

Real Estate Investment: A Strategic Approach

Fourth Edition, 2023

Andrew Baum

Chapter Nine

Real Estate Funds

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Property investment mandates



Direct

Buy land, buy
buildings
Joint ventures
IPsx?



Semi-direct

Segregated/separate
accounts



Indirect

Unlisted property vehicles

- Self managed
- Separate account: manager of managers
- Funds of funds

Public property companies

- Self managed
- Separate account
- REIT fund

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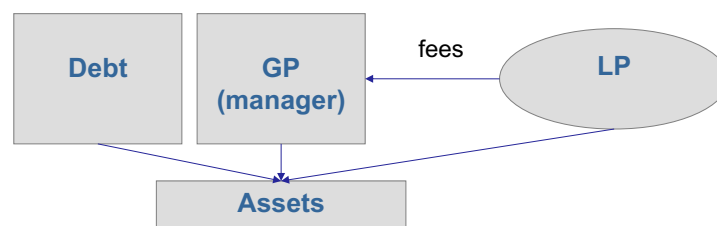
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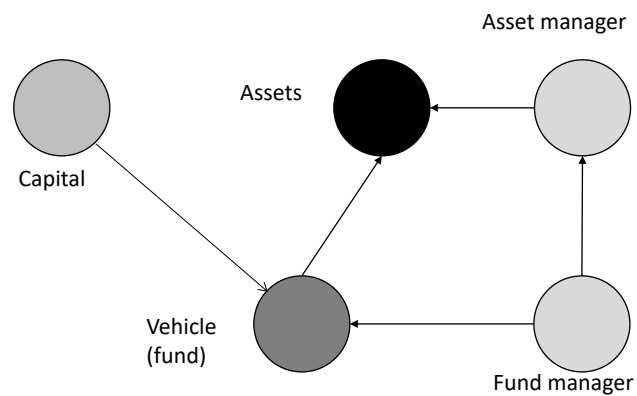
Mandates: clubs, JVs, platforms, funds

- A separate account is a single client service contract which combines the LP's capital with the GP's management resources
- A joint venture also combines the LP's capital with the GP's management resources, but the GP also invests capital
- A club is a small co-mingled fund (in terms of the number of investors – say 3-5) – several LPs, one GP
 - discretion, control
- A platform fund is an umbrella providing capital to a series of JVs (often an opportunity fund)
- A fund has many LPs, one GP
 - discretion, control

A typical JV



Capital, vehicles, managers



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What are unlisted funds?

- 'Core' funds (Type A)
 - UK property unit trusts, US/Germany open-ended funds
 - FCP (Lux), Spezialfonds (Germany)
- 'Private equity' real estate funds (Type B)
 - Usually limited partnerships
 - 'Opportunity funds'

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Four common legal structures

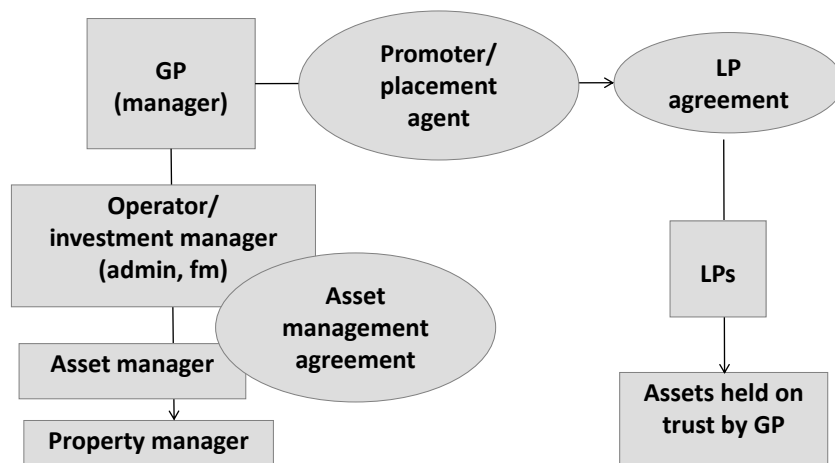
	Open/closed ended	Listed/unlisted	Retail/institutional	Main market
Corporate	Both	Both	Both	Luxembourg SICAFs, Dutch Bvs/NVs
Partnership	Closed	Unlisted	Institutional	US LLP, UK LP, German closed ended
Contractual	Both	Both	Both	Luxembourg FCP, German Spezialfonds
Trust	Both	Unlisted	Both	UK/CI Property unit trust

