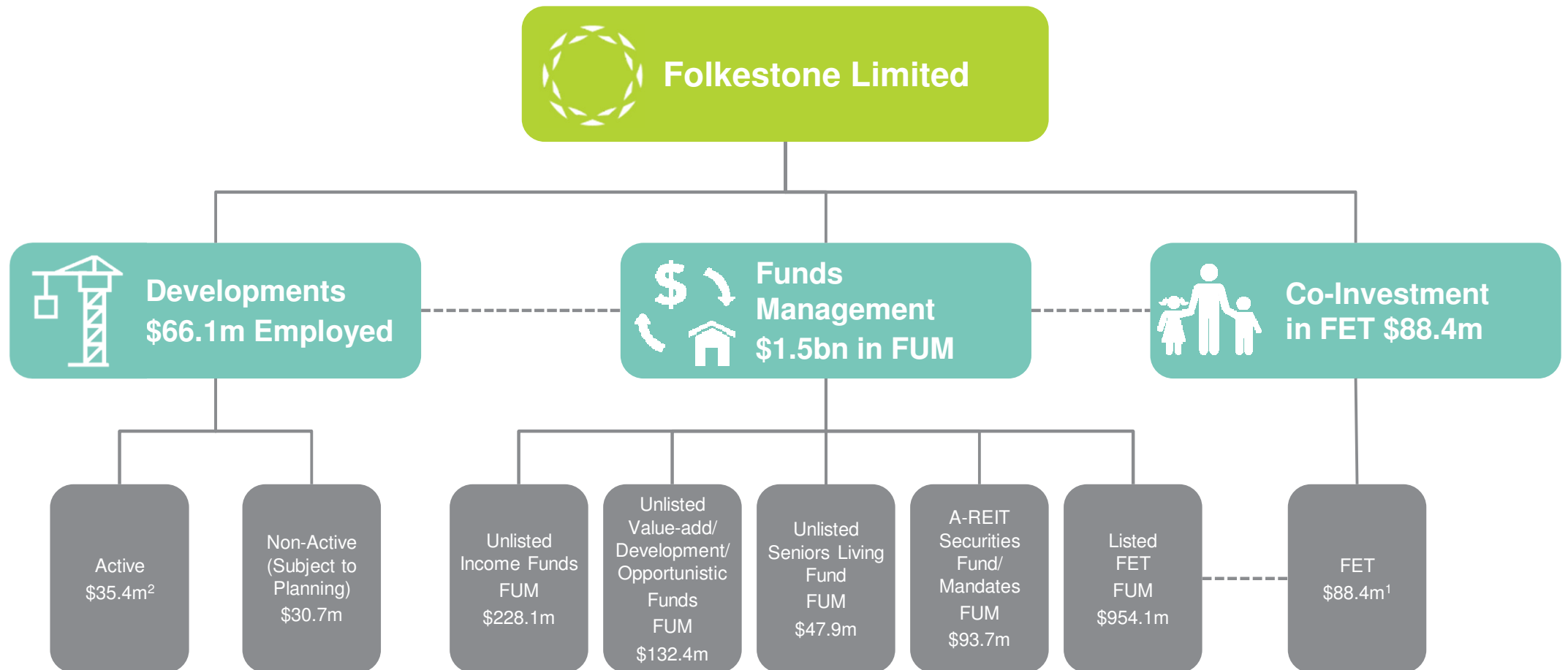


UNLISTED REAL ESTATE – THE HUNT FOR YIELD

Adrian Harrington
Head of Funds Management - Folkestone
July 2018



Folkestone is an ASX listed real estate funds manager and developer providing real estate wealth solutions for private clients and select institutions



1. Based on Folkestone Education Trust's (ASX:FET) Unit price of \$2.88 at 31 December 2017. Excludes interest in FET held by Folkestone Maxim A-REITs Fund/Mandates.
 2. Includes FLK's co-investments in the Folkestone Seniors Living Fund No.1, Folkestone Truganina Development Fund and Folkestone Wollert Development Fund.





REAL ESTATE LANDSCAPE

- Market forces continue to re-shape the landscape
- Capital is changing – a greater array of investors and investment opportunities
- Redefining what types of investment are included in the portfolio

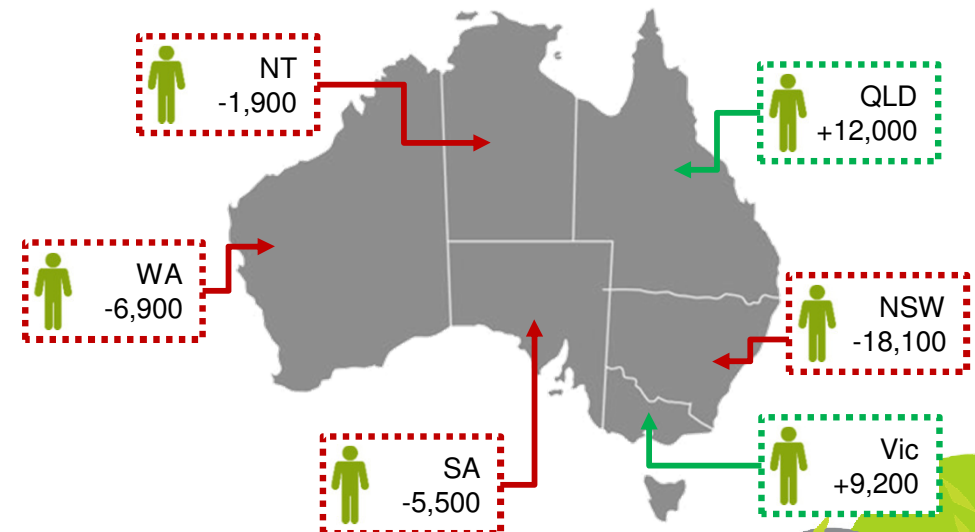


- Sydney and Melbourne growing above trend
- Population forecasting has consistently fallen short – ABS forecast's 1999 vs 2017:
 - Australia - 22.2m vs 24.6m
 - Sydney - 4.45m vs 5.1m
 - Melbourne - 3.67m vs 4.9m
- Inner city & middle ring population growth stronger than expected
- Infrastructure has not kept pace
- Pressure on social services – childcare/aged care/schools/medical especially inner & middle ring
- Creates social infrastructure real estate investment opportunities

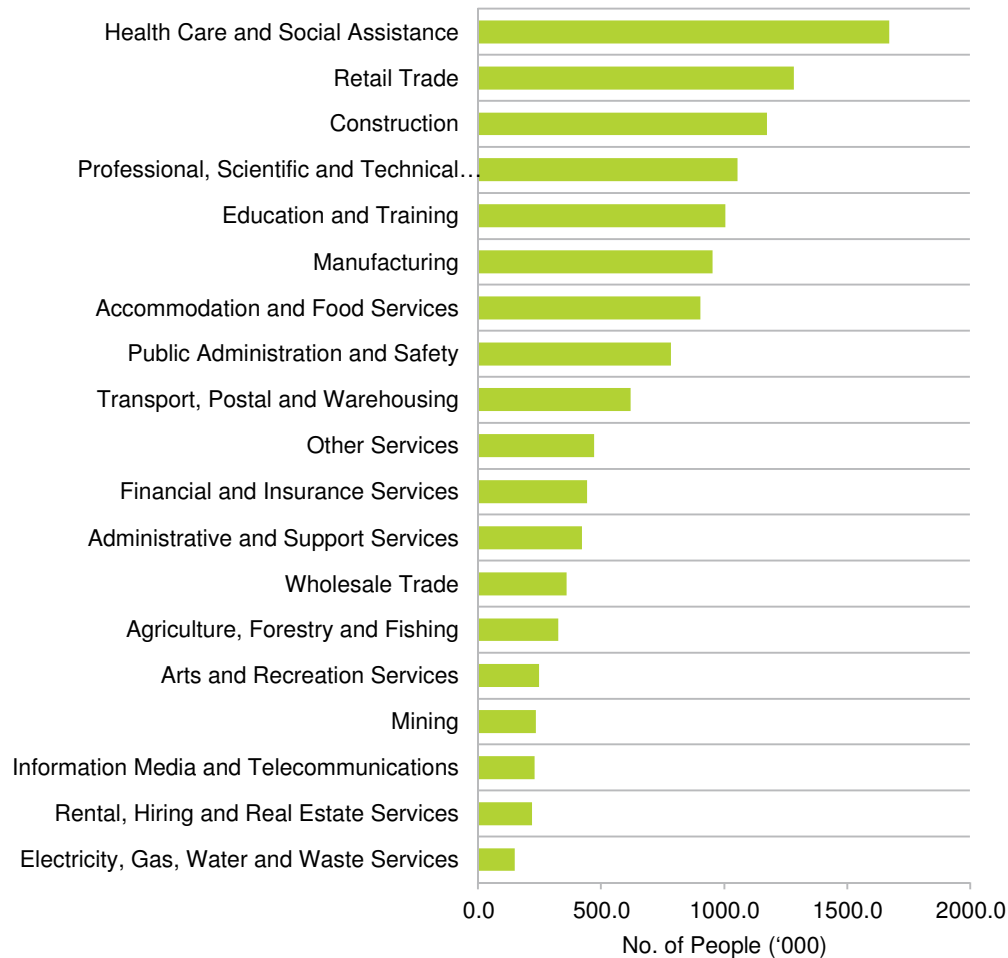
Demographic Shift – Cities

	Population at 30 June 2017	Change on Previous Year	
		No.	%
Greater Sydney	5,131,326	101,600	2.0
Greater Melbourne	4,850,740	125,400	2.7
Greater Brisbane	2,408,223	48,000	2.0
Greater Adelaide	1,333,927	9,600	0.7
Greater Perth	2,043,138	21,100	1.0
Greater Hobart	226,884	2,400	1.1
Greater Darwin	146,612	700	0.5
ACT	410,301	6,800	1.7
Total Cities	16,551,151	315,600	1.6

