

Pricing under exceptional market circumstances **2020**

Extract from the Open End Fund Pricing Paper



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 **AREF**
The Association of Real Estate Funds

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Introduction

The working group jointly convened by INREV and AREF to consider the pricing of open end real estate vehicles has been developing proposals on best practice in governance over the operation and maintenance of pricing models. Those proposals are well advanced and were due to be issued in consultation this spring.

One area that has been considered by the group is pricing under exceptional market circumstances. The following are excerpts from the group's work. They do not constitute Guidelines or Codes of Practice. However they do record leading thinking on best practice in the governance of pricing and are being released by INREV and AREF to aid investors in, and managers of, open end real estate vehicles respond to the impact on fund operations of COVID-19 .

The final paper is subject to change and is planned to be released for consultation in Q2 2020 and including the proposals set out below.

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Pricing policy under exceptional market circumstances

There are likely to be occasions, during a vehicle's life, where the continued application of normal pricing methodology could result in outcomes that are sub-optimal for investors, for example, under stressed market circumstances which may lead to a suspension or deferral or during a closure process.

This section considers the governance over pricing actions that may need to be taken to respond to such circumstances in the interests of delivering a fair outcome for investors where markets are dislocated, or a vehicle is being closed. These circumstances are not exhaustive, and the principles identified should be applied where continuing to operate an investment vehicle's documented pricing mechanism under exceptional market circumstances to avoid an outcome that is not fair to investors.

Pricing in dislocated markets

There are numerous scenarios that may lead to a dislocation in real estate markets. In some cases, the disruption may last for a relatively short time period, or in other cases the disruption has a longer-term impact.

These circumstances may include:

- Where there is a disconnect between market pricing and valuations;
- When a real estate market ceases to function efficiently; and
- As a result of force majeure.

This may also occur, in times of stress, where the investment manager is forced to sell assets in a timeframe that requires a significant discount to the "fair value" amount, for example, because there is insufficient time for a buyer of these assets to complete full due diligence.

Under these circumstances, managers are faced with a difficult decision – defer or suspend a vehicle due to uncertainty over pricing for investors entering or exiting a vehicle, or remain open but risk pricing of units being materially in error as it may prove difficult to reliably value the underlying assets in a vehicle, particularly where there is limited transactional evidence available. When the valuation ascribed to a material proportion of assets is less certain than under normal markets conditions, the issue or redemption

of units in the vehicle based on that valuation may result in the unintended transfer of value between investors.

In these circumstances, a deferral or suspension of the vehicle may be required, and the investment manager may temporarily change the pricing basis to protect investors' interests.

If an investment vehicle remains open but events dictate that a modification to pricing is required, the sole purpose of that amendment should be to bring about fair investor outcomes and ensure that there is no material transfer of value between remaining and exiting, or new, investors. The investment manager will need to use discretion in determining whether to implement a specific remedy identified in its constitutional documents or whether the particular circumstances had not been anticipated and require a different or new approach to be adopted. In the latter case, the constitutional documents would need to permit this course of action or enable it to be achieved promptly. For this reason, constitutional documents need to be regularly reviewed and amended where necessary.

Recommendation 1: Investment managers should adjust pricing where markets are dislocated, to ensure there is no material transfer of value between remaining and exiting investors.

It should also be noted that, in these situations, the interests of remaining and exiting investors may be in conflict and this position may not be capable of resolution while continuing to treat all investors fairly. Where that conflict cannot be resolved, the interests of the majority should take precedence, unless there is a clear regulatory obligation to act otherwise.

Recommendation 2: The interests of the majority of investors should take precedence, when there is a pricing conflict, unless there is a clear regulatory obligation to act otherwise.

Redemption penalties, an adjustment made to price that is unconnected with the underlying NAV of the vehicle and with the sole purpose of penalising and so preventing redemptions in order to manage a vehicle’s liquidity, are incompatible with this approach.

Recommendation 3: Redemption penalties should not be used as a mechanism to penalise exiting investors.

An investment management house should have consistent governance processes across its platform, including its response to pricing under exceptional circumstances – a “house policy”. That policy should be communicated to investors. Any change in pricing policy decisions should be consistent with that house policy and not at the discretion of the individual appointed as investment manager of the vehicle. For some vehicles, a regulator may provide guidance on how these situations should be managed and this direction should take precedence over any house policy or individual investment manager action. It is acknowledged that different approaches adopted by regulators may lead to a divergence in practice between vehicles. Where no such regulation exists, then the recommendations outlined in this study should prevail.

