Coming of age: the rebirth and renewal of the non-listed real estate industry **2019**

Research

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to build a competitive and sustainable asset class for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

INREV is Europe's leading platform for the sharing and dissemination of knowledge on the non-listed real estate industry.

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Executive summary

The non-listed real estate industry has experienced a coming of age since the global financial crisis (GFC) with many investors evolving their participation into hybrid investor/manager roles, and more professional investment managers offering a greater range of products that are better tailored to the risk requirements of their client base.

This paper sets out the evolution of the industry from 2004 to the present, evaluating the catalysts driving the re-birth, renewal and coming of age of the industry and the changes participants and products in non-listed real estate have experienced during this period.

Since the GFC, some investors, capitalising on their experience in the markets, have evolved to develop their own platforms, and now bring in third party capital to invest alongside them. The scale and type of this third party capital varies across investors, which has led to a blurring of the spectrum of industry participants from investors at one end through to investment managers at the other.

In between are a number of investor-hybrid models, which includes large institutional investors that have permitted small third party investors to co-invest; those investors that have sought third party capital to co-invest in their proprietary funds; and others that take a strategic decision to grow and extend their geographic reach by diluting some of their existing funds with third party capital.

The balance of investors in non-listed real estate vehicles has changed little since the GFC with a small number of large investors continuing to take a leadership role and with others content to follow their lead. This could be a future challenge to the industry as smaller investors which make up a large share of the market may have different views and issues than larger investors.

When it comes to different types of products, large investors have a strong preference for exercising greater control post-GFC, but there is divergence as to how this is achieved. Modes of investing vary considerably and reflect investors' internal capabilities, experiences, preferences regarding real estate investment strategies and the maturity profile of the institutional capital they are deploying. Investors that want to retain direct control over investment decision making and risk management require a large, dedicated internal platform.

The range of non-listed real estate products has also expanded and some large investors show a stronger preference for separate accounts, club deals and JVs rather than for commingled funds, particularly as strategies move up the risk curve. Although they remain a low proportion of the total volume of capital invested in non-listed real estate vehicles, family offices and high net worth individuals have increased their activity in recent years. However, their investment objectives and preferred vehicle structures are distinct from the evolving requirements of institutional investors. The tailoring of products for institutional investors may be limiting the choice and raising the barriers to entry for other investor types and presents an opportunity to create and tailor products for such alternative sources of capital.

> 'Large investors have a strong preference for exercising greater control post-GFC'

Investment managers with strong professional management proved to have resilient business models during and after the GFC. This professionalism has increased with the positive impact of the Alternative Investment Fund Managers Director (AIFMD), which, in addition to providing common rules for authorisation and supervision, requires the adoption of strong governance policies and detailed reporting to ensure adherence to fiduciary duty.

AIFMD has also impacted the structure of the industry for investment managers. Its requirements have sharply increased costs, and with these changes occurring at the same time as a reduction in fee levels, it has prompted investment managers to consolidate and reorganise their internal operations.

In 2008, the value of the global non-listed industry was estimated at €862 billion, with the top 10 managers accounting for 47%. Currently, the top 10 managers of European strategies account for 53% of the total €812 billion held directly in non-listed vehicles and the top 20 managers account for 80%.

Most large investment manager platforms offer a range of co-mingled investment products by style, including open end and closed end products. The growth in size of core, open end funds within Europe has been notable. In Europe they are still dwarfed in comparison to the size of the US open diversified core equity (ODCE) funds, but as they continue to grow, investors consider them to offer similar attributes.

Since the crisis, the product range for investors has also extended from real estate equity funds to real estate debt. This was created by the opportunity for new sources of capital to enter the market following the scarcity and high cost of real estate lending immediately post-crisis.

Sustainability and responsible investing are now strong driving forces for all participants in the industry. Environmental, social and governance (ESG) considerations are now embedded in the primary, secondary and tertiary stages of the investment process, with the financial benefits of ESG policy implementation becoming evident. Social responsibility is a current area of focus and is evolving, whether that is from wellness initiatives in location and design or how portfolio management impacts social sustainability such as through the affordability of housing.

> ‘Sustainability and responsible investing are now strong driving forces for all participants in the industry.’

Responsible investing is also flowing through to fund structuring and taxation as many investors are keen to have efficient tax structures that minimise tax leakage, while paying liabilities that are due. They see very low tax obligations as conflicting with organisations’ social responsibilities embedded in statements of ethics.

Going forward, both institutional investors and fund managers are adapting to structural changes driven by the economy and society, and the changing demand and use of real estate by its underlying occupiers. The opportunities arising from these broader shifts represent a move to a more operational form of real estate and the identification of changing sectors such as local logistics, office hotelling, retail anchored place-making and micro-living as well as emerging sectors such as senior housing, healthcare, student accommodation and data centres.

> ‘Since the crisis, the product range for investors has also extended from real estate equity funds to real estate debt.’

Section 1

Introduction

1. Introduction

As the industry adapted to the legacy of the global financial crisis (GFC), the spectrum, structure and objectives of investors and fund managers have profoundly altered. In turn, this has been reflected in a corresponding evolution in the range, structure and objectives of non-listed real estate products.

This research examines the structure of the non-listed real estate industry and evaluates the catalysts driving its evolutionary change since INREV's inception in 2004 to the present. The research is primarily based on a structured interview approach, with findings derived from the analysis of twenty-six interviews undertaken with ten investors, eleven investment managers and five legal and tax consultants.

All respondents were required to have longevity in the industry spanning the period from 2004 to present. Each interview was analysed and the range of diverse views of the interviewees distilled consistently. The evaluation of interview material is supported by analysis of data evidencing the issues and trends identified through the research.

The findings of the research are presented in four principal segments. The interviewees generally identified three major stages of industry development – pre-crisis, the GFC and post-crisis – and section 2 presents an overview of these evolutionary periods. This provides context to sections 3 and 4 which evaluate the structural changes that have occurred over the same period across the investor base and within investment management platforms.

Sections 5 to 8 consider how this evolution has been incorporated into the range and terms of non-listed products, investment strategy, environmental, social and governance (ESG) implementation, and in the structure of non-listed real estate funds.

The final section considers the current strength of the industry as it positions itself to embrace the opportunities and challenges of the coming decade.

This report would not have been possible without the contribution of the twenty-six interviewees who gave of their time, knowledge and experience within the industry over the past fifteen years. We are most grateful for their time and openness in discussing the issues addressed through the interviews.

We also appreciate the support of Real Capital Analytics (RCA), which provided data on investment flows in the wider real estate market for the purposes of this research.

Of course, those contributing knowledge and information are not responsible for the views expressed in this report.

> 'This research examines the structure of the non-listed real estate industry and evaluates the catalysts'

Section 2

Structural evolution of the non-listed real estate industry

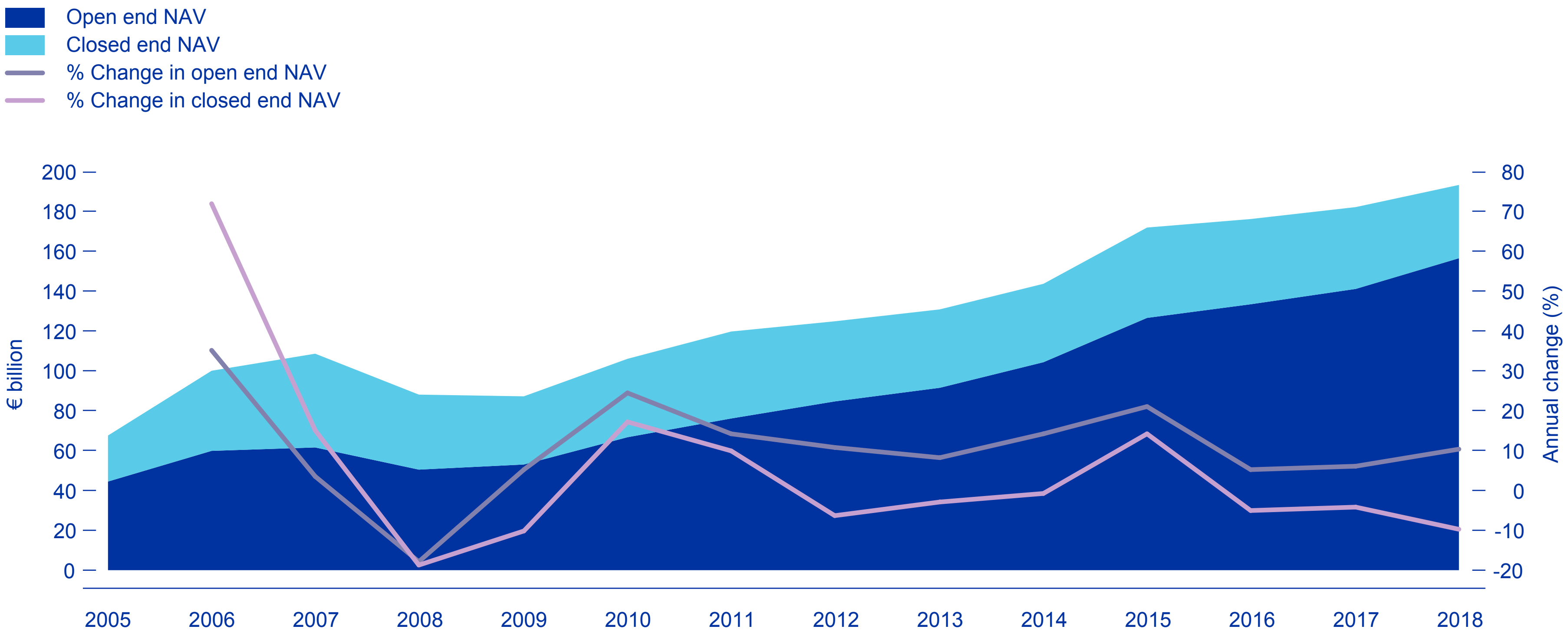
2. Structural evolution of the non-listed real estate industry

Pre-crisis

Although forms of non-listed real estate funds existed prior to the turn of the new millennium, the emergence of an industry enabling institutional investors to pool investments in vehicles managed by a sponsor or third party investment manager did not occur until the early 2000s. Its establishment was principally initiated by US investment banks, which transported the private equity real estate models they deployed in North American markets to Europe. Initially, these funds were predominantly opportunistic in style.

The investment model gained rapid acceptance in Europe. Regional investment managers emerged, employing non-listed real estate vehicles for both domestic and cross-border strategies. New products were developed across the spectrum of investment styles, using open end and closed end

Figure 1: Growth of open and closed end funds



structures (Figure 1). Core funds focused on assets generating secure income and these pooled vehicles offered many investors enhanced diversification benefits. They were particularly attractive to institutional investors that lacked the scale to invest in real estate directly in domestic markets and to larger institutional investors lacking the in-house capacity, scale or expertise required for investing cross-border.

Pre-crisis, the emergence of the non-listed real estate fund industry offered many larger investors the opportunity to diversify their portfolios geographically across new markets. Previously, such investors had developed real estate portfolios in their domestic markets, principally through direct investment. The capacity to diversify cross-border was impeded by the scale and expertise required. The development of a diversified portfolio across a range of real estate markets required knowledge and experience of local market practises and behaviours, and the different regulatory and tax regimes governing them.

The emergence of European non-listed real estate vehicles lowered the barriers to entry for cross-border investment, enabling investors to benefit from a pooled capital structure that offered returns from a diversified real estate investment portfolio. The specialist knowledge and expertise of third party investment managers offered investors an attractive solution for accessing new markets. From such investors' perspectives, the risks involved in entering new markets carried higher return requirements and, as a result, many investors moved up the risk curve as they started cross-border real estate investing.

At the same time, the emergence of non-listed real estate vehicles in domestic markets afforded smaller investors the opportunity to make asset allocations to real estate. Such investors lacked the capacity and specialist expertise to develop diversified real estate portfolios as part of their wider asset strategy as a consequence of investment scale and/or the associated costs of setting up a dedicated real estate division.

The growth of the industry coincided with a period of global liquidity. Fuelled by a low interest rate environment that offered an attractive spread between real estate and bond/swap rates, leverage ratios increased sharply. This sharply inflated the volume of capital targeting real estate, placing downward pressure on real estate yields. The resultant high returns from real estate attracted further capital to real estate and encouraged yet higher leverage, with the spiral fuelling a debt bubble that ultimately could not be sustained. This boom strongly contributed to the global financial crisis (GFC) that materialised as the global liquidity bubble burst.

The interview respondents considered that the reasons underlying the unrestrained use of real estate debt prior to the GFC were multi-faceted. A number commented that prior to the GFC, the real estate investment industry was largely unregulated and that while the banking industry was relatively

> 'The emergence of European non-listed real estate vehicles lowered the barriers to entry for cross-border investment'

more regulated, both industries failed to address factors driving individual behaviours, particularly rewards. In short, individuals in banks were rewarded for the volume of capital lent. Similarly, both the fund management platforms and individuals within them increased their rewards in line with the volume of capital managed or deployed, which could be readily bolstered by leverage.

In markets subject to stronger domestic regulations, sometimes due to previous domestic crises eg, Sweden, both investor appetite and provision from lenders were more restrained. Equally, a number of investors commented that unlike some peer investors, they did not suffer from any pressure to deploy their allocated capital and, as a result, did not invest in the years immediately preceding the crisis as the market overheated.

The situation of a rapidly evolving industry, over-burdened by debt and low governance was exacerbated by a light regulatory environment that also offered low barriers to entry to more short-term speculative investors. These included investors from a finance background that wished to exploit the prevailing yield gap and weight of capital targeting real estate, but that had an absence

> 'The non-listed real estate industry entered a period of general paralysis'

of real estate expertise. Crucially, they did not understand real estate's liquidity or transparency characteristics. Correspondingly, real estate professionals skilled in acquisition and property management established new fund platforms certain of their capacity to asset manage real estate, but lacked the financial skills and expertise required to structure and manage third party capital. A number of investors also commented that while their real estate strategies remained prudent, private equity teams within the same institutions who lacked real estate experience and failed to understand its liquidity characteristics, invested capital into highly leveraged private equity real estate funds. These legacy portfolios were later inherited by the real estate teams.

Both investor and fund manager respondents contend that the fiduciary duty involved in managing third party capital, especially that of institutional investors, was not fully understood or adhered to. Equally, institutional investors under pressure to deploy allocated capital invested in funds that offered limited transparency or reporting and both investors and managers failed to interrogate risk management structures and processes adequately.

The experience of the GFC

The sharp downturn in real estate values heralded the start of a wider financial crisis globally resulting from a debt-driven bubble across financial assets. The breadth and scale of the GFC was unprecedented. It resulted in a number of national economies being supported by the International Monetary Fund and the failure of major financial institutions, with some collapsing and others supported by various government and/or central bank initiatives.

The non-listed real estate industry entered a period of general paralysis, with global real estate markets entering an unparalleled synchronised downturn that was manifest across both occupier and capital markets, with debt markets frozen. In this environment, investors and investment managers refocused on their investment strategies, while regulatory authorities began to develop new policies to ensure that an event of this magnitude could not happen in the future.

As long-term investors, institutional investors have the ability to pursue counter-cyclical investment strategies. However, while a number of interviewees who were prudent pre-crisis were in a position to engage in counter-cyclical investing, the majority were engaged in attempting to unwind and/or manage their positions in non-listed real estate funds. In doing so, investors and managers began to learn some uncomfortable, but immensely valuable, lessons about the structure of non-listed real estate vehicles.

Some investors found themselves locked into positions due to excessive levels of debt resulting in out-of-the-money investments and/or the absence of an appropriate debt management strategy. The latter commonly resulted in mis-alignment of the duration of debt and associated hedging terms with that of the fund itself, with early redemption penalties effectively prohibiting asset sale and, in turn, fund termination. Clearly, this required a fuller understanding of the role of debt in real estate funds and its management.

One interviewee commented that with the benefit of hindsight it now seems ludicrous that the highest leverage was employed on the highest risk assets. A core fund manager, who had maintained very low leverage across the portfolios they managed stated that during the boom they often had to defend the relatively lower performance of their funds in comparison to the returns from higher leverage, opportunity style funds. They did so by demonstrating that the return on equity from their unleveraged core portfolio was higher than that of the opportunity fund, which had higher yielding underlying assets and therefore should have been relatively higher. This proved that the returns from the opportunity fund were driven by return on debt, rather than a return on equity or alpha generated from asset management expertise.

