

the decisive eye

A strategic bulletin from **Internos Real Investors** on issues and opportunities in European real estate



Real estate d-management

Has the fun gone out of fund management?

As the economic news grows ever more gloomy, real estate fund managers, weakened by three years of trimming sails to severe crosswinds, now face the perfect storm of a second recession, new demands from investors, institutions staffing-up to replace or duplicate their skills, looming peaks in loan and fund maturities, banks hamstrung by sovereign debt crises and threats posed by EU directives on alternative investments. Only the fittest will survive.

Regular readers will have noticed that we skipped a summer issue: uncertainties around the global economy, in Europe above all, suggested a wait and see approach – occasionally observation is the best strategy.

Now we can be sure that Europe's sovereign debt crises will significantly affect real estate and that much of our fund management industry will struggle to stay in business.

Andrew Thornton

Deconstruction

An industry peaking in 2007, built on the assumption that new investments will replace those that mature, that asset values in Europe would always increase, that leverage would thus always pay off, has suffered three years of new business levels way

below peak. Most tellingly, the industry's share of capital inflow into real estate has also declined reflecting investors' disillusion. Many fund management organisations have been disbanded, taken over or cut down in size.

We have yet to see the worst of it: the next two to three years will bring an industry shakeout - 'meltdown' could be appropriate - in which the survivors will be those who go in strong and are most realistic in addressing investor concerns.

Determined to be relevant

Despite a falling share of investment, despite the fact that some investors are newly engaged in direct asset control or combining in 'clubs' to improve control and cut fees, fund managers should have the advantage of specialisation and economies of scale. Collectively, their knowledge base should be greater and more up-to-date, ears closer to ground, speed of reaction

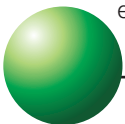
faster. But, there have been too many exceptions to the 'shoulds'. When the shakeout is complete, in two or three years, those remaining will have proved their relevance and will begin to rebuild the industry's share of real estate investment.

This bulletin establishes key facts and threats behind the past and coming decline, analyses investor discontent

and establishes what it will take to survive and deserve to be a relevant and thriving fund manager in 2014, growing both volume and share of European real estate investment - delivering both corporate and investment performance.



Andrew Thornton is Chief Executive Officer of Internos Real Investors which he founded with Jos Short.





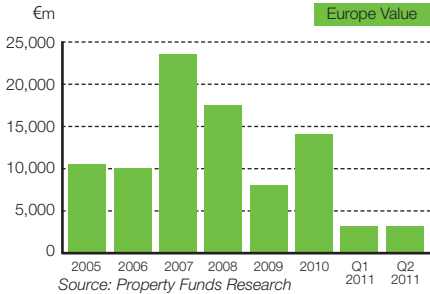
Detailing the Decline

The chart below highlights the decline in European property funds capital inflow since the 2007/08 peaks. PFR believes

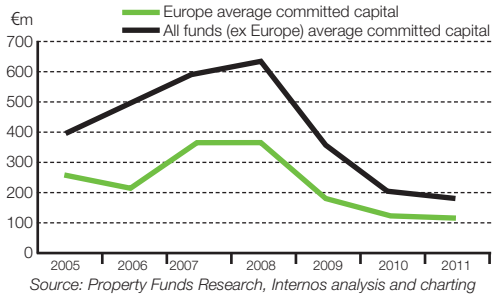
the data almost certainly understates the relative decline as, for obvious reasons, fund managers

are now much keener to report (and to have reported) their activities than they were in 2007.

