Adrian Harrington, head of funds management, Folkestone Limited

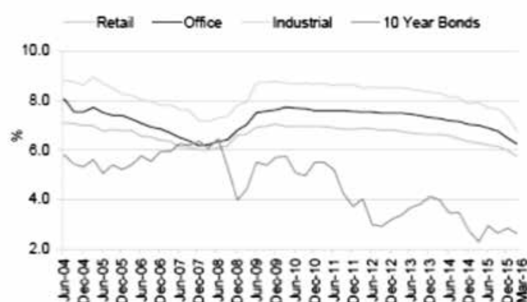
Harrington joined Folkestone in April 2011 following the acquisition of Equity Real Estate Partners, where he was a founding partner. He has more than 20 years' experience in the funds management and real estate industries.

WHAT TO LOOK FOR IN UNLISTED REAL ESTATE FUNDS

Adrian Harrington

In the current low interest rate environment, the hunt for yield is a powerful force. Non-residential real estate via listed real estate investment trusts (A-REITs) and unlisted real estate funds (syndicates) have both benefitted from strong investment inflows. To date, investors have not been disappointed. According to the Property Council/ IPD Unlisted Core Retail Property Fund Index published by MSCI, unlisted syndicates generated a total return of 37.8% in the year to 31 March 2016, with an income return of 8.8%. For the same period, A-REITs generated a total return of 11.4%, with an income yield of 5.8%.

Figure 1. Real Estate Cap Rates (Yields) in Various Sectors: 2004-2016



Source: MSCI/IPD & Folkestone

Most of the syndicates in the Index were established between 2010 and 2014 when real estate yields were higher and hence the relative higher income returns they are now generating. As prices of non-residential real estate assets have increased, yields have firmed (see Figure 1). Recent syndicate offers typically have starting yields of between 6.6% and 7.5%. When compared to the cash rate at 2% and 10 year bonds at 2.5%, the yields look attractive.

However, choosing to invest in any investment whether it is an A-REIT, a bank stock, or an unlisted real estate syndicate based on just the first year yield may lead to problems down the track when the market turns. Investing is about total returns – income and capital – over the life of the investment and a syndicate typically has a term of between five and seven years.

Unlisted real estate funds or syndicates offer a legitimate investment option for investors where liquidity is not a high priority. But like any investment, investors need to understand the risk and return. The first-year headline yield should not be a priority. Real estate is a long-term investment and chasing short-term yield may not deliver the best long-term investment outcomes.

Folkestone does not believe the non-residential real estate sector will fall off a cliff in the next year or so with the exception of those assets in cities or towns reliant on the mining sector (e.g. Perth CBD office). As we recently pointed out in our 2016 Outlook paper, we still see opportunities to invest in unlisted real estate syndicates but it is becoming increasingly difficult to find quality assets at reasonable value. We believe is not the time to stretch on price or overcommit to short-term strategies; maintaining investment discipline will be key.

Understand the asset and fund characteristics

Every real estate asset and fund are different, and investors should examine:

Asset level

- Characteristics of the asset – what is the age, quality and location of the asset?
- Tenant covenants – how good are the tenant covenants and what's the risk of default?
- Lease expiry profile – what is the vacancy, when are the leases due to expire, are they staggered through the term of the fund or do they extend beyond the term of the fund?
- Rent structure – is the asset under – or over-rented compared to the rent level in the market, what incentives have been paid to tenants, when and how are rents reviewed during the lease term?
- Capital expenditure – will the asset require capital expenditure during the term of the syndicate and if so, how will the fund pay for it?
- Market dynamics – what is the prognosis for supply and demand in the surrounding market?

Fund level

- Longer-term yields – don't just focus only on the first year yield published on the cover of the fund offer, remember it's a five to seven year investment at least.
- Distribution policy – is the fund paying distributions from its cash from operations (excluding borrowings) or capital, borrowings or other support facilities which may not always be commercially sustainable?
- Gearing – what's the fund's gearing level and how does that compare to the bank covenants, and how much buffer is there between the gearing level and the bank's maximum loan to value ratio? How much, if any of the debt is fixed versus variable?
- Fees – what is the fee structure, are they transparent and aligned with investors?
- Manager track record – what is the performance track record of the manager?
- Poison pills – does the fund have a 'poison pill' which requires the manager to be paid by the fund if removed by investors for poor performance?
- Regulatory compliance – has the manager clearly set out whether the fund meets the six benchmarks and eight disclosure principles for unlisted property schemes in ASIC's Regulatory Guide 46 - Unlisted Property Schemes, and if not, why not?
- Treatment of acquisition costs – does the manager write off or capitalise costs?
- Exit strategy – what's the manager's likely exit strategy?