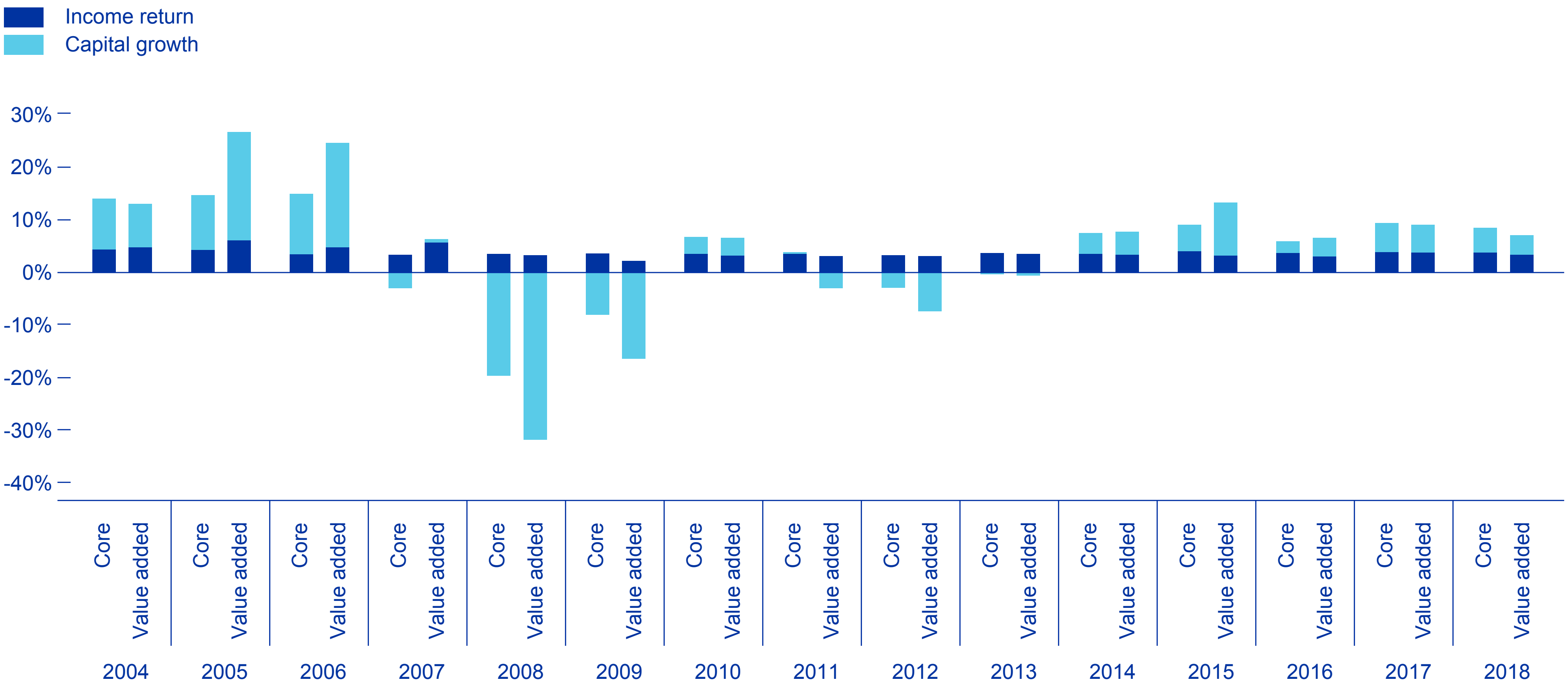
As real estate asset values declined, the quality of income generating assets in core portfolios protected their value relatively, and they recovered more quickly (Figure 2). In contrast, asset values in higher risk funds experienced a sharper decline and, given the high leverage, turned negative with the control of assets transferred to the lending institutions.

The limited understanding of the role of debt within portfolios formed part of a wider failure of risk management strategies that emerged as a failing of most non-listed real estate vehicles and had far reaching consequences.

Debt arrangements were commonly out of step with the duration of closed end funds and, in turn, inflation and currency hedging instruments they often employed carried significant penalties for early redemption. Although this mis-match appeared inconsequential pre-crisis, it was a significant obstacle to the effective management of portfolios during and immediately post-crisis. This contributed to the long period of extensions to individual fund positions that resulted in prolonged inertia across real estate markets, with both capital and time tied up in legacy positions.

Institutional investors and investment managers also recognised the extent to which they had allowed and enabled investment

Figure 2: Fund performance by style



strategies to drift in an effort to reach target returns in a market where yields had compressed to unsustainable levels. Focusing on target returns rather than risk, investment managers moved up the risk curve by acquiring higher yielding assets characterised by either a secondary location, and/or greater income risk and/or increased leverage rates. Although most funds specified a maximum leverage rate, this was often based on the future expected values of assets once they achieved income stabilisation after business plans were executed, rather than their value at acquisition.

In addition, late cycle it was common for fund managers to base leverage rates on the assumption that market values would appreciate by the fund termination date. In a market of rising values, this enabled fund managers to increase the loan to value ratio on an individual asset above the maximum leverage rate for the portfolio, particularly where real estate values of earlier acquisitions had increased, thereby lowering their loan to value ratio. Thus, as values declined, the strategy drift resulted in even some core portfolios having high leverage levels and higher risk assets.

> 'Fund managers' lack of understanding of debt, the risks it presented and the requirement for a debt strategy were a source of frustration for investors'

The misalignment of interest between investors and fund managers also became apparent. Many investors commented that this was not a major surprise as they had always appreciated that the objectives of investment managers naturally differed to those of investors. However, investors had failed to appreciate the degree to which the structure of management fees acted as an incentive to employ debt, and they had not paid sufficient attention to this when undertaking their due diligence.

Fund managers' lack of understanding of debt, the risks it presented and the requirement for a debt strategy were a source of frustration for investors, particularly where it resulted in a loss of control of assets to the lending bank and a subsequent forced sale. This significant risk associated with the potential loss of control of assets due to leverage was also raised by fund managers. They commented that during the GFC there were instances where banks took control of assets that had exceeded their loan covenants but retained satisfactory income coverage. In such situations, they spent a number of years managing assets for no return and simply paying the income to the bank.

Investors also discovered a misalignment of interest among co-investors in funds. In some situations, institutional investors in non-listed funds which were characterised by strong underlying assets favoured a long-term investment approach of holding and recapitalising assets through the downturn. However, they were often frustrated by co-investors, particularly fund of fund managers, who did not have the capacity to take a long-term position and who were required to unwind investments that could release capital required for other positions more quickly.

> 'Investors also discovered a misalignment of interest among co-investors in funds.'

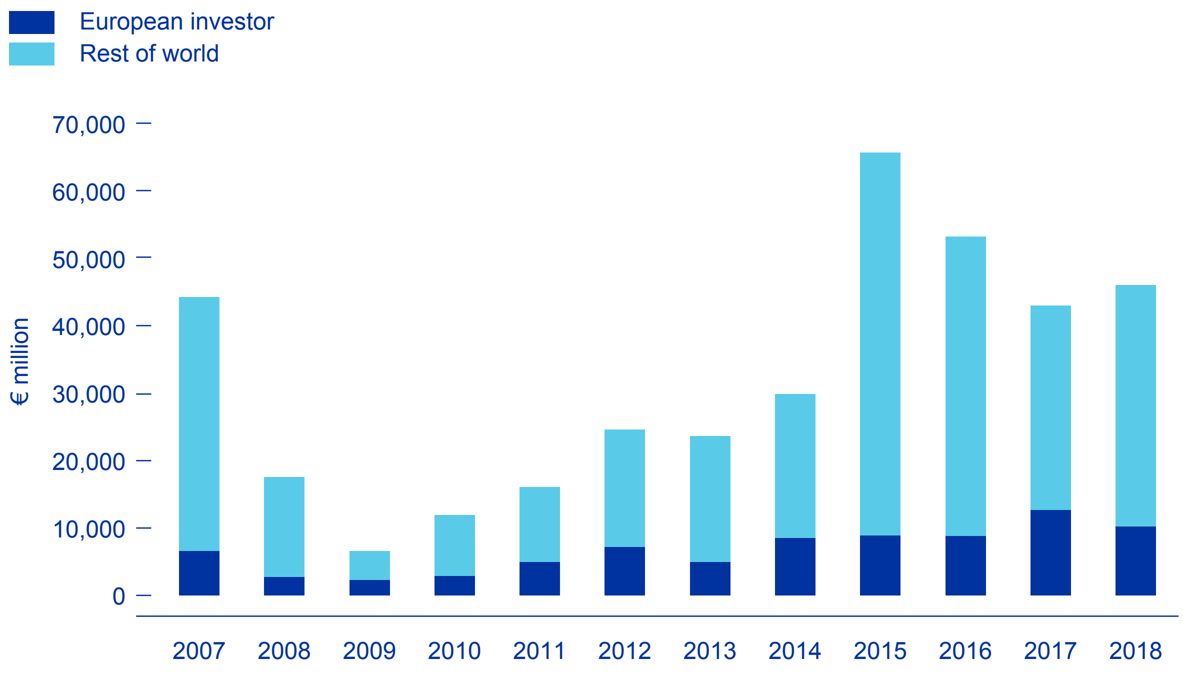
The investors interviewed commented that the crisis highlighted the need for stronger parameters around what is permissible within agreed investment strategies and the need for greater transparency and reporting. Both investors and fund managers commented on the importance of open and clear communication between stakeholders. Some investors and managers recalled that during the crisis a number of fund managers refused to provide information to investors, to establish advisory boards or to involve them in the process of unwinding positions in funds.

Post-crisis

All interviewees commented on the maturity and professionalism of the non-listed real estate industry in the post-crisis era. This itself is a legacy of the downturn and results from the experience of investing institutions, investment managers, a renewed appreciation of fiduciary duty and the implementation of a range of EU-wide and national regulatory regimes that, generally, have positively impacted the structure of the industry. At a European level, these include the Alternative Investment Fund Managers Directive (AIFMD), Solvency II, Basel III and IV, and the Markets in Financial Instruments Directive (MiFID II). While requiring some revision to smooth out inconsistencies between the various directives and perhaps reduce elements of reporting that are disproportionately burdensome, the real estate market has quickly adjusted and restructured to implement them in full.

There has also been renewed leadership from best-in-class investment managers and investors. Institutional investors have reasserted their long-term, and therefore universal, investor objectives and, in doing so, re-established their role as guardians of an equitable, sustainable economy and society in its widest context.

Figure 3: European investment volumes by investor domicile



Following the GFC, the predominance of US investment banks has diminished, with US regulation, principally Dodd Frank, limiting their investment capital to 3% in private equity funds, making them difficult to establish. Moreover, the appetite for such highly leveraged funds has not recovered.

The industry is primarily dominated by a smaller number of large investment platforms. There are fewer, but more broad based private equity platforms offering proprietary funds in more opportunistic investment styles, and a range of niche platforms offering expertise in specialist and operational segments of the real estate market, often participating as joint ventures partners to investors and/or investment managers. This has been largely driven by regulation, notably the requirements of AIFMD, and has resulted in market consolidation given the scale and organisation required to absorb costs, particularly for core funds (see section 3.0). Mid-sized platforms are disappearing with the mantra ‘Go big or go home, (or specialise)’ repeatedly quoted by interviewees. It is also difficult for new managers to emerge within the core segment given the associated costs of establishing a platform.

However, these barriers to entry also ensure that new entrants who do not possess the required expertise cannot enter the market speculatively to represent third party capital and, notably, such short-term opportunists have been absent during the growth phase of the current cycle. It has also curtailed the capacity of any individual within a platform to pursue over-exuberant strategies. Generally, post-crisis, the industry realises that to succeed, non-listed real estate investment requires more than the ability to be strong real estate asset managers and, equally, more than the application of finance and structuring expertise to cashflow models; it requires both. In this environment, a culture of mutual respect and cooperation among professionals has developed. This professional synergy has enhanced the application of such expertise and resulted in stronger risk management of third party capital within the industry.

The legacy of the crisis has also impacted investor behaviour. Insurance companies have been subject to greater regulatory change in the form of Solvency II than pension funds, while sovereign wealth funds and family offices/high net worth individuals (HNWIs) are outside of the direct scope of regulations addressing systemic risk. A number of investor interviewees commented that the crisis, and for insurers also regulation, amplified the desire to minimise exposure to leverage. However, Basel III and IV magnified the opportunity to benefit from attractive risk adjusted returns by providing real estate debt, expanding the range of real estate investing opportunities.

However, the reduction in leverage and general absence of non-institutional short-term speculators through the cycle post-crisis has not acted as an impediment to real estate investment volumes. The total volume of capital invested in European real estate has recovered to levels that have surpassed the peak prior to the GFC (Figure 3). This is the result of two main factors. First, many interviewees commented that the real estate industry is more global with cross-border flows increasing, especially from Asia. Second, monetary policies since the GFC have led to a sustained period of artificially low interest rates. These have reduced returns from fixed income assets, including negative returns on some government bonds and, in turn, have affected institutional investors' returns and asset/liability ratios. Consequently, investors have been attracted to real estate's fixed income investment qualities and relatively higher returns, which has compressed real estate yields.

Although there is no expectation this cycle of a systemic risk arising from debt levels, a number of interviewees commented that there is uncertainty as to how the market will respond as interest rates normalise. Yields are expected to rise broadly in line with interest rates. However, a more significant adjustment could occur should fixed income investors switch allocations back towards bonds abruptly.

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Section 3

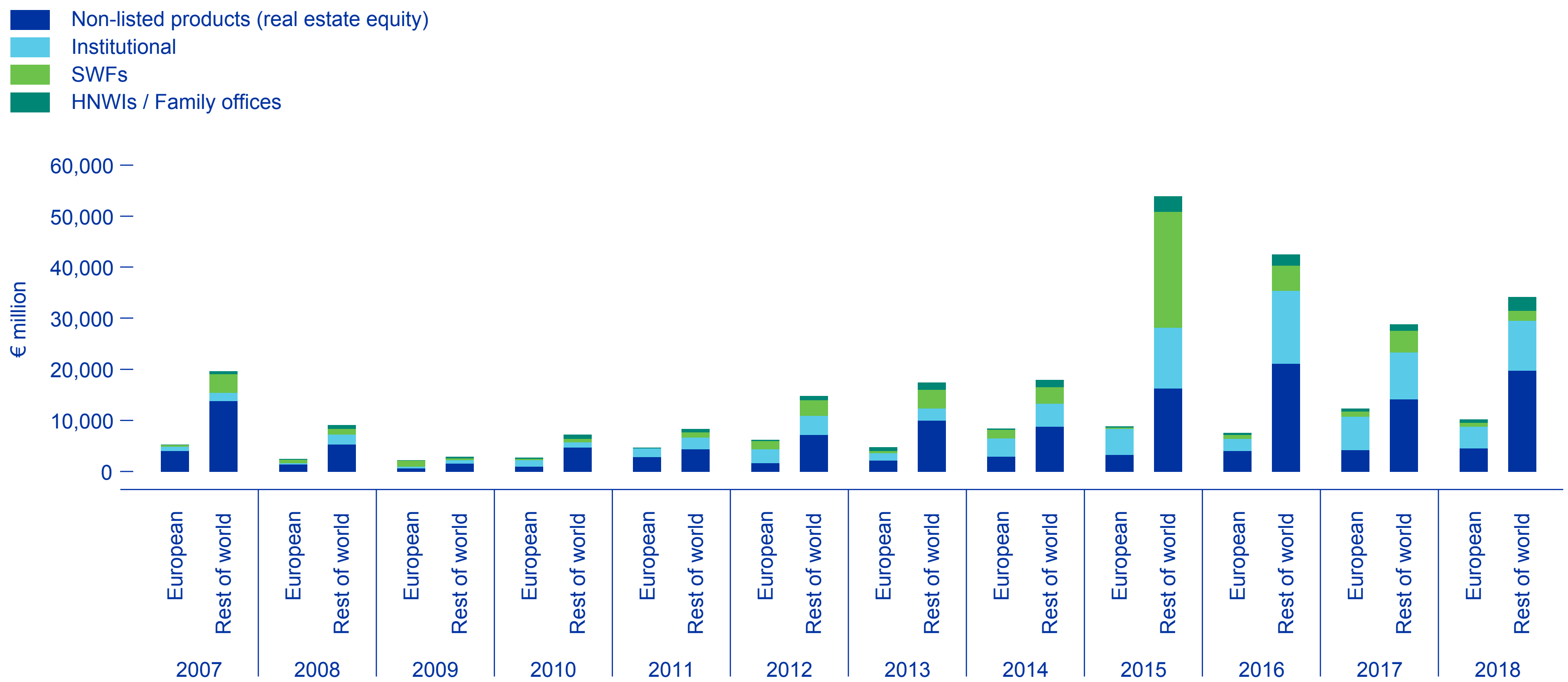
Investor evolution

3. Investor evolution

While European real estate investment requires local expertise and knowledge, its investor base is global. Indeed, even through the GFC, when many investors retreated to domestic markets as they reassessed their approach to real estate investing, inter-regional investors still represented the largest share of investment activity by investment volumes. In fact, their share is expected to be underestimated as they also invest in European domiciled non-listed vehicles (Figure 3).

This contradiction of global capital and the need for local and specialist real estate knowledge is central to the requirement for, and growth of, non-listed real estate vehicles. As Figure 4 shows, they are still responsible for the highest proportion of investment activity throughout the period. Although the overall share of total investment volumes accounted for by non-listed real estate funds has fallen since 2004, they have experienced strong levels of absolute growth in the post-GFC era.

Figure 4: European investment volumes by investor type and investor domicile

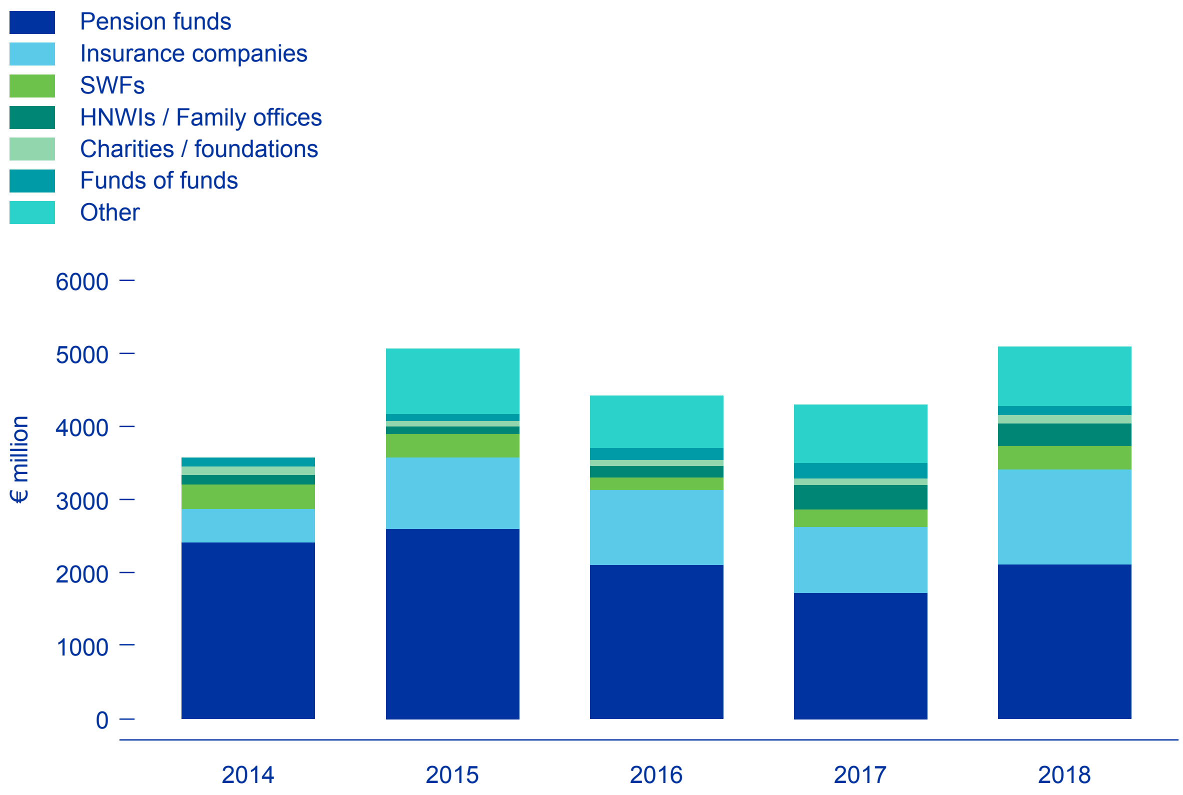


Eager to safeguard future real estate investment allocations, investors have revisited their over-riding investment objectives and the most effective way to deploy capital and manage risk. This has resulted in a wide range of investment strategies and business solutions that vary within and between different types of investors. In turn, this evolution has seen corresponding progress in the range, structure and objectives of non-listed real estate products favoured by investors.