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A typical LP



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Exit routes

- Open ended funds
 - Redemption of units by manager
 - Semi-open-ended: lock-ins, then limited redemptions
- Closed ended fund, limited life
 - Total asset sales (or securitisation) at end of life
 - Fund life extensions of 1-2 years.....or more
- Closed ended fund, perpetual life
 - Regular 'liquidity events'
- Joint venture 50:50 structure
 - Put and call

Fees

- Asset management fees
 - Committed capital? Drawn capital?
 - GAV? NAV?
- Acquisition fees, disposal fees
- Development management fees
- Expenses charged to fund
- Performance fees/carried interest

Property investment mandates

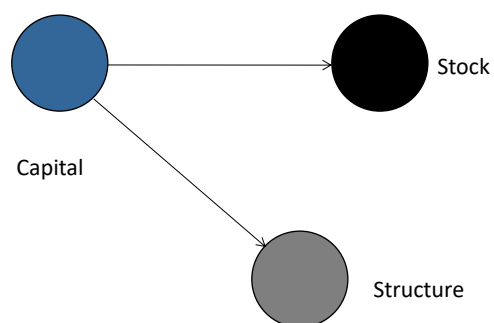
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Capital led: separate account, blind pool

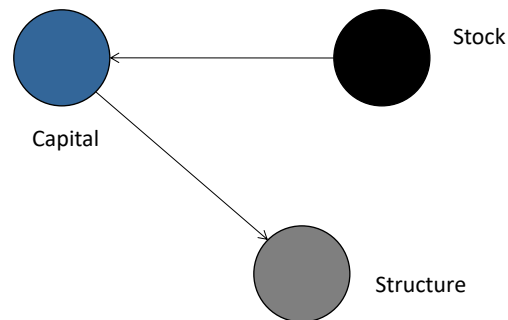


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Deal led: syndicate, seeded fund



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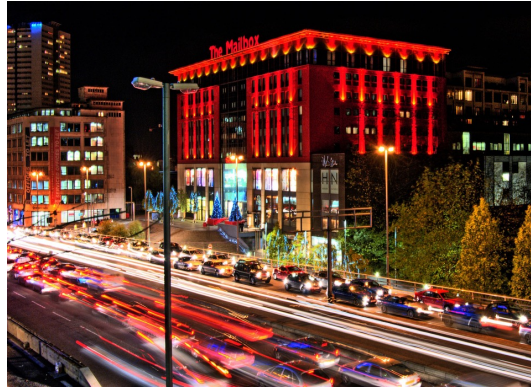
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IPSX/Tokenisation

- Wouldn't it be great if properties could be split into smaller pieces? And after a year or two why not use your phone to trade out, instantly, for a tiny fee?
- This, and more, is the promise of tokenisation
- This is defined by insiders as the process of **representing a fractional ownership interest in an asset with a blockchain-based token**



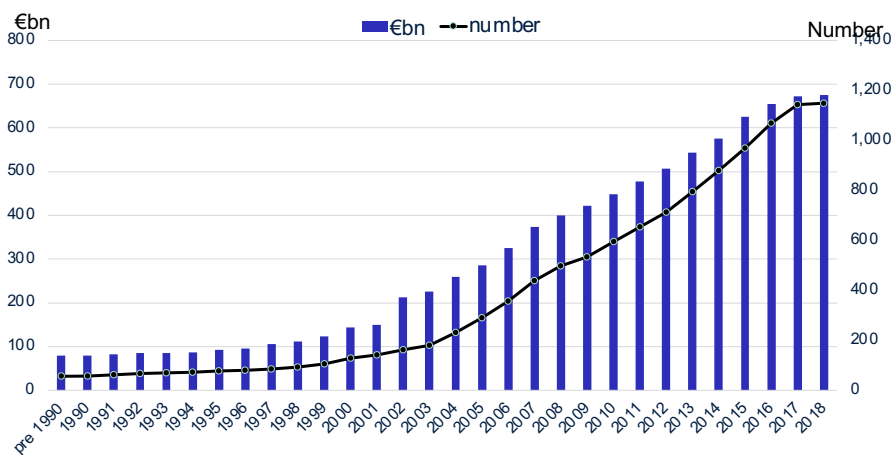
IPSX: The Mailbox, Birmingham

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Unlisted funds boomed post 2001



