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The City View – AREITs Issue 10

How high (and how low) can REIT yields go?

- Industry Overview

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- **Examining two major thematics –** In this report, we combine two key thematics we see as influencing REIT returns throughout FY12 and into FY13+: (1) sustained investor appetite for yield, and (2) Australian REITs' ability to "drive earnings" (and so dividends), predominantly through inorganic means ("pulling levers").

- **Investor appetite for yield remains unsated –** REIT dividend yields have compressed sharply, from 6.7% in Dec-11 to 5.1% today, based on trailing data. Against the broader market, Australian REITs are trading on a yield spread of just 60bp – the lowest recorded, and a figure that calls into question REITs' favoured position as yield investments. More positively for REIT investors, the yield spread to 10 year bond yields (190bp) is materially *wider* than average, suggesting scope for upside against bonds. For equity-focused investors, however, the yield argument for buying Australian REITs is weakening.

- **REIT managers pulling levers to help drive re-rating –** Australian REIT managers have been increasingly focused on driving earnings (or, often equivalently, ROE). We see this as having been a major tailwind to the sector's extremely strong performance (+31% over the last year, or c. 2000bp of outperformance) over the past year – and believe that further EPS (and DPS) upside may be required to drive REITs higher still.

- **Which levers?** Recent levers of choice have included hedge restructuring, buybacks, and overhead reductions. We focus here on two earnings drivers: (1) additional debt cost reductions, and (2) spread investing (buying assets at earnings accretive yields). We also examine the scope for REITs to lift payout ratios to drive DPS over and above EPS growth. We see DPS growth as the best defence against the criticism that REIT yields are becoming less enticing to investors.

- **Sector implications: DPS upside material at 12%, lifting CAGR 600bp –** We see scope for managers to drive the sector's FY14 dividend yield up from c. 5.8% to as much as 6.5% (+12%). Debt cost savings are the major driver (c. 30bp, a +6% improvement), with higher payout ratios contributing 20bp (+2%). Our spread investing estimates (10bp, +4%) could prove conservative if gearing tolerance exceeds our assumptions, or if acquisitions are focused on higher-yielding assets.

- **Stock implications –** Our results support our Buy ratings on CRF and SGP, which screen cheap on our base case numbers, with scope to meaningfully exceed these in our upside case. Amongst a multitude of Neutral-rated REITs, our analysis suggests a preference for CFX, DXS, MGR and IOF. All offer yields of c. 6%+ on our base case and c.7%+ in our upside case, levels we see as relatively attractive. We see less scope for CPA and GMG to grow their dividends inorganically, with GMG, WDC, CPA and GPT offering the lowest yields in our upside scenario.

Contents

How high (and how low) can REIT yields go?

Part one: what does history tell us about how much further REIT yields can compress?

We structure this report in two parts. In the first, we briefly examine the recent compression in REIT yields, driven by very strong price performance, and ask: how low can REIT yields go?

We then turn to address what we see as the key question: can REIT managers drive growth in dividends to help justify even higher prices? In doing this, we aim to both assess the potential upside for the sector as a whole, and identify those stocks for which the upside may be greatest.

Part two: how much can REITs "pull levers" to grow DPS inorganically and offset this yield compression?

Before we begin …

Our intention here is not to *advocate* a strong focus on earnings (or dividends) from a REIT manager's perspective, particularly past a certain point. We do, however, see the increased focus on earnings from REIT managers as aligning their thinking more closely with generalist investors' approach to the sector – and believe that this has helped in narrowing the NTA discount at which REITs had for some time traded.[1]

We would again highlight, as we have highlighted previously, that certain levers that have helped drive REIT earnings create no economic benefit, in our view – they may be EPS accretive, but they are not value accretive. We also see an excessive focus on earnings, and earnings growth/accretion, as being one of the pre-cursors to the sector's collapse from 2007 onwards – although we also see the risk of a repeat as being quite low in the near term. In short: elements of the recent increase in focus on REIT earnings have been positive, but this approach has its limits, and carries with it some risks.

1. How low can REIT yields go?

In this section, we examine how low REIT yields can go – essentially, how expensive can REITs get relative to their dividends? We use a number of benchmarks, which suggest differing conclusions.

REIT yields in a historical context

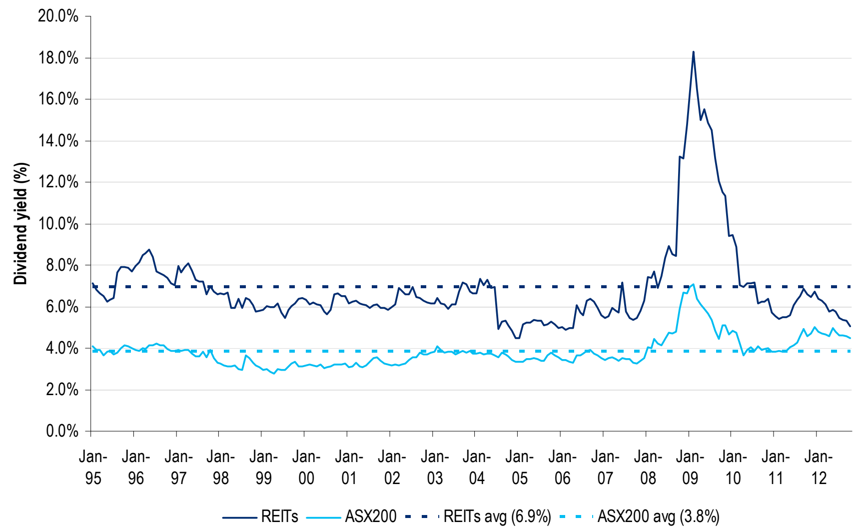
REIT yields have compressed 160bp YTD, as prices have rallied 25%.

We start by assessing the scene. As Figure 1 illustrates, REIT yields have compressed recently, from 6.7% in Dec-11 to 5.1% on 31 October, based on trailing data. Current yields are comfortably below a historical average of 6.9%, and towards the low end of the historic range.

Figure 1 also depicts a phenomenon highlighted in a recent report by our Strategy team, lead by Tony Brennan – the yield on traditionally yield-focused sectors, such as REITs, has compressed, narrowing the gap against the broader Australian market.

[1] Notably, much of the Australian REIT sector *continues* to trade at a discount to NTA – although (1) a number of REITs with more active business models (WDC, GMG, eg), now trade at large premia, and (2) passive small caps that own high cap rate assets (CQR and BWP) have reached and breached NTA in recent months.

Figure 1. REIT yields vs market yields

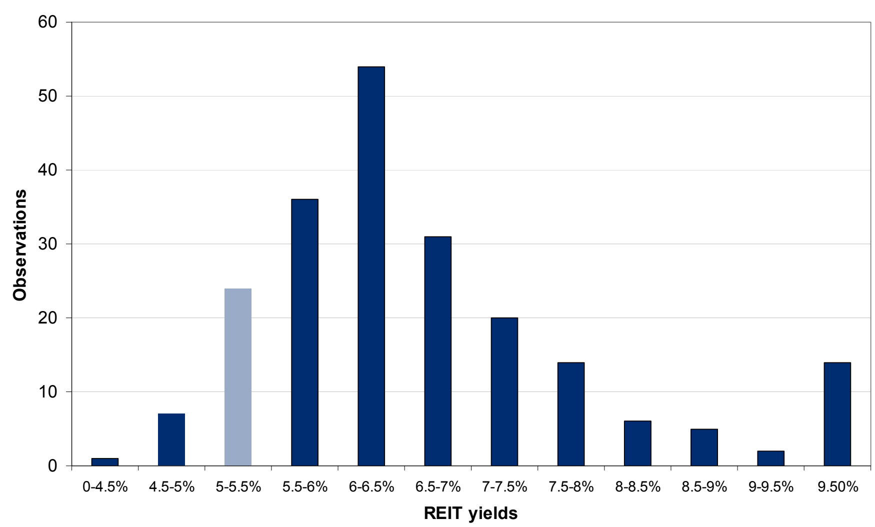


Source: Datastream, Citi Research

REITs have only traded on lower yields c. 4% of the time – suggesting limited scope for further upside unless DPS grows strongly.

Figure 2 depicts historical observations of REIT yields in histogram form, with a current yield in the 5-5.5% range. The REIT sector has traded on a lower yield for only 8 months in the last 17 years (ie, 4% of the time). While Figure 1 shows the recent compression in REIT yields, Figure 2 emphasises how low the current yield is in a historical context. A further rally of c.13% would put the sector on its lowest recorded dividend yield.

Figure 2. Historic REIT yield frequency (current yield highlighted)



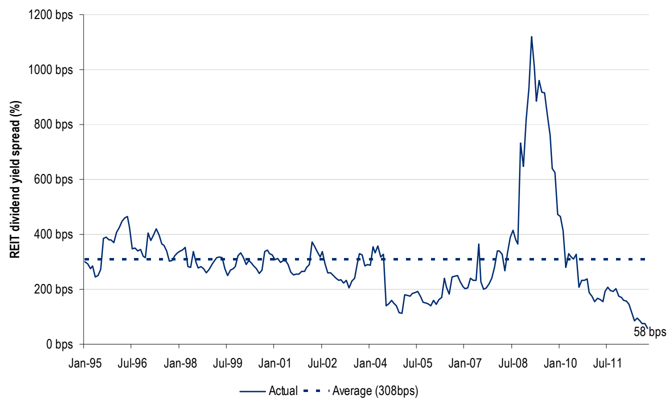
Source: Datastream, Citi Research

REIT yields versus market yields

REITs have never offered such a small yield spread above the broader market.

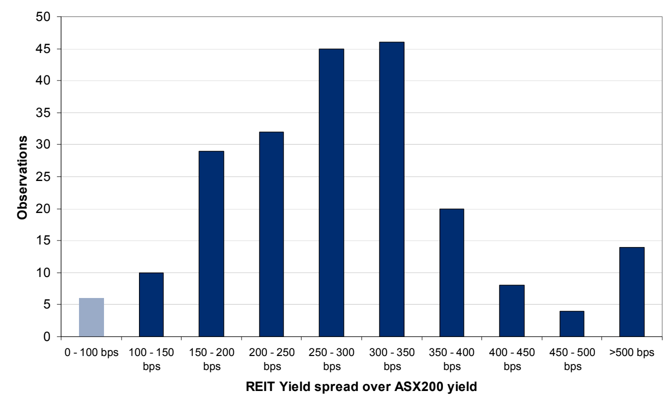
In Figure 3 we show the REIT sector's dividend yield spread above the ASX 200 yield (REIT dividend yield less ASX 200 yield). Relative to the broader Australian market, the REIT sector yield is making new lows, with the spread now well under 100 bp, versus c. 300 bp for much of the late 1990s. Until recently, the REIT sector yield spread has rarely fallen below 150 bp. Figure 4 highlights how unusual the recent yield convergence between REITs and the broader market is.

Figure 3. REIT yield spread over market yield



Source: Datastream, Citi Research

Figure 4. Historic REIT yield spread frequency (current val highlighted)



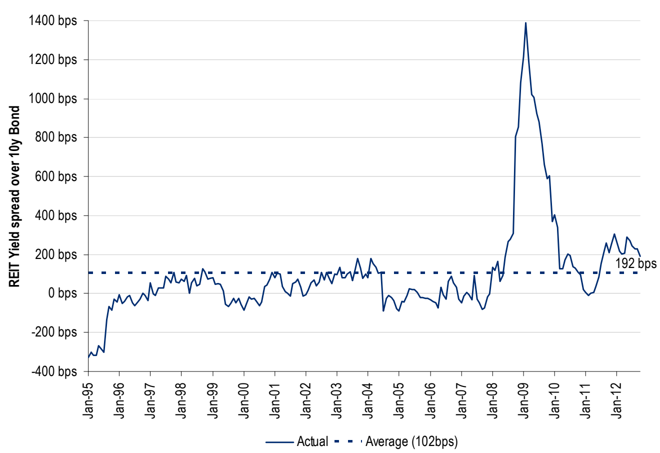
Source: Datastream, Citi Research

REIT yields versus bond yields

More positively, REITs' yield spread over bonds is well *above* average.

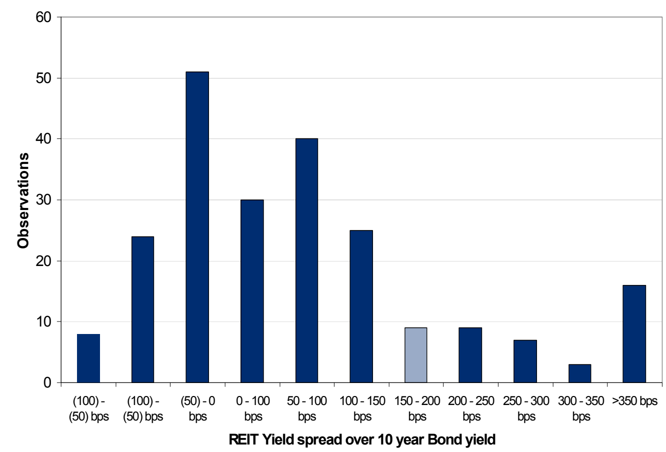
While REIT dividend yields have compressed significantly to historic low levels, comparing against bond yields reveals a somewhat different story. As Figure 5 illustrates, REIT yields currently exceed bond yields by close to 200bp. This spread is above the historical average of c. 100bp, and, as Figure 6 highlights, has only been exceeded on relatively few occasions (all during the 2008-2010 period).

Figure 5. REIT yield spread over 10-year bond yield



Source: Datastream, Citi Research

Figure 6. Historic REIT yield spread over 10y bond yield (current val highlighted)



Source: Datastream, Citi Research

Which REITs have driven the yield compression?

So, which REITs have been driving the sector towards lower yields? While the "yield thematic" might be thought to benefit passive, rent-collecting vehicles most, the best performing REITs over the last year have predominantly been more active names (CHC, GMG, WDC, MGR and ALZ) along with select passive names (WRT and BWP).

With this in mind, we look to compare across sub-sectors. In Figure 7 below we select a sample of REITs and depict their current (trailing) dividend yields relative to their own historic yield ranges. This chart essentially shows the proportion of our time series for which each stock has traded at a *lower* yield – 100% reflects a record high yield, 0% a record low yield. We include yield time series charts for each of these stocks in Figure 25 to Figure 29 in the Appendices.

REITs have compressed to historically low yields driven by groups with global exposure and the office landlords.

The stocks we have chosen as "sub-sector proxies" are as follows:

- **Global owner, developer, manager: WDC –** Westfield's dividend yield is at historic lows, and now stands at well under 5%. We see this as being driven by both (1) WDC's adoption of a lower payout ratio over time, and (2) the stock's sharp recent rally (+34% rolling-year). With a c. 29% weighting the ASX 200 A-REIT index (XPJ), WDC's falling yield clearly weighs heavily on the sector yield.

