Office incentives come into focus

by Jonathan Kriska

One of the themes coming out of the last REIT reporting season was the fact that Office REIT payout ratios may now start to come under pressure over the next five years. This view is based on the level of current tenant incentives that are being offered on new rental deals in the office market.

Since the Global Financial Crisis landlords have had to offer new tenants larger incentives to take up space. Currently these average around 20-25% for prime stock in Sydney, Melbourne, and Brisbane. Which means new tenants only pay 4 years rent from a 5 year term.

From the REIT perspective, with higher incentives, the decision on how to report operating earnings becomes a challenge. Historically when REITs have reported operating earnings they have assumed the full rent in their Net Property Income and then made an amortisation expense adjustment elsewhere in the P&L. However we note the recent trend of a number of REITs to adopt Funds From Operations (FFO) reporting instead, which adds back the amortisation. The argument here is that it aligns our REITs with reporting methods used offshore, however the problem with adopting this method in a high incentive environment, is that it overstates earnings.

However, as long as distributions are covered from free cash flows we believe the market will be happy. Nevertheless payout ratios for office REITs are expected to decline from the current levels if they continue to report FFO in a period where incentives remain at cyclical highs. This is primarily because average incentives of existing portfolios are significantly below the current market level of incentives.
Commercial property markets
by Jonathan Kriska

Perth CBD Office Market
This month Knight Frank published a market overview on the Perth CBD office market. Key takeaways from the report were:

- The highest level of gross supply additions in 20 years were recorded in the twelve months to July 2012, with 170,444m² added to the Perth CBD market.
- Because net absorption of this space was the highest level ever recorded the vacancy rate only increased from 3.3% to 4.2%.
- New supply in 2013 and 2014 looks limited at this stage.
- The resources industry has continued to be the largest absorber of space in the Perth CBD over the last twelve months, particularly by Rio Tinto, BHP and Chevron.
- The declining vacancy has seen increases in Prime net face rents of 6.3% over the past six months to an average of $805/m² per annum.
- Reports have noted that resources investment is expected to slow in the next two years, with companies in this sector moving from investment in construction to production.
- Sales are showing that purchasers are factoring in risk premiums which has seen yields soften marginally.

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<th>Perth CBD Office Market Indicators as at July 2012</th>
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<td>Prime</td>
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<td>Secondary</td>
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Source: Knight Frank/REA as at July 2012

Australian housing market
by Jonathan Kriska

Could interest rate cuts lead to a recovery?
The last couple of weeks have seen an increase in the number of positive articles regarding the Australian housing market.

"Sydney house prices tipped to recover", said the SMH on the 26th of September pointing to the SQM Housing Boom and Bust Report, which expects price growth in Sydney to be between 5 to 9 per cent next year.

Also RP Data was positive, saying “Australia’s home values rose 1.4 per cent in September, the largest monthly rise in two years, as lower interest rates attracted spring buyers”, and effectively called the bottom by saying “It’s no coincidence that housing market conditions bottomed out at the end of May, after the Reserve Bank cut the official cash rate by 50 basis points.”
Given these comments it would be easy to for readers to believe things are again rosy in the housing market. However let’s consider a few more facts.

Firstly, auction clearance rates still indicate a weak market.

Source: RP Data

Secondly, September is the start of the spring selling season, which partly explains the strong result in September. To keep this in context we should also consider that the ABS (which is probably the most reliable index) is reporting national house price growth of -2.1% to the year ended June 2012.

Lastly, let’s not forget that the RBA official rate has fallen numerous times by 1.5% over the past 18 months and during that time house prices have still fallen. Households are clearly now in debt reduction mode, as they should be. After two decades of strong credit growth, outstanding mortgage debt has increased to 135% of household disposable income – an increase of nearly 300%!
Australian REIT market

Each month in this section we provide an update on the Australian Real Estate Investment Trust (REIT) sector.

PERFORMANCE

During the month the S&P ASX 200 REIT index rose 1.4%. This compares to the broader share market S&P ASX 200 index which returned 0.5%. REITs continue to beat the broader market following the theme from last year as investors chase yield.

During the month the best performing stocks were MIX (19%), ILF (10%), IEF (10%) and the worst performing stocks were APZ (-33%), ABP (-5%), and GPT (-3%).

During the past 12 months the best performing stocks have been ILF (116%), CHC (74%), RNY (72%) and the worst performing stocks have been APZ (-55%), IEF (-21%), and ABP (7%).

VALUATIONS

As with many defensive sectors REITs have run very hard over the past year, so much so the sector is now looking fully valued at present.

Currently the average yield in the REIT sector is 5.9%. This is expensive compared to the long run average of 6.7%. Given the concentration in the sector to a few stocks it’s also worth considering the sector yield on a non-index weighted basis, and this is currently 6.4%. Also payout ratios are now much lower than pre-GFC times and currently earnings yields are 7.5%.

Compared to Bonds REIT yields now look very attractive. This follows a sustained period of fall interest rate rates. The current spread is approximately 3.3% spread above the 10 year bond rate, compared to the long term average of 1.2%.

Finally, after years of discounts, the REIT sector now trades on (non-index weighted) premium to NTA of 5%. However there still remain many REITs trading at a discount.

LATEST FUNDS

Armada South Brisbane Office Fund – second tranche open!
This wholesale property fund owns an A-grade office building in Brisbane with an adjoining development site, paying a 9.75% pa distribution.

Armada Property Securities Fund (coming soon!)
The Fund aims to be non-index aware and will focus on higher yielding property securities with deeper discounts to NTA.