New directions for European non-listed property funds

A focus on the roles of the players in the European property investment market

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Preface

The world of property has often acted like an exclusive, private club with a restricted membership that speaks its own vocabulary, applies its own set of country-specific rules and relies on its own sources of capital. As long as there was enough money to maintain the status quo, this system appeared to be a very civilised way to conduct business. The members all knew one another, and local players tended to dominate their markets.

The capital markets have rudely disrupted the smooth operations of this private club and the pace of change around the world is rapid. The property industry faces an uncertain future, assailed by investor apathy, reactionary participants and technology that could render some types of property redundant. This is a fertile ground for a new approach.

Access to capital and major tenants will become a function of willingness to disclose material information about past and future performance. Nevertheless, for many companies in the property industry, much work still remains to implement a clear alignment of interests among an independent board, a professional management team and shareholders. And as information becomes more widely available, investors will have to use their creative abilities to beat the indices. Only a few researchers investigated European non-listed property funds so far and they all faced a lack of data. I am convinced that if we want to improve our research efforts in this area, we have to share our knowledge to take a step forward.

Given my background, this paper is intended for all players in the property sector and certainly not only intended to assist institutional investors in their European-focused non-listed property fund selection. By putting elements in this paper from owner-occupiers to pension funds, I hope it will be interesting to everyone. Those who want to comment are encouraged to get in touch with me through my Web site (www.thissen.net), where I will post corrections and updates.

Maarten Thissen
Haarlem, April 2001

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Summary

This thesis examines the position of the European-focused non-listed property fund market in relation to the real estate investment market. The issues discussed in this paper are intended to support institutional investors in their selection of a non-listed property fund, which is operated from the European Union.

Three questions have been examined for this paper. (i) How does the market of non-listed property funds look like? (ii) Why do institutions choose to invest in non-listed property funds? (iii) What can be expected of European non-listed property funds in the future?

Although many non-European investors are active on the buy side of the European property investment market, the changes related to the European institutional investors - insurance companies and pension funds - will have the biggest impact on the demand for European property investments. Calculations forecast an increase in invested capital of 130 billion euros a year, in case of the development from a 'pay-as-you-go' to a funded pension scheme. This means that with a prudent asset diversification, European pension funds have to look for an annual 13 billion euros in property investments extra, in order to maintain their asset allocation.

The lack of investment product and the advantages of an indirect real estate vehicle have stimulated institutional investors to use these investment products. Pension funds use indirect real estate vehicles more often than insurance companies within their real estate allocation. This difference can be explained by the ALM-studies institutional investors use to diversify their portfolios, and the pension funds' goal to achieve a modest real return on a longer term. Indirect real estate vehicles can be divided in non-listed and listed funds; the latter can be divided in quoted and open-ended. Listed indirect property investments have several disadvantages for investors over other property investments on the short term: volatility, little control, and the possibility of an under-performing stock price.

The combined market value of the property portfolio of 150 of Europe's biggest non-listed property funds totals at least 60 billion euros. This property investment portfolio forms together with property investments in Europe by (i) overseas investment funds, (ii) investment funds with retail investors and (iii) global diversified funds, the combined sell-side of the 245 billion euro European indirect real estate private equity market. This is 7 percent of Europe's total commercial real estate market.

Four types of non-listed property funds can be distinguished. The percentage shows the distribution of the fund types over the total European non-listed property fund market based on portfolio size.

- Investment company (LLC): 46%
- Non-opportunistic limited partnership: 25%
- Opportunistic limited partnership (opportunity fund): 8%
- Independent property profit center of non-property company: 21%

I - A non-listed property investment company with a limited liability status is often formed by a group of collegial investors or in other cases initiated by a fund manager. This fund manager is often linked to a financial institution. This group also includes property companies that have been listed before, but gave up their listing because of shortage of investors' interest in their company.

II - The limited partnership has become a standard investment vehicle in the property world. In essence, limited partnerships have a set life span and are restricted to a maximum amount of partners. The general partner has unlimited liability and the right to control and manage the venture. For others partners, liability is capped at the level of their capital contribution and their control over management is limited. The partnership will usually limit the gearing ratio, but this may be anything between 20 percent and 80 percent of net asset value. Limited partnerships with these high gearing-ratios are called opportunity funds.

III - Opportunity funds are used for increasing an investor's exposure to investments with a projected high (>20%) total return, which can be realised within a short time frame of three to five years. Traditionally opportunity funds have an investment strategy, which revolves around two specific market-related areas, (i) exploiting arbitrage opportunities in the real estate capital markets with large amounts of discretionary cap-

ital, (ii) acquiring value-added opportunities and repositioning these assets.
IV - The fourth type is the group of European property investment companies that are not yet owned by institutional investors. These property companies are a subsidiary of a listed or private non-property company and behave as an independent profit center. The goal of these property profit centers is to attract additional investors and form sale-and-lease-back structures that have advantages on both sides of the transaction.

Non-listed property funds are investing in a diverse range of sectors and that makes it much easier for the institutional investor to diversify their portfolio. More than half of the European non-listed property funds (52.4 percent) is country and sector specific. There are less funds that are diversified over countries but investing in one specific sector (7.6 percent) than funds that are diversified over sectors but investing in one specific country (23.8 percent). Some experts believe that the interest for funds with a default portfolio, which is diversified over sectors and countries will decline over the next years, although 16.2 percent of the non-listed property funds still use this strategy.

The most important trend that influences the European investment climate today, is the introduction of the euro. It will increase the property capital flows between the European countries, because investors can invest without exchange rate changes. Institutions will have more possibilities to use foreign real estate to increase diversification-benefits in the property investment portfolio. European-focused non-listed property funds will meet a growing amount of investors' appetite, especially of big pension funds with a professional world-wide spread investment strategy. Most non-listed property funds will specialise and choose a specific sector and region, while others will develop broader strategies. Diversified funds with a default portfolio will face more difficulties to attract capital than specialised entrepreneurial non-listed property funds. The latter are going to take risks to create shareholder value and maximise their profits to outperform their peers.

If Europe follows the US outsourcing trend, the European companies could begin shifting property assets off their balance sheets and allocating the freed capital to their core business in the near future. Significant opportunities to start non-listed property funds will be created once this asset transfer begins. The trends from the sell-side and buy-side

will make the future's new equilibrium in the European non-listed property fund market.

Non-listed property funds face an increasing interest of investors, because they combine the advantages of direct and indirect real estate investments. The funds in its current form have five characteristics to the advantage of direct real estate investments: (i) small amounts of capital can be invested in diversified property portfolios, (ii) the use of the fund managers local knowledge, (iii) lower transaction costs, (iv) less object specific risk and (v) the funds are less management intensive.

Dutch summary

Deze afstudeerscriptie onderzoekt de positie van Europese niet-beursgenoteerde vastgoed fondsen in relatie tot de rest van de vastgoedmarkt. De punten in dit onderzoek zijn bedoeld om de institutionele belegger te ondersteunen bij zijn keuze van een niet beursgenoteerd vastgoedfonds, die vanuit de Europese Unie opereert.

Er zijn drie vragen onderzocht. (i) Hoe ziet de markt van niet-beursgenoteerde vastgoed fondsen er uit? (ii) Waarom investeren institutionele beleggers in niet-beursgenoteerde vastgoed fondsen? (iii) Wat kunnen we in de toekomst verwachten van niet-beursgenoteerde vastgoedfondsen?

Hoewel veel niet-Europese beleggers actief zijn op de Europese vastgoedmarkt, zijn het de veranderingen rond de Europese institutionele beleggers - pensioenfondsen en verzekeraars - die de grootste invloed op de vraag naar Europese vastgoedinvesteringen zullen hebben. Berekeningen voorspellen dat de Europese pensioenfondsen, in het geval van de omvorming van een omslagstelsel naar een kapitaal dekkingsstelsel, per jaar 130 miljard euro meer zullen investeren. Dit betekent dat ze indien ze willen vasthouden aan een verstandige diversificatie, per jaar op zoek zijn naar 13 miljard euro aan investeringsmogelijkheden in vastgoed.

Het gebrek aan investeringsmogelijkheden en de voordelen van indirect vastgoed vehikels stimuleerden de institutionele beleggers deze producten te gebruiken. Pensioenfondsen gebruiken indirect vastgoed vaker dan verzekeraars binnen hun vastgoedallocatie. Dit verschil kan worden verklaard door ALM-studies die ze gebruiken om hun portefeuilles te spreiden, en het doel van pensioenfondsen om een gematigd reëel rendement te behalen op de lange termijn. Indirect vastgoed kan worden onderverdeeld in niet-genoteerde en genoteerde fondsen, die vervolgens zelf kan worden opgedeeld in 'open-end' en 'closed-end'. Beursgenoteerd vastgoed heeft een aantal korte termijn nadelen ten opzichte van andere vastgoed investeringsmogelijkheden: volatiliteit, weinig invloed, en de mogelijkheid dat de koers van het fonds zich onder de onderliggende intrinsieke waarde begeeft.

De gecombineerde portefeuille van Europa's 150 grootste niet-beursgenoteerde vastgoed fondsen beslaat een markt waarde van 60 miljard euro. Dit vastgoed vormt samen met de investeringen in Europees vastgoed door (i) overzeese investeringsfondsen, (ii) investeringsfondsen voor particuliere beleggers en (iii) wereldwijd gespreide fondsen, de complete aanbodzijde van de markt in Europese niet-genoteerde vastgoed fondsen. Deze markt is 245 miljard euro groot. Dat is 7 procent van de waarde van de totale Europese vastgoedinvesteringsmarkt.

Vier typen niet-beursgenoteerde vastgoed fondsen kunnen worden onderscheiden. Het percentage geeft de verdeling van de fondsen weer op basis van portefeuille grootte.

- Investeringsmaatschappij (naamloze vennootschap): 46%
- Niet-opportunistische commanditaire vennootschap: 25%
- Opportunistische commanditaire vennootschap: 8%
- Onafhankelijk vastgoedonderdeel van bedrijf: 21%

I - Een niet-beursgenoteerde vastgoed investeringsmaatschappij met een beperkte aansprakelijkheid wordt vaak gevormd door een groep eensgezinde beleggers. In andere gevallen wordt het fonds geïnitieerd door een fonds manager, die veelal verbonden is aan een financiële instelling. Dit type fonds omvat ook vastgoedbedrijven die voorheen beursgenoteerd zijn geweest, maar hun notering moesten opgeven door te weinig interesse voor hun bedrijf vanuit beleggers.
II - De commanditaire vennootschap is een standaard investeringsvehikel geworden in de vastgoedmarkt. De vennootschap heeft een beperkte looptijd en is beperkt tot een maximum aantal vennoten. De initiatiefnemer en daarmee belangrijkste vennoot heeft onbeperkte aansprakelijkheid en het recht om de onderneming te besturen. Voor de andere vennoten is de controle en de aansprakelijkheid over de onderneming beperkt. Vreemd vermogen wordt vaak aangetrokken, maar daar waar verhoudingsgewijs veel vreemd vermogen wordt gebruikt spreken we over 'opportunity funds'.
III - Opportunistische commanditaire vennootschappen worden gebruikt door investeerders die op zoek zijn naar investeringen met een hoog (minimaal 20 procent) rendement op korte termijn (drie tot vijf jaar). Deze 'opportunity funds' maken gebruik van twee marktspecifieke gebieden: (i) kansen in de vastgoedkapitaalmarkt met grote bedragen en (ii) het herpositioneren van geworven vastgoed, nadat waarde is toegevoegd.

IV - Het vierde type is de groep Europese vastgoedbedrijven, die niet in eigendom zijn van institutionele beleggers. Deze vastgoedonderneming is een onderdeel van een bedrijf, wiens hoofdbedrijfsactiviteit niets met vastgoed te maken heeft. Het doel van dit onafhankelijke onderdeel is het maken van winst en het aantrekken van nieuwe investeerders om sale-and-lease-back constructies mee te maken.

Niet-beursgenoteerde vastgoedfondsen investeren in een divers aantal sectoren en dat maakt het de institutionele belegger makkelijker om de portefeuille te spreiden. Meer dan de helft van alle niet-beursgenoteerde vastgoedfondsen (52,4 procent) investeert in één land en één sector, terwijl er minder fondsen zijn die spreiden over landen en zich specialiseren in één sector (7,6 procent) dan fondsen die zich specialiseren op één land en spreiden over sectoren (23,8 procent). Sommige onderzoekers geloven dat de vraag naar fondsen met een standaard portefeuille, die over sectoren en landen is gespreid de komende jaren zal afnemen, hoewel 16,2 procent van de niet-beursgenoteerde vastgoedfondsen deze strategie nog gebruiken.

De belangrijkste trend die het investeringsklimaat vandaag de dag beïnvloedt is de introductie van de euro. Het zal de kapitaalstromen tussen de Europese landen stimuleren, omdat investeerders investeringen kunnen doen zonder valutarisico. Institutionele beleggers zullen meer mogelijkheden krijgen om gebruik te maken van buitenlands vastgoed, om zodoende hun spreidingsvoordelen te vergroten. De Europese niet-beursgenoteerde vastgoedfondsen zullen in toenemende mate zich mogen verheugen op interesse vanuit beleggers, met name vanuit de grote pensioenfondsen met een wereldwijde portefeuille. De meeste niet-beursgenoteerde vastgoedfondsen zullen zich specialiseren in een specifieke sector en regio. Gespecialiseerde ondernemende niet-beursgenoteerde vastgoedfondsen zullen makkelijker kapitaal kunnen aantrekken dan fondsen met een gespreide portefeuille. Deze fondsen zullen risico's durven te nemen om waarde te creëren voor hun aandeelhouders, hun winsten te maximaliseren en hun concurrenten voorbij te streven.

Europese bedrijven zullen de Amerikaanse trend volgen van het van de balans brengen van vastgoed eigendommen om zo het vrijgemaakte kapitaal te gebruiken voor de hoofdbedrijfsactiviteit. Significante mogelijkheden om niet-beursgenoteerde vastgoed-

fondsen te vormen ontstaan zodra deze verandering plaats vindt. Alle genoemde trends aan de aanbod- en vraagzijde van de markt creëren het nieuwe evenwicht in de markt voor Europese niet-beursgenoteerde vastgoedfondsen.

