely. If unanimous agreement is needed and a minority wish to exit, managers are likely to find a way to exit, probably through finding a new partner to buy out the one that wants to leave; alternatively, a new vehicle may be created by the fund manager for new investors or existing ones to take over the existing assets. Some subset of the existing investors may buy out the leavers by gearing up the portfolio.

A fee re-negotiation may have to be faced by the manager at the extension point. General partner contracts are not terminable, but in the views of some investors and advisors asset management contracts should be, and will aid the marketability of the structure.

#### **4.9 Will limited liability partnerships make a difference?**

During the course of this research the government indicated that limited liability partnerships would not be tax effective for exempt funds. Hence the interviewees were unanimous in their view that LLPs are of no interest as alternative structures.

*“The LLP was seen as a back door REIT, and promoted heavily as such by the industry, but LLP changes in the budget has killed the idea.”*

There are some residual points of interest. Each partner in an LLP can commit the whole fund, and this is a large and generally unconsidered problem. The Myners Report has recommended that LPs be extended beyond 20 partners, which may at some point allow listing to happen. Finally, one or two ‘no comments’ suggests that some work is continuing in addressing ways of using the LLP structure.

#### **4.10 What is current practice in performance and management reporting from operators? Is there much difference between different operators? What would be the ideal level of reporting?**

##### Regularity

There is general agreement that quarterly property and financial reports are both standard and preferable. More detailed and usually audited annual reports are common. A few managers report on a semi-annual basis and some report monthly. *“Quarterly reporting seems to be favoured by investors. Many have said that they do not want to read reports every month on this type of vehicle.”*

*“Generally, reporting has been very good and GPs have taken their roles quite seriously.”*

*“There is a variation in reporting standards and some are not of a sufficient standard.”*

*“We report monthly and do quarterly independent valuations – and think everyone should.”*

*“We believe we do it well, with audited processes. We encourage the parties to share consultants and share lawyers, and we provide an audited financial modelling package.”*

## Detail

*“At present we get more detailed information than we actually need.”*

Practice seems to be very variable. There is a dichotomy of view over the extent to which property information is essential. Parallels with unit and investment trusts, and the absence of company-specific data in their reporting, can be drawn, but a better parallel is private equity where more information is required due to the absence of public information about the underlying investments. This can be extended to distinguish the property joint venture (where property data is vital) from a true collective investment scheme (where there may be a larger number of properties).

*“More information on the financials would be preferable. Modelling of future performance is very poor.”*

*“Investors need an accurate projection of their income stream. That is what should be important to them in an arm’s length investment. They also need accurate information on what factors are impacting the capital values of the fund’s underlying assets.”*

*“The market is very mixed and there are many variations. Some reporting is very casual, particularly developers who just want to get property off their books. In an arm’s length investment, regular reporting and attention to detail are crucial.”*

*“There is confusion. Should there be property or financial reporting? We believe the investor should not be able to kick the tyres.”*

## Regulation

Concerns were raised over the extent to which LPs and PUTs are regulated by law. While the Association of Property Unit Trusts exists to provide a level of regulation for PUTs, no equivalent exists for LPs. One advisor commented that the current FSA requirements placed on operators are taken insufficiently seriously by promoters, but that the Financial Services and Markets Act 2001 will require general partners to be authorised.

*“Lack of regulation is not a serious issue per se, but more regulation will be a means of attracting more capital. We must be careful to distinguish property joint ventures from collective investment schemes.”*

## Performance reporting

There is widespread confusion regarding the way in which PPVs are and should be measured for performance purposes. IPD currently measures the performance of a share in an LP as if it were a single property investment, making no distinction between a long life collective investment scheme and a two-owner joint venture. The growing importance of AIMR’s GIPS (Global Investment Performance Standards) initiative will clearly begin to directly affect PPVs.

This is challenging for IPD, because the IPD index measures ungeared property returns: unpicking the effect of gearing from a joint venture may be possible, but collective investment schemes present more of a challenge.

*“Property performance and vehicle performance are both interesting, and IPD should measure both. The Association of Property Unit Trusts has done a good job in the PUT*

*market. Why not extend this to all collective investment products? More standardisation is needed to help make investors more comfortable.”*

In addition, there will be understandable reluctance on the part of managers to report returns in the early years, as it will take time for performance to overcome the vehicle's set up costs.

## Part 5: Liquidity

This section addresses the primary and (more importantly) secondary markets for PPVs, possibly the subject of greatest interest in the PPV market.

Is there a secondary market? Is there demand for a more active secondary market in property funds? What is needed to create an active secondary market in property funds? How many investors of what type would join the market if liquidity existed?

How many other investors would be interested in private property vehicles if there were more information and transparency, and/or more liquidity? What liquidity is needed? What is a reasonable price for that liquidity? How does the liquidity and trading costs of private property assets, shares in pooled vehicles (PUTs, LPs) and shares in quoted companies differ?

What information will managers need to provide to investors to maximise marketability? What is best practice in fund accounting, fund administration, valuation and performance reporting, legal structure, fee charges? How much will investors value transparency in property information, and what information will they value most?

### 5.1 How does the primary market work – how is capital raised?

Various different models exist for LP capital raising, the three main models being as follows.

Where small numbers of parties join together in a joint venture, there will be no need to raise capital, and a private agreement is reached to share ownership of an existing or target building. This partnership may be put together principal to principal, or through an agent operating quietly 'off-market'.

Where external capital is to be raised by the originator of the concept, two models exist. The originator may raise capital by producing a concept memo, arranging and delivering pre-marketing presentations to 'warm contacts', and then producing an information memorandum verified by lawyers that may be distributed more widely.

Alternatively, external capital raisers (usually agents) will be appointed. There are three or four market leaders, usually corporate finance divisions (because promoters need to be FSA registered) within the larger chartered surveying consultancies. The non-originating promoter (capital raiser) is sometimes rewarded via an interest in the vehicle, a fee or both. This will depend on their other interest in the vehicle, for which they may also act as asset manager or operator.

LPs may sometimes be grown by arranging property for unit/LP share swaps. Further capital may be needed to fund improvements and re-development. This is often achieved by offering shares pro-rata to existing participants (like a rights issue).

Larger capital raising exercises (ProLogis, for example) might involve investment banks, but this is very rare.

