October 2016

Voluntary Practice Note

ASIC Regulatory Guide 46 – Unlisted property schemes:

Improving disclosure for retail investors

Joint Voluntary Practice Note issued by the

Property Council of Australia and the

Property Funds Association

Background

Regulatory Guide 46 – Unlisted property schemes: Improving disclosure for retail investors (**RG46**) provides guidance for improving disclosure to retail investors in unlisted property schemes. RG46 sets out principles for improved disclosure to retail investors to help them compare risks and returns across investments in the unlisted property sector.

To provide responsible entities and retail investors with greater clarity over some of the RG46 disclosure principles, the Property Council of Australia and the Property Funds Association have jointly issued this Voluntary Practice Note (**Practice Note**).

The purpose of this Practice Note is to improve the consistency and quality of the RG46 disclosure by responsible entities of unlisted property schemes to provide investors with clear, consistent and meaningful information.

This Practice Note:

- does not replace RG46; and
- should be read as a supplementary set of guidelines to RG46.

Responsible entities of unlisted property schemes should still comply with RG46.

To the extent of any inconsistencies between RG46 and this Practice Note, RG46 will prevail.

This Practice Note will enhance direct comparison of Australian real estate managed investment schemes. They are not intended to impose a legal obligation on entities to comply with the guidelines in the Practice Note.

The Property Council of Australia and the Property Funds Association thanks the Australian Securities & Investments Commission (ASIC) for its on-going co-operation, support and input into the Practice Note.

Objective

Adoption of a standard set of guidelines for unlisted property funds is important to:

1. provide investors with clear, consistent and meaningful information;
2. allow direct comparison of Australian real estate managed investment schemes;
3. facilitate better understanding of the performance of a managed investment scheme;
4. increase the confidence of investors, financial advisers and government in Australia's unlisted property funds sector.

The guidelines are a working document and will be reviewed periodically. This will ensure the performance metric continues to meet the needs of industry, investors and advisers.

To ensure the guidelines are adopted consistently by the market, and are transparent for users, responsible entities will reference "Property Council and PFA RG46 Voluntary Practice Note" where they disclose information from this Practice Note.

Guidelines

Disclosure Principle 1: Gearing Ratio

Background

RG46.62 requires responsible entities to disclose the scheme's gearing ratio calculated using the following formula and based on the latest financial statements, unless the responsible entity is aware of material changes since those statements:

$$\textit{Gearing ratio} = \frac{\textit{Total interest-bearing liabilities}}{\textit{Total assets}}$$

Principle

To find out the extent to which a scheme's assets are funded by interest bearing liabilities.

Guideline to supplement RG46

(a) Responsible entities should give retail investors information on a scheme's gearing ratio and comply with RG46.62–RG46.70.

(b) 'Total interest-bearing liabilities' and 'Total assets' should be referenced to the latest financial statements. If the scheme's financial accounts do not have these labels, responsible entities should explain how they calculated each input with reference to the financial accounts.

(c) For clarity, 'Total assets' should exclude intangible assets (in a similar way intangible assets are excluded in RG46.109). However, if the scheme's financial statements include intangible assets, responsible entities should comply with RG46 (based on the value of 'Total assets' in the scheme's financial statements) and make an additional gearing ratio disclosure excluding intangible assets.

Disclosure Principle 2: Interest cover ratio

Background

RG46.71 requires responsible entities to disclose the scheme's interest cover calculated using the following formula and based on the latest financial statements, unless the responsible entity is aware of material changes since those statements:

$$\textit{Interest cover ratio} = \frac{\textit{EBITDA – unrealised gains + unrealised losses}}{\textit{Interest expense}}$$

Principle

To find out what cash flows from earnings are available to service interest costs, and to provide investors with information to understand the ability of the scheme to continue to pay distributions.

Guideline to supplement RG46

(a) Responsible entities should give retail investors information on a scheme's interest cover ratio and comply with RG46.71–RG46.77.

(b) 'EBITDA', 'unrealised gains', 'unrealised losses' and 'Interest expense' should be referenced to the latest financial statements. If the scheme's financial accounts do not have these labels, responsible entities should explain how they calculated each input with reference to the financial accounts.

(c) 'EBITDA' should be adjusted for:

   (i) realised gain or loss from the sale of a property (technically, it is only the realised gain or loss from the book value at the end of the prior year – not the original cost or tax cost base – that is booked into the E of EBITDA); and

   (ii) realised gain or loss from closing out interest rate derivatives (the same argument applies). This should also be excluded from 'interest expense'.

   Both of these items, if included in EBITDA, may mask the true earnings capacity and therefore the scheme's ability to continue to service its borrowings and pay distributions.

   Responsible entities should comply with RG46 (ie not make any adjustments to EBITDA) and disclose the interest cover ratio on this basis.

If the responsible entity wishes to make adjustments for a realised gain or loss from the sale of a property, or for a realised gain or loss from closing out interest rate derivatives, the responsible entity should make an additional interest cover ratio disclosure with the adjustments incorporated into the calculation, along with a qualitative explanation as to why the items were excluded from the calculation and why this approach is sustainable.

