BKI INVESTMENT COMPANY

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QUARTERLY REPORT

REIT's – The Other Listed Investment Company

Welcome to the 36th edition of the BKI Quarterly Report, prepared by Contact Asset Management ("Contact").

A Real Estate Investment Trust ("REIT") is a listed entity that owns and operates real estate assets to provide an investment opportunity. In many ways, it is not dissimilar to a Listed Investment Company (LIC). A REIT allows investors to benefit from valuable real estate assets in a variety of classes including Industrial, Commercial, Residential, Shopping Centres and Office. Access to a REIT through the purchase of individual company shares has its advantages and disadvantages, again not dissimilar to a LIC. In this report, we consider several REITs, some of which are owned in the BKI Investment Company and Contact Ex-50 Fund portfolios. We discuss that while the property sector's recent performance has been dominated by the movement in rates and yields, it's the core fundamentals such as balance sheet, pipeline of works, occupancy rates, rental growth and management that are essential for REIT stock picking over the longer term.

Return Hurdles

Synchronised global central bank tightening of monetary policy has driven the normalisation in bond yields. This has clear implications for future corporate spreads by adding cyclical economic risk, via relevant discount rates and a higher cost of debt.

Property investment Internal Rate of Return (IRR) hurdles normally include a 3.5% premium to long bond yields. Bond yields were ~1.7% at the start of 2022. The long bond is now ~3.8% for a total theoretical IRR of 7.3%, a 2.0% move in almost 12 months. Such a rapid expansion in required returns will challenge the economics of development opportunities in a weaker demand environment.

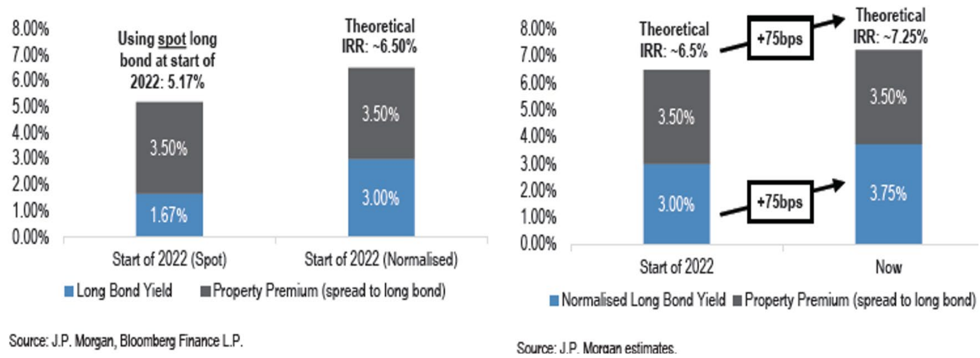

Chart 1: IRR Hurdles (Source: JP Morgan, Bloomberg Finance)

REIT Returns verses Bond Yield Correlation

The rally in bond yields has driven heavy relative under performance (by REITs versus the market) with a near - 100% correlation (see Chart 2). This is consistent with previous periods of sharp interest rate moves. Less volatile

environments almost completely erase correlation. The relationship to bond yields is due to both REIT status as a bond proxy due to perceptions of income stability that can be leveraged.

While financial positions appear strong, these are likely to be overstated by book values. That is, the book values may not reflect the change in cap rates which cause downgrades. A 100bps cap rate expansion would stretch gearing ratios and threaten funding while 200bps would require sector wide balance sheet repair.

