NEW ZEALAND EQUITY RESEARCH
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Real Estate Reflections: The 183rd Ed
Asset Backed

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After a stellar 10 year period, the Listed Property Vehicles (LPVs) haven't been immune to the outbreak of COVID-19, with the sector down ~-22% and broadly similar to the wider market. In this note we look at sector gearing and provide an update on our preferred LPVs, some thoughts on how investors should be positioned as uncertainty persists, and a reminder of what happened during the global financial crisis (GFC) and how things may be 'different this cycle'.

Eyes on upcoming valuations, and hence gearing and also dividend guidance

During the GFC we had a larger amount of office relative to what we have today. Office has historically been the most volatile in a recession, however, retail may face the toughest test this time. The NZ LPV sector was one of the best performing LPV sectors worldwide through the GFC period, although there was still a large pull back in share prices and asset values, but only two raised equity. During the GFC the broader NZ equity market had widespread discounted equity issuance and the cutting of dividends and this is happening again. Property is not immune this time given the uncertainties with retail assets the most at risk in terms of what asset values will do and the near-term dividend guidance. Boards will probably wait and get a steer from valuers, with a number of LPVs having 31 March valuations due including the larger retail owners KPG, APL, SPG and to a lesser extent ARG.

Investment rating changes

Going into this correction we had an OUTPERFORM on IPL given its defensive qualities and we recently pulled back VHP from OUTPERFORM to NEUTRAL following its share price rise. We had an OUTPERFORM on KPG based on relative valuation versus large caps GMT and PCT. We had an UNDERPERFORM on GMT given its substantial re-rating and sector premium. Over recent weeks IPL, PCT and GMT have outperformed the wider equity market, and VHP and PFI have been broadly in line. Share price falls are overdone in our view and we like listed property with its strong asset backing of cash flow generating property, but considerable uncertainty remains. **We have upgraded VHP and PFI to OUTPERFORM, GMT to NEUTRAL and downgraded KPG and APL to UNDERPERFORM.**

Note that our valuations and earnings have not changed and are under review.

Figure 1. NZ listed property sector summary

LPV	Code	Rating	Price 25-Mar	Target price	Gross yield	AFFO yield	P/NTA
Asset Plus	APL	UNDERPERFORM	$0.41	$0.65	12.5%	7.7%	58%
Argosy Property	ARG	NEUTRAL	$0.85	$1.38	10.5%	7.3%	66%
Augusta Capital	AUG	NEUTRAL	$1.20	$1.38	7.5%	5.9%	162%
Goodman Property	GMT	NEUTRAL	$2.07	$1.92	4.6%	3.0%	120%
Investore	IPL	OUTPERFORM	$1.44	$1.85	7.6%	5.2%	85%
Kiwi Property Group	KPG	NEUTRAL	$0.85	$1.62	12.1%	7.7%	60%
Precinct Properties	PCT	NEUTRAL	$1.50	$1.52	6.0%	4.0%	102%
Property for Industry	PFI	OUTPERFORM	$1.87	$2.15	5.9%	4.1%	94%
Stride Property	SPG	NEUTRAL	$1.33	$2.18	10.6%	7.1%	68%
Vital Healthcare	VHP	OUTPERFORM	$2.21	$2.76	5.8%	4.0%	95%
Core simple average					**7.9%**	**5.3%**	**86%**

1: Core average excludes APL and AUG. Source: Forsyth Barr analysis, Company Reports

Asset Backed

The early LPVs

We do not have much in terms of past cycles or history to work with given the first NZ LPVs in their current relatively conservative structure only got going around 1993 with KPG and PFI two of the first. The LPVs from 1987 all failed and were not structured like what we have today. In the mid 1990s we had a recession (Asian Financial Crisis) which, while short, did hold back a property market that was still recovering from the 1987–92 period. The listed sector had a lot of office exposure, which was impacted by the recession.

The GFC period and the NZ recession

During the GFC, we had a larger amount of office relative to what we have today. Office has historically been the most volatile in a recession/downturn given the impact of firms downsizing and also supply and demand issues, with new supply often hitting the market at the worst time. Retail may face the toughest test this time.

The NZ LPV sector was one of the best performing LPV sectors worldwide through the GFC period, although there was still a large pull back in share prices and asset values. The work we did at the time indicated VHP was one of the best performing REITs globally. What helped our market then (and should again) was the vanilla or traditional nature of our LPV market, being rent collectors and paying out good dividends. While our gearing was full, it was not as stretched as other markets. Also our LPVs did not have large funds management businesses that were priced with a growth multiple, or were large developers, or had construction businesses or residential operations like many of the global peers.

COVID-19 and today

The themes mentioned above should help us again this time around, although there has been nowhere to hide to date. During the GFC the broader NZ equity market (not listed property) had widespread discounted equity issuance and the cutting of dividends as companies looked to strengthen balance sheets in a very uncertain world in terms of the availability of credit and the speed of business recovery. This will happen again given the uncertainties at hand, and given that boards are more risk averse now with the tightening in corporate governance post the GFC.

The risks of a prolonged recession increases the risk of another credit crunch or rationing, especially if politically the banks are looking to provide residential mortgage relief/interest holidays and the sheer number of businesses looking to recapitalise. In terms of the LPVs during the GFC period, only PCT (under its former structure and management) had a large, deeply discounted, equity issue while KPG had a small issue. All others carried through without new equity being raised and while dividend pay-out levels were cut, they were coming off an unsustainable level.

