Legal & General Property has raised £175m of equity for a £1bn UK property fund that it claims gives its institutional investors a new level of flexibility and influence.

The Legal & General UK Property Income Fund is a fully discretionary fund run by LGP, but offers geared or ungeared returns, an investor advisory committee and alignment of interest via private capital investment by four LGP managers. Its performance fees will only be paid on fund expiry, subject to reaching a predetermined hurdle rate.

The £175m was raised at the fund’s first closing this month from four cornerstone investors, which have joined a unit holder advisory committee.

LGP head of property Bill Hughes said the fund’s structure was the result of listening to investors concerns “over two years in a very difficult market, when misalignment between fund managers and investors has been in the spotlight. We have talked to investors for nine months and listened closely to what they think is best practice.”

The investment management team, led by Charlie Walker, is obliged to meet investors three times a year, inform them of any significant changes to the fund and work with them on any conflicts of interests that arise.

Hughes said it was normal for managers of boutique or private equity-style funds to co-invest, but was unusual for institutional fund managers to do so, and is new for LGP. “It is difficult for individuals to find cash to invest in businesses, but to show true commitment it is a valid concept and will become more common, I think,” he said.

Walker said the fund’s strategy is to buy larger lot sizes of core or core-plus property than were now popular with investors and most of the banks funding them.

“We are targeting £50m to £100m assets, where the market is less congested, and aim to create a balanced fund of 15-20 properties, worth £1bn,” he said. The fund has a central London allocation and will also buy shopping centres, large regional offices, business parks and distribution centres.

Investors will choose whether to take geared or ungeared units at a ratio that suits them, but Walker said he expected a majority will come in on a geared basis. The maximum gearing is 50%.

The fund is targeting net returns of 15% geared and 10% ungeared over seven years. LGP has put a debt facility in place with one bank, which can be drawn down in tranches to fund acquisitions.

About 50 funds with a UK strategy were launched last year (see November issue, pp10-13), but only a handful had hit their capital raising targets by this quarter.

Cushman & Wakefield Corporate Finance is the placement agent for L&G’s new fund. Clifford Chance advised on its structuring.

Hughes (left) and Walker said the structure of the fund is a response to investor views of best practice.
Newspaper

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News

Bates steps into McNamara’s shoes at restructured RBS real estate finance arm

Chris Bates, a senior director within the European real estate finance division at Royal Bank of Scotland, has been appointed to lead the business from which his former boss, Mike McNamara, recently stepped down. Bates’ job title is now head of real estate in RBS’s global banking and markets division. A new business plan is being drawn up for the downsized RBS division.

McNamara, who joined RBS from Ernst & Young in 2007, is in talks to move to the trading side of the business, although this has not yet been formally agreed and there is still a chance that he will leave the group.

The European real estate finance arm is part of RBS’s global banking and markets division, which used to make large structured finance loans, many of them in Spain and Germany. But it has more or less stopped doing new business since the operation was deemed to be ‘non-core’ following the downturn and part nationalisation of the bank.

Stephen Eighteen, head of real estate in the global restructuring group, is overseeing RBS’s programme to run off or sell £36bn of its £90bn property loan book in the next three years.

Eurohypo is latest to move towards debt syndication

The bank syndication market is showing signs of re-opening in another step towards increasing liquidity for property borrowers. Eurohypo is talking to banks about placing up to £50m of a facility of around £100m it provided to fund the £183.5m purchase last week of 3 Hardman Street in Manchester’s Spinningfields, by Glenn Arrow UK Property Fund.

Eurohypo also arranged finance for the building’s development three years ago, by Allied London Properties. Margot Waddup, head of syndication at Eurohypo, said: “Last year everyone wanted a seat at the table as part of a club, but now there are more banks active and a shortage of deals.”

“[Arranging] a club deal is incredibly time-consuming and if a bank only has a small team to work on it, it can be difficult.”

“I hope we will get back to the model where there are banks underwriting. Some clients are keen to pay for the ease and speed of execution.” Other banks are also thought to be testing the potential for underwriting, particularly Lloyds Banking Group, Barclays Corporate and Royal Bank of Scotland, where Sam Atkins is looking at deals.

Barclays is placing some of the £100m it underwrote on Victoria House (see February issue, p9), while WestImmo is placing £30m of the £82.6m loan it underwrote for Meyer Bergman’s purchase of 50% of the Bentall Centre in Kingston this month. The Aviva Linked Property Fund sold the 50% stake for £130m and kept 50%.

Nigel Chapman, head of syndication at WestImmo, said: “For the right deal there are signs of an emerging market for syndicating deals, but only for sensible ones.”

“It gives the underwriting bank a chance to make a bit more money, while helping the borrower, because they are dealing with just one bank.”

Eurohypo and Lloyds have been tipped as two banks that have the credit approval to potentially underwrite an acquisition of all, or part, of the White Tower CMBS portfolio of London office buildings, in a joint venture with another bank.

This month CB Richard Ellis fired the gun on the sale of the nine buildings, which were assembled by investor Simon Halabi and are now worth around £1bn, putting eight of the properties on the market in two tranches.

Sources said the debt needed to finance their acquisition is about £550m.
Parent company and third-party clients back AXA REIM’s plans to step up debt market activities

AXA REIM seeks €1.5bn to ramp up real estate lending and debt buying

AXA Real Estate Investment Managers is raising another €1bn-€1.5bn of capital to buy debt and make real estate loans.

The insurance group’s fund management business has already spent about €1bn of its €1.7bn investment capacity for European debt.

But Isabelle Scemama, head of commercial real estate loans and corporate finance, said: “We are raising a significant amount of capital from the AXA Group and three or four third-party clients, and should reach €3bn in the coming weeks.”

Scemama said that after a period of buying secondary CMBS in 2008, AXA switched focus last year to new senior lending, or participations in larger deals targeting European countries where local AXA Real Estate teams can give a view on underlying assets and risks.

These are mainly France, the UK, Netherlands, Germany, Spain and the Nordic countries. “We are comfortable that the market offers good spreads and well-structured products, but the vintage is key,” Scemama said. “We want to put new vintage loans in the portfolio.

“We like to be in club deals at an early stage and be involved in the structuring and underwriting. Our target return per deal is 250-300bps over Euribor.”

She said AXA CRE Loans’ larger debt investment clients often preferred to have loans on their balance sheets, with AXA managing the assets. The group also has pools of capital from smaller investors.

According to Scemama, as an asset class for insurance companies, property debt is “quite favourable from a regulatory and accounting point of view.

“Insurance companies have the capacity to bring something different to the market for borrowers. Banks today are in the market to lend for three to five years, but we like long-term financing and can go up to 10 years or even longer.

“We do large-capacity, fixed-rate or floating loans and can execute them in two or three weeks, which is a key issue for a borrower.”

AXA CRE Loans is still interested in investing in secondary debt and has reviewed about €20bn of loans on the secondary market.

Scemama said the company had bid on parts of those portfolios, but had not been successful “because the bid-offer spread is still quite large and banks aren’t prepared to sell at a discount, and generally they were packaged with financing”.

The ins and outs of AXA REIM’s debt buying campaign

AXA REIM has done 39 debt acquisition deals since it started buying real estate debt in 2005 for AXA Insurance. It put such deals on hold in 2006-2007 because it was not comfortable with the state of the market, by which time the group had spent only half its initial €1bn allocation.

It resumed buying in 2008, mainly acquiring CMBS, which then offered good spreads, and paused again when the market was not active, from late 2008 and up to mid 2009.

Since September 2009, Scemama’s team have been active again in the senior lending market.

That month, it took a participation in the club deal that provided debt for the €1.2bn, BBVA Spanish sale-and-leaseback portfolio. It later took part in a €300m, 52% loan-to-value senior refinancing for a pan-European Prologis portfolio, arranged by Goldman Sachs.

SNS Property Finance to offload non-Dutch loanbook

Dutch property lender SNS Property Finance is retrenching to its home market and selling its non-Dutch loanbook, a mixture of performing and non-performing loans.

A €2.4bn European portfolio is up for sale, mainly comprising loans in Germany, France and Spain. Cairn Capital is thought to be advising SNS Property Finance.

Dutch loans account for 73% of the €13.2bn loanbook, and North American loans a further 9%. The sector split between residential, office and retail loans is fairly even.

One high-profile loan is an €815m development loan SNS Property Finance made in 2000 with Postbank for Heron International’s 450,000 sq ft Heron Parc Lille leisure, retail and office scheme in France. Lone Star is one potential buyer, while Goldman Sachs is also understood to be interested, most likely on behalf of its Whitehall International 2008 fund, a $2.3bn, opportunistic vehicle.

In the second half of 2009, SNS Property Finance posted a €128m net loss and wrote down the value of its loans by €126m, following a €91m loss and €153m writedown in the first half.

SNS Property Finance said its biggest writedowns were in the US and Spain, but the Dutch loanbook generated a profit.

SNS Property Finance is part of SNS Reaal and was formed through its parent company’s 2006 purchase of Bouwfonds Property Finance, from ABN AMRO, for €840m.

The asset management and development divisions of the business were bought by Rabobank.

Real Estate Capital  March 2010
BPN Paribas brings in Carter Keall for fund launches

BNP Paribas plans to raise two new property funds and has recruited Chris Carter Keall, formerly head of UK funds at Valad Property Group.

BNP Paribas Real Estate’s investment management business has launched a pan-European real estate fund called Next Estate, which will focus on green office buildings.

The company also plans to launch a UK balanced property fund for overseas investors, which it is believed Carter Keall will help to set up.

The investment manager hopes that Next Estate can raise up to £500m of equity, and a source said that £200m has already been committed ahead of its first closing, scheduled for Q2 2010.

With leverage of up to 40%, the fund could have total spending power of £800m.

The core vehicle will target 99% returns and provide regular distributions greater than 5%. Carter Keall left Valad last year after the company’s listed Advantage Property Income Trust (TAP), which he managed, was taken over by Robert Ware’s Conygar in a £28.5m deal in September.

At BNP Paribas, he will be a senior director in the bank’s investment management division and will help to expand the group’s pooled vehicles.

Carter Keall will report to John Claxon, head of investment management, and is working on a number of new ventures, which are thought to include the launch of the UK investment fund.

Henderson’s sequel to CLOF collects £100m

Henderson Global Investors hopes to have a first closing soon for its Central London Office Fund II, after receiving commitments from three investors.

It is thought that £100m of equity has been promised by UK, Nordic and North American institutional investors.

The seven-year, absolute-return, closed-ended fund, managed by Clive Castle and Nick Deacon, is modelled on CLOF I, which delivered strong returns and has recently been selling assets to return capital to investors.

CLOF II was launched last May with a 12% target annualised internal rate of return and maximum gearing of 50%.

With an overall equity target of £500m, Henderson had initially sought to raise up to £200m for a first closing by the end of 2009, but like many fund managers, has found fund raising tough.

The fund’s investment strategy was designed to take advantage of cyclical opportunities and has also been revised, given the saturation of the market for prime UK assets.

It will now seek £50m-plus, multi-let office buildings with medium and short-term leases and asset management angles.

AIM-listed group plans residential launch after refinancing resi portfolio

Terrace Hill courts partner to set up residential venture

Terrace Hill Group is in talks with a potential partner to set up an institutional residential fund, after refinancing its £236m residential portfolio with Lloyds Banking Group.

