# European Institutional Real Estate Survey 2013

Research supported by Invesco

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# FOREWORD

We are very pleased to present the first European Institutional Real Estate Survey conducted by IPE, covering 83 pension funds with more than €100bn in property investments and total assets of €1.29trn.

The survey offers a snapshot of the institutional property investor market in Europe, providing insight into pension funds' requirements, allocation levels and the different types of exposure, approaches and investment strategies adopted.

The decision to launch a survey dedicated to real estate reflects the growing maturity of the asset class at a time when investors are increasingly attracted to stable, income-producing investments.

We would like to thank all those who took the time to respond to the survey questions – it is certainly no effortless task, although we do our best to make it as easy as possible. Survey respondents help a much wider public than just themselves in sharing their information.

A number of conclusions and themes can be drawn from the survey findings. The most obvious is that investors continue to see a role for real estate within their multi-asset portfolios. Allocation levels can be best described as stable. The biggest grouping of respondents intends to maintain or increase its real estate allocation by up to 2% over the next two years. The next largest plans to increase its weighting by 3–5%, while the next set of investors may decrease their exposure by up to 2%.

It was mentioned earlier that real estate is becoming an increasingly mature asset class. The three most important criteria when selecting a real estate investment manager is very much in line with what we see for other major asset classes: risk control, clarity of investment process and performance.

A greater focus on risk is a phenomenon affecting capital markets in general. One way it has manifested itself in real estate markets is through a marked concentration on low-risk core property investments. The survey shows that core is still king when it comes to investing in domestic property markets. At Invesco, we see increasing interest in strategies that will invest in assets that sit outside today's very narrow definition of core with a view to repositioning them as core properties through active asset management.

Although core represents the preferred strategy for investors in all global markets, the results reveal a greater appetite for higher-returning investment strategies outside their domestic markets. This includes real estate investments within Europe outside their home borders. The appetite for value-added and opportunistic real estate strategies was particularly strong for Asia and other emerging markets.

In short, the survey demonstrates that European pension funds have a strong appetite for real estate, but they have a strong focus on risk management and very selective in terms of where and how they invest.

We thank IPE for its work in collecting and analysing the survey data and promoting the report.

As always, we welcome your feedback and would be delighted to hear from you as to how useful you found the results and if you have any suggestions for improvements.

***Yves Van Langenhove***
*Invesco Asset Management*

# Risk, returns and retrenchment

## Institutional investors are cautious about where and how they invest – and, as their allocation plans show, how much.

The 2013 EIRES/IPE survey of 83 pension funds with assets under management of €1.29trn indicates European pension funds are more cautious than ever about where they invest, how they invest and with whom they invest. The current preoccupations can be summed up as: retreat, retrench – and keep a close eye on both managers and assets.

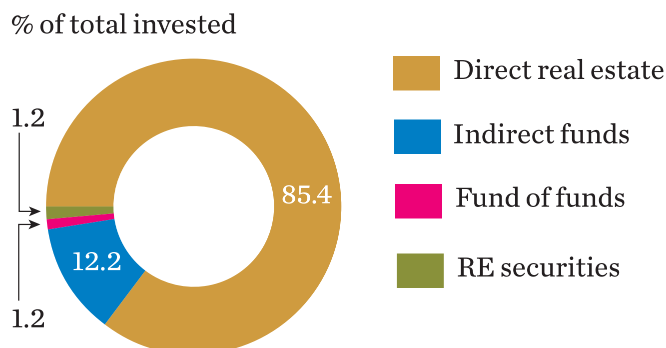
As a rule, domestic investment still dominates portfolios and, the closer the market is to home, the more likely it is to be managed directly. Of the €86.038bn in domestic investments, €73.4bn is invested directly by 47 institutions, compared with €10.5bn in funds (excluding fund of funds) by 42 schemes.

One reason for this is the widespread concern among institutional investors about control over assets (and risk). WPV, the German auditors' pension scheme is including direct in its portfolio for the first time a bid to mitigate what it sees as the lack of control inherent in pooled funds.

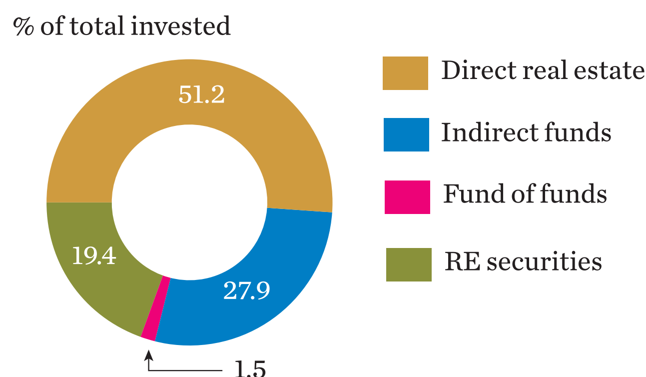
The correlation between market proximity and appetite for direct investment also explains the smaller, though still significant, gap between direct and fund investment in non-domestic European real estate. Direct investments in non-domestic European markets account for 51.2% (€15.4bn) of the total regional allocation, compared with 27.9% (€8.4bn) for funds.

What is interesting here is that relatively few

### 1. Investment type breakdown: domestic



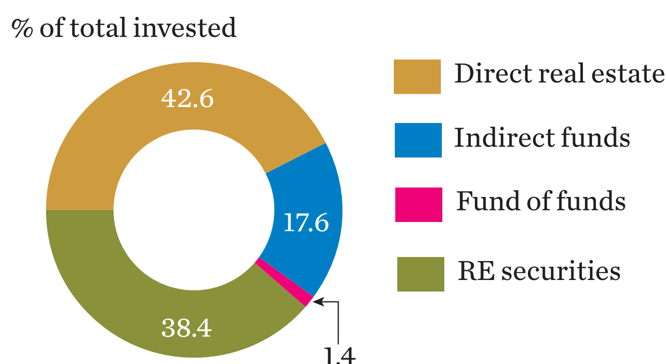

### 2. Investment type breakdown: Europe ex-domestic



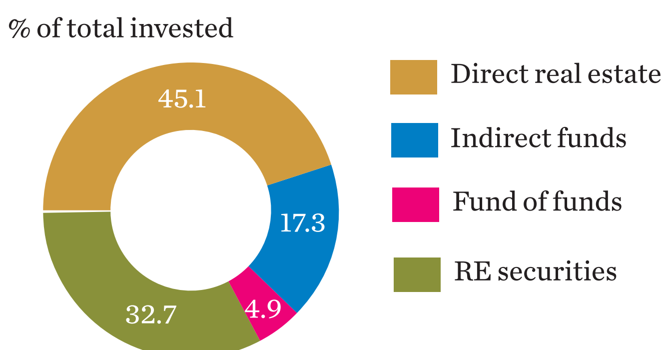

institutions – nine – invest directly but the average investment is significant (€1.7bn), accounting for an aggregate €15.4bn. In contrast, 38 pension funds have invested €8.4bn in indirect funds, excluding fund of funds, with an average investment of €221m.

Fewer than 4% of investors surveyed manage non-European portfolios internally – most likely a reflection of limits on internal capacity for all except the

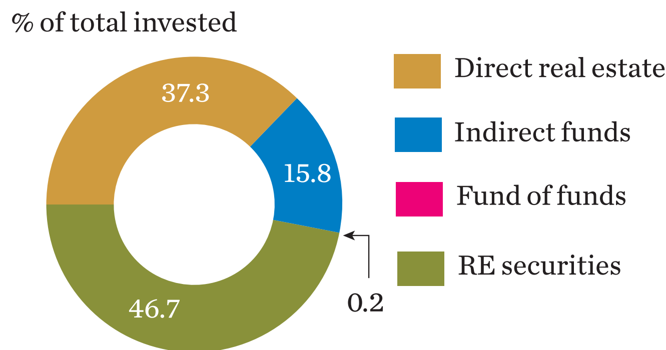
### 3. Investment type breakdown: US



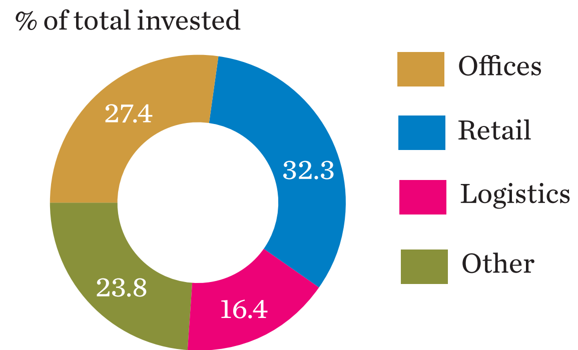

### 4. Investment type breakdown: Asia



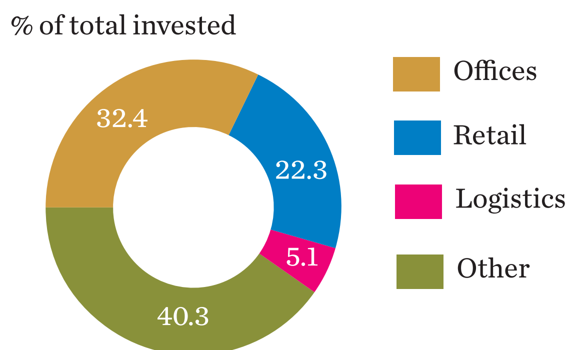
### 5. Investment type breakdown: other markets



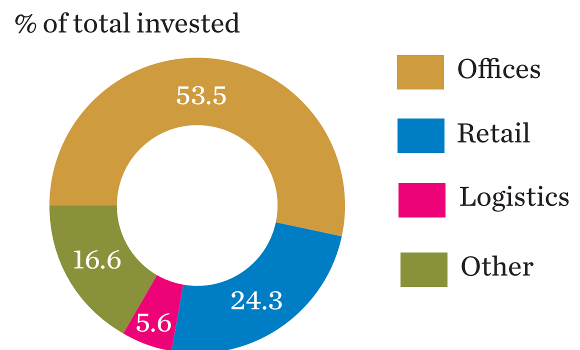

### 9. Property type breakdown: Asia



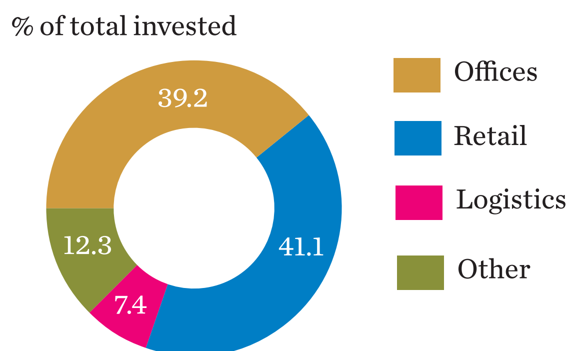

### 6. Property type breakdown: domestic



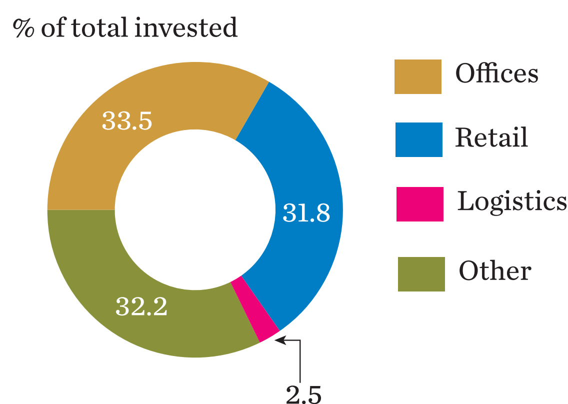

### 10. Property type breakdown: other




### 7. Property type breakdown: Europe ex-domestic




### 8. Property type breakdown: US

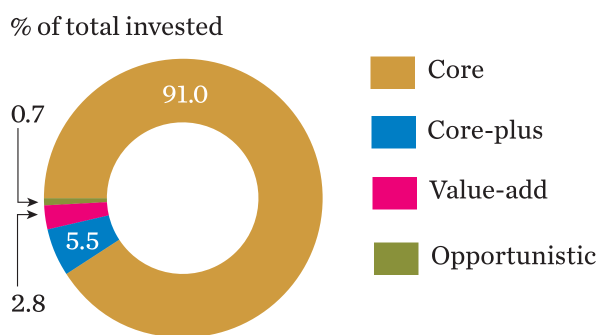



largest investors. Only four of 37 pension schemes have invested directly in US real estate, for example, compared with 20 investing in funds, but they have collectively invested €10bn, compared with €4.1bn for the fund group. When it comes to average investment, the direct investors average €2.5bn compared with €207m for funds.

