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The Growth of Private Property Vehicles in the UK: Causes and Conditions

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Introduction

The UK private indirect real estate market has seen a rapid growth in the last seven years. The gross asset value (GAV) of the private property vehicle (PPV) market has about tripled from a GAV of £22.6bn in 1998 to a GAV of £67.1 billion at the end of 2005 (OPC, 2006). Although this trend of growing syndication of real estate is not only a UK phenomenon, the rate of growth has been significantly faster in the UK. For example the German open-ended funds[1] have grown over the same period from €50.4bn to €85.1bn (BVI, 2006). In the US the market capitalization of equity real estate investment trusts (REIT) has grown 155% since 1999 to US$ 301bn (NAREIT, 2006)[i]. Each jurisdiction is offering different formats to invest indirectly into real estate but at the core all these vehicles are the same in that they provide a different route for investors to access real estate. In the UK, although the range of 'products' is now quite diverse, all structures have in common the 'wrapping' of property assets into a multi-investor vehicle. This paper examines the nature, pattern and process of market growth in PPVs and constructs a series of associations between causes and effects to explain this market shift.

Research Approach

Attempting to explain this rapid expansion in PPVs that has occurred over the last decade raises some fundamentally complex issues about causality; a tricky and unsatisfactory word according to Milton Friedman (cited in Hammond, 1992). When dealing with explanation in the context of a specific event in the past or a case study, there are distinctions that have to be made between various types of causal factors. A number of difficult explanatory distinctions need to be drawn.

- To what extent can a causal variable be identified as a necessary condition relative to a contributory factor? Additionally, to what degree are some necessary conditions trivial?

- Whether the explanatory variables are necessary conditions or contributory factors, how much weight should be given to structural and contextual factors relative to catalysts such as organisational agency and events?

- To what extent was the observed shift incremental or is it possible to identify a substantial departure from previous trends?

[1] Including both retail and institutional funds.

- Was the observed shift over-determined or was it a product of unique confluence of circumstances?

Although it is not possible to answer these questions with certainty in explaining the growth the PPV sector, they help to identify approaches to enquiry and generate a series of sub-questions illustrating the different aspects to causality.

- Why and when did certain types of property investors decide to create PPVs?
- What were (are) the important benefits of PPVs relative to direct property acquisition?
- Is it possible to identify specific 'catalysts' that triggered the observed changes?
- Is it possible to identify changes in market structures that caused or facilitated a market shift?
- Did similar changes happen in other markets around the same time?

The coincidence of other market changes with the growth of PPVs raises the potential pitfall of the *post hoc* fallacy. There are problems in assessing whether market changes were coincident and 'shadowed' the shift or whether they actually influenced changes in the PPV sector.

The remainder of this paper is organised as follows. In the first section, the timing and extent of this market shift is analysed in the context of the change in real estate and other capital markets. This is followed by a review of the limited literature on the growth of PPVs. We then outline the results of an interview survey of market participants who were asked to comment on the reasons for the growth of the sector. Finally, we report the results of a questionnaire survey that identifies the key benefits of PPVs relative to direct property investment.

The Growth of PPVs: Background and Context

An often overlooked feature of the PPV sector is the range of vehicles. In the UK this investment route in the UK is generally undertaken through employing one of three legal formats: partnerships, unit trusts or companies [ii]. Broadly speaking, the range of formats can be seen as lying on a continuum in terms of size, trading volume, number of investors and regulatory framework (see Figure 1 for a schematic representation).

Figure 1 The Range of Private Property Vehicles

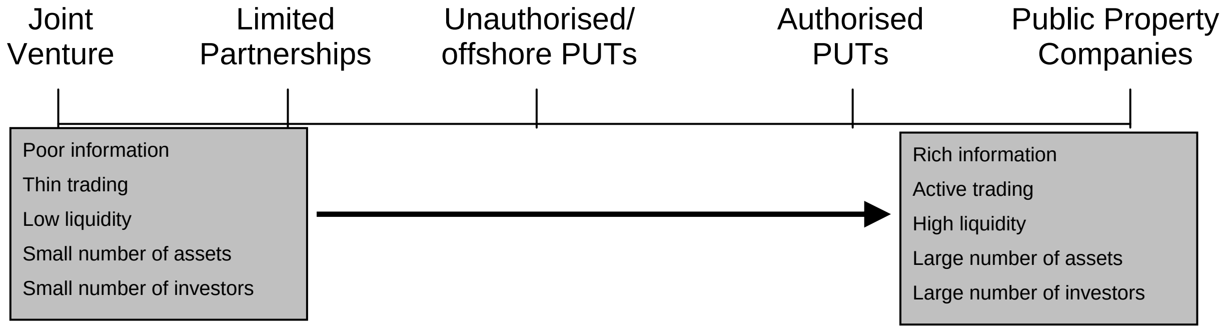


Figure 1 shows that the vehicles can range from joint ventures - vehicles with two or three investors pooling capital and expertise for a fixed period to acquire a clearly defined asset base - towards open-ended property funds with a high proportion of retail investors and a large portfolio of assets (in value and number). While joint ventures are normally customised towards specific investor needs, retail property funds can be highly regulated to decrease investor risk and, as a result, have relatively homogenised formats. These differences make it difficult to generalise about the investment qualities of PPVs.

Nonetheless, it is clear that an investment in PPVs will have different characteristics relative to a direct acquisition of the underlying property assets. These characteristics may be perceived as both negative and positive. Relative to direct ownership, there are significant differences in liquidity, trading and price formation, search costs, financial structuring, holding costs, management control, lot size, taxation and transaction costs *inter alia*. However, just as importantly, there will be significant inter-vehicle differences in all the qualities listed above. Later we discuss in more depth the characteristics of PPVs relative to direct investments and evaluate their advantages and disadvantages.

Research on private property vehicles is limited. However, Oxford Property Consultants undertook research in this field seeking the views of investors, managers and advisors within the market in 2001.[2] Their research was conducted just after the market had begun to grow and provides a useful contemporary snapshot of the views of market participants. Drawing upon an interview survey, OPC (2001) found that this structure is attractive to institutional investors due to their unregulated status and high level of flexibility to meet investor needs. In addition, tax transparency and the ability to gear (circumventing restrictions investors might be subject to in direct investment) seem to be positive characteristics of the structure. Other key advantages of PPVs cited were access to management expertise and access to projects that usually exceed the capital constraints of the investors. Further, the alignment of interests

[2]The research report generally identifies the views of the three groups: advisors, investors and managers separately and then identifies market consensus. The review here given will focus on these consensus statements. Readers who are interested in the opinions of single groups should refer directly to the report.

