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# INTERNATIONAL NON-CORE REAL ESTATE
# A PRIMER

**April 2018**

## EXECUTIVE SUMMARY

This primer provides a short overview of international real estate strategies **focussing primarily on the benefits of the addition of international non-core real estate assets to an institutional investor's portfolio**. It also provides a summary of the current macroeconomic environment and its relevance for real estate investing as well as a short coverage of general regulatory and tax trends. Finally, the primer outlines our thinking with regard to the ideal portfolio build-up of a private non-core real estate portfolio.

**Key take-aways** of this primer:

- Private non-core real estate strategies have three key benefits:
  - they can be a **powerful addition to an existing (core) real estate portfolio** as they **exhibit an outperformance potential** compared with traditional core properties
  - they provide **access to new investment opportunities** that may not otherwise be accessible, and
  - they are able to act as a **diversifier within real estate and overall portfolios of institutional investors**

- Average real estate target allocations of institutional investors sit around 10% of total assets (target allocations are slightly higher in Asia Pacific, at c.11.5%, and the Americas, at c.10.4%, but lower in Europe, at c.9.0%). On a globally aggregated basis **institutions continue to favour non-core** (particularly value-add) **strategies**.[1]

- While real estate investments (both core and non-core) play an important role in institutional investors' portfolios in most market cycles, in the current environment **we expect that idiosyncratic risks of local real estate markets and structural trends will drive strong future performance**. The addition of well-diversified selective value-driven strategies, ideally including an element of built-in distribution yield to provide some downside protection, can enhance the quality of portfolios that otherwise may be more exposed to valuation movements, especially in today's market cycle.

- Private non-core real estate allocations are ideally built up over time within a regular managed programme rather than by picking a few funds at one point in time. A **steady commitment pace** not only complies with diversification over cycles but also ensures a stable allocation to the segment and hence provides consistent value creation benefits to a portfolio.

- Consequently, a **long-term perspective, a prudent portfolio build-up and a rigorous investment selection** process are key components in order to be able to successfully implement non-core real estate investment programs.

[1] Source: Cornell University, Hodes Weill & Associates – 2017 Institutional Real Estate Allocations Monitor.

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# PRIVATE (NON-LISTED) REAL ESTATE AS A SUB-ASSET CLASS

## Real estate segments by risk/return profile

While investors may use different measures to distinguish the risk profile of specific real estate investments, e.g. by region, sector, leverage, stage, or share of income distribution of total return, a common denominator that tries to capture all risk factors used by many industry associations (e.g. NCREIF[2], INREV[3] or ANREF[4]) is the classification into core, value-add, and opportunistic. This classification typically applies to real estate equity. For completeness, we added real estate debt in the below summary.

**Core:** the most defensive sub-category (apart from similarly defensive debt strategies) comprises high quality properties in the traditional property sectors (office, retail, industrial, and rental apartments) that are generally well-leased (to high quality tenants) and ideally located. An investor in pure core real estate typically generates mid-single digit to high single digit returns (if levered) in the long-term. Institutional investors often own core property directly and domestically. The main purpose behind real estate core allocations is to buy a real asset for the long-term in order to generate a stable recurring distribution yield. While in the past few years core returns have been driven by capital appreciation, over the long-term, it is expected that they are primarily generated by their rental income component.[5] While core property is typically not as liquid as securities offered on an exchange (e.g. REITs), it is generally more liquid than value-add and opportunistic property (see below) because core assets are stabilised (i.e. a property with an occupancy of at least 80% that is not a development or a transition property) and generally marketable.

**Value-add:** this category comprises properties with some refurbishment, repositioning or leasing requirements and typically shows target returns in the high single digits (may also be referred to as “core plus”) to the low-to-mid-teens (net of fees of fund managers and inclusive of leverage). Besides the traditional property sectors, value-add real estate may also more often (than found in core products) include exposure to specialist funds focused more on value-add strategies in niche property sectors such as self-storage, senior housing, elderly care, data centres, parking, and so on (though we see increasing exposure to these sectors in core funds more recently). An allocation is generally built up through commitments through specialised managers that raise capital for closed-end vehicles with an average term of c.8 years (of which c.3 years investment period). Due to the required period to effectively create a core property from a previously non-stabilised property, value-add investors are generally expected to benefit from an illiquidity premium.

**Opportunistic:** this category comprises properties across all aforementioned sectors but is focused on development, complex distressed situations (recapitalisations), a higher level of exposure to operating risks (e.g. through hotel investments) or emerging market risks and typically show target returns of mid-teens and above (net of fees and inclusive of leverage). As with value-add strategies, an allocation is generally built up through commitments through specialised managers that raise capital for closed-end vehicles with an average term of c.10 years (of which c.4 years investment period). Also, in line with value-add investments, opportunistic investments are expected to be able to benefit from an illiquidity premium. However, it is difficult to isolate this risk premium from the main alpha-driver, which is value creation, including the sourcing and execution of complex transactions. Empirical research suggests that the premium may lie in between 0% (effectively no evidence found) and 3% p.a. Therefore, we find theoretical and some empirical support for the existence of an illiquidity premium but it’s hard to separate it from other return driving factors and therefore almost impossible to quantify.[6]

[2] NCREIF: National Council of Real Estate Investment Fiduciaries: NCREIF is a not-for-profit trade association that serves its membership, and the academic and investment community's need for improved commercial real estate data, performance measurement, investment analysis, information standards, education, and peer group interaction. NCREIF is headquartered in Chicago and focused on the USA.

