Research
Macquarie Wealth Management

Investment Strategy Update #35

REITs back in favour

- The prospect of a COVID-19 vaccine alongside the reopening of the Australian economy should be positive catalysts that help close the significant valuation discount that many REITs still trade on as we enter 2021.
- While the outlook for the sector will remain uneven as cyclical tailwinds battle structural headwinds (accelerated by COVID-19), the sector has re-capitalized and even at current dividend yields provides a substantial spread to bond yields.
- We expect REITs to outperform bonds through 2021, but to underperform equities, which offer more cyclical earnings and valuation upside. Investors in the REITs sector get access to yields which are already well in excess of bonds with the potential for dividend upgrades. However, we see more limited potential for capital appreciation vis-à-vis equities.
- Our preferred sub-sector of REITs remains Industrials. Residential has the capacity to continue to surprise on the upside through 2021 while Office & Retail remains constrained by structural headwinds.

We upgraded REITs recently

We upgraded REITs back to neutral from maximum underweight in early November (see "Investment Matters – November 2020: Vaccine a 'booster shot' for growth"). We had been underweight REITs since the onset of COVID-19. Our concern was that cyclical risks driven by social restrictions were combining with structural drags impacting, for the most part, retail and office.

However, we think recent developments around a global vaccine, in combination with the reopening of the Australian economy and where the sector is now trading, suggest downside is now limited and that the sector should gradually perform in line with an improving cyclical outlook – albeit underperforming equities.

Virus announcement boosts retail & office REITs

The recent announcements of potential vaccine breakthroughs had an immediate positive impact on the REITs sector and in particular those sub-sectors that have been most negatively impacted by social restrictions, such as retail and office.

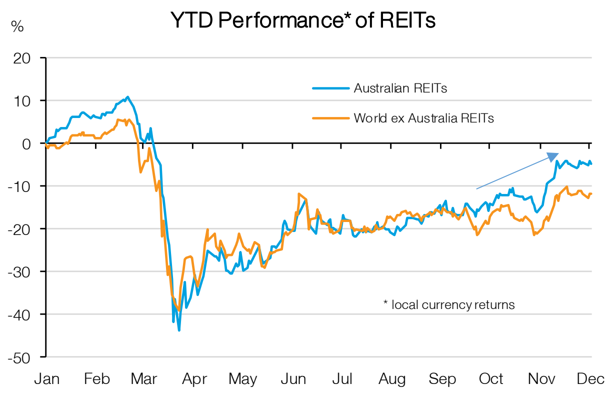
Performance since First vaccine announcement 9-Nov

	Australia	World-ex-Australia
REIT sector	4.8%	7.7%
Retail sub-sector	15.7%	23.2%
Office sub-sector	5.6%	16.3%
Industrial sub-sector	-5.4%	-3.9%

Source: Factset, MWM Research, December 2020

Even before the vaccine announcement, Australian REITs had begun to pull away from global REITs, due to Australia's better performance in containing the virus and consequent earlier re-opening.

Australian REITs pulling ahead of Global REITs



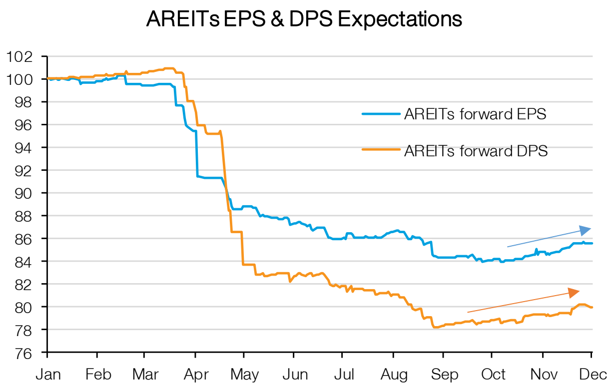
Source: Factset, MWM Research, December 2020

Fundamental backdrop improving

Earnings and dividend expectations for REITs, which collapsed during COVID lockdowns, have not only stabilised but are now being upgraded. Given the reopening of the Australian economy and resultant increase in foot traffic, the bias to EPS/DPS expectations going forward is more likely to be upgrades rather than downgrades.

The stabilisation of earnings/dividends is a particularly important 'marker' as the recent selloff was 'income driven' – i.e. driven by concerns over collapsing rental income as opposed to the GFC driven selloff, which was 'capital driven' – i.e. driven by concerns over lack of capital.

