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Introduction

Welcome to the *BVCA Guide to Real Estate Funds*, the latest in our series of guides into business sectors, investment strategies and international markets.

Private equity and real estate have a long history, stretching back to well before the financial crisis as the maturing asset class sought to diversify into new areas. It was simple to understand the rationale. Real estate, at least in the opening few years of the 21st century, offered a relatively low-risk, stable investment profile and was well-suited to the private equity model.

In recent years it is a sector which has experienced huge growth, moving from a subset of private equity to an asset class in its own right. And with this has come greater diversification; there is now a variety of different strategies, fund structures and firms operating in the real estate space.

As a result, it is a very competitive environment to be in. Institutional investors are continuing to pump in money. Over US$15 billion was raised for European funds in the first half of 2015, US$60 billion globally. According to data provider Preqin there is a record US$254 billion of dry power available. This last figure is obviously partly driven by the attractiveness of the sector, but it is also a reflection of the increased competition for assets.

This guide provides an overview of a hugely dynamic market, covering market trends, tax structuring, regulatory developments and more. It is aimed at anyone looking to gain greater insight into private equity real estate funds and investment, and contains a wealth of information of value to both the new entrant and the experienced investor.

I hope you find this guide both interesting and insightful, and I would like to thank RPC for its support.

Tim Hames
Director General
BVCA

Foreword

Seven years on from the inception of the worst financial crisis we have ever seen, global capital continues to search out safe havens which guarantee return *of* capital as well as return *on* capital.

For real estate markets in primary cities such as New York, London and Hong Kong, this has driven up asset prices to historically high levels, with pricing further supported by quantitative easing by the world's principal central banks.

Another trend amongst many global investors, such as sovereign wealth funds and insurance companies, is to seek to identify investments which generate higher returns so as to match future long-term liabilities and this has prompted a return to more opportunistic investing with a return profile higher up the risk curve.

With those trends in play, and with a surplus of equity and debt capital washing around the system, it is clear that the real estate markets in much of the UK and the US, some parts of Europe, and in key cities in Asia, have normalised; and this is evidenced by real estate teams in many large law firms being kept consistently busy.

In terms of legal structures being used to deploy capital into real estate markets, we are now seeing ever greater fragmentation and unpredictability in terms of how deals are structured. Whereas prior to the financial crash many were adopting a typical private equity-style fund model with 2 and 20 fees payable, today we are seeing a broad spectrum of structures being used across different markets and risk profiles, from straight joint ventures and co-investment transactions (involving two equity investors), club and consortia deals (involving three to perhaps nine equity investors), through to fully fledged funds (involving say not less than 10 equity investors). And with club deals and funds, the assumption that equity investors broadly invest on the same basis and with the same economics is being gradually eroded, with varying commercial deals being struck between the different investors. This is making the world of real estate funds a much more vibrant place to inhabit.

In this guide to real estate funds, we cover the following topics:

- A comparison between funds and joint ventures;
- The principal protections investors seek when investing into real estate funds;
- The latest tax developments;
- Key trends in financing;
- An analysis of the frequently cited joint venture and co-investment exemptions under the Alternative Investment Fund Managers Directive (AIFMD).

Also included in this guide is a Q&A on current real estate fund raising trends, contributed by Lazard, which is one of the leading private placement agents in the real estate fund raising market, and another Q&A from Student Cribs, one of the UK's emerging real estate managers focusing on student accommodation.

We very much hope you find this guide engaging, readable and informative.

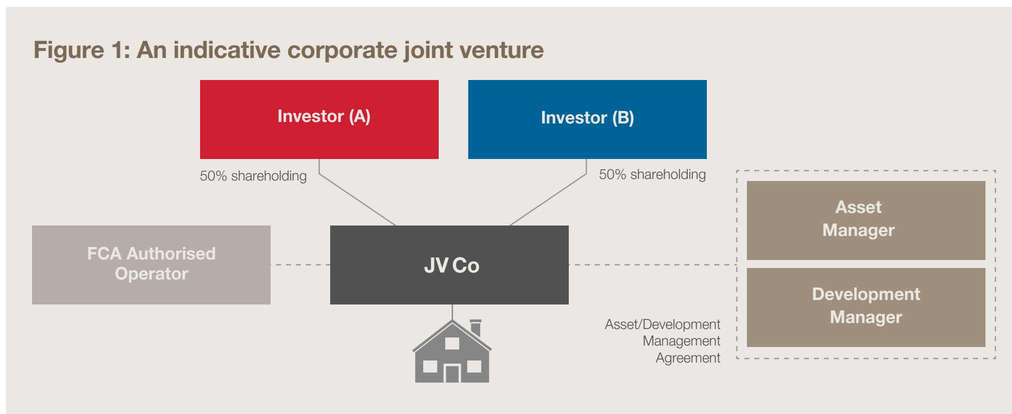
Anthony Shatz
Partner, Head of Investment Funds

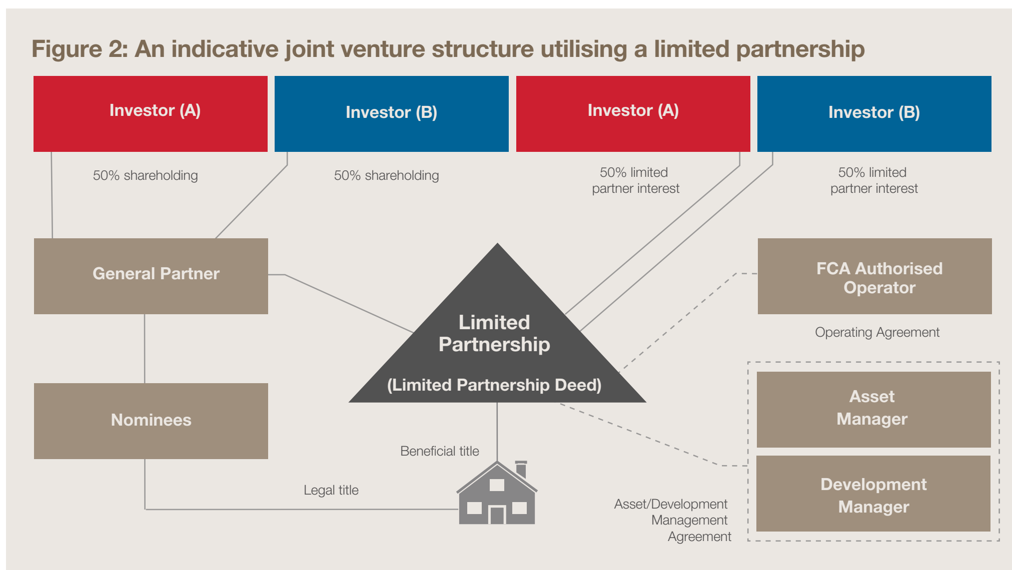
A comparison between real estate funds and joint ventures

Since the 2008 crash, real estate funds have adopted ever more diverse structures to take account of market dynamics and drivers.

