Voluntary Practice Note

TREATMENT OF ACQUISITION COSTS FOR UNIT PRICING

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PROSPERITY | JOBS | STRONG COMMUNITIES

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1.0 BACKGROUND

Acquisition costs typically represent a material percentage of the purchase price of an asset.

These costs are borne by unit holders that have an interest in the fund at the time the asset is acquired.

Acquisition costs are not incurred by new investors when new equity is raised even though these investors enjoy the returns associated with the underlying assets.

In addition, different funds have different methods of reflecting acquisition costs in the fund's unit price.

This gives rise to a number of issues including inequitable treatment between existing, joining and leaving investors within a single fund. In addition, unit pricing and fund performance is not comparable between funds.

This practice note outlines voluntary best practice for reflecting acquisition costs in the unit price of unlisted property funds. This practice note proposes two methods for calculating fund unit price.

These two methods seek to improve comparability between funds, promote industry consistency and achieve greater equality between unit holders within a single fund.

The definitions of key terms are as follows:

1.1 Acquisition Costs

Acquisition costs are costs directly attributable to the purchase of an investment property. Expenditure can include, amongst other things, legal fees, due diligence costs and stamp duty.

Acquisition costs are usually in addition to the price of the asset and typically range from 5% to 6% of the purchase price of the asset. Acquisition costs are unusually high in this asset class, compared to shares and fixed interest investments.

1.2 Statutory Accounting Definition of Net Tangible Assets (NTA)

NTA is defined in the International Financial Reporting Standards (IFRS) and is calculated by way of a two-step calculation.

First, the initial carrying value of an investment property is computed. This includes both the purchase price and acquisition costs.

Second, the fund manager is required to compare the carrying value of the investment property to its fair market value.

To the extent carrying value exceeds fair market value (which may often be the case since the carrying value includes acquisition costs) the difference between the two values is written-off at the time of acquisition.

This paper does not propose to challenge the accounting standard.

1.3 Current Unit Value (CUV)

The method of calculating the CUV (i.e. the fund unit price) is contractually defined in the fund's constitution and may vary from NTA.

Since funds have different contractual methods of calculations in place, unit prices are not directly comparable. As a result, fund performance is also not directly comparable.

Acquisition costs may be treated in any one of the following ways for the purposes of determining CUV:

1. being written-off following a fair value adjustment immediately upon acquisition;
2. being written-off following a fair value adjustment at the end of the current quarter;
3. being written-off following a fair value adjustment at the end of the year;
4. costs are capitalised and written-off over a number of years; or
5. not being written-off at all on the basis that it is considered immaterial.

As a result there is inconsistency within the industry and benchmarking performance between funds is difficult given the different treatment of acquisition costs.

2.0 THE ISSUE

The different timing for writing-off acquisition costs, and the fact that some funds do not write them off at all, creates the following problems:

- variance in the CUV over time which may create inequity between current, joining and leaving investors within a single fund due to the timing of the acquisition cost adjustment;
- CUV is neither transparent nor comparable between funds;
- fund performance (which is based on the CUV) is not comparable between funds; and
- funds suffering a short-term reduction in returns due to writing-off acquisition costs may be interpreted as poor performance and result in lack of support by investors.

3.0 THE OBJECTIVE

The objective of this paper is to identify possible solutions to the issue and achieve:

- greater equity between current, joining and leaving investors;
- transparency regarding what is included in calculating a fund's CUV;
- easier comparability between funds; and
- greater consistency across the industry.

The paper acknowledges and does not seek to over-ride statutory accounting requirements.

4.0 ALTERNATIVE APPROACHES AND SOLUTION

To achieve the objectives listed above, it is proposed that CUV be calculated in either of the following two methods. The starting point for both methods is NTA as calculated under IFRS:

Method 1: Capitalising acquisition costs where CUV = NTA + acquisition costs. Acquisition costs will then be written-off (amortised) over a defined period.