Net Interstate Migration

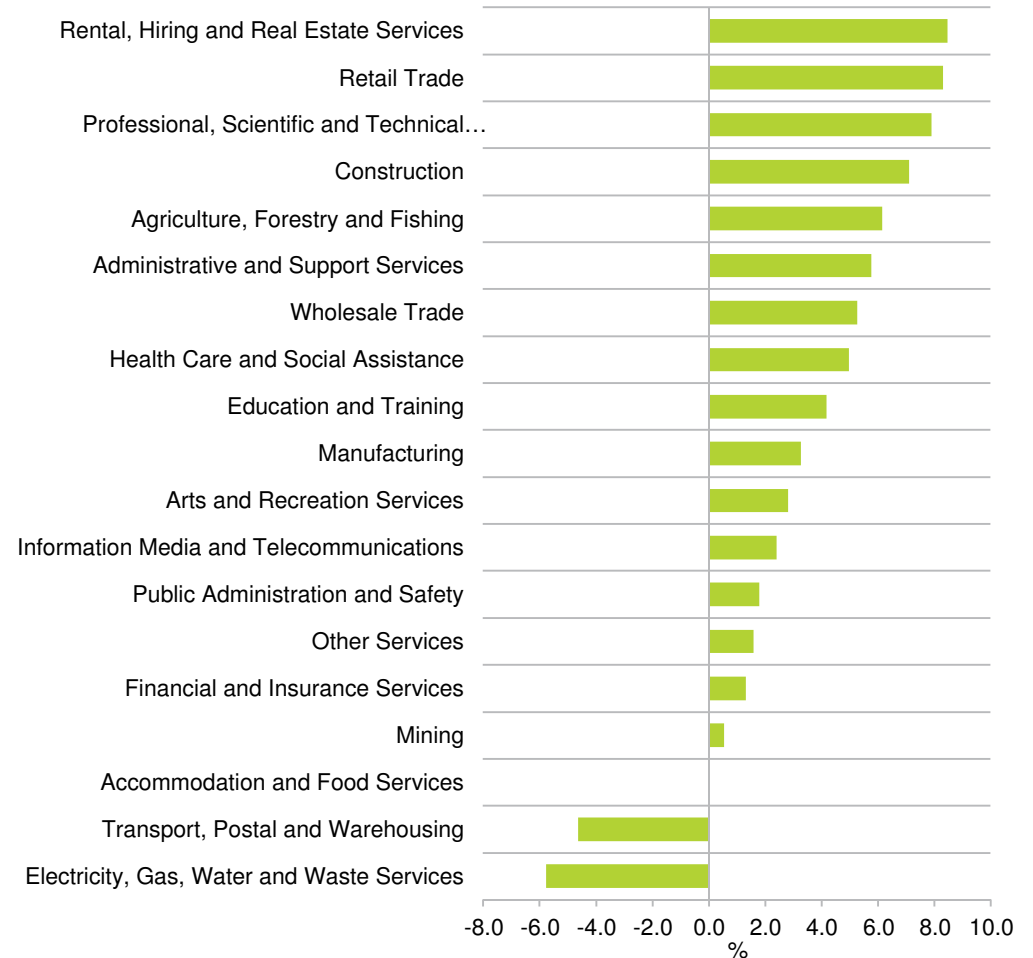


Employment By Industry: As At May 2018

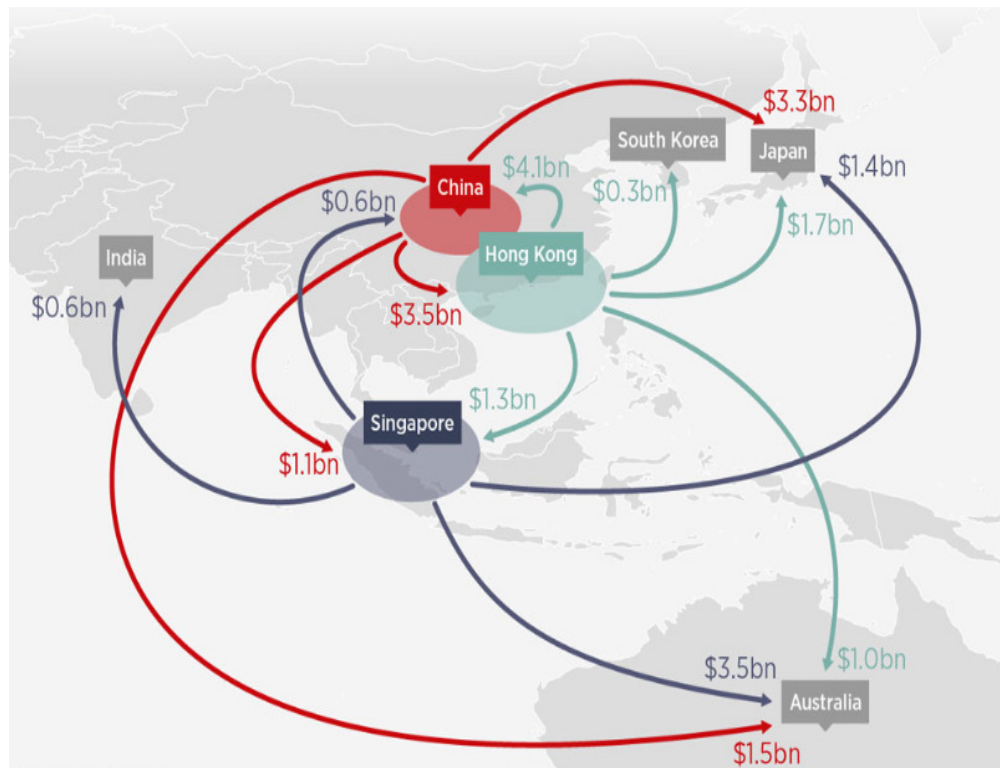


Source: ABS

Employment By Industry Change: 2017 - 2018



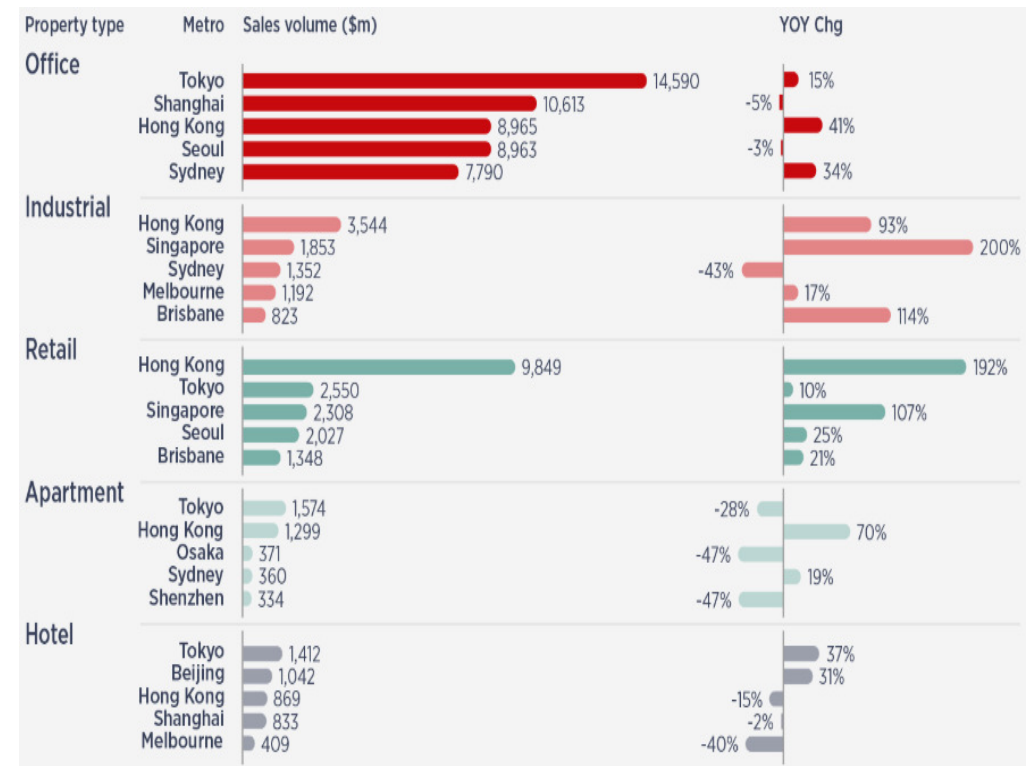
Asia Pacific Cross Border Investment: 12 Months to 31 March 2018



Source: Savills

- Australia continues to be attractive to Asian investors

Most Active Metros By Real Estate Type: 12 Months to 30 June 2018



Source: Savills

- Sydney office, Sydney/Melbourne/Brisbane industrial and Brisbane retail in demand from Asian investors



BANK CREDIT TIGHTENING

- More rigorous credit risk assessment especially with respect to new clients
- Reduction of loan to value ratios
- Land bank facility approvals more difficult – given they are non income producing
- Increased presale levels from 50% to as high as 130% debt cover for residential development loans
- Increased complexity with respect to credit assessment and approvals
- Slower approval and settlement timeframes