Recommendation 4: Where markets are disrupted, regulator guidance on managing the situation should take precedence. When no such guidance is available, the investment house should adopt a pre-determined platform approach or “house policy”.

The processes involved in changing pricing policy during a period of market dislocation should be outlined during vehicle creation and maintained up to date rather than being determined reactively in the event of such a situation arising. This applies whether the

processes are driven by the regulator or by the investment manager.

Legally binding vehicle documentation should contain a clear description of how the vehicle will behave in the event of a dislocation in pricing, including an explanation of why the approach being adopted is in the best interests of all investors, both existing and prospective.

The rights conferred on the investment manager to adjust pricing during periods of unusual circumstance should be reviewed on an annual basis, by the investment vehicle board and IAC on behalf of all investors, and the vehicle’s documentation amended for any changes made.

Information in legally binding vehicle documentation should include:

- How the vehicle intends to manage such situations;
- Circumstances under which plans would be implemented;
- When the vehicle would be expected to revert to applying its normal pricing methodology;
- The basis of any adjustment made;
- The communications to be made when the actions planned by the vehicle are being invoked, which should be clear and timely; and

- The computations and data expected to be used for determining pricing in these exceptional circumstances.

Recommendation 5: A vehicle's constitutional documents should include provisions to enable the investment manager to take appropriate and pre-determined actions to amend pricing mechanisms during periods of exceptional circumstances. These provisions should be reviewed annually by the investment vehicle board and IAC and updated as required.

While investment managers are encouraged to consult with IACs prior to implementing any temporary amendment to pricing, the nature of many unusual circumstances may mean that there is insufficient time for the investment manager to undertake such consultation. Further, those investors represented on the IAC may gain an unfair advantage over other investors if consulted prior to any pricing change being announced. Accordingly, this is a matter that the investment manager will frequently need to deal with, on behalf of all investors, without consulting with the IAC. Where the investment manager takes action to temporarily amend its pricing policies, it should disclose the changes made to investors through a circular at that time and also include disclosures in the next annual reporting. The disclosures to be provided should include, as a minimum:

- A description of the temporary change;
- A qualitative explanation of why the temporary change is in the best interests of investors;
- The date the temporary change was implemented;
- The date the temporary change ceased; and
- In the annual reporting only and on a retrospective basis, a quantification of the financial impact on the amounts paid or received by investors as a result of the temporary change.

The management board and any independent representatives, if appointed, should scrutinise the investment manager's actions to ensure that they are proportionate to the circumstances and have been taken in the best interests of investors as a body. The role of an independent representative in pricing is set out at Appendix 1.

Recommendation 6: Investment managers should disclose promptly to investors when a temporary change has been made to its pricing mechanism and the nature of the amendment. Investors should also be notified when the temporary change ceases.

Where market dislocation is significant, and particularly if the vehicle is receiving redemption requests, then placing a vehicle into suspension or deferral may be required. Such action should be led by the investment manager following consultation with any independent representatives on the management board or IAC, the vehicle's depositary and its regulator. Once suspension or deferral has been implemented, there should be open communication with all investors on the investment manager's proposed actions and the adjustments required to pricing to ensure all investors are treated fairly where they are still able to invest or redeem capital.

Full disclosure of the changes proposed to the pricing mechanism and any planned changes to pricing assumptions should be made available to all investors. Actual costs should be tracked against pricing assumptions, retrospectively reported annually to investors and adjusted when material.

Recommendation 7: Full disclosure of the investment manager's amendments to the pricing policy should be made available promptly to all investors. Pricing assumptions should continue to be monitored, amended as required and any changes reported to investors.

Pricing when closing an investment vehicle

Due to their nature, open end vehicles are rarely closed but when this does occur, or a vehicle becomes insolvent, it is exposed to incremental costs of relevance to pricing.

There are a number of scenarios that may result in a vehicle being closed. A key factor is the continued effectiveness of the vehicle as an investment product, for example, whether it still provides sufficient diversification or remains of relevance to investors. As a vehicle's size declines, investment manager profitability is also a consideration, as managers should not be expected to operate vehicles that sustain losses over the long term. Both the investment manager and investors should be able to initiate the process by which a vehicle is closed.

