This article sets out the impact of the Covid-19 crisis on open-ended real estate funds offered to institutional investors. In particular, we explore the difficulty of calculating a reliable net asset value ("NAV") in light of the current economic turmoil and the associated legal and regulatory implications of this scenario.

The NAV of open-ended real estate funds is calculated regularly, usually on a monthly or quarterly basis. The accuracy of the NAV relies on the valuation reports produced by external valuers or valuation advisers with respect to the underlying real estate assets. Due to the Covid-19 crisis, virtually all, if not all, of these external valuers and valuation advisers in Europe have activated “material uncertainty” clauses in their valuation agreements. This means that their valuations are heavily caveated and subject to qualifications and assumptions, which in turn makes it difficult to calculate the NAV at the fund level.

A reliable NAV is an essential feature in the operation of an open-ended fund, as it is used to calculate the price at which fund interests are issued and redeemed, to calculate the value of an investor’s interests and the management fee, and to provide reports to investors. Therefore, where the NAV cannot be accurately ascertained, managers are forced to consider the consequences of an unreliable NAV and to also consider whether the NAV calculation should be suspended.

In the UK, certain open-ended real estate funds offered to retail investors have suspended dealings following FCA statements in light of upcoming FCA rules, which require suspension if more than 20 per cent of a fund’s assets cannot be accurately valued. However, this approach has mostly not been followed by managers of products aimed at institutional investors, where there has so far been little appetite for suspensions of the NAV calculation or of dealings generally. Indeed, the CSSF in Luxembourg (which is the domicile of choice for many open-ended funds marketed at institutional investors) has not necessarily considered NAV suspensions as the preferred approach in times of valuation uncertainty.

We set out below the contractual and regulatory considerations with respect to the current valuation uncertainty and its impact on NAV calculations. We also discuss the current practice and views in the market, which has been garnered from our experience in advising a number of leading funds in this sector.

**Contractual Considerations**

**NAV Suspension Rights and Procedures**

The fund documents of open-ended real estate funds typically include a right for the manager to suspend the calculation of the NAV in certain specified circumstances. The grounds on which the manager may exercise this right are generally drafted carefully to afford the manager sufficient flexibility in determining whether the NAV calculation should be suspended.

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**Contractual Considerations**

**NAV Suspension Rights and Procedures**

The fund documents of open-ended real estate funds typically include a right for the manager to suspend the calculation of the NAV in certain specified circumstances. The grounds on which the manager may exercise this right are generally drafted carefully to afford the manager sufficient flexibility in determining whether the NAV calculation should be suspended. Although specific references to “material valuation uncertainty” are rare, fund documents will typically allow the fund manager to suspend calculating the NAV where it considers it not possible or not practical to calculate the NAV.

Nevertheless, if contemplating a suspension, managers should carefully check the fund documents to ensure they are comfortable that the relevant criteria have been satisfied. To the extent these criteria involve an element of the manager’s determination, as is
common, then the manager should also bear in mind its broader legal and contractual obligations, as well as the regulatory overlay that applies to it, as further described below in Regulatory Considerations.

Enhanced governance rights in suspension scenarios (for example, that the manager must consult with the advisory committee before triggering the suspension) have been a focus of investor negotiations in the current market and are a feature of a number of leading funds. Managers will need to ensure they comply with these governance rights and should also check whether an individual investor has negotiated additional protections, such as notification rights, by way of side letter. Managers should also ensure that they continue to comply with the contractual requirements of valuations contained in the fund documents – even if the valuers themselves are placing caveats on their valuations, the manager will be required to continue to procure those valuations on the terms and frequency set out therein.

Consequences of a Suspension: Dealing

Whilst a NAV suspension will also typically result in the suspension of dealings in the fund, including redemptions, for the duration of the suspension, it should be noted that these rights also typically co-exist with the manager’s specific rights to suspend or restrict redemptions. While the manager’s contractual powers to deploy these tools are generally wide, the use of such powers is rightly viewed as a last resort by investors. Consequently, any exercise of these powers needs to be handled carefully from an investor relations perspective and any suspension - whether of the NAV calculation or of redemptions generally - may well lead to a negative feedback loop, triggering further redemption requests and therefore further restrictions or delays on satisfying those requests. In addition, any discussion regarding limits on redemptions will set alarm bells ringing for investors whose memory stretches back to the Global Financial Crisis, where certain open-ended real estate funds experienced a severe liquidity crisis. That being said, it is important to emphasise that the current Covid-19-generated crisis is a valuation crisis and not, at this stage, a liquidity crisis and there has been no rush to the exit by investors.