Westpac flags credit slowdown from bank tightening

Sydney Morning Herald

Banks tighten home lending controls

Sydney Morning Herald

Investor home loans drop to six-year low as April mortgage lending slows

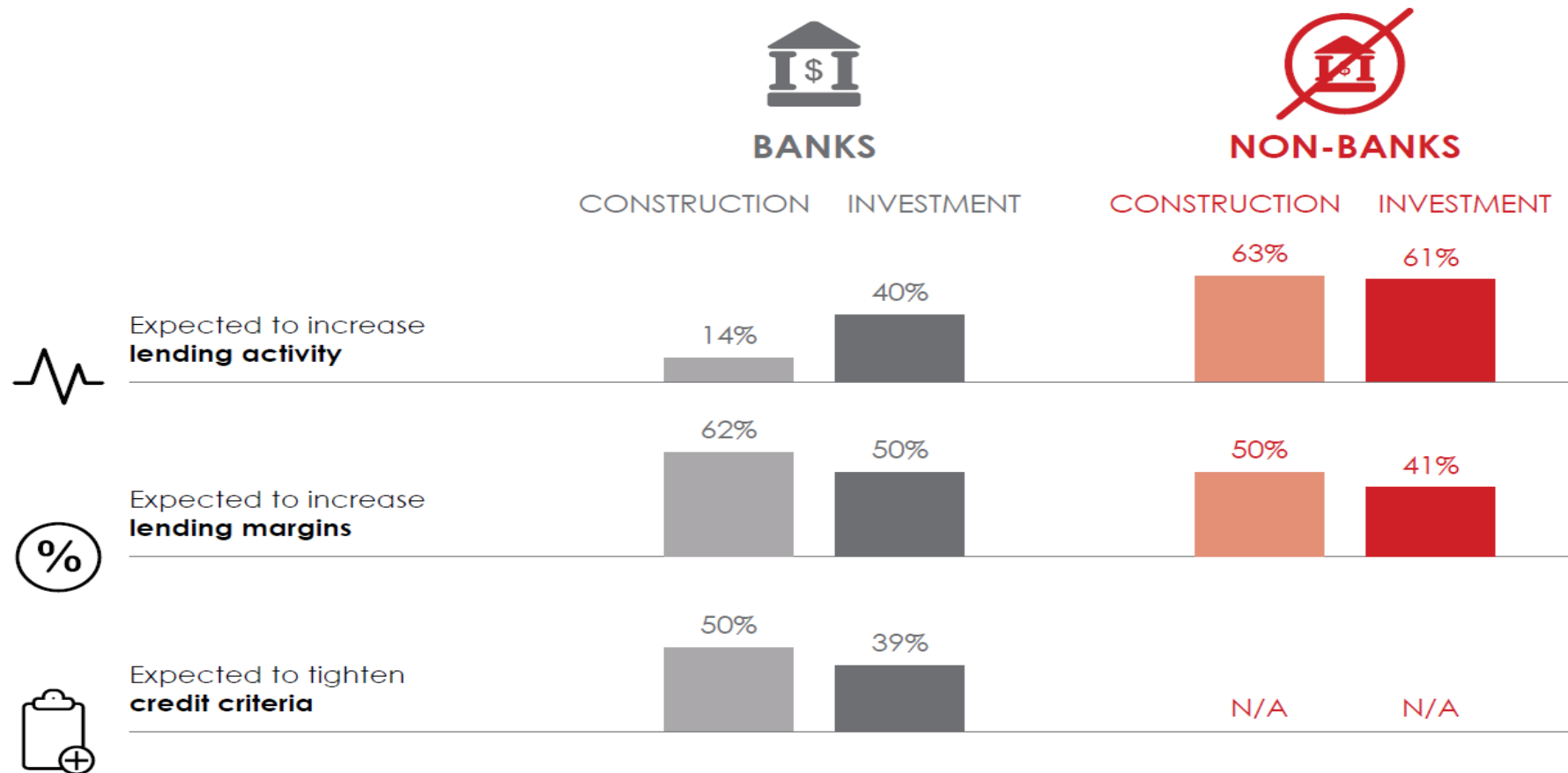
Australian Financial Review

Citi slams residential lending brakes amid warnings of looming property crunch

Australian Financial Review



THE RISE OF NON-BANK LENDERS



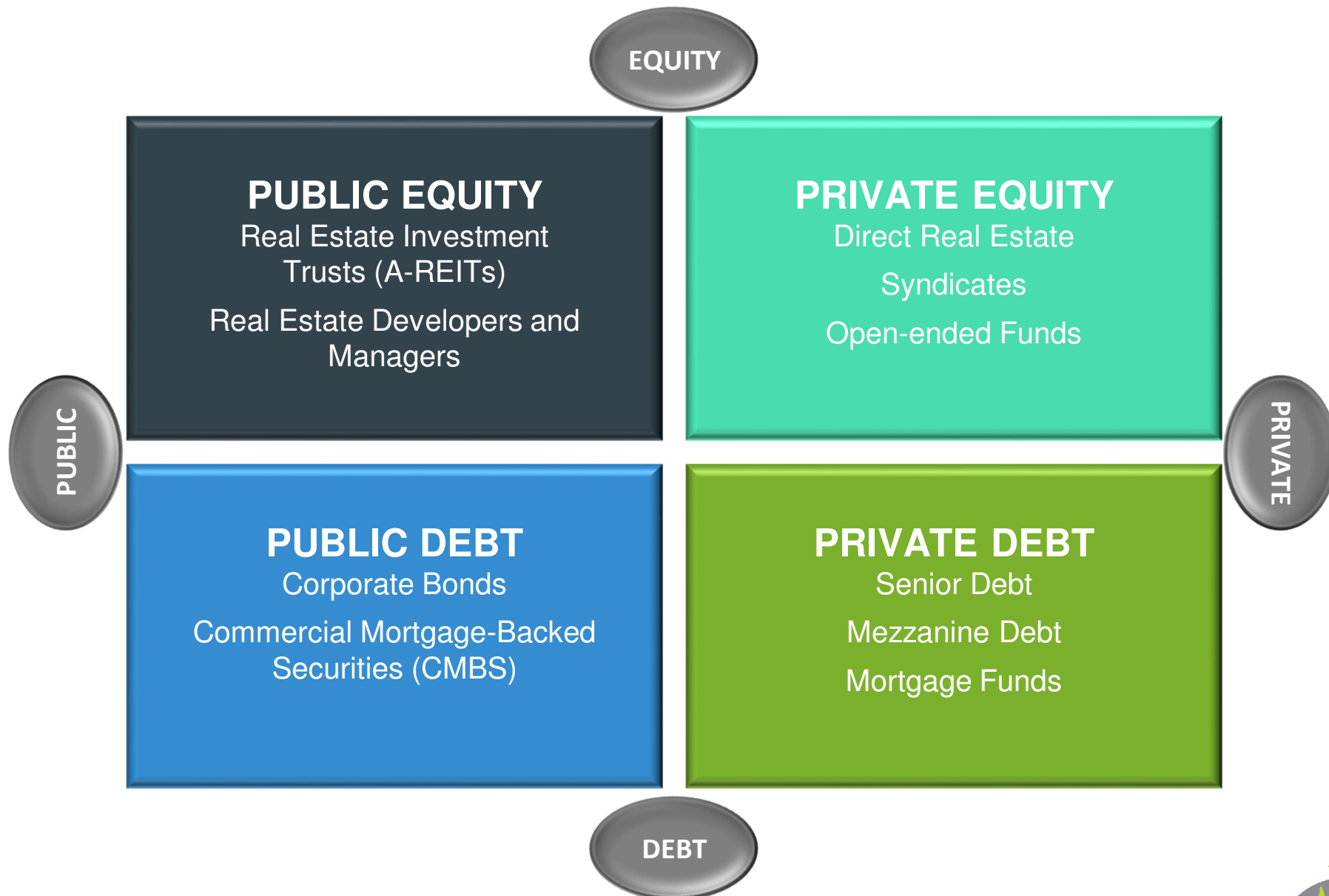
- Major banks still have appetite for investment loans but less so for construction loans
- Non-bank lenders are increasing their stake
- New funding sources are emerging
- Lending criteria to remain tight



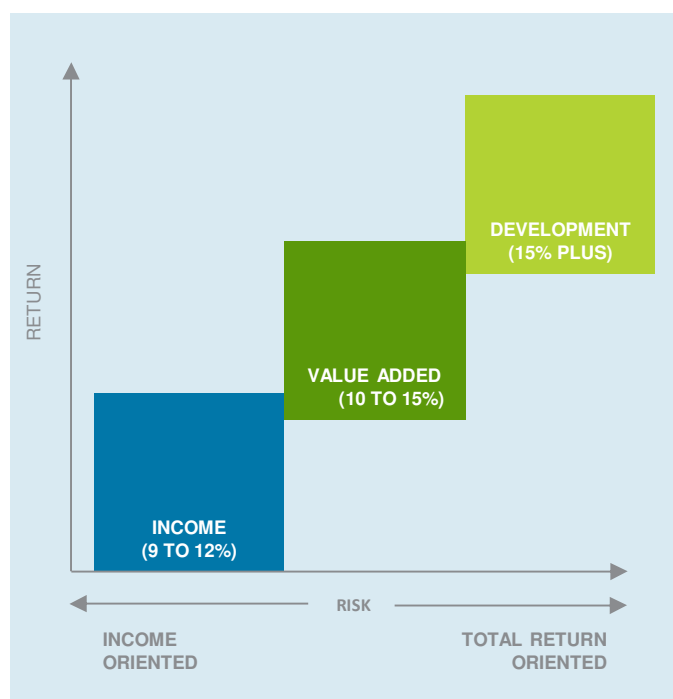
UNLISTED REAL ESTATE PERFORMANCE



FOUR QUADRANT REAL ESTATE INVESTING



Investment Strategies Across The Real Estate Spectrum



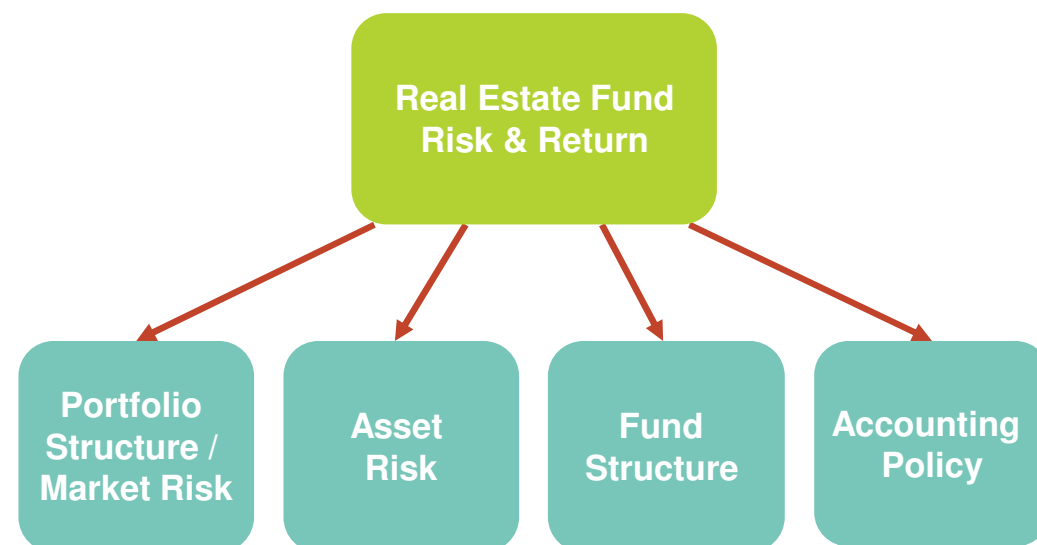
	INCOME	VALUE-ADDED	DEVELOPMENT
RISK:	Low	Medium	High
TARGET RETURN (IRR – PRE TAX NET OF FEES):	9-12%	10-15%	15%+
SOURCES OF EARNINGS:	Current income (70%) + capital appreciation (30%)	Current income (50%) + realised capital appreciation (50%)	Current income (<20%) + realised capital appreciation (>80%)
HOLDING PERIOD:	5+ years	3-7 years	2-5 years
FINANCIAL LEVERAGE:	0-50%	30-70%	50-80%
BUILDING TYPE:	Quality assets with long leases and quality tenants, fully or almost fully occupied	Assets with upside potential through refurbishment, re-leasing and repositioning	Development assets, distressed assets



