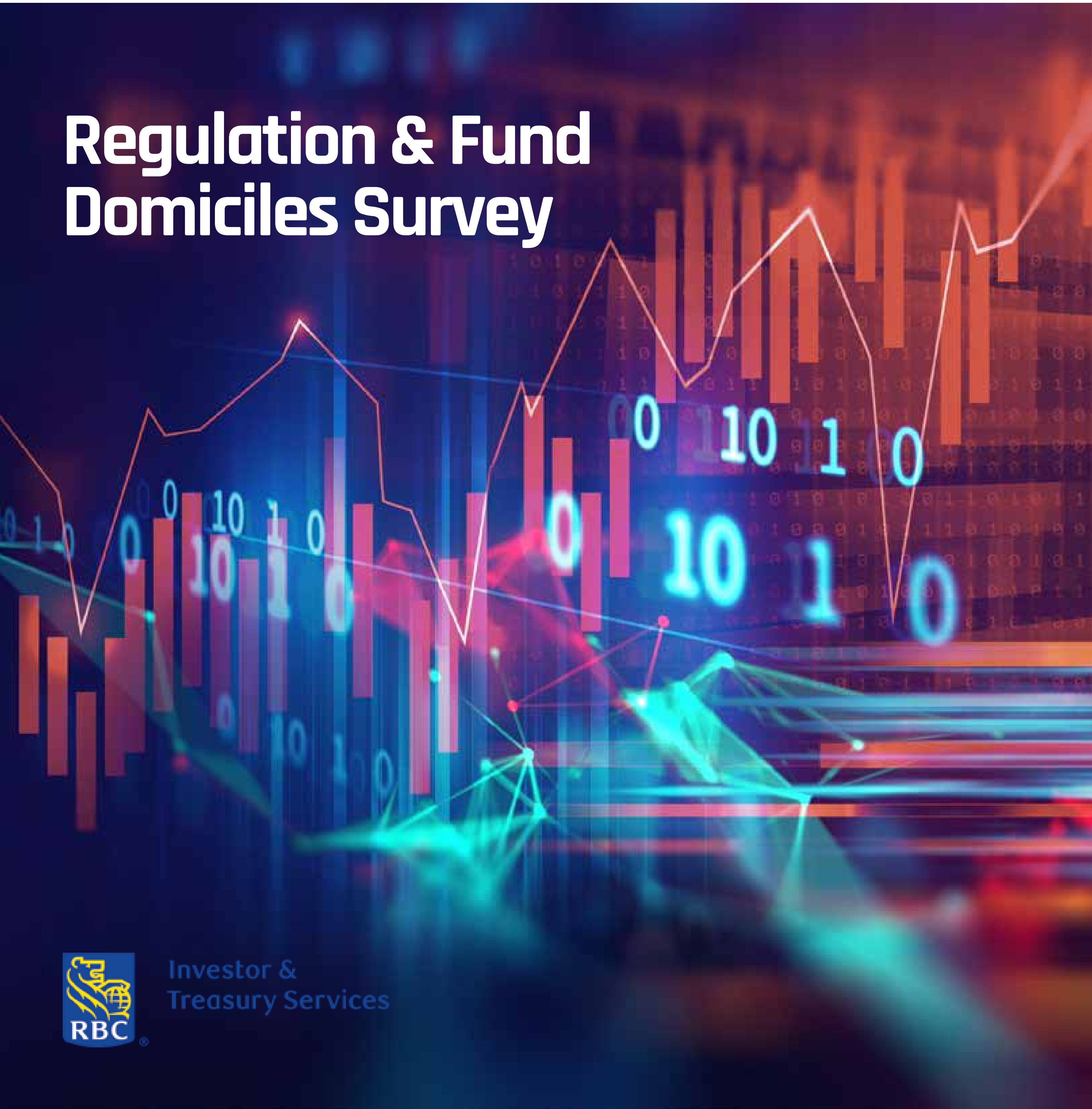
PERE

In partnership with Royal Bank of Canada • October 2021 • perenews.com



Regulation & Fund Domiciles Survey

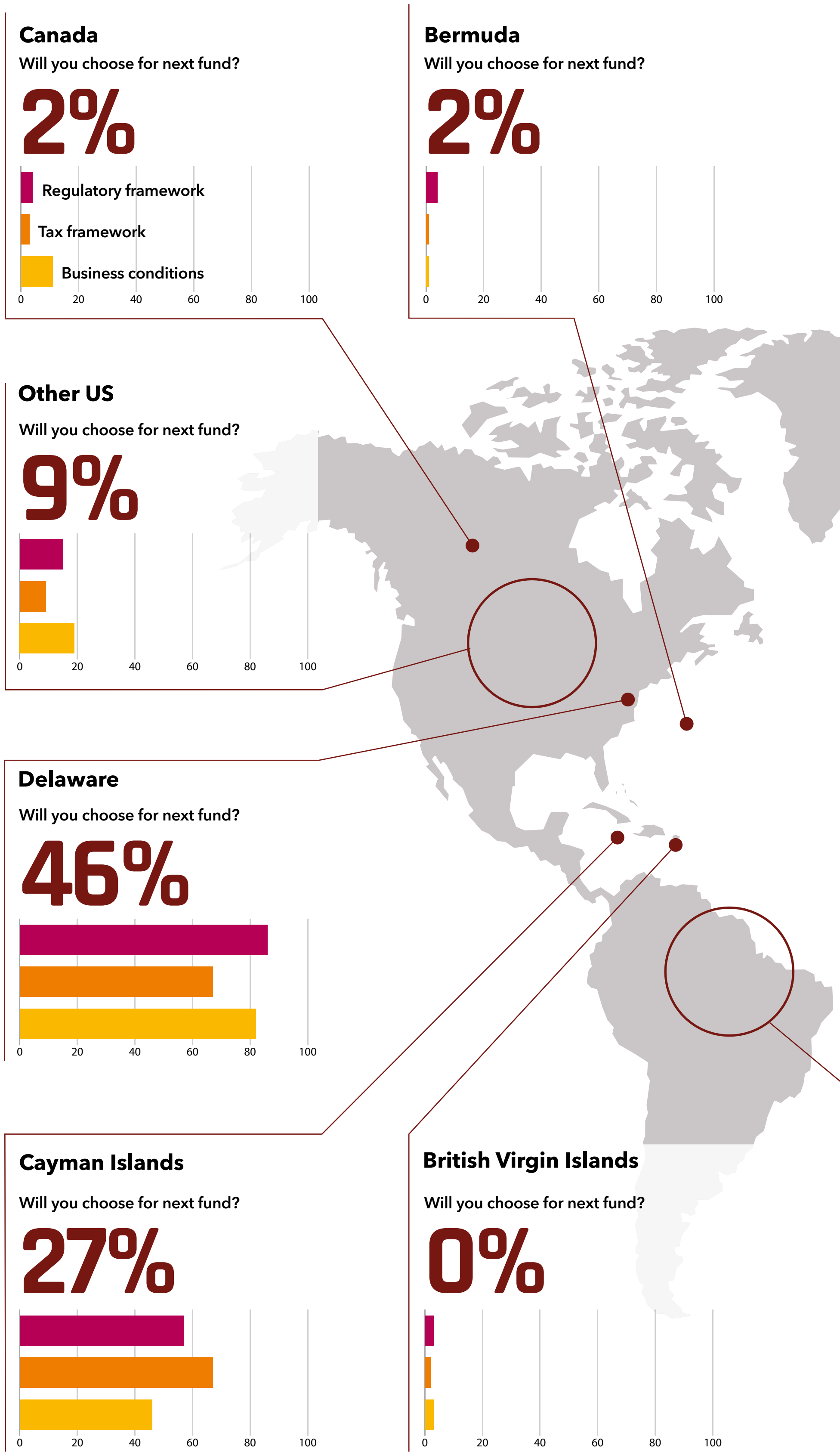
RBC Investor & Treasury Services

REGULATION & FUND DOMICILES SURVEY

A 12-page special

Global rankings

Luxembourg, Delaware and the Cayman Islands remained the top choice jurisdictions for private fund managers according to our survey, which asked respondents to rate locations based on their business conditions, regulatory and tax framework



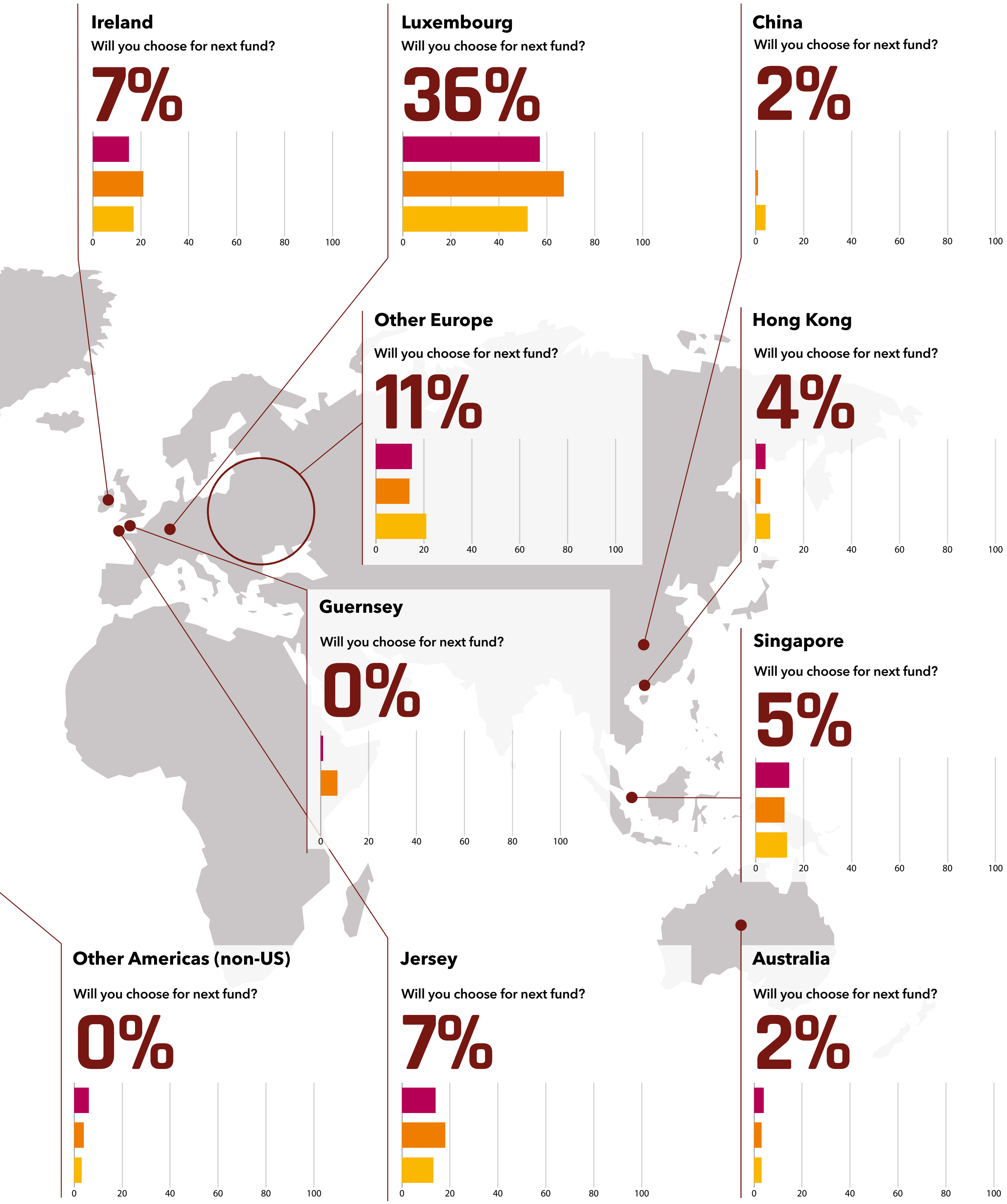
The jurisdictions were rated based on the below-listed questions, and each respondent selected three. The percentage amounts indicate how many of the respondents chose the jurisdiction in question. Where respondents were asked to rank their three answers, the first answer was given three points, the second two points and the third one point.

Next fund
Which of the following domiciles will you choose for your next private fund launch/reallocation?

Regulatory framework
Which of the following domiciles offer the optimal regulatory framework in 2021?

Tax framework
Which of the following domiciles offer the optimal tax framework in 2021?

Business conditions
Which of the following domiciles offer the optimal conditions for doing business in 2021, such as local expertise?


