REAL ESTATE FINANCE

CHAPTER 12: THE EMERGENCE OF REAL ESTATE FUNDS

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1. Introduction to real estate funds

1.1 What is a real estate fund?

Over the last decade, a change in the investment strategy of pension funds and other professional investors has generated an increased investor appetite for global real estate investment. The worldǿs top investors are going global, and real estate investment managers have facilitated this through the creation of innovative indirect real estate investment solutions. The most popular of these indirect solutions can be called real estate funds.

One of the primary drawbacks of investing in direct real estate is the lumpy, illiquid nature of the asset class and a move to indirect investment is an appealing alternative. As this chapter will illustrate, real estate funds *per se* do not solve the liquidity problem, but some formats are more liquid than direct real estate holdings. Excluding debt products, real estate funds (referred to elsewhere as commingled real estate funds) primarily include unlisted open-ended core funds, closed ended unlisted private equity real estate (or opportunity) funds, REITs (Real Estate Investment Trusts) and mutual funds of listed property companies. All of these fund types will be discussed in this chapter.

The recent pace of change in investor attitudes has been rapid. Taking UK pension funds as an example, balanced, unlisted real estate funds began to dominate institutional investment strategies early in the new millennium, and domestic multi-manager mandates focussed on these funds rather than direct real estate became common. In 2005-2006, pan-European pension fund mandates became typical and global multi-manager mandates and global listed/unlisted mandates started to appear. Given time, the standard pension fund mandate will almost certainly become global, and will continue to require the development of more global listed and unlisted funds. This is a good thing. High quality real estate is a fundamental necessity for a developed global economy. Continued improvements in transparency are both essential and inevitable in the drive to attract institutional investment in the global markets that are most in need of capital investment and which will offer both diversification and the highest rewards, and real estate funds have the potential to play a significant part in this process.

1.2 How much global real estate is in funds?

The value of commercial real estate owned by institutional investors around the world has been estimated (by DTZ and RREEF, among others) to be around $16 trillion at the end of 2006. This is the investable stock, meaning stock that is of sufficient quality to become institutional investment product, and which therefore represents the potential for market growth if owner-occupation rates were to tend to zero.

UK-based real estate funds specialist Property Funds Research (PFR) has made estimates of the gross asset values (GAVs) of stock held in both listed REITs and property companies and unlisted funds. The $16 trillion investable stock of real estate can be broken down to the regional level and further disaggregated by ownership structure (see Table 1). Publicly available REIT and property company market capitalisation data has been used and grossed up as shown to reflect the use of debt in the capital structure of the typical listed company.

Table 1: the global real estate investment universe ($m)

	Europe	**Asia**	**Emerging**	**N America**	**Total**
Size of market	6,353,676	3,440,101	485,212	5,872,705	16,151,694
Listed sector market cap	408,983	695,895	113,359	597,517	1,815,755
Estimated gearing listed	61%	30%	75%	25%	
Listed market size	658,463	904,665	198,379	746,896	2,508,402
Unlisted market size	732,298	262,539	180,433	475,905	1,651,175
Direct market size	4,710,915	2,272,897	106,400	4,649,903	11,740,114

Source: Property Funds Research, RREEF, AME Capital, December 2006

PFR estimates that the total unlisted real estate fund market has a value of $1.6tr (£800 billion), around 10% of the investable stock, and that Europe (excluding the UK) represents the biggest component of this market, holding around 40% of the global unlisted fund market (by number of funds). Unlisted fund GAVs have been estimated by PFR using a combination of individual fund data from the PFR fund universe ($1.4 trillion, an 88% sample: see Table 2) and extrapolation. The US and hence North American data is a minimum estimate, as PFR data is still being assembled for this region.

Table 2: PFR's unlisted fund vehicle universe

Regional focus	Estimated GAV ($m)	Number
Europe (Ex - UK)	473,225	756
Global (pan-region)	298,570	231
UK	238,573	378
North America	190,205	220
Asia	110,026	197
Australasia	33,687	64
Latin America	13,279	63
Africa	5,016	13
Middle East	983	8
TOTAL	1,363,561	1,930

Source: Property Funds Research, January 2008

According to PFR estimates, the $16 trillion investable market splits as follows. $4.16 trillion or 26% of the total stock is held by listed and unlisted real estate vehicles, with 16% held in listed vehicles and 10% in unlisted funds. PFR's estimate of the size of the unlisted fund market is a minimum of around $1.65 trillion, of which data is held on over $1.36 trillion. The remaining $11.84 trillion or 74% splits into directly held investment stock and owner-occupied real estate.

The global market is split by GAV into 40% Europe, 38% North America, 17% Asia and 5% emerging markets (defined for this purpose to exclude China and include India). Within this split, Europe is relatively fully supplied with unlisted product while Asia is under-supplied. Asia, on the other hand, has been well served by the listed sector, and (with emerging markets) has the fastest growing unlisted fund market.

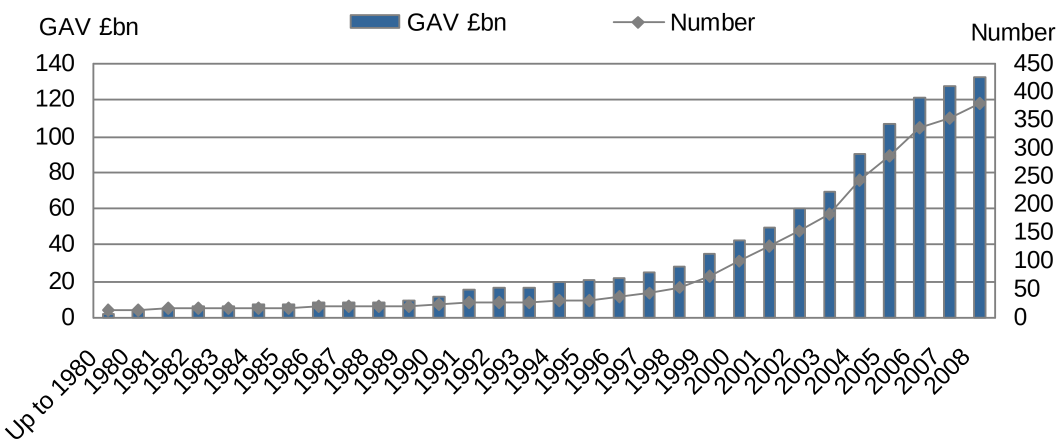
1.3 Growth in the market of unlisted real estate funds

