WHY ACTIVE MANAGEMENT OF A-REITS IS KEY IN 2017

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Despite the many uncertainties on the political and economic front, Australian Real Estate Investment Trusts (A-REITs) have not disappointed in the February reporting season. A-REITs either came in line with, or in a number of cases, such as Dexus Property Group (DXS), Mirvac Group (MGR) and Goodman Group (GMG), exceeded our expectations. Net asset values were up driven by further yield compression pushing the underlying real estate values higher. But what has been most pleasing is the sector's earnings stability with a number of A-REITs refining their FY17 earnings guidance to the top end of their ranges. However, despite the relative good performance of most A-REITs, now is not the time for investors who invest through A-REIT securities funds, to be complacent and invest in index funds. We believe that A-REIT securities funds which take an active approach to stock selection are well placed to outperform the Index in the year ahead.

A quick run around the grounds, however, shows that the various sub-sectors are not performing in total sync. The standout in reporting season so far has been the office sector. Landlords have continued to see strength in the Sydney and Melbourne markets both in terms of rising rents and asset values driven by improving demand, limited supply and stock withdrawals (particularly in Sydney). Perth is weak off the back of the mining sector slowdown but the A-REITs, with the exception of Dexus and GDI (DGI), have limited exposure to this market.

The residential exposed A-REITs, such as Mirvac and Stockland, reported buoyant conditions and their forward book as measured by their locked in pre-sales continues to be high. Despite, Mirvac reporting an increase in defaults to 2 per cent (or 23 lots) vs <1 per cent at FY16, on the positive side, 70 per cent of defaults were re-sold with financial upside. Settlement risk will continue to be a key focus of the market over the next 18 months.

The retail sector, which comprises 60 per cent of the sector, is considered to be facing enormous headwinds. The rise of internet retailing, a wave of international retailers entering the market (Amazon is mooted to be coming) and local retailers struggling as evidenced by the demise of Dick Smith, Pumpkin Patch and Masters are impacting the retail landscape. The reporting season saw specialty sales metrics continuing to moderate for the large cap A-REITs, evidenced by lower growth in turnover for Vicinity Centres (VCX) (2.2 per cent vs: 3 per cent at June 2016), GPT (2.6 per cent vs 3.7 per cent at September 2016) and SCentre (SCG) (2.6 per cent vs 4.0 per cent at June 2016).

The social infrastructure sector which includes childcare (Folkestone Education Trust (FET) and Arena REIT (ARF)) and healthcare (Generation Healthcare (GHC)) is benefiting from strong demographics driving demand, investors chasing yield and longer dated 'net' lease structures which most social infrastructure assets typically have.

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Looking ahead, the A-REIT sector is expected to remain captive to the gyrations of capital markets. Clearly if bond yields continue to back up further as they did between August and November last year, then we could see additional pricing risk in the short-term. However, we believe the A-REITs are in relatively good shape and almost incomparable to those in the lead up to the GFC. Gearing is lower (circa 30 per cent), refinancing risk in the next two to three years is low (majority of debt is due to expire FY21+), asset quality has significantly improved, pay-out ratios are respectable and the exposure to offshore real estate is limited (Goodman and Westfield being the two exceptions).

Despite the positive results season, given the high concentration of the A-REIT Index to the larger A-REITs (the top eight represents 82 per cent of the S&P/ASX300 A-REIT index) coupled with its large exposure to the retail sector, and the growing number of hedge funds investing in A-REITs, now is not the time to take a passive approach to the sector (i.e. use Index funds). We believe the variation of performance across the A-REIT universe is expected to widen in the year ahead. Individual characteristics of each of the A-REITs will be more of a key driver of relative performance within the sector than it has been in the past few years. In our opinion, investors now more than ever, will need to focus on those A-REITs that have quality management and can generate real value from their portfolios rather than simply relying on lower debt costs to support earnings and firming cap rates (property yields) to drive underlying asset values higher. We expect A-REIT securities funds that take a high conviction, active management approach to selecting individual A-REITs for their portfolios are well placed to outperform the index in the year ahead.

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