Liquidity of real estate funds available to the general public in France

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The data on variable capital SCPIs and retail OPCIs used in this report comes from the IEIF for the period up to 2001 and from the ASPIM-IEIF partnership for the period from 2001 onwards.

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Executive summary

Real estate assets under management account for approximately one third of the total value of commercial real estate worldwide. Commercial real estate is a relatively illiquid investment asset: during periods when the markets are functioning normally, annual transaction volumes are in the order of 10% to 15% of the invested universe, depending on the country. During times of market stress, illiquidity increases: transaction volumes fell to 3% of the invested universe in France in 2009 amid the recession following the global financial crisis and plunged even lower in 1995 at the height of the 1990s real estate crisis.

Worldwide, the vast majority of real estate funds are closed-end funds. Most are either listed on the stock exchange in the form real estate investment trusts (REITs) or take the form of unlisted funds reserved for institutional investors and subject to lock-up clauses. A small fraction are unlisted funds available to the general public. These funds are specific to certain countries: in Europe, France and Germany are the main countries concerned. In France, these funds fall into two types: SCPIs (*Sociétés Civiles de Placement Immobilier* - real estate investment companies), which are alternative investment funds (AIFs) within the meaning of the AIFM Directive and can be closed- or open-ended, and OPCIs (*Organismes de Placement Collectif en Immobilier* - undertakings for collective investment in real estate). In 2019, the capitalisation of open-ended real estate funds represented a small fraction of the total for French UCIs and AIFs (4.3%).

By nature, open-ended funds are exposed to the risk of liquidity mismatch between their assets and liabilities. They are vulnerable due to the organisation of their liquidity on the liabilities side, which relies on the fund buying back shares from investors seeking to regain a certain degree of liquidity. This mismatch means that liquidity comes at a price and risks breaching the equal treatment principle between shareholders, which can result in a significant change in the fund's risk-return profile.

Managing this risk is a major concern for management companies, which seek to ensure the liquidity advertised to investors while complying with the fundamental principles of treating investors equitably and preserving market integrity. Crisis periods put pressure on liquidity across all markets and trigger waves of withdrawals from all types of investment funds. During a crisis, markets are adversely affected by both expectations of declining values and the drying up of transactions, which make valuations uncertain.

The liquidity of open-ended funds can be managed on the assets side by diversifying the portfolio, managing the frequency of exposures valuations and having a minimum reserve of liquid assets at all times. On the liabilities side, the mechanisms are based on the frequency at which net asset values are published, the monitoring of possible interests dominance held by investors, the use of debt, an increase in inflows, or changes to redemption arrangements involving protection mechanisms geared towards reflecting the impact of liquidity in prices or directly limiting liquidity on the liabilities side.

Open-ended real estate funds in France have a large number of robust liquidity mechanisms. The variable capital SCPI model has proved to be highly resilient for more than fifty years, particularly during the real estate crisis of the 1990s and the global financial crisis, both overall and at the level of individual funds. It is still a little too early to give a final verdict on the OPCI model, which has only been around for ten years and has yet to weather a crisis, although no liquidity problems have arisen to date.

The economic crisis linked to the Covid-19 pandemic and widespread lockdown measures led to large-scale redemptions of funds invested in corporate bonds in March which, had it not been for the European Central Bank's rapid response through the Pandemic Emergency Purchase Programme, could have weakened liquidity in the markets. OPCIs and variable capital SCPIs did not experience such withdrawals but continued to see steady inflows during the first quarter. However, the damage done to the economic fabric points to an increase in unemployment and business insolvencies to come. A fall in rental income is likely to follow, which will in turn affect income return on property, so difficulties are anticipated in the second half of 2020. That said, prices of shares in these funds have remained stable since the beginning of the year, avoiding the sharp correction seen in financial asset prices in March and April.

Introduction

Real estate as a savings vehicle
The amount of real estate assets under management via unlisted funds or mandates worldwide stood at €3,240 billion at the end of 2019[1]. As of the same date, the amount of real estate assets under management via listed real estate companies is estimated at €5,900 billion[2].

Real estate assets under management account for approximately one third of the total value of commercial real estate worldwide[2]. However, they represent only a small share of residential real estate, the vast majority of which belongs to owner-occupiers. Commercial real estate is a relatively illiquid investment asset: during periods when the markets are functioning normally, annual transaction volumes are in the order of 10% to 15% of the invested universe, depending on the country. Some real estate segments are significantly more liquid than others, in particular the prime office segment. At times of market stress, illiquidity increases: transaction volumes fell to 3% of the invested universe in France in 2009 amid the recession following the global financial crisis and plunged even lower in 1995, at the height of the 1990s real estate crisis.

Funds invested in real estate provide a key avenue for households to build up their wealth alongside their mandatory pension schemes. In France, concerns about the financial balance of the various pension schemes amid an ageing population make it all the more necessary for households to set aside precautionary savings through personal savings plans.

Real estate provides high current yields and stable, long-term inflation-linked income. The high yield premium on real estate relative to government bond yields is the reward for the relative illiquidity of the physical market, the risk associated with fluctuating rental and market values, and the investments needed to avoid obsolescence.

Given the specific nature of these assets, which have high idiosyncratic risk and require professional management, it makes sense for households to invest in them collectively through sizeable investment funds. Such funds also have the advantage of enabling investments to be made in the form of fungible units, thus offering higher potential liquidity than the underlying assets. For there is always a residual liquidity gap, if only relating to arrangements for the transfers of assets in heritage and other life events (separation, donation, etc.). The question then is how can investors' liquidity needs be reconciled with the long-term investment horizon required for the effective management of real estate risk exposure and how can the price of this liquidity be minimised?

Open- and closed-ended real estate funds
Worldwide, the vast majority of real estate funds are closed-ended funds. Most are either listed on the stock exchange in the form of real estate investment trusts (REITs) or are unlisted funds reserved for institutional investors and subject to lock-up periods. A small fraction are unlisted funds available to the general public.

In closed-end funds, the liquidity on the liabilities side is backed by the liquidity of the real estate assets. It is provided through a liquid, well-organised secondary market, such as a centralised market managed by a market operator (stock exchange) or an investment firm authorised to operate a multilateral trading facility or an over-the-counter market managed by the fund's management company, inter-dealer brokers or any other intermediation channel. The price of liquidity can be reflected in shares in the fund showing a discount or premium to the fund's net asset value, which

[1] Source: 2020 *Fund Manager Survey* published by ANREV, INREV and NCREIF
[2] Source: EPRA

ensures that the social contract between shareholders is complied with. Such discounts or premiums are not a bad thing in themselves insofar as they reflect investors' expectations of change in the fund's net asset value. However, it must be ensured that these expectations can come together and be expressed in the context of an organised market adapted to the fund's structure.
Listed real estate stock markets meet strong demand for liquidity corresponding to annual turnover of at least 30%, but in return certain sacrifices must be made which alter a real estate fund’s characteristics in the short term, such as relinquishing the decorrelation offered by the real estate asset class and increased volatility. In practice, this type of market effectively creates liquidity for funds held by a very large number of investors. OTC markets are more suited to funds held by a small number of investors with weaker demand for liquidity.

Unlisted real estate funds available to the general public are specific to certain countries. In Europe, France and Germany (*Immobilien Sondervermögen*) are the main countries concerned, but this type of fund also exists in the United Kingdom (Property authorised investment fund), Spain (*Fondo de inversión immobiliaria*), the Netherlands (*Commanditaire Vennootschap* and *Fonds voor Gemene Rekening*) and Portugal (*Fundo de investimento imobiliáro*). In Italy, real estate funds are essentially closed-ended (*Fondi comuni di investimento immobiliare* and *SICAF Immobiliari*).

SCPIs and OPCIs

In France, there are two types of unlisted real estate funds available to the general public: *Sociétés Civiles de Placement Immobilier* (SCPIs), which are alternative investment funds (AIFs) within the meaning of the AIFM Directive, and *Organismes de Placement Collectif en Immobilier* (OPCIs).

