Australian Property Outlook

October 2023

Key Highlights

It may be all in the price.

- Brokers forecast Australian Government bond yields to fall in 2024 as the global economy slows. Falling yields may provide a tailwind for REITs.
- REITs have deleveraged since the Global Financial Crisis. Interest coverage ratios are supportive.
- By subsector, retail and office offer the most potential long-term upside capture. Trading at significant discounts to NTA.
- Refinancing risk low. Peak debt maturity roll-off in fiscal-year 27. Low interest rates are partially secured for 2024.

Introduction

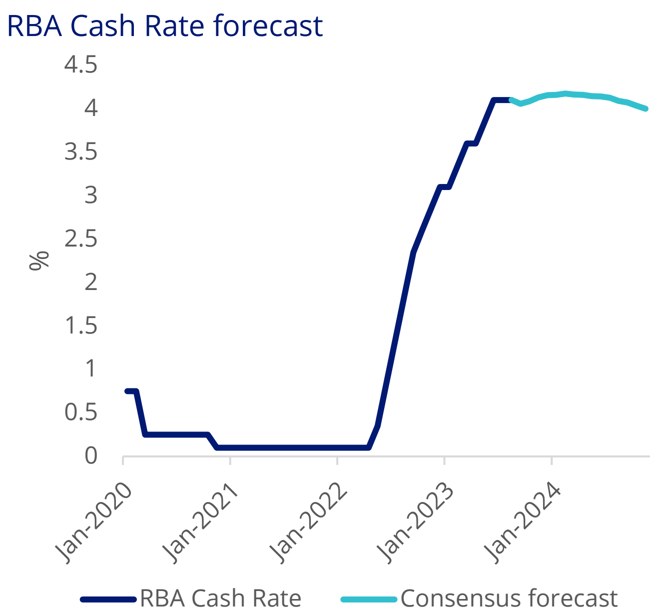
The macro-economic environment, characterised by elevated inflation and low growth has historically been an environment where REITs have outperformed. The asset class offers inflation-linked revenue streams including exposure to subsectors that offer inelastic demand in an environment where the global economic activity is subdued.

Australian inflation is at risk of remaining elevated over the medium term. Return of migration and the housing shortage are driving rental inflation. Energy prices have increased and Australian dollar weakness adds inflationary pressures.

By subsector, we favour office and retail REITs. Markets may have overpriced the downward revision in valuations expected. Subsectors are trading at significant discounts.

Macroeconomic environment overview

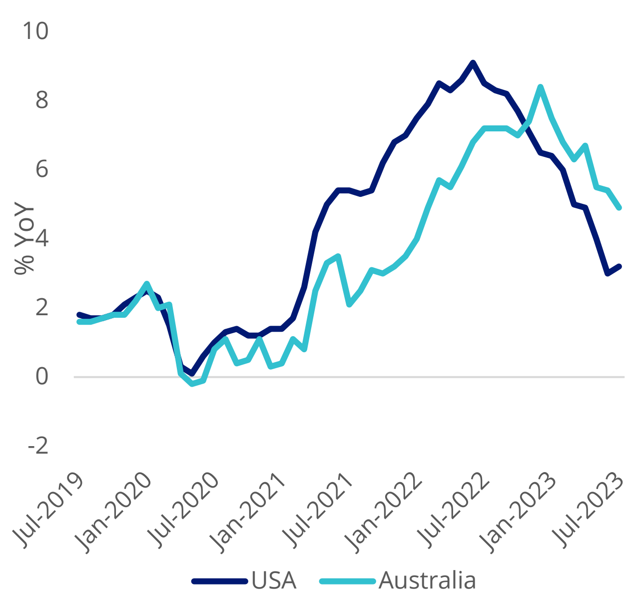
Front of mind for investors is whether we have reached the end of the rate hike cycle or see a second leg of rate hikes at the back end of the year. The RBA held the cash rate at 4.1% for a third consecutive month but warned that they may have to raise it again. Markets expect the cash rate to hold with the first cut coming in Q2 2024.



Source: Bloomberg, RBA, as at 6 September 2023.

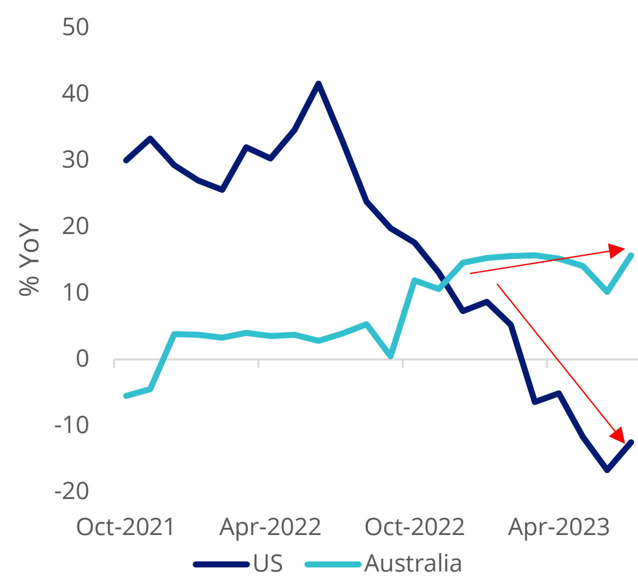
Australian headline inflation is trending down like we've seen in the US but risks unique to Australia do linger. Rental prices are accelerating and likely to remain elevated considering the gradual influx of migrants and the multi-year transition required to boost the housing supply. Energy prices have increased locally. Services inflation which is a function of near-record-low unemployment and strong wage growth shows little sign of unwinding. Recent AUD weakness adds further inflationary pressure.

Australian and US Headline CPI YoY



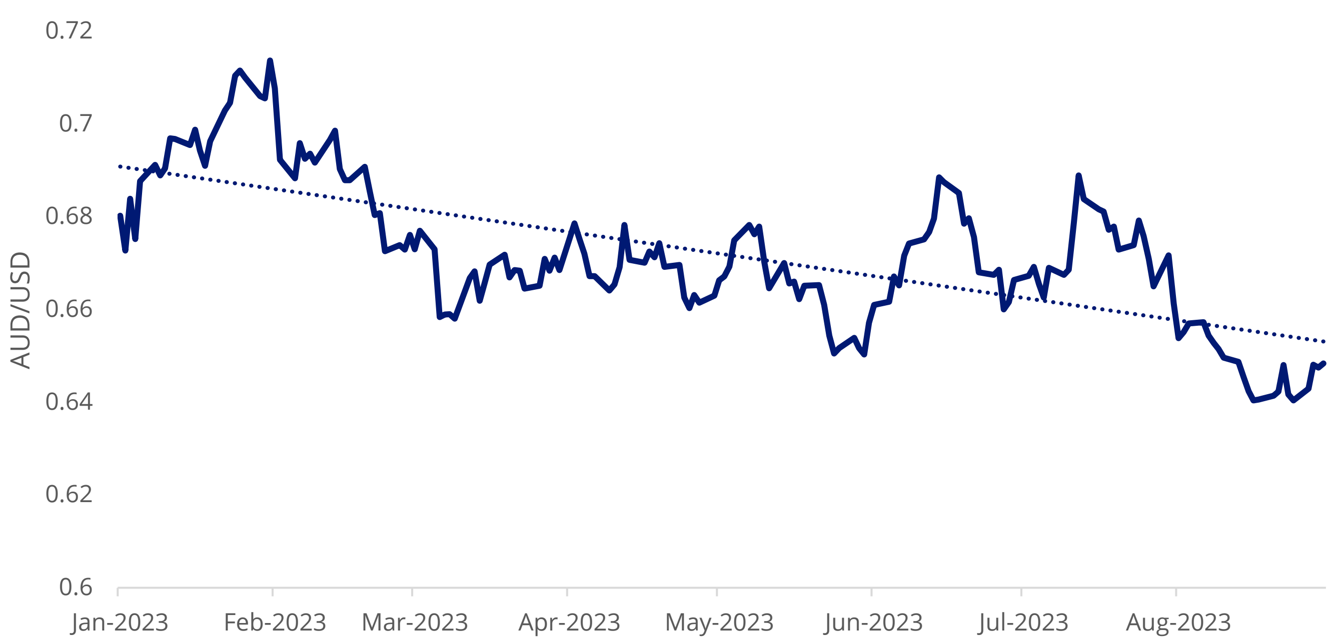
Source: Bloomberg.

