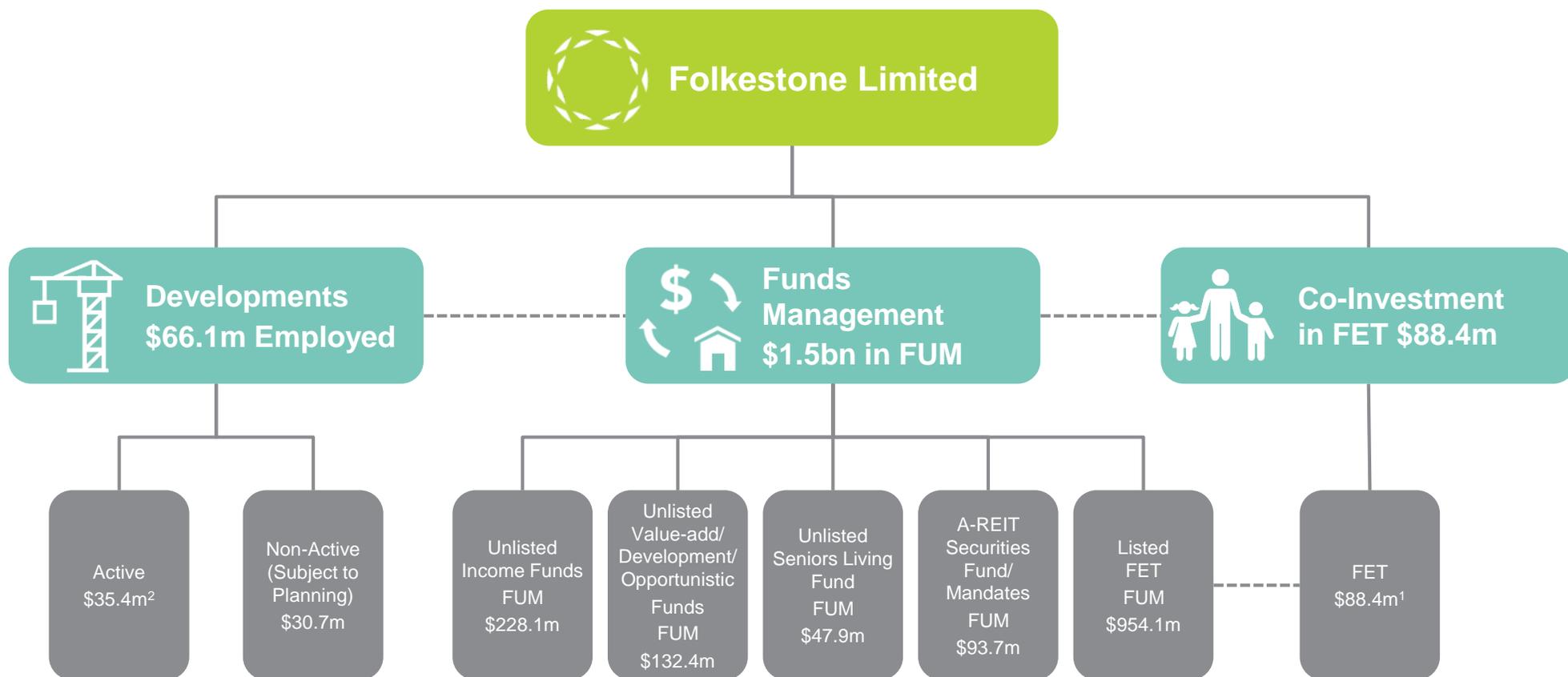


# DIVERSIFICATION VIA REAL ESTATE

**Adrian Harrington**  
**Head of Funds Management - Folkestone**  
**May 2018**



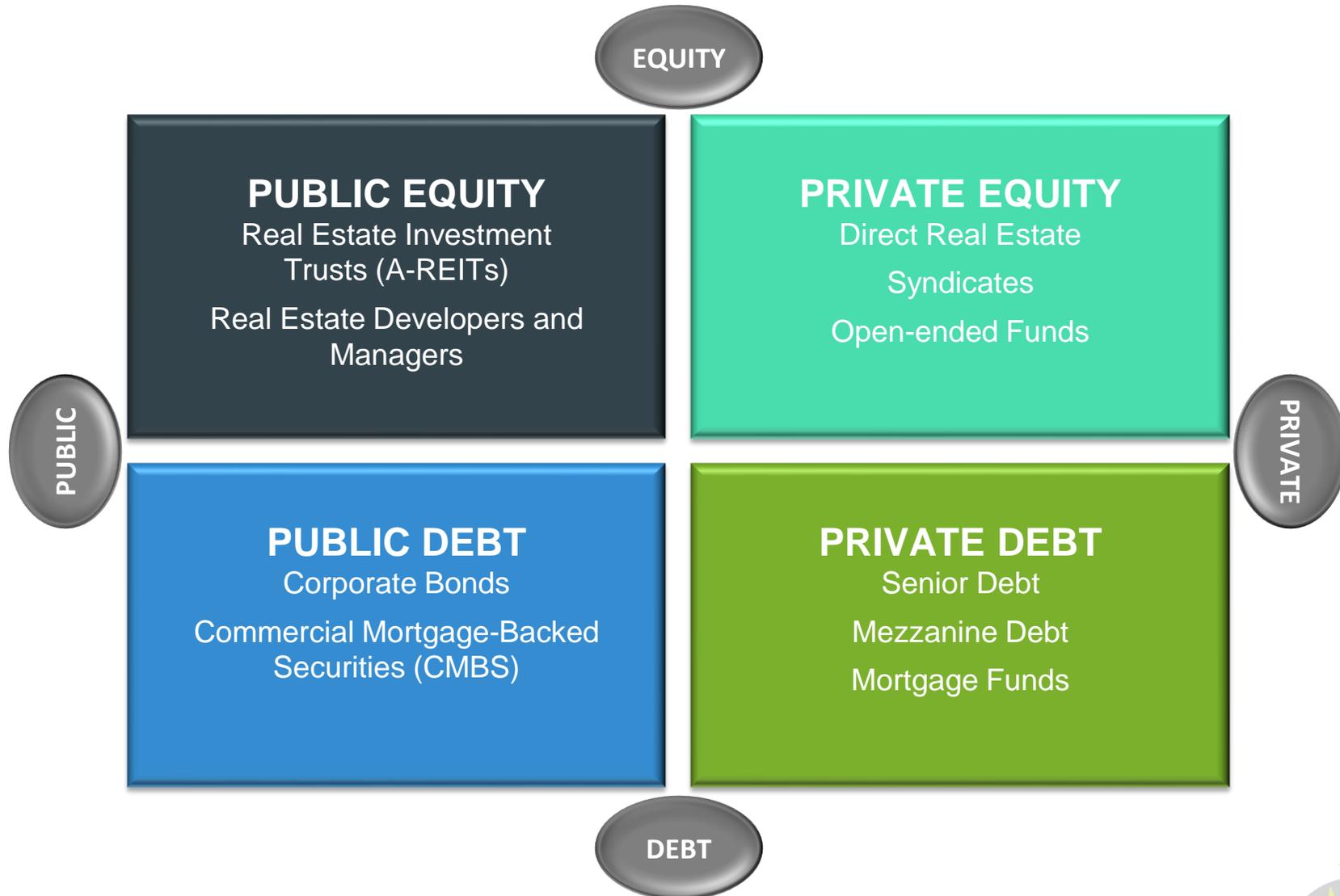
Folkestone is an ASX listed real estate funds manager and developer providing real estate wealth solutions for private clients and select institutions



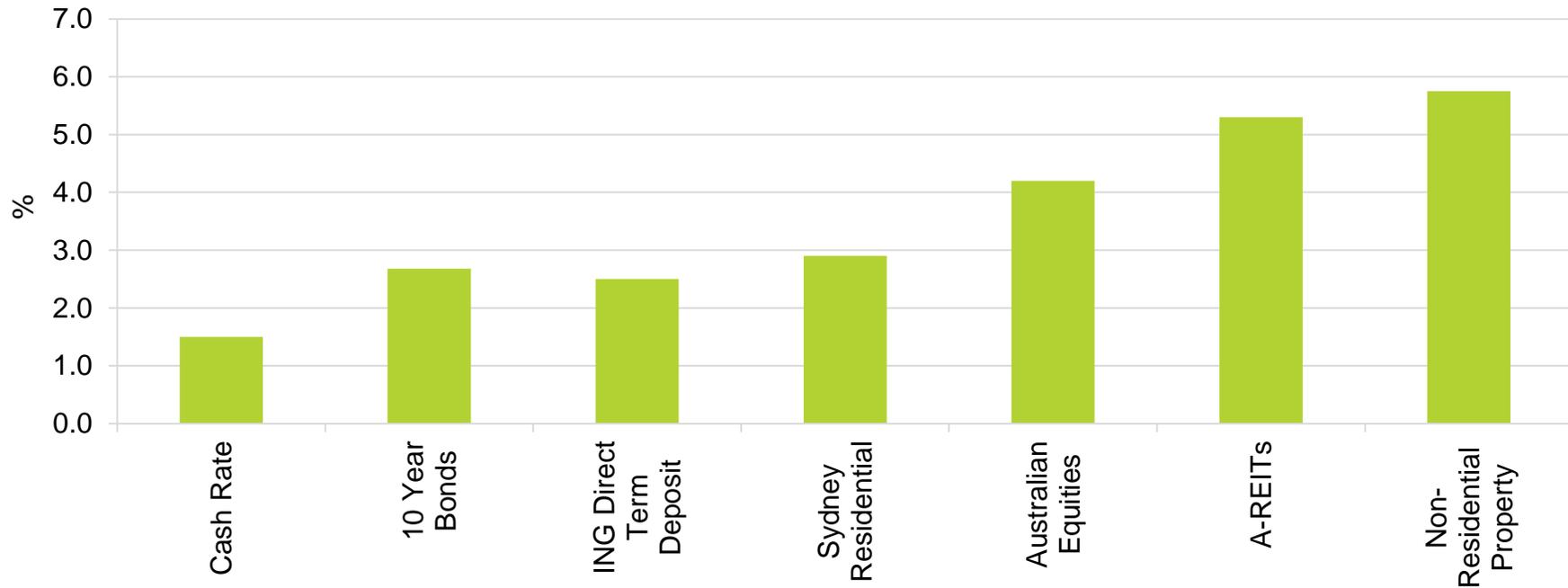
1. Based on Folkestone Education Trust's (ASX:FET) Unit price of \$2.88 at 31 December 2017. Excludes interest in FET held by Folkestone Maxim A-REITs Fund/Mandates.  
 2. Includes FLK's co-investments in the Folkestone Seniors Living Fund No.1, Folkestone Truganina Development Fund and Folkestone Wollert Development Fund.



# FOUR QUADRANT REAL ESTATE INVESTING



## Investment Yields: 30 April 2018



Source: Yield Report, Core Logic, RP Data, Credit Suisse, IRESS Folkestone

- Non-residential property and A-REITs provide an attractive yield relative to other investments



# NON-RESIDENTIAL PROPERTY



**Folkestone**  
MAXIM A-REIT SECURITIES FUND

- Real estate has provided a **competitive return** over the long term
  - “core” real estate is expected to generate a lower return than equities but higher than bonds
- Real estate **generates income** from contracts and leases
  - more stable income streams across the cycle
  - approximately 70% of the total return from core real estate is derived from current income generated by contractual rent payments associated with tenant leases
  - provides a hedge against inflation
- Brings **diversification benefits** to the mixed-asset portfolio
  - real estate exhibit lower correlations with equities and bonds
- **Active management** in real estate can add significant value
  - an owner can actively manage a portfolio through market, sector and or asset selection decisions
  - an owner can make physical changes to an individual asset, increase its operational efficiency or alter its capital structure in efforts to increase returns

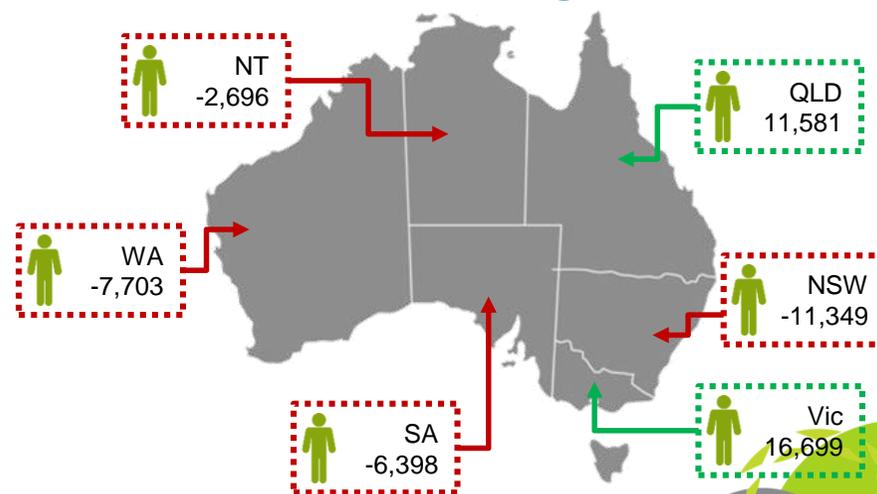


- Sydney and Melbourne growing above trend
- Population forecasting has consistently fallen short – ABS forecast's 1999 vs 2016:
  - Australia - 22.2m vs 24.2m
  - Sydney - 4.45m vs 5.0m
  - Melbourne - 3.67m vs 4.7m
- Inner city & middle ring population growth stronger than expected
- Infrastructure has not kept pace
- Pressure on social services – childcare/aged care/schools/medical especially inner & middle ring
- Creates social infrastructure real estate investment opportunities

