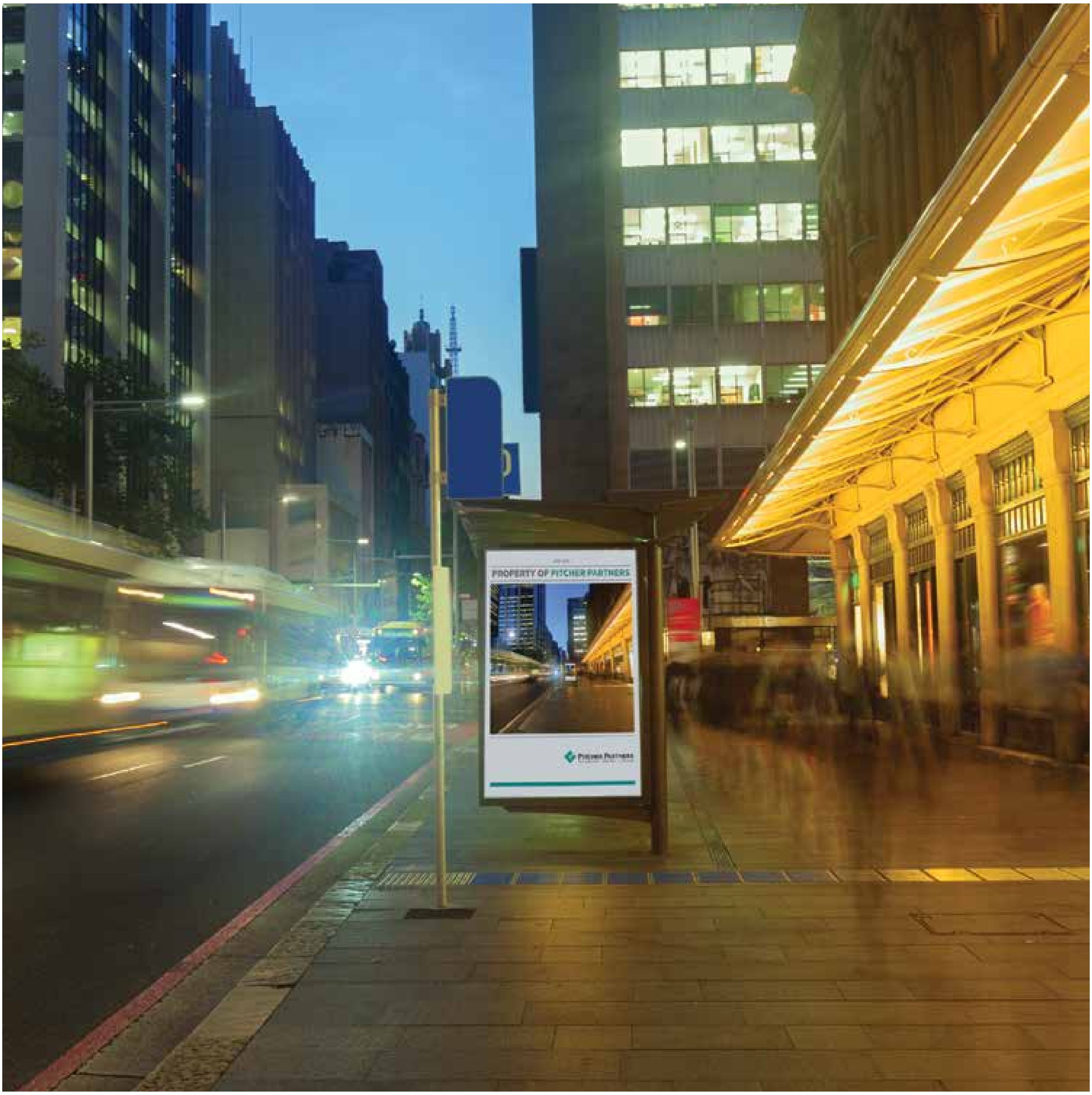
JUNE 2016

PROPERTY OF PITCHER PARTNERS



PITCHER PARTNERS

ACCOUNTANTS • AUDITORS • ADVISORS

Inside Cover:
Glenelg, Adelaide

Front Cover:
Sydney CBD

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WELCOME

By Andrew Beitz, Pitcher Partners, Adelaide

At Pitcher Partners we have a passion for the property industry. We are attuned to the needs of all contributors in this complex and exciting sector – owners, developers, investors, builders, values, agents and of course debt/equity participants. We have a well-established and proven track record in contributing to our clients' success based on our extensive knowledge and our intimate approach to servicing our clients.

In recent times banks have slowed down lending for developments across the industry. This means that developers have looked elsewhere for alternative sources of funding for their projects.

This issue of *Property of Pitcher Partners* focuses on the various alternative sources of funding being used by property developers right across the sector.

Firstly, Matt Whitby and Paul Henley from Knight Frank take a look at the property market, giving us an in-depth analysis and trends of the residential and commercial sectors.

Leon Mok of Pitcher Partners Perth explains the rise of foreign investment as a source of funding for development projects, including the tightened FIRB thresholds.

Simon Chun and Tom Splatt of Pitcher Partners Brisbane delve into the tax implications of crowdfunding as a source of development funding, including the technical issues and practical challenges.

Pitcher Partners Melbourne's Andrew Clugston interviews Brae Sokoloski, Founding Partner of MaxCap, about development funding through superannuation funds.

