European IMRE News

Insights on developments in the European landscape*

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Valuation in times of volatility

How to cope with unprecedented volatility in an era of 'fair value' accounting? A consistent and thorough methodology is the answer.

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The markets have displayed unprecedented levels of volatility in the period since July 2007 – especially in the past few months. Fear, lack of confidence and, in some (but not all) cases, irrationality have created markets where fundamentals are discarded and the frenzy of a rush to cash is the key driver in determining market values.

In the 'fair value' accounting era in which we live, this causes huge daily swings in fund valuations. Where market liquidity has dried up, what really represents fair value? Where recovering assets is uncertain, how do you estimate likely net realisable value? Where prices are plummeting, but you intend to hold onto your investment for the foreseeable future, is marking to market reinforcing the downward spiral of valuations? We'd like to deal with each of these topical issues in turn – lack of liquidity, realism of recoverability and fair value accounting – and explore how best to cope in these uncertain times.

Lack of liquidity

One of the biggest issues facing many investment managers is how to value an asset (or liability) that simply is not trading. If no one is trading it then what is its value and where do you start? FAS 157 promulgates the use of an exit (rather than an entry) price, so even the use of cost, or what you paid for the investment, is being replaced by what you would get if you sold it.

In the absence of any trading data it is necessary to go back to first principles. Certainly, while you cannot default to using 'cost', it absolutely must be a consideration in determining the value. However, the longer the period elapsed between the dates of purchase and valuation, obviously the less the relevance of cost as a benchmark. One has to consider what has happened in the meantime – in a private equity environment important factors would include the company's performance versus budget, cash flows, projections, the economy and the industry in which it operates, as well as foreign currency impacts.

In an esoteric over-the-counter derivative-type position, this usually involves employing a model. But first principles involve challenging the model. Is it an industry standard? Are its methodologies for valuation and calculation valid in today's environment? One also has to challenge the model's intrinsic assumptions. Do volatility or default rates that applied a year or two ago remain realistic in today's uncertain environment? If you produce a model valuation, can it be tested/second-guessed in any way to market data? The advent of consensus data has delivered a great improvement in estimates

and inputs being used for today's valuations. However, it remains necessary to challenge how each and every assumption holds up in the current environment.

When valuing asset-backed securities, thorough and realistic analysis of the underlying assets, the tranche owned and the structure of the deal (in terms of seniority for payment, trigger events, etc.) is needed. The emphasis is on realism – past assumptions cannot be assumed still valid in a world of rising unemployment, where many countries are officially now in recession. Following this analysis one has a fundamental value – but if there is evidence of transactions at different prices then these values have to be used in lieu (see discussion below on fair value accounting).[1]

Realism of recoverability

A fresh challenge is the reality of recovering assets held by entities that are either in administration or have filed for bankruptcy. Here, the likelihood of getting assets back obviously affects net asset value. Given the lack of certainty it is extremely challenging to form a view on the likelihood of recoverability.

The first step involves legal interpretation of ownership rights and creditor status (ranking secured or unsecured). Are the assets in segregated accounts or are they pooled and eligible for rehypothication? Does the fund have legal title and ownership of the securities or has ownership moved to another entity? Following this analysis, full consideration of all information available from those in charge of the administration or bankruptcy is needed.

Many feel that there is just too much uncertainty to form a view and, therefore, where legal documents permit, some funds are forming side pockets or special purpose vehicles (SPVs) to 'ring-fence' the issue – planning to start trading that part of the portfolio again when there is more certainty. Where the amounts are significant, some managers have decided to suspend funds – again until there is more certainty. This becomes more challenging in a regulated fund/retail environment where daily liquidity is a given. The advice appears to be to err on the side of caution when estimating recoverability.

How 'fair' is fair value accounting?

The fair value accounting model has been attacked for exacerbating the current crisis. Many regard marking positions to market at a time when prices are falling as creating a vicious circle, with consequent fear and worry about future valuations encouraging more selling, so forcing prices down further. For sure, this can be an unfortunate consequence of marking to market, but the concept and the reasons behind it remain valid. In a world where funds are offering liquidity to investors (daily, weekly, monthly or even less frequently), we believe that ignoring the market's validation of values would be extremely naïve. If you have to provide frequent liquidity to investors then you will probably have to sell investments to fund redemptions. When you sell, the most likely price you will get is the market value. Therefore, this provides the best estimate of your portfolio's value at a point in time when you may need to fund redemptions.

Conclusion

The above summarise just three of a myriad of valuation challenges. Illiquidity and uncertainty are causing many valuation headaches. However, a consistent methodology, adequately researched, analysed and documented is the best approach to valuing in a volatile world.

[1] For further information see 'Measuring and disclosing the fair value of financial instruments in markets that are no longer active', International Accounting Standards Board Expert Advisory Panel, October 2008.

European Parliament ratchets up pressure on hedge funds and private equity

Market turmoil and the contents of two Parliament reports make regulation more likely, with proposals now probable in 2009.

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The European Commission's stance on the regulation of hedge funds and private equity (contrary to the views of some key EU supervisors) has been not to adopt an EU-wide regime, believing that these industries were sufficiently covered – if indirectly – by existing bank, securities and investment fund regulations. Given the impact of the financial market turmoil on hedge funds and, more explicitly, two reports adopted by the European Parliament on 23 September 2008, the Commission may be forced to change its position.

The two Parliamentary reports both call for tougher and more coordinated EU regulation of hedge funds and private equity. Poul Nyrup Rasmussen, the author of one of the reports[1] believes '…the time is right for these alternative funds to enter the single market'.[2] Notably, Rasmussen has called upon the Commission to set out how it plans to how to respond to these issues by the end of December this year. Klaus-Heiner Lehne, author of the second Parliamentary report,[3] said, 'it was clear […] that there are shortcomings in existing legislation.'[4] The Commission is now expected to come forward with a response in December which may lead to a legislative proposal in 2009.

European Parliament activism strengthened by the financial crisis

Within the European Parliament, some voices have been calling for tightened regulation of hedge funds and private equity[5] for nearly four years. This view, however, was not necessarily shared widely by all political groups. Many still warned against 'demonising' hedge funds and private equity, and also against bundling the two together (particularly given that there is no clear definition for a 'hedge fund').

In a resolution adopted in December 2007,[6] the Parliament recognised some positive traits of hedge funds, which 'often result in higher market liquidity, dispersion of risk, in particular for traditional portfolios, and enhanced competition among market makers and intermediaries..'. It supported an industry-led self-regulatory initiative in terms of the adoption of a transparency and disclosure code under the aegis of the International Organisation of Securities Commissions (IOSCO). While recommending that hedge funds should also consider adopting a code in respect of portfolio valuation, risk management systems, transparency of fee structures and enhanced insight in investment strategies, the resolution noted that hedge funds could play an increasingly important role in strengthening corporate governance more generally in the capital markets, through promoting enhanced shareholder activism.

