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Private Equity Real Estate

An empirical study of investors and funds in the Nordics

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Abstract: *This paper describes a limited sample of non-listed real estate funds operating in the Nordic countries. Non-listed closed-ended funds are typically associated with a lack of transparency, limited size and tradability and complicated structures. More and more non-listed closed-ended funds have been launched in Europe and the Nordics for the past ten years. The purpose of this study is to describe and examine the potential benefits with investing in non-listed funds in relation to other real estate investments. By conducting interviews with fund managers and investors alike, this paper reviews the recent developments of funds, discusses typical fund structures and presents how investors and fund managers consider non-listed funds as opposed to other real estate investments. Our findings suggest that non-listed funds are not suffering from low transparency. Moreover, there are indeed liquidity issues but they are not considered to be of particular concern. The findings also suggest that there has been a homogenization of distribution policies and administration fees. The answer to the specific research question is that institutional investors invest in non-listed funds in order to achieve greater diversification effects as the investment is seen as a complement.*

Keywords: Non-listed real estate; Private equity real estate; Closed-end fund; Listed real estate shares.

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Introduction

The purpose of this paper is to describe and examine the potential benefits with investing in non-listed, closed-ended, real estate funds in relation to other real estate investments, especially listed real estate shares. The specific research question is;

What are the key drivers for an institutional investor to invest in non-listed real estate funds?

Previous studies in the field have chiefly focused on the role of direct real estate or listed real estate shares as opposed to traditional assets. Research carried out on non-listed real estate funds is limited and mostly based on the prevailing conditions in the US and UK. Since non-listed real estate funds are a rather new phenomenon in the Nordic countries there has not been a significant amount of research published on the matter. As the sector has experienced significant growth, it is of interest to achieve a better understanding of the investors' motivations.

Real estate has historically been characterized by a lack of transparency, high transaction costs, high management costs and high information costs. It has mainly been considered by investors as a hedge against inflation while providing stable cash flows. With increased securitization, some of the abovementioned concerns have been alleviated which has permitted real estate to become increasingly accepted as an investable asset class. Liquidity and accessibility have also been ameliorated. As a result, institutional asset managers have increased their allocation to real estate (Garay and Ter Horst, 2009).

The main benefit of investing in real estate is its negative correlation with traditional asset classes such as bonds and equities, which improves the mean-variance efficiency (Garay and Ter Horst, 2009). Returns of real estate investing have also proved interesting. Garay (2008) shows that annualized returns from investing in real estate through REITs (Real Estate Investment Trusts) were higher than for general equity while showing a somewhat lower volatility for the period 1990 – 2007. In comparison to private equity, returns were lower while volatility also was lower.

Though volatility is low for real estate in comparison to traditional assets, the risks of real estate investing can be underestimated due to data smoothing (Garay and Ter Horst, 2009). The inflation-hedging potential of real estate can also be questioned according to Goetzmann and Valaitis (2006) as it has been analyzed with varied outcomes.

According to Hudson-Wilson, Fabozzi and Gordon (2003) real estate for institutional investors includes four main market sectors (quadrants): Private commercial real estate equity held as individual assets or in commingled vehicles; Public real estate equity structured as REITs or REOCs (Real Estate Operating Companies); Private commercial real estate debt, held as whole loans directly issued or commercial mortgages held in funds or commingled vehicles and Public commercial real estate debt structured as CMBSs (Commercial Mortgage-Backed Securities). The revenue source for all four is based on leases paid by tenants who occupy commercial real estate properties (Lynn and Wang, 2010).

Private commercial real estate equity held as individual assets, direct real estate, can require significant funds in order to achieve a diversified portfolio and costs are still high (Geltner, Miller, Clayton, and Eichholtz, 2006). As a result, institutional investors have increased their share of publicly listed real estate as it is a cost-effective and more liquid alternative to their real estate investments (Brounen, Op 't Veld and Raitio, 2007). The listed real estate companies above all hold real estate or real estate related assets. This should mean that correlation between their returns and the development of the real estate market. However, Conner and Falzon (2004) mean that this is not the case. Brounen, Op 't Veld and Raitio (2007) argue that the low-cost trading dimension is not present in the private market. This leads to substantial short term variations in pricing between the public and private markets which raises the question whether publicly listed real estate can still be classified as a real estate investment. The fluctuations between the two markets contribute to discounts and premiums to NAV (net asset value). These differences are in part due to changes in investor sentiment that affect the share prices. In an economic downturn real estate shares tend to go out of favor much like shares in general (Conner and Falzon, 2004).

Brounen, Op 't Veld and Raitio (2007) mean that though public and private real estate vary less in the long run, fluctuations in stock market sentiment still weaken correlations between the public and private market.

According to the report “Property shares – joyride or roller coaster?” by Leimdörfer (2008), correlation between publicly traded property shares and the stock market remains higher than the correlation between directly owned properties and the stock market. As a result, the diversification effects are not so favorable for publicly listed real estate shares as they are for direct real estate.