Next, we look at building upgrade finance, a source of funding for the upgrade of ageing buildings, as Darren Bilsborough, CEO of Office Space Matters, talks us through the model and the opportunities for both landlords and tenants.

We take a look at the rise of social impact bonds as Ben Brazier from Pitcher Partners Adelaide gives an overview of this relative newcomer in the funding space and the opportunities available for a 'pay for success' funding model.

Finally, Pitcher Partners Sydney's Brendan Jones explains the funding of property investment through unlisted property trusts, including the various factors investors should consider along the way.

We trust that you find this issue informative and welcome your feedback. If you have any suggestions on articles you would like us to cover in future editions please send them through to info@pitcher-sa.com.au.

PROPERTY MARKET REPORT

By Matt Whitby, Head of Research & Consulting, Knight Frank Australia and
Paul Henley, Head of Commercial Sales, Knight Frank Australia

Residential

Global (Prime) Perspective

The value of the world's leading prime residential property markets rose on average by 1.8% in 2015, according to Knight Frank's unique Prime International Residential Index (PIRI). This is similar to the 2% growth seen a year earlier.

Ranking the top 25 cities in the PIRI 100 (see Figure), Vancouver leads the rankings by some margin, with prices accelerating 25% during 2015. Antipodean markets also performed strongly, with Sydney, Melbourne and Auckland all recording double-digit annual price growth, up 15%, 12% and 10%, respectively.

There is renewed optimism that prices in Europe's most popular second-home destinations, particularly Spain, Italy, the Algarve and parts of the Côte d'Azur, are close to bottoming out. Munich, Amsterdam, Monaco and Berlin are Europe's standout performers, recording price growth of 12%, 10%, 10% and 9% respectively in 2015.

The prime central London market remained in positive territory during the year (+1%) despite the introduction a raft of new property taxes, the introduction of many of which were aimed at foreign buyers. The relaxation of cooling measures in some Chinese cities has had an immediate impact on performance, with luxury prices in Shanghai ending 2015 14% higher.

The US Federal Reserve's recent rate rise, the resulting strong dollar and the collapse in commodity prices all help to explain why Buenos Aires (-8%) and Lagos (-20%) are located at the foot of the PIRI 100.

Local (Prime) Perspective

Sydney followed Vancouver in second place in the PIRI 100, with growth of 14.8%. Many comparisons can be drawn between the two cities – a lack of prime supply, coupled with foreign demand, and spurred on by a weaker Canadian (and Australian) dollar, these are all factors explaining both cities' stellar performances. Melbourne prime property prices grew 11.9%.

Price growth in the Sydney and Melbourne prime residential markets, although lagging, has generally followed an upward trajectory in the Australian share market. When indexed to December 2008 (post the Lehman Brothers' collapse) to December 2015, the Melbourne prime market recorded cumulative growth of 31% while prime Sydney prices grew by 30%. Despite this vast capital growth in both prime markets over the seven-year period to December 2015, the broader mainstream market in Sydney and Melbourne significantly outperformed at 80% and 52% respectively.

There continues to be limited new stock available at the high end of the market in prime locations, especially in Sydney. However, there is continued demand from foreign buyers not meeting the investment migrants' criteria of the Significant and Premium Investment Visas. These foreign buyers must buy a 'new' property in order to comply with the federal government's foreign investment regulation.

This demand for foreign buyers comes at a time when the purchasing power of the lower Australian dollar has been much stronger. Many foreign buyers have already seen success in other global cities after buying into new projects where new life has emerged in once obsolete inner-city areas; these buyers are now in a position to add a Sydney or Melbourne property to their global portfolio.

Counter-balancing this are the recent increases to stamp duty in Melbourne for foreigners (increasing from 3% to 7%), the increased FIRB application costs, and even more recently the announcement that all purchasers of properties (commercial or residential) valued at more than $2 million will need to deduct 10% from the price and pay that amount to the ATO, unless the vendor has a clearance that they are not "foreigners".

Commercial

Five Future trends in the Commercial sector

The insatiable rise of urbanisation

The stage for future commercial real estate investment is undoubtedly urban. The momentum behind urban place creation is unstoppable. This will create tremendous opportunities for investors in three ways:

First, the changing shape of the city and the creation of new urban quarters through regeneration will generate investment opportunities.

Second, as business models adapt to the needs of urban consumers, new types of real estate product will emerge. Most notable here is the inevitable rise of urban logistics in direct response to the growth of e-commerce.

Third, the changing shape of cities presents opportunities for adding value – obsolescent office stock being converted to hotel, residential or specialist uses or being upgraded. Urban infrastructure projects present a huge opportunity too and Sydney is currently on a wave of record transport and non-transport infrastructure investment, which will transform the city.

Experiential real estate

Successful investors must be attuned to how the occupier will utilise the real estate asset they are renting or buying. It is the key to income generation. Yet the wants and needs of the occupier, and the strategic significance placed upon real estate, is transforming.

No longer can the office be viewed simply as a container for staff. Similarly, the modern retail unit is today about much more than the throughput in the cash register. Real estate is increasingly about the user experience. Best performing retail assets will support retailers indirectly in driving increased sales – being one, albeit important, part of an omni-channel presence.

Office buildings will be central to driving occupier efficiency, productivity and talent retention. Understanding these changing dynamics will be pivotal in stock selection and investment return.

