Global market outlook:

Trends in real estate private equity

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The recession, financial crisis, and pullback in the credit markets have taken a toll on real estate private equity over the past few years, causing commitments to shrink to about a third of their 2008 levels. In reaction to the crisis, legislators and regulators from around the world have been busy evaluating what went wrong and developing the policy measures necessary to prevent a reoccurrence. Yet most seasoned professionals will tell you the real estate business is not for the faint of heart. One need only look over the past 30 years to see that there has been no shortage of boom and bust years. The boom periods are most often a derivative of an overcharged business cycle due to the availability of capital, strong optimism for the asset class, changes to tax codes, and expectations for rapid growth. The bust years are the inevitable aftermath of a supply and demand imbalance. Yet from the 2008 financial crisis up until today, the cycle has had its very own unique fact patterns, and real estate private equity investors need to weigh several new variables to ascertain the proper investment thesis going forward.

There are three major differences from prior cycles that need specific consideration in updating one's economic outlook: 1) the US Federal Reserve's unwinding policy measures, 2) the European sovereign debt crisis, and 3) the problem of the massive US debt affecting future GDP growth.

In recognizing what occurred during the Great Depression, central banks from around the world understood that liquidity and an easy monetary policy were the key to mitigating many of the adverse consequences that follow a financial crisis. However, the aftermath of nearly US$3 trillion in asset purchases by the second quarter of 2011, and what is known as Operation Twist, have created their own by-products from such serious intervention. Lower interest rates have helped support asset prices via lower capitalization rates in commercial property and through affordability in housing, yet these have minimized the cleansing of weaker borrowers and lenders that is most often the characteristic of a market correction. A change in ownership is not the revitalizing aspect; rather, it is the repricing of assets so that their new owners have capital structures more conducive to reinvesting and repositioning their properties. Such events also serve as a catalyst for economic activity in the broader global economy. This is why global real estate transaction activity is currently off from its peak by more than 50%, much of which can be ascribed to "hanging on" by borrowers and lenders. The extraordinary measures taken by various central banks averted a harsh correction, but as a result, extended the deflationary pressure from defaulted properties working back into the system over time. Widening of spreads in the CMBS market may also hasten the number of defaulted projects, as the capital structures for certain deals may not be able to support the higher cost of refinancing.

Globalization is now a factor in driving an asset's cash flow. For certain properties, international trade and sales may have no direct consequence, yet corporations today get on average 47% of their sales from international trade, and the buildings and household incomes in submarkets where this activity resides will be impacted. For example, Europe has been and will continue to be a valuable contributor to US GDP, although there is evidence Europe is slowing. More time will be required for certain countries to address their finances in a way that will ultimately resolve the sovereign debt crisis and its impact on European banks. The framework of the Eurozone, with its many political parties and governance challenges, will make policy changes difficult, and therefore news headlines, and the financial uncertainty that comes with such headlines, will be commonplace for some time.

Finally, the US balance sheet is in need of major restructuring, and this has major consequences for global financial markets, given the US is the largest economy in the world. The dollar serves as the world's reserve currency, which has given the US Treasury tools not available to most countries, such as the ability to borrow from itself or other countries to smooth out any serious belt-tightening while running sizable deficits. As that total obligation approaches 100% of GDP, not including the present value of commitments made from entitlements that operate under a pay-as-you-go system, there is the possibility of annual spending cuts of US$1 trillion in the not-too-distant future. Over time, entitlements will be managed to provide less to future beneficiaries either through reduced benefits or currency deflation. The more tangible impacts on property markets will be in the form of cuts in federal, state and local programs. Budget cuts in military spending and spending reductions by certain large vendors to the US Government may also have a substantial effect. In the near term, this will slow economic activity, but increased investor confidence from policies of financial responsibility will help reduce the stifling effects of uncertainty.

While the current economic environment could be perceived as offering limited options, times like this are often a good time to invest. Things are never as bad, or as good, as they seem. In fact, all of these issues affecting the health of the real estate market and the US and European economies have solutions. Policy makers have made efforts to explore options to place Europe and America on a fiscally responsible path, and it appears that the difficult choices are now imminent. The real question will be how quickly policy makers get us on the right path. In the meantime, the 6 billion people in the global economy, and the global suppliers and vendors for those individuals, are waiting.

In this year's *Market outlook*, we describe the direct impact of the financial crisis on fund structuring terms, and how numerous regulatory reforms will affect the daily operations of funds. We also provide insights into a potential accounting change that will have far-reaching effects on how funds report to their investors.

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Key findings in this report:

- There will be a long, slow recovery in the real estate funds sector, but distressed deal opportunities will continue, and convergence of the bid-ask spread will foster greater deal volumes.
- Due to a wave of regulatory and financial reporting changes, the fund operating models will change over the medium to long term.
- Overall fund terms have not come back to where they were pre-crash, and many real estate fund managers have had to make investor concessions.
- Investors are now more focused on scrutinizing the real estate fund platforms where they are placing capital. More information will be needed to meet investors' reporting requirements.
- For most fund managers, the fundraising process is significantly longer compared to predecessor funds.
- Fund managers required to register may find their marketability to investors improved.

"Managers may need to actually increase the management fee to cover additional costs incurred to comply with new regulatory requirements"

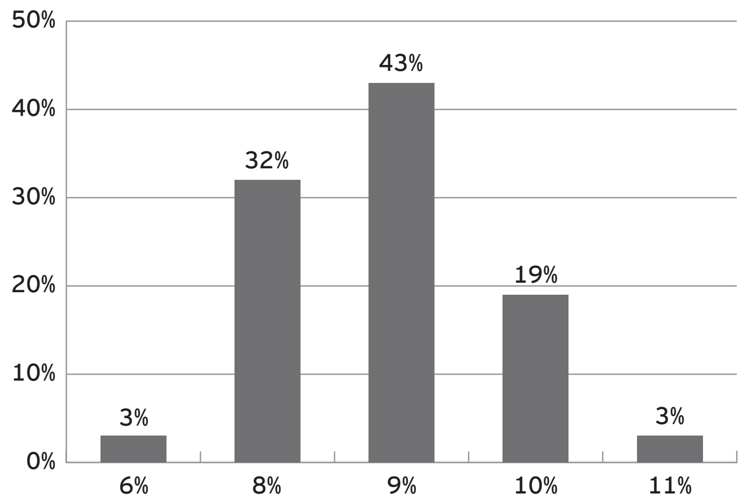
Update on market deal terms in private equity real estate

As a result of the economic crisis, there has been a concentrated focus placed on fund management fees. Fund managers are being pressured to structure fees consistently with industry norms. Deal terms that were standard before the crisis have been challenged and modified as the sector moves into the post-crisis era. The pendulum has definitely moved for many managers, although there is some evidence that it's starting to swing back toward pre-crisis levels. The big mega-managers powered through for the most part. For fund managers with multiple funds, it's likely their next fund will look similar with minimal alterations. For a new manager raising a fund, it's likely that deal terms will be fundamentally different from pre-crisis equivalents. This being the case, some real estate fund managers have been affected while others have not, depending on size and track record in the real estate asset management sector. The managers with proven track records were for the most part able to hold tight on terms, but some of the new managers have had to compromise.

