Chris Burrell's
Market View Blog

Australian Real-Estate Investment Trusts (A-REITs)

A-REITs were trading above net assets prior to covid in January 2020. With the advent of covid, there were dramatic price falls with some A-REITs falling by almost half. While a deal of this was due to the fear of a Spanish flu like epidemic and with some just cause in the early stages, over time it became clear that the vaccines would work and the A-REITs have recovered in varying amounts.

Industrial property

Industrial property fell in-line with listed property trusts generally during the first quarter of calendar 2020, but over time the realisation became that industrial property would be a beneficiary of covid. With China closed, many businesses experienced stock shortages and delays. We moved from "just in time" to "just in case" or "not at any time". The resulting behaviour was for businesses to order stock from multiple suppliers and multiple countries because it was unknown when stock would arrive. Shipping was constrained and freight prices soared dramatically. Shipping costs which were previously under $5000 per container traded at over $20,000 per container.

In the fullness of time, the stock arrived. Some orders were never filled, but most were and so this resulted in higher levels of stock held by Australian businesses. Where to store it? The answer was in industrial sheds. This means that the vacancy rate in industrial sheds in Australia has been under 1% in many parts of the country. One listed industrial property trust reported on the 28th of May 2024 that rent increases were 50% on the 11% of the portfolio that matured during the period. The portfolio is 30% under leased i.e. as those leases expire in the future, material increases in rents are anticipated. Further almost no businesses have moved, as there is nowhere to move to. These dramatic increases in rent still leave Australia materially below the industrial rents that are paid by international businesses in the USA and UK.

Offsetting these rent increases will be the increase in interest costs. Several property trusts were able to hedge their interest costs at around 2% during covid. Interest costs have already increased to 3.5% and as the hedging comes off, it might be expected over several years that interest costs could increase as high as 6%. Industrial property remains the sweet spot in the A-REITs, although the market has recognised this with some better recoveries in listed prices of industrial A-REITs.

Shopping centres

Shopping centres were initially the worst performing sector, as no one was allowed to visit shopping centres during the first 12 months of covid. As soon as the covid restrictions were lifted, families tentatively made their way back to shopping centres. Nowadays, the food halls are busy with families and shoppers have returned so that foot traffic is high, although consumers have been reluctant spenders since April 2023. Westfield for example, now known as Scentre Group, fell from $4 in January 2020 to $1.60 in March 2020. The stock has recovered a good portion of that fall and is again paying a yield of 5.22%. There has been reasonable performance in the re-leasing of shops in shopping centres with modest rent increases, despite the fact that we all see shops that are vacant. Shopping centres have some barriers to entry in that it is difficult to find plots of land sufficiently large as Indooroopilly or Carindale and so by dint of the rezoning laws and other restrictions, shopping centres have some attractive attributes for owners of A-REITs.

Office trusts

Office trusts were ultimately the sector which suffered the greatest falls during covid. As firms were restricted from attending CBDs and working from home became an accepted norm, businesses adapted to increase the percentage of workers who could work from home (WFH) from 10/20% to 80%+. In some businesses such as IT, WFH has remained the norm. However for many businesses, employers have been keen for employees to return to the office to allow for training, collaboration and productivity improvements. This is an ongoing debate. What is even more difficult is to understand the changes in the space requirements, which different businesses will require going forward. Certainly more meeting rooms and collaborative spaces are required where employees only work in the office say 3 or 4 out of 5 days. Looking at the difference between A-REITs market prices and net assets, the office sector remains with the largest difference. The physical sales of office properties fell to low levels post covid and it has been difficult to gage the extent of the falls. However, in the Sydney CBD, there was a suggestion that market prices have fallen say 12% whereas the falls in A-REITs listed prices were in some cases up to 40%. Even today, a number of the A-REITs in the office sector are trading at discounts as high as 30% to net assets.

Capitalisation

A-REITs have been revising down their net assets to reflect the higher interest rates and consequent capitalisation rates. If a building has $1m in rent, then at a capitalisation rate of 10% the building is worth $1/.1=$10m. If the capitalisation rate applied is 5%, the building is worth $1m/.05=$20m. It can be seen building valuations are highly sensitive to changes in capitalisation rates.

During covid interest rates including the 10-year interest rates which are used to value shares, property and other longer term assets fell to record lows. These falls continued the trend since the global financial crises in 2007. Covid continued this trend and 10 year rates fell below 1%. Such low rates were unsustainable and rates are now normalising in the 4.5-5% bracket. Reflecting these increases in interest rates, there has been some reductions in net assets reported by A-REITs. It may be this trend has a little further to go; such that is suggested one reduces the reported net assets by 10-15%. In a number of cases, this leaves a good margin of safety between current listed prices for A-REITs and net assets as restated.

Summary

In summary, the listed property trusts sector or A-REITs as they are known suffered dramatic falls during the covid period. We are now seeing useful recovery in those prices with the A-REITs index up well over 10% financial year to date. While the opportunities across the three major sectors of industrial, shopping centres (retail) and office vary and within those sectors, different A-REITs have different debt and property attributes, A-REITs offer some useful risk adjusted returns for investors.

Burrell have prepared a schedule showing the various discounts noted above which is available to clients upon request.

Happy Investing,

Chris Burrell