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FINM3406
Real Estate Finance

Lecture 3
Real Estate Ownership Structures – Pt 2

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Outline

- Risk Management (continued from last week)
- Indirect Ownership Structures
  - REITs
  - LPTs
  - PPPs
  - JVs, partnerships, clubs etc
- Modern Portfolio Theory Overview
- Acquisition and Disposal Process

RISK MANAGEMENT

Risk Analysis

- What is Risk?
  - The extent to which an actual outcome is adverse and differs from the expected/predicted outcome
  - The probability of the adverse outcome occurring
- Risks vs Issues
  - Risks are potential adverse outcomes
  - Issues are actual adverse outcomes
- Risk vs Returns
  - The greater the degree of risk should correspond with a greater expected return

Risk Analysis

RISK ANALYSIS MATRIX AND LIKELIHOOD CRITERIA

Consequesces					
Likelihood	**Insignificant**	**Minor**	**Moderate**	**Major**	**Significant**
Common	Medium	High	Very High	Very High	Very High
Likely	Medium	Medium	High	Very High	Very High
Possible	Low	Medium	Medium	High	Very High
Unlikely	Very Low	Low	Medium	Medium	High
Rare	Very Low	Very Low	Low	Medium	Medium

Types of Risk

- Systematic Risk (beta):
  - Variance attributable to the market and influences all assets.
  - Example: RBA changes interest rates
  - Cannot be diversified away.

- Unsystematic Risk:
  - Is asset / firm specific risk and unrelated to the market.
  - Example: Balance sheet changes in a firm or vacancy in property asset due to a tenant restructure.
  - Diversification is key for the protection against unsystematic risk

Sources of Risk

Sources of Risk

3. Property Risk:

- Risks that affect the property investment but not the market as a whole. May damage location, buildings and tenants.

- Risks:
  - Location – rental and capital value impacts: trading potential of a retail store impacted by reduced pedestrian access
  - Building failure - unexpected running costs, claims against owners allowing contaminating uses etc
  - Soundness or 'covenant' of a tenant – checks on financial stability of a tenant prior to purchasing a property
  - Many building risks can be insured against

Sources of Risk

4. Other major risks impacting property ownership:

- Business Risk
- Financial Risk
- Liquidity Risk
- Inflation risk
- Management risk
- Interest Rate risk
- Legislative risk
- Environmental risk

Sources of Risk

- Business Risk
  - Business risks due to fluctuations in economic activity that affect the variability of income produced by the property.
  - Properties with well-diversified tenant mixes are less subject to business risk

- Financial Risk
  - Use of debt financing magnifies business risk.
  - Degree of financial risk increases as the amount of debt increases and depends on the cost and structure of debt

Sources of Risk

- Liquidity Risk
  - Occurs when a continuous market with many buyers and sellers and frequent transactions is not available. The more difficult an investment is to liquidate, the greater the risk that a price concession may have to be given to a buyer should the seller have to dispose of the asset quickly.

- Management Risk
  - Most investments rely on management to keep space let and maintained.
  - The rate of return that the investor earns can depend on the competency of the management

Sources of Risk

- Interest Rate Risk
  - Changes in interest rates will affect the price of all securities and investments.
  - Real estate tends to be highly levered, thus, rate of return earned by equity investors can be affected by changes in interest rates.

- Legislative Risk
  - Real estate is subject to numerous regulations such as tax laws, rent control, zoning and other restrictions imposed by government.
  - Changes in legislation can adversely affect the profitability of an investment – especially for new development.

Sources of Risk

- Environmental Risk
  - Value of real estate is often affected by changes in the environment or sudden awareness that the existing environment is potentially hazardous. E.g. Asbestos
  - Environmental risk can cause more of a loss than other risks mentioned because the investor can be subject to clean-up costs that far exceed the property value.

- Inflation Risk
  - Unexpected inflation can affect an investors expected rate of return if the income of the property does not increase sufficiently to offset the impact of inflation.