Segment Update

Office — historically very volatile through cycle

The office market is less significant in the sector now than 10 years ago. We only have PCT with close to 100% office, plus KPG, APL, ARG and SPG have less office exposure ranging from around 15%–45% office in portfolios. WALTs are longer than last cycle and there is structured rents. New major supply has looked manageable and there is little vacant stock which is very helpful, but this dynamic can swing relatively quickly with corporate downsizing. While corporates may still be in business and hence paying rent, many may need less space and this then creates a discounted sub-leasing market (and artificially low official vacancy levels) which ultimately feeds its way into lower market rents and lower asset values. Forced selling could be an issue from private or offshore markets if balance sheets are stretched which puts pressure on cap rates. Listed office occupancy dropped to the low 90% level last cycle.

Other dynamics at play this time include the working from home dynamic and how firms will think about office space going forward and some leases that deal with tenants not able to access space. These lease clauses were designed to deal with a protracted period of entry to a building following a major earthquake so it could depend on how long this crisis lasts.

Industrial well positioned

Good, well located, industrial property has proven to be fairly resilient through the cycle, typically with a lower level of vacancy than office, but it has had a massive re-rating in terms of asset values this cycle. The industrial space in the NZ LPV market is GMT at 100% (although that includes some office space in industrial parks), PFI ~90%, ARG ~50% and SPG ~30%. Most are typically Auckland based and/or good quality. Its smaller average asset size means it is popular with private investors and this should continue to be the case depending on private balance sheets. Small asset size also makes it helpful for divesting assets to reduce debt in a slower market, although is not helpful for cap rates. Quality listed industrial occupancy only dropped to around the ~95% level last cycle.

Retail in the eye of the storm

Listed retail space is mostly KPG, although its last stated position was only 20% pure retail with the balance comprising its new classification of mixed use for its three major shopping centres and its office assets. IPL is 100% (all large format and mostly supermarkets) and others are APL 50%+ retail, SPG ~40%, and ARG ~10% with most including large format retail. Large format should be relatively resilient given the typically large corporate nature of the tenants. Shopping centres with specialty tenants are more problematic, but these tend to be fairly dominant centres in most cases in the listed market which will hold up better. The near-term risks are rent relief to keep tenants going for when centres fully re-open, rental levels and occupancy over the next 12 months and what valuers say near-term.

Gearing insights and near term dividend risk

While dividend pay-out levels are lower than pre-GFC and are close to AFFO (essentially operating cash flow less an allowance for maintenance capex) in most cases, the unprecedented level of potential economic disruption and uncertainty, and arguably more risk-averse boards, means some LPVs could cancel near-term dividends and look to raise equity.

This is despite:

- Having slightly better balance sheets (~31% geared on average) than going into the GFC — but with reasonable tenor for most and the widespread use of corporate bonds, so less reliance on the banks.
- Longer WALTs and well managed near-term lease expiry.
- Significantly more structured rental contracts which will help offset the near-to-medium term risk of market rental declines.
- Vacancy levels at record lows for major office and industrial assets going into this correction and high occupancy in major retail assets.

- The sector will also benefit near term from lower floating interest rates and recent changes allowing depreciation on building structures.

Figure 2 highlights sector gearing levels which average ~30%, well below the typical maximum of 50%. As detailed in Figure 3, most LPVs need asset values to decline around 30%–40% to threaten covenants. PCT is closer to 50% and GMT above 60%.

There is uncertainty as to how valuers will react in the near term. There is a lag at times based on the time taken for market rents to adjust down and for market evidence on sales to come through. For large assets there may be no evidence for a while. Certainly, valuers will be building in more cautious assumptions around occupancy levels, releasing time frames etc, pulling back market rents and rental growth assumptions.

Last cycle valuers in the UK were very quick to move and tended historically to be evidence setters themselves rather than more reactionary like our valuers were. This time our valuers may be different and the major valuation firms have yet to sign off on 31 March valuations. Most LPVs are March year end and by now we would typically be getting valuation information from them; we haven't yet.

We have 31 March valuations due for APL, ARG, GMT, IPL, KPG, and SPG with retail valuation risk in particular for KPG, APL and SPG. Then the next valuations will be 30 June 2020, being 1H20 for PFI, and FY20 for PCT and VHP.

Figure 2. Balance Sheet summary

	As at	Reported gearing	Target gearing	Bank covenant	Bank facilities (NZ$m)	Issued Bonds (NZ$m)	Facility capacity (NZ$m)	Term - bank (years)	Term - bonds (years)	Term - weighted (years)
APL	Mar-20	30.2%	35-40%	50%	75	-	27	2.2	-	2.2
ARG	Sep-19	36.2%	30-40%	50%	535	200	85	2.7	6.3	3.7
GMT	Sep-19	17.9%	25-35%	50%	400	556	400	2.6	4.6	3.8
IPL	Sep-19	40.6%	<48%	65%	270	100	65	1.5	4.1	2.2
KPG	Sep-19	27.4%	25-35%	45%	825	475	303	3.5	3.7	3.6
PCT	Dec-19	25.4%	<37.5%	50%	610	586	322	3.3	5.1	4.2
PFI	Dec-19	28.2%	<40%	50%	300	200	84	3.1	5.1	3.9
SPG	Sep-19	34.4%	38-42%	50%	400	-	67	1.8	-	1.8
VHP	Dec-19	35.1%	na	50%	870	-	225	2.0	-	2.0
Average/total		**30.6%**		**51.1%**	**4,285**	**2,117**	**1,479**	**2.5**	**3.2**	**3.0**

