Secondaries for Open-End Funds: Another Step Toward Even Greater Liquidity

Point of View is an occasional PREA Quarterly *column offering the opinions of leading individuals in real estate. The* PREA Quarterly *welcomes opinions from PREA members on significant issues affecting our industry.*

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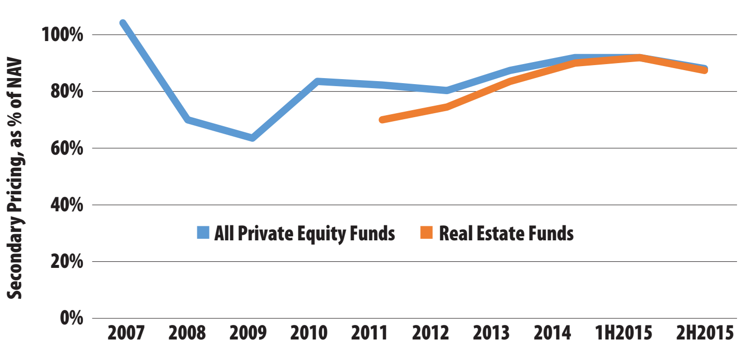
The secondary market for limited partner interests in real estate funds has undergone tremendous growth the past few years. CBRE Capital Advisors estimates that secondary market volume for real estate funds totaled between $10 billion and $11 billion in 2015, with annual volume having grown at around a 30% rate for several years. While some of the recent growth has been driven by a few large transactions, Greenhill Cogent has declared that "real estate is here to stay" as part of the overall private equity fund secondary market and estimates that real estate now accounts for 19% of the overall market.[1]

Pricing of secondary deals for closed-end funds has also risen as the overall real estate market has strengthened, as seen in Exhibit 1. While large discounts to NAV were the norm a few years ago, discounts have narrowed substantially (albeit they increased somewhat in the second half of last year). Looking at the pricing for secondaries in private equity funds in general, which is available over a longer time period, prices appear pro-cyclical, so prices for real estate funds going forward will depend on the state of the market. However, secular as well as cyclical changes are occurring in the secondary market. It used to be assumed that sellers who tapped the secondary market faced distress and/or needed liquidity and therefore would accept large discounts, especially post–financial crisis. Today, the nature of the market is changing: the secondary market has morphed into a portfolio management tool, allowing investors to rebalance portfolios or redeploy capital to more attractive opportunities. While the benefits of relatively quick rebalancing mean that sellers in the secondary market may still be willing to transact at some discount to NAV, potential buyers should not look at the market assuming deep discounts will be the norm.

Exhibit 1: Closed-End Fund Secondary Pricing



Source: Greenhill Cogent

Most real estate market participants are aware of the secondary market for closed-end fund interests, but an increasingly important part of the market, one that is driven by portfolio management considerations, is the secondary market for interests in open-end funds. According to CBRE Capital Advisors, open-end funds accounted for approximately 10% of real estate secondaries in the US last year, while representing a far greater percentage in Europe, where the market is more firmly established and where about $3.5 billion worth of open-end funds traded in 2015. Given its popularity as a portfolio management tool in Europe, the open-end secondary market is likely to see growth in the US as market participants become more familiar with it.

Getting Around the Queue

Those unfamiliar with open-end secondaries may wonder what the point is. After all, the rationale of an open-end vehicle is to allow capital in or out on an ongoing basis. But while open-end funds provide far more liquidity than closed-end funds, there are still limits that secondary transactions can help overcome. Open-end funds are typically not required to provide funds to those wishing to redeem if such an action would require disposing of assets (which might adversely affect investors remaining in the fund) and are not required to take in capital until assets for investment have been identified (to avoid holding excessive cash). Small redemption requests can be funded from normal cash reserves of the fund (open-end funds held an average 2.9% of assets in cash as of the end of 2015). Alternatively, requests to redeem capital can be crossed with new requests to invest in the fund, using the new capital to pay out the old investors and leaving the underlying property portfolio of the fund untouched.[2] But when demand and supply in the market for units in open-end funds are unbalanced, queues arise. In some cases, these queues entail substantial waiting times before investors are able to effect transactions. As one might expect, entry queues typically occur during strong markets and

