CROMWELL FUNDS MANAGEMENT • • • Phoenix Portfolios

CROMWELL PHOENIX PROPERTY SECURITIES FUND

MARCH 2024 QUARTERLY REPORT

Money Management Australian Property Securities Fund of the Year Winner 2023

Performance (Periods ending: 31 March 2024, Net of fees)

	3 Months	1 Year	3 Years	5 Years	7 Years	10 Years	Since inception (16 Apr 08)
Fund	10.35%	22.61%	9.35%	5.37%	6.67%	9.97%	8.28%
S&P/ASX 300 A-REIT Accumulation Index	16.16%	35.36%	11.52%	6.72%	8.25%	10.74%	5.70%
Outperformance	**-5.81%**	**-12.74%**	**-2.17%**	**-1.35%**	**-1.58%**	**-0.77%**	**2.58%**

Fund Strategy

The **Cromwell Phoenix Property Securities Fund** invests in ASX-listed property securities including Real Estate Investment Trusts (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

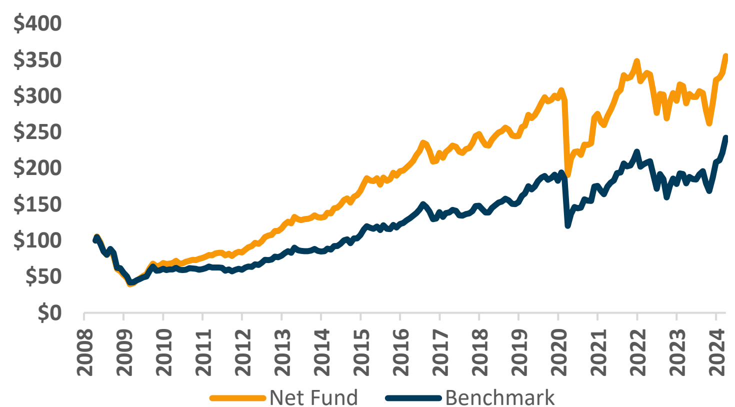
Factors influencing performance:

- The S&P/ASX 300 A-REIT Accumulation Index shot higher over the quarter, adding 16.2%.
- Dominating performance, Goodman Group closed 33.6% higher. The median property stock rose 6.2%.
- Reporting season was solid, with Retail the positive highlight, showing ongoing recovery post COVID.
- The Fund added value in a relative sense, by not holding some of the weaker stocks, including Dexus and Vicinity Centres.
- While Goodman Group remains a significant position in the Fund, the benchmark holding is much bigger, so was a material detractor to relative performance.

Current Positioning

- Broadly diversified across all key property subsectors of Industrial, Retail and Office, in that order.
- Preference for small cap, specialised property stocks 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	Newmark Property REIT Region REIT	Peet Limited GPT Group Lendlease Group
Underweight	Goodman Group	Dexus Vicinity Centres National Storage REIT

Market Commentary

The S&P/ASX 300 A-REIT Accumulation Index continued its march higher in the first quarter of 2024, gaining 16.2%. Property stocks meaningfully outperformed broader equities in the quarter, with the S&P/ASX 300 Accumulation Index adding a lessor 5.4%. This outperformance was predominantly driven by the 33.6% return of Goodman Group (GMG), which is the largest component of the property index, with a weighting of approximately 36%. The median return of stocks in the property index was a lesser 6.2%. Of 33 stocks within the index, only five were outperformers.

During the quarter, companies under coverage reported financial results for the period ended 31 December 2023. In general (with some notable exceptions), financial results were marginally better than expectations, demonstrating the resilience of property income streams. Outlook statements tended to acknowledge uncertainty, as the future path of interest rates remains a key input into likely outcomes.

