WILSONS

A-REITs – Are Higher Borrowing Costs Priced into the Sector?

Our weekly view on Australian equities.

13 April 2022

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What Happens When Rates Rise?

With the prospect of an RBA interest rate tightening cycle beginning as soon as June this year, we look at how the A-REIT sector performs when interest rates are rising.

Read Looking Through a Volatile Start to the Year

Since 2000, there have only been 3 RBA rate tightening cycles (99-00, 01-08, 09-10). Across all 3 periods, Australian real estate valuations fell as the P/E ratio of the sector contracted on average by -120bps.

In all 3 tightening periods, the P/E ratio contracted most during the pre-tightening period. This makes sense as the market moves ahead in anticipation of higher short-term rates.

In the current cycle, a similar pattern has emerged. Since the A-REIT index peaked in December 2021, the sector's P/E ratio has fallen by almost 200bps, whilst A-REITs have underperformed the broader market by ~14%. All of this occurred before the RBA hiked rates.

If we extend the analysis across more periods, a similar pattern emerges when the Australian 10-year bond rises. The A-REIT sector tends to underperform the broader equity market as bond yields rise. Once 10-year bond yields have stopped rising, the A-REITs sector P/E typically begins to expand.

We remain market weight in the A-REIT sector while the interest rate backdrop is currently creating headwinds for the sector. We suspect most of the relative underperformance has now passed. Our bottom-up preferred names include Goodman Group (GMG) for exposure to global industrials, e-commerce and real estate funds management. HealthCo (HCW) for exposure to an ageing population and rising healthcare expenditure. Full deployment of the balance sheet would lift HCW's distribution by ~25% per share.

A-REITs vs 10-year Bonds

A-REITs have underperformed the S&P/ASX 300 in 10 of the 12 periods where bond yields have risen (since 1995). The P/E multiple during these periods fell by 1.1 P/E points. In these 12 periods, the average rise in bond yields was +120bps, taking place over 10 months (on average).

This compares to the current period, which has seen the long bond rise by +130bps over 9 months (fastest bond sell-off we have seen outside of crisis), and the P/E multiple contract by 1.7 P/E points. The dramatic fall in the sector P/E multiple is partly a function of the high growth REITs being almost 40% of the index.

While the relative performance of the A-REIT index since August is mild at -2%; this decreases to -8% if we just look at the performance calendar year to date (CYTD). During the first part of the upward move in bond yields, the A-REITs sector rallied to post-GFC highs in late December 2021.

A-REIT Performance

Within the A-REIT index, the higher multiple more growth-focused REITs - Charter Hall Group (CHC), Centuria Capital Group (CNI) and Ingenia Communities Group (INA) have been the worst performers CYTD. 'Growth' orientated REITs currently represent almost 40% of the index. They all have a higher beta to the rising bond yields given long-term growth optionality within their portfolios.

Within the index, only Vicinity Centers (VCX) has outperformed the broader market, a function of cleaner operating performance, depressed share price and leverage to both domestic and international borders reopening.

Figure 1: A-REITs typically underperform the broader market when long bonds are rising

Period	# of Days	Movement	P/E chg	Rel Performance
Low	120	0.7%	0.7	9%
Average	**302**	**1.2%**	**-0.3**	**-6.4%**
High	1004	2.1%	-2.7	-34%
Current Period	**243**	**1.3%**	**-1.7**	**-2%**

*Data looks at 12 episodes of rising AUS 10yr bond yields since 1995. Relative performance of A-REITs vs S&P/ASX 300.