- Alpha and beta originate from both portfolio structuring and asset selection
- Asset alpha:
 - cost control, leasing strategy, asset enhancement, acquisitions & dispositions
 - asset management and transaction skills are the driver
 - eye for unrealised latent value
- Structure alpha:
 - higher than benchmark allocations to outperforming markets and sectors
 - forecasting skills are the driver
- Asset beta:
 - asset level (operating) leverage
 - continuum from ground rents to speculative developments
- Structure beta:
 - domestic benchmark: allocations to more volatile sectors
 - global benchmark: exposures to higher risk geographies – not fully quantifiable
 - financial leverage

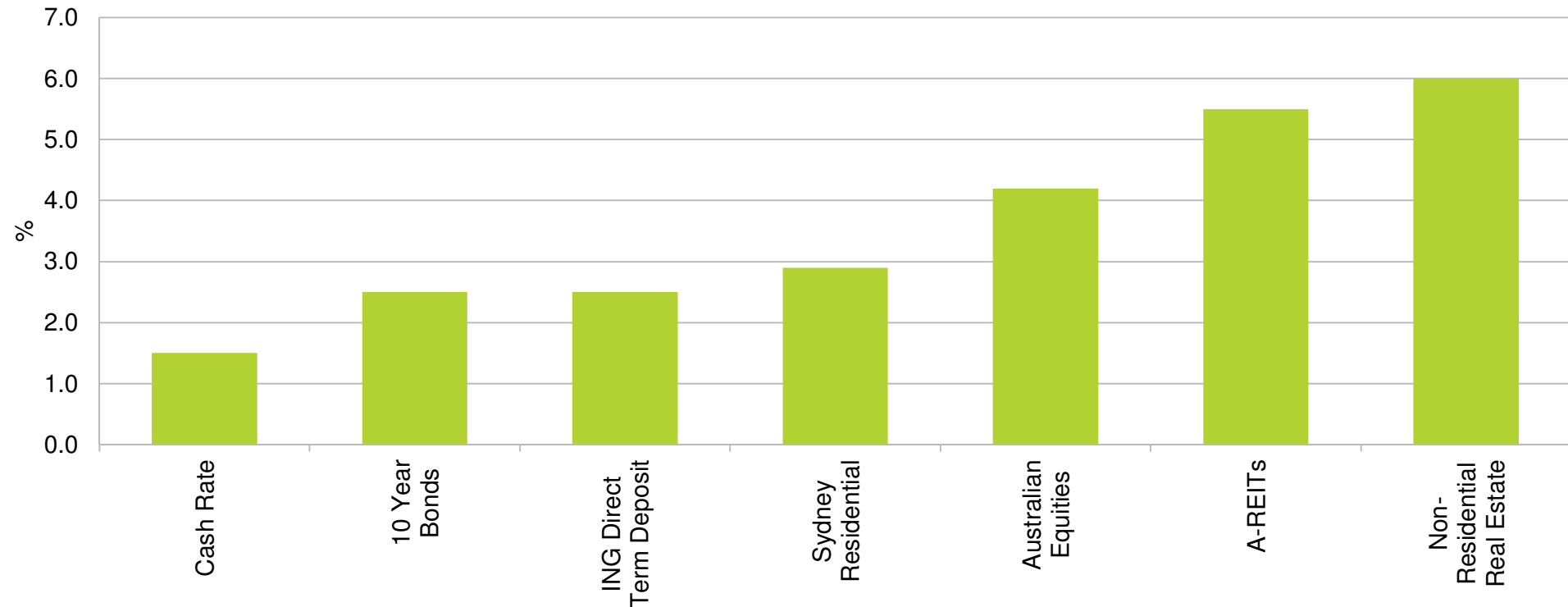


- Market risk:
 - allocations to more volatile sectors
 - macro / supply risks
 - transparency, property rights
- Asset risk:
 - asset level (operating) leverage
 - risk continuum from ground rents to speculative developments
 - age, structure
 - income quality
 - diversification
- Fund structure:
 - financial leverage: floating rate/fixed rate debt, collateralization
 - vehicle characteristics: age, structure, fees/costs (alignment), fiscal efficiency
 - public market volatility if listed
- Accounting policy:
 - treatment of items e.g. mark-to-market valuations of interest hedging instruments, right off or capitalise costs incurred



YIELDS – THE SEARCH FOR INCOME

Investment Yields: 30 June 2018



Source: Yield Report, Core Logic, RP Data, Credit Suisse, IRESS Folkestone

- Non-residential property and A-REITs provide an attractive yield relative to other investments



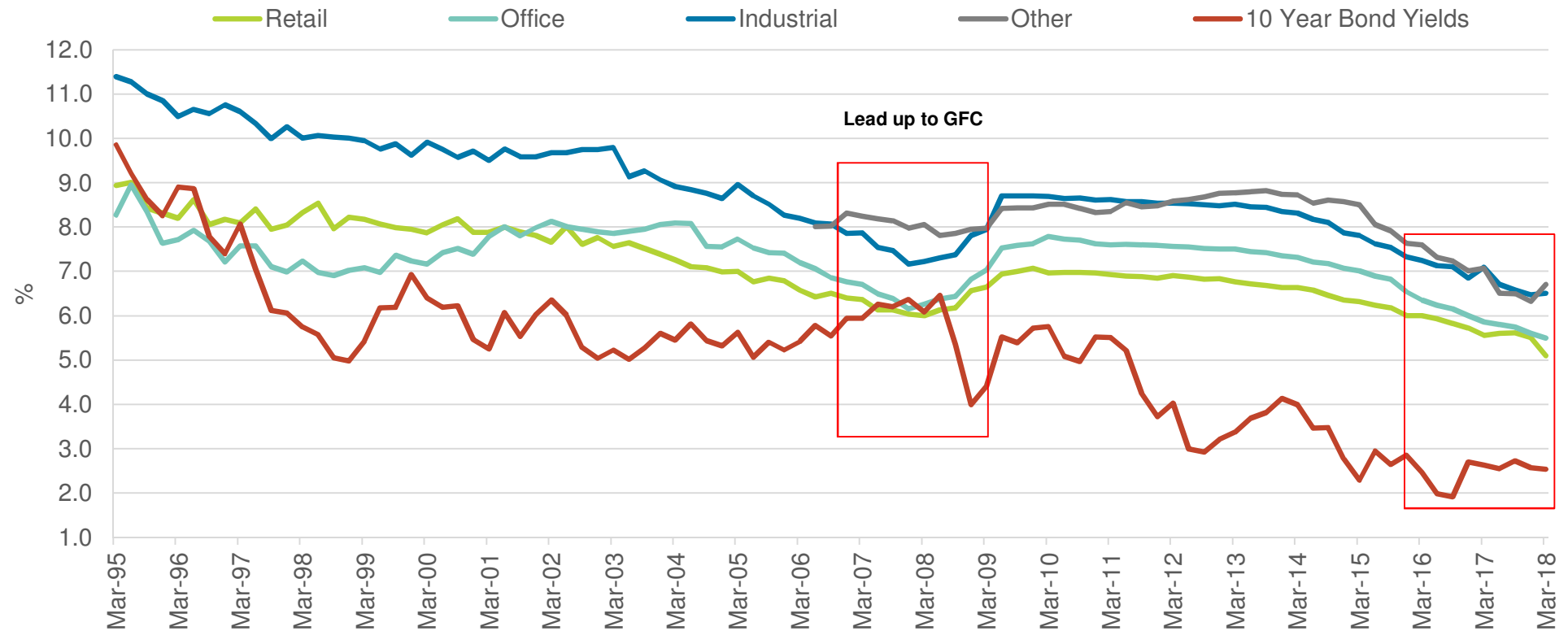
WHY UNLISTED REAL ESTATE IN THE PORTFOLIO?

