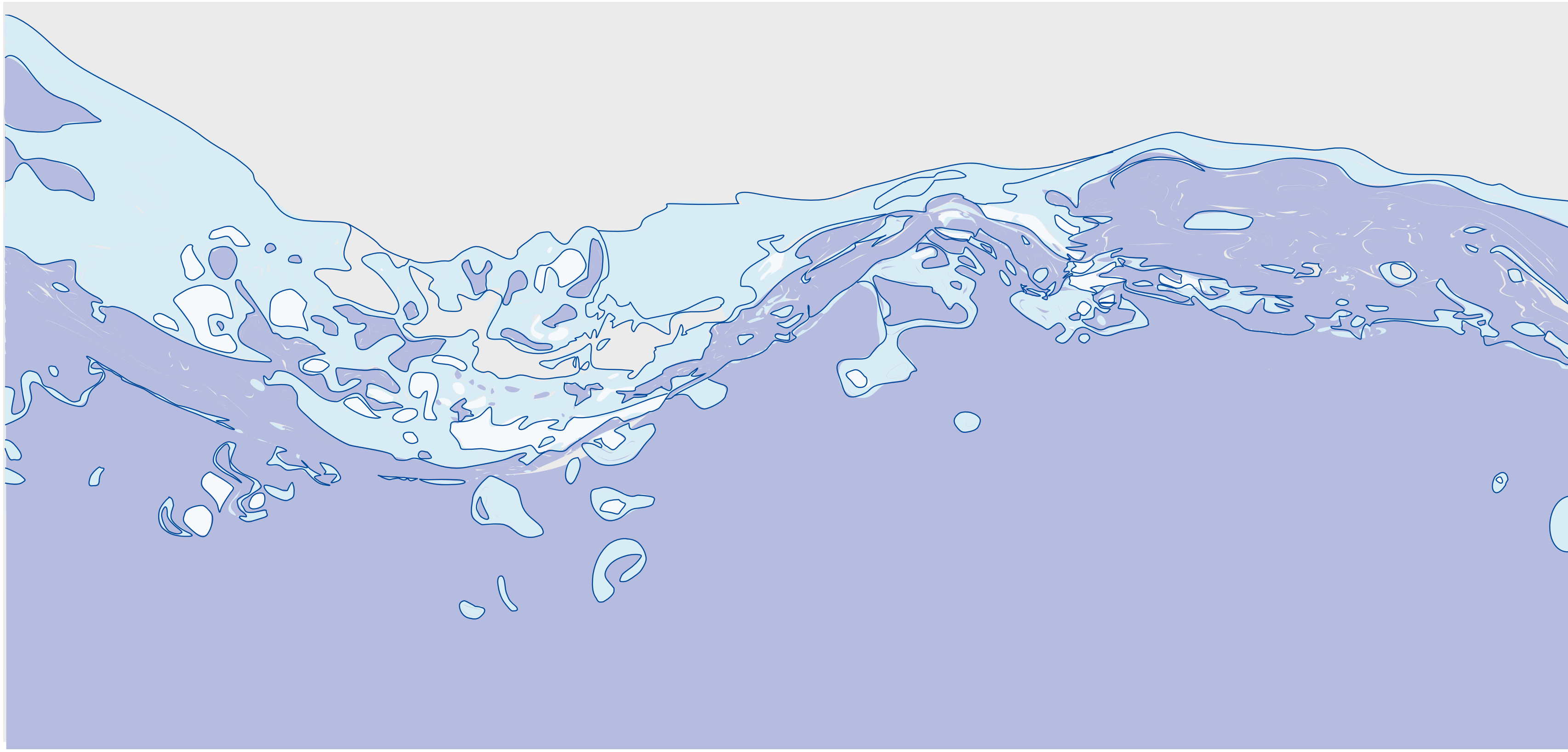

# Guide to Secondary Trading

**February 2018**

Professional Standards

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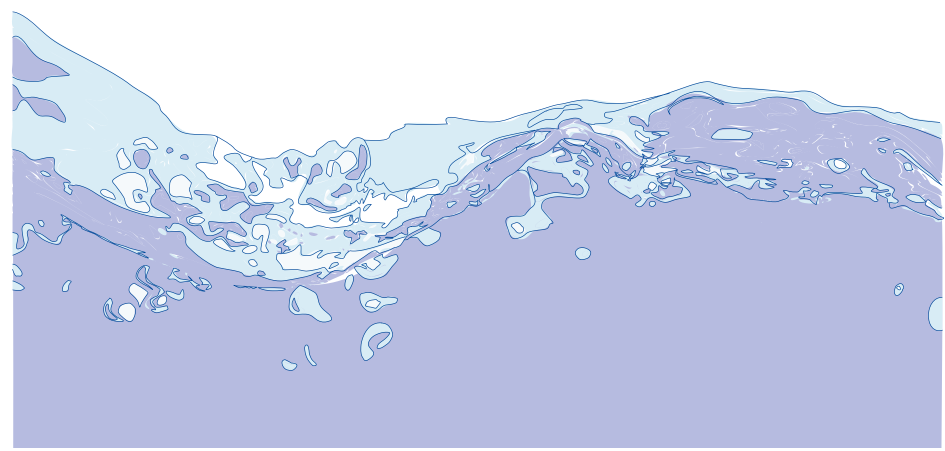
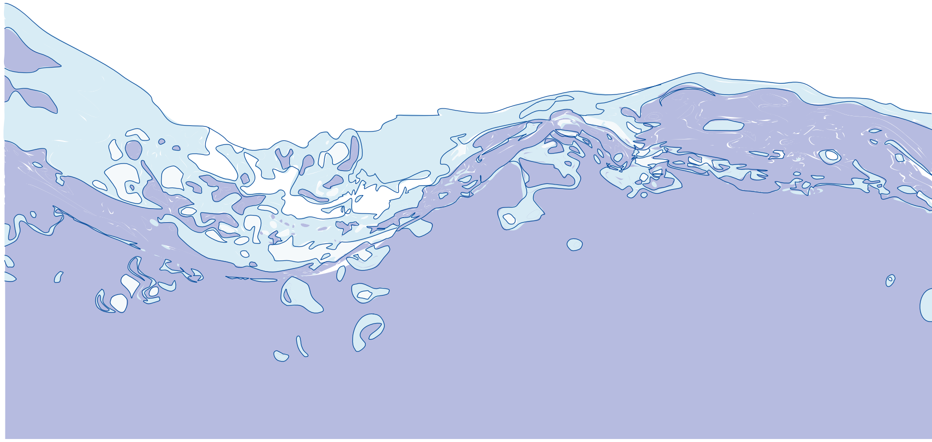


# Contents





# User Guide

# Introduction

Secondary market trading can assist investors with their portfolio construction, reducing reliance on the primary market for principal fund investing and dis-investing.

The secondary market can at times feel impenetrable for investors that have not previously been market participants. This guide aims to demystify some of the language and terminology used, as well as providing some examples of the secondary market at work.

The INREV Secondary Trading and Liquidity Study 2016 found that close to 25% of European non-listed funds have undertaken secondary trading.

According to the report, the benefits of secondary trading include:

- Increasing liquidity for investors
- Exiting closed end strategies that have drifted from their original mandate
- Easier portfolio rebalancing
- Investors in open end funds can spend less time queuing for redemptions or subscriptions
- Improved governance by streamlining manager relationships
- Better guidance by buying into closed funds when the pool is no longer 'blind'
- Easier fund recapitalisations
- Opening up the possibility of buying at a deep discount

