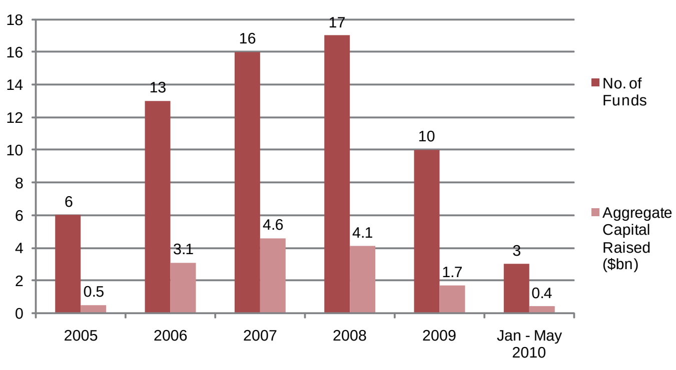
Preqin Research Report
Real Estate Fund of Funds and Their Contribution to Market Recovery (1)

Real estate funds of funds play an important role in the private real estate market as a whole, acting as key investors for fund managers and allowing smaller institutions, which lack the capital or resources to construct their own fund portfolios, to gain real estate exposure diversified by strategy, geography and property type.

Fundraising for funds of funds has declined since the onset of the global economic downturn. Funds of funds raised just $1.7 billion in 2009, compared with $4.1 billion in 2008 and $4.6 billion in 2007. This decline is in line with the whole private real estate fund market, which saw a significant fall in the amount of capital raised in 2009. The first real estate funds of funds date back to the late 1990s, but it was not until several years later that a significant industry began to emerge. Preqin has identified 57 firms active in the fund of funds market, managing a total of 119 funds of funds.

There was some consolidation in the fund of funds market during 2009. In November 2009, Aviva Investors Real Estate Multi-Manager announced it had taken over the management of two real estate funds of funds previously managed by BlackRock Realty and in July 2009, Capital Dynamics assumed the management of HRJ Capital's fund of funds business, including its private equity real estate fund of funds platform. There is potential for further consolidation as the larger players within the market look to cement their positions as market leaders.

Fig. 1: Real Estate Funds of Funds Fundraising, 2005 - May 2010



Diversity in the Fund of Funds Market

Funds of funds are key investors for managers raising their first vehicle, as they will typically have the knowledge and resources to carry out the extra due diligence required on this type of investment. 73% of funds of funds surveyed do invest with first-time fund managers, while a further 17% would consider doing so. There are several funds of funds designed solely to provide exposure to emerging managers. These include AVP Advisors' $400 million American Value Partners Fund I, which targeted newer managers that demonstrated a competitive advantage in a specified property type or geographic market. Hawkeye Partners also targets newer firms, although its investments are typically structured as joint ventures rather than fund commitments.

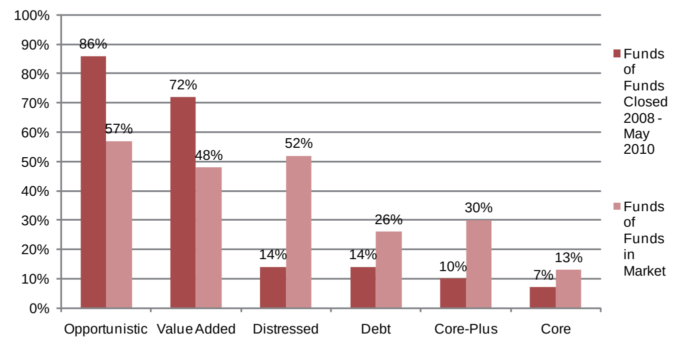
In contrast, some funds of funds aim to give smaller investors exposure to some of the largest firms in the industry. The larger minimum commitment size required would normally stop many smaller institutions from committing to these funds. Syndicated Equities' Syndicated Access Fund II has committed to funds managed by Blackstone Real Estate Advisors, Morgan Stanley Real Estate and RREEF Real Estate. Granite Hall Partners' SVP RE I has a similar approach and its underlying investments included commitments to Walton Street Capital, Carlyle Group and JP Morgan Asset Management.

There have also been a number of funds of funds launched with a specific regional focus and most notably, a number of funds of funds target Asian real estate funds. Aberdeen Property Investors raised $600 million for AIPP Asia in 2007 and closed AIPP Asia Select in Q2 2009 with commitments of $221 million. CBRE Investors Global Multi Manager's CBRE Asia Alpha Plus Fund raised $250 million and invests in value added and opportunistic funds across the Asia Pacific region. Franklin Templeton Investments raised $383 million for its Franklin Templeton Asian Real Estate Fund and began raising capital for Franklin Templeton Asian Real Estate Fund 2 in the first quarter of 2010.

As a result of the increased interest in distressed real estate and real estate debt, a number of funds of funds focused on this sector have been launched. Metropolitan Real Estate Equity Management raised $162 million for Metropolitan Real Estate Partners 2008 Distressed Co-Investment and is marketing MREP Distressed Strategies II. Investors Diversified Realty is marketing the Investors Diversified Realty Fund, which will allocate its initial capital to funds that are originating first mortgages and mezzanine debt positions.

