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VISIONFOCUS

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Real Estate: A New Model for Fund Managers

Real estate fund managers face a fast-evolving environment, driven by the continuing implications of the financial crisis and the emergence of major new global investment opportunities. While the latest figures confirm strong institutional appetite for real estate assets, managers must contend with increased reporting and compliance demands from both investors and regulators. These pressures are driving a greater focus on outsourcing and other partnerships as managers establish a new operating model to position themselves for the significant opportunities ahead of them.

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*This AUM includes the assets of the SPDR Gold Trust (approx. $58 billion as of June 30, 2011), for which State Street Global Markets, LLC, an affiliate of State Street Global Advisors, serves as the marketing agent.

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Foreword

Several high-profile real estate investments by large institutions and sovereign wealth funds have demonstrated that property assets are back on investors' agendas. Major investors have announced their intention to increase their real estate asset allocation, including some major sovereign wealth funds.

Research suggests that institutional investors are increasing their allocations to alternatives in the wake of the financial crisis. According to Towers Watson, the top 100 alternative asset managers globally managed $952 billion on behalf of pension funds in 2010, up 16 percent on 2009. Real estate assets accounted for 55 percent of this total, a rise of 3 percentage points on the year.[1] On the supply side, sales of distressed real estate assets by banks that saw their portfolios ravaged by the crisis are now boosting availability of prime properties in key centres.

Despite the resurgence in real estate investment, the environment has changed significantly since its 2007 heyday. High-leverage deals are a rarity as banks have tightened their lending criteria post-crisis, and it is likely that it will be some time before banks return to property lending at significant levels. In addition, there are many leveraged deals that are coming up for review. Consequently, cash-rich investors including institutions now lead market activity and are keen to close deals on terms that are favourable to them. Conscious of their increased power in the marketplace, institutional investors want a greater influence in their real estate investments. They also want more granular data and more frequent reporting on the underlying assets amid the post-crisis emphasis on risk and transparency.

The real estate industry is braced for significant regulatory change in the coming few years, as regulators turn the spotlight on issues of investor protection and systemic risk. Among other regulatory initiatives, the Alternative Investment Fund Managers Directive (AIFMD), the European Market Infrastructures Regulation (EMIR), Basel III and Solvency II may have significant implications for real estate fund managers, although the final shape of the regulation remains uncertain in some cases. Increased compliance requirements are likely to create greater costs for managers, and regulation will sometimes create specific challenges for the real estate sector, given the unique characteristics of real estate portfolios.

As they seek to add value for their clients, managers of real estate investment funds face several conflicting pressures that threaten to distract them from their core purpose of managing real estate assets for maximum return. In response to these pressures, many managers are undertaking a review of operating models and

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

responsibilities that is unprecedented in its scope and rigour. At the same time, there is a creeping tide of complexity stemming from the way funds are structured as well as new regulatory requirements. Real estate managers are considering what tools and support they need to navigate this new environment — including embracing outsourcing with a new enthusiasm — to concentrate on their core investment skills.

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 alternatives industry. Our European Real Estate Fund Manager Study 2011 generated more than 50 responses from managers across the region, focusing on such issues as the impact of regulation and the trend toward outsourcing.

This Vision paper draws on these insights to examine the trends that real estate managers are facing, including increased investor activism and burgeoning regulation. We have also published a companion paper that examines these issues from the perspective of institutional investors and their growing interest in real estate as an asset class. We also identify the emerging operating model that prioritises outsourcing and closer collaboration with service providers, and offer perspective on how these drivers will affect the role and functioning of real estate funds in future years.

Challenges and Opportunities for Real Estate Fund Managers

While significant, the challenges and opportunities facing real estate managers can be viewed as the beginning of a new phase in the industry's evolution, requiring a recalibration of traditional business models. Certainly, this year has seen a pick-up in investment activity, with commercial real estate funds transacting €26.7 billion in Europe in the first quarter of 2011, an increase of 26 percent on the same period last year.[2] Furthermore, the European Public Real Estate Association says the listed sector has the potential to double in size over the next five years.[3] One of the drivers of growth is likely to be the increased appetite of institutional investors for alternative assets as they look to support the long-term liabilities associated with ageing populations and the shift to defined contribution pensions.

At the same time, the field of play has expanded to be global in scale. Figures from Towers Watson show that while 46 percent of real estate investment in 2010 was in North America, assets invested in Asia Pacific had doubled year-on-year to 14 percent.[4] Investors can originate from any part of the world, and the investment opportunities in real estate are equally global. To operate at the nexus of such supply and demand offers significant gains to those fund managers that can demonstrate attractive long-term returns on investment for their clients while operating with optimal efficiency.

