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Email Bulletin

Investors Helping Investors

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PROPERTY

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COORDINATOR'S MESSAGE

By Adrian Vorbach

This Property Bulletin focusses on Unlisted Property Trusts (UPTs).The two articles contrast the recent fortunes of UPTs and the old Listed Property Trusts (LPTs) now known as Australian Real Investment Investment Trusts (AREITs).

The first article, "The outlook for Unlisted REITs in Australia", is from Jim Papanicolaou, General Manager, Kinsmen Securities in Adelaide. This is an excellent overview of the problems experienced by all sections of the property investment market during the recent global financial crisis (GFC).

The second article "Property continues to deliver most stable returns to investors", is from the Australian Direct Property Investment Association, (ADPIA). It is based upon the respected research from the consulting group, Atchison Consultants in their Investment Performance Report.

Adrian Vorbach is a Councillor of the AIA.

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THE OUTLOOK FOR UNLISTED REITS IN AUSTRALIA

By Jim Papanicolaou

As the first positive signs of economic recovery begin to appear in the form of an improvement in share market performance, improved retail sales and stronger residential property clearance rates, many analysts are now questioning whether such data represents a short term response to the Federal Government stimulus package or the first meaningful signs of a truly sustainable economic recovery.

Analysts and investors alike are also turning to the question of what this means for unlisted REITS and the property sector in general going forward.

All property investors have suffered during the downturn associated with the global financial crisis. Unlisted REITS have not been immune from this downturn, however a recently commissioned report for the Australian Direct Property Investment Association (ADPIA) prepared by Atchison Consultants has found that direct property investments suffered less than listed trust holdings.

While listed property trust returns outperformed unlisted property trusts from June 1989 to June 2007, the situation was reversed from July 2007 as the market collapsed. Measures of volatility and downside risk show that unlisted property trusts held up better than investments in listed property trusts. Hence the inclusion of unlisted property trusts in diversified investment portfolios could reduce the chances of negative returns. This augurs well for unlisted property trusts going forward as the value of equity portfolios continue to recover and as managers look to diversify and rebalance their portfolios.

There are, however, still a number of challenges facing property trusts. High levels of gearing and an inability to refinance due to lack of available finance from traditional banking sources has been the most challenging issue for the property industry over the past 12 months and still persists to date. Any new funds face similar lending challenges unless they can show very high levels of pre commitment (usually over 75%) from either property sales or tenancies.

This coupled with moderating demand for office, commercial and industrial space over the last 18 months have resulted in lower property valuations across Australia and continues to hold back any signs of early recovery in the property sector. This is expected to be the case until demand for business investment picks up off the back of sustained signs of recovery in economic activity.

Unlisted property trusts are however well placed to benefit from current market fundamentals that have seen a lack of competition for properties from institutional investors still looking to improve their balance sheet positions.

The fundamentals for future property investment also remain sound. These include projected levels of future population growth and long term growth prospects for the Australian economy in the South East Asian region off the back of demand for resources and general trade activity as the global economies recover. This combined with current levels of interest rates and a softening of capitalisation rates over recent times (leading to higher yields on property investments) do present some attractive investment opportunities at the present time.

Not so long ago, the combination of high capitalisation rates (leading to lower property yields) combined with high interest rates resulted in many property product providers seeking to satisfy the demand for higher income yields by including excessively high levels of gearing (usually 55-70%) and relying on complex structures feeding capital, complex development and hedging gains rather than pure rental returns. This was unsustainable.

In response to the current circumstances unlisted property product providers are now responding with a more "back to basics" approach toward product offerings which capitalise on the higher available yields and lower interest costs at present to offer a more stable product based on the pure rental returns. Much lower gearing ratios (of between 40-55%) are now also being adopted.

The lessons from the economic downturn, the fallout from the recent failures in the industry and regulators response to these is also shaping unlisted REIT product offerings going forward. There is a move away from large upfront and trailing commission products as advisers turn to fee for service models. Fund managers are also reducing levels of management fees to remain competitive. The combination of these changes and good investment opportunities should result in positive benefits for investors going forward.

Jim Papanicolaou is the General Manager with Kinsmen Securities Limited.

