STATE STREET.

VISIONFOCUS

DECEMBER 2011

Real Estate: New Opportunities for Institutional Investors

Renewed interest from institutional investors and increased global investment opportunities point to a bright future for real estate as an asset class. Capitalising on the opportunities of the new environment will take adjustments on the part of both investors and real estate fund managers, as the impact of the financial crisis continues to reverberate. Investors are demanding increased control and reporting on their real estate investments, while regulatory change creates new challenges. Adapting efficiently to this new model will be key to success.

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Foreword

While real estate is one of the oldest forms of investing, in global investment terms it falls into the category of "alternative assets". Real estate is an established feature of the portfolios of some of the world's largest investors, including pension funds, insurance companies and sovereign wealth funds. Recent research indicates that real estate remains the largest block of alternative assets for pension funds, accounting for 55 percent of the alternative assets managed on behalf of pension funds globally by the top 100 alternatives managers in 2010. Real estate increased its market share by 3 percentage points on the previous year.[1]

Real estate investment is, however, undergoing significant change in the wake of the financial crisis, which dramatically impacted asset values and investor sentiment. While institutional investors show an increasing appetite for real estate assets, they have learnt from their experiences during the crisis and are seeking more control over their real estate exposure. Regulatory changes sparked by the financial crisis, including the Alternative Investment Fund Managers Directive (AIFMD) in Europe, will also change the landscape for real estate investment.

The good news is that the fundamental attractions of real estate as an asset class have not changed, and with evidence that institutional investors are set to increase their exposure to alternatives, the future for real estate investment looks bright. Capitalising on the opportunities of the new environment will, however, take adjustments on the part of both investors and real estate fund managers. In this paper, we examine the attraction of real estate to institutional investors; their approach to the market; the preferred ways of structuring and managing real estate exposure; favoured property strategies in the current market; and investors' increased reporting requirements amid the post-crisis emphasis on transparency, liquidity and risk.

[1] Towers Watson/FT, Global Alternatives Survey 2011, June 2011.

As a leading servicer and manager of real estate assets, State Street is well positioned to analyse the changes that are taking place in the market. In August 2011, we conducted a research study in partnership with Preqin, a leading provider of market intelligence for the alteratives industry. Our European Real Estate Fund Manager Study 2011 garnered more then 50 responses from managers across the region, focusing on issues such as the impact of regulation and the trend toward outsourcing. This Vision paper and a companion paper focused on the perspective of real estate fund managers draw on these insights and research to explore some of the key shifts that are taking place as institutional investors revisit and renew their approach to real estate.

Institutional Investors: Why Real Estate?

How institutional investors choose to gain exposure to real estate will depend on their risk appetite, their preferred structures and what level of involvement they want in the properties in which they invest. There is a spectrum of potential approaches. Direct investment in specific properties will suit some investors while others may prefer to pool their funds alongside other investors to expose them to different sectors and assets than they can access on their own. Diversification can require significant capital resources, and investors may choose to achieve this goal via pooled funds. Unlisted funds are another option, while buying shares in listed real estate investment trusts (REITs) or in their preferred stock offers an equity market route to real estate exposure.

It is important to note that the listed values of property companies do not necessarily reflect the value of the underlying property as the share price is also determined by factors such as liquidity and general market sentiment. Alternatively, investors that prefer their exposure to be structured through debt instruments can opt for secured mortgage debt, either as first mortgagees or mezzanine lenders. Commercial mortgage backed securities (CMBS) offer yet another route to market, while unsecured debt in the form of corporate bonds issued by special purpose property companies provides another option. A number of valuation methodologies exist for real estate (see panel), and different markets favour different approaches.

Over the last few years, new institutional investment in real estate has been restricted as a result of, among other reasons, asset allocation criteria. Amid depressed equity markets, property assets held within their portfolios have tended to appear overweight. As equities regain some equilibrium, additional allocations to property assets have become timely in order to rebalance portfolios.

Property prices in key markets have begun what some real estate analysts believe to be a tentative upswing that may offer scope for capital gain, despite an underlying lack of confidence. In addition, there is evidence of rental growth in locations such as central London, which has had a positive effect on capital values in some instances.

