Property Income Fund
Spotlight Series – October 2022

Australian Unity
Real Wellbeing

Have A-REIT risks been overblown?

Another listed property (A-REIT) reporting season has come and gone. In financial Year 2022, a period defined by rising inflation, it is no surprise that **hedging levels** and the **impact of rising rates across the listed market** were hot topics for investors.

Against a backdrop of monthly interest rate rises, this calendar year Australia's A-REIT sector has sold off approximately 28%, as at 30 September 2022.

Market confidence is low, and we can see why when we look at fixed income yields. The 10-year Australian Government bond, used by investors as a proxy to measure relative value between assets, has lifted significantly, from 1.65% to 3.88% over the calendar year, while three-year Australian interest rate swaps are trading at circa 4% to 30 September 2022. For investors, this means a higher cost of borrowing, coupled with a potential reset of value across all asset classes.

It is little wonder A-REITs have been adversely impacted, with the market coming to grips with the idea that the days of ultra-cheap financing are behind us. The big question investors must now tackle however, is whether the **deep 28% plus plunge across A-REITs is justified**, or if the **environmental threats and market risks are overblown**?

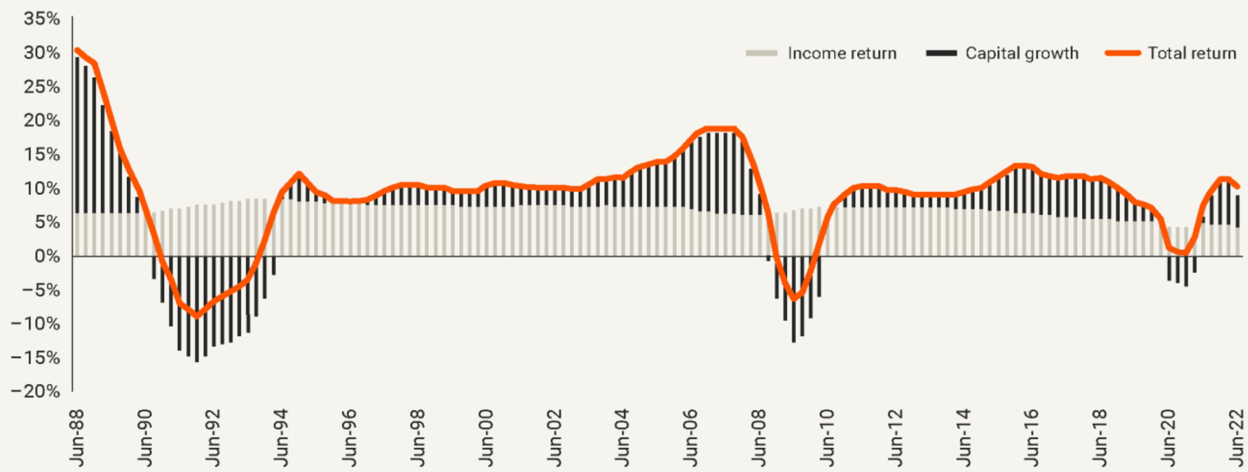
3.88%
10 year Australian Government bond (lifted from **1.65%**)

-28%
A-REIT sector plunge – justified or overblown?

This article explores this question, based on insights from the FY2022 reporting season.

In the lead-up to the GFC, gearing across the A-REIT sector had soared to more than 40%. Meanwhile, the FY22 reporting season showed gearing rests at a more manageable ~24%. Debt maturities have been extended from approximately three years in the pre-GFC years to around five years. So tellingly, debt is still available today and borrowers can still borrow: it just costs more. Rightfully, a key concern though in markets is credit availability, pleasingly most A-REITs appear to have relatively limited refinancing risk (expiries versus liquidity) over the next couple of years. So tellingly, debt is still available today and borrowers (under current conditions at least for now) can still borrow; it just costs more.

Direct property investment returns (Jun 1998 to Jun 2022)



Source: MSCI, Zenith PFA & PCA Property Investment Factsheet 2Q22

FY2022 reporting season showed many A-REITs choosing their own interest rate

In the interesting basket, this reporting season we saw examples of A-REITs essentially choosing their own interest rate, setting a low interest rate of circa 1.5% for debt that might ordinarily cost a lot more in the current environment and paying an upfront balloon payment to the bank for the 'out of the money' component.