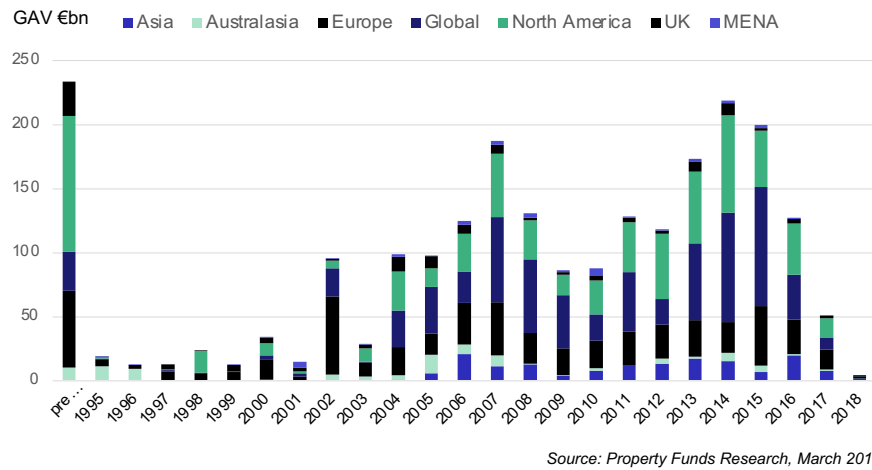
Source: Property Funds Research, March 2018

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€2.5 trillion, 3,200 live funds

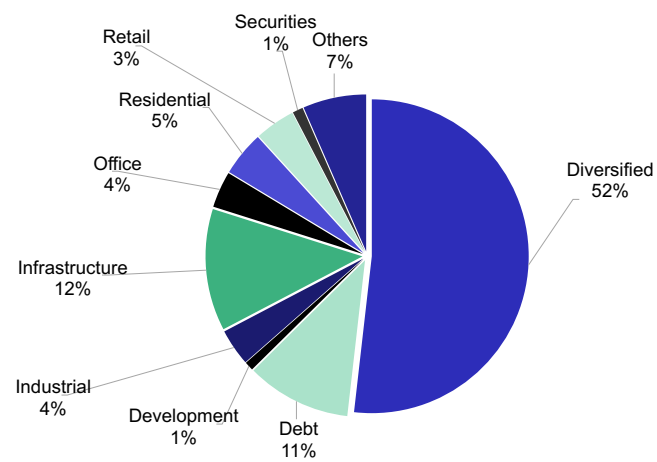


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Target sector



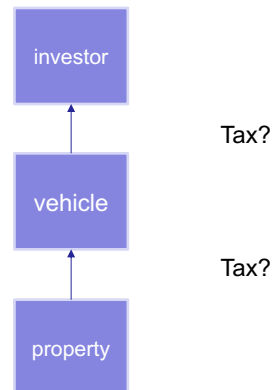
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REITs

- Listed real estate companies
- Tax exempt
- Required to distribute income
- Limited development exposure
- Leverage limited to c.35%



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REIT/fund pricing - theory

share price = net asset value/number of shares in issue

net asset value = gross asset value - debt

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Pricing - practice

share price = net asset value/number of shares in issue +/-
premium/discount to NAV

Pricing - basics

gross asset value £900m
- debt £400m
= net asset value £500m
+/- premium to NAV 10%
= market capitalisation £550m
/ number of shares in issue 1.1m
= share price £5

Pricing – gearing impact

Values fall 11% and premium becomes discount

gross asset value £800m
 - debt £400m
 = net asset value £400m
 +/- discount to NAV -10%
 = market capitalisation £360m
 / number of shares in issue 1.1m
 = share price £3.27

Share price falls 35%

The case for funds

- Returns - real estate style performance
- Lower specific risk
- Tax transparency
- Out-sourced management
 - Specialist, motivated, aligned?
- Some retained control
 - Investment committee

The case against funds

- Exit routes and liquidity
- Gearing – discolouration of return
- The J-curve effect
- The drawdown profile
- Fees and performance