[3] INREV: Investors in Non-Listed Real Estate Vehicles: INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. INREV is headquartered in Amsterdam.

[4] ANREV: Asian Association for Investors in Non-listed Real Estate Vehicles. ANREV is headquartered in Hong Kong.

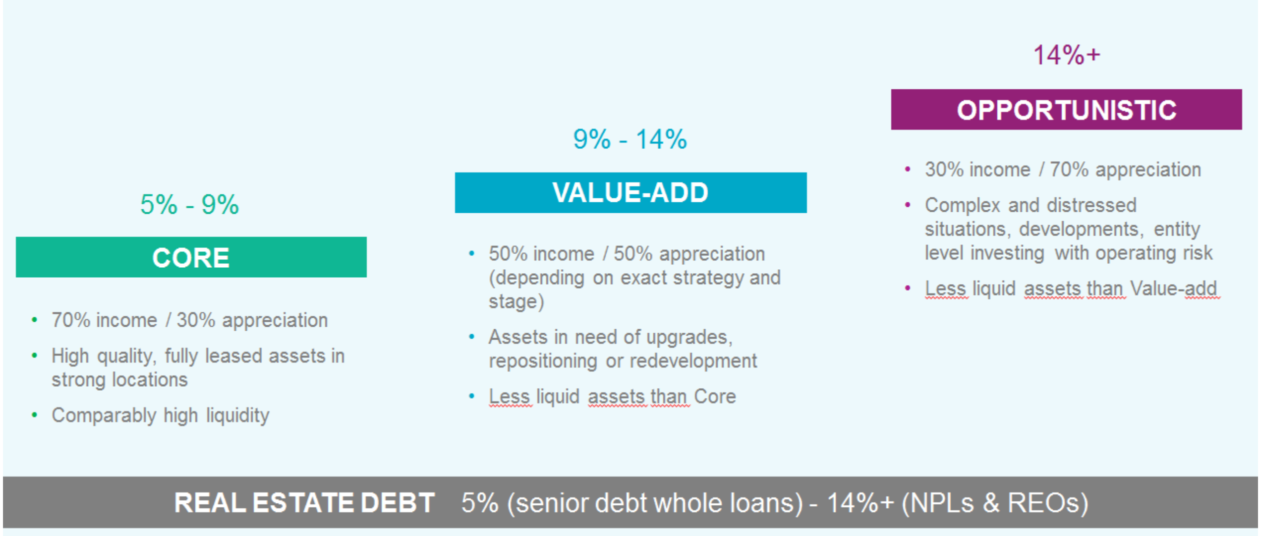
[5] By way of example, the NFI-ODCE Index (NCREIF Fund Index Open-End Diversified Core Equity) that covers 36 North American property core funds reported as of the end of 2017 a 3 year gross return of 10.4% p.a. (net of 9.4%), of which 5.7% was derived from appreciation and 4.5% from income (sum of income and appreciation does not equal total return due to rounding and compounding of parts). The 40 years (since inception gross return was 8.7% (of which 7.2% was from income and 1.4% from appreciation).

[6] For more information on the illiquidity premium in private markets see “Seeking Returns in Private Markets”, February 2017

**Debt:** this category includes numerous sub-strategies that can be broadly classified into two main sub-categories, i.e. i) (senior) debt, whole loan and mezzanine strategies with target returns between 5% and 14% p.a. (depending on the exact strategy and the use of additional leverage), and ii) non-performing-loans ("NPLs") and real estate owned ("REO"), i.e. foreclosed-upon property owned by banks. This second sub-category involves a higher risk and accordingly generally has target returns of above 14% p.a. The duration of closed-end debt funds varies but on average is somewhat shorter than value-add or opportunistic (i.e. c. 2 years investment period and 7 years term).

The following illustration (Figure 1) summarises the previously described classifications:

**Figure 1: Risk/return classifications of real estate investments**




***Source: Mercer Research***

In the remainder of this primer, the focus will be put on private non-core real estate. This non-core segment (i.e. value-add, opportunistic real estate equity and real estate debt) combines strategies that involve a meaningful degree of value creation and debt themes. Investors can typically access opportunities through commitments (primary or secondary) to closed-end investment vehicles or via co-investments with closed-end fund managers.

## The value of private non-core real estate

Private **non-core real estate strategies have three key benefits** for an institutional investor: i) they have an outperformance **potential** versus traditional real estate strategies, ii) they provide **access to new investment opportunities** that may not be accessible through listed or core real estate allocations, and iii) they are able to **act as a diversifier** within institutional investors' real estate or overall portfolios. These benefits will be outlined in more detail in the following paragraphs.