Ireland
Will you choose for next fund?
7%
0 20 40 60 80 100
Luxembourg
Will you choose for next fund?
36%
0 20 40 60 80 100
China
Will you choose for next fund?
2%
0 20 40 60 80 100
Other Europe
Will you choose for next fund?
11%
0 20 40 60 80 100
Hong Kong
Will you choose for next fund?
4%
0 20 40 60 80 100
Guernsey
Will you choose for next fund?
0%
0 20 40 60 80 100
Singapore
Will you choose for next fund?
5%
0 20 40 60 80 100
Other Americas (non-US)
Will you choose for next fund?
0%
0 20 40 60 80 100
Jersey
Will you choose for next fund?
7%
0 20 40 60 80 100
Australia
Will you choose for next fund?
2%
0 20 40 60 80 100

KEYNOTE INTERVIEW

Shopping for retail money

Real estate managers have begun to target retail investors. However, the challenges involved suggest this route is not for everyone, says RBC's Dirk Holz

The private real estate funds management industry has historically focused on investing institutional capital. However, the largest global real estate general partners are now turning their attention to the relatively under-exploited retail investor market, which has had limited access to private real estate. This large pool of untapped capital could be transformative for the industry but will require managers to manage a new set of risks and think about their business in a different way. *PERE* talks to Dirk Holz, head of private capital services, product management at RBC Investor & Treasury Services, about these new developments.

Q How are real estate managers seeking to expand their capital base?

Historically, I would say, the main driver for real estate and also private equity and infrastructure was institutional money. We have seen significant growth in real estate assets under management over the past 10-15 years, which has come from institutional investors in funds and club deals. However, over the past 24 months, we have seen the global top managers starting to assess their future source of investment funds. There is a large part of the world's overall assets and wealth that has been largely ignored by private real estate managers and that is the retail space.

The definition of a retail investor is broad and might range from individuals investing $50 a month to high-net-worth individuals who might be happy to invest half a million or even more in a single vehicle. We are now seeing some new funds being designed to entice retail investors.

Q Do managers expect the flow of institutional capital to slow at all?

I think there will be even more institutional money flowing in. There have been a couple of regulatory changes in the US, particularly for pension plans, which are now allowed to invest more into real estate and other private assets. We are also seeing more liquid and listed money moving into the private asset or real estate space. In Canada, in particular Canadian pension plans, this is a trend we have been witnessing in the last 10-15 years. Some of these big pension plans have an allocation towards private assets and real estate of around 40 percent.

However, I think the competition is also increasing. Over the past five to 10 years, we have seen a huge consolidation of investments going to a few really big managers. Around 60 percent of the global money raised for real estate goes into the top 10 managers, which suggests there are untapped areas such as retail investments. Managers are looking at areas that are untapped. For example, retail investment in real estate via real estate investment trusts in the US and UK.

However, the exposure and the returns are not the same as those offered to institutional investors in closed-ended structures. Also very few retail investors can access private funds; for example, according to *Forbes*, only 2 percent of the US population is able to invest in private funds. Therefore managers, especially those with a large platform, are looking to roll this out into the retail market.

Q Most managers said they were 'quite or very prepared' to manage liquidity in open-ended real estate funds in the case of a downturn. Does this seem realistic?

This is not just in relation to retail funds of course, but all open-ended structures. When there is a downturn or a global financial crisis as we have seen, there is significant pressure on managers because values fall, which affects loan-to-value ratios. And as we have seen in the pandemic, there might be sectors with falling rents.

However, I am not surprised that managers are pretty confident because managers have learned a lot over the last 10 years about how they can manage downturns. However, these questions around liquidity are rather different when a manager is operating with retail investor capital.

Q What are the challenges for managers looking to attract retail capital?

There are clearly some challenges. A traditional real estate fund is normally a closed-ended structure, with seven, eight, perhaps 12 years where the investor is committed and locked in for the whole life cycle of the fund. This is generally not what retail investors are really looking for; they always want to have a little bit of flexibility, which is why the stock market appeals to them.

This creates a challenge because if you are in the real estate space, by definition, these are illiquid assets. If you wish to liquidate a property, even though the process is faster these days than 10 years ago, there is still a bidding process and due diligence, and financing to be taken care of. I would say three to six months is quite usual and for bigger portfolios, it's even longer.

Managers which are opening up towards retail investors have to design a model that offers them some sort of redemption possibilities. Perhaps daily redemptions are not necessarily the way forward with an illiquid asset class – although you could allocate a percentage of the portfolio to more liquid assets, which could be real estate investment trust units for example or other real estate-linked liquid products.

However, by that, you're automatically taking away a bit of the performance, especially if you have to hold more cash. When you're investing in liquidity, you are not getting the same return as if you were investing directly into the assets.

We are seeing some managers moving into what you might call semi open-ended funds, where there is a notice period and some lock-up periods, which gives the fund a little bit more flexibility in the case of a redemption.

However, while these structures work in a good market, we have seen in the past that they are vulnerable in a downturn. For example, during the financial crisis in 2008, there was a run on some funds, because investors wanted to liquidate and get all their money out. This is exactly where this asset class has limitations because you cannot just sell a building overnight, and if everybody else is fire selling then sales are even more difficult to execute.

There are mechanisms and ways to get around these obstacles, such as lock-up periods and a queue of investors who only join when someone leaves, but this is the main challenge for managers – to manage the contradiction between a long-term investment and short-term liquidity.

As well as liquidity management, there will be an entirely different kind of connectivity between managers and retail investors. Reporting and the feedback from investors will also be different. Until now, the world of private real estate has been quite closed; it is a niche and so there is not much noise publicly about performance or transparency.

With more retail investment, there

will also be more visibility of funds, which managers need to be prepared for. If retail investors go into these fund structures, you will read things on social media; there may be negative comments on the internet about a fund or manager. This will require a completely different kind of perspective, which perhaps the managers have not yet fully assessed and potentially even understood.

Q What type of managers are looking at products for retail investors?

In the retail space, the leading large managers have a big advantage. We have seen a rise in mega-funds, raising $10 billion or $20 billion, for global real estate mandates. People are talking about the possibility of a $100 billion real estate fund. The largest managers have the infrastructure to raise the money and to invest it as well. They can take on huge deals and portfolios. This gives them a completely different kind of investment power, a different kind of purchase pressure on the seller.