There are key differences between PUTs and LPs. The open-ended pooled fund is always open for new investment, and the institution running the vehicle will usually seed the fund and then see if it can attract further investor interest. Often the fund manager will use actuary/consultants as a means of accessing and informing the wider small pension fund market. These consultants are not involved in capital raising for LPs.

*“We did the first fund very formally, with formal sponsorship and going around the market with a presentation. The second we did much less formally which is far more typical of the LP market. LPs tend to be more like glorified joint ventures than true ‘hands off’ co-mingled investment vehicles. However, there is a growing sophistication and the market is getting more formal as it matures. There is a trend toward greater size, more investors and more of a proper co-mingled vehicle stance.”*

*“The easier it is to raise capital, the worse are returns. Historic performance tends to drive interest, but this is misleading.”*

## **5.2 How many investors are preferable in a LP?**

### **Advisors**

Opinion ranged from “as few as possible” (three to five, or perhaps five to 10), through “it depends”, to “the more the merrier”.

Low numbers are favoured to protect the interest of the limited partners and to simplify management.

*“Three to four plus a promoter is a good size. More than four or five is always going to be an unwieldy instrument. If there are too many investors, each individual does not feel they have sufficient input and one of the main attractions of an LP is that each partner feels they can make a contribution.”*

The distinction between a true co-mingled fund (collective investment scheme) and a joint venture emerged as an issue for serious consideration.

*“It depends. Some just want a joint venture type arrangement, but those that want to be a ‘fund’ usually want eight or more investors.”*

Delaware and other non-UK LPs are not limited to 20 investors, and some offshore structures may begin to look more attractive for true co-mingled funds, even perhaps as retail products.

Two advisors suggested that liquidity demanded that as many investors as possible was optimal. In addition, preferred absolute limits on the damage suffered by an investor in an under-performing or illiquid vehicle suggested a problem: *“We prefer clients to hold less than 5% of PUTs and any other private property vehicle, so LPs create a problem by definition.”*

### **Investors**

Investors had a slightly different view: three to seven, five or six, five to eight or five to ten was suggested by the large majority of those interviewed.

*“Five or ten so that no single partner has undue influence. This number also affords more liquidity. There are more partners to sell your stake to without going to the market.”*

*“Fund A has 20 – and that is too many. Fund B has four – and that is too few. The optimum would be between five and eight. Some partners believe they should have undue influence because of their size and who they are, which can be disruptive. It is helpful to have a spread of views around the table, but it has to be manageable. Each partner should have input into what is happening and when there are too many around the table this gets difficult. My board expects me to have an input because the LPs are among our largest individual investments.”*

Three investors stated that the optimum number of investors was not key, or depended on circumstances.

*“It depends on the size of the vehicle. Perhaps 10-20. Not three to four. It has to have enough investors so that no one dominates it, but not so many that you cannot get a consensus view.”*

*“If there is only one property, maximum three investors. If it is a big LP it does not matter if it's two or 19 as a partner has no say in running it.”*

### **Managers**

Seven of 20 managers had a preference for large numbers of investors (up to 20), primarily to aid liquidity.

Five to ten was popular with three managers: a smaller number was popular with six managers. The most common reason quoted was ease of client management and reporting.

*“(Manager A) is a property manager, not an investment manager, so administrative intensity is not an objective. Hence three or four partners is fine.” “More than two, less than 10. Four to five is ideal, to save reporting.” “No more than eight or nine, to create manageable relationships.”*

Investor influence was seen as important by some managers.

*“Consultative committees are important for investors to have their views known, and more than 6 makes this less effective.” “Four to five investors are ideal because no one investor will be dominant but there is sufficient focus. Any smaller and the vehicle becomes no different from a joint venture.”*

The remaining managers interviewed suggested that the ideal number of investors is either an irrelevance (*“Whatever is needed to get the capital in”*) or depends on circumstances, with the distinction between the JV or true co-mingled product again seen as key.

*“This depends on the product. In a joint venture, small numbers are appropriate. In a true co-mingled product, the more investors the better, as the investors should rely on the manager’s discretion, or they are not getting what they are paying for.”*

### **5.3 Are LP pre-emption rights typical? Are they desirable?**

On balance, pre-emption rights have become unpopular with the majority of players. As an illustration, many references were made by interviewees to an individual example. Advisor A marketed Investor A’s £25m share in Fund A to the market and achieved a 10% premium over valuation on sale to Investors B and C (each of whom had pre-emption rights).

Despite the premium, investor A was not happy with the process: it would have preferred that the manager persuaded existing investors not to exercise pre-emption rights, in which case (it argued) a higher price would have been achieved and existing investors would have seen a greater valuation uplift.

### **Advisors**

Advisors were generally agreed that, while pre-emption rights were initially standard in LP agreement in the 1900s, they are becoming less typical and are generally not desirable.

*“There is now a strong feeling against pre-emption rights. These rights will have to be waived on future secondary market sales of LP shares.”*

Some reflection on the way in which the pre-emption right might be sensitively modified was urged: *“They have been typical but are not desirable and now falling away. But why not have pre-emption rights only if property is being sold at less than NAV?”*

*“In some development-type LPs, pre-emption can apply over a certain period while the properties are being developed, after which they are no longer in force.”*

Finally, the distinction between the JV or club and the true co-mingled product was raised again in this context:

*“In joint venture type LPs they are typical and desirable. In ‘fund’ type LPs they are no longer typical or desirable because they reduce liquidity.”*

### **Investors**

Four investors thought these clauses to be undesirable on balance because *“they complicate matters”, “because the GP does not want to be in business with his opposition”* or *“because they reduce liquidity”*.

