UNLISTED PROPERTY FUND DECISION MAKING: DECISION MAKER SURVEY PRELIMINARY FINDINGS

ABSTRACT

While unlisted property funds are multi-billion dollar property investment vehicles, relatively little research has been undertaken into their adopted property investment decision making process. Following a literature review, the property investment decision making process is described as a multi-step, linear, sequential process capable of taxonomizing as 20 steps.

The paper provides a brief summary of the preliminary findings of a survey of unlisted property fund decision makers in Australia, funded by the RICS Education Trust, which finds the hypothesized steps in the property investment decision making process to be substantially supported. An RICS Research Report, comprising the detailed findings of the research, will be published in 2013.

Keywords: property, unlisted fund, decision making, Australia, RICS Education Trust

1.0 INTRODUCTION

This paper provides some preliminary findings from an investigation into the property investment decision making process adopted by Australian unlisted property funds, being how $1 of unitholder capital is converted into $1 of investment property, through the use of semi-structured interviews with the decision makers for nine of the largest unlisted property fund managers in Australia.

Previous research has investigated the property investment decision making process for Australian listed property funds (or REITs) and aspects of the decision making process adopted by unlisted property funds overseas, but very little research has been undertaken into the property investment decision making process by unlisted property funds in Australia.

Unlisted property funds, for the purposes of this research, are considered to be wholesale property funds that are not traded on a stock exchange.

Following the capital markets framework proposed by Higgins (2007), as shown in Figure 1, unlisted property funds are situated within the private markets/equity assets quadrant.

	Public Markets	**Private Markets**
Equity Assets	Shares Real Estate Investment Trusts	Private Entities Unlisted Property Wholesale Property Funds Property Syndicates
Debt Assets	Traded Debt Securities Commercial Mortgage Backed Securities Property Trust Bonds	Bank Loans Wholesale Commercial Property Mortgages

Four Quadrant Investment Market of Real Estate Topical Areas
Source: Higgins (2007)
Figure 1

Unlisted property funds may be distinguished from retail unlisted property funds (being those funds open to the public for investment), unlisted syndicates (being funds comprising a small number of unitholders with an affinity) or listed property trusts (or REITs, being funds traded on a stock exchange).

The investment characteristics of unlisted property funds include offering wholesale institutional investors:

- access to the private property equity market without requiring extensive time input and property management experience;
- access to high quality commercial properties which are seldom available on the open market;
- access to experienced property fund managers;
- a total return focus with low risk;
- significant risk-adjusted performance and portfolio diversification benefits;
- asset allocation opportunities across diversified and sector specific property funds;
- performance aligned with the underlying property assets;
- investor representation on management steering committees;
- debt funding opportunities but with low gearing (around 16% (Harley (2012))); and
- alignment with the appointed fund manager for development opportunities;

but with:

- low liquidity;
- significant minimum investment levels; and
- high entry costs. (Newell (2007), Higgins (2010))

The total size of all unlisted property funds has grown significantly over the last decade, from less than $20bn in 2003 to $78bn in 2008 falling, due to the impact of the GFC, to $61bn in 2009 (Higgins (2010)) and then rising to $83bn in 2012, with current inflows approximating $2bn each year (Harley (2012)).

Relative to the Australian investment universe, Higgins' (2008) landmark study estimated the Australian investment market to total $1.6 trillion, comprising equity and debt assets in the public and private markets (Figure 1), with commercial property comprising $288bn and total unlisted property funds comprising $69bn or 5.96% of the private equity market.

In order to understand the property investment decision making process by unlisted property funds, a literature review was undertaken to endeavour to identify the property investment decision making process and to provide an indication of how decisions ***should*** be made.

Through the use of structured interviews with unlisted property fund decision makers, information was then collected concerning how unlisted property fund decision makers ***do*** make decisions. That information collected concerning how they ***do*** make decisions was then compared with how they ***should*** make decisions, conclusions drawn and areas for further research identified.

2.0 LITERATURE REVIEW

Multiple aspects of property investment decision making in general are considered in limited detail in such UK textbooks as Baum (2002) and Brown and Matysiak (2000) and in such US textbooks as Jaffe and Sirmans (2001), Pagliari (1995), Pyhrr et al (1989) and Roulac (1994). Conversely, individual aspects of property investment decision making specifically are considered in great detail in such journal papers as Farragher and Kleiman (1996) and Farragher and Savage (2008).

Significantly, a survey of the literature found neither textbooks nor journal papers that solely addressed the property investment decision making process in the context of Australian unlisted property funds. Certain text books considered investment decision making in the property sector generally including reference to property funds (see, for example, Geltner et al (2007) or Farragher and Kleiman (1996)), whilst others considered property investment decision making by property funds managers (see, for example, MacCowan and Orr (2008) or Roberts and Henneberry (2007)).

