

Essential Guide to Investing in Unlisted Property Trusts

JUNE 2019



CROMWELL
FUNDS MANAGEMENT

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CHAPTER 1

Introduction

Property is one of the favoured investments of Australians due to its potential to provide both income and capital return. Substantial wealth has been built on the back of the increase in the value of Australian property over the last 30 years, and many Australians see property as a key tool in achieving their financial goals. The relatively low volatility of Australian property compared to shares is another strong attraction.

Most Australians achieve their exposure to property solely through residential property, with only a small number having commercial property investments. While we all understand the value of diversifying our share portfolios across a number of different companies and market sectors, we don't often do this when investing in property.

Diversification can help lower an investor's overall risk level whilst increasing potential returns as changes in the value of residential and commercial property are not directly correlated and the income returns of these two asset classes can be quite different.

Over the last five years, commercial property has achieved an average (annualised) total return (inclusive of income and growth) of 11.5% p.a., 9.7% p.a. over the last ten years, and 10.4% p.a. over 15 years, up to March 2019, according to the MSCI Australia All Property Index (which is published by MSCI's analysis of over 1,444 Australian commercial properties).

The 15-year performance is particularly strong and is inclusive of the global financial crisis (GFC), where property took the brunt of negative investor sentiment and volatility. Furthermore, the current average income return for commercial property is 5.4% per annum (as at March 2019), making it an appealing option for income-hungry investors.

This guide briefly examines the differences between residential and commercial property and also looks at different types of commercial property and the possible ways to gain exposure.

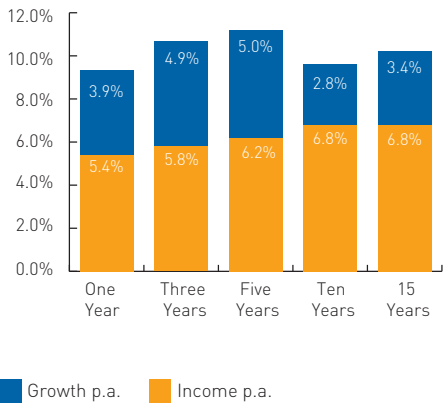
The primary focus, however, is on one particular method of achieving exposure to commercial property – by investing in unlisted property trusts. Unlisted property trusts provide

an easy way for you to invest in professionally managed commercial property, or properties, which, if chosen wisely, can produce stable monthly income and capital growth over the term of the investment.

There are risks when investing in property just as there are in any type of investment. Throughout this guide, the major risks will be discussed

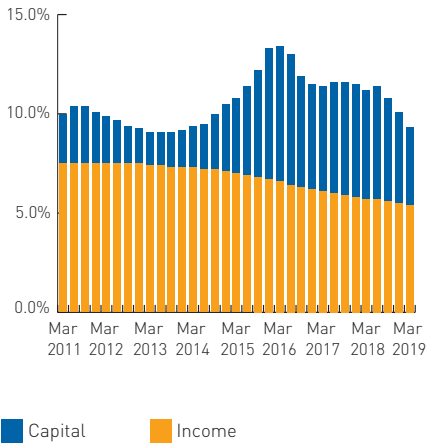
with the aim of assisting you to understand how to invest in property. Finally, remember that all property investments should be considered over a medium to long timeframe of five years or more.

Property growth and income history



PCA/IPD Australian All Property Digest (Source:MSCI) as at 31 March 2019

Commercial property total annual returns (%)



PCA/IPD Australian All Property Digest (Source:MSCI) as at 31 March 2019

CHAPTER 2

The different property asset classes

Property is an asset class that is usually separated into two distinct groups:

01

Residential property

This can include your own home, holiday home and residential investment properties; and

02

Commercial property

Which in turn has a number of sub-classes:

- 2.1 Retail property
- 2.2 Office property
- 2.3 Industrial property
- 2.4 Specialist property

1. Residential property

Residential property is the most commonly held type of property investment. This is due, in part, to familiarity as most investors would also be home owners and because residential property allows investors to own and control the investment themselves, with the process generally well understood.

Whilst longer-term investors in Australian residential property have generally achieved strong returns, just like any other investment, it is still possible to lose money, especially when low-income yields and the substantial costs of investing, such as stamp duty and agent fees, are taken into account.

The ongoing cost of owning a residential investment property, both financially and in time is often underestimated. Rates, insurance, land tax, ongoing maintenance and capital works add up, and if a professional letting agent is not used, substantial time can often be devoted to the ongoing management of tenants and the asset.

Investors also tend to have portfolios that lack sufficient diversification,

with many only holding one or two properties, often in the same town as their family home. This lack of diversification further increases their risk of capital loss, especially when property values drop.

Residential property investments generally provide a low-income yield, often lower than the cost of borrowings associated with the property – which makes them negatively geared. Whilst negative gearing may generate a tax loss that can potentially be offset against other income, any loss still needs to be recovered before a profit is made.

Even an investor on the highest marginal tax rate can only recover less than 50% of any losses against other income tax payable, meaning that to recover the other 50% they must first earn that amount in capital gains before they start to generate a

positive return on their investment. Generally, therefore, investors in residential property are reliant on strong capital growth to make a profit on their investment.

