review insights from real estate experts

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Commercial property lessons from the pandemic, one year in

Around a year ago on now, on 23 March 2020, the S&P/ASX 200 hit a low of 4,402.50 The fall had been precipitous. From its 20 February 2020 peak of 7,197.20 the equities index fell a staggering 2,795 points or 39% in just 22 trading days. The AREIT sector was impacted even more significantly with the S&P/ASX 200 A-REIT index falling 49% over the same period. Markets hate uncertainty, we got that in spades with the Covid 19 global pandemic.

Since then, what we once knew as normal life has taken on new meanings, from hand washing, working from home and face masks to domestic holidays, home gyms and lots of takeaway food. Every area of life has been affected, but perhaps none more so than commercial property.

To help advisers and investors untangle the complexity, we asked our investment team for their standout lessons from the first – and hopefully, last - year of the pandemic.

Pete Morrissey, Chief Executive Officer, Real Estate Securities

After the global financial crisis (GFC) of 2007/2008, the AREIT sector set about getting its house in order. After a period characterised by ambition and excess, REITs were successful in lowering debt, installing more conservative management and focussing on delivering reliable rental returns. They returned to their knitting.

This put the sector in good stead to deal with the impacts of the current pandemic. What was truly surprising was the diversity of those impacts within the sector through the initial stages of Covid 19.

Retail was most severely affected but even here, diversity ruled. Whilst local Westfields and CBD retail centres became ghost towns, those with supermarkets as anchor tenants, or those offering essential services, continued to trade.

As we have seen from the recent half-year results from Coles and Woolworths, many did so very successfully. Mark has more of the detail below, but the pandemic was a boon for some shopping centres and a trial for those with fewer non-discretionary tenants.

Covid 19 drove a wedge between robust non-discretionary retailers and discretionary categories affected by shoppers having to stay home. Discretionary retailers with an omnichannel strategy (stores and online) generally enjoyed massive sales growth, although even here the effects were diverse. Whilst electronics, furniture and homewares shot the lights out, others including entertainment (cinemas), dining and travel floundered.

Realising these impacts early in the pandemic, we repositioned the APN AREIT Fund's portfolio. That proved fortuitous for our investors, although a few further points need to be made.

First, whilst some types of commercial property have flourished and others struggled, the overall resilience of the sector has been impressive. Of course, a 1 in-100-year event required capital raisings but there was no sense of ill-preparedness as there was during the GFC. This is to the sector's credit and reassuring to investors relying on it for their monthly income.

Second, the complexity of the impacts reveals that investing in commercial property isn't as straightforward as it is often made out to be. It is tempting to think of a data centre or warehouse as one might a shopping centre or office block – a building with people and things in it for which rent is charged – but these are very different assets.

The pandemic has proved that. In so doing, it has also proved the value of a business like APN, where analytical subtleties rely on deep dives into the nuts and bolts of commercial property. At the risk of pushing our barrow, the pandemic has proved the value of bread and butter analytical work that we do here every day.

For me, helping our investors navigate this challenging environment was one of the few good things to come from the last year or so.

Mark Mazzarella, Portfolio Manager, Real Estate Securities

My two big lessons stem from Pete's observation about the resilience of grocery-led retail assets. Firstly, income from high quality, long-let, inflation-protected leases from supermarkets has proven to be even more defensive than anyone thought. Whilst everyone has jumped on the industrial sector – an obvious beneficiary of the growth in online sales – this is a point less understood.

As with industrial assets, prime supermarkets have seen yields compress by 50 basis points to around 4.0%. They have also enjoyed 100% rent collection rates, befitting their status as essential infrastructure, often also doubling up as fulfilment centres for online purchases.

My second point concerns the future demand for office space – an unknown at this point – about something that I think we can depend on.

Whilst it is too early to say to what extent people will continue to work from home or return to the office, we can say with a relatively high degree of confidence that demand for data capacity will only increase, regardless of whether people return to the office or not.

Since March, peak downstream internet usage in the U.S. increased by a cumulative 30% while peak upstream internet usage increased by 51.2%. This is a terrifically powerful tailwind for data centre REITs, which will continue to benefit from an increase in data usage globally.

These two insights are driving some of our decisions in the positioning of APN's AREIT Fund and its recently launched APN Global REIT Income Fund.