*“We’ve seen LPs with and without pre-emption rights. There’s no clear answer here. On one hand, pre-emption gives you some degree of control over who comes into the vehicle if someone sells. On the other hand, pre-emption rights impact the price of the interest one wishes to sell. What does that do to the value of the interest that one is holding? On balance we might prefer no pre-emption rights so the market can determine the price.”*

*“They used to be typical, but we have just voted to remove them on (Fund A). It depends on the situation. The majority of investors now think they will get a better price in the market if there are no pre-emption rights.”*

The US private equity-style LP is clearly different: *“We are not allowed to exit. These are strictly limited life products, with no-pre-emption rights.”*

Three investors, who all saw themselves as natural co-investors rather than investors in funds, had no doubt that pre-emption is desirable: *“Yes, pre-emption is typical. It is also desirable – in fact critical to us. I want to know who the other partners will be because I want the other investors to have similar aspirations. I am in an LP with conflicting aspirations and it creates problems. I do not buy without pre-emption rights.”*

## **Managers**

Some managers accept the need for pre-emption rights:

*"I think rights of first refusal are desirable. If a partner wants to sell, he tells the other partners what price he wants and they have 28 days to accept. If no one buys, then the seller can offer his share to the market at a price not less than was offered to the partners."*

*"They are acceptable, to provide control and limit the influence of potentially dominant investors."*

*"Investors may require them to protect against dilution and the potential CGT impact".*

But in the main managers do not like pre-emption rights: thirteen expressed a strong view to this effect, consistently because the impact on liquidity is seen to be negative. The attempted sale of a share in the Lend Lease retail partnership (the Bluewater LP) on the secondary market was consistently quoted as a reason for not having pre-emption clauses in a true collective investment scheme.

### **5.4 Are LPs strictly limited life products?**

#### **Advisors**

Limited partnerships are often assumed to be limited life products, if only because investors usually have the right to force the winding up of the partnership at some point in the future, typically 7-10 years from closing. Increasingly, however, the market includes those who do not expect funds to be wound up: properties may be sold, but the vehicle itself is expected to continue. The majority of advisors feel this to be the case.

*"I would differentiate between the portfolio and the vehicle. Most portfolios will not be fully wound up. However, investors want and need the ability to exit. There is usually a mechanism to extend the life of a vehicle for one or two years if the point in the cycle is not a good one for wind-up. No one wants a fire sale."*

*"There can be no secondary market in true short life vehicles."*

*"They are probably long life funds. I am not convinced about how easy they will be to wind up. Unless the market is disastrous they will continue."*

*"The LP format was developed for venture capital which matures; property is different and cyclical, and this naturally forces extension. But they are largely in limited life format, which acts as a way out and a proxy for liquidity. It is a form of direct ownership."*

*"In many cases the portfolio will go on. A new vehicle may be created by the fund manager for new investors or existing ones. Some subset of the existing investors may buy out the leavers by gearing up the portfolio."*

Other advisors suggest that external factors will encourage longer life products. *"Lending banks may insist on long life, and some new products have up to 30 year life. (On extension) fee levels will have to be changed, and the manager must be removable."*

Some advisors make the point that competing managers invested in another product may force closure. One advisor only felt that the vehicle should close at a finite point: *“property is a cyclical performer, so there is a strong case for a limited life format and funds should be more prepared to play the cycle in this way.”*

### **Investors**

Investors demonstrated a clear split between two opposing views. On the one hand:

*“We assume they will be extended, but it is nice to know that they have a finite life in case we want to walk away.”*

*“They are not essentially limited life, despite the agreements”.*

And on the other:

*“All (Investor A) investments are developments and strictly limited life. The exit point is natural – as soon as income is stabilised.”*

*“We are not allowed to exit. These are strictly limited life products, with no-pre-emption rights. The funds are completely illiquid.”*

### **Managers**

The overwhelming view of managers (15) was expressed as a preference for LPs to be long life products.

*“Ours expire after 10 years, but I would be surprised if they did not go on in some form – as long as they perform and there is sufficient liquidity in the stakes. There is no particular reason why they should not continue in some form.”*

*“LPs are not limited life vehicles; the end date is set to allow an exit, but promoters and investors normally expect to extend. Hence valuation-based fees may be necessary. Some partially open structures exist, with exit options every two years.”*

*“Investors should plan for LPs to be wound up as advertised. Managers should be subject to this pressure, as the pressure to earn fees can otherwise lead to inappropriate behaviour. On the other hand, set-up costs and the time taken to close (8 months is typical) can encourage extension. Why wind up a successful business that cost money and time to establish?”*

*“LPs have to have a limited life. Investors feel the need to be able to get out because the market is immature and there is no effective secondary market. However, the market is moving towards longer life vehicles.”*

*“We see these as long term vehicles, even though they are set up as partnerships with a 10 year life. The set up costs encourage longer life and we may sell assets but retain structure by re-investing. Eventually all larger assets may be held in this format, which will grow and become more popular.”*

*“We used to see these vehicles as strictly fixed life, but now we see the structures as long life and the assets as short life. The vehicle is not used tactically. The structure will be finessed into a long term vehicle.”*

*“They are fixed life, but we expect to extend indefinitely.”*

*“Our vehicles should have been set up as longer life products. Short term performance shortfall damages the interests of some IPD-benchmarked investors. Why not reward the initial investors for taking this hit, while creating longer life products with higher fees for later joiners? You can have a long life vehicle with transaction based fees: the vehicle simply trades. This should not create any tax or actuarial problem for institutions when the LP is such a small share of total property assets.”*

While two managers run strictly limited life products, the minority view indicated some unease about using the LP format for long life products.

*“Yes, limited life. Investors should have no right to exit. Long life products only work if the manager dominates the market sector in the long run.”*

*“A finite business plan is a good feature of an LP. Offshore PUTs are better long term products.”*

## **5.5 Are shares in these products liquid compared to direct property investments and shares in quoted companies?**

There are arguments in favour of LP liquidity relative to direct property and there are arguments against. The major argument in favour is the opportunity to reduce due diligence costs where the manager provides full information (*“Shares in LPs could be liquid if GPs acted to provide full vendor packs”*) and investors concentrate their decision-making on the manager and his proposition; the opportunity to reduce stamp duty by offshore trading is also available (but also exists in the direct market).

However, given that few investors are yet prepared to behave as if they were unit trust investors choosing managers and funds and not the underlying companies, the arguments against are currently overwhelming. Advisors, investors and managers all agree that presently PPVs (especially LPs) are less liquid than buildings.

There is no established secondary market for LP shares, with 6 or so trades so far recorded; investors feel the need to undertake double due diligence, examining both manager/vehicle issues as well as property issues; and pre-emption rights, still prevalent, inhibit the willingness of new investors to expend time and money in pursuing shares in LPs which are likely to be bought by existing partners. In addition, fee levels can be slightly higher on the sale of an LP share than when selling buildings.