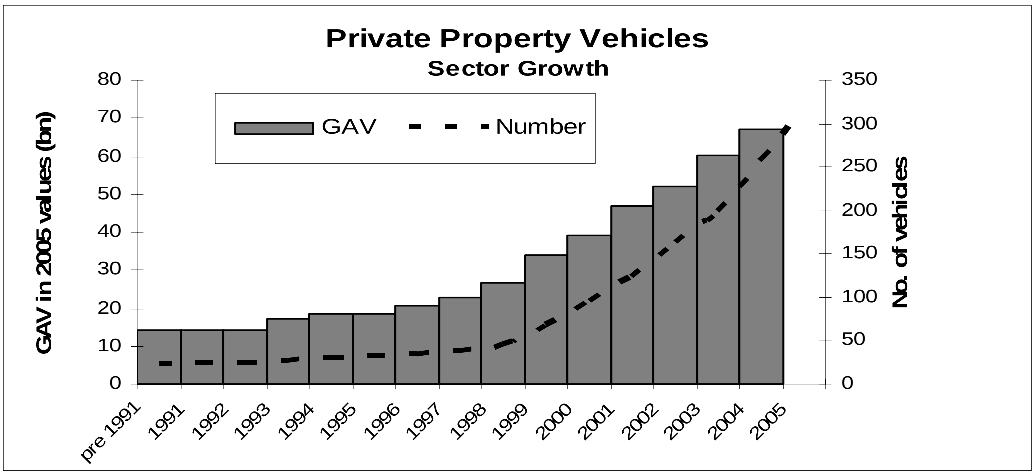
with the manager[3], the transparency of information and the possibility to access gearing[4] were mentioned as being advantageous in comparison to direct investments. However, as we discuss in depth below, the vehicles had the potential to offer such benefits prior to 1999.

A key issue in analysing causation in the growth of PPVs is the timing of this growth. Overleaf, we present time series data on the size of the PPV sector in the UK in terms of Gross Asset Value (in 2005 values) and number of funds launched. Figure 2 illustrates that the growth has been dramatic since 1999. The years 1998 and 1999 seem to mark a significant departure. Although the number of funds launched in 1998 was small compared to subsequent years, it was the first notable increase. More significantly, decisions to launch many of the funds in 1999 were almost certainly taken in 1998. It is interesting that the initial stage of rapid growth in the PPV sector was not associated with a downturn in the equity market. The FTSE All Share index delivered returns of 13.8% and 24.2% in 1998 and 1999 respectively. It was in 2000 that the stock market correction began to take place and in 2001 and 2002 when the major falls took place. Bearing in mind the lag between fund launch and conception, it is difficult to attribute the 'take off' of this sector to the weak performance of equities, although it may have increased demand for PPVs subsequently.

However, there is an association between institutional enthusiasm for real estate and the growth of the PPV sector. As Figure 4 illustrates, the period 1997-2000 saw a marked increase in institutional net investment in real estate. Whilst, there were periods of institutional 'hunger' for real estate assets in the past that were not associated with the growth of PPVs, it is reasonable to suggest that this demand for real estate would have meant that the market was more receptive to this type of innovation. Moreover, around the same period there were other market changes that would have made property investors more interested in new types of property investment products.

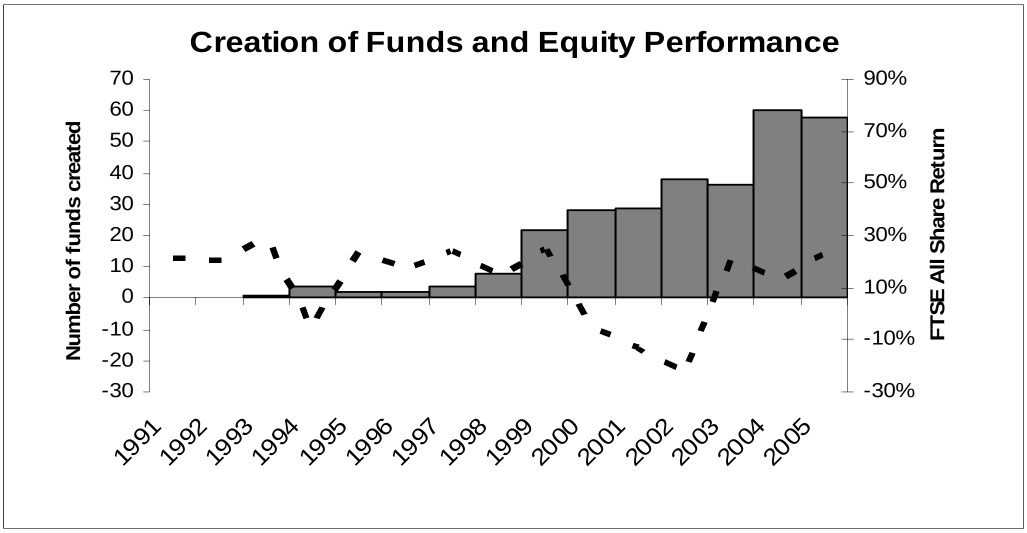
[3] Which can be achieved through either co-investment or performance related remuneration.
[4] This is mainly the case for pension funds which are often restricted in the trustee treaty to use gearing in their direct property portfolio.

Figure 2



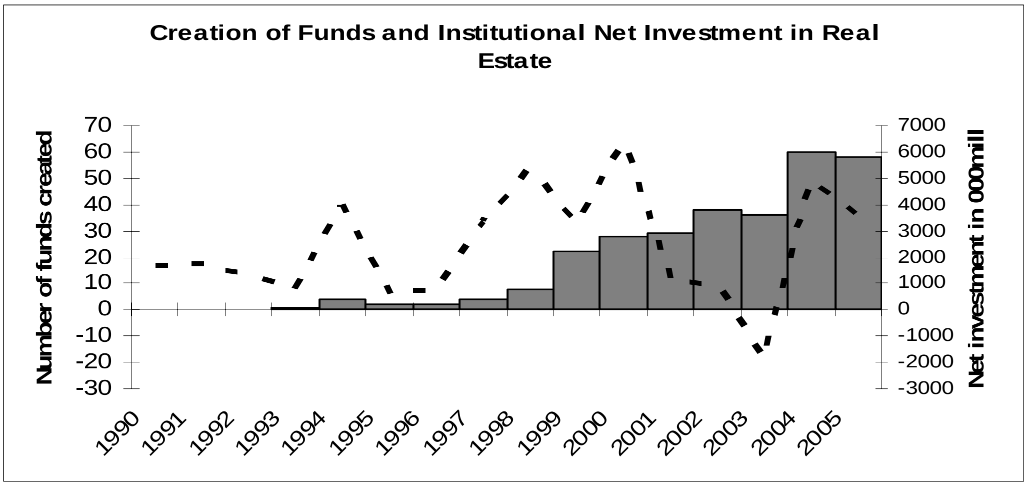
Source: OPC 2006

Figure 3



Source: OPC 2006, Datastream

Figure 4



Source: OPC 2006, IPD

The growth of PPVs was part of a much broader shift in the commercial property investment sector. The 1990s were a period of financial innovation in the application of new financing techniques to the UK commercial property market so that, in 2001, Lizieri, Ward and Lee were able to argue

> "..a breed of finance-led property professionals have emerged in the UK, less influenced by the "all-risk yield" than a concern for total returns and cash-flow-generated performance" (Lizieri *et al*, 2001, 53)

In addition to the emergence of the corporate outsourcing sector, they identified a range of innovations including; increased use of asset and mortgage backed securitisation, the development of property derivative products, new forms of sale and leaseback and off-balance sheet structures and growth of limited partnerships and special purpose (offshore) vehicles. Consequently, a potential (contributory) factor in explaining why investors and fund creators were receptive to new types of property investment products was ideational change in the commercial property market.

