Around 75% of funds surveyed have value-added or opportunistic strategies, reports *Jane Roberts*

European retail is hot sector as funds seek higher returns

A majority of investors and fund managers placing capital this year are seeking higher returns in value-added and opportunity funds rather than core or core-plus vehicles.

Almost three-quarters of 35 funds launched this year have value-added or opportunity strategies. They will represent more than €20bn of capital if they reach their targeted gross asset values. The total target GAV of all 35 funds is €28bn.

This finding forms part of the first Capital Flows Survey, launched this month by *EG Capital* and Property Funds Research, and it suggests that recent demand has been for products that continue to generate relatively strong absolute returns at a time when many property markets are slowing down or are expected to slow down.

The inaugural survey covers vehicles launched in the first eight months of 2007 and will be updated quarterly. The objective is to track the sources of capital raised by unlisted property funds and where the money is to be invested.

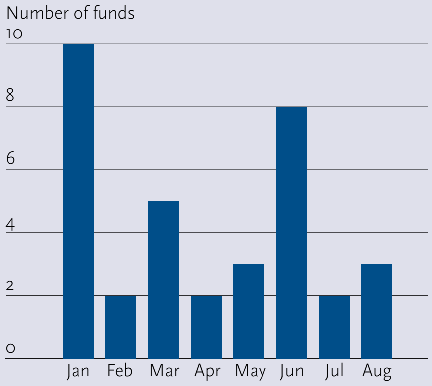
The survey also reveals that the majority of capital still comes from UK, US and Dutch pension funds. More than half the €9.6bn of equity raised by the funds surveyed comes from pension funds (see 'sources of equity for funds' graph, p20), with private bank clients, insurance funds and retail investors accounting for a further 30%.

Retail property – although not in the UK – was the most popular target sector, accounting for more than 35% of the target gross asset value of 22 funds that were prepared to give a breakdown of their target investment sectors and jurisdictions.

The UK, however, is the single biggest target market. No less than seven funds, representing target GAV of €4.2bn (14.5%), were raised to invest only in the UK, including one fund of funds. This doesn't include some pan-European vehicles that include the UK as a target market.

Funds launched in 2007

The survey attracted responses from 35 funds



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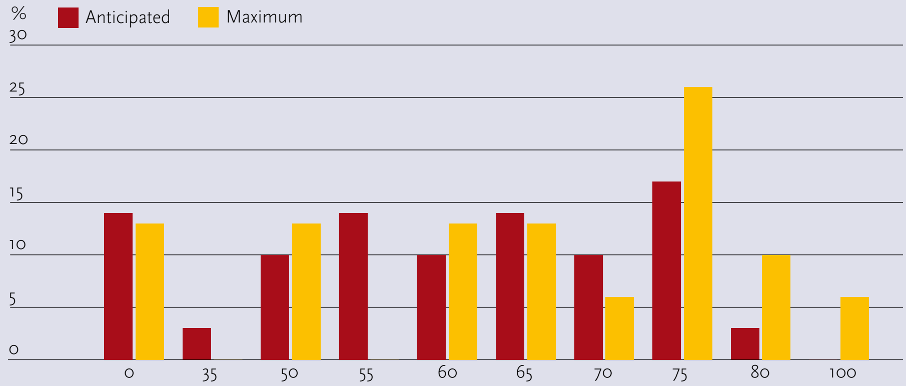
Anticipated and maximum gearing

The average level of gearing planned by the 35 funds is high, at 54%



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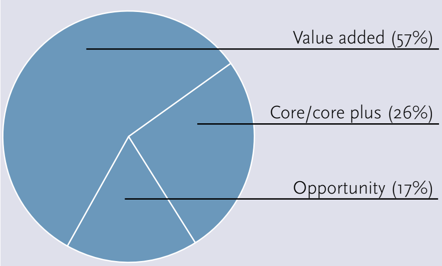
Breakdown by fund type

