review insights from real estate experts

September 2020

AREIT reporting season wrap Q&A

1. At a high level, what's your overall impression of the quality of results this reporting season?

That's a more complicated question than it sounds. The quality of the disclosure was generally pretty high, which is what we needed given the lack of clarity on rent receipts, provisioning and asset values. The detail around rent receipts and provisioning in particular was useful, along with the relatively high number of independently-valued assets. This built trust and confidence at a time of huge uncertainty. We scored the season highly for transparency.

As for the numbers, retail was poor, office was middling and logistics shone. Most AREITs were unable to give earnings and distribution guidance for the coming year, which is understandable – everything depends on the virus. Hopefully, a progressive lifting of lockdown restrictions will prompt AREIT managers to offer earnings outlooks with more confidence. Until then, forecasting earnings for some AREITs is like playing darts with a blindfold – dangerous and not much fun.

2. What was the biggest surprise?

There were three genuine surprises. First, despite shuttered stores, a depressed housing market and a looming recession, Stockland beat expectations. There was even an uptick in residential development sales activity in June and July, better cash rent collection from its retail portfolio than its peers and an outlook highlighting some great logistics development opportunities. Very impressive.

The resilience of large format retail was also notable. Aventus, a REIT specialising in large format retail in which we have an over-weight position, owns a portfolio inadvertently made for pandemics with tenants dealing in home improvement, office supplies and electronics. These retail segments largely remained open, drawing high foot traffic, with click and collect for those wanting to avoid store visits. Amongst its retail peers, cash rent collection was the highest, with minimal deferrals and abatements.

In the case of Goodman Group, it's been a positive. The scale of the opportunity in its growing global development platform is now even clearer. Goodman has increased its work in progress to capitalise on demand from tenants in the online retail, grocery distribution, logistics and data centre industries. This should lead to higher development earnings and overall portfolio quality growth in the longer term. There's a lot of excitement around this expansion and the pandemic has shown much of it is deserved.

3. What was the biggest disappointment?

You only need to visit a Melbourne shopping centre to see it for yourself. The impact of lockdowns and social distancing has been huge. There isn't an analyst alive that ran a model scenario where footfall all but disappeared. Disappointment doesn't begin to describe it. With tenants unable to pay rent and the introduction of a mandatory code of conduct for rent negotiations – resulting in many of those that could pay flat out refusing to do so – there have been massive impacts on income, tenant sales, valuations, vacancies and holdovers. It's genuinely unprecedented. It's a shame that many retail AREITs were unable to provide earnings or distribution guidance but unsurprising. They hadn't run a scenario with near-zero shoppers, either.

4. What are gearing levels like currently compared to history? Does serviceability appear to be sustainable or do some REITs need to consider deleveraging?

It's less of a worry than people think. Gearing across the sector is currently lower than the historical average and has actually improved over the last six months. On balance, the level of debt used to finance AREIT portfolios is conservative, with greater diversity, tenure and hedging than in the past.

Lower rates have also improved debt servicing ratios. As higher priced debt facilities expire, replaced by those costing less, we'd expect this tailwind to continue. The market expects some AREITs will raise capital to reduce debt but these are stock specific rather than sector concerns. If the outlook for cash collection and asset values deteriorates, asset sales and/or equity might be required but, at this stage, debt isn't a problem for most AREITs.

5. A lot of attention has been turned towards retail REITs this year, particularly with the stage 4 lockdowns in Melbourne forcing most retail to close. How did the result for this subsector compare with expectations?

Expectations for retail REITs were extremely low. These expectations were spot on. The retail sector disappointed in every way we thought it would. Shopping centre portfolios showed the lowest levels of cash rent collection, the largest increases in vacancies and the biggest declines in asset values. As a result, landlords have been forced to make large provisions for rent that is owed but as yet unpaid.

Victoria is the epicentre of the retail sector's problems with the lockdown creating a two-speed economy. But it's important to pick up on the nuances; non-discretionary retail is faring far better than discretionary; some retail is doing fine, with Aventus a good example; the code of conduct will end, as will the pandemic; and when it does footfall will return everywhere, just as it did after the first lockdown and as it is now beyond Victoria. With large anchor tenants, an attractive offer and 16 million people living within 30 minutes of a Westfield shopping centre, Scentre is best positioned for the rebound.