Method 2: Incorporating acquisition costs in a "buy spread". Under this method, CUV = NTA. However, at the time of issuing new equity, a "buy spread" premium (equal to acquisition costs) is added to the CUV.

These two calculation methods are discussed in more detail below.

4.1 Method 1: CUV = NTA + acquisition costs

The rationale for this approach is that acquisition costs are capitalised into the CUV.

When new equity is raised, the new investors pay CUV, which includes their fair share of previously incurred acquisition costs. In the event that investors' units are redeemed by the fund (if applicable) then they are redeemed at NTA. In this way, the investor incurs its fair share of acquisition costs.

There remains only the consideration of whether to take into account full acquisition costs into perpetuity, or to write-off acquisition costs over a period of time. This is discussed in section 4.1.1

The process of capitalising acquisition costs provides transparency. This is because acquisition costs associated with underlying assets are reflected in the CUV and are not "lost".

This approach measures up against the issues and objectives as follows:

- by raising equity at a CUV (which reflect acquisition costs) and redeeming units at the lower NTA, greater equity is achieved between current, joining and leaving investors;
- if all funds chose to adopt Method 1 (or Method 2) then transparency, industry consistency and easier comparability between funds would be achieved; and
- by reporting the higher CUV (including acquisition costs) the short-term reduction in returns as a result of writing-off acquisition costs is avoided.

Other considerations relevant in adopting Method 1 are discussed below:

4.1.1 Period of amortisation

If Method 1 is adopted, it is necessary to decide whether acquisition costs are capitalised into the CUV into perpetuity or if they are written-off over a period of time.

The benefit of writing costs off over time is that the CUV changes over time and converges with the NTA. This would make it easier for managers to raise new equity.

The disadvantage of writing costs off over time is that it is not completely equitable between new and existing unit holders, as new unit holders do not pay their full share of acquisition costs. However, this is fairer than the current practice where new unit holders typically pay no contribution to past acquisition costs.

This decision to write off costs over time will need to be made by the manager, in conjunction with unit holders. The decision will be based on a number of considerations including the life of the fund and liquidity of the fund's unit holder base.

INREV recommends that acquisition costs are capitalised at the acquisition date and written-off on a straight line basis within the first 5 years of an investment property being acquired.

When a property is sold during this 5 year period, the balance of the capitalised acquisition costs are written-off by charging them as a cost to the income statement in the period of the sale. INREV recommends this practice for performance measurement and for unit pricing for buying and selling units and raising equity.

On balance it is recommended that a 5 year write-off period is adopted, and is acknowledged as a compromise solution. However, individual fund circumstances and the appetite of unit holders may drive a different outcome for some funds.

4.1.2 Constitutional Change

It will be necessary for existing funds to go through the process of reviewing and amending fund constitutions to adopt Method 1. This will require unit holder consultation and approval and could take some time and may not be acceptable to all investors.

4.1.3 Funds Management Fees

It is recommended that base and performance fees are calculated on the NTA price rather than a CUV which includes acquisition costs. This ensures that fees do not increase as a result of adopting the new methodology.

4.1.4 Prior Acquisitions

It is necessary for each fund to decide if the CUV should reflect only new acquisitions made from the date that the constitutional change is approved, or whether the CUV should be adjusted to reflect acquisitions made during prior years.

4.1.5 Investors' Mark to Market of Unit Price

Despite the provision of the CUV including acquisition costs, investors may choose to hold units on their books at the lower NTA to reflect the fair market value of their units.

4.1.6 Distribution Reinvestment Plan

It will be necessary to decide whether the Distribution Reinvestment Plan units are issued at the higher CUV including acquisition costs (which would be more equitable) or the lower NTA unit price.

4.2 Method 2: CUV = NTA. A "buy-spread" premium is added at time of issuance

The starting point for calculating CUV under Method 2 is the NTA. However, a "buy-spread" premium reflecting acquisition costs is then added to the unit price when new units are issued.

There remains only the consideration of whether to take into account full acquisition costs into perpetuity, or to write-off acquisition costs over a period of time. This is discussed in section 4.2.1.