Key terms prior to the financial crisis (2007)

Key term	Trend in 2007
Waterfall structure	Mostly deal-by-deal returns
Carried interest	80/20 the typical structure, with a 50/50 distribution to get to the agreed-upon profit split
Preferred returns	Mostly 9%
Target returns	Levered returns of 20%+
Investment period	Average of four years
Overall fund period	Eight-year period, with option to extend for two one-year periods
Clawback provisions	Generally did not extend beyond the term of the fund
General partner (GP) commitments	Standard of 1%
Management fees	Average of 1.5% of capital commitment during investment period and invested capital after investment period
Leverage (maximum)	Averaging in the 65%–75% range

Preferred return level: Funds closed post-crisis



Source: Ernst & Young survey

Key terms based on new fund-raising post-crisis:

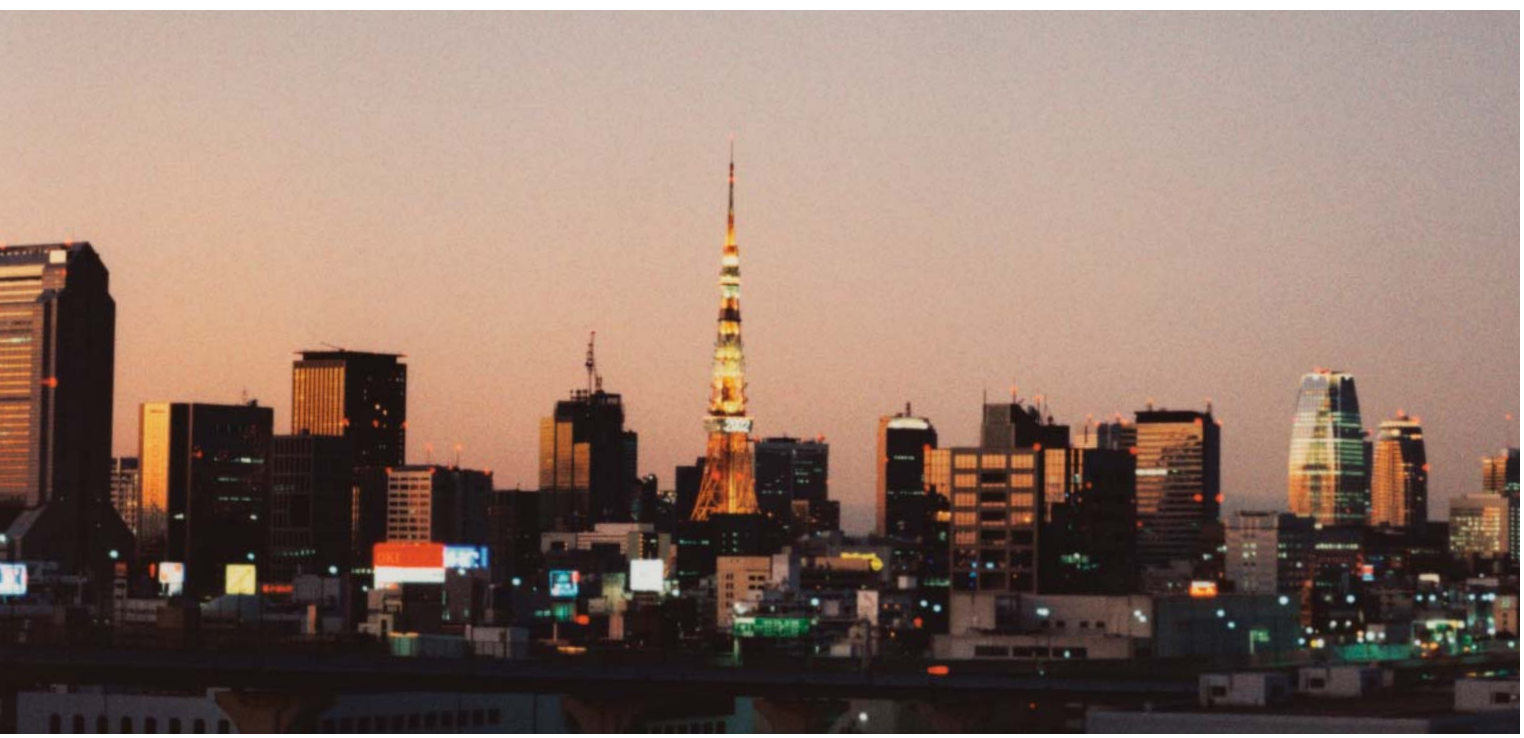
Key term	Trend in 2011
Waterfall structure	Seeing an increasing trend toward full pooling of returns as opposed to deal-by-deal returns, which were common on the legacy funds
Carried interest	80/20 the typical structure, with a 60/40 or 70/30 distribution in favor of limited partners (LPs) to get to the agreed-upon profit split becoming increasingly prevalent New trend — carried interest to be reviewed by auditors before payment
Preferred returns	Should be calculated from the day capital is contributed to the point of distribution Average of 8.8% (see graph above for details)
Target returns	Levered returns of 16%–20%+
Investment period	Generally now being scaled back to three years
Overall fund period	Evidence suggests shorter fund durations, now six years on average vs. the typical eight year-term pre-crash, with the option to extend for two one-year periods
Clawback provisions	The period should extend beyond the term of the fund, including liquidation and any provision for LP giveback of distributions
GP commitments	LPs are expecting aggregate GP commitments to be meaningful. This should be contributed through cash and not through the waiver of management fees
Management fees	Based on actual costs incurred by the GP on a cumulative basis and capped — with many having .5% on committed capital and 1.35%–1.75% on invested capital, but can go lower depending on size of committed capital and can vary based on commitment period and investment period
Leverage (maximum)	Averaging in the 60%–70% range

Deal terms and fees

The management fee was established to cover the cost of administration of the fund. For real estate fund managers, this includes the cost of overhead, for example, the cost of finance operations, the CFO, and compliance activities, to name a few. It was not intended to be a profit center. Although management fees have been squeezed over the last few years, they may actually increase again to cover additional costs incurred to comply with new regulatory and reporting requirements. However, other types of fees, such as acquisition, asset management and disposition fees that have historically been paid to sponsors, may get squeezed as the pressure to reduce fees results in the desire for better alignment with LPs.