2. Commercial property

The fundamental difference between commercial and residential property is that commercial properties are usually valued based on the income return they will provide to an investor, which is known as the capitalisation rate (often shortened to 'cap rate') or yield.

For example, if an A-grade office building typically trades at a cap rate of 7% at a given point in time, then the market value will be calculated using the formula: $\text{income} / \text{cap rate} = \text{value}$. So, for a building generating an income of \$1,000,000, its theoretical value would be \$14.3 million (i.e. $\$1,000,000 / 7\%$).

CAP RATE

The capitalisation rate, often abbreviated to 'cap rate', is the net income of a property divided by its value, which reflects the percentage return the market is prepared to accept for the property at a specific point in time.

The value is also affected by factors, including the lease terms, quality of tenant and other building attributes.

Management expertise is an essential consideration with commercial property, as there are undoubtedly more issues to address compared to residential property. Tenants, particularly government or large corporate tenants, have specific and often complex needs which may extend to how their leases are structured to ensure better funding or tax outcomes.

Compliance requirements, such as Occupational Health and Safety are a significant burden to commercial property owners and understanding the applicable regulations and associated costs is essential. For these reasons, most commercial property owners use professional property managers, which, as discussed later, should be a core part of a property fund manager's business.

2.1 Retail property

Retail property is a broad sector covering small suburban shopping centres all the way up to large shopping malls. They generally have

the lowest yields of the three major classes of commercial property. Larger, well-located malls tend to have the lowest yields whilst smaller, less fashionable or less well-located malls have higher yields.

As you can imagine, ongoing capital expenditure (referred to as 'capex') can be significant for retail property, because to continue to attract customers for your tenants and therefore maximise rental income, retail properties need to be maintained to a high level.

Retailers may also be impacted by economic factors, shopping trends, location and tenant mix issues, which can all have significant impacts on patronage.

2.2 Office property

From a yield perspective, office property sits between retail and industrial property. There is, however, a substantial difference in the yield you would expect to receive from a premium-grade building (low yield) compared to a C or D-grade building (high yield). Other factors which can affect yields include the location of the property, the tenants and length of lease.

Premium-grade property is not necessarily a better investment than a lower grade building. However, it does tend to attract more financially secure tenants, which lowers the risk for investors. As office buildings are rarely located in isolation, it is important to review the supply and demand characteristics of the area in which the property is located to ensure long-term demand for your building.

In recent years, government and blue-chip tenants have increased demand for newer, environmentally-sustainable office buildings. This is a vital consideration when assessing the long-term outlook for office properties.

2.3 Industrial property

Of all the commercial property segments, industrial property (which includes manufacturing as well as logistics or distribution centres) has the lowest barriers to entry. New industrial properties are usually quick and reasonably cheap to construct. The land they are located on has historically been outside major cities and often has limited capital growth potential, unless rezoning changes the dynamics of the area.

For these reasons, industrial property generally provides the highest income yields of the three core commercial property classes. But the risk of obsolescence when a tenant vacates a purpose-built facility means it's especially important that detailed due diligence has been done on any industrial property purchase.

2.4 Specialist property

Included in this sector are retirement living villages, hospitals, aged care facilities, medical centres, storage centres, pubs, hotels and childcare centres. These types of assets tend to require intensive management by a specialist manager. Property management often equates to operational management of the business, so you need confidence the manager, or in some cases a third-party business, has the appropriate skills and the underlying business model is strong.

As properties are generally purpose-built, there is a significant risk that if the existing tenant leaves, the owner may be left with a property that is difficult to lease without substantial capital expenditure or downtime.



OFFICE BUILDING QUALITY

Office buildings in Australia are classified under a voluntary, market-based system developed by the Property Council of Australia (PCA).

The PCA's Guide to Office Building Quality provides two classification tools – one for new buildings, and the other for existing buildings.

The Guide classifies office buildings into grades – Premium, A, and B for new buildings and additional C or D grades for existing buildings – according to their size, design, configuration, environmental performance, location, communications, security, lifts, air conditioning, other services and amenities.

To earn a Premium classification, a new building would need to be a landmark office building located in a major CBD office market with expansive views and outlook, ample natural light, premium quality finishes and amenities, and a 5-Star or above National Australian Built Environment Rating Scheme (NABERS) Energy rating. It would also need to have a minimum net lettable area (NLA) greater than 30,000 square metres (sqm) if in Sydney or Melbourne.

The criteria to earn a Grade A classification is less stringent, but still requires a building to have high quality views, lifts, finishes and amenities, a 4.5-Star or above NABERS Energy rating and a NLA over 10,000 sqm if located in major capital CBDs.

B-grade buildings are required to be 'good quality' with a minimum 4-Star NABERS Energy rating.

Existing buildings are rated on slightly different parameters with additional categories for C and D-grade buildings. The ratings acknowledge that existing buildings will not be as energy efficient as new buildings but reward owners and tenants for taking steps to improve efficiency.