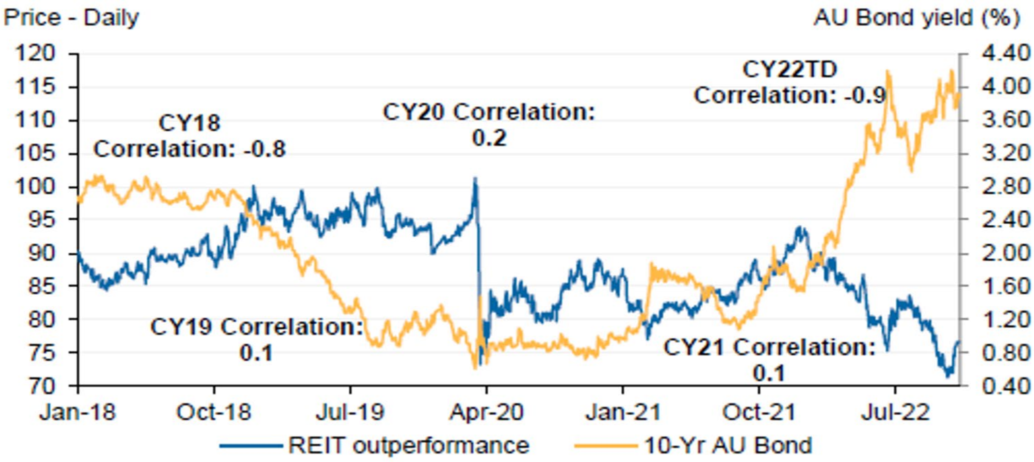

Chart 2: REIT Returns vs Bond Yield Correlation (Source: Macquarie)

The Cost of Debt

As illustrated in Chart 3, at the spot cost of debt, interest coverage ratios for the majority of the sector would likely trigger a review of covenents. About 65% of sector debt is hedged which, like fixed rate mortgages, will see the cost of funding shoot up as arrangements expire.

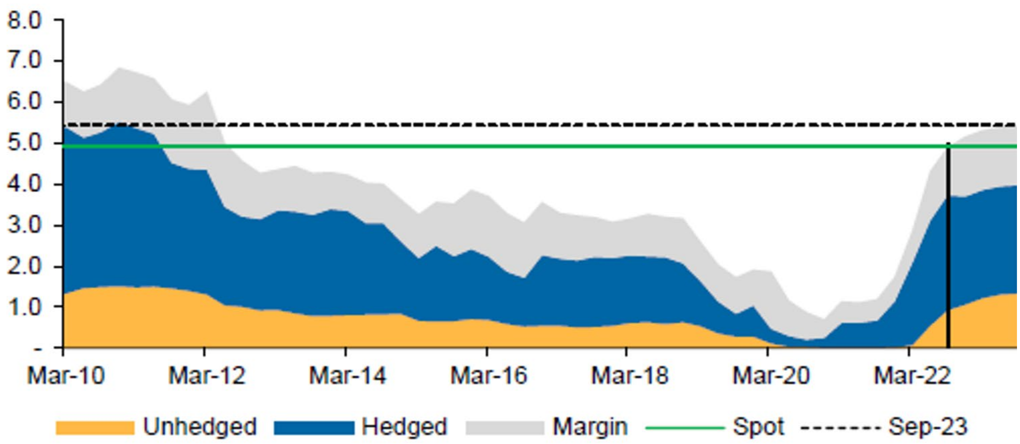

Chart 3: Implied Cost of Debt (Source: Macquarie)

We have been closely following interest coverage ratios for the REITs. We consider it an important test of Quality. In the BKI Investment Company portfolio as at 30 November 2022, we were 6.2% underweight the Real Estate sector. BKI owns only Goodman Group (1.3% portfolio weighting) and Stockland Group (0.3% portfolio weighting). Within the Contact Ex-50 Fund portfolio, our only major portfolio exposure to Real Estate is through Charter Hall (4.7% portfolio weighting).

As illustrated in the table below, Goodman Group and Charter Hall rate very well, with strong interest coverage of 163X and 56.3X respectively for FY2023. Stockland Group, while not as robust, has ample interest coverage at 5.8X.

	Reported	MRE					
	FY0	FY0	FY1	FY2	FY3	FY23 sens.	Covenant
ABP	6.1x	6.1x	5.2x	4.3x	3.4x	2.4x	2.0x
ARF	7.1x	7.2x	5.4x	4.3x	3.8x	4.0x	2.0x
CHC	n.a.	57.5x	163.6x	46.8x	40.6x	n.a.	4.0x
CIP	5.4x	5.2x	3.6x	3.2x	3.2x	2.0x	2.0x
CLW	5.4x	5.0x	3.3x	3.2x	3.6x	1.9x	2.0x
CQR	5.0x	5.0x	4.4x	4.2x	4.3x	2.7x	2.0x
DXI	6.1x	6.1x	4.2x	4.3x	4.2x	3.2x	n.d.
DXS	6.0x	6.0x	5.5x	6.2x	6.6x	3.2x	2.0x
GMG	36.7x	36.7x	56.3x	85.8x	146.1x	13.5x	n.d.
GOZ	5.2x	5.2x	3.6x	3.6x	3.8x	2.7x	1.6x
GPT	7.5x	7.5x	5.5x	4.1x	3.9x	3.0x	2.0x
HCW	n.a.	7.9x	6.0x	3.4x	3.6x	3.3x	2.0x
HDN	n.a.	6.3x	5.0x	4.9x	4.8x	2.4x	2.0x
HMC	n.a.	24.0x	12.1x	14.2x	21.9x	n.a.	2.0x
LLC	5.6x	5.6x	6.5x	9.0x	8.5x	8.6x	n.d.
MGR	>6x	6.7x	5.6x	5.7x	5.9x	4.1x	2.0x
NSR	7.5x	7.5x	4.1x	3.1x	3.0x	3.4x	2.0x
QAL	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
SCG	4.0x	3.9x	3.8x	3.2x	3.2x	3.2x	1.5x
SCP	6.1x	6.4x	5.2x	4.1x	4.1x	3.4x	2.0x
SGP	6.9x	6.9x	5.8x	5.1x	5.3x	6.2x	2.0x
VCX	4.7x	4.7x	4.7x	4.8x	4.9x	3.7x	1.8x