Niet-genoteerde vastgoedfondsen worden geconfronteerd met een toename aan interesse vanuit beleggers, omdat ze de voordelen van direct en beursgenoteerd vastgoed combineren. De fondsen hebben vijf voordelen ten opzichte van directe vastgoed investeringen. (i) Kleine hoeveelheden kapitaal kunnen in gediversificeerde vastgoedportefeuilles worden geïnvesteerd, (ii) het gebruik van de lokale kennis van het fonds, (iii) lagere transactie kosten, (iv) minder object specifiek risico en (v) de fondsen zijn minder management intensief.

1 Introduction

1.1 Background

Financial theory stresses the need to diversify portfolios across different types of assets to obtain the optimal risk and return trade-offs. Traditionally the asset mix of institutional investors - pension funds and insurance companies - has consisted of stocks, bonds and cash. When American research in the late 1970's reported that returns on real estate were comparable to those earned on common stocks, the US government acknowledged real estate as a suitable asset class for multi-asset pension plan portfolios. European governments followed some years later.

Since the 1980's investment managers and advisory firms have helped institutional investors fulfil their real estate allocation goals, which according to Henderson Global Investors usually counts 5 to 10 percent of the investor's total assets . Real estate investments can be characterised by long-term return and relatively low risk. To date, managers and advisory firms have created a wide range of real estate-based investment vehicles, which can be categorised in four main sectors. This thesis is focused on the grey marked quadrant of table 1. These grey marked cells can be found in tables throughout this paper.

	public market	private market
debt	commercial mortgage backed securities	participating loans convertible loans traditional mortgage lending
equity	real estate investment trusts listed real estate operating companies	direct property investment indirect investment vehicles - commingled funds - joint ventures - limited partnerships

Table 1 The real estate capital market sectors

There are major differences between countries in the use of these vehicles. Americans make the most use of all the different vehicles and Europe is lagging some years behind. These country specific differences are typical for the real estate market, and this thesis will deal with that theme several times. Two examples of country specific differences are the height of the property transefer tax and the availability of tax efficient vehicles.

1.2 Formulation of the problem and research objective

As mentioned before, there have been several studies examining real estate as an asset class. Most studies to date have focused on the risk/return issues of real estate and on certain securitized investment vehicles, mostly REITs and commercial mortgage backed securities. Earlier research covering direct real estate investments has focused on property level returns and factors relating to portfolio performance[1]. Some studies have also looked at the role geography in a diversification strategy[2] or on the role of real estate private equity fund managers[3]. To my review of research literature there have only been a few empirical studies conducted on the performance of the real estate private equity market. These studies often focused on small parts of the market, like opportunity funds[4] or direct property investments, and not on the market of indirect investment vehicles or real estate private equity vehicles as a whole.

With regard to the European focused real estate private equity funds, the availability of historical performance information is extremely limited. Although the Investment Property Databank does have historical performance information on private equity vehicles from the United Kingdom and Ireland, the returns are not generally representative for the rest of the European property market. Additionally the confidential nature of real estate private equity funds makes the data collection difficult.

Fortunately Global Property Research, a subsidiary of merchant bank Kempen & Co, gave me the opportunity to do a six-month internship in Amsterdam. This financial consultancy firm, focused on real estate securities, recently expanded its research activities into the private equity market. GPR's service is based on a comprehensive database including all listed property companies in the world. This database contains information regarding performance, management and finance. GPR's experience of databases creates a stimulating academic environment for interns and gives the best possible start to do

1 Mueller and Laposa (1995), Gold (1996)
2 Mueller and Ziering (1992)
3 Miles and Etsy (1982)
4 Spencer (2000)

research into the real estate private equity market.

Because of possible speech confusions and the difference between the complete real estate private equity market and the market of real estate private equity funds, from this point real estate private equity funds are called non-listed property funds. These funds form together with the direct real estate investment market, the real estate private equity market. Therefore the problem statement of this thesis can now be formulated. 'It is unclear how the European non-listed property fund market looks like'. Two additional questions can be formulated.

- Why do institutional investors choose to invest in European non-listed property funds?
- What can be expected of European non-listed property funds in the future?

Summarised, the research question for this thesis can be formulated as: 'How does the European non-listed property fund market look like, and what is the impact of the changes - in the real estate investment market - on the decisions of institutional investors to invest in the non-listed property fund market?' With the formulation of the research question the following sub-questions appear:

- Why do some non-listed property funds have more success in raising equity?
- What are the trends in the non-listed property fund market?
- In what direction are non-listed property funds developing?

The ability to add value is the key selling point of a property fund manager. Therefore we will also address the critical success factors for adding value.

1.3 Research method

The research in this thesis can be described as an analysis of a market. Because of the opaqueness of the market an exploring approach was used. In this exploring approach we will go through the empirical cycle more often than normal testing-approach research does. In this case the empirical cycle can be split is two segments, (i) testing a model with the latest results from the market analysis and (ii) changing the model and demarcating

the research. Testing and changing by turn makes the model more complicated and takes our provisional model and theory as close as possible to reality. The research methodology can be divided in six phases.

- Analysing literature and news sources to collect data
- Interviewing industry professionals to collect data
- Using the data to define the model and demarcate the research
- Making two scenarios based on two different market situations
- Making predictions based on the scenarios and the model
- Making conclusions based on the predictions, the scenarios, the model and data.

The first phase comprised the activities of processing incoming responses in a database and sending out lists with fund names to industry experts (appendix 2) from the United Kingdom and The Netherlands. Subsequently interviews with these experts were held. As soon as the final model was defined (table 5), two scenarios were made which were tested to the model. Afterwards predictions combined with current trends in the real estate market were developed into a conclusion. The quality of the analysis of the market is strongly related to the quality of the first phase, the data-collection.

1.3.1 Data collection

Empirical research needs data, and therefore a database had to be made. Based on the structure of Global Property Research's database a new file was made and filled with data of non-listed funds.

The three options that were available to investigate the 'European market' were to look at property investment vehicles in the countries that (1) are a member of the European Union, (2) are adopting the euro or (3) form a group like the Benelux. Because option 2 and 3 would exclude important real estate focused countries like the United Kingdom, option 1 was selected for this thesis. Including the central European countries in this thesis was not an option because language problems and more intransparency could be expected. The names of the 15 European Union members are descending in size: Germany, France, Italy, United Kingdom, Spain, The Netherlands, Belgium, Greece, Portugal, Sweden, Austria, Denmark, Finland, Ireland, and Luxembourg.

To find information of European-focused non-listed property funds operating in the European Union, several sources were used.

1. MIPIM's[5] online database
2. Freeman's guide to the property industry
3. Magazines[6]
4. Internet in general

The funds that were found through this selection gave the first rough analysis of the market size. This resulted in a list of 150 non-listed funds. Funds operated from Greece appeared to be not available at all. At the same time many European fund managers, who operated a fund from one of the major capitals of Europe used tax-friendly regions like Luxembourg or the Channel Islands to register their vehicles. It was clear was that requirements had to be made to for include a comparable and consistent type of vehicles. And because the available time to write this thesis was limited and the impossibilities to get a good view on all non-listed funds, we choose these requirements to exclude funds.

The fund:
- invests in European property only
- is operated from a country that is member of the European Union
- has institutional investors as stakeholders and no retail investors
- is not listed on a securities exchange - it has no continuous price-fixing -
- has at least two real estate investments - two buildings -
- has a clear legal structure
- has a portfolio size of at least 25 million euros
- the fund's major income is generated by rental income - no major developments -

As the list of requirements mentions, the vehicle has to be registered in a member country of the European Union, but the fund itself is allowed to invest in the complete direct European real estate market. This exception is made because several funds appeared to have small stakes in central European property. Another exception is made for property funds that are owned by non-property companies (see also chapter 3.1.4), if these non-

[5] One of the world's biggest real estate conferences yearly held in Cannes, France

[6] e.g. Europroperty, Immobilien Business, Property Week and Vastgoedmarkt

property companies have serious plans to invite a second investor in the fund. The property investment fund categories that are included in this thesis are extensively described in detail in chapter 3.

For some countries it was very difficult to find out what the current market situation was. While the French property professionals have been working in their home market for years in a way they are used to, Finnish property companies make their annual reports, booklets and web-sites in Finnish only. The only way to get information from these countries was to get some basic knowledge of the main real estate related words in the foreign language. These 'islands of information' in the European market will probably disappear when the European property investment market will become reality. While the data collection resulted in dozens of documents, annual reports and emails, the inside information that real estate professionals shared was probably most useful.

The most important funds that were excluded are (i) property funds with investments in Europe but operated from outside the EU15, (ii) property funds with a global diversification, and (iii) property funds with retail and institutional investors. The first and second group of excluded funds included the European-focused opportunity funds operated mainly from the United States and Switzerland. It was impossible to compare their investments in European property, because only rough data was available. The third group includes many small limited partnerships, mainly initiated by a financial institution or fund manager. The importance of these small limited partnership is diminishing because a decreasing number of retail investors wants to keep involved in the investment of their own pension savings.

1.3.2 Demarcation of the research

To demarcate the research and to place the vehicles of the quadrant from table 1 into a first model, we have to go back to the three basic property investment possibilities for institutional investors. Direct property investments, non-listed property funds, and listed property funds.

Table 2 The first model: three property investment possibilities

While this thesis only deals with the investment vehicle in the middle, together with the listed funds they form the indirect property market, and are considered increasingly important as the focus of institutional investors moves to the right side of this model. If it would be true that institutional investors regard the indirect property investment market as one entity, the total non-listed property funds market could show a similar market value as the current European listed property market with a market capitalisation of approximately 130 billion euros.

Now we have looked at horizontal demarcation, we have to determine which information of the non-listed funds should be collected. Using Global Property Research's database of listed property funds as an example, we made four categories of data. In comparison with GPR's database, this collection did not contain information about stock-listing (there is no listing), vacancy (no information was available) and profit loss account (only a few companies provided data).

- General information
- Diversification
- Short balance sheet
- Additional information (legal structure, development activities)

The first group of information contains addresses, the composition of the management team and the name of the company that makes the independent valuation. Diversification information is available per sector and per country. The third category is a short balance sheet, which is split in assets and liabilities. Assets are divided in fixed, current and other assets, where fixed assets are considered the same as the value of the property portfolio. The liabilities are split in long- and short-term debt, equity, provi-

sions, minority interests and other liabilities. The last category of data holds information like current shareholders, legal structure and development activities. The distribution over legal structures can be found in table 7. Property companies that had more development activities than property holdings were also not included (page 19). Besides these categories some companies were asked additional questions (appendix 1) to check the reasons behind the choices.

2 Institutional investors and the European real estate market

In contradiction to the three investment possibilities of the model in chapter 1.3.2, some institutional investors use a different model to define the variety of property investment possibilities. Mn-Services uses three sub-categories for non-listed property funds (table 3[7]).

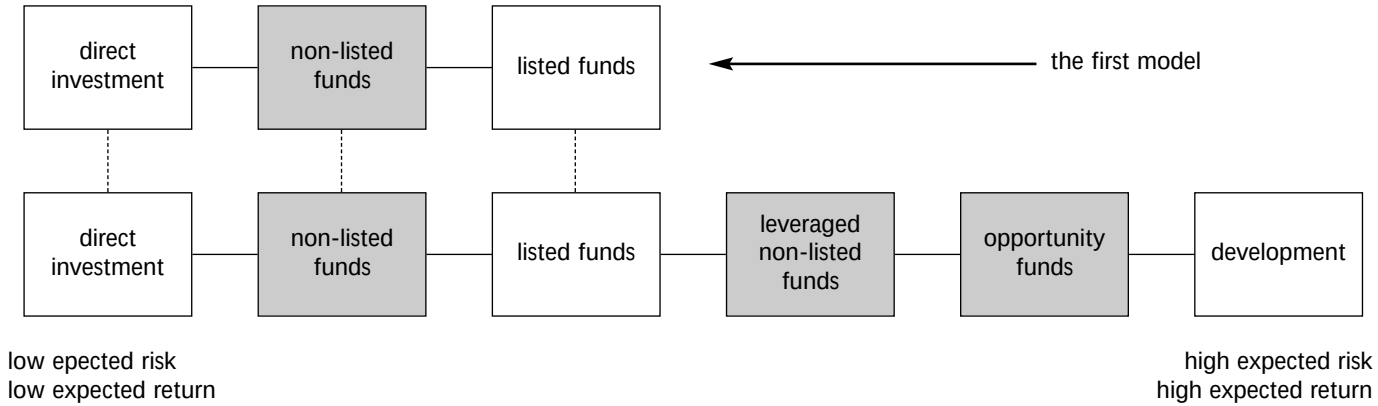

Table 3 The second model: six property investment possibilities

The model shows where the property investment possibilities are positioned with respect to each other. The non-listed funds have been split into two groups, one group without - the British often say gearing - leverage and one group with leverage. In fact, non-listed funds without any leverage do not exist. The difference that Mn-Services wanted to address is funds with a little bit of leverage against funds with more than 50 percent leverage. The latter group use equity debt ratios up to 70 percent to increase their return on equity performance. The opportunity funds were kept separate because of their focus on specific niche markets, very limited life span and high returns.

[7] VOGON meeting September 2000, presentation Mn-Services/BPMT

While institutional investors are re-thinking their real estate strategy, more and more replace their direct holdings by indirect vehicles. Some, especially pension funds, place their direct portfolios in a non-listed fund and others are looking for a candidate to merge portfolios. At the same time on the sell side, listed funds are taken private, while other funds have their initial public offering. This makes clear that properties have moved along this risk return graph in the past and will do so in the future. Two questions appear: What does this mean for the market share of non-listed property funds and what is the best vehicle to use?

