

Fund managers need to lift their game

REAL ESTATE FUND MANAGERS NEED TO IDENTIFY AND EXPLAIN INVESTMENT RISK BETTER TO THEIR STAKEHOLDERS IF THEY ARE TO WIN BACK THEIR TRUST

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To compete for position at the start of the next economic cycle, real estate investment fund (REIF) managers need to deal with three core strategic factors in order to be successful. They need to:

- demonstrate they can generate appropriate returns from their chosen investment strategy (including related leverage);
- implement a competitive cost base for fund structures and;
- raise capital to acquire assets which appropriately diversify risk.

Importantly, REIF managers need to win the confidence of financial stakeholders (investors and bankers). Their ability to do this is essentially based on their ability to pick the right strategies and convince investors they have the skills and track

SUCCESS FACTORS

High performers build stronger relationships with investors by:

- Identifying and explaining risk
- Anticipating regulatory change
- Enhancing their reporting

record to deliver. At the same time they need to demonstrate their ability to manage strategic risks, which is particularly important in the current environment, given the conservative nature of much recent real estate investment activity. It is also strongly influenced by:

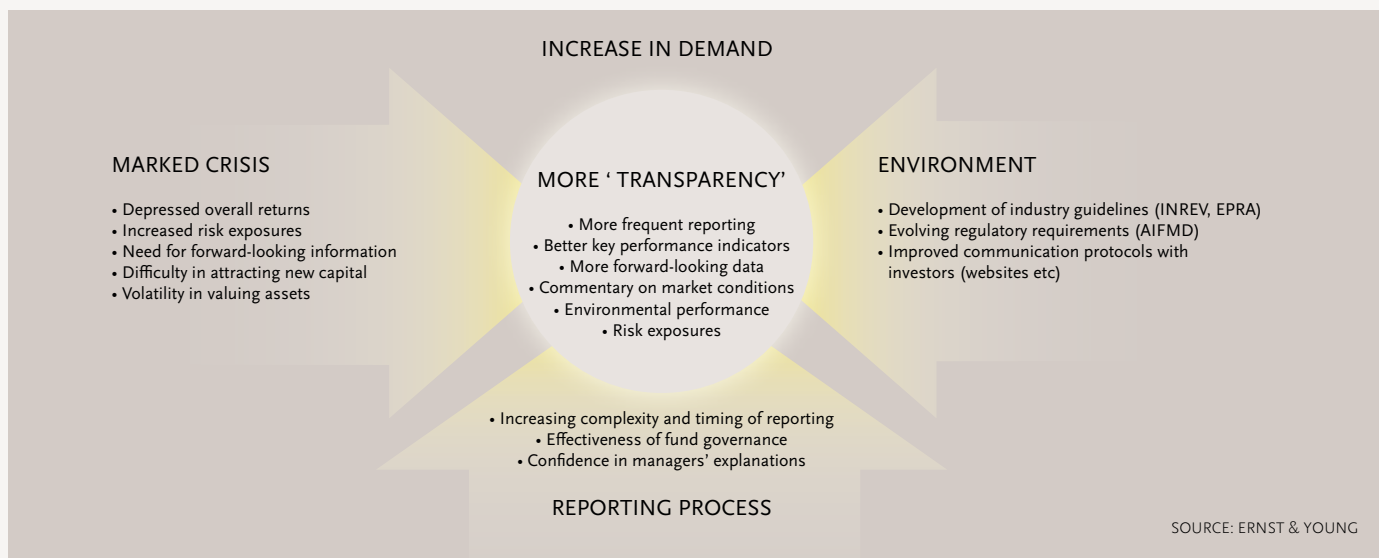
- how the REIF manager communicates performance metrics;
- his ability to respond quickly and accurately to requests from stakeholders;
- how well he anticipates risks and regulatory requirements.

There has been an erosion of confidence on

the part of a broad range of stakeholders, investors, lenders, regulators and tax authorities. This erosion of stakeholders' trust stems from the decrease in, and volatility of property valuations, compounded by the inability of managers to satisfy stakeholders with appropriate transparent reporting and the perceived weaknesses in fund governance arrangements. This has led to increased expectations and due diligence from investors in the area of operations and reporting.