A lot of institutional investors love these mega-funds, because they automatically offer diversification and I think this will appeal to retail investors too. Another big advantage of the mega-funds is that they can deploy capital quickly, which means they face less of a challenge to manage liquidity.

Q Where does that leave smaller managers?

Smaller boutique or specialist funds, those with $500 million to $1 billion of assets, will always play a very important role. They tend to be very specialized, focusing on a sector, a geography, or a strategy – you might have a niche strategy looking at converting offices affected by the pandemic into housing.

Such strategies, by definition, have a different kind of risk profile but are very attractive for institutional investors who don't need diversification at the fund level because they have diversification in their own portfolio. These funds are offered by smaller managers, which are a different sort of business; they are very close to the assets and are very hands-on in generating value. Their funds have a more limited pool of investors who tend to be more active in their involvement.

"We are increasingly seeing that managers need global partners to assist them with their global portfolios of entities, assets and investors"

Q Turning to the survey, were you surprised to see a fairly neutral response to the query about the effects of regulatory changes on marketing to retail investors? There was also a majority view that hybrid institutional/retail funds would be at least moderately successful in attracting retail investors.

It was surprising to me that most people were neutral on the effects of regulation, with more positive than negative, but I think it is partially explained by the relatively small number of managers who are looking in to launching retail funds. However, the Alternative Investment Fund Managers Directive, for example, will have a significant effect because it limits the ability of managers to market funds which are regarded as high risk to retail investors. It is slightly the same with regard to how hybrid institutional/retail funds will work – most managers are not yet thinking about this.

Q What changes do you see coming for managers, especially for those considering a move to take on retail capital?

We have seen managers doing a lot of fund services work in-house or using service providers to manage fund administration.

However, I think we are seeing more and more managers looking for support from banking players. This is because they can support managers with regard to fund administration and regulation, but more importantly, helping with cash and liquidity is in the DNA of banks.

As I previously mentioned, liquidity management will be the major challenge for managers looking to take on retail capital. For example, banks can offer bridge financing to help with capital calls. A lot of managers use non-bank players, which cannot offer that piece, so I think that need for liquidity support served by banks will be a differentiating factor.

The reporting side will change; we have already moved from annual to quarterly or monthly reporting and we may see even more frequent reporting to aid redemptions. There is also a lot of data, which is not structured or even readily available. Managers and service providers are working to make more of this available and there is also a need, not just to use it, but to add value... Both the redemption and reporting environments will be different due to the scale of retail investment. An institutional fund might have between five and 50 investors, but a retail fund can easily have 10,000.

We are increasingly seeing that managers need global partners to assist them with their global portfolios of entities, assets and investors. As well as a global presence, a crucial part of this service offering needs to be technology; especially to support managers on reporting. These changes in the operating environment of managers will all be affected and accelerated by a move into the retail investor space. ■

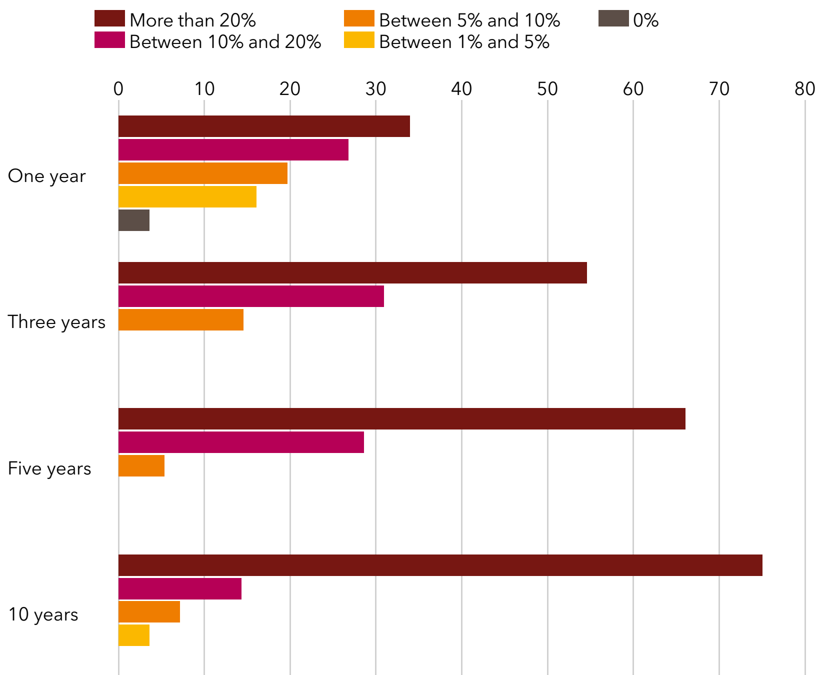
Reasons for optimism in a period of recovery

Managers are positive about growth expectations even as they prepare for new challenges in the regulatory environment

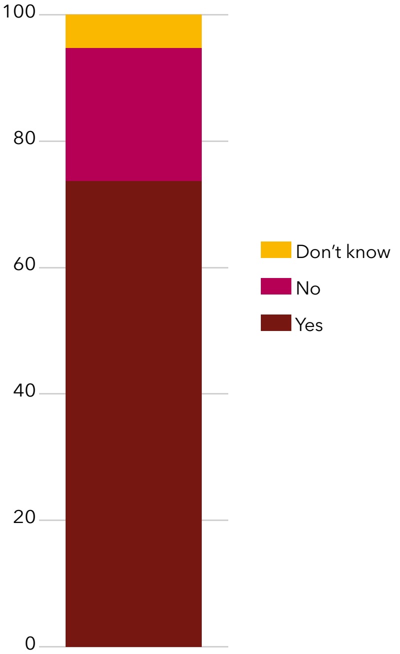
The ongoing coronavirus crisis has forced managers to re-evaluate many aspects of their business, including adapting to changes in their investor base and determining the best locations to domicile funds going forward. The market sentiment during these uncertain times is captured in our exclusive survey, carried out in conjunction with RBC Investor & Treasury Services. The survey looks in depth at the impact of covid-19 on the industry, such as how much managers view the crisis as a barrier to meeting their objectives in 2021 compared to other factors including the economic environment and competition.

