Improving the liquidity of secondary units in unlisted property funds

Simon Berrill & Tom Jackson, Macquarie Capital Advisers

According to the European Association for Investors in Non-listed Real Estate Vehicles (INREV), there are 107 unlisted property funds with a 'UK only' focus, (of which 64 are closed ended) with a total GAV of c.£69bn. Given the size of the UK unlisted property funds market, one might expect there to be an inherent level of liquidity. However, this is currently not the case.

In fact, of the 66 UK funds tracked by the Association for Real Estate Funds (AREF), just 0.2% (c.£120m) of aggregated GAV was traded on the secondary market in the six months to 31 December 2008. By contrast, a reasonably deep and well established secondary market has become established in the private equity fund market, in which up to 7% pa of outstanding equity is traded in various forms of secondary activity annually.

The growth of unlisted funds in the property sector has been extraordinarily rapid in the recent decade, and the lack of liquidity has not been uppermost in investors' minds. That has changed as the recent survey of investors undertaken by INREV has shown.

Reasons for developing market liquidity

There are compelling reasons for investors and fund managers (FMs) to promote the development of secondary market liquidity. These include:

- Investors needing to recycle cash to meet underlying redemptions;
- Investors needing to recycle cash to meet capital commitments elsewhere;
- Investors suffering the denominator effect needing to rebalance portfolios;
- Investors / FMs looking to repair balance sheets and protect gearing covenants; and
- FMs looking to safeguard goodwill with LP investors.

Unsurprisingly, the impetus to do so has been heightened by recent events in both the property and the credit markets.

Defining 'liquidity'

What then would be the required volume of annual secondary trading for the UK market to be considered sufficiently liquid? Clearly this is a highly subjective question but, in Macquarie's view, a 5-10% churn of the total equity would provide investors in these vehicles with comfort that there was sufficient secondary market activity so as to provide liquidity should it be required. This would translate to an annual secondary market trading volume in the order of £3.5-7bn, based on INREV's figures.

However, trading volume alone will not be sufficient to demonstrate a liquid market. Pricing is also important. Secondary units in unlisted funds should probably trade on average at a discount to the underlying NAV of no more than 20-25% greater than the prevailing discount seen in the listed market.

It is clear that the market is nowhere near this level of secondary trading. So what is holding back liquidity?

Barriers to UK secondary market liquidity

The current illiquidity in the direct property market is affecting the liquidity of indirect funds but there are a number of other factors that are also contributing to secondary market illiquidity, the subsequent lack of trading volume and the excessive discounts to NAV seen on those trades that have taken place. These include:

Limited capital awareness of this space

At present trades within the UK secondary market are executed on an ad-hoc match-bargain basis. In many instances, the few active brokers in the market do not have access to a joined-up, global distribution platform and instead broker trades within their existing, typically UK/ Euro-centric, client base. It is rare that US / Asia-Pac / Middle Eastern investors are presented with UK secondary opportunities.

In addition, since the secondary market for UK unlisted real estate funds is relatively immature, most investors have not transacted in this space, and are not aware of the opportunity such trades can present. As a result of these two factors, the weight of capital with visibility on secondary opportunities is relatively small.

Inability for purchasers / vendors to establish likelihood of 'best price'

There is no pooling of sell-side orders by a single intermediary and therefore the opportunity for a single purchaser to have sight of all available sell orders at any given time, is not provided. Therefore neither offeror nor, most importantly, the bidder knows that they are getting 'best price'. Bidders are often concerned that there might be a seller at a much better (i.e. lower) price and therefore hold off.

Lack of information provision on a fund secondary opportunity

At present, it is often the case that purchasers will price in an additional discount to NAV to reflect the level of uncertainty around the lack of viable due diligence they have been able to undertake on a fund – effectively an additional risk premium. This is because, to date, FMs have, in many instances, been relatively uncooperative with regard to the provision of full fund due diligence materials, such as the latest fund valuation and property reports, as well as strategy and business plans for assets held to fund expiry.

The complexity of the underwriting process

In most instances, the level of due diligence required for undertaking a secondary investment is greater than that required for a primary investment into an unlisted fund. This is because a secondary investment is made typically once a fund has completed its investment period and is therefore fully seeded, with a capital structure in place. Many bidders have limited resources to undertake such detailed research.