CHAPTER 3

Various ways to invest in commercial property

Direct investment

Purchasing a property directly yourself, with or without borrowing, is commonly used for residential property investment. For commercial property, however, this is usually only an option for very wealthy investors. Unless you are fortunate enough to be in this category, this is not a realistic method of gaining exposure to commercial property for most investors, and having any diversification is even more challenging.

Private syndicates

Sometimes a group of investors get together (either privately or with the help of a manager) to pool their money and buy a property. In this case, there may be limited legal agreements and professional involvement around the choice of assets and their management.

This type of investment generally requires a substantial level of investment by each investor and may or may not include borrowing. Often there is no way to exit your investment unless you can find another buyer or the property is sold. Again, unless you have a large amount to invest,

the property type is limited and diversification is difficult to achieve.

Pooled professionally-managed property trust

A property investment can be made through a professionally managed investment trust, which is regulated by the Australian Securities and Investments Commission (ASIC). In Australia, there are two major types of property trusts: ASX-listed Real Estate Investment Trusts (A-REITs) and Unlisted Property Trusts.

There are several benefits that investors gain from using professionally managed trusts:

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- ✓ Investors' funds are pooled, providing access to assets they could not otherwise purchase individually, such as large office buildings or major shopping centres;
 - ✓ Internal gearing is non-recourse to investors, which means that if there is a default, the issuer of the debt (usually a bank) can seize the collateral but cannot seek out the investor for any further compensation. This reduces the risk to each individual investor and
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makes them available to self-managed super funds;

- ✓ Regular income stream, with distributions ranging from monthly to six-monthly payments;
- ✓ You get to share in any capital growth, proportional to your holding in the trust;
- ✓ Opportunity for tax advantaged income, potentially increasing your after-tax return;
- ✓ Professional management, which covers due diligence, debt, property and tenant management;
- ✓ Liquidity, depending on the structure used; and
- ✓ Only a small investment is required, allowing you to diversify your investment funds across properties and managers.

ASX-listed Real Estate Investment Trusts (A-REITs)

ASX-listed property trusts used to be called listed property trusts, but are now known as A-REITs. They invest in a wide range of commercial property types and can be traded just like any other share. The wide variety of A-REITs available, the large

asset diversification generally within each A-REIT, and their high level of liquidity are strong positives.

Whilst each A-REIT generally offers exposure to a number of properties in the one investment, these can change over time as the manager looks to improve the portfolio.

A-REITs can be traded on the stock market like any other share. Therefore, their value moves with market sentiment, and the price does not necessarily always reflect the underlying value of the property assets or any change in value of the assets. These market movements can also cause the value of the investment to be more volatile than a direct property investment.

Another issue that came to the fore during the GFC is that many A-REITs are not simply property investments, but are 'stapled' to a management company, meaning that when you purchase most A-REITs you are buying both commercial properties and a business.

Unlisted property trusts

Unlisted property trusts provide an investment with characteristics most like a direct purchase of a commercial property, with the added benefit of professional management. As unlisted property trusts are generally priced based on the underlying valuation of their assets, their price volatility is a lot lower than A-REITs and the value of the investment is primarily influenced by movements in the commercial property market, rather than by the broader share market.

There are two types of unlisted property trusts:

i. Open-end property funds

Open-end funds don't have a maturity date or a finite number of units. Instead they can continue to issue units so long as they raise money, using the new funds to purchase additional properties.

As there is no specific maturity date, to allow investors to exit the investment they must offer some other method of liquidity. Liquidity is usually provided by holding a portion of the fund's assets in cash; using new investors' funds to pay out

exiting investors; or, selling assets if necessary. This can allow investors to exit at regular intervals.

As with A-REITs, these funds tend to have a number of assets to increase diversification, but it is at the manager's discretion to buy or sell assets, so investors do not have certainty over the properties they are investing in.

ii. Fixed-term, closed-end property trusts (often referred to as syndicates)

Syndicates contain one or more properties that will be held for a specified period of time, usually five to ten years. At the end of the specified time, investors will vote on the future of the trust, with the default outcome usually that the property be sold, the trust wound up and investors paid out. Syndicates should be considered illiquid investments and you need to have an expectation that you will remain in the investment for the full investment term.

Market volatility dramatically increased investor interest in simpler syndicate investment vehicles post the GFC. Syndicates provide a strong proxy for the direct purchase

of commercial property. They are generally fairly easy to understand and you know for certain which property/properties will be owned. As such, if you don't like the property you simply don't make the investment. Managers are also striving to make the structures of these vehicles as transparent as they can.

Single-property syndicates don't provide any diversification on their own, but because the minimum investment is generally as low as \$10,000, you can combine investments in a number of syndicates to provide diversification

by property, location, sector and manager. Ideally, you would also choose syndicates with different maturity dates, so you are not reliant on the property market being strong at a given point in time.





TAX ADVANTAGED INCOME

For tax purposes, a managed property fund's distribution often includes a component of 'tax deferred' or 'other non-attributable amounts' (collectively referred to as 'tax advantaged distributions'). This component has the potential to increase the investment's after-tax return.