One notable finding is that in an unpredictable and volatile market, the expectations for growth were surprisingly optimistic, as outsourcing gathers momentum and ESG initiatives are expected to generate growth and drive innovation. The survey included a wide range of managers, both in terms of geography and size, in order to gain a clear perspective of current views surrounding regulatory changes and future opportunities in the marketplace. In total, we surveyed 57 firms, of which 53 percent were located in the US, 25 percent in Europe and 9 percent in Asia. Over a third of survey respondents have AUM of more than $5 billion and 84 percent have more than $1 billon. ■

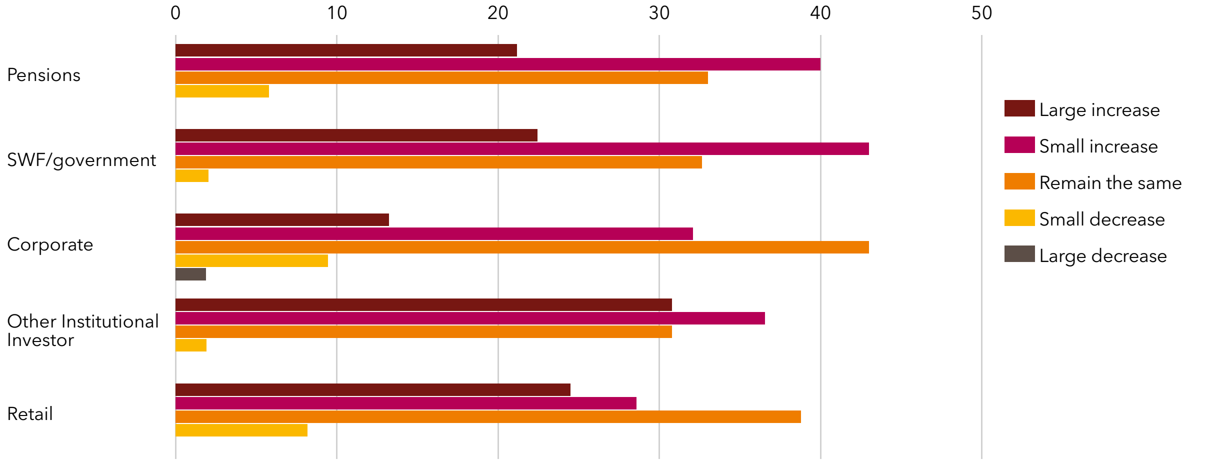
What is your growth forecast (based on % increase from now) for your AUM over the specified time horizon? (% of respondents)



Does your organization plan to leverage capital call facilities over the next 12 months? (% of respondents)



How do you expect your investor base to change in the next five years, by type of investor? (% of respondents)



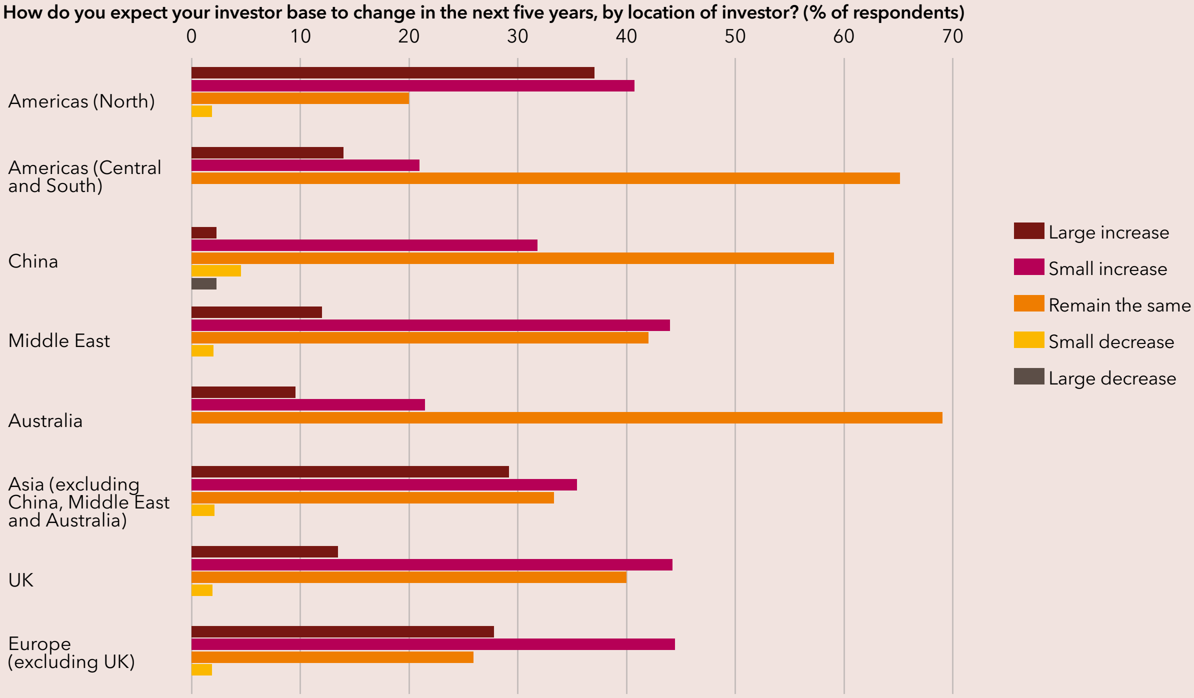
Strongest growth expected in North America

Real estate fund managers expect the strongest growth in their investor base to come from North America, continental Europe and parts of Asia. However, they expect less growth from the UK, Australia and China.

More than three-quarters of managers predicted either a large or small increase in their investor base to come from North America, with 37 percent expecting strong growth. Meanwhile, a total of 72 percent expected growth in their European investor base but were less optimistic about the UK. While 44 percent of managers expected a small increase from both the UK and Europe, more were optimistic about seeing a large increase from European investors – 28 percent versus 13 percent for the UK.

While 64 percent of managers expected growth from Asia (excluding China, Middle East and Australia), only 34 percent expected growth from China, which also saw the largest number of managers expecting their investor base to shrink (5 percent).