*“Very illiquid compared to both. The properties, the partners and the structure all contribute.”*

*“Absolutely less liquid, due to pre-emption rights and due diligence. The operator can prevent sales to competitors/undesirables.”*

*“Buildings are probably easier to sell because there is a wider market. It may just be a question of people understanding these things better.”*

*“They are less liquid than both direct property and quoted companies. But there has not been time for a secondary market to develop.”*

*“They are not liquid. There is no decent prospect of secondary market sale. Promoters creating LPs are aggregating assets and may be damaging value by introducing a liquidity risk premium.”*

*“Generally, these vehicles are less liquid unless we are at the top of the market.”*

*“The next 5 years will prove the case one way or the other. There is now enough volume for a secondary market to become established, but there will be no market makers. If the asset share trades at NAV, how will they make a turn? An over-the-counter market will develop, driven by brokerage fees charged by brokers.”*

*“Single asset LPs may trade more easily than the properties. Multi-asset LPs will go to a discount, which will create too large a bid/ask spread in a poor market. Generally, there is no secondary market in these products, which are ‘club’ investments. All SPVs trade at a discount.”*

*“ They are currently illiquid, largely because double due diligence is required. As investors gain more confidence in their general partners/managers then less due diligence will be needed and the market can become more efficient and liquid.”*

PUTs are regarded by some as being very different from LPs. As open-ended vehicles with established dealing mechanisms, this form of pooled vehicle *“can be more liquid than direct property investment unless it is a time of extreme distress”* but *“in difficult conditions pooled can be less liquid because the manager has the right to delay the liquidation of a holding. If the transaction is large enough to necessitate the liquidation of underlying property holdings it can take time.”*

*“It depends on performance. If you had a poorly performing PUT and a poorly performing direct property they would be equally hard to sell. The converse is also true.”*

*“LPs are not liquid, but PUTs are.”*

On the other hand: *“In the 1970’s there were PUTS invested in North America and everyone involved lost a fortune. Investors could not get out for 10 years, and many of the investors that experienced this would never invest in an indirect vehicle again.”*

**5.6 Do you believe that improved liquidity would be desirable? If so, how might such liquidity be introduced? Is there a secondary market? Is there demand for a more active secondary market in property funds?**

Possibly the subject of greatest interest in the PPV market is the potential for secondary market trading of LPs and other private property vehicles. To date, there appear to have been few secondary market deals, with 5 regularly discussed (UK Prime, Whitgift, Cheshire Oaks, MWB and Lend Lease Retail Partnership). There is an enormous demand for more liquidity, but scepticism as to whether this is achievable.

**Advisors**

The advisor group was split between those who unreservedly saw the introduction of more liquidity as desirable:

*“Liquidity would be very desirable and great for advisors. We would use it. Why should there be any differences between sales in the direct market and the market for shares in vehicles?”*

and those in the large majority who, while agreeing over its desirability, were sceptical about its achievability.

*“Yes, liquidity is a possibility. But fees, lack of transparency and lack of trust in the format/market will lead to a discount. Investors insist on looking through the structure to the properties.”*

*“Stamp duty is a problem in terms of creating a secondary market. Basically you cannot use stamp duty mitigation techniques with traded instruments. No one will be a market maker because of it. Also the purchaser of a share in an existing LP is often liable for the tax. An exception is charities as they do not have to pay stamp duty. They may become a more important player in this market.”*

*“I think LPs would have to be a more standardised vehicle to be liquid and I do not see that happening. It would require a standard level of service from the Managers and the investments are just not homogeneous enough for this. There will always be differences in the management intensity of schemes and therefore the fees that should be paid.”*

*“We need legislation and mechanisms like they have in Australia to create a liquid traded market.”*

*“Yes, improved liquidity is always desirable. The caveat is at what cost. If LPs were more liquid one of their disadvantages would be addressed.”*

*“I don’t know how liquidity for LPs could be introduced. In vehicles I am familiar with, such as PUTS, investors tend to be long term. They can already trade when they want to (liquidity issues are not suppressing a desire to trade).”*

*“More education and more performance information is needed.”*

*“ Matched bargains are likely, but a true secondary market will be difficult. Changes in stock exchange regulation and tax are both needed to create true liquidity. Otherwise, informal markets may become more established.”*

The minority view concerned LPs as limited life vehicles. *“True limited life vehicles do not need transparency or liquidity”.*

### **Investors**

Four investors were unreservedly positive about the desirability of increased liquidity.

*“It is inevitable that a liquid vehicle will be introduced and LPs may be converted into this structure.”*

*“Yes, liquidity is desirable and will happen. We have used the secondary market, which operated just like the single property market.”*

However, the majority of investors expressed reservations about the likelihood of introducing liquidity.

*“LPs are probably not the vehicle for this”.*

*“It would be desirable, but pre-emption rights will stifle it. And at what price? A minority shareholder in an unquoted vehicle is in the horse trade business – this is not a liquid sector, and trading at full OMV is highly unlikely.”*

*“A closed swap-based over the counter market may work between similar-interest partners, but no true secondary market is likely. Making a market is just about impossible: who could make it?”*

*“The liquidity of a limited partnership share must be limited by the permitted maximum number of limited partners. This is not true of properties. Liquidity would be an advantage, but who will be sellers?”*

What is needed to create an active market? Information and transparency is seen as the key missing necessity by most investors, with market makers a key yet elusive requirement. Others suggest either that the PUT model seems to offer what is required (*“There should be a market price, and a bid/offer spread for LPs”*) or that legislation is essential before a secondary market in vehicles can work.

### **Managers**

12 managers were advocates of improved liquidity and were optimistic about the prospects.

*“Yes, this is key. Major consultancies should get together and create a market using some sort of technological platform. (Brokers) could create a platform for matched bargains or even make markets if there was critical mass (as bng as the secondary market was divorced from the rest of their businesses). We would use such a market.”*

Five admitted scepticism.

*“Yes, but it is not achievable. Let us see what happens in a downturn. In any event, there is no liquidity in the first two years of life of a LP, as costs need to be absorbed before performance is delivered, and no-one will buy close to the end of the life. So how large is the active trading window?”*

*“I do not know how liquidity could be enhanced. There is no secondary market. Each fund makes its own market. Some people have talked about creating a secondary market, but what discount would be needed to induce the market maker to take the risk? And the seller would not want to sell at a discount and crystallise a loss. One could match buyers and sellers at a much lower fee as is being done with PUTs”.*

Some managers have given serious thought to the way in which liquidity might be introduced.