- **Residential developer: SGP –** Unlike many REITs, SGP's dividend yield continues to screen in line with historical levels (51st percentile).

- **Australian retail: CFX –** CFX's current yield is toward the upper end of a narrow historical range. CFX's relatively tight historic yield range (4.5%-7.5%) was largely driven by its share price resilience through the GFC, which limited the "blow-out" in yields seen elsewhere over that period (see Figure 25 to Figure 29).

- **Australian office: CPA –** Currently yielding c. 5.6% on trailing data, CPA has never traded firmer based on our data set – although the market appears to have been willing to accept a yield of c. 6% from CPA for well over a year now.

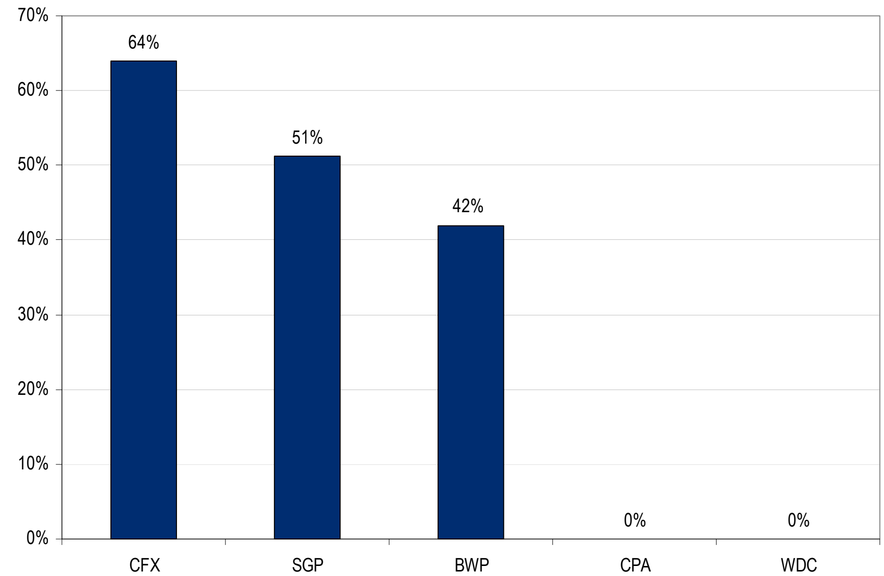
- **Passive small cap: BWP –** Somewhat surprisingly, given that BWP continues to make new post-GFC highs,[2] the stock is currently trading on a yield similar to levels seen for most of its history (42nd percentile). We attribute this to the Trust's strong track record of growing distributions over the last decade, and superior GFC performance (ie, avoiding the highly dilutive capital raisings that were widespread throughout the sector).

Based on these results, REIT yield compression to historically low levels has been predominantly driven by the globally exposed REITs and the office landlords.

[2] Indeed, BWP is within striking distance of its all-time highs – and, with the exception of CFX and those trusts that listed post-GFC – is the only REIT we cover that comes remotely close.

CPA and WDC are currently trading on record low dividend yields, based on our data set.

Figure 7. Current yield – percentile relative to historic yield range



Source: Datastream, Iress, Citi Research

Conclusions – part one

- The REIT sector has rarely traded on a lower dividend yield (c. 4% of the time). Despite this, a return to a historical low yield of c. 4.5% would still permit price upside of 13% (assuming constant dividends).[3]
- Comparisons against the Australian market suggest less scope for upside for the sector. REITs' yield spread has recently hit record low levels – suggesting smaller scope for future outperformance. With REITs outperforming by an enormous 2000bp over the last year, perhaps this should not be surprising.
- Against 10 year bond yields, the picture is somewhat more optimistic: REITs are actually trading on an above average yield spread of c. 190bp.

While comparisons against bond yields suggest ample scope for upside, we believe this comparison may be of fairly limited relevance to equity investors. Given the significant recent compression in REIT yields, especially versus the broader market, we believe REITs may need to grow their dividends to help justify further outperformance. In part two of this report, we ask: how high can REIT yields go?

[3] This is an important assumption, and one we address in detail shortly.

2. How high can REIT yields go?

As we outlined earlier in this report, we see REIT managers' increasing focus on earnings as having been a significant tailwind for the sector. Recent levers used by REIT managers to grow EPS include hedge restructuring, buybacks and overhead reductions.

Australian REITs have successfully pulled a series of levers to supplement modest organic EPS/DPS growth.

In a lower growth environment, these levers can provide material supplements to REIT earnings (and dividend) growth. As we showed in The City View 9 – Will buybacks drive continued REIT outperformance?, REIT buybacks were capable of delivering accretion comparable to a whole year of organic earnings growth. While REIT shares have rallied substantially since that time, debt costs have also fallen sharply – so buybacks would remain EPS accretive for many REITs. Management appetite for buybacks appears to have waned significantly in recent months, however, perhaps reflecting a view that they deliver more limited *value* accretion at higher purchase prices.

We examine the upside available via three key levers in this report.

In light of this, in this report, we focus on three financial levers:

- Additional debt cost reductions,
- Spread investing, and
- Payout ratio increases.

We see the first two as potentially powerful earnings levers, while the third provides additional scope for DPS upside. We see this as quite attractive to investors in a yield-focused environment, especially given the compression in REIT yields outlined above (see Figure 1).

Additional debt cost reductions

Australian REITs have progressively reduced their debt costs over time via a range of methods, including refinancing at lower margins, reducing undrawn debt capacity and, especially, hedge restructuring.

Plummeting interest rates have been a boon to Australian REIT earnings.

As Australian base rates have declined (from c. 5.5% at Dec 2010 to c. 3% today), interest rate hedges entered into at earlier, higher, rates became meaningful liabilities on REIT balance sheets. By paying out these liabilities in cash, some REITs have been able to capture debt cost savings – accessing the new, lower, market rates to boost earnings, but at the cost of a long-term earnings drag.[4] For a sector with relatively low ROE (low earnings relative to book value), this has arguably provided very significant support to REIT share prices and helped in narrowing the NTA gap.[5] Some generalist investors, some previously tempted by REITs' large book value discounts, but put off by less attractive PEs (driven by low

[4] Where derivative liabilities are paid out with debt funding, we see the cost of servicing this debt as an ongoing drag on REIT earnings. In effect, a REIT using this strategy captures a meaningful short term earnings benefit, with a smaller but longer term earnings detriment in later years. Importantly, our upside sensitivities later in this report do not capture this longer term impact – although we note that alternative approaches can help mitigate its impact.

[5] In The City View – AREITs Issue 9, we explained our view that for some time, earnings accretion has been a much larger driver of REIT share prices than NTA accretion. If this is the case, actions that are earnings accretive but not NTA accretive (like hedge restructuring) should help narrow the NTA gap.

ROEs), have come to view REITs more favourably as earnings have improved.[6] We also believe specialist REIT investors, while typically having a more detailed knowledge of which REITs have used hedge restructuring to drive higher earnings, may not have always priced stocks accordingly.

The opportunity today

We see scope for debt cost savings to be comprised of:

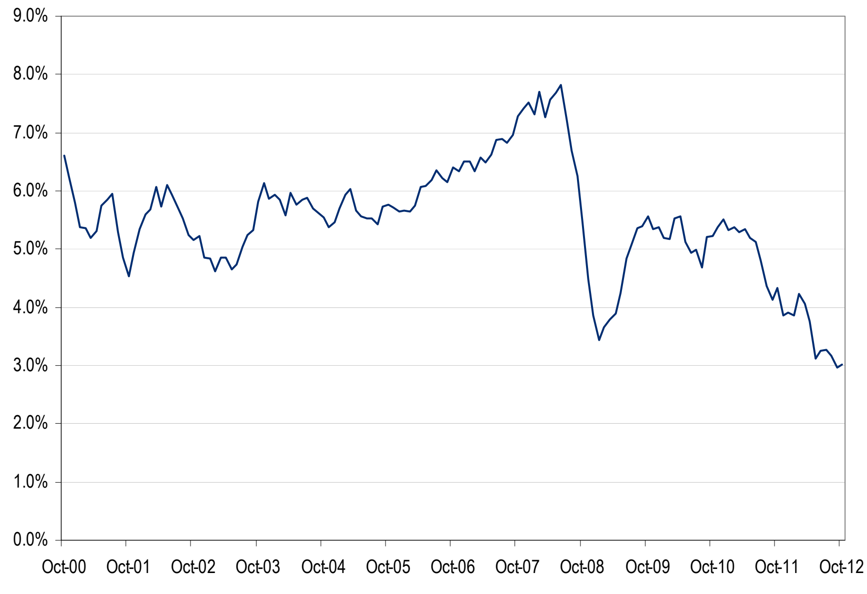
- Hedge restructuring benefits,
- Potential line fee savings,
- Reducing margins upon refinancing, and
- The direct impact of lower base rates on the cost of floating rate debt.

We see more than one way for REITs to reduce debt costs further.

We expand on each of these briefly below, before quantifying the potential upside.

While capturing earnings gains through hedge restructuring has been fairly widespread across the REIT sector, further recent declines in Australian base rates (see Figure 8) have re-expanded the pool of potential gains.

Figure 8. Australian 3 year swap rates



Source: Iress, Citi Research

We also see scope for REITs to generate savings from further reductions in line fees. REITs typically pay in the order of 100bp in fees to maintain access to undrawn debt capacity, so reducing the amount of undrawn capacity can directly support earnings.

[6] Other factors, including broad investor appetite for yield, and defensive earnings streams, have also contributed.

Refinancing GFC-era debt at lower margins may also provide earnings gains to certain REITs. We believe the scope for upside from this avenue may be limited, however, as (1) we see refinancing margins as having been quite stable for quite some time (see Figure 38 in the Appendix), and (2) there are still select cases of facilities being rolled from low pre-GFC to higher post-GFC margins, which will offset potential benefits elsewhere.

Of course, lower base rates also directly support REIT earnings through the floating component of REIT debt books. Lower rates also reduce the cost of debt as fixed rate debt and/or interest rate hedges simply mature over time, being replaced at lower rates.

Quantifying the upside

In Figure 9 below, we show our current forecast for FY14 debt costs[7] across the large and mid cap REITs, as well as an assessment of the current market cost of this debt.

We compare our base case debt cost forecasts against a current market cost to quantify the potential upside.

Our market cost estimates are derived as follows:

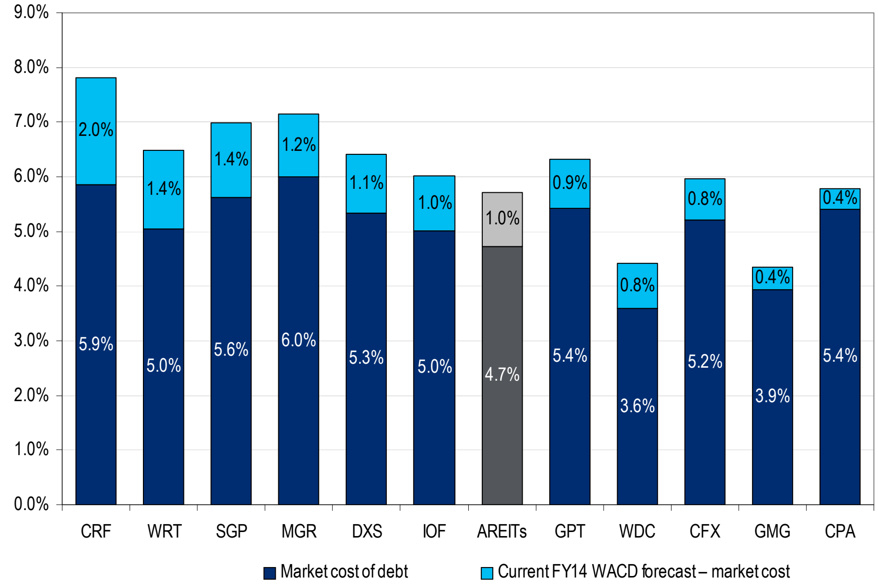
- The base rate is a geographically weighted average of market base rates across each REIT's markets.
- Estimated margins reflect current market conditions, each REIT's credit rating (where applicable) and the likely term of the debt.

The base rate plus margin represents the market cost of drawn debt. We then make assumptions regarding additional costs (such as the amount of undrawn debt required, and line fees, on a stock-by-stock basis). Our estimated market cost of debt includes these costs, spread over our assumed FY14e debt balance – so our estimates are designed to reflect "all-in" debt costs.

We depict our estimates of the all-in market cost of debt, as well as the additional cost of this debt based on our current FY14 forecasts, in Figure 9 below. The total height of each column represents our current FY14 WACD forecast.

[7] Throughout this report, our sensitivities focus on FY14 estimates, to see the full-year impact of potential earnings benefits (FY13 is well underway for many REITs). Our estimates do not reflect the impact of some recently announced transactions.

Figure 9. Market cost of debt and potential debt cost savings (equals current FY14 WACD forecast less market cost)



Source: dataCentral, Company data, Citi Research
Note: AREITs' numbers calculated using market cap weights

As the chart highlights, we see typical market debt costs as being in the order of 5-6% for most REITs. The sector average of 4.7% is dragged down significantly by WDC and GMG, however, due to their use of offshore debt (and WDC's outsized weighting).

We see scope for REITs to reduce their weighted average cost of debt (WACD) by c. 100bp.

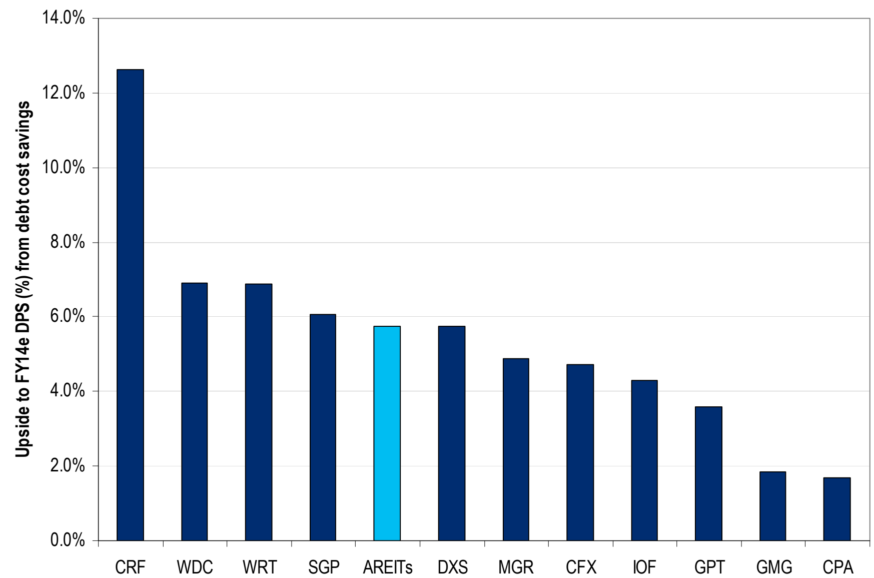
The scope for debt cost savings against our base case forecasts varies widely from stock to stock, from c. 40bp for CPA to c. 200bp for CRF. We have highlighted the scope for CRF to achieve very material debt cost savings previously. Across the sector, we estimate debt cost savings of c. 100bp. To put this in context, a 100bp saving on a base case forecast WACD of 5.7% represents a saving of c. 18% in one of the largest expense lines in a REIT income statement.