SCPIs came into being in 1964 and were designed as jointly owned savings vehicles. The SCPI is a fiscally transparent vehicle. Individual investors are taxed on the basis of the rules governing real estate income, so they can optimise share purchases using debt. Governed by regulations dating back to French law no. 70-1300 of 31 December 1970, these funds have gradually developed into financial products managed by management companies that were initially only responsible for rental management, hence the specific nature of their remuneration as a percentage of rents received and not as a percentage of net asset value. The fund's model has proved resilient, having weathered the real estate crisis of the 1990s and the global financial crisis of 2008. There are two types of SCPI: fixed capital SCPIs and variable capital SCPIs. Fixed capital SCPIs are closed-end funds. The management company can carry out a capital increase during a specified period, but outside such subscription periods, shares can only be acquired on a secondary market organised between shareholders by the management company. Variable capital SCPIs may be considered to a certain extent as open-ended funds as their capital can vary at any time depending on the creation and withdrawal of shares. However, unlike collective investment undertakings, the funds’ liquidity is not intrinsic. This report deals only with liquidity issues relating to variable capital SCPIs.

OPCIs were created much more recently. Their legal status was established by French decree no. 2005-1278 of 13 October 2005 but the decree approving the provisions of the AMF's general regulation was only published on 16 May 2007[3]. OPCIs are fiscally transparent vehicles. Individual investors are taxed under the rules on securities income. OPCIs only really took off after the global financial crisis. Therefore, not enough time has passed to assess their liquidity.

At the end of 2019, SCPIs amounted to €65.4 billion, of which €56.3 billion in the form of variable capital funds and €9.1 billion in the form of fixed capital funds. OPCIs stood at €18.6 billion. Together, unlisted real estate funds available to the general public in France totalled €84.0 billion, versus €1,960.4 billion for French UCIs and AIFs, i.e. 4.3% of the total[4]. The ratio is similar for listed real estate

[3] This report deals only with so-called retail OPCIs; it does not cover those intended for institutional investors.
[4] Sources: IEIF and AFG

funds: real estate companies listed in France (SIIC) amounted to €77.8 billion at the end of 2019, or 2.6% of the capitalisation of French equities.

Liquidity risk management in open-ended funds in Europe: general principles

For open-ended investment funds, liquidity risk is defined as the risk that a position in the portfolio cannot be sold, liquidated or closed out at a limited cost and within a sufficiently short period of time, thus compromising the fund's ability to comply at any time with the requirement to issue and redeem shares at the request of investors[5]. By nature, open-ended funds are exposed to the risk of liquidity mismatch between the fund’s assets and liabilities. Managing this risk is a major concern for management companies, which seek to provide the liquidity advertised to investors while complying with the fundamental principles of treating investors equitably and preserving market integrity.

Crisis periods put pressure on liquidity across all markets and trigger waves of withdrawals from all types of investment funds. Open-ended funds are by nature particularly vulnerable due to the organisation of their liquidity on the liabilities side, which relies on the fund buying back shares from investors seeking to regain a certain degree of liquidity. During a crisis, markets are adversely affected by both expectations of declining values and the drying up of transactions, which make valuations uncertain.

Assets

On the assets side, although there is a certain assumed hierarchy in terms of liquidity between the different asset classes, liquidity cannot be taken for granted. The assets’ relative liquidity can vary over time, affecting the cost or liquidation time of the position held in the portfolio, and may sporadically decrease or even dry up altogether in the event of a serious liquidity crisis in a given market segment. However, a fund that is highly diversified across several countries and asset classes has more liquid assets than a fund invested in a single country and asset class. More generally, the liquidity facility offered to investors in open-ended funds encourages management companies to adopt an investment discipline that limits moral hazard, promotes diversification and thus drives performance.

The frequency of asset valuations, especially for illiquid assets that must be appraised on the basis of expert opinion, also plays a role in the fund's liquidity. At times of market turbulence, infrequent valuations encourage investors to resort to inter-temporal arbitrage. In the case of real estate funds, valuation standards for real estate assets pose a particular problem. Depending on the country, these standards vary according to the weight given to valuations based on the analysis of comparable transactions (mark-to-market), the discounting of expected rental income taking a risk premium into account (mark-to-model) and replacement value (sustainable value), which smooth performances to a greater or lesser degree. This results in significant differences in risk-return profiles which, if the smoothing effect is not adequately corrected, subtly and misleadingly place real estate funds at an advantage to funds invested in equities or bonds by making them look like high-performing money market funds.

When it comes to the mechanisms that enable a fund to redeem its own shares, the intuitive choice is to maintain a minimum reserve of liquid assets at all times. The drawback of this, however, is that it weighs on the fund’s performance. It represents an opportunity cost, i.e. the cost of providing liquidity. Long-term investors who only use the liquidity facility infrequently implicitly subsidise short-term investors who use it frequently.

Liabilities

[5] Article 3(8) of European Directive 2010/43/EC, the regulatory framework governing fund liquidity in Europe is constituted by the UCITS Directive 2009/65/EC and the AIFM Directive 2011/61/EU.

Liquidity risk management involves analysing the degree of liquidity of the portfolio under management in light of its liabilities. In this respect, the frequency at which net asset values are published, and thus the timing of redemption windows, plays an important role. A low frequency allows for more robust assessments of share values and limits the first-mover advantage through the accumulation of buy and sell orders between two net asset value calculation dates. This frequency can be daily, bi-monthly, monthly, quarterly or half-yearly, depending on the assets under management and the countries in question.

Controlling the possible interests dominance held by investors in the fund is another keyway to improve liquidity on the liabilities side: if one or more investors control significant amounts of capital, the liquidity risk is higher than if the capital is broadly distributed.

There are only two ways to increase a fund's liquidity: by taking on debt and by selling assets. The use of debt has the drawback of increasing the fund's risk profile to the detriment of investors who remain in the fund. Managing debt can also be a complex task if the existing debt is subject to restrictive conditions (covenants). Selling off assets to create a redemption fund has the disadvantage of diluting the positions of investors who remain in the fund. The management company has the choice between selling the most profitable and most liquid assets or selling the least profitable assets or those whose potential to create value seems limited. The pressing need to free up cash may lead to these assets being sold below their market values, especially given that redemption requests often signal a downward trend in the assets in question. Selling assets also automatically reduces the mutualisation of risk within the fund.

Another response to redemption requests can involve increasing inflows, so that new investors compensate for exiting investors. However, leaving aside the marketing efforts to be made in such situations, the management company does not really have the means to influence this parameter.

While inflows are not a solution, it remains possible to change redemption arrangements by triggering protection mechanisms geared towards either reflecting the impact of liquidity in the price, or directly limiting liquidity on the liabilities side. The mechanisms applicable to French open-ended funds, UCIs or AIFs are: adjusting the net asset value to reflect the cost of reorganising the portfolio (swing pricing), applying adjustable entry and exit fees payable to the fund (anti-dilution levies), implementing notice periods, capping redemptions (redemption gates), implementing in-kind redemptions, setting up side pockets and temporarily suspending subscriptions/redemptions. Different mechanisms are used in different situations depending on the degree of deterioration in liquidity (see Chart 1), which must be mentioned in the fund's instruments of incorporation.

These mechanisms are only activated if the movement in liabilities net of subscriptions and redemptions exceeds a predetermined threshold and they are applicable to all assets. Upper and lower thresholds may differ and can be expressed as an amount, number of shares or percentage of assets. Generally speaking, these thresholds are not specifically disclosed in advance, in order to avoid undermining the mechanism's efficiency and to prevent manipulation.

As a first defence against a limited reduction in liquidity, adjusting the net asset value and applying adjustable entry and exit fees payable to the fund protects investors remaining in the fund from the adverse effects of liability movements caused by incoming or outgoing investors, since the associated costs are borne by the latter. Based on observations, activating this mechanism curbs the scale of withdrawal requests and improves the medium and long-term performance of the funds concerned, while increasing their volatility. However, the mechanism is less effective during periods of severe turbulence and can still be misused so as to automatically improve the fund's performance.

In the event of a more serious liquidity crunch, other lines of defence may be activated.

By imposing a notice period for investors wishing to redeem their shares, the manager can obtain better conditions under which to free up the liquidity needed to pay for the redemptions. The management company can gain a window between the order's centralisation date and trading date, enabling it - when necessary for positions that are more difficult to liquidate given the market conditions at the time of redemption - to arrange orders in the market so that the assets can be realised under the best possible conditions. There are two types of notice: mandatory and incentive-based, the latter being the most commonly used.

