

Global Market Outlook 2016

Trends in real estate private equity



EY

Building a better working world



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Introduction

A full seven years after the financial crisis that rocked the world's economies, we find ourselves today in an environment where every aftershock – whether set off by a slowing Chinese economy, sovereign debt concerns or geopolitical concerns – is greeted with disturbing headlines that foster more fear that additional shocks are just around the corner.

It's an understandable reaction, given that the financial crisis exposed the interdependent nature of the global financial system – a crash in one part of the world led to a domino effect that has taken years to untangle. Much of the coordination of monetary authorities is principally done. Quantitative easing is more of a country-based initiative and needs to be evaluated as such. While volatility continues to be a feature of our globalized world, it's time to take a more measured view of how specific events affect individual markets. The basic effort to understand submarket-level supply and demand, localized pro-growth initiatives, and employment and demographic trends provides the construct of solid real estate investment strategies. Fund managers should keep an eye out not only for events that could move interest rates quickly but also for the impact of a slowing Chinese economy on an investment portfolio.

The point is this: there will be bumps along the road, but as our report this year demonstrates, the real estate industry continues on. Fundraising is up, real estate investors are finding a variety of opportunities in markets across the globe (including in some markets that have seen slowdowns), new sources of financing are emerging in markets such as Israel, and the industry is innovating to provide investors and fund managers with liquidity. At the same time, the real estate industry is going through a phase of institutionalization as it formalizes processes, outsources non-core activities and takes proactive steps to managing increased regulatory oversight. And, as the industry matures, it builds strength, and its ability to withstand external shocks increases.

The most successful real estate fund managers will be those that are able to stay focused: they must focus on fundamentals and keep one eye on international events and the impact they may have on their local investments. Taking this twin-track approach will help guard against overreaction to aftershocks and promote stability in investment strategy as we move firmly into the new, post-crisis era.

Mark Grinis
Global Real Estate Fund Services Leader

A handwritten signature in black ink, appearing to read "Mark A. Grinis". The signature is stylized and fluid, with a prominent flourish at the end.

A photograph of a modern building with a curved glass facade. The building is composed of many rectangular glass panels framed in a dark material, creating a grid-like pattern. The glass reflects the sky and clouds. The building's structure is curved, and the perspective is from a low angle looking up. A yellow rectangular box is overlaid on the right side of the image, containing the text.

A new environment for real estate fund managers

An investment thesis for 2016

Real estate in a 2% growth economy

We are heading into new economic territory as 2015 draws to a close, and with this comes a new environment for real estate fund managers that have become accustomed to low interest rates and rising values. Many fund managers are lightly tapping the brakes given competition for deals, an abundance of debt and equity capital, and an awareness of the typical duration of a real estate bull market. What does this mean for the industry?

It's now seven years since the financial crisis hit hard and brought with it loose monetary policies in the US, Europe and Japan, characterized by quantitative easing and reduced interest rates. At the same time, investors have also been able to take advantage of the post-crisis expansion of emerging-market economies, with China in the driver's seat steering new developments toward growing urban populations and an increasing desire for commercial real estate.

With a rate rise on the horizon in the US, and a slowdown in China that some fear may destabilize its real estate market and affect both developed and emerging economies, the rising tide that had previously lifted all real estate boats over the last several years seems likely to recede. Yet the counterweight to such real concerns is that many local economies are showing slow yet steady growth, and real estate supply and demand are in relative check, in part because that growth did not lead development to overshoot the needs of industry and commerce. The cycle is clearly turning, and the successful investment strategies of yesterday may not suit the conditions emerging today.

Interest rates first

Looking first at interest rates, we believe there will be some time for managers to adjust, as there are a few examples of economies that were able to normalize rates after profound actions by monetary authorities. EY analysis¹ shows that while an expected modest increase in the Federal Reserve's funds rate may increase the expense of developing new projects and refinancing existing debt, and may even prompt a reactionary sell-off in real estate

investment trusts (REITs), the spread between 10-year Treasury and commercial real estate yields (relative to historical averages over the last 30 years) appears to allow room for further expansion. This suggests that values are not immediately threatened by rising interest rates. In addition, there are other forces that will help maintain real estate values, such as improving economies, record amounts of inbound capital (although such capital can quickly dry up), available private equity dry powder and a generally positive economic outlook for the US, which should drive demand for commercial and residential real estate.

Added to this is the increasing sophistication of the debt market offering to real estate investors. In the past, debt was usually priced according to the bank's prime rate. In today's market, debt providers offer pricing pegged to a variety of rates and the rise of nontraditional lenders, such as hedge funds, credit funds, business development funds and sovereign wealth funds; this means that real estate investors can source debt packages that are not closely tied to rates in short-term markets.

The China effect

Of more immediate concern, perhaps, are the events unfolding in China. The summer's stock market correction showed some of the fault lines that had been developing in an economy that accounted for more than 16% of the world's gross domestic product (GDP) in 2014.² Indeed, China has driven global growth since the global financial crisis, and according to calculations by the Organisation for Economic Co-operation and Development (OECD),³ a two percentage point decrease in Chinese GDP would lower global GDP by more than 0.5% in 2017, although the effect on the US and euro area would be more moderate, at a little more than 0.25%.

While the direct impact from the correction of Chinese share prices is not expected to be great, it has focused minds on some of the issues that may contribute to a slowdown or possibly even a shock to the economy. One of these is spiraling debt: China's debt has quadrupled since 2007, to reach 282% of GDP⁴ – and half of all loans are linked directly or indirectly to the country's real estate market. Indeed, investment overall in real estate has grown to represent around 15% of China's GDP, higher than the US historical rate of approximately 10%.^{5,6} This could lead to a rise in nonperforming loans in Chinese banks, local governments and the shadow banking system. China certainly has the sovereign balance sheet and ample reserves to fill any hole created by defaulting loans. The bigger question is this: will the Chinese government tolerate a slowing construction industry and the consequence of lower GDP?

¹ *Commercial property outlook in a rising rate environment*, EYGM Limited September 2015.

² "China GDP," *Trading Economics* website, www.tradingeconomics.com/china/gdp, accessed DD MM YYYY.

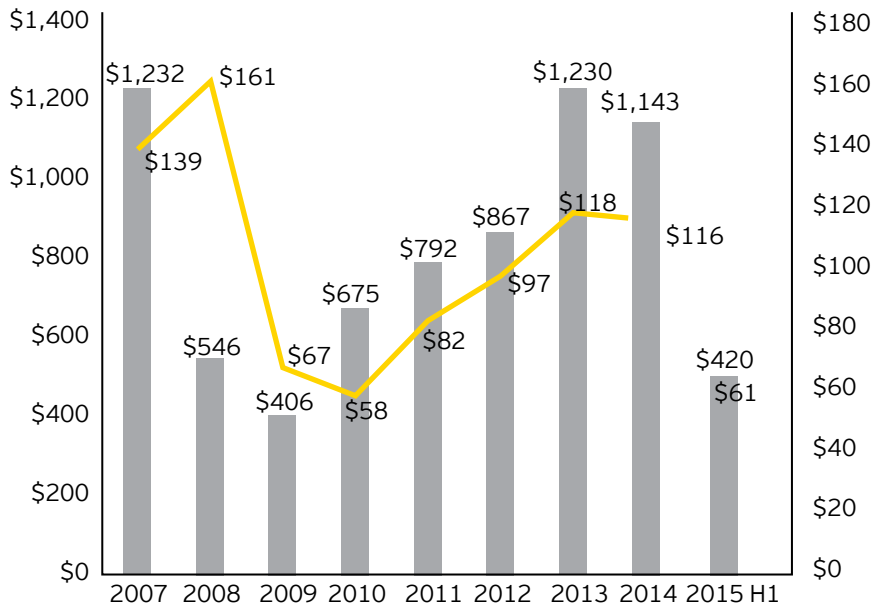
³ Interim Economic Outlook, OECD, 16 September 2015.

⁴ Richard Dobbs, Susan Lund, Jonathan Woetzel, and Mina Mutafchieva, "Debt and (not much) deleveraging," McKinsey Global Institute, February 2015.

⁵ "National Real Estate Development and Sales in the First Six Months of 2015," National Bureau of Statistics of China, 15 July 2015; and "China's Economy Showed Moderate but Steady Growth," National Bureau of Statistics of China, 15 July 2015.

⁶ US Department of Commerce Bureau of Economic Analysis Industry Data, www.bea.gov/iTable/iTable.cfm?ReqID=51&step=1#reqid=51&step=51&isuri=1&5114=a&5102=15, 5 November 2015.

Global private equity real estate fundraising vs. deal activity



■ Global real estate deal activity – public and private (US\$b)
 — Global private equity real estate fundraising (US\$b)

Source: RCA and Preqin

- ▶ Over 60% of RE funds have closed at or above their fund raising target
- ▶ The average time to close an RE fund is now up to 21 months
- ▶ There is a record high level of capital available for real estate investment globally

A new era

The upshot for real estate managers is that where there is change, there is also opportunity. Where, in the years following the crisis, an index-style approach to investing could have generated substantial gains, the successful managers in today's market will need to behave much more like stock pickers. The new environment of rising interest rates, potential falls in property values over the longer term and the emergence of distressed opportunities will require firms to take a more creative approach to investing, to hone and fine-tune their strategies and to ensure they are identifying the right assets to acquire in the right markets to fit with their risk-reward tolerance.

Opportunity for all fund types

This is a situation that the real estate market is already starting to adapt to. The market this year has been characterized by healthy levels of deal flow across the gamut of fund products, from core, opportunity and value-add, to separate accounts and direct

investments by sovereign wealth and pension funds. This speaks to a market that is firing on all cylinders as primary markets remain strong. Secondary markets still have a little way to go as local economies have improved, creating demand for new construction, and development and distressed opportunities are starting to emerge.

While there is no doubt that competition in core markets continues to intensify, especially as cross-border investment ticks up, demand for space in primary cities across the US, Europe and Asia remains high. Competition and high prices have led some, over the last 18–24 months, to move farther from the city centers of core markets and also to move across the risk curve toward secondary cities. Here we are seeing good new product origination, and there is certainly opportunity, although newer investors may need to tread with caution as this part of the market is deep into the real estate cycle.

⁵ Preqin Quarterly Update: "Real Estate, Q2 2015," 2015 Preqin Ltd."

⁶ "Preqin Global Q2 2015 Real Estate Fundraising," 1 July 2015, Preqin Ltd.

Meanwhile, the commercial mortgage-backed securities (CMBS) market is steadily maturing. Many of these debt instruments have benefited from low interest rates, but more than US\$300b needs to be refinanced by 2017 (a time of anticipated increases in interest rates), more than 2.5 times the amount that came due between 2012 and 2014. Loans that have originated for solid projects, where demand remains strong, are likely to have little trouble refinancing, although some sectors, such as retail and hospitality in tertiary markets, will require recapitalization. We see this as a positive development for opportunity funds, which may well find good return prospects in this space.

