Sanlam

Investments

One decade and three freezes

Could this be the last gasp of Private Open-ended Property Funds?

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Contents

What to expect in this report

Concerns have been expressed about the liquidity issues associated with property funds (in general), but not all property funds are created equal. For those investors contemplating property funds that own and manage the underlying properties (unlike a fund that owns listed REITs), liquidity risk is certainly something to consider, i.e., That you should be able to demand access to your money when the need arises.

The ugly truth laid bare

Private Open-ended Property Fund ("OPF"): Liquidity concerns

Due to the liquidity mismatch, and the stale and uncertain valuations in private OPFs, redemptions have had to be suspended three times in the last 10 years: once after the 2008 global financial crisis, followed by the 2016 EU referendum and again in 2020 with the coronavirus pandemic and the resultant lockdowns.

The OPF structure cannot avoid a liquidity mismatch when people worry about property prospects. A sudden exodus by investors meant that the private OPF managers could not sell properties quickly enough to get sufficient cash to satisfy withdrawal requests and proved, once again, the liquidity constraints of these fund structures.

In March 2020, investors pulled £589m from U.K. real estate funds, breaking the previous record of December 2018 on Brexit fears. Aviva was the first casualty of the pandemic when they announced during mid-May that it will close its private OPF and wind down its assets. Many of the larger UK private OPFs such as M&G Property Portfolio and Legal & General UK Property Fund have reopened for trading during April. The Aegon private OPF is currently the last remaining private OPF that is closed for trading as it is raising cash levels to meet redemptions.

Private OPFs are promoted on the basis of liquidity and investment in real estate. In truth they do not offer liquidity when it is really needed and often hold as much as 25% or more in cash. If cash levels are that high, one should question whether this is the best real estate capital allocation vehicle.

The FCA proposal to address private OPF illiquidity

Long-Term Asset Funds ("LTAF"): the hoped panacea?

Following the raft of private OPF suspensions, the FCA is still struggling to solve how best to protect investors from the liquidity mismatch. The UK financial watchdog recently postponed (until Q3 2021) its decision on notice periods of between 90 and 180 days for private OPFs, while it looks into creating a new fund structure, a long-term asset fund ("LTAF"), to address the liquidity mismatch issue.

The aim of the LTAF is to offer an appropriate level of investor protection and to address the specific risks of investing in long-term illiquid assets via a private OPF, i.e., embed longer redemption periods, high levels of disclosure and specific liquidity management and governance features. The plan seeks to fix a long-running reputational challenge for UK private OPFs, but would also pose a fundamental challenge to major operators, such as M&G Investments and Legal & General Investment Management, making their funds largely unsuitable for retail investors.

Do not hold your breath. The details on the eventual shape of the fund remain unclear and market participants are sceptical about the LTAF proposal:

- Many industry players have voiced their concern that LTAFs will face the same operational challenges as private OPFs as LTAFs would need to contain a lock-up period to account for the illiquidity of the underlying assets.
- Other industry players have expressed that it is the investing behaviours, rather than the investment structure, that need to change. They believe that LTAFs are unlikely to be the solution until managers better educate retail investors about their "cavalier attitude" of churning in and out of property funds.

The LTAF consultation closes on 25 June 2021. While OPFs remain shuttered with approval from the regulator, investors remain trapped. The lengthy redemption notice periods proposed by the FCA will effectively kill the viability of private OPFs for property investors. Property investors can, of course, buy REITs and other closed-end property funds or investment companies listed on the London Stock Exchange. These all remained open for trading throughout the Brexit and coronavirus shock. Refer to the Annexure: Channels to gain property exposure for more detail.

Let's now turn our attention to REITs.

REITs: You can have your cake and eat it

What is a REIT?

An alternative to the direct approach is to invest in a mutual fund, unit trust fund or open-ended investment company (OEIC) that invests in listed property companies or Real Estate Investment Trusts (REITs). These differ from private OPFs, because they invest in listed REITs that own and manage properties, as opposed to the properties themselves.