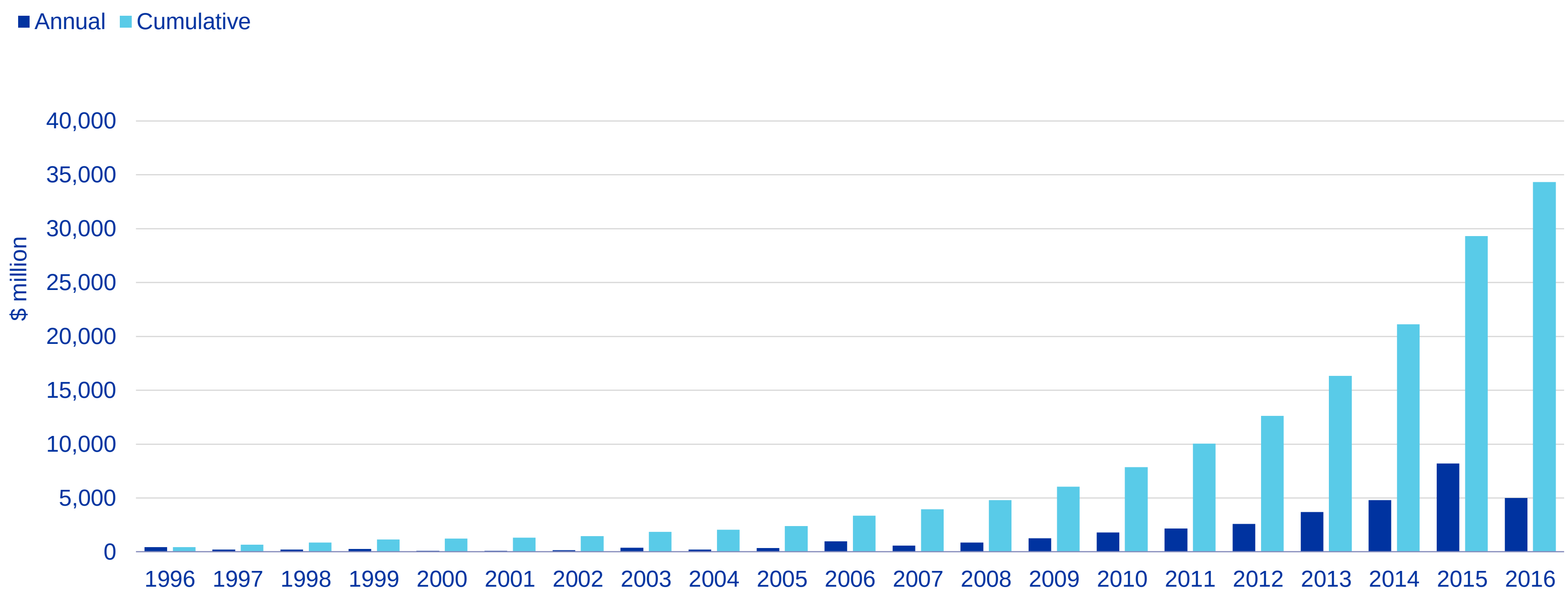
This Guide is designed to explain how transactions can take place in the secondary market, an area where there is still limited understanding in the sector, and thus assist in creating further liquidity in the market.

#  Evolution of secondary trading market

Secondary trading is becoming more common among European non-listed real estate funds. The market for secondary trades has been growing since 1996 and was worth an estimated €5 billion globally in 2016.

The chart below shows an estimate of the trajectory of the global market for secondary trading since 1996. The data is dominated by higher return strategies and therefore core strategies are under-represented.  The data does not include all investor-to-investor trades (for example, a trade such as private endowment selling to a family office may not feature), and as such market size is likely to be under-estimated.

**Market evolution: secondary trading volume in global real estate since 1996**




Source: Landmark Partners

# Structures

Standard non-listed real estate fund structures vary by country and region, with each structure having certain regulatory and legal requirements in relation to secondary market transactions.

Although each structure has its own specific requirements, tax transparency and purchase/disposal taxes (for example, stamp duty) are the factors most relevant to secondary market pricing.

Fund structures that are often seen by INREV investors include:

- Fonds commune de placement (‘FCP’)
- Société d'investissement à Capital Variable (‘SICAV’)
- Société d’investissement en Capital à Risque (‘SICAR’)
- Société d’Investissement à Capital Fixe (‘SICAF’) (Luxembourg)
- Organisme de Placement Collectif en Immobilier (‘OPCI -FPI’)
- Société de Placement à Prépondérance Immobilière à Capital Variable), (‘OPCI – SPPICAV’) (France)
- Spezialfond / GmbH&Co / Immobilien-Sondervermögen / Spezial-Sondervermögen (Germany)
- Società di Gestione del Risparmio). (‘SGR’)
- Real Estate Investment Fund (‘REIF’) (Italy)
- Commanditaire Vennootschap (‘CV’) (Netherlands)
- Jersey Property Unit Trust (‘JPUT’), (Jersey)
- Guernsey Property Unit Trust (‘GPUT’), (Guernsey)
- Limited Partnership (‘LP’) (many countries)
- Property Authorised Investment Fund (‘PAIF’) (United Kingdom).

