Centuria

The best of three: liquidity, yield and capital growth

Can you achieve these through commercial property investing?

Contents

Jason Huljich, Joint CEO at **Centuria Capital Group** shares his thoughts on rebalancing tactics for 2022.

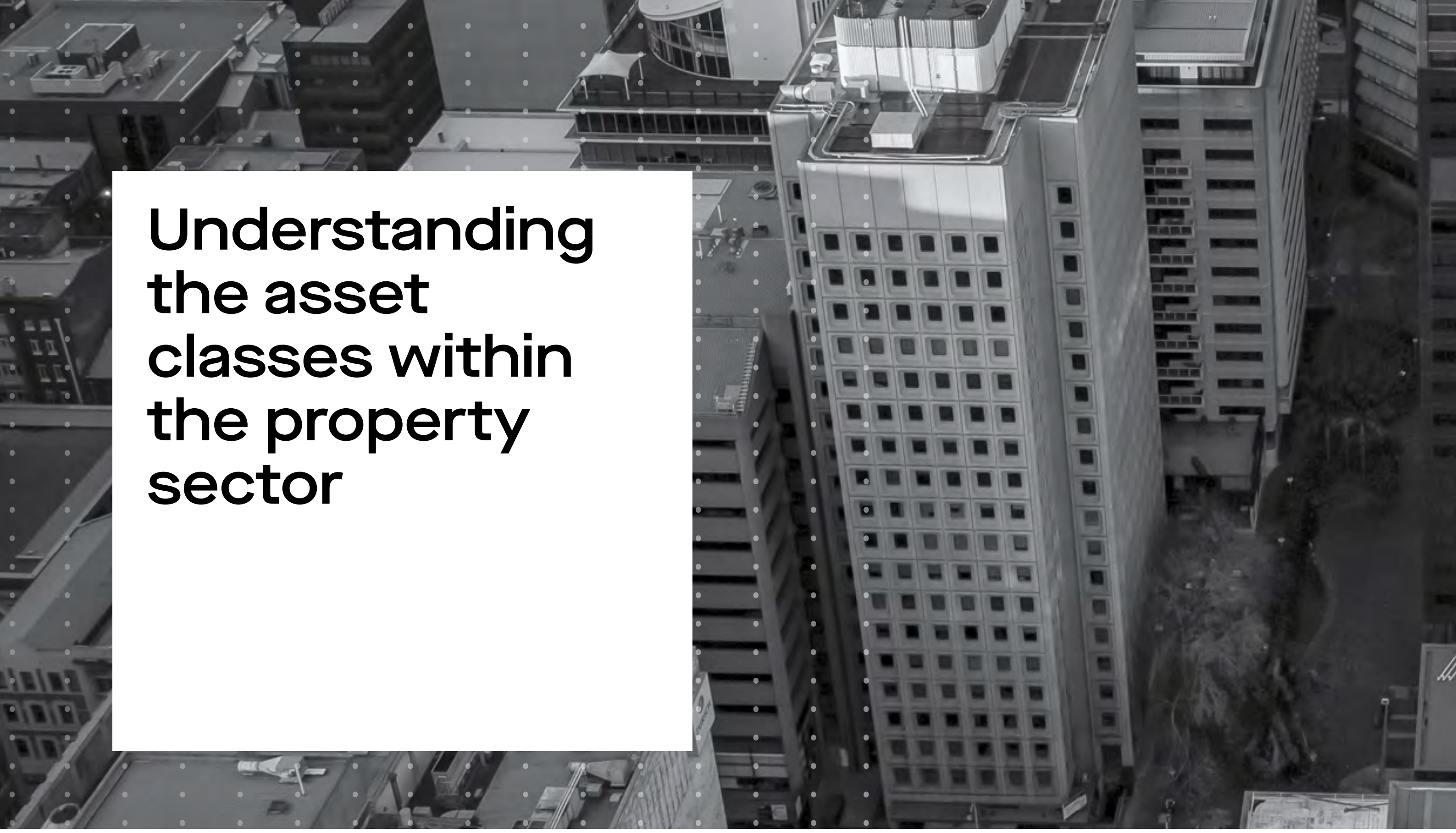
As Australia, and the world has navigated a turbulent two year period, marked by a prolonged pandemic, lock downs, border closures and significant behavioural shifts commercial real estate has continued to demonstrate its resilience and ability to deliver attractive returns to investors.