Notes: 1) ICR is calculated by MRE informed by company definitions and is approximate only. 2) Highlights represent where a company is within 1.5x of ICR; blue represents low ICR but no covenant disclosed. 3) FY23 "sens." refers to sensitivity of FY23E EBIT/EBITDA compared to a theoretical "spot" interest expense of 5.50% with relevant adjustments for capitalised interest, etc. 4) Earnings as original publication on 14-Oct-22.

Table 1: Interest Coverage Scenarios (Source: Macquarie)

Cap Rates

Cap rates, or capitalisation rates, refers to the ratio of a property's net income to its purchase price. It's an essential number for gauging a property's rental income potential. As cap rates compress, the implied value of the property increases (and vis-versa).

Chart 4 is illustrative in that it highlights just how far cap rates have declined over the last 30 years. Industrial cap rates have fallen from 12% to 4%, driving a significant uplift in valuation. Retail and Office cap rates have also compressed. The current implied cap rate levels are 6.9% for Office, 5.9% for Retail 5.1% for Industrial.

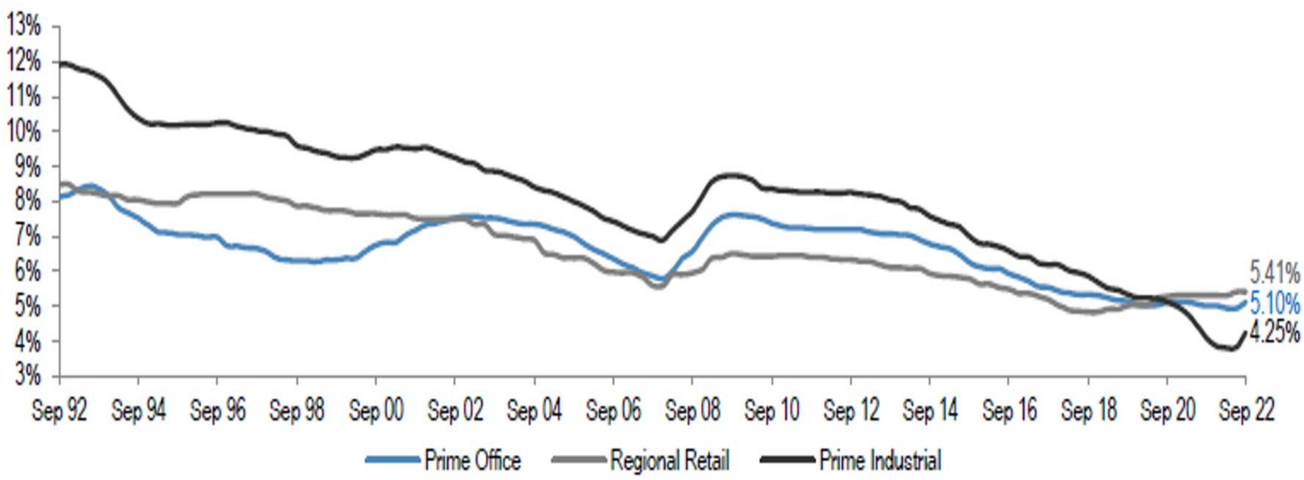

Chart 4: Direct Property Cap Rates (Source: JLL Research)

Consensus expectations anticipate cap rates will increase by approximately 50 bps for Industrial and 120 bps for Office. This could equate to a further 10% devaluation beyond the consensus cap rate forecasts or 20% relative to the June 2022 book values. Simply put, the market expects quite material cuts to property valuations as rates increase. The risk is that cap rates blow out more than expected.

