Following Current Trends Can Be A Very Short-Term Exercise

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Oksana Patron finds out how financial planners and their clients can benefit from the current trends in the commercial property sector and whether now is a good time for investors to jump in.

Despite many global uncertainties, 2016 saw the majority of the Australian real estate investments trusts (A-REITs) perform well, with a number of trusts either delivering or exceeding market expectations.

Both listed and unlisted real estate had good runs and, according to some experts, are expected to follow this trend in the coming months.

Investors have stressed that REIT and commercial property investments should be considered as a long-term objective and that the sector should be viewed as a slow-moving asset as returns are best measured over time.

However, AMP Capital's head of Australian listed real estate, Mark Ferguson, warned investors that following any property trends was short-term in nature and encouraged them to take a look at fundamental value instead.

"Market trends are ephemeral and, for investing in REITs/A-REITs or real estate, following market trends is the antithesis of what investing in listed/unlisted property is: a long-term investment," he said.

"Planners and their clients should see REITs/A-REITs and property investments over a long-term horizon and need to assess how cheap listed and unlisted property is."

He stressed that decisions on whether it was the right time to enter into the real estate investments space should take into account a number of factors, including their existing portfolio's exposure to listed and unlisted property or their return/risk expectations.

"If investors are seeking an A-REIT investment in the sector, then a five per cent dividend yield plus three to four per cent earnings growth is currently on offer," Ferguson said.

BE SELECTIVE

According to Quay Global Investors' principal and portfolio manager, Chris Bedingfield, while there were some good opportunities in the Australian market, investors should be selective.

"Stock picking will be absolutely critical in the next two to three years," he said.

Folkestone's Maxim Asset Management's managing director, Winston Sammut, stressed that A-REIT securities funds that took an active approach to stock selection would be well placed to outperform the index in the year ahead.

"Whilst the A-REIT sector is still considered attractive, having regard to the income stream generated, in spite of the relatively good performance of most A-REITs, now is not the time for financial planners to be complacent and navigate their clients into the index funds," he said.

"The quality of management and the way A-REITs actively manage their real estate portfolio will be crucial as the tailwinds of cap rates compression pushing values higher are waning."

"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," he said.

REACTION OF RISING BOND YIELDS

One of the top concerns for advisers in the near future would be rising bond yields which have created some headwinds in the sector.

"What's happened over the last six months in terms of bond yields has probably gone a little bit too far," Bedingfield said.

He said that one of the consequences of such a big increase in bond yields might be damage to stocks that used to be fairly income-secure.

Ferguson agreed that the increasing bond yields would be one of the biggest challenges for advisers when offering advice in the current environment.

"A common mistake of some market participants is to sell out of real estate when bond yields are rising but it is important to realise that higher bond yields are priced into REITs instantaneously and at the point of inflection of expectations moving from falling bond yields to rising bond yields, the REIT pricing volatility will be high," he said.

"In the medium-term, though, higher bond yields coupled with the steepening of the yield curve is a positive sign for economic growth and consequently REIT rental growth will be increasing."

The second half of 2016 saw a sell-off of the A-REITs as a reaction to bond yields rising.

However, according to Sammut the sector managed to clawback some of this underperformance over the past few months.

"The sector continues to trade at slightly above fair value and will be susceptible to further increases in bond yields," he said.

"We believe however, that whilst there will be some short-term volatility in the sector, investors need to look through this."

Sammut also stressed that a sudden rise in global bond yields that the markets saw last year, might see A-REITs sold off again.

PORTFOLIO QUALITY

When it comes to the quality of the average portfolio, most experts agreed that across Australian commercial assets the average portfolio was well balanced and of a very high quality.

"For access to the highest quality of Australian commercial property and with the added benefit of liquidity, A-REITs can be the investment of choice for investors," Ferguson said.

"Many A-REITs have continued to make property divestments throughout this cycle and have successfully upgraded the quality of their portfolios.

"Also, some A-REITs have improved portfolio quality via acquisition and some have also upgraded their portfolios by in-house developments. The sell discipline of A-REITs has improved considerably compared to prior cycles and it is one that should remain deeply ingrained in management teams and boards."