The growth of PPVs was also associated with a change in the roles of pension funds and life insurance companies. The two decades prior to the growth of PPVs saw dramatic growth in the assets of pension funds, life assurance companies and, particularly, investment companies (OECD, 1997); many of which were attempting to provide fund management services. Financial deregulation and liberalisation, technological innovation and disintermediation in the banking sector were significant drivers of the increased blurring of functional boundaries in the financial services sector as banks moved into fund management, life assurance companies provided banking services (and vice versa) and pension funds, banks and life assurance companies entered the independent fund management services sector. As a result one possible cause or contributory factor to the growth of PPVs from the supply perspective was the pressures generated by the restructuring of the 'traditional' life assurance and pension funds.

During this period, property companies were under pressure to be seen to be more innovative as the performance of the quoted property sector had been perceived as poor. Property companies in the UK had been trading at large discounts to Net Asset Values averaging at 28% between 1999 and 2003 (Morri, McAllister and Ward, 2005). Criticism focussed on the high management costs associated with the sector relative to direct investors and the lack of added value. They were labelled 'value destroyers'. John Plender was in tune with a body of opinion when he stated in 2001 that

> "Quoted companies are much more risky than direct property investment, yet they have offered historical returns no higher than the ungeared raw material of land, bricks and mortar. The conclusion must be that, on average, corporate investors in property have been lousy financial managers." (Plender, 2001, p. 23)

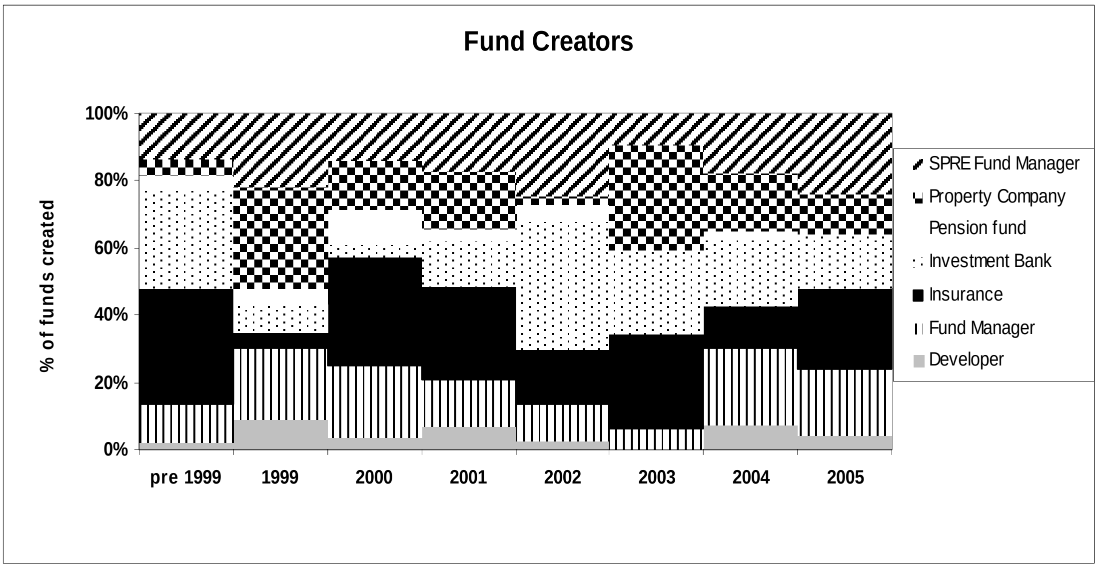
As a result of the pressure to improve performance, a number of property companies attempted to generate additional income streams from asset management.

In Figure 5, we examine suppliers of PPVs and classify them according to their core business. Whilst traditional life insurance companies (59 out of a total of 258) and property companies (39) have been the largest creators of funds, it is clear that they did not create the majority of funds. Overall life insurance companies account for just over 20% of the funds created and are the largest single group. However, there are three other large groups that have created significant numbers of funds; investment banks (54), independent fund management groups (40) and specialist real estate advisors (45).

It is difficult to argue that the change in the nature of the life insurance and property companies was a necessary condition for the growth of the sector. They did not create the majority of funds. A more logical explanation is that life insurance and property companies were exploiting the business opportunity created by the demand for the vehicles in the same way as investment banks, fund management companies and real estate advisors. However, the fact that many of advisors and managers for pension funds were also creating the vehicles is likely to have influenced the rate of sector growth.

Below we analyse the results of a set of interview and questionnaire surveys in order to further assess the key drivers of the growth of the PPV sector.

Figure 5



Source: Data provided by OPC[5]

[5] The PPV data used in the analysis was provided by Oxford Property Consultants. OPC is the leading data provider for indirect data in the UK offering information on vehicles, managers, investors and advisors. The data we used was an aggregate set of data for the UK growth and number of vehicles and a list of launch years and manager names

RESEARCH METHODOLOGY

As noted above, the research uses a range of approaches to investigate the range of causal factors in the market growth of PPVs. The aim of the qualitative research in this context was not to test the validity of pre-conceived hypotheses about the topic. Rather it is mainly concerned with discovery about processes and motivations. Given that there is a limited literature on the operation of the market in PPVs, our approach was to investigate in an explorative manner a number of issues about the development of PPVs. As themes emerged from our initial interviews, subsequent interviews had modified structures.

Disaggregation of results by respondent type is not appropriate given the lack of standardised research instrument, the small sample size by number and the range of experience of the respondents. The individuals within this sample frame represent, in the view of the researchers, a very substantial sub-set of the investment community available from UK-based organizations.[6] Our interview sample, although categorised as currently being attached to a type of organisation, had often gained their experience in a range of organisations. The sample is too small to render any attempt at measuring statistically significant differences. Further, given the open-ended and evolving nature of the interviews and the diversity of experience of the participants, any attempt to quantify differences would at best have limited relevance. Where we have used a standardised research instrument (the questionnaire), we report the results.