Innovative access to real estate product

Although the wave of innovative financial instruments crashed following the global financial crisis, as illustrated by the demise of real estate derivatives, new innovative products will emerge over the short to mid-term that allow the private investor to access commercial real estate. We live in an era of crowdsourcing and crowdfunding and these collaborative models will develop in commercial real estate.

We will see greater tie-ups between private wealth and real estate expertise in joint venture structures and anticipate syndicated approaches that utilise strata title in office buildings. This will enable the wealthy to invest in lot sizes that would have otherwise been difficult to access.

Specialist sectors move further into the vanguard

Specialist commercial real estate sectors such as student accommodation, automotive, healthcare and hotels have become an established favourite of investors over the past decade. But wider socio-economic and demographic dynamics mean that the opportunity has been barely exploited. We expect the Purpose Built Student Accommodation sector (or PBSA) to become a mature investment class in Australia over the next five years and huge opportunity exists to capture the burgeoning foreign student population in Australia, most of which need PBSA.

Demographic upheaval caused by an ageing population will also serve to create future market opportunity in the healthcare and aged care sector. While such opportunities are currently focused on Western markets, the absence of state systems of welfare, the rising ability to pay for private provision, and the sheer weight of demography, will open up the emerging markets too.

India emerges from the shadows

BRIC economies (Brazil, Russia, India, China and South Africa) have been on the investor's radar since Jim O'Neil first coined the acronym in 2001. Although these economies have been buffeted in recent years and still present transparency challenges for investors, we see strong opportunity, particularly in India, over the next decade.

The election of the Modi government has ushered in a pro-business, pro-technology agenda that is starting to play out in the real estate markets.

The incredible progress of the technology sector in India has served as a catalyst for the emergence of high quality commercial real estate in leading Indian cities, such as Mumbai, Delhi and Bengaluru, and has positioned these markets as credible investment destinations from a global standpoint. Outward investment from India into global real estate markets (à la China) will also start to occur more frequently and in larger amounts.

For further information about this report, please contact the authors below.

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Top 25 Performing Global Cities for Prime Residential Property

Source: Knight Frank Research, The Wealth Report (PIRI 100)

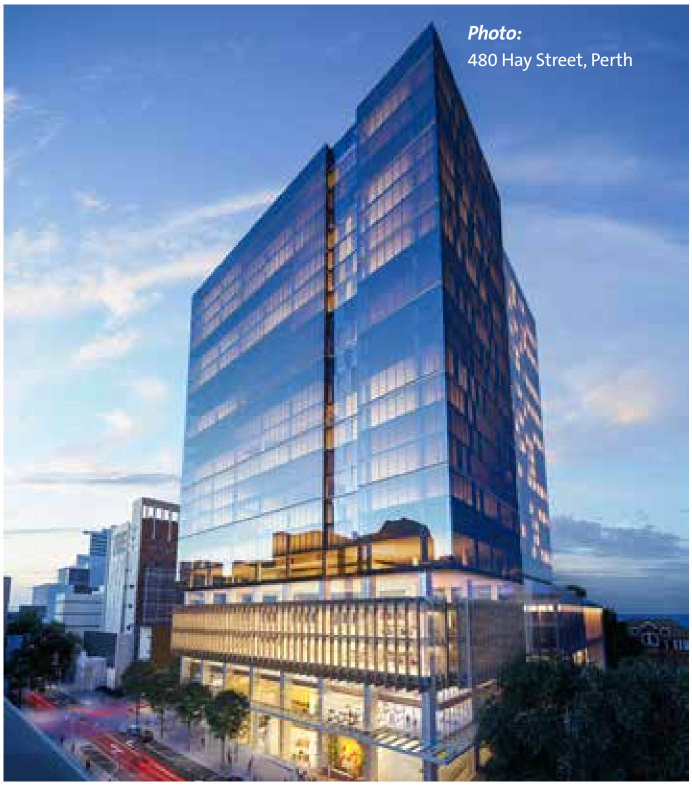

Photo: 480 Hay Street, Perth

LOOKING OVER THE HORIZON

FOR PROPERTY DEVELOPMENT FUNDING

By Leon Mok, Executive Director, Pitcher Partners Perth

The landscape of property development and investment is often viewed through the prism of market trends, average prices, occupancy percentages and number of building approvals. There is of course so much more that affects the feasibility of a project or investment. Leon Mok looks at some of those issues facing property players in the current environment.

Bank funding

There has been a clear tightening of credit markets in the last six to twelve months in Australia's property sector. Banks have very much exhibited a tightening bias in terms of development and investment funding.

Much of the tightening has been attributed to regulatory changes implemented by the Australian Prudential and Regulation Authority (APRA) in mid-2015. Broadly, these changes effectively required banks to hold more capital or in terms of funding property transactions, banks are now required to hold more funds against their mortgage books.

The result of these prudential requirements on funding is upward pressure on funding margins as return on equity from mortgages decreases, in turn making debt more expensive. Banks also need to find more capital to write loans, effectively tightening the credit markets.

The flow-on effects to developers and investors have been noticeable, with feasibilities taking a hit and multiple projects falling over due to banks pulling out.

Overseas funding

With a reduction in traditional bank appetite for funding property transactions, non-bank sources are starting to look to fill the void. While mezzanine lenders have traditionally played this role, there are other players starting to emerge.

