


RESEARCH PAPER

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Listed property sector – has been or hot property?

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Predictions two years ago of the demise of active management in the listed property trust sector were premature. There is no doubt that the merger of the Westfield Group of companies in 2004 was a major catalyst for structural change in the Australian listed property trust asset class. However, the consolidation led by Westfield also paved the way for new market entrants, resulting in a deeper, broader market universe today. There is now a greater focus on return on equity and cost of capital rather than the accumulation of assets. This paper examines the concept that the current diversity in the sector is playing into the hands of active managers who can demonstrate a strong property and equities skill base and argues why listed property trusts should still be a part of investor portfolios.

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The Australian listed property trust (LPT) sector has grown consistently on an absolute and relative basis compared to Australian equities, from a market capitalisation of around \$A3 billion in 1986 to close to \$A92 billion in 2006. The LPT sector accounts for around 10% of ASX/S&P 300 Listed Property Trust Index, and the sector represents a continuing source of real estate capital, with new capital of approximately \$A3 billion being raised every year. This remains broadly in line with the average level of natural demand, with annual demand of \$A3 billion to \$A4 billion expected from compulsory superannuation inflows. Future capital raised will continue to be allocated to offshore and domestic acquisitions and balance sheet strengthening.

Performance

Australian LPTs have performed extremely well over the longer term (Figure 1). Outperformance is thought to be due to advantages created through various factors, including the structure of listed investment vehicles, greater liquidity and lower transactions costs. For the future, access to international property at higher yields is likely to continue to drive higher potential returns, albeit at higher risk.

Consolidation

The number of stocks in the sector (as represented by the ASX/S&P 300 Listed Property Trust Index) increased from 11 in 1991 to a peak of 51 in 1999 (Figure 2 overpage). It then dropped through consolidation to a

low of 21 stocks, but has since recovered to stand at 32 in 2006. Despite the decline in the number of stocks available in recent years, the diversity of offerings in the sector has actually improved. Investors are now able to target domestic vehicles (for example, Commonwealth Property Office Fund), passive trusts (for example, the ING Office Fund), active fund managers and developers (for example, Centro/Investa) and vehicles owning offshore assets (for example, the Babcock Japan Trust).

Earnings volatility is still much lower than the Australian equity market (which LPTs have outperformed), however there is now greater earnings divergence between stocks within the sector.

Consolidation in any market typically allows room for new entrants, and new vehicle creation remains high with sixteen new entrants into the listed property sector since the Westfield merger. Further offerings are mooted, with further diversification also highly likely.

History of consolidation

- Early 1990s – the listing of previously unlisted vehicles due to the unlisted trust crisis.
- Mid 1990s – the era of sector-specific trusts, with a number of new listings in commercial, retail, industrial, hotel and other specialist sub-sectors.
- More recently – the trend towards amalgamation of trust vehicles into diversified conglomerates with an internal management structure, similar to the US real estate investment trust (REIT) model.

Current trends in the LPT sector

The average size of LPTs is increasing

The average market capitalisation of Australian LPTs is now approaching \$3 billion. Market capitalisation has increased by around 19% per annum over the past 10 years (Figure 3 overpage). Excluding the big four trust sector vehicles, average LPT market capitalisation has trebled over the past three years from \$340 million to

Figure 1: Australian LPTs – returns to 31 Dec 2005

INDEX	3 YRS (%PA)	10 YRS (%PA)	15 YRS (%PA)
PCA COMPOSITE PROPERTY INDEX	12.7	11.6	10.8
ASX LPT 300 INDEX	17.5	15.8	14.3
ALL ORDINARIES INDEX	21.4	12.6	12.1

Notes: Includes institutionally owned property in Australia Source: PCA Investment Performance Index



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\$1.5 billion. To illustrate further, 10 years ago there were two LPTs with market capitalisation of over \$1 billion, now there are 16. This improves managers' ability to gain exposure to a wider diversity of liquid trust sector vehicles.

Increasing liquidity

Annual liquidity of the Australian LPT market (that is, the annual monthly value traded as a percentage of market capitalisation), has trebled over the last 10 years, from 30% in 1995 to 90% today.

Increased gearing

LPT gearing has increased from around 6% in 1992 to 39% currently. However, property has a high level of earnings certainty, with long leases on enforceable contracts. The important issue is how additional gearing is used relative to the stage in the economic cycle. Increased gearing is not necessarily irresponsible, merely an attempt to increase shareholder value.

