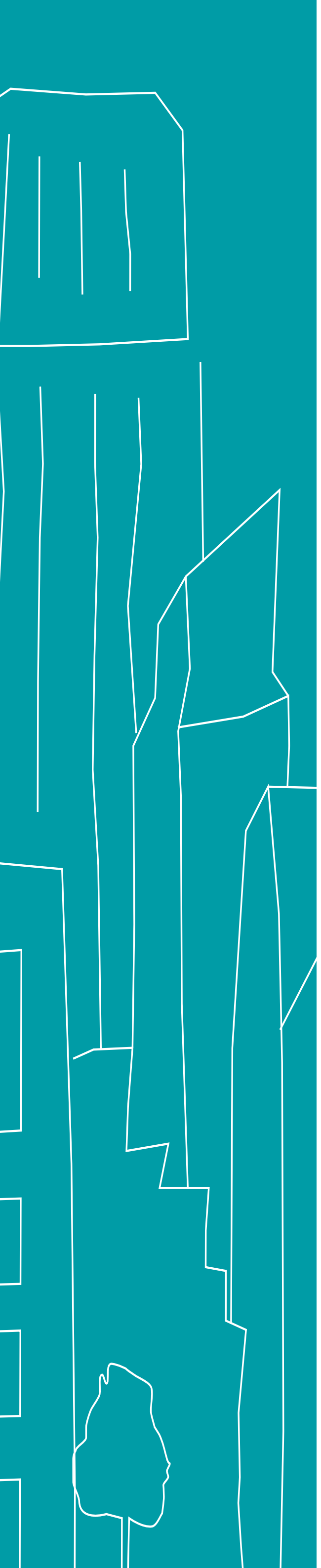

Open End Fund Pricing Conclusion Paper
2021

Professional Standards

INREV is the European Association for Investors in Non-Listed Real Estate Vehicles. Our aim is to improve the accessibility of non-listed real estate vehicles for institutional investors by promoting greater transparency, accessibility, professionalism and standards of best practice.

As a pan European body, INREV represents an excellent platform for the sharing and dissemination of knowledge on the non-listed real estate industry.

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Executive summary

> Pricing policies in open end real estate vehicles shelter investors from the impact of dilution. Recommendations made to improve the governance around pricing aim to:
>
> Deliver a fair and transparent outcome to all investors.
>
> Encourage the growth of European open end diversified core products.

The number of European open end institutional investment vehicles and the value of funds under management have grown steadily over the last few decades. Despite this success, European investment vehicles lack the scale of US-style Open End Diversified Core Equity (ODCE) vehicles and the deep and active secondary trading market that their scale permits. Nevertheless, there are opportunities to further develop the European marketplace by promoting more efficient and transparent market practices that better serve the needs of investors and improve understanding and governance of the pricing of vehicle units and/or shares[1].

Costs of trading European real estate are often significant. Investors have different preferred models to systematically and equitably allocate these costs between different investor vintages. This has contributed to a degree of market fragmentation in terms of their treatment. One reason driving this divergence is that in certain key markets, such as the US, transaction costs are not so significant and consequently the relative effectiveness and impact of fund pricing models in minimising dilution and treating investors fairly is not a key consideration for investors that is widely analysed.

In phase 1 quantitative modelling demonstrated that the two common methods used for pricing institutional open end real estate investment vehicles, Classic Dual Price and Capitalisation and Amortisation (‘Cap & Am’) are both effective in allocating transaction costs between different vintages of investors and protecting existing investors against dilution.

In phase 2 practical recommendations are made to support both investment managers and investors in establishing pricing policies under both normal market conditions and during exceptional circumstances. The recommendations are wide ranging and include proposals to enhance disclosure and to increase the scrutiny of investment managers in ensuring that pricing models are designed and operated to deliver fair and transparent outcomes for all investors. Specifically, these proposals are intended to ensure:

- Transparency with investors over why the selection and design of the pricing model for a new investment vehicle is in their best interest;
- Active monitoring of pricing models and assumptions by investment managers throughout an investment vehicle’s life, and regular reporting to investors on the operational effectiveness of the model and the accuracy of its underlying assumptions and data; and
- Fair treatment of investors, as part of the fiduciary duty of care of the investment manager.

The final list of recommendations that will be included in the INREV Corporate Governance Guidelines is provided in this report.

The choice of pricing model, the way it is operated, and its impact on value dilution have been the focus of this two-phase project and its recommendations. However, pricing is only one factor in determining investor outcomes. Investors should continue to take a balanced approach to investment decisions by also considering qualitative factors such as investment strategy, manager’s track record and portfolio diversity. These are some of the factors expected to have a greater influence on investor outcomes. When making an investment decision, it is not recommended to focus on the pricing models alone. However, by adopting appropriate governance around pricing actions, this contributes to better outcomes for investors in the long run and helps accelerate the development of diversified open end real estate investment vehicles in Europe.

1 For sake of clarity, pricing in this paper is referring to the mechanism used to determine the issue price of units and/or shares by the investment vehicles. It is not related to the valuation of the investment vehicles’ assets.