Institutional investors including pension funds and insurance companies are the largest investors in European real estate. They invest in non-listed real estate both directly and indirectly through non-listed real estate vehicles. Their direct investment activity has increased in the post-crisis era both relatively and absolutely, with a number of large investors seeking to retain greater control over the execution of their strategic investment portfolios. Despite this, institutional investors continue to dominate the investor base of non-listed real estate vehicles managed by third parties (Figure 5). This reflects an increase in the number of small and medium sized pension funds seeking a real estate exposure or a higher allocation.

Sovereign wealth funds, family offices and HNWIs have also increased their level of investment activity. This is particularly evident in the direct investment activity of inter-regional investors, although their share of capital invested through non-listed real estate vehicles has also increased in recent years.

Figure 5: Capital raised for European non-listed real estate equity vehicles



Pre-crisis, the growth of non-listed real estate vehicles was predominantly through funds. Ostensibly, these structures enabled investors to access new markets and sectors by lowering risks through pooled capital. The emergence of such funds offered a solution to the scale required for such real estate investment strategies, to the provision of the required expertise and local knowledge and, at the same time, presented diversification benefits.

During the GFC the risks of investing through such vehicles, while not unknown, became manifest. In particular governance issues, alignment of interest with managers, co-investors and control of investment decision making surfaced. Through the GFC and the recovery period that followed, real estate investment declined over-all and volumes invested through non-listed real estate funds declined even more sharply. As real estate investment volumes recovered, there was a discernible shift in the preferred mode of investing, with many large investors investing a higher proportion of their allocation through direct investments or more bespoke vehicles. These included separate account mandates, club deals and joint ventures (Figures 6 to 9).

This expansion in the range of indirect non-listed real estate products materialised during the slow recovery in the volume of non-listed real estate funds by both number and capital. Although each of these products shares some characteristics with non-listed real estate funds, each has a distinct structure. Many interviewees commented that they class all such vehicles as non-listed real estate regardless of their structure and that they do not differentiate between them significantly, but rather are led by how the vehicle fits with the underlying opportunity. For a smaller number of other investors, closed end funds, particularly for strategies that move up the risk curve, are considered to offer too little control (Section 5)

Figure 6: Expected changes in allocations to directly held real estate

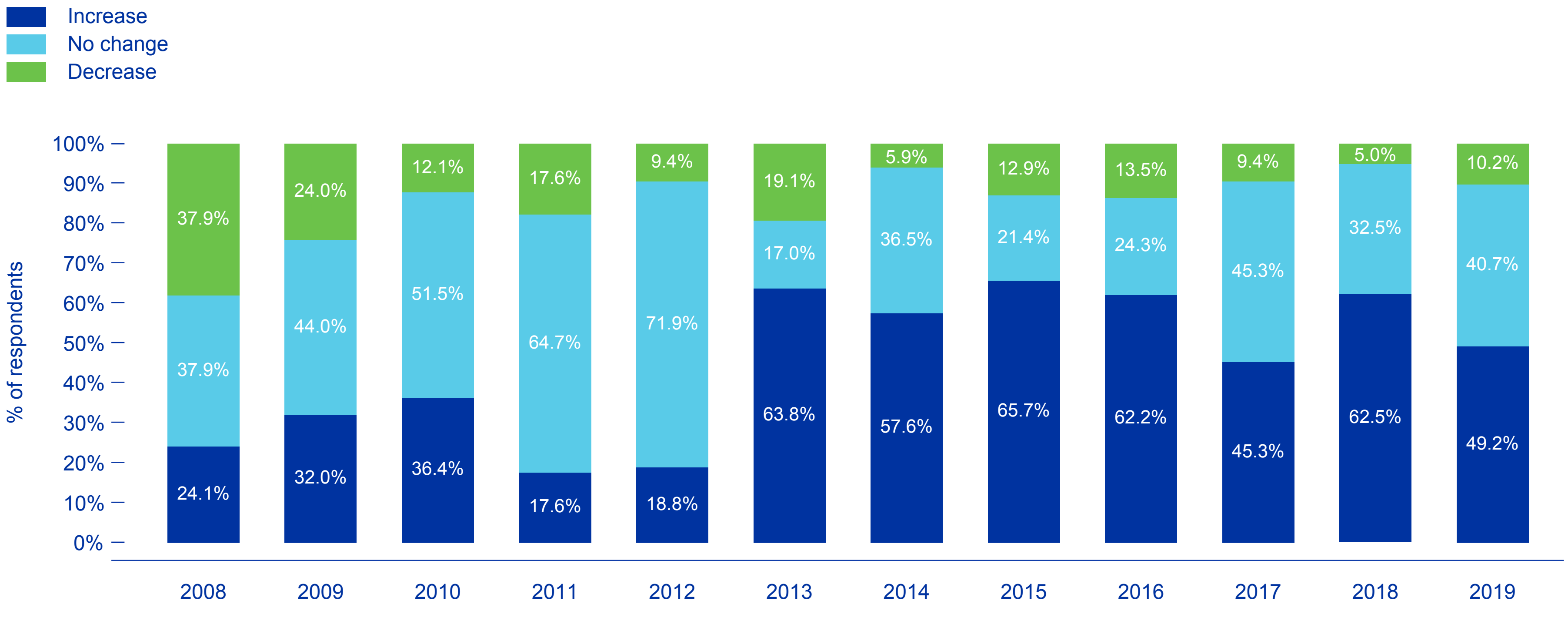


Figure 7: Expected changes in allocations to joint ventures and club deals

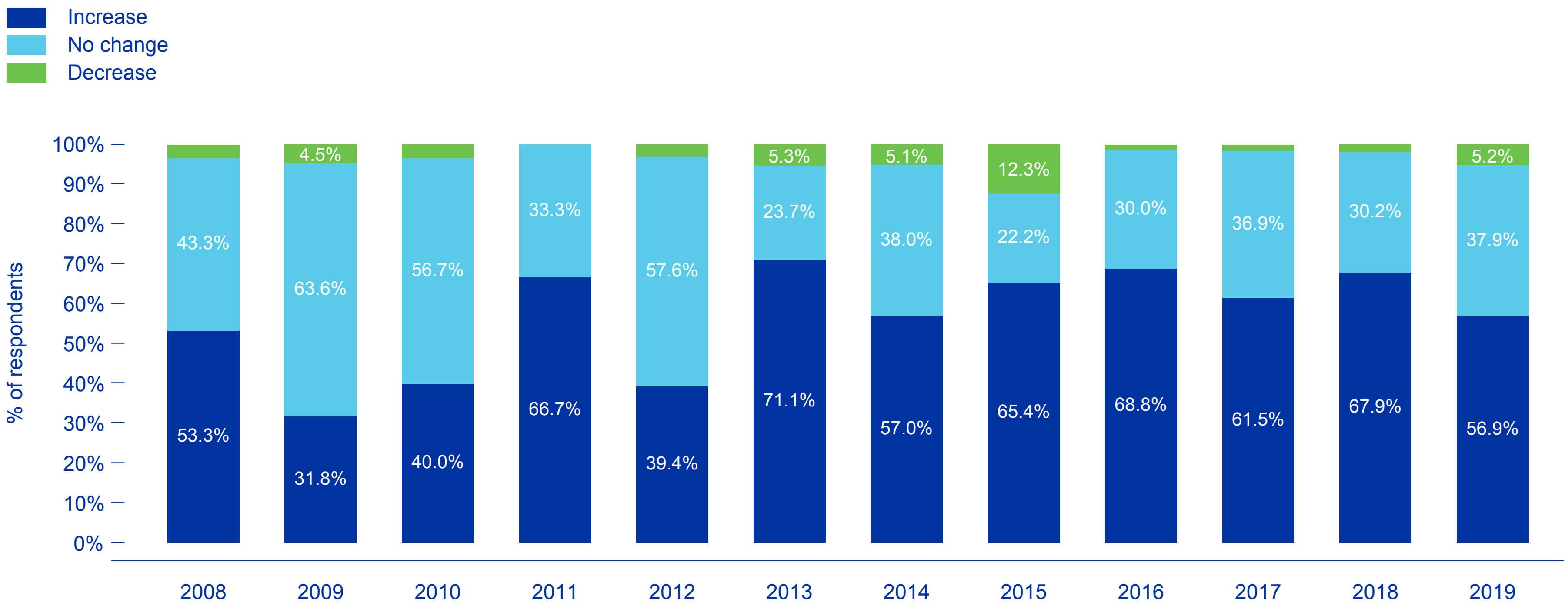


Figure 8: Capital raised by type of vehicle (European strategies of all managers)

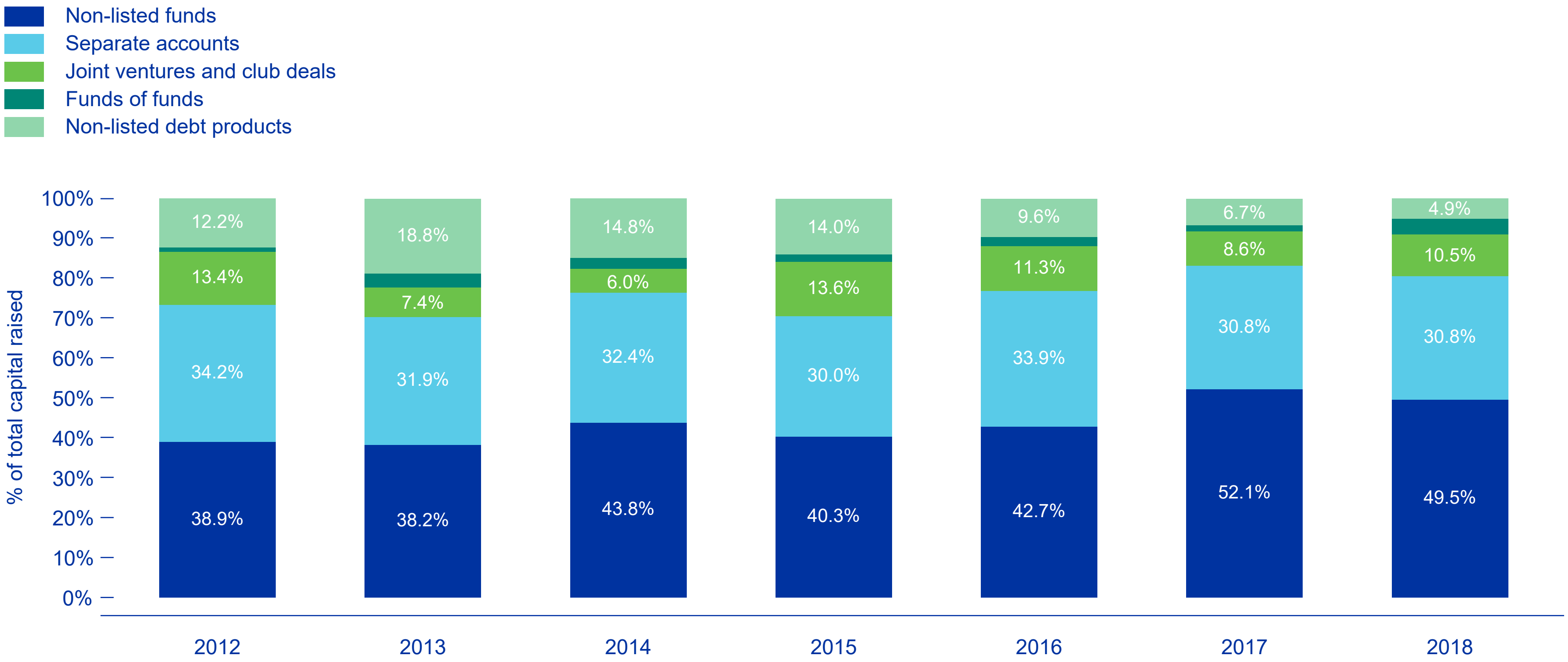
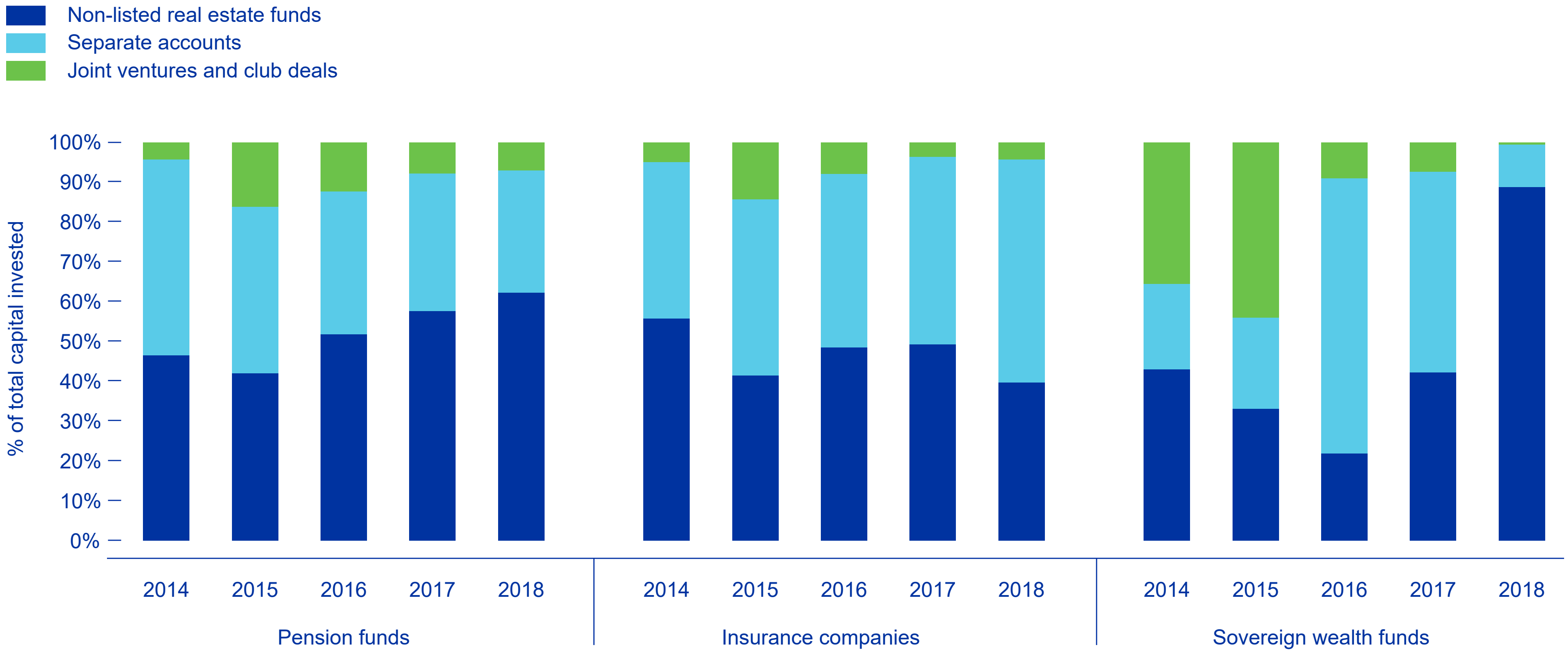


Figure 9: Distribution of capital invested in European non-listed real estate by product and investor type

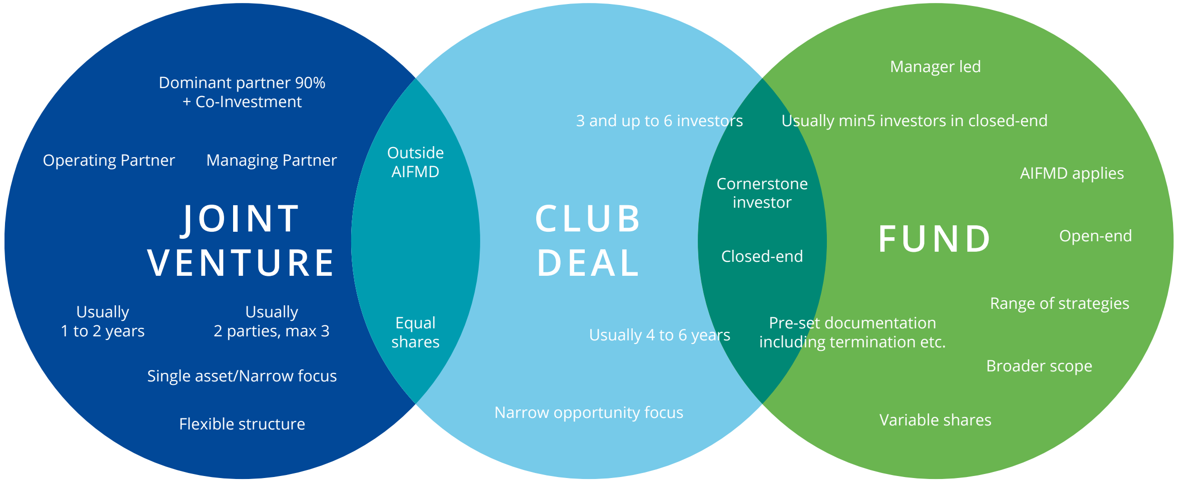


In the wake of the GFC most investors sought greater control and this materialised in many large investors shifting their preferences toward direct investing. However, many large investors lacked the internal capacity and capability to construct, execute and/or asset manage real estate investment strategies. Many appointed preferred investment managers to undertake separate account mandates. Initially, investors usually devised their investment strategy and effectively instructed the investment manager to execute it. However, as this investment model was further adopted by medium sized investors, investment managers also developed separate account strategies for clients based on their defined investment objectives.