Tax advantaged distributions represent a distribution of non-assessable income arising because a trust's rental income is generally higher than its taxable income. This is due to the trust's ability to claim tax deductions for items such as depreciation, capital allowances and the costs of raising equity and establishing debt facilities.

Unitholders are not normally assessed on tax advantaged income at the time received. Rather, unitholders adjust for tax advantaged distributions when calculating the cost base of their units for capital gains tax purposes. This can 'defer' the payment tax until unitholders pay capital gains tax, normally at the time of disposal of their units. Depending on a unitholder's situation, the benefits of receiving tax advantaged distributions can include:

- There may be a timing benefit as the component of the distribution that may otherwise be taxable can be reinvested. The compounding benefit from reinvesting this amount could be significant over time.
- Rather than being fully taxed as ordinary income at your marginal tax rate, tax should usually be payable on the component under the capital gains tax regime. There may be a permanent tax saving if you hold units for more than one year and apply the 50% discount for individuals, or by the 33⅓% discount for superannuation funds.

TAX ADVANTAGED INCOME CASE STUDY

The case study below shows the effect of being attributed tax advantaged distributions for an investor on the top marginal tax rate (inclusive of the 2% Medicare levy). The case study compares a hypothetical investment of \$100,000 into an interest-bearing investment earning 8% per annum with a property investment paying 8% distributions.

	ABC Interest Investment (\$100,000 initial investment)			XYZ Property Investment (\$100,000 initial investment)			Difference
Year	Interest	Tax Payable	Net Income	Distribution	Tax Payable	Net Income	
Year 1	\$8,000	\$3,760	\$4,240	\$8,000	-	\$8,000	\$3,760
Year 2	\$8,000	\$3,760	\$4,240	\$8,000	-	\$8,000	\$3,760
Year 3	\$8,000	\$3,760	\$4,240	\$8,000	-	\$8,000	\$3,760
Year 4	\$0	\$0	\$0	-	\$5,640 ¹	-\$5,640	-\$5,640
TOTAL	\$24,000	\$11,280	\$12,720	\$24,000	\$5,640	\$18,360	\$5,640

As you can see, an investor on the top marginal tax rate is \$5,640 better off over the three-year investment period, equivalent to approximately a 44% improvement in the after-tax returns, and a better cash flow profile under the capital gains taxation regime. This calculation is shown below.

- 1 Capital gain = \$100,000 capital redemption less reduced cost base of \$76,000 [\$100,000 initial investment less \$24,000 tax deferred distributions = \$76,000] = \$24,000. Tax payable = \$24,000 x 47.0% x 50% = \$5,640.

Assumptions used in the case study:

- a. The property trust pays tax advantaged distributions.
- b. An investor invests \$100,000 into XYZ Property Investment (for example, an unlisted property trust) on 1 July of year one at a cost of \$1.00 per unit (XYZ Investment).
- c. The XYZ Investment is redeemed after three years at a unit price of \$1.00. No allowance has been made for any potential capital gain or loss from unit price increases/decreases during the period the investment is held. This would also have CGT implications.
- d. Distributions from XYZ Investment are declared 100% to be tax advantaged distributions for the full period of the investment.
- e. XYZ Investment distributes 8.0 cents per unit per annum.
- f. The investor does not have any capital losses available to offset gains.
- g. The tax rate used of 47% consists of the top marginal tax rate of 45% plus Medicare levy of 2%.

The above commentary and case study has been prepared for general information purposes only and should not be relied upon as tax advice. An investment into property trusts can give rise to complex tax issues and each unitholder's circumstances will be different. As such, we recommend before taking any action, that you consult your professional tax advisor for specific advice in relation to the tax implications.

The manager and disclosure documents

Unlisted property trusts can only be offered by ASIC-licenced managers, who are called the 'Responsible Entity'. ASIC issues the manager an Australian Financial Services (AFS) licence. The manager has a fiduciary duty to act in the best interests of investors, including prioritising the interests of unit holders over their own interests.

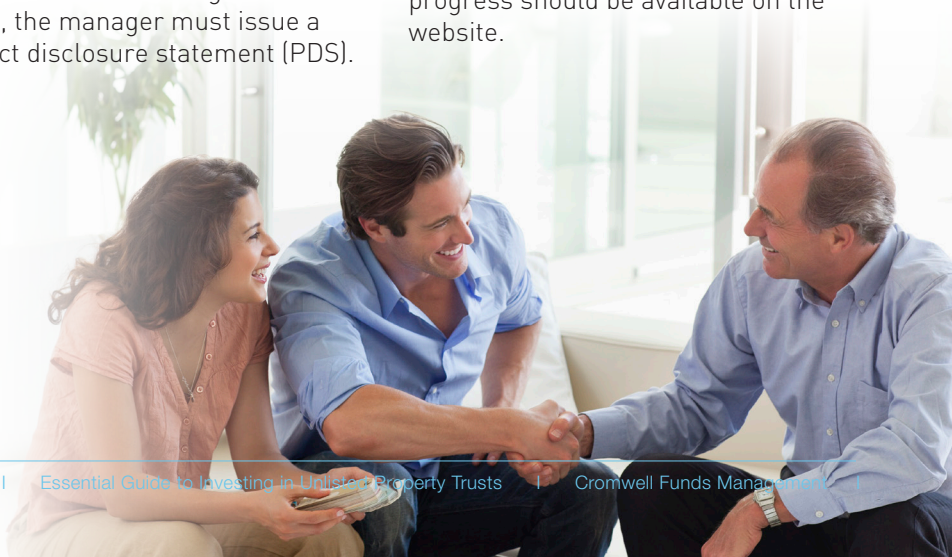
The vast majority of fund managers are licenced to give 'general advice' only. This means that they can provide you with factual information about their product in their documents or in communications with you, but they are not licenced to provide any advice specific to you or your situation.