Prime property located in key investment centres typically benefits from consistent, long-term tenant demand. For investors, these properties represent an opportunity to acquire long-term income flows as well as gain from potentially increased capital values. In slowing markets, top-quality properties with stable rent rolls are likely to continue to provide stable income flows even if capital appreciation becomes muted or even negative. Because of the nature of its value streams, the performance of real estate may exhibit low correlation with the performance of major equity markets. Crucially, real estate's income cash flows match institutional investors' continuing and equally predictable liabilities, such as annuity payments to the end policyholder. Indeed, real estate assets with long leases and long-term contractual income streams can function as an alternative to fixed-income investments.

Real Estate: Valuation Methods

One of the complexities of real estate investing stems from the variety of standards applied to the valuation methodology, depending on the particular assets or the country in which the valuer or appraiser is located. These factors are key because the valuation usually makes up the majority of the net asset valuation (NAV) prepared by the fund. Unlike many other investments, where mark to market can be applied using like-for-like market transactions, this approach is not possible with real estate because every property is unique in terms of the landholding, its history, any buildings constructed on it and the occupying tenants.

Without actually offering the property on the open market, property valuers can give their professional opinion only on what price a property might achieve. In doing so, the valuer must make a series of assumptions. These assumptions, supported by particular valuation standards, may vary from country to country. The valuation standards, assumptions and valuation definition used may depend on who is providing the opinion of value and for what purpose, but either way it will always be an opinion.

Different valuation standards are published by various institutions in different countries, but many will cross-reference the standards published by the International Valuation Standards Council (IVSC), especially if a fund is reporting to, say, International Financial Reporting Standards. International valuation standards have been adopted and supplemented (where appropriate) by the Royal Institution of Chartered Surveyors in its RICS Valuation Standards — Global edition.

Local market knowledge and a sound understanding of property and the construction of buildings are essential for a valuer to form a professional opinion of value. In many cases, the ability to analyse similar market transactions and apply this evidence to determine value is paramount. However, where there is a lack of open-market evidence, other valuation methods may be appropriate, but in applying these methods, varying degrees of risk may be introduced. Examples include discounted cash flow models (especially when explicit cash flows can be estimated) and residual valuations (when the valuation is likely to be determined by, say, redevelopment).

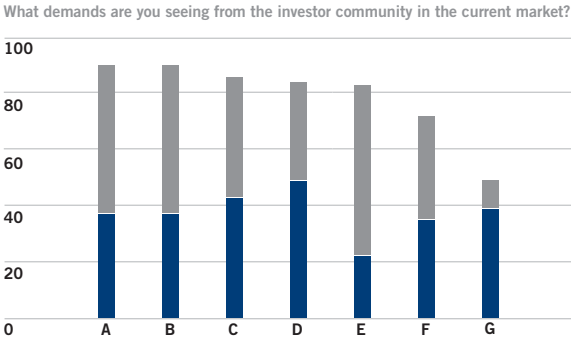
Income-producing property investments will typically be valued on the basis of the capitalisation of the income generated from the property (i.e., rents). The rate of return applied can be drawn from other similar transactions appropriately adjusted to reflect the different risks of the particular investment. Risks will vary from those specific to the property (e.g., the quality of the tenants paying the rent and the age or condition of the buildings) to those relating to the wider economy. The rate of return will also be driven by other factors such as the opportunity cost of other investments.

Approaches in the Current Market

While the appetite of pension funds, sovereign wealth funds, insurance companies and other high-net-worth investors for real estate exposure continues to be strong, these investors are more demanding in a number of ways (see Figure 1).

Moreover, because of constraints on leverage due to tighter lending policies at funding banks, those investors with cash of their own to invest are able to demand a closer relationship with their fund manager. They may choose to provide real estate funds with the required equity but are also likely to insist on fund managers being more accountable.

