Open-end vs Closed-end Private Equity Debt Funds – Structural Considerations

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Commercial real estate (CRE) lending has seen structural shifts as regulations and more cautious lending have inhibited traditional bank lenders and allowed non-traditional lenders the opportunity to fill gaps in demand for commercial real estate lending further down the capital stack. In today's climate of softening rent growth and tepid appreciation, opportunities exist in the CRE debt sphere, where investments can offer solid risk-adjusted returns. Investors, for those reasons, are increasingly looking to CRE debt, and many toward subordinated positions (i.e. mezzanine loans), which offer equity-like returns in which the lender/investor may be more protected by loan covenants and sufficient debt service coverage ratios; additionally, the lender/investor doesn't have to manage the tasks associated with equity ownership of a property.

Private equity CRE debt funds have provided an efficient means for institutional and retail investors to invest in senior and subordinated debt. Many of these private equity CRE debt funds, after raising capital, lend directly to borrowers and frequently have a competitive advantage over traditional lenders by being able to close deals faster, with advantageous terms, and less onerous legal and regulatory considerations slowing them down.

Private equity CRE debt funds are structured as either closed-end or open-end (evergreen) investment structures, and have recently been pushed in the direction of fair value reporting for their investor base (particularly with respect to open-end funds), especially as investors look to riskier (subordinated and transitional vs. first mortgage) debt positions for returns. As with public funds, there are risks and considerations when investing in different private equity debt fund structures.

Open-end and closed-end CRE private equity funds have both unique and shared considerations. Considerations for both closed-end and open-end CRE private equity debt funds are listed below.

1. **Fair Value of Investments:** Fair valuing illiquid debt instruments is common practice among publicly traded open-end funds. With private CRE debt funds holding illiquid investments, investors must look to fair value estimates for transparency relating to both risk evaluation as well as quarterly return reporting. Funds with riskier investments (i.e. mezzanine debt, distressed debt, development loans, etc.) for both private open-end and closed-end CRE debt funds have an increased need to fair value their investments, as the risk of default is typically greater than senior debt positions.

    a. OE: Fair valuing CRE debt is more important with private open-end CRE debt funds than private closed-end funds due to the liquidity being provided and shares being bought or sold at the reported net asset value (NAV). Fair valuing the debt instruments in a fund is necessary to determine the fair and reasonable price of shares at redemption or issuance, and such a process is typically best executed by a third-party valuation agent who can provide independence and mark-to-market expertise. Independent third-party fair value estimates on debt positions are becoming increasingly important as investors push for greater transparency and look for best practices in the policies and procedures of the debt funds that they (look to) invest in. Additionally, the importance of selecting a third-party debt valuation provider that understands the positions (senior mortgage, mezzanine, subordinated, cross-collateralized, foreign, etc.) held in the fund is great, as a third-party debt valuation provider must understand the considerations relevant to the positions held in the fund in order to provide accurate and supported fair value estimates for the positions.

    b. CE: While private closed-end CRE debt funds often fair value their debt internally, it is less important to do so if the funds do not offer liquidity and investors have committed capital through the life of the fund. Investors' returns will be based on the yield to maturities (YTM) of the CRE debt instruments at their purchase dates in the funds, adjusted for any impairments. If there are loans in private closed-end debt funds that are impaired or at significant risk of becoming impaired, it is advisable that third-party debt valuations be done on those positions. Outside of impairment, closed-end debt funds may want to consider third-party debt valuation services on riskier positions (i.e. subordinated or transitional) if they do not have the in-house expertise or supporting data to accurately mark their positions and feel that there is a need to do so (i.e. investor demand).