Three-quarters of the 35 funds are value-added or opportunity funds



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Target rate of return

About 60% of the 35 funds expect to get returns of at least 10%

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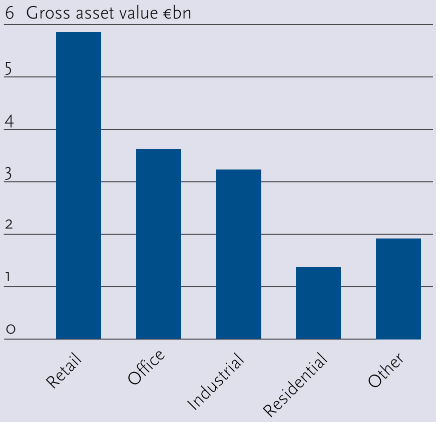
Sector allocations by target GAV

A third of all capital is targeting retail



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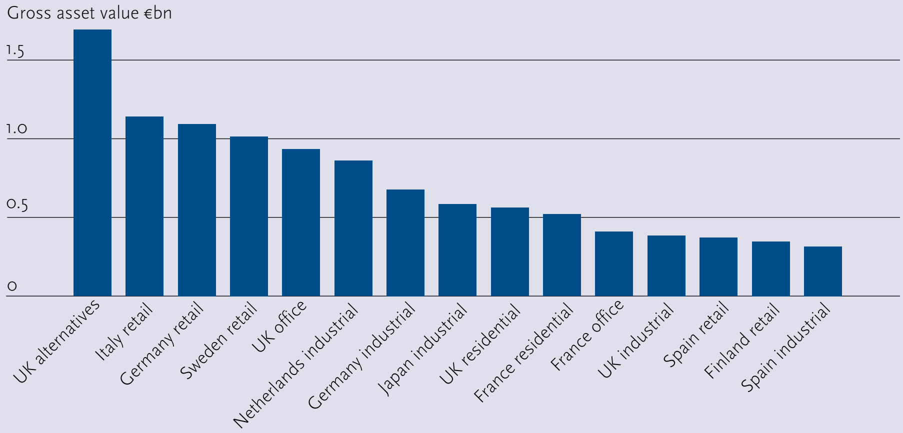
Top 15 target sectors

The leading sector is 'UK alternatives', such as healthcare and hotels, followed by European retail



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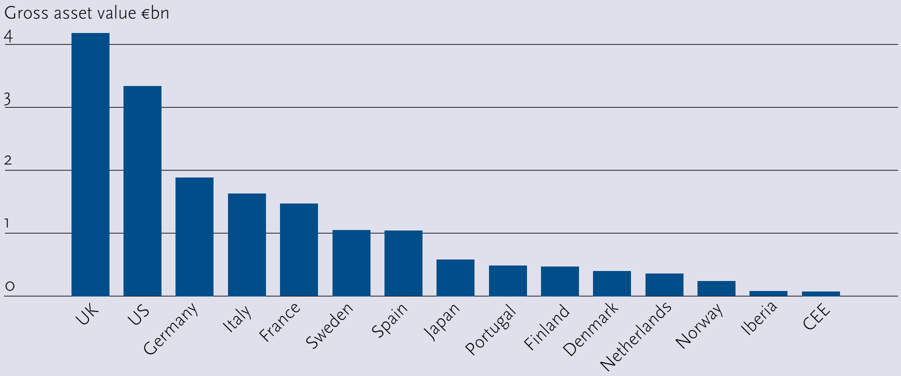
The 35 funds' average targeted return is 13% and the average anticipated gearing is 54%, while 60% is the maximum gearing.

There is some overlap between the returns targeted by core-plus and value-added vehicles, reflecting the lack of standardisation of terms, despite INREV's best efforts.

Most managers of core-plus funds said they were looking for 6-10% returns, but two said their target was 10-12%, while two managers of value-added funds said their figure was 6-8%. However, it is clear that more than 60% expect to get returns of 10% or higher (see 'Target rate of return' and 'Fund Style by target returns' graphs, left and below).

Top 15 target countries

Most money is targeted at the biggest markets, with the UK still attracting significant capital



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Ambitious return targets

The findings beg the question: will the returns and gearing levels prove to be realistic in the current, more difficult, market? Simon Redman, head of business development and fund structuring at manager Invesco, suggests that an average 13% target return looks ambitious.

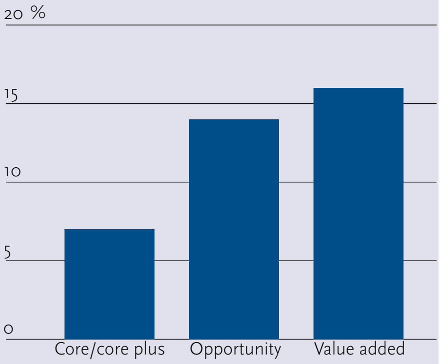
"Recent turbulence in the debt markets and a lower returns environment could see average target returns of 13% looking rather optimistic" he says.

