

Listed property securities – have they bottomed?



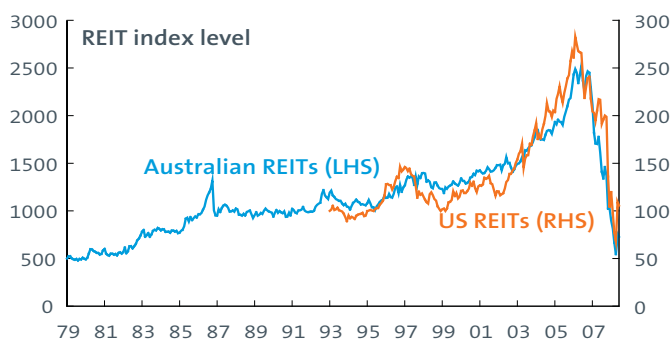
Key points

- Listed property securities are unlikely to soon return to their once exalted status.
- However, they are showing signs of having bottomed. The credit crunch is gradually fading, funding risk is now low and gearing has been reduced. Further, Australian real estate investment trusts (REITs) are trading at a huge discount to net tangible assets and they are offering very high yields. As such they offer attractive medium-term returns, particularly given that Australian REITs are at levels last seen 25 years ago.
- Unlisted non-residential property valuations face further downside. However, the recovery in listed property securities and their recapitalisation is a positive sign.

Introduction

Listed property securities (or REITs), whether in Australia or globally, have been the worst affected asset class throughout the global financial crisis. From their highs in 2007 to their lows in March this year, US REITs had a 77% fall and Australian REITs had a 79% fall. This compares to top to bottom falls in global and Australian equities of around 55%. Thankfully, **with the gradual return to investor confidence, listed property securities are now showing signs of recovery.** In fact they have had very strong gains over the last three months (up 61% in the US and 39% in Australia), but still remain a long way from their previous peaks. In fact, Australian REITs are still trading around levels last seen in 1984!

The 'great' listed property crash of 2007-2009



Source: Thomson Financial, AMP Capital Investors

Listed property securities fall from grace

Until a few years ago, listed property securities had long been a favourite of investors reflecting their high returns, high yields backed by property rental income, their tax transparency and their perceived attractiveness as a highly liquid proxy for directly held property. Many investors saw them as an alternative to cash or government bonds. This enthusiasm was rewarded with very strong returns. For example, over the 20 years to December 2006 Australian REITs returned 13.4% per annum (pa), versus 11.4% pa from Australian equities and 10% pa from Australian bonds. However, rising levels of gearing, increasing offshore exposure, rising exposure to non-property income and industry consolidation led many to start questioning the ongoing attractiveness of Australian listed property trusts about five years ago. Subsequently, 5% or less distribution yields then left them vulnerable going into 2007.

From 2007, listed property securities globally and in Australia started to come under pressure. The sub-prime mortgage crisis turned into a credit crunch making it difficult for highly geared listed property securities to roll over any maturing debt or to offload properties in order to reduce gearing. This turned into a rout in 2008 as the full force of the financial crisis hit and the very existence of some REITs was called into question. Forced cuts to distributions have also accentuated the weakness. Quite clearly, listed property has turned out to be far more risky and its income flow far less stable than had been assumed.

The nearly 80% slump in listed property securities has obviously harmed investor confidence in the asset class. It will be a long time before they retain their once exalted status. The further increase in the concentration of the Australian REIT sector (with Westfield accounting for nearly 50% of the index and just three stocks accounting for 70% of the index) along with the increased offshore exposure of the trusts, also adds to the case for investors to rely more on global listed property securities. Ideally, the Australian sector needs to return to a greater focus on managing properties in less geared, less complex structures. However, notwithstanding these issues, there are good reasons to believe that the worst is behind us and that listed property securities will continue to recover.

Reasons for optimism

There are four main reasons for optimism. **Firstly, the credit crunch is gradually fading.** Credit spreads are narrowing, economic conditions are showing signs of improvement and lender confidence is gradually improving. Over time, all of this should gradually start to ease the financial pressure REITs face. In any case, the major Australian REITs have a very low amount of debt to be rolled over during the next year, and so funding risk is low.

