Investors 'cautioned' over A-REIT returns

Investment trusts There are big differences in quality and performance, writes **Duncan Hughes**.

Big gains from real estate investment trusts could taper off after years of stellar growth if prices begin to look toppy and investors shell out for $3 billion in new REIT issues.

Top-performing property trusts have produced average returns of up to 25 per cent over the past two years, says Folkestone Funds Management, or about eight times fixed-term bank deposits and Australian 10-year bond yields.

"Investors should approach with caution," warns Shane Oliver, head of investment strategy for institutional investor AMP Capital, which has about $160 billion under management.

"Underlying property fundamentals are good and continue to offer relatively attractive yield compared to cash and bonds, but the huge gains of the last few years are unlikely to be repeated."

Oliver expects returns to slip back to about 7 per cent.

Australian real estate investment trusts (A-REITs) posted an average return of about 22 per cent during the 12 months to the end of June, or about 19 per cent more than equities. The trusts aim to provide diversification, income streams and long-term capital growth.

Analysts say the sector has had a Goldilocks period, with falling debt supporting income, lower bond rates backing valuations and defensive income strategies producing rental growth.

It has also been buoyed by takeover activity, rising valuations and strong inflows from offshore investors chasing Australia's relatively high yields.

Adrian Harrington, head of funds management for Folkestone Funds Management, which has more than $1 billion under management, says while most A-REITs are in good shape, there are big differences in quality and performance.

Investors will get some insights into A-REIT managers' outlook for economic growth, capital gains and yield over coming weeks when major A-REITs announce results.

The Reserve Bank of Australia (RBA) has delivered a mixed outlook for growth, with warnings that Melbourne and Sydney office strength was being offset by downturns in the former resource boom capitals, such as Perth and Darwin, where supply was increasing despite falling demand.

"How much of the strong take-up of office space in Sydney and Melbourne – and deterioration in demand for space in Perth – is flowing through to the bottom line?" asks Harrington. "Is the slowdown in retail sales impacting sales growth in centres owned by retail A-REITS? Is the RBA's concern over settlement risk in the apartment market flowing through to the earnings of A-REITs with residential exposure?"

Some nervous investors see parallels with US commercial real estate, where recent strong performance is under pressure from rising volatility, increased regulations, maturing loans and uncertainty about future foreign investment, according to US analysts.

"While there are concerns US commercial property has done its dash, this largely reflects perceptions the US Federal Reserve – which is the US equivalent of the RBA – is further through the interest rate cycle and is raising rates gradually. The RBA is still cutting rates," says Oliver.

The main risk would be a spike in US bond rates, but this is not expected, he says.

A-REITs were standout performers in the lead-up to the global financial crisis before collapsing as fears that the fallout from toxic debt infecting US and European markets would spread to Australia.

Analysts claim this time around the gearing – or borrowing – is much lower, debt terms are longer and balance sheets have been bolstered by diversifying their sources of debt.

S&P Global Ratings recently reported that Asia Pacific real estate investment trusts (which include A-REITs) had "solid business positions and moderate financial positions that would likely hold up in a market downturn".

In a separate report, Moody's Investor Services added A-REITS are managing their balance sheets conservatively, are maintaining healthy liquidity, looking after their core assets and recycling non-core assets.

"The weight of money that has flowed into Australian non-residential real estate is set to continue," says Folkestone's Harrington, who describes Australia as a safe haven delivering attractive returns.

"Strong increases in values over the past few years will moderate but remain positive. But the next year is not one where managers can afford to be passive."

He prefers funds where managers have a proven record of active management with exposure to social infrastructure.

Folkestone has overweight positions in Rural Funds Group, which owns and manages rural properties, Gateway Lifestyles, specialising in over-50s communities, and Asia Pacific Data Centres, which invests in real estate being developed, or used, as data centres.

"I don't have a strong sectoral preference," says Oliver. "We would lean towards office trusts focused on Sydney and Melbourne, though, where the leasing market is strongest and have a bias towards trusts exposed to healthcare given their long leases."

Investors also need to review the quality of the trust's assets, the valuation of the underlying assets and the outlook of the sector in which they operate.

For example, the gap between the best- and worst-performing funds this year in the S&P/ASX300 A-REIT Index was more than 47 per cent.

Rural Funds Group, which manages a portfolio of large horticulture, cropping and poultry farms, returned about 54 per cent for the 12 months to the end of June.

By contrast, National Storage, one of the nation's largest self-storage providers with about 100 storage centres in Australia and New Zealand, returned just 6.5 per cent.

Investor checklist

Questions to ask your A-REIT

Clear investment strategy
Does management follow its investment strategy?

Simple structure
Complicated financial structures increase risk, reduce clarity and add expense.

Fees
Are your interests aligned with that of the management team? Is the performance fee based on a reasonable hurdle? Are there extra fees for raising debt, or are they included in the management fees?

Gearing
Experts generally advise against borrowing higher than 50% in unlisted funds and 30-40% in listed A-REITs. High gearing increases risks in a market downturn.

Asset quality
Do assets have strong tenant covenants and long-term leases? Are they located in good positions and do they have quality cashflows?

Disclosure
You need regular updates on fund performance, assets and strategy to critically assess their management.

SOURCE: FOLKESTONE FUNDS MANAGEMENT

Property power

Top performering A-REITs (% YoY)

Rural Funds Group	53.6
Astro Japan PT	47.3
Generation Healthcare REIT	40.3
Scentre Group	38.0
Arena REIT	37.6
Folkestone Education Trust	34.8
GPT Group	32.2
Dexus Property Group	30.3
Hotel Property Investments	29.0
BWP Trust	24.9
Stockland	21.4
Westfield Corporation	21.0
Vicinity Centres	20.4
Charter Hall Retail	19.5
Charter Hall Group	18.3

SOURCE: FOLKESTONE FUNDS MANAGEMENT

Next year is not one where managers can afford to be passive.
Adrian Harrington, Folkestone