LIFT-OUT INFORMATION SUPPLEMENT

Tips for buying Management Rights in a COVID-Era

resortnews
Tips Series

March 2021

Putting the fine in finance

As I contemplate an attempt to make some sense in this article, there is an old English expression that springs to mind...

'May you live in interesting times' is claimed to be a translation of a traditional Chinese curse. While seemingly a blessing, the expression is normally used ironically; life is better in 'uninteresting times' than in 'interesting' ones, which are usually times of trouble. Talk about ironic alright.

Anyway, I digress.

Rather than write my usual meandering stream of consciousness, I have decided to cut to the chase and outline some specific thoughts that might hopefully assist buyers to navigate a management rights purchase in a world of apparent uncertainty.

Mike Phipps,
Director, Mike Phipps Finance

> If you are stuck, remove the title 'business plan' and replace with: 'Here's, why I won't go broke.'

The fundamentals have not changed.

While the world has most certainly changed, the basics of purchasing a management rights have not. The process of accounting verification, legal due diligence, finance, and settlement remains the cornerstone of a successful acquisition.

Sure, there are some extra hoops to jump through and some days more hoops than others. However, it is important for buyers to appreciate that a proven process that has held the industry in very good stead with lenders continues to deliver positive outcomes. There is simply no reason to reinvent the wheel. Maybe put a couple of extra spokes in it and some performance tyres but it is still a wheel.

Get pre-qualified.

The first, and perhaps the most important step is to talk to us about your situation and gain some level of certainty. No point having a grand plan if you fall at the first hurdle. Our brokers will assess your personal and financial situation and offer guidance. They will be a sounding board and help you review opportunities, pointing out the potentially good and not so good aspects of the business you are looking at. While we encourage anyone who is interested to research the industry, there is simply no point in making listing enquiries or inspecting properties until you are pre-qualified.

The COVID-era has delivered an incredibly volatile lending policy environment. It is imperative that buyers speak with a finance specialist who is talking to the banks on a daily basis.

Know what you want and why.

If you do not know where you are going, any road will get you there. It is an old cliché but also pretty accurate. We encourage buyers to think long and hard about what is important and what boxes a listing needs to tick. Lenders are keenly interested in why you are buying a particular asset. We love talking to clients about the opportunities they see in a particular listing and how best to make the deal happen. Part of that process is making the deal look as compelling as possible for lenders.

Insist on the vendor playing fair.

While the fundamentals have not changed, there is no denying that COVID has had an impact on how we assess a lending opportunity. Regrettably, there are vendors out there who would prefer to pretend that COVID did not happen. The vendor mindset of 'I bought it this way; I'm selling the same way' needs to be avoided if possible.

On the flip side, there are management rights businesses that have actually benefitted from COVID-driven demand. We think that vendors need to be realistic with respect to additional information and buyers have every right to ask. The bank simply does not care how the vendor bought or financed the asset; the game has changed. You will know you're in good hands when your agent has already asked the tough questions and has the answers ready.

COVID impact: What happened and what's next?

Lenders will focus on this question above all others. Regardless of what happened we need to explain why. If it is a holiday property enjoying record occupancy due to international travel restrictions, that is great. But what happens when borders reopen?

A permanent property may be enjoying strong rental demand based on inter- and intra-state migration. How much of this is COVID-life-change driven? Is it sustainable? Will government first homeowner incentives and other economic policies impact letting pool numbers?

The trick in presenting a compelling case to a lender is to summarise how the business was travelling pre-COVID, what has happened since and what the likely future holds. The better we can demonstrate that our client understands these three 'COVID impact' phases the more likely a finance approval.

Financial due diligence is a mixed bag.

I think it is fair to say that the banks are treating every deal on its merits when it comes to trading history, current performance, and future prospects. Remember, in the absence of compelling data bank credit managers will default to their imagined worst possible scenario. We do not want that!

The historical benchmark in the industry has been the review of the past 12 months' financial performance of the business. In this regard, management rights are unique.