One technique chosen for data collection was semi-structured interviews. Nineteen interviews, each approximately one hour long, were conducted with individuals who were either responsible for the creation and/or investment in PPVs. We present the results of the interviews through quotations. The use of quotations is a commonly accepted method of presenting the research data in interview-based research. The interview transcripts are the research data.

The interviews were guided by a common question framework that had been developed from the researchers' prior knowledge of the subject and from the review of the literature. The purpose of this framework was to ensure that, as far as possible, the data collection focused on the specific area of research interest, both across the sample and in relation to each respondent. The authors acknowledge that by controlling most of the interview agenda[7] this approach involves a potential compromise between generalizability and discovery. This is

currently in the PP-UK product, which we in the following categorized to allow us an analysis of the supply side of the PPV market.

[6] According to OPC the assets under management of the participating investors and managers encompasses 59.5bn assets under management, which represents 40.46% of the IPD Index in 2005.

[7] i.e. By excluding an invitation to talk about things which interviewees may have wished to talk about, but which were not prompted by the framework.

not, however, regarded as a significant problem in the study and is mitigated by the interviewees having been invited, at the end of the interview, to discuss any other issues not prompted by the interviewers' question framework. Two researchers were present at all but two of the interviews. In order to facilitate reflection upon and analysis of the interview data, all interviews were, with the agreement of the interviewees, recorded and subsequently transcribed.

In addition, we use an Analytic Hierarchy Process (AHP) methodology to attempt to measure quantitatively the relative importance of various factors. This is discussed in detail later.

Sample

The 19 interviewees[8] all had current or prior active involvement in the indirect property investment market for limited partnerships, which means that non-investors were excluded from the sample. Data provided by Oxford Property Consultants showed that many investors seek external investment advice from professional advisors, which were therefore included in the sample. The majority of advisors are also actively managing their own vehicles and/or actively investing their own money into indirect structures. Non-investors are difficult to identify and their exclusion from the sample suggests that it may be positively biased towards benefits of investment in private vehicles. However, the sector is still in its development phase and non-investors might not necessarily have taken an active step to refuse investment in this sector. The interviews were mainly held during the months of March, April and May in 2005. A summary of the main interview findings and the results of a paper based questionnaire which the participants were asked to fill in are reported below.

[8] 19 is a good sample considering the concentration of vehicle and capital managers in the market. OPC reports in their statistics 42 capital manager and 88 vehicle managers with a high percentage of overlap between the two categories (OPC, March, 2005). The sample focussed on the largest managers.

RESULTS 1 – INTERVIEW SURVEY

Interview Findings

In this section we draw upon the transcripts of the semi-structured interviews to analyse market perceptions of the development of the PPV sector. We approach this topic from several directions trying to follow the patterns used earlier to analyse possible triggers for the market growth. Asking participants why the market took off they mostly dated the growth in the latter half of the 1990s with rapid expansions in 2000/2001, which is similar to the conclusions we were able to draw from Figures 2-4. Even though Figure 3 shows that the market growth of the PPV sector preceded the decline in the equity market there seems to be a perception in the market that links the two events.

"It really took off when the stock market crashed. People started to create more vehicles and we did our retail warehouse fund in the course of 2000, 2001."
Fund Manager in Fund Management Organisation

"Why did it change? Well, definitely the stock market. The volatility and the reality that equities are not a one way bet, there is a risk attached to it. Putting all your eggs in one basket, which appears that most pension funds in the UK with 70%-80% learnt a very harsh lesson that diversification into other asset classes is much more important than anybody really perceived in the past."
Institutional Fund Manager

"It really grew very strongly in the 1999/2000 and then it slowed off a lot. I think the market has changed in lots of different ways since the late 1990s and there have been lots of contributory factors to why LPs have become increasingly popular as a vehicle and there is no one particular reason for it."
Fund Manager in Property Advisory Firm

After having determined when the market took off we were interested in drivers of both the supply and the demand side. Whilst the rationale for partial interests in large property assets and portfolios is relatively well documented in the literature, there has been less analysis of the rationale underpinning the supply of vehicles. Figure 5 indicated that a diverse range of creators has been launching these products which seem to have a common motivation of building a fee generating business. However different groups of vehicle creators have to cope with different pressures. Insurance companies, which we identified as having created the largest number of funds, seem to be driven by pressure to liquidate from shrinking with-profit-funds and new FSA regulations as well as the expansion of their asset management subsidiary through third party fund management.

"One of the other reasons is trying to hang on to the management of those assets so you are collecting fee for managing the assets meanwhile you are reducing the life companies exposure."
Head of Property of Life Insurance Company

"But in terms of DELETED and the other life companies and their dialogue ongoing over the last couple of years with the FSA. There are a number of tests that they now have to place on their with-profits-funds…the regulator seems to quite like getting property in with-profits-funds in unitised or more liquid vehicles"
Fund Manager of Life Insurance Company

"The other thing is that with-profits-policies are not being sold anymore. ... So the obvious solution because we are the asset management subsidiary and our business is to sell investment management services and make fund management fees, is to take these assets and ask our big friendly client whether they would mind if we did that and unitise them… but we get to retain the management of these high quality assets and get the fund management fees from it."
Fund Manager of Life Insurance Company

"The life companies have had changes in the liability profile and that made them come out of certain asset classes and especially property. They have to shift their asset mix since property is a non-qualifying asset. So they have to get out of property and also want to generate revenues, through putting them into a vehicle."
Fund Manager for Life Insurance Company

"Also at the same time you could see big life fund managers and mandates change. In the mid 90s late 90s were looking after their own life funds. For example Norwich Union Fund Management was looking after Norwich Union Life fund and his job was to look after that fund and make sure it performed as well as it could. Then we have series of mergers and the next thing we know is that Morley the new branded fund manager has a very different mandate to the old Norwich Union Fund Manager. Their job is to grow third party funds under management, create a successful business in their own right, not just coming to work every morning looking after the Norwich Union Life fund that is not what they are about. So that calls upon a much more entrepreneurial environment for these fund managers to operate in and that has led to them seeking opportunities with their very large cheques books to create opportunities for themselves."
Investment Advisor in Property Advisory Firm

Around the same time property companies, which were trading at large discounts to their underlying net asset value and therefore were performing poorly in comparison to the other sectors in the equity markets, were looking for new ways to add value for their shareholders. However, rather than simply stressing the fee generation potential, this investment advisor stressed the importance of corporate market re-positioning and rebranding.