# How to run a secondary trade

There is no single best way to run a secondary trade. This will depend on many different factors, including the type of fund, the seller's knowledge and experience, the importance of timing relative to pricing and confidentiality, the size of ticket, the liquidity of the fund, whether it contains a single asset or portfolio, the country of domicile, and so on.  Buyers and sellers will also inevitably have different perspectives on a trade.

For sellers, there may be some advantages in using a specialist secondary market broker, including:

- Securing best execution – using a secondary market broker in a structured, broad marketing process normally gives the seller more confidence in reaching all likely buyers, and therefore in achieving the highest price.
- Reducing workload – compiling comprehensive marketing and due diligence materials normally requires extensive work, which may be difficult for an individual Limited Partner ('LP') to resource. This is particularly likely for larger portfolio sales across multiple countries.
- Catalyst in the sale process – a broker can act as an intermediary, accelerating the process and ideally bringing parties together to finalise a transaction.

The drawbacks of using a secondary broker include the level of fees payable.

Occasionally the fund manager themselves may act as a broker or intermediary. Although this is unlikely to mean any fee or increase in assets under management for the manager, the attractiveness of their fund products and their long-term relationship with investors will be enhanced by supporting an existing Limited Partner (LP) that wants to sell. There is a potential advantage from the fund manager assisting new investors, which could mean potential buyers are lined up to enter the fund, making the transaction faster and more efficient. However, in this case there is also a risk that the seller will not receive the best possible price (although under MIFID II a manager operating in this way must take 'all sufficient steps to get best execution').

In some cases, a secondary market transaction is agreed 'principal-to-principal' in an off-market deal. This normally occurs when the seller and buyer have agreed on the price and terms, and they want a rapid transaction. They might also want to keep the transaction confidential by limiting the number of parties involved.

Before any initial analysis is undertaken and bid pricing can take place, the seller and the fund managers are normally required to negotiate and sign a non-disclosure agreement (NDA). Running a secondary trade can sometimes be a quick and easy process (eg for some highly liquid and transparent UK funds, where the buyer already knows the fund), but it is normally lengthy and complex, particularly if the buyer is entering the fund for the first time, or if the portfolio is large.

Before spending a long time on detailed due diligence and engaging additional internal or external resources, it is recommended that the buyer and the seller sign a Letter of Intent (LOI). This will allow both parties to define and agree the main commercial details of the transaction before expending significant time and costs. The LOI can be relatively short and straightforward, but should at least include:

- Specification of the underlying instruments; eg x number of units y in property fund z.
- The actual purchase price of the units or % of the net asset value (NAV). Since there are several different reporting definitions of NAV (INREV, IFRS, Lux gap, etc.), the NAV under discussion should be clearly specified. The date/quarter of the NAV should also be stated.
- A description of the basis of the offer price (eg detailed list of funds, NAV, undrawn capital, etc.) and conditions attached (eg no major findings in due diligence, normal reps and warranties, possible deferred payments, etc.).
- The treatment of distributions up until change of ownership, including income, capital gains and return of equity
- Any external and internal approvals required, with dates.
- An exclusivity period during which the seller promises not to negotiate the deal with any other party.

Following due diligence, the transaction needs to be made legally binding and formalised in various documents. In some cases, these are just the transfer documents and forms that are provided by the fund administrator and custodian bank. These documents simply register the change of ownership of the units. More frequently, however, the parties also negotiate and sign a separate sale and purchase agreement ('SPA'), which stipulates more details about the transaction, including the different representations and warranties from the parties. Depending on the complexity of the transaction and the number and requirements of involved parties, such an SPA can range between 5 and 100 pages in length.

Before the transaction can be completed, there may in some cases be pre-emption rights or Rights of First Refusal ('ROFR') to consider. This normally means that an existing investor has the right to buy the units at the price that has been agreed by the parties. Buyers will generally want to eliminate this risk at an early stage rather than going through a long due diligence and transaction process beforehand, and may even be reluctant to start a transaction if there is a serious risk of pre-emption by existing investors. Funds with an ROFR mechanism may therefore suffer from attracting less interest and the risk of lower pricing in a secondary sale.