*“Double due diligence should not be necessary. Costs can be kept very low if the manager prepares a seller’s pack and the buyer concentrates on the legal documentation and not the property. It may take a downturn to introduce some forced sales and liquidity. Some shares will sell at a discount, and some will not sell. There will be parties interested in dealing. International and retail investors need to be attracted to provide broad-based liquidity.”*

Information and transparency was again the most sought after market improvement (mentioned by eight managers) as a route to liquidity. Others sought more radical change.

*“Yes, it would be desirable but it is not clear how it might be achieved. Packaging property in manageable chunks is an ideal, and once this can be done then all institutional property can go into funds, creating a true unitised market.”*

*“Liquidity is desirable, but not really achievable without the use of capital markets.”*

*“A secondary market will not work yet. There is not enough transparency of asset values and valuations do not yet reflect the possibility of trading.”*

*“We need more LPs, more varied and tailored LPs, and a change of view in the investment community regarding the need for direct control.”*

*“ There is too much property-specific due diligence in LPs. There should be more faith in the manager and his legal advisors. The market should be more liquid than it is and the need to undertake due diligence at both partnership and property level inhibits liquidity.”*

### **5.7 Do you see benefits in having a standardised structure and process for limited partnerships and other private property vehicles and what would these be?**

*“There are huge potential benefits in a standard process, but it will take outside interference to create it. These are specialist vehicles – so how can standardisation be expected? On the other hand, long and idiosyncratic documentation can inhibit liquidity. Negotiations can be immensely complex. LP agreements could hang off a broadly standard document.”*

#### **Advisors**

Two advisors unreservedly agreed that standardisation of documentation and detailed structure would be advantageous, with appointed advisors, especially lawyers, acting as a deterrent.

Three considered that documentation is already reasonably standard, as five or six legal practices dominate the PPV market, or that a simplified model is now emerging.

Two made the point that documentation for PUTs is already standard.

Three advisors thought that the standard structure is a pipedream: it is not possible to standardise the structure because the investments are too dissimilar.

Lawyer: *“Everyone thinks it would be a good idea but it is not really possible. We have never even been able to fully standardise shareholder agreements. However, we don’t re-create the wheel each time we do an LP. There could be a set of standard articles or stand alone bylaws to which we could add special provisions for each partnership agreement. Of course, that would take quite a bit of work/time/investment and then our competitors would copy it – so what is the incentive? However, if a group of investors wanted to pay us for drawing up standard articles we could do it.”*

#### **Investors**

Investors were split 7:3 in favour of those who would make an unqualified request for more simple documentation: one investor, a large life fund, quoted an example where a document of 200 pages was presented before a £10m decision had to be made, so he

shelved the proposal. This might be quite a reasonable length of documentation in private equity: was the investor complaining that he was unable to delegate the due diligence?

*“Yes, there is insufficient standardisation. “More standardisation is needed on corporate governance.”*

*“Yes, a standardised structure would be highly beneficial. At present you have to go through all the documentation each time, effectively re-inventing the wheel. Other markets, even derivatives, have standard forms.”*

*“Yes. The fees and carry should be standardised in a range according to management input. Standardised documentation would help as well since it would save on legal fees.*

*“Yes, and it is happening slowly. Some legal firms are leading the market and this produces standardisation.”*

Three were in the ‘yes, but’ camp.

*“I’m not sure how much further they could be standardised. LPs all have their little quirks but they are basically similar in structure. Property is too varied an asset to fully standardise these structures.”*

*“Time has already been spent on this in the UK. There are enormous benefits in theory but they are very difficult to achieve in practice.”*

### **Managers**

Around 40% of promoters would like to see more standard documentation, for some good reasons including the potential enhancement of liquidity. The concept of a seller’s pack has some support, and the role of the Association of Property Unit Trusts (APUT) in standardising some reporting features of PUTs is seen as a good lead.

*“Yes, standardisation would be helpful. Some areas would have to be left open for customisation to emphasise the scope and focus of the fund. It would make the transactions much easier to do. At present, each LP has to create its own documentation. Perhaps an association of LPs similar to APUT would be helpful and could drive standardisation.”*

The remainder see this as a long term preference which is unattainable in the short term.

*“Yes, at the right time, but not yet. Currently, the market is being driven for the benefit of the best operators: survival of the fittest.”*

*“This is unlikely to happen, just as standard leases and standard contracts have not happened.”*

*“There should be a range of these structures.”*

## **5.8 How much will investors value transparency in property information, and what information will they value most?**

What other information will investors need to encourage participation?

There are two information requirements necessary to help grow this market. First, managers need to produce information about the funds they manage; second, independent observers need to produce and distribute information about the universe of funds available.

### **Advisors**

#### Market data

There is a concern that confidentiality clauses may get in the way of the wider distribution of data. Key terms, investors, properties, life, fees, performance, pre-emption rights, business plan, basic sales information are all required, perhaps in a two stage process: basic details might be provided widely, with fuller details on application.

*“Transparency and information should be fully promoted. The need to create and promote fund management businesses means more marketing will be needed and this will produce more and more public information.”*

*“This is a big issue and the GP should help to provide transparency. A listing service is needed.”*

#### Manager-produced data

Most investors do not want a barrage of detail. They are hiring professional managers to deal with the details and they just want regular reports with processed information and analysis. Investors probably just want to know valuation, income and costs. In addition, any unanticipated changes should be well flagged.

*“Investors always value transparency. Investors need to know the strategy of the funds, the investment philosophy and the track records of the people involved. They require good reporting (semi-annual or quarterly) and clear value-added from the fund managers. There should also be someone continuously available to deal with questions. The whole process should be very open including how the funds are performing relative to expectations and why.”*

### **Investors**

Investors would generally like to see more information made available to the market.

*“We would like to have access to the sort of information we are used to having for our directly-owned investments.”*

*“Transparency is always a good thing, and would lead to lower costs. We have no problems in providing information to the market”.*

*“LP shares are less liquid than buildings because managers may prevent sufficient information from reaching the market.”*

A minority would prefer that information is not widely distributed.

*"We don't want a great deal of detail. We just want good performance. We get all sorts of unnecessary detail as far as we are concerned, but we may not be typical in this respect."*

*"Property is a quiet, inefficient market. Information and transparency may damage returns."*

*"This is a private market."*

The detailed information that investors would like to receive from managers is highly varied.

