



**CROMWELL**  
FUNDS MANAGEMENT



# Essential Guide to Investing in Unlisted Property



# The different property asset classes

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



## Residential property

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



## Commercial property

Which has a number of sub-classes:

Retail

Office

Industrial

Specialist

## Residential property

Residential property is the most commonly held type of property investment. This is due, in part, to familiarity, as most investors are also homeowners 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 also 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 a little 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.





## 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.  $\$1,000,000 / 7\%$ ).

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 be addressed compared to residential property. Tenants, particularly government or large corporate tenants, have specific and often complex needs which may include how their leases are structured to ensure better funding or tax outcomes.

Compliance requirements, such as Occupational Health and Safety, are also 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.

## Retail property

Retail property is a broad sector covering small suburban shopping centres all the way up to large shopping malls. Larger, well-located malls tend to have the lowest yields whilst smaller, less fashionable or less well-located malls have higher yields.

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 considered an attractive destination and maintained to a high standard.

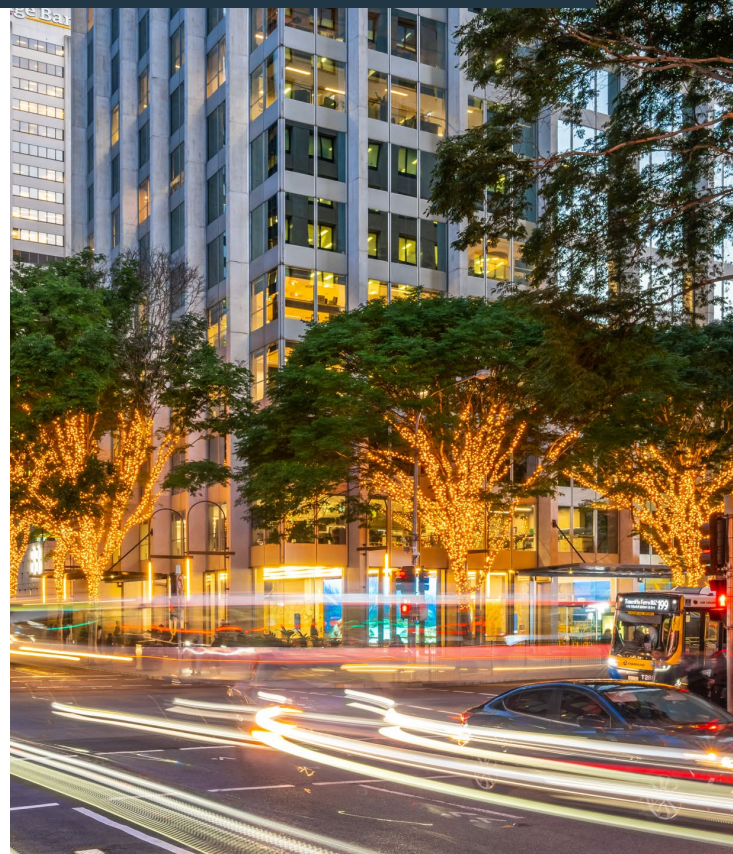
Retailers may also be impacted by economic factors, shopping trends, location and tenant mix issues, which can all have significant impacts on footfall and patronage.

For example, as shoppers are now able to buy almost any product, anywhere, shopping centres, malls, and brick and mortar retailers must pivot to fulfil consumers' desire for entertainment and experience, rather than the traditional procedure of purchasing and owning things.



### Capitalisation 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.





## 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 Premium, A and B grades for new buildings and additional C or D grades for existing buildings – according to their size, location, configuration, environmental performance, 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.

## Office property

From a yield perspective, office properties can also vary substantially. There is 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 space in your building.

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

## Industrial property

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

In recent times the growth of e-commerce and online shopping has driven a boom in the sector particularly for logistics and distribution centres located closer to the consumer. These buildings can be quite different to the traditional industrial property with sophisticated technology and automation requirements customised to the tenant and they are often located close to the city where there may be competing uses for the land.