The narrative has begun to shift from "lower for longer" to "capturing growth" and managing inflation. Whilst commercial real estate has benefited from capital growth as interest rates and return expectations have lowered, the next period will highlight how investors can capture growth at the income level.

Importantly, over time, real estate has long been considered hedge against inflation. As costs of building new supply increase, rentals for existing building should also follow suit. Additionally, commercial property leases typically have annual rental escalations, often linked to CPI which allow the rental income to grow over time, supporting the value of assets.

When we are talking to advisers and investors, they indicate that their property allocations usually make up somewhere between 15-30% of their portfolios. Recently we have seen a significant increase in demand for our unlisted property funds, driven by several factors, but one clear one being the desire for regular and relatively stable income. At present SMSF investors account for up to 60-70% of Centuria's inflows into our Property investment offerings. Unlisted property funds are one of the few asset classes distributing monthly income above 5% p.a. and depending on an investor's appetite for risk, this may compare favourably to other asset classes. The benefits of unlisted property funds stretch further. They are considered less volatile compared to listed property investments, as you are less affected by day to day market sentiment, however, this should be considered against the fact that unlisted funds have lower liquidity than the listed securities. Still, there are several approaches to property investing that may help investors achieve the best of three.

Understanding the asset classes within the property sector



Office Real Estate

Office real estate remains an attractive investment opportunity –knowing your tenants and their employees' demands is key when selecting properties for your portfolio. In other words, returns, and particularly income returns from A-REITs are tied to tenant and asset quality – so understanding what tenants want, and giving it to them, is key to leasing success, and therefore, consistent income returns.

New research shows that the office space employers lease, plays a key role in employee satisfaction and retention. People are time precious in today's work environment and prioritising a work/life balance has never been more important. So reduced commute times or seamless transport connections is key. Then upon arrival to work, end of trip facilities and well thought out office plans and technology are also critical to staff efficiencies and motivation in the office.

Finally, having quality amenities close by enabling employees to complete their personal tasks more effectively helps to alleviate stress i.e. dry cleaners, day care facilities, supermarkets and dining now play a more critical role attracting long-term reliable tenants.

Industrial/Logistics Real Estate

Industrial property selection is also a sector undergoing significant change. The infrastructure investment boom, combined with the e-commerce thematic, manufacturing trends, and other developments, signals both change and good news for industrial real estate. What fund managers now look for in the 'Shed' space is rapidly changing. Reliable infrastructure is needed to connect supply chains, to move goods and services efficiently and to connect households to opportunities for employment, healthcare and education across cities and regions. Money spent on infrastructure powers industrial property.

Centuria have identified 5 key market movements that matter when selecting properties for an industrial portfolio: infrastructure, location, eCommerce, logistics and manufacturing. Find out more about the significance of these themes in our recent Industrial Investing report: How Australia's 2020 infra peak will fuel industrial property.

Office and Industrial sector specific A-REITs listed on the ASX can be great investments if you want direct exposure without being mixed into other asset classes. These two sectors both offer attractive income yields typically yielding at 4.75-7%. They can attract very high-quality tenants and, the big positive with listed REITs is the liquidity so you can gain commercial/industrial exposure, but also redeem easily and get your money back within a few days.

Healthcare Real Estate

Another sector that is increasingly growing in awareness is in the healthcare real estate arena. We think this is a big growth sector - the listed health sector, for example, is the second largest REIT sector in the United States - however there are minimal listed healthcare asset owning vehicles in Australia.

With changes in human geography, an ageing population and demographics clearly showing that people are living longer in Australia, healthcare is a sector that is, and will continue to be in demand. With consistent, non-cyclical levels of demand and attractive long term macroeconomic trends, healthcare investments can provide attractive returns for lower levels of risk.