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Exit routes

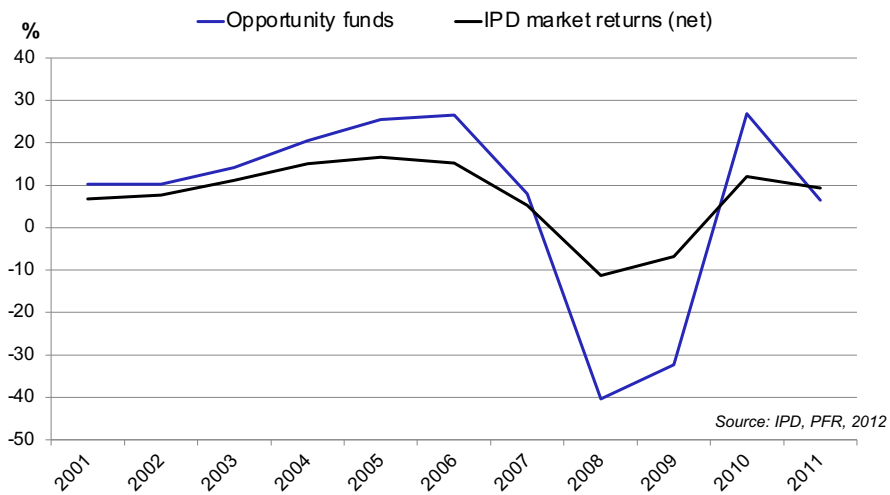
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Leverage impact

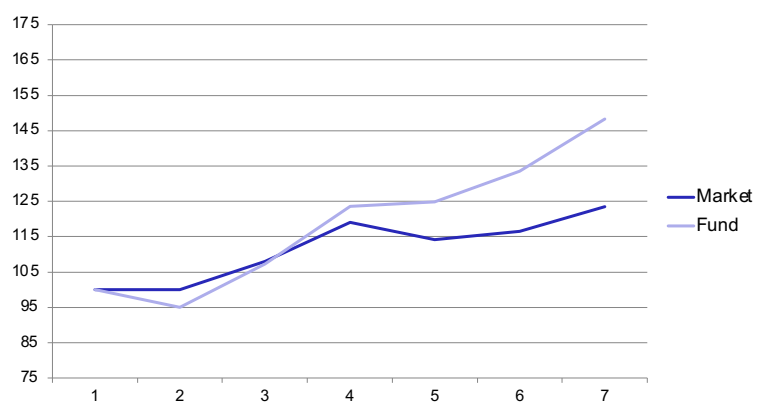


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The J curve



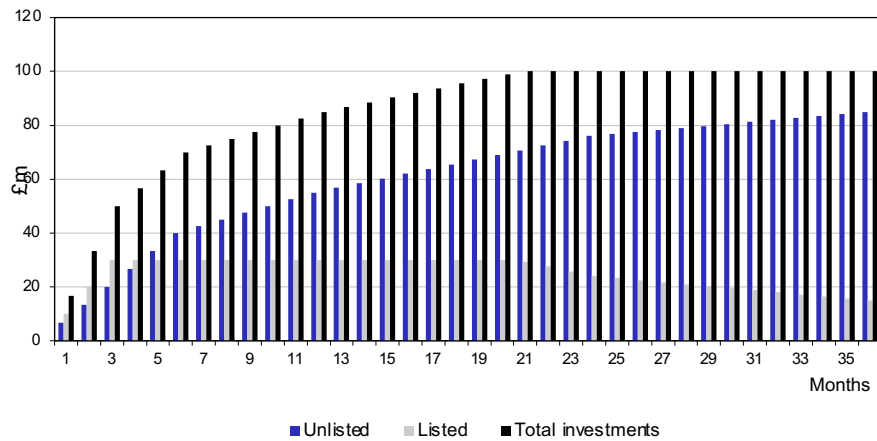
Fund out-performs by 5% p.a. but destroys capital year 1

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The drawdown profile



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Fund management fees

- Base fee pays for fund management, fund administration and financial reporting and asset management
 - strategy, research, investment process
 - governance
 - portfolio planning
- Fees are paid on GAV (say 0.4-1%), NAV (say 0.5-1.5%), or distributions (say 5-10%)
 - INREV average is 60bps of GAV
 - Fees are paid on committed or drawn capital (1-1.5%)
- Performance fee: in 70% of core INREV funds and all value-add/opp
- Typical hurdle (or pref) 8-12% (but zero for latest Blackstone product and 2.5% seen in Germany)
- Typical share over hurdle 10-20% to manager

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Pricing: premium or discount?

