Finding your perfect match

How property companies and private equity investors can leverage the emerging PERE market

Building a better working world

Tighter lending conditions imposed by traditional banks mean Australian property developers are becoming more sophisticated about chasing capital. They seek new ways to fund developments without having to draw on their own capital and compromise their pipeline.

At the same time, there is a strong flow of capital from alternative sources wishing to invest in well-structured developments in Australia's cities. The question for both developers and investors is how to best structure a funding arrangement so both sides benefit.

Private Equity Real Estate (PERE) provides a viable equity finance platform that offers developers access to additional capital and the ability to recycle their funds in existing assets or in other opportunities. For investors, the PERE market offers a range of risk and return levels to suit all appetites.

EY is experienced at working with both developers and investors to find the perfect partner on each side and identify the optimum PERE structure. We encourage you to consider the information in this publication and would be happy to discuss how we can help you find your PERE match.

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Investing in Australian Real Estate

Overview

Real estate investors determine their investment allocations within the context of risk tolerance and underlying objectives.

They make allocations across four broad real estate related financial markets. Each is characterised by the financial product (equity or debt) and access to the market (public or private).

	Debt	Equity
Private	Senior/ Mezzanine Loans	Single asset trusts/ unlisted funds
Public	Corporate bonds/ securitised loans	Real estate investment trusts ("REIT")

For all these investment types, the level of investor returns and the cost to the property company rely on the performance of the underlying real estate asset/s.

This publication focuses on the private/ equity quadrant – or PERE – which is becoming increasingly popular in Australia.

What is PERE?

Historically an institutionally-owned market, Australia is opening up to new sources of capital, driven by the need for recapitalisations, redevelopment and new construction in its aging real estate stock. One emerging market is private equity real estate (PERE).

PERE represents direct equity investments in individual assets (land, developments and buildings) or unlisted funds that own real estate assets.

These investments are privately traded, and between purchase and sale, valuations determine their security value. As a result, they are relatively illiquid.

The PERE market is providing new local and overseas funding sources for Australian cities. These include Asian funds, which see Australia

as a core market. These funds are showing a willingness to explore higher risk, opportunistic investment opportunities in Australia because of its overall stability relative to other markets in the region.

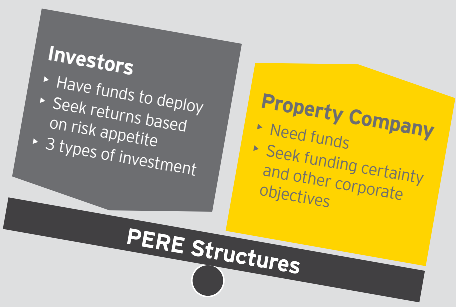
The advantages of the PERE market

The alternative funding environment has arisen because property companies are being forced by tightening bank lending restrictions to look for other funding sources.

Post-GFC, traditional banks in Australia have progressively limited the availability and cost of credit for property developers, forcing them to direct money away from their project pipeline in order to increase their equity stake in developments.

This makes little financial sense: the return on capital that is recycled or invested in the development pipeline is far greater than the cost of borrowing the same amount. In addition, having a healthy pipeline is the lifeblood of property development and without it, a property company will flounder.

PERE funding provides a win-win solution for both developers and investors. It allows developers to achieve a greater return on their equity and access cheaper funding, and provides local and offshore investors with access to real estate projects in Australia's capital cities that are likely to provide good long term yields and a solid return on investment.



Find out more

In this publication. EY aims to help investors and developers understand the inherent risks and opportunities presented by the PERE market and its related structures. It provides a good background for anyone wishing to explore this option.

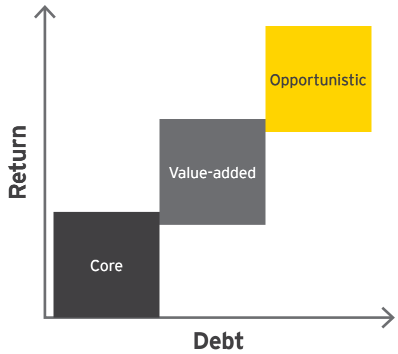
If you are interested in taking the next step, it is best to seek the advice and assistance of an experienced third party. Identifying, setting up and managing an appropriate PERE structure that matches the needs of both the investor and the property company is a complex area requiring specialised knowledge.

Investor needs and considerations

Overview

Identifying the appropriate source of funds for property companies depends on the asset or portfolio of assets held or being developed. As the perceived asset risk increases, the returns that investors expect increases exponentially.

There are three types of PERE investment strategies, each with its own risk/return profile for investors.



Core investing is characterised by well-located assets with quality tenants and funded with modest gearing. Examples include CBD office buildings, retail centres and industrial warehouses.