For the purposes of calculating the buy-spread premium under this method, funds will be required to maintain an acquisition costs schedule.

It is noted that the Financial Services Council (FSC) Standard 8 recommends that its member consider a number of matters when considering the appropriate buy-spread, whilst under this this approach, a buy-spread is calculated on the basis of incurred acquisition costs only.

The buy-spread premium would be payable by the new unit holders to the issuing fund (not the manager) and would have a positive impact on fund performance. In effect, this will compensate existing unit holders for acquisition costs incurred by existing unit holders in the past.

This approach measures up against the issues and objectives as follows:

- by raising equity at NTA plus a buy-spread premium, greater equity is achieved between joining and current investors; and
- if all funds chose to adopt Method 2 (or Method 1) then transparency, industry consistency and easier comparability between funds would be achieved.

4.2.1 Period of amortisation

As with Method 1, it is necessary to decide whether the acquisition costs are retained in the buy spread into perpetuity or if they are written-off over a period of time.

The benefit of writing costs off over time is that the buy-spread reduces over time. Managers perceive that this would make it easier to raise new equity.

The disadvantage of writing costs off over time is that it is not completely equitable between new and existing unit holders, as new unit holders do not pay their full share of acquisition costs. However, this is fairer than the current practice, where new unit holders typically pay no contribution to past acquisition costs.

On balance it is recommended that a 5 year write-off period be adopted, and is acknowledged as a compromise solution. However, we recognise that individual fund circumstances and the appetite of unit holders may drive a different outcome for some funds.

4.2.2 Constitutional Change

Adopting Method 2 may be a simple process for most funds since constitutions commonly allow fund managers to charge a premium to the unit price. Therefore it is unlikely that a unit holder vote would be required to implement this method.

4.2.3 Funds Management Fees

It is recommended that funds management base and performance fees are calculated on NTA, excluding a buy spread. This ensures that fees do not increase as a result of adopting the new methodology.

4.2.4 Prior Acquisitions

It is necessary to decide if the buy spread premium is to reflect only new acquisitions made from the date that the change is approved, or whether the buy spread premium should also reflect acquisitions made during prior years.

4.2.5 Investors' Mark to Market of Unit Price

Investors typically hold fund investments at NTA, as this reflects the "sell price" of the units. With Method 2, the CUV equals the NTA which equals the "sell price", thereby minimising complexity and reducing the possibility administrative errors when compared to Method 1.

4.2.6 Distribution Reinvestment Plan

It will be necessary to decide whether the Distribution Reinvestment Plan units are issued with a buy premium (which would be more equitable) or not.

5.0 OTHER CONSIDERATIONS

5.1 Sell spread

Property funds also incur significant costs selling real estate assets which are not reflected in a typical valuation.

The objective of most valuations is to determine the price that a buyer is willing to pay for an asset, assuming they also pay acquisition costs. The seller, however must pay his selling costs out of the proceeds of sale. The order of magnitude of the selling costs is 1-2%, being significantly less than acquisition costs at 5-6%.

The selling costs are particularly relevant in a closed-end fund or a Fund which is winding up, as the selling costs will most likely be incurred in the near term. In the case of an open ended fund, however, it would be reasonable to assume that an exiting investor is replaced by a new investor, and the underlying assets are not sold.

It would therefore be reasonable to adopt a sell spread in a shrinking fund or a closed end fund. In an open ended fund, it would be reasonable to assume a sell spread on the valuation of an asset which is earmarked for sale at a future date.

The introduction of a sell spread is a matter for the fund manager to take up with the investors. It would be a simple matter to incorporate a sell spread using the principles outlined in this paper.

5.2 Mark to Market of Derivatives

It is not part of the brief to consider the treatment of mark to market of derivatives and the effect on unit pricing and performance benchmarking. Although it is a similar issue for the industry to the treatment of acquisition costs there is more diverse industry opinion on the subject.

A separate review is being undertaken in relation to the treatment of mark to market of derivatives.