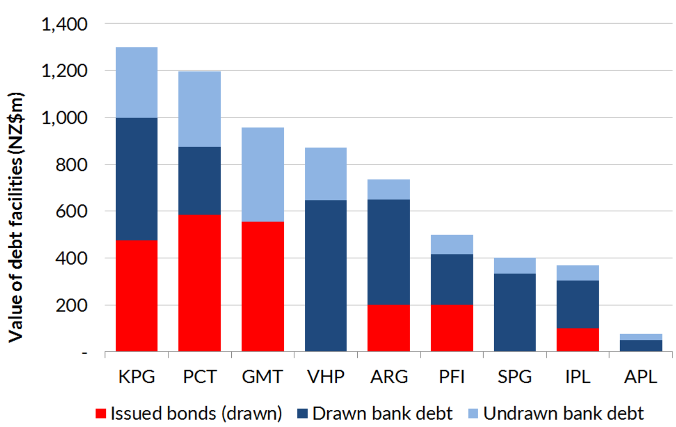
Source: Forsyth Barr analysis, company reports

Figure 3. Hypothetical asset value declines required to breach banking covenant

	Reported Gearing	Bank Covenant	Approx Debt Drawn	Approx Asset Value	Minimum Asset Value	Asset Value Decline
APL	30.2%	50%	50.0	160.0	100.0	-40%
ARG	36.2%	50%	650.0	1,790.0	1,300.0	-28%
GMT	17.9%	50%	530.0	2,960.0	1,060.0	-64%
IPL	40.6%	65%	300.0	750.0	470.0	-38%
KPG	27.4%	45%	930.0	3,400.0	2,070.0	-39%
PCT	25.4%	50%	870.0	3,440.0	1,750.0	-49%
PFI	28.2%	50%	430.0	1,520.0	860.0	-44%
SPG	34.4%	50%	300.0	880.0	610.0	-31%
VHP	35.1%	50%	680.0	1,940.0	1,360.0	-30%

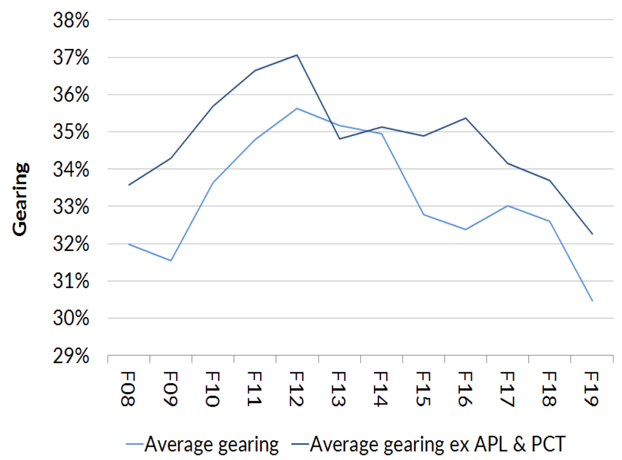
Source: Forsyth Barr analysis, Company reports

Figure 4. Summary of debt facilities



Source: Forsyth Barr analysis, Company Reports

Figure 5. Sector gearing



Source: Forsyth Barr analysis, Company Reports

Changes to investment ratings

We make the following rating changes:

- We upgrade Vital Healthcare Property to OUTPERFORM (from NEUTRAL)
- We upgrade Property for Industry to OUTPERFORM (from NEUTRAL)
- We upgrade Goodman Property to NEUTRAL (from UNDERPERFORM)
- We downgrade Kiwi Property Group to NEUTRAL (from OUTPERFORM)
- We downgrade Asset Plus to UNDERPERFORM (from NEUTRAL)

Rating Changes

Vital Healthcare Property — OUTPERFORM (from NEUTRAL)

Defensive portfolio characteristics and well managed on the ground in NZ and Australia. Relatively fully geared but this is offset by its portfolio qualities of strong tenants, low lease expiry profile, structured rental growth and resilience to the economic cycle. Has a relatively low dividend payout ratio that is helpful. Sentiment towards manager NorthWest remains a risk factor and brownfield development activity will stall.

Property For Industry — OUTPERFORM (from NEUTRAL)

Strong track record and well managed. Smaller asset size helps with managing liquidity if needed and a defensive asset class, being essentially prime and secondary Auckland industrial assets.

Goodman Property — NEUTRAL (from UNDERPERFORM)

Has continued to outperform and continues to trade at a large premium to the sector. However, it has a strong portfolio for the times with prime industrial assets and is well managed, and well placed with lowest gearing in the sector. GMT can continue to leverage the global strength of its manager. It has done a good job divesting leasehold office in particular.

Kiwi Property Group — NEUTRAL (from OUTPERFORM)

Having lower than sector average gearing is helpful with its capital raise late in the cycle. However, it will be difficult to divest any of its assets and the retail sector has arguably the most asset value downside in the near term. KPG has 31 March valuations due. We remain confident of the longer term positioning of the large mixed use assets and its key office assets but see downside for its other pure retail assets. While KPG has been significantly re-rated downwards by the market, the near term news flow will remain problematic and there are large uncertainties for the retail/consumer outlook, the impact on specialty rents in particular, and any rent relief to retain tenants. KPG also has one of the highest dividend payout rates in the sector.

Asset Plus — UNDERPERFORM (from NEUTRAL)

The current environment makes APL's growth strategies and efforts to diversify and expand its asset base problematic. Eastgate Shopping Centre remains a key concern, and while may be priced in given APL's discount to NTA, the outlook is challenging relative to the broader sector. APL also has a relatively high dividend payout ratio.