Source: Refinitiv, Wilsons

Figure 2: Top 5 A-REIT performance CYTD, only Vicinity has outperformed the broader market

Name	ASX Code	Total Return Since 1 Jan
Vicinity Centres	VCX	11%
Charter Hall Long WALE REIT	CLW	7%
Shopping Centres Australasia Property Group Re Ltd	SCP	1%
Arena Reit No 1	ARF	-1%
Growthpoint Properties Australia Ltd	GOZ	0%

Source: Refinitiv, Wilsons

A-REIT Earnings Continue to be Upgraded

Against the backdrop of rising long bond yields, earnings upgrades have continued across the A-REIT sector. This is primarily due to higher growth A-REITs seeing stronger operating conditions – particularly in industrial-focused A-REITs like CNI, CHC and Goodman Group (GMG) that continue to benefit from strong underlying operating conditions. We believe this is not fully reflected in forward estimates for these stocks.

How do A-REIT Valuation Measures Look?

One of the key questions we get from clients is whether the valuation multiples of the sector have expanded due to lower bond yields over the past 10-years. In short, there has been a 2-point expansion from 15x to 17x over the previous 10 years (peaked at 19x in December 2022).

Some of the expansion reflects changes in the composition of the sector, particularly the increased weight of the higher growth (and multiple) property asset management companies. CNI, CHC and GMG have traded on an average yield of ~20x over the past 5-years. Overall though, we do not see the earnings multiple as being significantly vulnerable to higher interest rates from here.

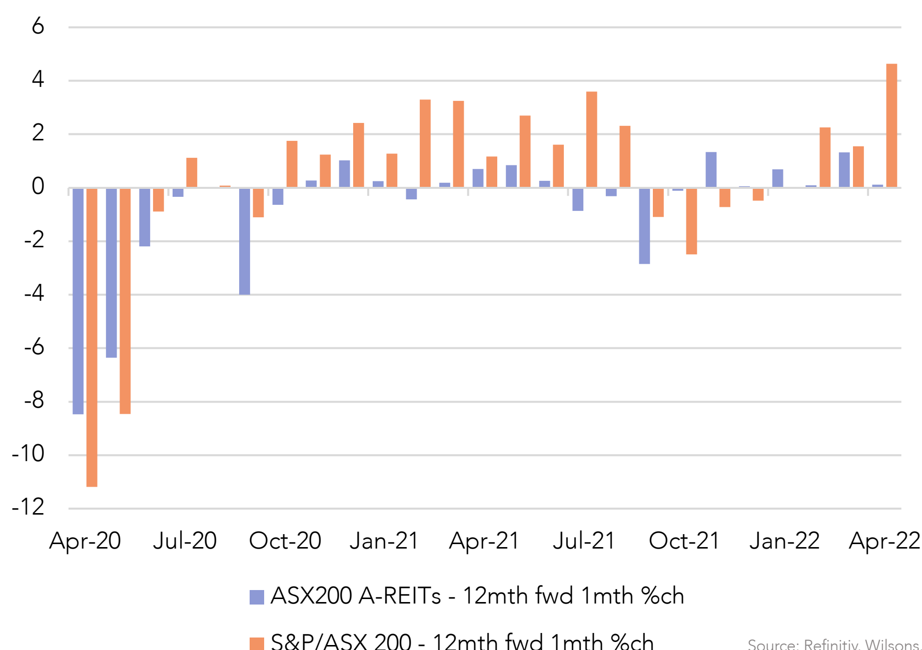
The yield premium of the A-REITs to government bonds is typically around 200bps. Today, that premium is around half that at 100bps. There are two ways to interpret this; 1) property yields need to rise (higher dividends or lower share prices), or 2) the bond yield has risen too far. We believe bond yields have moved too aggressively here in Australia, distorting this measure. With earnings upgrades through this year, higher dividends should also follow. Alternative measures of A-REIT value P/E, P/NTA, P/NAV all suggest the A-REIT index is currently trading around fair value.