Investors typically target 9%-12% p.a. total returns and seek secure income plus modest capital appreciation.

The ability to significantly enhance the value of core real estate is limited compared to value-added and opportunistic investment strategies.

Core assets generally require little or no short term capital expenditure other than normal repairs and maintenance.

Value-added investing is when developers apply active value creation strategies to the underlying real estate investment, such as refurbishment, redevelopment and/or leasing vacant space.

This strategy typically targets assets with a deteriorated value or depressed income levels. With value-added strategies, these can provide investors with income and capital appreciation.

Value-added investors require enhanced returns in exchange for higher levels of asset operating risk.

Opportunistic investing focuses on riskier investment strategies, including greenfield developments, leveraged financing and distressed investments.

Investors target short term capital appreciation, with returns typically back-ended by way of asset sale or settlement of a development. Throughout the investment horizon, income is generally limited.

Given the complexity of transactions associated with such strategies, opportunistic investors usually require strategic partners to help mitigate their risk.

In return for their increased risk appetite and comfort around higher levels of leverage, opportunistic investors target higher returns.

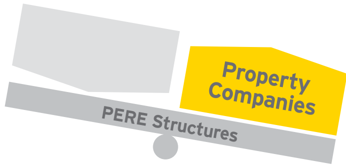
How to mitigate risk

It is essential that PERE investors find the type of development and investment structure that suits their risk profile. They need to seek out information about key considerations such as the expected funding flow, the loan repayment structure and the anticipated return.

Investors should also conduct thorough due diligence before entering a PERE agreement. At a minimum, they should expect the developer to provide them with financial forecasts, a risk/return analysis, project schedule and a comprehensive, independent report about the company's financial status and development history.

Topic	Core	Value-added	Opportunistic
Risk	Low	Medium	High
Target Return	9-12%	10-15%	15%+
Earnings Split	70/30 income/capital appreciation	50/50 income/capital appreciation	20/80 income/capital appreciation
Investment Horizon	5+ years	3-7 years	2-5 years
Leverage	<50%	30-70%	50-80%
Asset Type	Quality assets with fully occupied long term leases	Assets with upside potential through refurbishment	Development assets, distressed assets

Developer needs and considerations



Overview

Throughout the process of seeking capital, a developer's goal should be to identify an investor or investment group whose objectives match their own. While cheap money is attractive, the non-financial price of being tied to an investment partner who is a poor fit could be high.

To facilitate a mutually beneficial relationship that satisfies the needs of both parties, a number of factors need to be considered when determining the optimum PERE investor, structure, and terms and conditions.

Nature of asset

The type of currently held – or to be acquired – property asset or pool of assets plays a key role in the type of PERE investor a property company can partner with.

As outlined on the previous page, each asset type carries a different level of risk and return. Finding an investor who is comfortable with the risk/return ratio of the development to be funded is the key to a successful relationship.

To attract the right investor, property companies should facilitate they are transparent about every aspect of the development and be willing to provide supporting documentation.

Financing objectives

A property company's financing objectives will impact the size of the investment pool for its pipeline.

- **Certainty of funding.** Does the property company have short term funding requirements (e.g. an individual development) or prefer funding from a partner with a long investment horizon for a growing pipeline of work?
- **Scalable fund raising platform.** Is one-off financing with a bespoke structure required? If the arrangement is likely to be repeated (e.g. for other portfolio assets), a streamlined structure may be better.
- **Fees.** The property company's appetite for paying fees may limit the number of investors that can support them.

Relationships

A property company's preference for the type of relationship it has with investment partners may also shape the nature of a PERE investment. It is important interests are aligned.

- **Number of investors.** Having fewer investors makes relationship management easier.
- **Operational control.** Active investors will demand more attention and involvement with decision making than passive investors.
- **First right of refusal.** Some investors will expect first access to subsequent fund raisings, which will limit the developer's future funding options and commit them to continuing the relationship regardless of its success.

Structure

Property companies should optimise their funding platform to improve its attractiveness to investors as well as enable future capital raisings.

Closed or open structure. Different investors are attracted to each type.

- **Nature of legal entity.** Partnership, company, trust or special purpose vehicle?
- **Capital raising process.** A bespoke arrangement or streamlined process?
- **Tax structure.** Determine the structure that improves attractiveness to investors, particularly those offshore.