The resolution noted that private equity, while ‘an important source of start-up, growth and restructuring capital’, can also contribute negatively to the levels of debt in the economy overall, and advocated increased transparency towards investors and supervisory authorities. It also noted that the regulation of counterparty risk and clear investor eligibility criteria were crucial, and invited the Commission to undertake an analysis of private equity’s impact on employment. Essentially, Parliament was ‘convinced that a more in-depth analysis is needed better to understand the impact of alternative investments such as hedge funds and private equity on financial stability, corporate governance, consumer choice and protection as well as employment’.

Ten months on, though, Parliament’s ‘softly-softly’ approach has disappeared. Both Parliamentary reports call for specific legislative proposals in relation to hedge funds and private equity. According to the Rasmussen report, hedge funds were part of the ‘collective failure to appreciate the extent of leverage taken on by a wide range of institutions (…) and the associated risks of a disorderly unwinding’.[7] As a result of this, inter alia, ‘the Commission should monitor and analyse the effects of the operations of hedge funds and private equity and consider putting forward a directive on the minimum transparency rules on how investments are financed in the future, risk management, methods of assessment, managers’ qualifications, possible conflicts of interest as well as the disclosure of ownership structures and the registration of hedge funds’. Additionally, the Commission should set up a one-stop shop website for codes of conduct. Rasmussen also believes that employment laws should apply to hedge funds and in private equity arrangements (currently exempted from these rules in some countries), and that the incentives created by hedge fund and private equity managers’ remuneration packages should be subject to review.

The Lehne report covers similar ground but its main point is that transparency is crucial for investor confidence. It calls on the Commission to put forward legislative proposals on transparency requirements without stipulating a specific deadline. The report notes that the Transparency Directive has led to divergent levels of transparency in the EU and to high costs for investors, but any expansion of the transparency regime needs to be balanced in order to avoid jeopardising competitiveness. It also needs to recognise that transparency itself should not be seen as a substitute for due diligence.

European Commission to examine the recommendations

Under EU law, the European Commission is the only EU institution that can propose legislation. The European Parliament, however, can request the Commission to submit ‘appropriate measures’ in relation to matters of interest to the Community. While there are still moderate voices in Parliament, suggesting inter alia that any action should be postponed until the efficacy of the recently proposed industry code of conduct (put forward by the Hedge Fund Working Group (HFWG) in January 2008) has been tested, the cross-party support evidenced by the two reports adds political weight to Parliament’s position and, combined with recent international calls for regulation or oversight of all financial market players, leaves the Commission little room for manoeuvre.

Charlie McCreevy, Internal Market Commissioner, who has long resisted Parliamentary calls for regulation, as late as last September was still very much against jeopardising ongoing innovation through (over)regulation: ‘Let me be clear the EU economy is going to need massive investment in the time ahead. Without sovereign wealth funds, private equity and the like, Europe’s recovery from today’s turmoil will be all the slower’.[8] He will, however, examine Parliament’s recommendations and report back by the end of the year.

That said, the Commission – and industry – could have some breathing room. According to the EU ‘better regulation’ requirements, any legislative proposal has now to pass a cost/benefit litmus test before the Commission adopts it. Such an assessment will take time and is unlikely to be accomplished in time for a legislative proposal to be tabled and passed before the current European Parliament is dissolved in June 2009. If a legislative proposal is put forward, it is likely that this will only be once the next Commission is established in November 2009.

However, clearly this issue will not go away. Industry needs to take advantage of next year to implement the code of conduct, tighten risk management and valuation practices, and consider disclosure enhancements. It may also wish to ensure a structured dialogue both with regulators and with legislators at both the national and EU levels.

[1] Report with recommendations to the Commission on hedge funds and private equity (2007/2238(INI)).

[2] Euractiv, ‘Explaining the Rasmussen report on hedge funds and private equity funds’, 12 June 2008 http://blogactiv.eu/about/.

[3] Report with recommendations to the Commission on transparency of institutional investors (2007/2239(INI)).

[4] Europolitics: ‘Financial markets: MEPs force Commission to legislate’, 24 September 2008.

[5] See: www.pes.org/downloads/Hedge_Funds.pdf.

[6] European Parliament resolution of 13 December 2007 on Asset Management II (2007/2200(INI)), paragraphs 39–48: see A6-0460/2007 – www.europarl.europa.eu/oeil/file.jsp?id=5531522.

[7] Global Financial Stability Report (April 2008), quoted in the Rasmussen report.

[8] ‘EU’s McCreevy says no need to regulate hedge funds’, Reuters, 22 September 2008: see: www.forbes.com/reuters/feeds/reuters/2008/09/22/2008-09-22T184842Z_01_LM476148_RTRIDST_0_EU-HEDGEFUNDS-UPDATE-2.html.

Differentiating private equity businesses in difficult markets

Private equity firms need to demonstrate how they are adapting to a series of key issues – how they are anticipating tomorrow's world.

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After the unprecedented financial events of the past year, private equity is operating in an environment where fundraising will become more competitive. What is more, as the turbulence affects the 'real economy', so investing will be more difficult.

In this new world, the industry needs to make use of the flexibility it has become so well known for. Clearly, private equity is embarking on a new phase and firms need to adapt. They need to look long and hard at how they create value. They need to consider how this is reflected in their brands. Not only will they have to change, but to be distinct they will have to demonstrate how they are anticipating tomorrow's world.

No private equity firm can currently take growth for granted. Based on our internal experience and conversations with leading industry players, we view a number of specific challenges and opportunities that are fundamental to the future:

Key issues

Sustainable growth becomes critical

The most important form of differentiation is performance. With a less supportive capital market environment, firms have to accomplish this by improving their portfolio businesses – so increasing growth. This means a shift in skill sets and culture for many firms.

Building the business model

The logic for diversifying into other alternative asset classes is not diminished by the downturn. As macroeconomic and capital market conditions change, so opportunities emerge. Building bigger, more diversified businesses introduces a whole new set of management and control challenges.

Reconciling responsibility with returns

Until recently corporate responsibility appeared to offer few advantages for private equity. It was chiefly seen as having a brand or investor relations benefit for companies in the public arena. Now this is changing, as sustainability issues look likely to have a major impact on companies' bottom lines.

Fair value challenges in the current environment
The move to fair value reporting in today's market conditions, made necessary by new accounting conventions, is leading to a difficult 2008 year-end accounting process. But with investors generally dissatisfied with the standard of reporting received from alternative investments, fair value is an important step in the right direction.

Addressing tax in a wider world
As private equity has become a global industry, and an owner of increasingly high-profile businesses, so tax issues have become more complex. In certain countries, tax structures that appeared secure are being challenged. A greater awareness of tax risks is required.