There is a broad array of fee structures common in the sector both in terms of the nature and number of fees charged. Even fees that appear to be similar in nature can be very different when comparing detailed calculation methodologies between managers. Acquisition fees are a good example. This has been challenging for investors to follow and to make like-for-like comparisons across the sector. Many have resorted to undertaking more intensive benchmarking exercises across investment portfolios and challenging fund managers with the results.

The private placement memorandum (PPM) or prospectus should clearly define fee structures in place. In practice, this has not always been the case, despite clear guidelines from investor-driven organizations such as the European Association for Investors in Non-listed Real Estate Vehicles (INREV) and the Institutional Limited Partners Association (ILPA). Fee descriptions in fund documentation are often vague and are not supported by detailed calculation examples, as would be leading practice, or have not been adapted to be appropriate in situations of deep market distress as we have experienced recently. For example, the ILPA suggests that all fees generated by the general partner (GP) should be periodically and individually disclosed and classified in each audited financial report and with each capital call and distribution notice. INREV guidelines require that fund documentation should contain a detailed description of the performance fee mechanism and fully disclose, among other things, the catch-up and clawback features, the percentage fee above the stated hurdle rate, and how the hurdle rate is defined. Further, real estate fund managers are encouraged to provide examples to illustrate how performance fees and Internal Rate of Return (IRR) are calculated.



> "Registration is likely to bring with it more stringent requirements for clearer definitions regarding fees and better controls over how those fees are calculated"

There is no doubt that this is likely to change, not only as a result of increasing investor scrutiny, but also with regulatory pressures. Registration as an investment advisor with the US Securities and Exchange Commission (SEC) or as an alternative investment fund manager with the European Commission is likely to bring with it more stringent requirements for clearer definitions regarding fees and better controls over how those fees are calculated.

Investors challenging costs and fees

Overall fund costs have also been in the spotlight. There has been a lot of pressure from institutional investors in terms of the costs and fees that are required to be paid to the fund managers. In the past, many of the largest real estate private equity funds have charged several types of fees — management fees, acquisition fees, disposition fees, asset management fees, and several others. The fees are still there today, and there is still not consistency across funds. But institutional investors are challenging the amount of the fees and the types of fees being charged.

That is putting a lot of pressure on real estate investment platforms to figure out ways to be more efficient. Outsourcing of the back office has been very common in the hedge fund world, and it's trickling its way down to real estate funds. Over the last five years, we have seen many non-real estate private equity organizations outsource their back-office operations. This could include bookkeeping, capital calls and administrative functions. There is increasing interest today in outsourcing within the real estate private equity space. One of the reasons it hasn't caught on sooner is that there haven't been many players that are appropriately set up to handle outsourcing within the real estate private equity space, and the systems were not up to par. But that's changing, and it's changing very quickly. A larger number of organizations, especially those that have traditionally been in the hedge fund and the private equity outsourcing space, are developing platforms to address the real estate space. This could bring about more efficiency, from a cost perspective, to real estate private equity managers.

There has been significant evidence over the past year that real estate fund managers are more willing to adjust both financial and nonfinancial terms and conditions. This has been occurring since the financial crisis began in 2008, driven largely by LPs' strong desire to pursue a closer alignment of their interests with the fund sponsor by challenging the terms and conditions of the real estate funds they invest with. Areas where LPs say they have witnessed changes in the past two years include adjustments to management fees, a reduction in the hurdle rate and changes to the carry structure.

To a large degree, due to the challenging capital-raising environment, institutional investors have become more assertive and feel entitled to negotiate more favorable terms, and this reflects a shift in power in the industry that is likely to remain for the foreseeable future. Only mega-funds with long-standing track records of outperformance in the market are likely to be able to raise capital without having addressed the changing business model and the underlying economic expectations of the industry.

Investor pressures on real estate fund managers

Markets have changed significantly relative to where they were a few years ago. First, yields on asset classes are lower relative to pre-crisis levels, and second, as returns have been low, institutional investors have become much more attuned to the internal control agenda, which was not previously a primary focus. There are typically five types of investors that commonly use real estate private equity funds: pension funds, insurance companies, high net worth individuals, endowment funds and fund of funds. Many of these groups have had sub-par returns in their real estate portfolios and other asset classes, and have a heightened awareness of investor fraud. It is no surprise, therefore, that there is a greater focus on governance and transparency, particularly in the area of risk and liquidity management.

Institutional investors have been more focused on scrutinizing the manager they are investing money with than they have historically. Today, a larger number of institutional investors are performing operational reviews and asking more questions. They're also working with organizations like ILPA and INREV, which are trying to increase the level of transparency for their constituents. By instituting some level of consistency and a framework around things like capital calls, reporting, and the types of data they're requesting, they're creating a format their constituents can utilize. This is driving a level of transparency that has not previously existed.

Update from around the world

Asia-Pacific

Asia-Pacific has substantial variation between markets, as it hosts both well-established and mature real estate markets and relatively new markets that are just now becoming available for core real estate investment.

The region continues to show solid, steady growth in commercial property investment. Although growth in the Asia-Pacific region is expected to be stronger than the rest of the world over the near term, the total returns are unlikely to considerably outperform the US and Europe, mainly due to pricing and aggressive bidding from domestic investors, which may bring down overall returns.

Europe

There is a widening divergence in investor outlook across core and peripheral European markets. Real estate pricing has been generally flat, and yields on acquisitions have changed little since the beginning of the year. Following recent strong gains, European transaction volumes have now stalled, some of which can be attributed to the lack of bank financing, uncertainty around the sovereign debt crisis, and slow overall GDP growth of the European Union.

Because they are seen as a safe haven, the core markets of Germany and the Nordic countries have emerged as favored investment targets and have posted robust increases in transaction activity this year. This has helped offset significant declines in the UK and France, in addition to continued weak performance in the peripheral markets such as Greece, Portugal, Spain and Ireland. Domestic and cross-border demand has broadened in both Germany and the Nordic countries, as they currently offer the highest risk-adjusted yields.

Looking at investment volume across European markets and comparing spreads between cap rates and relevant government bonds, it is clear that the momentum of real estate investment in Europe is toward the highest relative yields in the safest markets.

