Open-End vs. Closed-End Real Estate and Infrastructure Funds

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This article offers a high-level overview of the benefits and drawbacks of investing in real estate and infrastructure assets through open-end and closed-end funds.

While real estate and infrastructure fund managers understandably are concerned with developing and implementing their investment strategies, some consider fund structure an afterthought. That can be a costly mistake.

Fund managers often ask us whether an open-end or closed-end fund structure is best suited for funds investing in real estate and infrastructure assets. Real estate and infrastructure funds offer a potential for participation in the operating income from the fund's underlying assets and in the capital appreciation associated with owning an equity stake in such assets. One of the main considerations when investing in these assets is how their long-term nature interacts with the life and other characteristics of pooled investment vehicles.

This article offers a high-level overview of the benefits and drawbacks of investing in real estate and infrastructure assets through open-end and closed-end funds.

Open-End Funds

Open-end funds have no specific term (unless otherwise required by the state law of the state in which the fund is formed). They allow for continuous solicitation of additional capital, and periodic subscriptions and redemptions.

Liquidity

Open-end funds offer more liquidity to investors than closed-end funds. Investors have flexibility as to when to enter and exit the fund. Open-end infrastructure funds usually allow for quarterly subscriptions and redemptions. Thus, investors may withdraw from the fund if the return on investment is not what they expected, lock in their gains or losses at that point in time, and allocate their capital to new investments.

Balancing the liquidity needs of a fund's investors with the illiquid nature of the underlying real estate and infrastructure assets may be challenging for sponsors. Ideally, sponsors would like to avoid having to sell any fund as-

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sets to satisfy redemption requests. In order to lower redemption risk, sponsors often subject investors in open-end real estate and infrastructure funds to initial lock-up periods, ranging from two to five years.

During the lock-up periods, investors may not withdraw their capital from the fund. Other liquidity options include satisfying investor redemption requests through subscriptions from new investors and dampening investor redemption requests by periodically distributing to them cash which has been generated from the income-producing assets.

The long-term nature of open-end funds is a good match for investors with the same long-term horizon. In fact, the steady income stream makes such funds particularly attractive to certain institutional investors. For example, pension funds find that the long-term nature of open-end funds often matches pension funds' obligations to make beneficiary payments while still providing them with the potential for capital appreciation.

Open-end funds provide both sponsors and investors with the liquidity necessary to allow them to periodically reevaluate their investment objectives and rebalance their respective portfolios if necessary. The indefinite term of open-end funds coupled with their ability to provide some liquidity to investors without having to sell any underlying assets is important in light of the cyclical nature of real estate and infrastructure assets.

Indeed, sponsors seek to avoid selling these types of assets during an economic downturn.

Accessing Capital

The fundraising relating to open-end funds is perpetual, thus allowing sponsors to continuously access new capital. Because infrastructure investments are subject to long due diligence processes, including regulatory clearance, sponsors of infrastructure funds are able to anticipate their need for additional capital and ramp up their fundraising efforts accordingly. In the event of significant withdrawals, sponsors may seek and access capital from new investors.

In addition, sponsors of open-end funds also have the ability to wait out a difficult fundraising environment and pick up new capital once market conditions and the investing climate improve.

Investment Strategy/Return on Investment

The general investment strategy of open-end funds is to maximize cash flow over the long-term rather than capital gains over the short/medium term. This "buy and hold" investment approach of open-end funds is well suited to real estate and infrastructure assets. Because such assets are long-term investments, open-end funds allow managers to have more long-term stability. Managers can buy and sell assets at the times that would produce the best returns to investors, rather than at the end of the fund-term (as is the case with the closed-end fund).

Open-end infrastructure funds offer the mix of periodic income and the potential for capital appreciation when the underlying assets are sold. However, the need to maximize periodic cash flow may potentially reduce the aggregate income stream and result in a lower total return than the one achieved by a closed-end fund.

