UBS

May 2016

# Even lower for even longer

## Why REITs remain attractive

We've previously written how income producing assets would benefit in an environment where interest rates and inflation were 'lower for longer'. Following the RBA rate cut, there's more upside given that interest rates are at record lows and look like being 'even lower for even longer'.

What a difference a year makes. In 2015, most economists forecast a succession of US interest rate rises and a gradual improvement in the global economy. At the same time Leicester were at 5000–1 odds to win the English Premier League and Donald Trump was 150–1 to become president. Now most economists have retracted US rate rises, Leicester have won the league and Donald Trump is at 2–1 odds to become President. Locally, 1Q16 inflation came in well below expectations, and the record low underlying inflation rate of 1.5% year-on-year led to the RBA cutting the cash rate to 1.75%. We've also seen firmer bonds, a lower Aussie dollar, the retention of the negative gearing and capital gains tax regime and the $50 billion infrastructure spend. In an environment of 'unknown unknowns', the focus on income producing real assets is intensifying, for some of the reasons below.

# Why REITs are attractive

### The dividends are relatively high and they're not dropping!

REITs are presently paying a dividend yield of 4.9%, which is a 'yield premium' over term deposits of ~250bps. The dividend compares to the earnings yield of 5.9% which implies REITs are paying out ~83% of earnings to unitholders. Unlike some banks, miners and other stocks, the income received by REITs is not projected to fall or be cut. If anything it's expected to rise in the next year by ~4% per annum in the next few years. Globally, these yields are compelling. Plus, it's a liquid investment meaning you can buy or sell it anytime you like.

### Property fundamentals remain solid

Australia remains the 'lucky country'. Whilst the Australian economy is not fantastic, it's still alot better than some of its peers. The forecasts are for GDP growth between 2.5%–3.0% versus Japan at ~0.5%. Although we have low interest rates, we can still cut rates further if necessary. In terms of demographics, our population growth is expected to be alot stronger than our peers. More population equals more demand for food, clothing and accommodation. In the office, retail and industrial sectors there are no oversupply concerns. The only areas of concern are Melbourne and Brisbane apartments, but there is minimal exposure to this in REITs.

### Strong balance sheets and lower interest costs

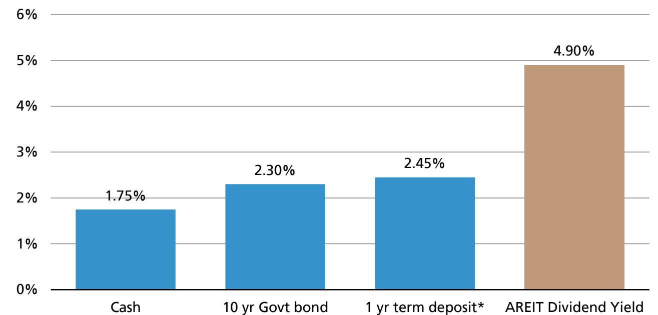
Unlike previous property cycles, debt is not an issue. REITs have taken the opportunity to 'blend and extend' debt facilities, that is, extend the duration of loans and diversify away from the big four Aussie banks. Average gearing levels (debt to assets) is ~30% and interest cover is around 4x. The better management teams have been selling non-core assets to reduce debt even further. AREIT's biggest expense line is interest expense. With lower rates, the potential saving is significant and earnings growth should therefore be stronger than previously forecast.

### The Aussie dollar

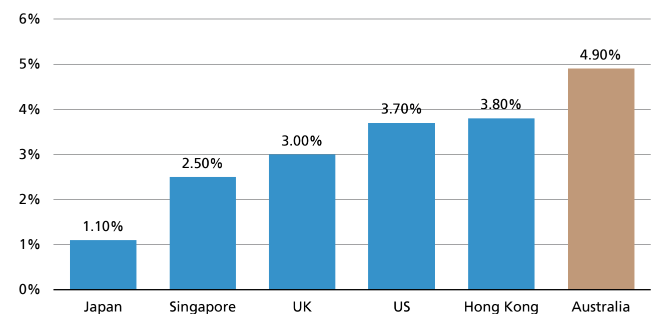
With the Aussie dollar trading ~73c versus the US dollar, and expected to reach ~70c in the next year, offshore investors not only get a higher yield but also pay less to receive it. The purchase by China Investment Corporation (CIC) of the Investa Property Trust for A$2.45bn ended up being US$1.8bn (AUDUSD ~73c) in July 2015. When the deal was first being touted in late 2014 the AUDUSD was ~90c which equated to US$2.2bn. Global demand for yield is strong and while Australia isn't the biggest market we have high yields, a relatively stable economy and most importantly, excellent transparency.

Now this all sounds great BUT before you invest further we should provide you with a balanced opinion and outline some potential risks.