To offer the trust to the general public, the manager must issue a product disclosure statement (PDS).

The content of a PDS is governed by legislation and ASIC regulations, through which ASIC can force a manager to withdraw their PDS if it is found to be lacking in information or is potentially misleading.

Managers must clearly include in their PDSs the ASIC Disclosure Principles linked to ASIC Regulatory Guide 46. These set out eight disclosure principles which, if followed, ASIC believes will help investors understand, compare and assess unlisted property trusts.

Whilst the majority of information on the trust will be contained in the PDS, there will most likely be further information contained on the manager's website. For example, for an investment that includes a building project, updates on the building progress should be available on the website.



CHAPTER 4

How does an unlisted property trust work?

The structure

Unlisted property trusts are unit trusts. This means when you invest, you are issued a number of units proportional to your holding. A trust structure is used as it preserves the ability for you to access capital gains tax discounts.

The unit structure also allows investments to be potentially redeemed, sold or transferred depending on the individual trust's setup. In particular, assuming it is a widely-held trust (which the majority of publicly-offered unlisted property trusts are), then, within limits, units can be sold or transferred with no stamp duty payable. This is significantly different from a private syndicate or directly-owned property when usually stamp duty is imposed on a transfer.

Issuance of units

Fixed-term trusts

A fixed number of units are issued (usually at \$1.00 each). The capital raising is completed when the full cost of the property, plus fees and costs less any borrowing, has been raised.

Open-ended trusts

An open-ended trust continues to raise funds indefinitely so long as it can keep purchasing properties. Units will be issued based on a unit price, with the unit price based on the value of the properties. Unit pricing policies and frequency of issue will depend on the manager and fund.

Borrowings

A key advantage of the trust structure is that all borrowing is entered into by the trust and not by the unitholders. This means that the loan is non-recourse to the unitholder (i.e. you can't be asked to pay more than the cost of your units). It also provides an easy way for a self-managed superannuation fund (SMSF) to gain access to geared property without the SMSF having to go through the costly and complex process itself.

As part of arranging borrowing for the trust, the manager may also enter into hedging (fixing the interest rate) for all or part of the loan to provide debt security and more certainty of future distributions for the trust.

Property management

A key reason for using an unlisted property trust is gaining the expertise of a manager not just of funds, but also of properties. The best property fund managers have an internal property management division which looks after the buildings in the trusts it manages. Having this function in-house ensures an alignment of interests between the parties.

External property managers are often used in the industry, but they may look after a number of properties owned by different owners in the same area. What is going to make them prioritise your building in terms of leasing opportunities or allocation of resources?

Property management includes leasing, ongoing maintenance of buildings, building concierge services, fire safety and other compliance requirements and – most importantly for you as an investor – making sure rent is collected! You will pay for these services, but they will already be taken into account in the forecast distribution rates in whichever trust you choose to invest in.

Costs and fees

The trust will generally be charged acquisition fees, ongoing management fees, property management fees and various other fees by the manager depending on the individual trust, its assets and structure. The trust is also likely to pay stamp duty for the acquisition of properties plus legal and other costs.

As an individual, you will not pay these fees and costs, and any returns forecast will also take these fees in account. ASIC requires all managers to display their fees and costs in a consistent format in the PDS, which makes it easy to compare the fees associated with various unlisted property trusts.

You need to remember that if you invest via an adviser, they may also charge you an entry fee, which must be disclosed to you. While this may be processed by the manager, it is not a fee paid to them.

Distributions

The trust will receive rental payments from tenants and this is passed on, less any expenses, to unitholders as distributions on a regular basis.

Depending on the trust, distributions may be paid monthly, quarterly or six-monthly.

Exiting your investment

Fixed-term trusts

These are essentially illiquid throughout their term unless you or the fund manager can identify someone to purchase your units. At the end of the trust's term, the property is sold, the trust wound up and investors paid out proportionately to the units they hold.

Open-ended funds

Each open-ended property fund will have a different liquidity mechanism, but as the underlying property assets are illiquid, the ability to exit the fund will have limitations. Common ways of providing some liquidity is to hold some of the fund's assets in cash, using cash from incoming investors to pay out outgoing investors or, if demand is high and market conditions allow, selling assets.



CHAPTER 5

Reviewing an unlisted property trust

The manager of an unlisted trust provides you with a lot of information about the trust and its assets in the PDS, so make sure you read it and understand it. In particular, ensure you have read the 'Risks' section.

