# Cromwell Phoenix Property Securities Fund

## June 2023 Quarterly

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

| | 3 Months | 1 Year | 3 Years | 5 Years | 7 Years | 10 Years | Since Inception (16 Apr 2008) |
|---|---|---|---|---|---|---|---|
| Fund | 2.90% | 7.97% | 10.15% | 3.64% | 4.18% | 8.83% | 7.46% |
| S&P/ASX 300 A-REIT Accumulation Index | 3.15% | 7.49% | 8.52% | 3.88% | 3.73% | 7.95% | 4.11% |
| **Outperformance** | -0.25% | 0.47% | 1.63% | -0.24% | 0.46% | 0.88% | 3.34% |

## 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

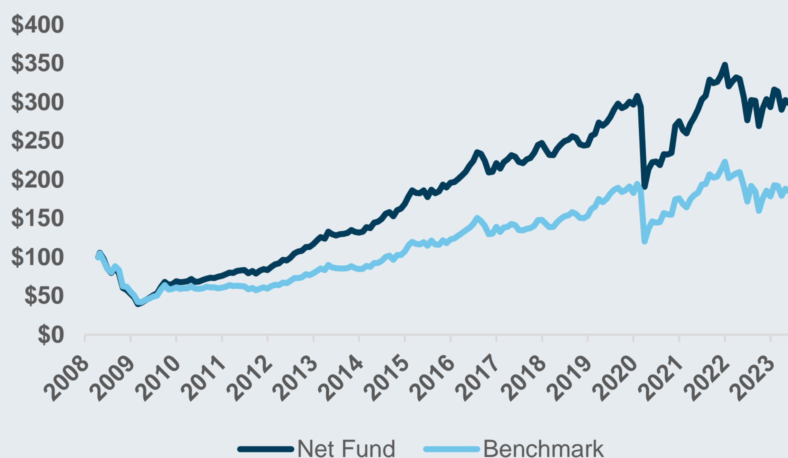
### Factors influencing performance

- The S&P/ASX 300 A-REIT Accumulation Index moved higher over the quarter, adding 3.2%.
- Fund managers HMC Capital and Centuria Capital Group were outperformers – up 40.9% and 13.1% respectively.
- Property valuations mostly moved lower, falling roughly 5% on average.
- The Fund lost value through holdings in Charter Hall Group and Hotel Property Investments.
- The Fund's holding in Peet Limited and underweight holdings in retail landlords Scentre Group and Vicinity Centres were all additive to relative returns.

### Current Positioning

- Broadly diversified across all key property subsectors with 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.

## Value of $100 Invested at Inception




| | Outperformed | Underperformed |
|---|---|---|
| Overweight | Peet Limited<br>Abacus Property Group | Charter Hall Group<br>Hotel Property Investments |
| Underweight | Goodman Group<br>Home Consortium | Scentre Group<br>Vicinity Centres<br>National Storage REIT |

## Market Commentary

The S&P/ASX 300 A-REIT Accumulation Index moved higher in the June quarter, rising 3.2%. Property stocks reversed recent trends and outperformed broader equities in the quarter, with the S&P/ASX 300 Accumulation Index adding a lessor 1.0%. This outperformance is relatively surprising considering the 10 Year Australian Government Bond yield increased meaningfully over the quarter, finishing at approximately 4.0%.

Many property owners released their valuations as at 30 June. Broadly speaking properties saw expansions in capitalisation rates (cap rates). For industrial property owners, strong market rent growth mostly offset this cap rate expansion, holding valuations close to flat in most cases. Retail and office properties did not hold up as well, with market rents holding relatively steady amidst cap rate expansion. Properties with long weighted average lease expiries (WALEs) and low capitalisation rates saw the biggest declines in values due to their interest rate sensitive nature.

Property fund managers were predominantly outperformers during the quarter. Smaller capitalisation fund managers performed particularly well, with Centuria Capital Group (CNI) up 13.1%, Qualitas Limited (QAL) gaining 12.6% and Elanor Investors Group (ENN) adding 9.3%. Goodman Group (GMG) was also a solid performer, lifting by 7.6%, while Charter Hall Group (CHC) gave up ground, off 0.7%, likely due to its exposure to office property.

