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“Is there a role for Private Equity Real Estate Funds post REITS?”

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This paper seeks to balance the enthusiasm being shown in the worldwide growth in the Real Estate Investment Trust (“REIT”) market by ensuring that those investors seeking an in-direct investment into real estate consider the merits of Private Equity Real Estate funds.

This paper will initially consider the growth of the REIT market in the last 20 years. Once this background has been explored the driving forces of its expansion and REITS role in the investment universe going forward will be considered. The paper concludes with some investment themes for 2006 and why Rynda is likely to be executing those strategies via Private Equity Real Estate funds rather than by investment into REITS.

This paper is not about being “anti-REITS” – it is about investors having objective information on which to base judgements rather than just the current wave of positive press comment associated with REITS. The real estate industry must want investors to invest in the most appropriate vehicle for their needs and avoid a herd instinct to follow the latest trends.

Let’s however, just check our definitions of a REIT and what is meant by a Private Equity Real Estate Fund.

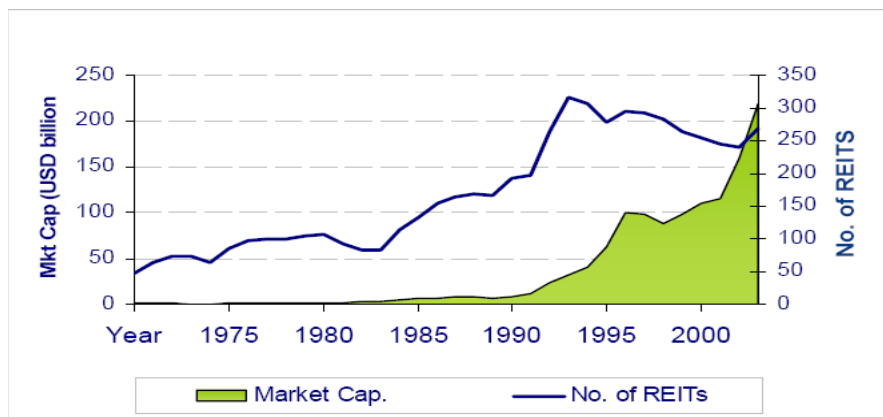
Firstly, REIT – a Real Estate Investment Trust that is a tax transparent company owning, and in most cases, operating income-producing real estate. Some REIT’s even finance real estate and are known as Mortgage REIT’s. To be a US REIT, a company must distribute at least 90% of its taxable income to shareholders annually in the form of dividends. This is really the defining characteristic because if this is achieved the company then comes tax transparent i.e. it does not pay tax. Thus pension funds get the gross income rather than a dividend once the company has paid its own corporation tax – a far preferable position. Other countries have different percentages but most are in the 80-95% range in order to qualify for the tax benefits.

Not surprisingly it is the publicly traded/listed vehicles that have the highest profile but there are significant non listed publicly registered REIT’s in the US. There are approximately 180 publicly traded REIT's in the US today, with assets totaling \$375 billion. The shares of these companies are traded on major stock exchanges, which sets them apart from traditional real estate.

Secondly, Private Equity Real Estate Funds – these are traditionally created by Fund/Asset managers who, having established a fund, manage it to a pre-determined investment strategy. The Fund Managers are specialist real estate fund managers who usually co-invest equity into the fund alongside their investors. These funds are not listed and so there is no daily market in the shares. Funds do have pre-determined fixed lives after which assets are sold and proceeds distributed. Leverage is often employed and its percentage of asset value will partly determine the classification of that fund on the risk/return scale from “core” through “value added” to “opportunistic”. These funds are heavily structured to mitigate tax and in terms of fund size, range from gross assets of £50 million to multi billions.

The growth in the REIT market in the last 20 years has been phenomenal - see the table below that represents just the US market:-