The healthcare property sector is also expected to grow in response to increasing demand for primary and secondary healthcare services, reflecting a Federal and State Government focus on preventative care as they seek to implement strategies aimed at reducing the overall costs of the healthcare system.

We are seeing very high-quality operators in this space, so when you do purchase healthcare real estate, you are getting strong operators and usually longer-term leases. Because they are investing so much into their tenancy, they want the longer lease, so it bodes well for an unlisted investment that can generate regular income as well as the potential for enhanced capital growth.

Retail Real Estate

Retail properties are spaces that are used to sell or market consumer goods and services. They include single shops through to large shopping centres or malls. It is important to find assets with key anchor tenants and local and national specialty stores.

Centuria Australian* retail property portfolio comprises a mixture of neighbourhood shopping centres, regional centres and large format retail assets with local and national tenants in metropolitan and regional areas. These trusts are offered to our wholesale clients.

*Through wholly owned subsidiary Primewest.

How to invest in property

Direct property investments

Unlisted closed-ended property funds

Unlisted open-ended property funds

Listed property funds

Direct property investments

The benefits and pitfalls of investing directly in property through your SMSF

Benefits

- 100% of the SMSF money can be invested in commercial real estate which can minimise your business' overheads and maximise cashflow long term
- A member can borrow money to purchase commercial property through an SMSF, but the purchased property will only be available to the SMSF fund
- Tax on rental income is only 15%, and capital gains tax just 10%, if the property is kept for more than a year, so there are some distinct tax advantages to using your SMSF to purchase your business premises
- Your business can rent the commercial property you invest in through your SMSF
- Your business can then pay rent to your SMSF, not a landlord.

Pitfalls

- High cost of entry to buy quality asset. As a high proportion of super monies would need to be used to invest, this limits the potential for diversification of your SMSF
- High initial investment requirements via deposit
- Need an exit plan in place for the property for when you retire so you don't end up with a liquidity crisis (unless it is paying enough rent to fund an income stream)
- You need to have done your research to buy in a location that will be able to be rented throughout the lifecycle, and has the potential for capital gains, i.e. you need to become an expert in the commercial property market
- Tax losses from the property cannot be offset against your personal income tax
- You need to appoint a property manager and will pay fees for this service and trust that they will be reputable and do the right thing by the owner.

Unlisted closed-ended property funds

Let's look at the unlisted fixed term funds first. Investors like to invest in these because they can choose the actual asset they are investing in; it's not a portfolio that keeps growing so they know exactly what they have got; they can do their own due diligence on the tenants and the building; and so forth. A lot of these investors choose to gain diversification by investing in a number of these single asset unlisted funds. The distributions are paid monthly so the fund is generating an attractive regular distribution. Commercial leases usually have   term of three to ten years and depending on the property or tenancy profile, and tenants may include government, ASX listed or blue chip companies. Hence some investors say they like the diversification of property as well as the stability of income.

High net worth (HNW) investors do sometimes look to buy a small property themselves, but some can find it difficult as it's a very competitive space, especially in that $2-5 million price range. Whereby with single asset unlisted property funds, all investor types can enjoy exposure to high quality institutional grade commercial property ($100m - $200m), with high quality tenants through a smaller minimum investment entry point (generally around $50,000). So, what investors seem to like is that they can get blue chip tenants, institutional grade property and it's a lot easier to invest than trying to find their own smaller investment property.

Some investors wrongly compare these funds to residential property investments, but the benefits compared to residential include: longer lease terms (sitting at between 3-15 years as opposed to six months to one year); and reduced overhead costs (unlike a residential tenant, the commercial tenants pay for all the repairs, maintenance, property management fees and rates in the building); and of course net distribution returns that will often compare favourably (after factoring in gearing).

