

Listed trusts spread their wings

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Australia's LPTs are trying their fortunes overseas, writes Carolyn Cummins.

MORE than \$5.5 billion from Australia's listed property trusts has flooded into the US and Europe over the past two weeks as managers snapped up offices and shopping centres.

Centro has paid \$4.4 billion for the US Heritage shopping centre group, DB RREEF \$140 million for property in France and the US, and ING Office \$64 million for offices in Prague. Rubicon Europe spent \$250 million on a development in Brussels and Record Realty \$564 million on seven sites around Germany.

The sector is spending anywhere, it seems, but home. Suburbs such as North Sydney and Chadstone in Victoria have lost their status as choice locations.

Small investors have been putting money into LPTs for many years. Generating healthy rents from office blocks and malls across the nation, the trusts were considered a safe haven, offering a stream of stable, tax-advantaged distributions.

Indeed, many equated LPTs with government bonds, since yields usually rise and fall with official interest rates.

But as the LPT sector has grown, investors have seen what many consider major changes in the make-up and risk profile of what were initially seen as defensive, low-risk and "steady as she goes" investments.

Back in the early days, property trusts were set up to enable investors, both large and small, to collectively own income-producing property to which they had no access as individuals.

Now, as some investors are starting to realise, the picture has changed.

The buildings and malls the trusts own are in places where local conditions and pricing are not as familiar as those at home, and the state of the economy is perhaps less predictable.

An increasing share of trust income is in foreign currencies - implying a foreign exchange risk.

Many overseas projects are shared with foreign venture partners whose priorities may be different from Australian ones.

Many of the trusts are far more specialised than before.

And debt levels have risen sharply in an environment where world interest rates are starting to pick up.

All these factors mean property trusts aren't as safe a haven as they once were.

Over the past five years LPTs have had a dream run, with the ASX 300 Property Accumulation index growing 16.5 per cent a year, some 380 basis points ahead of the general sharemarket.

Over the past year, though, the sector has returned 17.4 per cent - 570 basis points behind the broader equities market.

Traditionally it has offered yields of 7 to 8 per cent with a modest growth component as rents rose. That may change.

Maggie Callinan, research manager for RetireInvest, says the sector may not be able to sustain the high returns of recent years. These were aided by falling interest rates and a strong economy. That's an environment which is unlikely to continue in the next decade.

And she notes the structural changes to the composition of LPTs, including an increase in borrowing and overseas investment, and increased exposure to property management and development activities.

"These changes mean that the basic characteristics of the listed property sector are different than they were 10 years ago," she says.

"As an asset class the LPT sector is now much riskier."

Winston Sammut, a director of Maxim Asset Management, says the sector is the third largest in the ASX 200 index, behind the banks and the materials sector, accounting for 9.1 per cent of the index.

He points to its increasingly specialised nature.

"For the first 20 years or so, LPTs were diversified, with investments across the full range of sub-sectors [commercial, industrial and retail]."

But since the early 1990s many trusts have been formed that focus on sub-sectors of the property market. "So much so that nearly two-thirds of the LPT market comprised sector-specific trusts by the mid-1990s," Sammut says.

"Today investors not only have a choice of which specific property sub-sector they can put their money to work but they can also choose in which part of the world their investment dollar will be exposed."

The push offshore is a result of the vast amount of cash flooding into managed funds, of which at least 10-20 per cent has been siphoned off to the LPTs.

It is also due to the lack of available investment-grade property: the trusts already own more than 80 per cent of office towers in Australia. Thus the search for assets must be in other markets.

More than 60 per cent of the overall sector's income is generated by overseas assets, many of which are jointly held by property groups that are unknown - at least to the average investor.

Australian fund managers undertake thorough due diligence on overseas assets and joint venture parties, but there is always some concern among unit holders as to the quality of the deals done.

The Australian LPT sector is considered the most transparent and sophisticated in the world, and its managers are held in high esteem. The concern that local players are being sold dud buildings when they get off at LA Airport is all but groundless.

Still, in the past, one of the attractions of owning an LPT unit was that smaller investors could at least go to Pitt Street and see the building their trust owned. It's harder to get a feel for an apartment block in Germany or a warehouse in Chicago.

Rising debt is another concern. Five years ago the average gearing ratio in the sector was in the 20-30 per cent range. That has now increased to 40-50 per cent and in some cases even higher. Managing that debt, particularly when there are foreign exchange and interest rate risks, can be knife-edged.

All managers have strict hedging in place which can mitigate most foreign exchange concerns. But the manager must also be vigilant on economic risk.

What if petrol prices soared in the US, for instance, leading to lower retail sales in shopping centres, or there was a fall in white-collar employment, resulting in vacant office towers?

Callinan says the increase in borrowing may magnify the rate of return of underlying investments and leave the sector more exposed to the ups and downs of the interest rate cycle. "The increasing debt level is also an outcome of the relatively small size of our market and the recent slowdown in development.

"This increased debt also increases risk in the sector, with the potential for greater variance in returns."

Maxim's Winston Sammut says a major concern that has arisen in recent years is the inclusion of development income in the investment equation.

"A number of the larger diversified trusts have exposures to commercial and residential developments which were not made with a view to generate rental income but rather to generate development profits and as such, are much riskier by nature," he says.

"In recent times the market has experienced a fall in housing demand, with a commensurate fall in property prices due to concerns about rising interest rates. This has negatively impacted on a number of developers/developments as margins have been squeezed and previously expected profits have not materialised.

"This does not only relate to housing but also to other developments such as sporting stadiums where very large losses have been incurred by one particular group.

"So over the years, along with the growth of the property sector, investors have witnessed some big changes and the sector is now seen by many as having become a much more complicated investment choice from the one that originally prevailed back in the 1970s.

"However as those choices get harder so do the rewards. The reality is that today a lot more homework and assessment of the choices are now required to achieve a successful investment outcome in listed property securities, particularly as the sector is focusing on going global, which is where specialist professional investment managers come in."