Retail property owners were the major underperformers during the quarter. A series of more negative data points came out across the period. Firstly, retail sales figures underperformed expectations. Furthermore, many retailers who provided sales updates during the quarter disappointed investors. Fashion retailer Universal Store Holdings Limited (UNI) severely disappointed and fell almost 40% in May. Larger retailers JB Hi-Fi (JBH) and Super Retail Group (SUL) also had soft performance, declining by more than 10% from intra-period highs. This weak performance of retailers was reflected in the share prices of their landlords. Vicinity Centres (VCX) lost 5.1%, Scentre Group (SCG) gave up 3.6% and offshore property owner Unibail-Rodamco-Westfield finished 3.8% lower. The performance of less discretionary neighbourhood shopping centre owners was not as weak, however still underperformed the broader property market, with Region Group (RGN) and Charter Hall Retail REIT (CQR) off 0.1% and 0.6% respectively.

Office property owners had mixed fortunes in the June quarter. Dexus (DXS) recovered some lost ground in the period, adding 7.0%. In contrast, Centuria Office REIT (COF) lost 1.7% and Growthpoint Properties Australia (GOZ) gave up 5.0%. Direct office transactions have been extremely limited in recent periods, with buyers and sellers appearing to have divergent price expectations. Those properties that have traded have done so at discounts to book value of between 10% and 25%.

Those with exposure to residential development had a very strong period of performance. Mirvac Group (MGR) led the way, up 11.2%, while large capitalisation peer Stockland added 4.9%. Peet Limited was also an outperformer in the quarter, gaining 9.3%. Resilience in residential house prices has been surprising, with developers likely to be supported by high net immigration numbers along with limited supply of new housing.

## Performance Commentary

### Abacus Property Group (ABP) ▲ 7.1%

The portfolio holds an overweight position in ABP. The stock added value from an absolute and relative perspective during the quarter.

ABP is an owner of both self-storage properties and commercial properties. Its commercial property portfolio is primarily invested in non-prime office buildings. ABP's Storage King branded self-storage properties are heavily weighted towards the East Coast of Australia, with much of the property value in metropolitan locations. It also owns the Storage King operating business and brand. Investor appetite for these two property asset classes could scarcely be more different. Even those with exposure to the best office buildings in the country are trading at meaningful discounts to their net asset values (NAVs), whilst self-storage properties are well bid, both in Australia and offshore.

Earlier in the year, ABP made a preliminary announcement that it would "de-staple" and create a separately traded self-storage real estate investment trust (REIT). Whilst initial information was relatively scarce, it was announced that ABP would retain up to a 19.9% stake in the new REIT, which was to be known as Abacus Storage King REIT, to be traded under stock code ASK. It was also announced that ASK would be externally

managed, with ABP serving as the external manager. This may be a somewhat unusual choice of structure for the separation of the businesses, however allowing the storage business and the commercial property to trade separately is absolutely a move in the right direction.

During the quarter, ABP announced an equity raise in the new ASK entity, which will begin trading separately in August, should the transaction be approved by shareholders. Alongside the equity raise, a more than 400-page transaction document provided more information on the exact structure of the new entities. Supported by the equity raise, ASK will have a mandate for growth, looking to develop new self-storage properties, with developments expected to have attractive returns. The core ABP vehicle will operate with reduced gearing and is unlikely, in the short term, to have a cost of capital allowing for growth.

Assuming ASK trades at the price of its equity raise, the remaining ABP business is trading at approximately a 45% discount to its net tangible asset backing. This would make it one of the most heavily discounted stocks in property indices.

### HMC Capital Limited (HMC) ▲ 40.9%

The portfolio does not hold a position in HMC. Its outperformance detracted value from a relative perspective over the quarter.

HMC is predominantly a property fund manager, managing both unlisted funds as well as the listed HomeCo Daily Needs REIT (HDN) and HealthCo Healthcare and Wellness REIT (HCW). It began life when former investment banker David Di Pilla, with the support of high-net-worth financial backers, entered into a cleverly structured transaction to take over the property of the failed Masters Hardware business. HMC is now a fully-fledged, relatively capital light fund manager.

