Institutional residential property portfolio management

Residential property is the largest property sector in Australia but this market is under-represented by institutional investors. The authors explain how a residential property portfolio can be managed both effectively and efficiently.

R esidential property is the largest property sector in Australia, with an estimated value exceeding $2.6 trillion. The rental market represents 30% of this value, which translates to $780 billion and highlights the market potential for residential property investment vehicles in Australia.

It is a market with substantial potential for generating investment returns and yet it is not institutionalised in Australia. A contributing factor is the inability of fund managers to present investors with a residential property portfolio which would be managed both efficiently and effectively.

This article describes how this could be achieved and illustrates the fundamental difference between managing a property portfolio (portfolio management), and managing a portfolio of properties (property management) – the former dealing in the investment policy and the latter in the physical context.

PORTFOLIO MANAGEMENT

Portfolio management concerns the elements of the investment policy and decisions which include:

- Investment objectives
- Asset allocation/diversification
- Assessment and selection criteria
- Exit strategy
- Capital structure
- Information resources and benchmark
- Risk management and compliance
- Portfolio reporting and monitoring.

Investment objectives

At the outset, the portfolio’s investment objectives will need to be established and then reviewed at suitable points in time. Appropriate investment objectives would be either an absolute return or a percentage return above a benchmark index over a defined period and at a stated risk level.

Asset allocation/diversification

Fund allocation will follow the process of macroeconomic analysis of the investment universe in respect to GDP, employment growth, interest rates and population growth including immigration. Residential property as a sector has a range of fundamental influences, and therefore it is important to recognise the correlation of these characteristics when determining the investment allocation. A residential property portfolio can be diversified through various parameters as follows:

Location/geography

The portfolio can be diversified at a national level or across a selection of six Australian States and two Territories. Table 1 shows the residential value of each State and Territory in Australia as at December 2005. States with the major capital cities such as New South Wales and Victoria comprise a large proportion of the Australian residential property universe in line with their population.

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Property

Table 2 illustrates the relationship between total investment returns from residential property in capital cities in Australia. Overall, the Australian capital cities are lowly correlated when comparing unit dwellings. Size of individual assets

Sensitivity due to the dominance of an individual residential property is unlikely unless the portfolio is of limited size or a property is of significant value. In this respect, residential properties are more likely to have characteristics similar to securities than commercial property, where there are a large number of similarly valued assets, differentiated by type.

Types of residential property

Residential property is typically categorised into flats/apartments, terrace houses, semi-detached and detached houses. Each type represents a different range of capital value, and from a diversification perspective, each type exhibits different market characteristics such as growth, cycle and yield.

Tenant mix

Tenant diversification is difficult where property is let in an open market. When demand is low, there is a trade-off between tenant quality and vacancy, although a minimum rental criteria will maintain control. Tenant diversification can be achieved through type and location of property with examples such as student housing, inner-city apartments, and multi-bedroom housing near schools influencing the tenant mix.

Quality

Strategic improvements of lower quality property can increase capital values and yields, although some of the highest yields can be achieved from low value, low quality property. The level of quality of the residential properties should be commensurate with the respective needs of the target rental and investment markets. Higher quality assets are typically more attractive to investors.

Age of assets

Varying the age of the assets within a portfolio assists in the smoothing of maintenance costs over time. Newer properties require lower maintenance costs in the initial years than older properties. However, specific older styles have less price volatility and a greater potential for price appreciation.

Lease expires

Longer-term lease contracts are preferable for the portfolio as they provide income stability, lower vacancy risk and therefore lower volatility in the investment return. Where possible, the longer leases should expire at different times to avoid vacancies occurring concurrently. This will have no major benefit when dealing with leases in the 6–12 months timeframe. A trade-off between diversification of tenant mix and diversification of lease expiry is likely given that only certain types of tenants will be willing to negotiate longer leases.