A middleground to publicly traded real estate shares and direct real estate can be found in non-listed real estate funds according to Brounen, Op 't Veld and Raitio (2007). The funds offer many of the advantages of public real estate while it correlates with direct real estate to a much greater extent. On the downside however, liquidity is limited the size of the secondary market is limited or inexistant and there is a lack of information transparency (Brounen, Op 't Veld and Raitio, 2007).

A qualitative approach was chosen for the paper as data are scarce for non-listed real estate funds. It was also deemed to be more valuable to conduct interviews in order to attain a better understanding of the the investors motivations and how these were met by the fund managers.

It was found that the typical drawback with non-listed real estate funds are not considered to be a real concern by the professionals that were interviewed. Moreover, it was found that the main motivations for investing in non-listed funds is to achieve a greater degree of diversification and to gain access to investments that the investors would normally not be able to undertake.

I. Literature Review

A. Investors

The typical investors in real estate are institutional investors such as pension funds and life insurance companies. This is especially true for closed-ended fund structures (McMahan, 2006).

Until recently, the investment strategies of pension funds have been characterized by the relatively low need for liquidity for a relatively small proportion of total beneficiaries who are retired and receiving benefits. The constant flow of contributions from employees in the plan has contributed to significantly more funds than needed to pay benefits and the pension funds constantly have to find outlets for this money. Normally, the pension funds invest directly in office properties, apartment projects and industrial parks for example where they can find good yields (Hines, 2001).

However, this balance is changing. The number of retirees will grow while the number of contributing workers will decline. This requires a higher degree of liquidity and increased cash returns for the pension funds. In order to meet this, asset yields have to be higher (Hines, 2001).

Life insurance companies have historically received constant stable flows of funds from its policy holders. This was due to the fact that the policies mostly were of the endowment type. However, this has changed and term insurance is preferred among policyholders in many cases. Policies have also been cancelled to a greater extent. Thus, funds are not as stable and abundant as before. As a result, the life insurance companies have to be somewhat more liquid which affects their investments (Hines, 2001).

Lynn and Wang (2010) mean that investors typically invest in funds in order to reach new market segments or niches that they do not generally invest in.

B. Liquidity

Liquidity is poorer and risk is higher for private equity as opposed to public equity. As a consequence, returns have to be higher. On the public market, shares can be traded with ease on centralized and efficient exchanges. There is an abundance of information and the markets are highly transparent. On the private market, transactions are carried out between individual buyers and sellers. Information is scarce and transparency is low (Connor and Falzon, 2004). McMahan (2006) means that the limited access or the lack, in some cases, of a secondary market is the reason for the low liquidity. Liquidity might be affected further should the fund liquidate when the real estate cycle is unfavorable (McMahan, 2006).

Historically, real estate funds tended to adopt open-ended structures. The funds were called open-ended as the investors could withdraw capital from the funds, normally on a yearly basis. This gave the funds a rather liquid nature as the investors could be redeemed. However, it didn't reflect the highly illiquid nature of the underlying assets, the properties. If there were too many investors who wished to withdraw their funds, the fund sponsor would have to liquidate some of their real estate which generally wasn't advantageous. If investors wished to withdraw their capital, it was done on a first-in-first-out basis, which could create a run-on-the-bank mentality. As a response to this, many funds adopted closed-ended structures instead, as they reflected the illiquid nature of real estate better. Closed-ended funds are more focused on a specific type of properties or a specific geographical area. When a fund has raised the targeted amount of capital it is closed and is thus no longer available for new investors. Closed-ended funds have a finite life and the invested capital cannot be accessed until the fund liquidates. There are however funds that can be traded on the secondary market, especially in the United States (McMahan, 2006).

C. Fund Structure and Investor Influence

The typical fund real estate equity fund structure consists of a number of investors who acquire interests in an investment vehicle managed and controlled by a fund sponsor. The investors provide most, if not all, of the capital while the fund sponsor will provide the investors with their expertise. There are two main structures that are generally used, the limited liability company and the limited partnership. The most common and best known vehicle has long been the limited partnership. In Europe however, the limited liability company is becoming more and more popular. Legislation and taxes differ from country to country, but both structures are generally tax efficient although not tax shelters (Larkin, Babin and Rose, 2003).

The investors or the limited partners are responsible for providing the fund capital while the fund sponsor or general manager takes care of the running of the fund. Under many jurisdictions, the general partner has unlimited liability to third parties for the debts of the partnership. Limited partners are not allowed to participate in the running of the fund; otherwise they would face different and less favorable tax regimes. Depending on the agreement and the jurisdiction, the limited partners or investors have different levels of influence. Under Delaware law in the United States where most partnerships are registered, it is not uncommon that investors or limited partners have

approval rights over major decisions such as refinancing, sales, leases, service contracts and so forth. This also varies from fund to fund and the investors might wish to have more or less control. Some funds have investment committees that include the weightiest investors in the fund. The fund sponsor or the general partner can seek advice and consult the committee on various issues and solve conflicts of interest. Advisory boards are also common with the principals from the fund sponsor or general partner as well as persons with knowledge about the industry. Investors are allowed to participate in a wide range of monitoring activities under Delaware law without risking their status as limited partners. (Larkin, Babin and Rose, 2003).