Introduction and background

- Phase 1 of this project promoted an enhanced understanding of two commonly used pricing models, Classic Dual Price and Capitalisation & Amortisation.
- Phase 2 explored current pricing practices and aimed to deliver practical recommendations that should benefit both investment managers and investors. The final list of recommendations, to be included in the INREV Corporate Governance Guidelines, is provided in this report.
- These recommendations should bring about increased transparency and relevance, as well as improved oversight, to ensure pricing policies are operated effectively for investors.

Trading real estate properties in Europe, and other jurisdictions, can incur significant transaction costs. Therefore, it is standard practice for open end real estate investment vehicles to adopt pricing models that seek to equitably allocate such costs between investors in different subscriber vintages, as they leave or enter a vehicle. The impact of any sub-optimal design or operation of pricing models in this context is commonly referred to as dilution and, if not managed effectively, acts to offset the benefits to be obtained from investing in commingled products, such as risk sharing and diversification.

Consequently, transparency over the choice of pricing mechanism applied to the issuance and the redemption of units and/or shares of vehicles and the way it is operated should be areas of interest both to sources of capital contemplating investment in a vehicle and existing investors making hold or sell decisions.

To address this concern, INREV, the European Association for Investors in Non-Listed Real Estate Vehicles and AREF, the Association of Real Estate Funds launched an industry-wide project in 2017 to investigate pricing models used by open end real estate investment vehicles.

The first phase was completed in July 2018 and undertook a quantitative research on the effectiveness of the two most common pricing policies – Cap & Am and Classic Dual Price, and the principal factors influencing pricing outcomes. It concluded that both pricing models are effective in minimising investor dilution but did not produce identical outcomes for investors.

In the second phase, an expert group, appointed by INREV and AREF, researched areas where operation and governance over pricing can be enhanced. In May 2020, INREV published together with AREF a consultation paper that set out these detailed recommendations.

These recommendations were opened to member consultation until 15 September 2020 and INREV received a total of 20 responses from members. They were predominantly investment managers located in Continental Europe, the UK and North America, with ten out of the thirteen managers represented in INREV's ODCE Index providing responses. No significant geographical trends were noticeable in the responses. Two responses were received from investors and their advisors but none from other service providers.

Based on the feedback received, the proposed recommendations on pricing were divided into two categories. The first group was validated through consultation albeit some edits were made to clarify the meaning of those recommendations. The second group has wider application than the governance of pricing alone and will be further considered as part of INREV's work on corporate governance.

This report presents the final set of validated recommendations on pricing. These recommendations will be formally incorporated as best practice in the upcoming update of the Corporate Governance module of the INREV Guidelines. In the meantime, market participants may also consider adopting these recommendations immediately, as far as they are applicable to their products and structures.

INREV would like to thank all respondents for their contributions to this consultation exercise, as well as to the focus group members and other contributors to the report for their support and guidance on this project. More details on the consultation paper and the project are available on the INREV website.

Section 1

Best practices on the pricing governance of open end funds

Best practices on the pricing governance of open end funds

This section contains the final list of recommendations on the pricing governance of real estate open end non-listed investment vehicles. These recommendations will be incorporated as best practice into the INREV Guidelines.

1.1 Pricing policy under normal market conditions

OEF 1.1: When creating an investment vehicle, the investment manager is responsible for selecting a pricing mechanism that is likely to provide the fairest pricing outcomes for investors and has regard for the requirements of the target investor market.

OEF 1.2: Once the pricing methodology has been determined, the investment manager should include details in all appropriate constitutional documents at vehicle launch. Investment managers are encouraged to include pricing information in all other relevant vehicle documentation communicated to potential investors.

OEF 1.3: All information relating to pricing mechanisms, disclosed in vehicle documentation, should be clear and unambiguous.

OEF 1.4: The investment manager should include the reasons why the chosen pricing methodology was selected, why it considers this model to be in the best interests of investors and states clearly whether the disclosures made comply fully with the INREV Guidelines.

OEF 1.5: As a minimum, the accuracy of pricing assumptions and operation of the published pricing methodology should be reviewed on an annual basis and pricing assumptions adjusted where necessary. This review and the resulting adjustments to pricing should take place more frequently where circumstances require and details of any changes to pricing assumptions should be reported to investors on a timely basis.

OEF 1.6: Pricing should only be adjusted to improve accuracy. It should not be adjusted for other commercial reasons, such as managing inflows or outflows of capital.

OEF 1.7: Constitutional documents should set out the investment vehicle's approach to situations resulting in the dilution of investors' interests through, for instance, the absence of incremental transaction costs or any pre-emption rights being offered.

OEF 1.8: In specific circumstances and under carefully defined conditions as allowed in the vehicle constitutional documents, where new capital is being raised with a view to issuing units and/or shares 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.

OEF 1.9: 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.

OEF 1.10: All inputs should be considered whenever there is an update to a vehicle's pricing assumptions. However, it is only necessary to amend published vehicle prices where the impact of revised assumptions is material.

