Australian Unity A-REIT Fund

Fund Update
30 June 2022

The Fund invests in a portfolio of select Australian Real Estate Investment Trusts (A-REITs), aiming to deliver a total return, consisting of income and capital growth, above the S&P/ASX300 A-REIT Accumulation Index over the medium to long term.

Performance as at 30 June 2022

	3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	7 yrs % p.a.	10 yrs % p.a.	Since inception % p.a.
Distribution return	3.37	6.11	6.21	12.15	12.20	12.28	12.10
Growth return	(18.51)	(16.92)	(8.06)	(8.59)	(7.22)	(3.28)	(2.21)
Total return	(15.14)	(10.81)	(1.85)	3.56	4.98	9.00	9.89
S&P/ASX300 A-REIT Accumulation Index	(17.49)	(11.22)	(1.95)	4.96	5.94	9.50	10.39

Inception date for performance calculations is 31 July 2011.
Returns are calculated after fees and expenses and assume the reinvestment of distributions. Past performance is not a reliable indicator of future performance.

How the listed property market performed

The end of the 2022 financial year has coincided with a changing global and local economic and political environment. In what proved to be a busy month for market commentators, May 2022 saw a change in Federal Leadership with the Australian Labor Party elected, while the Reserve Bank of Australia (RBA) began increasing interest rates (i.e. the Cash Rate). Concerns over escalating inflation levels and rising cost of living pressures are being experienced in many global markets, while geo-political pressures remain with the ongoing Russian-Ukraine conflict; and COVID-19 constrained goods production in China continuing to hamper global supply chains. As a result, the June 2022 quarter has seen increased volatility across financial markets, sensitive to economic changes as stakeholders adjust to a post COVID-19 financial environment.

As the direct implications of the COVID-19 pandemic subside, the Australian economy continues to perform well with GDP growth of 0.8% over the March 2022 quarter, meaning the economy is now 4.5 percent larger than it was in Q4 2019 (KPMG, June 2022). A historically low unemployment rate, 3.9% in May 2022, together with reduced underemployment has resulted in significant tightness in the labour market, driving an acceleration in wages growth. However, despite such labour supply restrictions, the Australian Bureau of Statistics (ABS) reported that year on year wage growth to March 2022 was 3.4%, below the current inflation levels. Albeit the national minimum wage level increased by 5.2% in July 2022. Continued supply restrictions and a post COVID surge in demand for goods saw rising costs passed on to consumers who are also now facing increasing mortgage repayment levels, surging energy costs and rising fuel costs as the Government stimulus simultaneously rolls off. While 'household savings' levels remain healthy, consumer demand is forecast to subside as increasing costs of living are absorbed, which may serve to dampen economic growth expectations going forward. Inflation is currently forecast to peak at 7% (KPMG, June 2022) with NAB anticipating GDP to grow by 2.7% over 2022 (previously 3.4%) and a below-trend of 1.8% in 2023 (previously 2.1%).

Following rate increases in both May and June, July 2022 saw the RBA increase the cash rate by a further 50bps to 1.35%; its highest level since 2019. The decision was taken to combat rising inflation levels as the country winds back COVID-19 related stimulus following resilient economic performance. While current headline inflation levels in Australia are c.5.1% (March 2022), substantially above the RBA's target range of 2%-3%; it does remain below levels currently being experienced by other western economies. As such, the RBA's somewhat hawkish approach to these initial rate rises would appear to reflect a desire to address the position sooner rather than later. Arguably, it's somewhat ironic given its sluggishness to commence rising rates in comparison to the stance taken by other central banks globally. The attention is now on where the cash rate is forecast to end up. In its July 2022 statement, the RBA Board noted that they expect to take further steps to raise rates over the coming months, with decisions and timing to be guided by their assessment on the outlook for inflation and the labour market.

