Pendal Property Securities Fund update

April 22, 2020

	Market peak (21/2/20) to date (%)	2020 YTD (%)	12m to date (%)
Pendal Property Securities Fund	-31.32	-23.45	-17.63
S&P/ASX 300 TR	-34.64	-27.56	-23.25
Active	+3.32	+4.11	+5.63

Source: Morningstar April 16, 2020. For the 1, 3 and 5 year performance of the Fund, please refer to the table at the end of this document.

The Real Estate Investment Trust (REIT) sector underperformed the broader index in the sell-off. This was due largely to higher levels of gearing in REITs than in other parts of the market (given the long-term nature of leases). A spike in credit spreads raised concerns over stress in funding markets. Liquidity injections and asset-purchase programs by central banks have largely calmed this fear.

Given this, we expect the performance of Commercial Real Estate and Australian REITs (AREITs) will now be more dependent on their relative earnings opportunities and risks and pricing relative to other parts of the market.

The Fund has outperformed through this episode. This was largely due to a large pre-existing underweight in retail, eg Scentre Group (SCG), Vicinity (VCX) and positions in companies with good earnings visibility such as Charter Hall Long WALE REIT (CLW) and Rural Funds Group (RFF).

The FY20 AREIT dividend yield of 6.5% is 560bp above the bond rate, well above the LT average of 200bp. However we do expect earnings and dividends to come under pressure in FY20/21 as tenant's ability to pay rent is impacted by forced and voluntary temporary closures.

Gearing levels are relatively low by historical standard at 26%, versus 45% prior to the GFC. We do not expect to see GFC-style pressure on REITs as a result of this episode. Gearing is expected to increase as asset values fall. However, we expect the majority of REITs to remain well inside loan covenant limits. We expect the greatest asset falls to be in the discretionary mall REIT sector.

Within the portfolio, we have a bias to stronger balance sheets. Gearing within the portfolio is lower than the market due to large positions in Goodman Group (GMG) which is only 9% geared, Charter Hall Group (CHC) which has no gearing and an underweight in Scentre Group (SCG) which is 34% geared.

In recent weeks we have been adding to selected niche exposures where we see policy support playing a strong role – such as in childcare REIT Arena (ARF). We have also been adding to our office and logistics exposure. We remain heavily underweight in retail. Despite an improvement in sentiment over the last week, we believe that the retail sector will face continued pressure and uncertainty as the economic and earnings reality of the shutdown measures becomes apparent.

Retail

About 43% of the AREIT index is in retail malls. This is roughly twice the proportion in the US, UK or Europe. It's why the Australian REIT market has underperformed those overseas. Malls have been particularly hard hit by social distancing rules. Many retailers that weren't forced to close by federal or State regulations did so anyway to protect the health of their staff or because incremental revenues weren't covering variable labour costs.

Some retailers have announced they will not be paying rent. The federal government has tabled a national code that proposes both retailers and landlords shoulder the burden through a combination of rental deferment and abatement (rent foregone). This has to be implemented at a State level. There is still uncertainty over how the leasing issue plays out, which is weighing on the retail sector.

The retail sector is also facing headwinds from a weak AUD and the issue of re-stocking for next season, given challenges in selling current season's stock.

We continue to be underweight the discretionary malls REITs. We do have an overweight position in Charter Hall Retail REIT (CQR). It tends to own neighbourhood-style malls, anchored on a supermarket, with a high degree of non-discretionary tenants such as pharmacies, medical practitioners, banks, etc.

Office

Office REITs have performed reasonably well through the sell-off.

Those with tenants in government, IT, accounting, finance, legal and top 100 companies head offices have benefited from the fact that these tenants can continue to work from home.

However some tenants have asked for rental abatements – so this sector won't be immune.

Smaller office tenants may also be impacted, as will the retail and parking parts of office buildings – although these are typically less than 10% of an office REIT's income.

The Sydney and Melbourne office markets entered March with very low vacancy rates, ie 3% to 4%. We do expect the vacancy rate to lift towards 7% to 8% in the near term. This is in line with the long-term average, but pricing power will definitely fall to tenants.

We have some exposure here via the Centuria Office REIT (COF) and also via diversified operators such as Mirvac (MGR) and Charter Hall (CHC).

Industrial

Industrial is likely to be the key beneficiary of this shutdown as retailers accelerate plans for online distribution.

Online operations require three times the logistics space of in-store retailers because they store additional products – and the format of automated picking in warehouses requires significantly more space.

Rent as a percentage of the cost of online fulfilment is around 5% with transport running at 50% of the cost. So for retail companies an efficient, well-located logistics property can more than pay for itself.

We have exposure to Goodman Group (GMG), among others, in this space.

Residential

Development activity for the likes of Stockland (SGP) and Mirvac (MGR) is difficult to predict.

On one hand, residential transaction activity has largely evaporated. On the other, there is the probability that large government stimulus at some point will get this sector moving again, given the multiplier effect it has on employment growth.

We are staying with our overweight position in Mirvac given its larger weighting in office (most of which they have developed themselves so are fairly new and don't require a lot of maintenance capex), lower weighting in retail and stronger balance sheet.

The table below provides the 1, 3 and 5 year performance information for the Fund:

	1 year	3 years pa	5 years pa
Pendal Property Securities Fund	-24.85	-1.52	2.37
S&P/ASX 300 A-REIT Accumulation Index	-31.33	-4.75	0.46
Excess return	6.48	3.23	1.91

Source: Pendal Property Fund, after fees and before taxes

*Inception date 16 Apr. 1993

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