BRIC opportunities – and the accompanying risks
While emerging markets are clearly vulnerable to the global crisis, their medium-term growth prospects still appear better than elsewhere. Private equity houses need emerging market strategies. Yet these economies have idiosyncratic regulatory, legal and taxation environments. Careful planning, structuring and due diligence is essential.

A new phase

Taken individually, these issues have implications of varying seriousness. Combined, however, they mean that firms have to make significant changes – from value creation, through to structuring, controls, reporting, and so on. In addition, firms may face greater regulation – notably within the European Union, where there are calls for tougher capital requirements.

Just as the benign conditions of the past five years fostered a phase of growth when large buyouts became increasingly dominant, so in the coming years the industry will reshape itself again to adapt to the new environment. Those firms that do so most effectively, and invest in portfolio companies at today's valuations, are likely to generate strong returns.

This article is an extract from the PricewaterhouseCoopers report: 'Seeking differentiation at a time of change' (published in October 2008). www.pwc.com/globalprivateequity report

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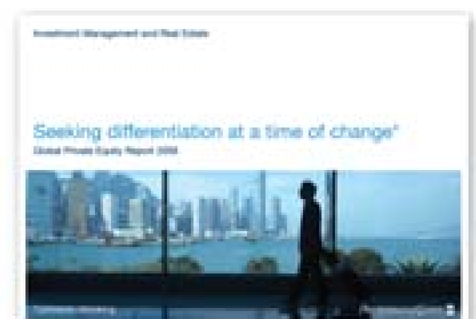

Switzerland clarifies tax treatment for private equity managers

The tax authorities are clarifying the tax treatment of private equity managers in order to make Switzerland a more attractive base for managers.

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Although Switzerland has a very high quality of life and is therefore attractive for employees, the tax situation of private equity managers has not always been optimal. Important institutions, such as the federal assembly and the federal tax authorities, have recently made efforts to strengthen Switzerland as financial centre for fund managers.

In reaction to the recent public discussion with the tax authorities, in September the task force 'STAFI' (Steuerungsausschuss Dialog Finanzplatz Schweiz – tax committee dialogue financial centre), consisting of high-ranked representatives of tax authorities and business (including PricewaterhouseCoopers Switzerland), announced new measures intended to strengthen Switzerland as a centre for fund managers.

No change in the tax law is necessary to improve the tax situation, as the current tax law is deemed to be sufficiently attractive. The tax authorities will publish shortly a circular that should clarify the possibilities for fund managers and reduce current uncertainties.

Historical situation

Up until this announcement, income derived from funds – such as carried interest and excess profit – received by the fund manager (individual) has generally been subject to income tax in Switzerland at the ordinary income tax rate of approximately 15–40%.

New developments

The planned circular will differentiate between the situation where (a) the fund manager participates in the performance (gains/profits of the fund) disproportionately to the invested fund equity and (b) the fund manager participates proportionately to the invested fund equity.

- **Disproportionate participation to investment in fund equity by the fund manager**
  If the fund manager is participating in the performance of the fund disproportionately (e.g. based on the offering memorandum or the management agreement) related to its formal equity investment, carried interest as well as excess profit (the amount received exceeding his/her owing quota calculated on his/her equity investment) is subject to income tax.
  The fund manager is deemed to be self-employed if s/he receives the excess profit personally.
- **Proportionate participation to investment in fund equity by the fund manager**
  If the fund is not structured fully by equity, but also by a large amount of debt received from the ordinary investors and profit participation is made proportionately to the formal equity, this set-up generally has to be accepted by the tax authorities.
  By structuring the fund this way, it is possible that no excess profit would have to be paid out and the full amount could be paid out as capital gain. Swiss resident fund managers generally can receive such payments tax-free.

In a nutshell

Carried interest paid out disproportionately to the investment in a fund's equity directly from the fund to the fund manager is taxable (income as self-employment) and not tax-free. But if the fund is structured correctly, the fund manager can be rewarded tax-free by receiving capital gains paid out as proportionately to their equity investment and not by carried interests.

Tax joins hedge funds' operational risks

As tax risks for hedge funds mount, we believe that they have become a significant operational risk that should be monitored by fund boards.

The theme of our 2008 hedge fund white paper is operational risk.[1] To some, it may seem odd to include tax within this definition. In our view, however, tax is simply another risk, which should be assessed by both the fund board and the fund manager.

The last few months have seen a number of developments in this area, with two commanding particular attention.

Key developments

The first is the Report of the Investor Committee of the US President's Working Group. For the first time, this highlighted taxation as a risk that investors, fund boards and managers should be considering. Given that most alternative investments aim to minimise the taxation suffered by the fund, a degree of tax risk is inherent in all of these structures.
The extent of this needs to be continually assessed, documented and monitored.

The second is the fact that following the introduction of FIN48,[2] accounting standards are starting to drive tax issues. While the Financial Accounting Standards Board has recently delayed implementation for non-public entities until fiscal year starting after 15 December 2008, some funds had already commenced work on the required disclosures. Consequently, certain fiscal authorities are receiving unexpected tax payments.

A good example of this is the German tax on capital gains derived from the sale of shares. This is an extremely difficult issue to monitor, due to the 1% threshold and the fact that it is necessary to look back over a five-year period.

As a local capital gains tax rather than a withholding tax, this would not be covered by a prime broker agreement. It is the fund's responsibility to identify the issue, file a tax return and settle the tax. The fact that some funds are already taking this action will only serve to focus the tax authorities' attention on the topic and current enforcement procedures.

Time to review fund structures

A related point is that the objective of minimising tax has led to the creation of multiple investment holding companies underneath the main Cayman Islands fund. Historically, the fund's board has delegated the investment structuring to the manager. In the current environment, boards should be reviewing these structures to ensure that they understand the risks and judge them to be reasonable. Equally, going forward it is anticipated that investors and regulators will be looking for structures that are more transparent and easier to understand; therefore, groups should be looking to simplify complex structures.

Take the use of investment holding structures to mitigate withholding taxes on income flows such as interest and dividends. The effectiveness of these structures relies on accessing the relevant double taxation treaty to reduce the rate of withholding tax. Increasingly, the fiscal authorities in the paying countries are questioning the extent of the business activities carried on locally. They are looking for offices, employees and bank accounts as evidence of genuine economic activity. In an environment where revenues raised from corporate taxes are on the decline, the ability to generate revenue from indirect taxes such as withholding tax becomes increasingly attractive. Any funds that include these types of entities within their structures should review them carefully to ensure that they are effective – both historically and looking forward.

In summary, fund boards can no longer ignore tax risk. They must take an active role in tax risk management policy, ensuring that the policy is properly documented, adhered to, reviewed and adapted to changes in circumstance. Failure to do this could expose the fund to unacceptable tax risk and, ultimately, have a significant impact on the net asset value of the fund.

