





# Independent Non-Executive Directors in real estate

## Current state and future outlook



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**Before moving to his current role, he has been working for Jones Lang in various European countries and, among others, set up their Russia and CIS operations.**

Most European stock markets now require company boards to include Independent Non-Executive Directors (INED), and in some cases, the Directors must comprise a majority of the board.

**T**he position for fund structures is much less clear. In Luxembourg, where so many funds are based, real estate structures are not subject to these requirements. Nonetheless, CSSF, the regulator, is definitely encouraging the appointment of non-executives in Luxembourg, and their appointment is considered to be best practice, so their occurrence is becoming increasingly widespread, but, as yet, by no means universal. This seems to be the case in most other European jurisdictions.

Much has been written about the role of independent directors and their responsibilities. The specifics of property are such that the role of independent directors in real estate structures needs to be explored in more detail.

If companies are being encouraged to have a majority of INEDs on their boards, in the case of real estate fund structures it is very unusual for there to be more than one INED in a structure. This puts a particular responsibility, even strain, upon the INED who in some ways must become a 'Jack of all trades'. If problems should arise, the INED may feel rather lonely and exposed, which is why experience, a robust character, and a certain level of maturity are necessary attributes.

To be successful it is essential for the INED to get to know the organization and the people involved, directly and indirectly, in running it. This should be the basis on which to establish the mutual trust indispensable for the INED to be effective. Although rarely seen in practice in the fund world, proper induction procedures should be a very important step in achieving this.





## Risk monitoring should be a major preoccupation for the directors.

Luxembourg real estate funds have over €50 billion under management. Taking into account underlying SPVs and other structures, there are several tens of thousands real estate rich corporates domiciled in Luxembourg. The Luxembourg 'tool box' contains a veritable cocktail of different corporate animals to cover a wide variety of investment requirements. It is not always appropriate to nominate independent directors. Investors are increasingly expecting them to be in place when they are not directly managing the investment process.

Because the role of the INED in most structures is not defined by any binding legal requirements, job descriptions – if they exist – and expectations vary widely. This can sometimes lead to misunderstandings, or worse. It is therefore essential that these expectations should be clearly defined and agreed at the time of appointment.

It sometimes seems that the main criterion for selection is residency to ensure a majority of "local" directors. While it is important to be able to demonstrate that board decisions are indeed taken in the place of incorporation, the INEDs role goes well beyond this.

Of course, the INED role is specifically one of supervision rather than of execution, but that will involve many different aspects of the investment process. Effective monitoring requires a basis of trust between the parties to ensure open and transparent communication, without which the INED's job is almost impossible.

Efficient boards require timely information. Agendas and board packs need to be distributed in good time to allow for adequate preparation. Only a properly prepared board member can, when appropriate, ask the questions needed to challenge executives' positions.

Most real estate investment structures will not require the committees usually appropriate for quoted companies, such as Remuneration and Nomination committees, and the full board will assume the role of the Audit Committee.

Risk monitoring should be a major preoccupation for the directors. Market and currency risks are common to all investments, and due consideration to AML has become increasingly important.

In considering the suitability of investments for a given fund, apart from the basic criteria laid out in the prospectus, other short and longer terms factors need to be taken into account. This will increasingly include all aspects of ESG characteristics of prospective investment.

Property has a number of more specific areas of risk that require the board's attention. Some of these are more general such as country or market risk. Some are more specific to individual assets such as tenant risk, technical or structural problems, or clarity of title. Financing risks including LTV and interest rate changes leading to problems of debt service provision are of particular concern.

Open-ended fund structures have their own very specific risks.

For smaller structures, it may be necessary to follow quite closely the governance of the structure, including reporting both to investors and to the regulator, property valuations, NAV calculations, and distributions. One particular problem that may arise in Luxembourg is the need for a variety of service providers to be properly coordinated. Small service providers may not always have the necessary skills in-house, whereas larger organizations may not give the right level of attention to smaller “one off” structures.

When the sponsor is a large well-established group with a significant presence on the ground in Luxembourg, basic accounting, reporting, AML functions, etc., should be well covered and the INED will focus on acquisitions and operational aspects. This means ensuring not only that proper due diligence has been carried out and that prospective purchases correspond to the fund's aims as set out in the prospectus, but also that the bases for the pre-acquisition valuations are robust, and that diversified funds should hold sufficiently diverse assets in different locations, to achieve this. Sometimes investment managers can be influenced by the fads and fashions of the investment world. These may be based on genuine economic, technical, demographic or geopolitical trends, which should always be taken into account. Occasionally the justification is only because everyone else is piling into a particular asset class, or location. Then it may well be too late to capture the added value that is forecast.

Previous experience in property is a definite plus for an INED in real estate structures. This first-hand experience may be in investment, development or leasing, as well as investment management or property management.

Many funds hold assets across all the regions of the world so it is impossible to have had this experience in all possible jurisdictions. It will be possible to draw valuable general conclusions having experienced even two or three different markets.

Unless a fund is limited to a single market, it is important that the INED can appreciate how different countries may have very different dynamics and characteristics from his home market. Extrapolation from a narrow base is always a danger.

INSEAD and the Institute of Directors provide excellent groundwork to prepare prospective INEDs for the challenges of their position.

Some jurisdictions suffer from a lack of facilities aimed at maintaining INEDs as fit for their task. Luxembourg is lucky that with ILA and ALFI, directors can benefit from a variety of courses and other events to keep them abreast of the developments in best practice. They also provide an invaluable forum for INEDs to meet and exchange views.

As yet, there is no specific organization for real estate focused INEDs. With growth in the number of larger real estate funds, and the expectation of many investors, this would justify a specific organization for real estate INEDs. ●

