Winning Long term by not losing Capital

Given the stark divergence in performance between AREITs, we will discuss the overarching **Themes** driving the AREIT sector at this late-stage of the cycle and then go through three key examples, highlighting how such themes have driven the pricing of certain AREITs.

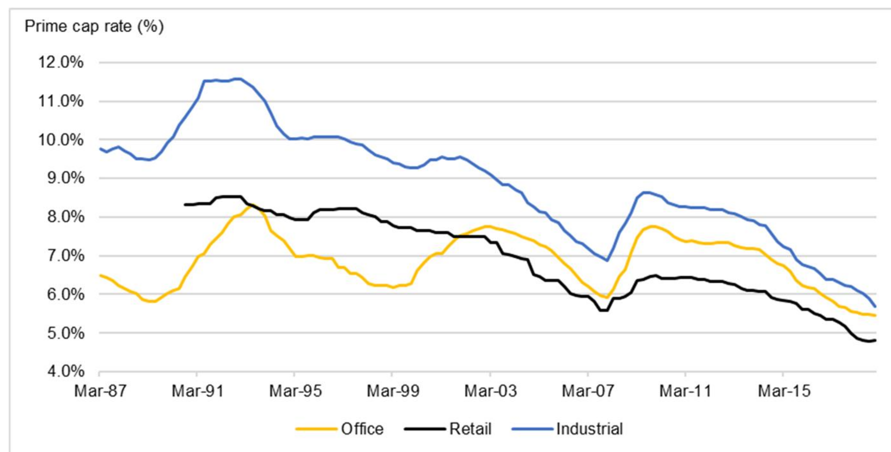
Themes

Low Historical Interest Rates…

We note that the continuation (globally) of a historically low Interest Rate environment is skewing the fundamentals, leading to pockets of rising valuations past all-time peak levels (especially on a Cap Rate basis). Hurdle rates of return demanded by some investors have subsequently reduced, diminishing a margin of safety one should ordinarily and prudently proceed with. On face value within Property, this is via **Industrial** and **Office** exposure, versus **Retail** and **Residential**.

Leads to Low Historical Capitalisation Rates/Yields

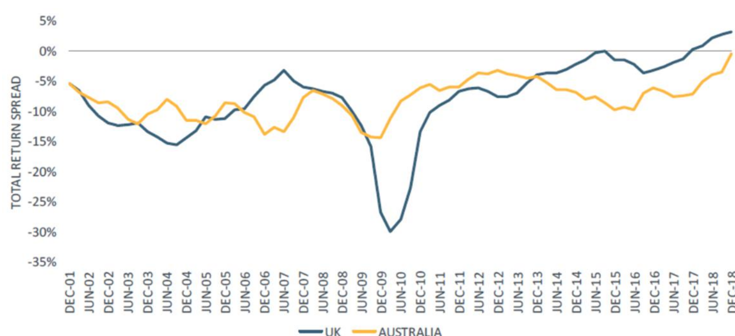
This has subsequently manifested itself over the cycle via a reduction in the spread in Cap Rates/Yields between different asset classes (as illustrated in the following chart from Macquarie).



Within the respective Property sub-sectors, the margin between Secondary and Prime assets has reduced, with their only now being evidence of an emerging divergence in Retail between Prime and Secondary-Grade assets. This will invariably flow through to Industrial and Office.

