Property Securities: dead end or global beginning?

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The Australian property securities sector has provided exceptional returns over the past 10 years. There have been several changes to the sector which are leading many commentators to the belief that the market is overvalued and assuming more risk. This paper will examine the current state of play, taking into consideration the underlying property market, macro-economic drivers and the influence of global property securities funds on the local sector. In the context of structural change over the past 5 years we will look at the prospects for total returns from property securities in the future.

Background

The Listed Property Trust (LPT) structure was introduced to bring liquidity to traditional property investments. Over the past fifteen years the LPT sector has witnessed significant transformation from its origin as a collective investment in property. The early nineties proliferation of listed trusts was largely a result of the liquidity failure of unlisted property vehicles during 1989-1991. Listed trusts offered investors liquidity and property exposure, something which had not previously existed on a widespread basis (although Westfield listed in 1982 and General Property Trust 1971). Listed trusts became the dominant structure for acquisition and investment in commercial property. Capital structures of LPT's at this stage were quite simple and gearing levels low. Gearing levels in the two leading trusts (Westfield Trust and General Property Trust) in 1990 were 7% and 0% respectively (compared to 35% and 33% as at 31 December 2006).(Westfield and GPT Annual Reports, 2007)

The next significant phase for property trusts started around 1994/1995 with the listing of several sector-specific trusts (eg. Macquarie Industrial Trust [January 1994], Colonial Commercial Trust [November 1995], Goodman Hardie Industrial Trust [July 1995], Paladin Commercial Trust [December 1995]. These trusts offered investors sector specific property exposure. Around this time the market saw widespread use of various mechanisms such as partly paid equity structures, different classes of equity (notably, Colonial's capital entitlement units), vendor income support and higher gearing. At this stage, valuation methodology started to advance from simple yield comparisons and Net Tangible Assets (NTA) ratios to capital asset pricing and discounted cash flows.

The third major phase, consolidation, started to occur in the late nineties. Consolidation of the sector occurred via the merger of "house" sector-specific trusts into diversified trusts as well as take-over activity. At the beginning of 1998 there were 38 trusts in the ASX Listed Property Trust Index. The largest of these trusts was Westfield ($3,690m) and the smallest Darling Park Trust ($105m). The median size trust was Colonial Commercial Trust at $350m. The index is now called the S&P/ASX300 Property Index. There are 35 trusts in the index, the largest being Westfield ($34,195m) and the smallest Australian Education Trust ($184m). (IRESS)

The growth of integrated property businesses is one of the more noticeable changes to the LPT landscape over the past 5 years. There is an increasing trend toward a stapled security structure, internalisation of

management and the pursuit of broader property related activities. The merger of Westfield Holdings, Westfield Trust and Westfield America Trust in mid 2004 was to become the largest internally managed stapled security which led other major groups such as GPT and DBREEF towards a similar structure. Over the past 5 years new integrated property businesses have delivered investors higher earnings growth and greater capital gain prospects compared to traditional property trusts.

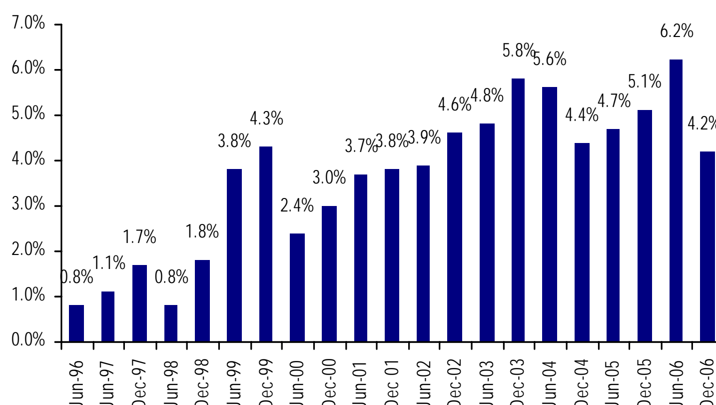
Consistently high returns

The LPT sector has delivered significant returns over the past 10 years, out performing the broader equities market by 2.0%pa (IRESS). To ascribe only one or two factors as the key drivers to returns over the past 10 years would be underestimating the complexity of the market. Interest rates are certainly a key contributor, but it is several influences acting in unison which has resulted in strong prolonged growth. The major factors include:

- Progressively lower bond yields
- Increased financial leverage
- Increasing operating leverage (new higher ROE businesses, leveraging human resources)
- A new management style with increased focus of shareholder value and cost of capital
- Strong direct property fundamentals
- Increased demand for income oriented investments

Recently, much commentary has suggested that the LPT sector is overvalued. In examining some of the traditional valuation metrics it is possible to come to the conclusion that some of these metrics are at all time highs, and that the sector is overvalued (evidence of this?). This alone, however, may not accurately portray the state of the LPT market. While the sector has started to trade on a yield below that of the ten year bond yield it is also producing the strongest earnings and distribution growth over its 35 year history. Chart 1 shows distribution growth over the past 10 years.

Chart 1: <u>LPT sector reported DPS growth</u>



Source: UBS

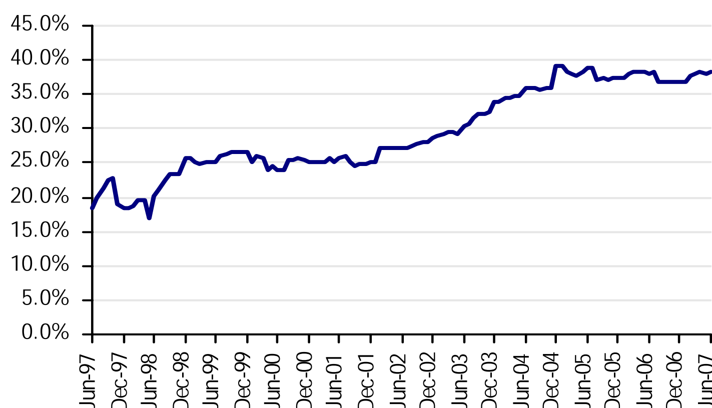
Now that the majority of the sector is internally managed there is a greater focus on return on equity and cost of capital. This has been a structural shift in the sector which has led to new business units such as development, funds management and property services being added to the more traditional property trust structure. Activities within these new business units include syndication, wholesale property funds management, short term property trading, mezzanine debt funding, development of in house assets and

speculative development. This is a significant departure from passive asset ownership of the past. The sector's focus has moved from FUM to ROE. This has completely changed the management style of CEOs within the sector. For example????

This structural change has been progressively priced into the sector over the past 5 years. Most of this structural change can be broadly described as financial leverage and operating leverage, but there have also been other powerful catalysts. Strong returns from the LPT sector have also been backed by a solid direct property market where underlying asset values are increasing, as well as a bullish equities market with plenty of corporate activity.

There has also been increased financial leverage in a sector with improving fundamentals; rental growth and capital values. Obviously, financial leverage works in both directions, but to date it has served to increase returns to shareholders. Chart 2 shows the increase in gearing over the past 10 years.

Chart 2: LPT sector gearing



Source: UBS estimates

Valuation methods have evolved to reflect these changes but there was some obvious under-pricing of securities based on lagging valuation methodology. Initially it was a fixation with Price/NTA and then, sum-of-the-parts valuations, neither of which really reflected the inherent value that was being created by some of the management groups within the listed entities. The market has now moved to earnings yields, PEs and is increasingly looking at PE/EPS-g ratios, whereby they are looking at the security as a whole and taking into consideration the marriage value between the businesses and the assets.

The LPT sector has also benefited from a switch from growth style assets to (tax effective) yield assets as the population increasingly becomes skewed to retirees. This trend is likely to underpin continued demand for LPT style investments that deliver a high yield and an appropriate level of earnings certainty.

Future return prospects

We anticipate continued strong returns from the LPT sector based on a long term trend of lower bond yields, a strong underlying property market and a continued leveraged ROE focus.

