

## APN A-REIT

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APN Funds Management's (APN) A-REIT Fund (the Fund) provides investors with an exposure to Australian listed property trust's (LPT) in accordance with APN's long-standing and highly successful approach to maximising income returns in a tax effective manner. Zenith view's APN's investment style and approach highly based on the investment team's long-standing track record within the domestic real estate investment trust (REIT) market.

The APN investment team of 6 is led by Michael Doble (Deputy Chief Investment Officer, Portfolio Manager - APN AREIT). Doble heads up the listed property trusts (LPTs) segment of the business, reporting to Howard Brenchley (Chief Investment Officer). Both Doble and Brenchley are highly regarded by Zenith, with each displaying a thorough understanding of the key risks within the property market and are extremely focused on the cashflow generative potential of all investments. In addition to the research generated by this team, the investment committee (IC) provides a key source of input. Doble manages the portfolio construction process in relation to the A-REIT's stock and active weight allocation. Zenith believes the level of resources at APN compares favourably against the funds competitors within the domestic property market.

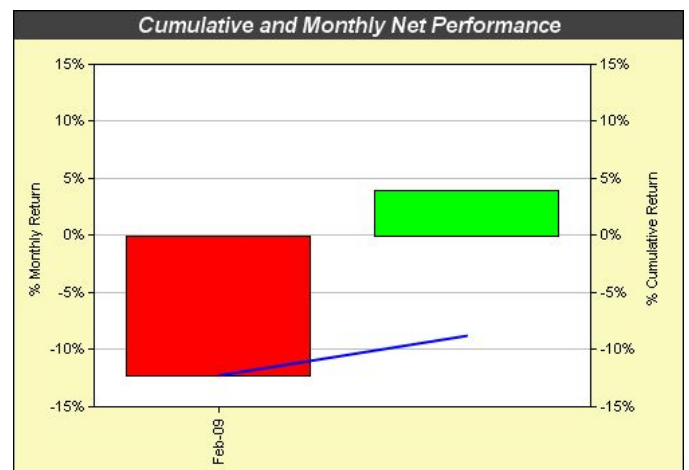
The stock selection process begins with assigning each A-REIT a beta, within APN's asset beta model. The beta is then geared to reflect APN's views on management, debt, hedging, currency exchange management and corporate style earnings. In-conjunction with the stocks beta, a 5-year distribution forecast is constructed covering all potential investments, with a discounted cash flow approach used to determine the fair value of each security. Based on the distribution forecasts, APN compiles a list of securities that meet its yield objective of 110% of the index yield and then culls any stocks that are perceived to be trading above fair value. In constructing the final portfolio, the portfolio manager will make adjustments to allow the inclusion of significantly undervalued lower-yielding stocks and to ensure that specific asset allocation guidelines are met. Zenith considers APN's yield focused philosophy and detailed approach to modelling listed property trusts to be intuitively appealing. Also, by design, APN's 110% of index yield objective will result in a portfolio that is biased towards higher yielding rental income based securities.

APN focuses on high yielding securities and a monthly distribution payment which makes this product ideal for income seeking investors. APN aims to "smooth out" the monthly distributions by retaining a portion of dividends (which are generally paid quarterly or semi-annually) in months when dividend payments are high, and then paying this amount out to investors in subsequent months. Zenith views monthly distributions as a positive and is pleased by APN's innovation in delivering this product feature to retail investors.

APN integrate the portfolio's risk management constraints through the initial security screening phase to identify stocks with significant corporate or international earnings. The manager's pro-active approach to minimising corporate and international earnings exposure should reduce absolute volatility and assist in maintaining a portfolio yield higher than the benchmark. Zenith is highly positive on the risk management approach employed by APN.

Zenith believes the Fund provides investors with a strong income producing, tax effective, risk contained domestic property fund that will provide excellent diversification within an overall diversified portfolio. As a result we have assigned a RECOMMENDED rating to this Fund.

Key Features	Description
APIR Code	APN0008AU
Asset Class	Property
Sub-Asset Class	Australian Securities
Investment Style	Active
Benchmark	S&P / ASX 200 Property (Accum)
Recommended Investment Timeframe	5 + years
Portfolio Manager/Deputy CIO	Michael Doble
Investment Team Size	6



### Performance Analysis

The Fund was launched in January 2009 and there is only a short performance history from which to conduct a meaningful analysis. The Fund's characteristics and constraints mirror the listed component of the APN PFIF, which performed well in

comparison to benchmark and median manager over the past 3 years. Zenith is confident that given the strength of the investment team and the robustness of the process employed at APN, that the Fund has the potential to outperform the benchmark and competitors over a full market cycle.