D. Transparency and Administration Fees

The general partner or the fund sponsor is thus responsible for the running of the fund. This includes finding, evaluating and negotiating potential real estate investments. When the properties have been acquired the fund managers are responsible for monitoring the investments. After a certain amount of time the manager exits the investments to create liquidity. The fund charges its investors an annual fee for these services called the management fee to cover operating costs and salaries. Larkin, Babin and Rose (2003) claim that the fee is about 1 to 2 % of capital commitments until 75 to 90 % of commitments have been drawn down and invested in real estate assets. After this, the fee equal between 1 and 2 % of the net asset value of the fund in general. Larger funds tend to have lower percentage fees while smaller funds tend to have somewhat higher percentage fees. Fees are also often negotiated (Larkin, Babin and Rose, 2003). Investors that contribute with bigger investments pay a lower fee than those who contribute less capital (Chertok, 2009). The most common way to calculate the management fee is to base it on committed capital during the investment period and then invested capital after the investment period. In addition to this, the general partner or the fund sponsor receives a share of the funds waterfall, the carried interest.

E. Distribution Policy and Incentives

Carried interest is one of the most important aspects of the financial terms in a real estate fund with the management fee. There are two main ways to calculate the carried interest, on a “deal-by-deal” basis and on a “whole fund” basis. Furthermore, there are variations to the two models, which affect the performance and the incentives of the fund. The carried interest is the essential part of the manager’s incentive compensation (Marrs, Hellebusch and Das, 2009). Larkin, Babin and Rose (2003) claim that carried interest is typically 20 %, but that it varies depending on the agreement. Marrs,

Hellebusch and Das (2009) claim that preferred returns is 8% per annum for successful opportunistic funds while the overall carried interest is normally 20 %. According to Chertok (2009), the typical preferred return is 9 to 10 % compounded annually but can range from 8 to 12%.

When carried interest is calculated on a deal-by-deal basis, the fund manager receives carried interest on the profits that are realized on each individual investment. When it is calculated on a whole fund basis, carried interest isn't distributed until the investors have received their total capital contributions to the whole fund and the preferred return on all such contributions. If there is a claw-back feature, the sharing of total profits will be the same over the lifetime of the fund. However, the timing of these distributions will be different between the two. If a deal-by-deal approach is used, the manager will receive them earlier than for the whole fund approach. This is important not only from a time value of money perspective, but also for the goals and incentives that are set up for management (Marrs, Hellebusch and Das, 2009). Naturally, it is more favorable for the investors to adopt a whole fund approach as they will get more cash more quickly. Furthermore, the risk of underperformance of the later investments made by the fund are reduced (Chertok, 2009).

The distribution model used can vary depending on the income source of the fund. Either it can be based on current income, such as rents and hotel room revenue, or it can be based on disposition proceeds, such as income realized from the sale or disposition of the funds underlying assets. Most funds do not make a distinction between the two while some do in order to create specific incentives for management. (Marrs, Hellebusch and Das, 2009)

F. Benefits and Drawbacks of Closed-Ended Funds

Information costs take another dimension when investors seek international exposure or even national exposure. Costs related to seeking information for an international investor are also considered sunk costs. Therefore, home bias tends to be strong. Naturally, information can be bought from specialized consultants, but it is questionable whether they, as insiders, are ready to share their most attractive deals with foreign investors, the outsiders. Another way of getting exposure to private real estate equity for investors, regional or international, is through commingled fund vehicles. Often, international real estate investors team-up with well-informed local investors with

extensive knowledge of the particular market or sector (Geltner, Miller, Clayton, and Eichholtz, 2006)

Public real estate equity has two main advantages over private real estate equity, a higher degree of transparency and a higher degree of liquidity although the underlying assets are the same as in private real estate equity. For an investor with limited funds it is significantly easier to get real estate exposure through public real estate equity. This also goes for the international investor (Hines, 2001). However, correlation with traditional assets such as shares and bonds tends to be higher than that of private real estate equity. The most significant difference between the two markets is the considerably higher volatility of public equity real estate. Investors also tend to be different between the two. Private real estate investors are long term investors while public real estate investors can be both short term and long term investors. The private market is thus more stable but less liquid while the private market is more liquid but also more volatile (Connor and Falzon, 2004).

Direct real estate is typically associated with many of the benefits and caveats that property investing is known for. Liquidity is normally low and there is a lack of transparency. It is also associated with high transaction costs, high management costs, product heterogeneity and high information costs (Garay and Ter Horst, 2009).

According to Larkin, Babin and Rose (2003), funds focusing on appreciation are opportunity funds as they offer rather high risks and returns. Funds focusing on income-producing properties offer a greater degree of stability but internal rates of returns are lower. The investment cycle varies depending on the chosen strategy of the fund, the targeted assets but also on the investors. In general, funds have a lifetime of five to ten years.

II. Methodology

An inductive method of data collection was chosen in order to collect relevant theories and knowledge that already existed on the particular topic. As a result of this it was possible to gain an understanding of the prevailing circumstances and the potential problem to investigate. This led to a number of questions for the qualitative interviews which were the basis for the primary data collection. The data is collected directly from

the source and is designed for the particular purpose of the study. Primary data can either be collected through interviews, observations or questionnaires (Jacobsen, 2002).

