Why should Canadian institutional investors consider global private equity real estate?

Whitepaper

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Executive Summary
Highlights as to why Canadian pension plans should consider global private real estate include:

- Going global can open up additional opportunities for Canadian Pension Plans to access high quality real estate investments in markets that are comparable in terms of size, transparency and liquidity.
- Canadian pension plans can enhance diversification and dampen portfolio volatility by investing into global real estate.
- The availability of pan regional or even global open-end core funds can provide one-stop shop solutions with low minimum investment thresholds.
- Relative pricing currently appears to suggest that opportunities outside Canada may be poised to offer stronger returns.
- Canadian plans contemplating a real estate allocation should consider investing outside Canada and we think now appears to be a good time to do it.

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Introduction
For many years, investor motivations for considering real estate have included its characteristic stable income, strong historical relative performance across multiple cycles, and potential diversification benefits when held with other asset classes in a portfolio. Historically more domestically focused, institutional investors around the globe are now increasingly investing into non-domestic or even global real estate. Large Canadian institutional investors have been at the forefront of this trend. Reasons include a lack of domestic real estate investment opportunity, potential diversification benefits and risk reduction as well as return enhancement.

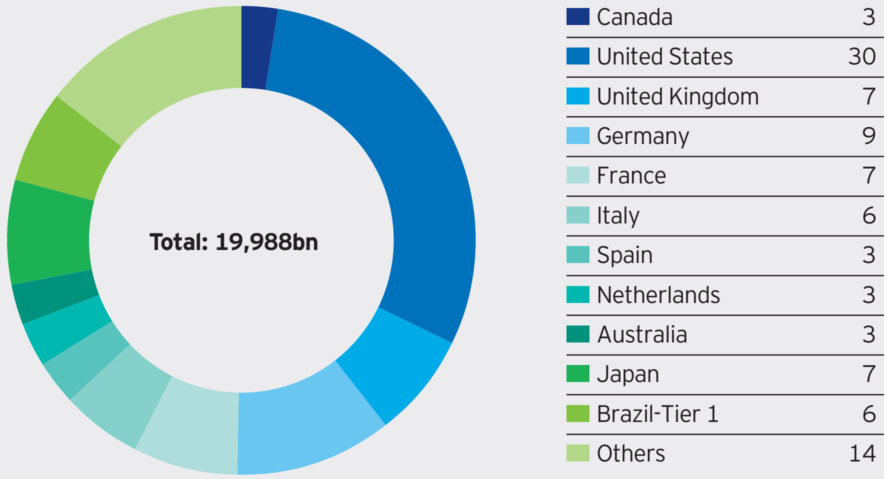
Private equity real estate includes direct investment in buildings (either wholly owned or in joint venture) and indirectly through unlisted commingled funds (or fund-of-funds). Public equity real estate includes real estate investment trusts (REITs), other listed real estate companies and listed real estate funds. In this paper our focus is largely on unlisted private equity real estate. It is noteworthy that listed and unlisted real estate tend to have similar characteristics in the long-term but different characteristics in the short-term:

1. Listed – with daily liquidity comes with greater volatility
2. Unlisted – with periodic liquidity comes with greater stability (under normal market conditions)

Investing in Global Real Estate
While some investors prefer the control that investing directly into real estate can offer, many others lack the specialist skills or resources. Instead they may choose to invest in privately held pooled vehicles such as core real estate funds or publically traded listed real estate. The challenge of managing real estate investments is further compounded when considering a non-domestic or global real estate portfolio. Generally only the largest pension plans are able to contemplate a global portfolio invested directly in real estate.

Going global can open up additional opportunities to access quality real estate investments. Based on our estimates, the transparent global real estate market totals USD 20 trillion (figure 1). Why focus on transparent real estate markets? When considering investing outside of one's home market, it can be reassuring that there are many cities in many countries that offer a broadly comparable investment experience to one's domestic market. The most transparent countries (rated Highly Transparent) include Australia, Canada, France, Ireland, the Netherlands, New Zealand, the United Kingdom and the United States. Outside of the US, no other single country has more than 10% of the total transparent global real estate universe. The Canadian domestic real estate market is a finite opportunity. According to the OECD, Canada represents approximately 5% of global pension assets yet Canada's domestic real estate market represents only 3% of the transparent global real estate market. As such, it is not surprising that many investors are looking abroad to source high quality real estate investments.

