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THE ROLE OF REAL ESTATE FUNDS IN TURNING SAVERS INTO INVESTORS AND IN RESPONDING TO CHANGING SOCIETAL NEEDS

It is estimated that the EU real estate sector employs around 4 million people in Europe and **contributes around 3% to Europe's GDP** - the equivalent to both the automotive and telecom sectors combined[1]. An **important portion of such contribution comes from the real estate fund management sector**[2].

The contribution of real estate fund managers is not just an economic one. Unlike other asset managers, real estate fund managers **directly manage "real", long-term assets in which a broad range of economic activities are carried out** (offices, shops, maternity clinics, student and retirement homes, hotels, hospitals etc.). As such:

- They **host a significant industrial ecosystem** of small and large companies as well as an **ecosystem of public-sector buildings** which is relieved from administrative and other burdens (e.g. energy efficient renovations, adaptations etc.), so that it can focus on core business or public duties.
- They have a very **concrete positive impact on the transition towards more socially and environmentally responsible investing**.

In doing so, real estate fund managers are rightly subject to a wide range of property, energy and financial services regulations, providing investors with a **robust environment in which to generate higher than average returns** for the long term.

Therefore, real estate fund managers are **uniquely positioned to support EU political goals for a more sustainable, retail investor-oriented economy** - and this in 3 ways:

- By providing a stable, long term alternative source of diversification from bank deposits - **helping turn savers into investors,** a crucial piece of the Capital Markets Union project.
- By enabling income derived from such investments to complement shrinking state supported pension systems - an **additional source of retirement income**.
- By proactively helping a sector that is the biggest energy consumer and third largest producer of CO2 emissions **transition towards the Paris Agreement climate change targets**.

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[1] Source/ Eurostats, EPRA/InRev data

[2] Around 40% of the EU real estate sector is held as an investment, of which unlisted real estate funds are the largest providers (Source/ Eurostats, EPRA/InRev data)

The COVID 19 crisis has put the resiliency of the real estate funds sector to the test. Yet, little is known about its robustness and potential, and the current EU regulatory framework is not conducive to its development at a time where real estate investing is taking place on an **increasingly cross-border** basis.

To deliver on the above promises, **Europe needs a true EU label that accommodates the growing needs and demands of long-term retail investors** in Europe and beyond.

The basic structure is already in place. The Regulation setting up the European Long-Term Investment Fund (ELTIF) was intended to create an EU label that would drain the demand for long-term investments in real assets – and complement the highly successful EU UCITS label for traditional funds managing securities portfolios. **ELTIF could become the natural home** for all forms of patient investments, be it infrastructure, real estate or private equity. However, its take-up has been very limited.[3]

Hence, with appropriate **recalibrations to both attract retail investors and increase their investment firepower**, ELTIFs would be able to concretely support and help deliver on the above listed EU political objectives (see the annex attached for more details on the key technical adjustments required).

The alternative would be to profoundly restructure the current UCITS label (to allow much more illiquid assets in portfolios), or the legal framework that regulates AIF managers, the AIFMD (to turn it into an AIF product regulation and extend the passport to retail investors) - neither of which appear politically realistic for the time being.

To further enable the **adaptation of the real estate sector to low carbon and energy efficiency objectives**, EU policy makers should ensure that the development of Europe's taxonomy for sustainable finance facilitates the emergence of **sector specific ESG labels.** Here again, real estate actors can help drive adoption of such broad labels, going beyond the Environmental aspects, given the very strong Societal dimension a building encompasses (in its conception and use), such as addressing new ways of living (eg co-living), of working (eg the surge in co-working with COVID 19), or new needs from certain parts of the population (eg adaptation to an ageing population).

[3] It is estimated that only 27 ELTIFs have been established and mainly targeted to institutional investors

Real estate fund managers have an important role to play, and a collective responsibility, in supporting capital markets that can respond to longer-term economic, environmental and societal needs. The fact that they do not just manage the funds, but also the assets in their funds, means that they can tangibly align their actions with relevant political objectives. **But they do need policymakers to provide a delivery mechanism** in the form of a workable EU vehicle for long-term investments that recognizes the specifics of real assets such as real estate.

ANNEX

MAKE ELTIF A TRUE EU LABEL TO FOSTER LONG-TERM INVESTMENT

Regulation (EU) No. 2015/760 of 29 April 2015 on European Long-Term Investment Funds (the "ELTIF Regulation") is a continuation of the policy launched by the European Commission in 2013 to support long-term financing of the European economy.