No other going concern business is bought and sold on the strength of a single accounting period. I would argue that the COVID-era has pushed the tide out and found our industry sans bathers.

So, what to do? At the risk of dodging the question… it depends.

For a permanent management rights in the 'burbs', I would be happy to go to the bank with a one-year P and L review. The reality is that these businesses are easy to analyse with likely profitability being an outcome of a basic set of data. The industry has developed a 'COVID impact' info summary for permanent management rights which I think does the trick. My observation would be that the impact sheet has, to some degree, been rendered obsolete by the demonstrated resilience of permanent MLRs, many of which are showing improved trade, zero COVID arrears and rising rents.

For leisure-based short stay properties, the process is a little more "horses for courses". If we come from the old adage that certainty equals value, then the more info the better is a good place to start. There will not be many leisure-based MLRs that did not see some sort of negative COVID impact in 2020. The trick is to normalise the 2020 calendar year and achieve some sense of what sustainable net profit looks like. Setting a trend line or benchmark based on a couple of prior years' makes sense so I think, if possible, a look at 2018 and 2019 calendar years is the place to start. Provided those years show trading stability or growth it is reasonable to review 2020 through the prism of *year in, year out* trade. I also think it is reasonable to reconstruct the 2020 P and L to identify COVID impacted months and compare those with the same trading months of the prior years. At the end of the day, we are trying to assess sustainable net profit over time so a once in a lifetime event certainly needs commentary and adjustment.

In my mind, it is no different to having a unique event that drives occupancy and tariff up, it has to be netted out to get to the likely sustainable $NP. If, by some miracle, COVID had zero impact on a leisure property, we still need to explain why so best to be ready.

There is merit in preparing a projection based on the best market intel at this point. The report should be supported by commentary explaining what happened and why and justifying the projections. I do not think projections should be a 'must have' as I've never seen one in any industry that didn't predict a positive result. However, as an indication of expectations driven by the business plan and broader economy a projected reconstruction of the 2020 calendar year P and L is a handy report to have and will be well regarded by the lenders.

Valuers appointed by the banks will certainly be looking for insight into the sustainability of the net profit so the more compelling and complete the data the better.

The plan:

The last piece of the jigsaw puzzle… We encourage all buyers to write a business plan. Not some enormous document filled with waffle and platitudes. The plan should cut to the chase and demonstrate that you know what you are buying, why you are buying it and what you plan to do in order to be successful. We know what banks are looking for, and we can help. But… it is important that you are able to articulate the why, what, and how of your decision to buy a particular management rights.

If you are stuck, remove the title 'business plan' and replace with: 'Here's, why I won't go broke.'

In closing, I think it is important to appreciate that we are dealing with an incredibly fluid situation and the banks are in this boat with the rest of us. Today's business plan can be rendered obsolete by a snap border closure or new strain of the dreaded virus. But I believe Australia has managed the situation better than most. We have a very stable and well capitalised banking sector, a mostly competent government (at Federal level anyway) and a reasonable economic outlook. Add record low interest rates, a population in transition and all the big spenders trapped in Oz and I've gotta ask… what are you waiting for?

PS: We have had six different lenders approve finance for short stay leisure-based management rights in the past week. Our advice is not to believe any stories you hear about banks not lending. ■

Tried and tested rules remain post-COVID

To say that the last 12 months have been among the most tumultuous periods ever witnessed by the modern world would be an understatement.

The seismic impacts of the pandemic have undoubtedly had untold knock-on effects across the globe. Although Australia emerges comparatively unscathed, it is fair to say that certain things are somewhat different.

Well, when it comes to buying management rights, I'm happy to say that most of the tried and tested 'rules' for purchasing a management rights remain much the same. We work in an industry fortunate enough to have long-standing and pre-determined processes in place. When buying, if you follow the processes and take appropriate advice, your chances of going off track are drastically reduced.