To a large extent the structure is driven by the number of equity investors participating in the fund, such that one could categorise the market into the following broad categories:

- Pure joint ventures, where two parties come together to develop a specific asset or series of assets. See Figure 1 and 2.
- Club or consortia transactions, similar to true funds in that the manager has discretion to expend investor capital in accordance with a specific investment policy, but where the number of financial investors is say between three and nine, and where a number of those investors may have enhanced control or management rights. See Figure 3





- True funds, whether open-ended or closed-ended, where the number of passive financial investors in the fund is say 10 or more, and the manager has discretion to expend investor capital in accordance with a specific investment policy. See Figure 3
- Co-investment transactions, where investors in a fund increase their exposure to a specific fund asset by committing additional co-investment equity capital, usually on a passive basis, and often where the equity is 'syndicated' after the original acquisition takes place. See Figure 4

Real estate funds often have many similarities to private equity fund models and, as with private equity funds, the limited partnership remains the most common structuring vehicle in the UK.

The limited partnership allows investors to invest together on a scale that they may not be able to achieve alone, to diversify risk by pooling capital with other investors and to access the management skills of fund managers. Real estate funds also provide investors with the added attraction of tax efficient structuring and limited liability of investors.

As with private equity funds, real estate fund managers are often paid a management fee designed to cover the fund manager's overheads and a performance fee (known as the 'carried interest' or 'promote') which is intended to incentivise managers to enhance the fund's performance, although in this market there are often large discrepancies between the fees charged by different funds.

Light touch legislative constraints on limited partnerships allow for considerable flexibility for parties to negotiate appropriate commercial terms between themselves. The Alternative Investment Fund Managers Directive, however, has clearly added a further level of regulation for investors and managers to comply with.

Figure 3: An indicative real estate fund/club

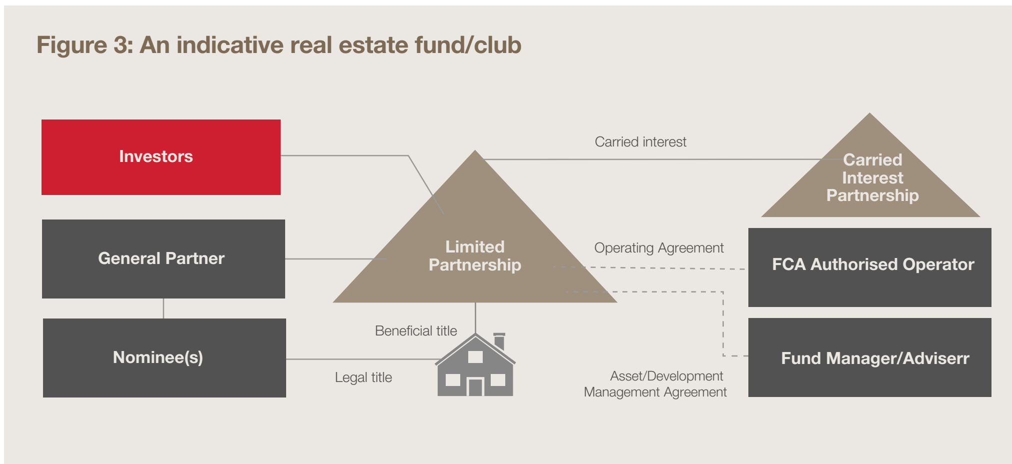
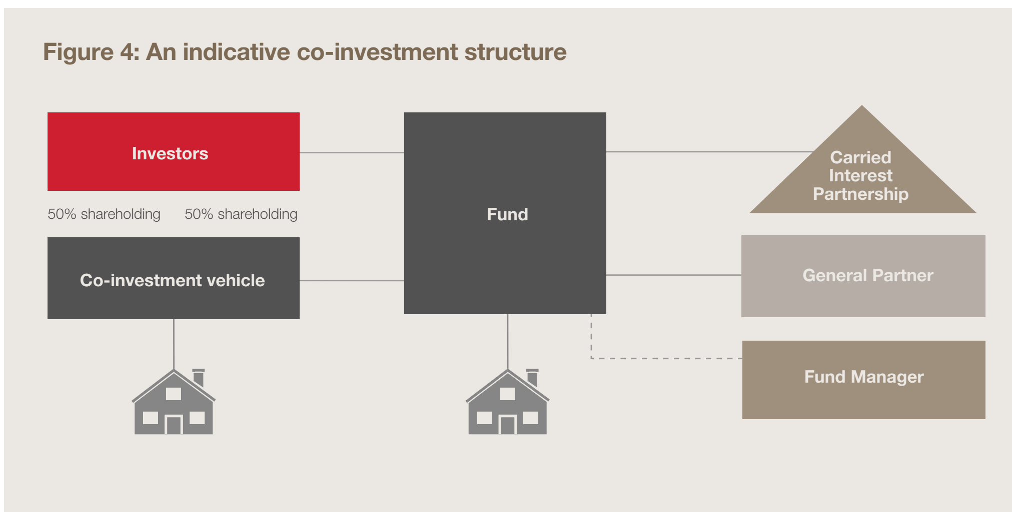


Figure 4: An indicative co-investment structure



Selecting the right structure

The following table sets out some of the key characteristics of joint ventures, funds and co-investment transactions.