The emergence of alternative players in the funding game has occurred not only as a result of banks pulling back but also as a result of the low-yield environment that pervades globally at the moment. As capital in Australia and around the world searches for yield, there is an increasing appetite to explore funding of property development projects.

Second and third-tier developers in Australia are increasingly searching for foreign partners with deep pockets to solve the funding conundrum.

Engaging foreign funding sources brings a number of aspects into play which change the equation drastically as compared to only dealing with domestic funders. Foreign funders that have access to foreign currency sources or reserves can effectively access lower cost funds, which can in turn be flowed onto Australian developers.

The flip side of this is that foreign currency risk will need to be managed. With the mining boom well and truly over and with RBA rates at historic lows, there will be funders in the market with a view that the Australian dollar does not have too much more downside.

Foreign funders also have the advantage of only suffering an effective tax rate of between nil and 10% in Australia as opposed to 30%+ for domestic funders, which can ultimately result in a lower cost of flow on funds for Australia developers.

Image:
Perth Jetty

FIRB approval

Foreign investors buying into Australian property will be well aware of Australia's Foreign Investment Review Board (FIRB).

Officially, FIRB is a non-statutory body that advises the Treasurer and the federal government on Australia's foreign investment policy and the administration of that policy, in particular on the question of whether certain investments are in the national interest.

In essence, FIRB is a gatekeeper for foreign investments into Australia.

In practice, for property investments that are above certain specified thresholds, the 'approval' of FIRB is required before foreign parties can complete acquisitions of Australian property.

As property prices have risen to historic highs in Australia, foreign property ownership has become a highly politicised issue. The great Australian dream of owning your own home is now no longer a reality for many young Australians hence the political gravitas of the issue.

The tightening of FIRB thresholds and processes is one card that the government can be perceived as playing. While FIRB decisions may well be carefully and objectively considered on their merits, this process is often discounted as decisions and the reasons behind them are not made public. The emotive response of foreign investors seeing negative responses is that Australia is or is becoming an unfriendly place for foreign investors.

There is no better example of the above than the Treasurer's recent rejection of the Chinese-led bid for the large expanses of rural properties held by S.Kidman & Co. Regardless of the merits of the decision, the impact is that Australia is seen to be sending out mixed messages to the world in terms of being an attractive destination for foreign capital.

For further information about overseas investment for property development, please contact your Pitcher Partners representative or Leon Mok.

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ALTERNATIVE FUNDING STRUCTURES

FOR CROWDFUNDING OF PROPERTY INVESTMENTS

By Simon Chun, Partner – Taxation and Tom Splatt, Senior Manager – Taxation, Pitcher Partners Brisbane

In recent times we have seen the emergence of crowdfunding as a legitimate source of funding for innovative businesses. While not traditionally used in large scale property development projects, the increased mobility of private capital as a result of ever more sophisticated crowdfunding platforms creates another viable source of funding. This has given rise to a number of technical and practical tax challenges.

In the first instance, while it may seem like a simple 'peer to peer' transaction, appropriate pricing of loans requires an understanding of the risk associated with the loan, which must, *inter alia*, factor in the credit worthiness of the borrower(s) and the 'enforceability' of the loan as between the borrower and the lender.

In the context of what is normally a 'faceless' transaction, the question is how a borrower can obtain any level of certainty as to:

- The level of risk that the loan will be able to be repaid (i.e. the credit worthiness of the debtor),
- Its ability to recover the funds lent (i.e. the enforceability of the loan contract).

A simple solution to this may appear to be a 'pooling' mechanism, whereby funds accrue in a structure (SPV), with the SPV having a mandate to lend only to borrowers of a particular class of credit worthiness. There are two key weaknesses to this approach in the context of crowd funding:

- It can eliminate the 'instantaneous' element of peer to peer lending that is one of the attractions of the method of funding (i.e. for the lender, while the SPV 'fills' and for the borrower, until there is a 'pregnant' SPV able to lend for that particular class of borrower),
- It can eliminate a lender's ability to be completely selective in terms of which specific asset out of a pool of assets it would like to directly finance, acknowledging that motivations for lending in the context of crowdfunding can often extend to reasons outside of pure risk/reward assessments, and there may be social or environmental considerations that may dictate a lender's decisions as to who to lend money to.

Similarly, although it may not remedy the above-discussed issues, traditional direct loans may not be feasible as it may be unlikely that a single funder would be willing to lend the entire amount that a borrower is seeking for more innovative projects (especially in the context of emerging property transactions). This is due to the risk diversification implications – all eggs in one basket – and the simple economies of scale implications. In other words, it is unlikely that the borrower and lender will be seeking to borrow/lend exactly the same quantum of capital, especially when it comes to the significant capital required in the context of property investments.

While there may never be an entirely perfect solution, the introduction of the new Attribution Managed Investment Trust (AMIT), and as of 3 May 2016 the proposed Collective Investment Vehicle (CIV) under the Federal Budget announcement, may provide more innovative structures that address many of the above-noted issues in the context of crowd funding.

The key advantages of an AMIT and/or a CIV are:

- It enables 'pooling' of funds, whilst also enabling lenders and borrowers to be selective in terms of the class and/or nature of the borrowers and assets subject to the financing transaction.
- It allows multiple classes of investments within a single structure, enabling diversification even within what might otherwise be a loan amount that would not facilitate such diversification.
- If structured appropriately, it may actually allow lenders/investors and borrowers to be very selective in terms of the particular properties the financing relates to and the returns on the financing facility can be matched on a property by property basis.
- It facilitates economies of scale such that appropriate risk management frameworks can be implemented and enforced, and allows for pooling of debt collection/enforceability functions.
- Flow through taxation treatment is still achievable for lenders and borrowers alike.