Although processes and tips for buying management rights remain much the same, I would point out that it is more important than ever to ensure

Alex Cook,
Director, Resort Brokers

you follow them. There really is no room for cutting corners when making management rights purchases these days. Sellers, banks, and committees simply will not allow it! I would also point out that there are a some post-COVID nuances to keep an eye out for... but I will get to those later.

What do we all know already?

Well, it pretty much boils down to two key things. Number one: be prepared. Number two: surround yourself with trusted industry professionals. Generally speaking, the two go hand-in-hand, which makes life easier. If you can comfortably say you

> What to do? First, join ARAMA.

have covered these two areas, you are well ahead of the game.

What first? Well, unless you are that 1-in-1000 buyer fortunate enough to be making a cash purchase (there are some, believe it or not), understand your financial position before you do anything. What is the point in starting to consider options if you do not know your purchasing capacity? LVRs and interest rates vary from month-to-month and buyer-to-buyer, so it is next-to-impossible to know exactly where you stand without dealing with a specialist in the field.

For long-standing players in the industry, it is understandable to have direct relationships with specific bankers. Long-term relationships produce great results. But, and definitely for those towards the start of their management rights career, we would always recommend dealing with a specialist finance broker. Remember, different banks have different policies for different assets and different buyers. Use a specialist broker to shop things around for you – it will save you a lot of time and probably get you a better deal.

Then get the rest of the team around you. True, you will not necessarily need your accountant and lawyer until you're proceeding from an agreed offer to a contract, but that doesn't mean you should wait until then. Not only will these specialists be able to give you valuable third-party advice while you are considering MRs, but it also makes you come across as prepared and professional to brokers and sellers. At the end of the day, for in-demand assets, brokers and sellers are always going to favour buyers who are clearly prepared.

And what about your broker?

Well, I am obviously a bit biased here, but I would recommend developing a solid and trusting relationship with a broker that you like and operates in a location/field that matches your requirements. There are many subtle nuances to buying management rights, and a good broker should have a solid grasp of all areas. In other words, they can look at the bigger picture for you. This is not to say that you should not look at other brokers' listings. If you did not, you would be restricting your search – it is impossible for one broker to control all the good listings. But if you have got a trusted relationship with a good broker, he/she will be more than happy to give you advice on other brokers' listings.

What goes around comes around!

One area of preparation for buying management rights that is not new, but has certainly grown in importance in recent years, is the assignment process. Or, in other words, getting yourself ready to impress a committee.

What to do? First, join ARAMA.

Not only do they have a wealth of useful information to share with managers, but they also advocate for our industry. At the end of the day, our industry is built on legislation. Legislation can be changed. So, we need someone to key an eye of this for us. Think of a membership as an insurance policy for the industry or your industry karma contribution!

ARAMA run the *Management Rights Induction Training Program* (MRITP), which is well worth doing. The BCCM online training is also worth completing. These courses are increasingly expected, and even required, by committees. Get them done early so you have one less thing to think about when going through the assignment process. It will help you to look professional and prepared in a committees' eyes. I would even recommend these courses for experienced buyers buying a new MR. First-time buyers might also consider using specialist consultants to assist with assignment (particularly business plan preparation), handover and supervision in the first few months.

Is there any new advice I can give to those looking to buy in the post-COVID era? Well, I would break it down between permanent and short term MRs. The permanent MR market, particularly at the larger ($400K+ NOP) end of the market is very competitive. There simply are not enough assets to meet demand. Let us be honest, if you're looking for a $800K+ NOP, business-only, permanent, in a Brisbane inner suburb and you've got limited experience… you could be looking for a long time.

Everyone started somewhere, and if you look slightly further afield or 'outside the box', you can secure great businesses that will build your skillset and quite possibly give you a better return on your money. So, keep your options open!

With short-term MRs, bear in mind that the rule book is still being rewritten in regard to how they are valued and financed. I am not suggesting for a second not to consider short term. The future of Australian tourism is exceptionally bright, and if you are looking to get into this area, follow your dreams.