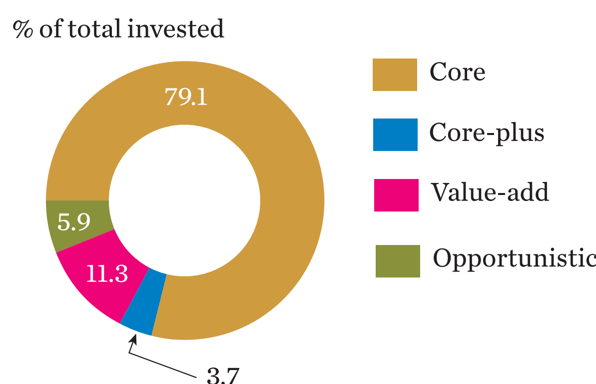
Yet the appetite for overseas real estate remains strong. Although the amount pension funds have invested domestically is triple that invested in US real estate (€86bn compared with €23.5bn), the gap between average investments is noticeably small (€1.4bn domestic, €1.3bn in US real estate).

This suggests a certain level of confidence on the part of investors in US real estate, even if there are relatively few of them. (The aggregate amount, for example, is smaller than the €30.1bn invested in non-domestic European real estate.) Geography correlates closely with the investment style adopted by the investors polled. Core is still king, with domestic investments from 47 schemes accounting for 91% of the overall regional allocation, compared with 5.5% for core-plus, 2.8% for value-add and 0.7% for opportunistic. Yet despite continued overwhelming preference for core in domestic markets, pension funds are willing to move somewhat up the risk curve outside their home region. When it comes to non-domestic

## 11. Strategy breakdown: domestic




## 12. Strategy breakdown: Europe ex-domestic




European markets, desire for returns is driving a slight shift, with value-add investments making up 11.3% of the total. Likewise investments in the US market, where core accounts for 76% and value-add 15.7%, and to a greater degree Asia, where core accounts for 61.2% and value-add 26.5%.

**LIMITS ON LISTED**

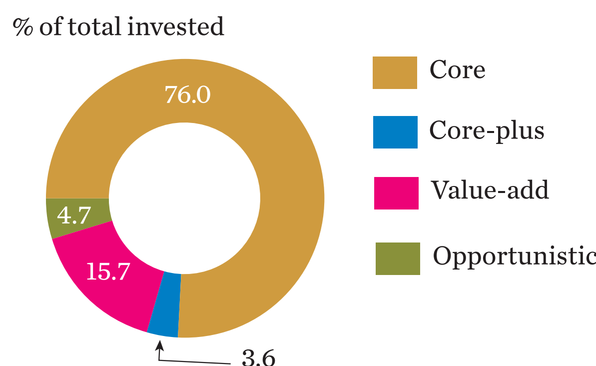
Listed real estate has limited appeal, with most investors who use it to access property markets doing so primarily for reasons of diversification. Listed accounts for 19.4% of the non-domestic European regional total, compared with indirect funds' 27.9%, and the average investment in domestic listed real estate is €206m, against a total value of listed domestic investments of €1bn.

The size of the scheme is a factor in its appetite for listed. Dutch pension fund manager APG, for example, splits its real estate portfolio into non-listed and liquidity-providing listed. German pension scheme BVK likewise plans to invest at least part of its €7.5bn real estate portfolio in real estate investment trusts (REITs) to diversify risk and increase liquidity, as well as to access otherwise unavailable niche asset sub-classes.

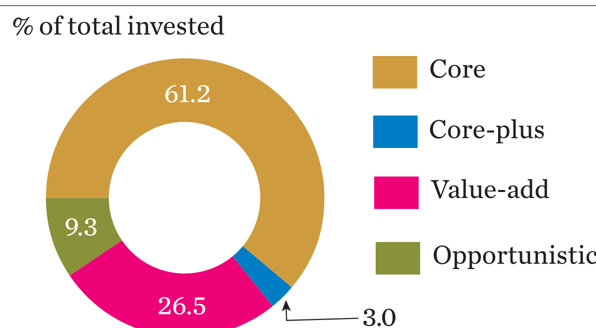
Not least because of the US's significant REIT market, US listed has proven to have greater traction among a small number (five) of European pension funds. The average investment in US listed is €1.8bn, with a total value of €9bn. The Dutch pension fund manager PGGM, for example, has allocated 39% of its real estate portfolio to North American markets in a quest for liquidity since the US makes up around half of the listed market.

Asian listed has yet more traction – and marginally more investors among those surveyed. Compared with indirect funds, it has fewer investors (seven, compared with 13) but still more than the four pension schemes investing directly. Yet the aggregate value of listed investments, at €3.1bn, is significantly higher than that for funds (€1.7bn), though significantly below direct investments (€4.4bn).

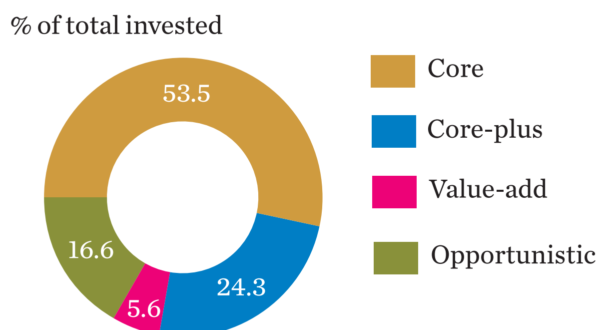
## 13. Strategy breakdown: US




## 14. Strategy breakdown: Asia




## 15. Strategy breakdown: other markets



## MANAGERS AND CONSULTANTS

Control remains a driver for significant numbers of pension funds across Europe, partly driven by regulation – in Germany and the Netherlands, for example – and characterised by close scrutiny of both assets and the external managers hired to manage them.

But what makes a good manager? The number of factors identified as important or very important on a scale of 1–5 indicates what a complex business choosing a manager can be.

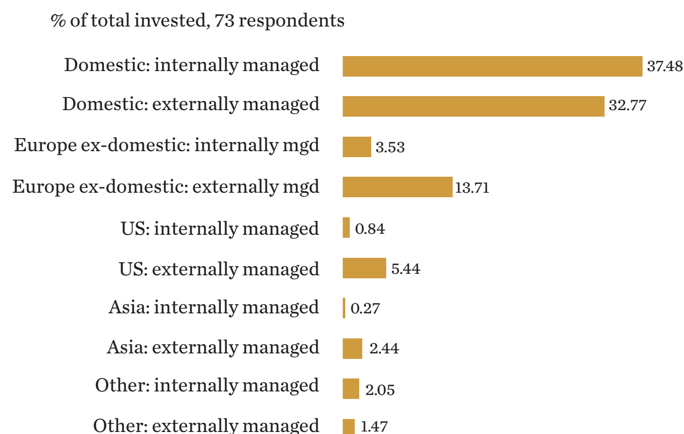
At least 50% of 72 respondents identified performance, clarity of investment process and risk control as priority criteria in the selection of new managers.

Fee levels and transparency continue to exercise investors. More than 40% of respondents identified fees as 'very significant'; and 44% prioritised alignment of interests, a related criterion for manager selection. Those paying performance-related fees alone are in a minority. Most investors in domestic vehicles (36) pay fixed fees, with a minority (21) paying both fixed and performance fees.

The pattern is reversed outside schemes' domestic markets with a correlation between unfamiliarity of the market and the likelihood the scheme will pay both kinds of fees. In non-domestic European markets, for example, 58% of schemes pay both, but that percentage increases to 67% for the US, 68% for Asia and 74% for other markets.

Fund investment is a consultant-mediated mar-

### 16. How is your real estate managed?



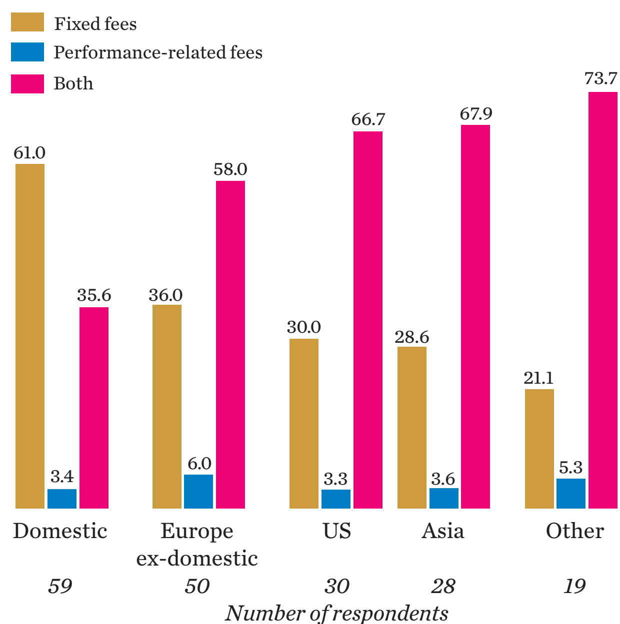

### 17. When selecting an external real estate investment manager, how significant is each criterion shown below to your organisation?

% of 72 respondents to question

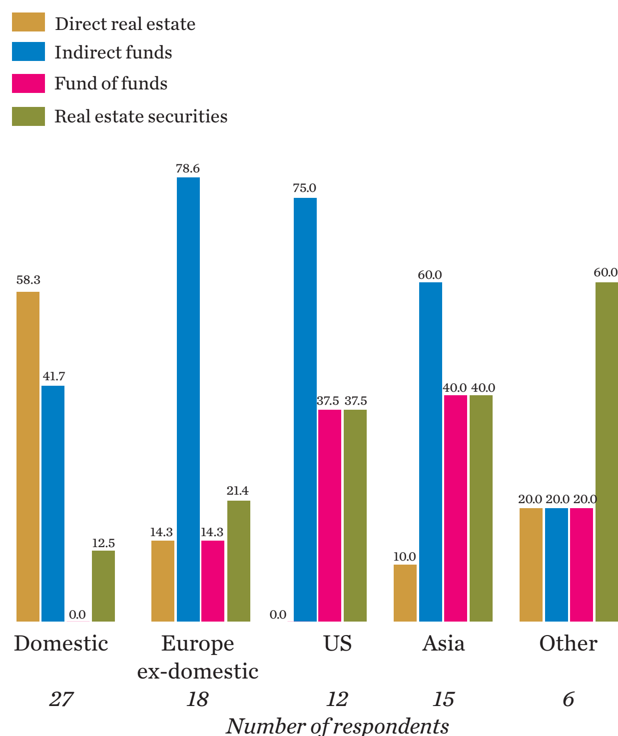
Not at all significant 1 2 3 4 5 Very significant

Clarity of investment process
Client service
Corporate governance
Financial strength of external manager
Investment management fees: level of fees
Investment management fees: transparency of fees
Performance fees
Alignment of interests
Performance
Quality of reporting
Reputation of asset manager (brand)
Risk control
Stability of investment team
Understanding of your organisation's goals and needs
SRI/ESG credentials
Other criteria

## 18. Do you currently compensate an external investment manager with fixed or performance-related fees, or both?




## 19. Have you employed an external investment consultant during the past three years?




ket, even outside markets such as the UK, where this has long been the case. With the exception of direct investment in domestic real estate, for which 58% of respondents had hired an external investment consultant during the past three years, decisions on non-domestic European (79%), US (75%) and Asian (60%) funds all warranted external advice. The lower score for Asian funds is most likely the result of few pension schemes investing in them, rather than a perception that they need less help to do so.