Increased Investor Influence

While the opportunities for real estate fund managers are growing, investors have become more demanding. They seek a greater understanding of the investment strategy of their fund manager, and their requirements include increased influence over their investments, greater flexibility over entry and exit from funds, and more transparency and rigour in reporting. These demands are a legacy of their experiences during the crisis, when some of them were unable to exit portfolios that were illiquid or struggled to reconcile the different attitudes of their fellow investors. Nowadays, some investors prefer to invest alongside a small group of like-minded investors as opposed to playing proportionately smaller roles in larger syndicates or pooled funds, which was more acceptable to them prior to 2007. As well as focusing on cost and flexibility, they expect more granular reporting and one-on-one meetings with real estate fund managers to drill down further into the detail of investment strategies.

[2] CB Richard Ellis, European Investment Quarterly MarketView Q1 2011.

[3] Fraser Hughes, head of research at the European Public Real Estate Association, quoted at REALTY 2011.

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

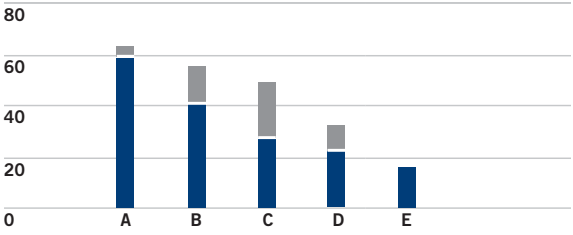
Outsourcing

Inevitably, the growing demands from investors — ranging from increased flexibility to more rigorous reporting — add to the costs of doing business for fund managers, while more rigorous standards of regulatory compliance also add complexity and cost. For these reasons, fund managers are reconsidering their operating models. While already required to "segregate" certain responsibilities, they are reassessing what is fit for the purpose of addressing these new challenges and opportunities. They are deciding where they should focus their skills and energies as well as their financial and human resources. Some fund managers are choosing to work with outsourcing partners as part of the most suitable structure for their businesses going forward. Figure 1 shows the back- and middle-office processes that fund managers are most likely to outsource or have already outsourced.

Many managers have already outsourced certain responsibilities. They may, for example, require third-party administration services because the fund structure is domiciled in a location where they have no presence of their own. Now, however, they are beginning to expand their outsourcing brief. The financial crisis brought with it cost pressures that have caused them to examine their risk management and cost structures. They have begun to look at day-to-day functions such as accounting and reporting and have queried whether these are economic to run internally. Our research shows that when managers have established core in-house administrative functions, a growing number — 37 percent — are prepared to consider a "lift-out" of these operations to a third-party provider. They are also acutely aware of the investment required to maintain cutting-edge technology platforms to support capabilities such as analytics and reporting, and they are increasingly turning to service providers to access this expertise.

Figure 1: Attitudes to Outsourcing

What elements of your back/middle office have you already outsourced or would consider outsourcing?



■ Already outsourced
■ Would consider outsourcing

A Rent collection
B SPV holding vehicle accounting/administration
C Fund accounting/administration
D Investor registrar
E Performance analytics & look-through reporting

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

Our research also indicates clients overwhelmingly seek flexibility and adaptability from their service provider, with 82 percent naming these characteristics as a priority. Technical excellence, meanwhile, was viewed as "very important" by 47 percent of respondents. At the same time, larger fund managers that outsource a variety of functions have started to consider consolidating third-party service providers in the quest for greater efficiency and lower cost, while the range of services that can now be outsourced has expanded (see panel).

Third-Party Expertise — The Options

Real estate funds can draw on a range of third-party expertise, starting with the setting up of funds with appropriate, tax-efficient structures. Tax structuring has become more complex and, given the increasing global investment opportunities within real estate, it may involve multiple foreign jurisdictions. Fund managers will be looking to structure the arrangement using locations that match their investors' tax circumstances. As fund managers are unlikely to have a presence in all the relevant locations, they may need to outsource their formal set-up and administration to service providers who do. An additional consideration is whether or not the fund is set up to be leveraged and this may require further expert advice and administration that can be outsourced. However, fund managers are still wary of outsourcing for a number of reasons, with 71 percent of respondents citing variable quality/service levels as a concern. This response represents an opportunity for the servicing industry to consolidate its position and distinguish itself through high-quality services and dedicated expertise.

