DIRECT PROPERTY ON THE COMEBACK TRAIL

- By Janine Mace on 20 June 2011
- Money Management

Following a period of uncertainty, the direct property market appears to be undergoing post-GFC resurgence. Janine Mace reports.

In the wake of the global financial crisis (GFC) there were some pretty dark days for the direct property sector. Valuations came under strong pressure and many funds were forced to suspend redemptions and distributions as they struggled to survive.

However, dawn seems to have finally broken for the sector and it now appears on the cusp of an upswing. Returns are up, rentals are rising, many frozen funds are inching closer to a solution and investors are willing to take a look at new investments.

Centuria Property Funds CEO Jason Huljich sums up the current view, saying: “Most analysts are upbeat on commercial property at the moment. The market is a lot healthier than 12-18 months ago.”

This optimism contrasts with the flat performance – or even decline – expected from residential property over the next year or two and marks a welcome change for many property investors.

Ken Atchison, managing director of property consulting firm Atchison Consulting and a long-time market observer, believes the picture is now much brighter.

“The outlook is more encouraging than a little while ago. In the major property classes, we see the revaluations down as being finished. Over the next 12-18 months we will see increasing rental income returns and that is quite a positive development at the moment,” he explains.

Huljich agrees the prospects for most major markets are upbeat. “Valuations have stabilised and we are seeing them start to go up.”

Rents are also starting to rise. “Melbourne rentals have moved up. In Sydney there are still quite a few incentives, but this is starting to drop and in the next 12 months we expect to see rentals increase. However, we expect Brisbane to be flat for the next 18 months,” he says.

Funds slowly defrost

All this is a far cry from the gloom after listed property trust prices collapsed and there were concerns direct property would see major downward revaluations and fire sales as investors headed for the exits.

Although the sector is now more optimistic, the problem of suspended funds remains, with thousands of investors still trapped in troubled property funds. While some funds still face major problems in unwinding their positions and freeing up investor monies, there have been encouraging signs.

According to Atchison, the largest group of frozen funds are in the Centro Properties Group. He believes the deal with the US-based Blackstone Group to acquire Centro's international assets for US$9.4 billion is a definite step in the right direction.

"We are now looking at the prospect that this year there will be a resolution with the frozen international funds. A liquidity solution is also expected in 2011 for the Australian asset funds," Atchison explains.

"We believe the impact on sentiment will be quite positive. There will be a price available and that will be hugely significant."

The situation with other managers has yet to progress that far. "Other funds are slowly freeing up – tortuously – but it is happening," he says.

Many funds are being recapitalised with equity from new managers and this will improve the situation, Atchison notes. "So we are looking at 2011-12 and expect to see other frozen funds being freed up."

Upswing in the property cycle

Charter Hall Direct Property CEO, Richard Stacker, agrees the situation has improved and believes it is time for financial advisers to reconsider property funds. "Property is still an important component in portfolio construction."

He believes there are currently good opportunities for investors considering property investments, with the property 'clock' or cycle at the right point to move back into the market.

"If 12 is the peak, then most property sectors are between six and nine. This is the early stages of the upswing and the time to get into the sector before prices start to move too much. We are at the right time of the cycle for investors to reconsider property investing," he claims.

"Property fundamentals are very good at the moment."

Although most leases have rental increases embedded in them, significant capital growth has yet to re-appear in most markets. "The next 12-18 months will see more subdued capital growth than previously, but there are good prospects," Atchison says.

The outlook is also positive due to supply problems from a lack of new developments. "There is not a lot of supply coming on, due to the banks' constraint of funding," Huljich explains.

“There was a nine-and-a-half per cent vacancy rate nationally at the peak of the GFC when the long-term average is 10 per cent, so it is interesting that it was below that.”

Although interest rates are a key issue subduing the residential market, the story is different when it comes to commercial property.

“Commercial is not as sensitive to interest rates as residential. If interest rates rise, that means both the economy and growth are looking good,” Stacker says.

This is being reflected in the outlook for the office market, which is closely linked to economic growth.

“The office market is in good shape with a less than eight per cent vacancy rate around the country and it is in a balanced position,” Stacker explains.

“The Melbourne vacancy rate is even less. The position is similar in Sydney, with strength coming back after the GFC, when it was hit hard due to its finance sector exposure. Perth and Brisbane are doing well off the back of the mining and infrastructure developments.”

Stacker is also positive about the outlook for the industrial sector.