Accordingly, while it is early days, we are seeing increased viability in the use of an AMIT and/or CIV structure to facilitate strategic funding in the context of property investment. This is starting to create what may be the dawn of a new era in terms of the marriage between lenders (and other more passive property investors) and active property managers and development participants.

If you would like further information about crowdfunding, please contact your Pitcher Partners representative or Simon Chun.

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DEVELOPMENT FUNDING:

WILL SUPERANNUATION FUNDS FILL THE GAP?

MaxCap Group

Business Advisory Partner at Pitcher Partners Melbourne, Andrew Clugston, speaks to MaxCap's Chief Investment Officer and Founding Partner, Brae Sokolski.

Property developers are facing a difficult time when it comes to accessing project funding finance. Despite strong market fundamentals, growing populations, and significant supply being absorbed, our clients are reporting that it has become more difficult to procure debt finance from the major banks than during the Global Financial Crisis (GFC) period.

With such a tight lending environment, developers are being forced to look for alternate sources of funding. We've spoken to Brae Sokolski from leading real estate debt and investment manager, MaxCap Group, to gain insight into the state of the property market in Australia and their thoughts on alternative sources of capital for first mortgage secured funding.

Andrew Clugston: Brae, how are property market conditions looking in Australia?

Brae Sokolski: Well, we're still seeing very strong market fundamentals. The property market in Australia is still healthy – our population continues to grow, and overseas investors continue to see value in the Australian real estate market. Settlement defaults are low, vacancies are down, and rentals are strong. All of the critical data suggests that we aren't headed towards a correction in the near future.

Photo:
FV – Flatiron
147 Alfred Street,
Fortitude Valley, QLD

There's been a lot of rumour about oversupply, and certainly here in Melbourne people point to all of the newly approved and under construction development apartment towers as evidence of a market glut. But it's critical to remember that a lot of supply doesn't necessarily equal oversupply – Australia's capital cities are coming off a very low base in terms of urban density levels compared to similar cites abroad and certainly with Melbourne's population tipped to overtake Sydney's by 2030, the need for housing is set to continue.

AC: So why then are we seeing such a constrained lending market?

BS: It's almost entirely a regulator-driven phenomenon. The Australian Prudential Regulation Authority (APRA) has told Australia's banks that their level of exposure to property sector debt is too high, and so now we see banks really only lending at 50% Loan to Value or up to 65% loan to cost on projects in Melbourne. That's a lot of equity for a developer to stump up on a new development. And we're already starting to see attrition among developers – it's becoming uneconomical for them to develop sites.

The market isn't being left to its own devices, it's really a case of regulators stepping in and saying, "We think property is overvalued, so we're going to decree that Australian bank lenders' portfolios are overweight in property". It's critical to understand that this is not just a challenge for new local and offshore entrants to the development industry. Even established Tier 1 developers are struggling with a lack of access to debt finance.

Add to this the Victorian government's tighter planning restrictions and their imposition of additional surcharges on foreign investors and landowners, and you're starting to see a lot of developers considering exiting the Melbourne market – especially internationals and smaller players.

On the upside, if you're a patient and established developer who can afford to wait, it definitely means there'll good buying and value to be had around the third and fourth quarters of this year.

Photo:
Courtesy of MaxCap

AC: But in terms of economic effects, what are the implications of developers exiting the market due to a lack of funding?

BS: Well that's obviously an issue. APRA's decisions have put the brakes on development and have slowed the growth in housing stock, despite the fact there's still a continuing under-investment in residential developments which has caused a supply problem in major cities at least. If APRA thinks the market is over-valued, and its aim is to take some of the heat out of the market, this is going to achieve the opposite effect. Constraining supply will just keep residential property prices higher for longer.

Our biggest concern though is that with the mining boom slowing off, property has really overtaken as a key driver of economic growth. APRA does not take a broad economic view. They focus on bank capitalisation and aim to prevent banks from being over-exposed to the property sector, but they do not have a holistic position on what happens to the economy if the property market crashes because developers can't access finance.

Although, as I said, market fundamentals are strong. Informed buyers know that lending is tight but they are still investing; they're aware of the risks but the risks haven't really changed in the last 5-7 years. We're really worried about APRA causing a bit of a self-fulfilling prophecy; whereby it's so concerned about a property market slowdown that it essentially causes it by making lending for development more difficult.

AC: So what's the solution? Who fills the void now that banks aren't lending?

BS: Well that's where we like to think we can assist in a small way. Offshore banks lack the infrastructure and commitment to the Australian property market and are only really participants in this market through syndicates with Australian majors, so that doesn't really solve the problem.

Institutional lenders, however, superannuation funds and offshore pension and sovereign wealth funds, are the logical void fillers. We're seeing a lot of interest from North American pension funds and Asian pension and sovereign wealth funds. Super funds in particular are struggling for fixed interest returns; with interest rates so low, bonds aren't providing the steady source of fixed income they once were, so it makes sense to invest in property.

