A-REITs looking at M&A yet again

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ANALYSIS

The 2018 financial year, like the past few years, turned out to be a security picker's market.

Performance varied across the 31 A-REITs in the S&P/ASX 300 A-REIT Index, ranging from Propertylink at 34.4 per cent down to Stockland Group at negative 3.6 per cent.

Even within sectors, the variation in performance was wide. Among the retail A-REITs, SCA Property Group took line honours with a total return of 18.4 per cent while Aventus, the specialist large format retail centre owner, lagged with a total return of just 4.7 per cent. It was a similar story in the office sector, GDI Property Group returned 33.8 per cent while Dexus returned 7.5 per cent. Among the diversified A-REITs, Abacus turned in 25.5 per cent and Stockland negative 3.6 per cent. Overall, the S&P/ASX 300 A-REIT Accumulation Index finished the year on a high, returning 13.2 per cent, in line with the broader equities market, with the last three months delivering a strong return of 9.8 per cent.

The strength in the A-REIT sector coincided with rising concerns of an escalating trade war between the US and China, political tensions in Europe, a pullback in US bond yields and the flattening of the Australian yield curve.

Although reporting season doesn't kick off in earnest for a few more weeks, a number of A-REITs have already given us a taste of what's to come with their pre-results updates to the market. Valuations are up and earnings/distribution guidance ranges have narrowed towards the upper end supported by solid rental growth across most office and industrial markets, and notwithstanding the broader market's concern about the weakening housing sector, strong settlements recorded across the Stockland, Mirvac and Ingenia residential portfolios.

Darren Steinberg, chief executive of Dexus, was on the money when he recently said: "It is pleasing to see higher market rents being reflected in our latest round of valuations across many of our assets. In addition, valuers have taken into account recent transactions where there has been no softening in the underlying investment demand for good quality office and industrial properties, which continue to attract a variety of domestic and offshore buyers."

Looking ahead, we expect corporate activity to remain elevated reflecting many of the A-REITs' inability to acquire assets in the direct market at reasonable prices; finding bargains is next to impossible at this point in the cycle. So, to grow, A-REITs are now looking to mergers and acquisitions. And we've seen this play before. In 1999-2000 and again in 2006-2007, M&A became defining factors.

Also, the lower Australian dollar is making the valuations of A-REITs increasingly attractive to foreign acquirers (note the Unibail-Rodamco acquisition of Westfield, Blackstone's bid for Investa Office Fund and Blackstone and Hometown's fight for Gateway Lifestyle).

A-REITs trading at the smallest premiums or discounts to NTA (net tangible assets) will be most prone to being merged or taken private.

Overall, we expect the A-REIT sector to deliver relatively attractive returns given the continued low domestic interest rates. The two wildcards being the impact of more M&A activity and A-REITs, like interest rate-sensitive sectors, being susceptible in the short term to any major sell-off in global bond markets. That is if bond yields move higher and capital flees to more growth-oriented parts of the market.

Unfortunately, short-term volatility is now a permanent feature of the A-REIT market. With more A-REITs owned by general equity funds, hedge funds and global investors, the sector is more susceptible to the gyrations of these investors, who move in and out of the sector, at a whim. Back in January and February, the A-REIT sector returned negative 3.2 per cent and negative 3.3 per cent respectively, as concerns about rising global inflation pushed global bond yields higher. Fast forward to May and June, as concerns about rising bond yields abated, the A-REIT sector rallied, with returns of 3 per cent in May and 2.3 per cent in June.

In such an environment, as a high-conviction, active manager that doesn't follow the weighting of each A-REIT security in the Index, we continue to look through the short-term noise, and favour those A-REITs with exposure to the social infrastructure and specialised property sub-sectors, selected real estate developers and managers who have growing funds management platforms, and those securities with quality management and relatively attractive yields that have the ability to actively manage their portfolios to drive income growth. Looking ahead, not all A-REITs will perform the same. Active security selection will be the key.

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