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# AREITs: Death of an Asset Class, or Compelling Opportunity?

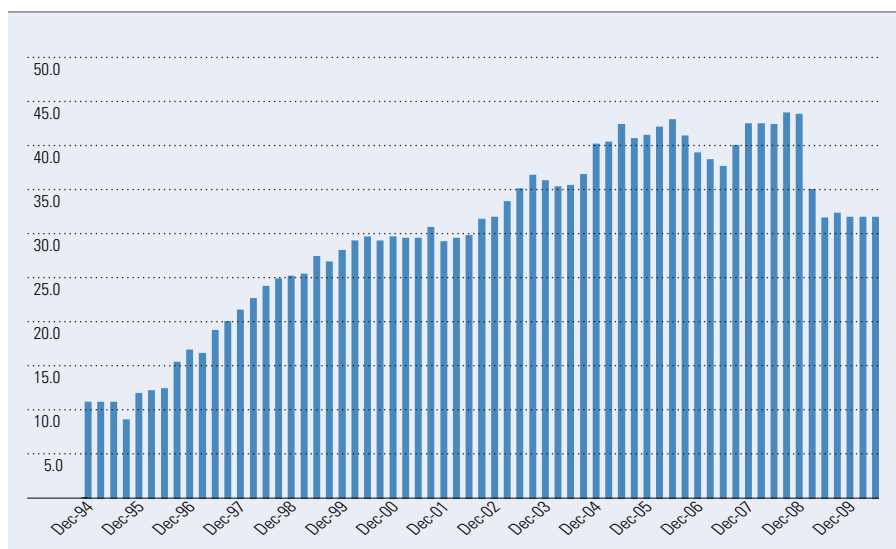
Australian listed property trusts, or as they're now more commonly known, Australian Real Estate Investment Trusts (AREITs), disappointed investors during the Global Financial Crisis (GFC). Far from delivering a steady income return profile with less downside risk, AREITs delivered very poor negative returns to investors. This was especially the case in 2008, when the S&P/ASX300 AREIT Accumulation Index produced an annual return of -55.30 percent.

Why did AREITs perform as poorly as equities and global listed real estate securities (global REITs) in 2008? There were a number of reasons: taking on too much debt, paying out unsustainably high dividends (in some cases more than 100.0 percent of earnings), paying expensive management fees to related companies, and sourcing earnings from newer, less stable income sources (such as development earnings, funds management, and under-researched overseas property investments) rather than from traditional Australian property rental income sources.

The AREIT sector today does not exhibit the same risky characteristics as it did leading up to the GFC. It's therefore important to look to the future rather than back at the past when evaluating the outlook. We think the prospects for AREIT performance are excellent, and consider the sector likely to be one of the most attractive growth asset classes over the next five years on a risk-adjusted basis.

We believe that returns will be positive and the investor experience far less turbulent than it

**Figure 1.** Arithmetical Average Total Debt/Asset Ratio for AREIT Sector, 31 December 1994 – 30 June 2010.



Source: JP Morgan.

has been in recent years, as many of the larger AREITs have resolved the issues that plagued them during the GFC. In this Ibbotson Insight, we discuss the many issues that have affected the AREIT sector, and how positive change has created a compelling investment opportunity.

### Gearing

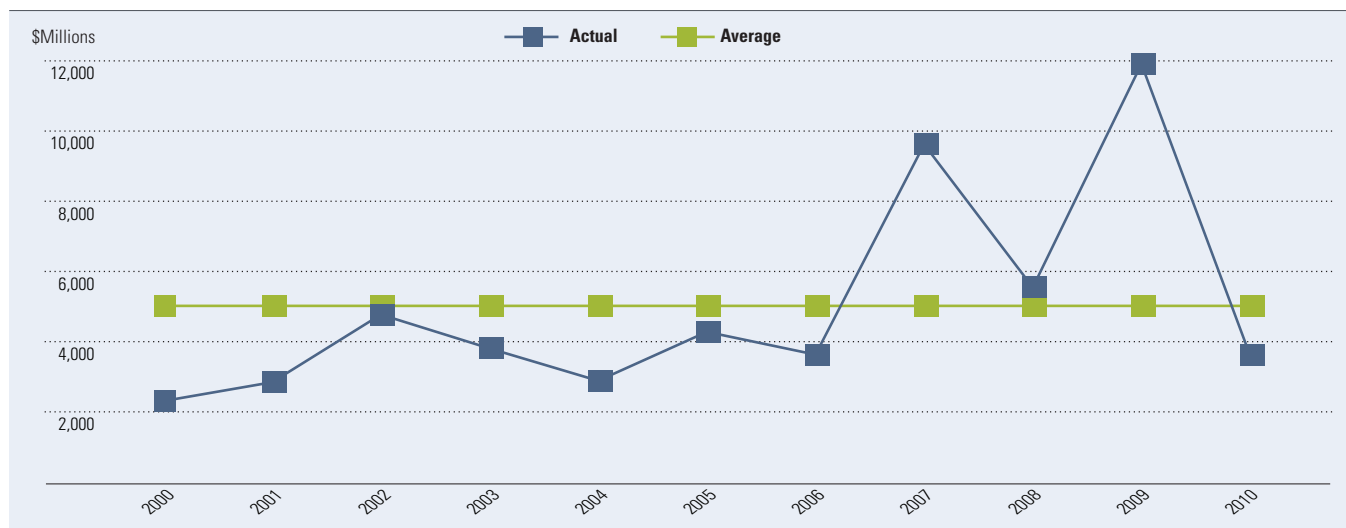
During the GFC, it was the highly-g geared AREITs that produced the worst outcomes. Figure 1 shows the historical gearing ratios for the AREIT sector over the past 15 years, as represented by the trusts' debt/asset ratios.