The best vehicle to use for a particular fund will depend on the precise facts and circumstances of that fund. In structuring a property fund, there are five key goals[8]. (i) Marketability is important because if a fund doesn't meet the regulations, you will not be able to sell it. (ii) Flexibility, fund sponsors should have a solid investment plan and be prepared to react quickly to unanticipated events. (iii) Running costs must be acceptable. (iv) Liability must be limited as much as possible (v) Tax efficiency, this means that the fund itself is not a separate taxable entity, but each investor is taxed in its share of the fund's income in accordance with its own tax status. Tax efficiency of a fund is measured by comparing the amount of overall additional costs incurred by investors to the taxes they would have incurred if they had invested directly in the underlying investments. This is particularly important for investors such as pension funds, which are normally exempt from taxation by law. Investing in the property through a taxable vehicle would reduce a pension fund's net return. Some European countries have introduced special tax transparent vehicles for property investment, the best known being the real estate investment trust (REIT) in the United States. The European countries have not yet introduced an equivalent vehicle, and there are no announced plans to do so. A variety of different collective investment vehicles are therefore used to form property vehicles in Europe.

Used vehicles can be divided in (i) investment corporations and (ii) investment partnerships. Investment corporations are often limited liability companies, or a European equivalent[9]. The advantages of this business form are limited liability, ease of marketability of ownership shares, generally centralised and constant management, and a perpetual life for the business. However, income earned by a corporation is taxed twice,

[8] Global Real Estate Now, PWC 2000, other minor goals are method of creation and duration

[9] e.g. Naamloze Vennootschap in the Netherlands, Aktien Gesellschaft in Germany, Sociedad Anónima in Spain, Sociedade Anonima in Portugal and Société Anonyme in France

once at the corporate rate and again when dividends are distributed to shareholders. In addition, tax losses can only offset previous tax payments at the corporate rate. Finally, for some small companies, it may be more expensive and time consuming to form a corporation or to dissolve one than to use the partnership form.

The ownership of an investment partnership is split in participation units. These funds use limited partnerships or a European equivalent[10] as a vehicle. Limited partnerships attempt to secure the best of both worlds: limited liability on the part of the limited partners and taxation at personal rates. This form also requires a general partner (or partners) to serve as managing agent for the entire operation. In addition, termination provisions are typically provided in the agreement. However marketability is somewhat difficult due to problems with transfer of ownership, and withdrawal of the general partner can terminate the partnership agreement. Therefore limited partnerships would be attractive to investors who seek a passive investment, free of management problems and obligations, and one in which liability is limited to the amount invested, tax losses offset ordinary income, and where marketability is not the most important consideration.

	taxation status	management	duration
limited partnership	flow through (single)	general partners have equal voice, limited partners have no voice	termination provided in the agreement
limited liability companies	non-flow through (double)	shareholders elect directors who set policy	perpetual

Table 4 Differences of business organisations

In some European countries investments companies can apply for the status of a fiscal investment institution. In the Dutch situation, when a company is granted for this legal form, the company will benefit a lower - in this case 0 percent instead of 35 percent - corporate tax rate and capital gains can be re-invested. This means that in case a Dutch pension fund invests in a property investment company that is a fiscal investment institution, the tax burden will be zero percent. Against this there is an obligation to distrib-

[10] e.g. Commanditaire Vennootschap in the Netherlands, Kommanditegesellschaft in Germany and Société Commandite in France

ute the annual profit as a dividend not later than eight months after the end of the financial year. In the Dutch situation, these advantages of a fiscal investment institution encourage property funds neither to develop any properties themselves nor to undertake any other entrepreneurial projects. An extra disadvantage is that non-resident investors in the fund are subject to a 25 percent withholding tax.

Current Issue 2-1: Tax regime in the United Kingdom
In the United Kingdom a specific regulatory or tax regime for property companies does not exist. Property companies are taxed on their profits and gains at 30 percent. This is one of the reasons why the sector has under-performed the London stock market overall, and the reason why so many UK property companies are so heavily involved in development.

It is expected that the recent move of mergers and acquisitions in Europe could create a number of very big pan-European property funds. These funds will spread their investments throughout Europe and will have shareholders from all over the world. While finding a tax efficient structure becomes more complex with each added category of investors. The consequence of the principle that income generated from real estate will be taxed in the country where the property is, makes it impossible to keep the European property funds or their shareholders from the different fiscal and legal jurisdictions. And if these European funds want to compete with the local property funds, fiscal barriers should be broken. Some researchers claim that tax should only be imposed in the countries where the property is, while the country where fund and shareholders are based should be irrelevant.

2.1 Institutional investors and the EMU

There has never been a project in history as big as the formation of the Economic and Monetary Union in Europe. It has been the biggest challenge of the European Union since it's foundation in 1957. As Europe makes the biggest step forward in the integration process, the implications of the introduction of the euro in 12 nations have been noticeable since 1996.

- Inflation, long-term interest rates, budgetary deficits and national debts converged
- As the currency risk fell off, the capital flows within Europe increased
- Convergence of the EMU economies

The Euro-zone creates an economy of 290 million people, comparable in size to the United States. The three EU member states that remain outside the Euro-zone are Denmark, United Kingdom and Sweden. It is uncertain how long their lack of enthusiasm about joining Europe's single currency will stand.

The creation of the Euro-zone will also have a regional effect, with trade becoming increasingly inter-regional. Already, European Union countries trade predominantly with each other. Even in the United Kingdom, which likes to emphasize its trade tie and 'special relationship' with the United States, two-thirds of its trade is with other European Union countries. On the longer term all European markets will continue to see convergence in economical growth, short-term interest rates and unemployment. But if inflation drops, the importance of the asset real estate, which is often used as a hedge against inflation, could decrease too.

In real estate, Dutch and British investors have traditionally been quite internationally minded, led by the pension funds of big multinationals like Royal Dutch Shell and Unilever. But for most continental property investors this wasn't true and they stayed investing in their countries. In case of pension funds, until recently many European funds were restricted in investing abroad. German pension funds were only allowed to put up to 20 percent at risk, while the French were forced to invest at least 50 percent of their money in government bonds. Depending on the country, a whole range of investment restrictions existed, but thanks to the euro, many of these restrictions have been eliminated. Instead, the 'prudent man rule' is beginning to obtain, at least in the United Kingdom and the Netherlands. This rule implies that funds managers can do what they like as long as they meet requirements for diversification and risk management. If the investments of institutional investors are subject to restrictions, they cannot go to where the returns are highest, and this makes a difference to pension premiums. Research shows that in the liberalised United Kingdom the returns of investments by pension fund are 2 percent higher than in France.

Current Issue 2-2: Corporate tax for Dutch pension funds
Dutch pension funds do not have to pay corporate tax by law. In this way pension insurance companies can not compete with pension funds and normal competition is not possible. Some experts believe that if competition is created by demanding pension funds to pay corporate tax, the Dutch corporate tax rate of 35 percent could be lowered with around 1000 basis points.

Pension systems in the European Union will become more individualised and will move from 'pay-as-you-go' to funded pension systems. In a 'pay-as-you-go' pension scheme, the working society is paying for the pensioners at that time, while funded pension schemes are based on capitalisation instead of distribution. These funded pension systems demand more investments for property assets. In support of this view, the Netherlands and the United Kingdom already have strongly funded pension systems, and in both these countries, property is very important. But in countries like France the pension sector functions more as an extension of the French social security system than as institutional investors. In case of unemployment, benefit agencies, the employer's confederation and the trade unions have a significant say in the commercial policies of the French pension funds.

In twenty year's time, the European Union's dependency ratio - the ratio between the working men and pensioners - will increase from 3.5-1.0 to 2.5-1.0[11]. According to Eurostat, only the European countries Ireland, Portugal and the metropolitan areas of big cities will not have to deal with the ageing of the population to this extent. The change of the dependency ratio will result in higher expenses in healthcare and pensions for institutional investors. Pension funds in European countries with 'pay-as-you-go' pension schemes will have more problems with the changing population.

A changing dependency ratio will cause troubles in guaranteeing the payment to the pensioners. Some researchers claim that the pension schemes based on distribution are the biggest danger for the western society. The government in Germany already took some first steps to change the system to a funded pension plan. It is clear that the reformation of the pension funds will have a big impact on Europe's capital markets. Before the United States changed to fully funded pension systems in 1974 the total invested

[11] Pension funds in Europe, Vastgoedmarkt August 2000, Winters

capital was 300 million US dollars. At this moment the total invested capital by funded US pension schemes is 4,500 billion dollars. If the Euro-zone will face similar developments in the coming two decades, the invested capital by institutional investors will increase dramatically. Research by Eurostat shows us that in 1998 the total capital invested by institutional investors from the European Union already counts 5,184 billion euros[12]. This can be divided in 3,721 billion euros (71.8%), invested by insurance companies and 1,463 billion euros (28.2%) invested by European pension funds, see figure 2. This latter number excluded the investments of pension funds from EU members: Germany, France, Ireland, Greece and Luxembourg, because these countries don't gather data about pension funds. The number also didn't include other investment companies, because of their relative small size and the lack of data.

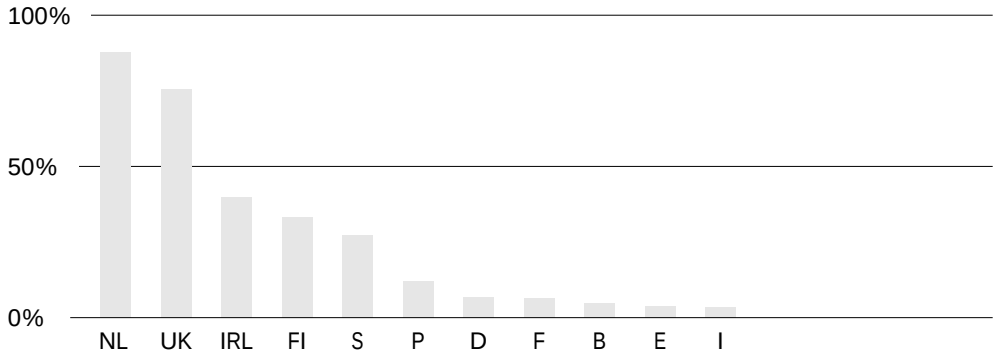

Figure 1 Total capital pension funds in percentage of GNP (1999)

Calculations forecast, in case of the development from an 'pay-as-you-go' to a funded pension scheme with invested capital as high as 60 percent of the gross national product, an increase in invested capital of 130 billion Euro a year. This will result in 3,300 billion euros extra investments within 25 years. And as the pension structures are changing in the near future, a move towards more equity based investments can be expected. With a prudent asset diversification, the increasing call for equities could also lead to an increasing share of pension funds investing in risk capital, which could stimulate the European enterprise sector. But even when we take a normal asset-mix where 10 percent

[12] Eurostat, Special feature on insurance and pension funds (2000)

of the capital is invested in real estate, European pension funds have to look for an annual 13 billion euros in property investments extra, in order to maintain their asset allocation. This demand for property investments will have great impact on the European property investment market.

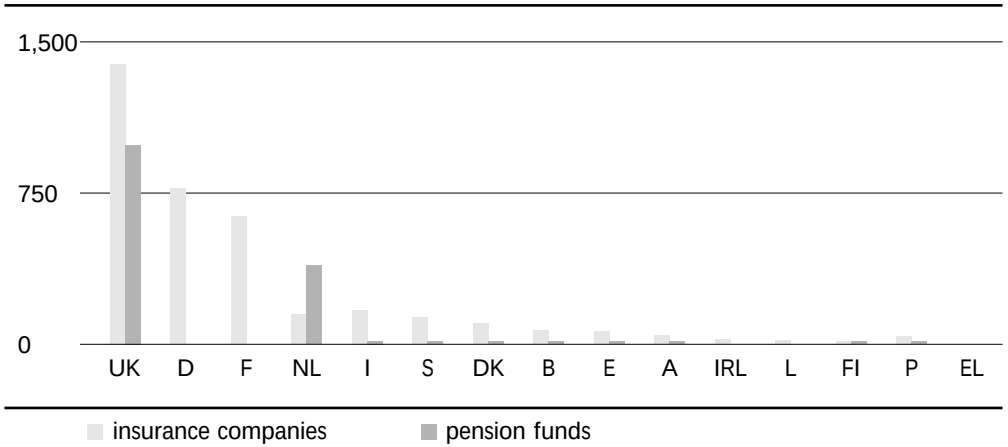

Figure 2 Total investments by European institutional investors in billion euros (1998). The United Kingdom is the absolute number one with 2,370 billion euros in investments

After looking at the invested capital of European pension funds and insurance companies, we will now focus on the diversification of the investments. Figure 3 shows us the percentage of direct real estate investments made by insurance companies and pension funds. The weighted average of these direct property investments made by these European institutional investors is also displayed, except when no data for one of the groups of institutional investor was available. The figure clearly shows the missing data from the pension funds from Germany, France, Ireland, Greece and Luxembourg. The average percentage (AV in figure 3) of direct real estate investments for insurance companies is 5.25 percent (195.4 billion euros). The average for pension funds is 4.17 percent (61.1 billion euros). These numbers exclude indirect real estate investments.

