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Many Investors, One Voice

Vital Healthcare Property Trust - management internalisation proposal – a commentary

A number of unit holders have sought comment from the NZSA about the proposal to internalise the management of Vital Healthcare Property Trust. (Vital)

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 into a much sounder and more transparent regulatory environment. However change cannot be at any price. It must stack up. The independents say internalisation will be cash accretive to the Trust, but have not quantified this. Regardless of how internalisation is achieved, we have assumed the same long run benefits will apply.

History:

Vital is structured as a unit trust. It is managed externally by Vital Healthcare Management (the Manager), 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, Bill Thurston and Graeme Horsley were asked to negotiate with One Path, and prepare a management internalisation proposal. On 27 April they announced that One Path was prepared to sell for a consideration of \$14m. The Trustee (Trustees Executors) requires an independent report on this proposal from Grant Samuels.

A second option was subsequently tabled by Ascot Capital Management (Ascot). This required them to gain the support of at least 10% of units and force the Manager to convene a special meeting. This threshold has been achieved. On 23 June, Vital announced “it would arrange for Ascot’s proposed resolutions to be considered at the meeting of unit holders expected to be convened in August to consider the previously announced internalisation proposal.”

If the Ascot proposal receives votes representing 75% of units, it would result in the manager being dismissed for a one off payment of \$3.1m. Ascot would be appointed to run the trust short term (subject to the trustee agreeing), while making arrangements to internalise the management. Ascot would be paid under the existing fee structure for acting as manager (approximately \$4.2m p.a. in a full year). Ascot have advised the NZSA they would not seek any additional bonus payments that might accrue as a result of increases in the unit price. Once internalisation is completed, Ascot would step away taking a one off fee of \$1.4m for facilitating the deal.

On the 14th of July ACC and other institutions announced that they would pursue a different option. They believe that if they can get an ordinary resolution passed by 50% of the unit holders, the Trustee will be persuaded to dismiss the manager without payment “in the interests of unit holders”. ACC believe that a sum of \$2m would be sufficient to cover management costs while internalisation is effected.

Factors to Consider

On paper it seems pretty simple. Pay \$14m, \$4.5m or \$2m to achieve much the same outcome. However there are a number of matters that need to be considered by unit holders before they decide on a course of action. Adding to the difficulty in evaluating the proposals is that while many costs are known, some

are not in the public domain. Others need to be estimated as the actual amount will depend on the complexity and timeliness of the transfer process.

So far no group has committed to changing to a corporate structure. All have said they would consider it. An unequivocal commitment to do so would be a positive factor to be added into the mix in our view, but in the absence of any definite plan, we have given this no weight.

Our view on the One Path proposal

Once the Ascot proposal surfaced, the independent directors backed away from their original insistence that \$14m was a fair price saying this was a “starting point”. They have now said a lower figure would be appropriate and are attempting to negotiate this. We think this U-turn has damaged their credibility. Of course there remains the perception of a conflict of interest. Both claim a moral duty to the unit holders, but they also have a fiduciary duty to the external manager on whose board they sit.

The independent directors claim Ascot has insufficient expertise to manage Vital. Ascot’s principals are David Glenn, Craig Priscott and Sandy Maier. They are all experienced business people with a history of managing complex structures and property. They run a number of elderly care hospitals and rest homes via Radius Property Group. Ascot has indicated to us that day to day management in the transition period would be contracted to a specialist manager such as JLL. This is a common arrangement and in this regard is similar to the ACC proposal.

One concern is the potential loss of institutional knowledge and the impact on customer relationships if the current management team resigned en masse. We think this is a possible outcome. The independents claim the relationship between the trust and its tenants would be detrimentally affected; pointing out that Vital is doing considerable expansion and facilities enhancement at several sites. Vital has very long term leases and its tenants are obliged to continue payments, so we see little likelihood of income disruption. Without knowing in detail how the ongoing work is being managed, these factors are difficult to quantify, but some impact is inevitable and this is acknowledged by the ACC group.

Vital has a favourable tax treatment for its Australian property investments and long term bank funding arrangements which the independent director’s suggest could be compromised. For their part both the other groups say they could duplicate these arrangements. Similarly, the tax deductibility of the Ascot and ACC options has been questioned by Vital. We understand that both groups expect their costs to be deductible. However, it is likely that an orderly transition would be effected promptly and at much lower cost than a contested change. For example, the management team will transfer straight across, and cooperation between buyer and seller will minimise delays and reduce legal costs.