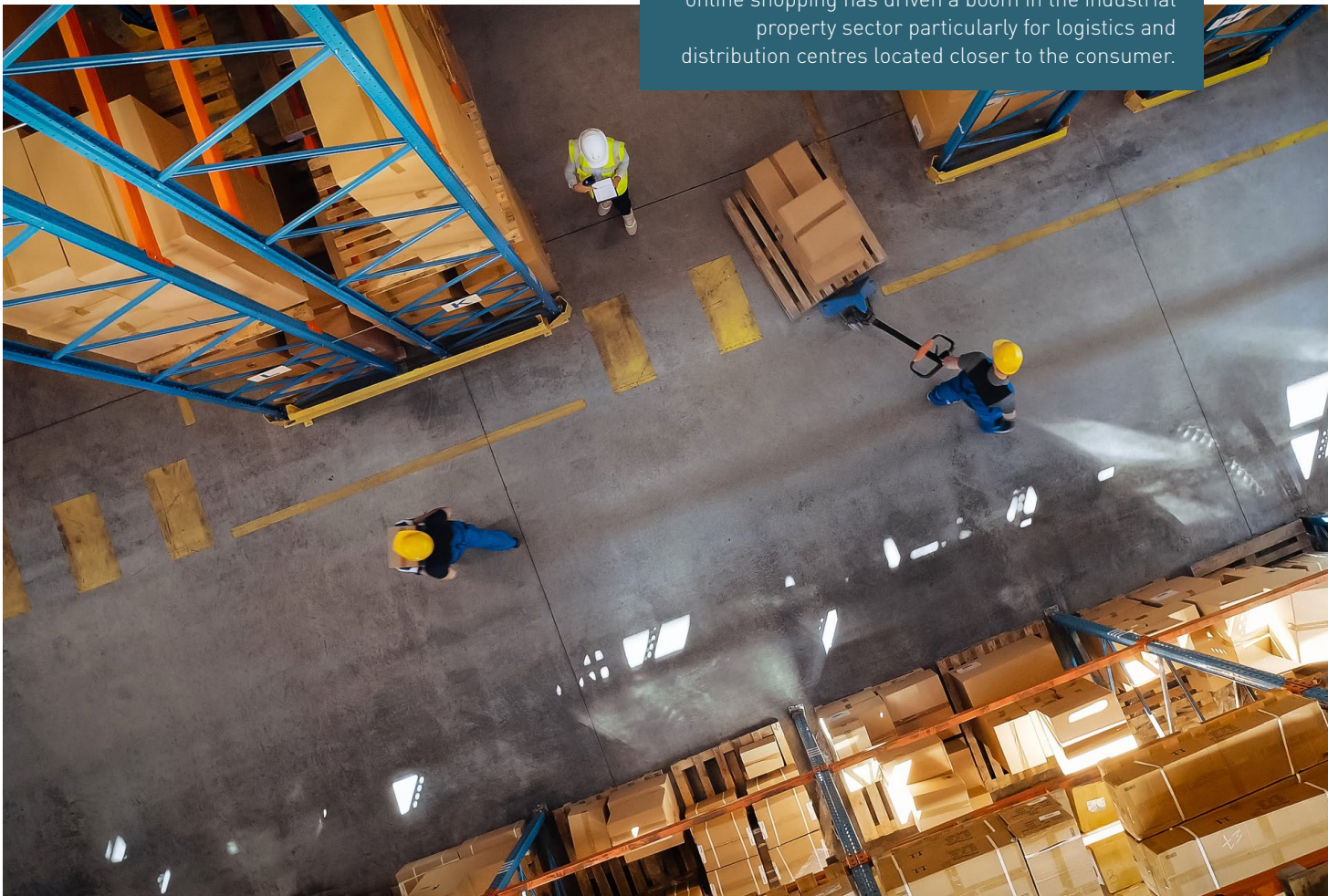
Irrespective, the risk of obsolescence when a tenant vacates a purpose-built facility means it's especially important that detailed due diligence has been done on any industrial property purchase.

