

Argosy Property trust-management internalisation proposal

- A commentary

A number of unit holders have sought comment from the New Zealand Shareholders Association about the proposal to internalise the management of Argosy Property Trust. (Argosy)

In line with the policy statements on our website, the NZSA favours internal management and a corporate, rather than unit trust structure. We believe this best aligns the interests of management and investors. It also brings the governance and takeover activity into a much sounder and more transparent regulatory environment. However change cannot be at any price. It must stack up.

The Argosy independent directors are proposing a management buyout process costing \$20m. A second proposal requesting the Trustee dismiss the current external manager of Argosy without compensation has been put forward by a group of institutional investors lead by ACC. Subsequently, listed property company DNZ has proposed a form of merger with Argosy. Neither of these outside proposals will directly result in internalised management. We do not see the status quo as a viable alternative nor do we believe that One Path could sell the management rights to a third party due to the prevailing uncertainty.

Therefore, the question facing investors is which current option is, on balance, in their best interests.

History:

Argosy was formed by a series of mergers and takeovers including Paramount Property and Urbus Property management. Along the way it acquired 71 properties from MFL and SIL. MFL and SIL (via One Path) remain large holders controlling 26.4% of the units. In 2005, the current structure was largely complete. Known then as ING Property Trust, Argosy was renamed in late 2010. Over time Argosy has bought and sold a number of properties. The current portfolio consists of 74 properties with 294 separate tenants and an average lease term of 4.92 years. The portfolio is split relatively evenly between Industrial, commercial and retail. Occupancy averages over 96%. Argosy is the fourth largest listed property investment on the NZX with around \$948m in assets and a market cap of \$430m. The large number of participants makes this a complex entity to manage.

Argosy is structured as a unit trust. It is managed externally by Argosy Property Management (referred to here as One Path), a company owned by One Path, which in turn is owned by ANZ Bank.

Earlier this year, the two independent directors of the external Manager, Peter Brook and Trevor Scott began negotiations with One Path, and prepared a management internalisation proposal. On 19 April they announced that One Path was prepared to sell for a consideration of \$32.5m. This was widely opposed in the market as being excessive. Three months later they announced this figure had been negotiated down to \$20m.

In June, A group of institutions proposed that the unit holders vote to direct the trustee to remove the manager “in the best interests of the unit holders” and appoint a temporary manager with a view to eventually internalizing the management. Although this vote requires a simple majority, it is not binding and the Trustee has clearly stated that it will not take this action.

Also in June DNZ proposed a share based takeover of Argosy followed by internalisation of management. An unspecified fee would be paid to obtain the management rights. DNZ propose to manage the combined entity using their own in-house team. This offer lacks detail including the relative value to be attributed to Argosy units, and is subject to due diligence.

An independent report was commissioned from Grant Samuels (GS) for the benefit of unit holders. This is very comprehensive and in our view addresses the issues, but at 75 pages it taxes any reader. Most of the figures we use are extracted from this report.

Key points to consider

The unit holders decision comes down to a simple question of cost certainty versus a potential (but by no means certain) cost saving. The Argosy proposal would result in management internalization with minimal disruption. In addition, the Grant Samuels report identifies ongoing annual cost savings to the Trust of \$2.9m from internalisation. These would be available almost immediately in the case of an orderly transition.

Both the ACC and DNZ proposals are only first steps in a process. They do not immediately result in internalisation and they both carry a range of risks that are difficult to quantify. We have ignored taxation implications as these are not entirely clear given the lack of detail in some proposals. However, GS believe the Argosy proposal will be deductible to the trust reducing the net figure to around \$15.2m.

The Argosy proposal

When considering the views of the Argosy independent directors it is necessary to remember that while they have a moral duty to the unit holders, they also have a fiduciary duty to the external manager on whose board they sit. Additionally, the GS report points out the problem in deciding how to value these types of transaction, and works through a range of scenarios.

In our view, the logical way is to work backwards from a known outcome cost. The Unit Trusts Act Section 18 makes it possible for unit holders to dismiss a manager on payment of a fee. While no such deal is proposed here, it is a good starting point from which to calculate the cheapest certain outcome.

In Argosy’s case, a Section18 removal after 1 October will cost \$11m plus a range of other expenses. These are outlined in the GS report. A separate division of One Path is contracted to provide the operating side of the management arrangements for the next two years, so \$3.7m will be expended either paying for the work, or buying out this contract. There will need to be a temporary manger appointed, estimated by GS at \$1m. Using only 60% of the relatively generous GS figures, a further \$1.8m will be required for rebuilding the database and records, legal fees, Trustee fees and recruitment of a new team. There would also be bank facility fees estimated at \$600k by GS. GS do not attempt to quantify any aspects of disruption with the tenants or lease renewals, but we think a

very conservative effect would be 0.5% of gross rentals or \$400k. The GS report shows it will take a minimum of 6 months before internalisation can be effected. This means that a further \$1.45m in identified annual cost savings from internalisation will be forgone over this time.