Figure 3: Bottom 5 A-REIT performance CYTD

Name	ASX Code	Total Return Since 1 Jan
Goodman Group	GMG	-13%
Mirvac Group	MGR	-16%
Ingenia Communities Group	INA	-20%
Centuria Capital Group	CNI	-20%
Charter Hall Group	CHC	-20%

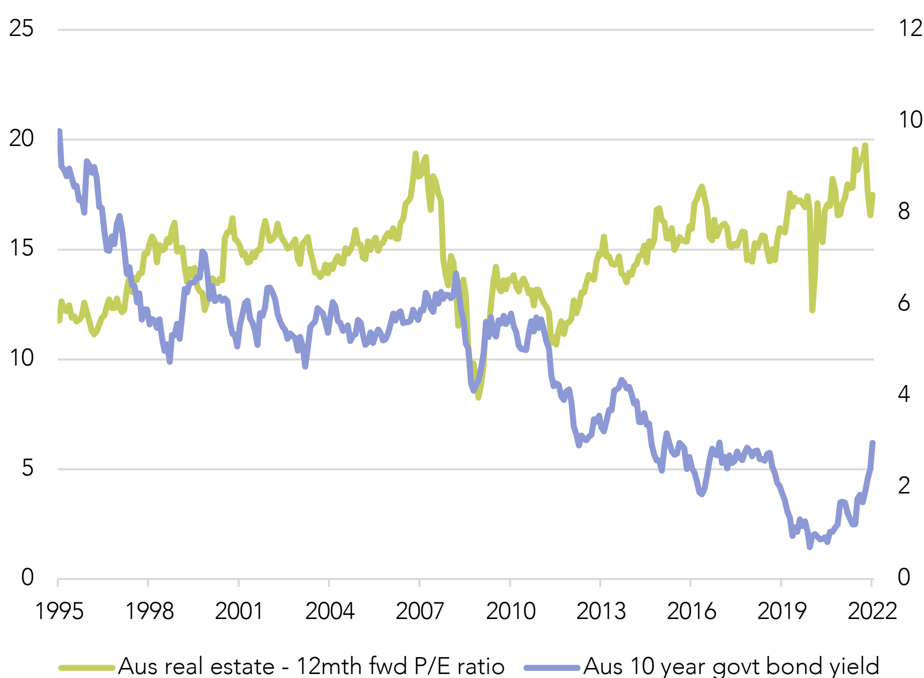
Source: Refinitiv, Wilsons

Figure 4: A-REIT earnings upgrades continue but at a slower pace than the broader market



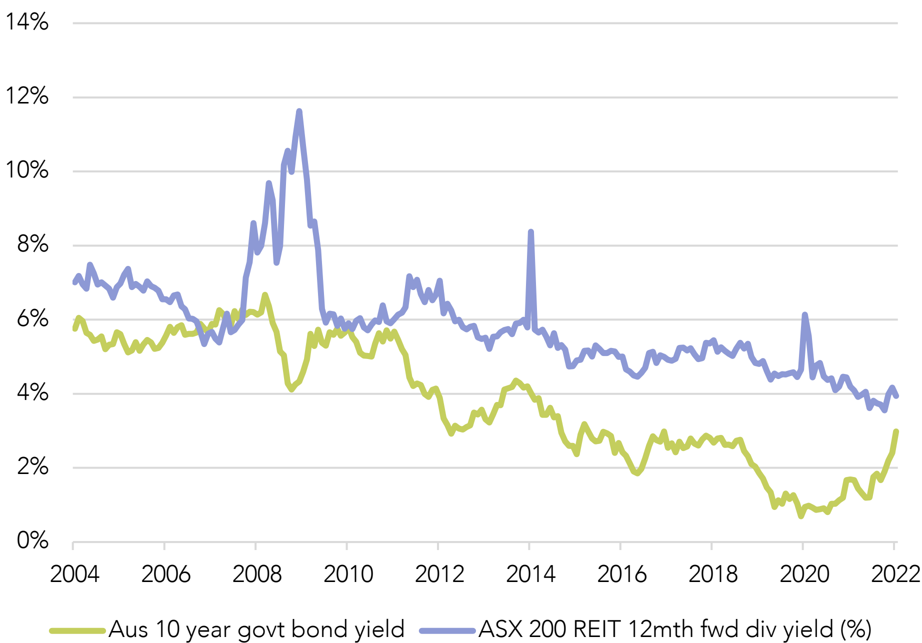
Source: Refinitiv, Wilsons.