## Specialist property

Included in this sector are retirement living villages, aged care facilities, hospitals and medical centres, storage centres, data centres as well as 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 that the manager, or in some cases a third-party business, has the appropriate skills and a strong underlying business model.

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

In recent times the growth of e-commerce and online shopping has driven a boom in the industrial property sector particularly for logistics and distribution centres located closer to the consumer.





# 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 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, 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: Australian Securities Exchange (ASX) listed Real Estate Investment Trusts (A-REITs) and Unlisted Property Trusts.

Investors gain several benefits from using professionally managed trusts:

- 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 makes them available to self-managed super funds;
- Regular income stream, with distributions ranging from monthly to annual 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

Property trusts listed on the ASX used to be called listed property trusts but are now more typically known as ASX-listed Real Estate Investment Trusts (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.

Given A-REITs can be traded like any other share, 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.

Further, A-REITs are often 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, giving rise to additional considerations.

As stapled securities are legally bound together, they cannot be sold separately. For example, if you like the assets, tenants and more in a trust, but do not like certain aspects of the management company the trust is stapled to, you are unable to invest in solely the trust. However, while a stapled security is dealt with as a whole, the individual securities that are stapled are treated separately for tax purposes.

## 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 between five and ten years. At the end of the specified time (called a Term), investors will vote on the future of the trust. The usual outcome is for the property to be sold, the trust wound up and investors paid out, but the trust can also be extended for a specified period of time, called a Further Term. Syndicates should be considered illiquid investments and there should be an expectation that funds will remain invested 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 easy to understand and you know for certain which asset or assets 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 do not provide diversification on their own, however with minimum investments as low as \$10,000, you can combine 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 strength of the property market at any given point in time.



# How does an unlisted property trust work?

## The manager and disclosure documents

Unlisted property trusts can only be offered by ASIC-licensed 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 unitholders over their own interests.

The vast majority of fund managers are licensed to give 'general advice' only. This means they can provide you with factual information about their product in their documents or in communications with you, but they are not licensed 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) and a Target Market Determination (TMD).

### Product Disclosure Statement

A Product Disclosure Statement is a document that managers must provide to a prospective investor when they offer a financial product. It must include information about the product's key features, fees, benefits, risks and the complaints handling procedure.

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 regarding 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, progress updates should be available on the website.

### Target Market Determination

In October 2021, ASIC introduced a new set of Design and Distribution Obligations (DDO) for organisations to follow. The DDO are intended to help consumers obtain appropriate financial products by requiring issuers and distributors to have a consumer-centric approach to the design and distribution of products, ensuring financial products reach consumers in the target market determined by the product issuers.

The DDO state that issuers and distributors 'must take reasonable steps that will, or are reasonably likely to result in financial products reaching consumers in the target market determined by the product issuer.'

As such, issuers are required to provide a TMD to prospective investors. A TMD is a document which describes the type of customers a product is appropriate for, based on their likely needs, objectives and financial situation, and establishes the conditions and restrictions around how the product can be distributed to customers. The aim of the TMD is to make the target market of the fund easily identifiable.

## 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 where stamp duty is usually 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 funds

An open-ended fund 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 fund's properties and other assets. 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. Internal gearing is non-recourse to the unitholder, which means that if there is a default, the issuer of the debt can seize the collateral but cannot seek out the investor for any further compensation. In essence, you cannot be asked to pay more than the cost of your units.

Not only does this reduce the risk to each individual investor, it also provides an easy way for a self-managed superannuation fund (SMSF) to gain access to geared property without having to go through the costly and complex process itself.

When 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 certainty over interest expense and future distributions for the trust.

