Invest in real estate: A dedicated real estate stock exchange opens new opportunities for investors

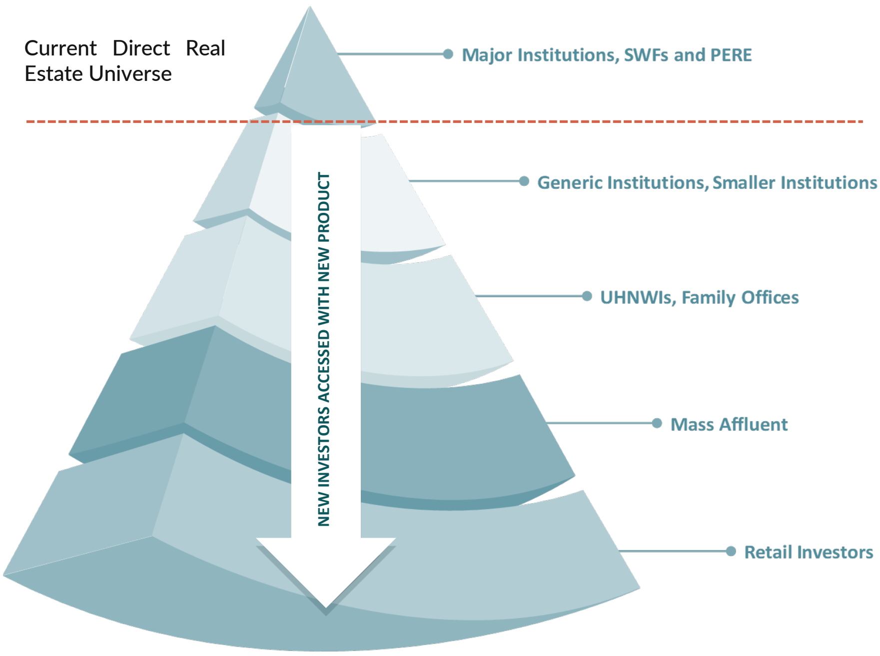
The current investment options (pre-IPSX) are limited and exclusive

Only a small number of major institutions, sovereign wealth funds and private equity real estate funds can access commercial real estate directly through the purchase of direct physical assets. Other investors must rely on quoted property companies, quoted and private funds, and OEICs, where, as well as making a judgement on an asset or asset class, they need to take a view on the manager of their assets and their ability to switch between assets successfully.

Direct exposure to real estate is only an option for those with a very large "lot" size

By number, IPSX is for the many, not the few

Investor categories



For acronym definitions, please refer to Glossary. Not to scale.
Source: IPSX

The illustration above demonstrates the way in which a vastly wider range of investors will be able to gain, effectively, direct access to assets via IPSX. IPSX's focus on commercial real estate, the operation of a MiFID regulated market, which enables retail investment, and the built-in low cost of acquiring shares relative to direct investment in commercial real estate are the foundations to the proposition – this opens the door to a variety of investor types.

Different types of investors

Different types of investors are a good thing

Having a variety of investors attracted to IPSX is good for liquidity and the flow of funds. Different investors bring a variety of quantum and timing of cashflows, and multiple time horizons. This will provide resilience in times of stress.

Investing in commercial real estate comes with a varied list of opportunities and costs. Those costs revolve around illiquidity, excessive concentration by location or type (with several options only realistically available for residential letting) and cost inefficiencies in running the assets. Part of the contribution to illiquidity and cost is the SDLT, payable on purchase. SDLT paid by commercial real estate totals ca.£3bn (albeit this is much below VAT payable on rent, at £5bn, and occupiers paying business rates of ca.£20bn).

Retail investors

The current investment options for retail investors

The current investment options open to investors seeking to invest in real estate are wide-ranging, yet exhibit a number of intrinsic drawbacks. Below, we outline the main types and their difficulties.

Current options have drawbacks

Retail investor base: current investment options

Options	Comment
Open-ended funds	Illiquid when liquidity is needed; most asset type/quality "creep"; not optimising tax efficiency.
Buy to let direct	Tax inefficient; time-intensive/significant running costs; only residential; permanently illiquid; significant entry costs.
Unquoted "micro-REITs"	Lack of transparency; residential; no long-term track record.
Direct commercial investment	Large lot size; significant risk of long void periods; for "professionals"; debt financing very difficult; illiquid.
Quoted real estate shares	Liquid; information asymmetry; mismatch to asset performance.
Crowd funding	Illiquid; no long-term track record.