MaxCap essentially acts as an intermediary between these funds and developers. We do all the due diligence and assist financiers who aren't necessarily familiar with the Australian property market in making sound decisions about providing debt finance for developers. We can provide something closer to 60-65% LVR to developers by facilitating this alternative funding avenue.

I'll also share with you the recent example of listed developer PAYCE. We assisted PAYCE in obtaining first mortgage debt finance via funding provided by a large Australian superannuation fund, allowing them to complete an urban renewal project in a public-private partnership with the NSW government.

Superannuation funds in this instance were participating in a space traditionally occupied by banks. It's very encouraging for developers to see this sort of alternate lending in the marketplace, and banks are very supportive of MaxCap as well – as they're at capacity. Everyone in the industry is keen to see some relief solution to the strained debt funding environment.

AC: So it's not as bleak for property as it sounds?

BS: Well, basic supply and demand dictates that players like superannuation funds will fill the void but the issue is the delay. There's obviously a lag between the identification of the need for alternate funding sources and the ability to input capital. And what's the impact on the market while we wait?

It may take a while for further super funds to see the benefit of acting as alternate lenders to the development industry, and for super funds to be successful in this space they'll have to be agile. Our concern is how much impact the constrained lending will cause economic growth and push prices even higher when we already have an affordability crisis.

FUNDING VIA THE BUF

TO AVOID A 'USE BY' DATE ON YOUR PROPERTY ASSETS

By Darren Bilsborough, Chief Executive Officer, Office Space Matters

Can your ageing property assets really be competitive over the long term, or do they represent dwindling returns until they signify land value only? This really is a glass half empty question, so asked in a different way – are happy tenants, increased cash-flow and improved building maintenance all mutually exclusive?

This is definitely one question that every building owner should be asking of their asset and property managers.

Poor performance and disaffected tenants are often the consequences of a poorly maintained building. Too frequently, the upgrade of elderly or redundant plant and equipment is deferred until either complete failure is imminent, or when the inevitable drop off in performance can no longer be tolerated. This drop in performance could either be due to an external impact on a tenant's business through a customer's experience, or an internal impact through decreases in staff productivity and operational efficiency. Both outcomes will most likely lead to increasing tension between landlord and tenant and a poor reputation for the building.

Neither of these outcomes are ideal, so the obvious question is why?

- **Why would a landlord risk the chance that their building's reputation would worsen in an already competitive marketplace?**
- **Why would a landlord risk a reduction to a tenant's comfort levels and to the building's energy efficiency?**

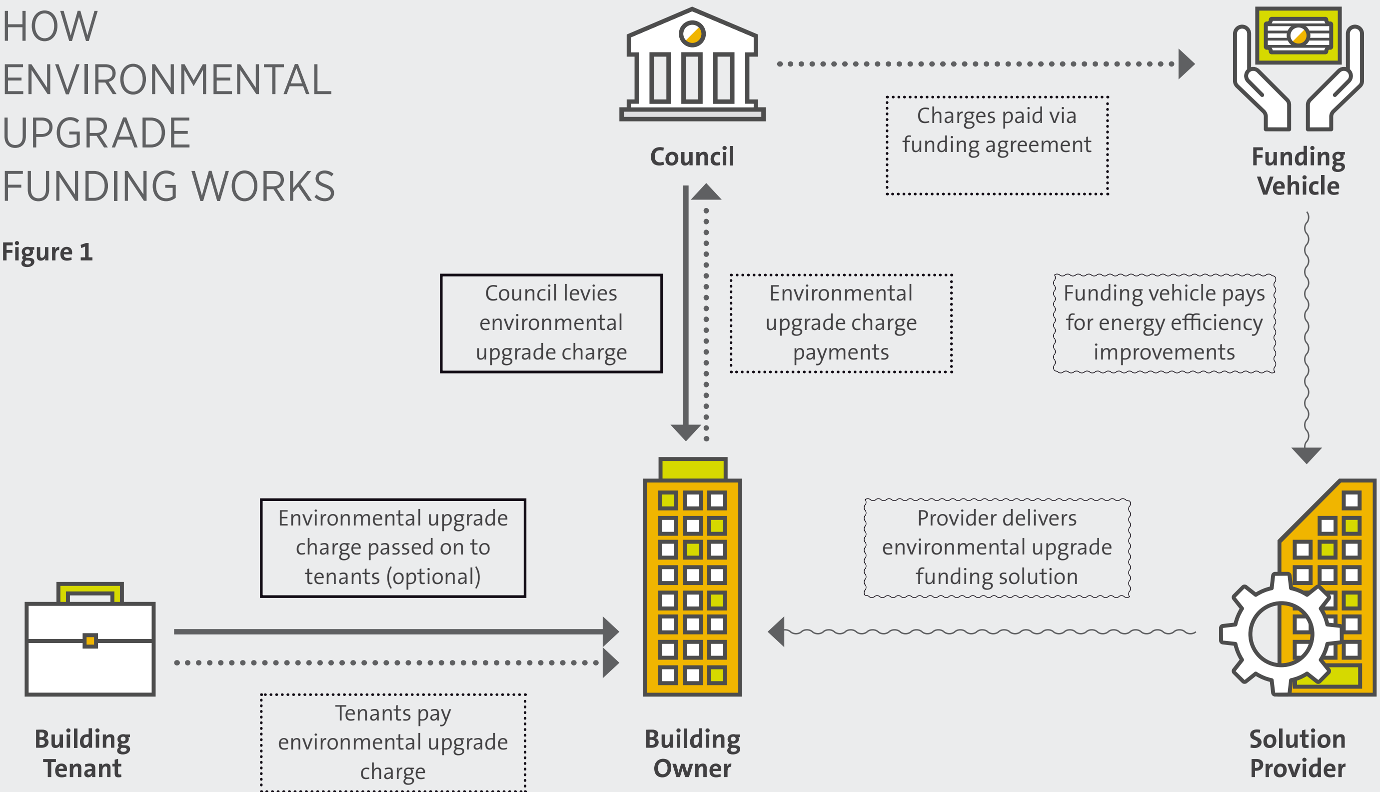
The answers to these questions are twofold:

- Firstly, the landlord normally doesn't pay for the energy costs in the building as these costs are passed onto the building's tenants in the form of outgoings. This is often referred to as the split incentive.
- Secondly, the ability to defer these costs is likely to improve short term cash-flow forecasts and represent the chance to invest capital elsewhere (i.e. no lost opportunity cost).

Each of these outcomes assume that the cost of improved building maintenance and increasing cash flow are mutually exclusive, particularly if you don't take into consideration the effects these issues have on the underlying value of the property asset.

HOW ENVIRONMENTAL UPGRADE FUNDING WORKS

Figure 1



New legislation has recently been introduced into South Australia (and is already in effect in NSW and Victoria) that overcomes these issues. This legislation is called Building Upgrade Finance (BUF) and uses a financial instrument known as an environmental upgrade agreement (EUA).

So, how is this possible and what is an EUA?

An EUA is a market-driven mechanism designed to make it easier to access finance for building upgrades that incorporate an environmental outcome, including energy efficiency improvements, for existing commercial, retail and industrial buildings.

Under EUAs, a finance provider lends funds to a building owner for the building upgrade and this low-risk loan is repaid through a local council special charge on the land – similar to normal council rates. This special charge can then be levied against the tenant as part of their outgoings, provided that the charge is never greater than the amount of savings that are generated through the upgrade or unless otherwise agreed to by the tenant, and represents an additional income stream to be used to pay off the EUA debt. The mechanism therefore provides building owners the opportunity of increasing cash flow benefits whilst also accounting for necessary building expenditure. See Figure 1.

The key to tapping into the benefits provided by an EUA, for building owners and their tenants, is their ability to access the right expertise and quickly develop a deep understanding of any given building's current operational limitations and therefore upgrade potential.

The obvious place for this expertise to reside is within your property management and maintenance contracting teams, and this is where Pitcher Partners are able to partner with your teams, and assist them in overcoming any perceived complexities they may have with the EUA mechanism. This will allow both landlords and tenants to get together and agree on solutions that will result in a better performing building.

The end result will be a desirable property with increased cash-flow and improved medium to long term asset value.

For further information about Building Upgrade Finance, please contact your Pitcher Partners representative or Darren Bilsborough.

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Scan here for a copy of Darren's e-book, "Don't Worry About the Rent: Choosing new office space to boost business performance"

SOCIAL IMPACT BONDS:

THE 'PAY FOR SUCCESS' FUNDING MODEL

By Ben Brazier, Principal – Private Clients Group, Pitcher Partners Adelaide

Social Impact Bonds (SIBs), also known as Social Benefit Bonds, are one of the fastest growing social impact investment products, having been launched by Social Finance UK in September 2010. Since then, 44 SIBs have been raised worldwide, including two in Australia. Pitcher Partners Adelaide is currently involved with Not for Profit (NFP) organisations who in the preliminary stages of using SIBs to fund social housing projects.

What are Social Impact Bonds?

A Social Impact Bond (SIB) is a form of finance designed to raise capital for projects which address pressing social needs. In some cases, the existing social services do little to address the underlying causes of the problem and the government lacks the resources for long-term funding to create real solutions for these problems.

In this 'pay for success' model, private investors provide capital to service providers to projects that achieve agreed social outcomes. If those outcomes are achieved, investors are repaid according to the savings the government accrues as a result of the success of the program, along with a dividend. If outcomes do not eventuate, the investors do not receive a return on their investment (see Figure 1).

With increasing pressure on governments to provide funding for a broad range of initiatives, SIBs are one way to reduce initial government spending and therefore financial outlay. This contrasts with the traditional philanthropy model where the money is spent once and is gone; under this model, the money comes back and can be reinvested into the program for future investment.

The advantages of this funding model are:

- Innovation to address pressing social needs
- Focus is on outcomes rather than actions
- Provides extra resources for other programs
- Re-allocates risk
- Accountability and transparency

How are Social Impact Bonds used in the Property Industry?

Some NFP organisations in the property industry may be eligible to fund social impact projects using SIBs. In Richmond, California, for example, an SIB for US$3 million was recently announced to refurbish over 800 abandoned homes to make them suitable for first-home buyers at an affordable price, helping to solve a housing problem in the area.

Are SIBs successful?

One of Australia's first SIB experiences was in New South Wales, where UnitingCare Burnside and Social Ventures Australia worked with the NSW government to develop the Newpin SIB to the value of $7 million. In the first two years of operation, Newpin was able to achieve the defined targets, with investors receiving a 7.5% return in the first year and an 8.9% return in the second year of operation. Further success of Australian projects is coming to light as more organisations take on this funding model.

