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Outlook optimistic, with a hint of caution

As this report lands on desks, the first quarter of 2019 will be almost at a close. And as things stand, there are challenges aplenty to occupy the collective thoughts of investors and managers in private real estate.

Headwinds, both of the economic and political ilk, are gaining momentum: the prospect of rising interest rates and slowing economic growth; looming trade wars between superpowers; the pending extrication of the UK from the EU and uncertainty surrounding what a final deal will look like, if one can be reached at all by departure day; and the spread of populism. Likely, these just scratch the surface.

The point is this: these factors merit some degree of twitchiness as investment decisions are made in the months ahead. Risks and their potential impact on performance are beginning to prey on minds. And the first signs of investor caution, albeit very subtle, are duly revealed in this PERE Investor Perspectives 2019 survey report. Only 16 percent of respondents intend to increase target allocations to private real estate in 2019, with 63 percent happy to keep target allocations at current levels. Now is not the time, it seems, to be experimental and shake up the status quo. The same applies to manager relationships, and 56 percent of our investor respondents do not allocate capital to first-time funds. Overall, sticking with those they know well is the order of the day.

But the real estate story for 2019 is far from one of doom and gloom, as many of the commentators in this report emphasize. There are several positive themes to excite investors: growing urbanization, population growth and the march of e-commerce are just a few examples of trends presenting opportunities for growth and performance. If more people are living and working in major cities, it creates demand for more homes and office space. The rise in online shopping will require more logistics property. These mega-trends and their impact on real estate were key topics of discussion and analysis in PERE special reports in 2018, and this is set to continue in our coverage this year.

The pages that follow are packed with survey data offering a view of how investors intend to approach real estate investing in 2019, and the issues of concern to them at this point in the cycle. And for managers, the survey findings reveal, among other things, how investors feel about the fees you charge them, as well as the areas they are most likely to question you on when they are conducting due diligence.

We hope you find plenty of insights you can relate to, and even some that will surprise.

Enjoy the report.

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Special Projects Editor
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Six investor perspectives that matter
The survey reveals increasing investor caution as economic headwinds register higher

1. **Treading carefully in 2019**
   
   Recent years have been kind to investors in performance terms, and there are positive themes on the horizon in 2019, with growth opportunities being driven by megatrends like urbanization and population growth. Here comes the ‘but.’ A sense of caution is emerging as investors keep an eye on economic and political headwinds. Ambitions seem muted: 17 percent believe real estate benchmarks will exceed expectations, lower than for other alternative asset classes. And a greater number of investors intend to decrease their allocations to real estate compared with the other asset classes.

2. **Red flags**
   
   Investors’ antennae are particularly acute to potential economic headwinds. The survey indicates that extreme market valuations are top of mind for 66 percent of respondents, while rising interest rates dominate the thoughts of 56 percent, followed by an escalation of the US-China trade war. Although less evident from the survey findings, there are also political niggles that could cause twitchiness in the investor community in the months ahead, including a worrying rise in populism, as well as the UK’s impending departure from the EU.

3. **Faith in trusted partners**
   
   Mindful of this year’s potential disruptions – which could take the wind out of the sails of real estate market performance – investors are weighing up if now is the best time to forge new manager relationships. Our survey reveals investors in real estate remain loyal to their current managers: the ones they trust and have worked with over the long term; 56 percent of respondents will not consider investing in first-time funds, suggesting established managers are more likely to attract available capital. This is a tricky time for new market entrants and managers seeking to grow their investor base.

4. **Focus on Asia**
   
   Investors have one region on the brain as they consider which emerging markets offer the best potential for growth: Asia-Pacific. A whopping 84 percent of respondents declared it the emerging market in which they are most likely to consider investing in 2019, with Central and Eastern Europe a distant second for 39 percent. Demographic fundamentals are underpinning the region’s attractiveness, with rising population and urbanization fueling growth and investment opportunity. Transparency is also improving in core markets like India, making investing an altogether less risky venture than in years past.

5. **Money mindfulness**
   
   Investors’ primary goal is to capitalize assets that will make them good returns. Their second is to minimize costs that could eat into profits. So it is unsurprising to see that the issues of fees and fee transparency are very much on investors’ radars: 64 percent of respondents either strongly agree or agree that the fees currently charged by their managers are difficult to justify and 65.5 percent are seeking greater fee transparency and disclosure from their managers in 2019. And the fund term causing most disagreement with managers during diligence? Management fees.

6. **Room for improvement**
   
   Some survey findings may surprise, and no more so than in the critical area of investor due diligence. ESG, sustainability, equal pay and gender diversity have become major talking points in recent years. Yet the survey shows they are, in relative terms, low on the list of investor priorities. Nearly 57 percent of respondents report that the gender pay gap at the GP level forms no part of their diligence efforts, and 41 percent consider ESG to be a minor consideration. And despite more data breaches, just 3.1 percent see cybersecurity as a factor that could impact performance in 2019.
Investors are adapting to a changing world
Real estate markets today are susceptible to many factors. Kiran Patel, global CIO and acting CEO of Savills Investment Management, considers how investors will evaluate and adjust to current conditions.

Commercial real estate (CRE) investors have largely enjoyed the benefit of good returns in recent years, but as we progress through 2019, many are wondering how long the momentum can last. To focus on slowing economic growth and an increasingly uncertain political climate, however, would be to overlook several positive themes in the real estate market.

Economic and political factors
This year marks the end of a decade characterized largely by the aftermath of the Global Financial Crisis (GFC). While the monetary kitchen-sink approach, which central banks instigated in response to the GFC, restored demand and output, the immediate future long-term average economic growth rates are expected to remain modest for some time.

The United States is now unwinding its quantitative easing program while the eurozone and Japan are expected to do so soon. Unless stimulated by extraordinary public actions, especially monetary and fiscal policies and/or unsustainable private sector borrowing, the private economy will be prone to sluggish growth caused by insufficient demand. At present, the long-term real rate of interest is still very low.

Investors also face uncertain times politically. The rise of populism, which has found expression with the elections of President Trump and right-wing parties in Europe, means political tensions constitute a substantial concern for investors, even in markets historically considered stable.

Positive themes are emerging
Against these factors, however, investors are weighing up the benefits of some strong positive themes emerging in global real estate.

A clear global theme is growing urbanization. Cities are developing fast, especially in Asia but in Europe, too. So much so that over the last 20 years, the top 10-listed cities in our Dynamic Cities Index have collectively outperformed the EU-28 overall in terms of GDP and employment growth, providing a backdrop for stronger commercial real estate investment performance.

The index ranks cities across six categories: innovation; inspiration; inclusion; interconnection; investment; and infrastructure. It highlights those cities able to attract and retain talent, spur innovation and increase productivity, which
encourages the wealth and population growth that drives successful commercial real estate markets.

London notably ranked first for a second consecutive year, followed by Cambridge, Paris, Amsterdam, Berlin, Dublin and Munich, newcomers Oxford and Basel, and then Stockholm. The majority of 2017’s top 40 cities consolidated their places in 2018’s index by increasing their scores, underlining their continued progress.

The index predicts that all commercial real estate sectors will benefit over the long run from several key trends: rising employment will help support the office sector, wealth creation will benefit the retail sector; and the explosive growth in e-commerce will drive demand for urban logistics and warehouse facilities.

Nor is this just about size. While some ‘super cities’ such as London and Paris are clearly established, there are some smaller cities that have what it takes to attract investors, namely infrastructure investment projects, fast-growing knowledge networks, high-quality universities, innovative businesses drawing from a global talent pool and strong cultural amenities to help retain that talent.

On average, Savills Investment Management expects cities to outperform countries. And within cities, we like markets that have lagged the current European property cycle. We see, for example, selective opportunities in the office sector in Brussels, London, despite short-term Brexit concerns, Lisbon, Amsterdam and Frankfurt.

Technological changes are particularly hard for investors to ignore, especially in relation to the logistics and retail sectors. Technology has, for example, driven the rise of online retail. This has created the need for distribution centers but also a shift toward ‘omnichannel,’ which integrates the different methods of shopping, including online, physical and phone, in one place, such as a retail warehouse.