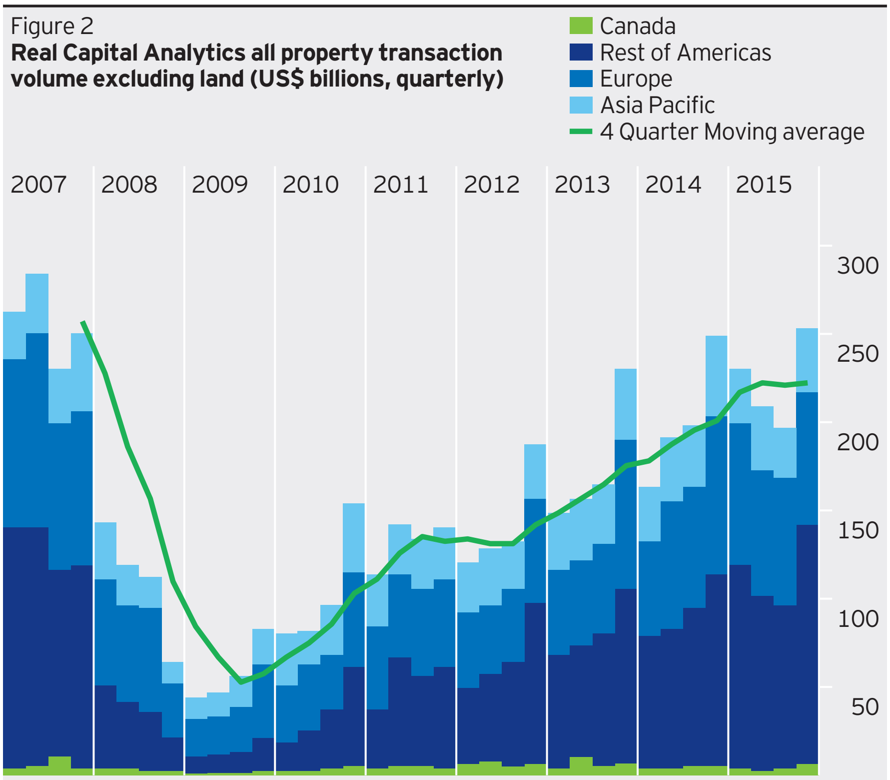
Figure 1
Estimated Size of Highly Transparent and Transparent Real Estate Markets Globally (US$ Billions, %)



Note: "Transparent Universe" is estimated based on the Jones Lang LaSalle (JLL) Transparency Index 2014 Edition. The JLL index was derived based on factors such as investment performance, market fundamentals, listed vehicles, regulatory/legal environment, and transaction processes in 2014. For this analysis, the Transparent Universe included 27 countries, which were categorized by JLL either as "Highly Transparent" or "Transparent". The size of the investable stock in each country, shown in the pie chart was then estimated based on the latest DTZ Money into Property report as of year-end 2014. Investable stock is the value of investment grade commercial real estate held by different investor groups or owner-occupiers. They are not direct investment only.
Source: Invesco Real Estate based on data from DTZ Money into Property and JLL Transparency Index as of September 2015. Latest available data.

The availability and depth of liquidity is also a key consideration when it comes to investing in real estate. While any given real estate market may have episodic periods of illiquidity, generally speaking there are many large and liquid markets around the globe. According to Real Capital Analytics, the last three years have averaged quarterly transaction volume (excluding land) ranging from approximately USD 150 billion to USD 250 billion (figure 2). Significantly, the transaction volume has not been isolated to any one region indicating that there are liquid markets accessible across the globe.