*"How much has operator invested? How does this compare with the fee take? Records of secondary trading. Partners. Structure, relationships."*

*"Performance figures are needed for the LPs that exist at present. Transparency of returns are needed. More transactions between investors would also encourage more participation. More knowledge is needed on the part of investors, more liquidity and more standardisation."*

*"Investors ...need to know general information about the sector and the fund manager's strategy. They need to know about the history of the performance of the sector, its risks and the track record of the fund manager. They need to know what kind of returns they can expect and they need to feel confident that they can get out. The development of a secondary market would definitely encourage participation in this respect."*

## **Managers**

Most managers were very clear that the market would benefit from the making public of more information.

*"Lots of education is needed to familiarise investors with LPs. Most institutions still do not know much about these vehicles. In fact the ignorance in some major institutions is astounding. There is a need to educate a wider audience of property investors as to how these vehicles work and what they have to offer."*

*"A single source of information would be valuable."*

*"Transparency is essential. Lack of transparency destroyed the quoted sector."*

*"There is much confusion and a lack of understanding of this market. There is a great need for more information and education."*

In addition, there are several qualified responses.

*"Transparency of information at the property level is a strength for the LP format over PUTs. But it is a private contract, and managers must respect investors' wishes. This is a property investment product, and professional investors are happily included in a club approach. It is treated as a direct investment."*

*"There may be a reluctance to disclose information to investors because of investors' requirements to maintain confidentiality. This will change in future."*

*"Fees are available in the annual reports and accounts of PUTs. Purely private vehicles will not issue such information in reports, but marketing packs will often share fee*

*information. Performance is disclosed in PUT reports, but LPs tend not to disclose this information.”*

*“There is a lot of variation. Some managers are worried about providing excellent reports for their competitors to mimic. High performers will be happier to advertise their performance, while some vehicles will remain very private. Transparency will certainly improve liquidity.”*

*“LPs should provide the same information as the PUT market”.*

Managers suggested the following details would be of interest to the market: dates of set up; investors; fees and performance; a statement of assets; gearing; start date, term date; valuation date; cash flow data; certificate of title, building surveys; tenancies; parties involved; legal and tax advisors.

### **5.9 What is the value of an LP/PPV share? How should a share in an LP be valued?**

Valuation of LP shares is an increasingly large issue. Nobody appears to be valuing shares in LPs *qua* shares; valuations are typically of gross property asset value divided by the percentage share owned. Few appear to be comfortable with this, and at the same time there is little agreement regarding potential premiums and discounts.

Should LP shares be valued on an initial yield net or gross of fees? If a property worth £10m on a 6% initial yield basis net of costs is placed in an LP format with a management fee of 1%, how much less is it worth? Should carried interest be rolled up and deducted from the LP share value?

There are examples of LP shares trading at a premium. This may be because there is no stamp duty payable, or no set up costs, or no need to set up the debt. Is there a premium for avoiding specific risk (unitisation)? Is there a premium for management expertise?

In addition, the debt structure may add to or damage value, depending on the terms of the debt. Advisors will offer an opinion on this, but valuers will typically ignore them.

Some believe that it is not appropriate for valuers to value shares in LPs. “They should value properties and allow the market to move to premium or discount.”

Recent concerns over valuations for performance measurement was directly relevant to PUTs and could easily spill over to the LP market, where a lack of valuation transparency will damage liquidity. Hence others believe that a wholly different, transparent and cash flow-based valuation process will inevitably develop for LPs, in a rapidly growing LP market, challenge the traditional valuation basis for the property market in general.

## **Appendix 1: Interviewees**

### **Advisors**

Angus Dodd and Teresa Gilchrist, Invesco Real Estate Advisers  
Antony Grossman, Berwin Leighton  
Greg Nicholson, James Bryer and Paul Robinson, CB Hillier Parker  
Andrew Tunningley, Bacon and Woodrow  
Mailesh Shah, William M Mercer  
Colm Quinn, Nabarro Nathanson  
Richard Gale, DTZ  
Charles Beer, KPMG  
John Atkins and Dalia Joseph, HSBC Investment Bank  
Andy Rothery, Arthur Andersen

### **Investors**

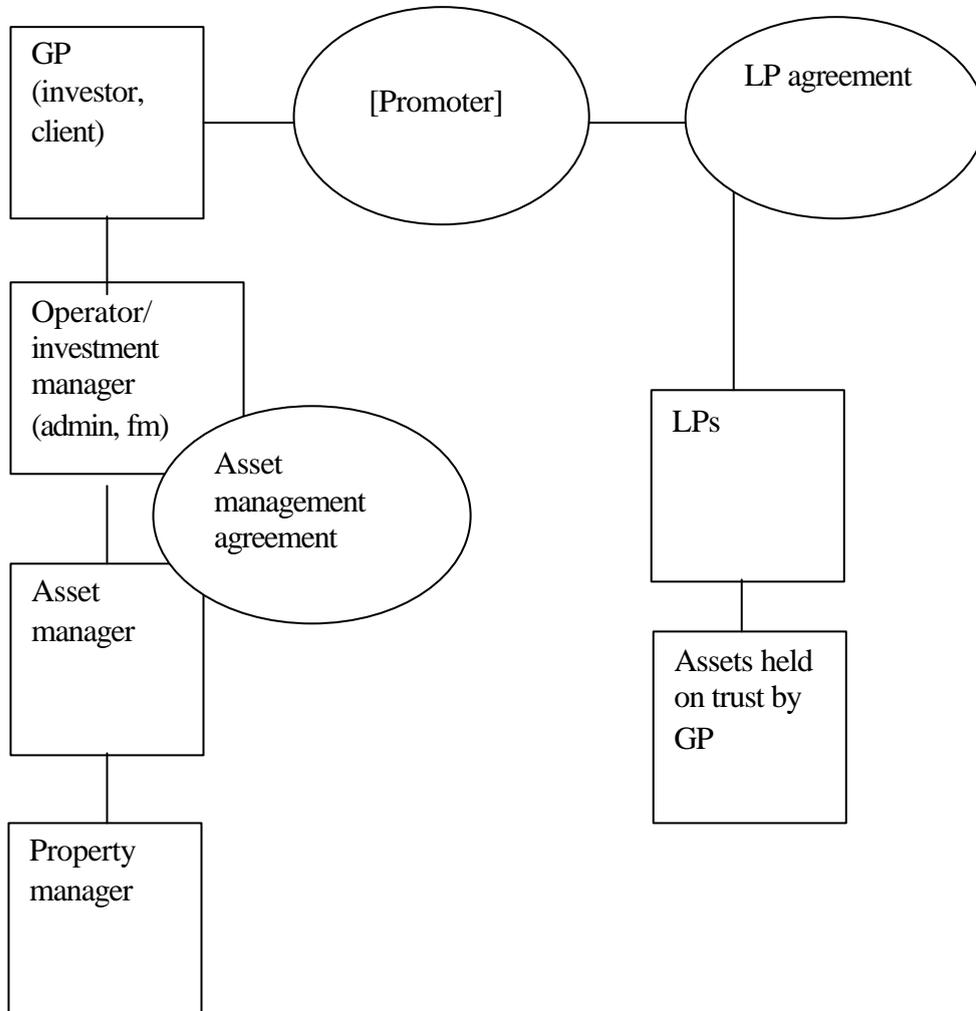
John Story, Unilever  
Neil Turner, Alecta  
John Cartwright, Prudential  
Alan Tripp, Clerical Medical  
Stuart Crisp, BA Pension Fund  
Bob Martin, NFU Mutual  
Peter Pereira Gray, Wellcome Trust  
Mark Burton, AIG  
Paul Herrington, Friends Ivory and Sime  
Paul Wilson, MetLife  
Chris Morrish, GIC  
Peter Haasbroek, PGGM  
Charles Lofstedt, Greater Manchester Pension Fund