Typically, private non-core real estate investments are pursued by specialised investment management firms that generally define their strategy by applying one of the following **value creation methods** that provide investors with outperformance potential versus traditional core strategies:

- **Active asset management:** examples include the leasing up of vacancies, refurbishment activities, repositioning or change of use of a property as well as (re-) development of real estate projects.
- **Operationally-driven strategies:** examples include the build-out of property platforms through the acquisition of portfolios or the aggregation of single property assets (e.g. senior housing, self-storage, hotels, gas stations, etc.) with the focus, apart from growth, to drive operational efficiency.

- **Sourcing and execution of complex transactions:** examples include real estate with favourable supply/demand dynamics held by distressed sellers or liquidity-constrained owners that can be acquired below replacement cost and/or through recapitalisation. Other examples may involve capital market arbitrage strategies, such as assembling a platform for an IPO or purchasing all assets owned by a public entity ("take private") as well as the capitalisation on structural changes in emerging markets or targeted debt strategies (loan-to-own, transitional[7] loans, NPLs).

The commonalities of these strategies lie in the investment managers' ability to identify and unfold the alpha potential hidden in real estate assets. Therefore, in contrast to core real estate, where in the long-term, returns are expected to come mainly from stable rental income, closed-end non-core real estate strategies are expected to have a higher portion of total returns from capital gain or appreciation whereas income is expected to grow over the holding period of the asset. This is also reflected in the long-term (20.25 years) return of NFI–CEVA (the NCREIF fund index for US closed-end value-add funds), that, as of September 2017, showed a total performance of 12.7% p.a., of which c. 54% attributable to income and 46% to capital gain.[8] By way of comparison, the NFI-ODCE index (the NCREIF fund index for US open-end core funds) reported as of September 2017 a return of 8.7% p.a. over the long-term (39.75 years), of which c. 84% attributable to income and 16% to appreciation.

While **NFI-CEVA's headline return figures exceeded NFI-ODCE's return figures over the long-term and the shorter terms**, i.e. 1-year, 3-year, 5-year, and 10-year-terms[9], it is important to note, that the **right selection of closed-end non-core funds is a very meaningful return driver[10]** (whereas the return spread among core property investment portfolios is tighter). The main reason being that **non-core funds exhibit different sources of risk** (e.g. operational risks, construction risks, leverage risks) that are generally less pronounced in core property investments. Additionally, non-core real estate managers are often trying to benefit from specific themes or trends that they identify. However, if these trends do not materialize, the downside is bigger because traditional core real estate investments inherently provide for more downside protection due to the stabilised nature of their contracted income streams. As a consequence, the **dispersion of returns of non-core funds managed by differently skilled managers is significant** (the average dispersion between non-core closed-end top quartile and median funds in the vintage years 2003 to 2015 was approximately 5.7% p.a.).[11] As in other private market investment areas, selection therefore plays a key role and investors need to be fully aware of the risks of inaccurate manager selection.

Apart from the outperformance potential, non-core real estate also offers investors the benefit of **access to investment opportunities that may not be accessible otherwise**, e.g. through public markets or core real estate allocations. Institutional investors typically show a domestic bias with regard to their real estate allocations. Additionally, core real estate portfolios of institutional investors generally tend to be concentrated in traditional property sectors, i.e. office, logistics, retail and multifamily. The implementation of a private non-core real estate portfolio (apart from its access to property projects with a different risk-return profile) is therefore expected to contribute to an expansion of the investable universe as these portfolios may involve:

- **More regions:** non-core real estate managers cover the investment universe globally through single-country or pan-regional funds. According to estimates, the global market for investable commercial real estate stands at roughly USD 27 trillion in 2017[12], of which Europe and North America account for c. 32% each, Asia Pacific accounted for 28% and the remainder mainly in Latin America and the Middle-East. By way of example, the German real estate market accounted for c. 5.8%, the UK market accounted for c. 5.7% (France: 4.2%, Netherlands: 1.3%, Switzerland: 1.1%, China: 10%, Japan: 7.4%, Australia 2.1%, UAE: 0.8%, USA: 29.5% and

[7] Transitional real estate generally refers to properties that experienced some sort of capital, cash-flow, maintenance or positioning issue. These properties require (value-add) expansion capital or upgrades as they have previously been neglected by their prior owners. However, these properties may be located in attractive locations and may be hidden gems once repositioned. Debt on such property is often called transitional loans.

[8] National Council of Real Estate Investment Fiduciaries (NCREIF), NFI-CEVA (Fund Index Closed-End Value-Add) snapshot 3Q 2017

[9] NCREIF NFI-CEVA and NFI-ODCE 3Q 2017 snapshots (Total, gross of fees)

[10] See Figure 3 of this primer

[11] Preqin database, Mercer Research; see also Figure 3 of this primer

[12] CBRE: Global stock of investable real estate.

Canada 2.7%)[13]. Therefore access to non-domestic real estate is relevant for any institutional investor worldwide as it significantly expands even a US investor's opportunity set. While this argument applies to core and non-core strategies, in many markets (particularly emerging markets), core funds are still rare and exposure can often only be built up through non-core funds.