- Real estate has provided a **competitive return** over the long term
 - “core” real estate is expected to generate a lower return than equities but higher than bonds
- Real estate **generates income** from contracts and leases
 - more stable income streams across the cycle
 - approximately 70% of the total return from core real estate is derived from current income generated by contractual rent payments associated with tenant leases
 - provides a hedge against inflation
- Brings **diversification benefits** to the mixed-asset portfolio
 - real estate exhibit lower correlations with equities and bonds
- **Active management** in real estate can add significant value
 - an owner can actively manage a portfolio through market, sector and or asset selection decisions
 - an owner can make physical changes to an individual asset, increase its operational efficiency or alter its capital structure in efforts to increase returns



NON-RESIDENTIAL REAL ESTATE PERFORMANCE

Non-Residential Real Estate Yields: March 1995 – March 2018



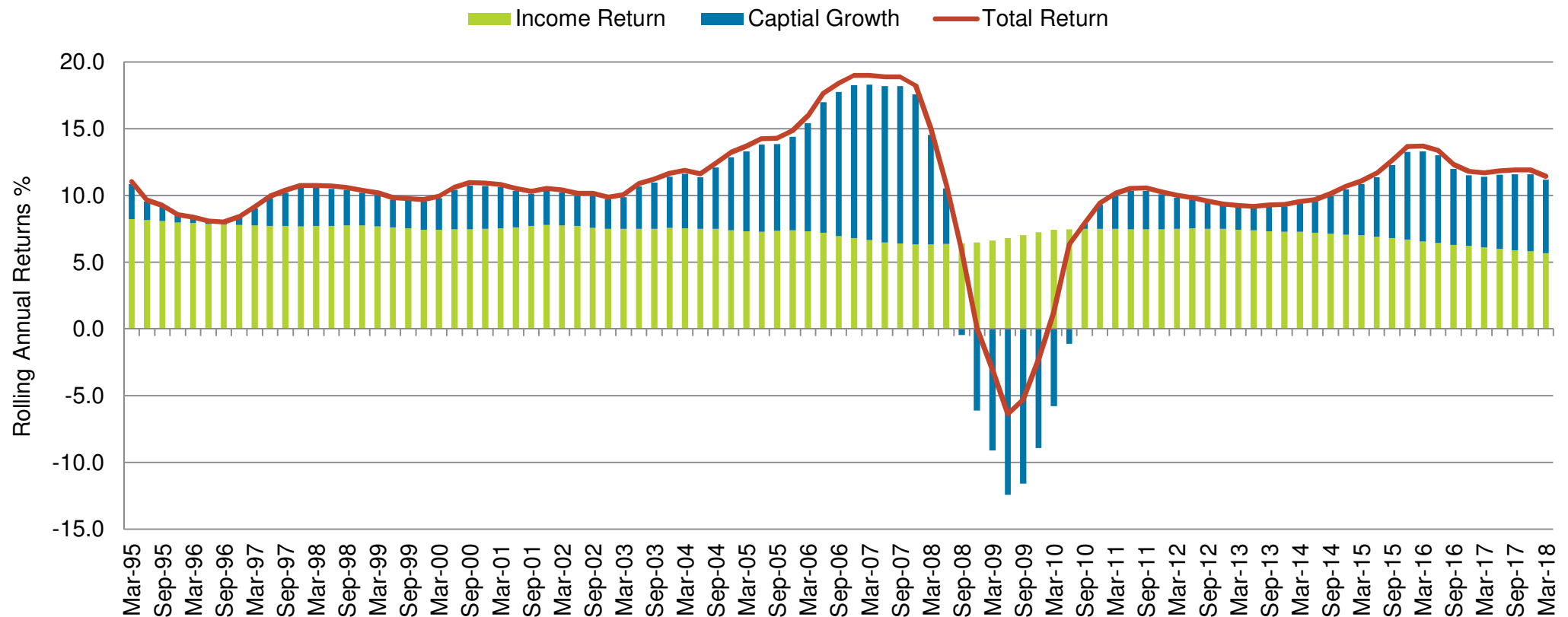
Source: MSCI/PCA

- Cap rates at record lows – difference between 2007 and now is spread between bond yields



NON-RESIDENTIAL REAL ESTATE PERFORMANCE

Drivers of Non-Residential Real Estate Investment Returns: 1995 - 2018

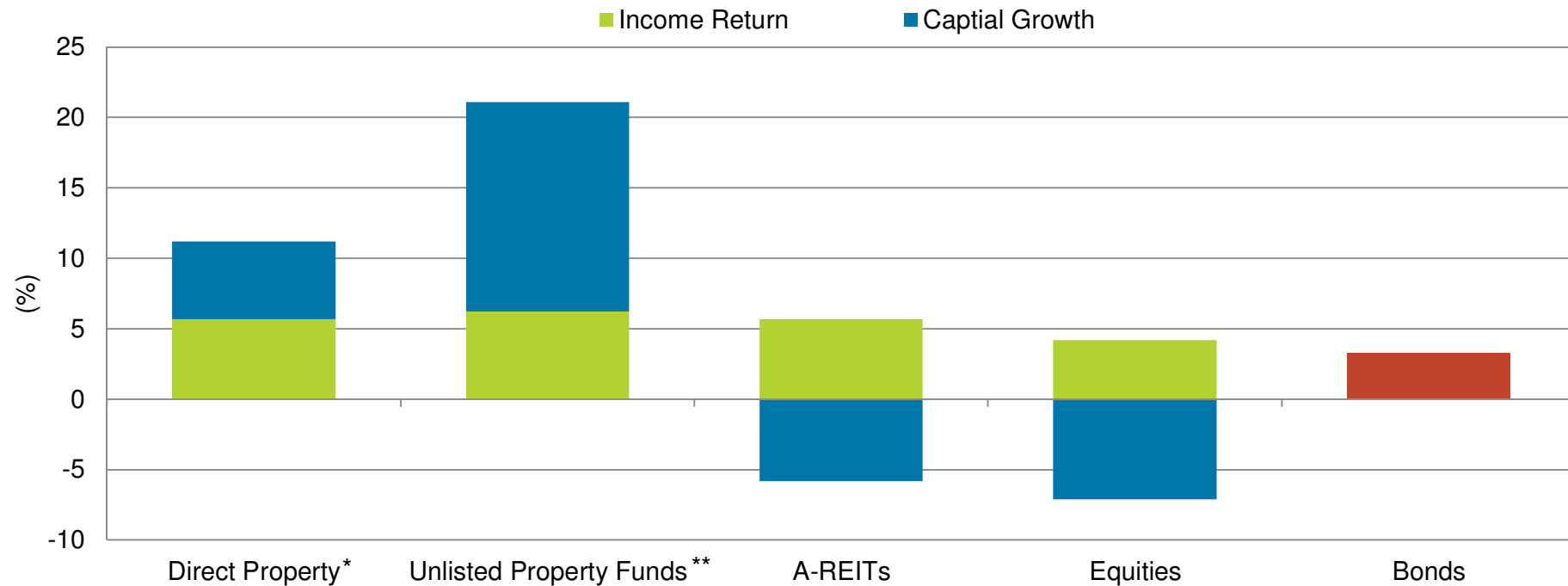


Source: MSCI

- Returns have been driven by cap rate compression rather than income growth



Asset Class Returns: Year to 31 March 2018



Source: MSCI/UBS

- Unlisted real estate funds the best performing asset class

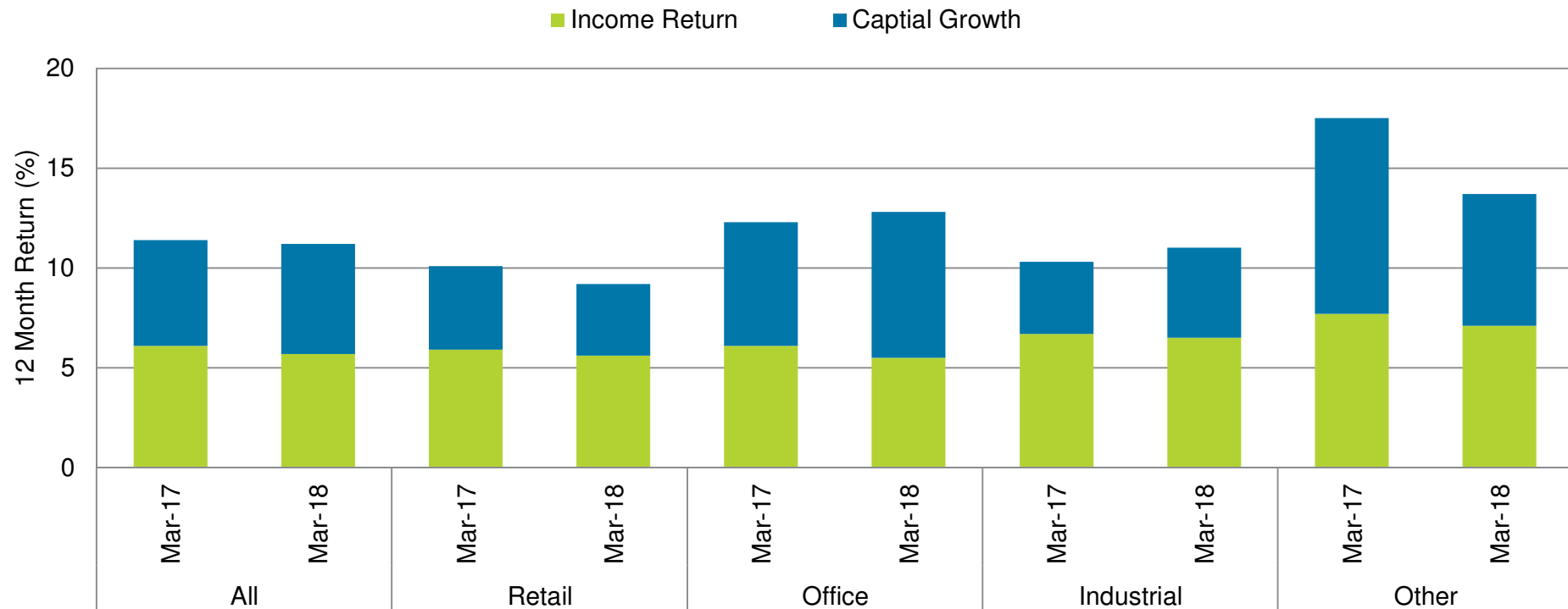
* Direct Property – PCA/IPD Australia Direct Property Index (excludes residential real estate)