REITs

- Instant exposure
- Liquidity/divisibility
- Value > reported NAV?
- Value < projected NAV?
- Management skills and efficiency v costs
- Embedded tax liability
- Debt marked to market

Unlisted funds

- Instant exposure?
- Liquidity/divisibility?
- Value > reported NAV?
- Value < projected NAV?
- Management skills and efficiency v costs
- Embedded tax liability
- Debt marked to market

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The Spanish property market and Metrovacesa

- Economic change did not occur in isolation
- Fundamental change in property laws (Boyer reforms of 1985 and 1994 Lease Law)
- But poorly developed pension system relative to Northern European countries
- Very little institutional interest in real estate

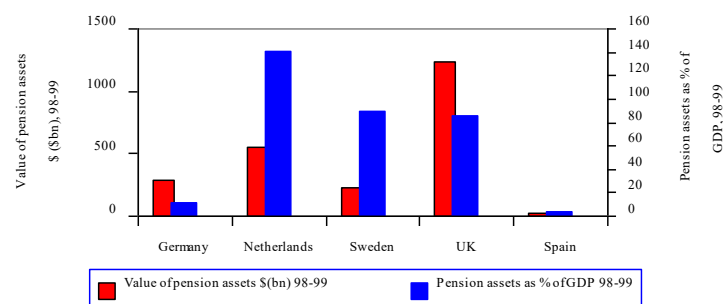
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Spain had no institutional market

Pension assets in Europe



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The Spanish property market, late 1990s

- Poor quality data (vacancy rates, rents, yields, portfolio-based performance index, floor-space, stock)...
- “Madrid office audit uncovers new space” (EuroProperty, April 2000): JLL now estimates Madrid office stock at 11.2m sq m, rather than previously estimated 7.2m sq m!
- No demand for or supply of asset management services
- The costs of buying and selling are high
- Research information is thin
- No natural partners

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Metrovacesa

- Decision to gain exposure to the Spanish property market by investing in Metrovacesa in March 1999
- One of the two largest listed Spanish property companies with office exposure in Madrid and Barcelona
- Market cap of over €1bn
- Portfolio similar to investor’s direct holdings
- Located in major Spanish cities
- 25% discount to NAV in April 1999

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Metrovacesa

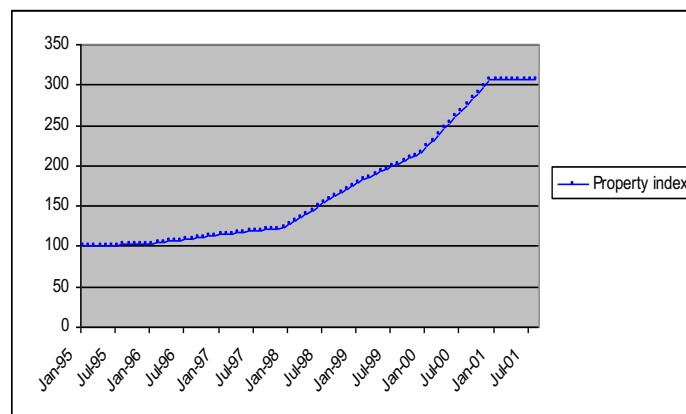
- Given size of discount and backdrop of rapidly increasing rental values underpinned by sound fundamentals, the pricing seemed very attractive
- Purchased in April 1999 at about €21 per share
- Expected growth in Spanish market values and narrowing discount promised superlative performance
- In 1999, rental values and capital values increased by 17% and 23% respectively – and in 2000 they increased by 40% each!

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The Spanish property index



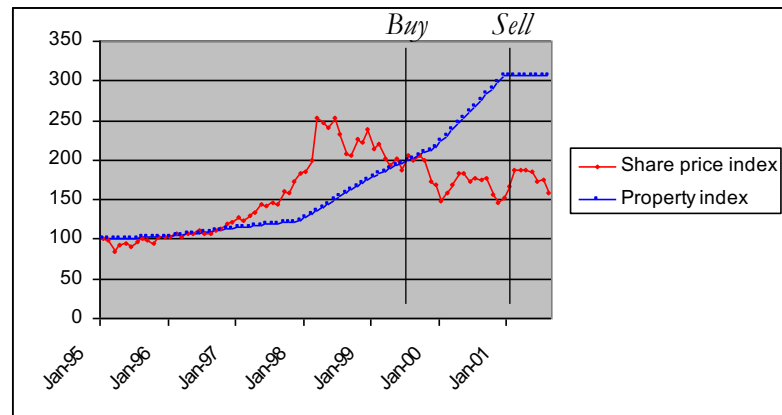
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The Metrovacesa share price



In contrast to the direct market, the share price fell during 1999-2000!