Table 1

<table>
<thead>
<tr>
<th>State – house</th>
<th>Number of houses</th>
<th>Total residential value (m)</th>
<th></th>
<th>Number of units</th>
<th>Total residential value (m)</th>
<th></th>
<th>Total number of dwellings</th>
<th>Total residential value (m)</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>NSW</td>
<td>1,896,466</td>
<td>$841,554</td>
<td>662,867</td>
<td>$218,008</td>
<td>2,559,334</td>
<td>$1,059,562</td>
<td>39.9</td>
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<td>VIC</td>
<td>1,569,262</td>
<td>$537,450</td>
<td>365,710</td>
<td>$104,285</td>
<td>1,934,971</td>
<td>$641,735</td>
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<tr>
<td>QLD</td>
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<td>$389,603</td>
<td>343,575</td>
<td>$82,187</td>
<td>1,568,834</td>
<td>$471,790</td>
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<tr>
<td>SA</td>
<td>502,983</td>
<td>$129,698</td>
<td>128,905</td>
<td>$25,424</td>
<td>631,888</td>
<td>$155,122</td>
<td>5.9</td>
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<tr>
<td>WA</td>
<td>633,774</td>
<td>$192,670</td>
<td>153,523</td>
<td>$37,458</td>
<td>787,297</td>
<td>$230,127</td>
<td>8.6</td>
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<tr>
<td>TAS</td>
<td>176,435</td>
<td>$40,974</td>
<td>23,152</td>
<td>$4,112</td>
<td>199,587</td>
<td>$45,086</td>
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<tr>
<td>ACT</td>
<td>38,645</td>
<td>$13,931</td>
<td>18,522</td>
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<td>$19,231</td>
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<tr>
<td>NT</td>
<td>102,574</td>
<td>$31,695</td>
<td>27,927</td>
<td>$6,123</td>
<td>130,502</td>
<td>$37,819</td>
<td>1.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>6,145,398</td>
<td>$2,177,575</td>
<td>1,724,181</td>
<td>$482,897</td>
<td>7,869,579</td>
<td>$2,660,472</td>
<td>100.0</td>
<td></td>
<td></td>
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</table>

Source: Atchison Consultants, utilising data from the Real Estate Institute of Australia and the Australian Bureau of Statistics. – * includes flats and townhouses.

Table 2

<table>
<thead>
<tr>
<th>18 Years to 31 March 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sydney</td>
</tr>
<tr>
<td>1.00</td>
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</table>

Source: Atchison Consultants, utilising data from the Real Estate Institute of Australia.
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Assessment and selection criteria
The property assessment and selection criteria translate to how the portfolio manager will screen and approve the purchase of new housing stock for the portfolio. Having determined the criteria for purchase through the objectives and allocation process, the property management team will undertake the search and assessment exercise and recommend a number of properties that meet these criteria. All other elements being equal, the final selection criteria between properties will include the relative value, estimated net yield, and estimated growth potential.

Exit strategy
The exit strategy considers three elements:
- Criteria for selling individual property assets
- Criteria for investor redemptions
- Criteria for winding up the investment vehicle.

These criteria will dictate the structure of the investment vehicle, making it one of the primary considerations. Individual property sales will be a function of investor redemption, winding-up and the ongoing asset allocation process. Investor redemptions are directly related to the liquidity provided in the investment vehicle, with direct property inherently illiquid.

The return characteristics of residential property demand a buy and hold strategy to maximise the long-term capital gain. Property sales will occur throughout the life of the investment vehicle for a number of reasons, including:
- The property no longer meets the portfolio objectives.
- An offer has been made on the property that is too good to refuse, effectively accelerating the capital gain of the general market for a particular property.
- A requirement is anticipated for major capital expenditure.

With these scenarios, the avoidance of a forced sale at any point is paramount.