Figure 1: Key Demands Made By Institutional Investors

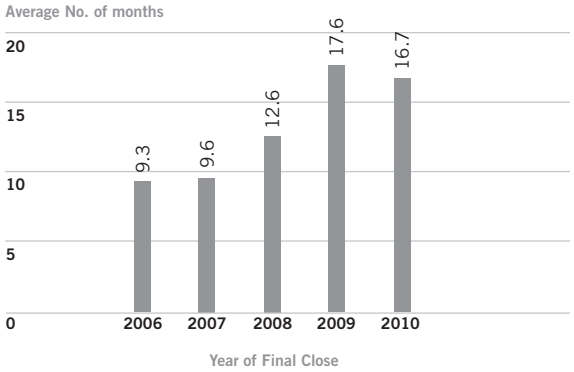


■ Somewhat significant
■ Very significant

A Increased transparency of information on underlying investments
B Increased transparency of information on fees
C Increased reporting
D Investment advisory committees
E Manager co-investing
F Club deals
G Aggregated property and investment data available online

Source: State Street European Real Estate Fund Manager Study 2011.

Figure 2: Average Time Taken for Private Equity Real Estate Funds to Close



Source: Preqin, Private Equity Real Estate Summary, Q1 2011.

While some real estate funds are seeing improved investor activity, the typical length of time between invitation and closing has extended (see Figure 2), as investors take longer to make a final decision and pay greater attention to due diligence. Real estate fund managers are finding that potential and current investors are looking for more one-on-one conversations, both at the outset of their investment and during the lifecycle of the fund. In addition, standard periodic reporting is not always sufficient to satisfy their requirements for improved insight into the fund and the performance of underlying assets in which they are invested. In some cases, fund managers' fees have come under greater scrutiny, which increases the climate of competition and the need for operational efficiency. At the same time, investors are seeking greater comfort by looking to negotiate terms. For example, some fund managers are having to consult with investors on fee levels and strategy prior to set-up. Large institutional investors providing seed capital to a fund are likely to be able to negotiate lower fees than subsequent investors.

Flexibility on Exiting Funds

Investors are also seeking greater flexibility in their real estate investment, sometimes as a consequence of their experiences during the financial crisis when investors found themselves locked into funds from which they could not exit quickly enough. In the event of loan-to-value breaches, longer-term, cash-rich investors were often prepared to contribute further equity to prevent the bank stepping in to seize the portfolio. However, fund managers found that some of their perhaps cash-strapped investors were unable to match these investments, making for difficult discussions. Reconciling these divergent interests can prove challenging. In some cases, investors that contributed additional cash, at a discount to the NAV, diluted the interests of those that were unable to do so, and this situation led to additional tensions.

Consequently, some investors now contemplating new investments are seeking like-minded co-investors to join them so that, if difficulties arise, it is easier to reach terms and agree a way forward. This trend, naturally enough, leads to smaller "clubs" of investors being formed to invest in particular properties, portfolios or redevelopment projects, in a way that has been common in the private equity space for some time. Some investors are looking for funds to be structured in a way that promotes greater liquidity, for example by incorporating a platform to allow redemption through a secondary market. In addition, some larger pooled funds are creating investor registers to enable increased communication among their investors.

The desire for an alignment of interests among co-investors is leading in turn to other distinct trends in the current market. Institutional investors now seek greater independence on the boards and representation on investment committees of the funds in which they participate. More timely information on performance metrics is also expected. It remains to be seen how real estate fund managers respond to these increased demands. While they may need to be more flexible in the current market environment, many managers will argue that it is their job to concentrate on generating returns for their investors, so they will seek other solutions to meet investors' additional demands.

Structuring Real Estate Investment

The methods that institutional investors choose for structuring their real estate exposure will be determined by factors such as their investment goals and tax efficiency. For example, many UK pension funds and insurance companies have tended to prefer unit trust structures that provide tax transparency, with rents typically paid to investors free of withholding tax. These structures may also be exempt from capital gains tax, which can be particularly important when investors are buying into the real estate assets at or close to the bottom of the market cycle in the expectation of making capital gains. Such structures may involve offshore locations to allow for optimal tax planning. Investment duration is also a key consideration. For example, a project-based structure assembled to invest in property for development may have a limited time horizon and include a provision for closure or investors' exit from the fund once the development has been completed and sold.

