HD Corporate: Cover Story - ARA's new growth phase

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The REIT and property fund manager is facing tougher regulation. But CEO John Lim is already steering the company in a new direction and executing a new growth plan.

John Lim has sensed the winds of change blowing in the property funds business for some years. And, with the proposals mooted by the Monetary Authority of Singapore in its recent consultation paper on improving the governance of real estate investment trusts (REITs), he now feels the breeze blowing harder.

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Among the raft of proposals in the MAS consultation paper, which was released on Oct 9, is that REIT managers should have to seek reappointment every five years, and that their performance fees should be standardised and based on the distribution per unit (DPU) of their REITs. MAS is also proposing that REIT managers charge acquisition and divestment fees on a cost recovery basis, rather than the current practice of charging 0.5% to 1% of the value of the asset being transacted.

"The whole paper sounds as though the managers are charging [too much], or trying to enrich ourselves," Lim tells The Edge Singapore. Lim founded ARA Asset Management more than a decade ago with the backing of Hong Kong billionaireLi Ka-shing, and grew it into one of the largest managers of property funds and REITs in the region. In fact, REITs have proven to be good long-term investments, Lim adds. Over the past decade, Suntec REIT — the largest of ARA's REITs — has returned 12.7% per annum. On the same basis, CapitaMall Trust — the largest REIT in Singapore — has returned 13.1% per annum.

Over the same decade, ARA, which was listed in December 2007, has delivered a return of 15.3% per annum, as it rolled out new REITs and funds and steadily grew them. In 2003, following the listing of Fortune REIT, the firm had just $600 million in assets under management (AUM). Today, its AUM tops $26 billion. Including Suntec REIT and Fortune REIT, ARA manages eight REITs, two of which are privately held REITs in South Korea. In total, ARA's REITs account for some $19.6 billion of its AUM. Suntec REIT has AUM of $8.4 billion and is among ARA's biggest money spinners.

UOB Kay Hian notes in a report that performance fees from Suntec REIT alone accounted for about 9% of ARA's total revenue of $140 million in 2013. If the proposals from MAS are adopted, possibly by 2016, ARA could see revenue from its stable of REITs eroded, UOB Kay Hian says.

Lim is unperturbed by the gloomy forecasts, though. The way he sees it, heavier regulation of the REIT sector would ultimately make it harder for small REIT managers to operate and benefit the largest players in the industry. "I would say I'm one of the pioneers," he says, adding that ARA would probably be among the winners. "If this whole consultation paper is adopted in full, this is a game changer for the whole industry," he adds. "The whole playing field will tilt towards big players like us — Mapletree Investments and CapitaLand, they will benefit from this."

At any rate, Lim sees Singapore-listed

REITs gradually playing a smaller role in driving ARA's growth. According to him, ARA is increasingly focusing on creating privately held property funds, and using these more flexible vehicles to venture into a broader range of investments in markets around the region.

ARA isn't pursuing this strategy because of the possibility of greater regulation of

REITs in Singapore, Lim notes. On the contrary, it is more a reflection of the limitations of the REIT model itself, which he says he began to realise about eight years ago. “In 2006, I [discovered] that REITs going out to acquire assets found it quite challenging, because they were competing with the private funds. Private funds react much faster than REITs.”

At the time, ARA had already listed Fortune REIT and Suntec REIT in Singapore as well as Prosperity REIT in **Hong Kong** and AmFirst REIT in Malaysia. And, Lim was already familiar with the process of growing the portfolios of these REITs through acquisitions, and raising additional debt and **equity** capital to fund the deals. “It easily takes two to three months, whereas private funds can take down assets in 30 to 45 days,” he says.

That was when Lim decided ARA needed to move into private funds. “We needed to go into the private funds, in the more opportunistic space.” In 2008, he got his big break in the field when he secured the California Public Employees' Retirement System (CalPERS) as a major investor in ARA's first Asia Dragon Fund (ADFI). “We set up the ADF series, and we grew from there,” Lim says. ADFI is now in the divestment stage. However, ARA has a total of six other funds with AUM of around $6.1 **billion**. Including ADFI, ARA's fund AUM would be more than $9.8 **billion**.

ARA hasn't given up on REITs, though, Lim adds. On the contrary, since 2008, it has launched Cache Logistics Trust in Singapore and Hui Xian REIT in **Hong Kong**. Lim says his plan over the last couple of years has been to develop a broader platform to draw capital from investors and take on a wider range of **property**-related investment opportunities. “I realised that if you have the public REITs and the private funds, you still don't have enough. You don't have the capital to support your growth in a more flexible manner.”