A UK investor told us: 'It's incredibly frustrating when the CEO/CFO's team cannot explain why their performance has been different to what was predicted. It's important, even if performance was positive, because, either you were lucky when you took risks, or something shifty happened in the sector and you've benefited from it. Being able to demonstrate – even though you're surprised by your performance – that you understand what happened, is key.'

Increased investor expectations are not necessarily a bad thing. Indeed, they provide an



opportunity for asset managers to differentiate themselves. We have noticed that the best performers are those that provide the clearest information, not just on management performance, but on the major judgements and estimates that drive it.

Successful REIF managers focus on the following areas:

Overall fund performance: investors obtain relevant data to understand overall returns, the benefits of diversification and the cost of generating gross returns. Investors need to understand correlations and the volatility of real estate as an asset class relative to securities, bonds and investments in other types of alternative funds.

Track record and recent performance: the financial reporting (annual and interim financial statements) provides recent historic data, detailed but easy-to-read information about the portfolio.

Forward-looking information: investors obtain useful forward-looking information, particularly with respect to draw-downs, liquidity management and income distribution data.

Risks and market exposure: investors understand the level of exposure to key operating

and market risks and how managers mitigate those risks.

Valuation of assets: in many cases, investors struggle to fair-value their positions in funds. This stems from misconceptions or uncertainties relating to the nature and timing of the financial data provided (eg different NAVs such as IFRS, INREV and contractual NAV amounts).

In addition, REIF managers should anticipate increased reporting requirements to regulators. There are two significant developments in this area:

1. The implementation of the Alternative Investment Fund Managers Directive (AIFMD): Transparency is one of the key provisions of the AIFMD. It requires managers to enhance investor disclosure and periodic reporting, to get ready to disclose previously confidential information and to implement/upgrade the regulatory reporting process.

2. The ambitious schedule in the IFRS changes: significant changes are on the agenda of the IASB in 2011, which include, amongst others, hedge accounting, lease accounting, revenue recognition and fair value measurement.

In conclusion, now is the time for REIF managers to reconsider if their reporting to stakeholders is up to scratch. There is no doubt that there has been a major shift in investors' sentiment as a result of the financial crisis. Managers need to be confident that they have the framework and systems in place to record, analyse and report in line with top quantile managers. Investors compare the financial reporting they receive from the real estate funds with peers and other alternative fund products and asset classes. REIF managers should facilitate this process.



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KEY QUESTIONS FOR REIF MANAGERS WHEN REPORTING TO STAKEHOLDERS

OVERALL FUND PERFORMANCE

Does your reporting provide relevant information to support:

- Issue/redemption and additional commitment decision?
- Portfolio analysis metrics (volatility, correlations, etc)?
- Comparability with other asset classes?
- Relevant expense ratio data?

RISKS AND MARKET EXPOSURE

- Are the disclosures on risks and uncertainties understandable to investors?
- Are relevant risks addressed?
- Are there sufficient disclosures on operational risks related to the properties and the fund?

FORWARD-LOOKING INFORMATION

- Do you provide forward-looking KPIs in

compliance with INREV?

- Are cash-flow and other fund models sufficiently robust to give a clear picture of up-coming major events (covenant breaches, tax issues, re-financing, etc.)?
- Does forward-looking information allow investors to make educated decisions on how to manage their future cash flows related to the fund?

TRACK RECORD AND RECENT PERFORMANCE

- How does your track record compare to your peers?
- Can investors easily look through the fund at the underlying portfolio, including leverage and underlying financial positions?
- Is your reporting well structured, easy to read?
- Are key judgments and estimates clearly

explained?

- Does your reporting give some insights into the cost structure of the fund and property operations?
- Is your reporting in accordance with INREV reporting guidelines?

VALUATION OF ASSETS

- Are the assets valued using clear methodologies and consistent protocols?
- Are explanations about the quantities of different NAVs clear (IFRS, Fund and INREV NAV)?
- Are accepted best practices, such as INREV NAV and valuation guidelines, used for estimating fair value of fund positions?
- Is other relevant information made available to investors to enable them to make appropriate adjustments for liquidity, portfolio and other effects?