While the REIT market has seen steady growth in the US, and in European and Asian markets[1] as the necessary legislation has been passed in the leading markets,

[1] See Chapter [ ], REITs, and Chapter [ ], New Risks, New Opportunities, Asia

it is the universe of *unlisted* real estate vehicles that has recently grown more dramatically. Growth in the gross asset value held in UK funds has exceeded 15% since 2000. This is illustrated in Figure 1.

Figure 1: Growth in UK unlisted real estate funds



Source: Property Funds Research, April 2008

In Europe, the number of funds in the PFR Universe has grown on average by over 20% per annum over the past ten years. Over the same period, GAV has grown by 10% annually in the European market while explosive, albeit more recent, growth is evident in Asia and the merging markets. This is now a truly global phenomenon which has greatly facilitated executable global real estate investment strategies and has expanded the investable opportunity set for the benefit of many.

2. Types of real estate funds

2.1 Fund structures: introduction

The global real estate fund market can be categorised in several ways. There are listed funds and unlisted funds, although a more useful distinction is between those actively traded on major stock exchanges and those which are not; there are open-ended and closed-ended funds, both listed and unlisted; there are low risk core funds and high risk private equity or opportunity funds; and there are funds for private investors and funds for institutional investors. There are also different legal forms of fund: the most common forms of UK unlisted fund structures include limited partnerships and property unit trusts.

2.2 Unlisted funds

Being unlisted means there is no requirement to be public, so unlisted fund data is hard to find. Property Funds Research holds the largest global dataset of unlisted funds. INREV (The European Association for Investors in Non-Listed Real Estate Vehicles) is also tracking the market, as is AREA (the Asian Real Estate Association) in Asia, and IPD produces print directories of unlisted real estate funds. There are other information sources, such as Prequin and Private Equity International, aimed primarily at the higher risk opportunity fund sector. Information on REITs and other listed funds is more readily available (through, for example, NAREIT ï the National Association of Real Estate Investment Trusts - and EPRA, the European Public Real Estate Association).

PFR suggests that there are four popular legal structures in use globally. These are (i) companies; (ii) partnerships; and (iii) trusts, all backed by the general body of law relevant to each; and (iv) contractual agreements backed by special laws, especially common in Germany, France and Luxembourg.

In the UK, core (lower risk) real estate funds are typically open-ended property unit trusts, while private equity real estate funds are all closed ended limited life structures. Liquidity is the key issue which defines the relevant structure. A REIT or listed fund can usually be traded quickly on a major stock exchange, but an unlisted fund cannot. Investors in unlisted funds need to know how they can get their money back, and how much they will get.

In the absence of an active secondary market for units in unlisted funds, which appears from time to time in the UK but does not generally exist anywhere in the world, the open-ended fund appears to guarantee óredemptionô of capital by the manager at something close to net asset value; in the absence of this, closed ended funds have to have a termination date at which point all assets can be sold and capital returned.

2.2.1 Limited Partnerships

Conceived by the Limited Partnership Act of 1907, this vehicle became popular in the UK real estate market in the 1990s. The limited partnership (LP) enables a pool of investors to invest together in one or more assets. The number of partners is now unlimited in number, one of which, the general partner (GP), must have unlimited liability while the other partners have limited liability. The investment vehicle 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 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, as stated, 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 real estate 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.

2.2.2 Property Unit Trusts (PUTs)

In practice, PUTs fall into four categories: exempt, non-exempt unauthorised UK trusts, authorised PUTs and offshore trusts.

PUTs 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 ñpension 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 1992ò.

Investors in unauthorised PUTs tend to be professional investors. While the operator/manager of the fund will be regulated in the UK by the Financial Services Authority (FSA), 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 real estate 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 real estate 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.

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 ï 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.

PUT structures can be complex. A supervisory board may be appointed to represent what is usually a large pool of investors. 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.

The largest UK PUT is the Schroder Exempt Property Unit Trust, established in 1971, with a real estate portfolio valued in 2007 at in excess of £2bn.

2.2.3 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. 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.

2.2.4 Property Authorised Investment Funds (AIFs)

UK REITs (Real Estate Investment Trusts) were launched on 1 January 2007[2]. Given that REITs were tax transparent but APUTs were not, the UK Government considered the tax position of Authorised Investment Funds (AIF) investing in real estate in order to try to produce a level playing field between listed and unlisted funds. As result, the point of taxation was moved in the 2007 budget from the AIF to the investor, with the result that investors face broadly the same tax treatment as they would have had they owned real real estate or REIT shares.

[2] See Chapter [ ], Part 1, UK REITs

Access to the AIF tax regime is available only to AIFs whose investment portfolio comprises predominantly real estate or shares in UK REITs. However, unlike REITs, FSA regulations require property AIFs to value their fund each day.

Property AIFs can be constituted either as Authorised Property Unit Trusts (APUTs) or as Open-ended Investment Companies (OEICs). Any new property AIF regime will be available only to those established as OEICs.

2.2.5 Funds of funds

There are four ways to invest in unlisted funds. Investors may select a single diversified fund; use advisors or an in-house team to select a group of funds; appoint a discretionary manager to select a group of specialist funds (a multi-manager mandate); or invest in a fund of funds. The multi-manager and fund of funds models are highly appropriate for pension funds of significant size without expert in-house teams.