Further distressed opportunities are also becoming apparent in some emerging markets, such as Brazil, where a variety of forces are combining to create attractive pricing in a market that looks set to establish a bottom in price. In China, volatility remains a feature of the market (which in itself creates opportunity), but while stock markets may be down around 35% from their peaks, this has not had a far-reaching effect on the real estate market, where values are down, but not by much.

There is room to run

Overall, then, it looks as though we are entering into a stable period of real estate investing. Although historically the market has been characterized by peaks and troughs, what we're seeing today is opportunity across the spectrum of real estate investment products domestically or abroad suited for core value-added or opportunistic investing.

Getting to the core

As real estate has earned its place in institutional allocations, core investment strategies have gained strong momentum. Pricing has risen sharply in this sector in response to competition. So what does the future hold?

Many of the headlines may suggest that investors are flocking wholesale to the opportunistic space as investing in prime markets becomes less attractive. However, a closer look at the real estate investment space suggests that core strategies are also continuing to gain ground. Indeed, research suggests that 54% of investors are seeking to commit to private core real estate funds in the next 12 months, up from just 43% in December 2013.⁷

It's a trend that hasn't gone unnoticed by some of the players that might historically have been considered as opportunity funds. Many of the larger firms are now adding to their investor offering by raising capital for investment in core markets. And where traditionally the US and London have been seen as the primary core markets, we are now starting to see more large vehicles being raised for deployment in core properties in Asian cities (such as Singapore and Tokyo) and in key Australian cities.

Capital flowing to real estate

The backdrop to this is increasing allocations among investors such as pension funds and sovereign wealth funds to core real estate as they search for yield to meet their liabilities and investment return targets. Many seasoned investors now recognize that real estate allocations along the order of 5% or more can move the needle when it comes to their overall return numbers. In addition to investments made by the traditional investor base, new sources of capital are emerging as institutions that haven't previously invested in the asset class warm up to the opportunity. Over the medium term, there is also the prospect of funds tapping retail investors, and further out still, there are pools of capital that are starting to accumulate in emerging markets as a swelling middle class starts saving and buying insurance products.

Fundamentally sound?

Although core real estate pricing has risen markedly over recent years to reflect increasing competition for assets in the space, viewed with a wider lens, this type of investment still has the potential to beat many other asset classes with a similar risk profile. Yields may be squeezed, but the fundamentals of core real estate remain strong – at least over the medium term – as demand for prime property continues to be high, balanced by steady, rather than strong, supply. The influence of Millennials in the labor force, who are opting for the lifestyle of city centers, remains a solid trend.

This balance of supply and demand has remained in check in large part because of the discipline that has been exercised by investors and leaders over the last several years as many economies, such as the US, have followed a path of slow-burning economic growth. With returns for open-ended diversified core funds continuing to edge up – Q2 2015 showed returns of 3.82%, up from 2.93% a year previously⁸ – it seems that there remains an upside in the market, and this is being generated through income gain as well as value appreciation (for now at least).

⁷ "Real Estate H2 2015," *Prequin Investor Outlook*, December 2015.

⁸ "ODCE Returns," *NCREIF Fund Index*, 2015.

Traditional vs. alternative

The question, however, will be where these sources of capital choose to invest. While the closed-ended core fund (or build to core) market is largely the new kid on the block, offering a blind pool, investors can choose to invest in the more liquid open-ended market, where some managers have been building out and refining their portfolios of core assets over many years, sometimes decades. A closed-end fund does provide investors with stability (perceived lower volatility seen in publicly traded funds), but a fund's track record remains one of the key determinants for committing capital to a manager. Yet with so much capital destined for this part of the market, it may well be that investors choose to do both, gaining greater diversification across their real estate exposure.



Secondaries

Liquidity enters real estate

As a number of firms have raised secondary vehicles to buy up investor positions in real estate funds and a new fund has emerged to acquire stakes in real estate managers, the industry is entering a phase of increased liquidity at both limited and general partner levels.

This year has seen some large, successful fundraisings in the secondary funds market, which will lead to greater liquidity for those limited partners (LPs) seeking it. The driver behind this is a confluence of factors that attest to an increasingly mature real estate fund market and an increasingly discerning investor base. Yet it is also a reflection of a rising market: pricing in secondary stakes has risen over the last few years – in 2010, discounts to net asset value were around 19%, but in today's market, the average has fallen to single digits. As the economic recovery is factored into pricing, so is the increased visibility on assets – while buyers are more willing to pay lower discounts as portfolios have reduced risk over time, they are also benefitting from the J-curve effect on their investment returns. Rising prices, in turn, are encouraging sellers to enter the market, many of whom are in the process of tidying up portfolios and reducing the number of relationships they manage. Sellers are now able to price at non-distressed levels.

The process of buying secondary positions clearly comes with some rather large caveats: it's a highly specialized business that requires a deep understanding of an entire fund portfolio; a large portfolio of funds may be required to underwrite sometimes large investment amounts; and a limited partner agreement may be required that affords commercial terms and conditions to transfer the interest. However, with specialist funds growing in size and number, the ability for limited partners to achieve liquidity is growing, while also providing investors with an attractive buying opportunity.

The recent launch of new vehicles dedicated to acquiring stakes in real estate management companies is providing new opportunities for increased liquidity, growth and access to a broader array of capital services.





Regulatory reviews, compliance and exams

SEC exams

The challenges brought on by a nearly 50% increase in registered investment advisers since the implementation of the Dodd-Frank Act required the Office of Compliance Inspections and Examinations (OCIE) to consider both tactical and strategic opportunities to examine higher-risk registrants and, within those examinations, focus on high-risk compliance areas.

From a tactical perspective, in late 2012, OCIE launched the Presence Exam Initiative to conduct focused, risk-based exams of newly registered private fund advisers. The Securities and Exchange Commission (SEC) sought to establish a “presence” with the private fund industry to better assess and understand the associated risks and issues embedded within the industry.

OCIE has indicated that it has completed its goal of examining 25% (roughly 400) of these newly registered advisers. The presence exams were conducted in a more streamlined manner with a focus on high-risk areas, including marketing, portfolio management, conflicts of interest, safety of client assets (custody) and valuation. It is expected that OCIE will release a summary report on the Presence Exam Initiative, outlining the more common deficiencies, violations and risk areas identified.

Strategically, OCIE has been working to build and develop stronger examination teams and tools for several years. With significant emphasis on people and data, it seems as though a new era of regulatory examinations is upon us.

Focus on people

In April 2014, the SEC announced the formation of a private funds group within OCIE that is dedicated to the examination of the private adviser industry. The private funds group is staffed with examiners with private adviser expertise and specialized knowledge of real estate.

Focus on data

In addition to enhancing its examination staff, OCIE has solidified its risk-based examination approach through the extensive use of data. From the examination selection process to examination analysis, OCIE routinely uses data from multiple sources (e.g., exam data, regulatory reports/filings, public databases) to refine and strengthen its risk-based focus.

In 2014, OCIE disclosed the development of its Machine Analyzed Risk Scoring tool (MARS). Using data mined from regulatory

reports (e.g., Form ADV, Form PF) and public databases, OCIE is able to select registrants for examination based on certain factors that may indicate a firm’s risk to clients, investors and the market. These risk factors can include a high-speed growth in assets under management, number of investment professionals, industry affiliates, use of complex investment strategies and products and the firm’s regulatory history.

Additionally, in 2011, the SEC adopted Form PF and Advisers Act Rule 204(b)-1 that requires private fund advisers to report information, including but not limited to assets under management (AUM), leverage, counterparty credit risk exposure and trading practices. Although Form PF was primarily intended to assist the Financial Stability Oversight Counsel’s systemic risk monitoring efforts, the SEC uses the information obtained from Form PF in its regulatory oversight to better understand, among other things, the nature of the private fund adviser’s business, investment strategy and the associated risks to select private fund advisers to examine.

In addition, the use of a risk-based examination approach means that OCIE devotes more resources, earlier on, to identify the adviser’s high-risk areas before and during the on-site examination. So while advisers may initially receive a broad document request letter, they should expect specific follow-up conversations and document requests that increasingly focus on the adviser’s weak compliance points.

Four types of examination scrutiny

Since 2011, OCIE has been building the Quantitative Analytics Unit. Broadly speaking, OCIE conducts three types of exams – each with a different degree of scrutiny – depending on how long the adviser has been registered, the time elapsed since the last SEC exam, and internal staffing resources.

The most common of these exams is the “routine” examination. This type of examination will include an on-site review of the adviser’s main compliance and operational areas: its compliance program, valuation, advertising and marketing, portfolio management and conflicts of interest. These examinations are generally announced in advance with a phone call and an initial request for documents to be provided before the examination team arrives on-site. Items that may be on an initial document request include:

- ▶ Compliance policies and procedures
- ▶ Annual compliance review documentation
- ▶ Custody arrangements
- ▶ Code of ethics

- ▶ Best execution review documentation
- ▶ Portfolio management/investment committee meeting minutes
- ▶ Sample of advertising and marketing materials and pitch books
- ▶ Solicitation agreements
- ▶ Business continuity and/or disaster preparedness
- ▶ Organization charts and employee lists
- ▶ Customer and investor complaints, pending litigation and regulatory actions

Another type of examination is the “risk-targeted” examination, formerly referred to as a “sweep” exam, in which OCIE focuses on a specific issue in the industry and conducts a targeted review of selected advisers to look for indications of commonality or diversity within the industry. In 2014, for example, OCIE conducted a series of risk-targeted exams with multiple advisers on cybersecurity. These examinations generally begin with a narrowly focused initial document request list and tend to stay centered on one or two issues throughout the examination. It is not uncommon for the SEC to publish a summary report highlighting the general findings and industry practices that resulted from the targeted review, without identifying the specific advisers that were included in the review.

In addition, OCIE will conduct “cause” examinations of advisers on the basis of a tip, complaint or referral. The tip or complaint may come from any individual; referrals, instead, come from other regulatory or government agencies. These examinations may begin with a standard request list that is amended to include specific document or information requests. Examinations of this type will likely not be announced to the adviser in advance.

Although OCIE will generally not disclose the type of examination, the scope of the initial document request usually offers a clue:

- ▶ A broad document request letter is a good indication the examination is “routine.”
- ▶ A more specific document request that relates to a particular industry practice and is received by others in the adviser’s peer group indicates a “risk-targeted” examination.
- ▶ A document request letter that addresses only a few specific items may indicate a “cause” examination.

There is a fourth type of exam, but it serves mainly as a tool for OCIE to ascertain how urgently it needs to examine a recently registered adviser. This is typically used for advisers who have never been the subject of an examination and signals a sort of “welcome registration” to the newly registered adviser. This “light touch” examination typically consists of a phone call and limited document request, usually asking for 10 or so items, designed to provide the examination staff a big-picture view of the adviser’s operations and activities. This type of review typically results in either a full-scope on-site examination or a letter stating that OCIE has no further questions. Newly registered advisers should take advantage of this light touch examination and collaborate with the examination team to identify ways to strengthen their policies and procedures and general compliance culture.