**Two key documents**

**Step 1:** Letter of Intent (LOI)
**Step 2:** Sale and Purchase Agreement

# Mechanics of the trade

Trading non-listed real estate is very different to screen-based share trading.  While the prices for a secondary market trade may be available on-screen, through a broker, the actual trade will have to be completed 'Over the Counter'.

This Guide does not discuss the pricing level of a transaction, which is a matter for the buyer and seller to resolve, but confines itself to the mechanics of a trade.

A secondary market transaction can range from a simple agreement at an agreed price to a complex structured arrangement, for example involving deferred payments.  Generally, the complexity of the transaction depends on the style of the underlying investment. A transaction in a core open end fund should take place through a relatively simple deal, the only complication perhaps being to account for distributions payable. A transaction in a private equity style fund may, however be, much more complicated.

As with trading in shares, the trade date and settlement date should be agreed in advance. However, a key difference from shares is that unlisted fund trades must take the timing of dividend payments into consideration. To navigate this issue, the fund manager should ideally be made aware of the trade. Once the trade is completed, distributions should be apportioned between the buyer and the seller. Where this is not possible, the price at settlement will need to reflect an apportionment of income, or else the income due to the seller may have to be paid later, once the buyer has received their dividend.

If using a broker, now an increasingly frequent occurrence, a brokerage fee will be payable for the transaction.  This will usually need to be paid to a different bank account from the settlement account, as the broker is only responsible for bringing together the two parties in the transaction. The settlement proceeds themselves will be paid across directly to the seller's bank account.

A secondary market trade will require some degree of due diligence about the counterparty. The level of this due diligence is likely to vary depending on whether the counterparty is a regular secondary market participant or an organisation that is less experienced in the market.

As these trades are 'OTC', they will always have the possibility of failing.  To help avoid this, the deal ticket provided by the broker or manager should be taken as a legal document that requires the counterparties to fulfil the trade.

> If using a broker a fee will be payable

References such as 'Subject to Investment Committee approval' should be resolved prior to the trade being agreed. Likewise, all tax and legal due diligence should ideally be confirmed before the deal ticket is finalised.

# Common language

When undertaking trades, several acronyms may be used that may be unfamiliar to newer market participants. The following phrases are commonly used in transactions:

Pre-emption Rights/Rights of First Refusal – A provision in the fund documents granting existing investors the right to acquire an additional interest in the fund if a unit-holder is looking to trade their units. The seller is not free to sell their investment in the fund to an external party, unless the existing investors do not want to participate in the trade.

Letter of Intent (LOI) – This is not a legally binding document, but provides a 'Heads of Terms' for a trade, incorporating the key issues. The LOI may include provision for a period of exclusivity, allowing the buyer to undertake more due diligence.

Sale & Purchase Agreement (SPA) – This is the legally binding agreement between the parties for the transfer of interests in an investment. It can be a complex document, as it includes all the key issues.

Pre-emptions/Notification – In some instances the fund documentation states that the General Partner (GP) must be notified of a trade, and in some cases that their consent is required. This kind of clause is not standard, but sometimes exists for older funds.

Registration – Re-registration is required on the transfer of a fund holding, whatever the structure. The form of registration will vary depending on the jurisdiction of the investment. A decision will be required on whether the investment is to be registered under the beneficial owner or the nominee of the investor.

**Regional perspectives**

The secondary trading model is not universal globally, or even across Europe. There needs to be agreement on the currency of the trade and the jurisdiction under which it is to be undertaken. Both issues can be complicated by the type of fund being transferred and the domiciles of the counterparties.

In Germany, some local funds are sold using national exchanges whereas in the Netherlands, some vehicles require unanimous approval from all investors before trades can be effected.

In the US, some core funds require the buyer and seller to complete a transfer booklet, where the buyer can prescribe a number of units or an amount of capital. When the latest NAV figure has been released, the units are transferred and the money moves from the manager (typically a bank).

# Warranties

The transfer of interests in real estate funds is principally documented in a Sale and Purchase Agreement. This document includes a series of seller undertakings or warranties. There are various types of warranties, with different levels of scope and content. The wider ranging the warranty, the more complicated the transaction. The scope, term and extent of any warranty may also have a bearing on price. Warranties can be broken down into four categories:

**Fundamental Warranties**

These warranties are unlikely to be contested and comprise undertakings that the seller is appropriately incorporated; is solvent; owns the units; that the units are uncharged; and that the seller has the authority to execute the agreement. Typically, the warranty will be for the full consideration.