During the period, HMC announced a surprising capital raise for HCW. The capital raise was to be used to purchase a portfolio of 11 private hospitals, operated by and leased to Healthscope. A total of $1.2 billion was to be paid, with HCW paying $730 million for its share, the rest funded by related-party, unlisted funds. What was particularly surprising about this deal, was both its large size and the discount at which the capital raise took place. HCW shares on issue increased by almost 75% and the raise took place at a 32.5% discount to net tangible asset backing. HMC is now developing a track record of undertaking transactions others would believe to verge on impossible, with HDN previously acquiring the large Aventus Group portfolio of bulky goods shopping centres.

Large deals like the one undertaken by HCW in the period undoubtedly add value to HMC in the short term, increasing funds under management and therefore management fees for shareholders. It must be said these deals are extremely aggressive and may not be well received by some investors. A fund manager's ability to raise capital in the future is reliant on the goodwill of both existing and potential investors. Balancing non-associated investor interests with those of a fund manager can at times be a fine line. Time will tell how HMC manage this balance.

### Charter Hall Group (CHC) ▼ 0.7%

The portfolio holds an overweight position in CHC. Its underperformance during the quarter detracted value from an absolute and relative perspective.

CHC is Australia's largest property fund manager and as such has come under pressure as interest rates have increased and property securities have weakened. As at 31 December 2022, CHC had property funds under management (FUM) of $73 billion. This FUM is diversified by asset type and by investor type, which should serve to limit damage to CHC investors.

Whilst it does maintain a diversified exposure, its largest exposure is to office property, which represents just over 40% of its total property FUM. Office property has come under significant pressure, as vacancy has ticked up and effective rents have moved sharply lower, off previous highs. This has occurred whilst future use of office space has become more uncertain, with the proliferation of work-from-home and the obsolescence of older styles of office. It appears as if these concerns are weighing on CHC as it is undoubtedly leveraged to the office investment environment.

CHC does however have a meaningful exposure to less troubled asset classes such as industrial and long weighted average lease expiry (WALE) assets. To the extent that interest rates move sharply higher, these assets will also be affected, however the long-term use of these assets has, if anything, become more certain in recent periods.

CHC has been able to grow rapidly in recent periods and whilst these growth rates are impossible to maintain, it is now a resilient, high margin funds management business, with a very capable management team.

Across its direct and wholesale investment platform, performance of CHC's funds has remained solid and ahead of benchmarks. Beyond being supportive for performance fees, this is important to maintain goodwill and further fundraising capacity with existing investors when markets are more conducive. CHC has also had a focus on high profit margin funds management business, limiting the costs associated with running its platform. Should times become more challenging this should somewhat insulate the impact of any potential decline in assets under management on financial results.

## Melbourne Office: If we built it, will they come?

Phoenix recently toured a number of Melbourne office assets and developments and met with commercial real estate agents. There is some exciting new product in the pipeline, but therein lies the ongoing problem – what becomes of the existing stock? Some observations are set out below.

### Vacancy is high

While there are differences across grade and precinct, nearly 16% of space in the Melbourne CBD is vacant. It has been more than 20 years since vacancy was so high, and we expect it to get worse, not better in the short term. This figure ignores the physical occupancy of leased space – where employers are paying for space, but employees are working from home. In Melbourne, this remains a significant issue, particularly on weekend-adjacent Mondays and Fridays. While difficult to measure accurately, we estimate physical occupancy remains below 60%.

### Tenant requirements are changing

It's not just large corporations who require solid environmental ratings on buildings. Larger companies are looking at scope 3 carbon emissions, which requires pushing back on their suppliers and associates, expecting they too to address carbon emission intensity. As a result, 5-star NABERS energy ratings are becoming a "must have" for many tenants, and the vast majority of buildings don't meet these standards.

Somewhat dovetailing into the environmental theme, is a consistent "flight to quality" and / or "flight to new" drive among tenants and prospective purchasers. Modern amenity helps corporates encourage workers back to the office and overcome the friction inherent in the daily commute.

Also featuring in many of our conversations was a "Flight to Flexibility" – where a tenant might sign up for less dedicated space, provided there is flex space within the same building. GPT, Dexus and Charter Hall Group all provide versions of flex space to address these requirements.

