Secondary liquidity and misleading NAVs

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When we talk about indirects, we refer to investing in property and gaining an exposure to real estate by buying units in a fund that holds properties, rather than actually purchasing a physical asset directly.

Over the last 20 years there has been a rise in closed-ended sector specialist funds. There are many advantages to these:

- Sector specialist management skills;
- Lower transaction costs;
- Diversified exposure;
- Access to larger lot sizes; and
- No primary liquidity removing 'cash drag'.

A key attraction of this form of investment, relative to holding a physical property, was perceived to be increased liquidity; units within a fund are homogenous and can be traded in varying volumes on the secondary market with low transaction costs. However, there has been criticism on a regular basis that unlisted funds have failed to provide improved liquidity and are, in fact, less liquid than physical property.

This article explores whether unlisted funds really are illiquid and the reasons for this perception.

Comparing unlisted funds with the listed sector

It is interesting to compare the respective liquidity of the unlisted and listed sectors, given there is a general perception that stock market listed funds offer ongoing liquidity.

SEGRO is a publicly-listed company that aims to "be the best owner-manager and developer of 'industrial' properties in Europe and a leading income-focused REIT." Well-established and comprising a large portfolio of high-yielding industrial property, the Industrial Property Investment Fund (IPIF) is a good comparable in the unlisted universe.

Figure 1 shows the relative trading volumes of IPIF and SEGRO as a percentage of units/shares in issue from July 2009 to March 2013 – the period since SEGRO acquired Brixton.

Since July 2009, 57.7% of units in IPIF have been traded. This compares to 64.0% of shares in SEGRO. The level of trading within SEGRO is very consistent over time, while IPIF has shown larger variations in volume from one month to the next. This is not surprising given IPIF has only around 100 unit holders.

This is only one example, so cannot be used to provide definitive proof of liquidity. However, it does show that these two investment vehicles running similar strategies offer similar liquidity.

In the listed sector, market makers provide continued liquidity. There are no market makers in the unlisted sector; brokers such as JLL and GFI have done excellent work in recent years to match buyers with sellers but the lack of a market maker does technically reduce liquidity.

There is liquidity in unlisted funds, but not at NAV

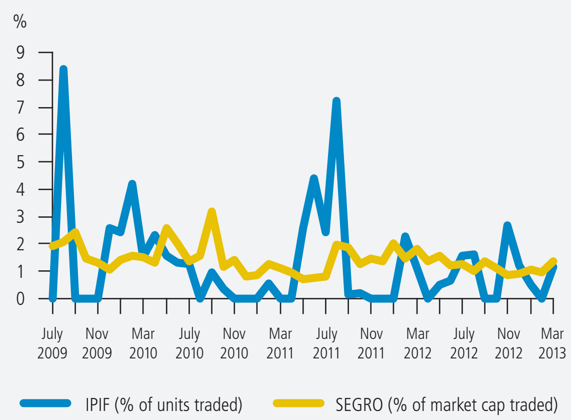
A key area affecting liquidity, or the perception of it, is pricing.
A report bid and offer is provided and updated continually for REITs. Investors can then hold any REIT investments on their books at a price very close to a realisable value. This realisable value may be above or below the net asset value (NAV) of the underlying assets within the REIT.

Unlisted funds also trade at premiums or discounts to NAV, although funds do not report a realisable value. Funds such as IPIF report NAV on a monthly or quarterly basis, with investors usually holding units at NAV. It should be noted that different unlisted funds use different accounting standards and so the NAV of two funds is not always directly comparable.

The value of the underlying assets is not a fair assessment of the value of the units. The NAV comprises the current valuation of all properties within the fund plus cash, less incentives, drawn debt and capital provisions. An adjustment may also be made for any mark-to-market valuation of any swap contracts, although this is not always included.

The underlying properties have been valued in accordance with Red Book requirements, which capitalises the expected future cashflow. Valuing unlisted funds at NAV does not do the same, as an owner of units does not receive the cashflow of the underlying property. Instead, they receive a cashflow that has been altered to take a number of things into account, including fees, debt, transaction costs, operational expenses and cash. Debt particularly may increase or decrease the expected future income stream.