AREITs' average gearing levels (as measured by the trusts' debt/asset ratios) were around

10.0 percent in the mid-1990s. By the end of 2007, the average gearing level had increased to around 40.0 percent. With debt markets freezing and asset values falling in 2008, these gearing levels would have increased to even higher levels if AREIT management teams had not undertaken equity capital raisings to recapitalise trusts' balance sheets and ensure their survival.

We believe that the gearing issue for AREITs is now behind us. The sector average is now back to a far more appropriate gearing level of around 30.0 percent. While gearing varies across the individual trusts, the post-GFC sector average is not alarming. Some AREITs have

**Figure 2.** Calendar Year Equity Capital Raisings Undertaken by AREITs, 2000–10.



Sources: JP Morgan, Bloomberg.

actually commenced share buybacks, which would be unlikely to occur if gearing were still an issue.

Figure 2 shows that equity raisings undertaken by AREITs during the GFC exceeded the 10-year average. According to JP Morgan, the AREIT sector had reduced its overall debt exposure from \$A76.50 billion at 30 June 2008 to \$A45.0 billion by 30 September 2010. We think that the current debt/asset ratio of 30.0 percent is at a more manageable level than it has been in recent years, given that Australian commercial property valuations appear more reasonably-priced than they did in 2006/07.

### Overseas Versus Domestic

#### Earnings Profiles

The AREIT sector is also shifting gradually back to a focus on Australian property assets.

We believe this is a good thing for the asset class, the passing of time enabling trusts to avoid having to take fire-sale prices for assets.

Another characteristic viewed unfavourably by investors during the GFC was AREITs' exposure to overseas assets, as overseas property asset values fell more than Australian values. Several AREITs had significantly increased their investments in overseas property assets over the past 10 years.

Looking forward, a number of AREIT management teams have indicated that they plan to divest trusts' overseas property assets, and concentrate instead on Australian assets. It remains to be seen whether these management teams will sell these overseas assets at the 'right time' and achieve high or low proceeds. What is clear, though, is that with the exception of a select number of management teams which have proven that their business model works overseas, AREITs are likely to hold fewer overseas assets and focus more on Australian property assets in the immediate future. This should lead to AREITs exhibiting less correlated return profiles with their overseas REIT counterparts, and result in increased demand from overseas investors.

#### Fundamentals for Australian Commercial Property Market

While there's been considerable debate about whether or not the Australian residential property market is overvalued, AREITs' incomes are heavily-exposed to the fortunes of the Australian commercial property market, with only small exposures to residential property. The fundamentals supporting the Australian commercial property market (office, retail, and industrial properties) appear sound, and AREITs do not seem troubled by significant vacancy issues.

Economic conditions remain healthy in Australia, as evidenced by consistently positive economic growth and low unemployment rates. Occupancy levels for high-quality Australian office assets are generally above 90.0 percent. Unlike previous Australian commercial property downturns, the decline during the GFC was due to debt concerns, rather than oversupply.

#### Dividend Yields and Earnings Payout Ratios

AREITs offer a competitive dividend yield and, more importantly, appear to have good capacity to meet dividend payments going forward. There's also scope for future dividend increases, as well as share buybacks. This income return should underpin AREITs' future returns.

