Open End Fund Pricing – Guidelines for AREF Members

Background

The Open End Fund Pricing Project is an industry-wide project conducted in collaboration with INREV.

The first phase was completed in July 2018. Its key purpose was to promote a better understanding of the effectiveness of the two principal types of pricing mechanisms commonly in use, through quantitative analysis, and whether their methods of calculation result in different outcomes for investors. It concluded that both commonly used pricing models, (classic dual and Cap & Am), are effective in minimising investor dilution but did not produce identical outcomes for investors.

In 2020 AREF and INREV launched the Open End Fund Pricing Consultation Paper, representing the second phase of the project, offering insights into the complexities around the pricing of institutional open end real estate funds. The paper and supporting materials can be downloaded here.

Following the consultation period, it was proposed to implement the recommendations in the Consultation as guidelines.. In April 2021 AREF members were given the opportunity to review the guidelines before their implementation in May 2021.

Further recommendations in the Consultation regarding governance matters will be considered by the AREF Corporate Governance Committee during 2021.

Key conclusions

It was concluded that there are steps that can be taken to fine-tune each of the two models individually to minimise the impacts on investors. One example is to increase the amortisation period used under the Cap & Am approach. Another example is to regularly re-set the spread used for the classic dual price model based on actual transaction cost history. Phase 1 of the study also concluded that it may be possible to combine the comparative qualities of both models which may provide improved results for investors.

Both pricing models are popular in their respective regions. The dynamic qualities of the Cap & Am model and its link to established industry guidelines contribute to its widespread use for internationally diversified vehicles. On the other hand, the stability of the classic dual pricing model and its greater effectiveness in reducing dilution makes it better suited to single jurisdiction vehicles as the transaction costs in single jurisdiction vehicles are expected to be less variable.

The supporting document for the Consultation included examples of two calculations for refining dual (bid/offer) pricing:

- Calculating the effective acquisition cost rate (page 3)
- Including the effect of gearing (page 6)

Guidelines

AREF guidelines for the pricing of open end real estate funds for institutional investors are set out below. These mirror the guidelines that have been introduced by INREV. INREV NAV is the most widely used pricing mechanism using Cap & Am. The update to the INREV guidelines proposes to distinguish between INREV reporting NAV, which remains unchanged, and trading NAV which may have a different amortisation period. AREF NAV does not capitalise and amortise acquisition costs so the term INREV NAV is also used in the proposed new AREF guidelines to describe this Cap & Am model.

1 General

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

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.

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

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 state clearly whether the disclosures made comply fully with these guidelines.

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 resulting adjustments to pricing should take place more frequently where circumstances require and details of any changes to pricing assumptions reported to investors on a timely basis.

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.

1.7 Constitutional documents should set out an investment vehicle’s approach to situations that will result in the dilution of existing investors through, for instance, the absence of incremental transaction costs or any pre-emption rights being offered.

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.

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.

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 pricing assumptions where the impact of revised assumptions is material.

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.

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.

1.13 Where an investment vehicle chooses to operate its pricing model based on 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.

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. This approach and rationale should be disclosed in the constitutional documentation when an investment vehicle is being launched.

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

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

1.17 The adjustments made to INREV NAV where it is used 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.

1.18 Investment managers should facilitate secondary market transactions with qualified investors 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 measures at fair value and may otherwise distort the secondary market price.

2 Pricing in dislocated markets

2.1 Investment managers should evaluate pricing and consider adjustments where markets are dislocated, to ensure there is no material transfer of value between remaining and exiting investors.

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.

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

2.4 When no such guidance is available, 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 board including investors' representatives body, if any, and updated as required following the investment vehicle's normal approach to amending such terms.

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.

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.

3 Pricing at the end of life of a fund

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.

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

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

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.