"Higher debt costs and an absence of further downward yield shifts mean that it is down to real estate fundamentals to produce much of the targeted returns. It is questionable whether some of the targeted returns are achievable. Managers more used to financial engineering than active property management could find themselves in difficulties over the next few years."

Invesco is raising capital for a core fund

Fund style by target returns

The average value-added return is 16%



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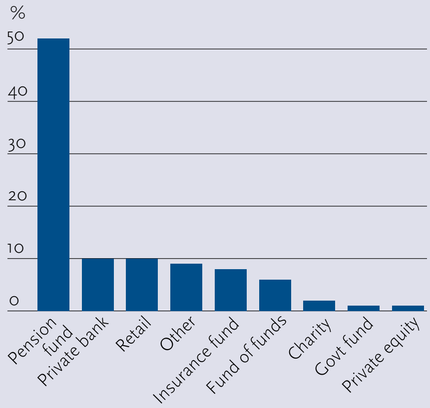
Key facts: managers in the survey

• The questionnaire was sent to the managers of 106 funds logged in the Property Funds Research database as having launched (first closing) this year between January and August.
• The majority of the 106 funds target European property but a minority target other international markets, including Asia and the US.
• Of the 106 surveyed, 35 responded – a 34% response rate.
• Of the 35, 23 target Europe, seven the UK, two Asia, one the US and two are global.
• The total target GAV of the 35 funds is €28bn, giving an average size of €800m (seven declined to give a target GAV; an average of €741m has been assumed to get a total).
• Target GAV ranges from €3.3bn to under €20m. Four funds have a target GAV of more than €1.5bn.
• 14% of the funds in the survey are funds of funds.
• Nine of the 35 funds have no termination date. The remainder have termination dates spread relatively evenly over the next 15 years.

Sources of equity for funds

Pension funds are the leading source of equity



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Investor types by equity committed

Retail investors are a growing force, accounting for 10% of all equity committed

Fund type	Equity committed %
Pension funds	52
Private banks	10
Retail	10
Other	9
Insurance funds	8
Fund of funds	6
Charities	2
Government funds	1
Private equity	1

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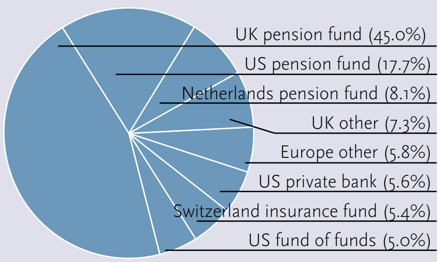
Investor types by domicile

UK pension funds are the dominant investors



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Investor domiciles by equity committed

US and Dutch-based investors are the second and third biggest investors

Country	Equity committed €m
UK	1,288
US	623
Netherlands	356
Germany	186
Switzerland	127

SOURCE: PROPERTY FUNDS RESEARCH/*EG CAPITAL*

because it believes that there will be a flight to quality, with investors feeling more risk averse and switching their money back to core and core-plus vehicles.

"Although many of the vehicles launched are in the value-added category, some investors are questioning the level of risk taken to achieve these returns," Redman adds. "Potential yield spread divergence, exacerbated by high leverage, is leading some investors to actively seek core or core-plus strategies."

Property Funds Research chairman Andrew Baum agrees. "Average proposed gearing levels above 50%, with more than half the funds targeting levels above 60%, are highly challenging in a market in the early stages of a liquidity crunch," he says. "Some managers have debt facilities in place at agreed margins but others have not; both may find good reasons for slowing the pace of investment as they watch the markets, either to seek distressed sellers or wait for lower base rates and cheaper debt."

Considering that it takes an average nine months to a year to plan, build a book for, and close a fund, almost all the funds in the survey would have been conceived last year, when everyone was expecting the UK market to slow down ahead of some other Continental markets, but before these changes had started to happen.

The proportion of capital targeting the UK is therefore surprisingly high, at €4.2bn of GAV in seven funds (see 'Top 15 target countries' graph, page 19) despite much recent talk of investors seeking to rebalance their portfolios by adding assets from outside the UK.

