

A-REIT Sector

Going Through Change Again!

INSIGHTS

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Pulses are racing as corporate activity heats up in the A-REIT sector. Just when everyone thought the number of trusts was only going one-way – down, Westfield announced they were splitting into two – Westfield Group and creating a new listed vehicle to be called Westfield Retail Trust.

The Lowy's are masters of reading the market and adapting to change. In the past 50 years, Westfield has re-invented itself on numerous occasions. In 1979, Westfield spun-off Westfield Trust into a separately listed vehicle and generated enormous upside to its shareholders. In 2004, they remerged into one entity, which Frank Lowy said at the time was "to provide a management and capital structure with improved scale, competitive advantage and access to capital to pursue opportunities globally". The success of Westfield in pursuing global growth is the envy of not just the A-REIT sector but corporate Australia en masse.

In 2010 Westfield are going almost 180 degrees and spinning out part of the business. The current proposal involves spinning-off half of its Australian and New Zealand assets (bar two) from the Westfield Group into a A-REIT managed by Westfield with approximately \$12bn of assets and gearing between 9 and 24% depending on the success of the capital raising to assist in funding the new entity.

I still remember the day - 22 April 2004 - when Westfield announced the merger of their three vehicles (Westfield Holdings, Westfield Trust and Westfield America Trust) to create the Westfield juggernaut. The A-REIT sector went into a frenzy as investors dumped A-REIT stocks across the board to free-up cash to take-up the new Westfield Group securities.

For active managers of A-REIT securities funds, the new look Westfield was a nightmare. Investors began questioning why they should pay active management fees to a manager to select A-REIT securities that could outperform the Index when 50% of the Index was made up of one stock – Westfield Group - and more than 75% of the Index was concentrated in just 5 stocks.

Active REIT securities managers and direct investors should be more than happy with this latest change. Westfield Group will now comprise around 27% of the Index and the Westfield Retail Trust will be a new addition at around 13% of the Index. The timing couldn't have been better as the sector has recently lost the Mirvac Real Estate Investment Trust and the Westpac Office Trust both to the Mirvac Group. Depending on the final proposal put to unitholders, the Goodman Group with the help of a few very powerful and cashed-up pension/sovereign wealth funds – China Investment Corporation, Canadian Pension Plan Investment Board and APG (a Dutch pension fund) - are set to take the ING Industrial Fund private. The other four ING managed A-REITs are now all up for grabs as well.

The A-REIT sector has seen three distinct phases of consolidation in the past 10 years so it's not new:

- ◆ 2000 – 2003: A-REITs merged to get scale – Paladin Commercial with Deutsche Commercial and Paladin Industrial with Deutsche Industrial or internally managed vehicles acquiring externally managed vehicles – Stockland's raid on both the AMP Diversified Fund and Flinders Industrial Trust, and Investa Property Group's take-over of the Principal Office Trust.

- ◆ 2004 – The rise of stapled securities – where externally managed vehicles merged with their management companies to create A-REIT stapled securities – Goodman, Dexu (the Deutsche vehicles) and Westfield.
- ◆ 2007 – Public goes private – three major listed vehicles went private – Brookfield took Multiplex private, Morgan Stanley acquired Investa and Prologis acquired Macquarie Prologis.

An active capital market also creates opportunities for new vehicles and a greater choice for investors. Between 1993 and 2000 a number of unlisted trusts went from the private to the public markets and between 2003 and 2007 we witnessed a number of IPO's, particularly vehicles that owned offshore assets such as Mirvac Industrial Trust (US), Galileo Japan Trust (Asia) and APN European Retail Fund (Europe) and new stapled securities like Valad, Cromwell and Multiplex. So going forward, new vehicles will emerge but don't expect the sector to offer the same degree of choice as in 1999 when there were more than 60 A-REIT vehicles.

At least the Westfield deal will offer investors a choice between the more passive, income focused Westfield Retail Trust and the more active, development orientated Westfield Group. One of the criticisms in recent years of the A-REIT sector has been the increased risk-profile of many of the A-REITs, particularly those with a stapled security structure where a company and trust are stapled together. Invariably the exposure to active earnings from development and funds management activities in the company dilutes the 'lower risk' earnings from the income producing assets.

As Frank Lowy said when announcing the latest Westfield deal "it responds directly to significant market demand for a domestic trust focused on investing in high-quality retail real estate, with conservative gearing and income sourced primarily in Australian dollars".

The market will no doubt put the spot-light on other A-REITs with stapled security structures to see whether they too should follow the Westfield lead and let investors choose how they allocate capital between active and passive earnings depending on their own specific risk appetite.

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