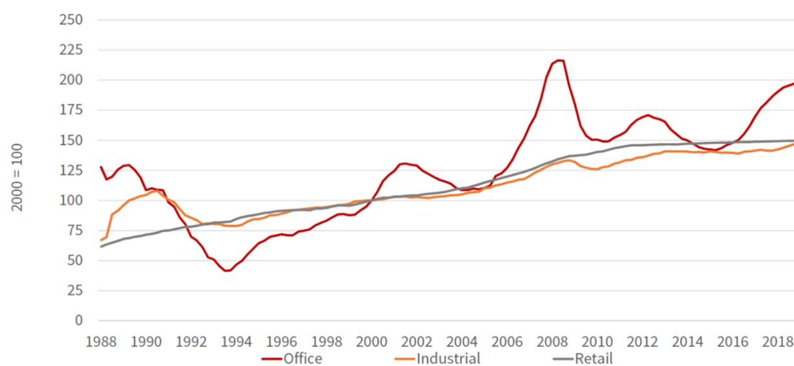
E-Commerce and the Evolution of Retail

Some Investors are seeking Industrial exposure over Retail, given a view of Online Retail superseding Physical Retail. This thematic has prevailed to such an extent that Bottom-Quartile Industrial Property is Outperforming Top-Quartile Retail Property in the UK, with Australia on the verge of demonstrating the same phenomenon. (This is demonstrated in the following chart). Such an outcome is unprecedented and unwarranted in our view.



Source: MSCI

Over the long-run, Retail produces a far more stable Income Stream than Office and Industrial (to a lesser extent). The following chart demonstrates the Rental growth achieved over the last 30-years.



Source: JLL

(Please note, Office is Net Effective (i.e. Incorporating Incentives) whilst Retail and Industrial is Face Rents (noting Retail and Industrial Incentives are traditionally materially lower than Office).

Flow of Capital

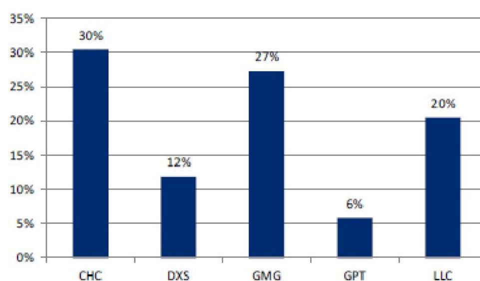
There is presently an abundance of Institutional Capital (especially from Offshore) seeking Australian Property exposure. This Capital is not only playing the Online Retail thematic (seeking Industrial) but also views Australia more generally as a more transparent and growingly liquid market, in which to invest in.

Global/Institutional Capital has traditionally focussed on Australian Office and Industrial assets. Retail historically had been considered too hard to gain meaningful exposure too, to generate a scale to warrant an investment (especially for the Regional/Destinational Centres, which trade by appointment, such as **Chadstone** and **Bondi Junction**). The Online Retail thematic has exacerbated this trend.

AREITs with Funds Management operations catering to this Institutional Capital have been the chief beneficiaries. This has been via Acquiring Assets and/or Developing Product, with the AREIT deriving Management, Performance and Transactional Fees for the service, along with direct exposure to the asset(s).

The flow of capital, coupled with the Compression in Cap Rates (lifting Valuations) have significantly increased such AREITs Assets Under Management ("AUM") and hence, via the lift in Fees derived in the process. Above Average Multiples are being applied by certain Investor cohorts to such a Fee stream, not truly reflecting the volatile and cyclical nature of such earnings streams in our view. Such beneficiaries of

this include: **Charter Hall Group**, **Dexus Property Group**, **GPT Group**, **Lend Lease** and **Goodman Group**. The following chart signifies the respective growth in AUM over the past 12-months.



Source: Citi

Lower Quality Earnings

To maintain the high growth rate and justify the Premiums/High Multiples on which these names presently trade on, the quality of the earnings derived has deteriorated and is forecast to do so (over the near-t-medium-term). On our metrics, **25% of the AREIT sectors composition is now derived from Non-Rental Income Streams**. This is set to be further exacerbated from two Groups who already generate a majority of their earnings from Non-Rental Income streams:

- **Charter Hall Group**: Recognising Performance Fees prior to being earned, in order to smooth its Earnings/Distribution profile; and
- **Goodman Group**: Ramping-up their Development Pipeline to build Industrial product globally. This is being done on lower Yields, requiring more Debt and hence, keeping Distributions flat.
- **This is aside from having half of their Long-Term Incentives not accounted for in the Profit and Loss Statement. Therefore artificially and materially inflating the Earnings of the Group and hence, the Valuation Premium on which it trades by over 15%.**

