

# CROMWELL PHOENIX PROPERTY SECURITIES FUND SEPTEMBER 2023 QUARTERLY REPORT



Money Management Australian  
Property Securities Fund of  
the Year Winner 2023

## Cromwell Phoenix Property Securities Fund Performance (Periods ending: 30 September 2023, Net of fees)

	3 Months	1 Year	3 Years	5 Years	7 Years	10 Years	Since inception (16 Apr 08)
<b>Fund</b>	<b>-6.27%</b>	<b>4.00%</b>	<b>6.40%</b>	<b>1.97%</b>	<b>3.23%</b>	<b>7.86%</b>	<b>6.88%</b>
S&P/ASX 300 A-REIT Accumulation Index	-3.04%	11.94%	4.89%	2.84%	3.55%	7.60%	3.84%
<b>Outperformance</b>	<b>-3.23%</b>	<b>-7.94%</b>	<b>1.52%</b>	<b>-0.86%</b>	<b>-0.33%</b>	<b>0.26%</b>	<b>3.05%</b>

## Fund Strategy

The **Cromwell Phoenix Property Securities Fund** invests in ASX-listed property securities including REITs, developers, fund managers and infrastructure securities.

Actively managed by Phoenix Portfolios, the Fund is both benchmark-unaware and tax-aware, with holdings selected from a universe much wider than the benchmark, and position sizes based on long term proprietary valuation metrics.

The Fund aims to deliver a total return (after fees) in excess of the S&P/ASX 300 A-REIT Accumulation Index over three to five years with lower overall volatility of capital.

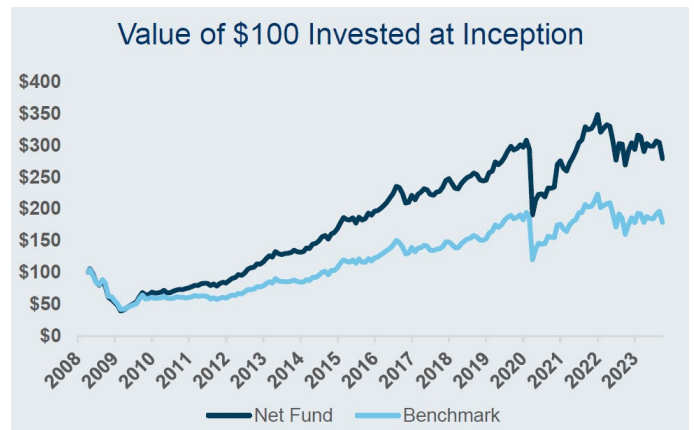
## Quarter in Review

### Factors influencing performance

- The S&P/ASX 300 A-REIT Accumulation Index moved lower over the quarter, losing 3%.
- Goodman Group was the major outperformer, up 6.9% and now represents ~30% of the index.
- Reporting season showed the impact of rising interest rates on near term earnings, however also showed resilient rental income.
- The Fund lost value through its holding in Charter Hall Group and relative value from an underweight holding in Goodman Group.
- The Fund's holdings in Peet Limited and Desane Group were additive to relative returns.

### Current Positioning

- Broadly diversified across all key property subsectors with a skew to small cap names.
- Increasing exposure to industrial, given valuation metrics and robust outlook.
- Preference for small cap property developers over the large cap diversified stocks.
- Fund investors likely to receive more franking credits than the benchmark index.



	Outperformed	Underperformed
Overweight	Desane Group Peet Limited	Charter Hall Group Hotel Property Investments Abacus Storage King Abacus Property Group
Underweight	Goodman Group	Charter Hall Long WALE Dexus

## Market Commentary

The S&P/ASX 300 A-REIT Accumulation Index moved lower in the September quarter, losing 3.0%. Property stocks underperformed broader equities in the quarter, with the S&P/ASX 300 Accumulation Index giving up a lesser 0.8%. This underperformance is unsurprising considering the 10 Year Australian Government Bond yield increased meaningfully over the quarter, finishing at approximately 4.5%.

Despite the property index underperforming over the period, the headline result masks the weak performance of most property stocks. Only 8 out of 32 index constituents outperformed the index. This result was mostly driven by the outperformance of the index's largest stock, Goodman Group (GMG), which rose 6.9%, despite the weakness seen elsewhere. Many investors became excited about the opportunity in data centre investment that GMG referenced in their result. For more on GMG, see the performance commentary section of this report.