How to invest in property

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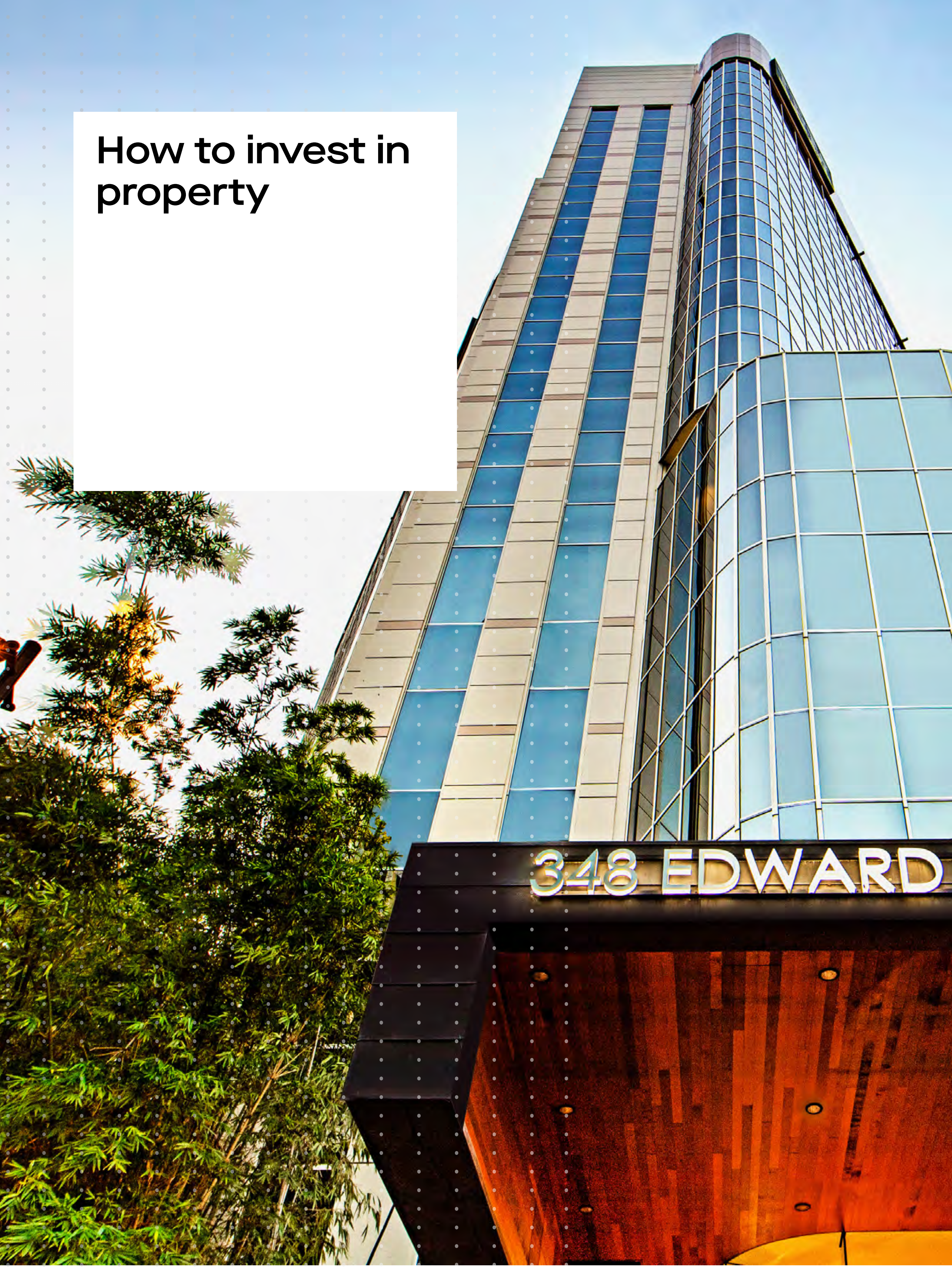


Unlisted open-ended property funds

Another way to access the property sector is through unlisted but open-ended investment vehicles. We have a couple of these types of property funds. They have the benefits of unlisted investments, combined with some of the benefits of listed funds. They hold a portfolio of properties, are always open, have daily unit pricing and limited quarterly redemption features, giving investors some limited liquidity if they do wish to get out of the investment, which for some is an attractive option. Because we typically hold 10% in liquid products to allow for the redemptions, they will return slightly lower yields (5-6%) compared to a closed ended 5-year unlisted asset, but still offer attractive returns.