Energy CPI YoY



Source: ABS.

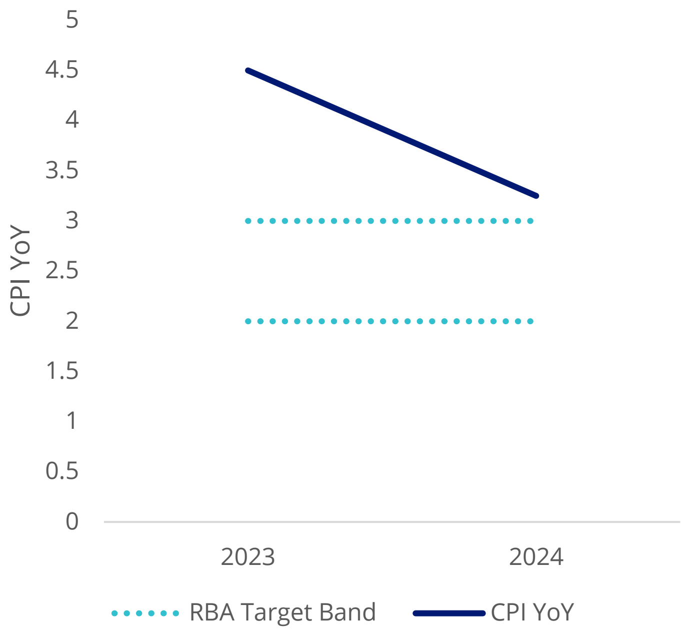
AUD/USD



Source: Bloomberg.

These signs suggest that Australian inflation will remain elevated and is consistent with the RBA's latest forecasts. The RBA is also likely to take a tempered approach to setting the future cash rate change as it is conscious of the mortgage pain already inflicted on households and businesses with the majority now on variable rates. These components are positive for A-REITs. The sector is widely considered to be an inflation hedge and minimal rate path changes help keep valuations stable.

RBA CPI YoY forecast



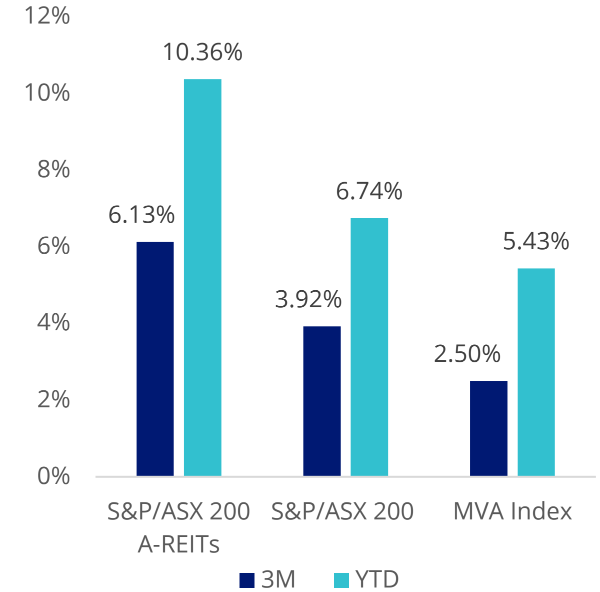
Source: RBA.

Market performance update

S&P/ASX 200 A-REITs index outperformed the Australian equity market benchmark S&P/ASX 200 over 3 months and year to date by 2.20% and 3.62% respectively. Better than expected earnings results for A-REITs during February and August updates including the 10-year Australian government bond yield holding steady at 4% supported performance.

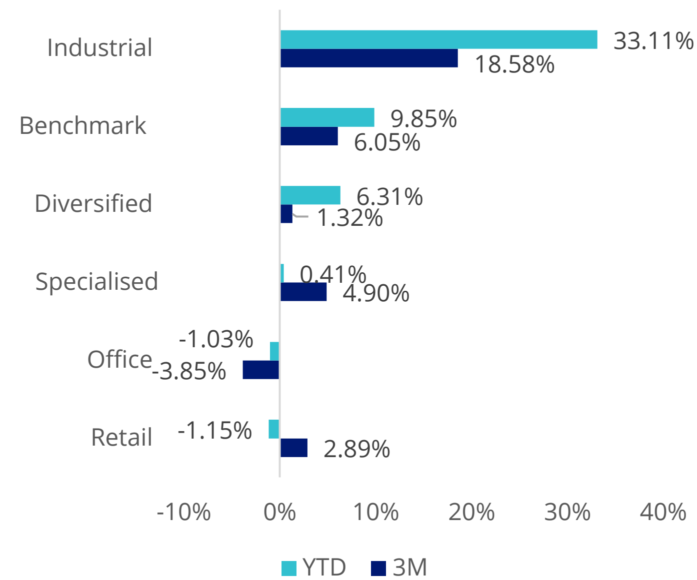
Australia's largest REIT Goodman group returned 33.11% year to date. The company at their August earnings update announced a large data centre pipeline, resulting in the share price jumping 13%. Office REITs dragged on performance, weighed down by tenants trimming office space due to the adoption of hybrid working and layoffs in tech and financial services. Office REIT Dexus sold 1 Margaret St, 21% lower than the June 2022 book value.

Australian Equity Performance



Source: Bloomberg, MVA Index is MVIS Australia Property Index. As at 31 August 2023. AUD Returns. You cannot invest in an index. Past performance is not indicative of future performance.

A-REIT Subsector Performance



Source: Bloomberg, S&P/ASX 300 A-REIT Subsector Indices. As at 31 August 2023. AUD Returns.

August Earnings Season

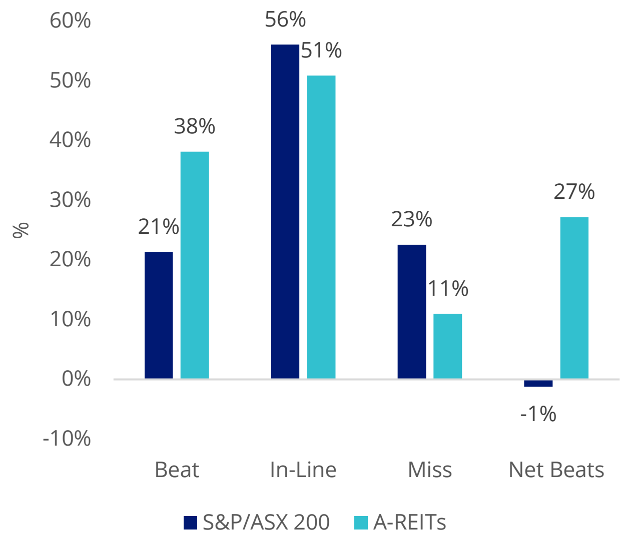
The major concern heading into the earnings seasons was fears of a significant downward revision in net tangible asset valuations (NTAs), notably office REITs and implications for listed share prices. There had been reports of several office buildings selling up to a 20% discount relative to December 2022 valuations and tenants handing back space. While this did play out, the results were better than feared.