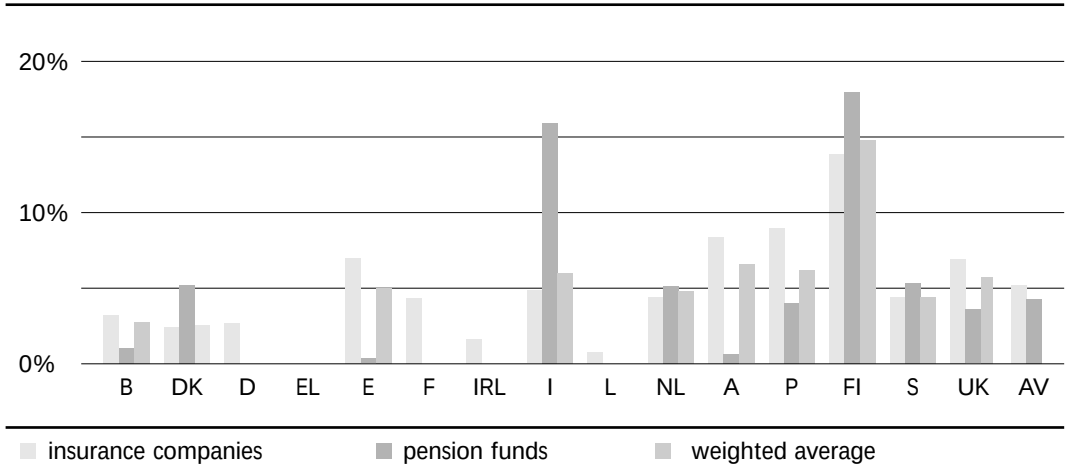

Figure 3 Percentage in direct real estate investments by European institutional investors (1998)

Although we now know what the percentage of direct property investments by institutional investors from the European Union is from the buy-side, we don't know what this says about the size of the sell-side of European property funds. And the numbers in figure 3 also don't tell us, which part of these European investments is made in European property or in property outside Europe. We also don't know how much non-EU countries invest in European property. An extra disadvantage is that some researchers consider investments in non-listed property funds as a form of direct real estate investment, while others like Eurostat, include non-listed property funds in other categories. It is therefore very difficult to convert these buy-side numbers to sell-side numbers. The following figure was made based on Eurostat's numbers.

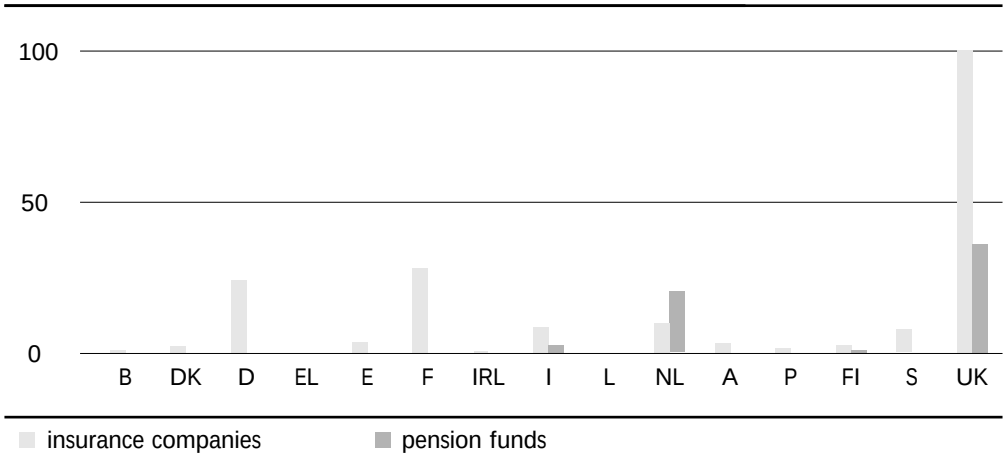

Figure 4 Total investments in direct real estate investments by European institutional investors in billion euros (1998)

The enlargement of European property investments can fortify the trend of indirect real estate investments and can increase the importance of indirect real estate vehicles. At the same time a process could start, where big owner-occupiers will bring their property to the market and be securitise them. These owner-occupiers will include large companies and municipal property, which are regularly unaware of the value of their properties. According to research of Jones Lang LaSalle, 71 percent of Europe's commercial real estate is owned by occupiers, while this percentage is 20 percent in the United States. The private property companies owned by owner-occupiers are discussed on page 50.

It is clear that institutional investors have to make several strategic choices in the future. According to Winters in Vastgoedmarkt, the strategic considerations that are at stake are displayed in figure 5. Pension funds based on distribution will start with a property portfolio in several sectors in their own country (the upper circle) before investing abroad. While pension funds based on capitalisation have a different starting-point. Their portfolio can be split into several sub-portfolios (the lower circle in figure 5) which are focused on specific markets and countries. At a certain property portfolio size, both types of pension funds will be in a need to add extra international real estate investments in the portfolio (arrows). It is interesting to see if these new European capital-flows will

flood well-developed property markets like the property market in the United Kingdom, or that the European money will start to flow to new opportunistic markets.

	indirect real estate vehicles listed non-listed	direct real estate vehicles
few sectors in a few countries	correlation with stock exchange sentiment, liquidity	management intense, transparent market
few sectors in one countriy		
one sector in a few countries		sector specialisation
one sector in one country	transaction costs control	

Figure 5 Strategic decisions for European institutional investors according to Winters[13]

We end this chapter with an example of the Dutch situation including numbers from 1998.

Current Issue 2-3: Dutch institutional investors and property (numbers 1998)[13]
The Dutch institutional investors had 612.4 billion euros in investments, with 38.4 billion euros (6.27%) in property, divided in 29.9 billion Euro (4.88%, in figure 3) invested in direct property and 8.5 billion euros (1.39%) in indirect real estate vehicles. From the 38.4 billion euros invested in property, approximately 19.2 billion euros (50%) is invested abroad and the other half is invested in the Netherlands. The most popular foreign countries are in descending order: the United States (10 billion euros), France and the United Kingdom (both 2 billion euros). In general one can say that indirect real estate vehicles are more often used for property investments abroad, while direct investments are often (77.8% in case of Dutch pension funds) used for domestic exposure.

[13] Vastgoedmarkt October 2000

2.2 Diversification

Pension funds and other institutional investors have long accepted the role of domestic real estate in their multi-asset portfolios. Several studies[14] have concluded that pension funds should hold between 5 and 15 percent of their portfolios in the domestic real estate market, primarily for diversification reasons, but also as a hedge against inflation and for superior return performance in certain periods. In the current (1999) Dutch situation pension funds hold 10.9 percent of their portfolio in real estate[15], of which the biggest part (6.3%) is hold in direct real estate investments and the rest (4.6%) in indirect real estate vehicles. The real estate allocation of Dutch insurance companies has significantly decreased over the last 25 years from 16.1 percent in 1976 to 4.1 percent in 1999. It is remarkable that the percentage in indirect real estate vehicles compared to the total property investments by insurance companies differs from this percentage by pension funds. While pension funds hold 42.4 percent of their real estate investments in these vehicles, insurance companies use the vehicles rarely (only 7.8 percent). This difference can be explained by the ALM-studies institutional investors use to diversify their portfolios. These studies investigate the funds optimal asset diversification based on the risk-return profile of the asset classes and the (expected) premium income. The longer investment horizon of pension funds and their goal to achieve a modest real return can explain the big difference between their high percentage in indirect real estate vehicles, which are risky on the short-term. Insurance companies are more focused on nominal returns. Several studies have examined how real estate itself should be diversified. Two classifications have generally been used in the analysis of diversification: diversification by property type and by geographic region.

2.2.1 Diversification by property type

The property investment market can be divided in several sub-markets. While many professionals distinguish three major sectors: offices, residential and retail, more and more add to these three the sector industrial. The industrial sector has recently gained attention from investors, because opportunities seemed to be available in warehousing-property. Besides the four sectors, smaller sectors and sub-markets - a group of a specific property type from one of the four main markets - can also be defined.

[14] Hartzell (1986); Ross and Zisler (1990) and Giliberto (1991)

[15] Vastgoedmarkt October 2000

Some examples of sub-markets and small property sectors

- Office sub-markets: serviced offices
- Retail sub-markets: shopping centres, inner city shops, leisure property and factory outlets centers (foc)
- Residential sub-markets: luxurious apartments, single family houses
- Small sectors: hotels, carrier-hotels (data-centres), parkings and airports

It is clear that every property sector needs management with special knowledge, and this is especially the case for the smaller sub-markets and sectors. And because some small markets are performing better than the average property market, investors are often looking for extra exposure in indirect property investment opportunities in these smaller markets to use the fund's inside information, in-house management and market knowledge. Some property companies in these niche markets have recently experienced interesting attention of investors. The success of the Prologis European property fund, with 15 institutional investors as partners can be caused by the lack of interest in industrial property in the last decade. In some cases institutional investors initiated specialised property companies themselves to have access to a certain niche market. An example is the car parking company Q-park, owned by six Dutch institutional investors.

Some investors put question marks with these specialised property companies. They question whether property companies specialised in parking and hotels behave as a real property investments or behave more like a normal company that generates income on property management. While the investment return is often related to the performance of the company and not directly to the leases of hotel rooms or parking places, the link is now much closer than in case of an office building and his tenants. These specialised funds are often involved in development, what makes them more than a simple property investment vehicle. Academic research often supports the 80 - 20 percentage, where a minimum of 80 percent of the income is generated by rents. An analysis on the diversification of the European non-listed property funds can be found in chapter 4.

2.2.2 Diversification by geographic region

Total returns on property investments are highly related to macro economic factors like local interest rates and inflation. In general wide spreads between local yields and inter-

est rates only occur on short term. This relation is and the fact that property markets are locally driven, are the two reasons why international property investment can be a very effective way to spread the risk of a property portfolio.

Nevertheless, while stock investors quite commonly invest abroad, property investors only do so very rarely, with the investors from the United Kingdom and The Netherlands as notable exceptions. One important causation factor is that international investments through direct property markets are less efficient than the public stock markets, which involves less information costs. International investors always face a trade-off between diversification benefits and information costs, the optimal point on that trade-off being determined by the efficiency of the markets in which they operate. If markets are very inefficient, the information costs may be so high that all potential benefits of international diversification are outweighed. In that case, international investment will not occur.

Some academic literature supports economic, rather than purely geographical diversification[16]. These economic diversification studies analysed the basic economic components of regions to determine efficient diversification strategies. These studies typically focus on employment as classifying variable, making a demand-side connection to the real estate market. Although there have been no tests of portfolio performance using these categories and specific property return data; the intuition behind the approach is appealing. A property fund focused on the geographical micro-market of offices in the surroundings of urban railway stations is the Dutch Vasloc[17]. The fund welcomed many interested investors at the start in early 2000. Investors apparently appreciate this type of regional focus too.

One of the key questions involved in a regional specialised property fund is whether the fund manager is planning to operate on a regional, pan-European or world-wide basis. Investors will have to identify if the fund manager has found the right equilibrium between the potential benefits of a more geographically spread portfolio and the benefits of smaller property units. More about diversification trends of non-listed property funds can be found in chapter 4. For several years the Dutch property company Rodamco thought it could handle a multi-billion euro world-wide portfolio in one

[16] Hartzell, Shulman and Wurtzebach (1990)

[17] also known as 'stationslocatie fonds'

organisation, but later decided to demerge into four more or less independent regionally focused real estate companies. Other property companies tried to resolve the disadvantage of the absence of local presence in targeted countries by the formation of alliances with local partners.

2.3 Securitisation

As already said, international investors always face a trade-off between diversification benefits and information costs, the optimal point on that trade-off being determined by the efficiency of the markets in which they operate. Investing in securitised vehicles are an efficient way to invest in specialised markets, but as these vehicles are slowly becoming available, some investors still have only non-listed property funds at theirs disposal. Only three European countries have a double-digit degree of securitisation of their property capital market (Germany 36% mainly due to the open-ended funds, United Kingdom 31% and France 13%). If we look at major trends in the real estate industry in the United States, we see that trend of securitisation of real estate and the trend to invest in indirect real estate funds dominates research topics. GPR made figure 6 of the total market capitalisation of the REIT market. The current size of the REIT market is about 125 billion US-dollars in North America and 115 billion euros in Europe.

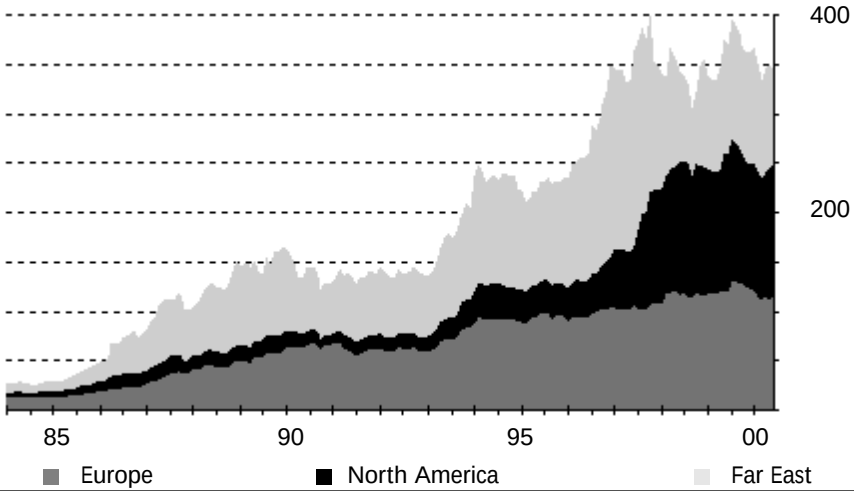

Figure 6 Market capitalisation in billion US dollars of listed property companies

The trend of securitisation of real estate companies through Initial Public Offerings (IPO) will result in a more liquid and more transparent market, partial by the fact that the transparent securitised funds can acquire capital in a more simple way. Other advantages of securitisation for the investor are the (i) cost and time efficient way transactions can be made, the (ii) well measurable performance, (iii) daily price information and the (iv) possibilities to grow the portfolio quickly. For the last couple of years the performance of the European real estate stocks have been quite poor. The question appears whether non-listed real estate companies should collect their equity at the public or private equity market in the near future.

At the same time securitisation brings several disadvantages. The most important is that securitisation adds unasked volatility. While direct portfolios are calculated on the basis of appraisals, what leads to smoothing and lagging of returns, property share returns are more volatile than the stable returns on the underlying property portfolio.

In this chapter we looked at the influence of changes on the buy side of the equity market and the demand for real estate investments. In the following chapters, the accent will be on the sell side of the market.

3 The European non-listed property fund market

In chapter 2, we looked from the buy side to the indirect property market. A deviation could be made between a listed part and non-listed part, where a stock exchange listing created a big difference in how the value and the performance of a property company are measured. In this chapter we will look from the sell side to the European-focused non-listed property funds market.

Before 1990 many Dutch listed property companies were open-ended, which meant that property companies could sell or buy back their share for prices around the net asset value of the company. Because of this, the analysts of property stocks were focused on making an estimation of the future net asset value of the company. But at a certain moment some Dutch listed property companies didn't have enough money to buy back any more share and were forced to transfer to an close-ended structure. And the analysts changed their valuation methods to the methods that are commonly used for other stocks like the 'cash-flow approach', 'dividend discount model' or the 'return on dividend'.