How do you expect your investor base to change in the next five years, by location of investor? (% of respondents)



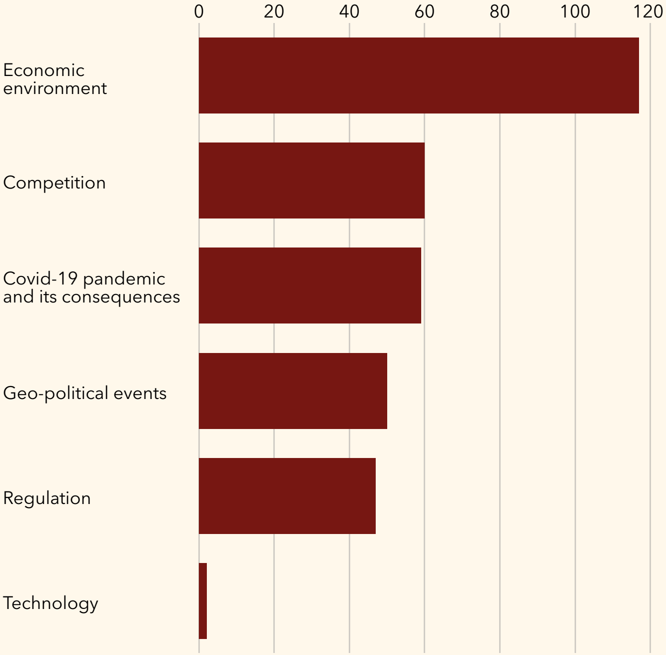
Faltering economy threatens managers more than covid-19

A flagging economy presents the largest threat to real estate investment managers achieving their objectives this year, with more than half saying it was the main barrier to their success.

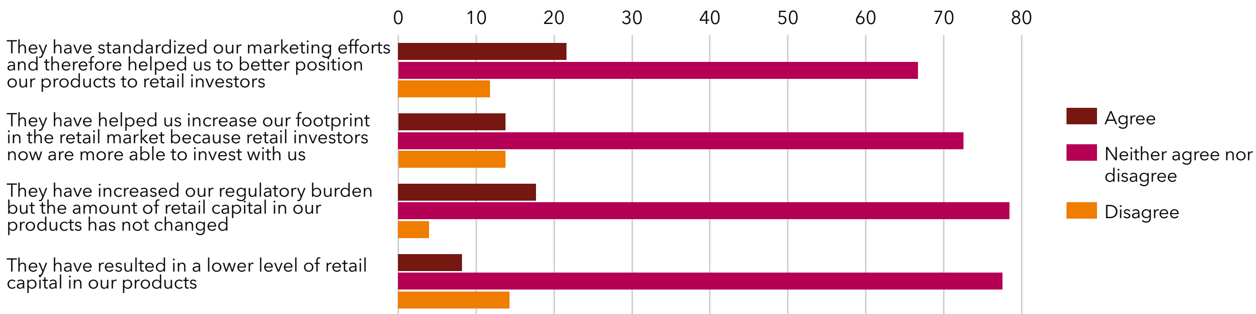
Participating managers were asked to list the top three barriers to achieving their goals in 2021, leading to a score for six risk factors. The economic environment scored nearly twice as high as the second most cited factor, competition. However, the covid-19 pandemic and its consequences scored only marginally less than competition.

Geopolitical events and regulation were also considered significant barriers to managers getting what they wanted in 2021, scoring almost as highly as competition and the pandemic. However, technology – which is becoming increasingly important for real estate investment managers, especially for fund administration and reporting – appears to be firmly regarded as a benefit rather than a threat to managers, with only a small number declaring it one of their top three threats.

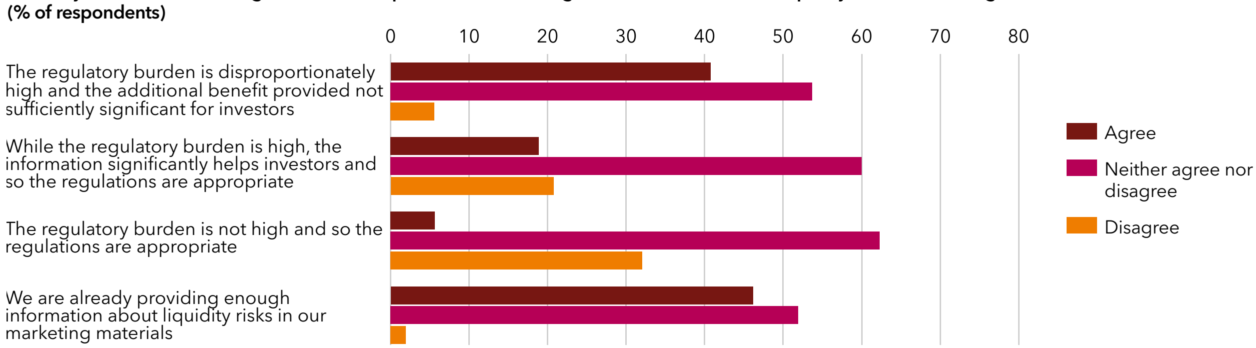
What will be the main barriers from meeting your objectives in 2021? (Respondents selected top three. First-rank concern: three points; second rank: two points; third: one point)



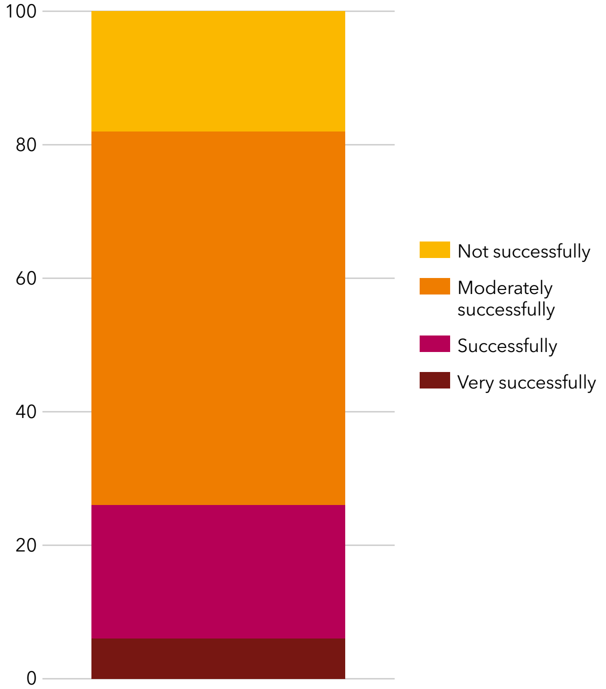
How have regulatory changes affected the marketing of your real estate funds to retail investors? (% of respondents)



