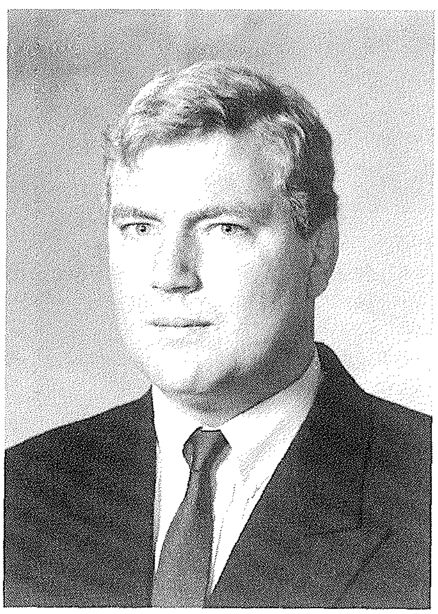
BREATHING LIFE INTO PROPERTY MARKETS

SPVs: THE ANSWER TO LIQUIDITY PROBLEMS



By MICHAEL MAXWELL

An active secondary market in securitised property vehicles could revive Australia's shaken property sector—but support from investors is vital.

IF ever there were a time for launching property securitisation in Australia, it is now. An active market in tradeable interests in securitised property vehicles (SPVs) would go a long way towards alleviating the problems in both the property and funds management sectors—by increasing the range of potential purchasers and, therefore, the liquidity of major properties.

If property securitisation does not take off in the present market environment, when there is a demonstrable need for its introduction, one must question seriously whether it is ever likely to succeed.

Considerable progress has been made over the past 12 months in the development of the securitisation concept in Australia. The Securitised Property Market Association (SPMA), a non-profit organisation of more than 80 members, is continuing discussions with the Australian Stock Exchange (ASX) about the listing of SPVs.

A number of SPVs already exist, such as the Aust-Wide Grosvenor Place Trust, which made a placement of units to institutional investors in 1988. However, there is a need for the establishment of more SPVs and, most important, a credible marketplace with genuine secondary market support. Capturing this support is the immediate challenge for the promoters of securitisation.

What is property securitisation?

Property securitisation may be defined broadly as the process of dividing the equity component of a real property asset into tradeable securities. The principal objective is to create, as far as possible, an investment vehicle offering returns which mirror the returns of the underlying unencumbered property.

SPVs will normally hold a single property asset but may hold a portfolio of properties. They are most likely to be structured as trusts and, accordingly, ownership of a unit in an SPV would entitle the unitholder to a share of the income from the underlying property.

It is important to distinguish between SPVs and other types of collective ownership vehicles,

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including both listed and unlisted property trusts.

In the case of an SPV, an investor knows precisely which property (or properties) he is investing in. Stringent restrictions restrain the manager and trustee from changing either the underlying assets or the financial structure without unitholder approval. In contrast, an investor in, say, an unlisted or listed trust is essentially backing the manager's investment capability (in addition to management skills) as much broader powers are conferred on the manager to change the asset mix of the trust.

The continuing problems of the unlisted property trusts have highlighted their need to match the liquidity of the underlying property portfolio, as far as possible, with the investment horizons of unitholders. In fact, while the focus of attention seems to have been directed at the illiquidity of the units (through the inability of unitholders to redeem), the root of the problem continues to lie at the property level.

Even solutions such as the recently announced "redeemable listed trust" proposal, while providing short-term relief to unitholders, will ultimately depend on the managers' ability to liquidate enough of their underlying property portfolios to meet redemption requests.

Further, the lessons learned during the present turmoil will no doubt curb the willingness of unlisted trust managers to invest in larger properties because of the potential for mismatch problems.

How would an active securitisation market alleviate this situation?

- It would enable managers of unlisted trusts to purchase part-interests in the larger properties, to be held in a readily tradeable form—units in SPVs. This would preserve the investment appeal of the unlisted trusts by avoiding the need to restrict future acquisitions to smaller (secondary) properties. As required, a manager could reduce or increase exposure to the underlying property (by buying or selling SPV units) to match the trust's own liquidity requirements.
- Prime properties now held by the unlisted trusts could be securitised, thereby enabling the managers to reduce exposure and raise cash through a placement to third parties, without the requirement to sell the building in its entirety. This is illustrated in Figure 1.