Major retailers now focus on core markets that not only support sales activity but also aid product, showcasing and helping to project their brand. This has resulted in increased demand for mega distribution centers, last-mile urban cross-docked logistics and prime high-street shops. The UK, Sweden and Germany are ahead in the curve and momentum is building in the rest of Europe. In pure-play retail, we like lifestyle, user experience, outlet malls, value, retail on infrastructure hubs and convenience formats.

Investors’ appetites are changing

Real estate investors are now changing more than just their asset allocations. Their approaches to choosing investment management partners and types of products have undergone dramatic shifts, too.

Before the GFC, investors were often more open to approaches from new managers. This situation has certainly changed: it now takes much longer to develop relationships with them. After the dramatic losses sparked by the GFC and the successive layers of extra regulations that followed, they have become much more cautious and prefer to concentrate on fewer relationships with managers they know and trust.

This has made it difficult for new entrants into the market. It is more important than ever to be a recognized brand, especially with institutional investors that are saying ‘you are great but I have managers in place and do not need another.’ They have strict processes and must check every manager to fulfil their due diligence, which can be elongated by up to a year before a decision is taken.

The rise of debt products

The last decade has seen the rise of debt products, which are a direct consequence of the GFC. Before 2008, bank lenders dominated CRE due to the Basel I framework’s favorable regulatory capital environment. Banks provided roughly 95 percent of all outstanding debt in the form of traditionally funded bilateral loans held on their proprietary balance sheets, according to the Cass UK Commercial Real Estate Lending Report.

Europe’s CRE lending landscape changed dramatically after the GFC because high leverage CRE lending became very expensive for banks under the Basel II regulatory capital rules. This trend has continued as regulators have introduced further reforms under Basel III and IV.

Such regulatory activity forced banks to retrench, resulting in a massive reduction in both the amount of debt and leverage available for European CRE, creating a funding gap that has been bridged by alternative lenders. Today, according to the Cass report, banks hold approximately 75 percent of outstanding CRE debt in Europe, with alternative lenders and insurance companies holding less than 25 percent.

The European debt market is likely to continue to evolve into a more balanced and efficient lending market similar to the US, where according to the Cass lending report, the banks hold approximately 40 percent of all outstanding CRE debt versus a far greater proportion provided by alternative lenders. The role of alternative lenders in Europe should continue to expand for the foreseeable future, providing much

“Investors are weighing up the benefits of some strong positive themes emerging in global real estate”
needed diversification from the historically bank-dominated landscape. For investors, the opportunity to diversify their portfolios with debt investment products has been welcome. They like the asset class because it comes with income and less risk than equities.

Furthermore, a shortage of available debt means the current recovery will not match the highs of the previous economic cycle, when debt was more freely provided by banks. This supply-demand differential allows alternative lenders to achieve higher income returns for investors while taking less property risk, which is increasingly important as we enter the later stages of the current cycle.

Responsible investing is a growing requirement
Another major global phenomenon occurring among investors generally, but which we will see more of in coming years in real estate, is responsible investing. The integration of environmental, social and governance (ESG) factors into investment processes is gaining momentum worldwide, but whereas until recently responsible investing was more about avoiding investments associated with harm, such as oil and gambling companies, there are growing requirements among investors to go one step further and make a positive impact.

Investors are looking for evidence that their ESG commitments are being fulfilled by their asset management partners and key hallmarks of this include signing up to the United Nations-supported Principles for Responsible Investment, which we joined in 2014, and seeking the Global Real Estate Sustainability Benchmark, the organization committed to measuring and reporting the ESG performance of real estate portfolios globally.

Measuring, monitoring and improving are the foundational steps for having a positive ESG impact.

The last stage of the market requires prudence
Reliable indicators continue to signal that developed economies have the stamina to keep growing through 2019. This suggests any market outlook should be more about assessing opportunities that would benefit from an extension of the global business cycle but are insulated against the possibility of a more pronounced downturn in the next few years.

But after several years of good growth, Savills Investment Management does believe that prudent investors should position themselves for the last stage of the market cycle. Lower yields may tempt some investors to move further up the risk curve and outside their defined fund style. However, we strongly advise investors to consider the intrinsic value of an asset versus chasing yields, particularly when assets are underwritten on a five-year hold. Historically, this has resulted in underperformance, as downsides are most acute in markets and assets that do not have the support of fundamental demand drivers.

High rates of return are unrealistic
In a low growth, low-interest rate environment, delivery of what would be high real rates of return, considerably higher than in the past, can be considered as too unrealistic. Something has to give; either those target returns are reduced or the property market has to see a severe correction in capital values to improve entry prices.

As we feel the property market is not so imbalanced, fundamentals do not support a major correction in prices. Therefore, we would advise against high value-add and opportunistic strategies that are dependent on economic growth but would instead target location or asset-specific investment cases.

The focus should be on income
The focus should be on preserving income streams. Demand for core property – investment-grade income streams – in core cities has remained strong. Based on our ‘market momentum indicator’, a coverage of over 100 sub-markets, average European core property yields, including the UK, continue to remain under downward pressure, although we expect yield compression to moderate over the next 12 months.

Investors can also focus on longer-term trends such as demographics, urbanization and technology and their continued impact on occupier demand for new micro-locations and real estate segments.

Asia is growing stronger than Europe
There are still highly promising investment opportunities, particularly in the overlooked retail sector, and the logistics sector, which is seeing positive structural changes. In Asia, which is growing stronger than Europe, there are highly attractive longer-term fundamentals in terms of population growth as well as faster-growing prosperity and urbanization. This is leading to increasing occupier demand, while a growing middle class also drives demand for retail space and logistics via growing e-commerce.

Whatever investors decide strategically, it is important to work with a commercial real estate investment manager that has local knowledge and expertise to help investors navigate these uncertain times. □
How we conducted our investor survey

Investor Perspectives 2019 is PERE’s study of institutional investors’ approach to alternative asset classes.

More specifically, it aims to provide a granular view of the alternatives market, both current and future, by gathering insight on investors’ asset allocation, propensity to invest, and performance predictions.

Investor Perspectives is a global study, reflected in the question-set and the respondents, which allows for meaningful worldwide views and cross-regional comparisons across alternative asset classes.

The question-set for Investor Perspectives is reviewed annually, with the objective of reflecting market developments and shifts in sentiment.

For this 2019 study, fieldwork was carried out from August to October 2018.

Participation in Investor Perspectives is anonymous, with the findings amalgamated and presented in this supplement. □
Preparing for choppier waters
Investors are wary that macroeconomic factors could threaten their performance in private real estate, writes Marine Cole

Private real estate investments performed well in the past year, but if the findings of the PERE Investor Perspectives 2019 survey reveal anything it is that investors are bracing themselves for tougher times ahead as several potential risks could threaten performance.

Nearly half – 46.8 percent – of investor respondents say their private real estate investments have met benchmarks over the past 12 months, while 41.9 percent say benchmarks were exceeded.

Core concerns
With an economic downturn likely to happen in the next few years, investors are wary of potential risks that could threaten performance. When asked which factors could slow down returns, 66.3 percent of respondents cited extreme market valuations, 56.1 percent are concerned about rising interest rates, and 33.7 percent are keeping a watchful eye on a US/China trade war. Cybersecurity threats and natural disasters, now well documented as growing global threats for all business sectors, are at the bottom of the list of concerns.

This is impacting the way investors see their real estate portfolios performing in the coming year with more respondents expecting their performance to fall below rather than exceed benchmarks. Only 17 percent think their real estate benchmarks will exceed expectations in the next 12 months, the lowest of all the asset classes surveyed, which include infrastructure, private
equity and private debt. Some 20 percent of respondents believe performance will fall below benchmarks in real estate, higher than in any of the other alternative asset classes. And although 63 percent of investors are anticipating benchmarks will be met in the next year, overall, the expectations for private real estate are the lowest of all alternative asset classes. Investors are the most enthusiastic for their private equity portfolios; 50 percent feel private equity will meet their benchmarks and 41.5 percent that it will exceed benchmarks. A total of 87 percent think private debt will meet or exceed their benchmarks.

Maybe because of a somewhat pessimistic outlook, more investors responding to the Investor Perspectives 2019 survey are planning to decrease their target allocation to private real estate than to any other asset class. Within private real estate, most investors plan to maintain their target allocations to the different sub-strategies.
Value seekers
Real estate investors are shunning core-plus, with 18.7 percent planning to decrease their target allocation to it. There is slightly more confidence in value-add with 22 percent of investors planning to increase their target allocation to the strategy over the next 12 months.