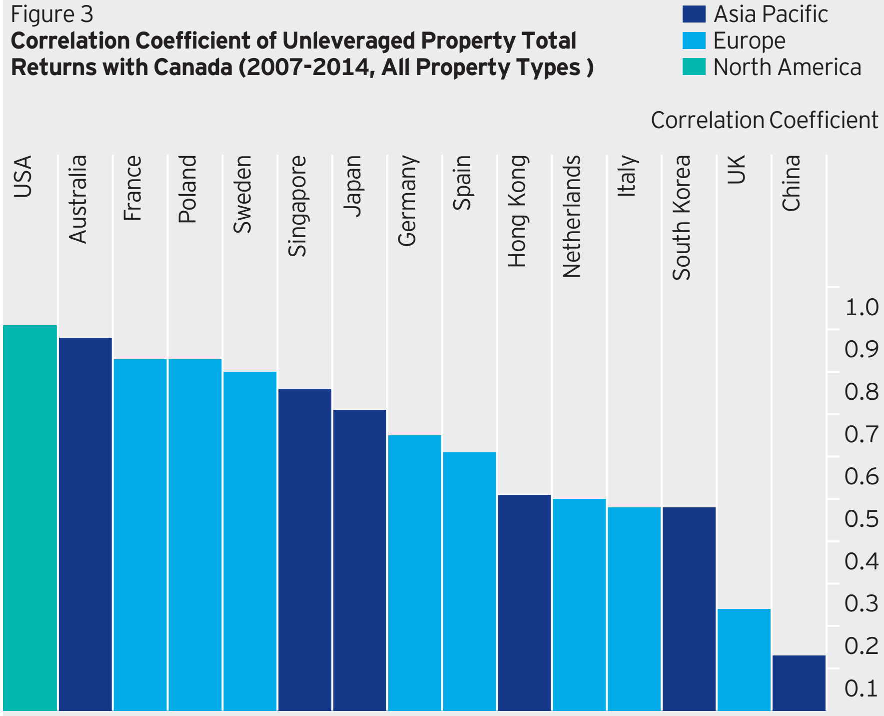
Figure 2
Real Capital Analytics all property transaction volume excluding land (US$ billions, quarterly)



The figure relates to direct transactions involving all property types except for land.
Source: Invesco Real Estate based on data from Real Capital Analytics as of December 2015.

Diversification opportunity
The lack of synchronization in economic cycles around the globe has historically reduced the correlation of real estate returns from market to market. As evidenced by correlation data from property returns of major economies, there has been diversification of property returns across the world. Canadians are well positioned to enhance diversification by investing into global real estate. Specifically, since 2007, Canada had correlations below 0.8 with ten out of 15 other countries (figure 3).

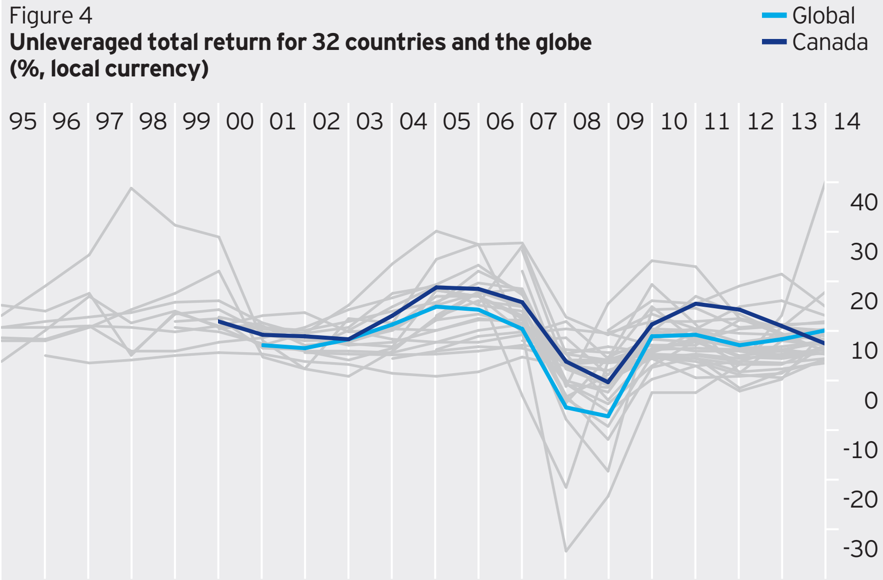
Figure 3
Correlation Coefficient of Unleveraged Property Total Returns with Canada (2007-2014, All Property Types)



Source: Invesco Real Estate using data from MSCI IPD as of September 2015.

Further exemplifying the potential diversification advantages of a global real estate portfolio, we look at unleveraged real estate total returns for 32 countries (figure 4). The grey lines in the background each represent a different country. The global portfolio had a long term average return of 7.3% with a standard deviation of 6.4%. Generally, most individual countries have had greater volatility than that of the global average and a diversified global portfolio appears to offer a smoother ride over time. It is notable that over the period from 2000-2015, Canada has historically fared better than the global average. Yet, recently Canadian returns have dipped below the global average calling into question whether it is realistic to assume that Canada will continue to consistently outperform a global portfolio.

