

It will never be the same again for listed real estate

Will your investment survive? Debt and valuations are the key, writes **David Potts**.

Property trusts have paid a heavy penalty for being overgeared, overvalued and over there. Unit prices have been marked down so far that real estate investment trusts (REITS), as they are now called, are valued at roughly half the worth of the properties they own.

But then exactly what the properties are worth is a moot point, given the dearth of sales over the past 18 months.

Furthermore, the property development and funds management divisions of REITS have been discounted to zero, if not negative values.

Although the feared wave of asset sales, which would highlight immediately the extent of property price falls, hasn't come, it seems there is room for downgrades in valuations in any case as accountants and actuaries alter their assumptions about rental yields and the state of the economy.

"We're expecting values to decline 20 per cent from peak to trough," Goldman Sachs JBWere head of property research Simon Wheatley says.

In which case, we are not even halfway there yet.

This decline would be much shallower than the early 1990s crash, yet unit prices have been marked down far more this time.

REITS are trading at a 49 per cent discount to the value of their underlying properties, having plunged to a 62 per cent discount at one point. At the low point in the 1990s, the discount to net asset value was 37 per cent.

As a result, the income yields on REITS are more than 10 per cent a year, despite the sharp falls in distributions. To cap it all, some fund managers are saying property trusts are no longer even an asset

class in their own right. Another problem with the local REIT market is that it is heavily concentrated.

Three stocks — Westfield, Stockland and GPT — account for about 70 per cent of the index.

Incidentally, none of these three are old-style property trusts but stapled securities that mix property ownership with management and development.

Rather than invest directly in Australian REITS, professional investors tend to use unlisted global property funds such as Perennial to gain access to the property market.

"We support going into a global fund that invests in Australia. You still get 8 per cent invested in Australia and the best of the global property managers," Atchison Consultants managing director Ken Atchison says.

Global funds that include Australian properties are run by

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SIMON WHEATLEY
GOLDMAN SACHS JBWERE

Advance, AMP Capital, Colonial First State, Jones Lang LaSalle, Macquarie, Perennial (rated favourite by Morningstar) and UBS.

But whenever offshore investments are involved, there is a currency risk. Furthermore, Morningstar warns these funds are capital- rather than income-oriented, so regular predictable distributions can't be counted on.

Although Australia's property fund managers are considered among the world's best, the truth is the trusts as an investment class long ago lost their innocence.

They turned from being some of the world's most transparent vehicles into the most complex, borrowing more to boost returns and expanding overseas, often as property developers. It was offshore expansion that undermined Centro, and has Valad struggling.

Nobody suggests REITS will return to their heyday, at least in their current form.

"If you invested in them prior to the market turmoil it's created a permanent loss of income," says APN Funds Management executive director Howard Brenchley.

Resolution Capital's Andrew Parsons calls the sector "a crashpoot of stocks fighting to survive" and adds "most will never be the same again because they need too much equity to rebalance their capital".

Two funds, Rubicon and Record Realty, have collapsed. Mirvac Industrial Trust, which has properties in Chicago, is trying to sell its portfolio. Pengana Capital last month closed its property securities fund to new investors.

REITS have also slashed or abolished their distributions. A recent survey by Morningstar found "none of the fund managers in our review were able to give an estimate as to when distributions will return to normal".

There's also a complication with those that do make a distribution.

"We won't know whether it's from capital or income until June 30 or December 30," Richard Elmslie of RARE Infrastructure told the Morningstar investment conference last month.

This is not to say that it is all doom and gloom. Some experts believe that at least distributions may not fall much further.

"Maybe there will be some more cuts in distributions but we've seen the worst," APN Funds Management's Brenchley says.

The big funds have successfully re-capitalised, which suggests that investor appetite remains reasonably robust.

In the past month alone more than \$4 billion has been raised from institutions and private investors, albeit at hefty discounts.

GPT and Dexus Property Group have gone to the market not once but twice with jumbo raisings in the past six months.