The AIM-listed developer and investor has invested in residential since its flotation 14 years ago.

Terrace Hill bought the At.Home portfolio from Nationwide in 2006 and owns a 49% stake, while a company associated with Terrace Hill’s chairman, Robert Adair, owns the other 51%.

The portfolio has been measured by IPD for eight years since the residential index was set up and has always outperformed the benchmark.

Jon Austen, finance director of Terrace Hill, said the group is in talks with an institutional fund manager to set up a joint venture.

“Audten: "We think institutions are interested in resi investment" is in talks with an institutional fund manager to set up a joint venture.

“We have started soft marketing the fund and think institutions are interested in residential investment,” he said.

Terrace Hill and the fund manager would co-invest.

Several fund managers are exploring residential investment, including Aviva Property Investors, Legal & General and Paul Oliver’s new boutique, Curlew Capital (see p8).

The loan refinanced in the £208m deal with Lloyds matured in July 2009 and the new term is for three years; the blended margin is 280 basis points over Libor with 50% hedged through a cap.

Austen’s team has negotiated a ‘back-ended’ 1% exit fee rather than paying an upfront arrangement fee.

Austen said: “This is still a high loan-to-value ratio, but we have a strategy for the assets to cover the interest, and the interest shortfall guarantees stay in place.”

Since October 2008, Terrace Hill has refinanced £340m of loans and extended the average maturity to 30 months.

UK institutions back third Columbus opportunity fund

Columbus Capital Management, the separately run, opportunity fund division of Schroders’ property business, has raised £80m at the first closing of its third fund.

The new fund has a lower target return than previous funds, at 15%.

Ten UK institutional investors have subscribed to the fund. Like other sponsors, Columbus hopes to attract more equity in subsequent closings over the next 12 months.

Columbus’s managing partner is Joe Froud, who has invested in the new fund along with four other Columbus and Schroders directors.

Real Estate Capital | March 2010
Buyer agrees to take on liability of previous loan on German properties

Hansteen rescues UniCredit loan with GPT portfolio buy

UniCredit has salvaged a €300m loan on the former GPT Halverton portfolio of German industrial property by selling the portfolio to UK REIT Hansteen. Hansteen has exchanged on a deal to buy the 34 properties totalling 860,000m², which are 24% vacant, for just €4.

But it is effectively taking on the liabilities, by amending and restating the old UniCredit loan secured on the portfolio at the previous €300m loan size.

The portfolio’s former owner, GPT Halverton, bought the properties in 2007 for €440m, originally in a joint venture with the now bankrupt Babcock & Brown, and has had its equity wiped out.

On completion of the deal next month, Hansteen will pay down €40m of the loan. It will also pay around €30m to break a swap hedging the loan, and re-hedge at mark-to-market levels, halving the coupon from 4.5% to around 2.3%.

The loan-to-value ratio is very high, but there is interest cover of more than two times two, giving Hansteen freedom to sell assets. The industrial specialist said its aim is to sell assets and reduce the gearing.

A source said Hansteen has got the debt on almost identical terms to the original loan, for five years, at 110 basis points over Euribor, at a time when such a portfolio would be near impossible to refinance.

UniCredit director Trevor Homes agreed that the loan terms were soft, but said: “We had a portfolio where arrears were rising and there had been a lack of spending. Now we have a very stable owner/manager; we have cut our bulk exposure by paying off €40m of debt; and changing the coupon on the swap improves the interest cover and gives huge headroom.

“The pricing has remained at under 200bps, but that more than covers the banks’ underlying cost of funds.”

Co-operative effort turned debt around

UniCredit bought the GPT Halverton loan in December 2007, jointly with JP Morgan, from Barclays Capital, which had planned to securitise it.

JP Morgan later sold most of its holding to Austrian bank Hypo Invest. UniCredit now owns 70%, Hypo Invest 24% and JP Morgan 6%.

UniCredit’s Trevor Homes said: “In mid 2009, GPT decided to get out of Europe and sell its European asset management platform. It told us that it wouldn’t put any more money into this deal.

The portfolio needed capital expenditure and vacancy rates were rising.

“We were concerned about our borrower’s decisions, so we worked with GPT’s London team, which brought in Richard Ellis as an adviser to find a buyer at the level of the existing debt.

“Everyone was co-operative and supportive. Hansteen has acquired a portfolio of critical mass with stapled debt, while GPT had burned through all of its equity, but worked to support the sale and keep the properties going for an asset management fee, when it could have given us back the keys.

“CBRE and Internos [which bought the GPT Halverton fund management platform] are managing the properties in the interim.”

Cushman calls time on Capital Asia business

Cushman & Wakefield’s first attempt to build up a global investment management business in Asia has ended in failure.

The firm has closed down its Cushman & Wakefield Capital Asia operation, which was based in Hong Kong, three and a half years after hiring Helen Wong to lead it.

Wong, who had previously worked at Moody’s, Lazard and as chief financial officer at Pacific Century, had recruited a team and planned to launch vehicles targeting China and India, as well as a pan-Asia fund. The team has now all left.

Cushman & Wakefield said: “The decision was made due primarily to changes in the economic environment, which made it difficult for us to achieve its objectives.

“Cushman & Wakefield Capital Asia was just a part of our overall global investment management strategy.

“In Asia, we will leverage our acquisition of Pacific Investment Corporation, the private fund asset management subsidiary of Japanese real estate fund Pacific Holdings Group, now renamed Cushman & Wakefield Asset Management KK.

“This business manages approximately $2bn of assets on behalf of 20 private funds.”

Cushman & Wakefield Investors has $1.6bn of assets under management in Europe.

CMSA Europe ponders change of name and remit to widen membership

CMSA Europe, the chief lobbying group for Europe’s commercial securitisation market, is widening its remit to include more participants in commercial property finance.

With no sustained return to primary CMBS issuance since the market shut down in August 2007, global CMSA membership has been shrinking.

The US-based Commercial Mortgage Securities Association’s European arm is still in talks on a possible name change to reflect the shift. This month its US parent trade body changed its name to the Commercial Real Estate (CRE) Finance Council.

CMSA Europe plans to set up forums for debt investors, lenders and service providers.

More details will be given at its Spring conference in London on 19-20 April. For more details, contact Carol Wilkie or Jaymon Jones on 020 7073 2853.
Fitch Ratings predicts that only 1% of 73 CMBS loans due to mature this year will be fully repaid

High leverage will put brakes on 2010 repayment of maturing CMBS loans

Repayment of mature European CMBS loans will remain at low levels at least until the end of the year, mainly because of the loans’ high leverage, according to Fitch Ratings.

A further 73 loans worth €3.22bn (£2.86bn) are due to expire this year, bringing the total for the year to 57% of total European securitised debt, 49 of which have loan-to-value ratios above 80%.

This means significant equity contributions will be needed to refinance the loans, as well as an improvement in bank appetite for commercial property debt. Fortunately, the average size of loans maturing this year is €50m; 19% of loans with high LTV ratios, low interest coverage ratios, and other types of CMBS to be used as collateral for government-regulated covered bonds (see Analysis, pp12-13), but this is a less viable solution, as it requires note holders’ agreement.

Centre Parcs loan set for extension

A proposal to extend the loan underlying the £750m securitisation of holiday company Centre Parcs looks likely to be approved next month.

About 75% of CENTP-2007-1 Class A bond holders have said that they will vote for a two-year loan extension to October 2013. In return, the borrower, Blackstone Group, has offered an incentives package including suspending dividends and a 176 basis points rise in margins on all five classes of notes.

There is speculation that the changes are intended to help pay down the loan ahead of a sale of 75% of the profitable business to institutional investors, via a bond issue structured on the cashflow.

US Congress ponders bill to establish government-regulated covered bonds

The US has taken an important step towards setting up a system of government-regulated covered bonds similar to those that exist in the UK, Germany and other European countries.

Republican Scott Garrett has put the US Covered Bonds Act 2010 before Congress. Crucially, the legislation would allow commercial mortgages and CMBS to be used as collateral in the pools backing the bonds. Residential property, home equity assets, and other types of assets such as credit card and car loans are also included.

The Act provides for a regulatory authority to approve bond programmes of eligible issuers and maintain a public list of the issues.

The covered bonds regulator would also specify eligibility criteria for cover pools and set minimum over-collateralisation requirements for bonds backed by different asset classes.

The CRE Finance Council (formerly the Commercial Mortgage Securities Association) has welcomed the move. It believes covered bonds will be a new source of debt finance for commercial and residential real estate, adding much-needed liquidity to the capital markets.

Covered bonds already exist in the US, but supporters of the bill argue that without a statutory framework, the market will not develop.

European covered bonds such as Germany’s pfandbriefs are a big source of mortgage finance (see January issue, pp14-17).

The legislation also includes provisions in case of default and insolvency of covered bonds, and for them to be governed by the appropriate securities regulations.

The move to introduce regulated covered bonds to the US began two years ago, when former Secretary of the Treasury Hank Paulson suggested they might be used to help the US housing market regain liquidity.
US REIT Anthracite files for liquidation

New retail property company Metric Property Investments floated this month on the London Stock Exchange main market, beating its £150m target to raise £175m of equity.

The company, launched by retail experts Andrew Jones, Mark Stirling and Valentine Beresford, has three cornerstone investors, including pension fund USS, which took close to 10% each.

As well as UK investors, the share register includes Dutch, US and Australian names. The directors have invested £6.5m.

Metric is structured as a REIT – the 22nd to be launched in the UK and the third start-up.

One of these, Anthracite Metric, is structured as a REIT – the 22nd to be launched in the UK and the third start-up.

USA Property Capital, a specialist in real estate debt, has filed for liquidation in the US after defaulting on its own debt.

Managed by BlackRock, Anthracite invests in CMBS, commercial real estate loans and REIT securities, at the riskier, high-yield end of the market, buying mostly B-notes and subordinated CMBS.

Anthracite also funds itself by securitising property loans and CMBS. It issued seven collateralised debt obligations between 2002 and 2006.

One of these, Anthracite Euro CRE CDO 2006-1, a €245m issue of floating-rate notes, was collateralised with commercial real estate, mainly CMBS and subordinated loans.

Two-thirds of the underlying properties, mostly offices, are in Germany and the rest in the UK. Also managed by BlackRock, it was issued in 2006 but is not due to mature until 2042.

In Q1 2009, Fitch downgraded many of Euro CDO’s assets, triggering a breach of its covenants. In November, the company said cash flow remaining after paying interest on class A and class B senior notes was being diverted to pay the class A notes’ principal.

The credit crunch hit the value of Anthracite’s assets and its funding sources dried up as banks stopped lending and demand for CDOs evaporated.

In December, the company defaulted on $1.6m of interest payments on $79.25m of senior notes, due on October 30.

Anthracite’s bankruptcy filing puts its assets at $100m-$500m and its debt at $500m-$1bn.

Shareholders are likely to be wiped out and recovery for unsecured creditors would be "minimal", the company said.

Around 14% of the shares are held by a limited partnership Credit Suisse runs for its clients.

In brief

Norway targets indirect property

Norway’s government pension fund has published long-awaited guidelines allowing the £100bn fund to invest 5% of its equity in real estate. The fund is switching the cash out of fixed-income investments. It is thought that the fund’s manager, Norges Bank Investment Management, will put all £15bn into unlisted property funds in the UK and Europe. Norway’s finance ministry first announced that it was considering investing in property two years ago.

