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REAL ESTATE OUTLOOK 2016 – POSITIVE RETURNS EXPECTED BUT WILL BE A CHALLENGING YEAR TO DEPLOY CAPITAL

Folkestone is pleased to release its Real Estate Outlook 2016 entitled *Navigating the Road Ahead*. The paper provides an in-depth look at the three real estate sectors – residential, non-residential and A-REITs.

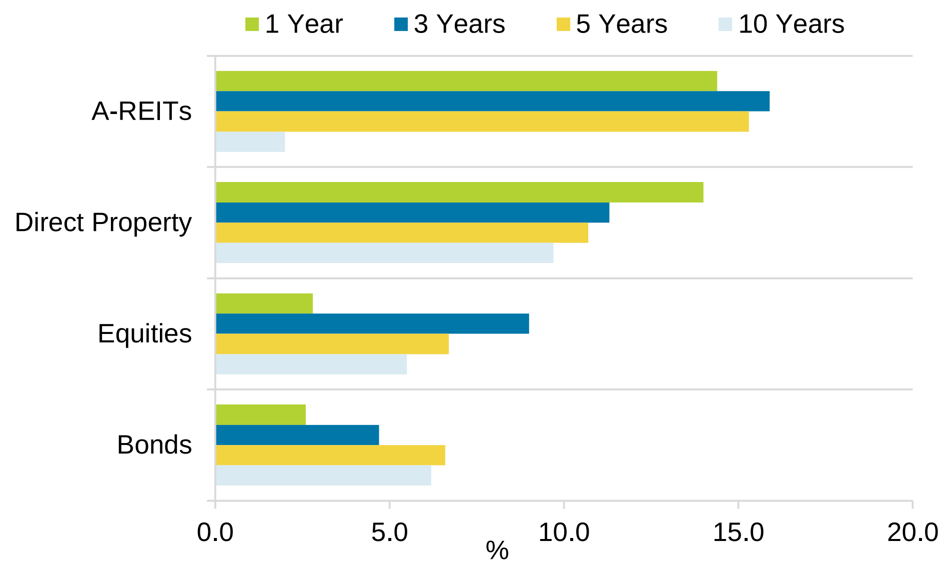
As we enter 2016, investors are now asking the question “which road should I take” – real estate markets have, or are close to, peaking ... or is there more upside in this cycle?

Mr Adrian Harrington, Head of Funds Management, Folkestone said “Since the lows of the GFC, non-residential real estate and listed A-REITs have delivered positive risk-adjusted returns. In fact, A-REITs have been the standout performer over the past five years – taking the title as the best performer in 4 of the past 5 years.”

Over the five years to 31 December 2015, A-REITs have delivered a total return of 15.3 per cent per annum, more than double the 6.7 per cent per annum from equities and 6.6 per cent per annum from bonds and higher than the 10.7 per cent for non-residential property (Figure 1).

In 2015, both listed and direct real estate performed strongly relative to other asset classes. A-REITs delivered a 14.4 per cent total return in 2015, outperforming non-residential property (14.0 per cent), equities (2.8 per cent) and bonds (2.6 per cent) (Figure 1).

Figure 1: Asset Class Total Returns: to 31 December 2015



Source: S&P/ASX, UBS, MSCI/IPD

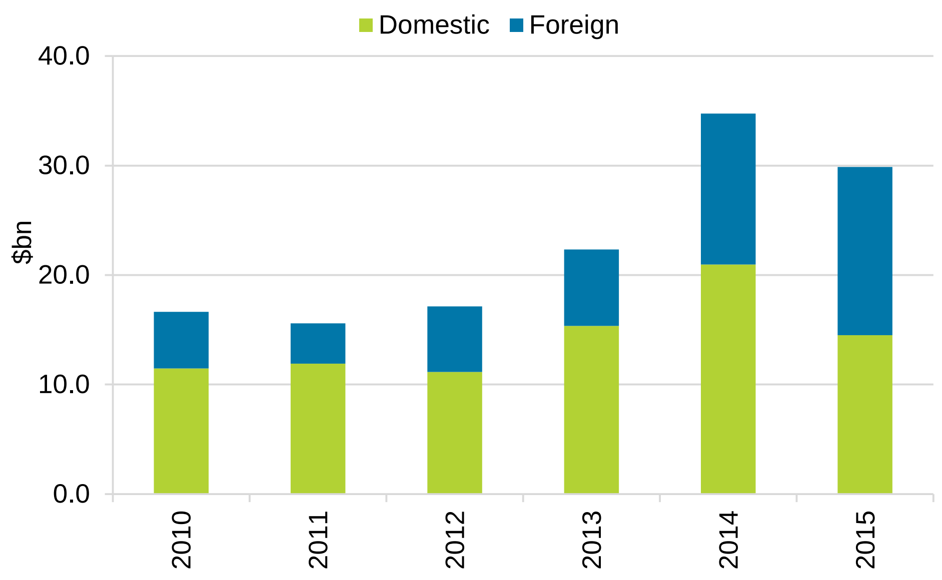
It is not surprising that investors are increasingly questioning “is this as good as it gets?”