Retail property was one of the stronger subsectors in the March quarter. Results released in February's reporting season showed solid sales growth within shopping centres and even more impressive were the much-improved re-leasing spreads. Owner of Australian Westfield shopping centres, Scentre Group (SCG) led the way, gaining 16.2%, whilst foreign owner, Unibail-Rodamco-Westfield (URW) also moved sharply higher, adding 14.8%. Peer, Vicinity Centres (VCX) underperformed the index, but performed strongly, up 7.3%. Owners of smaller neighbourhood shopping centres didn't keep up with their larger competitors, with Region Group (RGN) lifting 5.8% and Charter Hall Retail REIT (CQR) finishing the quarter 2.8% higher.

Once again it was office property that was the laggard as elevated vacancy and incentives continue to create concern about the prospects of office ownership. Dexus (DXS) materially underperformed the index, up 3.0%. Centuria Office REIT (COF) was weaker still, adding only 1.9%, whilst GDI Property Group (GDI) lost 5.4%. Large Capitalisation office owner GPT Group (GPT) also had a tough quarter, losing 1.5%.

Returns of property fund managers were mixed through the quarter. As previously discussed, it was GMG that dominated all comers. HMC Capital Limited (HMC) outperformed, finishing the quarter 17.7% higher, but much of its performance was tied to non-property funds management targets. Charter Hall Group (CHC) also performed solidly, gaining 14.2%. Centuria Capital Group (CNI) couldn't keep up with peers, losing 0.3% whilst Elanor Investors Group (ENN) gave up 12.2%.

For some time, we have highlighted the disconnection between private real estate valuations and public real estate equity share prices. It is inevitable, given time, that this gap closes. This can occur through private market devaluations, share price appreciation or M&A transactions serving to close the gap (or some combination of those options). During the quarter we have seen a combination of all three, with valuations moving marginally lower, share prices moving meaningfully higher and we have also begun to see some M&A activity. Each of Newmark Property Group (NPR), Eureka Group Holdings (EGH) and Hotel Property Investments (HPI) received takeover bids or had strategic parties acquire large stakes in the companies. Each of these companies were amongst the few outperformers in the quarter. Should small capitalisation securities continue to underperform, we would expect M&A activity to be an ongoing feature of the market.

Performance Commentary

Goodman Group (GMG) ▲ 33.6%

The portfolio holds an underweight position in GMG. Its outperformance detracted value from a relative perspective in the March quarter.

During the period GMG reported its financial results for the half year to 31 December 2023. As was widely expected, GMG increased its earnings growth guidance for the full year, now expecting earnings per share growth of 11% year-on-year. This will likely be upgraded once again as the year progresses. For the half, property management income and development income accelerated sharply. Management income was supported by the recognition of performance fees. Development income also moved sharply higher as more development work was undertaken on behalf of assets that are owned on GMG's own balance sheet. These will either be sold down to third parties or into funds and 100% of the development profits will accrue to GMG shareholders.

GMG also provided more detail on its nascent data centre business. As an owner of global infill logistics facilities, many existing sites lend themselves to a transition to data centre properties. Whilst this was raised in previous earnings announcements, GMG now stated it has a global power bank pipeline of 4.0 gigawatts, with 0.6 gigawatts already delivered and 2.1 gigawatts of power secured. The development margins would likely be attractive and accrue to both existing GMG funds as well as assets owned on GMG's balance sheet. No doubt more detail on this opportunity for GMG will be revealed over time, however it appears the opportunity is of a meaningful size.

GMG's share price rallied after the result, and it took another leg up towards the back end of February and into March. This was due to the inclusion of GMG into the globally relevant FTSE/EPRA NAREIT Global Real Estate Index Series. It has long been kept out of the index due to its non-property earnings streams. Whilst the earnings components have not changed, the inclusion criterion have. Market participants are aware that this will lead to significant flows into GMG stock on a formulaic basis, which will be independent of its valuation. This led to a second leg of share price appreciation in the period.

Newmark Property REIT (NPR) / BWP Trust (BWP) ▲ 41.2% / ▲ 2.7%

The portfolio holds a position in non-benchmark stock NPR. Its outperformance added value from both an absolute and relative perspective during the period. The portfolio does not hold a position in BWP Trust (other than its exposure through NPR). Its underperformance also added value from a relative perspective.