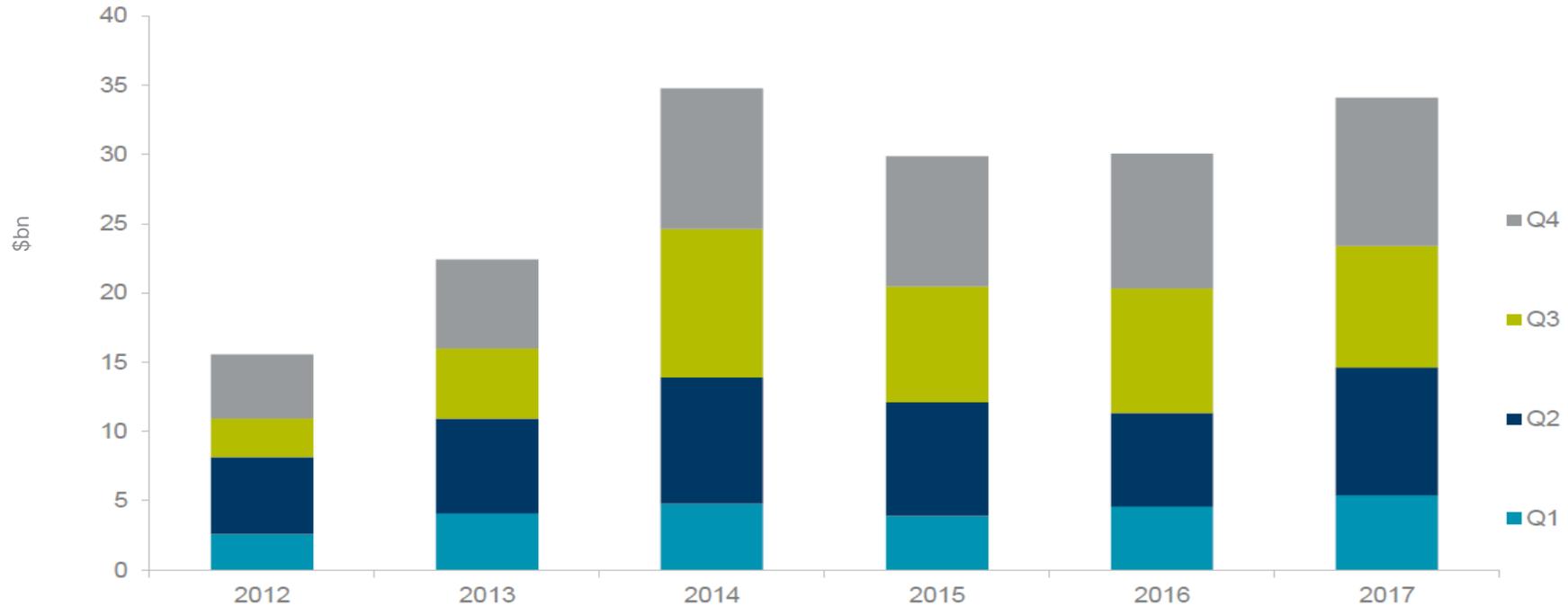
## Demographic Shift – Cities

	Population at 30 June 2016	Change on Previous Year	
		No.	%
Greater Sydney	5,005,358	82,797	1.7
Greater Melbourne	4,641,636	107,770	2.4
Greater Brisbane	2,349,699	41,135	1.8
Greater Adelaide	1,326,354	9,371	0.7
Greater Perth	2,066,564	27,428	1.3
Greater Hobart	222,802	1,786	0.8
Greater Darwin	143,629	1,147	0.8
ACT	396,294	5,020	1.3
<b>Total Cities</b>	<b>16,152,336</b>	<b>276,454</b>	<b>1.7</b>

## Net Interstate Migration



## Total Australian Non-Residential Investment Activity: 2012 - 2017

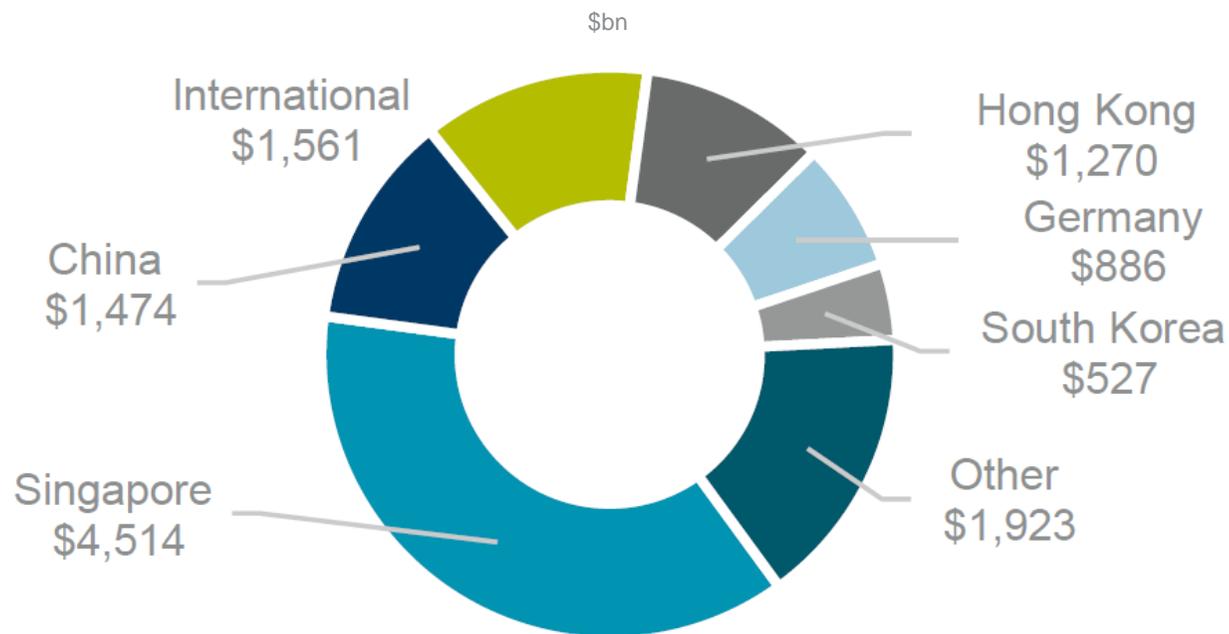


Source: Cushman & Wakefield

- Strong investor interest continues - \$34.1 billion in sales in 2017, up 14.0% on 2016 levels



## Non-Residential Foreign Investment In Australia By Country: 2017

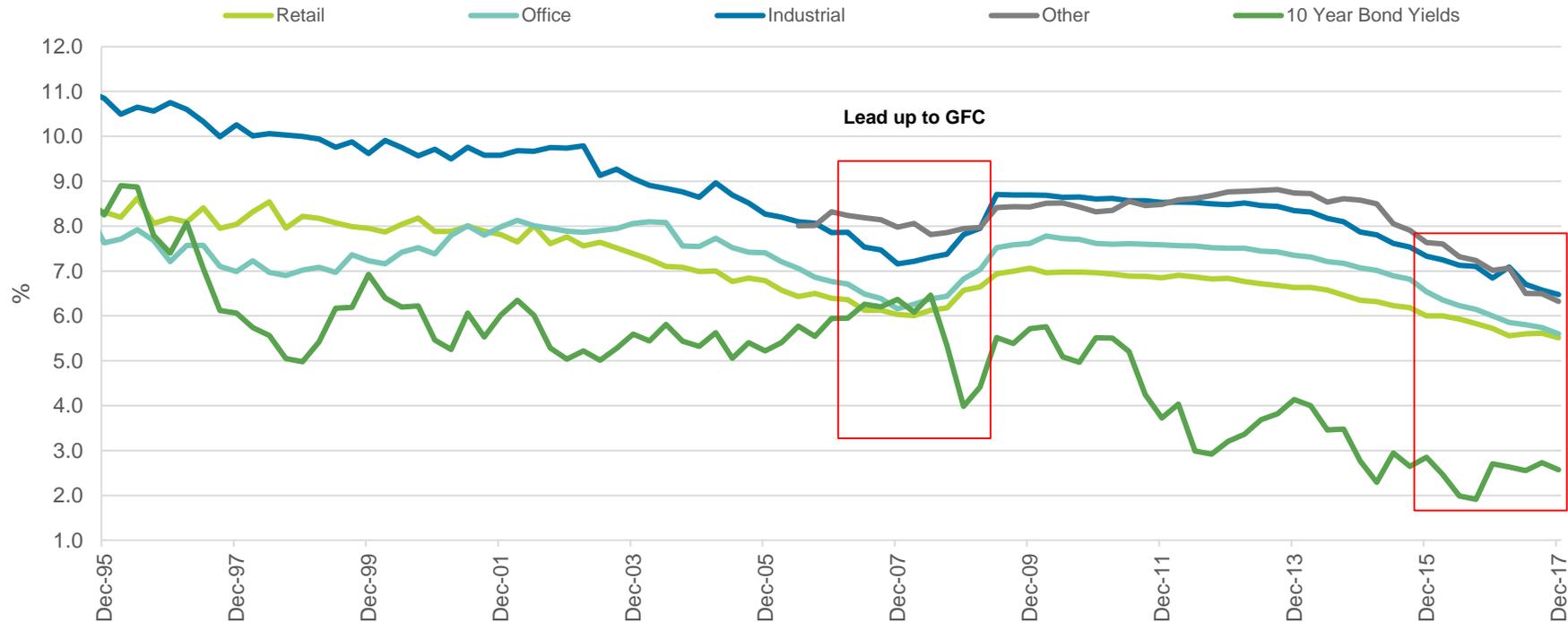


Source: Cushman & Wakefield

- Foreign investment of \$12.2 billion – 36% of all transactions
- Asian lead the investments - \$8.4 billion driven by Singapore and China



## Non-Residential Real Estate Yields: 1995 – 2017

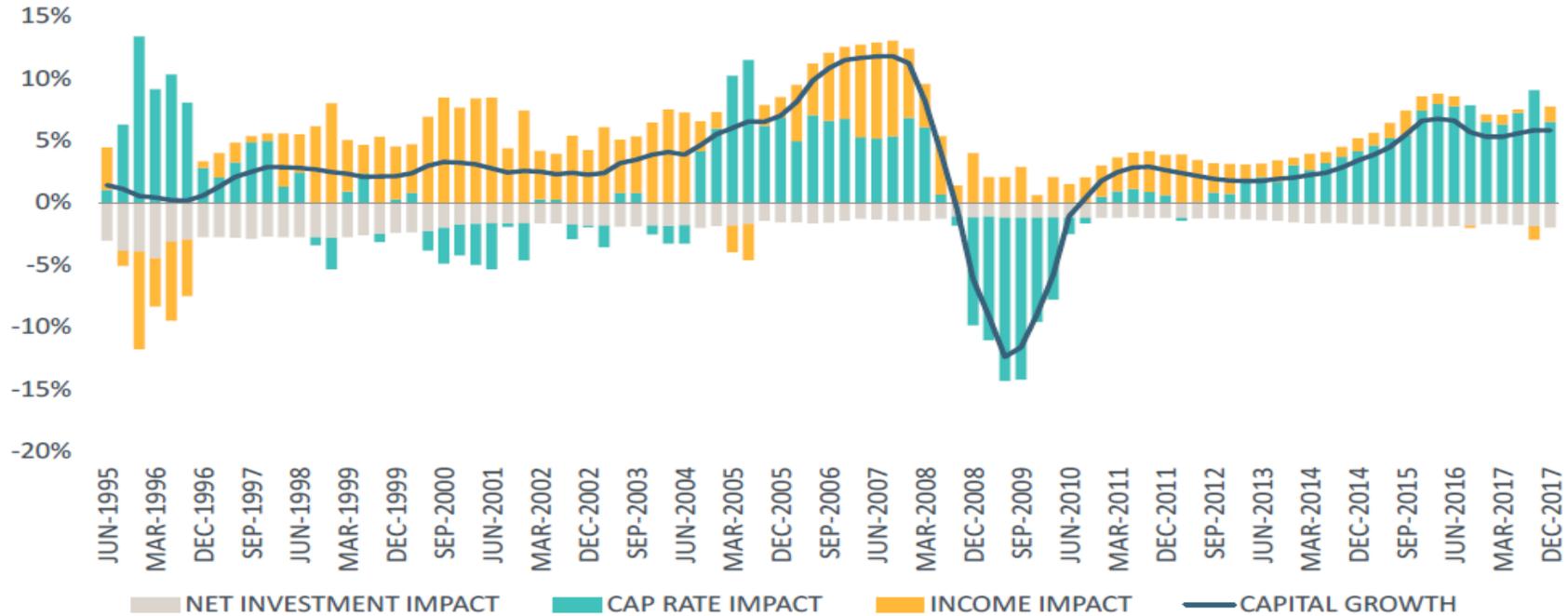


Source: MSCI/PCA

- Cap rates at record lows – difference between 2007 and now is spread between bond yields