Early Exits

Many real estate funds are closed ended and have a life of approximately five to seven years. This timeframe can be too long for some investors to have their capital locked away, so a further structural consideration is whether the funds are open or closed ended. Either way, investors may seek to exit by selling their interest to other investors via a secondary market, although such markets are often restricted.

Leverage and Regulation

An additional risk management factor is whether or not funds are set up to be leveraged. In the current lending and regulatory environment, leverage has become a concern for a couple of significant reasons. The use of debt in property transactions can give enhanced returns that outweigh the debt risk, especially in a rising market. Problems arise, however, in uncertain or falling markets. The negative implications of leverage are quickly felt when prices fall, swallowing up equity and increasing the likelihood of the debt provider stepping in to manage the underperforming loans or forcing the manager to sell assets. More recently, the traditional suppliers of leverage have constrained their lending activities within the property space, creating challenges for managers when they seek to renew finance during the life of the fund. Add to this the continuing tightening of capital adequacy and liquidity regulation under Basel II and, in due course, Basel III accords, and it seems likely either that property debt funding will be substantially constrained or it will become so highly priced as to be unattractive to real estate funds.

Meanwhile, Solvency II, aimed specifically at European insurers and modelled in large measure on the Basel models, is looming on the horizon. Solvency II will require insurers to adopt capital adequacy and liquidity measures that are likely to raise their cost of capital. In addition, they will need to be able to mark-to-market the value of their property investments on a regular basis, which may present difficulties as real estate cannot be as readily valued as liquid, marketable securities such as equities and bonds. Understandably, both insurance and real estate investment industry representatives are currently lobbying regulators to revisit these issues.

It looks likely that leverage for real estate funds will become more restricted as a consequence of Basel III and Solvency II regulation. This restriction will tend to play to the strengths of cash-rich investors such as sovereign wealth funds and others that have no need of leverage and are not subject to the same regulatory regimes as banks and insurance companies.

Other regulatory challenges do, however, await real estate investors. In brief, the Alternative Investment Fund Managers Directive (AIFMD), one of the regulatory initiatives aimed at strengthening investor protection and increasing transparency, will place additional controls on alternatives managers, including real estate managers, while the European Market Infrastructures Regulation (EMIR) will set out rules governing the use of derivatives such as those used by leveraged funds to control interest rate risk. Both pieces of regulation may add costs to real estate funds that will act as a drag on yields to investors while enabling non-fund unleveraged direct private investors, who may be unfettered by such regulation, to reap commercial advantages in the marketplace. For example, the new regulation may require real estate funds to hold increased liquidity on their books in order to cover the hedging instruments used to fix interest rates on debt. It remains to be seen precisely how these scenarios will play out as regulation is fine-tuned for implementation.

Investment Trends

The period 2007–2010 was characterised by a collapse of property asset values, even in prime locations. Data from real estate research firm Investment Property Databank indicates that UK commercial property prices dropped by 44 percent across the board in the period July 2007 to July 2009.[2] The resulting trend among property investors globally was a flight to prime property assets, a flight to their home market — the market they understand best — or a combination of these trends. While the real estate market has recovered somewhat during late 2010–11, prime property is still the most attractive to large institutional investors.

Against this background, some major investors have announced their intention to increase their property asset allocation, including some major sovereign wealth funds. In the face of increased demand, yields have firmed in prime commercial property globally. Yet, as the demand for office space in major city locations expands again, constrained supply caused by reduced property development during the financial crisis has pushed up both rents and capital values.

As noted above, cash-rich investors may have ample liquidity to invest but they are approaching real estate assets with caution and with strict requirements born of careful risk management. They are seeking prime locations, where buildings are fully let, with strong tenant covenants. London is highly attractive in this context with major new trophy assets such as the Shard, Heron Tower, and Olympics-related projects. Research by CB Richard Ellis shows that while London and Paris continued to be the two largest European real estate investment markets in the first half of 2011, their share is lower than usual, declining by seven percentage points on H2 2010. The presence of Warsaw and Moscow in the top 10 underscores the increased activity in Central and Eastern Europe amid huge competition for prime assets in Western Europe (see Figure 3).

