Making a Liquid Property Market
SPVs Promise a Good Chance of Success

by Andrew Adams

Analysis of the proposed securitised property vehicles suggests that they will trade at a premium to estimated NTA — a recipe for success.

Michael Maxwell's article, "Breathing Life into the Property Market" (JASSA, September 1991), described the proposed Australian securitised property vehicles (SPVs) and touched on the question of whether the vehicles will trade at a discount to net tangible assets (NTA). While valuation of the underlying property assets is necessarily subjective, the question of discount or premium is of crucial importance.

Ignoring certain complications for the moment, potential vendors in the primary SPV market must expect to achieve a new issue price, net of flotation costs, at least equal to the net proceeds that might be expected from sale of the property assets in the direct property market. And as the new issue price of an SPV will largely be determined by the expected opening price in the secondary market, judging whether the new market will succeed essentially reduces to a question of whether secondary-market prices will be high enough in relation to estimated NTA.

The objectives of the Securitised Property Market Association (SPMA) are "to create a framework to allow the creation of marketable securities which will be classed as real-estate assets; to provide an organised and efficient market for them and to promote and widen that market to facilitate liquidity".

Despite the fact that SPVs are being designed to mirror as far as possible the investment performance of the underlying unencumbered property assets, they essentially remain a special type of listed property investment vehicle. Existing listed property investment vehicles around the world include US real estate investment trusts (REITs) and UK property investment companies as well as Australian listed property trusts. In the case of each of these vehicles, there has been considerable debate among both practitioners and academics about what should be the "correct" price of the vehicles in the market in relation to underlying NTA. In practice, discounts and premiums vary within each sector and each sector's average discount or premium varies over time.

Existing listed property investment vehicles show that many different factors influence the discount or premium to NTA: management, taxation, liquidity, risk, takeovers, innovative capital structures and inefficiencies.

It is necessary to examine each

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factor carefully in assessing whether SPVs will trade at a discount or at a premium to NTA in a secondary market.

**Pricing SPVs directly in the secondary market**

Assuming that both the SPV and its underlying property assets are priced efficiently, a discount (or premium) to NTA implies that properties held indirectly through the SPV are less (or more) valuable than if they were held directly. Thus, in considering the above factors, we must make a straight comparison between SPVs and direct ownership of the underlying property assets, rather than considering the attributes of SPVs in isolation.

- **Management** In attempting to create a security which is as close as possible to direct property ownership, the SPMA proposes that SPVs will be managed passively. This essentially eliminates questions relating to management investment decision-making ability. It is likely that acquisition or disposal of properties will not be allowed without the approval of 75 per cent of unitholders.

Under the management heading, the important issues would seem to be:

(a) Relief from the burden of management. Eventually, some institutions might even consider that an in-house property management team is no longer needed.
(b) Loss of management control, as compared with direct ownership of the underlying property assets by a single investor.
(c) Management fees (including unitholder administration), compared with management expenses associated with direct ownership.

The first is a positive factor for SPVs and will tend to result in a premium, whereas (b) and (c), which taken together are probably more important than (a), are negative factors and will tend to result in a discount.

- **Taxation** SPVs will be tax-transparent, meaning that unitholders are taxed as if they hold a direct property investment, with no additional taxation in the hands of the SPV. It follows that the taxation factor will have no influence on the discount/premium.

- **Liquidity** This is the most important factor in favour of SPVs and is probably the key to success. The SPMA is in discussions with the Australian Stock Exchange (ASX) which could lead to the listing of SPVs. Given that listed property trusts are already established stockmarket securities, the liquidity factor is bound to encourage a premium in comparison with the underlying direct property assets, particularly given the current state of the direct property market in Australia. If the state governments treat units as marketable securities for stamp-duty purposes, this will be an added advantage.

- **Risk** The concept of risk which is relevant to this analysis is the aggregate perception of risk for those investors influencing prices in the market. If holding the underlying property assets indirectly through the SPV is perceived to be more (or less) risky than holding the underlying property directly, this will tend to cause a discount (or premium) to NTA.

The SPMA intends not to allow gearing (except for working-capital purposes). This follows from the requirement that the returns from the SPV should mirror the returns from the underlying property assets. The main risk factors to consider would therefore be volatility, divisibility/diversification and uncertainty as to true NTA.

If traded on the ASX, it seems likely that SPVs will be more volatile than direct property. However, it is very difficult to assess this factor as one is not comparing like with like. Adjustments to the market prices of SPVs will be made each trading day if the new market is successful — a very different situation from direct property.

An important positive aspect of the SPV is that holdings are divisible, thus enabling investors to spread risk more effectively through a portfolio and opening up the possibility of investment in very large “landmark” properties to all types of investor. This aspect encourages a premium.

Some commentators would argue that the uncertainty as to true net asset value factor is a positive one for SPVs, as investors in SPVs will have a visible quoted central market price, unlike direct owners of the underlying assets. Others argue that direct ownership of the underlying assets means greater information on which to estimate asset value.

Again, the SPMA intends to minimise this negative factor by requiring a full valuation report giving pages of relevant information about the underlying property assets annually, which should enable investors to make an informed estimate of NTA.

- **Takeovers** The possibility of takeover will be left open. Directors of the manager of a target SPV will have the same responsibilities to provide advice to unitholders as do the directors of a target company to their shareholders. The possibility that an SPV could be taken over should limit any discount to NTA but could not on its own create a premium.

- **Innovative capital structure** Although it is expected that SPVs themselves will have no gearing, there remains the possibility of creating an associated geared investment vehicle holding only units in the SPV, along the lines of the GPT Split Trust. This would allow the best of both worlds: the SPV itself, as required, would have no gearing, but the investors’ risk and income preferences could be satisfied by the associated split capital trust, thereby heightening demand. Unitholders might be allowed to exchange one ordinary SPV unit for one “growth” unit and one “income” unit, both of which could then be traded separately. As with the GPT Split Trust, the “income” and “growth” units could be combined and converted to an ordinary unit if the unitholder so wished.