**General Warranties**

These warranties are also unlikely to be contested, and represent an official guarantee by the seller that the Articles of Association of the Fund provided to the buyer are accurate; that there has been no material breach of the terms of the fund by the seller; that there is no outstanding litigation; details of any capital receipts or commitments made after the 'cut-off date'; the extent of undrawn commitments/recallable distributions; and so forth. The buyer will typically seek these warranties for two years and for as large a proportion of the buyer price as possible. The seller will seek to mitigate them as far as possible without it having a bearing on price.

**Tax Warranties**

Limitations on tax warranties may have a bearing on price. A warranty that any tax attached to the shares has been paid, or that the LP has done nothing to fetter the tax status of the fund, is unlikely to be contested. The extent of that warranty (% of the purchase price) and its term may be disputed by the buyer and seller.

Buyers of private equity secondary interests also typically seek a warranty from the seller in respect of any tax assumption that is posthumously challenged by the tax authorities.

The tax warranty is likely to cover both transfer tax and deferred tax that may have been mitigated by the acquisition or sale of an asset through the sale or purchase of shares or units in a company or trust. The warranty typically reflects a claw back provision in respect of any distributions received by the seller prior to the 'cut-off date', but may be a defined in quantum. The term of the warranty sought normally extends to the length of time a tax authority has to retrospectively challenge the tax assumption and will be different depending on the jurisdiction. This claw back clause frequently triggers protracted negotiations if it is not headed off prior to entering into an LOI. The perspective of the buyer is that the seller/fund has a contingent liability to make good any change in the tax assumptions and that the seller should not have benefited (through a distribution) from tax assumptions that were subsequently found to be incorrect. The stance of the seller is typically 'caveat emptor', that is, buyer beware.

Clearly, the more risk the buyer is asked to assume, the higher their discount rate and the lower their price is likely to be, other things being equal. Furthermore, the importance of this warranty and its impact on price will increase with the maturity of the fund. If the fund is a long way through harvesting its assets and has made substantial distributions to equity, the scale of the contingent liability relative to the value of its residual assets will be larger than for a fund that has just commenced selling down. Accordingly, the existence or otherwise of this warranty can result in considerable variation in price for 'tail funds' where most assets have been realised and significant distributions made to shareholders.

**Specific Warranties**

The range of specific warranties that may be sought can be wide ranging and will depend on the specifics of any given fund. They are, however, typically limited to two years and for a lesser sum than the purchase price.

**Cut-off Date**

Secondary trades in private equity real estate funds are agreed generally by reference to an historic NAV figure, which is typically the most recent NAV for which quarterly reports are available. The date is referred to as the 'cut-off date'. All receipts (income or capital) subsequent to the cut-off date are for the benefit of the buyer and all commitments made by the seller are refunded by the buyer.

The settlement date can be six to nine months after the cut-off date. During the marketing phase, details of near term investor cash flows can become more apparent and there may be subsequent asset appraisals. Information post the cut-off date can clearly have a material impact on pricing when the reference point is historic rather than current.

**General Partner (GP) point of view**

Liquidity is generally regarded as a very important aspect of a fund by LPs. As well as redemption and exit mechanisms, LPs increasingly demand full GP support for secondary market activity, as this directly influences the actual liquidity of the units and pricing.  Such GP support can vary, and may include:

A clear guide explaining how the vehicle units can be traded on the secondary market;

Standardised transaction documents such as NDA, LOI and/or SPA;

Transparent reporting and availability of such documents to candidate investors.

# Differences in pricing

Of course, the value attributed by a buyer and seller to a holding in a fund will depend on many factors. Typically, in real estate funds, pricing is quoted relative to the most recent NAV, though other factors (including the fund's remaining life if it's a finite fund) are also important.

**Infinite Life (Open End) Funds**

These funds are typically valued monthly or quarterly and have some liquidity windows, usually quarterly or annual. Secondary market pricing is usually quoted relative to NAV, but also often against the subscription (offer), redemption (bid) or the middle point (mid) price.