Unchanged ratings

Investore Property — OUTPERFORM

Essentially 100% large format retail and mostly supermarkets. It has broadened its mandate lately but is yet to fully execute that. It should remain relatively resilient. Highest geared in the sector at ~40%, but has a 65% covenant, long WALT and structured rents. Reducing tenant concentration remains a key medium to longer term objectives.

Argosy Property — NEUTRAL

Has done a good job divesting retail and other non-core assets through the last cycle. Retail is now under 10% and is mostly large format. Its appeal remains its large industrial portfolio. It is one of the higher geared at ~38% (around top of target gearing but well below 50% covenant) but has a small average asset size which is helpful for balance sheet management. We recently added this to the institutional model portfolio as per the report dated 18 March 2020.

Precinct Properties — NEUTRAL

Much better portfolio and lease structures than at the end of the last cycle. It will need to dial back some development activity where it can, which will most likely be Wynyard given its ability to stage that project. Its imminent opening of Commercial Bay Retail will be a more subdued affair but longer term it will still be a very strong asset given its location and retail remains a small part of the business. The balance sheet is solid but again the office market can be volatile in terms of asset values through the cycle. It has very well located assets which will support occupancy levels through the cycle, but market rent levels are a risk as is the impact of sub-leasing over time. Again, some help from a starting point of very low vacancy in the sector.

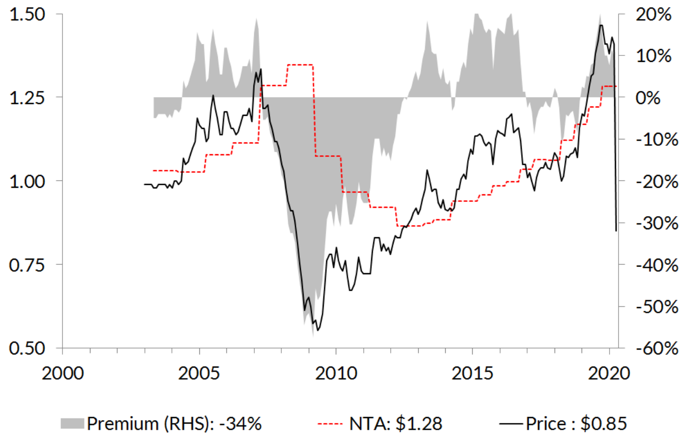
Stride Property — NEUTRAL

A diversified fund but has a reasonably high weighting to retail at ~40% and has above average gearing at ~35%. Probably back to basics in the near-term with its funds management growth strategy harder to execute.

Note that our valuations and earnings have not changed and are under review.