The lack of visibility on pricing of opportunities

Aside from the complexity of the underwriting process, purchasers have the difficult job of correctly pricing secondary opportunities. This is because the level of disclosure on comparable trade settlement prices is poor, and therefore market comparison points are few and far between.

The complexity of the execution and settlement process

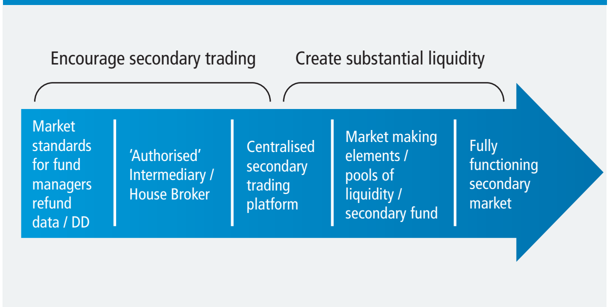
The execution of secondary trades is often an administratively intensive process, with considerable resource required, not only to bring parties together initially at an agreed price for a match-bargain trade to take place but also for the follow on process of due diligence material provision, agreement of heads of terms (HoTs) and settlement. More often than not FMs struggle to commit dedicated management resources to overseeing this process, especially given the typically low trading volumes.

The complexity of trade execution can be exacerbated by the need to apportion equity distributions depending on the agreed settlement date, as this then affects the total consideration price paid for the secondary units, (in accordance with the agreed pricing to NAV).

Finding the solutions to secondary market illiquidity?

We believe that by addressing the barriers to secondary liquidity identified above, market liquidity can and will emerge. There are a variety of ways in which this could be achieved, from execution of basic match-bargain trades, (already facilitated by some FMs) to a full-blown secondary market. However, there are a number of points on the way, exemplified in Figure 1 below.

Figure 1: Steps towards secondary market liquidity



Whichever solution the market gravitates towards, there are some key points that have to be addressed in order to circumvent existing barriers to liquidity:

- Information must be standardised – It is vital to standardise the method by which secondary buy-side opportunities are presented to investors, so that opportunities are initially flagged in a format that provides investors with return metrics and enough information to make an initial 'investment in principle' decision. The use of a standardised 'opportunity overview' form, providing a tablet of verified fund overview information and return metrics at various pricing points, will undoubtedly assist new capital to access the market.
- Facilitation of buy-side underwriting / due diligence analysis – It is essential for FMs to work together with intermediaries to produce verifiable due diligence information at both the asset and the fund level, including the use of virtual data rooms made available to pre-qualified investors.
- Standardised execution / settlement framework – Intermediaries would need to adhere to this. Such a mechanism, together with standardised documentation around completion of HoTs, and unit transfer requests, as well as specific timeframes for process completion, should reassure new capital to the sector that the secondary trade execution process is one which can be relied upon when transacting.
- Aggregation of all sell orders – By creating a 'pooling' of vendors in the same fund, a purchaser could take reassurance that, at any given time, they could achieve 'best price'.

House broker services

We are of the opinion that a 'house broker' service provides for many of the suggested solutions to overcoming the illiquidity of the unlisted real estate fund secondary market.

This approach removes a number of the inherent conflicts that arise from a FM attempting to undertake secondary trade execution 'in-house'. Furthermore, it redirects the management resources and administrative labouring to the intermediary house and away from the FM. The house broker is responsible for the production of all initial opportunity promotion materials, and for sourcing buy-side interest via its own distribution platform (which in many cases will be more global in its reach, than that of the FM, thereby attracting a greater pool of capital). The house broker is then also responsible for maintenance of a virtual data room and facilitation of all due diligence material provision to the interested buyer pool (working closely with the FM to aggregate up-to-date asset and fund level information).

From the purchaser's point of view, the house broker role ensures that all sell orders for a given fund are available through a single intermediary, thereby ensuring that, across a given time frame, 'best price' is achievable, and volume requirements are more likely to be met.

Similarly, from the vending LP's viewpoint, buy-side competitive tension is created and each LP knows that it will have the opportunity to meet a purchaser's bid (within a given time frame), and be cleared at a given price pro-rata, should there be other LP offers at the same level.

We are a long way from a perfect secondary market for unlisted property funds. There is a clear need for improvements to the flow of information, greater standardisation of market materials, the provision of verifiable due diligence information and the provision of a formalised execution / settlement process if we are to increase liquidity significantly. In the short term, the house broker relationship could provide these characteristics.