### LITTLE OR NO CHANGE

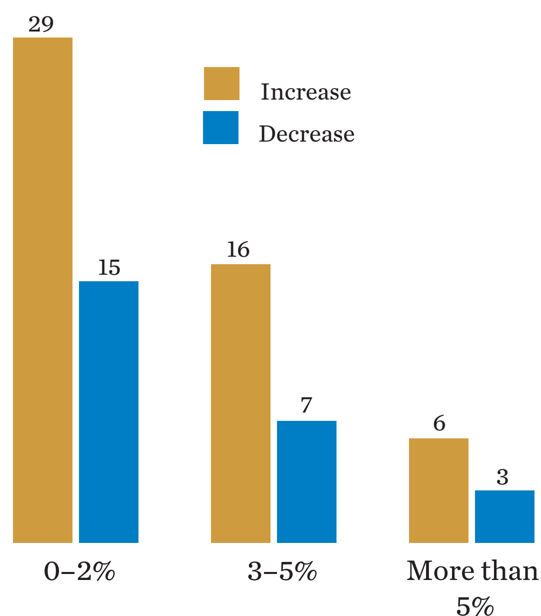
There are unlikely to be major changes in investors' real estate allocations over the next two years, but there will be tweaks.

While most (51) pension funds aim to increase their allocation, a significant number (25) plan to decrease theirs. In both categories, most of the planned changes will be modest. By far the largest category of investors intend a change of between 0–2% (29 increase, 15 decrease); only nine intend a change of more than 5%.

Although the average real estate allocation among schemes polled is 14.2%, it belies significant variations, particularly between investors from different markets. One perhaps surprising finding, given the paucity of potential returns in Gilts, is that pension funds that may have been expected to increase their allocations have effectively placed a moratorium on expansion.

Among Austrian schemes, for example, a 0.5% decrease in allocations to 3.5% across 2012 suggests it is going in the wrong direction. The €3bn Pensionskasse APK has called a (possibly temporary) halt at 3% of the overall portfolio. Meanwhile, Dutch manager CSM Pension Funds has switched 5% of its real estate allocation to emerging market equities as a result of concerns about concentration risk.

## 20. What changes, if any, do you plan to make in the next two years to your total real estate strategic asset allocation?



Austria

# Sticking to what you know

## Exposure to real estate is still only an almost negligible part of most Austrian institutional investors' portfolios but some are seeking to change this.

Austrian institutions have always had to go abroad to achieve diversification in their real estate portfolios – if they had an allocation to the asset class in the first place.

Overall, real estate only made up 3.5% of the approximately €15bn in total assets under management in the Austrian second pillar as per end-September 2012, which is even less than at the beginning of the year when the exposure stood at 4%.

This is most likely due to the late start of Pensionskassen in Austria in the mid-1990s when real estate was not a necessary addition to portfolios as equities and bonds sufficed to generate returns.

Of course, that changed at the turn of the century and pension funds started to move into real estate. The €500m Victoria-Volksbanken Pensionskasse (VVP) started to invest in real estate at the turn of the millennium with an initial allocation of 5% in total over all portfolios.

Like all Austrian pension funds, VVP offers different risk-adjusted portfolios for its clients to choose from and some opt for no real estate exposure.

Meanwhile, the property portfolio at VVP has grown to make up 6–6.5% of the total assets under management but Claudia Gligo, head of asset management, says there is not likely to be any change to this allocation.

The €5bn VBV Pensionskasse is also planning to maintain its 6% real estate exposure, which managing director Karl Timmel says "performed well" in 2012. The pension fund is mainly invested outside Austria with one pan-European and several Spezialfonds for Germany, Norway and Asia.

Similarly, Christian Böhm, managing director of the €3bn multi-employer Pensionskasse APK notes "there will be no fundamental change to our strategic real estate portfolio" which makes up around 3% of the assets.

APK has already expanded the regional exposure to include Northern Europe, while VVP is looking into increasing diversification. "Over the long term we are planning to expand our portfolio geographically," says Gligo. "At the moment we are very strongly focused on Austria and Germany but we will add more properties from other countries in Europe."

There have been some recent obstacles to the increasing of real estate allocations. Last year, there was uncertainty as pension funds waited to gauge the impact of a regulatory change under which Pensionskassen might have had to to pay a lump sum tax on behalf of their pensioners. In the end the impact was limited.

In 2013, the amendments to the law governing the pension funds (Pensionskassengesetz – PKG) took effect. The new rules do not alter investment regulations directly, but once again, pension funds like the VBV are cautious to ensure they have sufficient liquidity in their portfolios.

Under the new regulations, certain pensioners may opt to transfer their money to an insurance-based scheme (Betriebliche Kollektivversicherung or BKV) offering guarantees. Most analysts believe that the costs of the transfer and the guarantee will stop most pensioners from changing their pension vehicle. But, of course, pension funds like the VBV have to be prepared for the worst, which in its case could mean an outflow of €1.3bn in pensioners' assets by November 2013.

Like most Austrian institutional investors, the Pensionskassen are mostly investing indirectly in real estate using external managers. According to Böhm, this can consume considerable resources. "We strongly feel that it is part of our responsibility towards our pension fund members to constantly monitor our external managers to check whether the fee structures and the performance are still up to the necessary standards," he says. "But I have to admit it takes more time than initially thought as it is not enough to just read a manager's quarterly reports."

Pension funds are cautious when it comes to control over their investments and due diligence on co-investors in pooled vehicles is important.

Gligo points out that all of VVP's indirect investments are externally managed but as Spezialfonds club deals and not in German open-ended real estate funds. For this reason, fund-of-fund structures are "uninteresting", Gligo adds, "because we want to have a seat on an investment committee".

For Böhm there is an additional drawback to these vehicles – namely caution around additional costs and

whether these are included in fund-of-fund fees. "The curse of diversification is additional costs and they do not always pay off," Böhm says.

APK, like other institutional investors, has grown more cautious when it comes to checking the real sources of return in a property portfolio, eschewing leverage above 50% in favour of rental cash flow or improved added value.

Böhm – unlike most other Austrian institutional investors – is always including opportunistic and value-add investments in his search for real estate, particularly now that prices have increased considerably in the core segment.

VVP, on the other hand, still sees opportunities in the core sector and it is now investing solely in core properties. This strategy will stay in place over the medium term, with a concentration on commercial properties, mainly office and retail.

Other institutional investors in Austria have started to look at niche sectors like nursing homes, but for the most part the portfolios are mostly made up of a mixture of office and retail assets.

Retail is also interesting for APK – Böhm notes that shopping malls were still going strong during the crisis. APK does not plan any major expansion of holdings in the office and residential sector, other than from a few opportunistic investments in certain regions.

**Recent deals**

- **October 2012: Union Investment Real Estate acquired the fully let Euro Plaza in Vienna for €150m. The 48,500 sqm office building was sold by Kapsch Immobilien.**
- **The CCP III fund bought the Stadlay Shopolis retail park in Vienna from Babcock and Brown for €150m.**

Exotic investment approaches, such as debt funds, are not yet on the agenda. Although Gligo and Böhm do not rule this strategy out completely as a future option, they both stress the completely different risk-return structures of debt investments and the challenge of getting the pricing right.

Listed real estate is also only used in tiny doses to add diversification or to gain quick access to a market that is otherwise trickier to enter.

Some pension funds are also increasing their research regarding green properties and VBV's Timmel points out that the green German property fund it is invested in performed exceptionally well last year.

Meanwhile, foreign investors are discovering the Austrian, or more particularly the Viennese property market – on the radar of many European property investors looking for low-risk, stable returns – which might make some Austrian institutional investors sorry they did not enter the market earlier or hike their exposure.

## Germany

# Diversifying a real portfolio

### Real estate has ceased to be a second-rank asset class for German institutional investors – if it ever was. They know what they want and where they want it.

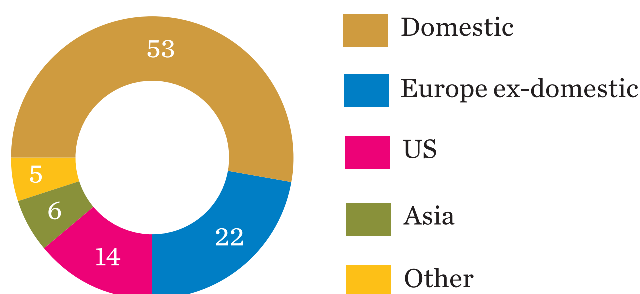
The professional pension fund for auditors and chartered accountants – the Versorgungswerk der Wirtschaftsprüfer und der vereidigten Buchprüfer (WPV) – is including direct real estate in its property portfolio for the first time. Another institutional investor also wants to get "as close as possible to bricks and mortar". The Bayerische Versorgungskammer (BVK) is looking into REITs and the largest Pensionskasse in the country, the BVV covering the financial sector, is opening up its investment strategy to include global opportunities.

All four institutions are moving in different directions but mostly with the same aims: achieving stable, diversifying returns while ensuring greater control over their real estate investments.

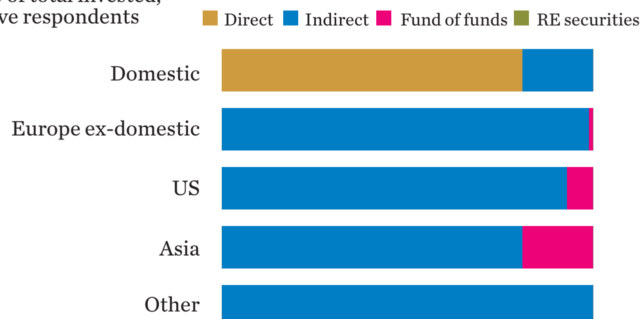
"Up until recently I had been of the opinion that indirect investments into properties are preferable, but in a pooled fund you only have limited decision-making powers and you have to accept being tied to a certain manager, sometimes for a decade," WPV managing director Hans Wilhelm Korfmacher explains.

In future, he wants "to reduce these limits to our decisions" and if absolutely necessary he wants "to be able to replace a manager" – therefore the funds will be organised in a master structure which will also allow the €2bn WPV to "either purchase properties directly or use several managers aiming at choosing specialists for various countries and sectors".

## 1. Germany: regional breakdown




## 2. Germany: investment type breakdown




Identical reasons for the creation of a master structure are given by the €23bn BVV, which will be integrating its new funds for global opportunities in property investments in a master-fund structure "to be able to replace the managers easily if necessary".

Meanwhile, the €10bn professional pension fund for doctors in Westfalen-Lippe, ÄVWL, has restructured its real estate team to increase the internal resources for monitoring external managers. The move is part of an overall strategy to move closer to the underlying assets again, according to the investor, and become more involved with fundamental decisions at the asset level.

Getting closer to the underlying asset and taking more control over returns generated in a portfolio is also why some of the German institutions are cautious when it comes to club deals or pooled funds. The financial crisis showed that achieving alignment of interest between investors, their managers and their fellow investors is an area that should be monitored carefully. One case in point is the so-called German open-ended fund (GOEF) structures, which suffered severe liquidity problems when some large investors wanted out in the wake of the financial crisis.

One institutional investor notes "club deals or pooled vehicles make more sense in Asia, the US and Canada because otherwise the volume invested would be too small to get into good deals". And analysts agree German institutions will pool their resources to enter new markets while they will try to get individual deals at home.