"They would go to the big property companies, who themselves were going through their own change; I mean we saw Capital & Regional and Pillar redefining their own purposes from an asset owning property company to a manager of asset and as soon as they had decided this was the route to go and that was the route the shareholders wanted them to go the sooner they got on with it the better. That change is huge and if you replicate that for the other life funds and what they have done is that they have teamed up with the property companies and lot of these assets that were held in public vehicles are now held in private vehicles, managed by the life fund manager. These vehicles have been the vehicles of choice through which to achieve the ambitions."
Investment Advisor in Property Advisory Firm

"It suited both parties; both firms came out in a better position then previously. It was not driven purely by the investment managers wanting fees, it was partly driven by the mandate change described, partly by the asset managers, property companies no longer wanted to be properly valued as asset owning public companies, driving themselves towards services sector businesses.… Fees were a by-product for something that actually that met both the objective of the fund management houses and the property companies. Property companies were trading at a big discount. It was all dot com, property in the context of at that time glamour stocks, property was just way of scale. The way the assets were abandoned was no way that this would generate the necessary excitement to compete with the other parts of the market. They were trading at a average discount at around 30%."
Investment Advisor in Property Advisory Firm

"Off the back of that, what you then found was that a lot of the property companies, probably C&R one of the best examples- probably by a long way in some way, took the view of what is the point of actually trying to buy and own assets on balance sheet, we could actually earn considerably more fees on a consistent basis by being a fund manager."

Head of Property in Investment Bank

On the supply side both insurance companies and property companies seeded funds with their own stock to reduce their exposure and at the same time retaining control over the assets and earning third party fees. But what were the drivers of the demand side. Why did investor choose to buy participations in indirect vehicles rather than buying directly? From the interviews four themes emerged: access to prime assets, access to specialist management, gearing and tax transparency.

Given the lumpy nature of property it is difficult for capital constrained investors to diversify their portfolio sufficiently, especially into sectors such as shopping centres or London offices. The possibility of decreasing the investment necessary and therefore the possibility to access prime assets, which in turn allows for more diversification and a decrease in exposure to specific risk of the properties, has certainly been one of the strongest drivers in the growth of the PPV sector.

"*They have grown principally because the weighting to real estate has gone up with a lot of pension funds and it has become increasingly difficult to buy direct and they presented another way of getting money into the market and certainly some of the smaller pension funds who either had property and divested it or had an amount of property that was too small to avoid specific risk.*"
Investment Advisor

"*Indirect obviously enables people to have an interesting commercial property without owning the whole asset.*"
Fund Manager of Investment Management Company

"*Very, very quickly the simple reason why people are in these is that they provide the opportunity to get into something big like a shopping centre which you might not be able to do as a small fund or to buy in expertise you might not have like messy industrial estates around the country.*"
Fund Manager in Investment Advisory Firm

"*The situation on that was that it is going back probably five years now, at that time we certainly weren't big enough to buy a shopping centre on our own and difficult to get access to that and we didn't have any resources at the time and this seemed to be an obvious route to get exposure to this area of the market, obviously a prime product.*"
Fund Manager of Insurance Company

"*I think it started, I suppose you are talking my first experience late 1990s, 1996, 1997, it was really for investors to spread the risk and to get investors into a product which perhaps they could themselves access. Some small pension funds couldn't get exposure to City offices, shopping centres etc., which they are such a size that they couldn't go and buy the single assets themselves.*"
Fund Manager with Insurance Company

"*…that is primarily to gain access to some of the larger lot sizes, so Central London offices, retail warehouses where they just don't have the necessary capital to buy directly or even if they can buy directly they can't diversify between centres or between assets.*"
Pension Fund Advisor in Fund Management Firm

"*I think a strong investment market and a shortage of product has been the backdrop really from the late 90s through to now. And that really had a big impact with institutions have been struggling to get hold of the stock.*"

Investment Advisor in Property Advisory Firm

"I would add to that you are able to spread your risk. As well as getting access to large assets such as Bluewater, which we have exposure to, that is unique but you can invest the same amount of money but get a spread of investments."
Fund Manager in Insurance Company

In close connection to the access of assets is the access to specialist management. Especially bigger institutions, which are able to diversify their portfolio in their own right, often use vehicles to access either specialist sectors or management intensive sectors for which they don't have the knowledge or management base.

I think the original reason was that some sort of vehicle enabled an investor to access either a specialist sector or a specialist set of skills that they weren't able to do directly."
Investment Advisor

"*They will only invest into vehicles when they really don't have the expertise in-house and that might be something like residential where you have thousands of units and they are so time consuming and labour intensive, so they will potentially outsource that to a fund. Or something like urban regeneration, where it is down to the management team to deal with local authorities. Different organizations where the chances are they cannot get that management expertise in-house.*"
Pension Fund Advisor in Fund Management Firm

"I think it enables institutions to take a stake into asset for which they might not have the appetite for 100%. It enables them to actually stand back from the direct management of those assets and expense and the issues around them."
Fund Manager in Insurance Company

"… were set up because either they required very specialist management, which you couldn't get from a single manager or in-house or the asset were so large that there is significant specific risk of identifying individual assets. So these were set up both to have expert management and although to be able to provide access to assets, which the perception is that they perform well, but you wouldn't invest in them as one pension fund because you either couldn't buy them they were too large or if you did they were too a significant proportion of your portfolio"
Head of Property with Investment Bank

"To invest in shopping centres, City office buildings, where the specific risk of assets is very high, or the number of assets is very low."
Fund Manager for Life Company

A further attraction of vehicles is the ability to gear. Pension funds are often restricted in employing debt in their direct property portfolio. Since this does not apply to investments into leveraged firms like limited partnerships, investors can therefore take part in geared returns through indirect investments. However, it was clear that gearing was difficult to pin down as an advantage since it added 'non-real estate' performance and increased risk (contingent upon the level of gearing).