INDIRECT OWNERSHIP STRUCTURES

Investor Types

Retail

- Suitable for institutional and "mum and dad" style investors
- Minimum investment for syndicates generally $5,000+

Wholesale

- Designed for large scale sophisticated investors
- Investors must qualify under Corporations Act
- Minimum Fund investment $500,000+

A-REITS	Property Securities Funds	Syndicates	Wholesale Funds	'Clubs'	Mandates	Direct Ownership

Scope of Discussion

Investor Types: Wholesale

- Wholesale Investor Types:
  - **Sophisticated investor**:
    - Deemed to have sufficient investing experience and knowledge to weigh the risks and merits of an investment opportunity.
      - Net assets of at least $2.5m or;
      - Gross income for each of last two financial of at least $250,000
  - **Professional Investor:**
    - Australian financial services licensee;
    - A body regulated by APRA outside of Superannuation;
    - A body registered under the Financial Corporations Act 1974
    - Trustees of superannuation funds with assets >$10m

Wholesale Funds: Overview

No. of Investors	**Typically 20 – 50 investors for Funds**
Minimum Investment	$500,000 upwards
Diversification	Usually 10+ assets Sector specific or diversified across assets
Term	Generally open ended
Gearing	0% to 30% for ‘Core’ Funds e.g. Target gearing of 15% to 25% with a maximum of 40%

Wholesale Funds: Overview

- Institutional investors make investments to wholesale funds based on a view that unlisted private equity format accurately represents the true returns of the underlying real estate assets

- Wholesale unlisted property trusts are aimed at institutional investors
  - Predominantly AU superannuation funds or foreign pension and sovereign wealth funds
  - May include Ultra High Net Worth Individuals

Wholesale Funds: Overview

- Each trust tends to have a specific strategy or mandate to invest within a particular sub sector of the real estate market and takes two forms:
  - **Open-ended vehicles:**
    - No fixed life, target 'core' real estate assets across industrial, retail and office sectors
  - **Closed-end fixed-life vehicles:**
    - Invest in higher risk real estate
    - Involves value-add opportunities or development projects

Clubs / Mandates: Overview

No. of Investors	Clubs: Less than 5 investors Mandates: Generally 1 investor
Typical Investor	Large Super Funds Insurance Companies International Institutions
Minimum Investment	$50 million upwards
Diversification	Usually 5+ Assets Generally target a specific strategy
Term	Opportunity specific
Gearing	Opportunity Specific

Mandates and Clubs

- Clubs and segregated mandates becoming more popular
- Investors:
  - Tend to be large domestic superannuation funds
  - Sovereign wealth funds
  - International institutions

- Most vehicles no or low gearing
- Particular strategy, particular risk profile ie. Mandate

Mandates and Clubs

- Reasons for growth
  - Larger investors favour a more hands on approach with asset managers
  - Investors are becoming more sophisticated and are looking for specialist skills in asset classes and geographies
  - Ability to gain tailored exposure to specific asset classes

Syndicates: Overview

Size	$5 million to $50 million
No. of Investors	Typically 100+
Typical Investor	Private investors Self managed super funds
Minimum Investment	$1,000 to $10,000
Diversification	Varies from funds with only one asset up to 10+ assets
Term	Fixed term investment (typically 5 -7 years)
Gearing	Typically 40% to 60%

Syndicates

- Closed-end funds with a fixed life expectancy
  - Further capital is not raised after initial offering
- Target high net-worth individuals and SMSF
- Investors hold their interest until property is sold or rolled over
- Offer document such as a product disclosure statement (PDS)
- Repetitive process
  - Identify opportunity
  - Negotiate structure and investment
  - Purchase building
  - Raise debt and pool investor equity