Office building sales relative to December 2022 book value

Building Address	Book Value	Market Value	Discount
180 George St Sydney	$2.2bn	$2.0bn	-10%
367 Collins St Melbourne	$413m	$365m	-12%
1 Margaret St Sydney	$350m	$296m	-15%
44 Market St Sydney	$475m	$392m	-17%

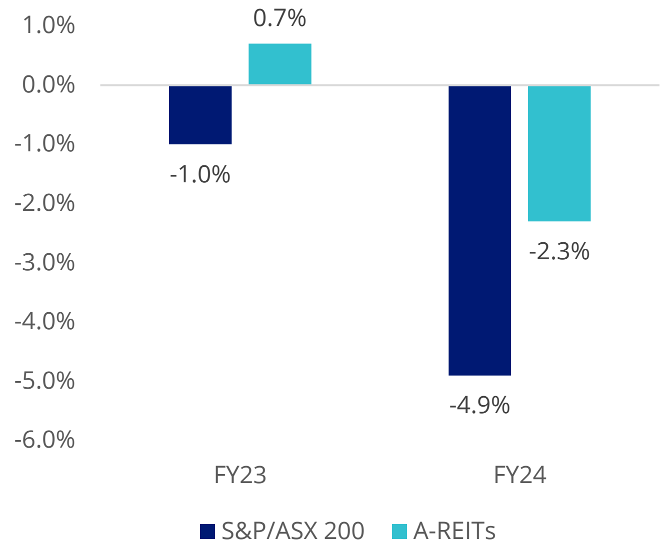
A-REITs earnings results were ahead of the S&P/ASX 200 with net earnings per share (EPS) beats higher by 28%. A-REIT FY24 EPS was revised down less than the S&P/ASX 200. While there were NTA revisions down across office and retail REITs, this had been priced in with listed prices already trading at a discount to NTA. The market responded positively with weighted average REIT price change post earnings release jumping +2.7%.

August 2023 EPS results (±2.5% range)



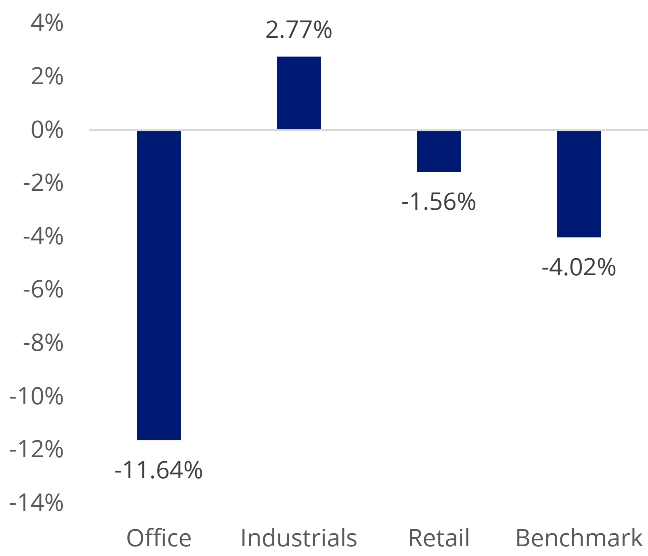
Source: Bloomberg, Index Weighted. A-REITs is S&P/ASX 200 A-REITs Index.

EPS Forward Consensus Revisions during earnings season



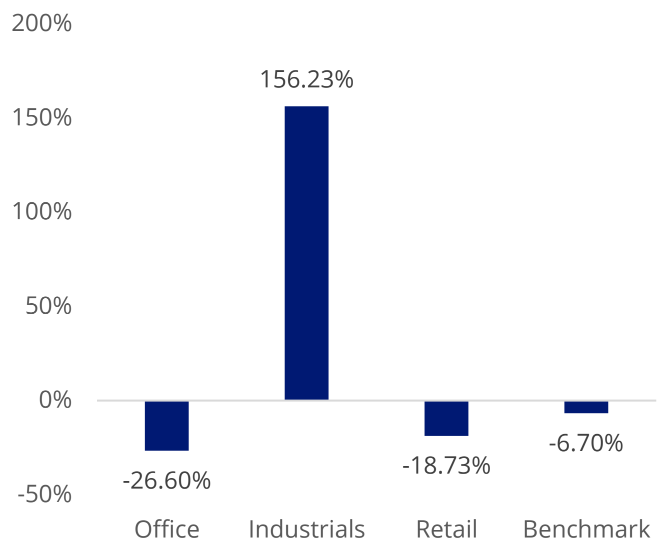
Source: Refinitiv. Index weighted. A-REITs is S&P/ASX 200 A-REITs Index.

NTA revisions (December 22 to June 23)



Source: Bloomberg, Office as Dexus. Retail as Vicinity Group, Industrials as Goodman Group, Benchmark as MVIS Australia A-REIT Index..

Premium/Discount to NTA



Source: Bloomberg, Office as Dexus. Retail as Vicinity Group, Industrials as Goodman Group, Benchmark as MVIS Australia A-REIT Index.

REITs outlook

We think the macro-economic environment, characterised by elevated inflation and low growth is the central scenario over the medium term. This environment is beneficial for real estate assets for several reasons.

1. Inflation-linked sources of revenue

An elevated inflation environment can be positive for REITs. REIT's commercial leases in office and logistics typically have inflation-linked annual increases in rents written into multi-year contracts, providing inflation protection on income.

2. Long duration exposure

Duration describes the relationship between changes in interest rates and valuations. The longer the duration, the bigger the impact of interest rate changes on valuations. REITs hold property investments on their balance sheet offering long shelf lives. Any change in yields have a material impact on valuations and present value of future earnings. Below highlights the performance of A-REITs relative to S&P/ASX 200 versus Australian 10-year government bond yield.

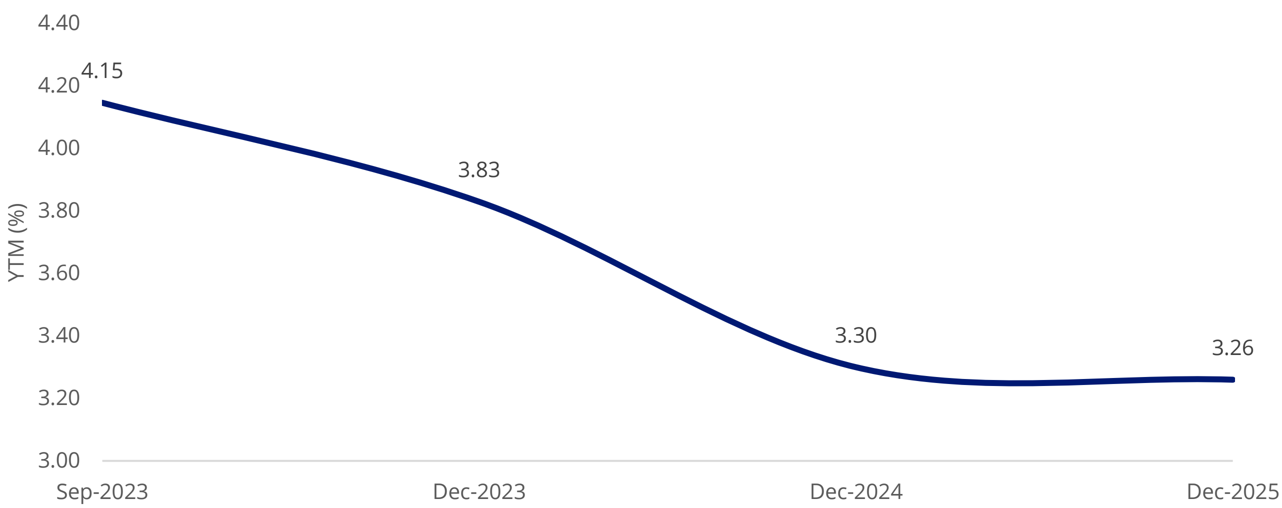
A-REITs

Source: Bloomberg, Benchmark as S&P/ASX 200 A-REIT index. MVA Index as MVIS Australia A-REIT index. Past performance is not a reliable indicator of future performance. You cannot invest in an index.

