

Schroders

A wolf in REIT's clothing

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"More money has been lost reaching for yield than at the point of a gun"
Raymond F. DeVoe, Jr

The last time we wrote about Australian Real Estate Investment Trusts (A-REITs) in 2010 the post GFC reforms to operating models and balance sheets, as well as reasonable valuations, made the sector more appealing than it had been for some time. In markets, a lot can change in four years and this paper provides an update on the current investment opportunity in the sector.

REITs are supposed to be the simplest of listed investment vehicles, but the past 15 years has proven them anything but. In theory, a REIT is a vehicle that passively passes through rents from a portfolio of commercial property (office, industrial and retail mostly) net of the costs of ensuring these properties are leased and maintained. These passed through rents can then be capitalised (valued) by investors to perform a short hand valuation exercise. Unfortunately, as with most things investment related these days the temptation for management to over complicate makes the reality a little less simple.

There are three factors that determine A-REIT investment merit that we cover in our analysis: 1) the sustainable ungeared cash flows these assets generate over time, 2) the risk that REIT investors assume for which they need to be compensated and 3) the total expected return (not just income) that REITs generate for their investors over time.

Sustainable cash flows

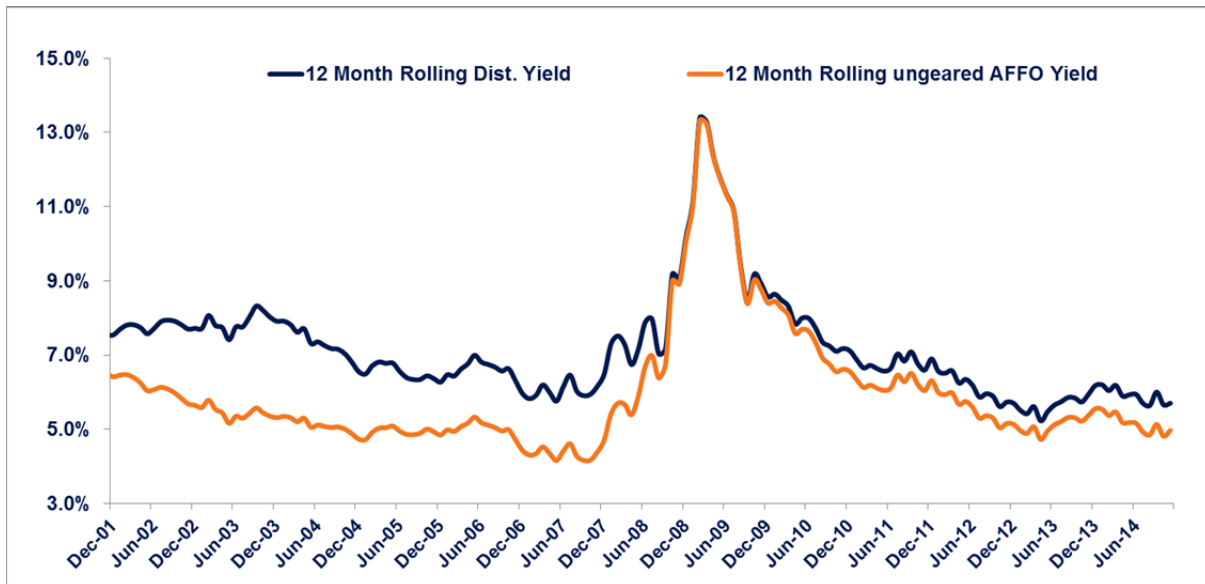
The valuation estimate for any asset is always the discounted value of all cash flows delivered to the investor over its life. The most common method investors use to assess the cash generated by REIT assets is by reference to the distributions paid out to shareholders as the net (after all costs - including financing) share of rent received. Pre-GFC this was problematic due to the distortions caused by the distribution of non-cash development accruals and although distributions are now closer to the cash flow that we consider appropriate for discounting (Free Funds from Operations or FFO) there remain a couple of issues we need to resolve.