Which of the following best describes your assessment of manager investment behavior in the last 12 months?

- I see occasional examples of 'style drift' among my managers: 8.3%
- Managers remain disciplined and stick to their investment thesis: 35.7%
- I see widespread examples of 'style drift' among my managers: 1.2%
- Other: 54.8%

Source: PERE

Thinking of your private markets portfolio, which three factors will have the greatest impact on performance over the next 12 months?

- Extreme market valuations: 66.3%
- Rising interest rates: 56.1%
- US/China trade war: 33.7%
- Access to top-choice PE vehicles: 32.7%
- Availability of leverage in alternative investment: 19.4%
- Fee levels: 18.4%
- Foreign exchange rates: 18.4%
- Commodity price volatility: 12.2%
- Impact of the UK's exit from the European Union: 9.2%
- Natural disasters: 4.1%
- Cybersecurity threat: 3.1%

Source: PERE

Which of the following emerging market geographies will you consider for investment over the next 12 months?

- Asia-Pacific: 84.1%
- Central/Eastern Europe: 39.0%
- Latin America: 31.7%
- Middle East and North Africa: 17.1%
- Sub-Saharan Africa: 13.4%

Source: PERE
On average, how many fund opportunities are presented to you per year?

<table>
<thead>
<tr>
<th>Category</th>
<th>Average Number of Fund Opportunities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private real estate</td>
<td>38.1</td>
</tr>
<tr>
<td>Private equity</td>
<td>86.5</td>
</tr>
<tr>
<td>Private debt</td>
<td>34.3</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>25.4</td>
</tr>
</tbody>
</table>

Source: PERE

Do you plan to buy or sell fund stakes on the secondaries market in the next 12 months?

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private real estate</td>
<td>Yes, both buying and selling: 6.2%</td>
</tr>
<tr>
<td></td>
<td>Yes, buying only: 8.6%</td>
</tr>
<tr>
<td></td>
<td>Yes, selling only: 4.9%</td>
</tr>
<tr>
<td></td>
<td>Neither buying nor selling: 58.0%</td>
</tr>
<tr>
<td></td>
<td>Unsure: 22.2%</td>
</tr>
<tr>
<td>Private equity</td>
<td>Yes, both buying and selling: 20.9%</td>
</tr>
<tr>
<td></td>
<td>Yes, buying only: 22.1%</td>
</tr>
<tr>
<td></td>
<td>Yes, selling only: 4.7%</td>
</tr>
<tr>
<td></td>
<td>Neither buying nor selling: 32.6%</td>
</tr>
<tr>
<td></td>
<td>Unsure: 19.8%</td>
</tr>
<tr>
<td>Private debt</td>
<td>Yes, both buying and selling: 2.6%</td>
</tr>
<tr>
<td></td>
<td>Yes, buying only: 5.1%</td>
</tr>
<tr>
<td></td>
<td>Yes, selling only: 2.6%</td>
</tr>
<tr>
<td></td>
<td>Neither buying nor selling: 59.0%</td>
</tr>
<tr>
<td></td>
<td>Unsure: 30.8%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Yes, both buying and selling: 3.7%</td>
</tr>
<tr>
<td></td>
<td>Yes, buying only: 12.3%</td>
</tr>
<tr>
<td></td>
<td>Yes, selling only: 3.7%</td>
</tr>
<tr>
<td></td>
<td>Neither buying nor selling: 55.6%</td>
</tr>
<tr>
<td></td>
<td>Unsure: 24.7%</td>
</tr>
</tbody>
</table>

Source: PERE

Exploring secondaries

While the secondaries market is reaching new proportions, with $80 billion in volume in 2018, up 31.3 percent from the previous year, real estate deals have dropped 8.3 percent to $5.8 billion, according to Setter Capital. This more subdued embrace of real estate secondaries is showing in the survey, too.

Less than 10 percent of investor respondents plan to commit to real estate secondaries funds in the next year, far lower than private equity funds (47 percent). Nearly three-quarters of investors do not plan to commit to real estate secondaries funds at all over the next 12 months.

Similarly, the overall participation of investors in the private real estate secondaries market as sellers or buyers remains lower than in private equity secondaries. Fifty-eight percent of respondents plan neither to buy nor sell real estate secondaries in the next 12 months. Only 6 percent plan to both buy and sell real estate fund stakes, compared with 21 percent planning to buy and sell private equity stakes.

One final interesting wrinkle to highlight from the survey results is that investor respondents say they will be the most active sellers when it comes to private real estate fund interests, at 4.9 percent, compared with 4.7 percent in private equity.
Investors aim for Asia-Pacific

Institutional investors prefer the region to other emerging real estate destinations, the PERE Investor Perspectives 2019 survey reveals. Mark Cooper reports

Demographics and growth underpin the attractiveness of the Asia-Pacific region for real estate investors, while its mature markets also offer stability and attractive pricing.

The PERE Investor Perspectives survey asked investors which emerging market geographies they would consider for investment over the next 12 months; 84.1 percent declared they would consider Asia-Pacific. The next most popular area was central and eastern Europe, a pick for 39 percent of respondents.

Benedict Lai, research manager at Savills Investment Management, says: “Global institutional investors are keen to diversify into Asian real estate due to the region’s robust macro fundamentals and its relative value amid heightened global economic risks.”

This enthusiasm for Asia-Pacific real estate has been shown in other surveys. In January, an investment intentions survey by non-listed real estate organizations ANREV, INREV and PREA found that 56.7 percent of investors expected to increase their allocation to Asia-Pacific real estate this year, compared with 51.5 percent expecting to invest more in Europe and 47.8 percent that said they would raise their allocation to US real estate.

Urban attraction

Underpinning the region’s attraction is demographics and growth. It is home to the world’s post populous nations, with China and India having a combined population of more than 2.7 billion. Asia-Pacific is also home to many of the world’s largest cities and the United Nations predicts it will have 30 cities with a population above five million by 2030.

Most dramatically in China, where 20 million people move from rural areas to cities very year, urbanization has driven growth. Agricultural workers have moved into more productive jobs. China is moving to a new stage of urbanization with the creation of multi-city conurbations. The Greater Bay Area, which includes Hong Kong, Macau, Guangzhou, Shenzhen and five neighbouring cities, has a population of 70 million and is predicted to be the seventh largest economy in the world by 2030.

Urbanization has kept GDP growth above 6 percent in China, even though it has slowed in recent years. India is growing even faster. The Asian Development Bank reckons Asia-Pacific accounts for 60 percent of global growth. This economic growth is creating hundreds of millions of middle class consumers, all of whom need retail, residential and commercial real estate. By 2030 the United Nations projects that the region will account for 60 percent of the world’s middle-class wealth.

The e-commerce factor

The growth of e-commerce has been as significant for real estate investors in Asia-Pacific as for consumers. The regional picture is very diverse: China is the world’s largest and most advanced e-commerce market, while countries such as Indonesia and India are just beginning to embrace online shopping. The rise of e-commerce, as well as continued growth in manufacturing and exports, has made logistics property a top pick for investors in Asia-Pacific.

Large global investors such as PGGM, GIC Private and Canada Pension Plan Investment Board have allocated billions of dollars to logistics real estate in Asia-Pacific, backing platforms and investing in funds. Smaller investors are seeking to follow them.

“The logistics sector has become very popular given the growth (and projected growth) in e-commerce, the shift away from traditional retail and the predictable income...”

Benedict Lai
streams the asset class offers investors,” says Lee Tredwell, head of investment, Australia, at Savills Investment Management.

More transparency, less risk
Developing real estate markets in Asia is also much less risky than in the past. “The Asian real estate market has come a long way as transparency in the region continues to improve. This has also resulted in significant capital flows into the region,” says Lai. Many nations have introduced real estate investment trusts and data is more available than ever. For example India is starting to see improvements in transparency following a raft of legislation from the pro-business government of Narendra Modi. This includes the Real Estate (Regulation and Development) Act, 2016, which introduced greater protection for property buyers and better registration of development projects. More mature markets mean a greater range of risk and return opportunities for investors.