Maintaining diversification as a vehicle shrinks in size due to investor redemptions may result in the portfolio being churned and vehicle closure, both incurring incremental costs. These resultant costs should be borne by all investors (including those who continue to invest or redeem during the closure process) but would not be reflected in pricing under either dual price spread or Cap & Am pricing models unless those models are amended.

Despite its infrequency, the possibility of closure should be considered when open end investment vehicles are designed and launched. The investment vehicle's legally binding documentation should describe the

necessary actions to be taken if this outcome was to occur. However, it is accepted that future events are difficult to predict, and an element of reactive decision-making will always be necessary. Therefore, it is not feasible to be overly prescriptive, but documentation may include details of:

- How the resultant round-trip costs are to be dealt with, as the portfolio is likely to be churned to maintain diversification as a vehicle shrinks prior to a closure decision;
- The trigger point(s) for closure (for example: vehicle distress, change in vehicle strategy, dissatisfaction with investment manager performance);
- Issues influencing the delivery of fair pricing to investors; and
- Proposed actions by the investment manager.

These provisions should be reviewed annually by the IAC, and any independent representatives on the management board, to ensure they remain relevant and are amended as required.

Recommendation 8: A vehicle's constitutional documents should include provisions to enable the investment manager to take appropriate and pre-determined actions to amend pricing mechanisms when a vehicle is being permanently closed. These should be reviewed annually and amended as required.

A vehicle should only be proposed for closure by the investment manager following consultation with the management board, including any independent representatives, as well as the depositary. This should occur before presenting a closure proposal to the IAC, and subsequently all investors. Before any consultation with the IAC takes place, the vehicle should be suspended in order to ensure no existing investors gain an advantageous position by exiting early and avoiding the costs of termination.

The final decision to close the vehicle should be put to an investor vote, with a recommended threshold of 75%, in the absence of any regulatory requirement or statement in the vehicle documentation. If this decision is agreed, the vehicle effectively becomes a closed end product, and INREV and AREF guidance on closed end vehicles should apply (See the [INREV Guidelines](#) and [AREF's Code of Practice](#)). The vehicle should also be permanently closed to new subscriptions (with the possible exception of dividend re-investment plans). The investment manager should lead the closure

process in consultation with the IAC and any independent representatives on the management board.

Recommendation 9: A vehicle should be placed into suspension or deferral immediately prior to closure being proposed to investors and the IAC.

Recommendation 10: The investment manager is expected to consult firstly with its independent representatives and subsequently with the IAC before the decision to close a vehicle is finalised.

Once suspension or deferral has been implemented, there should be timely and open communication, with all investors, on the investment manager's proposed actions and the adjustments required to pricing to ensure all investors are treated fairly when investing or redeeming capital.

The cost of selling a vehicle's asset portfolio to facilitate its closure should be borne by all investors. Where such costs arise from insolvency, they will automatically be reflected in the investment vehicle's NAV, and hence pricing, by applying accounting rules for assets and liabilities when an entity ceases to be a going concern. When a vehicle is in a closure scenario, but remains a going concern, a separate mechanism is required to ensure that the costs of terminating a vehicle

are borne fairly by all investors once the decision to close a vehicle has been taken. The price investors pay to enter or leave the vehicle should reflect these costs, requiring the pricing mechanism to be adjusted accordingly.

Recommendation 11: The costs of closing a vehicle should be borne by all investors and the pricing mechanism should be adjusted as necessary to ensure this occurs.

Full disclosure of the changes proposed to the pricing mechanism and any planned changes to pricing assumptions should be made available to all investors. Actual costs should be tracked against pricing assumptions, reported to investors in the annual reporting of the investment vehicle and adjusted when material.

Recommendation 12: Full disclosure of the investment manager's future proposals for the vehicle and proposed amendments to the pricing policy should be made available promptly to all investors when a vehicle is being closed. Pricing assumptions should be monitored, amended as required and reported to investors.

Both the classic dual price mechanism and Cap & Am should operate effectively when

a vehicle is being closed. For the classic dual price spread, it will be necessary to ensure that there is no build-up of a mismatch between historical acquisition costs actually paid, or settled, and the amounts of spread contributed or deducted on entry and exit respectively. The unamortised costs in a Cap & Am model should naturally wind up to zero as unamortised costs are clawed back on exit. When closing an investment vehicle, it is important that the impact of using actual historical cost, current replacement cost or future deployment cost is considered.

Alternative closure scenarios, such as on the sale or merger of a vehicle, have not been considered as part of this study.