First is the consideration of capital expenditure. As income producing assets, the value of a REIT is in the buildings not the land. Land and scarcity (often artificial due to planning laws) determine supply but the building determines the cash flows. Investors want to estimate the useful life of these buildings able to sustain the rents tenants are forecast to continue to pay and account for the depreciation charge required. So FFO which contains no allowance for maintenance capex is adjusted by our estimate of a fair maintenance capex number to achieve Adjusted FFO or AFFO.

The second issue in the current environment relates to financing costs. Indeed there is not much else for REIT management to do but M&A and financial engineering. It is no surprise that unless investors revolt (2008 - 2010) there is always a fair bit of this going on in the sector. The issue at the moment is that both net AFFO to equity holders and distributions are flattered by - in our view - unsustainably low financing costs driven by low underlying interest rates. Paying out the benefit of these low rates today means that investors may face a reality of distributions being clipped by higher interest rates in the future. While the M&A can't be avoided, it is possible to look through the illusions of financial engineering by assessing REITs on their ungeared returns.



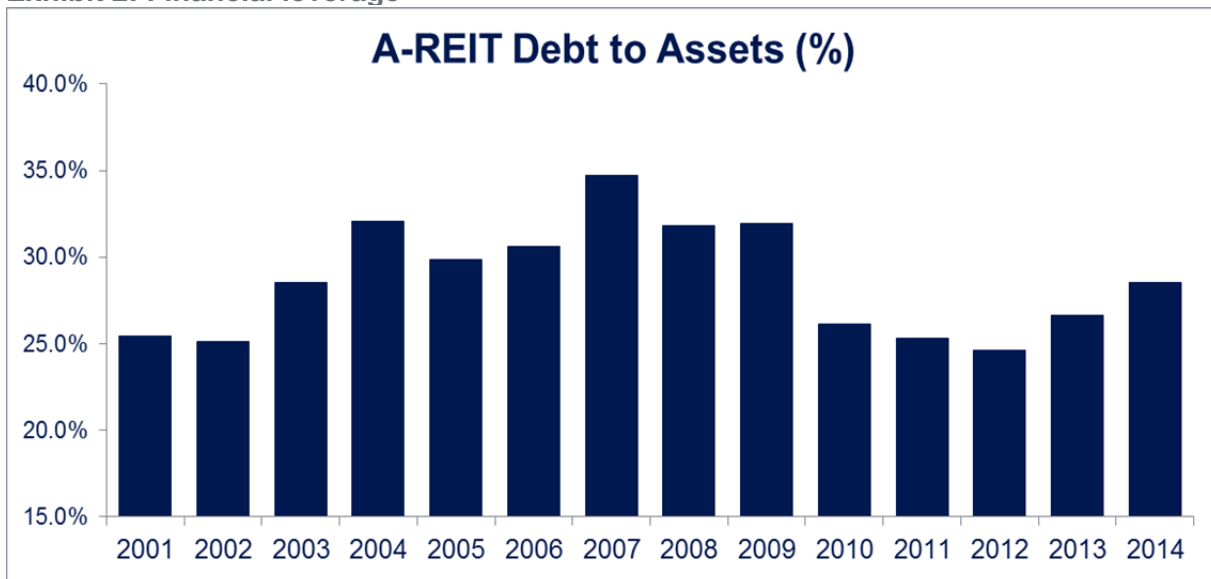
Exhibit 1: Underlying cash flow yields



Source: Factset, IRESS, Schroders, Company Accounts

Finally, although there is an assessment of sustainable cash flows on this basis it's not possible to prevent the engineering from adding risk to the investment - and as time heals all wounds, REITs are gearing up again to take advantage of cheap debt; to leverage distribution growth, justify M&A or a combination of both. Debt to total assets has not only been creeping up over the last couple of years in financial statements, the rhetoric from management has also started to move the prudential goal posts - with appropriate gearing being redefined from '25 - 30%' a couple of years ago to '30 - 35%' today. 'Sophisticated' investors smirk at the thought of the home buyer increasing their price range for a 25+ year financial obligation due to temporary declines in interest rates however the average Australian may look at those atop the commercial property ladder in this country and wonder if they are not doing pretty much the same thing.

