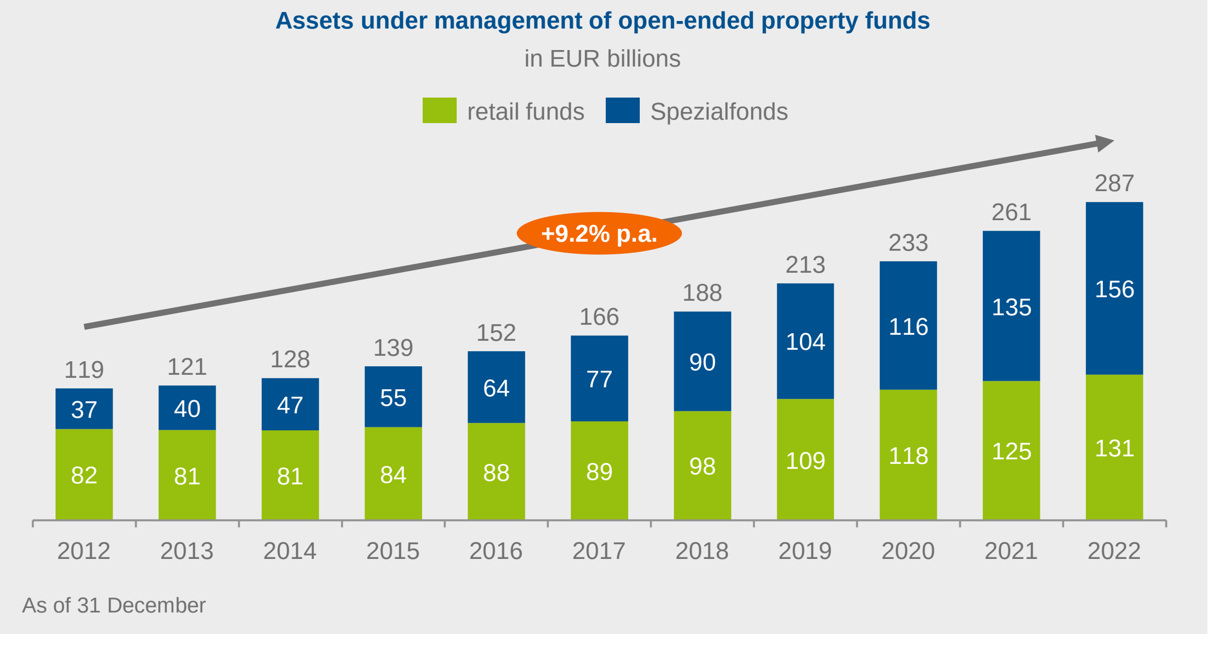
Snapshot Property Funds

LIQUIDITY MANAGEMENT IN OPEN-ENDED PROPERTY FUNDS

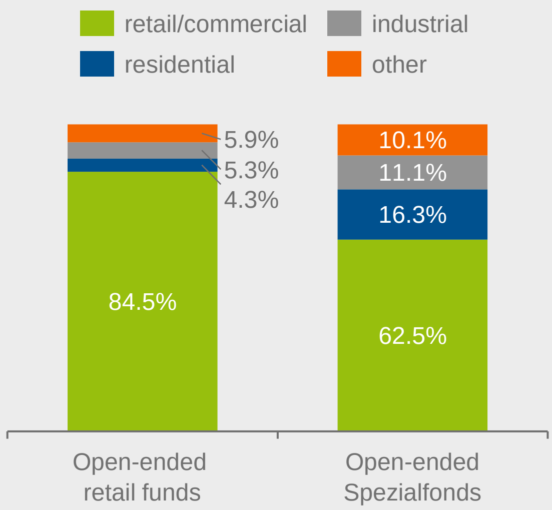
Holding and notice periods as well as the investor structure of Spezialfonds limit liquidity risks in open-ended property funds

Open-ended property funds play a key role in the German real estate market. After ten consecutive years of growth, their assets under management reached with EUR 287 billion another record value at the end of 2022. This corresponds to an increase of ten percent compared to the previous year. The volume of retail property funds, that are primarily held by private investors, rose to EUR 131 billion. The assets under management of open-ended Spezialfonds (for institutional investors) have even quadrupled since 2012. At the end of 2022, they stood at EUR 156 billion. Among other things, the low interest rates has prompted investor groups such as insurance companies and pension funds, which prefer investment forms with regular returns, to invest in property funds.