Examination phases

Prior to the on-site phase, it’s worth noting that the examination staff conducts “pre-exam” work to understand the adviser’s ownership structure, business model and affiliations and to assess the adviser’s risks and conflicts of interests. However, perhaps the most difficult phase of an examination is when the examination staff is on-site at the adviser, typically referred to as “fieldwork.” During fieldwork, the exam staff will request information and conduct interviews of the adviser’s personnel about the adviser’s activities to understand its business. The adviser should select knowledgeable persons that understand the adviser’s operations to participate in the interviews. The exam staff will review the requested information and documents, and may make supplemental requests for additional information and meetings throughout the exam process. It is not unusual for the examination fieldwork to last several months, although it will vary by regional office. A significant factor is whether the examination team must travel for the fieldwork.

After the on-site phase, the examination staff will continue to review documents, conduct research and vet issues from the SEC regional office as the examination report and deficiency letter, if any, are drafted. From there, the examination report and deficiency letter go through a supervisory review. Finally, the examination team will conduct an exit interview with the adviser, and a deficiency letter,

if any, will be issued. If a deficiency letter is issued, the investment adviser will be asked to respond in writing to any issues identified in a deficiency letter, including the steps the investment adviser will take to remedy the issues and prevent reoccurrence. The investment adviser's response will generally be due within 30 days of the date of the deficiency letter. The entire examination process can easily take eight months or more.

The number of examination staff on-site will depend on the size of the adviser and the complexity of its operations. Mid-size advisers should expect at least three OCIE staffers while large, global advisers should expect twice that number, sometimes including an exam manager (formerly called a branch chief).

The examination staff is the eyes and ears of the SEC. In addition to sending an adviser a deficiency letter, the examination staff will refer the matter to the SEC's Division of Enforcement (Enforcement) and others, including criminal authorities, if the examination staff identifies serious issues. Based on the examination staff's referral,




Private fund focus areas

- ▶ Fund expense allocations
- ▶ Investment and trade allocations
- ▶ Conflicts of interest
- ▶ Marketing and fundraising practices
- ▶ Valuation practices
- ▶ Custody

Enforcement will investigate the issues to determine whether it should bring charges against the investment adviser for violations of the federal securities laws.

Going forward, it is clear that more and more private fund advisers will receive greater examination scrutiny. But the consequent potential for decreased systemic risk and increased confidence on the part of investors and counterparties will be a significant benefit for the industry as a whole.

SEC examination phases

Phase 1	Phase 2	Phase 3	Phase 4
Examination announcement	On-site examination (About two weeks later)	Off-site analysis	Examination completed (Usually between 60 and 180 days of last SEC contact)
 <ul style="list-style-type: none"> ▶ Phone call announcing the examination and expected start date ▶ Initial document request (generally some documents due prior to start date and some documents due on start date) 	 <p style="color: #FFD700;">Lasts several weeks to several months</p> <ul style="list-style-type: none"> ▶ SEC staff comes on-site to conduct examination <ul style="list-style-type: none"> ▶ Day one presentation ▶ Additional document requests ▶ Interviews of personnel ▶ SEC completes on-site examination and holds exit interview (oral discussion of examination findings to date) 	 <p style="color: #FFD700;">Lasts several weeks to several months</p> <ul style="list-style-type: none"> ▶ SEC continues examination remotely <ul style="list-style-type: none"> ▶ Conducts additional analysis/testing ▶ Additional document requests ▶ Interviews of personnel 	 <ul style="list-style-type: none"> ▶ Examination letter issued (80% of the time) <ul style="list-style-type: none"> ▶ SEC issues examination letter identifying deficiencies pertaining to rule violations, compliance weaknesses and ineffective internal controls ▶ Within 30 days – firm is required to respond to all identified issues with plans or evidence of corrective action ▶ No findings letter issued (10% of the time) <ul style="list-style-type: none"> ▶ SEC issues no findings letter stating that it has found no deficiencies in the areas examined; however, this does not mean that there are none – simply that the SEC did not identify any ▶ Enforcement referral (10% of the time) <ul style="list-style-type: none"> ▶ SEC exam staff refers issues to the Division of Enforcement for further investigation ▶ Enforcement investigations generally last two to four years

Source: EY

AIFMD update

A cost, but also an opportunity

Now that the dust has settled around the European regulation of alternative investment managers, real estate funds need to start thinking strategically about how they can benefit from these principles-based rules.

When the European Commission first drafted the Alternative Investment Fund Managers Directive (AIFMD) in the aftermath of the financial crisis, there was a high level of concern among real estate fund managers (and other managers of alternative investment funds) about how the new regulations would affect them. After all, the initial intention was to provide a framework largely aimed at hedge funds, with their frequent trading strategies. Real estate is clearly a very different type of investment that is held for the long term. However, because of the AIFMD's broad coverage, Europe has ended up with more generic, principles-based regulation that can offer fund managers the opportunity to streamline their businesses and improve efficiency of operations. This could ultimately lead to a transformation of the way real estate fund managers raise capital and manage their business.

We are now more than a year on from the requirement for EU-based alternative investment fund managers (AIFMs) above the €500m AUM threshold (or €100m threshold if leverage is used) to apply for authorization under the directive, and the industry has now entered the next phase: the optimization of their platforms.

Improving risk management

That's not to say there haven't been some challenges along the way. While many larger real estate managers have found that many of the requirements under the directive relating to areas, such as risk management, valuation oversight and portfolio management, were already in place, there has been a need to codify how these functions should work. In addition, the need to segregate some of these responsibilities, such as risk management and portfolio management, has created some issues: how, for example, is it possible to separate the two when there are risks inherently embedded within a portfolio? Such questions have led to the formation of industry forums where risk managers share best practices and discuss how to apply broad-brush principles to specific situations. Overall, this will ultimately lead to deeper risk management competence and a refinement of skill sets at many real estate managers.

A more harmonized approach

Before the directive, Europe was a patchwork of different regulations, making it very difficult for fund managers to gain from the benefits of scale, deploy technology effectively across European states and align different specialist service providers. However, the AIFMD has brought with it a more standardized approach that could allow fund managers to operate more efficiently. Not only does this make the creation of Europe-wide technology platforms more feasible, but it points toward the opportunity to outsource non-core operations. As third-party service providers, such as administrators and depositaries, are able to scale up their businesses to take advantage of harmonization, the services they offer can be built around a more consistent Europe-wide model.

There are, however, issues for smaller managers who struggle toward entry. Smaller managers may find that the costs of getting up to speed are high, particularly for those that are just above the AIFMD thresholds. While there may be some consolidation, we've also seen some managers opting to use new, specialist third parties, such as those providing platforms for asset management and investment management on behalf of clients.

Marketing passports

The AIFMD allows authorized EU managers to raise funds from qualified investors across European states without having to comply with the individual requirements of each country's national private placement regimes. Following a consultation period, which ended in the summer, the European Securities and Markets Authority has now published its advice on extending this "passporting" scheme to non-EU managers. It has suggested that managers registered in the US, the Channel Islands, Hong Kong and Singapore could be next in line to be granted equivalence, provided they meet certain AIFMD requirements and obtain a license. How long this process will take is still unclear.

This gives many non-EU managers three main options if they wish to raise capital from European investors:

1. Managers can establish a parallel fund for European investors that can act as an entry point for them to invest in global deal flow.
 2. Managers can opt to use an AIFM for European investors, managed by a third party.
- Or
3. Managers can stay offshore and apply for a license under the AIFMD, if and when this becomes available.

The latter option may not be suitable for all real estate managers, particularly as there will be technical requirements that need to be met under the AIFMD. However, the overall effect will be to increase the fluidity of capital across Europe and beyond as capital can be raised more efficiently. Larger alternative asset managers should benefit as they will be able to align the needs of investors to specific products. In addition, becoming a regulated AIFM may provide competitive advantages: if, for example, an investor is reviewing fund investment opportunities, funds that are regulated are more likely to meet with investment committee approval than those that are not.

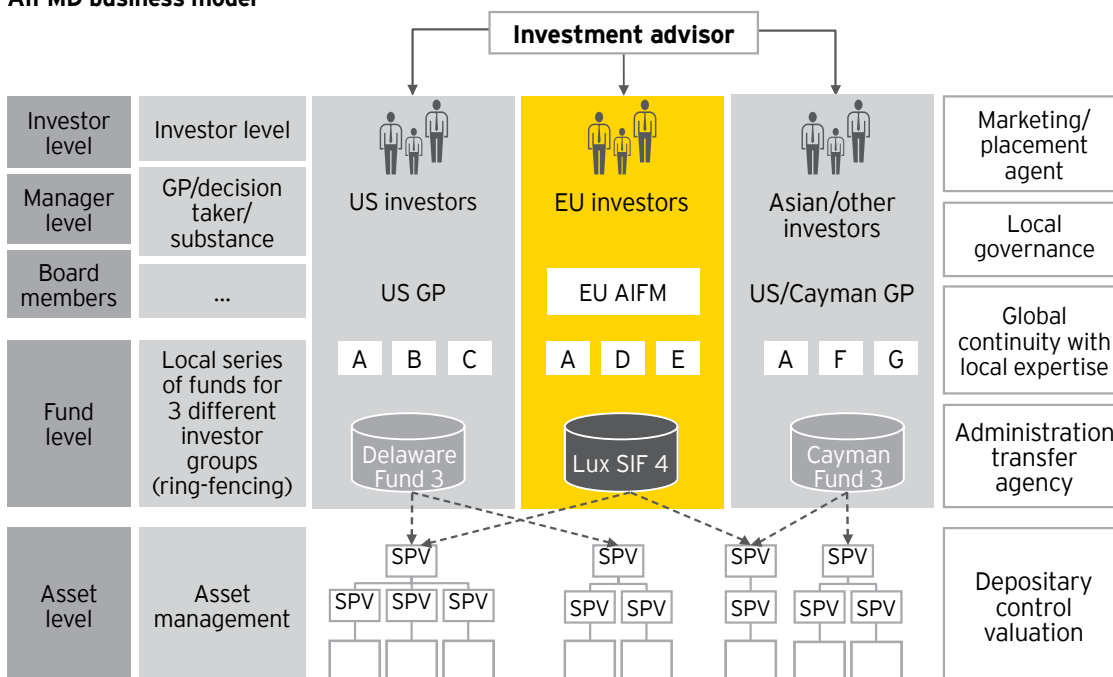
The big picture

While the AIFMD may not have been welcomed with open arms by many alternative fund managers – and there is no doubt that there are added costs involved, particularly with the requirement to appoint a depositary – the harmonization of regulation across the EU does create opportunities for the industry in Europe and beyond to improve operational efficiency and to raise capital in a more orderly fashion than was the case under the old regimes. Some may struggle to keep up, but for those with adequate resources and an eye on the strategic benefits the directive can bring, the AIFMD marks a new chapter in alternative asset management in Europe.

