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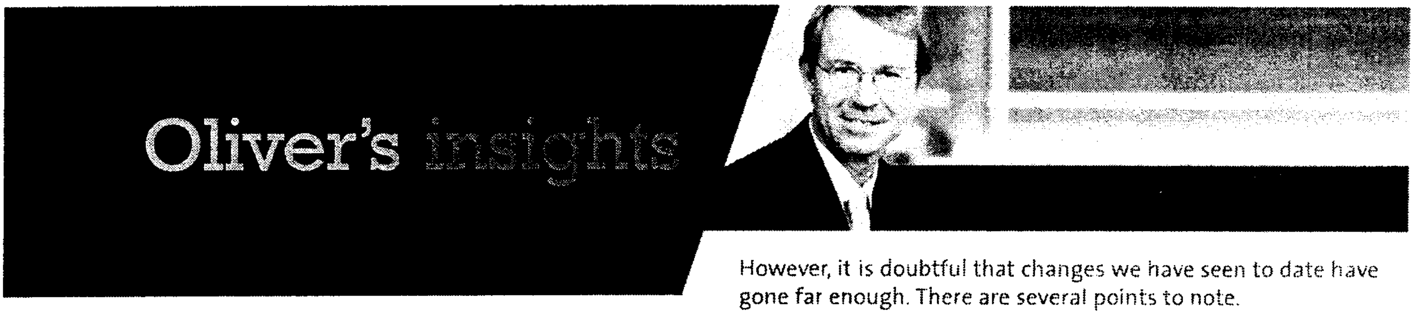
Listed property trust changes – implications for investors



Listed property trusts (LPTs) have long been a favourite of investors due to their high returns, high yields backed by property rental income, their tax transparency and their (supposed) attractiveness as a highly liquid proxy for directly held property. However, a range of changes have led many to question the ongoing attractiveness and viability of LPTs as a separate asset class. Also, many argue it is becoming harder to justify active management of listed property trust portfolios.

Key changes

Concerns about LPTs stem from the following:

- The level of debt has increased from 10% of gross assets in 1995 to 35% today.
- The sector's exposure to offshore assets has increased to 45% of total assets and is still rising.
- The rise in the number of stapled vehicles (where property management is combined with property investment) and the inclusion of development activities has seen a fall in LPT's exposure to rental income.
- After significant merger activity the number of stocks in the S&P ASX 200 listed property trust index has fallen from 51 in 1999 to just over 20 and still falling. After its merger, Westfield is around 35% of the sector's market capitalisation.

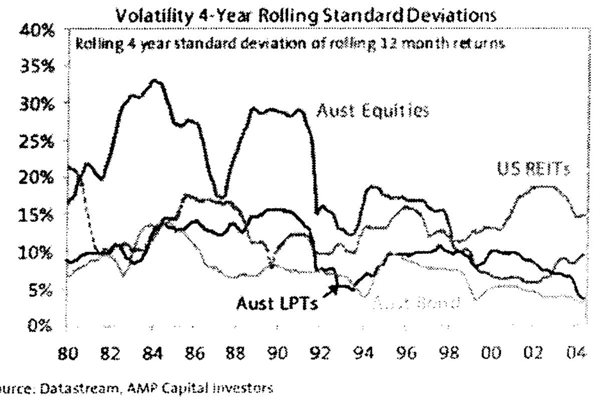
Taken together these changes have led to fears that LPTs will become more volatile, more interest sensitive, less reflective of property market conditions, more concentrated and dependent on the performance of one or two trusts and less amenable to successful stock picking by active portfolio managers. What's more, they are leaving investors with an arguably inefficient exposure to offshore property.

Issue No 1 - the ongoing viability and attractiveness of LPTs as an asset class

The trend towards higher gearing, less property rental income exposure and greater stock concentration certainly make listed property less attractive as an asset class. As trusts take on a greater global exposure it is reasonable to ask whether having them as part of a global listed property portfolio makes more sense than as part of a supposedly "local' listed property trust exposure.

However, it is doubtful that changes we have seen to date have gone far enough. There are several points to note.

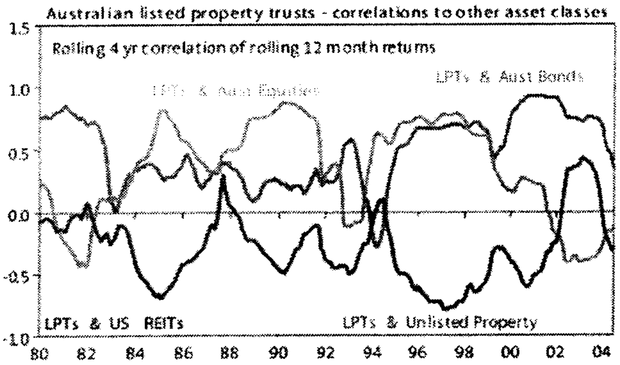
- Firstly, **the increase in gearing in large part reflects the increased exposure to offshore property**, where having higher offshore (mainly US$) debt provides a natural hedge. It should also be noted that listed property trust gearing levels are still relatively modest compared to real estate investment trusts in say the US.
- **Secondly, while exposure to property rental income is falling (from 96% in 2000) it will still be greater than 87% even if the GPT/Lend Lease merger proceeds[1].** Furthermore, over time it would be reasonable to expect that the proportion of earnings from development activities will decline as many properties developed by trusts' development arms find their way into the trust portfolios themselves. In addition, the sector's distribution yield is still around 7%. So, the high yield property underpinning of listed property trusts will remain largely in place.
- Thirdly, while the number of stocks has declined it is still higher than when the sector started to grow in popularity in the early 1990s and the average size of trusts has increased, contributing to increased liquidity.
- Fourthly, **despite the changes in recent years there is little evidence to date that it has had much practical impact.** Volatility of the sector remains low - see the next chart. It should also be noted that LPTs remain less volatile than one of their main alternatives, US REITs, which are the dominant component of global listed property. (The volatility of global listed property is between US REITs and Australian LPTs is shown below.)