Investors are more able to allocate capital to Asia-Pacific today than in previous years. More Asian nations are opening up to foreign direct investment, while Australia and New Zealand remain among the world’s most open economies. There are more large international and local investment managers operating in Asia-Pacific than ever before and a broader range of strategies, from niche sector strategies to regional core and core-plus vehicles, available for investors.

While Asia-Pacific might overall be considered an emerging market, it contains mature markets which have proven very attractive for cross-border investors, Tredwell says: “Investors are attracted to Australia because it offers a connection to the overall growth story of Asia alongside stability and transparency: a Western legal system, freehold land and landlord-friendly lease structures.”

Australia and Japan, the largest mature markets in the region, offer attractive pricing compared with developed markets elsewhere, due to higher yields (in Australia) and low borrowing costs (in Japan). Lai says: “While Asia-Pacific has been traditionally associated with emerging markets such as Eastern Europe or Latin America, its gateway cities are comparable to the developed US and European markets. For instance, yield spreads in some of the developed Asian office markets like Osaka and Tokyo in Japan or Brisbane and Melbourne in Australia offer similar or higher yield spreads compared with other gateway cities such as New York or London.”

The ANREV, INREV, PREA Investment Intentions survey found Sydney, Melbourne and Tokyo to be the top three investment destinations for those institutions that planned to invest in Asia-Pacific real estate.

As monetary policy tightens in Europe and the US, Japan’s expansionary policies, designed to keep the economy buoyant after two decades of stagnation, offer a contrast for real estate investors, says Lai. “With Japanese monetary policy set to remain loose for the foreseeable future, historically wide yield spreads suggest a strong possibility for further modest yield compression in Greater Tokyo and the major regional Japanese markets, where investors are increasingly active.”

In contrast, a more difficult financing environment for domestic real estate players is attracting foreign capital to China. Restrictions in China on shadow banking and other domestic capital sources have made life more difficult for local investors, while selective reduction of barriers to foreign investment in some jurisdictions are leading private equity firms and other cross-border investors to take another look at China.

A similar picture is emerging in Australia, says Lai. “The liquidity crunch, due to credit tightening in the housing market reducing major banks’ ability to lend, has created a funding gap in the market. This offers funding opportunities as the market cycle matures, with debt frequently offering more protection than equity.”

The ongoing trade war between the US and China may be causing jitters and dampening economic expectations in the short term, but Asia-Pacific remains relatively politically stable. Lai says: “Asian countries are fostering stronger integration as well as trade ties at a time when Europe is dealing with uncertainties surrounding the EU and the breakaway of one of its key trading partners, the UK.”

Diversification is an important consideration for global investors and Asia-Pacific real estate returns tend to be less correlated with returns in the US and Europe. Furthermore, Asia-Pacific is a diverse region, with markets tending to be at different stages in the cycle. For example, strong rental growth is being predicted for the office sector in Singapore, Sydney and Osaka, while rents are bottoming out in the same sector in Jakarta. □

Dynamic Asia
The region has enjoyed solid growth

<table>
<thead>
<tr>
<th>GDP growth (%)</th>
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</thead>
<tbody>
<tr>
<td>2016</td>
</tr>
<tr>
<td>Asia-Pacific</td>
</tr>
<tr>
<td>North America</td>
</tr>
<tr>
<td>Europe</td>
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Source: IMF; Savills Investment Management
Running into debt
Real estate investors craving downside protection are increasingly favoring debt over equity investing, argues DRC Capital managing partner Dale Lattanzio.
By Stuart Watson

Since the end of the global financial crisis, debt investing has developed from the new kid on the block to an established niche strategy within the European real estate market. Now, as the recovery that lifted investment returns across the asset class is beginning to lose its buoyancy, debt strategies are attracting capital that would previously have been channeled into equity investing, says Dale Lattanzio, managing partner at commercial real estate debt advisory platform, DRC Capital.

PERE: What factors are driving investor interest in real estate debt?
Dale Lattanzio: Ten years ago, investors coming into real estate debt funds were particularly focused on high-yielding and mezzanine funds. Typically, it was the real estate allocation in that investor’s portfolio and they were looking at debt opportunistically, thinking that the risk-adjusted returns were good because there was a significant correction in capital values across the board in most asset classes throughout Europe. What we are seeing now is that those investing in debt are still looking at it as an opportunity to get compelling risk-adjusted returns, but are also comparing debt strategies to the equity opportunities in the market place. As investors receive money back from equity strategies, and seek to re-invest it, CRE debt will be the recipient of a decent portion of that capital given where we are in the cycle. Right now, it is harder to foresee cap rates coming in and income going up further across the market as a whole, so investors have to pick their real estate equity strategies very carefully. Debt is a good way for investors to protect themselves should the market deteriorate a bit.

There are also a lot of investors with liabilities that are required to meet a certain annual rate of return. Some of them do not want to take public market equity risk or indeed real estate equity risk. Debt can match up with those liabilities quite nicely. In addition, property debt is becoming interesting for investors because it can be seen as an alternative form of credit investment. Because we have been in a low interest rate environment, we have seen investors that prefer to invest down the risk curve looking at alternative credit because corporate bond yields are very tight.

PERE: Where is investor demand coming from?
DL: Debt funds have evolved and there are many more products on offer. They still include high-yield and mezzanine strategies, but now there are also whole loan strategies that do not take mezzanine positions, but provide a little bit more leverage than the banks, and even products that offer senior mortgage risk. They all offer different risk-return profiles. That means there is also an increasing diversity to the types of investors looking at real estate debt. There is demand now not only from pension funds, but insurers have also shown an increased appetite. Solvency II, which is the regulatory
regime that governs insurance company capital in Europe, is more favorable to debt investing than to equity real estate investing. Increasingly, we will see sovereign wealth funds coming into the space. They have been very active investors in real estate and have a lot of capital to deploy. The debt space could be the beneficiary of some of that capital as they consider where we are in the cycle.

**PERE: And what kind of strategies do those lenders prefer?**

**DL:** In the last two years we have seen a lot more interest from investors in senior or whole loan strategies. That has been driven by low interest rates and the lack of alternative income-based product in the market. In terms of the underlying assets, investors usually want their managers to build a diversified pool both by property type and geography. For example, in a UK strategy they typically do not want to see all the loans made against offices in London. They like to see the regional cities included in a portfolio, together with different kinds of assets, some stabilized, others parts of portfolios where there might be scope for value-add initiatives.

**PERE: Is it difficult to deploy capital?**

**DL:** The key to deploying is to be realistic about return expectations, carefully representing to investors the returns that are available in the marketplace for the risks they are taking. Investors should also consider the manager’s track record with, and network of, borrowers. It is that origination network that enables deployment. Germany is probably unique in our region in terms of the tools the banking system has with respect to refinancing its commercial real estate lending activities. That means it is somewhat more challenging for alternative lenders, but there are usually situations alternative lenders can fulfil even in jurisdictions where the banks are active and offering quite compelling terms. That might be because of the underlying property asset type, the amount of leverage requested or even the loan structure. Ten years ago, the banks provided around 95 percent of all the lending in our marketplace. That has probably been dialed back to 65 to 70 percent as alternative lenders have come in and taken up some of the slack. There is still a growing market, albeit one that is growing at a slower rate.

**Lattanzio:** European real estate debt market has matured

“**There are usually situations alternative lenders can fulfil, even in jurisdictions where the banks are active, and offering quite compelling terms**”

**PERE: What tips would you offer for selecting a manager and strategy?**

**DL:** The market has matured, so investors looking at our space for the first time now have the benefit of being able to look to a number of managers with fairly significant track records. They can see how the managers have succeeded in deploying capital, managing it and achieving the returns they were aiming for. Then have a dialogue with the manager about what is possible. If there is a need in an investor’s portfolio for a certain kind of return profile, there are many strategies available in the real estate debt market. If there isn’t a commingled fund available that meets that profile, then oftentimes managers are able to directly access investments with the kind of risk and return specifics investors might want.

**PERE: Commitments to real estate debt funds spiked in 2017 and fell in 2018, according to PERE data. Does this signal waning investor demand in debt?**

**DL:** I think that just reflects the fact the funds in our marketplace mostly tend to go back to market on a similar cycle. I would suggest there were fewer funds out looking for capital in 2018 than there were in 2017. If there were the same number of funds out there looking for the same amount of capital, but they were unable to raise it, that might be pointing to investor attitudes and appetite, but actually I think there were fewer funds in the market because there was quite a lot of capital raised in 2016 and 2017 still being deployed last year.