Diversification

The perpetual nature of open-end funds allows sponsors to access more capital if needed to grow their existing assets or purchase new ones. These funds also allow sponsors to acquire assets when they can pay the lowest price and exit the assets when market conditions are favorable. Thus, the portfolio composition of open-end funds is generally more diverse (and may be rebalanced over time depending on market conditions) than the portfolio composition of closed-end funds that must buy and sell assets within their prescribed lifetimes.

Portfolio Transparency

Existing investors in open-end funds have full transparency with respect to current investments, and new investors are immediately exposed to the entire portfolio and any income generated from it. Naturally, a sponsor may rebalance its portfolio within the fund's investment mandate. However, investors may withdraw from the fund if they do not like the returns produced or are not comfortable with the risk profile of the rebalanced portfolio.

Valuations

After the first closing, sponsors must periodically mark to market open-end funds in order to establish the current net asset value (the "NAV") for investors' contributions and withdrawals. Sponsors usually retain independent third parties to perform periodic independent valuations of the underlying assets of their funds.

However, valuation of unrealized illiquid real estate and infrastructure assets is often difficult and thus periodic valuations may significantly vary from the actual realized value of such assets once they are sold. Because the incoming and redeeming investors are investing and redeeming based on the value of the unrealized assets, investors in the same fund may achieve very different returns depending on the timing of their admission to the fund and their redemption from the fund.

Thus, while the ability to subscribe for and redeem interests in an open-end fund based on the then current NAV of such fund is often cited as one of the primary advantages of open-end funds, this advantage may be problematic in the context of open-end real estate and infrastructure funds where determining an accurate NAV may be challenging.

Administration

Managing the investor base in open-end funds is usually more time-consuming and complex when compared to closed-end funds. Sponsors must manage periodic subscriptions and withdrawals.

Further, because fundraising is perpetual, new investors usually attempt to negotiate more investor-friendly fund terms through side letters or amendments to the existing fund documents.

This requires sponsors to expend additional resources to handle such negotiations, and it also necessitates periodic most favored nation elections. In comparison, the most favored nation election in closed-end funds is performed just once, after the expiration of the fundraising period.

Closed-End Funds

Closed-end funds have a specific predetermined term which is usually 10-12 years. This term typically may be extended for additional one to two year terms in the discretion of the fund sponsor and a possible further two to three year extension with the investors' or investors' advisory committee's consent.

Closed-end funds take equity positions in the underlying assets (similar to open-end funds), but have a pre-determined subscription period (usually 12-18 months) and offer no redemption options.

Liquidity

Committed capital is locked-up for the term of the fund with possible extensions as noted above. Thus, once committed to a closed-end fund, investors may not reallocate invested capital (except under narrow circumstances where redemption of an investor's interest is necessary for legal or regulatory reasons or the investor sells its interests through a secondary transaction).

Generally, closed-end fund investors receive no significant cash flow until an asset is sold.

Of course, all the underlying assets must be sold before the expiration of the fund term, even if market conditions are not favorable to the seller. However, during the fund term, the manager has locked-in capital at its disposal and full flexibility as to when to sell assets, without having to worry about maintaining liquidity to fund withdrawals.

Accessing Capital

Upon launch, sponsors of closed-end funds have no ability to wait out a difficult fundraising environment as fundraising may only take place during a 12-18 month commitment period after the first closing (subject to certain negotiated extensions). If a fund fails to reach its target commitments by the end of the commitment period, sponsors will no longer be able to access new capital from investors.

Thus, sponsors must carefully consider the fundraising environment when launching a new closed-end fund. However, the need for new capital may be counterbalanced by not having to fund redemptions (as none are permitted) once the capital has been committed.

Investment Strategy/Return on Investment

Typically, more of the expected return in closed-end funds is derived from capital gains generated through asset sales rather than from an income stream. Once all the capital has been deployed, the manager will actively manage the acquired assets to create value and maximize the return generated when assets are sold at the end of the fund term.