Premium/Discount to NTA

As is the case with LIC's, REIT's can trade on a premium or a discount to their stated NTA's. Such devaluations, as explained above, could be quite confronting for the market with the inconsistency driving the significant discount to published NTA's at present. These 20% discounts experienced by some REITs are at a historic low and haven't been seen since the GFC, a period when some businesses were carrying unsustainable levels of debt.

Chart 5: A-REIT Price to NTA market cap weighted excluding fund managers (Source: JP Morgan)

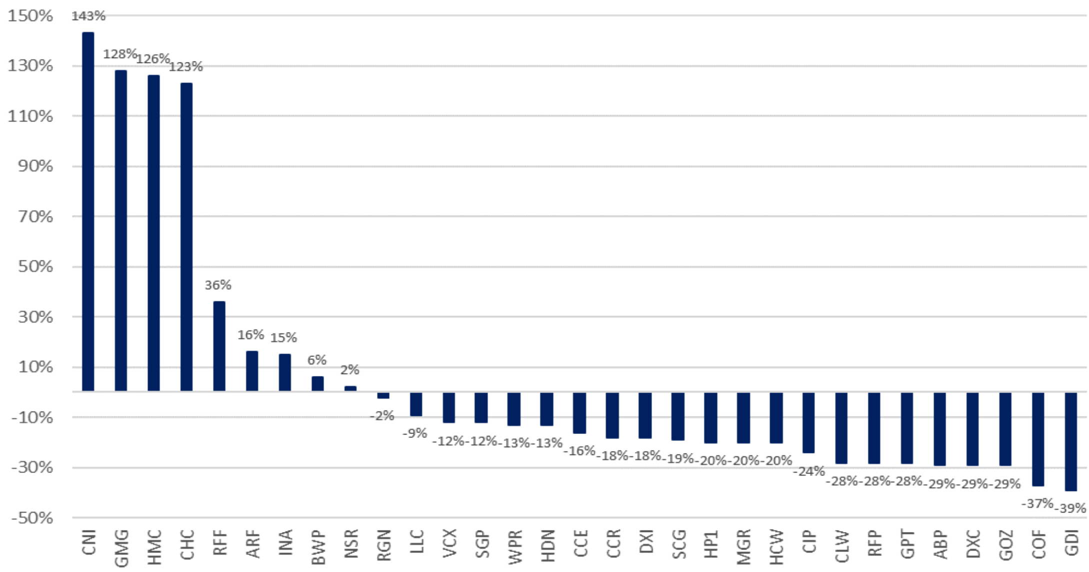

Chart 6: Price to NTA (Source: Credit Suisse)

This all suggests listed equity markets have moved ahead of direct markets, in effect partially pricing in more appropriate multiples which reflect new and genuine discount rates. While this is similarly true for the remainder of share markets domestically and globally, REITs are complicated by financial leverage. Unlike most other sectors where gearing is relatively low, this risk has increased for the highly geared REITs. However as for industrials, investors must also assess the correctness of the denominator, that is cash flow earnings. For REITs the funding of the above-mentioned debt could also be more a material factor in this determination.

Yields

Rents and income can be volatile. In previous shocks, the net effective Office rents fell significantly. In COVID-19 they fell 10%, almost 20% in the Dot Com bubble and approx. 35% in the GFC. Current rates are 14% below peak levels. Retail was more durable, actually rising marginally in the Dot Com and GFC periods, although falling 7% during COVID-19. Industrials have been the strongest with rents flat during the Dot Com period, down just 5% in the GFC, and rising during COVID-19 to be at peaks currently. This has been driven by strength in the Sydney market in particular, with the other capital cities relatively flat. Despite this, capital values outside Sydney have also increased materially impacting yields. With weighted average lease expiry (WALE) greater than 7 years, the normalisation in rents will impact earnings incrementally in the future.