The Equity Market Volatility of late-2018, saw the capital in the markets seek more Defensive/Safe Haven sectors. AREITs have been a chief beneficiary of this but this has predominantly been into those AREITs delivering the aforementioned lower-quality, higher growth earnings. Value names based on sound metrics have been shunned, due largely to fears of a Retail "Apocalypse" across the board and the softening conditions of the Residential market.

Comparisons illustrating the thematic discrepancies

Global Industrial v. Global Retail

Stock		SGH position	Distribution yield	Price to NTA	FFO Multiple	Gearing
GMG	Goodman Group*	Nil Holding	2.3%	153.5%	25.0x	18.9%
URW	Unibail Rodamco Westfield**	Top 5 Holding	7.6%	-29.8%	12.0x	44.0%

*Goodman Group adjusted for Employee Security Payments Multiple is ~30x.
**URW is the Headstock equivalent in €.

Goodman Group ("GMG") - High EPS Growth, driven by Thematics, Overstated Earnings and Asset Price Appreciation

Goodman upgraded their earnings guidance from 8% to 9.5% for FY19. The primary factors for the upgrade were:

- Material Cap Rate compression, which tightened from 5.7% to 5.2% (on pcp). This is a very low Cap Rate reflective of the late-stage of the cycle, driving FUM growth;
- "Super Normal" Development returns; and
- Higher Performance Fee recognition.

The Cap Rate firming is equivalent to a 9.6% uplift. This is similar to their reported Operating EPS Growth of 9.4% (i.e. Firming Cap Rates drive FUM, Development Margins and Performance Fees). Tighter Cap Rates also saw the NTA rise from $4.64 per security to $5.05 per security.

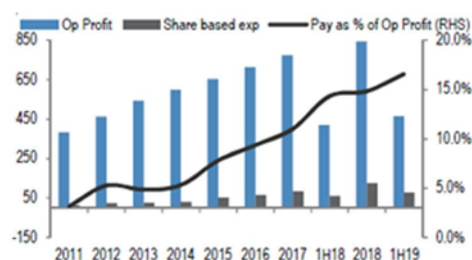
Goodman has increased their planned "Work in Production" from ~$3.6 billion to ~$4 billion over the medium-term. This has resulted in them planning to Gear-Up (currently ~19% on a Look-Through basis (ex-Intangibles)) and maintaining their Dividend at 30 cents per security over the medium-term, reducing their Pay-Out Ratio from 60% to 50%.

Goodman's Income Statement for 1H19 comprised the following:

Property Investment	$181.8 m
Management	$189.4 m
Development	$273.3 m
Operating Expenses	($129.0) m
Operating EBITDA	$515.5 m

Of note from the Income Statement:

- Property Investment Income represents **<u>less than 30% of Group Income or 35% of EBITDA</u>**. This delivered Net Property Income Growth of 3.2%;
- The Development Profit is more lumpy and cyclical and should translate to a much lower Multiple than what the market is presently willing to ascribe;
- While Performance Fees can extend for a longer time frame in Property Funds Management due to embedded Profit, they are highly cyclical and uncertain over the long-term. Importantly, new Fund Initiatives will find it very hard for Goodman to achieve Performance Fees on current hurdles and market pricing. When the cycle turns, Performance Fees will come under pressure and the income will therefore fall. In addition, the Multiple should contract; and
- The headline Earnings growth (9.4%) is not what it appears. The treatment of **<u>half of the Group's Long-Term Incentives (LTI's) being taken below-the-line</u>** (i.e.: NOT Incorporated in the Profit and Loss Statement) continues, with it growing at ~30% on pcp. Hence, growing far quicker than the Inflated Earnings figure. It comprises a growing portion of Operating Profit (16.6%) as illustrated below. Treating this above-the-line (as is Industry practice) **<u>reduces EPS Growth from 9.4% to 6.7%</u>**. (Source: JP Morgan).