Closed-ended structures have several advantages. (i) The share price of closed-ended listed property companies is a real-time market price, which is considered as the only honest value and always reflects the current market situation. If investors appreciate the company's management, share prices can show a premium to the net asset value of the property. In this way the remuneration of the management of a property company can be based on share price performance. Although many professionals think that remuneration based on property performance will stimulate the management's short-term thinking, and will harm the long-term profitability of the company. (ii) A closed-ended property fund invests in property only, while an open-ended property fund invests also a part of the funds capital in other assets (for example bonds). The German real estate market has an outstanding number of open-ended real estate funds issued by banks. The market that excludes these open-ended funds is called the quoted real estate market; the market that includes these vehicles is called listed.

For direct property investments and non-listed property funds, things haven't changed and the net asset value of these investments is still the way to resolve the value of the investment. Therefore valuation problems will occur in case of a split of a non-listed property fund or if one of the fund's shareholders wants to exit the investment vehicle.

3.1 Modelling the European non-listed property fund market

From the model with property investment possibilities in table 3, a new model is developed with four categories of non-listed property funds, which can be found in table 5. The table shows that non-listed pooled vehicles can be divided in investment funds (partnerships) and investment companies. The investment funds can be divided in non-opportunistic and opportunistic with high returns. The percentages behind the categories will be explained on page 56.

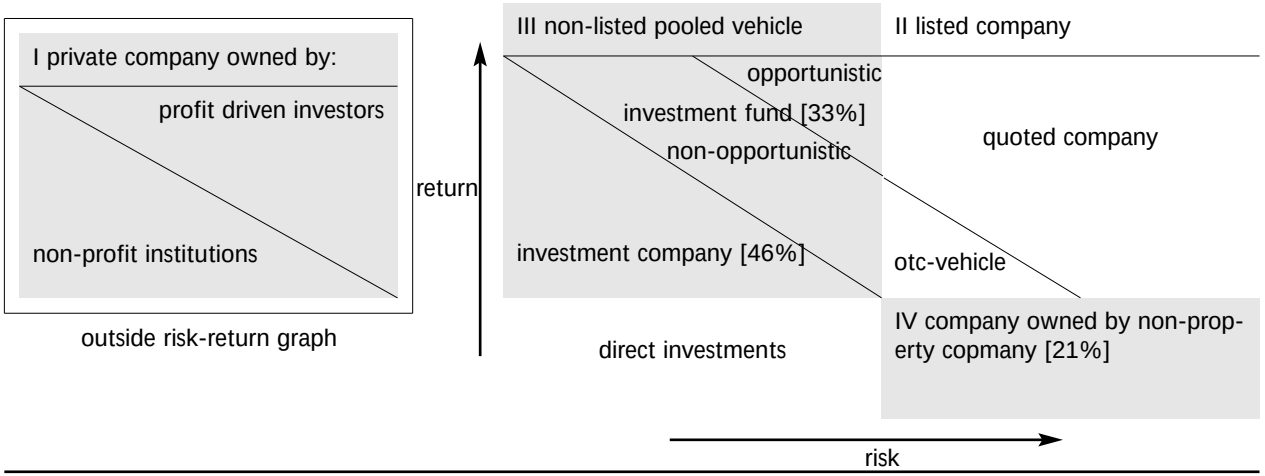

Table 5 The third model: more property investment possibilities

Group I: The first category in this model is the group of private property companies. This group can be divided in profit and non-profit oriented institutions. The first group is often indirectly owned by the central government.

This group includes property companies that operate:

- Social housing (housing associations)
- Infrastructure property (airports and railway stations)
- (Semi-) Government housing (Dutch Government Buildings Agency, Swedish Vasakronan)

In some EU15 countries, attempts are made to turn these property companies with the help of commercial companies into profit centres. It is interesting what governments will do with their property holdings. Will competition, in case of turning a property unit in a profit-centre, make accommodation more cost-efficient? Or will the sale of the shares in a property unit, turn out to be a nightmare, in which the wallets of the new shareholder are filled with profits? In the Netherlands a few years ago, the Government Buildings Agency experienced an unreliable investor that was involved in a sale and lease back structure of several jails. The question appears, if this structure for these specific building ads value for both parties. In the coming years more attempts will be made, and this will make clear if a future exists for a government housing organisation as profit-centre. These attempts need close investigation to rule out conflicts of interest.

The other half of this first group also contains very big portfolios. The difference is that these property companies are profit-driven and are owned by one or more private investors. Examples are Uitsluitend Mooie Winkelpanden, owned by three Dutch individuals, and UK-based Grosvenor Estates Holding, owned by the trusts of the Grosvenor family, headed by the 6th Duke of Westminster. Some of the owners of the companies in this sub-group specifically requested not to mention their company, as they would like to keep low profile. Others were more open, because they were involved in co-investments or searching for new shareholders. Many researchers who try to investigate this kind of companies face the understandable lack of information and transparency. This lack of information makes it impossible to add these private property companies to this research.

Group II: The second category is the group of listed property companies, which can be separated in quoted companies and over-the-counter (OTC) vehicles. Shares of stocks in

quoted companies are regularly traded on organised exchanges and their prizes are shown each day in the newspaper. In case of over-the counter vehicles, there is no organised exchange and a network of dealers trades the financial assets. Forms of over-the-counter vehicles are the German open-ended fund, the French SCPI and the property unit trust (PUT). Some of these markets have been quite popular, and in case of the 10-billion euro market of UK property unit trusts, liquidity is considered higher than investments in quoted property companies. The activity on the secondary market in property unit trusts have increased till 310 million euros per year (2000). The main disadvantage of this vehicle is that overseas investors are not allowed to invest in it. Many researchers believe these vehicles will distinguish in this decade, because of problems with marketability and competition of other investment vehicles.

Another key-issue of a quoted property company is the free float, the percentage of shares that is listed on the organised exchange. Some of the listed property companies have a free float of less than 20 percent. In this case the question comes up: Does the market capitalisation (amount of shares times the share price) reflect the current market value of the company, or is the share price overvalued because of a shortage of shares?

Sometimes property companies are owned by a listed property company (e.g. a US REIT) but operated as an independent profit centre by a European management team. Because listed property companies often have a majority stake in these property companies it won't be interesting to compare the latter with other non-listed property investments vehicles. At the same time institutional investors are also able invest indirectly in the non-listed property company by investing in the listed property company. An example is the listed Security Capital European Realty's majority stake in European property developer Akeler.

Group III and IV: The rest of the funds from the third model are included in this research and the rest of this chapter describes the differences within the group. The assumptions are based on the database non-listed (database status 2000) with information of these European funds. The combined market value of the property portfolio of these funds totals 60 billion euros. This property investment portfolio forms together with property investments in Europe by (i) overseas investment funds, (ii) investment funds with retail

investors and (iii) global diversified funds, the combined sell-side of the European indirect real estate private equity market. Research from Jones Lang LaSalle estimates that the European real estate capital market has a size of 245 billion euros (table 6), 7 percent of Europe's total real estate market. Owner-occupiers control, with a 71 percent stake, the European commercial real estate market that totals 3,400 billion euros. Public real estate still totals only 3 percent of the market with 115 billion euros in equity and debt. In the United States, public real estate totals 5 percent of the real estate capital market.

	private	private indirect	public	corporate occupiers
dept	275	30	15	2400
equity	325	245	100	

Table 6 European Real Estate Capital Market in billion euro (2000)

3.1.1 Non-listed investment companies

The traditional way to invest indirect in property is done by an investment in a non-listed property company with a limited liability status. This limitation of liability is an important advantage for most investors. The emergence of the non-listed property fund, providing a vehicle for smaller investments, has also brought with them the need for more frequent valuations, which are often carried out on a yearly basis. These valuations are determined by reference to transactions taking place in the market. In this principle way of valuation non-listed property companies defer most to listed property companies.

A non-listed property company is often formed by a group of collegial investors or in other cases a fund manager. This fund manager can be linked to a financial institution (for example the ING Office Fund) or a property company (for example property company Mc Arthur Glen). Trends in these non-listed investment companies can be found in chapter 4.

3.1.2 Non-opportunistic limited partnerships

Over the past few years the limited partnership has become a standard investment vehicle in the property world. Limited partnerships have invested in a diverse range of sectors and that makes it much easier for the institutional investor to diversify their portfolio. In essence, limited partnerships have a set life span and are restricted to a maximum amount of partners (e.g. an UK-partnership cannot exceed 20 members by law). The general partner has unlimited liability and the right to control and manage the venture, while for the others partners, liability is capped at the level of their capital contribution and control over management is limited.

Corporate governance for limited partnerships is rather different to that for normal corporations. Limited partners risk losing their limited liability status, if they take part in the management of the partnership. Although limited partners are allowed to appoint directors to the general partner company and for those directors to be given special powers, for example in relation to conflicts of interest arising in relation to the persons running the partnership. This can be particular useful if the partnership is involved in development being carried out by the general partner or persons connected with the general partner.

Because interests in limited partnerships are not readily marketable, a discount should be applied to the net asset value of the properties held within the limited partnership. This is similar to the discount applied by investors in the stock exchange to quoted property companies whose shares are, according some researchers in practice, still illiquid. The difference between a quoted property company and a limited partnership is the that when a partnership comes to an end and the property is sold, then the full net asset value should be recovered. Pressure from this direction suggests as short life as possible. However the institutional investors often don't want to run the risk of their activities being characterised as speculative 'trading'. They want the life span of the partnership to be as long as possible to satisfy advisers that the activity can be properly characterised as 'investment'. And as the market for limited partnerships grows, it is clear that the marketability of interests will become irrelevant.

An approach that has worked well in practice in the United Kingdom and The

Netherlands is the set up a partnership with a longish life span, e.g. 25 till 40 years, but allow it to be wound up at an earlier revised date. The first review might be after, seven or eight years. This should satisfy tax collectors that the intention is to continue as an investment and institutional investors that it is appropriate to treat interests in the partnership as having a value equal to the appropriate percentage of the net asset value. In practice the majority of investors will not want to wind up at the end of the initial period or on subsequent review dates. Provisions can therefore be included allowing those wanting to continue to buy out the interest of those wanting to leave. Those wanting to continue could set up a new limited partnership that would then have the right to acquire the property.

In the fall of the year 2000, the total level of secondary trading in UK limited partnerships was £500m. Despite growing confidence in holding property indirectly - £9bn of funds are now held in limited partnerships and the volume of secondary trading is still increasing - there are still reservations about liquidity in this secondary market. Very often pre-emption rights enable existing investors to match the highest bid to increase their exposure to an investment. This keeps outside bidders away from limited partnerships.

Some general partners have developed sophisticated structures to find a solution for the disadvantages of limited partnerships. The Triton Property Fund created feeder funds, which enabled investors to make a smaller financial commitment than would be possible for limited partners in the total fund. The Fund, formerly known as the Phillips and Drew Property Partnership, made a structure in which the fund itself is an English limited partnership with three feeder funds for different types of investors beneath it. One unauthorised property trust, a unit linked life company property fund, especially developed for investments of life companies, and a third feeder fund for new investors.
Because of 'tax efficient' and modern law for limited partnerships in countries like Jersey, Guernsey, the Cayman Islands, the Irish Republic and Luxembourg, it will remain standard to set up a limited partnership with a split capital. One part will be equity and the rest a loan. This structure permits partners to receive back part of their investment, for example when a property is sold, without the risk of this being classed (and taxed) as a return of capital. Some conservative asset managers[18] (e.g. Bouwfonds Asset

[18] In Bouwfonds Magazine 'Indruk', number 4, January 2001

Management) declared recently that their professional status would be crumbled, if their property investment vehicles would be put offshore. While other general partners don't have any problem to use this tax-route. ING asset management's Iberica retail property fund for instance is offshore on Guernsey. The tax efficiency of these offshore funds will define the future of offshore fund management for European non-listed property funds.

If the partnership is involved in development or a phased purchase programme, then instead of the full advance being paid upfront, there may be a loan commitment to draw down sums required to meet development or acquisition programmes. In such cases, it is important that the general partner is satisfied that the partners will be good for the cash when it is called for. Therefore care should be taken to allow only companies with sufficient resources to become limited partners. And from the limited partners point of view, if the limited partnership is involved in property development, the general partner is often property company with its own portfolio. To rule out conflicts of interests, limited partners should monitor closely the relations, or even transfers, between the fund's portfolio and the general partner's portfolio. It is therefore obvious that limited partnerships often operate in a different market segment than the market of the portfolio of the general partner. In case of British MWB, leisure funds were initiated, a segment hardly related to the serviced offices of the MWB group. But general partners can bring in more than just knowledge. In the case of the Dutch limited partnership Vasloc, the general partner was the real estate arm of the national rail road company. This general partner brought in the land that would be developed by the limited partnership. More about the role of property fund managers can be found in chapter 5.2.

Apart from loans from partners, a partnership may want to borrow from third parties on normal commercial terms. The partnership will usually limit the gearing ratio, but this may be anything between 20 percent and 80 percent of net asset value. Limited partnerships with these high gearing-ratios are often called opportunity funds.

3.1.3 Opportunistic limited partnerships (Opportunity funds)

In the early 1990's a relatively new form of real estate private equity vehicle for institutional investors evolved. These vehicles are described as real estate opportunity funds and are usually structured as limited partnerships. Opportunity funds have been used as a

viable means of increasing an investor's exposure to investments with a projected high total return, which can be realised within a short time frame of three to five years. There seems to be significant institutional investor interest in opportunity funds as an alternative to commingled funds consisting of core property. By investing in an opportunity fund an investor can create a bigger presence in a certain market in an easy and quick way. Commingled core real estate funds, in comparison, have a long-term investment horizon - form 10 to 15 years - and are generally comprised of real estate portfolios consisting of properties generating stable low non-leveraged income returns.