FIGURE 1: SPVs — VALUABLE TOOLS FOR UNLISTED TRUSTS

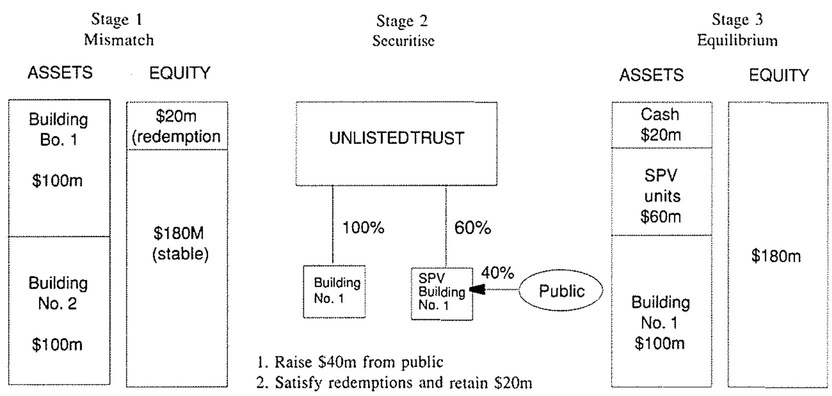
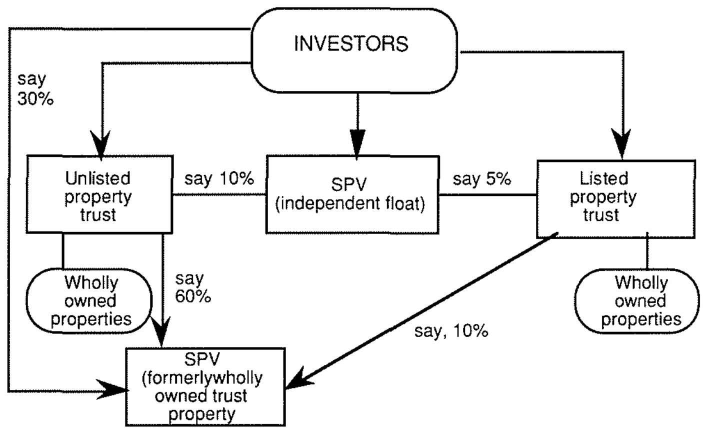


FIGURE 1: THE RELATIONSHIP BETWEEN SPVs AND OTHER COLLECTIVE PROPERTY OWNERSHIP VEHICLES



SPVs therefore offer the potential to redress the structural difficulties of unlisted trusts and to ensure their survival as investment vehicles in the long term.

The relationship between SPVs and other collective property ownership vehicles is illustrated in Figure 2. Over time, the linkages between the various investment vehicles would become increasingly apparent. This process has already begun with the Australia Wide Flexi Property Fund (an unlisted trust) holding units in both the Aust-Wide Grosvenor Place Trust and an SPV owning the No.1 O'Connell Street property.

The role of managers of unlisted and listed trusts would remain just as important as it is today—units in SPVs becoming just another type of potential investment. It is, of course, conceivable that a trust will be established to invest solely in units in SPVs, with investors relying on the manager's ability to assemble an attractive portfolio.

The introduction of securitisation will therefore result in greater investor choice and extend the scope of the existing collective property investment vehicles.

The first two stages of the securitisation process (the structuring of the SPV and the placement of units) go only part of the way towards improving the liquidity of property. The real key to success is the fostering of an active secondary market in the units, which will develop only if investors are convinced of the credibility of the market.

Two alternatives are being considered by the SPMA: a separately established property exchange or the ASX.

The initial focus of the SPMA was on a separately established market, as this would allow existing property intermediaries to be involved as well as enabling a focus on property securities as a separate asset category. The Investment Funds Association of Australia also recently considered the feasibility of a new market.

The regulatory and practical problems of starting up a separate marketplace are considerable. The principal challenge is to create a trading forum which will enjoy at least the same level of investor confidence as the ASX.

At another level, recent discussions appear to have produced preliminary support in the ASX for the listing of SPVs—although there is some way to go in determining details such as new listing rules applying to SPVs. In any such decisions it is important to ensure that the SPV maintains its structural integrity so that it is differentiated clearly from the other forms of collective property investment vehicles. However, trading and settlement procedures would be as for any other quoted security. Flotations and new issues would be subject to the prospectus provisions of the Corporations Law.

Property analysts would undoubtedly follow the SPV market and publish research reports. Formal or informal associations would also probably develop between the broking firms and commercial property agents, providing a mix of knowledge between the property and securities markets.