Our view on Ascots claims

For its part, Ascot is probably understating the true cost of their deal by only highlighting the “principal” costs. They also made claims that Vital bought Australian assets and immediately wrote them down by \$12m. In fact nearly all of this was stamp duty, a tax payable on purchase and clearly not an ongoing asset.

Ascot claims that internalisation could be achieved in 2-4 months. In our view, this is optimistic. Vitals’ operations are spread over two jurisdictions and have a number of structural, funding and taxation issues to be resolved. We see 3-6 months as a more likely outcome. Consequently, unit holders will be required to fund the external management costs (and profit) during this period.

Ascot say there will be minimal or no interruption to ongoing operations. Again we question this assumption, although the extent to which it will impact is hard to quantify in dollar terms. Very likely, both the Ascot and ACC arrangement will involve much higher legal, employment and accounting costs. There may be duplication of structures that would have transferred under the Vital proposal and the process could be slow going if institutional knowledge is lost.

The ACC proposal

The third option is similar to that proposed by this institutional group at Argosy Trust. ACC have the necessary support to force a vote. This will also be done at the Vital meeting in August. ACC are confident that a 50% vote calling for the removal of the manager will force the Trustee to act accordingly. However, there is no compulsion on the Trustee and it has never happened before in similar circumstances. It is notable that just today; the Vital trustee has effectively rejected this course of action, even before a vote is taken. The removal option is intended to apply where the manager has been incompetent or failed in some material way. This is not the case for Vital. There has been some disquiet over reduced NTA as a result of fund raising to buy the Australian assets last year, but that is arguably well short of incompetence. Vital directors are adamant that a large discount was a pragmatic commercial decision to ensure the success of the fund raising in the current difficult climate. It would seem the Trustee is of a like mind.

If the ACC approach is successful and if the Trustee was persuaded to remove the manager, we think it inevitable that One Path would sue the Trustee. ACC claim these costs would fall to the Trustee. We are of the opinion that they would flow back to Vital and ultimately the unit holders, and would likely involve millions of dollars. Should One Path succeed in a claim, damages could be substantial.

The 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 a commercial decision.

The costs

It is possible that matters will become clearer when the Grant Samuels report is available. However, unit holders should remember that this is prepared based on limited terms of reference.

The NZSA believes the solution should be a commercial one, rather than getting mired in legal process. Further, it is in everyone's interest to get the deal finalised. With three options on the table, there is a fair chance that none will succeed and the status quo will remain for some time before another attempt is made. This may be to the detriment of unit holders who ultimately bear ever increasing costs.

In our view the initial OnePath offer of \$14m is excessive. Most commentators agree.

If Ascot succeeds, what would the likely final cost be? Normal management costs including a management contractor such as JLL will be paid by Ascot from the ongoing management fee, but under the contract, many other expenses can be charged directly to the Trust by both the Manager and the Trustee. In our view this is likely to occur for one off or abnormal items associated with the changeover.

The contractual buyout is a minimum of \$3.1m. Ascot's success fee is \$1.4m. We think that 3-6 months to finalise the Ascot deal could add another \$425k-\$850k in external management profit that would not otherwise have been payable. Since the Australian asset purchases, the management fees have roughly doubled which is not yet fully reflected in the annual figure. To cover this we have added \$300k-\$600k to cover profit not otherwise payable during the changeover period. As the margin in management contracts is not disclosed, we have used 55% of the known gross payments for these estimates.

Although the intentions of existing management personal are unknown, investors need to consider the potential costs of a sudden departure. We conservatively estimate these at \$370k, well below the ACC figure. We have also allowed for tenant disruption effects based on 0.3% of gross rental income (\$120k). If investors accept these estimates, a more realistic total cost of the Ascot proposal is around \$5.7 to \$6.4m.

The ACC bid could be anything from \$2m plus. If court action resulted, and damages were paid, this could easily top \$6m. We also believe this proposal would take the longest to finalise due to the much greater involvement of the Trustee .

Summary

The key to any decision will be what final buyout figure the independent directors are able to achieve given the price tension that now exists. This would need to be similar or below the true cost of the Ascot bid. It would also need to be pitched at a level that makes the uncertainty, time and litigation risk inherent in the ACC bid not worth the risk. ACC may have a level in mind where the commercial imperative outweighs the risks, but have not been willing to share this with the market. Unit holders will of course have their own views on the relative weighting of each factor.

In our view, a figure of \$5.5m (pre any tax considerations) to buy out the management contract seems a reasonable balance point. If the independent directors are able to obtain agreement from One Path at this level, the NZSA would vote any proxies we hold in their favour.

John Hawkins

Chairman