The redemption gate mechanism allows managers to temporarily spread redemption requests over several net asset valuation calculation dates. It enables them to manage liquidity risk in the sole interest of investors. In a liquidity situation that does not justify the total suspension of redemptions, it can be more in the interest of investors and market integrity to temporarily spread redemption requests. Investors who so wish can always exchange their shares on a secondary market at a discount to the net asset value to reflect the uncertainty on that value while the redemption gate mechanism is in place.

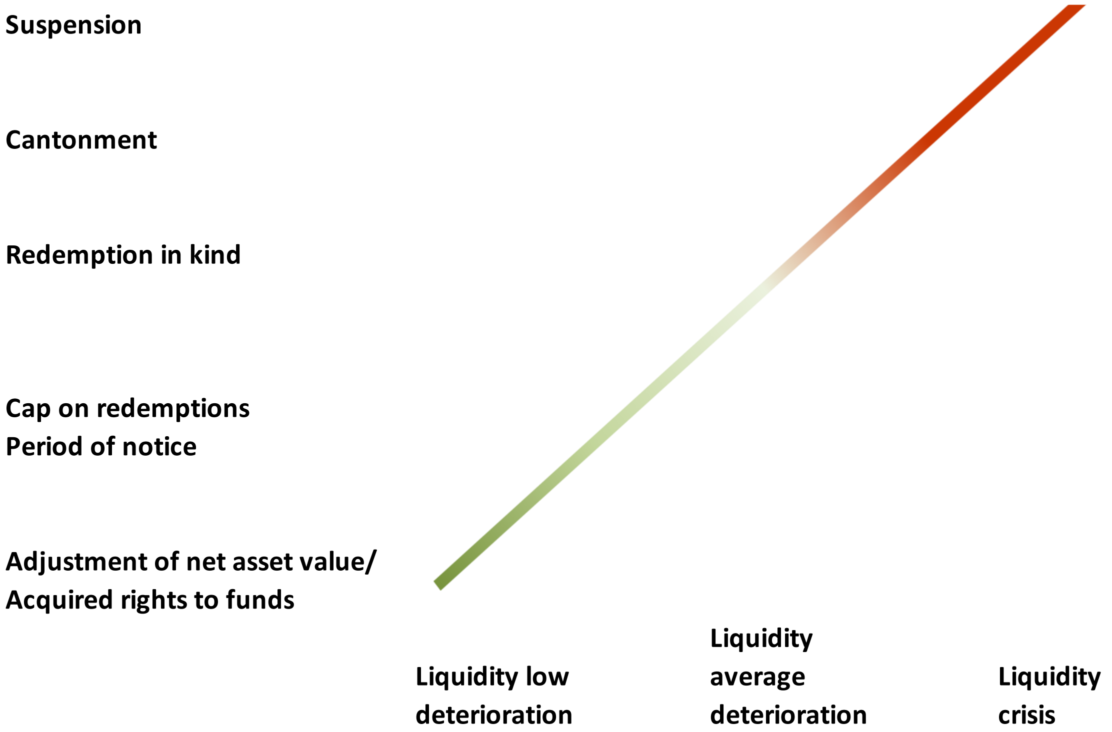
In-kind redemptions involve providing exiting investors with assets rather than cash. The fund transfers to exiting investors the cost of selling a portion of the overall portfolio, thus avoiding the costs associated with obtaining liquidity in less liquid or illiquid markets. This mechanism is attractive as an additional option for investors able to manage the assets received themselves, but it is not appropriate for retail investors. The activation of this mechanism assumes that outgoing investors, or indeed all investors, agree to its use.

A side pocket mechanism is put in place when certain assets are difficult to value and sell in the market or are distressed. In such cases, the fund is split into two, with, on the one hand, liquid/recoverable assets, and on the other hand a separate side pocket of illiquid/distressed assets intended to be sold at a later date under the best possible market conditions and in the best interest of investors. The liquid portion continues to be managed as normal, with net asset value calculation frequencies and subscription/redemption conditions remaining unchanged, while for the side pocket, subscriptions and redemptions are no longer allowed, and the assets are managed purely on a run-off basis. This exceptional measure ensures that investors are treated equitably, since only those invested in the fund on the date of the split are allocated a share in the side pocket.

The temporary suspension of subscriptions/redemptions is a means of last resort. It effectively amounts to closing the fund[6]. It preserves investor equality in very difficult market situations, such as when it becomes impossible to realise or value assets. This mechanism also protects potential subscribers, who run the risk of paying an unrealistic price if there are no reliable valuation methods available. Here again, investors who so wish can always exchange their shares on a secondary market.

[6] The best-known example internationally is that of the Rodamco real estate fund in 1990.

Chart 1: Liquidity risk management mechanisms in open-ended funds



Critical review of the liquidity of variable capital SCPIs

Principle

The SCPI is a simple vehicle. Its assets consist only of physical real estate assets and liquidity provided by rents, enabling dividends to be paid plus possible retained earnings to facilitate dividend smoothing. The real estate assets of SCPIs consist mainly of commercial real estate: offices, retail premises, industrial premises, logistics platforms, service buildings (hotels, clinics, nursing homes), but also include a small share of residential real estate and serviced residences such as senior or student housing (see Chart 2). The vast majority of assets in the portfolio are located in France: in Paris, the Paris region and the provinces, while international diversification has been underway for several years now, mainly in the euro zone, in Germany (see Chart 3).

SCPIs can use debt but they have low debt levels, with an average loan to value ratio of around 14% at the end of 2018, having risen over the past few years, and a maximum loan to value of 40%. The highest debt ratios are seen in very small SCPIs, often the most recently created, as well as in very large SCPIs.

Chart 2: Breakdown of SCPIs' real estate assets by sector at end-2018

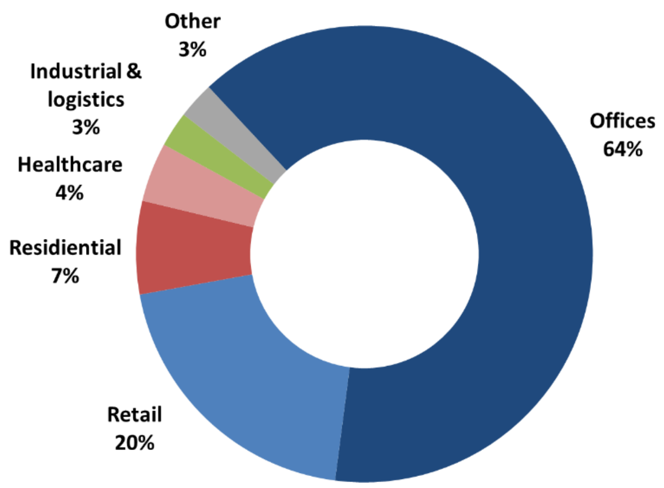
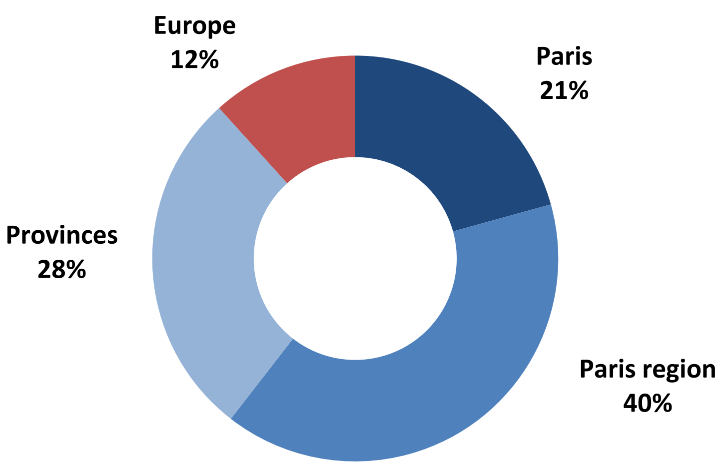


Chart 3: Geographical breakdown of SCPIs' real estate assets at end-2018



SCPIs are generally held by individual investors. The share held by institutional investors represents no more than 20% of the total capitalisation, and a small number of SCPIs are essentially held by institutional investors. The marketing of these funds as part of life insurance policies has developed in recent years, increasing the share of SCPIs' capital held by insurance companies to around 17%, of which 12% via unit-linked policies.