Current Issue 3-2: How do opportunity funds use debt?
Most opportunistic property fund managers use significant amounts of debt to finance acquisitions. Positive financial leverage - the difference between property investment yields and the cost of debt - can substantially improve returns. If a fund manager for example can finance 50 or 80 percent of a 100 million euro portfolio and borrow at 4.5 percent, his pre-tax return on equity would be 22 percent (instead of 8 percent return on assets if no leverage was used).

In response to institutional investor demand, opportunity fund managers are focusing more attention on institutional markets and allocating capital in those markets where inefficiencies or imbalances are present. A consequence has been the introduction of various European focused opportunity funds by fund managers whose stated aim is to achieve a performance similar to that of the original US-focused funds. The goal of these American and European opportunity funds is achieving excess returns of 20 percent or higher. The main reason for these new European-focused funds was that American fund managers couldn't find any opportunities in the United States. And the only way these fund managers thought to get above the 20 percent is to develop, leverage risks and find opportunities overseas. Traditionally opportunity funds have an investment strategy, which revolves around two specific market-related areas:

- Exploiting arbitrage opportunities in the real estate capital markets with large amounts of discretionary capital
- Acquiring value-added opportunities and repositioning these assets

1 - Status of the real estate life-cycle of the targeted market
Arbitrage opportunities can be described as the simultaneous sale and purchase of a security in two different markets for different prices. This involves the asymmetric information or price discrepancies in the real estate capital markets. A good example is a premium (e.g. 30%) that is paid over the net asset value. A fund manager could repackage a property portfolio in such a way that it meets the necessary demands of a publicly traded real estate vehicle. Selling the portfolio to a third party or launching an Initial Public Offering can now make excess returns. In both cases the fund manager would receive a premium over the normal market value in the private real estate market.
2 - The availability of capital for financing acquisitions and developments
A value-added opportunity is an opportunity to acquire a property that is inadequately capitalised or poorly managed, where cash flow and asset value may be increased through proactive management or capital commitment. These under-performing assets are sometime located in or operate in a 'distressed' market and therefore priced at a discount. Markets are usually considered distressed due to lack of capital in those markets. However, a value-added opportunity can also be an existing building whose value can be enhanced by changing its use. For example, a commercial building located in a desirable residential area that is redeveloped to a building for residential use. The opportunity funds that focuses on redevelopment are often sector specific, while the rest of the opportunity funds are just looking for the best deals.

In opportunity fund limited partnerships the fund manager functions as a general partner and the fund investors are limited partners. The fund managers are usually an advisory company or management partnership and are often characterised as aggressive, risk-taking investors who are able to identify bargains in the property investment market. Most fund managers calculate fees of a European average of 1.5 percent of capital commitments, and don't use flat fees or fees based on acquisitions or dispositions. In this way, the remuneration of investment managers who manage the European opportunity funds is highly related to their performance. If they make losses, there is no place for them to hide and if the business is good, it's very good. Quite often these fund managers even earn more than the investors on the sponsor side of the table earn. But at the same time opportunity fund managers take the risk that they cannot enjoy the security of a defined career path and a long-term pension.

The amount of capital the fund managers themselves personally invest in the fund can show the commitment of a fund manager to the fund. The majority of opportunity funds active in Europe have some form co-investment by the general partner. These co-investments are often mentioned as important factors in private placement memorandums. Some professionals put questions to these co-investments of the opportunity fund manager. 'Their co-investments is often as big as their bonus, so it is not their money they are investing and it is not a real co-investments' one investor said.

Some fund managers have an affiliation or are sponsored by a financial service company, which can be used to access international capital markets for attractively priced debt. This access can influence an opportunity funds overall performance. Research done by Spencer (2000) indicated that funds affiliated with a financial service company have a competitive advantage relative to traditional funds. This advantage should create superior value-enhancement opportunities, which as a result increases the possibility of achieving excess returns.

A recent study by CB Hillier Parker indicated that there are at least 45 opportunity fund managers active across Europe. These new offerings were in response to investor demand for opportunity funds. The expectation that fund managers can earn excess returns underlies future interest in European-focused opportunity funds.

From the sponsor side, the institutional investors, it is important to determine a fund manager's potential to add value. According to Spencer, before an investor reviews a private placement memorandum, he should determine the four areas in which the opportunity fund manager of this memorandum competes in the ability to:

- Access a steady stream of potential investments (deal flow)
- Acquire assets below market values and determine risk variables (acquisition pricing)
- Increase cash flow growth of the assets at an above market rate by restructuring, repositioning and managing the assets (cash flow growth)
- Transfer the assets to another investor under the most advantages terms of the fund (establishing exit opportunities)

Once the fund managers offering the highest potential for adding value have been iden-

tified, the final step of selecting the most appropriate fund manager has to be made. Institutional investors often state that the most significant attribute to select a fund manager is - besides the affiliation with a financial service company - their track record.

When US funds started acquiring non-performing real estate loans and distressed property assets in Europe in 1995, opportunity was a euphemism for 'vultures'. Professionals thought that these fund managers would give the industry a negative image and would create a highly speculative property market. But now that the rotting carcasses of Europe's property crash have been thoroughly picked over, the genuine distressed situations are few and far between. Now opportunity really means what it says, and an unprecedented amount of US capital is searching for new ways into the market. London-based adviser Parkes and Company calculated that between mid 1997 and the end of 1998 some 14 billion dollars has been spent by US investors in Europe. But because most deals of US investors are highly geared, the equity invested in the transactions is much less than the 14 billion dollar.

The idea that some companies, who run an opportunity fund and are at the same time also a real estate agent, could use inside information, which they obtained at independent property valuations, could lead to conflicts of interest. And as more and more firms of chartered surveyors like CB Hillier Parker, DTZ, FPD Savills and Jones Lang LaSalle also supply investment management services, we should be thoughtful. While some professionals believe Chinese walls within these companies should restrain them to use inside information, some investors only see the availability of it as an advantage of an opportunity fund manager.

3.1.4 Companies owned by non-property companies

This section is about European property investment companies that are not owned by institutions like insurance companies and pension funds. These property companies are a subsidiary of a listed or private non-property company and are an independent profit centre with their own annual report. That's why we don't see these properties just as an owner-occupied property (table 5). Some of these companies are looking at possibilities to sell a portion of their shares in the company to other investors. One property company made clear it needed a five-year period to decrease the percentage of tenants relat-

ed to the mother company in favour of third party tenants. This makes the fund a real property investment vehicle independent from the performance of one company. Some of these funds even talk about plans for an initial public offering. While some others are also looking at possibilities to sell a section of their portfolio to investors through limited partnerships. This trend has recently begun and it is expected to have great impact on the European real estate capital market.

Examples of two retail companies, that created a property profit centre:
- owned by a listed company: Chartwell Land owned by Kingfisher
- owned by a private company: Redevco owned by C&A

The question appears in what type of property investors are willing to go first. The successful launch of an office fund - once completely owned by the Swedish telecom operator - offers a nice perspective. The first results of research regarding the sale of property portfolios by owner-occupiers make clear that most important is, whether the locations of the properties are strategic. In case of a supermarket-chain these locations are very important, which could mean that sale-and-lease-back structures are not profitable. Working with market-conform rents and an in-house property support unit would in this case be a better solution to keep the costs for accommodation low. In the United States sale and lease back techniques have been quite popular because equity capital was either more expensive or unavailable for commercial real estate investment. In addition, there are advantages on both sides of the transaction. For the leasing firm, this arrangement frees equity for other uses. For the investor, the expected returns from leaseback are relatively long in term and typically large in size. There are other advantages if the value of the property appreciates at a higher rate than expected. Finally there are income tax advantages for both sides. More about the role of owner-occupiers with big and interesting portfolios can be found in chapter 5.3.

3.1.5 De-listed funds

Besides the four mentioned categories of non-listed property funds, an extra subcategory can be defined: the property fund that has been listed before. Permanent market valuation is named by some industry professionals as an advantage for a property investment company. It means total transparency, because the investor has full knowledge of

the market valuation at any time. On the other hand, the biggest disadvantage of a stock listing is their dependency to the relative volatile market situation on the stock exchanges. The past has shown that if the US market is interested in the REIT-sector, the REITs will see premiums. This will mean that the REITs have to find new properties to invest in. At that moment REITs will experience that they are not the only company that is looking for new investments and this will result in lower initial yields. During a period of disinterest of the market in REITs, the companies have to deal with shareholders who want their money back, and analysts who expect REITs to buy your own cheap shares.

At this moment the quoted property sector is undergoing a worrying split between the managers, who want to grow the companies, and shareholders, who want their money back. Research produced at Morgan Stanley Dean Witter's third annual European listed property company conference in June 2000 showed some remarkable results.[19] The European top-executives, 73 investors and 88 property companies, showed how entrenched the loss of confidence in the sector has become.

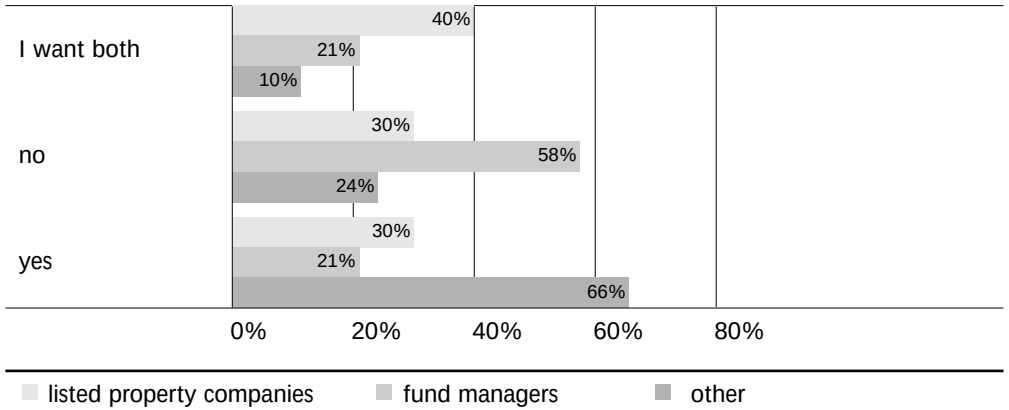

Figure 7 Is big better than small?

[19] Whose company is it anyway? Article in property week 14 July 2000

Current Issue 3-2: a comparison with Dutch housing associations
A comparison can be made between the management of listed property companies and the management of Dutch housing associations. While many housing associations recently merged or are planning to do that, research has shown that smaller housing associations run their business more cost effectively per home than big associations. It is astonishing that the management team of big housing associations also seemed to have higher salaries than the management team of smaller housing associations.

The growing dichotomy of views between the management of property companies and those investing the sector became obvious when delegates were invited to vote on whether big companies really are better than small ones. While two-thirds of those representing the management of leading property companies present supported the concept, 58 percent of fund investors called for greater focus.

Most of the fund managers at Morgan Stanley Dean Witter's listed property company conference have a particular problem with property managers whose shares are trading at a up to 45 percent discount[20] to net asset value and who refuse to buy any shares back. The managers are custodians of other people's capital. If you don't buy back your shares when they are at a 40 percent discount it doesn't really make the shareholder keen to give you any more capital. More than half of the property companies blamed competition from dot.com stocks for the recent under-performance in the sector, however, only 35 percent of fund managers saw this as the primary factor. Fund managers placed more emphasis on poor management as a likely cause. One-fifth of property companies took the view that illiquidity in the sector was largely responsible, whereas this tallied with the views of only 5 percent of fund managers. Despite the heavy criticism levelled at the listed sector, 73 percent of investors present felt there was a need for a listed property sector - though 8 percent of listed property companies present felt there wasn't.

[20] Kempen AKX index

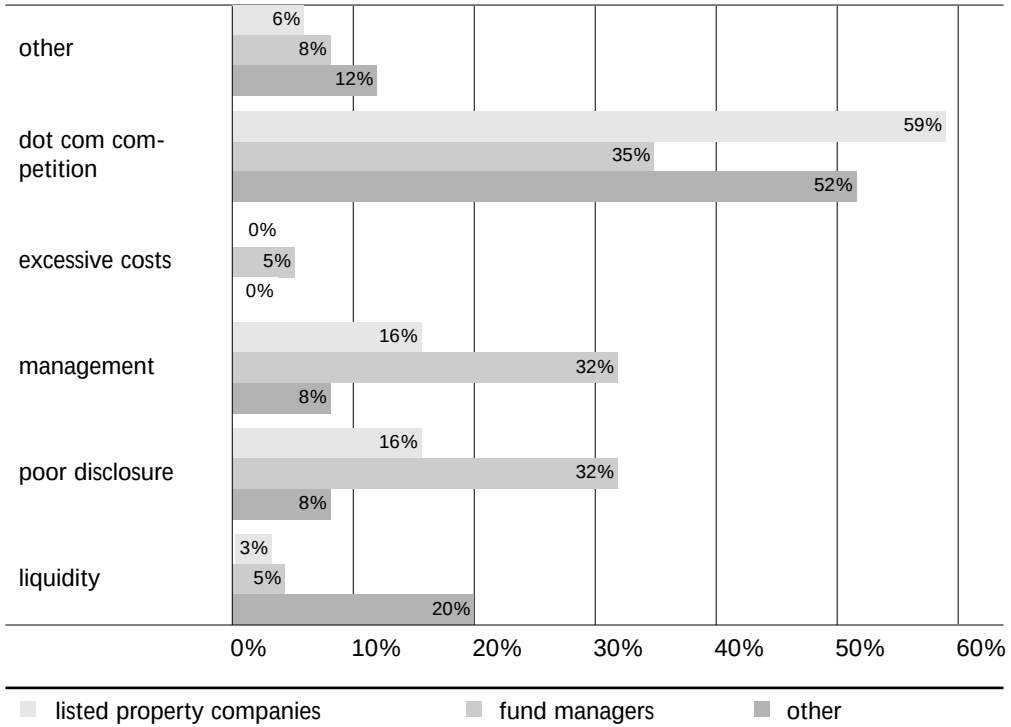

Figure 8 What is responsible for sector under-performance?