Increased overseas holdings

The Australian LPT sector's exposure to overseas assets has risen from 2% in 1992 to close to 40%. The key driver is the ability to source international assets at higher yields and at least partly debt-funded acquisitions

at a cheaper rate using locally sourced borrowings. By and large, LPT managers are taking a sensible approach to ownership of offshore assets through the use of joint venture arrangements with international partners for on-the-ground acquisition, development, leasing and management expertise. Currency exposures are typically hedged for five years on a rolling basis to quarantine most non-property risk.

The move to internalised structures

In line with the US REIT model, the Australian LPT sector has undergone a migration from passive structures to stapled securities (Figure 4). This is a result of the search for increased growth in earnings and greater diversity in property-related revenue sources. Stapled securities now account for over 90% of the Australian LPT sector. It should be noted that while moving to an integrated property business model theoretically increases risk in the vehicle, the cyclical nature of property markets means there will be times when this model actually reduces earnings volatility.

The future

With the merger of the Westfield Group of stocks and, more recently, the Macquarie Goodman vehicles and GPT, the market could be forgiven for assuming a small number of super-stocks will be likely to dominate the Australian LPT sector. This then begs the question: will those super-sized stocks take on the characteristics of normal stocks? Is this the end of the sector as we know it, with institutional investors simply taking exposure to the Australian real estate sector by including a handful of property-related stocks in a balanced portfolio and/or opting for wholesale property funds? This would presumably leave the smaller, passive (that is, externally managed) trusts to transition to retail ownership.

Active management born again

Perhaps the future is not all bad. Firstly, it is important to remember that all markets move in cycles. In fact, the Australian LPT sector is very dynamic and the latest proposals are simply another challenge in the evolution of the sector. Remember, the LPT sector grew substantially out of the unlisted trust crisis of the late 1980s and early 1990s, due to conversion to access liquidity. Also, despite the number of stocks in the LPT sector having reduced from 51 in 1999 to around 32 today, the sector has more than doubled in size in the same time frame.

Secondly, while Westfield has become the dominant vehicle in the short term, there are still another 16 stocks with market capitalisation of over \$1 billion. In addition, around 91% of the sector's earnings will still be derived from rental income, with another 3% coming from annuity-style funds management. Risky activities such as construction remain a very small (less than 5%) contributor to earnings.

Furthermore, a smaller concentration of stocks has enabled others to enter the sector (sixteen new stocks since the Westfield merger. The wider GICS Index

Figure 2: Index constituents – S&P/ASX300 LPT Index vs REIT GICS Sector

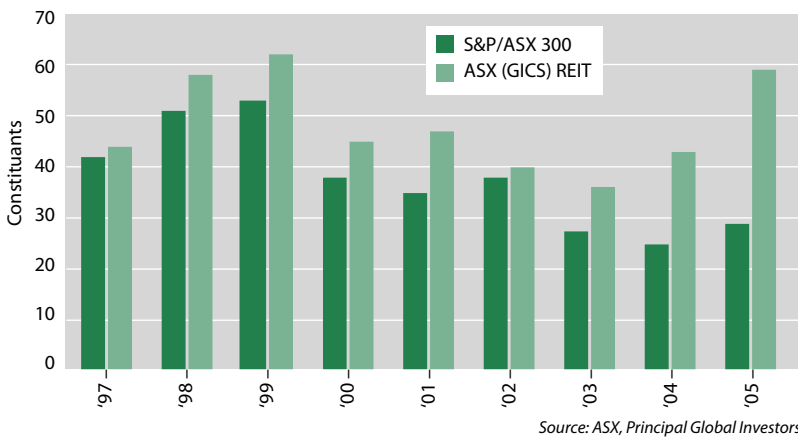
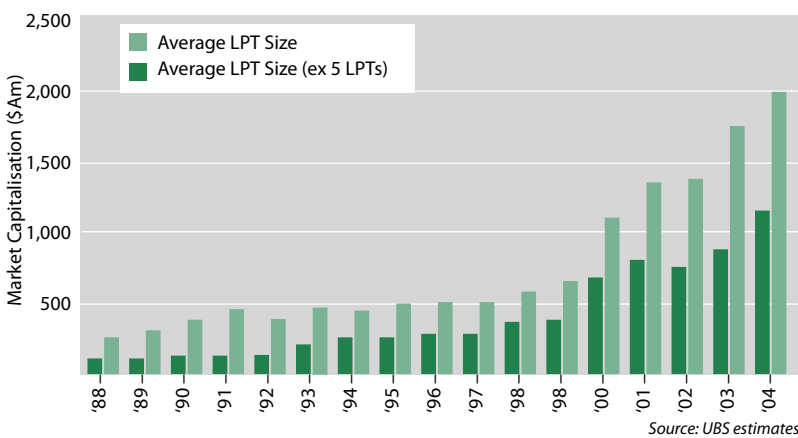