At the same time, other sectors within, for example, the UK market that promise relatively low risk and dependable cash flows are also returning. These opportunities include prime retail where footfall is high and visitors are affluent, infrastructure such as airports and train stations whose cash flows are dependent on imperative use, social housing and student accommodation. In an increasingly globalised investment world, real estate can offer focused exposure to very local economic conditions. While this characteristic makes the exact choice of location critical, it also underpins the role of real estate as a diversifier within a portfolio and enables investors to capitalise on market-specific opportunities.

Reporting in the Post-crisis Environment

Across countries and segments, investors are insisting on greater levels of transparency, following their experiences during the financial crisis. Regulatory initiatives are also driving this focus on transparency and risk. While historically investors have preferred their fund managers to provide them with appropriate reporting of exposures,

[2] Investment Property Databank.

Figure 3: Ten Largest European Commercial Property Investment Markets, H1 2011

	Turnover (€ million)	% of European Market*
Central London	7,921	17.1
Paris	3,721	8.0
Manchester†	2,013	4.4
Moscow	1,759	3.8
Stockholm	1,494	3.2
Frankfurt	1,388	3.0
Hamburg	1,176	2.5
Milan	1,096	2.4
Warsaw	1,003	2.2
Berlin	885	1.9

* Excluding indivisible multi-city portfolios

† Manchester's presence is as a result of the transfer of the Trafford Centre from Peel Holdings to Capital Shopping Centres

Source: CB Richard Ellis, European Capital Markets MarketView Q2 2011.

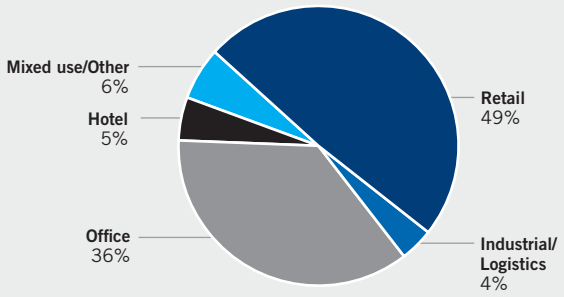
yields and fund values, the scale, scope and granularity of their requirements have changed significantly. Real estate fund managers typically hold quarterly investor presentations, including such information as fund performance data, details of underlying assets, updates on asset sales and purchases, key asset management initiatives, and the performance of debt within the fund structure. Now, however, investors increasingly require one-to-one meetings with fund managers. Details of fund managers' strategies, which could be passed to competing funds or to competing property owners and investors, could adversely affect the fund and its other investors. Therefore one of the challenges for fund managers is to strike a balance between meeting these requests while protecting commercially sensitive information.

Focus on Italy: An Evolving Real Estate Funds Market

Italy faces a number of challenges as it seeks to kick-start economic growth. While the Italian real estate sector performed relatively well during the financial crisis, the country has recently introduced a number of structural changes designed to broaden the appeal of its real estate market to investors as it seeks higher levels of foreign investment.

Traditionally, the market has been dominated by major Italian pension schemes and insurance companies that invested directly in real estate assets. However, these investors have started a progressive shift toward real estate funds to avoid the cost and administrative complexity associated with direct real estate investing. This trend coincided with the emergence of active, professionally managed, closed-ended real estate funds. Closely regulated by the Bank of Italy, these funds are increasingly attracting local institutional investors.

Figure 4: Volume of Investments in Italy by Sector, H1 2011



Source: CB Richard Ellis, Italian Quarterly MarketView Q2 2011.

The real estate investment market has typically focused on commercial property in key centres, including Milan, Rome and Turin. While a shortage of quality assets has limited investment volume, the proposed privatisation of publicly owned assets would add considerable volume to the Italian real estate fund universe. Italy's social housing programme — designed to create low-income housing, particularly for rental — is also generating new opportunities for investment. Such moves will also help to stimulate the Italian economy — the third largest in the European Union — and create opportunities to invest in the country's future.