Useful tools for investors comparing property trusts are independent research reports. Prepared by organisations that have no link to the fund manager, such as Lonsac, Zenith or Standard & Poor's, these reports provide a detailed review of the trust and its assets.

The analysts who prepare these reports have experience in property markets and understand trust structures. They review the trust, its properties, the financial models, and the manager's processes. The researchers aren't always going to get it right, but can investigate a trust and a manager in a far more detailed way than most investors can.

Due to research reports often being construed as 'advice', they are often not allowed to be shared with direct investors. However, if you use a financial adviser, they should be able to get a hold of any research conducted on a trust and assess whether the product fits your

objectives, financial situation and needs. You should feel comfortable in calling, emailing or writing to the manager to ask any questions you may have or to ask for information in the PDS to be clarified.

The manager

The manager is critical when choosing a property trust. These are the people and organisations you are relying on – and paying – to carry out appropriate due diligence on the property asset, to build and manage the trust, and usually to physically manage its assets.

In reviewing the manager, you should consider their experience and past performance, and ask yourself the following questions:

- Has the manager managed properties, tenants and trusts like the one you are considering?
 - Do they have in-house property management skills?
 - Is the manager financially secure?
 - What compliance processes do they have in place?
 - Do they seem transparent and prompt in giving you information?
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- If they seem unwilling to provide you with information when they're trying to sell a product, what chance will you have once you've invested?

Distribution yield

The distribution yield is the income you can expect to receive for every \$1 of investment (e.g. a dividend yield of 6% per annum means you can expect to receive 6 cents per year for every \$1 invested). Questions to ask include:

- What level of distributions are forecast?
- Do the forecasts seem reasonable?
(For example, do they require unleased areas to be leased or rents to increase significantly? Are they sustainable, being paid out of real rental earnings rather than a distribution of capital?)
- What level of tax deferral is available? Remember, tax deferral can substantially increase your after-tax returns.

Independent research reports can be very helpful when reviewing distributions.

The property asset

When reviewing the buildings in a trust there are a number of things to consider:

- **Location** – We all know the maxim 'location, location, location' in terms of residential property, and it applies equally in commercial property. However, you need to think in terms of the asset type and tenant needs. For example, for industrial property an ideal location is on a major access road, potentially with easy access to a port or airport. For an office building, accessibility to public transport and being in the 'right part of town' is important. What level of vacancy currently exists in this location and are there a lot of new buildings about to come on the market?
- **Building quality** – What sort of capex is required and has it been budgeted for in the financial forecasts? Is the building suitable for the area and the type of tenant it has or is trying to attract? A property that needs a lot of work to gain new tenants can provide potential good upside, but also carries substantial levels of risk

and is unlikely to be an appropriate choice if you are looking for a secure income stream.

- **Growth** – Is there opportunity for capital growth? Is the property being purchased at a cap rate that is appropriate for its lease profile, quality and location? Is it in a growth area?

- **Tenants** – Who are they? Are you confident they will be around for the life of their lease and pay their rent? Generally, government tenants (federal or state) are the most preferred, with blue chip corporates next most favoured.

- **Lease** – Is the rental rate market or is it 'over-rented' (at a rate higher than market levels for this type of property in this location)? Whilst it sounds good to be getting a level of rent higher than market, this presents an issue if the lease expires or a market review results in the income dropping suddenly. Does the agreement have regular rental reviews and are they inflation-linked, at a fixed rate or market reviews?

- **Lease term** – How does the lease term compare with the term of the trust if fixed-term? Ideally for a fixed-term trust, the lease term will be longer than the term of the trust, as this ensures security of income stream throughout the term of the trust. If the lease term is substantially longer it will help the value of the property when it comes time to be sold.

- **Green credentials** – Even if you don't care about the environmental impact of your investment, you should consider the green credentials of the property from a financial perspective, particularly if you are looking at office property. Commercial buildings are now rated under the NABERS (an ongoing energy, water and waste usage rating) and Green Star (a green design rating) schemes.

These ratings are becoming increasingly important, with government and many large corporates considering the ratings when leasing space. This means if your property doesn't meet sustainability expectations, you could be limited in who you can lease it to.

NABERS

The National Australian Built Environment Rating Scheme (NABERS) is a national programme designed to rate a building's operational performance against environmental benchmarks. NABERS is available for office buildings, hotels and shopping centres. It currently measures the operational impacts on the environment in the areas of energy, water, waste and indoor environment quality.

The NABERS waste from the operation of an office building is benchmarked on a rating scale of zero to five stars, with five indicating market leading performance emissions and zero meaning very poor performance. The NABERS Indoor Environment, Energy and Water benchmark measures performance using a rating of zero to six stars with, six stars rated as market leading performance and zero rated as very poor performance.

Trust structure

- Is the trust fixed-term or open-ended?
- If it is fixed-term, are you willing to invest for the full term?
- What happens at maturity?
- If it is open-ended, how is liquidity provided?
- How are units priced?
- As part of the pricing, how are properties valued (independent or directors' valuations) and how frequently?

Fees

What fees and costs will you be paying?