### A REIT Dividend Yield Comparables

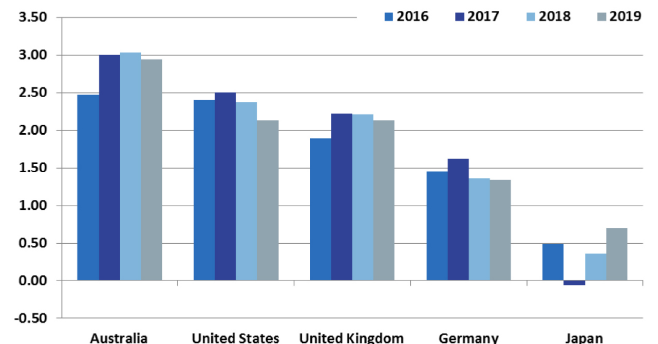



### Global Property Forecast Dividend

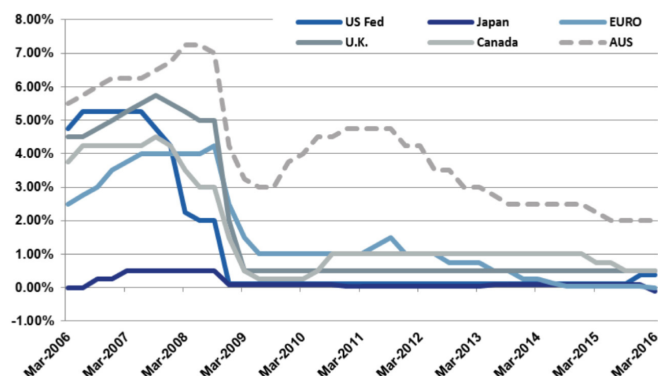



* This is Westpac 12 month term deposit rate which is the highest rate of the top four Australian banks. Source: UBS Asset Management, Facset. As at 18 May 2016

### IMF Economic Growth Forecasts




### Interest Rates by Country




Source: IMF World Economic Outlook, April 2016.
Note the Interest Rate chart doesn't reflect the recent 25bps cut.

# But what about the potential risks?

**Rising bonds**

The biggest risk to valuations is rising bonds. As bonds rise, this signals the economy is improving and ultimately leads to a switch from 'defensives' to 'growth'. In this environment, the broader equities market should outperform REITs. This may be caused by a sharp spike in oil prices given supply cutbacks, albeit if China growth falters and the world enters a recession then demand will reduce. At this stage, rising bonds seems unlikely given the 'even lower for even longer' thesis.

**Low inflation and price deflation**

Lower CPI means lower rental growth given that many leases are linked to CPI. All else being equal this could lead to lower asset values given you pay less if you expect lower growth. However, if rates remain low then you arguably lower your return expectations and could pay a firmer yield for an asset. Thus it should not materially impact. If low inflation persists for many years, and if leases have fixed reviews, then the assets could become over-rented. The great thing is that the average lease term of the sector is ~5 years so the sector can react to this potential issue ahead of time. The other concern is the impact of supermarket wars, leading to price deflation. As rent is often linked to sales, this too could impact rental growth. Once again, if the economy is weak, investors will likely be forced to accept lower returns. There will be greater issues in other sectors.

**Bankruptcies**

If the economy is weaker than expected, we expect some businesses to go bust. This is par for the course and REIT management teams have staff monitoring the solvency levels of every tenant. Westfield for instance know when tenants are struggling well ahead of time and try to work with the tenant to improve sales. Failing that they have lead time to try to secure a new tenant. The fall-back position is that most tenants will pay a rental bond upfront, similar to a housing bond. If the tenant has issues then there's at least a few months rent in the bank. Bankruptcy is a part of the business cycle. Luckily for REITs, there's massive diversification of markets, assets and tenants to reduce the impacts of such an event.

**Housing**

We do have concerns for an oversupply of apartments in Melbourne and Brisbane and continued house price weakness in Perth. However, these markets make up a tiny proportion of REIT earnings. In fact, less than 5% of the sectors earnings come via residential sales. Solid population growth, employment growth and supportive interest rates should reduce the downside risk. If the economy weakens to such an extent that house prices crash, I'd be more worried about banks and service sectors than REITs. The sales evidence we have seen suggest that it's been offshore based developers paying large premiums for sites while local players watch and wait for opportunities to emerge. In every cycle there's winners and losers and my bet is the locals win this cycle. REITs have been selling non-core sites and have excellent balance sheets. Any short term pain will have longer term benefits as the REITs reposition for the next cycle.