The current unit price that any incoming (or outgoing) investor will have to pay (or receive), to enter (or exit) a fund on the primary market via a subscription (or redemption) will have a material impact on any secondary market price. For example, a fund with a significant subscription queue may see secondary market transactions occurring at a premium to the offer price. Conversely, if an exiting investor is near the back of a redemption queue, they may be willing to accept a discount to the prevailing bid price.

Some open end funds may have what is called 'Swing Pricing,' where the fund only has either an offer or a bid price at one point in time – never both. Other open end funds have 'Single Pricing,' where investors are called or paid out at NAV, regardless of the subscription and redemption queue. Secondary market pricing will usually consider these mechanisms, which will likely impact any agreed price.

As a rule of thumb, secondary market transactions in open end funds occur at NAV or at small single digit discounts or premiums relative to the prevailing bid, offer or NAV price. For transactions to occur outside this range, the supply and demand dynamics for the fund would need to be highly unusual.

**Finite Life (Closed End) Funds**

Closed end funds do not usually have liquidity windows, except when they are wound up (often 7-10 years after launch). Pricing can therefore deviate much further from NAV than for open end funds.

Assets in closed end funds are typically valued monthly, quarterly or annually. In some cases, they are only valued at the time of acquisition and disposal, though this is more usual for opportunistic private equity real estate funds.

A buyer will relate their pricing to the most recent valuations which, when coupled with other factors (such as fund desirability, gearing, etc.) may result in significant discounts or premiums to NAV. Many buyers of closed end fund holdings will seek to identify the pricing point required to achieve a target return. This contrasts with most open end funds, where investors tend to be driven by performance relative to a benchmark.

**Semi Open End Funds**

Funds that are considered semi open end share attributes with both open and closed end funds. For example, a fund may have a 10-year life but with liquidity windows each year, though these could be limited to 10% of the fund's value per year. Secondary market pricing will usually consider this akin to a traditional open end structure, by taking a view on the fund's likelihood of meeting subscriptions and redemptions.

# Conclusions

We hope that this Guide is helpful for participants undertaking secondary market trades. The more trades that are actually undertaken, the better the secondary market will be understood, and this should in turn increase liquidity and the number of participants.

There are likely to be changes in the way such trades operate in the future. One possibility could be the introduction of screen based trading, as currently used in the securities market. This would be a truly ground-breaking development.

Today, one of the issues that often delays trades is a lack of uniformity in the settlement process. There are some examples of best practice, but in general little thought is given to how secondary market trades will operate when a fund is launched. The mechanics of trading often turn out to be cumbersome for the participants. Ideally fund managers should ensure that their administration teams understand what is required for such trades and have a documented settlements process in place as soon as a new fund is launched.

Indeed, it is generally in the best interests of the fund manager to encourage secondary market trades. In this respect, there is a clear benefit in being open and transparent when working with potential buyers and sellers of holdings in their vehicles, as such assistance is much appreciated by market participants.

Failed trades are a source of frustration

Failed trades represent a continuing source of frustration for all secondary market participants, as trading in non-listed funds should be less open to transaction failure than direct real estate. Failed trades would be less common if deals were considered binding once they have been agreed between the participants, as is the case for equities trade.

# Appendix

Due diligence checklist

**A secondary trade will in most cases require cooperation from the General Partner and the selling entity. The following documents are critical for a buying entity to review, ahead of a secondary trade:**

Legal Document Request:

Limited Partnership Agreement and any amendments ☐

Seller's subscription agreement ☐

**Fund Reporting:**

Quarterly reports for past year (business reports and financials) ☐

Most recent audited financials ☐

Most recent capital account statement ☐

Capital call and distribution notices (post the last quarterly reporting period) ☐

Annual meeting presentation, if applicable ☐

Supplemental Investment Report, if provided to LPs

**In some cases, the General Partner may also make the following documents available:**

Formation/Organisational information:

Private Placement Memorandum ☐

Fund organisational structure ☐

**Broadly, buyers are looking to understand the following key items as part of their due diligence:**

Fund Diligence (to underwrite assets and cash flows of the fund):

Financial statement analysis and assessment of fund's liquidity (i.e. debt structure, capitalisation) ☐

Assessment of unfunded commitments and blind pool analysis ☐

Review of fund governance provisions ☐

Understand the alignment of interests ☐

Review of fund structure relative to tax exposure ☐

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