- **More sectors:** Apart from the traditional real estate sectors, non-core real estate strategies often also include sectors that benefit to varying extents from structural trends in different regions e.g. from e-commerce (affecting logistics), the influence of millennials in the labour force affecting small office or flexible office space requirements as well as TMT office demand[14], or other trends such as an increasing demand for externalised self-storage solutions, student housing, or for-rent residential (due to migration to gateway cities), as well as healthcare and assisted living facilities (due to ageing populations), datacentres (increase in data consumption), or carparks.[15] While core funds include some of these sectors, it may be more difficult to build up a large scale, diversified exposure across such sectors via core funds only.
- **More sub-categories of real estate investing:** Through access to specialised investment managers, the coverage across broader investment themes can be augmented when implementing non-core strategies and may include examples such as i) US or European value-add ("creation of core" in a market with healthy real estate fundamentals), ii) US (and European) private real estate debt (benefiting from long-term regulatory trends that limit bank lending), or iii) emerging market growth themes (e.g. China's share of worldwide consumption has almost doubled in the last decade[16] due to a rapidly increasing middle class that, by way of example, also spends more money for experiential retail[17], e-commerce (Alibaba) and international travel (in 2016, the number of Chinese people travelling abroad increased 6% to 135 million[18]) amongst others).

The third key benefit of non-core real estate (apart from its outperformance potential and access to new investment opportunities) is **diversification**. It should be noted that real estate markets find themselves in different cycles around the world as they are driven by different factors outlined below (some of which are more correlated to each other but others are effectively uncorrelated[19]). When non-core real estate is added to a portfolio, the higher the allocation to specific idiosyncratic risks in heterogeneous assets/strategies, the greater the expected diversification benefits.

However, diversification occurs not only within real estate but also in a private markets context as the return drivers of property are distinguished from typical return drivers relevant for other private market investments, like private equity, private debt or infrastructure. Examples of typical real estate return drivers (apart from classic macroeconomic factors that will be addressed in the next section) are i) the point in the cycle of localised supply/demand fundamentals for specific property (mostly at healthy levels nowadays in contrast to the pre-GFC cycle), ii) demographics (ageing population in developed economies and the migration trend to gateway cities), iii) the composition of an economy (commodity-driven, finance-driven, or government sector-driven, etc.), iv) the maturity of existing stock (requiring diverse strategies, e.g. mainly refurbishment of existing real estate in developed markets, particularly in Europe vs. development of new real estate driven by the upcoming middle class in many emerging markets), or v) secular trends, such as the aforementioned trends in logistics (growth in e-commerce) or data centres (growth in data consumption).

Some of these return drivers are suitable for all real estate risk/return-profiles; others are more relevant for non-core real estate. Therefore, the addition of non-core real estate to an institutional investor's portfolio, apart from providing

[13] Pramerica Real Estate Investors ("A Bird's Eye View of Global Real Estate Markets: 2017 Update").

[14] By way of example, according to Brockton, a UK-focused value-add fund manager, the demand for flexible space as a percentage of total office stock is expected to increase from 5% to 25% over the coming years (Brockton has created an integrated OpCo/PropCo platform to benefit from this trend).

[15] PwC Emerging Trends in Real Estate: Reshaping the future: Europe 2018; sector prospects in 2018.

[16] ATKearney: The rise of China's middle class consumer.

[17] Florentia Village (developed by Asian value-add fund manager Gaw Capital) is a good example: the Italian designer outlet outside Beijing offers international luxury brands on a site inspired by classic Italian architecture combining plazas, galleys, fountains and monumental buildings and creating an "instagrammable" retail experience.

[18] ATKearney: The rise of China's middle class consumer.

[19] Datastream, Credit Suisse: Real Estate as an asset class: Correlation of price changes: the correlation of direct investment in office property in the world's leading cities with global equity markets is low at 0.3, and even slightly negative in the case of the bond market, at -0.15.

access to numerous real estate investment themes, also provides the investor with a natural diversification of return drivers, from which the investor's overall real estate portfolio, its private market portfolio and its overall investment portfolio will benefit.

As a consequence of these benefits, it is Mercer's view that successful real estate programs should – apart from the important backbone of domestic (and international) core holdings – include the "value investing" part of private real estate – as well as debt themes in order to be able to benefit from the entire real estate investment universe that can be accessed by institutional investors.

## Institutional investors' allocations

Real estate is a widely used asset class within institutional investors' portfolios worldwide. According to the 2017 Institutional Real Estate Allocations Monitor[20] **average real estate target allocations of 244 participants in 28 countries representing USD 11.5 trillion in AuM sit around 10% of total assets**. Regionally, target allocations are slightly higher in Asia Pacific, at 11.5%, and the Americas, at 10.4%, but lower in Europe, at 9.0%.

