ATCHISON
CONSULTANTS

Property Observer **June 2014**

AREITs applying the gearing lessons learnt in the GFC

By Binesh Seetanah – Atchison Consultants

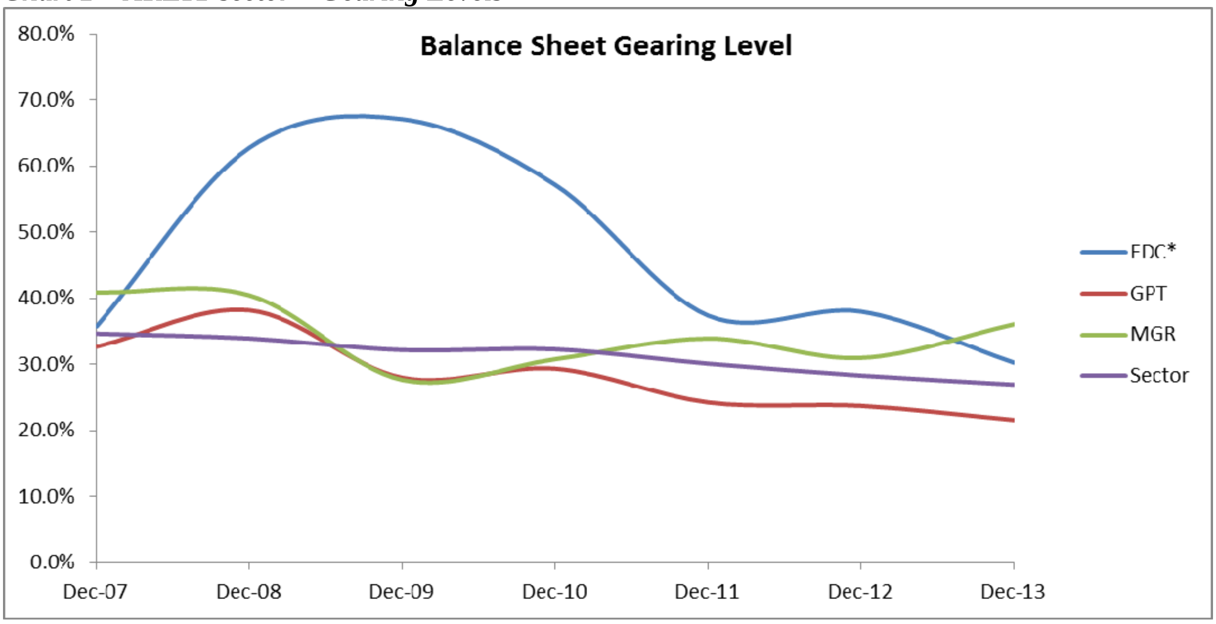
Lessons learned by management in AREITS about gearing in the GFC, are being applied now as AREITs acquire assets with debt on accretive terms. Yields on property are higher than interest rates on loans so that return on equity is enhanced.

Gearing can change the characteristics of an investment significantly and in the worst case, force the sale of the underlying assets when prices are depressed. AREITs can enhance returns for investors through gearing, when they are generating total returns that are greater than the interest rate on debt.

Gearing increases downside risks. A major contributor to the AREIT sector fall of close to 70% between 2007 and 2009 was excessive gearing including paying distributions from unrealised profits funded by debt. Valuations of property assets fell during the GFC and loan covenants were tightened by banks, causing breaches of loan covenants prompting banks to call for loan repayments. AREITS were forced to sell assets at distressed prices and raise capital at significant discounts to NTA.

Chart 1 illustrates the gearing levels of GPT Group (GPT), Federation Centres (FDC), Mirvac Group (MGR) and the sector over seven years to 31 December 2013.

Chart 1 – AREIT sector – Gearing Levels



* Previously Centro Retail Australia (CER)
Source: Company financials, UBS, Atchison Consultants (2014)

As shown in Chart 1, the three AREITs have all reduced their gearing levels since the GFC. AREITs have re-focused on the fundamentals of property ownership and management and recapitalised through equity raisings resulting in lower gearing levels

Over the twelve month period to 31 December 2013, AREITs have undertaken bond issuances mainly in overseas markets in order to finance property acquisitions or refinance existing debts. Mirvac Group has increased its gearing level by 5% over the period from 31% to 36% financing property acquisitions. Gearing below 40% does not place any strain on bank loan covenants.

A total of $5.8 billion of debt has been raised over the year to 31 December 2013. This reflects the prevailing low interest rate environment and consequently attractive financing conditions for new property acquisitions. Currently, interest rates on debt of 4.6% are below yields of 5.5% to 8% on property assets in the market.

In the current low interest environment, AREITs will continue acquiring assets at yields above loan interest rates, which is accretive for returns on assets for investors. Provided that levels of debt are judiciously managed, AREITs have the potential to enhance return on equity for investors whilst minimising the potential for breaching loan covenants.

Binesh Seetanah is an analyst at Atchison Consultants