The interviews revealed that there is no accepted definition of what constitutes a joint venture or a club deal. Indeed, the boundaries between them appear blurred. For some investors and investment managers, it is simply a question of how many parties are involved with two or a maximum three investors constituting a joint venture, while a club deal is three and up to six investors.

For others, the separation is more nuanced, but there remains little consensus on any specific differentiating characteristics. For some investors, a joint venture represents a co-investment arrangement with an operating partner (as opposed to an investor) or specialist fund manager, with the investor holding a large majority stake. In contrast, others view a joint venture as being characterised by relatively equal share

Figure 10: Comparison of joint ventures, club deals and funds

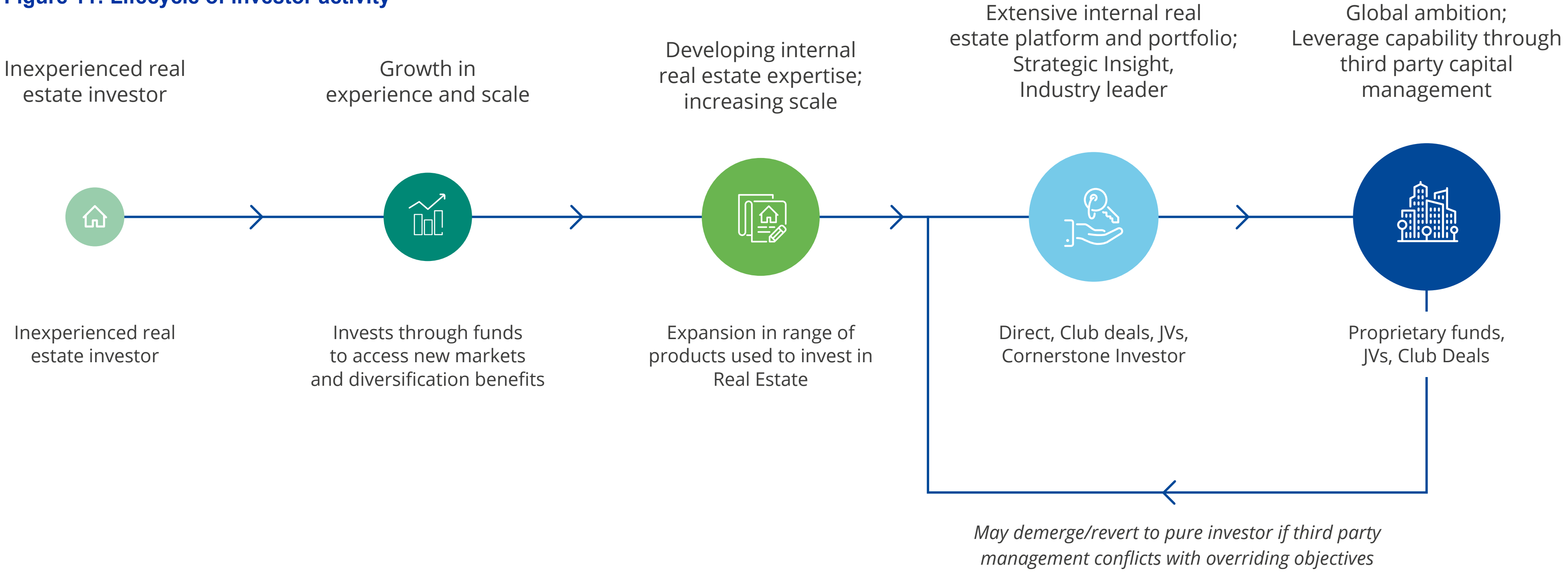


holdings between two or maximum three investors and/or operators. In addition, joint ventures are usually focused on a specific asset or type of investment. As they have fewer parties and are based on a specific business plan, with a relatively defined timeline for an asset or group of assets, the structure is often more flexible than a club deal, with less pre-set documentation around termination rights, extensions and exit strategies.

For club deals, there is also considerable variation into how they are defined. Some interviewees consider them to be very similar to funds, while others consider them to be almost indistinguishable from joint ventures. It was agreed that a club deal involves three or more parties. Some consider club deals to usually have unequal shareholdings, often with a cornerstone investor leading the structure. To this end, some interviewees view them as an extension to separate accounts, with the initiating investor and manager selectively opening up the bespoke fund to other investors.

For others, club deals are characterised by relatively equally shareholdings and managed by an appointed third party manager. In addition, some interviewees consider that club deals usually represent a wider investment strategy than joint ventures, involving the acquisition and/or development of a diversified portfolio of assets in comparison to joint ventures. As a result, the structure and terms of club deals are very similar to those

Figure 11: Lifecycle of investor activity



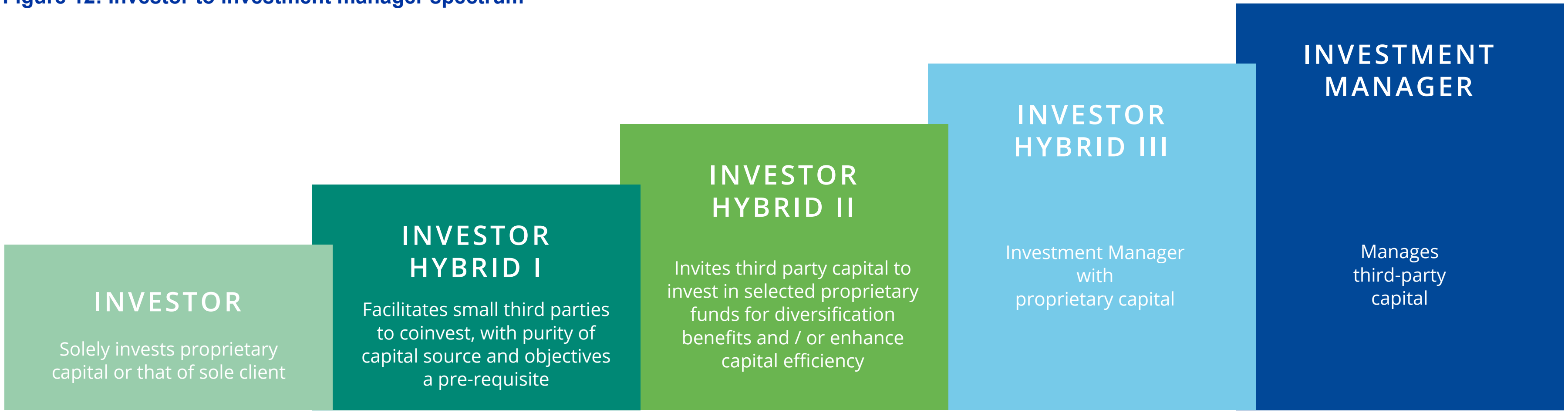
of non-listed funds and are pre-defined at the outset of the fund. They include detailed parameters of the investment strategy, debt strategy, legal and tax structure, investment horizon, termination rights and mechanisms for changing the strategy and/or dealing with unforeseen events.

One investor suggested that he views club deals as being equivalent to funds in all respects except that you are selected by private invitation to join and to this end, it is the equivalent of receiving your platinum frequent flier card. A fund manager also noted that these type of club deals are beyond the scope of AIFMD and do not require a capital reserve, enabling acquisitions to be funded out of available liquidity.

To an extent the GFC accelerated and amplified a natural evolution in investor participation in non-listed real estate funds, reflecting an identifiable life-cycle (Figure 11). Investors new to real estate, specific real estate markets and sectors benefit from the opportunity to invest through funds managed by third party investors. These funds reduce the initial capital allocation required by an individual investor to gain exposure to a desired region, market or sector by offering risk management solutions through the greater diversification offered by pooled capital, access to product through existing relationships and local knowledge, local asset management expertise and legal and tax expertise required for effective financial management. As investors gain experience in new markets and expand their scale, they develop proprietary knowledge and expertise.

For investors with critical mass, their investing options expand as their experience in new markets matures. They may choose to develop their own platforms and invest directly, to appoint a third party manager to

Figure 12: Investor to investment manager spectrum



These descriptions do not represent INREV member definitions

invest using a separate account, or with other selected investors through a club deal, or with other investors or operator partners through a joint venture.

Investors developing their own platforms may choose to capitalise on their expertise and allow other investors to co-invest. In doing so, expand their position in the real estate market from investor to third party capital manager.

However, the scale, type and role of third party capital varies across investors. Figure 12 illustrates the spectrum of investor to investment manager roles, with various investor-hybrid models lying between them. At one end of the spectrum is ‘investor’, representing institutions and companies that solely invest proprietary capital and at the other, is ‘investment manager’, representing organisations that solely manage and invest third party capital.

Between the polar ends of the investor-manager spectrum are various hybrid investor/manager forms and these are classified as Hybrid I, II and III. Hybrid I describes large institutional investors that have permitted small third party investors to co-invest, or invest side by side in their investments. Importantly, permitted investors are domiciled in the same jurisdiction, from the same financial industry, subject to the same regulatory controls and mirror the principal investor in terms of maturity profile and investment objectives.

Hybrid I investor-managers contend that these characteristics result in a ‘purity of capital’ in respect of the source and intended purpose of capital. The limited scale and homogeneity of this third party capital scarcely impacts on the principal investor’s behaviour. The aggregate capital of third party investors is dwarfed by that of the principal investor. Indeed, this is the attraction for these small investors that essentially take the opportunity to piggy-back on the investment strategy and due diligence of what are behemoths within their sphere.

Hybrid II contains investors that have sought third party capital to co-invest in their proprietary funds. Such third party capital is usually from relatively large institutional investors and, in comparison to Hybrid I, the number of third party investors is low and the scale of investment more significant.

The decision to pursue third party capital is driven by strategic business objectives and while these vary among Hybrid II investor-managers, the dilution of existing funds with third party capital allows the investor-manager to increase scale and potentially extend geographic reach without diminishing the diversification benefits of existing portfolios. However, third party access is limited to certain funds within the wider portfolio and participating third parties are selected and invited to invest.

Other investors experienced a more complete transformation into full-service investment managers that have the benefit of proprietary capital and are classified as Hybrid III investor-managers. The business drivers underpinning this evolution vary and may stem from merger and acquisition activity, investors seeking to capitalise on their internal expertise, to increase their geographic reach and/or to increase their scale.

Importantly, the evolutionary curve also involves investors that had evolved into investment managers later withdrawing from third party capital management or separating the entities, and often ownership, of the original proprietary investor from the investment management business.

For the purposes of this research, Hybrid I and Hybrid II investors managing third party capital that is less than 15% of real estate AUM are considered as investors. This is in line with INREV's standard definition. Hybrid II and Hybrid III investors that have third party capital in excess of 25% are considered investment managers. This higher threshold is for the purposes of this research analysis only and reflects a greater blurring of the boundaries between investor and manager within Hybrid II, particularly. Some investor-managers may have less than 25% third party capital in real estate AUM, but within certain funds it might be higher while third party capital is not permitted and therefore 0% in other funds. For the purposes of this research, Hybrid II investor-managers with third party capital of up to 25% AUM are discussed alongside those with less than 15% within the investor section.

Investors working through the GFC generally highlighted a number of weaknesses of fund structures and agreements. This was particularly around alignment of interest between managers and investors, and between investors; control of decision-making especially for fund terminations, and risk management in terms of governance; fund strategy and management, and investment strategy.

Institutional investors

Institutional investors include pension funds and insurance companies that may be segmented by scale and by maturity. Smaller investors lack the scale required to develop and manage a diversified real estate portfolio domestically and even medium size investors

'Investors working through the GFC generally highlighted a number of weaknesses of fund structures and agreements'

struggle to do so internationally. They have three real estate investment options: invest in non-listed real estate; invest in listed real estate directly or indirectly through a fund, multi-manager or fund of funds, or do not allocate to real estate.

The scale of large investors affords them a wider range of possible investment modes. Most institutional investors employ a range of modes including direct, non-listed fund structures, separate accounts, club deals and joint ventures. Their preferred weightings vary across investors, reflecting internal capabilities, diverse experiences of the GFC, differences in favoured real estate investment strategies and the maturity profile of the institutional capital they are deploying.

In turn, this led to a restructuring of the real estate investment platforms within institutional investors that can be summarised in the emergence of a new typology of institutional investors. The typology may be split into institutional investors that retained a relatively small internal team and those that retained or established a large real estate platform to undertake a high proportion of real estate investment and/or asset management internally. For some investors, the expansion and/or strengthening of their internal capability also opened up the potential opportunity to manage third party capital. The impetus behind exploring this opportunity varied across investors with some seeking perhaps to cover the costs of internal management, while others sought to increase their scale or geographic reach. This resulted in the emergence of various hybrid investor-manager models, classified as Hybrid I, II and III.

Small internal team

A number of interviewees representing institutional investors with large real estate portfolios in excess of €8 billion continue to manage their investments with a relatively small, but highly skilled and experienced team. Their real estate allocation is deployed broadly, across a combination of direct investing, separate accounts, funds, club deals and joint ventures. It was stressed that there is no set allocation to any structure, rather they are led by the underlying investment opportunity and apply the most appropriate structure to it.

> ‘Institutional investors prefer to co-invest with pension funds or insurance companies that share a similar maturity profile’

Following the crisis, these investors focused on transforming the structure and terms of funds to guarantee effective risk management and secure stronger alignment of interest. These investors do not seek to retain discretion, rather they ensure that the parameters of the investment strategy are set appropriately and that fund documentation is detailed and covers unforeseen events. Once they have undertaken their due diligence thoroughly and are satisfied of the manager’s capability, these investors hand over discretion to the investment manager to execute the knowledge and expertise they appointed it for.

Generally, core assets in domestic markets are direct investments and core open end funds are used to access income return from standing assets in non-domestic markets. Investment in alternative sectors and in higher risk strategies involving an investment period and business plan application to reach stabilised assets are usually made through closed end funds, club deals and joint ventures. While some investors seek majority or controlling interests in such structures, others require them to be more evenly balanced with a strong advisory board.

In making such allocations, the underlying business objectives of co-investors are a major consideration. Institutional investors prefer to co-invest with pension funds or insurance companies that share a similar maturity profile and that are subject to the same regulation, as this ensures a closer alignment of interest should unforeseen events occur. Similarly, one German investor prefers to invest in non-core assets through separate accounts or joint ventures due to the culture of discretionary funds dominant in Germany for closed end structures, particularly Kapitalverwaltungsgesellschaft (KVG) vehicles. The separate account structure was seen to better enable the investment objectives to be met, and for the portfolio to benefit from the expertise of the appointed manager. With KVG funds, co-investors were seen to often lack the expertise for cross border strategies and could overly influence direction and decision-making.

> ‘Retaining control over investment decision-making is central to risk management and requires a large, dedicated internal platform.’

Large internal real estate team

Following the GFC, many large institutional investors began to construct large internal real estate platforms in order to retain greater control over investment decisions. Some investors had rapidly expanded their real estate activities, especially cross-border, during the 2000s without developing their internal capabilities. Others no longer considered the advantages of non-listed real estate funds to outweigh the disadvantages, given they had gained experience and knowledge of non-domestic markets. In addition, the misalignment of interest with investment managers, and particularly co-investors, had impeded their ability to deploy long-term counter-cyclical investment strategies.

For these investors, retaining control over investment decision-making is central to risk management and requires a large, dedicated internal platform. Some investors extended the platform to enable them to act in a 'semi-direct' capacity; that is devising investment strategies internally and, where appropriate, selecting partners and/or investment managers, but outsourcing its execution and management. Other investors sought to develop a full-service capability. This impacts on the business structure of such investors and on their mode of investing.

Business structure

A number of very large institutional investors already possessed the required scale to operate an economically efficient internal platform. However, others, especially those seeking to establish a full-service platform, required additional capacity.

This variation in the underlying business objectives of investors, coupled with differences in scale and existing expertise, is mirrored in the diverse business strategies employed to develop internal platforms and the more complex spectrum of institutional investors that exists post-crisis. At one end of the scale are large investors with a large internal platform that invest their own proprietary capital or on behalf of the sole institution for which they act as real estate investment manager.

At the other end of the scale, a number of institutional investors acquired or merged with established investment managers in order to secure the required expertise to manage investments internally and to achieve the economic scale required. In many of these mergers and acquisitions, a key objective was to increase activity globally through recapitalising. This was achieved by diluting existing portfolios with third party capital enabling scale and diversification benefits to be retained. In doing so, they have transformed from being institutional investors into Hybrid III investor-managers; full-service investment managers with proprietary capital. In this respect, they have a similar profile to institutional investors that transformed into investment managers pre-crisis by expanding their capital under management by opening to third party capital management.