A fund of funds is a wrapper placed around other wrappers (the underlying real estate funds). As in a multi-manager mandate, two sets of fees are charged: one by the fund of funds manager, and a second layer by the managers of the underlying funds. The fund of funds manager needs to justify the additional layer of fees either by the additional diversification and risk reduction produced by the strategy, or by its skill in identifying and sourcing excellent underlying funds, or both.

The first real estate fund of funds was launched in 2005, but this market has grown rapidly, and as at May 2008 PFR held data on over 80 real estate fund of funds products. The vast majority of UK funds of funds are open-ended, investing in a mix of open ended and closed-ended specialist funds.

2.3 Listed funds

2.3.1 REITs and property companies (real estate operating companies)

Using unlisted funds has drawbacks in terms of liquidity and potential capacity constraints limiting accessibility. Also, for a UK pension fund investing in certain (for example, US) unlisted funds there is potential tax leakage, whereas investment in US listed securities is tax efficient. In Asia, the unlisted market is still relatively immature, and, although the unlisted market in Asia is developing rapidly, it may be that the preferred route of exposure to some markets is via listed securities. Some exposure to the US and Asia is therefore more likely to be obtained via listed securities.

The global universe of real estate companies has expanded dramatically over the past decade due to the very strong performance of the sector, ongoing equity issuance and a proliferation of REIT vehicles across the globe, which has attracted capital into the sector. In addition to the aforementioned European markets, current major REIT markets include the US, Australia, Canada, Japan, Singapore and Hong Kong. The positive impact of the successful Japanese REIT model on REIT legislation in other Asian countries and the similar effect of the French REIT model on REIT legislation in other European markets has generated significant interest amongst global investors and suggests significant potential for growth in the market. The UK and Germany saw a successful REIT market launch in 2007 and other markets are expected to follow shortly. However, progress in Germany has been glacially slow, and the UK REIT market was challenged by very weak performance in its first year.

The listed market has no problems with liquidity, and trades can be made quickly and easily on a daily basis, albeit sometimes with a pricing penalty for transactions of scale. Listed securities also allow immediate exposure to the market, while some unlisted funds will take capital only as it is required to buy assets.

Although the pricing of listed securities is linked to that of the real estate portfolio, there is also a significant degree of variability around the underlying net asset value. This is because both REITs and property company shares are influenced by price movements in the equities markets in general. Consequently, there can be price anomalies compared with the underlying real estate market which can be exploited tactically. However, it can also increase the risk of underperforming its underlying market. Hence REITs are unlikely to provide access to the same level of pure real estate performance in the short term as the unlisted market.

2.3.2 Mutual funds

A mutual fund ï a US term not widely used in the UK ï typically describes a listed security which invests in other listed securities, similar to a fund of funds, but in this case a listed fund of listed funds. Hence there are listed (mutual) funds investing in UK, European and global REITs providing a diversified exposure to the sector.

2.3.3 Exchange traded funds (ETFs)

Traded like normal shares, but more like mutual funds, ETFs allow investors to spread investments even more by tracking the performance of an entire index, but by buying a share in a single asset. The range of ETFs includes the EPRA universe of European REITs and real estate stocks, and the global listed real estate sector can be accessed through the EPRA /NAREIT Global Property Yield Fund. ETFs provide exposure to global property companies and REITs without the manager selection risk ï or benefit - of a mutual fund.

3. Characteristics of real estate funds

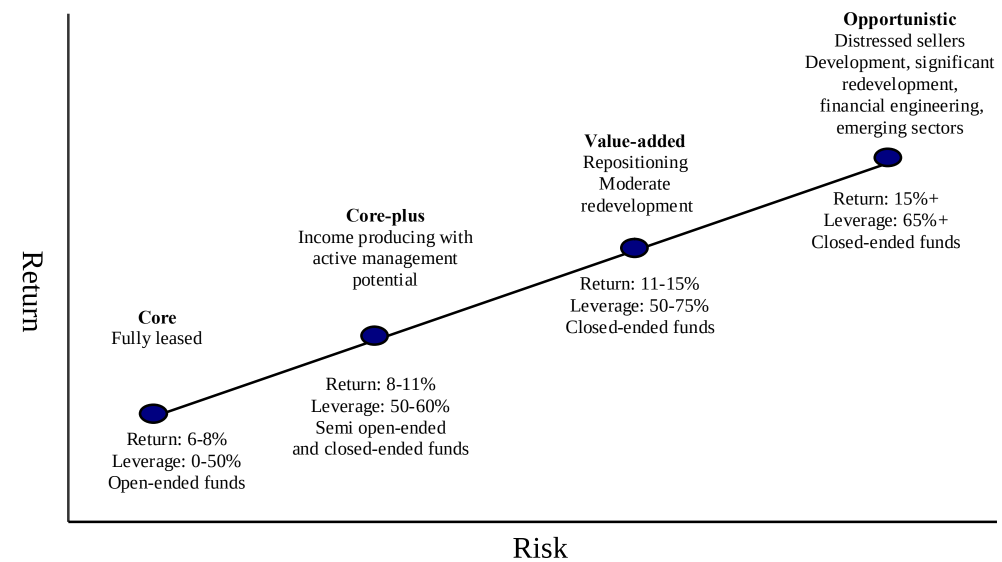
PFR held detailed information on 381 UK unlisted real estate funds as at May 2008 (378 at January: see Table 2), with a total gross asset value of around £116bn. This dataset is used as in the following descriptive statistics.

3.1 Style

It is common to distinguish between core funds, which are lower risk, lower return and often open-ended funds, which should aim to closely replicate returns on the IPD UK index of direct real estate. Core plus and value added funds involve higher gearing and more active management, and opportunity funds are more similar in nature to private equity funds.

PFR data as at May 2008 shows an even split of core and core-plus/value-added funds ï roughly 45% each of the database ï with the remaining minority constituted by opportunity funds. Figure 2 illustrates the typical criteria used to distinguish global unlisted fund styles.

Figure 2: Unlisted real estate fund styles



Source: CBRE Investors

3.2 Domicile and structure

Limited partnerships make up roughly 40% and unit trusts make up around one third of the UK universe by number of funds, but PUTs are bigger in terms of current and target gross asset values (£440 and £516m respectively for PUTs against £338m and £240m respectively for LPs).

