



Global market outlook 2015

Trends in real estate private equity



EY

Building a better
working world

Introduction

We often come across the word “disruption”; so much so that it has outgrown the need for explanation. When people say that traditional media is being “disrupted” by social media platforms such as YouTube and Twitter, it is quite clear that the industry is not facing small-scale quaking, but rather off-the-charts seismic activity that is tearing down the old order. The same applies to traditional brick-and-mortar establishments, such as schools, banks and retail shops, which are being disrupted by online classrooms, mobile payment systems, and all varieties of consumer products that are now only “one click” away from your front door.



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Coming of age in real estate fund operations

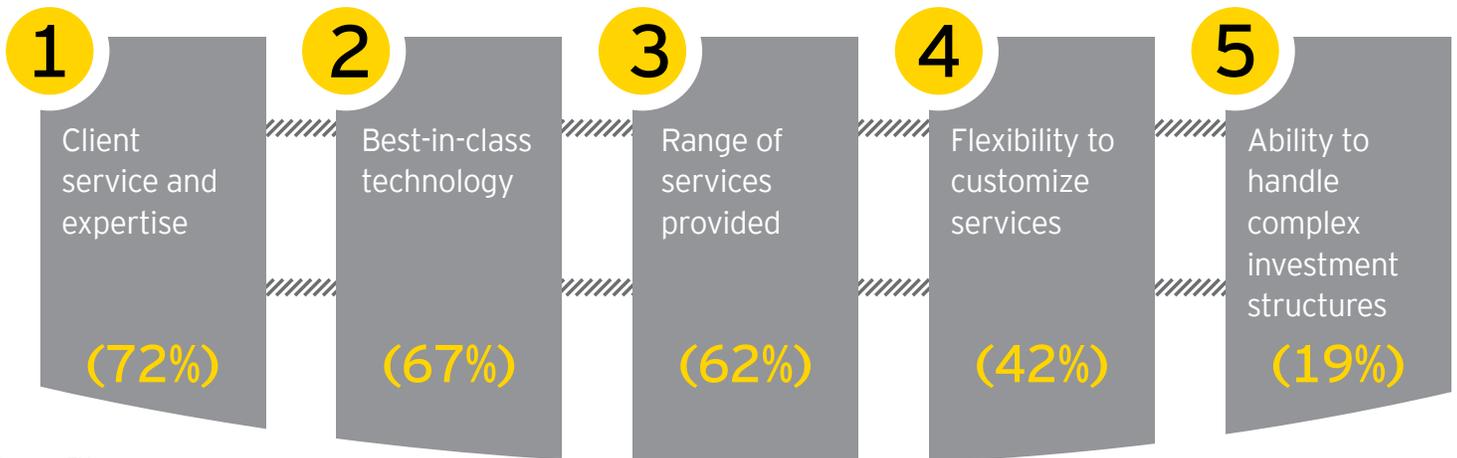
There has been an increased interest in back-office operations outsourcing among real estate fund managers proving how far interest in real estate fund administration has come in the industry.

Shaking the cost burden

It isn't that the sophistication of fund administrator platforms has improved so significantly for real estate. In all, it is still a fairly immature market. Rather, real estate funds have been feeling the squeeze on costs and management fees and are beginning to evaluate something they see as non-strategic. Momentum is now building, with several other high-profile liftouts on the books, a number of other large real estate fund managers are looking to move in the direction of outsourcing.

Differentiating from competitors

Top five items investors look for in operations



Source: EY survey

While cost management may be a driver, funds considering or pursuing such a significant move are also making a strong statement about their vision for the future of the business. Outsourcing isn't a simple exercise in improving operational efficiency or cost-effectiveness; it requires that everything related to business strategy be separated from all other functions, particularly replicable processes like accounting, investor servicing, property-level data collection and standardization, and reporting. The message this sends to the market is that fund managers understand clearly what their key value to investors is, and they should be trying to optimize around it.

There also seems to be a shift in fund manager attitudes toward the cost of these large-scale projects. Whereas several years ago, most managers were unable to justify the cost of a major outsourcing move because of the lack of most administration platforms' capabilities, many now appear more willing to bet on long-term cost savings, in spite of the significant up-front price tags. It remains to be seen whether managers with the flexibility in their fund documents will elect to pass on third-party administration costs to their investors, as most have been reluctant to do so thus far.

Understanding outsourcing costs is difficult at this stage, as no clear benchmarks have been set and the models used by the various administrators have generally been inconsistent. The industry is still testing too many different approaches. For example, there are a number of fund administrators that have established models for private equity or hedge funds and are working to adapt these to the real estate sector. These models have proven best equipped to handle

large-scale outsourcing transactions so far, as most are accustomed to handling fund and portfolio-level services. Tackling asset-level services, however, is often completely new territory for these "above the line" administrators, and many are still trying to recruit the right personnel to design and test these services. The learning curve, therefore, continues to be steep. Approaches for adding asset-level services, for example, property-level data collection and standardization, equity reconciliations and other services to existing platforms, are also extremely varied. Indeed, the reason the industry hasn't seen more asset-level outsourcing recently comes down to administrator capability, not fund manager demand.

On the other end, some asset managers and real estate services providers have taken on a different approach by trying to expand into full-service reporting and fund-level accounting. The convergence between these two approaches will eventually solidify best practices, but this is likely several years away.

Otherwise, the fund administration space hasn't experienced any significant false starts that would damage its reputation or stall the momentum of outsourcing or future demand for real estate fund services, but the industry is still in its nascent stages. So far, it appears that fund managers who are coming around to the prospect of significant long-term cost savings and improved operational efficiency are willing to be patient through the development and experimentation process.

“Bread and butter” outsourcing

If the recent examples of full-scale liftouts have been making the most noise in the fund administration space, they are still far less common than piecemeal outsourcing. This is especially true in the boutique and midsize fund space, where large-scale outsourcing deals are viewed as unnecessary and there has not been significant market demand. In fact, the most sophisticated real estate administration platforms tend to be concentrated in this segment of the market. They have remained here in spite of demand from larger funds because these providers do not have the capability of scaling up to the level that the multibillion dollar fund managers require.

