

MANAGEMENT RIGHTS - the good, the bad & the ugly!!

What a turbulent time the industry is having, here we are September 2011 and the economic conditions are no better. August brought to light the dire conditions of the USA economy and the ongoing debt crisis. The \$AUS dollar rides the roller coaster and the two tier Australian economy continues to suffer. Retail and tourism suffering are aligned, no tourists, no tourism turnover, no retail spending. To exacerbate even further Europe in general continues to feel the effects of continuing unpaid debt by some of their close neighbours, in fact we are all victims of the current times. Why the good, the bad and the ugly? Let's quickly look at each word in no particular order and how it affects the management rights industry.

THE BAD, (*bād*) *adj.* worse or worst. Current financiers are calling for vendors to produce a current profit and loss "knowing full well that this will be a reflection of the current economic market, high \$AUS dollar and low tourism numbers". The purpose of this request is to revisit the lending requirements of the current loan or in simple terms, 'the Honeymoon is over'. This exercise then calls for new loan facilities or if possible for the vendor to refinance. Normally the financier requires another cash injection (one begins to wonder why the loan was originally approved at maximum lending and minimum cash input) however the answer is very simple if you think about it. At the time the purchaser was confident that the business would continue to grow on a yearly basis and the financier was happy to lend at the time with a similar outlook. The GFC at the time of the loan was a distant thought in the heads of many economists.

THE UGLY, (*ūglē*) *adj.* Repulsive; objectionable. The financier requirements to rearrange the loan are based on the newly established Profit and Loss as pointed out in the previous paragraph, the financier also requires a current valuation. Given this valuation is based on a principal that the financier can sell the business in a 90 day period if this becomes a requirement and using the current somewhat 'new' distressed profit and loss. Taking into account the current market however has substantially lesser than normal sales due to the two major factors, the poor economy and weaker than normal supply and demand, that being the lack of consistency of management rights sales in the normal selling cycle.

Given Valuers will only value on fact and not expected or anticipated improvement or 'blue sky', and they only take into consideration sales that occurred in a similar nett profit range and similar geographical location, THE UGLY becomes very apparent. Valuers are always conservative by their general nature and face the possibility of legal action by their client, 'the financier', if the business fails to perform or even worse is placed by the financier in a forced sale scenario. It all then begins to get even Uglier.

Who would have thought we would have seen the financiers placing management rights in the hands of Receivers, the Receivers and Managers appointed then in turn follow the instructions of the financier and place the rights on the market by way of Expression of Interest or Offers to Purchase, known in the industry (right or wrong) as a distressed sale. This sale process in the past was the normal to achieve the best market price available and normally only occurred with Off the Plan opportunities, a highly market driven vendor and in some cases with a sudden death in a family.

THE GOOD, (*gōōd*) *adj.* better, best. Oh yes there is a positive side to my ramblings. Management Rights continue to sell and financiers continue to lend. The good side from an industry point of view is that financiers now offer their services on a more conservative level supported by current industry accountants Profit and Loss scenarios and supported by current valuations. No question that multipliers or 'years purchase factors' are less than the halcyon days of the industry. However quality management rights ticking all the correct boxes are attracting qualified purchasers resulting in satisfied vendors. Prices being achieved in certain management rights areas, i.e. large nett profits, corporate letting etc, are reaching very satisfying results for all parties concerned. One would expect in the coming years the economy will improve, above industry occupancies will return, consumer confidence will re-emerge and if the current economic conditions return in another cycle we will be better prepared to meet it head on. The Good will be excellent, the Bad will be avoidable and the Ugly will just be another word in the English dictionary.

Jake Clarke

SEPARATING TO SELL – WHEN DIVORCE IS GOOD!

By Matthew Manz, Partner - Mahoney Lawyers



With the changing economic conditions over the past few years it has become increasingly difficult for owners of certain types of management rights businesses to sell their unit and business together. Problems arise where the caretaking and letting agreements require the manager to own and/or reside in a unit in the complex and –

- the business is netting a relatively low nett profit (say under \$70,000 - \$80,000 a year); and/or
- the value of the unit is disproportionately high in comparison to the value of the management rights business.