6.0 RECOMMENDATION

The Property Council of Australia recommends that:

- Fund managers adopt a voluntary "best practice" of reflecting acquisition costs in unlisted property funds to provide a more equitable approach to the impact of acquisition costs on unit holder returns.
- Reflecting acquisition costs can be implemented either by:
  - Method 1 - Capitalising acquisition costs in the CUV; or
  - Method 2 - Incorporating acquisition costs in a buy spread applied to the CUV when new units are issued
- Fund managers adopt a 5 year write-off period, noting that this is a compromise and is not a perfect solution. An individual fund may choose to select a longer or shorter write-off period or none at all. Amortisation profile will depend on the fund's specific circumstances.
- If a fund manager chooses to incorporate acquisition costs in the CUV, performance should be reported on both an NTA and CUV basis.
- Each time they report performance, funds clearly state the basis on which their performance numbers are calculated.
- Funds maintaining flexibility and discretion in their treatment of acquisition costs, recognising that it is a contractual matter between investors and the manager.

7.0 Worked Examples

Method 1: Capitalisation of acquisition cost into CUV and writing off over 5 years

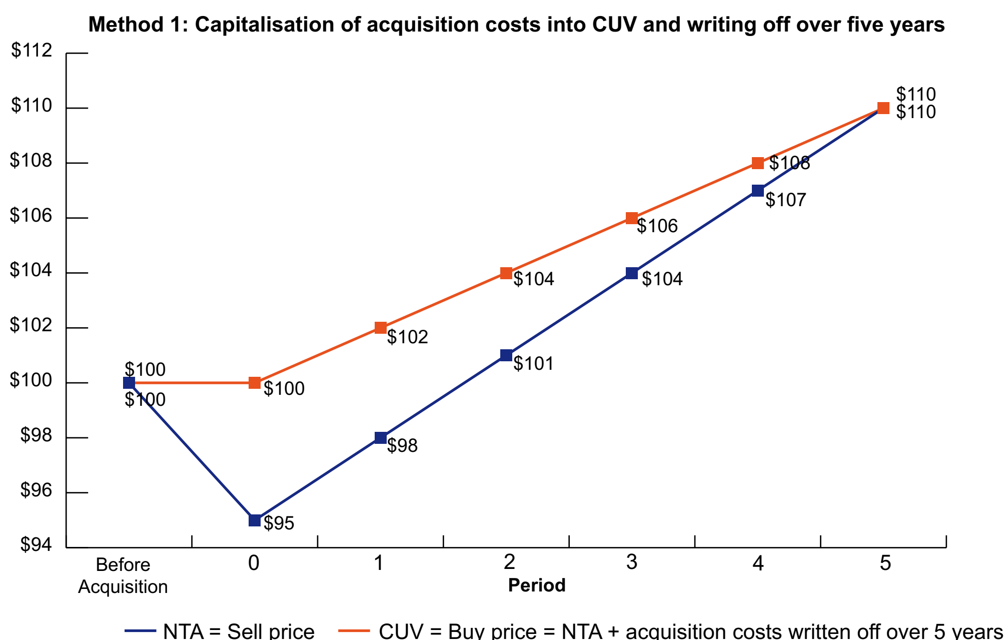
	Before acquisition	0	1	2	3	4	5
NTA = Sell price	100	95	98	101	104	107	110
CUV = Buy price = NTA + acquisition costs written off over 5 years	100	100	102	104	106	108	110