Closed-end funds often deliver negative returns in the initial years (as management fees must be paid based on the entire committed capital and there may be no offsetting income stream) and investment gains in later years once assets are sold (a J-curve effect). Thus, closed-end funds offer potentially higher returns in later years, but the potential downside is the lack of, or the decrease in, any income stream. This may make a fund less attractive to institutional investors, as many (e.g., pension funds) seek income streams that match the horizon of the obligations they owe to underlying beneficiaries.

Because investors may not withdraw their capital from closed-end funds, sponsors of such funds know that they will not be required to sell assets during the term of the fund. Thus, there is no risk of a forced asset sale during the term of the fund.

Prior to the expiration of the fund term, sponsors may pick the time to dispose of an asset based on market conditions. However, the disadvantage of closed-end funds is that sponsors must sell any remaining assets at the tail-end of the fund even if an asset produces a steady income stream and/or has a much longer life expectancy than the fund itself (for real estate and infrastructure investments, the life expectancy may be 25-30 years before major renovations are needed).

Moreover, savvy potential buyers of closed-end fund assets may push for significant discounts, knowing that sponsors have no choice but to liquidate assets within the finite time frame.

Market conditions at the time of sale may not be optimal, thus hurting investor returns. Even worse, the entire portfolio may be exposed to adverse market conditions since it must be sold during the same pre-determined period. Thus, investors with investment horizons that are longer than the closed-end fund term, such as pension funds, may prefer open-end funds to avoid indirectly participating in a fire sale. Open-end funds also allow investors to avoid having to look for other suitable investments upon the liquidation of a closed-end fund.

Diversification

The mangers of closed-end funds are only allowed to purchase assets during a prescribed four to six year investment period (except for some follow-on investments in the existing assets). This may result in a less optimal portfolio as managers face pressure to fully deploy committed capital within the prescribed period. They may invest in ill-advised projects and miss out on better opportunities that arise after the investment window has closed.

In addition, given the short investment period, opportunities for rebalancing the portfolio are limited in closed-end funds, in general, and even more so in closed-end real estate and infrastructure funds, in particular, given the illiquid nature of the underlying assets. Thus, portfolios of close-end funds are often less diversified than portfolios of open-end funds.

Portfolio Transparency

Generally, there is no portfolio transparency when investors are admitted to a closed-end fund, save for the general description of the type of investments (size, industry) that the fund will be making. However, exceptions include investments that are warehoused by sponsors prior to the first closing or, for investors coming at subsequent closings, investments made prior to the final closing.

Valuations

A close-end fund's return on investment is calculated once each asset is sold, and thus that return is based on the market value of each asset. Thus, returns to investors and sponsors' fees are determined in a more objective manner than those determined in an open-end fund context. The objective nature of asset valuation is one of the main advantages of a closed-end fund from the investors' perspective.

Administration

Managing an investor base in closed-end

funds is relatively straight forward when compared to open-end funds. Because fund-raising relating to a closed-end fund may only take place during the 12-18 month commitment period, any negotiations of investor-friendly provisions are condensed to that period (and if a fund hits its targeted commitment amount in the first closing, all negotiations of terms cease once the first closing occurs).

The manager does not need to handle redemptions as none are permitted until the fund liquidates (save for certain circumstances where redemptions are permitted due to investors' legal or regulatory requirements), and the handling of the subscriptions is limited to the commitment period. Thus, a manager only needs to address most favored nation considerations once, and the manager does not initiate that process until the expiration of the commitment period.

Summary

To summarize, both open-end and closed-end funds have certain characteristics that may be advantageous for investments in real estate and infrastructure assets. Choosing the right fund structure will generally involve a careful balancing of the sponsor's objectives with those of the prospective investors.

The liquidity considerations and their impact on the execution of a sponsor's investment strategy and portfolio composition, especially given the illiquid nature of real estate and infrastructure assets, must be factored into the choice of investment structure and must be compared to other available options that may better match portfolio attributes.

Ultimately, it is up to each manager to determine which structure will best match its goals and the objectives of its targeted investor base.