The answer to the question if shareholder of a listed company should choose to de-list the shares is a complex corporate finance problem and depends on the company's situation, strategy and scale. Although currently many listed property companies see their shares trading at huge a discount to net asset value, shareholders are often offered small premiums to net asset value to convince them to sell their shares. In the past, the de-listing of shares in small property companies were often management buyouts. While bigger property companies were taken private by big financial conglomerates. The best example here is the privatisation of MEPC by Leconport Estates, a new vehicle jointly owned by GE Capital Real Estate and the BT Pension Scheme.

4 Analysing the non-listed funds

Information on the non-listed fund statistics covers the 15 European Union member countries. The data presented in this chapter are the result of the data collection based on annual reports from the reference year 1999. As the availability of statistics on non-listed property funds differs from country to country, information on individual variables may be missing regarding some countries. Throughout this chapter, data with financial values are expressed in the euro.

Figure 9 shows the distribution of the portfolio size of the funds, in which the smallest portfolio is 100 percent. On the left side, the figure starts with the biggest fund, which has a portfolio of more than 4 billion euros. The first half of the portfolios is bigger than 325 million euros (A in figure 9). The weighted average of the size of a portfolio is 582 million euros, while 72 percent of the funds have a smaller portfolio (B in figure 9). The combined portfolio size is 60 billion euros. Because the portfolio size was not available for one out of four funds in the database, it can be expected that the combined portfolio of all funds in the database will be around 80 billion euros, if the mentioned average fund size applies to all 150 funds. This 80 billion euros is approximately one third of the size of the size of the European commercial real estate private indirect equity market.

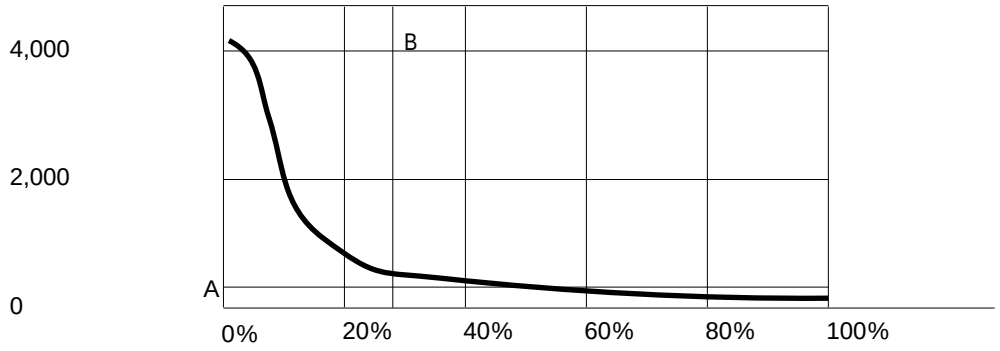

Figure 9 Distribution portfolio size in million euros

Table 7 shows the distribution over the different vehicles, based on the portfolio size of the funds. The biggest part of the vehicles is the group of limited liability companies owned by one or more institutional investors.

	distribution
funds owned by institutional investors	46%
limited partnerships	25%
opportunity funds	8%
companies owned by non-property companies	21%

Table 7 Distribution of non-listed property funds based on portfolio size

The distribution over countries based on the size of the funds' portfolio is showed in figure 10. The majority of the funds is operated from the United Kingdom (38%) and The Netherlands (26%). These percentages can be explained by the availability of funded pension schemes in these countries and the fact that these countries have relative quite developed real estate markets. This also applies to the other countries in figure 10, Germany and Sweden, which are quite familiar with real estate investments.

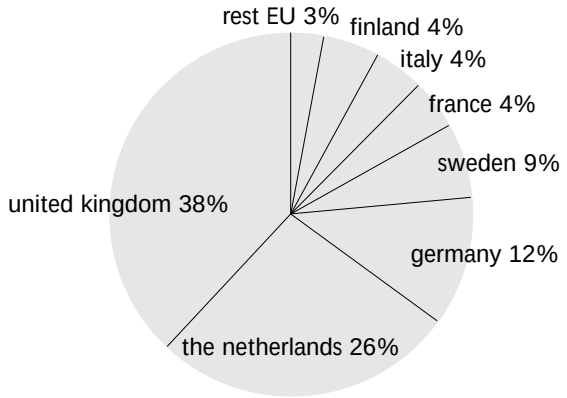

Figure 10 Distribution over countries of the non-listed property fund market

After looking at the total size of the market, extra attention is needed for the strategy of the individual funds.

4.1 Diversification

In chapter 2.2 we already saw that two classifications have been used in the analysis of diversifying property investments, the diversification by property sector and by geographic region. The question whether a fund can be called diversified or not depends on two assumptions, (i) the amount of different sectors that are distinguished and (ii) the maximum percentage of property from a different sector in which case the fund is still called not diversified.

In case of the first assumption, this chapter uses the four major sectors: office, retail, residential and industrial. This implies that property funds, which are investing in for example leisure and retail property, can be called non-diversified, because the leisure property sector is in this case a part of the total retail property sector. For the second point, we take a maximum of 10 percent in which case the fund is still called not diversified. This means that funds, which have 95 percent of their investments in offices and 5 percent in retail property, can not be called diversified. The reason behind this assumption is that many funds have small non-strategic portions of properties from a different sector in their portfolio. These properties are for example small retail properties on the lower levels of apartment buildings or small offices on top of industrial properties. For the diversification over geographic regions, the individual European countries are used.

Of all non-listed property funds in the database, 60 percent is sector-specific (table 8), while even 76 percent is country-specific (table 9). Most of differences between the fund types are quite logical. While most fund types are more often country and sector specific, for opportunistic limited partnerships it is the other way around.

	distribution over sectors	
	yes	no
funds owned by institutional investors	40%	60%
limited partnerships	28%	72%
opportunity funds	88%	12%
companies owned by non-property companies	25%	75%
overall	40%	60%

Table 8 Percentage of sector-diversified funds

	distribution over countries	
	yes	no
funds owned by institutional investors	7%	93%
limited partnerships	12%	88%
opportunity funds	100%	0%
companies owned by non-property companies	25%	75%
overall	24%	76%

Table 9 Percentage of country-diversified funds

The relationships between country- and sector-diversification can be found in table 10. More than half (52.4%) is country and sector specific, while there are less funds that are diversified over countries but investing in one specific sector (7.6%) than funds that are diversified over sectors but investing in one specific country (23.8%). Some experts believe that the interest for funds with a default portfolio, which is diversified over sectors and countries will decline over the next years, although 16.2 percent of the non-listed property funds still use this strategy.

		distribution over countries		
		yes	no	total
distribution over sectors	yes	16.2%	23.8%	40.0%
	no	7.6%	52.4%	60.0%
	total	23.8%	76.2%	100.0%

Table 10 Cross-table country-diversification and sector-diversification

4.2 The sell-side

It is clear that institutional investors still have big difficulties to find reliable data to make an investment decision for a non-listed property fund based. This might be the reason, why many investors prefer to invest in a non-listed property funds together with a group of well known colleague investors. During the research, on which this thesis is based, some independent funds appeared to have the same participating independent investors. Apparently the sell-side of the market prefers this kind of security.

Some non-listed property funds had some additional requirements for participating investors. The Prologis European property fund for example wanted shareholders who were familiar with investing in listed property vehicles and positive about a stock market flotation of the fund. Similar requirements are also made by the investors regarding the funds amount of leverage.

5 Players in the European non-listed property fund market

The property investment market, so also the non-listed property fund market can be divided into two separate markets with a buy and a sell side. With investors who are looking for non-listed funds and property fund managers who supply the investment management services. At the same time these property fund managers have tenants that pay rent for the use of the buildings, which creates the turnover. While the property fund managers are on the supply side concerning the property funds, they are on the demand side concerning the properties themselves. The role of the investor, the property fund manager and the owner-occupier will be described in this chapter.

5.1 Role of investors

If we look from the sponsor side, we see that the European property market attracts investors from all over the world. Especially the European institutional investors, the investment and merchant banks, but also the American pension funds and institutional investors from the Asia use international diversification by investing in European property to improve their investment performance. The last decade investors have changed their way of international diversification from direct investments in objects to buying real estate securities and other indirect vehicles. This may be caused by the fact that the non-efficient markets for directly held property are less efficient than the public stock markets and involve more information costs.

Schweitzer (2000)[21] has shown that indirect investment strategies, which used listed property companies, outperform the so-called direct strategies with 2.7 percent on an annual basis. Although there have been no tests of portfolio performance using non-listed property funds; if the results are similar to the results of Schweitzer, the indirect international diversification approach through listed and non-listed property funds might get more attention. Research in this direction will have to make clear whether non-listed property markets are as efficient as stock markets or as inefficient as directly held property. The current lack of actual information and inefficiency of non-listed property funds keeps these indirect vehicles near the direct property investment market on the road from buildings to property stocks (table 3).

[21] Performance of institutional investors (2000)

Recent changes in regulations for some European pension funds allowed them to invest in other property markets than only their domestic market. When this change to allow investors to invest in foreign property markets came for the Swedes some years ago, they invested quite opportunistic. And when the investments appeared to be disappointing, many Swedish investors went back to their former property investment strategy. But there are also successful stories. The German open-ended property funds, traditionally conservative in purchasing fully let buildings in good locations in major markets, are becoming increasingly important in other European countries and the United States.

As each year goes by, the ownership and management of investment property by institutions has become more concentrated. Consolidation was a result of the following trends[22]

1 Many of the larger European insurance companies have merged
- example UK: Royal and Sun Alliance
- example The Netherlands: ING Group
- example France: BNP Paribas
- example US: Citygroup

2 Institutions with a small amount of property have closed their direct property activities and either sold the portfolio, or outsourced the responsibility to a fund manager, or merged the portfolio with the portfolio of another institution.
- example The Netherlands: Altera Vastgoed

3 There has been an increasing tendency to separate out the fund managers as a division in their own right, even where they are managing assets for their own policy holders.
- example Sweden: Celexa
- example The Netherlands: Vesteda, KFN

4 There remain a number of major firms of chartered surveyors, which manage large amount of property for pension fund clients
- example US: Jones Lang LaSalle
- example UK: Parkes and Company

5 Specialist fund managers without in-house clients have started
- example UK: RREEF

[22] DJ Freeman's Guide to the Property sector, Chapter Investment managers and institutional owners

The major reason behind these trends of consolidation (mergers, acquisitions and concentration of ownership) is that institutions found out that despite the fact that property markets are locally driven, profits could be made if one could benefit from economies of scale. Another reason behind these trends of consolidation is that some companies believe independent profit centres can not compete more effectively with the rest of the market. Currently the world's biggest pension fund is America's Teachers Insurance and Annuity Association College Retirement Equities Fund with more than 290 billion dollars in assets under management. Europe's biggest pension fund is the Dutch ABP, with 155 billion euros under management. ABP is the worlds' third pension funds after the California Public Employees' Retirement system. Although the relatively large amount of assets under management, world-wide premiums of Europe's biggest insurance companies are even higher than the premiums of the biggest pension funds. UK's biggest insurance company is CGNU, with more than 325 billion euros under management.

Investment and merchant banks have a different approach to the real estate market and their role is similar to the approach of fund managers, which are in fact often investment banks. Both are focused on delivering corporate financial transactions, partial for own account (investment banks) or on behalf of its clients (merchant banks). These companies use an extensive network of European property investment professionals combined with a broad array of expertise to secure significant increases in enterprise value. Four categories of corporate finance deals can be distinguished.

1 Public to Private and Private to Public
2 Spin Off
3 Growth Capital
4 Venture Capital

In some deals (category one and two) the investment banks try to enhance the valuation of real estate companies significantly through re-capitalisation or repositioning the company. In other deals equity investments are made in (category three) real estate companies with good prospects and superior operating skills or (category four) new ventures with operating partners with a proven track record (including management buy outs).

5.2 Role of property fund managers

As institutional investors move from investing in direct properties to indirect vehicles, the tasks of the investors and property fund management companies become strictly divided. Investors have to review the property funds possibilities and will make decisions based on their own asset liability management model. They have to minimise risk and have to be clear to the pension holders or the insured about how they measure their (maximised) performance.

The company that manages the property fund will be responsible for the day-to-day portfolio management and will tend to follow the principles of enterprise management. Some property companies will specialise and choose a specific sector or region, while others develop broader strategies. Although practice shows us that only a very few European real estate companies are in a position to benefit from economies of scale on a pan-European basis. An accessible management and regular communication with investors is also crucial, as the same is true for the communication between building owners and their tenants. Moreover, institutional investors and major tenants expect special treatment. The new challenge for CEOs and building owners is to manage the expectations of shareholders and tenants.

Fund managers have to do active property management and have to take risks to outperform their peers and keep shareholders satisfied. Entrepreneurial property companies have showed us how to create shareholder value and maximise profit. These points can be divided in:

1 portfolio management
2 property development
3 offering tenants extra services
4 multiple use of buildings
5 offering property funds focused on sub-markets for investors
6 tax transparency

The timing to buy or sell the right building at the right time is an all-time number one. Property companies often use a clock diagram to illustrate where each real estate market

falls within its individual rental cycles.

Research by Kanters[23] has made clear that American equity Real Estate Investment Trusts involved in development have a significant higher return than those REITs who do not develop. It is clear that development activities add a great amount of risk, but normally leads to a higher performance. An extra advantage of in-house developing activities can be a better 'feeling with the market'. Kanters also found that if the extra risk involved in developing activities is taken into account - through the Jensen Alpha method - developing property companies do not outperform the non-developing property companies more often. The question comes up if this theory also applies for European listed property companies or even for European-focused non-listed property funds. The general opinion of professionals about the European property market is that there are too less opportunities for too many investors. This could mean that the in-house development activities could have more advantages in Europe than else where. Strong strategic relationships between developers and investors will remain attractive.

In general, rental contracts do not include any extra services, and tenants can't work in offices without daily cleaning. Property companies can easily expand their business with services for tenants like cleaning services, laundry services for employees, catering and data- voice-network services. The property company can outsource all these activities to specialised companies and can for example arrange a percentage of the profit the telephone company makes on the phone calls of the tenants. And if tenants get value for money offers from their landlord, all three parties will be satisfied. In case of a property company specialised in shopping centres, the same can be done with an advertising agency and the advertisement for the shopping centre. In case of industrial property special warehousing-solutions can be offered to the tenant.