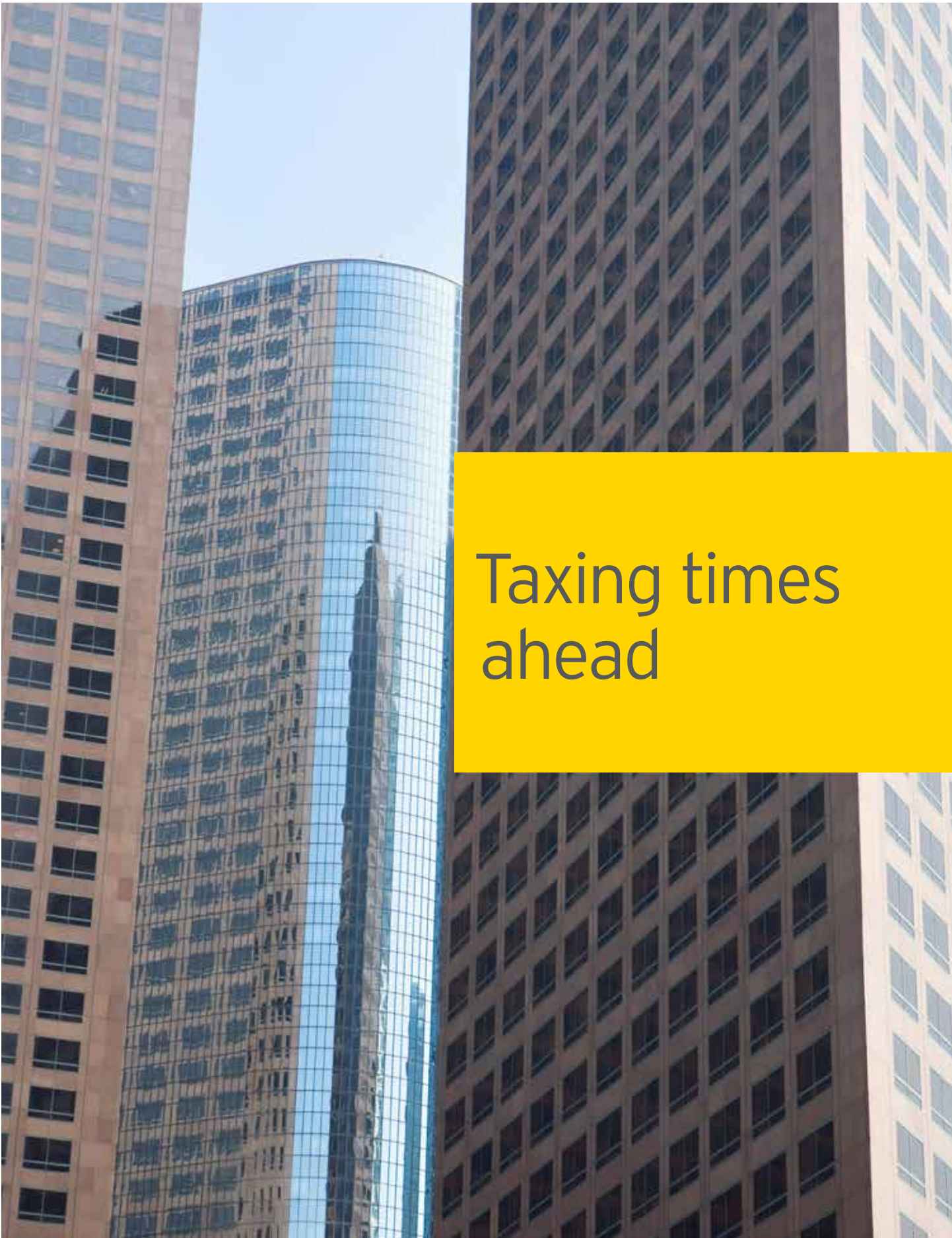
Key points to consider:

- ▶ **Non-EU managers seeking European capital should weigh the options available.** Is it worth seeking equivalence (with uncertainty about timing and the added regulatory requirements that need to be met), or should you set up parallel structures or use a third-party manager?
- ▶ **Should you outsource?** Have you thought about the opportunity to standardize operations and technology across Europe? Could you outsource some of your non-core functions to focus on building scale across your platform?
- ▶ **How could you best use the passporting scheme?** Are you thinking strategically enough about the opportunities this could bring? Which new fund distribution skills does your firm need to acquire? How could you align investors with specific products?

AIFMD business model



Source: EY



Taxing times ahead

BEPS

Making waves in the real estate industry

As the Organisation for Economic Co-operation and Development (OECD) reaches the end of the initial work on actions to reduce tax avoidance by multinationals, the real estate investment industry is getting caught in the crossfire. What can fund managers do to minimize the risk of falling afoul of a shifting legislative environment?

The OECD's project on base erosion and profit shifting (BEPS) may have been originally intended to tackle real and perceived tax avoidance by multinational companies, but its effects have rippled through to the real estate fund management industry. Measures to prevent so-called "treaty abuse" and to legislate for the reduction of interest deduction clearly have a significant impact on the way that managers structure their funds and their transactions.

Even though the OECD has now finalized its reports on all 15 action points, there is still further work to be done on a number of points, such as transfer pricing, interest deductibility, profit allocation to permanent establishment, the taxation of hybrids and tax treaty abuse.

One big issue for the industry will be the recommendation that countries adopt a fixed ratio rule to limit deductions on interest payments (see Action 4) – while many countries have introduced similar rules in recent years, the extension to being a global best practice is a surprising outcome from where the project started. It is also disappointing to note that there is still no clarity on a key area that affects most of the real estate fund industry – Action 6 on treaty abuse. The OECD has delayed a final decision on how non-collective investment vehicle (non-CIV) funds will be treated until December 2016. While this may give the industry some breathing space, the uncertainty surrounding this issue is unhelpful.

Now that the first phase of work has been completed, the next phase will be implementation, which may present a number of challenges such as making the changes in a coherent and consistent manner – especially given that some proposals require domestic law changes – and the need to monitor impact on double non-taxation and double taxation.

The risk for any business, including for real estate firms, that operates on an international basis is that possible different approaches by individual countries create a highly complex and constantly evolving tax landscape. In addition, even where legislative changes are not made, it is fair to assume that governments, under pressure to increase their tax bases, will tighten up the enforcement of their existing rules.

Key points

All this requires real estate fund managers to think carefully about a number of aspects of their business and the way in which it is managed.

Keep an eye on developments. Remain on top of the changes and, importantly, ensure that staff are kept up to date and aware of the ever-changing and tightening tax environment.

Plan for increasing tax leakage. With the reduction of the tax benefits of interest and the overarching environment of governments seeking to increase their tax base, firms need to understand and manage how this will affect their business.

Take a long-term view on new fund structures. Look long and hard at any structures you are putting in place – a cookie-cutter approach based on previous funds runs the risk of a non-future-proofed structure. Spend time kicking the tires of different fund structures, considering where the business and the fund will be in five years' time, and be prepared to be flexible.

Avoid having funds based in more than one jurisdiction. In addition, limit the number of holding jurisdictions. Make it easier to keep an eye on developments and manage around changes to tax treatment.

Continually review existing structures. With so much change in the air, it's worth reviewing on, say, a six-month basis whether the structures you have in place are still fit for purpose.

Assess for substance requirements. Fund managers will face increasing requirements for substance to qualify for withholding tax exemptions. Check rigorously whether there is enough economic life in the entity in question, and ensure that it employs people with sufficient commercial experience and authority to provide genuine management in these entities from their jurisdiction of establishment.

Hold all-hands meetings regularly. Given the increasing complexity of tax considerations at all levels of the real estate fund management business, make sure you are communicating effectively with all parties, both internally and externally. This includes investors, asset managers and property managers. For example, where permanent establishment needs to be avoided, decisions will need to be made at a fund level in the jurisdiction of that fund – property managers cannot be seen to be doing this.

Anticipate more challenging tax audits. There is increasing scrutiny around areas such as the allocation of the purchase price of assets. Tax authorities will, for example, be looking at how the price paid is allocated between land, buildings and fixtures and fittings.

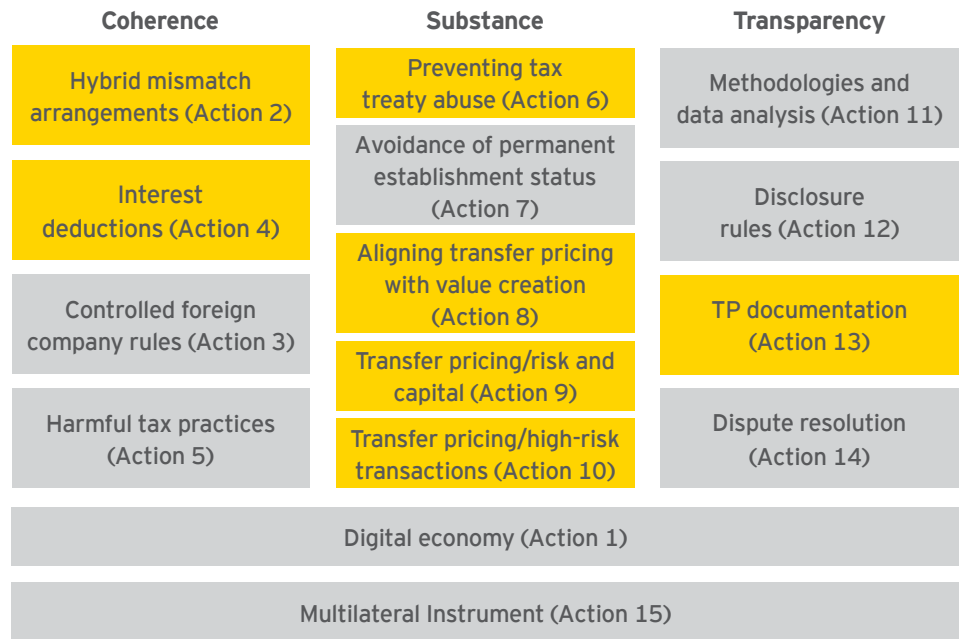
While uncertainty is clearly the byword when it comes to the industry's tax treatment, one thing is certain: real estate fund managers will need to be much more proactive in managing their tax affairs – at both a fund and portfolio level – than ever before if they are not to get caught out by current and future developments.