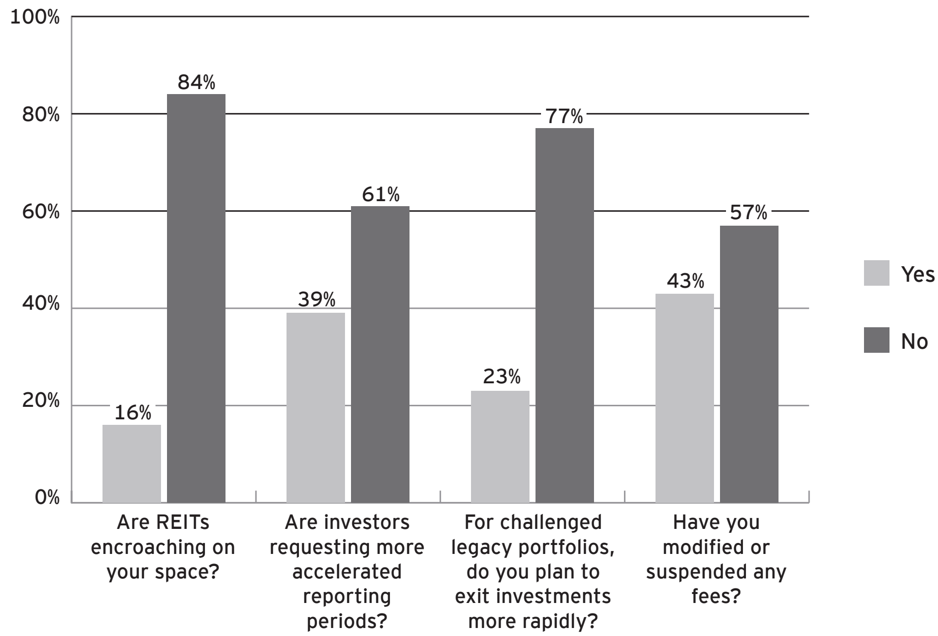
US

By property type, average US cap rates are flat across most sectors, except industrial and suburban office properties. Except for certain central markets, these sectors have been the slowest to attract investors in the recovery, but their yields were down slightly. Across all sectors, yields for prime assets are significantly lower than the average and this gap is at historically wide levels, a trend that shows no signs of abating even as investors begin to stretch their horizons.

US-focused investors see more opportunities to purchase problem loans, particularly from regional and smaller banks. Smaller banks have a larger percentage of commercial real estate (CRE) loans in their portfolios than the biggest banks. By mid-2010, CRE values had fallen 40% from their peak in late 2007, eroding the earnings and reducing the capital of banks generally, especially smaller banks. Property values have since started to recover, but the biggest banks have benefited more from the recovery than smaller banks, which tended to finance more local investments, including land and acquisition and development loans.

The Federal Deposit Insurance Corporation (FDIC), which has been by far the biggest seller of distressed loans, will remain an active seller in 2011 and beyond, but not at the same high rate as in recent years. Likewise, the largest banks will remain sellers. While investors will continue to buy loans from the FDIC and the biggest banks, they will focus more on buying loans from smaller institutions. Given the convergence of carrying values and market prices, 2012 could shape up to be the most active market yet.

Source: Real Capital Analytics Global Midyear Review, May 2011



Source: Ernst & Young survey

General observations from our survey

Competition for deals

There is a clear indication in the survey that REITs have not been encroaching on the real estate fund's area of the deal market, with only 16% of the respondents suggesting they have had to compete with REITs while chasing deals. Given that REITs were quite a success on both sides of the Atlantic in recapitalizing during the financial crisis, it seems that they are in a strong position to actively chase opportunities as they come to market. However, because of the difference in operating strategy and purchase criteria, they will generally be looking at core, core-plus and lower-risk assets.

Investor reporting

This is an area that may change over time, as the main industry associations that represent investors are pushing for more frequent and transparent reporting. Most established funds are in the habit of reporting on a quarterly basis, and within three months of year-end. A point to look for in the future will also be additional disclosures on assumptions, fair value criteria, and debt analysis, among others.

Legacy portfolios

Most of our respondents have indicated that they still plan to stay the course regarding their original investment strategies and have not decided to alter tactics based on investor pressure or current market challenges. The clear signal here is that unless they are holding assets in certain top-tier markets where capital values have almost returned to their peak, fund managers plan to hold onto assets until the overall economy improves so that real estate pricing can start to tick upward. No fund manager with difficult vintage funds wants to crystallize losses, and investors have not been pressuring their managers to sell in a challenging environment where they know it will be at a significant loss, especially if there is no debt or other need to do so.

Changes to fees

There seems to be a fairly even split in terms of fee modification as a result of the market turmoil and the challenges investors and managers are both facing. As noted above in our terms study, management fees, or at least the methods to calculate them, have slightly changed in favor of the investors since the crash. Also, as identified in various other market studies, several of the other fees traditionally used to increase manager returns, such as acquisition and disposition fees and debt arrangement fees, are now coming under more scrutiny by investors.

> "The new changes may have an impact on the real estate private equity industry to an extent we have never really seen before"

Regulations

The regulatory bodies are focusing on the alternative investment industry, which until now has been lightly regulated. The new changes may have an impact on the real estate private equity industry to an extent we have never really seen before. What was previously a very immature industry is starting to take on an increased element of operational maturity and is benefiting from better deployment of technology. These items have always received some level of focus, but options were limited. When returns were very high, there wasn't the pressure to ask questions around operating effectiveness, and this area of the business was not a primary focus. Over the last several years, as transaction volumes have declined, managers have focused internally to improve operating efficiencies in many areas. This was both a result of a cost-cutting efforts as well as a function of the available time to reassess these areas.

The European Commission, as a regulatory body, is introducing a framework across the European Union (EU) to enhance oversight and control over alternative investment funds. It wants to make sure it has more visibility for both regulators and investors in alternative investment funds. This covers a wide range of the manager's activities, and in particular building more accurate risk and liquidity profiles for fund products. The intention is to offer improved investor protection at both a macro and micro level. As seen in the table below, there is a broad range of regulations that are currently being issued in the EU.

A great number of real estate fund managers are coming under US SEC scrutiny for the first time as well. Many fund managers will be required to register as registered investment advisors (RIAs) for the first time. New regulations will require them to provide substantial disclosure about their business and employees and will require that RIAs disclose, in "plain English" and narrative form, significantly more information than they had before, including detailed profiles of key personnel, training programs, compliance policies and infrastructure, valuation processes, fund-specific risk factors, and fees. The information submitted pursuant to these changes will be used by the SEC to enhance its advisor regulatory program.