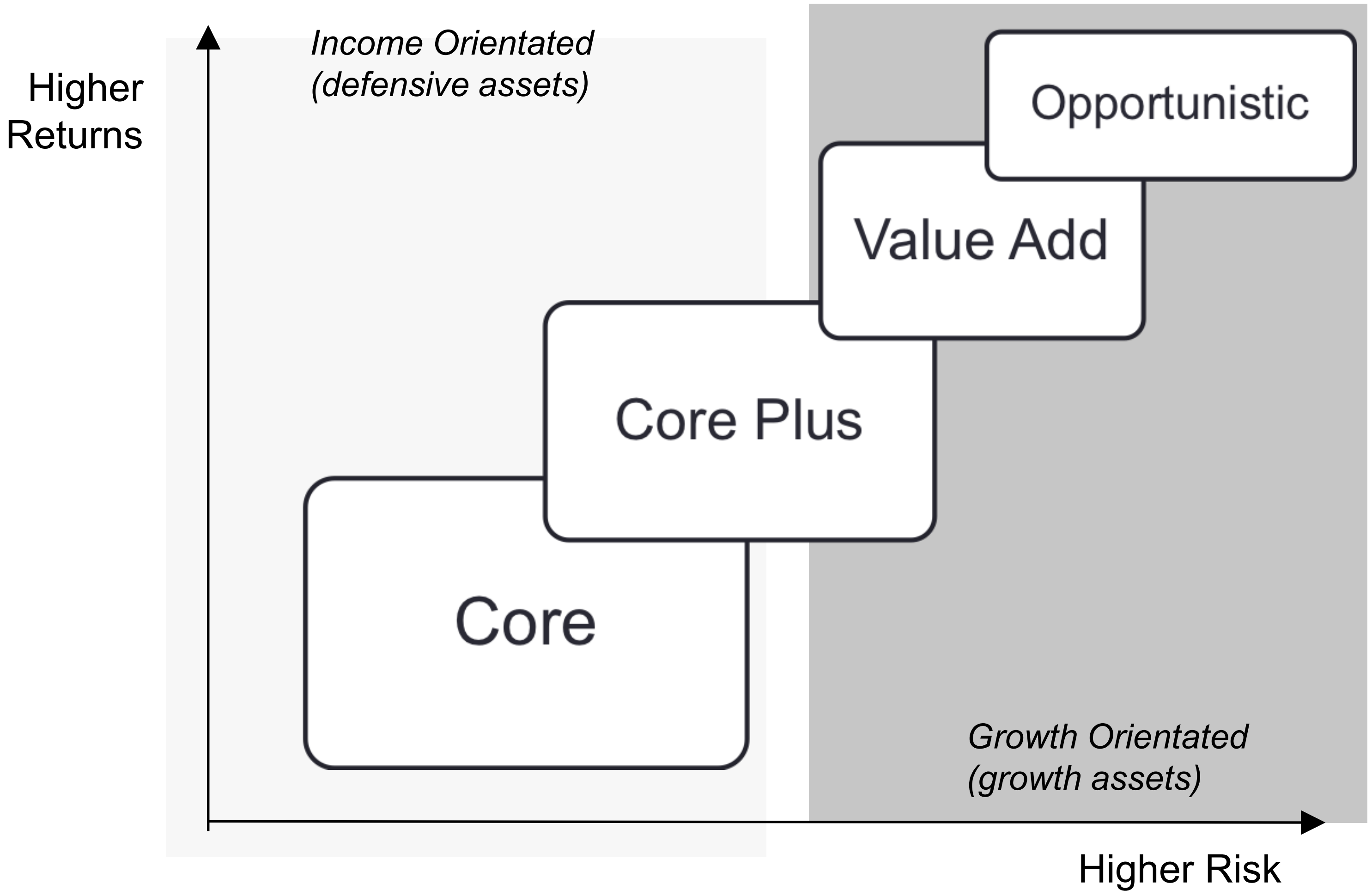
Syndicates

- Individual property strategies
- Enhanced regulatory focus in recent years
- Recent resurgence in popularity for syndicates
- Retail funds management industry is less consolidated
  - Lower barriers to entry and wider investment base
  - Difficult to identify all players due to small size of typical funds

Ownership Characteristics by Vehicle

	Unlisted Wholesale Fund	Clubs / Mandates	Syndicates & Unlisted Property Trusts	A-REITS
Liquidity	✗	✗	✗	✓
Gearing	Low	Low	High	20% - 40%
Entry / Exit Costs	--	✗	✗	✓
Low Volatility of Returns	✓	✓	✓	✗
Alignment with direct property returns	✓	✓	✓	✗
Diversification	✓	✓ ✗	✗	✓

Fund Investment Strategies



Primary Focus

← Opportunity funds

← Development funds

← Syndicates
← Listed property trusts
← Wholesale funds
← Direct mandates
← Ungeared private holdings

Fund Investment Strategies: Core

- Primarily invest in:
  - Stabilised existing properties
  - Current cash flows
  - Low vacancy
  - Located in major metropolitan areas

- Invest in a wide variety of property types
- Use limited leverage – low risk

Fund Investment Strategies: Core Plus

- Core plus properties can be a minor component of core fund:
  - Core assets in need of minor improvements
  - “a B property in an A location”
  - Core property that includes current undeveloped land

