Why Galileo Lies In Astro's Dust

As pointed out by a number of Bristlemouth readers yesterday, the two Japanese property trusts in yesterday's piece are **Astro Japan Property Trust** (formerly Babcock & Brown Japan) and **Galileo Japan Property Trust**. As you can see in the chart below, Galileo is the one that's performed abysmally and Astro the relatively good performer.

AJA v GJT Comparative

The point of yesterday's post was to show that both trusts were in remarkably similar positions back in 2008. Both also had debt maturing in the 2010 financial year and substantial derivatives liabilities. On paper, they were difficult to split and it's not as if one was preparing for the oncoming financial earthquake and the other wasn't. In fact, the chairman of Astro (remember this is the better performing trust) had this to say in the 2008 annual report:

> With no short-term financing risk, a well located, diversified property portfolio and an experienced asset management team in Tokyo, [Astro] remains well positioned to capitalise on future opportunities as they arise.
>
> We continue to believe that the underlying Japanese property market fundamentals are sound. While volatility in global credit markets has seen a reduction in transaction activity leading to a modest softening in cap rates, we do not anticipate a significant cap rate softening in Japan given the substantial spread which already exists between cap rates and the risk free rate.

So how did the owners of these two trusts end up with such different outcomes? Well, first I'll explain what happened and then try and throw some light on why.

As I already mentioned, both trusts had debt maturities in the 2010 financial year. In January, Astro announced that it had refinanced its ¥13.4bn loan due this year with a new lender. The 5-year new loan came with a margin 1.95%, compared with a margin of less than 1% on the previous loan but, all in all, a pretty good result.

Galileo, on the other hand, refinanced its maturing debt with a debt facility as extortionate as any I have ever seen. The ¥11bn facility from European real estate company Forum Partners comprised a ¥9.8bn 5-year loan carrying a fixed *15%* interest rate (in a country where base rates are close to zero) and a ¥1.2bn convertible note. The note also sports a 15% interest rate, but is convertible into 40% of the equity in Galileo. At 30 June, 40% of Galileo's equity was supposedly worth ¥5.4bn, more than four times the face value of the convertible note.

Forum provided a lifeline, but Galileo securityholders were annihilated in the process. And that's the reason the unit prices have taken such different trajectories over the past two years. Astro's management struck a good deal. Galileo's didn't.

When I first started looking into this situation, my original suspicion was that misaligned incentives must have had a role to play. The management company of Astro used to be Babcock & Brown. When Babcock went into administration, that gave the trust the opportunity to internalise the management, which it duly did. As a significant owner of Astro securities, CEO Eric Lucas's main incentive was to get the best deal he could. Galileo, on the other hand, is managed by Galileo Japan Funds Pty Ltd, a company effectively owned by Neil Werrett's family trust. Werrett is managing director and CEO of Galileo and responsible for all the big decisions. Was it in his interests to keep the show on the road at any cost, just so he could keep collecting the management fees?

It may have been in his interests, but his behaviour has been exemplary. Galileo Japan (the management company) waived its base fees for the 2009 and 2010 financial years and has been racking up substantial losses. The company has $6.7bn of accumulated losses on $9.3bn of contributed equity, a long way from a business lolling about in a sea of management fees. Werrett hasn't been paid a directors' fee or salary for years and the only thing he has been doing is putting additional money in to buy more Galileo Trust securities. He added 14.3 million to the existing 5.9 million units he already owned, and the company recorded a $2.6m loss on its holding in the 2010 financial year (on top of a $3.4m loss the year before).

He is now the effective owner of 20 million units in the trust and isn't collecting management fees. The truth couldn't be further from my initial suspicions.

The two big differences are that Astro's debt comprises five non-recourse facilities that are completely independent of each other, while Galileo's lenders have recourse to all of its assets, and that Astro's management team are substantially more experienced. The non-recourse nature of the debt shouldn't be underestimated. Both trusts had less than 20% of their debt maturing in the 2010 financial year. If Astro couldn't refinance, it would have lost a small portion of its assets because the lenders only had security over the assets relating to that particular debt facility. If Galileo couldn't refinance, the whole empire would have come crashing down because, although only a small amount of debt was due, the lenders had security over *all* the assets. The different nature of the loans gave Astro a lot more leverage in negotiations than Galileo.

Then again, perhaps it was just luck. Humans try and attribute skill and meaning to everything that happens in life. I was standing in the shower this morning wondering why one of my toenails is black after Sunday's Melbourne Marathon, while the rest are fine. Is that toe longer than the rest? Do I land differently on my right foot than my left? Sometimes, as a friend likes to put it, 'shit just happens'. One lender is in a friendly mood, the other isn't and you end up with vastly different results.

One final explanation is that the difference shouldn't be as big as it is. Perhaps Galileo is just cheap. To be sure, it isn't in a pretty place. Buying long-term assets like property with short-term debt is a risky game to start with, but owning property that yields 6% with debt that costs you 15% is certain path to financial ruin. But if Galileo can sell some assets at or near book value and repay the debt, it might be in a much better place in a few years' time. After the convertible note is converted to equity, Galileo's NTA would be 22 cents per security. The current price is 2.7 cents.

Helpfully, management provided the following table in its recent results announcement:

Estimated proceeds per unit if liquidated by 30 June 2013

	10% Discount	Current Book Value	10% Premium
AUD/JPY = 60	$0.11	$0.29	$0.48
AUD/JPY = 80	$0.08	$0.22	$0.36
AUD/JPY = 100	$0.06	$0.18	$0.29

A fortnight ago Astro announced that it has sold two properties at 6% and 9% premiums to book value (remarkably, one of them was ‘100% vacant’). At current exchange rates, a liquidation of Galileo’s portfolio at similar prices would mean a tenfold return on the current price. Are the asset sales just another sign that Astro’s management is superior, or could Galileo’s luck be about to change?

Disclosure: The Value Fund does not own units in either trust.