



# Preferential treatment: High income opportunities in global REIT preferred securities

As global REIT specialists, delivering relatively high risk-adjusted, income-based returns to our investors is our priority. My colleague David Kruth recently highlighted how the breadth and depth of North American REIT markets help us to deliver on our income objectives and generate capital growth from types of commercial real estate that aren't readily available, at least to the same extent, in Australia.

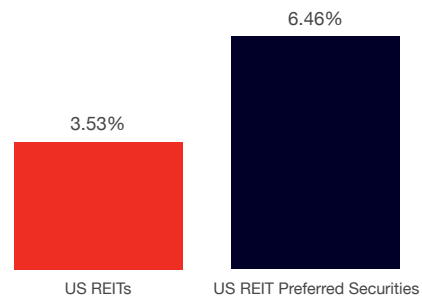
But there's a lesser known but highly compelling component of the REIT capital structure that isn't available in Australia at all.

So-called REIT preferred securities offer a diverse source of funding to REITs in North America especially that help them meet their ongoing capital requirements. They're publicly listed, a cost-efficient source of capital and can be repaid at the time of the REIT's choosing. Whilst preferred securities have many benefits to the issuer, the attractions for investors are equally alluring.

## Benefit #1: Relatively high income compared to common equity

REIT preferred securities typically deliver far higher levels of income yield compared to common equity. As the chart below shows, our analysis suggests that, of the preferred securities we cover, the average yield is ~6.5%, which is about 1.8 times higher than that delivered by US REIT's common equity.

For investors like us, focused on reliable, attractive dividends, that's a meaningful and attractive difference.



Source: Capital IQ, BMO Capital Markets, JP Morgan, APN FM

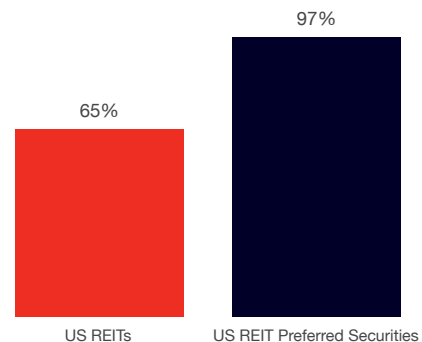
Note: Weighted average by market capitalisation, US REITs universe comprises APN of US carve-out of GPR 250 REIT Index yield, US REIT Preferred universe comprises APN coverage October 2020

## Benefit #2: Reliable income stream

There's little point enjoying relatively high yields if they're unreliable. As the COVID-19 period has proved, just one or two missed payments can play havoc with what was supposed to be a stable income stream.

This is where preferred securities come into their own. As the following chart shows, 97% of the REIT Preferred shareholders received their full dividends through the pandemic versus only 65% of the common shareholders. This is because preferred payments are just that – preferential, which is why they are paid ahead of the common dividends. The chart illustrates how this consistency of payment was true for all property sectors.

Being able to meet distribution commitments during an unprecedented global pandemic which closed shopping centres and offices gives us great confidence in the ability of these securities to meet their distribution commitments to investors.

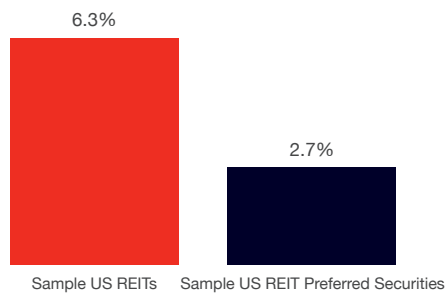


Source: Capital IQ, BMO Capital Markets, JP Morgan, APN FM

Note: Percentage by market capitalisation, US REITs universe comprises JP Morgan coverage, US REIT Preferred universe comprises APN coverage.

## Benefit #3: Resilience through lower volatility

Along with delivering a higher and more stable level of distribution yield, REIT preferred securities have also demonstrated very stable pricing. Our sample analysis suggests that preferred securities have been about 60% less volatile than their common equity counterparts.



Source: Capital IQ, APN FM

Note: Average from a sample of seven REIT preferred securities held by the Fund at inception.

#### Benefit #4: Capacity for price appreciation

Preferred securities also provide opportunities for price appreciation. During the pandemic, we were fortunate to establish our portfolio when many of these securities were trading well below face value. The result is a portfolio with highly defensive attributes and relatively high, risk-adjusted income-based returns. And we still believe there are good opportunities for potential further capital appreciation.

#### Benefit #5: Big opportunity set

Whilst REIT preferred securities are unavailable in Australia, the US market for them is deep and diverse. There are about 100 individual REIT-issued preferred securities in the US with a market capitalisation of A\$25 billion. These cover multi-family residential, manufactured housing, self-storage, office, logistics, health care, discretionary retail, data centre and other sectors. For those interested in stable, relatively high yields, it's an attractive hunting ground.

#### Benefit #6: A niche capital ranking with special features

Preferred securities have a higher ranking within the capital stack. Preferred Shareholders sit right behind the debt and before the common shareholders.

In practice, this means preferred securities, which rank lower than senior debt holders but ahead of equity investors, will receive their distributions after debt holders receive their interest repayments but before any dividends are paid to common shareholders.

And, unlike the dividends from common equity, which can be reduced or cancelled altogether in times of stress, any missed preferred dividend payments are cumulative. Eventually, they must be paid to investors. This is one reason why nearly all of these distributions are paid. And lastly, distributions are paid in fixed quarterly payments.

These six factors explain why preferred securities offer a relatively more reliable source of income than a standard REIT equity investment.

#### Is there a catch?

Preferred securities are one of the ingredients of the secret sauce that makes the APN GREIT portfolio so compelling. The fact that they simply aren't available in Australia only adds to their appeal.

There isn't a catch to preferred securities but they do require some work. None of these benefits, delivered in the form of higher income and capital growth, accrue without diligent investigation and expertise.

As real estate securities investors, we closely examine a REIT's fundamental and financial characteristics before investing. We apply the same process when assessing a preferred security, albeit with a more specialised checklist covering issues like:

- **Call date:** Preferred securities are issued at a face value and are often both perpetual in nature and callable. This means they usually have no stated maturity date but come with call options, typically at the five or 10-year mark, after which time the issuer can redeem them at face value. The call date therefore determines the length of the potential income stream.
- **Call risk:** This should be viewed in the context of total return, in particular whether there is near-term risk of the security being redeemed at par at a time when the security is potentially trading either above or below par value.
- **Fixed charge coverage:** A ratio that expresses how covered the preferred dividend is by the REITs other fixed charges, including debt interest which must be paid before the preferred dividend. The higher the coverage, the more secure the distribution.
- **Size and liquidity:** The ability to appropriately access any investment opportunity as well as actively manage its position is important, especially with preferred securities given their above features.

Examining issues like these informs our assessment of risk, especially around future distribution yield and total return from potential price appreciation. Ultimately, this guides our preferred security investment decision making and position sizing.

The APN Global REIT Income Fund, currently yielding 4.24%<sup>1</sup>, has about a 12% allocation to US REIT preferred securities. All positions are optimised to provide relatively defensive income-based returns together with the potential for attractive levels of capital growth.

Our ability to invest in REIT preferred securities interlaces nicely with our 'property for income' philosophy but their particular nature and benefits make them compelling to investors in the APN Global REIT Income Fund. It's an exciting area of the global REIT market and one we're happy to have found plenty of attractive opportunities.

We hope this article enlightens you to their unique aspects and investment appeal.

1. As at 15 December 2020. 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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#### **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 \$2.7 billion (as at 30 June 2020) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

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