HD A-REITs Perform Strongly But Value Is Scarce

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-Bumper year for A-REITs -Supported by low cost of debt -Recovery in Sydney, Melbourne CBDs -Rental growth weak

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Australian real estate investment trusts (A-REITs) continue to perform strongly. With yield spreads to direct property investment at near 20-year highs, a lower-for-longer interest rate outlook and strong transaction evidence, a narrowing of cap rates - book value versus the income produced - is expected, as properties are re-valued for December 31 reporting purposes.

December is historically the strongest month of the year, with Goldman Sachs noting a positive absolute performance in 17 of the last 22 years for the month. Historically, December provides a 1.8% excess return on the weakest month, January, despite some breaking down of the trend in the past few years. The broker consider 2014 is on track for a record year in terms of direct property transactions by value. A-REITs remain a strong performer on a global comparison, behind both US and Chinese developers. Value is scarce, in the broker's opinion, but it can be found in Mirvac ((MGR)). Goldman Sachs also prefers Dexus ((DXS)) and Goodman Group ((GMG)). Macquarie believes the outlook for further cap rate compression in the CBD office market is good. The cost of real estate debt is lower, because of reduced cash rates, low bond yields and lower debt margins. The investor profile has also broadened, with foreign buyers joining domestic pension funds. The broker retains Outperform ratings for GPT ((GPT)) Investa Office ((IOF)) and Charter Hall ((CHC)). An Underperform rating is attributed to Cromwell Property ((CMW)), given its relatively low exposure to the Sydney CBD and significant leasing risk in other office markets such as Brisbane and Canberra.

The withdrawal of office space from the Sydney market via conversion to other uses, namely residential, hotel or retail, should help vacancy rates but Macquarie is mindful new supply is also coming to market, with large projects such as the Barangaroo towers and 200 George St developments. The broker's mid case scenario calculates vacancy rates will fall to 8.0% by 2018, from current levels around 10%, to be broadly in line with the 30-year average CBD vacancy rate. On balance, Macquarie expects effective rents to improve over time but there will not be sufficient upward pressure in the near term. While, nationally, a recovery is expected in Sydney and Melbourne the broker expects Brisbane and Perth office markets will lag, as falling commodity prices flow into business confidence and conditions in these markets.

The A-REITs did outperform the S&P/ASX 200 in November, JP Morgan asserts, the sixth consecutive month of this being the case. The S&P/ASX 200 A-REITs are up 21.6% year to date in absolute terms and 18.1% against the broader market. Large caps which led this outperformance were Westfield Corp ((WFD)), Federation Centres ((FDC)) and Novion Property ((NVN)). Mirvac notably underperformed and was joined in November by Stockland ((SGP)) and Dexus. JP Morgan considers the sector is fairly valued with its top pick being Mirvac, which is trading at a 15% discount to the broker's fair value assessment.

Re-leasing rates will remain significantly negative for the next two years and UBS considers the largest drag will be in office sector. A-REIT rental growth has underperformed versus global peers. The broker suspects this is because rents did not re-base lower as significantly in Australia, as was the case elsewhere after the global financial crisis. In turn, this means upside is more muted. The broker believes little positive organic earnings growth is likely, preferring those A-REITs which have growth options through a global portfolio, such as Westfield, with its US and UK exposure, and Goodman Group, with Japanese developments and Australian residential conversions. UBS flags Sell ratings for Dexus, Novion and Scentre Group ((SGG)) on this basis.

JP Morgan expects believes re-leasing spreads are stabilising, while slow but steady improvement will play out in the better retail centres over the next few years. GPT and Scentre **Group** are expected to benefit from a more favourable retail sales environment because of their heavy NSW exposure, where retail sales growth is now running at an impressive rate. The broker observes the entry of international retailers into the Australian market is a significant trend over the past few years and the majority of brands have been successful. The ability to attract ad accommodate these stores is likely to create a division in shopping centre profiles and characterise performance over the next decade, in JP Morgan's opinion.

The broker's discussions with the industry signal that H&M and UNIQLO are performing strongly, while Zara continues to trade well. Topshop is softening and GAP is struggling. Forever 21 is the latest entrant in fast fashion and the broker is keen to see how this store progresses, particularly in the larger markets of Sydney and Melbourne. On newly opened store that is expected to have a large impact on A-REITs is Sephora, the French cosmetics and skin care retailer. Sephora plans to open 20 Australian stories, targeting sales of up to $250m within five years.

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