

## GREAT FUND INSIGHTS

# Covid-19 coronavirus: NAV issues in open-ended real estate funds

The Covid-19 pandemic and resulting government lockdowns have brought intense volatility both to financial markets and the real economy, and a sharp return of challenges that confronted asset managers in the Global Financial Crisis of 2008-10.

## Introduction

This publication focuses on the key challenge currently facing managers of open-ended real estate funds offered to institutional investors: the difficulty of striking reliable valuations of properties under the Covid-19 conditions of:

- generalised market volatility and damage to businesses, particularly in the retail, leisure and hospitality sectors;
- seizure – or severe slowdown – in property transactions; and
- independent valuers providing managers with fair value valuations subject to material uncertainty caveats.

This valuation uncertainty puts pressure on managers' ability to strike a net asset value (**NAV**) for (i) dealings in fund units (i.e. raising new capital by issuing units at a NAV per unit, allowing reinvestment of cash distributions and satisfying redemption requests), (ii) quarterly reporting, and (iii) calculating any management fee linked to the NAV.

The key rationale for suspending the NAV is to avoid using an incorrect NAV per unit or interest which results in an incorrect transfer of value between investors subscribing into, redeeming out of and/or remaining in a fund. It is generally an impossible and unforgiving task to re-adjust holdings of units or interests in a fund and reclaim overpaid redemption cash where, with hindsight, the previously determined NAV per unit or interest is called into question.

Even if the fund's constitutional documents provide that a NAV is binding on investors absent manifest error, a manager who has not complied with the fund's contractual provisions or the rules imposed by the Alternative Investment Fund Managers Directive (**AIFMD**) in relation to determining the NAV faces legal and reputational risk where allegations are made that those provisions and rules have not been properly followed.

Following the suspensions in UK retail offered real estate funds' daily dealings in light of the UK FCA's 2019 rules requiring suspension if there is material uncertainty in the pricing of more than 20% of a retail fund's assets, a number of managers of institutional funds are now considering whether they can strike a reliable NAV for the forthcoming 31 March 2020 quarter date or if they also need to suspend dealings in their funds and use an indicative NAV solely for reporting purposes, caveated with a statement of "material valuation uncertainty".

Managers facing issues of valuation uncertainty should consider the following factors in deciding how to proceed, including the rules imposed by AIFMD.

## What contractual rights does the fund have to suspend calculation of the NAV and dealings in fund units?

Most open-ended funds will include a right for the manager to suspend determination of the NAV and/or dealings on certain specified grounds. However, managers should carefully check the extent of these grounds for suspension. For example, where a fund's independent valuers deliver valuations, but with "material valuation uncertainty" statements (as permitted under the RICS Red Book), that in itself may not be a ground for suspension. More broadly framed grounds to suspend due to events of force majeure beyond the reasonable control of the manager, or where the manager considers suspension to be in the best interests of the fund, are less likely to prompt a later challenge.

Regardless of the contractual position, there is a stigma associated with any NAV suspension due to the perception that it reflects a lack of confidence in a fund which could encourage a rush to the exit when eventually lifted. However, the evidence from the liquidity issues that arose during the Global Financial Crisis was that only a minority of liability-driven institutional investors in open-ended real estate funds sought to redeem, while the vast majority – having allocated for the medium term – retained their medium-term outlook for real estate even if they had lost significant value in the liquid non-alternative parts of their portfolios. Additionally, most open-ended real estate funds established

post-Global Financial Crisis do not include any hard-wired timetable for returning capital to redeeming investors. Rather, the common approach to redemption liquidity is to allow investors a right to request redemption but leave the timetable for meeting those requests in the discretion of the manager (having regard to the best interests of investors as a whole). Where a fund has that approach to redemptions it should reduce a manager's concern that suspending the NAV will trigger immediate redemption requests from investors and allow liquidity events to be deferred until market conditions stabilise. Funds that did not have that discretion during the Global Financial Crisis (including funds of real estate funds) became a targeted source of liquidity for institutional investors because of their hard-wired redemption timetables and some then had to suspend redemptions when they could not meet their stated timetables, which in turn increased redemption requests from other investors.

A number of open-ended funds have suspension mechanisms requiring the investors' advisory committee or equivalent (or even investors as a whole) to be consulted in advance of (or even consent to) any suspension. Managers should also consider whether any investor side letters require notification of suspension events.

## What are the Manager's regulatory obligations under AIFMD?

Under Article 19 of AIFMD, managers are responsible for the proper valuation of a fund's assets, calculation of its NAV and publication of that NAV and have to ensure that any valuation is performed impartially and with all due skill and care (irrespective of any lower contractual standard agreed between the manager and the fund). Accordingly, the manager will need to ensure that it complies with the consistent valuation procedures it is required to have in place in meeting those responsibilities. Those procedures are usually applied by a valuation committee of the manager and should include escalation measures.

