Seven key takeaways from AREIT reporting season

The February 2021 AREIT reporting season was eagerly anticipated. After the initial Covid 19 shock last March, which hit the FY20 reporting season, investors were keen to see how the sector landed as we emerged from the pandemic.

More smoothly than might have been expected six months ago is the answer. With impressive improvements in cash (rent) collection and distributions, the numbers were ahead of expectations. So too was guidance for the 2021 financial year.

After the stupendous wobbles of this time last year, the impacts of Covid 19 are finally subsiding, clearing a path forward. This reporting season proved that the AREIT sector will be okay.

Unfortunately, that message got lost amid the noise of rising bond yields, up 76 basis points in February alone. This resulted in AREITs underperforming the broader market by 4%[1].

This doesn't worry us. In fact, it can be a source of opportunity. The key takeaways from this critical reporting season are of far more importance to us and commercial property investors than monthly sector performance:

1. Rent collection is improving fast

With lockdowns rolled back, retail rent collection rates rebounded with around 90% collected and, in some instances, over 100% as landlords received payment for rent deferrals. At -8.5%, releasing spreads did further deteriorate (-4.8% in June 2020) as rents were reduced to more sustainable levels. Will this trend continue? It's impossible to say but retailers are posting record profits thanks to high savings rates and a buoyant consumer sentiment.

To remain prudent and conserve cash despite improvements in operating cashflow, the retail sector delivered lower payout ratios, although these should increase once the recovery is complete. Future distribution growth awaits. All up, retail landlords now face a less treacherous path to negotiate than through the depths of the pandemic-induced crisis.

Office rent collection was in the mid-90% range, primarily due to the closure of retail tenancies. Industrial was again the stand-out at close to 100%. High rent collection means more predictable income for investors. This is what AREITs delivered, with almost all now providing earnings and distribution guidance.

2. Shoppers are returning

A recent UBS[2] survey showed consumer intentions to visit a Westfield centre are at their highest level for the past six quarters. Apparently, shoppers still value the experience of going to the mall. As investor and consumer confidence recovered, the retail sector was the best performer in February, up 3.7%[3]. Bricks and mortar retail isn't dead after all.

3. The office sector is struggling

While leasing bounced back strongly in the last quarter of 2020 as lockdown limitations diminished and tenant inquiry increased, this sector faces headwinds. There was a further decline in occupancy rates (down from 95.2% in June last year to 94.5%)[4] with further declines expected. New supply, higher incentives (effectively a decline in rents) and work-from-home means uncertainty in this sector is greater than anywhere else, at least for 2021.

4. Asset values (generally) held up

The office sector was broadly flat and industrial is flying, however retail remained weak, though the decline was minimal, suggesting a pause in the valuation cycle as tenant profitability improved. Industrial assets saw further cap rate compression (assets values increasing) with strong investor demand and limited new supply driving another leg of value growth in 2021. In Sydney, prime industrial cap rates are now lower than office and retail assets.

In retail, some sectors are struggling more than others. In 2020, larger malls and CBD assets suffered declines in value while large format and neighbourhood centres, along with stand-alone supermarkets were keenly sought by investors seeking growing cashflows from high quality tenants with long leases. These trends reflected valuers' concerns regarding the short and longer-term impact of Covid 19.

Service stations also performed well, with transaction activity hitting record levels in 2020. You can understand why. Who wouldn't want earnings certainty, quality tenant covenants and long lease terms in this environment? There are still opportunities though. The gap between the cap rates in the two listed service station landlords (APN Convenience Retail Fund REIT and Waypoint REIT) and their market pricing is a positive sign for both. Other sectors more resilient to Covid 19, including childcare, healthcare and primary production (farms) also enjoyed higher valuations.

5. Australian interest rates are not about to go up

As expectations of stimulus-induced inflation increase, the market has been pricing possible increases in the cash rate as early as late next year. And yet RBA Governor Philip Lowe has reiterated that this is not an expectation the bank shares. The RBA remains committed to keeping interest rates low even if the Australian economy and GDP recover at a better-than-expected rate. Perhaps the inflation fears are overdone though a shorter-term lift from the stimulus sugar hit is a distinct possibility.

6. Buybacks support attractive valuations

Companies like Dexus Property Group (DXS), with a good balance sheet and trading at a material discount to NTA continued with its buyback program while Growthpoint Properties (GOZ) and GPT Group (GPT) announced them for the first time.

The merits of a buyback can be debated but at significant discounts to NTA they're generally good for earnings and provide a share price floor (subject to significant events!). Buybacks such as these suggest there's still great value in some of the names in the AREIT sector.

7. Funds management earnings more robust than rent

This was one of the biggest surprises of 2020. During the global financial crisis, AREITs with funds management earnings were savaged. In the Covid 19 crisis, they were rewarded while rents were anything but predictable, especially those sourced from retail assets.

A key reason why funds management earnings were more robust through 2020 can be explained by the Government's Leasing Code of Conduct, which restricted landlords from collecting rent from tenants that met certain revenue reduction criteria.

For a period, a tenant's obligation under their lease to make monthly rent payments to their landlord was halted. While there definitely was merit in supporting struggling tenants, the Code's impact was lopsided. REITs owning retail assets incurred a significant financial burden as a greater number of their tenants suffered due to Covid 19. This occurred as other asset classes such as industrial, thrived due to the lockdown/s.

Wrap-up

Compared with the last reporting period, this season's results make things a lot clearer. The AREIT sector is emerging from Covid 19 not unscathed, but in solid shape.

In retrospect, the market lows of March last year were a massive over-reaction, although none of us had any way of knowing that at the time. AREIT earnings of all types did not vanish after all, something I would have anticipated were it not for the fact I couldn't access the crystal ball on my desk because I was locked out of the office.

More seriously, this reporting season highlights the quick and tough decisions made by AREIT management teams under significant duress. Those decisions ensured their survival and a platform to recover.

What else can we conclude? The chatter about the pandemic accelerating online sales, with several years growth compressed into a few months, is correct. Whether this is a permanent shift remains to be seen but we can say with confidence that, while the rug was pulled from under the retail sector, this has been a golden era for industrial real estate.

The period has also proved that not all retail is created equal. Success stories such as supermarkets will be unable to maintain their sales growth at lockdown levels. Real estate is a cyclical game and last year's losers may well become this year's market darling. With discretionary sales recovering and consumers keen to get out from behind their screens, large mall landlords such as Scentre Group and Vicinity are seen as real long-term value opportunities.

Returning 31% and 16% respectively over the past six months[5] shows that the market has identified this opportunity and that the worst is behind them. However, with both trading at around 20% discounts to NTA, even factoring in further valuation declines, there is significant gap between their share price and their underlying post-pandemic value.

We're now heading back towards normality with investors confident about the speed of the recovery. Cashed-up consumers are desperate to get out and spend, the prospect of international travel, immigration and even students returning to Australia is now a real possibility which should prolong the stimulus sugar hit beyond 2021. A post-pandemic era of sustained growth for all classes of real estate may soon be upon us. It's a great time to sit back and collect a 5.94% p.a.[6] yield and watch it all unfold.

1. Source: UBS
2. Source: UBS Consumer Survey Q1 2021
3. Source: Bloomberg
4. Source: JP Morgan
5. Total return for six months to 28 February 2021.
6. As at 22 March 2021. 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. Past performance is not an indicator of future returns.

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