New reporting requirements

Under BEPS, the country-by-country reporting template will require multinational corporations to report the following items annually for each country where they have an entity or permanent establishment:

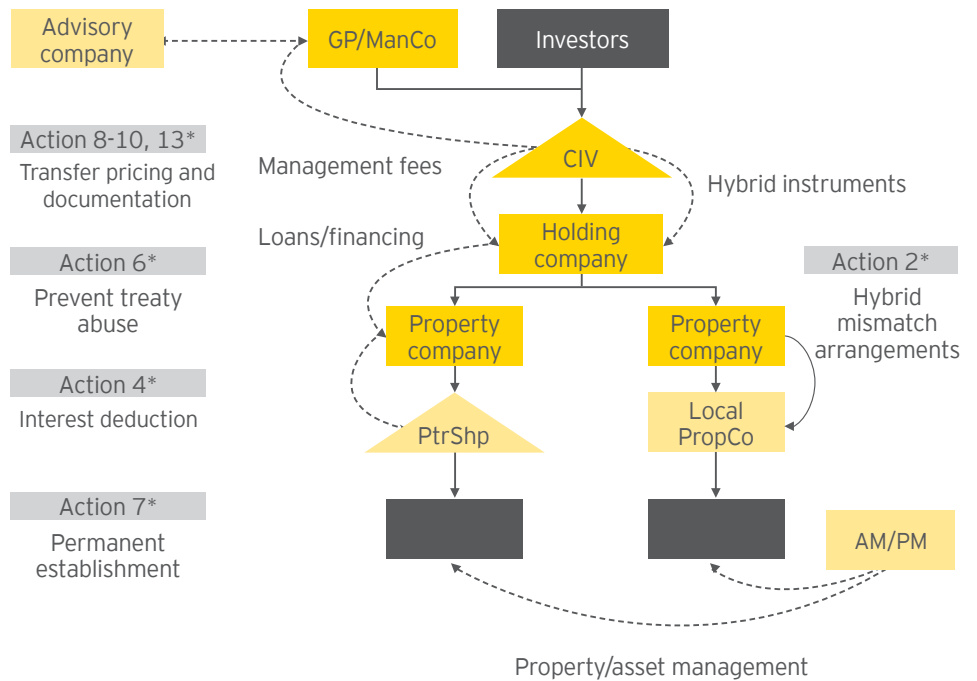
- ▶ Revenue, related and unrelated party
- ▶ Profits
- ▶ Income tax paid and taxes accrued
- ▶ Stated capital and retained earnings
- ▶ Employees
- ▶ Tangible assets
- ▶ Identification of each entity in the country and the business activities of each entity

BEPS Action Plan – changes to the international tax landscape



Source: EY

BEPS – impact on real estate funds



*See BEPS recap on p17

Source: EY

BEPS recap: select action points

There are a number of BEPS action points that have a bearing on the real estate investment sector.

- 1 Action 2 – neutralize the effects of hybrid mismatch arrangements**

This is broadly aimed at preventing situations where double non-taxation and double deduction may arise through the use of hybrid instruments or entities.
- 2 Action 4 – limit base erosion via interest deductions and other financial payments**

Many countries, such as Germany, Spain, Denmark, have restricted interest deductibility, whether or not from a third party, to a certain fixed ratio of profits (generally 30% of earnings before interest, taxes, depreciation and amortization [EBITDA]). The OECD has recommended this rule as “best practice” for countries to consider implementing into local law, but in the band of 10%-30% EBITDA, but with a limited relaxation if the overall group external debt burden is higher. Depending on how these rules are implemented into local law, and how much variation on grandfathering existing debt or de minimus limits are implemented, it could have a significant impact on real estate funds as the economic benefits of using leverage may be reduced.
- 3 Action 6 – prevent treaty abuse**

This includes updating the definition of permanent establishment to prevent abuses. This has caused the fund industry generally (including real estate) considerable concern as the final document has targeted non-listed structures where the ultimate investors do not come from the country seeking treaty protection and as an alternative suggested that entities that were not classified as active businesses should be denied treaty benefits. In effect, both these alternatives present issues for real estate funds in particular, which deploy international capital into investments in several countries. While the final recommendation has included some protection for collective investment vehicles (broadly regulated funds aimed at the retail market), for closed-ended and private funds, the OECD recognizes further work is needed and has proposed the end of December 2016 to consider this point.
- 4 Action 7 – prevent the artificial avoidance of permanent establishment status**

This may mean some real estate fund manager structures, especially those that operate on a cross-border basis, are considered to have permanent establishments in jurisdictions – and therefore taxable presence – where they were not previously. While this should not give rise to investors having additional reporting requirements, the fund itself may need to be more rigorous than in the past.
- 5 Actions 8-10 – moving toward aligning transfer pricing with value creation**

On Actions 8-10 there has been a key change in how the OECD’s guidance on transfer pricing are drafted: there is a move toward a general theme of aligning transfer pricing with value creation, rather than on a pure arm’s-length basis, and in particular heavy emphasis on payments for intangible assets, particularly those where pricing is hard to measure (e.g., internally generated know-how). Given the real estate sector has historically little in the way of intangible assets and value is primarily driven by the location of the real estate itself, the sector is not a core focus of these changes, but fund managers may consider whether their internal pricing models are sufficiently robust.
- 6 Action 13 – re-examine transfer pricing documentation**

This requires firms to provide reporting on global allocation of income, economic activity and taxes paid among countries to all governments of countries in which the firms operate. However, earlier this year, the OECD introduced a €750m annual revenue threshold below which companies would be exempted, bringing the vast majority of real estate investment funds outside the scope of this requirement. Clearly, for those that do not qualify for exemption, there will be additional costs associated with this “country-by-country” reporting.

FIRPTA

Focus on FIRPTA

In a bid to attract more inbound investment to the US real estate sector, the Obama administration has proposed reforming the US Foreign Investment in Real Property Tax Act (FIRPTA), to exempt foreign pension plans from the application of the law. At the same time, the congressional tax writing committees have been pursuing FIRPTA reform. In addition to the Obama administration's foreign pension plan proposal, the main change relates to the current tax exemption for foreign investors holding 5% or less of the stock of publicly traded United States real property holding companies. Both changes are included within the Real Estate Investments and Jobs Act 2015, H.R. 2128, which is cosponsored by 30 of the 39 members of the House Ways and Means Committee. The increase in the portfolio investment exemption is also included in S. 915 which passed the Senate Finance Committee in April 2015.

Increased threshold

The first change would increase the threshold for investment in publicly traded stock from 5% to 10%, enabling all overseas investors, including sovereign wealth funds, pension funds and insurance companies, to double their positions in publicly traded REITs without being subject to tax on the sale of shares or on receipt of capital gains from the REIT. If enacted, this change would open up larger pools of capital to investment in publicly traded REITs.

Tax exemption for foreign pension funds

The second change, which has appeared in the last three budget announcements by President Obama, would exempt qualified non-US pension funds from US federal income tax on gain they derive from the sale of US real estate interests. This change was proposed to put them on an equal footing with US pension funds, which generally can structure their investments in US real estate so that the income and gain they derive is exempt from tax.

By exempting qualifying foreign pension funds from US federal income tax on gains from US real property entirely, this proposal would appear to put foreign pension funds in a more favorable tax position than sovereign wealth funds, many of which have a strong appetite for US real estate and represent a substantial pool of capital for investment.

Both proposals have bipartisan support, but at the time of writing, have not yet been passed by the Senate amid concerns that the revenue cost of the proposals exceeds US\$10b.

Domestic control?

Proposed legislation changes to FIRPTA include clarification of the rules determining whether REITs and regulated investment companies are domestically controlled (currently those with 50% or more of the stock held by US persons). This is particularly important at a time of high demand among overseas institutional investors for good quality, core real estate in US gateway cities. Many are investing via REITs by teaming up with US investors to avoid being subject to FIRPTA, yet the structuring possibilities are currently unclear under the FIRPTA rules, giving rise to ambiguity about how the Internal Revenue Service (IRS) may treat such structures. The proposals, as they stand, offer certainty on two key points. The first is that publicly traded REITs may presume – unless they have information to suggest otherwise – that small shareholders (with less than a 5% interest in the REIT) are US residents. The second is that shares in a REIT, where the stock is held by an upper-tier REIT that is publicly traded, is treated as owned by a foreign entity unless the upper entity is domestically controlled, i.e., more than 50% of the stock of the upper-tier REIT is held by US persons. If enacted, these proposals would provide a clearer framework for REITs and their investors to structure vehicles in a tax-efficient manner and remove some of the uncertainty that currently surrounds such structures.

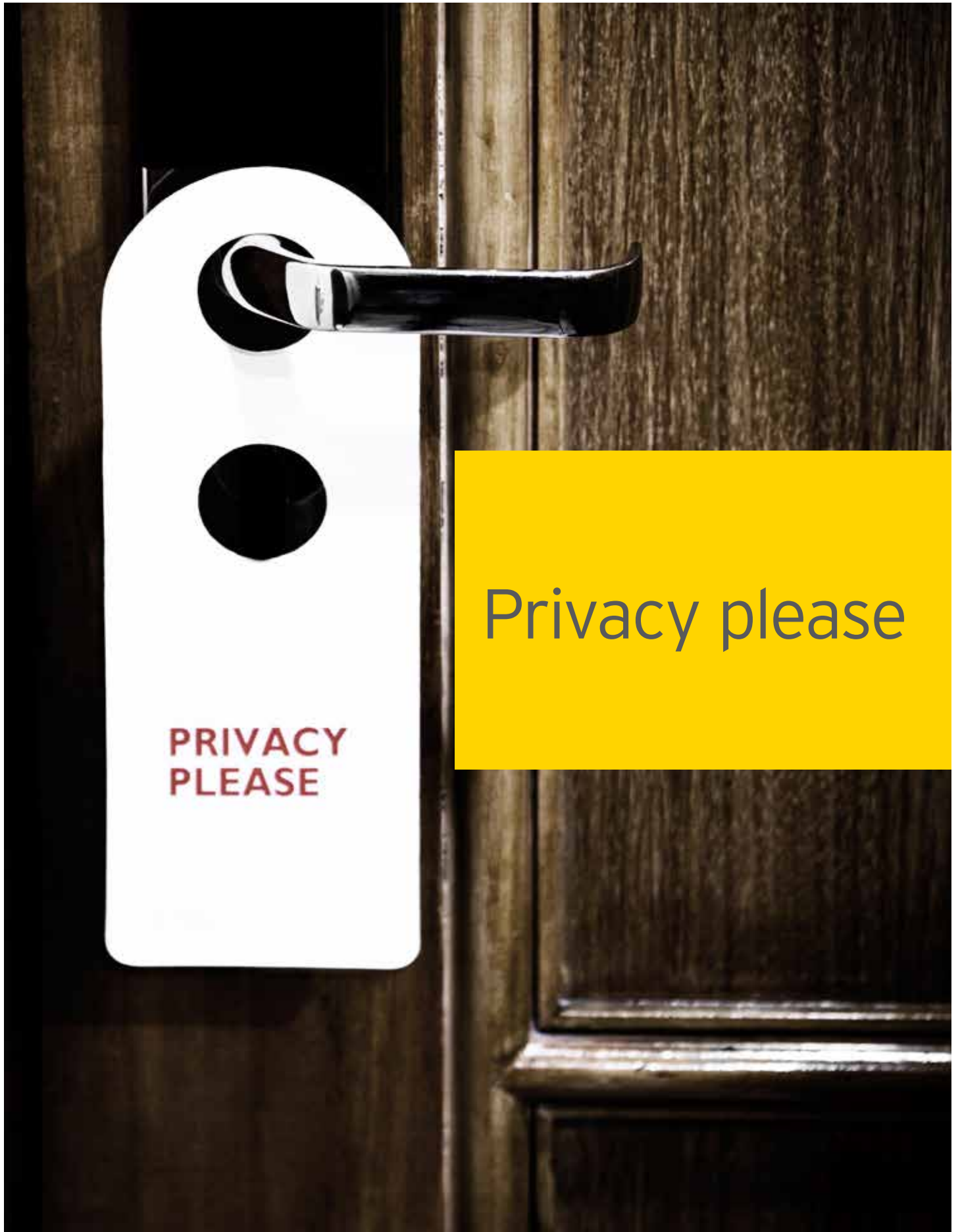
Further ahead

There is a growing recognition that the FIRPTA rules that were enacted in 1980 and last significantly revised in 1988, need updating to accommodate an increasingly globalized and technology-driven world. In addition, the current regulatory scheme contains a number of traps for the unwary. There has been some talk of overhauling the legislation to produce a holistic approach to the tax treatment of foreign investment in the US, yet this is clearly not a part of the current legislative or regulatory horizon. The current heavy workload faced by the IRS places a question mark over whether the IRS will have the resources and ability to work on any major regulations projects in the foreseeable future.