This is also true for a large Versorgungswerk, such as the €53bn BVK. "In principle, we are aiming for separate accounts. But within these it might happen that we are entering into a joint venture, but this is not our preferred option," Norman Fackelmann, head of real estate investment management, explains.

The BVK wants to open up its view on property investments to include opportunities worldwide: "In future we want to try and take a more global view on real estate," says Fackelmann. As the BVK is limited to OECD countries in its real estate investments, under the regulations for insurance-based retirement vehicles (VAGs) Asia and Australia are the two regions "currently of particular interest" to the fund.

The BVV "will be setting up global mandates to enable us to make use of every window of opportunity" and adds the fund "wants to be able to participate wherever we see interesting investments – no matter the region or sector".

Analysts agree that German institutions are more willing to go abroad in their search for real estate yield mainly because the necessary expertise is now available on the market. Especially master fund structures have allowed foreign asset managers to bring in their expertise to the German market more easily as they do not have to set up a so-called Kapitalanlagegesellschaft (KAG) themselves. This is necessary to issue what is dubbed German institutions' favourite investment vehicle, the real estate Spezialfonds.

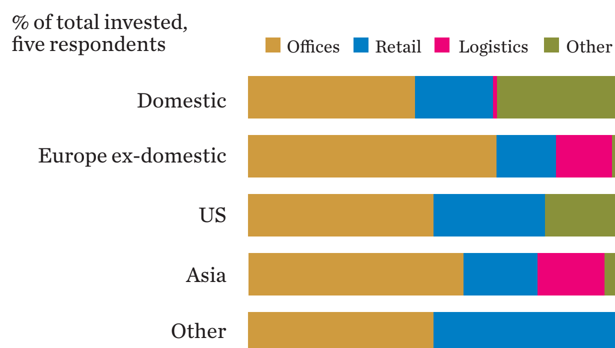
During the latter half of 2012, when it was unclear whether or not the Spezialfonds would survive the government's attempt to implement the Alternative Investment Fund Manager Directive (AIFMD) with a new Kapitalanlagegesetzbuch (KAGB), there was a heated debate in Germany over the importance of the Spezialfonds.

Some asset managers, especially those without a KAG as part of their business range, pointed out that for most large institutions it might be just as easy to invest in a Spezialfonds under a Luxembourg structure. Indeed, Korfmacher confirmed that the WPV is "currently deciding between a German investment structure or a Luxembourg vehicle" as administrator for its master-fund structure.

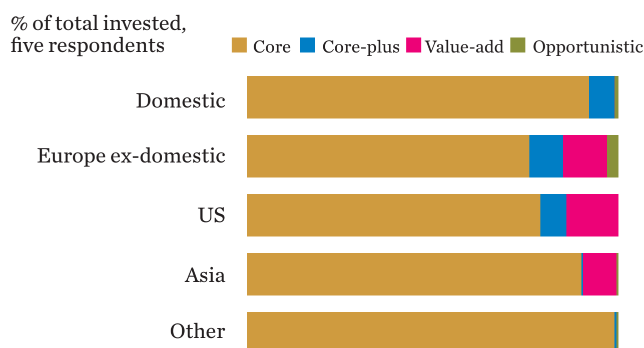
In fact, most institutions are already using a large number of different vehicles in their efforts to increase diversification within the portfolio – according to their size and needs.

The BVK, for example, is starting to move into REITs for the first time while Korfmacher says "listed

### 3. Germany: property type breakdown




### 4. Germany: strategy type breakdown




real estate does not suit our strategy at the moment because this is an equity volatility which I do not want in the portfolio".

But the BVK – which is around 25 times larger – argues it is looking into REITs now "because with a €7.5bn real estate portfolio we have reached a size where we want to diversify further, improve liquidity and enter new markets to diversify our risk". Additionally, Fackelmann points out that this vehicle will allow the fund to "aim for other sectors like healthcare" which according to him are "niches which we could not cover otherwise".

Niche sectors are also on the agenda, especially if investors want to stay in Germany where the demand for core property has exceeded the supply. Despite their forays abroad, German properties will continue to make up the major share of almost every German institution's portfolio.

For many, the safe haven option is now residential property in Germany, which had been rejected in pre-crisis times because returns were too low. But now everyone wants in and in some regions the market has started to overheat slightly. In its Finanzmarktstabilitätsbericht 2012, a report on financial stability in Germany, the Bundesbank warned that "price exaggerations are possible" in certain real estate sectors and regions of Germany but added the danger of a bubble in Germany in general remained low.

Some investors have pinned their hopes on the approximately €22bn in properties that will have to be sold by GOEFs in liquidation over the coming years. But others argue those will not help bring down prices in Germany either as many of the funds' holdings are elsewhere in Europe.

Therefore, German institutions are looking into alternative sectors: ÄVWL has moved into infrastructure by buying grid operator Amprion together with other Versorgungswerke. Another institutional investor is also planning to up its exposure to infrastructure, mainly via wind energy.

Others, like the BVK, are widening their search to core-plus and value-add property. Fackelmann confirms: "As part of the diversification a few value-add objects might be included maybe via the fund-of-fund structure." The portfolio is currently 98% invested in core or core-plus; Korfmacher points out that WPV is not currently looking into project developments, as he likes "to invest in properties that already exist and are let to a certain degree if possible. Redevelopments, additions, and so on, are not part of our business."

Real estate debt might be another interesting area for WPV. At the moment, however, Korfmacher thinks "senior debt conditions are so meagre that it is not attractive". He adds: "I do need a certain spread to a covered mortgage bond to warrant the additional risk."

The BVK, which has already financed one major project in Frankfurt, is "looking into other real estate debt investments" and wants to stay in Germany as it "wants to start locally". Other investors are entering this side of the market via debt funds rolled out in late 2012 attracting institutions' interest.

Nevertheless, experts think financing real estate

**Recent deals**

- **January 2013: GBRE Global Investors bought a 16,660 sqm retail warehouse in Erding for its Pan European Core fund for €38m.**
- **January 2013: Union Investment Institutional Property acquired three Berlin apartment blocks, comprising nearly 1,400 units for €87m.**
- **December 2012: Hahn Immobilien bought 16 property companies, allowing access to a portfolio of retail properties spread out across Germany. The 146,000 sqm in rental volume is located in North Rhine-Westphalia, Lower Saxony, Bavaria, Saxony, Baden-Württemberg and Brandenburg, leased to a number of supermarket chains.**
- **October 2012: Fund EPI sold a department store in Frankfurt for €115m. The 44,412 sqm development is currently one of the largest stores in Germany and houses the flagship store of retail chain Karstadt.**

deals will remain difficult given the banks' reluctance to provide capital. This in turn is an opportunity for equity-strong investors like many German retirement vehicles with mandatory contribution schemes. Korfmacher says: "Being able to replace debt with capital is also one of the reasons for us to go into individual funds rather than pooled funds".

Overall, German institutions have probably never been more focused on real estate as they are now. And they are taking a much more individualised approach to diversification in these portfolios which make up around 10% of the total assets under management on average.

The crisis has occasionally presented investors with bitter truths about correlations in their portfolio as well as the performance of managers – consequently they are now trying to gain as much control as possible over both.

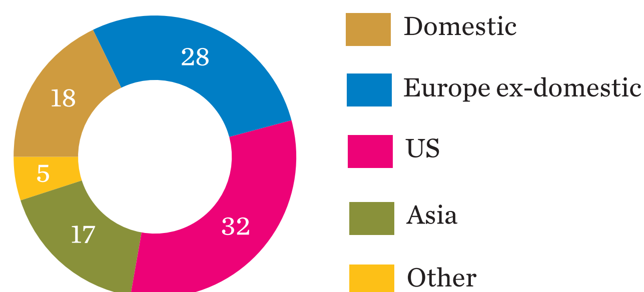
## Netherlands

# Pension funds shift towards listed

Risk management is driving some pension funds into listed real estate – and others to reduce their allocations.

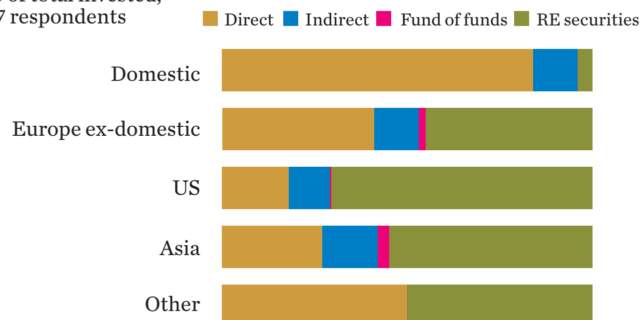
### 1. Netherlands: regional breakdown

% of total invested, 17 respondents




### 2. Netherlands: investment type breakdown

% of total invested, 17 respondents




Dutch investors have lost none of their voluminous appetite for real estate over the past year, although that looks set to change.

Currently, the larger the pension fund manager, the more likely it is to be slightly overweight in the asset class. APG and PGGM, for example, have both marginally exceeded their target allocations – 10% and 12%, respectively.

Some smaller pension schemes have tended to allocate significantly higher percentages of their overall portfolios to property. Although Pensioenfonds TDV plans to decrease its 25% strategic allocation over the next couple of years by 3–5%, director Theo Hillen says the reduction is "not that important – we'll still have one of the highest allocations in the Netherlands afterwards".

Although Hillen says the primary driver of TDV's planned reduction is to reduce risk within the portfolio, including concentration risk, he acknowledges that the Dutch central bank (DNB), which regulates pension schemes, has identified it as an issue.

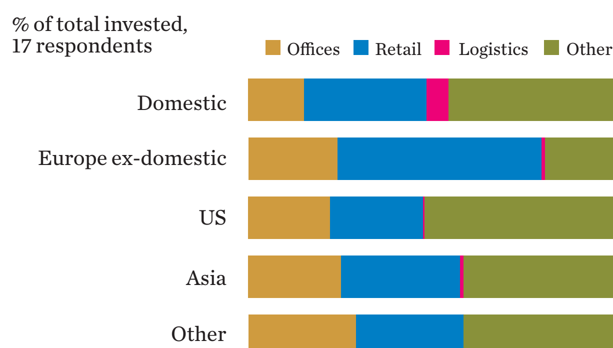
Pressure to reduce risk within the overall portfolio has encouraged some pension investors to divert at least part of their allocation out of real estate and into other asset classes. CSM Pension Funds, for example, pulled out of direct investment in real estate last year over regulatory concerns about concentration risk. The result has been that its 10% target allocation to real estate has changed to a 5% allocation to listed real estate and 5% allocated to small emerging market equities.

**Risk and regulators set return limits**

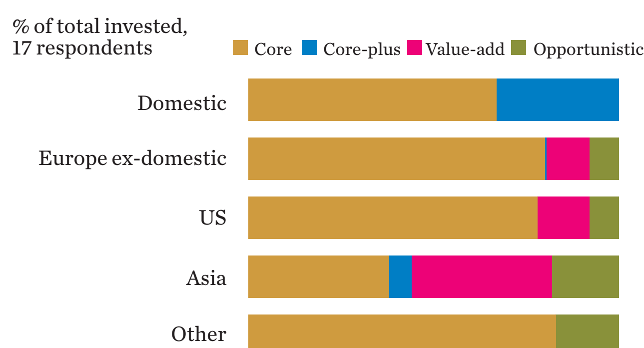
These examples point to two of Dutch investors' immediate and related concerns: risk reduction and regulation. The intensified emphasis on risk management is being driven in part by regulatory scrutiny. According to the supervisor, DNB, 231 pension schemes have yet to meet the required coverage ratio. It is clear that shifts in real estate allocations to generate higher yields will form part of plans to meet short and long-term solvency targets.

Several pension fund managers have pointed to

## 3. Netherlands: property type breakdown




## 4. Netherlands: strategy type breakdown




a greater need for their portfolios to deliver higher returns – but within acceptable, usually cautious, risk parameters.