Europe: capital committed to real estate funds



Average committed capital per fund



If the above data overstates recent years by comparison to 2006-08, the chart alongside detailing average fund size, is a valid and sombre comparison: average size of reported European funds in 2011 is at about one third of 2007/8 levels. Though global (ex-Europe) funds have shown a similar drop-off in size, their average is about 80% higher than in Europe. This is bad news for Euro fund managers: the effort made to analyse, prepare, pipeline, market and,

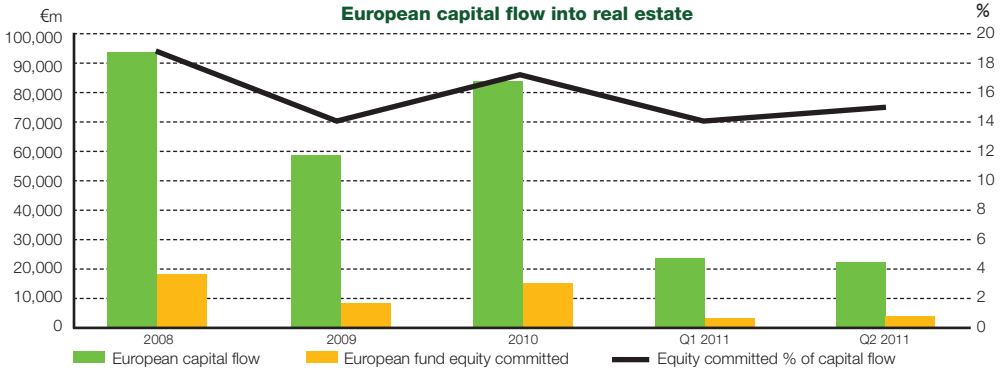
frankly, sell a new fund may differ relatively little from big fund to small. Then, managing a small fund after close is bound to be significantly more

“Expertise is being rewarded increasingly thinly.”

costly per Euro invested. Expertise is being rewarded increasingly thinly.

And, as claimed in our introduction, European funds are achieving a declining

share of real estate capital flow. The drop since 2008 from about 18% to 14%, shown in the chart below, possibly overstates the percentages and understates the decline: the total capital flow excludes residential property and transactions of under \$5million and the latter years of fund equity are thought to be more fully reported, exaggerating their importance.



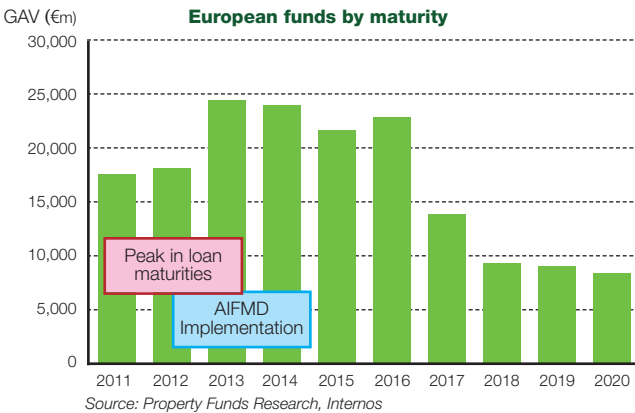
Sources: Jones Lang LaSalle, Property Funds Research, Internos analysis and charting

Knowing now that 2010 was not a return to growth, rather a hopeful blip, an inevitable conclusion from this data is that closed-ended real estate fund managers have not received, and will not receive, the new funds they need to sustain an economic model which rolls over its business

every 6-9 years. Fund managers, investors too, have been tightening their belts, holding their breaths, extending the time frame of funds and awaiting an upturn in valuations and, crucially, holding out for a return of confidence. As a result of the events of the last three

months, confidence and significant new capital are becoming a remote possibility - with a best guess that we will wait for another 2-3 years before they return. What is more: time is catching up and new threats loom...

Defences down: double peaks and directives



For many managers a double whammy of timing is no longer over the horizon but in plain sight. As the funds maturity chart shows, the coming years will bring a tsunami of maturing funds. The critical question is

“...say goodbye for ever to ‘amend, extend and pretend.’”

will there be sufficient confidence in the marketplace and, by investors, in the industry, to replace them? Almost certainly not - furthermore, our research last year* into bank unbundling now presents evidence of a crisis in flood defences even before the tsunami breaks...