	Joint Ventures	Closed-ended funds	Open-ended funds	Co-investments
Management and control	Joint venture parties in a real estate project retain management of the joint venture through the appointment of directors to the board. Deadlock situations will often be put to determination by senior employees of each joint venture party or, sometimes, to industry experts (such as chartered surveyors). Alternatively, or if there is a breakdown in relations between participants, a buyout provision may be applied whereby a party bids to buy out all of the other party's joint venture interest.	Investors rely on the knowledge and expertise of the manager to produce enhanced returns on their investment and are therefore largely passive in the management of the fund (unless for instance they have a seat on the advisory committee).	Investors rely on the knowledge and expertise of the manager to produce enhanced returns on their investment and are therefore largely passive in the management of the fund (unless for instance they have a seat on the advisory committee).	One or more investors will rely on the knowledge and experience of the manager to operate the co-investment vehicle and take all management decisions with a view to producing enhanced returns, usually in connection with a specific real estate asset.
Duration	Joint venture parties are free to set whatever term of the joint venture they deem appropriate. They will be able to extend or shorten the term by mutual consent.	A term of 8-12 years is common in a closed-ended real estate fund. Often the manager will have discretion to extend the term of the fund by up to two additional years (with the consent of the advisory committee) if circumstances require an extended fund term to ensure enhanced returns for investors.	Open-ended funds have an indefinite term, but with a provision that enables investors representing a certain percentage of the fund to wind-up the fund at a future date.	In a similar manner to a closed-ended fund a co-investment will sometimes have a fixed term and the manager may have the opportunity to extend the term of the co-investment in certain circumstances (e.g. for two years). Alternatively, the co-investment will have no fixed term and will terminate at such time as the parties agree.
Default	Joint venture parties have freedom to impose whatever consequences are commercially agreeable should a party fail to advance necessary capital to the joint venture on demand (so long as the terms are not punitive). The forced sale of a party's joint venture interest at a discount is not uncommon, as is a provision enabling the non-defaulting party to fund the defaulted amount at a penal rate of interest.	Investors are subject to significant consequences for failing to fund following a drawdown request from the manager. Typically investors will be subject to interest of up to 10% for late payment, and forfeiture of the investor's stake in the fund at a discount of up to 20% is common.	Investors are subject to significant consequences for failing to fund following a drawdown request from the manager. Typically investors will be subject to interest of up to 10% for late payment, and forfeiture of the investor's stake in the fund at a discount of up to 20% is common.	The consequences of an investor default are severe and can include forfeiture of its co-investment interest, distributions may be retained, or part of an investor's interest may be sold or redeemed on such terms as the manager determines is appropriate.
Exit	Joint venture parties will often agree specific provisions around exit such as incorporating pre-emption rights and drag/tag along rights for minority joint venture parties.	Closed–ended real estate funds offer limited opportunities for investors to exit the fund prior to the end of the fixed term. However, secondary transactions where the investor sells its interest in the fund is widely permitted, subject to the consent of the manager.	Open-ended funds are inherently more liquid and investors may sell, transfer or redeem their interests in the fund. However, redemption periods and contractual limits on the amount of an investment that can be redeemed or transferred within a given period of time mean that investments in open-ended funds are not as liquid as investors sometimes expect.	The transfer of an investor's interest in the co-investment vehicle will often be subject to the absolute consent of the manager.
Equalisation	Generally not applicable	Investors investing after the initial closing date will be required to advance additional sums in addition to their investment to ensure that they are in the same financial position as the investors admitted on the first closing. Such amounts, and an amount equal to the preferred return on such amount, will be paid to the existing investors pro rata to their respective fund interests.	Usually the same or similar provisions to closed ended funds.	Not applicable as it is rare for additional closings to be held and/or additional partners admitted to co-investment vehicles. Admission of additional investors will be at the manager's discretion.
Side letters granting enhanced or specific rights to particular investors	Not applicable	Often used	Used, but not as frequently as in closed-ended funds because of the inherently more liquid nature of open-ended funds.	Not applicable

Investor protection – current trends in real estate funds

Concern over downside scenarios and investment risks are now at the forefront of investor thinking.

Institutional investors negotiating the terms of their cornerstone investments in real estate funds now see investor protection mechanisms as key points of negotiation. The following key areas of negotiation between a manager and investors are indicative of a trend towards enhanced investor protection in real estate funds.

Participation and control

Since the global financial crisis, real estate fund investors have sought to take a greater degree of control of how their investments are managed. Advisory committees are increasingly common with ever greater participation by investors. A seat on the fund's advisory committee is very often a 'must have' for all but the smallest investors.

Conversely, however, investors do not want advisory committees to become too large as they become cumbersome and an investor's influence becomes diluted. This inherent contradiction is often solved by capping the maximum number of members of an advisory committee and insisting that membership is purely a question of capital commitment to the fund.

Key person clauses are also becoming increasingly common as the management skills and industry experience of specific fund managers and their teams are vital considerations in an investor's decision to invest. An example of how investor participation has grown in recent years is the now common requirement of advisory board consent to the appointment of a replacement key person by the fund manager.

Corporate governance

Corporate governance issues, specifically the composition of the fund's board, have also become forefront in investors' minds.

Ensuring that the board, particularly where a majority of the directors are located offshore, has sufficient knowledge and expertise to fully understand the fund's investment strategy, investment decisions and the underlying assets is essential.

And the independence of a fund's board of directors remains crucial to investors to ensure impartial decision making in the best interests of investors.

Escrow accounts and claw-back

Since 2008, investors have been increasingly reluctant to permit fund managers to be paid carried interest without ensuring appropriate investor protections are in place, and fund managers are increasingly prepared to accept such requirements from investors as market norms.

Accordingly, escrow accounts and/or claw-back mechanisms are increasingly common in real estate funds as they provide investors with recourse against the carried interest parties should, for example, one investment greatly outperform expectations and other investments underperform. An escrow of 50% of carry is quite typical.

Removal of the fund manager - no-fault divorce

The ability of investors, often by 75% approval, to remove a fund manager even if they are not in breach of the fund agreements, remains an important form of investor protection. Compensation pay-outs to deposed general partners, however, can be a key consideration for investors before exercising their entitlement to remove the fund manager. As a result, removal of the general partner without cause remains an extremely unusual occurrence in real estate funds.

