Property Council of Australia

Property Council White Paper

VOLUNTARY BEST PRACTICE GUIDELINES FOR DISCLOSING FFO AND AFFO

A guide to calculating Funds From Operations and Adjusted Funds From Operations

June 2013

From the President

Investment in commercial markets depends on investor confidence and trust.

The property industry aims to provide investors with clear, consistent and meaningful financial information.

These voluntary best practice guidelines will enhance direct comparison of Australian real estate organisations.

The Property Council thanks industry members for their thought leadership and support.

Darren Steinberg
National President, Property Council of Australia

Introduction

These voluntary best practice guidelines (Guidelines) set out principles for determining Funds From Operations (FFO) and Adjusted FFO (AFFO) in Australia.

The Guidelines can be tailored to the needs of individual real estate organisations.

Background

Investors and analysts consistently request additional financial information from real estate organisations to help understand and compare the underlying financial performance of property entities.

Across the globe, there are several alternative performance metrics used by real estate organisations to provide additional financial information. For example:

- National Association of Real Estate Investment Trusts (NAREIT) FFO;
- European Public Real Estate Association (EPRA) Earnings Per Share; and
- Real Property Association of Canada (REALpac) FFO.

No one performance metric has been adopted globally.

Aims of the Guidelines

Adoption of a standard voluntary performance metric is important to:

1. allow direct comparison of Australian real estate organisations;
2. facilitate better understanding of the performance of an entity and create a practical and meaningful bridge to the audited accounts;
3. increase the confidence of investors, analysts and government in Australia's real estate sector; and
4. attract global capital to Australian property.

The Guidelines are a working document and will be reviewed periodically. This will ensure the performance metric continues to meet the needs of industry, investors and analysts.

How to use the Guidelines

- The Guidelines provide a voluntary framework for determining FFO and AFFO.
- The Guidelines set out adjustments for FFO and AFFO together with principles for determining those adjustments.
- The Guidelines are not intended to represent an exhaustive list of all possible adjustments.
- The adjustments made to statutory profit will depend on each organisation's operations.

  Each organisation should assess whether to apply the adjustments. To the extent an item is not relevant or should be treated differently in an organisation, that entity is not expected to adopt the item. The entity will need to disclose the rationale and difference in the adjustment.

  The FFO and AFFO adjustment for "other unrealised" or "one-off items" is intended to give industry scope to adjust for additional unrealised or non-recurring items as necessary (see F2 and G4 over page). It can be utilised as appropriate to the organisation. Clear explanations should be provided in support of any adjustments.
- To ensure the Guidelines are adopted consistently by the market, and are transparent for users, entities will:
  - reference "Property Council FFO" or "Property Council AFFO" where they use the Property Council definitions and Guidelines;
  - follow the Guidelines applicable to their organisation; and
  - disclose upfront any adjustments that differ from the Guidelines, along with a clear explanation for the change.
- Organisations should calculate and present FFO and AFFO consistently for all periods in their financial statements and analyst briefings.
- Organisations should provide a reconciliation between FFO and statutory profit and provide a clear explanation of how FFO is calculated.
- As part of compliance with existing disclosure regulations, entities will need to present FFO as part of their AASB 8 Operating Segment note where it is used by the "chief operating decision maker to make decisions".
- This White Paper is not intended to impose a legal obligation on entities to comply with the Guidelines.

Property Council Definitions of FFO and AFFO

The Property Council reviewed the NAREIT FFO definition in order to draft a suitable Australian FFO definition.

In the NAREIT 2002 White Paper, FFO is defined as:

> *"FFO means net income (computed in accordance with generally accepted accounting principles), excluding gains (or losses) from sales of property, plus depreciation and amortisation, and after adjustments for unconsolidated partnerships and joint ventures."*

While the NAREIT definition is fairly simple and easily understood, it does not fit well in the context of Australian accounting standards.

United States and Australian accounting standards differ significantly, for example, the treatment of lease incentives and fair value adjustments to real estate.

The Property Council FFO and AFFO definitions have been tailored for the Australian marketplace. This will ensure preparers and users of financial information understand the purpose of the measure and how it is determined.

The definitions are not intended to be a measure of cash generated by the entity – this information is already disclosed in an entity's cash flow statement.