“In industrial, there is very high demand for prime grade property. Industrial is well positioned with rents down in 2009, but up in 2010 and 2011,” he says.

“Supply of industrial is very constrained, especially due to the tight funding conditions and this has led to increased rents. As container traffic increases through the ports, industrial take-up goes up with it.”

As extensively reported in the media, the outlook for residential property is less upbeat. “Residential has hit a plateau and come back a bit, largely due to interest rates,” Stacker explains.

The other struggling sector is retail property. “The weakest sector is retail as there is some hesitation on retail sales growth due to questions about the strength of the economy,” Atchison says.

Property funds restructure

With the outlook picking up, the direct property sector is determined to put its GFC disasters behind it.

“In 2007 there were about 30 managers doing unlisted property, but most of these have been shaken out, as they were often not property companies,” Huljich explains.

“There are only really three big groups left now doing direct property.”

Managers are taking a new approach and Stacker believes the sector has learnt its lesson. “It is time for financial planners to take a fresh look,” he says.

“The sector has changed a lot from the pre-GFC period. Investment mandates are very tight and property yields are around 8 per cent, which is better than at the bank.”

The suspension of redemptions has resulted in fund changes. “Exit mechanisms are now very clear and this should provide investors with greater confidence,” Stacker says.

Atchison agrees funds are evolving and points to their lower gearing levels. “The lesson from the last few years is there is a level of gearing that is detrimental to investors. The crash showed a 60-70 per cent level of gearing is excessive,” he says.

Managers have acknowledged this problem, according to Stacker. “The lesson from the frozen funds is not to be over-geared,” he explains.

“Our funds are geared at 35-45 per cent, which is now a lot lower than the sector before the crisis, where some managers were at 65-75 per cent. As the cycle moves up, we want to be less geared and have gearing fall naturally.”

There are also new controls on underlying fund assets. “Investment mandates are very tight on what the manager can invest in,” Stacker explains.

Huljich agrees managers are listening closely to investors. After Centuria replaced the existing manager of several of the Becton funds, it introduced a series of changes, including a lowering hurdle to replace the manager, removal of all ‘poison pill’ provisions, new performance fee structures and fund terms, and improved investor transparency and communication.

The changes have been very well received by planning groups, he says. “These five initiatives have got us a lot of traction and we have recently received the largest single equity placement from a single planning we have ever had.”

Going direct or not?

While interest may be picking up, many investors seem wary about returning to listed property trusts (LPTs) and real estate investment trusts (REITs).

The March 2011 Multiport SMSF Investment Patterns Survey showed direct property allocations by Self Managed Super Funds (SMSFs) increased over previous quarters to reach 13.7 per cent. However, allocations to listed property, managed funds and syndicates continued to decline, with investments down to 2.4 per cent at 31 March 2011.

Many in direct property argue the GFC provided a clear demonstration listed property performs more like equity than a true property investment.

“The definition of property has crystallised, with the difference between direct property and LPTs becoming very clear after the GFC,” Huljich says.

He argues LPTs and direct property perform quite differently, with direct property performing better. Over the past year, the Property Council of Australia/IDP Property Index recorded a total return of 10.4 per cent for the year ending March 2011. This consisted of a 7.5 per cent income return and a 2.7 per cent capital return. The S&P/ASX 200 Australian Real Estate Investment Trusts (A-REIT) Index returned -0.77 per cent for the same period, while the five-year return to 31 May 2011 was -14.65 per cent.

This different return profile highlights the disparities between the two investment approaches. Huljich says. “The LPT correlation to shares is huge and it is more volatile than direct property.”

He believes the GFC has changed advisers’ views on the use of LPTs in client portfolios. “A couple of the large planning groups are now putting LPTs into their equity allocations and then looking to direct property as a separate asset class.”

Stacker believes unlisted property offers investors many advantages. “Direct property investments are not as volatile as listed property investments. Investors should have more confidence as they are being paid valuations, which are not influenced by equity markets.”

IPD managing director Anthony De Francesco made this point in the May 2011 IDP Property Market Review. He noted the “return profiles for unlisted/direct and listed investment structures are distinctly different, especially over the short-term … This can be evidenced in the steady positive growth exhibited in unlisted/direct property in the recovery phase of the GFC post-June 2010, compared to the variation experienced in annualised A-REIT returns, moving from 20.4 per cent in June 2010 to 5 per cent in March 2011.”