In terms of structure, 82% of funds of funds are private closed vehicles. A further 15% are private open-ended funds. These include Henderson Indirect Property Fund (Europe), a €450 million fund that targets underlying European core-plus, value added and opportunistic vehicles, and the €732 million ING Eurosiris Fund of Funds, which targets core and core-plus funds across Europe. There are also a small number of listed funds of funds that target underlying private equity real estate funds. These account for 3% of all funds of funds.

Fig. 2: Underlying Strategies Targeted by Real Estate Funds of Funds



Targeted Strategies

Fig. 2 shows the underlying fund strategies that are targeted by

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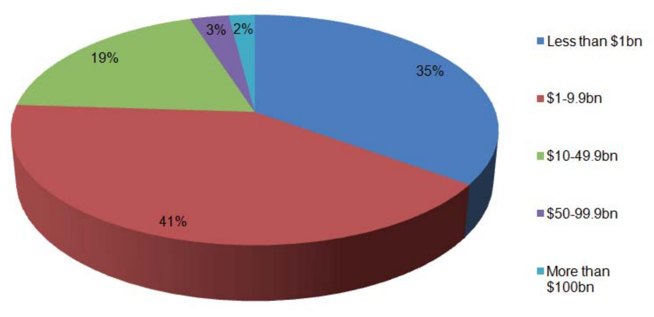
funds of funds that closed in the period 2008 to May 2010, and those that are currently in market. This shows that fund of funds managers are altering their strategies in light of the opportunities within the current real estate market. While opportunistic and value added funds remain commonly targeted strategies, the proportion of funds targeting these strategies has fallen. In contrast, the turbulent market conditions have led to an increase in the proportion of funds of funds seeking to invest in distressed vehicles. 52% of funds of funds in market plan to make this type of commitment. Furthermore, many fund of funds managers now believe that the best market opportunities are presenting themselves in core and core-plus investments. This explains the 20 percentage point increase in funds of funds investing in core-plus vehicles, as investors seek to reduce the level of risk in their portfolios and target returns through income, rather than appreciation.

Fund of funds managers were largely inactive during the past 12 months. They were either reluctant to commit before the market bottomed out or delayed new investments at the request of investors keen to avoid additional capital calls. Many firms do have capital available to invest and most expect to be far more active in the coming year.

Funds of Funds as Investment Consultants

Fund of funds managers do not just manage the capital raised through funds of funds, many also act as investment consultants to a number of investors and allocate to funds through managed mandates and separate accounts. These firms are therefore responsible for an even greater proportion of the capital that is allocated to the private equity real estate asset class. Many manage segregated multi-manager mandates on behalf of institutional investors, creating a real estate fund portfolio based on the investor's geographic preferences and appetite for risk. Aviva Investors Real Estate Multi-Manager is one such firm. It has invested over $6 billion in private real estate funds on behalf of its institutional clients.

Fig. 3: Breakdown of Real Estate Funds of Funds Investor Universe by Assets under Management



Who Invests in Funds of Funds?

Fund of funds investments are a popular option for small to medium-sized investors. Fig. 3 shows that 76% of investors in funds of funds have a total asset base of less than $10 billion. 41% have total assets of between $1 billion and $9.9 billion, with 35% managing less than $1 billion in assets. However, it is not exclusively the smallest investors that commit to funds of funds. Larger investors may commit to these vehicles to gain exposure to a market they have little knowledge of or a region that they might not be able to reach through direct fund commitments.

Diversification is one of the key reasons investors commit to funds of funds. One commitment provides the investor with a fund portfolio diversified by geography, strategy and property type. This is achieved at a fraction of the cost required if the investor were to invest in individual funds. The due diligence and research is all carried out by the fund of funds manager, which is likely to have a greater degree of expertise and contacts than most smaller investors.

Investor Appetite

Market conditions have led to many investors halting their real estate investments, and the small to medium-sized institutions that invest in funds of funds have been affected by the decline in property valuations. Many investors that had hoped to return to the market this year are postponing further, and many are as yet undecided as to when they will resume commitments. Most investors are not abandoning the fund of funds route however, and will continue to make this type of commitment.

Outlook

The real estate fund of funds market has grown into an important part of the private real estate fund industry as a whole. The industry saw significant growth between 2005 and 2007, with funds of funds raising increased amounts of capital. 2009 was a difficult year for fundraising. The aggregate capital raised fell to $1.7 billion, just 37% of the capital raised in 2007. Seven funds of funds made their first investments in 2009, the lowest number since 2003. Raising capital for new funds of funds during 2009 was an extremely challenging prospect in a market in which most investors were extremely cautious and reluctant to make new fund commitments. As a result some firms were forced to abandon their funds, while those firms that did close funds often raised less capital than they had originally targeted.

The fundraising market remains extremely competitive, as many investors remain reluctant to make new commitments. These institutions still see the value of funds of funds and are likely to return to the market, but it may not be until 2011 that the rate of fundraising improves. There has been some consolidation within the fund of funds market and this is a trend which seems likely to continue as the larger firms seek to further cement their position as leaders within the industry.

Despite the slow fundraising environment, funds of funds do have capital available to commit and while they may have spent the past 12 months on the sidelines, most have indicated to Preqin that they will look to make new investments in the coming year. These firms are experienced investors and are adapting their approach in order to take advantage of the prevailing opportunities in the current market. Fund of funds managers that invest wisely in the coming months could well secure strong returns for their investors.