This article is an extract from the PricewaterhouseCoopers report: 'Operational risk: an alternative challenge' (published in September 2008).

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[1] Operational risk: An alternative challenge – published September, 2008.

[2] FIN 48 stands for Financial Accounting Standards Board Interpretation No. 48.

A quantum shift for HR

With the financial landscape dramatically changed, investment managers are likely to be asked some serious questions over current reward programmes and in some cases make far-reaching changes.

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Times aren't changing – they've already changed and in all probability these changes will be permanent. Who would have believed 18 months ago that international financial markets and the financial services sector in particular would be in their current state of turmoil? With the global economy in crisis, the eyes of politicians, regulators, media commentators and the general public are focusing squarely on the reward policies of financial institutions.

Commonly cited criticisms of compensation in the industry include the annual nature of performance measurement, the lack of ability to claw back rewards when decisions made previously prove to be poor, and the widespread practice of rewarding on profits that are not a fair reflection of 'true' profits, as the allocation of risk, operational costs and costs of capital to specific parts of the business have proved too difficult.

Whether the blame falls solely on inappropriate reward practices and the culture of the financial services industry is highly questionable. Yet, such remuneration practices face a double whammy, with external pressure for long-term change combining with the far more pressing challenges facing organisations today as a result of the economic downturn.

Profits under pressure

The profits of many investment managers have been hit hard with revenues subdued, following wide-scale plunges in performance fees, and many institutions facing net outflows as investors re-examine where the best risk-adjusted returns are to be found. The cost base is also suffering as the price of seed capital and other funding ratchets up.

Discretionary cash bonus pools are down. Until now, we have seen gradually emerging tensions associated with rewarding certain employees and, in particular, sales staff, through formulaic arrangements and commission. These are now thrown firmly into the spotlight as businesses strive to ensure they are rewarding the right people with the right compensation when total spend is heavily constrained compared to previous years.

While stock can prove a cheaper alternative to cash for rewarding key employees, a major issue facing larger institutions is the lack of credibility carried by stock deferral plans. Although widely used by the major banks and their subsidiaries, they often carry negative connotations for participants.

These programmes are seen by many fund managers as a way of withholding bonuses earned and the line of sight between the performance of the asset manager and the parent company is often too divorced to provide any genuine incentive moving forward.

HR adapts

All of the above mean that HR is under more pressure than ever before to manage both compensation costs and talent, while at the same time facing the challenge of ensuring reward arrangements are fit for purpose in the new environment.

However, it is unfair for executives to expect HR to deal with these issues in isolation and the right solution can only be found when HR, finance, treasury and the board work together to develop robust, risk-controlled reward programmes to support their own business. A one-size-fits-all approach to compensation is no longer sustainable.

Given the speed with which the landscape is developing it would be foolish to predict what changes investment managers will make to reward programmes over the next 24 months, either through desire or force. The smart money, however, is on wider measurement of risk, the use of longer term performance measures and an increasing prevalence of business-focused deferral and long-term incentive plans.

Whether the blame falls solely on inappropriate reward practices and the culture of the financial services industry is highly questionable.

Where next for sovereign wealth funds?

With a new code of conduct and shifting economic fortunes, sovereign wealth funds are making some changes to how and where they invest.

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Alongside the re-regulation of industry, sustainability and demographic shifts, the transfer of economic power from established western G7 markets to emerging economies is a mega-trend that will dominate the asset management industry for the next few years. Against that background, sovereign wealth funds (SWFs) will increasingly become a key vehicle through which emerging markets will make their presence felt.

Although in many instances established for more than 30 years, so much has been written about these SWFs over the last couple of years that many would believe them to be a new phenomenon and a larger part of the investment management industry than they are estimated to be (<4% according to many commentators). Indeed, the size of the current proposed US and European bailout funds exceeds that of most Asian and petro-dollar SWFs.

New IMF code

At an International Monetary Fund (IMF) conference last September, many of the SWFs agreed a voluntary code of conduct. The deal with 26 countries that run investment funds was revealed in more detail at the IMF October meeting. The new guidance covers issues like transparency, governance and accountability of these huge funds, which is likely, to some extent at least, to alter the recent investment patterns of the SWFs.

If we assume that the high-profile investments in the first round of banking refinancing and the earlier headline grabbing raids of western assets have left the direct investment teams in many of the SWFs more cautious, a logical question follows: where next for SWFs?

Our current hypothesis is that there will be change in both the investment channel mix and the geographic focus of new investment.

Changing channels and geographies

Flows to third-party investment and real estate asset managers will likely increase (either through direct investments or as new mandates). Indeed, recent research by PricewaterhouseCoopers financial services strategy team suggests that many of the new banks and asset managers springing up in the Middle East and Asia are effectively investment vehicles for larger pools of sovereign and high-net-worth wealth.

Apart from strategic investment in domestic infrastructure, SWFs will continue to look to new regions abroad to balance their risk and secure strategic assets. Africa, for example, was once seen as an unpromising and overly risky no-go zone for international investment groups, yet sub-Saharan Africa is now one of the world's fastest growing emerging markets and most sought-after investment destinations.

Economies are expanding rapidly on the back of soaring oil and mineral prices, while steadily increasing consumer affluence is creating fresh demand for banking services. Mergers and acquisition activity has been growing as groups seek to increase their strategic coverage and tap into this demand. Africa's gross domestic product (GDP) more than doubled between 2000 and 2006 and its economic momentum continues to gather pace. GDP grew by 5.8% in 2007 and is set to increase to 6.2% in 2008.[1] Central Africa has experienced the fastest acceleration in economic expansion, with growth expected to rise from 3.9% in 2006 to 6.3% in 2008, although this generally remains the most underdeveloped of Africa's regions. Of the 10 countries expected to record the fastest GDP growth in 2008, three are from sub-Saharan Africa, including Angola at number one.

From a return on investment perspective – as well as the ability to secure their resource supply chains – these countries can make attractive opportunities for SWFs.

As SWFs revisit their investment strategies, investment management and real estate companies will need to review their product and sales strategies, as well as their geographic coverage models.

Apart from strategic investment in domestic infrastructure, sovereign wealth funds will continue to look to new regions abroad to balance their risk and secure strategic assets.

[1] All African economic data sourced from 'Economic Report on Africa 2008', published by the United Nations Economic Commission for Africa and the African Union on 02.04.2008.

Why size does not always bring economies of scale

While asset management should be a highly scalable business, in fact, it often is not. At a time when costs are under scrutiny, understanding which factors are blocking economies of scale is essential.

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Conceptually, asset management is the area of financial services most like industrial production (apart from pure operations). In theory, therefore, it should show strong cost scalability potential and a high propensity for industrialisation.

