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AREITs – Attractive Yield Margins

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Since the start of quantitative easing in the US and UK in the aftermath of the global financial crisis, yields on fixed interest investments have fallen significantly. This has encouraged investors to seek investments with higher yields. One of the attractive asset classes has been real estate investment trusts (AREITs). AREITs provide both attractive yields and prospective capital growth.

What Attractions?

AREITs have a history of providing investors with strong and growing distribution income through growth in rental income. Investors have been embracing REITs in recent years for their attractive income yields.

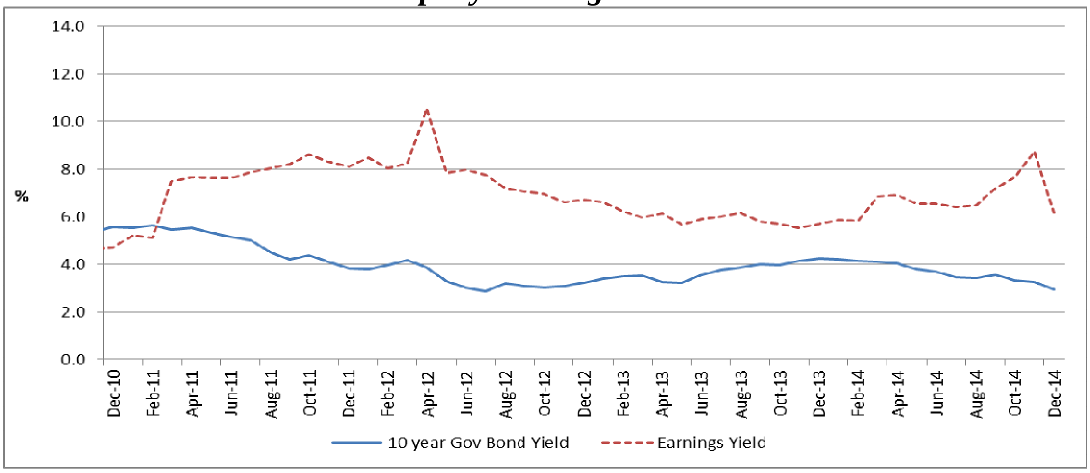
Table 1 compares the income return of AREITs and the 10 year Australian government bond yield for 15 years to 31 December 2014. The average income yield of AREITs over 15 years to 31 December 2014 is 1.6% higher than that of the average10 year government bond yield.

Table 1- AREITs Income Yield vs Government Bond Yield – 15 Years

	Average Yield (%)
AREITs	6.8
10 Year Government Bond	5.2

In the current environment, AREITs provides attractive absolute earnings yields of 6.0% and a margin of 3.0% over the 10 year government bond yield. Chart 1 compares the AREITs earnings yield and 10 year government bond yield. AREITs have been providing significantly higher earnings yields than that of the 10 year government bond since March 2011.

Chart 1 – Australian Listed Property Earnings Yield vs Government Bond Yield



Source: RBA, IRESS

In addition to yield, investors have benefited from capital gains. Large numbers of investors who have found the yields from AREITs attractive have invested in listed property trusts, pushing up AREITs prices. Over the one year period to 31 January 2015, the AREITs price has risen by 29.1%.

When Interest Rates Rise?

Investors will be concerned that AREITs will become less attractive when interest rates rise. While we acknowledge that this is a valid concern, there are some offsetting factors.

Firstly, although higher interest rates will cause higher costs of borrowing, the rise of interest rates is also a signal of a strengthening economy. Higher growth in the economy will increase the demand for commercial real estate, improve occupancy rates and rental income. Hence, any increase in cost of borrowing may be offset by the landlord's ability to raise rental rates, which will flow through to higher distributions to investors.

Secondly, the AREITs sector today does not show the same risky characteristics as it did during the GFC. Table 2 below shows that AREITs, on average, have reduced their gearing levels, as measured by debt/asset ratios, since the GFC. The highly geared trusts, which are more likely to suffer from negative cash flow impacts when interest rates rise, are less exposed than in 2009. It is believed that the burden of rising interest rates on AREITs will be much less.

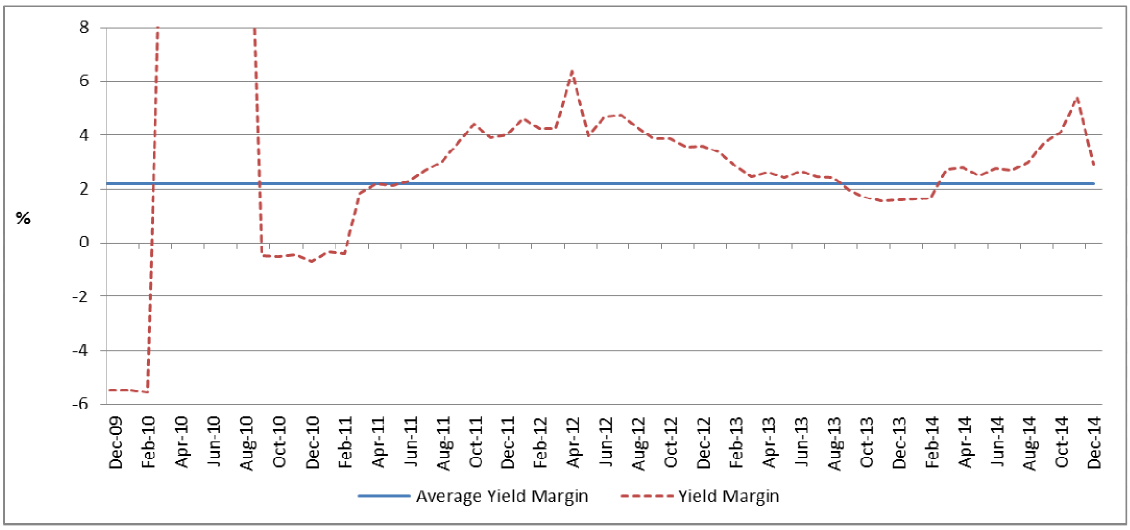
Table 2- AREITs - Average Gearing Levels

	GFC (Dec-09)	**Current (Dec-14)**
Average Gearing (%)	34.0%	30.0 %
Gearing Range (%)	24.0% - 61.0%	0%-40.9 %

Source: UBS, ASX

Moreover, the spread between AREITs earnings yields and 10-year government bond yields remains wide. This point is demonstrated in Chart 2 by comparing the margin of the current earnings yield of AREITs with 10 year government bond yield and the long term average. The current margin of 3.0% is above the long term average of 2.2%, which provides a buffer when interest rates rise.

Chart 2 –Property Earnings Yield vs Bond Yield - Margin



Source: UBS, IRESS

Interest rates have remained low for a long time. AREITs provide stable income and prospective capital growth. When interest rates rise, investors still have some support from rising rents, the wide yield spread and the lower gearing levels. Prices may fall but only marginally.