The investment objective of the Fund is to provide investors with a relatively high level of income (110% average yield of the market) to be paid out in a consistent 'smoothed' monthly distribution, combined with capital growth that matches at least the increase in the consumer price index (CPI). In addition, the Fund has an objective of providing a relatively high tax advantaged income component of distributed income. Tax advantaged income refers to the portion of tax associated with rental income earned by LPTs that can be deferred.

### Consistency Analysis

Given the Fund's limited performance history, to conduct a meaningful analysis a longer performance history is required. Zenith endeavours to identify fund managers who can outperform their respective benchmark consistently (>50%) through market cycles, representing a persistence of manager skill. Based on APN's strong track record within the A-REIT market, Zenith envisages the A-REIT Fund to consistently outperform the benchmark over the investment timeframe prescribed.

### Investment Personnel

Name	Title	Time with Manager
Howard Brenchley	Chief Investment Officer	12 Yr(s)
Michael Doble	Portfolio Manager/Deputy CIO	6 Yr(s)
Damian Diamantopoulos	Portfolio Manager - PFIF no.1	7 Yr(s)
Pete Morrissey	Portfolio Manager - PFIF no.2	2 Yr(s)
Andrew Smith	Portfolio Manager - IPFIF	6 Mth(s)
Cheng Yeoh	Analyst	2 Yr(s)

The APN investment team of 6 is led by Michael Doble (Deputy Chief Investment Officer, Portfolio Manager - APN AREIT), who is also involved in the investment management functions of APN's flagship product PFIF and PFIF No.2. In addition to the research generated by this team, the 9 person Investment Committee (IC) also provides a key source of input into the fund's overall construction in relation to active weight allocation.

The IC has undergone some turnover since Zenith's last review with Peter Cumming (Manager, Research and Strategy) and Laurence Parisi (Portfolio Manager) departing APN. Additions to the IC are Andrew Smith (Portfolio Manager - IPIF) and Cheng Yeoh (Analyst). Smith has over 12 year's industry experience working previously at Goldman Sachs JB Were as Executive Director of Real Estate. Yeoh was internally promoted to provide analytical support to the funds management team. Zenith view's the departure of Parisi as

significant given his level of input into the A-REIT models; however we acknowledge the appointment of Smith given his significant level of A-REIT experience.

The two new additions will form part of the IC which meets on a weekly basis. Zenith still maintains the view that the IC comprises of too many individuals and may therefore lack efficiency in decision making and individual accountability. None-the-less Zenith believes that the level of resourcing at APN compares very favourably within the domestic property sector.

Along with the additions, the other members of the IC include Howard Brenchley (Chair), Michael Doble, Pete Morrissey (Manager, Portfolio Manager - PFIF no.2), Damian Diamantopoulos (Portfolio Manager PFIF), Steve Lawford (Portfolio Manager APN Direct Property Fund), John Freemantle (Chief Financial Officer), and Ron Palermo (Operations & Compliance Manager). Doble heads up the listed property trusts (LPTs) segment of the business, reporting to Brenchley. Both Doble and Brenchley are highly regarded by Zenith, with each displaying a thorough understanding of the key risks of property investing and a concerted focus on the cashflow generative potential of all investments.

Brenchley established APN Funds Management (APN), the asset management arm of APN Property Group, in 1998 and has over 20 years experience in the property and investment industries. Prior to APN, Brenchley co-founded Property Investment Research Pty Ltd, a research company specialising in the property trust sector. Since the appointment of Doble, Brenchley has relinquished most of his hands on investment management responsibilities and, while still playing a critical role in the peer review of bottom-up investment decisions, his primary input is now from a top-down macro and overall investment strategy perspective. Doble joined APN in June 2003 and as Director, Retail Funds, and has portfolio management responsibility of the APN A-REIT fund. Doble has over 20 years experience in funds management, property valuation and consultancy roles across both the listed and direct property markets. Before joining APN, Doble was Head of Property at ANZ Funds Management.

Doble is the key decision maker for the Fund; however property sector allocation decisions are generated by the investment team and overseen by the IC. The IC must approve stock holdings, where portfolio exposure exceeds the single manager limit amount of 10%. Doble remains involved in research of LPTs and unlisted property trusts, and is solely responsible for dealing for the AREIT Fund; a function which APN believes should be performed by a single person in order to achieve the best prices possible. Morrissey and Diamantopoulos are also heavily involved in the research of LPTs, whilst Smith covers a combination of Australian and Australian listed international REITs. The team is also supported by Yeoh who provides performance reporting as well as analytical support for the funds management team.