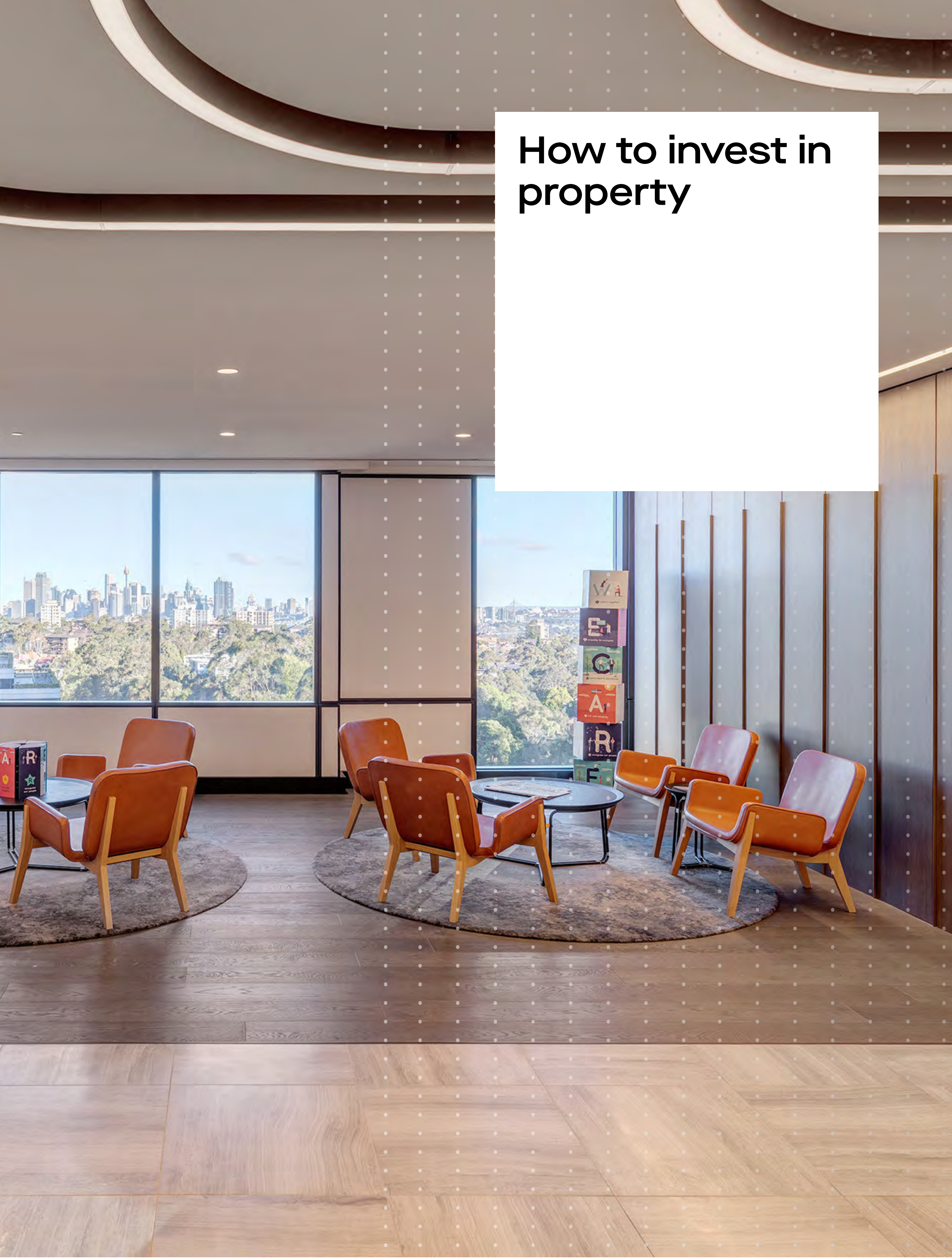
Listed property funds

Put simply, Australian Real Estate Investment Trusts (A-REITs) pool the resources of investors together to buy a range of property assets, which the trust then manages for a profit. They generate most of their income through rent, with the lion's share then returned to investors via distributions.