In an Australian context, Higgins (2010) examined the investment style adopted by unlisted property funds, identifying the adoption of a range of structured and active styles and noting that investment evaluation techniques can be a valuable decision making tool for an investment into unlisted property funds. Also, Reddy (2012) examines asset allocation to property by superannuation funds, investment management funds and asset consultants

Based on an extensive literature review of both the text book and journal literature and drawing on an analysis of themes and elements within that literature reviewed, Parker (2012) describes the property investment decision making process as sequential and linear, comprising twenty steps which may be summarised as:

Envisioning Stage:

- ***Vision***
  - being a statement of where the fund is aiming to be;
- ***Style***
  - being the form of management offered to unitholders;
- ***Goal(s)***
  - being one or more measures or steps towards the realisation of the vision;
- ***Strategic Plan***
  - being the approach to be adopted to achieve the goals;
- ***Objective(s)***
  - being one or more measures or steps towards the realisation of the strategy and/or achievement of the goal(s);

Planning Stage:

- ***Property Portfolio Strategy***
  - being the route map linking vision to an operational property portfolio;
- ***Strategic Asset Allocation***
  - being the quantitatively determined optimal allocation to various sectors, geographies and so forth within the portfolio;
- ***Tactical Asset Allocation***
  - being to seek outperformance through short term underweight or overweight exposures relative to the strategic asset allocation;

- ***Stock Selection***
    - being the determination of those criteria that may make assets suitable for acquisition;
- ***Asset Identification***
    - being the process of identifying potential assets for acquisition that meet the stock selection criteria;

Dealing Stage:

- ***Preliminary Negotiation***
    - being the process of developing a short list of preferred properties for acquisition;
- ***Preliminary Analysis***
    - being a simple, single period comparative analysis of preferred properties for acquisition;
- ***Structuring***
    - being the shaping of the commercial and funding terms of the transaction;
- ***Advanced Financial Analysis***
    - being the use of a pricing model to identify mis-pricing and the opportunity to earn abnormal returns;
- ***Portfolio Impact Assessment***
    - being the determination of the impact of the potential property acquisition and funding structure on the portfolio as a whole;

Executing Stage:

- ***Governance Decision***
    - being the formal accept/reject decision for a potential property acquisition by the relevant decision maker;
- ***Transaction Closure/Documentation***
    - being an iterative process of negotiation and documentation of the transaction with the vendor;
- ***Due Diligence/Independent Appraisal***
    - being the verification of information and assumptions relied upon;
- ***Settlement***
    - being the exchange of capital in return for the rights and responsibilities of property ownership; and
- ***Post Audit***
    - being a review of assumptions adopted and forecasts made with remedial action, if required.

Having regard to previous research, Parker (2012) proposes the following taxonomy of the way in which the property investment decision making process ***should*** be undertaken:

Accordingly, therefore, based upon a review of the literature, it may be hypothesised that the property investment decision making process by unlisted property funds ***should*** comprise twenty sequential, linear steps.

Step	Step	Step	Step	Step
Vision	Style	Goals	Strategic Plan	Objectives
Property Portfolio Strategy	Strategic Asset Allocation	Tactical Asset Allocation	Stock Selection	Asset Identification
Preliminary Negotiation	Preliminary Analysis	Structuring	Advanced Financial Analysis	Portfolio Impact Assessment
Governance Decision	Transaction Closure / Documentation	Due Diligence / Independent Appraisal	Settlement	Post Audit

Taxonomy of the Property Investment Decision Making Process
Source: Parker (2012)
Table 1

3.0 PRACTITIONER INTERVIEWS

Having proposed a hypothesis for the property investment decision making process by unlisted property funds, information concerning how unlisted property funds ***do*** make property investment decisions is required with which to test the hypothesis.

How unlisted property fund managers make property investment decisions requires such fund managers to answer the fundamental question:

> "How do you convert $1 of capital into $1 of investment property?"

and so requires a research methodology which is designed to obtain such an answer impartially and independently.

A qualitative research methodology using a semi-structured interview data collection technique has been adopted in a wide range of other practitioner focused studies (see, for example, de Wit (1996), Levy and Schuck (1999), Gallimore et al (2000), Baum et al (2000) and Levy and Schuck (2005)), providing a depth of discipline specific experiences upon which to draw.

Levy (2006) notes that such a semi-structured interview approach is preferred for the collection of rich, in-depth and informative data which may be confidential, being particularly suitable, therefore, for the collection of information from a sample of unlisted property fund managers.

To facilitate possible future analysis of the decision making process identified and the returns achieved, it was proposed that the interviewee sample should include those unlisted property fund managers included in the Mercer/IPD Australian Pooled Property Fund Index – Core Wholesale (IPD Index) which includes nine of the largest unlisted property fund managers in Australia. It is noted that a sample of nine respondents falls within the mid-portion of the sample size range used in other discipline specific studies, being comparable to Cameron (2008) with two other studies having smaller samples and three having larger samples.

