CROMWELL PHOENIX PROPERTY SECURITIES FUND

September 2024 QUARTERLY REPORT

Money Management Australian Property Securities Fund of the Year Winner 2023

Performance (Periods ending: 30 September 2024, Net of fees)

	3 Months	1 Year	3 Years	5 Years	7 Years	10 Years	Since inception (16 Apr 08)
Fund	17.10%	38.69%	6.15%	5.82%	7.91%	9.78%	8.59%
S&P/ASX 300 A-REIT Accumulation Index	14.30%	45.93%	8.82%	7.23%	9.61%	10.46%	6.01%
Outperformance	**2.80%**	**-7.25%**	**-2.66%**	**-1.41%**	**-1.70%**	**-0.68%**	**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

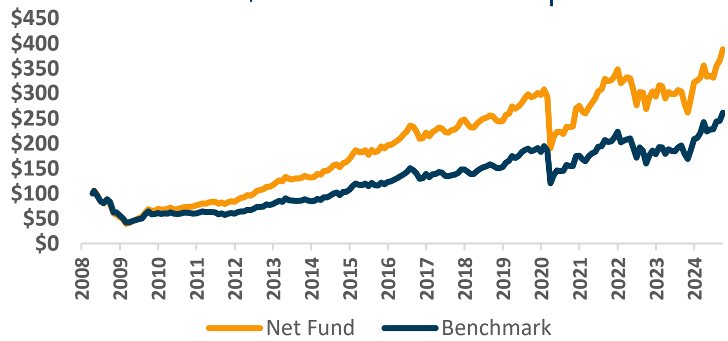
Factors influencing performance:

- The S&P/ASX 300 A-REIT Accumulation Index rose sharply, adding 14.3%.
- Charter Hall Group and Lendlease Group led performance, up 42.8% and 33.0% respectively.
- Reporting season in August, demonstrated the resilience of the property sector, with some growth starting to reemerge.
- The Fund added value in an absolute and relative sense, by holding overweight positions in Charter Hall and Lendlease.
- The Fund added relative value by holding an underweight position in Goodman Group.

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	Charter Hall Group Lendlease Group GPT Group	Desane Group Garda Property Group Peet Limited
Underweight	Scentre Group	Goodman Group

Market Commentary

The S&P/ASX 300 A-REIT Accumulation Index rocketed higher during the September quarter, gaining 14.3%. Property stocks outperformed broader equities in the period, with the S&P/ASX 300 Accumulation Index adding 7.8%. During the quarter most companies in the property sector released their full year financial results to 30 June 2024. The solid results and upbeat outlook statements aided performance. The other (related) factor was the reduction in interest rates over the period. At the end of June, the 10 Year Australian Government Bond yield was 4.4%, however it ended September below 4.0%.

Traditional property fund managers were some of the strongest performers in the September quarter. The earnings of these companies are particularly sensitive to movements in interest rates. At current levels, property funds management product is once again in demand, with yield and expected internal rates of return (IRRs) which are appealing relative to fixed income products. Charter Hall Group (CHC) led the way, gaining 42.8%, as its earnings guidance for the next financial year surpassed the expectations of market participants. Centuria Capital Group (CNI) was also a meaningful outperformer, adding 26.7%, as it was carried by the same positive sentiment that drove CHC higher. Alternatively, Goodman Group (GMG) returned a respectable 6.4%, but underperformed the index as lofty expectations of future earnings growth were not met by the guidance provided at its annual financial result.

Shopping centre owners were also outperformers, as they produced solid results and presented earnings guidance that demonstrated resilience. Operating metrics, such as specialty sales and leasing spreads did diminish across the year, but some believe that a lower interest rate environment over the medium term and tax cuts in the short term are likely to lead to strong consumer spending and income growth for retail property owners. Vicinity Centres (VCX) was the major outperformer, moving 22.6% higher in the quarter. Scentre Group (SCG) also rose sharply, up 19.7%. The owners of smaller neighbourhood shopping centres saw more muted, but still strong performance, with Charter Hall Retail REIT (CQR) returning 14.9% and Region Group (RGN) lifting 9.0%.

Large capitalisation diversified property owners were also beneficiaries of the renewed enthusiasm from property securities. Stockland (SGP) rose 25.7%, aided by solid operational progress and the prospect of an improving market for the sale of new residential homes and land. GPT Group (GPT) also performed well, up 24.5%, with new CEO Russell Prout outlining his vision for a more capital efficient and higher return on equity (ROE) future for the business. Despite dropping on an underwhelming financial result, Mirvac Group (MGR) more than recouped its losses, finishing the quarter 15.0% higher.

