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AREITs shine (but choose carefully)

AREIT exposure to major shopping centres has boosted returns. **ANDREW GOLDIE**

by **Duncan Hughes**

Listed Australian trusts investing in property are yielding about 4.8 per cent – or double the return of most banks savings accounts or the benchmark 10-year government bond.

Renewed pressure on the Reserve Bank of Australia to keep down interest rates and a flood of foreign investors (particularly yield-hungry Japanese whose interest rates are negative) means yields on Australian real estate investment trusts (AREITs) should continue, say analysts and advisors. AREITs are listed funds that allow investors diversified exposure to property.

But investors considering them need to be aware the outlook could quickly deteriorate if sentiment on interest rates changes, there is a sudden withdrawal by overseas investors or global equity markets suffer another big shock that impacts all securities.

"These are not set-and-forget, long-term strategies," says David Bryant, chief investment officer of Australian Unity, which has more than $9 billion under management. "They are set-and-watch strategies."

Shane Oliver, chief investment officer for AMP Capital, says despite trading at a 26 per cent premium to net asset value, they "still remain cheap on our measures – to the tune of 5-10 per cent."

Oliver adds: "This reflects still very low bond yields and – as it's hard to see much inflation or RBA/global central bank rate hikes on the horizon, apart from very gradual moves from the Fed – AREITS should perform reasonably well as investors continue to search for relatively reliable and attractive sources of yield, including from foreign investors."

AREITs suffered a calamitous collapse in the wake of the global financial crisis (GFC) as fears that the fallout from toxic debt infecting US and European markets would spread to Australia.

"Unlike in 2007 – just before the GFC-inspired correction in the commercial property market – AREIT yields offer a decent risk premium over bond yields and AREIT balance sheets are less geared with longer maturities," says Oliver.

"They are also being aided by reasonably solid earnings growth as underlying property demand and supply fundamentals are okay – apart from in mining exposed cities like Perth. Average vacancy rates look like they are in the process of peaking and retail sales growth is reasonable."

BIG OUTPERFORMANCE

AREITs have been the top-performing asset class for three of the past four years and are this year's top performer, according to investment bank Credit Suisse.

The sector's average 16 per cent return over three and five years is nearly three times the return of the S&P/ASX 200, the nation's leading share market index of the top 200 listed companies.

AREITs have also outperformed financial stocks – ie, the banks and other financial institutions – in nine of the past 15 years, says another investment bank JP Morgan. Further, they've outpaced the S&P/ASX 200 in eight of the last 15 years (with outperformance in seven of those years exceeding 9 per cent).

AREIT management teams are "largely stable" and business strategies well-defined, reports JP Morgan, with gearing expected to remain around existing levels. The bank predicts "solid and robust" performance for this year.

Investors considering an AREIT are spoilt for choice between listed vehicles offering industrial, commercial, retail, industrial and agricultural property and buildings.

HIGHS AND LOWS

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But the quality, calibre and performance of the funds can vary dramatically.

Among the top performers is Rural Funds Group, which leases high-quality agricultural land to experienced farmers, with gains of more than 60 per cent during the 12 months to the end of March.

Among the worst performers is RNY Property Trust, a hangover from the pre-GFC days which invests in New York commercial property, with losses of more than 60 per cent over the same period.

High asset concentration in some sectors, such as retail, means using a property index fund to average out losses and gains might not provide the usual spread of assets achieved from that approach.

"What many investors do not realise is the top eight AREIT stocks represent nearly 86 per cent of the index and the exposure to retail A-REITs is more than 50 per cent," says Winston Sammut, portfolio manager for Folkestone Maxim A-REIT Securities Fund.

VOLATILE

"If we include the retail assets owned by the diversified AREITs like Mirvac and Stockland, the exposure to the retail sector goes beyond 60 per cent. These are big bets investors are taking on the large-cap securities and the retail sector."

AREIT performance has also become increasingly volatile in recent years.

For example, last year the S&P/ASX 200 A-REIT Index was up or down by more than 3 and 5 per cent in a month on five and three occasions respectively. Ten years ago, says Sammut, there was not one month where the index rose or fell by 5 per cent.

He attributes the higher volatility to more buying and selling by mum and dad investors attracted by the yields. Also contributing has been increased hedge fund involvement and continued uncertainty in global equity markets.

"The short-term volatility makes us recommend investors take a three-year-plus investment horizon, which will smooth out some of this volatility," Sammut says.

Ken Atchison, managing director of Atchison Consultants and a financial market veteran with more than 43 years experience, says investors should "buy on market weakness".

WHERE TO BUY

For example, he likes the prospects for billion-dollar sector retail behemoth Westfield Corporation.

Others, such as Oliver, see better value in directly held commercial property rather than AREITs.

Sammut says good earnings prospects and the likelihood of continued net asset value growth make them a good defensive strategy in unpredictable markets.

Australian Unity's Bryant recommends that investors look for companies with quality, well-located buildings, good tenants and long leases.

"If something goes wrong with the existing tenancy, it should be desirable enough for someone else to rent," he says.

For example, owners and managers of shopping centres such as Vicinity Centres, Westfield Corp and Scentre Group continue to be popular with shoppers and retailers, leading to increased sales turnover and higher rents.

Chadstone Shopping Centre in Melbourne (jointly owned by Vicinity Centres and Gandel Group), and Westfield Sydney and Westfield Bondi Junction topped $1 billion in sales in 2015.

GOOD PROSPECTS

Other property sectors with good prospects include health care, services for seniors, data centres and child care, analysts say.

But investors need to be careful about where the buildings are based.

Offices in Melbourne and Sydney are performing strongly compared with Perth and Darwin which are struggling.

The recent RBA's Financial Stability Review warns office vacancy rates in resource-intensive states remains "very high" as additional new supply comes on line.

Industrial sites are often single-tenanted, which can increase risks, and can easily be replaced by competing sites closer to major transport hubs.

AREIT's dividends are unfranked. Speculation about increased interest rates could impact sentiment and result in lower prices.

Sammut says the sector is better-placed to absorb global market shocks then at the onset of the GFC.

Gearing levels are around 30 per cent, compared to 37 per cent in 2009. Payout ratios of around 90 per cent are more sustainable and offshore exposure is about 5 per cent, compared to nearly 40 per cent.