Fund Investment Strategies: Value Add

- Take on more risk by purchasing properties which:
  - Carry current vacancies
  - Have upcoming major tenant rollovers
  - In need of renovation and capital outlay

- Funds create value by renovating and leasing up the property

- Use more leverage compared to core plus

Fund Investment Strategies: Opportunistic

- Take on even more risk by doing ground up development projects
- Expose the fund to additional construction risks:
  - Entitlements
  - Construction delays
  - Cost overruns
  - Complex JV management issues, etc.
- High degree of financial leverage
- May be less diversified and concentrate in certain geographic areas or property types
- Strategy may involve purchasing "distressed property assets"

Investment Management Fees

- Fees charged by fund managers generally fall into one/more of the following categories:
  – Transaction fees:
    - Acquisition fees
    - Disposition fees
  – Management fees
  – Performance fees

Investment Management Fees

- **Acquisition fees** charged when each property is acquires and typically a percent of the acquisition cost

- **Disposition fees** charged when asset is sold.

- **Performance fees** paid as an added incentive to enhance fund performance
  - Based on the extend to which the fund managers return exceeds a "hurdle rate of return"
  - Typically paid to fund managers to compensate them for taking on additional risks in development or repositioning properties
  - Performance fees disappearing from the Wholesale 'Core' landscape

Investment Management Fees

- **Management fees**:
  - Charged to the investor for the entire term of the fund
  - Core funds charge base fees on equity capital
  - Generally expressed annually as a percentage or basis points (bps)

- **Management fees** may be calculated on:
  - Committed capital or invested capital
  - A percentage of cash flow distributions
  - Project Revenues
  - Project costs

Australian Real Estate Investment Trusts (A-REITs)

- A Real Estate Investment Trust (REIT) is an investment vehicle that allows investors to purchase an interest in a diversified and professionally managed portfolio of real estate that is listed on the stock exchange.

- A-REITS or Listed Property Trusts (LPT) make up one of the largest sectors on the Australian Stock Market

- A-REITs were established to allow investors to gain exposure to high-grade real estate both domestically and offshore, without the need for large levels of capital, and with the addition of liquidity.

A-REITs

A-REITs are designed to generate wealth in two ways:

- they provide exposure to the value of the real estate assets that the trust owns and the accompanying capital growth,
- as well as rental income.

- The fund manager selects the investment properties and is responsible for all administration, improvements, maintenance and rental.

A-REITs

- Some A-REITs specialise in particular sectors, and usually fall into one of the following categories:
  – Industrial trusts invest in warehouses, factories, and industrial parks
  – Office trusts include medium- to large- scale office buildings in and around major cities
  – Hotel and leisure trusts invest in hotels, cinemas and theme parks
  – Retail trusts invest in shopping centres and similar assets
  – Diversified trusts invest in a mixture of industrial, offices, hotels and retail property.

A-REIT History

- **Early 70's:** General Property Trust (now GPT) listed as an externally managed REIT
- **Late 70's/ 80's:** Developers emerged in the market. Westfield pre-dates GPT, however, it was not a REIT until 1979. Stockland 80's.
- **Early 90's liquidity crisis:** Proliferation of listings of previously unlisted trusts. Aim to provide liquidity through externally managed REITs (rent collectors)
- **Mid 90's:** Sector-specific trusts (industrials, hotel, development) then life company assets (Legal & General, AMP, FAI Emerge)
- **Late 90's offshore assets:** Westfield America, Lend Lease US Office
- **Early to mid 2000's:** Consolidation driven by stapled trusts
- **2005 to 2007:** Ongoing offshore vehicles (US, Europe Japan)
- **2008:** Credit crisis (Centro, Allco/Rubicon, Babcock & Brown failures)
- **Late 2008 to date:** Large-scale recapitalisation of sector, rationalisation of offshore assets, growth of funds management, institutional investors appetite for yield moves up the risk curve to REITs.
  - Emergence of new asset classes including childcare, self-storage and residential aged care

Why Would You Invest in A-REITs?