Mutual Funds/ unit trust funds/ OEICs investing in REITs have an inherently better structure to get exposure to real estate and do not have these liquidity mismatches to deal with. In addition, REITs provide investors with regular income streams, long-term capital appreciation, diversification, strong corporate governance and a high level of transparency, wrapped up in investor-aligned corporate structures.

REITs address the liquidity issue of Private Open ended Property Funds

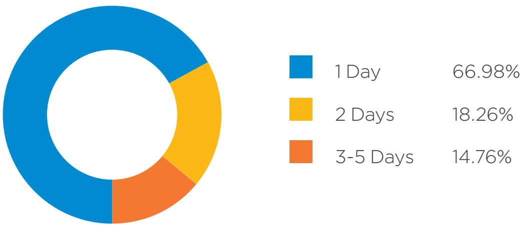
Listed property companies enjoy greater liquidity than private OPFs since you are buying a share of the company, rather than a share of the underlying properties. Shares in these companies trade on large public exchanges, such as the London Stock Exchange, so should investors want to redeem a portion of their investment, they can simply sell the required amount of shares or units in the open market. That does mean investors might experience volatility in the short term, but for many this is an acceptable price to pay for daily liquidity.

- Please also refer to the **misconception of volatility (putting private open OPF share price stability charade to bed)** below.

Listed REITs can be sold in a matter of seconds, and property unit trusts that own listed REITs like those managed by Catalyst Fund Managers are all able to raise cash in the same, quick way.

Our Catalyst Global Real Estate UCITS Fund can be liquidated within 5 days.

Days to liquidate fund
Max 20% of daily trade



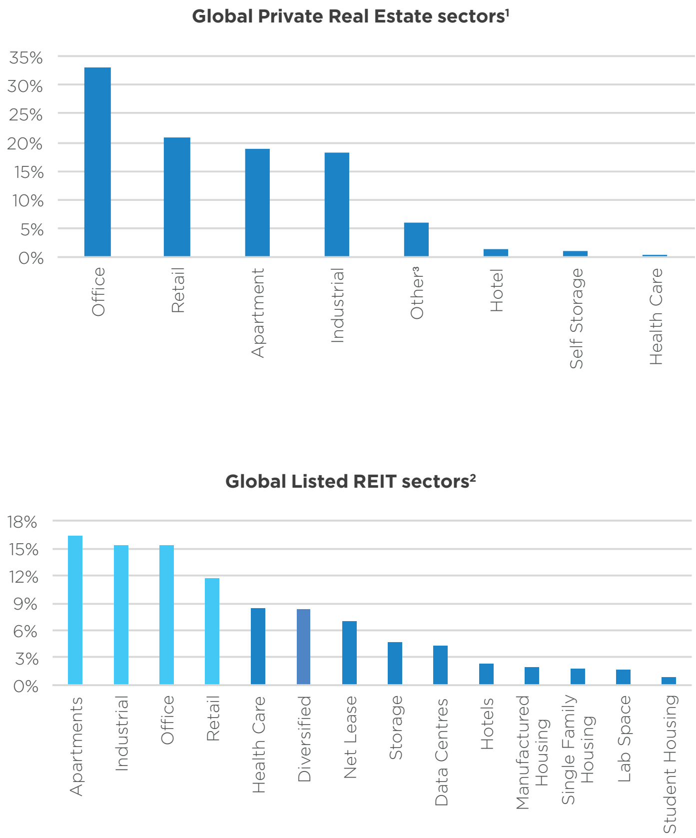
Our commentary
Based on average daily trade and not being more than 20% of the daily trade we should be able to liquidate 85.2% of the fund in two days, and the whole fund in 5 days.

Diversification

Diversification (including access to niche sectors)
For many investors, existing unlisted real estate allocations can often be characterised by a lack of sufficient diversification, with too many assets in one region, country, or sub sector. Listed REITS provide a diverse opportunity set which is difficult to replicate in the private market – Refer to Chart 1: Global Listed REITS offer greater diversification compared to private real estate.