Italian real estate fund investments are closely regulated, with important third-party roles being played by depositary banks and other independent advisers such as property valuers. Structured real estate funds have attracted both local retail and institutional investors, and a number of new funds are starting to emerge specifically to attract foreign investors. Some of those funds targeting foreign institutions will be structured as offshore entities for optimal tax efficiency and investor protection.

As real estate fund managers increasingly prioritise transparency and operational efficiency, the opportunities for third-party providers of depository, administrative, reporting and risk management services are likely to grow. Fund managers are also seeking working capital and bridge funding from suitable providers to add liquidity when making new investments.

Now that local pension schemes and insurance companies can invest in more transparent and liquid funds, they are returning to the real estate market without some of the administrative concerns associated with their previous direct real estate interests.

Increased Reporting

Increased information requirements — and standardised valuation measures — are becoming the norm (see "Real Estate: Valuation Methods" on page 4). Institutional standards of reporting such as those set out by INREV, the European association for investors in non-listed real estate funds, are now expected by investors. These standards make it easier to compare performance across the industry. In addition, the experiences of the financial crisis have prompted a rethink of the way in which performance fees are linked to industry benchmarks.

Investors' increased information demands are understandable. Amid the overall focus on risk management, they are looking to gain greater insights into the variables that affect the performance of their investment and the liabilities associated with it. When it comes to real estate, these variables are myriad — from the extent to which a fund is exposed to a single high-street retail chain to the ongoing non-recoverable repair costs. In addition, investors or their property advisors may seek details of individual tenants and their rental performance in the context of specific properties.

Increased frequency of reporting is also high on investors' agendas. Reporting was typically quarterly in arrears, but the events of the financial crisis, when portfolios were hit hard by declining asset values, have compelled investors to seek more regular updates from their fund managers.

As investors seek increasingly detailed and frequent reporting, tools are now emerging that enable fund managers to meet this demand. While larger fund managers may be prepared to meet the increased cost of technology that this reporting entails, proprietary analytics providers that can leverage their capital investment across a range of fund manager clients may be better placed to provide these sophisticated tools and sustain the technology investment required to stay ahead of the curve.

Competitive Pressures

Although fund managers face greater costs in supplying the information required of them, when a specific reporting framework becomes industry standard they can no longer charge higher fees for it. This places them under greater financial pressures while impending regulation, such as Solvency II, the AIFMD and EMIR, will create further compliance requirements. Large fund managers may meet these further demands by recruiting and training employees, investing in upgraded systems and running slicker, better administrative systems. Smaller fund managers may decide that they cannot afford to operate profitably in these new conditions and opt to outsource to a professional service provider to meet investors' increasing demands. Alternatively, they may decide that joining forces with other fund managers will enable them to achieve the size of firm that can meet clients' requirements and compete for business in the post-crisis real estate fund management environment.

World of Opportunity

It is clear that the real estate market and the expectations of investors have both changed radically since 2007. Moreover, additional radical regulatory changes — that will, in turn, force organisational change — are set to follow rapidly in the coming months.

However, investors continue to demand exposure to real estate as an uncorrelated, alternative asset class, and the latest research on global institutional investment trends shows a growing appetite for real estate. Investors can choose from several different routes to market as drivers for predictable, liability-matching cash flows and/or as a source of above-index-level returns. In addition, they have a global market to choose from, depending on their location, preferred structure, risk appetite and return requirements.

Notwithstanding the imperatives of increasing regulation and rigorous reporting, real estate fund managers are faced with the opportunity to develop their businesses on a worldwide stage to meet such investor demand. With third-party service providers at their side to provide the local execution that is fundamental to investing in bricks and mortar, those real estate fund managers with global ambitions and those with niche, local market expertise have major potential opportunities, especially at this time in the market cycle.

Renewed interest from institutional investors and increased global investment opportunities are likely to underpin rapid growth in real estate investing. The current market uncertainty is driving investors to diversify their portfolios, and real estate is set to be a key beneficiary of this trend as the advantages of diversification become clearer and alternative asset classes become more accessible. While investors are coming with a longer list of demands than ever before, the real estate sector is responding with a renewed sense of innovation, indicating a bright future for one of the oldest and most fundamental forms of investing.

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