New direction

In November last year, Lim **sold** a 20% **stake** in ARA to The Straits Trading Co (STC), controlled by Chew Gek Khim, a granddaughter of the late banker and philanthropist Tan **Chin** Tuan. ARA also set up a fund called Straits Investment Partners (SIP) to manage STC's investment **property** portfolio, worth around $850 **million**. Raffles Investments, which holds STC for the Chew family, now also owns 7.07% of Suntec REIT.

Separately, STC and Lim's family office have set up a joint venture called Straits Real **Estate** (SRE), with capital of $1 **billion**. SRE is not controlled by ARA, but is an independently run joint venture with its own team of eight personnel, headed by Desmond Tang, a former managing director of Alpha Investment Partners, Keppel Land's fund management platform. “He is ex-Prudential [Real **Estate** Investors] who worked with me 20 years ago,” Lim says.

“We use this [capital] from SRE to seed funds or to warehouse and incubate products for ARA's future growth. SRE will become a source of capital for ARA… to propel our AUM for the next… many years,” Lim explains. “So, our jigsaw puzzle is now in place.”

The team at SRE is now ready to study various deals and make investments, according to Lim. This could include providing seed capital to new funds managed by ARA. Lim estimates that SRE can seed as much as an additional $10 **billion** of AUM for ARA. He adds that while SRE will consider all manner of deals, its primary focus will be helping ARA to grow its business. “There is a lot of synergy between SRE and ARA. SRE is the capital provider, ARA is the manager.”

SRE has already provided $100 **million** in capital for a new fund, the Summit Development Fund I (SDFI). The fund's mandate is to invest in development projects and projects with value enhancement potential in Australia and Southeast Asia. SDFI is currently evaluating some development projects in Australia. “The rest of the money for SDFI, we will go out and raise. But we have to invest first for the development fund. No one is going to give you a blind pool,” Lim says.

He figures SRE will help solve one of ARA's competitive disadvantages. Funds and REITs under the major **property** groups such as CapitaLand, Keppel Land and Ascendas have parents capable of making investments that eventually find their way into their portfolios. These funds and REITs essentially have the balance sheets of their parents working for them. Now, ARA's REITs will also have a pipeline of potential assets to acquire.

Could ARA not just have relied on its growing number of funds to make these early investments? Lim says the strategies of the private funds ARA manages are clearly defined, which makes them too inflexible to take on every good opportunity. “You can't get out of the box. If the investors want a certain return, or just **China**, you can't do anything else.”

 

Outside of its alliance with STC, ARA manages four funds. Besides ADFI, there is ADFII, an "opportunistic blind-pools fund". There are also China Investment Partners (CIP) and Morningside Investment Partners (MIP), which are specific separate-account funds that are income-producing.

CalPERS, Teacher Retirement System of Texas, New York State Common Retirement Fund and New Jersey Pension Fund are investors in ARA's private funds. CalPERS has been with ARA since ADFI, and is the main investor in CIP. Separately, ARA Harmony Fund holds Suntec Singapore Convention & Exhibition Centre, and its investors are Suntec REIT and City Harvest Church.

SRE is different. "They can do mezzanine, funds, seed products, warehouse products, take-down products," Lim says. Take-down products are where the capital is used for an empty building, which can be redeveloped or refurbished, leased and transferred or sold to a fund. "Sometimes, the timing of the fund's setting up and the opportunities available may not match. So here, [with SRE], we have the flexibility of capital to 'warehouse' for a while, then transfer to the fund," Lim explains. "That makes my whole funding source complete for the next two to three years. We are transforming. We are putting all this in place."

Lim figures that ARA is now in a position to grow faster over the next few years. "Our AUM has grown by $1 billion to $2 billion a year from fund management, but to add on a new source of capital is very key for us," Lim says. "Now, I can compete." ARA is now also positioned to take advantage of the slowdown in property markets in China and the region, Lim adds.

"Lumpy" returns

While SRE and property funds might be ARA's ticket to faster growth, they might also make the company's earnings "lumpy". That's because property funds run by ARA generally have a defined lifespan. Some last for five years. Others last for seven years. CIP's fund life is 10 years, with two additional extension options of six years each. MIP has a life of eight years, with two additional extension options of one year each.

"We invest; we divest; we harvest the performance," Lim says. "When it comes to harvesting time, when the performance is good, we will see some lumpy [income]." That would be the performance fee element of the funds. However, Lim says as ARA's fund business grows, its recurring fee income will grow too. And, as ARA rolls out more and more funds, maturing at different times, the "lumpy" income from performance fees should gradually even out.

As it is, ARA saw a surge in performance fees to $16.26 million in 3QFY2014 versus just $618,000 in the same quarter last year. This was largely due to performance fees from Harmony Fund, in which Suntec REIT holds a 60.8% stake. Harmony Fund delivered an internal rate of return of 27.4% during its initial five-year term, and achieved an equity multiple of 3.1 times. During this time, the value of Suntec Singapore Exhibition & Convention Centre grew from around $235 million to $663.25 million. "The product is something you can see," Lim says, adding that the value of the convention centre was improved by an asset enhancement initiative. "The new convention centre is totally different."