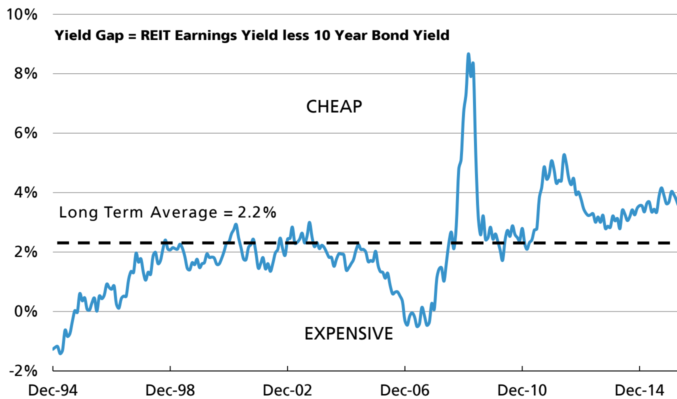
**Valuations**

The REIT sector has delivered excellent returns. Against the broader equities market (S&P/ASX 200) it has outperformed by ~50% since January 2014 to May 2016. Has it run too far? We certainly get nervous when things deliver such strong performance if we can't explain it. Given the slump in commodity prices and ensuing downgrades, the general global uncertainty and the security of rental returns, we can explain the rationale. Our first level of screening is to compare the REIT yield versus bonds and cash and there's still a massive 'yield gap'. If we have record low interest rates, why can’t REIT yields go lower? One concern we have is the premium to net tangible assets (NTA) with some stocks trading at large premiums to 'break-up' value. The first thing we note is that valuation yields are expected to compress further given the 'even lower' outlook. Thus some NTA's are likely under-stated. However it does not explain some stocks. For instance Bunnings (BWP) trades at a 43% premium to the estimated break-up value (share price of $3.60 versus an assessed valuation of $2.52). The implied capitalisation rate (yield) is 5.5% vs published cap rate of 6.8%. Would a large fund pay more than a 6.8% yield for a Bunnings portfolio? Yes it would. Would it be 5.5%? I don’t think so, but keep in mind a 5.5% yield plus ~3% rental growth pa = an 8.5% IRR. That doesn’t seem out of the question. Anecdotally, retail investors (mum and dad's) like this stock because it's a trusted brand, they likely visit one quite often, it delivers a solid yield and it's never disappointed! We, on the other hand, think there's better value elsewhere.

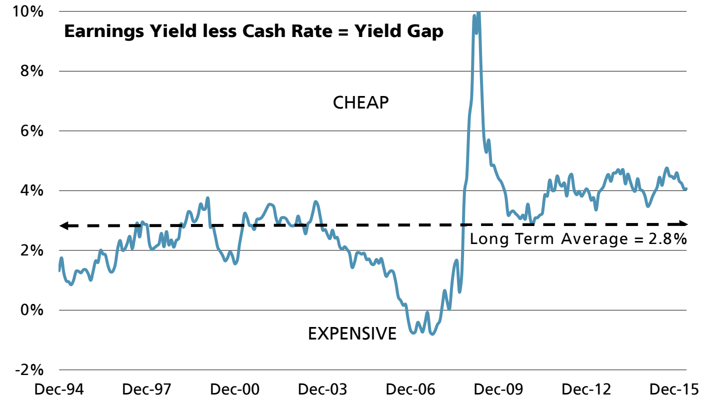
**GFC version 2**

If there is another GFC we are happy to take shelter in real assets. The biggest lesson we learnt last cycle was that income producing assets have a much better chance of surviving downturns. If an asset can service the debt then it's in a great position to avoid being shut down. The A,B,C of the GFC were Allco, Babcock & Brown and Centro that were all highly leveraged beasts. Allco and Babcock are no longer around but Centro survived as it had physical assets that continued to collect rent and meet it's repayment schedule. Those assets are still standing and are now owned by Vicinity.

### A REIT Yield less 10 year bonds




### A REIT Yield less cash




Source: UBS, IRESS
As at 18 May 2016

# The outlook is positive

Investors chasing high returns in this environment face a tough battle finding growth, while anxious investors are struggling with the cash rate at 1.75%, 10-year bonds at 2.3% and the major banks paying up to 2.45% for a 12 month term deposit. In such an environment, there are not many options for investors seeking a decent yield. REITs are one of them, and it is for this reason that we remain optimistic about their outlook.

The sector benefits from solid operating fundamentals, strong financials (low gearing), good dividend coverage and strong demand for institutional grade real estate. A continuation of low interest rates, reasonable consumer confidence, and corporate activity / M&A will support the sector.

The sector is offering a 4.9% dividend yield, with forecast growth in dividends of ~4% pa for the next 4 years. Profit growth is reasonably predictable being largely driven by contractual rental arrangements, some development profits and asset sales. Unlike some of the broader industrial companies, there's no question marks over REIT dividends!

Even with no yield re-rating, the sector should give a return of 8-9% this year. In perspective, the current AREIT dividend yield is 2.1x the current 10 year bond yield and 2.8x the cash rate.

The greatest risk is a softening in bond yields, which would negatively impact pricing, however:

a. this seems unlikely at this juncture; and

b. would be partially absorbed by the large yield gap between the REIT earnings yield and 10 year bonds.

2016 will remain an eventful year with US elections, UN elections, the UK referendum, a refugee crisis, Brazil hosting the Summer Olympics, and Abenomics trudging along in Japan. Throw in concerns over commodity prices and the Chinese economy and it's shaping up to be a tough year for investors.

REITs remain an attractive investment.

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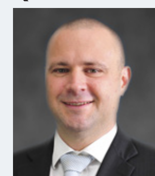

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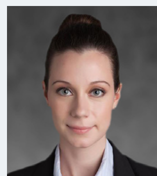

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