Boutique and midsize service providers are proving to be in especially high demand in Europe. With the deadline for registration under the Alternative Investment Fund Managers Directive (AIFMD) now past, a number of mid- to large size managers looking to build out pan-European platforms are taking a closer look at which back-office

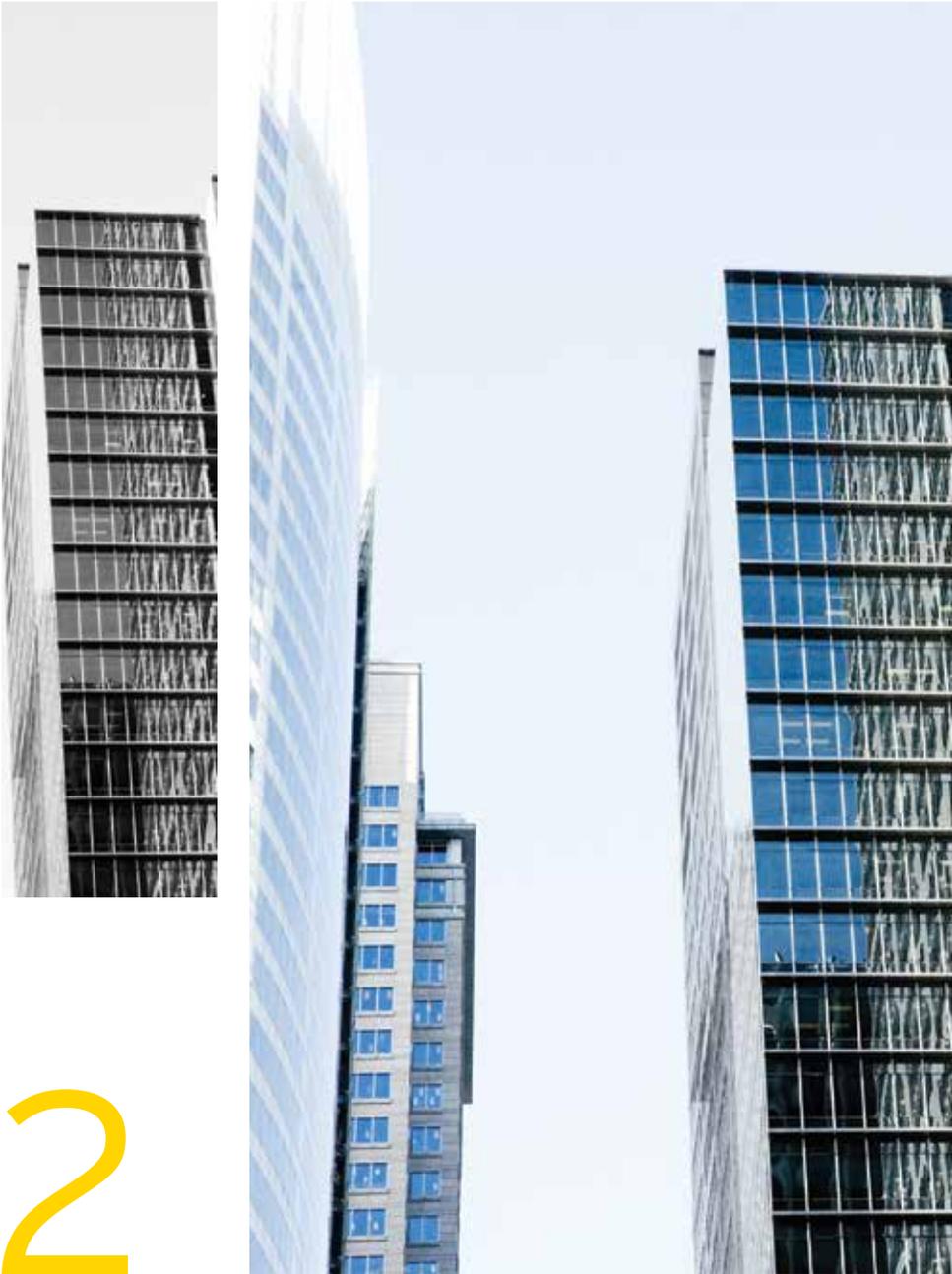
functions can be outsourced to help them streamline their operations and bring down costs. Most are motivated by concerns that intense governance and reporting demands will draw too many resources away from executing deals and managing assets.

Regardless of what level real estate fund managers are operating on, the overall maturity of real estate administration platforms is still a ways off. Most of the capabilities exist, but they are not yet offered by one shop. When they are, back- or middle-office functions should never be entirely outsourced. The lion's share of the 'repeatable' aspects of the core processing functions can be designed and managed by the administrator, but the management and control elements necessary for a real estate fund must always be handled by the manager. Additionally, while an administrator can take over data collection and financial report generation, it will always come down to the fund manager to verify that these services are producing accurate results.

Key issues and concerns in the market – property manager and investment manager



Source: EY



2

Fundraising: green shoots

With the amount of global capital looking for real estate, mid-market funds must be wondering why they cannot seem to get a break. The fundraising environment continues to prove challenging for many funds in this segment of the market. Many have been fundraising consistently for the past several years and are increasingly turning to third-party placement advisors for help in building new investor relationships.

The main challenge for the mid-market is that most investors, in spite of their real estate interest, have continued to be intensely selective of the funds they partner with. In addition, investors are cautious about unfamiliar funds; most will opt to re-up with their existing managers rather than explore new relationships. Additionally, the vetting processes of those who do explore new relationships can be extremely slow.

Unsurprisingly then, the field of players in the mid-market has not grown significantly in recent years – a trend that will likely continue for two to three years. Interestingly, management teams that have difficulty raising capital don't sit still, as evidenced by many high-profile players being picked off by several large real estate fund managers. What differs between current consolidation activity and the wave of activity that previously hit is that managers are engaging in consensual deals, and many more are quietly expressing their interest in finding a buyer.

This trend is a clear reflection of market improvement. Many of these managers now feel they are no longer in survival mode; rather, they may choose whether to sell or not. Those opting to sell may be motivated to turn their businesses over to fresher hands, having survived the financial crisis. Others may be looking to expand their platforms and capabilities or to engage in new markets. In the long run, this type of consolidation will strengthen the fund space and improve the overall health of the mid-market.

As for midsize players trying to hold their own, if there is any consolation for their persistent fundraising struggles, it is that the environment for launching new funds is equally difficult, particularly in Europe. Unlike in the US, the European markets remain cautious and have not yet developed a strong appetite for new, specialist

and boutique offerings. In spite of immense competition for core and core-plus deals, most investors are not yet willing to test small allocations for new, unique strategies. However, we expect this trend to change quickly as investors start to receive capital back from some of their larger manager relationships.