- A-REITs have been the preferred property asset class for retail investors and some wholesale investors over direct property.
- The key benefits of investing in A-REITs are:
  - Exposure to high quality assets
  - Diversification – geographic, sector etc
  - High yielding
  - Liquidity
  - Management efficiency and quality
  - Low transaction costs (no stamp duty)
  - Corporate governance
- On the negative side – volatility, fee leakage.

Funds from Operations (FFO)

- There are 5 ways a REIT can grow income and increase funds from operations;
  - Growing income from existing properties
    - Renting more space
    - Raising rent
    - Redevelopment
  - Growing income through acquisitions
  - Growing income through development
  - Growing incomes through provision of services
  - Financial engineering

Australian REIT Characteristics

- Legal Form
  - No specific REIT rules in Australia – can be listed or unlisted
    - May be sector specific or diversified
  - Corporations Act states a REIT must be registered as a Managed Investment Scheme

- Capital Requirements
  - No capital requirements for a REIT if listed (but must meet ASX requirements)
  - Capital requirements for a manager

- Listing Requirements
  - No listing requirements – REITs can be listed or unlisted

Australian REIT Characteristics

- Restrictions on investors
  - No investment restrictions on investors
- Restrictions on foreign assets
  - No restrictions on foreign assets
- Distribution requirements
  - Undistributed income on gains taxed at 46.5%
  - Full distribution of income and gains by REITS generally occurs