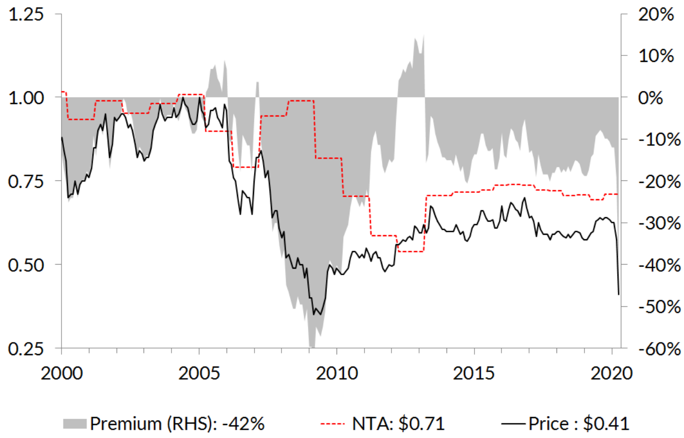
Long run P/NTA

Figure 6. Argosy



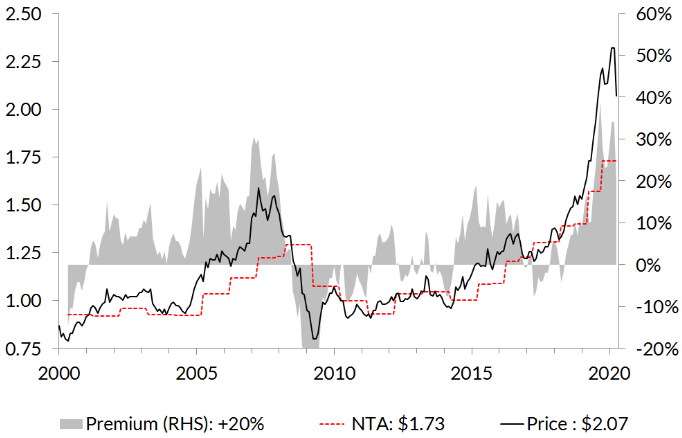
Source: Forsyth Barr analysis

Figure 7. Asset Plus



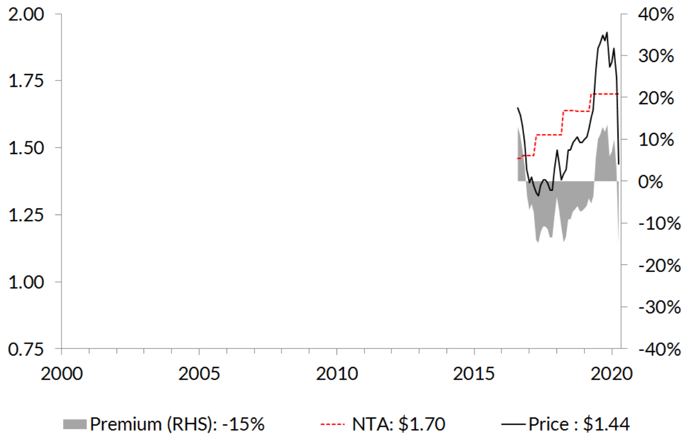
Source: Forsyth Barr analysis

Figure 8. Goodman Property



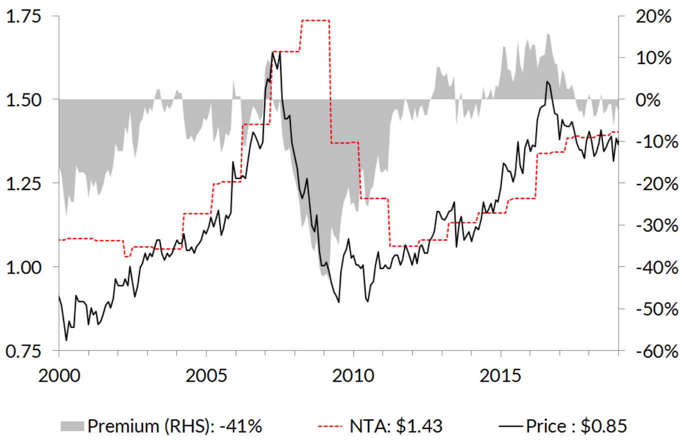
Source: Forsyth Barr analysis

Figure 9. Investore Property



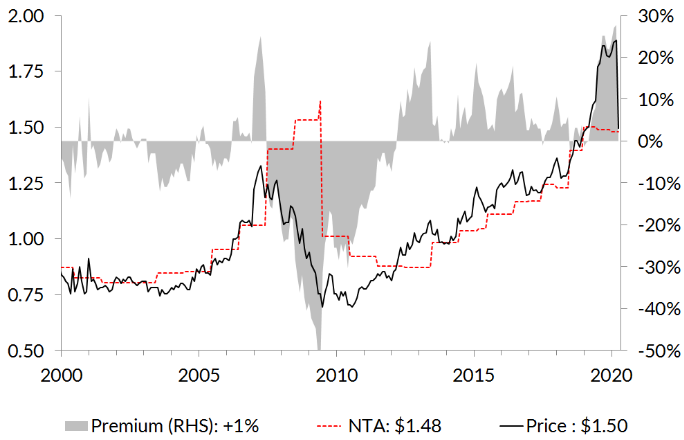
Source: Forsyth Barr analysis

Figure 10. Kiwi Property Group



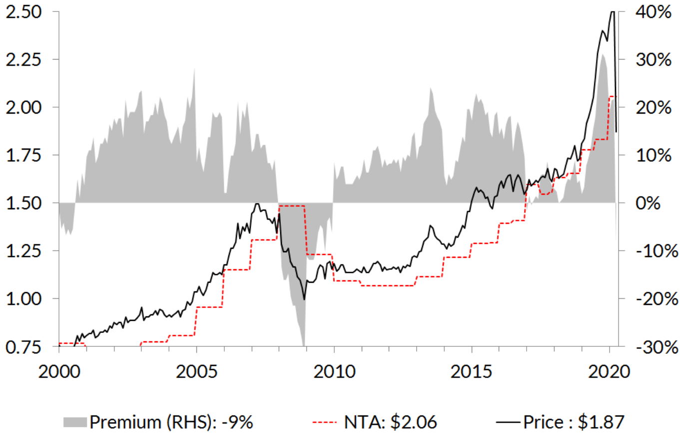
Source: Forsyth Barr analysis

Figure 11. Precinct Properties



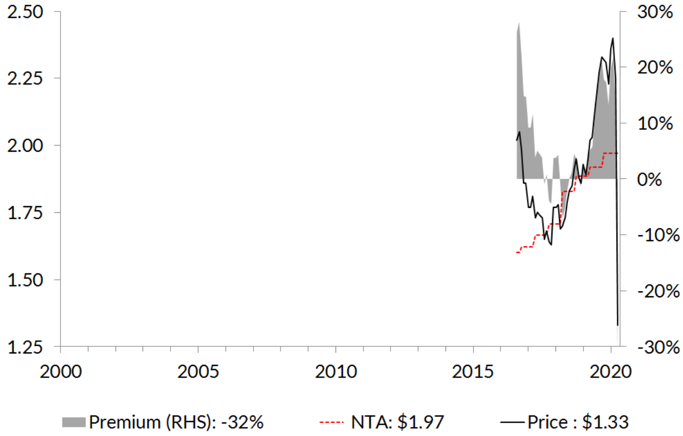
Source: Forsyth Barr analysis

Figure 12. Property for Industry



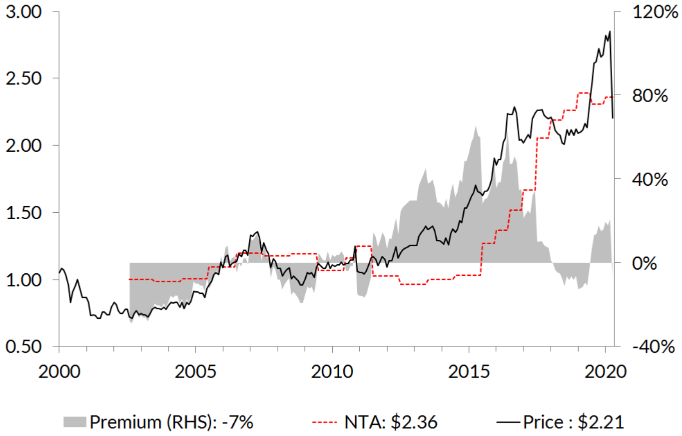
Source: Forsyth Barr analysis

Figure 13. Stride Property



Source: Forsyth Barr analysis

Figure 14. Vital Healthcare



Source: Forsyth Barr analysis

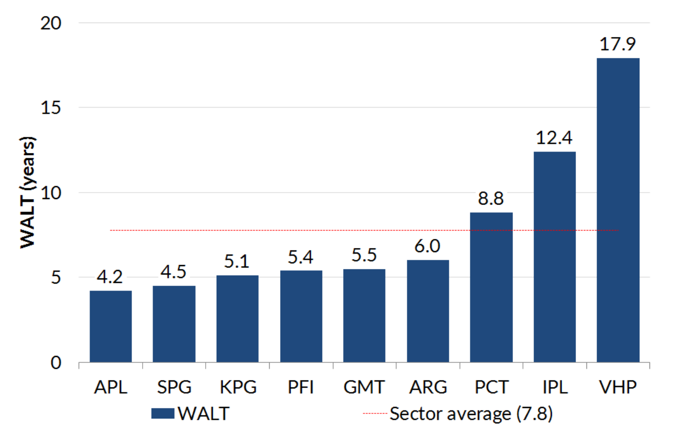
Portfolio Summary

Figure 15. Portfolio metrics summary

Company	Value (NZ$m)	NLA (000sqm)	No. assets	No. tenants	Market cap rate (%)	Contract / passing yield (%)	Average asset size (NZ$m)	WALT (years)	Occupancy (%)	Vacancy	FY1 expiry	FY2 expiry	Vacancy + FY1-FY2 expiry