Larger land lease retirement property owners were the major underperformers during the quarter. Lifestyle Communities (LIC) lost 31.8% as it was the subject of an ABC investigation, which suggested it was taking financial advantage of its customers. It has also been the subject of a short report, questioning its business model. Beyond this, it solely operates in Victoria, which is currently the weakest state in terms of house price growth and new home sales. This combination of factors forced the company to withdraw its sales guidance for the coming years. Ingenia Communities Group (INA) produced a solid financial result, albeit the quality of its earnings has been questioned. It underperformed the index but still lifted 6.5% in the period.

Performance Commentary

Charter Hall Group (CHC) ▲ 42.8%

The portfolio holds an overweight position in CHC. It was a positive contributor for the portfolio from both an absolute and relative perspective during the quarter.

As a diversified property fund manager, CHC has faced challenging conditions in recent times, with the increase in interest rates causing valuation challenges for existing funds and limited demand for new funds. Many market participants thought that this would present earnings growth headwinds for some time, with negative valuations being compounded by negative fund flows. As such, CHC's operating earnings guidance of 79 cents per security for the 2025 financial year (as compared with 75.8 cents this year) was a positive surprise. Managing Director, David Harrison, struck a surprisingly positive tone on the earnings call, stating, "I don't think it's going to be much different to previous cycles. And if and when rates come down, I think that demand is going to accelerate… quicker than people think." This flies in the face of expectation of ongoing tepid demand into the medium term.

CHC's operating performance has been impressive, even in a backwards looking sense. Each of its sources of equity saw net inflows across the 12 months to 30 June 2024. Most of this was seen in wholesale partnerships, demonstrating the advantage of having a diversified source of equity funding. Development activity has also supported both funds under management and earnings, with a meaningful amount of industrial development completed during the period.

CHC also changed the way it reports its earnings from co-investment stakes. Whilst this is a nuanced change, it made the stock eligible for inclusion in the FTSE EPRA NAREIT series of indexes and became a constituent late in the period. This *should* have no bearing on the value of the company however it meant that a meaningful amount of CHC shares were purchased by index funds, likely supporting the share price.

Goodman Group ▲ 6.4%

The portfolio holds an underweight position in GMG. Its underperformance added value from a relative perspective.

GMG presented a solid set of results for the 2024 financial year, with operating earnings per security growing 14.0%. The quality of this growth was mixed, with most being driven by management earnings. This growth included a jump in performance fees, which are not perpetual by nature, and one-off earnings from the internalisation of GMT New Zealand. More positively, commenced developments stepped up in the fourth quarter of the year and the yield on cost of commencements increased to 7.5%, comparing favourably with the 6.7% yield on cost of work in progress.

GMG once again updated its global power bank for potential data centre developments. It stated it now controls 5.0GW of power, of which half is procured and the other half in advanced negotiations. Data centres now represent 40% of GMG's work in progress, however this could easily go above 50% in future periods. Whether GMG will develop powered shells (power plus the physical real estate) or will develop completed data centres (or anything in between) is still to be seen.

GMG's relative weakness in the period was likely driven by earnings per security growth guidance of 9%, below what many were expecting. GMG has a history of outperforming guidance and it is highly likely that they will again. However this has been such a longstanding phenomenon, that it is expected and likely priced into the current share price.

Scentre Group (SCG) ▲ 19.7%

The portfolio does not hold a position in SCG. Its outperformance detracted value from a relative perspective.

Scentre Group is the owner and operator of Westfield-branded shopping centres across Australia and New Zealand. Its recent strong performance is somewhat confounding. It closed the period as one of a minority of property owners in the property index to trade at a premium to its net tangible asset backing. Its book capitalisation rate is 5.35%, much tighter than most other property types and the tightest of all retail property owners. In the short term it has the benefit of rent growth tied to inflation, however, over time rent will be tied to the profitability of retailers. Recent updates from SCG's major tenants have been somewhat underwhelming.

For the first time in a while some stakes in SCG operated shopping centres have transacted. Most recently, SCG teamed up with Barrenjoey Private Capital Management to purchase a 50% stake in Adelaide shopping centre, Westfield West Lakes, at a 10% discount to its prior book value at an implied capitalisation rate of approximately 7.7%. The price represents a discount of 36% from its peak value. This comes after SCG and Barrenjoey teamed up to buy a 50% stake in Westfield Tea Tree Plaza, also in Adelaide, for similar valuation metrics. These transactions are not supportive of the valuation currently ascribed to SCG's equity, further confusing the recent uplift in its share price.

