The structure of unlisted property funds

The unlisted property sector is in crisis, writes ROBERT KEAVNEY. He explains why this is not the first time and expresses concerns that it will happen again.

Today, many unlisted property structures are frozen, many are struggling with excessive debt, some have been forced to cease distributions and there is uncertainty about the value of unit-holders' investments if properties are sold on the open market.

This has happened before. After the complete collapse of the unlisted property sector at the start of the 1990s, it seemed inconceivable that they would return to popularity – but they have.

Unless the next generation of planners learn the lessons from the past, over the forthcoming decades we may again be fated to experience a mass freezing of investors' property holdings.

The previous cycle

Property rose strongly throughout the 1980s. At that time most planners used unlisted property trusts (UPT) for clients' property exposure. There were a handful of older heads who issued dire warnings about the liquidity risks inherent in investment vehicles that offered ready redemptions despite their underlying assets being illiquid. However, the vast majority of advisers – including this writer – were too naïve to understand the risks.

During the global recession at the start of the 1990s the property market crashed. Redemption queues immediately formed for unlisted property funds and, one by one, trusts froze their redemptions. Finally, the regulators were forced to impose a freeze on every UPT in the country. This was a wholesale failure of the then structure of UPTs.

Investors found themselves in the stressful position of not knowing when they would be able to access their funds or what value they would ultimately receive. It was at this point that I learned the merit of liquidity and a ready market price.

In those days, UPTs came in geared and ungeared forms. Those with gearing were called growth trusts and those without were called balanced trusts. Growth trusts obviously suffered most in the 1990s property collapse, to the extent that at least one fund reached a negative unit price.

By contrast, balanced funds performed relatively well (ie, less badly). Most continued to pay strong distributions and their capital losses were limited to the not insignificant fall in the property market. In fact, there were a number of balanced funds with nil debt and around 40 per cent of their assets in cash. It might be expected that these funds were well placed to survive a weaker market. Yet, while they suffered less than most others, they were still locked up for several years and delivered material losses when funds were finally accessible.

In the vast majority of cases, unlisted property funds were ultimately listed as the only way for investors to gain liquidity. There was a lesson in that.

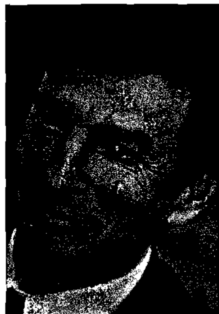
Lessons half learnt

In their second emergence, many UPTs attempted to address the liquidity issue by building the capacity to suspend redemption into their deeds. Further, many elected to hold a portion of their assets in cash or real estate investment trusts (REITs) to meet redemptions. The latter seemed to be a tacit admission that certain unlisted property funds can only operate so long as not all their money is in unlisted property.

In any case, the precedent of the previous cycle, where even funds with nil gearing and 40 per cent of their assets were brought unstuck, suggested this mechanism could not meet redemption demand at peak periods.

Some funds actually wrote into their trust deed that they must hold x per cent of their assets in liquids. When redemptions were required, it was realised that it would breach the trust deed to allow liquidity to fall below the level they held, so the liquids couldn't be used to provide liquidity.

A realistic lesson to learn from the last two property cycles is that there are many conditions under which it is impossible to provide liquidity from most unlisted property funds. Therefore, Product Disclosure Statements (PDSs) of UPTs



should make this explicit and not set expectations to the contrary.

There are some unlisted property vehicles that do not offer any access to investors' funds until the properties are sold and the fund wound up, realistically reflecting the reality of the illiquidity of the underlying assets.

The PDSs of many unlisted funds describe liquidity mechanisms being funded by using liquids, selling assets or raising debt. This raises the potential of portfolio decisions being forced by the coming and going of investors rather than solely on investment grounds. During the recent downturn, it was very difficult to sell properties, was generally undesirable to increase debt, and worsened LVR (threatening loan covenants) to pay out liquid cash. Thus, any investors who wished to retain their holdings were at risk of the quality of their funds being eroded by the decisions of others to redeem.

By contrast, a benefit of a listed structure is that the portfolio of a fund is never altered by the decision of investors to buy or sell units, and trading is rarely halted.

Why redemption queues are inevitable

The valuation of direct properties is appraised by property valuers using market evidence. In the early stages of the last two property collapses the situation arose that the market was falling but sales had not yet taken place at a lower level. The lagging nature of the valuation process meant that the net tangible assets of funds and thus their unit price were unavoidably out of date and too generous, and would remain so until market evidence emerged of the price to which properties had fallen.

A rational response to an overvalued unit price is to try to sell before it inevitably falls. It is therefore likely that every property cycle will see redemption pressure on unlisted property structures.

Unlike the 1980s, today funds are not in breach of their deeds to freeze, but the effect on investors is identical. They can't get their money.

Gearing

Before the financial crises there was a tolerant attitude to gearing, now the world has been reminded that gearing really does involve risk. This is certainly so in the property sector, where many funds, listed and unlisted, had their viability threatened by loan covenants as valuations fell.

Yet for some inexplicable reason, virtually every property fund today involves internal gearing. In this respect (and not many others), the 1980s offered a better range of options through the existence of balanced (ungeared) funds.