Yet, empirical evidence from quantitative benchmarking of asset managers' cost bases yields mixed results. On the one hand, a PricewaterhouseCoopers benchmarking of mid- and back-office costs for 12 Swiss and Austrian asset managers in 2007/2008 indicates a strong correlation between size and costs. On the other, a similar analysis for Germany and Europe (by Droege & Co (2008) and McKinsey & Co (2006)) finds only a mild correlation.

What is clear from our study – at a time when we are increasingly being asked about scalability – is that it is not size that matters, but the cost scalability of the asset manager's operating model.

Understanding operating models

Below are the key factors affecting scalability of the operating model.

Product:
The complexity and fragmentation of the product range is particularly important. There is strong evidence that asset managers with large funds invested in plain vanilla instruments (i.e. blue-chip equities) tend to maximise cost scalability. Product appears to be the primary driver of scalability.

Processes:
Asset management still has a lower degree of straight-through processing than other financial services areas, and a considerably lower level than many other economic sectors. Consequently, there is a high level of manual processing in mid- and back-offices. A particular difficulty is that asset management processes are notoriously difficult to streamline end-to-end. This is because the asset manager's clients or custodians initiate most processes. The asset manager has no control over the quality of the data it receives, with many counterparties using faxes for communication of data. While process management methods (e.g. lean sigma) or labour arbitrage (offshoring) can greatly improve cost efficiency, these methods may only mildly boost cost scalability. What has improved scalability significantly in our experience, however, is greater automation of fund processing.

Applications:
In theory, applications should improve scalability almost perfectly because they are mostly fixed cost. Our work with clients has identified that this is not always the case. The main reason for this is the licensing cost of software packages, which are almost linear and so prevent significant scaling. Another reason is the application's age. There is strong evidence that it takes up to three years for newly implemented software to become efficient. And applications typically start to become inefficient after eight to ten years – so they have only a small time window to contribute to cost scalability.

IT infrastructure:
IT infrastructure appears to make organisations more scalable, with significant jump points. The only exception is outsourcing, where the pricing mechanism of the outsourcing contract is key.

Conclusion

In summary, size does matter for asset managers, yet there are factors that can limit economies of scale. Large asset managers need to understand what is blocking them from achieving these economies if they are to take advantage of their size.

Capital market utilities and stock exchanges as fund distributors

Emerging distribution models are likely to improve liquidity, price transparency, management of counterparty exposure and straight-through processing efficiency.

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Europe's post-trade services, and the related clearing and settlement infrastructures are highly fragmented and prevent the achievement of efficient cross-border securities distribution. Unlike the United States, where the Depositary Trust & Clearing Corporation (DTCC) acts as the unique Central Securities Depositary (CSD) linking fund distributors, fund managers and transfer agents, Europe has a more complex and diversified mosaic of domestic and cross-border models.

Indeed, fund managers looking to distribute their products as widely as possible in Europe have to work with a large network of distributors. These distributors rely on disparate infrastructures that often have little integration. These encompass order routing systems, transfer agent platforms, clearing facilities and other market-specific procedures.

Now there is pressure to change this model, mainly due to the high cost of cross-border processing. Recent studies show that the average cost of end-to-end fund cross-border orders amounts to EUR 35 for manual orders, versus EUR 10 for automated ones.[1] By comparison, DTCC cut the fee per transaction this year to USD 0.075 (EUR 0.057).[2]

New utility initiatives

The European Union (EU) cannot replicate the US model, due to obvious differences in legal regimes, languages and tax laws, but initiatives are underway to improve fund distribution efficiency and to reduce the related costs.

Among these developments, both Euroclear and Clearstream are working on solutions to enhance straight-through processing (STP) and to integrate EU domestic markets into a larger cross-border clearing and settlement platform. The fund processing services of Euroclear group's CSDs (France, UK, Netherlands, Belgium, Sweden and Finland) will soon be integrated into a single platform (Euroclear Settlement for Euronext-zone Securities (ESES)). Clearstream's Link Up Markets project will create a hub linking the local CSDs from Spain, Germany, Swiss, Austria, Greece, Denmark and Norway.

Moreover, the Target 2 Securities (T2S) project, supported by the European Central Bank, will by 2013 connect all the European CSDs through a global clearing and settlement hub. T2S, ESES and Link Up Market are clearly transforming the European securities distribution landscape (including fund distribution) and provide new horizons for the investment management industry.

Stock exchanges join in

Some stock exchanges are going a step further by proposing new distribution alternatives that combine the trading of open-ended funds with clearing/ settlement capabilities, and the possibility of using a central counterparty to minimise risks.

In the latter model, liquidity providers support fund trading by calculating market-driven prices and ensuring liquidity. More broadly, stock exchanges could also estimate intra-day gross asset value, so providing enhanced independent price transparency.

Fund distribution via stock exchanges and related post-trade infrastructures is an ambitious model. However, it should be viewed in the medium term as a credible alternative to support European fund distribution. Indeed, this model provides key characteristics such as liquidity, price transparency, management of counterparty exposure and STP efficiency, all of which will be expected in the framework of the future financial environment.

[1] Source: Eurofi and SWIFT.
[2] Source: DTCC.

Italy acts to remove a conflict of interest

At a time when assets under management are falling, Italy's supervisory authorities believe one solution is to introduce a more open distribution system – which may ultimately benefit foreign asset managers.

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On 1 October 2008, Italy's supervisory authorities – Consob, the public authority responsible for regulating the Italian securities market, and Bank of Italy – launched a joint consultation committee with representatives from the asset management industry associations. They are aiming to establish a mandatory system of central depositary services for mutual fund units and a multilateral trading facility (MTF).

The committee, which is expected to disclose its results by 31 March 2009, has been set up to identify and adopt the operational measures necessary to implement this system, which would necessitate a dematerialisation of mutual fund unit certificates. Currently, a single cumulative certificate, kept in custody at the depositary bank, with sub-accounts for each individual unit-holder, represents a fund's outstanding units. This prevents the fund's units from circulating.

The authorities are attempting to tackle a conflict of interest, which is partly responsible for a significant fall in the Italian asset management industry's funds under management. At present, the banks are both the manufacturers of investment funds – through their asset management subsidiaries – and own the distribution networks. This has led to high distribution costs and high asset management fees.

Potential benefits

In principle, the proposed system could bring several advantages. With the link between the management company and captive distributor broken, investors would find it easier to shift from one fund to another, regardless of which company is the ultimate producer. Additionally, the MTF would result in a wider offer of funds, from a variety of authorised intermediaries. These could be bought 'off-the-shelf' – hopefully at lower or even nil distribution costs. Similarly, asset management companies would gain direct access to a significantly higher number of potential clients than through traditional distribution channels.