"In the particular proposition in the West End we did have gearing on that. Potentially it would be of interest geared on the right product, geared on the right asset. As a general rule we can't gear up it has to be done indirectly so that is why we moved to using this SPV vehicle but as a life fund company we can't gear."
Fund Manager in Insurance Company

"I can be either. Gearing in terms of good performance gearing is positive, but if you get terms of underperformance gearing can hit you just as hard on the other side of the equation."
Fund Manager in Insurance Company

"Risk through gearing I don't think that is so relevant. If the manager is prudent, which is why you would invest. You wouldn't invest into a geared manager if you didn't want gearing and if you want gearing you are accepting gearing. The manager has a duty to be prudent with the gearing..."
Investment Advisor in Property Advisory Firm

"You had a number of institutions and even today that within their direct portfolio do not allow gearing for constitutional, risk whatever reasons it may be. But actually if the invest 5% of their fund into a LP and the LP is geared that is does not give them problem. So slightly cynically, what you would find is that the ultimate clients down there, who were thinking "I would really love to gear my portfolio because I think it is the right thing to do because I can't since I have this hierarchy of trustees, were actually saying' oh well that is fine we go through that route' "
Investment Manager in Investment Bank

"Obviously gearing is a double-edged swordt, it is fine when it is going up but once it is going down it double hits you. And obviously managers at the moment don't think it adding that much. It is an extra risk."
Capital Manager in Investment Management Firm

"Investor specific. Quiet a few pension funds don't like gearing because it increases their exposure towards "bonds" instead of real estate. Others like it because they see potential for an enhancement of profit and others think that it introduces volatility."
Business Development Manager in Investment Bank

"Pension funds don't like borrowing on their own account, because this exposes the fund to banking governance, so they prefer to do it through vehicles where they have no direct responsibility. There is a limited liability aspect, they are not overexposed, they go into a geared vehicle with the opportunity of getting a higher rate of return but the downside is covered so if the thing falls apart they are not damaged."
Fund Manager in Insurance Company

One of the big problems listed property companies had is the double taxation issue. Property companies are taxed on a corporate level as well as an investor level. This is obviously tax inefficient for property investors. Furthermore is it a prerequisite for a liquid investment structure that the costs of trading are low.

"At the time it was the sort of most tax efficient way of dealing with it…and I think there was a desire at the time to have a part ownership structure that was UK based and I think that has gradually gone away over the years…because I suspect that they (Limited Partnerships) are on the way out, because they are now not efficient Stamp Duty wise."
Fund Manager of Investment Management Company

"At that time that was the only vehicle that was available for a wide range of investors that was as tax transparent as you could get. So basically that was why it took off."
Fund Manager of Life Insurance Company

One comment summed up the importance of tax transparency as a *sine qua non* of the development of the sector.

"If tax efficiency does not work, an investor won't do it. So it is the most important issue but it is almost not an issue because it doesn't even come into the analysis. If we invest the first thing we do is to get a sign off of the tax before we start any due diligence. If you don't get a tick in the box there is no point in doing it."
Investment Advisor in Property Advisory Firm

Given changes in the 2004 Stamp Duty Land Tax regime has increased the trading costs for LPs considerably, which initiated a move to offshore structures. This move is underpinning the importance of tax transparency.

"For example the Standard Region Retail Parks Partnership, which has been set up in 1999, has just been pushed offshore into a JPUT and a number of others have followed suit and Henderson have done the same with all of theirs. And that is simply because LPs in the UK are just not tax efficient anymore"
Fund Manager of Investment Management Company

"Because they are not tax efficient anymore. People don't want UK domiciled vehicles and as I understand it LPs units are now not void of Stamp Duty when they are traded. Tax is obviously the vehicle marking factor, selling up these structures and if they don't avoid this tax then why place them when there are more efficient vehicles around there."
Fund Manager of Investment Management Company

"The reason they have all gone is stamp duty and there(OFFSHORE) is no other reason for them to go there. I don't think they added anymore liquidity because for most of them their strategy is not to be widely diversified by unit holder base, maybe they change some might develop like that. Their first step was a stamp duty law change that forced them into it."
Fund Manager in Property Advisory Firm

When examining the growth of the market it is important to also note on the structure of the market. While we have seen that limited partnerships have been the vehicle of choice for many years, the introduction of SDLT on trades of partnership units has changed the structure of the market. LPs have moved offshore or have created offshore feeder funds. In March 2006 the UK Budget finally announced the introduction of UK real investment trusts after two years of uncertainty for the market. Given that our interviews have been conducted in the first half of 2005 this uncertainty is still the overriding issues. However opinions on the introduction and the success of REITs as a structure were often questioned. Another trend that received some attention from the industry is the emergence of fund of funds.

"What has been growing significantly over the last three or four years is the fund of funds approach, which in some instances has include LP interests. This as a way forward in terms of indirect investment; I think that they will be growing significantly and the people instead of having as they had seven or eight years ago 80% in direct and 20% in indirect holdings, the core satellite approach, it will go either one way or the other and those who can afford to do so will buy directly. Where as eight or nine years ago you used to have a minimum investment of 50m to have a diverse property portfolio direct it is now over a 100 or 150m. Anything below that people are now going to increasingly to a fund of funds approach."
Fund Manager of Investment Management Company

"The new structures, the REITs and PUTs, will have more of a leaning towards the retail type products. But there will still be a role for LPs for informed professional investor, smaller in number, who want to own property jointly."
Fund Manager in Insurance Company

"Where do you see fund of funds?
I think that is the way they will access it… That is where the fund of funds manager has an advantage over an investment consultancy company. They have the knowledge of the sectors, of the properties and they have researched these funds to back up their fund of fund product."
Investment Advisor in Property Advisory Firm

"There are two levels of answer. One is our view of life and the second is how we think it will affect our specific business. And we are very much part of the industry and yes we think this is a very positive

thing to happen and I'm sure it is. But when you get down to our part of the business you know we are running private vehicles, unlisted vehicles and from our point of view it is quiet hard to see what the incentive is to convert the structure we have now into a REIT as imperfect as they might be"
Fund Manager in Private Property Company

"That could well be the scenario but then you might have the whole thing with REITs come on board. There is devil is in the detail yet with REITs, it got o good press from the budget but it is still two bottoms down on what is going to happen."
Capital Manager in Investment Management Firm

Below, we analyse the results of a questionnaire survey in order to measure the relative importance of the various drivers of the growth of the sector.

RESULTS 2 – QUESTIONNAIRE SURVEY

As we have seen above, respondents explained the growth of PPVs as a function of their benefits relative to direct real estate investment. However, the characteristics (e.g. access to specialist management and specific assets) were not new. The main characteristics of the vehicles did not change significantly in 1999-2000. However, for growth to take place it was a necessary condition that for a significant group of investors that the advantages should outweigh the disadvantages of this investment route. In terms of explaining the growth of the vehicles, this was a trivial necessary condition[9] in the sense that it involves a relatively constant set of features. Yet this is not to argue that these factors are trivial in the conventional sense. Using a common, possibly overly simplistic, metaphor from historical explanation, these vehicle characteristics created a powder keg that required a spark. More fundamentally and, perhaps more speculatively, although the attributes themselves may have been constant, the relative importance attributed to them may have changed in 1999-2000.

In order to explain more fully the attractions of this investment route and hence its growth, we evaluate the relative contribution of the various attributes of PPVs with particular reference to Limited Partnerships relative to direct real estate investment. Following the interviews discussed above, respondents were asked to complete a questionnaire which focussed on their perceptions of the most important (both negative and positive) attributes of PPVs. As noted above, the method selected was an AHP approach. Partovi and Burton (1993) described the methodology as a simple three-step process:

1. Description of the decision problem in form of a hierarchy, through the identification of decision criteria and sub criteria.
2. Calculation of the relative weights of the decision criteria on each level of the hierarchy using pair-wise comparison of the criteria.
3. Development of a decision model through the integration of the relative importance of the criteria.