Most equity funds are ungeared, with a small number of geared funds also available. If individuals wish to borrow to invest in shares, they can borrow personally and invest in equity trusts or direct stocks. Thus the decision to invest is separated from the decision to gear. Yet for some reason almost all property vehicles involve internal gearing. Why?

Gearing increases assets on which to charge fees, so some managers may be influenced by self-interest in this respect. However, there has to be a market opportunity for products that offer exposure to property without exposure to gearing.

> "This is the second time such a crisis has befallen the unlisted property sector."

An anomaly that has arisen in recent years is funds with gearing holding high levels of cash for liquidity purposes. The cash can be used to reduce debt but, by not doing so, they are effectively gearing into cash. Prima facie, it doesn't add much to a property investment to have borrowed money that sits in cash, especially if the fund charges ongoing fees of a per cent or two. (Of course, individual funds may have had particular circumstances that required this.)

Costs

Property is a very expensive asset to buy and sell. Stamp duty and agent fees to buy and sell properties are likely to add up to more than 6 per cent (ignoring any Goods and Services Tax). Some managers charge a fee to acquire properties, so let's allow another 1 per cent for this, bringing the total to 7 per cent. If such a fund carries gearing of 50 per cent, these costs consume 14 per cent of investors' equity. If a product features an entry fee, the total acquisition cost will be higher. In my view, no investment justifies that amount. (Note that some of these items will be amortised in the accounts rather than hitting the unit price at once. Nonetheless, this money is spent.)

On these grounds alone, many property vehicles are too expensive. However, if clients are to have any exposure to property, they must inevitably face some share of capital costs.

REITs

All other things being equal, perhaps the most expensive way to invest in property is via a new fund with a fixed life. In this case, investors bear the whole cost of setting up and ultimately winding up the fund, plus the costs of acquiring the properties and ultimately selling them.

It will generally be cheaper for investors to buy units in an ongoing fund, with an already existing portfolio, and have the ability to sell the units without requiring the sale of fund assets or needing the fund to wind up. This is the listed model, where buying and selling units makes no difference to the assets of the fund. (It is not quite as simple as that as rights issues, for example, do bring new funds into a trust.)

Average listed trusts' ongoing management fees (particularly those with internalised management) are also a fraction of average unlisted property fund fees – though of course there will be exceptions.

This is not to say that REITs are always good value. At times they are materially expensive compared to net tangible assets or fair value. The point is simply that they are structurally more robust.

Some REITS collapsed during the financial crises. A badly managed fund won't thrive simply because it is listed. Further, listed property fell heavily in the crises. Whether listed or not, investors will lose money in a falling market.

But the listed structure itself has not floundered and the market continues to function. Investors have retained their ability to choose to hold, sell or by more. And they know exactly what their asset is worth on any given day to help to inform their decisions.

Conflicts of interest

This is the financial services industry so, as always, we need to assess conflicts of interest. It must be recognised that there may be a conflict of interest in decisions about frozen funds. If the fund is wound up, the management company will pay out funds under management (FUM), producing a loss of revenue. Planners need to scrutinise these situations carefully to ensure their clients' interests are served.

If liquidity can't be guaranteed from a UPT, it is important to examine fund termination provisions before investing. Some deeds make termination more achievable than others. Take for example a trust deed that provides for a unit holders meeting every six years to consider a wind up, with a 75 per cent vote required for termination.

Assuming that a manager will usually recommend for continuation to preserve FUM, it will require a 75 per cent vote against the managers' recommendation to terminate the trust. Anyone who has been involved in corporate actions knows how hard this is to attain. If the fund is not terminated at the first of two such unit-holder meetings, it will have at least an 18-year lifespan. This is a very long investment period for an investment recommendation. If such a fund also froze, money may be locked in for an unacceptable period of time.

Perspective

I have explored what I believe to be weaknesses of the unlisted property structure. It is therefore appropriate to end such an article by acknowledging that there have been successful unlisted funds that have produced sound returns for investors. No doubt there are many reputable and well-intentioned individuals and organisations operating in this field.

The point is that planners and investors need to understand the structural risks inherent in providing liquidity from vehicles that hold illiquid assets. This is not limited to the property sector. Where an unlisted fund carries higher fees and bears a liquidity risk, investors need good grounds for anticipating a higher return than available elsewhere to justify investing.

The benefit most often argued for unlisted property is that it is less volatile than listed, actually only because current values are not frequently assessed. However, this is no benefit when a fund is frozen. Knowing you have lost money but not knowing how much because the NTA doesn't reflect the achievable sale of the underlying assets nor how long before the situation will be clarified simply induces stress.

Conclusion

This is the second time such a crisis has befallen the unlisted property sector. In the last crisis most funds were forced to turn to the stock market for a solution.

Yet seeing how little was learnt from that experience, it is hard to have confidence that it won't happen a third time.

It is a wonderful thing to be able to buy or sell an asset at any moment, and to know the price at which this transaction will take place. When dealing with illiquid assets, stock markets do this best. Planners should never sacrifice this liquidity lightly.

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