** Unlisted Property Funds – PCA/IPD Australia Unlisted Core Retail Fund Index



NON-RESIDENTIAL REAL ESTATE PERFORMANCE

Non-Residential Real Estate Sectors: Total Returns March 2017 and March 2018



Source: MSCI

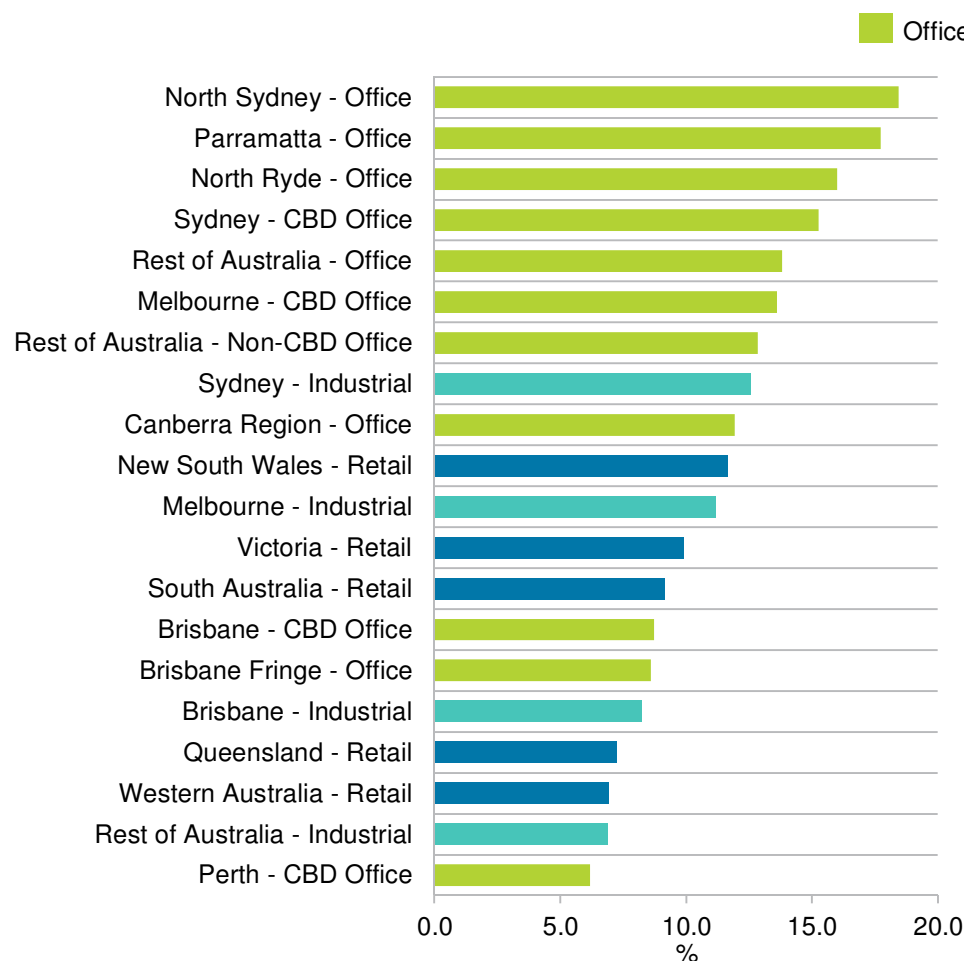
- Other real estate – healthcare, car parks etc. outperformed in both 2017 and 2018
- Retail lagged for the 2nd year in a row



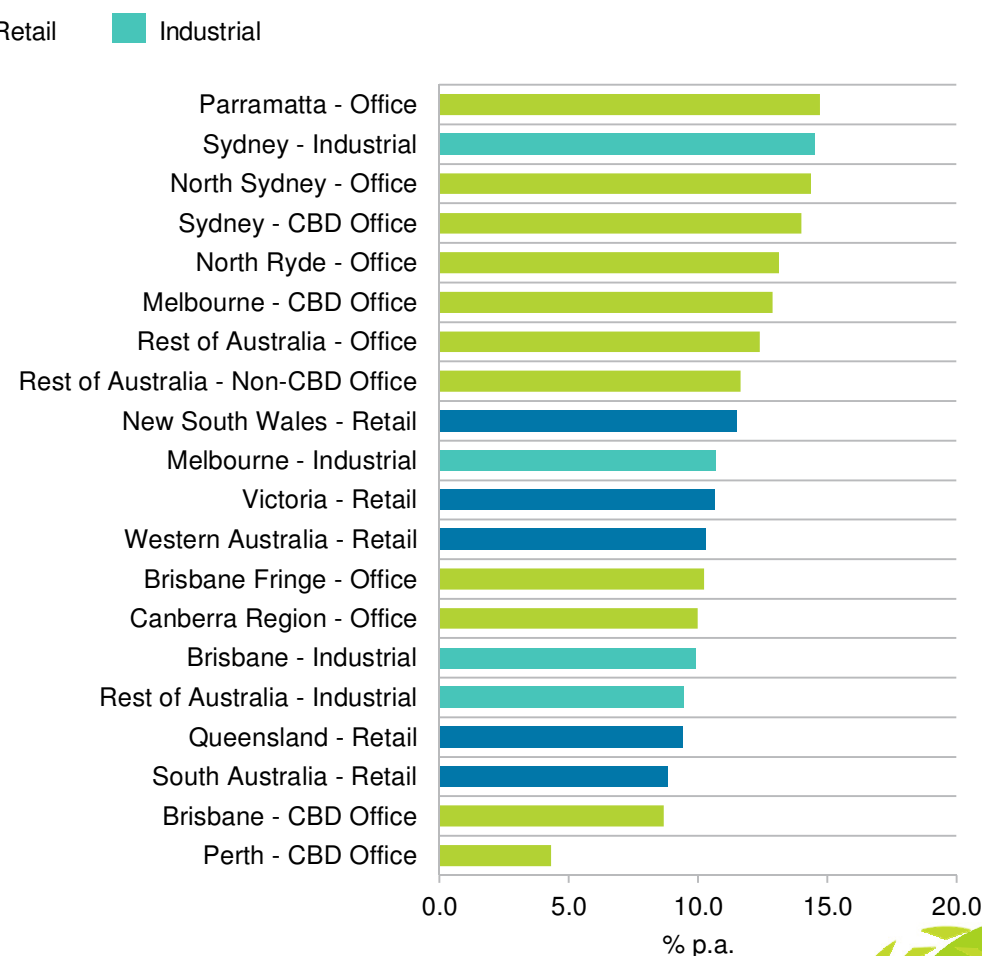
NON-RESIDENTIAL REAL ESTATE PERFORMANCE

Non-Residential Real Estate Markets: Total Returns March 2017 and March 2018

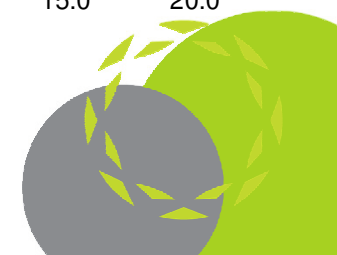
Total Returns: 1 Year to 31 March 2018



Annualised Total Returns: 5 Years to 31 March 2018

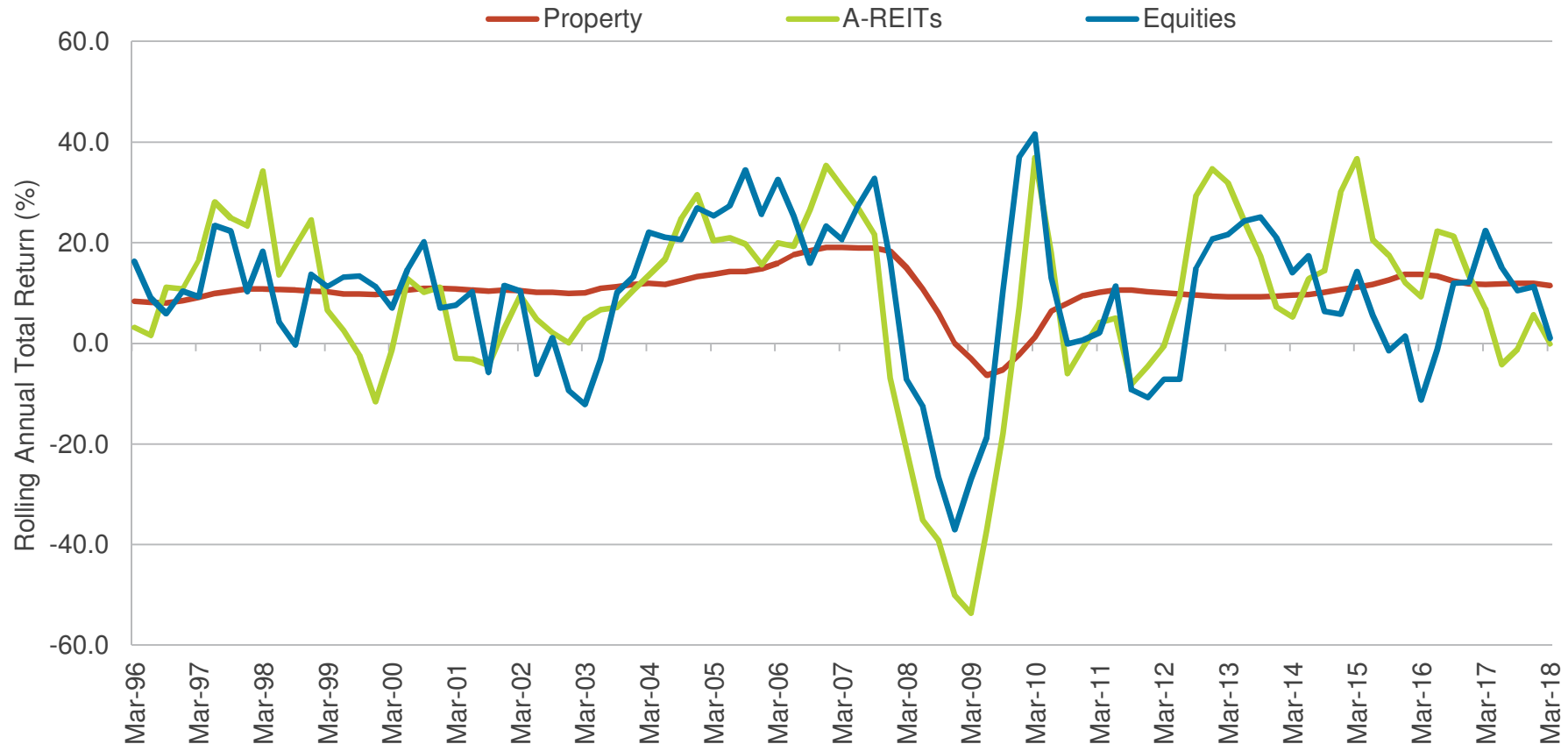


Source: MSCI/IPD



LISTED VS DIRECT REAL ESTATE

Total Returns: 1996 - 2018



Source: MSCI/IPD

- Direct real estate is less volatile than listed real estate – in part due to the less frequency of valuation