Target allocations are slightly above the current allocations of c.9% and accordingly a majority of the participants (60%) are underinvested relative to their target allocations. As in previous years, **institutions (on a globally aggregated basis) continue to favour non-core strategies (value-add and opportunistic) for property investments**, i.e. 86% of participants invest in value-add real estate, 72% in opportunistic, and 69% in core (the lower percentage may reflect investors' recent perception of high valuations particularly in core real estate). However according to this report, we note regional discrepancy in this regard, i.e. North American institutions prefer both value-add and opportunistic over core whereas European and Asia-Pacific institutions prefer core and value-add over opportunistic. As an alternative to equity strategies, **investors are also showing increased interest in credit strategies** (60% of investors intended to make commitments to this segment in 2017).

As regards regional focus, **more than two thirds of investors invest in Europe and North America**, whereas less than 50% of investors consider allocations to Asia-Pacific and emerging markets. In terms of third-party management, c. 66% of institutions are outsourcing their entire real estate portfolio to third parties (72% of smaller institutions and 42% of larger institutions). 7% of participants completely manage their real estate allocations in-house and the remainder apply a mix.

The main access route to real estate investments is through closed-end and open-end private funds (more than half of respondents) while a relatively constant share of c. 30-40% of participants invest directly, through joint ventures or separate accounts. In terms of closed-end vehicles that are typically used by fund managers of value-add and opportunistic strategies (as well as targeted debt strategies), the **fundraising has steadily strengthened over the last 7 years**. In 2016, 355 funds raised an aggregate amount of USD 141bn[21]. While the absolute amount is in the range of capital that was raised at the peak years before GFC (during 2007 and 2008) the number of funds with a final closing has slightly decreased owing to the fact that a few very large funds have recently been raised. Overall, we note that the closed-end private real estate industry has experienced a material growth with assets under management and number of active firms constantly increasing over the last 25 years.[22] We also positively note that the trend of increasing demand (fundraising activity) has gone hand in hand with more supply (global transaction volumes) that **in 2015 and 2016 were slightly above the previous peak achieved in 2007**.[23]

[20] Cornell University, Hodes Weill & Associates – 2017 Institutional Real Estate Allocations Monitor (October 2017). The 244 participants in the 2017 review come from the following regions: 69% North and South America, 20% EMEA, and 11% Asia Pacific. 34% were public pensions, 31% endowments and foundations, 18% private pensions, 14% insurance companies, and 3% sovereign wealth funds and government-owned entities. In terms of size, 82% have AuM of less than USD 50bn, and 18% have more than USD 50bn.

[21] Preqin: Real Estate Spotlight November 2017.

[22] Preqin: Real Estate Spotlight September 2017.

[23] Real Capital Analytics: Global Capital Trends Report Q2 2017.

According to an investor satisfaction survey recently published by Preqin[24], 95% of investors stated that their real estate investments have met or exceeded expectations over the past 12 months. On the back of this positive development, 72% of same investors plan to maintain or increase their commitments to private real estate funds over the next 12 months.

We note, however, that the **addition of non-core real estate to institutional investors' portfolios requires some pre-conditions to be met**.

First and foremost an **investor needs to have tolerance for risk** (additional volatility) in the portfolio as the return premium being offered by non-core real estate investments is based on various additional risk levers (be it strategy-inherent risks previously mentioned, e.g. operational, construction or leverage risks, specific theme-related risks or emerging market risks).

Additionally, as **non-core real estate is less liquid during its holding period** (until an asset is stabilised) and investment solutions are normally implemented via closed-end funds (not offering liquidity except through a sale in secondary markets), an investor needs to accept illiquidity and the fact that in the early years of implementation gross returns are often not sufficiently large to fully offset the fee burden borne by investors, leading to the so-called J-curve effect (the net IRR over time produces a curve that is shaped like the letter J).

As pointed out throughout this primer, while an investor is expected to get rewarded for illiquidity and the other risks outlined above, they need to be factored in and understood when making the decision to allocate capital to non-core real estate.

## CURRENT ENVIRONMENT

### Macroeconomic view

It is clear that cental banks (led by the Fed) are seeking to gradually normalise monetary policy over the next few years through a combination of rate rises and balance sheet reduction. As a result, **total returns for pure core real estate strategies** may be lower than in recent years as the potential for further capital gains resulting from declining yields has reduced. In line with this view, Mercer's Dynamic Asset Allocation update[25] suggests, by way of example, that the UK property market is approaching a cyclical high in valuation terms and entered a phase of 2-3 years when returns are expected to be driven by rental growth mainly. Similarly, our outlook for German and French property is neutral to negative. We have also observed some reversal trends in the US where, after many years of absorption outpacing supply, a pickup in construction is more recently coinciding with a slowdown in absorption across sectors (e.g. office, industrial, apartments). However, in Europe as well as the United States, while an expected modest increase in interest rates may increase the expenses of developing new projects or costs of refinancing existing debt, and may even prompt a reactionary sell-off in real estate investment trusts (REITs) if rates were to rise sharply, the spread between 10-year Treasury and commercial real estate yields (relative to historical averages over the last 30 years) actually appears to allow some room for limited further compression[26]. **Risk premia for real estate investments in North America and Europe are still above their historical average**, which suggests that **values may not be immediately threatened by rising interest rates**[27] **or bond yields**. Summarising the above, an analysis of global property risk premia suggests that while it is hard to find arguments to underwrite yield compression, there might indeed be some protection against a moderate increase in interest rates for all real estate investments.

