

A-REITs - Reporting Season is Upon Us

INSIGHTS

August 2010

The Australian listed real estate trust (A-REITs) sector reporting season kicks off in earnest this week with the one of the largest REITs in the sector, Stockland, scheduled to report on August 11. Stockland is a bellwether for the sector given both its size (\$9.0bn market cap) and extensive reach across the office, retail and residential sectors.

The past 12 months has seen a significant turnaround in the performance of the A-REIT sector. At the end of June 2010, A-REITs returned 20.3% for the year, a stark contrast to their abysmal 2009 performance when A-REITs lost investors 42.0%. A-REITs comprehensively outperformed equities – 20.3% versus 13.1% in the past year.

Post the GFC, the A-REIT sector has gone back to basics - the larger REITs have recapitalised their balance sheets, lowered their gearing, disposed of non-core assets and reduced their distribution pay-out levels to more sustainable levels.

The A-REIT sector is not without risks. Many of the smaller cap A-REITs have yet to fully re-capitalise their balance sheet and reduce gearing. Some A-REITs like the Galileo Japan Trust and the EDT Retail Trust (formerly known as the Macquarie DDR Trust), and more recently, the Mirvac Industrial Trust (MIX) has issues with debt funding. MIX announced on August 7 that they had defaulted on a US\$123.5m commercial mortgage-backed security (CMBS) loan facility.

UBS recently released a report setting out seven key factors that will drive A-REIT returns during the forthcoming reporting season and over the next six months. Here's a snapshot of what UBS have suggested investors look out for:

1. Earnings – “we see few surprises to FY10 earnings”;
2. Earnings risk in active segments – “the greatest risk lies in the active earnings, and in particular the residential names (Stockland, Mirvac and Australand)”;
3. Office Recovery – “the recovery seems to have been pushed out to the second half of CY11 at the earliest ...we have downgraded our earnings assumptions for office stocks”;
4. Debt – “UBS estimate \$27bn of debt expires over 2010-12...importantlysector leverage has fallen from 39% at its peak to 24% ex WDC”;
5. Asset values – “we therefore expect only very marginal changes in asset values ... the uncertainty of Europe has neutralised any potential for meaningful upside”;
6. Distribution policies – “the sector has now settled with FY10e DPS/EPS payout ratio of 78%, rising marginally to 79% in FY11e” (Note: this is well down from 100% plus payout ratios between 2004 and 2008); and,
7. Real estate retail funds – “the net inflows in the past year indicate a recovering retail investor appetite for property exposure”.

Investors shouldn't expect any significant earnings per share (EPS) or distribution per share (DPS) growth for the FY10 year. The significant dilution from their huge capital raisings in 2009, the lower active earnings stream and the more conservative pay-out ratios have put paid to that. Take for example Stockland - it distributed 45.5c per share in FY08 compared to just 21.8c per share in FY10.

With on-going uncertainty surrounding the global economic outlook and patchy demand in some sectors – like retail – expect management to be extremely cautious on publicly setting specific earnings targets for FY11. The acid test for the sector is whether with the significantly larger capital bases, the A-REITs can generate significant earnings and distribution growth going forward. With an average yield across the sector of 6.1% against a 10 year bond rate of 5.2%, A-REITs are not compelling value unless you take the view earnings growth is going to be strong in FY11 and FY12.

Most A-REITs are still trading at discount to net tangible assets. According to JP Morgan, the A-REIT sector is currently at an 8% (ex Westfield) discount to NTA, although there is wide variation across the individual trusts. This suggests that there is still have some way to go before investors are fully confident that the worst is over and earnings growth gains momentum.

One of the key issues we believe investors need to focus on is A-REIT debt. Whilst A-REIT debt levels may have fallen, as noted above, there is still a significant amount of debt to be re-financed in the next few years and the cost of debt will remain high. How A-REITs manage their debt – duration (length of debt), sources of debt (banks vs corporate bond markets, domestic vs offshore) and the cost of debt (margins, line fees etc) will be a key factor in picking the winners from the losers.

Turning back to the UBS report, they conclude that the re-structuring of A-REITs has reinstated their defensive characteristics and should provide investors with a lower volatility investment relative to general equities.

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