Key points

For foreign investors, it is very much business as usual for the time being. Should the changes to FIRPTA be enacted, they will affect foreign investors in publicly traded REITs and overseas pension funds, which will see an improvement in their tax position when investing in US real estate.





Privacy please

PRIVACY
PLEASE

Take-privates on the rise

The last 12 months have seen a clutch of public-to-private deals led by private equity real estate managers, and the stage looks set for further activity, with rising levels of dry powder among real estate funds, some attractive pricing for the REIT sector and shareholder activism.

Real estate funds are actively seeking opportunities to take listed property companies, including REITs, off the public markets. Indeed, in late 2014, Blackstone took shopping center REIT Excel Trust private in a deal worth around US\$2b, and announced a going private acquisition of Strategic Hotel Capital.

Attractive pricing drawing out sellers

Public-to-private activity in the real estate sector is a trend we expect to continue. The attractiveness of the sector to buyers stems back to actions taken by REITs following the downturn. Many REITs took advantage of a high level of available and lower-cost capital to refinance and clean up their balance sheets. In addition, many sold off assets that were non-core or that did not fit their strategies. As a result, today's REITs are in relatively good shape, characterized by lower risk, better yields and better capitalization than was the case pre-downturn.

Another factor driving activity is the attractive pricing that sellers are able to achieve in the current market. While valuations for REITs remain below pre-crisis levels, the current discount to net asset value is relatively low (around 400 basis points, according to the July 2015 Lazard Real Estate Indicators Report). When put into the context of a wave of shareholder activism targeting REITs – there were 18 campaigns involving REITs in 2014, up from just 2 in 2010, according to research firm Activist Insight – many REIT management teams are overcoming their historical reluctance to sell and are recognizing that a deal at today's relatively high prices can produce a good outcome for their business and their shareholder base.

Strong fundraising fills coffers

Pricing is being partly underpinned by strong appetite on the buy side. This is coming in particular from the larger end of the private equity real estate fund market, a factor that is adding to the attractions of selling: there are generally fewer of the social/cultural issues that are inherent in REITs or REIT mergers when it comes to private equity buyouts.

Private equity real estate funds now have greater firepower and ability to write large equity checks than ever before as a result of a highly active fundraising market. This year so far has seen some especially strong performances as a number of funds have raised multi-billion dollar funds, with many of them meeting or exceeding their targets. As a result, the sector now has record amounts of capital to deploy: by the first half of 2015, real estate private equity funds had more than US\$250b of dry powder, an increase of 37% on the US\$185b available for investment at the end of December 2014, according to Preqin figures.

Added to this is the weight of capital flowing directly from institutional investors, with sovereign wealth funds and US and European pension funds and insurance companies seeking co-investment opportunities in the real estate sector in the hunt for steady, long-term returns at a time of low yields.

Locking in rates

The specter of interest rate rises provides a further spur to the take-private trend. REITs can offer the opportunity to deploy a large amount of capital in assets that can provide yield-oriented returns regardless of interest rates. Many funds pursuing this strategy are locking in debt packages at attractive rates, with multifamily investors securing Fannie Mae funding.

More activity to come

While current higher valuations are helping to build a pipeline of potential deals in the current market, further out we see continuing take-private activity. There is still growth in the operational metrics of real estate: rents and occupancy rates have not yet peaked, and values look set to inch up. For those with dry powder and the ability to execute this type of deal, the REIT market continues to offer upside.

And at some point, the market will turn. When that happens, some of those who didn't sell will face issues and possibly even greater pressure from activist shareholders as their leverage ratios increase following a fall in stock market prices. This could present new deal flow for private equity real estate funds. There may also be opportunities for real estate private equity funds to take minority positions in REITs or other listed property companies.

Public real estate sector full of activity beyond going-private transactions.

Just as the publicly listed sellers are finding appetite for their real estate companies, large private equity real estate funds have taken advantage of relatively high pricing to exit existing portfolio companies via initial public offering (IPO). Oaktree Capital Management's IPO of Store Capital last year raised US\$585m, following on from Blackstone's IPOs of Brixmore Property Group and Hilton Worldwide Holdings in 2013, a banner year for REIT IPOs, and of La Quinta Holdings in 2014.

New listed REITs are also arising from IPOs of non-traded REITs and spin-offs of REIT property companies or "propcos" as corporate owners of real estate form new REIT public vehicles to hold their real estate.

These combined activities are changing the public real estate landscape and adding to their vibrancy and vitality in the current market.

Issues to consider

Take-privates are complex transactions, particularly those involving REITs. Here are some points to consider when executing this kind of deal.

Effective business, tax and financial structuring are vital to the success of the transaction, particularly if the buyer wants a step-up in the tax basis. The structure of US REITs can also present issues in a buyout situation, especially if the operating partnership unit holders have tax protection agreements in place.

REIT qualification due diligence is especially important. Given the potential risk of REIT disqualification if certain criteria are not met, buyers should conduct this due diligence up front to gain comfort that the REIT being targeted has the proper tax compliance measures in place and, in fact, genuinely qualifies as a REIT.







Managing complexity

Operational challenges

With ever larger funds being raised, more products and strategies being offered to investors and greater demands for transparency and improved reporting, fund managers are increasingly looking to outsource their administration. So how is the market developing?

Fundraising in real estate continued its upward trajectory through 2015, with many seasoned investors looking to gain access through separate accounts. In addition, firms are broadening their offerings to investors to capture a larger share of their wallet. For their part, investors are seeking a greater granularity of information from fund managers, while increased scrutiny from regulators, particularly in the US and Europe, is leading to an ever greater need for transparency of information and data.

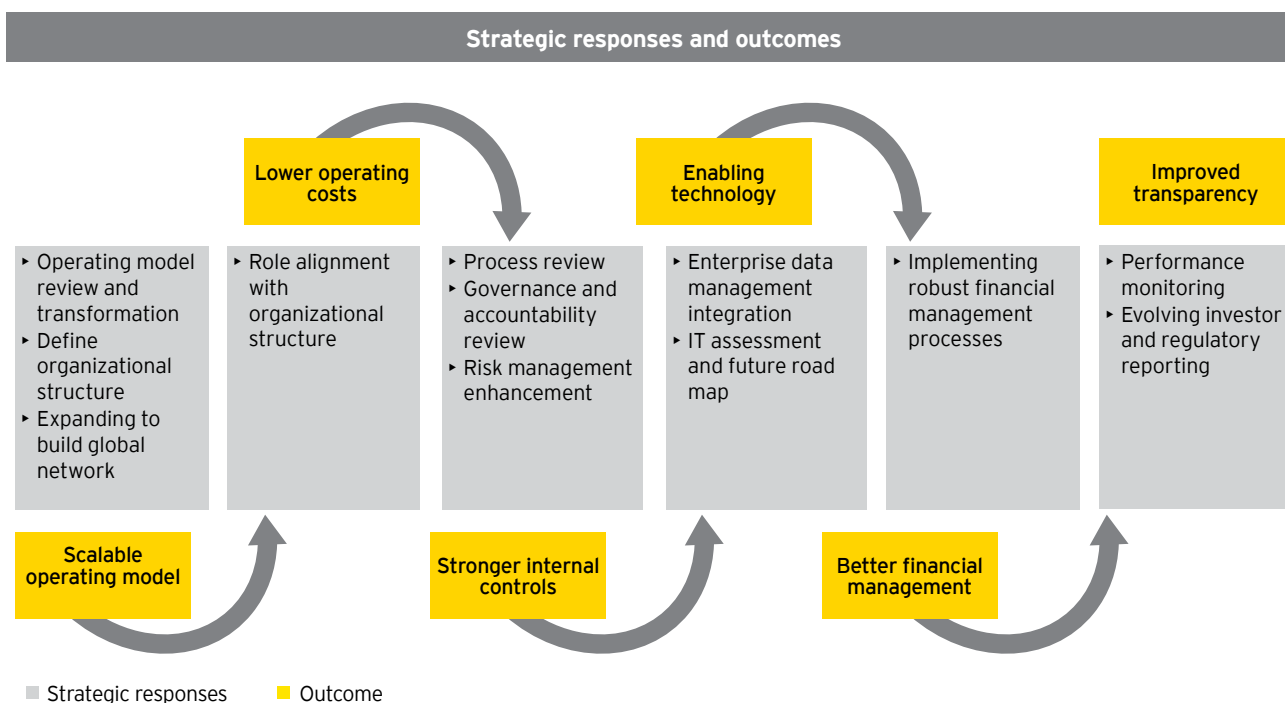
Taken together, these trends are making the real estate fund management business an increasingly complex place to do business. Not only do managers need to collect more data, they also need to analyze it consistently and accurately in a timely manner across a variety of strategies and geographies while also taking account of different investors' information needs. And it is this complexity that is giving many managers pause for thought: should they focus on their core business of identifying and executing deals and then monitoring their progress, while outsourcing some or all of the administrative functions? Or should they invest in the technology platforms and people required to meet the administrative demands of today's real estate fund management industry?

Administrators adapting to market need

Meanwhile, the administrators are evolving too. While many may have started out as hedge fund administrators, they first expanded to offer private equity administration services and are now seeking to capture market share in the real estate administration arena. There is clearly plenty of scope for further development, particularly when it comes to developing new and robust technology platforms to service the industry. In addition, given the current small scale of many third-party administration outfits and the relative newness of the real estate line of business, there are few providers (if any) that are so far able to offer real estate managers the ability to tick off all of the three wish-list items of price/value for money, quality and responsiveness. However, there are signs that the market is advancing.