The exception was during the emergence of COVID-19 where REITs underperformed despite government yields falling. Retail and Office REITs were legislated to offer rental abatements during the lockdown.

The Australian 10-year bond yield could be near the peak. Brokers forecast yields to fall in 2023 and 2024 as the global economy slows in the face of managing higher interest rates. The futures market also expects the RBA cash rate to be cut in H2 2024. Falling yields may provide a tailwind for the performance.

Australian government 10-year bond yield broker consensus forecasts



Source: Bloomberg, As at 31 August 2023.

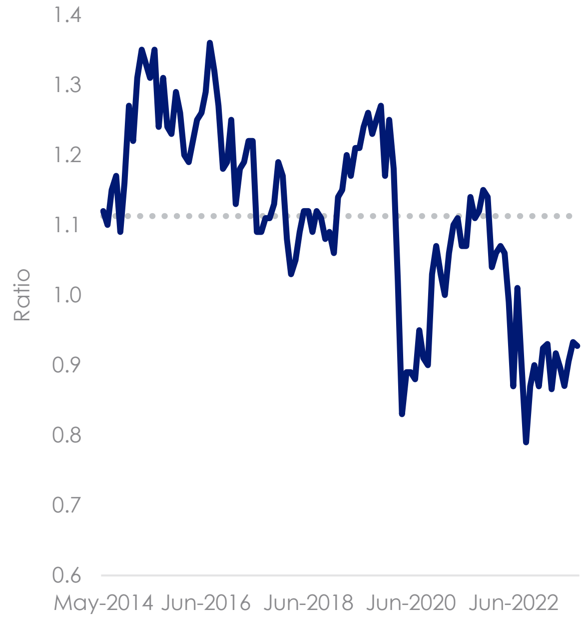
3. Valuations attractive

REIT Price to Adjusted Funds from Operations (AFFO multiple) and price to NTA are below the historical average and at a discount.

REIT AFFO Multiple

Source: Bloomberg, Equal weighted composite of constituents in MVIS Australia Property Index.

REIT Price to NTA



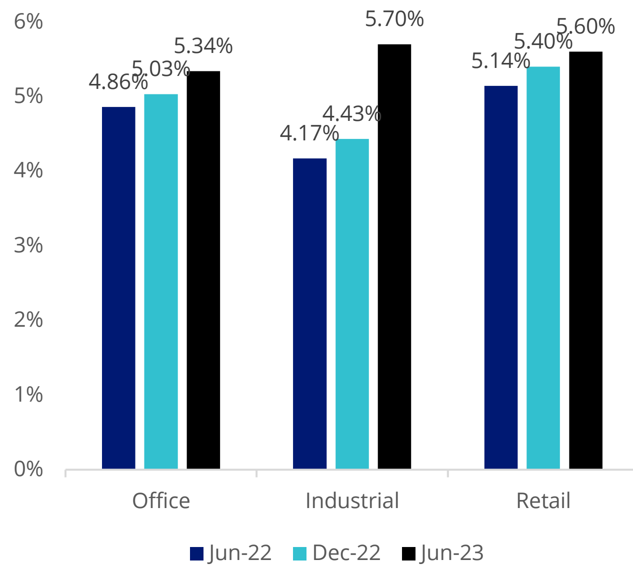
Source: Bloomberg, MVIS Australia Property Index.

Cap rates have marginally increased over the past 12 months across all subsectors.

Cap Rate

Source: Bloomberg, Equal weighted composite of constituents in MVIS Australia Property Index.

Cap Rate change by sector



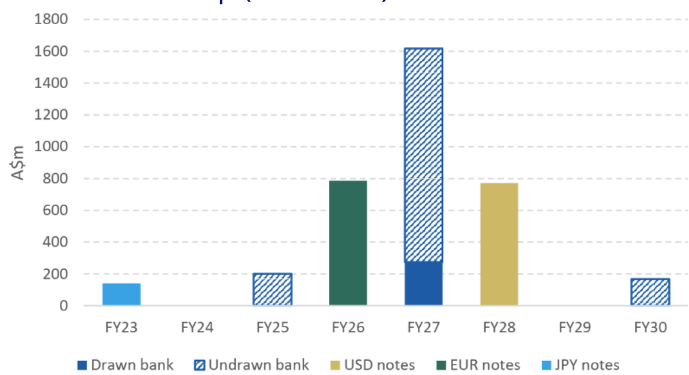
Source: Bloomberg, Office as equal weighting of DXS, GPT, SGP, MGR, ABP and GOZ. Retail as equal weighting of VCX, GPT, SCG, SGP, MGR, CQR, SCP, HDN. Industrials as GMG.

4. Low refinancing risk

15% of A-REIT debt expires in FY24 and the largest percentage roll-off is not until FY27. This means that many existing loan arrangements were locked in during the low-interest rate environment and won't roll off for a few years. An average of 65% of the REIT universe in Australia is interest rate hedged.

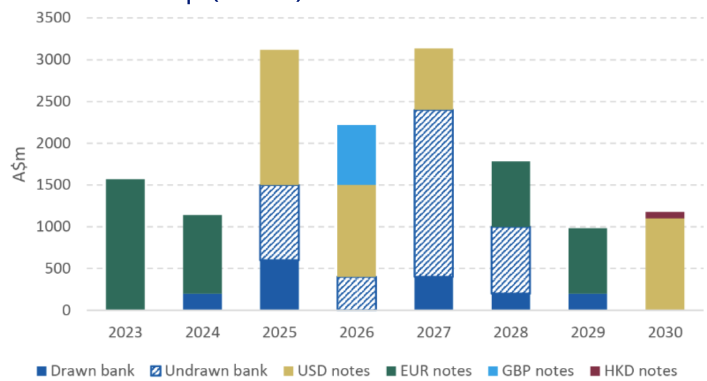
Debt maturity profiles – largest REITs by subsector

Goodman Group (Industrial)



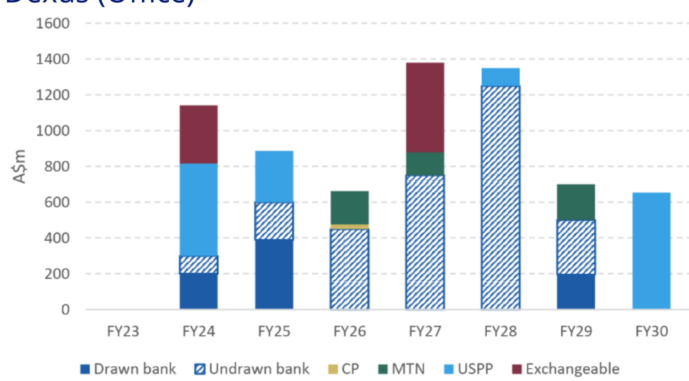
Source: Morgan Stanley

Scentre Group (Retail)