The primary market for variable capital SCPIs corresponds to net inflows, the sum of shares issues less any share redemption non-compensated by a subscription.
The subscription price is established by the management company at more or less 10% of the replacement value, i.e. the realisable value (net asset value) plus the cost of acquiring the assets. This subscription price is determined in accordance with the commercial strategy of the SCPI's management company: a value per share higher than the replacement value limits inflows by lowering the income return. Conversely, a price lower than the replacement value attracts inflows by showing an income return higher than the income return on the assets. In a way, it acts as a value adjustment mechanism that can be used to regulate liquidity (swing pricing).
There can only be non-compensated redemptions if a redemption fund has been set up. The creation of such a fund using asset sales is only justified in the event of stress caused by non-compensated withdrawals. Shares are redeemed at a discount and their price cannot be higher than the realisable value or lower than the realisable value less 10%.

The secondary market for variable capital SCPIs corresponds to the procedure for compensated withdrawals put in place by the management company, where a redeeming investor sells their shares to the SCPI, which issues new shares to a buyer and to the over-the-counter market, which plays a very marginal role. The redemption price is set by the management company and may not exceed the subscription price less the subscription fee.
Shares pending sale are sell orders that could not be honoured due to a lack of buyers and the inability to process non-compensated withdrawals. These sell orders are executed as and when inflows are received.

The primary and secondary markets mainly have quarterly dealing frequencies on the basis of updates to real estate asset valuations. In a period of inflows, variable capital SCPIs therefore offer greater liquidity than direct investments in real estate. In a period of outflows, the liquidity may approach that of the underlying real estate asset.

History
During the 1970s, most banks, together with a few independent groups, set up SCPIs. At the time, these funds had long-term buy and hold strategies for real estate assets, made few adjustments to their investments and had limited scope for value creation. In the 1980s, SCPIs really took off. In 1986, the "Commission des Opérations de Bourse" (COB - French securities authority)[7] established industry standards, particularly in terms of transparency. This secure framework against a backdrop of rising real estate prices contributed to the growth of SCPIs.

In the early 1990s, the real estate market entered a serious crisis and SCPIs, which were mainly fixed capital funds at the time, fell victim to inopportune regulations. In January 1993, the COB imposed a recommended redemption price based on net asset value, whereas the share price before the reform was lower than this value. Income returns automatically fell and buyers disappeared. As a result, the crisis affecting SCPI performances due to unfavourable real estate conditions was exacerbated by a liquidity crisis. To address this difficult situation, from 1996 onwards, management companies developed an over-the-counter market, allowing investors to exchange their shares at a freely agreed price rather than at the recommended sale price.

[7] Now the "Autorité des Marché Financiers" (AMF - French financial markets authority)

From 1999, due to the rise in real estate prices, SCPIs entered a new growth phase. Liquidity in the market for SCPI shares returned to normal from 2000 and, from 2003 to 2007, SCPIs again enjoyed substantial inflows. Management companies gradually converted fixed capital SCPIs into variable capital SCPIs, which now became the majority. They also merged funds to create larger vehicles. At the same time, professionals worked to ease the restrictive rules on SCPIs in terms of real estate management and the market for SCPI shares. A reform of the secondary market for SCPIs introduced by the French decree of 26 April 2002 approving COB regulation no. 2001-06 dropped the system of recommended management prices for fixed capital SCPIs. Decree no. 2003-74 of 28 January 2003 eased management constraints on sales of buildings and works, thereby allowing more proactive management of real estate assets to be implemented.

After the 2008 global financial crisis, a period of low interest rates set in following the implementation of accommodative monetary policy and investors turned to real estate as a safe haven. Inflows remained high and management companies increasingly used bank debt to manage real estate purchases in anticipation of inflows and to boost returns through financial leverage.

In 2013, SCPIs joined the universe of European savings funds with the transposition into French law by decree no. 2013-676 of 27 July 2013 of Directive 2011/61/EU issued by the European Parliament and Council on 8 June 2011 on alternative investment fund managers, known as the AIFM Directive. On this occasion, SCPIs gained even more flexibility in the management of their real estate portfolio and their governance increased with the appointment of a depository responsible for the custody of financial instruments, the recording of assets and the monitoring of cash flows, as well as an independent real estate appraiser.

Consequently, SCPIs are subject to the regulations governing the key information document on packaged retail and insurance-based investment products (PRIIPS), no. 1286/2014 issued by the European Parliament and Council on 26 November 2014. Variable capital SCPIs generally have a market risk level of 3.

These structural changes in the market for variable capital SCPIs since 1990 are shown in Charts 4 and 5. In Chart 4, periods of real estate crisis appear in grey. They result in a downturn in the EDHEC IEIF price index for SCPIs invested in corporate real estate. After each crisis, the capitalisation of variable capital SCPIs remains stable or even declines. Chart 5 shows change in the number of variable capital SCPIs, which decreased until 2004 then stabilised, before increasing as from 2017 to 102 vehicles at the end of 2019, while the average capitalisation increased sharply from 2012 to nearly €550 million at the end of 2019.

Chart 4: Change in the capitalisation of variable capital SCPIs and the EDHEC IEIF price index at the end of the year

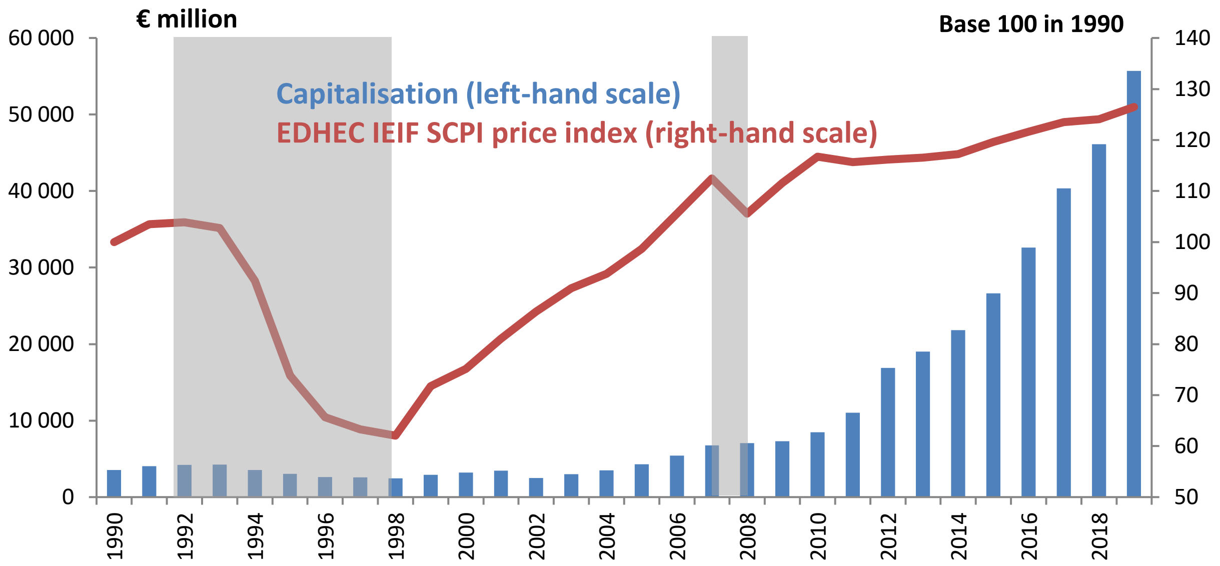
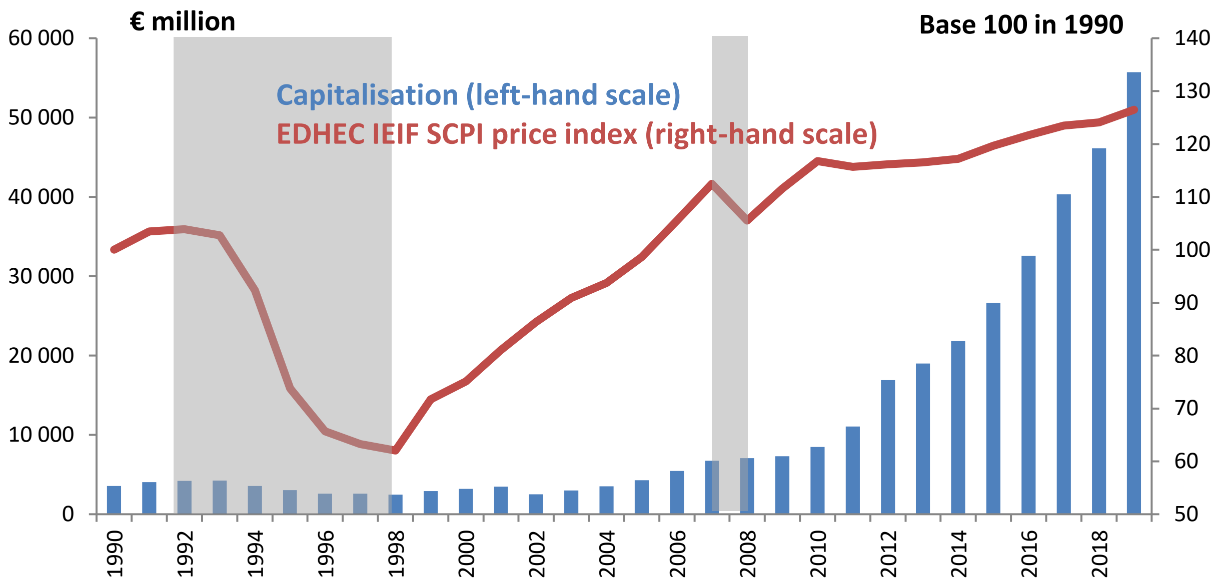