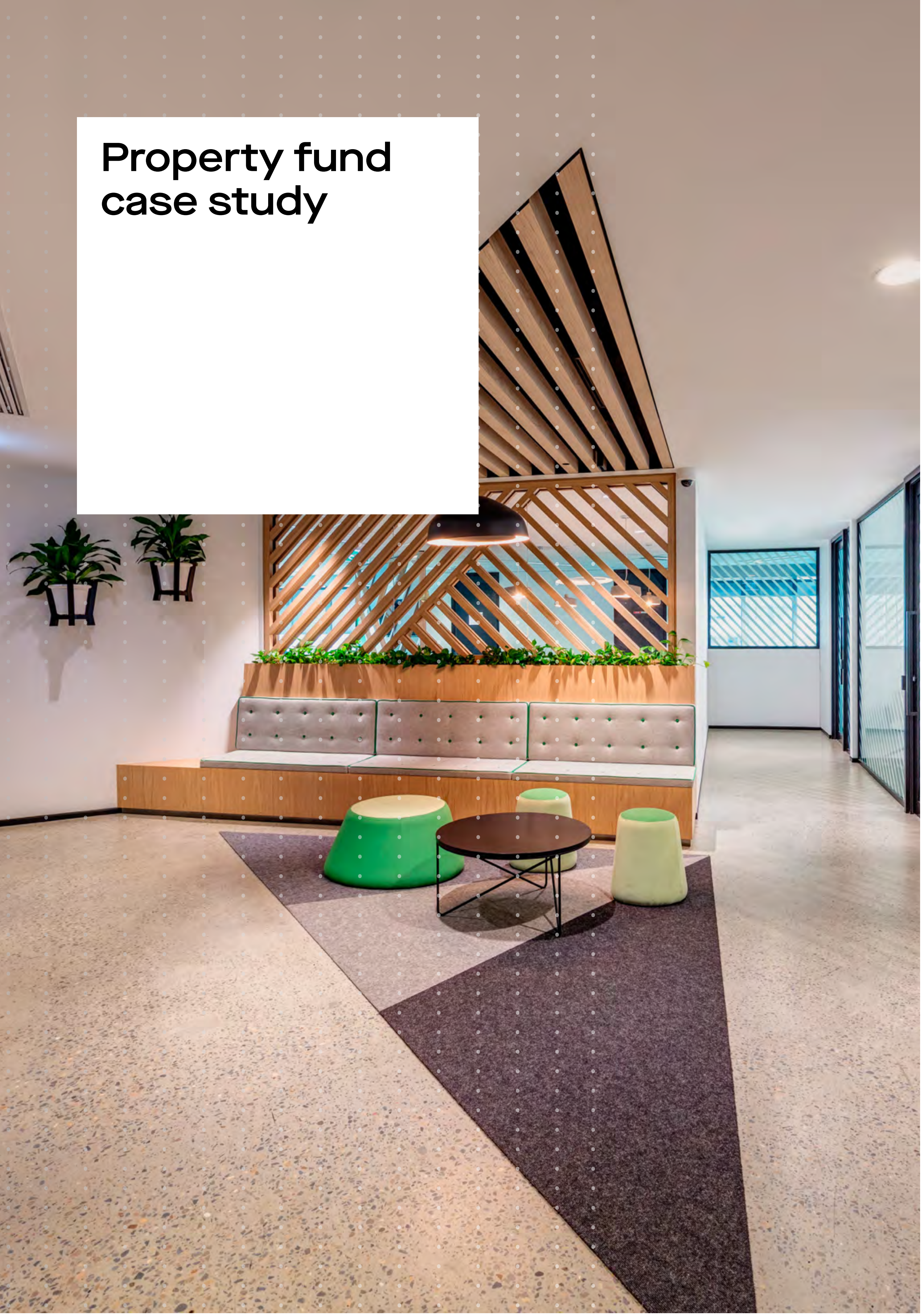
Centuria have two ASX listed sector specific A-REITs: an office A-REIT (ASX:COF), with 23 high-quality office assets located around the country and an industrial A-REIT (ASX:CIP), with 80 industrial/logistics buildings throughout the country. The benefits of these are that because they are sector specific A-REITs an investor can choose the sector they want exposure to.

