LPT FUND MANAGER DECISION-MAKING IN THE EMERGING PROPERTY SECTORS

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ABSTRACT

In recent years, the emerging property sectors, including retirement, healthcare, leisure and childcare, have taken on increased importance for institutional investors. This paper assesses the increasing significance of emerging property sector funds in Australia and the investment decision-making by emerging property sector LPT fund managers. Motivating factors and risk factors are identified; as well as the processes involved in selecting a suitable business partner, given the operating business element involved with these emerging sector property assets. The ongoing future development of the emerging property sectors is also identified and discussed.

Keywords: Emerging property sectors, LPTs, motivating factors, risk factors, business model, investment strategies, investment decision-making

INTRODUCTION

Institutional investors in Australia have traditionally concentrated on low-risk core property portfolios of office, retail and industrial properties; in both sector-specific and diversified portfolios. Recent years have seen significant growth in superannuation fund assets in Australia; at over $1.2 trillion at Q3:2007 (APRA, 2007). This has seen significant capital inflows available for property, with superannuation funds seeking to increase their exposure to property (Newell, 2007a, b).

This mismatch between available funds and available core property assets in Australia has seen institutional investors expand their focus beyond the traditional property sectors to consider both higher risk value-added and opportunistic property (Schuck and Howard, 2005), as well as other "alternate" sectors such as infrastructure (Peng and Newell, 2007). This has seen increased attention given to the property investment opportunities for enhanced returns available from the emerging property sectors, such as self-storage, healthcare, retirement, leisure and entertainment property. This has been further supported by the ageing population in Australia (ABS, 2004), seeing increased institutional investor attention given to the retirement and healthcare sectors. Importantly, the significant risk-adjusted performance and portfolio diversification benefits of the emerging property sectors have recently been demonstrated for both Australia (Newell and Peng, 2006a, 2007) and the US (Newell and Peng, 2006b).

As well as this performance analysis for the emerging property sectors, it is also important to assess the strategic investment decision-making issues identified by fund managers in effectively developing their emerging property sector portfolios. As such, the purpose of this paper is to assess the significance of the emerging property sector funds in Australia and present the results of a survey of emerging property sector LPT fund managers to identify the motivating factors, risk factors and business partner selection strategies utilised by LPT fund managers in these emerging property sectors.

SIGNIFICANCE OF EMERGING PROPERTY SECTOR FUNDS IN AUSTRALIA

In recent years, the emerging property sectors such as self-storage, retirement, healthcare, leisure and entertainment have taken on increased importance in property portfolios in Australia. At June 2007, there were 70 property funds with total assets of $10.2 billion comprising 1,387 properties; particularly focused in the leisure, retirement and healthcare sectors (see Table 1). These property funds were identified (and updated) by the authors from PIR (2007), as well as being updated from the various annual reports and PDS reports.

Table 1: Australian emerging property sector funds profile(1): June 2007

Emerging sector	Number of funds	Total assets	Number of properties
Leisure/entertainment	13	$4,144M	351
Retirement	10	$2,671M	158
Healthcare	13	$1,011M	69
Agriculture	20	$779M	77
Childcare	6	$676M	627
Self-storage(2)	5	$647M	95
Carparks	3	$257M	10

(1) Authors' compilation and update from PIR (2007), miscellaneous annual reports and PDS reports.
(2) Includes self-storage component in Valad Property Group portfolio

This now sees a range of property investment vehicles available for both retail and wholesale investors to obtain exposure to these emerging property sectors. This includes LPTs (comprising 43.6% of total assets in these 70 emerging property sector funds), unlisted retail funds (21.3%), direct property syndicates (17.9%), property investment schemes (9.7%) and unlisted wholesale funds (7.5%). The dominant role of LPTs in these emerging property sectors will see these LPTs as being the focus of this paper.

