Where to find reliable returns in a volatile commercial property market

Recent months have tested the nerve of Australia's commercial property investors, with **inflation, rising rates, recession concerns** and a **turbulent construction environment** weighing on investor sentiment.

In the three months to 30 June alone, **listed property assets fell a staggering 15.3 per cent** in the face of rising real yields, ending the FY2022 financial year with negative year-on-year returns of 8.9 per cent. A-REITs were not the only asset class affected by headwinds; the same financial year saw fixed income returns fall 15.9 per cent, global equities fall 11.7 per cent, and Australian equities fall 5.7 per cent.

15.9% decrease	11.7% decrease	5.7% decrease
Fixed income returns (FY2022)	**Global** equities (FY2022)	**Australian** equities (FY2022)

Looking at the key drivers of cooling market sentiment, the FY2023 financial year is unlikely to bring relief. Europe's economy stands on the brink of recession and US economic growth is slowing. Here in Australia, household budgets are strained and building materials have continued to skyrocket, threatening the balance sheets of many residential builders. In a matter of months, the RBA has introduced numerous rate rises, **lifting the cash rate to 2.35 per cent from 0.10 per cent.**

For investors seeking regular income from commercial property assets, navigating these current volatile conditions can seem daunting. The good news is however, that attractive income opportunities still exist across the market with an investment strategy that focuses on diversification, risk management and importantly, exposure to resilient assets.

As Head of Property Research and Fund Manager of Australian Unity's Property Income Fund, I am pleased to share three segments of Australia's commercial property market that may offer respite to investors through this current period of volatility and uncertainty.

Industrial and alternative direct property sectors offering investors a line of defense

While public markets have been hit by sell-off activity in recent months, the same can't be said for direct property. In the past 12-months to 30 June, direct property assets have delivered steady total returns of 10.4 per cent, with growth across the office, retail and industrial sub-sectors.

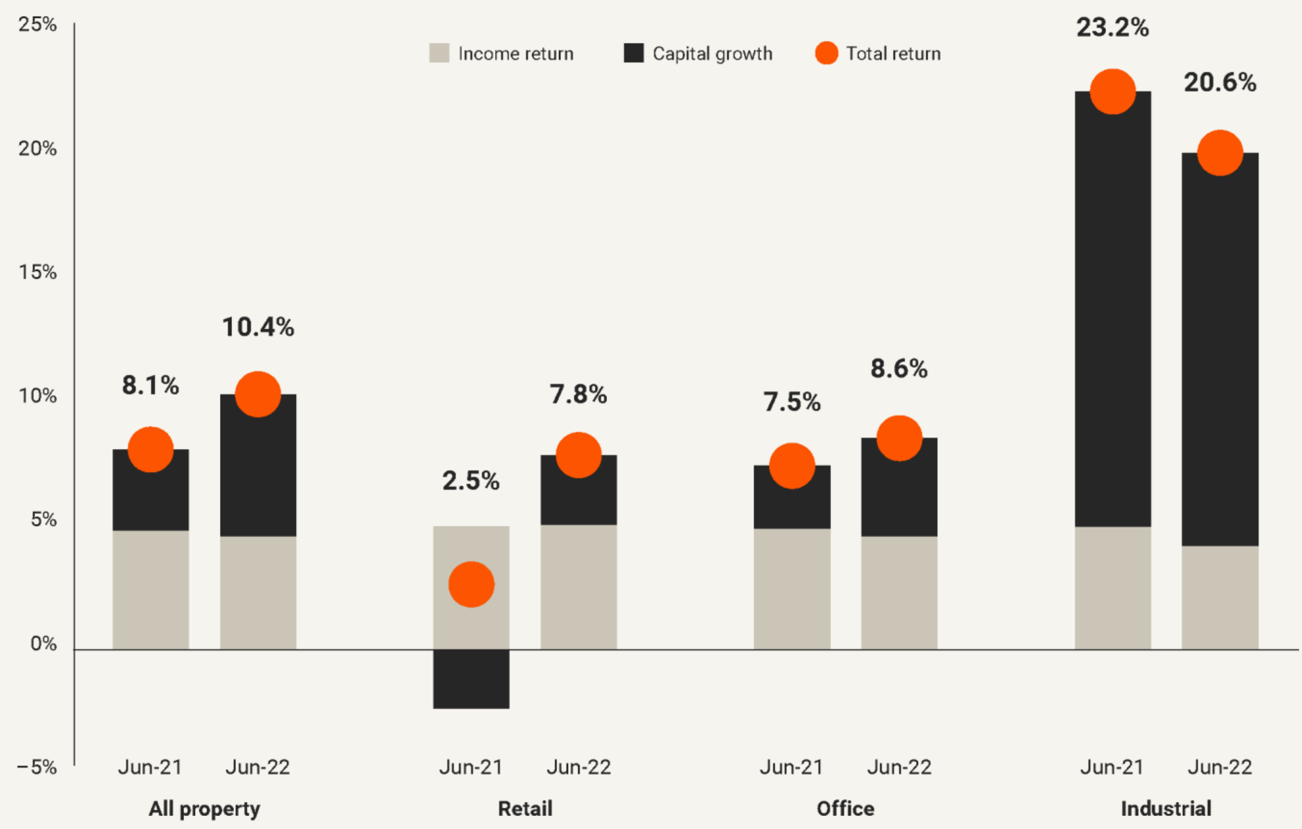
Investor confidence has been highest in the industrial and logistics sector, with growth returns of 16 per cent and total returns of 20.6 per cent. Industrial and logistics assets, which include warehouses and factories, proved their sturdiness during the COVID-19 pandemic, supporting a booming e-commerce industry and operating continuously and at low vacancy rates during forced lockdown periods. Looking ahead, the supply and demand outlook for these assets appears favourable, with rents anticipated to continue rising ahead of inflation while new supply is quickly absorbed.

