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focus

An investment seesaw: The ups and downs of property syndicates

Property, arguably, is a national obsession in New Zealand. For many, it's a key plank of their investment portfolios. While residential has generally been the focus, over the past decade low interest rates combined with regulatory and tax changes has driven a surge in the popularity of commercial property. This included more than NZ$1 billion being invested in unlisted commercial property vehicles over 2020 to 2022.

As we've seen in prior cycles, however, the landscape can quickly change. Higher interest rates have impacted asset values and reduced dividends, while low liquidity is limiting investors' ability to access their capital. Unfortunately some investors probably didn't properly fully appreciate the nature of the investments they were getting into.

FORSYTH BARR

...multiple options for investors who want exposure to commercial property...

Rental housing has typically been the property investment of choice for New Zealanders. However, in recent years we saw a bit of a shift. Low rental yields, increased equity requirements, and unfavourable tax changes around the treatment of interest costs all decreased the appeal of residential property. Commercial property on the other hand retained these key features and has even gained some tax advantages over recent years. The result has been increased investor interest in commercial property.

There are multiple options for investors who want exposure to commercial property including purchasing the property directly, unlisted single property syndicates, multi-asset unlisted property funds, and listed property vehicles. The attractiveness and appropriateness of these options depend on an investor's expertise, risk profile, distribution preferences, and investment size.

COMPARISON OF PROPERTY INVESTMENT VEHICLES

	Direct property	Single-asset syndicates	Unlisted property funds	Listed property funds
Structure	n/a	Company/trust	Company/trust	Company/trust
Typical investment size	NZ$2m+	NZ$50,000+	NZ$10,000+	No minimum
Management	External/ internal	External	External	External/internal
Management costs vs. asset value	n/a	30-40bps	50-60bps	40-60bps
Performance fees	n/a	No	Yes	Yes (for externally managed)
Taxation	Various	Distributions are gross of tax	Multi-rate PIE's - dividends are net of tax	Listed PIE's - dividends are net of tax
Tax efficiency (interest/ depreciation deductions)	High	High	High	High
Diversification	Low	Low	Moderate	High
Typical gearing	n/a	50%-60%	40%-50%	30%-40%
Portfolio strategy	n/a	Closed ended/ passive	Open ended/ actively managed	Open ended/ actively managed
Liquidity	Low	Low	Moderate	High
External governance	n/a	Low	Low/Moderate	High
Typical distribution	n/a	Monthly	Monthly	Quarterly
Disclosure requirements	High	Moderate	Moderate	High

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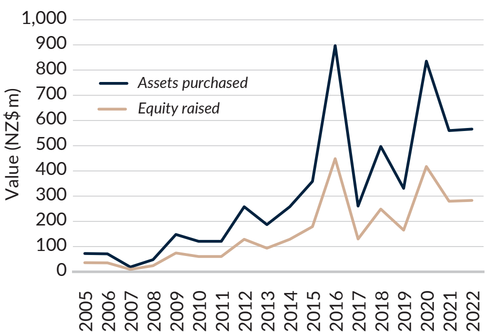
What are unlisted property investments?

Unlisted property vehicles are a type of pooled investment where multiple investors take an equity interest via a specially established entity that owns one or more commercial properties.

With a relatively low minimum investment of NZ$10k–50k, unlisted property vehicles found favour with many investors who wanted exposure to commercial property and the attractive advertised yields. This resulted in approximately NZ$2 billion of commercial property being acquired by unlisted property groups between 2020 and 2022, with an estimated NZ$1 billion of equity raised in the process.

UNLISTED PROPERTY INVESTMENTS 2005-2022



Source: CBRE, Forsyth Barr estimates

Listed vs. unlisted property investments

We view commercial property as a core asset class within a diversified portfolio. Many were attracted to unlisted property vehicles by the advertised income yields. But this isn't the only factor to consider. Part of our role is to find the best way for our clients to access different investments. On balance we generally prefer to use the listed market to access the asset class for our investors for a number of reasons.