It is intended to encourage long-term investments in real assets (eg private equity, infrastructure, real estate), while also further deepening the single market by establishing an EU passport so ELTIFs can be marketed throughout the EU to professional and retail investors.

Despite its laudable intention, the ELTIF label is only too rarely being adopted by AIF managers of “real assets”. Below we identify 5 key structural barriers that limit the use of ELTIFs and offer some suggestions for addressing such barriers – focusing on the real estate sector.

1. <u>Restrictions linked to eligible assets requirements</u>

A significant challenge for real estate fund managers and their regulators stems from the **definition of “real assets” in Article 2.6 of the ELTIF Regulation**[4]:

- it contains an implicit negative principle that property is not welcome to qualify as a “real asset”, and that if it does qualify, it must always be part of a broader infrastructure project;
- it attaches conditions of contributing to “smart, sustainable and inclusive growth” which are somewhat vague and subjective

Both of which create uncertainty that prevents the development of real estate ELTIFS.

We believe that **investments in commercial or residential property should be clearly permitted to qualify as eligible assets**, and that the conditions should be clarified, for example by (i) taking into account compliance with sufficiently robust public norms and/or ESG type labels that exist in the real estate sector and meet certain societal needs (eg job creation, housing provisioning) and (*ii*) recognizing that owning commercial or residential

[4] *‘real asset’ means an asset that has value due to its substance and properties and may provide returns, including infrastructure and other assets that give rise to economic or social benefit, such as education, counselling, research and development, and including commercial property or housing only where they are integral to, or an ancillary element of, a long-term investment project that contributes to the Union objective of smart, sustainable and inclusive growth;*

assets over a long-term period (at least 5 years) should not be considered as a speculative strategy.

Restrictions on the ability to launch funds of funds in article 10-d should also be relaxed to allow real estate funds of funds to be launched under ELTIF, alongside EuVECAs and EuSEFs funds of funds.

Finally, to enable the further deployment of ELTIF funds, article10-d should be revised to allow **indirect** (eg via a fund, a holding company or any other type of vehicles) as well as direct investments in eligible assets

2. **Restrictions linked to high entry ticket level for retail investors**

Article 30.3 of the ELTIF Regulation imposes a mandatory €10,000 minimum entry ticket for retail investors and prevents them from investing more than 10% of their portfolio in ELTIFs.

The 10% threshold in particular acts as a real barrier to investments in real estate which tends to be of significant size. Removing, or at least Increasing the 10% limit would encourage stronger investor participation in more productive long-term investments, including real estate assets.

It may also be worth looking into whether the 10 mn ticket entry may be too high for retail investors.

3. **Possible restrictions linked to fund composition & diversification rules**

The fund portfolio composition/diversification ratios in ELTIF[5] are closely aligned to those required of UCITS funds which manage securities (shares and bonds), most of which are listed.

[5] Under Article 13, an ELTIF shall invest 1) at least 70 % of its capital in eligible investment assets; and 2) no more than 10 % of its capital directly or indirectly in a single real asset with a value of more than EUR 10,000,000.

Consideration ought to be given as to whether these ratios are well suited to investment funds that manage long term real assets, most of which are not listed, and also often of a much bigger asset value size.

In addition, the leverage could be other 30% if the manager is able to prove through a stress test that the level is appropriate in term of portfolio risk.

4. <u>Restrictions linked to time limited nature of the fund and total lock-in</u>

ELTIFs are closed-end funds and the Regulation currently locks in investors for the entire duration of the ELTIF's life. This works well for traditional private equity funds which are typically locked in for a 3 to 5-year period and investors redeem their shares upon the sale of the asset.

However, for real estate (as well as some infrastructure) funds, consideration should be given to the possibility of **offering perpetual (so-called "evergreen") fund structures that match the much more longer-term profile of the underlying property asset, coupled with specific long-term liquidity management rules and tools that recognize investors' potential needs for earlier redemption.** The fund would remain closed-end as investors would remain committed to remain invested, knowing however that there would be a carefully tailored liquidity mechanism in place to allow for a phased redemption process if need be.

To further support such phasing out, consideration should also be given to allowing real estate fund managers to organize liquidity in the secondary market, as is the case for the French real estate closed-ended funds (SCPIs) and works well. Article 19 currently prohibits the provision of secondary market liquidity if not provided by a regulated market, which simply does not work for long-term assets which are inherently illiquid.

5. <u>Tax treatment</u>

It will be important to create a certain level playing field across Europe in the tax treatment of income and/or dividends, to ensure the development of a truly cross-border market in ELTIFs distribution.