Continually improving measurement tools assessing the success of social impact projects could lead to a greater participation in SIBs as a funding model. For example, some super funds have begun to express an interest in supporting investments of this type, given the right criteria.

There is certainly an appetite in Australia for SIBs, and with an increasing number of social organisations looking for funding to achieve social outcomes, SIBs could be a viable funding model for their future projects.

If you would like more information about Social Impact Bonds, please contact your Pitcher Partners representative or Ben Brazier.

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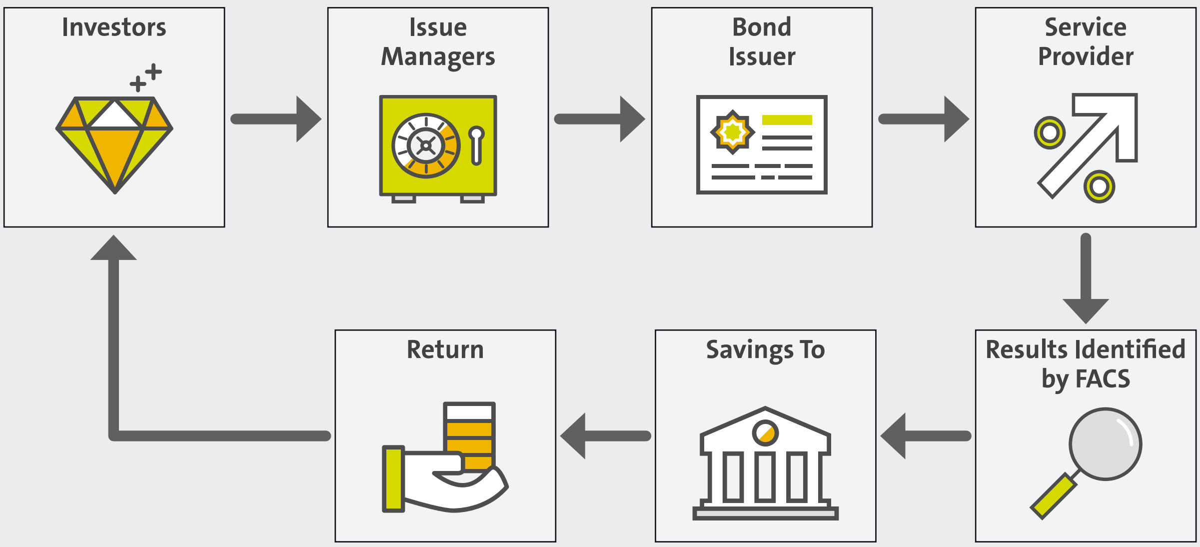
HOW SOCIAL IMPACT BONDS WORK

Figure 1



FUNDING PROPERTY INVESTMENT

THROUGH UNLISTED PROPERTY TRUSTS

By Brendan Jones, Partner – Private Clients Group, Pitcher Partners Sydney

With banks tightening their lending criteria in property markets it has become increasingly difficult for individual investors to find the equity to directly acquire property assets.

Unlisted property trusts provide a mechanism for investors looking for exposure to commercial, industrial and retail property to participate in ownership of such asset classes when they may not have the financial capacity to invest directly themselves.

Unlisted property trusts, also called funds, syndicates or schemes, are an alternative way to invest in property. Investors buy 'units' in a trust holding investment property or properties, which are managed by a professional investment manager.

Generally the initial capital remains invested until the property asset(s) is sold when the trust ends, and any net proceeds are distributed among the investors. Throughout the life of the trust, investors also receive income distributions that are paid at set intervals (e.g. monthly or quarterly).

Investment properties are chosen by the investment manager and bought by the trust. The investment manager then manages the associated maintenance, administration and rent collection. The property classification could be commercial, retail, industrial or some other class.

Gearing levels in unlisted property trusts tend to be modest (by comparison) and therefore fit more reasonably within the banks appetite for lending in the current environment.

There are various factors that investors should consider when assessing a potential investment in an unlisted property trust:

- **Investment strategy**. What is the fund's investment strategy? Does it match your income and/or capital growth needs?
- **Gearing**. A loan to value (LVR) ratio of between 30 and 50 per cent is considered reasonable, while funds that are more than 50 per cent geared should be examined with greater scrutiny.
- **Loans**. Are there any risks associated with the maturity of the loans taken out by the trust or interest cover ratios?
- **Fees**. Fees should be based on net, not gross assets, which prevents managers being rewarded for increased gearing. Even so, is the performance fee based on a reasonable hurdle?
- **Asset quality**. Look for trusts invested in long leases with strong tenants to ensure quality cash flows.
- **Valuations**. How and when does the fund value underlying assets? Is it done by an independent third party? This information should be disclosed in the Product Disclosure Statement.
- **Related party transactions with family, friends or associates**. The manager should disclose arrangements relevant to investment decisions.
- **Net Tangible Assets (NTA)**. How is the manager calculating NTA on day one? Are acquisition costs being capitalised or written off?
- **Quality and frequency of reporting**. What information does the manager provide to investors on an ongoing basis?
- **Distributions**. Are they being paid from operating cashflow or being artificially supported from unrealised revaluation gains, capital or additional borrowings?

Pitcher Partners have many clients who have invested in unlisted property trusts and we also act for numerous Fund Managers.

If you would like more information about unlisted property trusts, please contact your Pitcher Partners representative or Brendan Jones.

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