Budget break for REITs

REITs received a boost in the Budget, which proposed to allow stock dividends to count towards their requirement to distribute 90% of earnings to shareholders. Currently only cash dividends count toward this distribution. The change will enable REITs to conserve cash to fund working capital requirements, but the measure will not be enacted until the next parliamentary session.

Property bankers forge links

The Association of Property Bankers is looking at ways of expanding its links with the wider property industry, according to president Andrew Goodbody. One idea being considered is setting up a financial/debt-focused special interest group with the Investment Property Forum.

MedicX gains £24.7m injection

Quoted UK healthcare property investor MedicX Fund has raised £24.7m from a placing and new shares offer, at a price of 72p per share. The proceeds will be used to buy purpose-built primary healthcare properties leased to GPs, health trusts and councils. Pinsent Masons’ corporate property team advised the fund. The sponsor and bookrunner was Collins Stewart Europe.
People

CBRE trio joins JLL in Houston
Jones Lang LaSalle has poached three senior managing directors in the US from rival CB Richard Ellis to beef up its global capital markets business and run its Americas real estate investment banking (REIB) business. Thomas Fish, Michael Melody and Thomas Melody will work with Jay Koster, JLL Americas’ capital markets president, to expand REIB, which has offices in Chicago, Los Angeles, New York and Washington DC. The trio, to be based in Houston, has completed $20bn in debt and equity deals in the past decade. The Melodys formerly helped build LJ Melody & Co, which CBRE bought in 1996.

Kavanagh takes AXA REIM post
Anne Kavanagh has left Lazard after less than two years to join AXA Real Estate Investment Managers as global head of property services. Kavanagh will be responsible for acquisitions, sales, asset management and development. She will report to CEO Pierre Vaquier, join the management board and be re-united with Dennis Lopez, global chief investment officer at AXA REIM, whom she previously worked with at Cambridge Place Investment Management.

Soult moves to Cordea Savills
Cordea Savills has appointed Helen Soult as assistant portfolio manager for the Charities Property Fund, reporting to director of investment Harry de Foster. Soult was previously at Savills, where she advised on rent reviews and lease renewals. The fund bought Apex retail park in Twickenham earlier this month for £4.4m, at a net initial yield of 6.4%, and four other investments totalling £4om in the second half of 2009, with an average of 12 years left until the leases expire.

Quartet teams up for £100m retail fund

Four retail property veterans plan to raise £100m of equity for a new UK shopping centre fund. Centenary Investments, Ashcroft Estates and Henry Boot hope to raise the money by the summer for the CAB Shopping Centre Fund. Curlew Capital, a new company set up by Valad’s Paul Oliver, is advising on the fund raising and is targeting UK and continental European investors. Centenary Investments is run by experienced trader-investor Ranulph Philips, while Ashcroft Estates, run by Tony Baker, Ian Moorcroft and Anthony Suchlick, has a track record in intensive retail asset management. CAB will target £50m to £80m schemes where it can improve income, particularly investments that changed hands in the rising market without having any money spent improving them.

Baker said: “A number of cornerstone investors have said they will come in. We think there is value in certain areas of the retail market now.”

Oliver will remain a consultant at Valad Europe until September.

Listed agent was unable to find buyer for stake in fund management arm

Savills takes back 40% stake from Cordea’s management

Savills has bought a 40% stake in its European property fund management arm from the management, after failing to find a buyer.

Savills will pay £13.6m-£15.4m over two years for the stake in Cordea Savills LLP. The business manages £2.5bn of assets mainly in co-mingled, specialist funds. It made a £2.9m profit in 2009, and £3.6m in 2008. It has £12.4m of gross assets and no external debt.

Management is guaranteed £13.6m, reflecting a multiple of 11.7 times 2009 earnings, or about 9.5 times 2008’s profit, on which the deal was based.

To receive the full £15.4m, the Cordea Savills team will have to have boosted profits over 2009 (when they fell), 2010 and 2011 by 100%, compared with the three years to the end of 2009.

The business has 89 staff, including the members who owned the 40% interest, and offices in London, Paris, Milan, Munich, Stockholm, Luxembourg and Singapore.

Chairman John Partridge, chief executive Justin O’Connor and chief operating officer Bill Hackney owned almost 18%, and about 10 staff own 22%.

O’Connor said prices for fund management businesses “were in the high teens” times earnings at the top of the market “but now are seven to 12 times”, while “salaries are probably down by a third ahead the board”.

When the business was set up in April 2004, Cordea Savills’ management agreed that after five years, Savills would sell the 40% stake to a management-approved buyer with resources to expand the business, or buy them out. “But people were only interested in buying the whole business,” O’Connor said.

The buy-out rewarded the management for developing Savills previous, small, in-house business, O’Connor added.

“We took a small, segregated fund manager and made it an international business. But as individuals, we didn’t have the capital to fund the business and Savills said: ‘why should we fund your share of the business?’.

“The next phase is to see where Cordea Savills can grow, by acquisitions or co-investment. The good thing is there is no change in control, management or structure. If we had sold to someone else, we would have had to change the model.”

In its results for the year to December 2009, released on 18 March, Savills said buying the stake was part of its strategy to “build the non-transactional aspects of the business”.

Cordea Savills’ revenue fell 10.8% to £17.4m (from £19.5m in 2008) “mainly as a result of lower transaction income,” the company said. “Like much of the industry, Cordea Savills spent most of 2009 consolidating its fund positions and working through the impact of asset value falls.

“IT restructured its closed-end Italian Opportunities Funds (1 and 2), and other Northern European closed-ended funds.

“The team launched the UK Income and Growth Fund. This, plus strong inflows into the UK Charities Property Fund and Euro Commercial Fund, represented successful fund raising in a difficult year.”
Invesco Real Estate has expanded its flagship pan-European property fund after taking in a €61m commitment from two new investors in February.

One is a Dutch fund, which has helped broaden the open-ended vehicle’s previously German and UK investor base.

The core/core-plus vehicle was launched in November 2008 with €530m of equity from two German investors.

In a second closing last July, Invesco raised a further €55m from three UK and German investors: a savings bank, fund of funds, and a pension fund. The fund has now raised more than €190m from nine investors.

Simon Redman, Invesco Real Estate’s head of business development, said the fund recently drew down most of the capital, spending €80m last month on 13,900m² Munich office building Renaissance House and two Madrid logistics buildings totalling 35,000m².

The fund’s first buy was Lyon office block City One, for €60m.

“It wouldn’t surprise us if more of our investors increased their commitments; we have a pipeline of people working on due diligence,” he added.

US-owned Invesco’s European team has also raised $120m at the first closing of US Fund IV, a closed-ended vehicle for four European investors targeting the US. The investors are a mix of new and existing clients.

The European business now manages €4.7bn of assets.

Redman said: “Raising money is still difficult. This fund took time because the US is behind the UK and the final signing was about recognising where the market is [in the cycle]. But we are seeing huge interest in the US from continental European investors.”

Invesco also plans to launch a second pan-European hotel fund this year, which will continue its first hotel fund’s strategy of buying mid-range properties.

“This model has proved very successful,” Redman said. “We have maintained the 7.5% dividend distribution and capital values have held up.

“We had about seven investors and two closings for the first hotel fund. It appeals to lots of clients because its income is focused in a specialist sector.”

A pan-European fund that will target higher returns, at around 12-15%, is also in the pipeline.

“Some of our investors want to be higher up the return curve,” said Redman. “We see investment opportunities across Europe that would yield slightly higher returns and we have the platform in place to do that.”

A third central and eastern European property fund is also on the cards, although not until the timing is right.

**Derivatives buys on the cards for SWIP PUT as investors back strategy change**

The £1.9bn SWIP Property Unit Trust could buy £100m of property derivatives after unit holders voted by a 98% majority to change the open-ended fund’s investment parameters.

Malcolm Naish, head of Scottish Widows Investment Partnership, said: “We will probably buy a series of staggered terms and maturities.

“Even if we limited ourselves to [a derivatives allocation of] 5% of the fund, that would be £100m of notes or swaps; at times it could be more, or less.”

Naish said the fund might trade IPD sectors or subsectors.

Naish and fund manager Gerry Ferguson wanted a mandate to invest in a wider range of liquid investment options, rather than only holding low-yielding cash. The property unit trust has taken in £400m of new money over the past six months.

Naish said: “Previously the PUT could hold cash or direct property. Money has been coming in at a strong rate and we didn’t want to be in a position of being forced buyers.

“We thought that 2010 could be challenging, with a strong capital markets recovery, but the occupier side still fragile.”

SWIP PUT holds about 10% of its assets in cash and the target is 10-20%.

The change of investment focus will also allow Ferguson’s team to buy listed real estate and liquid, mainly government, bonds.

“The idea is to get a better return than was being generated by cash, but it is still primarily a bricks-and-mortar fund, focused on the UK, which is the story the investors bought into,” said Naish.

SWIP’s previous investments in property derivatives involved buying three notes for the £1.1bn Scottish Widows Unitised Fund. The last of the three matures this month.

“I suspect that we would use derivatives to get exposure to beta returns in the market, with the alpha coming from direct investment,” Naish said. “This is not fundamentally altering the PUT, but it is modernising it.”

**IPD seals deal to benchmark AEW Europe’s funds**

IPD has signed a second, multi-country contract to benchmark funds, this time with AEW Europe.

IPD will benchmark all 23 of AEW’s core and value-added funds, worth a total £8.9bn.

The four-year contract follows IPD’s global deal to benchmark all of ING REIM’s funds.

IPD managing director Laurent Ternisien said: “This allows a whole management house-view of performance and is a powerful tool.”

Fifteen of the funds are French focused; four are pan-European; and four are other single-country funds. They include portfolios managed for Caisse des Dépôts et Consignations and CNP Assurances.
Commercial Real Estate Finance: The way forward

Spring Conference
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Secret of success for new funds is listening to investors’ gripes

Last summer, when 60, 70 or even 80 fund managers said they planned to launch UK funds, there was widespread scepticism.

Now, at the end of Q1 2010, the target date for most of them to close, only a handful have done so. Brockton Capital’s £400m raising for a second opportunity fund is a stand-out success. Aviva Property Investors (backed, but not exclusively, by powerful in-house clients) closed on £250m, while Legal & General has just had a respectable first closing of £175m (see p1).

Others have had first closings, but equity is not exactly rolling in. Cordea Savills scraped £70m at last month’s first closing of its UK Income & Growth fund, while Schroders’ Columbus Capital Management managed £80m for its third UK fund.

Aegon Asset Management kicked off its healthcare vehicle with £30m. A year ago, F&C REIT confidently set a £400m target, but apparently more like 10% of that sum has been committed so far.

Hopefully these funds will boost their firepower as other investors come in – they will have to, or else they will not have the necessary critical mass to implement their strategies or earn their managers even adequate fees.

Judging by the alignment and fee structures of recent launches, such as Legal & General’s UK Property Income Fund, managers have also listened to investors complaints and tried to make improvements. Fund managers that have not yet been successful should take note.

Bank is due credit on GPT debt deal

It is not the 1990s again, but bank sales and restructurings are gathering pace. This month, Hansteen’s Ian Watson and Morgan Jones have pulled off their own “German Industrious” by clinching the old GPT Halverton portfolio in Germany.