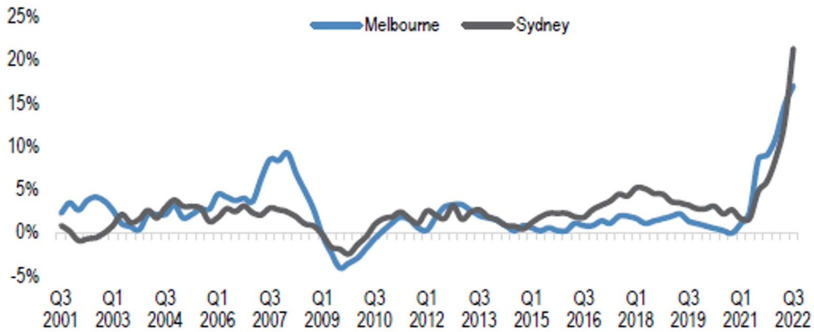

Chart 7: Industrial Rent Growth (Source: JLL Research)

During the above-mentioned economic shocks (Dot Com, GFC and COVID-19), vacancies for more cyclical Retail and Office properties rose, before reverting to a 5%-7% range for retail. In parts of the Office segment there is only 60% occupancy. Industrial remains near fully leased.

Until the GFC, REITs were considered a Defensive style in the equities market. Since then, that hasn't been the case, including during the most recent volatility, illustrated in Chart 8. With rental growth and occupancy, the two other fundamentals that we have been conscious of when selecting quality REITs, now cycling through, it's interesting to see that across the sector, these fundamentals have actually resulted in 3 year CAGR earnings growth of 0%. The exception here is again Goodman Group (GMG). At their most recent AGM presentation, GMG declared that their occupancy has held at 99% around the world. An impressive result and reflective of the current period. We are confident that GMG will continue to see high demand from customers seeking greater productivity and solutions from distribution and logistics.

Elsewhere, our discussions with property developers and builders recently have uncovered that deposits and sales are deteriorating, which is unfortunate. The good news is that contracts on hand have recovered slightly.

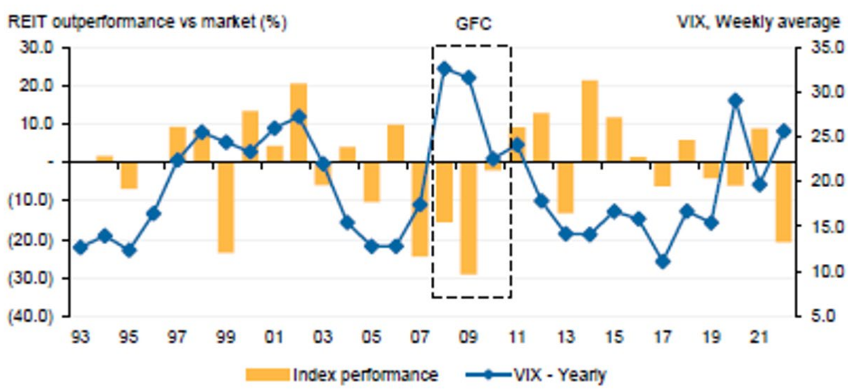

Chart 8: REITs Performance vs Volatility (Source: Macquarie)

Sector earnings and Funds From Operations (FFO) multiples are 15.5X (lower excluding fund manager/developers Charter Hall and Goodman Group) with large caps at 14X and small and mid-cap REITs at 16X. Relative to the broad industrials space, REITs appear cheap and in PEG terms, a group of stocks offering 4%-6% EPS CAGR trading at 14X-16X P/E multiples appear interesting on face value. However as for equities overall, denominators do not reflect a possible correction as multiples somewhat have.

Again, Goodman Group stands out here. In Chart 9 below, GMG are trading on a FY2023 Price to Earnings multiple of 18X. One could argue that the stock looks expensive, however with 2-year EPS CAGR of approx. 7.5%, sometimes you are happy to pay up for a quality stock.