Preliminary data from Jones Lang LaSalle (JLL) noted positive net absorption (i.e., where take up of accommodation is higher than office space becoming vacant) in three of the six capital city markets for the June 2022 quarter. Negative absorption was noted in both Melbourne CBD and Sydney CBD markets despite Property

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Council of Australia (PCA) data continuing to demonstrate increasing office attendance in their May 2022 data. Consolidation of space from larger corporates together with an increase in backfill space from occupiers moving to recently completed developments was noted as a contributing factor to the increase of vacancy rates in these markets. Effective rental growth was largely unchanged for the quarter with some minor positive movement recorded in prime rental levels in Sydney and Brisbane. Prime incentive levels were broadly stable across all markets, albeit they remain elevated with totals ranging across the six major CBD markets from c.24% to c.49% in Canberra and Perth respectively. Despite the uncertainty regarding the future of office use, recent CBRE research notes that since 2021, nearly three quarters of office CBD relocations have resulted in the same or higher market rents. This reinforces the 'flight to quality' narrative as occupiers choose to prioritise their workplace location, design and environmental credentials in order to attract and retain talent in the current, highly competitive staff retention setting. Despite rising bond rates, office property yield levels across the major CBD markets were effectively unchanged within JLL's latest data.

The Industrial property sector has continued to perform well over the quarter with over $1.8 billion in sales transactions recorded. While below the record levels achieved in 2021, this still sits substantially above the 10-year average of $1.16 billion Industrial assets per quarter. JLL data highlight modest yield compression with the national industrial prime midpoint yield at 3.80% for the quarter. Industrial occupier demand remains strong nevertheless activity levels are being hampered by a lack of available stock. In a July 2022 report, CBRE reported that the national vacancy rate in the Industrial property market is currently 0.8%, one of the tightest vacancy rates globally. As a result, competitive tension for accommodation is driving significant rental growth in the sector with Melbourne's West, North and South East precincts reporting average rental growth for the quarter of 7.3% (JLL). Despite some major completions, supply response continues to be constrained by rising construction costs and supply chain delays impacting feasibilities. As such, rental growth in the sector is forecast to continue in the short term with short lease duration industrial properties favoured by investors seeking to capitalise on the strength of the industrial rental market.

Australian retail sales climbed to record high levels in May 2022, the fifth month in a row of a positive month on month sales growth. JLL reports that retail leasing demand over the quarter has been muted with most of the activity from these tenants looking to take advantage of current market uncertainty. This is to expand store footprints as well as retail service tenants (hairdressers, opticians etc) who have seen uptick in patronage as COVID-19 concerns become less prevalent in consumers' minds. Rental growth for the quarter has been largely flat across most categories, however CBD rents remain under pressure with Sydney, recording further falls. Essential spend shopping centres continue to be highly preferred by investors this quarter. Of which, SCA Property Group purchased a portfolio of 5 neighbourhood centres from Centuria for $180 million reflecting a fully let yield of 6.0%. Retail property yield levels have remained largely stable this quarter with JLL recording some softening (25 bps) across some of the slightly larger shopping centres in Sydney and Melbourne.

The pressures of rising inflation and further interest rate hikes are anticipated to continue in the short term, as both businesses and consumers deal with escalating costs. From a property perspective the higher inflationary and interest rate environment is likely to impact individual assets and sectors to varying degrees going forward. It is worth noting most commercial real estate leases provide for annual contractual rent escalations, either indexed to inflation or a fixed amount, acting as a partial hedge against inflation. Some sectors such as industrial property are currently benefiting from strong underlying rental conditions while essential spend shopping centres, hospitals and childcare assets continue to be highly prized by investors. In addition, Australia is regarded as a highly desirable destination by global real estate investors. Overall, properties with strong underlying cash flow profiles and owned in investment structures with conservative debt and interest rate profiles are best positioned to weather any future market uncertainty.

For the quarter ending 30 June 2022, the Australian listed property sector, as measured by the S&P/ASX 300 A-REIT Accumulation Index (A-REIT Index), returned negative 17.5% underperforming the broader equities market as measured by the S&P/ASX 300 Accumulation Index which returned negative 12.2%, as listed markets reacted to the changing economic back drop. Over the year to 30 June 2022, A-REITs returned negative 11.2% compared to the broader market return of negative 6.8%.