## Property management

Another benefit of investing in an unlisted property trust is gaining access to 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 not only the manager and investors, but also tenants who are ultimately responsible for providing unitholders with real income.

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

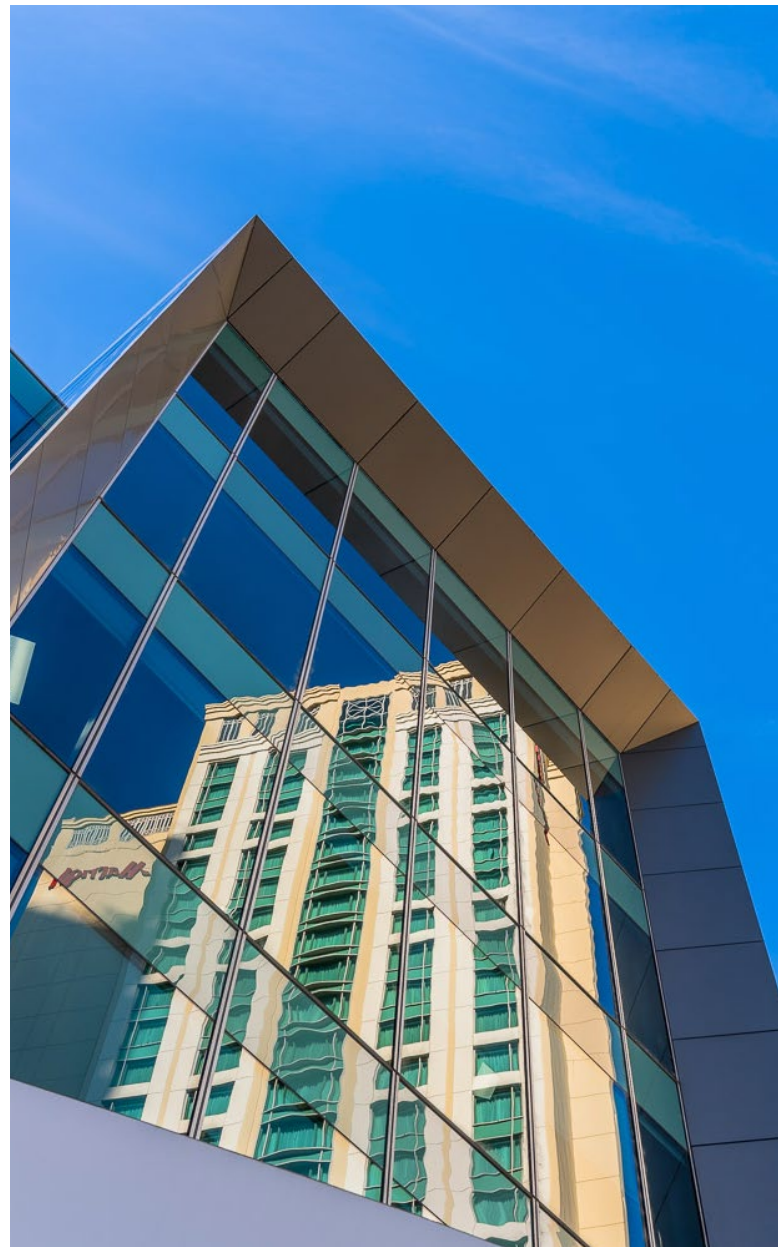
Property management includes leasing, ongoing maintenance of buildings, building concierge services, fire safety and other compliance requirements and – most importantly for you as an investor – making sure rent is collected! You will pay for these services, but they will already be taken into account 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 into 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, six-monthly, or annually.

### Tax-deferred distributions

Tax-deferred distributions can be an attractive feature of many property investments and have the potential to increase the after-tax return of an investment. Despite this, tax-deferred distributions are not particularly well understood outside the community of professional investors and tax specialists because of their complexity.