Structuring options

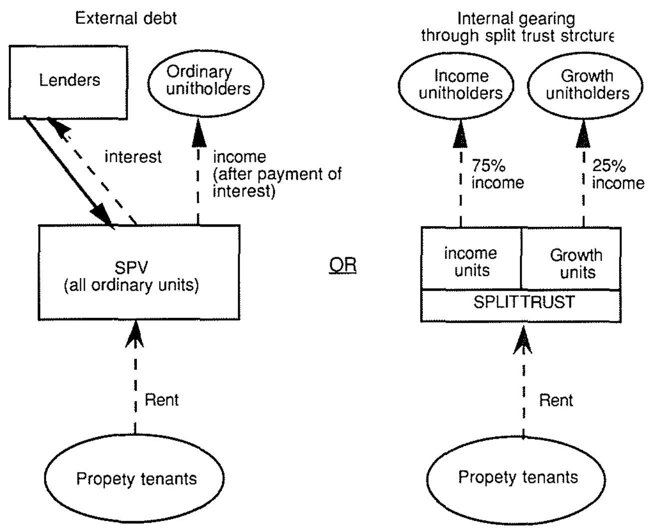
Bearing in mind their almost universal market acceptance of unit trusts in Australia, and their simplicity and their tax-transparent nature, these are likely to be the most common structures adopted for SPVs. In this regard, Australia enjoys significant advantages over other countries, such as the UK, where more complicated structures have to some extent hampered the success of securitisation.

The SPMA is developing a recommended structure for SPVs. The more important elements are:

▪ *Minimum number of unitholders: 100.* This is considerably below the present ASX threshold for property trusts of 200.

▪ *Minimum initial gross asset value: $50m.* This will tend to confine listings to better-quality buildings and exclude poor- quality properties.

FIGURE 3: GEARING WITHIN SPV



▪ *Standard trust deed provisions with permitted variations.* The intention is to give a degree of investor certainty to the boilerplate provisions (in contrast, both the listed and unlisted trusts have a wide range of trust deeds) and to reduce the costs of a listing.

▪ *No limit on the par value of units.* In considering a separate market, the SPMA originally favoured a minimum unit size of $500,000 to enable the buy-back operation to be suspended. However, if the ASX becomes the chosen marketplace there seems no reason not to have, say, $1 units. This would enhance access for private investors.

▪ *Controls on acquisition or disposal of properties.* None would be permitted without the approval of 75 per cent of unitholders present and voting. This is central to the SPV concept and is one of the principal distinguishing features between SPVs and other collective property ownership vehicles.

▪ *No gearing except for working capital purposes.* There is a debate about whether gearing should be allowed in the SPV itself. This could be achieved either by way of external (bank) debt or through some form of debt instrument such as "debt participation units" with a fixed or stepped coupon. These alternatives are illustrated in Fig. 3.

The SPMA's preference is that SPVs should not be geared, so that they mirror as closely as possible the investment performance of the unencumbered underlying property. This is consistent with a clear market (and regulatory) preference for ungeared property investment structures. However, it would not preclude investors gearing their own unitholdings or the establishment of associated geared investment vehicles holding units in the SPV.

▪ *Ownership of part-interests of properties.* It would be possible to securitise either the whole or a part-interest in a property, thereby providing flexibility to proprietors.

▪ *Rules relating to takeovers to apply.* The directors of the manager of the SPV are to have the same responsibilities in providing advice to unitholders as the directors of a target company. The prospect of takeovers should keep the market price of SPV units "honest".

▪ *New capital raisings.* No new capital to be raised without the approval of 75 per cent of unitholders, except where the funds are to be used for:

- refurbishment and renovation;
- buying-in of leases; or
- any prudent measures to enhance the value of properties.

This would avoid the problems of the diluting effects of rights issues at deep discounts to market.

▪ *Comprehensive reporting of relevant information.* Unitholders must receive all relevant information about the underlying property which will enable them to make an informed investment decision.

▩ *Capital structure—only one class of units to be permitted.* This should ensure a simple and easily understood structure but will not stifle innovation.

Because of the taxation and structuring advantages conferred by traditional trusts, it will be relatively simple to arrange equity structuring in separate, associated trust vehicles, as is shown in Figure 4.

It should be possible for the SPV structures to accommodate various risk preferences by offering investors a range of financial instruments such as capital-guarded units, "mezzanine" participating units, conventional split-income and growth units, etc.