As the global economy has evolved to be more tech focused, the listed real estate sector has also evolved. The weight of "traditional" sectors of Retail, Office, and Lodging (mostly Hotels) has drastically diminished, whilst niche sectors like Data Centres, Cell Towers, Lab Space, Healthcare Facilities, Manufactured Housing, Single Family Housing (new in the public and institutional space) have grown rapidly – Refer to Chart 2: REIT Sector Evolution: Shift from traditional to niche sectors. Access to many of these niche sectors are practically impossible for retail investors outside of public markets. Furthermore, it is interesting to note that these niche sectors have mostly outperformed the traditional sectors as depicted below – Refer to Chart 3: Niche sectors have achieved better performance.

Chart 1: Global listed REITs offer greater diversification compared to private real estate
(Traditional sectors vs Niche sectors)

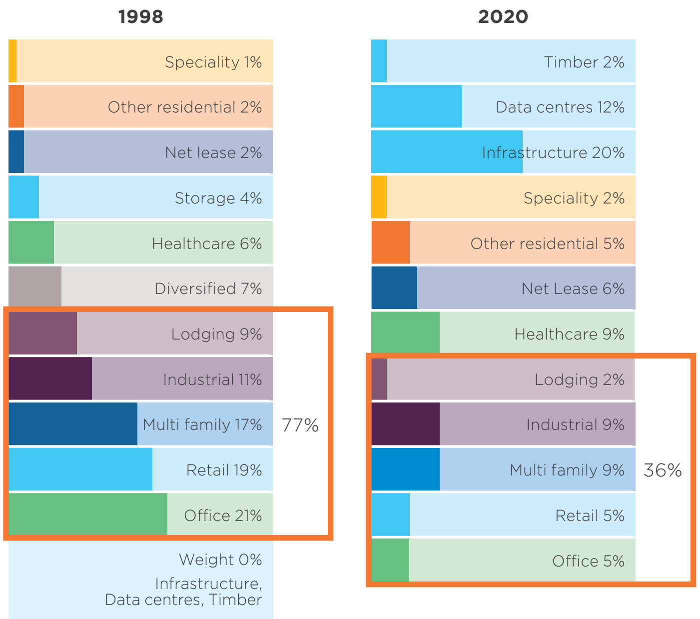


Source: ANREV, INREV, NCREIF And Catalyst Fund Managers (Pty) Ltd at 30 June 2020.

[1]Global Private Real Estate sectors represented by the Global Real Estate Fund Index –Core (GREFI Core). It is an index showing the performance of core non-listed real estate funds on a global scale and is created by leading non-profit association of investors in non-listed real estate: ANREV (Asia), INREV (Europe) and NCREIF (U.S.). Sectors are based on ANREV, INREV and NCREIF classifications. Weights as of March 31, 2020.

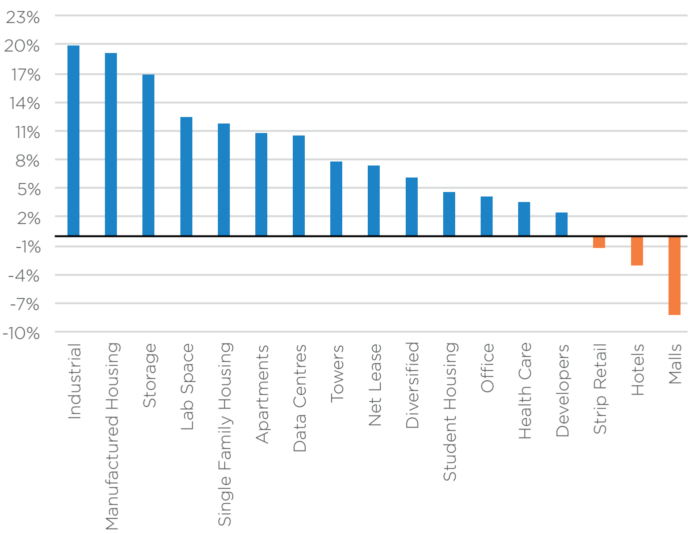
[2]Global Listed REITs represented by the FTSE EPRA Nareit Developed Real Estate Index which is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets. Sectors are based on FTSE EPRA, FTSE Nareit and internal Catalyst Fund Managers classifications Includes following sectors defined by ANREV, INREV and NCREIF: Mixed, Not Reported, Other, Cash, Aged Care, Student Housing, Leisure, Parking, Land, Seniors Living.