Corrine Ng, Portfolio Manager, Asian Real Estate Securities

A global pandemic has global consequences. Some of the themes evident in the West were present in Asia. One was the top-down nature of the impacts. The theme for the year was to buy or sell the sector rather than particular companies within it. Despite diverse measures of quality and valuation, the correlation among the winners and losers was high.

Having recognised this early in the pandemic, we increased our exposure to the industrial sector and datacentres, where we have long been overweight. Things played out as we expected, although we perhaps could have weighted our bets even more. In Japan, for example, we only ever owned one of the large-cap industrial stocks but should have bought both.

The impacts on Asian retail, despite Asia generally dealing with the pandemic very effectively, were also similar to the west. Regardless of how defensive you thought the retail you owned - and our retail exposure, focused on local, domestic shoppers rather than tourists - was very defensive. Even so, their share prices underperformed. In hindsight, we could have taken a little more off the table and gone into the winners a little more heavily. As Pete notes, an ebbing tide takes every stock down.

As for the big lesson, I think the pandemic has demonstrated the maturity and competence of the region that many western investors previously failed to appreciate, a point indicated by the financial performance of the REIT sectors in the region.

In October 2020, the Global Health Security Index[1] ranked 195 countries on their pandemic preparedness. The United States and the United Kingdom occupied the top two positions. The APN Asian REIT Fund's principal markets of Japan, Singapore and Hong Kong were ranked 21, 24 and 30 (as part of China) respectively.

The real-world impact of the pandemic on particular countries was the inverse of what this report expected. Whilst the Asian region generally managed to control the outbreaks with shorter periods of 'lockdowns', the US and UK struggled. Through the second half of 2020, life returned to 'relatively normal' in parts of Asia. Economic activity resumed with confidence, and this was reflected in the dividends Asian REITs continued to deliver.

Whilst many REITs globally either dramatically cut dividends or suspended them altogether, among our investment coverage universe of Asian REITs, (about two thirds of all Asian REITs) dividends fell on a weighted average basis by around 1%[2], with many that returned to their pre-pandemic run-rate by the end of the year.

David Kruth, Regional Advisor, North America

Having been the portfolio manager for Goldman's REIT funds during the GFC and now managing the North American component of APN's Global REIT Income Fund during a pandemic, I can categorically say that history does indeed repeat, although to a different tune.

Having endured the GFC, the "muscle memory" our team had developed from that period meant we were wide awake to what was quickly unfolding in North America and elsewhere.

Speed and experience were vital in understanding the potential impact on various sectors and stocks. The situation also demanded flexibility. Through incorporating the most recent information, often updated daily, we were able to quickly change direction.

The key was to avoid getting stuck on what had been. Instead, we looked forward and tried to anticipate what was to come. Speed, experience and flexibility were central to successfully reaching that objective.

We undertook company-by-company analyses on the expected impact on rents and cash flows, and how that would flow through the capital stack and dividends. The ability to make quick decisions on the portfolio based on this approach was key to navigating the pandemic.

The result was a rapid pivot, towards companies that would most likely benefit from changes in consumer behaviour. We increased our exposure to industrial, data centres, mobile towers and health care and away from sectors likely to suffer, including hotels, mortgage REITs, CBD office and retail.

Having witnessed their stability during the GFC, we also built a portfolio of preferred securities (see Preferential treatment: high-income opportunities in global REIT preferred securities). Our 'preferreds' exposure grew from nothing to 16% of the portfolio at the peak of the pandemic. Offering stability, high yields and deep discounts, these investments were our ports in the storm.

This process of constant tweaking hasn't abated. The year-long Covid 19 journey has required a constant re-evaluation of the investment portfolio as the US and Canada moved through the pandemic. As we saw the exit ramp approaching, the portfolio has once again changed. With stability and growth re-emerging, we have added to our positions in "reopening" sectors such as retail and away from our preferreds.

Again and again; speed, flexibility, evaluation and teamwork have shown their worth. We're pleased to have navigated this difficult period and look forward to future opportunities.

1. https://www.ghsindex.org/
2. APN Property Group

Source: https://www.ncta.com/COVIDdashboard

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Established in 1996, APN's listed on the ASX and manages $2.9 billion (as at 31 December 2020) of real estate and real estate securities. APN trades on the ASX under the code 'APD'.

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