In Figure 10 below, we show the potential impact of lower debt costs on DPS,[8] both individually for the larger REITs, as well as for the sector.[9]

[8] We focus most of our calculations in this report on DPS (rather than EPS) impact. Generally the two will be quite similar – if a constant earnings payout ratio is maintained, they should be identical. We focus on DPS throughout because (1) DPS is what matters for a stock's dividend yield, the focus of part one of this report, and an increasing point of focus for investors, and (2) we examine payout ratios as the third major driver in part two of this report.

[9] Throughout this report, we focus our sensitivities on the large and mid cap REITs – those in the ASX100. These contribute the vast majority of sector market cap (c. 95%) and sector earnings/dividends. The smaller REITs may have scope to benefit from pulling similar levers, as we have flagged previously, but are unlikely to contribute meaningfully to upside at a sector level.

Figure 10. Upside to FY14e DPS (%) from debt cost savings



Source: dataCentral, Company data, Citi Research
Note: AREITs' numbers calculated using market cap weights

CRF's potential to reduce debt costs continues to stand out.

Re-setting debt books to market rates could provide DPS upside of c. 6% across the sector. This would equate to a c. 30bp increase in the sector dividend yield, offsetting some 20% of the sector's yield compression YTD (160bp compression from 6.7% at Dec-11).

REITs with the largest scope for upside on this basis include CRF, WDC and WRT. Those with less potential upside include GPT, GMG and CPA. The stocks with less upside are characterised by being more successful in minimizing debt costs to date (potentially supported by a more aggressive approach to hedge restructuring) and/or by lower leverage than peers (limiting the earnings impact of potential debt cost savings).

We turn now to examine one of the flow-on benefits of REITs' lower cost of debt: an enhanced ability to acquire accretively ("spread invest").

Spread investing

Falling debt costs improve the prospects for accretive acquisitions.

The second lever we examine in this report – spread investing – refers to REITs' ability to acquire assets at valuations that provides earnings accretion. We see this accretion as being largely determined by the spread between asset level yields and the cost of funding.[10]

While Charter Hall Retail (CQR) has recently funded an acquisition of new assets with equity, and Goodman Group (GMG) has also announced an equity raising, we see debt funding as a more likely funding source for most REITs in the near term. A number of factors contribute to this view, including: (1) the fact that many REITs still

[10] This is a little over-simplified. Transaction costs, the cost of managing assets, as well as the quantum of any acquisition also influence the level of earnings accretion. We account for each of these factors in our calculations later in this report.

trade at a discount to NTA,[11] coupled with our belief that equity issuance at a price below NTA is likely to be quite poorly received by the market, (2) the sector arguably having quite material re-gearing capacity, and (3) the sharp decline in the marginal cost of debt.

We focus our analysis on debt-funded property acquisitions – although other alternatives may remain attractive.

In examining the deployment of this acquisition capacity, we focus here on the acquisition of direct property assets. Other alternatives include redeployment through development activity, and further buybacks, although we see these as being increasingly unlikely (if potentially equivalent) uses:

- A number of REITs have significantly scaled back their **development activity** in recent times, in part because the economics are less attractive than they have been in the past. Development also takes time, whereas the acquisition of assets can potentially provide REIT earnings/dividend accretion essentially immediately.
- In addition, many REIT **buyback programs** have become inactive or only very selectively active in recent months, and pricing is typically much less attractive than in the past, given the sector's strong rally. As we have highlighted previously, however, many REITs could still buy back stock earnings accretively because of the sharp drop in debt costs, and much of the sector continues to trade at a discount to NTA (see Figure 37 in the Appendix). This means that the typical rationale for buybacks continues to apply in many cases, even if it is weaker than previously.

The opportunity today

Cap rates have only compressed moderately from post-GFC levels for a range of asset classes (see The City View 7 - Centro's Rebirth: Implications for the A-REIT Sector for further analysis), while debt costs have fallen sharply. As a result, we see an opportunity for REIT managers to lift earnings (and dividends) by taking advantage of this improved spread, through debt-funded acquisitions.

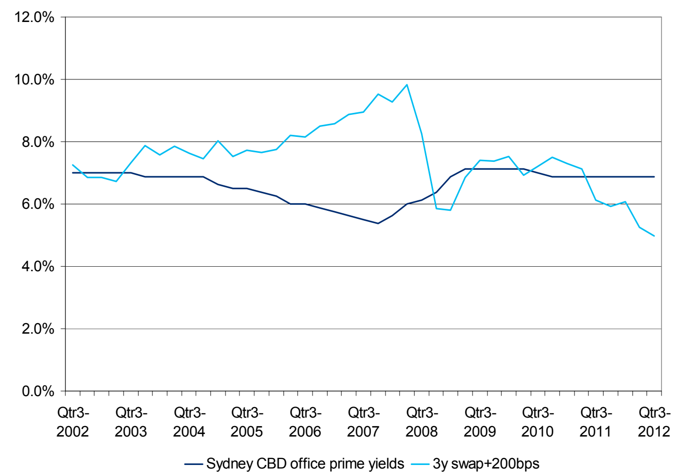
Cap rates are stable, debt costs are down – creating a positive spread.

In Figure 11 and Figure 12, we depict cap rates for two asset classes widely owned by Australian REITs (Sydney CBD office, and Sydney regional shopping centres) against a debt cost proxy (three-year swap rates, plus an assumed margin of 200bp[12]). For both office and retail, yields have been stable for quite some time, with falling debt costs now creating a positive spread in favour of a debt-funded purchaser.

[11] If the REITs achieved DPS upside of the magnitude outlined in Figure 10, but maintained the same dividend yield, many would likely trade at a premium to (current) NTA. This could improve the attractiveness of equity as an alternative source of acquisition funding, while a combination of debt and equity funding could mitigate the gearing impact of any acquisitions.

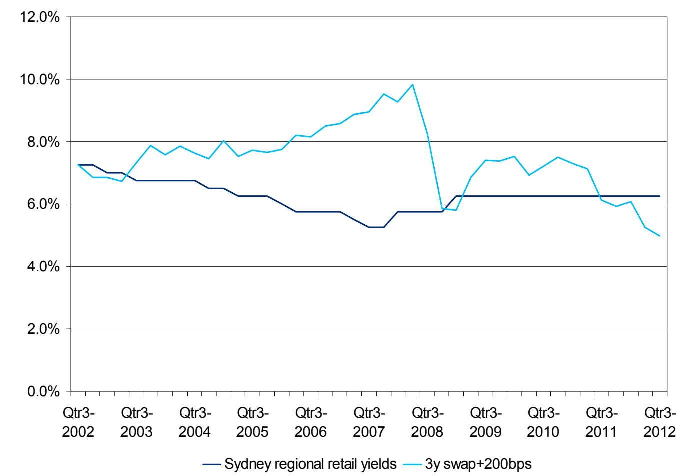
[12] We see this as a reasonably representative margin assumption today and for the relatively recent past, although margins have varied significantly over the longer term. The primary purpose of these charts is to demonstrate the recent "cross-over" between cap rates and a representative marginal debt cost, and we believe this assumption serves that purpose.

Figure 11. Sydney CBD office yields



Source: JLL, Iress, Citi Research

Figure 12. Sydney regional shopping centre yields



Source: JLL, Iress, Citi Research

The other major factor determining the earnings/dividend upside from spread investing is the extent to which REITs engage in it – ie, the quantum of re-investment. Given that we are focusing here on debt-funded acquisitions, we see this as largely determined by REIT managers', and the market's, gearing tolerance (our "upside case" for gearing).

Importantly, Australian REITs are positioned well to take advantage of positive spreads.

We suspect that significant debt-funded acquisition activity may be met with some (understandable) resistance from certain managers and/or investors. We believe that a range of factors may, however, support a moderate level of re-gearing without an undue increase in risk/adverse investor reaction:

- Many REITs (including DXS, CPA and CFX) have material re-gearing capacity even while maintaining gearing within their stated policy ranges (see Figure 14 later in the report). Policy ranges themselves have fallen sharply in recent years, and typically sit well below covenant levels, adding a further layer of conservatism. Investors *may* also become more comfortable with modest rises in gearing policy ranges over time

We think a number of factors point to scope for A-REITs to re-gear moderately.

- REIT gearing levels already vary widely across the sector. IOF and GPT report gearing levels of close to 20%, while WDC recently reported gearing of 31.9% (down from 36.1% at June 2011) and CQR reported gearing of 40.4% prior to its recent acquisition/equity raising. We believe this implies scope for some lower-geared REITs to increase gearing levels.
- We believe REITs' financial management has improved dramatically in recent years. We see this as having enhanced REITs' ability to *prudently* use debt to supplement investor returns.
- The sharp decline in debt costs (the price of debt) improves the attractiveness of this form of funding. We see this as an important consideration.
- Many REITs have inactive buyback programs in place that, if fully executed upon, would increase gearing levels moderately. We see the investor reception to REIT buybacks as having been very positive, suggesting that investors may *already be willing* to accept higher REIT gearing levels where the use of funds makes sense.

In light of this, we turn to examine the scope for REITs to grow EPS/DPS through debt-funded property acquisitions.

Quantifying the upside

In quantifying the potential upside from spread investing, we make the following assumptions:

- Each REIT acquires assets generating a yield in line with its weighted average cap rate (WACR). We note that some REITs are likely to focus their acquisition activity towards asset classes that tend to yield more than their portfolio average (GPT in logistics and business parks, eg) or less than average (DXS in office, eg).
- We account for transaction costs at an estimated 6% of asset value. Based on an asset level yield of 7%, this is equivalent to a yield reduction of c. 40bp.
- Debt costs are in line with the market cost of drawn debt[13] outlined above.

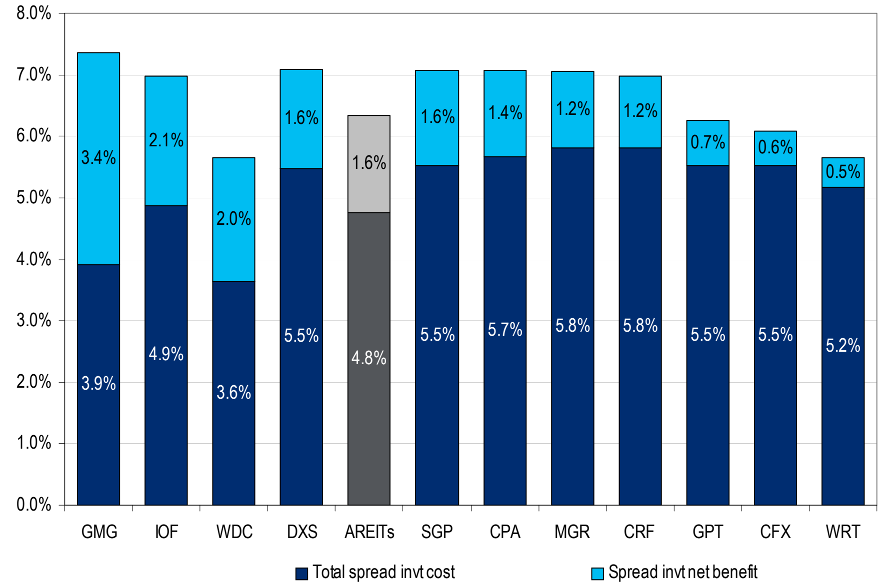
Our analysis incorporates the impact of costs that are sometimes overlooked.

- We account for the cost of managing the additional assets. For externally managed REITs, this is equal to the fee rate charged on assets. [IOF is a key exception, with a market cap-based fee, and so no incremental fee associated with managing debt-funded acquisitions.] For internally managed vehicles, we apply a lower rate, but still include a charge for the cost of managing a larger pool of assets.

These assumptions determine the spread between the additional income generated from acquisitions, and the additional expenses (including funding costs) associated with them. We depict this graphically in Figure 13 below, with the total height of each column representing the income yield on acquisitions.

[13] We assume that additional costs, such as line fees, are maintained at the same level as pre-acquisition.

Figure 13. Spread investing cost and benefit



Source: dataCentral, Company data, Citi Research
Note: AREITs' numbers calculated using market cap weights

The stock with the widest spread is GMG, driven by the highest asset-level yields (industrial cap rates exceed retail and office cap rates) and the second lowest funding/management costs. We also see a wide spread (200bp) for WDC (given low debt costs) and IOF (due to relatively high asset yields and moderately low debt costs). REITs that predominantly own Australian regional malls (WRT, CFX and GPT) all face relatively low spreads (<100bp), driven by the moderate cap rates these assets trade on.

Spread investing benefits can be highly sensitive to small changes in cap rates, and funding/transaction/management costs.

We see the level of acquisition-driven accretion being highly sensitive to modest changes in cap rates, debt costs, and/or the cost of management, because accretion is driven by the *spread* between the additional income and the additional expense. To illustrate, on our numbers, CPA and CFX face similar funding and management costs (a total of c. 5.5-5.7% for each), but CPA benefits from assets yielding some 100bp higher, at 7.1% vs 6.1% (post-transaction costs). This means that CPA's spread is *double* CFX's, at c. 1.4% vs 0.6%. This means that CPA gets twice as much bang for its re-gearing buck. Alternately, an estimate that ignored the impact of both transaction costs and the cost of managing assets would overstate CFX's spread by more than 2:1 – these "on-costs" essentially cut CFX's spread in half.

As we have highlighted above, the other major factor determining the accretion benefit from spread investing is the (relative) scale of the acquisition. For the sensitivities included in this report, this is driven by reported gearing levels and our assumed levels of gearing tolerance. Our gearing tolerance assumptions have been guided by:

- **Reported gearing levels.** These are typically in the 20-30% range, with more at the low end than the high end.

- **Gearing policy ranges.** These vary widely, with REITs such as MGR towards the low end (20-25%) and DXS at the high end (30-40%). A 25-35% policy range is popular, being used by CFX, CPA, CRF and IOF.

- **Historical gearing levels.** A number of REITs have recently de-geared through asset sales, so there may be scope to lift gearing without exceeding recent gearing levels. As an example, WDC's gearing has declined (31.9% at 1H12, from the mid-high 30s previously), as a result of very active capital recycling, both in Australia and overseas.

