How best to invest in real estate – directly or indirectly?

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There are four main ways of gaining exposure to real estate: direct ownership of buildings ("direct investment"), investment via unlisted funds and other co-mingled vehicles ("indirect investment"), investment via property companies and REITs listed on stock markets ("listed investment"), and Real estate debt ("debt").

Here we focus on Direct and Indirect investment as these are the options chosen by most pension schemes. Conscious of the pressure to reduce costs and improve risk-adjusted returns, this article provides a summary of the advantages and disadvantages of these two forms of investment. We start by describing some practical issues that investors need to consider when deciding how to invest.

How much money is needed to build a direct portfolio?

Every property is unique and real estate's "lumpiness" creates specific risk. This can be reduced through diversification. Studies have been undertaken which suggest that 25-30 properties are required to bring tracking error compared to the market down to 3% pa. The challenge for many investors is that property assets are individually large investments.

Figure 1 shows the amount of money required to produce a market neutral portfolio based on a notional assumption that an investor would want at least four properties of median size in each segment.

In summary:

- Without selecting small properties, it is difficult to build a balanced direct portfolio with less than £100 million.
- For investment in the range £100-350 million, a direct investor has two choices: reduce diversification – either in terms of number of properties or sector mix, or select smaller lot sizes. Shopping centres and Central London offices would be the most challenging sectors to access.

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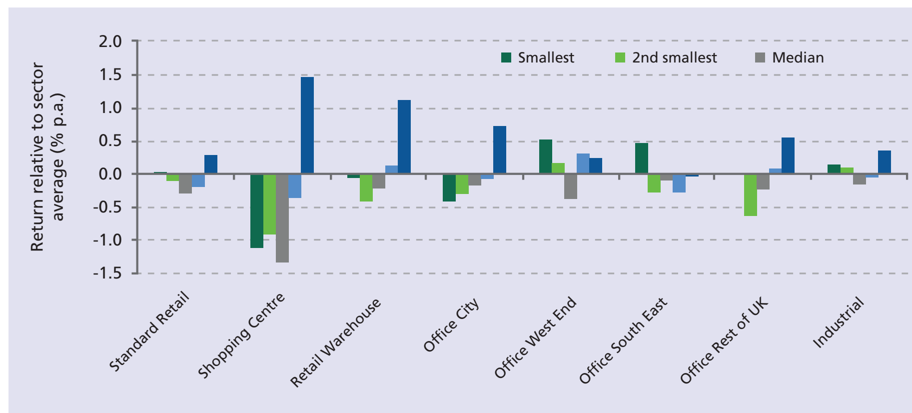
Figure 1: Number of properties with median lot size that can be acquired whilst retaining IPD neutral weightings

Portfolio value (£m)	Standard Retail	Shopping Centre	Retail Warehouse	Office London	Office Ex London	Industrial	Other
50	2.5	0.3	0.9	0.6	1.2	2.0	0.4
100	5.0	0.5	1.8	1.2	2.5	4.0	0.8
150	7.5	0.8	2.7	1.8	3.7	6.1	1.2
200	10.0	1.0	3.6	2.4	4.9	8.1	1.7
250	12.6	1.3	4.5	2.9	6.2	10.1	2.1
300	15.1	1.6	5.4	3.5	7.4	12.1	2.5
350	17.6	1.8	6.3	4.1	8.6	14.1	2.9
400	20.1	2.1	7.3	4.7	9.9	16.2	3.3
450	22.6	2.3	8.2	5.3	11.1	18.2	3.7
500	25.1	2.6	9.1	5.9	12.3	20.2	4.1

Source: CBRE Global Investors, IPD Quarterly Universe as at September 2013

Figure 2: Performance of IPD subsectors broken down by size based on floor area



Source: IPD Annual Universe (1980-2013)

- With more than £350 million a direct investor is able to diversify across the sectors, though they would require £800 million to acquire four median-sized shopping centres. Even then, dominant shopping centres and trophy Central London buildings would be out of reach as they cost hundreds of millions of pounds.

Some investors prefer to measure performance in absolute terms rather than relative to an index. As such, it may not matter if they do not have exposure to a particular sector, though it remains important to have a suitable number of assets, tenancies and property types to reduce specific risk and ensure a robust flow of income.

Does lot size influence returns?

Selecting smaller lot sizes, or not being able to acquire very large assets, may not be a concern unless it has an impact on portfolio performance, i.e. if the largest properties produce the highest returns.

Breaking down the IPD Annual Universe into five size bands by floor area shows that the largest buildings have outperformed in every sector except South East offices (Figure 2). This impact is most marked in shopping centres, retail warehouses and City of London offices.

Is it possible to improve returns by investing in specialist funds?