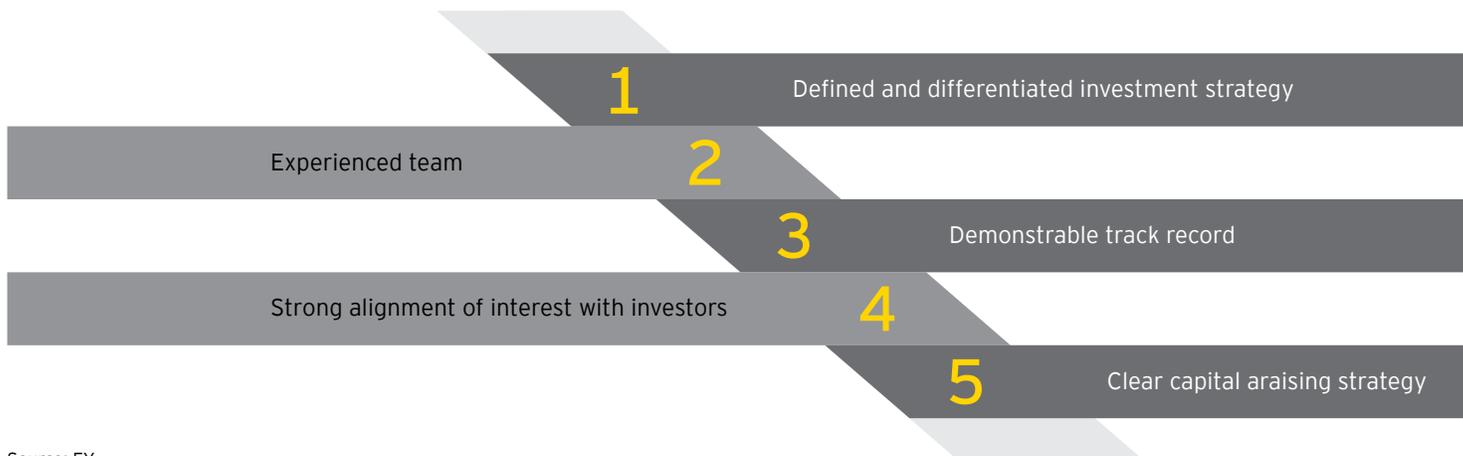
Those that have been successful with fundraising, whether they are boutique or midsize players, have tapped into a new level of creativity to do it. Many players now offer service "menus" to their investors, including separate accounts, club deals, and other options such as mini-funds structured as co-investment vehicles. Another strategy is demonstrating a strong deal pipeline by negotiating buyer exclusivity on individual assets or portfolios. This proposition is attractive to investors, given their difficulty in placing capital. Nevertheless, only the most skilled managers have been able to hold down deals long enough to pitch for capital.

One bright spot in the fundraising world is that equity funds are once again in vogue, both in the US and Europe. In Europe, this trend lagged far behind the US, and debt funds secured the largest share of capital over the last two to three years. This year however, investors everywhere have shown appetite for risk, which has translated into renewed interest in equity funds. Those being the most successful have core-plus and value-add investment mandates and investors with a tolerance to reach for higher risk-adjusted returns.

Debt funds, meanwhile, have not fallen out of favor. In the US, the market is very well developed, while in Europe the debt fund market has matured. The scope of offerings in Europe now spans beyond senior debt into junior and mezzanine levels. This will continue to be a key area of opportunity for funds in Europe, given the amount of real estate refinancing still required, and in the US market for the large volume of low maturities originated 7-10 years ago.

Top five influences on capital raising

Although change in the industry is constant, some things stay consistent over time.



Source: EY



3

Real estate M&A: spin-offs and mergers and acquisitions

The recent surge of mergers and acquisitions (M&A) activity appears very reminiscent of 2007, after several consecutive years of improving confidence in the economy and deal markets. M&A activity is driven by a desire for incremental growth, strategic merit of transactions, and the availability of debt and equity on favorable terms. All three of these elements are currently present, which has allowed for healthier and more robust deal markets. The volume of global capital chasing real estate opportunities has contributed to recent M&A activity. In the US, for example, roughly 11% of 2013's US\$355 billion in property deals were made by foreign investors; foreign investment is expected to surpass 2013 levels in 2014/2015.¹ The difficulty this capital influx has placed on deal sourcing for fund managers has driven many of them to look for new ways of expanding their real estate portfolios. And favorable market conditions have given them the confidence – and risk appetite – to do this.

1. "Cross Border Capital Tracker"; "Year in Review," Real Capital Analytics, January 2014.

Real estate investors are more confident in pursuing the acquisition of real estate operating platforms with the objective of owning the underlying real estate and not necessarily operating the platform as an operating business.

The challenge for traditional real estate investors is how to vet these deals, particularly under an increasingly high-speed diligence period. Real estate investors may be familiar with underwriting individual properties, assessing value and modeling cash flows, but these kinds

Top items to consider when acquiring a real estate investment platform



Source: EY



4

Global deal flow: it's a small world

The amount of global capital currently earmarked for real estate investment is extraordinary. With few exceptions, institutional investors are competing for core assets in global gateway cities. Whether they are Canadian pension funds, sovereign wealth funds, or Asian and Middle Eastern high-net-worth investors, all are looking for long-term assets in these markets.

The effect of foreign investment on the availability of opportunities in these markets has been enormous. In London, there are a significant amount of foreign cash buyers in the housing market, and in the US, the surge of capital into primary cities that elevated competition for deals has not deferred investor appetite.

This bodes well for the industry at the macro level, but it has also created new challenges for private equity players trying to allocate funds or hit return targets. These funds are rarely present amid New York's and London's core bidding wars. More can be found searching for yields in markets and asset types that fall farther along the risk curve.

In the US, the uptick in interest outside of gateway markets is beginning to create heat in some well-known secondary cities – ones deemed “secondary” for their rental rate growth prospects rather than their economic diversity or viability. Examples of these include Atlanta, Seattle and parts of southern Florida. Investors engaging in these parts of the country are betting on increasing demand for high-quality assets and have pegged their chances for a high-yield exit.

Private equity interest in development has also picked up, with a number of funds backing new hotel and distribution space construction in particular. On the industrial and distribution side, a surge in new construction is underway in southern Florida as a direct result of the ongoing Panama Canal expansion.

New development in any asset category outside of multifamily has not yet reemerged significantly in secondary markets, however.