"Our major objective is to deliver real estate returns, while diversifying the total portfolio and controlling risks," says Maarten van der Spek, senior strategist and researcher for private real estate at PGGM.

Overall, core still dominates domestic (67%), European (80%) and US (78%) portfolios, although core-plus has gained some domestic traction and Asian portfolios are split more evenly between core (38%) and value-add (38%).

For higher returns, Dutch pension funds are looking to next generation asset sub-classes. Debt is emerging as a potentially significant category. One portfolio manager says he was unlikely to invest in debt before 2014, although he will watch carefully to see how the real estate debt market develops and conduct in-house research into whether the risk/return profile is acceptable.

"The [real estate debt] market isn't there yet. People are putting money into it but we'll wait to see what works and what doesn't," he says.

Meanwhile, Dutch pension funds, faced with upcoming liabilities, are looking to improve the liquidity of portfolios comprising what is essentially an illiquid asset class. The result in some cases appears to be a partial shift towards listed real estate. Although listed accounts for just 4% of overall domestic portfolios, it makes up 45% of non-domestic European, 70.5% of US and 55% of Asian portfolios.

In PGGM's case, the requirement for liquidity has resulted in a strong position in US property. The US accounts for more than 50% of the listed market, hence the pension fund manager's 39% allocation to North American real estate. At the same time, 30% of its private real estate allocation is invested in the US. CSM Pension Funds will not in fact invest in non-listed real estate because of the liquidity issue. "Our liabilities are quite short term – around six to nine years – so liquidity is important," says specialist asset manager Marc van Maarle.

"With unlisted, you would have the same problem you would have with direct investment. A large chunk of investment in private equity is even harder to sell [in the current market] at the right price – and direct holdings we could sell at a better discount than private equity holdings. But so far the regulator hasn't mentioned anything about private equity."

SPF Beheer strategy and acquisition manager Bauke Robijn in turn has expressed concern over potential leverage in private investments. "Extra risk is not something we want in the real estate portfolio," he says.

Another manager says his pension provider employer was looking to increase its allocation to listed real estate, perceived as offering better quality assets and greater transparency than non-listed funds or directly held real estate. The move, long on the wishlist, will likely begin this year or next.

But a potential problem for this portfolio manager is that directly held assets, which currently make up around 40% of the domestic portfolio, could prove difficult to sell in a moribund office market without a significant discount. "That can hold up the process but we're not in a hurry," he says. "Things are going to change but it will take a few years."

Eventually, listed could make up 30–40% of the manager's overall portfolio – a percentage he says would bring the provider closer to the rest of its peer group. Listed currently comprises 70% of its Asian exposure but a negligible percentage overall. The portfolio manager is also looking to invest in listed infrastructure for what he described as "more dynamic exposure".

### Inflation, diversification drive sector and market preference

In the meantime, pressure to generate returns while modifying risk has not necessarily led Dutch pension schemes in the same direction. SPF Beheer, for example, is looking to divert part of its inestment alloca-

tion in office towards retail, despite non-food retail's recent poor performance, because of its potential inflation-hedging characteristics. Retail currently accounts for 33% of the overall domestic investments of institutions surveyed, compared with office's 15%. In the rest of Europe, the difference is even larger: 55% for retail, compared with 24% for office.

Speaking of the scheme's domestic portfolio, Robijn says: "Over the next 12 months, office will be much more work in terms of the management effort and the focus on the tenant. But there are opportunities in the market. We could sell more assets that don't meet our inflation-hedging requirements and buy more that do."

The pension scheme expects prices for domestic residential – likewise, a potential inflation hedge – to fall still further as a result, among other things, of government measures, which will create opportunities to acquire assets at the bottom of the market. In the meantime, the pension fund is developing new percentage allocations for each asset class, although Robijn says these will be sufficiently flexible to exploit opportunities in the market.

There is significant diversity among Dutch investors when it comes to geographic diversification. Unsurprisingly, the larger the pension fund or pension fund manager, the more globally diversified its real estate allocation is likely to be. PGGM's portfolio is overwhelmingly invested outside its domestic market, which accounts for 10%. With 16% allocated to the rest of Europe, it has 39% invested in the US and 26% in Asia. "We're a true global, diversified player on the real estate spectrum," says van der Spek.

In contrast, Pensioenfonds TDV and Pensioenfonds Grontmij both have more than 90% of their respective portfolios invested in the domestic market. For Altera Vastgoed, the figure is 100%. Overall, the Dutch market accounts for 18% of investors' allocations.

Yet even for larger players, euro-zone macro uncertainty could lead to a switch in the regional weightings of geographically diversified portfolios towards North America and potentially Asia. "There will be no big changes to [our] allocation, though there may be some minor changes in detail," says van der Spek. "The European outlook isn't good, especially relative to other markets, so we may be slightly more defensive in Europe than in Asia."

He adds: "Nothing specific keeps me awake but I worry about risk in Europe. If there were a big structural market-changing event, the impact on real estate would be strong. Some people think the euro-zone could break up. Personally, I don't think it will, but the uncertainty is there for all investors."

**Recent deals**

- May 2013: Real IS Investment has purchased the De Kroon mixed-use property in The Hague for €38m from joint developers MAB Development and Haag Wonen housing corporation.
- April 2013: The real estate manager, Delin Capital Asset Management, has acquired Distripark Sittard, a distribution warehouse located in Born from DHG Group. The purchase price is estimated at €36m.
- March 2013: Jones Lang LaSalle's Hotels & Hospitality Group has sold the Hotel Ibis Hague City Centre to the Internos Hotel Real Estate Fund. According to John Laing, the sale of the hotel for €15.5m, reflects a gross yield of approximately 7.36%.
- March 2013: Union Investment Real Estate has acquired a development project comprising Akzo-Nobel's new headquarters, which will be transferred to the holdings of open-ended real estate fund UniImmo Deutschland, and the Amsterdam Marina Offices, acquired from ASR Vastgoed Ontwikkeling.
- February 2013: Fidelity Worldwide Investment has acquired the Sonion office property in Beukenhorst Zuid business park in Hoofddorp for €12.4m. According to Fidelity, the price reflects a net initial yield of 8%. The property was purchased from OVG.

**Fees, transparency top external manager concerns**

It is not yet clear what impact the shift towards listed will have on pension funds' reliance on external managers. In recent years, there has been a bifurcated trend for larger pension funds and pension fund managers to opt for joint ventures and club deals, avoiding blind pool funds. A few smaller investors, such as Altera Vastgoed, manage their entire portfolios in-house – an approach made substantially more possible when the portfolio is exclusively domestic.

Possibly because of a strengthened regulatory requirement for asset-level risk management, as well as an incremental recasting of external managers as investment partners, clarity of investment process, understanding of what the client is trying to achieve and stability of investment teams emerged as significant priorities for some investors. But almost all the pension fund investors who invest domestically via funds – which account for €1bn compared with €7bn invested directly – identified level and transparency of fees, alignment and strong governance as non-negotiable.

"When it comes to choosing external managers, we determine the right one to supplement our portfolio, and then we will look for the best manager to deliver it, based on criteria that include strong governance and transparency," says van Maarle.

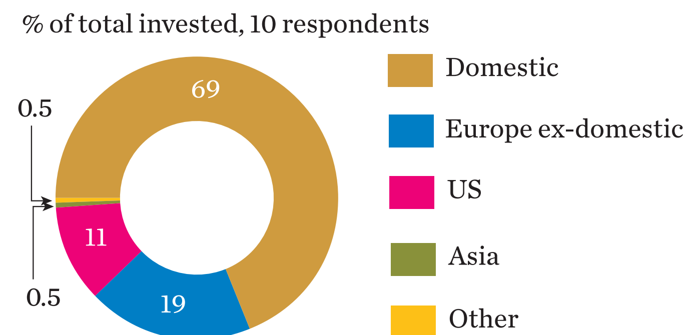
"We see ourselves as a partner for fund managers, and selecting managers is a deal we're doing for the long term."

Nordics: Denmark, Finland & Sweden

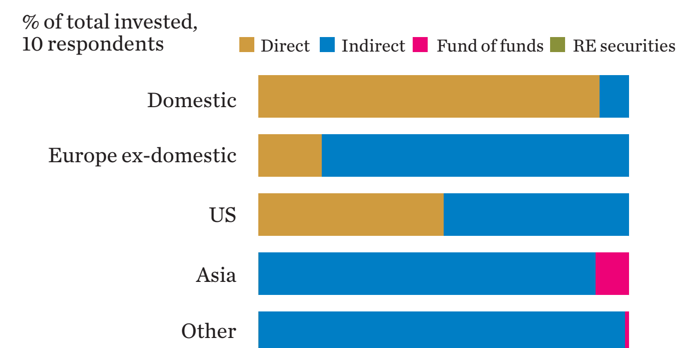
# Northern safe havens

Investors see the Nordic countries as low-risk, safe haven markets. But challenges such as size and liquidity remain.

### 1. Nordics: regional breakdown




### 2. Nordics: investment type breakdown




The Nordic real estate markets are not homogenous, although all have fared relatively well in the global economic downturn and are therefore seen as safe havens for international investors.

Despite good fundamentals – 2013 growth rates for these three countries and Norway are estimated at between 1.4% and 2.1% according to Eurostat – they have been affected by the global financial crisis and the lingering uncertainty from the European debt crisis.

Sweden has attracted the most foreign capital into real estate, followed by Finland, whereas Denmark has remained more heavily dominated by domestic players.

Nevertheless, the stability of the economies continues to have a positive influence on the Nordic property investment markets.

Domestic investors have maintained their competitiveness, but international investors view the region as a safe haven where it is still possible to achieve fair and stable returns with relatively low risk.

However, challenges remain such as the size and liquidity of the markets.

According to indices from IPD and KTI, total returns have remained quite attractive in the Nordic property market.

In 2012, Sweden was the best performing real estate market in the region, producing a total return of 6.4% in local currency terms. Finland also performed relatively well, with a total return of 6.0%. In total, Nordic countries produced a return of 6.6%.

The best performing sector in 2011 was Swedish retail, followed by Swedish offices and industrial properties and Finnish residential.

At the other end of the spectrum, Danish residential, Finnish office and Danish industrial sectors produced the lowest total returns, due to negative capital growth.

The total annual transaction volume of the Nordic region has remained well above €10bn. The only exception to this was in 2009, when annual volume dropped to €5bn, as a result of the financial crisis.

In 2011, the Nordic transaction volume amounted to €15bn, according to DTZ.

Investors have targeted Sweden in particular, and the country has climbed into the top five countries in terms of property transaction volume.

In the first half of 2012, transaction volume decreased in most European countries, but increased in the Nordic countries from the same period a year before.

In 2012, the investment market was particularly active in Sweden whereas in Denmark and Finland market activity was relatively low.

**DENMARK**

The tendency of investors internationally to focus on lower risk is one factor behind the high level of interest in the Danish property market.

"Compared to the last three years, we don't expect to see a significant change in the agenda of the market in the coming years, the lack of bank financing is the key issue, and therefore the market is dominated by investors who have equity," says Jan Østergaard, CIO at Industriens Pension. "This type of investor is typically very aware of yield versus risk."

This high level of interest from international inves-

tors is a new factor in the Danish property market.

Not only are the Scandinavian countries seen as safe havens in the current euro crisis, but Danish cities are seeing monthly population rises, notes Michael Nielsen, managing partner at ATP Real Estate Partners.

Real estate yields in Denmark are currently seen as satisfactory compared to those of other asset classes, but looking ahead, investors see a risk that large institutional and international investor interest could push yields downwards.

There seems to be little prospect of rising yields as investors chase these core investments.

"As long as we have such a low interest rate environment, there will be buyers at these low yields," Nielsen says.