Once set up, external providers can offer a number of other functions:

- Performing Anti-Money Laundering (AML) procedures
- Performing investor registrar services including recording of subscriptions and redemptions, and maintenance of the share register
- Capital drawdowns to acquire assets
- Income and capital distributions deriving from the assets over the life of the structure
- Calculating net asset value (NAV) based on independent property valuations
- Organising and running board meetings to achieve necessary decision making
- Organising investor meetings
- Providing compliance services to comply with local regulations
- Book keeping, producing management accounts, and coordinating and facilitating annual audits, and consolidating accounts (potentially based on multiple layers of accounts from multiple jurisdictions)

Additional services that may add value for clients include:

- Setting up and maintaining a key document library that can include core documents relating to the establishment and legal status of the fund and also tax and distribution notices and other communications for managers, clients and lawyers to access
- Banking and FX services, cash brokerage
- Complex performance and analytics services, based on advanced proprietary technologies and typically delivered online

Larger service providers, such as State Street, also offer managers "lift-out" opportunities where a fund manager's team of accountants and administrators transition across to an external provider. While allowing managers to focus undistracted on their core investment capability, this approach can also avoid the continuous investment in technology and training, while benefiting from the external provider's economies of scale.

Further cost savings for fund managers arise from not having to continuously invest in new technology and staff training to stay ahead of the competition.

While tax and corporate structuring and cost saving can be key drivers for adopting an outsourcing model there are others that also make this an attractive route to follow.

Independent Functions

The events and experiences of the financial crisis have led to a greater focus on corporate governance. As a consequence, investors have expressed a stronger preference for greater separation between fund managers and the administrative running of the funds they manage — the so-called "segregation of duties". This drive is supported by recent regulatory efforts. Greater independence, transparency of key functions and the handling of cash are high on investors' agendas. There is also the perception that the core function of the real estate fund manager is to apply their fund management skills and understanding of property to their best effect — and that the outsourcing of certain administrative functions may give them the opportunity to focus on fund performance.

An outsourcing approach offers a number of tools to fund managers that they buy in on a take-and-pay basis, depending on the services that they wish to retain in-house. There are two other drivers that are becoming increasingly imperative, namely the need for greater detail in reporting fund performance and compliance with new regulatory requirements that are administratively burdensome.

Reporting and Regulation

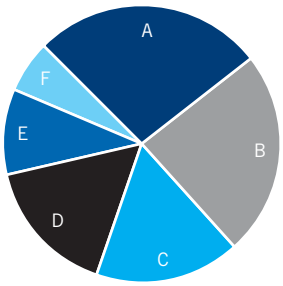
Investors have always expected quarterly reporting of key metrics, including exposure reports, yields and NAVs. Since the financial crisis, however, investors are more inclined to scrutinise manager performance. Where investors used to receive quarterly performance data in arrears, they are now demanding more frequent and detailed updates from their real estate fund managers. At the height of the crisis, some managers provided monthly valuations. In addition, investors are focusing on metrics such as how liquidity is being managed. Figure 2 illustrates the various levels of data being sought by investors.

This shift is partly to do with the severity of the downturn and with the depths to which some property values fell. In addition, real estate is a complex investment, and investors want to be aware of any inherent risks. There are myriad factors that may together have an impact on the attractiveness of the property.

Furthermore, the tenant covenant — including who the tenants are, what their business is and whether they are stable rent payers — is also a critical driver of successful returns. Investors are increasingly seeking this level of detail on the assets in which they have invested, and they expect their fund managers to be able to provide it more quickly and precisely than ever before. For example, they may want to know their exposure to a particular high-street retail chain.

Figure 2: Increased Reporting Requirements

If you are experiencing increased reporting requirements, what level of data is being sought?



A. Gearing levels 27%
B. Industry performance metrics (e.g., TERs) 24%
C. Increased frequency of reporting 17%
D. Specific tenant information 16%
E. Sector only (retail, office, etc.) information 10%
F: Increased demand for online reporting 6%

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

The level of detailed reporting required is likely to increase in the years ahead. Risk management has become a significant factor in investors' thinking, and these financial metrics are also valuable to fund managers as they enable them to ensure they are meeting their investment mandates. For example, they may have a limit on the level of gearing in the portfolio, or how much exposure there is to particular sectors such as office or retail. The energy efficiency of a building is set to become an even more important factor in the years to come, as tenants — particularly in the public sector — increasingly make real estate choices based on "green" ratings.