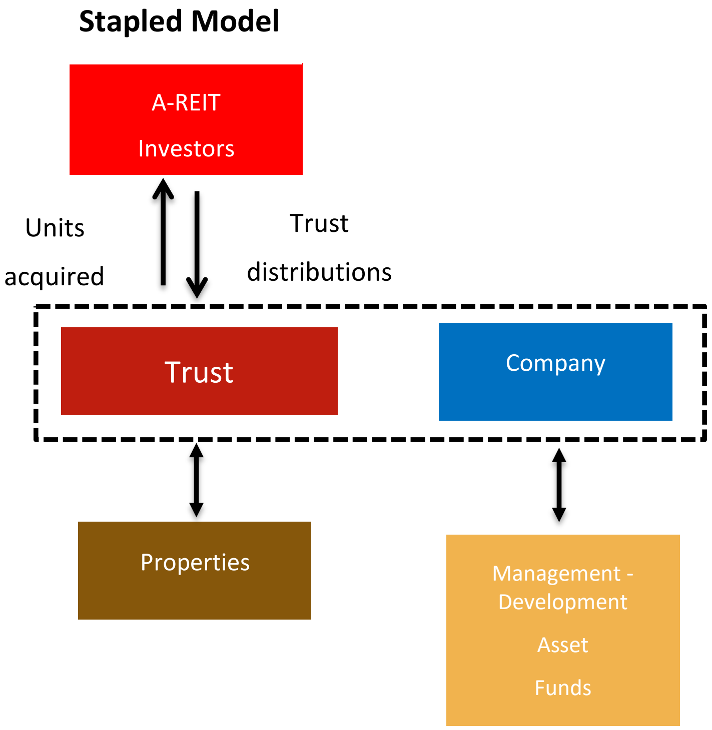
REIT Distributions

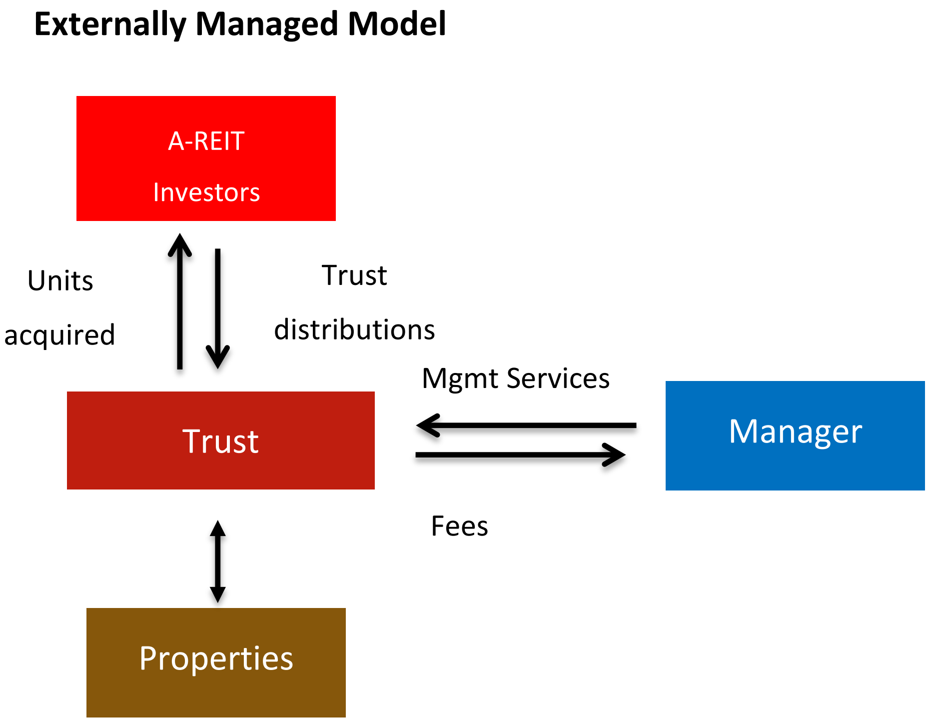
- Trusts distribute 90% to 100% of earnings
- AREIT trusts do not have franking credits – income is not taxed at trust
- Distributions taxed at the individual income tax rate
- REIT distribution includes a tax deferred component
- **Tax deferred component –** represents the return of capital rather than income
- As REITs collect income – manager can decide if the payments made to investor are income collected or capital invested

A-REIT Forms

- Broadly speaking, A-REITs comprise one of two forms:
  - Externally Managed (passive); or
  - Stapled (active).

Externally Managed vs. Stapled





Stapled Securities

- Some trusts adopt hybrid structures called ‘stapled securities’ funds.
- Stapled securities A-REITs provide investors with exposure to a funds management and/or a property development company, as well as a real estate portfolio.
- A share in a stapled securities fund usually consists of one trust unit and one share in the funds management company.
- These securities are ‘stapled’ and cannot be traded separately.
- The trust holds the portfolio of assets, while the related company carries out the fund’s management functions and/or manages any development opportunities.

Externally Managed vs. Stapled

- Internally Managed (Stapled):
  - Model of choice
  - Provides investors with exposure to funds management/ development company as well as underlying property portfolio
  - Company and trust valued separately
  - Company valued on EBITDA

Externally Managed vs. Stapled

- Externally Managed model:
  - – Management taken on by separate entity to the property trust
  - – Slowly collapsing over time
  - – Often conflicts of interest between management and trust
  - – Can provide better resourcing and management services than some REITs have capacity for

MODERN PORTFOLIO THEORY

Overview of Modern Portfolio Theory

- For many investors income properties are just one part of an investment portfolio:
  - May include other properties or asset classes (shares, interest bearing securities)
  - The key is that the risk of a property as an isolated investment is greater than the risk the property adds to a portfolio.
- Modern portfolio theory (MPT) has become a well-accepted framework to construct or rebalance real estate portfolios
- MPT assumes investors are risk-averse
  - Given two assets offer the same expected return, investors will prefer the less risky one
  - Investors will accept increased risk if compensated by higher expected returns