At the end of February at its close price of $12.80, Goodman is trading on a **FFO multiple of 25x, <u>or closer to 30x Adjusted for the aforementioned LTI's above the Line</u>**.

We find this Multiple for a Property Group staggering, with high cyclical risk, as well as the Corporate Governance concerns. Management have also had a strike against their Remuneration Policy and Performance Rights at last year's AGM (having previously received a strike in 2016). This makes the 2019 meeting crucial in attempting to avoid a second-strike.

We also note post the result that the CEO has sold $5 million of securities, whilst a direct report to has sold $8.3 million of securities.

Unibail Rodamco Westfield ("URW") - Quality Group in a global context, with an attractive Yield, trading at a substantial valuation discount.

URW is the global owner, operator and developer of Retail Centres, owning a 93 Shopping Centres (87% of the portfolio) 56 of which are classified as Flagship Centres. The remaining portfolio is spread between Office, Convention and Exhibition Centres and Other Services. There are a couple of issues negatively impacting the Group presently:

- Negative sentiment towards Retail generally;
- Integration of **Westfield** has seen an impact due to;
  - Some delays in realising a higher Income, post recently completed Redevelopments in London and California;
  - Softer Retail environment in London (due to BREXIT) and the US (secondary-grade assets, which comprise sub-5% of URW's portfolio);
  - Higher Financial Expenses (less Capitalisation of the Interest Expense); and
  - Elevated Taxes than originally forecast.
- The Group is selling Non-Core assets to improve its portfolio and reduce Gearing. At its recent result, URW announced they would increase their disposal program from €3 billion to €6 billion. This is dilutive to short-term earnings but not valuation, improving the portfolio for longer-term growth. Since the Merger, URW has sold over €2 billion worth of assets, for a Premium to Book Value of 8.9% (for the end of December). This is in contrast to URW overall trading at a sizeable Discount to Book Value.

Transacting earlier improves the balance sheet, the quality of the portfolio, removes the perceived overhang and places URW on a platform for growth. (**Charter Hall Retail** have successfully undertaken a disposal program and is now on a growth path once more).

As a result of the aforementioned ramp-up in Asset Sales and Integration impacts, URW announced it will forecast to hold the 2019 Distribution Flat at €10.80 per security, as the forecast Underlying EPS for 2019 will be lower than the €12.92 per security that was achieved. Post a completion of the Asset Sales, on a normalised basis, forecast Underlying Growth is forecast at between 5% and 7%.

Both Goodman and URW reported on the same day and announced a forecast flat distribution level, yet Goodman was up 4.3% on the day, whilst URW fell 8.4%.

This for us highlights the themes and momentum within the market, depending on your asset-level exposure. Investors are happy to overlook all of Goodman's issues, given it is exposed to Industrial. Conversely, URW is priced at levels that suggest Investors do not believe their valuations. This despite being able to issue 15-year Debt recently at 1.75%, versus Goodman at a Weighted Average Cost of ~2.4%.

Australian Office v. Australian Retail

Stock		SGH position	Distribution Yield	Price to NTA	FFO Multiple	Gearing
DXS	Dexus Property Group	Nil Holding	4.2%	19.4%	19.3x	23.7%
SCG	Scentre Group	Top 5 Holding	5.8%	-11.0%	14.9x	33.9%

*Dexus Guidance includes $35 million to $40 million of Trading Profits.

Dexus Property Group ("DXS") – Quality assets but Expensive. Trading at Substantial Premium to NTA, at the Peak of the Office cycle.