Figure 3: Australian Listed Property Trusts – average size



accounts for another 30 property stocks, many of which are seeking to qualify to get into the ASX/S&P 300 Listed Property Trust Index.

In addition, there is now a far wider variety of property types and structures in which to invest. Outside the traditional retail, office and industrial property sectors, assets include bulky goods, hotels, residential, retirement villages, theme parks and even vineyards. There are purely domestic vehicles versus other trusts which have added international assets to their portfolios. There are traditional trust vehicles versus stapled securities in which a passive property portfolio has been ‘stapled’ to an operating property company with diverse income streams (funds management, property development, etc).

Of significant interest is that over recent years, the volatility of the LPT sector has been falling. The three-year rolling standard deviation reduced from 13.3% per annum in 1998 to 7.1% to 2003.¹ This reflects increased diversification in asset ownership and increased stability in the sector’s funds inflows/outflows. Yet, at the same time, the sector’s constituents are providing more volatility in isolation, due to variation in asset ownership, gearing, revenue sources, etc. As recently as two or three years ago, listed property trusts provided 1% to 2% earnings and distribution growth across the board. Now, with the diversity of vehicles, average growth has increased to 4.5% to 5.0%, however the variation between vehicles is now significant (Figure 5).

Thus the continuing presence of a larger number of meaningful listed property vehicles, plus increased volatility of individual stocks, will support active sector specific fund managers providing excess sector returns. As can be seen in Figure 6, the listed property sector now clearly favours active managers. Passive managers (that is, managers seeking to provide index returns) are forced to own all stocks in the index, even those in strife, so they miss out on the opportunity to invest in the broader market.

Implications for property securities funds

With the recent significant changes in the sector, including a migration from passive trust structures to stapled securities, the listed property trust sector has evolved from being focused on accumulating assets under management, to focusing on return on equity and lowering cost of capital to increase competitiveness.

Property securities funds, by and large, have responded by broadening mandates to include stocks outside the sector where those stocks have a clear relationship to property. Such stocks would include property developers and contractors, selected infrastructure stocks and international REITs. It should be noted that property stocks, even a super-sized Westfield, are still a yield play, with the bulk of revenue coming from property-related income, implying stability and therefore lower price volatility. Property securities have an advantage over other

Figure 4: Australian Listed Property Trusts – number of stapled securities

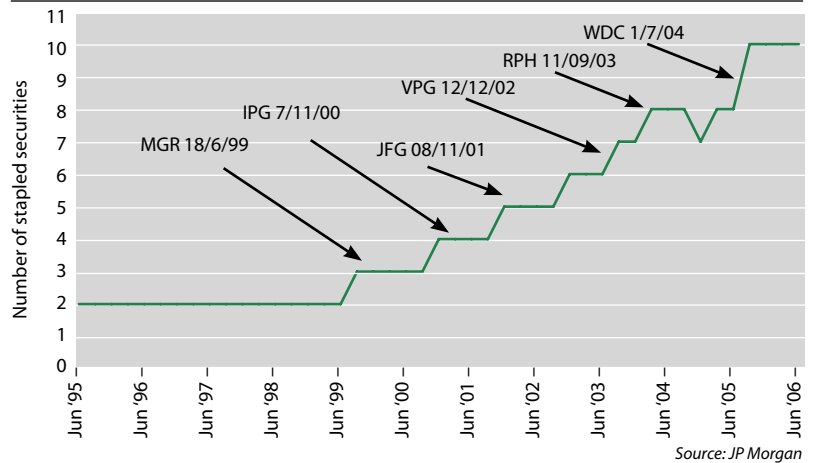
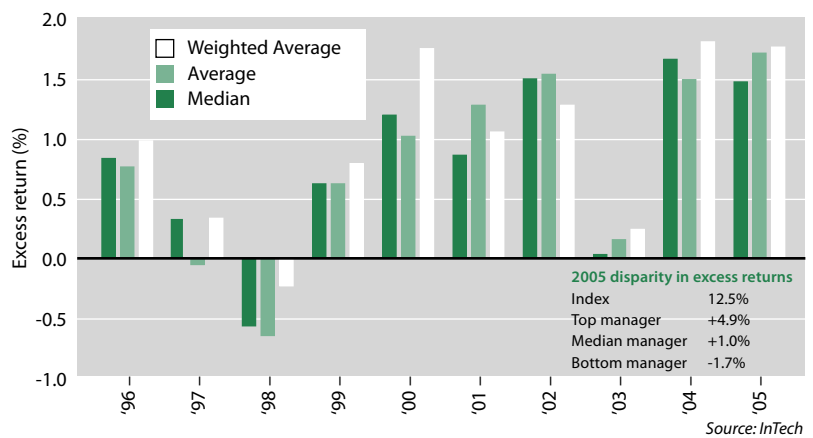