Mr Harrington said “At this point, we acknowledge the strong performance of both listed and unlisted sectors in 2015 won’t be repeated to the same extent this year, but we also believe that a major downturn is unlikely in the year ahead. The one caveat on this is if the volatility and negative investor sentiment that has transcended global financial markets in the first two months of this year persists, leading to a major tightening of liquidity in financial markets, then real estate whether listed or unlisted won’t be immune to the fallout.”

Volatility will remain a feature of the 2016 investment landscape. In such an environment, prime real estate with secure income and strong tenant covenants and quality listed A-REITs with quality assets and management will continue to look attractive.

International capital was a feature of the Australian market in 2015 and will also be in 2016. According to Cushman & Wakefield, non-residential transactions topped $29.9 billion, with foreign investors accounting for just over 50 per cent of total transactions by value (Figure 2).

Figure 2: Non-Residential Transaction by Sector: 2009 - 2015



Source: Cushman & Wakefield

A Challenging Year to Deploy Capital

Mr Harrington said “International investors will continue to be active buyers in Australia particularly for prime office, retail and industrial assets making it difficult for local investors who typically have a higher cost of capital to compete. We also see the listed A-REIT market as being attractive to foreign capital in 2016 for much the same reasons as direct real estate.”

Folkestone expects steady real estate demand across most non-residential sectors with the exception of Perth and to a lesser extend Brisbane, which are being impacted by the resource sector downturn. Notwithstanding cap rates are nearing pre-GFC lows given the weight of money chasing real estate assets, capital values for quality assets (i.e. those with strong covenants, long leases and quality locations) will rise in the year ahead, albeit not to the extent recorded in 2015.

The challenge in this environment is to avoid broad “beta” plays on real estate (investing in the hope that the market uplift will drive asset performance) or simply taking greater risk in search of higher (yield) returns.

Mr Harrington said “Given we are close to full valuations in some markets, earnings growth rather than yield compression will be the key driver of value creation going forward.”

“Investors seeking higher returns by taking on more risk may not be rewarded. Instead investors should focus on value-creation through active management of assets via releasing, repositioning or refurbishing. Now is not the time to stretch on price or overcommit to acquisition-driven strategies – maintaining investment discipline will be key. Be disciplined, and be patient. Sometimes being defensive, including raising some extra cash, is actually an offensive move as it creates optionality when the future appears most uncertain. In our view, the next 12 to 24 months could be one of those times.”

Folkestone continues to believe that real estate related social infrastructure (childcare, seniors living, healthcare and student housing) will offer attractive investment returns in the coming year. The demographic drivers and a shortage of quality accommodation in these sectors will see investors increasingly look at these investments as a legitimate part of a real estate portfolio.

Residential Real Estate Not Homogeneous

The residential sector is not homogenous and therefore the prospects for residential will vary across markets and between detached housing and medium density housing. Tighter credit conditions, patches of over supply, lower yields and affordability issues will temper price growth in the Sydney and Melbourne markets - the double digit growth recorded in the past two years is not sustainable. However, Folkestone does not expect these markets to collapse.

Mr Harrington said “The residential market will moderate in 2016, with a slow down in the rate of price growth and construction activity from historical highs. The apartment markets in south Sydney, inner Melbourne and inner Brisbane will come under pressure due to an oversupply of apartments and a slowdown in investor activity.

Folkestone’s preference in the coming 12 months, is well located, residential land offering affordable product in the growth corridors of Melbourne, Sydney and Brisbane, apartments in Sydney around major transport nodes and residential in mixed use developments.

A-REITs Still Look Attractive as a Defensive Play

Mr Winston Sammut, Managing Director of Folkestone Maxim Asset Management and Portfolio Manager of the Folkestone Maxim A-REIT Securities Fund said “the A-REIT sector has generally been disciplined in their capital allocation, focusing on their core investment strategies (and not undertaking risky global expansion plays like they did prior to the GFC), maintaining low leverage, employing sustainable pay-out ratios and growing earnings through active asset management.”

Mr Sammut said “we expect A-REITs to deliver a total return of circa 10 per cent in 2016, underpinned by a dividend yield of 5 per cent. A-REITs present well on yield relative to the cash rate and other ASX listed equity sectors and global REIT markets. We believe A-REITs will continue to be well supported given their relative visible earnings and distribution growth which will be attractive for investors looking for defensive income streams.”

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Mr Sammut said"2016 is shaping up as another year where performance of will vary across both sectors and individual A-REITs. Security selection will be crucial. Despite the overall strong performance of the A-REIT sector we have seen a wide variation in performance and this is a stark reminder to advocates of indexing this sector, that active security selection can add value."

To access the Folkestone 2016 Real Estate Outlook paper, please click here.

For further information contact:

ADRIAN HARRINGTON
Head of Funds Management
Tel (02) 8667 2882

WINSTON SAMMUT
Managing Director Folkestone Maxim
Tel (02) 8667 2825

About Folkestone
Folkestone (ASX:FLK) is an ASX listed real estate funds manager and developer providing real estate wealth solutions. Folkestone's funds management platform, with $964 million under management, offers listed and unlisted real estate funds to private clients and select institutional investors, while its on balance sheet activities focus on value-add and opportunistic (development) real estate investments. www.folkestone.com.au