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Transparency

Not only are investors looking for enhanced protection in terms of their investment but they are now entitled to increased transparency thanks to the Alternative Investment Fund Managers Directive (AIFMD).

While the parties to joint venture agreements have total transparency as to their commercial terms, real estate funds have been characterised by confidentiality. Secretive side letters and most favoured nations clauses have historically brought a degree of secrecy to real estate funds.

Preferential fee breaks (including fee holidays), as well as guaranteed positions on advisory boards commensurate with the size of an investor's capital investment, are common in real estate funds and only investors with equal or greater investments are entitled to benefit from, or have disclosure of, such preferential treatment.

Thanks to the AIFMD, fund investors are increasingly aware of the obligations on managers to treat investors fairly and to disclose the nature of preferential treatment to potential investors in EU funds. How this duty will be implemented by different fund managers in practice remains to be seen.

Tax structuring and recent developments

Real estate funds need to be structured in such a manner so as to ensure there is little or no tax at the fund level, and that the downstream structure is efficient in keeping local tax on rental income and capital gains to the minimum.

There are a number of different options to be considered when setting up a fund vehicle to invest in real estate, and the tax treatment is a key factor influencing the choice of structure. Tax transparency at the fund level is a key driver, providing pension funds and life insurers, as well as investors from a variety of jurisdictions, the opportunity to invest alongside taxable corporates and individuals without compromising their own tax status. Two of the most popular investment vehicles for UK real estate are the limited partnership and the offshore unit trust, both of which are often used in conjunction with subsidiary special purpose vehicles.

Limited partnership structures

Limited partnerships (LPs, often English but sometime established offshore) remain a widely used fund vehicle. More recently limited liability partnerships (LLPs) have become more popular as they have a separate legal personality, unlike LPs, although LLPs are not efficient for UK pension vehicles as the income and gains derived from property investment LLPs are not tax exempt.

LPs and LLPs are, from a UK tax perspective, transparent and hence are not subject to tax on their income and gains. Tax transparency in other jurisdictions will, of course depend upon local rules, although LPs are usually transparent in most, and whilst LLPs may not be regarded as such in some countries, from a US tax perspective LLPs can 'check the box' to be treated as tax transparent partnerships.

UK tax resident investors are subject to tax on their share of any net income (including property rental income) and on their share of any gains arising to the partnership in accordance with their profit sharing rights under the partnership agreement. Non-UK investors are generally only subject to UK income tax on their share of any UK source income of the fund, with non-UK source income and all capital gains typically not subject to UK tax. Where there are non-UK investors in the partnership that is invested in UK property then tax must be withheld at 20% from their share of the rent as it arises, although it is common to apply under the non-residents' landlord scheme (NRLS) for gross payments to be made.

As the income and gains are taxed in the partners' hands as they arise to the partnership there is no further tax to pay when the partnership distributes its profits.

Although some partnership funds will invest directly into the underlying real estate, it is common for funds to use wholly owned subsidiary companies (SPVs) to acquire and hold each investment. Such SPVs are typically set up and tax resident in jurisdictions such as Jersey or Guernsey. There are various reasons why such SPVs may be used. One of these is to assist in the tax efficient funding of each underlying property so as to ensure that tax deductible interest payments can be generated for offset against the rental income. Another is to provide the option of selling the SPV rather than the property on exit, which may be more tax efficient for certain investors, and in certain jurisdictions, than selling the property. Furthermore in some jurisdictions this may reduce or eliminate stamp or transfer taxes (e.g. in respect of UK properties this prevents UK stamp duty land tax (SDRT) at rates of up to 15%) arising on the sale consideration.

As the SPVs are typically located in jurisdictions in which no local tax is paid, the only tax incurred on income will be on the rental income in the jurisdiction of the property. For UK source income the SPV would typically register under

"Two of the most popular investment vehicles for UK real estate are the limited partnership and the offshore unit trust"

the NRLS so as to receive its rental income gross and then pay tax at 20% on any net income. If the SPV sells the property then tax on gains may, depending on local rules, be payable in the jurisdiction in which the property is located.

The UK has always exempted all non-residents from tax on disposals of UK investment properties, but has recently introduced a tax on non-residents disposing of UK residential property, subject to exemptions for widely held companies and funds. Where the fund is investing in non-UK property then the SPV may in some cases be located in the jurisdiction of the location of the property, or possibly in a third jurisdiction benefitting from double tax treaty access, to ensure tax efficiency (e.g. in respect of interest payments or capital gains) under local rules.

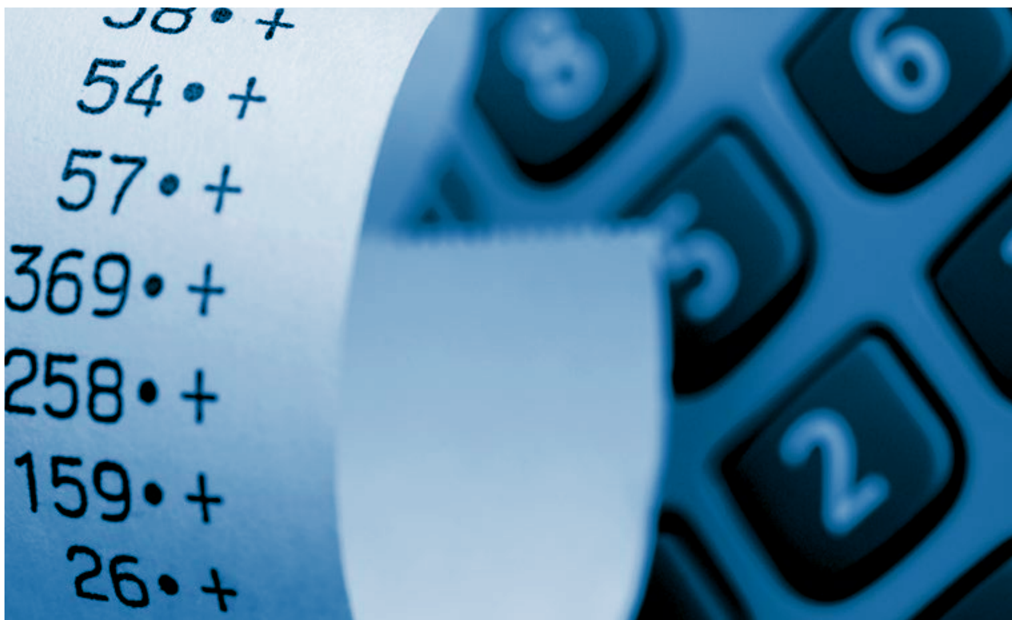
Where SPVs are used investors will typically receive dividend distributions from the underlying SPVs rather than rental income, and will only be taxed as and when such distributions are made. Capital gains will arise either when the partnership sells an SPV, or where an SPV sells an underlying property when the SPV is wound up.