Exhibit 2: Financial leverage



So, when assessing the cash flows investors can expect from REITs they should look at the ungeared AFFO for a true measure of asset returns – which currently shows a yield of 5.1% against a distribution yield of 5.7% - and keep a watchful eye on the behaviour of management in leveraging the balance sheet to

wonder if the risk of loss is once again creeping higher. As observed during the GFC, the impact de-gearing a REIT under stress has on total returns can be devastating for investors.

Growth

Long term performance indicates that nominal ungeared sustainable cash flow growth rates have been anything from 0% (industrial) to 1% (office) to 5% (retail). Retail rent growth over the past 20 years has been flattered by 1-2% per annum as shopping centres have increased their share of tenant revenue and with global trends in retail changing it is expected this tailwind will be removed at the least and replaced with a negative headwind as a reasonable consideration for future growth.

Based upon historical growth rates nominal ungeared AFFO per share growth at around 1.5% per annum for the A-REIT universe is expected- and although there may be some argument about greater or lesser growth in the future, the economic realities of these assets means the range of outcomes is likely to be pretty narrow.

Because of the nature of a REIT structure, all income must be distributed to shareholders. This means that if a REIT is required to de-gear their balance sheet unlike companies they cannot retain excess earnings and suppress the payout ratio to achieve this. Instead REITs have to issue new equity – either directly via rights issue or placement in times of stress, or more surreptitiously through ongoing dividend re-investment programs where cash “paid out” via distributions returns to the balance sheet via regular new equity issuance and dilutes the AFFO per share for existing investors. So, if the current behaviour of increased balance sheet leverage needs to reverse course at some point in the future, a nominal per share growth forecast of 1.5% per annum can very quickly become an optimistic assumption.

Hurdle rate of return

Once the amount of cash generated by REIT assets is determined and forecast into perpetuity it is necessary to determine the appropriate return hurdle required for REIT investments to deliver - and therefore based upon cash flow forecasts what price to pay today to achieve that return.

The easiest way to determine the hurdle rate of return is to look at the risks investors are exposed to in any investment and ensure that we are being adequately compensated for those risks. In the market there are really only two contractual forms investments take - debt and equity. Regardless of its income characteristics or modern classification as a "real asset" a REIT is an equity investment given it has a perpetual duration, is subordinated to all other claims in the asset structure and any distributions are residual to senior claims and therefore uncertain. The obvious place to start then is to determine what return equity requires to compensate for such risks and then form a view on whether REITs are more or less risky (and by roughly how much).

The starting point is the long term estimated risk free rate - the 10 year Australian government bond - estimated to be 5.3% pa. With bonds currently at 3.3% our belief is that this is a function of short term environment rather than the structural rate over the next 10-20 years. Compared to a government bond, the owners of equity take on a range of additional risks and estimated to require an additional 3.5% per annum of return meaning that Australian equities need to deliver 8.8% per annum.

And what of A-REITs? Most of the same risks exist - indeed these were all observed during the GFC and a recapitalization that dilutes existing equity holders by 90% is a total loss of capital for all intents and purposes. As an asset however REITs possess one characteristic most non-REIT corporates do not - contracted revenue from tenants that stretches many years into the future. The benefit this confers to REIT owners is a level of near term cash flow certainty that is by definition higher than for non-REIT corporates. So, most risks are the same but the near term uncertainty risk for REITs is lower and that may reduce the premium investors demand for this risk.

In the interests of providing analysis consistent with investor expectations it is assumed that of the 3.5% risk premium demanded for equities, investors appear to credit REITs with a benefit of ~1.0% due to their lower near term cash flow uncertainty. If applied this would result in a required premium of 2.5% over bonds - or a total return hurdle of 7.8%. In our opinion this is a generous estimate and an alternative – or perhaps more realistic – approach would be to recognise that over the past 20 years, A-REIT observed

equity volatility has been higher than that of the S&P/ASX 200 which is counter to the “lower risk asset” assumption most investors run with.