This study will be made in form of a qualitative study with an inductive method of data. The primary and empirical data is data the authors collect from people and organizations for the first time. The data comes directly from the source and is directly designed for the purpose of the study. Primary data collected through interviews, observations or questionnaires (Jacobsen, 2002). In this paper, the primary data is collected through interviews. It was deemed to be the most appropriate alternative in order to get as detailed answers as possible as it is a more suitable alternative than a questionnaire or an observation. The interviews provided more extensive answers with a larger spread than a questionnaire would as it has a limited number of alternative answers.

The type of interview that was carried out was open individual semi-structured interviews. As a starting point, an interview guide was done and sent to the respondents' in advance to permit them to prepare before the interview.

As a semi-structured interview approach was used it was possible to ask follow-up questions. It also made it possible to angle the interview so as to obtain pertinent answers and relevant information in order to answer the problem formulation. Two different questionnaires were used, depending on what role the respondent and its employer had. The questions in both questionnaires had the same focus but were angled differently depending on the company's activities. All interviews were telephone interviews except the interview with the Swedish real estate fund based in Stockholm, which was carried out at their headquarters. Telephone interviews were preferred to physical interviews as some of the respondents' are based abroad and because the time available for this paper was limited. By doing telephone interviews, access to relevant persons was facilitated and the information supplied by these permitted the authors to gain a deeper understanding of the subject. After the interviews the notes were sent back to the respondents' for them to approve in order to avoid potential misunderstandings and to obtain even more pertinent answers.

A. Selection of respondents

A selection method often used in qualitative studies, a non-probability selection, was used as the respondents' were selected randomly, a type of non-probability sample. The selection consists of the researcher choosing, according to its own preferences, which respondents' that will be interviewed. Thus, the researcher chooses respondents' it believes will be able to answer the research question in the manner (Larsen, 2009). The selection of respondents' was based on a list of investors, potential investors, fund sponsors and fund in funds active in the Nordics, published by PERE Connect, <http://www.pereconnect.com>, an integrated news and data service, tracking institutional investments into private equity real estate. The data is fully searchable which enables searches of particular regions, risk return profiles, investors, fund sponsors and so forth. There were however two exceptions; Sven Dahlin of Leimdörfer and Magnus Lange of Cushman Wakefield. They were chosen as they represent leading analyst firms in order to attain a broader and more neutral opinion. The following respondents' were interviewed:

- a. *Anette von Mentzer*, head of real estate investments at pension fund PP Pension. They have direct real estate investments. Have not invested in a closed-ended real estate fund.
- b. *Anonymous A*, head of indirect real estate investments at a major Swedish Pension Fund and Life Insurance Company. Have invested in a closed-ended real estate fund.
- c. *Anonymous B*, partner at a Swedish Real Estate Fund in Stockholm.
- d. *Jussi Rouhento*, managing director and responsible for real estate investments EPI Healthcare I fund – Evli Property Investments, Finland.
- e. *Kent Jonsson*, head of indirect real estate Sweden at pension fund Alecta. Have invested in a closed-ended real estate fund.
- f. *Magnus Lange*, CEO Capital Markets, partner, head of office in Sweden, Cushman & Wakefield, an international commercial real estate services firm.
- g. *Per Gebenius*, fund controller at Genesta, responsible for Genesta's Nordic Baltic Real Estate fund's reports and analysis.
- h. *Peter Helfrich*, country manager Sweden, Finland and Denmark at ING Real Estate Investment Management.
- i. *Sven Dahlin*, senior partner and former CEO at Leimdörfer, an independent financial advisor on the Nordic property market.

B. Method of Analysis

Qualitative text analysis consists of producing the essential elements through careful reading of the text parts the overall context is included in (Esaiasson, Gilljam, Oscarsson and Wängnerud, 2007). By using a qualitative text analysis, it has been possible to communicate and analyze the entirety of the information collected during the investigation. This is possible through intensive reading of the text to reach a depth in the analysis and not just summaries out of the data collection.

A thematic representation was chosen to divide the information. Thematic representation means that the interview guide is used as a starting point for the presentation and the areas dealt with in order to reach the most relevant information to answer the research question (Dalen, 2008). The paper was divided into six themes; the Investors; Liquidity; Fund Structure and Investor Influence; Transparency and Administration Fees; Distribution Policy and Incentives; Benefits and Drawbacks of Closed-Ended Funds. Larsen (2009) means that the purpose of thematic representation is to identify relationships, patterns and commonalities or differences. After the data collection was completed, it was compiled on the texts and then grouped according to the above themes and compared with the theories considered in the literature review.

III. Findings and Analysis

A. The Investors

According to the respondents, the typical real estate fund investor is an institutional investor; a pension fund or a life insurance company. The investors that were approached for this paper were indeed mostly pension funds and life insurance companies with a few rare exceptions, such as foundations and fund-in-fund investors. The investors country of origin were somewhat mixed. The Swedish real estate fund based in Stockholm has only Swedish investors and is highly specialized. The Finnish EPI Healthcare I fund has only Finnish investors. Again, the fund is highly specialized. ING Real Estate's Nordic fund has a large number of investors, all European, but only one of them was from a Nordic country, Finland. The fund has diversified holdings in the Nordic countries. Genesta's Nordic Baltic Real Estate fund also has a larger number of investors, more than the Swedish and Finnish funds. Its investors are European and the fund is diversified both over sectors and geographically.