This has the effect of preserving earnings and distributions, but essentially reduces cash and/or increases gearing – this sleight of hand works while gearing levels are manageable. What it tells us is interest-cost ratios are less relevant if balance sheets are in good shape, although the earnings quality of this manoeuvre should be perceived as low.

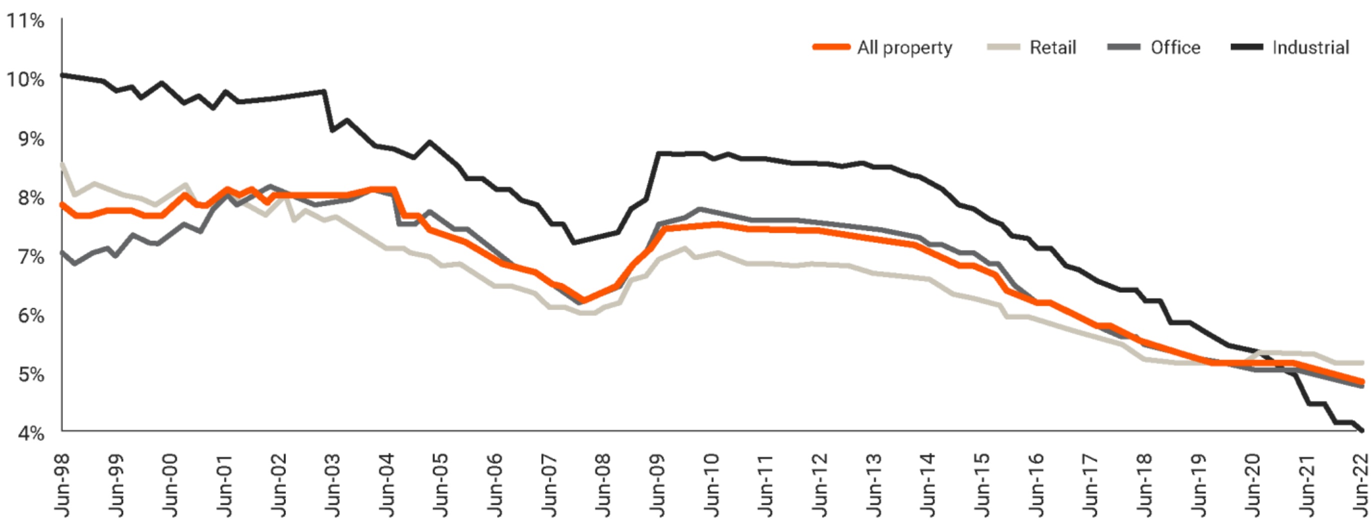
Based on the recent reporting season, asset values are largely holding, though it is important to remember the balance date was several months ago at 30 June. Net Tangible Asset (NTA) backing was generally flat-to-up for most A-REITs, with NTA a good barometer of what the underlying assets are worth at a point in time. The question of where property yields (i.e. asset values) might be headed in a rising interest rate environment really depends on what level of returns investors are expecting to compensate them for the level of risk they are taking in this environment.

The other part to a property valuation equation is the income, i.e. what is happening to rents? It is worth noting most commercial real estate leases provide for annual contractual rent escalations, either indexed to inflation or a fixed amount, acting as a partial hedge against inflation. To put this simply, for valuations to stay flat, rental returns must increase approximately 5% to offset a property yield rise of 25 basis points. Looking beyond contracted rent escalations, the trajectory of rental increases by market is the next lever to consider.

Using the industrial property sector as an example, its yields have re-rated. Before 2018, the sector was seen as the poor cousin of the traditional property sectors, well below in the pecking order when compared to office and retail. Then the pandemic hit. Australians were all forced to stay home while supply chains were being reorganised, logistics and warehousing came to the fore, and even in the strictest lockdowns, industrial tenants continued to operate and pay rent. Coupled with a de minimis amount of industrial vacancy and a dearth of shovel ready zoned industrial land, industrial rents began to rise. Extrapolating out the current low industrial yield signals this – buyers of industrial property have been prepared to pay up to own these assets, on the expectation of super-sized rental growth (which is happening) to flow and theoretically preserve values in the face of rising yields.