SCG also released its half year financial result in August. It produced a solid result, with funds from operations increasing 2.0% and specialty sales increasing 2.1% in the six months to 30 June 2024. More positively, rent escalations were +5.5%, aided by contractual rent growth linked to inflation. Over longer periods rent growth is likely to match the profitability growth of retailers.

It must be said that SCG's capital management has been impressive. The company did not issue equity in the COVID-affected period, when many others did at share prices which turned out to be very cheap. Instead SCG issued long dated subordinated notes at a lower cost of capital. With improved sentiment, SCG has now issued new cheaper subordinated notes to redeem the higher cost notes issued during COVID. This should reduce the company's cost of debt and support earnings growth in the near future.

Keep it Simple Stupid – The Three C's

Sometimes the simplest ideas are the best ones. That is how the current market feels. Recent drops in global interest rates and more positive sentiment generally provide a good backdrop for property and property securities. Many of the larger or more active property securities appropriately reacted to this, as can be seen by the 14.3% return of the property sector in the September 2024 quarter. Some larger securities have seen their discounts to net tangible asset (NTA) backing close entirely, or trade at premiums to NTA. The prospective returns of these securities are likely to be more muted in future periods. The good news is there are some securities which have not fully caught this wave of optimism and continue to trade at discounts to NTA. As it happens, these securities tend to be smaller, simpler and have very forecastable earnings. This set of opportunities provides very attractive prospective risk-adjusted returns. In this article we will outline three examples of simple property owners that present attractive investment opportunities.

Centuria Industrial REIT (CIP) – A well managed industrial property owner

Industrial properties have been the beneficiaries of ever-expanding e-commerce and less and less infill space available for industrial use. Vacancy for industrial property across the country is approximately 2.0%. With almost no spare space, industrial rents have increased at approximately 20% per year for the past two years. This type of growth is not sustainable, but demand for space continues to be high and there are still constraints to new supply. In the short-term rents are continuing to grow at above average rates and in the medium term we do not expect to see rents collapse.

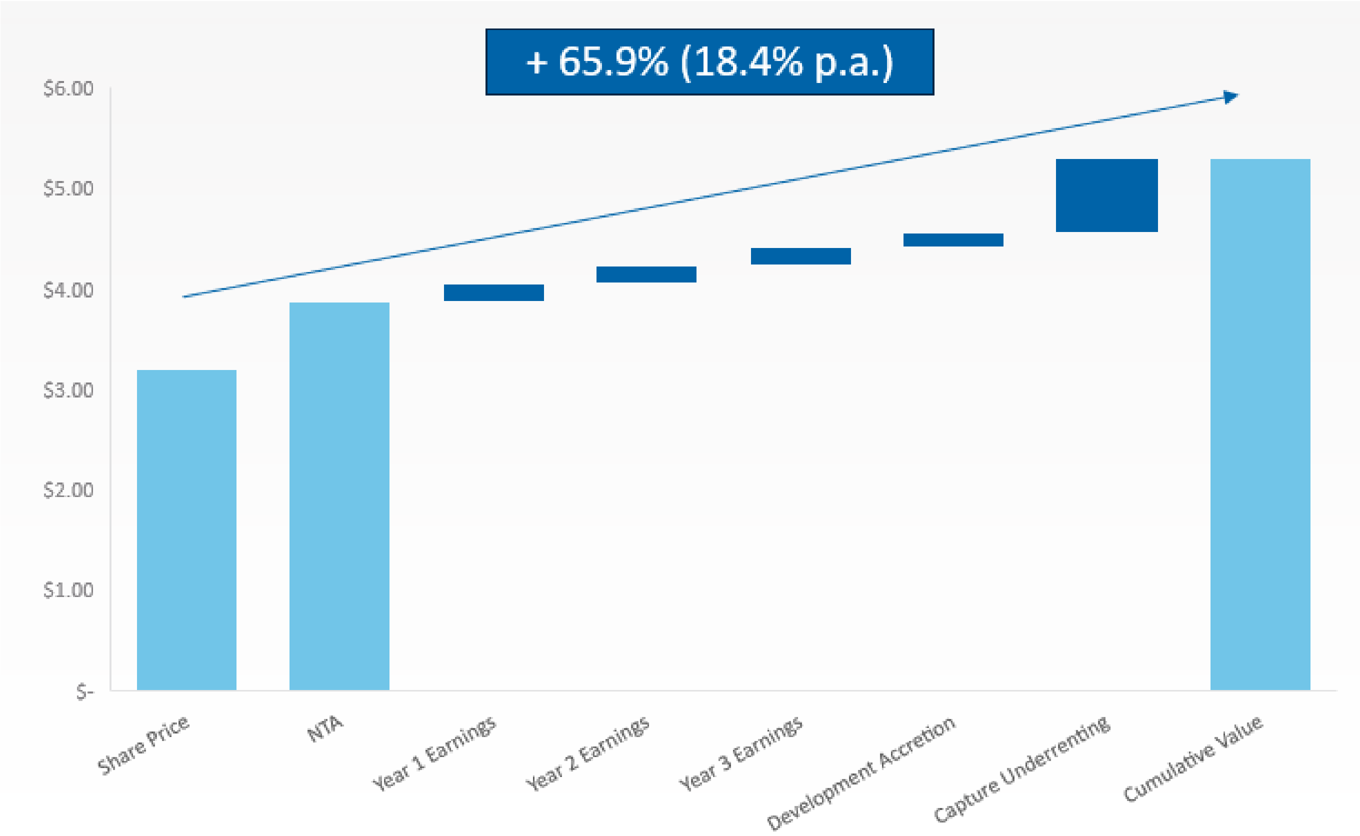
CIP is the owner of 89 Industrial properties across Australia. The vast majority of properties owned by CIP are located in urban infill markets. CIP's portfolio is high quality and weighted towards distribution centre properties, which are the key beneficiaries of the trend towards the increasing adoption of e-commerce. CIP has also reviewed its portfolio and identified over $1 billion of development opportunities. CIP has a strong track record of industrial development, and these opportunities are likely to provide attractive returns to shareholders.