But €1.7bn – 40% of the €4.2bn earmarked for the UK – is destined for alternative sectors, including healthcare, student accommodation, hotels and listed securities.

UK retail out of favour

Most of the balance is for UK offices (€900m), other UK residential (€580m) and UK industrial (nearly €400m) (see 'Top 15 target sectors' graph, page 19). None is destined for UK retail, which was out of favour earlier this year and last.

However, retail is the most sought after sector for investors in the rest of Europe. Of the 22 funds that gave detailed breakdowns of their target spending, the second, third and fourth most favoured assets were Italian, German and Swedish retail, with UK offices the fifth. Overall, almost €6bn of the target GAV is earmarked for shops, shopping centres and retail parks, representing 35% of the capital spending of the 22.

Capital is destined for industrial property in the Netherlands, Germany and Japan. The high proportion of money targeted at the US – the second highest, at €3.3bn – is accounted for by one fund manager that replied to the survey and closed a fund in the US, rather than capital raised by European fund managers targeting the US.

Asia would be the third biggest category, as one fund has a target GAV of €2.2bn to invest in this region, but did not complete the questions on target markets.

The amount of money targeting Central Europe was extremely low, at only 0.2%.

About two-thirds of the respondents (22) gave detailed breakdowns of their sources of equity, accounting for €4.6bn of the estimated total equity raised. Six more gave overall equity raised without details of the sources, bringing the total to €7bn. If the average of these 28 is grossed up, total equity raised by the 35 would be €9.6bn.

Pension funds, led by UK funds, were the leading source of equity capital for unlisted funds, accounting for more than all other sources put together, or 52%, (€2.4bn) (see 'Sources of equity for funds' graph, above).

Key facts: equity sources and target markets

• The total equity raised by the 28 of the 35 funds who gave the information is €7bn. This has been grossed up to €9.6bn to take account of those who didn't provide information. (based on an average of €270m of target equity per fund).
• Additional closings are permitted by 74% of funds.
• The market is dominated by pension funds, which invested more than half of all equity.
• The leading investor category is UK pension funds, followed by US and Dutch institutions.
• 10% of equity was raised from retail investors.
• UK alternative sectors such as hotels, student housing and healthcare are the most popular target sectors, followed by Italian, German and Swedish retail.

UK pension funds committed €1.05bn of equity, US pension funds invested €411m, while Dutch pension funds put in €190m (see 'Investor types by domicile' pie chart, left). The dominance of UK institutions may reflect their increasing move into cross- border vehicles this year. According to Invesco's Redman, as a group they were still generally a minority in funds open to pan-European investors in the past.

The next largest investor group after pension funds was private banking clients, which committed €470m, followed by €450m of retail money – at 10%, a substantial slug of the whole (see 'Investor types by equity committed', left).

Securities complement direct investment

Fund managers were also asked whether they would complement direct investment to implement their strategies (see 'What do funds invest in?', right). The 25% figure for the funds' combined exposure to property securities is due to the inclusion of one large pure securities fund, but also to seven direct property funds that said they could also include investment in securities.

One open-ended European fund designed for retail investors as well as institutional investors allows up to 15% in shares.

Seven of the funds – 22% of those surveyed – said they would consider using derivatives. One fund that was prepared to use derivatives said it would also consider bonds or commercial or residential mortgage-backed securities, while a second fund said it would also consider CMBS.

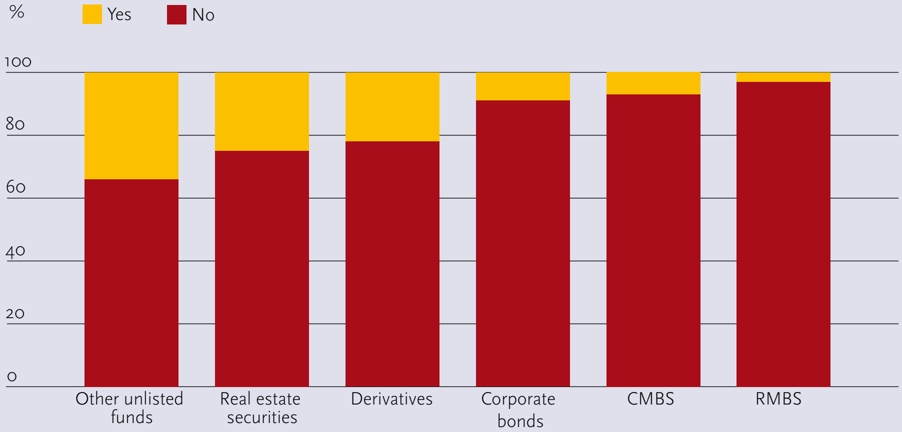
Several direct property funds said they would also consider investing indirectly in other unlisted funds, which explains why 'other unlisted funds' is the highest category, even though there are only five funds, which are funds of funds, representing 14%.