## Drivers of Non-Residential Property Investment Returns: 1995 - 2017

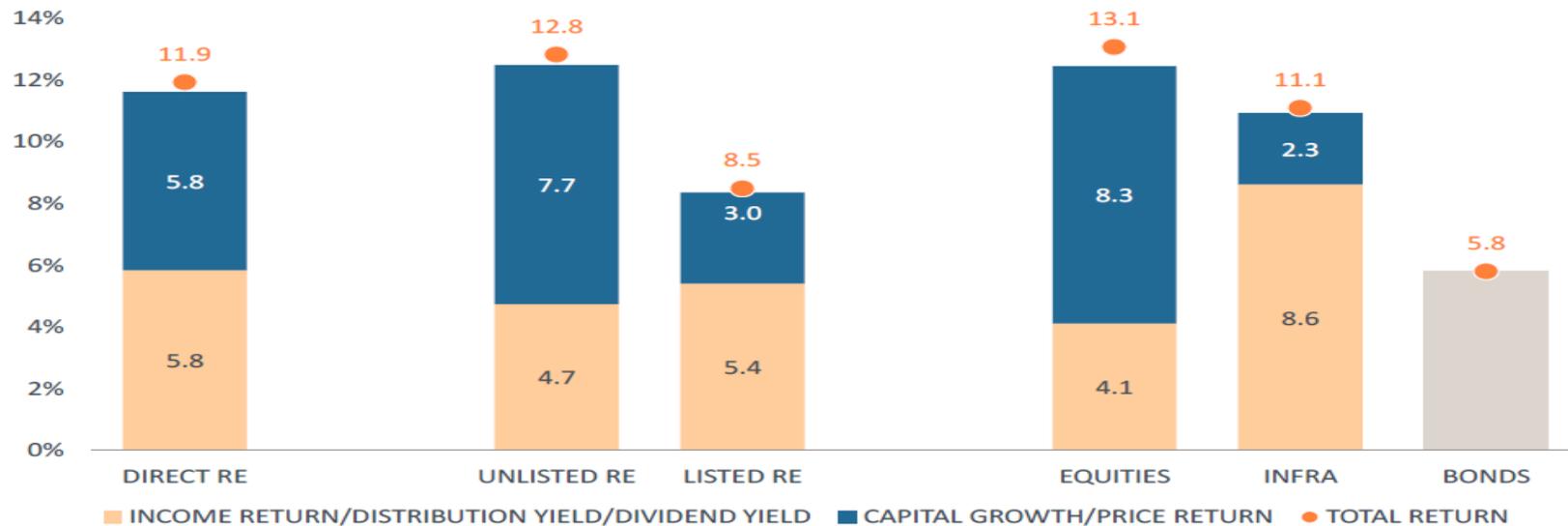


Source: MSCI

- Returns have been driven by cap rate compression rather than income growth



## Asset Class Returns: Year to 31 December 2017



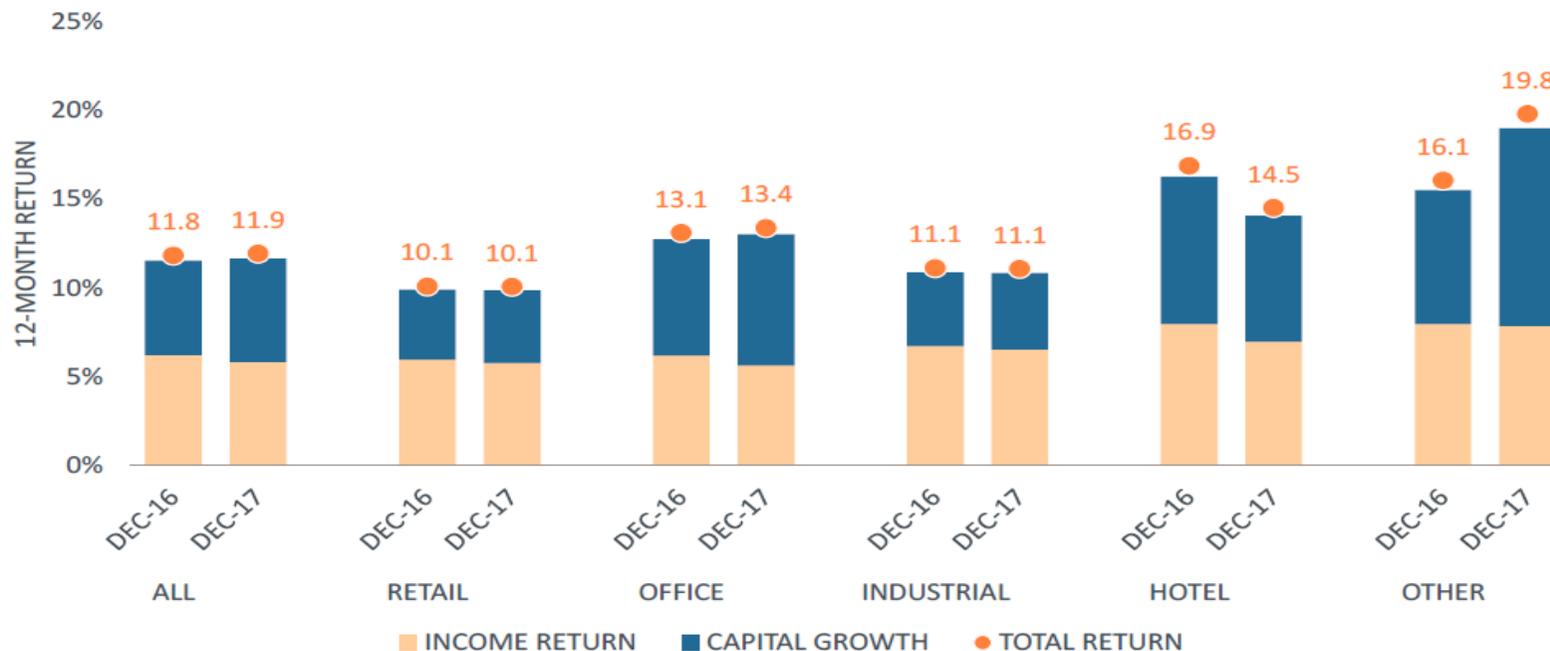
\* Direct = Property Council/PD Australian All Property Index, Unlisted = Mercer/IPD Australia Unlisted Core Wholesale PFI, Listed = MSCI Australia IMI Core RE Index, Equities = MSCI Australia IMI, Infrastructure = MSCI Australia Quarterly Unlisted Infrastructure Index, Bonds = J.P. Morgan, GBI Global, Australia, Unhedged index

Source: MSCI

- Unlisted real estate funds were the second best performing asset class



## Non-Residential Real Estate Sectors: Total Returns 2016 and 2017

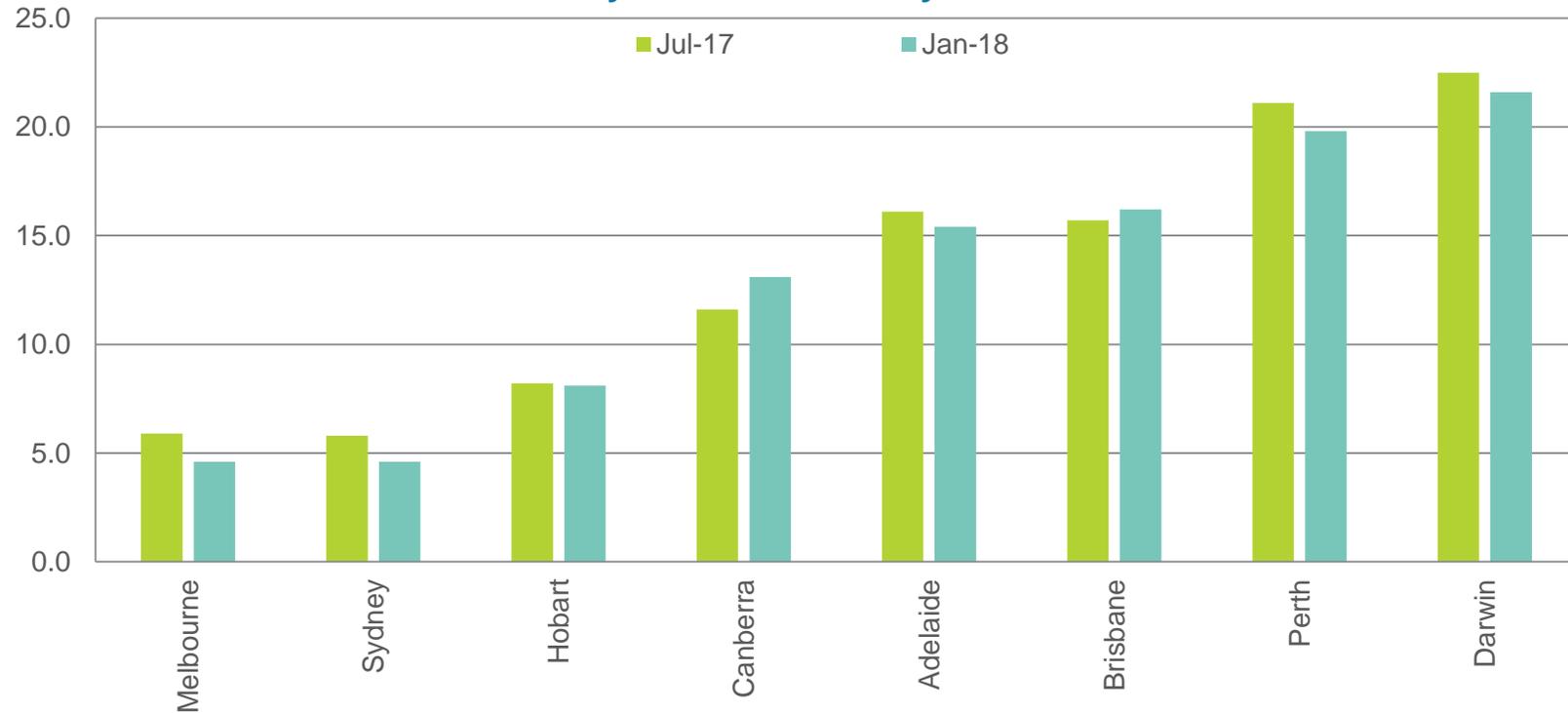


Source: MSCI

- Other real estate – healthcare, car parks etc. outperformed in both 2016 and 2017
- Retail lagged for the 2<sup>nd</sup> year in a row



### CBD Vacancy Rate: July 2017 and January 2018

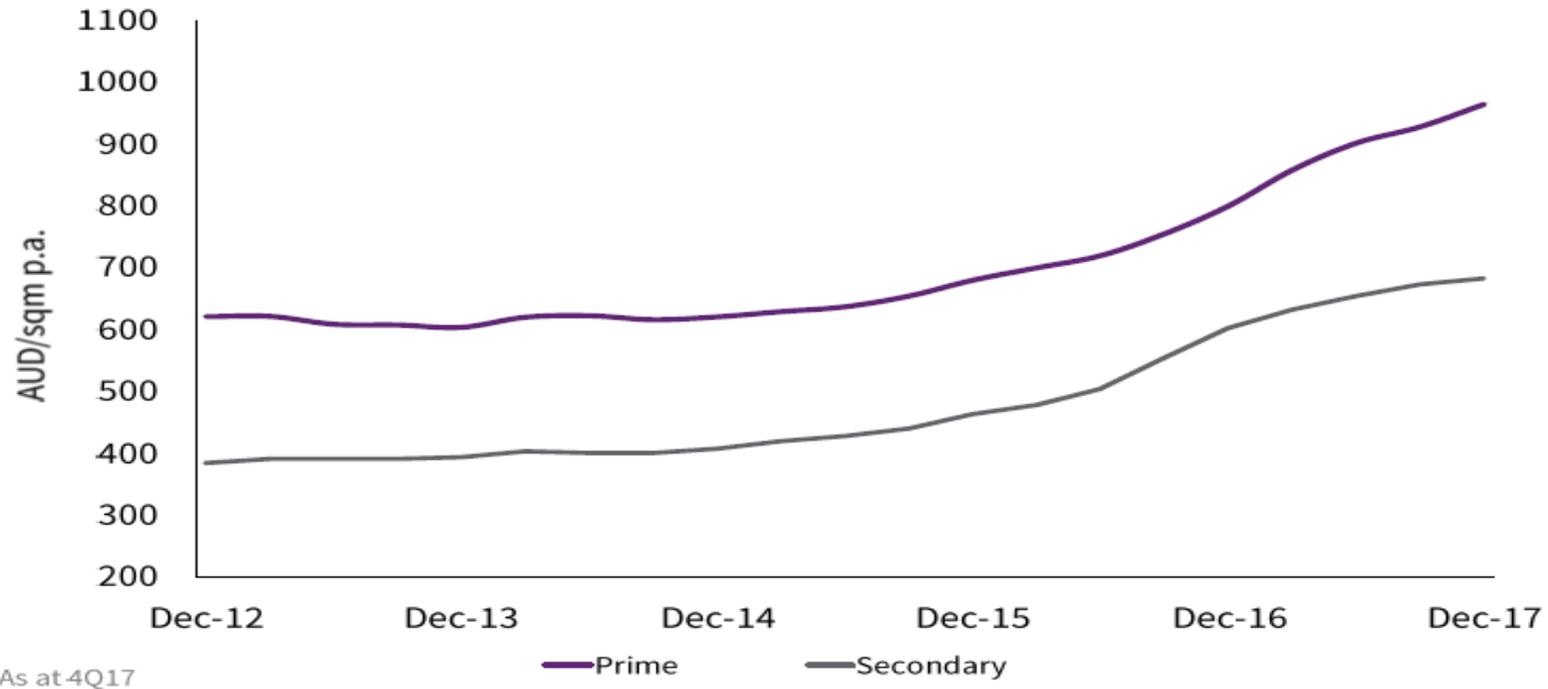


Source: Property Council of Australia

- Sydney and Melbourne have low vacancy rates



## Sydney CBD Effective Rents: 2012 – 2017



Source: JLL

- Rent growth increasing across both prime and secondary buildings



**amazon.com\***



**Challenges the economics of established business models**

**Forces businesses to change their business models, often to their detriment**

**Operates a broad ecosystem of products and services and doesn't only make money selling its own products**

*“Amazon in Australia, it is not going to be as easy as the US ... Most of the retailers there rolled over but they won't here.”*

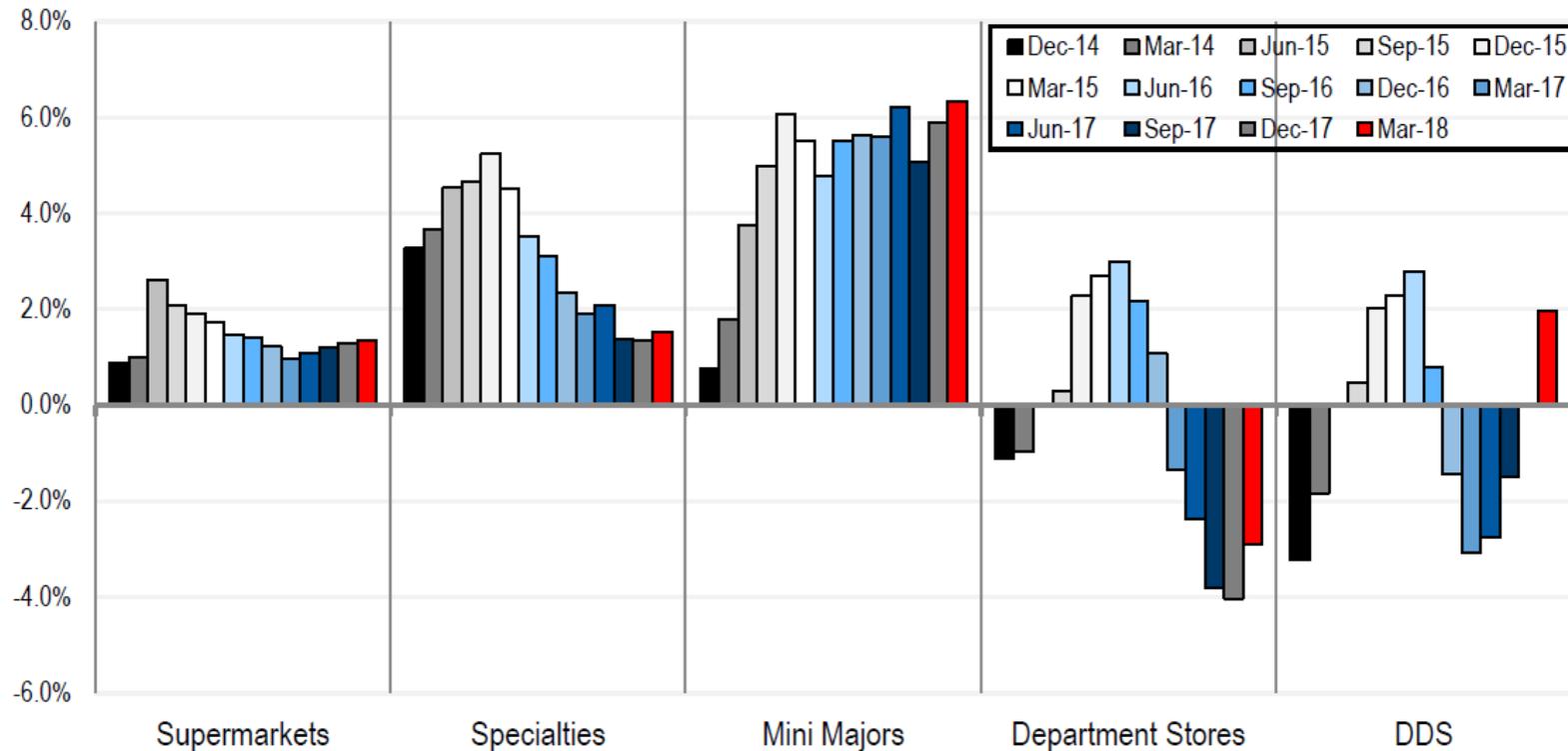
*– Gerry Harvey: Harvey Norman  
News.com.au 26/04/17*