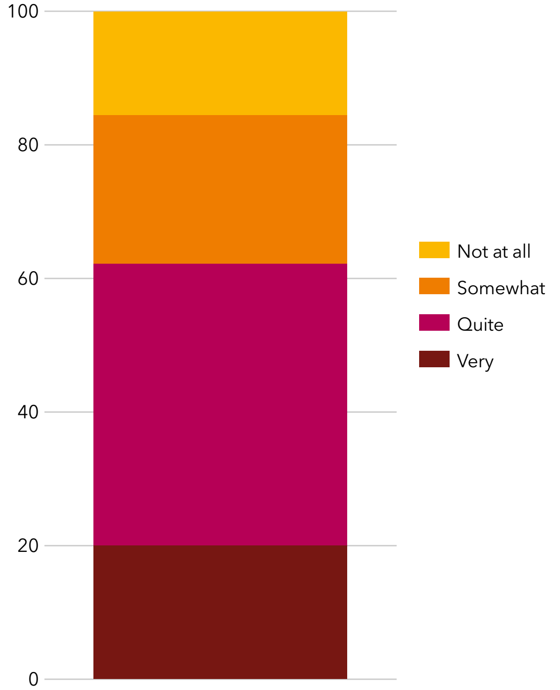
What is your assessment of regulations that require the inclusion of greater information about liquidity risks in marketing materials for retail investors? (% of respondents)



Generally speaking, how successfully do you feel hybrid institutional retail real estate funds are structured to attract retail investors? (% of respondents)



How prepared are you to avoid liquidity risks for open-ended real estate funds in case of a downturn? (% of respondents)



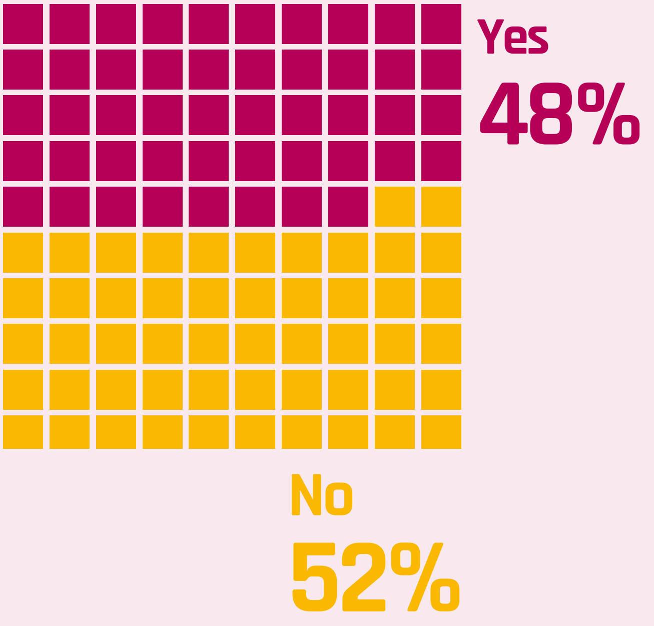
Regulatory burden is a price worth paying

The majority of real estate managers surveyed believe that the regulatory burden involved in attracting retail investor capital to their funds is a price worth paying. However, that majority is only slender.

A total of 52 percent of managers said the regulatory barriers currently in place, as well as possible future requirements, for allowing retail capital into fund products did not outweigh the benefits of attracting more capital.

More real estate investment managers are turning toward retail capital as a way to grow and diversify their businesses. At the same time, retail investors are looking for higher return strategies, especially those with higher income. Matching their needs with the ambitions of managers, however, involves dealing with a strict regulatory environment designed to protect consumers. This burden and the likelihood of more regulation in the future was enough to discourage 48 percent of managers.

Do you think all regulatory barriers currently in place, as well as possible future requirements for allowing retail capital to flow into fund products, outweigh the benefits of attracting more capital?



KEYNOTE INTERVIEW

Preparing for global growth

US alternative fund managers are growing and diversifying their businesses, which is leading to a rise in outsourcing and the popularity of EU domiciles, says RBC I&TS's Cyril Schopfer

Many US-based alternative investment managers have grown rapidly over the past few years and expect further growth from new markets and new investor audiences. Larger managers with more international business are turning to domiciles in the EU in order to keep in line with regulations and to meet investor demand, says Cyril Schopfer, director of client coverage at RBC Investment & Treasury Services (RBC I&TS). Meanwhile, demand for outsourcing is both increasing and being refined by managers looking for a one-stop solution for many of their back and front office needs.

Q The survey shows Delaware, Luxembourg and the Cayman Islands as the most preferred domiciles. What are your thoughts on this and some of the other popular domiciles with regard to US managers?

Firstly, over time we have seen that managers and structures have become more global and complex. Historically, from a US perspective, we witnessed investment structures mainly domiciled in Cayman and Delaware. However, it has evolved dramatically over the last few years with a sustained trend towards Luxembourg, and what we typically see now are parallel structures that are being established in Luxembourg, which are then co-investing alongside Delaware or Cayman entities, for example.

We see this reflected in the survey, with the results showing Luxembourg overtaking Cayman with respect to the intention of managers for the domicile of their next fund. This is happening despite significant efforts by the Cayman Islands to enhance their regulatory framework.

In addition, Ireland has recently put itself on the map with the amendment of the Investment Limited Partnership Act, establishing Ireland as a solution for private funds, which was previously lacking. I believe we could expect some of that capital flow being redirected toward Ireland in the future as we have already seen some first movers launching ILPs. Drawing the parallel with UCITS and liquid alternatives, US-based asset managers tend to prefer Ireland because of the cultural alignment and the language. We should also not underestimate the time difference. Ireland is one hour closer to the US, which makes a difference in a day, especially if the manager sits in the Central or Pacific time zone. Ireland has a long history of servicing alternative funds, using well-established leading service providers, including RBC.

These trends are also driven by investor demands and regulations. Europe continues to offer an attractive fundraising opportunity for private vehicles. With the right partner, setting up and managing a vehicle in Europe is easier than it previously has been. In the US, the alternative investment marketplace has become very crowded and highly competitive, therefore US-based asset managers are looking for additional channels and additional source of capital. However, there are two ends of the spectrum: at one end we are seeing some US-based asset managers still operating in the Cayman Islands and Delaware with intentions to continue doing so.