Capital structure
While the physical management of the investment funds is undertaken by the responsible entity of the residential property investment vehicle, the decisions on the structure of the funds and how these funds will be managed fall to management. Management will consider issues such as:
- Capital position – What are the net funds available after new funds are invested and following redemptions?
- Investment position – What funds have been committed where, and what is the timeframe for realising this investment?
- Liquidity – What funds need to be allocated to cash for redemptions and how will this cash be invested in the short term?
- Gearing – What will be the gearing ratio for the investment vehicle both as a maximum and as a target operating level?
- Fees – What are the fees incurred?
Liquidity
The most widely held limitation of the property market in general is the illiquidity of the individual assets. Illiquidity reduces the investor's ability to switch between property sectors and other asset classes when market conditions warrant this. In other words, it prevents portfolio management from taking place. Contributing to this issue are factors such as large lot size, high transaction costs, small number of market participants, no central marketplace, and the delay for legal work.1

In the above context, liquidity refers to both that of the property security and of the underlying asset. Depending on the investment vehicle, these may or may not be mutually exclusive.

At the security level, a critical mass contributes to the liquidity of the product. Sufficient numbers of individual funds are required to make a market that attracts buyers and sellers. This turnover will generate realistic prices although the infrequency of transformations means the market prices are not as reliable as those from a public market.

Without securitisation, institutional investors face difficulties in acquiring a large-scale portfolio in the residential market. The availability of housing stock in sufficient bulk quantities exists only in private portfolios or new major developments.

At the property level, turnover will be on a delayed basis as each property bought and sold goes through what can be up to a four month process. The turnover performance of house and unit sales in Australia as a proportion of total housing stock (7.79 million dwellings as at 2001) is illustrated in Table 3. Turnover value is based on Australia’s total housing value of $2.6 trillion. The numbers demonstrate that in the broader context, there is sufficient potential turnover to maintain liquidity of the investment vehicle over the long term.

Gearing
While gearing can enhance the returns generated by the portfolio, a high level of gearing can actually change the characteristics of the portfolio significantly. The key issues are the expected income yield and the interest rate on debt. Negative gearing, where the interest cost is greater than the rental income, is cash flow negative and more risky. As a result other income sources are required to fund the debt.

Fees
Fees for a residential property portfolio will typically be higher than for other types of property portfolios due to the greater amount of time required to manage such a portfolio. An appropriate fee structure would be a base fee to cover basic management expenses and performance fees above a specific level of outperformance, as a reward.

Information resources and benchmark
A fundamental difference between commercial property and residential property is the timeliness, availability and longevity of data. Residential property exhibits an amplified version of some of the less desirable characteristics of unlisted commercial property in relation to sales data, income data, and operating cost data.

From an institutional perspective, the availability of a valid and reliable national residential property index as a benchmark is paramount. There are three main issues that have been identified that impact on the validity of residential property information currently supplied by the major data providers such as the Real Estate Institute of Australia (REIA), Australian Property Monitor, the Australian Bureau of Statistics, Residex and Commonwealth Bank of Australia. These include:

- Timeliness
- Compositional changes
- Changing characteristics

The major problem, timeliness, arises from the difficulty of obtaining reliable residential data such as house prices and rents as quickly as possible. As a result, the residential property index is released on a delayed basis.

Compositional changes arise when shifts in the sample occur between suburbs with differing average housing values. Only a proportion of the overall movement is attributable to actual price change.

The changing characteristics of the housing stock through renovations and extensions can have a large impact on the sale price and can lead to misleading data when used as an indicator of prices.

“Concerns raised by the Reserve Bank of Australia5 over these issues prompted a review of residential property data by the Australian Bureau of Statistics. In November 2005 the ABS released an updated methodology for their index which sought to address compositional and characteristic changes.6 The timeliness of the release of the index was an issue they recognised could not be dramatically improved. An approach similar to the ABS is used by Australian Property Monitors in the construction of their index.5

Risk management and compliance
A clear risk management process should be in place and followed. Considerations include ensuring that portfolio constraints are not breached, and procedures are in place for rectifying breaches.

