Reporting season wrap: Challenging environment, impressive results

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The most recent chance to peek under the bonnet of the Australian Real Estate Investment Trust or Listed Property (AREIT) sector was most welcome, arriving after an eventful 12 months. US voters elected a surprise new leader, US interest rates were increased for the first time since the global financial crisis and, more recently, political tensions in North Korea have grabbed the headlines.

None of the uncertainty provoked by these events was evident in the results. The sector remains primed to deliver the defensive and sustainable income returns on which investors have come to rely.

Balance sheet strength is improving, especially among the stocks in APN's portfolios; property-level operating metrics were impressive; and managers have taken sensible capital management decisions. For us, this was a most satisfying reporting season, with a few fascinating developments.

These impressive results have been delivered in a challenging environment. As the table below shows, economic growth, core inflation and wage growth are now all lower than they were two years ago.

And yet the retail, office and industrial sectors each delivered comparable income growth of between 2-3% to 30 June 2017 whilst maintaining high occupancy levels. This performance, along with capital and investment market dynamics, was reflected in rising AREIT book values.

	Jun-15	June-16	Jun-17
Like-for-like Net Property Income growth (h/h)			
Retail malls	2.7%	2.7%	2.3%
Office	2.7%	4.0%	3.1%
Industrial	2.4%	0.9%	3.2%
Occupancy			
Retail malls	99.6%	99.5%	99.5%
Office	94.0%	95.1%	95.5%
Industrial	96.0%	94.8%	96.6%
Capitalisation rate change (bps p.a.)			
Retail malls	-19	-33	-29
Office	-36	-62	-44
Industrial	-46	-48	-33
Economic indicators			
GCP Growth	2.0%	3.1%	1.8%
Core Inflation rate	2.2%	1.7%	1.8%
Wage Growth	2.3%	2.1%	1.9%

Source: JP Morgan, Trading Economics, APN FM

Seven takeaways from the retail sector

1. The vacancy rates among high quality regional malls was just 0.5%. In the US the comparable figure is 10 times that. This data refutes media narratives that draw a parallel between what's happening in the US and what might occur in Australia. The comparison is erroneous, and the 0.5% figure from this reporting season proves it. There is no retail apocalypse.
2. Like-for-like net property income growth in all three sectors lines up with GDP growth. That's encouraging and also, more pertinently, sustainable. There would be cause for concern if net property income growth were much lower (or higher) than GDP growth, but it isn't.
3. Whilst specialty retail sales moderated from the last period, growth was still achieved. In a low growth environment this demonstrates the resilience of speciality retailers in sectors like technology, appliances and footwear.
4. Landlords are taking advantage of a buoyant commercial property market to offload lower performing property assets while honing their tenant mix. Scentre Group, for example, in the last six months introduced over 100 new tenants to its portfolio. This is evidence of high quality management and their responsiveness to changing retail trends.
5. Shopping centre owners are working more collaboratively with tenants, positioning themselves as partners aiming to maximise sales for mutual benefit. By investing in technology that helps analyse shopper behaviour, for example, the data is then shared with retailers.
6. When Amazon announced it was entering the Australian market, the market reaction was decisive, leading to key retail stocks trading at a discount to their asset backing. This was a great buying opportunity for those that could see through the panic and stick with the facts and a good lesson in the art of opportunistic investing. Scentre Group, for example, is up 5% since reporting its results.
7. Online retail growth is having a far higher adverse impact on secondary retail outlets like high streets and strip malls compared to high quality shopping centres.

Three takeaways from the office sector

1 Sydney and Melbourne still lead the way with dramatically different, and booming, office property markets compared with other capital cities. To 30 June 2017, effective rents were up 25.2% in Sydney and 16.2% in Melbourne (JLL) while Brisbane and Perth remained weak. This was good news for APN's AREIT Fund, which is focused on the Sydney and Melbourne markets.

2 The table above shows that like-for-like net property income growth in the office market was a steady 3.1% in FY17. Due to the term of an office lease (generally 3 to 5 years or more), market-based rent reviews do not happen annually. Thus, the protection a lease provides when rents decline can also limit a landlord's ability to participate in strong rental growth markets. Eventually, tenants will have to pay a market rent and for office landlords these have risen considerably in Sydney and Melbourne.

3 This leads to our final point. Whilst high occupancy levels and long Weighted Average Lease Expiry (WALE) profiles are desirable attributes of commercial property, they're less important when rents are rising. Landlords in Sydney and Melbourne will have to wait before marking their leases to market rents, but it is happening. AREIT investors will eventually get their fair share of rising rents.