US REIT Market Growth 1970-2004



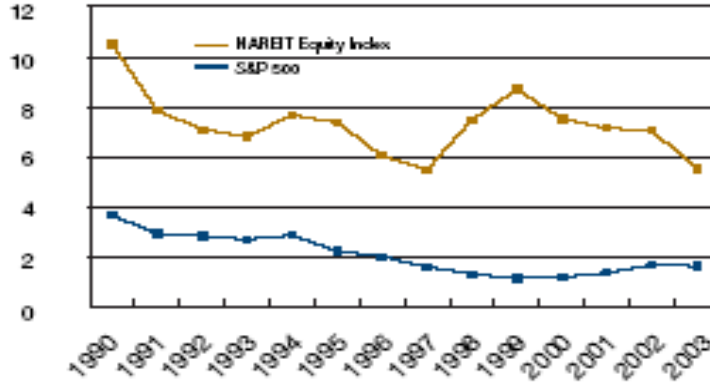
Source : NAREIT data library

US Congress created REITS in 1960 to give everyone the ability to invest in large-scale commercial properties. The REIT industry has grown dramatically in size and importance especially during the last decade. Factors sparking increased investor interest include:

- REITS - have outperformed most other major financial market benchmarks over three decades with significantly less volatility.
- REITS - own properties in nearly every major region across the US and in several international locations.
- In 2001, Standard & Poor’s recognized the evolution and growth of the REIT industry as a mainstream investment by adding REITS to its major indices, including the S&P 500.

A significant attraction of REITS in the US has been the premium dividend yield they have paid investors against the dividend of the Standard & Poor's 500 – see below.

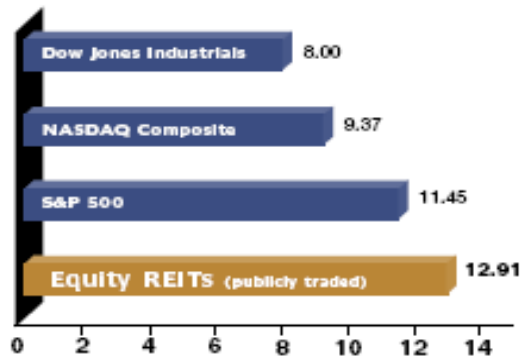
Dividend yields - REIT versus S&P 500



Source: NAREIT

Coupled with the high dividend yield, that have proved particularly popular in a lower interest rate environment, on a total return basis US REITS have performed well over the long term – see below.

Compound Annual Total Returns 1971-2003



Source: NAREIT

REITS have also been a global phenomenon that is spreading as additional countries adopt the necessary legislation. As the table below shows, there are very significant REITS markets outside the US with the UK to develop its own REITS market shortly. The global total in mid 2005 was €67 billion.

Global REITS markets as @ 30th June 2005

Region	€billion	Global Share %	Comment
North America	339	39	Canada 7% of region
Europe	226	26	Nil for UK
Asia	302	35	Australia 20% of region

Source: EII

This is the size of the market – what then was the driving force behind the growth?

Initially REITS found little favour as they were seen as very restrictive compared to normal publically listed vehicles. It was the savings and loan crisis in the early 90's that generated a catalyst for REITS. The crisis resulted in enormous amounts of non-performing loans and assets being transferred to government agencies that were keen to stabilise the market after the debt excesses of the late 80's. Post stabilisation, these agencies were then keen to off-load the assets back into the market place as soon as possible. The easiest way to achieve this in the early 90's was to bundle them up into parcels of similar asset types and sell them on to the stock market as a REIT. To sell these assets often a 10%+ yield was offered to the market. The catalyst to the growth of REITS was not therefore demand - it was supply lead.

As the 1990's real estate recovery took hold the existing REITS had impressive capital growth performance as well as a reliable dividend so yields fell and they successful raised new capital from the market and grew massively in size – hence the scale of the existing market.

The REITS market is heavily dominated by institutional investors but it does attract many smaller retail investors seeking an exposure to commercial real estate that would be difficult, if not impossible, to achieve on an individual basis.

On the face of it REITS looks an ideal method of achieving an exposure to the real estate market as:-

1. the value is ascertainable every business day by reference to the latest quoted trades and
2. perhaps most enticing to investors there is liquidity – the holy grail of real estate investing – that allows investors to exit their investment each trading day.

So with so many positives, why would anyone want to still invest in any other “old style” real estate vehicle?

This paper suggests that investors should carefully assess the relative merits of REITS and Real Estate Funds and highlights that investors should be aware that REITS have, partly from analysis of historical US data, some disadvantages that should be considered alongside their obvious advantages. The paper explores two such disadvantages of REITS as compared to Private Equity Real Estate Funds namely:-

1. the **Lack of Diversification** benefits
2. the **Restriction of Entrepreneurship** in REITS

Lack of Diversification

The issue here is that history shows that REITS are a relatively poor mirror of real estate performance – let's consider the table below of US data over a 25 year period.