The recent success of mobile phones in Europe showed an extra potential income stream for property companies, the use of their roofs for antennas. A less significant, but also extra income stream could be - in case of multi-tenant buildings - the letting of sign-space on the building to one of the tenants.

Some listed European property companies used another way to attract equity from the

[23] Developing property funds, the success factor? A focus on US Real Estate Investment Trusts

market besides through the normal listing of their shares on the exchange. They created non-listed property funds focused on sub-markets and placed them on the private equity market for a new group of investors. The listed property company Marylene Warbuck Beaufort, normally focused on serviced offices, started three leisure property funds and one hotel fund. Non-listed property fund activities can improve the overall performance of the company. Privately issued funds should not operate in similar markets to restrain the company of conflicts of interest.

Some European property companies apply for a tax-transparent status. The advantage is that the company will benefit a lower corporate tax rate but the biggest disadvantage is the obligation to distribute the annual profit as a dividend at the end of the financial year. This distribution of the profit is not possible when property companies use the five earlier mentioned possibilities to enlarge their turnover, in which case profits have to be reinvested. Tax-status is therefore a strategic decision, and is closely related to the distribution over the type of investors. Some researchers believe that if more and more property companies apply for a tax-transparent status continues, not-entrepreneurial huge investment vehicles will dominate the market. According their scenario, the property market will transform into a dull investment sector, instead of an interesting asset class.

The global capital industry has come to expect a performance-related fee across all other assets classes. And as US sponsored opportunity funds that operate in Europe are already using this model, more compensation arrangement tied to performance will be seen in Europe as well. The problem that occurs is the lack of data of direct property returns for performance measurement. Because UK-based company Investment Property Databank (IPD) collects data for only six countries of the European Union - The Netherlands, Sweden, Ireland, United Kingdom, France and Germany - the other countries don't have any reliable index or reference yet. Although the investors expect that transparency will increase and other sub-indices will be made, some professionals question in which way the performance numbers can be used. The next important question that comes up is: if a fund manager can get a yearly bonus that is related to his out-performance on a direct property index (which represents only a small percentage of the property investment market) will this stimulate his short-term thinking? If this is true, why do most investors see a real estate investment as a long-term stable investment?

5.3 Role of owner-occupiers

The last participant that will be mentioned is the owner-occupier. European companies own percentile a bigger part of their property portfolio than the Americans. As chapter 3.1 showed, owner-occupiers control with a 71 percent stake the European commercial real estate market that totals 3,400 billion euros. According to Jones Lang LaSalle research, approximately 20 percent of US commercial real estate is owner-occupied. If Europe follows the US outsourcing trend, the European companies could begin shifting property assets off their balance sheets and allocating the freed capital to their core business in the near future. Significant opportunities to create non-listed property funds will be created once this asset transfer begins.

Increased competition provided a catalyst for corporate Europe to reorganise, prompting intense activity in mergers and acquisitions. Plants were rationalised, units were consolidated into even larger units and more flexible lease arrangements were made. Blue chips companies like British Telecom, Sweden's Telia, Deutsch Telecom, and Dutch KPN made plans to sell off their offices, in an effort to improve their debt position caused by costs for UMTS licenses and UMTS networks.

The Swedish property company Amplion can be considered as one of the first who transferred assets to other European investors. Examples in which such a company was transferred into the public equity market do not exist yet. Until these transfers are more likely, European corporations stick to creating non-listed vehicles such as limited partnerships and limited liability companies.

Current Issue 5-1: British Telecom chooses Land Securities Trillium for property transaction[24]*.*
BT announced that it has choosen Land Securities for the divestment of its UK property portfolio. This follows the company's announcement that it was in negotiations to realise the value of its estate. BT has 30 billion pounds in debt, and said it will cut borrowings by 10 billion pounds by the end of 2001. The company is expected to receive some 2 billion pounds in proceeds from the sale of its property estate. The divestment of the property estate will enable a more flexible approach to BT's office arrangements and building requirements. BT Business Services is responsible for BT's property estate which comprises 7,500 properties.

[24] Financial Times, March 23, 2001

6 The future of European non-listed property funds

In the current European property investment market, several trends can be found. The most important influence to the investment climate today, is the introduction of the euro, which will increase the property capital flows between the European countries. This will results in more investment possibilities for institutional investors to invest in foreign real estate to increase diversification-benefits in the property portfolio. But from the sell-side, the trend of the decrease of owner occupancy could flood the property investment markets with opportunities.

sell-side	buy-side
- less owner occupancy	- more cross border investments
- more sale-and-lease-back structures	- wider spread of investment exposure
- more entrepreneurial fund managers	- more demand for European equity investments
- more specialised funds	- more concentrated ownership
- more deals	- more deals

Table 11 Recent trends in the European property investment market

Other trends on the sell side of the property market are the expected increase of sale-and-lease-back structures, which have advantages on both sides of the deal (described in chapter 3.1.4). As the investors become more focused on the performance of property funds, the property companies will be more entrepreneurial to outperform their peers (described in chapter 5.2) It is likely that they will focus on one sector or country (described in chapter 4.1). As all these trends are likely to appear, the sell side of the market will be dominated by more corporate deals.

From the buy side, the ability to invest cross-border without currency risk is becoming a key factor in investor's investment strategies. The euro has allowed investors to make 'purer' investment decisions based on individual country, city and property characteristics rather than being coloured by exchange rate risk and this has began to open up a range of new markets for consideration as part of a pan-European investment strategy.

At the same time, evolving portfolio management techniques have raised the demand for a wider spread of investment exposure. However, where winning locations such as London attract more investment and carry a price premium compared to regional centres, the euro-zone supra-national locations such as Frankfurt and Paris appear likely to continue to carry a premium. Another trends on the buy side of the property market is the increasing demand for European equity investments, caused by more funded pension schemes (described in chapter 2.1). The last trend is the concentration of ownership caused by the consolidation of corporate Europe (described in chapter 5.1).

6.1 Two scenarios

The trends from the sell-side and buy-side will make the future's new equilibrium in the European property investment market. It is clear that the market can develop into two directions, which will lead to two different scenarios. In case the decrease of owner occupancy and other sell-side trends can not keep up with the pace of the increased demand for property investments, the amount of property investment opportunities will decrease. The other scenario describes if its the other way around and more property investment opportunities will be available.

Scenario 1: More property investment opportunities
- *Higher returns*
- *Less developments*
- *Consolidation developers*
- *More possibilities for opportunistic property funds*

In the first scenario, the market will be flooded with property investment opportunities, and this will decrease the competition on the market for real estate objects. This will result in higher returns and less interest in development activity. The increase in property investment opportunities will also result in more possibilities to find higher returns and potential investors to develop a opportunistic limited partnership.

Scenario 2: Less property investment opportunities

- *More developments by funds*
- *Consolidation investors*
- *Mergers between fund managers and development companies*
- *Lower initial yield*
- *More entrepreneurial fund managers*
- *Threat of hog-cycle decreases*
- *Threat of boom-burst cycles decreases*
- *More interest for smaller sub-markets (e.g. serviced offices), because of higher returns*
- *Capital flows to foreign markets*
- *Capital flows to other asset classes*
- *Discounts to net asset value for listed property funds*
- *Consolidation of property funds*
- *Less possibilities for opportunistic limited partnerships*

In the second scenario, the emphasis will be on the shortness of possibilities in the property investment market. This could stimulate fund managers and direct real estate investors to buy a real estate developer, to secure a flow of good new potential quality objects for the investment portfolio. In this market yields will remain under pressure, which will stimulate fund managers to be more entrepreneurial. This means that a growing number of fund managers will be looking for smaller sub-markets, which could show higher returns. In general in case of these lower yields, capital will flow out of the markets to other continents and other asset classes. And this could lead to a consolidation between property companies.

In today's market, the second scenario is more likely. A recent Dutch development in the struggle between private and public real estate companies are two mergers between a non-listed and a listed property company. Amvest merged with Rodamco Continental Europe and WBN and VIB merged into a new company called Corio. Other developments are the formation of Altera Vastgoed linked to the pension funds of Royal Dutch Airlines and Corus/Hoogovens. Consolidation is likely to continue.

6.2 Predictions of the future of non-listed property funds

Reflections from the specialists, the third model in table 5, and the two scenarios can be developed into predictions about the future of non-listed property funds. In general one could say that the property investment market is going to be more concentrated and transparent. The non-listed property funds are for the time being a good vehicle, but will always have to compete against the direct market and the listed property market. The ideal model for real estate is not necessarily the US REIT, the UK property unit trust, the German open-ended funds or the 'opportunity fund' structure, each of which has its own problems.

Although the market situation decides through premiums or discounts if the value of non-listed property funds differ from listed property funds, in general one could say that in the long term it does not matter. And as more interest and more exposure for non-listed property funds by institutional investors (especially pension funds) is expected, the funds in its current form have several advantages regarding to direct real estate investments.

- Small amounts of capital can be invested in diversified property portfolios
- Use of fund managers local knowledge
- Lower transaction costs
- Less management intensive
- Less object specific risk

For the sell side of the market, the average property portfolio size of 500 euros seems to be the ideal property fund size. And the question whether to use a limited partnership or a limited liability company depends on the funds situation (described in table 4). The convergence of Europe's legal systems and the possible creation of a European REIT will influence this question. Governments and decision-makers will be pushed to develop new investment products in Europe, as soon as the property industry feels that institutional investors prefer American or Asia property investments above the European property investments, because of legal differences. And Europe has to keep up with the standardisation of the European legal environment regarding the other continents.

7 Conclusions and recommendations

The overall conclusion that can be made is that the real estate companies and the real estate asset managers (the investors) will become two complete independent industries. In this situation, European-focused non-listed property funds will meet a growing amount of investors' appetite. They are especially attractive for big pension funds with a professional world-wide spread investment strategy. But for these pension funds it is still very difficult to make an investment decision for a non-listed property fund based on reliable data.

As a diversified property investment portfolio becomes more and more normal, property investments across Europe still remain less achievable outside of a fund scenario. And when an institutional investor with large amounts of assets under management use asset liability management (ALM) studies to support their decision, the next step to a modern investment policy is the decision to invest in an index and follow the total market. The main reason behind this idea is that nobody can beat the market on the longer term. A disadvantage of investing in the index, is the need for a reliable index.

For the sell side of the non-listed property fund market, this means that liquid and specialised funds will be able attract capital much easier than diversified funds with a default portfolio. With specialised funds investors can make their own diversification, related to their personal asset liability study. And as liquidity is concerned, the listed property funds could be more attractive than non-listed if the market shows premiums to net asset value. Everybody knows that in the current situation, conditions are not in favour of the public market.

If we look at the roles of the players in the European property market, managers of property funds should start (i) acting as real entrepreneurs and (ii) focus to be successful. In this way they can (iii) create shareholder value for the investors, while (iv) finance as appropriate. Dutch property companies should therefore not apply for the fiscal institution status, which is not part of innovative entrepreneurship and 'belongs' to real investors.

The investors have to: (i) determine an investment strategy, (ii) supply equity to entrepreneurs, (ii) focus on long term and direct stable returns and (iv) measure performance. The institutions are the ones who make the diversification by choosing the right funds. Which fiscal status the parties should prefer depends on the combination of the investor and the intention of the property fund. As the rest of the world learned that all goods decrease in value over their life period, the property market should realize that indirect returns on property can not stay as high as the current levels. Additionally, institutional investors should not behave like entrepreneurs. This means that pension funds should not start fund management for other institutional investors.

Although this thesis sometimes considered the property market as perfectly efficient and transparent, many questions are still an empirical matter. If a forecasting ability does not exist, then it still suggests that investors should pursue some policy of diversification over asset classes, sectors, and investment vehicles. Today, the number and quality of property vehicles is still limited. Much work remains, before more institutional investors will start to use non-listed property funds.

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Appendices

Appendix 1 Questionnaire

Strategy

- Does the company have a clear strategy?
- What are the company's stakeholders (in what distribution)?
- Is the company well known?
- Is the company involved in development?
- Is the fund diversified over location, regions and sectors?
- What is the legal status of the company?
- How does the company use criteria to select new investors?
- Has the company the intention to do an initial public offering?

Financial

- What is the ratio indirect direct return?
- How do stakeholders of the fund measure the performance of their investment?
- Does the property fund use a direct benchmark (e.g. IPD)?
- What is the direct return per sector (residential, offices, industrial and retail)?
- What is the indirect (sum of the capital growth) return per sector?
- What is the debt/equity ratio of the company?

Organisational

- How many employees does the fund have?
- What is the distribution of the employees between the departments (sales, maintenance)?
- How many places of business does the company have?
- What is the track record of the management?
- Does the company manage the property themselves?

Appendix 2 List of experts

Alex Bennett ARICS, Senior Asset Manager
Grosvenor Estates Holding

Dr Robin N Goodchild, Director European Research and Strategy
La Salle Investment Management

Pieter W. Haasbroek & Drs F.L.P. Muller BEd, institutional investors
PGGM Investments

Christopher Merrill, Executive Vice President, Director of European Investments
Heitman International

Geert de Nekker MRE, Director
IVBN, Association of real estate investors Holland

H. Pons, fund manager
Eurindustrial NV

Jeroen H. Elink Schuurman, Senior Tax Manager
PriceWaterhouseCoopers NV

Joen Siggeln & Andrew Thornton, institutional investors
Parkes and Company

Richard Tanner, executive director
Triton Property Fund UBS Asset Management

Appendix 3 Index of figures

Appendix 4 Index of tables

Appendix 5 Useful internet-sites

http://www.thissen.net/
http://www.bmvb.nl/
http://www.propertyshares.com/
http://www.propertyatfreemans.com/
http://www.ivbn.nl/
http://www.epra.com/
http://www.eres.org/
http://europa.eu.int/eurostat.html
http://www.egi.co.uk/
http://www.aput.co.uk/
http://www.mipim.com/
http://www.jll.com/