PensionDanmarks's head of real estate Mogens Muff reports renewed interest in residential property investments in Copenhagen from institutional investors.

Research from Colliers International confirms demand is still centred on the residential segment in Denmark, and that this is especially the case in the large cities where investors are interested in both existing properties as well as housing projects.

The continuing concentration of the Danish population is capturing the attention of investors. Populations of large urban areas are on the increase while occupation levels in peripheral regions are coming under pressure.

Even with demographics in Copenhagen and Århus making residential and prime commercial properties very attractive, Østergaard points to uncertainty ahead because of the general state of the economy.

"Prime are at the moment the only attractive investments, because in general yields are still too low compared to the risk on other real estate investments opportunities," he notes.

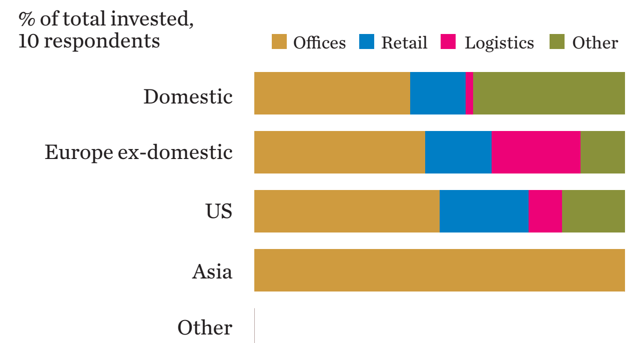
The retail market may be strained overall, but demand is strong for investment properties housing retail businesses in primary locations. For office properties, the divide remains sharp between properties in primary and secondary locations. Demand for office properties in central Copenhagen is high, as it is in other prime locations including Ørestad, Broerne and Valby.

But in the south and west of Copenhagen demand is decreasing drastically due to a weak rental market in secondary locations.

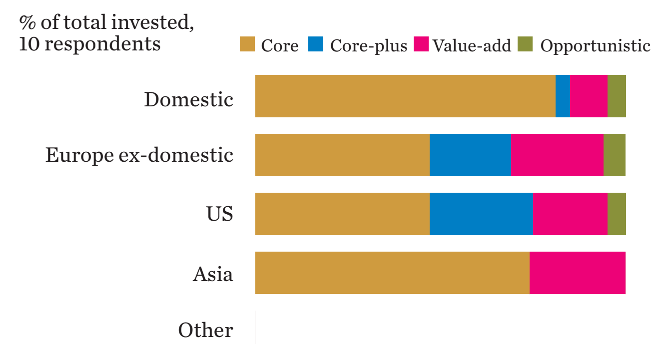
This trend broadly holds for industrial and logistics properties as well, with primary locations remaining attractive.

Danish institutional investors have slimmed their allocations to real estate over the last four years, according to the Danish pensions and insurance association Forsikring & Pension. The average allocation to

## 3. Nordics: property type breakdown




## 4. Nordics: strategy type breakdown




**Recent deals : Denmark**

**➔ December 2012: PKA, PensionDanmark and Sampension signed an agreement with property administrator DEAS and Nordic contractor MT Højgaard to cooperate on future construction-related projects, investing as much as DKK5bn (€670m), within Public Private Partnerships.**

**➔ November 2012: Commercial pension provider Nordea Life & Pension and labour-market pension funds PensionDanmark and Lægernes Pensionskasse bought a construction plot in the Ørestad district, next to the headquarters of the Danish national broadcaster DR, to own and build Nordea Bank Denmark's new headquarters in Copenhagen, in a DKK1.3bn joint investment deal**

**➔ September 2012: Meyer Bergman European Retail Partners II acquired a property on a prime location in Copenhagen. The building has a retail area of 5,000 sqm and the price was DKK250m.**

**➔ August 2012: Cubic property fund acquired three properties on Copenhagen's most famous shopping street, Strøget, for DKK430m.**

**➔ June 2012: Jeudan acquired a portfolio of seven office buildings in inner Copenhagen. The portfolio has a combined area of 13,000 sqm, a yield of 5% and a total price of DKK349m.**

**➔ June 2012: PKA and Topdanmark acquired the building project 'Udsigten' for DKK1bn. It has a combined area of 45,000 sqm and includes 458 residencies and one commercial lease.**

the asset class has fallen to 12.4% currently from over 14% in 2007–08.

Demand from the institutional side shows signs of expanding, however, with some of the country's large pension funds indicating they intend to increase property holdings.

In the next few years, for example, PensionDanmark plans to increase its investments in real estate to about 10% of assets from 6% now, which means the fund would put DKK2bn into real estate every year.

On top of this, some investors see infrastructure allocations increasing as Public Private Partnership structures become more common. Some of the key institutional investors – notably PensionDanmark – are moving to facilitate these financing structures.

This could result in more investment opportunities in public construction projects, such as hospitals and local authority buildings.

Industriens Pension expects investment opportunities of this type in the future, as long as the price is right, Østergaard says.

But some investors still doubt that these hoped for deals will come off because the public authorities will expect pension funds to take on too much risk for too little reward.

**Recent deals : Finland**

- November 2012: Pension insurance company Varma acquired the fourth phase of Lempola Retail Park from NCC. The 2,065 sqm property was completed in November. The transaction price was not disclosed. Varma also owns the first three phases of the Lempola Retail Park.
- Q2/2012: Shopping centre under construction of 26,300 sqm in Hämeenlinna bought by Keva for €100m.
- Q2/2012: Portfolio of 37 retail properties of ca 31,000 sqm was acquired by SN Properties Ky fund (Amplion's fund).
- Q2/2012: Helsinki CBD office property of 8,700 sqm was acquired by The Central Church Fund of the Evangelical Lutheran Church of Finland for €37m.
- Q1/2012: Portfolio of 68 grocery store properties bought by Sveafastigheter and Capitol Asset Management for €100m.

## FINLAND

Investor demand in the Finnish property market focused on prime properties in 2012. This trend pushed yields in this segment lower, and prices to the precrisis levels of 2007.

But institutional investors still see yields as satisfactory, especially in prime areas of Helsinki. They remain supported – at least in part – by the restricted investment supply.

As Hanna Hiidenpalo, CIO of LocalTapiola Pension, points out, on average the yield level is still substantially higher than in many other European prime markets.

While housing markets have made steady positive progress, particularly in the Helsinki area, office markets in Finland have seen a clear rise in vacancy ratios.

"We believe we will see more challenges on that front in the future," predicts Timo Ritakallio, CIO of pensions insurance company Ilmarinen.

Hiidenpalo also sees this as one of the main problems in Finnish real estate. A particular difficulty is the high level of speculative property development and new construction, she says.

The trend towards a divergence between yields in prime and secondary locations is seen as intensifying in the future.

Ritakallio says yields on prime locations are unlikely now to change from their current tight levels, but predicts that second and third tier locations will show signs of yield widening.

The retail and business park sectors continue to experience strong demand in Finland, according to Colliers International.

Financing is still a major problem and the main cause of low transaction activity. Industry experts say financing is still available, though mainly for existing and well-regarded clients.

The slowdown in market volumes has made it hard for international investors to realise investments. But the level of forced sales due to refinancing problems or covenant breaches has remained low.

Regardless of cyclical changes, the Finnish market remains a small and relatively illiquid one, and pension funds see no change on this front.

The largest transactions in Finnish property have been undertaken by Finnish pension companies, German investors and foreign property funds.

According to the Finnish property information and analysis firm KTI, only 12% of investors in the market are from overseas, with domestic pension and insurance companies making up 40% of all investors.

Most large domestic investors prefer direct or unlisted investments with only a few taking the listed route. One of the more unusual investors is Valtion Eläkerahasto (VER), the state pension fund, which does not invest directly in Finland and has the majority of its investments abroad, also via funds.

On average Finnish institutional investors allocate 10.6% into real estate, a number which has remained fairly stable since 2005 and peaked at 12.5% in 2007, according to statistics from TELA, the Finnish Pension Alliance.

## SWEDEN

Activity in the Swedish real estate investment market remains at a high level in spite of the euro crisis.

The total investment volume for 2012 was SEK105bn (€12.2bn), in line with 2010 and 2011, according to Colliers International.

International investors are a significant force in the Swedish market, with cross-border deals representing 18% of the total transaction volume in 2012.

Financing remains a key issue for property deals, but investors do report a certain improvement in the availability of financing compared to the situation six months ago.

"However, loan-to-value [LTV] ratios are a large threshold to overcome for many smaller investors and newcomers, and this situation is here to stay for a long period," says Martin Tufvesson, head of transaction and analysis at AMF Fastigheter.

The maximum LTV allowed by the banks is roughly 60% for office, 65% for retail and 70% for residential, according to Colliers International. However, market participants report the right client with the right property can find LTVs even above 70%.

Large domestic institutional investors such as AMF, Alecta and Vasakronan, owned by the country's buffer funds AP1, AP2, AP3 and AP4, dominate partly because they do not depend on external financing.

Colliers expects institutional investors to continue being active on the market as well as Swedish property companies and international funds with solid finances.

With overall demand for modern core assets still reported as strong, the downward pressure on core yields is expected to continue.

"For smaller office properties in markets outside the largest regions, financing is still an issue depending on cash-flow and owner," says Tufvesson.

In smaller markets where there are some vacancies, yields are seen as attractive for those investors able to bear high risk.

The gap between core and non-core, and the tightness of external financing in less attractive locations has led to a very bifurcated picture.

Investors also report that the underlying office leasing markets are currently showing signs of slowing, due to signs of a weaker economic outlook.

**Recent deals: Sweden**

- **December 2012: The Canada Pension Plan Investment Board (CPPIB) signed an agreement to jointly acquire the Kista Galleria Shopping Centre in Stockholm. The deal is being done in conjunction with Citycon Oyj, a major owner and operator of retail assets in the Nordic and Baltic countries. The amount to be invested by CPPIB is approximately CAD177m.**
- **August 2012: 26,000 sqm prime logistics was sold in central Gothenburg to M&G Investments. The price was SEK224m.**
- **July 2012: AFA acquired an office building in Stockholm CBD from Fortin Properties. The building has a rentable area of 22,000 sqm and the price was SEK1.4bn.**
- **June 2012: Platzer acquired a 67,400 sqm office portfolio for SEK950m in Gothenburg.**
- **June 2012: Humlegården acquired 6 office properties from Länsförsäkringar for SEK4bn. Portfolio consists of 145,000 sqm office premises in the Stockholm area.**
- **June 2012: Vasakronan acquired a property in Västra Hamnen in Malmö from Skanska. A 16,700 sqm office for SEK652m and a yield of 5.5%.**

Swedish institutional investors allocate around 10% to real estate on average, and trends point towards increasing interest in public buildings such as schools, hospitals and prisons.

The Stockholm region is the most attractive submarket, accounting for around half of the transaction volume. Activity in Sweden's second city, Gothenburg, also remains high. But transaction volume in Malmö – the country's third largest city – decreased in the first half of 2012 compared to the corresponding period in 2011.

Because institutional investors are most active in the three largest cities, office yields have declined in these markets over the past year.

Yields for the three main cities have converged the last five to 10 years and some believe they will diverge in the future, as the natural differences due to liquidity and size are likely to become factored into the market.

Apart from the issue of financing, international investors are also concerned that they are paying too much and some believe that once property markets recover elsewhere, Sweden may lose its status as a safe haven, bringing down premiums.

Switzerland

# Home, sweet Swiss home

## The Swiss market is overheated, but many Swiss Pensionskassen are determined to cling on to what they know and hope for the best.

Many have "seen it all before", like Reto Schär, head of real estate investments at the €14.5bn Pensionskasse of the Swiss retailer Migros (MPK): "I have seen this cycle before when in 2001 Swiss real estate was almost impossible to sell – no price increase like this is sustainable."