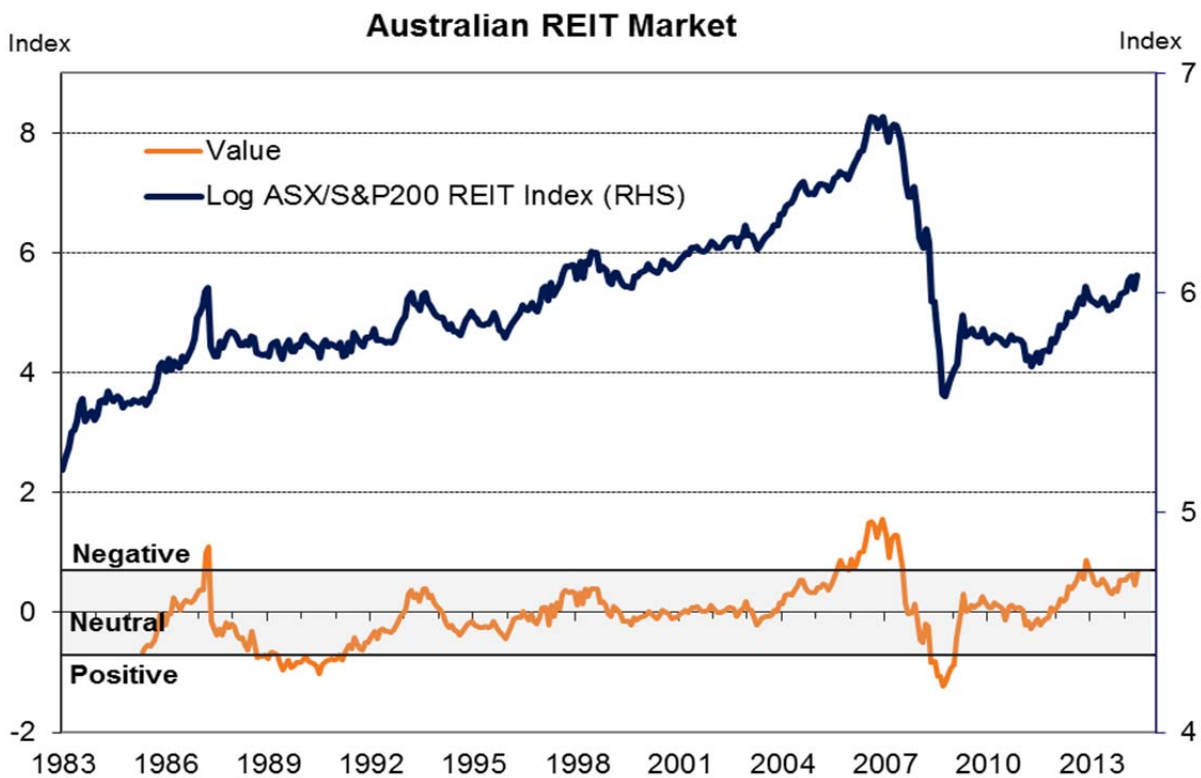
Now just because investors "require" certain rates of return to compensate for risk does not mean that the market at all times will provide them. It's a case of observing the returns that the market is likely to provide and then determining whether this is acceptable based upon the hurdle - and other opportunities (relative to their own hurdles) available in the market at the same time. To determine the return provided by the market the standard equity valuation methodology is applied that composes a total return from Yield (Y) + Growth (G) + Change in Valuation (ΔV).

Yield: As discussed previously, once all relevant adjustments are made, the current ungeared AFFO yield for A-REITs is 5.1%.

Growth: realised sustainable cash flow per share growth has been, and expected to continue to deliver 1.5% per annum over the next 10 years.

Change in Valuation: If the hurdle return rate is significantly above what is offered today, at some point the yield will adjust to restore the required risk premium. From current levels that implies a negative adjustment of almost 5% per annum over the next three years.