Therefore the total cost for a Section 18 removal is likely to be in the order of \$19.95m.

The ACC/Institutions Proposal

The second option is similar to that proposed by ACC at Vital Healthcare Property Trust. ACC claim that a 50% vote calling for the removal of the manager under Section 19 of the Unit Trusts Act will force the Trustee to remove One Path without compensation. However, there is no compulsion on the Trustee, and it has never happened before. On at least two occasions, the Argosy trustee has rejected taking this course of action, regardless of any voting outcome. The removal option is intended to apply where the manager has been incompetent or failed in some material way. There has certainly been disappointment over the performance of the Trust in the past, but in 2010 and 2011 total shareholder return rebounded to 38% and 8.3% respectively. NTA has been impacted by the GFC and asset sales, but tables in the GS report show Argosy has performed well against its peers over the last two years. Our biggest concern is the level of gearing. Currently this is 39.3% and would increase to 41.5% if the change was debt funded. Argosy has assured us that property sales in the pipeline mean that gearing will not go above 40%. This still remains higher than we would like long term.

If the ACC approach is successful and the Trustee removes the manager, both we and Grant Samuel consider it inevitable that litigation would follow from One Path. Conversely, ACC has told us that they may sue the trustee if the trustee fails to act. How such an action could be in the interest of all unit holders beggars belief. The trustee has made it clear that all litigation costs would ultimately be borne by the unit holders.

Even if the ACC action succeeded, this would not result in internalisation immediately, as a temporary manager would be required, and the additional costs described in the preceding section would still apply. The GS report says that these would total at least \$7.9m. In addition, banking facilities may need to be renegotiated at a likely cost of \$600k. ACC claim that current management staff may stay which mitigating some risk. We believe that the staff position would be untenable as a vote in favour of the ACC proposal would effectively be a vote of no confidence in the management team. We understand that management staff are also covered by a comprehensive redundancy scheme resulting in little financial pressure for them to stay. The sudden loss of most institutional knowledge could be very damaging to the Trust and unit holders.

If litigation occurs, the costs would be very significant. Argosy said on Friday that defending a DNZ request to hold a special meeting a week before the AGM has cost almost \$300k. This was only a brief skirmish involving almost no court time. If the court found in favour of One Path, the lowest likely compensation would be the \$11m payable under a Section 18 removal, plus costs. More significantly, any litigation would inevitably drag on for at least a year. Management fees would continue and expected savings from internalisation would not be realised. Combined, these could total over \$5m for every six month period the process was held up. ACC claim little litigation risk, but when we asked, they were unwilling to indemnify unit holders against litigation costs.

The time uncertainties around the successful conclusion and the potential cost of the ACC proposal mean that in our view, unit holders would be taking an open ended gamble rather than making a commercial decision.

The DNZ Proposal

DNZ, a smaller listed property trust has proposed a share based takeover of Argosy. This is not a cash offer. As with the ACC proposal it would not result in immediate internalisation of management. DNZ would pay One Path a fee to buy the management rights, however they have not said how much or how this would be funded. In our view, One Path would still require the \$20m currently being asked, meaning no cost savings to the unit holders. DNZ would then incorporate the management into their own operation. There are many uncertainties with the DNZ proposal. Critically, it does not even spell out the relative value to be attributed to Argosy units, saying this will be decided later. The DNZ offer is also subject to due diligence, meaning there is no guarantee it will proceed.

In our opinion, the DNZ offer lacks far too much detail to be credible in its current form.

Corporatisation

At the time of writing, none of the offers has a clear path towards corporatisation. The NZSA favours a corporate structure as it affords far more control and protection. A change to this structure should have significant value for investors.

Following discussions with Argosy, the NZSA has obtained a firm undertaking that if the Argosy independent director's management internalisation proposal is approved, the Argosy board will prepare a corporatisation proposal for unit holders to vote on at the next AGM in a year's time.

Summary

For the reasons outlined above we see little merit in either the ACC or the DNZ proposals.

The question then becomes "is the Argosy proposal reasonable for unit holders"?

The Argosy proposal is for a management buyout costing \$20m. GS have identified additional cost (mainly legal) that will push the final figure to \$21.3m.

The NZSA believes the fair figure is around \$19.95m. **However, the inclusion of a firm corporatisation proposal is the clincher for us.** The opportunity cost of \$1.35m to achieve this is minor relative to the longer term benefits.

Accordingly, the NZSA proposes to support the internalisation process as proposed by the Argosy independent directors and will be voting any proxies it holds in favour of motions 1 to 3.

We will be voting against the ACC and DNZ proposals (motions 4 to 10), plus the two late motions (13 and 14) from DNZ.