The liquidity of real estate investments

White paper: investor challenges during the real estate cycle
The various phases and indicators of a real estate cycle

As in the wider economy, players in the real estate sector tend to think in terms of cycles. In macroeconomics the discussion is of economic cycles, meaning the fluctuations in the degree of utilization of production potential. Economic theories investigate economic cycles and attempt to explain how the wavelike changes in the level of economic activity come about in a market economy. This refers not only to overall economic growth measured in terms of gross domestic product (GDP), but also to changes in employment levels, prices and in interest rates.

An economic cycle is typically divided into four phases:
- Expansion
- Boom
- Recession
- Depression

Graphical representation of an economic cycle

As in the wider economy the real estate sector are very firmly anchored in a particular location the real estate cycle tends to follow the economic cycle. The indicators used by the real estate sector to describe a cycle make a distinction between supply and demand indicators on the letting market and the investment market.

In an economic expansion phase there are increasing signs of recovery on the letting market. Increasing demand for space results in both a modest net absorption of space and a slight fall in vacancy level as construction activity is at a low level and rents are stabilizing in the top segment. At the beginning of an expansion phase the supply of investment properties is high, but investor demand is still low, as many investors prefer to see the upturn fully established first. In this phase it is mainly anti-cyclical and of interest to opportunistic investors who are active in the market. As the expansion phase continues to progress, investor interest increases.

During the boom phase companies become highly expansive, which results in strong demand for space and a high level of net absorption. Rapidly rising rents in the prime segment, and increasingly in the non-core segment, motivate developers to step up their activities, which leads to increased construction activity. Supported by favourable market fundamentals, investor demand increases, while the supply of properties becomes increasingly scarce. During this market phase many investors are misled into paying a substantial premium on current valuations, thus increasing the risk that they then relax their underwriting standards, although there is already a recognizable development cycle.

At the start of an economic recession, demand for space amongst companies progressively decreases whilst increasingly reduces while the supply of space from developments reacts with little or no elasticity and thus continues to increase. The increasing supply of space puts negative pressure on rents, especially in the prime segment, but also increasingly in the non-core segments. Many investors seek a market exit, which leads to an increased supply of properties, while new investors increasingly hold-back. Consequently, the gap between sellers’ asking prices and buyers’ purchase price expectations widens, which leads to reduced market liquidity and falling valuations and prices.

In the depression phase of the market real estate fundamentals appear to be very weak. The low level of demand for space and low net absorption lead to sustained pressure on rents, above all in the non-core segment, while rents in the prime segment re-stabilize due to the low level of construction activity and companies take advantage of the lower rental price environment in order to relocate to more central locations or to higher quality properties. Investors are still heavily impacted by the recession phase and are holding back on new investments despite a good supply of investment properties and low purchase price levels.

1 Joseph A. Schumpeter: Konjunkturzyklen. Eine theoretische, historische und statistische Analyse des kapitalistischen Prozesses. Volume 1, Göttingen 1961
### Real estate indicators

#### Letting market

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<th>Supply</th>
<th>Demand</th>
<th>Prices</th>
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<tbody>
<tr>
<td><strong>Expansion</strong></td>
<td>Falling vacancy level</td>
<td>Rising demand with continued low absorption</td>
<td>Stabilizing to slightly rising rents in the prime segment, whilst rents continue to fall in the non-core segment</td>
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<td>Low, but increasing level of construction activity</td>
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<tr>
<td><strong>Boom</strong></td>
<td>Very low vacancy level</td>
<td>High and increasing level of demand with high level of absorption</td>
<td>Rapidly rising rents in the prime segment and rising rents in the non-core segment</td>
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<td>High level of construction activity</td>
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<tr>
<td><strong>Recession</strong></td>
<td>Increasing vacancy level</td>
<td>Falling demand with significantly negative absorption</td>
<td>Collapsing rents in the prime segment and rents starting to decline in the non-core segment</td>
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<td>Continued, but decreasing level of construction activity</td>
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<tr>
<td><strong>Depression</strong></td>
<td>High vacancy level</td>
<td>Low and consolidating demand with negative absorption</td>
<td>Stabilization in the prime segment, but rents contracting in the non-core segment</td>
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<td>Low level of construction activity</td>
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#### Investment market