The first step was, therefore, the identification of factors and sub-factors. These are based on the literature review, as well as pilot interviews with experts in the industry. A full list of the factors and their description can be found in Appendix 2. The factors are split into four categories:

[9] When completing the questionnaire, a small number of respondents implicitly recognised the difficulties associated with this issue. For instance, when completing the questionnaire, they pointed out that, although certain points were relatively unimportant compared to others, they were a *sine qua non* of the growth of the sector.

- o Benefits associated with investing in private vehicles (access to specialist management, tax efficiency, ability to gear, access to assets),

- o Benefits associated with the LP structure itself (limited liability, fixed life span, interest alignment, presence of co-investors),

- o Costs associated with reduced liquidity (pre-emption rights, limited secondary market, effects of limited lifespan, market price uncertainty)

- o Additional costs associated with LP structure (complexity of structure, fees, gearing risk, performance measurement uncertainty, potential conflict with co-owners)

In a second step, the relative importance of the factors is assessed. Respondents were asked to make pair-wise comparisons of the factors and rate them on a scale of 1-5. The scale ran from 2 “slightly more important” increasing to 5 “completely dominates”; 1 indicated equal importance.

The final step was the analysis of the questionnaires using the Expert Choice 11 software, which calculates the relative importance as a percentage. By evaluating the factors and sub-factors, a hierarchy of the sub-factors could be produced taking into consideration the relative importance of both levels. A fuller explanation is provided in Appendix 1.

Given the rapid market growth of this sector, it is anticipated that the advantages will be perceived to outweigh the disadvantages. As a result, the main contribution is expected to be an evaluation of the relative importance of the various advantages and disadvantages specified. The results of the comparison process are displayed in Table 1. As expected, a clear-cut finding is that respondents perceived that at the time of response the investment benefits of PPVs significantly outweighed the costs associated with this approach to property investment. This result was anticipated and it is unlikely that the market would have grown at the rate that it has if investors did not view the vehicles as offering significant advantages relative to direct investment.

More specifically, it is the fact that the vehicles offered investors the ability to access both particular assets and specialist management that seemed to be the key attractions driving this growth. For investors excluded from sectors such as shopping centres, retail warehouse parks and ‘trophy’ office developments due to problems of lot size and specific risk, private vehicles offered an attractive option. Ability to gear and tax efficiency remain important in the overall context, but are dominated as investment benefits by the access to specific assets at the right lot size and specialist management.

Clearly, the effects of these variables will be contingent upon the perceived quality of the management and the nature of the underlying assets. The key benefit for investors in terms of the vehicle structure was the ability to align the interests of the manager and the investor. This is typically facilitated by co-investment and performance-related fee structures. One source of major concern in the market still was the liquidity of this type of vestment. After investment benefits, liquidity costs were the second most important group of factors. Within this group, lack of secondary market trading was the most important aspect of lack of liquidity. Although participants often argued that the current market allows for fast execution of fractional interest sales, they questioned the marketability of such interests in a market downturn. This implies that investors are aware that liquidity is closely linked to market conditions. As suggested earlier, liquidity (ability to exit at fair value) varies cross-sectionally between various interests and structures and will change at an aggregate level over time.

Compared to liquidity-related issues, the other costs associated with the LP structure were regarded as less important. In the interviews, management fees were often raised by market participants are a source of friction between managers and investors. .

Table 1: Relative importance of valuation criteria

Factor	Weight	Subfactor	Weight
Investment benefit	47.21%		
		Access to specialist management	29.42%
		Access to specific asset	29.01%
		Tax efficiency	23.37%
		Ability to gear	18.22%
Liquidity Costs	19.30%		
		Limited secondary market trading	36.18%
		Liquidity effects of limited life span	23.70%
		Market price uncertainty	20.55%
		Pre-emption rights	19.58%
Positive aspects of LP structure	18.83%		
		Interest alignment with manager	37.92%
		Limited Liability	30.14%
		Presence of co-investor	22.17%
		Fixed life span	9.76%
Other costs of LP structure	14.65%		
		Management fees	32.78%
		Risk through gearing	25.68%
		Potential for conflict	20.68%
		Performance uncertainty	10.89%
		Complexity of LP Structure	9.98%
Total	100.00%		

Interestingly, the ability of high gearing to change the performance patterns of the investment was regarded the next important problem of the vehicles. The gearing point reflects some of the difficulties inherent in this research. Discussions suggested that the attractiveness of various gearing levels varied with investor. In essence there were significant clientele effects and it is extremely difficult to make a general judgement about whether the ability to gear is an advantage or disadvantage. Additionally, the perception of gearing is also linked to the amount of gearing and changes of expectations over time

Table 2 sets out the overall hierarchy of sub-factors. These are simply calculated by multiplying the weight of the main category by the weight of the sub-factor within that category. Given the strong dominance of 'investment benefits', the four sub-factors in this category are at the top of the rankings. The only disadvantages of the vehicles that have any prominence are the management fees and lack of secondary market trading.

A fixed life span, defining a fixed exit point for the investor, is not rated as an important benefit. The additional information gained through the interviews suggests that with the current weight of money pouring into the market selling your interest is most likely to be possible with some vehicle recording "waiting lists". More than one participant commented that these vehicles yet had to be tested in a market downturn. In such a case a fixed life span/ fixed exit point might be of higher importance underlining that these results can only be seen as a snapshot of the current investor sentiment.

The low importance rating given to both pre-emption rights as well as the complexity structure indicate the growing maturity in the market and the increased ease of investor with the structure. Baum and Fear noted in 2001 that even though many Limited Partnership agreements included pre-emption rights the major players in the market were decreasingly favouring them. Giving them the lowest rating in the characteristic class liquidity costs shows that the market does not see them as an important factor anymore. In addition anecdotal evidence suggests that they are hardly used in agreements anymore. In connection with this the importance of the complexity of the structure has probably dropped in recent years since more restrictive arrangements have been eliminated. Given the general market trend to move away from investment clubs, except in JVs, towards larger collective investment schemes both the complexity of the structure as well as the restrictions on sales naturally need to decrease.