Anti-avoidance tax provisions need to be borne in mind, however, when SPVs are used. In the UK context, legislation such as close company provisions, the controlled foreign company regime and the transfer of assets abroad provisions, all need to be considered as these can attribute offshore income and gains to UK tax residents, although in most cases these should not be in point. In addition some care is needed to deal with the UK offshore fund provisions which can have the effect of treating any gain arising in respect of an SPV as income subject to higher tax rates.

Funds set up as partnerships also facilitate the tax efficient payment of carried interest to the fund management team via the use of a special limited partner vehicle which is entitled to a share of the fund's profits (typically capital gains taxable at lower rates) once certain targets have been met. However, recent announcements in the 2015 summer Budget may impact on the long-established tax status of carry in real estate partnerships.

Offshore unit trust structures

Unit trusts established and resident offshore are also quite a common property fund vehicle. These are often established in Jersey or Guernsey, and are not subject to tax in their jurisdiction of residence on their underlying income and gains. Sometimes offshore subsidiary unit trusts or companies may be established to hold each underlying property. This provides the option of selling the subsidiary unit trust or company rather than the underlying property, which may have tax advantages and may also prevent stamp and transfer taxes arising (e.g. in respect of UK property, no SDLT or stamp duty is payable on the transfer of the units or shares).



An offshore unit trust is typically set up in such a way so as to be transparent from an UK income tax perspective, but treated as a company from a capital gains perspective and hence not transparent for investors. Accordingly each of the unit holder investors will, from a UK tax perspective, be subject to tax on their share of the net income of the unit trust, whether it is distributed or not, in a manner similar to a limited partnership as described above. However, as the unit trust is treated as opaque from a capital gains perspective, unit holders are not subject to tax on any gains realised by the unit trust on disposal of its properties or subsidiary entities. Instead UK resident taxable investors will be subject to tax on gains when they dispose of their units in the fund. The position of investors in other jurisdictions will of course depend upon their local tax rules, but from a US tax perspective unit trusts can 'check the box' to be treated as tax transparent partnerships.

Anti-avoidance tax provisions of course need to be borne in mind when considering the tax position of investors. In addition the UK's offshore fund provisions need to considered, although an exemption is available for unit trusts which meet certain conditions.

REITS and PAIFs

A brief mention of two UK onshore property investment vehicles that are aimed more at the retail market.

The first is the UK real estate investment trust (REIT), which is a closed-ended corporate vehicle that must be approved by HM Revenue & Customs and must be listed on a recognised stock exchange. The REIT is exempt from tax on its income and gains arising from its qualifying property rental business. However, it must distribute 90% of its annual profits to its shareholders, and must withhold 20% tax from such distributions, save for certain exceptions such as tax exempt bodies or UK companies. UK resident shareholders are then treated as being in receipt of property income and are taxed accordingly, and are subject to tax on any capital gains made on a sale of their shareholding.

The property authorised investment fund (PAIF) is in effect the open-ended, regulated version of the REIT. It is an open-ended company or OEIC, and is authorised and regulated by the Financial Conduct Authority (FCA) either as a UCITS or a non-UCITS retail fund. As it has variable capital and is considered a more liquid investment than a closed-ended vehicle. The PAIF is exempt from tax on its capital gains and from tax on income derived from its qualifying property investment business. It must distribute all of its net income each year, and must withhold 20% tax from it property income distributions, save for certain exceptions such as tax exempt bodies or UK companies. UK resident shareholders are then treated as being in receipt of property income and are taxed accordingly, and are subject to tax on any capital gains made on a sale of their shareholding in the PAIF.

> "An offshore unit trust is typically set up in such a way so as to be transparent from an UK income tax perspective, but treated as a company from a capital gains perspective and hence not transparent for investors"

Finance – some key trends for real estate funds

Real estate debt funds

UK commercial real estate lending has recovered. Figures published in the latest (May 2015) market leading De Montfort University report show that £45.2 billion (a six-year high) of new lending was provided in 2014 with an acceleration of 30.6% in the second half of 2014 (£19.6 billion was provided in the first half and £25.6 billion in the second half).

Following the 2008 financial crisis, the UK and European real estate finance landscape has changed radically. Whilst banks, under the weight of increased regulatory pressure, have been forced to focus their efforts first on reducing their exposure to the sector, the continuing demand for real estate finance has precipitated the introduction of new alternative providers. Along with insurance companies, real estate debt funds have been the greatest of such sources.

Such real estate debt funds are often structured as closed-ended limited life vehicles, and so the legal and structural considerations, and the terms that are negotiated between the manager of the real estate debt fund and its investors, are often similar to a more typical real estate fund.

Borrowers have seized upon the ability of real estate debt funds to be more flexible finance partners than banks. Rather than, for example, raising a dedicated mezzanine lending fund, many real estate debt funds have investment strategies flexible enough to enable them to lend into different parts of the capital stack.

Increasingly real estate debt funds are utilising their ability to lend at both senior and mezzanine levels to their competitive advantage by initially providing ‘whole loans’ and then controlling the onward sale of the senior portion to another party. Funds will ensure that the ‘whole loan’ blended return is satisfactory enough in case the senior portion cannot be sold. Then a sale of the senior and leaving the fund holding just the mezzanine portion at the mezzanine rate is a bonus. Borrowers understand that they have to pay more for this whole loan approach but often they are willing to do so.

The traditional banks are returning to the market but they remain constrained by stringent external and internal lending criteria restricting them to the least risky assets at the most favourable loan to value/loan to cost ratios. This means that, even in a capital stack that includes a

traditional bank lender, there is capacity for real estate debt funds to lend at other levels within the stack.