NPR is a small capitalisation, externally managed owner of large format retail (LFR) properties, with most of its income tied to properties leased by Wesfarmers-owned behemoth Bunnings. An amalgamation of existing syndicates, managed by Newmark, NPR listed on the Australian Stock Exchange in December 2021 at a price of $1.89. These assets, particularly those with long-term leases to Bunnings, attract very low capitalisation rates, due to the very high certainty of income and limited capital expenditure requirements faced as a property owner. Whilst this makes the properties extremely attractive, with cash flows more akin to a financial instrument, it does also mean capital values are extremely sensitive to interest rate movements. Given the secured nature of cash flows, NPR took on higher than average gearing levels. This in combination, with increasing interest rates led to a significant drop in NPR's share price, falling to as low as $0.97 in January 2024.

BWP Trust began life as a separately listed entity in 1998. It is also the owner of LFR assets, predominantly, but not wholly leased to Bunnings. Like NPR, it is externally managed, however BWP's external manager is Wesfarmers, the owner of the Bunnings operating business. BWP is also substantially larger than NPR, with a market capitalisation in excess of $2 billion. Due to the vintage of BWP, its properties have a shorter weighted average lease expiry (WALE) than NPR.

In late January, it was announced that NPR had agreed to merge with BWP. The proposed consideration was 0.4 BWP units for every unit owned in NPR. At the time of the announcement, this represented a 43.1% premium for NPR shareholders, based on prevailing share prices. For NPR shareholders the benefit of the deal would be the immediate realisation of value at a meaningful premium to the current share price. The acquisition price does however represent approximately a 17% discount to NPR's pro-forma 31 December 2023 net asset value. BWP traded at a skinnier 7% discount to its pro-forma net asset backing at the time of the deal's announcement. From the perspective of BWP shareholders, this deal is therefore attractive on a relative basis.

Adding some controversy to the deal, the manager of NPR, Newmark Group is being paid $22.5 million by Wesfarmers for the management rights of the vehicle. This amount along with the headline discount to net tangible asset backing has caused angst amongst some NPR investors who have publicly voiced disappointment with the deal. Despite the contentious nature of the deal, as at the end of the quarter it has become unconditional and is all but finalised.

Lendlease Group (LLC) ▼ 13.1%

The portfolio holds a position in non-benchmark stock LLC. Its underperformance detracted value from an absolute and relative perspective.

LLC has produced disappointing results in recent periods and has stated that its earnings will be below target in the short term. At its results for the first half of the 2024 financial year, LLC announced that outcomes for the year would be below prior expectations. Its existing office project in North Sydney was written down, after it had previously recognised development profits on the project. More write downs are likely to eventuate in future periods. Furthermore, LLC announced that it would exit its construction operations in the West Coast and Central United States of America, which will include meaningful wind-up costs. Even past transactions were causing disappointment, with an additional provision taken for remediation works associated with a business LLC acquired in the United Kingdom, on projects that were completed prior to LLC’s acquisition. It also revealed that the Australian Tax Office is likely to pursue it for a nine-figure sum over tax practices associated with its now divested retirement business.