Figure 5: Earnings growth of selected Australian listed property trusts

	FY04 EPS GROWTH (%)	FY05 EPS GROWTH (%)
MACQUARIE LEISURE TRUST	+42.0	+43.0
STOCKLAND	+12.9	+ 5.3
MACQUARIE OFFICE TRUST	- 6.8	+ 4.9
GPT	+ 4.1	+ 4.6
CENTRO	+11.3	+ 3.2
COMMONWEALTH PROPERTY OFFICE	+ 3.6	- 6.3
MIRVAC	+ 5.2	-18.6
MULTIPLEX	n/a	-66.0

Source: ASX, Principal Global Investors

Figure 6: Excess returns – fund managers vs S&P/ASX 200 LPT Accum Index

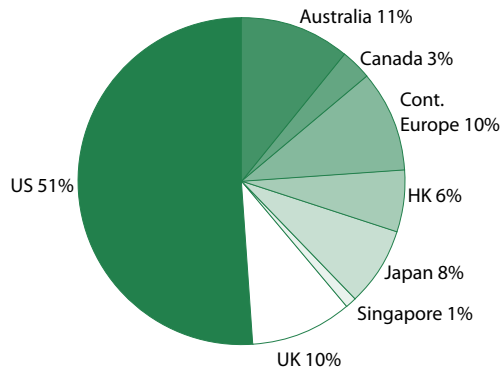


Source: InTech

forms of property investment due to lower entry/exit/ transaction costs, lower management fees, liquidity and the flexibility as to how much capital to invest.

Globally, the demand for real estate is increasing, leading to growth in securitisation of property in many countries. For instance, US institutions recently announced the intention to increase their real estate allocations from 4% to 6%, while the fledgling Chinese

Figure 7: Global securitised property market



Source: UBS, EPRA, NAREIT, Euronext

institutions (for example, insurance companies) are currently seeking authority to start allocating funds to real estate.

As a consequence, securitised real estate is growing at a rate of 10% per annum on a global basis. Australian listed property trusts currently represent 11% of global securitised real estate (Figure 6). In Australia and overseas, through compulsory superannuation saving and ageing populations requiring stable, secure income streams, the demand for listed property securities in whatever form will not go away.

Conclusion

The listed property sector in Australia has a history of continual change and evolution. The recent migration of the sector from the passive trust structure to stapled security is a prime example. Listed property remains predominantly underpinned by stable, annuity style revenue sourced from long-dated lease agreements. Despite recent consolidation in the number of stocks in the sector, the average LPT is now close to \$A3 billion in market capitalisation and 16 stocks are over \$A1 billion, giving an active manager plenty of opportunity to strive for excess returns.

The opportunity also exists for LPT managers to take advantage of opportunities outside the sector in Australia and, more particularly, overseas as the march towards the globalisation of securitised real estate gathers pace. ■

ENDNOTES

1. IRESS/UBS estimates.

ABOUT THE AUTHOR



Simon Hedger is co-portfolio manager for the Principal Property Securities Fund. Simon has over 27 years of property experience, including positions as an analyst and portfolio manager. He has an MBA from the University of New England and is an associate member of the Royal Institute of Chartered Surveyors and the Australian Property Institute.

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