Source: Hardman & Co Research

The REIT environment provides a framework for quoted real estate stocks, but a single- asset REIT or SARC is structurally different. An IPSX SARC should be a closer share price match to the asset performance than a general REIT (whose assets may change significantly over time). While this seems intuitively correct and has been empirically demonstrably correct over the past year, different academic studies have reached varied conclusions for the long term.

Academic studies

This is not to say that current options are all bad. IPSX optimises the choices open to investors; it does not replace an irretrievable model. We note, for example, that Ling and Naranjo in 2012 calculated that a typical unleveraged SARC outperformed the direct property market by 46 bps from 2Q 1994 to 4Q 2010[7].

The advantages of IPSX to retail investors

We anticipate IPSX will be welcoming to retail investors. The single-asset component is the key to it all.

Not only will IPSX offer retail investors an alternative way to participate in the returns from property assets, but they are likely to be encouraged to be involved. IPSX is keen to see the involvement of retail investors in book building for its IPOs and, it is believed, is keen to encourage retail participation via several platforms. It is also thought that widely distributed research will form part of the package to ensure a level playing field for retail involvement.

There are, we consider, numerous and significant further benefits from securing exposure to real estate for retail investors through fractional shareholding in SARCs dealt on IPSX (see table overleaf).

[7] Quoted in an article by Alex Moss in the CFA Journal in 2013/14

A significant diversity of benefits

Retail investor base: IPSX investment options

Characteristic/attribute	Comment
Transparency of data	IPSX will require six-monthly valuations, in addition to financial and other periodic company reporting.
Information asymmetry	There is a "fighting chance" an investor will have deep expertise in the locality where investment is made.
Quantified "pick and mix"	The retail investor may find funds begin trading that have a transparent and quantified stock-picking screening process.
A sense of ownership	These are not "high-frequency trade" shareholdings.
Liquidity	Market-making, plus two auctions per trading day.
Diverse risk spread	Exposure can be through a diversity of SARCs.
Income flow	SARCs (at IPO) must be stabilised assets.
Cost efficiency 1)	We anticipate management fee structures will be efficient.
Cost efficiency 2)	Cost of debt will be at efficient "corporate" margins over LIBOR.
Tax efficiency	The REITs regime is designed to encourage tax-efficient investment, and this is unlikely to change under evolving/different political regimes.
Governance	Each SARC will have a board of directors.

Source: Hardman & Co Research

Retail and IPOs

The retail investors may decide on their own stock selection strategy, or they may find funds begin trading that have a transparent and quantified stock-picking screening process.

Institutional investors

In addition to the benefits outlined above, many of which apply equally to retail and other investors, institutional investors will have additional reasons to consider investing in IPSX-traded stocks. For institutions, there are a number of benefits not available elsewhere. The table below lists only some.

Institutions will often wish to be seen as long-term investors in the asset – a sense of stewardship

Institutions running OEIC structures have issues to address – see following section

Institutional investor base: IPSX investment benefits

Attribute	Comment
Transparency of data	IPSX will require six-monthly valuations, in addition to financial and other periodic company reporting.
Low costs	We anticipate EPRA cost ratios will be below those of larger, generalist, REITs.
A sense of ownership	The institution can create and benefit from asset "stewardship".
Reputation	Institutions who operate open-ended real estate funds run reputational risks if they need to "gate" those funds. IPSX directly addresses that.
Quantified "pick and mix"	Institutions can add value and fees by creating open-ended funds investing in liquid, transparent real estate positions.
Liquidity, diversity, income, cost and tax efficiencies, governance	All attributes as per table above.

Source: Hardman & Co Research

An important additional benefit for investment institutions managing funds is the ability, over time, to launch products where third parties (be they retail, family offices or other investors) can invest in certain, predetermined criteria via SARCs dealt on the IPSX. Clearly, the greater the number of SARCs traded on IPSX, and the wider variety of types of assets, the more attractive this becomes. The data recommended or mandated by IPSX could form the basis of customised filtering for investor characteristics determined by the ultimate investor. Those filters could comprise locations, or asset types, or net initial yields, or various or a whole range of investor criteria.

OEICs/PAIFs

Open-ended funds, by their nature, are subject to monies coming in or going out on a day-by-day basis

OEICs are open-ended investment companies, and some invest in commercial real estate on behalf of holders (usually retail investors) of units (or shares) in the fund. The number of units rises and falls as investors put money in, or take money out (as cashed-in units). PAIFs are targeted on property, i.e. real estate. PAIFs, while similar to OEICs, enjoy a more favourable tax treatment – similar to REITs. Clearly, one characteristic of these funds is that the invested money can be added to or withdrawn by investors, leading directly to an expansion or a shrinkage of funds available to be invested in the real estate. A liquidity "buffer" is needed, as a result. There have been three recent episodes where the liquidity buffer proved to be only partially successful against significant sums being withdrawn by investors in these collective funds.