Stocks, Bonds and Real Estate – 1978-2003

	Mean		Std Dev	Correlations						
	Nominal	Real	Nominal	CPI	Bonds	Int'l	Lg. Stocks	Sm. Stocks	REITs	R.E.
CPI	4.3%	-	3.1%	1.00						
Bonds	9.4%	5.1%	8.0%	(0.33)	1.00					
Int'l Stocks	13.7%	9.4%	23.6%	(0.08)	0.15	1.00				
Lg. Stocks	15.0%	10.7%	17.7%	(0.05)	0.27	0.62	1.00			
Sm. Stocks	19.5%	15.2%	23.5%	0.10	0.12	0.42	0.67	1.00		
REITs	15.2%	10.9%	15.3%	0.08	0.33	0.29	0.43	0.64	1.00	
Real Estate	9.4%	5.1%	6.2%	0.51	(0.20)	0.09	0.08	0.02	0.00	1.00

Source: UBS Real Estate Research based on data obtained from the Lehman Aggregate Bond Index, EAFE International Stock Index, S&P 500 Stock Index, Ibbotson Small Stock Index, the NAREIT Equity Index and the NCREIF Property Index, from 1978 to 2003, as of December 31, 2003. Correlations and standard deviations are based on rolling four quarter returns. Means are calculated from quarterly returns and annualized.

Concentrating on the final two rows of the table it is possible to draw the following important conclusions:-

1. Direct Real Estate performance is strongly correlated to inflation (here defined as CPI). Bonds, large and international stocks are negatively correlated so as inflation increased these types of assets have performed poorly. REITS are both less correlated to inflation than small cap stocks and drastically less than Direct Real Estate.

Therefore history shows investing in REITS rather than Direct Real Estate loses substantially all of the traditional benefits of Direct Real Estate being a good hedge against inflation.

2. Considering the correlation to Bonds - how do REITS and Direct Real Estate stack up? Here there is a massive difference in past performance. Perhaps not surprisingly as REITS “value driver” is primarily its dividend, there is a strong correlation between bonds and REITS of + 0.33. Meanwhile, Direct Real Estate is negatively correlated to bonds at – 0.2.

Therefore history shows investing in REITS rather than Direct Real Estate loses substantially all of the diversification benefits of adding Direct Real Estate to a bond portfolio.

3. Taking the next three columns together – the international, large and small capitalisation equities and looking at the differences in the three figures for REITS against the three figures for Direct Real Estate. The REITS figure for the three equity classes is, on average, 0.45 while for Direct Real Estate it is an average of 0.06.

Therefore history shows investing in REITS rather than Direct Real Estate loses a substantial part of the diversification benefits of adding Direct Real Estate to an equities portfolio.

As the above historical data from the US shows REITS have been relatively poor substitutes for Direct Real Estate in an investment portfolio and in particular are closely correlated to bonds – the direct opposite to Direct Real Estate. What this means, if the future follows historical trends, is that in the extreme those investors seeking a real estate investment who invest in REITS will get a proxy for bonds and, as such, an investment where value is primarily driven by the price of money rather than the balance in the underlying supply and demand of accommodation and real estate as an investment.

Should this be a surprise? Perhaps not given that REITS are assessed by analysts by their ability to generate a dividend/income. Clearly a REITS ability to deliver a robust income yield is highly attractive for investors and if that income grows it will, in time, translate into capital growth of the REIT stock/share. The point being made is that investors/analysts in/of REITS have, to date, placed a higher significance on income yield than traditional real estate equity investors/analysts. It is this focus on income that has meant in the current market Listed Property Trusts in Australia (equivalent to REITS) have been trading at very significant premiums (30-60%) to net asset values. Traditional Real Estate stocks have always been benchmarked against net asset values.

It is also interesting to note that some investment houses do not categorise money for REITS as part of a real estate allocation managed by real estate professional but place it under the management of either fixed income or the equities teams. Some institutional investors also seem to see REITS performance as gaining little from real estate professionals and more from bonds analysts.

So to recap REITS performance has been more closely aligned to the performance of bonds than Direct Real Estate but at least the market has liquidity so an investor can buy

into and sell out of the market quickly. But is that a good trade off if what the investor really wanted was a portfolio of diversified assets? This paper suggests that, on historical data, not, especially when long term investors are reconsidering why they have traditionally placed such a high premium on liquidity. This paper therefore advocates that investors should treat any REIT allocation differently than Direct Real Estate.