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<tr>
<td><strong>Expansion</strong></td>
<td>Potentially large supply of properties</td>
<td>Start of cautious investor interest in the prime segment</td>
<td>Stabilizing to slightly rising prices in the prime segment, but with prices continuing to fall in the non-core segment Buyers’ and sellers’ price expectations are moving closer together.</td>
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<td><strong>Boom</strong></td>
<td>Large supply of properties</td>
<td>Strong investor interest in the prime segment, but also an extension of risk profiles to include the non-core segment</td>
<td>Rapidly increasing prices in the prime segment and a declining price differential between this and the non-core segment. Buyers often paying a premium on current valuations.</td>
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<td><strong>Recession</strong></td>
<td>Continuing large supply of properties, above all in the non-core segment</td>
<td>Falling investor interest in all risk profiles</td>
<td>Falling prices in all risk profiles. Gap widens between sellers’ asking prices and buyers’ purchase price expectations.</td>
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<tr>
<td><strong>Depression</strong></td>
<td>Large supply of properties, above all distressed properties</td>
<td>Weak investor interest in all risk categories.</td>
<td>Rapidly widening gap between sellers’ asking prices and buyers’ purchase price expectations. Purchasers expect a significant discount on current valuations.</td>
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Source: UBS Asset Management, Real Estate & Private Markets (REPM), Research & Strategy – Europe; January 2017
Current assessment of the real estate market
In previous cycles there has typically been a connection between initial yields for real estate investments and rental growth in most markets, even if there is a certain time lag involved. Market sentiment and investor expectations with regard to future rental growth have tended to affect yields.

However, this viewpoint represents a highly self-contained system and only worked as long as real estate as an asset class was not fully integrated into the global capital market. Since the global financial crisis (GFC) and the subsequent sovereign debt crisis from 2008, this situation has changed substantially, perhaps even fundamentally in many property real estate markets. In this cycle the central banks’ interest rate policies have had a significant influence on the real estate market. The recession phase of the last cycle in the European real estate market (2008-2009) can still be explained by reference to the classical methods. Declining tenant demand as a result of an economic downturn accompanied by a highpoint in the completion of construction projects led to a fall in rents, and due to the low potential for rent increases, initial yields also raised – driven by endogenous factors. The interest rate environment as an exogenous factor was still had no far-reaching consequences in this case.

However, as early as 2010 there was already talk of an upturn (expansion phase) in the UK and in the US, and this extended to continental Europe from 2012. However, this upturn must be viewed in context. The central banks’ interest rate policies supported by the general governmental policies have created a low interest rate environment never seen before. The primary aim of this interest rate policy is certainly to boost the economy and to avoid a deflationary environment and to boost inflation, but this also has an effect on the prices of real assets such as real estate. So at the beginning of the expansion phase of the current cycle, property portfolios underwent significant upwards revaluations mainly due to the low interest rate environment and not because there was any improvement in the prospects for future rent growth. In the current cycle, interest rates and interest rate policy have therefore become the central drivers for the pricing and valuation of real estate as an asset class, although these are exogenous factors.

Yield movement of Eurozone government bonds, ECB principal refinancing rate and real estate value change

Source: Oxford Economics January 12, 2017, CBRE EU-15 ex UK Index Numbers 3Q16
It was only with a considerable time lag after the falling initial yields that there emerged a positive climate for anticipated rental growth. We did not reach this point until mid-2014 (2013 in the UK) in most continental European markets. With this positive view of anticipated future rental growth, lower initial yield assumptions appear justified, and an endogenous factor are again gaining importance, and translates in increased requirements of professional work relating to the respective property. However, external factors, such as changes in interest rate policy, and also increasing statutory regulations, such as limiting rent increases via the so-called rental price caps or changes in building law and planning zoning regulations restricting future supply, can also restrict growth to some extent. Statutory regulations and increasing intervention, also in the real estate market affecting the evaluation of the market in future are playing a more important role. As a central bank’s interest rate decisions and statutory regulations do not lack a certain element of surprise, real estate investors increasingly need to think in terms of scenarios. Investors should not only think in terms of economic parameters such as base, best and worst cases, but they should also take account of the various time horizons of their investments. In the case of a long-term investment horizon, investors can better tolerate short-term volatility, and be able to tolerate, short-term volatility and this should not cause them to abandon their strategy. Depending on the prioritization of the individual factors, market participants can therefore have very divergent views of the future development of a market. This can also result in different liquidity requirements to be made of an investment. However, is certainly true that in recent years the need for institutional investors to involve themselves tactically and strategically in an investment has grown significantly – and not only in a crisis situation, but also after a period of rapid increases in values, in order to be able to rebalance real estate holdings or reposition between several different asset classes.

