This was a fantastically dull reporting season

SEPTEMBER 2018

This was a boring reporting season for Australian Real Estate Investment Trusts, and all the better for it. Excitement in this area of the market usually spells trouble.

The sector's total return of 13.2% for the 2018 financial year might get investors a little excited, especially with earnings growth of 3.4%[1] over the period. But the most satisfying aspect was the way things are ticking along exactly as we hoped; with no surprises, improving fundamentals and lower risk. Satisfyingly dull in other words.

The three key takeaways from this reporting season:

1. **Earnings and distributions are going up.** AREIT earnings per share (EPS) increased 3.4% over FY18 with similar growth expected next year. While the extent of this growth was lower than last year, the consistency with next year's forecast is a good sign. FY19 earnings were revised down by analysts, driven by retail AREITs (see below), but with inflation running at about 2%, EPS of 3.4% looks just fine.

2. **Asset values are rising:** Real estate values continue to rise across most commercial asset classes. Net tangible asset values (NTA) were up 9.7%[1] across the sector over the year. The office sector, driven by strong capital appreciation along the eastern seaboard, was the best performing. Industrial assets values also performed well with logistics assets leading the charge.

3. **Debt is coming down:** Gearing (debt to gross asset values) was 25.9% across the sector, 1% lower than a year ago and, according to JPMorgan, the lowest since 1999. AREITs are well positioned to deal with higher interest rates, with average debt terms over 5.5 years. Reliance on bank debt - so detrimental during the GFC - has also been significantly reduced. AREIT investors may be unaware of such progress but it makes their investments appreciably safer.

Let's now look at individual asset classes, starting with retail.

Some retail centres hit harder than others

A stark variation in performance is beginning to emerge in the retail asset class. This won't surprise long term investors in APN's AREIT Fund - we've long held a view that flagship centres will prosper while sub regional malls may suffer. Now the hard facts are emerging due to the current difficult trading conditions.

Low wages growth, declining house prices and rising household expenses (especially in utilities, mortgages and health expenses) aren't conducive to heading to the mall to buy big ticket items. Sub-regional centres and high street retail are bearing the brunt of these headwinds. We don't own High Street retail which is the worst affected.

The weaker performance of these assets was in contrast to flagship centres, which enjoyed good valuation growth. A number of transactions and revaluations occurred at record levels and these centres remain our favoured exposure.

Convenience/Neighbourhood retail was also a bright spot, along with CBD retail which is enjoying a resurgence, driven by tourism and higher inner-city densities. These centres continue to be well supported by shoppers and investors, as do catchment dominating regional centres in our biggest cities and towns.

While retail assets delivered mixed results the sector's income growth closely matched inflation at 2.1% but was down on the 2.8% seen last year. It's not a great environment for retail right now but some areas offer better protection than others.

While income growth slowed, shopping centre productivity (the amount of sales a centre gets per square metre of space) was a bright spot growing by 3.1% over the year. That's a good indication that, as we suspected, Amazon isn't having the impact on bricks and mortar the market thought it might a year or so back. Shopping centre occupancy rates were also stable at 99% indicating landlords aren't seeing this impact either.

Convenience, differentiated products and compelling shopping experiences will keep the foot traffic coming. Reporting season has shown that retail assets lacking these attributes will struggle in this cyclically slow and evolving environment.

The office party continues

The music remains loud and thumping in the Sydney and Melbourne office markets, where vacancy rates are just 4.7% and 5.0% respectively. The result is predictable: extremely strong rent growth of almost 8% in these markets. Without the glut of supply usually associated with such conditions there's every chance rental growth will continue.

It's gratifying that the lessons from the '90's office development boom haven't been forgotten. What landlord could forget an oversupply hump causing >25% vacancy rates leading to rental declines of over 50%.

Income growth of 3.6% for the year was up from 1.4% in FY17. This more tempered growth occurs due to the term of an office lease. With an average lease expiry of five years, around 20% of AREIT office tenants renew their lease each year, the remainder having fixed annual increases. Sydney and Melbourne tenants are paying far higher market rents to remain in their buildings or a new tenant is signed up, providing extra fuel to normal fixed increases across 80% of an AREIT's portfolio. The effect is to smooth out earnings growth, improve its sustainability and shelter investors from the volatility of the business cycle. Very nice.

