WHAT DID WE LEARN FROM THE FY16 A-REIT REPORTING SEASON?

A-REITs have performed strongly in recent years. With a total return of 26.0% for the year to August 2016, A-REITs outperformed equities and bonds which returned 9.7% and 6.2% respectively (Figure 1). Year to date, the sector's total return stands at 18.0% compared to 12.0% for equities. The obvious question is whether this level of outperformance is sustainable and can A-REITs outperform the other major asset classes for a third consecutive year.

So what did the recent August reporting season tell us about the health of the A-REITs and more importantly what lies ahead?

Our overall assessment is that there were many positives coming out of the FY16 results, however commentaries relating to the outlook appear to be more muted than they have been in recent years.

Here's our key take outs from the reporting season:

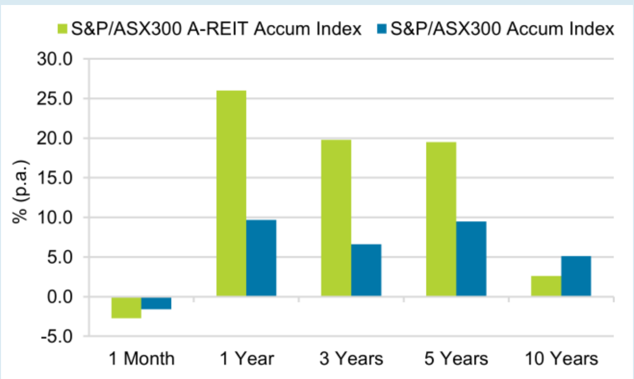
VARIATION OF PERFORMANCE ACROSS SECTORS

- Performance varied across the property sub-sectors with residential surprising the most on the upside. The market was focused on sales volumes, settlement levels and margins. The residential A-REITs performed strongly on all three measures with record levels of pre-sales, settlement default rates remaining low and expanding margins. Mirvac delivered one of the best results of the season with guidance of 8-11% EPS growth in FY17.
- The social infrastructure sector, particularly the child care A-REITs (Folkestone Education Trust and Arena REIT), generated another positive performance while most developers (Mirvac, Stockland) and fund managers (Charter Hall, APN) also reported strong results off the back of positive development returns and growth in funds under management respectively.
- The office sector reported, with the exception of GDI, improving office fundamentals and stronger like for like net operating income growth which is expected to continue in FY17. It is fair to say the office A-REITs were more positive on the year ahead than the one just past.
- The retail A-REITs by and large were disappointing, reporting moderating speciality sales growth, higher tenant incentives and lower returns from development. This was particularly evident with Westfield Corporation's weaker outlook on developments and those retail A-REITs with a large expose to supermarkets anchored centres including Charter Hall Retail.

BALANCE SHEETS IN GOOD SHAPE

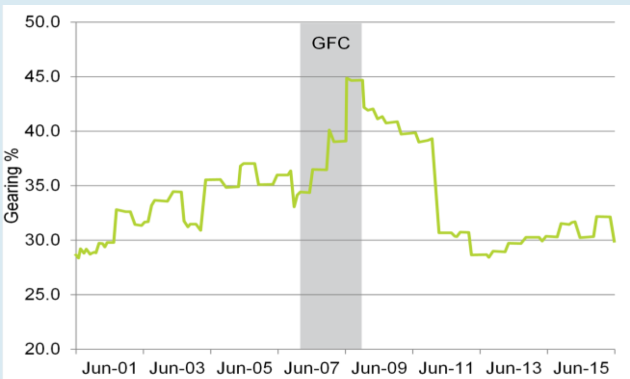
- Driven by asset value increases and a number of A-REITs selling assets over the last 12 months, balance sheets are in good shape. Sector gearing is low at circa 29% across the sector (Figure 2) with many A-REITs at the low end of their target ranges providing significant capacity to fund acquisitions and developments. The exceptions are GrowthPoint and Cromwell who are both above 40% however, the weight of money chasing quality assets continues to make it harder and more expensive for the A-REITs to buy assets on market.