The most powerful price catalyst over the next 5 years is likely to be continued yield compression in the bond market, lowering the discount rate for equities valuations and also the yield structure for LPTs. While yields have moved up over the past year, we do not anticipate this to be a change in the **long** term trend.

The longer term trend will be for lower yields and this will predominantly be due to the fragility of the household sector to asset price corrections and variations in economic growth.

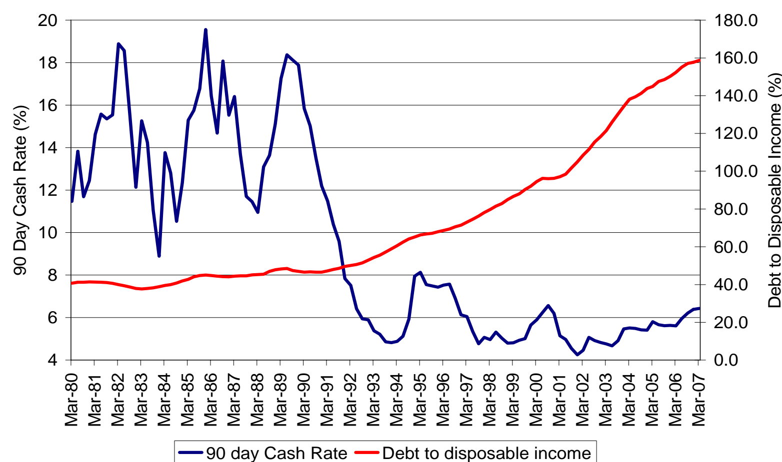
The increase in household gearing levels over the past 10 years has been a major boom to the economy but the private sector credit growth trajectory cannot continue and the marginal appetite for debt will eventually fade, slowing economic growth and asset price inflation. And this is not taking into consideration a major economic debacle, like a correction to the mainland Chinese economy or a collapse of the US dollar.

Central banks in the major western countries will need to progressively lower interest rates (over the long term) as highly geared households become increasingly sensitive to economic changes.

"Mortgage credit has become available on easier terms to borrowers almost everywhere…. household consumption during the current upswing has made an unusually high contribution to GDP growth in advanced industrial countries. The rise in the propensity to consume and the decline in household saving rates have been broad based over the past four years. Rising debt levels might have increased the sensitivity of household balance sheets to financial and macroeconomic shocks" - Bank for International Settlements 77th Annual Report

Chart 3 illustrates rising household debt and the movement of interest rates over the same period. Is it a case of the tail wagging the dog? The higher household gearing rises, the greater the need to lower the cost of debt to ensure the current level of economic growth continues. In the longer term, significant economic impacts (such as the sub-prime mortgage collapse in the US) will result in central banks having to lower rates to buffer the economy from significant financial impacts, much the same way as the US Federal Reserve reduced rates after the World Trade Centre attacks..

Chart 3: Cash Rate vs Debt to Disposable Income



Source: RBA

The state of the underlying property market

The fundamentals of the Australian direct property market are very good. The market has witnessed significant cap rate compression across all sub-sectors, but notably within the retail market. Vacancy rates continue to fall in the office sector, putting upward pressure on rents. Retail sales continue to grow

keeping occupancy costs at sustainable level, and supporting further rental growth. Retailers are enjoying lower cost of goods with the strong rise of the AUD. The industrial sub-sector is benefiting from improved national infrastructure, lowering of international trade barriers and a strong local economy. We see continued long term cap rate compression in the direct market as rental growth in each sub-sector continues. This will be supported by lower overall yield structures as discussed above.

Leveraging human capital

This progressively lower yield structure will underpin continued performance of the LPT sector over the long term. It will support LPT pricing via strong NTA growth and earnings growth. Those companies with operating leverage to the property sector, via development or funds management will continue to earn performance fees as the strength in the property asset class continues.

In the past, LPT managers focus was predominantly on the use of capital to acquire property assets. In the new era of stapled securities there is a far greater focus on the real estate 'skill-set' to leverage returns. The preference is now to have assets off balance sheet (in managed funds or development projects) and to extract fees by applying a high level of expertise in managing the assets/process. Under the current structure, leveraging real estate skills (or human resources) has become a key focal point. These businesses are showing higher profitability while employing a lower level of capital compared to traditional listed property trusts.