Rather, some managers have been considering carefully the impact that material valuation uncertainty has on the price at which investors are drawn down. Managers will need to determine the appropriate NAV at which to issue any units to investors following a capital call. It may be appropriate to inform investors that a retroactive NAV rectification may occur in the future once the manager has more certainty over valuations. Applying a retroactive valuation brings with it many challenges when running an open-ended fund, for example where several consecutive capital calls are made from different investors at different times. The CSSF has nevertheless indicated, provided that a manager’s actions are transparent, that it is broadly comfortable with this approach.

If a manager is concerned about pricing and if the fund documents permit them to do so, it may wish to consider offering a right of first refusal to existing investors prior to issuing further fund interests, thereby mitigating risk caused by valuation uncertainty in this context. However, right of first refusal provisions are uncommon in the market and, with respect to funds that are subject to CSSF direct supervision in Luxembourg, it is unclear if the CSSF would accept such an approach.

Consequences of a Suspension: Management Fees

The issue of calculating management fees is likely to be an important topic, on which clear communication will be key. Fund documents are often silent or broadly permissive in terms of how the management fees are calculated in a NAV suspension scenario. While investors will accept that the manager is still managing the fund and is entitled to receive a fee for doing so, there is an open question as to whether the fee basis should be the latest available NAV prior to the suspension, an estimated NAV, or another form of reduced fee basis. The latter option may seem fairer to investors given that, where there is a NAV suspension, this is likely to be associated with a reduction in the value of their own interests in the fund even if such reduction is only temporary.

Where faced with this situation, managers can point out to investors the general acceptance in the market that management fees will be based off the latest available NAV. Managers may also note that, in those funds where the fund documents expressly set out what management fee is payable in a suspension scenario, the contractual approach typically taken is to use the latest available NAV. More innovative solutions such as paying a catch-up rate or set-off mechanism once a more accurate NAV is established could also be contemplated.

In any event, we would recommend that managers communicate with investors clearly and openly on these issues. It will be important for investors to understand the proposed approach that a manager intends to adopt, and if there is a retroactive calculation of NAV, they will be keen to know how this would impact the management fees in relation to the product in question.

Consequences of a Suspension: Secondary Transactions

The suspension of NAV calculation can also impact the secondary transaction market, that is, investors selling their units or shares to third party prospective investors by way of a transfer procedure.

Where investors may not be able to, or feel that it is not advisable to, redeem their fund interests, a secondary transaction poses a potential liquidity solution. Secondary transactions would still technically be possible when a fund has suspended its NAV calculations as the price of the transaction can be freely agreed between the seller and purchaser.

However, in practice secondary dealing prices are often calculated by reference to current NAV. In the context of a NAV suspension (and indeed to some extent in the context of valuation uncertainty even where it does not result in a NAV suspension) it could be practically difficult for a seller and purchaser to agree an appropriate price for fund interests on the secondary market. Existing investors looking to realise liquidity should be aware that purchasers and bidders may request larger discounts to last stated NAV than would ordinarily be expected to account for valuation uncertainty. For opportunistic investors who do still have liquidity, including funds of funds with capital to deploy, this impact on the secondary market could pose an
interesting investment opportunity, the full impact and scope of which remains to be seen.

**Regulatory Considerations**

**AIFMD**

Open-ended real estate funds in Europe will often be managed by European AIFM, who will be required to manage these products in accordance with AIFMD.

Specifically, under article 19 of AIFMD, managers are subject to a rigorous valuation framework and are responsible for ensuring the proper and independent valuation of the fund’s assets, calculation of its NAV and publication of that NAV, and are required to ensure any valuation is performed impartially and with all due skill, care and diligence. Managers commonly address these regulatory requirements by ensuring consistent valuation procedures are followed and larger managers also frequently establish a valuation committee within the manager entity itself.