Three takeaways from the industrial sector

1. Owners of industrial and logistics assets across the sector were upbeat on the health of their portfolios. Given this segment achieved the highest level of comparable income growth at the asset level, they had good reason to be.
2. Despite subdued economic activity and a rising Australian dollar making life difficult for exporters, industrial logistics tenants servicing e-commerce companies enjoyed increasing demand.
3. Unlike their office landlord counterparts, industrial portfolios, especially those with vacancies in western Sydney, took advantage of rising market rents, leasing available space at market levels.

Whilst the residential sector accounts for only a small part of the AREIT sector, there were a few notable points. Whilst Mirvac and Stockland reported peak market development returns, volumes appear to be moderating, reducing the risk of oversupply. Again, this is good news for AREIT investors, as are the absence of signs of market dislocations in terms of price and settlements.

Let's now look at a few major themes that we think offer advisers and their AREIT-owning clients some additional comfort and security, starting with the very thing that has brought the sector undone in the past.

1. Debt is low (and cheap)

Despite negative stock price performance the AREIT sector has further strengthened balance sheet positions over the past year. Buoyant transaction activity saw net tangible asset (NTA) levels increase by an average of 10%, allowing AREITs to book substantial valuation gains. Meanwhile, AREITs were sensibly offloading lower quality assets at attractive prices, using the proceeds to lower debt.

The result was a further fall in the level of debt held on AREIT balance sheets against the properties they hold. Gearing (the ratio of debt to gross assets) declined to 28.3% (JPM). Since 2009 gearing levels have remained between 28% to 32%. This is a very different, risk-averse sector to the one prior to the GFC.

The sector's weighted average cost of debt meanwhile, sits at a low 4.4% (APN). This was assisted by large-cap AREITs like Dexus Group and Mirvac Group, which managed to reduce their annual cost of debt by 70 and 20 basis points respectively.

The low cost of debt has assisted AREIT income returns but the outlook is helped by the high level of hedging (67% of debt is hedged over the next five years) which will reduce over coming years. With GDP growth low and i nterest rates lower than they've ever been, the expiration of hedging facilities should boost sector earnings and, by extension, distributions.

This reporting season has delivered lower debt, lower servicing costs, higher hedging and higher quality portfolios across the sector. As commercial property fund managers focused on delivering a high quality income stream to our investors, this is exactly what we hoped to see.

2. Share price declines offset by buybacks

No one enjoys share price declines, although after so many years of outperformance, periods of weakness are to be expected. That's been the case in the AREIT sector over the last 12 months or so, driven by the decline in retail AREITs. But this reporting season offered a silver lining; a number of AREITs have announced they will be undertaking share buybacks.

Capital management initiatives like this are a public vote of confidence by AREIT boards in the value of their portfolios. In an environment where earnings growth could easily be driven by debt-funded asset acquisitions, resisting this temptation and opting instead to reward shareholders through buy-backs is reassuring. It gets a big tick from us.

3. Payout ratio changes won't affect distributions

Two AREITs also announced changes to the way they will consider future earnings and distribution payouts. Vicinity Centres announced it will effectively reduce the company's payout ratio. Scentre Group has followed suit, opting instead to retain capital to fund highly accretive developments targeting total returns in excess of 15% pa.

These changes could be viewed as unfavourable, especially for an income focused investor. But they come from the right place. In pursuit of sustainable future earnings growth, they're driven by the desire to preserve and grow shareholder wealth through portfolio growth.

We do not expect these changes to have any impact on future rates of distributions in APN's funds.

Future outlook and two key risks

Reporting season may have met our demanding expectations but nothing in investing is certain. There are two risks that stand out. The first is short term, what economists call a mispricing.

Meanwhile, the political environment is unstable and unpredictable, with tensions over North Korea the most obvious example. The term for this risk is "geopolitical", and in our view, it is not appropriately reflected in asset prices. There is a reasonable chance of price falls in riskier assets like shares if and when it becomes so.

The second risk concerns the modest growth in retail sales. Many commentators put this down to low cost competition from the like of Amazon, and poor retail management. The bigger issue is slow wages growth. Without real wages growth we cannot expect retail sales growth. This is a looming problem worth watching.

Overall, though, the reporting season offered convincing evidence that the AREIT sector remains an attractive option for income-focused investors.

Our expectation is that the sector will deliver earnings growth of 5-6% and a total return of between 11-14% over the next 12 months[1]. We've long been confident that APN Property's AREIT Fund can deliver relatively high levels of income with lower volatility than the market. Despite the sleeper risks, that always present in some form or other, this reporting season only makes us more confident of that position.

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A specialist real estate investment manager

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Established in 1996, APN's listed on the ASX and manages $2.4 billion (as at 31 December 2016) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

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