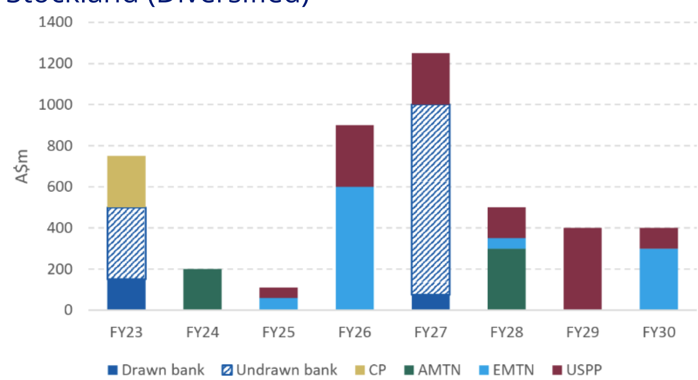
Source: Morgan Stanley

Dexus (Office)



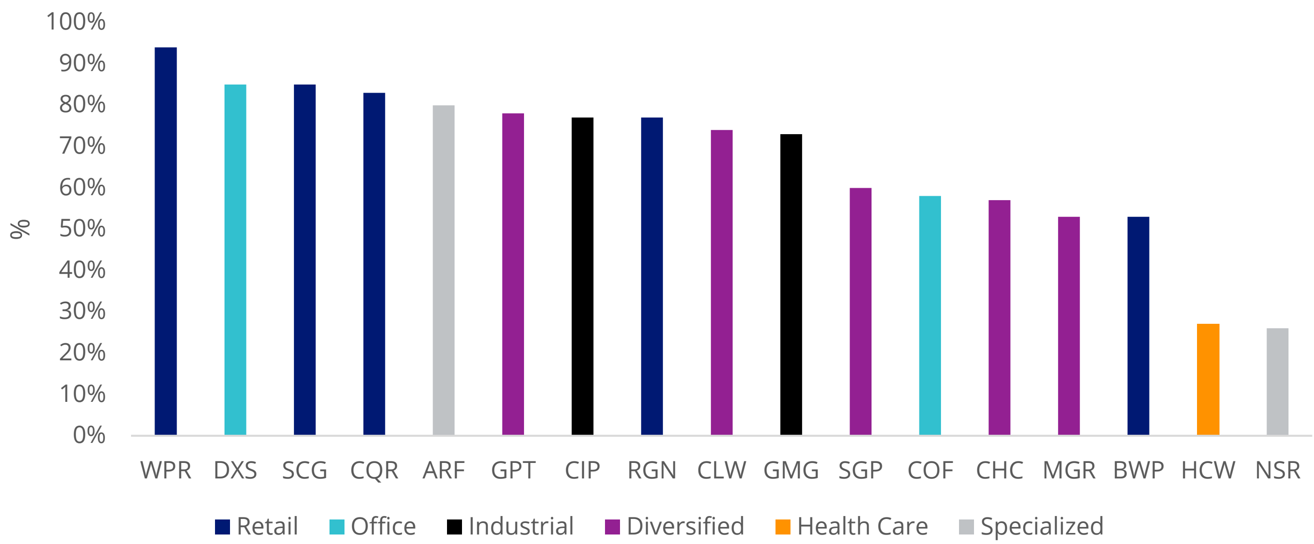
Source: Morgan Stanley

Stockland (Diversified)



Source: Morgan Stanley

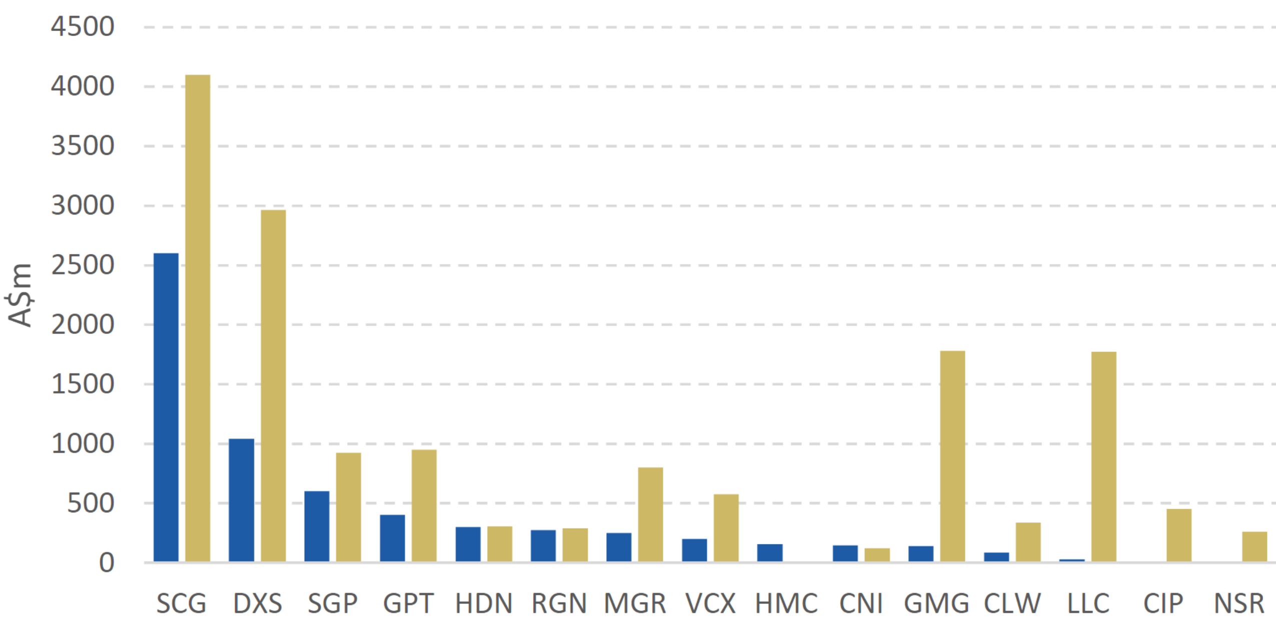
Percentage of interest rate hedging during FY24



Source: Company data, as at 31 August 2023.

A-REITs have access to onshore banking facilities charging floating rate interest. Most REITs have undrawn facilities that could cover FY24 maturities multiple times over in the event like-for-like refinancing is not available.

REIT FY23/24 debt expiries versus undrawn bank facility availability

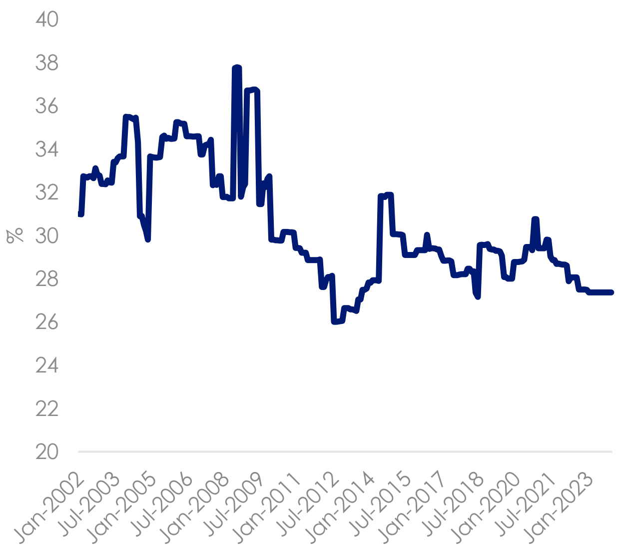


Source: Morgan Stanley.