Despite recording a negative return over the quarter, Retail property focused A-REITs were the most resilient stocks, achieving a positive 3.2% return over the year. Alternative sectors such as Healthcare / Childcare (ASX: ARF) and Self-Storage (ASX: NSR) also performed positively over the last 12 months but like all sectors, A-REITs returns have been impacted. During the June quarter, Office A-REITs were down negative 16.0% over the quarter, followed by Diversified A-REITs which fell negative 19.9% while Industrial stocks (heavily influenced by global developer and fund manager, Goodman Group - GMG) were down negative 21.6%. The best performing property stocks for the quarter were Investec (IAP) and BWP Trust (BWP) returning positive 2.0% and negative 1.2% respectively. The laggards for the period were fund managers, Centuria Capital (CNI) returning a negative 35.3% return and Home Consortium (HMC) which returned negative 34.6% for the quarter, continuing the prior falls of several fund manager focused stock falls within the A-REIT Index.

Attention is now focussed on how well individual A-REITS are positioned to perform in the current rising inflation, interest rate and bond yield environment. Despite such challenges, June asset valuations across the sector have continued to demonstrate uplifts, albeit to more moderate levels than were seen earlier in the year. Alternative sectors led the way with National Storage (NSR) property valuations up c.9.2% from December 2021, while Arena REIT (ARF) recorded a 7.8% uplift in asset valuations from over the same period; assisted by a high percentage of inflation linked leases and compression in the portfolio weighted average capitalisation rate to 4.91% from 5.14%. Other valuation announcements include Centuria Office Fund (COF) up 0.4%, Vicinity (VCX) up 1.7% and Centuria Industrial Fund (CIF), up 1.3%.

The A-REIT sector is trading at around -15.8% discount to last stated Net Tangible Assets (NTA) which excludes Charter Hall Group, Centuria Capital Group, HomeCo (HMC Capital) and Goodman Group as these have a large portion of non-rental earnings/assets (i.e. development and funds management businesses) and their market pricing can deviate substantially from NTA backing. Rising and volatile bond yields are creating uncertainty for the sector, with the 10-year bond yield level closing for June 2022 at 3.67% despite peaking at 4.21% earlier in the month. This is impacting pricing stability for A-REIT stocks which is likely to continue until there is some stabilisation in long bond yield levels, as bond yields can be used to assess relative value between asset classes. Gearing across the sector (S&P/ASX 300 A-REIT Accumulation Index) is currently a manageable c.24%, with most individual stocks operating within target rages. In general, balance sheets are in good shape and more conservative than they were when compared to pre-GFC as an example, with A-REITs exhibiting relatively lower gearing levels and longer debt expiry profiles than when they entered the GFC.

The cost of debt across the A-REIT market has trended downwards over the last 24 months, as A-REITs took advantage of the pandemic induced low interest rate environment. Going forward, A-REIT stock earnings are likely to be impacted to different degrees as the cost of borrowing is now increasing. The impact to A-REITs earnings can be mitigated where interest rate hedges (most A-REITs are well hedged into 2023 with hedges beginning to taper off from 2024 and beyond) are in place and where increased rental returns can offset the negative impact of additional interest payments. This impact of earnings will not however be uniform across the market. Landlords benefiting from tenancy agreements, including annual rental review provisions, which are pegged to rapidly increasing inflation levels, as well as those able to enact market rent reviews in strongly performing occupier markets (e.g. Industrial), will be better positioned to weather any earnings challenges.

Outlook

In general terms, returns over the past few years have been strongly influenced by substantial property yield compression and a low interest rate environment. Listed market volatility is likely to continue in the short term, while returns moving forward are likely to be increasingly guided by underlying property fundamentals.

Top 10 A-REIT holdings

Stock	Portfolio %
Scentre Group Limited	9.72
Stockland	8.46
Vicinity Centres	7.46
Dexus	7.20
GPT Group	5.78
Mirvac Group	5.51
Goodman Group	4.83
Centuria Industrial REIT	4.31
Shopping Centres Australasia Property Group RE Ltd.	3.21
Growthpoint Properties Australia	3.17

Asset Allocation

Asset class	Portfolio %
Listed Property	97.64
Cash	2.36