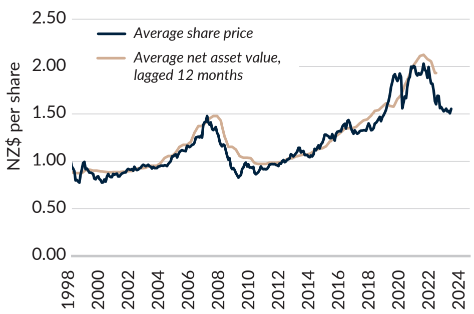
1) Real-time forward-looking prices

The current value of an investment in a listed property vehicle is easy to find, you just have to call your broker or check online. The listed market is also forward-looking, meaning new information is baked into share prices immediately including any likely changes (up or down) in the underlying value of the property assets.

In contrast, the valuation of unlisted funds is backward-looking and may be out of date, especially when the market has meaningfully moved. The value of these funds is typically at book value which includes estimated values of the underlying property assets. These valuations are typically based on similar assets that have been transacted in the market. The problem is that during a downturn transaction activity dries up and it can take quite a while for new transaction benchmarks to emerge and "official" valuations to catch up.

...more than NZ$20 billion of commercial property assets listed on the NZX...

LISTED PROPERTY PERFORMANCE 1998-2023



Source: Eikon, Company data, Forsyth Barr estimates

2) A deeper pool of buyers and sellers

On an average day, 4.4 million shares of the listed property vehicles, worth NZ$6.5 million, are traded on the NZX. For most people this is more than enough liquidity to enter and exit their investments in a timely manner.

For unlisted funds selling can be challenging (especially when the underlying asset values are uncertain). The main liquidity event for syndicates is typically the return of capital after assets are sold at the end of the investment term. Some syndicates allow trading of units but the queue of potential buyers can be short. Some unlisted funds provide liquidity by allowing redemptions but they have the ability to freeze these, which we understand some have recently done.

3) Higher quality assets and significant diversification

There are more than NZ$20 billion of commercial property assets listed on the NZX with the average portfolio being slightly larger than NZ$2 billion. Listed portfolios tend to have higher quality assets and tenants, you won't find a Commercial Bay, Sylvia Park, or Highbrook Industrial Park in an unlisted vehicle. Investors can also pick between retail, industrial, office, supermarket, and healthcare assets as desired.

Single asset syndicates are what they say on the tin — one asset. While multi-asset syndicates do have better diversification, the portfolios typically lack the scale of the listed market. An unforeseen issue with an asset or tenant will likely have a relatively larger impact on an unlisted portfolio.

4) Less debt and lower volatility

Most property investment involves the use of debt to enhance returns. Higher debt levels magnify the impact of the ups and downs in the property cycle on equity values. Whilst beneficial when property values are rising, it can be painful in a downturn. Listed property vehicles typically fund around a third of their asset value with debt compared to the unlisted vehicles at around 50%.

This higher level of debt also puts pressure on cash flow — more is required to meet interest payments and potentially reduce debt. We understand that some newer unlisted property vehicles have had to slash dividends as interest costs skyrocketed. The listed property sector is not immune to these challenges but the pressure is typically more manageable due to lower debt levels.

5) Greater oversight and transparency

Listed management teams are scrutinised by investment analysts, institutional investors, and the media. In our view this typically results in better long-term outcomes for shareholders. By virtue of managing larger more specialised portfolios, listed management teams also tend to have greater and more focussed internal expertise that can add value through other activities such as development and asset management.

...attractive yields come with risks that need to be fully understood...

Whilst the financial information of most syndicates is publically available, it is not consistently scrutinised by third parties. For syndicates that are for "wholesale" investors only there is no requirement to publically disclose financial information.

Cyclical pressure is more acute in the unlisted property market

> *"Know what you own, and know why you own it."*
>
> *Peter Lynch, legendary investor*

Despite the listed property share prices being well below their pandemic peaks, dividends are largely forecast to be maintained and debt pressures are being managed. In contrast, we understand that a number of newer unlisted property vehicles have had to take sharp action to manage higher interest costs including slashing dividends and freezing redemptions. Investors are reminded once again that attractive yields come with risks that need to be fully understood prior to making investment decisions. Whilst many syndicates will get through this current cycle, some may not. In previous commercial property downturns underperforming syndicates have looked to the listed market not only as a source of new equity but also as a source of liquidity for existing shareholders. In 2003 syndicates managed by Waltus were merged into Urbus which we now know as Argosy. Then in 2009 syndicates managed by Dominion were merged into DNZ Property Fund which we now know as Stride. Fortunately, being listed has proved a more enduring model for these property entities and their investors.

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If you would like to discuss your current holdings or how you can get commercial property exposure in your portfolio, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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