Unlisted property trusts provide you with access to professional management so you will have to pay some fees but they should be in line with market levels. ASIC has a standardised fee section for PDSs, which makes comparing trusts quite easy.

Net Tangible Asset (NTA) per Unit

What is the NTA per unit at the time of investment?

It will likely be less than \$1 per unit (assuming the unit price is \$1) as there are costs associated with setting up the trust, including stamp duty, acquisition and manager's fees. As the property value increases and start-up costs are paid, the NTA should improve. The NTA is a reflection of the asset value and as such is the amount (less any selling costs) you should receive when a trust is wound up at the end of the term.

Investing in buildings being constructed can increase your starting NTA as stamp duty will only be payable on land rather than the land and building. This can result in substantial savings, especially for office buildings, where the building often makes up the majority of the total asset value.

Borrowings

What is the level of borrowings of the trust?

There is no specific level that is good or bad, however, the loan to value ratio of new trusts tends to be below 50% (i.e. no more than 50% of a building's cost is paid for by debt). The appropriateness of the gearing level will also be influenced by the building and tenant quality – the better

the building, tenant and lease term, the safer a higher level of gearing is. Remember, gearing has the potential to magnify both capital gains and capital losses.

Are interest rates hedged (fixed) and for how long?

Interest for a geared trust is the largest cost and fixed rates provide certainty around the level of distributions the trust will pay.

Responsible investment

Increasingly, many investors wish to take into account environmental, social, and governance (ESG) considerations, as well as financial returns on the investments they make. Until recently, this was often quite challenging for investors to assess. However, you can now refer to the Responsible Investment Certification Program managed by Responsible Investment Association Australasia (RIAA) to see which products have had their responsible investment methodology and processes independently verified.

The nature of some trusts makes RIAA certification difficult, however, you can still assess the manager's credentials on their website to gauge their commitment to corporate responsibility.



GREEN STAR

The Green Star Rating Scheme, an initiative of the Green Building Council Australia, is a comprehensive, national, voluntary environmental rating system that evaluates the environmental design and construction of buildings. Green Star rates the environmental impacts of a project's site selection, design, construction and maintenance.

The following Green Star Certified Ratings are available:

- 4-Star Green Star Certified Rating (score 45-59) signifies 'Best Practice' in environmentally sustainable design and/or construction;
- 5-Star Green Star Certified Rating (score 60-74) signifies 'Australian Excellence' in environmentally sustainable design and/or construction; and
- 6-Star Green Star Certified Rating (score 75-100) signifies 'World Leadership' in environmentally sustainable design and/or construction.

CHAPTER 6

Getting further information

There are a number of useful online resources that you can use to help guide you to an intelligent investment:

MoneySmart

(www.moneysmart.gov.au)

is an excellent, easy-to-use website that provides information to help people make smart choices about their personal finances. It is created and run by ASIC.

Investment Property Databank

(www.ipd.com)

is a world-leader in performance analysis for the owners, investors, managers and occupiers of real estate. A significant amount of data and information can be accessed freely on their website.

InvestSmart

(www.investsmart.com.au)

is a good starting point for searching for open unlisted property funds.

Responsible Investment Association Australasia

(www.responsibleinvestment.org)

has further information on responsible investing, signatory financial advisers, fund managers and certified investment products currently open for investment.





DIRECT INVESTORS CONTACT:



1300 268 078



invest@cromwell.com.au



www.cromwell.com.au



CROMWELL
FUNDS MANAGEMENT

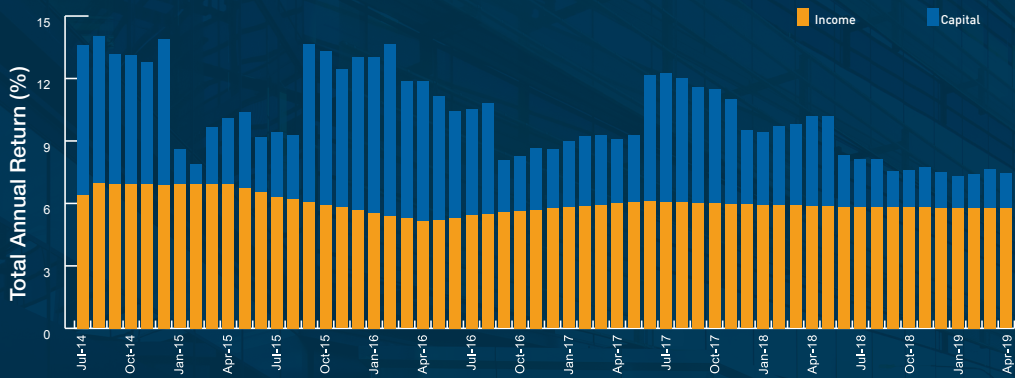
CASE STUDY

Cromwell Direct Property Fund

Meet Cromwell Funds
Management's newest stalwart –
the Cromwell Direct Property Fund

Regular, reliable income

An income-producing investment with long-term capital
growth potential, consisting of a diverse portfolio of carefully
selected commercial properties.