Today, most fund administrators provide multiservice offerings to cover back- and middle-office functions, with areas of expansion including tax reporting, legal services, private placement memorandum drafting, risk management and valuation support. Yet the market is far from uniform. Some of the larger players, for example, are starting to be able to offer one-stop shops to clients (at a price, naturally), while others are focusing on a more tailored approach to meet clients' specific needs. At the same time, there is a trend for administrators to consolidate or seek capital from sources such as private equity firms to invest in new product and service lines in a bid to add to their capabilities and benefit from economies of scale.

Changing regulatory framework and client demands



Source: EY

To outsource or not to outsource?

The answer to this question is far from straightforward in itself and may be different for different firms, but there are some key questions firms should ask themselves:

- ▶ What are the costs involved in outsourcing versus keeping an in-house team?
- ▶ Could the outsourcing costs be partly borne by investors?
- ▶ Are the activities being considered for outsourcing central to generating revenues?
- ▶ Can the firm's existing operations support expansion into new products, geographic regions and asset classes?
- ▶ What governance structure would need to be put into place to measure service expectations, processes and risk management?
- ▶ Are the activities or functions being considered for outsourcing viewed by the firm as commodities?
- ▶ Can the firm's in-house technology support future business growth and evolve quickly in line with reporting requirements?

Finding the right resources to meet your needs

As the landscape evolves and the need for a more professionalized approach to regulatory, compliance, risk management and reporting issues becomes more pressing, more firms will need to consider their options. Outsourcing to fund administrators can provide clear benefits, such as a more flexible use of resources, an ability to focus on revenue and return-generating activities, a more scalable platform, assurance for investors that reporting is being managed by an independent third party and more predictable operating costs. For new firms establishing themselves, this is likely to be a relatively easy decision to make as it obviates the need for building up large internal resources and allows managers to concentrate on setting up and fundraising. Yet for others, the deciding factors are likely to be more nuanced. Those firms with legacy platforms, for example, will need to consider the effect of a lift-out on a team of individuals that may have helped build the platform: there is bound to be some level of upheaval, no matter how well managed the process is. In addition, thorough cost-benefit analysis needs to be undertaken. Many firms underestimate the real cost of in-house operations; meanwhile, the fund administration industry, as we've outlined, has yet to reach a point where economies of scale can be passed on to clients. And then, of course, there is the issue of loss of control – some team members will need to remain in-house to oversee the arrangements and ensure service levels are of good quality.

Significant risks to consider when developing business processes and controls:

1. Acquisitions
2. Disposals
3. Investment decision governance
4. Portfolio management
5. Financing
6. Asset management
7. Construction and development
8. Third-party service providers
9. Valuations
10. Data security
11. Income allocation
12. Revenue recognition
13. Redemptions
14. Secondary market dealing
15. New client onboarding procedures
16. Cash flow
17. Fund pricing
18. Payments and receivables
19. Client reporting
20. Administration

Process and controls

Under control?

The globalization of real estate investment strategies and increased scrutiny from regulators and investors on investment advisors continues to lead many advisors to review their processes and controls.

This is a trend that has been playing out for some time, especially since the registered investment advisor (RIA) rules have come into play in the US and the AIFMD is being transposed into national law across Europe. This has been punctuated by the issuance of the internal control integrated framework issued in 2013 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). However, the focus on best practices that managers can follow – practices related to identifying investment opportunities, underwriting, reporting and improving transparency – is intensifying as funds move into new markets and larger advisors seek to institutionalize the way they operate.

Focus on risk

Many investment advisors are, for example, revisiting their organizational structures, approvals processes and the management of their fund investments to ensure that they are adequately addressing areas such as franchise risk, operational risk and reporting risk.

Valuations taking center stage

Perhaps unsurprisingly, advisors are taking a long hard look at valuation processes. This is clearly a key consideration for most funds given that the investments are by far the largest monetary amount on the balance sheet, which is generally reported using fair values, and their performance data, such as key performance indicators and internal rates of return, are predicated on the valuations they report.

This exercise requires a root and branch process re-evaluation of a number of specific factors, such as:

- ▶ How frequently should assets be valued?
- ▶ Should a third party be determining valuations or should this be carried out in-house?

- ▶ Which methodology should be utilized and what are the inputs into the valuations?
- ▶ How should the review and approval process of periodic valuations be conducted?
- ▶ If there is a valuations review committee, what should be the makeup of the committee?
- ▶ How consistent are valuations across different geographies?
- ▶ How can we put into place the right valuations monitoring process to ensure valuations are conducted consistently and accurately?

The importance of proper documentation of the process, the related controls, and the parameters for valuation technique becomes even more important as funds invest in multiple geographies and as different perspectives and valuation techniques are utilized.

SOC reporting – the end goal?

While many funds are reviewing their controls on an ongoing basis to ensure they are following best practices, managing their risk effectively and are able to demonstrate this to investors, auditors and regulators, the aim for others is to be at a point where they can produce annual service organization control (SOC) reports. For these funds, the SOC report can provide proof that they have the correct, audited procedures in place and may well act as a differentiator when raising new funds from institutional investors.

Key considerations for controls

1. Focus on the suite of controls: all activities that go into preparation for review
2. Valuation review: look at overall changes in value and assumptions
3. Dual purpose testing: need to address any errors both from control and substantive purposes
4. Consideration of exceptions: is there a value or assumption outside the range that is not supported?
5. Contrary evidence?

A woman with dark, curly hair is shown in profile, looking intently at a large world map spread out on a table. Her hand is visible, pointing at a specific location on the map. The map is colorful, with various regions in shades of green, yellow, and blue. A yellow rectangular box is overlaid on the right side of the image, containing the text 'Focus regions: Brazil, China and Israel'.

Focus regions:
Brazil, China
and Israel

Focus on Brazil

For investors that understand the Brazilian real estate market, now may be the best buying opportunity in at least a decade. Here's why.

Brazil is currently witnessing a rare confluence of factors that could make it a highly active real estate market over the coming 12 to 24 months. We've already seen some of this come through as Brookfield Properties acquired a US\$595m portfolio of assets and Blackstone bought a US\$310m portfolio, both in Rio de Janeiro and São Paulo and both from listed group BR Properties in August 2015. There is also strong interest in Brazilian real estate from a number of North American and Asia-Pacific funds as investors warm up to the prospects of a maturing market that now looks attractively priced.

Brazil's reduced real estate pricing is underpinned by three main factors:

Currency correction. The Brazilian real has devalued sharply over the last 12 months, with the exchange rate against the dollar falling by around 40%: on 29 August 2014, the real-US\$ rate was 2.2393; by 28 August 2015, it was 3.5787. For overseas investors, particularly those with US dollar-denominated funds, this is making Brazilian real estate assets far cheaper than they were just 12 months ago.

A slowdown in the Brazilian economy. Brazilian GDP growth was less than 1% in 2014, according to World Bank figures, and is forecast to head into negative territory for 2015. This macroeconomic slowdown is reducing demand for real estate and contributing to an oversupply.

A decade of high construction levels. This is borne out of a period when Brazilian – and global – GDP growth was strong. This led to Brazil's developers, who were mainly regionally focused, growing aggressively as they tapped buoyant IPO markets to become national players. While economic growth in Brazil continued, new developments sold quickly, but these newly created national developers soon ran into trouble once the economy started to turn. Not only had many real estate companies overstretched themselves by going into markets with which they were less familiar, but they also faced significant cost overruns. Many new developments have placed supply in the market precisely at a time when there is less demand: vacancy rates are up, while leasing rates and residential sales are down. This is having an inevitable effect on pricing.

These last two factors – the economic slowdown and construction leading to an oversupply – may lead some investors to conclude that the Brazilian market is too risky to pursue. However, there are also good reasons to suspect that real estate will recover over the medium term.

The slowdown over the last few years has largely been the result of loose monetary policies under the first term of Brazilian President Dilma Rousseff, which, for example, saw increased government spending and artificially controlled inflation through reduced domestic oil and gas prices. Yet since her re-election in January 2015, President Rousseff has sought to follow a more orthodox monetary policy, appointing finance minister Joaquim Levy, renowned for his ability to cut public spending under previous administrations. In addition, the real's devaluation looks set to have a significant effect on Brazil's exporting capacity. Indeed, the World Bank's projections for GDP growth in 2017 are currently at 2% – a significant improvement on the negative projection for 2015.

On the oversupply question, much of this was created by a lack of experience among many developers and their aggressive expansion strategies. Indeed, at EY we conducted some econometric analyses that concluded that 40% of the current real estate downturn is the result of the real estate market itself (the remaining 60% is driven by macroeconomic factors). While some of these companies are now feeling the pain, the rapid growth of real estate in Brazil over the last 10 years has created a more mature, knowledgeable and deep market: sales and leasebacks have increased in Brazil, for example, and the country has seen the development of a number of niche areas that did not exist before the construction boom, such as warehouses, hotels, storage and health real estate. This deepening of the market should help to mitigate and reduce some of the risks faced by investors.

History is littered with property markets that were overbuilt. All eventually come back, but picking the correct entry point is critical. The factors driving today's prices, coupled with the longer-term economic and market fundamentals, suggest there are some attractive buying opportunities to be had. While this does not apply across the board, the largest oversupply is in core office space, where pricing is at historically low levels.

Focus on China

Following the summer's stock market correction and the renminbi's devaluation, it's clear that some investors have become more cautious about parts of the Chinese real estate market. With pockets of overdevelopment in some areas, investors need to choose their markets wisely in China, particularly as recent figures suggest China's economic growth continues to moderate. Nevertheless, in some respects, it's business as usual for parts of this rapidly urbanizing country.

While Hong Kong has cooled a little, some of the other first-tier cities in the Greater China region continue to see an active real estate market, driven by both domestic investors and foreign funds that have raised significant amounts of capital to invest there.

And, while new developments continue apace, there is further opportunity for buyers as funds start to exit investments made several years ago.

In cities such as Shanghai and Beijing, commercial properties and retail malls remain favored investments. Although it is difficult to find good assets in these markets, the strength of appetite is reflected in the fact that in the first three quarters of 2015, there were six US\$1b+ deals done in Shanghai alone.

One of the hottest sectors in China continues to be industrial logistics. Interest in this sector has soared as the growth of e-commerce in China has not yet been matched by a supply of good and well-located logistics assets. Meanwhile, residential development is attracting some renewed interest. Urbanization is happening at such a pace in China that some second- and third-tier locations are starting to emerge as strong satellite cities. The sales value of commercial housing increased by 15.3% in the first eight months of 2015 versus the same period in 2014.⁹ With a sales turnaround that is quicker than other sectors, such as retail, the residential market in China has some attractive features.