Liquidity for managers of open-ended funds is cash-based liquidity…

In the period from the start of 2007 to the start of 2010, such funds lost 35% of their valuation[8] and, during this period, many fund managers restricted unit redemptions.

…sometimes the cash runs out

Perhaps both more surprising and more instructive, there have been occasions when collective investments have had to suspend withdrawals, even without any particular bearish trends in the wider real estate market. On 5 July 2013, Brandeaux, the property fund manager, suspended all eight of its funds after experiencing higher redemption requests and liquidity problems. As stated in the *Financial Times*: "The company, which manages the £1bn Student Accommodation Fund, an open-ended property fund, on Monday said it would no longer accept new subscriptions or redemption requests. The suspension includes Brandeaux's range of ground rent funds. It blamed the move on the uncertainty in the student accommodation market, stating that there is a considerable "overhang" of UK purpose-built student properties. Brandeaux said it was in discussions on various property transactions to create liquidity for investors. This includes selling about 80% of the ground rent portfolio by value. In a letter, Roger Boyland, chief executive of Brandeaux, told investors not to panic. 'The Brandeaux funds are all performing positively, and own hard assets represented by high-quality UK property. There is no basis for investors to 'panic' or to worry that they have 'lost all their money'." Indeed, investors in Brandeaux Funds did, in due course, receive, in cash, sums that could be considered to bear a fair reflection of the underlying fund assets (a Hardman & Co assessment). This episode – while being fairly concentrated in nature, does, we believe, show how these funds have built-in tensions.

Difficulties can be experienced even when the market as a whole is relatively benign

In 2016, significant problems were encountered

In early July 2016, the sector as a whole suffered cashflow strains as a direct result of the unexpected Referendum result regarding the future status of the UK in the EU.

Standard Life Investments announced that it had (temporarily) suspended trading in its Standard Life Investments UK Real Estate fund (and its associated feeder funds) due to "exceptional market circumstances". The strategy alone had assets under management of £2.9bn. A statement by Standard Life confirmed: "The suspension was requested to protect the interests of all investors in the fund and to avoid compromising investment returns from the range, mix and quality of assets within the portfolio." Aviva Investors temporarily suspended trading on the £1.9bn Aviva Investors Property unit trust because "the extraordinary market circumstances, which are impacting the wider industry" led to a lack of sufficient liquidity. M&G gated (i.e. severely restricted daily individual redemptions of) its M&G Property Portfolio. This lack of liquidity to cope with exceptional circumstances brings a number of issues. The main one is the suspension of trading. Another is how to find the correct price for the funds. There is an argument that the funds may have

[8] FE Trustnet

exacerbated the problem by not marking down units in line with REIT prices, giving investors an extra incentive to redeem units.

The FCA has been concerned that these vehicles do not work well in a crisis and may stop investors taking their money out in stressed economic circumstances. If some of the funds were held in IPSX-traded stocks, it should be easier to meet demands for disinvestment.

Using SARCs, the liquidity is no longer cash…it is replaced by real estate liquidity…

…so, no cash drag, no asset mis-match

Open-ended investor base: IPSX investment options

Attribute	Comment
Transparency of data	See page 45.
Liquidity 1)	Market-making, plus two auctions per trading day
Liquidity 2)	Open-ended funds currently suffer from "cash drag". Unless various synthetic investment styles are used, cash has to be held at all times to act as a buffer against unit redemptions.
Reputation	Gating (to reduce or suspend redemptions) or moving between bid and offer basis (to reduce redemptions) harms reputations.
Diverse risk spread	Exposure can be through a diversity of SARCs.
Income flow	SARCs (at IPO) must be stabilised assets.
Cost efficiency	A fund holding a "conventional" SARC would have been subject to two sets of fees, but an IPSX's single-asset company fees are likely not to be accretive.
No cash drag	Cash liquidity is replaced by liquidity via real estate IPSX assets.
Liquidity – governance	All attributes as per table above, page 16.