[24] Preqin Investor Outlook Alternative Assets 2H 2017

[25] European Dynamic Asset Allocation: 2018 Q1 Economic and Market Outlook

[26] Ernst & Young analysis (Commercial property outlook in a rising rate environment, EYGM Limited September 2015).

[27] Credit Suisse Real Estate Strategies, 2017, International Real Estate.

In terms of **valuations and cyclicality**, it is important to note that the tactical timing of real estate markets tends to be pursued by investors in listed real estate (given the illiquidity of unlisted real estate) and is generally more related to core property (which is also the focus of our dynamic asset allocation house views) than to non-core property. Non-core private market real estate allocations are ideally and typically built up as strategic holdings by investors and serve as powerful portfolio enhancers (for the reasons already discussed related to diversification, additional return drivers, and broadening of the opportunity set). Investors in non-core real estate typically have a long-term view on the sub-asset class and diversify their entry points over time, which is advisable due to the implementation features that come with building private market investment programs (see also the next chapter of this report: Private non-core real estate - ideal portfolio build-up). Therefore, investors in non-core real estate are looking to maintain stable exposures over time rather than to make short term tactical decisions based on valuation cyclicality.

While real estate investments (both core and non-core) play an important role in institutional investors' portfolios in most market cycles, in the current environment we expect that idiosyncratic risks of local real estate markets and structural trends will drive attractive future performance. Well diversified but selectively picked **value-driven strategies, ideally with an element of built-in cash-on-cash yield that is expected to provide for some downside protection, are considered to be more attractive than strategies mainly focused on valuation gains in the near-to-mid-term**. Compared to the recent past, where valuation gains driven by the market cycle have helped (property) investors to achieve strong returns, we therefore expect that a more selective investment approach (that does not only rely on market timing) will be required for the next few years in order to remain a successful property investor.

## Regulatory and tax perspective

With regard to the **regulatory environment**, private real estate strategies are mainly directly affected on the lending / financing side through the **Dodd Frank Act**[28] in the US and **Basel III**. Both regulations impose capital adequacy requirements that limit bank lending or make it less attractive for banks, particularly if the loans bear some risk (e.g. embedded in transitional real estate loans). As a consequence many private fund managers have been accessing this territory and offer not only borrowing solutions for real estate owners but also investment opportunities for private real estate investors. With regard to US property, these opportunities are particularly attractive for non-US investors who seek exposure in US real estate as an investment in US real estate debt does not result in a tax drag on capital gains stemming from FIRPTA ("Foreign Investment in Real Property Tax Act") or on income distributions stemming from ECI ("Effectively Connected Income") that can otherwise be relevant for foreign investors allocating capital to US real estate equity. As a consequence, depending on the exact underlying debt strategy and the quality of the manager (versus a specific equity strategy and the quality of an equity manager), **US real estate debt investments might be a good complement from a risk-adjusted standpoint to US value-add and opportunistic equity investments for non-US investors**. For non-US real estate core investors, however, the comparative advantage of debt may be less relevant as core investors are by nature less exposed to FIRPTA and depending on the qualification of the underlying investor ECI may not result in a tax drag at all.

Other regulations such as Solvency II[29] or MIFID II[30] effectively require a higher degree of transparency from fund (and fund-of-funds) managers. The further scrutiny applied in terms of specific transparency requirements, is expected to increase the benchmark level for fund managers to comply with the standards and qualify for investment.

Finally, with regard to tax adjustments, there have been some changes made recently in two major markets, the USA and Germany. While both changes may have a positive impact for institutional investors deploying capital in international

[28] The Dodd-Frank Act entails two key elements; the first deals with risk retention of securitisation and the second is the Volcker rule that limits affected banks from proprietary trading for their own accounts. Both provisions reduce the amount of commercial real estate bank lending and increase the cost of borrowing from banks.

[29] The Solvency II Directive is a directive in EU law that codifies and harmonises the EU insurance regulation. Primarily this concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency. It has become effective as of 1 January 2016.

[30] The Markets in Financial Instruments Directive is the EU legislation that regulates firms who provide services to clients linked to financial instruments. MiFID has initially become effective in November 2007 and revisions will become effective under MiFID II in January 2018.

real estate strategies (across the risk spectrum), both tax adjustments as well as some of the aforementioned regulatory adjustments are still subject to final intricacies that also very much depend on the qualification of the underlying investor. While investors should procure their own tax and legal advice when considering international real estate investments on their own, Mercer is steadily observing and analysing these trends in close interaction with our internal and external legal and tax counsel, in order to be able to provide optimised solutions for our clients.