It might be early days yet, but

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rental income is still growing at 2 or 3 per cent a year, Brencley says.

The falls in asset values have not yet been as severe as feared.

"All REITs covered by Morningstar reported falls in asset values ranging from 1.6 to 11 per cent at December 31, 2008," Morningstar senior research analyst David Parker says.

"A big decline may not happen because there won't be the transactions," Russell Investment Group investment strategist Andrew Pease says.

But it may be different for non-prime properties.

"The market is expecting secondary property to fall in value more than prime property, US and European property to fall in value more than Australian property, and

the Bunnings Warehouse Property Trust. Sometimes the valuations are performed in-house rather than by a third party.

Since valuations, especially of overseas holdings, are more likely to fall than rise over the next year or two, REITs will still have gearing issues. As values fall, the gearing ratio rises even without the trusts borrowing an extra cent.

This could put their interest cover covenants with their banks at risk.

Some analysts argue that when properties are re-priced, the valuers are overly conservative, which may bode well for investors further down the track.

"A shopping centre is being valued as if all the leases have expired, all the tenants have walked out, it'll take six months to replace them, the rent will be lower and there'll be higher incentives,"

management and uncompetitive properties", concedes they could bounce back.

"Supply [of property] is not the issue that it typically has been in past economic downturns," he says. "So if demand does recover more quickly than expected, well-located real estate will be well placed to provide competitive returns."

Despite depressed unit prices, there has been little takeover activity because of high gearing levels and an unwillingness to trigger change of control clauses with the banks.

But consolidation could yet occur.

Speculation invariably centres on Stockland as a potential acquirer, while potential prey include GPT and retirement village provider Forest Place Group.

Certainly REITs are "worth stepping back into again", Brencley says.

Research firm Adviser Edge has upgraded its recommendation of the property sector to neutral from underweight on the grounds that the market is trading at the largest discount to net assets since 1970 and the probability of bankruptcies in the industry has been reduced.

Adviser Edge recommends investors look at companies with low gearing.

The starting point may be Westfield, with its solid cash flow. However, a 36 per cent gearing ratio is hardly low, its American shopping malls are at the coalface of the US recession and its huge London shopping complex has been let on what Atchison says are "lease terms generous to tenants".

Also well regarded are GPT, Stockland, Colonial First Retail Fund, Commonwealth Property Office and Dexus.

Charter Hall, which recently raised capital, and Valad, look shaky but Atchison says: "I don't think either will go under."

Morningstar says the lowest risk REIT is Colonial First State Retail Fund, and the riskiest are ING Industrial Fund and Macquarie Countrywide.

Wheatley nominates Mirvac and Stockland because the outlook for residential real estate is better than the outlook for commercial property.

Those generally considered good to avoid are Valad, Charter Hall, ING Industrial and Goodman.



Darling Park, Sydney . . . part of GPT's portfolio.

industrial property to fall in value more than retail and office property," Parker says.

John Wakefield, managing director of REIT Review says "it will take another 12 months and several rounds of revaluations for the market to be fully informed of the extent and depth of asset price declines". He predicts "a minimum of another 10 per cent drop over two years".

One factor worth taking into account when looking at REITs is the regularity of property valuations, and the way in which they are carried out.

Only Westfield commissions an independent valuation for each property it holds at balance date. Often valuations are done on a three-year rolling program, such as

Australian Unity's head of property Martin Hession says. "Then they lift the cap rate [yield] from 7.5 to 8.5 per cent. It's like two shots to the head."

He says valuations are "marking down too far", and when the market bounces back, "assuming tenants haven't walked, values will have to be lifted 20 per cent".

Brokers expect the REITs to outperform the broad sharemarket, mainly because they're coming off such a low base.

"We expect REITs to outperform in the second half of the calendar year with a 20 to 30 per cent return," Goldman Sachs JBWere's Wheatley says.

Even Resolution Capital's Parsons, who says the funds are "over-leveraged with poor