Property trusts: What could go wrong (Part 4 - Rising rates)

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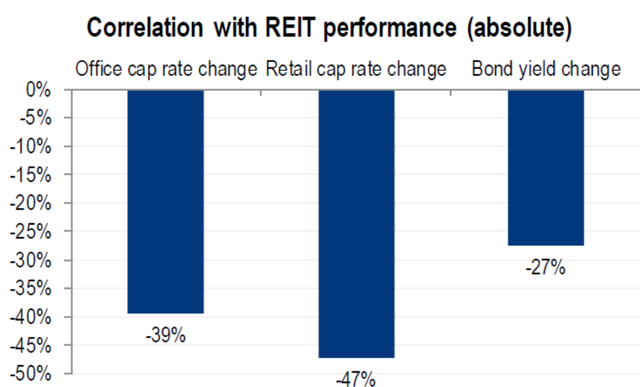
This is the fourth part in our series on "Property trusts: What might go wrong?".

Conventional wisdom holds that interest rates and capitalisation rates move in lock step. Rising interest rates can lead to higher capitalisation rates, which, in turn, lead to lower property values. That, the thinking goes, will have an impact on total commercial real estate returns. That's why property trust investors worry about rising rates.

Maybe they shouldn't be worrying so much. For a few years now, Australian interest rates have been at or near historic lows. In fact, the Reserve Bank cash rate of 1.50% is unchanged since July 2016 with key indicators pointing to minimal change.

Still, as we've seen in the US recently, the interest rate cycle has changed with rates now increasing. For investors in Australian Listed Real Estate Investment Trusts (AREITs) there are three factors that should arrest any concerns when this occurs here:



Source: JLL, RBA, Citi Research. Based on annual observations since Dec-1993.

1. Rising rates do not necessarily lead to lower property performance

On this issue at least, historical data suggests conventional wisdom is misplaced. Higher interest rates do not necessarily result in lower property values and total returns. In fact, property performance has often remained resilient in times of rising rates.

That makes sense when you think about it. If interest rates are rising because of stronger economic growth, higher wages and buoyant consumer demand, as is currently the case in the US, demand for real estate is likely to be growing rather than falling. For AREITs this is great as stronger tenant demand means higher rents.

AREITs' performance over the past year has been more correlated with bond yields than in previous periods (bond yields being a key reference rate for the sector). The markets focus on the yield trade (investing in AREITs to generate higher income as traditional income investments such as bonds are at extremely low yields) being a key driver of this relationship. However recent research from Citi indicates that the bond yield/AREIT performance correlation "is far from stable over time, varying both in strength and direction" (Citi, Jan 27 2017). Their view is that AREIT performance has a stronger relationship to cap rate movements than bond yields over the long term. The following chart highlights the correlations between AREIT performance, cap rates and bonds since 1993. It shows that both retail and office cap rates have a stronger correlation to AREIT performance over the long term hence their view that "the markets focus on bond yields as a driver of REIT performance should moderate over 2017."

This isn't to say that when rates eventually rise in Australia it won't have an effect on property values. But it is far from certain that they will. Moreover, if local rates increase, but remain at or below long-term averages as we expect, commercial real estate would be well positioned to benefit.

2. AREITs well positioned to deal with higher interest costs

On this issue, AREITs and interest rates are inherently linked. Interest costs are one of the largest expenses incurred in running a real estate portfolio that employs debt.

Westfield's gearing ratio (debt to assets), for example, is 37%. The equivalent figure for Stockland is 24%. If a company is using hundreds of millions in debt, the effect of rising rates on its debt servicing costs will be significant.

AREITs have a few tools to manage the risk of spiralling debt costs. The first is good old fashioned common sense, something which wasn't much in evidence prior to the Global Financial Crisis, when average debt tenure was less than three years, gearing was over 40% and domestic banks were their primary lenders.

Now, the average tenure of AREIT debt is 5.2 years, meaning on average only 20% of the debt is refinanced each year. The sector has also become much less reliant on the use of debt with average gearing of 28%, sourced from a greater variety of lenders and fewer Australian banks. These factors demonstrate 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.

These measures highlight the increasing sophistication of debt management across the sector. Much has changed to position AREITs to minimise the impact of higher interest rates on the bottom line.

3. Rates remain low

Despite the fear of rising rates, people forget just how low they have fallen. Even in the US, where rates have ticked up recently, they still remain well below historical averages. This is good news for the property sector because, even after a series of rate hikes, 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 through the landlord-tenant lease. Many leases stipulate inflation-linked rent rises. As inflation increases so will interest rates. Subsequently landlords can increase their rents to offset the cost of higher rates.

These facts aren't to deny the impact of interest rate increases on returns from commercial property. But they do suggest that the fears are somewhat overdone. Property trust managers have been risk averse in using modest levels of debt and have sensibly employed a range of tools to mitigate the risk of rising rates.

Although there's scant evidence that rising rates always impact property valuations, even if rates do rise the sector is well positioned to deal with them.

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Contact us

APN Property Group Limited

Level 30, 101 Collins Street,
Melbourne, Victoria 3000

Investor Services Hotline 1800 996 456
Adviser Services Hotline 1300 027 636

Email apnpg@apngroup.com.au
Website **apngroup.com.au**