The benefits

One of the most obvious benefits of property securitisation is improved tradeability and, therefore, liquidity.

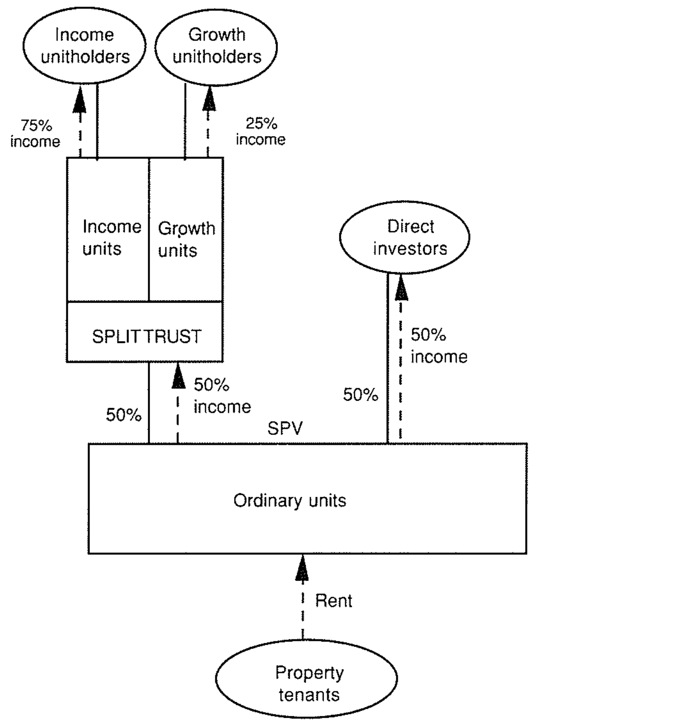
The relatively high cost of large property assets, the limited number of potential purchasers and the lengthy settlement procedures have emphasised the illiquid nature of property, compared with shares and fixed-interest securities. And the higher the value of a property, the more these problems seem to be exacerbated. The estimated costs of the following major projects highlight the need for innovative mechanisms such as securitisation.

Project	Approx cost ($A billion)
Westralia Square (Perth)	2.0
World Square (Sydney)	1.6
Chifley Square (Sydney)	1.2
Governor Phillip Tower (Sydney)	1.3
Angel Place (Sydney)	1.0
Darling Park (Sydney)	1.0
Bennelong Point (Sydney) .	1.0
Melbourne Central (Melbourne)	1.0

An active securitisation market would increase the tradeability of interests in the larger properties such as these and, therefore, through the multiplier effect, would improve liquidity generally.

Securitisation also promises greater investment flexibility by enabling to react more quickly to changes in market conditions. It is likely that prices of units in SPVs will reflect changes in investors' perceptions of the values of particular properties as well as the value of property generally, compared with other investments.

FIGURE 1: DIFFERENTIAL CAPITAL STRUCTURE THROUGH ASSOCIATED TRUST



* 50% held by individual investors receiving pro rata rights to income and capital growth
* 50% held by an associated trust (itself structured as a split trust)

An investor in an SPV will have an accurate picture of the value of his investment at any time—as well as an indication of the likely time required to realise his stake, based on the SPV's previous trading history. This degree of certainty is more difficult to achieve in the direct property markets.

The logical progression from a deep and actively traded secondary market in SPVs is the evolution of an options market. This would have obvious benefits for both vendors and investors.

Living with volatility

The myth of the stability of property has been shattered. Investors are having to come to terms with the more volatile nature of property. Critics of securitisation commonly point to the likely volatility of SPVs as a negative factor. My contrary view, however, is that volatility is a by-product of a more sophisticated marketplace its advantages far outweigh its disadvantages.

Inevitably, there will be short-term traders in SPV stocks, but most investors can be assumed to have longer investment horizons. Like long-term equity investors, long-term SPV investors will need to be mindful of, but not unduly influenced by, short-term fluctuations in trading prices. They will certainly have to place great importance on general trends.

To some extent, volatility in market prices of units in SPVs should not be as great as in the equity markets. Some stability is assured by the earnings streams derived from long-term tenants. However, volatility caused by changing investor valuation sentiment can never be avoided. But dealing with volatility must be a better option than dealing with the inability to sell a property within a reasonable period—or even at all.

Securitisation also offers the opportunity of an investment mix with greater potential advantages—a portfolio of stable, effectively direct, property interests no longer restricted solely to traditional ownership mechanisms.