Key regulations that will impact the real estate funds industry

	Key aspects	Implications for the real estate fund industry
Regulations that directly impact real estate fund operations		

Dodd-Frank	▸ As a result of the Dodd-Frank Act, many private equity fund advisors with more than US$100 million in assets under management (AUM) may be required to register with the SEC and will be subject to SEC regulatory oversight. Advisors with less than US$150 million in AUM whose only clients are private funds will remain exempt from registration, subject to record-keeping and reporting requirements and inspection by the SEC.
	▸ Advisors to real estate funds will only be required to register if their investment strategies cause them to fall under the definition of an "investment advisor." Some real estate advisors who are not required to register may elect to operate in a manner similar to registered advisors to meet investor expectations. Those required to register must do so by March 2012.
		▸ Dodd-Frank will have a material impact on an organization's operational and compliance requirements and processes.
		▸ It enhances the powers of the SEC and provides improved whistleblower protection.
		▸ Registered advisors will need to:
		  ▸ Designate a chief compliance officer.
		  ▸ Establish and maintain a compliance program intended to prevent violations of law and regulation.
		  ▸ Develop comprehensive written compliance policies and procedures.
		  ▸ Conduct annual assessments of the adequacy of the compliance program.

	Key aspects	Implications for the real estate fund industry

Dodd-Frank (continued)	▸ For all non-US advisors, there is a foreign private advisor (FPA) exemption.
	▸ However, this is tightly defined. To qualify for the FPA exemption, firms need to be able to establish that all of the conditions below are not relevant to them:
	  ▸ They have no US place of business
	  ▸ They have fewer than 15 US individuals as clients or investors in private funds they advise
	  ▸ They manage less than US$25 million of assets attributable to US clients or US investors in private funds
	  ▸ They do not manage any US mutual funds
	  ▸ They avoid holding themselves out to the US public as an investment advisor
	▸ If an FPA is unable to claim an exemption, it will need to register with the SEC or cease to operate as an investment advisor in the US.
		▸ Dodd-Frank has real significance for non-US financial companies (including real estate private equity funds) doing business in the US.
		▸ Non-US firms that do need to register as advisors face a number of practical challenges and will become subject to the US Investment Advisors Act, which is based on the concept of fiduciary duty.
		▸ They will need to file Form ADV with the SEC, both on initial registration and annually.
		▸ They will need to disclose the firm's disciplinary history and any conflicts of interest.
		▸ They will be expected to maintain books and records for inspection – including financial records, client transactions and advisory agreements.
		▸ They will also need data on value and type of assets under management, counterparty credit risks, the use of leverage, valuation policies and practices, trading practices and positions and the use of side pockets.
		▸ Once registered, a non-US firm will be subject to examination and oversight by the SEC.

	▸ Under the Volcker Rule, US banking entities (including those that are foreign-owned) are (1) prohibited from proprietary trading, (2) prohibited from investing in hedge funds or private equity funds or sponsoring such funds, subject to limited exceptions, and (3) subject to restrictions on certain transactions between an entity that serves as an organizer, sponsor, investment advisor or investment manager of a private equity fund or hedge fund (or any affiliate of such entity) and the fund itself.	▸ Limitations on relationships with hedge funds and private equity funds: banking entities are permitted to organize and offer, including sponsoring, a hedge or private equity fund on the condition that the bank:
		  ▸ Provides bona fide trust, fiduciary, or investment advisory services
		  ▸ Does not acquire or retain an ownership interest, except for a de minimis investment of 3%
		▸ Exceptions to fund ownership interests:
		  ▸ Allowed to provide seed capital to permit fund to attract unaffiliated investors.
		  ▸ Must seek unaffiliated investors to reduce or dilute fund investment to not more than 3% of total ownership interest within one year after establishment of fund.
		  ▸ Cannot allow aggregate investment interests in all such funds to exceed 3% of Tier 1 capital.

	Key aspects	Implications for the real estate fund industry
Dodd-Frank (continued)	▸ Dodd-Frank has also identified over-the-counter (OTC) derivatives as a key area of risk in the alternative asset management sector and has set out significant reforms specific to this type of investment.	▸ Areas that will affect alternative investment managers include margin and collateral management, swap execution facilities, major swap participant designation status, end-user exemption and derivatives data reporting.
Alternative Investment Fund Managers (AIFM) Directive	▸ While the main focus of the AIFM Directive is on managers of funds, the Directive has a broad scope and will impact not only EU and non-EU AIFM, but also EU and non-EU domiciled Alternative Investment Funds (AIFs), service providers to these funds, and their investors. ▸ The Directive covers all alternative sectors including hedge funds, real estate and private equity. ▸ The Directive lays down requirements that must be met by AIFM, covering: ▸ Authorization ▸ Capital ▸ Marketing ▸ Conduct of risk and liquidity management, including stress testing ▸ Functions and service providers ▸ Transparency ▸ In return for more regulation of AIFMs, their service providers and funds, the proposed Directive provides for the introduction of passports enabling AIFMs to offer their management services and market their AIFs throughout the EU.	▸ Strategic implications will flow from multiple "managers" of AIFs and AIFs within a typical structure, as well as the cost of complying with depository, reporting, authorization and risk-management requirements. ▸ Relationships with service providers will need to be reviewed, as will internal separation of functions. ▸ Remuneration of key personnel will need reviewing to align interests with fund strategy. ▸ Formalization of the risk and liquidity management function will be time-consuming, but has high notional value to investors. ▸ Each AIF requires a depositary which must be either an authorized credit institution, an authorized investment firm, or another institution subject to prudential regulation. This represents a significant incremental cost. ▸ AIFMs will need to develop and implement customized reporting templates at AIFM and AIF levels.
AIFM (Non EU-based platforms)	▸ For non-EU AIFs managed by EU AIFMs and non-EU AIFMs marketing EU and non-EU AIFs, two regimes will coexist for marketing: national private placement regimes (PPRs) may be phased out, with a passport regime to be phased in. ▸ The passport will not be available to non-EU AIFMs or for non-EU AIFs before 2015, and the national PPRs will not be phased out before 2018.	▸ Non-EU AIFMs intending to market AIFs they manage in the EU using a passport must acquire prior authorization from their member state of reference. ▸ This will require full compliance with the Directive or equivalent standards, as well as additional conditions relating to cooperation arrangements, tax information-sharing, anti-money laundering provisions, and the nomination of a legal representative to act as a single point of contact within the EU.