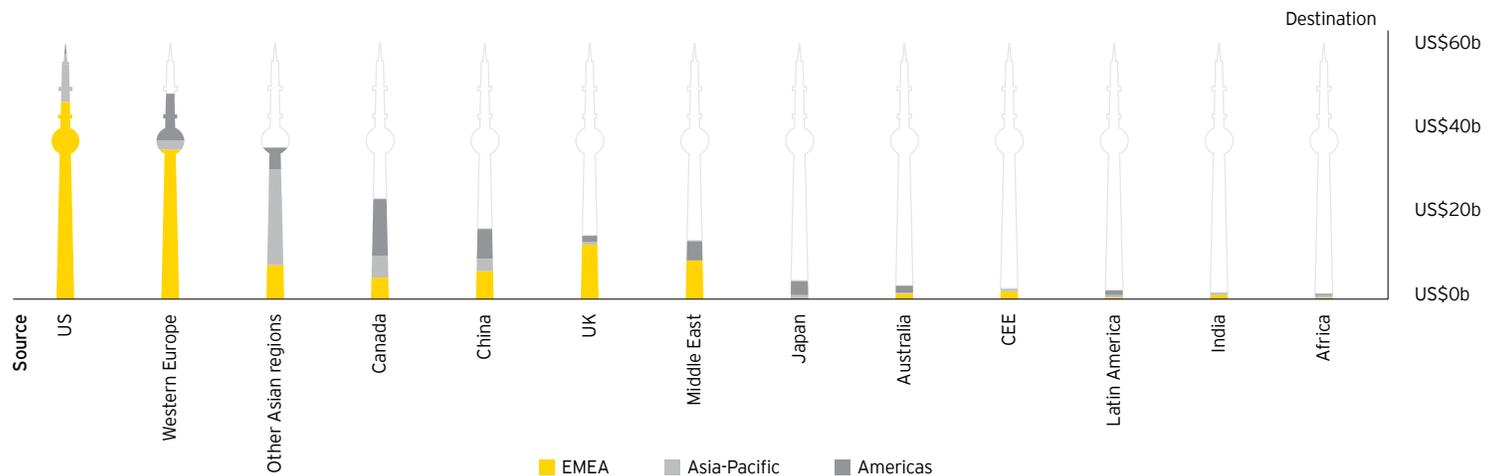
These still appear to carry too much risk for most real estate players. Equity requirements on new projects remain between 50% and 65% on average, and most lenders require some form of construction guarantee.

On the debt side, the industry is seeing strategy diversification, particularly from private equity players who entered this market several years ago. This trend is most pronounced in the US, with the rebound of commercial bank lending. Several high-profile transactions have highlighted the perception of value in the mezzanine segment of the market. Also, several dozen funds have cropped up as debt originators for commercial mortgage-backed security deals.

Meanwhile, in Europe, a significant amount of refinancing is still on the horizon. Commercial banks are unlikely to assume the entire burden, which will continue to create opportunities for alternative lenders.

The remainder of this section will delve into a number of global markets, exploring where investors are hunting opportunities and where funds are finding their niche. In all, for private equity funds, there is no shortage of deal opportunities that will meet or exceed their return targets, regardless of their geographic focus. But the tremendous global interest in real estate means that almost none of these opportunities are available for core assets in gateway cities. Finding them means continuing to identify new holes in the market to fill or accepting a greater appetite for risk. 2008 should continue to serve as a reminder, however, that the market can only be pushed so far.

Cross-border capital flow accelerating



* Last 12 months, ending Q3 2014, excluding Chinese land sales

Source: Real Capital Analytics

Bubble check: when will the balloon burst?

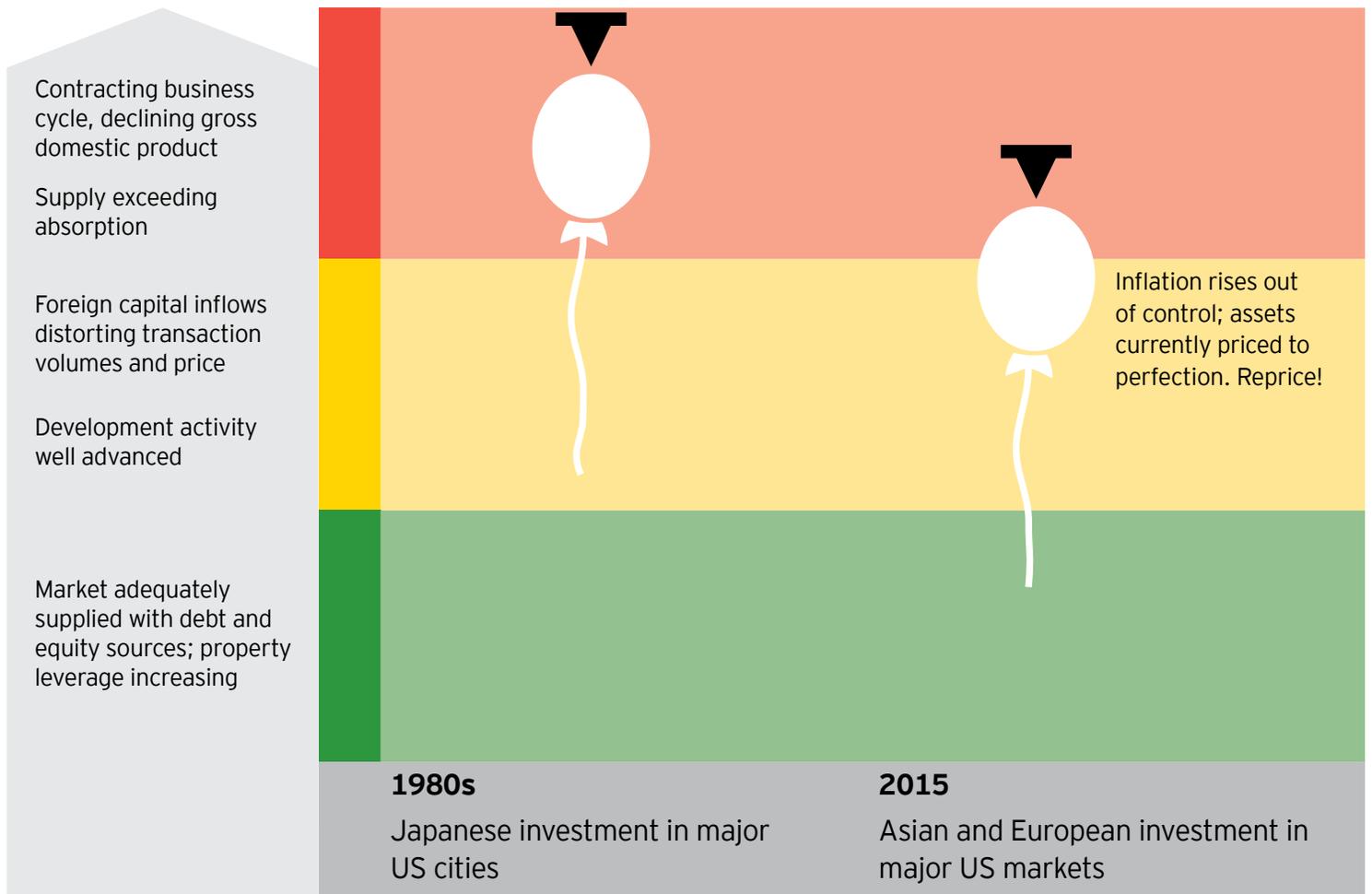
How capital inflows from foreign investors could result in a burst of commercial property prices.