Table 2: Emerging property sector LPT profile: June 2007

LPT	Total assets	Property types	Number of properties	Year listed	Countries in portfolio
ING RE Community Living	$1,020M	Retirement villages Student accommodation	95	2004	Aust., NZ, US
ALE Property Group	$830M	Pubs	103	2003	Aust.
Macquarie Leisure	$704M	Theme park Marinas Bowling alleys	58	1998	Aust., NZ, US
MFS Living & Leisure	$400M	Ski resort Aquarium	7	1999	Aust., China, Korea, Thailand
ING RE Entertainment	$394M	Pubs	56	2004	Aust.
Australian Education Trust	$386M	Childcare centres	388	2003	Aust., NZ
Challenger Wine Trust	$298M	Vineyards	27	1999	Aust., NZ
ING RE Healthcare	$153M	Medical centres	7	2006	Aust.
Cheviot Kirribilly Vineyard	$43M	Vineyards	5	2006	Aust.
Coonawarra Australia	$34M	Vineyards	2	2003	Aust.

Source: Authors' compilation from LPT annual reports

Table 2 presents a profile of these emerging property sector LPTs at June 2007. These emerging property sector LPTs had total assets of $4.26 billion and comprised 748 properties in the leisure, retirement, healthcare, childcare, student accommodation and vineyard sectors. Many of these emerging property sector LPTs have only been established in recent years, coinciding with the recent increased capital flows to property. Both Australian and international property are included in these emerging property sector LPT portfolios, with the international focus largely being New Zealand and the US. Leading property fund managers have been significant players in the emerging property sector LPT market (eg: ING, Macquarie), with ING having three emerging property sector LPTs in the community living (retirement, student accommodation), entertainment (pubs) and healthcare (medical centres) sectors.

Table 3: Other major emerging property sector funds: June 2007

Fund	Total assets	Property type	Property investment vehicle(1)	Number of properties	Year established
Mariners Cove Equity Trust	$1,187M	Leisure	DPS	41	2000
PrimeLiving Trust	$958M	Retirement villages	PIS	14	2005
Prime Retirement & Aged Care PT	$533M	Retirement villages	URF	37	2001
JF Stadium Trust 1&2	$353M	Stadium	UWF	1	1997
Aust. Unity Healthcare	$293M	Medical centres	URF	13	1999
APN National Storage PT	$275M	Self-storage	URF	38	2003
Childcare Prop. Fund	$213M	Childcare	URF	173	2004

Source: Authors' compilation and update from PIR (2007) and various property fund websites

(1) URF = unlisted retail fund, UWF = unlisted wholesale fund, DPS = direct property syndicate, PIS = property investment scheme

Amongst the other property investment vehicles involved in the emerging property sectors, there are 60 property funds with total assets of $5.9 billion and over 630 properties. Table 3 presents the leading emerging property sector funds amongst these unlisted retail funds, unlisted wholesale funds and direct property syndicates, with coverage across the range of emerging property sectors by a number of leading property fund managers. Typically, the asset value of these property portfolios are significantly less than that seen in the emerging property sector LPT portfolios.

METHODOLOGY

To obtain a fuller understanding of institutional investor decision-making in the emerging property sectors, a survey of emerging property sector LPTs was conducted in August 2007. This survey addressed a range of issues, but largely focused on the motivating factors, risk factors and the emerging property sector investment strategies used by LPT fund managers. These motivating factors and risk factors were identified by a literature review and a preliminary discussion with fund managers involved in the emerging property sectors. Given the dominant role of LPTs in the emerging property sectors (accounting for 43.6% of total assets), the emerging property sector LPTs were chosen to be surveyed using a mail survey. Other reasons for selecting the emerging property sector LPTs to survey included the public domain availability of the property information, including property portfolio and contact details; this is in contrast to the less readily available information concerning the unlisted property funds.

Table 4: Emerging property sector LPTs: survey respondent profile

Survey conducted: August 2007
Number of LPTs responding: 6
Survey response rate: 67%
Total assets: $3,081 million; representing 72.3% of sector
Number of properties: 676; representing 90.4% of sector
Total assets: 30.2% of total emerging property sector
Sectors covered by survey respondents: leisure, retirement, student accommodation, healthcare, childcare, agriculture

Surveys were sent to the fund managers of all ten emerging property sector LPTs (see Table 2), with LPTs which merged their emerging sector properties within their overall property portfolio (eg: Valad) excluded. Six LPTs responded for an effective survey response rate[1] of 67%. As shown in Table 4, these survey respondents accounted for $3.1 billion in total property assets, representing 72.3% of the total emerging property sector LPT assets and 30.2% of emerging property sector total assets in Australia. These

1 One LPT advised it was against their policy to respond to surveys; hence reducing the effective number of LPTs surveyed to nine.

survey respondents also accounted for 676 properties, representing 90.4% of emerging property sector LPT properties.