It will be possible to acquire minority interests in a number of properties, with a consequent spreading of risk. This will benefit investors, large and small, in a number of ways:

■ The individual investor will be able to make what is in effect a direct investment in a landmark building and will be able validly to compare it with a potential investment in the proverbial "Paddington terrace".

■ Small superannuation funds and other institutional investors can spread their investments over a range of major properties, rather than a small number of suburban and fringe-CBD properties. The benefits of participation in a rent-income stream from a greater number of "quality" tenants is obvious. For some, there would be no need for an in-house property management team.

■ Major property owners will have another avenue for selling-down interests in existing properties, allowing more effective diversification. This process may or may not be underwritten, as SPVs will lend themselves to a progressive sell-down by owners.

■ Offshore or new investors will find SPVs an ideal way to participate in the Australian market in a readily tradeable form. Securitisation should accelerate the globalisation of property investment.

■ The new classes of potential investors will represent another source of equity for developers (and unwilling mortgagees).

■ The flexibility afforded by the trust structure enables the differing risk profiles of investors to be accommodated. Financial advisers should be able to offer the entire range of investment options from full equity to full debt.

Will there be an active market?

Unless there is active secondary market support for units in SPVs, securitisation will be stillborn. Its success depends, too, on factors such as general confidence in the concept, the number of quality properties which are floated and their subsequent trading performance.

There are no doubt many landmark properties throughout Australia which are candidates for the SPV marketplace.

Unfortunately, the establishment of an active market is a "chicken-and-egg" situation: until investors see an active marketplace they will not give full support to the concept and, until there is sufficient market support, flotations of quality properties will be difficult.

What is required is for a sponsor to take the plunge and bring a building in an SPV structure to the marketplace—preferably with the support of one or more major institutions. It will be interesting to see who is the first to take up this challenge.

Will the units trade at a discount?

As Stephen Barter, a proponent of securitisation in the UK, noted, the answer to this question starts with another question: "A discount to what?"

Valuations are by nature subjective. At best, they provide a guide to the valuer's opinion of the value of the subject property, based in many cases on arbitrary assumptions. There are divergent views on whether unitholders in SPVs should be provided with regular valuations, or whether valuations should be published only at the time of the initial flotation and at subsequent capital raisings, leaving it to the marketplace to value the units. The latter practice has been adopted by the London Stock Exchange and I believe convincing arguments can be put to the ASX and ASC for such a market-led valuation process in Australia.

(There would still be a significant role for professional real-estate valuers, as analysts would continue to rely on their opinions for inclusion in regular research reports.)

Other valuation issues:

■ Will units in SPVs reflect a "portfolio price" or will a premium be payable for tradeability—especially if the State governments treat units as marketable securities for stamp-duty purposes?

■ How should investors compare an SPV investment with listed trusts, which may be trading at either a premium or discount to stated NTA (whatever that might mean)? For the reasons already given, SPVs are not directly comparable with the other collective ownership vehicles. In any event, the question does not arise if the market is the final arbiter of value.

Property assets or securities?

Whether SPV units should be treated as property assets or securities is a question of both practical and academic interest.

For instance, the Life Insurance Act imposes restrains life funds from investing in trusts (but not in equities or directly in property).

Institutions may also have to deal with the question of whether the equity investment department or the property investment department makes the investment decision in relation to SPVs.

The role of management

As with any collective ownership property vehicle, management—encompassing both property management and unitholder administration (including dissemination of relevant information to the market)—will be vital to the success of SPVs.

However, management responsibility will not extend to major investment decisions, as is the case with listed and unlisted trusts, because the property decision will have already been made. The level of management fees will be a matter for the market to decide but should generally be below those charged by managers of listed and unlisted trusts.

A sophisticated alternative

Securitisation would greatly improve the liquidity in larger properties by enabling investors to hold readily tradeable interests. It would also alleviate some of the serious problems in the unlisted property sector.

SPVs would help the progression of property into a more sophisticated market environment by extending the range of potential investors and by providing them with a complementary alternative to the existing property ownership vehicles.

In contrast to many countries, Australia has natural advantages in favour of securitisation, including tax transparency and the universal acceptance of the property trust structure.

The Securitised Property Market Association has made considerable progress towards the establishment of a credible marketplace—with the ASX emerging as the most likely trading forum. However, the progress made so far will count for nothing unless securitisation is supported by investors in the marketplace. □