The UK is the most popular domicile, as would be expected given that UK limited partnerships appear to be the vehicle of choice. Channel Islands funds (usually PUTs)[3] define 30% of the sector.

3.3 Sector focus

As at May 2008, 43% of UK unlisted funds by number in the PFR database were diversified. Nearly 30% of funds ï much more than is represented in the IPD direct real estate index - were targetting residential and other real estate, including healthcare, student housing and infrastructure. Retail was the most popular ótraditionalô sector with 14% of funds by number, then offices, with 10%.

[3] See Chapter [ ], Guernsey and Jersey

3.4 Open or closed?

Twice as many funds by value are closed-ended rather than open-ended. Over 50% of funds by value are closed to new investment, mostly closed-ended funds that had completed capital raising and a very small number of open ended funds that had closed their doors to new investment.

3.5 Target equity and permitted gearing

The average target equity level per unlisted fund is approaching £180m.

Defined as a percentage of gross target assets, permitted gearing levels vary from zero to 90%, with most funds limited to between 50% and 70%. Core fundsô permitted gearing levels averaged 40%, core-plus/value-added 43% and opportunity 70%.

Permitted gearing levels are shown in more detail in Table 3.

Table 3: permitted gearing levels

Levels of permitted gearing (% of GAV)	**%**	**Number**
0-9	9	16
10-19	1	2
20-29	8	13
30-39	7	11
40-49	2	3
50-59	25	43
60-69	30	51
70-79	8	13
80-89	8	13
90	2	4
	100	169

Source: Property Funds Research, May 2008

4. Liquidity and valuation issues

4.1 Liquidity

The lumpy, illiquid nature of real estate as an asset class means that indirect investment may be an appealing alternative. Liquidity in unlisted funds is generally limited, however, although different fund types offer different degrees of liquidity. Open-ended funds offer monthly, quarterly, or annual redemptions, although sometimes with an initial lock up period of three or four years. Following the example provided by the relatively mature UK market, there is an increasingly active secondary market in European closed-ended funds and this may develop in international markets. Nonetheless, closed-ended funds generally offer little liquidity.

Given that unlisted funds are not stock market traded, an alternative mechanism is needed to provide this liquidity. The key issue is whether the fund is open-ended, semi-open-ended or closed-ended.

Open-ended fund units can be redeemed on demand, and new investors will normally be allowed and encouraged to buy new units on demand. The manager will issue units at NAV plus an allowance for the costs of buying new properties with the new cash (the offer price), and will undertake to return capital to the investor at the latest NAV estimate less a deduction for trading costs (the bid price). (Technically, the NAV is adjusted to offer price by adding real estate acquisition costs and offer is reduced to bid by deducting the round trip costs of buying and selling real estate.)

Semi open-ended funds will have a ôlock-upôperiod, typically 5 years, during which investors are not allowed to redeem units and after which limited redemptions will be permitted.

Open-ended and semi-open ended funds can have infinite lives, and this is an obvious attraction for managers. Closed-ended funds, on the other hand, have a limited number of units in issue at any time (hence the term) and do not have a redemption facility, so that investors are reliant upon secondary market trading, which with some notable exceptions may be thin or non-existent. The manager of a closed ended fund is therefore forced to offer a termination date at which investors can force assets to be sold and capital returned. This is typically 6-10 years from launch.

Despite the obvious appeal of the open-ended structure, there are severe limitations. Investors will not redeem units from the manager if they can sell units in the secondary market for a higher price, and new investors will not subscribe for new units if they can buy units for less in the secondary market. Where there is a balance of buyers and sellers, buyers and sellers will deal directly with each other at something close to mid price (half way between bid and offer), and the bid-offer spread imposed by the manager is not justified because there is no need to undertake any direct real estate trading to grow or reduce the real estate portfolio. The manager may then wish to orchestrate a secondary market, either in search of broking fees or to offer a service to investors and to maximize the market appeal of the fund.

The open-ended structure can be fatally flawed in óone-wayômarkets where there is a large preponderance of buyers or ï much worse - sellers. A rush of buyers can flood the manager with cash, thereby diluting the real estate return delivered by the fund and damaging the managerøs performance. A rush of sellers can be much more damaging. Unfortunately, there may be a double problem in such circumstances.

If a majority of investors feels that the time is right to sell real estate units, this may be for either or both of two reasons. First, investors may feel that the units are fairly priced but that the future market return will be relatively unattractive. Second, investors may feel that the units are over-priced and will wish to exploit a pricing anomaly by selling. On several occasions, with late 2007 being the latest example, these two factors combined to create the equivalent of a órun on the bankô

In 1990, Rodamco, then an open-ended Netherlands fund, was forced to close its doors to prevent investors from exiting. In 2005, German open-ended funds suffered a large exodus of investors, forcing an immediate revaluation and audit of one large fund and the risk of its closure though mass withdrawals. Following this, the pricing of German open-ended funds was publicly debated, fraud was discovered in two cases and questions about investor protection were openly raised.

In 2007, in the UK, a weakening real estate market was coupled with the predictable conservatism of valuers reluctant to mark prices down without clear evidence and yet strong external evidence in the derivatives and REIT markets of much lower real estate prices. The September quarter end valuation of most open-ended funds was too high. Professional investors, primarily fund of fund managers, wished to exploit this anomaly by selling over-valued units in open-ended funds. The reaction of several open-ended fund managers was to defer redemptions and to reduce the valuation retrospectively, thereby preventing investors from exiting at valuation. At the time of writing the consequent damage caused to the open-ended fund industry is difficult to quantify but may yet prove to be significant.