AREITs' EPS & DPS Expectations starting to rise



Source: Factset, MWM Research, December 2020

Balance sheets generally resilient

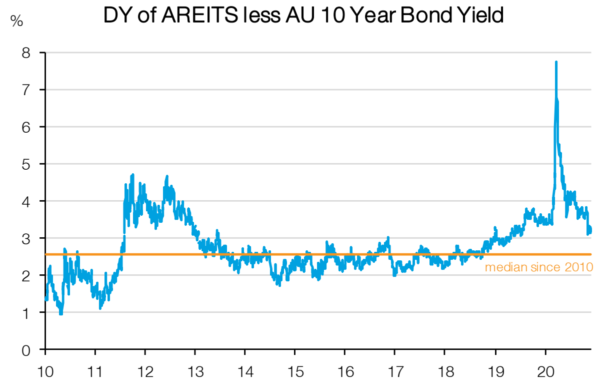
A key concern for the sector heading into lockdowns was if access to debt was restricted (as was the case during the GFC). However, we have not seen the same issue this time around although margins (risk priced against debt) initially spiked but moderated since. The cost of debt has been declining across the sector – in-line with the broad decline sovereign yields. Macquarie expects this to continue as reference rates are lower.

Gearing has been relatively low in the last few years for the REITs, with an increase in debt balances largely offset by rising asset values. This, and recent equity raisings, has generally underpinned confidence in the REITs' ability to weather any material downturns in asset values from this point forward.

Valuation versus fixed income looks compelling

REITs trade at a considerable (315bp) yield spread to bonds (10-year Australian government) and a greater than 10% discount to NTA (ex Goodman Group and Charter Hall Group). While Macquarie does not see the sector trading back at NTA or at the long-run DPS yield spread given structural headwinds facing retail and office, the vaccine news is likely to result in a compression of the above metrics.

REITs trading at a substantial yield premium to bonds

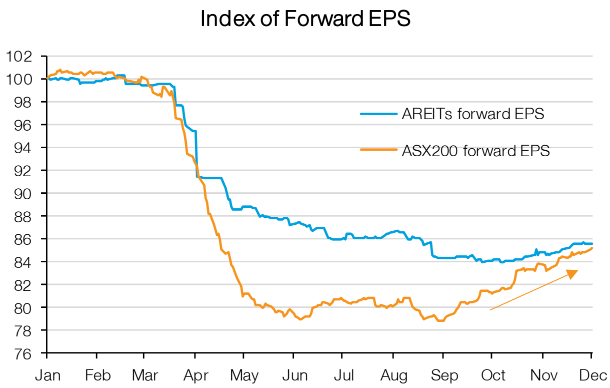


Source: Factset, MWM Research, December 2020

However, there is more cyclical upside in equities

REITs are notionally trading at a P/E discount to broader equities. However, this P/E discount reflects more cyclical earnings upside in equities: One year forward EPS growth is ~5% for AREITs versus ~14% for the ASX200 and earnings expectations for equities are rising faster than for REITs.

Equities have greater earnings upside than REITs



Source: Factset, MWM Research, December 2020

Industrial and Residential Sub-Sectors preferred

Among sub-sectors, we continue to prefer Industrials, where we see continued strength due to e-commerce penetration. Additionally, the residential sub-sector will

benefit from government initiatives to boost housing activity as well as ‘lower for longer’ interest rates: Macquarie recently upgraded their outlook for house prices to forecast a rise of 10-12% by the end of 2022 (see “Aussie Housing Update & Outlook - Momentum building”).

It’s not all good news, particularly in Office

The Office sub-sector (which comprises around a third of the sector on a ‘look-through’ basis) will continue to struggle shorter-term with oversupply (particularly in Sydney and Melbourne) and longer-term with the impact of Work-From-Home (WFH).

The Sydney office vacancy rate is now 10.2% with further upside pressure. Macquarie believes Sydney net effective rents will fall 20-30% peak to trough (they have already fallen 11%q/q).

QIC Global Real Estate recently estimated that, based on their assumption of 50% of the workforce working from home two days per week post COVID-19, this would result in an estimated 5% net fall in demand for office space, which is expected to see rental growth rates across Australian CBDs fall well below current market consensus forecasts, placing downward pressure on asset values.

Summary: Fixed Income < REITs < Equities

We expect REITs to outperform bonds through 2021 but to underperform equities, which offer more cyclical earnings upside. Additionally, the vaccine-inspired ‘risk on’ trade should see ‘riskier’ equities outperform relatively lower beta REITs.

Jason and the Investment Strategy Team

The report was finalised on 4 December 2020.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return

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