The likelihood of lower fees

Thanks to direct access to an MTF, sophisticated clients could operate through an 'execution only' mode, under the regulation introduced by the Markets in Financial Instruments Directive (MIFID). This should reduce distribution costs and, accordingly, the upfront and asset management fees currently burdening funds, because the 'execution-only' mode would not justify such fees.

Nevertheless, some believe it unlikely that an MTF for open-ended funds would reduce funds' costs in the short-run. They argue that only a limited number of clients, mainly professional ones, would be sufficiently knowledgeable to use the 'execution-only' mode, without assistance from a financial adviser.

Most retail investors have only a basic knowledge of financial instruments. Therefore, the potential benefit of lower fund costs would be eroded by the fees for advice needed to choose the most suitable investment solution. Still, retail clients would be granted access to research material and fund statistics on the platform, which would help them to compare fund costs. In the medium term, such ready available information would raise retail investors' awareness.

As to the prospected opening of the Italian market to foreign asset managers through the envisaged MTF, retail clients' rudimentary knowledge of investment could represent a practical barrier. This might prevent them from penetrating the marketplace without a strong Italian presence.

Ultimately, an MTF for harmonised investment funds could lead to two different classes of fund units: a cheaper class of units traded through the MTF's 'execution-only' mode, and a more expensive one reflecting the investment advice service provided to clients. Actually, clients seeking advice might be prepared to pay separate fees for advice to the bank-owned distribution channels, but only to the extent that they got value for money. Over time, captive distributors would have to enhance the quality of advice or lose market share. Eventually, competition would be strengthened, paving the way to new entrants, such as independent financial advisors, to the benefit of all the market participants.

The potential benefit of lower fund costs would be eroded by the fees for advice needed to choose the most suitable investment solution.

Switzerland eases UCITS distribution

Proposed revisions to the ‘Swiss Finish’ rules are making the country a far easier place for distributing UCITS funds.

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Registration of UCITS funds for distribution in Switzerland is being relaxed. In September, the Swiss Federal Banking Commission (SFBC) proposed revising rules and practices, collectively known as the ‘Swiss Finish’. Its clear goal is to improve the appeal of Switzerland as a place for distributing collective investments schemes.

The proposal started a consultation process, with a view to implementing the changes before the end of 2008.

Existing rules

Ahead of the amendments, the following practices apply when approving UCITS funds for distribution:

1. The ‘Two-Thirds Rule. At least two-thirds of a fund’s portfolio must correspond to its description. So, a fund called ‘US Equity’, for example, is obliged to invest at least two-thirds of its portfolio in US stocks.
2. The ‘Double Dip Rule’. This rule restricts the fees charged by a fund investing in other funds managed by the same or a related company. No subscription or redemption fees can be charged, and only a reduced management fee (generally 0.25%).
3. Additionally, the following disclosures are required:
   a. Existence or absence of the segregation principle. In other words, disclosure of whether investors are only entitled to the income and assets of the segment of an umbrella fund in which they are participating;
   b. Indication of the level of leverage allowed;
   c. Mention of the risk that net asset values of all classes may be impacted by exchange rate hedging in a single class;
   d. Disclosure of the names of representative and paying agents;
   e. Disclosure of reimbursements and trailer fees as requested by Swiss Fund Association (SFA) regulation.

Proposed amendments

After the adoption of the SFBC's proposed measures, the majority of these rules will no longer apply to UCITS funds.

For a start, the SFBC will give up the Two-Thirds Rule. Generally speaking, Swiss law requires a fund's description to avoid giving room for confusion or deception. Yet the SFBC will abolish the fixed quantitative level and allow investment managers to ensure that investors are given enough information to avoid confusion.

Secondly, the Double Dip Rule is being revised. The Swiss supervisory authority is aligning its requirements with those of other European countries. The levying of subscription and redemption fees remains prohibited for funds investing in other funds managed by the same or a related company. However, the SFBC will no longer impose a moderate management fee. Instead, investment managers can decide what the management fee should be, on the condition that they inform investors. Moreover, the SFBC proposes amending the Collective Investment Schemes Ordinance's stipulation that a company with a 10% participation level should be considered 'related'. The SFBC proposes replacing the existing 10% level with the EU equivalent mention of 'significant participation'.

Finally, the majority of disclosure requirements will no longer apply, with the exception of the information related to the representative and paying agent, as well as to the existence of reimbursement and trailer fees. The SFA is expected to issue a template document named 'information to Swiss Investors', containing the remaining required information for UCITS funds distributed in Switzerland.

These changes to SFBC fund registration requirements are intended to eliminate the main differences between Swiss and European Union rules in order to attract more funds for distribution in Switzerland. As a consequence, a UCIT III fund will be assumed compliant with Swiss law. Its authorisation for distribution in Switzerland is going to be much easier and quicker than is currently the case.

In September, the Swiss Federal Banking Commission proposed revising rules and practices, collectively known as the 'Swiss Finish'.

Transparency and comparability of real estate entities under IFRS progresses slowly

Our survey of 50 listed real estate entities' 2007 financial statements shows greater transparency and comparability, but there remains some way to go.

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Real estate entities are gradually improving the transparency and comparability of their financial statements under International Financial Reporting Standards (IFRS). These accounting principles are used by many listed entities throughout the world. For listed European Union entities, IFRS have been required since 2005.

In last year's survey of 2006 financial statements, we concluded that the real estate sector still had some way to go to increase transparency and comparability between entities' financial statements, this being one of the most important goals of IFRS. The entities' financial statements are significantly affected by certain accounting policy options under IFRS (e.g. the choice to measure investment properties at fair value or at cost, less depreciation and impairment), making transparency and comparability even more difficult to achieve.

Moving to 'fair value' and other improvements

Our survey of the 2007 financial statements, published in October 2008, revealed the real estate entities steadily improving transparency and comparability. In this 2007 survey, for example, we found that two of the six real estate entities that valued investment properties using the cost model in 2006, moved to using fair value, which is by far the most common valuation method in real estate. The two that changed said they did so in order to improve the presentation of their balance sheets, making their annual reports more comparable with competitors and to reveal the 'hidden value' of their investment properties.

The surveys of the 2006 and 2007 financial statements are not directly comparable because of the slightly different samples. Indeed, while the 2006 report focused entirely on western Europe, the 2007 one included a few entities from Asia and eastern Europe. However, in 2007, 92% of the 50 entities surveyed (46 out of 50) measured their investment property at fair value, compared with 88% in 2006.

Also, including an extract of an appraiser's report in 11 cases can be seen as an improvement in disclosing the fair value, including the assumptions used. Other areas that have been improved are the disclosures on classification, recognition and transfers.

