Property trusts: What could go wrong (Part 1 - Overview)

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Over the past few years just about everything has gone right in the AREIT sector, which is perhaps why advisers are now fielding questions from clients on what might go wrong.

Constantly assessing and managing the downside risk has been one of the keys to APN's long term performance track record so this is fertile territory for our team. Over the coming weeks we're going to share with you some of our risk analysis so that you're informed of the threats and have a strategy to deal with them, regardless of whether they happen or not.

Over the past five years to the end of March 2017, investors in Australian Real Estate Investment Trusts (AREITs) have enjoyed a 16.9% average annual return from the S&P/ASX 200 AREIT index.

Even the 20% fall in the index between early August and mid-November last year was quickly beaten away. Since the recent low on November 15, the index is up around 22%. So, nothing to worry about?

Well, maybe, although that's not really the point. Whether you see them or not, risks are ever present. Successful investing is about recognising and understanding the potential threats and managing them, even if they don't subsequently arise. Recent performance should not blind us to that fact. Just because you can't see something doesn't mean it ceases to exist.

We don't want our investors and advisers to make that mistake, which is why over the next few weeks we're going to assess these key challenges – from retail spending declines and the threat of Amazon to the potential for stretched commercial valuations and the impact of rising interest rates.

Please understand this isn't to scare you. As we made clear in Two words from this reporting season: rest easy, there's no real reason to worry about property trust performance right now.

But as an AREIT fund manager, it's our job to assess where departures from this trajectory might occur, assess their potential impact and, where necessary, manage the risk through our portfolios. As the old saying goes, if you want to capture the upside, first look at the downside. That's what this series is all about.

Let's kick things off by looking at the three areas of investor concern.

1. Retail is undergoing a structural shift

The first is a belief that the commercial retail sector is undergoing a structural shift, and not for the better. The local media has been full of stories recently about struggling or even vacant US shopping malls, the implication being that it is only a matter of time before these conditions hit Australian shores.

This issue has been amplified by the news that Amazon, a company all-too-willing to price competitively in order to gain market share, is about to launch locally. This can't be good news for key anchor tenants like Woolworths, Coles, Harvey Norman and department stores, nor the specialty stores that have driven the profitability of centre owners like Scentre Group. The latest disappointing retail sales figures add to the power of this argument, or so the thinking goes.

That's the first big issue we'll address, explaining why the Australian commercial retail sector is different to the United States and why the arrival of Amazon and the shift to online retailing won't affect major shopping centres anywhere near as much as the media coverage might suggest.

2. Will rising interest rates hit long term returns?

Rising interest rates are another concern. The long term decline in interest rates appears to be over and future rate changes are more likely to be up than down. This, the narrative suggests, will have a material impact on commercial property valuations through lower capitalisation rates – cap rate compression in the lingo. And rising rates will increase the costs of property trusts' debt servicing.

The rationale presupposes that both will feed into lower commercial property valuations and, ultimately, AREIT share prices. That raises the big question: do current valuations account for these risks, in which case there's less reason to worry, or do they ignore them?

Rising rates may also have an adverse impact on the residential property market, an additional cause for concern. With Australian personal debt at world-leading levels, even a small increase in rates could lead to mortgage defaults, perhaps triggering a recession as the wealth effect reduces retail spending and unemployment increases.

With a history of "soft landings" (that is, market corrections that are essentially elongated periods of zero growth rather than large, short term price falls) – the Australian residential market has proven to be a relatively stable market over the long term. Accordingly, we do not expect this worst-case impact to eventuate.

This concern will be the focus of our third article.

3. Will the trend toward flexi-working cause an oversupply of office space?

Finally, to a structural rather than cyclical issue. With the trend toward working from home, hot desking and offshoring, some investors worry that there will soon be an oversupply of commercial office space. Naturally, this would have an impact on AREITs and their investors, which is why we're devoting our fourth article in the series to this issue.

If you're worrying about anything in the AREIT sector, you're probably focussed on at least one of these things. Over the coming weeks, we're going to take each of these issues, examine the evidence relating to the concern and suggest the best way to manage the risk if the concern is warranted which we are actively employing and we believe does not detract from the attractiveness of a well diversified, income-focused commercial property portfolio.

As AREIT portfolio managers this is what we do for a living – we spend a great deal of time looking at the downside and how we can best protect our investors. We're looking forward to sharing our thinking with you.

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