Property Council Definition of FFO

> *"Property Council FFO is the organisation's underlying and recurring earnings from its operations. This is determined by adjusting statutory net profit (under AIFRS) for certain non-cash and other items. FFO has been determined based on guidelines established by the Property Council of Australia and is intended as a supplementary measure of operating performance."*

Property Council Definition of AFFO

> *"Property Council AFFO is determined by adjusting FFO for other non-cash and other items which have not been adjusted in determining FFO. AFFO has been determined based on guidelines established by the Property Council of Australia and is intended as a supplementary measure of operating performance."*

Property Council FFO Guidelines

The Guidelines set out adjustments to convert AIFRS net profit after tax to Property Council FFO:

Ref	Item	Definition	+/- to net profit
Statutory AIFRS Net Profit after tax			
A	**Investment Property and Inventory**		
A1	Gains from sales of investment property	The realised gain or loss is the difference between the sale price and the previous carrying value of investment property, net of transaction costs.	-
A2	Losses from sales of investment property		+
A3	Fair value gain on investment property	The non-cash fair value adjustment between the current fair value of the investment property and the built up book value at the date of valuation.	-
A4	Fair value loss on investment property		+
A5	Impairment charges on inventory	Assets classified as inventory are required to be carried at the lower of cost and net realisable value. This assessment should be undertaken on a project by project basis.	+
A6	Reversal of impairment charge on inventory		-
A7	Depreciation on owner occupied property, plant & equipment (PP&E)	Property assets where the owner is a material tenant of the building must be classified as PP&E and held at cost and depreciated. This is the depreciation charge included in the statutory profit.	+
B	**Goodwill and Intangibles**		
B1	Impairment of goodwill or intangibles	Impairment charges recognised on goodwill and other intangibles.	+
B2	Reversal of impairment of goodwill or intangibles		-
C	**Financial Instruments**		
C1	Fair value gain on the mark to market of derivatives	Non-cash movement of the unrealised fair value gain/loss on derivative positions held in the balance sheet.	-
C2	Fair value loss on the mark to market of derivatives		+
C3	Fair value movement of equity component of convertible bonds	Fair value movement on the equity component within a convertible bond.	+/-

Ref	Item	Definition	+/- to net profit
D	**Incentives and Rent Straightlining**		
D1	Amortisation of fit out incentives	The non-cash amortisation (over the term of a lease) of the incentives provided to a tenant to achieve a certain rent.	+
D2	Amortisation of cash incentives		+
D3	Amortisation of project incentives		+
D4	Amortisation of rent free periods		+/ -
D5	Rent straightlining	The adjustment made to rental income to reflect leases with fixed rate increases over the term of the lease.	+/-
E	**Tax**		
E1	Non-FFO deferred tax benefits	This represents the movement in the unrealised (non-cash) tax amount on non-FFO items.	-
E2	Non-FFO deferred tax expenses		+
F	**Other Unrealised or One-off Items**		
F1	Recycling of Foreign Currency Translation Reserve (FCTR)	The FCTR appears as a separate component of equity in the balance sheet. It represents the cumulative gains and losses on the retranslation of the entity's net investment in foreign operations. On disposal of the foreign operation, the cumulative amount of any exchange differences relating to that operation should be recognised in the income statement together with the gain or loss on disposal of the operation.	+/-
F2	Other unrealised or one-off items	To be adjusted in FFO at the discretion of the organisation with clear explanation. A one-off item is an item that did not occur in the prior period and is highly unlikely to reoccur in the following accounting period.	+/-
Property Council Funds from Operations		**=**	

FFO Explanatory Notes

A Investment Property and Inventory

A1 **Gains from sales of investment property**

A2 **Losses from sales of investment property**

Property assets are classified as investment property under AASB140 only if they are intended to be held in the long term to collect rent. Through the classification as investment property, the entity is stating that its primary intention is to collect rent from the building rather than trade for active income, therefore adjust statutory profit to show just the underlying income derived from the building (i.e. rent) not the capital movement.

A3 **Fair value gain on investment property**

A4 **Fair value loss on investment property**

As above

A5 **Impairment charges on inventory**

A6 **Reversal of impairment charge on inventory**

Gain or loss on inventory is recognised in the statutory profit and FFO once inventory is sold as an operational item. Impairment of inventory is adjusted in determining FFO as any impairment on reversal is an unrealised position. Organisations will need to ensure that any gain/loss on a project by project basis is adjusted to reflect life of project realised gain/loss rather than accounting gain/loss.