Figure 4
Unleveraged total return for 32 countries and the globe (%, local currency)



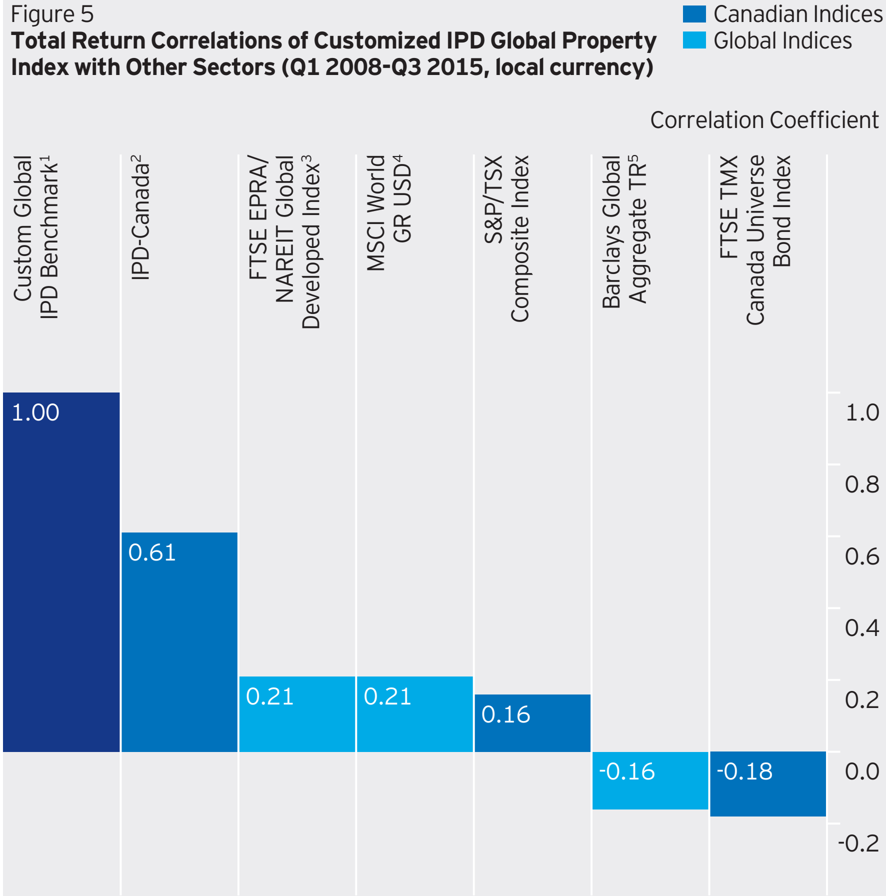
The MSCI IPD data relates to the unleveraged property-level total return data by country for all property types as tracked by IPD. For each country the longest available period as published by IPD is shown.
Source: Invesco Real Estate using data from MSCI IPD as of September 2015.

The role of unlisted private equity global real estate within a portfolio

Unlisted private equity global real estate can play a significant role within a portfolio by dampening volatility. In part this can be attributed to the smoothing effect of the appraisal/valuation process used to value a portfolio. Assets are appraised/valued periodically by professional, independent, third-party valuers that take into account evidence of recent transactions and other methods to estimate the value of each property were it to be sold at the appraisal/valuation date. Because this process relies on historical evidence, there can be a time lag in any change in the market value of a building being reflected in its appraised value. This tends to smooth the values of unlisted private equity real estate over time.

Figure 5 illustrates the correlations between unlisted global real estate and various global and Canadian traditional asset classes. A global private real estate portfolio of unlisted funds (referred to in the chart as the Custom IPD Global Property Index) offers additional diversification as compared to the Canadian real estate market as evidenced by the correlation of 0.61 and produced very low correlations with listed real estate (0.21), global equities (0.21) and Canadian equities (0.16). The diversification benefit was even more pronounced with global and Canadian bonds as evidenced by the negative correlation coefficient (-0.16 and -0.18, respectively). As such, an unlisted global private real estate allocation can help lower portfolio volatility because real estate has generally been less correlated with the more traditional asset classes and has had a low correlation with the domestic Canadian real estate market.