**PERE: What do you anticipate will be the principal headwinds and tailwinds for the real estate debt space in the coming months?**

**DL:** The potential headwinds are very similar to those facing a real estate equity manager — in other words, the macro backdrop: where we are in the cycle, and what is happening at the macroeconomic and political levels. I do not think that interest rates will come up as quickly in Europe as they have in North America, but the starting point for investors considering deploying into real estate strategies generally is that uncertainty. The tailwinds are that debt has a slightly different risk profile because the equity is eroded before the loans take a loss. Meanwhile, historically when we have found ourselves in interesting political and economic times bank lending has pulled back. That means spreads widen a bit, there is less liquidity and more room for alternative sources of debt capital. I expect that to happen again over the course of the next six months.
More of the same in 2019

Investors seem happy about the way their real estate portfolios currently look, with only small tweaks likely to be made in the year ahead, writes Marine Cole

Investors in private real estate are some the most content across the alternative asset classes, along with those in infrastructure, according to the results of the PERE Investor Perspectives 2019 survey.

This is especially true when it comes to the number of managers they currently work with – 37 percent say they are satisfied with the number, higher than in private equity, where 30 percent want to maintain the current number of relationships with managers.

In addition, just less than half of the survey respondents – 45.6 percent – say they are planning to make fresh commitments to existing real estate managers in the next 12 months, with 24.4 percent unsure about their plans. The remainder report they do not plan on making fresh commitments to their existing real estate managers.

Not only are investors highly reliant on their current fund managers, 56 percent are also shunning first-time funds, and only 3.4 percent report a defined allocation to it. About 10 percent of investors do not currently invest in first-time real estate funds at all, but plan to do so in the future. In private equity, by contrast, 51 percent invest in first-time funds and 9.2 percent have a defined allocation to it.

Despite being somewhat satisfied with their current portfolios, there are some small changes investors in private real estate are hoping to make in 2019. For example, nearly 38 percent of respondents to the PERE survey plan to increase their number of manager relationships. This is some way short of the 52 percent of respondents looking to increase the number of manager relationships in private equity.
Writing big checks
As far as the fundraising environment goes, investors across asset classes seem satisfied with their experience committing to funds in the past 12 months. Nearly 60 percent say they have consistently received their full requested allocation in their chosen funds. At the other end of the spectrum, 28 percent said they have had their allocation scaled back in most of their chosen funds due to excess demand. That question was not broken down by asset class.

How will your average commitment size change over the next 12 months?

And once investors are ready to commit, private real estate funds receive the biggest checks from investors at $100 million on average, followed by a $73.3 million average fund commitment in infrastructure, $67 million in private debt, and a $65.7 million in private equity (see p. 7). The average commitment size is likely to remain steady in the next year, according to the survey, as 69 percent of investor respondents said it will stay the same over the next 12 months, the highest of all asset classes. Less than a quarter, or 22.2 percent, said it will increase.

How confident are you that your managers’ deals have been structured to withstand a downturn?

What is your primary source of fund opportunities for the following alternative asset classes?
Diligence focus areas
The top three factors representing a major part of investors’ due diligence during fundraising are the manager’s team size and its investment capacity, the investment thesis and whether the manager has drifted from it, and the firm’s culture at the manager level. There has been, of course, much emphasis in 2018 on equal pay across all business sectors. The alternative asset space has been no exception, but the survey results indicate that this is still not top of mind for investors when conducting their due diligence – only 4.8 percent report this issue to be a major part of the diligence process while nearly 57 percent do not cover it at all. On ESG, another theme growing in importance for the industry, almost 37 percent of respondents consider it to be a major consideration in real estate fund due diligence while 41 percent see it only as a minor consideration.

<table>
<thead>
<tr>
<th>How significant a part do the following play in due diligence?</th>
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<tbody>
<tr>
<td>Manager performance track record</td>
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<tr>
<td>Manager team size and investment capacity</td>
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<tr>
<td>Investment thesis and style drift</td>
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<tr>
<td>Firm ‘culture’ at the GP level</td>
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<tr>
<td>Fund structural review</td>
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<tr>
<td>Succession planning and retention plans at the GP level</td>
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<tr>
<td>Fee validation</td>
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<tr>
<td>Manager balance sheet/financial strength</td>
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<tr>
<td>Gender pay gap at manager level</td>
</tr>
</tbody>
</table>

Percentage of respondents

Forms a major part of the process | Forms a minor part of the process | Not covered in due diligence

Source: PERE

To what extent do you believe your manager’s investments reflect your ESG policies?

- Manager’s investments strongly reflect my ESG policies: 18.7%
- Manager’s investments somewhat reflect my ESG policies: 38.6%
- Manager’s investments hardly reflect my ESG policies: 5.3%
- Manager’s investments do not reflect my ESG policies at all: 68.0%

Source: PERE

How much emphasis do you place on environmental, social and governance issues throughout fund due diligence for private real estate?

- ESG is a major consideration: 22.0%
- ESG is a minor consideration: 37.0%
- ESG is not a consideration: 41.0%

Source: PERE
**What are the most promising regions and strategies in 2019 and why?**

**Peter Ballon:** Emerging markets continue to be attractive. There is no doubt that demand for logistics continues to be strong and we expect that to continue throughout 2019. The most sophisticated tenants want to deal with the best builders and developers, so we expect to do more development in the logistics sector.

**Andrew Allen:** Broadly, 2019 will remain very positive for many parts of the logistics market. There is considerable ongoing demand for space, but not without some element of structural change relating to location and the influences of technological advance. We see similar momentum in the residential markets, where there are critical shortfalls of modern rental properties. The growth in demand for income-producing residential rental properties will remain buoyant, and while investors need to be wary of occupier affordability, the broad fundamentals are very compelling.

**Rutger van der Lubbe:** Our strategies are very much expected to be a continuation of our recent investment themes, with a strong focus on the more alternative real estate sectors. Although we have a decent amount of investment capacity, we feel no need to rush to deploy this capital quickly in light of where we see real estate pricing generally speaking.

**Matthew Strotton:** We expect the current trend of global capital favoring the US and select Asia-Pacific destinations to continue in 2019. In the Asia-Pacific, we see the Australian economy remaining buoyant. Key attributes driving the opportunity in Australia are high employment growth and a low unemployment rate. The longer-term economic outlook for Australia is robust compared with other advanced economies, underpinned by strong population growth, solid public finances and an economy that is broadening away from reliance on the mining sector. The US and Australia are attractive markets for global investors on a risk-adjusted return basis. We see continued GDP growth and population growth in both core markets and emerging core markets that are driven by the STEM industries of the future.

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**What is the biggest challenge in 2019?**

**PB:** The challenge is to always be mindful of the competitive capital coming into a market. Real estate has had a great run and while I do not worry about a market correction, because I think we can benefit from a market correction, too much capital for the sector is not good. We are always mindful of capital flows, seeing whether we think too much capital is entering a sector, and if we do we will try not to compete against that capital.

**AA:** The economic and political backdrop continues to present multiple challenges, whether that is global trading agreements or more localized issues.

There are still businesses and individuals well equipped to withstand near-term turbulence, so real estate will continue to produce reliable income streams and consequently attract investors. Not all sectors and regions will be insulated against shocks and, of course, some investment behaviors may prove to be too ambitious. For many, 2019 will likely be a period of caution – a time to manage risk: reduce voids, limit speculative development and so on. For those capitalized and capable to take on such near-term risks then of course they too will continue to find good value.

**RvdL:** Staying ahead of the fundamental changes that are occurring as a result of technological and demographical developments, among others.

**MS:** Evolution and adaptation are constants in our industry, particularly in retail, where they are necessary for survival. To remain relevant and create long-term value for clients, retail partners and local communities, we need to anticipate, rather than respond to, what consumers need. Evolving these retail assets into true town centers that bring together residential, office, hotels, experiential retail, and social activities where people want to be, will require a multidisciplinary approach. These are complex properties that need considered execution of redevelopment strategies in multiple phases. While this is no small challenge, it represents a significant opportunity to create enduring asset value.