Other investors have evolved their business models to include third party capital while seeking to maintain their investor focus. This has given rise to a range of different models which are segmented into Hybrid I and Hybrid II investor-manager models by the scale of third party capital being managed, the relative number and size of third party investors, and the homogeneity of the source and purpose of capital being managed. A number of pension fund managers interviewed operate a Hybrid I model, permitting a relatively large number of very small pension funds to co-invest alongside them, but the total volume of capital remains less than 5% of AUM. These large pension funds are able to capitalise on their expertise, with fees lowering the cost of their internal platform, although this is not a primary driver. They also consider it an important service for small pension funds that wish to benefit from an allocation to real estate, but that lack the scale of capital to invest either directly or through non-listed vehicles. They may also lack the knowledge and expertise to align allocations through multi-mangers to their long-term investment objectives. The large pension funds understand the business operations and investment requirements of their smaller counterparts and this purity in the source and purpose of the third party and proprietary capital is a pre-requisite to accessing this side-by-side investment opportunity.

> 'Investors have evolved their business models to include third party capital.'

This homogeneity of capital objectives is also present in the Hybrid II model, which differs in the structure of co-investors and in the drivers which underpin the decision to accept third party capital. Post-crisis, some investors reviewed their portfolio strategies with the aim of rebalancing domestic, regional and inter-regional holdings. Rather than seeking to dilute existing capital they sought third party capital to increase the size of certain international funds and thereby enhance diversification. In rebalancing their portfolios more globally, they also saw third party capital in certain domestic funds as an opportunity to more productively use their internal investment teams focused on domestic markets. In Hybrid II, the third party capital comprises a small number of relatively large investors experienced in real estate acting as co-investors in a fund structure. The third party capital remains less than 15% to 25% of total real estate AUM, although there is a higher concentration in certain individual funds as not all funds are open to third parties.

Over the same period, some investment managers that had evolved from a proprietary institutional investor pre-crisis into a third party management platform, de-merged following the crisis. All the examples discussed with interviewees were life insurance businesses. Pre-crisis, large life insurers with real estate investing experience harnessed the opportunity to capitalise on their knowledge and expertise to take advantage of the increasing capital being allocated to the sector.

The proprietary capital was often used to seed new funds and this approach continues to be employed by some investment managers that are classified under the Hybrid III model. However, during the crisis it became apparent within some of those investment managers that there was a disconnect between the long-term income objectives of the proprietary capital and the objectives of third party capital. Moreover, some structures rendered the rights of the proprietary capital as being secondary to third party capital. As a result, such investors de-merged from the investment management platform and resumed an autonomous investor position.

Mode of investing

Investments in traditional sectors in domestic markets are primarily direct. For non-domestic investments, all investors continue to make allocations across the range of non-listed real estate vehicles. The extent to which they employ any particular product type varies according to their wider business strategy, investment strategy and the underlying real estate opportunity.

Some large investors have established their real estate platforms to invest directly, or semi-directly through joint ventures and club deals where possible and only invest through non-listed funds in geographies or sectors where they lack the internal expertise or capability. For such investors, retaining control is a high priority and it is contended there must be a compelling reason to relinquish it and, at the same time, incur fees. Immediately post-crisis, it was common for large investors to devise strategies and either appoint an investment manager to execute it, or to act as a cornerstone investor and retain control of the fund, but permit third party investors. Many investors commented that their ability to dictate terms has diminished as the landscape has altered; the number of large investors in the market has increased and consolidation has decreased the pool of investment managers.

> ‘Many investors commented that their ability to dictate terms has diminished as the landscape has altered’

As investors commonly state that investment structure follows investment strategy, investment style is also an important driver of product selection. Many large investors make core allocations through large open end funds. Although some investors directly invest in core assets within Europe, most invest inter-regionally through non-listed real estate funds. The large open end diversified core equity (ODCE) funds in the US are favoured. While even large investors cannot influence their strategic direction, their scale offers a level of liquidity that compensates, therefore enabling the investors to trade easily and in this way retain control. It was noted that while core funds in Europe are not of this scale currently, the implementation of AIFMD and the rationalisation of investment managers that stemmed from it, have resulted in the emergence of a small number of very large European core funds (Section 4.0). These fund structures are favoured by many investors seeking to invest indirectly in passive, core investment strategies within the region.

A smaller number of investors prefer to award separate account mandates to investment managers and thereby maintain greater control. However, it was noted that this requires scale to achieve appropriate diversification and that investors pursuing this investing option who lacked such scale are increasing their specific risk within their portfolios.

Active strategies generally involve the execution of asset business plans with a development/repositioning phase (for example, construction, leasing, redevelopment, tenant engineering, maturing sector, etc.) prior to reaching income stabilisation across the portfolio. For this reason, open end vehicles are not considered appropriate. Investments in active strategies are predominantly made through club deals, joint ventures and non-listed closed end funds. A small number of investors considered fund structures to be inherently pro-cyclical and therefore contrary to their long-term investing strategies. However, most suggested that the time horizon of five to six years or less for closed end funds has shortened considerably in comparison to the pre-crisis era and that business plans underlying them are more focused. The selection of structure is primarily driven by the investment opportunity.

Some large investors prefer joint ventures where an investment strategy's success is reliant on an operating partner as they prefer to select the partner and manage the relationship. Moreover, the strategy enables them to invest over a longer-term investment horizon with the objective being to hold stabilised assets. Although many closed end funds are structured to enable them to turn evergreen at the end of the investment period, the mechanisms cannot provide certainty, as they are reliant on the decisions of co-investors and future developments in market pricing. Joint venture arrangements between an investor and an operator also arguably provide increased certainty for the operator and therefore increase the quality of potential partners. In this respect, joint ventures between an investor and an operator (as opposed to another real estate investor) are more similar to direct investments.

Sovereign wealth funds

Sovereign wealth funds emerged as significant investors pre-crisis. Although different to institutional investors in terms of asset allocations, fiduciary duty, asset liability ratios and governance, they share their long-term investment objectives in respect of real estate. Relatively new to real estate investing in the region pre-crisis, these investors primarily employed non-listed fund structures late in the growth cycle. As a result, their investments were particularly exposed to the strategy drift that occurred in terms of risk in both asset quality, pricing and leverage.

During the crisis, sovereign wealth funds shared a similar experience to long-term institutional investors, finding that their capacity to mitigate their losses by holding and reinvesting in assets to position for the recovery was frustrated by misaligned interests with both managers and co-investors. They also considered their own lack of internal expertise as an impediment to risk management and remedied this by building large internal platforms. Initially, the aim was to mirror the functions of professional investment manager platforms to enable better and more proactive decision making. By the end of the crisis, they had developed the capacity and capability to invest directly or indirectly across the spectrum of non-listed real estate vehicles.

> 'Sovereign wealth funds emerged as significant investors pre-crisis.'

Their mode of investing is skewed toward direct investment in advanced economies, with investment strategies developed internally. In the post-crisis era, they continue to seek control by investing with full equity, although they may appoint an investment manager to execute and manage a strategy. The consolidation of investment managers and growth in scale of core open end funds is restricting their capacity to appoint and diversify separate account managers.

Club deals and joint ventures are also used for specific opportunities. For strategies requiring operational expertise, they tend to invest as the sole real estate partner in a joint venture with their operating partner. They also continue to invest through funds, usually for niche sectors and higher risk strategies. Immediately post-crisis they sought a controlling interest in funds, but this has diminished for a number of reasons. First, they focus on their due diligence, ensuring the strategy scope is detailed and restricted appropriately, and that they are certain of the manager's capability. Second, they are selective when it comes to co-investors, preferring investors with a long-term investment horizon and compatible objectives and capital capacity. Third, they continue to take a large stake that ensures that they are part of the advisory board and enables them to steer, but not control the fund. These investors also commented that their power had diminished given the greater number of investors making large capital allocations in a consolidated marketplace.

Family offices and HNWIs

Although still a relatively small share of invested capital in the real estate market and in non-listed vehicles, the share of capital from family offices and HNWIs is expanding. In the context of the non-listed real estate universe, these private wealth investors may be segmented into three groups by value. First, HNWIs with total capital over €10 million but less than €100 million. These investors primarily invest in real estate through multi-asset funds or other retail products that are outside the scope of this research. Second are Ultra HNWIs with a net worth in excess of €100 million but less than €800 million. In a real estate context, they are classed as small investors, usually making allocations with a ticket size of around €15 million. These investors often invest directly or through club deals with other HNWIs within their network, or indirectly through multi-managers. Third, family offices with multi-generational, multi-billion euro funds. The investment objectives of Ultra HNWIs and family offices are summarised in Table 1.

Table 1: Comparison of Ultra HNWI and Family office investment profiles

	Net worth (€ million)	Allocation to real estate (%)	Geographical focus	Investment focus	Control
Ultra HNWIs	100-800	50	Strong domestic bias	Growth; Absolute Returns	Discretion
Family Office	1,000+	30-50	Domestic bias and international	Growth; Absolute Returns	Discretion

Although these private wealth investors share some common characteristics, their approach to real estate investing is varied and they employ a variety of strategies and styles. Their risk appetite spans all styles beyond core, although there is a greater emphasis placed on absolute returns and cash multiples. This reflects their over-riding real estate objective to maximise the total return on individual investments and increase their capital base. This makes them distinct from institutional and sovereign wealth funds seeking to secure a long-term stabilised income stream from a capital base.

Family offices and HNWIs are not subject to the fiduciary standards required of institutional investors, although they are accountable to their own internal boards. As a result, their decision-making processes are faster and more responsive to changing circumstances than institutional investors, for whom changing strategic direction is a more complex organisational process. This difference is also reflected in their mode of investing and preference for non-listed real estate structures. Family offices prefer to retain discretion and have certainty over time frames and therefore prefer closed end structures. These structures are also more suitable for higher risk strategies. Family offices are keen to retain flexible and agile strategies that enable them to quickly respond to short-term opportunities, particularly arbitrage pricing, that fall outside the scope of the agreed strategy. Their investment objectives and strategy scope are largely incompatible with those of institutional investors.

Family offices and HNWIs tend to invest directly or to co-invest with others across their network through funds, club deals and joint ventures. A fund will usually be established by an individual with access to capital from private wealth sources that may either manage the fund on an existing platform or appoint a third party manager.

However, there are often differences in the investment management behaviour of first generation and later generation family offices that persist across regions. First generation family offices/ultra HNWIs are primarily domestically focused, tend to reject core in favour of higher risk strategies and take an active role in investment decisions, retaining discretion. A proportion of first-generation investors also select assets on the basis of their perceived prestige rather than on the underlying real estate investment performance metrics.

‘Private wealth investors share some common characteristics, their approach to real estate investing is varied and they employ a variety of strategies and styles.’

Later generations are often less actively involved, typically preferring to appoint professional managers externally, or where large in scale, to build a professional capital and real estate asset management platform internally. These platforms represent a more professional and sophisticated approach to investing that is more institutionalised in approach and extends to core investing.

‘Family offices and HNWIs tend to invest directly or to co-invest with others across their network through funds, club deals and joint ventures.’

Section 4

Investment managers

4. Investment managers

Investment management platforms

The range and scale of investment managers have changed profoundly during the evolution of the non-listed real estate industry. Originating from private equity divisions of US investment banks, the asset management arms of European investment banks responded in the mid-1990s by establishing and/or expanding their real estate platforms to attract third party, predominantly institutional capital. While the US investment banks largely operate funds in the higher risk space, their European counterparts established funds across the risk spectrum. Proprietary capital was often employed to seed value add and opportunity funds.

Over the same period, many institutional investors established their internal investment management functions across asset classes as separate legal entities. Some of these European investment management platforms repositioned their businesses to capitalise on their expertise, including real estate. Initially, these managers focused on lower risk core funds. In addition to these platforms, low barriers to entry enabled a wide array of funds and their associated management entities to become relatively easily established. Some of these companies rapidly grew in scale and evolved into specialist real estate investment management platforms.

In the pre-crisis era, the industry was characterised by limited reporting, with investors generally commenting that the quality and performance of their investments in funds was opaque, particularly the higher risk funds. During the crisis they became aware that the underlying assets in higher risk funds were not very institutional in terms of their investment characteristics and that funds were reliant on capital growth to cover costs. For core funds, some fixed income investors underestimated the liquidity and transparency risks associated with real estate.

Believing that market pricing was stable and that open end structures provided liquidity, they accepted the contention proffered by some in the industry that real estate no longer warranted a significant risk premium. Of course, there was variation in the level of professionalism across investment and fund managers with some platforms delivered a high level of customer service and best practice in risk management. However, the industry was largely unregulated.

During the crisis, the quality of professional management for individual funds and across investment management platforms became self-evident. It was manifest in the quality of assets underlying portfolios and the risk management strategies (including debt management) employed along with the level of communication and engagement managers sought with investors as they began the process of unwinding positions. Those managers characterised by strong professional management pre-crisis proved to have resilient business models through the crisis. However, the low recognition of accepted professional standards in an unregulated market presented a systemic risk that is manifest in the severity of the real estate downturn that followed and which significantly contributed to the wider financial crisis. In the aftermath of the crisis, regulators focused on the industry and introduced AIFMD.

AIFMD applies broadly to the industry, regulating and supervising Alternative Investment Fund Managers (AIFMs) and the distribution of Alternative Investment Funds (AIFs) within the EU. AIFMD applies fully or partially to nearly all managers of non-UCITS investment funds that manage or market those funds in Europe, whether the AIFM and/or the AIF are located in Europe or not.

All interviewees commented on the positive impact AIFMD has had on the professionalism of the industry. Essentially, it is principled regulation that codifies what was already recognised as best practice, but was not always applied across the spectrum of managers. It provides common rules for authorisation, organisation and

> ‘Managers characterised by strong professional management pre-crisis proved to have resilient business models through the crisis.’

supervision of asset managers and creates a single market for these funds in the EU. The regulation ensures that new entrants that don't possess the required real estate or finance expertise cannot enter the market speculatively representing third party capital. It also requires those that do manage third party capital to adopt strong governance policies, with detailed reporting requirements to ensure adherence to fiduciary duty, effective risk management of capital and transparent communication with regulators and investors. It also introduced passporting for authorised European investment fund managers enabling authorised AIFs to be marketed across the EU.

The integration of AIFMD into existing business models has also impacted the structure of the industry in terms of organisation and scale. AIFMD requires that portfolio management and risk management are undertaken as separate functions in respect of any AIF, which must also have its own depositary. There are also specific rules in terms of liquidity management, risk management and reporting to the competent authority. These requirements sharply increased

> 'All interviewees commented on the positive impact AIFMD has had on the professionalism of the industry.'

Table 2: Comparison of top 10 Global and European managers by total real estate AUM

2008				2019			
Global Top 10	**€ billion**	**Europe Top 10**	**€ billion**	**Global Top 10**	**€ billion**	**Europe Top 10**	**€ billion**
ING REIM	65.6	Morley FM	44.3	Blackstone	201.6	AXA IM	65.3
RREEF	55.4	AXA REIM	42.0	Brookfield AM	163.8	Blackstone	53.0
Morley FM	44.5	JPMorgan AM	39.0	PGIM	147.7	Credit Suisse	47.5
AXA REIM	42.0	Pramerica Real Estate	27.1	Nuveen Real Estate	108.9	Aberdeen Standard	44.6
JPMorgan AM	39.3	PRUPIM	26.5	Hines	104.4	CBRE GI	44.1
LaSalle	33.5	Tishman Speyer	25.5	Prologis	84.8	Union Investment	40.7
UBS Global AM	31.9	Heitman	24.4	CBRE GI	84.0	Patrizia	37.8
Morgan Stanley Real Estate	31.8	ING REIM	23.8	UBS AM	83.8	Deka Immobilien	36.6
IXIS AEW Europe	30.0	Blackstone	23.0	AXA IM	74.5	UBS AM	32.5
PRUPIM	28.2	RREEF	22.9	AEW	65.4	AEW	31.4

Source: INREV Fund Manager Survey

the cost base of investment management platforms which occurred at the same time as a reduction in fee levels. This resulted in the reorganisation of existing platforms as well as consolidation of the industry.

Pre-crisis, many investment platforms increased their scale both organically and through merger and acquisition activity. Given the absence of EU-wide regulation, there were significant local market differences between local regulatory bodies and in local market practices. As a result, businesses owned by the same parent company might share the name of the umbrella investment management company, but otherwise continue to operate as separate entities with different business processes and practices, and with duplication of business functions.

Under AIFMD, each of these entities would require its own authorisation and each would be subject to aligning their business functions with those required under the directive. To create economies of scale, such businesses reorganised, rationalising the number of registered offices to the minimum required by the business. Portfolio management, risk management, valuation and reporting function were also systemised, aided by the introduction of technological solutions, thereby lowering the total cost base. Interviewees representing these companies commented that the reorganisation delivered a number of additional benefits that improved profitability. These included a common business culture across the organisation that delivered a depth in brand value recognisable in their approach to all aspects of the business across countries and regions. In turn, this has aided customer retention and growth, with client managers being assured that their customers receive the same experience across the organisation.

Given the lower fee income, particularly for core funds, investment managers recognised that economic sustainability in this new environment requires scale. In the post-crisis era, the investment management industry has experienced a period of rapid market consolidation and this is expected to continue in the near term. For example, 52% of the fund managers responding to INREV's Fund Manager Survey in 2008 had merged with or been acquired by another platform by 2019.

It is also evident comparing the scale and concentration of the industry. In 2008, the value of the global non-listed industry is estimated at €862 billion, with the top 10 managers accounting for 47%. Europe's share of real estate AUM in 2008 is estimated at €678 billion, with non-listed vehicles accounting for 61%. The non-listed real estate industry has expanded by region, sector and product type to €2.3 trillion since the GFC, with non-listed funds accounting for 55% of AUM, of which 40% are European strategies by value. Globally, the top 10 managers account for €800 billion and the top 20 managers €1.2 trillion of non-listed vehicles. This concentration of the non-listed industry is also pronounced within European. The top 10 managers of European strategies account for 53% of the total €812 billion held directly in non-listed vehicles and the top 20 managers account for 80%.