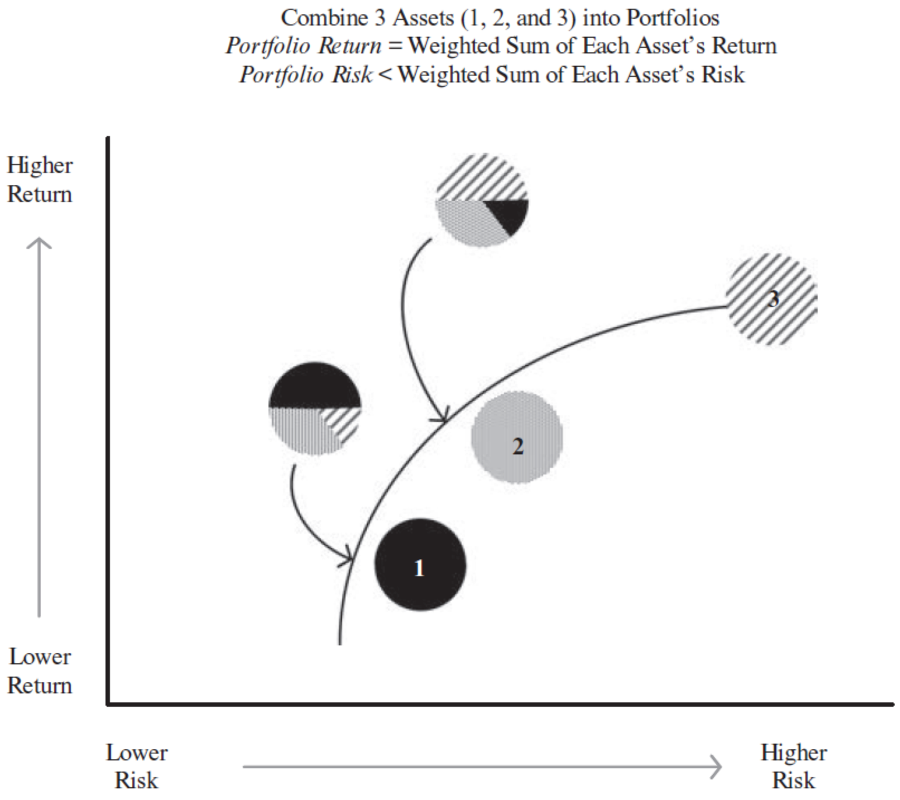


EXHIBIT C.1 Modern Portfolio Theory Overview
Source: ING Clarion Research & Investment Strategy.

Asset Returns

- **Total (Accumulation) Return** accounts for two categories of return: income and capital
  - Income includes interest paid by fixed-income investments, distributions dividends or the net income of direct property
  - Capital/ Price return represents the change in the market price of an asset.
- **Initial Yield**
  - The income yield for the asset. Shows the ratio of the current passing rent to the current property value
    - IY = passing rent / property value
- **Reversionary Yield**
  - The market yield for the asset. Shows the ratio of the market rent to the current property value (on properties rented below market)
    - RY = market rent / property value

Asset Returns

- A property is valued at $2.5m and has a current net income of $150,000 p.a. The assessed market income for the property is $175,000 p.a. Compute the initial yield and reversionary yield for the asset.

$$\boldsymbol{IY} = \frac{150{,}000}{2{,}500{,}000} = 6.00\%$$

$$\boldsymbol{RY} = \frac{175{,}000}{2{,}500{,}000} = 7.00\%$$

Asset Returns

- **Capital Return**
  - The change in capital value of an investment over a holding period as a percentage between any change in capital value and the purchase price or value at the beginning of the measurement period.

$$Capital\ Return = \frac{CV_1 - CV_0}{CV_0} * 100$$

Where:

CV_0 = capital value at the beginning of the measurement period

CV_1 = capital value at end of the measurement period

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Asset Returns

- **Income Return**
  - Net income over the measurement period divided by the purchase price or capital value at the beginning of the measurement period.

$$\boldsymbol{Income\ Return = \frac{NI}{CV_0} * 100}$$

Where:

CV_0 = capital value at the commencement of the measurement period

NI = net income received during the period

Asset Returns

- **Total Return**
  - Percentage relationship between any capital gain or loss and income over the capital value at the beginning of the measurement period.
  - True return to the investor on their money.

$$\boldsymbol{Total\ Return = \frac{CV_1 - CV_0 + NI}{CV_0} * 100}$$

Where:

CV_0 = capital value at the commencement of the measurement period

CV_1 = capital value at end of the measurement period

NI = net income received during the period

Asset Yields vs Asset Returns

- Yield reflects the relationship between a current net income and the purchase price and does not take into account any capital loss or gain made.

- Return usually reflects any income, expenditure and/or capital gain or loss made on investments.

- Return gives a clear indication of the financial position of the investor.

- Yields are used to estimate the market value of an investment while a return is used as a means of comparing the financial attractiveness of different investments to an investor.

Portfolio Returns

- **Portfolio return:**
  - Return is a weighted average of expected return on each asset.
  - Consider two assets with weights, $w_1 w_2$ and returns $r_1 r_2$.