Investors prioritising liquidity above yield in their 'best of three' approach, tend to be drawn to the listed property investments. Both industrial and office property, A-REITs in particular have seen significant changes across Australia over the years. Consumer behaviour, economic trends and changing expectations and priorities in people's lives and work are really altering how fund managers select the right properties as part of their REIT portfolios.

How to invest in property



Property fund case study



The Zenith
821 Pacific Highway Chatswood NSW

One of Centuria's very successful funds was the Centuria Zenith Fund. This example sets out the factors contributing to the return in that fund.

Centuria purchased the property for $279m in May 2016, investors received an average income return of 7.7% p.a. over the three year term of the Fund as well as a substantial capital gain. During the holding period, Centuria successfully executed a number of key investment strategies including completing over 40,000 sqm of leasing transactions, increasing the property's Weighted Average Lease Expiry (WALE) from 2.5 years to 4.3 years, installing state of the art end of trip facilities, refurbishing the foyer, completing a large number of fitted out office suites and achieving office rents approximately 40% above the average net market rent at the commencement of the Fund.

This property was sold in June 2019 for $438m.

May 2016

Price
$279.1m

WALE
2.7 years

Occupancy
94%

Market rent
$490/m2 (average)

June 2019

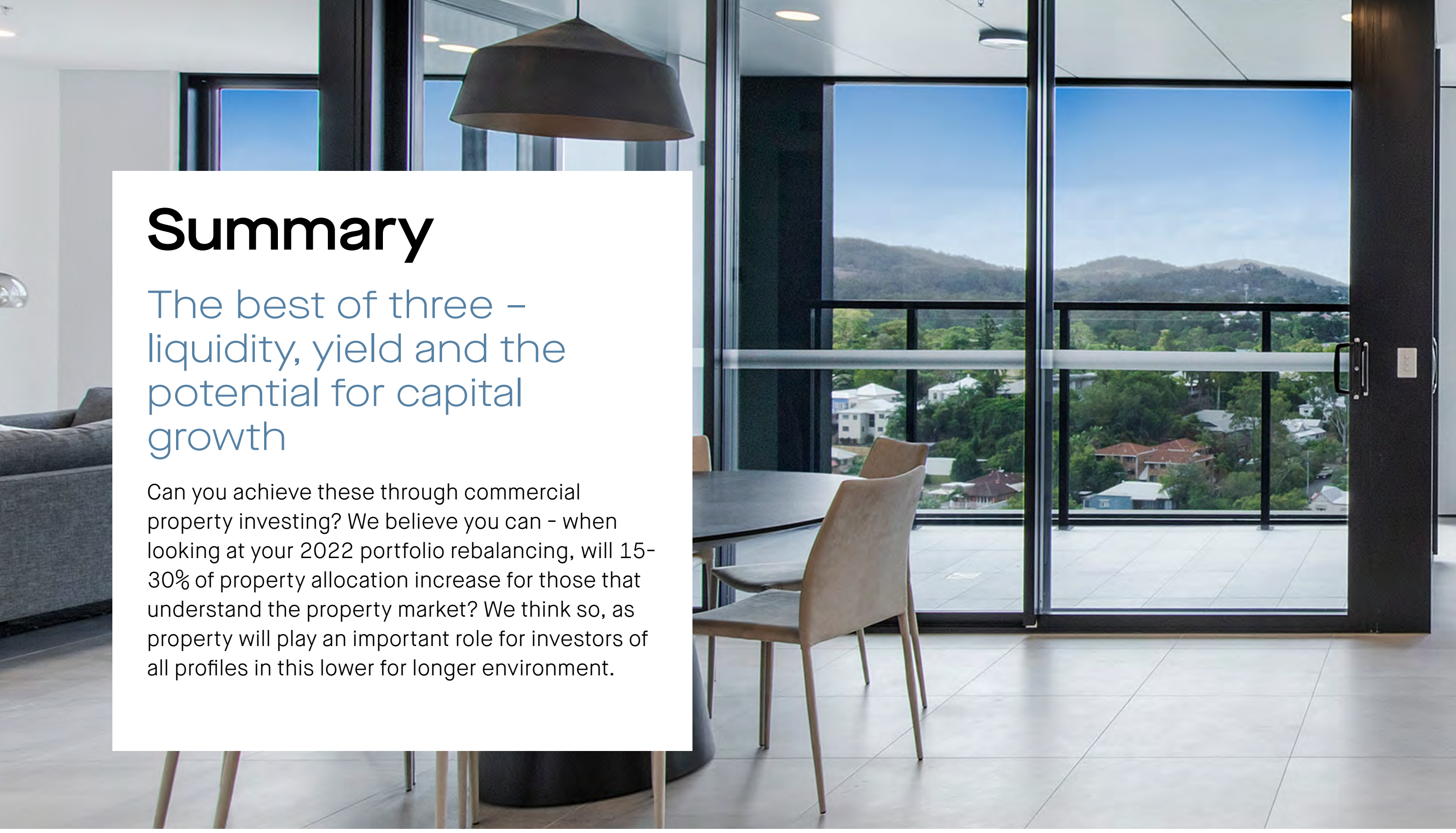
Price
$438.2m

WALE
4.3 years

Occupancy
100%

Market rent
$685/m2 (most recent)

It is important to note that this is a single example of what can be achieved by the active management of a property and is not representative of what can be achieved in other funds or properties. It is important that you assess each fund manager and each property fund individually before making a decision to invest.



Summary

The best of three – liquidity, yield and the potential for capital growth

Can you achieve these through commercial property investing? We believe you can - when looking at your 2022 portfolio rebalancing, will 15-30% of property allocation increase for those that understand the property market? We think so, as property will play an important role for investors of all profiles in this lower for longer environment.