Chart 2: **REIT sector evolution: Shift from traditional to niche sectors**
(Sector Weightings within the Index – 1998 vs. Current 2020)



Source: Citi Research: September 2020, REIT.com, SNL, Factset *Note – Other Residential includes Student Housing, Manufactured Housing, and Single-Family Homes

Chart 3: **Niche sectors have achieved better performance**
Benchmark weighted sector returns (TR USD)
4 year annualised (1 may 2017 - 30 April 2021)



Source: Catalyst Fund Managers calculations

Further benefits

Superior performance

Over the long run, returns for both private and listed real estate are tethered to the performance of the underlying assets. Regardless of ownership structure, property values and cash flows are determined by the same drivers: supply, demand and credit.

Where ownership structure and public listing has mattered is the speed with which prices reflect changes in these drivers: Listed REITs are priced in real time through a publically traded stock market that reflects investors' changing views of future cash flows and cost of capital. By contrast, private OPF funds are marked to market infrequently, using slow-moving appraisals that tend to rely heavily on recent property transactions. These differences can cause material short-term dislocations, especially in periods of heightened uncertainty.

Notwithstanding the above, it is important to note that global listed property has outperformed the UK direct property market quite significantly as depicted below – Refer to Chart 4: Global listed property has outperformed direct UK property.

Chart 4: **Global listed property has outperformed direct UK property**
(Annualised returns in GBP)

GBP returns	10 year annualised	5 year annualised	3 year annualised	1 year
Global Listed property[1]	8.31%	6.23%	7.28%	22.85%
UK Direct property[2]	2.67%	-0.28%	-1.77%	-2.14%

Past performance is not a guide to future performance

Source: Bloomberg and Morningstar;

[1]Benchmark annualised returns for global listed property: FTSE/NAREIT Developed Rental Net Total Return.

[2]Sector average for UK direct property as per Morningstar has been used: Investment Association UK Direct Property Sector.

Corporate governance
Listed property companies are subject to strict standards of corporate governance, financial reporting and information disclosure, as required by public exchange listing rules. Investors benefit from these securities regulations and from having a board overseeing the management on their behalf.

Companies enjoy high barriers to entry
The value of these companies depends on more than just the buildings they own. The management team of these companies is an expert in their sector, with years of knowledge and experience, and also have strong relationships with potential tenants which is difficult to replicate. They understand where they can add value to their portfolios, and when the right time to sell and maximise that value is.

Access to capital markets
Listed REITs have a distinct advantage over private real estate funds when it comes to raising capital. They have access to both public and private sources of equity and debt capital, they can issue preferred equity and they can seek joint venture partners. This capital can generally be raised faster and often at a lower cost than in the private market.

Misconception of volatility

Putting private open OPF share price stability charade to bed
One of the arguments often made by supporters of private property investments is that Joe Retail prefers to avoid the volatility of the stock market. Telling investors that the value of a private property investment is protected from the same economic forces influencing REIT share prices is misguided at best and dishonest at worst. This "charade of stability" in the private market is equivalent to favoring a threelegged horse over a four-legged version because the former cannot stray as far from the barn.

It is important to point out that the difference in volatility between private OPFs and the listed real estate sector is not significant, over the long term. Over the short-term there will be a difference in pricing between the two markets:

- This is due to the listed market pricing assets looking forward, using evidence as the market announces new information, such as leasing or investment transactions.
- In comparison, unlisted real estate funds will value assets (normally) every six months or perhaps annually and valuers will largely rely on historical evidence.
- The critical and common theme is that both markets are pricing the same assets, therefore the same direction will be followed, whether prices are increasing or decreasing and that over time the value of the underlying property assets will be reflected in the pricing of the equity.

