The curious disconnect between listed property and bricks and mortar

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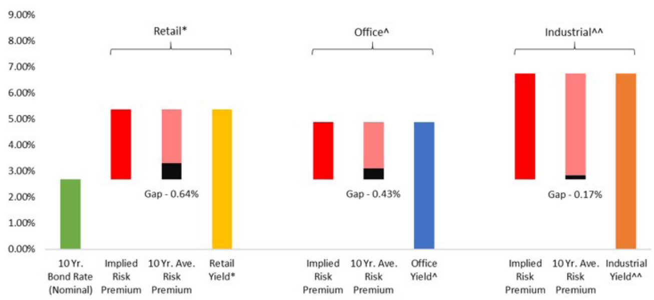
Potential investors in Australian property trusts shouldn't just look at the price of their investment holdings in isolation. The underlying value of the assets and the prospect of strong rental growth underpinning their investment are equally important perhaps even more so especially for income focused investors. This raises an interesting dichotomy. Whilst the S&P/AREIT 200 Accumulation Index was down 6.3% in the financial year to 30 June 2017, high quality commercial property prices in retail, office and industrial sectors are close to or have breached historical highs.

If an asset's value is a function of the income stream it delivers, you'd think the two would line up. And yet for the past year at least, they don't. Why?

Obviously, a variety of characteristics differentiate an investment in a physical property to its listed counterpart, mainly the relative liquidity. But the dichotomy, located at the intersection of risk and return, still exists. Our research team recently set about trying to resolve it.

The graph below shows the difference between the current implied risk premiums (transaction yield minus nominal risk-free interest rate) reflected by market transactions, and the prevailing level over the previous 10-year period. The gap between the two, shown in black for each property type, in particular, captured our interest.

Implied Current Transaction Risk Premiums versus 10 year average



N.B.: The Gap refers to the difference between current transaction yields and the 10 year average risk premium
Source: IRESS, JLL, Bloomberg, APN Funds Management (24-Jul-17)
*Average prime shopping centre yield for Sydney and Melbourne (31-Mar-17)
^Average prime office yield for Sydney and Melbourne (31-Mar-17)
^^ Average prime industrial yield for Sydney and Melbourne

Recent high-quality asset transactions in the retail, office and industrial sectors suggest implied risk premiums remain above historical averages. If an investor were to adopt a simple mean-reversion argument, this implies that there remains some valuation upside.

Essentially, a huge weight of sales evidence (based on billions of dollars' worth of assets 1) tells us that the value of assets held in AREITs are far from over-cooked; in fact, they are likely to increase. This should provide confidence for AREIT investors.

A selection of significant completed and proposed transactions are listed in the table below.

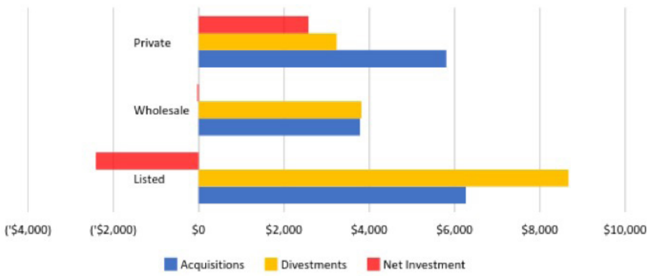
Retail					
Asset Name	Classification	Price $m	Initial Yield	Vendor Profile	Buyer Profile
Westfield Woden	Regional	$335	5.86%	Wholesale	Private
MidCity	CBD Retail	$320	4.60%	Wholesale	Wholesale
World Square SC	CBD Retail	$285	4.70%	Wholesale	Wholesale
Runaway Bay	Sub-Regional	$160	5.60%	AREIT	Private
Office					
Asset Name	Classification	Price $m	Initial Yield	Vendor Profile	Buyer Profile
Investa Portfolio	Various	$2,450	5.47%	Wholesale	Pension/ Sovereign
664 Collins Street Melbourne	A Grade	$276	4.97%	AREIT	Private Equity
Southern Cross Tower	A Grade	$675	5.00%	Wholesale	Private Equity
1 Shelley Street	Prime	$525	4.90%	Wholesale	Private Equity
320 Pitt Street Sydney	A Grade	$275	6.25%	AREIT	Listed Offshore
Industrial					
Asset Name	Location	Price $m	Initial Yield	Vendor Profile	Buyer Profile
GIC Portfolio	National	$1,073	6.10%	Pension/ Sovereign	Listed Offshore
Goodman Portfolio	National	$640	7.40%	AREIT	Fund Manager
Growthpoint Portfolio	National	$142	7.60%	AREIT	Listed Offshore
Australian Red Cross Blood Service	NSW	$113	5.35%	Wholesale	Private Equity