## PRIVATE NON-CORE REAL ESTATE - PORTFOLIO BUILD-UP

### Ideal constitution of a private non-core real estate portfolio

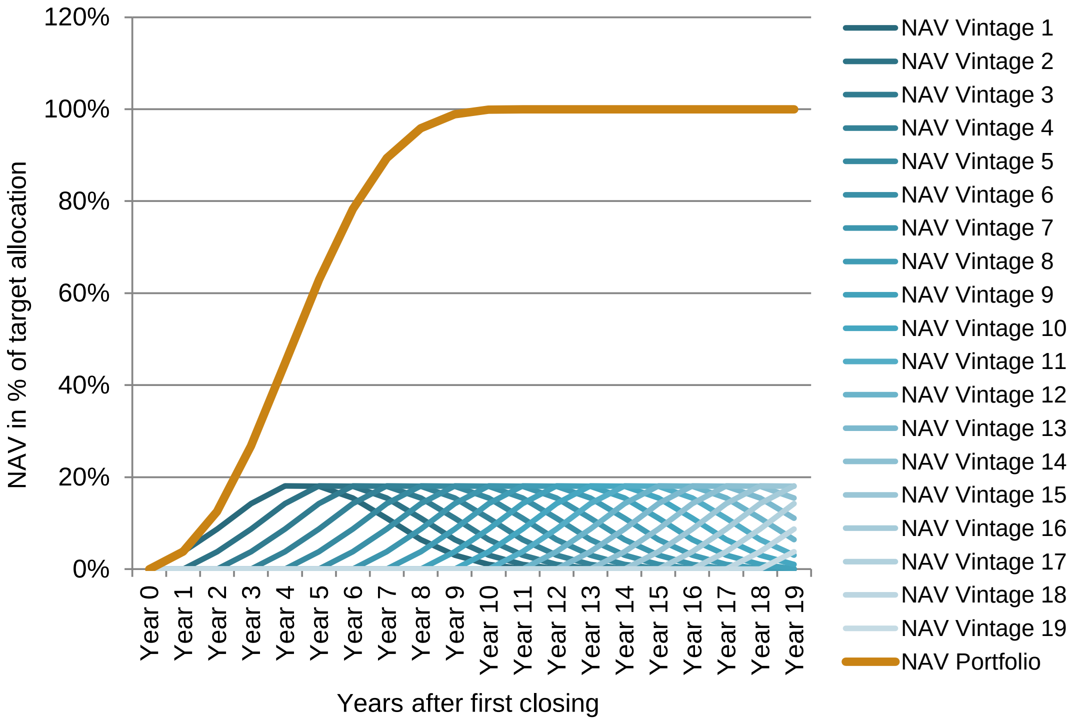
The common denominator of non-core real estate with other private market asset classes, apart from its explicit focus on value creation, is the legal structure generally applied in the build-up of private real estate programs, i.e. mainly through closed-end limited partnerships. Therefore, from a planning and structuring perspective, private real estate programs very much resemble other private market investments and should be considered part of this wider market when it comes to the implementation of solutions for investors in that area. A consequence of the nature of real estate, but particularly of the structure of private non-core real estate investing is the requirement of a long-term horizon in order to be able to fully exploit the value creation potential in this asset class and an allowance for steady diversification over time.

As such, the implementation of a private non-core real estate portfolio solution displays a comparable cash flow pattern to other private market asset classes, with capital contributions being made to closed-end investee partnerships during investment periods of c. 4 years and subsequent asset management and divestiture periods of c. 5 years. **Consequently, private non-core real estate portfolios are built up over time, ideally with a steady commitment pace, in order to achieve and then maintain the desired target allocation**. Figure 2 illustrates a simplified and idealised portfolio build-up over time. In each year a number of underlying fund investments (green curves) reflects the NAV-pattern per vintage year. Not only in order to comply with diversification over time and cycles but also in order to maintain the steady allocation to the segment that an investor needs to diversify its commitments to underlying funds over time[31].

As illustrated in Figure 2, the model suggests that an investor would reach its target invested capital after approximately nine years. After that, new funds added would be expected to hold the balance with old funds being liquidated. On average, investee partnerships typically invest in 10 to 30 underlying property investments. Depending on the number of funds selected per year (our general assumption for a good level of diversification across regions, sectors, managers, and strategies, amongst others, suggests a minimum number of 4 underlying partnership investments per year to be able to cover the relevant opportunities across segments), an investor therefore will have a considerable exposure to approximately 400 non-core real estate investments worldwide once the portfolio has reached its mature stage after year nine.

[31] Mercer Research

**Figure 2: Simplified non-core real estate / private markets portfolio build-up over time**




***Source: Mercer Research***

The allocation pace can be increased (and accordingly the number of years required to get exposed to a mature portfolio can be reduced) by adding not only primary (blind-pool) partnership commitments but also acquisitions of secondary interests in mature partnerships and co-investment opportunities. Apart from the advantage for an investor in achieving its targeted allocation faster, both investment forms also help to mitigate the J-curve effect. However, when including secondaries and co-investments it is important to maintain the same quality controls and to adhere to the same diversification rules, not only with regard to single-investment concentration but also with regard to cyclical diversification (as secondaries and co-investments are acquired at one point in time at then existing valuations, while primary fund commitments to investee partnerships implicitly involve a degree of diversification over time (throughout the investment period of the partnership)).