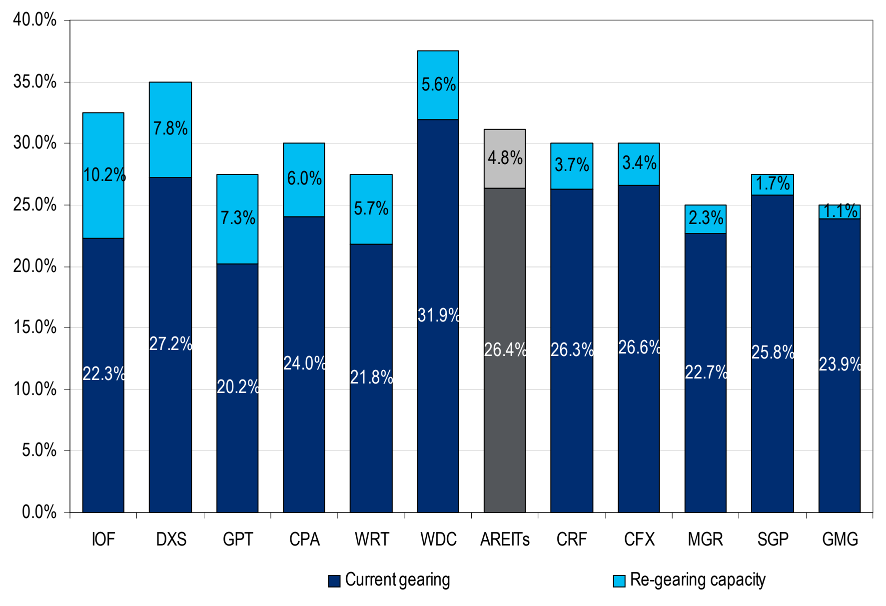
Our estimates reflect re-gearing capacity of c. 480bp across the sector.

- **Partially unexecuted buybacks.** Where a particular REIT has a partially unexecuted buyback in place, we consider the re-gearing impact of completing that buyback in assessing gearing tolerance.

- **Management feedback.** We have engaged with each of the companies included in our sensitivities to try to assess sensible "upside-case" gearing levels. Our final numbers take these discussions into consideration, while attempting to use a consistent approach across stocks.

In Figure 14 below, we show both recent reported gearing levels and our assumed level of re-gearing. The total height of each column represents our assumed gearing tolerance.

Figure 14. Current gearing and re-gearing capacity



Source: dataCentral, Company data, Citi Research. Current gearing is based on 30 June balance sheets, adjusted for select post-balance date transactions.
Note: AREITs' numbers calculated using market cap weights

Across the sector, we see scope for re-gearing of c. 480bp on average. Stocks with the greatest re-gearing capacity include each of the office-focused REITs (IOF, DXS and CPA), as well as GPT. IOF's very significant assumed re-gearing capacity (>10 percentage points) is driven by both a relatively low level of starting gearing, and an assumed gearing tolerance modestly greater than most peers.

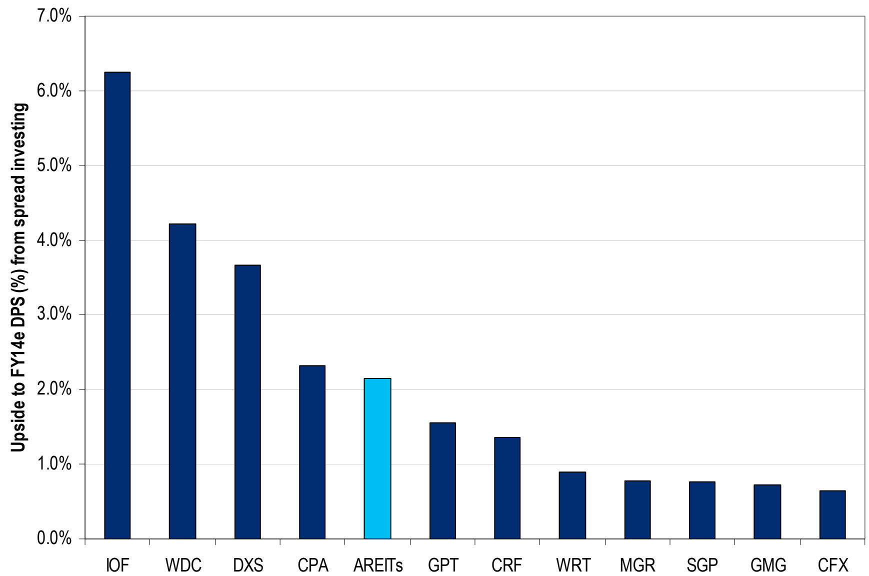
The developers typically have limited re-gearing capacity, as a result of conservative financial management.

Three developers – GMG, SGP and MGR – sit at the opposite end of the spectrum, with very low scope to re-gear based on our assumed gearing tolerance (<300bp). While gearing sits below the sector average for each of these groups (all are in the low to mid 20s), we believe each has adopted a relatively conservative approach in setting its gearing policy range, likely driven in part by their more active business models. For a more detailed discussion of the differences in REIT business models (as well as the trade-off between operating risk and financial risk), please see The City View 5 - Any port in a storm: How defensive are REITs today?, dated 8 Aug 2011.

As we have highlighted above, some REITs will benefit from a given level of re-gearing/spread investing to a much greater extent than others. We summarise the combined effects of these two elements (in essence, combining Figure 13 and Figure 14) in Figure 15 below.

The office landlords and WDC have the greatest scope to lift DPS through accretive acquisitions.

Figure 15. Upside to FY14e DPS (%) from spread investing



Source: dataCentral, Company data, Citi Research

On our estimates, the REIT sector could generate dividend upside of c. 2.2% through accretive acquisitions. This is somewhat lower than we had originally anticipated, particularly given the major "cross-over" between cap rates and funding costs highlighted in Figure 11 and Figure 12. We attribute this to (1) the fact that we have also incorporated transaction costs and the cost of managing assets in our estimates, and (2) relatively modest re-gearing assumptions (with sector gearing of c. 31% in our upside case).

Greater upside could be generated:

- Through investing in higher-yielding assets (either higher-yielding asset classes, such as industrial, or higher-yielding properties within the same asset class).
- If management teams and investors were willing to accept higher gearing levels.
- By investing in an asset with no meaningful transaction costs and no incremental management costs: a REIT's own shares (ie, further buyback activity). The sector's EPS yield of c. 7% still exceeds the post-costs yield achievable on acquisitions at each REIT's average cap rate for almost every stock examined in this report. As we highlighted above, development activity may also provide an

attractive investment alternative, although any accretion benefit would take time to be realised.

While our sensitivities focus on the purchase of direct property, buybacks remain EPS accretive for most REITs.

From a stock-specific standpoint, IOF could generate the greatest DPS upside (>6%) via accretive acquisitions. This is driven by a high level of assumed re-gearing, and a moderately higher than average spread, supported by the Fund's market-cap based management fee. Other office landlords DXS and CPA also show greater than average scope to grow DPS through spread investing, mainly through higher assumed re-gearing.

At the other end of the spectrum sit CFX and the developers, GMG, SGP and MGR. While some of the developers would get good "bang for their buck" if they chose to lift gearing somewhat, the impact on earnings and dividends is likely to be constrained by relatively limited scope for re-gearing. A re-assessment of gearing tolerance could improve accretion levels meaningfully, however. In CFX's case, below average re-gearing capacity and a below average investment spread (driven by the lower cap rates on offer for quality retail than for office and industrial assets) combine to limit the potential for upside.

We turn now to examine the scope for REITs to grow DPS over and above their EPS, through lifting payout ratios.

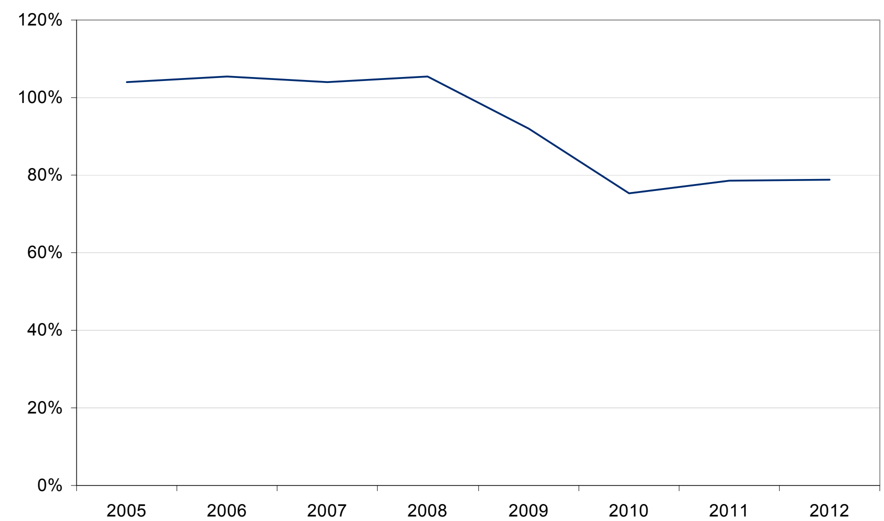
Payout ratio

The third and final lever we examine in this report is payout ratios: lifting DPS for a given level of EPS. We analysed the potential for higher payout ratios as far back as March 2010, in The Dividend Yield Conundrum - Dispelling the A-REIT yield myth, and payouts have in fact increased modestly over that time (see Figure 16). We continue to see scope for some upside to payouts, however.

We have analysed the scope for increased payout ratios in the past – but believe there is room for payouts to rise further.

We depict the trend in sector payout ratios in Figure 16, which shows the sharp decline in payout from 2008-10, with only a moderate increase thereafter, to a c. 80% payout today.[14]

Figure 16. Dividend payout ratio



Source: Citi Research
Note: Payout ratio aggregated based on CRF, CFX, CPA, DXS, GPT, GMG, IOF, MGR, SGP, WDC and WRT

[14] Our payout ratio estimate is admittedly imperfect, being coloured both by changes to the definition of "earnings", and changes to the composition of the sector, in recent years.

The opportunity today

Payout ratios remain well below pre-GFC levels for a combination of reasons. Initially, we believe payout ratio reductions were driven by a desire to re-set payouts to sustainable levels (consistent with sustainable cashflow/AFFO, rather than core earnings), and/or by the need to conserve cashflow during the GFC.

The "cash conservation" rationale for lower payout ratios has weakened significantly.

A sustainable payout level remains a desirable aim, in our view, although for quite some time Australian REITs have had greatly improved access to capital, alleviating the need for cashflow conservation – and potentially arguing for modestly higher payout ratios. More recently, a number of REITs have made what we see as a strategic decision to retain capital to fund development activity. For those REITs with large and active development pipelines, this may limit the desire (if not necessarily the ability) to raise payout ratios.

In the next section we outline our approach to assessing the upside case for REIT payout ratios, and quantify the potential DPS benefits, both stock-by-stock and across the sector.

Quantifying the upside

In determining upside-case payout ratios for each REIT, we use the following approach:

- For passive, predominantly rent-collecting REITs (such as GPT and the office REITs), we typically assume that payout ratios are capped at 100% of sustainable cashflow (AFFO) – ie, less than 100% of earnings.

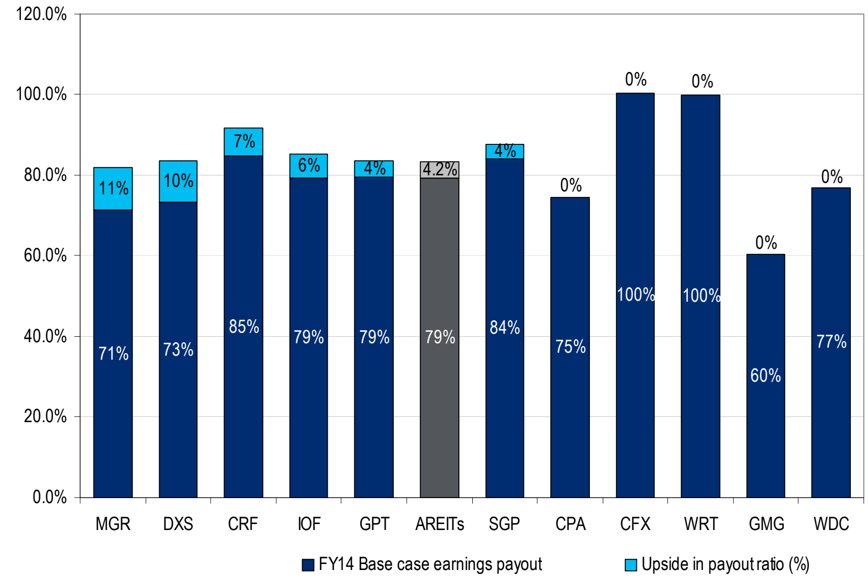
Our starting point is an AFFO-based payout policy, although we allow for stock-by-stock variations.

- For the residential developers, SGP and MGR, we assume that payouts could rise to 100% of AFFO.
- For WRT and CFX, which distribute 100% of earnings, we assume no scope for payout ratio upside.
- For WDC and GMG, we assume little to no upside to payout ratios, based on a desire for cashflow retention.[15]

[15] We note that our prior sensitivities examine the potential for *upside* to earnings. If WDC and GMG's current payout policies are designed to retain a certain quantum of cash, then *additional* earnings should be available to be paid out as dividends. This could allow for a small increase to payout ratios in our upside case.

We show our assumptions in Figure 17:

Figure 17. Base case earnings payout ratio and upside case earnings payout ratio



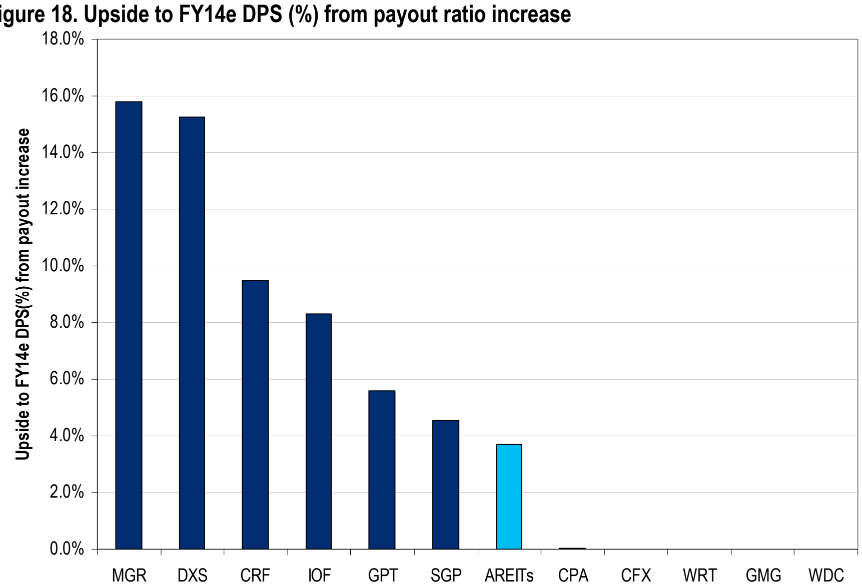
Source: dataCentral, Company data, Citi Research

Even with no contribution from a number of the largest REITs, we see upside of c. 400bp to the sector's payout ratio.