Table 2: Hierarchy of sub factors

Ranking	Subfactor	Weight
1	Access to specialist management	14,15%
2	Access to specific asset	13,88%
3	Tax efficiency	10,80%
4	Ability to gear	8,39%
5	Interest alignment with manager	6,34%
6	Limited secondary market trading	5,84%
7	Limited Liability	5,76%
8	Management fees	5,26%
9	Presence of co-investor	4,99%
10	Liquidity effects of limited life span	4,84%
11	Pre-emption rights	4,48%
12	Market price uncertainty	4,12%
13	Risk through gearing	3,30%
14	Potential for conflict	3,05%
15	Fixed life span	1,74%
16	Complexity of LP Structure	1,52%
17	Performance uncertainty	1,51%
Total		100,0%

Conclusion

The findings of the research conflict with two pieces of conventional wisdom about the growth of PPV in the UK. The first is that it was caused by a 'flight' to indirect property after the equity market crash and, secondly, that it was fuelled by pressures on the life assurance and property companies to generate asset management fees. However, following a number of 'pioneer' funds in the mid-1990s, the key turning point for PPV was probably in 1998 – at the latest 1999. This turning point occurred before the downturn in the equity market. The 'take-off' phase, in particular was more closely associated with a sharp increase in institutional investment in real estate rather than a change in the equity market. Further, although life assurance and property companies were important providers of PPVs, investment banks, independent fund management companies and real estate advisors were also major creators of funds. It is difficult to argue in any formal sense that changes in the equity market and life insurance/property company sectors were a necessary condition for or caused the growth of the PPV sector.

A contribution of this research is that it improves our understanding of the key attractions of PPVs. A clear necessary condition for their growth was that the perceived disadvantages associated with these vehicles were outweighed by the advantages. The research suggests that the key advantages have been the ability for certain categories of investor to acquire interests in assets that normally are inaccessible due to the amount of specific risk. The larger vehicles, in particular, offer investors the opportunity to access large portfolios relatively quickly and at a suitable lot size. Additionally, investors have been attracted by the ability to 'outsource' asset management in a manner that minimises perceived agency problems.

However, these advantages were relatively constant. It was a changing market environment in the 1990s that meant that more investors were receptive to innovative products. During this decade property investment professionals became increasingly knowledgeable about the capital markets. The growth of private vehicles was part of a broader growth in financial innovation in property markets encompassing securitisation and the launching of property derivative products. It may be that this ideational change rather than problems in equity markets and the life insurance sector that were the necessary condition for the growth of the PPV sector.

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Appendix 1 AHP: Further Details

Pair-wise decisions are then put into a matrix, using the relative score given by the rating scale. For the matching comparison the reciprocal value is put in. This allows for inconsistency between different pairs but not between the same pairs. The following is an example from the first level of the hierarchy:

Table 2: Example of the priority calculation

	Investment benefit of LP	Positive aspects of LP structure	Liquidity costs	Other costs of LP structure	Priorities
Investment benefit of LP	1,00	7,00	7,00	7,00	0,490
Positive aspects of LP structure	0,14	1,00	5,00	7,00	0,293
Liquidity costs	0,14	0,20	1,00	7,00	0,186
Other costs of LP structure	0,14	0,14	0,14	1,00	0,032

The priorities are calculated by finding the ratio between the sum of the scores in the row and the sum of all scores. The global hierarchy is a simple weighted model starting from the lowest level of the hierarchy (Saaty, 1998). Using Expert Choice 11 the software package for the Analytical Hierarchy Process a hierarchy for each participant was calculated and an average calculated.

Appendix 2 **Costs and Benefits of Private Property Vehicles**

Investment benefits of PPV

- **Access to specialist management** – The vehicle is managed by specialist in the sector.
- **Tax efficiency** – Assuming an offshore vehicle is typical, Stamp Duty is avoided.
- **Ability to gear** – Investor is able to access geared property investment.
- **Ability to access specific asset at appropriate lot size** - Investor is able to purchase interest in large assets. Direct acquisition would not normally be feasible due to the high level of specific risk.

Positive aspects of PPV structure

- **Limited liability** – The investor's liability is limited to the amount s/he has paid in.
- **Fixed life span** – There is a definite exit point for the investor.
- **Interest alignment with manager** – There is alignment of interest through co-investment by the manager of the vehicle and performance related fee structure.
- **Presence of co-investors** – Provides signal that the vehicle is appropriate.

Liquidity costs

- **Pre-emption rights (if present)** – Investor's disposal options are limited.
- **Limited secondary market** - Limited active secondary trading in LP interests can increase the uncertainty in timing and amount of capital receipts.
- **Liquidity effects of limited lifespan** – As the vehicle approaches a potential wind-up point, consequent uncertainty in future investment horizon limits marketability of interest.
- **Market price uncertainty** – Difficulties of valuation relative to direct investment can produce valuation uncertainty associated with LP interest and affect the sale process.

Other costs of PPV structure

- **Complexity of PPV structure –** Investor faces additional costs due to complexity of scheme. At purchase there are additional due diligence costs. During the holding period, the investor must monitor and manage the vehicle.
- **Higher management costs and performance related fees -** Management costs and fees for a LP interest are higher relative to direct holding.
- **Risk through gearing -** Investor is exposed to additional financial risk due to gearing.
- **Performance measurement uncertainty** - Uncertainty of performance measurement in LP scheme due to additional valuation uncertainty.
- **Potential conflict with co-owners**- Possibly that there will be potential disagreement among co-owners about asset and vehicle activities

[i] The comparison with the REIT market is problematic since the OPC figures are in 2005 values.

[ii] Limited Partnerships have been one of the most commonly employed vehicle structures to pool property investment. Based on the Limited Partnership Act 1907, these structures need a minimum of two partners; a general partner, in charge of management and fully liable for the partnerships assets/debts, and a limited partner, whose liability is by contrast limited to his share of capital invested. This limited liability status is conditional on the non-involvement of the limited partner in management decisions.

Another typical structure used for pooled investment in a portfolio of assets is unit trusts, with Property Unit Trusts (PUTs) investing in the property sector. PUTs are based on trust law which means investors typically elect a supervisory board, acting in a representative function for the investors in appointing and supervising the trustee and the investment manager. The trustee is responsible for the operation of the trust while the investment manager deals with the investment decisions and issuance and redemption of fund units.

In order for a PUT to be advertised and sold to retail investors, the PUT needs to be authorized according to the Trustee Investment Act 1961; all other funds are therefore unauthorised. The authorisation by the FSA implies certain restrictions on portfolio choice, redemption and cash-holding, which have been lightened considerably by the new collective investment scheme sourcebook, COLL, which came into force in 2004 (Lizieri and Ward, 2004).

UK based unauthorised PUTs tend to be exempt structures, implying that they are only open to tax exempt UK investors, which makes them tax transparent like LPs. These PUTs are often employed by small and medium sized institutional investors to gain exposure to quasi-diversified portfolios of commercial property assets. In addition to the UK based or onshore PUTs, institutional investors have created offshore PUTs in tax havens like Jersey and Guernsey.