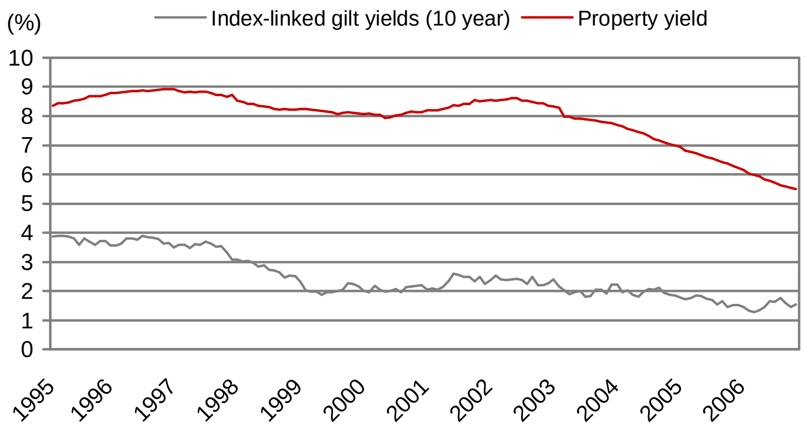
4.2 Valuation

As the secondary market trading of funds has begun to grow, pricing of these units has begun to take place at discounts and premiums to net asset value. This challenges market convention, as, unlike REITs, which trade in the stock market at market-determined prices in real time, unlisted funds are priced by reference to market valuations. For higher risk opportunity funds, valuations may be irregular and unimportant, as investors expect to see a return of capital within 5-7 years and interim valuations may not be helpful where development or other value-adding activity is the key focus of the fund. For low risk core funds with longer or indefinite lives regular valuation is a more accurate and necessary indicator of the managerõs progress, and monthly valuations are not uncommon, so secondary market premiums and discounts can appear to challenge the published valuation.

In late 2007, the UK real estate investment market had entered a period of relative crisis. Prices had been falling, liquidity had disappeared, and open-ended funds had closed their doors to those trying to exit. Why the loss of liquidity? Why had investors suddenly become trapped within an asset class ï and an apparently liquid structure - that had been performing so well but suddenly froze? The answer lies in the unique nature of real estate as a ôbig ticketö asset class, but also in the defects inherent within the practice of real estate valuation.

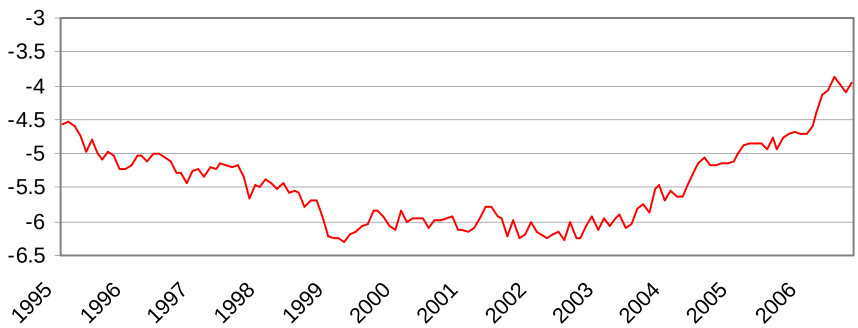
Figure 3 shows real estate yields and index-linked gilt yields for the period 1995 to 2007. It shows a remarkable correlation. The market appears to treat these asset types similarly, as excellent inflation hedges. However, by late 2006 the gap had closed, making real estate relatively expensive. This is illustrated more clearly in Figure 4.

Figure 3: Real estate yields and index linked gilt yields, 1995-2007



Source: IPD, FT, Property Funds Research

Figure 4: Real estate yields less index linked gilt yields, 1995-2007



Source: IPD, FT, Property Funds Research

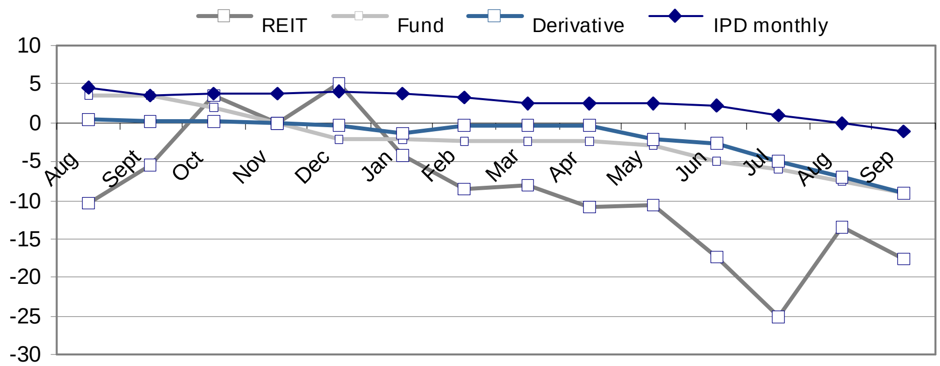
Real estate was looking expensive at the beginning of 2007. By this point, average premiums to NAV on unlisted funds had begun to fall, followed quickly by falls in REIT premiums and derivative margins[4]. However, it was not until the summer of 2007 that returns on the IPD monthly index ï the best indictor of prices in the direct UK market ï begin to turn down.

Figure 5 shows average three (calendar) year real estate swap margins over LIBOR from August 2006 to September 2007, turning from 0.4% over LIBOR to 9% under

[4] See Chapter [ ], Property Derivatives

LIBOR (Merrill Lynch estimates). Unlisted fund premiums over NAV fell (according to Jones Lang LaSalle estimates) from 4% on average to minus 9% in September. REIT prices collapsed from premiums to NAV at the start of 2007 to big discounts by summer 2007. Meanwhile, the IPD monthly index (unlike the other indicators, including income) produced its first negative return (-0.1%) in September 2007. This - at the very least - suggests some lagging in the IPD monthly index.

Figure 5: REIT and unlisted fund discounts to NAV, real estate swap margins over LIBOR, IPD monthly returns 2006-7



Source: IPD, JLL, CBRE, Merrill Lynch, Property Funds Research

Why has the IPD monthly index lagged other real estate indicators? The answer lies in the nature of the asset class and the conservatism built into UK real estate valuation practice.