Increasingly, powerful analytics tools are available that allow this level of detail to be mined and analysed for the benefit of the fund's investors. Historically, investors may have struggled to access and aggregate the relevant detail from multiple fund managers and other sources to gain a complete picture. Nowadays, the leading service providers in the real estate space can offer technologies that aggregate data from all the underlying real estate assets in a fund and store it in a data warehouse for ready access via the internet. By partnering with third-party service providers to access these capabilities, investors and managers can avoid the ongoing investment required to ensure that these technologies remain leading edge and keep pace with market evolution.

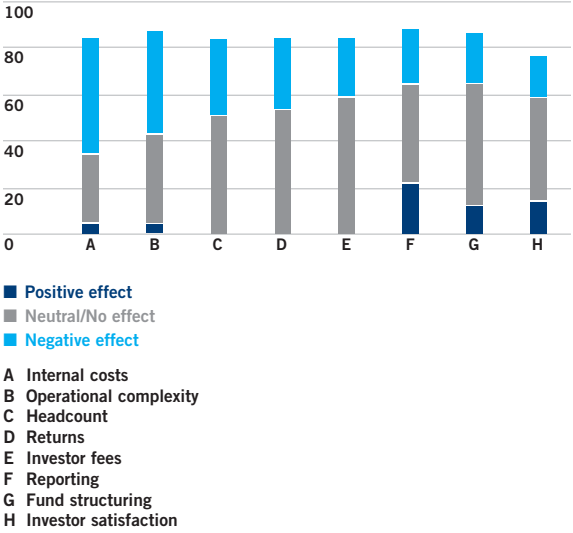
Impact of Regulation

While clients demand increasingly granular reporting, new regulatory demands are set to add to this administrative burden. Although the full scope of some of the regulatory requirements has yet to be established, several major pieces of regulation are in the pipeline that will impact fund managers in different ways and to varying degrees. Regulation therefore is becoming a driver for outsourcing key functions because of this increased complexity, which may be best handled by service providers expert in such work. Indeed, in our research, 55 percent of respondents stated that regulation is an important driver of outsourcing.[5] Furthermore, some regulation specifically prescribes roles for third-party service providers, and, in instances where regulation differs in its terms and/or application from jurisdiction to jurisdiction, service providers with local knowledge and presence can add value.

Regulation to further encourage and enforce the segregation of duties within the investment value chain is likely to tighten further. This is likely to result in increased outsourcing to ensure sufficient segregation between and regulation of these roles. Three major upcoming regulatory initiatives are likely to have a significant impact on real estate fund managers.

Figure 3: Impact of the AIFMD

How do you see the AIFMD impacting your operations?



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

AIFMD

The Alternative Investment Fund Managers Directive (AIFMD), a European regulatory initiative that is set to come into force in July 2013, impacts managers of all non-UCITS funds, including hedge funds, private equity and real estate funds with geared assets of more than €100 million or ungeared assets of more than €500 million. While the precise shape of the framework is being refined, its broad impact on real estate investment funds is already clear. In addition to affecting real estate funds, it may also affect other arrangements used in the real estate sector, such as joint ventures and property investment companies. As Figure 3 shows, many fund managers expect the biggest negative impact of the AIFMD to be on internal costs and operational complexity.

The AIFMD's requirement for alternative funds to ensure independent valuation — or at the very least ring-fence the valuation function — is likely to drive the trend toward outsourcing. In the wake of the Madoff fraud, the role of third parties in providing transparency and carrying out

[5] State Street European Real Estate Fund Manager Study 2011.

duties in an independent manner is a crucial step. For the moment, real estate funds are lobbying for special consideration, especially as far as asset valuations are concerned, because of the specific nature of real estate and the lack of a highly liquid and transparent market in such assets for benchmarking purposes.

In the context of the AIFMD, it is important to note that choice of domicile and jurisdiction will play an important role. For example, offshore locations such as Jersey, a popular jurisdiction for a wide range of property fund structures, will need to make certain undertakings in order to be compliant under the new directive.

EMIR

The European Market Infrastructures Regulation (EMIR), which is expected to be implemented in 2012 following publication of the proposed regulation in September 2010, will affect to some extent all market participants and users of over-the-counter (OTC) derivatives. This regulation is highly significant for real estate investment funds because they are typically leveraged and use OTC instruments to hedge their exposure to adverse interest rate movements. If they invest in overseas property assets that produce foreign currency cash flows, they may also use derivatives such as long-dated currency swaps to counter currency risk. EMIR is designed to impose transparency and greater control over derivatives markets. It will require standardised transactions to be cleared through central clearing counterparties (CCPs) with the posting of both initial and variation margin. Users of non-cleared OTC derivatives will also need to post collateral to safeguard against a defaulting counterparty.