1. Greenhill Cogent, "Secondary Market Trends and Outlook," January 2016.
2. Note that the fund is not crossing these orders in a legal sense; the orders are structured as two separate transactions, and we are referring here to just the effective result. Further, funds are not required to match orders in this fashion; in some cases, redemption gates may be kept in place even when new orders are coming in.

exit queues during weak market conditions; the implication is that the liquidity of open-end funds may be impaired precisely when investors would most value it. But even in the absence of queues, open-end fund liquidity is not instantaneous in the same sense as publicly traded securities such as equities. While each fund has unique procedures, typically those wishing to exit must register their wishes before a cut-off date, receiving the payout at the end of the next quarter (assuming no exit queue). That creates a delay of at least one quarter and, if the cut-off date is missed, potentially two quarters. In addition, a time lag usually exists between the date, typically quarter end, on which the investment manager "posts the price" of a unit and the date the trade settles.

Exhibit 2: Example of Secondary Buy Versus One-Year Entry Queue

	Wait in Queue	Buy in Secondary Market
Today: Price Paid		Current NAV + Premium = NAV + P
During Year (in Queue)	Receive Return on Waiting Capital Invested Elsewhere = R	Receive Income from Fund = I
One Year: Net Price Paid	Beginning NAV + Appreciation Over Year = NAV + App – R	NAV + P – I

Secondary market will be net cheaper if

NAV + P – I < NAV + App – R
P < App + I – R
Premium < Total Return to Fund Minus Return on Cash or Alternative Investment During Queue Period

Notes: Assumes the premium includes broker fee for the secondary transaction. For simplicity, we ignored two small issues given the relatively short time frame and near-zero short-term interest rates: we ignored any return earned on interim income paid out by the fund during the year (compound interest) and the effect of the time value of money on the premium paid.

Costs: Real and Perceived

The secondary market does not offer instantaneous liquidity, with deals typically taking two to six weeks to facilitate via brokers. And there are costs, including brokerage fees, the premium or discount paid or received, and the loss of the option to rescind orders. Even so, such trades potentially offer a significant step forward in terms of liquidity for real estate investors.

In a private, brokered market, fees vary from deal to deal and over time, but brokerage fees of 25 bps on the notional value charged to each side of the transaction are not unusual in today's market.[3] These costs are direct, easily measured, and must be incorporated into any decision on whether a secondary market trade makes sense.

Perhaps the most important cost in the secondary market is the premium or discount from NAV that a transaction might entail. In the closed-end fund market, the seller is usually seeking liquidity and thus is willing to accept a discount to NAV. For open-end funds, the demand for liquidity may come from either the buy or the sell side as investors look to enter or exit investments, so open-end secondaries can trade at either a discount or a premium to NAV depending on market conditions and the net demand and supply for the funds. Phil Barker of CBRE Capital Advisors notes that "we have seen a range of open-ended fund pricing from a high of a 6% premium to a 6% discount for certain UK and European funds, with the US having seen 4% to 5% premiums paid for some core-plus funds with long queues last year. More recently, small implied discounts have been observed, albeit fleeting, earlier this year, after taking into account the trailing NAV timing and income factors."

Why would, for example, buyers pay a premium to NAV when they could simply wait their time in the queue and invest at NAV? Does this imply that a buyer paying a premium is paying "too much" compared to waiting in the queue? Not necessarily. Consider the example in Exhibit 2: a secondary market purchase today compared to waiting in a one-year queue to invest in an open-end fund directly. A purchase in the secondary market may involve a premium to current NAV, but waiting in a queue entails an opportunity cost: the foregone income that would have been received by putting capital to work immediately. Further, an investor that waits in the queue does not end up paying today's NAV but rather the future (unknown) NAV when the money is actually accepted into the fund. The estimated appreciation of the fund's NAV during the time in the queue is therefore an extra cost to waiting. The net result of this is that a secondary market purchase will actually be less expensive than waiting in a queue if the premium is less than the total return to the fund (minus any return earned to cash or another investment alternative while waiting in the queue) during the time spent in the queue. For example, a secondary market purchase at a 1% premium of a fund with an expected income return of 4% and expected appreciation over the next year of 1.5% would on a net basis be cheaper than waiting in the queue, as long as cash earns less than 4.5% during the wait.[4]

This does not mean that buying in the secondary market is always the best choice. The future return on the fund (especially