Across the sector, we see average upside of c. 4% to payout ratios. This is spread across sub-sectors, with the greatest upside to payouts for MGR, DXS and CRF. Given the approach outlined above, we do not allow for payouts to rise for WRT, CFX, GMG or WDC. While we see little risk of WRT and CFX exceeding our assumptions on the upside given their elevated payout ratios, we note that any revision to GMG or WDC's policies could boost DPS significantly, given their relatively high levels of retained earnings. On our base case estimates, WDC and GMG are retaining close to $600m combined, over 50% of sector retained earnings.

In Figure 18 we show the upside to DPS from our upside case payout ratio assumptions.

Figure 18. Upside to FY14e DPS (%) from payout ratio increase



Source: dataCentral, Company data, Citi Research

Our analysis suggests that MGR and DXS have the greatest potential to lift payout ratios.

Unsurprisingly, MGR and DXS also show the greatest opportunity for upside on this basis, with double digit DPS increases possible, according to our analysis. IOF, GPT and SGP could see solid increases in DPS in moving to a 100% of AFFO distribution policy.

On our estimates, there is little to no scope for DPS to grow through payout ratio increases for a significant portion of the sector: WDC, GMG, WRT, CFX and CPA. For these REITs, DPS increases are likely to be driven through higher earnings.

Next, we look at the combined impact of the three levers we have examined – debt cost savings, spread investing and payout ratio increases – to assess how much REITs can grow their dividends.

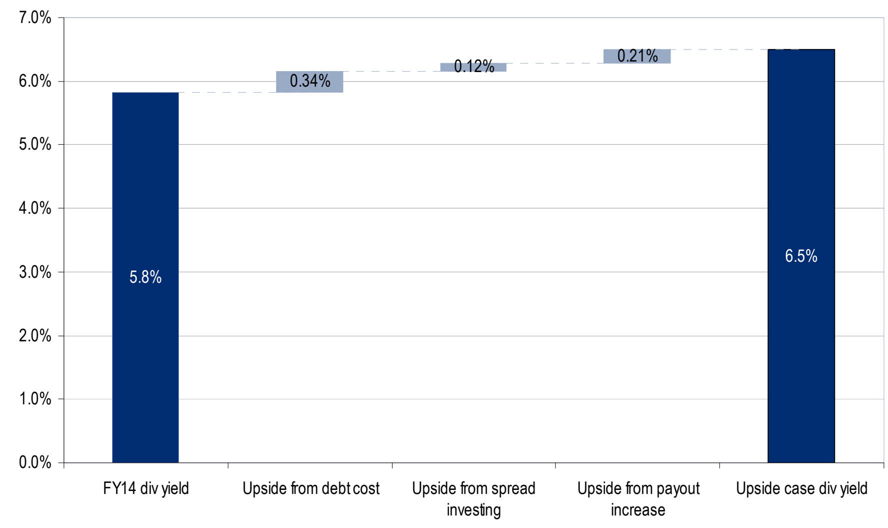
Putting it all together – how much upside is there to REIT yields?

Sector upside

In Figure 19 we summarise our results at a sector level.

Across the three levers, we see upside of c. 70bp (+12%) to REIT yields.

Figure 19. Upside to FY14e dividend yield – REIT sector



Source: dataCentral, Company data, Citi Research

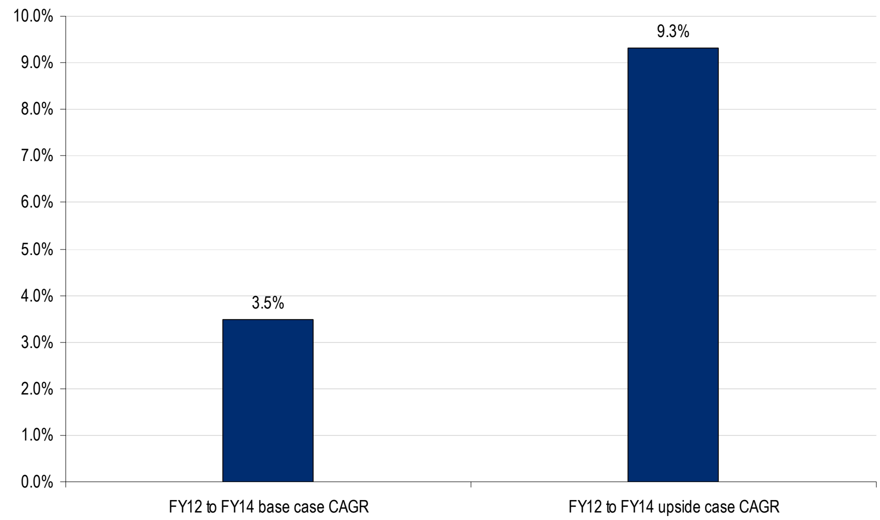
From a base case FY14e dividend yield of 5.8%, our upside scenario suggests upside of c. 12%, to 6.5%. To the extent that this c. 12% upside could be capitalized into REIT share prices, this represents scope for good capital gains for the sector, in addition to a solid running yield. The composition of this upside is reasonably evenly spread across the three levers we have examined, although debt costs contribute the most, and spread investing the least.

In our upside case, REITs' DPS CAGR would improve c. 600bp, from c. 3% to c. 9%.

In Figure 20 we show the impact of our upside scenario on the DPS CAGR for the REIT sector. The three levers we have analysed could improve REITs' DPS CAGR from 3.5% to 9.3%. By comparison, the broader market's DPS CAGR is 7.1%.

We acknowledge that it may not be fair to assess an *upside case* REIT DPS CAGR against the *base case* forecast for the broader market. We would point out, however, that forecasts for the broader market have been subject to repeated downward revisions over the last c. 18 months. This may suggest caution in relying on forecasts of strong DPS growth from the broader market – or it may suggest that the major downgrades have been incorporated, making current market forecasts more robust.

Figure 20. Upside to FY12-14 DPS CAGR – REIT sector

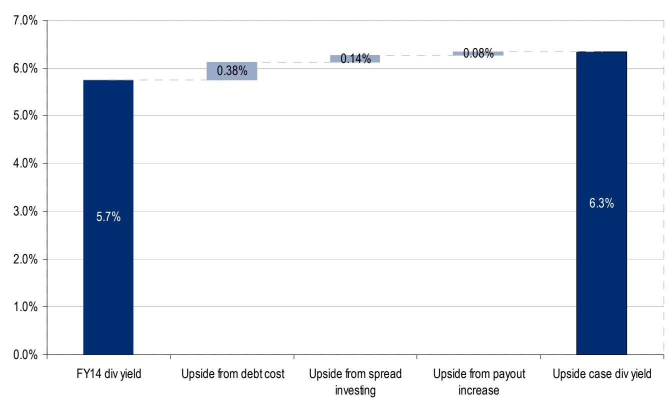


Source: dataCentral, Company data, Citi Research

Sub-sector upside

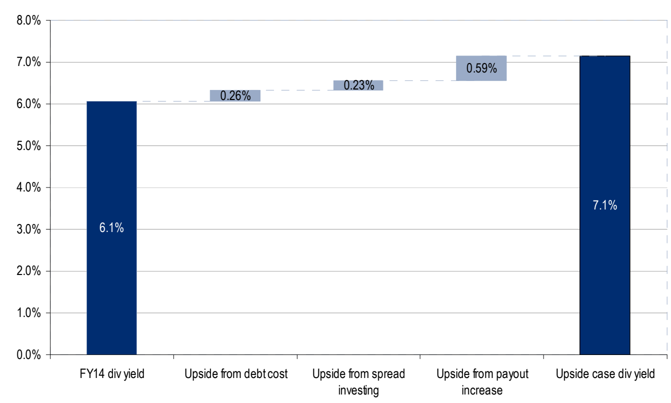
In Figure 21 to Figure 23 we include similar waterfall charts for the retail, office and residential sub-sectors.

Figure 21. Retail (WDC, WRT, GPT, CFX, CRF)



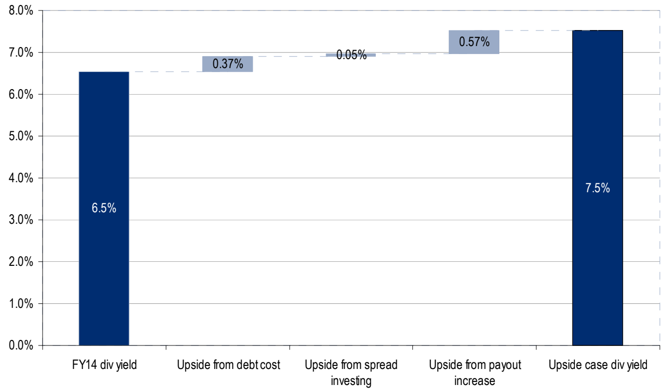
Source: dataCentral, Company data, Citi Research

Figure 22. Office (DXS, CPA, IOF)



Source: dataCentral, Company data, Citi Research

Figure 23. Residential (SGP, MGR)



Source: dataCentral, Company data, Citi Research

We see broadly similar upside for each, but with varying composition:

Debt cost savings are the most likely source of upside for retail REITs.

- For **retail**, we see upside of c. 60bp (5.7% to 6.3%), with the bulk of the benefit generated from potential debt cost savings. Payout ratio benefits are capped by WRT and CFX's already high payout ratios, and our assumption that WDC maintains a payout well below AFFO. WDC also weighs on the absolute level of the sub-sector yield given its scale.

- For **office**, we see upside of c. 100bp (6.1% to 7.1%), with greater benefits from spread investing than for the other asset classes, driven by more significant potential for re-gearing and relatively high asset yields. Payout ratio upside is the largest contributor to our office upside case, however.

Much of the potential upside for office and residential REITs could come from higher payout ratios.

- For **residential**, we see upside of c. 100bp (6.5% to 7.5%), with solid contributions from potential debt cost savings as well as higher payout ratios. Spread investing is unlikely to assist the residential developers without a significant re-assessment of gearing tolerance.

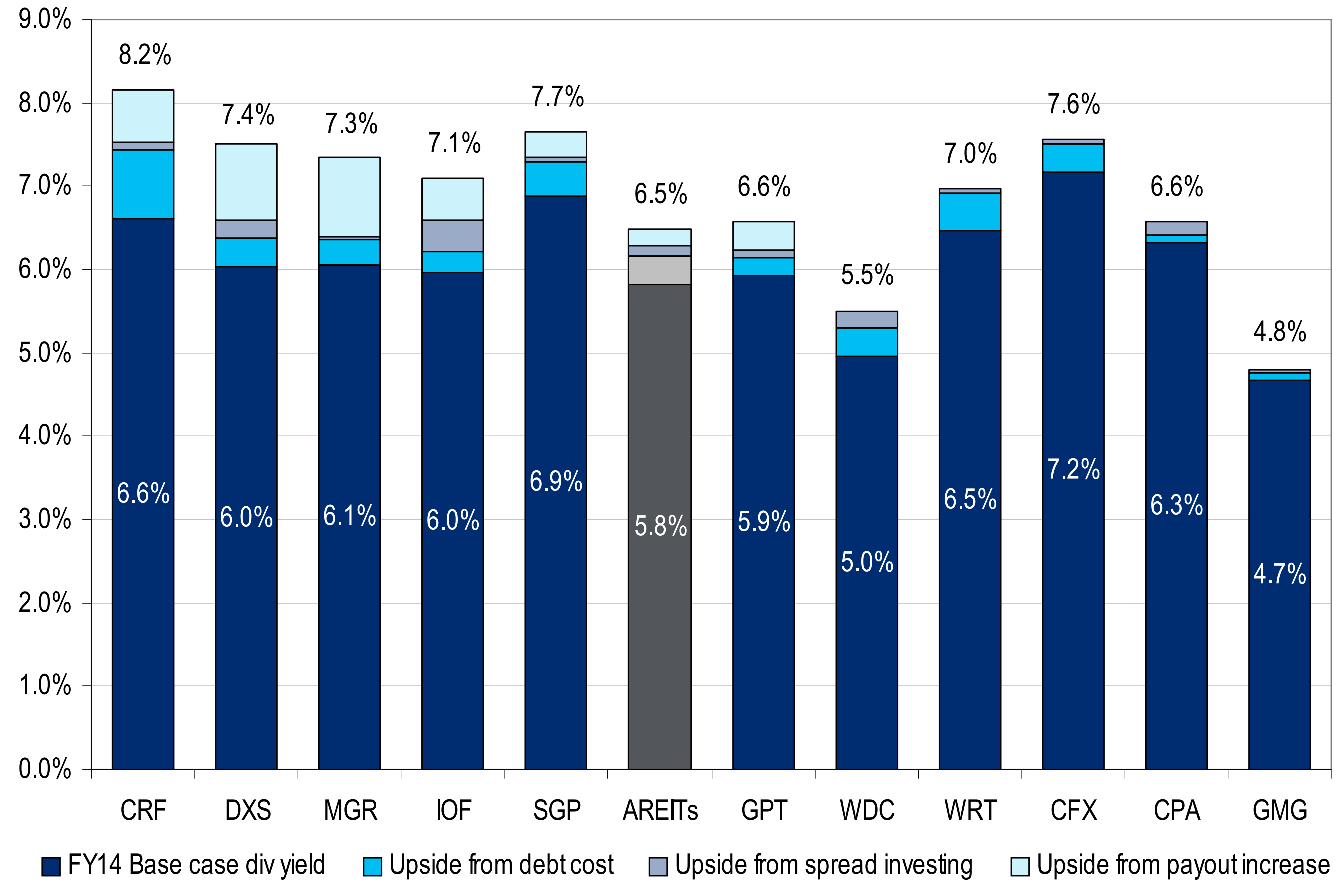
Stock implications: which REITs represent attractive relative value?

With only two large/mid-cap Buys, we attempt to distinguish a multitude of Neutral-rated REITs.

As we highlighted in part one of this report, REIT yields have compressed sharply over the course of 2012, especially relative to the broader market (see Figure 1 and Figure 3). We believe that attractive value is getting harder to find: the sector's rally has led to us downgrading our recommendations (from Buy to Neutral) on REITs comprising c. 70% of sector market cap so far this year. Our two remaining large/mid-cap Buys are Centro Retail Australia and Stockland.