5. Lower leverage

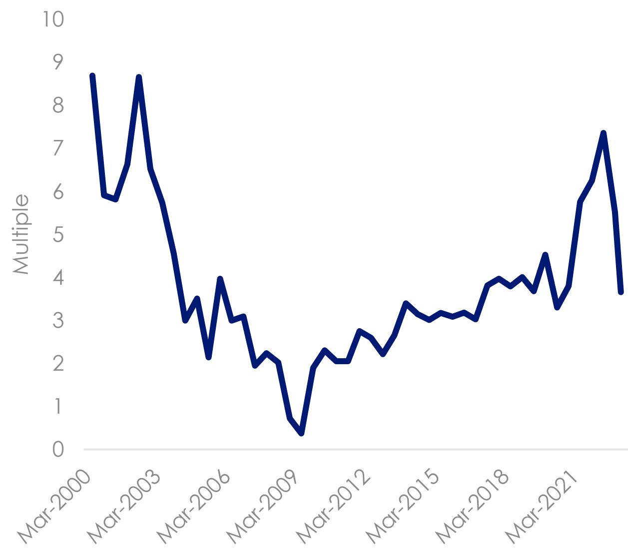
REIT leverage levels have been falling and interest coverage levels have been increasing since the global financial crisis. This should assist companies in weathering any increase in their debt costs as a result of rising interest rates. Those companies with lower interest rate hedging and tighter covenants will be affected the most. Retail REITs on average have the highest gearing.

Leverage – Debt/Assets



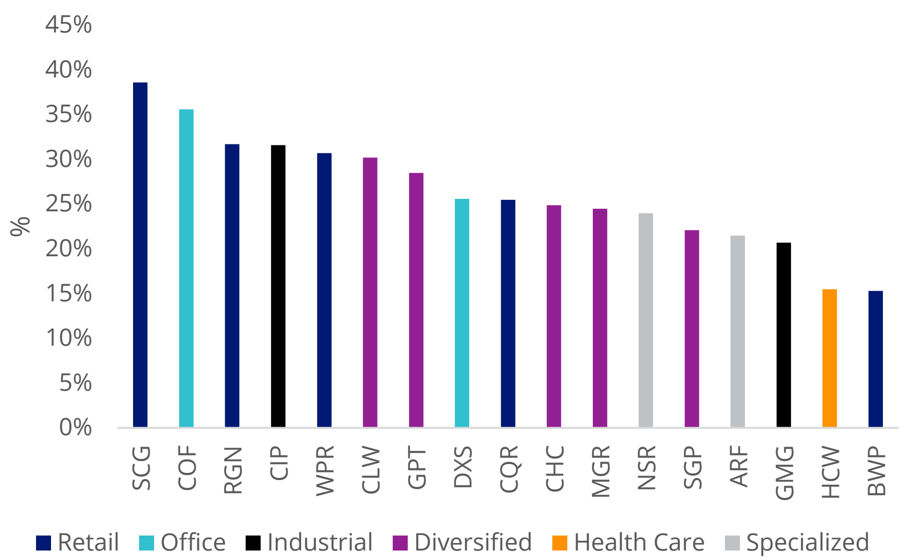
Source: Bloomberg. Data is S&P/ASX 200 A-REIT

Interest coverage ratio



Source: Bloomberg. Australia as Equal weighted composite of constituents in MVIS Australia Property Index.

Leverage by subsector



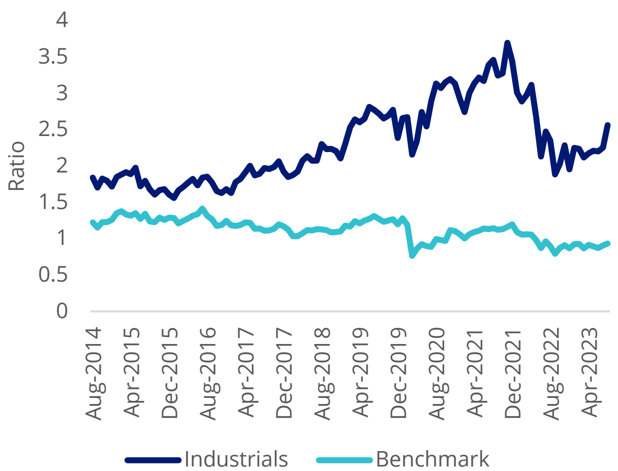
Source: Bloomberg

REIT Subsector Outlook

Industrial REITs

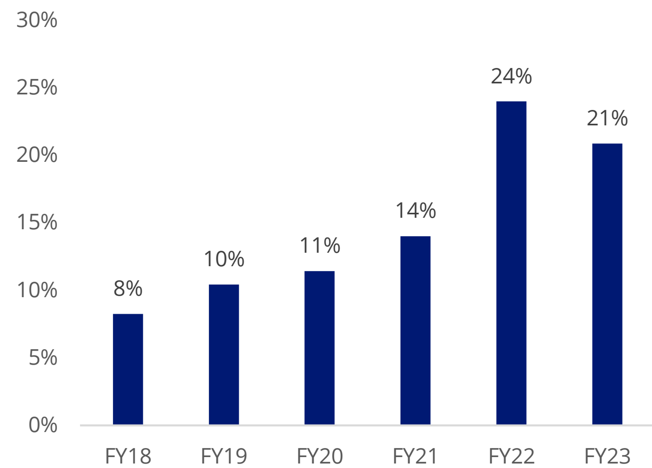
Industrial REITs were the best performer year to date. The subsector recorded strong rental growth and low vacancy rates, spurred by an acceleration in warehousing and logistics demand following the emergence of COVID-19. Australia's largest Industrial REIT Goodman group is trading at a 2.5 times premium to NTA.

Price to NTA



Source: Bloomberg, as at 31 August 2023. Industrials as Goodman Group. Benchmark as MVIS Australia A-REIT Index.

FY EPS Growth



Source: Bloomberg, as at 31 August 2023. Industrials is Goodman Group.

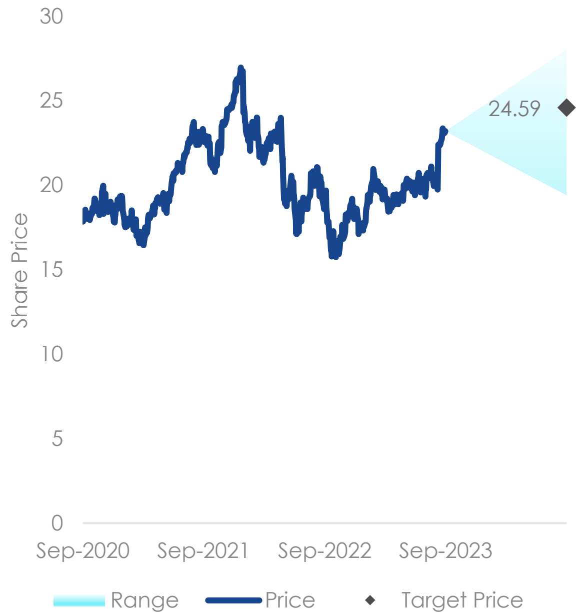
Looking forward, earnings growth is likely to trend back to pre-COVID high single digits. Industrial REIT cap rates are at risk of expanding as retailers reduce inventory levels when a prolonged period of high rates stump household spending and economic activity. Retailers will continue to invest in optimising delivery chains as they address demand for both in-store and online consumer spending but not at the same pace we've seen recently. On balance, this may not be enough to justify the 2.5 times premium to NTA and favour an underweight position to Industrial REITs.

Industrials focus – Goodman Group (ASX: GMG)

Industrial REIT Goodman Group was the best-performing REIT year to date. Share price strength was spurred by the company unveiling a large data centre pipeline, diversifying earnings growth channels.