6. On the other hand, Industrial REITs have been in vogue, as most industrial businesses have remained open and demand for warehouses has spiked. Do you think these trends will hold up post-COVID? Has all the good news been priced in?

That depends. Except for some minor pockets of stress from certain SME tenants and those with business exposure to affected industries like hospitality or events, industrial portfolios were largely unaffected.

As for the trends, further growth in online retail will assist logistics while higher inventory levels could drive incremental demand for additional warehouse space. These are favourable ingredients for longer-term rental growth, and something the market is already well aware of. The share prices of stocks like Goodman have quickly recovered and then some, assisted by some recent long-leased industrial assets attracting very tight cap rates. The trends should hold up but the market is assuming such. Whilst growth is generally priced in across the industrial sector there are still a few pockets of value.

7. What do you expect for the year ahead for AREITs? Please break it down by the different subsectors.

In the Office sector, there are cyclical challenges associated with a recessionary environment and depressed business confidence but also structural issues around evolving workplace practises. These will likely weigh on the sector. Listed portfolios with relatively high vacancy rates, fit-for-purpose spaces at an affordable price-point will likely perform better than those with near-term expiry risk and higher rental rates. And our preference is for metropolitan rather than CBD properties, which is why we're overweight Centuria Office and Growthpoint.

Contrary to popular belief, the office is not dead. Many businesses value the enhanced productivity and cultural benefits of having teams physically present. The water-cooler conversation is under-valued and difficult to replace. Nor will everyone be working from home full time. Finally, for various reasons, businesses, governments and bureaucracies need physical office space. Offices may evolve but they will not disappear.

In Retail, the risk is acute, up there with aviation and travel as sectors most exposed to a lengthy shutdown. All would love a vaccine but in the meantime, daily cases in single digits and no lockdowns would certainly help.

Non-discretionary retailers like supermarkets and pharmacies have fared better than discretionary retailers but overall, rent collections for the June half were around 80% of pre-virus figures. Scentre recently announced its numbers on rent collection are trending in the right direction but they have a way to go yet. The quality of its malls gives it a strong hand, the resolution of the dispute with Mosaic Brands an example of its power.

Business model concerns over some retail tenants also cloud the outlook. Whilst landlords generally have the balance sheet strength to endure difficult conditions, they'll be cautious, retaining earnings rather than paying them out as distributions. When a sector is as challenged as retail, everyone wants a larger capital buffer, especially as the values of some assets are also declining.

Of the three major sectors, Industrial has been the top performer. Many shoppers have tried online shopping for the first time and found they liked it. This has accelerated the structural shift, resulting in strong demand for logistics, distribution and data centres. In contrast to retail and office, the outlook in industrial and logistics is strong with capital and rental growth set to continue.

With parents working from home and minding the kids, childcare and pubs have also performed well. I don't have young children, but I can understand parents finding the two a powerful combination.

In residential, we expect transaction volumes to fall and unemployment to rise, raising the possibility of more mortgage defaults. Housing is an extremely important segment of our economy and the Government is likely to do everything in its power to prevent a collapse in employment and asset values, both of which would help protect the banking system.

8. Which two AREITs do you think have best prospects for the year ahead?

APN Property has always prioritised reliability and security of income. That's the attraction of Waypoint REIT. It offers exposure to a defensive portfolio of retail fuel and convenience-based assets, featuring long average lease expiry and extremely secure tenant covenants.

With 99.9% of rent collected in the first half, this is one REIT that hasn't been affected by the pandemic. In fact, Waypoint has upgraded its earnings and distribution guidance, with rental growth across the portfolio thanks to fixed annual increases of 3%. Book valuations also appear to be conservative, which dangles the prospect of capital growth in the years ahead.

The appeal of Charter Hall Retail REIT is its exposure to neighbourhood retail assets anchored by major grocers like Woolworths, Coles and Aldi and its exposure to fuel retail through an ownership interest in a portfolio of service stations leased to BP. Both segments have been unaffected by the pandemic, with these retailers reporting improved turnover, high levels of foot-traffic and no issue with rent collection.

In some cases, tenants have sought abatements, mainly in the form of lease extensions, but in the main didn't require a substantial provision for unpaid rent given management's ability to negotiate outcomes quickly with tenants. With consumers focusing their spending on non-discretionary retail and dining at home, this is one REIT that will prosper, with or without a pandemic.

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