APL	182	96	4	48	6.77%	6.77%	45	4.2	97.2%	2.8%	8.0%	7.0%	17.8%
ARG	1,690	558	59	nd	6.13%	6.13%	29	6.0	97.6%	2.4%	5.2%	9.7%	17.3%
GMT	2,878	1,040	10	171	5.30%	5.30%	288	5.5	99.5%	0.5%	2.0%	11.0%	13.5%
IPL	751	208	40	78	6.24%	nd	19	12.4	99.7%	0.3%	2.1%	2.1%	4.5%
KPG	3,111	440	12	892	5.99%	nd	259	5.1	99.4%	0.6%	9.0%	9.0%	18.6%
PCT	2,794	232	14	nd	5.70%	6.20%	200	9.0	99.0%	1.0%	7.0%	4.0%	12.0%
PFI	1,445	647	93	147	6.10%	6.09%	16	5.7	99.7%	0.3%	2.0%	12.7%	15.0%
SPG	999	254	26	391	5.76%	6.43%	38	4.5	98.2%	1.8%	3.8%	13.4%	19.0%
VHP	1,930	nd	42	nd	5.61%	nd	46	17.9	99.9%	0.1%	3.9%	3.8%	7.8%
Total	**15,779**	**3,476**	**300**	**1,727**									
Average	**1,753**	**434**	**33**	**288**	**5.96%**	**6.15%**	**104**	**7.8**	**98.9%**	**1.1%**	**4.8%**	**8.1%**	**13.9%**

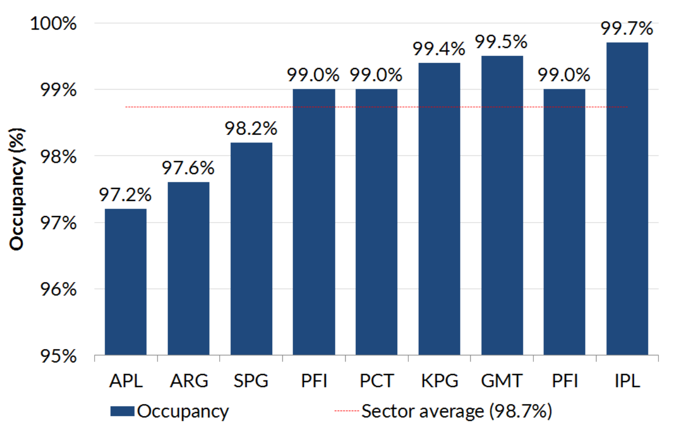
Source: Forsyth Barr analysis, Company Reports

Figure 16. Sector WALT (weighted average lease term)



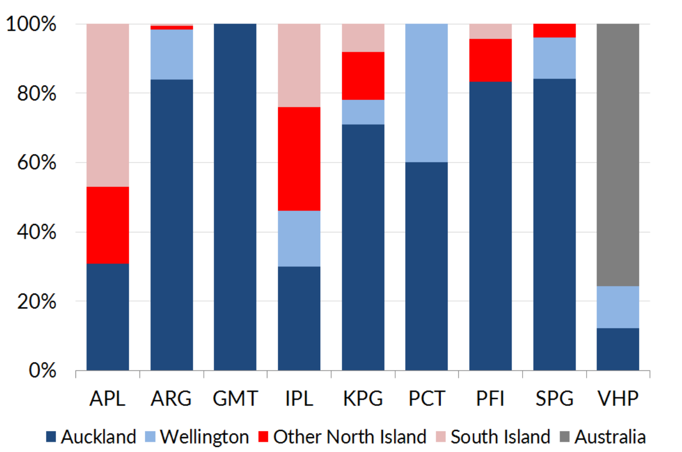
Source: Forsyth Barr analysis, Company Reports