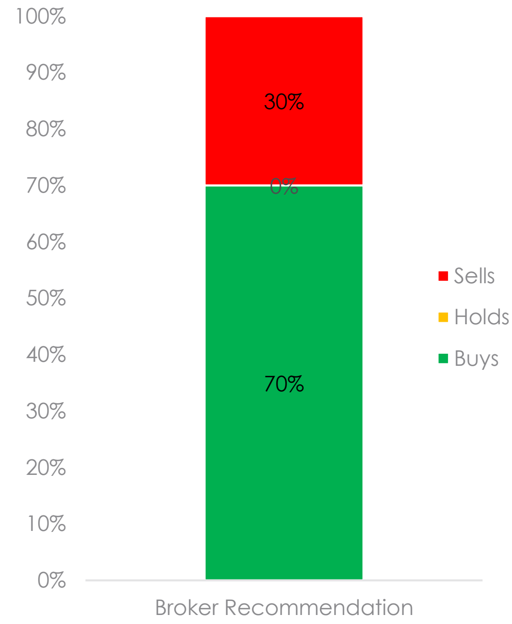
During the February and August earnings season, year-on-year EPS growth was in line with expectations at 10.8% and 20.9% respectively. However, it will be challenging for Goodman to maintain double-digit earnings growth as economic conditions weaken.

Median Broker Consensus Share Price 12-month target (+6%)



Source: Bloomberg, As at 31 August 2023.

Broker buy/hold/sell split (10 analysts)

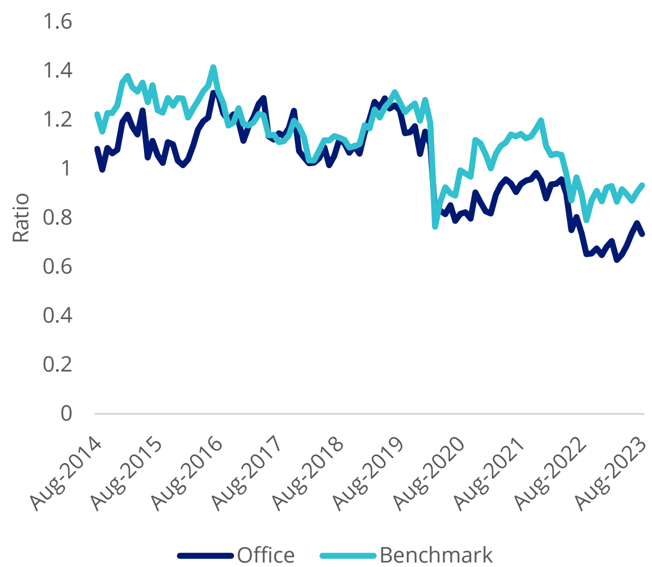


Source: Bloomberg, 31 August 2023

Office REITs

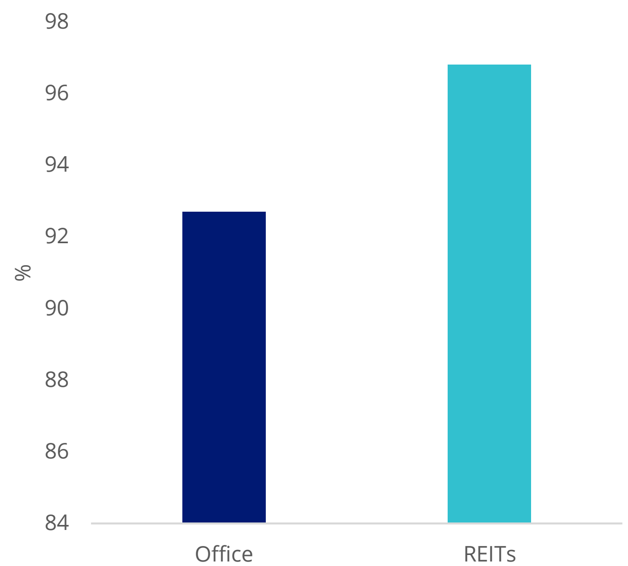
Office REITs have fallen 1.03% year to date. The adoption of the hybrid working environment has seen many companies consolidate office space and new office building supply has reduced landlord pricing power.

Price to NTA



Source: Bloomberg, Office as Dexus. Benchmark as MVIS Australia A-REIT Index.

Occupancy Rates



Source: Bloomberg, Macquarie Research, As at 31 August 2023. REIT as equal weighted average of industrials, retail and office. Office as equal weighting of DXS, GPT, SGP, MGR, ABP and GOZ.

While secular headwinds are likely to persist, the downside is priced. We are likely to see a further revision down in NTAs in the single digits but office REITs are already trading at the lowest discount to NTA relative to other subsectors. There are bright spots among the noise. Average occupancy rates are holding firm above 90 per cent and on balance, a soft landing in Australia is likely. Gradual migrant intake will help fill labour shortages across the industry and office space demand. However, capex is required to attract tenants to second-tier premises, putting downward pressure on margins. The increase in office supply has improved tenant bargaining power.

Being selective in office REIT exposure is prudent. Quality office REITs with sought-after space in good locations and amenities will remain attractive. We expect that top-tier office towers to provide an uplift in rental growth, while older office buildings will likely be less favourable.

The subsector offers a upside if fundamentals surprise by trading a 30% discount. For this reason, we favour an overweight position.

Office focus – Dexus (ASX: DXS)

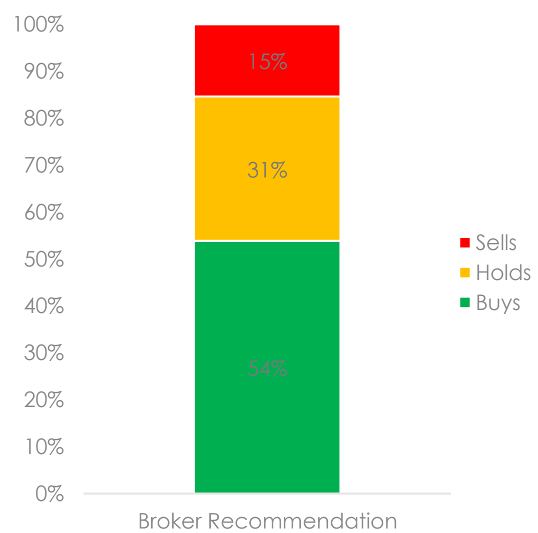
During the August 2023 earnings season, Dexus reported high occupancy levels above 95% and a prudent balance sheet with 86% of interest rate expenses locked at 2% for FY24, reinforcing the resilience of the portfolio compared to the broader market.

Dexus collects approximately 70% of its income from office rent, of which 50-55% is from Sydney CBD. High portfolio weighting to tier 1 office buildings across all major capital cities in Australia reinforces our overweight position to Dexus.

Median Broker Consensus Share Price 12 month target (+17%)

Source: Bloomberg, as at 31 August 2023.