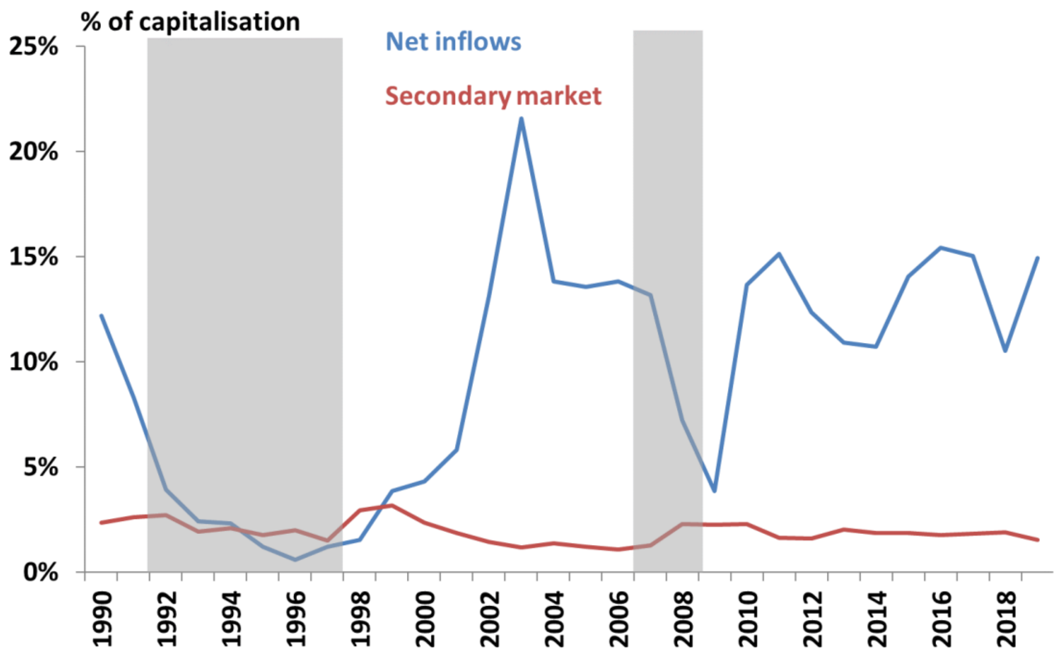
Chart 5: Change in the number of variable capital SCPIs and average capitalisation at the end of the year



General functioning of the market for SCPI shares

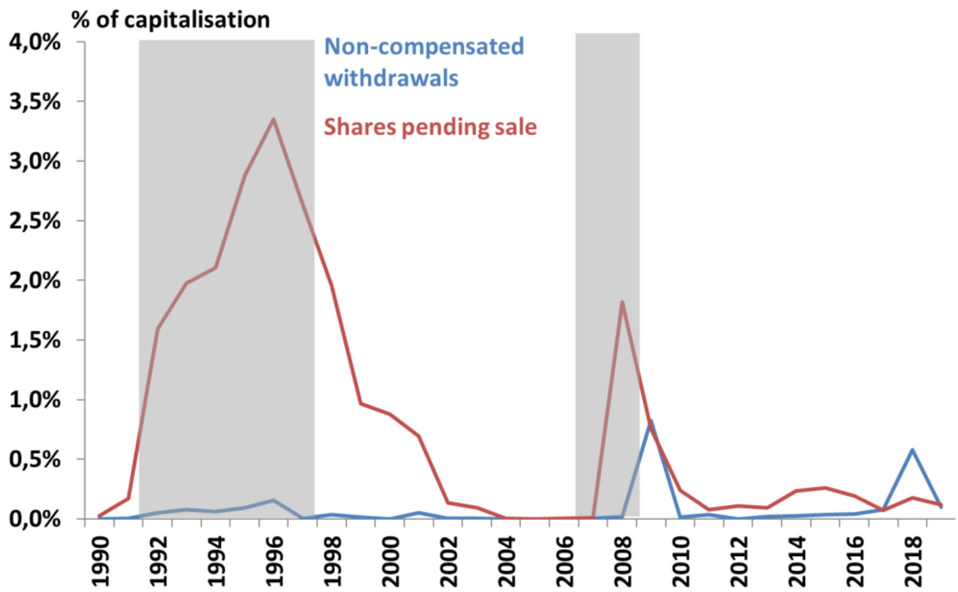
Since 2001, net inflows have been robust and, stripping out the effects of the global financial crisis, amount to nearly 15% of capitalisation each year (see Chart 6). The secondary market represents on average slightly under 2% of the capitalisation, which corresponds to an average holding period of fifty years. This turnover rate is at least four times lower than that for corporate real estate investment in France. SCPIs' underlying real estate assets are therefore much more liquid than the secondary market for SCPI shares. This is a guarantee of stability for the SCPI market, particularly given that real estate cycles last for ten to twelve years.

Chart 6: Change in net inflows and in the secondary market for variable capital SCPIs



Non-compensated withdrawals, which signal a liquidity problem, represent on average 0.1% of capitalisation, having peaked at 0.8% during the global financial crisis (see Chart 7). This is a very low percentage that can be easily managed.
The number of shares pending sale is also an indicator of liquidity stress. Since 2002, the number of shares pending sale has remained low. It peaked at 3.3% during the global financial crisis, then rapidly subsided, suggesting that the secondary market is functioning properly.

Chart 7: Change in non-compensated withdrawals and the number of shares pending sale at year-end for variable capital SCPIs

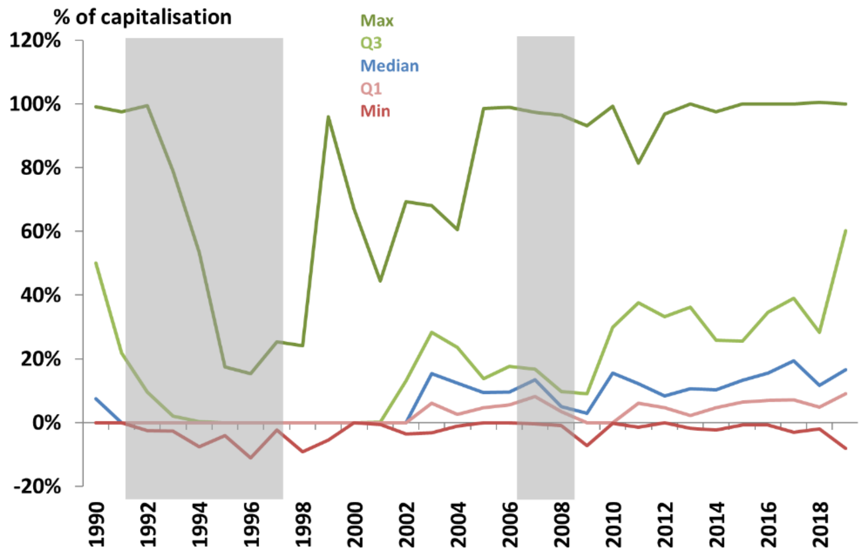


Specific functioning of the market for SCPI shares

While liquidity management is working well overall, it must also be assessed at the level of individual variable capital SCPIs. For this purpose, the previous indicators are broken down into quartiles (maximum, 3rd quartile, median, 1st quartile and minimum) for the entire universe of funds and for each year of observation. In this analysis, orderly liquidation procedures for SCPIs are excluded.