Industrial a top performer

Industrial income growth and capital returns topped the AREIT sector this reporting season, although the results are skewed by logistics-focused Goodman. The company now has over half its assets offshore and excels at development and managing assets on behalf of investors - less than half of its earnings derive from rent nowadays. Were it listed anywhere other than Australia it wouldn't be classified as a REIT at all.

Goodman is very good at what it does but in our view non-rental (corporate) earnings are higher risk than collecting rent, which is another reason why it won't ever be a big part of our portfolio. Other smaller cap industrial names provide the yield and sustainable income we desire from assets which are all located in Australia. They are also benefitting from strong capital growth due to leasing success and strong buyer demand.

FY18 Reporting Season Metrics		FY17	FY18	FY19
				Forecast
Earnings	Earnings Per Share Growth	5.2%	3.4%	3.5%
	Distributions Per Share Growth	4.8%	3.7%	2.8%
	Net Property Income Growth	2.7%	2.4%	
Debt	Gearing	26.9%	25.9%	Lowest since 1999
	Debt Cost	4.0%	3.9%	
	Hedging	81%	80%	
	Debt Term (Yrs)	5.1	5.8	
Asset values	Cap Rates	5.7%	5.4%	
	Cap Rate Change	(0.4%)	(0.3%)	
	Net Tangible Asset Change	8.2%	9.7%	
Sector Analysis				
Retail	Net Property Income Growth	2.8%	2.1%	
	Occupancy	99%	99%	
	Retail Sales Productivity (per sqm)	$9,984	$10,295	
Office	Net Property Income Growth	3.0%	3.7%	
	Occupancy	96%	95%	
Industrial	Net Property Income Growth	2.6%	3.9%	
	Occupancy	97.1%	98.3%	

Other AREIT milestones

In May we waved goodbye to Westfield and the Lowy family's 58 year[2] involvement in Australian listed retail shopping centres. The impacts of the merger were immediate. On its last day of listing, Westfield Corporation (ASX:WFD) constituted 13.7% of the AREIT300 Index. On the first day of the Unibail CDI listing (ASX:URW), the equivalent figure had declined to 8.4%.

Currently APN has calculated URW as being around 5.4% of the index, the further decline mainly due to offshore holders of the former WFD switching into the European-listed Unbail. We have previously extolled the virtues of Unibail and its long-term track record. At a current distribution yield of 6.5%pa[3], it's a compelling investment opportunity.

From a new opportunity to one that is about to conclude. Investa Office Fund (ASX:IOF) is the gift that is finally giving.

Blackstone made an initial $5.15 offer for IOF on 25 May this year, which we recommended investors reject. In our view the stock was worth a lot more. Updated valuations received in late June resulted in its NTA increasing from $4.95 to $5.48, the key premise of our position. All we needed was a higher offer from Blackstone.

That finally arrived after a shrewd move by Investa management, who introduced Oxford Properties to the bidding table. This has coerced two higher bids from Blackstone, the last being $5.52, with a counter from Oxford at $5.60. As we said in June, "In our view, a figure of at least $5.60 per share would be more reasonable."

Well, we're getting close. With offer pricing now above NTA our investors are getting appropriate compensation for losing the last specialised office AREIT. But a few more cents are always appreciated. Who doesn't like to be right on the money?

In conclusion, the AREIT sector remains in good shape with a solid earnings outlook. Providing investors with secure income and managing risk remains the key focus for AREIT management teams. This is the main attraction of the sector. We look forward to a boring 2019.

1 Source: JPMorgan
2 Westfield Group floated on the ASX in 1960.
3 APN estimate as at 18 Sept 2018.

This article has been prepared by APN Funds Management Limited (ACN 080 674 479, AFSL No. 237500) for general information purposes only and without taking your objectives, financial situation or needs into account. You should consider these matters and read the product disclosure statement (PDS) for each of the funds described in this article in its entirety before you make an investment decision. The PDS contains important information about risks, costs and fees associated with an investment in the relevant fund. For a copy of the PDS and more details about a fund and its performance, visit our website at www.apngroup.com.au.

Visit our Blog to read the latest insights on the market at **http://blog.apngroup.com.au**

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 $2.8 billion (as at 30 June 2018) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

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**