Figure 1: A-REITs vs Equities
Total Returns to 31 August 2016



Source: UBS

Figure 2: A-REIT Sector Gearing:
June 2001 – June 2016



Source: Factset, Macquarie Research, Sept 2016
Note 1: Gearing is on a net debt / total assets basis

CAP RATE COMPRESSION CONTINUES TO BE A POSITIVE

- Cap rates continue to decline (which impacts positively on NTA's), albeit the rate of compression appears to be moderating. Over the past year, the average A-REIT cap rate compression was circa 45 basis points taking the cumulative compression over the last four years to a more than 150 basis points and bring them back to pre-GFC levels.
- The strongest compression was reported by the A-REITs with office exposure – IOF, Cromwell, Dexus, GPT and Mirvac. Overall, average NTA growth was around 10% in FY16, and could have been higher, were it not for the unfavourable impact of the mark to market of interest rate hedges.

LOWER INTEREST RATES CONTINUE TO BE A TAILWIND

- The fall in the cost of debt was a significant positive for most A-REITs given the majority have some level of floating rate debt and a number were able to benefit from lower hedge costs as more expensive hedges rolled-off during the year. The weighted average cost of debt in the sector is circa 4.5% (Figure 3) and the interest cover ratio is now above 5.0%. We expect this to continue to be a positive for the sector as interest rates remain low for longer, credit spreads remain relatively stable (unless there is a major global shock) and the hedging profiles of most A-REITs limit the risk from any rise in funding costs.

ACTIVE PORTFOLIO MANAGEMENT IS PAYING OFF

- Those A-REITs who have taken opportunities to sell non-core assets and redeploy proceeds either into new developments or to reduce gearing have generally outperformed. Goodman Group has been the stand-out on this front. In FY16, they sold and conditionally contracted more than $1.0 billion of non-core industrial assets, particularly ones in inner urban areas that residential developers have been prepared to pay a premium for, with the intention to redeploy the capital into new developments.
- We have always advocated investing in quality managers who are prepared to roll their sleeves up and drive their assets harder.

EARNING OUTLOOK POSITIVE BUT MUTED COMPARED TO PREVIOUS YEARS

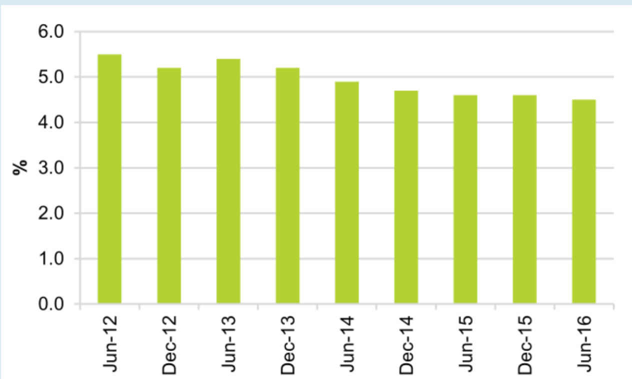
- All A-REITs provided or re-affirmed earning guidance with the exception of GDI (given the uncertainty around their asset sales program). The 2017 earnings outlook, whilst positive, did see analysts' consensus forecasts for 2017 and 2018 being downgraded slightly across a number of A-REITs. Those A-REITs with strong guidance included Mirvac (+8-11%), Arena REIT (+7%), Goodman Group (+6%) and Folkestone Education Trust (+6%). Those that disappointed included Cromwell (-11%), Westfield Corporation (-9.0%) and Charter Hall Retail (2.0%).

OUTLOOK

Given the recent strong returns of the A-REITs, it is somewhat difficult to see similar levels being accomplished over the next 12 months. Viewed in the context of the potential for future outperformance relative to the general equity market, on a number of metrics the sector looks expensive. It is trading on a forward PE of 18.5x (12.9x is the 26 year average) (Figure 4) and a 40% premium to NTA (long-term average is 12.9%) (Figure 5).