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Disclosure Principle 3: Scheme borrowing

Background

RG46.78(d) requires responsible entities to disclose, for each credit facility, and amongst other things:

- RG46.78(d)(iii): the scheme's loan to valuation and interest cover covenants under the terms of each credit facility;
- RG46.78(d)(iv): the interest rate of the facility; and
- RG46.78(d)(v): whether the facility is hedged.

Principle

To find out what level of risk scheme borrowings may have on the scheme's distributions and unit price.

Guideline to supplement RG46

(a) Responsible entities should give retail investors information on a scheme's borrowing and comply with RG46.78–RG46.86.

(b) While RG46.78(d)(iii) requires disclosure of the loan-to-valuation and interest cover covenants under the terms of the scheme's borrowing facility, it does not require disclosure of the actual loan-to-valuation and interest cover as calculated under the borrowing facility. Disclosure Principle 1 and Disclosure Principle 2 go some way to providing a comparison of the gearing ratio and interest cover ratio, but they are more often than not calculated in a different way to the borrowing facility. RG46.78(c) also provides an "amount (expressed as a percentage) by which the operating cash flow or value of assets must fall before the scheme will breach any covenants", but some retail investors may not be able to back solve these numbers to work out the actual loan-to-valuation and interest cover. As a result, and in addition to the gearing ratio required under RG46.62, the actual loan-to-valuation and interest cover ratios should be disclosed as calculated under the borrowing facility as at the date of the latest financial statements.

(c) The 'interest rate of the facility' should include the amortisation of the front end establishment fee (amortised over the loan period), the base rate, line fee, margin and include the effect of interest rate derivatives to the extent of the hedging in place for the scheme (ie reflect the base rate for the variable component of the interest expense and the hedged rate for the fixed component), and all calculated at a point in time to align with the latest financial statements.

(d) Hedging is a very complex area and is left open to interpretation at RG46.78(d)(v). Additional qualitative disclosure should be provided around hedging to the effect that:

   (i) hedging is generally done to fix some or all of the interest rate relating to the borrowing facility. Whilst hedging is put in place to reduce the volatility of earnings and therefore distributions, hedging generally has the effect of increasing the volatility of the scheme's unit price or NTA given that the pricing of the underlying interest rate derivatives change daily;

   (ii) if held to maturity, the positive or negative amount of interest rate derivatives in the scheme's balance sheet will reduce to zero;

   (iii) disclose the amount of the mark-to-market value of interest rate derivatives at the date of the latest financial statements (this information is already in the scheme's balance sheet);

   (iv) whether or not the responsible entity maintains and complies with a written policy that governs the level of hedging for the scheme, with an accompanying 'if not, why not' disclosure.

Disclosure Principle 4: Portfolio diversification

Background

RG46.87 requires the responsible entity to disclose the current composition of the property scheme's direct property investment portfolio, including, amongst other things:

- RG46.87(c): for each significant property, the most recent valuation, the date of the valuation, whether the valuation was performed by an independent valuer and, where applicable, the capitalisation rate adopted in the valuation *(underlined emphasis added)*;
- RG46.87(d): the portfolio lease expiry profile in yearly periods calculated on the basis of lettable area or income and, where applicable, the weighted average lease expiry;
- RG46.87(e): the occupancy rate(s) of the property portfolio;
- RG46.87(f): for the top five tenants that each individually constitute 5% or more by income across the investment portfolio, the name of the tenant and percentage of lettable area or income

Principle

Portfolio information helps investors monitor the financial position and performance of the scheme over time.

Guideline to supplement RG46

(a) Responsible entities should give retail investors information on a scheme's portfolio diversification and comply with RG46.87–RG46.97.

(b) RG46.87(c) requires disclosure of the 'most recent valuation'. If unconditional contracts have been exchanged to sell the property but the sale is yet to complete, the sale price net of adjustments and costs may be more relevant to disclose than the most recent valuation. This also accords with accounting principles. If responsible entities take this approach, they should comply with RG46 (ie disclose the most recent valuation) and provide additional information reflecting the sale price net of adjustments and costs.

(c) RG46.87(c) requires disclosure of the 'capitalisation rate'. Sometimes valuers stipulate three capitalisation rates; the market capitalisation rate, the passing capitalisation rate and the reversionary capitalisation rate. The 'market capitalisation rate' is the most relevant measure for RG46. Responsible entities should also provide a simple, short statement giving the definition of market capitalisation.

(d) RG46.87(d) and RG46.87(f) requires disclosure of the scheme's WALE and top five tenants by 'lettable area or income'. This can produce quite different results. Given that income is used to calculate distributions, income is probably more relevant for investors. As a result, the WALE and top 5 tenant calculations should be 'income' based only and be calculated as at the date of the latest financial statements or align with the date of the annual financial statements (as relevant to RG46.87(d)). When calculating the WALE by income:

- (i) use net income amounts;
- (ii) vacant space should be included:
  - A. at zero value in the numerator;
  - B. at the net market rent/income assigned by an independent valuer in the denominator; and
- (iii) declare if there is a rental guarantee.