Figure 17. Sector occupancy



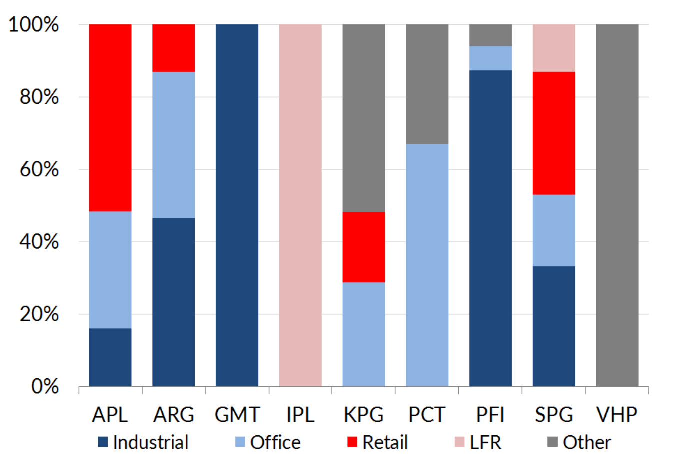
Source: Forsyth Barr analysis, Company Reports

Figure 18. Geographical diversification



Source: Forsyth Barr analysis, Company Reports

Figure 19. Sector diversification



Source: Forsyth Barr analysis, Company Reports

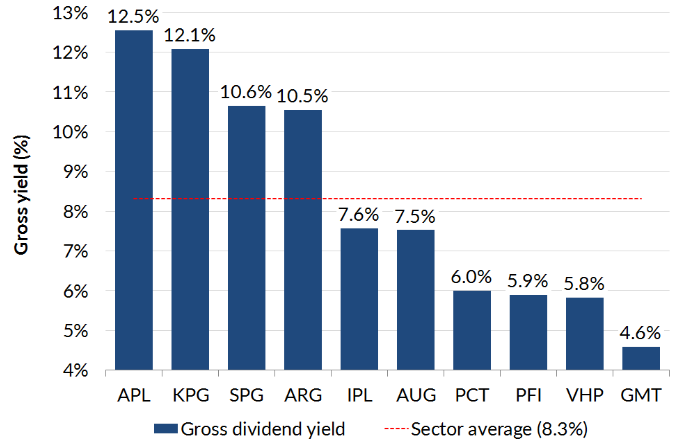
Relative value summary

Figure 20. Relative valuation metrics — 25 March 2020

Company	Rating	Value 25-Mar	Cash yield	Gross yield	P / NTA[1]	PE	EV/ EBITDA
Asset Plus	UNDERPERFORM	0.41	8.8%	12.5%	0.58x	11.4x	12.4x
Argosy Property	NEUTRAL	0.85	7.4%	10.5%	0.66x	12.4x	14.5x
Augusta Capital	NEUTRAL	1.2	5.4%	7.5%	1.62x	16.9x	13.2x
Goodman Property	NEUTRAL	2.07	3.2%	4.6%	1.20x	30.1x	25.0x
Investore	OUTPERFORM	1.44	5.3%	7.6%	0.85x	17.5x	18.0x
Kiwi Property Group	NEUTRAL	0.85	8.5%	12.1%	0.60x	11.7x	13.0x
Precinct Properties	NEUTRAL	1.50	4.2%	6.0%	1.02x	22.0x	22.1x
Property for Industry	OUTPERFORM	1.87	4.1%	5.9%	0.94x	21.3x	17.9x
Stride Property	NEUTRAL	1.33	7.5%	10.6%	0.68x	12.0x	14.2x
Vital Healthcare	OUTPERFORM	2.21	4.1%	5.8%	0.95x	21.6x	20.1x
S&P/NZX Real Estate Gross		**1,342**	**4.9%**	**7.1%**	**0.95x**	**21.4x**	**19.9x**
S&P/NZX50 Gross		9,264	3.7%	4.7%	1.74x	23.5x	12.3x

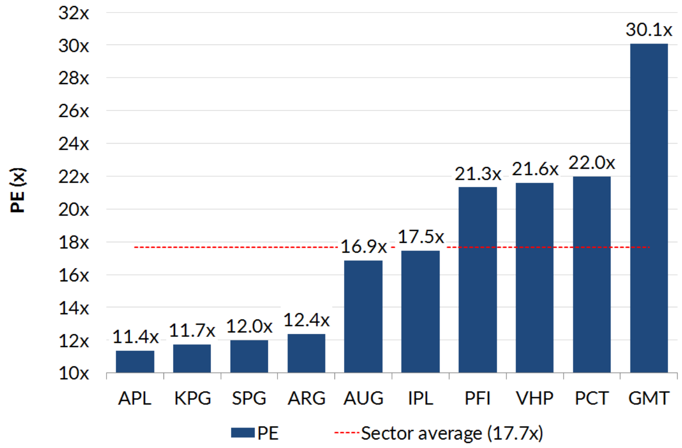
1: NTA is adjusted. 2: Index metrics reflect average constituent metrics weighted by market capitalisation. Source: Forsyth Barr analysis, Company Reports

Figure 21. Gross Yield



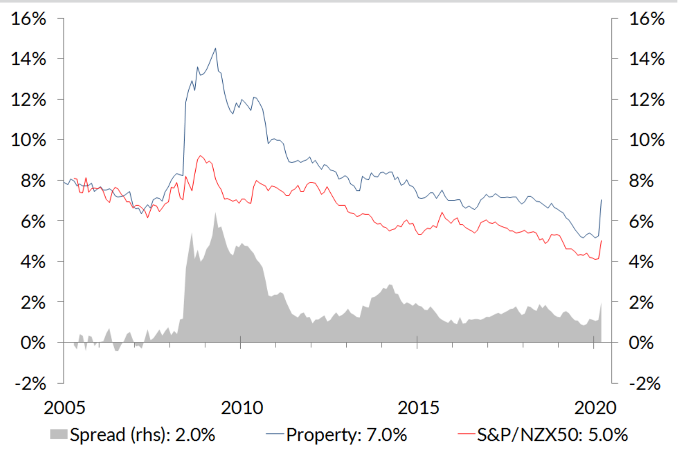
Source: Company reports, Forsyth Barr analysis, Thompson Reuters