Hines (2001) claimed that pension funds and life insurance companies sought to invest to a greater degree in more liquid real estate producing higher yields. This could not be confirmed by the respondent's. It was however claimed by a few of the fund managers that their investors sought to increase their exposure to funds.

Thus, two funds are specialized and have domestic investors and two funds are diversified and tend to have investors from other regions. This is in line with what Lynn and Wang (2010) argue, that investors tend to invest in a real estate funds in order to get exposure to a certain market segment or a specific region.

B. Liquidity

All of the respondents agree that liquidity is the main drawback when it comes to closed-ended funds, which is worsened further by the fact that direct real estate in itself is illiquid. This is in line with McMahan's (2006 findings).

Although a major disadvantage, it is not considered to be a problem. This is linked to the nature of the investors, mostly pension funds and life insurance companies. The investors have capital inflows every month that have to be placed. As their placement horizons per definition are long term, the lack of liquidity can be handled. Moreover, the investors do not place their whole real estate portfolios in closed-ended real estate funds; it is more of a complement. Garay and Ter Horst (2009) confirm that liquidity is indeed low, but the investors are typically pension funds and life insurance companies and they have very long time horizons.

Liquidity is also improved by secondary markets. Yet, the secondary markets tend to be somewhat inefficient according to some of the respondents. If a fund is performing poorly or if the real estate cycle is in a not so favorable phase it can be difficult to find buyers. Again, this is in line with McMahan (2006). Fund in funds also contributes to higher liquidity.

For a closed-ended fund, there is a clear exit at the fund's liquidation. However, if the market is unfavorable, liquidation can be slow according to the respondent's. Conner and Falzon (2004) mean that private real estate transaction costs are high and can take a considerable amount of time to realize which supports this.

C. Fund Structure and Investor Influence

The investors agree that influence on management is indeed low. As a result it is important to set up very a very specific mandate for the fund. There is a detailed business plan in which the type of properties, sector, leverage and what to achieve is clearly specified. Management is free to act within the frames of the stipulated rules in order to achieve the best possible return according to the respondent's.

The level of influence that closed-end fund investors can have on management tends to vary somewhat depending on the funds country of registration. The Swedish real estate fund does not have an advisory board contrary to Evli Property Investments' fund. Genesta's fund also has an advisory board and different committees, among them an investment committee. As describes in the literature review, the amount of influence for the investors did not only differ depending on the state of incorporation, or country in this case, but was also varying depending on the contracts that were set-up (Larkin, Babin and Rose 2003).

The respondent's argue that since investors' seek exposure to a different sector that they do not master it is normal to have less influence over the fund's operations. As Larkin, Babin and Rose Claim (2003), management provide their expertise. The investors' are also aware of what they are embarking on. As a contrast to this, the interviewed investors claim that the degree of influence is significantly higher in club deals and joint ventures as they often are members of the board. Ultimately, it is a question of priorities they argue.

All the respondents' state tax-reasons as a restraint on the level of influence for investors, Larkin, Babin and Rose (2003) claim that one of the interests of funds is that they are indeed tax efficient.

D. Transparency and Administration Fees

Transparency is not deemed to be a real problem by the respondent's. All the funds claim that they have good reporting and regular meetings with the investors. The investors also think that transparency is satisfactory. Often, the investors' and management are already acquainted with each other which increase transparency the investors mean.

Most argue that the situation is very different today than it was four years ago, as the requirements are much higher due to the more competitive market environment. INREV, the European association for Investors in non-listed real estate vehicles, has also contributed to increase transparency according to some of the respondent's.

Garay and Ter Horst (2009) mean that transparency is an issue in direct real estate but whether it is lower or higher than for closed-ended funds, is not clear. Connor and Falzon (2004) argue that there is a lack of transparency when it comes to pricing in the private market as opposed to the public market. Since the shares of listed real estate companies are traded on centralized exchanges with an abundance of investors and information, pricing is efficient and transparent. Since properties are highly heterogeneous and are not traded on centralized and efficient exchanges, pricing cannot be transparent. To what extent this is applicable to closed-ended funds is not evident. To Brounen, Op 't Veld and Raitio (2007), there is a lack of information transparency which is not supported by the respondent's answers. It is claimed though that as an investor transparency is good but not so good for an outsider.

According to Marrs, Hellebusch and Das (2009) the management fee is one of the most important aspects when you invest in a closed-ended fund. Judging by the answers from the conducted interviews, management fees have evolved since the global financial and economic crisis and tend to be lower today. Moreover, there is much more focus and discussion on management fees than there was before. There is also a homogenization of fees some claim although it can vary with the complexity of the fund.

The respondent's agree that the fee is supposed to cover costs for personnel, office and other normal costs that any company has. It is the carried interest that is the monetary incentive, not the management fee.