Sammut noted that in general A-REITs were in relatively good shape and far from those in the lead up to the global financial crisis (GFC).

"Gearing is lower, refinancing risk in the next two to three years is low, asset quality has significantly improved, pay-out ratios are respectable and the exposure to offshore real estate is limited.

"We expect now conservative positions held by the majority of A-REITs to remain in place with little in the way of change over coming months," he said.

"Also, we continue to caution advisers and their clients who might consider using the sector to park money in the short-term in the search for yield enhancement to their portfolios. Whilst the sector offers liquidity over direct property, short-term investment horizons could add risk to a portfolio."

On the other hand, Centuria's chief executive for unlisted property, Jason Huljich, stressed that financial planners and their clients could benefit from the strong yields and potential for capital gain from listed and unlisted

property investments.

"Most sectors have performed well and should continue to do so. However, there have been some headwinds in the retail sector due to Amazon's imminent launch in Australia and other online threats," he said.

THE 'AMAZON EFFECT'

Phoenix Portfolios managing director, Stuart Cartledge, also agreed that one of the most topical issues regarding the retail space in the future would be the arrival of Amazon to Australia and to what degree online sales would affect that sector.

"I think it's probably fair to say the impact will be negative, it's just the matter of how much and when," he said.

Sammut said the retail sector was expected to face enormous headwinds due to the increasing number of online sales providers.

"The rise of internet retailing, a wave of international retailers entering the market and local retailers as evidenced by the demise of Dick Smith, Pumpkin Patch, and Masters are impacting the retail landscape," Sammut said.

He said that the reporting season also saw "speciality sales metrics continuing to moderate for the larger cap A-REITs, evidenced by lower growth in turnover for Vicinity Centres, GPT, and SCentre".

OFFICE SPACE

In terms of office markets, rental growth in Sydney had been stronger than in Melbourne, and Sydney still remained a place "where everyone wants to invest", according to Cartledge.

"Offices in Melbourne are less exciting but [it's] still a pretty strong market and hasn't seen the same effective rent growth yet. There has been a bigger supply response in Melbourne, but there's also been quite a strong growth in demand," he said.

"We just haven't seen it translating into this type of rental growth that we see in Sydney."

Huljich said both Sydney and Melbourne had very strong fundamentals, and commercial property in these cities should perform well.

"Portfolios with large weightings to Perth and Brisbane may suffer due to tough leasing conditions. However we do see some light at the end of the tunnel for Brisbane and it may have bottomed," he said.

"We believe Perth will take some time to work throughout circa 24 per cent office vacancy."

Sammut stressed that the various property sub-sectors were not performing "in total sync" and in terms of the residential space, settlement risk would continue to be a key focus of the market over the next 18 months.

"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," Sammut said.

Cromwell Property Group's head of retail funds management, Hamish Wehl, said that most Australians typically achieved their exposure to property solely through residential investment.

"Most investors understand the benefit of divesting a share portfolio or managed fund portfolio across different companies and managers, they don't often do that with their property exposure," Wehl said.

According to Huljich, the majority of financial planners and advisers struggled to give their clients enough exposure to the sector.

"Many planners have allocations of zero to 10 per cent to real estate where we believe an allocation of 10 to 30 per cent is preferable," he said.

"We also believe a lot of advisers will only use listed REITs for their real estate exposure. However, unlisted property provided greater diversification to the ASX [Australian Securities Exchange]."

OUTLOOK

Looking ahead, the A-REIT sector is expected to remain captive. However, if bond yields continued to back up further like they did between August and November last year there would be additional pricing risk in the short-term, according to Sammut.

"The A-REIT sector is generally considered by some to be alternatives to bonds or term deposits. As a consequence, they fell out of favour late last year on expectations that global interest rates would start to rise in the future," he said.

On the other hand, Huljich said he expected most Australian REITs would continue to trade well over 2017 due to strong and/or improving fundamentals.

"However, the challenge will be for advisers looking for offshore REIT exposure. We believe global REITs will have mixed performance and choosing the right investments may have some challenges," Huljich said.