Figure 5: A-REIT P/E ratio vs 10-year bond yield



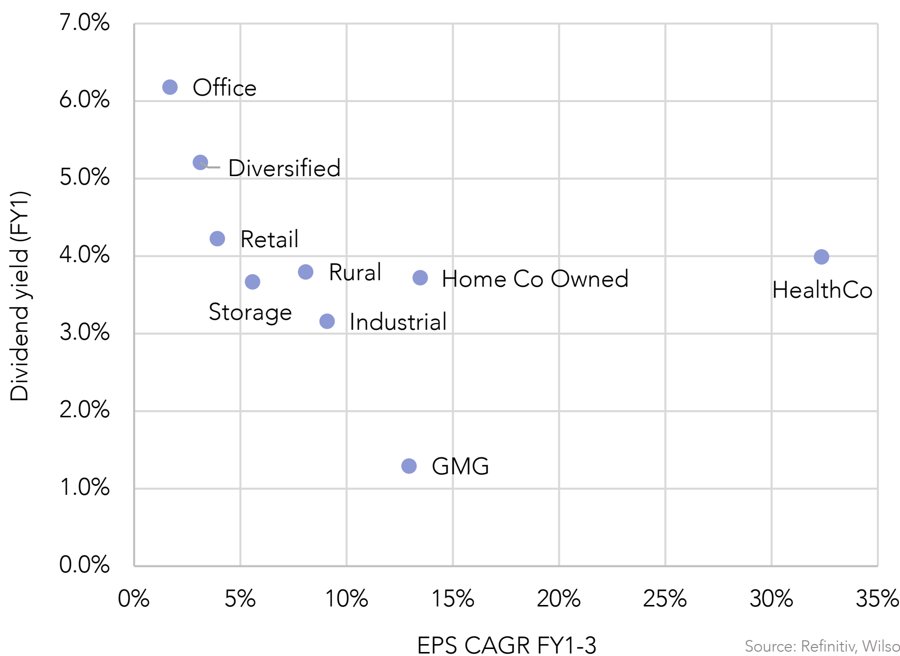
Source: Refinitiv, Wilsons.

Figure 6: A-REIT dividend yield vs 10-year bond yield



Source: Refinitiv, Wilsons.

Figure 7: A-REIT sub-sectors growth vs yield



Source: Refinitiv, Wilsons.

Sector Outlook: Growth vs Yield

We see the A-REIT sector as trading around fair value at present. The sharp underperformance of the sector this year has been driven by the anticipation of a lift-off in the global-rate cycle. In prior cycles, the property index tends to see most of the under-performance before rates begin moving up.

In our view, the A-REIT underperformance is likely to dissipate near-term as the market gets closer to a peaking Australian bond yield. Positive absolute price performance is conditional on the market becoming clearer about the speed and path of the interest rate tightening cycle. That could emerge locally as soon as 3Q22.

We remain market weight the A-REITs in the Wilsons Australian Equity Focus List. Our bottom-up preferred names include GMG for exposure to global industrials, e-commerce and real estate funds management. HealthCo (HCW) for exposure to population ageing and rising healthcare expenditure. Full deployment of the balance sheet would lift HCW distribution by ~25% per share.

HealthCo (HCW)

Focus List 3%

Listed in September 2021, HCW develops and manages long-life healthcare sector assets. The healthcare sub-sector of the property market continues to grow ahead of GDP growth. HCW has a pipeline of development assets worth >$500m.

The key to rerating the HCW share price in 2022 is deploying the balance sheet into new assets. Whilst this can happen relatively quickly, HCW needs to be able to cover the dividend from funds from operations (FFO). This creates somewhat of a balancing item for HCW over the next 2 years.