The benefits of accessing the property market via different investment types

INVESTMENT TYPE	LIQUIDITY	DISTRIBUTIONS	CAPITAL GROWTH POTENTIAL	TERM	ENTRY POINT
Direct property investments	Dependent on sale of property	Rental dependent	Variable and dependent	--	High
Unlisted closed-ended property funds	Term of Fund	Monthly	Highest	Minimum 5 years	Minimum $50k
Unlisted open-ended property funds	Quarterly (limited)	Monthly	Mid	Less flexible	Minimum $10k
Listed property funds	Daily	Quarterly	Mid	Flexible	Lowest - ASX

Know your risks

As with any investment, there are risks to investing - and these should be understood. Some factors to consider when investing in listed and unlisted property funds include, but are not limited to, stock market volatility, the liquidity of the fund, the gearing of the properties in the fund and understanding the individual properties held by the fund and their characteristics (e.g. tenant demand, property valuation metrics, cash flow sustainability etc).

It's important that you have a manager who has experience managing and mitigating these risks where possible. A critical part of the success of property investment is the quality of the ongoing management of tenants and the physical aspects of the property, both of which we consider to be strengths within our business. In addition, capital gain potential is maximised by ensuring the most efficient use of space, conducting services upgrades, building refurbishment and assessing potential re-development. The majority of our portfolio is managed by our in-house property division. Our team is comprised of experienced property professionals with backgrounds in leasing, agency and valuation. Any property managed externally is managed by hand-picked experts in their locations and asset types.

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FURTHER INFORMATION

For further information on Centuria's property offerings and to aid your clients in their property investing decisions visit **centuria.com.au** or speak to a member of our property team on **02 8923 8923.**