The benefits of tax deferral can be significant, especially for those with high incomes. For many investors, an investment that offers 100% or even 50% tax-deferred distributions can significantly enhance the after-tax returns from that investment.

#### What are tax-deferred distributions?

Tax-deferred distributions (or 'other non-attributable amounts') occur when a property trust (or fund) has distributable income higher than its taxable income.

This can occur due to the trust's ability to reduce its taxable income through tax deductions for items such as depreciation on plant and equipment, capital allowances on the building structures, interest and costs during construction or refurbishment periods, and costs of raising equity.

The tax-deferred component of a distribution is generally not assessed as taxable income when it is paid to investors. Instead, the investor's cost base of the investment is reduced by the amount of the tax-deferred distribution for Capital Gains Tax (CGT) purposes.

The tax liability is therefore deferred until such time as the investment is sold by the investor or the property trust itself is wound-up and a capital gain is realised.

The level of tax deferral depends on a number of factors such as the age of the asset or portfolio held in the trust, or the requirement for capital expenditure on an asset over time and so on. A trust or fund holding a newly completed property will generally have a higher level of tax deferred income due to the higher level of depreciation and capital allowances on that property available in the early years.

Therefore, an open-ended fund that holds a variety of properties and continues to acquire more assets may have a fluctuating tax-deferred component to the income due to be paid to unitholders. Alternatively, a fixed-term closed-end trust will have a predictable level of tax-deferred income, generally decreasing over time as the asset ages and depreciation deductions reduce.

### The benefits

Receiving tax-deferred income provides many benefits to investors, including the flexibility of managing the timing of their tax liability (and potentially their marginal tax rate) and a greater after tax cashflow.

The tax-deferred component of a distribution is not taxed as ordinary income at your marginal tax rate, but rather under the CGT regime, 'deferring' the tax usually until the sale of your units in the investment or upon the wind-up of the trust.

This may result in less overall tax being payable on the investment, depending on an investor's individual circumstance and the timing of the sale.

While the distribution reduces the investor's cost base for CGT purposes (thus increasing the gain on realisation), provided units have been held for more than 12 months, the unitholder may be eligible to reduce the portion of the gain that is taxable under the CGT discount rules. Eligible individuals can reduce the taxable portion by 50% and eligible superannuation funds receive a discount of 33 1/3%.

For units held in a SMSF, if disposal occurs once the superannuation account rolls from accumulation phase to pension phase, the capital gains (and ultimately the income generated from the initial tax-deferred distribution) may be tax-free.

Deferring tax payable can also provide a greater level of after-tax investable funds. The compounding benefit from reinvesting the tax that would otherwise be payable on these distributions can be substantial over time.

## 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 fund managers provide liquidity is by holding 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.



# 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.

Independent research reports are useful tools for investors when comparing property trusts. These reports are prepared by organisations with no link to the fund manager, such as Lonsec, Zenith or S&P Global Ratings, and 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 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?
- If they seem unwilling to provide you with information when they are 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.)

## The property asset

When reviewing the building(s) in a trust, there are a number of factors to consider and questions to ensure you have answers to before an investment is made.

### 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 could be 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?
- Are there a lot of new buildings about to come on the market which might make securing a quality tenant difficult?

### Building quality

A lower-grade building may still be as appealing a prospect as a premium or A-grade building. For example, 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.

- What sort of capex is required?
- Has this 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?

## Capital growth

While by no means assured, ideally the asset(s) in a fund will appreciate in value over the term of your investment.

- 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 located in a growth area?

## Lease 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.

For open-ended funds with multiple assets, it is important to consider the weighted average lease expiry (WALE). The WALE represents the duration of lease commitments across the portfolio and is weighted according to either the floorspace or income generated by each lease.

For a fixed-term trust, how long does the lease term compare with the investment term?

## Lease

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.

- 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)?
- Does the agreement have regular rental reviews?
- Are rental increases inflation-linked, at a fixed rate or market reviews?