As a property fund manager, Cromwell is a patient, conservative player. Investors in our 'back to basics' syndicates, Cromwell Riverpark Trust, Cromwell Ipswich City Heart Trust and Cromwell Property Trust 12 (the Trusts), will attest to that. Historically, we have taken syndicates like these to our investors and they know what to expect - consistent income with capital growth, backed by quality assets and tenants.

It's been a long time since the launch of our most recent syndicate, Cromwell Property Trust 12 in 2013. The growth in commercial property values since then has resulted in a dearth of properties that tick all of our boxes for another syndicate. In particular, paying too much for a property raises the risk of a capital loss at the end of the syndicate term, otherwise known as a Terminal Value Risk.

When suitable large single-asset, single-tenant opportunities became scarce, Cromwell continued to look for properties which met the same criteria - consistent, secure and reliable income from high quality

tenants on long-term leases; but were not large enough to suit a syndicate trust structure.

The Cromwell Direct Property Fund (the Fund/DPF) was borne out of that search and at March 2019, had gross assets valued at approximately \$270 million. This is split between five quality properties valued at approximately \$184 million and units in the Trusts valued at approximately \$62.3 million. Direct gearing is a very conservative 17%, and look-through gearing just 26%.

Fund key characteristics (as at 31 March 2019)

The portfolio is made up of assets that meet stringent criteria, and the results speak for themselves:

- Occupancy: 99.8%;
- Total portfolio Weighted Average Lease Expiry (WALE): 8.8 years;
- 77% income from government or listed company tenants;
- 6.7% income return since inception; and
- 10.5% total return since inception.



Government tenant

19 GEORGE STREET

19 George Street, Dandenong VIC



Government tenant

ICON IPSWICH

117 Brisbane Street, Ipswich QLD



Government owned tenant

ENERGEX HOUSE

33 Breakfast Creek Road, Newstead QLD



Government owned tenant

420 FLINDERS STREET

420 Flinders Street, Townsville QLD



ASX-200 Company

BUNNINGS MUNNO PARA

Cnr Curtis Road & Frisby Road, Angle Vale,
Munno Para SA



Blue chip tenants

PARAFIELD RETAIL COMPLEX

Main North Road, Parafield SA

Blue chip tenant



64 ALLARA STREET

64 Allara Street, Canberra ACT

Higher Education services



433 BOUNDARY STREET

433 Boundary Street, Spring Hill QLD

ASX Company



RAND DISTRIBUTION CENTRE

902 Caribou Drive, Direk SA

The Fund has a primary focus on commercial, industrial and retail property, valued in the \$20 - \$60 million bracket and tenanted by either government, ASX-listed or quality privately owned companies.

The major tenants include federal and state government departments, Energex, Energy Queensland, Bunnings and Rand Distribution (owned by ASX-listed Automotive Holdings Group) among others. This has provided security and consistency in the rental income stream since inception.

Liquidity from a Direct Property Fund?

One of the key differences between the Fund and the Trusts is the monthly withdrawal facility. While direct property is a fixed and generally inflexible asset class, as an open-ended fund, DPF is able to provide liquidity by holding a portion of assets in cash. Each month, the Fund makes available a withdrawal facility equivalent to 0.5% of the Fund's net asset value.

Want more information?

If you would like further information on the Cromwell Direct Property Fund, please call Cromwell's Investor Services Team on 1300 268 078 or go to the Fund's webpage at www.cromwell.com.au/dpf.

Up to date information on the Fund's portfolio, tenants and financial data

can be found on the Fund's website in the ASIC Benchmarks and Disclosure Principles Regulatory Guide. This document is updated when material changes occur within the Fund, and should be downloaded in conjunction with the Fund's Product Disclosure Guide before making an investment into the Fund.

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Cromwell Funds Management Limited ABN 63 114 782 777 AFSL 333214 (CFM) has prepared this case study and is the responsible entity of, and the issuer of units in, the Cromwell Direct Property Fund ARSN 165 011 905 (Fund). In making an investment decision in relation to the Fund, it is important that you read the product disclosure statement dated 29 September 2017 (PDS). The PDS is issued by CFM and is available from www.cromwell.com.au/dpf or by calling Cromwell's Investor Services team on 1300 268 078. Applications for units in the Fund can only be made on the application form accompanying the PDS. This update has been prepared without taking into account your objectives, financial situation or needs. Before making an investment decision, you should consider the PDS and assess, with or without your financial or tax adviser, whether the Fund fits your objectives, financial situation or needs. CFM and its related bodies corporate, and their associates, do not receive any remuneration or benefits for the general advice given in this update. If you acquire units in the Fund, CFM and certain related parties may receive fees from the Fund and these fees are disclosed in the PDS.

Please note: Any investment, including an investment in the Fund, is subject to risk. If a risk eventuates, it may result in reduced distributions and/or a loss of some or all of the capital value of your investment. See the PDS for examples of key risks. Past performance is not indicative of future performance. Forward-looking statements in this update are provided as a general guide only. Capital growth, distributions and tax consequences cannot be guaranteed. Forward-looking statements and the performance of the Fund are subject to the risks and assumptions set out in the PDS.





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