REGULATORY UPDATE

Liquidity Issues in Open-End Real Estate Funds: Key Considerations

Ben Briggs
Kirkland & Ellis LLP

Rebecca Lock
Kirkland & Ellis LLP

Kelly Ryan
Kirkland & Ellis LLP

Paul Sampson
Kirkland & Ellis LLP

Stephen Tomlinson
Kirkland & Ellis LLP

We hope this high-level summary of the primary mechanics that can impact the redemption process will help guide both sponsors and investors in making prudent determinations during this period of economic uncertainty.

Economic uncertainty and the "denominator effect"[1] are expected to continue to create fundraising and liquidity challenges in the near term for the private real estate market. As investors look to rebalance their investment allocations, many open-end real estate funds have received an increasing number of redemption requests. This wave of requests has occurred just as transaction volumes are slowing (making satisfaction of such redemption requests more difficult), mirroring the market reaction in prior times of economic uncertainty, most recently in the immediate aftermath of Brexit and the initial market downturn in response to COVID-19. Recent negative headlines in relation to a number of high-profile funds suggest investor frustration with ever-increasing redemption timetables.

What are the key considerations for a sponsor of an open-end real estate fund that has received a high volume of redemption requests and for investors in these products that need liquidity? The first step is to ensure transparent dialogue—the relationship between the sponsor and its investors is a long-term one, built on trust and pragmatism. Keeping the lines of communication open during times of distress will help ensure that relationships continue long after the market returns to normal.

Thereafter, an examination of the redemption terms in the applicable fund is the next priority. In this article, we lay out some of the most common mechanics (and variations) typically seen in the market.

Lockup Periods

An open-end real estate fund built after the global financial crisis typically has a multiyear redemption lockup period[2] applicable to all investors running from the date of the fund's initial closing and may have an additional lockup period for investors that close (or re-up) later, which period runs from such investor's acceptance date. During these periods, investors are generally unable to request a redemption, although sponsors typically have the right to either waive the redemption lockup period and/or redemption fee/levy (discussed later).

Available Cash

Redemptions occur only to the extent there is available cash, and if there is no available cash, investors' units will continue to participate in a fund's appreciation, depreciation, and distributions until a redemption occurs. Sponsors are (generally) not obligated to sell assets, borrow money, or take any other actions that might have a detrimental impact upon the fund as a whole to create liquidity to meet redemption requests. This is an important protection for non-redeeming investors as sponsors can avoid having to conduct fire sales in times of market distress (and to recognize the timing required to rebalance a portfolio of real estate assets).

1. The denominator effect is the decline in public values in institutional investors' equity portfolios with the result that investors unintentionally exceed their alternative investment targets and, in some cases, need to scale back and reduce investment in private real estate or other alternative asset classes.
2. These lockup periods can be "hard" (with an absolute prohibition on redemption) or "soft" (with a redemption charge payable upon an early redemption).

Fiduciary Obligations

Sponsors need to balance their fiduciary duties to both investors that remain in the fund (seeking long-term returns) and investors that request redemption (seeking short-term liquidity). The divergence of these interests is generally sharpest during periods of instability and market disruption. This divergence can occur not just with pricing but also if transaction volumes are very low and/or if financing is difficult to obtain, resulting in difficult questions for sponsors (particularly if a sponsor believes that a pricing or transaction dislocation in the market is likely to resolve in the near term). Some funds require that the sponsor use "commercially reasonable efforts" to satisfy redemption requests. A few older-vintage funds may offer investors a hard right to be redeemed (as opposed to a right to request redemption), with the sponsor then imposing redemption gates and/or suspensions if it is unable to satisfy redemption requests.

Redemption Queue Mechanics

Open-end funds typically employ one of two mechanics for satisfying outstanding redemption requests:

1. Pro Rata: This is currently the primary market approach. All outstanding requests are satisfied pro rata (regardless of the order in which requests were made), subject to a handful of exceptions for legal, tax, and regulatory considerations. This avoids a "run-on-the-bank" mentality from investors that would otherwise be incentivized to hold their place in the line, creating an artificially long queue.

2. "First-in-Time–First-in-Line" Queues: As the name suggests, with this approach, redemption requests are satisfied in the order requests are made. For the reasons explained earlier, this mechanic is now somewhat outdated and is seen mostly in older-vintage funds. That said, some funds employ a hybrid approach whereby a queue is implemented after redemption requests reach a certain scale (a "springing-redemption queue"). This is often combined with a requirement that the sponsor has to meet redemption requests on an increasing sliding scale for those that have been outstanding for an extended period.

Outstanding Redemption Queue Consequences

Many fund documents set forth specific consequences in the event outstanding redemption requests reach certain thresholds, including prohibiting new investments, permitting investors to vote for dissolution, and/or potentially requiring dissolution. However, the commercial consequences of a large redemption queue can be even more compelling for sponsors. There is the obvious aspect of managing disgruntled existing investors in the redemption queue, with potential implications in respect of multi-product investors' investments across a sponsor's platform. Additionally, large redemption queues can be a significant impediment to fundraising—sophisticated investors will likely inquire about a fund's existing and historical redemption queues (and the plan for addressing any existing queue) as part of their diligence—particularly when combined with depreciating net asset values (NAV). It is important to have good answers to these questions and to ensure a consistent message (in terms of both content and timing) is being delivered to existing and prospective investors alike.