Just as Nick Leslau pounced on the distressed UK Industrious deal, in which many parties lost their shirts, the duo has bought a large industrial portfolio that destroyed its previous owners’ equity.

They appear to have bought it with debt even cheaper than Leslau’s (see p5) and at a much higher loan-to-value ratio, when it would be impossible to get a loan in the open market on such terms, if at all, for a portfolio of this size and secondary quality.

Incumbent lender UniCredit effectively agreed a ‘soft’ loan to salvage its position. It may have been lucky that the perfect buyers came along with cash burning a hole in their pockets, and it may have had little choice but to instigate a sale last summer when GPT announced it was throwing in the towel in Europe.

But the bank deserves credit for keeping a large number of parties on side for nine difficult months and seeing it all through. And just in the nick of time, as far as the properties and the income are concerned.
Restructuring of German retail CMBS is first to extend maturity of notes, reports Jane Roberts

CMBS rescue deal brokered on Germany’s Highstreet

The owners of a massive €3.5bn pile of debt secured on a German retail portfolio have agreed an extension of the loans, which they hope will buy time to save tenant Karstadt from value-destroying liquidation.

The debt owners include Fleet Street Finance Two: a €1.13bn, single-borrower, four-tranche, CMBS deal. The restructuring, voted through by bond holders at the end of last month, is significant not just for its size and complexity, but because it extends the maturity of the notes, as well as the loan, for the first time in a CMBS.

The bond holders were in the driving seat when it came to restructuring the debt, secured on the Highstreet portfolio. The receivers, who also had to agree the restructuring, were German bank Valovis, owner of the rest of the senior debt secured on the mainly department store properties, and 23 owners of €1.4bn of mezzanine debt (see diagram opposite).

The restructuring was precipitated last summer when Karstadt’s parent company, Arcandor, filed for insolvency. Arcandor and its retail subsidiaries, Primondo and Quelle, are in the process of being liquidated. But the insolvency receiver is mandated by creditors to try to save loss-making Karstadt and sell the business.

The receiver had asked all stakeholders to agree a restructuring to stabilise the landlord as part of its attempt to sell Karstadt. To this end, the receiver wanted concessions on rent, but crucially, also an extension on the debt to give both Karstadt and the property owner time to recover.

Another unusual aspect of this restructuring is that the borrower approached the bond holders directly to negotiate. The Highstreet equity consortium was led by Goldman Sachs and RREEF, which appointed debt adviser Cairn Capital in October.

Concessions to be had
Some CMBS experts suggest that the bond holders could have won more concessions than the 52bps extra margin across all classes, and given away less, if they had negotiated directly with the receiver, or at least via servicer Capita.

They certainly didn’t get much compared with the carrot offered to bond holders in the Centre Parcs restructuring proposed this month (see news), although the circumstances of the two deals are totally different.

Cairn Capital director David Henriques agrees that with the threat of Karstadt’s liquidation hanging over bond holders, this was a restructuring achieved more by stick than carrot.

As part of the restructuring negotiations, Cushman & Wakefield valued Highstreet portfolio B, the properties securing Fleet Street, at €1.57bn with a tenant, but €713.2m if they were empty (the initial valuation at issue in October 2006 was €1.7bn). That implied loss would wipe out the equity, mezzanine, and three out of the four securitised senior classes in the deal, and would break in class A.

But Henriques rejects the idea that bond holders were not given every chance to negotiate. “This really wasn’t take it or leave it: we had eight weeks of incredibly intensive negotiation,” he says.

Cairn contacted a majority of the 50 bond holders. “We found a high percentage, then set up an informal steering committee of 17 key bond holders across all the classes, so there was a counterparty to negotiate with,” says Peter Hansell, Cairn’s head of real estate. “That steering group, encouraged by Cairn, took its own financial and legal advice, enabling more focused negotiation between two financial advisers acting for a broader group of clients.

“To try and negotiate against 50 bond holders individually is an impossible task,” Hansell adds. “We refined it to people who perhaps have a greater economic interest in the deal, but are respected by their counterparties across the capital structure.

“They are not making decisions on behalf of the bond-holder base, but are doing the work everybody else would need to do to feel comfortable with the deal. Then, having reached agreement with that steering committee, we were in a position to launch

Fleet Street’s latest edition
Cairn’s Peter Hanssell says the changes to Fleet Street Finance 2 “are all pretty positive: keeping the lease in place, trapping the cash; and hyper-amortising the deal”.

The loan maturity is extended from July 2014 to July 2017 and the margin paid on all four classes of bonds rises 52 basis points. All cash is trapped to pay off the CMBS loan, rather than paying down the mezzanine loan, while the €135m rent is cut by €13m over five years, in return for a five-year extension on most stores’ leases.
No downgrades for bonds

Rating agencies Fitch and Moody’s were convinced that the restructuring did not amount to a “coercive debt exchange” and did not downgrade the bonds, although Standard & Poor’s has not backed it.

Henriques says: “I think this is the first time a CMBS has been restructured with no comfort around the ratings, but once bond holders are worrying about principal loss, then the ratings, while important, become a secondary concern.

“By contrast, we also advised on restructuring Hercules Unit Trust, and there is no way we’d have got that done if we’d done anything resulting in a downgrade. That’s the difference between a deal where you’ve got potential principal loss and one where you don’t.”

In a note this month titled Recent trends in European CMBS servicing, securitisation lawyers Charles Roberts and Conor Downey of Paul Hastings said the Fleet Street deal may suggest “that CMBS restructurings will be easiest when risks to value are so great that every class of bond are at risk”.

Yet everything – not least whether Goldman Sachs’ equity will ever ‘come back into the money’ – still hangs on whether the receiver can sell the business.

For more on CMBS restructuring, see the January 2010 issue (Opera Germany 2) and October 2009 issue (Hercules Unit Trust)
Analysis: WestImmo disposal

Private equity players and German rival vie for profitable real estate lender, writes Lauren Parr

Blackstone leads five-horse race to snap up WestImmo

Five parties are vying to buy German real estate bank Westdeutsche Immobilienbank (WestImmo). Parent company Westdeutsche Landesbank (WestLB) is thought to have whittled down the shortlist for the second round of bidding to: The Blackstone Group – the likely frontrunner – Aareal Bank; Lone Star, Apollo Management and Colony Capital.

WestLB received non-binding offers for the real estate finance business in the early stages of the auction, all believed to be below book value. The deadline for table binding offers is said to be mid April.

WestLB valued WestImmo at €5.5bn (£4.53bn) at the end of 2008, but market speculation puts the asking price lower, at somewhere in the €500m-€700m range.

WestImmo – which has a €27bn balance sheet, is profitable, and operates in Europe, the US and Asia – is the first sizeable real estate bank to be offered for sale in the wake of the financial crisis.

Stricken WestLB hopes to offload €85bn of assets into what would be Germany’s first so-called ‘bad bank’ and is selling its subsidiary to meet European Union demands for a radical restructuring, in exchange for state aid that rescued the landesbank in 2008.

To the same end, it recently agreed to sell its Polish subsidiary, WestLB Bank Polska, to Abris Capital Partners and IDMSA for an undisclosed sum.

The price WestImmo fetches could determine whether other banks will be forced to revalue their real estate assets. The EU has ordered Commerzbank to sell Eurohypo, Europe’s largest pure property bank, by 2014, while Deutsche Pfandbriefbank, which was nationalised following several bailouts, is also shedding assets.

“WestImmo has been originating good new loans [see box], but its legacy portfolio is probably not marked at a price you could clear,” says one of the five shortlisted bidders.

WestLB began the disposal process for WestImmo in October, when it appointed Citigroup and JPMorgan Chase to arrange the sale. The bidding officially opened at the start of this year and bidders were invited to submit expressions of interest by 22 January, and indicative offers by 26 February.

WestLB will pick a buyer partly on its financial strength, in particular its rating, to safeguard WestImmo’s solvency in the long run. Access to financing and the ability to conclude the deal by the deadline will be other important factors. The group would prefer to sell the bank in its entirety, but will consider alternative acquisition structures, such as a majority shareholding that allows WestLB to exit from a minority stake later.

One rival bidder

Aareal Bank is the only direct rival bank in the running, which has surprised some observers, but may please WestImmo’s staff.

Aareal is a specialist property lender, but only resumed new UK business this year. The bank declined to comment on WestImmo.

The same bidder says: “We’re looking at WestImmo, as it’s a management team we know. A real estate lender is a good thing to be now. With access to pfandbrief to fund new business, and the combination of [WestImmo’s] global footprint and our real estate expertise, [the result] could be the emergence of one of the most dominant lenders, as everyone else is down.”

But funding the bank beyond the cost of the acquisition could be problematic for a private equity investor, unless it is granted access to German government capital, because future regulatory capital requirements for European banks are uncertain.

“The big issue about the WestImmo sale is the prospect of a busted auction,” says the bidder. “There is a high chance WestLB will fail, because this is not about buying a loan book, it is a private equity deal to buy a bank.

“We are in talks and it is not clear how keen they are. We would have a go on our own, but it wouldn’t be a conforming all-cash bid. We would need access to Landesbank capital and that would need to be tied up.”

Profitable deal-maker is a tempting takeover target

There are clear advantages to buying a business like WestImmo. The bank has been busy writing profitable new loans – €6.2bn across all markets in 2009 – and is among a club of German lenders becoming steadily more competitive for new business, which are said to be squeezing UK margins below 200 basis points to win clients.

Led in London by Peter Denton, WestImmo has been one of the most active banks in the UK. It has not made the biggest bilateral loans or taken the largest participations, but along with rival Eurohypo, arranged all of last year’s big UK club deals, including the refinancings of Capital Shopping Centres’ Lakeside in Thurrock, St Davids shopping centre in Cardiff (also for CSC, and Land Securities), and Bicester Village for Value Retail.

This month Denton’s team wrote an £82.6m loan for Meyer Bergman’s purchase of a 50% interest in the Bentall Centre in Kingston from Aviva Investors.

WestImmo issued £2.2bn of pfandbrief and uncovered bonds in the first half of 2009, compared to £2bn in all of 2008. Its 2010 global origination target is £3-3.5bn, 10-15% of it in the UK. Denton said recently: “People see WestImmo as a functioning business rather than a loan book and it is important for everyone that we do business.”

Denton: “People see WestImmo as a functioning business rather than just a loanbook and it is important that we do business.”
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Investors and fund managers: a relationship on the rocks?

Given the financial meltdown and real estate slump, many property fund managers still in business will have lost money, even if they haven’t yet realised losses. But their misfortune is not solely attributable to the crisis. It has also come to light that some funds made poor decisions.

A combination of bad investments and inappropriate financing leveraged their returns but also raised the risk. As a result, investors have lost trust in certain fund structures – and some fund managers.

“People are looking for the right product, the right fee structure and alignment of interests,” says Simon Redman, head of European product development at Invesco Real Estate. “They are also looking for stable fund management businesses. We had an industry that grew very quickly and not all the practices aligned investors and managers properly.”

Deborah Lloyd, a partner at law firm Nabarro, adds: “Most investors think most managers failed to manage debt well. Now they want to know how it will be managed, who will manage it, and the risks.”

In the current climate, gearing is a sensitive issue. With investors now keen to place some limits on borrowing, leverage levels are more in the 40-50% range than the 65-80% range.