What can be gleaned from our analysis to help distinguish the abundance of Neutral-rated REITs? Which may have scope to grow earnings and dividends to justify a higher valuation/stock price? Figure 24 below shows both our base case and our upside case FY14e dividend yields, including the amount of upside achievable via each lever.

Figure 24. FY14 Dividend yield – base case and upside case



Source: dataCentral, Company data, Citi Research

We provide the following stock-specific comments, highlighting our preferences both within and across sub-sectors where appropriate:

- **WDC:** WDC is currently priced on a relatively firm base case yield of c. 5.0%. This is well below historic levels (see Figure 25), but as we have highlighted above, WDC's payout ratio sits well below 100% given a desire to retain cashflow to fund its more active business model. We estimate potential upside of c. 11% to WDC's DPS, with no shift in payout but solid contributions from both debt cost savings and spread investing benefits. WDC's upside case dividend yield of c. 5.5% is still well below that of most other A-REITs – although we note that the Group likely attracts a less yield-focused investor base than its A-REIT peers, and that WDC's yield may still be attractive against offshore peers.

WDC and GMG trade on firm yields even in our upside scenario, but are not always held for their yield.

- **GMG:** GMG also offers a relatively modest yield of 4.7%, with upside of just c. 3% (an upside yield of 4.8%) based on our analysis. Most of this upside could be generated through debt cost savings, with our assumption of only small re-gearing potential and a low and steady payout limiting gains from the other levers. We note that the Group could likely take a less conservative approach to both gearing levels and payout if it wished to, and that GMG's organic growth prospects are likely superior to most other A-REITs – so the need to grow

EPS/DPS through inorganic means is lower. With this said, after generating a return of c. 60% YTD, the stock is increasingly priced for growth.[16]

- **WRT:** WRT offers an above average base case yield of c. 6.5%, with smaller than average upside, to c. 7.0%. The Trust's high payout ratio precludes any benefit from further payout increases, and its quality portfolio acts to limit the benefits from accretive acquisitions (using our methodology of assuming acquisitions at each REIT's WACR – additional development activity could improve the available spreads significantly, but would take time). WRT is currently priced at historic highs relative to CFX, and looks the less attractive of the two large domestic retail names at current pricing.

CFX offers a stronger yield than WRT under both our base case and upside case.

- **CFX:** CFX offers a universe-high base case yield of 7.2%, with modest upside to 7.6%. CFX faces similar payout and cap rate constraints as WRT, which serves to limit the upside from those levers, but has scope to reduce its debt costs moderately. As mentioned above, CFX is trading at historically cheap levels against WRT and offers a higher yield under both our base case and upside case.

- **GPT:** GPT's yield sits very close to the sector average in both our base case (5.9%) and upside case (6.6%). Given that sector averages are skewed downward by GMG and, especially, WDC, this also means that GPT yields less than most of its A-REIT peers in both scenarios. A smaller than average proportion of GPT's potential yield upside comes from debt cost savings, reflecting the Group's very active approach to lowering its debt costs to date. A moderate spread investing benefit could be improved upon through focusing investments in higher yielding asset classes such as industrial, as seems quite likely. We also note that the Group has been arguably the most successful of the Australian REITs at driving earnings growth through lever-pulling – so GPT may be one of the better candidates to drive growth through inorganic means *not* captured in this analysis. For quite some time the stock has traded expensive relative to most of its closer peers, although strong YTD performance from WDC, WRT and CRF has brought GPT's current valuation much nearer to the retail pack.

CRF continues to look attractively priced on our base case, with large potential upside to DPS.

- **CRF:** CRF offers an above average base case yield (6.6%) with substantial upside to a yield of 8.2% in our upside case, driven by large potential debt cost savings (as we have explored previously) and a potential payout ratio increase. We continue to see CRF as offering strong relative value, both within the retail sub-sector and across the broader REIT sector, and retain our Buy rating.

- **SGP:** SGP offers a strong base case dividend yield of 6.9%, as well as one of the highest upside case dividend yields (7.7%). SGP has the potential for above-average debt cost savings, but quite limited scope for spread investing accretion given a conservative gearing policy. The appointment of a new CEO raises the likelihood of a detailed strategic review – and we believe that any resulting changes (along with swings in residential earnings) may dominate the impact of the levers we examine in this report. With this said, we suspect the risk of strategic changes is skewed towards a somewhat less conservative approach to factors such as gearing and payout ratio – potentially allowing for greater DPS upside. We continue to prefer Buy-rated SGP over residential peer MGR, while

[16] It could be argued that GMG's recently announced operational update and equity raising reinforce the view that (1) the Group is taking a much more conservative financial approach post-GFC, and (2) GMG's organic growth prospects remain strong.

noting that the residential developers offer better yields than the office and retail names in both our base and upside cases.

The resi names offer the best upside case yields, with SGP starting cheap and significant DPS upside possible for MGR.

- **MGR:** MGR offers a mid-range base case dividend yield of 6.1% but as much as 7.3% in our upside scenario – amongst the greatest upside in the sector, on our estimates. We would highlight, however, that this upside hinges on a higher payout ratio to a greater than extent than for any other stock. To the extent that investors look through differences in payout ratios to underlying earnings or sustainable cashflow, this may limit the share price benefit MGR can achieve through driving dividend growth, given that other REITs see greater contributions from factors that lift both EPS *and* DPS. On the other hand, in a yield-focused market, DPS upside may be sufficient to generate further increases in MGR's stock price.

- **DXS:** DXS offers a mid-range base case dividend yield of 6.0% but large upside to a potential yield of 7.4%. Similar to MGR, this incorporates a relatively large contribution from a rising payout ratio, although we also see above average spread investing potential for DXS. This is driven by significant re-gearing capacity and an ample spread between investment yields and costs of funding/managing assets. We also note that DXS has recently traded through its NTA – arguably opening up the possibility of acquisitions being funded via equity (or a combination of debt and equity), rather than debt. Given that gearing already sits below the Group's target range, a combination of debt and equity funding could provide DXS with substantial acquisition capacity. With this said, we note the views of some market participants that DXS' in-place (and recently active – if at somewhat lower prices) buyback program may constrain the Group from issuing equity for some time yet.

CPA is as cheap versus peers as it has been for quite some time, but DXS and IOF offer stronger yields in our upside case.

- **IOF:** Similar to DXS, IOF offers a mid-range base case yield (6.0%) but with good potential upside (to 7.1%). IOF's potential upside is perhaps the most evenly spread across the three levers of any REIT, with below average potential debt cost savings but good scope to lift DPS through accretive acquisitions and a higher payout ratio. We provide further comment on relative pricing within the office sector below.

- **CPA:** CPA offers a 6.3% base case yield, which is higher than most of our universe, following significant share price underperformance this year. We believe CPA is now more attractively priced on a relative basis than it has been for quite some time. We see below average scope for CPA to grow its DPS, however, with an upside yield of 6.6% being mid-range and only a modest improvement on our base case. In light of DXS and IOF's firmer base case yields but stronger upside yields, relative performance within the office sub-sector may hinge on DXS and IOF's ability to realise the potential gains we have estimated (or CPA's ability to surprise us and the market). Given the outsized share price performance typically associated with earnings surprises, we expect DXS and IOF could outperform CPA significantly over the medium term should our upside scenario play out, although *some* upside may already be being priced into DXS and IOF.

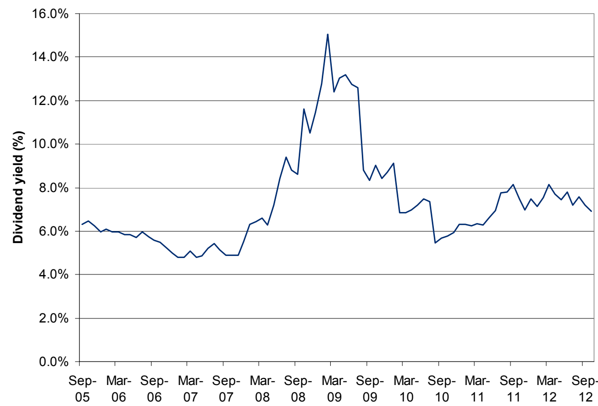
Appendix I

Stock specific historical dividend yields

Figure 25. WDC historic dividend yield

Source: Datastream, Citi Research

Figure 26. SGP historic dividend yield

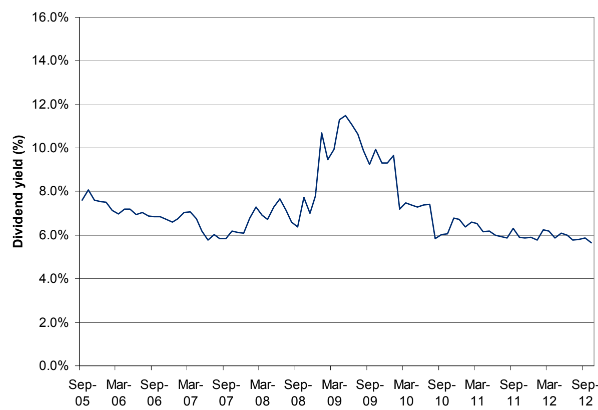


Source: Datastream, Citi Research

Figure 27. CFX historic dividend yield

Source: Datastream, Citi Research

Figure 28. CPA historic dividend yield



Source: Datastream, Citi Research

Figure 29. BWP historic dividend yield

Source: Datastream, Citi Research

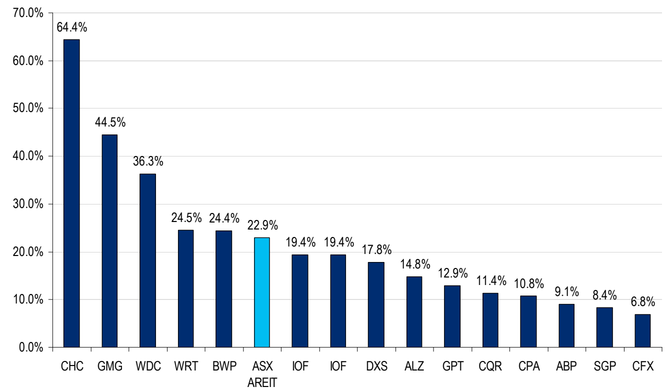
Appendix II

Australian REIT and property sector overview

Share price performance

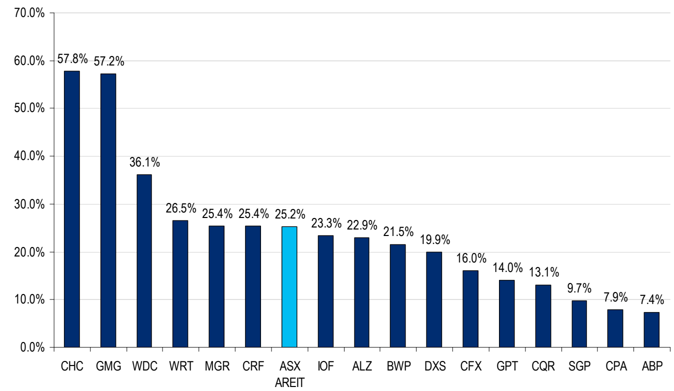
The ASX 200 REIT Index (XPJ) closed at 975.3 pts (on 7th Nov 2012). The index has risen consistently over 2012 with 25.2% year-to-date returns. In Figure 30 and Figure 31 we show the 12-month rolling and YTD share price performance of listed Australian REITs. In Figure 32 and Figure 33 we show the 12-month rolling and YTD share price performance of the XPJ (ASX 200 A-REIT) against Global REITs.

Figure 30. A-REIT performance last 12 months



Source: Datastream, Citi Research. As on 7th Nov 2012

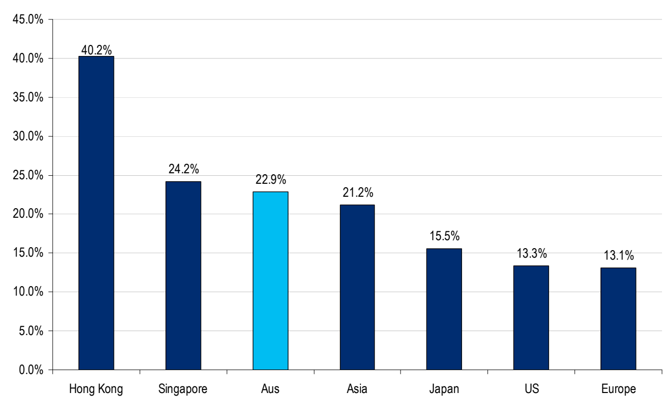
Figure 31. YTD A-REIT performance Jan 12 - current



Source: Datastream, Citi Research. As on 7th Nov 2012

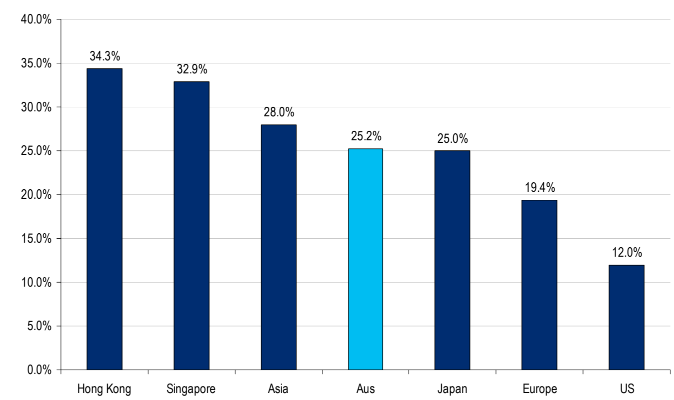
Against global REITs the Australian REIT sector has been one of the better performers on a rolling 12-months basis (Figure 32). Looking at year-to-date returns, most of the countries have performed well globally, with Aus right in between the other countries/regions (see Figure 33 below).

Figure 32. A-REITs last 12 months performance against global REITs



Source: Datastream, Citi Research. As on 7th Nov 2012

Figure 33. A-REITs YTD performance against global REITs



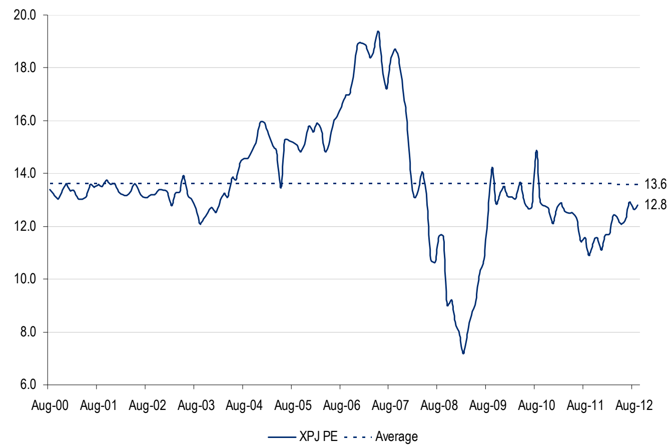
Source: Datastream, Citi Research. As on 7th Nov 2012

A-REIT Sector Valuation

The XPJ is currently trading on a 12.8x FY13 PE which is -6% below its 10 year average of 13.6x (Figure 34). The A-REIT sector is trading at a +4.4% premium against the ASX200 (Figure 35), versus its long run average of -2.5% discount.