Rental growth will benefit asset values to varying degrees and may act as a mitigant (in full or in part) toward upward changes to discount rates and/or property yields. The issue for valuers is transactions, or the lack thereof. For now, a standoff is brewing between buyers and sellers of commercial property, as owners of real estate look toward the pricing of debt settling. And what of a potential recession, at this current rate rise trajectory, will the RBA succeed in quashing inflation? What happens to long term interest rates in this scenario – have they peaked? How high property yields might rise is dependent on these variables. Who will be the marginal buyer and what are the catalysts? A peak in inflation, a Federal Reserve (RBA) pause.

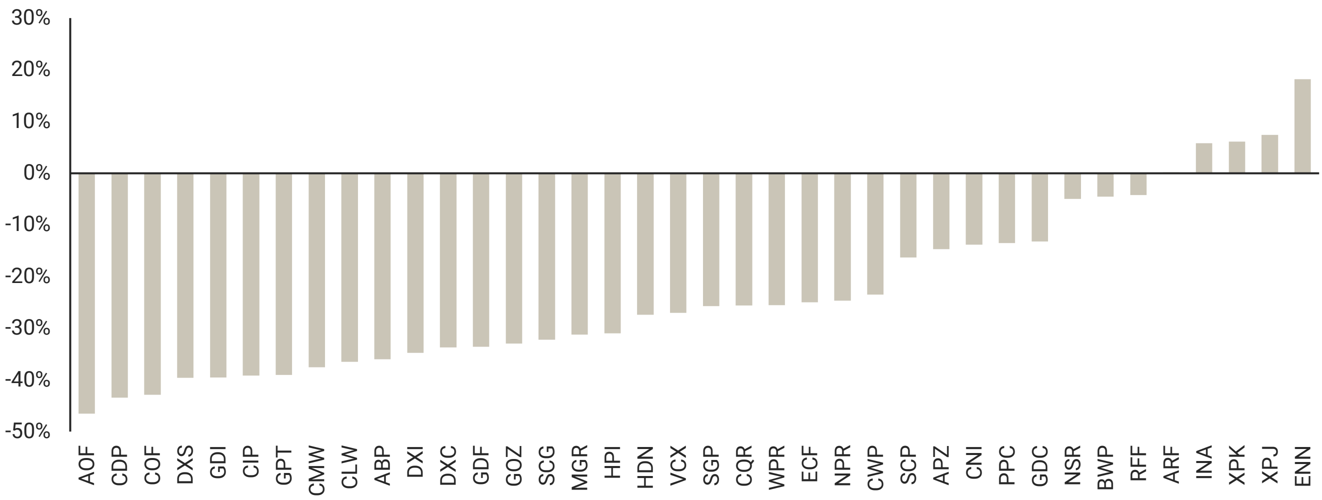
Direct property cap rates per sector (Jun 1998 to Jun 2022)



Source: MSCI, Zenith PFA & PCA Property Investment Factsheet 2Q22

While FY2023 A-REIT earnings guidance is lower than expectations, sector risks may be overblown

Prem. / (disc.) to NTA (%)



Source: Moelis (MA Australia)

Rising interest rates will act as a headwind in the coming periods, as evidenced by A-REIT FY23 earnings guidance being below market expectations. Guidance across the market was negatively impacted approximately 4–5 percentage points, though FY23 earnings per-share (EPS) guidance in absolute terms is positive, anticipated to land in the low to mid-single digits.

Value appears to be emerging, as traditional (or passive) A-REITs are already trading at substantial NTA (Net Tangible Assets) discounts. On this basis, it is possible to conclude that listed property markets may be overreacting. If we assess current prices and back solve implied property yields of the listed property stocks, the market is anticipating property yield expansion of around 25bps to 200bps, equating to property valuation falls of between 5 and 25%. As the chart above illustrates, stock prices are now reflecting substantial discounts to underlying stock NTAs (includes gearing).

The A-REIT sector is trading at a 5% FY23 estimated dividend per share yield and 10% premium to NTA. Or stated another way, a 27% discount to NTA if we focus on the more traditional A-REITs by excluding Goodman Group (a global fund manager and developer) and Charter Hall (a diversified fund manager) from the equation, whose revenues are driven by performance fees, funds management fees and development fees.

The impact from rising interest rates has been well documented and should be less of a surprise to investors going forward. There appears to be enough bad news already baked into current A-REIT prices. Thankfully we are not in GFC territory and maybe – just maybe – it is time to dip the toe back into the listed property sector.

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