A REAL ISSUE FOR THE TRUSTS

BIG GAINS OR JUST BIG TALK?

by NICK WRIGHT

Glittering promises of growth in property trusts may not always suit the interests of all unitholders. Two new techniques for raising new capital are deserving of wider adoption.

About the time this article was conceived, the latest would-be manager of a listed property trust, its underwriter having withdrawn, was nevertheless speaking confidently to the press about a new issue within a few months of the prospectus float being filled. The manager of another trust whose performance had been less than brilliant had just raised four times the money it had previously and was talking of having $500 million under management before long.

There is nothing new in this. Almost every would-be manager of a listed property trust thinks and talks in the same way about the succession of new issues it is going to make to the desperate hordes of eager investors.

Both managers might have been better served by being more reticent. On the other hand, such ambitions are healthy; and the investor should be wary of the property trust manager who does not wish to raise further capital sooner or later. Such a manager may not have incentive to keep the trust's growth in distributions, and hence market price, at competitive levels.

The most effective sanction the unitholders possess is the right to refuse to subscribe to a new issue. Beware the manager who does not know that the name of the game is raising more capital. That a manager may have a financial interest in some units itself is not necessarily an adequate incentive to keep up the growth in distributions; there may be other rewards.

However, the manager who makes much of new issues to come is not recognising the usual dilutionary effects on unitholders' returns.

Occasionally a new issue will not cause dilution but, generally speaking, exceptional market conditions are a precondition for this. The issues of Westfield Trust and Capital Property Trust in the second half of 1987 were probably cases in point, since the prospective yield of the new units appeared to be below the immediate income yield of the properties acquired.

Such a favourable outcome is more likely to be brought about by the proceeds of the issue being invested in cash. One manager had adopted the practice of always having an issue to raise funds for the investment after the next investment. Only in a tight and rapidly rising property market, or when short-term interest rates fall quickly, does this strategy backfire.

From all the brave talk about how a succession of new issues will make their property trust one of the largest in a short space of time, one wonders whether new managers-to-be have any conception of the difficulty of raising new capital for an existing listed property trust. It is a fact, supported by its sole exception, that every listed property trust's share of total capital raised by listed property trusts declines after its initial raising.

It is even more difficult, but vital, to expand the number of unitholders. The

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mere fact that the trust exists and has eye-catching buildings of acceptable quality will not of itself attract buyers for the rights.

It is surprising then that so few managers seem to give real thought to new raising techniques. Two such techniques that have been used in the past year and which are worthy of more widespread adoption are forfeiture and amalgamation, and managed issues.

Forfeiture and amalgamation

Forfeited rights are one of the underwriter's rewards, provided the issue has been correctly pitched. In this technique they are amalgamated into one or several parcels and sold by the trustee, and the proceeds distributed to the forfeiting unitholders.

Alternative variations, which may be termed the active and passive versions, are:

- Active — the trustee does not act unless a specific request from the unitholder is received.
- Passive — the trustee sells all forfeited rights. This must lead to questions of what to do with the proceeds where forfeiture occurred because the unitholder could not be contacted.

Alternative versions of the active variation are before or after the applications closing date.

- Pre-closing-date — the rights are sold towards the end of rights trading, requiring that forfeiting unitholders return their requests for sale promptly and possibly preventing use of the stock exchanges' abbreviated rights trading period.
- Post-closing-date — the rights are placed off-market after the issue closes. The passive variation is perforce a post-closing-date variation.

Managers may prefer the pre-closing-date version because it enables them to receive funds more quickly.

An unqualified right to accept post-closing-date facilities will lead to unitholders taking a judgment about whether a better price may not be achieved post rights trading. Consequently, to preserve the liquidity of the rights market — an important consideration for the manager — it may be desirable to restrict access to the facility to parcels of rights of less than a certain size.

Stockbrokers know only too well the problems that arise from dividend reinvestment plans and new issues creating small parcels of securities which cannot be handled economically.

The forfeiture and amalgamation technique facilitates consolidation of the register into viable marketable parcels. It may be a good idea for the Australian Stock Exchange to promote this technique actively, the interests of the odd-lot brokers notwithstanding.

Managed issues

In a sense, managed issues do not need underwriting but are in effect an underwriting arrangement.

The objects of a managed issue, apart from issuing further equity, are:

- To ensure that existing small unitholders receive some consideration for their rights, avoiding the adverse consequences on a trust's market-rating of a very low rights price.
- To promote wider holding of the trust's units among institutional investors.
- Not to hinder any expansion of the number of unitholders that may be a consequence of the rights issue.

Managed issues are unlikely to be necessary for issues by leading trusts but the technique can be useful for younger trusts, especially those with a history of heavy calls on unitholders.

The essence of a managed issue is that the rights price is supported at a level which, while not encouraging selling by smaller unitholders, ensures that they receive something for their rights. As it is likely that the buyers will be predominantly institutions, the price set for the rights needs to be attractive to them.

It is important that sufficient buying capacity exists to cover all rights which will be offered at the support price".

As it is counter to the intention of a managed issue that potential buyers who are not members of the supporting syndicate should receive competition for rights from the syndicate, it might be more accurate to say "sufficient capacity to absorb all rights offered at one cent below the support price."

The existence of a second line of support — a buyer of last resort — can make it easier to arrange a managed issue. The presence of a godfather in the form of a major life office or similar institution is a considerable advantage. In fact, in the writer's view, attempts to arrange support for a managed issue run a severe risk of embarrasing failure unless a godfather exists.

Note that if the support price has been set at an efficient level the shortfall should be merely "technical". However, given current brokerage and stamp-duty costs, in many instances selling will not be to a small unitholder's advantage. (It should be remembered that the relatively low to negative difference between yields on investment properties and property trust units makes it essential that the manager minimise the dilutionary effects of a new issue of units.) It is unlikely that the price of the rights to a well-pitched issue would exceed 10-15 cents.

Two points that need to be dealt with explicitly in the agreement are that members will actually take up any rights purchased, and whether members are obligated to accept and subscribe for their portion of any shortfall.

A difference between a managed issue and an ordinary underwriting is that members of a supporting syndicate for a well-pitched managed issue are likely to have to buy rather more rights than they would expect to receive as a shortfall from underwriting. This suggests that:

- It is important that members of the syndicate actually *want* to hold units in the trust.
- Fees received by them may need to be higher than those received by sub-underwriters. Overall costs of the issue may not need to be any higher than for an underwritten issue, as the services of an underwriter can be dispensed with — in effect, if not in formality.

A lesson for PRs

The writer's grandmother always preceded the words "bonus issue" with the adjective "nice". If his memory serves him correctly, in 1982 the chairman of one of the largest trusts promised his unitholders two new issues (for cash) a year and was cheered to the echo. The next issue was largely a failure, the exercise price being above the price of the units. Rather less than one issue annually followed for the next few years.

Perhaps unitholders and shareholders are learning. Is this Darwinian evolution? Perhaps institutions, whose managers certainly do understand dilution, are becoming more important in the listed property trust market. However, the writer's experience is that many do not acknowledge the importance of minimising dilution when it comes to discussing a proposed new issue.

Either way, it is about time the lesson was rammed into the PRs of sundry property trust managers who appear to believe that the intention to raise $500 million is a promise of prosperity rather than a threat to wealth. □