Exhibit 3: Borrowing from the future - A-REIT long run, recent past and forecast returns



Source: Factset, Datastream, Schroders

Therefore the expected return for A-REITs as at November 2014 is 5.1% + 1.5% - 5.0% or 1.6%p.a nominal or -0.9%p.a real over the next three years.

Exhibit 4: Borrowing from the future - A-REIT long run, recent past and forecast returns

Source: Factset, Datastream, Schroders

So if in the 'fantasy land of rational expectations' investors require a 7.8% return from A-REITs but are only likely to receive ~1.6% why is the market willing to accept such meagre returns? We think part of the explanation is that during periods of financial repression – resulting in compression of risk free rates and credit spreads – the reach for yield causes investors to look beyond the nature of the security they own, and the duration of claims to which they are entitled and focus solely on a single dimension of their investment - in this case income. Investors are starved of yield and seek anything that resembles that which they have lost. Recall that the face yield of A-REITs of 5.7% is higher than our ungeared AFFO yield of 5.1% which is itself higher than our expected total return of 1.6%.

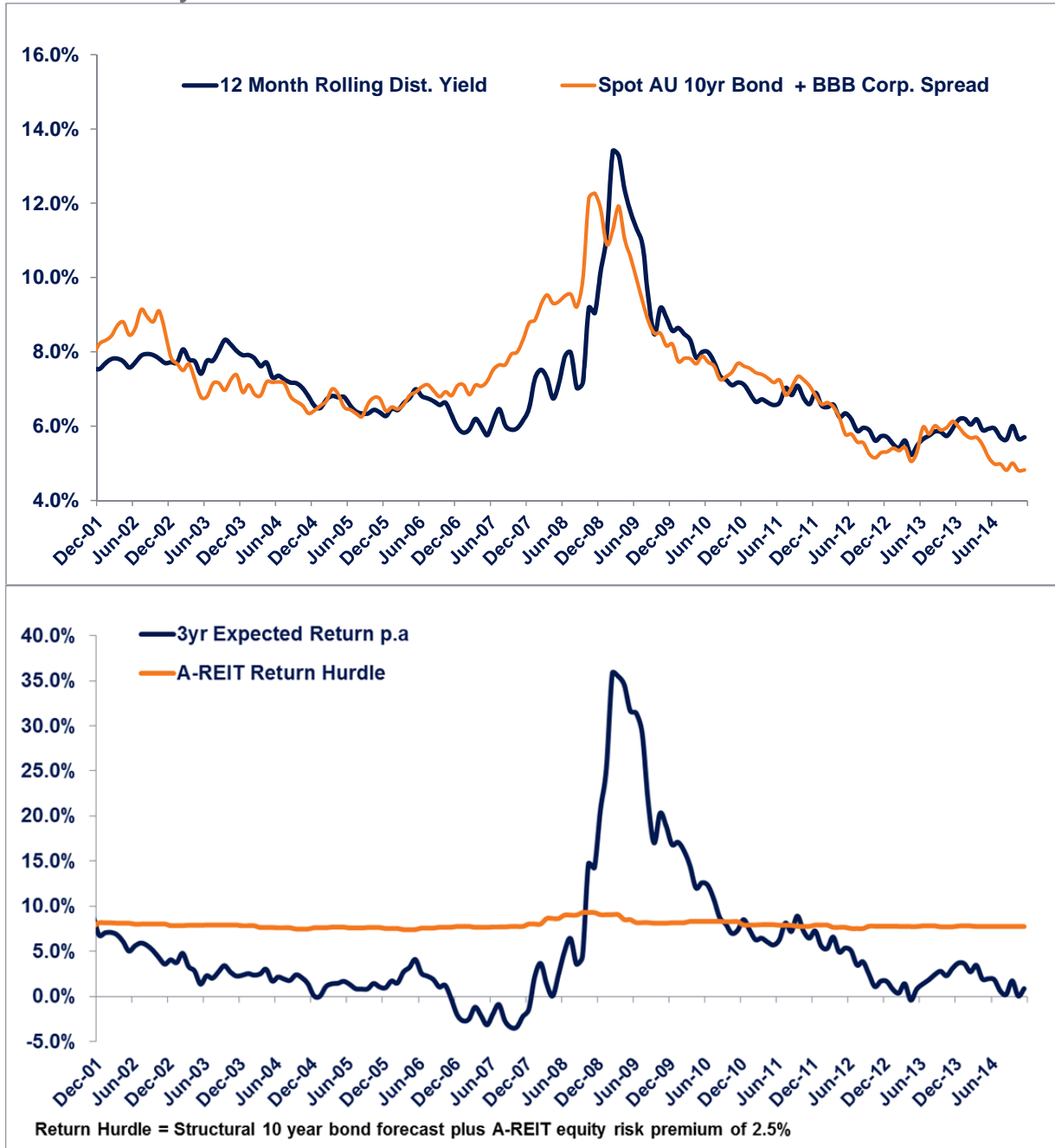
Investors (of all stripes) look at a fixed income portfolio yielding 3.5 - 4.0% and decide that a REIT yielding 5.7% with 'a bit of growth from rents' looks like a pretty good deal. We are not this flippant about the efficiency of markets, but sometimes marginal demand by specific investor groups can be enough to create such anomalies.