Conclusion

Listed real estate markets offer a broad opportunity set, including access to new-economy property types such as cell towers, data centers and modernized industrial facilities, as well as specialized property type markets such as self-storage and manufactured housing communities that may be difficult to assemble in size in the private market.

Investing in a global listed real estate fund gives your clients access to these opportunities, with the objective of achieving income and capital growth throughout the full economic cycle in a fully transaparent and liquid manner.

Contact us

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Annexure: channels to gain property exposure

<table>
<tr><th></th><th colspan="3">Direct / Private/ Unlisted</th><th colspan="2">Indirect/ Public/ Listed</th></tr>
<tr><td rowspan="2">Gain exposure to property</td><td rowspan="2">Private investor
Via sole ownership or partnership</td><td colspan="4">Pooled vehicles
(Subdivided into open-end and closed-end funds)</td></tr>
<tr><td colspan="2">Open-ended Property Fund (“OPF”)
Active, or Passive</td><td colspan="2">Closed-ended property funds
Generally active
(compared to ETFs that are generally passive)</td></tr>
<tr><td>Types</td><td>Family home
investment property</td><td>Private OPF
i.e.
• M&G property portfolio
• Legal & General UK Property Fund
• Aviva Investors UK Property Fund</td><td>Listed OPF
(*Which invest into listed REITs)
i.e.
• Catalyst global real estate UCITs fund</td><td>Property investment company</td><td>*Listed REITs</td></tr>
<tr><td>Trading
(Buy & sell)</td><td>Initial purchase of the property, followed by the selling of the property.</td><td colspan="2">When an investor purchases shares in an open-end fund, the fund issues those shares and when someone sells shares, they are bought back by the fund.
When shares are sold (known as a redemption), the fund pays the investor using cash on hand or it may have to sell some of its investments to pay the investor.</td><td>Since closed-end mutual funds are traded among investors on an exchange, they have a fixed number of shares.
Like stocks, closed-end funds are launched through an initial public offering (IPO) to raise money before they can trade in the open market.</td><td>Daily trading: Traded on a public stock exchange where it is being bought and sold with a supply and demand that sets the market value daily.
Things bring other factors into play when comparing to the direct real estate market,</td></tr>
<tr><td>Pricing</td><td>Appraisal valuations
Direct real estate is often subject to extended periods of not being traded at all – and investors can solely rely on appraisals done twice a year which yields a smoothing and lagging effect on the returns, in other words, lower volatility in the short-term.
Use appraisal valuations, which dampen reported volatility and potentially understate the impact of changes in real estate fundamentals. This was evident during the GFC and Covid when appraisal values were slow to adjust due to the lack of transactional data.</td><td colspan="2">End of day
Open-end funds are also priced differently from closed-end funds, which trade on a market like a stock.
Shares of open-end funds are bought and sold directly from the fund at a price per share that is based on the value of the fund’s underlying securities. On each trading day, typically at the end of the day, the net asset value (NAV) is calculated by dividing the market value of the fund’s assets (less expenses) by the number of shares held by investors.</td><td>Intraday
Although their value is also based on the fund’s NAV, the actual price of the fund is determined by supply and demand, so it can trade at prices above or below the value of its holdings.
Closed-end funds are often actively managed unlike exchange-traded funds, which track an index and generally do not trade at a discount or premium to their NAV.</td><td>Intraday
Securitized real estate is being valued daily by supply and demand, and such have larger short-term volatility of a common stock.
Another important difference is that the listed market prices include investors’ forward-looking expectations, whereas the direct fund valuations are backward looking based on recent transaction evidence (which was almost no-existent recently).
• Due to that the general market condition, outlook, sentiment, liquidity, and herding behaviour, it can result in share prices that are above or below the fundamental, or true, market value of the underlying real estate.</td></tr>
</table>

Important Information

Investments in real estate securities can carry the same risks as investing directly in real estate itself. Real estate prices move in response to a variety of factors, including local, regional and national economic and political conditions, interest rates and tax considerations.

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