Restriction of Entrepreneurship

Additionally there are some other inherent structural consequences in the way REITS are assessed by the investment community that produce a number of potentially unattractive traits which should be considered by investors. These are set out under a number of sub-headings.

1. Management of REITS

This section considers the management of REITS and assesses their ability to be entrepreneurial for their investors.

It has already been explained that REIT analysts consider the ability to deliver income as the key performance matrix. Is therefore a manager of a REIT incentivised to carry out a development if they thought market timing was right and are they incentivised to take a surrender of a lease if it was thought best in the long term? The answer is regrettably, in most cases, likely to be no.

As a result of this sharp focus on income REITS could find it both difficult to recruit and retain the best entrepreneurial minds in the real estate industry as it will be difficult to give employees a challenging position and pay substantial bonuses when the market only focuses on income rather than rewards an aggressive market timing stance. To confirm this point ask a selection of senior managers of an American REIT or perhaps better their analysts.

2. Alignment of Interest

This section considers the alignment of interest between investors and REIT managers.

There is usually precious little, if any, co-investment from REIT managers alongside investors. Typically Private Equity Real Estate managers co-invest 5-20% of the fund aligning their interests to the investors.

Additionally REITS are also typically one sector vehicles – i.e. they are 100% retail or 100% offices etc. As a result of this high specialisation there is no incentive for REIT managers to call the peak of their market and thus there is a transfer to the investor of the responsibility to allocate capital between real estate sectors. Is this what retail investors want? Is it what retail investors understood when they invest in REITS?

Many Private Equity Funds have some ability for the managers to select between sectors in the investment phase and most of the currently listed UK public real estate companies have a diverse portfolio thus leaving sector allocation at least partly in the hands of the specialist managers.

3. Other significant differences between REITS and Private Equity Funds

Item	REITS	Private Equity Fund
Debt finance	Via regulations and market practice.	Flexible debt strategies to maximise returns in prevailing market conditions within any overall fund guidelines.
Real estate management	Incentive to maintain income.	Incentive to maximise overall return through a combination of income and capital growth.
Due Diligence discipline on asset purchase	Due diligence focussed on ability to achieve income targets. Assets that are income dilutive will be passed by.	The due diligence is likely to be more holistic and closer attention paid on likely future purchasers as a sale is required to realise returns.
Development	With income goals a REIT may be dis-incentivised from undertaking any development.	Incentive to undertake if risk adjusted returns are acceptable.

Investment Themes for 2006

So assuming this paper has convinced at least some of the readers there is still merit in a traditional style of gaining an indirect exposure to Real Estate it is advocated that Private Equity Real Estate funds are closely considered. Key benefits of such funds include:-

- an alignment of interest between investors and managers
- a harnessing of the experience of local asset managers
- an entrepreneurial management team looking to maximise absolute returns for all investors
- the wide choice of a number of fund styles from a range of well qualified Fund Managers

So where are the opportunities in Europe?

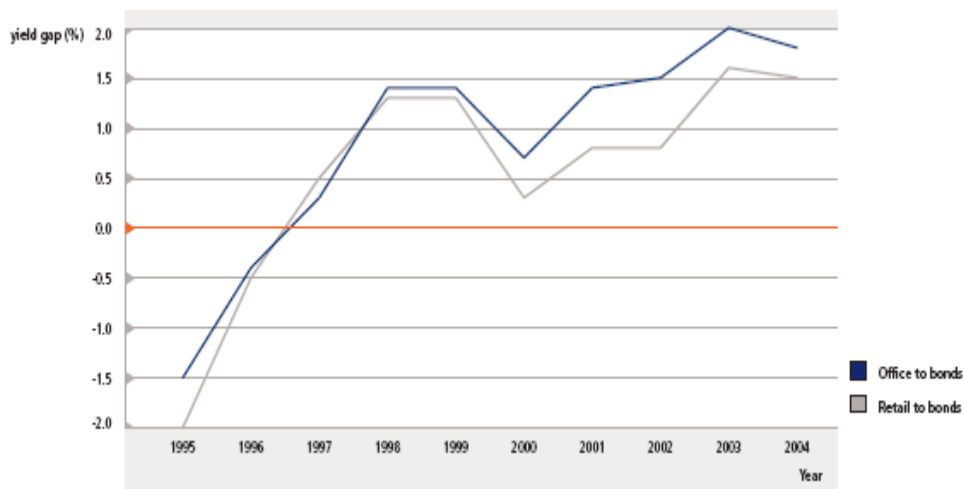
The following are some strategies on a country by country basis which will be carefully due diligenced on behalf on investors looking for attractive risk adjusted returns. These are likely to be pursued over the next year or so by the establishment of Private Equity Real Estate Funds.