During the quarter, most property stocks reported their full year financial results to 30 June 2023. A key feature of results was increased interest costs and the impact they are having to short term profitability and distributions. Phoenix normalises for mid-cycle interest rates when considering the valuation of a stock, so the impact was minimal to our valuations, however, was seen as very significant by those focussed on short term distribution outcomes.

Stocks with exposure to office property were particularly weak during the quarter. Incentives to secure office tenants remain elevated and vacancy is beginning to creep into office portfolios as existing long-term leases come to their end. Growthpoint Properties Australia (GOZ) lost 20.8%, whilst Cromwell Property Group (CMW) gave up 29.3% and Centuria Office REIT (COF) dropped by 14.6%. Large capitalisation office owner Dexus (DXS) also lost ground, off 6.4%. Charter Hall Group (CHC), whilst a diversified manager of property funds, has a meaningful exposure to office property and was also weak, giving up 11.4%.

Owners of large regional shopping centres broadly reported solid results in August's reporting season. Specialty sales were strong, supported by elevated inflation and resilient consumer spending. All-important specialty re-leasing spreads were positive for both Scentre Group (SCG) and Vicinity Centres (VCX). There is some concern that cyclical factors such as weakened consumer sentiment will weigh on future results despite the recent strong performance. SCG and VCX marginally underperformed the index, losing 4.1% and 4.7% respectively. Owners of smaller neighbourhood shopping centres were weaker during the period as their rental outcomes are not as directly tied to inflation, but their costs are rising sharply. Region Group (RGN) gave up 11.0% and Charter Hall Retail REIT (CQR) finished the quarter 13.0% lower.

Developers of residential property showed resilience during the period as the undersupply of housing in Australia came into focus. All else equal, a sharp increase in interest rates should have a cooling effect on residential house prices and sales, however the impact of interest rates is offset by an acute shortage of both rental and stock for sale. Peet Limited (PPC) outperformed, up 1.2%, AV Jennings Limited lost only 1.9% and large capitalisation developer Stockland (SGP) dropped 2.7%.

## Performance Commentary

### Goodman Group (GMG) ▲ 6.9%

GMG represents one of the biggest holdings in the portfolio. However, given the substantial benchmark weight, the portfolio remains underweight in a relative sense. The position thereby detracted value from a relative perspective during the quarter.

GMG released its full year financial result in August. The result itself was in line with expectations. Property investments performed solidly, with net property income growing 4.7%, supported by strong rental reversions upon releasing, particularly in North America. Despite the solid performance, GMG is not immune from cap rate expansion, with the portfolio's weighted average capitalisation rate expanding from 4.0% to 4.5% over the year, with further expansion likely in coming periods. GMG's funds management performance slightly disappointed, with earnings down from 2022 as performance fees were not recognised in the second half of the financial year. Over the longer term, GMG guided to fee income of ~0.9% of assets under management, below previous suggestions of ~1.0%. Assets under management did grow strongly, now at \$81 billion.

GMG's development earnings were the driver of growth in the 2023 financial year, increasing from \$960.7 million in 2022, to \$1,307.2 million. A strong yield on cost for developments and completions of \$6.9 billion supported this robust outcome.

GMG's share price initially had a muted reaction to the solid result, however some commentary in the earnings call and subsequent consideration by market participants led to a rally in GMG's share price. There was a focus on GMG's data centre business. The company commented that of their development work-in-progress, data centres represented 30%. This comes from rezoning existing industrial land and developing data centres. There was also commentary around the ability to establish a data centre platform, which could double the end value of developments. With much market excitement surrounding the use of data, artificial intelligence and the structural shifts that this may cause, some got excited about this nascent business. This business is still small relative to GMG's wider business and the ability to create a full operational platform is still uncertain. Economic depreciation of data centre infrastructure (as opposed to solely property) remains uncertain and could make this line of business more questionable.

Much like in the past, GMG also highlighted some of its more valuable land bank, which over time will be converted to residential usage. Property in South Sydney and North Ryde in Sydney and Port Melbourne are likely to have residential uses in the next decade. Whilst there is no doubt upside from these sites, it must be remembered that much of this property is held in partnerships, in which GMG is a minority investor and must be considered in the context of GMG's market capitalisation of more than \$44 billion.