Redemption Pricing

A detailed discussion on open-end fund pricing (i.e., the price at which investors buy and sell their units) is beyond the scope of this article. However, it is worth noting that the way a fund's units are priced is of increasing relevance during a market downturn. This is partly because of the illiquid nature of real estate as an asset class and because real estate carries higher transaction costs than other asset classes; such costs therefore need to be shared among investors in an equitable manner. In addition, and unlike daily-priced equity funds, the process of valuing real estate is both time- and cost-intensive, with several different methodologies deployed and, as a result, less frequently undertaken.[3] In any event, sponsors should be satisfied, from a fiduciary, contractual, and regulatory perspective, that any recent economic disruption has been priced into the NAV. This can be difficult in practice if independent valuers provide caveated valuations, and as such, a suspension of the NAV may be required (see the next section) if a

3. These methodologies can be broadly broken down into two main categories and four subcategories, each of which has its advantages and disadvantages: (1) Single Pricing—"swing" (the NAV is swung upward or downward by a predetermined factor depending on whether the net capital flows are positive or negative) or "NAV" (trades are based on the fund's NAV in accordance with the prevailing financial reporting framework); and (2) Dual Pricing—"classic" (a defined spread exists and is applied to the NAV so that units are bought at a premium and sold at a discount) or "cap & am" (a spread is established using the capitalization and amortization approach, coupled with a defined redemption levy).

sponsor considers it necessary to ensure that redeeming investors do not receive an excessive valuation of their units. Do the valuations of the fund's assets appropriately reflect the current valuations? Should the fund seek new valuations of assets (even if a new appraisal is not yet formally required under the valuation policy)? These are the types of questions sponsors should ask themselves.

Suspension of Redemptions

As mentioned earlier, fund documents usually include the right to formally suspend redemptions and/or NAV valuations upon certain trigger events. Although a formal suspension ultimately has the same impact as a sponsor's determination that the fund has insufficient liquid assets to satisfy outstanding redemption requests (i.e., in either case, redemptions are not satisfied), suspending redemptions and/or NAV would likely be received more negatively in the current market.[4] Consequently, private open-end sponsors have thus far avoided such formal suspensions in the current market, both for reputational reasons and because of the impact such a decision would have on dealing and other operational matters (e.g., the calculation of management fees).

Action Items

Open-end real estate sponsors should consider the following items as they analyze the redemption process and investors' liquidity options:

- Carefully review fund documentation (and side letters) to understand the applicable terms relating to the discussions above.
- Analyze the short- and long-term costs and benefits of having a large redemption queue versus selling assets at an inopportune time.
- Consider all available sources of liquidity as well as short and medium cash needs of the fund for investments, expenses, reserves, and redemptions.
- For funds with a springing redemption queue, carefully review the trigger(s) and consider the implication of investors' creating a "run on the bank" either following or leading up to the trigger.
- Review valuations and consider whether more recent valuations are advisable (even when not required by the fund documents).
- Consider divergent interests of redeeming investors versus the obligation to the investors that are staying the course.
- Weigh up any future adjustments to the fund redemption mechanics to protect against the next market disruption and potential wave of redemption requests.

Just as sponsors should be aware of the mechanics and triggers with respect to the redemption process, investors should understand the redemption mechanics of all their open-end fund investments and the current redemption queues for each fund. Investors should be aware of the lockup periods and early redemption charges applicable in each fund, as well as whether a fund employs a pro rata redemption queue or utilizes a first-in-time–first-in-line process (or a springing-redemption queue). With regard to the latter two approaches, when liquidity is important in the short to medium term, investors should consider whether submitting a redemption request is prudent to reserve a place in line. Investors that are able to remain in a fund (avoiding potentially below-par redemptions in the current market environment) will probably be best positioned to maximize long-term returns. Understanding redemption mechanics and the various available options can help investors think strategically about which funds can provide the desired liquidity in the most efficient manner. ■

Ben Briggs, Rebecca Lock, and Paul Sampson are Partners in the Investment Funds Group, Kelly Ryan is a Partner and the Global Leader of the real estate funds practice, and Stephen Tomlinson is a Partner in the Real Estate Group at Kirkland & Ellis LLP.

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4. Note that a formal suspension of redemptions/NAV is distinguished here from funds (especially non-listed REITs) that are required to satisfy redemptions unless they institute a redemption gate. One notable non-listed REIT has received a good deal of publicity lately around redemption requests, a subsequently imposed redemption gate, and that sponsor's response to raising additional capital. Although the underlying fundamental drivers are similar, the specific mechanics of gates and redemptions applicable to non-listed REITs differ from the mechanics of most private open-end real estate funds.