Narrowing options

Market turbulence is placing new pressures on fund manager selection, not least in debt financing and redemptions, says **Ulrich Kaluscha**

The due diligence framework of the typical fund of funds manager encompasses all the important aspects for an investment decision, including strategy of the fund, organisation and processes, track record of the fund manager, legal structure and, to the greatest extent possible, an in-depth analysis of the property portfolio. Over the past months, the changes in the market environment (eg, the credit crunch and downward pressure on prices) have put certain issues on top of the due diligence 'hot topics' list.

Strategy: Even if it sounds obvious, fully understanding the business case of the fund is of utmost importance. What is the investment strategy of the fund and how will the manager achieve the target returns? For example, there is a big difference between whether a planned capital appreciation stems from assumed market yield compression (which was often accepted uncritically in the past years) or if it instead derives from increased rental income achieved by active property management.

Even in the latter case it is helpful to drill down further to individual rent rolls to check whether the projected rental increases are realistically achievable. We recently examined a fund where the overall figures implied that every rental contract renewed in the first three years needed to be 20% higher than the current rent level. Independent valuations and our own market research, however, indicated that most properties were already over-rented in the current market, putting the whole business plan of the fund into question.

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Seed portfolios: During the initial capital raising period of a new fund, managers appear to be increasingly presenting investors with a seed portfolio that offers a flavour of the fund's investment strategy. From an investor's point of view this is in principle a favourable development. However, there are a number of issues surrounding these seed portfolios that need to be properly assessed. For example, the properties that comprise the seed portfolio are often not legally owned by the fund since in this early marketing phase the fund may not yet have received formal regulatory approval. In cases like this, it is crucial to understand the process of how the seed portfolio will be transferred to the fund at a later stage. What were the appraised prices and the actual purchase prices for the acquired seed portfolio properties? Who is the current owner and manager of these properties and what management or transfer fees will be charged to the fund? Who will benefit from a potential capital appreciation in the properties? Are there any tax consequences for the fund relating to the transfer?

Financing: Securing debt financing for acquisitions has become more challenging in the past few months, so it is becoming increasingly important to assess a fund manager's ability in this regard. Also the structure of a fund's debt financing (maturity, interest rate, amortisation) and the strategy for the management of interest rate risks (eg, through interest swaps) have a significant impact on the risk assessment. Sometimes even more fundamental questions relating to leverage need to be asked. For example, a core fund strategy involving substantial leverage on low-yielding prime properties is increasingly difficult to justify in the current market environment. The leverage allows the fund to gain in overall size but not necessarily in profitability, particularly when interest rate risk is factored into the calculation.

Redemption mechanism: From our experience with predominantly Swiss institutional investors, liquidity of indirect vehicles is a central question. Surprisingly enough these are normally long-term investors who have no problems with investing into private equity with a time horizon of eight to 10 years, or buy direct properties on a buy-and-hold strategy. Nevertheless, as soon as they deal with indirect real estate vehicles they request a 100% liquidity of the investment. This liquidity, however, is becoming increasingly difficult to assess. For example, similar to the situation in Germany two years ago, some UK open-ended funds have recently refused to accept redemption notices after having experienced significant capital outflows.

The Association of Real Estate Funds (AREF) reported that almost £1.7bn (€2.3bn) was withdrawn from UK property funds in the fourth quarter of 2007. This shows that open-ended structures are no guarantee for liquidity, particularly during difficult market conditions.

An additional layer of complexity (and confusion) was introduced with the emergence of so-called 'semi open-ended' funds. In order to protect the funds and the remaining investors in the funds against extensive cash outflows, the manager introduced 'lock-up periods', 'notice periods' or 'maximum redemption rates per annum' (eg, 10% of gross asset value). As fund managers are very creative when it comes to redemption clauses and there is no development towards an industry standard, every investor who decides to invest into an open or semi-open structure needs to spend time determining the 'real' liquidity of the fund. The extra effort might well pay off at a later time.

Fund manager selection has always been a demanding task for those who decide to invest in indirect real estate vehicles. The changes in the real estate market which we have witnessed over the last months have added some additional challenges as highlighted above. Today, it is even more important than in the past not to rely on commonly used buzzwords like core, value added or open-ended, but to analyse the business model and documentation of the fund and to engage the fund manager in a critical discussion.

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