	Key aspects	Implications for the real estate fund industry
Regulations that impact the flow of capital to real estate funds		
Basel III	New guidelines call for: ▸ Higher quality of capital, with a focus on common equity, and higher levels of capital to ensure that banks can better absorb the types of losses like those associated with this past crisis ▸ An internationally harmonized leverage ratio to constrain excessive risk-taking and to serve as a backstop to the risk-based capital measure ▸ Capital buffers, which should be built up in good times so that they can be drawn down in periods of stress ▸ Minimum global liquidity standards to improve banks' resilience to acute short-term stress and to improve longer-term funding ▸ Stronger standards for supervision, public disclosures and risk management — especially for capital market activities	▸ Bank business strategies and their attitudes to commercial real estate are undergoing the biggest change in a generation. ▸ The biggest banks are expected to unbundle real estate. ▸ Banks will return to what are judged to be core markets or sectors. ▸ Most real estate lending outside the home country will be deemed non-core. ▸ Where real estate is wholly or partially owned by banks, they will seek to sell the assets wherever there is a minimal impact on the balance sheet. ▸ Liquidity risk, stress testing and reporting are a huge change for many banks. ▸ The changes may pose strategic challenges for some banks because as the cost of capital increases, some business models may no longer be profitable. The cost of borrowing for real estate (and other) companies will increase.
Solvency II	▸ Solvency II is the updated set of regulatory requirements for insurance firms that operate in the EU. It aims to revise EU-wide capital requirements and risk management standards with the aim of increasing protection and reducing the possibility of loss or market disruption in the insurance industry. It is scheduled to come into effect on 1 January 2013. ▸ It applies to all insurance and reinsurance firms with gross premium income exceeding €5 million or gross technical provisions in excess of €25 million. ▸ Key elements include: adequate financial resources, an adequate system of governance, a supervisory review process, public disclosure and regulatory reporting requirements. ▸ Direct real estate investments will need a 25% capital deposit ratio with no leverage, or 39% if leverage is used. ▸ An internal model whereby insurers calculate their capital requirements using a tailored model may also be used.	▸ Given that the legislation will require insurance companies to significantly increase their capital reserves when investing in risky assets, it is anticipated that there will be a resulting impact on insurance companies' allocation to the real estate sector — the most likely result being more direct investments or becoming a lender to the industry.

> "Transparency and strong controls become a competitive advantage to get capital from investors"

	Key aspects	Implications for the real estate fund industry
European Markets Infrastructure Regulation (EMIR)	New regulations aimed at over-the-counter (OTC) derivatives, central counterparties and trade repositories. Many of the provisions of the EMIR are consistent with those proposed under Dodd Frank. Key elements of EMIR legislation include: ▸ Increased transparency through reporting of trades in OTC derivatives in the EU to central data centers. Regulators in the EU will have access to these repositories, enabling them to have a better overview of who owes what and to whom and to detect any potential problems, such as accumulation of risk, early on. ▸ Reduced risk by requiring "financial counterparties" to clear all eligible OTC derivatives with a central counterparty. "Financial counterparty" is defined as including investment firms, credit institutions, insurers, undertakings for collective investment in transferable securities (UCITS) and alternative investment fund managers.	▸ For real estate funds, it will focus on instruments used to manage risk, such as interest rate swaps on property borrowings (either for reasons of prudence or as required by lenders). ▸ EMIR will require swap activities to be cleared through exchanges, rather than be handled as they are now — over the counter. ▸ Another aspect is the mark-to-market requirement on all positions regularly and the requirement to post collateral in connection with negative-valuation movements. ▸ The cash collateral that will need to be posted in a margin account will have to sit on the sidelines un-invested. This will most likely come from calling down capital from investors.

The impact on real estate funds could be significant because they're going to have to budget for added costs to comply with the new regulations and in some instances, such as EMIR, potentially allocate significant amounts of capital to cover hedging transactions which are out of the money in margin accounts. This could have a fundamental impact on hedging strategies. Also, based on the definition of a financial entity as defined in the AIFM directive by the European Commission, if a company falls under AIFM as a financial entity, which includes real estate funds, all future regulation tied to the definition of a financial entity will have an impact on the industry. In the past, there wasn't such a holistic framework to regulate what the European Commission calls "alternative investment funds." The AIFM is just the starting point. Real estate funds will now be subject to a variety of other regulations as and when they are passed.

In the US, the biggest regulatory change has been Dodd-Frank. There are two specific aspects that are most relevant for real estate private equity funds. One is a requirement that any asset manager having assets under management of more than US$100 million must register with the SEC. However, there are some exceptions, which are somewhat difficult to interpret. It is possible, in fact, that funds that invest solely in real estate may not be subject to this requirement. But most of the larger private equity organizations that invest in various non-real estate hard assets would be subject to the Dodd-Frank requirement.

If a fund manager is subject to Dodd-Frank, it likely would have to hire a compliance officer and implement a compliance program. The compliance program must be specific to the fund manager's business. In the case of a real estate fund manager, this could cover many different process areas, including valuations with stringent controls having to be developed and applied consistently.

Fund managers may need to have better valuation infrastructure and technologies in place. The fund manager also will be required to have a compliance officer who would be responsible not only for putting together the compliance program at the start, but also would be responsible for annual testing. The fund manager would then be subject to SEC audits within the scope of the SEC.

Another key provision of Dodd-Frank is the Volker Rule. The objective is for large investment banks in particular to separate investment banking, private equity and proprietary trading. The Volker Rule limits the amount of proprietary capital a bank can place into its own private equity funds, including real estate funds. The rule will limit the amount of capital a bank is able to place into its own funds, which ultimately will reduce the profitability to the organization.

Real estate funds generally are one of two types. The first type is a captive investment manager under the umbrella of a larger organization, such as an investment bank, insurance company or some other type that's part of a bigger institution. The second type is a stand-alone real estate private equity organization that doesn't fall captive under a larger financial or other type of institution.

Traditionally, those organizations that have been at the forefront of implementing control programs are the ones that typically are part of a larger institution and can leverage its broader infrastructure and other back-office and oversight infrastructure not only for the bank but also the real estate fund. There's a possibility that if many of these organizations decide to get out of the fund business, the legacy funds may need to address what changes are necessary to maintain a good control environment.

There has also been an increase in the number of fund managers that have gone public. With the added regulatory requirements, there's a big change from being a private investment manager to being a public investment manager. A publicly listed company is subject to a lot more scrutiny — for example, Sarbanes-Oxley, reporting disclosures, transparency and so forth. This move is creating pressure to be more transparent, as institutional investors will want to invest their money in places where they feel the highest level of confidence. For this reason, transparency and strong controls have become a competitive advantage to raise capital from investors.

An important aspect of running a global real estate investment platform is maintaining effective controls over the data and the profits that are being generated. Real estate fund managers that operate internationally have to do a lot to comply with all the different regulations.

Addressing new regulations is going to be much more time-consuming, which investors appreciate. But at the same time, as much as they want to feel a little more secure that their investments are being looked after properly, they don't want the fund manager to be too burdened or overly focused on compliance with regulations and the increasing costs of running the fund, which will impact their returns. Very often, when investors place capital with real estate private equity funds, they're looking for outsized returns, which comes down to speed-to-market and being able to act quickly without having to deal with a lot of cumbersome regulations.