*“We have been expecting this for a long time. We have a healthy sense of paranoia. We are not complacent around the competitive risks.”*

*– Rob Scott: Next CEO of Wesfamers,  
SMH 20/04/17*



## A-REIT Average MAT Growth by Category: December 2014 – March 2018



Source: Credit Suisse

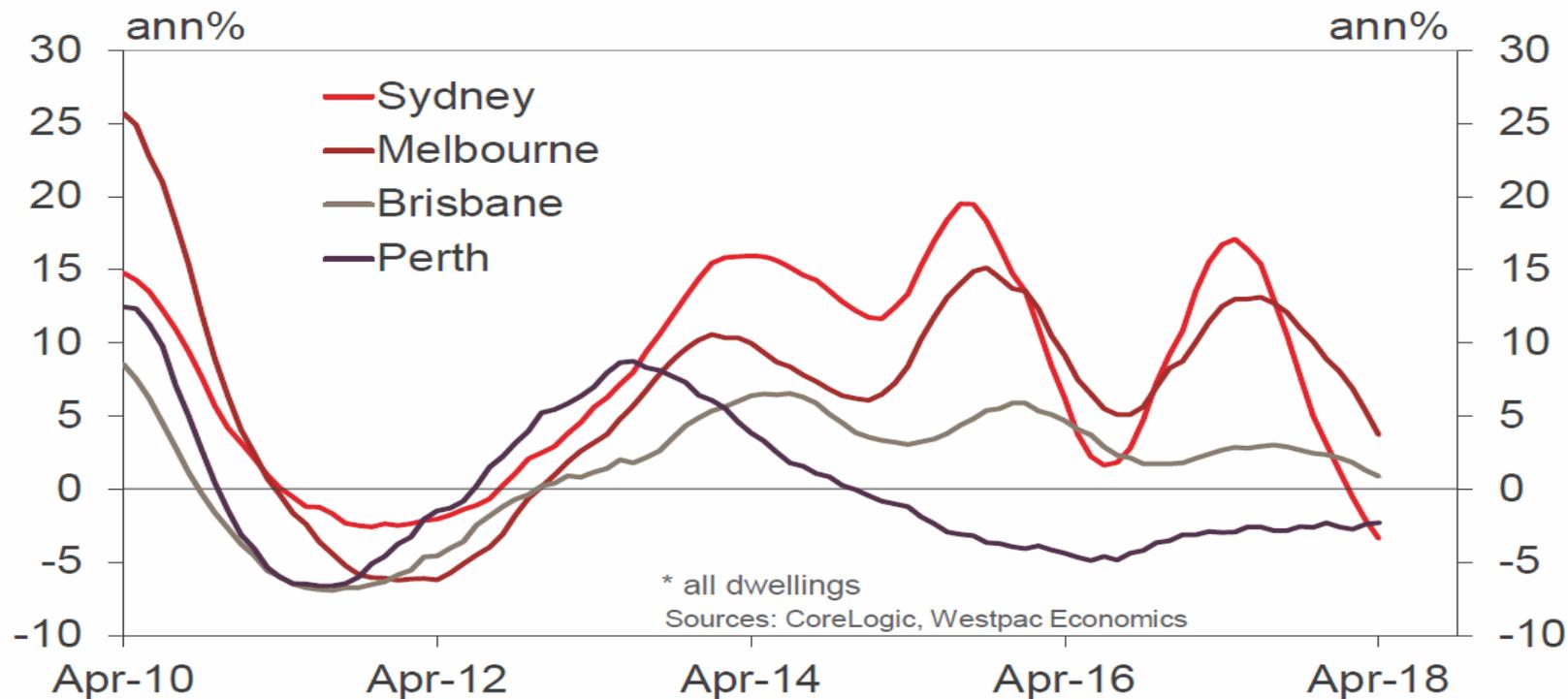
- Department and discount department stores remain under pressure whilst growth from retail services remains strong





# RESIDENTIAL PROPERTY

**Australian House Prices: Major Capital Cities:  
2010 – 2018**

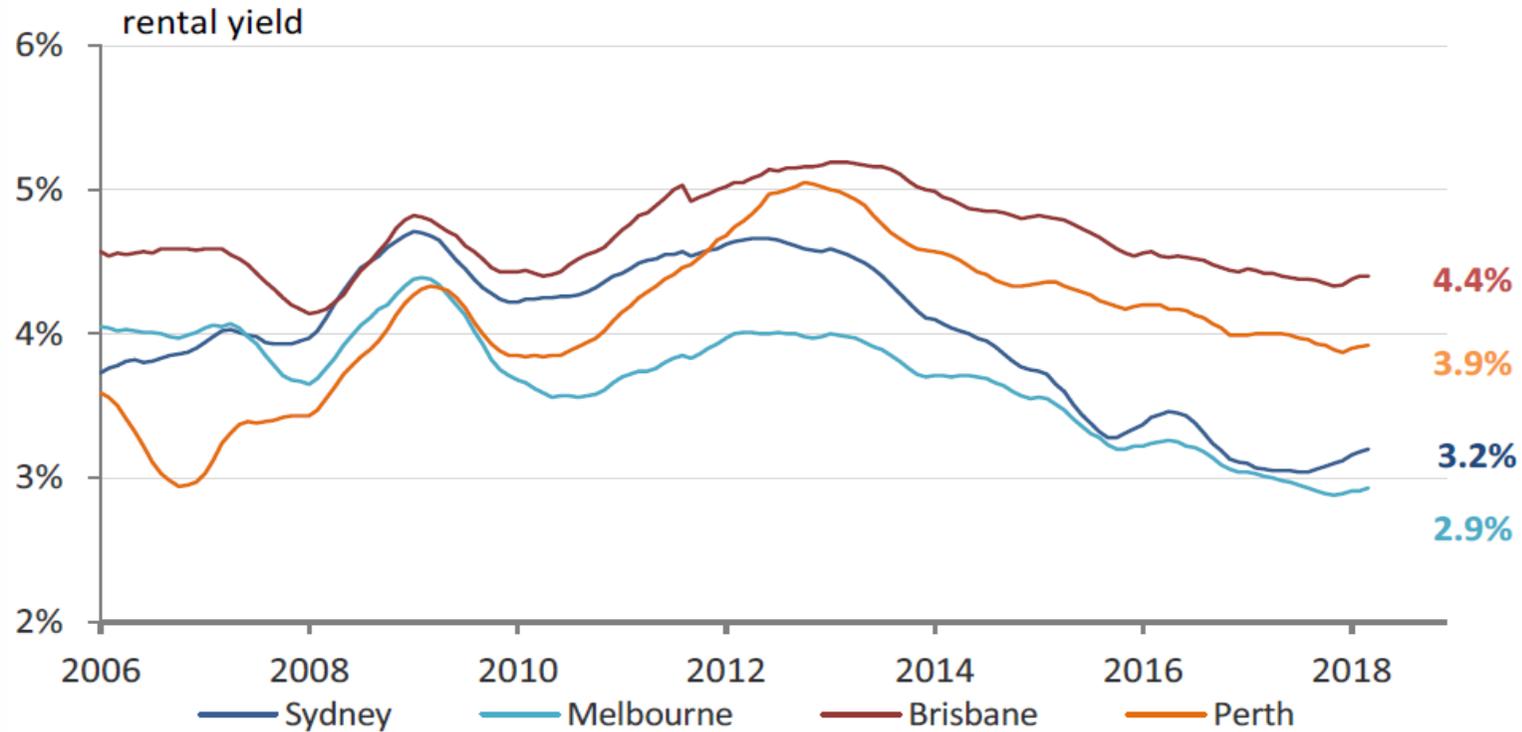


Source: Westpac

- Sydney house prices negative (-3.4% for the year) for 1<sup>st</sup> time since 2012
- Melbourne house prices continue to hold up (+3.7% for the year)



## Australian House Yields: Major Capital Cities: 2006 - 2018

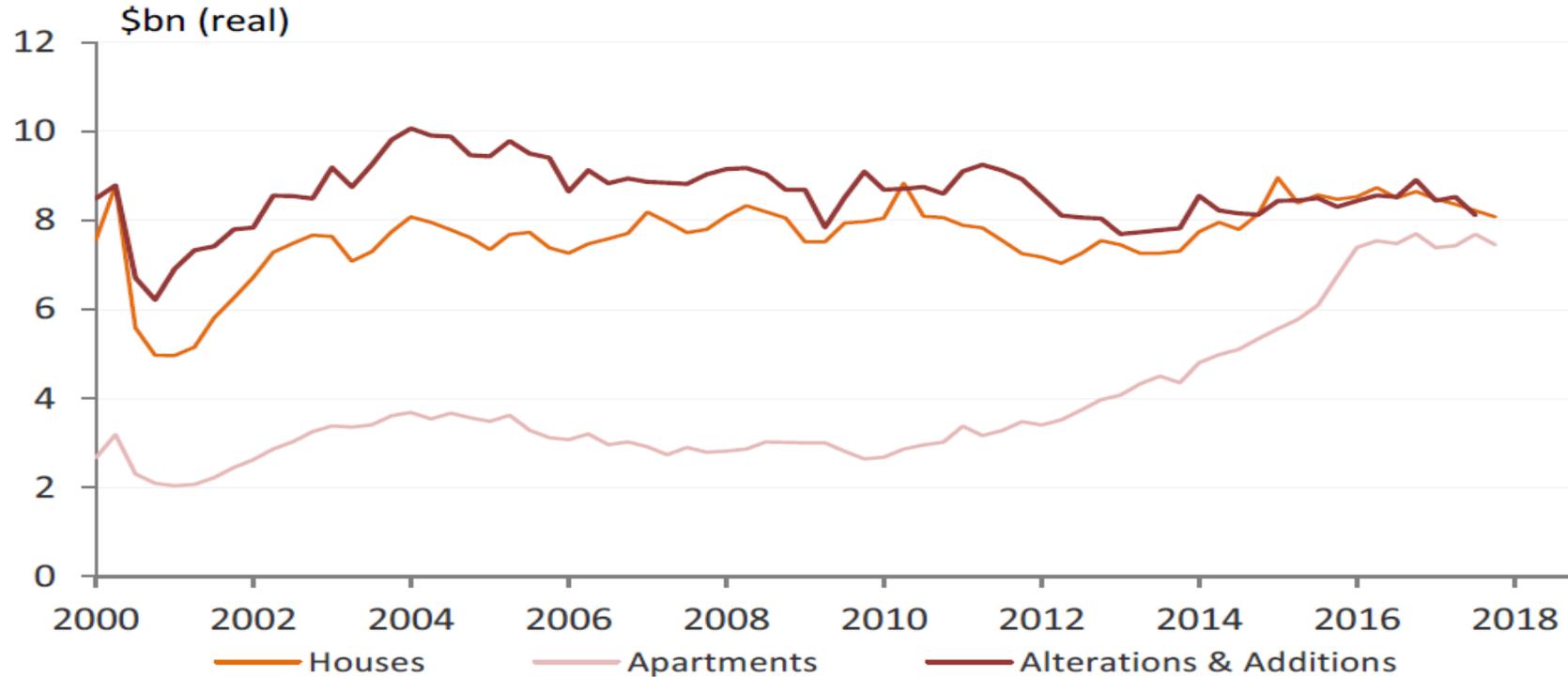


Source: Corelogic, Morgan Stanley Research

- Rental yields are slowly lifting from record lows



## Housing Construction By Type: 2000 - 2018

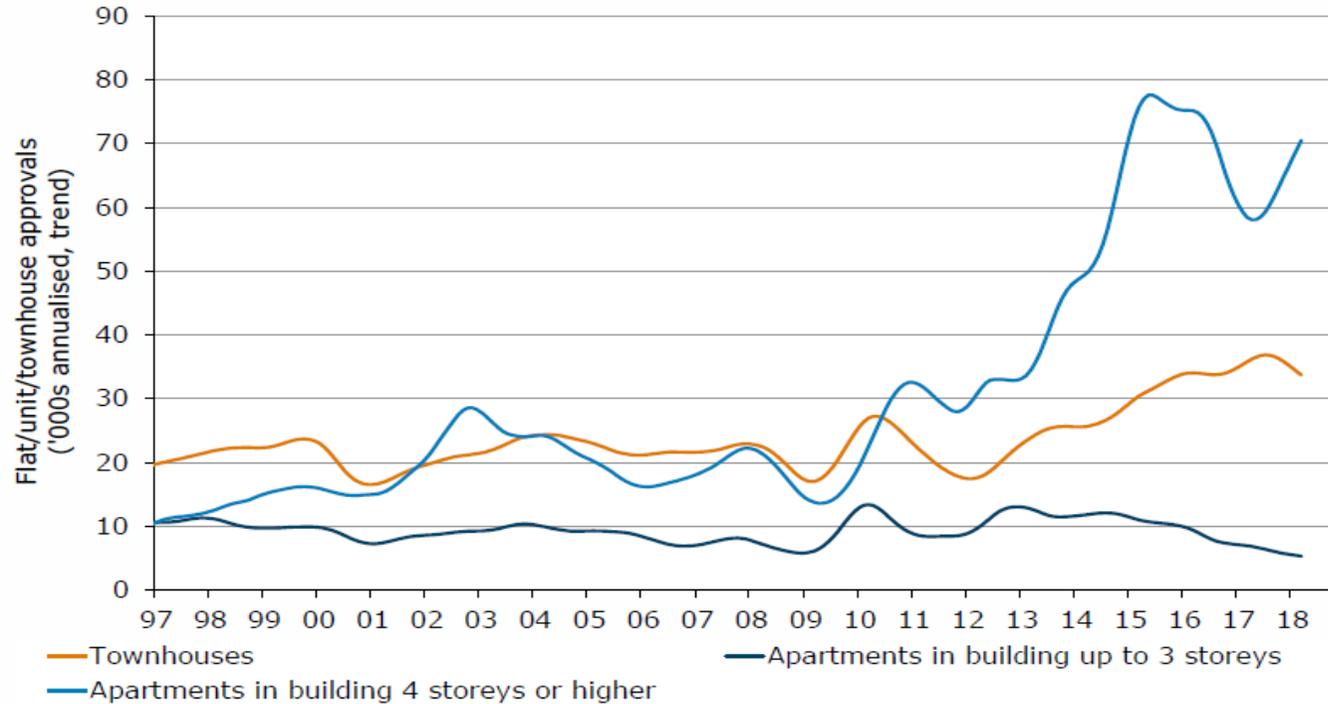


Source: ABS, Morgan Stanley Research

- Apartments have contributed most of the uplift in Australia's residential building activity



