When a duck is not a duck

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Imagine, just for a moment, that a property trust in which you invest is a duck. I know, it's an odd request, but please bear with me.

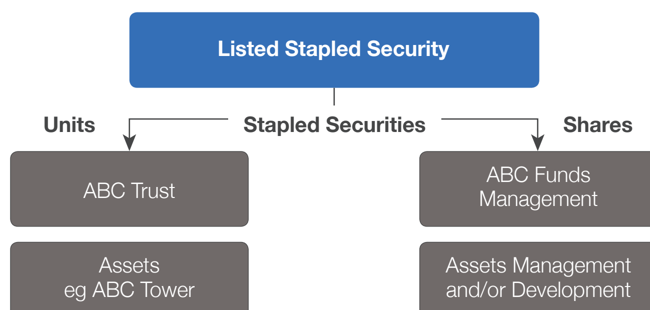
You know it's a duck because it swims and quacks like one. Every quarter you get a nice, juicy dividend, regular as clockwork, from the rents collected from the trust's properties.

Well, that's how it is in most Asian REIT markets where regulations stipulate 70-100% investment into real estate assets (most operate at the top end of this band) with development and other corporate types earnings generally prohibited or capped at low levels.

In Australia, however, there are no such requirements. Unlike most other REIT markets, Australian REITs (AREITs) have more choice in how they generate earnings. The upshot is that while all AREITs look like rent collectors, some generate as much as half of their income from property development, a riskier and more cyclical activity than rent collection.

In some cases – and we'll soon name them – what looks and sounds like a duck above the waterline is a different beast when you look below it.

To explain how, let's look at an AREIT's structure. Most adopt a stapled security format, which entails an investor owning two or more securities bound together through one vehicle. Typically, one is a trust unit that holds the portfolio of property assets, the other a share in a management company that carries out funds management and development-type activities. This is how it looks on paper.



Source: APN January 2018

There's nothing wrong with this structure. It's a legal and sensible way to organise a property trust with a variety of income streams covering rental income, funds management and property development.

The problem is that in our view stapled trusts with higher levels of non-rental income are more risky than traditional trusts. Profits from property developments are lumpy, unpredictable and volatile. Profits from rent collection are quite the opposite, which means the regular dividend you receive from a stapled trust may not be as predictable as you think.

What about funds management, the other primary source of non-rental income? Whilst less volatile than profits from property development, the global financial crisis showed how funds management income can rapidly fall. Panicked investors withdrew their funds, curtailing the income stapled trusts received from their funds management businesses.

To the big question; is the sector over-reliant on non-rental income? Pleasingly, for those seeking stable income (from rents) the duck still largely quacks like a duck. Around 80% of the sector's income comes from rents. It's the remaining 20% that AREIT investors need to worry about.

This is a particular rather than general problem. CharterHall (ASX:CHC), Goodman (ASX:GMG) and Mirvac (ASX:MGR) account for almost 20% of the AREIT Index but their average non-rental income is less than half of their total earnings, as indicated in the table below.

Westfield (ASX:WFD) is another AREIT with high non-rental earnings due to the large retail developments it undertakes. This soon-to-depart ASX-listed stock also generates all its earnings overseas. Goodman also manages and develops the majority of its assets overseas.

AREIT	Index	APN AREIT	Earnings Source			Dividend yield^
			Rent	Non-rent	Offshore	
CHC	2.3%	0.0%	41%	59%	0%	5.4%
GMG	10.6%	3.4%	43%	57%	54%	3.3%
MGR	6.9%	4.2%	61%	39%	0%	4.8%
WDF	14.3%	4.1%	88%	12%	100%	3.6%
Total/ Avg	**34.1%**	**11.7%**	**58%**	**42%**	**39%**	**4.3%**
					Wtd Avg	**3.9%**

Source: APN/Bloomberg – December 17

CharterHall, Goodman, Mirvac and Westfield are ducks that don't quite quack in the way many investors might expect.

APN holds these managers in high regard but whilst these AREITs account for more than a third of the Index, our APN AREIT Fund has a mere 11.7% portfolio allocation to them.

The reason, now you know their earnings components, is obvious. Because our investors want predictable, low risk income from Australian real estate, we tend to avoid too much exposure to AREITs with high levels of overseas and non-rental earnings.

Unlike many of our index-hugging peers, CharterHall, Goodman, Mirvac and Westfield do not and never will dominate APN's portfolios. In fact, APN's AREIT Fund has

40% lower exposure to corporate earnings and 70% lower exposure to offshore earnings than the index. That's the result of our strict mandate and greatly reduced exposure to these four stocks.

There's one final consideration. These four AREITs also feature low dividend yields that dilute distributions. Their weighted average yield of 3.9% is underwhelming, especially given their higher risk profile. In comparison, the APN AREIT Fund currently yields 6.28%[1].

All of which is to say we like ducks that look like ducks above and below the water. For investors seeking higher levels of sustainable income from quality Australian commercial property rents, APN's AREIT Fund does the job swimmingly. Quack.

1. As at 18 January 2017. Current running yield is calculated daily by dividing the annualised distribution rate by the latest entry unit price. Distributions may include a capital gains component. Distributions are not guaranteed and past performance is not an indicator of future returns.

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APN Property Group

A specialist real estate investment manager

We actively invest in, develop and manage real estate and real estate securities on behalf of institutional and retail investors. APN's approach to real estate investment is based on a 'property for income' philosophy.

Established in 1996, APN's listed on the ASX and manages $2.6 billion (as at 30 June 2017) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

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