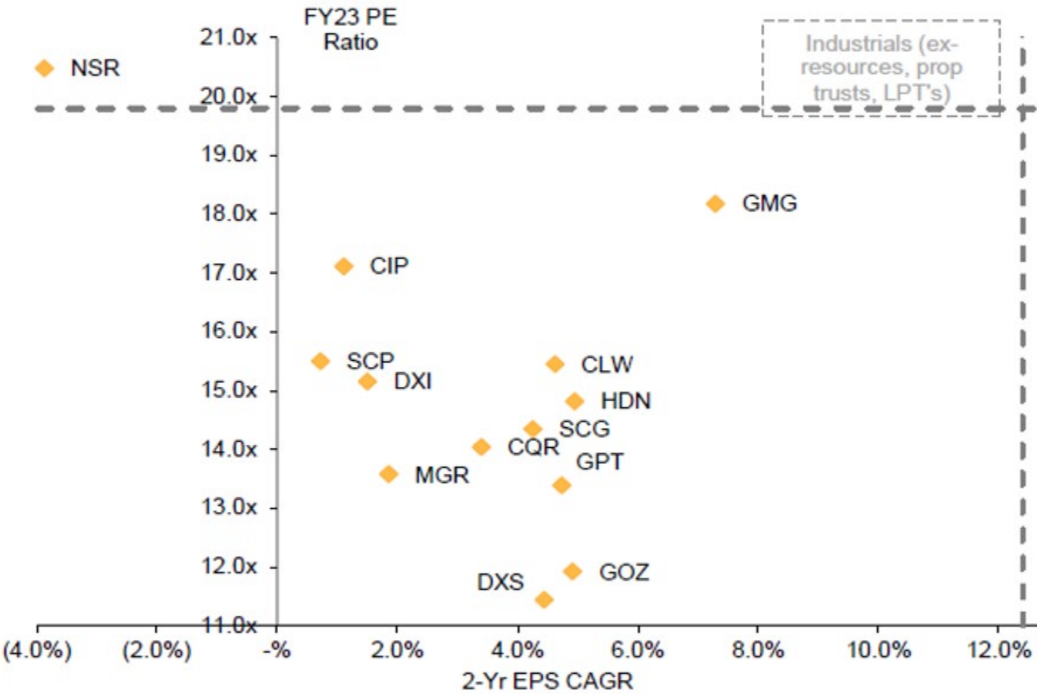

Chart 9: PEGs (Source: Macquarie)

Overall, Distribution Per Security (DPS) Yield for the sector is over 5.5%. At the stock level, the range of yields is substantial. Traditional passive REITs are somewhat in line compared to historical levels, while REITs who have recuring revenues from property fund management expertise (Goodman Group and Charter Hall) are extremely expensive on this measure. Compared to the Industrials sector, the average REIT DPS Yield of 5.5% is superior.

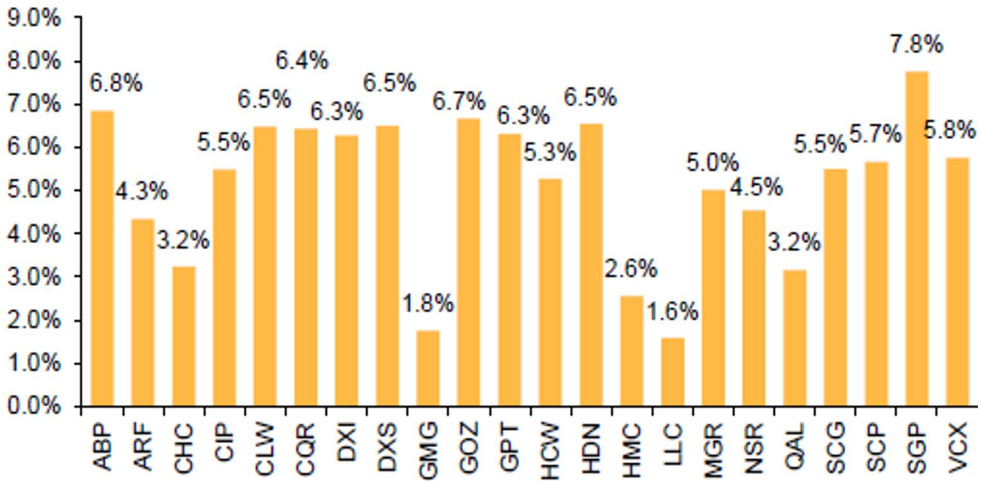

Chart 10: FY23 DPS Yield (Source: Macquarie)