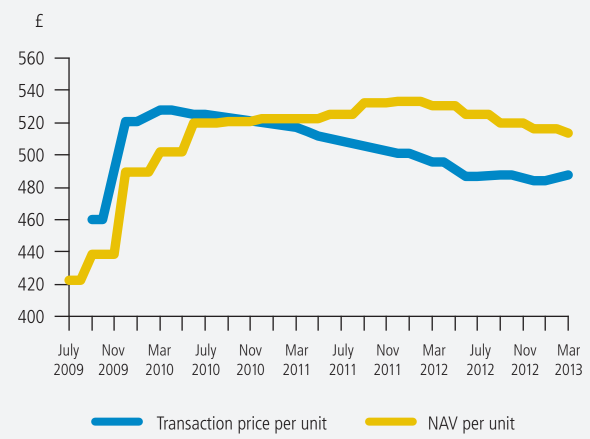
Figure 1: Trading volumes of IPIF & SEGRO



Source: State Street, SNL

Sophisticated investors in the unlisted space are modelling expected cashflows on units in funds. One element of that cashflow is rental income. Amongst other things, investors will assess sustainability, the strength of corporate governance, the manager's reputation and track record, and liquidity. All of these, as well as the underlying portfolio, impact the price a unit is worth. An entry price is then derived that would deliver the required rate of return to investors.

Figure 2: Trading price vs. NAV per unit of IPIF



Source: State Street, SNL

Holding unlisted investments at NAV does make sense if, as an investor, you have no intention of selling your units and expect to exit at fund expiry, when all assets have been sold and something near to NAV is returned. But, if there is any intention to trade, the units' NAV is not a fair measure of worth.

To believe that unlisted funds are illiquid because you cannot trade them at NAV demonstrates a misunderstanding of what they are and how they trade.

Calculating fair value

An independent valuation of units in a fund can be procured. These valuations look at the expected cashflow generation, underlying assets and market comparables of trades within similar funds. A number of fund management houses already receive these regularly for the units they own. This allows them a better estimate of realisable values at any given point, particularly important if the units are held in a vehicle with investors subscribing and redeeming units. The fair value assessments are not guaranteed sale prices; they are best estimates, using all available evidence, in the same way that a property valuation is.

There is a commonly-held view that the price unlisted units trade at will be affected by the volume of units being sold, therefore a single fair value is not valid. This is, however, the same in the listed market; equity dealers assume that if they were to trade more than 10% of the daily volume they will move the price.

The argument against a fund being held at 'fair value' rather than NAV is that there are no observable prices as, unlike a REIT, it is not a publicly-traded vehicle and the only disclosed metric is the NAV. However, with the inception of trade platforms there is increased market transparency. A number of funds already report the price of trades executed, but this information could be more openly reported and by a wider range of funds. This would improve the market evidence available, thereby providing a more accurate estimate of realisable value.

The argument for unlisted funds to be held at NAV is also less compelling following the regulatory pressures imposed by IFRS 9 and IFRS 13, which are now coming into effect. Both policies encourage a move away from holding vehicles at NAV in favour of fair value. Fair value is defined by IFRS 13 as: "The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date."

Even if calculations of NAV were uniform across all funds, it is not an accurate measure of value as it does not (like the RICS Red Book valuation) derive a valuation from a future cashflow, but rather a simple aggregate of assets and liabilities at any given point in time. The continued use of NAV as the basis of valuing holdings in unlisted funds creates a perception of illiquidity, as NAV is not an achievable sales price.

Impending regulation, in the form of IFRS 9 and IFRS 13, as well as improvements in market transparency, dictate that the independent valuation of units should be the way forward. This is especially true for unit holders in open-ended, frequently traded funds, who need to know what their realisable assets are at any particular point in time.

Unlisted funds can provide liquidity – easily-divisible ownership, with low transaction costs and fast settlement makes them an attractive addition to liquidity management, as well as holding them purely for performance reasons. But they need to be held at a realisable value and not at NAV.