Figure 5
Total Return Correlations of Customized IPD Global Property Index with Other Sectors (Q1 2008-Q3 2015, local currency)



Sources: IPD (Investment Property Databank), Ibbotson Associates, Barclays, Lipper Inc, Bloomberg and FTSE EPRA/NAREIT Index as of September 2015 and in local currencies.

1 The custom index is based on the reweighted to 50% North America, 25% Europe and 25% Asia Pacific. The GPFI is a consultative index of 86 capitalization weighted, core, open ended, quarterly valued direct real estate funds from around the world.

2 The IPD Canada Quarterly Property Index measures ungeared total returns of 2,350+ property investments with a capital value of $124.8bn as of Dec 2014.

3 The index is a equity market capitalization-weighted index composed of property company constituents that trade on several global exchanges. The returns are used here to represent global real estate investment trust returns (GREITs). [N.B. GREITS are a publicly liquid equity security whose underlying assets are real estate investments. GREITs are often viewed as the liquid proxy for real estate investing.

4 This index is a market capitalization-weighted index designed to capture large and mid cap publicly traded equity representation across 23 developed markets. The index covers approximately 85% of the free float-adjusted market capitalization of the public equity markets in each country. The returns are used here to represent global equity market returns.

5 The index is a market capitalization-weighted index that includes Treasury securities, Government agency bonds, mort-gage-backed bonds, corporate bonds, US traded investment grade bonds, and some foreign bonds traded in the US.

Why consider non-domestic opportunities?
There appear to be three primary reasons for Canadian institutional investors to consider non-domestic opportunities:
- Large institutional investors have led the way;
- New opportunities are emerging globally for institutions to invest smaller sums in unlisted pan regional and global core open-ended funds; and
- Relative pricing currently appears to suggest that multiple markets are priced within historical norms.

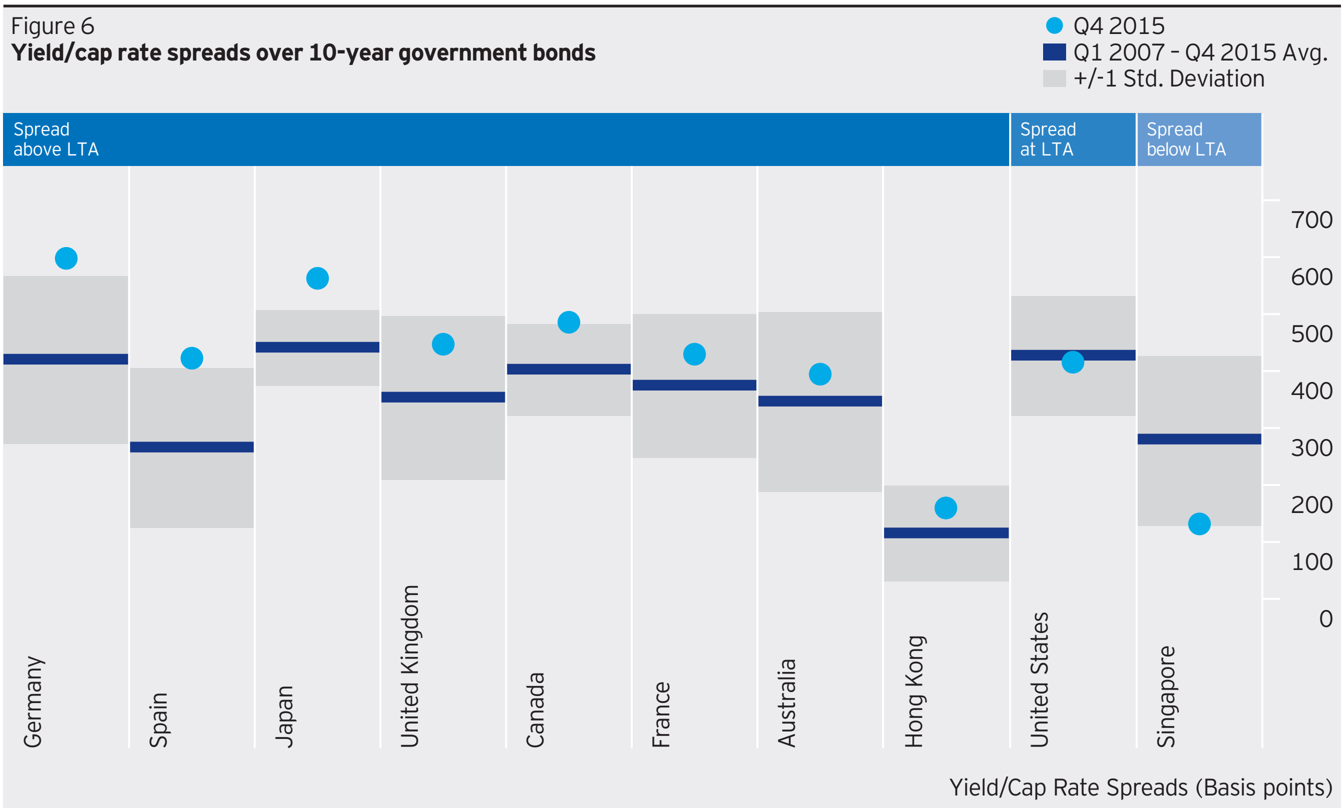
Large Canadian investors have paved the way
Over the last five years, Canadian investors such as CPPIB, PSP Investments, Oxford Properties, Ivanhoe Cambridge and others have been among the most active investors in global real estate. According to Real Capital Analytics, Canadian investors acquired US $139 billion of real restate outside Canada in the period 2011-15. One consequence is that there is now a host of experienced professional advisors familiar with the adoption of appropriate structures and the factors which should be considered by institutional investors prior to investing abroad.