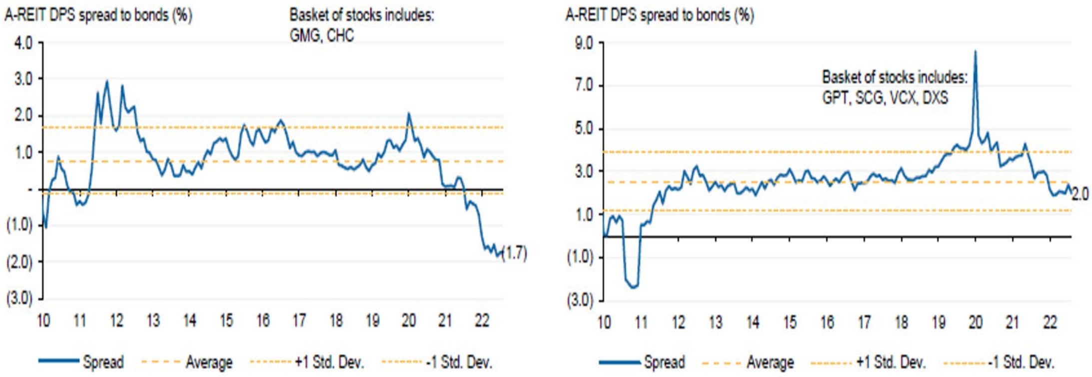

Chart 11: A-REIT DPS to Bond yields Spread (Source: Macquarie)

REITs appear to offer value based on current earnings multiples. This is possibly a function of uncertainty around property valuations. The challenge is a constant one for equity investors. How to identify companies with sustainable earnings yet be mindful of changing consumption, employment and supply chain management. One must also consider the impact of a higher interest rate environment. We expect that the best approach will be conservative investing across proven quality business models and industry exposures, well managed REITs with strong balance sheets and high quality assets with sustaining demand.

A Focus on Quality

We invest in stocks that we consider to be the highest quality REITs in the market being Goodman Group (GMG), Charter Hall Group (CHC) and Stockland Group (SGP).

Goodman Group is a global industrial property group, specialising in three main divisions, Property Investment, Development and Property Management. They develop industrial assets including logistics facilities, warehouses and business parks in strategic locations throughout 14 countries. GMG's Assets Under Management (AUM) are over $60b, increasing from $23b in 2013. They manage over 380 properties globally with over 1,700 customers with occupancy at 99%. FY2023 guidance was reaffirmed at their recent AGM and management are continuing to actively seek deployment opportunities that will set up GMG for ongoing growth given the demand from customers seeking greater productivity and solutions from distribution and logistics.

Charter Hall is one of Australia's leading fully integrated property groups. The company has over 30 year's experience in property investment and funds management. It operates across all core real estate sectors – Office, Retail, Industrial & Logistics and Social Infrastructure. CHC has recently indicated that it expects Group Property FUM to be circa $73 billion at 31 December 2022, continuing its history of strong growth. CHC's recent results have been characterized by strong FUM growth and crystallization of performance fees. The company has zero debt at the Group level and 25% gearing on a look through basis (to its underlying funds). CHC has strong return on capital metrics and an enviable history of distribution growth, currently trading on a yield of just under 4.0%.

Stockland Group recently celebrated their 70th anniversary and is one of Australia's largest diversified property groups, with an aim at "creating sustainable, thriving communities where people live, shop and work." Stockland own, fund, develop and manage a large portfolio of assets through two main divisions, Commercial Property (Logistics & Workplace and Town Centres) and Communities (Master planned Communities and Land Lease Communities). Stockland have restructured their business over the past few years and are now set to accelerate their pipeline of works. This includes a $41bn development pipeline across Commercial Property and Communities and $2.0bn Logistics & Workplace pipeline. SGP currently trades on a discount to NTA and their forecast DPS yield of 7.1% remains very attractive.

Conclusion

The current cycle may appear to be difficult to navigate and this is particularly true of the REIT sector. At Contact, we take a “Quality First” approach to investing. We have a stock selection and investment process that is proven, robust and repeatable. We focus on investing in quality companies to own for the long-term. The REITs sector can be complicated with different company structures and approaches to leverage. We believe that in this sector it is particularly important to focus on the high quality, profitable, well-run companies that will stand the test of time.

We see several similarities between REITs and LICs, not least of which is the listed structure and the variety of asset classes available to investors. From a fundamental point of view, we are conscious of “through the cycle” valuations on which companies trade with a focus on premium and discount rates on their Net Tangible Assets. As is the case with LICs, a company trading at a discount can provide a good buying opportunity. A company trading at a premium will need to justify its higher multiple by displaying a high-quality business. This can be achieved by delivering a long-term track record of performance through earnings and dividend growth, a robust balance sheet and a capable management team. All the things we look for at Contact when selecting stocks for a portfolio.