OEF 1.11: The results of the annual review of pricing and any adjustments made, including those made on a one-off basis, should be reported annually to investors.

OEF 1.12: For investment vehicles using a Classic Dual Price model, the disclosures should include a three-year retrospective analysis of the effectiveness of pricing and highlight differences between historical, current and anticipated future rates of transaction costs.

OEF 1.13: Where an investment vehicle chooses to operate its pricing model based on an INREV NAV, additional adjustments may be considered to amortisation periods, performance fees, future dividend payment calculations and all related deferred tax impacts on these adjustments as well as non-controlling interest effects, to improve the accuracy of this approach.

OEF 1.14: Amortisation periods of setup, acquisition and financing costs should be adapted to the planned holding period of a vehicle. For evergreen vehicles, asset specific features should determine the amortisation period and, in their absence, a 10-year period is recommended unless there is a specific asset feature which requires deviation from this period. The approach and rationale should be disclosed in the constitutional documentation when the investment vehicle is being launched.

OEF 1.15: Performance fees should be accrued as soon as a reliable estimation is completed.

OEF 1.16: Future distributions that are only attributable to investors pre-dating the INREV NAV calculation should be subtracted from the INREV NAV, for trading purposes.

OEF 1.17: The adjustments made to the INREV NAV where it is used as a basis for pricing purposes should be disclosed at least annually in the annual reporting to investors and where reported, clear differentiation made between INREV NAV and pricing NAV.

OEF 1.18: Under INREV Guidelines, investment managers should facilitate secondary market transactions with qualified investors by making available equally information to current and potential investors, subject to confidentiality agreements. Such information may include 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 measured at fair valued and may otherwise distort the secondary market price.

1.2 Pricing policy in dislocated markets

OEF 2.1: Investment managers should evaluate pricing and consider adjustments where markets are temporarily dislocated, to ensure fair and equitable treatment between remaining and exiting investors.

OEF 2.2: The terms of redemption penalties should be outlined in the constitutional documents. Redemption penalties should not be used as a discretionary component of fund pricing adjustments in dislocated market situations.

OEF 2.3: Where markets are disrupted, regulator guidance on managing the situation should take precedence.

OEF 2.4: In the absence of specific regulatory guidance, a vehicle's constitutional documents should include a pre-determined approach with provisions to enable the investment manager to take appropriate actions to amend pricing mechanisms during periods of exceptional circumstances. These provisions should be reviewed annually by the governing body of the investment vehicle including investors' representatives body, if any, and updated as required following the investment vehicle's normal approach to amending such terms.

OEF 2.5: Investment managers should disclose promptly to investors when a temporary change has been made to the vehicle pricing mechanism and the nature of the amendment. Investors should also be notified when the temporary change ceases.

OEF 2.6: 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.

1.3 Pricing when closing an investment vehicle

OEF 3.1: A vehicle's constitutional documents should include provisions to enable the investment manager to take appropriate and predetermined actions to amend pricing mechanisms when a vehicle is being put into liquidation. These should be reviewed annually and amended as required to ensure the fair treatment of investors if need be during the liquidation process.

OEF 3.2: A vehicle should be placed into suspension or deferral immediately prior to the liquidation being proposed to investors and/or the investors' representatives body, if any, as per the constitutional documents of the vehicle.

OEF 3.3: The costs of the liquidation of a vehicle should be borne by all investors and the pricing mechanism should be adjusted as necessary to ensure this occurs.

OEF 3.4: 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 put into liquidation. Pricing assumptions should be monitored, amended as required and reported to investors.

Transition

Managers should consider practical arrangements to adopt these new best practice guidelines. Constitutional documents should be amended at the next available opportunity as appropriate with the necessary regulatory and investor approvals. Governance and oversight arrangements referred to in these guidelines should be prepared and implemented by the manager to facilitate this transition. Any changes to amortisation periods should be applied on a prospective basis to new assets acquired to facilitate an equitable transition.

Conclusions

The aim of the first phase of the open end fund pricing project was to promote a better understanding of the effectiveness of two common pricing mechanisms used by open end real estate investment vehicles, Classic Dual Price and Cap & Am, and examine whether their methods of calculation provided different outcomes for investors. It concluded that while the two mechanisms produced different outcomes for investors, both were effective in minimising dilution.

The second phase of the project explored the research carried out by the expert group, appointed by INREV and AREF, to consider how the operation and governance of pricing could be enhanced. Current practices were noted and practical recommendations have been made that may be adopted by investment managers and investors to assist in the setting of pricing polices both under normal market conditions and during exceptional circumstances.

Following industry consultation and completion of the final report, INREV has determined the final list of recommendations that will be integrated as best practice into the INREV Guidelines. For the other recommendations, which elicited a wider range of views from market participants and have applicability beyond pricing of units and/or shares of a vehicle, they will be given further consideration as part of INREV's current work on updating its guidelines on corporate governance.

Ultimately, the key objective is to arrive at best practices to support the continued evolution of the open end real estate vehicles industry.

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