## Apartment/Townhouse Approvals: 1997 - 2018



Source: ABS, ANZ Research

Source: ABS/ANZ

- Apartment market continues to remain elevated, although volatile



## New Unit Completions: 2017

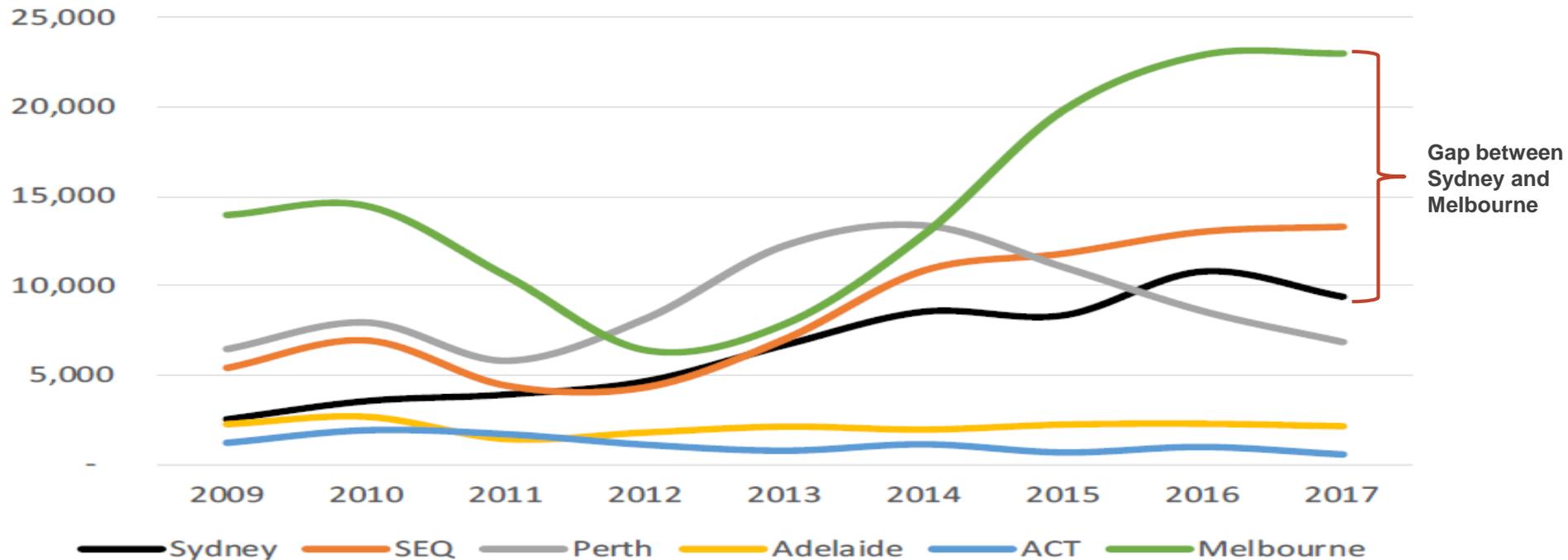


Source: UDIA

- 77,365 completions in 2017 – up 8% on 2016 and 64% increase on 3 years earlier
- 28,330 completions in Sydney – represented 73% of the completed stock in that market



Annual Lots Released:  
2009 – 2017

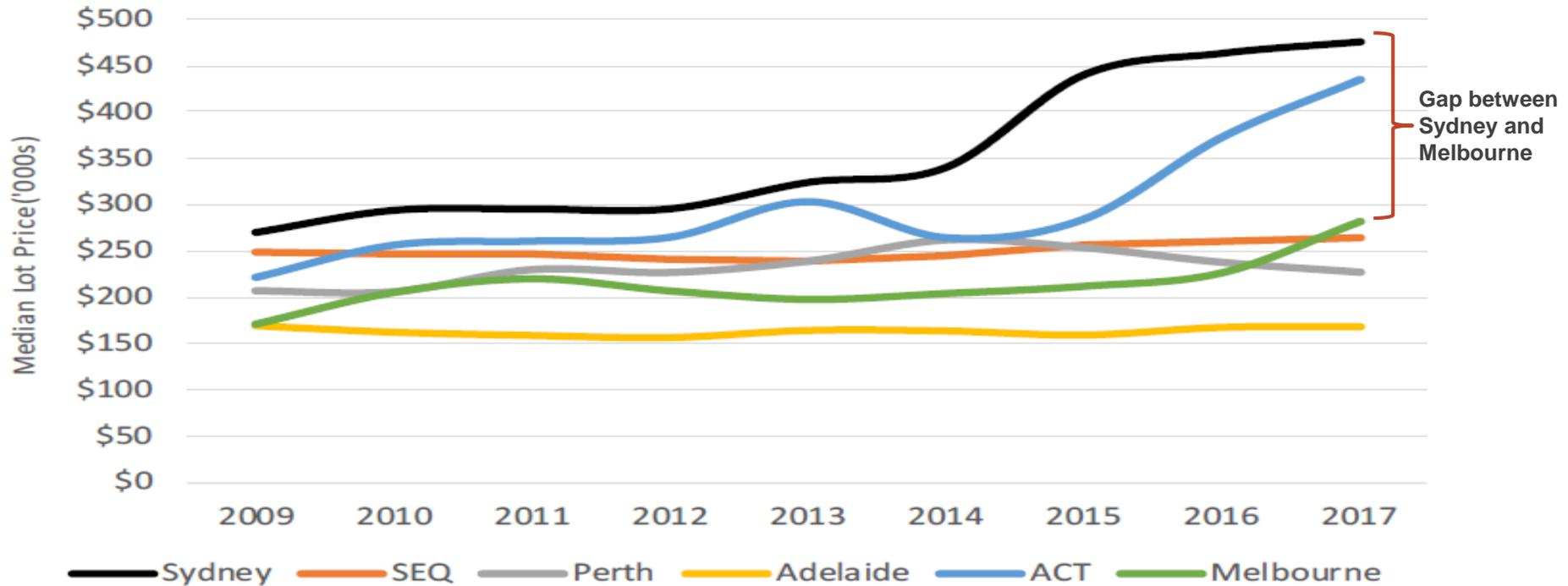


Source: National Land Survey Program

- 55,270 lots released in 2017 – down 6% from 2016
- Melbourne maintained 40% share of the nations land market
- SE Queensland only market to record an increase in lots (+2%)



## Median Lot Price: 2009 – 2017

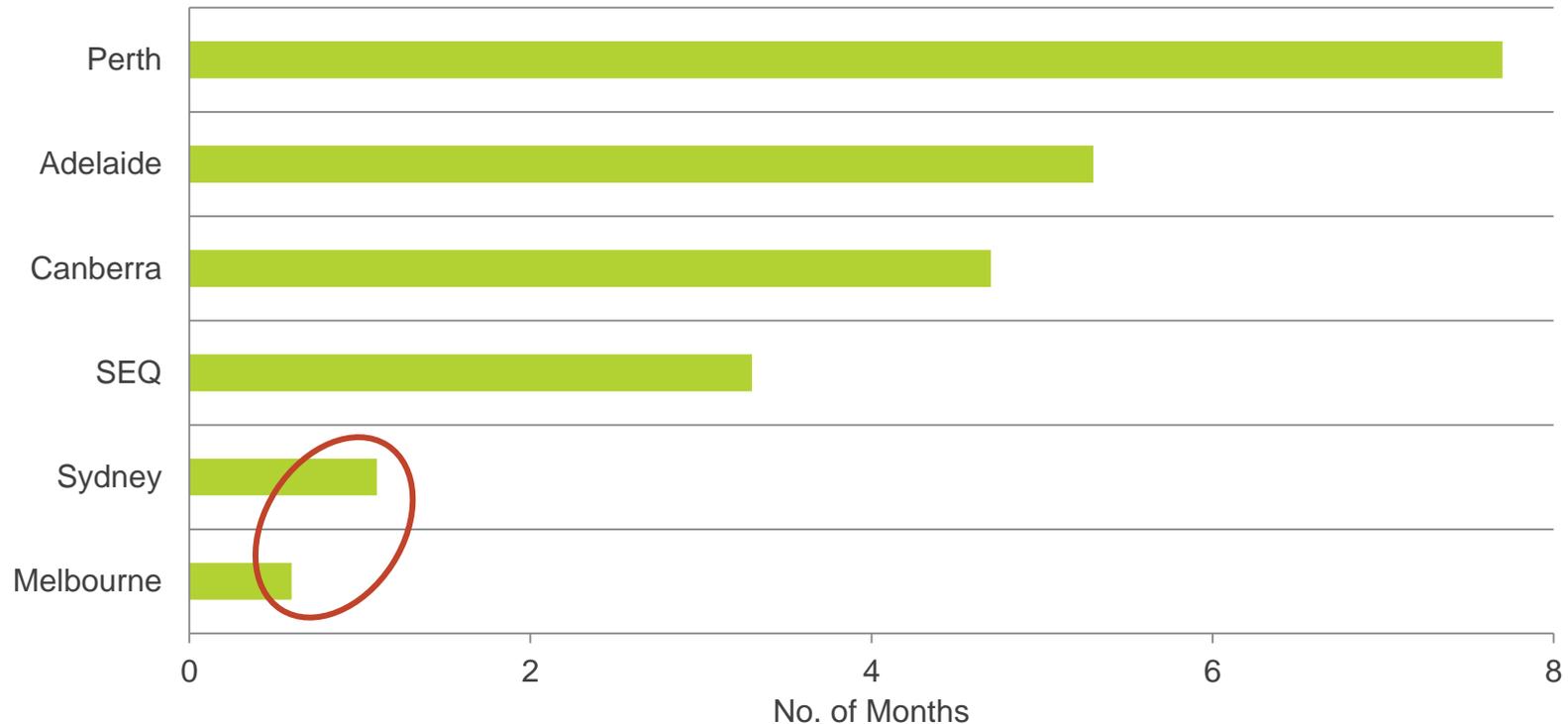


Source: National Land Survey Program

- Sydney's median lot price the most expensive at \$476,000 – up 40% since 2014 but only up 3% in 2017
- Melbourne's lot price increased 24% in 2017 to \$281,000



## Trading Months of Stock: 31 Dec 2017



Source: UDIA

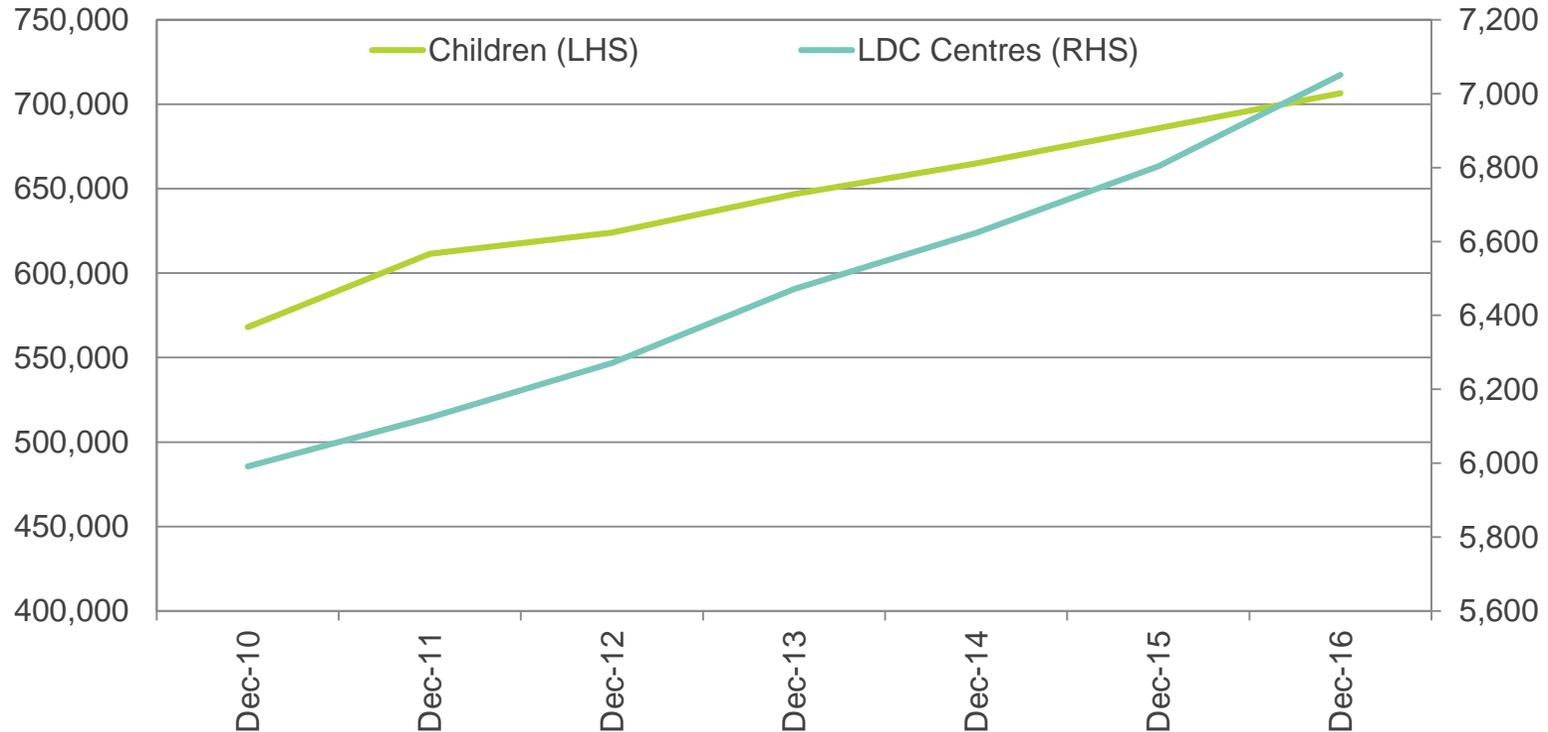
- Sydney and Melbourne have limited supply of ready to go land – function of strong demand (Sydney and Melbourne), planning (Sydney), titling issues (Melbourne) and access to civil contractors (Melbourne)



- Types of real estate social infrastructure
  - education –early learning, schools, tertiary/vocational, student accommodation
  - health – medical, hospitals, specialist centres
  - seniors living – manufactured housing, retirement villages, aged care
  - social housing
  - transport – bus & train stations, park & rides, car parks
  - government accommodation – police stations, court houses, prisons, etc.
- Benefits of real estate social infrastructure include
  - longer leases than traditional real estate assets
  - net or triple net leases (operator/tenant pays outgoings)
  - secure (often government backed) cashflows
  - low correlation to other real estate and non-real estate assets
- Drivers of demand for real estate social infrastructure
  - demographic and social changes
  - governments looking to private sector to fund
  - yields tend to be higher (although gap is narrowing)
  - some sectors have undersupply and/or existing stock is obsolete – opportunities to manufacture new product