The investment manager should establish a compliance committee, which would be responsible for, among other things, ensuring that the investment vehicle is managed according to appropriate legal and statutory requirements. An annual audit should also be conducted by an external auditor.

<table>
<thead>
<tr>
<th>Year</th>
<th>Turnover % of total housing stock</th>
<th>Turnover value ($b)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999-00</td>
<td>6.4</td>
<td>165.29</td>
</tr>
<tr>
<td>2000-01</td>
<td>5.3</td>
<td>136.60</td>
</tr>
<tr>
<td>2001-02</td>
<td>6.4</td>
<td>166.92</td>
</tr>
<tr>
<td>2002-03</td>
<td>7.0</td>
<td>181.69</td>
</tr>
<tr>
<td>2003-04</td>
<td>6.9</td>
<td>179.92</td>
</tr>
<tr>
<td>2004-05</td>
<td>6.4</td>
<td>166.05</td>
</tr>
</tbody>
</table>


TABLE 3 HOUSE AND UNITS SALES TURNOVER IN AUSTRALIA
**Portfolio reporting and monitoring**

Where appropriate for the particular investment vehicle, shareholders or unit holders should receive regular performance-related information. This will include returns, returns related to benchmarks, portfolio structure and activity in acquisition and sale. The portfolio should be monitored on a daily basis.

**PROPERTY MANAGEMENT**

Property management considers the portfolio of properties and includes the initial physical property acquisition and the ongoing management, in accordance with the portfolio manager’s investment process. The property management function may be outsourced to specialist service providers. It concerns:

- Purchase
- Tenant Services
  - Leasing
  - Maintenance
- Disposal.

**Purchase**

Once a property has been approved in principle by the portfolio manager for acquisition in accordance with the investment objectives, a formal assessment process will be conducted. This assessment process involves technical due diligence, legal due diligence and valuation.

Once the due diligence is completed and final selection approved by the portfolio management, a set of fixed terms and value guidelines will be established for the acquisition of the property. The acquisition can be undertaken through a specialist such as a buyer’s advocate working within these guidelines.

**Tenant services**

At an institutional level, a specialist external management team will provide tenant services due to the labor-intensive nature of dealing with multiple tenants with individual sets of problems. Rent/deposit collection and emergency call-out service supplement leasing and maintenance.

**Leasing**

Government legislation has provided residential tenants with the option to undertake a minimum six-month lease that from an investor’s perspective increases the potential for volatility in returns through vacancy or poor tenant selection. In managing a residential property portfolio, the process of leasing due diligence for each residential property involves the following steps:

**Tenancy profile**

The tenants are reviewed based on:

- Financial capacity and health of tenants
- Tenants’ history of tenure in the property
- Tenants’ attachment to the property

**Lease profile**

The property lease profile is assessed with specific reference to:

- Length of the remaining terms of all leases
- Likelihood of tenants remaining in the property at the expiration of the lease
- Weighted average expiry profile of all leases.

**Maintenance**

Like any property, a residential property has to be regularly maintained. Maintenance varies depending on the age of the property, with older properties typically requiring more maintenance than newer properties. Some residential properties may also require major capital works, or complete refurbishment. Part of the management process is the clear structure of the capital maintenance program.

**Disposal**

Sale of individual property assets will be undertaken by an appointed external party to guidelines established by the portfolio management. Sale will be triggered through the continuing management process.

**CONCLUSION**

The long-held concerns of institutional investors relating to the management of residential investment property have in some respects been warranted. Without an established institutional operation, the capabilities of investment managers in the residential property sector are yet to be proven.

However, what can be demonstrated is the ability to apply a portfolio approach to management with a clear distinction between this and property management, a methodology which is used in the commercial property sector. In doing so, these concerns can be addressed primarily through the management structures of the proposed investment vehicles and should not preclude institutional investors from the benefits of including this sector within portfolios.

**Notes**


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