Larkin, Babin and Rose (2003) mean that the fee varies with the size of the fund, something that is confirmed by the respondents. Larger funds tend to have a lower percentage fee while smaller funds tend to have a higher percentage fee. Chertok (2009) explains that investors that contribute with large amounts of capital have lower fees than those investors that contribute with smaller amounts of capital. This was not confirmed by the respondent's.

According to Larkin, Babin and Rose (2003), the fee is normally based on some sort of mixture between committed and invested capital. If the fee is based solely on invested capital, management might be overly eager to invest capital as quick as possible in order to collect a fee. It might lead to management acquiring sub-par assets which is not in the interest of the investors. This reasoning is confirmed by Anonymous B and their fee is hence based on committed capital. Genesta on the other hand mean that the fees depend on the performance of the fund. Up to a certain IRR there is a fixed fee. After that, for example 5 % above the targeted IRR there is a performance fee of a certain amount of the 5 %. If the targeted IRR should be surpassed further, the performance fee will increase even more. However, there is a maximum level (a percentage and an absolute number) for the performance fee.

E. Distribution Policy and Incentives

The general consensus is that there are clear incentives that keep management from not acting in the best interest of the investors. In order to mitigate potential problems, management invests significant amounts of their own wealth, sweat or hurt money, in the fund to align both sides' interests. The interviewed investors mean that they have avoided funds where these prerequisites did not hold. As a comparison, a CEO or a director in a listed company probably wouldn't have the same strong incentives, it is argued.

Marrs, Hellebusch and Das (2009) explain that carried interest is the essential part of management's incentive compensation rather than the management fee. The investors made clear that it was crucial to base carried interest on a whole fund approach and that they avoided funds with a deal-by-deal approach. The funds only used the whole fund approach for carried interest. There was thus no interest at all among the respondents to use a deal-by-deal basis for carried interest. It was argued that a deal-by-deal approach would create the wrong incentives. Management could do a few good deals in the early life of the fund and take a lot of money out which wouldn't be in the interest of management, especially if the fund would perform poorly at a later stage.

Marrs, Hellebusch and Das (2009) mean that although the basic versions are very different from each other, they are rarely used in their purest forms. There are a number of variations to them that can be adapted to the particular fund's activities depending on the income source of the fund for example. According to Marrs, Hellebusch

and Das (2009) carried interest can be tailor made, be it deal-by-deal or whole fund, in order to create very specific incentives for management. Thus, a deal-by-deal basis with a claw-back feature can be very similar to a whole fund basis, but the incentives are somewhat different to management. Naturally, a whole fund approach is more interesting to the investors in comparison to a deal-by-deal approach with a claw-back from a time value of money perspective.

F. Benefits and Drawbacks of Closed-Ended Funds

Most respondents claimed that open-ended funds had a tendency to restrict withdrawals if economic conditions were unfavorable. Therefore, open-ended funds do not really have an advantage over closed-ended funds in this perspective they argued. This is in line with McMahan's (2006) description of open-ended funds. One of the respondents argued that open-ended funds were of a different nature than closed-ended funds and maybe not aimed at the same investors.

The main advantages with closed-ended funds are the diversification effects that they offer according to the respondents. You can get exposure to larger and more diversified portfolios with the help of leverage much like Anson and Hudson-Wilson (2003) argue. Other reasons are the international exposure a fund structure can offer, without the volatility of listed real estate and without the information costs and managing costs of direct real estate.

Listed real estate shares and closed-ended funds are similar in the sense that they are both indirect real estate investments. However, although they more or less have the same underlying assets, they tend to be very different as investments. One is traded on the private market while the other is traded on the public market. This has implications on a few different factors, mainly the liquidity, as already mentioned. Geltner, Miller, Clayton and Eichholtz (2007) means that investing in public real estate is an interesting option if an investor want to get international exposure for example.

Conner and Falzon (2004) explain that the public market is efficient, information is abundant and pricing is thus transparent. Investors can trade in and out of the listed real estate companies at very low costs. It can be difficult to sell should you own a significant share of a listed company. The respondents share this view and mean that liquidity is superior to direct real estate and closed-ended funds. However, they all

argue, to different degrees, that an investment in a listed company cannot be considered to be an investment in real estate. The respondents claim that listed real estate shares correlate with the general equity market rather than with the underlying assets. Thus, the diversifying effect of investing in property more or less disappears. This is in line with Conner and Falzon (2004) view on correlation. According to the respondents, you do not only get exposure to real estate when you invest in a listed company, you also get exposure to their operations and other factors linked to the particular company.

However, in the longer term, listed real estate shares tend to correlate more closely with direct real estate rather than the general equity market according to Conner and Falzon (2004). The investors are of different character when you compare closed-ended funds and listed shares. The fund investors are long term investors, although closed-ended funds are defined as short term investments by the investors (in comparison to direct real estate). For listed real estate shares there are two types of investors on the other hand. There are short term investors and long term investors. The short term investors are in part responsible for the more efficient pricing of listed real estate according to Conner and Falzon (2004). However, they also contribute to the higher volatility. Pricing is driven by the prevailing sentiment of the investors so listed real estate shares will go down in an economic downturn, unlike a fund investment.