### **Promoters**

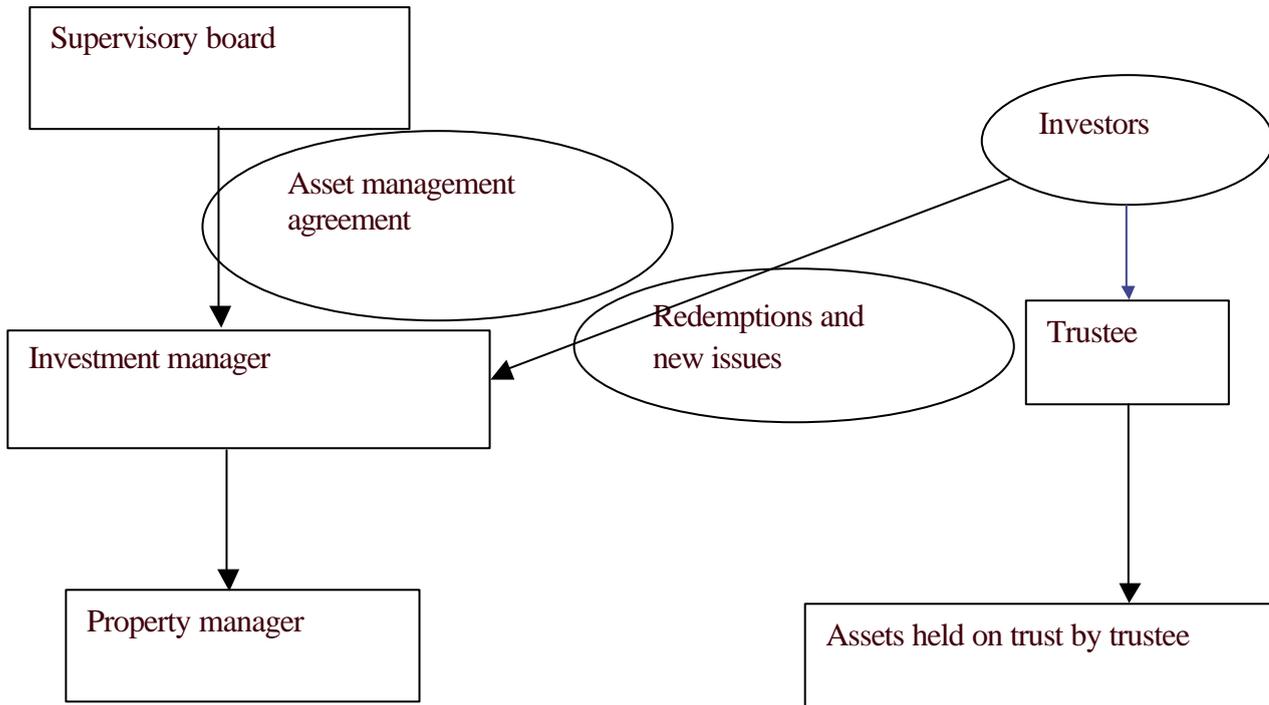
Ian Mason, Merrill Lynch Investment Managers  
Mark Preston, Grosvenor Estate Holdings  
William Hill, Schroder Property Investment Managers  
Stuart Beevor, L&G  
Robert King, Dusco  
John O'Halloran, BAA Lynton  
Andrew Jackson, Standard Life  
Stewart Cowe, Scottish Widows Investment Partnership  
Patrick Bushnell and Guy Morrell, Henderson Global Investors  
Nick Mansley, Morley Property Fund Managers  
Andrew Strang, Threadneedle Property Fund Managers  
Ian Cockburn, Lend Lease  
Kevin McGrath, REIT  
Mickola Wilson, Marylebone Warwick Balfour  
Philip Gadsden, LaSalle Investment Management  
Ric Lewis and Simon Martin, Curzon Global Partners  
Mike Andrews, Brixton  
Peter MacPherson, Baring Houston and Saunders  
Fiona Sweeney and Alastair Ross Goobey, Hermes  
Paul Oliver, Equity Partnerships/Teesland

Charles Weeks and Andrew Thompson, Aberdeen Property Investors  
Ann Lucking, Aberdeen Property Investors  
Martin Barber, Capital and Regional  
Bill Hackney, Deutsche Property Asset Management  
John Sims, Steven Tattershall, Peter James, the io group

## Appendix 2a: Typical LP structure



## Appendix 2b: Typical PUT structure



### **Appendix 3: References**

Association of Property Unit Trusts (2001) *Code of Practice*,  
[www.aput.co.uk/aput/codepractice](http://www.aput.co.uk/aput/codepractice)

Baum, A (2000), *Commercial Real Estate Investment*, Oxford, Chandos

Baum, A (ed) (2001) *Freeman's Guide to the Property Industry (second edition)*, London

Baumann, B (1999) *Liquidity in Limited Partnership Shareholdings*, Forum View , June, p 2,  
London, IPF

British Venture Capital Association (2001), *Private Equity Terms*,  
[www.bcva.co.uk/publications](http://www.bcva.co.uk/publications)