However, investors need to tread carefully. There are likely to be some tremors to emerge from China in the next two or three years. History has shown that it is very difficult for a banking system and economy to digest the kind of rapid development seen in the country – and the high rates of lending to support that. A recent estimate put the amount of vacant floor space in China at 600 million square meters, enough to cover Madrid, and local government borrowing has soared over recent years to CNY18t in 2013, up 80% in two years.¹¹ While urbanization is continuing, demand has not yet caught up with supply, and the resultant ghost cities will represent developments that are both costly to maintain and provide low or negative returns to investors. In a market where real estate investment accounts for 15% of GDP,¹² this oversupply will take some time to unwind.

While some investors may be looking at the distressed assets space, there are few opportunities currently available. With abundant financing available from a variety of sources – for now at least – from more traditional banks to alternative providers, even those under financial pressure have access to capital to pre-empt distress. Lenders are also taking a pragmatic approach to nonperforming loan situations and are reluctant to seize assets. Of the distressed assets that do come to market, many are in technical and/or legal distress, as opposed to financial distress, making them difficult to execute successfully.

⁹ National Bureau of Statistics.

¹⁰ Citymetric.com.

¹¹ National Bureau of Statistics.

¹² Mali Chivakul, W. Raphael Lam, Xiaoguang Liu, Wojciech Maliszewski, and Alfred Schipke, “IMF Working Paper: Understanding Residential Real Estate in China,” International Monetary Fund, April 2015.

Overall, China is a complex market that is far from uniform. It is also volatile, and the extent of government intervention is unpredictable from one month to the next. Yet these characteristics, combined with the unstoppable urbanization trend, can create conditions for good return prospects for investors that understand the market in depth.

Israeli bonds: an attractive source of global debt capital

Low interest rates and growing demand from investors for international exposure is making the Israeli bond market an attractive source of capital for real estate funds.

Last year represented something of a milestone for the Israeli bond market: not only did total issuance increase to more than US\$10b for the year, but 2014 also saw a large number of real estate companies seek capital there, with US\$2b of issuance accounted for by international companies. To date, 10 US real estate companies have tapped the Tel Aviv Stock Exchange for debt funding, and there is a growing pipeline of others looking to do the same. While the flow of issuers has largely come from the US, there are signs that some companies in other regions, such as the UK, are eyeing the market with interest.

Issuers are being lured by the relatively mature status of the bond market in Israel that features highly attractive interest rates, bolstered by the more favorable ratings they can achieve in the Israeli market versus international markets – for example, an international B rating is equivalent to roughly an A rating in the Tel Aviv market.

General timing

Procedure	Timetable
Filing the prospectus with the lawyers and the accountants	8-12 weeks
Working sessions with the rating companies	1-3 weeks
Israel Securities Authority approval for fundraising through the prospectus	4-6 weeks
Road show among Israeli investors	2 weeks
Tender for institutional investors and cash clearance	1 week

Overall transaction period: 3-6 months

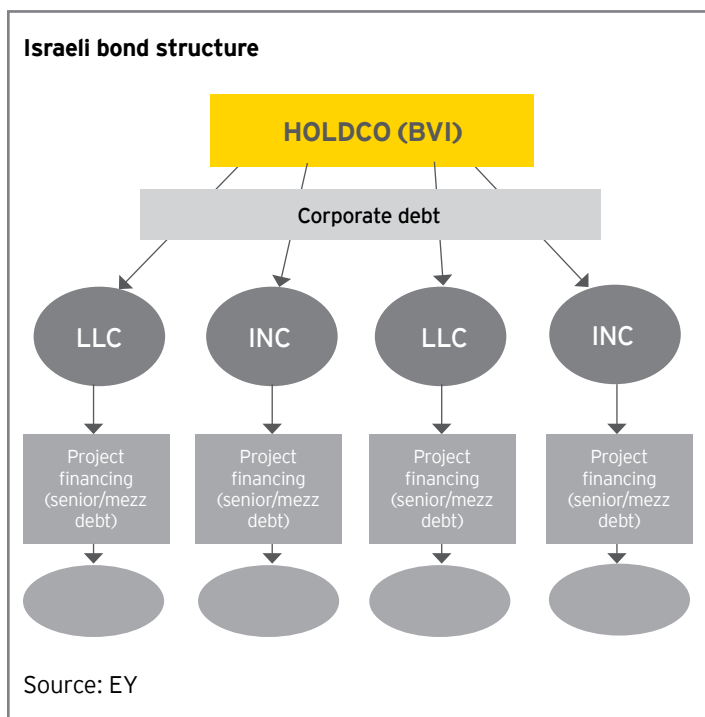
Source: Global debt capital – Israel Bonds

In addition, there is strong appetite from Israel's pension and other long-term saving funds, which by law receive between 20% and 25% of employee salaries. These growing pools of capital need to be deployed and, with a limited supply of domestic companies in which to invest these funds, are increasingly looking at foreign real estate issuers in a favorable light as they seek strong returns and geographic diversification.

The ideal candidate

Clearly, investors are looking for certain characteristics, and the ideal candidate would benefit from the following:

- ▶ An experienced management team
- ▶ Assets with a minimum value of US\$250m
- ▶ Shareholder equity with a minimum value of US\$100m
- ▶ A minimum local rating of A (equivalent to international rating B)
- ▶ Strong, diversified, income-producing assets and/or development projects with a proven track record (yielding assets will gain a better rating)
- ▶ Assets located in well-known and developed markets



The structure

In advance of the IPO, issuers will have no debt above the assets level, and the lender has a first mortgage. Following the IPO, assets are transferred to a wholly owned offshore special purpose company, which issues the bonds on the Tel Aviv Stock Exchange, a structure that usually has no tax implications. The senior debt lender stays with the first mortgage, and there is cross-collateral between the asset companies and the bonds.

The process

There is a well-established process for issuing bonds on the Tel Aviv stock market, which starts with the preparation of a prospectus. Issuers will need three years of financial statements that are either prepared according to international financial reporting standards (IFRS) or according to US generally accepted accounting principles, with an IFRS reconciliation report. The IPO process generally takes between three and five months and will need to include the following parties:

- ▶ A local rating company – S&P or Moody's – to provide a rating report
- ▶ A reputable appraiser to provide asset appraisals according to IFRS and the Israeli Securities Authority's requirements
- ▶ An Israeli law firm to prepare the prospectus
- ▶ A local accounting firm to review and audit financial statements and prospectus

Once the prospectus has been prepared, this is sent to the Israeli Securities Authority for review and approval.

The funding is raised in new Israeli shekels (NIS), which can then be hedged and converted to US dollars at a relatively low rate.

Quick funds

One of the advantages of the Israeli bond market is that capital can be raised quickly once the IPO has been completed – additional rounds can often be raised in a matter of a few days. Indeed, many companies that have launched on the bond market have completed further rounds.



Future outlook

As 2015 draws to a close, our report highlights the robustness and vitality of the real estate fund industry as it seeks out opportunities in new markets and consolidates its positions in some of the world's greatest cities. Yet there are some who are starting to raise warning flags about where we are in the real estate cycle, pointing to volatile pricing data globally following a run of rising valuations and the potential for interest rate rises to reprice the property market.

However, we believe the outlook is far more positive, based on sound macro-economic fundamentals. First, a stable inflationary policy over the long term will continue to benefit asset prices; second, unemployment figures continue to trend downward in most major markets, leading to increase demand for real estate; and third, commodity prices, which affect consumers and the real estate market, are low relative to recent years and look unlikely to rise significantly for the foreseeable future. When all these metrics are put together, there is a clear case for optimism, as the underlying business cycle that drives the need for real estate is stable.

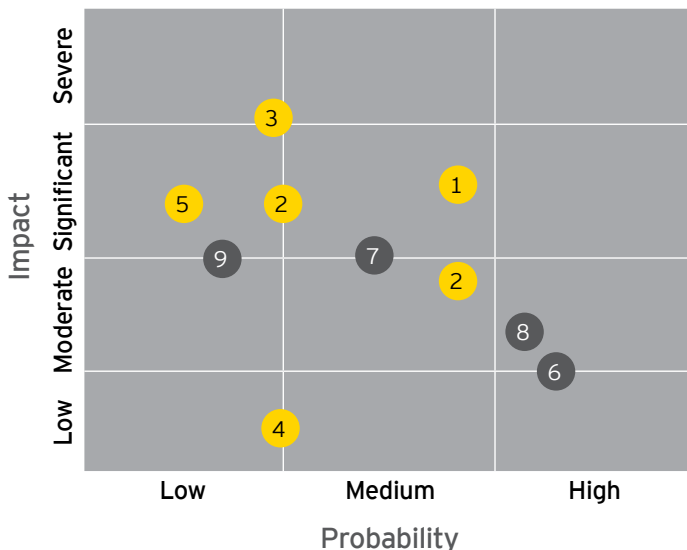
Added to this is the fact that post-crisis, we have seen the slowest recovery in around 50 years, with global GDP growth hovering at just over 3% for the last three years.¹³ While this may not sound like a cause for celebration, this more moderate pace of expansion has substantial benefits for real estate. Previous cycles have seen rapid economic rebound post-recession, followed by a rapid real estate development, leading to oversupply just as the economy starts

cooling once more. The deeper, longer cycle we find ourselves in today has required developers and lenders to proceed with a bit more caution to ascertain if the demand side of the equation would be met. Consequently, the real estate industry has achieved higher occupancy rates in existing properties and has shown a measured rate of new development. This slow growth has allowed supply to match demand more closely than has historically been the case.

This lengthening of the cycle has been matched by a deepening of the fund manager universe and opportunity set. Real estate funds continue to attract high levels of capital, with successful closes across the real estate investment spectrum, from value-added and opportunistic to core and distressed. And while dry powder is reaching record levels, the fact is that the opportunities available in the market globally are diverse and plentiful. While core real estate remains in demand, but pricey, new deals are emerging for opportunistic players in the CMBS space as these vehicles mature. At the same time, the developed US, European and Japanese markets are complemented by newer markets with different characteristics such as Brazil, Nordics, Eastern Europe and China.

With this coming together of both macro and micro factors, the real estate industry has much to gain both today and tomorrow. Where in the past, the warning flags would be justified over seven years into a cycle, the market data suggests this cycle will be longer than the average.

Key global risks – September 2015



Downside risks

- 1 China hard landing
- 2 Emerging market crises
- 3 Inflation increases sustainably
- 4 Political risk in Europe reignites crises
- 5 Prolonged US growth slowdown

Upside risks

- 6 Smooth start to Fed tightening – gradual
- 7 Eurozone growth surprises to the upside
- 8 Property fundamentals show steady growth
- 9 Legislative environment in the US becomes constructive

Source: EY

¹³International Monetary Fund.

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Today's real estate sector must adopt new approaches to address regulatory requirements and financial risks while meeting the challenges of expanding globally and achieving sustainable growth. EY's Global Real Estate Sector brings together a worldwide team of professionals to help you succeed – a team with deep technical experience in providing assurance, tax, transaction and advisory services. The Sector team works to anticipate market trends, identify their implications and develop points of view on relevant sector issues. Ultimately, this team enables us to help you meet your goals and compete more effectively.

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