### We're adding to supply, with or without a tenant

GPT presented **51 Flinders Lane**, a well-located development within the Eastern Core, consisting of two towers, totalling 29,000 sqm, with small floor plates (650 sqm in the larger tower, 250 sqm in the smaller tower) with the building aiming squarely at smaller tenants (< 1,000 sqm) which represent over 40% of the office market demand. Capitalising on the company's green credentials and heritage, the towers have been designed to achieve upfront embodied carbon neutrality.

Constructed by Lendlease, over 50% of the building will be fitted out, and therefore tenant-ready. This building is due to complete in 2024, and despite having no pre-committed tenants, is expected to lease up well given the amenity, location and target market.

Charter Hall Group (CHC) presented **555 Collins Street**, an asset located "Midtown", and not far from Phoenix, so it's a building we have watched grow, floor by floor.

Aimed at larger tenants, CHC as developer, and Lendlease as builder, have done a terrific job to deliver the first stage of this project, the North Tower, fronting Collins Street, in line with the original timeframe, particularly given the construction and supply chain issues encountered during the Covid period.

With practical completion in May 2023, the North Tower is 70% leased to tenants including Amazon, Aware Super and Allianz. An additional 10% leasing commitment is expected shortly.

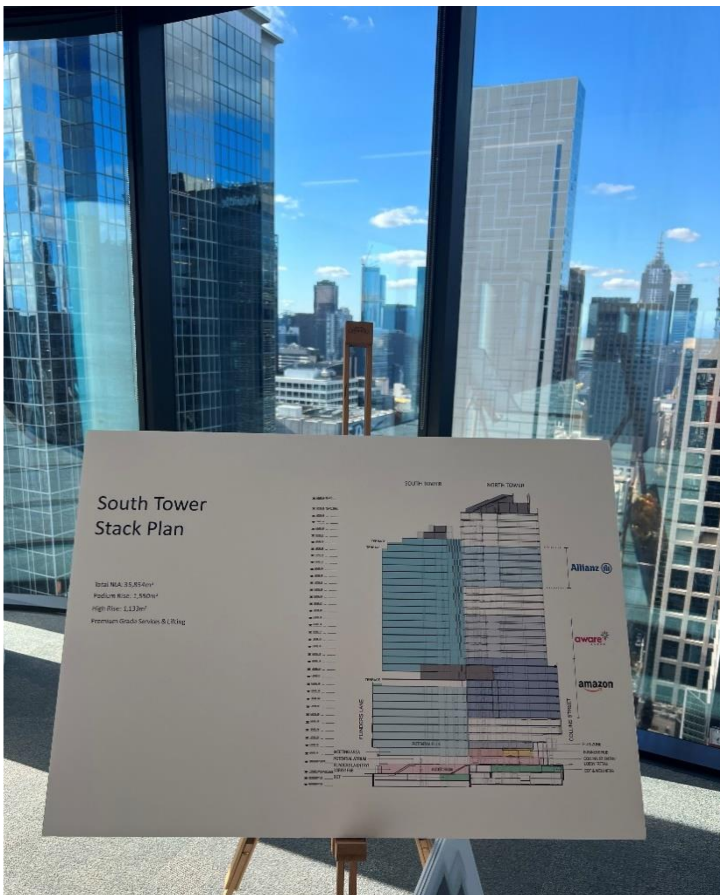
Once again, the building is highly credentialled in terms of ESG and scores well on transport metrics given its proximity to Southern Cross Station, a major transit interchange.

Sitting directly behind the North Tower, the South Tower has the potential to butt right up against the North Tower, potentially providing horizontal expansion space for tenants in the North Tower, in addition to their more traditional vertical expansion options.

Lendlease, in its capacity as both developer and builder, presented **Melbourne Quarter**, located just to the West of Spencer Street, in the Docklands precinct.

Melbourne Quarter comprises 3 commercial towers totalling 152,000 sqm, two residential towers, and approximately 5,000 sqm of retail space. The project also emphasizes sustainability and green initiatives through sustainable design principles, such as energy-efficient buildings, water-saving features, and green spaces. It aims to achieve high environmental standards and has received certifications such as the 6 Star Green Star Communities rating.

The image pictured below right, is of Melbourne Quarter Tower (MQT), the third of the three office towers. The first two are complete, and fully leased. MQT is currently anchored by Medibank, who will occupy approximately 25% of the tower. Leasing is active on the balance.