Presently, investors that might be defined as large by AUM in 2007 are considered mid-sized in 2019. The number of mid-sized investment management platforms has greatly diminished. This scale of investment manager has either been absorbed through merger and acquisition into a larger platform or such managers have refocused their business model on higher risk funds in niche markets, where they are able to partner large investors, offering specialist expertise. As a result, there is clear polarisation in the market between a small number of large investment management platforms and a range of smaller specialist platforms operating private equity style funds.

While AIFMD is considered to have positively impacted on the evolution of the industry, interviewees also suggested that a number of unintended consequences have arisen that should be considered by regulators. First, that the reporting requirements are too onerous. The granularity and frequency of reporting required are considered inappropriate to real estate and the benefits do not outweigh the time and cost burden. It was considered that reporting on all positions on a quarterly basis is unnecessary given the low price movements, trading and illiquidity of the portfolios, and that this could be replaced with reduced granularity of quarterly reporting, retaining full annual reporting.

Second, interviewees embraced the benefits of organisational change emanating from the implementation of AIFMD. However, it is also considered that the level of consolidation in the industry is approaching a level where investor choice is greatly reduced and monopolistic positions are beginning

> ‘Investment managers recognised that economic sustainability in this new environment requires scale.’

to become established, with the resulting concentration in a small number of companies creating its own risk. This concentration of the industry is particularly evident in core, open end products. The scale required to operate efficiently also impedes the emergence and potential growth of new investment managers in this segment of the market.

Real estate products

Investment managers have also grown scale through the range, type and style of products that they offer.

Range of products

Prior to the crisis, most real estate investment management platforms focused solely on real estate equity funds. The largest platforms also offered listed real estate funds, while a limited number launched infrastructure funds. Post-crisis this product range has extended to real estate debt, reflecting opportunities that emerged post-crisis partly as a legacy of the downturn itself and underpinned by investor demand.

Following the GFC a wave of regulation created an opportunity in real estate debt. Prior to the crisis, Europe's real estate debt market was highly concentrated in bank lending. The scarcity and high cost of real estate lending immediately post-crisis created an opportunity for new sources of capital to enter the market. This was sustained by the cost of capital weightings in Basel III and IV, which narrowed the focus of bank lending to income secure assets and which made the cost of providing development finance prohibitive. At the same time, the cost of capital weightings for real estate debt relative to real estate equity investing under Solvency II resulted in insurers focusing on the opportunity in the sector. Ostensibly, it appears that an unintended consequence of Solvency II is that insurers are rewarded for moving up the risk cure in this sector because the weightings do not differentiate effectively between senior and mezzanine debt. However, one interviewee contended that this is only the case if the other pillars of Solvency II including governance and risk management are ignored.

> 'The scarcity and high cost of real estate lending immediately post-crisis created an opportunity for new sources of capital to enter the market.'

The risk adjusted return characteristics of senior and mezzanine debt are quite distinct, with senior offering a low risk fixed income return, whereas mezzanine offers higher risk debt product more similar to private equity returns. Both products are now common in the range of real estate products offered by large investment platforms.

Some investment platforms also expanded into infrastructure products. However, while infrastructure is a separate division within the allocation model for most institutional investors, real estate allocations may extend to debt products.

Type of products

Pre-crisis, most investment managers offered real estate equity funds. In addition, they also managed a small number of large separate account mandates. Immediately post-crisis, many investors focused on establishing more control over their investments. Alignment of interest with co-investors was a key consideration and this led to growth in the number of separate accounts mandates, as well as cornerstone funds or club deals, with investment managers appointed to execute and manage strategies. This range in the type of products offered persists, although both investors and investment managers report a movement away from separate accounts and back to funds.

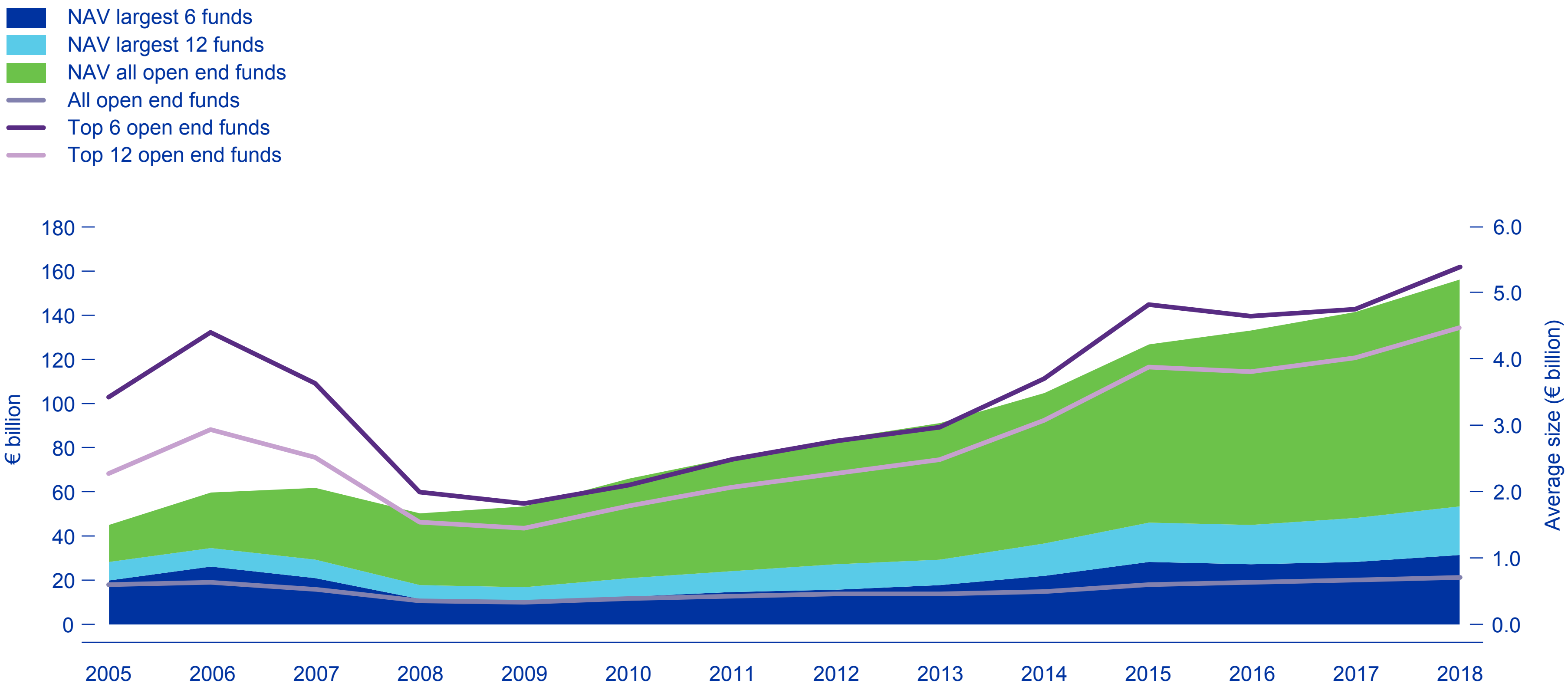
A number of investors commented that achieving diversification benefits requires scale and that medium sized investors are drifting back towards funds. Others cited the relevance of the 80/20 rule, contending that within Europe there are a relatively small number of large, sophisticated real estate investors at the forefront of the industry that understand its intricacies, but that the majority are small and medium sized investors that are best suited to real estate funds.

An investment manager also commented that where separate accounts are non-discretionary, this creates the potential for missed opportunities. Although this is often easily managed through a rotation policy, where a business has a large number of competing separate account mandates that are also competing with funds, issues can arise. Sometimes this may result in a long queue and this is exacerbated where there is a lack of discretion as it impacts on timing, and therefore potentially missed opportunities. As a result, this investment manager will only accept discretionary accounts and is careful to ensure that strategic mandates are not over-duplicated.

Most funds are comprised of small and medium sized investors, while club deals are formed of large investors. Investment managers will ordinarily have full discretion over funds, while this may vary with club deals. Whether discretionary or otherwise, investors in club deals will usually have involved their internal teams in setting the strategy and, in this regard, it is more of a partnership.

Alignment of interest between the investment manager and investors in all types of non-listed vehicles remains an area of focus.

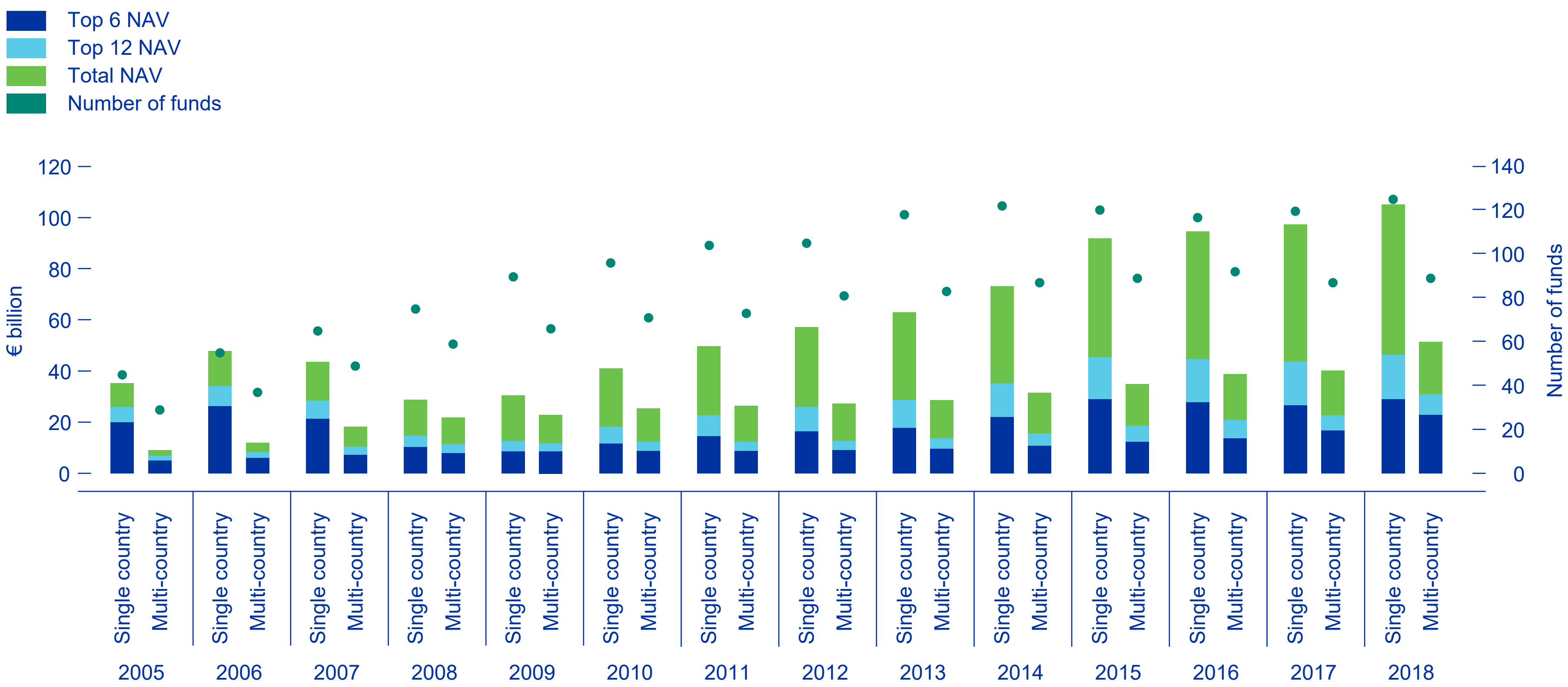
Figure 13: NAV open end funds and average fund size by segment



During the crisis it became apparent that fee structures based upon gross asset value (GAV) had over compensated investment managers and had rewarded them for taking additional risk, particularly by increasing the asset base through higher leverage use.

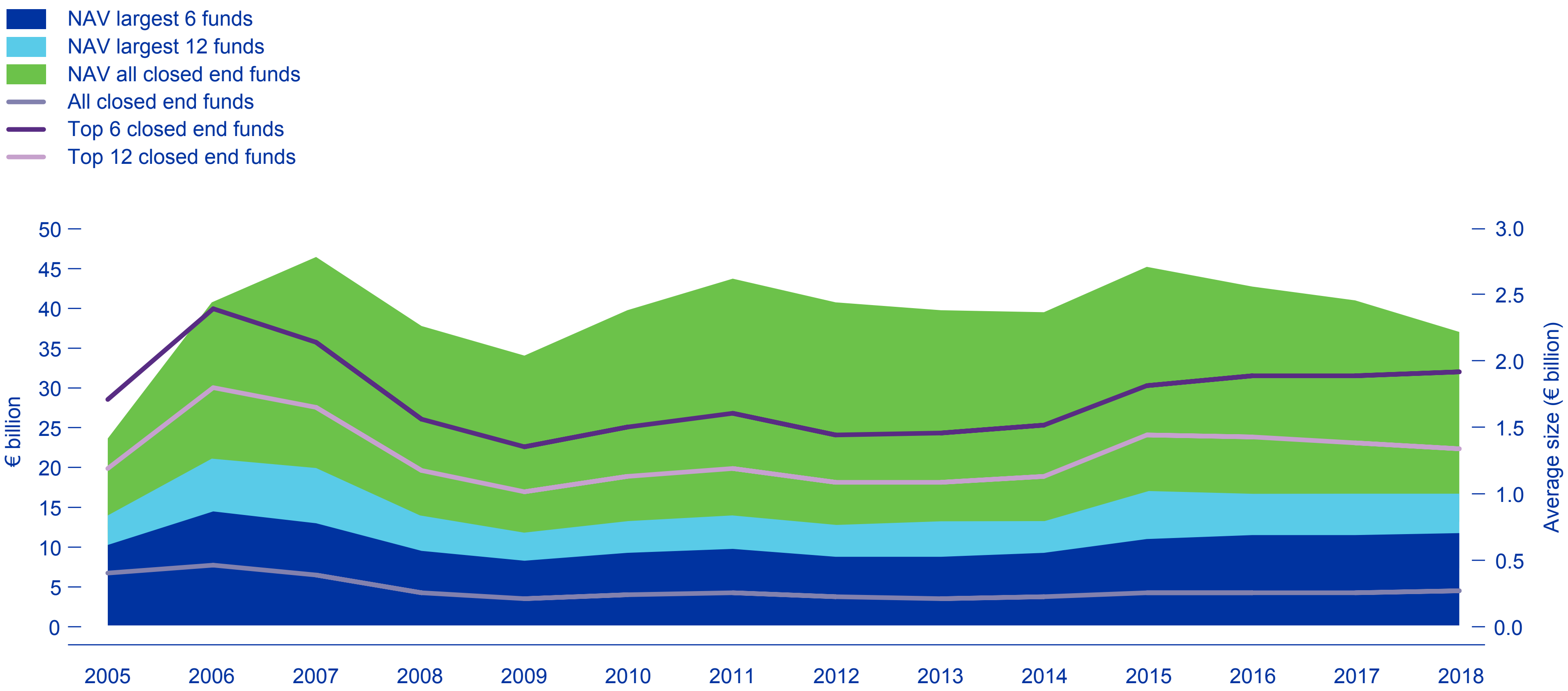
The basis of fees was revisited immediately in the post-crisis era, with fees rebased more appropriately on net asset value (NAV) and any performance fees rolled up over the life of the fund. In addition, many investors required investment managers to co-invest in funds, either with a substantial investment from the platform or a meaningful personal investment from individuals. This 'skin in the game' provided investors with comfort that their interests were more closely aligned with those of the investment manager. Following the introduction of AIFMD, investment management platforms are limited in the amount they are permitted to co-invest in funds as manager, as opposed to proprietary investor capital. Some interviewees commented that the presence of captive in-house investor capital has been advantageous to the growth of some investment management platforms.

Figure 14: Single country vs multi-country open end funds



A number of interviewees considered that the degree of co-investment required, particularly for personal investments, is unbalanced. Where individuals are required to invest capital that represents a high percentage of their net worth, the risk to the individual relative to the reward is too great. Moreover, this can also apply to non-discretionary funds or to separate accounts where the platform and/or individual has limited influence on decision-making from strategy to asset selection. The individual is therefore being asked to take a high personal financial risk on an investment strategy over which they have limited influence.

Figure 15: NAV closed end funds and average fund size by segment



Style of funds

Most large investment platforms offer a range of co-mingled investment products by style, including open end and closed end products. Generally, open end funds are appropriate for core, income generating investments and closed end funds may be employed for both income and growth strategies.

Open end funds
Many interviewees commented on the growth in size of open end, diversified, core equity (ODCE) funds within Europe. The size of the largest European open end fund in the INREV Index has grown from € 2.4 billion in 2008 to € 7.2 billion in 2019. Indeed, the significance of these funds is reflected in INREV's current development of a European ODCE index, which is in consultation. To be profitable, the reporting costs associated with core, open end products and the relatively low fee margins they generate require scale. They are still dwarfed in comparison to the size of the US ODCE funds, but as they continue to grow, investors consider them to offer similar attributes. Their scale delivers high diversification benefits, providing a product that better enables core investors seeking to generate a market return (beta) than funds smaller in scale. They also deliver improved liquidity, with investors able to trade in and out relatively easily, without any significant impact on pricing. Investors consider this capacity to liquidate as providing an alternative type of discretion; while they cannot influence the strategic direction of the fund, they can withdraw their capital.

However, there are concerns that as these open end funds continue to grow and dominate the market, there will be a limited choice of product for investors. Figure 13 shows that in the post-GFC era, the largest products have increased their share of the overall non-listed real estate fund universe and that while the average size of all funds has remained relatively stable, the average size of the largest funds has grown sharply. This is particularly pronounced for multi-country funds. Figure 14 illustrates that the number of open end multi-country funds has scarcely increased in the post-GFC era, in contrast to a sharp increase in their NAV. To a lesser degree, this trend is also apparent for single country funds, but there is a wider diversity of vehicles with the largest funds accounting for a lower proportion of total NAV.