**Number Of Children Utilising LDC Vs.  
Number Of LDC Centres In Australia: 2010 – 2016**

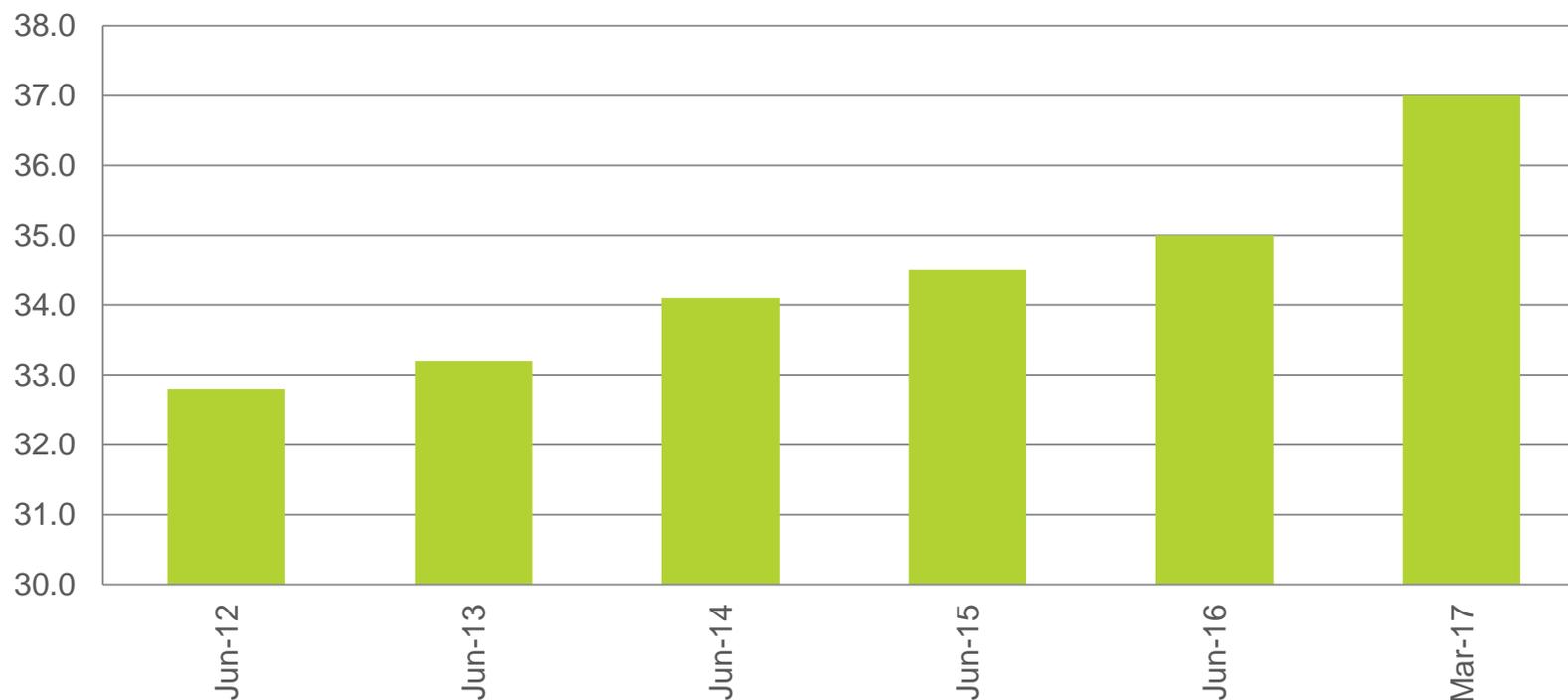


Source: ACEQUA, Folkestone, 2018

- Recent increase in supply beginning to moderate
- Catch-up in supply due to increased usage – up 24% since 2010 but supply only increased by 18%



## LDC Participation Rate Increases: 2012 - 2017



Source: Canaccord, Folkestone, 2018

- Participation rates continue to increase:
  - increasing female workforce participation
  - Improving quality of service
  - On-going government funding



## Retirement Village Trends

- sector consolidation
- larger villages with bigger apartments
- more lifestyle facilities - pool, gyms, café/restaurants, cinema, day spa
- vertical developments
- increasing/harmonising regulation

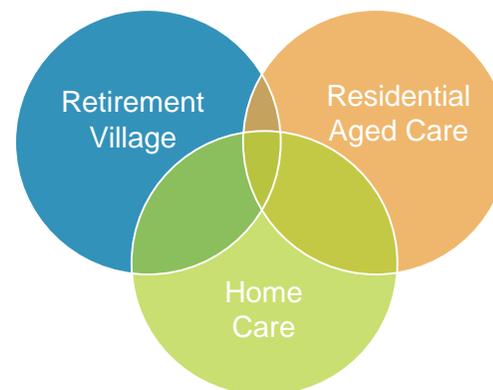
## Aged Care Trends

- sector consolidation
- greater emphasis/funding on home care vs residential care
- move to Consumer Directed Care
- Federal budget constraints putting more pressure on “user-pays”

## Convergence – Co-location

- co-location of retirement & aged care

### Convergence



### Customers Expectations Will Change As Customers Are Becoming:

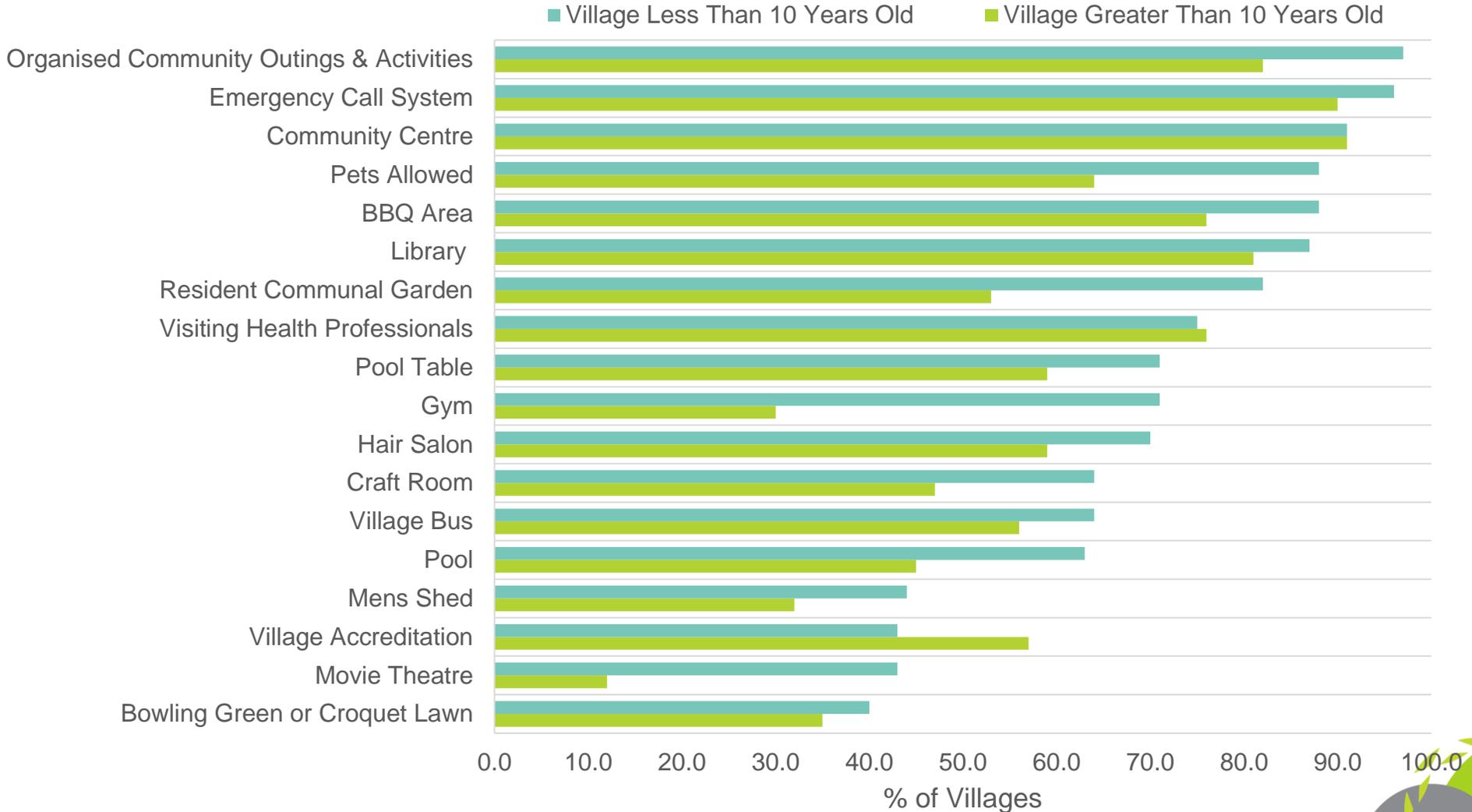
- more educated
- more discerning
- more demanding
- have more money
- with more choice



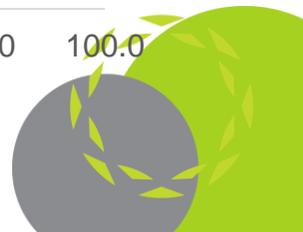
Consumer Directed Care

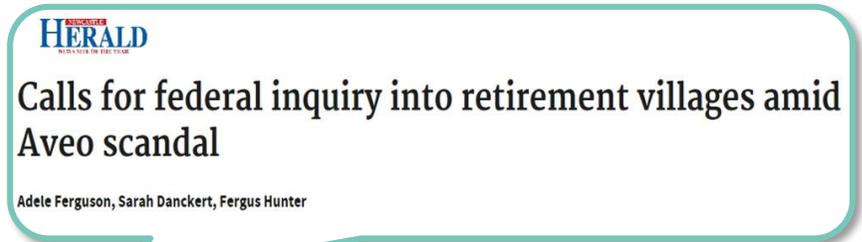
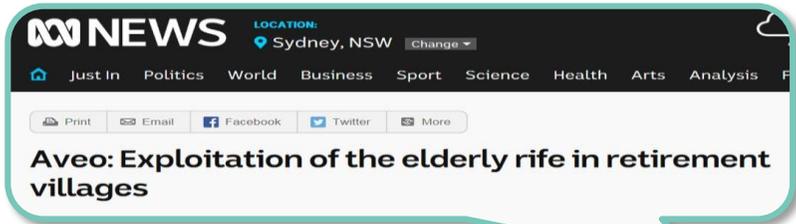


## Village Attributes In The Last 10 Years



Source: PwC/Property Council Retirement Census





## RETIREMENT VILLAGE INDUSTRY EIGHT POINT PLAN

for a policy platform that delivers quality resident experience

1. Support nationally consistent retirement village legislation and contracts.
2. Ensure there are transparent and easy-to-understand descriptions in contracts of entry pricing, ongoing service fees, reinstatement costs, and departure fees and payments, so residents have certainty about the costs associated with living in a retirement village.
3. Encourage all potential residents to seek independent legal advice before signing a contract, and work together with government and the legal profession to make this happen. We will also encourage potential residents to share this information with family members and trusted advisers.
4. Improve training and professional support for village managers, sales people and other staff who engage directly with current and potential residents.
5. Commit to improve industry accreditation standards and coverage, and support government initiatives to make accreditation a mandatory requirement for operating a village.
6. Work with the Australian Retirement Village Residents Association to implement an Industry Code of Conduct to set and maintain high standards about the marketing and operation of villages, including dispute management procedures for operators and residents.
7. Commit to the establishment of an efficient and cost-effective government-backed independent dispute resolution process, such as an Ombudsman or Advocate, for disputes that are unable to be solved at a village level.
8. Maintain and strengthen the relationship between industry and the Australian Retirement Village Residents Associations, to make sure resident issues are clearly identified and addressed.

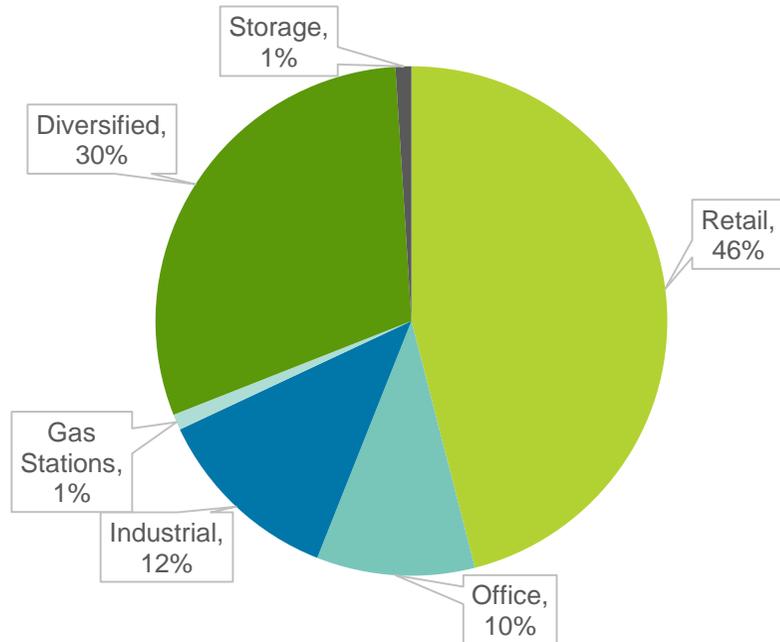


# A-REIT MARKET



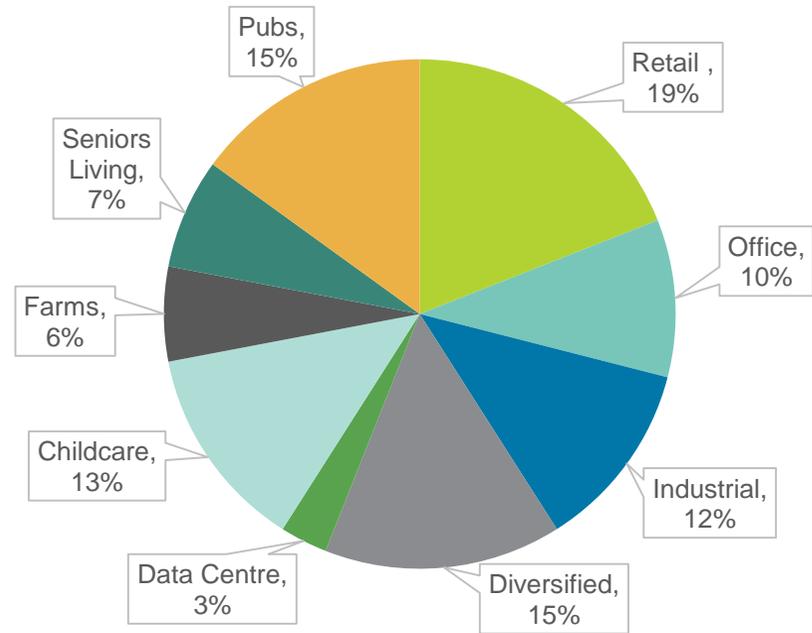
**Folkestone**  
MAXIM A-REIT SECURITIES FUND