The other 39.2% of Harmony Fund that Suntec REIT doesn't own is held by City Harvest Church, which bought it from a group of investors in 2011. Last year, City Harvest Church mortgaged its share of the convention centre to Vibrant Group (formerly Freightlinks). The interest rate was 10% per annum, excluding an upfront fee, which was 3% in the first year, 4% in the second and 5% for subsequent years.

"We have the first right to buy over the shares if they default," Lim says of the City Harvest Church deal with Vibrant Group. So far, however, the returns have been more than sufficient for City Harvest Church to pay its interest. "The returns are amazing, all shareholders are happy," Lim says.

Next year, some analysts are expecting ARA to get another performance fee boost. "ADFI, which is in the final stages of divestment, is expected to wind down in 2015, where ARA is entitled to performance fee, which could be a significant kicker for the stock price," notes Derek Tan, an analyst at DBS Vickers, in a 3QFY2014 results update. ADFI sold Nanjing International Financial Center for RMB2.48 billion ($527.5 million) in February this year. Last year, it divested Dalian Tianxing Roosevelt Centre. This year, it completed the divestment of the last of the residential units it held at Grange Infinite.

Lim is hoping to see more performance fee boosts in the future, as ARA's funds invest and subsequently harvest their returns. "We have the ADF series, Harmony Fund, CIP, SIP, MIP, SDF. Some will exceed the performance, some will be in line. That's the beauty of this business," he says.

Regional ventures

 

Besides growing its sources of capital, ARA has been expanding geographically, notably in Australia and South Korea. "We are now in **China**, **Hong Kong**, Singapore, Malaysia, Korea and Australia. Those are our core markets," Lim says.

Earlier this year, ARA acquired Macquarie Real **Estate** Korea Ltd, which manages two privately held Korean office **property** REITs with AUM totalling $708.6 **million**. The manager was renamed ARA Korea Ltd. ARA now holds a 10.2% **stake** in one of the REITs, called ARA-NPS Real **Estate** Investment Co.

In January next year, ARA plans to set up ARA Australia. "When we say we operate in a country, we have a real team based in the country; it's not like just one or two persons. We have a whole team for project management, marketing, leasing, **property** management, in **Hong Kong**, **China**, Malaysia, Korea," Lim says. These new markets could boost growth at ARA's existing funds and REITs. For instance, ARA's Australian team will also be able to hunt for suitable properties for Suntec REIT, Cache Logistics Trust and SDF, which are looking to acquire assets Down Under.

In December last year, Suntec REIT acquired a **property** at 177 Pacific Highway for A$413.19 **million** ($462.1 **million**). The freehold **property** is now being developed into the corporate headquarters for Leighton **Group**. It will be completed next year and is fully committed. Leighton **Group** itself is leasing 76% of the building for a WALE (weighted average lease to expiry) of 10 years. "It's a good location and a good deal for Suntec. At the end of 10 years, the yield will be nine-plus per cent. What else can you ask for? In 10 years, you can sell it for huge capital upside," Lim says.

SDFI is also hunting for development projects in Australia, with joint-venture partners. "We don't want to go into development ourselves," Lim says, adding that the partnership with Leighton is not exclusive. "For example, we could build an office building in Sydney, and Suntec can take it up later. In Melbourne, if we do a logistics warehouse, Cache can take it up later. The development fund creates that opportunity."

Among ARA's REITs that have made acquisitions this year is Prosperity REIT, which acquired 8 Chong Yip Street in **Hong Kong** in January. Meanwhile, its renminbi-denominated Hui Xian REIT acquired Metropolitan Plaza in Chongqing, **China** for RMB3.9 **billion** from

Cheung Kong Holdings and Hutchison Whampoa. "It's a very well-established mall in a good location," Lim says. "We are trying to avoid **hotel** assets in **China** because the five-star hotels got affected by the anti-corruption drive."

ARA reported a 33% rise in earnings to $69.3 **million** for the nine months to September, on a 35% rise in revenue to $130.8 **million**. DBS Vickers is forecasting a 22.9% rise in earnings (excluding exceptional items) to $91 **million** for this year. It sees ARA's earnings declining 7.7% next year to $84 **million** and has a "**buy**" rating on the stock. Shares in ARA are down 9.1% this year, and are currently trading at 15.6 times forecast earnings for 2015. The stock offers a dividend yield of nearly 3%.

Will shares in ARA perform better this year? Certainly, the new funds ARA is planning should gradually lift its baseline revenue and earnings. "The fund management business is a long-term one. We are putting in a lot of platforms in order to grow for the future," Lim says.

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