It seems likely that the existence of an associated split trust structure would tend to reduce any discount or help to create a premium.

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**TABLE 1: DISCOUNT TO ESTIMATED/STATED NTA**

<table>
<thead>
<tr>
<th></th>
<th>Discount to estimated NTA</th>
<th>Discount to stated NTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Property Trust</td>
<td>7.4%</td>
<td>23.3%</td>
</tr>
<tr>
<td>Schroders Property Fund</td>
<td>19.1%</td>
<td>19.1%</td>
</tr>
<tr>
<td>Stockland Trust Group</td>
<td>0%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Westfield Trust</td>
<td>(1.6%)</td>
<td>11.8%</td>
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The UK investment trust sector provides useful evidence. UK investment trusts are listed vehicles which invest mainly in shares. Thus, the discount or premium can normally be measured accurately. While non-specialist investment trusts currently trade at a 13 per cent discount, those with a split capital structure tend to trade at a premium. Of particular interest was the reorganisation of River and Mercantile in 1987 to create a split capital structure, resulting in the immediate elimination of a 20 per cent discount.

I am not suggesting that associated split trust structures would make a difference of 20 per cent in the case of Australian SPVs, but their existence is likely to have at least some positive influence on an ordinary unit's market price. Investors in different tax and risk categories will be more likely to find products which suit their needs.

Inefficiencies. Inefficient market pricing of the SPV or inaccurate valuation of the underlying property assets can obviously sometimes lead to an apparent discount or premium.

Summary. Management factors in aggregate encourage a discount but may be roughly cancelled out by the risk factors. This leaves the important liquidity factor and the possibility of associated geared investment vehicles, both positive factors. Overall, a small premium to NAV might be expected.

Pricing SPVs by comparison with listed property trusts

An alternative approach to assessing the likely discount or premium to estimated NTA of the proposed SPVs is by comparison with the existing Australian listed property trusts.

Since 1974, the weighted average discount to NTA of the top four listed property trusts has tended to move within the range -20 per cent to -20 per cent.

The recent high discount largely reflects the fact that stated NTA is an overestimate of the true NTA in falling property markets. In its Property Trusts Update in April 1991, County NatWest Securities gave, for the top four trusts, the figures shown in Table 1.

Using weights equal to the market capitalisation of the individual trusts at the time, these figures give a weighted average discount to estimated NTA of 4.8 per cent compared with a weighted average discount to stated NTA of 15.9 per cent.

The factors which might make the discount/premium of a typical listed property trust are management, liquidity and risk.

Management. SPVs will be managed passively, so that management fees are likely to be lower than those generally charged by managers of listed property trusts. However, the question remains of whether the freedom given to the managers of listed property trusts, including discretion over what assets to choose, leads to added value. Quality and independence of management are clearly important considerations.

Liquidity. As SPVs are likely to hold only one or a small number of large property assets, there may be less frequent news reaching the market in comparison with listed property trusts which hold many properties. However, the very detailed information about individual properties given to SPV unitholders should cause greater discussion about true NTA and lead to additional transactions in the market.

Risk. Historically, listed property trusts have tended to under perform in bear markets, as well as in 1985 to October 1987, meaning that historically they have had relatively low betas. Given that the SPMA is specifically designing SPVs to behave as direct property, it seems likely that SPVs will have even lower betas than listed property trusts. However, SPVs are likely to have higher specific risk, which is of particular importance to smaller investors who do not hold diversified portfolios of securities.

There should be less uncertainty about true NTA for SPVs than for listed property trusts. Unitholders in SPVs will receive the same level of detail about individual property assets as would a direct owner.

Another positive aspect of risk with SPVs is that they should provide better overall diversification benefits than listed property trusts in the context of an institution's total investment portfolio. This again follows from the close resemblance of SPVs to direct property.

Summary. Management and risk factors appear to favour SPVs over listed property trusts, whereas the liquidity factor is at best neutral. On balance, it seems likely that SPVs will trade on a somewhat lower discount (or higher premium) than listed property trusts. At present, this might suggest a small premium to estimated NTA for SPVs.

Pricing SPVs in the primary (new issue) market

It is usual for new issues to be priced below the expected opening price in the secondary market to try to ensure a successful flotation.

Research on new issue pricing in the US has produced some interesting results. A study by Ibbotson, Sindal and Ritter in 1988 examined 8,668 initial public offerings of US equity securities during the period 1960 to 1987 and documented a 16.4 per cent average initial return.

However, a recent study of 86 initial public offerings of REITs from 1971 to 1988 showed an initial return of -3 per cent on the first day of trading. So subscribers to new issues of these property vehicles seem to behave like lemmings, coming back time and time again to give their money away! Could it be the same with SPVs? I suspect that might be too much to ask — nevertheless, a new-issue discount to expected market price of no more than 10 per cent might seem feasible.

Will the new issue price be acceptable to vendors?

The following factors should encourage major property owners to securitise property.

Vendors have the flexibility to securitise only part of a property and would be able to "trickle out" units as desired.

Securitisation will lead to a greater spread of risk across the vendor's property investment portfolio.

Depending on market conditions, it may be difficult to sell very large properties in the direct property market in a reasonable time, so that sellers may have to accept a "forced-sale" price. Perhaps 15 buildings in Australia have a value of more than $300 million, and probably fewer than 10 Australian investors could contemplate purchasing such properties.

For these reasons, a new-issue price equal to estimated NTA should be attractive to vendors.