Dexus is classified as an Office REIT (currently 84% and increasing as the joint-venture sale of their Industrial Portfolio settles). Dexus also has a Funds Management operation, with $15 billion of FUM. There is positive sentiment towards Office at this late-stage of the cycle, as Vacancy Rates in Sydney and Melbourne are at very low levels, which is positive for Rental growth.

However, we see this as a short-term story, as Office buildings are trading on very aggressive Cap Rates (well-above Replacement Costs) making Development an attractive option. This will increase supply in the medium-to-long-term. We are also seeing signs of sites previously earmarked for Residential being reassigned to Office Developments, especially in Melbourne.

We are surprised by the market reaction to Dexus, notwithstanding the current market conditions being supportive in the short-term, underlying FFO growth was 3.6% for 1H19. Dexus is guiding towards full year underlying FFO growth of 3%. Dexus reports both FFO (which includes Trading Profits of $35 million to $40 million) and Underlying FFO Excluding Trading Profits. At the end of month price of $12.02, on an **Adjusted AFFO which adjusts for Maintenance Capital Expenditure and Tenant Incentives, the Multiple is closer to 25x.**

Scentre Group ("SCG") - High Quality Assets, trading well below Fair Value, with an attractive Yield.

Scentre is a high-quality Retail AREIT. Typically, such a Group would trade at a Premium through-the-cycle. This is because of the unique nature of top-end Malls which have:

- High Barriers to Entry to create a Regional Mall, given the stringent Planning Approvals process in Australia;
- Diversified Income Streams and Occupancy greater than 99%;
- Developments are typically demand lead, with less speculative supply such as Office and Industrial; and
- Occupy very large foot-prints of Land, creating opportunities to add-value through Development and transformation into more Mixed-Use property.

In 2017, Scentre delivered 4.25% Funds from Operation FFO (cash flow growth). 2018 has seen 3.9% growth, while guidance for 2019 is 3%, which appears to have been below market expectations of 4%. Growth of 3% is reasonable in the context of Inflation of less than 2%.

Bricks and Mortar Retail Sales are more subdued than the through-the-cycle average. Investors are concerned with regard to the impacts of E-Commerce and the lacklustre Retail Spending environment. We believe that the main constraints to Retail Spending presently are the lack of Real Wages Growth and Rising Utility Costs. More specifically, Scentre is remixing a number of Tenancies in certain Centres, leading to an elevated level of downtime. This has led to the recognition of Income taking longer than originally forecast, with a lack of tension from Retailers requiring extra space.

This all needs to be considered in context of where Scentre is trading. At $3.87 per security, this is meaningfully below the Book Value (NTA) of the assets of $4.35 per security (Ex-Accrued Distribution)

which does not attribute value to Scentre's Operating and Development platform. Scentre is forecast to provide a Distribution 2% ahead of 2018, reflecting an attractive and above sector Yield of 5.8%.

The following table best illustrates the similar growth profiles of Dexus and Scentre, yet the discrepancy in how they presently trade.

	Dexus	Scentre
Current FFO Growth	3.6%	3.9%
Forecast FFO Growth	3%	3%
Underlying AFFO Multiple	25x	17x

Office is late-cycle and delivering similar growth to Retail, which is currently operating in more challenging conditions. The valuation differential is significant ~50% between these two Groups. When the cycle turns, as the market factors in upcoming supply, we see substantial de-rating for Dexus and re-rating for Scentre.

<u>Diversified Groups with Residential Development Exposure</u>

Stock		SGH position	Distribution yield	Price to NTA	FFO Multiple	Gearing
MGR	Mirvac Group	Holding	4.5%	5.3%	15.1x	25.4%
SGP	Stockland	Top 5 Holding	7.9%	-16.5%	9.4x	26.4%

Mirvac Group ("MGR") –Diversified Group, trading at a small Premium to Fair Value, delivering a Low Yield and track-record of growth.

Mirvac owns a portfolio of Office, Retail and Industrial assets. Mirvac also has a considerable scale business in Residential Development across Apartments and Master Planned Communities.