Portfolio return:

$$r_p = (w_1 r_1) + (w_2 r_2)$$

Example:

In a \$100m portfolio you have one asset worth \$70m returning 10.4% and one asset worth \$30m returning 2.7%

$$r_p = (0.7 \text{ x } 10.4) + (0.3 \text{ x } 2.7)$$
$$= (7.28) + (0.81) = 8.09\%$$

ACQUISITION AND DISPOSAL PROCESS

Investment Criteria

- Direct or indirect ownership decision
- Timing – what stage of the property cycle do you buy into?
- Asset physical characteristics
  - Segment
  - Size
  - Location
  - Age and condition of improvements
- Financial characteristics
  - Hurdle rate for return on investment/return on capital
  - WALE (weighted average lease expiry)
  - Income and capital growth opportunities

Acquisition Process

Typical Expression of Interest process (can be over 12 months)

1. Initial Review of an Asset
2. Engage Consultants
3. First Round Bids
4. Second Round Bids
5.Third Round Bids
6. Due Diligence
8. Contract Signing
9. Settlement

Acquisition Process

1. Initial Review of an Asset
   - Meet with agents to discuss opportunity
   - Review of Information Memorandum
   - Initial Pricing of Asset based on Financial Pack – Budget, Outgoings recovery model, Tenancy Schedule
   - Initial review of documents provided in dataroom
   - Multiple pricing scenarios and sensitivity analysis

2. Engage Consultants
   - Usually only applicable in complicated transactions such as large scale retail for a market / trade area analysis

Acquisition Process

3. First Round Bids
   – Submission of First Round Bids to Agents
   – Includes price and terms
     • i.e. $80,500,000, subject to FIRB Approval, subject to Board Approval, 60 day settlement, subject to Due Diligence period of 4 weeks etc etc

4. Second Round Bids
   – Shortlisted parties (usually 3) are invited to provide a second round bid
   – Usually a higher/ more competitive bid based on sensitivity analysis, market assessment undertaken throughout first round bids and assumption clarification

Acquisition Process

5. 3rd Round Bids (BAFO – Best and Final Offer)
   - Only applicable in very competitive markets
   - Not always applicable in the bid process - subject to vendor and agent's preference

6. Due Diligence
   - Often 4 – 6 weeks
   - Hot / competitive market is reducing DD periods to 4 weeks or less
   - Some transactions in the market have taken place with no DD
   - Allows for detailed analysis of financial, technical and legal review of the asset

Acquisition Process

7. Contract Signing
   – Property sale contract signed by all parties

8. Settlement
   – Settlement varies dependent on vendor and purchaser preferences
   – Often 30 – 60 days
   – Can be as long as 6 months

Typical Due Diligence Checklist

1. Rent Roll Analysis
2. Lease Agreement Review
3. Review of Service and Maintenance Agreements
4. Pending or threatened matters review
5. Review of Title/deed documents
6. Property Survey
7. Government Compliance
8. Physical Inspection
9. Tax Matters
10. Insurance Policies
11. Engineering studies
12. Market studies
13. List of personal property

Divestment Criteria

- Reposition of Fund
  - Too much retail in a Fund benchmarked against diversified assets. i.e. high capital returns in funds invested in Sydney/ Melbourne office markets have increased the return benchmark for funds that might carry too much retail (lower total returns compared to certain office markets)
- Cyclical Play – i.e. Office Market – buy low, sell high
- Closed end Fund
  - requires divestment of assets at the end of the Fund
- Capital Requirements
  - Liquidity windows and unit redemption may force sale of assets

Disposal Process

1. Internal Approvals
   – Internal Board and Investment Advisory Committee Approvals

2. Data Collection
   – Collection of all documents relating to the asset
   – Leases, management agreements, service contracts, maintenance records, tenant tax invoices, dispute notices

3. Internal Valuation of the Asset
   - Multiple pricing scenarios to target marketing date, use for recommendation of divestment.

Disposal Process

4. Due Diligence
   - Validation of all documents related to asset
   - Can be 2,000 – 3,000 documents requiring validation

5. Agency Appointment
   - Agency submissions and appointment of successful agent
   - Agent's domestic and international reach taken into consideration as well as fees
   - One or two agents dependant on size of transaction

6. Launch Campaign
   - International campaign typically 1-2 weeks ahead of domestic campaign
   - Campaign length typically 4 weeks domestically

Disposal Process

7. Bid Submissions
   – Bid submissions taken and parties shortlisted

8. Second Round Bids
   – Shortlisted parties invited to submit second round bids
   – Parties shortlisted dependant on bid price, terms, perceived settlement risk

9. Due Diligence
10. Contract Signing
11. Settlement

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Questions?