Risks and rewards of direct property funds

When you think of the phrase 'property investing' what comes to mind? A unit in a nearby apartment block, a block in an expanding suburb, or maybe a beachside studio?

If so, we'd like to expand your horizons. With residential property prices falling it's a great time to look up to the buildings that dot the skyline of your nearest city, its shopping centres and industrial parks.

Nor do you need to be a billionaire. An investment in a landmark commercial development is closer and more accessible than you think.

Direct property funds, sometimes known as property syndicates, allow private investors to own commercial real estate. By pooling their capital, investors can collectively purchase property that would otherwise be out of reach.

For investors seeking stable, regular and attractive income, plus capital growth, a direct property fund is the simplest way to own a slice of what has traditionally been only for the very wealthy.

That's the first big advantage direct property funds. The commercial property it owns may cost ten or even hundreds of millions but ordinary investors can own a small slice with an investment from as little as $10,000.

The second is psychological. While the prices of Australian Real Estate Investment Trusts (AREITs) fluctuate with market sentiment, a direct property fund is independently valued once or twice a year. The absence of a traded market means investors can focus on the reliable, attractive income stream their properties deliver rather than worrying about what the price will be next week.

Of course, owning a building has its complications; renovations, administration, rent collecting and the like. Direct property funds employ specialist property managers to take care of day-to-day operations, allowing investors to focus on financial performance rather than rental renegotiations and tenant issues. Most direct property fund investors can still visit the properties they own but don't have to get their hands dirty. That's their third advantage.

But it's the fourth and final advantage that sets the pulse racing. The wealthy have traditionally owned commercial property for the attractive and reliable distribution yield, with capital growth along the way. Direct property funds allow their investors to reap the same benefits, without needing a namecheck in the annual AFR Rich List.

Take APN Property Regional Property Fund as an example. The Fund owns two buildings in Newcastle, a city benefiting from a growing population, attracted by cheaper housing, shorter commutes and a beach lifestyle. It boasts a rejuvenated central business district, including a recently opened tram line and new commercial property developments. Outside capital cities, Newcastle is Australia's most buoyant office market.

The buildings in the Fund are A-grade office developments in flagship locations, offering state of the art facilities and high quality tenants. With an occupancy rate of over 96%, they're independently valued at $51.75m[1]. But through a direct property fund structure the minimum investment is just $10,000.

The forecast distribution yield is a healthy 7% for this financial year, paid quarterly. In contrast, Core Logic recently reported that gross residential rental yields in Sydney stood at 3.4%. Then there's the rental growth potential; annual fixed rent reviews are expected to be in the range of 3-4% (APN forecast estimate).

If you like the sound of the distribution, you should be aware of what it entails.

Unlike ordinary shares or AREITs, you can't buy or sell an direct property fund when the mood takes you. Investment terms are often for five years or more, at the end of which the property may or may not have increased in value and may or may not be sold.

There's also the concentrated nature of the investment. Owning a small slice of a few office buildings should be seen as a valuable part of your overall investment portfolio, not the entirety of it.

Direct property fund investors also need to pay close attention to the key metrics that drive financial performance. The level of debt, or loan to value ratio (LVR), within the direct fund, the weighted average lease expiry (WALE), vacancy rate and quality of the tenants (financial strength), deserve close inspection.

These factors - the concentrated nature of the investment, illiquidity and ownership structure - mean investors in direct property funds tend to be more sophisticated and experienced.

1 7.25% capitalisation rate and $5,493/sqm Net Lettable Area. Valuation dated 31 December 2018.

But don't let that put you off. Investment in a direct property fund is like any other; a delicate balance between risk and reward. If you like the idea of a stable, relatively high yield from commercial property and appreciate the risks, maybe it's time to expand your property investing horizons and consider direct property funds?

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Contact us

APN Property Group Limited

Level 30, 101 Collins Street,
Melbourne, Victoria 3000

Investor Services Hotline 1800 996 456
Adviser Services Hotline 1300 027 636

Email apnpg@apngroup.com.au
Website **apngroup.com.au**