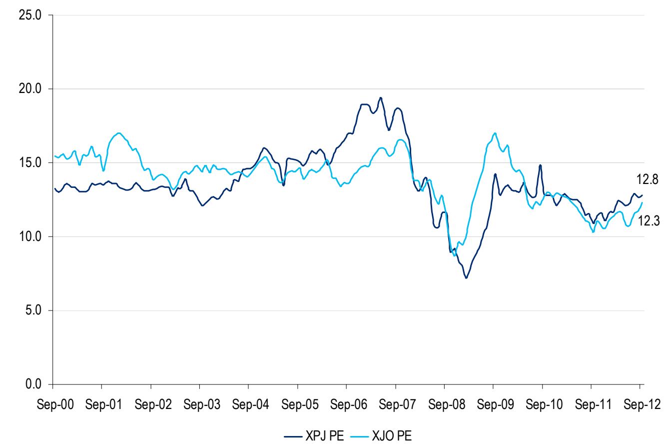
In Figure 36 and Figure 37, we show the PE ratio and Price to NTA of listed Australian REITs.

Figure 34. A-REIT historical PE



Source: IBES, Citi Research. As on 7th Nov 2012

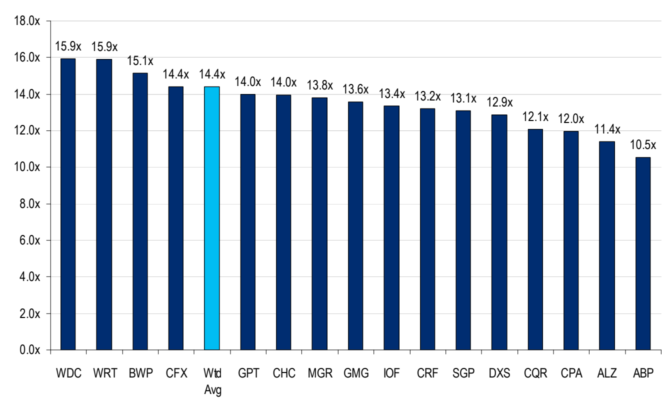
Figure 35. A-REIT PE versus ASX200



Source: IBES, Citi Research. As on 7th Nov 2012

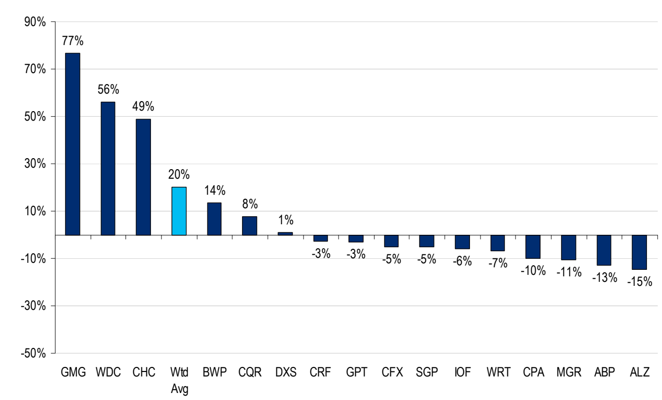
It's worth noting that A-REITs are largely trading at discounts to NTA, barring the active names (GMG, WDC, CHC) and a few small caps (BWP and CQR). However this discount has reduced to a considerable degree, given the rally in the sector during 2012.

Figure 36. A-REIT PE ratio FY2013E



Source: Citi Research. As on 7th Nov 2012

Figure 37. A-REIT price to NTA



Source: Company data, Citi Research. As on 7th Nov 2012

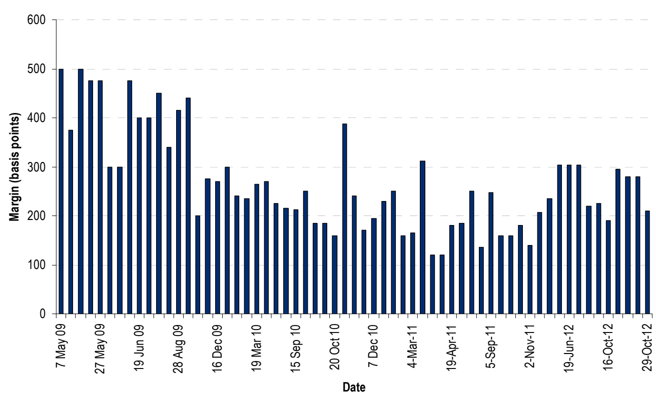
Financial

Debt pricing continues to improve with recent margins for better-rated REITs typically around 200bp (Figure 38) for 3-5 year durations. The yield curve has fallen significantly since the end of 2010 typically for medium term bonds, as such rates fall the most for 3 year and 5 year bonds (Figure 39).

Over the last four-five months, WDC and GPT CDS spreads have seen a fall in values from 240 bp to 140 bp. During the same time, SGP spreads fell by a wider margin, from c.300 bp to 160 bp (Figure 40). CDS spreads for these 3 stocks have reduced by more than half over the last 1 year with SGP seeing the biggest decline (c.350 bp in Oct 11 vs c.160 bp in Oct 12)

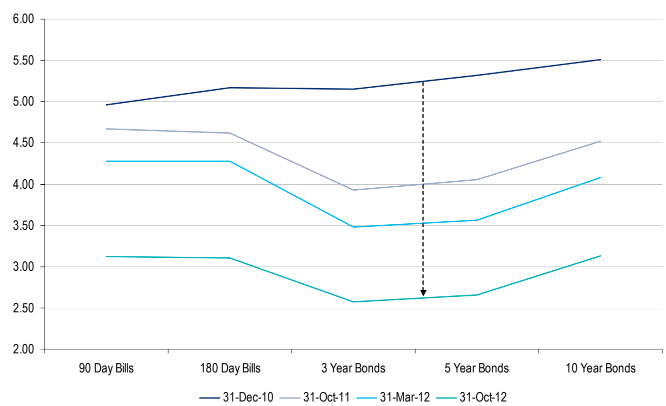
Swap spreads have started falling since April 2012, but are marginally above the stable levels of 2004-2006 (Figure 41).

Figure 38. Actual Australian property debt margins May 09 - current



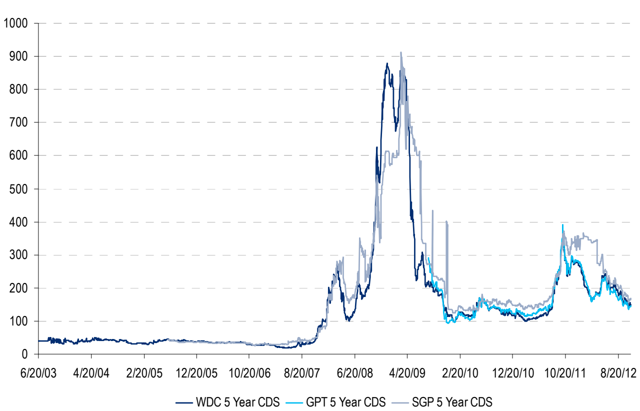
Source: Company data, Citi Research

Figure 39. AUD yield curve



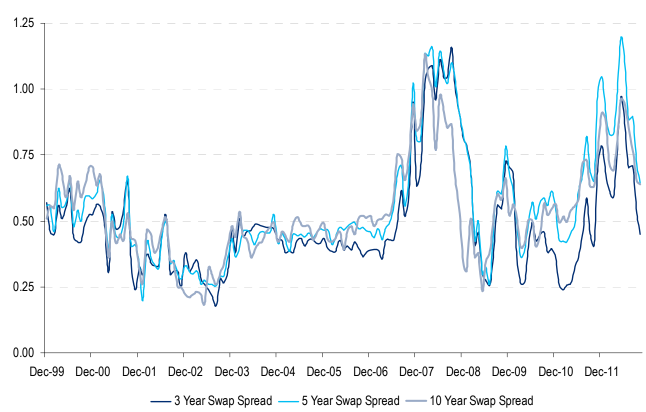
Source: IRESS, Citi Research

Figure 40. WDC, SGP, GPT CDS spreads July 03 - current



Source: Bloomberg, IRESS, Citi Research

Figure 41. 3, 5 and 10 year swap spreads Dec 99 - current



Source: Bloomberg, IRESS, Citi Research

Appendix III

A-REIT comparative valuation

						Prem/	Price Change - AUD					Total Return	Price Change - USD					Total Return		Earnings Per Share									CAGR
Company Name	Ticker	Rating	Target Price	NAV	Price 07-Nov	(Disc) to NAV	Day	Wk	Mnth	QTD	YTD	11	Day	Wk	Mnth	QTD	YTD	11	Div Yld	Est. `12E	Citi vs Cons.	Est. `13E	Citi vs Cons.	Growth `12E	Growth `13E	Multiple `12E	Multiple `13E	2008-2011
			($)	($)	($)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	($/sh)	($/sh)	($/sh)	($/sh)	(%)	(%)	(x)	(x)	(%)
Abacus Property Group	ABP	1	2.25	2.25	2.04	-9.5	0.0	-1.9	1.0	5.2	16.1	-9.8	0.0	-1.4	3.5	5.7	18.3	-9.7	8.2	0.192	0.000	0.193	0.001	-1.2	0.9	10.6	10.5	-35.4
Australand Property Group	ALZ	1	3.23	3.23	2.95	-8.7	0.0	-2.3	-5.1	0.0	27.3	-10.1	0.0	-1.8	-2.8	0.5	29.7	-10.0	7.3	0.245	0.002	0.259	0.004	4.3	5.8	12.1	11.4	-26.4
BWP Trust	BWP	2	1.88	1.88	2.10	11.8	0.5	0.5	1.9	5.5	27.5	6.6	0.5	1.0	4.4	6.1	29.9	6.8	6.6	0.135	0.000	0.139	-0.001	9.2	2.6	15.5	15.1	-0.8
Centro Retail Australia	CRF	1	2.34	2.34	2.15	-8.0	0.0	0.0	-0.5	2.9	29.2		0.0	0.6	2.0	3.4	31.6		6.4	0.092		0.163	0.007		77.1	23.4	13.2	
CFS Retail Property Trust	CFX	2	1.94	1.94	1.97	1.3	0.5	0.5	-0.5	1.8	20.5	3.1	0.5	1.1	1.9	2.4	22.8	3.2	6.9	0.131	0.010	0.136	0.000	2.9	4.2	15.0	14.4	3.1
Charter Hall Group	CHC	2	2.70	2.70	3.17	17.3	1.0	-0.6	10.5	10.1	63.9	-12.7	1.0	-0.1	13.1	10.7	67.0	-12.5	5.9	0.215	0.000	0.227	-0.002	4.3	5.6	14.7	14.0	-24.7
Charter Hall Retail REIT	CQR	2	3.25	3.25	3.64	11.8	0.6	0.3	3.7	6.1	17.8	17.6	0.6	0.8	6.2	6.7	20.1	17.8	7.4	0.288	0.000	0.302	0.004	3.0	4.7	12.6	12.1	-27.3
Commonwealth Property Office Fund	CPA	2	1.03	1.03	1.05	1.5	1.5	-3.2	-1.4	1.0	12.8	21.9	1.5	-2.7	1.0	1.5	14.9	22.0	6.1	0.076	0.001	0.087	0.002	19.5	15.4	13.8	12.0	-12.0
Dexus Property Group	DXS	2	0.98	0.98	1.01	3.1	1.5	2.5	4.1	6.3	24.9	11.0	1.5	3.1	6.7	6.9	27.3	11.2	5.7	0.076	-0.001	0.079	0.002	3.1	2.8	13.2	12.9	-13.2
Goodman Group	GMG	2	3.93	3.93	4.49	14.3	0.2	1.4	4.4	13.4	60.7	-6.5	0.2	1.9	7.0	14.0	63.8	-6.3	4.4	0.307	0.036	0.330	0.004	6.3	7.7	14.6	13.6	-42.2
GPT Group	GPT	2	3.45	3.45	3.54	2.7	1.1	-0.6	0.6	4.1	21.5	10.4	1.1	0.0	3.0	4.7	24.0	10.7	5.5	0.243	0.003	0.253	0.001	8.6	4.1	14.5	14.0	-31.7
Investa Office Fund	IOF	2	2.91	2.91	2.95	1.4	-0.3	-0.7	-0.7	2.1	27.9	15.2	-0.3	-0.1	1.7	2.6	30.3	15.3	5.9	0.201	0.000	0.221	-0.001	1.3	9.7	14.7	13.4	-20.0
Mirvac Group	MGR	2	1.50	1.50	1.49	-0.9	0.3	-1.3	-1.3	3.8	29.6	3.0	0.3	-0.8	1.1	4.4	32.1	3.1	5.8	0.107	0.000	0.107	0.000	1.9	0.1	13.8	13.8	-20.6
Stockland	SGP	1	3.70	3.70	3.49	-5.7	-0.3	0.9	0.0	4.5	13.2	-4.8	-0.3	1.4	2.4	5.1	15.3	-4.6	6.9	0.293	0.000	0.267	-0.004	-7.2	-8.9	11.9	13.1	-10.0
Westfield Group	WDC	2	9.71	9.71	10.60	9.2	-0.3	-0.6	2.5	4.3	42.0	-12.7	-0.3	0.0	5.0	4.9	45.0	-12.6	4.7	0.653	0.011	0.665	-0.010	0.7	1.9	16.2	15.9	-11.4
Westfield Retail Trust	WRT	2	3.15	3.15	3.14	-0.4	-0.3	1.3	3.3	8.7	33.2	0.2	-0.3	1.9	5.8	9.2	36.0	0.3	6.0	0.190	0.001	0.198	0.004	3.2	4.2	16.5	15.9	
Weighted Average						3.6	0.2	0.1	1.6	5.2	31.9	(1.9)	0.2	0.6	4.1	5.8	34.5	(1.8)	5.5					2.4	5.3	14.8	14.0	(14.1)
Simple Average						2.6	0.4	(0.2)	1.4	5.0	29.2	2.2	0.4	0.3	3.9	5.5	31.8	2.3	6.2					4.0	8.6	14.6	13.4	(19.5)