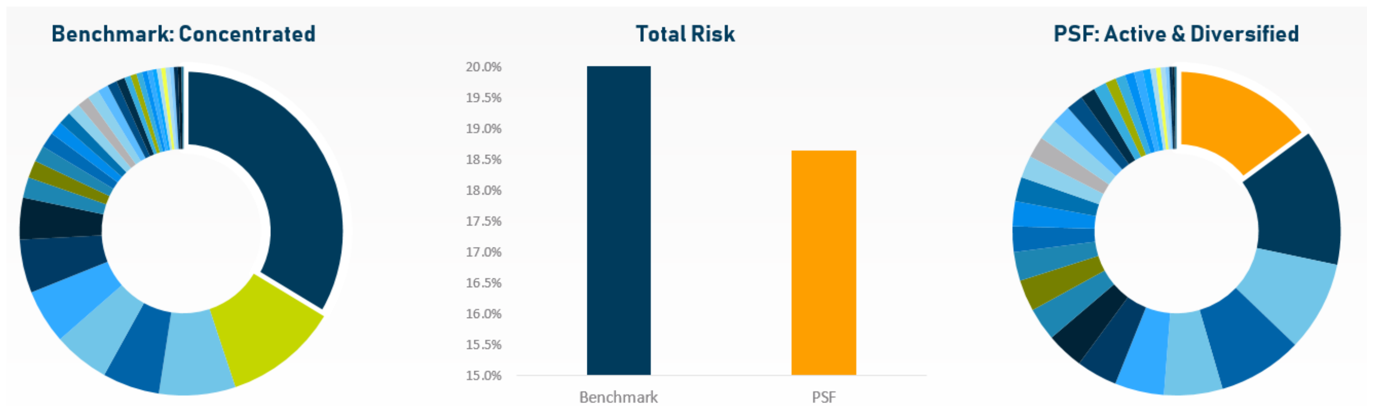
LLC has exposure to city shaping projects across the world. Its business model focusses on sourcing these extremely long dated projects and using its internal construction team to build them, its balance sheet to develop them and then its funds management partners to buy completed, or semi-completed product, thereby creating assets under management. This business model is somewhat similar to GMG’s and works extremely well, creating a virtuous cycle in good times. Through their full lives, the projects under LLC’s control are likely to be highly profitable and extremely important to many communities across the world. At present however much of the development pipeline requires the construction of office buildings. Globally construction costs have gone up, while demand for office space remains tepid. Further complicating matters, investment demand for office property is highly subdued. This has caused disruption to LLC’s business model. Despite this setback there are no doubt valuable components of LLC’s business, and it currently trades at a valuation which assumes substantial impairment.

It is possible that a strategic review to realise value for shareholders is undertaken. It is also possible that existing projects are recut to ensure LLC is a strong and viable business moving forward. Whilst the status quo is no longer feasible, should adjustments be made LLC could be a significantly more valuable business than its current share price implies.

What happens when the benchmark goes nuts, and you're not a benchmark hugger?

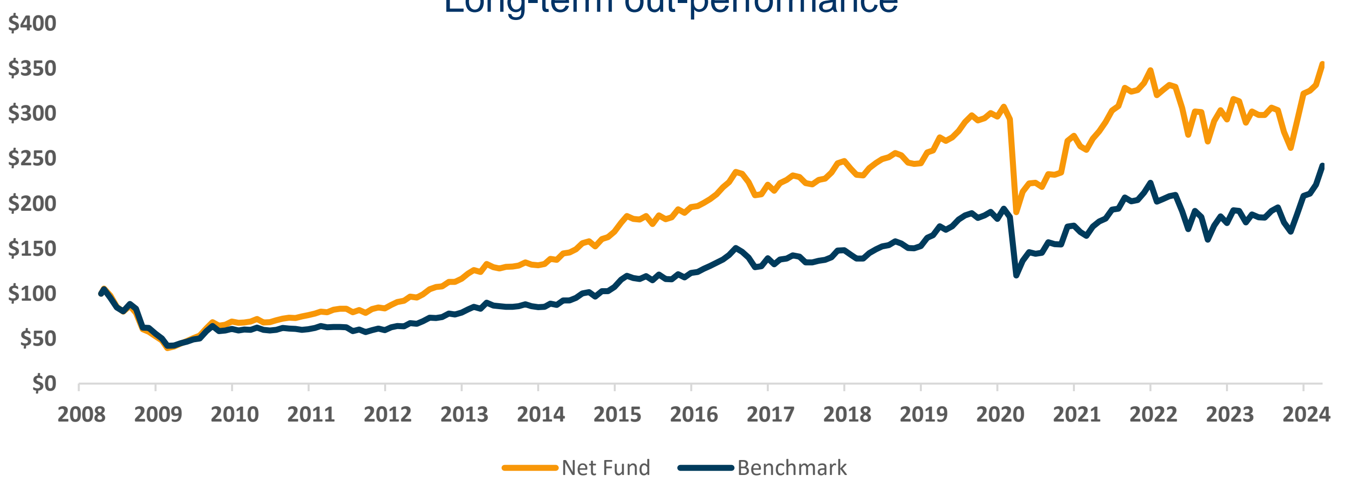
The Cromwell Phoenix Property Securities Fund (PSF) follows a "benchmark unaware" investment strategy.

