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The Changing Face of the Industry

A market crisis is usually a turning point for any industry whereby a 'change of the guard' takes place. Old names fade into obscurity whereas new names line up to be the major players during the new cycle. This time round, the property investment world has witnessed some spectacular cases. Recently, Morgan Stanley announced that its most recent real estate fund (MSREF VI) which had assets of $8.8 billion during its heyday, has lost two-thirds of its value. This was described as 'the worst losses in real estate private equity history..' Similarly, Whitehall Street International, Goldman Sachs's international real estate investment fund has lost almost all of its $1.8bn, following failed investments in US, Germany and Japan. All in all, Whitehall has lost about 98% of its equity...

These cases were but two of the nails on the coffin of the traditional fund structure that dominated private equity property investment over the last cycle. Such beasts would raise billions from investors, all of them promising above average returns. They would keep investors at a relative distance, relegating communications to the 'Investor Relations' department. And of course they would charge 'appropriately' for their market-beating skills.

There is now a widespread disillusionment with that model, with investors now opting for the exact opposite. Control and transparency are now on the top of the agenda. Investors are now opting for separate accounts and for 'club deals' where a small group of like-minded investors are jointly exercising control of an investment. Transparency is also very high on the agenda. Investors now want to speak to the deal makers themselves, and be in the loop for both good news and bad news. Fees have also taken a hit, reflecting the fact that (by definition) not everyone can be above average. Fees are now lower and substantially back-loaded (paid upon realised performance). All these are structural changes that will pervade the industry over the next few years. Fund managers who do not adapt to these new themes will probably not be around over the next few years.

As regards the latest fund trends, the last few months have seen the return of the Core fund (this is a fund which promises returns in line with the market, assumes low leverage and goes for safe investments). Nearly 90% of the funds raised in 2009 had a 'core' strategy. Such funds shy away from emerging markets (like Turkey), focussing mainly on western Europe (e.g. UK, France, Germany etc). This reflects the increased risk aversion prevalent in the market. However, several other funds (having raised billions of Euros) are still promising 20% plus returns. This should be possible only if a fund employs high leverage (which today is impossible), buys properties with a 'story' (e.g. vacancies), development or returns to emerging markets. And it seems that as the 'distressed assets' story is not unravelling as fast as investors would have liked, the return to emerging markets will be expedited.

There is also a change is perception as to what is an emerging market. Poland for example, which so far has been an emerging central European market, is now acknowledged as a mainstream (perhaps core market), like Spain. At the other end, Greece now goes by the adjectives of 'toxic' or even 'junk'. In Eastern Europe, there is now a differentiation in investors' minds between riskier markets (e.g. Russia, CIS) and less risky ones (Turkey). Geography is no longer an indication as to the riskiness of a country.

As risk aversion gradually diminishes, the relatively safer markets in the emerging league can be expected to benefit first. The newly re-discovered themes of transparency and ‘performance before size’ and ‘remuneration on performance’ will be the new mantras. Markets that facilitate this will have an edge over others.

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