Accessibility of global real estate
Listed real estate has been available to investors globally for quite some time with assets totalling USD 1.3 trillion (source: MSCI IPD as at December 2015). Unlisted closed-end funds or separate accounts have also long been available but globally these have been for either high risk strategies or management intensive activities. Only recently have regional open-ended core funds become available in all three major regions. According to MSCI IPD, as at December 2015 there was USD 284 billion in open-ended funds worldwide. This is significant for the following reasons:
- It provides a new opportunity for investors (including small to mid-size institutions and family offices) to consider non-domestic real estate strategies;
- It is now possible to invest relatively small amounts in global unlisted real estate and achieve significant diversification in a low risk strategy; and
- Although embryonic, there are indices available to measure performance.

Core open-ended funds have been available in various markets for domestic investors but were not necessarily open to or suitable for international investors. The U.S. led the way for international investors to enter into core open-ended funds while Europe witnessed the advent of pan regional funds over the past five years or so. In Asia Pacific, pan Asia Pacific funds have only emerged over the last couple of years. The increasing availability of product structures across the world is opening up the opportunity for pensions plans of all sizes to access global unlisted core real estate via a single manager solution.

Pricing considerations
Around the world real estate market fundamentals appear strong and in many ways prices appear high on an absolute basis. However, unlike other asset classes, especially long-term government bonds, real estate currently remains priced within or below normal ranges on a relative basis. Figure 6 depicts the spread between real estate yields/cap rates and local 10-year government bond yields as of Q3 2015 and compares that to the long term average spread. The real estate yields/cap rates we have used are the national averages for building transactions in each country in Q3 2015 provided by Real Capital Analytics, a data provider. It also shows a band plus and minus one standard deviation either side of the long-term average, which might be considered an indication of the normal range. Singapore stands out as a major country in which the spread was less than the long-term average in Q4 2015. The US was priced close to its long-term average. The United Kingdom, Canada, France, Australia and Hong Kong were all within the normal range while Germany, Spain and Japan all appear attractively priced on this metric.