As well as being critical to fund maturity, the years 2011-13 also represent a peak in maturities of bank loans to commercial real estate. Up to August this year, banks have been circumspect in withdrawing their support but how rapidly the times have changed. As we write, the extent of Greek and other sovereign debt default remains unclear but this much is certain: European banks will face massive new write-offs and will call in every maturing loan they can. We may have to say goodbye for ever to ‘amend, extend and pretend’. And what goes for debt finance will inevitably apply to the life of funds: life

support may be summarily switched off. If that were not enough, increasing the cost pressure on fund managers will be the EU’s Alternative Investment Fund Managers Directive (AIFMD). Entered into force in 2011, but not due for implementation until 2013, the Directive will in the words of one adviser add ‘generally more work, risk and cost’ and of another: ‘...have a profound structural impact on the fund industry.’

For all fund managers, interpreting new reporting, leveraged fund stress test and transparency demands will be onerous. Some have systems in place which will ease

“ ‘AIFMD...a profound structural impact on the fund industry.’ ”

adaptation. For others, it will be a cost too far. And finally, the Directive will require minimum reserves of operating capital that some managers will simply not possess.

*Decisive eye issue 2, Summer 2010: *Unbundle of Joy?*



Dodging Disaster, Deriving Benefit

Given the conditions of the coming 24 months or so, given also the weakened condition going in of many real estate fund managers, it is inevitable that many will not survive in present form. Those that grow will almost certainly not do so initially by launching numbers of profitable new

funds but by absorbing the responsibilities of those that fail. It goes without saying that they will be those that are now relatively strong, that are likely to have current recurring costs met by recurring income, have strong cash reserves and have staff and

systems already in place able to adapt to AIFMD demands.

To grow thereafter in terms of share of capital invested in European real estate, they will need to show that they have learned the lessons of why share has fallen over the last three years...

Dealing with disillusionment

Of course, fund managers' share of capital inflow has fallen for one overwhelming reason: for most mid-noughties investors, total returns have been disastrous and they have had to show they're doing something

and, even more: insight into real estate has not necessarily gone with competence in managing debt finance. It didn't matter much when valuations were rising and banks eager to lend. It has been of critical significance since 2008 and could be transformative in its effect on whether fund managers survive the next 24 months.

The ultimate investor response to disappointment and disillusion is to staff-up and do it all themselves. This provides the ultimate in transparency and control but, in the long run, it ignores the very reasons why real estate fund management was born in the mid-eighties and grew mightily from 1995 to 2007. More later.

"...belief that if they had had more control, they could have tempered the impact of the downturn."

about it. They endured (severe) disappointment. Hard on the heels of disappointment has come disillusionment: investors discovering that not all fund managers are equal, that not all co-investors share their objectives, that they would not have chosen them as co-investors, given the choice; a strong belief that if they had had more control, they could have tempered the impact of the downturn. In some cases, negative valuations came out of the blue, unwelcome and unexpected in their severity. Investors recognised a critical lack of transparency in dealings with fund managers

The instinctive response by investors has been to assert control. There is a clear trend towards separate accounts, joint ventures and clubs of investors with similar objectives - shared objectives not being, of course, the only goal. Any one of these investor approaches has two further aims: greater strategic control over the manager and greater transparency - attempted elimination of future shocks. And there may be a third aim - lower fees. 'If we're leading the strategy' it might be argued 'your role is that of execution only and merits a lower reward than before.

"Dealing convincingly with disillusioned investors...a sine qua non to be in business in 2014."

The fund management industry has grown up painfully. Dealing convincingly with rightfully disillusioned investors is a sine qua non of the fund manager who expects to be in business in 2014. We will end this bulletin with a summary of the attributes needed to get there. But first: would investors be worse off if the fund management business simply went away? And what should fund managers and investors be doing together over the next two years?