2. **Fund Life:** Private equity CRE debt funds may have defined fund lives or infinite fund lives.

    a. OE: It is common for open-end funds to operate under the assumption that they have infinite lives as long as their investment strategies remain executable and viable from a return perspective. Funds with infinite lives have a need for clear and transparent policies and procedures to appropriately reflect values throughout real estate cycles. There has been an increased push from investors for the liquidity that private open-end funds offer over private closed-end funds.

b. CE: It is common for closed-end funds to have defined fund lives based on the investment strategies of the funds. Certain investment strategies may result in private closed-end debt funds having longer lives, such as an investment strategy that invests in/originates senior mortgages on stabilized properties, which generally have longer terms (10 years) relative to other investment strategies such as originating transitional CRE loans (2- to 3-year terms with extension options are common). With defined lives and investors generally unable to invest or withdraw capital, the need for third-party valuation is limited to instances where positions in the closed-end funds may be impaired.

3. **Liquidity:** Unlike publicly traded funds, private funds are not actively traded on an exchange and are more illiquid than their public counterparts. Liquidity provisions can be a significant factor in attracting capital.

   a. OE: Often offer investors liquidity at intervals such as 5% of NAV on a quarterly basis. As liquidity is offered to investors, independent fair values are needed to determine the NAV that shares are bought and sold at on the date of liquidity. Investors are increasingly pushing for independent, third-party fair value estimates versus internally concluded fair value estimates on liquidity dates, especially when it comes to riskier illiquid investments such as transitional or subordinated CRE loans.

   b. CE: May offer no liquidity through the life of the fund. Liquidity, prior to the exit strategy of the fund, may be achieved via a secondary market transaction, whereby the current owner of a position in a closed-end fund sells their rights to the cash flows from their position to another party. In this case, a third-party valuation on the position would be done to determine its fair value, the price at which the position should be acquired/sold. While private closed-end debt funds offering no liquidity would likely not have policies in place to provide third-party debt valuations on their positions, they may have policies to have third-party valuations done on positions that are impaired, at risk of becoming impaired or are determined to be extraordinarily risky.

4. **Risks:** The risks associated with investing in a private CRE debt fund include: interest rate risk, liquidity risk, credit (default) risk, prepayment risk, reinvestment risk, refinancing risk, inflation risk, currency risk, etc. It is important to holistically understand and evaluate these risks at the fund and loan levels. Situs RERC is able to aggregate and analyze these risks and how they relate to the investments in CRE debt funds.

5. **Valuation Frequency:** Private funds do not have their prices updated daily – publicly traded closed-end funds are continually priced and publicly traded open-end funds are priced daily. The frequency of valuation is directly tied to the liquidity of the fund; if a fund offers quarterly liquidity, the fund has a need for quarterly valuation; if a fund offers daily liquidity, the fund has a need for daily valuation. Private funds, especially those that offer quarterly liquidity, often value their portfolio on a quarterly basis. The value of investors' positions in private funds may fluctuate widely due to a large swing in interest rates, but investors may not have a good understanding of the impacts the interest rate swing had on their investments as quickly as they would if they were invested in a public fund that priced more frequently. Situs RERC can advise and implement best practices and policies and procedures for CRE debt funds and has clients for which we mark positions as frequently as daily to as limited as one-off valuation work.

Conclusion

Private equity CRE debt funds may provide strong risk-adjusted returns and exposure to CRE in an environment where equity investments continue to be expensive and offer thinning returns. With private equity CRE debt funds, it is helpful to understand the considerations and distinctions related to open-end and closed-end funds, with some of the important considerations and distinctions being the need/demand for funds to fair value their investments, fund lives (defined or infinite), liquidity, risks and frequency of valuation.

Situs RERC has over 15+ years of experience providing debt valuation services on over $60 billion (1,500+ positions) in CRE debt annually, with approximately $6 billion being subordinated or transitional CRE debt. Situs RERC understands the concerns and considerations related to third-party debt valuation for different fund structures in today's market and is able to not only provide fair value estimates and consulting services on debt positions but also advise on best practices and policies and procedures regarding debt valuation.

For more information on Situs RERC's debt valuation services, please contact:
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