*Level 32, 555 Collins St. Views and a potential adjacent tower*

*Melbourne Quarter Tower, nearing completion*

### Making life difficult for owners

While new activity creates high quality assets, it only makes matters worse for asset owners looking to lease existing space, and of course contributes to a significant vacancy problem. We have consistently written about the low rental yields available to office owners, made worse by the need to pay large incentives to get leasing deals done and the ongoing maintenance costs. Upgrades, to meet ever tougher environmental standards also go to suppressing returns. For the sake of office landlords, we’d all better hope that the Covid-era “Working From Home” theme starts to shift, so that we can fill up both new and existing space and revitalise our CBDs.

### Phoenix Positioning

Listed markets are forward looking and are pricing office REITs at a big discount to their independently assessed asset values. We believe a discount is sensible, and have ensured that where we have exposure, it is typically in the newer stock where some of these issues identified above are minimised. Our exposure to office is the smallest of the key property sub-sectors.

## Market Outlook

February’s reporting season showed a property sector that was mostly performing solidly from an operational perspective. Increased interest rates are however unmistakably a drag to earnings, given the use of debt across real estate investment trusts. Current gearing levels are however very manageable. Property valuations to 31 December 2022 mostly showed slightly negative revaluations.

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 will support ongoing demand for industrial space, which is evident by rapidly accelerating market rents for properties.

The jury is still out on exactly how tenants will use office space moving forward, but demand for good quality well located space remains. Transactional activity of office assets continues to provide some evidence of value, but transaction volumes have recently reduced. Incentives on new leases do remain elevated and some vacancy in the market is becoming apparent.

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.

The recent increase in bond yields does present a headwind for all financial assets, and particularly yield based sectors such as property. However, with key large capitalisation REITs now trading at a significant discount to the value of their underlying assets and with no value ascribed to embedded active businesses, we believe the sector offers value, particularly in comparison to unlisted property.

Phoenix has for some time discussed the risk of inflation, given the enormous fiscal stimulus and extreme monetary policy setting that we have lived through. In recent times, commentators and bond markets have begun to react to the presence of such a risk. In this environment, long leases with fixed rent bumps, which were previously in high demand, may become relatively less attractive. Historically, real assets such as property and infrastructure have performed well during inflationary periods.

# Portfolio Detail

| Top 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 | 5.9% |
| ASX 300 A-REITS | 80.7% |
| Other ASX Listed Securities | 13.4% |

| | Fund | Benchmark |
|---|---|---|
| Office | 17.0% | 15.2% |
| Retail | 23.6% | 33.6% |
| Industrial | 32.9% | 43.7% |
| Infrastructure | 0.0% | 0.0% |
| Other | 20.6% | 7.5% |
| Cash | 5.9% | 0.0% |
| **Total** | **100.0%** | **100.0%** |

**Important Notice and Disclaimer**

Cromwell Funds Management Limited ABN 63 114 782 777 AFSL 333214 ("CFM") is the responsible entity of, and the issuer of units in, the Cromwell Phoenix Property Securities Fund ARSN 129 580 267 ("Fund"). In making an investment decision in relation to the Fund, it is important that you read the product disclosure statement dated 16 December 2021 ("PDS"). A Target Market Determination (TMD) is also available. The PDS and TMD are issued by CFM and are available from www.cromwell.com.au/psf or by calling Cromwell Investor Services on 1300 276 693. Applications for units in the Fund can only be made on the application form accompanying the PDS. This document has been prepared without considering your objectives, financial situation or needs. Before making an investment decision, you should consider the PDS and assess, with or without your financial or tax adviser, whether the Fund fits your objectives, financial situation or needs. CFM and its related bodies corporate, and their associates, do not receive any remuneration or benefits for the general advice given in this document. If you acquire units in the Fund, CFM and certain related parties may receive fees from the Fund and these fees are disclosed in the PDS.

Phoenix Portfolios Pty Ltd ABN 80 117 850 254 AFSL 300302 ("Phoenix") is the investment manager of the Fund. None of CFM, Phoenix, or their related entities, directors or officers makes any promise or representation, or gives any guarantee as to the success of the Fund, distributions, the amount you will receive on withdrawal, your income or capital return or the tax consequences of investing.

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.