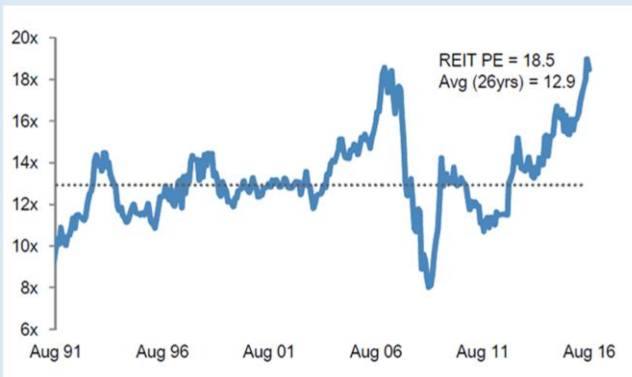
While it's prospective distribution yield of 4.6% is significantly lower than the historical average of 6.4%,

Figure 3: A-REIT Sector Debt Costs: June 2012 – June 2016



Source: UBS

Figure 4: A-REIT Sector P/E: August 1991 – August 2016



Source: JP Morgan

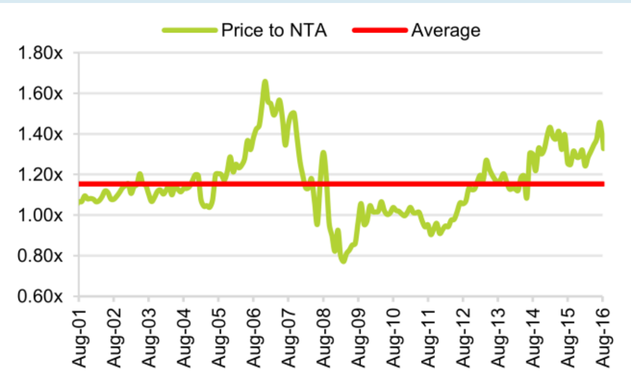
with the cash rate and bond yields at record lows, the 270 basis points yield spread to 10 year bonds remains attractive (190 basis point long term average) at least for as long as rates stay low (Figure 6). Whilst we are cautious about the abnormal rates environment, the actual yield and spread currently on offer is not a bad outcome when considered in the context of a lower for longer interest rate environment. The yield attraction of A-REITs will continue to be front of mind with investors, particularly given the relative earnings visibility across most of the A-REITs.

The easy wins from cap rate compression (helping NTA growth and improving balance sheet strength) and the lower cost of debt (helping earnings) are now mostly behind the sector. Going forward, the A-REIT managers are going to have to work harder to drive earnings and distribution growth in the year ahead.

As evidenced by the battle for control of GPT Metro Office Fund and the recent play for Generation Healthcare, and the listing of Propertylink and Viva Energy REIT both M&A activity and IPO is expected to continue to be a feature of the A-REIT sector going forward. However, the market will continue to focus on quality and pricing and those M&A and IPO deals that are incorrectly priced will struggle to be supported by the market. The recent IPO of Propertylink is a case in point, where it has yet to trade above issue price since listing.

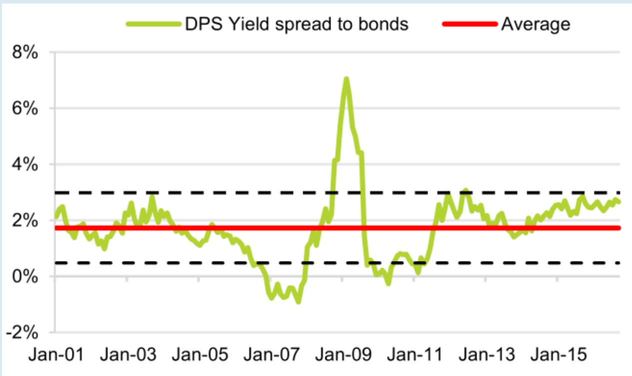
Value is getting difficult to identify particularly as A-REITs in the main are trading at large premiums to NTA and at record low yields. We therefore continue to advocate focusing on A-REITs with exposure to industrial and social infrastructure sectors, and securities with quality management that have the ability to actively manage their portfolios to drive income growth over time.