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**Investor Panel**

- **Peter Ballon**, global head of real estate investments, Canada Pension Plan Investment Board
- **Rutger van der Lubbe**, head of global real estate investment strategy, APG
- **Andrew Allen**, global head of investment research, real estate, Aberdeen Standard Investments
- **Matthew Strotton**, global director, capital, QIC Global Real Estate
Investors inclined to pick and choose

One of the established truths of real estate investing is the cycle. No bull market in property is ever eternal, and despite the excellent run the sector has enjoyed in recent years, investors are squinting nervously toward the horizon, trying to identify the point at which the cycle will turn. That has already begun to shape their behavior, observes Giuseppe Oriani, European chief executive at Savills Investment Management, with managers being asked to engineer defensive strategies and take increasing pains in allocating capital to investment opportunities that offer enduring value.

PERE: What are the most critical concerns facing global private real estate investors in 2019?

Giuseppe Oriani: The number of uncertainties at the macro level is a topic that we are now frequently addressing in our meetings with investor clients. One of the big considerations is the perception that interest rates, which have been at a low level in recent years, have begun to change course. How rapidly and to what extent they rise remains to be seen, but central banks in Europe are winding up their quantitative easing programs and there are other indications that interest rates may be increasingly volatile. The UK is the largest real estate market in Europe, so how Brexit will be resolved is a concern in terms of its effect on investments there, and also the spillover effects on other geographies. The currency volatility Brexit has prompted has led to some investors sitting on their hands and delaying investment decisions. There is also the threat of a trade war between the US and China. That could have implications for the growth of economies. The backdrop to those factors is a situation in which people are asking if we are now coming toward the end of a cycle and facing the replacement of the prolonged economic recovery that we have experienced since the global financial crisis with a progressive slowdown.

PERE: How are capital allocators changing their investment approach to alleviate those concerns?

Giuseppe Oriani: The number of uncertainties at the macro level is a topic that we are now frequently addressing in our meetings with investor clients. One of the big considerations is the perception that interest rates, which have been at a low level in recent years, have begun to change course. How rapidly and to what extent they rise remains to be seen, but central banks in Europe are winding up their quantitative easing programs and there are other indications that interest rates may be increasingly volatile. The UK is the largest real estate market in Europe, so how Brexit will be resolved is a concern in terms of its effect on investments there, and also the spillover effects on other geographies. The currency volatility Brexit has prompted has led to some investors sitting on their hands and delaying investment decisions. There is also the threat of a trade war between the US and China. That could have implications for the growth of economies. The backdrop to those factors is a situation in which people are asking if we are now coming toward the end of a cycle and facing the replacement of the prolonged economic recovery that we have experienced since the global financial crisis with a progressive slowdown.

Giuseppe Oriani: Investors want to feel even more supported in their decision-making. They want to be able to entrust investment managers with an additional level of delegation to ensure that, through selection and the ability to identify mitigants to these risks, they can construct investment strategies that provide a safe harbor for their capital. We do not anticipate a dramatic shift in investor preferences, but we will certainly see a significant move toward
making a more careful selection of assets.

The universe of investors is very diversified so managers need to be a good port of call for different strategies. Some investors like a level of delegation, others like to retain a degree of supervision and interaction with the manager. That said, we have seen some investors moving away from traditional fund structures toward a mandate structure where they are sole investors with the ability to have a larger input on governance and decision-making. There is still a lot of fundraising activity, however, and funds suit the investors that are more inclined to delegate selecting investments to an investment manager.

Those investors looking to mitigate risk may focus more tightly on core assets. They are less likely to be affected by the market volatility generated by macro events, and by investing in long-let real estate investors can look to ride out the bumps that might be generated by any potential downturn in the market. Investors are also increasingly looking at asset types that are more defensive in nature: infrastructure and forms of real estate that are less exposed to macroeconomic trends, perhaps because they are linked to the need for social infrastructure, such as homes for elderly people, or student housing in those markets where that sector is still comparatively underdeveloped. In addition, when the market is showing an element of volatility, debt financing collateralized by prime real estate represents a very attractive opportunity. Investing selectively in whole loans, senior debt and mezzanine finance provides a good complementary strategy to investing in the equity portion. Once again, the key to success is to be particularly selective about the underlying assets. It is the collateral that determines the quality of the underlying investment.

**PERE**: What real estate sectors will offer good opportunities in 2019?

**GO**: Demand for new forms of residential space for rent is emerging in some geographies because of greater mobility and changing working practices, so multifamily is an asset class that is attracting a lot of investor interest. Logistics is a very sought-after asset class on the grounds that there is a clear structural shift in that industry driving the demand for the big logistics buildings that serve as infrastructure for the operators and last-mile facilities that enable efficient delivery of goods to end consumers. A lot of investor interest is currently focused on that area because the evolution of formats in logistics and retail markets is ongoing, and that creates opportunity to cash in on those trends.

By contrast there is an element of aversion and prudency in retail real estate markets. We are less averse to retail than some, but we are much more selective than we were prior to the shift in the market provoked by the growth of e-commerce. We think you still need to consider carefully which of the various different categories retail assets fall into when judging their attractiveness. Some segments have much more intrinsic value protection and resilience than others, whether that is because it is prime high-street retail, or because it offers a better experience to consumers by including elements like entertainment within a more holistic experience.

Investing in the office market is also an increasingly selective process. Investors are keen to focus not on countries, but on those cities that have the capacity to attract corporate occupiers and residents over the long term. Our research department calls them “dynamic cities.” Well-connected high-quality offices adapted to the business practices of modern occupiers and situated in the right locations in those cities are still particularly attractive. The office market in London is still an area of interest for many of our investors, and so are markets in Paris, the main German cities, the Netherlands, Warsaw and Milan.

**PERE**: Results from our Investor Perspectives survey show that, compared to other asset classes, a higher proportion of investors in private real estate expect their performance to fall below benchmark. Also, a higher number of investors plan to decrease their target allocation to private real estate compared to other alternative asset classes. Are you seeing this reflected?

**GO**: We see an element of caution, but not a decreasing propensity to invest in real estate at this stage. Instead, there is a propensity to invest in anything which is more defensive. If interest rates were to go up that would affect the performance of real estate investments because there would be a decrease in the advantages that leverage has brought to boosting returns. Higher rates may also lead to the repricing of certain assets. That element is in play, but it is not currently affecting investor decision-making, and I am not concerned that there will be an immediate increase in interest rates. Central banks in Europe have shown caution over the potential detrimental effect that a rise in interest rates could have on the growth of European economies. I remain convinced that real estate will represent an area of continued great interest for investors in the year ahead, but on a very selective basis because most of the plays that were derived from cap rate compression and economic recovery have now come to an end.
Investors want lower fees, more transparency

Costs and disclosures are the top concerns emerging from PERE’s Investor Perspectives 2019 survey. By Kyle Campbell

Management fees and transparency remain top of mind for investors in 2019.

Roughly two-thirds of investors have sought greater transparency from their fund managers, and more than half feel they pay too much in fees, according to PERE’s Investor Perspectives survey.

Unsurprisingly, management fees were the most debated topic between investors and managers, according to the survey. More than 45 percent of respondents said it was a top-three issue, while 44 percent pointed to key-man provisions – or lack thereof – and 36 percent clashed over performance fees.

Overall, the survey highlights how private investors are concentrating their capital with fewer managers and expecting better terms in return.

“Since the financial crisis, [investors] have been more focused on fees than they were before,” Roger Singer, a New York-based fund formation attorney with Clifford Chance, says. “With the growth in size of funds, the management fees, for many managers, became a source of profit because the management fee was growing at a faster rate than the manager’s costs. Simply put, it doesn’t cost twice as much to run a fund that’s double the size.”

More than 65 percent of respondents say they requested more fee transparency within the past 12 months. Also, 63 percent agree that “fees charged by private equity funds are difficult to justify internally,” while only 2 percent strongly disagree with that statement.

Although some might argue that a billion-dollar fund comes with greater responsibilities than one half the size, many managers are reducing fees for large investors, PERE understands. However, questions remain about how that money is being spent.

Specifically, Singer says, many investors want to know if fees are being collected to pay for third-party services or to offset in-house costs.

“Paying a manager for the costs of its personnel comes with a different incentive than reimbursing costs from a third-party service provider, where the manager has no interest in those costs being inaccurate or too high,” he says.

To what extent do you agree that fees charged by private equity funds are difficult to justify internally?