1. France – Offices in both Paris and Regionally

The graph below, perhaps surprisingly, shows the continued high positive yield gap that continental European offices and retail property has to bonds. This gap has risen since 2000.

From an investors viewpoint the gap between rental yield and debt service costs provides an attractive starting point for an investment strategy as it provides a current return on invested equity and means, with very little capital growth, reasonable investment returns can be generated.

European yield gap between offices and retail to bonds



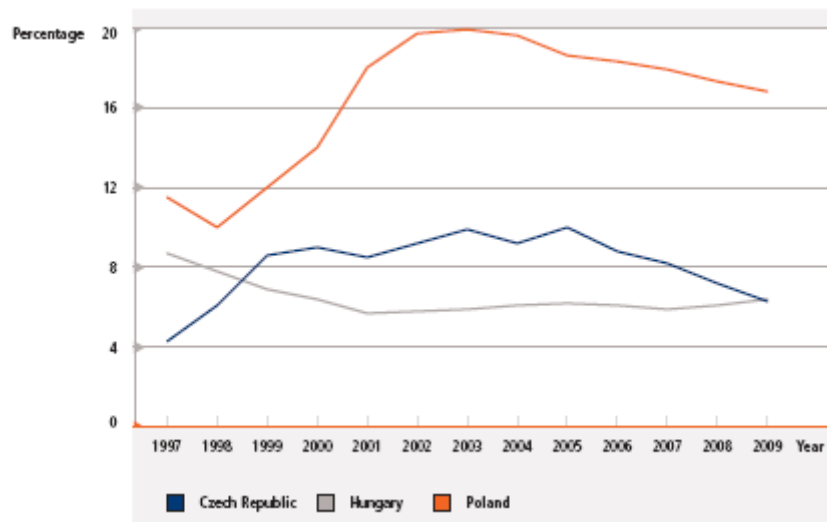
Source: PMA and Thomson Financial Datastream

In regional cities, especially in France, this gap widens and provides an interesting low risk investment opportunity. The strategy is to acquire completed assets, utilise leverage at 60-65% and fixing interest rates. The active management involves working with tenants to renew leases and leasing vacant space whilst allowing rental income to grow via the annual rises that are fixed to the French construction cost index. This index has grown at 3-3.5% per annum in the last 5 years. Against such a strategy an average distributable return can be achieved of 5-6% p.a. with an overall Internal Rate of Return (“IRR”) post all fees of 12-13%. Such an investment provides great diversification benefits whilst focusing on a sector of the European market that is very defensive/low risk in nature.

2. Central Europe

Central Europe is plagued by high levels of unemployment that provides an opportunity as these people will, over time, get back to some form of economic activity. The graph below shows the scale of the problem. Even accounting for differences in the way unemployment rates are calculated and a substantial black economy there is significant unemployment in Poland.