Alternative sectors such as healthcare, social infrastructure, specialist disability accommodation and childcare have also proven to offer investors dependable returns through periods of volatility. These assets are typically backed by long leases with tenants engrained in the community, and/or offering a social benefit. In the case of specialist disability accommodation, rental income is supported via the Federal Government backed NDIS, while Childcare is co-funded via the Federal Government, providing investors with a degree of comfort against uncertainty.

10.4% total returns
Direct property assets

20.6% total returns
Industrial and logistics sector

Income & capital return for direct property (12 months to Jun 2021 and Jun 2022)
Source: MSCI, Zenith PFA & PCA Property Investment Factsheet 2Q22



Unlisted property funds outperforming other asset classes

While investors have found resilient returns in industrial, logistics and alternative sectors, they should also consider how different property asset classes are positioned in the year ahead. There is merit in considering the latest data with the highest commercial property returns delivered by unlisted property funds.

As an asset class, unlisted property delivered total 12-month returns of 17.7 per cent in financial year 2022, outperforming direct and listed property, Australian and global equities, fixed income and cash returns. Importantly, this outperformance stacks up over a five-year period, with unlisted property producing a five-year annualised return of 16.6 per cent.

Past performance is never a guarantee of future performance, and likewise, unlisted property is not immune from changes in property market fundamentals. However, we have seen quality unlisted funds prove their resilience through periods of uncertainty, as a result of active management, diversification and investment in niche alternative property sectors. Although unlisted funds' lower liquidity has drawbacks compared with A-REITs, it also means investors are less impacted from frenzied panic-selling. Take the Covid years as an example, where A-REITs fell 50 per cent over the space of four weeks in early 2020, to then stage a miraculous comeback by the end of 2021. Unlisted funds, by comparison, saw much greater stability through this period.

17.7% total returns
Unlisted property in FY2022 over a 12-month period

16.6% annualised return
Unlisted property over a five-year period

Detailed Investment Type Comparison
Source: MSCI, Zenith PFA & PCA Property Investment Factsheet 2Q22

Date 12 months to	**Unlisted Property** PCA / MSCI Unlisted Retail Property Fund Index	**Listed Property** MSCI Australia Core REIT Index	**Australian Equities** MSCI Australia 200 Index	**Global Equities** MSCI World ex Australia Index	**Fixed Income** J.P. Morgan, Government Bond Index Australia	**Cash** Australian Banks' Term Deposits average rate
Jun–18	18.5%	9.7%	12.9%	11.9%	4.0%	2.0%
Jun–19	13.5%	14.9%	11.9%	5.9%	16.1%	1.9%
Jun–20	14.7%	–26.3%	–8.7%	3.1%	5.5%	1.0%
Jun–21	18.3%	28.4%	28.8%	39.2%	–3.6%	0.3%
Jun–22	17.7%	–8.9%	–5.7%	–11.7%	–15.9%	0.2%
5 year annualised	**16.6%**	**1.7%**	**7.0%**	**8.5%**	**0.6%**	**1.1%**
Standard deviation	**6.2%**	**24.0%**	**18.3%**	**19.6%**	**8.3%**	**0.4%**

Look for a diversified portfolio structure with a focus on quality assets and conservative direct debt levels

The pressures of rising inflation and further interest rate increases are anticipated to continue in the short term, as both businesses and consumers deal with escalating costs. From a commercial property perspective, the higher inflationary and interest rate environment is likely to impact individual assets and sectors to varying degrees going forward.

For commercial property investors, bear in mind that most commercial real estate leases provide for annual contractual rent escalations, either indexed to inflation or a fixed amount, that will act as a partial hedge against inflation. Some sectors including industrial property are now benefiting from strong underlying rental conditions while others, such as essential spend shopping centres, hospitals and childcare assets, continue to be highly prized by investors. Ultimately, properties with strong underlying cash flow profiles, and those that are owned in investment structures with conservative debt and interest rate profiles are better positioned to weather future market uncertainty.

Australian Unity's Property Income Fund was established more than 20 years ago, providing investors with diversified and comprehensive commercial property exposure by investing across listed, unlisted and direct property markets. Through our $360 million diversified property portfolio we offer investors a regular monthly distribution while providing access to a host of office, retail, industrial and alternative sectors such as healthcare and a mix of social infrastructure property investments. Importantly the Fund itself doesn't borrow in its own capacity to invest. Our directly owned properties are unencumbered and look through gearing is conservative and a manageable ~18 per cent.

Through this well-diversified and actively managed portfolio, our Property Income Fund is well-positioned to provide regular income to investors.

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