

REAL ESTATE INVESTMENT FUNDS: LOOKING BETTER THAN MOST

How has the real estate investment fund (REIF) industry withstood the financial crisis? In Luxembourg, the sector has benefited from some structural advantages placing it in pole position to benefit from market recovery; but the whole European REIF industry faces a challenge from Brussels. We interviewed Keith Burman, Chair of the REIF sub-committee at the Association of the Luxembourg Fund Industry (ALFI). Keith is Senior Vice President and Product Manager for Real Estate Fund Services at Brown Brothers Harriman (Luxembourg) SCA, which has over 1200 properties under custody supervision for real estate fund managers.

For Brown Brothers Harriman (BBH), as a custodian and central administrator, the financial crisis affected the REIF business in a number of ways, as Keith Burman explained.

"Valuations evidently fell in line with the market. However, since the great majority of Luxembourg REIFs invest multi-nationally, they were to some extent protected by their diversification: whereas valuations overall were down 20-30%, some individual markets such as the UK fell by as much as 50%".

Secondly, there was a dramatic fall in transaction volumes, to about 10% of levels seen in 2008. Typically, over the 10 year life span of an average fund, the managers are active buyers as they build the portfolio in the first three years and active sellers in the last three as the fund winds up. All this activity was suspended, as no-one wanted to buy in a falling market and very limited external debt finance was available.

This is linked to a third point, the virtual standstill in new fund launches. While investors tried to gauge the likely outcomes of the financial crisis and dealt with their own liquidity issues, fund managers were heavily focused on keeping their heads above water, by recapitalising deals and renegotiating finance terms with the banks. Very few new funds were proposed compared with 2007 or 2008, and the common themes that were talked about included deleveraging, equity-only investing and distress.

At the same time, significant operational challenges arose in the valuation of properties and accounting issues such as "the going concern assumption". Fund managers were obliged to increase the frequency of external property valuations as market turmoil and lack of evidence increased valuation uncertainty.



"Luxembourg rules have not been found wanting"

According to Keith Burman, the cautious regulatory model in Luxembourg enabled the REIF sector to come through the crisis in better shape than in many other jurisdictions. The vast majority of Luxembourg REIFs are closed-ended, with infrequent valuations (typically quarterly), while those that are open-ended tend to have long notice periods or other liquidity control provisions, so that there are minimal investor redemptions during the life of the fund. This is in contrast to open-ended, daily traded REIFs in markets such as the UK or Germany, where investor redemption pressure led to the suspension of redemptions of some funds during the worst of the crisis. Furthermore, Luxembourg is predominantly an institutional market, with clients holding for the long term. The advantage of international diversification has already been mentioned but a fourth advantage is key: Luxembourg REIFs are not as highly geared as real estate funds elsewhere, as the financial

regulator, the CSSF, has a default maximum level of 50% gearing. Anything higher must be individually discussed and authorised, so that only value added and opportunistic strategies reach borrowing levels as high as 65%-75%.

AIFMD: a revolutionary proposal

The European institutions are in full debate about the proposed Alternative Investment Fund Managers Directive (AIFMD). Hedge funds, private equity funds and real estate funds typically have little in common, so the REIF industry has become involved in an unprecedented way in lobbying the European institutions, to ensure that the specific nature of the real estate business is taken into account.

The AIFMD will affect all regulated Luxembourg REIFs and even some non-fund corporate structures that are being used as investment vehicles. In many ways, Luxembourg regulated funds are already substantially in compliance with the proposed AIFMD: for instance, they have a custodian and a central administrator, leverage rules are in place and CSSF rules cover the establishment of management companies. However, as currently drafted and taking into account the latest amendment proposals from the Swedish Presidency and the European Parliament, the AIFMD still poses significant concerns for Luxembourg in areas such as valuations and the liability of the custodian bank.

If the legislation fails to strike the right balance between stricter rules for fund managers and funds, on the one hand, and operational freedoms and the realities of investment in alternative investment markets on the other, European investors will see costs rise and parts of the European alternative fund industry may relocate outside Europe.

Alternatively, if it is done well, European alternative fund managers will be able to offer funds easily in all the 27 Member States, European investors will have access to a broader range of investment choices and Europe could see the rise of an AIF "brand" following the globally recognised success of the UCITS brand for retail securities funds.

An international model

Luxembourg has come from almost nowhere a decade ago to corner the European market in cross-border real estate funds. The number of regulated REIFs rose from just 16 in 2000 to 146 by July 2009. INREV (the European association for investors in non-listed real estate



vehicles) ranked Luxembourg second in 2009; and if you strip out single-country funds Luxembourg is clearly the leading domicile for multinational REIFs in Europe. Keith Burman highlights a similar growth story in the fund of real estate funds sector.

According to BBH, the appeal of Luxembourg is similar to its appeal in other sectors. There are thriving domestic real estate markets in Germany and France, but Luxembourg has the legal framework to handle complex international holding structures. Furthermore, adds Keith Burman, political stability is a major factor for investors. They want to know that there will be steady ongoing political support for the financial sector, as there has been over the past 30 years. ALFI efforts have led to the development of best practices, comparative data and REIF-specific training courses, which have accompanied the impressive growth in REIF service provider capabilities in the legal, tax, audit, central administration and custody areas.

It's good to have cash

Activity at BBH has already picked up in 2010, both within portfolios and in new product proposals. However, in Keith Burman's view, property valuations are likely to remain flat in 2010 while the businesses on which they depend to pay the rent struggle to recover. Banks that did not foreclose on borrowers in 2009 may have to do so in 2010. This is a market where cash-rich funds are king, and some managers are calling down equity to take advantage of exceptional buying conditions. Looking ahead, he predicts recovery in 2011 before a return to strong growth in 2012 and 2013. He also sees a growth in infrastructure funds - investing in roads, railways and renewable energy projects - as governments fight their deficits. Infrastructure projects can provide a long term, steady income stream that is highly attractive to investors.