And Stephan Kloess, head of KloessRealEstate consulting, warns that underestimating the cycle is one of the biggest traps in investing in real estate, especially in a domestic market you think you know: "You have to be aware of the cycle and be able to absorb possible devaluations of the properties as well as slumps in rental income over a long investment horizon – but depending on the price this might be up to 30 years."

Kloess quotes the Herengracht Index which shows "the importance of getting the cycle right" and it proves that "over 345 years there is practically no value appreciation".

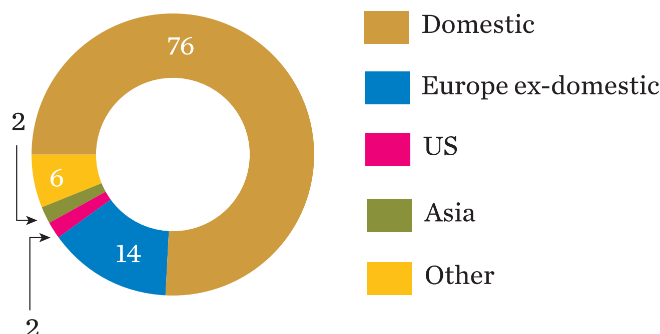
According to Kloess, the Swiss market is already hot and there is a danger of the tenant market decoupling from the investor market, especially in the office and retail sectors. He does not see a bubble yet but says that prices are at a very high level at some locations: "They are more likely to come down than continue to go up."

Schär also sees the threat of a real estate bubble in Switzerland and believes his fund's property portfolio, the vast majority of which is invested directly in Swiss properties, is priced very reasonably.

"If we had to buy now that would be a problem," Schär says. "It would not make sense to top up the real estate portfolio now because when prices are adjusted then value is lost. We never had a situation like this where experts had so diverging opinions on the value of Swiss properties".

Another investor agrees: "It is not easy to buy in

**1. Switzerland: regional breakdown**




Switzerland at the moment because everybody wants the same thing – so you have to go slowly."

Traditionally, Swiss institutions have a rather high exposure to real estate at around 20% on average. And if Pensionskassen with active members want to keep that level they will have to continue to invest in real estate, even in the current market environment.

According to our survey, over 80% of Pensionskassen are planning further investments "in the next two years" and only a small minority plans to decrease the exposure.

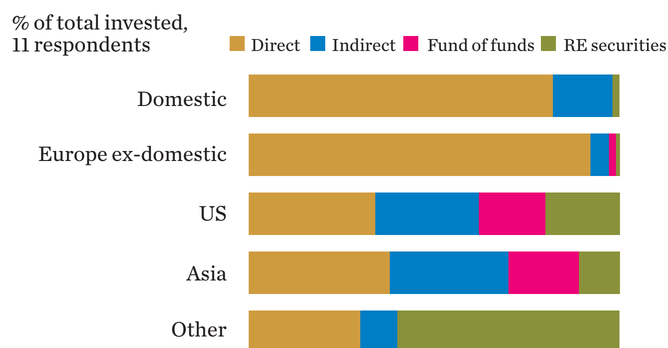
Some institutional investors trying to buy Swiss property sometimes do so at relatively high prices. Initial net yields in top office locations have fallen since the crisis from 4.5% to 3.5% on average and some market experts note that foreign investors are going in at even lower yields.

"The Swiss real estate market has become extremely limited given a continued value growth since the 1990s and the demand for Swiss property is extremely high as it is considered a safe haven," according to an investor. The situation is similar in the residential sector and existing residential properties are therefore "more or less ruled out by now" for the investor. Instead he is looking into niche sectors like leisure parks and also "trying to enter the value chain at an earlier point" by going into construction projects.

Kloess notes that some investors still suffer from the delusion that Swiss residential property is an absolute hedge against inflation: "It is not, because the question is not whether rents can go up but whether new tenants are still able to afford them. Swiss residential allows only an inflation-linked hedge of 40%."

Alternatively, Swiss institutions are looking into domestic project development as some of them are questioning whether it might be safer to take some more risk domestically rather than going abroad.

Kloess reports that he sees some demand, as a few investors have launched funds that include domestic




project developments. In combination with a strong brand, these products are immediately oversubscribed.

At the moment, the majority of the real estate portfolios in Swiss Pensionskassen is invested directly in Swiss properties and managed in-house. This will not change much according to an investor: "They might go into bespoke indirect solutions but we are seeing that they are very attached to their properties and do not want to give up ownership entirely. They are looking for professional support in managing them."

Individual mandates are a "definite trend" according to Kloess: "In Switzerland, just like in Germany, investors are reconsidering co-investing with others in certain vehicles and they are rather looking for individual mandates to be more flexible and have greater control."

But he adds that this increase in control "is not necessarily automatically leading to a higher return or a better managed mandate" and at the moment he is still missing the "increase in transparency which should accompany the increased demand for control".

Our survey among Swiss pension funds shows alignment of interest is an important or even very significant factor for all participating funds when it comes to manager selection – more so than the quality of reporting or the use of performance-related fees. An equally high ranking was only achieved by the questions on transparency of fees and performance.

The vast majority of the surveyed pension funds used fixed fees with only a small minority applying a mixture of performance-related and fixed fees, mainly for their foreign real estate investments.

Some investors, particularly large Pensionskassen like the MPK, continue to manage the whole directly-held Swiss portfolio themselves. "We have facility management offices in Zurich, Lausanne and Basel. This is more efficient than to deal with third parties and we can offer a high quality which we assessed via a benchmark study to confirm our competitiveness", explains Schär.

Peter Bänziger, head of asset management at Swisscanto, adds: "We have always been strategically overweight in direct Swiss real estate investments". In order to keep this quota, the Swiss asset manager is shifting the focus in the portfolio from pure core towards longer-term projects as existing properties do not yield adequate returns. "The projects we are looking into are also in the core or core-plus areas," Bänziger says. Apart from that, Swisscanto continues to actively manage its existing portfolio by renovating or adapting properties, which has always been part of its value creation.

For other Swiss institutions this is a relatively new approach, away from a buy-and-hold strategy and towards adding value to the existing portfolio for lack of alternatives. But Kloess notes that refurbishing and letting at a higher price might not always be possible, especially in lower-income areas.

One consultant puts the strong domestic bias down to Swiss investors having been "burnt by foreign investments" at the beginning of the decade and shying away from it since.

Kloess, too, notes that investing abroad, mainly in Europe, has only just begun in Switzerland and that it is still a "small plant". He notes "one new product launched by an institutional investor together with a European asset manager in which pensions funds were also invested." Furthermore, he knows that a few pension funds are thinking about setting up individual mandates. As a vehicle they could either use a Swiss investment foundation (Anlagestiftung), a Luxembourg vehicle or a German Spezialfonds: "So if they have to invest abroad they are rather choosing a vehicle they know from their home turf instead of foreign structures."

Of course there are exceptions to every rule and the MPK is one of the institutions with a comparatively large share of foreign real estate in its portfolio at around 15%, mostly in Asia followed by Europe and the US.

Another investor is "currently expanding" its foreign exposure which makes up 10% of the total real estate portfolio but is already "relatively well diversified" across core Europe, Australia and America.

Swisscanto too has holdings outside Switzerland, which it is managing indirectly via REIT: "We decided not to invest directly in foreign property as you need the necessary infrastructure for that," says Bänziger. "Given the low interest rate environment listed real estate is also very attractive outside Switzerland, for example in the US where we see a recovery". Therefore the asset management house is shifting its regional diversification outside of Europe by adjusting its benchmark to the developed markets' NAREIT.

The approach to listed real estate vehicles is completely different in Switzerland compared to Germany, for example, where the asset class is mostly viewed as being too similar to equities.

In Switzerland, institutional funds are set up as listed vehicles, which means there has never been a serious liquidity issue as shares are always tradable, albeit with a notice period. This means they offer greater liquidity than for example a German Spezialfonds or a Luxembourg FTP but a little less than a REIT.

One fund provider even sees "a strong trend towards passive global investments – but also in Switzerland passive is sought after alongside active mandates".

Another asset manager confirms a "good momentum on the Swiss market for indirect investments as investors are looking for such vehicles" and reports figures according to which around CHF3.2bn (€2.6bn) were invested in indirect real estate vehicles in Switzerland in the first nine months of 2012.

Investors note they include listed real estate vehicles to "improve liquidity in the portfolio" and leverage in the funds and generally in Swiss property deals is well below that in Germany or other countries. On average, Swiss investors are accepting 20% to 30% leverage and only in exceptional cases might it go up to 50% at the most.

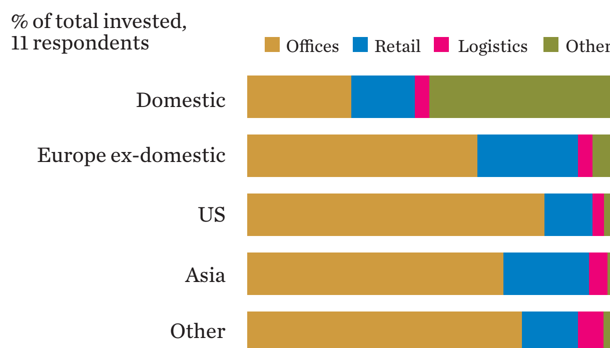
Therefore, real estate debt is not really a theme for Swiss institutions and furthermore Swiss banks – unlike some of their European counterparts – are still lending money.

One investor puts it succinctly: "We have gone into the crisis with a conservative approach and have come out of the crisis even more conservative. However, over the last years – given the low interest rate and lower risk premiums – the use of debt capital has become more attractive so we might be increasing the leverage a bit, but only by a small amount".

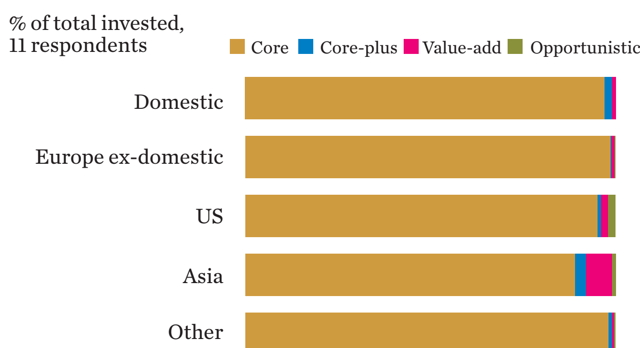
Many Pensionskassen do have a traditional exposure to mortgages, mostly for domestic residential properties, like the €12bn Swiss railway pension fund PKSBB which doubled its exposure to this asset class over the summer. It took on €524m in mortgages from its sponsor, Switzerland's federal railways company, which sold the portfolio including mortgages granted to 64 railway and 11 other building co-operatives in a bid to free up money to make investments in its core business. The SBB Pensionskasse said the investment would bring long-term, fixed income assets with stable returns and bring the share of mortgages in the portfolio to 5%.

In summary, Swiss institutional investors are betting on the "more of the same" approach rather than drastically re-structuring their portfolios. And why

## 3. Switzerland: property type breakdown




## 4. Switzerland: strategy type breakdown




### Recent deals

**➔ January 2013: The Swiss real estate investor, CORESTATE, acquired a German commercial and residential portfolio valued at €150m and entered into an exclusive agreement to purchase an additional €150m of residential assets.**

**➔ January 2013: Schroder Property raised €225m from Swiss institutions in the first close of a real estate fund targeting assets in core European countries.**

**➔ December 2012: PSPI completed the sale of its only investment property in Switzerland for a gross price of CHF12m (€9.8m). The board concluded that the sale was in the best interests of the company since the asset has significantly declined in value over recent years.**

**➔ November 2012: The Norwegian Government Pension Fund Global moved into the Swiss real estate market for the first time with the purchase of the Uetlihof office complex in Zurich for CHF1bn (€830m). This comes as part of the sovereign wealth fund's plan to build up core pan-European real estate exposure.**

**➔ January 2012: The private equity real estate investor Corestate Group acquired a portfolio comprising 3,000 residential apartments in Berlin and an office building in Stuttgart. The properties were acquired for approximately €230m from a foreign investor who had purchased the assets during the peak of the German real estate market.**

shouldn't they? Most of them have been holding their properties for several years, sometimes decades, and for many there is no need to make purchases now.