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PROPERTY CONTINUES TO DELIVER MOST STABLE RETURNS TO INVESTORS

Provided by the Australian Direct Property Investment Association

Independent research also confirms conservative gearing strategies enhance returns

The Australian Direct Property Investment Association (ADPIA) released the full Investment Performance Report from respected research and consulting Group, Atchison Consultants. The Report measured returns over the past ten and 20 years, to June 2009.

President of ADPIA, Linden Toll, said that while the volatility of the past two years had impacted returns, the traditional property benefits of strong total returns and low downside risk had remained evident.

“Direct property provided returns of 10.1 per cent over ten years and 6.9 per cent over the past 20 years. It also provided income returns of 6.7 per cent per annum over ten and 6.9 per cent over 20 years. Importantly, once again it did this at the lowest level of volatility and lowest downside risk of any investment.”

A Case For Gearing

Mr Toll said that while over-gearing had been responsible for much of the pain in property markets in the past two years, the research demonstrated that a conservative level of gearing was still a very effective way of enhancing returns.

“Gearing in property has been one of the most contentious issues for investors over the period of the GFC,” he said. “High levels of gearing and an inability to refinance, was certainly the most debated issue in our industry over the past 12 months.”

“However, our research has shown that conservative gearing does work. Gearing over the longer term is rewarded, but requires considerable management skill and restraint. Problems with gearing have arisen as managers continued borrowing as property values rose. No different to a residential mortgage that is continually drawn down as the market heats up, managers who instead conserved the upside and maintained a reasonable level of gearing have been rewarded – as have their investors.”

Returns over 10 years to June 2009 from geared property and components have been strong in absolute terms and relative to inflation.

Traditional Benefits Retained

Mr Toll said the Report also showed that Direct Property reduces negative annual returns in diversified portfolios. “Evidence is clear that the inclusion of direct property in diversified investment portfolios can reduce the chance of negative annual returns in the portfolio. When negative returns are avoided it is less likely the investors will take inappropriate defensive investment decisions as a response and will focus on longer tem objectives.”

"Additionally, secure income streams from sound tenants with leases structured for growth in rental income, provides the stability for which property investors have been rewarded."

Mr Toll said the study also shows that investors should be increasing property allocations from five to ten percent to 20 per cent in balanced, growth and high growth portfolios.

The Price of Liquidity

Property investment returns were reduced by almost 20 per cent over five years for investors in listed rather than unlisted property investments.

The Report showed that investors in direct property achieved a 9.8 per cent return over the past five years to June 09, against an -8.6 per cent for AREITs (or LPTs). The direct property returns also carried a much lower level of volatility – five per cent compared with 21.8 per cent.

The returns were also more favourable over ten years with a return of 10.0 per cent and volatility of 3.6 per cent for direct property. AREITs delivered just 2.1 per cent with 16.7 per cent volatility.

Atchison Consultants Managing Director, Ken Atchison, said it was clear that liquidity in property had a significant detrimental impact on investor returns. "Around the world baby-boomer investors were seeking high levels of income," he said. "What this led to were complex listed property structures that were artificially feeding income through complex development and hedging structures rather than pure rental returns."

"For a while LPTs produced strong returns, but what we now know is that these structures were unsustainable." The Report showed that LPT returns outperformed direct property from June 89 to June 07. However, since the market downturn commenced in July 07, the returns from direct were stronger that those from LPTs.

Key Findings

Returns

Returns over 10 years to June 2009 from industrial and retail property especially and office property have been strong in absolute terms and relative to inflation.

Volatility of Return

Direct property has provided very low volatility of returns. Low volatility of returns reduces the prospect for inappropriate reactive responses reflecting an aversion for losses. Loss aversion reflects the greater weight given by investors to fear of loss rather than hope of gain. Timing of purchases and sales in direct property will be less demanding than in listed growth assets. High volatility means that total returns can be greatly diminished by poor timing of purchases and sales by investors introducing loss aversion and prospectively poor decisions.