The survey respondents also covered all of the emerging property sectors, including leisure, retirement, student accommodation, healthcare, childcare and agriculture, with 67% of survey respondents having both domestic and international property in their emerging property sector portfolios. To assess the importance of the various motivating factors, risk factors and business partner attributes, a 5-point rating scale was used; ranging from 1 = unimportant, 2 = less important, 3 = important, 4 = very important and 5 = critical. Participants also responded via several open-ended survey questions.

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Motivating factors

Table 5 presents the importance of the various motivating factors for LPTs investing in the emerging property sectors. New property product diversity (average score of 4.4) was seen as the most important motivating factor, reflecting the investor preference to diversify their overall property portfolios beyond the traditional office, retail and industrial property sectors. Strong performance (4.0) was also seen to be an important motivating factor, with this reflecting the higher risk levels from the emerging property sectors due to the additional business risk elements, as well as the strong performance track record of the emerging property sector LPTs in recent years (Newell and Peng, 2006a; UBS, 2007). Both of these motivating factors were seen to be critical or very important by 100% of survey respondents.

Enhanced yields (3.8) were also an important motivating factor for the emerging property sectors, reflecting the higher yields expected from the emerging property sectors as well as the yield compression that has been evident in most office, retail and industrial markets in recent years. With these emerging property sectors only having been considered by institutional investors in recent years, availability and choice of properties (3.6) was seen to be important, reflecting emerging property sector LPTs being able to identify quality properties and establish strategic alliances to manage the business risk component in this property sector (Newell and Peng, 2006a).

Table 5: Motivating factors for emerging property sector investment

Factor	Average score	Percentage classified as 'Critical' or 'Very Important'
Desire for new product diversity	4.4	100%
Strong performance of emerging property sector LPTs	4.0	100%
Higher/enhanced yield than traditional properties	3.8	80%
Greater availability and choice of properties	3.6	80%
Significant capital inflow available for property (e.g. mandatory superannuation)	3.4	60%
Portfolio diversification benefit	3.2	40%
A greater understanding of emerging property investment risk	3.2	20%
A shortage of quality local commercial properties	3.0	40%
Favourable tax structure/treatment	2.4	20%
Compelled to expand due to strong capital inflow into fund	1.8	0%

Less importance was given to the impact of significantly increased capital inflows to property (eg: superannuation funds) and the portfolio diversification benefits of the emerging property sectors. Similarly, a shortage of quality local commercial properties was not seen as an important motivating factor; this being a more critical driver for international commercial property exposure in LPT portfolios in recent years (Newell and Peng, 2006a). This also reflects the emerging property sectors being seen as a separate property sector, having different property investment characteristics to the traditional commercial property sectors.

Other important motivating factors(2) for emerging property sector investment which the LPT fund manager respondents identified were:

- positive spread between emerging property yield and cost of debt

[2] *Additional motivating factors identified by LPT fund manager survey respondents in open-ended questions in survey.*

- barriers to entry
- concessions (eg: licensing laws)
- government funding to some emerging property sectors.

Risk factors

Table 6 presents the importance of the various risk factors or difficulties for LPTs investing in the emerging property sectors; reflecting the uncertainties of investing in these non-traditional property markets compared to the more traditional property markets.

Table 6: Risk factors for emerging property sector investment

Factor	Average score	Percentage classified as ‘Critical’ or ’Very Important’
Quality and availability of data	3.3	67%
Depth of market	3.3	34%
Difficulty in identifying reliable/strategic business partners	3.2	34%
Lack of quality property stock	3.2	17%
Competition of emerging property investments/acquisitions	3.0	50%
Uncertainty of government policy	2.8	34%
Inconsistence and ambiguity of legislation	2.5	34%
Difficulty in identifying sound emerging property investments/acquisitions	2.5	0%
Ongoing management and operation of emerging property investment	2.3	34%
Difficulty in identifying appropriate management structure	2.2	17%

The most significant difficulties in the emerging property sectors were identified by the LPT fund managers as the quality and availability of data (average score of 3.3) and the depth of the emerging property sector market (3.3). The small size of these niche markets is characterised by the lack of consistent and long-term investment performance measures. For example, there are no benchmark investment performance series for the direct emerging property sectors (eg: IPD/PCA series) or emerging property sector LPTs (eg: UBS). An emerging property sector LPT performance series over 2002 – 2005 has been developed by Newell and Peng (2006a); this being the only emerging property sector performance series produced to date in Australia. The growth and maturity of this sector and increasing institutional investor interest in the emerging property sectors is expected to be the catalyst to the future development of these indirect and direct property performance series by property organisations such as IPD/PCA and UBS.