Another important difference between listed real estate shares and closed-ended funds is the character of the assets that are held. According to the respondents, listed real estate companies generally have rather broad and diversified real estate portfolios. Real estate funds tend to be of a more specialized character with assets in a specific segment or geographical area. Since different types of properties correlate differently, it is possible to set up a very well-diversified real estate portfolio.

The degree of control is also different between an investment in a closed-ended fund and a listed company. When you invest in a fund you can negotiate the contract and you are involved. The fund has a very clear strategy that it will stick to. Thus, it is easier for an investor to use that particular investment as a diversifier for example. In a listed company, the investor doesn't have the same influence, or need to invest significant funds in order to get it.

Direct real estate and closed-ended real estate funds are similar in the sense that both are traded on the private market. As a result, liquidity is limited but on the other hand direct real estate and closed-ended funds do not correlate with traditional assets such as bonds and general equities (Conner and Falzon, 2004). Thus, the diversifying effects are more interesting than listed real estate shares for example. Investing in direct real estate can be demanding, especially if you wish to invest in a different market or a different geographical area. Information costs are high and are considered sunk costs (Hines, 2001).

Should you wish to invest in a different country, the abovementioned problems are even more pronounced (Geltner, Miller, Clayton and Eichholtz, 2006). In order to invest directly in real estate, you need to set up a purpose built organization to manage the investments. For this to be efficient, you need a critical mass, in order to achieve economies of scale. Thus, if an investor wants to get exposure to a particular country or region or to a particular type of property, a real estate fund might be a good alternative according to the respondents. Another reason for investing in a real estate fund structure is the fact that you can get access to leverage, something that many institutional investors cannot use in their direct property investments due to restrictions (McMahan, 2006). This argument is also used by the respondents.

Leverage offers many interesting benefits in real estate. Leverage combined with a fund gives the investor access to a more diversified real estate portfolio as you can acquire a greater number of assets, instead of buying smaller properties for example (Anson and Hudson-Wilson, 2003). This was one of the main motivations for Anonymous A.

The institutional investors usually invest in properties of core character as they cannot use leverage. These properties generate stable cash flows and are low risk investments (Brueggeman and Fisher, 2007). When institutional investors invest in closed-ended real estate funds, they usually choose something different on the risk-return scale according to according to the respondent's. Thus, through a fund investment, the investors get exposure to value-added and opportunistic strategies, offering significantly higher returns. As an example, the Swedish real estate fund in Stockholm had a clear value-added strategy for their properties, something that the investors wouldn't be able to do through a direct property investment.

IV. Conclusion and Discussion

The purpose of this paper was to describe and examine the potential benefits with investing in non-listed, closed-ended, real estate funds in relation to other real estate investments and what the principal motivations were to invest in these were.

Judging by the answers provided by the majority of the nine respondents, non-listed closed-ended real estate funds appear to be an increasingly interesting component of a real estate portfolio for institutional investors.

McMahan (2006) meant that the majority of closed-end fund investors were pension funds and life insurance companies. This is in line with the respondents' answers.

Liquidity is argued to be the most significant drawback when it comes to closed-ended real estate funds by a number of scholars; Brounen, Op 't Veld and Raitio (2007); Garay and Ter Horst (2009); McMahan (2006). The respondents' agree that liquidity is indeed low and that it is the principal drawback. On the other hand, it is not considered to a problem as the investors usually have long placement horizons.

Larkin, Babin and Rose (2003) mean that fund structure, the existence of advisory boards and investment committees varies with the country of incorporation and the fund. This is confirmed by the respondents' as the fund were different depending on their country of incorporation.

Marrs, Hellebusch and Das (2009) mean that a whole fund approach is the most favorable for the investors. This is confirmed by the respondents who agree and all the funds interviewed had a whole fund approach.

Geltner, Miller, Calyton and Eichholtz (2006) mean that home bias is strong for real estate investors. This is confirmed by the fact all the investors in the Swedish fund were Swedish and all the investors in the Finnish fund were Finnish. It is not supported by the two other funds. However, Geltner, Miller, Calyton and Eichholtz (2006) mean that an efficient way of seeking international exposure could be with a local partner which is supported by ING and Genesta.

Many scholars (Connor and Falzon, 2004; Brounen, Op 't Veld and Raitio, 2007) mean that correlation between publicly traded real estate shares and the stock market is greater than the correlation between direct real estate and the stock market due to investor sentiment. This is supported by the respondents'. In this sense, closed-ended non-listed real estate funds are considered superior to listed real estate shares it is claimed.

The majority of the points put forward by scholars were in line with the general view of the respondents'. However, all were not perceived to be as problematic as claimed by the scholars and many potential problems were mitigated by specific contracts.

The principal benefits of closed-ended real estate funds are access to more niched investments than those available on the public market in most cases; correlation with direct real estate rather than the stock market; access to a more diversified portfolio than through direct real estate in part due to leverage. It is also significantly easier to gain an influential role in a fund as opposed to a listed company as the listed companies' often are significantly larger.