Drilling Deeper: Expertise and Ethos

We estimate that an investor determined to manage real estate investment on a do-it-yourself basis could create a convincing fund and asset team with circa €250million AUM for a UK-sized country, €500m for Europe and perhaps €1bn AUM to justify global scope. Operating costs would be about on a par and the investor would boast control and transparency. But, at these levels, the team would be a generalist team – concentrating on the perceived mainstream – mainstream countries and mainstream sectors – and, most likely, mainstream returns. There is no way that a DIY team could apply the full range of specialised knowledge that the fund industry delivers. Core real estate in major cities in major

countries, perhaps, but when markets get difficult – past midpoint on the way up or in

“...no way that a DIY team could apply the full range of specialised knowledge that the fund industry delivers.”

decline – highly specialised knowledge is called for: deeper knowledge of slightly specialised sectors, such as retailing in a major country, expert technical knowledge of

“...when markets get difficult – past midpoint on the way up or in decline – highly specialised knowledge is called for”

emerging or re-emerging sectors such as sustainable buildings or hotels – expertise

readily and easily tapped in our industry, expertise which doesn't make economic sense when home-grown within an institution. Beyond expertise, there is the question of ethos and ears to the ground. Teams built up within an institution usually either adopt the ethos of that institution or eventually provide a disruptive factor. Real estate executives with cross-border nous and a nose for investment opportunity possess a distinct temperament and require reward systems fitting awkwardly into, say, a pension fund. If they come to fit comfortably into the latter, one suspects, the sensitivity of their ears to the ground will be blunted.



Doing the Necessary, Delivering Income, Preserving Capital

The coming months are going to be a hell of indecision for investors and fund managers alike. And it would be crass to expect significant investment action. If Europe has big red danger signals, so too do emerging regions which already seem overheated. Yet, generalist investors should have no reason to depart from traditional targets of 6-8% of capital allocations to real estate. Indeed, if inflation is a factor, real estate is the traditional refuge and that target could well increase.

We recall 1996-98, when many funds exited real estate, missing the best growth since the 1970's, only to return in haste as the market neared its peak. Fund managers will

“Fund managers will have to be able to deliver convincing arguments for income now combined with capital preservation,”

have to be able to deliver convincing arguments for income now combined with

capital preservation, eschewing significant gearing. In principle, we can hope that, in time, 2012 will deliver the opportunities to do just that. Within Europe, that will mean the Northern core where currency and GDP uncertainties have more upside than downside and where transparency arguments can prevail over global temptations.

**Destiny Deserved:
Surviving and Thriving**

Destined to survive

The fund manager destined to survive the coming brutal months will possess:

- Sound management of its own business – recurring costs covered by recurring income
- A robust balance sheet with cash reserves
- Existing staff and systems close to demands of AIFMD and able readily to adapt
- Sophisticated debt handling in-house, already advanced in pre-maturity negotiations
- Demonstrated ability to absorb and nurture the inherent competence of other fund managers

Deserving to thrive

The fund manager thriving after 2013 and re-growing share of European real estate will show:

- A European approach to relationships – based on trust and mutual benefit
- A North Atlantic value-driven approach to asset assessment: risks and returns scrutinised before funds are deployed
- A thoughtful and constant focus on exit – realised profits are the ones that count
- Expert and updated knowledge of markets and sectors
- Closer and faster acting asset management than investors can deploy on their own
- An aligned approach to debt financing and co-investor selection with strategies carefully matched to the portfolio and to a shared risk appetite
- A no-surprises relationship with investors – concrete transparency! And constant communication
- Ability to act decisively, achieving long-term outperformance against one's peers

Attributing success to speed and rigour of decision making, Internos has become a significant pan-European investment manager since its formation by Andrew Thornton and Jos Short in 2008. Now with offices in London, Frankfurt, Amsterdam, Paris and Luxembourg, over 300 commercial property investments in 8 countries, €2.0bn under management and its earliest funds dating from 2004, Internos has expertise across the real estate asset classes and major markets. Evidence of entrepreneurial flair and strategic credibility lies in the success of this owner-managed business in taking over the management of complex funds and situations and in building consensus among diverse stakeholders in competition with much larger industry peers. Internos uses the phrase 'the decisive eye' to sum up its approach and as the title of these strategic bulletins.



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Information accurate as at November 17th 2011