Over 25 years ago, EY tracked Japanese investment in US real estate and marked the peak of Japan's capital flows during 1988, when investment dollars into trophy US assets reached US\$17 billion.² Although the development of REITS and the commercial mortgage-backed securities (CMBS) market for investing in real estate has had a profound impact on institutionalizing our industry, the universal fact is that imbalances in capital flows into real estate have the same effects and risks for creating an asset bubble now as they did then. The disturbing truth is that the US and a handful of other markets have a very scarce commodity of institutional-grade assets protected by ownership rights and a rule of law that ensure institutional

investors a safe means of entry and exit. This is compounded by the fact that many central governments around the world are seeking diversification of trade surpluses and reserves. This is why it is not surprising that foreign investment in 2014 topped US\$39 billion, a 14.7% increase from the inflation-adjusted 1988 peak of US\$17 billion.³

So when will the bubble burst? Asset bubbles, much like history, have similar facts and circumstances, but rhyme more so than repeat. Today, the size of the market is significantly larger and has a far more diverse offering of debt to equity products.

Bubble check: 1980 vs. 2015



Source: EY

2. "Real estate: US slows," Kenneth Leventhal & Co., 1990.

3. Real Capital Analytics, December 2014.

European market spotlight: Germans love retail

Real estate ranks high on European institutional investors' investment priorities because of low returns in the bond markets. Many institutional investors are looking to increase their real estate allocations.

German institutional investors invested most heavily in their domestic markets in 2014, rather than searching for opportunities elsewhere. Their asset class of choice has been retail, which is surprising for such a low-risk group. Eighty percent of those polled said they had been chasing retail investments, in spite of several high-profile bankruptcies among large German retailers in the last couple of years. But unlike foreign investors that come into European markets looking for value-added retail with potentially high yields, German institutional investors have focused on core opportunities: modern shopping centers and high street retail, rather than power centers or shopping centers in need of redevelopment.

In other asset classes, more than half also looked into the office and residential sectors, while just below half are focusing on industrial and logistics options.

For those that have explored real estate investments outside of Germany, 2014 marked a significant shift, with only a third investing in North America compared with more than half in 2013; rather, they have stuck closer to home, concentrating on core European markets: the UK, France and Scandinavia.

Meanwhile, Germany is also starting to see more interest from a new crop of foreign investors, particularly from Asian funds, which are beginning to expand their European real estate scope beyond the UK. Unsurprisingly, they are almost exclusively in search of core opportunities. But with these becoming increasingly difficult to find, a few have begun to make small steps farther along the risk curve by considering core-plus deals or ones that have a small value-added component, such as vacancy improvements.

This means that for opportunistic private equity players, returns are becoming narrower and narrower in Europe's northern markets. As a result, they are migrating south, to Spain and Italy, where price discovery is underway through increasing transaction activity. Those who continue to look for opportunistic plays in Northern Europe are getting involved in larger, more complicated transactions, such as ground-up new development or complete redevelopment.

Latin American market spotlight: uncertainty wave hits Brazil

2014 has been a challenging year for Brazil, in spite of the excitement of the World Cup. GDP growth has been sluggish, with year-end results expected to fall in line with last year's: a glum 1%. Business was actually negatively impacted by the football tournament, and the anticipation of October's presidential elections and a tense campaign cycle contributed to uncertainty in Brazilian markets.

With these events and predictions in mind, enthusiastic investors who joined the Brazilian real estate market several years ago are now pulling back.

Furthermore, the downward trend in Brazil's economic performance has not boded well for the country's existing real estate stock. In São Paulo, the office market is highly oversupplied. This is because of the number of new buildings planned and started three years ago, when GDP growth projections were more positive. Now, it could take up to two years or more to absorb the city's current supply.

Most of Brazil's other office markets are facing some degree of oversupply as well, though none to the extent of São Paulo. Rio de Janeiro is the one notable exception. Wedged between mountains and the sea, the city's geographic constraints mean there is limited space for new development. In fact, the redevelopment of its old port, Porto Maravilha, is one of the country's few new construction projects attracting investors, including real estate private equity funds.

Two sectors where there appears to be near- to long-term investment opportunity in Brazil, however, are logistics and retail. The logistics market is currently in growth mode with a spate of redevelopment projects converting single-owner warehouses into modern, professional-grade properties. Until now, most warehouse sites had been built by individuals for small business use. There is a significant lack of larger-scale industrial real estate infrastructure to cater to Brazil's transport and logistics industries. However, with the first wave of conversions completed several years ago, domestic real estate investors have been flocking to development and redevelopment projects in this sector.

Meanwhile, growth in retail real estate has slowed substantially, even though it is largely believed to be underbuilt. This is especially true for shopping malls, which are attractive to consumers for their security. Yet for a large emerging market, Brazil has a small shopping mall footprint.

Asia-Pacific market spotlight: Asian investors expand closer to home

Fund activity in the Asia-Pacific region has been heating up around Australia. Historically an institutionally owned market, Australia is beginning to open up to new sources of capital with a need for recapitalizations, redevelopment and new construction in its aging real estate stock. A key source of the new money coming into Australian cities is Asian funds, which see Australia as a core market. These funds are demonstrating a willingness to explore higher risk opportunities there because of Australia's overall stability relative to other markets in the region.

In general, however, Asian investors are looking to invest closer to home more than they have in the past. Chinese funds, for example, continue to allocate a significant amount of real estate capital into the US and Europe but are increasingly exploring opportunities within Asia as well. This marks a strategic shift, suggesting that they are more convinced of their own regional markets' viability. However, in spite of the extent of opportunity within China, Chinese funds are still slow to reinvest capital domestically.

Across the region, real estate investment activity continues to be stable, though less frenzied than in recent years. The threat of interest rate increases in the US and moderating growth in China have been a big contributor to the slowed pace. Thailand's market has shown resilience, in spite of political turmoil. Indonesia has been hit because of last year's currency devaluation and this year's elections.

Meanwhile, Malaysia and Singapore are both facing headwinds in their residential markets, owing to strict equity requirements for investment properties. Additionally, in Malaysia, there is concern about oversupplied apartment stock as a result of Chinese development. This is particularly true for the region closest to Singapore, where residential prices have fallen as much as 15%. In Singapore, investors' perception is that the residential market is overpriced and that cap rates are too low to enter the market.