Zenith believes the team is well resourced to cover the Fund's investment universe which focuses primarily on the S&P/ASX top-200. The introduction of the single portfolio manager across APN's range of funds is viewed positively by Zenith, to illustrate management ability and providing a greater level of accountability.

Key person risk exists within APN Funds Management with Brenchley, given that he was the architect of the APN investment process and was previously the primary portfolio

manager of PFIF, we believe his departure would be a material loss for APN. However, Zenith acknowledges that Doble's appointment as portfolio manager in June 2003 has mitigated a significant portion of this key person risk.

### **Investment Process**

APN's investment philosophy is income focused; fundamental based and portrays a value bias. Quality and security of income stream within an investment is paramount. Its portfolios tend to be benchmark unaware and as a result reflect a higher tracking error. The Manager employs a combined top-down and bottom-up investment approach. From a bottom-up perspective, APN considers the quality and sustainability of income streams, which it achieves through a focus on factors such as: quality of tenants; ability of property management; and long term and well structured lease agreements. The top-down overlay measures the influence of micro and macro economic factors on the property cycle, including interest rates, retail trade, unemployment rates and consumer sentiment.

The investment philosophy employed for the Fund is essentially identical to the listed component within APN's flagship product PFIF.

### **Security Selection**

There are essentially 2 steps in the APN stock selection process:

#### 1. Forecasts and Valuation

The stock selection process begins by assigning each A-REIT a beta, within APN's asset beta model. The beta is then geared to reflect APN's views on management, debt, hedging, currency exchange management and corporate style earnings. Qualitative factors are not formally scored but are intuitively measured and incorporated into the beta calculations.

In-conjunction with the stocks beta, a 5-year distribution forecast is constructed covering all potential investments, with a discounted cash flow approach used to determine the fair value of each security. All forecasts are based on stockbroker models. APN filters broker consensus forecasts and data as a form of quality assurance.

APN then run Dividend Discount Models (DDM) to derive the net present value (NPV) of all stocks. APN has also introduced a "Sum of the Parts" (SOTP) and "Adjusted Funds from Operation" (AFFO) valuation metrics as a complement to using distribution forecasts. Zenith believes that the introduction of SOTP and AFFO valuations are a logical enhancement to the valuation process, and given the diversity of corporate earnings within trusts, these metrics should help to ensure the more accurate overall valuation of potential investments. As is the case with distribution forecasts, corporate earnings information is sourced primarily from broker consensus data.

Using the forecast LPT index yield as a base, APN then calculates its own yield benchmark to satisfy its yield objective (i.e. 110% of the index yield). The stock selection model identifies those securities that, as standalone investments, satisfy the 110% of index yield objective over the next 5 years.

Zenith considers APN's yield focused philosophy and detailed approach to modelling to be intuitively appealing. Also, by design, APN's 110% of index yield objective will result in a portfolio that is biased away from lower yielding (and potentially riskier) property development dependent securities

and more towards higher yielding, less volatile rental income based securities.

#### 2. Securities Filtering

With the investment universe narrowed to those stocks delivering the 110% of index yield objective, the next step is to filter out those that are considered overvalued according to APN's "fair value" assumption. What remains is a list of securities that are expected to achieve the 110% yield objective and are trading at or below fair value.

Despite being removed in the initial filter, lower yielding stocks that are trading significantly below "fair value" may still be considered for the portfolio, so long as the overall portfolio yield objectives are met.

### **Portfolio Construction**

Portfolio construction begins with an asset allocation process. There are 2 components to the asset allocation process: Security Type and Property Sector.

Security Type identifies the allowable investments in which the Fund can allocate to which includes listed property trusts and cash. The IC determines the level of investment permitted within each security type (within pre-defined ranges outlined in the Product Disclosure Statement) based on the dividend yield, value and total returns of individual stocks and the property sector. Property Sector allocation refers to the allocation between the various property sectors (Retail, Industrial, Commercial etc), with the IC employing a similar process to that used for Security Type allocation (i.e. allocation guidelines based on return expectations for each sector).

Since our last review, APN have made the following enhancements to the portfolio construction process as follows;

- No single investment can account for more than 20% of the Fund's portfolio unless its A-REIT index weight is greater than 10%, or IC approval obtained;
- A 10% maximum exposure to individual managers, which is set at 5% for APN products, with additional exposure only granted at the consent of the IC; and
- Ranges have also been incorporated enabling the fund to accumulate exposure into a stock over a gradual period of 12 months, with exposure determined by income, capital growth and current yield to value.