DTZ (2001), *Money Into Property*, London, DTZ

HSBC /APUT/IPD (2001), *Pooled Property Fund Indices*, London, HSBC

Myners, P (ed) (2001) *Institutional Investment in the UK: A Review*, London, HM Treasury

Pension Consulting Alliance, Inc. (2001) *Real Estate Opportunity Funds: The Numbers Behind the Story*, Portland, PCA

Rodrigues, M (2001), *Find the REIT Solution*, Estates Gazette, 10 March, p 153

Royal and Sun Alliance/DTZ Research (2001), *Indirect investment vehicles and the measurement of institutional exposure to property*

## Appendix 4 - INVESTMENT VEHICLES

### SUMMARY OF TAXATION TREATMENT

	<b>Exempt unit trust (i.e. all investors are UK resident and exempt from UK tax)</b>	<b>Unauthorised property unit trust (exempt and non-exempt investors)</b>	<b>Off-shore unit trust</b>	<b>Limited partnership (1907 LP Act)</b>	<b>Limited liability partnership (2000 LLP Act)</b>
<b>Tax on income</b>	Income is taxable at the basic rate of income tax, currently 22%	Income is taxable at the basic rate of income tax, currently 22%	If structured as a bare trust, the entity is considered tax transparent, and therefore not taxable itself (although this may vary between structures)	The entity is tax transparent, and therefore not taxable	Taxed as a unauthorised unit trust, unless all the trustees are non-UK resident
<b>Tax on capital gain</b>	Exempt unit trusts are not chargeable to tax on capital gains	Net chargeable gains accruing in the trust are chargeable at the basic rate of income tax	Capital gains of non-resident entities are not taxable in the UK	The entity is tax transparent, and therefore not taxable	Taxed as a unauthorised unit trust, unless all the trustees are non-UK resident
<b>Tax on investors:</b>					
<b>(1) exempt</b>	Distributions from UUTs are treated as annual payments which are not taxable for exempt investors. In addition, exempt investors are able to reclaim the tax on income suffered by the trust	Distributions from UUTs are treated as annual payments which are not taxable for exempt investors. In addition, exempt investors are able to reclaim the tax suffered by the trust	No tax payable	No tax payable	Exemption from tax denied - pension funds are taxable at the rate applicable to trusts on income and capital gains

	<b>Exempt unit trust (i.e. all investors are UK resident and exempt from UK tax)</b>	<b>Unauthorised property unit trust (exempt and non-exempt investors)</b>	<b>Off-shore unit trust</b>	<b>Limited partnership (1907 LP Act)</b>	<b>Limited liability partnership (2000 LLP Act)</b>
<b>(2) taxable</b>	N/A	Distributions from UUTs are treated as annual payments from which basic rate income tax has been deducted. The gross amount is taxable and the tax suffered by the trust is then fully creditable for the unit holders in proportion to their holdings	Taxed under the relevant schedule (e.g. D Case V for overseas assets, Schedule A for UK located assets) at marginal rate. Capital gains in the trust are taxed in the UK when distributed and are treated as income (again, will depend on trust structure).  Annual imputed tax may be charged on increases in the value of offshore funds for life fund investors, spread over 7 years	Taxable to corporation (or income) tax on their share of the profits under the relevant schedule and chargeable gains of the partnership, in line with the profit and capital sharing ratios	Distributions are treated as annual payments from which basic rate income tax has been deducted. The gross amount is taxable and the tax suffered by the LLP is then fully creditable for the partners in proportion to their holdings
<b>(3) foreign</b>	N/A	Dependent on status	Not chargeable to UK tax on capital gains, but will be subject to UK income tax on rents received. The income tax will be withheld at source unless the investor accounts for the income tax under the Non-resident landlord's scheme	Not within the charge to UK taxation. However, care must be taken for non-resident limited partners who trade in the UK, to ensure that the general partner does not constitute an agent for the purposes of tax	Dependent on status

	<b>Exempt unit trust (i.e. all investors are UK resident and exempt from UK tax)</b>	<b>Unauthorised property unit trust (exempt and non-exempt investors)</b>	<b>Off-shore unit trust</b>	<b>Limited partnership (1907 LP Act)</b>	<b>Limited liability partnership (2000 LLP Act)</b>
<b>Taxation of transfer of interests</b>	<p>New unit holders can be introduced with no corresponding disposal for existing unit holders.</p> <p>Exempt investors are not chargeable on the sale of units in an exempt unit trust</p>	<p>New unit holders can be introduced with no corresponding disposal for existing unit holders.</p> <p>Units are treated as shares in a company, and are the capital gains are chargeable for UK resident companies and individuals. There are no UK tax consequences for exempt or foreign investors</p>	<p>New unit holders can be introduced with no corresponding disposal for existing unit holders.</p> <p>Units are treated as shares in a company, and capital gains thereon are chargeable for UK resident companies and individuals. There are no UK tax consequences for exempt or foreign investors</p>	<p>The introduction of new partners into a partnership is a taxable event on which a chargeable gain may arise.</p> <p>On ultimate disposal of the partnership interest for consideration, a capital gain or loss will be taxable, unless the investor is exempt by virtue of status or residence</p>	<p>The introduction of new partners into a partnership is a taxable event on which a chargeable gain may arise.</p> <p>On ultimate disposal of the partnership interest for consideration, a capital gain or loss will be taxable, unless the investor is exempt by virtue of status or residence</p>
<b>Stamp duty</b>	<p>Investments can be put into a exempt unit trust with no stamp duty arising, subject to certain conditions.</p> <p>Transfers of units in an exempt unit trust are subject to stamp duty at 0.5%</p>	<p>Investments can be put into a UUT with no stamp duty arising, subject to certain conditions.</p> <p>Transfers of units in an UUT are subject to stamp duty at 0.5%</p>	<p>Investments can be put into the trust with no stamp duty arising, subject to certain conditions.</p> <p>Units can be traded outside the UK with no stamp duty cost</p>	<p>Provided that no consideration is payable outside of the partnership on entry, no stamp duty is payable.</p> <p>On disposal, stamp duty will be chargeable at 1%, 3% or 4% dependent on the value of the interest</p>	<p>Stamp duty relief available for any property transferred into an LLP within one year of incorporation.</p> <p>On sale of a partnership interest, ad valorem stamp duty at 1%, 3% or 4% will be charged</p>

Source: Arthur Andersen