Forms of liquidity and liquidity requirements of real estate investments

First of all, it should be noted that liquidity is understood to mean the speed at which investors can access their funds\(^2\). The focus is therefore on the exit from an investment and not on making an investment, whereby the investment capacity is the main consideration. Real estate investments can have very different degrees of liquidity. Liquidity not only depends on the type of investment itself (for instance core property holdings vs. development projects), but above all on the modalities, which means the form of the investment vehicle holding the investment.

The most illiquid forms are private equity vehicles whose terms often run for five to seven years, possibly in conjunction with an option to extend by one to two years, with no provisions for redemption during this period. An assignment of the vehicle’s shares would only be possible with the provider’s agreement, with the result that there is de facto hardly any liquidity at all. An investor’s exit strategy could be a possible listing on the stock exchange or the organized sale of the portfolio. The valuation basis is always the current net asset value (NAV) of the portfolio. Fluctuations in value between two valuation phases are therefore ruled out.

On the other side of the spectrum we find listed vehicles such as REITs or property companies, which can be extremely liquid when compared to the illiquidity of the underlying properties; this is the result of free secondary trading on the stock exchange depending on market capitalization and of course the supply and demand situation. Listing on the stock exchange sometimes involves substantial premiums or discounts and thus a significant deviation from the NAV of the portfolio. However, greater liquidity and potential for premiums also have their price. The correlation between listed real estate vehicles and traditional shareholdings is considerably higher, which reduces the stability of the overall portfolio. Thus the correlation between a global real estate stock portfolio and a global share portfolio between 2001 and 2015 was 0.8, but only 0.3 for a global direct real estate portfolio\(^3\). In order to increase the stability of the overall portfolio and to benefit from the additional diversification, particularly in phases of uncertainty and market turbulence, non-listed real estate vehicles are commonplace in an international context. However, in order not to suffer a complete loss of liquidity, there are various solutions and structures, which can be used by real estate investment vehicles

\(^2\) RCS Royal Institution of Chartered Surveyors, August 2015.
\(^3\) Source: Datastream, IPD, UBS Asset Management, Real Estate & Private Markets, Research & Strategy, as of May 2016
Note: Global Equities = MSCI World, Global Bonds = JP Morgan GBI Global All Maturities, Global Real Estate Equities = FTSE EPRA/NAREIT Developed, Global Real Estate Direct = IPD Global.
Primary market
In the first instance there is the possibility to offer investors liquidity within the primary market and therefore on the level of the vehicle itself. This is achieved via a fixed cash component (often up to 5% of the investment volume), a credit limit (also limited via a maximum borrowing ceiling for the investment vehicle, usually 30% - 40% in the case of core vehicles) or even by selling off properties from the portfolio. As redemptions can influence the management of the vehicle, the ability to plan accurately and therefore achieve a lead-in time is of central importance for portfolio management. The result is a set of rules dictated by national laws and within this framework possibly by additional individual structuring of the investment vehicle. In concrete terms, it is initially a matter of the proposed termination date. This is often set at the end of a quarter, but it may vary between daily and once a year. The notice period is more relevant and is ultimately a compromise between increased liquidity for investors who are making disinvestments versus the stability of the portfolio and therefore security for the remaining investors. The starting point for the valuation is the current NAV at the time of the redemption. It can be adjusted by a spread for any transaction costs incurred, in order to cover at least some of those costs. The way in which a portfolio is valued is more important than one might imagine at first glance.

The German-speaking countries use a DCF (discounted cash flow) method with a long-term perspective (buy and hold), and which is heavily orientated towards future cash flows (Market Value). A comprehensive valuation is usually carried out only once a year and the result is a smoothed performance. This can mean that there is a significant differential between the current valuation and achievable market prices. In markets with falling real estate prices this can be of benefit to investors who have received their money back at an earlier date.

By contrast Anglo-Saxon countries follow an approach based on current market prices: The responsible appraisers also use transactions of comparable properties recently observed in the market in order to value the portfolio (mark-to-market). Furthermore, valuations are carried out more frequently, usually every quarter and often monthly. Although this results in greater market accuracy, there is also much greater volatility. There is in any event less risk of the payments made to investors who are disinvesting being too high. In the case of political or capital market events which have a crucial impact but whose real implications and therefore influence on valuations is not yet directly foreseeable, there may also be uncertainties with this valuation approach – the most recent example is the UK’s BREXIT referendum in June 2016. Leading organizations such as INREV4, which represents the real estate vehicle industry in Europe, are trying offer some direction for providers and investors during difficult market conditions5 by providing guidance and recommendations. All this makes it clear just how crucial it is that all investors have trust in the valuation of a portfolio. This not only applies to the method itself, but also to the approach, governance etc. Globalization has resulted in increased efforts being made to achieve standardization and improved quality in this area6.