These features are likely to have significant consequences for real estate funds. First, they will need to pay for the additional stages in the cleared model (electronic execution facilities, clearing members, CCPs, trade reporting) — costs that they do not currently have to meet. Second, as real estate funds do not normally hold appreciable amounts of cash or assets that are eligible at the CCPs (such as gilts), they could struggle to find the cash or eligible assets to collateralise their use of derivatives and may perhaps have to liquidate some of their property holdings to raise funds. In addition, if real estate funds are unable to arrange swaps to hedge the interest rate on their debt, they may need to seek fixed-rate interest payments (which are necessarily higher) or they may even be unable to raise finance. The net result could be that less capital is available to the real estate market.

Solvency II

Affecting EU-based insurance and reinsurance firms, Solvency II establishes a “three pillar” system for risk management, governance, reporting and ongoing supervision, as well as capital and solvency requirements. It will result in additional reporting and costs involved with upgrading systems and hiring staff to assist the firm in its compliance duties. However, the increased capital requirements in Solvency II may also influence insurers’ choice of investments. Real estate will carry a higher capital charge than some other asset classes, such as highly rated sovereign debt. In effect, certain assets will become more expensive to invest in.

As insurers need cash flows from investments to be matched to their continuing liabilities, long-term investment in property has been considered a suitably low-risk element of allocation. Real estate fund managers are watching the evolution of Solvency II with interest and concern. It is worth noting, however, that pension funds do not currently fall within the scope of Solvency II, although this proposal is being considered as part of the review of the IORP Directive. Indeed, the widespread shift from defined benefit pension schemes to defined contribution structures may conceivably increase pension fund investment in real estate assets. The stable, long-term income streams available from prime property assets lend themselves to long-term pension liability matching.

While Solvency II was originally scheduled for implementation in January 2013, a 12-month delay has been proposed in order to smooth the transition to the new rules, and it is still too early to gauge the impact of Solvency II on the overall availability of funding for real estate investment.

Looking Ahead

Real estate fund managers face a wealth of conflicting factors that are likely to have sustained, far-reaching and fundamental implications for their business models. Complexity is on the increase. They may need to adjust their business models and consider, among other approaches, closer relationships with third parties with specific expertise and geographic coverage as well as the critical mass to deliver services.

This trend will be furthered by the growing globalisation of real estate investment and fund management. Investors may be based on any continent; the real estate assets they invest in may be located in any geography; and many funds will offer investment opportunities on a city, country or regionally focused basis. While Western Europe, North America and Japan have traditionally drawn the lion's share of real estate fund investment interest, offerings spanning emerging markets such as Brazil, Russia, China and India are rapidly growing, reflecting economic growth in those markets. For this reason, servicing partners that can offer global reach and expertise across multiple jurisdictions will prove to be a valuable support for fund managers. Familiarity with local regulations, tax rules and fund structures will form part of the value-added services they will offer.

What will also be crucial will be expertise in real estate itself. Perhaps because real estate funds have been slower to embrace outsourcing than other alternatives managers, there are still relatively few outsourcing partners who are familiar with real estate. Third-party service providers with the experience and track record to offer real estate capabilities will be in a strong position to deliver benefits to their fund management clients.

Another key area is reporting, and the increasing level of detail being required by investors amid the general emphasis on governance and transparency post-crisis. While there is growing pressure on managers to invest in the technologies required to deliver the desired level of analysis and aggregation, the more effective long-term option may be to partner with service providers that offer these capabilities and have the scale to invest in them.

Indeed, it will become a selling point for fund managers that they work with substantial, secure and well-established partners that ensure their operational efficiency and regulatory compliance are robust. The international reach and the spread and depth of services offered by service providers are likely to enhance the perceived operational standing and efficiency of fund managers themselves. Consequently, outsourced services will add value in terms of client perception, service level in the face of increased administrative demands placed on fund managers from various sources and, as is likely, in terms of cost containment under pre-defined and transparent terms with their outsourcing partner.

In summary, it is clear that we are on the cusp of significant change in the way that real estate fund managers structure and operate their funds. The sector is opening up in a way never before contemplated by the industry and offering rich, globally diversified returns for real estate investors. The net result of the global diversity of the market, increased regulation, competition and technological capability will be that real estate investors will wield increased influence. Their demands in terms of structuring, reporting, and access to data and to their funds will require greater flexibility from their real estate fund managers. Looking ahead, those managers that are equipped to meet these demands — and retain their focus on optimising portfolio returns — face huge opportunities in the years ahead.

Notes

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