Germany is by far the most important market for open-ended property funds in Europe: According to the latest figures available from ESMA, German



Types of use by net target rental income



Funds domiciled in Germany
As of 31 December 2022

funds account for more than half of the assets of all products launched in the European Economic Area (EEA).

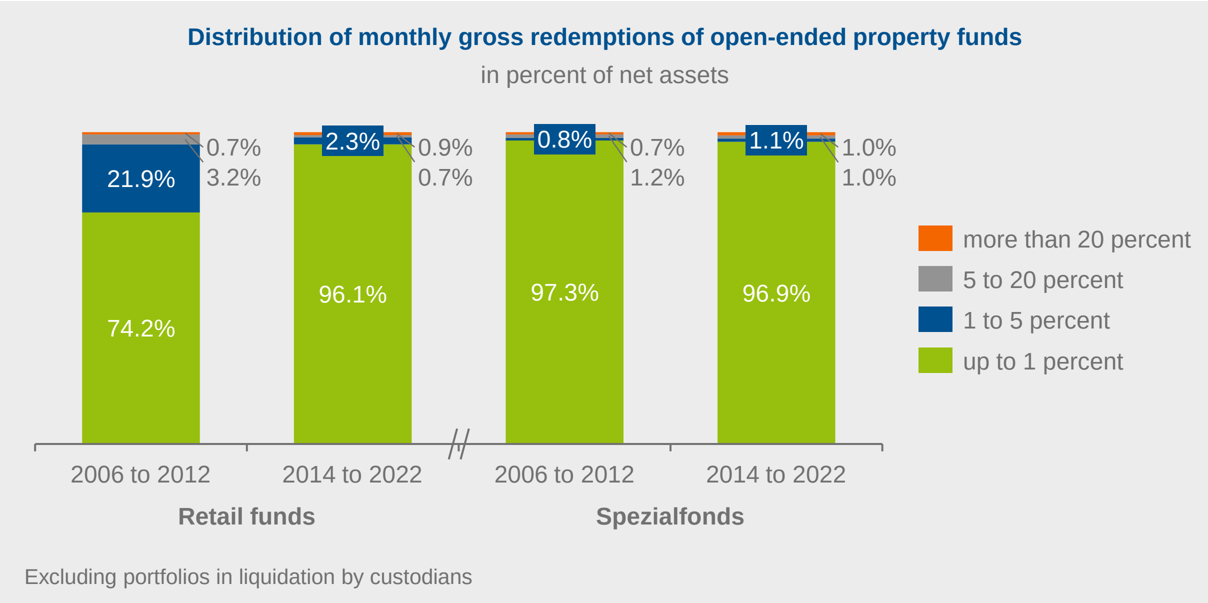
They invest predominantly within the EU; this applies in particular to Spezialfonds with a portfolio share of over 90 percent. In the case of retail funds, around three quarters of their properties are located within the EU. Other target regions are the rest of Europe (in particular the United Kingdom and Switzerland) as well as North America.

In terms of types of use, commercial properties are the most important assets. In the retail fund segment, they generate more than 80 percent of net target rental income, while other types of use play only a subordinate role. Spezialfonds invest to a somewhat greater extent in the residential market (16 percent), industrial real estate (10 percent) and other market segments. According to ESMA's EU Alternative Investment Funds Report 2022, the types of use of German property Spezialfonds correspond roughly to the European average of all property funds.