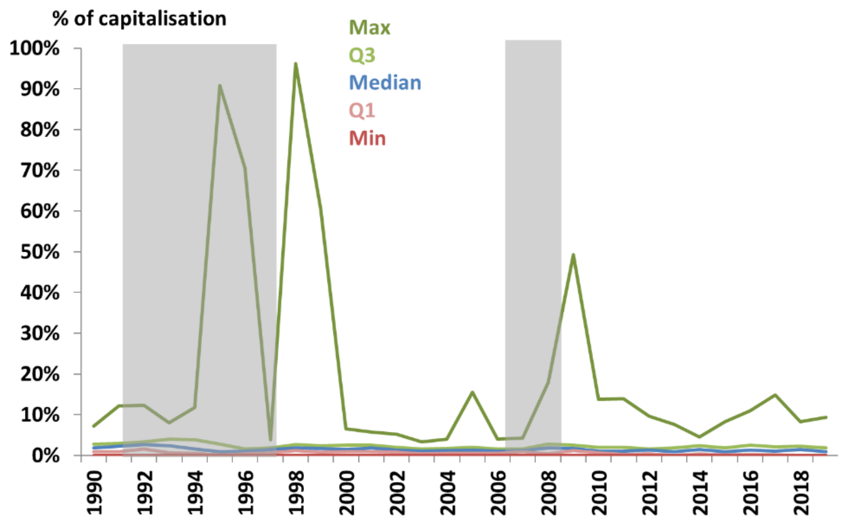
Periods of crisis in the real estate sector coincide with a downturn in inflows for all quartiles except for the SCPI with maximum inflows which was not affected by the global financial crisis. Up to the 1st quartile, SCPIs show inflows or are stable and outflows were low for the SCPI with minimum inflows year after year (see Chart 8).

Chart 8: Change in quartiles with net inflows as % of capitalisation



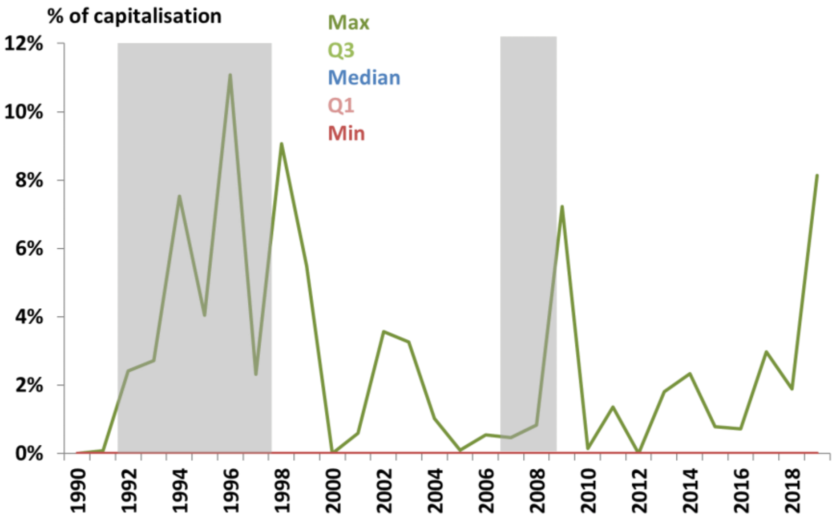
The secondary market was very active during the real estate crisis of the 1990s for the maximum value secondary market SCPI, but much less so during the global financial crisis (see Chart 9). This concerned only very small funds.

Chart 9: Change in secondary market quartiles as a % of capitalisation



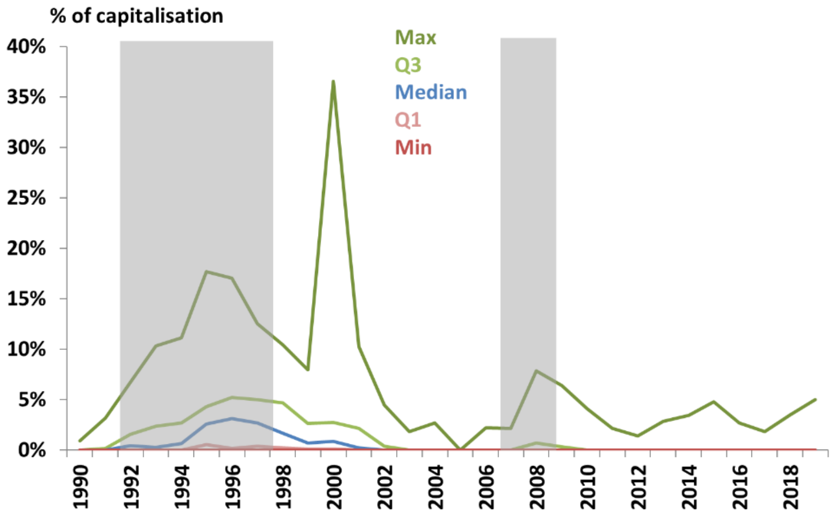
Non-compensated withdrawals only concern the SCPI with maximum non-compensated withdrawals (see Chart 10). The problem is therefore very limited. Moreover, the SCPIs showing a level of non-compensated withdrawals above 2% of capitalisation are small in size.

Chart 10: Change in quartiles of non-compensated withdrawals as a % of capitalisation



Shares pending sale again only really concern the SCPI with maximum numbers of shares pending sale (see Chart 11). Therefore, here again the problem is very limited; the peak in 2000 involves a very small SCPI.

Chart 11: Change in quartiles of shares pending sale as % of capitalisation



General review of OPCI liquidity

Principle

The OPCI is an asset allocation vehicle. 60% of its assets are real estate, of which at least 50% in the form of physical real estate and the remainder in the form of listed real estate companies. The other 40% of assets are financial assets, equities and bonds, of which 5% cash (see Chart 12). As 40% of the underlying assets are liquid assets, the OPCI offers savers much better liquidity than real estate.

SCPIs' brick-and-mortar real estate assets consist mainly of corporate real estate: offices, retail premises, industrial premises, logistics platforms, service buildings (hotels, clinics, nursing homes), but also include a small share of residential real estate and serviced residences such as senior or student housing (see chart 13). These assets are mainly located in France: in Paris, the Paris region and the provinces, but also widely distributed in Europe from the outset (see Chart 14).

The financial assets consist mainly of bonds (government bonds, bonds issued by listed real estate companies and other corporate bonds) and cash.

OPCIs can borrow up to 40% of the value of the real estate assets and up to 10% of the value of the other assets, i.e. 28% of the total net assets. The average loan to value ratio for OPCIs at end-2018 is around 15%.