The REIT market in Singapore remains healthy, however, with a number of new entities looking to be listed there, thanks to market transparency and investors' familiarity with Singapore's capital markets regime. Another market segment that is expected to see heightened activity is Singapore's office market. Several high-profile deals are expected to hit the market, and most of the buyer interest is expected to come from other Asian investors.





5

Now: European Asset Quality Reviews; transactions to follow

The release of the European Central Bank's (ECB) Asset Quality Review (AQR) results marked the latest step in the ECB's process in attempting to set the region on a surer footing for growth. The exercise, which assessed the balance sheet strength and economic shock resistance for nearly 125 banks across the EU may not seem ideally timed, given the current economic outlook for the Eurozone. However, it was arguably the quickest and most effective way to level the playing field for banks under the ECB's direct supervision.

Potential consequences of AQR

Although the impact of AQR results on the supply of loans to transaction markets is unclear, there are a number of potential consequences. Furthermore, resetting the dial for the region's main banks is essential to a sustainable Eurozone economic recovery and to instilling market confidence in the region going forward. The ECB has taken important measures this year to try to kick-start funding for the real economy. These include the Asset-Backed Securities (ABS) and the Targeted Long-Term Refinancing Operations (TLTRO) programs, with both measures relying on a strong banking sector for transmission into the wider economy.

Once the dust settles on the AQR results, the way forward for both the banks and the businesses that rely on them for funding should

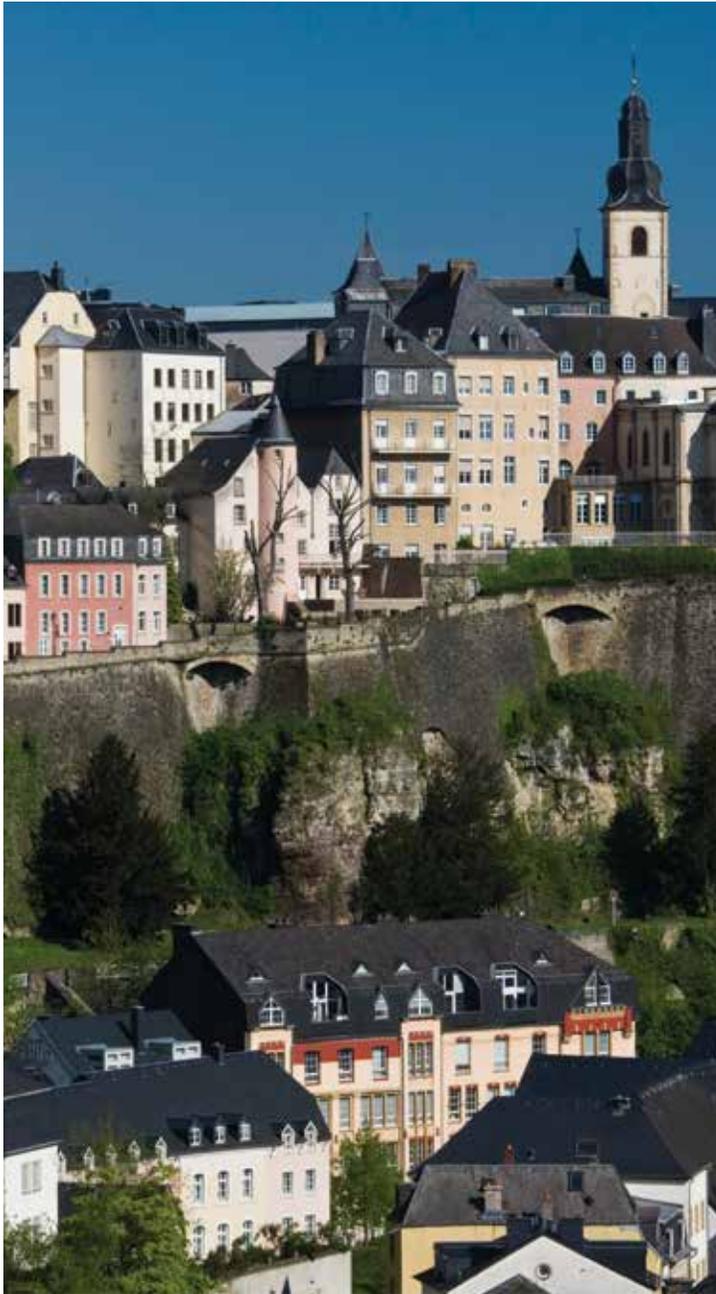
become clearer. Banks and regulators will have a much deeper level of knowledge to draw from in paving the way forward, given the scale and granularity of the AQR exercise. These insights will both finesse the banks' recovery and resolution plans and facilitate the creation of a single resolution mechanism.

As for the real estate market, the banks' process for navigating the way forward will likely have a significant impact on new opportunities for the foreseeable future. There will undoubtedly be a sizeable volume of sales coming to the market in the near term, including both loan books and unresolved foreclosed assets. Private equity funds will certainly have a role to play in resolving key pools of capital.

Capital requirements timeline

	1 Jan 2015	1 Jan 2016	1 Jan 2017	1 Jan 2018	1 Jan 2019
Capital requirements	Phased in				Full compliance
Capital Requirements Directive (CRD) IV leverage ratio	Public disclosures begin			Binding requirement	
Net stable funding ratio	Observation period			Introduction of minimum requirement	
Liquidity coverage ratio	60% compliance required	Phase to full compliance		Full compliance required	

Source: EY



6

BEPS and other tax updates

Several years of intensified efforts by global tax authorities to combat tax evasion and avoidance have finally resulted in a collective effort led by the OECD with the support of the finance ministers of the G20, focusing on BEPS. Last year, the OECD released its first set of measures to help ensure that businesses are adhering to tax regimes where they are based. The aim is to finalize these action plans by September 2015.

Direct relevance to the RE fund industry

Regulated vs. unregulated collective investment vehicles

- ▶ In light of industry feedback from an earlier draft, the OECD has proposed that countries could consider adding collective investment vehicles (CIVs) to the list of qualifying entities able to automatically claim treaty benefits (albeit with potential restrictions as to whether full relief is available). A CIV is not clearly defined but is generally a diversely held investment vehicle subject to investor-level regulation – such as a UK open-ended investment company (OEIC) or a Luxembourg société d'investissement à capital variable (SICAV). Although the OECD promises to consult further on similar protection for alternative funds such as private equity real estate, no further details are available as yet.
- ▶ It is clear, therefore, that the trend in recent years for greater substance requirements in any fund vehicles will only increase, and fund managers should bear this in mind while making future expansion plans.