CIP's passing rental income is also extremely secure. In fact, as leases were predominantly signed some time ago, the current rental levels are significantly below market rates. This situation is described as "under-renting" in the property industry. Independent valuers assess CIP's portfolio as approximately 15% under-rented, however valuers tend to be backwards looking and the true level of under-renting is likely to be at least 15% more than this assessment. This is supported by the re-leasing spreads achieved by CIP, which were 43% in the financial year that ended on 30 June 2024. Whilst this under-renting can't be crystalised immediately, as leases expire, they will reset to higher levels, supporting rent growth into the medium term.

CIP's weighted average capitalisation rate (cap rate) is 5.81%, which is probably a fair reflection of the market and may even be slightly wider than current market cap rates. Despite all the positives associated with CIP, it finished the quarter trading at a 17.3% discount to its NTA, or an implied cap rate of 6.54%. With secure earnings and strong growth prospects, this is a compelling return proposition. To highlight just how compelling the financial returns could be we present an ***optimistic*** three-year scenario with the following assumptions:

- Underlying earnings grow at 3% p.a.
- Developments add 1% to portfolio value p.a.
- Actual under-renting is full captured by valuers
- CIP trades at book value in three years' time

The results of this scenario can be seen below:



Again, this scenario is an optimistic one and makes many simplifying assumptions[1]. As shown above, a total return of more than 65% (18.4% p.a.) over three years would be exceptional. Even less ebullient assumptions would show good prospective returns, particularly when you consider CIP is a simple owner of low-risk, infill industrial properties that are meaningfully under-rented.

Charter Hall Social Infrastructure REIT (CQE)- Government-backed income at a discount

CQE is predominantly the owner of childcare properties across Australia. Time and time again the Australian Government has shown a commitment to the childcare sector. This commitment has had consistent bipartisan support. This is not surprising, given its positive impacts. Childcare directly and positively impacts the employment participation rate, particularly amongst females and research has demonstrated the benefits of early learning. In the 2023 financial year, childcare subsidy spending was more than $10 billion and this is expected to grow to $16 billion by 2027 as part of the 'Cheaper Childcare Plan' introduced in 2023. More recently, the Productivity Commission's draft report recommended the Government provide three days a week of early education for every child.