### Abacus Group (ABP):

#### Abacus Property Group (ABG) ▼ 19.8% / Abacus Storage King (ASK) ▼ 26.2%

The portfolio began the quarter holding an overweight position in ABP and ended the quarter holding an overweight position in both of the restructured entities, ABG and ASK. Their underperformance detracted value from an absolute and relative perspective over the quarter.

During the September quarter, ABP split into two stocks, a newly spun off ASK and the residual entity, ABG. Initially announced at its half yearly financial result in February, ABP completed its spinoff of its storage properties into ASK in August. ASK is now the owner and operator of 131 self-storage property assets across Australia. These properties are operated under the Storage King brand, which itself is now owned by ASK. In Phoenix's view ASK owns the premier storage property portfolio in the nation, with a heavy weighting to in-demand, metropolitan locations. Under Abacus management, the self-storage portfolio has had a very strong history of industry leading occupancy and revenue per available metre (RevPAM) growth. Abacus also has a strong history of developing successful self-storage assets. Currently 36 of its 131 assets are classified as part of the "stabilising portfolio", meaning they are either development sites or recently completed developments.

Globally, the self-storage asset class is in strong demand. US heavyweight, Public Storage, recently announced it was acquiring Simply Self Storage from Blackstone for US\$2.2 billion and Teachers Insurance Annuity Association of America (TIAA) announced it was acquiring Norwegian company Self Storage Group ASA for a premium of 66.7% to its prevailing share price. ASK's most direct competitor, National Storage REIT (NSR), finished the quarter trading at a relatively modest 11% discount to its net tangible asset backing. In contrast, ASK finished the period trading at an enormous 34% discount to its net tangible asset backing.

As part of the split transaction, ASK undertook a capital raise, which served to reduce gearing across the Abacus entities. The ongoing ABG entity is a beneficiary of this. With reduced leverage, ABG now owns the fund manager of ASK and its largest asset is a 19.9% stake in ASK. It also owns office properties with a carrying value of more than \$1.7 billion and other property assets (mostly retail property) with a carrying value of more than \$800 million. These assets suffer from the same concerns as any office property portfolio, with the requirement to pay elevated levels of incentives and a more uncertain future of the usage of office buildings. ABG closed the quarter trading at approximately a 50% discount to its net tangible asset backing, among the largest discounts in the sector. This discount exists despite ABG having significantly lower leverage than many other REITS and an investment in the more popular self-storage sector.

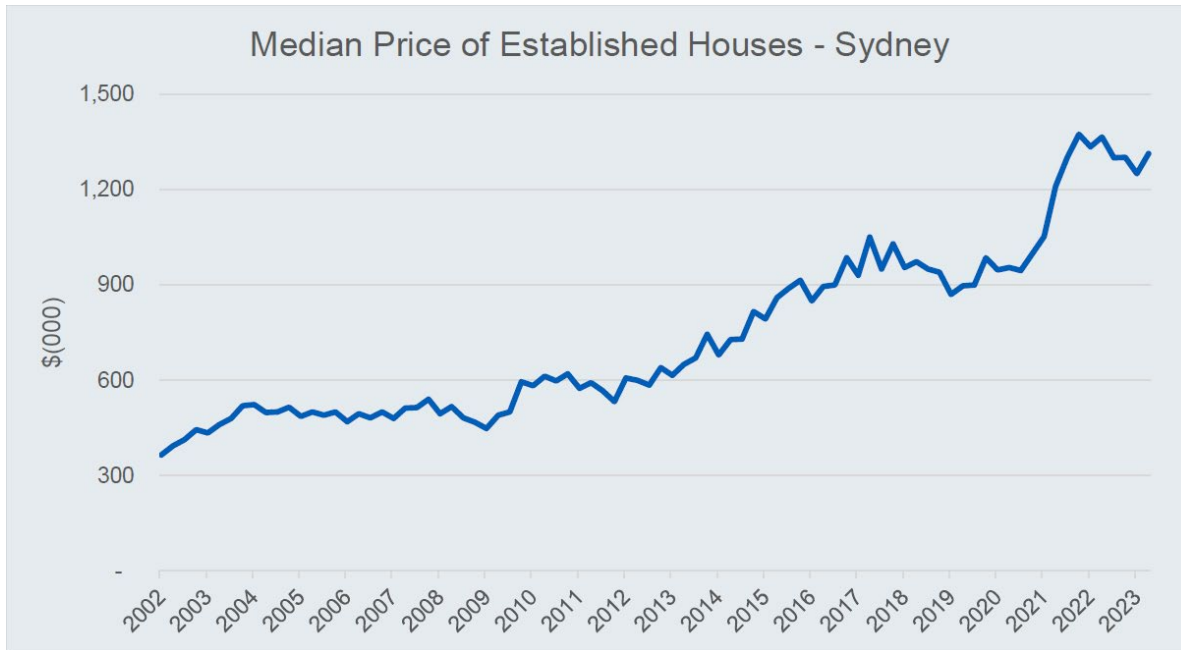
The new Abacus entities have created some confusion by revising distributions lower relative to the old ABP entity. In the case of ASK, capital is being retained because of good reinvestment opportunities. In the case of ABG it is prudent to retain funds for capital expenditure required on its properties. We believe the discounts assigned to ABG and ASK are excessive and have maintained overweight positions in both stocks.

