# Three big themes from reporting season

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The details emerging from the recent reporting season mask a few important themes, the first of which concerns the retail property market. A few years ago, shopping centres were deemed under threat from online shopping. The most recent results prove that not only is the sector alive but very much kicking.

Of course, not all shopping centres are alike. Investing in best-of-breed centres in prime locations takes advantage of the growth in speciality sales in a way that less attractive centres do not.

Nevertheless, the sector's figures tell the story. With a 99.1% occupancy rate, the retail environment is improving, driven by comparable specialty sales growth of 5.1%. You may have noticed how this figure is reflected in the subtle changes in centres like Westfield's Sydney City and Chadstone in Melbourne. While department stores are shrinking, new specialty chains like Smiggle, Uniqlo and Zara are taking their place.

Conventional retailing is moving from consumption to an experiential-based activity, one defined by an integration of online shopping and the deeper, more engaging experience of shopping in-store. Retailers call this the omni-channel approach and its one that AREIT investors are reaping the benefits.

The second theme is in how this trend is benefiting the sector. From an income perspective, during the 2016 first half period the retail sub sector was the best performing asset class. Net operating income (NOI) growth was up 3.0% while the weighted average capitalisation rate (WACR) of 6.26% was down 25 basis points reflecting improving valuations in the sector.

Specialty store sales growth of 5.1% doesn't just reflect the changing nature of retail, either. With unemployment and interest rates low, consumers are feeling secure in their jobs and reasonably optimistic, spending more on their regular visits to shopping centres as a result. Lower savings rates and petrol prices are adding to the positive sentiment.

The second biggest component to the AREIT sector is also improving. Office assets, primarily in the Sydney and Melbourne markets, enjoyed a comparable net operating income of 1.9%, occupancy of 94.9%, and a WACR of 6.67% (a 30 basis point compression, reflecting improving valuations).

Sydney and Melbourne also enjoy lower levels of sub-lease space (surplus space with existing tenants), a high level of tenant enquiries and fewer new buildings in construction. These are good indicators of a sector performing well, as is the conversion of a number of office assets into residential use. This reduces the total amount of office space, increasing competition for remaining space.

Although industrial sector income growth was the weakest of the main AREIT sectors, it remains attractive, delivering an income return of 6.8% with an average lease term of 4.6 years, net operating income growth and a relatively low vacancy rate of 3.8%. That's impressive in its own right but the diversification this sector offers boosts the argument for the industrial sector's exposure to the AREIT sector.

The same cannot be said for residential property, which continues to attract media attention, and generally not in a good way. Data appears to be pointing to a peak in the value cycle for residential property – particularly in Sydney, the market that had appreciated the most.

From the AREIT market's perspective the two stocks that invest in residential (Stockland and Mirvac) actually reported improved returns and a good outlook. The third big theme is that while it gets a lot of attention, this sector constitutes very little of the overall AREIT market, less than 5% in fact. Except for the potential 'wealth effect' of slowing house price growth, there's little point worrying about a house price property bubble.

So, where does all this leave us?

In a pretty good place. The 2015 first half reporting period delivered earnings growth of 5.3%, driven by rental growth and lower interest rates. That's down from 5.4% in the corresponding half last year but for anyone looking for a reliable income stream, that's an enticing figure.

Asset value increases of around 7% have reduced gearing levels from around 29.5% (debt relative to gross assets) to around 28.5%, meaning the ability of AREITs to service their debts has also increased. Balance sheets look very healthy. Distributions per share (DPS) grew by 2.6% for the period with the sector currently trading on a forecast 4.8% yield for the year. Remove Westfield Corporation from the calculations and that figure increases to 5.1%.

For the analytically inclined, the table on page 2 offers more detail. The bigger picture is that while interest rates have remained low, retail rents have grown and the sector is benefiting from healthier balance sheets and higher consumer spending. For investors looking for a reliable, growing return from a low risk investment, the AREIT sector remains one of the few places they're likely to find it.

| Metric | 1H15 | 1H16 |
|---|---|---|
| Earnings Per Share (EPS) growth | 5.4% | 5.3% |
| Net Tangible Asset (NTA) growth | 4.5% | 5.3% |
| Net Operating Income (NOI) growth | | |
| Office | 1.5% | 1.9% |
| Retail | 2.7% | 3.0% |
| Industrial | 2.3% | 0.7% |
| Occupancy | 97.1% | 97.2% |
| Vacancy rate | 2.9% | 2.9% |
| Cap rate/ (movement) | 7.1% (44bps) | 6.5% (58bps) |
| Gearing | 29.5% | 28.5% |
| Index Return (total) | 12.7% | 7.1% |

Notes:
1 6 months to 31 December 2014 & 2015 metrics reflecting the half year periods.
2 Iress; 12 months to 31 Dec metrics reflecting each calendar year.

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