The top 5 questions financial advisers are asking right now

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Understandably, financial advisers have been peppering us with questions right now. The mainstream media can't stop writing about how Amazon will kill retailing and, over the past 12 months, the commercial property sector has returned negative 6%[1].

We welcome the cross-examination. A critical and enquiring mind is essential to outperforming fund managers as much as it is to financial advisers helping clients to meet their wealth goals. Here then are the top five questions that we're getting right now:

1. What does the future of retail look like considering the challenge of online shopping and Amazon's entry to Australia?

There's no doubt the retail AREIT market has been spooked by these factors. But it is fear rather than facts that has resulted in the sector currently trading at a 7% discount to our assessed Net Asset Value (and a greater discount based on DCF valuations).

We've written in detail on this topic in our blog but, in a nutshell, we think this is a buying opportunity. Although the sector is facing significant challenges, the facts speak loudly.

First, the fear of the death of conventional retailing is being driven by US experience, which is quite different from elsewhere. The US has more than twice the retail floor space per capita, almost twice the department store space per capita and more than four times the vacancy rate of Australia. The parallel is badly drawn. Australia leads the world in the quality of its shopping centres; the US lags it.

Second, it's a myth that online sales are growing at fever pitch. The evidence suggests the rate of growth in online sales is actually slowing. The Australian Bureau of Statistics (ABS) indicates growth of 4.1% a year while NAB and Quantium estimate it to be about 7.4%. Either way, it's surprisingly small. And the main drivers are media and food, which tend not to compete with bricks and mortar.

In the US, online sales accounted for just 8.3% of total sales in calendar year 2016, remaining steady in the second half. Online sales may peak at less than 10 cents in every dollar spent. That's not something you read in the headlines. Furthermore, only around 6% of US online sales compete with shopping centres, which is likely to be similar to Australia's experience.

Thirdly, conventional stores still work well for products that customers prefer to experience prior to purchase, a lesson not lost on online retailers like Peter Alexander which now has over 100 homewares stores around the country. Amazon recently spent $18 billion on purchasing Wholefoods, a bricks and mortar retailer, and global retailers like H&M, Uniqlo, Apple and Zara are rolling out stores across Australia. Clearly, like Amazon, these leading global brands see a bright future for conventional retailing.

Fourth, shopping centres are transforming into 'experiential' environments. Whether it's eating out, going to the gym, watching a movie or tasting a new Nespresso blend, the aim is to deliver something that cannot be easily replicated online.

Shoppers appear to love the new direction. In the year to December 2015, there were over 80 million visitors to Australia's three largest shopping centres , 3.5 visits for every man, woman and child in the country. Going shopping, gathering to meet, eat and play, is an essential human activity that the Internet cannot replicate. How else to explain low vacancy rates of between 0.5% and 1.0% in the best mall assets, and the heaving crowds?

Finally, our research indicates Amazon is more likely to cannibalise existing online sales than take market share from conventional retailers. Total online sales will grow, albeit at a slowing rate, taking Amazon's proportion of current sales, now modest, perhaps to around half of all online sales. That's more likely to impact online retailers like ASOS, The Iconic and Shoes of Prey than shopping centres and their tenants.

What does all this mean for advisers and their clients? We suggest they avoid "middle ground" assets and focus on "convenience and experience" assets that are well located, face little competition, offer discretionary and non-discretionary goods in an alluring physical environment with an interesting mix of conventional retail, food, beverage and entertainment.

These centres tend to be well diversified with high quality tenancy bases and exceptional management. And if a centre cannot deliver an attractive experience, then it must be perfectly convenient; a place where shoppers go for their regular spend on everyday items because it's either close or there's no other choice.

2. How can REITs continue to increase rents when retailers are complaining they're already too high?

It's a simple question of supply and demand. For every local retailer complaining about high rents there's an international or upcoming local chain ready to take their place. In June last year, Macquarie Equities estimated that international retailers needed an additional 326,000 square metres in the long term to meet this demand. That equates to an additional 1.5 Chadstones.

They're attracted by our growing and wealthy population and lethargic competitive environment. Retailers that haven't responded to the online threat and have grown fat on high margins, or those that compete primarily on price, are ripe for the picking.

Good retail centre managers know this. They may have an incentive to push retail rents as far as possible but not to the point of overburdening the tenant. Generally, rent negotiations strike a balance between what can be afforded by the tenant and what a similar tenant should be able to afford (the market rent).

With retailers queueing up to get into Australia's best shopping centres and supply limited, we expect rents to increase over time. This reporting season, this is one metric we'll be paying close attention to.

3. Can Retail REITS maintain their current distributions?

Yes. We believe retail assets in key AREITs will continue to produce attractive, consistent, lower risk income in the short, medium and long term. Again, we expect the current reporting season to offer more evidence supporting this proposition.

4. Are AREIT assets over-valued and is the market inherently higher risk with cap rates compressing?

We don't think so. In fact, there's plenty of sales evidence (based on billions of dollars worth of property transactions1) that indicates AREIT asset values are more likely to increase than fall. We recently wrote an article about this in our blog.

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. In the long run this should increase the quality of AREIT portfolios overall and drive higher market valuations.

To capitalisation rates; we've examined in depth the dynamic between the actual commercial real estate market and the securitised markets to try and establish the embedded (or "implied") capitalisation rate in AREIT share prices.

We found 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 physical property market.

This, along with strong demand for physical commerical real estate, indicates AREITs are not over-valued. In fact, if AREITs were valued in the same way as direct investment in commercial property, unit prices would probably be higher. That doesn't mean that gap will close but it does suggest AREIT investors can take additional comfort in the security of their distributions. It also suggests income-focussed investors can secure an attractive yield at an attractive price.

5. What about the threat of rising interest rates, their impact on debt levels and the flow on effects?

First, if interest rates rise the sector is well positioned to deal with it. The average AREIT debt term is 5.2 years. That means, on average, only 20% of the debt is refinanced each year. The sector is also less reliant on debt; average gearing is just 29%, sourced from a greater variety of lenders and fewer Australian banks. This demonstrates a risk averse, conservatively managed sector that has learnt the lessons of history.

The sector's average debt hedging, which stands at 64% over five years, means that only 36% of the sector's debt on average is exposed to variable or rising interest rates over the next five years. Again, this dramatically reduces the impact of rising rates. AREITs have positioned themselves to minimise the impact of higher interest rates on the bottom line.

Second, despite the fear of rising rates, people forget just how low they have fallen. Even in the US, where rates have risen lately, they remain well below historical averages. This is good news for the property sector because debt is likely to remain cheap. The current rate incurred by AREITs on their debt averages a modest 4.4%.

Interest rates will rise at some stage but AREIT investors enjoy an additional layer of protection. Many leases stipulate inflation-linked rent increases. As inflation increases so will interest rates, after which landlords can increase their rents to offset the cost of higher rates.

All up, we think the threat of higher rates is limited and even when they do rise, the sector has planned for it. Distributions aren't likely to be affected.

1 The S&P/ASX 300 Property Trust Accumulation Index total 12 month return to 30 June 2017.

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