We expect HCW to generate FFO of 5cps in FY22E (payout ratio of ~145%), before lifting to almost 9cps in FY23E – driven by an additional $125m of asset purchases. This should broadly cover the DPS in FY23E.

The balancing act for HCW remains in play into FY24E/25E wherein absence of further cap rate compression, additional equity or reducing the size of the development pipeline HCW gearing will reach the upper levels of the 30-40% target band (given development assets in South West Sydney). At present HCW is in a net cash position, but we estimate effective pro-forma gearing to be around 10-20% inclusive of committed CAPEX.

HCW trades at P/NTA of 1.05x, a material discount to peer A-REITs like Arena REIT (ARF) at 1.6x. Closing this gap by half would imply a share price of ~$2.40. Deploying ~$125m of asset purchases remains a key near-term catalyst.

Figure 8: Health co earnings can lift by >25% as balance sheet is deployed

	Acqusitions (100% debt funded)				
	50	**100**	**150**	**200**	**250**
Earnings Base	29	29	29	29	29
Earnings Spread	2%	2%	2%	2%	2%
Earnings accretion	1.0	2.0	3.0	4.0	5.0
Accretion as % of Earnings	**3%**	**7%**	**10%**	**14%**	**17%**
Gearing	18%	23%	27%	32%	36%

* $Am

Source: Refinitiv, Wilsons

Goodman Group (GMG)

Focus List 4%

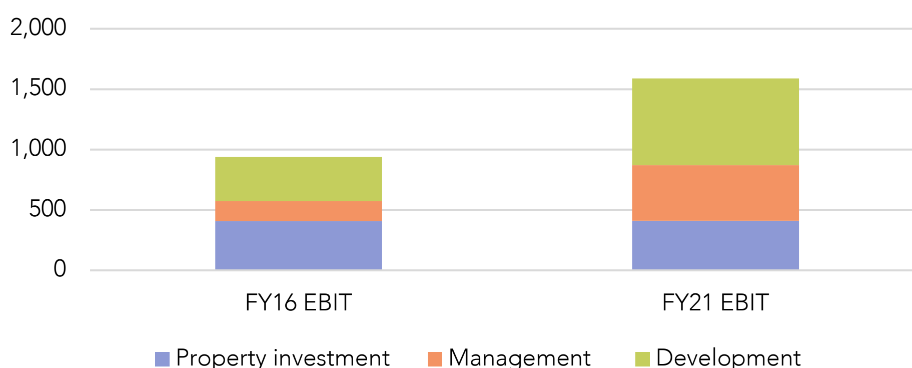
GMG is the largest constituent of the A-REIT index. Unlike traditional REITs GMG focuses its capital allocation towards growth and reinvestment activities. EPSg has averaged 9.5% over the 2014-21 period. Prior to COVID, GMG lifted its CAPEX spending as the demand for industrial assets accelerated.

Development earnings have grown at ~20% CAGR FY14-22E, reflecting the growth of its work in hand. In contrast, the property investment line has been flat since 2014. This is primarily due to the capital allocation decision to dispose of $30bn of assets since 2014. Going forward, asset disposals are now largely complete.

We believe property investment could now grow at 3-4%, with new developments adding ~10% pa. When combined with performance fees that can continue to average $150-200m pa (asset management has outperformed its benchmark by ~8%pa since 2015). Going forward, the larger asset base should make the ability to generate $150-200m pa relatively easier.

Earnings should become more diversified and more stable in the future. A decline in development earnings, which GMG has alluded to, should not be feared. GMG offers superior earnings growth to US peer ProLogis (PLD.US) whilst also offering a pathway into Asian industrial sector growth. GMG trades at 28x P/E, or around half the multiple of PLD.

Figure 9: GMG earnings are increasingly skewed towards both development and asset management



Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

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