Reporting and compliance

- ▶ Although country-by-country reporting is principally aimed at large multinationals, the same requirements are likely to apply to multinational fund structures, which will give much more visibility over structures to tax authorities than what has historically been the case.



Substance

- ▶ Most real estate funds will pool international investors in order to invest in a particular region (e.g., US and Asian investors will invest in European real estate). Therefore, they will usually route this investment through one jurisdiction, such as the Netherlands or Luxembourg, both for reasons of administrative simplicity and to minimize tax leakage through access to the treaty network of that country. The BEPS program proposes restricting access by a company to treaties only if one of the three tests below are satisfied.
 1. Firstly, that it is a qualifying entity; broadly, one that is publicly listed in that country or controlled by a listed company in that country
 2. Failing this, that it has sufficient business activities in that country; the guidance is clear that being a holding company passively managing investments is not sufficient
 3. Finally, that the company was not put in place with a main motive of claiming treaty benefits



Hybrids

- ▶ “Hybrids” is shorthand for financial instruments or entities with differing treatments in two jurisdictions (e.g., equity in country A and debt in country B or capital/income or opaque/transparent). The OECD is proposing a mixture of treaty and domestic law changes to remove the tax advantages potentially achievable by arbitrage between these treatments. Of interest to real estate funds is that these rules would, if implemented as proposed, lead to funds having to consider the tax treatment of investors on funding instruments and potentially disallow expense at fund level.



No need for immediate action

- ▶ Clearly, if implemented as proposed, BEPS may have significant implications to the complexity, tax efficiency and running costs of a typical real estate fund. However, implementing this process will require global cooperation between governments, and given that many of these carry significant political implications, although there is a clear will of the OECD as an organization to implement this, whether full cooperation from governments can be secured in a timely fashion is impossible to be assessed at this time. However, action to ensure appropriate substance and beneficial ownership in relevant jurisdictions is of the highest importance. Fund managers should consider the use of domestic exemptions from withholding taxes (so as not to rely on treaties) and/or local tax-efficient vehicles (e.g., REITs, Organisme de Placement Collectif en Immobilier (OPCIs) or and sociedades cotizadas en el mercado de inversión inmobiliario (SOCIMIs) to ensure their structures meet the objectives and goals of their investors.



7

Trends in fund reporting

AIFMD and EMIR

The Alternative Investment Fund Managers Directive, more commonly known as the AIFMD, finally came into full effect on 22 July 2014. By this date, fund managers within the scope of the directive were required to have submitted their applications for authorization to manage and/or market alternative investment funds in the European Union.

Also coming into effect is the European Market Infrastructure Regulation (EMIR), which its designers hope will provide more stability and increased transparency in the over-the-counter derivatives market. The first requirement, the EMIR portfolio compression obligation, involving the reporting of derivatives was effective in 2014. Further, certain fund managers may be classified as Financial Counterparties (FCs) and they will have to comply with the full range of EMIR requirements when they finally come into effect, including the upcoming central clearing and cash collateral posting obligations, which many believe will be burdensome.

The European Association for Investors in Non-Listed Real Estate Vehicles (INREV) released a survey on 9 December 2014, exploring the impact of regulatory compliance, such as the above, on the non-listed real estate funds industry. Fund managers reported that AIFMD depositary and operational requirements were the most challenging – both before and after application for authorization – and that the costs of complying with AIFMD were considered significant. INREV reported that *“Many fund managers say they are still concerned with reporting to local regulators. At the heart of this concern is the AIFMD’s requirement that the reports be validated, formatted and posted 30 days after the end of the reviewed period (or 45 days for fund of funds) – an onus for an industry that, heretofore, has not implemented methods for handling such reporting granularity or frequency, and a very narrow window for managers with multiple funds. For funds that report quarterly, the challenge is particularly acute.”*

In contrast, the survey revealed that EMIR’s current reporting obligations were delegated by most managers and that the associated cost was not considered significant, despite the challenge of meeting the first reporting deadlines for many respondents.

Transparency

Large institutional investors such as pension funds, family offices and insurance companies continue to demand more transparency over investment activity and products on behalf of their stakeholders. For example, stakeholders may apply pressure on fund managers to comply with the Global Investment Performance Standards (GIPS). GIPS are a voluntary set of standards – based on what the authors see as fundamental principles of fair representation and full disclosure of performance results – that were created to provide an ethical framework for the calculation and presentation of the investment performance history of an investment management firm.

It’s also important to note that the AIFMD requires that all information provided in the annual report be presented in a manner that provides relevant, reliable, comparable and clear information that investors may need in relation to particular alternative investment fund (AIF) structures. Perhaps particularly challenging is the information to be provided about manager remuneration, fee structures, risk profile and management and investment strategies.

Alternative performance and non-GAAP financial measures

In 2014, the European Securities and Markets Authority (ESMA), the European public financial reporting regulator, launched a consultation on “Guidelines on Alternative Performance Measures” (APM). ESMA sets out that *“The aim of the guidelines is to improve the transparency and comparability of financial information, reduce information asymmetry among the users of financial statements, coherent use and presentation of alternative performance measures (APMs) and finally to contribute to restoring confidence in the accuracy and usefulness of financial information and improve investor protection.”* Although the guidelines apply mainly to issuers of public securities, these guidelines may also become common practice in the European fund industry. The final guidelines are expected soon.

The International Organization of Securities Commissions (IOSCO) continued the theme with its 2014 consultation on its proposed Statement on Non-GAAP Financial Measures (NGFMs), which partially overlaps the APM. However, where the APM also comprises measures designed to illustrate the physical performance of the activity of an issuer’s business, IOSCO’s NGFMs only relate to financial numerical measurement of an issuer’s current, historical or future earnings, financial performance, financial position or cash flow that is not determined by GAAP.

SEC developments

In June 2014, the US Securities and Exchange Commission’s (SEC) Division of Investment Management issued a Guidance Update for Private Funds and the Application of the Custody Rule to Special Purpose Vehicles. Under one of several scenarios in the guidance, the SEC clarified that a special purpose vehicle, such as a vehicle created for tax purposes with third-party investors, may need to be considered as a separate client for purposes of the Custody Rule. In some circumstances, the SEC examination staff have applied this guidance and issued deficiency letters indicating that the private REITs inserted in private fund structure for tax purposes should be considered a separate client and subject to the provisions of the Custody Rule, thereby requiring a separate financial audit. Individual circumstances are different, and legal counsel should be consulted when performing an evaluation of the entities that meet the definition of separate clients under this updated guidance.

Investment entity financial reporting

A new international model

Perhaps the most significant development in reporting this year was the release of the new International Financial Reporting Standards (IFRS) 'Investment Entity' exception. This new model brings IFRS guidelines closer in line with US GAAP, potentially enabling real estate funds in multiple jurisdictions to use similar accounting practices – a step in the right direction to standardize data points and to improve fund comparability globally.