With asset allocation guidelines and a refined stock selection list in place, Doble is responsible for constructing the portfolio. All stocks that meet the 110% of index yield objective and are at or below fair value are initially included. From here the portfolio manager will make adjustments to allow the inclusion of significantly undervalued lower-yielding stocks and to ensure the asset allocation requirements are met (for example the "top down" view of the IC may suggest an increased exposure to the office sector and therefore the Fund may hold some lower yielding but attractively priced office sector investments). Overall the final portfolio will have a forecast yield that is 110% of index yield and will consist of primarily undervalued securities.

In regards to APN's sell discipline, stocks within the portfolio that trade above fair value will be considered for sale, but only after a consideration of the premium above fair value, transaction costs and asset allocation requirements.

APN's portfolio construction approach is impressive and is an efficient extension of the stock selection process. While there is some discretion for the portfolio manager to make adjustments for risk control, asset allocation objectives and to include opportunistic undervalued securities, the portfolio composition is essentially driven by APN's yield focus and detailed modelling work.

## Risk Management

Portfolio Constraints	Description
A-REIT Exposure	90% - 100%
Cash	0% - 10%
Income growth objective	110% of Index
Stock - corporate earnings exposure	20-30%
Stock - International asset exposure	Up to 100%
Portfolio - International assets	Max. 50% of index
Portfolio - Corporate earnings	Max. 15% of portfolio income

APN's approach to risk management is significantly different to most of its peers in the LPT funds management space. While many of its competitors measure their risk in terms of volatility against the benchmark (i.e. tracking error), APN has more of an absolute focus, concentrating primarily on the stock specific risk of each investment and the implications this has on overall portfolio volatility. In this regard, APN will generally avoid (or hold underweight positions in) securities that have significant corporate or international earnings, regardless of their size in the benchmark. This approach is expected to lead to a tracking error well above the median; however it should also result in an absolute volatility (i.e. standard deviation) below the median and benchmark. The manager has risk management constraints in place to limit exposure to international and corporate earnings at 50% and 80% of benchmark respectively.

Zenith is highly positive on the risk management approach employed by APN. The manager's pro-active approach to minimising corporate and international earnings exposure should reduce absolute volatility and assist in maintaining a portfolio yield higher than the benchmark.

## Risks of the Fund

As with all property based funds, the major risk to the Fund is a sustained downturn in the Australian property market, which could see property values and rental income decline. Also, a rise in interest rates generally has a negative impact on the LPT market. While APN's diversified approach (which ensures exposure to a broad range of sectors) may partially insulate the manager, a cyclical property downturn is likely to lead to negative returns being delivered to investors. This risk can be significantly reduced by investors adopting a medium to long-term (5 year) investment time frame when investing in the fund.

Another risk with this fund is its expected high tracking error, driven by a portfolio composition primarily focused on small to mid cap trusts, which is significantly different to the benchmark. While we expect the Fund to provide consistent long-term returns with a high yield, its performance profile may be significantly different to the S&P/ASX 300 Property Accumulation Index and the median LPT manager. Zenith

believes the manager's high tracking error will be more than compensated for by the manager's expected low absolute volatility.

As at 31 March 2009, APN had a moderate level of funds under management (FUM) in Australian LPT investments of approximately \$473 million, this figure equates to around 0.95% of the S&P/ASX Property 300 Index market capitalisation of around \$50 billion. High levels of FUM can constrain a Managers ability to add value; however APN has advised Zenith that it considers its capacity in LPTs to be approximately 2.5% of the S&P/ASX Property 300 Index market capitalisation.

## Applications of the Fund

While the Fund currently has an insufficient performance history to undertake meaningful statistical analysis, it is interesting to note that the APN Property For Income Fund (PFIF) has historically displayed a lower correlation with Australian and international equities than many of its competitors. APN's avoidance of equity-like corporate earnings has resulted in a performance profile primarily driven by rental income and has provided an excellent diversifier within a typical equities based diversified portfolio.

The Fund provides investors with A-REIT exposure through a reasonably concentrated portfolio of high yielding listed property trusts. The Fund's investment objective is aimed at generating a gross annual income yield of 110%; maintaining CPI (consumer price index) levels of capital growth and providing a tax effective income distribution smoothed on a monthly basis. The characteristics listed would attract "income orientated" investors with an appetite for a moderate level of risk.

## Fees

The wholesale management fee is 0.85% p.a. which is comparable amongst the Fund's peers. The Fund does not have a performance fee.

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