Gearing will also soon be subject to strict regulation. The European Commission’s proposal for a Directive on Alternative Investment Fund Managers aims to place restrictions on leverage and introduce capital adequacy tests for funds.

Cross-collateralisation is also unpopular with investors. Some managers secured debt against a pool of assets, rather than on an asset-by-asset basis, because this approach allowed them to secure better financing terms. As investors have discovered, this formula exacerbated risk because if one asset fell, they all did.

It is also common for established fund managers to have a revolving bank facility, so they can respond to investment opportunities quickly, rather than drawing down capital from investors. But leverage-wary investors are now seeking to ensure that the size of borrowing facilities is capped and that there is an obligation to repay by a set date.

Risk-averse investors “Investors don’t want anything smart or stupid – they want something that’s going to reduce risk... investors are now analysing the risk and returns in more detail than they were before” Dominic Field, Grosvenor

“Investors don’t want anything smart or stupid – they want something that’s going to reduce risk,” says Dominic Field, business development director at Grosvenor Fund Management.

“Managers need to put someone in front of them who is going to arrange the debt, to explain how they are hedging interest rate risk and currency risk, for example. Investors are now analysing the risk and returns in more detail than they were before.”

Investors are looking at different return metrics, such as equity multiples, which indicate how many times their initial equity they are likely to get back at the end of the fund’s life, rather than just the internal rate of return (IRR), which is a time-weighted calculation of returns and thus very sensitive to the timing and magnitude of investments.

“People are very focused on the multiples, particularly now, because you can have a very high IRR but a very low multiple,” Field says. “You can’t bank an IRR, so investors want to know how much money they’re actually going to make and for that they need to look at the multiple.”

The focus on aligning investors’ and managers’ interests is sharper than ever before. In funds launched during the 2003-2006 boom years, the balance of power lay with managers.

“The parameters of investor control over issues like voting mechanisms, debt levels and investment restrictions have been severely tested during the downturn,” says Albert Yang, director of institutional business at Henderson Global Investors. “The lessons learned have been incorporated into new fund documentation leading to more focused and complex investment solutions.”
Investors in these funds are finding it difficult to assert control because of the level of discretion they originally gave to managers. But now that capital is scarce, equity providers are feeling more empowered and are looking for structures that will ensure that managers don’t wander off-piste.

“Investors want more alignment between the manager and fund, so they’re asking for co-investment from the house, even on core funds,” says Grosvenor’s Field.

“Having co-investment in itself doesn’t make things better, because when the market goes down, everyone loses money. But it makes investors feel better, as they think the manager will look after their money.”

With fund raising still very challenging, managers are more willing to negotiate points (within reason) to get investors on board. Peter Hughes, a partner at law firm Salans, cites a deal where the fund manager agreed that the sponsor’s equity would be treated as subordinated to other investors’ capital. “This put a real onus on the sponsor to back an idea they were confident would be a possible fund, because they had to put in the first chunk of capital,” he says.

Some – mainly larger – investors are eschewing funds as an indirect route into real estate altogether. “This year and possibly next will be the years of separate accounts and joint ventures, as opposed to the years of co-mingled funds,” notes Field.

**Pooled funds out of favour**

Large pooled funds have fallen out of favour somewhat, because with so many investors involved – not all of whose interests are the same – decision-making can be tortuous. This is especially true when, as Field puts it, “strong but sensitive leadership is hugely lacking”.

Corporate governance has also been tested – and in many cases found wanting. Some funds’ advisory board members have been reluctant to get involved when difficulties arise. “They don’t want to be put in the firing line,” says Hughes. “Investors are spending more time on corporate governance.”

The relationship between fund managers and investors has also come under stress, prompting pressure for ‘no fault divorces’ – US-born clauses that allow a fund's limited partners to vote to remove the general partner if they lose faith in it or are dissatisfied with the fund’s performance. Without this clause, investors must prove the manager was negligent or fraudulent.

However, divorcing your general partner is an extreme move and one that is likely to remain the exception. “As unpopular as it may be with managers, they feel there are few circumstances in which divorce clauses would be invoked – the notion is that it gives investors a greater sense of control over their money,” says Henderson’s Yang.

As with marriage, communication between partners in funds is crucial to the health of the relationship. Reporting mechanisms are being beefed up and fund managers will be wise to flag up any problems early on.

Field concludes: “When the market falls, investors are understanding of bad performance, but they’re not understanding of bad behaviour.”

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**EU cracks down on fund managers’ pay policies**

The European Union’s original draft directive on alternative investment fund managers (AIFM) did not tackle fund managers’ pay. But the latest version, due to come into effect in 2012, includes measures that would heavily regulate the way fund managers are remunerated.

It says that:
- **Pay policy must promote “sound and effective risk management and not encourage risk-taking that exceeds the level of tolerated risk of the fund”**.
- **Performance-related pay must be assessed over a “multi-year framework” that is appropriate to the lifecycle of the fund and spread over a period “which takes account of the underlying business cycle” of the fund, and the business risks.**
- **At least 40% of performance-related pay or bonuses must be deferred for at least three years, and if it is a “particularly high amount”, at least 60% must be deferred.**
- **The fund’s annual report should disclose the pay of highly paid individuals.**
- **Large fund management houses, or those managing large or complex funds, must have an independent remuneration committee for pay policies and incentives.**

Only funds that market to investors across EU borders will be subject to these rules. So some fund managers won’t be affected and will still be covered by national laws, which are not expected to change in Northern Europe. But more protectionist countries like Spain and Italy may prohibit managers from marketing there unless they operate under the new EU directive.

“Only one or two people have said they won’t operate under these regulations,” says Nabarro’s Deborah Lloyd. “Some clients think it will be good for them because they only want to market in one jurisdiction so won’t have to comply with the directive.”

As well as tackling pay, the EU directive says a regulated fund has to have its main decision-maker authorised. As most limited partnerships’ general partners aren’t authorised, decision-making in these funds may have to shift to the investment partner.

The directive also requires regulated funds to have a depository: a custodian that ensures the assets, eg share certificates or title documentation, are secured. APUs already have trustees, but LLPs don’t.

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**The changing shape of fees and carried interest**

Turbulent times mean investors want changes to managers’ fee structures

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<td>Unrealised capital gains</td>
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<td>Deal-by-deal return</td>
<td>Whole fund return</td>
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Source: Nabarro
Special report: Fund structures

In future, investors are only likely to accept certain fees if managers work harder to earn them

Fees minus the performance is an unfair sum for investors

Investors recognise that they must pay decent fees to get capable managers and stable platforms. However, as Joe Valente, head of investment strategy at German investor Allianz Real Estate points out, managers have lost money while collecting “astronomically high fees”.

Investors are sore and pushing for changes. “They have realised that the fees have been quite an important factor in how managers have behaved, because some fees give the manager an incentive to maximise leverage, for example,” notes Antonio Alvarez, investment director at Aberdeen Property Investors.

This January, consultancy Towers Watson warned that the fees for many real estate funds, particularly opportunistic ones, are too high, and pointed to features it would like to see changed.

These included a move to deal-by-deal payment of performance fees (with capital invested in individual assets returned), as opposed to prioritising the return of all capital first; and fees based on net, rather than gross, asset value, and on invested capital, rather than commitments.

As Towers Watson indicates, levying management fees on gross asset value (GAV) rather than on net asset values (NAV) may not be in investors’ interest – yet this was the arrangement favoured by 53% of the European funds polled by INREV in a 2009 survey.

Bigger bets risked bigger losses

This approach to fees ignores gearing and encourages managers to increase their assets under management: in other words, to take bigger bets and risk bigger losses.

“Gone are the days of trying to charge management fees on gross asset value – there’s definitely a sway by investors towards net asset value,” says Alvarez.

Invista recently switched to charging a NAV-based fee for its flagship UK listed property trust.

Meanwhile, as part of a restructuring that raised £22.4m of fresh equity, ING agreed to swap GAV to NAV as the fee basis for its UK Property Income Fund. The fund manager also introduced six-month liquidity, capped at 10% of NAV, as well cutting gearing.

Investors are also questioning whether they should be charged fees on committed, rather than invested, capital, as they resent paying for idle capital. This arrangement was common when the real estate fund management business was starting up and managers needed the fee income to survive while their first funds got under way. But now that most fund managers are well-established, this argument has lost force.

However, INREV’s survey found that for European real estate opportunity funds, the average management fee is 1.64%, with drawn commitment being the most commonly applied basis.

Covering costs, not making profits

Investors now argue that management fees should just cover the operational costs of running a fund and not generate any profits for the fund manager – especially if the fund already has a profit-sharing arrangement in place.

Albert Yang, director of institutional business at Henderson Global Investors, says: “Investors want to change the way fees are paid. But they realise that if they squeeze managers too much on fees this may not provide sufficient long-term management incentives”

Albert Yang, Henderson

However, using invested capital as the basis for fees runs the risk that managers will be encouraged to rush money into the market, buying property at the wrong time or wrong price.

Some fund managers are also under pressure to lower their management fees, particularly for opportunistic funds. To help it raise equity from big US investors for two distressed debt funds, Lone Star recently cut the minimum management fee it will charge to 0.35%, from 0.75% in its previous fund.

INREV’s 2009 fees survey found that for unlisted European real estate funds, the average management fees (based on GAV) is 0.59% for core funds and 0.61% for value-added funds.

In the past, opportunity funds tended to follow the “2 and 20” private equity model: charging a 2% management fee on committed capital and a performance fee, or ‘carry’, of 20% of the fund’s profit.

“Investors want to change the way fees are paid. But they realise that if they squeeze managers too much on fees this may not provide sufficient long-term management incentives”

Albert Yang, Henderson

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Investors now argue that management fees should just cover the operational costs of running a fund and not generate any profits for the fund manager – especially if the fund already has a profit-sharing arrangement in place.

Albert Yang, director of institutional business at Henderson Global Investors,
target internal rate of return (IRR) was two percentage points across all funds and was highest for opportunity funds, where the differential was 5%-5.5%.

“There is likely to be some adjustment of hurdle rates, to move closer to the fund’s target internal rate of return in new funds,” said Lonneke Lówik, INREV’s director of research and market information, when the research was published. ‘Style drift’ among funds is another issue that has come to the fore. As the market heated up and yields compressed, some fund managers were tempted to move higher up the risk curve; sitting on cash because the market was too hot would not have earned them performance-related fees.

But when the slump came, investors discovered that what they thought was a core fund had drifted into making value-added, or even opportunistic, investments. Hence investors are now trying to limit fund managers’ discretion to invest – even though this runs the risk of hamstringing them by slowing down the investment process. The industry is also trying to develop performance benchmarks and hurdle targets that include a broader definition of risk, to better classify different investment styles.

Claw-back agreements are another area of contention. These entitle investors to retrieve a proportion of the performance fees paid to managers if, at the end of a specified term, the fund underperforms.

Last month, Hermes announced that it would roll out its claw-back option across all its businesses, including third-party mandates. This gives investors the option of splitting annual performance fees, to be held in escrow and paid over three years. If a fund underperforms in any given year, Hermes will forfeit the fee for that period.

But according to Nabarro’s Lloyd, claw-back provisions have rarely covered all of investors’ losses. Investors also have to consider the financial strength of the company the obligation is coming from.