## Tenants

Generally, as a result of the likelihood they will pay their rent without issues over the term of their lease, government tenants (federal or state) are the most preferred with blue-chip corporates the next most favoured.

- Who are they?
- Are you confident they will be around for the life of their lease and pay their rent?

## Weighted Average Lease Expiry

One of the bigger risks associated with investing in commercial property is the vacancy risk. When a part or all of an asset is left vacant, income and distribution to unitholders can be affected. Subsequently, the weighted average lease expiry (WALE) metric is a useful tool for assessing the vacancy risk of a property or portfolio. The WALE is calculated across all the tenants in a property or portfolio and is weighted by either the tenant's lettable area in square metres or the tenant's income against the total combined area or income of the other tenants.

Below is an example of a commercial office building comprised of four tenants.

Tenant	Lease term remaining (years)	% of building sqm	% of rental income
Government agency	10	75%	70%
Blue-chip tenant	6.5	15%	22%
Retail tenant #1	1.5	5%	3%
Retail tenant #2	2	5%	5%
		100%	100%
		<b>WALE (area): 8.65 years</b>	<b>WALE (income): 8.58 years</b>

In order to calculate the WALE of this property in terms of lettable area, the remaining lease term is multiplied by the percentage of each tenant's floorspace. For example, the government agency would be as follows:  $10 \text{ years} \times 75\% = 7.5$

Following these steps for each of the remaining three tenants, and then combining all four outcomes reveals the WALE:  $7.5 + 0.975 + 0.075 + 0.1 = 8.65$  years.

The same process, just substituting the percentage of rental income, yields the WALE by income.



## National Australian Built Environment Rating Scheme

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.

NABERS performance in each category is benchmarked on a rating scale of zero to six stars, with six indicating market-leading performance and zero meaning very poor performance.

## Green credentials

Even if you do not 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 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 does not meet sustainability expectations, you could be limited in who you can lease it to.

## Trust structure

It is important to understand the trust structure to ensure it is suitable for your needs and anticipated outcomes. Once again, the PDS can be used to answer the following questions:

- 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.

### Green Star Rating Scheme

The Green Star Rating Scheme, an initiative of the Green Building Council of 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:

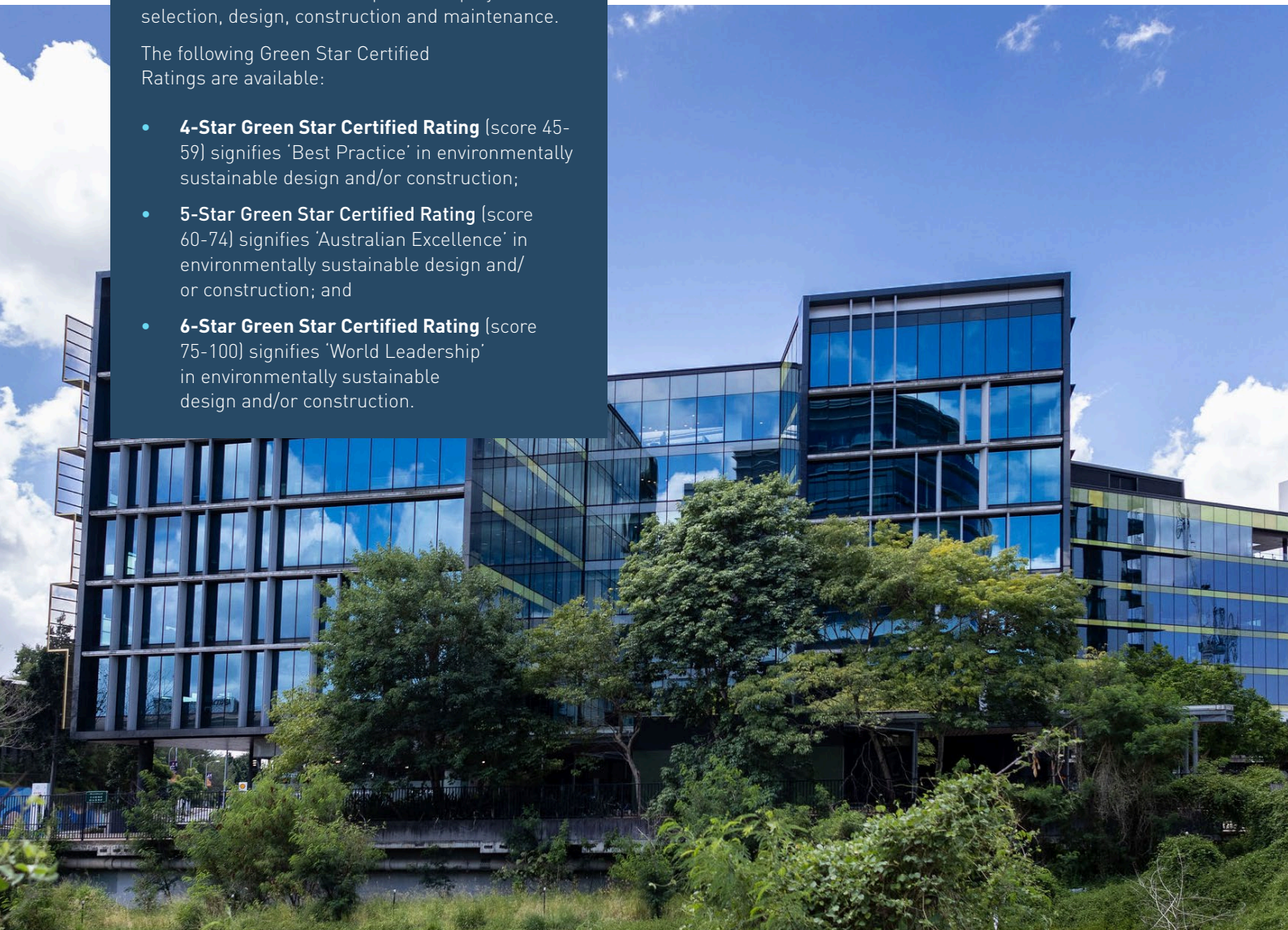
- **4-Star Green Star Certified Rating** (score 45-59) signifies 'Best Practice' in environmentally sustainable design and/or construction;
- **5-Star Green Star Certified Rating** (score 60-74) signifies 'Australian Excellence' in environmentally sustainable design and/or construction; and
- **6-Star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

## Net tangible asset (NTA) per unit

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

It will likely be less than \$1.00 per unit (assuming the initial unit price is \$1.00), 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 a new trust 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.

## Environmental, social and governance considerations

Considering environmental, social and governance (ESG) factors when it comes to making investment decisions is no longer optional. Whether it's part of a personal philosophy or not, affording significant weight to sustainability within investment decisions is prudent given ESG-based strategies deliver superior long-term capital protection, creation and growth.

Earlier, we touched on ESG considerations from an individual asset standpoint via NABERS and Green Star ratings. When it comes to comparing entire trusts, going beyond simply asset level sustainability initiatives and instead placing weight on the manager's investment methodology and processes, the Responsible Investment Association of Australasia is an invaluable tool.

### Responsible Investment Association Australasia certification

The Responsible Investment Association Australasia (RIAA) is a resource which can be used to compare investment opportunities based on their approach to ESG. The RIAA is an organisation which champions responsible investing and a sustainable financial system across Australia and New Zealand, and is dedicated to ensuring capital is aligned with achieving a healthy society, environment and economy.

The RIAA's Responsible Investment Certification Program allows investors to see which products have had their responsible investment methodology and processes and approach to ESG independently verified. While the nature of some trusts makes RIAA certification difficult, you can still assess the manager's credentials on their website to gauge their commitment to corporate responsibility. ■

In September 2012, the **Cromwell Ipswich City Heart Trust** (the Trust) became the first single-asset property investment vehicle to be certified by the RIAA as a Responsible Investment.