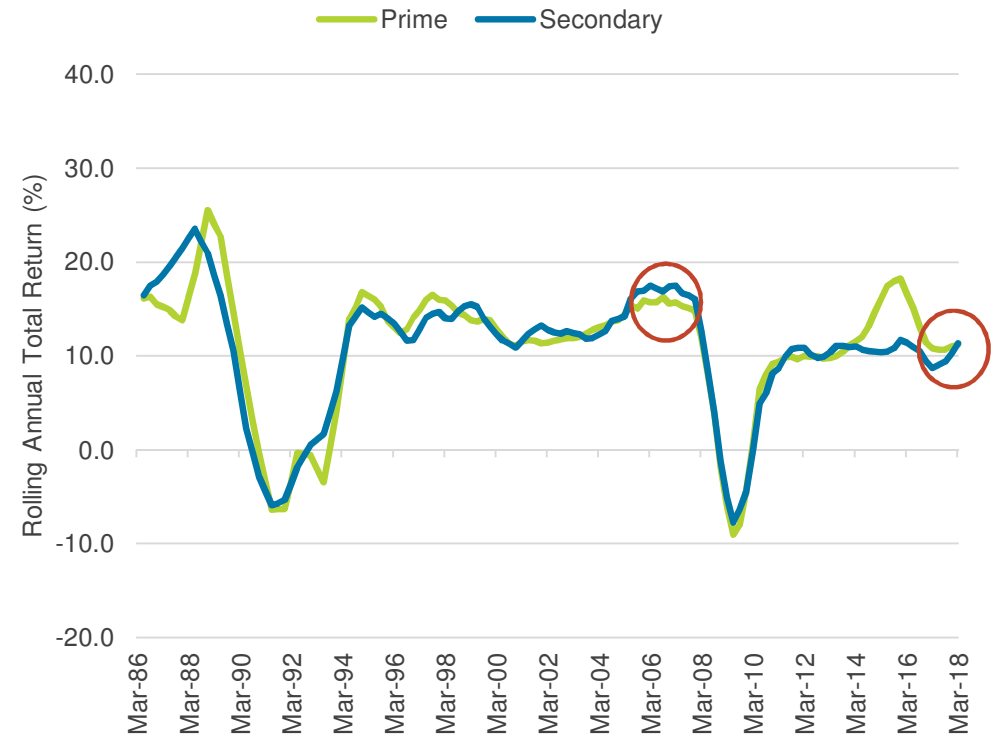
* Direct Property – PCA/IPD Australia Direct Property Index (excludes residential real estate)



Office: 1986 - 2018



Industrial: 1986 - 2018



Source: MSCI/IPD

- Secondary real estate assets have higher yields than prime real estate
- Secondary assets tends to outperform in latter part of the cycle – investors move up the risk curve in hunt for yield
- Be careful – don't get caught with poor quality assets when the market turns



CORRELATION OF RETURNS

Return Correlations to March 2018

Market Sector / Asset Class	Retail	Office	Industrial	Other	All Property	MSCI AU Real Estate Equities	MSCI Australia Equities Index	J.P. Morgan, GBI Global, Australia, Unhedged index in AUD, 7-10 Years, AUD	CPI: Eight Capital Cities
Retail	1								
Office	0.66	1							
Industrial	0.71	0.89	1						
Other	0.42	0.69	0.62	1					
All Property	0.77	0.98	0.91	0.64	1				
MSCI AU Real Estate Equities	0.33	0.25	0.38	0.20	0.32	1			
MSCI Australia Equities Index	0.24	0.09	0.13	0.14	0.13	0.61	1		
J.P. Morgan, GBI Global, Australia, Unhedged index in AUD, 7-10 Years, AUD	-0.15	-0.22	-0.18	0.03	-0.23	0.04	-0.17	1	
CPI: Eight Capital Cities	0.44	0.34	0.21	-0.07	0.36	-0.04	0.12	-0.01	1

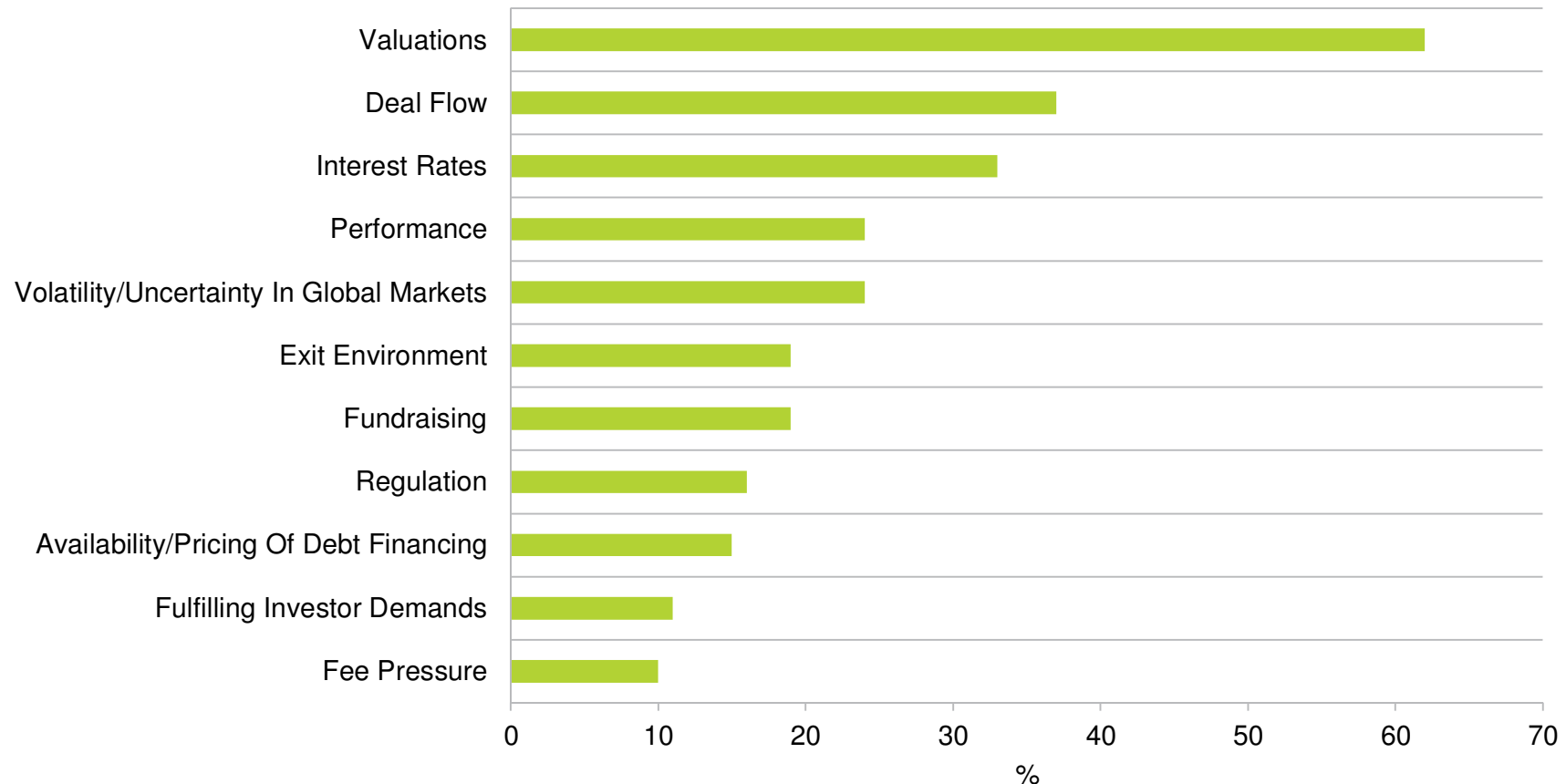


Diversification Benefits of Real Estate

Source: MSCI AU Real Estate Equities Gross in Local Currency, MSCI Australia Equities Index Gross in Local Currency, J.P. Morgan, GBI Global, Australia, Unhedged index in AUD, 7-10 Years, AUD, CPI: Eight Capital Cities



Key Challenges Facing Private Real Estate Fund Managers: 2018



Source: Preqin (survey of 215 global real estate firms)

- pricing and competition for assets have intensified – more difficult to deploy a growing pool of capital



UNLISTED REAL ESTATE FUNDS



Folkestone

ISSUES	PRE-GFC	POST-GFC
Asset Quality	Focus on higher yielding, lower quality assets rather than lower yielding, higher quality assets	Higher quality assets with longer term leases
Leverage	Gearing above 50% with little or no head room in LVR and ICR covenant	Gearing between 30% - 50% with head room on LVR and ICR covenant
Distribution	Higher yields sometimes due to propping up from higher payout ratios (sometimes greater than 100%) and/or financial engineering	Focus on income generation of the asset, sustainable payout ratio less than 100% of income and not using debt to drive higher distribution yield
Fees	No alignment of interest, focus on up front fees and disposal rather than performance fees	Greater alignment with investors on fees with a focus on lower upfront and ongoing management fees (often based on net not gross assets) and a performance fee based on actual outperformance
Liquidity	Often had daily/monthly/quarterly redemptions and roll over provisions at end of initial term with low hurdles	Limited or no liquidity during investment term, clearer mechanisms for rolling over funds at review date and a performance fee structure that incentivises the manager to wind up the fund early if in the best interest of investors
Manager Capability	Lack of transparency and sometimes poor governance	Managers focus on alignment of interest with investors, stronger corporate governance, higher quality reporting and often backed by an institutional manager or listed A-REIT



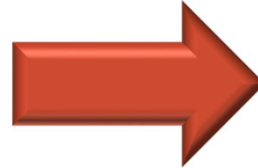


Table 1: Benchmarks and disclosure principles for unlisted property schemes in which retail investors invest

Gearing	<i>Benchmark 1</i> addresses a scheme's policy on gearing at an individual credit facility level. <i>Disclosure Principle 1</i> addresses disclosure of the gearing ratio of the scheme, the calculation of the ratio and its explanation.
Interest cover	<i>Benchmark 2</i> addresses a scheme's policy on the level of interest cover at an individual credit facility level. <i>Disclosure Principle 2</i> addresses disclosure of the interest cover ratio of the scheme, the calculation of the ratio and its explanation.
Interest capitalisation	<i>Benchmark 3</i> addresses whether the interest expense of a scheme is capitalised.
Scheme borrowing	<i>Disclosure Principle 3</i> addresses disclosure of the scheme's credit facilities, including the circumstances in which credit facility covenants will be breached.
Portfolio diversification	<i>Disclosure Principle 4</i> addresses disclosure of the scheme's assets, including specific information about development assets.
Valuations	<i>Benchmark 4</i> addresses the way in which valuations are carried out by a responsible entity in relation to the scheme's assets.
Related party transactions	<i>Benchmark 5</i> addresses a responsible entity's policy on related party transactions. <i>Disclosure Principle 5</i> addresses disclosure about related party transactions.
Distribution practices	<i>Benchmark 6</i> addresses a scheme's practices for paying distributions from cash from operations available for distribution. <i>Disclosure Principle 6</i> addresses where distributions are sourced from and whether forecast distributions are sustainable.
Withdrawal arrangements	<i>Disclosure Principle 7</i> addresses disclosure of the withdrawal arrangements within the scheme and risk factors that may affect the unit price on withdrawal.
Net tangible assets	<i>Disclosure Principle 8</i> addresses disclosure of the net tangible asset (NTA) backing per unit of the scheme.