Largely speaking, the short term businesses that we have sold and settled since COVID are those that basically didn't have a COVID, such as parts of Noosa, Stradbroke Island and Byron Bay. But for those that are in areas still recovering, there is likely to be some fairly complex analysis when it comes to verifications and valuations. Make sure you are dealing with a broker who really knows what he is talking about and has his finger firmly on the pulse of valuers' and financiers' thinking.

I think that is enough from me… Happy hunting! ■

Where do I start?

It is hard to believe it has been twelve months since much of what we took for granted was turned upside down.

But even harder to believe might be how transacting a management rights business and the fundamentals behind it have not. Waking to daily case numbers and riding the rollercoaster of border restrictions may have changed sentiment and types of management rights on the market right now, but the guidelines to being prepared to buy, and then buying a management rights business remains remarkably similar to pre-pandemic times.

Some commentators will put this down to the resiliency of the industry, the entrepreneurial nature of those within it or even the types of management rights transacting through the pandemic (and those that are not). But it is also a reflection of a decade's old tried-and-tested purchase process and a small(ish) group of experienced professionals providing brokering, accounting, legal, finance, training and handover services to the sector. Most of us specialising in the management rights sector have now done so for many years, through good times and those more challenging. There is a respect for each professional's opinion, even if we do not always agree.

Summarised very briefly... The purchase process sees a buyer go to contract with a 'get out' right typically lasting five to six weeks. This 'get out' can be triggered

Trent Pevy,
Director, Pevy Lawyers

if, for any reason they are not satisfied with any aspect of the business, or their ability to secure satisfactory terms of finance. Only after that has occurred, is a buyer compelled to settle (subject to the body corporate consenting to the sale). The presence of this 'get out' period ensures that the seller and its broker want the buyer to get the best possible advice. This ensures the business is tested and financed on its merits by those capable of identifying them, rather than cowboy professionals that proliferate many other industries where no due diligence or short cutting is all too frequent.

The by-product of this process is the basics of what makes a good or bad management rights business are constantly being scrutinised, at every step of the way. The outcome? Very few 'bad' or misrepresented businesses make it to market, let alone make it through a purchase process to settlement. And needless to say, this is a good thing, as every buyer (be they a first timer or not) can have absolute confidence in the process.

> Engage, and then take the advice of, those specialised industry professionals tasked with guiding you through it

So, we have established that following the process will allow a buyer to better understand if a management rights business is appropriate for them and will give them the best chance to achieve their objectives. But it will also save you money! Not just from the obvious one of helping you avoid a potentially bad investment if a business is not right for you. It will also supply you with a treasure trove of information about opportunities within the business once you have purchased, and how you can make it more appealing when you go to sell.

Like many of our colleagues, we place a high emphasis on proactively sharing all our knowledge of what works and what does not. Following the process also ensures that if you do not proceed, you have committed only those funds necessary to get to the step which has caused you to reconsider going ahead. With that in mind, the best buyer tip, as my fellow scribes have echoed, is follow the process! Engage, and then take the advice of, those specialised industry professionals tasked with guiding you through it.

So, without detracting from this top tip, or from any of the other tips provided by Alex and Mike elsewhere in this guide, what else can you do to ensure you are best prepared before and during the purchase process?

1. Familiarise and involve yourself in the industry. The industry body, ARAMA, is a great place to start to understand day to day matters that impact managers. It is also a great avenue to meeting others in the industry.
2. Attend training opportunities to help keep you abreast of best practice. The purchase process may not have changed all that much, but the way in which management rights operators interact and communicate with lot owners and others in the strata environment has. Do not get me wrong the down to earth operator will always have their place. But pairing it with a professionalism and confident, sound judgment based on an informed

Pain-free purchases a challenging prospect?

When buying any business, the key outcomes of a successful acquisition typically include achieving a quick and pain-free purchase at an appropriate price.

Sounds easy in theory but can be quite challenging in practice. As with most things though, by careful planning and getting the small things right and trusting in the industry professionals to guide you through the process, you will certainly improve your chances of achieving the right outcome.