Currently, interviewees suggested that there are around six to eight multi-country open end core products of scale in the market. They expect this to reduce further as some products accelerate their growth, while others lose their competitive position and, should they subsequently plateau, be acquired by larger funds. Further manager consolidation is also expected to result in rationalising the number of products.

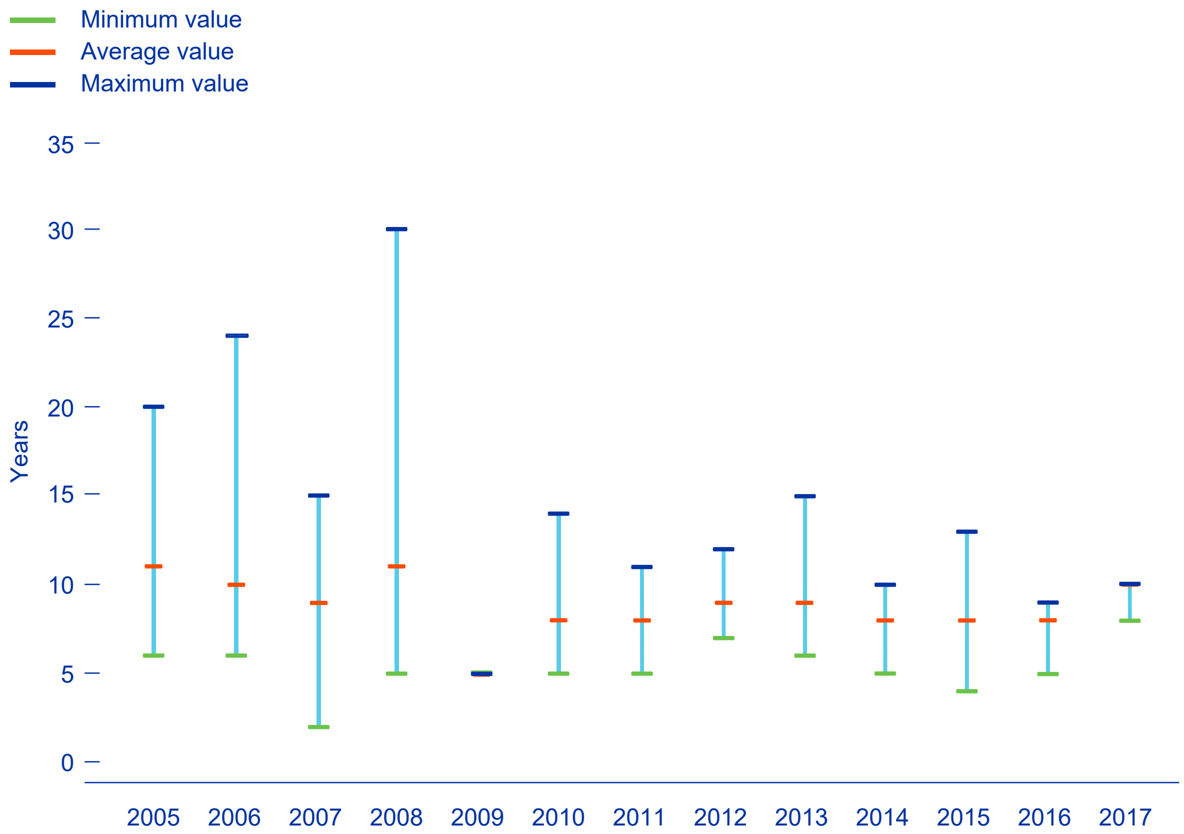
Closed end funds
Closed end funds may also be employed for core investing and are usually accessed for specific market or sector strategies. The average size of closed end funds has been fairly consistent over the period (Figure 15). The largest multi-sector funds have increased their scale in the post-GFC era, but at a slower rate than open end funds. The latter are widely considered by interviewees to be inappropriate for higher risk strategies due to the timescale required to achieve stabilised returns across a portfolio. Some large investors seek to have a controlling interest in such funds and some smaller and medium sized investors lacking real estate expertise can rely on the presence of such investors as a proxy for their own due diligence to some extent. Most investors prefer to have a balanced fund in terms of investor holdings, with many commenting that they look at the quality of participating investors, their objectives and their past behaviour as this is a major component of the overall risk.

> 'The presence of multi-managers is sometimes an issue for larger institutional investors.'

Some interviewees stated that the presence of multi-managers is sometimes an issue for larger institutional investors. This stems from differences in their investment remits with long-term investors seeking to ensure they can protect their investments from unforeseen events by extending funds to hold through a downturn in values, while multi-managers have a more medium-term mandate. Equally, multi-managers commented that they are nervous investing in funds that have a dominant investor with a controlling interest and question whether they are investing in the fund strategy or aligning themselves with the investment strategy of the investors going forward. Moreover, they are cautious of investing in funds that can easily result in a lock-up of capital without their agreement.

The terms of funds have adapted in the post-crisis era in response to such investor concerns. The range in the lifespan of closed end funds has narrowed sharply, with the maximum falling from an average of 22.3 years between 2005 and 2008 to 10.5 years in the post-crisis period 2014-2017. Comparing the same periods, the average expected fund life by year of first closing has fallen from 10.0 to 8.3 years. Similarly, extension periods have fallen from up to two years, to six-months (Figure 16). The terms also provide a clear process and associated mechanisms at fund termination and in respect of unforeseen events. Often this includes limited extension periods of six months to a year, mechanisms to turn value add and opportunity funds that have reached income stabilisation into evergreen core funds and options to acquire/redeem holdings.

Figure 16: Exepcted life of fund by first year of closing



Section 5

Investment strategy

5. Investment strategy

Investment strategy operates at two levels. First, the allocation to real estate as an asset class and, second, the allocation within the real estate asset class. The approach to both has shifted since the GFC.

Asset allocation

The role of real estate within a portfolio varies across investors and this also impacts allocations to real estate. Institutional investors with maturing profiles are seeking secure, stable income in applying their asset liability matching (ALM). Fixed income strategies dominate, but their ALM also requires assets that can deliver a risk premium to assist in meeting liabilities in a low interest rate environment.

Real assets that offer relatively stable, often inflation hedged income are beneficial and allocations fall in the range of between 6% and 10%. Most European public pension funds are maturing, while some corporate pension funds have a younger profile. Many non-European pension plans share a younger maturity profile and this requires assets that can deliver growth within their ALM. These plans tend to make higher allocations to real estate, with one North American interviewee indicating that at 15%, their allocation to real estate was considerably higher than most European pension plans. Another investment manager explained that some early maturity Asian pension funds allocate as much as 50% of AUM to real assets. These allocations are also focused on a blend of income and growth strategies.

There is strong consensus among interviewees as to what constitutes real estate. Although real estate and infrastructure are both real assets, they are considered to be two distinct asset classes within real assets. However, while transport, energy and telecoms networks are easily distinguished as infrastructure, there is a more blurred boundary between real estate and social infrastructure, particularly in regard to social housing, healthcare real estate and data centres, which are real estate assets that provide social infrastructure.

Real estate allocations are also extended to real estate debt in many organisations. In others, senior debt will form part of the fixed income strategy and mezzanine may be either a real estate or private equity allocation. However, the responsibility for due diligence, selection and management is shared with the real estate team. In these organisations the asset allocation and corresponding organisational structure is less silo driven than in the past. Rather, asset allocation considers the underlying investment characteristics of assets as a 3D matrix. First, investments are segmented into passive and active allocations. Passive include indices, trackers and investment styles that lend themselves to IT solutions. Active investments include the spectrum of alternative investments including real estate, infrastructure, private equity, private debt and structured debt. Second, investments are considered by their risk profile in terms of liquidity and income/growth profile. This approach enables the risk return profile of investments to be viewed in the context of an asset's investment characteristics, rather than by its traditional silo.

> 'Institutional investors with maturing profiles are seeking secure, stable income in applying their asset liability matching.'

Real estate portfolio strategy

Interviewees identified three significant changes that are common across the industry in their approach to real estate strategies pre and post-crisis. First, investors seeking to expand cross-border prior to the crisis perceived it as higher risk investing even in major markets, regardless of the underlying real estate. Notwithstanding a marginally higher exposure to liquidity and transparency risks, this risk perception was predominantly subjective and stemmed from a lack of expertise in cross-border markets. To achieve their desired return hurdle rate, such investors tended to move up the risk curve.

Through the crisis, investors retreated to domestic markets in a risk averse environment and concentrated on restructuring portfolios. In the post-crisis era, real estate strategies refocused on portfolio diversification and global strategies were developed across investment styles, recognising that global, income focused strategies could be developed for core investing that delivered valuable diversification benefits. Post-crisis, interviewees considered that the real estate industry is lower risk and more global in its operations.

Second, the basis of real estate strategies shifted from being driven by cyclical pricing movements within the asset class to the analysis of long-term fundamentals driving the economy and society. Through the analysis of structural trends, investors can anticipate change and evaluate its likely impact on the demand for, and use of, real estate by its underlying occupiers. This enables investors to be more forward thinking and counter-cyclical in their approach to identifying investment opportunities and managing portfolio risks through appropriate asset management strategies. Cyclical pricing remains important and is a second stage consideration. This is followed by tactical investment considerations in respect of timing and tilting the execution of the strategy in line with changing opportunities.

‘Post-crisis, interviewees considered that the real estate industry is lower risk and more global in its operations.’

Third, the adoption of strategies that are better aligned with long-term underlying mega-trends has enabled investors to identify new opportunities in both existing sectors, including local logistics, office hotelling and place-making within retail and mixed use, as well as exploring emerging sectors such as senior housing, micro-living, healthcare and student accommodation. A defining characteristic of these opportunities is that they represent a more operational form of real estate. This itself has been a driver of investment mode, with some large investors indicating that because the success of the investment is heavily reliant on its operation as a business, they prefer to invest directly or through joint ventures with a self-selected operator to enable them to better manage risk.

‘Through the analysis of structural trends, investors can anticipate change and evaluate its likely impact on the demand for, and use of, real estate by its underlying occupiers.’

Section 6

ESG responsibilities

6. ESG responsibilities

In 2004, institutional investors signed up to the United Nations Environment Programme's responsible investing initiative, with the aim of placing environmental, social and governance (ESG) at the heart of investment decision-making. In 2006, they published their Principles for Responsible Investment (PRI) which applied to all financial assets. The principles required investors to incorporate ESG issues into investment analysis and decision-making processes, to actively incorporate ESG issues into ownership policies and practices, and to seek appropriate disclosure on ESG issues from investment managers.

Longer-term holdings in real assets such as real estate provided investors with an opportunity to begin to apply ESG policies that could have an impact. Pre-crisis, most initiatives focused on environmental responsibility and on reducing C02 emissions by increased energy efficiencies and integrating renewable sources of energy into portfolios. In 2008, leading European institutional investors in real estate established GRESB to enable ESG considerations to be measured and benchmarked.

'In the post-crisis era, ESG has evolved to become embedded in every stage of the investment process.'

Most institutional investors and some investment managers assigned responsibility for ESG to key individuals within existing management teams and by the GFC, many had established ESG as a specific role or division. At this time, ESG largely remained focused on environmental considerations, but had extended its focus from ensuring new developments were 'green' to retrofitting existing portfolios where possible and assisting occupiers to lower their energy use through new technologies. Activities also expanded to the efficient use of other resources including water and importantly, a new emphasis on building materials and also on recycling them evolved.

In the post-crisis era, ESG has evolved significantly. Most investors and fund managers interviewed detailed a major shift in the industry since the PRI were adopted in 2006. Institutional investors explained how efforts before and during the crisis were centred on rating, measuring, establishing targets and devising action plans to achieve them, primarily around energy efficiency and other resources. However, this process tended to be separate from investment decision-making and was part of a wider asset strategy implemented after acquisition.

In the post-crisis era, ESG has evolved to become embedded in every stage of the investment process. Importantly, many commented that measurements need to focus on the improvement achieved as well as overall use. This enables ESG efforts to remain authentic, with one interviewee citing

'ESG policies have also matured from being almost entirely environmentally focused pre-crisis to encompassing social and governance responsibilities.'

funds that are sometimes labelled as ESG/ impact, with this applying to a small proportion of the fund's GAV, with the remainder having no ESG target at all.

It was also commented that the financial benefits of ESG policy implementation are becoming evident. Well-designed, energy efficient buildings lower occupancy costs per capita and often command higher rents. While it is hard to quantify the impact of ESG, one interviewee commented that an asset is likely to underperform if it is not optimised.

Importantly, interviewees also integrate environmental risks into their wider investment strategies. The impact of global warming has also become more manifest over the last fifteen years with increased risks of flooding, fire, drought and storms. Investors are overlaying these risks on investment strategies by region, country, local market and in asset selection.

ESG policies have also matured from being almost entirely environmentally focused pre-crisis to encompassing social and governance

> ‘For many investors, the role of ESG has already shifted from being a secondary to primary consideration.’

responsibilities. Social responsibility is a current area of focus and is beginning to evolve. For some investors, activity in this area focuses on wellness initiatives in location and design and on the impact on occupier productivity. Other investors are focusing on how their portfolio management impacts social sustainability, with one investor commenting that for their residential portfolio holdings, they seek to raise rents equitably ensuring that rents remain affordable for existing occupiers and are not driven by market pricing.

Many investors are also beginning to refocus on impact investing. The difference between ESG and impact investing is that ESG is usually secondary to the investment strategy, as opposed to impact which is embedded in the overriding investment objectives. For many investors, the role of ESG has already shifted from being a secondary to primary consideration. Moreover, many investors and investment managers are recognising that as real estate essentially provides the social infrastructure within which citizens work, rest and play, their portfolios have always had a social impact. The current challenge is to create objective measures and benchmark this impact.

For a number of interviewees, what is meant by ‘governance’ within ESG is an unknown, yet as other interviewees established, this has been the transformation of the industry through AIFMD, EU AML V and KYC, Basel IV, Solvency II and a host of further regional and national regulations. Interviewees also commended INREV’s leadership role in the industry, specifically establishing professional standards, common reporting, and improving transparency. This was achieved by establishing and coordinating working groups comprising members of the industry who together defined the components required for good governance in the management of third party capital.

Those with global portfolios commented that Europe is leading in this area in terms of transparency and harmonisation between investors and investment managers. Although the granularity of market and investment data employed in devising investment strategies is far superior in the US to Europe, the transparency of fund documentation and reporting is considered more transparent and rigorous in Europe. In short, pre-crisis the US was more transparent because of data, but many interviewees contend that Europe is more transparent because of greater harmonisation in investor and manager investor relationships, which is considered more crucial.

Structuring and tax are also considered part of ESG and impact investing initiatives. Pre-crisis, minimising tax liabilities through structuring was often an objective for funds and this frequently included exploiting loopholes where they existed. Post crisis, many investors, particularly universal investors, are keen to have efficient tax structures that minimise tax leakage, but wish to be equitable in approach and pay what is due or their ‘fair share’. Very low tax obligations are often not acceptable as they conflict with their wider social obligations.

Equally, HNWIs and family offices (though their threshold may be lower) are also conscious of reputational risk. Of course, what is acceptable and considered ‘fair’ varies between different types of investor and within a type of investor, but there is a change of emphasis and a sense of leadership. Beyond legal and commercial issues, larger institutional investors have a statement of ethics which also applies to tax structuring. Indeed, a number of such investors were able to quantify the blended tax rate acceptable to their organisation as being a minimum threshold of between 15% and 20%.

Section 7

Fund structures and taxation

7. Fund structures and taxation

Investors, tax and legal consultants all consider fund structures and tax as a secondary consideration to finding an appropriate strategy, assets that they wish to invest in and/or partners that they wish to invest through or with. Subsequently, structuring is very important, but is not a driver; if an investment no longer meets the required return targets due to tax exposure this will result in a decision not to invest in it.

However, tax is the first point of structuring as it impacts investment returns and, thus, any design must be around tax considerations. Pre-crisis, minimising tax was often a primary objective; however post-crisis there has been a shift in structuring objectives. Currently, the principal aim is to create tax neutrality between investing through the structure and investing directly for each investor in the fund, avoiding double taxation and, as far as possible, preventing differences in tax treatment between the two modes of investing. The challenge for investors and investment managers is that tax rules change frequently. Within real estate, it is difficult to foresee how tax liabilities will develop in the future, or even where they stand presently given blurred boundaries within many national tax regimes.

Many investors, including investor-hybrid organisations, but whose investors are from the same jurisdiction and who share the same investment and tax characteristics by type of investor, domicile their funds in their home market.

For fund managers, single country funds are often registered in the same domicile (or associated tax hub) if it is also an investment centre for the organisation authorised under AIFMD. For example, UK funds will often be domiciled in Jersey. Pre-crisis, investors used a wider range of alternative tax locations including Luxembourg, Singapore, Bermuda and the Cayman Islands for non-domestic investments and funds, despite having homogenous investors from the same jurisdiction. Such investors explained that a sustainable tax policy is now embedded in their fiscal responsibility. Although they understand the value of having multi-jurisdiction funds with complex investor bases domiciled in locations, they indicate that their organisation has no reason other than tax to locate there.

In Germany, domestic regulations are complex and it is common for investment managers to have an investment centre in the country to enable them to use domestic structures for German clients in line with AIFMD. This is for a number of reasons. First, the German real estate investment industry has longevity and permeates through the market far beyond institutional investors, to sophisticated and retail investors. In this sense it has more depth and, historically, the market has developed a structure built on institutional segmentation in terms of lending as well.

Second, in addition to having a long-standing market of large open end funds for institutional and retail investors, non-discretionary closed end funds and spezialfonds are also common in the market. Third, German investors subject to the Germany Federal Financial Supervisory Authority (BAFIN) rules tend to pool together. In part, this is because they share common investment objectives and are subject to the same regulation. However, it is also because of KVG funds, a tailored product that has been agreed by BAFIN and the German Investment Funds Association (BVI) that is both time and cost efficient. BAFIN and BVI approved a standard set of documents to support KVG funds which makes them easy to administer and reduces the requirement for external advisors. It is also possible for non-domestic investors to co-invest, but they generally have not yet accepted it probably due to unfamiliarity. Investors may also have concerns about creating a permanent establishment through their activity, which is also a consideration for certain investment structures in France.

