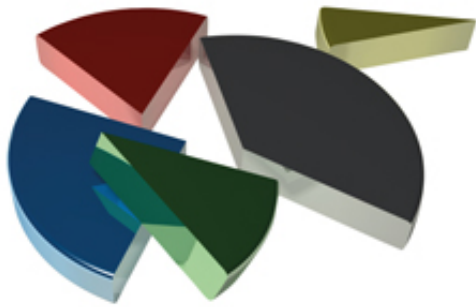


Allocation shake-up

Published: 16 Aug 2011 Author: Janine Mace Source: Property Australia



Key points

- Asset allocation trends have seen a re-weighting from retail to office
- Superannuation funds will be competing against the behemoth Future Fund, which is underweight in property
- Investors are unlikely to target foreign property markets in the short term

With life looking fairly bleak for Australian retailers at the moment, the shine is going off the retail property sector for investors – particularly when it comes to big direct property players like super funds.

Instead their attention appears to be turning towards the office sector and its better growth prospects. As Frontier Investment Consulting's head of property research Leigh Gavin explains: "Funds are looking at the office sector due to the potential for rental growth and the headwinds in the retail market."

Tough times for retail

Charter Hall head of wholesale investment funds management Andrew Glass agrees the slowdown in the retail sector is changing views among large property investors.

"Sentiment towards regional and super regional malls is waning – especially as profit margins are declining in specialty retailers, which makes it harder to get rental increases," he says.

"However, value remains in the sub-regional and neighbourhood centres as these are still priced at trough levels and have not been repriced."

According to Glass, cap rates are around 8 percent for neighbourhood centres due to their greater security of income from long leases.

With the appeal of retail property declining, attention is increasingly turning to the office sector as the next hot area, according to Keith Atchison, managing director of Atchison Consulting and a long-time asset consultant to the super industry.

"Now the sentiment at the institutional level is into office, as vacancy rates have peaked. The cycle view is the office sector is now at the right price," he says.

Although the outlook for the office sector in general is favourable, Sydney is seen as the most attractive geographic region.

Demand for office space in the city was badly affected by the GFC due to its close association with the financial services industry, but Atchison believes super funds now view Sydney as being more attractive than other capital city markets.

The limited supply of office space coming on stream and the geographical limits on the city's CBD area also increase its appeal.

"Sydney is the main area of interest for super funds at the moment," Atchison says.

New competition appears

While local super funds may be eyeing off quality office property, they are likely to find themselves facing some stiff competition.

The Federal Government's \$75 billion Future Fund has signalled it will continue accumulating local property assets as it builds towards its overall target asset allocation for the fund.

Although the fund's target allocation for the tangible asset class (which includes property, infrastructure and

timberland) is 14.5 percent, in June 2010 tangible assets only represented 5.0 percent (\$3.1 billion) of the total assets. By the end of March 2011, this had risen to 6.1 percent or \$4.5 billion.

This still leaves room for significant property acquisitions – some of which are certain to be in the office sector. For example, in May this year the Future Fund finalised a deal with Stockland to buy a 50 percent stake in the premium grade Brisbane office tower Waterfront Place.

It also agreed to buy a 50 percent interest in the adjacent Eagle Street Pier, a waterfront precinct with restaurants.

Another source of competition is international pension funds and sovereign wealth funds. The Canadian Pension Plan Investment Board (CPPIB) has already made its presence felt by buying a half-share in Melbourne's Northland shopping centre for \$455 million.

This deal followed the acquisition of a 42.5 percent stake in the ING Industrial Fund's portfolio and the CPPIB has indicated it is likely to continue diversifying its exposure to various sectors of the Australian property market as it finds attractive opportunities.

The value in the local property market seems to have made Australia a destination of choice for large international investors looking to diversify their portfolios. "Australia is at the top of the list for international capital from the UK and Asia, and we are now seeing increasing interest from the US," notes Glass.

Competition from infrastructure

Another asset allocation trend likely to affect the Australian property market is growing competition for infrastructure assets from pension fund dollars.

The Future Fund's bracketing of property with infrastructure assets in its target asset allocation is a high profile example of this approach.

According to asset consultants working with Australian super funds, there is an increasing view that infrastructure assets have similar investment characteristics to property assets and the two should be grouped together when considering a pension fund's overall asset allocation.

