Pricing policies for open-ended property funds continue to differ across markets, raising the need for a globally accepted approach

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The period of economic recovery following the financial crisis saw significant developments in the market for internationally diversified open ended real estate funds. A few important general trends are the further institutionalisation of real estate as an asset class and the introduction of the Alternative Investment Fund Managers Directive which establishes a European wide regulatory framework and the strengthening and further utilisation of industry-wide forums and trade groups. In short, the real estate funds industry has increased in size and in sophistication.

The ability to market funds globally has significantly altered the process of product design. Funds now compete for equity globally and, as such, product design must take into consideration the preferences and requirements of investors globally. As of yet, global market consensus has not been achieved on the matter of pricing.

Looking ahead, the key question is: will we see the emergence of a truly globally accepted approach? Or will pricing policies continue to differ across different jurisdictions and industry segments?

Pricing Policies and Liquidity Mechanisms

When compared to closed ended real estate funds, open-ended real estate funds present a range of additional challenges in relation to product design. Chief among these are pricing policies and associated liquidity mechanisms.

The basic problems faced are as follows:

1. A long-term asset class does not lend itself to short-term trading of units;
2. There are high transaction costs at an asset level;
3. Managers may be obliged to sell assets within an impractical timeframe;
4. Failure to recognise these issues exposes investors to a threat of dilution.

These issues can be mitigated and managed through certain means but never entirely removed. Equally, these issues have varying degrees of impact depending on the situation and circumstance of the specific fund.

US versus European Market Practice

If we look at two of the key jurisdictions more closely, we see some of the drivers of these distinctions in pricing policies. Firstly, the US market can be generally defined as having larger funds, lower levels of transaction costs, tighter ‘lock-in’ features and a more active secondary market. These four factors combine to greatly reduce the need for complex pricing policies and as such many of these products simply trade at their contractual Net Asset Value (NAV) with no bid-offer spread or other complex pricing mechanism.

In contrast, the European market can be generally defined as having smaller funds, higher transaction costs, looser lock-in features and a less active secondary market for units. In direct contrast to their US counterparts, these factors combine to greatly increase the need for more complex pricing policies in order to mitigate the four problems listed above. Hence, it has traditionally been common in the market for European open-ended real estate funds to observe ‘dual-price’ strategies where a significant bid-offer spread is imposed to protect investors from dilution. Taken in isolation, these two markets and their chosen approaches make sense. However, the ability to market funds globally has spurred European investment managers to design pricing policies which address the challenges faced while also recognising the expectations of US investors.
APPROACHES TO PRICING

Approaches to pricing for these types of products generally fall into three broad categories:

1. A single price based on NAV
   For many US funds, a single price is established based on the fund’s NAV. The first and most obvious advantage of this approach is that it is the most simplistic. But the most obvious flaw with this model is that it does not consider the dealing costs which therefore means the investors in the fund are fully exposed to dilution. However, it is argued by market participants that there is some protection from these issues in a US context. Generally, funds are bigger, transactions costs in real estate are lower, the fund lock-in features are tighter and there is a highly active secondary market in operation. While these assertions are valid in the US market they could not be considered to be equally valid in a European context.

2. A dual pricing with a bid-offer spread
   Dual pricing seeks to establish a dealing spread in fund units which reflects the transaction costs of the underlying real estate assets. One of the main advantages of this approach from a conceptual perspective is that the cost of trading in units is reflective of the cost of trading in the underlying asset class.
   Dual pricing has traditionally been the favoured option for internationally diversified real estate funds. However, as the market for real estate funds becomes more global and the expectations for US investors are brought into consideration, this policy has come under pressure.

3. Capitalisation and amortisation
   Many of the European funds established in the period following the financial crisis have opted to establish more simple and transparent deal terms including, among others, their pricing strategies. These post-crisis funds tend to use the contractually defined NAV directly for the purpose of subscription pricing. In many instances these contractual NAVs are based on the guidance of various industry bodies such as INREV. This allows for the capitalisation of certain establishment and acquisition costs and the spreading of such costs overtime. This approach makes some effort to protect investors from dilutive effects while also establishing a method of pricing which is based on widely understood market standards.

REACHING A COMPROMISE

Considering these challenges, from an academic perspective, a dual price strategy would, in theory, appear more suitable for internationally diversified funds. However, given the global nature of the industry today, and the desire of investors to have single-price funds, retaining a dual price policy would appear to present challenges from the perspective of marketability.

As a compromise, the capitalisation and amortisation method has some merit and as this approach is being adopted by many new funds it may form the basis of a solution going forward.

While clearly witnessing the emergence of a single price for subscription purposes to facilitate global marketing, we conclude that there is no single ideal scenario as it is. Compromise is inevitable given the multitude of factors in the equation. The expectations of a fund’s target investor base are paramount and the need to strike a balance between academic accuracy and a simple model is crucial.