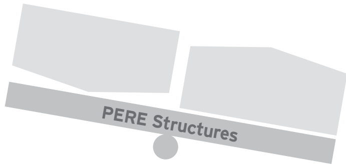
Governance

The property company must be on top of governance issues if it is to appeal to a wide array of investors. Investors or their agents will focus on how the money is deployed, managed and reported on. They will ask a few or many questions, according to their risk tolerance levels. These could include:

- Investment mandate. Is there a constitution which governs how investment funds are employed?
- Defined liquidity events. What happens when there is a defined liquidity event e.g. a sale?
- Individual or co-mingled investments. Are funds kept separate when supporting a portfolio?
- Compliance and reporting requirements. What regulatory framework is in place, how are investments reported on and how often are they reported?
- The PERE market offers property companies many potential investment partners in Australia and overseas. The task of preparing to chase capital, locating potential investors, identifying the best partner and dealing with due diligence can be time-consuming.
- However, it is worth the investment of time and effort: having the right partner will not only provide the property company with funds, it will make the development process smoother and could be the foundation of a successful long term business relationship.

PERE Structures

General/Limited Partnership



Overview

A general/limited partnership model is a common structure for a PERE investment.

The General Partner (GP) assumes responsibility for the operations of the fund, making all day to day decisions.

The Limited Partner (LP) is has no control over daily fund management and their liability is limited to their investment amount.

Characteristics

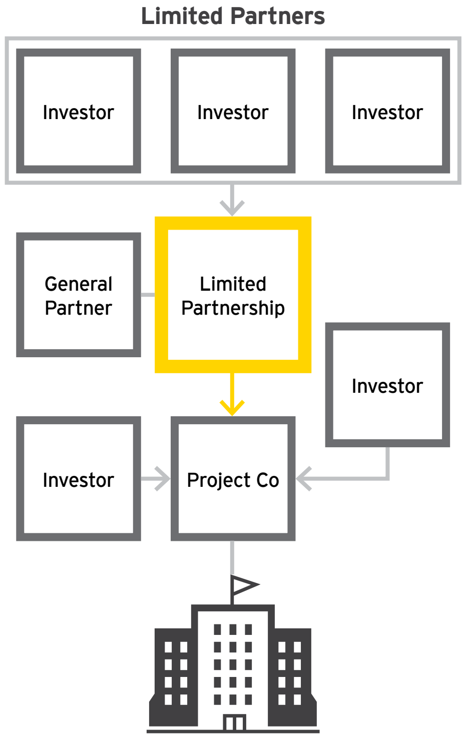
Capital: As required, the GP makes a capital call to its LP or LPs in order to raise the funds required to make an investment, with calls made on a pro rata basis. Once an LP's capital is allocated to the fund, it is drawn down for individual investments. If additional funds are required for an investment, LPs may co-invest alongside the fund to which they already provide capital.

Fees: These are typically a combination of management and performance fees paid to the GP. The management fee is based on a percentage of the committed funds (usually 1–2% p.a.). The performance fee is based on the after-costs profits of the fund – typically up to 20% carried interest.

Strategies: Typical strategies employed by larger funds are:

- **Core.** Low risk/return with investments in stable, predictable returning commercial real estate
- **Core plus.** Moderate risk/return, with similar property types to Core but requiring some enhancement or value add element
- **Value added.** Medium to high risk/return with purchased properties requiring improvement prior to sale
- **Opportunistic.** High risk/return, given investments require a large amount of enhancement; this strategy also incorporates some development projects.

Indicative structure

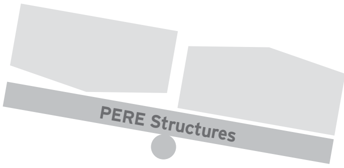


Considerations for investors

General Partner	Limited Partners
✓ Increased returns	✓ Passive role
✓ Decreased capital deployed	✓ Access to a pipeline of investment opportunities
✓ Certainty of funding	✓ Simplicity
✓ Efficiency of capital call structure	✓ Institutional friendly investment process
	× Returns diluted by GP/LP fee structure

PERE Structures

Development Fund-Throughs



Overview

Pure play development funds are not common. Property companies with development assets often look for investment partners that are comfortable moving up the risk curve to employ opportunistic strategies.

Property companies wishing to partner with greenfield investors may be better off structuring bespoke joint venture agreements with experienced investors who have a track record of supporting similar projects. The development fund-through PERE structure (also known as forward-funding) is ideal for this arrangement.

Under this structure, an investor acquires a completed project but signs prior to construction commencing. In essence, they purchase the land and fund the developer's construction costs through to completion.