**Composition of S&P/ASX 200 Index A-REITs:  
31 December 2017**



Source: Petra Capital

**Composition of Non S&P/ASX 200 Index A-REITs:  
31 December 2017**

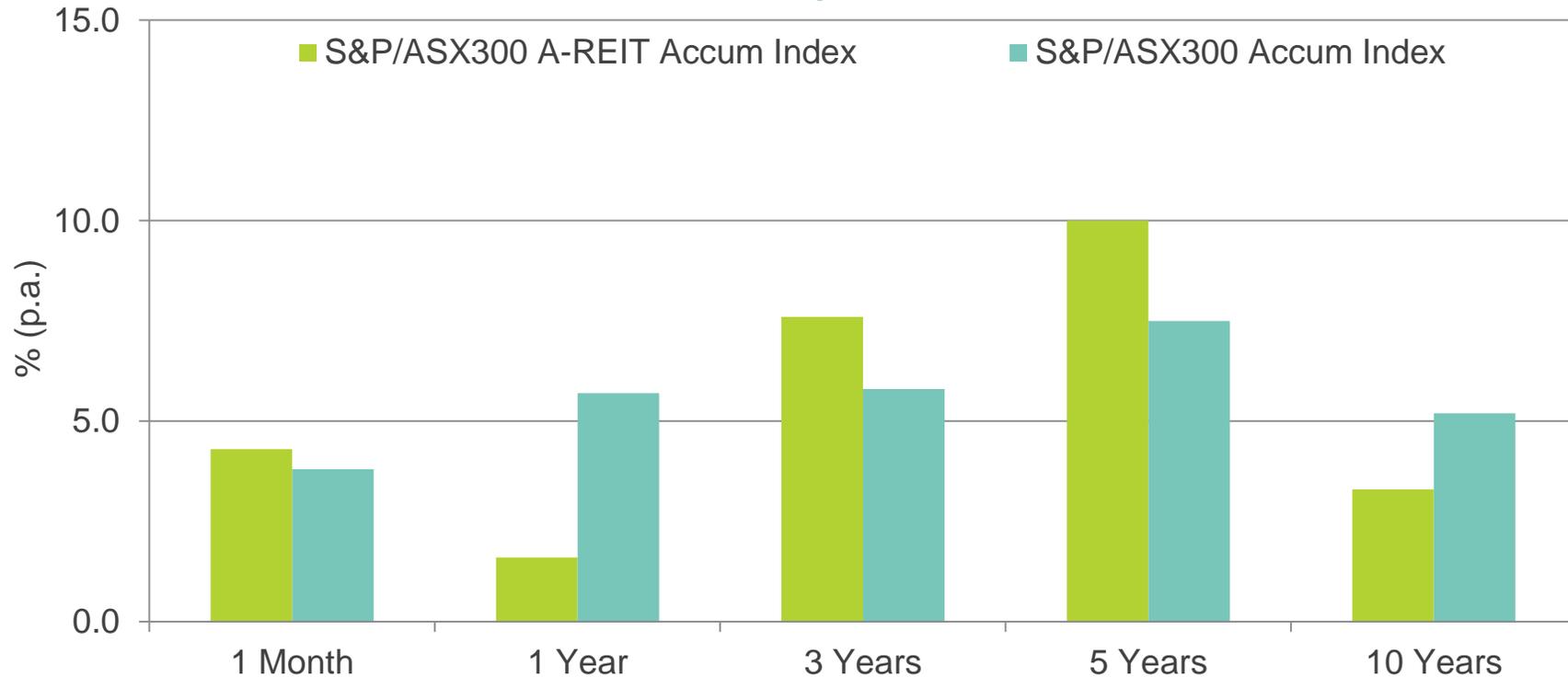


Source: Petra Capital

- Traditionally, the A-REIT sector has focused on core sectors – office, retail and industrial which comprise 90% plus of the sector’s market cap
- Broader sector diversity and more non-core sectors outside of the S&P/ASX 200 Index



## A-REIT Vs Equities - Total Returns: To 30 April 2018

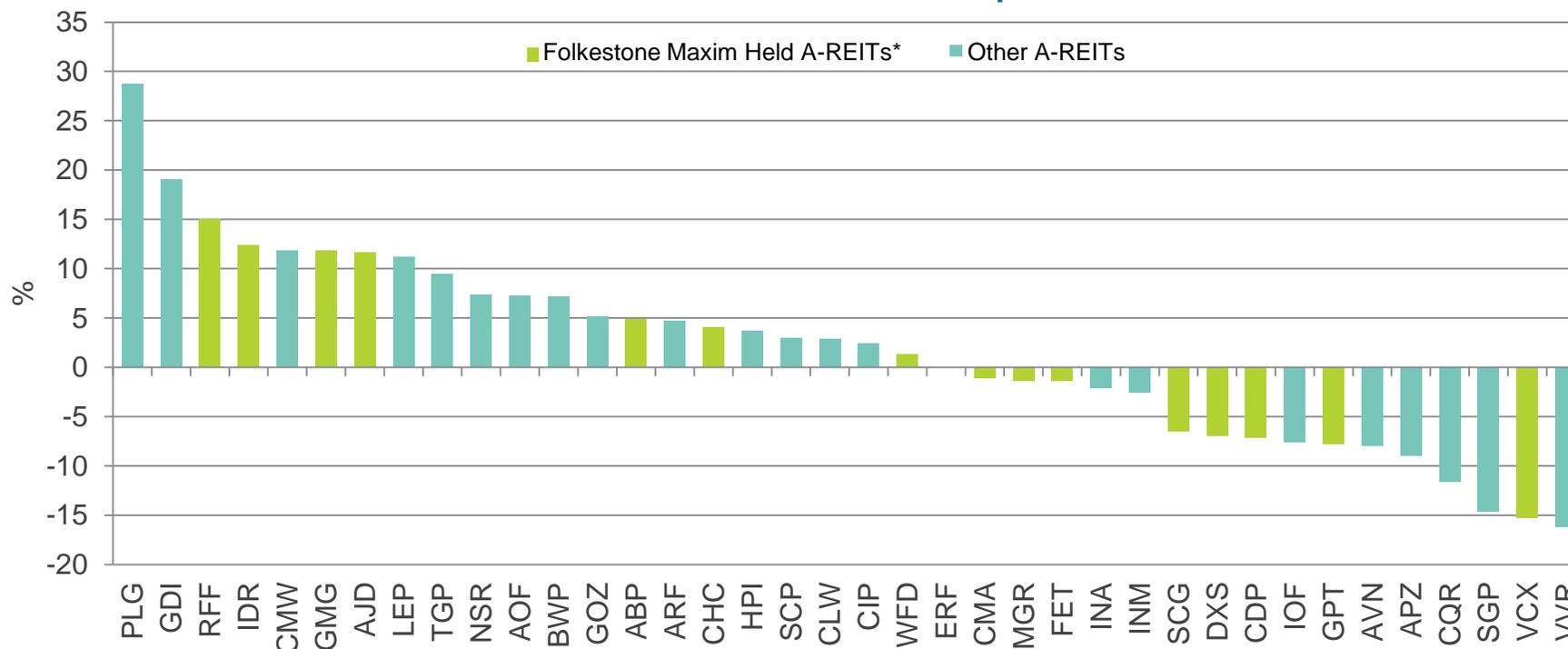


Source: UBS

- A-REITs outperformed in the month to 30 April 2018
- A-REIT sub-sector performance showed little differentiation over longer term but wider variation over short term



## A-REITs 1 Year Returns: To 30 April 2018

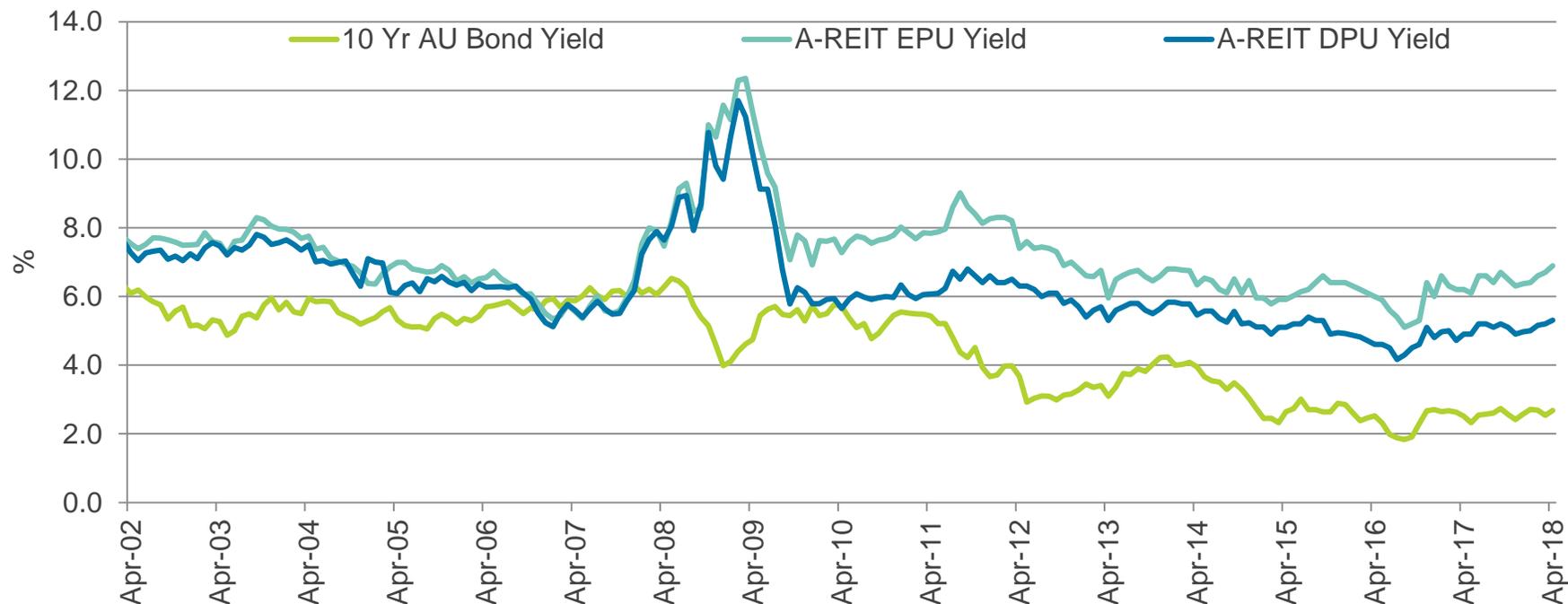


Source: IRESS \*Excludes Real Estate Managers & Developers Securities held by the Fund

**Wide variation in individual security performance – reinforces case for active security selection in the sector**



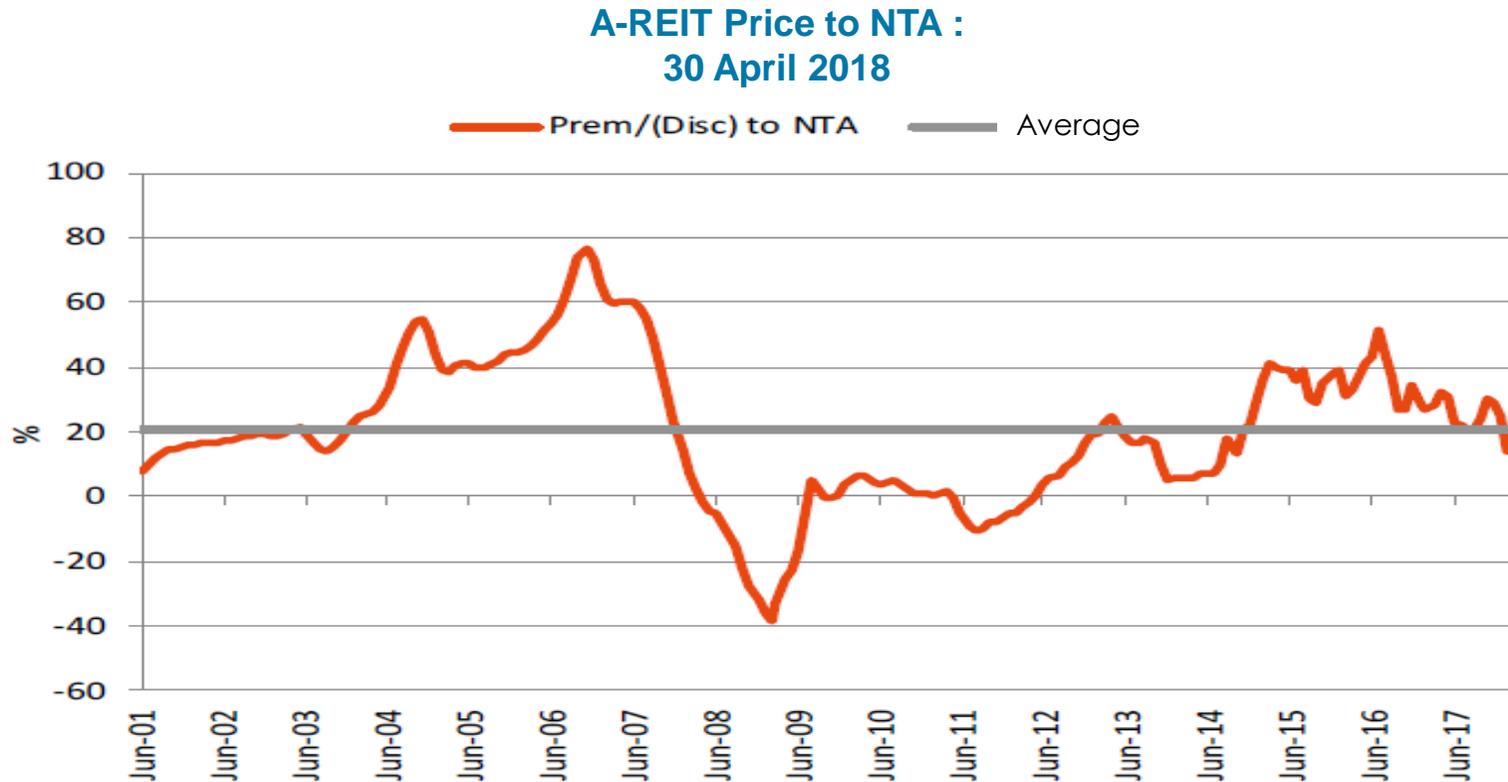
## A-REIT Sector EPS and DPS Yields Vs. 10 Year Australian Bond Yields: April 2002 – April 2018



Source: Bloomberg

- A-REITs have strong correlation to 10 year bond yields
- Low bond yields and wide spread of A-REIT DPU and EPU (well above average) is a key driver of A-REIT performance to April 2018
- A-REITs underperformed in the last twelve months when bond yields increased substantially but in recent months bond yields have stabilised and A-REIT returns have followed suit