Source: J.P. Morgan, JLL, Colliers, AFR, APN Funds Management

What does this tell us? That AREITs have been active over the last year, taking the opportunity to sell non-core assets into buoyant demand from wholesale and private investors. As long-term investors, we approve of this strategy. Take Growthpoint Properties Australia (ASX.GOZ), for example, an AREIT featured in many of APN's portfolios. It recently sold a portfolio of four industrial assets deemed surplus to portfolio requirements to an offshore investor at an attractive price.

The graph below shows that listed owners have taken the opportunity to offload about $2.6 billion in assets over the last 12 months alone:

Major transactions by Investor Type showing 12-month net position ($b)



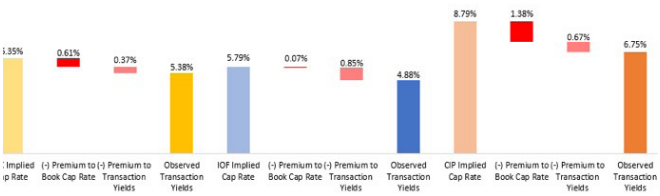
Source: J.P. Morgan, APN Funds Management

For AREIT investors this means two things. First, that AREIT book valuations stand up to scrutiny. If buyers can be found for commercial properties at prices above book value, then those valuations are conservative. Second, as was the case with Growthpoint Properties Australia, further opportunities exist for AREITs to fine tune their portfolios at a time when they can sell at attractive prices. In the long run this should increase the quality of AREIT portfolios overall and drive higher market valuations.

Now, to capitalisation rates. As part of our research we also examined the dynamic between the physical commercial real estate market and the securitised markets to try and establish the embedded (or "implied") capitalisation rate in AREIT share prices. It's a bit technical but worth the effort so please bear with us.

We selected three AREITs (Vicinity Centres (VCX), Investor Office Fund (IOF) and Centuria Industrial REIT (CIP) with a focus on generating passive earnings from rental receipts. We then made a few adjustments to calculate an implied capitalisation rate for each portfolio, comparing this implied rate to that reported in AREIT book values, plus transaction evidence for similar properties. Here are the results of that analysis:

Analysis of Transactions Yields, Book Cap Rates and Implied Cap Rates for Passive AREITs



Source: JLL, Company Data, APN Funds Management (March to July 2017)

In a nutshell, what this suggests is that reported book values and implied capitalisation rates for the types of rent-focused and passive AREITs we favour continue to show discounts to levels prevailing within the capital transactions market.

Together with our investigations into the strength of demand within the direct real estate market, this gives us a high level of comfort regarding the value of the assets held by our AREIT investments generally. To put it another way, if AREITs were valued along the same lines as direct investment in commercial property, share price would probably be higher.

Now, that doesn't mean that gap will necessarily close. But it does mean AREIT investors can take additional comfort in the security of the value of their investments and distributions. It also suggests income-focussed investors can secure an attractive yield at an attractive price because right now, AREIT investors appear to be under-pricing the relative value of this income compared with direct investors in commercial property who are currently most active.

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