Cromwell was an early adopter of incorporating ESG factors into its investment analysis and decision-making process, while demonstrating that sustainability can be a pathway to profitability at an asset level. The Trust's Responsible Investment certification ensured investors who took RIAA certified products into consideration now had the option to include exposure to direct commercial property, thereby providing further diversity to their portfolios.

# Getting further information

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

## Australian Securities and Investments Commission

[www.asic.gov.au](http://www.asic.gov.au)

ASIC is Australia's integrated corporate, markets, financial services and consumer credit regulator, whose role includes, but is not limited to promoting confident and informed participation by investors and consumers in the financial system.

## MoneySmart

[www.moneysmart.gov.au](http://www.moneysmart.gov.au)

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

## MSCI

[www.msci.com](http://www.msci.com)

MSCI is a global independent provider of research-driven insights and tools for the owners, investors, managers and occupiers of real estate. A significant amount of data and information can be accessed freely on their website.

## Australian Taxation Office

[www.ato.gov.au](http://www.ato.gov.au)

The Australian Taxation Office is the Australian Government's principal revenue collection agency, administering the legislation governing tax, and supporting the delivery of government benefits to the community.



# Staying up to date

## Insight Magazine

Cromwell provides retail securityholders, investors, financial planners and all other stakeholders with topical monthly research and insight. Featuring our view of industry trends, news and educational matters, we also share our achievements in property markets and report on the progress of our investment funds.

If you would like to receive the next Insight Magazine by email, go to [www.cromwell.com.au](http://www.cromwell.com.au) to subscribe. A catalogue of articles is also available at [www.cromwell.com.au/learn/](http://www.cromwell.com.au/learn/)

## Contact us

If you have any questions about Cromwell or our suite of investment opportunities, our Investor Services Team is available to assist.

**1300 268 078**

[invest@cromwell.com.au](mailto:invest@cromwell.com.au)

## About Cromwell Funds Management

Cromwell Funds Management Limited is part of the ASX-listed Cromwell Property Group (ASX:CMW), an Australian real estate investor and manager that has owned, managed and invested in commercial property since 1998.

## Why 'Invest in real' with Cromwell Funds Management?

Cromwell utilises real expertise to invest in real assets and deliver real returns. We aim to build investor wealth through the careful selection, acquisition and management of secure, income-producing commercial properties and portfolios.

Cromwell's suite of investment opportunities offers access primarily to unlisted property trusts and A-REITs, providing different methods of investing in commercial property and diversifying your portfolio.

Visit [www.cromwell.com.au](http://www.cromwell.com.au) for further information.



Invest in *real.*

## Glossary of terms

<b>A-REIT</b>	ASX-listed Real Estate Investment Trust
<b>AFS licence</b>	Australian Financial Services Licence
<b>ASIC</b>	Australian Securities and Investments Commission
<b>ASX</b>	Australian Securities Exchange
<b>Capex</b>	Capital expenditure
<b>Cap rate</b>	Capitalisation rate
<b>CGT</b>	Capital Gains Tax
<b>Cromwell</b>	Cromwell Funds Management Limited
<b>DDO</b>	Design and Distributions Obligations
<b>ESG</b>	Environment, social and governance
<b>GFC</b>	Global Financial Crisis

<b>NABERS</b>	National Australian Built Environment Rating System
<b>NLA</b>	Net lettable area
<b>NTA</b>	Net tangible asset
<b>PCA</b>	Property Council of Australia
<b>PDS</b>	Product Disclosure Statement
<b>RIAA</b>	Responsible Investing Association of Australasia
<b>SMSF</b>	Self-managed superannuation fund
<b>SQM</b>	Square metres
<b>TMD</b>	Target Market Determination
<b>WALE</b>	Weighted average lease expiry

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