## Australia’s Housing Battle: Interest Rates versus Supply & Demand

Residential property occupies much of Australia’s news coverage and much of the brain space of Australians in general. Everyone seems to have an opinion on house prices and housing policy and not all of it seems to be based on fact. This article will try to provide an analysis of the current factors influencing residential property and in dealing with those facts, provide some examples of how Phoenix is making investments that are supported by the current environment.

### Interest Rates

It seems all of us have heard comments like “house prices always go up”. Anyone with a basic understanding of maths and economics have told those people they cannot be correct. With that, let’s look at the median house price in Sydney since 2002:

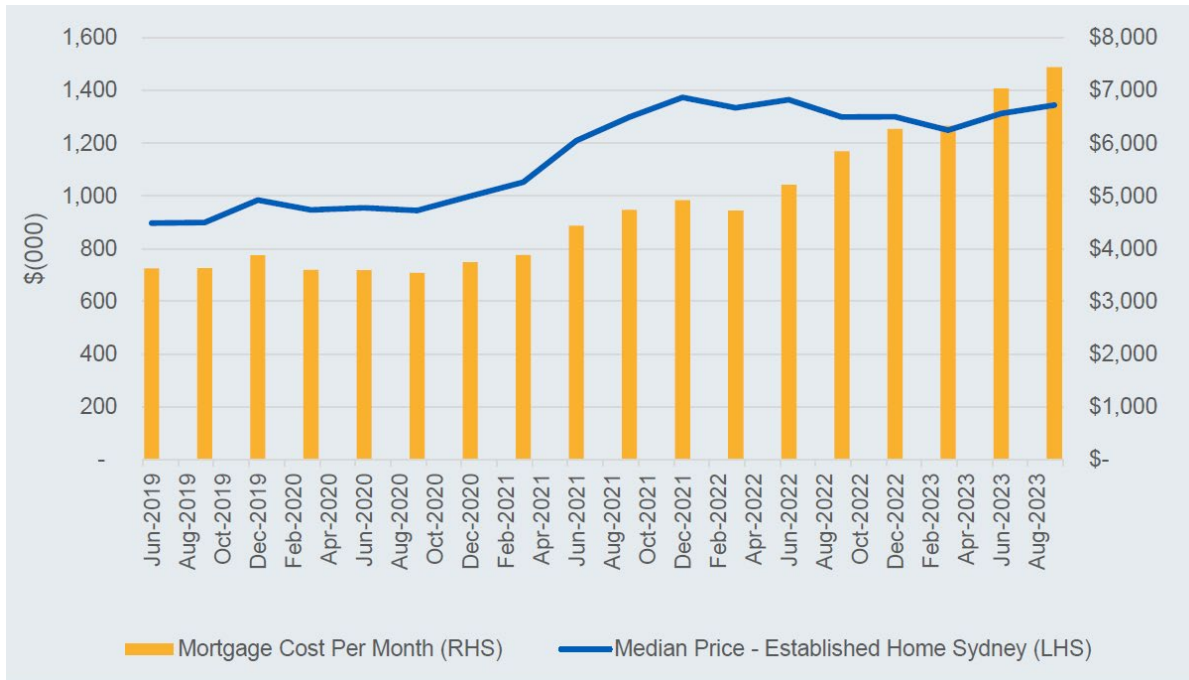


Looking at the chart above it almost does seem like house prices always go up. But wait: what happens when interest rates go up, surely house prices will crash? Let’s zoom into the chart above and look at the effect of recent interest rate rises on the value of homes in Sydney:



Despite interest rates on new home loans more than doubling off their lows, it is clear that house prices have been stunningly resilient, growing once more after marginally decreasing when rates began to increase.

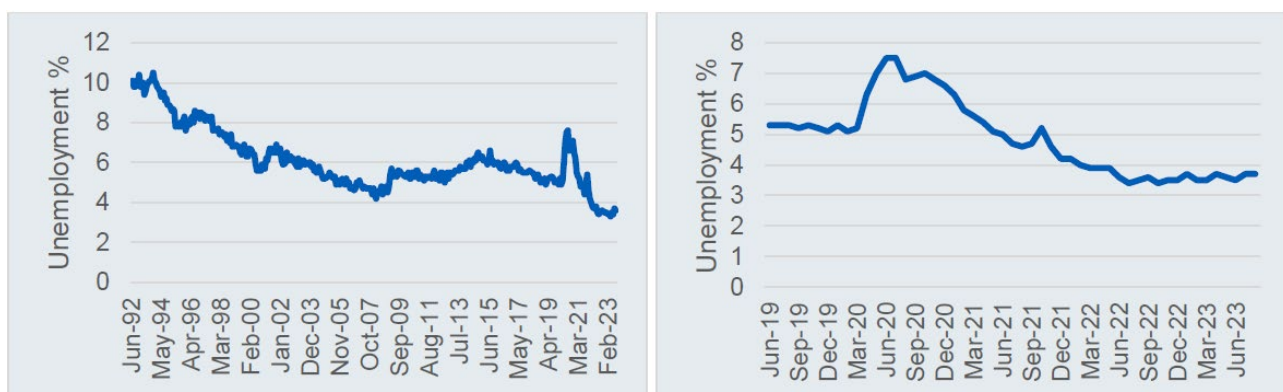
Those concerned about the sustainability of current house prices will correctly point to just how much it costs to own a home. Approximately 75% of home purchases are supported by the use of a mortgage. Obviously, those making the purchase can only do so if they can service the payment on that mortgage. To show this, the chart below looks at the monthly cost of servicing a new mortgage (Loan to Value = 90%) on the median home in Sydney and how it has changed over the same period.



The cost of servicing a mortgage has clearly risen dramatically. A mortgage obtained on the median home in Sydney now costs more than \$7,400 per month to service. This has increased by more than 50% since December 2021, less than two years ago. Common sense suggests that this must have a limit. Surely at some point people can't afford to service their mortgage anymore and surely even the ~25% of people who buy a home with cash won't have enough cash to buy the home they want. That all has to be true, but house prices prove that at this stage we have not reached that breaking point.

**How can we afford this?**

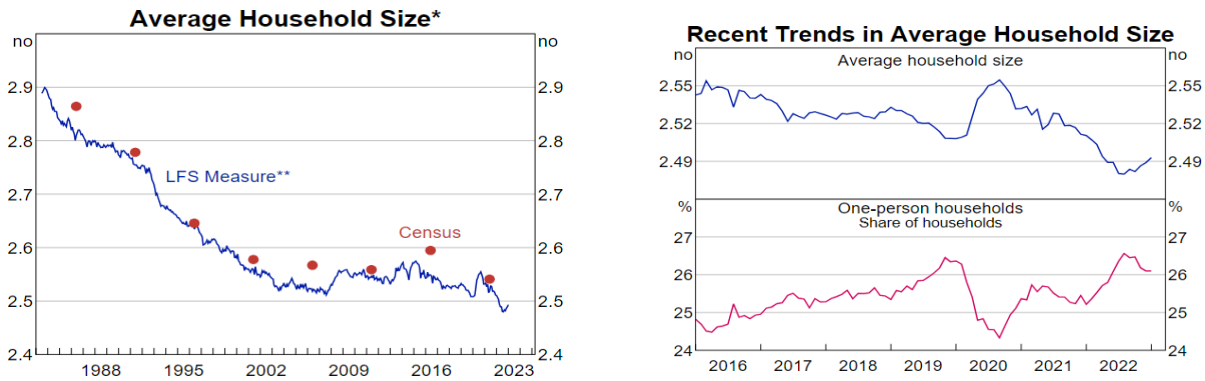
Basic economics states that in a market economy, the price of a good or service is a function of its supply and demand. Housing is no different. The demand for housing should be simple to understand. All Australians have demand for a place to live. To support "elevated" house prices and increased mortgage servicing, there has to be a capacity to pay monthly costs. This capacity is most commonly tied to a person's income. When entering into a 30-year mortgage, someone's view of their job security is also front of mind. In this context, a chart of long-term and more recent unemployment rates in Australia is presented below:



As can be seen, unemployment rates are at multi-generational lows, serving to add to demand for housing at ever-increasing prices.

### Housing Demand

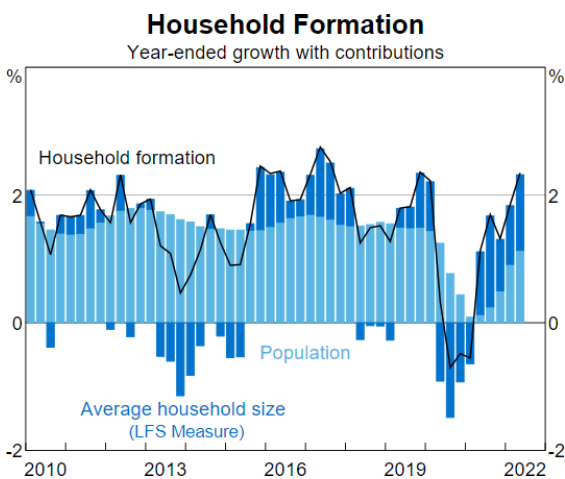
In the most basic sense, the quantum of dwellings needed in Australia is related to the amount of people in each dwelling and the population of the country. The Australian Bureau of Statistics (ABS) and Reserve Bank of Australia (RBA) have compiled the nation’s historic average household size and recent trends as shown below:



While perhaps a controversial figure, former RBA Governor Phillip Lowe summed up recent changes astutely, saying:

*“During the pandemic, the average number of people living in each household declined. People wanted more space. They were working from home. Rents actually declined for a while. People said, ‘Rather than have a flatmate I will just have an office at home,’ so the average number of people living in each dwelling declined and that increased the demand as a result for the total number of dwellings”*

So, we have less people living in each dwelling and the other component of household requirements, **population**, is also increasing strongly. Again, the RBA and ABS help by showing both the impact of population growth (in light blue) and change in household size (dark blue) over time in the chart below:



Again, Phillip Lowe sums up the situation:

*“The other thing that is now happening is a big increase in population. The population is increasing by two per cent this year. Are there two per cent more houses? No. The rate of addition to the housing stock is very low. We have a lot of people coming into the country.”*

This comment touches on the other key element to home prices in Australia. Namely, the supply of new property.

### Housing Supply

So there clearly is a need to build new houses. Given the voracious demand for residential properties at elevated prices, one would think that residential developers would address this demand and supply the properties the population clearly want. Two major factors are holding back the supply that would otherwise naturally occur.

Firstly, the cost of building new homes is a major factor. A residential property developer will require approximately a 20% profit margin on top of their costs to put new housing supply into the market. The costs of developing that property comprise:

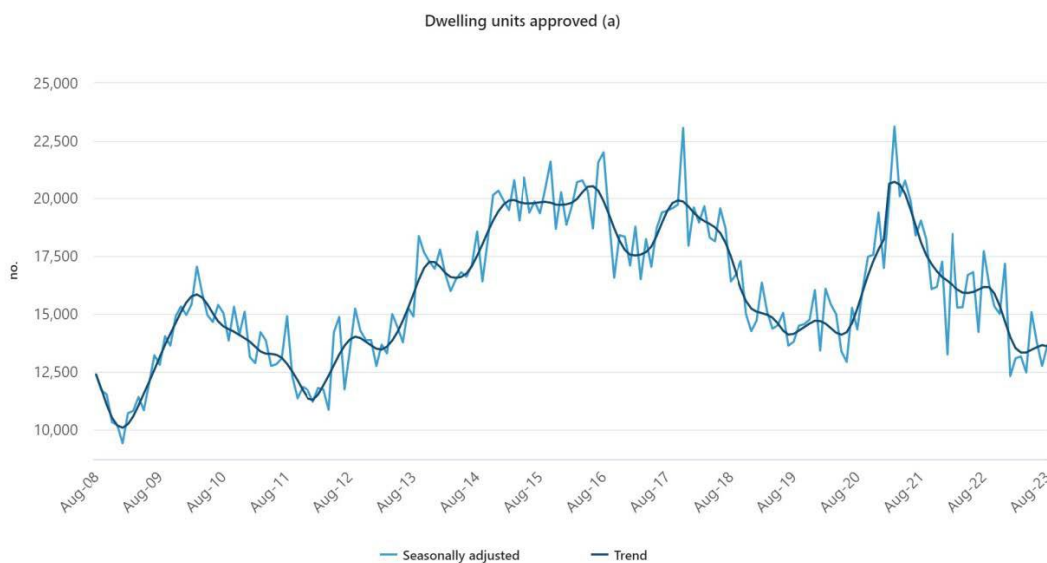
- the cost of the land on which it is built,
- the hard costs of the materials used,
- finance costs,
- architectural and planning costs and
- the cost of labour to physically build the property.

In recent times, all of these costs have been increasing. Materials costs increased significantly with supply chain disruptions during the COVID-affected period and only now is the “rate of growth” slowing. Labour costs are also ever increasing, as even the availability of workers is a significant challenge in many cases (see unemployment rates). Each of these increased costs place downward pressure on the supply of new properties.

### The real issue

Arguably the biggest factor limiting new supply however is simply being allowed to build new properties. New building requires a myriad of approvals, principally development approvals, from local councils or state governments. Local constituents tend to be against development in their area, often known as NIMBYs (Not In My Backyard). Local councils and members of parliament are voted in by existing residents of a geographic area and hence are incentivised to block the building of new houses.

To provide one such blatant example, one member of parliament (MP) made the comment: “Housing in Australia is in crisis,” describing the cost of housing forcing “families [to sleep] in their cars”. This same MP has vehemently opposed the development of more than 800 dwellings on an unused site in their electorate. Going further, in an attempt to justify the position, he argued that such development activity “drives up the cost of rent and house prices.” This is demonstrably false and fails to pass even the most basic test of common sense. We are not referencing it to call out an individual, but rather providing an example of just how difficult it is to obtain approval to address the housing supply shortage, even from those aware of the need. To see how dire this supply issue has become, see the chart below, provided by the ABS, showing the trend in approvals for dwelling units despite the obvious need for housing.



Source: Australian Bureau of Statistics, Building Approvals, Australia August 2023

## What are we doing about it?

Amending the long-held planning practices, incentives of government and fixing global supply chains is above our pay grade. What we can do is observe and acknowledge the situation and make investments that benefit from the realities of housing undersupply. This can be done by investing in companies that either have development approved housing projects, or a history of working with planning authorities to obtain approval, despite all the complexities inherent in residential development.

One such investment in the portfolio is Mirvac Group (MGR). Most of MGR's development takes place in urban infill locations. These projects often increase density and at times have included iconic projects across Australia. MGR is currently developing the old Channel 9 headquarters in Willoughby in Sydney's North, which will deliver 417 lots, with a total development value of \$800 million. Existing iconic projects completed by MGR include The Melbournian, and The Eastbourne in Melbourne. MGR has also been a pioneer in the embryonic "build to rent" property sector. This involves building large apartment buildings, with all lots held for rent on an ongoing basis as opposed to being sold on completion. Those in Melbourne can inspect LIV Munro, adjacent to Queen Victoria Markets, which was recently completed and has 490 apartments available for rent. In the midst of record low rental vacancy, this business both addresses a need and provides low risk returns to investors.