Unlike the benchmark (left in diagram below), we have a more diversified portfolio (right) with less risk of a permanent loss of capital (middle).



Recognised by investment research houses for its strong long-term track record

The Fund has earned multiple awards for its exceptional performance as one of the top property securities funds in Australia. Since inception, net of fees, the strategy has delivered on its objectives, both from a return and risk perspective.



Poor Short Term Track Record

However, over the 12 months to 31 March 2024, despite delivering a net return to investors of 22.4%, the far more concentrated benchmark has done much better. The benchmark is up 35.3%.

So, what happened?

One stock predominantly driving benchmark performance

Goodman Group is an owner, manager and developer of industrial property in Australia and New Zealand, Hong Kong, China, Europe, the UK, and parts of the US and Brazil. The business is among a small number of domestic businesses that have developed an expertise and exported the capability offshore. Westfield would be another.

Industrial property has been the beneficiary of the move towards online retail sales, because of the extra demand this creates for industrial space. As a result, the acceleration of the move to online, brought about by COVID, helped industrial landlords. Today, with the acceleration in the application of Artificial Intelligence, the demand for data centres is creating another high value use for industrial land. This is particularly true for landlords that have had the foresight to acquire land in strategically important locations, with access to, or the ability to deliver abundant power and water and fibre network adjacency.

Goodman Group has positioned its business well and is focussed on industrial property in specific cities across the world. There is a lot to like about the Goodman Group business.

However, like any good business, it is not without risk. Approximately three quarters of Goodman's operating earnings come from a combination of development activity and funds management activity, including performance fees. These activities are cyclical, and some consideration of their sustainability needs to be factored into valuations and portfolio positions.

No matter how good something is, do you really want more than 20% of your portfolio in it?

The Cromwell Phoenix Property Securities Fund is "benchmark unaware", so no matter how attractive a stock might appear, the position size is capped at 20% of the Fund. This is for risk control reasons.

Over the 12 months to 31 March 2024, this risk control measure has resulted in fund performance differing materially from the performance of the benchmark.

At the end of March 2024, the Fund held a position in Goodman Group of nearly 15%. The stock's weight in the benchmark is closer to 36%.