And it is also apparent that some borrowers are willing to pay a premium for the privilege of borrowing from a real estate debt fund as opposed to a traditional bank lender given the former's relative speed of execution and more flexible approach to financial and other covenants.

How can a real estate debt fund take advantage of the best opportunities?

Real estate debt funds often have the characteristics to offer a better lending proposition than the traditional banks, but how can such funds best ensure that they have timely, ready access to the greatest pool of cash possible with which to seize upon the best lending opportunities? Investor call bridging facilities and loan-on-loan finance are two financial products that can assist.

- Investor call bridging facilities: These general purpose (within the boundaries of the overall investment remit of the fund), short-term loan facilities can be provided by banks to funds in order to bridge between a fund seizing on an opportunity to provide a real estate loan and the fund being able to effect drawdowns of committed fund monies following a call it makes on investor capital. A fund can set up a bridging facility with a term that matches its proposed investment timeframe. The facility will remain in place throughout and operate in the manner of a revolving credit facility with the individual loans under the facility being short-term over the necessary bridging period. For further details on this type of financing see the *BVCA Guide to Private Equity Fund Finance.*
- Loan-on-loan financing: Loan-on-loan financing is probably most commonly associated with loans provided by investment banks to entities which wish to use the proceeds of such loans in order to, themselves, purchase distressed debt. Increasingly, however, in the real estate world, loan-on-loan financing refers to banks letting funds do the work of putting a loan in place (which, as mentioned above, funds can typically achieve more quickly than a bank) and then stepping in to refinance the fund in respect of such loan. We expect this form of financing to become increasingly common amongst real estate debt funds.

"It is also apparent that some borrowers are willing to pay a premium for the privilege of borrowing from a real estate debt fund as opposed to a traditional bank lender given the former's relative speed of execution and more flexible approach to financial and other covenants"

Key exemptions under AIFMD

With the introduction of the Alternative Investment Fund Managers Directive (AIFMD), the regulation of funds in Europe has become very wide. Only a limited range of funds are able to fall outside the scope of the AIFMD. Given the strictures of the AIFMD we have seen the market turn to particular exclusions to the scope of the AIFMD.

Specifically, we have seen the increasing use of pure joint ventures, where two parties come together to develop a specific asset or series of assets, as well as co-investment structures in which an experienced manager invests alongside an institutional investor. Both structures can fall outside the scope of the AIFMD.

The FCA has set out guidance on the scope of the activities it regulates in its Handbook of Rules called the Perimeter Guidance manual (PERG). The PERG guidance provides some detail on the types of joint venture and co-investment that will fall outside the scope of the AIFMD.

The AIFMD regulates managers of Alternative Investment Funds (AIFs). There are a number of key elements to the AIF definition of an AIF. If a structure does not meet one or more of these elements of the definition then it may not fall within the definition and the manager may fall outside the scope of the AIFMD.

We have summarised the key aspects of the PERG guidance in the table below. The FCA will look at the substance of particular structures, i.e. how they work in practice, and not merely their legal form when applying its guidance.

Although the market is becoming more familiar with the requirements of AIFMD, compliance costs are set to remain relatively high for the foreseeable future given the complexity and novelty of the Directive's requirements. We expect an increasing number of funds to be structured to take advantage of the FCA's (evolving) guidance on joint ventures and co-investments.

Structure	Joint ventures	Co-investment
Situations in which FCA guidance applies	The PERG guidance provides that joint ventures are not normally caught by the scope of AIFMD.	The PERG guidance covers two situations: (a) An institutional investor confers a substantial mandate on an investment manager and structures the mandate through an investment vehicle where the other investors are the manager itself and its employees, or a vehicle taking a carried interest for the benefit of the employees of the manager. (b) A family investment vehicle employs a third-party professional investment manager (with no family relationship) and the employees and managers invest in the co-investment vehicle alongside the family vehicle.
Key element(s) of the definition of an AIF which structure fails to meet	(a) AIFs are Collective Investment Undertakings (CIUs). A CIU is an undertaking which does not have a general commercial or industrial purpose, and which pools capital raised from investors for the purpose of investment with a view to generating pooled returns for those investors from the investments, and over which the unit-holders or shareholders, as a collective group, have no day-to-day discretion or control. (b) AIFs raise capital from external investors with a view to investing that capital for the benefit of those investors.	AIFs raise capital from external investors with a view to investing that capital for the benefit of those investors.

Structure	Joint ventures	Co-investment
Explanation	The term 'joint venture' does not have a precise legal meaning in EU law so PERG guidance considers the underlying principles to mean joint ventures fall outside the scope of AIFMD. The PERG guidance provides that: (a) Joint ventures are not managed by third party managers or by only some of the parties. (b) Joint ventures do not raise external capital because, where parties come together on their own joint initiative, the persons raising and providing the capital to the joint venture are the same.	In the situations set out above, co-investment vehicles do not raise capital from external investors. The PERG guidance provides that: (a) Nominal investments by the manager or employees should be disregarded when considering whether an undertaking raises capital from external investors. Even if the investment is more than nominal, capital is only raised from a single external investor, the institutional investor. The purpose of AIFMD is to protect investors by regulating managers, so investment by the manager does not amount to an external investor requiring the protection of AIFMD. (b) Where the external investor is a family office vehicle, PERG guidance provides that where there is a pre-existing group of family members and where the sole ultimate beneficiaries are family members, there will be no raising of external capital.
Key factors to consider	(a) The parties should have day-to-day control (in the ordinary sense) over the joint venture's activities. (b) Day-to-day control or discretion is a form of direct and ongoing power of decision (whether exercised or not) over operational matters relating to the daily management of assets. This control must go substantially further than the ordinary exercise of decision or control through voting at shareholder meetings on matters such as mergers or liquidation, the election of shareholder representatives, the appointment of directors or auditors or the approval of annual accounts. (c) Nonetheless, in a marriage of experience and equity, the experienced partner may carry out day-to-day management while the equity partner is involved in more key, strategic decisions. The parties may also hire an outside person to manage the joint venture. What is important is that each of the parties should have a continuous involvement in the overall strategic management of the undertaking. It is important that a single party cannot control the activity of the venture unilaterally and that strategic decisions should require the unanimous consent of the parties sharing control. (d) Participation by limited partnerships in a joint venture can still be excluded. (e) If a party retires from the joint venture but remains a party to the investment, the joint venture will not become an AIF if it was an excluded joint venture at the time it was set up. (g) A key element of the definition of an AIF is that it has a defined investment policy, i.e. a fixed investment policy which is part of, or is referenced by, the rules or instruments of incorporation of the undertaking, which is legally enforceable and which specifies investment guidelines. Many joint ventures will have a policy focused on the achievement of the parties' commercial goals rather than a defined investment policy. (g) The joint venture parties should have come together before the structure of the joint venture is determined and capital raised. The parties may have a pre-existing relationship and the joint venture may relate to a pre-existing business that the parties are already carrying on.	(a) Ensure that the co-investment is made by the manager or its employees, i.e. those who are regulated by the AIFMD rather than those who require its protection. (b) The primary investor should not be a feeder fund, a fund-of-funds or a nominee acting for more than one underlying investor as the AIFMD may apply to funds with only a single external investor in those circumstances.