There is a risk that in times of very tense market conditions, there will be an increasing number of redemptions with the result that they can no longer be served on time in the usual way, by the means described above, without being forced to sell properties from the portfolio at short notice and at a significant discount. In this case the vehicle is temporarily closed or the redemption is limited for a certain period of time (a so-called gate of 5% per month, for instance). If no improvement in the situation is possible, the vehicle is immediately liquidated over a limited period of, for example, two years. In order to prevent investors from requesting tactical redemptions in order to ensure precedence when payment is made, providers in Europe have increasingly stopped making payments in sequence (first come first served), but on a pro-rata basis across all redemptions at the same time (pro quota), as has long been customary in the US. This is most welcome from the viewpoint of the entire investor community as it creates additional stability. However, for an investor who has requested a redemption at an early stage it can mean a significant delay before payment is received.

Secondary market
The comments above make it clear that investors may be critically impaired in their flexibility due to the modalities, but also because of the costs incurred, which affects the focus of their portfolio. The secondary market offers a way out for units held in real estate vehicles. This is an insight shared by more and more professional investors and thus the volumes traded have risen sharply in recent years - globally by 71% to USD 8.2 billion from 2014 to 2015 alone, with very large transactions of more than USD 200 million dominating more than 70% of the market, led by large institutional investors from the US7. In addition to tactical or strategic re-weighting, the motivation behind the transactions was also the wish to reduce the number of third-party manager relationships or simply just to achieve a rebalancing. More complicated transactions, such as the take-over of large shareholdings in a real estate vehicle towards the end of its term in order to participate in refinancing operations or the type of liquidation, still tend to be the exception rather than the rule.

The secondary market, also known as OTC trading, takes various forms.

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4 European Association for Investors in Non-Listed Real Estate Vehicles
5 INREV: ‘Pillars to Ensure Open End Fund Liquidity 2016 – Professional Standards’
6 A central role here is played by the RICS Valuation – Professional Standards (‘Red Book’).
7 IPE Real Estate, March/April 2016; Landmark Partners, 2016.
The most important distinction is certainly whether the provider of a real estate vehicle itself acquires and trades units or whether it provides a trading platform where supply and demand are brought together to be processed (so-called match bargain). In both cases the starting point for the valuation is the latest NAV. On top of this there are the costs of processing and, last but not least, price premiums or discounts, which are determined primarily by supply and demand. From an investor’s point of view, interesting opportunities for market entry can present themselves over and over again, if somebody wishes to sell a position at short notice and is willing to accept a significant discount. In addition, this can weaken the effect of the J-Curve, which is traversed when building up a portfolio.

A fully functioning secondary market also requires a high degree of transparency and governance in the sense of a clear set of rules. The UK is already well advanced in this regard and leads the field internationally, whilst further development and improvement are necessary in continental Europe. This not only applies to regular reporting, but also to regulations relating to the transferability of units, where the provider’s agreement is sometimes required or where a transfer is even excluded altogether.

Conclusion

While exogenous factors, such as interest rate policy and the effective interest rates level, have increasingly influenced the performance of real estate investment values in the various markets, endogenous factors, such as rental growth, are once again gaining in importance over the medium term. The requirements relating to property management are therefore increasing.

Nevertheless, interest rate policy and potential new regulations bring about uncertainties, which may cause investors to feel an increased need to adjust their real estate portfolios. As a rule, they continue to expand their real estate portfolios preferably by investing in non-listed investment vehicles due to the deeper correlation. They attempt to secure the liquidity necessary for the flexibility of their investments via the secondary market in preference to the primary market. The pre-condition for a fully functioning secondary market is a high degree of trust in the underlying primary market, but at the same time the secondary market itself must also offer transparency and exemplary governance as well as the generally free transferability of the shares of real estate vehicles. Those who invest today in an even less developed secondary market should consider from the very beginning what their exit strategy is going to look like as an exit might be difficult or may only be achievable on unfavourable conditions.

Greater trust, a more professional approach and subsequently the growth of the secondary market, especially in continental Europe, would be most welcome for all market participants and could mean a decisive step forward for the positive development of real estate as an asset class.
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