A few years ago, a deal team wanting to launch a fund put together a strategy of what it was going to do. Hiring an operational team was an afterthought. Many of the related processes took a backseat to things like strategy and doing deals. This will no longer be a possibility going forward. Organizations that are looking to launch new funds are now obliged to consider the mechanics of their back office up front. Alternatives to the previous approach will be followed by changes to fee structures and costs realigned with new requirements. Certain fees may actually increase to accommodate some of these new requirements while other fees decrease.

Reporting and accounting changes on the horizon

The Financial Accounting Standards Board (FASB) recently issued an exposure draft that would significantly change the way real estate entities account for their investments. The proposal requires investment property entities to measure investment property at fair value with changes in fair value reported in net income. Investment property entities would present investment property assets and related debt on a gross basis on the balance sheet, and rental revenue and related expenses on a gross basis in the income statement. Investment property entities would only consolidate controlling interest in other investment property entities, investment companies and entities that provide services to such entities.

Currently, an entity that invests in real estate properties and does not qualify as an investment company under Topic 946 is required under Topic 360, *Property, Plant, and Equipment*, to measure its real estate properties at amortized cost. The proposed amendments would require an entity that qualifies as an investment property entity to measure its investment properties at fair value, with all changes in fair value recognized in net income.

The FASB's proposal would be a significant change for entities that currently follow a historical cost accounting model (e.g., certain REITs), as well as real estate funds that follow a variety of fair value accounting models. The proposal would also affect real estate funds that follow the investment company guide and account for their investments at fair value without consolidation.

The International Accounting Standards Board (IASB) does not have and has not proposed an investment property entity concept. Under IAS 40, *Investment Property,* which the IASB is not planning on changing, investment property is identified at the asset level and then measured at either fair value or at historical cost at that level. This proposal differs significantly from IAS 40 in several key ways, including:

- Fair value measurement would be required rather than optional
- Proposal focuses on investment property entities that meet specific criteria
- No fair value measurement exceptions provided for investment property under construction
- Rental income is recorded on a contractual basis

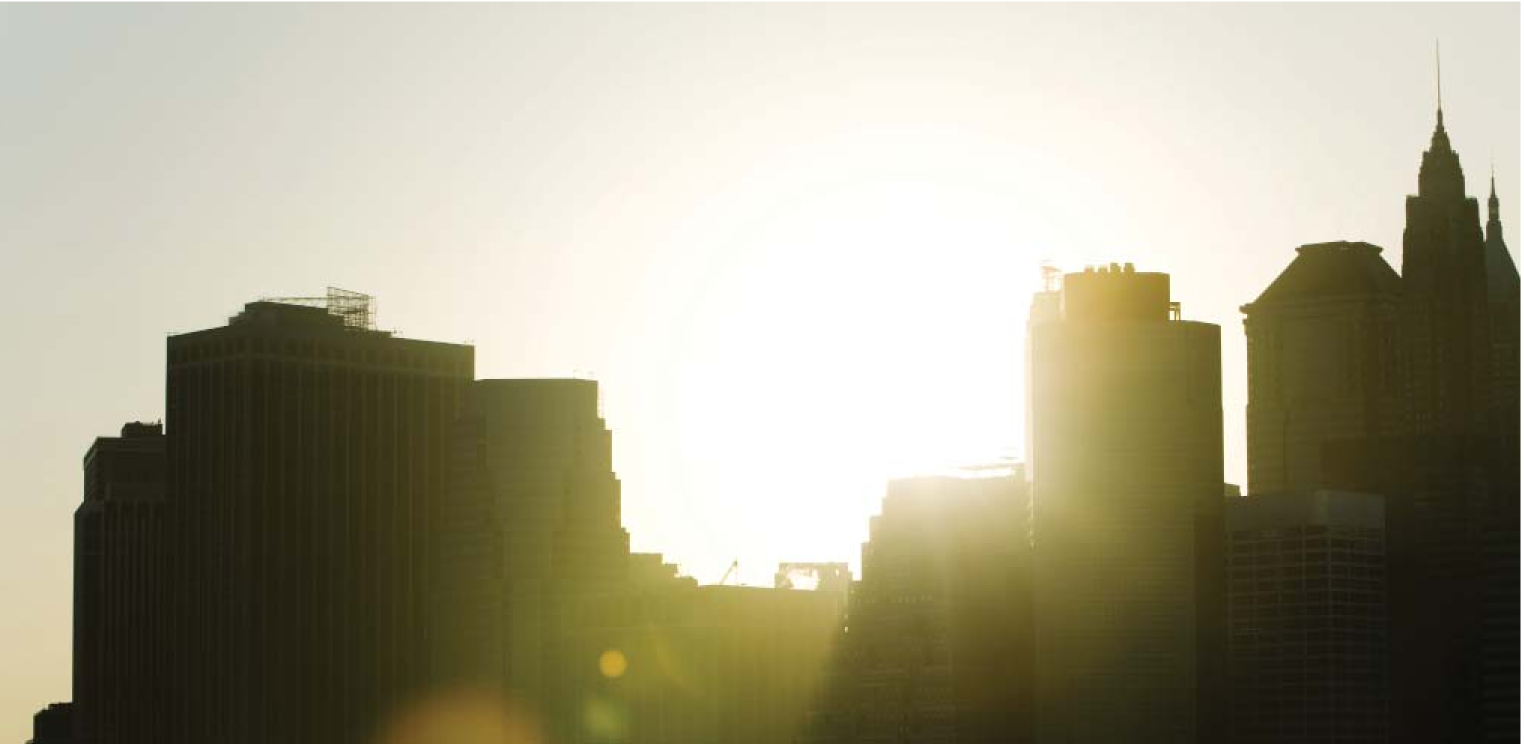
	Reporting entity	
Criteria	**Real Estate – Investment Property Entities**	**Financial Services – Investment Companies (Topic 946)**
Separate legal entity	Not required	Not required
Nature of business	Business activities relate primarily to investing in real estate	Multiple substantive investments. Invests for returns from capital appreciation and/or investment income
Express business purpose (explicit to investors)	Purpose is to invest for total return, including objective to realize capital appreciation (i.e., sale of property to maximize return)	Purpose is investing to provide returns from capital appreciation and/or investment income
Investment plans that include exit strategies	Yes	Yes
Unit ownership	Yes	Yes
Pooling of funds	Yes	Yes
Manage and evaluate on a fair value basis	Not required	Yes
Provides financial information about its investment activities to its investors	Yes	Yes
Investment company registered under the Investment Company Act of 1940*	N/A	Yes[1]

[1] Not required to meet other criteria of an investment company.