Identifying reliable strategic business partners (3.2) was also identified as a difficulty. This is important for the emerging property sectors, given the operating business being strongly linked with the property assets. Being a niche property sector, the lack of quality property stock (3.2) was also identified as a potential difficulty. This reflects institutional investor expectations of investment-grade properties to include in the fund's property portfolio, as well as some emerging property sectors having previously been dominated by small investors or private companies (eg: self-storage, healthcare, leisure) or church/charity organisations (eg: retirement).

Importantly, the emerging property sector LPT fund managers did not score these potential difficulties as highly as the motivating factors for investing in the emerging property sectors; with lower levels of difficulties being seen as critical or very important. This reflects the LPT fund managers being comfortable with the emerging property sector investments where they already have significant expertise and know-how, as well as being familiar with the emerging property sector markets.

Business partner selection strategies

Compared to the traditional commercial property sectors, the emerging property sectors have strong links to the operating business attached to the utilisation of the property assets. The importance of identifying reliable strategic partners was seen as the third most important potential difficulty (see Table 6), with 34% of LPT fund managers considering it to be critical or very important.

Table 7: Criteria for business partner selection

Partner attribute	Average score	Percentage classified as 'Critical' or 'Very Important'
Business know-how	4.7	100%
Good reputation	4.0	67%
Long-term tenancy	3.7	67%
Supplying capital	2.2	17%

Amongst the current business models, long-term lease agreements were preferred by 83% of LPT fund managers, significantly ahead of those preferring lease-back and joint venture arrangements. This clearly indicates the majority of respondents prioritising the property opportunities rather than the operating business activities. Table 7 presents the criteria for business partner selection by emerging property sector LPT fund managers. Knowledge and expertise in the particular business sector (4.7) was clearly seen as the most important business partner selection factor, with 100% of respondents considering it to be critical or very important. This has been particularly evident in the self-storage sector in which institutional investors have linked with established and experienced operators in this sector (eg: National, Kennards, Storage King). A good reputation (4.0) and long-term tenancy (3.7) were also seen to be important business partner selection strategies. For example, the ALE Property Group has the portfolio of 103 pubs leased to ALH on 25-year leases. Other factors identified by these emerging property sector LPT fund managers as influencing their business partner selection strategy included market dominance, profitability, growth prospects and long-dated investment horizons.

Future developments

All emerging property sector LPT fund managers showed strong interest in increasing their emerging property sector portfolios, as well as in long-term holdings for their emerging property sector portfolios. All respondents also planned to increase their Australian emerging sector investments, with New Zealand and the US being the preferred international markets (50%), as well as the UK and Canada (33%). This future international focus on New Zealand and the US continues the current international property exposure in these two countries with mature property markets (eg: ING Community Living, Macquarie Leisure).

CONCLUSION

The emerging property sectors have taken on increased importance with institutional investors in recent years. This sees over 70 emerging property sector funds in Australia with over $10.2 billion in assets and over 1,350 properties in their portfolios. Emerging property sector LPTs have been particularly active, with these ten LPTs accounting for $4.3 billion in assets and representing 44% of total assets in the emerging property sector funds.

Given the increasing significance of the emerging property sectors, this paper has investigated the investment decision-making by emerging property sector LPT fund managers in Australia. Motivating factors and risk factors are identified, with the significance of the motivating factors exceeding the risk factors, reflecting the experience and confidence of LPT fund managers in these emerging property sectors. Successful strategies in business partner selection have also been identified, with this being particularly important, given the strong link between the property assets and the operating business for most emerging property sectors. These factors will take on increased importance with the continued future growth of these emerging property sectors, driven by an increased appetite for property by superannuation funds, acceptance of higher risk levels by many investors (eg: value-added and opportunistic property), demographic changes favouring the retirement and healthcare property sectors, and increased experience in including emerging property sector assets in their property fund portfolios.

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