Fortunately, the management rights industry has evolved over many years to achieve a robust purchase process largely designed to protect the interests of a purchaser. A purchaser could enter a transaction with the comfort of knowing that their interests were being well looked after by industry professionals following a program of financial verification, legal due diligence, and independent valuation. From a financial verification standpoint, the process is spelled out in the management rights contract and is agreed and well understood between industry accountants. Generally, the process works smoothly and then along came COVID-19, nothing like a 1-in-100-year pandemic to turn the industry on its head.

Tony Rossiter,
Director, Holmans

COVID-related considerations

At the time of writing this article, the management rights industry is approaching 12 months since the pandemic first took hold of the industry. With the vaccine currently being rolled out and outbreaks largely being controlled, the future is looking a lot more positive. Despite these positive signs, there remains the risk of further significant lockdowns and border closures which can have a catastrophic effect on the industry. So where to from here?

Long term letting

Fortunately for the long term letting industry, the impact has not been too significant for most operators. Apart from inner city apartment complexes and properties relying heavily on international student tenants, most long term letting operators are reporting a negligible impact on their business revenue as a result of the pandemic.

It is important to understand, however, that the impact on long term letting management rights will vary from property to property and a buyer and their advisors should assume the worst and carry out investigations accordingly. ▶

awareness of what could go wrong is absolutely crucial in a strata ecosystem which is much more demanding than 20 years ago.

3. When going to contract on your dream management rights business, do not mentally buy it on day one. Yes, I appreciate this is easier said than done. But understand that you have made an offer based on assumptions, which, whilst often correct, are not always. That risk free period of five to six weeks is there to get you comfortable with your capacity to buy, verify the numbers, test the representations the agent or seller have made about the business (yes, including those numbers!) allow for a rigorous legal due diligence process to occur, and to obtain a satisfactory finance solution to enable the purchase to proceed. If you 'mentally purchase' before this has occurred it can compromise your bargaining position when things are not as represented, or worse still could cause you to make a bad decision against professional advice.

4. Understand that the management rights sector operates within a dynamic property market. This will see different trends emerge from time to time as to what qualifies as value and what attributes are non-negotiable or a luxury. For example, the pandemic has changed how people invest, where people want to live, and what they are prepared to pay for certain services (in some cases more, and in some cases less). This has seen a shift in property use and in turn the makeup of some letting pools. Identifying and trying to stay in front of these trends can deliver strong opportunities and rewards.

Embarking on the purchase journey need not be a stressful one. Surrounding yourself with industry experts and following 'the process' will ensure one less uncontrollable in these strange times we are thankfully appearing to emerge from.

Best wishes. ■

As a result, it will pay for a vendor to be prepared. A verifying accountant will want to understand what the current vacancy rates and rental arrears are compared to pre-COVID levels. If they have increased the accountant will look to understand the reason for the change and determine the extent to which the change has been caused by the influence of COVID or from other factors. Consideration will also be given to average weekly rentals and how they have changed compared to pre-COVID average weekly rentals.