In addition, an authorised AIFM will be subject to a number of broad principles under AIFMD including a duty to act in the best interests of the AIFs or the investors of the AIFs it manages and the integrity of the market. An AIFM will need to take these broader principles into account when determining whether or not it should suspend NAV calculations. In doing so, the duty to act in the best interests of investors in the AIF should be at the forefront of the AIFM’s mind and the AIFM should ensure it has clear documentary evidence of the options that have been considered by the AIFM and why a decision has been made one way or the other.

In dealing with the current valuation uncertainty, managers will need to ensure continuing compliance with their valuation procedures and their existing regulatory obligations under AIFMD, as well as any contractual obligations, as outlined above in **Contractual Considerations**.

As further discussed below in **Market Practice**, the majority of managers seem to be taking the view that even taking into account the qualifications made by external valuers and valuation advisers, they are able to calculate the NAV of their funds sufficiently accurately.

However, any decision to continue pricing the fund should be carefully weighed against the position set out in the fund documents with respect to NAV suspension and the broader legal and regulatory duties of the fund manager.

**Regulatory Obligations and Luxembourg Product Overlay**

Depending on what regulatory regime applies to the relevant fund, prior regulatory approval may be required to implement a suspension, or in some cases a notification (either before or after the event) to the applicable regulator will be sufficient. In other cases, no regulatory approval or notification will be required.

Luxembourg funds that are subject to CSSF direct supervision (such as Specialised Investment Funds (SIFs) or Part II Undertakings for Collective Investment (Part II UCIs)) will need to notify the CSSF of the suspension of the NAV and provide the CSSF with a copy of the investor communication informing investors of the suspension. The CSSF will likely request to receive information on the rationale for the suspension (e.g. an inability to receive reliable valuations) and ask for regular updates on the evolution of the situation. The CSSF would also closely review the suspension provisions in the fund documents and consider if, in its view, the current market circumstances are covered and accordingly whether a suspension can legitimately be activated in accordance with the fund documents.

Although these are additional procedural steps for managers to comply with, the involvement of the CSSF may give investors additional comfort that the suspension is monitored by an independent regulatory authority.

**Market Practice**

Currently, all the signs point to investors and industry bodies being sympathetic to the situation with which managers are faced. There is an appreciation both that these events are outside of managers’ control and so long as there is no compelling reason for investors to redeem their interests, investors broadly seem willing to weather the storm.

However, there is an inherent tension between the desire amongst both managers and investors to estimate the NAV, and the legal rights or obligations of managers to suspend the NAV calculation if the NAV cannot be accurately determined. The current view of many fund managers of pan-European open-ended real estate funds offered to institutional investors is that, on balance, they can justify the veracity of the NAV notwithstanding current underlying valuation uncertainty and as such, they are continuing to price their funds and calculate the NAV on that basis.

In doing so, managers should continue to comply with general best practice in terms of fund governance, such as ensuring qualifications and caveats on value are clearly disclosed in the reports to investors to the extent necessary, as well as engaging with their investors and/or advisory committee. The investor dialogue is crucial, particularly where investors are nervous about their own economic situation or, as is frequently the case in open-ended real estate funds, are themselves fund vehicles who are subject to their own reporting obligations and rely on the fund’s NAV to meet these obligations. To the extent a suspension is ultimately triggered, then the investor dialogue will become even more important and may also be contractually underpinned in the fund documents.

Market participants will now no doubt have a keen eye trained on external valuers amidst the June quarterly valuations. Many are hopeful that with lockdown restrictions easing across Europe, it may be possible to value underlying investments without the same valuation uncertainty which has been prevalent in recent months and we hope that many valuers are able to remove valuation qualifications as a consequence, and that this trend continues such that the current valuation crisis will ease and a liquidity crisis can be avoided. Otherwise, managers may have to think more seriously about activating their suspension powers.
Key contacts

If you would like to discuss any of the topics in this note, or real estate funds more generally, please contact any of the individuals named below or your usual Linklaters LLP contacts.

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