"We are already well diversified in Switzerland with properties in Zürich, Basel, around Lake Geneva and it would be difficult to add new properties in other regions now given the current market environment and price level," as Schär puts it.

And he stresses: "Sometimes it is better to park your money at zero interest rather than buying an expensive property – but not all investors think that way."

He is referring to investors who have tried to jump the bandwagon of real estate investments after realising Swiss properties can be a stabiliser in the portfolio – even in times of crisis.

But Schär is convinced: "Once the trust in the market returns then money will flow back into equities – and those you can buy for a comparatively honest price."

UK

# No big changes for UK investors

## UK pension funds will tread carefully for the next few years but they're keeping an eye on longer-term trends.

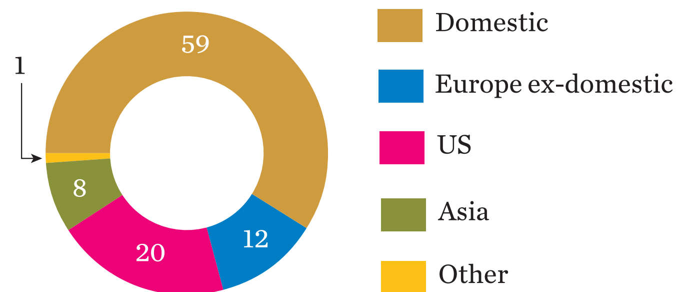
UK institutional investors' property allocations will remain stable over the next two years, judging by the responses from UK investors in the EIRES survey. But a few themes are emerging – notably a concern with sustainability – that could influence how schemes structure their allocations in the longer term.

None of the UK pension schemes interviewed actively plan to alter their allocation or make any major changes to their property portfolios over the next two years. Where there is the possibility of change, it will be the result of an exogenous event.

The pension scheme of retailer Next, for example, is looking at "more of the same in the same proportions" for its real estate allocation over the next 12 months. Group pensions manager John Stevenson said if there were to be a change in his scheme, it would come by default from a buy-in. The scheme set up such an arrangement in July 2012, with the potential for a subsequent buyout, following a significantly larger buy-in in 2010.

"Without us doing anything with our property allocation, a buy-in would make both our assets and liabilities smaller and in the process increase the proportion of property as part of the overall portfolio," said Stevenson. "But there is no change planned for the real estate allocation, either in the short term or the long term."

**1. UK: regional breakdown**




Among local authority pension schemes, especially, there appears to be little expectation of significant activity of any kind in the short term. One manager described property as occupying a middle ground between asset classes offering higher and lower risk/returns. When the scheme's triennial review takes place next year, it is the allocation least likely to move.

Despite its relatively attractive risk-return profile, few investors are planning to increase their allocations. The £12bn (€14.7bn) British Steel pension fund is considering a 0.2% increase over the next two years; likewise the €980m London Borough of Ealing local authority pension fund, Next pension fund and Hermes. Nestlé is looking to decrease its allocation by 0.2%. On either side, these are negligible shifts.

Caution is not an indication that pension funds are oblivious to external market changes, only that – as long-term investors – they are not necessarily inclined to follow them immediately. Peter Wallach, head of the £5.1bn (€6.2bn) Merseyside local authority pension fund, said there should be no surprise over the lack of major shifts over the past year, for example. "We're not looking to trade properties – not least because stamp duty is high," he said. "These are medium-to-long-term investments. Asset management is

more important at the moment in terms of enhancing our properties' valuations."

Another manager said he was looking to increase the scheme's exposure to "the better end of the market" – prime, although he acknowledged a paucity of available assets. "We're following the flight to quality. The allocation hasn't really changed but we have money to spend," he said.

Yet at the same time he is unfazed by the current poor performance of secondary assets within the portfolio, which stretches across retail, office, industrial and agricultural land ("for its hope value").

"Some of the assets are not doing well but in previous markets they did – and we're long-term investors," he said. "Some of the stuff is pretty poor and other assets are the very best. I suppose you could call it a balanced portfolio. We don't need to sell but, if we did, we will probably find it difficult to sell some of the secondary stuff."

### Cautious investors go direct

Among many pension schemes there is a lingering preference for in-house management of directly held core assets. Overall, 91% (€17.9m) of domestic investments are held directly. The same preference is evident in all regions except non-domestic European real estate, which is split between 70% direct and 30% indirect. The British Steel scheme, for example, has a strategic allocation to real estate of 10%, entirely invested domestically, directly, and in core assets.

This preference does not necessarily correlate with the size of the scheme. Hermes, for example, which has a 10% target allocation to real estate, invests 85% of its allocation domestically and 65% of it directly. Core assets account for 69% of its domestic investments.

For one manager of a medium-sized scheme with a five-strong in-house property team, it makes more sense to manage the portfolio directly because it's cheaper than outsourcing it to external managers.

"I'm not sure how many external managers would do it to the level we do or be as motivated by the success of the pension fund. In our case, all pensioners are totally aligned," said the manager.

"Cost is important to us and the running costs for the portfolio if it is managed in-house will be lower than those charged by an external manager."

Yet he acknowledged that handling the entire allocation in-house limited the kind of investments he could make. The scheme invests only in UK property. "There's only so much knowledge a team can have," he said. "Not only do overseas property markets have different attributes than the UK market, but if you're looking overseas to diversify the portfolio, it costs a lot of money to get real diversification."

### The science of selection

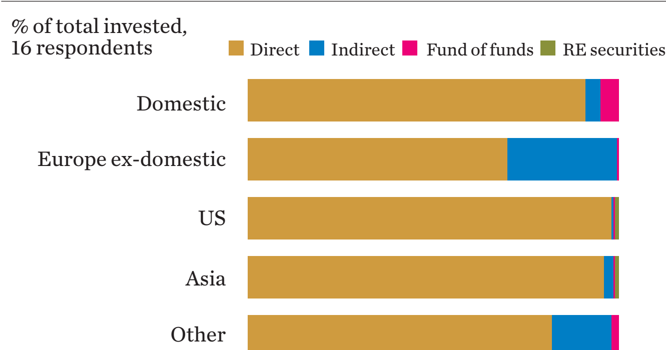
The most variation in the survey came from the criteria weightings for selection of external managers. Fees were a concern for most respondents but the weighting of other factors reflects to some extent the type of investor. The Crown Estate, the company charged with managing the Crown's assets, ranked as priorities almost every criterion from performance to investment team stability.

Unsurprisingly for an organisation engaged in joint ventures with institutional investors including the Norwegian sovereign wealth fund, it rates alignment of interests most highly in its selection of real estate investment managers.

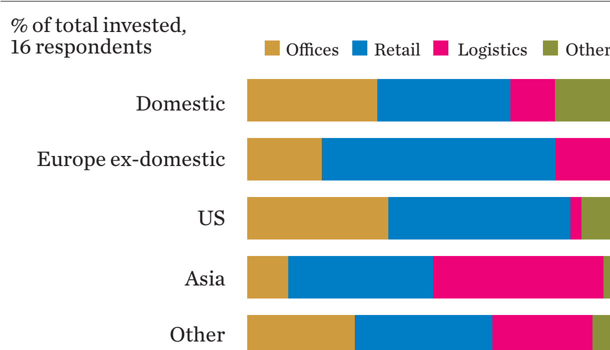
In any case, there are significant exceptions to the broad preference for directly held assets. The Merseyside scheme has over the past five years increased its investment in funds to 30% of the total allocation. Wallach pointed to opportunities the scheme could only access indirectly – in niche areas such as student accommodation, healthcare and senior care. More broadly, investing in funds is an easier route to expanding its global exposure.

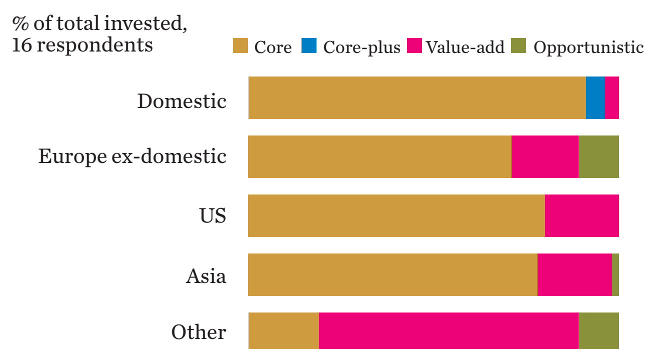
"We're thinking about both direct and indirect and we're comfortable with the current split," he said. "As

**2. UK: investment type breakdown**




**3. UK: property type breakdown**






with all our investments, the principle is diversification. Until our next strategic review, we're happy with the allocation we have. In any case, we tend to select investments rather than take a strategic view of markets. We evaluate opportunities, buy them and hold them."

Elsewhere, moves outside direct investments in core domestic assets have been cautious – but they have also been innovative in the sense that a focus on core at home does not necessarily mean a similar focus overseas.

Nestlé Capital Management, the £3bn corporate pension fund, which has an 8% target allocation to real estate, invests 80% of it domestically, 5% in non-UK European markets, 10% in the US and 5% in Asia. In contrast to its domestic focus on core assets (80%), it invests its 20% global allocation opportunistically.

**Recent deals**

**May 2013: Ontario Municipal Employees Retirement System, through Oxford Properties, takes 50% stake in joint venture with Crown Estate. £320m (€376m) to redevelop St James's Market.**

**May 2013: APG is to team with LaSalle Investment Management to provide £238m in senior debt financing for London residential and UK-wide student housing projects.**

**April 2013: Great Ropemaker Partnership acquired a London property let to Royal Mail from the BP pension fund for £30m.**

**February 2013: The UK government sold a £400m property portfolio, formerly owned by Royal Mail Pension Plan, to Santander Pension Scheme.**

Two years ago, the Nestlé group set up a commingled property fund, which is unitised to allow all the group's pension funds to invest in it. "We invested what we could without destroying our existing allocation," says CEO Peter Tait. There remains an outstanding drawdown on the fund before the triennial review next year, which could see the global portion increase from 20% to 25% of the overall portfolio – a significant exception to the broader trend towards little or no change.

The review next year will focus on issues such as illiquidity in the market place and the underlying economy, especially its impact on the UK portfolio. Above all, Tait and his team will be looking at the attractiveness of real estate vis-à-vis bonds. "We view property at least partly as an income-generating asset," he says.

### The green imperative – but not yet

What is clear from this year's survey is an emerging interest in sustainable real estate, particularly as an element of risk control. The impetus appears to be coming not from the asset class itself but from an overarching concern with environmental, social and governance (ESG) issues. Sustainability, for example, has permeated all the asset classes the Merseyside scheme invests in.

"Investors are starting to recognise the cost of poor environmental performance," says Wallach. "It's certainly something we consider when we look at prospective investments. In the last financial year, environmental ratings are one of the criteria we look at in potential acquisitions, even if it isn't the principal factor."

Eventually, he said, it would be one of the criteria for judgements about which assets to buy or sell. "One of the reasons is that corporates – tenants – are insisting on buildings with good environmental performance. The focus will increase over time. You can't change it overnight. But it will be a consideration," says Wallach.

The Merseyside scheme is not alone. The Ealing scheme, which channels its entire real estate investment via funds and has a strategic allocation of 7–10%, rated ESG above all listed criteria – including fees, corporate governance and risk control – when it came to choosing external managers.