Method 2: Buy spread with acquisition costs never written off

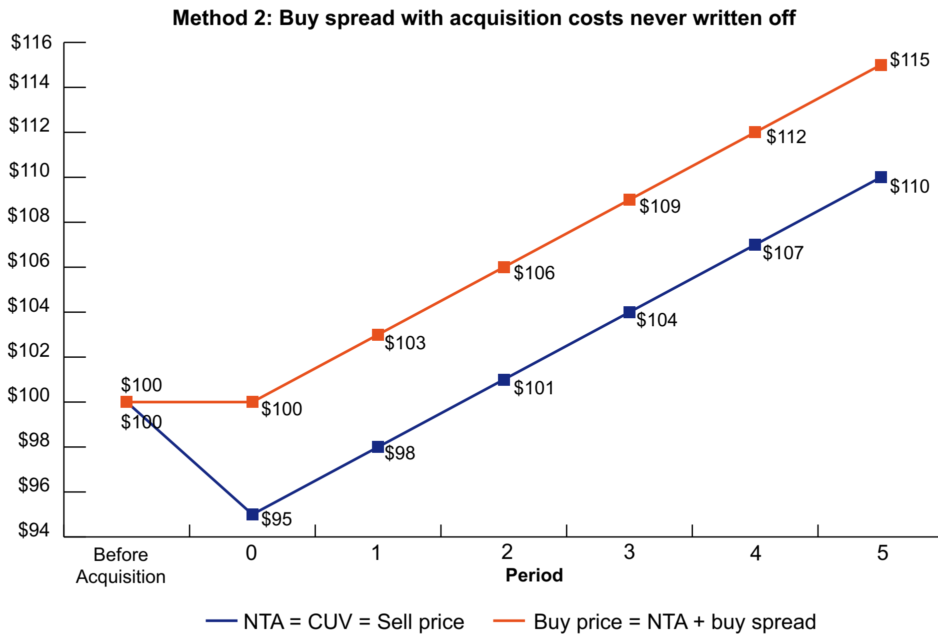
	Before acquisition	0	1	2	3	4	5
NTA = CUV = Sell price	100	95	98	101	104	107	110
Buy price = NTA + buy spread	100	100	103	106	109	112	115

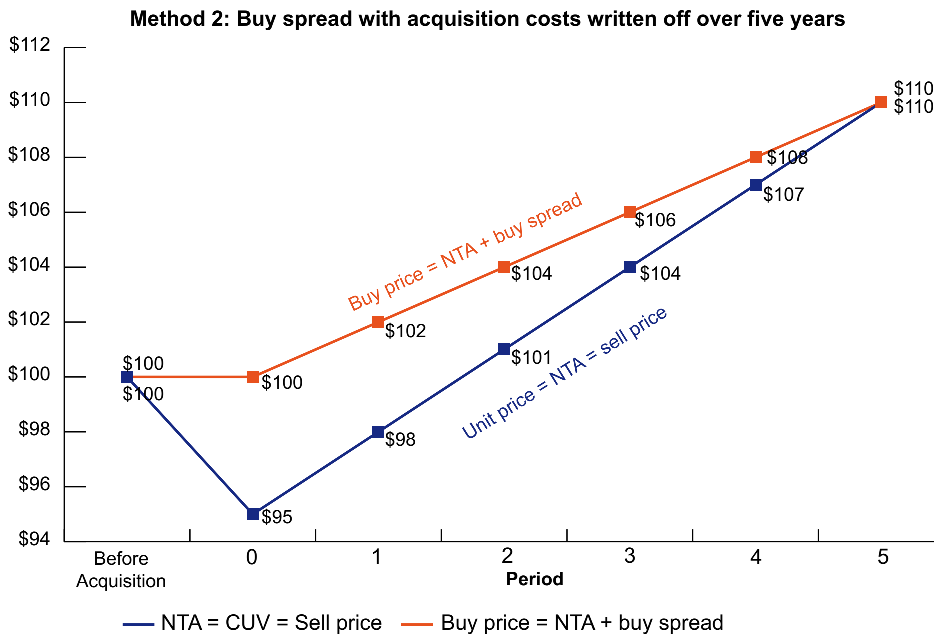
Method 2: Buy spread with acquisition costs written off over 5 years

	Before acquisition	0	1	2	3	4	5
NTA = CUV = Sell price	100	95	98	101	104	107	110
Buy price = NTA + buy spread	100	100	102	104	106	108	110



7.0 Worked Examples





Feedback

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