Figure 5: A-REIT Price to NTA: August 2001 – August 2016



Source: Credit Suisse

Figure 6: A-REIT DPS Yield Spread to Bonds: January 2001 – August 2016



Source: Credit Suisse

Folkestone
MAXIM ASSET MANAGEMENT

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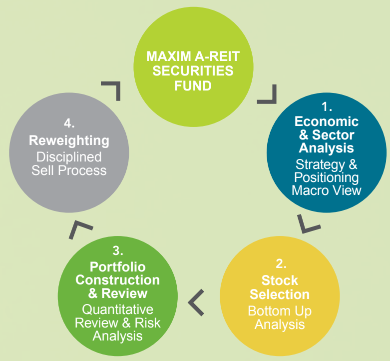
LONSEC UPGRADES FUND TO "RECOMMENDED"

"OVER THE PAST THREE YEARS THE FUND HAS OUTPERFORMED THE LONSEC PEER GROUP CONSIDERABLY" - LONSEC FUND REPORT, MAY 2016

19.31% P.A.[1]

[1] OVER PAST 3 YEARS AFTER FEES AND BEFORE TAX TO 30 JUNE 2016. PLEASE SEE THE PRODUCT DISCLOSURE STATEMENT DATED 11 JUNE 2014. PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE PERFORMANCE.

INVESTMENT PROCESS



FUND BENEFITS

- **INVESTMENT EXPERTISE**
  Folkestone Maxim Asset Management (Folkestone Maxim), has extensive experience in managing listed real estate securities as well as having access to Folkestone Limited's (Folkestone) direct real estate expertise.

- **EXPOSURE TO REAL ESTATE**
  Provides access to a diversified portfolio of quality ASX listed real estate securities which own office, retail, industrial, residential and real estate related social infrastructure assets.

- **HIGH CONVICTION, ACTIVE STRATEGY**
  Securities are selected and a portfolio built on individual merit and not by benchmark (Index) weights.

- **LIQUIDITY**
  Investing in listed real estate securities provides greater liquidity than investing in direct real estate.

- **QUARTERLY DISTRIBUTIONS**
  Distributions are paid quarterly or can be reinvested into the Fund.

- **STRATEGIC CAPACITY LIMIT**
  Folkestone Maxim has set a capacity limit of up to 1.0% of the market capitalisation of the S&P/ASX 300 A-REIT Index to enable the Fund to take active positions in smaller securities and allow more efficient management of re-weightings between individual securities.

ABOUT THE MANAGER

Folkestone Maxim Asset Management is a boutique investment manager, specialising in A-REIT securities and real estate debt. It was founded in 2003 and acquired by Folkestone in 2014.

Folkestone is an ASX listed (ASX: FLK) real estate funds manager and developer providing real estate wealth solutions to private clients and select institutions.

Folkestone's funds management platform offers real estate funds to private clients and select institutional investors across income, value-add and opportunistic (development) real estate investments. Folkestone's on balance sheet activities focus on value add investments and developments.

Folkestone had more than $1 billion in funds under management at 30 June 2016.

Folkestone Maxim Asset Management Ltd
ACN 104 512 978 AFSL 238349

e: office@folkestone.com.au
www.folkestone.com.au

Sydney Office
Level 10, 60 Carrington Street
Sydney NSW 2000

t: +61 2 8667 2800
f: +61 2 8667 2880

Melbourne Office
Level 14, 357 Collins Street
Melbourne VIC 3000

t: +61 3 9046 9900
f: +61 3 9046 9999

Folkestone
MAXIM A-REIT SECURITIES FUND