3. Whether both sides of a transaction are charged a fee may vary if the broker's mandate comes from only one side.
4. Similarly, when secondary market pricing involves a discount to NAV, sellers need to balance the discount and income they would give up against any potential depreciation in the fund they might foresee, the return earned on proceeds of a secondary sale, and other benefits from a quick sale and the enhanced liquidity.

the appreciation portion) is unknown. If the market turns and the fund's value falls, waiting in the queue would have been the better option.[5] There is always risk as future returns are not known today—a secondary involves paying a known price today and receiving income starting now, versus foregoing that income and paying an uncertain price in the future. Determining which avenue is optimal depends on the expected return to the fund, current interest rates, the length of the queue, and the premium. Neither strategy is guaranteed, but investors can take those factors into account to come to a reasoned decision.

Further, a premium-to-NAV secondary price may not, in fact, be purely a premium for immediate access (liquidity). The price in a secondary transaction is generally quoted as a premium or discount against the last recorded NAV. While this was the last official "price," it may no longer represent the true value of the fund interest at the time of the secondary transaction. For instance, the NAV of a fund may be $10 as of December 31, and a secondary transaction might take place on January 31 at a price of $10.30, implying a 3% premium. But buyers on January 31 are not getting a unit that is still worth $10; they also receive one month's worth of accrued income and any estimated appreciation in value between December 31 and January 31. The premium of the secondary price over the true economic value of the fund at the time of the transaction might be substantially less than 3%.

Pricing of open-end secondaries takes into account income accrual, expectations of future fund appreciation, and a potential liquidity premium. If priced appropriately, a secondary transaction can be a win-win situation for both sides. Using the case of a premium to NAV as an example, the buyer gets access to the fund with the economics outlined above, and the seller receives a value greater than the last NAV. Most important, both sides transact quickly, allowing for rapid rebalancing of their portfolios. The ability to easily and quickly rebalance real estate portfolios, and the ability to do so on an ongoing basis if required, is the key benefit to the open-end fund secondary market. According to Barker, "The increased liquidity provided by the secondary market mechanism clearly enhances the functionality of open-ended fund investing—the certainty of timing and execution price is clearly valuable to some investors."

An additional factor is the loss of the option to rescind orders inherent in investment queues, a more subtle cost to secondary markets. Optionality arises when an investment sponsor allows investors in the queue to change their minds about a previously indicated action without penalty. For example, consider an investor submitting a redemption order. While that order sits in the queue waiting to be fulfilled, the investor usually has the option to reverse the decision and remain in the fund. Anecdotal evidence suggests that many exit queues in open-end funds following the financial crisis disappeared over time not because all redemption requests were paid out but because some "sell" orders were canceled as the market recovered. The option to negate an order depending on market conditions has a value to investors, and as with all options, the more volatile is the market, the greater the value. An argument is sometimes made that by transacting (almost) immediately in the secondary market, investors give up this option. However, this cost may be lessened as the existence of an active secondary market constitutes its own type of option. Investors considering exiting a fund via the secondary market could, if they want, exit immediately. But if the option to wait is particularly valuable to them, nothing is forcing them to sell on the secondary market immediately; they could observe market conditions and keep open the possibility of a secondary sale in the future. The simple existence of the secondary market means that an investor always has the option to exit or not exit at any time; increased liquidity creates its own options for investors. In our view, the loss of the "free option" to cancel orders is less a real cost of secondaries and more a perception.

Because the relative value of utilizing the secondary market rather than waiting in a queue depends on future fund returns, some say that the secondary market is really for "market timers." However, that misconstrues the situation. Our assumption is that the decision to invest in (or divest) the fund has already been made and the decision timing is done—the question now is simply whether it is better to enact that decision (almost) immediately and pay a known price or wait and pay an unknown price in the future.

The secondary market may or may not, depending on market conditions and expectations, be a more cost-effective way in which to transact open-end fund interests. There is no guarantee which method will turn out to have been the best choice. But beyond cost, the secondary market provides a more-immediate and liquid avenue for real estate investing, allowing investors the ability to quickly rebalance portfolios and implement investment decisions. The correct decision of how to buy or sell open-end funds depends on market conditions and the situation of the specific investor, but at the very least, a secondary market for open-end fund interests creates new options for investors and is another step toward greater liquidity for real estate as an asset class. ■

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5. Although if the market was expected to go down, the market-determined premium would presumably fall, perhaps even turning into a discount.