The growth of funds management businesses and the associated leveraging of human capital rather than financial capital will be of benefit to those who participate. Furthermore, those companies that can achieve economies of scale will grow profits exponentially to their asset base.

The management style of the stapled securities is also very different to the management of LPTs of the past. The focus for management is to establish and maintain a high level of return on equity without compromising their cost of debt. The chief aim is to have the lowest cost of capital possible which provides management with a competitive advantage in acquiring new assets and growing the business. The vehicle with the lowest cost of capital can make future acquisitions accretive to earnings.

A warning on the retail asset class

Principal Global Investors see considerable medium term risk in retail asset pricing. Given the level of household gearing (and over exposure to the residential property market) retailers will have to work increasingly hard to extract the marginal dollar from consumers in CY2008. Savings rates cannot continue to be negative for too long, when households are already highly geared. Retailers have benefited from a decade long surge in consumerism which is reflected in the yields of retail property assets. It is at this junction however, that investors should be considering the likehood of future retail growth, given where we have come from since 1995. Future growth carries significantly more risk from its current base.

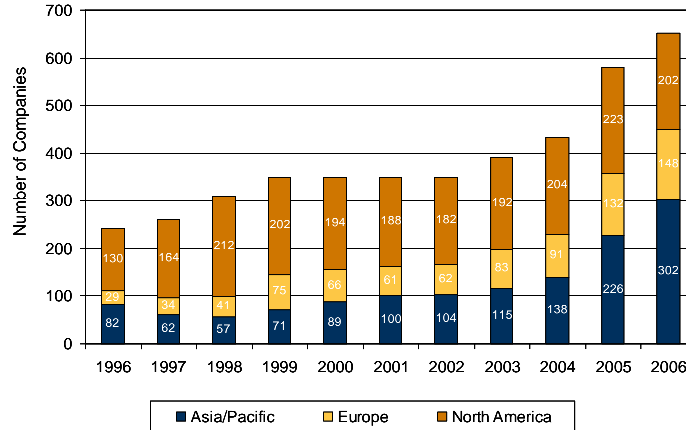
It was the business sector that over geared in the 1980s, this time around it is the household sector. Corporate expansion in the late 1980s led to strong take up of office space. This time around it is the households that have overextended and retail yields look to be in the same precarious position to the office sector yields in 1989/90.

Being a retail landlord over the past decade was like being in the funds management industry as the government introduced compulsory superannuation.

Asset allocation to Global Property Securities

Investors worldwide are increasingly embracing cross-border real estate investments. As illustrated in Chart 5, the universe of global property securities has grown significantly over the last 10 years, and we expect this trend to continue. The Asia/Pacific region has been at the forefront of this growth, placing Australian property managers and investors in a good position to benefit.

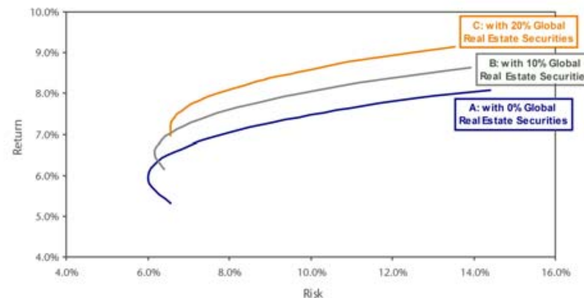
Chart 5: Growth of Investment Universe



Source: Principal Global Investors.

Global property securities provide diversification benefits which allow for the construction of a more efficient, multi-asset class investment portfolio. Using historical returns for all three asset classes, Chart 6 shows how the addition of global property securities can increase portfolio return for the same amount of risk. Chart 7 shows that global property has historically delivered higher returns than equities for the same level of risk – making it essential to consider not only local but global property securities in the portfolio construction process.