As the ideal interviewee should have an overview of the entire property investment decision making process undertaken by the unlisted property fund manager, it was considered preferable to interview the fund CEO, CIO, manager or effective equivalent. Of the sample of nine unlisted property fund managers, face-to-face interviews were held with eight such operational decision makers and one teleconference interview was held with the head of the capital transactions team who may be contended to be an effective equivalent.

While one interviewee declined to provide portfolio composition data for reasons of confidentiality, the balance eight unlisted property fund managers managed funds comprising a total of 432 properties with a value of $47.5 billion. Accordingly, the sample is contended to be representative, acceptable and therefore valid.

Interviews were conducted in early 2012 on a confidential basis and designed to be capable of completion within a period of around 60 minutes. Being semi-structured, each interview comprised an initial open question to which responses were unprompted, followed by a series of open questions to which responses were prompted.

The initial open question to which responses were unprompted was designed to allow general information to be elicited and to permit the respondent to provide a "top of head" or "front of mind" response, so indicating those aspects of the property investment decision making process that were of greatest importance, significance or relevance to them, being:

> "Please describe the investment decision making process adopted by your fund for the conversion of unitholder capital into investment property?"

repeated as:

> "Please describe the investment decision making process whereby your fund converts $1 of unitholder capital into $1 of investment property?"

The subsequent open questions to which responses were prompted were designed to allow specific information to be elicited in order to add depth to the response, with great care taken to open a particular topic for response without providing an indication of a possible answer.

Responses to the questions were noted by hand on an aide-memoire designed to remind the interviewer of the range of issues to be considered during the interview.

Accordingly, the interview was designed to collect information about how unlisted property fund managers ***do*** make property investment decisions in practice, from an interviewee who was in a position to have an overview of the entire process.

4.0 FINDINGS

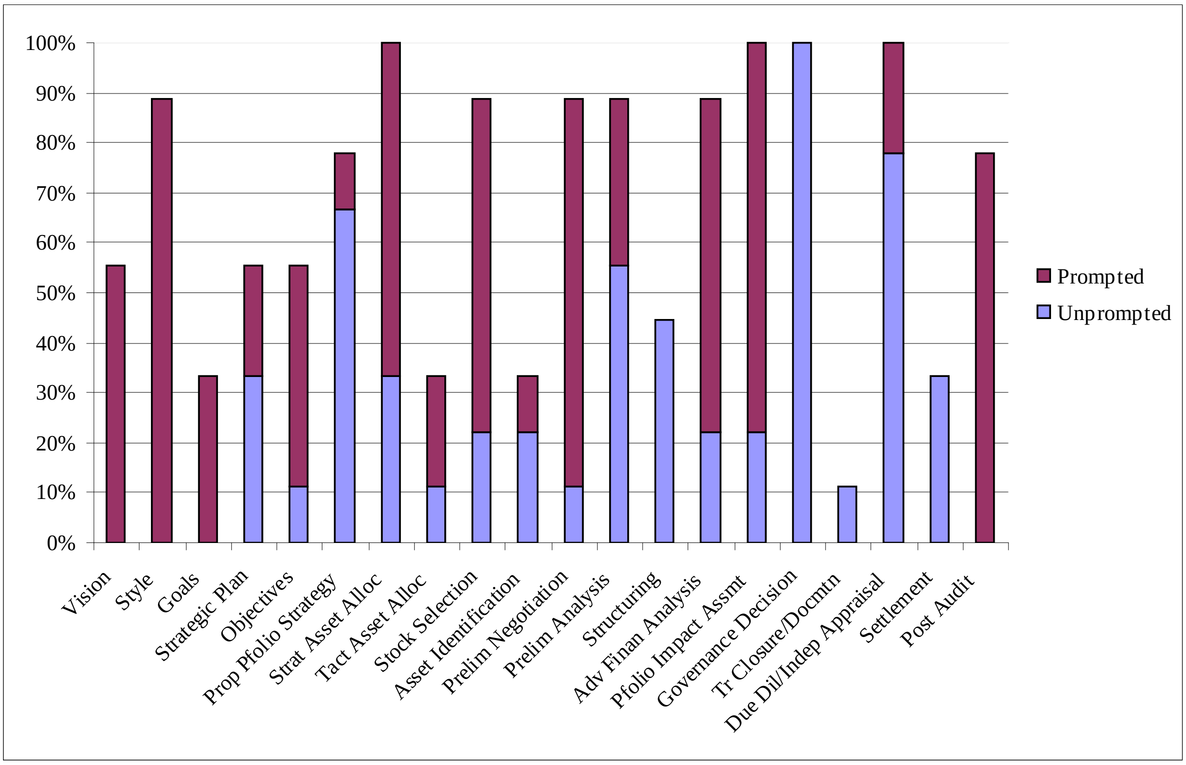
Having collected information about how unlisted property fund managers ***do*** make property investment decisions, this was then analysed for comparison to the information on how unlisted property fund managers ***should*** make property investment decisions proposed in the taxonomy in Table 1, above.