<table>
<thead>
<tr>
<th>Strongly agree</th>
<th>Agree</th>
<th>Disagree</th>
<th>Strongly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.4</td>
<td>16.7</td>
<td>34.5</td>
<td>46.4</td>
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</table>

Have you asked for greater fee transparency and disclosure from your managers in the last 12 months?

<table>
<thead>
<tr>
<th>Yes</th>
<th>No</th>
<th>Unsure</th>
</tr>
</thead>
<tbody>
<tr>
<td>65.5</td>
<td>33.3</td>
<td>1.2</td>
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</tbody>
</table>
Despite these sticking points, investors are inclined to remain loyal to their existing managers, with 45 percent saying they would make fresh commitments, compared with 30 percent that would not. Three-quarters of respondents plan to renew their commitments at the same amount or more. Roughly 40 percent prefer partnering with fund managers for direct investments, while 32 percent would rather invest in an existing general partner’s fund (see pages 16-18).

Managers have accommodated institutional investor demands for fee breaks and added disclosures, but the relationship between the two may be worse for wear. Constant haggling has led some fund managers to seek other sources of capital, Evan Hudson, a New York-based fund formation lawyer with Stroock & Stroock & Lavan, says.

“Because of that endless discussion about fees, some managers are looking more to the retail space,” Hudson says. “They’re looking to smaller, private clients to get a wider investment base and not rely so heavily on mega institutions like pension funds and sovereign wealth funds that bicker over every single economic term.”

Which three LPA terms cause the most disagreement with managers when conducting fund due diligence?

<table>
<thead>
<tr>
<th>Term</th>
<th>Percentage of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management fees</td>
<td>45.2</td>
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<tr>
<td>Unsatisfactory/no key-man clause</td>
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<tr>
<td>Performance fees</td>
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<tr>
<td>Manager commitment</td>
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<td>Structure of carry distribution waterfall</td>
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<td>Hurdle rate</td>
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<td>Set-up costs</td>
<td>16.7</td>
</tr>
<tr>
<td>Board representation policy</td>
<td>10.7</td>
</tr>
</tbody>
</table>

Source: PERE
Stakeholder collaboration key to improving ESG performance

Lucy Auden and Lucy Winterburn of Savills Investment Management explain how investors, managers and tenants are working together to drive forward sustainability in real estate

Sustainable investing and ESG have risen up the agenda in the real estate investment world in recent years. Pop along to any industry event or conference and the topic is more than likely going to feature as a key talking point; an indication that the matter is being taken seriously. So it was a surprise that only 37 percent of respondents to the PERE Investor Perspectives 2019 survey declared it a major consideration during their fund due diligence. PERE’s Helen Lewer spoke to Savills Investment Management’s head of ESG, Lucy Auden, and director of investment, Lucy Winterburn, to get their expert take on current investor and manager attitudes to ESG, and where the industry is at in terms of meeting its sustainable goals, and discovers an altogether more rounded and positive picture of the sector’s commitment.

PERE: How committed are investors to ESG and sustainability now? Are you seeing greater articulacy around these issues?

Lucy Auden: Institutional investors are now articulating clearly to their managers their expectations and goals on ESG. In the last three years in particular, investors have shown greater depth to their knowledge of the issues and precision of their queries to us. In the past, for example, we would get asked a fairly simple question: ‘Do you know what ESG is: yes or no?’ Now it is common to receive two pages of very detailed questions, and they factor in the responses to their manager selection. Last year, we asked our investors how influential ESG was to their selection of managers and products on a scale of 0 to 100, zero being not important at all and 100 being absolutely essential. On average, investors ranked ESG as highly influential, scoring 77 on that scale. I think that speaks to the articulacy of investors on the topic and how important it is to them nowadays.

PERE: What factors have driven up the level of awareness and knowledge of ESG issues in such a short time period?

Lucy Winterburn: One of the key drivers is the ability to attract tenants to buildings. Just to give you one illustration, in the office sector tenants are increasingly concerned with how they are going to retain talent, so they want to ensure they lease property that provides the ‘right’ working environment, where staff will want to come to work, enjoy their working environment and where increased work output is tangible. So investors, and their managers, are proactively future-proofing their assets to meet ESG goals based on changing tenant needs. There is just a general recognition that this is the right thing to do. If you are developing a building today, it is very obvious that it is relevant for a tenant taking space today but also for that future occupier and what that demand might be in order to have the widest possible market appeal. Flexibility in design is really important – one size does not fit all.

LA: I think that’s right. There’s a realization now that real estate is essentially a people-oriented business so we, investors and managers, really need to be thinking about people’s welfare in the assets we own and manage. Also, historically there are certain types of investors, like insurance and pension funds, that have been particularly proactive in pushing forward ESG, driven in large part by their boards and underlying...
beneficiaries placing sustainability high up on their corporate agendas, so these issues have become very material to these types of investors as a result. And that is where a lot of the drive has come from.

LA: Policymakers are also driving increased awareness and commitment to ESG in the sector through initiatives like setting country-wide decarbonization emission targets. ESG is no longer a ‘nice to have’. It has become a regulatory, legislative and compliance concern too. Real estate investors and managers have to be part of the conversation if they are going to successfully let their buildings.

**PERE: Is it challenging to align investor and manager goals on ESG?**

LA: In our experience, there’s something inherently collaborative about ESG because the end game is essentially to improve the environment and social sustainability for everyone. All stakeholders in every sector are dealing with the issue now; it’s everyone’s responsibility – investors, managers, tenants, policymakers, industry bodies – and all of these parties need to talk to each other. There just seems to be a sense of common goal that is driving forward ESG and sustainability, and we are seeing this play out in the real estate investment world too.

As a manager, we’ve found a lot of opportunity to engage with our investors on sustainability. For example, we recently surveyed our clients in order to really understand what issues are material to them. This has given us a clear picture of what the hot topics are for them right now and it has directed our own policies and approach. Having that kind of dialogue early ensures investors and managers are singing from the same hymn sheet.

**PERE: Delivering a consistent approach and outcome to ESG across a diverse property portfolio must be difficult. What is your experience?**

LW: It’s definitely challenging. I look after a multi-asset, predominantly commercial, UK portfolio. The retail and office sectors, particularly city offices, have led the way in ESG considerations and how owners and occupiers run their buildings. The motivation is driven by sophisticated corporate tenants that are fully up to speed with the benefits of ESG and that, from a reputational standpoint, need to be seen to be taking the necessary steps to improve their performance in this area. It is also easier to integrate ESG into assets that are being redeveloped or refurbished. As a manager, this is the moment when we can collaborate with end users and identify where there are opportunities to improve the sustainability credentials of the building with a drive to implement measures that could help to reduce that asset’s carbon footprint.

LW: Development and refurbishment opens up new windows of opportunity to integrate ESG into the portfolio. We have also been able to take lessons learned from redeveloping buildings, especially in central London and major cities, where there is real demand from tenants to go the extra mile on ESG, and apply them to assets in the portfolio where historically sustainability has been perhaps less of a focus area. Industrial assets can be quite soulless, concrete and cladding heavy places for staff to work in with very little regard paid to the built or landscaping aesthetic. It is often a case of function over form. In a 300,000 square foot scheme that we have recently submitted for planning in Oxfordshire, we were keen to include some of the initiatives learned from our experience in the office sector to improve the industrial offer. This includes the provision of ample green and social spaces shared by the industrial premises to encourage exercise and promote health and well-being. We see this as a real opportunity to differentiate our offering from the more mainstream industrial development.

LW: It is much more difficult to integrate ESG features into existing assets in the portfolio, particularly in the case of single-let buildings where as a manager your hands are tied unless the tenant is happy to engage with us to improve sustainability. Often this requires us to prove that ESG adaptations will translate into a tangible cost saving or benefit to the tenant in the long term.

With a multi-let building, where there are common parts shared by several tenants, it is generally easier to take steps to improve the sustainable features of a building. And often that also opens up a wider conversation with individual tenants about making improvements within their own leased space.

But generally, yes it is easier to improve sustainability in a redevelopment project, and taking steps forward in ESG is easier in some property assets than in others. Achieving consistency across the portfolio is a challenge. And a constant dialogue among all key stakeholders to drive the agenda forward is critical to meet targets. □
Co-investment is easier said than done

Sidecar investments have become more common and more sought out in recent years, but only certain investors can take advantage of them. By Kyle Campbell

Co-investment has become more than just a tool for managers to acquire costly assets. Increasingly, private real estate investors are openly pursuing these opportunities, even making fund commitments contingent on them.