4.2.1 Real estate as an asset class

Real estate is just one of a set of conventional and alternative assets for investment funds and must compete directly with them. In the UK and US, over the long term equities have performed best, real estate second best and bonds worst. But the volatility of real estate is much lower than the other two, as measured by the standard deviation of those returns.

However, there are problems with this argument. The capital values of real estate used in the performance calculations are produced by valuations[5] and are not transaction-based. It is commonly argued that the way in which valuations are produced means they tend to lag market movements, producing a lagging effect in the performance figures which tend to smooth the peaks and troughs of movements in prices.

Valuation issues, along with considerations of liquidity and the depreciation of real estate, have been cited as issues which have been used to disadvantage real estate in the asset allocation process. Yet when these differences are exposed they provide an opportunity for professional investors to make money through the identification of pricing anomalies, which hedge funds (for example) increasingly try to do. In the UK, the recent introduction of a UK REIT and the development of derivative products are both illustrations of the driving together of real estate and the capital markets, the opportunity for arbitrage and the impossibility of real estate appraisal methods standing apart from these markets. This is a good thing for markets, investment managers and investors.

4.2.2 How market prices are estimated

However, real estate is different in as far as market valuations are required for performance measurement purposes. The established doctrine underpinning the identification of market value requires best evidence of trading prices of other similar assets. This doctrine is underpinned by the courts and by the perceived best practice of other competent practitioners. ‘Other similar assets’ is invariably interpreted as other similar *real estate* assets; and the use of transactions in similar properties means that a lag is built into real estate valuations. Over the period 1996 to 2006, a period of rising prices, sale prices were around 3% higher than valuations. This suggests some lagging of valuations. As a result, few analysts accept that appraisal-based indices reflect the true underlying performance of the real estate market. Such indices fail to capture the extent of market volatility and lag underlying performance.

Real estate valuation is founded primarily on the use of comparable sales evidence. Similarity in real estate characteristics is paramount and good recent comparables may be rare. Hence the evidence used to value a property as at December 31st 2007

[5] See Chapter [ ], Valuing Real Estate

may be collected over the period July to December. In a rising or falling market, this will again result in a lower variance of prices. As a result, valuations will be based upon the previous valuation plus or minus a perception of change, and the perceived changes, unless the subject of very reliable transaction evidence, will be conservative.

4.2.3 Client influence

There may also be client influence. The way property fund managers are typically rewarded, with an annual fee and a performance fee based on delivered returns with no reference to risk, may mean they will benefit greatly from a particular performance outcome which will earn a bonus or carried interest, or support a track record to win or retain fee-earning business. There are circumstances in which clients and other stakeholders may put pressure on the valuer to report a specific outcome. For example, in early 2006, some German open-ended funds with unit prices set by valuations were subject to very high withdrawals from investors, and it has been suggested that this was because investors did not trust the valuation-based price levels.

Given that valuations tend to lag price increases and falls, valuations in a bear market will not follow price reductions down as quickly as they occurred. If this bear market continued for a long term, which was the case in Germany, valuations could become higher than prices. It is not surprising therefore that investors would be nervous of this cocktail of moral hazards, with plenty of incentives for the funds to influence valuers, and that some investors lost confidence in the valuation levels being reported.

In the UK, there is thankfully no evidence of client influence maintaining artificially high price levels (Baum et al, 2000). However, there is a secondary market for units in unlisted funds. There is also a growing real estate derivatives market, and a REIT market, not to mention a securitization (CMBS) market. All offer pricing indicators to valuers of direct real estate. Yet while there was patent over-pricing in a falling market in the second half of 2007, valuers claimed a lack of comparable evidence, with few transactions. Evidence is all around in the capital markets and unlisted real estate vehicles, and it is yet to be seen whether valuers will begin to be influenced by the evidence provided in increasingly integrated markets for direct real estate and real estate funds[6].

5. The case for and against unlisted real estate funds

5.1 The case for unlisted real estate funds

5.1.1 Unlisted real estate funds can diversify real estate specific risk

A lot of money is needed to build a diversified real estate portfolio. The capital investment required to mimic the performance of a real estate index depends on both the efficiency of diversification within the segment and upon the average lot size within each segment. Investors with higher levels of risk aversion require more capital investment in real estate segments in order to reduce the specific risk component of the portfolio to the desired level.

For example, Baum and Struempell (2005) found that over £1bn is needed to build a diversified portfolio of London offices with a 2% tracking error. This presents a very strong case for using an unlisted fund focussed on London offices. Assuming that such a fund is financed by 50% debt and 50% equity, 20 investors committing £25m each will produce enough capital to achieve the diversified fund. Yet the investor's £25m is enough to buy only one or two London offices of average lot size.

5.1.2 Unlisted funds are priced by reference to NAV

The above argument could also be used to justify investments in listed property securities. However, the pricing of listed REITs and property companies will vary from real estate prices and in the short to medium term (0-5 years) distort the performance of the securities relative to the underlying real estate market. Figure 6 shows the premium and discount to NAV (net asset value) which coloured the performance of the US REIT sector over the period 1990 to 2006. It shows how there is some short term volatility, and that significant discounts and premiums to NAV can affect pricing for periods as long as five years.