Chart 12: Breakdown of OPCI assets at end-2018

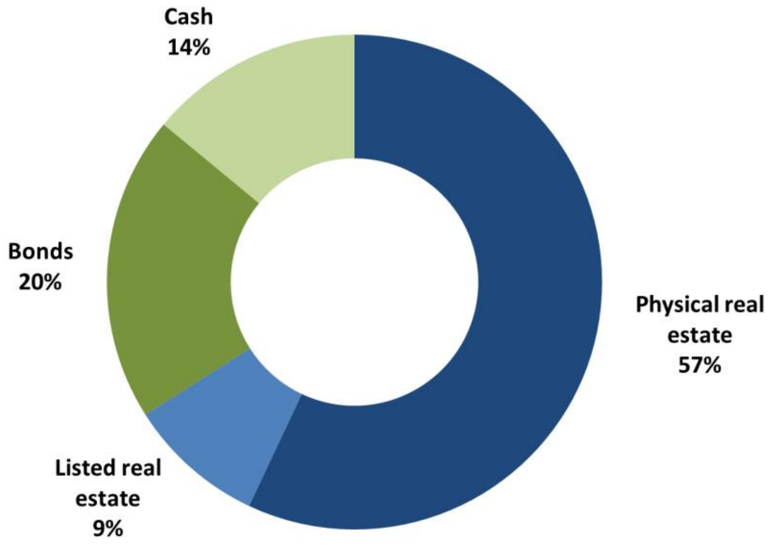


Chart 13: Breakdown of OPCI physical real estate assets by sector at end-2018

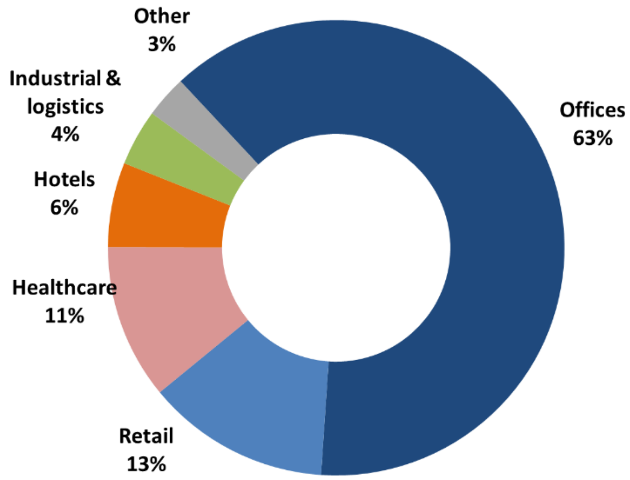
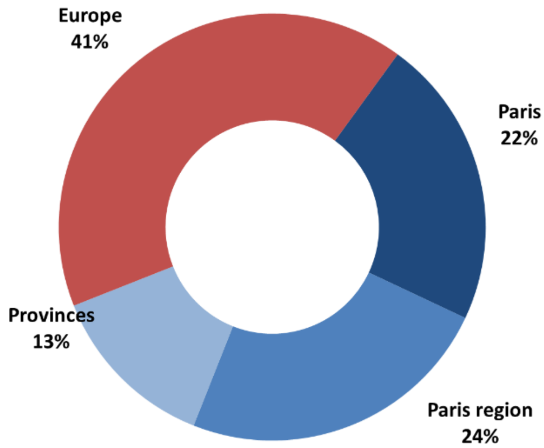


Chart 14: Geographical breakdown of OPCI physical real estate assets at end-2018



OPCIs are generally held by individual investors. They are mainly marketed in unit-linked policies as part of life insurance policies.

The management company determines the net asset value no more than twice a month and no less than twice a year. A bi-monthly frequency is the norm.

History

OPCIs got off to a slow start amid the economic and financial turbulence of the global financial crisis. It also took time for their commercial positioning to be understood by the distribution networks given their unique investment strategy, which reduces the weight of total returns from real estate in the overall performance in favour of the total return on investments in securities.

The inclusion of OPCIs in unit-linked life insurance policies in 2012 generated significant momentum. The number of OPCIs rose rapidly to 20 at the end of 2019, as did the average capitalisation, which stood at nearly €1,850 million at the end of 2019 (see Charts 15 and 16).

Under the PRIPPS regulations, OPCIs generally have a market risk level of 2.

Chart 15: Change in capitalisation of OPCIs and the IEIF price index at year-end

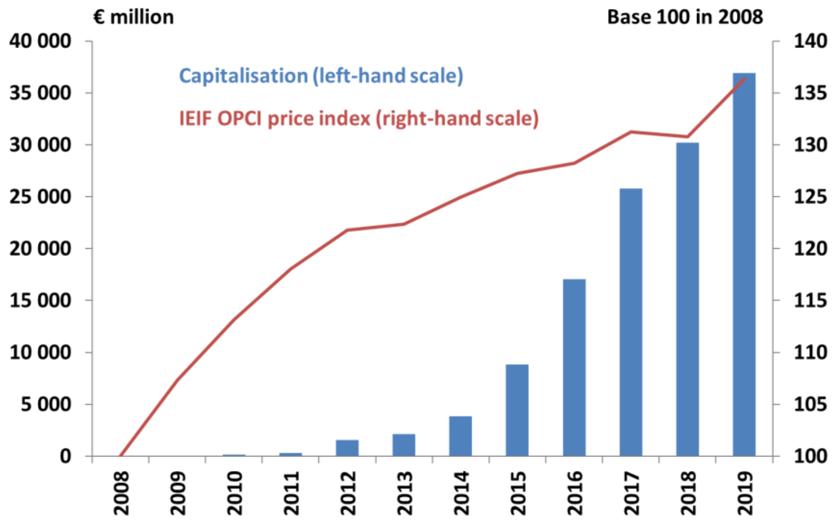
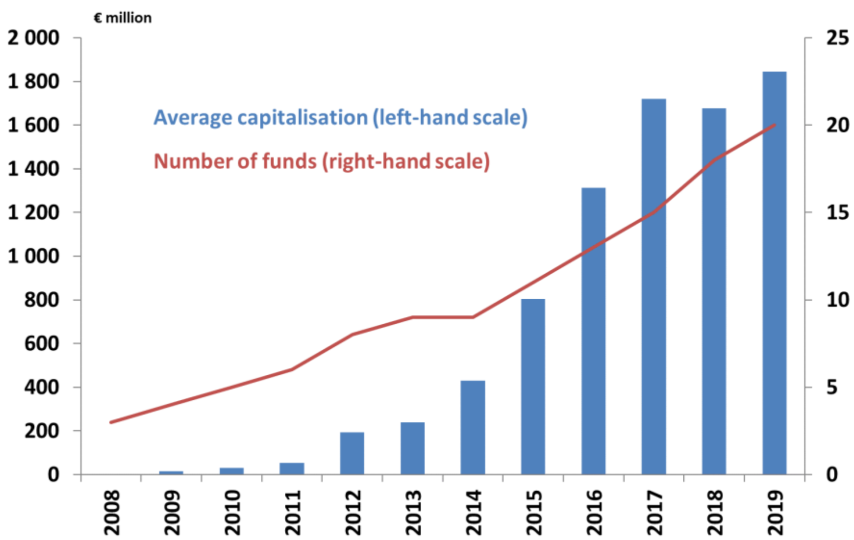


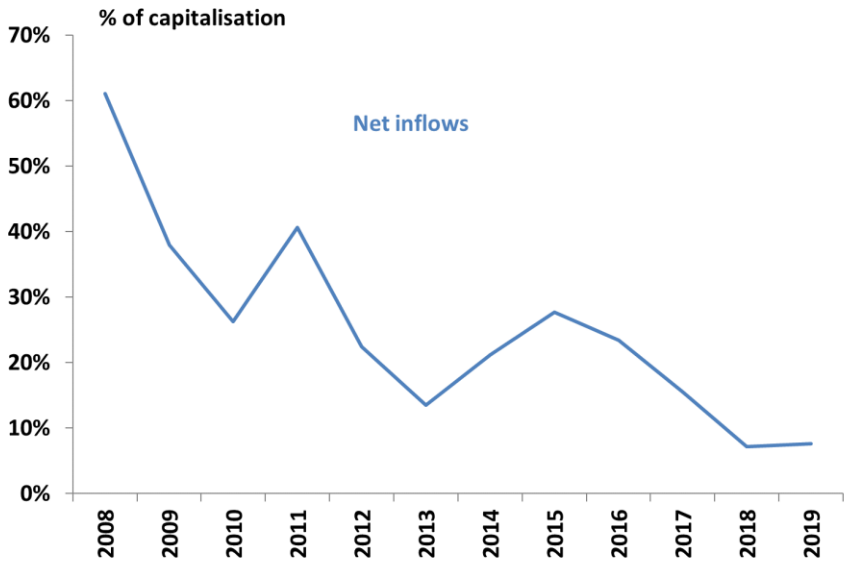
Chart 16: Change in the number of OPCIs and their average capitalisation at year-end



General functioning of the market for OPCI shares

After a start-up phase during which inflows were naturally very high compared to capitalisation, the momentum of inflows stabilised at slightly under 10% of capitalisation (see Chart 17). To date, no years of outflows have been recorded.