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Lessons from the Metrovacasa case

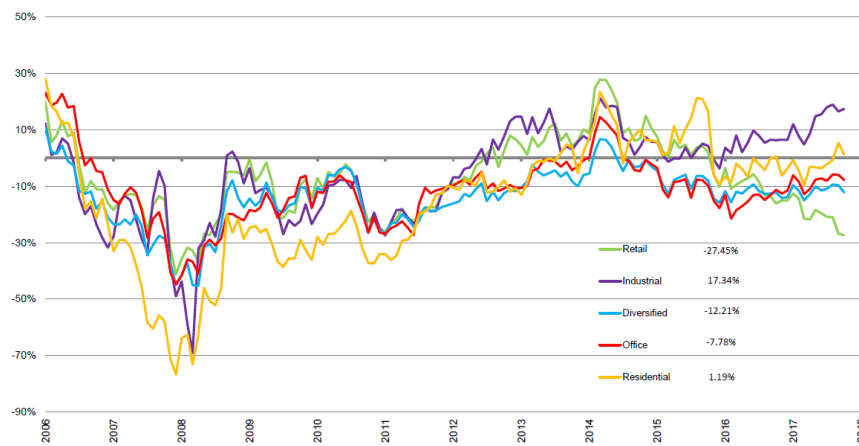
- Property shares sold at 20% loss after 18 months
- What do you think happened next? (Clue: rebound)
- Do property securities deliver real estate performance?

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Retail falling off a cliff; industrial peaking



FTSE EPRA/NAREIT Europe Sector Indices Discount to Published NAV – data as at Sep 2018

Source: EPRA

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Real estate funds: product design

- Structure:
- Style:
- Life:
- Domicile:
- Currency:
- Debt to GAV:
- Target return/benchmark:
- Strategy:
- Target sector:

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Real estate funds: product design

- Target portfolio:
- Number of properties:
- Target investors:
- Target equity:
- Minimum/maximum investment:
- Fees:
- Corporate governance:
- Co-investment:
- Risk controls:

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Real estate funds: product design

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Newcore Strategic Situations V LP



Newcore Capital
Specialist UK investment manager
with strong 9 year track record

- A management-owned, UK specialist founded in 2011 with £250m under management
- Strong 9 year track record
- 12 person team: managing 69 current assets, with 34 realisations and no single asset losing principal, to date
- First dedicated UK real investment manager to become a Certified B Corporation



**INVESTMENT
THESIS**

- Value-add, social infrastructure
- Targeting real estate assets central to the continuing needs of society and under the radar of larger investors
- Operating in sectors that provide some resilience to the deflationary effects of technology and the internet
- Occupational demand remains high and supply is often constrained
- Majority of assets deemed 'key worker' uses and remained open during lockdown, or were amongst the first to reopen



**The Fund:
NSS V LP**

- Clear investment strategy and focus with £150m target raise
- Utilising in-house active asset management skills to create long-income social infrastructure assets, which are increasingly sought after by the institutional investment market.
- Attractive target risk-adjusted returns: 13%-15% net IRR
- Low gearing (up to 30% LTV)
- 5 year fund life (closed ended, LP)

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Fund terms

Vehicle	Newcore Strategic Situations V Limited Partnership		
Structure	English Limited Partnership (with EUT and JPUT feeder structures)		
Target Offering	Target equity raise of £150m		
Manager Co-investment	>£1.0m		
Maximum Leverage	Less than 30% LTV, measured at the fund level, from the end of the Investment Period		
Target Return	13%-15% p.a. net levered IRR after fees		
Risk / Reward	Value-add		
Investment Focus	Target sectors (anticipated mix) <ul style="list-style-type: none"> • Social infrastructure (40%-50%) • Accommodation (30%-40%) • Storage (10%-30%) 	Investment geography <ul style="list-style-type: none"> • UK (South East focus) 	Permitted Form <ul style="list-style-type: none"> • Direct real estate • JV partnerships • Real estate backed operating companies
Investment Period	2 years from final close		
Fund Term	Five years from final close, with 2 x 1 year extensions		
Restrictions	<ul style="list-style-type: none"> • No single asset to exceed 20% of Commitments post investment period • No more than 35% of Commitments to be in any single sub sector (e.g children's nurseries, senior living, care homes) post-investment period • No more than 30% into asset-backed operating companies (no more than 20% into operational care homes) post-investment period • No more than 50% into strategies requiring planning permission for change of use into Newcore's target strategies post-investment period • No more than 15% into speculative land without income post-investment period 		
Fees and Expenses	1.5% p.a. on drawn Commitments		
Performance Fee	<ul style="list-style-type: none"> • 20% over 8% hurdle rate (no catch up) • Calculated at the fund-level (not deal by deal) 		
Co-investments	Investors have the option to secure co-investment rights based on the size of their commitment		