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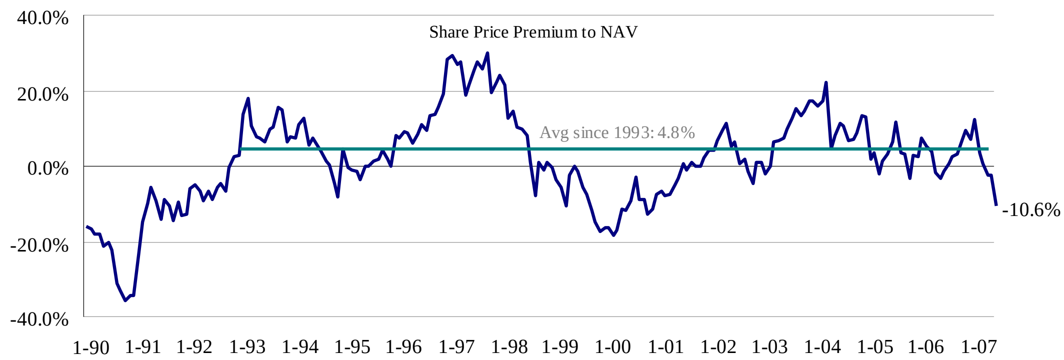
[6] See Chapter [ ], Valuing Real Estate

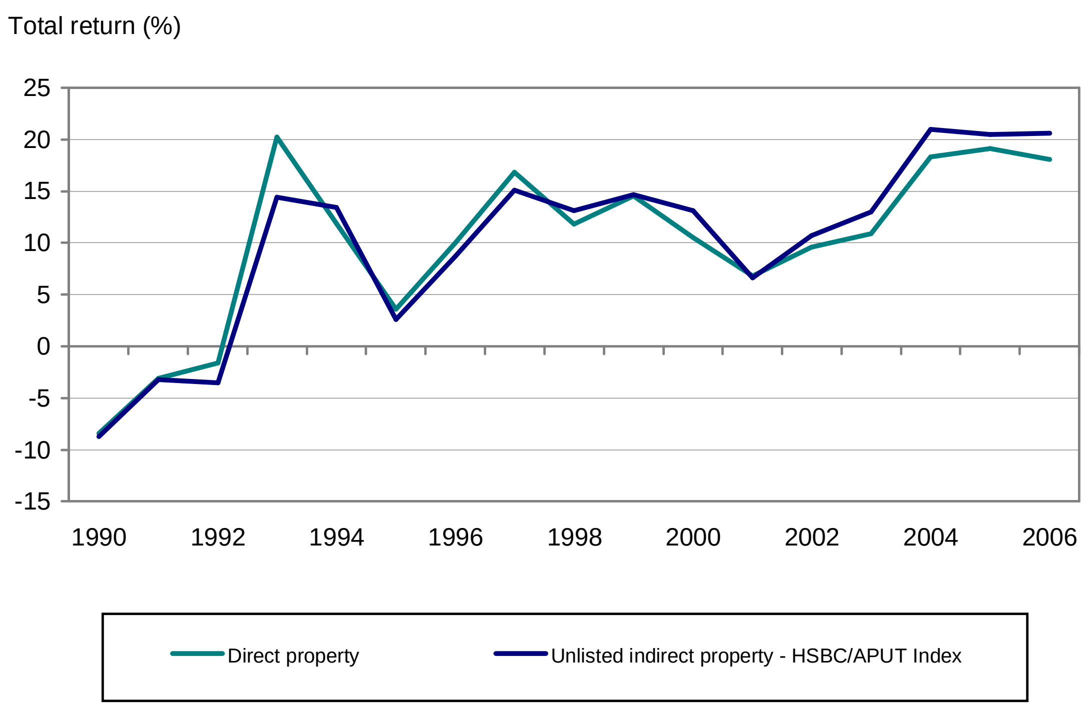
Figure 6: US REIT pricing relative to NAV



Source: Green Street Advisors

On the other hand, core open-end unlisted funds appear to track real estate NAVs. Figure 7 shows how core (lower risk, often open-ended) UK funds have tracked the UK IPD index of direct real estate returns.

Figure 7: UK core unlisted funds - performance relative to NAV



Source: Property Funds Research, HSBC/AREF/IPD

5.1.3 Unlisted funds provide access to specialist managers

It is likely to be the case that specialist managers, meaning experts in a market sector or a specific geography, will produce better performance than a manager or investor located in a single market yet attempting to buy assets globally. PFR global data shows that the majority of closed ended unlisted funds are typically focussed on a geography (India, London) and sector (shopping centres, London offices). Good fund and manager selection can lead to the holy grail of lower risk and higher returns.

5.2 The case against unlisted real estate funds

Investing in unlisted funds suffers from three key challenges. First, cash may not be taken immediately by the discretionary manager, fund of funds or selected fund(s). This produces a slow expected cash drawdown profile. Second, the initial performance will be coloured by the costs involved in the manager buying the initial portfolio, producing what is known as J-curve effect. Finally, unearned fees can challenge thoughtful investors.

5.2.1 The drawdown profile

Managers will not wish to draw cash immediately for a variety of reasons, the key issue being their desire to deliver real estate returns not coloured by cash returns. Hence cash is drawn from investors as and when it is needed to complete the purchase of assets. The result is a delay in attaining full exposure.

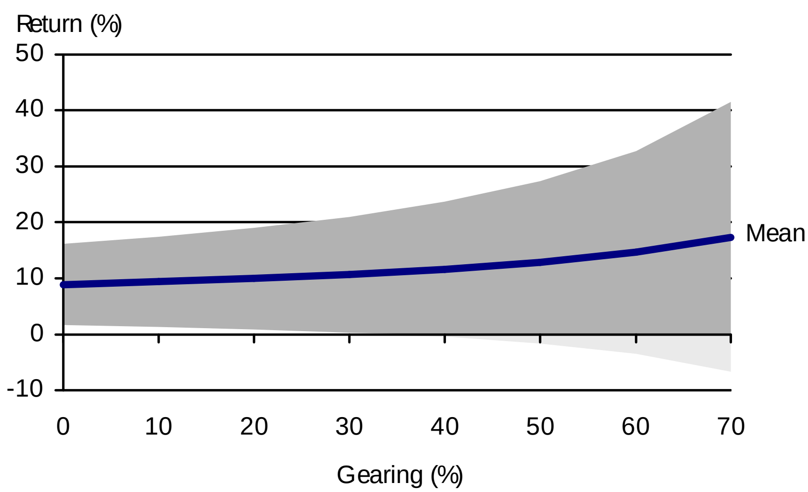
5.2.2 Gearing and the J-curve effect

The performance of an allocation to unlisted funds will also be damaged in the short term by the costs involved in the manager buying the initial portfolio. The result can be poor short term performance. In the early years, newly-launched fundsô performance can be negative relative to the direct real estate index ï but after fund costs are amortised, and the gearing in the unlisted fund takes effect, the unlisted funds can out-perform the direct market.

