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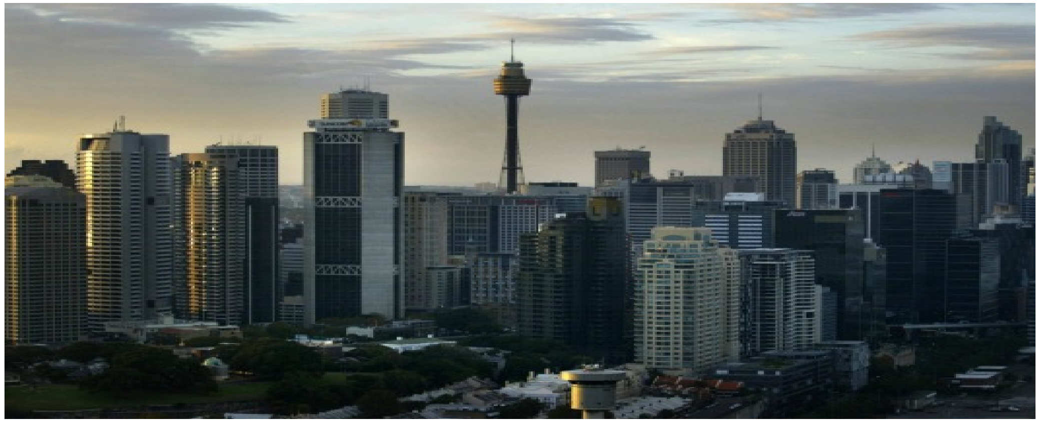
Investors brace for lower property returns, fundie bonuses under threat



The lucrative bonuses earned by property fund managers are under threat. **James Alcock**

by **Larry Schlesinger**

Most unlisted property funds could miss the targeted returns that have generated their managers' hefty annual performance fee bonuses in past years, as commercial property yields tighten and capital growth slows, new research shows.

Either that, or property fund managers will need to convince their investors to pay out bonuses on lower single-digit returns.

A new *Performance Fee Assessment* report commissioned by the Property Funds Association suggests most fund managers won't achieve the nine and 10 per cent total returns that have generated performance fees over much of the past two decades.

Yield compression, which has been occurring across the commercial property market, combined with minimal rental growth, low inflation and minimal capital growth will drive total property returns lower over the next three to five years, said Atchison Consultants in its report for the PFA .

How fund managers earn performance fees

Structures	Number of managers	Number of funds	Hurdle rates
Absolute return	15	40	9-18%
Australian government bonds	2	2	Aust. govt. bond 10yr + 4%
Property market	5	8	Mercer IPD Index
Real return	1	3	CPI
No performance fee	8	13	n/a

SOURCE: ATCHISON CONSULTANTS, PFA

The firm forecasts an average rental yield of 4.5 per cent over the next three to five years.

A survey of 27 fund managers and 66 unlisted property funds they manage undertaken by Atchison found that 60 per cent of these funds paid performance fees based on a total absolute return "hurdle rate" of between nine and 18 per cent. Twenty-seven funds had an absolute return hurdle rate of 10 per cent.

Hurdle rate

However, Atchison Consultants is forecasting total annual returns of between six and 7.5 per cent over the next three to five years (down from a historical average of around 10 per cent) meaning many of these fund managers won't achieve the returns needed to earn performance fee bonuses which can add an additional 15 to 30 per cent to base management fees.

"An absolute return of 9 and 10 per cent per annum, which was achieved historically, is unlikely as the property return forecast is 7.4 per annum and income is 5.9 per cent," the PFA report said.

"An absolute return of 6 per cent to 7.5 per cent per annum may be achievable reflecting rental income yields and moderate gearing. This range of 6 to 7.5 per cent would be an appropriate absolute hurdle rate of return for fund managers."

Paul Healy, CEO of the PFA, told *The Australian Financial Review* the research indicated that performance fees on new funds should kick in around the 7 to 8 per cent mark.

"With internal rates of return [IRR] declining because of large capital growth in the sector, the IRR targets for performance fees appear to be too high. A typical 10 per cent hurdle is difficult to achieve without going up the risk curve," he said.

He contended that investors would accept a lower performance fee hurdle, recognising the importance of incentivising managers to deliver a maximum return for them.

Investors may look elsewhere

Mr Healy said he believed investors would continue to allocate funds to unlisted property despite the lower returns because of the favourable and "quantifiable" risk-return scenario compared with other investment opportunities.

Wealthy individuals, institutions and SMSFs are the traditional investor base for unlisted property funds. Some with riskier appetites might consider allocating more capital to the growing number of mezzanine debt funds which offer returns well into the double digits.

But even with cap rates now around 5 per cent, Mr Atchison said unlisted property funds were still a sound investment given where bond rates are at.

Jason Huljich, CEO of unlisted funds at ASX-listed fund manager Centuria, which participated in the PFA survey, said most investors now have lower IRR expectations.

"[Return hurdles] have been static around 10 per cent for a long time but they are now hard to achieve," he said.

"In the current and forecast property market conditions it is clear that a performance fee based on a benchmark of 10 per cent is inappropriate. A maximum 7.5 per cent benchmark, or lower, is a more acceptable rate going forward."