Manager quality

Good real estate managers are asset enhancers. They create value by their ability to manage the asset through the cycle. They don't rely on tricky capital management and financial engineering to deliver returns to investors. They also offer true to label simple and transparent funds with fee structures that are reasonable and aligned with investors. We advocate on-going management fees based on a percentage of net assets (not gross assets) of the fund as the manager is not incentivised to take on higher gearing. A management fee of 1.3% of net assets assuming 50% gearing is equivalent to 0.65% of gross assets. A performance fee is also appropriate so long as the benchmark rewards the manager for real outperformance not just turning up for work.

Understand how the manager calculates the NTA of the fund

Some managers capitalise part of the acquisition costs rather than write them off on day one, which means the initial NTA when costs are capitalised are higher. Table 1 shows the initial NTA when acquisition costs are not capitalised and Table 2 shows the impact when costs are capitalised.

Table 1. Unlisted fund – acquisition costs not capitalised

Gearing	40%	50%	60%	A
Property price/Debt & Equity				
Acquisition yield	7%	7%	7%	B
Annual net property income	3,000,000	3,000,000	3,000,000	C
Purchase price	42,857,143	42,857,143	42,857,143	C / B = D
Debt	17,142,857	21,428,571	25,714,286	D * A = E
Equity - asset	25,714,286	21,428,571	17,142,857	D – E = F
Acquisition & establishment costs				
Acquistion costs				
(stamp duty/asset due diligence – 6% of purchase price)	2,571,429	2,571,429	2,571,429	D * 6% = G
Debt establishment – 0.25% of debt	42,857	53,571	64,286	E * 0.25% = H
Acquistion fee - 1.5% of purchase price	642,857	642,857	642,857	D * 1.5% = I
Fund establishment costs (legals, tax,				
accounting)	100,000	100,000	100,000	J
Total acquisition & establishment costs	3,357,143	3,367,857	3,378,571	G+H+I+J=K
Fund equity required	29,071,429	24,796,429	20,521,429	F + K = L
Profit & Loss				
Total annual net property income	3,000,000	3,000,000	3,000,000	C
Recurring Fund Costs (registry,				
accounting, tax, audit etc)	120,000	120,000	120,000	M
Interest – 4.5%	771,429	964,286	1,157,143	E * 4.5% = N
Management fee - 1.3% of net assets (equity)	334,286	278,571	222,857	F * 1.3% = O
Total annual costs	1,225,714	1,362,857	1,500,000	M + N + O = P
Total net fund cashflow	1,774,286	1,637,143	1,500,000	C – P = Q
No of units on issue – assume issued price $1	29,071,429	24,796,429	20,521,429	L * $1 = R
Distribution yield	6.1%	6.6%	7.31%	Q / R = S
NTA ($)	0.88	0.86	0.84	F / R = T

Assumes the asset and debt upfront acquisition costs are not capitalised ie they are written off on day one. As a result, more equity is required on day one which results in a lower yield and NTA as more equity needs to be raised.

Table 2. Unlisted fund – acquisition costs are capitalised

Gearing	50%	
Purchase price	42,857,143	D
Acquistion costs (stamp duty/asset due diligence – 6% of		
purchase price)	2,571,429	G
Debt establishment – 0.25% of debt	53,571	H
Capitalised asset value	45,482,143	D + G + H = U
Debt	21,428,571	E
Equity – asset	24,053,571	U – E = V
NTA ($)	0.97	V / L

Table 3. Unlisted fund - impact of gearing levels and debt costs

Gearing	40%	50%	60%
Debt cost – 3.75%	6.52%	7.21%	8.19%
Debt costs – 4.5% (Table 1 example)	6.1%	6.6%	7.31%
Debt costs – 6.5%	4.92%	4.87%	4.8%

Instinctively when presented with the two options, an investor may think they are better off investing in the fund adopting option two. However, we and most of the leading managers advocate, taking the conservative path and writing these costs off on day one which unfortunately results in a lower initial NTA. Managers capitalising costs run the risk that if the value of the asset has not risen by at least the amount of the capitalised costs at the next financial review date, then they will have to be written off at that time impacting the NTA.

Gearing enhances returns but also risk

Many investors must look at an unlisted real estate's funds yield at say 7.3%, on a property acquired with income yield of say 7%, and wonder where the money comes from. The answer is leverage and cost of debt. Whilst a syndicate's yield is a function of the net income that the underlying property generates, the ultimate yield to investors depends on the gearing level and cost of debt.