Also known as sidecars, these structures have become popular among investors with ambitions to add direct exposure to their property portfolios, maintain greater discretion over these exposures and seek better returns – all while paying reduced fees to familiar sponsors.

Savvy investors are hiring real estate underwriters and amending their internal policies to make swift decisions and allocations. The goal is to secure the most attractive positions in investments possible.

“We’ve been adding support staff and I think the biggest thing we’ve done is organize our team to have more processes and procedures to make sure we’re reacting to these opportunities in a more cohesive and uniform way,” Jennifer Wenzel, head of the Texas Teachers Retirement System’s Principal Investment program, tells PERE.

Top fund managers have raised steadily more co-invest capital in recent years and investors of all sizes have petitioned for favorable terms. However, there is a gulf between investors that would like to co-invest and those that actually can.

Only 31 percent of investors that responded to the Investor Perspectives 2019 survey said they planned on participating in a real estate co-investment in the coming year. Meanwhile, 52 percent said they would not and 16 percent were unsure.

The top two reasons investors gave for not co-investing were the risk involved and the speed required to execute these deals. One-third of respondents feel they are not properly staffed for co-investment, and nearly a quarter said ticket sizes are too big.

Investors sometimes have only a few days to pull the trigger on co-investment opportunities. This makes co-investing impossible for pensions and other institutions that need the approval of boards that meet monthly or quarterly.

Even large institutions, such as Allianz Real Estate, which has €60 billion of assets under management, have had to retool to meet these arduous demands. The Munich-based insurer has focused its effort on co-investment and other shared-ownership structures during the past two years.

“It’s all about speed,” Annette Kroeger, CEO of Allianz Real Estate in North and Central Europe, says. “We’ve set up our approval processes internally that we only work with a veto right and not [the] full approval that we’d usually have when we do the main fund investment itself. That has allowed us to execute on these co-investments.”

Co-investments carry relationship value. Investors and managers alike are using them to lay the groundwork for future collaborations. This contributes to the trend of consolidation.
in the private real estate space, Philip Marra, head of US real estate funds at audit firm KPMG, tells PERE.

“LPs are narrowing the playing field and focusing on investing with fewer managers, which leads to a higher degree of trust between the advisor and LP and higher levels of co-investment activity,” Marra says.

Muddied waters
Co-investment is trickier in private real estate than corporate private equity, where the practice is common and long-standing. The real estate industry, as of late, has struggled to reach a consensus about what constitutes co-investment and what types of incentives it should entail.

Some attribute this to investors that are new to co-investing – or new to real estate altogether – confusing it with a joint venture, club deal or structures. But managers play a role in this confusion, too. Rather than offering sidecar opportunities to existing investors exclusively, some managers have branched out to other institutions to complete these transactions. Often this is because the fund investors cannot be relied on for the fast cash required for these acquisitions, but this deviation from the norm proves that rules for co-investing are not static.

As co-investment becomes more intertwined with real estate strategies, Wenzel adds, a lack of uniformity could become an issue as managers set expectations and investors compare sidecar outlays.

“It just muddies the water,” she says.

This murkiness also makes it difficult to quantify exactly how much the practice has grown in recent years beyond the escalating anecdotes and noise surrounding it.

There has been a clear uptick in sidecar use among the sector’s top 20 firms, according to PERE data. Co-investments accounted for almost 13 percent of the total five-year equity raised for private real estate funds by these firms in 2017 and 2018, up from about 10 percent in 2016. In absolute terms, $29 billion was raised for sidecars from 2014 to 2018 by the top 20 firms, according to data. Co-investments accounted for almost 13 percent of the total five-year equity raised for private real estate funds by these firms in 2017 and 2018, up from about 10 percent in 2016. In absolute terms, $29 billion was raised for sidecars from 2014 to 2018 by the top 20 managers, a 52 percent increase on the $19 billion they raised for the vehicles between 2012 and 2016.

However, a senior executive at a global private equity firm told PERE that with much attention being given to co-investments, investors of all sizes feel obligated to ask about co-investment opportunities, even if they do not have the capacity to participate in them.

“The investor talk about co-investing is so overbearing, I think there might be some investors who might not really want co-invest, who feel compelled to say to themselves or their bosses or the market that they are active co-investors and want to grow their proportion of co-investment as well,” he says.

Also, as co-investments become breeding grounds for future deals, they run the risk of creating conflicts of interest. One long-time industry participant tells PERE some consultants have already raised eyebrows by placing outside capital into co-investments while also advising investors in the underlying funds.

“The inherent conflict comes in when consultants are advising investors on strategies while managing money for outside co-investors,” the participant says. “It raises the question: ‘Could the advice I’m getting be biased?’”

Everything is negotiable (for some)
Mid-size managers have the most to gain from sidecar dealing. Hard-pressed to compete with mega-sponsors for large investors’ capital, the firms can use co-investment incentives to entice large investors to commit to future comingle funds, PERE understands.

Negotiations often focus on dollar-for-dollar ratios and discounted management and carried interest fees. Even smaller investors have started asking for these guarantees to keep from being passed over when co-investment opportunities arise.

Joshua Sternoff, a lawyer with New York law firm Paul Hastings, who advises managers on structuring funds, told PERE he advocates against making blanket concessions during fundraising.

“Some GPs feel like, if we’re co-investing, we don’t want to pre-judge any particular opportunity’s attractiveness to outside capital at the time of fundraising and cut off our ability to raise capital from third parties on more attractive terms,” Sternoff said. “So, even though co-investing is becoming more prevalent and the LPs are asking for reduced economics up front, it’s a little bit of a varied experience and depends on the circumstances whether those GPs will agree to the economics [requested].”

Predictably, managers will dangle favorable co-investment rights to top-tier investors, PERE understands, to secure pivotal fundraising commitments and build relationships. In these negotiations, the biggest investors can secure fee discounts beyond the normal 50 percent, as well as governance rights and advisory board seats.

Strategic exposure
Co-investing’s rise in popularity has been driven by investors in search of direct exposure to assets they believe will

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complement their portfolios and drive their returns. Sidecar performance can be judged by comparing the internal rate of return to that of the underlying fund, PERE understands. Wenzel said Texas TRS, for instance, aims for its direct investments to perform 200 basis points better than equivalent comingled holdings. In other instances, it is benchmarked by stability and income.

Nevertheless, co-investments do result in greater concentrations of capital and require large amounts of cash on hand, sometimes even doubling an investor’s initial fund contribution. Alive to that inevitability, investors have grown more sophisticated, their mandates shifting toward establishing greater portfolio controls. A long bull run in the market has given them the funds to do so too.

And so ascendant public pensions, such as Texas TRS and the California State Teachers’ Retirement System, have targeted greater asset exposure through various investment vehicles, including co-investment and separate accounts. Along with giving it more control over the makeup of its holdings, Texas TRS’s Principal Investment program also helps it align interests with its managers, Wenzel tells PERE. “We’ve found that by doing a co-invest directly with one of our managers, we really get to know them well, a lot better than just going to an advisory meeting, and that’s probably one of the biggest by-products that we’ve seen,” she said. “You really get to know your managers better, how they think and how they view risk and how they underwrite specific deals. So that’s been really helpful.”

Province of the few

In stark contrast to private equity, co-investment in real estate is a strategy pursued by a minority of investor respondents to our survey.

Do you plan to invest in co-investment opportunities in private real estate over the next 12 months?

What factors hinder your participation in co-investing opportunities?

- Risk level: 36.0%
- Speed required to conclude transaction: 36.0%
- Lack of supply of available co-investment opportunities: 33.7%
- Not staffed up for it: 33.7%
- Ticket size required: 24.4%
- Lack of opportunity to be invited to participate: 32.1%
- Other (please specify): 9.3%

Source: PERE

INVESTOR PERSPECTIVES SURVEY RESULTS: CO-INVESTMENTS

Do you plan to invest in co-investment opportunities in private equity over the next 12 months?

Percentage of respondents

Source: PERE
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- Funds
- Separate Accounts
- Strategic Partnerships

We see property from all angles