“If you are going to have a claw-back, you want it to be from a company of substance,” says Peter Hughes, a partner at law firm Salans. “If you’re dealing with a small fund, or an entrepreneurial individual, I would say you shouldn’t even have the concept of a claw-back, because you shouldn’t allow a situation to arise where the general partner receives a penny until the investors receive every penny of their investment back.”

Acquisition fees are also being questioned. These fees, paid by investors on transactions, can amount to around 15-20 basis points (based on an acquisition fee of 1% on a property held for five years, over which period amortisation takes place). Such fees can encourage fund managers to spend money quickly.

**Argument for acquisition fees**

Simon Redman, head of European product development at Invesco Real Estate, insists that acquisition fees have their place, however. “If you look at the resources you have to deploy as part of the business – a big transaction team and the associated underwriting and legal teams – it is a very heavy resource,” he argues.

Although Invesco does not charge acquisition fees for its open-ended, pan-European fund, it does charge them for most of its other funds.

“You look at the overall economics on the fees you get, so that the economics stack up for the manager,” Redman says. “If you don’t have acquisition fees, you have higher overall annual management fees.”

Instead, back-end disposal fees hold more weight. David Kirby, group head of funds management at Valad, says that in the future, alignment of investors’ and managers’ interests could come from splitting fees between asset value and income, to ensure that the manager focuses on the performance of the fund.

Although INREV’s 2009 poll found that only 22 of the 238 funds surveyed had actually changed their fee structures, it is clear that new funds launched this year will be rather different.

For example, Grosvenor says it has not felt any pressure from investors to change its “fairly conservative” management fees. But it does not plan to charge performance fees on any of the four new funds it is thinking of launching this year, though it is establishing a system that lets individual fund managers share in the funds’ rewards.

Invesco’s Redman believes more aggressive fees will be curtailed and some boutique managers will disappear as a consequence of a maturing market.

Others are more sceptical. “There is still a level of arrogance in part of the industry, which is ‘very 2006,’” says Allianz Real Estate’s Valente. “Not all, but many of those managers haven’t recognised the full extent of the change in the market, despite what they say.”
Having reinvented itself as a commercial property lender, the German bank hit the UK just as others were retreating, helping it to almost double its loan book last year. Jane Roberts reports

Germany’s new kid on the block builds on timely arrival

In the cohort of German specialist real estate banks that have been so vital to Europe’s property market in the past two years, DG Hyp is the new kid on the block.

The bank has been around for many years as a residential mortgage lender (see panel) but was completely re-invented five years ago as a commercial real estate lender, first in Germany and then overseas.

The Hamburg-based bank is not nearly as large as Eurohypo or Deutsche Pfandbriefbank in terms of book size or origination, but has grown into a successful medium-sized lender from a standing start.

The bank completed €4.2bn of new lending on European and US property last year. Its total commercial real estate book was worth more than €21bn by mid 2009.

To UK minds, the bank’s structure seems unusual: it is owned by more than 1,000 German co-operative banks and their customers, via DZ Bank, the ‘central bank’ for these ‘Volksbanken’. But its lending model is “very simple”, says Steffen Günther, head of international and secondary market business.

Günther, who joined from Landesbank Berlin/Berlin Hyp in 2008 to manage overseas expansion, says: “We are a balance-sheet lender. Whatever we do, we take a long-term view for our balance sheet; we are not lending to repackage or sell back to someone else. We want to be a reliable, relationship bank for clients with a long-term view.”

DG Hyp’s domestic business has offices in six of Germany’s biggest cities but also works with the network of 13,000 co-op branches. For example, last year, the real estate bank and Dortmunder Volksbank led a consortium including two local savings banks to fund construction of the Neues Thier-Areal gallery shopping centre in Dortmund, for German developer ECE.

But DG Hyp is also fashioning its own stable of private and institutional property clients, first at home and increasingly abroad.

Günther says German assets account for between two-thirds and three-quarters of the total property book, a proportion DG Hyp wishes to maintain. The rest is international business, developed after expansion of the bank’s franchise outside Germany began in 2006, when the bank opened a New York office. The London office opened in 2007.

Until this year, business with clients in other markets was managed by desks in the Hamburg HQ – and the Nordic business still is. But recently, DG Hyp opened a Paris office. So far the French team has just two
staff, headed by Anne-Isabelle Carbonnières.

Günther hopes a fourth international office will open by April, in Warsaw, headed by Marek Buzek. The bank is just waiting for its banking licence to come through.

“When we think about international markets, our first priority is to ask ‘where do our German clients want to target?’,” says Günther. “Then we look at markets from an economic standpoint and at the robustness of their legal system, especially whether they recognise mortgages as security collateral. Third is the growth story, which Poland has.”

Poland completes this phase of expansion. “Now we want to consolidate in these four markets and excel there,” Günther adds.

The London office is run by Andrew Goodbody, formerly of Erste Bank. Last year his seven-strong team carried out £450m of new lending, making the UK DG Hyp’s largest international market, with a more than 40% share of the £1.1bn of overseas loans written last year and almost doubling the UK book to around £1bn.

In its first year in London, the bank participated in three or four loans, including Eurohypo’s facility for 3 Hardman Street at Spinningfields in Manchester (see news).

Goodbody says: “Our timing could not have been better”, as by then only a few banks were left in the market and DG Hyp could take advantage of lending on repriced prime property deals at higher margins.

DG Hyp’s timing was not so lucky in the US. In its first couple of years it was lending at the top of the market, in mainly secondary market business in the capital markets. Günther now spends a lot of time travelling to the US and Asia to manage some of these participations that have soured.

The bank is still lending on US property – it issued £300m of loans there last year – but in less complex, first-mortgage lending, European-style structures.

Günther claims the bank is not volume driven, despite much talk at the MIPIM property conference this month that German banks are cutting prices to increase their market share. Günther says: “We are risk and quality driven. We want good assets and simple, conservative finance structures backed by strong sponsors, as that is the best guarantee to see the loan through its life.

“We anticipate £300m-£400m of new UK business this year; if it’s £500m, that will be great. But quality is the thing.”

DG Hyp’s lending parameters are also influenced by the collateral rules of the pfandbrief market, which it uses to help fund its lending programme. It issued

more than £3bn of the bonds last year. For funding, DG Hyp also has the back-up of DZ Bank and its huge retail business.

Prime deals shortage

The main barrier to faster expansion has been the low number of prime deals, but this doesn’t surprise or disappoint Günther. In fact, new European lending business rose 19% in 2009’s tough first half, compared with the first half of 2008, to €1.98bn.

But he adds: “I expected more refinancing business, with banks pulling out of the market for whatever reason and borrowers looking for new banking partners.”

With relatively small international origination teams, DG Hyp does not plan to take on Germany’s bigger property banks in chasing arrangement fees for assembling and managing large club deals.

Goodbody’s team has done one or two simple deals as agent, like the financing of 151 Buckingham Palace Road last year. But Günther adds: “Being the arranger is not a business we are keen on, as it requires a lot of resources and the extra responsibility is not always worthwhile.”

This year, Goodbody believes competition from other lenders will increase in the UK. He does not think loan-to-value covenants will rise, but agrees that banks’ margins on deals are already under pressure as a result.

“At the start of the year I thought margins may fall to 150 basis points (from 200-220bps),” he says. “We haven’t seen signs of that yet, but they are slowly falling.”

Günther maintains this is not a big issue and says that in Germany, margins are generally lower anyway. “You don’t win the battle on price; you win or lose on the risk front,” he adds. As the lending field gets more crowded, DG Hyp hopes that its track record as a reliable bank that makes quick decisions and executes deals fast will pay off.

### DG Hyp’s major 2009 UK lending deals

DG Hyp collaborated with other banks to fund a number of major UK deals, mainly in the second half of 2009.

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction</th>
<th>Client</th>
<th>Participation</th>
<th>Participation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan 09</td>
<td>Capital House, Lombard St</td>
<td>n.a.</td>
<td>£40m (Bilateral)</td>
<td></td>
</tr>
<tr>
<td>April 09</td>
<td>One Exchange Square, EC2</td>
<td>KanAm</td>
<td>£140m (Bilateral)</td>
<td></td>
</tr>
<tr>
<td>Jun 09</td>
<td>One Plough Place</td>
<td>Union Real Estate</td>
<td>€40m each with Santander</td>
<td></td>
</tr>
<tr>
<td>Jun 09</td>
<td>Milton Gate, EC2</td>
<td>Evans Randall</td>
<td>£40m each with Santander</td>
<td></td>
</tr>
<tr>
<td>Jul 09</td>
<td>151 Buckingham Palace Road</td>
<td>SITQ</td>
<td>£96m with Helaba on 50/50 basis. DG Hyp was agent</td>
<td></td>
</tr>
<tr>
<td>July 09</td>
<td>Harvest Limited Partnership</td>
<td>n.a.</td>
<td>£68.4m, with RBS/Santander</td>
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</tr>
<tr>
<td>Aug 09</td>
<td>Prince Bishops Shopping</td>
<td>RREEF Special Invest</td>
<td>£40m (Bilateral)</td>
<td></td>
</tr>
<tr>
<td>Sept 09</td>
<td>Heathrow Big Box</td>
<td>Prudential/Bruton</td>
<td>£40m, with Westimmo</td>
<td></td>
</tr>
<tr>
<td>Oct 09</td>
<td>Bishops Square, London</td>
<td>Hammerson/Oman</td>
<td>£40m in Bayern LB facility</td>
<td></td>
</tr>
<tr>
<td>Dec 09</td>
<td>Garrard House, Cremsham St</td>
<td>AFIAA (Sweden)</td>
<td>Participation</td>
<td></td>
</tr>
<tr>
<td>Dec 09</td>
<td>Bicester Village Value Retail</td>
<td>Value Retail</td>
<td>£40m in five-bank club deal</td>
<td></td>
</tr>
</tbody>
</table>

SOURCE: DG HYp
Optimism looks short-lived as investors scale back 2011 expectations

Investors’ views about the property market in 2010 continue to improve, following more compression in yields, especially secondary ones. Respondents to the latest Colliers CRE/Real Estate Capital survey have upgraded total return forecasts, expecting less severe rent falls and positive capital growth.

But they are less optimistic about 2011, predicting that capital growth will turn negative and lowering their expectations of total returns for next year.

The survey, in its 16th year, is published three times a year and carried out by KASPAR Associates’ Dr Karen Sieracki.

Investment intentions: buy, not sell
Buying continues to be the story. Retail, investors’ favourite since November 2008, is still the top buy with 64% of respondents, followed by offices and industrial, at 57%.

Central London, south-east and south-west retail were favoured by 29% of respondents.

Sentiment towards offices improved, with 57% considering them a buy, compared with 54% in November. Central London offices remain the top pick, but are slightly less favoured than previously, at 36%, compared with 46% last time. Central London, south-east and south-west retail followed, all at 29%.

Pooled on the best locations and sectors to deliver strong medium-term returns, given an anaemic UK economy, 79% of respondents picked central London offices, followed by south-east offices (50%), central London retail (43%) and south-east retail (36%).

Half of those polled felt that now was the time for speculative development. Offices were the favoured sector, with 36% citing central London and 21% saying a prelet would be ideal. Another 28% thought speculative development should start from 2011 to 2013 and after.