The strong increase in the exposure of funds to commercial real estate over the past few years is attracting the attention of supervisory authorities. They fear structural liquidity mismatches in open-

Legal framework for ensuring fund liquidity in open-ended retail property funds

	Regulations
Holding and notice periods	Since 2013, investors in open-ended retail property funds have been subject to a twelve-month notice period and a 24-month initial holding period.
Suspensions of redemptions	The redemption of shares is to be suspended if the liquidity is insufficient for the servicing of redemptions and property management. There are further specifications under which conditions properties may be sold below market value during the suspension period.
Liquidity requirements	▪ The liquidity available for the redemption of shares amounts to at least five percent of fund assets (maximum liquidity: 49 percent). ▪ Investments are limited to bank deposits, money market instruments/funds, securities eligible as collateral for certain lending operations with the ECB, other listed securities and shares of REIT corporations (in each case up to five percent of the fund assets).
Leverage	▪ Short-term borrowing up to 10 percent of fund assets. ▪ Long-term borrowing up to 30 percent of the market value of the properties. ▪ No borrowing to finance the redemption of shares.
Risk and liquidity management	▪ Adequate risk and liquidity management system with procedures for monitoring material (including liquidity) risks. ▪ Liquidity stress tests at least annually under normal and adverse conditions. ▪ Review whether the liquidity profile of the fund is in line with the investment strategy and redemption policy.

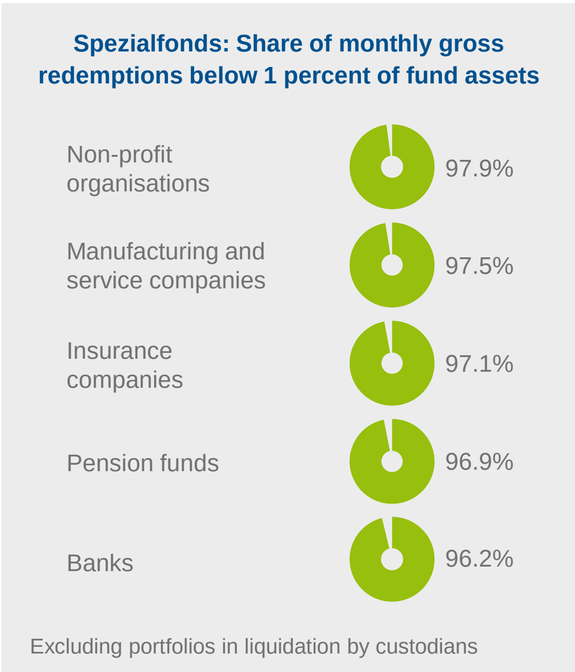


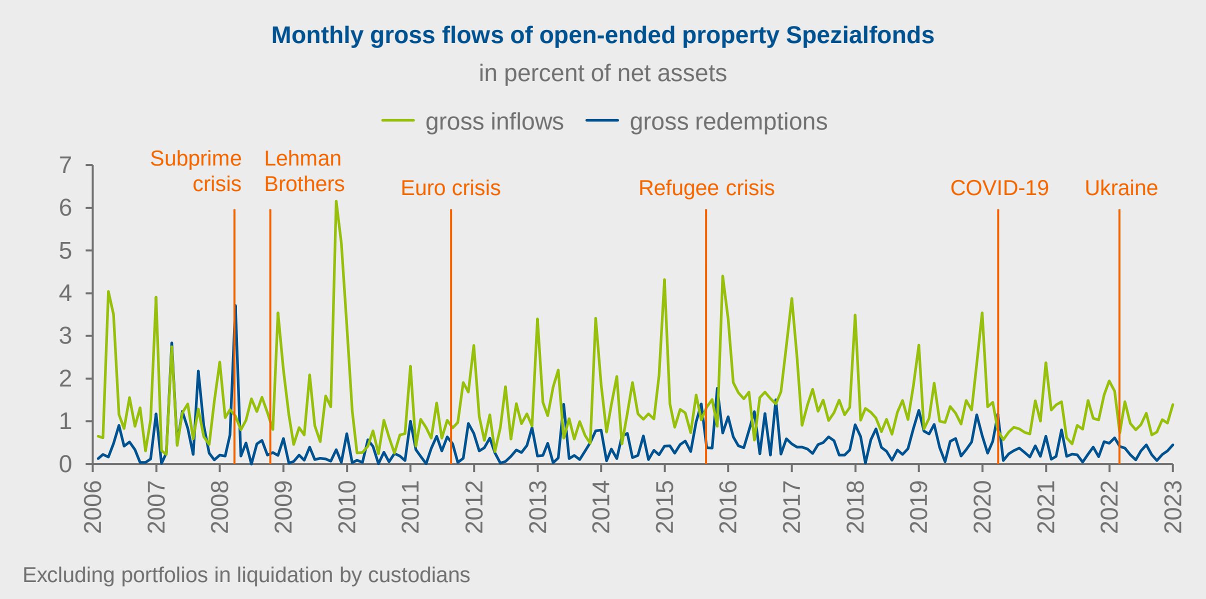
ended property funds that could affect the stability of commercial real estate markets in Europe. However, this concern cannot be confirmed for the German fund market:

After several retail funds temporarily suspended the redemption of fund shares or even had to be liquidated to protect investors during the financial crisis in 2008, the German legislator reacted with strict rules on liquidity management. Since 2013, investors in open-ended retail property funds have to hold their shares for at least 24 months and respect a notice period of 12 months. This gives managers sufficient time to generate additional liquidity, if needed. Moreover, there are further regulations on minimum liquidity and loan financing. Also, fund management companies are obliged, among other things, to conduct liquidity stress tests at least once a year as part of their overall risk and liquidity management (see table).

These measures are having a positive effect: an analysis of gross outflows from open-ended retail property funds shows that the volume of redemptions exceeded 1 percent of fund assets in one quarter of observations until the introduction of holding and notice periods. After 2013, this value dropped to only four percent; larger gross redemptions are rare today. Incidentally, the average liquidity ratio of open-ended retail property funds in 2022 stood at around 15 percent according to Scope, the rating agency. Even under adverse circumstances (i.e., unusually large redemptions and no gross inflows), only a small part of the portfolio would have to be liquidated – and that with one year's notice.

In the case of open-ended Spezialfonds with strict investment conditions, there are equally established rules for ensuring fund liquidity. First, the above-mentioned minimum liquidity level of five percent applies as well (it may be waived with the consent of the investors, though). Moreover, the sum of loans may not exceed 60 percent of the market value of all directly and indirectly held properties. Finally, funds





may not use leverage on a substantial basis since August 2021.

The existing regulation is appropriate for the specific liquidity risks, as redemptions in Spezialfonds were insignificant in the entire period under review (2006-2022): Gross redemptions of more than one percent of fund assets occurred in just about three percent of the observations.

The rare occurrence of larger gross outflows does not differ significantly between investor groups of open-ended Spezialfonds. In the period 2006-22, between 96 percent and 98 percent of monthly redemptions were below one percent of fund assets, depending on the investor group. Significant redemptions were particularly uncommon among non-profit organisations (such as foundations) and non-financial corporations.

The reason for the low redemption activity in Spezialfonds, even without formal holding or notice periods, is their investor structure. Typically, only a few institutional investors invest in a Spezialfonds, often it is just one. A substantial surprise withdrawal is therefore very unlikely because investors would have to bear the losses in value resulting from any "fire sales" themselves. Since the investor is known to the management company, it can instead discuss and implement a course of action appropriate to the specific liquidity situation on an individual basis.

The asset flows of open-ended Spezialfonds are, therefore, largely unaffected by short-term economic conditions. This is demonstrated by gross inflows and outflows of funds on a monthly basis. Even in times of crisis, there is no increased redemption activity. This includes, for example, the market collapse at the beginning of the COVID 19 pandemic, although the economic outlook for commercial real estate deteriorated rapidly due to strict lockdowns. The only time gross outflows reached a slightly higher level was during the subprime crisis in 2007 and 2008, when house prices in the US collapsed. Nevertheless, net outflows across all funds were still only 2.6 percent of fund assets – which is, for example, below the generally applicable minimum level of liquidity.

This means that liquidity risks in open-ended property funds are effectively limited: In all funds via targeted risk and liquidity management. It is supplemented in the case of retail funds by holding and notice periods introduced in 2013, and in the case of Spezialfonds by the investor structure and a line of direct communication between the fund manager and investors.

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