Source: Hardman & Co Research

For all these reasons, OEICs currently are drawn down the route of cash-based liquidity buffers. This is, at best, a cash drag, and, at worst, an asset mismatch, as investors invest in OEICs to have money in real estate. Cash drag equates to the impact that an investment company will suffer, by holding some of its assets as cash – thus not fully matching the performance of the real estate asset class in which it is designed to invest. There is an inefficiency: a "drag". To mitigate this, OEICs could buy "mainstream" REITs, as those investments would be a closer match than cash would be, but there are major hurdles. Existing REITs' ERPA costs open OEICs to accusations of charging fees on top of fees.

No fee-related conflict of interest

An OEIC might choose to securitise one of its assets. By securitising it, the OEIC could sell down its holding rapidly, were it to need to raise liquidity quickly. The liquidity issue is positively addressed, and there is no fee issue. Where it continues to be the asset manager of the underlying asset, it is not "paying" fees away; rather, the wider OEIC is just continuing to earn the same fees on the underlying asset that it would if it were unlisted. This is a large issue – PAIFs/real estate OEICs in the UK total ca.£20bn funds invested.

A large (£20bn) issue that needs addressing

Family offices

Family offices have a stated affinity for investing in physical property. In a recent survey of European family offices, 79% stated this preference – for physical assets – and a significant number also wanted the ability to check a secure legal title (30%)[9]. In short, family offices welcome the tangible nature of the asset.

[9] Survey by UBS and Campden Wealth

A sense of ownership, but with a market price

These preferences are reflected in European family office asset allocation. On average, 50% of their assets are invested in alternatives (private equity, hedge funds and real estate), with commercial real estate amounting to 23% of the total (17% of which is held directly)[10]. This reflects the European culture of seeking wealth protection, rather than the growth strategies more prevalent in the US and Asia. When these family offices enter into direct, co-investing deals with professional managers, the allocation to real estate rises to 60%.

Family office investor base: IPSX investment options

Attribute	Comment
Transparency of data	The market price gives a transparent valuation.
Liquidity 1)	Market-making, plus two auctions per trading day.
Liquidity 2)	The ability to drive investment through desired investment "style" characteristics and not the "drifting" characteristics of the asset.
Reputation	Stewardship, a sense of ownership and the SARC's ability to benefit from long-term asset management opportunities.
Touching the underlying asset	Prefer tangible assets.
Diverse risk spread	Exposure can be through a diversity of SARCs.
Liquidity – governance	All attributes as per table page 16.

Source: Hardman & Co Research

Attractive though investment in direct property is to family offices, even large family offices are subject to illiquidity and high transaction costs, along with the issues surrounding the securing of the finest of terms on debt finance. IPSX solves this.

Companies/investment trusts

Cash drag remains a significant problem here too…

Traditional REITs themselves often suffer cash drag post an equity raise during the fund deployment process. This can negatively affect NAV, in that a significant portion of the assets may initially be held in cash. This will certainly affect income, and hence dividend cover. IPSX-traded SARCs might solve this problem. Non-IPSX-traded REITs could become temporary investors in IPSX-traded stocks, while they secure opportunities to deploy their funds, so long as IPSX offers a trading platform with characteristics that suit them. Clearly, transaction costs on IPSX would need to be low, and liquidity high.

…which IPSX addresses directly

Of course, a fund in rundown can use IPSX stocks in the same way. As the end of its term approaches, it can sell direct assets and temporarily redeploy the cash in an IPSX stock, without suffering the crunching of income that would result if it held the money in the bank. When it is ready to return money to investors, it just sells its IPSX holdings.

SARCs and corporate investor base: IPSX investment options

Attribute	Comment
Transparency of data	See page 45.
Diverse risk spread	Exposure can be through a diversity of SARCs targeted to the investment mandate of the investing SARC.
Low transaction cost	SDLT is not paid when shares are traded – just at set-up on the SARC.
Income flow	SARCs (at IPO) must be stabilised assets.
Cost efficiency 1)	We anticipate management fee structures will be efficient.
Cost efficiency 2)	Cost of debt will be at efficient "corporate" margins over LIBOR.
Liquidity – governance	All attributes as per table page 16.

[10] Source: Global Family Office Report (UBS and Campden Wealth) 2018/ IPSX

Holding benefits	IPSX SARCs can be a good interim destination for funds awaiting deployment: liquid and with low transaction costs.

Source: Hardman & Co Research

Private equity

These funds can reach very large sizes. In January 2019, Blackstone closed a $20bn real estate fund raise for just one fund. In total, it had $119.9bn in real estate assets under management at the end of the third quarter of 2018.

Again – cash drag problem solved

These fund managers can use IPSX-traded stocks in the same way as other investor categories to reduce cash drag.

This has been taken from a report on IPSX written by Mike Foster, Hardman & Co.