AURORA FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

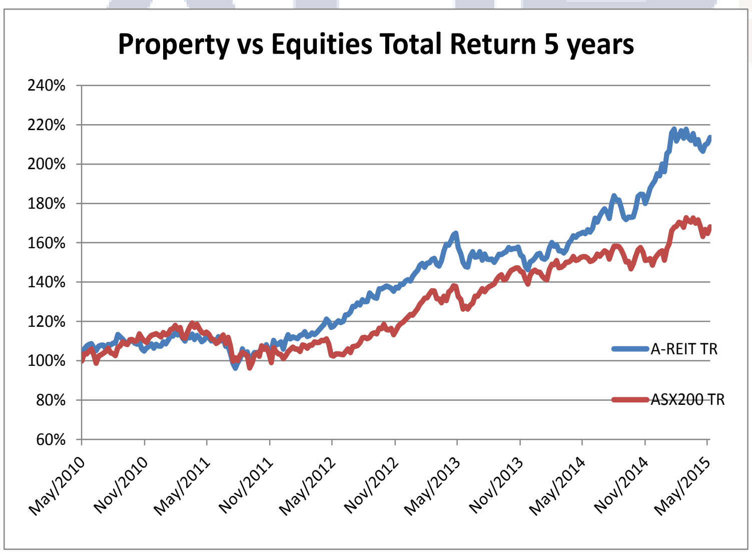
By Hugh Dive 12th May 2015

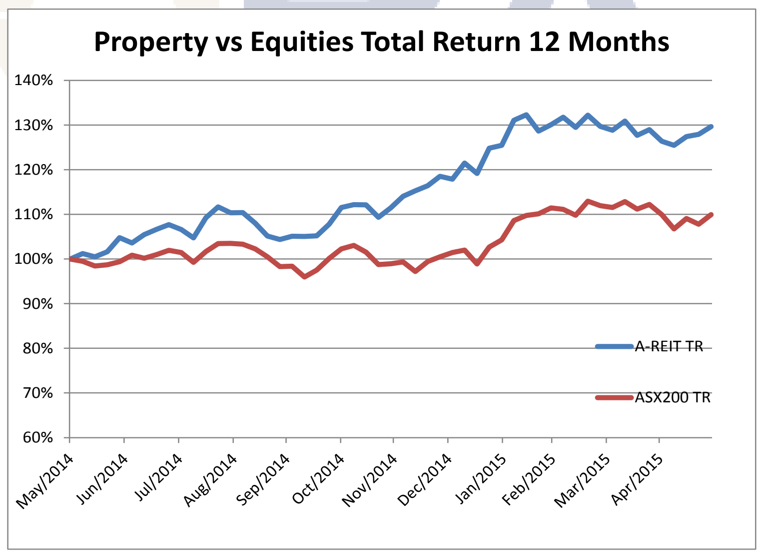
What's going on in Listed Property?

Over the last twelve months, listed property has been one of the top performing sectors on the ASX 200. Whilst Australian other sectors in the equity market have faced concerns about a rising and then falling AUD, falling commodity prices, Eurozone issues and bank capital raisings in the wake of Basel III; listed property has seemingly sailed under the radar and the index has posted a total return of +23% over the past 12 months bettering the overall equity market by 17%! In this note we will look at what is going on in listed property together with our positioning in the Aurora Property Buy-Write Income Trust (AUP) in the various property sectors.

What's driving performance?

The charts below illustrate the one and five year performance of LPTs vs equities. After tracking Australian equities throughout 2010 to 2013, listed property has outperformed equities over the past 2 years. The key catalysts that pushed the sector higher were under-valuation, trust reducing interest costs by refinancing high cost GFC-era debt, extensive buy-backs below net tangible assets (NTA) and high relative yields. Additionally the effects of quantitative easing have kept interest rates low and buoyed the interest in Australian commercial property. The excess liquidity has opened up property earnings yield differentials between Europe (3.2%), US (3.3%), Asia (2.8%) and Australia (5.0%) and has boosted the valuations of Australian property trusts.





Recent Activity in the Listed Property Sector

Over the last year the listed property sector has been largely untouched by macro concerns mentioned above. The falling AUD boosts Westfield Corporation's offshore earnings and decreases the attractiveness of global internet shopping while the falling oil price and declining mortgage rates has translated into an increase in domestic retail spending at shopping malls. Further the last 12 months has been a banner year for corporate activity (and has allowed property bankers at the investment to acquire upgrade their Porsches and Ferraris to the 2014 models) with the Westfield demerger, Colonial Retail Trust management internalisation, new property trust IPOs and the $12 billion Novion merger with Federation Centre's.

Furthermore foreign buyers continued to be especially active in the Australian property market, purchasing nearly $5B worth of commercial property or about 40% of the value of properties that were sold. This interest is primarily confined to the office market in Sydney and Melbourne, with little foreign buying of retail and industrial property. According to the RBA the main source of this buying has been foreign developers and investors with a spike in sovereign wealth fund investment.