Investors are more demanding of their managers when it comes to reporting, risk management processes, governance and succession planning



WHAT TO LOOK FOR IN A MANAGER?



- **Asset level considerations**

- **the point in the cycle** - what is the likelihood of the asset's price increasing or decreasing in the coming years
- **location** – how deep is the market if you want to exit, what are the supply and demand fundamentals?
- **quality of the tenant covenants** – what is the likelihood of tenant default?
- **lease expiry profile** – are there any vacancies or upcoming lease expiries?
- **quality of an asset's income streams** – can the cashflow from the asset adequately cover the debt costs, what are the lease structures and rent review mechanisms in the leases?
- **investment hold period** – is the asset being held for short-term trading or long-term investment?
- **impact on operational flexibility** - cash flow escrows, deposit requirements, prepayment lockouts and penalties

- **Structuring and managing debt considerations**

- **cost of debt** - the higher the leverage, typically the higher the cost of the debt that the lender requires to compensate for the increased leverage risk
- **debt covenants** – the maximum loan to value ratio and minimum interest cover ratios that the lender will require
- **type of debt** – interest only or principal and interest?
- **source of debt** – traditional bank lending or capital markets medium term notes, CMBS etc?
- **capital stack** – is the debt just senior “first ranking” or has the capital stack been layered to allow a combination of senior and mezzanine debt
- **duration of the debt** - short or long-term debt?
- **hedging profile** - how much of the debt is at fixed or variable interest rates?



Impact Of Leverage On Real Estate Value

Price Change	Asset Value	30% Leverage			50% Leverage			65% Leverage		
		Equity Value (\$)	Change in Equity Value (%)	Leverage (times)	Equity Value (\$)	Change in Equity Value (%)	Leverage (times)	Equity Value (\$)	Change in Equity Value (%)	Leverage (times)
25%	1,250,000	950,000	35.7	1.32	750,000	50.0	1.67	600,000	71.4	2.08
20%	1,200,000	900,000	28.6	1.33	700,000	40.0	1.71	550,000	57.1	2.18
10%	1,100,000	800,000	14.3	1.38	600,000	20.0	1.83	450,000	28.6	2.44
5%	1,050,000	750,000	7.1	1.40	550,000	10.0	1.91	400,000	14.3	2.63
0	1,000,000	700,000	0.0	1.43	500,000	0.0	2.00	350,000	0.0	2.86
-5%	950,000	650,000	-7.1	1.46	450,000	-10.0	2.11	300,000	-14.3	3.17
-10%	900,000	600,000	-14.3	1.50	400,000	-20.0	2.25	250,000	-28.6	3.60
-20%	800,000	500,000	-28.6	1.60	300,000	-40.0	2.67	150,000	-57.1	5.33
-25%	750,000	450,000	-35.7	1.67	250,000	-50.0	3.00	100,000	-71.4	7.50
-35%	650,000	350,000	-50.0	1.86	150,000	-70.0	4.33	-	-100	-
-50%	500,000	200,000	-71.4	2.50	-	-100	-	-	-	-
-70%	300,000	-	-100	-	-	-	-	-	-	-

- For an investor to lose all of their equity using:
 - 30% leverage – value needs to decline by 70%
 - 50% leverage – value needs to decline by 50%
 - 65% leverage – value needs to decline by 35%



UNLISTED REAL ESTATE FUNDS PERFORMANCE

Top 10 Performing Unlisted Real Estate Funds: March 2018

Manager	Fund	12M	3Y*
Centuria Property Funds	Centuria ATP Fund	35.17	-
Centuria Property Funds	Centuria Zenith Fund	33.85	-
Folkestone Funds Management	Folkestone Real Estate Income Fund at Altona North	27.18	29.28
Folkestone Funds Management	Folkestone Sydney Olympic Park	26.14	25.88
Centuria Property Funds	Centuria 203 Pacific Highway Fund	25.60	-
Centuria Property Funds	Centuria 8 Central Avenue Fund 2	21.53	-
Centuria Property Funds	Centuria 8 Central Avenue Fund	20.57	22.27
Centuria Property Funds	Centuria Havelock House Fund	20.06	-
Australian Unity	Retail Property Fund	19.04	18.47
Cromwell Property Group	Cromwell Riverpark Trust	19.03	21.00

*Annualised

Contributors to the Property Council/IPD Australia Unlisted Core Retail Property Fund Index

Manager
Australian Unity
Centuria Property Funds
Charter Hall Group
CorVal Partners
Cromwell Property Group
Folkestone Funds Management

The above list contains only funds that currently contribute to the index.

Source: MSCI - The Property Council/IPD Australia Unlisted Core Retail Property Fund Index



- **Real Estate & Capital Markets**

- need to understand both real estate and capital markets
- capital structure is important – balance between debt and equity and investing across the capital stack
- capital flows at certain times in the cycle will overwhelm real estate fundamentals (**its happening now**)
- markets come unstuck when risk is not understood and therefore not priced appropriately

- **Investors**

- need to fully understand their risk and return profile
- want basic, transparent and true to label products
- need to understand that comparing funds and/or A-REITs based on 1st year yield does not guarantee it is a good product – real estate is a total return proposition and has a cycle!

- **Managers**

- must remember investors come first
- be transparent with investors – especially in relation to NTA and yield calculations
- need to always be looking ahead – what are the key drivers? what are the keys risks? - be prepared to adapt and change

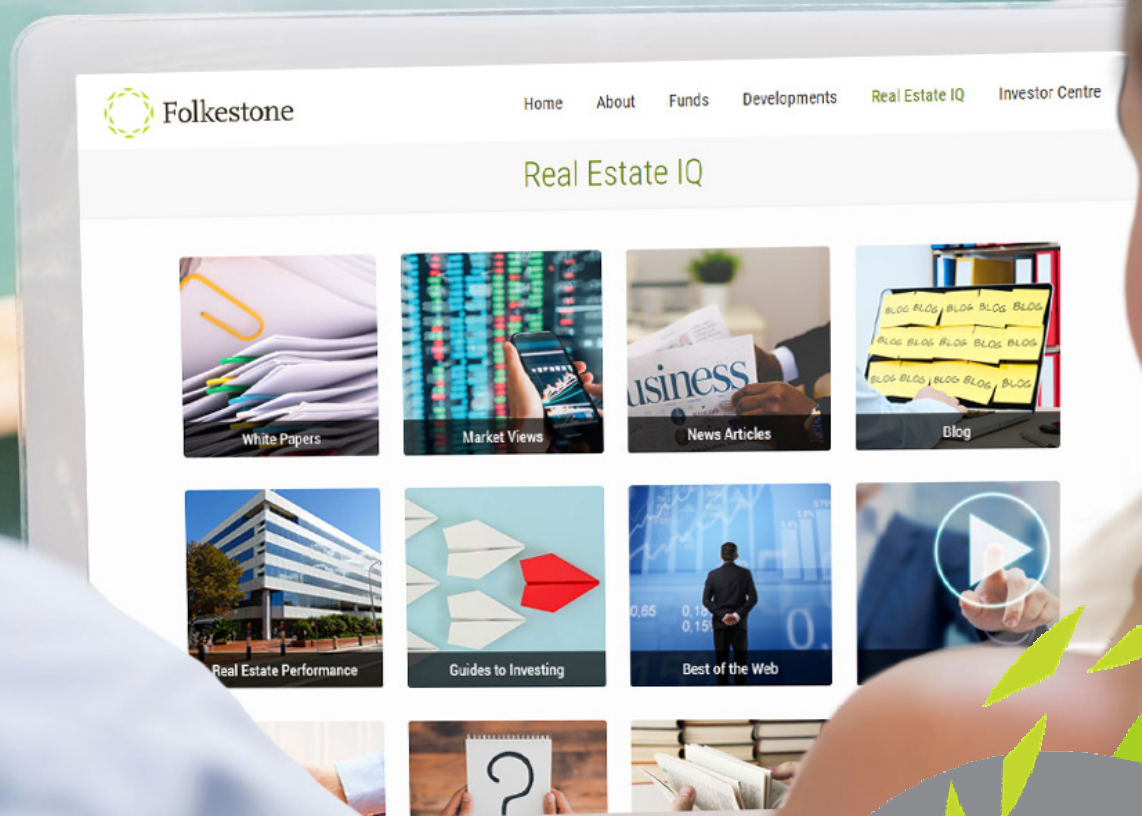


- Investors should focus on quality non-residential assets with secure income
- Cap rates have followed interest rates down (and real estate values have gone up) – nearing end of compression cycle but cap rates should remain low while we remain in a lower for longer interest rate environment
- Direct real estate offers benefits for investors
- Unlisted real estate funds – quality managers, quality assets, transparency and low gearing

**The challenge in the low interest environment is to avoid
simply taking greater risk in the search for yield...
investors need to remain disciplined**



FOLKESTONE REAL ESTATE IQ



Real Estate IQ provides our latest thinking on real estate to assist you in navigating the world of real estate markets and issues, to make more informed investment decisions.

Visit: www.folkestone.com.au/real-estate-iq/



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