Characteristics

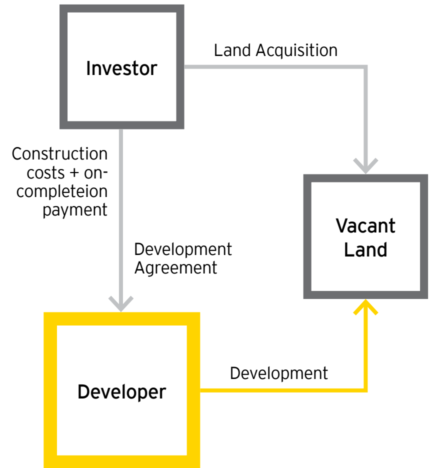
Agreement: The property company and the investor sign a development agreement based on the investor making a down payment (usually the cost of the land) followed by progressive payments throughout construction and a lump sum at completion.

Costs: From the investor's perspective, they are acquiring an asset with low transaction costs, with stamp duty payable on the land and any construction payments rather than on the completed value.

Investor benefits: The development risk continues to reside with the developer. The investor receives ownership of a newly constructed, high quality asset without incurring the normal risks associated with undertaking a development, which are usually mitigated through mechanisms such as a fixed construction price or post-completion income guarantees.

Developer benefits: The development has been pre-sold, removing the developer's exit risk. The developer also benefits from being able to use the investor's capital during construction. This provides an effective mechanism for reducing their equity investment and increases their return on equity from development. Furthermore, by moving away from a traditional single-bank funding arrangement and entering a PERE agreement, the developer is not reliant on a single banking entity for funding, reducing their vulnerability to bank policy changes.

Indicative structure



Examples of fund-through transactions

Its risk mitigation benefits for both developers and investors make this PERE structure a popular choice for large commercial developments that will attract major tenants.

Project	Value	Investor	Developer
Kings Square office development Perth	$435m	Dexus Property Group	Leighton Properties
Keysborough industrial development Melbourne	$19m	Growthpoint	Australand
480 Queen St Brisbane	$544m	Dexus Property Group	Grocon

PERE Structures

Single Asset Trusts

Overview

Most property funds invest in multiple projects that provide diversified risks and returns. Single asset trusts provide investors with a risk and return profile that is linked directly to a single property development while offering property companies a viable source of capital for individual projects.

Typically, the fund manager will establish a new single asset unit trust for each development project. This facilitates the associated risk and target return are linked directly to that development and are not subject to the performance of other projects or to external influences.

Characteristics

Liquidity: With single asset funds typically unlisted, liquidity is reduced and investors can be faced with difficulties in cashing in their investments ahead of the forecast cash inflow date(s). Likewise, property companies need to facilitate liquidity is committed for the projected duration of the development and protocols for defined liquidity events are clear.

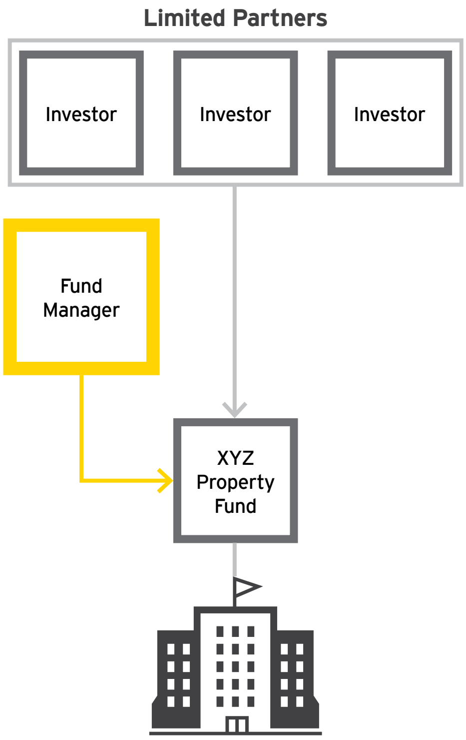
Risk: A lack of diversification means risks are solely tied to one development, with no ability for losses in one development to be offset by profits in another.

Transparency: There is a general perception that single asset funds lack transparency. They are unlisted, so unit prices or recent movements are not public, and they are not subject to ongoing ASX listing requirements (e.g. continuous disclosure). As invested capital is typically tied up for long periods, this is a significant risk that investors need to address.

Distributions: Once the development project is completed, the respective single asset trust distributes according to its information memorandum, providing investors with a clear and defined liquidity event i.e. investors know in advance when they will have access to their money and the target return to expect.

Returns: Given the liquidity, concentration and transparency risks of the investment, investors will typically seek a higher rate of return hurdle.

Indicative structure



Example of a single asset trust

Folkestone Truganina Development Fund	
Fund Type	Closed end unlisted real estate fund
Project	Residential land subdivision in Truganina, Melbourne
Amount	‣ Equity Raising – $18.25m ($3.65m co-invested by fund manager) ‣ Minimum Investment – $100,000
Forecast Return	Equity Internal Rate of Return (IRR) of 18.0% p.a
Term	4.5 years
Return Profile	Periodic returns until completion

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