Harbour Navigator

Corporate structure changes in New Zealand Listed Property securities: Scale and alignment

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Listed property securities investors need to consider the scale and alignment of listed property entity management teams. Investors need property securities to be large enough that the costs of having a capable management team and costs of being listed don't cause an unnecessary drag on returns.

But more importantly, property security management structures and management teams need to be aligned with the investors in the securities. Alignment refers to whether the management team are incentivised to make excellent returns for underlying investors. Property security management should be thinking about whether key decisions such as leasing or not leasing a building, buying or selling a building, undertaking development work, and increasing or decreasing debt levels increases returns and reduces risk for investors. If management are focused on increasing returns to the management structure ahead of investors then they are not aligned with investors, and may make decisions that are not in underlying investors best interests.

There are currently two New Zealand listed property security entities that are testing investor thinking on scale and alignment. NPT is proposing to expand its property portfolio by acquiring assets from Kiwi Property, including the sale of the right to manage NPT to Kiwi Property. This will externalise NPT's management. Property for Industry (PFI) is proposing to internalise its management contract, with PFI investors buying the management company that manages PFI.

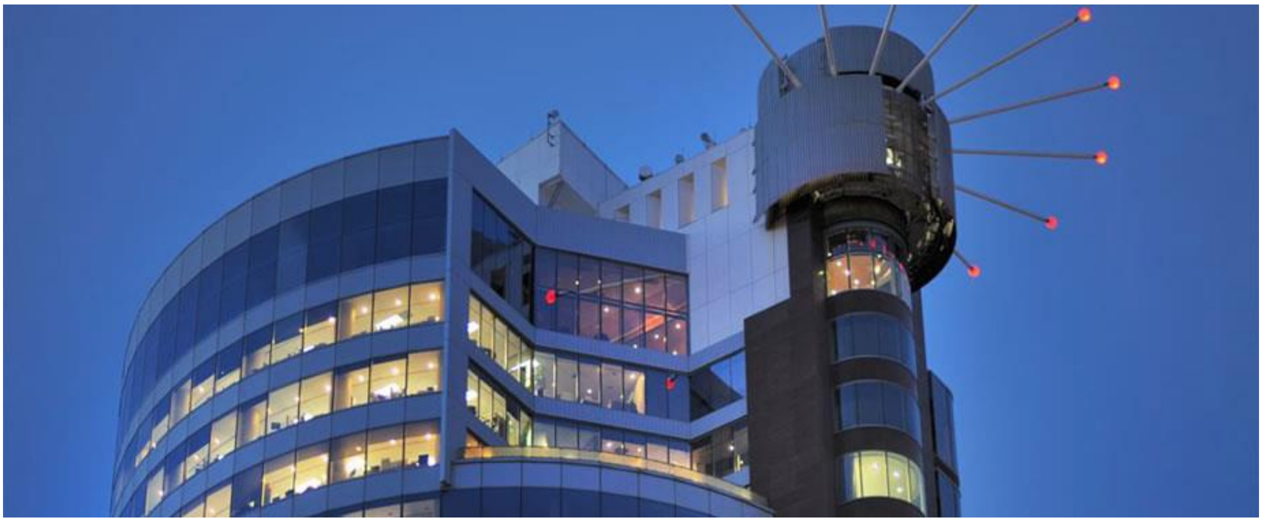

Photo of the Majestic centre, a Kiwi Property building in Wellington. Source: www.majesticcentre.co.nz

NPT is currently internally managed – the shareholders in NPT own the manager of the real estate owning vehicle. In theory this should increase alignment between NPT management and NPT investors. But NPT, with a property portfolio of $170m, lacks scale to carry a full management team. Various NPT boards have not grown the business over the last five years, and NPT has a very high corporate overhead relative to its portfolio (with a management expense ratio, of indirect operating expenses to total assets, of 1.3%), because it is too small. Kiwi is proposing to sell assets into NPT, and invest in NPT, effectively giving NPT better scale with a property portfolio of $400m.

But the Kiwi proposal also includes Kiwi acquiring the management rights of NPT, meaning that NPT would be externally managed. External management means that the investors in a property vehicle don't own the manager of the property vehicle. External management of property securities, unless controlled by a strong board of the underlying property owning entity, can result in poor alignment with underlying investors. External managers may be incentivised to grow the size of the portfolio to increase their fee pool without growing returns to underlying investors. For example, a manager may advocate buying an additional property into the portfolio that has modest return prospects relative to the returns investors expect, because the manager may be paid on the absolute size of the property portfolio rather than actual returns to underlying investors.

So investors need to think about whether NPT's proposal to grow its business to a greater scale by acquiring mature assets from Kiwi Property and selling its management rights to Kiwi Property, reducing NPTs management expense ratio to 0.7% but potentially changing management alignment, increases overall shareholder returns, or decrease risk, overtime.

In PFI's case, investors are being asked by the PFI Board to buy the rights to manage PFI back from the current owners of the PFI manager. PFI has been a very successful investment for investors, over a long period of time. The external management company that has managed PFI has done a good job for PFI investors. The $1.1bn PFI property portfolio has scale by New Zealand real estate security standards, and can carry the full costs of an internal management team.

However the price that the PFI management rights are being offered to PFI investors is relatively full at $42m, equivalent to 3.9% of PFI's assets under management or 17x effective earnings before interest and tax, when compared to similar historical transactions. Investors need to balance this relatively high price against improved alignment of investor and management interests, and the potential for lower all in costs around performance fees that may be payable to the current PFI manager. The current PFI external management contract is evergreen with very limited rights of termination, creating an almost perpetual cash flow to the current manager. Analysis provided to the PFI Board by Deloitte indicates the acquisition of the management contract is expected to boost PFI's earnings per share and lead to net present value gains for PFI shareholders. Some of this improvement reflects lower management costs - under the proposal, PFI's management expense ratio is expected to fall from 0.6% to 0.3% of total assets post-internalisation. Some of the improvement in earnings reflects increased debt levels, with debt funding costs costing less than PFI's overall cost of capital.

While in our view the PFI internalisation proposal is only modestly earnings enhancing, the key question investors need to consider for the PFI proposal is whether management will continue to deliver the same, or better, returns to PFI investors as they have in the past. Management alignment with shareholders may be enhanced as a result of the internalisation – PFI's senior executive remuneration will be linked to relative PFI shareholder returns versus New Zealand comparable companies, as well as providing incentives for an internalised management expense ratio to be below 0.3% of total tangible assets. This compares with the current incentive structure that rewards the external management company for achieving a 10% or better total return target.

The commercial property cycle in New Zealand is mature, and companies are positioning themselves for an environment where capital value growth may be more subdued. While the capital value growth may slow in the near term, new commercial property development continues to lag user demand (even if the NZ economy slows), providing a sound supply and demand backdrop for commercial property returns medium term. But the slowing tail winds of capital growth mean that investors need to be increasingly selective when considering listed property security investments. In our view, listed property securities with strong management alignment, productive assets that generate strong cash flow, idiosyncratic portfolio growth potential and solid balance sheets will be best positioned to take advantage of the change.

Harbour Asset Management

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