Disclosures

Yet, there remains much room for improvement in disclosing the IFRS policy options adopted. Further, the disclosures on the treatment of, for example, lease incentives when calculating the fair value of the investment property in order to avoid double counting has mostly not been disclosed; the disclosures on whether investment entities are acting as principal or agent could be improved. Industry bodies have issued guidance on the options the sector might choose under IFRS and what disclosure details might be given in the financial statements – for example EPRA (the European Public Real Estate Association) has issued Best Practices Policy Recommendations in areas such as net asset value calculation. Although not a disciplinary body, EPRA actively encourages adherence to these policies. The survey reveals that only one entity stated that the financial statements fully complied with the EPRA guidance or similar guidance, applicable in their jurisdictions.

To really accelerate the journey to more transparency and comparability, real estate entities should give more extensive disclosures.

This article is an extract from the PricewaterhouseCoopers report: 'Are you keeping up with the pace?' (published in October 2008). www.pwc.com/ifrsrealestatesurvey

Table of key findings

Classification, recognition and transfers	Real estate entities have several types of real estate on their balance sheet (e.g. investment property, inventory, non-current assets held for sale and property, plant and equipment). Investment property remains the main balance sheet item. The notes to the financial statements provide useful disclosures on classification, recognition and transfers. Limited information is given on the type of costs included in the transaction costs at initial measurement of investment property. The most frequent transfer between different categories of real estate was from development property to investment property.
Measurement	Forty-six out of the 50 entities surveyed (92%) apply the fair value model for subsequent measurement of investment property. For determining the fair value, almost all entities involve an external appraiser. The names of the external appraiser firms are often mentioned in the annual report. In 11 cases an extract of the appraisers' report is included in the annual report. The disclosure of the external appraiser fees and the assumptions used in the external valuation (e.g. discount rate and inflation) is limited. Furthermore, it is unclear in what way the entities take into account the risk of double counting for lease incentives in the fair value of the investment property.
Income statement	Only two out of the 50 entities (4%) present revenue on a net basis in the income statement. Different presentation of the income statement (e.g. revenue on gross or net basis and presentation of expenses by function or nature) reduces comparability of the entities. Due to the fact that trading in real estate is part of the core business, 15 entities present proceeds on disposal of real estate as part of revenue and the carrying value as part of cost of sales in the income statement. Furthermore, disclosures on the accounting treatment of service charges (e.g. clarification on whether the entity acts as an agent or as a principal) are limited. Acting as a principal or as an agent can have a significant impact on the presentation in the income statement.
Consolidation	Real estate acquisitions are accounted for both as asset deals and business combinations, depending on the nature of the transaction. Seventeen entities account for their joint ventures using the proportionate consolidation method. Based on Exposure Draft 9 'Joint Arrangements', this might lead to changes in the accounting policy of those entities in the future.
IFRS 7	The most common assumptions used for the analysis of sensitivity of the interest rate risk were 0.5%, 1% and 100 basis points. For the currency risk the most common used assumptions were movements of 5% and 10%. Disclosures on market price risks are limited.
Segment reporting	Only one of the entities surveyed early adopted IFRS 8. IFRS 8 will be effective from 1 January 2009. Under IFRS 8 disclosures about segments of an entity and related information must be identified in the same way as in the internal management accounts. The primary segmentation of the entities surveyed is generally business segments (e.g. offices, residential and retail) and the secondary segment generally used is geography.
Deferred tax	Nearly all entities surveyed present deferred tax on the face of the balance sheet, as required by IAS 1. The deferred tax is not discounted and is calculated using applicable tax rates that have been enacted or substantively enacted by the balance sheet date and are expected to apply when the deferred tax is realised or settled. The disclosure on the percentages used to calculate the deferred tax and the influence of fiscal facilities (e.g. tax structures such as SIIC in France or FBI in the Netherlands) on the deferred tax is limited.
Industry-specific guidance	Thirteen entities disclose the NNNAV or EPRA NAV and 14 entities disclose the like-for-like growth in rental income. Only one entity stated that the financial statements are fully compliant with EPRA guidelines. Four entities disclosed 'direct result' and 'indirect result', two of them on the face of the income statement and two in a separate overview in the primary statements.

French SPPICAV becomes a real estate investment vehicle of choice

With SPPICAVs not subject to the anti-avoidance provisions established for SIIC structures, they are in vogue with French and foreign investors alike.

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A Société de Placement à Prépondérance Immobilière à Capital Variable (SPPICAV) is one of two possible legal forms of an Organisme de Placement Collectif Immobilier (OPCI), which develops or acquires (directly or indirectly) real estate and rents it out. For tax reasons, it is becoming increasingly popular.

Originally introduced in 2005, the SPPICAV is a regulated investment vehicle that must be managed by a France-based management company (ManCo). Both SPPICAVs and ManCos must obtain prior approval from the French Autorité des Marchés Financiers (the authority supervising the French financial market). Investors in a SPPICAV have the right to ask at any time (except in very specific circumstances) to buy back the shares they hold. Sixty percent or more of the assets held by a SPPICAV must be represented by real properties held directly or indirectly. SPPICAVs must comply with certain ratios (liquidity and diversification ratios, gearing limits, etc). However, these ratios are not imposed on SPPICAVs, which are restricted to qualifying investors.

Tax position

SPPICAVs are exempt from French corporate income tax (CIT) – provided they fulfil certain dividend distribution requirements (bearing in mind that the gearing of the SPPICAV reduces the dividend distribution requirements). The French tax authorities have not yet indicated whether or not dividends declared by SPPICAVs, which are, as indicated above, companies entirely exempt from CIT, can benefit from the treaty provisions and, in particular, the reduction or exemption of French withholding tax on dividends provided by the applicable double tax treaties. However, given the wording of the France/Luxembourg double tax treaty, dividends paid by a SPPICAV to a Luxembourg company holding at least 25% of its shares can benefit from the reduced 5% withholding tax rate.

SPPICAVs also benefit from a significant competitive advantage in acquiring real estate assets since capital gains realised by French vendors on the disposal (or contribution) of real estate assets or shares in real estate companies are taxable at the reduced CIT rate of 16.5%. This is provided the SPPICAV commits to keep the assets acquired (or received as a contribution) for at least five years. Listed Sociétés d'Investissements Immobiliers Cotées (SIIC) companies also benefit from this competitive advantage.

In theory, this favourable tax provision should expire at the end December 2008. However, although this cannot be guaranteed, it is likely to be extended for one or more years.

The SPPICAV regime is available to both newly incorporated and existing companies, although the latter have to pay a CIT exit tax at the reduced rate of 16.5%. This is payable on the latent capital gains arising on the real estate assets held at the time of the conversion.