Structuring issues for real estate funds

Q&A with James Jacobs, Managing Director, Lazard

How has the appetite for real estate funds changed since the global financial crisis?

Over the last 12-24 months we have noticed a renewed appetite amongst real estate investors to commit to real estate funds. For a period immediately following the financial crisis the fund model was certainly called into question. A significant proportion of traditional fund investors shied away from funds given perceived issues of control, liquidity, governance etc. However, a number of these investors, as well as new entrants, are embracing funds again in the current market as an efficient way to gain exposure to certain markets, sectors and strategies with specialist investment professionals.

Does real estate asset sourcing remain a particular problem for real estate funds?

It is often the way that as liquidity returns to the fundraising market, the job of the investment professional becomes more challenging. Deploying capital is increasingly difficult due to the level of competition for deals. For core assets there is intense competition; increasing allocations to real estate, as an attractive alternative to fixed income, has driven up prices. Even for assets which require more active management, the increasing capital flows into the European markets has resulted in investors having less time to assess, diligence and structure a transaction.

In the United Kingdom, does London real estate remain the most attractive asset class to fund managers or are the regions becoming more appealing?

London will always be the largest, deepest, most liquid market in the UK but its attraction depends on the investors' cost of capital given where pricing currently stands. Many of the managers we work with, who tend to focus more on 'value add/opportunistic' real estate, find London in general too expensive, as global capital flows drive yields to new lows, so they are favouring cities and areas outside of the capital.

Are fund managers continuing to move away from mainstream to more alternative property segments such as student accommodation, healthcare and leisure?

We continue to witness the investors' search for yield which is driving demand for alternative sectors given the spread over traditional assets. Many of these sectors have been considered 'mainstream' in the US for some time, and as such, in addition to the higher yields, investors are also hoping for a re-rating and convergence to pricing levels seen in other markets. An increasing number of fund managers in the UK are developing expertise in order to operate these assets, which provides opportunity for investors to gain exposure to the alternative sectors.

To what extent does the liquidity of real estate fund investments remain a key issue for investors?

Liquidity certainly does remain a concern for institutions investing indirectly in real estate, which is of course an inherently illiquid asset class. During the downturn it became clear that even funds with liquidity provisions have limited options if a large proportion of the investors try to redeem/sell at the same time. Investors today seem to be more concerned with the liquidity

> "Over the last 12-24 months we have noticed a renewed appetite amongst real estate investors to commit to real estate funds"

of the underlying assets and making sure the investments made by the fund managers have realistic exit assumptions. Obviously from time to time investors may have a requirement for liquidity and use the increasingly active secondary market as a mechanism to sell their fund participation.

Where do you see real estate returns in the UK going over the next five years?

We unfortunately don't have a crystal ball but in the absence of a market correction in the UK, given pricing has recovered significantly, returns are more likely to be driven by income than capital gains. Investors buying five years ago have benefitted from significant yield compression, which is unlikely to be a feature of the market going forward. However, it is our belief that best in class fund managers will be able to make good returns in almost any market through sourcing the right assets at the right price and using active asset management to improve the quantum, quality and duration of income, as well as the institutional liquidity, to drive total returns.

How onerous an impact has the Alternative Investment Fund Managers Directive (AIFMD) had on real estate fund managers?

AIFMD has obviously had an impact on the marketing of real estate funds. Most fund managers have had to spend a significant amount of resource understanding how the Directive applies to them and what approach they will now take to marketing. In practice, although navigating the different jurisdictions has become more complicated, time consuming and costly, our sense is that the majority of fund managers will continue to comply and be in a position to market their AIFs to the investor community widely throughout Europe.

What advice would you give to real estate fund managers about approaching sovereign wealth funds to capitalise their vehicles?

It is hard to generalise how to approach sovereign wealth funds (SWFs) as their investment models vary markedly. Many of the larger groups have started to move to a more direct model, with significant in-house resource. Alongside this, however, they often still have appetite for the 'mega funds' which assist them in their capital deployment, provide exposure to large scale, complex and more corporate-style transactions, and potentially access to co-investment opportunities. Recently SWFs have realised they are missing out by not gaining exposure to the return profile of the mid-market private equity real estate fund funds and as a result a few have awarded consultants with specific mandates to commit capital on their behalf within the mid-market space.

How would a United Kingdom exit from the EU affect the real estate funds industry?

Our view is that in the medium term a 'Brexit' would not have a significant impact on the attractiveness of the UK market, which is likely to remain one of the largest and most liquid in Europe and hence remain attractive to global capital. However, without a doubt there will be wariness in the short term as the referendum approaches. Should the UK decide to leave the EU there will clearly be a transitional period which will likely impact transaction volumes and pricing. Periods of market uncertainty create opportunity.

What are the biggest challenges currently facing real estate fund managers?

The most significant challenges we see ahead are:

- The influx of capital into the market resulting in heightened competition for deals;
- The increasing costs of managing funds, from the fundraise through to the operations, primarily as a result of increasing regulation and aggregating capital; and
- Pressure on fees for many managers which, combined with the increase in costs, results in lower margins and lower profitability – this ultimately impacts the ability to attract and retain talent.