The paper has given the authors valuable insights in the functioning of closed-ended real estate funds. The authors suggest that further research is conducted on the ability of fund managers to deliver alpha in comparison to listed real estate companies, a matter not covered by this paper as a number of funds on the Nordic market have not yet liquidated.

Appendix A. Investment Strategies

Equity investments in real estate can be divided into a few different categories depending on their risk and return ratios. Anson, Hudson-Wilson and Fabozzi (2005), identify three different strategies, core, value-added and opportunistic while McMahan (2006) adds a fourth strategy, enhanced core, or core plus as PERE Connect call it (PERE Connect, 2011).

A. Core

A core strategy is the least risky and its main objective is to generate stable cash flows. This strategy is generally applied in very large portfolios and modern portfolio theory is

used to find an optimal allocation between different property types (Anson et al, 2005). Core properties are often acquired as a foundation in a real estate portfolio while building a larger portfolio. The properties are considered to be low-risk and seasoned with a minimum of 80 % leased to tenants with good credit. No changes are needed in the operation of the property (Brueggeman and Fisher, 2007). Leverage is normally not used and investment returns are usually in the range 8 to 10 % IRR (McMahan, 2006).

B. Enhanced Core - Core Plus

Investing in core plus properties is usually synonymous with investing in core properties that have experienced some sort of problems or properties that are in need of refinancing, redevelopment or reteaming. It can also be consistent with making changes to management or increasing rents or outperforming similar properties in the same submarket (Brueggeman and Fisher, 2007). It could also mean the development of new core properties. Leverage is used in order to “enhance” returns further. Investment returns are normally in the range 10 to 12 % IRR (McMahan, 2006).

C. Value-add

A value-add strategy is a strategy that requires the investor to add some sort of value to the initial investment. This might comprise repositioning properties or it could be new properties that are not fully leased yet. The investors are looking for assets that have experienced some sort of difficulties. The strategy calls for substantive efforts in both leasing and management activities. The use of leverage starts to be rather significant. Value-add investing generate equal amounts of appreciation and cash flows. The investors do not use modern portfolio theory in order to construct a well-diversified portfolio. In fact, the investment strategy tends to have a specific geographical and sectarian focus. Unlike the core strategy, the value-added strategy is limited in time (Anson et al, 2005). Often, a value-added strategy includes properties such as hotels, entertainment complexes, restaurants, business showrooms and factory outlets. Expected investment returns are generally in the range 12 to 15 % IRR (McMahan, 2006).

D. Opportunistic

An opportunistic strategy could be said to be an extreme form of a value-added strategy. It is associated with acquiring properties that are in need of renovation, upgrading, redevelopment or repositioning on the market. The sellers of these properties are normally in some sort of financial distress or difficulty. This means that the investors

can buy the properties at a discount. It is also of importance for management how to renovate, upgrade and/or reposition the property, i.e. the opportunity (Brueggeman and Fisher, 2007).

The opportunities can also arise from sort of disequilibrium in the market that give rise to arbitrage opportunities. However, these opportunities are difficult to find and they require a well-defined exit strategy (McMahan, 2006). Furthermore, it requires significant expertise and funds. Leverage is used extensively and risk is high (Anson, Hudson-Wilson and Fabozzi, 2005). Returns are usually high, sometimes in excess of 20 %, but usually in the high teens (McMahan, 2006).

Appendix B. Questionnaire – Fund

Q1. What are the main advantages and disadvantages of investing in a closed-end fund structure?

Q2. Can you characterize the investors in your fund?

Q3. Some investors claim that influence on management is too low in closed-end funds. What is your view on this?

Q4. Do investors have any “approval rights” over major decisions?

Q5. Agency problems are an inherent problem of non-listed real estate investment vehicles. How are these problems mitigated?

Q6. Some investors claim that the transparency is too low. What is your view of this?

Q7. Some investors claim that management fees are too high for closed-end funds. What is your view on this?

Q8. Is the management fee based on invested capital or committed capital?

Q9. Is carried interest calculated on a deal-by-deal basis or on whole fund basis? What implications might this have on the performance of the fund?

Q10. Some investors claim that liquidity is generally too low for a closed-end real estate fund structure, even lower than for direct real estate. What is your view on this?

Q11. Do you have restrictions on transfers of interest for the investors?

Q12. Can you get the same exposure through a listed real estate company's shares as through a real estate fund structure?

Appendix C. Questionnaire – Investors

Q1. Shortly, can you describe your real estate investments?

Q2. How do you proceed when you want to invest in a real estate fund structure?

Q3. What are the main advantages and disadvantages of investing in a real estate fund structure?

Q4. Closed-ended real estate funds have very low liquidity. Do you think this is a problem?

Q5. Do you think you should have a greater influence on management in the funds you invest in?

Q6. Do you think that transparency is too low?

Q7. How do you know that management act in the best interest of the investors?

Q8. What is your opinion on management fees? Is the level acceptable?

Q9. Do you know if carried interest is calculated on a “deal-by-deal” basis or on a “whole fund” basis? Do you perceive this as important?

Q10. Can you not get the same exposure through listed real estate companies as through unlisted fund structures?

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