The charts below summarize these two views of the A-REIT pricing puzzle:

1. Income proxies or carry trades: the first chart looks at the current A-REIT distribution yield and compares it to the spot 10 year Australian government bond yield plus the spot BBB rated corporate debt spread. This highlights how the near term compression of interest rates and short term credit risk feed into the assessment of relative value for A-REIT equities by those investors that look at face value distributions rather than total cash returns. Under this model, if A-REIT distribution yields offer enough spread over the fixed income proxy then A-REIT prices are bid up and the yield spread will compress.
2. Valuation models or mean reversion trades: the second chart shows the return hurdle required to compensate investors for risks of holding the A-REIT asset and compares this to the total expected return ($Y + G + \Delta V$) over the next three years. This model considers income at the ungeared sustainable cash flow level and looks at income as only one component of the total return that investors will receive through holding a perpetuity asset.

Our philosophy clearly aligns us with the valuation view of all assets rather than any single component (such as income) taken in isolation. This means that rather than trading on the optical illusion of short term carry we invest in A-REITs the 1-2 times per decade when they offer returns in excess of our hurdle. Now is most definitely not one of those times.

Exhibit 5: Carry Trade vs Valuation Models



Source: Factset, BA Merrill Lynch, IRESS, Schroders

Sensitivity to assumptions means that return expectations for A-REITs are an approximation and are best thought of in a range. The two variables that have the most bearing on the total return achieved by A-REITs are the long run 10 year Australian government bond yield (the risk free rate) and the premium investors require for taking on A-REIT equity risk. Relative to the core bond assumption – which provides a consistent anchor to value all other assets in the investment universe – and the 2.5% A-REIT risk premium scenario the sensitivity table in Exhibit 6 allows investors with different views to see what returns are achievable under alternative assumptions. Given empirical evidence that A-REITs are not structurally less volatile than equities, investors are also advised to note the returns expected should the past 20 years of data be more appropriate than common wisdom and a 3.5% risk premium prevail.

Exhibit 6: Sensitivity of A-REIT 3 year per annum total return to risk free rate and risk premium

		Long run 10yr Govt Bond		
		4.0%	5.3%	6.0%
A-REIT Equity Risk Premium	2.0%	9.9%	3.5%	0.7%
	2.5%	7.1%	1.6%	-0.9%
	3.5%	2.6%	-1.7%	-3.6%