Mirvac have improved their portfolio in recent years through selling lower quality assets and building new assets. Mirvac is guiding towards FY19 FFO Growth ~3% to 4%.

A substantial part of Mirvac's earnings is derived from Residential Development. Mirvac's strategy is to dilute this exposure gradually as they build-out their passive portfolio. We agree with this strategy and Management's disciplined approach to date. However, Office is late-cycle (Mirvac's biggest exposure) and we have more concerns around Apartment Development than Land. Apartment Development has a higher skew to towards Investors, Foreign Purchasers and competes more readily with the inner suburban established house markets, which are under the most pricing pressure in Melbourne and Sydney.

Stockland Group ("SGP") - Diversified Group, trading below Fair Value, delivering an attractive Yield, with a track-record of growth.

Stockland is a Diversified AREIT, with a majority weighting towards Retail and a material (~30%) exposure to Residential Land Development.

In delivering its results, Stockland provided guidance of ~5% FFO growth for FY19, which follows 6.6% growth in FY18. The market was disappointed with the growth at the lower level of its prior guidance of 5% to 7%. A softer, more challenging Residential environment, coupled with the rebasing of its Retail assets, has seen the lowering of guidance.

Stockland plans to sell $1 billion of Retail assets. To date it has sold $113 million. Whilst this is negative to short-term earnings, selling its lower quality assets provides capital to redeploy into other initiatives such as a Buy Back, which is presently active. Stockland revalued their Retail assets, which saw some valuation

slippage (down 2.4%) but this was offset by Office and Logistics, leading to a one cent rise in NTA to $4.19 per security.

Investors are concerned about the Residential environment. Credit Conditions have materially tightened and this has seen a softening in Prices. Stockland is in the Land business and whilst Volumes have come back from very elevated levels, prices are more stable (ex-Sydney) as they deliver affordable product in key growth corridors. Promotions and Incentives have become more prominent but their Margins are still well-above the long-term average, providing Stockland with the scope to undertake such activities.

Importantly, its Land Bank is held at Historical Cost (plus Capitalised Costs) which we believe is understated. For example; they recently sold a Residential Estate in Melbourne of ~$202 million, 59% above Book Value.

In their Half Yearly results Stockland also signalled that they will pursue more capital partnering opportunities. This has the potential to redeploy capital to be accretive, driving a higher Return by having the capital to optimise the development potential of its entire, diversified portfolio of assets and sites.

Comparing the metrics to Mirvac and Stockland, reflects a ~20% relative NTA discount, a FFO Multiple Discount of 40% and has a Distribution Yield some 3.3% higher. These dispersions are too great.

Summary

We believe that we are at a late-stage of the property cycle, with very aggressive pricing for Industrial and Office assets in particular. There has been strong rental growth and investment demand for these subsectors. This has particularly benefitted the entities with exposure to this theme through **Funds Management**, such as **Goodman Group** and **Charter Hall Group**. However, aggressive pricing and ultimately, cycle risks have us meaningfully underweight this theme as part of our valuation process. In conclusion:

- Our process is focussed on Value metrics, with counter-cyclical/defensive cash flows sought;
- We conservatively push up the Capitalisation Rates (i.e. Lower Valuation Multiples) reflecting the stage of the cycle we are in;
- We do not assign aggressive Multiples for other Income Streams;
- We aim to position the portfolio to perform through-the-cycle; and
- We rate Environment, Social and Governance ("ESG") factors highly.

Reinforcing our view is that we are at a late stage of the cycle, we would prefer to have a more boring (i.e. safe) exposure to high quality assets, trading at Discounts and that are out of favour. When the Cycle turns/momentum changes we believe that our portfolio will significantly outperform.

In essence our portfolio is positioned to the defensive higher yielding stocks and less exposed to the high growth entities trading on record metrics, which is where we see very material downside risk.

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