We saw a number of these problems on the Sunshine Coast in particular where in small to medium size complexes on or near the water, the value of the manager’s unit increased dramatically, but the income of the business barely changed, making the purchase unviable. The problem also manifested itself in many smaller complexes with low levels of income placing the purchase of the business and the manager’s unit outside general lending guidelines.

As a result we have received numerous enquiries from, and handled a number of transactions for, managers seeking to “separate” or “de-couple” the manager’s unit from the management rights business. By separating the business from the manager’s unit, when it comes time to sell the business, a wider range of buyers will be attracted, as a buyer –

- is not required to outlay a significant amount of money to acquire the manager’s unit (in comparison to the business), particularly if the buyer does not intend to reside in the manager’s unit; and
- can add the business to an already existing business or businesses, particularly if the building is within close proximity to the others owned by the buyer.

In order to “separate” or “de-couple” the unit from the business it is necessary to amend the caretaking and letting agreements and in most cases the by-laws. Any changes to those documents must be considered by the Body Corporate at an extraordinary general meeting or an annual general meeting.

In the past few years and more so in recent times, we have had considerable success in achieving such an outcome for a number of managers. However, as with any change to agreements or by-laws, it is essential that a manager have a good relationship with the owners and importantly the Body Corporate Committee as Committee support is generally critical to success.

We are generally able to arm our clients with reasons why the Body Corporate and owners will benefit from the proposed “separation” and put in place a strategy for achieving the outcome sought. We expect that given the continuation of the poor economic conditions prevailing at the moment, there will be many more managers looking to do likewise.

For further information, please don’t hesitate to contact [Matthew Manz](#).

Partnerships in Management Rights: Do They Really Work?

By Mike Phipps, Mike Phipps Finance

Over the years I’ve worked with various partnership vehicles in financing the purchase of management rights businesses. Some come to me fully formed while in other cases I introduce people who may be of like mind and manage the entire process for them. With multiples down and the market somewhat depressed there seem to be more than usual numbers of potential partnership investors emerging. I think both working partners and investors need to understand very clearly what it is that they entering into, the likely return and any downside. My observation would be that in some cases investors in partnerships have little or no idea what they are getting themselves in to.

Just to set the scene let’s have a look at the basics of partnership investment and return calculations. The following is a simplified version of the maths:

Managers Unit	\$500,000
Management Rights	\$4,000,000
Total Purchase Price	\$4,500,000
Costs and working capital allowance	\$250,000
Total Required to complete	\$4,750,000
Bank Finance @ 70% LVR	\$3,150,000
Equity Required from Partners	\$1,600,000

Assumed Net Profit	\$740,000 p/a @ 5.4 multiple
Less bank debt servicing	\$252,000 p/a @ 8% interest only
Less working partner's salary	\$100,000 p/a + unit to reside in
Return to partnership	\$388,000 p/a before tax
Return on investment before interest/wages	16.44%
Return on investment after interest/wages	8.62%
Return on equity	24.25%

What we see here is that through the miracle of low interest rates and leverage investors have the potential to enjoy significant returns. In fact, even if an investor in the scenario above borrowed their portion of the equity required the return is still pretty attractive. Let's say you have real estate or indeed a management rights of your own with significant equity built up. You decide to take a 20% stake in the scenario I've outlined. That's an equity contribution of \$320,000 and let's assume you borrow the lot at 8% on an interest only basis. Again, here's the simple maths:

Equity Investment @ 20%	\$320,000
Return on equity investment	\$77,600 p/a
Interest on equity investment loan	\$25,600 p/a
Return after interest	\$52,000 p/a
Return on equity investment (fully geared)	16.25% p/a

This all looks too good to be true and sadly in some cases it is! Firstly, you will notice that in my example I've used a gearing ratio of 70%. This is, in my view, the absolute maximum a partnership should go to. It's tempting to gear higher due to that miracle of leverage and low rates I mentioned earlier but there's an unpleasant downside. If, for any reason, the value of the business falls then the partners will be asked by the bank to contribute additional funds to pay down debt in order to comply with maximum gearing ratio guidelines. You may recall I wrote about bank reviews and valuations last month. I know of instances where, due to the scale of some buildings, the multiple on which they are purchased and the gearing involved, that partners have been faced with significant debt reduction demands when these assets have been revalued by the lender. These capital call ups by the lenders can be a real cause of disharmony in a partnership as the various investors seek to understand why the business value has fallen. I think it's better to be a little conservative on gearing and have a sustainable business model. While on the subject of lenders you should try and avoid an unlimited personal guarantee when your partnership borrows money. Not always possible but certainly preferable.