The typical European fund, whether core, core-plus or value-added, is likely to be somewhat different from the UK open-ended funds. Adjustments will need to be applied to direct real estate risk, return and correlation data to describe investment in closed-ended vehicles with gearing or leverage.

It is known that gearing increases risk and volatility. It also makes performance more responsive to interest rates and the bond market, depending on whether the interest rate is fixed or floating. Debt can alter the cash flow, and will typically decrease the investor's income return. In summary, the risk of a geared fund is likely to be higher than the risk of an ungeared fund, as shown by Figure 8, in which the shaded area shows the likely spread of returns, increasing as gearing increases.

Figure 8: The impact of gearing on return



Source: Baum, 2006

The price of specific risk reduction achieved by unlisted vehicles may be higher volatility introduced by gearing – albeit balanced by higher prospective returns.

5.3.3 Unearned fees

Fees charged by the manager of a real estate fund (or a fund of funds) will usually be charged on an annual *ad valorem basis*, typically between 50 bps and 100 bps every year on a growing gross asset value, despite the fact that much of the manager's activity is front-loaded. In addition, performance fees may be charged and related to absolute returns or returns relative to an index. Often, the use of high gearing will mean that the manager has increased the risk profile of real estate investing but, to the extent that this delivers extra returns, will be paid for the risks taken with client’s capital. These issues are challenging for managers to justify.

In addition, double fees charged in funds of funds may be hard for clients to bear. Managers need to be able to justify the additional fee layer by proven added diversification and risk reduction, or alternatively by the provision of expert access to out-performing managers.

6. Issues for the future

6.1 Green funds

Several initiatives (especially the United Nations Principles for Investing, launched in April 2006, and the establishment of the UN Environment Finance Initiative’s Working Group on Responsible Property Investment) have put pressure on institutional investors to behave in a more responsible and accountable manner across the investment spectrum. The link between sustainability characteristics and investment performance is becoming more tangible as occupiers seek carbon-efficient real estate investrments.

The real estate strategy of the California Public Employees' Retirement System (CalPERS), for example, focuses on the generation of attractive investment returns while adopting environmental and green building technologies. Energy reduction targets of 20% in the core real estate portfolio have been set for the next five years. Launched in 2006, the £250 million Hines CalPERS Green Development Fund will focus on developing high performance, sustainable office buildings certifiable through the Leadership in Energy and Environmental Design Core and Shell Program.

This is not a rare example of a ‘green’ fund: many others have been launched by specialists such as Revival, as well as the Rose Smart Growth Investment Fund and the New Commons Fund which both aim to invest in energy-efficient new urbanist projects, Climate Change Capital’s Carbon II fund which invests in developing country projects which will lead to reductions in greenhouse gas emissions, and the Terra Green Fund which will invest in aforestation and reforestation projects in Brazil to be utilised in the production of vegetal coal.

Given their ability to specialise and a lack of constraints based on historic practice, real estate funds are in an excellent position to offer a responsible lead in this field.

6.2 Emerging market funds

Baum (2008) used PFR data to explore the role played by unlisted real estate funds as intermediary structures carrying capital from developed to developing markets. Defining the developing or emerging markets as the regions outside Europe, Australasia and North America, and focussing on the largest 55 countries in these regions by population, the research found that emerging markets were becoming increasingly popular for unlisted fund investors (who are concentrated in the non-developing markets of the USA, Australia, Canada, the UK, the Netherlands, Germany etc).

Both GDP per capita and population explain the number of unlisted funds targetting emerging markets, but there are several interesting outliers, meaning countries whose observed investment does not fit well with predicted investment. The promotion of a mutuality of economic interest is in the best interests of everyone, and unlisted real estate funds have the potential to play a significant part in this process. Continued research will be essential in the drive towards the transparency necessary to attract both entrepreneurial and risk-averse institutional investment into the markets that most need investor capital.

6.3 Hedge funds

A hedge fund is an investment vehicle that can ógo shortô ï in other words, it can sell the liability to pay out cash based on the future performance of a security or an index. It may also be an investment vehicle aiming to be market neutral ï delivering a good return even if the market performs badly. By being market neutral it can aim to deliver an absolute return rather than aim to perform well relative to a benchmark.

The introduction of efficient real estate derivatives has permitted the introduction of a new wave of unlisted real estate ôhedgeô funds. An example of a real estate hedge fund strategy is to buy a basket of REITs at a discount to NAV and sell the IPD direct real estate index. If the REIT index is correlated with the IPD real estate index in the longer term, then the fund can be somewhat market neutral. The performance of the fund will then be determined largely by the pricing of the REIT market relative to

NAV, so buying at a larger than average discount to NAV should deliver positive returns. For better or worse, more hedge funds can be expected, and strategies designed to exploit anomalies in the relative pricing of REITs, unlisted funds and other forms of real estate exposure will no doubt be developed.

6.4 Alpha and beta: performance issues

Performance fees may be charged by managers of unlisted funds, especially those at the riskier end of the spectrum, and will be related to absolute or relative returns. The use of high gearing increases the risk of the client's capital and should generate extra returns. This can be called beta investing, whereby the manager increases the exposure of the client's capital to the market. It is different from alpha investing, whereby the manager uses skill to out-perform the market competition *at the relevant risk level*. It can be expected that more focus is placed on defining and distinguishing alpha and beta investing in real estate funds, if only because performance fees charged purely for beta are commonplace, yet plainly unfair.

This, among other, issues will add to the transparency which is necessary to bring self-regulation to a growing and globalising market for real estate funds. Aided by the participation of world-class global managers and investors, real estate funds are likely to be the engine which drives best practice in a truly international real estate market.

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