Few respondents intended to sell property and it is several years since sale intentions have been so muted. This reluctance to part with assets could have implications for market liquidity, limiting availability of stock.

Yields: secondary fall faster
Yields, which first started to fall in the last survey, continued their downward path. The average prime yield was 6.5%, 30 basis points lower, but secondary yields fell twice as much, by 60bps on average.

The biggest prime yields fall was 60bps for retail warehouses, to 5.8%, while distribution registered the smallest, remaining static at 7.2% – the highest yield of all sectors. Prime shop yields are still the lowest, at 5.4%.

Average secondary property yields fell to 8.0%, from 8.6% in November. Secondary retail warehouse yields fell furthest, by 110bps to 7.3%, while the smallest fall was 10bps for business parks, to 9.1%. Shops had the lowest secondary yield, at 7.1%, and business parks the highest, at 9.1%.

With secondary yields falling faster than prime yields, the gap between the two has narrowed. In absolute figures, distribution has the smallest gap, at 103bps, while shops has the widest, at 179 bps. The prime and secondary yields gap range has risen to 76bps (a 150-202bps range), indicating that expectations for secondary property performance have deteriorated.

“In light of continued rent falls forecast for 2010, pricing continues to be dictated by the capital markets, not property fundamentals,” says Sieracki. “Property pricing now depends on the level of interest rates, gilt yields and quantitative easing. If these change before 2011, property yields are likely to move out.

“There is also an assumption that the economy will not deteriorate when quantitative easing and interest rates change. Pricing dictated by fundamentals is forecast to return in 2011.”

Rental growth: continuing optimism
Rental growth expectations for 2010 and 2011 continue to improve (see table above). Rents are still forecast to fall this year, but by almost half of November’s prediction: a 170bps drop, November (a 150-202bps range), indicating that expectations for secondary property performance have deteriorated.

Average prime yields %
Retail warehouse yields have fallen 60bps since November, the biggest reduction by sub-sector.

Yields, which first started to fall in the last survey, continued their downward path. The average prime yield was 6.5%, 30 basis points lower, but secondary yields fell twice as much, by 60bps on average.

The biggest prime yields fall was 60bps for retail warehouses, to 5.8%, while distribution registered the smallest, remaining static at 7.2% – the highest yield of all sectors. Prime shop yields are still the lowest, at 5.4%.

Average secondary property yields fell to 8.0%, from 8.6% in November. Secondary retail warehouse yields fell furthest, by 110bps to 7.3%, while the smallest fall was 10bps for business parks, to 9.1%. Shops had the lowest secondary yield, at 7.1%, and business parks the highest, at 9.1%.

With secondary yields falling faster than prime yields, the gap between the two has narrowed. In absolute figures, distribution has the smallest gap, at 103bps, while shops has the widest, at 179 bps. The prime and secondary yields gap range has risen to 76bps (a 103-179bps range), after a 52bps fall in November (a 150-202bps range), indicating that expectations for secondary property performance have deteriorated.

“In light of continued rent falls forecast for 2010, pricing continues to be dictated by the capital markets, not property fundamentals,” says Sieracki. “Property pricing now depends on the level of interest rates, gilt yields and quantitative easing. If these change before 2011, property yields are likely to move out.

“There is also an assumption that the economy will not deteriorate when quantitative easing and interest rates change. Pricing dictated by fundamentals is forecast to return in 2011.”
Real Estate Capital  March 2010

Shops continue to have the lowest secondary yields, now down to 7.1%

Average secondary yields %

<table>
<thead>
<tr>
<th>Sector</th>
<th>March '10</th>
<th>November '09</th>
<th>July '09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Offices</td>
<td>5.8</td>
<td>-1.5</td>
<td>0.7</td>
</tr>
<tr>
<td>Business parks</td>
<td>1.9</td>
<td>-3.9</td>
<td>-2.4</td>
</tr>
<tr>
<td>Shops</td>
<td>5.4</td>
<td>0.4</td>
<td>-1.5</td>
</tr>
<tr>
<td>Retail warehouses</td>
<td>7.3</td>
<td>1.5</td>
<td>0.1</td>
</tr>
<tr>
<td>Shopping centres</td>
<td>3.7</td>
<td>-0.8</td>
<td>-0.9</td>
</tr>
<tr>
<td>Industrial</td>
<td>3.8</td>
<td>0.8</td>
<td>-0.8</td>
</tr>
<tr>
<td>Distribution</td>
<td>3.5</td>
<td>1.7</td>
<td>-0.7</td>
</tr>
</tbody>
</table>

SOURCE: KASPAR ASSOCIATES

rather than 333bps, on average. The greatest positive change, 470bps, was for offices, where a 2.4% fall is expected, continuing the trend in the last survey. The least change was for industrial and distribution sectors (270bps for both). Business parks are forecast to produce this year’s worst rental performance, at -5.6%, while offices are expected to perform best, at -2.4%. Average rental growth for 2010 is being pencilled in at -3.4%. Rental growth is likely to return in 2011, albeit at a muted 0.9%: an average rise of 177bps. But business park rents are forecast to continue falling, by 0.8% over the year.

The office sector is expected to improve most (by 350bps) and to produce the best rental growth, at 3.4%. The smallest rises are predicted for shop rents, at 50bps.

“In relative terms, offices and business parks are forecast to improve the most from 2010 to 2011,” says Sieracki. “These are the sectors to target for better performance. The industrial sector is likely to improve the least.”

Capital growth: all values to rise in 2010

Capital growth forecasts for 2010 have also improved. Values are now expected to rise in all sectors this year, by 4.5% on average – a 461bps rise. The biggest rise, of 730bps, is expected for offices, returning the sector to positive territory. Offices are expected to register this year’s best capital growth, at 5.8%, and business parks the worst, at 1.9%.

In November, respondents predicted across-the-board rises in capital values for 2011. Now, they expect them to fall by an average -0.7%. Only two sectors are likely to show growth: offices at 0.7%, and retail warehouses, at 0.5%. Shops are expected to perform the worst, with 1.5% capital value falls.

In relative terms, retail warehouses and shops are predicted to register the largest changes over 2010-2011, at 690bps and 680bps respectively, so will need the most care in terms of pricing. The smallest relative change is expected in distribution (420bps) and business parks (430bps), which could be seen as less volatile over the two years.

Total returns: better in 2010, worse in 2011

Investors’ total return expectations for 2010 rose to 11.2%, from 6.6% in November. Nearly two-thirds (64%) of respondents felt this was due to an investment rally, encouraged by capital flows into property.

But the predicted 2011 total return fell to 5.6%, from 7.6% in November, with 43% of respondents citing slow rental growth and higher yields as the main causes. Some 57% of respondents said property’s high income yield and relative cheapness relative to other asset classes made now a good time to buy.

Investors are still wary of investing via vehicles, joint ventures or derivatives: 50% of respondents would not use these indirect formats. But this was less than the 62% who polled no in November. The 36% that said yes to indirect investment mentioned derivatives, REITs and joint ventures.

For more on the Investor Pricing Survey, contact: Karen.sieracki@kasparassociates.co.uk or: mark.charlton@collierscre.co.uk

A vote of no confidence

With a general election looming, 43% of investors polled thought that a hung parliament would create uncertainty and worry the markets about the government’s ability to act, but they were not sure how long this uncertainty would last.

The same proportion felt a Conservative majority would be positive in the short term. However, others were concerned that a Conservative government would cut expenditure too hard and too fast, causing the economy to experience a double dip.

Nearly a third of respondents (29%) felt the property market would be indifferent to a Labour majority, but 21% thought property would do badly under Labour, predicting more taxes and less of a push for business, slowing the UK’s pull out of recession.
Long-term doubts linger despite encouraging 2009 return
The IPD UK Annual Index showed a 3.5% property return for 2009, but post-2010 pricing reflects fears that recovery will falter

CBRE-GFI market commentary
The pricing of future property risk has been remarkably stable in recent months, with the derivatives market expecting income return to be the main form of growth in the coming years, writes Michel Heller.

The release of the IPD UK Annual Index for 2009, although showing better-than-expected performance, has done little to re-price the risk. The annual index showed a 3.5% total return, or a capital value fall of -3.6% for 2009. Prior to the release of these figures, the derivatives market expected a 2.5% total return for the year.

The lower expectations were the result of earlier figures such as a 0.37% return for 2009 according to the Estimate of Annual Index; the IPD UK Monthly Index posting 2.18%; and the Quarterly Index 3.4%. However, 2009 was the third year of capital falls.

Retail performed best, with a 4.6% total return, followed by industrial, at 4.1%, while offices massively underperformed, with a 0.95% total return. There was huge disparity within sub-sectors, with retail warehouses returning 4.2% capital growth, compared with -11.3% for shopping centres. Income rose 7.4% for all commercial property, compared with 5.6% in 2008.

Despite the better-than-expected IPD pricing, derivatives’ price volatility has been restricted to the front end of the curve. Total returns for 2010 are expected to be 10.6%, an 8bps gain on the month.

This year has continued to trade in its tight 9%-11% range, a development that began in November. Assuming a 7.1% income return, 2010 pricing implies that UK commercial property values will rise for the first time in four years, at 3.5%.

After the 8.8% bounce in capital values from the July 2009 low point to December 2009, the market expects capital values to grow modestly this year, then fall into negative territory again until after 2014.

The market is pricing in 6.4% annual total returns for the 2011-2014 period; a fall of 35bps on the month per calendar year. Overall, the curve implies a 1.2% capital value rise between December 2009 and December 2014, with minor capital value falls expected after 2010.

The derivative curve has given a very consistent message so far this year: the market is convinced that yields will fall further in the short term, which is leading to a stronger expected total return for 2010.

However, the market is not convinced that the UK’s economic recovery will be sustainable, because of the uncertainty created by the forthcoming general election and the potential for the Bank of England to take a hawkish stance, at a time when vast levels of CMBS debt needs to be refinanced.

This indicates an interesting dynamic: for those who believe that these risks are being over-priced, the derivatives market is a screaming buy. Investors are buying derivatives as the cheapest way to gain property exposure at a time when REITs and secondary unit trusts are typically trading at premiums to net asset values.
Indirect investment market

Jones Lang LaSalle market commentary

UK market overview
The Jones Lang LaSalle Balanced Fund Index showed a 1.07% monthly increase in February, reflecting a 1.8% increase over the past 12 months – the first positive 12-month figure for some time, writes Julian Schiller. Taking into account secondary market pricing, the index has moved closer to par, at -6.39% for the 12 months to the end of February.

Balanced funds
Activity in the balanced funds sector has been relatively high, but this has taken the form of many small deals, rather than significant volumes being transacted. Given the high level of demand for balanced fund units and the continued lack of availability of larger holdings for sale, pricing has been at, or even above, funds’ offer price (typically a 3-6% premium to prevailing net asset value). These premiums to NAV will remain for the time being, or at least until the number of vendors is enough to dilute this pent up demand.

Retail warehouse funds
Investors’ opinions on the medium-term prospects for retail warehouse funds continue to diverge, with a corresponding impact on views of fair market value. That said, sizeable deals continue to occur in the Henderson Retail Warehouse fund and Hercules Unit Trust at quite substantial premiums to January NAV.

Shopping centre funds
The limited number of deals that have occurred have been completed at premiums of 3-7%. Pricing has fallen since January on a relative basis only, as the funds have by and large increased on an absolute price per unit basis over the month.