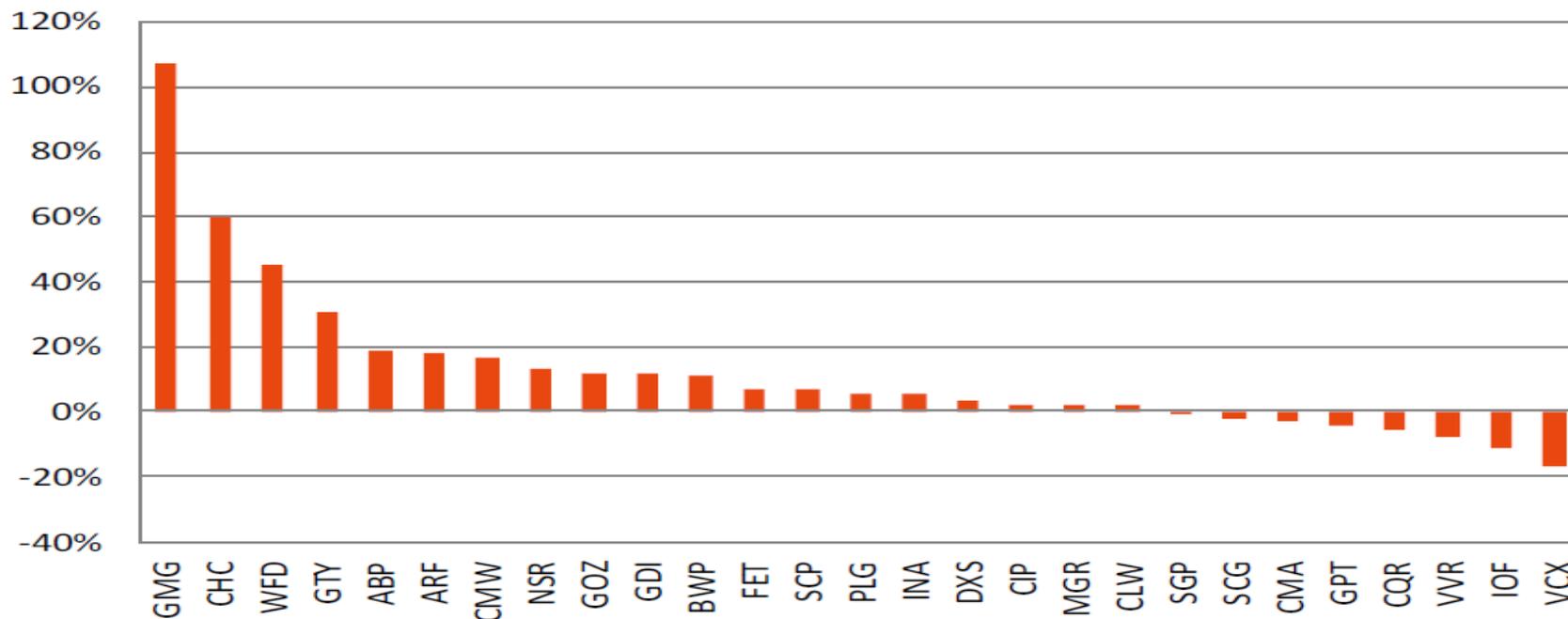


Source: Shaw and Partners, FactSet

- A-REIT pricing is fair at present
- A-REITs currently trading on:
  - circa 15% premium to NTA versus 21% premium historically



**A-REIT Price to NTA By Stock:  
30 April 2018**



Source: Shaw and Partners, FactSet

- A-REIT pricing is fair at present
- A-REITs currently trading on:
  - circa 15% premium to NTA versus 21% premium historically



## A-REIT Return Volatility: 2000 – 2018



Source: IRESS

- The A-REIT sector’s volatility has increased recently but not back to the heightened levels of the GFC
- A-REIT investor base is now more diversified – different returns and time frame outlooks creating short term volatility:
  - A-REIT securities funds and global REIT securities funds
  - general equities
  - hedge funds (including shorters)
  - “mum and dad” investors





# REAL ESTATE DEBT

- Why Use Leverage?
  - **allows for greater diversification** – can put more equity to use across multiple investments
  - **often enhances returns** – higher leverage equals less equity and therefore potential greater return on equity
  - **tax advantages** – negative gearing
- Asset level considerations
  - **the point in the cycle** - what is the likelihood of the asset's price increasing or decreasing in the coming years
  - **location** – how deep is the market if you want to exit, what are the supply and demand fundamentals?
  - **quality of the tenant covenants** – what is the likelihood of tenant default?
  - **lease expiry profile** – are there any vacancies or upcoming lease expiries?
  - **quality of an asset's income streams** – can the cashflow from the asset adequately cover the debt costs, what are the lease structures and rent review mechanisms in the leases?
  - **investment hold period** – is the asset being held for short-term trading or long-term investment?
  - **impact on operational flexibility** - cash flow escrows, deposit requirements, prepayment lockouts and penalties
- In structuring and managing the debt, factors to consider include:
  - **cost of debt** - the higher the leverage, typically the higher the cost of the debt that the lender requires to compensate for the increased leverage risk
  - **debt covenants** – the maximum loan to value ratio and minimum interest cover ratios that the lender will require
  - **type of debt** – interest only or principal and interest?
  - **source of debt** – traditional bank lending or capital markets medium term notes, CMBS etc?
  - **capital stack** – is the debt just senior “first ranking” or has the capital stack been layered to allow a combination of senior and mezzanine debt
  - **duration of the debt** - short or long-term debt?
  - **hedging profile** - how much of the debt is at fixed or variable interest rates?

## The impact of leverage using 30%, 50% and 65% gearing on a real estate asset that has been acquired for \$1 million

Price Change	Asset Value	30% Leverage			50% Leverage			65% Leverage		
		Equity Value (\$)	Change in Equity Value (%)	Leverage (times)	Equity Value (\$)	Change in Equity Value (%)	Leverage (times)	Equity Value (\$)	Change in Equity Value (%)	Leverage (times)
25%	1,250,000	950,000	35.7	1.32	750,000	50.0	1.67	600,000	71.4	2.08
20%	1,200,000	900,000	28.6	1.33	700,000	40.0	1.71	550,000	57.1	2.18
10%	1,100,000	800,000	14.3	1.38	600,000	20.0	1.83	450,000	28.6	2.44
5%	1,050,000	750,000	7.1	1.40	550,000	10.0	1.91	400,000	14.3	2.63
0	1,000,000	700,000	0.0	1.43	500,000	0.0	2.00	350,000	0.0	2.86
-5%	950,000	650,000	-7.1	1.46	450,000	-10.0	2.11	300,000	-14.3	3.17
-10%	900,000	600,000	-14.3	1.50	400,000	-20.0	2.25	250,000	-28.6	3.60
-20%	800,000	500,000	-28.6	1.60	300,000	-40.0	2.67	150,000	-57.1	5.33
-25%	750,000	450,000	-35.7	1.67	250,000	-50.0	3.00	100,000	-71.4	7.50
-35%	650,000	350,000	-50.0	1.86	150,000	-70.0	4.33	-	-100	-
-50%	500,000	200,000	-71.4	2.50	-	-100	-	-	-	-
-70%	300,000	-	-100	-	-	-	-	-	-	-

- Two key points:
  - leverage magnifies the creation or loss of value; and
  - the volatility of an investor's equity rises as leverage increases.





# OUTLOOK

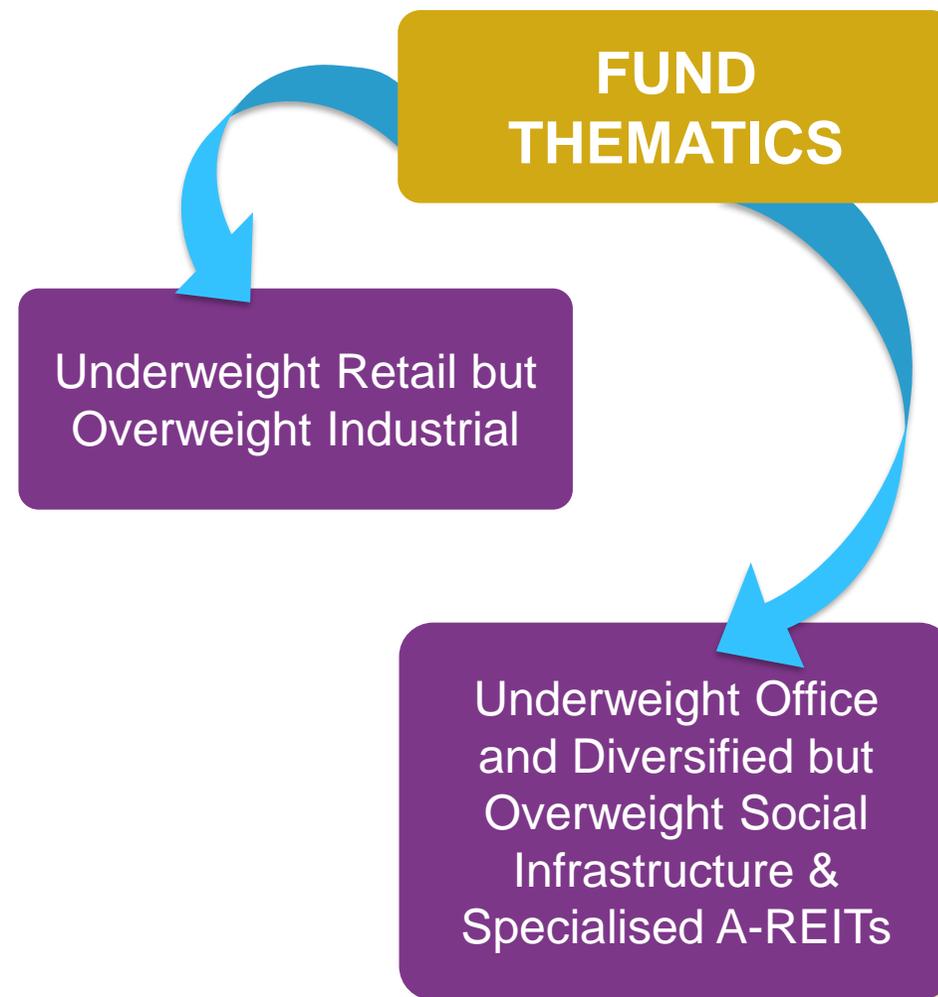
# FOLKESTONE MAXIM A-REIT SECURITIES FUND

## PORTFOLIO WEIGHTING

### Portfolio Weighting: As at April 2018

	Portfolio (%)	Index <sup>1</sup> (%)	Relative Weighting
Real Estate Developers & Managers	7.7	0	7.7
Cash	5.2	0	5.2
Industrial A-REITs	16.2	13	3.2
Other	3.1	0	3.1
Social Infrastructure A-REITs	3.6	0.5	3.1
Office A-REITs	12.6	12.2	0.4
Specialised A-REITs	4.2	4.1	0.1
Retail A-REITs	34	44.1	-10.1
Diversified A-REITs	13.4	26.1	-12.7
<b>TOTAL</b>	<b>100.0</b>	<b>100.0</b>	<b>0.0</b>

<sup>1</sup> S&P/ASX 300 A-REIT Index



- **Real Estate & Capital Markets**

- need to understand both real estate and capital markets
- capital flows at certain times in the cycle will overwhelm real estate fundamentals (its happening now)
- A-REITs trade in a listed environment – short-term liquidity comes often at a cost – volatility, therefore need to take a longer-term view if A-REITs are to be considered as a property play
- markets come unstuck when risk is not understood and therefore not priced appropriately

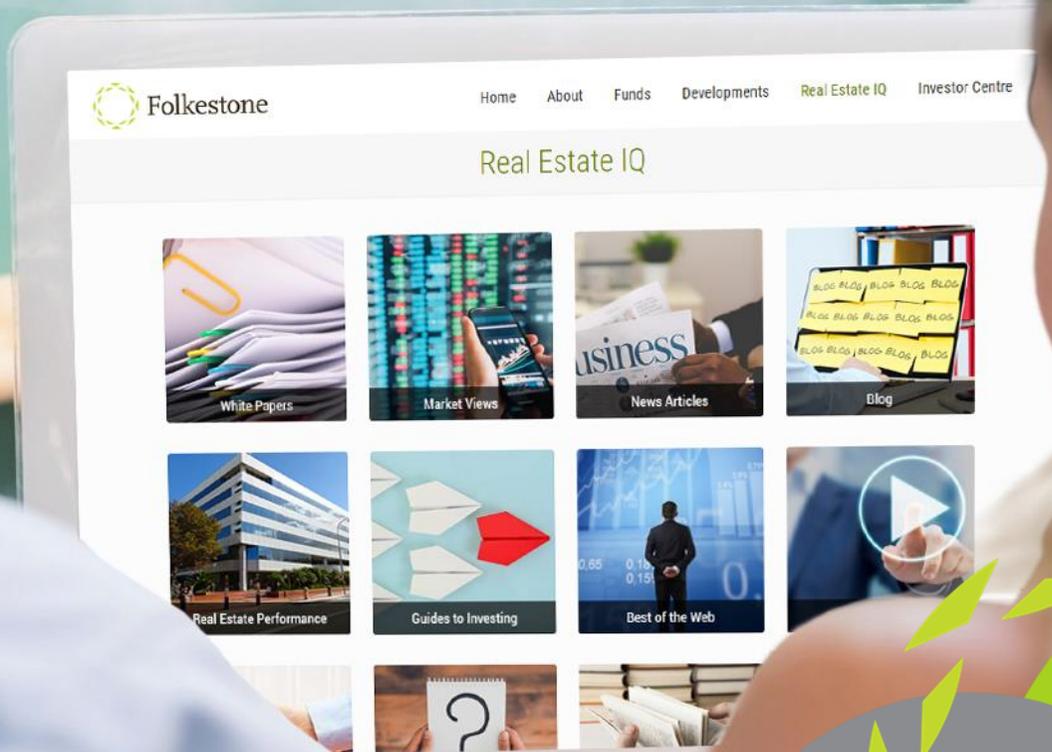
- **Investors**

- need to fully understand their risk and return profile
- want basic, transparent and true to label A-REITs
- need to understand that comparing funds and/or A-REITs based on 1st year yield does not guarantee it is a good investment – property whether listed or unlisted is a total return proposition and has a cycle!

- **A-REITs**

- must remember investors come first
- focus on strategy and sticking to it (pre GFC A-REITs lost focus – went offshore, took on too much gearing, etc.)
- must be transparent with investors – especially in relation to EPU, DPU and NTA
- need to actively manage assets (don't rely on the cycle tailwinds) and capital structure (don't rely on high gearing to drive returns) to drive performance

# FOLKESTONE REAL ESTATE IQ



**Real Estate IQ provides our latest thinking on real estate to assist you in navigating the world of real estate markets and issues, to make more informed investment decisions.**

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