Q&A with Charlie Vaughan-Lee, CEO, Student Cribs

To date you have raised three funds and all your LPs are high-net worth individuals (HNWIs). You have more funds in the pipeline – do you always see your equity coming from HNWIs or will you look to other sectors of the investor market?

We started by buying HMO student houses for individuals, identifying suitable properties for our investors to purchase in their own name. This worked, but it was time consuming matching each property with an investor and meant that we couldn't be opportunistic in the market place. In 2010 we met with one of Cinven's founding partners, Brian Linden who is now our chairman. Brian suggested we solve this issue by raising a fund. Thanks to the track record of our investments with individual investors and with Brian's help, we raised a pilot first fund from HNWIs. This fund went well and in 2012 we raised Fund 2 both from our existing and new HNWIs including a number of senior investment bankers as well as current and former private equity partners in their personal capacity.. Earlier this year we also raised a fund to invest in London private rented sector housing along the Crossrail route, again using HNWI capital.

We are in advanced talks with a large, well-known institutional investor as a sole investor for Fund 3. We thought long and hard about whether to raise from HNWIs, family offices, institutions or even via crowdfunding. They all have their pros and cons, with the crowdfunding space representing an interesting new way to raise equity and effectively giving us access to retail investors with a lighter regulatory wrapper. It was in fact the lack of regulation and track record of the crowdfunding space that put us off, but we are watching the space closely.

HNWIs and family offices are a good fit for us - they understand our product well and like the strong yields we can generate from a house that has a very clear value underpinned by both the rent we can generate and the residential housing market, but their pockets are not as deep as the institutions.

We have targeted institutional investors with the view to forming a long-term relationship with one or two LPs who have appetite and enough firepower to partner with us to realise our goal of becoming the largest provider of second and third year student accommodation in the UK.

The majority of institutional investment to date in the student property sector has been focussing on large purpose built blocks. The assets in your funds largely comprise of HMO houses - why have you not followed the others and gone into blocks?

Purpose-built student accommodation (PBSA) has been delivering very solid returns since Unite started out in the early 1990s. However, after 24 years, the space has matured and is highly competitive, as shown by the significant yield contraction over the last couple of years. What's more, when I was a student, I didn't want to live in halls for more than a year. I was desperate to rent a house with my friends and be independent for the first time in my life. It is a rite of passage for young people in the UK, and many other developed countries. Large purpose built blocks tend to appeal only to first year students and some international students in subsequent years of study.

Operators have historically been attracted to scaling quickly by putting up tower blocks and the management efficiencies of concentrating bed spaces. Over time we have developed systems and technology that enable us to build and manage similar scale as the block operators, but in a horizontal portfolio of houses (which have a clear second use value). We have a strong team that manages the entire investment process through sourcing, development, letting and portfolio management. This enables us to act quickly to market opportunities and tightly control product quality and operating costs. The HMO sector is generally under-researched and undermanaged.

> "At the end of the life of our funds we need to sell the properties in the fund to return capital to investors. What we really need is a structure that is tax efficient (so that rental income is only taxed once) and enables our investors to have liquidity without requiring us to sell assets"

We've made it our business to know it inside out which provides us with competitive advantage and a level of knowledge that is hard to replicate. We've researched over 25,000 HMO bed spaces across the top university cities and we have a tried and trusted model for sourcing attractively priced acquisitions. Our product appeals to the largest segment of the student accommodation market (2nd, 3rd and 4th year students) and the assets we buy are not as hotly contested as a prime lot of development land or unconverted office block. We are pleased to see that the institutional market is starting to see this as the next growth area in student accommodation as sector matures.

Your funds are closed-ended unregulated collective investment schemes (UCIS). What other structures did you consider?

Operating as a UCIS has worked well to get us to some scale. Our current structure is similar to that of a private equity fund, but it is not an ideal long-term structure. At the end of the life of our funds we need to sell the properties in the fund to return capital to investors. What we really need is a structure that is tax efficient (so that rental income is only taxed once) and enables our investors to have liquidity without requiring us to sell assets. We looked into a Property Authorised investment Fund (PAIF) but were put off by the requirements to hold 10-20% of the assets in cash. A Real Estate Investment Trust (REIT) structure would suit us very well, but with £60m of gross assets we are too small for an IPO. Following the investment of our third fund we should have gross assets of around £115m at which point we will consider an IPO.

Is debt financing for new acquisitions trending towards traditional or 'alternative' lenders? And what is your experience of lenders' current approach to financial and other covenants?

We have a good relationship with Handelsbanken who probably sit somewhere between traditional and alternative. They have a simple approach to lending and are supportive and flexible. Their approach to covenants is pragmatic and in line with our business model rather than the 'one solution for all' approach that some of the larger lenders take. We have considered crowdfunded debt but given that we are relatively lowly geared at 50%, and have very strong interest cover, the rates are too high. We are just about large enough for a long-term bond which could have some benefits, but might cause issue in the future if we want to IPO and will reduce our flexibility. So long as Handelsbanken continue to be competitive I can't see a good reason for us to change how we lever our funds.

Notes

About the Sponsor

RPC

We deploy cross-departmental teams to advise on the structuring and raising of a wide variety of investment funds, with a particular expertise in private equity, real estate and debt funds, in both the listed and unlisted space. What's more, our Regulatory team understands the sophisticated and complex regulatory environment in which investment funds now operate, with many senior team members benefitting from time in-house at the Financial Conduct Authority.

Our strong relationships with many firms in key overseas jurisdictions are critical when it comes to advising on and successfully implementing many investment fund structures. With lawyers who understand the market and who can advise GPs on the raising of funds, LPs on investing into funds, and on funds secondaries transactions, RPC is recognised as a credible and modern alternative to the more traditional law firms in the investment funds market.

Contacts

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Anthony specialises in investment funds and secondaries transactions acting for a range of clients across a number of sectors. He has a particular focus on real estate, acting for clients such as Griffin, Melford and Clipstone. Anthony was part of the team shortlisted for Real Estate Team of the Year at the Legal Business Awards 2012, and is co-author of Practical Law's maintained note on real estate joint ventures.

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