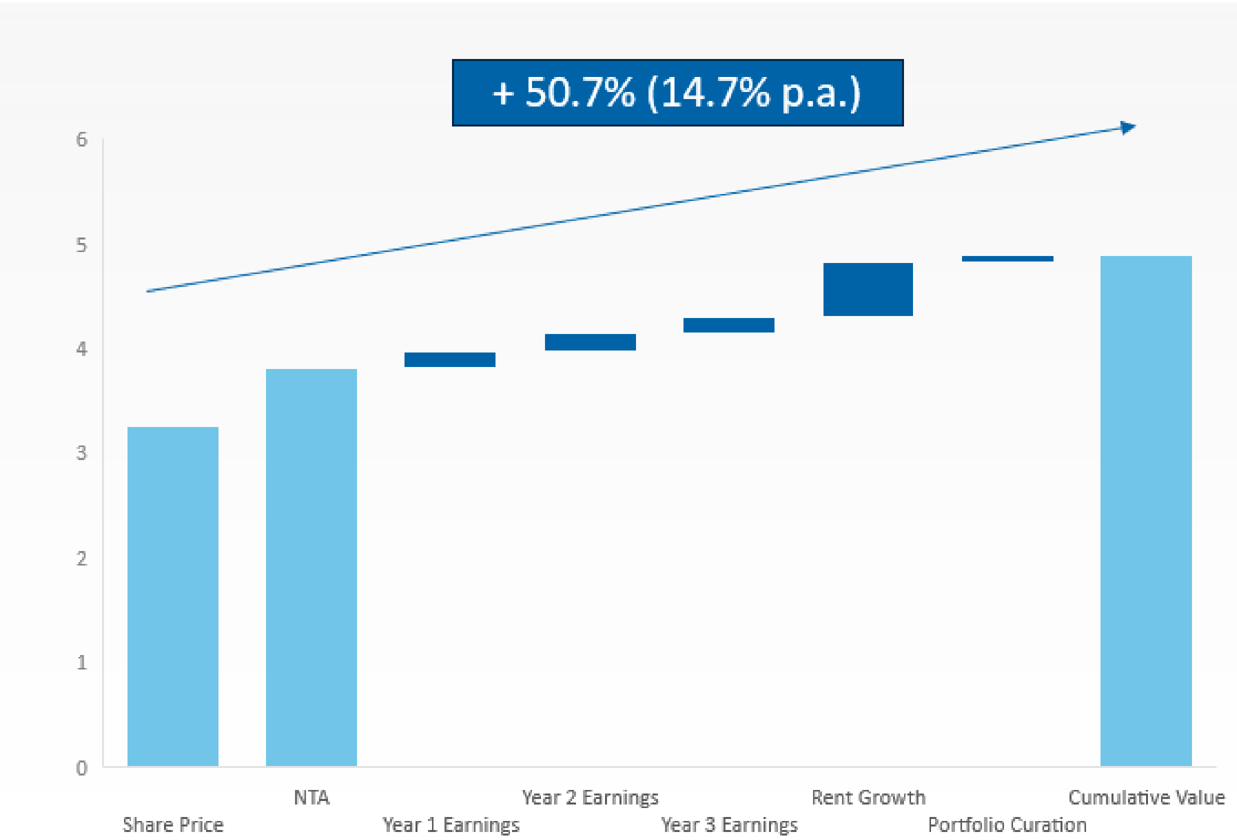
Governments have also shown they will step in when times are tough. CQE's largest tenant, Goodstart Early Learning traces its origins to the bankruptcy of ABC Learning in 2008, when the government stepped in and injected $22 million to ensure the centers would keep running, despite the turbulent economic period. During the COVID-affected period the government also stepped in, providing funding to keep centres running.

Childcare leases also benefit from being triple net, meaning the tenant is responsible for all capital expenditure during the life of the lease. The properties by their very nature tend to be in populated, residential areas, with strong land backing and alternate uses. Like CIP, CQE's portfolio is also under-rented (not to the same extent). There are mechanisms within the leases to capture this under-renting over time in a capped manner.

[1] These include not considering maintenance capex and incentives, no reinvestment of earnings/dividends, stable capitalisation rates and others. The purpose of the analysis is to demonstrate potential upside and the building blocks to get there.