Based on the detailed hand written notes on the aide-memoire, taken during the semi-structured interviews, the descriptions of activities provided by respondents as either an unprompted or as a prompted response were matched to each of the steps described above and proposed in the taxonomy in Table 1, above.

If the description of the activity broadly accorded with that given above, a score of one point was attributed and these were then summed. Accordingly, if a respondent described an activity that matched every step, this would be attributed 20 points or 100%. Similarly, if a respondent described four steps unprompted and six steps prompted, giving ten steps in total that matched, the score would be 20% prompted, 30% unprompted and a total score of 50%.

As the respondents were the decision makers for the unlisted property fund managers, the portfolio of funds under management often included both sector specific and diversified funds. Regrettably, therefore, it was not possible to disaggregate the interview responses between sector specific and diversified funds in order to investigate any similarities or differences in the property investment decision making process between each.

Figure 2 summarises the scores for each of the steps in the property investment decision making process described above and proposed in the taxonomy in Table 1, above.



Respondent Scores - Steps in the Property Investment Decision Making Process
Source: Author
Figure 2

The scores attributed by respondents to the proposed steps were in the range of 11% to 100% with an average of 68% which is considered to be high. The Dealing Stage achieved the highest average score (82%), followed by the Planning Stage (67%) and the Executing Stage (64%), with the Envisioning Stage achieving the lowest average score (58%).

Four of the proposed steps in the property investment decision making process scored 100% reference by respondents, being the Strategic Asset Allocation, Portfolio Impact Assessment, Governance Decision and the Due Diligence/Independent Appraisal steps.

A further ten steps scored 56% reference or greater by respondents, such that 70% achieved reference by more than half of the respondents. This is considered to be a surprisingly high level of reference, suggesting that 70% of the steps proposed in the taxonomy of the property investment decision making process would appear to be correctly identified and appropriately described.

However, while none of the proposed steps scored 0% reference, indicating none to be potentially irrelevant, of particular interest were the 30% steps which scored 44% or less reference by respondents. While the Structuring step scored 44% reference by respondents, the Goals, Tactical Asset Allocation, Asset Identification and Settlement steps scored only 33% reference and the Transaction Closure/Documentation step scored the lowest 11% reference.

It may be argued that the Settlement step and the Transaction Closure/Documentation step each scored low references because they may have been considered so obvious that respondents felt there was no need to refer to them. However, the low levels of reference to the Goals, Tactical Asset Allocation and Asset Identification steps suggests that these require further research to determine if they are incorrectly identified and/or inappropriately described, particularly given the low level of unprompted responses achieved.

5.0 CONCLUSIONS

The review of previous research suggested that the property investment decision making process by unlisted property funds ***should*** comprise twenty sequential, linear steps. With 70% of the proposed steps appearing to be correctly identified and appropriately described, the hypothesis would appear to be supported and this would generally appear to show how unlisted property funds ***do*** make property investment decisions.

Having identified how unlisted property funds should and how they do make property investment decisions, a prescriptive model for the property investment decision making process may be developed. This may be particularly useful in practice as it may provide a template for the decision making process to be followed by unlisted property funds and a basis for benchmarking the decision making process of other property funds.

However, it is also apparent that not all of the twenty steps may be correctly identified and/or appropriately described with a better understanding required of the role, if any, of the Goals, Tactical Asset Allocation and Asset Identification steps. For unlisted property funds these steps may be undertaken as part of another step, such that the same outcome is achieved but by a different route.

If these steps are irrelevant for unlisted property funds, as may be the case for the Tactical Asset Allocation step which is often a short term activity that may be inappropriate for a fund with a long term focus, then a better understanding may be required of how unlisted property fund decision makers manage progress towards the realisation of the funds vision or identify potential assets for acquisition that meet stock selection criteria.

6.0 AREAS FOR FURTHER RESEARCH

For the unlisted property fund industry, a significant unanswered question is whether an objective, explicit and transparent property investment decision making process does lead to "good" decisions. For example, are some unlisted fund managers consistently delivering superior risk-adjusted returns by following an alternative property investment decision making process or by omitting certain steps in the proposed process without adverse impact?

Industry funded research into such issues would appear an unlosable proposition – if such outperformance is the result of repeated maverick opportunism and a large component of luck, the embrace of a minimum decision making process for risk management and investor protection may be advocated. Conversely, if such outperformance is a result of adopting other steps or processes not identified in this research, then an awareness of such may benefit all participants.

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