PROPERTY RETURNS, FREE CASH-FLOWS AND NEED FOR DISCLOSURES

In the long term, and especially in times when property values appreciate, investors are primarily interested in the total return on investments. But what of free cash-flows?

During the good times, investors' focus is on total return on investments, which is broadly the income return plus capital growth. Capital growth can be defined as the difference between gross asset value appreciation less capital expenditure. This preoccupation for total return often means that less attention is paid to the underlying operating cash-flows. However, in times when property values grow very little, or fall, the underlying cash-flows receive increased attention.

In valuing companies or assets, including real estate, a key consideration is the free cash-flows to the firm. Of course, in such assignments analysts and/or valuers aim for the free cash-flows expected to be generated in the future. However, nobody knows for sure about future cash-flows. Thorough knowledge of free cash-flows from past outcomes is essential when making assessments and projections of future outcomes in this respect. Free cash-flow to the firm (FCFF) is calculated by the formula below (if income taxes are disregarded):

$$FCFF=EBIT^{1}+depreciation(if\ relevant)-Capital\ expenditure-\triangle Working\ capital^{2}$$

With listing comes data

One may ask, what kind of information on historical outcomes we have access to when trying to make such projections? All listed property companies in the EU are required to report under International Financial Reporting Standards (IFRS) when preparing consolidated accounts. An important question is what focus the IFRS rules have in terms of income statement versus balance sheet. For various reasons outlined below, IFRS is focused on an asset-liability approach, meaning the balance sheet is the primary report. Still, many analysts focus on the Income Statement in trying to assess the capacity for future free operating cash-flows to be generated by the company or property.

In the real estate industry, a key performance measure used by investors is the net rental/net operating income. While this is certainly useful, the figures extracted from the Income Statement only tell part of the story in respect of free cash-flows. To get the full picture one must read and analyse the disclosures in the notes to the financial statements. The industry has developed various measures (e.g. EPRA Earnings, FFO) which remove the impact of non-cash valuation movements, but even these are not pure cash-flow measures. In the case of EPRA earnings, this has its basis in IFRS Earnings and includes, for example, certain depreciation and amortisation costs.

According to IAS 40 – Investment Property, a company shall disclose separately the additions of investment property assets attributable to acquisitions of investment property (A), subsequent expenditures attributable to existing investment properties (B) and finally, additions resulting from acquisitions >

1 Earnings Before Interest and Taxes
2 See for instance Damodaran, 2002, 'Investment Valuation - Tools and Techniques for Determining the Value of Any Asset.'

The free operating cash-flows, after deducting administration costs and capex, are approximately 3.5% of fair value per annum... this is not overly impressive vs. 4% interest rate.

through business combinations (C).

The question is how to decide what costs should be included in each category above – A, B or C? Acquisitions of investment property (A) include asset acquisitions/wrappers, newly-erected buildings and significant extensions of buildings. Subsequent expenditure (B) consists largely of the replacement of components or creating new components,[3] redevelopment, refurbishments attributable to existing properties/buildings. Acquisitions attributable to business combinations (C) are those falling within the scope of *IFRS 3 - Business Combinations.*

IFRS standards are based on the way in which different users use financial reports in making economic decisions on the basis of financial statements. The need to keep properties up-to-date in a market, where properties are exposed to competition, normally results in large cash outflows (subsequent expenditure) which are not reflected in the Income Statement. Income Statement figures only show the net rental/net operating income. This could lead to over-estimation of the free cash-flows from property companies if the analysts fail to get adequate information in analysing the notes to the financial statements. As a result, more emphasis should be placed on how property companies interpret and categorise capitalised costs according to IAS 40 and the classifications (A, B and C) described earlier.

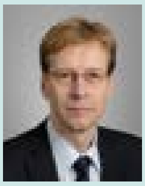
Studies involving listed property companies in Sweden suggest that there are different interpretations in this respect. This can lead to frustration among analysts in trying to analyse the free cash-flows from the property companies.

The vast majority (90-95%) of listed property companies in Europe apply the fair value model in IAS 40 and show no depreciation charge in the Income Statement. However, showing no depreciation in the income statement doesn't mean that there is no consumption of the benefits associated with property assets or parts of such assets[4]. Instead of a depreciation charge in the Income Statement, such consumption can be seen by analysing the levels of maintenance expenditures and capital expenditures (capex) that are in fact cash outflows to keep properties up-to-date and competitive in the market. To determine the free cash-flows produced by a property company, one must deduct this maintenance capex from the net rental/net operating income. Of course, administration costs should also be deducted when calculating the FCFF (Free cash-flow to the firm).

My studies of the listed Swedish property companies show aggregated levels of net rental/net operating income of about 5.0-5.5% in relation to reported fair values. Put another way, the income return is approximately 5.0-5.5% per annum. These figures are average levels for the years 2009-2012. However, the free operating cash-flows, after deducting administration costs and capex attributable to B above, subsequent expenditure, imply free cash-flows of approximately 3.5% (% of fair values) per annum for the same period of time.

In my opinion, such analysis gives an important and somewhat different picture of the cash-flow capacity of the property companies. Since the Swedish property companies have interpreted the rules in IAS 40 differently, we had to make some extra analysis to arrive at the 3.5% figure just mentioned.

In conclusion, property companies need to use similar classifications dividing cost into A, B and C as discussed above, and probably there is also a need for separate disclosure of the FCFF in line with the definition as described initially in this article. And lastly, approximately 3.5% in FCFF isn't overly impressive from a liquidity-perspective when the average interest rate on debt is close to 4% and the dividend ratio on equity is also at least about 4% on average over a period of time[5].



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3 Costs that should be capitalised in line with IAS 40 pp 16-19, see also IAS 40 p 20 which tells that the whole acquisition cost is added to the carrying amount, not only e.g. an estimated market value-adding part of such costs.
4 I recommend reading for instance Andrew Baum – Property Investment Depreciation and Obsolescence, see www.andrewbaum.com and RICS Research: 'Cutting Edge 1997 - The Causes and Effects of Depreciation in Office Buildings a ten year Update' by Andrew Baum.
5 See for instance Monthly Statistical Bulletin, December 2013, EPRA Research
6 FAR is the professional institute for authorised public accountants , approved public accountants and other highly qualified professionals in the accountancy sector in Sweden.