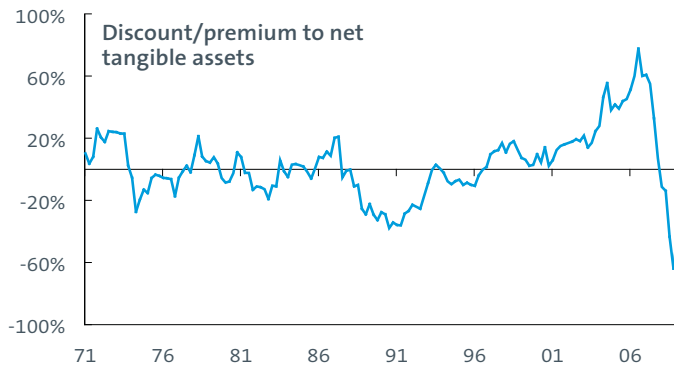
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Secondly, the sector has been able to reduce gearing by raising equity capital. Australian REITs have raised nearly A\$14 billion since September. While this has been concentrated in the big trusts, they cover 90% of the index. As a result, and despite property valuation write downs, gearing has actually fallen to its lowest level in four years on a weighted average basis – from a peak of around 36% early this year to around 31% currently. This has substantially reduced the need for asset sales – forced or otherwise – that was hanging over the whole non-residential property market. This could have had the effect of creating a downwards spiral as it would have placed valuations under more downwards pressure.

Thirdly, while downside exists to underlying property fundamentals and valuations, this is arguably already reflected in listed property security valuations. Despite the rally in the last three months, the Australian REIT sector is still trading on a 49% discount to the value of net tangible assets, which is still close to an historical record.

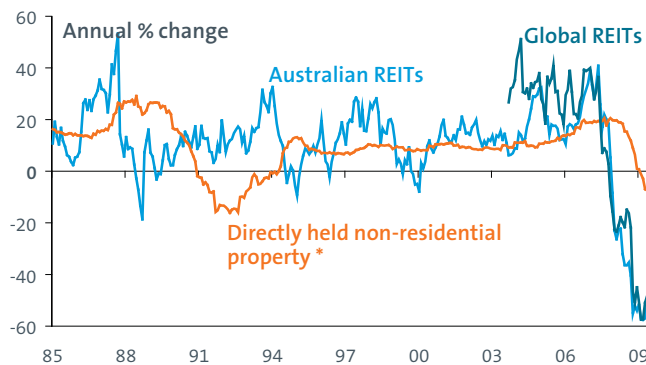
Australian REITs are trading at a big discount to net tangible assets (NTA)



Source: Goldman Sachs JB Were Research

As can be seen in the chart below, movements in the returns from REITs normally lead the returns from directly held non-residential property at extremes. The slump in listed property securities this time around was arguably exaggerated by their relatively much higher gearing coming into this cycle. But the point is that a very big fall in underlying property valuations is already factored into the values of listed property securities.

Non-resident property returns

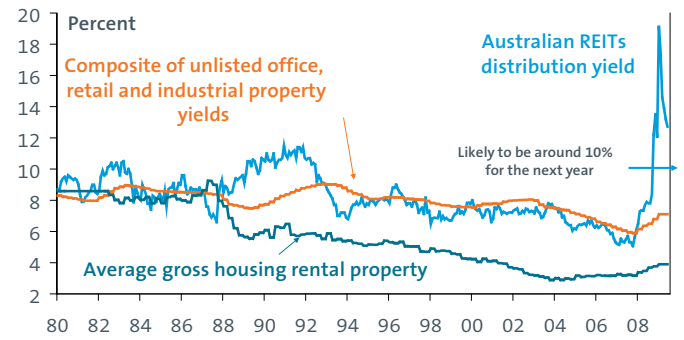


*Direct property comprises AMP Capital's direct property fund and a Mercer survey of unlisted property funds.

Source: Thomson Financial, Mercer Investment Consulting, AMP Capital Investors.

Finally, listed property securities are now offering very attractive distribution yields. While distributions are still being cut and this exaggerates the yield shown in the next chart for Australian REITs, they will probably settle around 10% at current share prices.

Australian listed property yields are very high compared to unlisted property and housing



Source: Thomson Financial, REIA, AMP Capital Investors

This compares with an average 7.1% or so yield now offered by directly held Australian non-residential property and a 4%-5% gross yield offered by directly held residential property. A 10% distribution yield is well above anything seen in the last decade and should help underpin very solid medium-term returns from Australian listed property securities.

Implications for unlisted non-residential property

Australian unlisted non-residential property valuations have started to decline over the last nine months or so in a lagged response to the global financial crisis and the slump in listed property securities. Specifically, the rise in property capitalisation rates and fall in values reflects a number of factors including: the increased cost and reduced availability of debt capital; selling pressure from listed property securities to reduce gearing - brought on by superannuation funds that have seen their direct property weightings rise as listed assets fell in value; and from weaker economic conditions which are resulting in lower rents. To the extent that listed property securities lead direct property valuations, their improvement over the last three months is a positive sign. In particular, the recapitalisation and reduced gearing of the listed property sector has removed a lot of selling pressure that was hanging over the non-residential property market. In fact, now that listed property securities have successfully recapitalised, they may start to become buyers of non-residential property again.

Concluding comments

Listed property securities appear to have turned the corner. Given that they are offering underlying distribution yields of around 10% and are trading at levels last seen 25 years ago (and have therefore largely factored in the likely fall in underlying property values), they are judged to offer pretty attractive returns for the next five to 10 years.

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