Historically, the accounting model that real estate funds in the US have followed under US GAAP was ASC 946, Financial Services — Investment Companies (formerly known as the Investment Company Audit Guide). That guidance prescribes that investments are carried at fair value, but there have been different ways that funds have presented financial statements in accordance with US GAAP. Some have been consolidating the properties, so they'll present all of the underlying property investment assets and liabilities, such as payables, receivables, the normal operating assets and liabilities and rental income, property-related expenses, and other such items. Other funds have been presenting their investments as the fair value of their net equity in the investment without a breakout of their operating details. The financial statements have shown investment in real estate and include a schedule of investments that lists each of the investments with details such as geography and asset type, but it doesn't provide much more in the way of detail. For example, if the fund owns 10 material investments, the schedule of investments will list each of the 10 material investments at the fair value of its net equity in those investments, but it won't show the actual details of the individual assets comprising the investment or the terms of the debt within the investment.

	Reporting entity	
Investment in:	Real Estate — Investment Property Entities	Financial Services — Investment Companies (Topic 946)
Investment property entity/investment company — controlling financial interest	Consolidate	Consolidate
Operating company — controlling or significant influence	Fair value[1]	Fair value[1]
Investment property entity/investment company/operating company non-controlling, significant influence	Fair value (not equity method)	Fair value
Investment property entity/investment company/operating company — non-controlling, non-significant influence	Cost method	Fair value

[1] If the operating entity provides services to the investment property/company entity:
Controlling interest — consolidate
Significant influence — equity method



IFRS did not have an investment company model, but it does have a concept called investment property as defined in IAS 40, which gives entities the option to report certain real estate investments at fair value, but other than that, it provides for regular consolidation. Therefore, the model under IFRS is similar to the consolidation model currently used by some funds in the US. As part of the convergence between US GAAP and IFRS, the FASB and the IASB are trying to link the two to provide for a clearly defined investment company model under IFRS and US GAAP and to provide a fair value model for real estate. As a result, the FASB has proposed the investment property entity model described above, which will require real estate entities meeting certain criteria to present their real estate at fair value.

The opportunistic real estate fund world has not typically presented its financial statements on a consolidated basis. The FASB is now proposing an amendment to the investment company guidance, which funds currently follow. As the guidance is currently proposed, it appears that many of the funds that invest solely in real estate will fall under the definition of investment property entities instead of investment companies, which would require them to fully consolidate many of their investments based on US GAAP consolidation rules.

Real estate fund managers are going to have to show rental income, real estate taxes, operating expenses, property level debt, etc. on financial statements — a difference from the way it was previously presented under the investment company model. It will require a significant amount of effort to obtain and maintain this additional information. Worse yet, if a fund falls under the investment company entity model, as opposed to the investment property entity model, and has an investment in an investment property entity, it would have to be consolidated by the investment company. This means the fund would not be able to present the investments in one line, but would have to provide all of the details. It would have to consolidate the investments, which would then result in the presentation being more like an investment property entity. This may be something for which real estate fund managers do not have the information to act as quickly as they have historically.

This will create issues and challenges with getting the information, as well as challenges around consistency and timeliness. While real estate fund managers monitor this information, they understand what they need to do from an asset management perspective. But to have to actually account for it in detail and properly apply GAAP accounting rules could create challenges in terms of getting the information on a timely basis in order to roll it up at the fund level. Real estate fund managers will have to plan ahead to get the information they need.

Accounting practices used by European real estate funds have been stable for several years. For example, IFRS is very commonly used, and it is generally accepted that investment properties should be accounted for at fair value. However, some have questioned whether an IFRS-based net asset value (NAV) best represents the fair value of an investor's interest in a fund.

The fair value of a fund may differ from an IFRS-based NAV measure because many IFRS assets and liabilities are not accounted for at fair value. For example:

- Deferred taxation liabilities are usually calculated without reference to the timing of any settlement and on the assumption that a property would be sold as an asset rather than through a share sale of an entity — and the opposite is often the case
- Investment properties are typically valued without regard for transaction costs that might be saved when selling the shares of the asset holding entity
- Property assets held as inventory are accounted for at cost, not market value

As a consequence, many European fund managers prepare a fund's financial statements with additional "non-IFRS" adjustments to get closer to what they may consider a fair value measure. Some of these adjustments are described in the guidelines published by industry associations, such as the INREV.

INREV's guidelines are modular, and full implementation may not be appropriate for all types of fund products — for example, closed-ended funds with a limited number of investors may only adopt a certain "package" of guidelines. Full implementation would typically be appropriate for large core funds with a diverse investor base.

The current focus of INREV is on helping managers with their implementation. To this end, INREV released an online tool to support its guidelines. This tool includes a data base of Q&As, dealing with practical issues when implementing the INREV valuation, NAV, and fee metrics guidelines.

Nevertheless, fund managers will face challenges in the coming years when preparing the financial statements of the real estate funds in accordance with IFRS. In particular:

- The IASB is proposing to allow an "investment entity" to avoid consolidation of subsidiaries if it meets certain criteria. Rather than presenting all of a group's assets and liabilities, an investment entity would include only the value of its investments in its subsidiaries on its balance sheet (similar to the investment company concept in the United States).
- Even if a fund does not qualify to be accounted for as an "investment entity" or the proposals are not implemented, there may be changes from 2013 going forward:
  - The new standard IFRS 10, *Consolidated Financial Statements,* may expand the number of entities included in a fund's financial statements.
  - The IASB has also revamped the accounting for joint ventures to eliminate the option to account for joint venture companies using proportionate consolidation.
  - Finally, a single model for the accounting of leases has been proposed that may change the way a fund's rental income is accounted for.

Summary and future outlook

The aftermath of the financial crisis has had a substantial impact on the availability of debt and equity capital, along with sellers reluctant to transact into a weak market; consequently we are in a low transaction environment. Investors are also demanding more transparency, and the sophistication of advisors and the role of pension fund advisors raise the level of expectations every year. The market is considerably smaller than it was in 2007, but it is positioned for a rebound.

There are three legs to the stool: the availability of equity, the availability of debt, and the availability of deals. All three are needed in order to have a healthy marketplace. There are a number of players sitting on the sidelines, particularly sellers, and the most activity there has been from sellers is for the higher quality, premier class A properties in major city centers because of attractive pricing.

In a very low interest rate environment, many assets have been able to perform because debt service is so low, but that doesn't necessarily indicate improvement in the market. Job growth hasn't returned, and the global economy, with a few exceptions, has been running in place. There is more activity, with banks eager to dispose of their portfolios of property assets, but a mass exodus through fire sales is unlikely. However, there are still a significant number of distressed real estate portfolios that will eventually hit the market.

For 2012, we'll be able to reflect back on this period as a floor and see a crescendo of deal flow and activity that eventually starts to establish a trend. The likely scenario will be a gradual build-up, making this a good time to have capital to deploy today.

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