This exception means that for entities in scope, subsidiaries would not be consolidated, but rather the investment therein would be measured at fair value. This exception applies if:

- ▶ An entity obtains funds from one or more investors for the purpose of providing investors with professional investment management services.
- ▶ An entity's main purpose is to invest funds solely for capital appreciation, investment income or a combination of capital appreciation and investment income.
- ▶ An entity measures/evaluates performance of substantially all investments on a fair value basis.

New guidance for existing US GAAP model

At the same time, for US GAAP reporters, under new guidance for investment companies, an entity that is regulated by the SEC under the Investment Company Act of 1940 (the Act) automatically qualifies as an investment company. Entities that are not regulated under the Act must have certain fundamental characteristics and consider other typical characteristics to determine whether they qualify as investment companies. An entity should consider its purpose and design when making the assessment.

An investment company must have the following fundamental characteristics:

- ▶ The entity obtains funds from one or more investors and provides the investor(s) with investment management services.
- ▶ The entity commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income or both.

- ▶ The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

Typically, an investment company also has the following characteristics:

- ▶ It has more than one investment.
- ▶ It has more than one investor.
- ▶ It has investors that are not related parties of the parent (if there is a parent) or the investment manager.
- ▶ It has ownership interests in the form of equity or partnership interests.
- ▶ It manages substantially all of its investments on a fair value basis.

An entity that does not have one or more of the typical characteristics could conclude that it is an investment company, but it would have to apply judgment and determine, considering all facts and circumstances, that its activities continue to be consistent with those of an investment company.

These US GAAP guideline updates are otherwise unlikely to significantly impact real estate funds already qualified under the structure. REITs continue to be scoped out of this guidance, although we understand that diversity in practice remains on the application for private REITs set up for tax purposes, and it will likely be an issue that continues to be hotly debated in the near term.

As discussed above, this US GAAP assessment is similar to that under IFRS, except under IFRS an investment company must measure and evaluate the performance of substantially all of its investments on a fair value basis and must have an exit strategy for investments without stated maturity dates. Crucially, though, for IFRS real estate reporters, the Investment Entity exception contains specific guidance for real estate. This acknowledges that most real estate investments require active management – such as leasing, cap-ex, redevelopment and maintenance – and these are activities may preclude the entity from meeting the criteria as an Investment Entity.

Therefore, a real estate fund that actively manages its assets and does not have a defined exit strategy may not meet the criteria to be an Investment Entity under IFRS. We do not currently observe many real estate funds in Europe seeking to adopt this new reporting model, but this may change over time.

One interesting result from the potential alignment of the US GAAP and IFRS reporting models could be that, as this reporting model is operationally easier to implement, a number of funds could explore how to outsource their reporting functions. As with most outsourcing discussions in the fund space, this is primarily a cost-driven consideration, although administrators may be better equipped to serve entities utilizing this reporting model, making it a more feasible option. This particular change seems to be motivating funds to explore bigger outsourcing strategies.

Other new international financial reporting standards

For funds not reporting under the Investment Entity exception, other recent changes to IFRS may also have an impact. IFRS 10, 11, 12 and 13 came into effect on 1 January 2013 (albeit IFRS 10, 11 and 12 were not mandatory until 2014 for entities reporting under European Union-approved IFRS). We cover certain aspects of these below.

IFRS 11 applies to joint arrangements and sets out that partners to the venture should account for their direct rights to its assets in the arrangements and their joint liability for its obligations (similar to proportionate consolidation) only if those rights exist. For transparent entities like partnerships, that may be the case, but many other structures do not meet these criteria and for them equity accounting is mandatory. IFRS 11 has therefore tended to lead to equity accounting instead of proportionate consolidation as seen under the previous accounting standard.

IFRS 13 is concerned with fair value measurement and disclosures thereto. For the real estate industry especially the amount of real estate valuation disclosures about significant assumptions, unobservable inputs and the level of aggregation (segmentation) of such disclosures is a significant issue. In the first reporting year after IFRS 13 came into effect, we noted considerable diversity in the level of such disclosures and we expect that there will be regulatory interest and some harmonization in this respect in future periods.

Separately, for fund managers themselves, IFRS 10 may require some to consolidate the assets and liabilities of the funds it manages into

its own financial statements. Consolidation is required if the fund manager is considered to control the fund, which is the case if the fund manager has:

- ▶ Power over the fund
- ▶ Exposure, or rights, to variable returns from its involvement with the fund
- ▶ Ability to use its power over the fund to affect the amount of its returns

IFRS 10 provides an example where a fund manager has to consolidate the fund it manages if it (1) has a 20% interest in the fund, (2) can only be removed as manager for cause, (3) has broad decision rights and (4) a variable remuneration of between 1% of net asset value and 20% of profits if certain hurdles are met. Clearly interpreting whether a fund manager controls a fund will require considerable judgment. In this respect, the Investment Entity exception may provide a safe haven.

Integrated reporting

An integrated report is a concise communication about how an organization's strategy, governance, risk management, performance and prospects lead to the creation of value over the short, medium and long terms. In our experience, investors like the introduction of integrated reporting and, despite identifying concerns and obstacles, many fund managers look forward to its development and progress, viewing integrated reporting as an improvement in disclosures for investment decision-making.

As a consequence, integrated reporting is commonly seen as enhancing significantly the reputation and competitiveness of a fund manager. The tendency to move to integrated reporting will soon be the norm.



Outlook

In this year's *Global market outlook*, we have focused substantially on the amount of global capital chasing real estate investment opportunities. Looking forward to next year, we anticipate a continuation of this trend, which will fuel top-level pricing in the global gateway cities and push more investors into the opportunistic and value-added space in other markets around the world. This should bode well for the broader real estate industry.

However, we have heard whispers from investors about concerns of a bubble in markets like London and New York, where prices are at all-time highs. If we look at history, however, market collapse has always been preceded by deteriorating economic fundamentals and stress factors like overdevelopment and

rising vacancy rates. So far, there is little evidence of these precursors. What's more, industry players have moved carefully along the risk spectrum in this cycle, which is why we have not seen an excessive amount of development activity or movement in secondary and tertiary markets that lack the economic drivers that justify speculative development. This means that although the global top-tier markets are being priced to perfection, there appear to be few obstacles to their stable performance on the horizon. The only caveat is low interest rates, with the vulnerability of the inevitable return to a more normal interest rate environment. However, for the near term, the coast is clear assuming real estate investors take a sensible approach to underwriting.



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