My second concern is partnerships involving investors with no history in or particular knowledge of the management rights industry. In some cases we even see situations where the working partner has never run a management rights or accommodation asset before. To me investing in such a model is akin to throwing your super into a managed fund operated by a fund manager with no prior history of making wise investment decisions. It may work out but the risk seems excessive, even for a 24% return.

These business models need to be robust. I see little merit in partnerships purchasing buildings running less than \$700,000 net profits and I don't think equity stakes of less than 10% are useful. In fact, in the \$700,000 to \$1M net profit range I think 20% equity should be the minimum investment. The partners need to understand the business model and the industry. There will be highs and lows in profit performance so unrealistic expectations of the management rights industry can be a cause of friction within the investor group. These investments should be designed for a passive return on equity and hopefully some future capital gain. Don't go into one if you need the return to pay the food bill and don't invest with someone who does.

I find that approaching partnerships (I prefer to call them syndicates) in a disciplined manner usually results in a happy outcome for all. Run off the rails and risk a train wreck.

PS: Yes, you can invest in a management rights partnership via your SMSF but you'll need expert legal and accounting advice.

For further information, please contact [Mike Phipps](#) on 0448 813 090.



Whale Watch Ocean Beach Resort, North Stradbroke Island
Holiday letting business in 2 buildings overlooking the Pacific ocean. It's the perfect place for guests to watch the whales frolicking, unsurpassed ocean views. Long agreements, office, reception, conference room on title. 3 bedroom, 2 bathroom managers residence. Room for growth.

Nett Profit: \$215,630 Asking Price: \$1,550,000

Exclusive Agent Warren Oliver 0416 216 625

ID 8252



Sunshine Coast Holiday – Priced to Sell
Well maintained mid-rise holiday resort with spacious apartments, all with Mooloolaba harbour water views. Motivated vendor, ill health has forced sale, priced to meet the market. Large 3 bedroom managers residence, pet permitted.

Plenty of growth for new managers.

Nett Profit: \$210,700 Asking Price: \$1,850,000

Exclusive Agent Judi Handscomb 0449 141 373

ID 8108



Great Living – Great Business
Permanent management rights in well maintained townhouse complex, facilities include pool, spa, gym, tennis court, sauna. New 25 year agreements in place, average rents of \$425 per week. Large 4 bedroom managers residence with large outdoor area - would suit a family.

Nett Profit: \$130,000 Asking Price: \$1,145,000

Exclusive Agent Nigel Kilgour 0421 333 268

ID 8248



Riverfront Permanent High-rise, Surfers Paradise
Modern high-rise offering permanent letting (holiday permitted) in the heart of Surfers. Excellent rental pool with opportunity to increase income. 3 bedroom managers apartment with separate titled office and reception, 3 car spaces. Special building with huge upside available to industry savvy operator.

Nett Profit: \$335,499 Asking Price: \$2,500,000

Exclusive Agent Jake Clarke 0418 663 661

ID 8181



Top Gold Coast Location – Ocean Views
Located opposite the beach at Burleigh Heads this is an opportunity to acquire a holiday resort business with good repeat clientele. Excellent facilities, close to restaurants, shops and transport. Well established, well maintained resort. Fully equipped office with unspecified hours and good Body Corporate salary.

Nett Profit: \$315,600 Asking Price: \$2,300,000

Exclusive Agent Wal Karlo 0412 200 362

ID 8251



Holiday Management Rights & Free Extra Income
North Coast NSW, main street location with little opposition. Full resort facilities, 3 bedroom managers apartment + office reception on title. Long agreements expiring 2027, very attractive remuneration package.

Nett Profit: \$270,000 + \$25,000 cleaning contract at no charge

Asking Price: \$1,595,000

Exclusive Agent Jake Clarke 0418 663 661

ID 8036