Chart 17: Change in OPCI net inflows

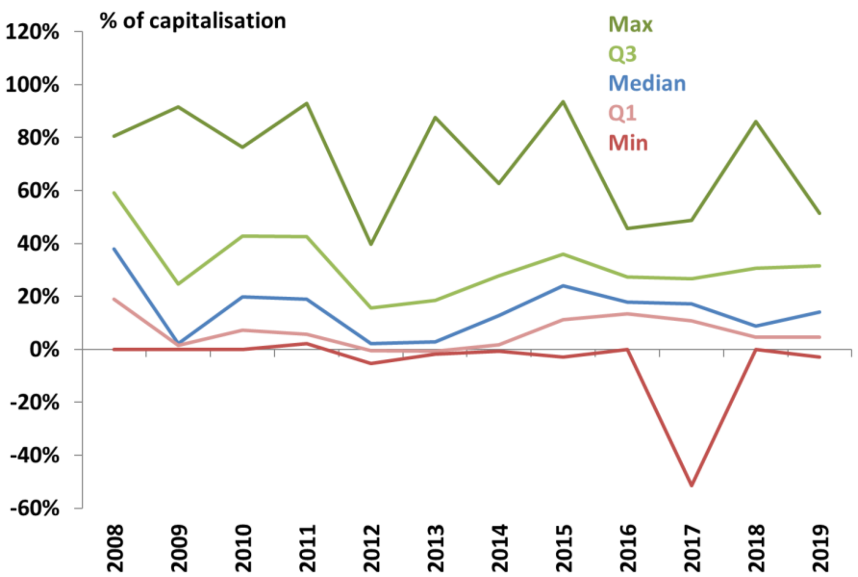


Specific functioning of the market for OPCI shares

Inflows must also be assessed at the level of individual OPCIs. For this purpose, the previous indicators are broken down into quartiles (maximum, 3rd quartile, 2nd quartile or median, 1st quartile and minimum) for entire universe of funds and for each year of observation.

Up to the 1st quartile, the OPCIs show inflows and outflows were insignificant for the minimum inflow OPCI year after year, except in 2017 when a small OPCI experienced significant outflows, which did not create any problems.

Chart 18: Change in net inflow quartiles as a % of capitalisation



Conclusion

Open-ended real estate funds in France have several robust liquidity mechanisms (see Table 1). The variable capital SCPI model has shown strong resilience to crises for more than fifty years and it is still a little early to give a verdict on the OPCI model, although no liquidity issues have been encountered to date.

Table 1: Summary of the liquidity mechanisms effectively used by variable capital SCPIs and OPCIs

	Variable capital SCPIs	OPCIs
Mechanisms to increase the fund's liquidity		
Diversification of real estate assets	High	Very high
Liquidity reserves	Not required, but possible presence of retained earnings	5% minimum and 40% of financial assets
Debt	Established in the articles of association	Up to 40% of the value of the real estate assets and 10% of the value of the other assets
Mechanisms to reflect the impact of liquidity in prices		
Adjustment of net asset value	Yes, up to 10% of the replacement value	Yes
Application of adjustable entry and exit fees	Yes	Yes
Mechanisms to limit liquidity on the liabilities side		
Limiting the holdings of a dominant shareholder	No	No
Dealing frequency of the market for shares	Quarterly	Bi-monthly
Notice period for redemptions	Yes	Yes
Redemption caps	Yes	Yes

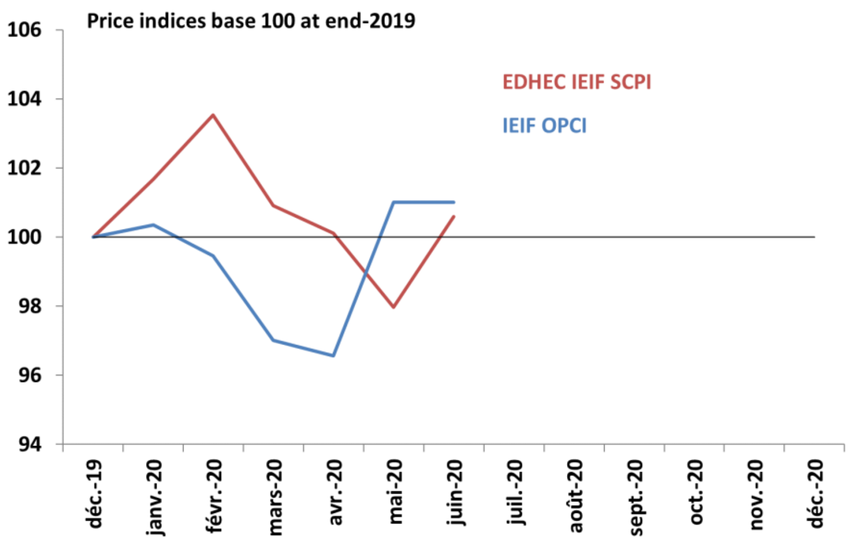
Conversely, severe liquidity crises were experienced by German open-ended real estate funds during the global financial crisis, after the system had worked perfectly for nearly fifty years. More recently, similar crises broke out among UK open-ended real estate funds exposed to the retail segment, which has been undergoing structural transformation for several years due to the disruptive impact of e-commerce. Unlike French funds, these funds offer daily liquidity, are controlled to a much greater extent by institutional investors and can thus be subject to movements in large positions, and invest widely in real estate markets that are more volatile than those of the euro zone in the US and Asia.

Funds rating

A rating process requested of funds by an independent agency is also desirable because the public information available to investors is not always easy to process. The traditional classifications used by wealth management consultants are becoming increasingly unsuitable and the descriptions of risks assumed and key performance factors are increasingly poor. The market risk classification under the PRIIPS regulation provides a partial response to this issue. As the fund offering expands and grows more sophisticated, the need for ratings is becoming more pressing. A rating system would be part of an effective response in the event of a liquidity crisis triggered by a self-fulfilling run on an inherently viable fund. This is particularly important as experience has shown that a crisis stemming from a single fund can ultimately have a systemic effect on the industry as a whole. A rating system could help to contain this kind of systemic contagion, provided that it remains relatively general and does not lead to recommendations to buy or sell[8].

Multilateral trading facility
Given the substantial increase in the capitalisation of variable capital SCPIs in recent years, there is a need to modernise the primary and secondary markets for these funds so as to further strengthen their resilience to future crises. The economic crisis linked to the Covid-19 pandemic and widespread lockdown measures led to large-scale redemptions of funds invested in corporate bonds in March which, had it not been for the European Central Bank's rapid response through the Pandemic Emergency Purchase Programme, could have reduced liquidity in the markets. To date, the market for variable capital SCPIs and OPCIs has not experienced such withdrawals: funds continued to enjoy steady inflows during the first quarter, followed by a sharp slowdown in the second quarter then an improvement in June. But the damage done to the economic fabric suggests a rise in unemployment and business insolvencies to come. A fall in rental income is likely to follow, which will in turn affect income return on property, so difficulties are anticipated in the second half of 2020. To date, the rent recovery rate remains high and, apart from in certain sectors such as retail and hotels, rental income should not be down by more than 10%, which can be broadly offset in variable capital SCPIs by accumulated retained earnings. The rent cycle is also likely to enter unfavourable territory, with low rental demand and negative rent indexation over the coming quarters. Nevertheless, prices of shares in these funds have remained stable since the beginning of the year (see Chart 19), without experiencing the sharp correction seen in financial asset prices in March and April. The sizeable yield premium differential relative to other asset classes provides some protection against a downturn in prices.

Chart 19: Change in SCPI and OPCI price indices in 2020



The modernisation of the variable capital SCPI market should focus on its organisation by streamlining the settlement-delivery process using digital entries in secure accounts (blockchain technology) and by increasing the transparency of trading information by centralising it on a common platform for all the management companies concerned. This platform would have a direct benefit on the fixed capital SCPI market thanks to the efficiency of a multilateral trading facility compared to the scattered trading organisation actually in effect. In case of a deep real estate crisis, it could be open to the variable capital

[8] The rating agency Scope seems to have contributed to worsening the crisis in Germany by issuing such recommendations.

SCPIs aiming at closing their capital in order to provide liquidity to their shares without having to dismantling their property portfolio inappropriately.

Another candidate for modernisation could be transaction costs. High transaction costs are an effective barrier to overly frequent transactions that could have a destabilising effect. However, studies on the possible consequences of the introduction of the *Tobin-Spahn* tax on financial transactions show that, at times when the markets are functioning normally, excessively high transaction costs increase volatility. The transaction cost for variable capital SCPIs, the subscription fee, is particularly high, representing nearly two years' dividend payments.

The secondary market for variable capital SCPIs should logically be able to handle the same level of activity as the underlying real estate. Currently, this is far from being the case, but dealing conditions should be adapted so that it can be brought into line seamlessly if need be.

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