As required by Article 23 of AIFMD, investors in each fund will have received details of the manager's valuation procedures. That disclosure is commonly set out in the fund's constitutional documents as having contractual force and may include a standard to which valuations are to be performed (e.g. "fair and accurate"). That contractual valuation standard, combined with the valuation responsibilities imposed by AIFMD on a manager, may in some funds be difficult to satisfy where independent valuers provide caveated valuations (and so the manager needs to consider suspending determination of the NAV).

In this unprecedented situation it is important that managers' valuation committees take care to carefully apply their funds' contractual valuation provisions and AIFMD-required valuation procedures, and that relevant escalation measures are applied and documented.

In practical terms this means that a manager's valuation committee should be convened to consider all relevant factors in deciding whether a NAV can be determined and, if not, whether an indicative NAV for reporting purposes can be determined.

Managers should also note that under Article 21 of AIFMD, a fund's depositary has an obligation to ensure that the value of units in the fund is calculated in accordance with the valuation rules in AIFMD and a fund's constitutional documents. Managers facing issues of valuation uncertainty should therefore engage with the fund's depositary at the earliest opportunity. There should be similar engagement with the fund's administrator where it has a role in calculating the NAV once asset values have been determined by the manager.

## Suspension of NAV and impact on dealing?

Once the NAV is suspended, the number of units or interests in a fund that would be issued in respect of contributions of new capital and cancelled in respect of redemptions cannot be determined.

However, some open-ended real estate funds will still need to be able to draw down undrawn commitments to meet existing cash demands or to prepare for this period of extreme uncertainty. Subject to a fund's constitutional documents it may still be possible for drawdowns to occur on the basis that at some point in the future the manager will be able to determine a reliable NAV for the fund and then extrapolate backwards to the NAV per unit or interest as at the date on which the earlier capital was drawn.

Agreeing an approach to striking a NAV per unit or interest on a retrospective basis will require engagement with all investors and not just those making capital contributions. It may be that a fund's constitutional documents give the manager some flexibility to unilaterally alter the usual rules on striking a NAV under conditions of market volatility or disruption (e.g. postponing determination of the NAV until market conditions stabilise and then drawing a straight line back to the 31 December 2019 NAV for the purposes of fixing an appropriate dealing NAV for each drawdown date between those two points). However, it is more likely that

the fund's documents will need to be amended with investors' consent to specifically authorise the agreed approach to allowing continuing drawdowns during this period of Covid-19 disruption.

The same approach would need to be considered where existing investors in a fund have a right to reinvest allocated cash distributions into units or interests. Where those investors are not willing to waive that right, the manager will have to agree with those investors an approach to determining the NAV per unit or interest at which reinvestments will be made.

For redemptions, due to the typically long notice periods for submitting redemption requests, the speed of the Covid-19 impact means that most funds are not yet facing Covid-19 driven redemption requests. Those may come in due course from some investors. Where a fund has the approach to redemption requests described above, the manager can rely on its discretion as to when to meet such requests. However, for a fund that has a hard timetable and has suspended the NAV or cannot create appropriate redemption cash, there is a risk that the manager may need to look to suspend redemptions in accordance with the suspension provisions in the fund's constitutional documents.

## Should managers report any suspension to their regulator?

This will depend on the rules of the manager's home state regulator under AIFMD and any overlaying regulatory regime applicable to a fund.

Note that under Article 24 of AIFMD, all managers have a periodic obligation to their home state regulator to report on the market risk and liquidity profile of their funds' investments as well as the percentage of fund assets that are subject to special arrangements arising from their illiquid nature.

Managers should pay particular attention to the percentage of a fund's NAV that is subject to redemption requests – whether or not gated – and engage proactively with the relevant regulator(s) as to whether a formal regulatory filing or notification needs to be made.

## What should managers communicate to investors and others?

A fund's constitutional documents typically provide that in the event of any suspension of the NAV, this must be communicated to all investors. Even in the absence of an express contractual obligation, any manager suspending the NAV of a fund should communicate this promptly to investors.

Modern relationships between managers and institutional investors are built on the expectation of open communication and regular and transparent disclosure of material information, particularly during periods when investors are themselves directly affected by conditions of general economic uncertainty and market volatility. Consistency of message is important and so it can be helpful to prepare a Q&A document ahead

of any suspension communication and to maintain discipline in ensuring that all investors are given the same information at the same time.

It can also be helpful to ensure that all service providers to a fund (including any independent directors on the board of the fund or its general partner) are appropriately briefed as to any decision by the manager to suspend dealings in the fund, and the rationale for and expected consequences of this.

Where indicative NAVs are to be struck in lieu of a normal NAV, these should be communicated to investors promptly and with full and clear explanations of any qualifying statements.

## How should management fees be calculated?

Where the management fee is determined by reference to the NAV and the NAV is suspended, the question arises as to how that fee should be determined and this will become a commercial issue. There are a number of approaches that may be adopted. For example, managers may seek to use an indicative NAV as a proxy combined with the straight line approach discussed above, with the manager agreeing that where it is subsequently determined to have been overpaid

or underpaid there is a set-off mechanism to address that (including a similar set-off mechanism for any fee rebates paid to certain investors, if applicable, based on the indicative NAV). Whatever approach is taken, the fund's constitutional documents may need to be amended to address the agreed solution.