Another investment in the portfolio is Peet Limited (PPC), which specialises in master planned communities across the country. These tend to be extremely large plots of land on the urban fringe of major cities and will effectively be new suburbs and in some cases almost new cities. PPC's largest project is Flagstone, located between Brisbane and the Gold Coast in Southeast Queensland. It will take a generation to complete, however once built will house 120,000 people and become Australia's 20th largest city, a similar scale to Cairns. It will include a 100-hectare town centre, with a regional shopping centre similar in size to Chatswood Chase and will have a bigger town centre than the Brisbane CBD. This project has all relevant approvals. It is projects such as this that will go a small way to addressing Australia's housing undersupply.

## A closing note

The current balance in Australian housing is a bit like an unstoppable force meeting an immovable object. Interest rates are having a meaningful impact on the affordability of housing and clearly are putting downward pressure on housing prices. Fighting against this, ever increasing demand and insufficient supply are supporting home values. Over time, these factors should find an equilibrium. Investing in those who are helping to address this undersupply is prudent both from an investment perspective and for the benefit of the nation.



*Peet Limited's Artist Impression of Flagstone City's Future Town Centre*

## Market Outlook

The listed property sector is in good shape and provides investors with the opportunity to gain exposure to high quality commercial real estate at a meaningful discount to independently assessed values. While share market volatility may be uncomfortable at times, the offset is liquidity, enabling investors to rebalance portfolios without the risk of being trapped in illiquid vehicles.

Rising interest rates have been a headwind for many asset classes, with property, both listed and unlisted, a particularly interest rate sensitive sector. The August reporting season saw a number of listed stocks come under pressure as short term interest rates hedges are beginning to roll off and higher interest costs are impacting earnings growth and distributions. Long term valuations are driven by “normalised” interest costs, meaning the impact of short term hedges maturing is mostly immaterial.

The industrial sub-sector continues to be the most sought after, given the tailwinds of e-commerce growth, the potential onshoring of key manufacturing categories and the decision by many corporates to build some redundancy into supply chains to cope with current disruptions. All of these factors are contributing to ongoing demand for industrial space, which is evident by rapidly accelerating market rents and vacancy rates at historic lows of around 1% in many markets.

We remain cognisant of the structural changes occurring in the retail sector with the growing penetration of online sales and the greater importance of experiential offering inside malls. Recent performance of shopping centre owners has however been strong, with consumers showing resilience. It is interesting to note the juxtaposition of very high retail sales figures despite very low levels of consumer confidence, no doubt impacted by rising costs of living. Importantly, we are also now seeing positive re-leasing spreads in shopping centres, indicating strengthening demand from retail tenants.

The jury is still out on exactly how tenants will use office space moving forward, but demand for good quality well located space remains. Leasing activity is beginning to pick up, and there has also been some transactional activity, albeit at prices typically at discounts to book values. Incentives on new leases do remain elevated and some vacancy in the market is becoming apparent.

We expect to see further downside to asset values in office markets, but elsewhere expect market rent growth to largely offset cap rate expansion, particularly in industrial assets. Listed pricing provides a meaningful buffer to such movements.

## Portfolio Detail

### 10 Holdings (In Alphabetical Order)

Abacus Property Group  
 Centuria Industrial REIT  
 Charter Hall Group  
 GPT Group  
 Goodman Group  
 Hotel Property Investments  
 Mirvac Group  
 Peet Limited  
 Scentre Group  
 Stockland

	Fund
Cash	2.9%
ASX 300 A-REITS	84.0%
Other ASX Listed Securities	13.1%

	Fund	Benchmark
Office	17.1%	14.4%
Retail	25.3%	31.8%
Industrial	33.8%	46.1%
Infrastructure	0.0%	0.0%
Other	21.0%	7.7%
Cash	2.9%	0.0%
Total	100.0%	100.0%

### Important Notice and Disclaimer

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Any investment, including an investment in the Fund, is subject to risk. If a risk eventuates, it may result in reduced distributions and/or a loss of some or all of the capital value of your investment. See the PDS for examples of key risks. Past performance is not indicative of future performance. Forward-looking statements in this document are provided as a general guide only. Capital growth, distributions and tax consequences cannot be guaranteed. Forward-looking statements and the performance of the Fund are subject to the risks and assumptions set out in the PDS.