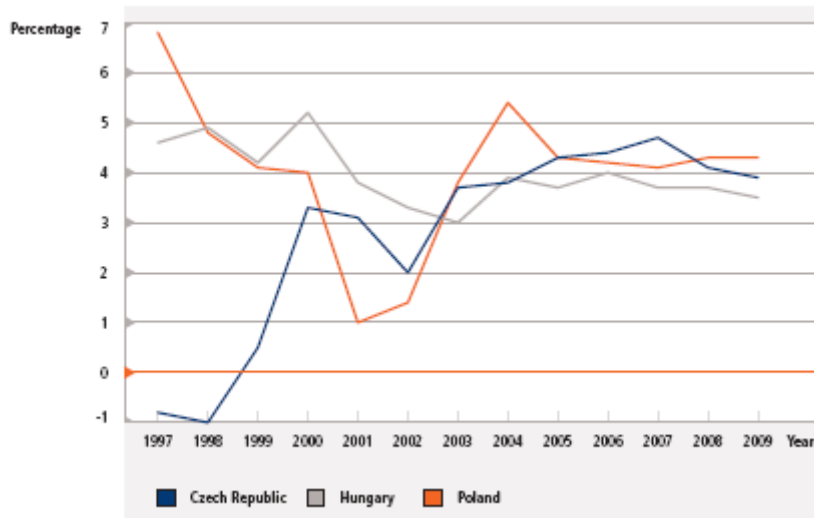
Unemployment



Source: EIU

The recent fierce round of negotiations on the EU budget for 2008-2012 has resulted in a far greater share of the budget being directed to Central Europe that will add to an already strong positive economic growth forecast (see graph below) that does not exist in the rest of Europe. The graph shows both recent and predicted GDP growth converging for the three major Central European countries at 4% p.a. in real terms. This is at least double the average for Western European countries over the past 4 years.

GDP Growth



Source: EIU

The structural changes in these economies from a substantially rural to predominately urban society will be a significant driver in these economies which is why a retail fund in Central Europe concentrating on assets outside the capital cities looks interesting. Such a fund would benefit from increases in consumer spending and growth in city populations. The property acquired would be substantially leased and over an 8 year timescale would benefit from modest rental growth and the benefits of active management to lease vacant accommodation and improve the attractiveness of the asset. It is important to have the capacity to buy in regional Polish cities in particular, as Warsaw has become incredibly competitive with numerous sources of international capital targeting it.

This medium risk strategy should produce an annual dividend of 6-7% and an Internal Rate of Return (“IRR”) post fees of 14-16% over a 7-8 year hold.

3. UK offices

The London and South East UK office markets are emerging from a period of over supply and rental growth is now expected to pick up relatively sharply over the next 4 years. The West End of London has already seen rental growth and supply of available opportunities is very scarce and where they do exist there is intense competition from every conceivable source of capital.

The City of London market is seeing a small supply of investment opportunities that should perform well over the next 4 years. These vary from full scale redevelopment opportunities to investment assets that offer active management opportunities as rental growth increases.

Outside London the recovery is more patchy giving local expertise the opportunity to selectively put together a portfolio of assets in locations that are going to benefit most from the upturn in this sector.

This proposed strategy would include the ability to add provincial city purchases but as the graph below shows those cities have not seen any material rental declines and thus are less likely to experience a material bounce in rental values over the next 4 years.

Prime office rental levels



Source: PMA

This UK offices strategy is a medium to high risk investment because of the likely redevelopment of certain assets. Given the relatively higher UK interest rates to property yields there is likely to be little, if any, annual dividend with all the return likely to be via capital growth which is crystallised at the end of 4 years. Risk is mitigated by the diverse range of locations in this portfolio and the fact that UK property has been, and is likely to continue to be, viewed as the most attractive in Europe over the long term. Such a fund is projected to yield a 15-17% IRR.

Conclusion

If this paper has added to the fuller appreciation of the benefits and disadvantages of REITS, as derived from historical data, it will have achieved its objectives.

It is right to be enthusiastic about the increased availability of REITS and, of course, to welcome the increased interest in real estate as an investment class. However, it must be hoped that investors do really understand the characteristics of the investments they are making and do not only find out when the lack of diversification benefits come to light. It would be a shame if all the gains made in recent years to ensure real estate is taken seriously as an investment were lost if REITS performed poorly.

There is undoubtedly a place for both REITS and Direct Real Estate in most portfolios – however, it would be wrong to substitute the previous Direct Real Estate allocation entirely for REITS because of their liquidity advantage and in so doing lose most of the diversification benefits.

The rationale for the split of investment capital between REITS and Private Equity Real Estate Funds is sure to be an even hotter topic of debate going forward. This paper suggests that on empirical evidence from past performance and on the analysis of entrepreneurial drivers of individual behaviour that the split may be best drawn along the lines of investment styles.

There seems merit in considering using the REIT allocation to gain an exposure to “core” real estate as this is where the liquidity and tax advantages of REITS are particularly attractive given the longer hold periods of such assets and the higher income distributions. Private Equity Real Estate Funds seem best suited to “opportunistic” assets where a highly incentivised and co-invested manager has more flexibility to follow a more entrepreneurial style of fund management on what are usually short term investment hold periods with no annual dividends. This leaves “value added” investment styles perhaps suitable for both types of vehicles as individual circumstances and preferences suit.

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