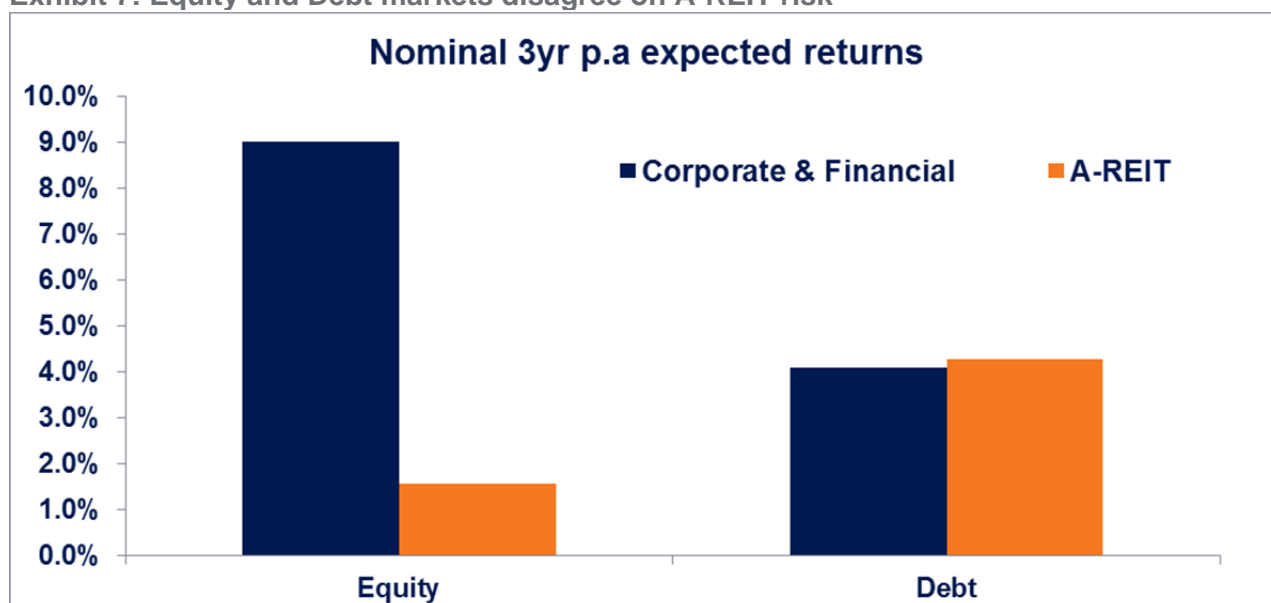
Source: Schroders

A-REITs do not exist in a vacuum

We may be more understanding of the current situation if the return suppression was equally apparent more broadly across Australian equities - however that is not the case. Using the same building block assumptions to forecast returns for the S&P/ASX200 (and grossing up for the presence of franking credits that are attached to most S&P/ASX200 dividends but entirely absent from REIT distributions) we arrive at an expectation of 5.4% (Y) + 3.3% (G) + 0.4% (ΔV) or 9.0% p.a. nominal returns, 6.5%p.a. real over the next three years.

We may also be more understanding of the A-REIT equity pricing if all investors agreed on the structurally much lower risks present in these assets - however again this is not the case. A-REIT bond investors continue to price the spreads of these issues marginally wider than most other Australian corporate bonds - and ironically it is these investors who are in the best position to benefit from contracted lease profiles of similar duration to their bond maturities and having senior secured positions over tangible and saleable assets in the event of default.

Exhibit 7: Equity and Debt markets disagree on A-REIT risk



Source: Bloomberg, Schroders. Debt refers to total return over 3 years from corporate and A-REIT bonds.

Conclusions and implications

After enduring the heat of excess leverage and insufficient cash flow the A-REIT sector has reformed greatly from its pre GFC excesses and subsequent Icarus moment. Despite the underlying fundamental risks now being far lower than seven years ago, the valuation risks facing investors are almost as extreme today as they were then. Recent performance can sometimes be a useful guide to future performance however often the sign is reversed – having outperformed Australian equities by 3.5% p.a. over the past three years and subsequently pushed valuations to levels not seen since just before the GFC our view would be the recent past has sown the seeds for a risky future. With a market obsessed by a single factor

– the reach for ever smaller yields, and an increased acceptance of leveraging up the spread – complacency concerning other risks and the relative pricing of A-REITs to other assets underpins an underweight exposure to the sector in the Australian multi asset portfolios.

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