Industrial funds
A small number of significant deals have taken place in the industrial sector. There was a trade in IPIF, the most frequently traded industrial fund, at a premium of around 7% to December NAV. However, in the final month of each quarter there is usually a pause in trading, as investors seek clarity on fund pricing prior to their results being released. So activity is now expected to be limited until the start of the second quarter.

 Demand is still restricted to those funds with lower gearing and more prime assets.

Offices and alternative sectors
There have been no transactions of note in the office sector this month to our knowledge, mainly because of the relatively large difference between buyers’ and sellers’ opinions of pricing. Vendors continue to seek premiums of above 6% for the HLCOF and WELPUT funds – a price that most potential buyers refuse to meet.

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UK property equities

UK REITs performance February 2010
Upbeat interim results made Warner the month’s best REIT performer

<table>
<thead>
<tr>
<th>Company</th>
<th>Feb total return %</th>
<th>Price at end of Feb, p</th>
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<tbody>
<tr>
<td>Warner Estate Holdings</td>
<td>21.3</td>
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<tr>
<td>Rugby Estates Investment Trust</td>
<td>13.9</td>
<td>58</td>
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<tr>
<td>Town Centre Securities</td>
<td>11.5</td>
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<tr>
<td>Primary Health Properties</td>
<td>6.5</td>
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<td>Liberty International</td>
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<td>Local Shopping REIT</td>
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<td>Segro</td>
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<td>Hammerson</td>
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<td>Big Yellow Group</td>
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<td>Great Portland Estates</td>
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<td>Workspace Group</td>
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</tr>
<tr>
<td>Shafesbury</td>
<td>-1.3</td>
<td>376</td>
</tr>
<tr>
<td>Hansteen Holdings</td>
<td>-3.1</td>
<td>77</td>
</tr>
<tr>
<td>Mucklow A &amp; J Group</td>
<td>-3.7</td>
<td>290</td>
</tr>
<tr>
<td>AME Capital UK REIT Index</td>
<td>0.8</td>
<td>39</td>
</tr>
<tr>
<td>FTSE100</td>
<td>3.8</td>
<td>5,355</td>
</tr>
<tr>
<td>UK Property companies*</td>
<td>-0.3</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Source: Macquarie Global Property Securities Analytics  * Market capital weighted average return

UK REIT share prices since launch to 15 March 2010
UK REITs continue to mark time and have underperformed the wider stockmarket

UK REITs by 12-month performance to February 2010
Derwent continues to be the top large-cap performer of 2010

<table>
<thead>
<tr>
<th>Company</th>
<th>12-month total return</th>
<th>Price at 16 March, p</th>
<th>Market cap £m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Workspace Group</td>
<td>131.6</td>
<td>23</td>
<td>267</td>
</tr>
<tr>
<td>Derwent London</td>
<td>121.9</td>
<td>1,338</td>
<td>1,334</td>
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<tr>
<td>Rugby Estates Investment Trust</td>
<td>112.1</td>
<td>53</td>
<td>31</td>
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<tr>
<td>Warner Estate Holdings</td>
<td>111.4</td>
<td>37</td>
<td>21</td>
</tr>
<tr>
<td>Local Shopping REIT</td>
<td>111.1</td>
<td>62</td>
<td>51</td>
</tr>
<tr>
<td>Segro</td>
<td>107.1</td>
<td>331</td>
<td>2,439</td>
</tr>
<tr>
<td>Hansteen Holdings</td>
<td>94.7</td>
<td>86</td>
<td>380</td>
</tr>
<tr>
<td>Town Centre Securities</td>
<td>89.4</td>
<td>146</td>
<td>78</td>
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<tr>
<td>Land Securities Group</td>
<td>82.2</td>
<td>673</td>
<td>5,255</td>
</tr>
<tr>
<td>Great Portland Estates</td>
<td>80.3</td>
<td>301</td>
<td>940</td>
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<tr>
<td>Hammerson</td>
<td>64.9</td>
<td>385</td>
<td>2,721</td>
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<tr>
<td>McKay Securities</td>
<td>62.3</td>
<td>152</td>
<td>70</td>
</tr>
<tr>
<td>Shaftesbury</td>
<td>60.7</td>
<td>377</td>
<td>851</td>
</tr>
<tr>
<td>Big Yellow Group</td>
<td>50.0</td>
<td>328</td>
<td>426</td>
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<tr>
<td>Mucklow A &amp; J Group</td>
<td>45.1</td>
<td>307</td>
<td>177</td>
</tr>
<tr>
<td>Liberty International</td>
<td>43.3</td>
<td>482</td>
<td>3,000</td>
</tr>
<tr>
<td>British Land</td>
<td>31.7</td>
<td>469</td>
<td>4,076</td>
</tr>
<tr>
<td>Primary Health Properties</td>
<td>22.8</td>
<td>298</td>
<td>1,181</td>
</tr>
<tr>
<td>AME Capital UK REIT Index</td>
<td>16.3</td>
<td>41</td>
<td>22,166</td>
</tr>
<tr>
<td>FTSE100</td>
<td>27.9</td>
<td>5,620</td>
<td>1,532,274</td>
</tr>
<tr>
<td>UK property companies*</td>
<td>149.7</td>
<td>n.a.</td>
<td>14,837</td>
</tr>
</tbody>
</table>

Source: Macquarie Global Property Securities Analytics

Real Estate Capital UK commentary
UK property stocks rose 1% in February, compared with a wider stockmarket uplift of 2.8%; UK REITs share prices rose 0.8%.

Capital values rose by 1.3% on IPD’s monthly index for February, while rents fell -0.1%. All-property prime initial yields fell 12bps to 6.8%.

Liberty’s demerger into a new REIT holding its shopping centres, US business (earmarked for sale) and Indian investments, and a non-REIT property firm holding its Central London assets, was greeted favourably. But its shares fell on worse-than-expected 2009 results showing a 13% fall in its portfolio value. The weak occupier market hit industrial REIT Segro, which raised its vacancy rate with last year’s takeover of Brixton. Segro said it will focus on developments in France, Poland and Germany.

Central London specialist Derwent has earmarked £200m for developments, saying rental recovery offers better prospects than buying overpriced investments. Its full-year results – a 20% uplift in net rental income and a 3.3% fall in the portfolio value – underlined the strong central London recovery. The first major REIT flotation of the year was announced in early March; Metric Property has raised £175m to invest in repriced retail property.
Global property equities

Global property performance by region, Feb 2010
Europe was the only region to lose ground in February

SOURCE: MACQUARIE GLOBAL PROPERTY SECURITIES ANALYTICS

Developed markets performance, Feb 2010
Canada and the US led the strong performance by the Americas

SOURCE: MACQUARIE GLOBAL PROPERTY SECURITIES ANALYTICS

Leading markets 12-month performance to Feb 2010
Singapore was by far the best performer for the year to February

SOURCE: MACQUARIE GLOBAL PROPERTY SECURITIES ANALYTICS

Global property securities 12-month returns, Feb 2010
All regions continue to experience a strong recovery in 12-month rolling returns, with the Americas and Asia leading the way

SOURCE: MACQUARIE GLOBAL PROPERTY SECURITIES ANALYTICS

Monthly equity issuance 2009-Feb 2010
Global equity issuance is running at £1bn-plus per month and in February outstripped debt raised

SOURCE: MACQUARIE GLOBAL PROPERTY SECURITIES ANALYTICS

REC global commentary
Global property shares rebounded in February, as total returns rose 2.8%. They also outperformed global stock markets; the MSCI AC World Index registered only 1.5%.

The Americas performed best, at 5.9%. Europe bucked the rising trend and was the only region to end in negative territory, with returns of -0.5%. Of the developed European markets, Spain and Norway led the way down with -12.0% and -4.9% returns respectively. EPRA Europe fell 1.3%, while EPRA North America rose 5.2% and EPRA Asia 2.7%.

Equity raising outstripped debt issuance, with £1.4bn raised globally (see graph, left). There were five IPOs and 11 secondary issues, the latter mainly in the US, Canada and Brazil. Debt issuance fell to £0.7bn; the largest issue was by Unibail, worth £456m.
It is now largely agreed that levels of global real estate investment will be higher this year and prices will firm up, at least for prime stock. The latest Cushman & Wakefield forecast points to a 30% leap in global trading to $478bn (£362bn) – not far off 2005 levels – and this could be bettered if the economic recovery remains on track.

There are plenty of hurdles to overcome to hit these figures, of course. Economic uncertainty persists and while risk appetite is returning for real estate, it has become more volatile lately in other investment markets. Global liquidity could also fall and availability of affordable debt is still a problem in Europe and North America.

The case for buying core assets in key markets is easily made and competition to buy and lend in such markets is now high. Feeding off this market segment may help fill hotels in Paris, London, New York and Sydney, but with available stock scarce, this won’t drive the expected leap in activity.

So where else should investors that are willing to compromise look? For the opportunistic, the answer is virtually anywhere. If the price is right, any market offers opportunities and could contain a rising number of motivated sellers.

But for core players and the small, but perhaps growing, number of value-added investors, greater selectivity is needed as performance polarises. In Europe, they will be slow to leave the larger, more liquid UK, French and German markets. But Nordic markets should pick up this year and Italy, Dutch retail and Swiss offices offer potential.

Core, modern retail should be preferred, while new, leased distribution property looks good value. Supply-constrained office markets may perform well, with a cyclical recovery driven by falling yields in the short term and rental growth in 2011/12.

North America is also getting more attention. Canada has emerged from the downturn as a good target for global diversification, but competition for core assets will be strong and the US offers a bigger opportunity. The second half of the year may be a better time to target the US, but bearing in mind how quickly the UK adjusted, investors should not leave it too late; with many US investors sitting on cash, a strong revival is possible. Yield compression now extends from trophy assets to core, well-let properties such as grocery-anchored malls.

Industrial and apartment markets are expected to lead the US recovery, helped by improving demand, limited construction and below-replacement-cost prices. Space-constrained gateway office markets should stabilise this year, but out-of-town offices, and most retail, may take longer to recover.

Even for core investors, there are now opportunities in all regions, not just mature ones. Brazil, for example, now looks like a strong candidate for investors, with Class A offices (particularly in Rio), hospitality, residential and retail markets offering potential. Mexico may also attract more interest as it recovers from recession and the peso falls.

More activity can be expected across Central and Eastern Europe, especially in Poland and Turkey, as owners recycle stock and corporations seek lower-cost production and service hubs. In South Africa, meanwhile, conservative lending policies have made the market resilient, while this year’s football World Cup will boost the country’s profile.

Asia offers a range of mature and emerging possibilities, such as Australian and Singapore offices or Chinese retail. Risks remain, of course, but expanding businesses and growing confidence should boost property demand in New Delhi, Mumbai and Bangalore; Beijing, Shanghai and Hong Kong; as well as Sydney and Seoul.

Japan is also looking compelling, with a fairly high spread between yield and finance costs, and huge investment-grade opportunities, particularly distressed assets selling at below-replacement cost.

Overall, with more forced and opportunistic sellers, public-sector sales and potential for debt as well as equity instruments, investors’ global range of options is growing. But they may have to cast off old ideas of what constitutes mature or emerging markets, and focus on today’s fundamentals.

David Hutchings is head of European research at Cushman & Wakefield