				Adjusted Funds From Operations (AFFO)					EPS Mult Prem		Hist. EPS Multiple			Net Asset Value		Net Tangible Assets				
Company Name	Ticker	TEV/ EBITDA Mult.	Implied Cap Rate	Est. `12E	Grwth `12E	Grwth `13E	Mult. `12E	Mult. `13E	6 Yr. Sector Avg	Current vs. Sector	High	Low	6 Yr. Avg	Spot NAV 4Q'12	Cap Rate	NTA	Prem/ (Disc) to NTA	CAGR 2006-2011	Debt/ GAV	Net Debt/ EBITDA
		(x)	(%)	($/sh)	(%)	(%)	(x)	(x)	(%)	(%)	(x)	(x)	(x)	($/sh)	(%)	($/sh)	(%)	(%)	(%)	(x)
Abacus Property Group	ABP	13.1	8.0	0.179	(1.1)	1.4	11.4	11.3	(3.2)	(21.1)	13.6	9.5	11.6	2.25	8.7	2.34	-12.8	-14.8	40.3	5.9
Australand Property Group	ALZ	11.6	5.9	0.195	21.6	17.1	15.2	12.9	(13.7)	(14.7)	14.6	4.3	10.7	3.23	8.3	3.46	-14.7	-11.4	45.2	4.9
BWP Trust	BWP	14.3	7.3	0.130	9.4	2.6	16.2	15.8	19.8	0.6	17.3	12.7	14.2	1.88	7.9	1.85	13.5	3.5	20.8	2.8
Centro Retail Australia	CRF	12.4	7.8	0.084		77.6	25.7	14.5		(8.9)	0.0	0.0	12.2	2.34	7.9	2.35	-8.5		28.4	3.5
CFS Retail Property Trust	CFX	16.1	6.6	0.124	3.0	4.3	15.9	15.2	26.1	6.4	18.5	13.2	14.9	1.94	6.6	2.07	-5.1	3.7	27.9	4.9
Charter Hall Group	CHC	13.4	4.9	0.215	4.3	5.6	14.7	14.0	15.4	(25.2)	22.0	10.0	13.5	2.70	8.0	2.13	48.8		82.4	0.3
Charter Hall Retail REIT	CQR	13.7	8.1	0.260	2.6	4.8	14.0	13.4	(15.2)	(17.9)	13.9	7.3	10.2	3.25	8.1	3.38	7.7	-17.9	41.9	5.5
Commonwealth Property Office Fund	CPA	14.4	7.9	0.076	29.1	(2.6)	13.7	14.1	19.4	(13.1)	17.9	12.2	13.9	1.03	7.5	1.16	-9.9	-2.2	23.7	3.8
Dexus Property Group	DXS	14.4	7.7	0.068	28.7	(3.6)	14.8	15.3	4.7	(11.4)	16.5	10.3	12.5	0.98	7.5	1.01	0.0	-7.1	26.6	3.8
Goodman Group	GMG	15.3	6.4	0.265	7.5	15.0	16.9	14.7	11.9	(16.9)	19.8	6.0	12.6	3.93	7.0	2.54	76.8	-19.8	33.2	3.5
GPT Group	GPT	14.6	7.1	0.203	6.5	4.1	17.4	16.8	33.8	4.6	21.0	12.6	15.1	3.45	6.8	3.65	-3.0	-21.2	21.5	3.2
Investa Office Fund	IOF	14.3	7.6	0.190	148.4	0.4	15.5	15.4	(1.8)	(8.1)	16.1	8.2	11.9	2.91	7.4	3.16	-6.6	-10.1	21.8	3.3
Mirvac Group	MGR	15.6	7.8	0.089	9.1	(7.3)	16.7	18.0	28.1	(11.2)	24.0	11.6	15.2	1.50	7.7	1.63	-8.9	-12.7	21.5	4.1
Stockland	SGP	16.4	7.5	0.254	(9.0)	(12.6)	13.7	15.7	12.1	(13.7)	17.8	11.0	12.9	3.70	7.9	3.68	-5.2	-3.2	19.0	4.2
Westfield Group	WDC	17.1	6.2	0.562	(1.2)	3.8	18.9	18.2	15.4	19.3	17.6	11.0	14.0	9.71	6.3	6.79	56.1	-11.3	34.2	5.0
Westfield Retail Trust	WRT	14.9	6.3	0.175	3.8	5.1	17.9	17.1		18.9	14.0	13.1	14.3	3.15	6.3	3.37	-6.8		21.7	3.5
Weighted Average		15.2	6.6		7.4	5.0	16.8	16.0							6.8	3.8	19.5	(8.5)	28.0	4.1
Simple Average		14.5	7.1		17.5	7.2	16.2	15.1							7.5	2.8	7.6	(9.6)	31.9	3.9

Valuation Summary	Forward PE Multiples (x)									Historical Premium/Discount						Hist Premium/Dis	
Company	2006	2007	2008	2009	2010	2011	6 Year Average	High	Low	2006	2007	2008	2009	2010	2011	6 Year Average	High
	(x)	(x)	(x)	(x)	(x)	(x)	(x)	(x)	(x)	(%)	(%)	(%)	(%)	(%)	(%)	(%)	(%)
Abacus Property Group	10.9	13.5	13.6	9.5	10.6	12.1	11.7	13.6	9.5	-20.4	-13.1	18.2	-3.8	-17.1	3.1	-5.5	18.2
Australand Property Group	10.2	14.6	4.3	11.6	12.4	9.8	10.5	14.6	4.3	-25.5	-6.0	-62.4	18.2	-2.7	-16.1	-15.8	18.2
BWP Trust	15.3	17.3	12.7	13.4	15.0	13.5	14.5	17.3	12.7	12.1	11.5	10.3	35.6	17.3	15.1	17.0	35.6
Centro Retail Australia								0.0	0.0								
CFS Retail Property Trust	16.5	18.5	14.9	13.2	14.8	13.9	15.3	18.5	13.2	21.0	19.4	29.8	33.6	16.5	18.6	23.1	33.6
Charter Hall Group	13.7	22.0	14.2	13.2	11.6	10.0	14.1	22.0	10.0	0.0	41.7	23.8	33.7	-8.6	-14.4	12.7	41.7
Charter Hall Retail REIT	12.1	13.9	7.3	8.2	9.8	11.1	10.4	13.9	7.3	-11.4	-10.6	-36.8	-16.4	-22.8	-4.9	-17.2	-4.9
Commonwealth Property Office Fund	15.4	17.9	14.6	12.2	14.6	12.4	14.5	17.9	12.2	12.4	15.6	26.6	24.1	14.7	6.1	16.6	26.6
Dexus Property Group	12.9	16.5	14.7	10.3	10.4	11.5	12.7	16.5	10.3	-5.6	6.5	27.5	4.8	-18.5	-1.5	2.2	27.5
Goodman Group	19.1	19.8	16.4	6.0	11.0	11.5	14.0	19.8	6.0	39.4	27.5	42.9	-38.8	-13.7	-1.7	9.3	42.9
GPT Group	21.0	19.4	16.8	14.6	13.1	12.6	16.3	21.0	12.6	53.9	25.3	45.8	48.0	2.9	7.9	30.6	53.9
Investa Office Fund	13.1	16.1	10.7	8.2	11.6	12.7	12.1	16.1	8.2	-4.4	3.7	-6.9	-17.0	-9.1	8.9	-4.1	8.9
Mirvac Group	14.9	24.0	19.7	11.7	12.5	11.6	15.7	24.0	11.6	8.9	54.8	70.9	18.3	-2.1	-0.4	25.1	70.9
Stockland	16.0	17.8	14.0	11.0	11.8	11.6	13.7	17.8	11.0	16.8	14.5	21.4	12.0	-7.6	-0.4	9.4	21.4
Westfield Group	16.1	17.6	11.0	12.9	14.8	12.0	14.1	17.6	11.0	17.6	13.3	-4.5	31.2	16.0	2.4	12.7	31.2
Westfield Retail Trust					14.0	13.1	13.5	14.0	13.1					9.6	12.3		
Weighted Average	13.7	15.5	11.5	9.9	12.7	11.7	12.5	15.5	9.9								
Simple Average	14.8	17.8	13.2	11.1	12.5	12.0	13.6	17.8	11.1								

Source: DataCentral as at 7 November 2012

See footnotes on following page.

Footnotes to comparative valuation and performance table

- **Rating key** — 1=Buy, 2=Neutral, 3=Sell. Risk: H=High
- **Price change** — Percentage price changes: Week is from the last closing price seven days prior, Month is from the last closing price one month prior, QTD is from last trading day of the prior quarter, and YTD is from last trading day of the prior year, to the most recent closing price.
- **Total return** — Stock price change and dividends paid.
- **Dividend yield** — The return on investment for a stock, or the annual dividend income per share received from a company. Dividend yield is calculated by dividing the 12 month forward dividend Citi forecasts, by the most recent share price.
- **Earnings per share (EPS)** — Defined as Reported NPAT adjusted for profit on asset sales, abnormal items and non-cash items including asset revaluations and amortisation, per share.
- **Est ‘12E** — Citi Research's 2012 Core EPS estimates.
- **Est ‘13E** — Citi Research's 2013 Core EPS estimates.
- **Citi vs. cons** — The difference between our EPS estimate and IBES consensus. Positive numbers represent where our estimates are above consensus.
- **Growth '12E** — Percentage change in EPS per share from 2011 to 2012 estimates.
- **Growth '13E** — Percentage change in EPS per share from 2012 estimates to 2013 estimates.
- **Multiple '12E** — The valuation ratio of the current share price divided by 2012 estimated EPS per share.
- **Multiple '13E** — The valuation ratio of the current share price divided by 2013 estimated EPS per share.
- **TEV/EBITDA mult** — The valuation ratio that eliminates a company's financing decisions. The multiple is calculated using total market capitalization plus debt less cash (Total Enterprise Value) divided by earnings before interest, tax, depreciation and amortization (EBITDA) plus associates income for the next forecast financial year.
- **Implied cap rate** — Measures the cap rate or yield on the rental real estate owned by using the next forecast financial year’s net operating income divided by the current TEV. Non-rental income assets are valued separately and the TEis reduced by our estimate for non-income producing assets to arrive at an implied cap rate.
- **Prem (Disc.) to NAV** — The premium or discount of the current share price to our estimate of Net Asset Value per share using our spot cap rate estimate of current market conditions. Spot cap rate is the cap rate at which real estate is currently trading.

- **Adjusted funds from operations (AFFO)** — EPS (defined above) adjusted for straight lining of rents, leasing capex, leasing commission, maintenance capex and net capitalised interest after tax (for developers).
- **EPS mult prem 6 yr. avg** — The 6 year average of the premium or discount forward EPS multiple to the sector weighted average forward EPS multiple from 2006-2011 inclusive.
- **EPS mult prem current vs. sector** — The premium or discount of the current forward EPS multiple for a stock to the sector weighted average forward EPS multiple.
- **Historical EPS multiples** — Calculated using year-end stock prices and full year EPS estimates for the following year. The average, high, and low multiples for the past 6 years are shown**.**
- **Net asset value (NAV)** — Our estimate of the private market value of the company's real estate net of liabilities on a per share basis. We use the current spot cap rate for the net operating income to derive NAV. NAV is calculated using our 12 month forward NOI estimates.
- **NAV cap rate** — The rate used to estimate the value of a company's net assets by using 12 month forward NOI estimates.
- **NAV CAGR** — The compounded annual growth rate in NAV per share over a specified time period.
- **Net tangible assets** — The value of Total Assets of the company less intangibles and total liabilities per share.
- **NTA cap rate** — The current stated cap rate of the company.
- **Debt/GAV** — The measure of a company's leverage and is the ratio of Total Debt including Minority Interests to Total Assets.
- **Net debt / EBITDA** — The ratio of total net debt to EBITDA incl associates produced by the business.
- **Fixed coverage** — The ratio indicating the ability to satisfy financing costs and is calculated as follows: EBITDAInclAssociates/[Interest Expense + Capitalized Interest].
- **Float** — The market value based on the current share price of all common shares outstanding, but does not include equity operating partnership units.
- **Total market capitalization** — The market value based on the current share price of all common shares as of the date of this report.
- **Forward PE multiple** — Calculated using year-end stock prices and full year EPS estimates for the following year. The average, high, and low multiples for the past 6 years are shown.
- **Historical premium/discount** — The premium or discount of the forward EPS multiple for a stock to the sector weighted average forward EPS multiple.
- **Hist premium/discount 6 year average** — The average of the Forward PE Multiples Historical Premium/Discount from 2006-2011 inclusive.

Previous Research

2012 Citi Australian Investment & Asian G10 Rates Conference (23 Oct 2012)

We conducted a Residential property panel discussion at our 2012 Australian Investment Conference, discussing the state of the markets, the impact of rate cuts and the outlook for house prices in a 2 to 5 year timeframe.

Link to full note

Pan Asia: Citi Focus List – Analysts' Key Buy Ideas (29 Oct 2012)

Stockland (SGP.AX) was highlighted as one of the top 30 strongest Buy ideas for the next 12 months, across Pan-Asia region.

Link to full note

Westfield Retail Trust (WRT.AX) - Downgrade to Neutral on strong performance (31 Jul 2012)

In this report, we downgraded WRT to Neutral and highlighted that WRT had been one of the strongest performers in the Australian REIT sector. The Trust's performance since its FY11 results were released in February 2012 has been particularly strong: +30%, ahead of all other A-REITs (sector +17%) and the broader market (+2%). WRT's rally has reduced the scope for near-term upside.

Link to full note

Centro Retail Australia (CRF.AX) - Upgrade to Buy, Catalysts for Upside Coming to Fruition (28 May 2012)

In this report, we outlined our updated view on CRF, which was much more positive than at the time of our initiation report (28 Feb 2012). Since that time, CRF had (1) reached a better-than-expected conditional settlement of class action proceedings, (2) announced meaningful asset sales at a premium to book value, while retaining management rights, and (3) underperformed its retail REIT peers by more than 500bp, returning 1.7% vs 6.9%.

Link to full note

CFS Retail Property Trust (CFX.AX) - Downgrade to Neutral, Buyback Having Mixed Effects? (26 Apr 2012)

In this report, we highlighted that CFX was one of the best performers YTD during that time and thus the valuation appeared less attractive. We also noted that EPS was down due to the sale of interest in Myer Centre and that the accretion from buyback was very minimal (if any).

Link to full note

The City View – AREITs Issue 9 - Will buybacks drive continued REIT outperformance? (16 Apr 2012)

REITs outperforming: buyback thematic a major contributor? – REITs have outperformed the broader market by >900bp since 2010. Buybacks have been a major theme in the sector, and a potential driver of this outperformance. Seven of the top 11 REITs have announced buybacks, representing a total of >5% of sector market cap.

Link to full note

Appendix A-1

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