Advantage over SIIC structure

While SPPICAVs, broadly speaking, have similar tax features to listed SIIC companies, there are three anti-avoidance provisions, introduced two years ago, which only apply to listed SIIC companies. They are as follows:

- A 20% special tax is levied on dividends distributed by French SIICs out of non-taxable profits to a corporate shareholder holding 10% or more of the financial rights, if the dividends received are not taxed at a rate of at least circa 11%;
- At the time of the election for the SIIC tax regime, at least 15% of the financial and voting rights of the listed company must be held by shareholders owning less than 2% of the capital; and
- Several independent shareholders must hold 60% or more of the financial and voting rights of the listed company. Listed companies that elected for the SIIC regime before 1 January 2007 must comply with the 60% threshold before 31 December 2008.

For the time being, the above tax constraints (or similar ones) are not applicable to SPPICAVs. Additionally, having a regulated SPPICAV is less burdensome and costly than a listed SIIC. SPPICAVs can hold a single property whereas (in practice) listed SIIC companies cannot. Investors wishing to use a SPPICAV can either set up their own ManCo or can purchase management services from a third-party ManCo.

For all the reasons mentioned above, a substantial number of large foreign investors are investigating setting up SPPICAVs to hold French real estate assets. In addition, several existing listed SIIC companies (in particular those that have to comply with the 60% threshold before 31 December 2008) are reviewing migrating to a SPPICAV structure, and some foreign investors are considering purchasing existing listed SIIC companies through SPPICAVs (and delisting them after purchase).

In France, fashion is extending to finance. The listed SIIC regime is a has been, whereas the SPICCAV vehicle is in vogue.

A substantial number of large foreign investors are investigating setting up SPPICAVs to hold French real estate assets.

IRS ruling on property index swaps creates opportunity

A new IRS ruling appears to open the door for European funds to gain tax-efficient access to US real estate through index-notional principal contracts.

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The Internal Revenue Service (IRS) has recently published taxpayer-friendly guidance concerning interests in certain notional principal contracts (also commonly called swaps), whose return is referenced to a broad-based US real estate index. The ruling opens the door to foreign investors looking for indirect US real estate exposure without the downside of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) taxation.

The FIRPTA subjects to US tax certain dispositions of US real property interests (USRPIs) by foreign persons. Specifically, a non-resident alien or foreign corporation (taxpayer) must recognise gain or loss from the disposition of a USRPI, as if the taxpayer were engaged in a trade or business within the United States, and as if the gain or loss were 'effectively connected' with such trade or business. For corporate investors, the applicable tax rate is generally 35% – for individual investors, generally 15%.

The law broadly defines a USRPI as 'any interest, other than an interest solely as a creditor' in real property located in the United States or the US Virgin Islands. An interest, other than solely as a creditor, includes not only the obvious types of ownership interests such as fee-ownership, co-ownership, leasehold interest in real property, a time-sharing interest, a life estate, remainder, or reversionary interest – but also derivative types of ownership such as 'any direct or indirect right to share in the appreciation in the value, or in the gross or net proceeds or profits generated by the real property'. Looking at this list, one may ask, what alternatives are available for foreign investors?

Tax-efficient contracts

The answer to that question is the new ruling, which excludes certain notional principal contracts (NPCs) from the definition of a USRPI, if the return is calculated by reference to a broad-based US real estate index. If properly structured, the NPC is not subject to the FIRPTA regime.

So what hurdles must be overcome for the NPC to satisfy the IRS ruling?

Well, in order not to conflict with the aforementioned laundry list, the return on the NPC should not be 'directly or indirectly generated by the property'. This is where the index comes into play. The nature of the index described in the ruling was one that seeks to measure the appreciation and depreciation of residential or commercial real estate values within a metropolitan statistical area (MSA), a combined statistical area (CSA), or a similarly large geographical area within the United States, which has a population exceeding one million. The ruling concluded that due to the index's broad-based nature, the NPC does not represent a 'direct or indirect right to share in the appreciation in the value...[of] the real property'. In other words, the index must be large enough and, if you will, opaque enough, to ensure that the NPC holder has no direct or indirect interest in the real property.

UCITS III structured funds

The broad-based real estate index described by the IRS ruling may – depending on the circumstances – fall within the definition of a 'financial index' in Article 9 of the UCITS III Eligible Assets Directive. This opens the door for all European mutual and hedge funds, whether based in Luxembourg, Ireland, Germany, France, Malta or anywhere else in Europe, to gain tax-efficient US real estate exposure through the use of carefully structured property index-notional principal contracts.

Challenges for family offices building in-house teams

As family offices and high-net-worth individuals increase their expertise in alternative investments, so they need to take a well-planned and focused approach.

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In recent years, high net worth individuals (HNWIs) and family offices have significantly increased their allocations to alternative assets. Mainly driven by the opportunity for superior long-term returns and their entrepreneurial experiences and networks, wealthy entrepreneurial families have enhanced their expertise and structures for investing in alternatives. Entrepreneurs have turned from occasionally making business angel investments into building private equity teams – in some cases extending this to the hedge fund, real estate, infrastructure and commodity sectors.

While some have adopted diversified fund of fund-type approaches across all alternative categories, others have focused on their specific areas of entrepreneurial expertise. Yet common to both approaches is a requirement for well-trained and experienced professionals, who possess in-depth industry knowledge and significant dedication.

Improved structures and well-defined strategy

As a result of the enlarged teams, structures have to be improved. Less organised and uncommitted structures used for occasional business angel projects have to be adapted to the greater complexity of managing multiple projects, implemented by several teams and strong personalities. In addition, changing team structures – depending on the expertise required and the development stage of the targets – often adds complexity.

When making such a transition, remaining flexible enough to adapt to the fast-changing investment environment is challenging. Organisational structures have to be introduced, which allow management to monitor investments effectively and to make the right decisions. These decisions may include introducing fresh expertise to teams, as well as deciding which specific situations justify consulting external resource and service providers. Doing this requires a well-defined strategy and efficient structures – as well as effective information, resource, knowledge and network management.

A defined strategy helps to focus limited resources and expertise to the best possible effect, improving the chances of generating above-average returns. A well-planned approach should, therefore, enable efficient resource management and decision-taking.

Effective information and resource management

In addition to management and team structures, high-quality information systems and infrastructure need to be in place. These enhance the transparency of information management, increase efficiency and allow effective decision-taking. Inefficient information and resource management create lengthy decision-taking procedures.

Effective knowledge and network management is essential for managing complex key issues. Yet this should go beyond information management. Indeed, these factors are essential for composing the right project teams.

The importance of the challenges highlighted in this article are realised, generally, by management, yet they have given them little attention. In order to meet their objectives, however, they must place the topic high enough on their agenda to address all areas of concern, adequately.

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European IMRE News is produced by experts in their particular field at PricewaterhouseCoopers, to address important issues affecting the investment management industry. If you would like to discuss any aspect of this document, please speak to your usual contact at PricewaterhouseCoopers or one of those listed below:

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