Source: Datastream, AMP Capital Investors

[1] These estimates are from "The changing nature of LPTs...or NOT?", UBS Investment Research, June 2004.

And there is little evidence of any change in the correlation between shares, bonds and unlisted (i.e. directly held) non-residential property – see the second chart.



The correlation coefficient shows how closely two assets move together. It ranges between -1 (ie, the two assets move one for one but in opposite directions) to +1 (ie the two assets move one for one in the same direction). Source: Datastream, Mercer Investment Consulting, AMP Capital Investors.

While many argue that LPTs are a proxy for unlisted property - this has never been the case (as evident in the low correlation between LPT and unlisted property returns). Likewise there is no evidence that trusts are becoming more share or bond-like in terms of their correlations to these assets. It should be noted that the high correlation between LPTs and bonds over the past decade appears to reflect their shared defensive aspects. Of course, the increase in gearing does imply a greater vulnerability to the interest rate cycle - but as long as this remains mild this is likely to have little relevant impact.

- Finally, **while trusts do have some short-term vulnerability to rising bond yields and interest rates (after having been pushed higher in price by merger activity) their-medium term return prospects remain solid.** Their distribution yield of around 7% remains relatively high and distribution growth of around 2.5% should be easily achievable suggesting a prospective five to 10 year return of around 9.5% p.a. It should also be noted that the process of rationalisation should be positive for individual LPTs to the extent that it leads to more efficient corporate structures and cheaper access to capital.

Our view is that a typical 70/30 growth/defensive investment portfolio should have about a 13-15% exposure to property (depending upon the exposure to alternative assets). This should be split between unlisted or directly held property and listed property. Ideally, the latter should be split between Australian and global listed property (our diversified funds have already moved in this direction). While recent changes reduce the attractiveness of Australian listed property trusts, given the above-mentioned considerations there is no need to revisit this strategic asset allocation.

- The sector never was a proxy for directly held property in terms of its short-term performance characteristics.
- While LPTs are expensive relative to direct property it is hard to justify a higher exposure to direct property given liquidity issues.
- LPTs rental property/high yield underpinning remains largely intact.
- LPTs are not expensive relative to global listed property. Local yields are actually more attractive.

But eventually it will be time to move more aggressively elsewhere, probably to global listed property. (Infrastructure is another alternative.) However, for investors who do not have exposure to global listed property or unlisted property along the lines suggested here, there is a case to consider moving towards such an allocation with changes in the LPT sector and its overvaluation relative to direct property supporting such a change.

At the retail investor level, the scope for such a move is limited - both global listed property and unlisted property are harder to access directly. In this case, given that medium-term return prospects for LPTs remain bright, the best approach would be to hold tight.

Issue No 2 - Active v Passive?

The opportunity for active management to add value is not affected as much as many claim.

- In terms of the scope that active managers have to add value recent changes are clearly negative, but not necessarily terminal. There are still more stocks than was the case when the sector took off in the early 1990s. However, as rationalisation continues this will become more of a concern. This is particularly the case compared to global property securities where the scope to add value is huge.
- In recent years the correlation between key sectors within the asset class has actually been falling and this should enhance the ability of managers with skill to add value. Going forward, correlations may actually decline further as global activity in major stocks like Westfield make them more volatile relative to the rest of the market.

The biggest concern on the active management front is that the dominance of Westfield will make it harder for managers to take decent positions in it (without blowing out their so-called tracking error) and hence in other stocks. While a solution to this may have been to cap Westfield's weight at 15% or so of the index this approach appears to have been dismissed by the market and Standard and Poors as impractical. Ultimately, the issue comes back to the willingness of managers to take on tracking error risk - and this might have to rise.

Conclusion

- Ongoing change within LPTs does reduce its relative attractiveness as an asset class.
- Ideally, availability and liquidity issues permitting, investors should have an exposure to unlisted (direct) property and global listed property as well as Australian LPTs.
- The changes within LPTs to date are not yet sufficient to warrant their complete elimination from investors' portfolios - they remain underpinned by high rental property driven yields, offer attractive returns, remain relatively low risk and offer low correlations to shares. That said as LPTs continue to rationalise and globalise, having primary exposure to them via a global property securities portfolio (as opposed to via a stand-alone portfolio of Australian LPTs) will eventually make sense.

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Further information

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