This approach is also used by the CPPIB, which brackets real estate with infrastructure as part of its overall allocation to 'inflation-sensitive assets'. Its \$3.5 billion purchase of toll road company Intel could be the first of many similar deals from major international pension investors.

Although allocations to the property sector are unlikely to decline, Atchison believes there is increasing interest by funds in 'real' assets such as airports and power stations, as they have similar investment attributes to property.

"There is increasing examination of infrastructure as part of the property universe. It has a strong contracted income stream and this is what super investors are looking for," he says.

Keeping the money close

Although super funds are keen direct property investors, they remain cautious about taking the plunge into international property and not even the high Australian dollar has been enough to lure them offshore.

According to Atchison, international property allocations remain 'a work in progress' with a lot of looking but not much investment actually occurring. "The commitments are still yet to be made."

Most super funds currently allocate more than 80 percent of their property portfolio to domestic assets and Gavin believes this is unlikely to change in the near future. "The Australian dollar has not had a big impact as funds mostly hedge their overseas exposures. What is more important is the interest rate differential between different markets," he says.

The dramatic recovery and lack of distressed sales in major markets such as the US have also stayed their hand. "The pricing has run ahead of the fundamentals, especially in the core prime asset space in the US," Gavin notes.

In contrast, the Australian property market is still seen as good value. As Charter Hall head of investor relations Nick Kelly explains: "When there is so much value on offer here, why would they go overseas?"

Stability and low volatility

For pension fund investors, the main emphasis for the foreseeable future will be on property assets that offer strong, stable income streams and low price volatility. These attributes provide an important counterbalance in their portfolios to the increasingly volatile returns from listed assets.

This means top quality assets will remain in high demand. "The strong theme at the moment is pension funds are looking for prime assets with secure income flows," says Glass.

He says this has led to a "flight to quality" where more volatile property sectors such as hotels, aged care and retirement villages are out of favour. That approach is unlikely to change until pension funds are willing to re-embrace riskier assets within their portfolios.

Life outside the core

Although superannuation and pension funds are focused on prime assets that provide strong, stable cash flows and reduced portfolio volatility, the picture is a little different when it comes to the REIT space, says IPD research manager Peter McGuinness.

"In contrast to the direct market, the REIT market is well allocated through both the core and non-core sectors. They invest in sectors that are not seen in the direct space," he says.

In the wake of the GFC the Australian REIT sector may be returning to portfolios of more traditional income generating assets and seeking to de-risk, but it is not abandoning property sectors perceived as having more price and income volatility.

"Although there have been changes, there has not really been a movement away from exposure to non-core assets in REITs," McGuinness notes.

While REITs have shown no reluctance to allocate to non-core sectors like hotels and retirement villages and are still investing in a highly diversified range of assets, they are reshaping their portfolios and undertaking asset swaps, he explains. "Over the past two to three months, there has been a lot of movement and this includes a lot of consolidation and M&A activity."

The deals have resulted in significant asset allocation changes, with several groups seeking to introduce greater portfolio specialisation and focus on specific market sectors.

The most high profile example of this trend is Stockland, which has continued to re-weight its portfolio as it seeks to achieve its new 3-R Strategy, which focuses the group on the residential, retail and retirement living property sectors.

As part of its portfolio reweighting activities, Stockland has added residential assets, acquiring two major residential projects in Perth from Brookfield. This transaction also saw Stockland sell office assets, with its 50 percent holding in the Perth's BankWest Tower going to Brookfield.

In addition, Stockland added retail assets to its portfolio when it purchased the Point Cook Town Centre in south-west Melbourne from Walker Corporation and the Centro Hervey Bay shopping centre from Centro Australia Wholesale Fund and Leda Holdings.

In announcing the deals, Stockland managing director Matthew Quinn explained the transactions were part of its portfolio reallocation and were part of a move to "recycle funds from the sale of non-core, office assets into good quality, strategic residential and retail assets".

Another example of the asset allocation changes occurring in the REIT sector was the Investa Property Group's takeover of the ING Office Fund. The transaction resulted in Investa strengthening its focus on the office sector, where it now has ownership and/or management of more than 60 office buildings in key prime commercial centres around Australia.