Higher gearing enhances the yield if the cost of debt is below the yield of the asset, as in the current market. We advocate gearing not to exceed 50% and start with at least a 10% buffer to the bank's loan to value (LTV) covenant, usually 60%. This provides a buffer if asset values fall.

Table 1 shows an example of an asset generating a net income of $3 million per year and purchased on a yield of 7%. Let's assume that it is fully tenanted and relatively new so the capital expenditure requirements are minimal. There are three scenarios – the asset has leverage of 40%, 50% or 60% and the acquisition costs are not capitalised.

The cost of debt also has an impact. Table 3 shows the impact under two other scenarios related to the cost of debt. Firstly, the manager secures debt at 3.75% (assume a 90 day BBSY base rate of 2.3% and a bank margin of 1.5%) – highly possible in today's low interest rate environment – and secondly, interest rates move back to more long-term levels and debt is secured at 6.5% (a base rate of 5% and a margin of 1.5%).

It is clear there is a wide variation in a fund's yield based on the gearing levels and cost of debt.

Leveraging up in a market when asset prices are rising (yields are falling) and debt costs are low, as the table above shows, can generate supersized returns. However, the risk in those funds is significantly heightened when the cost of debt goes up and/or the real estate cycle turns and prices fall as it inevitably will at some point down the track. Given the power of leverage to magnify investment returns, both positive and negative, investors need to understand that prudent use of leverage, with appropriate capital management strategies (covenant levels, type of debt – principal and interest or interest only, duration of debt – short or long-term and hedging – level of fixed versus variable debt) can be an effective financial instrument but abused, the ramifications can be significant.

As real estate yields have fallen, it is pleasing most managers of recent unlisted fund offers are avoiding the temptation of leveraging up to boost a fund's yield. Managers and investors must remain diligent as real estate yields head to cyclical lows, and avoid the temptation to supersize fund yields by over-leveraging. As Warren Buffet said: "When you combine leverage and ignorance, you get some pretty interesting results."

Exit strategies are important

We are often asked what happens at the end of the syndicate's term? What happens if an investor needs liquidity? Why does the syndicate require such high thresholds to rollover for a longer term? These are all legitimate questions which managers need to clearly articulate to investors.

Unlisted real estate fund is a long-term investment. If investors are concerned about short-term liquidity needs they should consider investing in listed real estate. There are times when a person's circumstances change due to death or divorce and they wish to liquidate the investment. The only way this can be dealt with is via an off-market trade in which another investor is willing to buy their units in the fund. There is no secondary market for trading of units although there are some funds that have been established to acquire units from investors, and from time to time, the manager may be approached by other investors who may wish to invest in the fund. The manager may put the two investors in touch with each other to negotiate an appropriate price but the manager is legally not able to create a secondary market in trading the units of its fund.

The GFC highlighted the inadequacy of many unlisted funds whereby they did not focus on the exit strategy which created a misalignment between investors and managers. A number of funds were extended for a further term prior to the GFC and then took a hit as the market collapsed. In effect, some managers 'rolled the dice' and kept their funds running beyond the initial term. This allowed the managers to collect fees for longer when asset pricing started to reach excessive levels and the funds had already delivered strong returns to investors.

Most of the leading managers now use structures that require unitholders to vote to amend the fund term and performance fee structures. They incentivise the manager to recommend to unitholders to wind-up the fund early if they believe the returns from the asset have been maximised or the cycle is nearing the peak. Managers have also inserted early wind-up provisions into the terms of the fund typically based on a Special Resolution i.e. at least 75% of votes cast by unitholders on the resolution to be in favour of the resolution for it to be passed.

The Special Resolution provision should also apply if the manager believes it is in the best interest of investors to extend the term of the fund. This may arise as the property has an upcoming lease which if renewed or extended can add value to the fund if the sale is delayed until this is actioned, or it could be that the market is soft and liquidating the asset at the time may not optimise the return to investors.

The key with exit strategies is for the investor to recognise that investing in an unlisted fund is a long-term investment and that a manager's role is to optimise the value of the asset and the return to unitholders which may mean, in certain circumstances, winding-up early or extending the life of the fund. At the end of the day, the decision should be relatively straightforward for both the manager and investor if there is an alignment of interest, the manager presents a clear and rationale case for action and there is an appropriate voting mechanism that gives investors a say in what happens. **FS**