Figure 22. PE Ratio



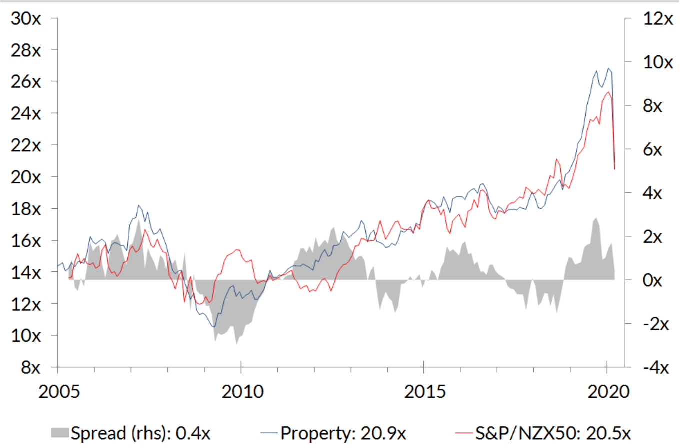
Source: Company reports, Forsyth Barr analysis , Thompson Reuters

Figure 23. Sector gross yield versus S&P/NZX50 gross yield



Source: Company reports, Forsyth Barr analysis, IRESS

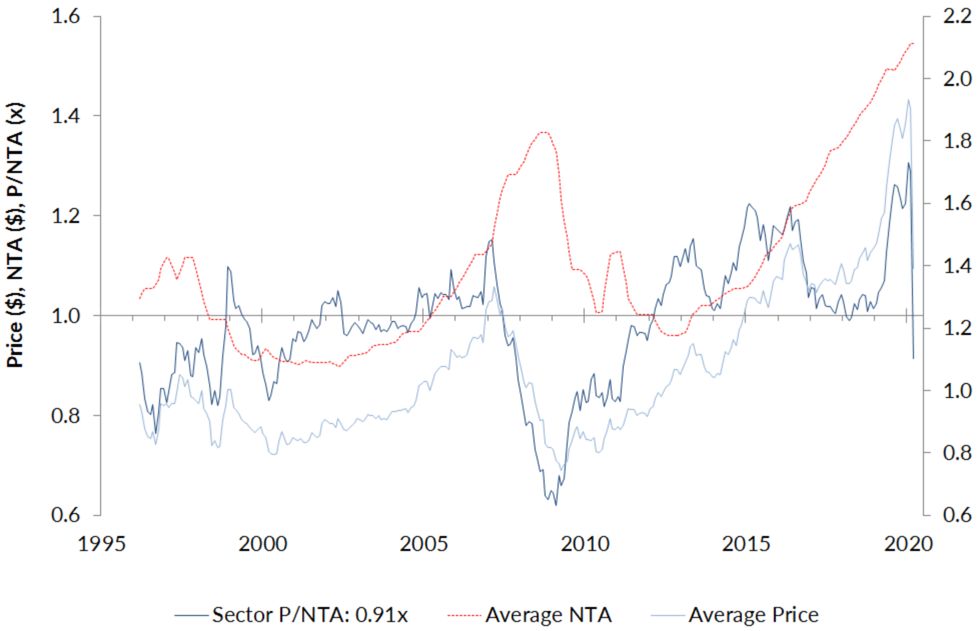
Figure 24. Sector PE versus S&P/NZX50 PE



Source: Forsyth Barr analysis, Company reports, IRESS

Key monthly charts and tables

Figure 25. Sector P/NTA, NTA and price



Note: Series represents simple average of price to reported NTA for core LPV's (ARG, GMT, IPL, KPG, PCT, PFI). Source: Forsyth Barr analysis, IRESS, Forsyth Barr analysis.

Figure 26. Peer Multiples

Company	P / NTA	P / NAV	PE	P / AFFO	Cash yield	AFFO yield	Gross yield	AFFO Pay-out
APL	-42.3%	-37.4%	11.4x	13.0x	8.8%	7.7%	12.5%	114%
ARG	-33.7%	-35.6%	12.4x	13.7x	7.4%	7.3%	10.5%	101%
AUG	+62.2%	-13.7%	16.9x	16.9x	5.4%	5.9%	7.5%	91%
GMT	+19.7%	+8.9%	30.1x	32.8x	3.2%	3.0%	4.6%	105%
IPL	-15.3%	-13.3%	17.5x	19.2x	5.3%	5.2%	7.6%	102%
KPG	-40.5%	-45.3%	11.7x	12.9x	8.5%	7.7%	12.1%	109%
PCT	+1.7%	-6.6%	22.0x	24.8x	4.2%	4.0%	6.0%	104%
PFI	-6.0%	-9.2%	21.3x	24.2x	4.1%	4.1%	5.9%	100%
SPG	-32.5%	-35.0%	12.0x	14.0x	7.5%	7.1%	10.6%	105%
VHP	-5.0%	-6.6%	21.6x	25.0x	4.1%	4.0%	5.8%	102%
Average	**-9.2%**	**-19.4%**	**17.7x**	**19.7x**	**5.8%**	**5.6%**	**8.3%**	**103%**
Core average[1]	**-14.0%**	**-17.8%**	**18.6x**	**20.8x**	**5.5%**	**5.3%**	**7.9%**	**104%**

Source: Forsyth Barr analysis, company reports, Eikon 1: Core LPV's are ARG, GMT, IPL, KPG, PCT, and PFI.

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