Podcast transcript: Essential bricks and mortar

First Sentier Investors

Good afternoon everyone and welcome to this First Sentier Investors podcast on Global Property Securities on Thursday 30th April 2020. I'm Peter Heine and with me today is Stephen Hayes, Head of our Property Securities team to discuss how the listed property sector has responded to the Coronavirus crisis and of course the threats and opportunities that exist for investors in this universe.

Stephen has managed listed property investments for about 25 years and his team manage approximately $2.0b across domestic and global listed property portfolios.

Stephen, thanks for joining me.

My pleasure Peter, happy to be here.

You've been a property investor for a long time. How does the current Coronavirus-driven volatility compare to that of say the GFC?

The market volatility for Real Estate Securities has been very similar to that seen in the GFC but for very different reasons. Although, one noted difference is the extent of the drawdown or sell off, is much less extreme than that experienced in the GFC. Year-to-date, the fund is down approximately 20%, versus the benchmark which is down -28%. It should be noted the funds 3 and 5 year returns are positive and the 10 year return is 8.1% after fees.

Clearly today is just a point in time and market volatility continues to be high. However, at this stage the extent of the sell-off in the GFC was much greater.

Listed property has traditionally been a consistent source of income for investors. Given that many companies are withdrawing guidance as well as cutting their dividends, how do you view the listed property sector's ability to continue to provide a regular income stream?

Many of the REIT's in Australia and globally have withdrawn earnings and dividend guidance either for the first half or for the full year. We view this as simply prudent given the uncertainty around the timing of the removal and staging of the lock downs. There are medium and longer term implications for some sub-sectors such as shopping malls with the greater adoption of ecommerce, and potentially office buildings and student accommodation with greater adoption of remote working and learning. Overall many sub-sectors will benefit such as logistical warehousing, data centres and private hospitals. Once things start to normalise, dividends are expected to return to normal, with the usual regular income streams, to flow through to investors.

You've already touched on how the current crisis compares to the GFC, but we have seen a number of companies globally recapitalise their balance sheets via both equity and debt capital markets. How have listed property balance sheets changed over the last 15-20 years?

The Real Estate Securities are simply not in the same balance sheet position as they were leading up to the GFC. The balance sheets today are in a much stronger position, with lower loan to values, greater sources and duration of debt and higher interest rate coverage. Whilst there may be some poorer quality outliers that may come to market, such as the Charter Hall Retail REIT did earlier this week in Australia, this is atypical with the great majority of the sector having no need to come to the equity markets to raise capital. And from the Fund's perspective, it is in an even stronger position than the sector, with the funds look through gearing at 30%, average debt maturity of 6.9 years and interest cover of 7.0X.

Given current Coronavirus isolation measures, many of us are working from home, staying away from shopping malls, unemployment is expected to increase sharply which suggests pressure on rental tenancies. Which sectors do you see as being challenged?

It's difficult to generalise with regards to real estate given the localised nature of the assets. However, there are distinct differences between different forms of retail real estate. For example, convenience and sub-regional shopping centres focussed on high levels of non-discretionary spend, they are simply not exposed anywhere to the same extent to the greater adoption of ecommerce. For instance, I'm yet to have a virtual haircut. Shopping centres should continue to be a viable part of the retailing landscape for decades to come. For the larger regional shopping malls the situation is different and I expect these assets to carry higher natural levels of vacancy in the future and have lower levels of market rents. But that does not mean these assets still can't provide economic returns over time. One further observation, many of these assets sit in urban infill locations in the some of the world's most bustling cities where land is scarce and the land on which they reside is rare and very valuable, so there are still high amounts of intrinsic value in these assets.

What about office buildings with the implications for more remote working?

Whilst this trend bears monitoring over the next few years, we currently do not believe that office buildings will be materially impacted from a greater adoption of remote working. There are a number of things at play here. Firstly, if services and other businesses trial greater levels of staff remote working and productivity can either remain the same or improve, then the businesses will likely require a smaller future office footprint, which will deliver a net economic benefit to those businesses. However, it should be noted, occupancy costs for many service businesses are low, so the cost savings may not be that great, with the largest component of service company expenses by far being staff costs.

However, our expectation is that in the future we will witness a greater adoption of remote working, particularly given the likely economic benefit to business. This doesn't mean office buildings still can't deliver very good economic returns over time, as there will likely be lower levels of new supply. This should continue to see occupancy levels remain very high.

Stephen, given the current environment, how are you positioning your global portfolio to protect capital and to provide growth and income?

By far the largest of the fund's sector exposure is in residential buildings, representing approximately 1/3 of the portfolio. These are apartments and single-family housing assets located in the US, Canada, Finland, Germany and the UK. These assets today remain structurally full, with occupancy levels at +95%. Anecdotally, April rent collections have remained high, with rent collections typically above 90%. It should also be noted, in the current environment, that the residential REIT's are being very good corporate citizens and not currently passing on lease renewal rent increases. They are also offering those tenants affected by the crisis typically free rent and/or rent deferral options. However, at this stage, this represents a very small part of the rent roll. Given the extent of the lock-downs, tenant retention levels are very high with move-in and move-out activity effectively stalling.

The balance of the portfolio is invested in logistical warehousing, office buildings, data centres and health care assets such as hospitals. We are expecting these assets, to continue to generate good returns for investors and for income levels to continue to grow over time.

Stephen, thanks for your time today. It's certainly been an unsettling period for investors of all stripes over the past few months. I really appreciate you offering your insights into the listed property sector, and I look forward to catching up with you again as markets continue to react to this pandemic.