Around the Grounds

Retail (63% of LPT Index)

Discretionary retail continues to face the challenges of digital competition to bricks and mortar, reduced tenant margins due to increased price transparency, and rents increasing faster than sales. Retail malls will not become redundant, but will continue to evolve as they have in the past. Though the fall in the AUD over the last six months has reduced the growth in international online sales. Potential moves to impose GST on larger foreign online purchases could further reduce international online sales growth. Occupancy across the retail sector remains strong at 99% and the trusts have reported improving retail sales aided by a decline in petrol prices, greater inbound tourism courtesy of a falling AUD and the impact of falling mortgage rates on disposable income.

Non-Discretionary Retail continues to outperform the large retail shopping malls as spending on staples (food and liquor) remains stronger than on discretionary items. Whilst this doesn't involve owning assets like glitzy shopping malls with lots of fashionable retailers, we prefer the more stable returns from consumer staples. In February Shopping Centres reported +12% earnings growth; similarly Charter Hall Retail reported earnings growth of 8% ahead of the average for retail landlords.

Office (16% of LPT Index)

Office trusts continue to have to deal with anemic white-collar employment growth and the rise of "hot-desking" which is reducing the space requirements per person in new buildings/ refurbishments. Overall the Australian CBD office market continues to look weak (11% vacancy and 20-30% incentives being given to new tenants), but the market has ignored this and focused on corporate activity and rising asset values. In this weak CBD office market the larger trusts appear to have some advantages. Currently the major office LPTs had vacancy of just 5%, compared to the most recent 11% CBD office vacancy rate from the Property Council of Australia (PCA). This reflects the higher average asset quality and lesser exposure to the weaker Brisbane (15.6% vacancy) and Perth (14.8%) markets for the major listed office trusts. Nevertheless a positive factor influencing the office market has been the conversion of office buildings into residential developments including Aurora's very own 1 Alfred Street, which was sold to China's giant Dalian Wanda Group to be developed into high-end apartments for $425 million. Aside from office trust bolstering profits, office to residential conversions such as this cause a tightening in the market for office space.

Residential (4% of LPT Index)

Whilst the residential market in Sydney and Melbourne has been very strong the major residential developers Mirvac and Stockland have underperformed the index by ~19% over the last 12 months. This is primarily due to stock specific issues, the market views that Stockland is acquisitive and may overpay for assets at the top of the cycle and Mirvac's 2015 performing substantially below market expectations. Additionally the residential developers face the potential for the RBA to use macro-prudential regulation being used to control property lending to investors.

Industrial (17% of LPT Index)

Whilst the industrial sector has enjoyed cap rate compression that has led to higher asset prices, this space could be tougher in the future as increased supply hits the market (+500,000 m² in Brisbane and Melbourne, +700,000 m² in Sydney under development). The industrial trusts as well as the office trusts are generating profits from re-zoning industrial property to residential. In November Goodman sold an industrial park in Erskineville for $350M to Hong Kong's Golden Horse Group. The site has the potential for about 1765 residential dwellings. The profits coming from re-zoning industrial property to residential should bolster industrial trust earnings. In 1H 2015 over $1billion of industrial property has been sold to residential developers.

Aurora's View

The Property Trust sector as a whole appears to be trading at a premium to fair value. We see that catalysts that propelled the sector up over the last three years have largely been played out and the majority of returns over the next 12 months will come from distributions and income from writing call options over existing holdings. The sector currently trades at a +32% premium to net tangible assets (excluding Westfield Corporation), 16.2x forward PE and 5.0% yield. Our portfolio strategy of populating the portfolio with higher quality domestic rent collectors combined with a derivative overlay strategy to enhance income should outperform in this market. Further, the focus on trusts that are delivering recurring yield should result in a higher distribution yield and lower earnings volatility for investors.

Income Enhancement

The trust seeks to generate additional income through writing call options over existing positions (at around 80% of the portfolio). The trust adjusts the level at which calls are written based on its outlook for the sector. Increased recent market volatility and our outlook for the sector have resulted in income receipts over the past quarter that has been above the long term average. The trust also purchases protection through put options, which is currently trading at fair value and below long term averages. This resulted in the trust receiving a net premium income of 2.9% (against a long term average net premium receipt of 1.4%). The trust historically outperforms the Property Trust sector in flat and declining markets due to this strategy.

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Aurora Funds Management Limited is a fully owned subsidiary of ASX listed, Keybridge Capital (ASX Code: KBC). Aurora is a boutique investment manager that was established in 2003, and has established a long track record of producing risk adjusted returns for retail, institutional and high net worth investors. The investment strategies are offered through both ASX listed investment vehicles and managed funds. They aim to deliver income whilst also managing the risks associated in investing in Australian and global equities.

Aurora is the issuer of the:

- **Aurora Dividend Income Trust (Managed Fund) (ASX code: AOD)**
- **Aurora Absolute Return Fund (ASX code: ABW)**
- **Aurora Fortitude Absolute Return Fund**
- **Aurora Global Income Trust (ASX code: AIB)**
- **Aurora Property Buy-Write Income Trust (ASX code: AUP)**

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