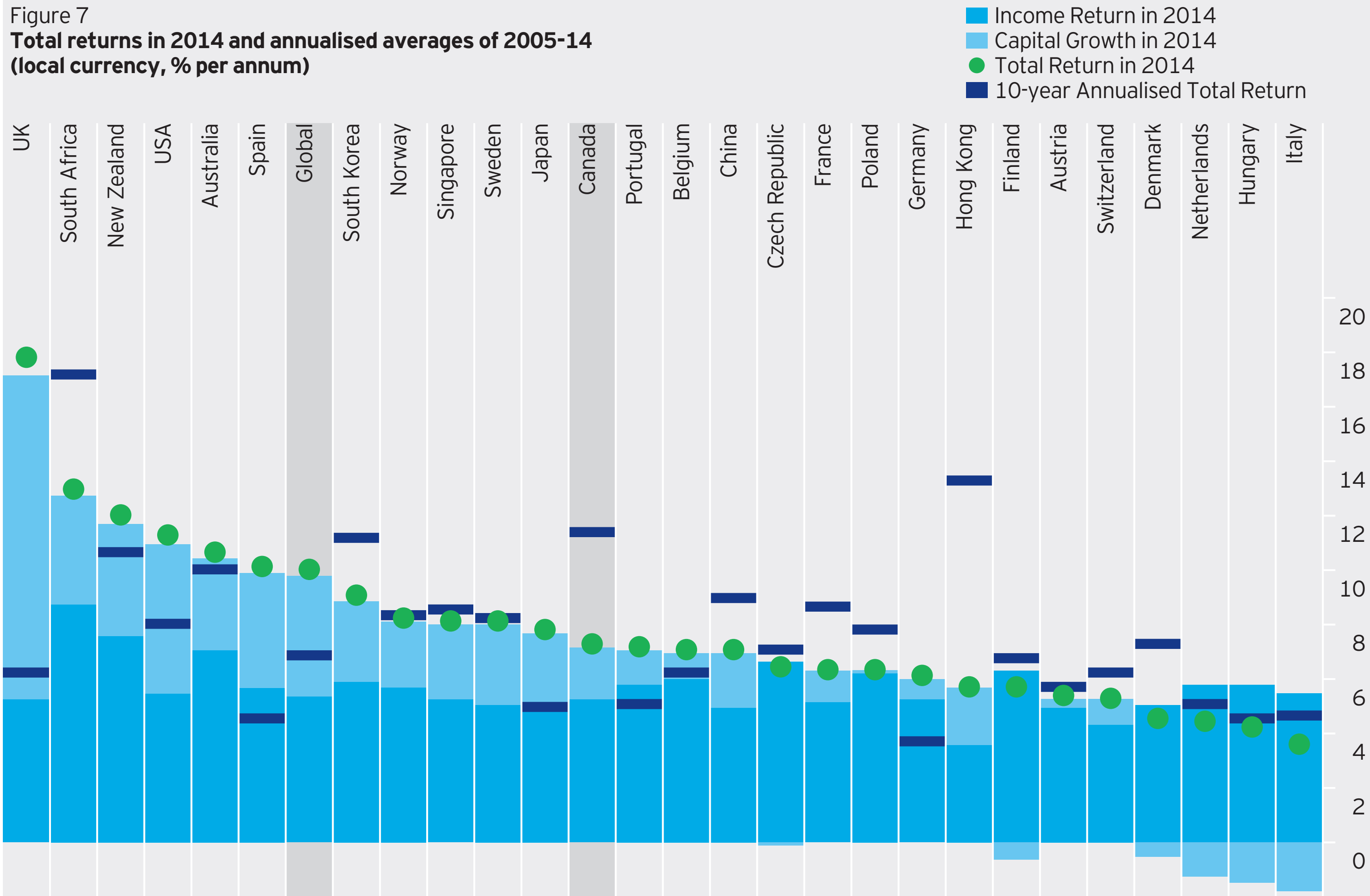
Figure 6
Yield/cap rate spreads over 10-year government bonds



Note: Cap rate spreads are based on properties and portfolios $5 million and greater, for office, industrial and retail sectors in each country.
Source: Invesco Real Estate using data from Real Capital Analytics as of February 2016.

Canada's average property return from 2005 to 2014 was 11.3% which significantly outpaced the global average of 6.8%. One reason is that Canadian returns held up much better during the Global Financial Crisis than in many other countries. However, recently Canadian returns have started to decline. In 2014 they lagged the global average. In 2014, Canada's property returns totalled 7.3% and as of the third quarter of 2015 the annualised returns totalled 7.2% .