Other matters of relevance to pricing policy under exceptional market circumstances

Pricing policy applicable to secondary markets

The secondary market can provide investors with an opportunity to buy or sell units in an investment vehicle that may offer a more cost effective route to acquiring an interest compared to the issue of new units or where the primary market in units is disrupted.

When a secondary trade occurs, the vehicle's published price will usually form the starting point to which any discount or premium to be paid by the buyer is applied. Therefore, it is important that the price, the underlying NAV

and other relevant information are disclosed to provide maximum transparency when setting the price.

The spread between the premium on NAV for commitments and the discount on redemptions provides a natural range for the strike price of a secondary trade. The official NAV of the vehicle should be explained in detail so that investors can negotiate the price and it should be noted that if the NAV is not derived from assets and liabilities held at fair value, such items should be considered, and adjustments negotiated between the parties when agreeing the price. Areas where adjustments to price may need to be considered include:

- Fixed-rate debt;
- Real estate valued according to “stabilised”¹ valuation concepts;
- Unamortised transaction costs (where the investment vehicle uses the Cap & Am pricing methodology);
- Transfer taxes avoided;
- Latent capital gains; and
- Non-controlling interests in other vehicles.

Information on the NAV, items not held at fair value and any unamortised transaction costs should be clearly disclosed by the manager

on request from the seller to allow both the buyer and seller to understand the difference between quoted NAV and the secondary market price on offer.

Recommendation 13: When investment vehicles are traded on the secondary market, information should be disclosed on the published NAV, quoted prices in the primary market, any unamortised transaction costs and any significant asset or liability incorporated within NAV that is not fair valued and may otherwise distort the secondary market price.

See [INREV Liquidity module](#) and [AREF Code of Practice](#) for general guidance on secondary markets.

Issue of units for less than the normal set offer price

There are occasions when a manager may wish to raise new capital at a price below the quoted price for the investment vehicle that would result from the normal operation of the investment vehicle pricing model, for example where transaction costs are below the normal level as would be the case for capital expenditure on existing assets, or where an investment vehicle has become stale and existing investors have agreed to new capital being issued at a discount. Under such circumstances, new investors would be

able to acquire units in the investment vehicle at a price less than existing investors have paid and who risk being diluted. Under these circumstances, existing investors should have the right of first refusal, proportionate to their existing holding. If the equity raise target is not reached, from existing investors, third parties can then be invited to subscribe to the remaining units. Relevant disclosures should be provided to investors, by the investment manager, to enable them to fully evaluate the implications of the equity raise.

Recommendation 14: In specific circumstances, where new capital is being raised with a view to issuing units below the normal offer price of the investment vehicle, existing investors should have the right of first refusal, proportionate to their existing holding. If the equity raise target is not reached, third parties can then be invited to subscribe.

Recommendation 15: When a new capital raise is proposed by an investment manager, at a price lower than the set offer price, relevant disclosures should be provided to investors to enable them to fully evaluate the implications.

¹ Real estate carried at “stabilised” valuation is not carried at current fair valued, but at an alternative valuation including historical cost, at valuation with a smoothing of volatility, or at valuation but based upon assumed “stabilised” occupancy.

Appendix 1: Role of an independent representative in pricing

The role of independent representatives in the governance of open end vehicle pricing should include:

- Acting as an independently minded advocate for the interests of all investors, with a particular focus on protecting the interests of smaller investors and those investors who are not represented on the IAC;
- Annually considering the continued suitability of an investment vehicle's published pricing policy and recommending changes where appropriate;
- Advising investors on the merits of any proposed change to an investment vehicle's pricing methodology;
- Scrutinising any proposed temporary changes to an investment vehicle's pricing mechanism due to market dislocation or other circumstances;
- Where that dislocation is so significant as to require an investment vehicle being placed into suspension or deferral, consulting with the investment manager on proposed actions;
- Scrutinising any proposals to close an investment vehicle made by the investment manager;
- Reviewing key decisions on the implementation of any proposed investment vehicle closure plan;
- Reviewing and endorsing any communications and disclosures with investors on proposed changes to pricing mechanisms;
- Reviewing disclosures in the annual reporting to ensure they fairly and accurately reflect actual transaction costs;
- Annually reviewing the effectiveness of the control environment over the operation of the investment vehicle's pricing methodology and information disclosed on its effectiveness; and
- Annually reviewing the documented process for adjusting pricing in the event of investment vehicle closure.

Independent representatives are expected to act independently when participating in collective decision making.