UK real estate funds: Back to basics

| BY PATRICK LECOMTE |

The recent problems encountered by UK real estate funds reveal the complexity of this asset class, and how vehicles and structures that have been successful for financial assets are often wrongly applied to real estate. When faced with economic stress or market turmoil, these flawed financial structures have been known to fail (for example, property derivatives in the 1990s), and increase systemic risk for the whole economy.

Before forecasting doom and gloom for the UK and global economies, let us go back to basics. Commercial property investments can be classified in four quadrants: They are either listed on public markets or exchanged on private markets, and they can trade as equity or debt. For instance, real estate investment trusts (REITs) represent equity holdings in commercial property that trade in public markets. Mortgage-backed securities represent debt that is traded in the public market. On the other hand, private-equity funds are equity in the private market, while mortgages are debt that can be traded in the private market.

The different quadrants cater to different investors' profiles and needs. Investors looking for the ease to enter and exit property markets as well as transparency will customarily focus on public securities rather than direct real estate, which is notoriously lumpy and inefficient. Investors aiming to generate pure property returns without the interference of public markets will focus on direct real estate.

However, the market for direct real estate is characterised by asymmetric information and illiquidity. This hampers the so-called price discovery mechanism, that is, the process by which transaction prices are determined by sellers and buyers. Anybody who has tried to sell a house in a soft market knows that the lack of liquidity can have a dramatic impact on prices. One gauge of illiquidity in direct property markets is time on the market.

That said, there is no reason that, as flawed as it is, the direct commercial property market cannot serve some investors well. Illiquid property markets do function quite efficiently when investors have a time horizon long enough to allow for orderly transacting of the assets. This is especially necessary when prices are heading south. In extreme circumstances, fire sales at hugely discounted prices may trigger a vicious cycle, involving not only property investors but also banks. That is when systemic risk looms. Even so, investors who can wait out a crisis would eventually be able to realise the value of their direct property assets.

Given this conceptual backdrop, what should happen when there is a major political or macroeconomic event leading to uncertainty and uneasiness such as Brexit? How are direct commercial property investors and fund managers expected to react under duress?

Mismatch of container and content

Commercial properties are driven by macro-variables, intertwined with their specific idiosyncrasies such as location, physical characteristics and tenant mix. At the aggregate level, it is therefore common sense that a change in outlook for the UK economy will have an impact on commercial property markets in terms of both valuation and liquidity.

In the UK, the real estate funds that opted to freeze redemptions were overwhelmingly property authorised investment funds. Originally introduced in 2008 in the UK, the PAIF structure is an open-ended investment company investing primarily in "bricks and mortar" alongside property-related securities such as REITs. Direct commercial real estate and public real estate should account for at least 60% of the total assets of these funds. As pass-through vehicles, PAIFs are exempt from corporation taxes on income derived from their property investment activities. Eligible investors include tax-exempt individuals and institutional investors, for example, pension funds.

A PAIF is a hybrid structure, neither fully public like a REIT nor totally private like a private-equity fund. As a result, they are an oddity in real estate finance, an aberration that does not easily fit into the usual four-quadrant framework. In essence, a PAIF is akin to an open-ended REIT, with a daily single price based on a net asset value (NAV) projection set by its fund manager rather than the market. Unlike REITs, which are closed-ended investment vehicles, the open-ended structure of PAIFs makes them susceptible to redemptions, thus incurring significant liquidity risk in extreme market conditions. A PAIF's holdings of listed securities and cash are supposed to serve as a buffer in normal circumstances.

Although marketed as transparent and liquid, PAIFs cannot easily accommodate sudden requests for redemption. Direct commercial real estate are "slow" assets that cannot be liquidated easily. Indeed, direct commercial real estate price indices, such as those of MSCI, are published quarterly only, and the data lags by a month. In the case of PAIFs, there is clearly a mismatch between the container and the content, and that mismatch may eventually disrupt the commercial property market's fragile ability to adjust smoothly over time to new economic realities, like those of Brexit.

The shortcoming of PAIF lies in focusing on accommodating the tax situation of investors, rather than fostering sustainable property markets. The creators of these vehicles also evidently did not learn the lessons of history. During the global financial crisis, a series of UK open-ended property funds, albeit not PAIFs, halted trading and were forced to sell properties at rock-bottom prices.

Freezing redemptions right

In the wake of Brexit, the managers of open-ended direct property funds are right in suspending redemptions. In doing so, they are protecting all investors in their funds, those with both short- and long-term horizons, while preventing fire sales that could have adverse consequences for the UK economy.

So, how big is the potential problem with property funds in the UK? Out of £800 billion ($1.4 trillion) worth of commercial properties in the UK, these funds account for only £24.5 billion. About 45% of the units are held by foreigners. Reports suggest currency movements have played a big role in foreign investors' decision to cash out of these funds while frothy valuations had convinced many investors to cut their exposure to UK commercial properties even before the Brexit referendum.

Nonetheless, the excessive financialisation of real estate assets, done without paying enough attention to their highly idiosyncratic nature, makes real estate especially vulnerable in case of market turmoil, and a recurrent vector for systemic risk. It is a bad idea to assume that property markets will be liquid and efficient. In a crisis, one should plan for exactly the opposite to be true. E

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