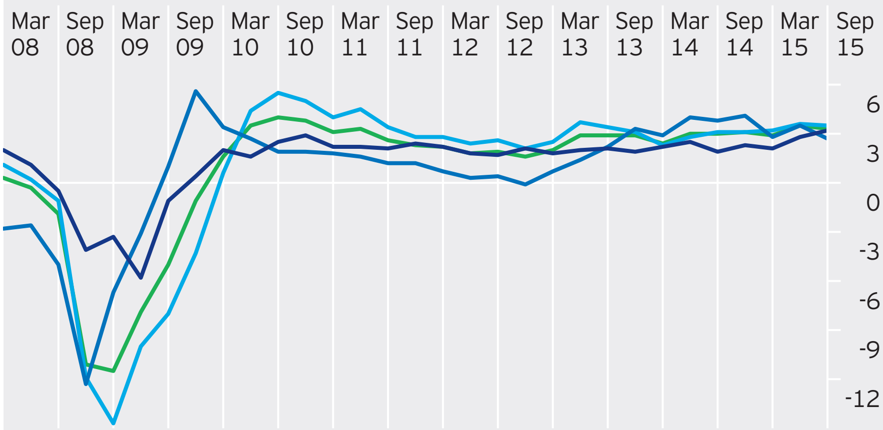
Figure 7
Total returns in 2014 and annualised averages of 2005-14 (local currency, % per annum)



Note: Annualised averages are generally calculated based on the geometric averages of total returns in 2005-2014. For China, Hong Kong, and Singapore, annualised averages are calculated using the longest available time periods from 2007-2014 . Canadian perspective given by the REALpac / IPD Canada Quarterly Property Index. Results for the year to 30 June 2015
Source: Invesco Real Estate using data from IPD Multinational Digest as of June 2015.

Real estate returns vary not only by city and country but also by region with any one region over or under performing at different points in time. Figure 7 shows the MSCI IPD Global Property Fund Index (GPFI). This is a consultative index comprising open-ended core funds around the world. Over the five years to 30 September 2015, the GPFI shows an annualised total return of 11.4% per annum on a rolling four quarter basis. North America has outperformed the global average at 13.4% per annum on a rolling four quarter basis as of Q3 2015 while Europe has outperformed in various quarters over the past year (13.6% per annum over the last year on a rolling four quarter basis). Timing can and will impact performance of a global real estate portfolio and real estate investors with a global view have the opportunity to add outperformance by tactically leaning into or out of regions at different points in time. Per Invesco Real Estate's H2 2015 Global House View, tactical allocation targets by region as of H2 2015 were an overweight to the U.S. with mild underweights to Europe and Asia Pacific.

Figure 8
IPD Global Property Fund Index NAV Level Total Returns for the Three Major Regions (% q/q, periods to September 2015)



The IPD Global Property Fund Index (GPFI) incorporates a consistent dataset of unlisted core open-ended funds across the globe, and tracks core real estate performance in the primary investment regions – Asia Pacific, Europe, and North America. NAV-level. Returns are local currency returns. Data from Q1 2008 to Q3 2015.
Source: Invesco Real Estate based on data from IPD Global Property Fund Index Q3 2015.

Other Considerations

While there are a number of motivations for investing in global real estate, institutional investors will need to assess various factors before making an allocation. These factors include among others the impact of currency and tax as well as an assessment of internal capabilities.

Specifically, currency fluctuations can create volatility within returns particularly over the short term. Investors have varying perspectives on how to view the risk of currency fluctuations. Some view this as part of the diversification that real estate offers while others who may be more liability driven may decide to hedge potential currency risk.

Taxes are also an important factor to consider. However, as more and more pension plans have begun to invest in international real estate there have been substantial positive developments in terms of how to structure investments to reduce tax leakage and/or tax filing requirements in various jurisdictions. Additionally, recently enacted legislation within the U.S. may exempt certain foreign pension plans which meet specified criteria from FIRPTA ("the Foreign Investment in Real Property Tax Act of 1980").

Assessing the global real estate market and the different ways to invest can be a daunting task. One needs to assess what resources and capabilities they have to execute a global real estate allocation. Generally speaking only the largest pension plans have the capabilities and resources to directly invest in a global real estate portfolio. Most others will instead invest in listed real estate, unlisted commingled funds or fund of funds in order to gain access to global real estate.

Conclusion

Going global can open up additional opportunities for institutional investors to access high quality real estate investments in markets that are comparable in terms of size, transparency and liquidity. Further, by investing in global real estate institutional investors can enhance their diversification and dampen overall portfolio volatility. Given the advent of new product innovations, global real estate is more accessible than ever with one-stop shop solutions and low minimum investment thresholds. Consequently, institutional investors contemplating a real estate allocation should consider investing outside their domestic market.

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