Credit crunch fails to dent real estate investment sector

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With its biggest market, the UK commercial property sector, in the doldrums for more than a year and the credit crunch casting a baleful shadow over large swathes of the global investment industry, Jersey's property funds specialists might be expected to be considering the future with some nervousness.

However, practitioners say that the growing diversity of its property sector has insulated it against the market difficulties across the English Channel. Meanwhile, in general real estate has so far proved less affected than other types of alternative investment by the financing, valuation and liquidity issues afflicting certain asset classes.

Once heavily focused on the UK, a trend intensified for a while by the exemptions to stamp duty land tax on real estate in Britain enjoyed by Jersey limited partnerships and unit trusts, the property fund sector is increasingly servicing promoters, investors and assets in regions such as Central and Eastern Europe and Asia.

'We are seeing a pattern of assets and investors in funds diversifying away from a UK base, and Jersey has been well positioned to deal with this, given that we have long experience in dealing with the asset class,' says Vic Holmes, chief executive of Northern Trust's businesses in the Channel Islands and managing director of Northern Trust International Fund Administration.

'Apart from complementing its existing range of fund vehicles, this now sets Jersey apart from competition including the Isle of Man, Luxembourg and Ireland. As the market has matured we are now administering a range of real estate fund types including residential, retail, office and industrial funds based in various global locations. There is an increasing interest in real estate as an asset class.'

Russell Turner, managing director of State Street Fund Services in Jersey, says that following diversification into other target markets, especially Eastern Europe, the island's property fund business is today very much focused on a global market. In addition, he says, what has been up to now primarily an institutional asset class is beginning to change as interest grows from retail investors.

His colleague Damien Barry from State Street's specialist property fund services team in Kilkenny, which handles core administration functions for Jersey-domiciled vehicles, notes that the fall in the UK commercial property market over the past couple of years may yet result in a resurgence of business there in the future, since investors are starting to find prices increasingly compelling.

'Up to mid-2007 the trend was to expand assets outside the UK, and there was a sweep toward Europe over the previous 12 months, particularly in the fund of property funds sector,' Barry says. 'That trend appears to have eased back, because people have been watching their investments very carefully amid the general market volatility. Now the UK is increasingly viewed as a potential buying opportunity in the second half of this year, and the market expects to see a renewed flow into UK assets.'

Barry notes that the property sector has typically not used the same levels of leverage as the private equity buyout industry in recent times, but he argues that constraints on credit are being felt by funds. 'There's no doubt that the ability to obtain funding in the wider property market is under more scrutiny that in the past,' he says.

'Leverage has generally not been as big a factor for property funds, but the squeeze on liquidity and its effect on valuation is an issue throughout the investment market. And while the sector is relatively uncorrelated with the wider financial markets, the credit squeeze has resulted a downturn in the values of property assets.'

Andrew Weaver, a partner with Appleby's corporate and commercial practice group in Jersey, says the wider financial market problems have been reflected in the property fund sector, but argues that promoters are quick to react to the changing conditions and to adapt their investment strategy to the different opportunities opening up in the market.

'We had two funds pulled toward the end of last year,' he says. 'They didn't sell because the analysis was that the markets they were investing in were likely to decline. However, the same fund promoters are identifying the new opportunities that are arising. They are looking to structure funds with different levels of leverage and targeted at more opportunistic investors to take advantage of the decline in prices.'

The more awkward credit environment is likely to benefit managers who are less dependent on leverage to deliver results, Weaver believes. 'When a market is rising, it's easy to raise a fund with 80-85 per cent leverage and go in with all guns blazing,' he says. 'But managers will really show they can make money if they can instead leverage at 50 per cent and grab some cheap deals. Those that have a track record and can demonstrate they don't need too much bank financing will be in a good position, as long as they can show sellers they can close a deal and raise the financing.'

The broader scope of property fund investment is bringing new business to the island's administrators but with it new challenges. However, the real estate sector differs from other asset classes in that some of the work specific to the property may be carried out in the jurisdiction in which the investment is made or elsewhere.

For example, Weaver notes, investment in Ukraine or Russia will typically go through an intermediate vehicle in Cyprus, and management of cash flows at the property level is done there or in Ukraine or Russia and fed back to the Jersey service provider. 'What the administrator has to do is build up relationships and understanding with providers in other jurisdictions,' he says.

'To some extent they are familiar with this anyway because with investment in UK property they would be dealing in any case with managing agents. There's always a relationship with a local agent who typically handles a fair amount of the management of individual properties. Nevertheless, administrators do need to learn specific skills related to the jurisdictions funds are operating in. For example, the trustee of a unit trust that owns a UK property has to register for value-added tax, and there are equivalent issues in other jurisdictions.'

Jersey service providers face the constraints of operating on a relatively small island where skills are in strong demand and salary and other costs are relatively high, although the political authorities are praised for their willingness as far as possible to accommodate the growth of the financial services industry by flexibility on work permit and housing rules.

Nevertheless, administrators see benefits in carrying out at least some activities in other jurisdictions, within the limits set by the regulator, the Jersey Financial Services Commission, which insists that oversight and responsibility for functions outsourced elsewhere must remain on the island with the licensed service provider.

State Street has taken advantage of its global reach to establish centres of excellence such as the specialist property fund team in Kilkenny, which brings together a group of experts to handle the accounting elements of the administration business, and which deals with property investment business from State Street operations in other jurisdictions.

'These functions include maintaining the books and records of the funds, production of net asset values, and liaison with managing agents, solicitors, the fund manager and others,' Barry says. The team in Ireland is also responsible for relationships with auditors and various aspects of taxation and regulatory functions in areas such as valuation.

'We carry out all the day-to-day functions required to maintain the books and records,' he says. 'From a client service basis, there is a joint relationship with the Jersey and Irish operations. The structural relationships from a trustee and other perspectives remain the responsibility of Jersey, while operational relationships are maintained with the Irish office. On a monthly basis we're calculating up to 50 structural NAV prices. By their nature these property funds can be quite complex in terms of accounting, tax-driven structures and final consolidation of the numbers for the client.'

Turner notes that in addition to the trend toward outsourcing of property administration, there is increasing demand for consolidation of reporting systems through specialist systems that encompass the managing agent, the fund manager and the administrator. 'Co-ordination of systems between different parties is a significant trend, but it's a major challenge because not everyone agrees on what the best system is for any particular function,' he says. 'You can end up having to run more than one system.'

These challenges are unlikely to be wholly resolved soon, given the paper-based nature of much of the property investment process and the growing diversity of the legal structures, geographical scope and types of investment seen by the funds sector in Jersey. However, participants believe that this complexity, and the need for human rather than just IT skills to handle it, is one of the most powerful arguments for the continuing development of the island as an international centre of excellence in property fund services.

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