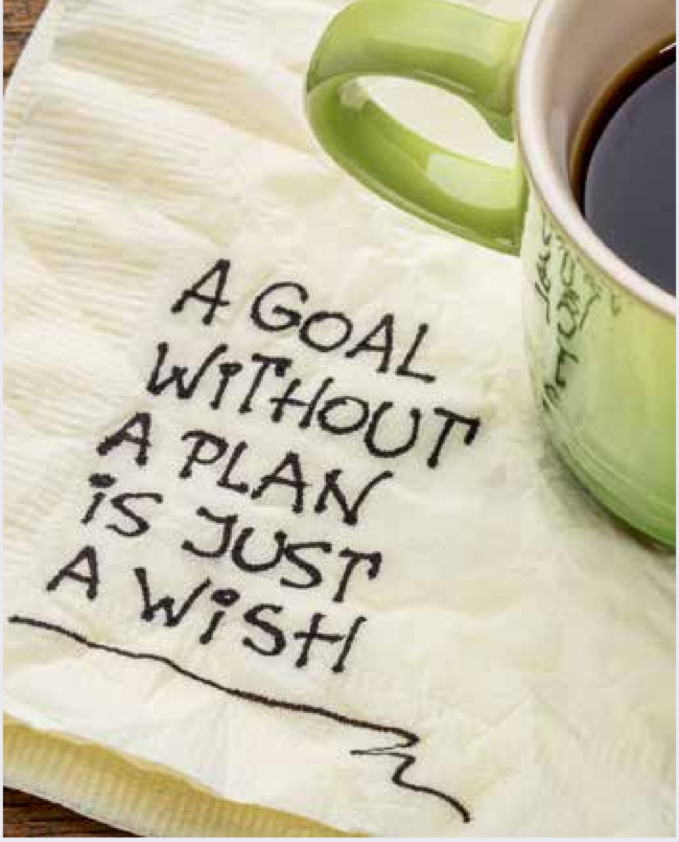
A verifying accountant is likely to have a series of questions for the vendor during the verification, designed to determine the impact of COVID on the business. The accountant will be looking for an explanation for how the vendor has responded to COVID, how they have addressed tenants who may have claimed financial hardship and what the outcome was on the business profitability.

Fortunately, the industry is resilient and sales of long term letting management rights have continued through the pandemic and in fact, in some areas demand has increased for what is seen to be a very low risk business model.

Moreover, some long term letting management rights have experienced a reduction in rental arrears and have been able to increase weekly rents largely of the back of Government subsidies increasing the disposable income of their tenants.

Short term letting

Short term letting has been far more problematic than



long term letting with most businesses being decimated during the lockdown and very few bookings occurring during the height of the pandemic. As we come out the other side, optimism and indeed the level of interest from buyers is growing. However, a buyer and their advisors (accountants, lawyers and valuers) will all be keenly interested in understanding how a property was affected and how it has managed to recover in recent months. For a lot of short term letting businesses, it is increasingly looking like a 'V' shaped recovery with bookings increasing month on month and forward bookings showing positive signs.

There are several ways to present the figures of a short term letting business effected by COVID. A common approach is to present at least two years figures, one set of figures showing the pre-COVID profitability up to say, February or March 2020 and a second profit and loss statement showing the most recent trading result including the COVID effected months. The COVID effected profit and loss statement can then be 'normalised' to provide a third profit and loss statement. The process of normalising involves identifying the most severely COVID effected months (typically March, April, and May 2020) and replacing the actual trading with 'normal' trading months based on prior years. The outcome is a profit and loss statement which seeks to identify what the likely outcome of the business would have been had it not been impacted by COVID.

A vendor will then have three sets so figures, pre-COVID, COVID effected and normalised which will ideally tell the story of how the business has fared during COVID. Careful consideration then needs to be given to how to value the business. In our opinion, it is not necessarily a matter of simply applying an appropriate multiple to the normalised net profit.

A verifying accountant should also obtain from a vendor monthly trading data comparing the key trading indicators, average room rates, occupancy, and total room revenue to the same month in the previous year. Ideally these reports should be obtained for a minimum of 36 months. Once graphed the year-on-year comparison will show the recovery the business has experienced since borders opened and demonstrate whether the business is on a trajectory toward achieving pre-COVID results. Assuming the business has not already reached that point.

Forward booking data will also be important to demonstrate the return to normal trading conditions and provide a buyer and their advisors with confidence.

Above all, a buyer will need to be patient, transactions of short term letting properties are happening and will continue to increase moving forward however, the time required to complete a due diligence and for a buyer to secure finance is taking considerably longer than in the past. ■

The information, opinions or conclusions provided above are generic in nature and do not express individual advice or recommendations. You should always consult a suitably qualified professional before taking any course of action outlined above. Holmans welcome any queries you may have in relation to the above matters.