Luxembourg's rising popularity as a domicile for unlisted funds in the past two or three years – overtaking the Channel Islands – is confirmed in this survey. It attracted more than €10bn, or 36%, of the 35 funds' target capital. Limited partnerships remain the most popular structure, again, accounting for more than €10bn.

Redman says this survey comes at an interesting time for the industry. The findings show the strength of capital and may support the contention that a lack of confidence in the market might be overcome by weight of money, particularly from pension funds – "even though investors will become more discerning in terms of investment sectors, style and fund duration".

What do funds invest in?

Seven funds each said they would buy property shares and use derivatives



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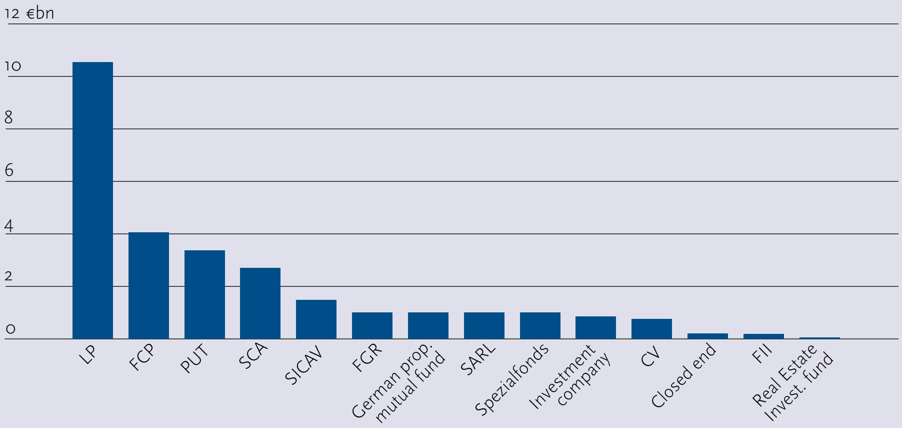
Legal type of funds by gross asset value

Limited partnerships, the most popular structure, account for more than €10m of targeted capital



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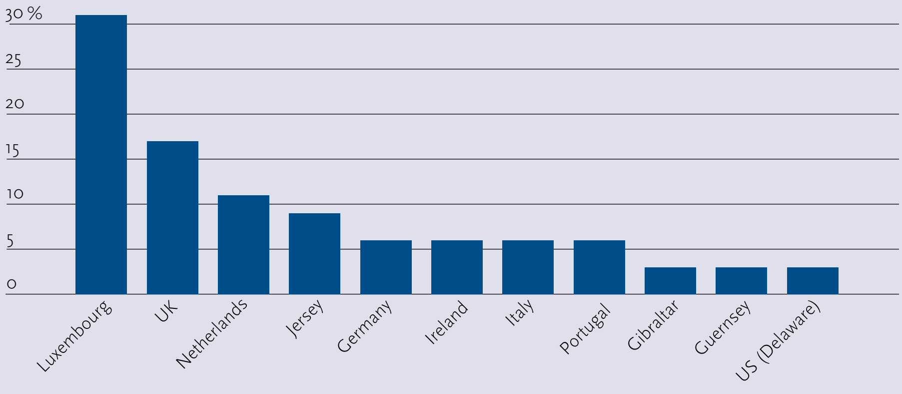
Where funds are domiciled

Luxembourg is the most popular base but funds are spread across Europe and the US



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EG Capital and Property Funds Research hope to carry out the Capital Flows Survey every quarter, to continue to track the sources of capital raised and where the money is destined to be invested, as well as tracking changing trends over time. If you would like more information or can take part in the next survey, please contact Jane Fear at Property Funds Research: jf@propertyresearch.com