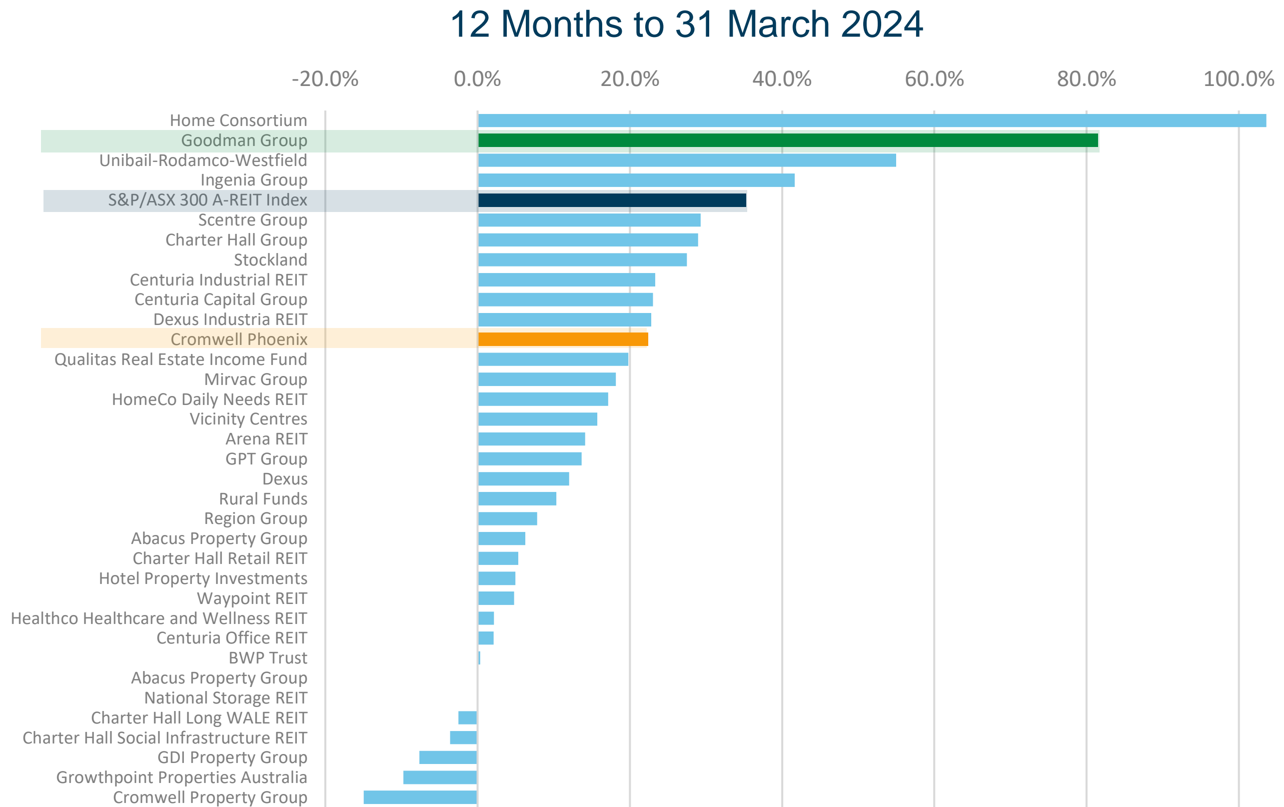
Over the 12 months to 31 March 2024:

- Goodman Group delivered a total return of +81.5%
- The benchmark delivered a total return of +35.3%
- The Cromwell Phoenix Property Securities Fund delivered a total return after fees of 22.4%.

However, given the magnitude of Goodman's weight in the benchmark, its performance explains almost all of the benchmark return for the period. We estimate the benchmark, excluding Goodman Group delivered a total return of approximately 7%.

Goodman Group Dominates Benchmark

As shown in the chart below, Goodman Group was the second strongest return, and is one of only two large capitalisation stocks (shown in green, that beat the benchmark return (shown in dark blue). The performance of the Cromwell Phoenix Property Securities Fund is shown in orange.



Flow of Funds also a factor

There are of course other factors at work, not least of which has been the significant flow of money into index funds, with the resultant upward pressure on index constituents. The bigger a stock is in the index, the more money that index funds have to invest in it – that's how a capitalisation-weighted index works. Not unlike the broader share markets, both locally and globally, this has resulted in a widening in performance between large capitalisation and small capitalisation names. For a fund with a typical skew towards some of the smaller stocks, this impacts negatively in the short term.

Sticking with the process

While it is disappointing to reflect on such a poor relative performance, the explanation and charts above hopefully provide some context. We should expect periods of material deviation from benchmark performance, and provided the manager has the gumption to stick with the process, robust long term returns, both absolute and relative to a benchmark should prevail.

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 February reporting season saw stocks providing solid updates, with cautiously optimistic outlooks, based on the assumption that interest rates may have peaked. Long term valuations are driven by “normalised” interest costs, meaning the impact of short term hedges maturing is mostly immaterial. Should the forecast decline in interest rates eventuate, recent headwinds may dissipate and possibly reverse.

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 remain elevated.

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 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	2.3%
ASX 300 A-REITS	87.3%
Other ASX Listed Securities	10.4%

	Fund	Benchmark
Office	15.9%	11.8%
Retail	26.4%	30.8%
Industrial	35.2%	49.7%
Infrastructure	0.0%	0.0%
Other	20.2%	7.7%
Cash	2.3%	0.0%
Total	100.0%	100.0%

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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.