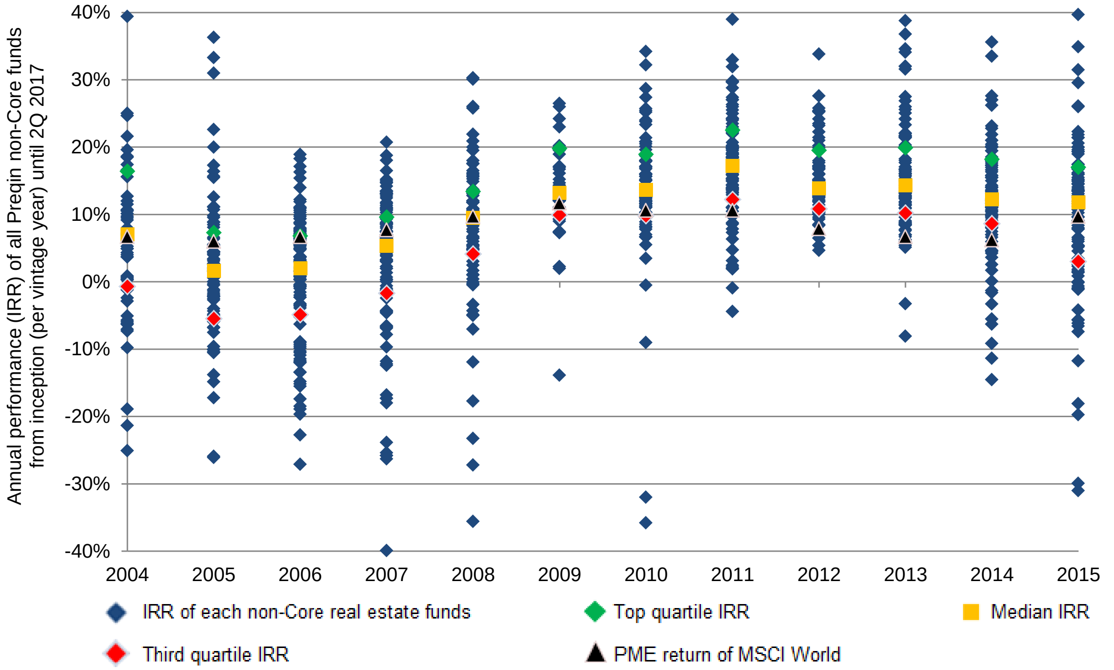
## The importance of the appropriate selection of private non-core real estate funds

Mercer reviews over 100 private non-core real estate funds every year (including single country, single sector, pan-regional, and global funds with target fund sizes of at least USD 100mn), which reflects the abundance and breadth of investment strategies available to investors in this space.

As a consequence, as with other private market investments, (after sensible diversification), **the prudent selection of partnerships is a crucial element for a successful implementation of a private non-core real estate solution as return deviation among underlying funds is significant**. This is illustrated in the chart below (Figure 3), which displays the net IRRs of individual underlying closed-end real estate fund tracked by Preqin (and with available information) for each vintage year since 2004, including the top, median, and third quartile IRRs as well as the cash-flow weighted public market equivalent (PME) returns as if invested in the MSCI World Index.[32]

[32] Preqin (real estate funds data as of most up to date figures – chart does not show funds with a net IRR > or < +/- 40% p.a.), Mercer Research

**Figure 3: Dispersion of net IRRs for private non-core real estate funds by vintage year (2004-2015)**




***Source: Preqin, Mercer Research***

An effective way to achieve a prudent selection of partnerships is by applying a **consistent due diligence process**. The due diligence itself ideally involves both a quantitative and a qualitative process and should enable the investment decision makers to distinguish between attractive, merely mediocre, and poor opportunities. Experience, judgment, insights, an open dialogue, a global platform, and challenge among involved investment professionals are additional factors that are expected to support a successful investment process.

In this context, it is also important to note that there is evidence of **persistence of strong investment results** achieved by non-core real estate fund managers (if related to the direct predecessor fund)[33]. Persistence in returns has been an often debated topic in private market investing and given the performance dispersion of non-core real estate funds shown in Figure 3 of this primer, it is not surprising that high-performing managers generally have a limited need to seek new investors, which creates **access problems** for new participants in the asset class. Established investors with an existing network benefit from their ability to absorb capacity of these highly sought-after funds. Nevertheless, proper pipeline management as part of the overall due diligence process is indispensable to secure the access where desired. At the same time, it is as important to maintain such a network with investment professionals in the industry as spin-outs and new formations are an important breeding ground for tomorrow's strong performers (access to these funds is probably easier today but it might not be tomorrow).

It is the advantage of experienced market participants not only to have established a time-tested due diligence process but also to be able to manage these relationships that in combination should allow them to prudently select fund managers and be successful in the long-term.

[33] Performance persistence in real estate private equity: Journal of Property Research, Volume 33, Siem Arts and Andrew Baum, July 2016

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