There is investor demand for more regulated structures that offers better transparency and investor protection. Therefore, on the other end we are witnessing some of the larger managers selecting Luxembourg as their domicile of choice. At RBC I&TS, we specialize in consulting with managers to support their future offshore ventures from an early-stage of providing insightful knowledge to execution. We evolve and partner with managers as they continue to become more global and diversified.

Q The survey found that nearly three quarters of managers intended on leveraging capital call facilities over the next 12 months. Were you surprised by this?

No, there was an overwhelmingly positive response to that question! This is aligned with what I have stated about the need for that one-stop shop, where the provider can support the fund manager with balance sheet as well as their fund servicing needs. A capital call facility has become the norm, whereas a few years back this wasn't necessarily the case. It is the exception when a manager doesn't use a capital call facility as it provides speed to market and provides operational efficiencies.

You might think that a capital call is an easy process, but where there is a global investor base, a capital call can be a complex operation. Since its 2015 inception, our fund finance team has provided in excess of 250 facilities. The team provides multi-currency subscription capital call facilities, NAV/hybrid facilities, liquidity redemption facilities and manager/ManCo financing to global private capital managers across buyout, infrastructure, real estate, credit and secondaries strategies and other alternative asset managers. We have built a global platform with expertise in lending to structures domiciled in and across geographies including Asia, EMEA and North America.

Q The Channel Islands domiciles of Jersey and Guernsey didn't emerge as preferred locations – Guernsey wasn't picked at all – despite having the same time zone as Ireland. Why is that?

Guernsey has been very popular for British and European asset managers, but not as popular for US-based asset managers. Before the Alternative Investment Fund Managers Directive regulation, European asset managers were operating offshore from EU jurisdictions, and would operate and set up funds in the Channel Islands, whereas US managers would have set up funds in Cayman and Delaware.

The Channel Islands offers a fast, efficient and commercially-minded financial environment with strong regulators, however they are not in the EU therefore they do not offer the European passport like Luxembourg or Ireland. The Channel Islands are doing a lot of work to promote their jurisdictions to US managers.

Jersey and Guernsey are considered "third party" countries from an EU perspective. Therefore, the full scope of AIFMD does not apply and they can provide third-country access to EU investors through the National Private Placement Regimes.

Q What are the options for US managers looking to set up in Europe?

To be successful with a European launch, a manager needs to familiarize oneself with the European regulatory framework and the operational differences that it creates. We spend a lot of time talking to managers to help them understand the options and the impact for their operating model. The intention is always to add value and to be an extension of the existing operating process and to not change the way they operate today. Many US managers believe launching in Europe is complicated and difficult, but the reality is that the European market is simpler, faster and easier to enter than many US managers may think.

It is very important to get the right partners from the outset such as the right fund lawyer, the right fund administrator, depository, auditor and, if the company decides to outsource the alternative investment fund manager function, to get the right AIFM. Two important requirements of AIFMD for US managers are the necessity for a designated AIFM and a depositary.

One of the first things to consider is whether the manager wants to launch their own AIFM or whether they want to outsource. Many US managers would initially go for the outsourcing option with the intention, for some to bring it in-house at some point in the future. I think it's a good model because it means you immediately work with a partner who has local expertise. Once appointed, the third-party AIFM can delegate some functions. It's normally the case that the AIFM delegates the portfolio management back to the asset manager in the US.

Taking the in-house option means the manager must file an application for authorization with the relevant regulator. Furthermore, it must demonstrate local substance to design and implement the required frameworks of oversight, governance, compliance and risk as per the directive.

It is also important that managers targeting Europe have access to the markets they wish to access, which may be difficult as European regulations are continuously changing.

For example, with the implementation of the Cross-Border Fund Distribution directive in Europe, there is a change in the definition of pre-marketing, which means previously one could test the waters, however now one needs to be registered. There are different outsourced models which deal with this, for example chaperoning, which works well where the manager is targeting a set number of investors. The model provides regulatory cover and the service provider is involved in activities and interaction between managers and investors. If the manager wants full access to Europe, a tied agent model is the preferred option.

We are also seeing an increase in fund managers working with a credit institution, which provides the security, stability and reliability a bank can offer, back the depositary liability while increasing investor confidence and supporting a manager's financing needs, whether that is at the fund level or at the asset level.

Q How do you expect outsourcing as a solution for managers to develop? Will we see more of it?

Outsourcing already has momentum and is only going to grow in future. Europe has been slightly ahead of the US because demand for outsourcing has been driven by local regulation, but the US is catching up.

There is a strong culture of conducting activities in-house but I think the cost of technology, digitalization, demand for data to meet investor demand and the rapid evolution of regulatory framework are all factors driving outsourcing. Fund administration or anti-money-laundering/know-your-customer, for example, are two of the main areas where managers are considering outsourcing.

Managers are at different stages of their respective journey. Some have a fully outsourced model and others are doing most things in-house, but I think they are all looking at optimizing and organizing their operations. What has happened with some of those largest managers, with the significant amount of capital that they have raised in recent years, is that some of them have added providers on an ad hoc basis. Subsequently, this results in 10-15 service providers across the board, which is certainly not the optimal model.

We are also seeing an increased demand for a one-stop shop solution, where managers are looking for partners who can support investment activity as well as fund administration and investor services. A partner that can support capital deployment by providing financing solutions at the fund or asset level. As a large global bank, we offer an end-to-end solution leveraging RBC's breadth of expertise and services with the ability to support them throughout the fund life cycle across all levels of the structure, for example by providing a capital call facility and fund administration at the fund level, by acting as an adviser on a deal at the asset level and by supporting the financing needs, which is closer to the individuals.

Q There appears to be a considerable amount of optimism among managers, with most forecasting strong, and in some cases very strong, growth in assets under management in the next 10 years. Does this chime with what you see in the market?

The survey came up with some astonishing expectations for future growth, with more than a third of managers expecting in excess of 20 percent growth over the next 12 months and more than half expecting more than 20 percent growth over the next three years. That shows that these managers are delivering the performance investors are looking for – the track record is there to support their fundraising. The largest managers are getting a big share of the cake and they are achieving it by acquiring teams, diversifying, launching new asset classes and new products, and entering new geographies.

There are also new distribution channels where we are witnessing diversification of the investor base. An increasing amount of family offices are investing in private assets, and high-net-worth individuals want to have the ability to benefit from the performance of those investments. Managers are also looking at the retail space, and we are seeing an increasing amount of institutional investors allocating more to private assets. ■