Relative rewards for volatility arising from investments as measured by the Sharpe ratio indicate that retail, office and industrial property have all been attractive relative to all other asset classes. As volatility of returns is a key factor in poor investment decisions this enhanced risk adjusted return outcome represents a benefit from property investment.

Income

Over 10 years to June 2009 direct property has provided the highest level of income returns and among lowest volatility of income returns. High and sustainable income has considerable attraction for investors who seek consistent absolute returns. The prospect of sustainable of pension payments received by investors in retirement is significantly enhanced.

Downside

Property represents relatively low downside risk exposure when measured against other asset classes on a one year prospective. Enhanced preservation of capital arises from property providing stability of income. Poor decision making by investors responding with fear when short term negative movement in markets has occurred, is less likely when investing in property.

Over the past 10 years, stability of property returns is highlighted when the measure of maximum drawdown is used. This reflects the measure from the peak of markets to the trough on a quarterly basis and shows that property loss has been relatively low.

Liquidity

Based on three liquidity measures, listed property has a higher level of liquidity than unlisted property. The liquidity trade-off indicates that expected returns from unlisted property should be higher than listed property, which it has been over the long term – but not necessarily over the shorter terms.

Property Investment Management Models

Analysis confirms that as the risk of in the investment model increases from gearing and stapled sectors the volatility of returns becomes significantly higher.

This media release was first distributed by ADPIA on 13 October 2009.

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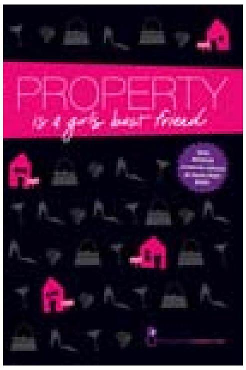
BOOK REVIEW

Title:	***Property is a Girl's Best Friend***	Author:	Propertywomen.com
Publisher:	Wright books, Brisbane, 2009	ISBN:	9781 7421 69347
RRP:	$32.95	Reviewer:	Jennifer Williams



Real estate is a very important form of investment for Australians. This book comprises a series of essays by Australian women (and one man) who have different areas of expertise in real estate matters. Each area is essential to be a successful property investor. The author, propertywomen.com, is a membership website which provides information and events relevant to property investment.

The book attempts to provide a one-stop-shop for all the issues encountered in real estate investment. I think it would be a good handbook for anyone starting out as a property investor. It perhaps lacks the in-depth detail to be of great use to established property investors.

However, some chapters would be of interest to those with more experience, for instance the chapters on setting up joint ventures and on ownership (title) structures.

Areas covered by the book include:

- Budgeting and tracking cash flow
- Networking – identifying suitable real estate agents, accountants and insurance brokers.
- Strategies for making money through property investments, eg. renovating to increase rental income.
- Cash flow and gearing – benefits of being positively or negatively geared
- Renovation – can you profit by buying, renovating and selling in a short time period?
- Subdivision and development – steps involved in subdividing land and building multiple dwellings
- Setting up joint ventures
- The Title – legal and tax implications of ownership structures
- Options – for example giving a tenant the option to buy the property they are renting
- Property management – using professionals or doing it yourself.

What I found particularly useful were the lists and worked examples found in many of the chapters. For example, Robyn Masters' chapter on analysing a deal explained how to calculate rental yields and listed these basic guidelines on acceptable rental yields:

- "**Low yield: 1 to 4 percent.** This property must have huge capital gain potential, but will be cash-flow negative, so make sure you have the cash to hold this property for the long term. For me this would have to be an amazing property – perhaps something on the beach!
- **Average rental: 5 to 7 percent.** This is what most investors expect, but you can do better. I would only buy a property in this range if it had good potential for capital gain or was new with low maintenance requirements.
- **Target yield: 7 percent and upwards.** Now you're talking. These properties have reasonable cash flow and the rent might even pay for all the expenses before the tax refunds. Just make sure there is still some capital gain potential: investors normally create huge wealth through capital gain, not net surpluses, so make sure the property still has potential for growth."

In summary, *Property is a Girl's Best Friend* would be very useful for beginners (women or men) in property investment. Those who already have a toe in the water will find some of the information adds to your knowledge.

Jennifer Williams is a member of the AIA.

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