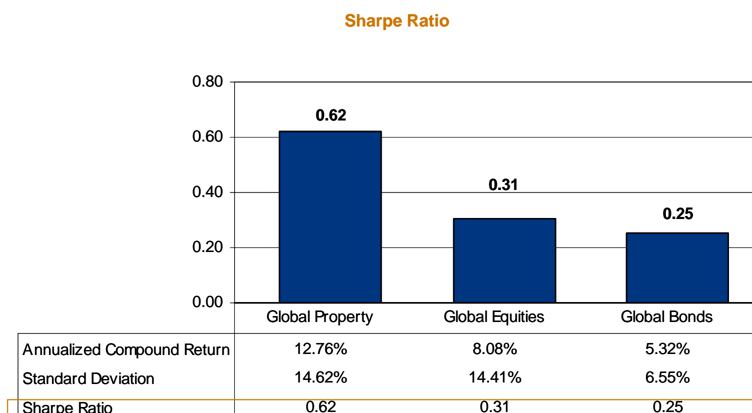
Chart 6: Risk-Return Tradeoff Curve – Global Equities, Bonds & Property Securities



Portfolio A	0% Global Property Securities, 55% Global Equities, 45% Bonds
Portfolio B	10% Global Property Securities, 50% Global Equities, 40% Bonds
Portfolio C	20% Global Property Securities, 45% Global Equities, 35% Bonds

Source: Principal Global Investors; FTSE EPRA/NAREIT Global Index, MSCI World Equity Index, JP Morgan Global Bond Index; monthly returns in USD. Dec 1996-Dec 2006

Chart 7: Risk-Adjusted Performance (1 Jan 1997 – 31 Dec 2006)



	Global Property	Global Equities	Global Bonds
Annualized Compound Return	12.76%	8.08%	5.32%
Standard Deviation	14.62%	14.41%	6.55%
Sharpe Ratio	0.62	0.31	0.25

Source: Principal Global Investors; FTSE EPRA/NAREIT Global Index, MSCI World Equity Index, JP Morgan Global Bond Index. Returns in USD.

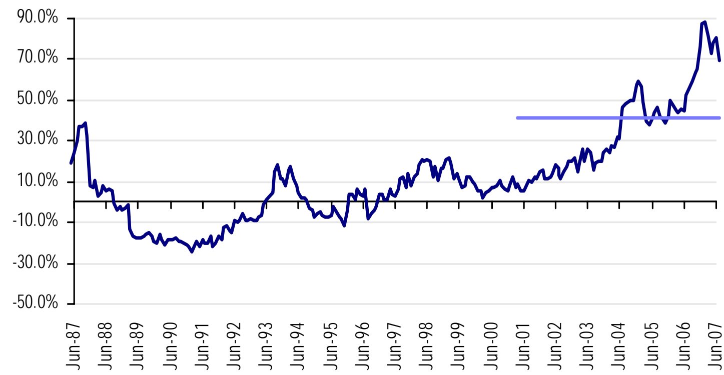
Conclusion

Active management of both Australian and global property securities is extremely important in the current market environment – to capture returns and minimize risk. Although significant changes have occurred in the property securities sector over recent years, sound investment opportunities remain and property securities remain an essential element of portfolio construction.

Principal recognises that real estate stocks may trade in line with real estate values plus or minus capital structure leverage, in the longer term, but behave as listed securities on a day to day basis. As listed securities there are a multitude of influences at any one time. It is important to be flexible in managing portfolios and to understand the structural changes that are taking place and the key catalysts for change. The increasing diversity of the LPT sector will offer a greater opportunity for active management than in the past. Furthermore, an increased emphasis on management rather than hard assets is likely to result in a more difficult environment for fund managers to determine relative value.

We expect that in due course the developers and contractors and infrastructure sector will be included in a broader Real Estate grouping, thereby offering a wider investment universe than currently exists. Furthermore, the current premium to NTA for the sector (Chart 4) is likely to attract new listings, which will be included in the current index. The term "listed property trust" or "LPT" is likely to become redundant as the international property conglomerates dominate the sector.

Chart 4: Discount/Premium to NTA (LPT sector)



Source: UBS, IRESS.