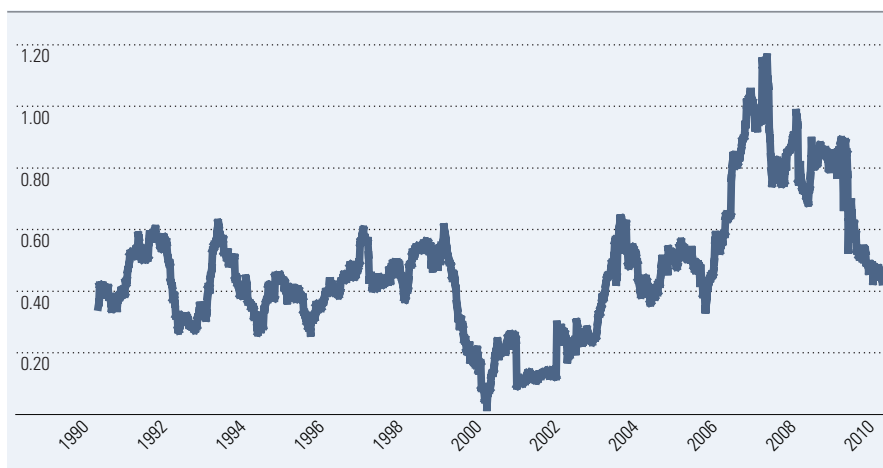
The average dividend from the AREIT sector is sitting around six percent, the same level it was at the end of 2007, but there is more certainty now that future dividends will be paid at this rate than was the case in late 2007. Earnings payout ratios – the portion of earnings paid out as dividends – were high in late 2007, with most AREITs' payout ratios close to 100.0 percent. This was at an unsustainably high level, given the need to retain some earnings to cover general maintenance and building renovations to keep property assets in a good state. Management teams have reduced the average earnings payout ratio to a more prudent level of just under 80.0 percent.

**Figure 3.** Regional REIT Returns in 2010



Sources: Morningstar Desktop Consultant and UBS Global Investors Indices. Returns are shown in local currency terms, except for Asia ex-Australia, which is in \$A terms.

**Figure 4.** 12-Month Rolling Beta of AREIT Sector Relative to Australian Equities.



Source: JP Morgan.

**Investor Flow Activity**

AREITs have been unloved of late. They have experienced selling pressures from a range of sources. For the most part, this selling has not been related to the trusts' fundamentals.

Many institutional investors abandoned their standalone AREIT portfolio allocations following the disappointing returns during the GFC, citing concerns about concentration and inadequate diversification. A number of fund managers elected to reassign their AREIT allocations to other property asset classes such as global REITs (which often include investments in AREITs), Australian

direct property, and/or Australian unlisted property. These strategy shifts have created selling pressures.

While this is not a favourable dynamic, positive future investment opportunities are often created when this type of investor behaviour is present. If the future return opportunity is favourable, buyers will appear. This could include greater investment by Australian share investment managers or global REIT managers. Both groups have AREITs in their benchmarks and have to consider the sector. Australian share investment managers have been reluctant investors in AREITs in the past, but that could change substantially.

**REIT Returns in the Calendar Year 2010**

AREITs significantly underperformed global REITs in 2010 (Figure 3). This is hard to reconcile, as AREITs have arguably done a better job of addressing their shortcomings than has been the case in most other regions. This suggests that AREITs have become a classic contrarian play where the opportunity is good, but investors in general are disinterested.

There are several potential reasons why this happened. These include the availability of high interest rate-paying term deposits reducing the attractiveness of AREITs for yield-focused investors; the strong \$A limiting AREITs' appeal to overseas investors; and investor inflows favouring global REITs over AREITs. Other contributing factors may have included a significant improvement in overseas capital market conditions, and that AREITs' return to a more defensive profile proved unpopular in a 'risk-on' environment that favoured pro-cyclical asset classes such as Australian and international equities. (Perhaps ironically, after having been penalised by the market for adopting more risky business structures during the GFC, AREITs seem to have been penalised in 2010 for being too conservative and defensive in nature.)

Figure 4 shows the rolling one-year beta profile of AREITs (as defined by the S&P/ASX200 AREIT Accumulation Index) compared to Australian

equities excluding AREITs (as defined by the S&P/ASX200 Accumulation Index ex-AREITs). The beta indicates the return sensitivity of one investment's return profile to another investment's return profile. A beta above one means that an investment will rise more than the comparison investment in rising markets, but also indicates that the investment will fall by more than the comparison investment in falling markets.

AREITs' rolling one-year beta to Australian equities' returns was 1.15 at 28 February 2008. In general terms, this meant that if Australian equities rose by 10.0 percent, AREITs would rise by 11.50 percent, but that if Australian equities fell by 10.0 percent, then AREITs would fall by

11.50 percent. The AREIT sector currently has a low one-year beta ratio to Australian equities of 0.42, meaning that if Australian equities was to fall by 10.0 percent, then AREITs would fall by only 4.20 percent, and their more defensive profile should provide better downside protection relative to Australian equities in a falling market environment.

#### Outlook

The AREIT sector has shifted to a less risky return profile over the past two years, as there has been a general reduction in gearing levels, and the adoption of more conservative dividend to earnings payout ratios. AREIT management teams' decisions to increase Australian property holdings and/or reduce overseas

property exposures should also lead to the earnings fundamentals for AREITs being aligned more closely with Australian commercial property fundamentals.

For the reasons we've outlined, Ibbotson believes that the AREIT sector is positioned to perform very well going forward. We also believe that there are portfolio solutions that can be designed to address concerns about index concentration (such as the dominance of Westfield Group WDC) while retaining the attractive attributes (such as low gearing levels), a topic we'll discuss in more detail in a future Ibbotson Insight. ■

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