(e) RG46.87(e) requires disclosure of the scheme's occupancy. In the property industry, this can also be calculated by area or income, but it is silent in RG46 as to the method. To align with the above, we recommend the calculation of occupancy be 'income' based only, and be calculated as at the date of the latest financial statements, where:

- (i) net income amounts are used;
- (ii) vacant space should be included:
  - A. at zero value in the numerator;
  - B. at the net market rent/income assigned by an independent valuer in the denominator; and
- (iii) declare if there is a rental guarantee.

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Disclosure Principle 5: Related party transactions

Background

RG46.98 requires responsible entities that enter into transactions with related parties should describe related party arrangements relevant to the investment decision. The description should address, amongst other things:

- RG46.98(a): the value of the financial benefit, except to the extent that, at RG46.101(b) investors already have adequate information about the related party transactions as a result of past disclosures, so it is not reasonable for the information to be repeated in full.

Principle

Investors should be able to assess whether responsible entities take an appropriate approach to related party transactions.

Guideline to supplement RG46

(a) Responsible entities should give retail investors information on a scheme's related party transactions and comply with RG46.98–RG46.101.

(b) The 'value of the financial benefit' should be the value of financial benefit paid since the last full year annual accounts (generally 30 June, but otherwise the full year reporting period adopted by the scheme). This aligns with disclosure in the scheme's annual financial statements around related party transactions as required by Australian Accounting Standards.

Disclosure Principle 6: Distribution practices

Background

RG46.102 provides that if a scheme is making or forecasts making distributions to members, the responsible entity should disclose:

(a) the source of the current distribution (e.g. from cash from operations available for distribution, capital, unrealised revaluation gains);

(b) the source of any forecast distribution;

(c) whether the current or forecast distributions are sustainable over the next 12 months;

(d) if the current or forecast distribution is not solely sourced from cash from operations (excluding borrowings) available for distribution, the sources of funding and the reasons for making the distribution from these other sources;

(e) if the current or forecast distribution is sourced other than from cash from operations (excluding borrowings) available for distribution, whether this is sustainable over the next 12 months; and

(f) the impact of, and any risks associated with, the payment of distributions from the scheme from sources other than cash from operations (excluding borrowings) available for distribution.

Principle

Investors should be able to assess whether responsible entities is paying distributions from earnings, capital, or a combination of both.

Guideline to supplement RG46

(a) Responsible entities should give retail investors information on a scheme’s distribution practices and comply with RG46.102–RG46.103.

(b) Responsible entities should include a reconciliation of the net profit or earnings amount to the distribution amount (in nominal dollars) accompanied by an explanation that if the distribution is higher than earnings or net profit, then whether the scheme is paying some of its distribution out of capital (and highlight the risk of doing so and whether these distributions are sustainable). The following example/template maybe used:

Net profit/net earnings disclosed in the scheme's financial statements	$xx
+/- Valuation changes	$xx
+/- Interest rate derivative changes	$xx
+/- Other	$xx
= Distributable earnings / Funds From Operations (FFO)	**$yy**
Distribution	$zz

Comment: If $zz (ie distribution) is greater than $yy (ie distributable earnings), then the responsible entity should state whether the scheme is paying some of its distribution out of capital (and highlight the risk of doing so and whether these distributions are sustainable).

Disclosure Principle 7: Withdrawal arrangements

No proposed guidelines to supplement RG46.

Disclosure Principle 8: Net tangible assets

Background

RG46.109 requires responsible entities to calculate the value of the net tangible assets (NTA) of the scheme on a per unit basis using the following formula:

$$NTA = \frac{\text{Net assets} - \text{intangible assets} +/- \text{any other adjustments}}{\text{Number of units in the scheme on issue}}$$

Principle

An NTA calculation helps investors understand the value of the assets upon which the value of their unit is determined.

Guideline to supplement RG46

(a) Responsible entities should give retail investors information on a scheme's net tangible assets and comply with RG46.108–RG46.115.

(b) 'Net assets' should reference to net assets in a scheme's latest financial statements and:

  (i) be based on the 'ex-distribution' value of net assets assuming the calculation is done at the end of each distribution period for a scheme (or if it's 'cum-distribution', explain what this means)

  (ii) disclose, in a qualitative sense, whether the RE writes off acquisition costs immediately or at the time of the next valuation and whether any acquisition costs are imbedded in 'net assets'. An October 2014 PFA survey found quite a disparity within the industry; 38% of respondents capitalise acquisition costs at acquisition and write them off at the first valuation (as required by Australian Accounting Standards) whilst 62% write off acquisition costs immediately upon the acquisition.

(c) A qualitative explanation should be provided to investors about the difference between the scheme's NTA and its unit price (including buy price and sell price).

Feedback

Please send your feedback to:

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