Why APN Property Group will vote against the IOF sale and you should too

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The battle for Investa Office Fund (IOF) hasn't lasted quite as long as the Anglo-French 100-year war but it's beginning to feel like it might.

Since December 2015, when Dexus lodged a bid for the office property specialist, there have been four further attempts to gain control of the company, the latest from Blackstone at $5.25 a share. None have been successful. Yet.

The board of IOF's responsible entity supported the Dexus bids, the last of which was rejected by shareholders. The current bid is also supported by the board. We recommend shareholders, which includes APN's AREIT Fund, stir themselves for another fight.

There is hidden value in IOF, something Blackstone well understands. We'll therefore be voting against the current proposal and urge other shareholders to follow suit.

On the face of it the price looks fair. Blackstone's cash offer of $5.15 per share (ex a 10 cents distribution) is a 4% premium to current net tangible assets (NTA). It is also $1.24 higher than Dexus' original 2015 cash and scrip offer ($3.91), which was pitched at a 5% premium to NTA at the time.

We can understand the IOF board supporting the bid. Having been subjected to numerous and unsuccessful takeover offers and last year's failed attempt to have IOF internally managed, it isn't just investors that are possibly fatigued by issues that detract from the everyday running of the business.

Blackstone's bid offers a potential end to this long-running saga, one that understandably appeals to board members and exhausted shareholders.

It is also apparently reasonable. In the months prior to Blackstone's bid, IOF traded at a 10-15% discount to NTA. The 25 May offer price represented an 11% premium to IOF's $4.63 price at the time and a 4% premium to its NTA figure of $4.95. That's respectable.

So, why is APN Property against it when the board and shareholders have, on the face of it, good reasons to accept?

Because we think the primary figure on which this deal rests - net tangible assets per share is out of date, understating the true value of IOF's assets as a result.

JLL is a leading Australian commercial property information provider. JLL data to March of this year reveals that prime office capital values increased by 15% in Sydney and 17% in Melbourne over the past year. Prime office capitalisation rates compressed by 31 to 37 basis points (bps) in these markets with prime office rents increasing by 11-16% over the same period. In other words, office markets are roaring.

For the June quarter, especially in Sydney and Melbourne where IOF holds close to 80% of its assets, this trend has continued.

Dexus, for example, just announced an estimated 4.4% increase in NTA for the six months to June, with an estimated 9.3% increase in book value over the past year. It expects a further 10-15bps in cap rate compression over the next 12 months indicating further NTA upside for its investors. Australian Unity Office, meanwhile, enjoyed an 11% increase in its NTA for the six months to June post the revaluation of its properties.

If one were to apply just half of the increase in capital values suggested by JLL data (geographically weighted) to IOF's portfolio, it would, at around a $5.40 NTA, be 5% above Blackstone's offer price. We'd suggest the real figure is even higher.

IOF's 151 Clarence Street development in Sydney is now 83% pre-committed. Due for completion in the last quarter of 2018, it could add over $0.10 per share to NTA. The company's West Perth asset at 836 Wellington Street has been reported as being close to sale at a level significantly higher than its current valuation of $76m. This sale would boost IOF's NTA even further.

Finally, AREIT acquirers according to JPMorgan have on average paid a 13% premium to NTA across 18 transactions since 2003. This reflects the extra amount buyers are willing to pay for a portfolio of assets, along with the stamp duty savings made from not buying assets directly. The stamp duty savings alone (circa 5%) equate to about $200m for IOF's portfolio! A 13% premium to current NTA would be $5.60 so there is clearly no sign of this in the current bid.

Investa, the external manager of IOF, has done a great job over the past 18 years, building a high quality, well managed $4bn portfolio of office properties. As a shareholder in this fine business we don't want to let it go cheaply, especially at such a strong point in the office property cycle.

If shareholders were to accept Blackstone's bid using an NTA derived from property valuations that are, on average, a year out of date, that's what they'd be doing. They'd also be forgoing the upside that has been attracting bids for IOF for the past three years.

In our view, a figure of at least $5.60 per share would be more reasonable. Until then, let the 100-year war continue.

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