Broker buy/hold/sell split (12 analysts)

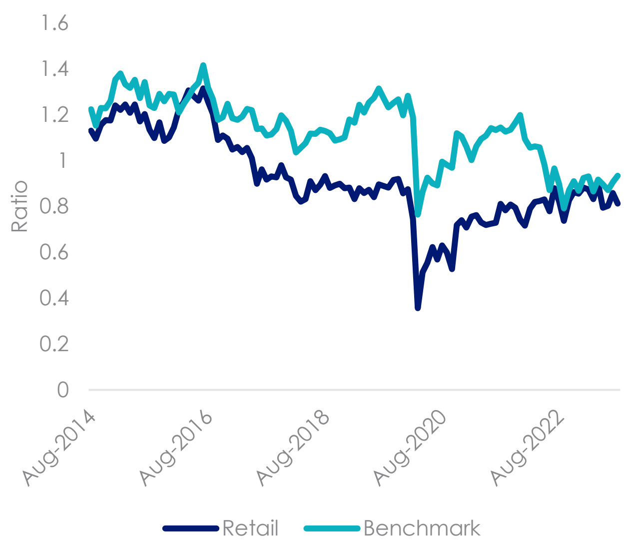


Source: Bloomberg as at 31 August 2023

Retail REITs

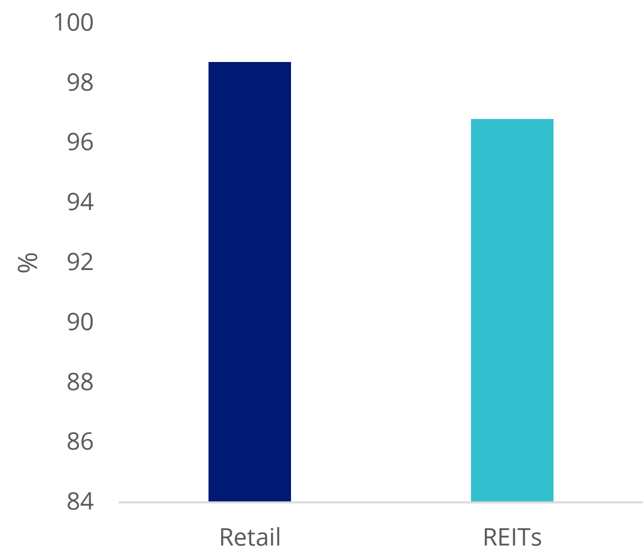
Retail REIT returns were positive over 3 months. During the August earnings season, many consumer discretionary names demonstrated earnings resilience. Consumers unfazed (for now) by the rapid increase in interest rates, fixed-rate mortgage cliff and elevated inflation, saw many retailers report sales growth for FY23. This dynamic saw Retail REITs Vicinity Group and Scentre Group report better-than-expected earnings growth, solid rental price growth and improvement in occupancy rates.

Price to NTA



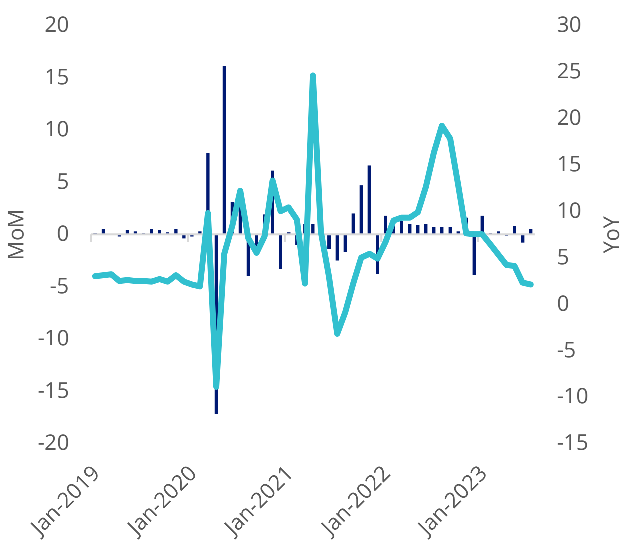
Source: Bloomberg, Retail as Vicinity Group. Benchmark as MVIS Australia A-REIT Index.

Occupancy Rates



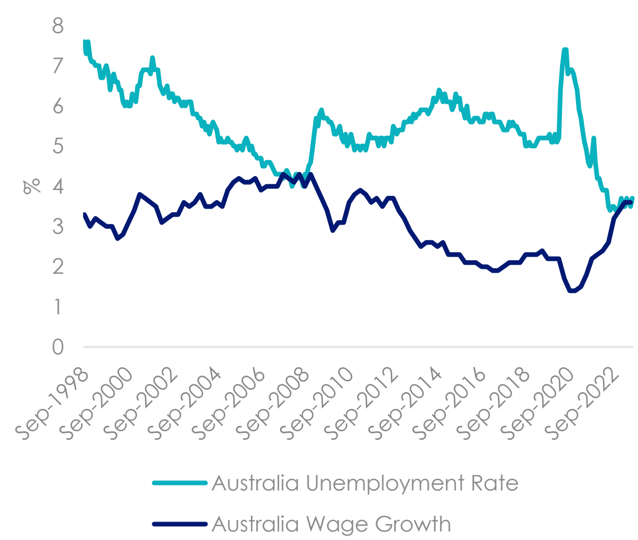
Source: Bloomberg, Macquarie Research, As at 31 August 2023. REIT as equal weighted average of industrials, retail and office. Retail as equal weighting of VCX, GPT, SCG, SGP, MGR, CQR, SCP, HDN.

Retail Sales Growth



Source: Australian Bureau of Statistics

Labour Market Conditions



Source: Australian Bureau of Statistics

While we anticipate retail sales growth to weaken, the trend may surprise to the upside. An Australian soft landing would see unemployment stay below 5 percent – low historically and wealth effect from house price increases could provide a further catalyst for robust discretionary spending. Higher rate environment has also improved the 'risk-free' rate of return, encouraging spending across the largest population cohort 'baby boomers' which typically have lower debt obligations.

We do note though that high rents, more households rolling off fixed mortgages and a sustained period of higher rates will squeeze budgets, with the impact worst in lower socioeconomic regions and among the younger cohort. We favour seeking exposure to retail REITs servicing higher socioeconomic regions.

We believe forecast retail sales weakness is sufficiently priced with most names trading at a 20% discount to NTA and favour a neutral stance.

Retail focus – Scentre Group (ASX: SCG)

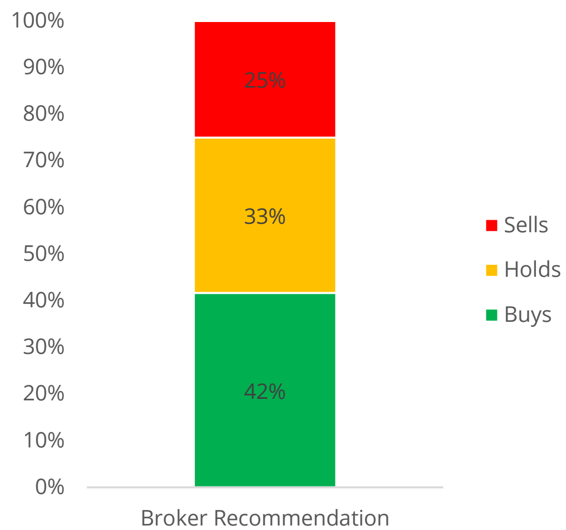
Retail REIT Scentre Group finished middle of the pack year to date. February and August earnings results were strong, reporting better-than-expected earnings growth on both occasions. Occupancy rate increased 30 basis points to 99.0%.

Looking ahead, Scentre Group is well equipped to manage an inflationary environment with approximately 75% leases priced at CPI + 2%, providing scope for rental growth. The company has overweight portfolio exposure to wealthier areas by house prices and salary.

Median Broker Consensus Share Price 12 month target (+20%)

Source: Bloomberg, as at 31 August 2023.

Broker buy/hold/sell split (13 analysts)



Source: Bloomberg. As at 31 August 2023.

Conclusion

REITs are well-positioned for an environment of elevated inflation and low growth. REITs have deleveraged since the global financial crisis, have low refinancing risk and offer inflation-linked revenue streams including exposure to subsectors that offer inelastic demand in an environment where the global economic activity is subdued.

For 2024, we favour office and retail REITs. While we anticipate a further downward revision in valuations, it could be less than feared. Trading at a significant discount offers greater scope for long-term price appreciation.

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