A7 **Depreciation on owner occupied PP&E**

Property assets are classified as investment property under AASB140 only if they are intended to be held in the long term to collect rent. Through the classification as investment property, the entity is stating that its primary intention is to collect rent from the building rather than trade for active income, therefore adjust statutory profit to show just the underlying income derived from the building (i.e. rent) not the capital movement.

B Goodwill and Intangibles

B1 **Impairment of goodwill or intangibles**

B2 **Reversal of impairment of goodwill or intangibles**

Excluded as a non-cash item. Impairment would support lower revenue flows in future periods therefore if amount is not added back there will be a double count.

C Financial Instruments

C1 **Fair value gain on the mark to market of derivatives**

C2 **Fair value loss on the mark to market of derivatives**

Excluded as a non-cash treasury number that does not reflect the underlying performance of the entity's property assets.

C3 **Fair value movement of equity component of convertible bonds**

Represents a cost of equity rather than a cost of the entity's underlying operations, therefore excluded.

D Incentives and Rent Straightlining

D1 **Amortisation of fit out incentives**

D2 **Amortisation of cash incentives**

D3 **Amortisation of project incentives**

D4 **Amortisation of rent free periods**

Excluded as doesn't demonstrate the underlying performance of the passing income of the entity's property portfolio.

D5 **Rent straightlining**

Excluded as the amount included in statutory profit reflects a smoothing of the rent earned over the life of the lease rather than the rent that is contractually received.

E Tax

E1 **Deferred tax benefits**

E2 **Deferred tax expenses**

FFO should include the tax incurred on the organisation's underlying operations for the period and should not include future tax positions

F Other Unrealised or One-off Items

F1 **Recycling of FCTR**

Adjusted so FFO represents stabilised / ongoing underlying earnings.

F2 **Other unrealised or one-off items**

Adjusted so FFO represents stabilised / ongoing underlying earnings. Clear explanation to be provided for any adjustments.

Property Council AFFO Guidelines

The Guidelines set out adjustments to convert Property Council FFO to AFFO:

Ref	Item	Definition	+/- to net profit
Property Council Funds From Operations			
G	**AFFO Adjustments**		
G1	Derivative close out costs	Break costs incurred from the early termination of a derivative position crystallising the gain or loss on the derivative.	+/-
G2	Maintenance Capex	Capital expenditure spent as part of maintaining a building's grade / quality. In principle, this should be capital expenditure from the entity's cash flow statement less development capex.	-
G3	Incentives given for the accounting period	The amount of cash and cash equivalent incentives (cash, rent free etc) given to tenants during the period.	-
G4	Other one-off items	To be adjusted in AFFO at the discretion of the organisation with clear explanation. A one-off item is an item that did not occur in the prior period and highly unlikely to reoccur in the following accounting period.	+/-
Property Council Adjusted Funds From Operations		**=**	

AFFO Explanatory Notes

G1 **Derivative close out costs**

One-off items, adjusted to show passing operational cash earnings.

G2 **Maintenance capex**

Cash spent during the period but not expensed as part of statutory profit or FFO, adjusted to reflect cash earnings for the year.

G3 **Incentives given for the accounting period**

Cash and cash equivalent incentives given during the period but not expensed as part of statutory profit or FFO, adjusted to reflect cash earnings for the year.

G4 **Other one-off items**

Adjusted so AFFO represents stabilised / ongoing operational cash earnings. Clear explanation to be provided for any adjustments.

The Property Council acknowledges and thanks the following members for their feedback and guidance:

AMP Capital
APN Property Group
Australand Holdings Limited
Brookfield Office Properties
Challenger Limited
Colonial First State Global Asset Management
Cromwell Property Group
Deutsche Asset and Wealth Management
DEXUS Property Group
Ernst & Young
Federation Centres
The GPT Group
Investa Property Group
KPMG
Merrill Lynch Equities (Australia) Limited
Mirvac Group
PricewaterhouseCoopers
Provecho Partners
Quadrant Real Estate Partners
Stockland
UBS
Westfield Group

The above members have contributed to the development of the White Paper. This acknowledgement does not bind them to adopting the Guidelines and does not indicate that they agree with all aspects of the White Paper.

Feedback

Please send your feedback to:

Andrew Mihno
Executive Director
International & Capital Markets Division
Email: amihno@propertyoz.com.au
Phone: (02) 9033 1944
Level 1, 11 Barrack Street
Sydney NSW 2000
AUSTRALIA

PROPERTY COUNCIL *of Australia*