> ‘Tax is the first point of structuring as it impacts investment returns and, thus, any design must be around tax considerations.’

Multi-country funds with underlying investors from multiple jurisdictions and representing different types of investors that have different tax characteristics require more involved structuring solutions. These funds require complex tax structuring and are often located in investment centres in regional tax hubs. All interviewees investing in or managing multi-country funds and/or funds with multi-jurisdiction investors considered Luxembourg as a centre of excellence for fund structuring. Its political neutrality makes it a low risk jurisdiction as it is much less exposed to domestically driven political shocks, yet as an EU member, it adheres to EU directives and therefore AIFMD, in what has become a heavily regulated market for all funds.

Generally, the Luxembourg market has offered a solution-orientated business culture, which has contributed to its success, as it has developed a specific toolset of solutions. The range is expansive and includes transparent and non-transparent, regulated and non-regulated products. The emphasis is on enabling investors to get a good fit using a flexible range of products that can be customised. The aim of structuring is to be tax efficient across a range of investors and

‘All interviewees investing in or managing multi-country funds and/or funds with multi-jurisdiction investors considered Luxembourg as a centre of excellence for fund structuring.’

achieve a blended position that meets their needs. By not creating discrimination between investors, each is left in a neutral position as regards investing directly versus indirectly as far as possible. This is not always possible. In these circumstances, investors must decide whether a fund with some tax leakage has benefits that outweigh the leakage in terms of returns or diversification.

The Luxembourg Reserved Alternative Investment Fund (RAIF) regime is a favoured solution that provides a tax transparent vehicle that is especially relevant to certain types of investors whose activities are subject to beneficial tax attributes, including institutional investors. Of course, although often sharing a long-term investment strategy, the tax position of institutional investors varies. Most jurisdictions give tax exemptions to pension funds whereas life insurance companies are subject to tax on income. For life insurance companies, their neutral position is to be exposed to income tax, so their focus is on ensuring they are not exposed to/liable for double taxation, while a pension funds’ neutral position is to avoid exposure to income tax entirely.

The application of structuring solutions can be more difficult where investors with weaker tax attributes are mixed into a fund with institutional investors. To remedy this, parallel streams and tax channels are used, but these solutions have an impact on complexity and costs. Differences in national regulatory requirements may also require feeder funds, with master KVG funds often

‘The aim is simply to retain the tax position at inception for each investor and in adapting structures, to ensure investors are treated equally.’

employed for German investors. Similarly, Italian regulated entities require a specific feeder structure. Non-European investors investing through an AIFMD platform are subject to the regulations. However, such investors are also subject to their own regulatory regimes in their own jurisdictions and are keen to reduce the complexity of investing in multiple tax jurisdictions. To accommodate this, it is possible to establish parallel funds domiciled in other jurisdictions that mirror a specific Luxembourg fund. These funds mirror the AIF structure in all respects but are entirely separate entities that assist in simplifying investment management processes for non-EU investors. The mirror fund shares the same strategy as the AIFMD regulated fund and invests side by side in assets. However, it is important to consider the scale of capital involved against the risk/reward to the manager and/or the investor.

Fund managers stressed that tax considerations remain a major challenge from inception, through the life of the fund to termination. The issue is that there is constant movement in the regulatory landscape and that this needs to be monitored across three dimensions including the fund structure, investor domicile and investment domicile. The aim is simply to retain the tax position at inception for each investor and in adapting structures, to ensure investors are treated equally. One manager commented that he views tax like a currency market in that it is unpredictable, although it is usually possible to identify where there are higher risks and constantly monitor developments to protect assets. This creates a financial burden in terms of time, resource and costs of structuring. Managers and investors suggest that a stable and aligned tax regime at a European level is required to create transparency and certainty.

The EU Anti Tax Avoidance Directives (ATAD) I and II are steps toward greater harmonisation, although there are concerns regarding their implementation at a national level. The primary aim of ATAD is to impede very large corporations from structuring themselves to avoid tax, often without substance in the tax jurisdiction. AIFs are not the focus of ATAD, but current legislation may create a situation where AIFs could be interpreted as being subject to the regulation. UCITS and collective investment vehicles (CIVs) are generally exempt, but it remains unclear as to whether this extends to AIFs. Given the time horizon of real estate funds, it is prudent for fund structures to be ready to comply.

> ‘The EU ATAD directives reduce a company’s ability to erode the tax base artificially and impedes the exploitation of loopholes, notably through the introduction of hybrid mismatch rules.’

The Organisation for Economic Co-operation and Development (OECD)-wide Multi-Lateral Instrument (MLI) introduces new anti-avoidance measures that centre on impeding tax treaty shopping through requiring investors to have substance in a domicile. The EU ATAD directives reduce a company’s ability to erode the tax base artificially and impedes the exploitation of loopholes, notably through the introduction of hybrid mismatch rules. The importance of substance is captured within the Principal Purpose Test (PPT), which is an important component of the MLI. Its aim is to prevent investors and managers solely using a domicile for tax treaty advantages. If a principal purpose of an arrangement includes accessing treaty benefits, then treaty benefits could be denied. From an EU perspective, it may have more limited application as EU law restricts application to ‘wholly artificial arrangements’. However, together with the impact of AIFMD on consolidation of the number of investment centres operated by investment management platforms, organisations are concentrating their activity in a reduced number of hubs. This has further accelerated Luxembourg’s standing as a European centre of excellence as organisations are drawn to its adherence to AIFMD and other regulatory regimes, along with the strength and depth of its investment services.

ATAD I and II also impact the tax basis. Pre-crisis, the industry benefitted from very limited tax exposure, favourable depreciation and interest deductibility. It was also common for non-residents to realise capital gains on an asset without being subject to capital gains tax (CGT) in the country of where the gain originated. However, the tax basis has now broadened with ATAD limiting interest deductions and the MLI increasing incidences of taxation of so called ‘share deals’ by non-residents.

Countries are increasingly levying CGT for non-residents in all circumstances. However, there are differences between investors in terms of treatment and this also varies by jurisdiction. Overlaying this is the prevailing principle of non-discrimination within the EU. For example, if non-residents are subject to CGT in Germany, but German pension funds are not subject to CGT, then a non-resident pension fund would not be subject to CGT, but a life insurer or fund would be. As a result, exempt investors may be in a better position if they invest directly as a fund may be subject to CGT, lower depreciation and lower interest rate deductions than could be applied otherwise. However, interviewees also noted that tax considerations are secondary to such investors’ investment strategies and there may be circumstances where the access to a management platform and their expertise in certain sectors or markets will override tax leakage concerns. In short, commercial objectives will prevail.

As yet, there has been little guidance on the application of ATAD I and II by tax authorities pertaining to different countries. The directive applies to the entire EU and provides minimum standards; however, their implementation is varying considerably across countries, as is the timing. Fund structures need to adapt each time there is a change that impacts the risk/return profile of the fund and, in turn its diversification, as well as each time it impacts an investor or the alignment of the treatment of investors. This requires different tax channels for different investors/assets, with the overly complex structure always having cost implications. The interviewees stressed that they are not trying to avoid taxation and especially tax relating to CGT and transfer taxes. However, as their investors pay taxes on income received in their country of domicile their over-riding duty is to repatriate income and capital without it being subject to taxation en route.

Investment managers also raised concerns regarding the potential for very large funds to trigger country-by-country reporting requirements which are designed to capture the activities of multi-national corporations rather than real estate funds with multiple subsidiary vehicles. Managers would prefer to avoid such requirements due to their complexity and the considerable cost of implementation, which delivers little benefit for risk management.

The role of tax structuring has evolved significantly since 2004. Prior to GFC, many investors and managers used locations with preferable tax environments as a means of minimising tax and exploiting loopholes where they existed. This objective has disappeared entirely. Post crisis, many investors, particularly universal investors, are keen to have efficient tax structures that minimise tax leakage, while paying liabilities that are due. Indeed, very low tax obligations are often not acceptable as they conflict with organisations social responsibilities embedded in statements of ethics.

Equally, HNWIs and family offices are also conscious of reputational risk and avoid controversial tax havens, preferring regional centres of excellence for tax structuring. The requirement for such locations is driven by global strategies and the maturity of the industry which has impacted on the complexity of funds and their investor base. Expertise in structuring across jurisdictions and investor types, that is regulatorily compliant, has led to the emergence of specialist centres such as Luxembourg. Currently, these centres are required for their expertise and professional services in a tax neutral and tax transparent location.

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Section 8

Conclusion

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The European non-listed real estate industry emerged in the early 2000s as investment managers recognised pooled vehicles as an effective means of harnessing global capital sources for cross-border real estate investment strategies. This early phase of the industry coincided with a period of global liquidity that encouraged more opportunistic investors to use excessive levels of leverage to boost returns, without implementing effective debt management strategies. Fiduciary duty requirements were poorly understood by some fund sponsors. The industry was largely unregulated and this enabled short-term speculative investors, without real estate investment expertise, to represent third party capital. The resultant debt-driven real estate bubble exposed the weaknesses of this new industry as investors, managers and regulators picked through the debris of the GFC.

However, there was a risk of throwing the baby out with the bath water. The benefits of non-listed vehicles for real estate investors, including access to expertise, local markets and, most importantly, enhanced diversification endured. It was generally accepted that the issue lay less in the appropriateness of the model and more in how it had been structured, implemented and governed. As a result, the legacy of the GFC is the transformation and re-birth of the industry. Both managers and investors overhauled their inter-relationship, its governance, and in turn, the evolution in the range, structure and objectives of non-listed real estate products, fully implementing regulatory requirements. As we approach the end of the second decade, the industry has come of age.

All interviewees commented on the maturity and professionalism of the non-listed real estate industry in the post-crisis era. This itself is a legacy of the downturn and results from the experience of investing institutions, investment managers, a renewed appreciation of fiduciary duty and the implementation of a range of EU-wide and national regulatory regimes that, generally, have positively impacted the structure of the industry.

This ambiguity of global capital targeting real estate investments that depend upon local and specialist knowledge to manage their specific risk component is central to the requirement for, and growth of non-listed real estate vehicles. However, the experience of the GFC highlighted the need for investment objectives to be more fully aligned with the structure and strategic parameters of non-listed real estate vehicles. This includes the structure of agreements with investment managers, the selection and relationship of co-investors, debt strategy, strategic investment objectives and the need for greater transparency and reporting. This varies across investors according to their risk/return objectives, regulatory and fiduciary requirements relating to their capital and with the scale of the investing organisation. This is evident in the evolution of three key aspects of the non-listed real estate industry.

First, investors seek to exercise more control over the implementation of investment strategies, tailoring their mode of investing to their individual requirements and capabilities. Some large investors ensure the structure, terms and investment parameters of funds are de-risked and aligned with their objectives, and that the sponsor is capable of implementing the fund strategy.

For other large investors with in-house capacity, this involves devising strategies and products internally, with the execution undertaken in-house or through the appointment of an external manager. The GFC has perhaps accelerated a natural evolution in investor behaviour. Within this lifecycle, non-listed funds serve as an important gateway to real estate investing, providing access to markets, product, expertise and risk management. As investors gain experience and move up the learning curve they are able to develop their own strategic insights and/or partnerships. Where they possess scale, they may invest independently of third party managers and potentially act on behalf of third party capital themselves. The roles of investor and investment manager are less distinct in the post GFC era, with an identifiable range of roles along the investor-manager continuum. Importantly, the evolutionary curve also involves investors that had evolved into investment managers later withdrawing from third party capital management due to conflicting investment objectives.

Second, this tailoring has resulted in a greater range of products including open and closed end non-listed funds, separate account mandates, club deals and joint ventures. Product selection is tailored to the underlying opportunity and will also vary with the investors preferred mode of investing. However, scale is a determining factor and, beyond the largest investors, non-listed real estate funds remain the primary option for most investors seeking a real estate exposure while diversifying risk.

Third, investment strategies are more closely aligned with over-arching investment objectives and this also impacts product selection. For example, investors seeking long-term income that have the capacity to invest counter-cyclically are devising strategies that are driven by long-term structural trends. Where such strategies require an operational partner, joint ventures may be preferred. Equally, investors seeking capital growth including young profile pension funds as well as family offices and HNWIs, have a stronger preference for mis-pricing opportunities, development and pro-cyclical strategies. For some investors, this alignment of investment objectives is also impacting asset allocation modelling, with the boundaries between asset classes increasingly blurred. There is a more nuanced understanding of the variation in risk that emanates from different types of real estate investments.

The non-listed real estate industry was subject to light regulatory oversight pre-crisis. Given the scale of real estate's contribution to the GFC and the systemic risk inherent in its institutional capital base, regulatory authorities subsequently focused on the industry directly, introducing AIFMD. It was also impacted indirectly by the treatment of real estate within increased regulatory oversight of the banking and insurance sectors (BASEL IV and Solvency II), as well as through a range of other over-arching regulations impacting on the wider investment industry.

AIFMD is considered to have positively impacted the evolution of the industry, creating a more professional and mature industry, with barriers to entry safeguarding against short-term speculators seeking to represent third party capital. The integration of AIFMD into existing business models has also impacted the structure of the industry in terms of organisation and scale. Many investment managers indicated that this restructuring to meet AIFMD requirements had led to greater assimilation of their business services, generating brand value for the company and improved service levels for investors. However, high levels of merger and acquisition activity have also resulted from AIFMD, as absorbing the costs of implementation requires significant economies of scale. This is polarising the market between a relatively small number of large investment management platforms and a range of smaller specialist platforms. It is noteworthy that the largest investment manager by AUM in 2007 would be considered mid-sized by 2019 and, as such, have its future viability questioned. There is now some concern that the level of industry consolidation is reducing investor choice, particularly in respect of core products, which are becoming increasingly concentrated in a small number of platforms, potentially generating an unforeseen risk.

The reporting requirements of AIFMD have been a significant contributor to the escalation of the cost base for investment management. Pre-crisis, fund documentation often failed to address reporting and communication and during the GFC some managers refused to discuss the performance and future strategy for distressed funds with investors in the absence of any contractual obligation to do so. Many investors commented on the transparency of fund performance and quality of communication from investment managers in the European region in the post-crisis era, noting its superiority to their experience in other regions. However, the same investors also considered the frequency and granularity of reporting requirements under AIFMD to be excessive. Investment managers also considered them too onerous given that assets are traded infrequently, and that pricing volatility is low in comparison to daily exchange traded assets. It was considered that reporting on all positions on a quarterly basis is unnecessary and that this could be replaced with reduced granularity of quarterly reporting, retaining full annual reporting.

The re-evaluation of non-listed real estate investing post-crisis and the refocus of institutional investors on their long-term investment objectives have also led to a renewal of their leadership role in their pursuit of wider universal objectives. This is particularly evident in the success and further progression of ESG policies. The difference between ESG and impact investing is sometimes defined as being that while ESG initiatives are often overlaid as a secondary consideration, impact investing is embedded within the primary investment decision and in every subsequent stage of its management. This step change has already been taken by leading institutional investors in respect of environmental considerations and currently, the emphasis is on extending initiatives to social sustainability. Investors and managers recognise that real estate is a core component of the economic and social infrastructure that underpins the growth and success of the economy and society. By explicitly considering this contribution within investment decision-making, positive externalities can be maximised. The current challenge is finding how to measure this impact consistently.

ESG considerations are also embedded in a shift in approach towards fund structuring and tax arrangements. Prior to the GFC, investment managers sought to minimise tax exposure for investors and post-crisis the emphasis is firmly on creating structures that are equitable. Indeed, a number of institutional investors require investment vehicles to have a tax liability above a minimum threshold. Investors and/or funds with a capital source from a single jurisdiction in which the manger has an authorised investment centre are mostly domiciled and subject to the tax regime within that jurisdiction. Multi-country funds and/or funds with investors from multiple jurisdictions are commonly domiciled in Luxembourg, which has established itself as a European centre of excellence for developing appropriate structures that accommodate the complex nature of such real estate funds. The emphasis is on creating structures that attempt to leave each investor in a non-listed real estate vehicle with the same tax liability as they would have if investing directly. ATAD provides a useful framework for the EU, but differences in its incorporation into national tax regimes and timing of its implementation create uncertainty. Indeed, frequent changes in the treatment of real estate within countries creates a challenge for a global industry that has a very local footprint. Both investors and investment managers consider that greater transparency, consistency and certainty of the tax landscape would be beneficial.

As we approach the end of cycle, the non-listed real estate industry is in a good position to address the challenges that may arise. The volume of capital invested in European real estate has recovered to similar levels achieved during the pre-crisis peak. However, the components of the current invested capital are distinct, consisting predominantly of equity capital with leverage remaining relatively low. Equally, non-institutional short-term speculators have been largely absent from this cycle. The known uncertainty that the industry is preparing for is how the long-awaited normalisation of interest rates will impact on asset allocations towards the sector and how this might impact pricing, and how the industry might respond.

It is expected that real estate yields will rise broadly in line with interest rates. However, a more significant adjustment could arise should fixed income investors abruptly switch allocations back towards bonds.

> ‘The GFC represents a watershed in the evolution of the non-listed real estate industry over the past fifteen years.’

The GFC represents a watershed in the evolution of the non-listed real estate industry over the past fifteen years. Pre-crisis, the rapid acceptance of the benefits of non-listed real estate vehicles in a regulation-light, debt-driven environment facilitated short-term, speculative decision making using a longer-term, illiquid asset and permitted those without the required real estate and/or financial expertise to represent third party capital. The crisis that ensued, including the financial impact for pensioners and savers, resulted in regulators as well as investors and professional investment managers, implementing safeguards to ensure it could never reoccur. The industry that has emerged through the post-crisis era is considerably more professional, transparent and more stream-lined in its objectives and it is fully apprised of its fiduciary duty.

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