Management of some large assets, like major shopping centres, requires specialist skill to produce an appropriate environment, branding and tenant mix. In addition there are property types in the "other" category which may require specialist management, such as student housing, residential, hotels, and elderly living facilities. Extracting performance from these assets requires detailed understanding of the operational business. Specialist funds in the Central London, industrial and "other" sectors have outperformed their relevant segments of the IPD Quarterly Universe by a considerable margin over the last five years (to December 2016).

What other factors are important?

1. Liquidity

Real estate is a relatively illiquid asset class and can be slow to transact. Due to indirect investors are able to obtain exposure to the market more quickly than transacting in the direct market. This is advantageous when prices are rising making speed of entry important. However, under more challenging market conditions, exiting indirect investments can become difficult – redemptions can be restricted and/or secondary trading might cease – whereas a direct investment can usually be sold even if the price may be unattractive.

2. Control

Generally speaking, an investor has greater control when investing directly:

- If they desire, they can be involved in the selection of properties and approve capital expenditure. This is not usually possible with indirect investments.
- They can change manager. Indirect investment may require the consent of a majority of unitholders, which can be difficult to achieve.
- They can set a benchmark that aligns with their objectives. Indirect investments are governed by the fund documentation and strategy of the vehicle.
- They can specify environmental and social responsibility policies to support their corporate strategy.
- Indirect investors only carry a proportional vote meaning that they can be affected by the actions of other unitholders. Inflows and outflows of capital can force the manager to make decisions which may affect future performance.

This additional control makes direct property more management-intensive for the investor though most of this administrative burden can be transferred under a separate account to the investment manager.

3. Management fees and other operating costs

Over 16 years to December 2016, the total return on the IPD Quarterly Universe (as a proxy for Direct property) was 150 bps pa. higher than the AREF/IPD QPFI All Balanced Property Funds Index (as a proxy for Indirect). The IPD Quarterly Universe's returns are stated before management costs, implying that direct property outperformed indirect by 110-130 bps pa. Three things contribute to this: higher management fees, additional costs of administering the vehicles, and poorer performance at the property level. We estimate that the first two factors contributed 90 bps pa. of the

Figure 3: Performance of UK Balanced Funds vs UK Quarterly Universe over 16 years (to December 2016)

Source: IPD Quarterly Universe, AREF/IPD QPFI Pooled Property Funds Index.
Past performance is not a guarantee of future performance

underperformance – costs that can be saved by investing Directly.

4. Transaction costs

Transaction costs in the direct market are high – approximately 6.8% to buy (including 5% stamp duty) and 1.8% to sell. These costs are reflected by open-end indirect investments in their bid-offer spread, which passes the costs of direct transactions through to the subscribing or redeeming investor.

A potential advantage of indirect investment is that it presents opportunities to reduce transaction costs by acquiring in the secondary market. Specialist closed end funds can trade at a wide discount or premium to NAV, with prices reflecting factors such as: the projected outlook for the market and fund, investor sentiment, leverage risk, manager reputation, and supply and demand of units.

5. Reputation and litigation

Some investors do not want to be associated with disputes that arise between landlords and tenants, occasionally involving litigation. In extreme cases there can be reputational issues, where an aggrieved party "names and shames" the landlord. In the case of direct investment these issues are handled by the investment manager but, as the legal owner, the underlying investor is the counterparty. Also, without clever legal structuring, the direct investor has unlimited liability. By contrast, indirect investors are shielded from the property and its tenants by a limited liability structure.

Conclusion

Investors can access real estate indirectly regardless of the amount of money they have available. By contrast, our analysis shows that £350 million is required to build a balanced direct portfolio with relatively few sacrifices on asset type or sector mix. Even then, to maximise performance, "large" investors should consider indirect investment in some sectors – shopping centres and London offices – to access the biggest lot sizes, which have outperformed their peers historically, and the "other" sector, where specialist managers have produced attractive returns.

Each portfolio needs to be reviewed on its own merits. In particular, the following should be considered:

- The investor's needs and demands
- Relative pricing/sector positioning
- The investment objective and benchmark
- Transaction costs

An holistic approach, combining direct and indirect investment, is often the optimal solution for real estate allocations, providing an attractive and efficient solution for investing in the UK.

Figure 4: Secondary market pricing of Indirect funds as at December 2016

Fund Style	Typical LTV Ratio	Pricing vs NAV
Balanced Funds	0-15%	-2% to +4%
Retail Warehouse Funds	0-40%	-15% to -5%
Shopping Centre Funds	0-30%	-15% to -5%
Central London Office Funds	0-30%	-15% to -9%
Industrial Funds	0-40%	-5% to NAV
Student Accommodation Funds	20-40%	-4% to NAV
Other – e.g. Leisure/Healthcare	20-50%	-20% to NAV

Source: CBRE GIP