CQE's weighted average cap rate is 5.2%, perfectly reasonable for an under-rented, government supported income stream growing at approximately 3% per annum, with no requirement to pay for any capital expenditure. Recent market evidence is supportive of this valuation and during the most recent financial yar, CQE itself divested 12 assets at an average yield of 4.7%, representing a 4.1% premium to book value. Since 30 June, CQE has agreed to divest a further three assets at a yield of 4.5%, representing a 4.8% premium to book value. Despite all of this, CQE ended the quarter trading at a 15% discount to its book value, or an implied cap rate of 6.24%. Once again, we will highlight an ***optimistic*** three-year investment scenario, with the following assumptions:

- Underlying earnings grow at 3% p.a.
- Portfolio curation, such as the recent selling of assets adds 0.5% p.a.
- No change to under-renting
- CQE trades at book value in three years' time



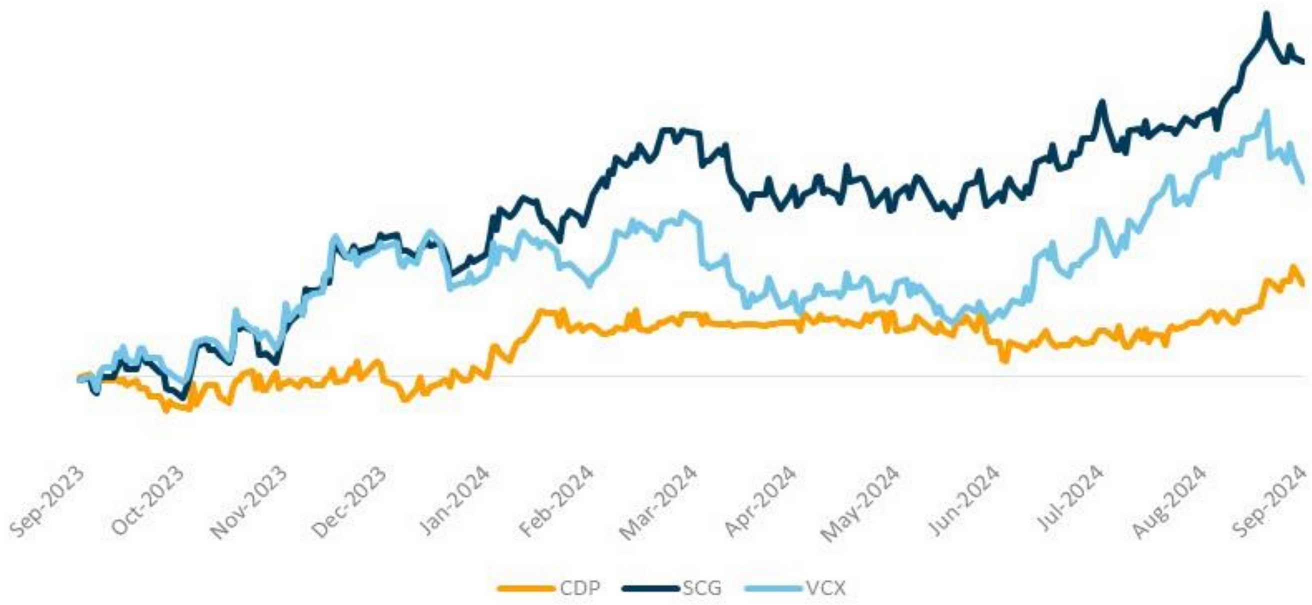
Whilst not quite as eye watering as the returns for CIP, a total return of more than 50% (14.7% p.a.) would be a great outcome, particularly when considering CQE's assets are government supported, heavily land-backed and the portfolio maintains conservative gearing. We will take those types of risk adjusted returns any day.

Carindale Property Trust (CDP) – Simply owning a shopping centre

CDP is one of the simplest property trusts in the investment universe. It owns a 50% stake in Westfield Carindale, a regional shopping centre in the Brisbane suburb of Carindale. CDP is externally managed by Scentre Group (SCG) the owner and operator of Westfield shopping centres across Australia and New Zealand. Thanks to its simplicity, CDP's financial accounts are clean and easy to understand and have the benefit of providing a 21-year history of the operations and financial results of the asset. It is one of SCG's better assets, with its future supported by ongoing population growth and increase in wealth within its catchment.

Westfield Carindale has a book cap rate of 5.52%, however CDP trades at more than a 30% discount to its book value. This leads to a share price implied cap rate of 7.06% as at the end of September. Undertaking a similar three-year scenario for CDP as was presented for CIP and CQE, is somewhat fraught, as a share in CDP represents a minority position in the asset and there has been limited transactional evidence to support market cap rates. For the purposes of illustration such a scenario would result in a total return of **72.3%, or 19.9% p.a.** This would be a spectacular outcome but is very much on the optimistic side.

There is however another reason to be optimistic about the future returns of CDP. That being the recent share price movements of the much bigger regional shopping centre owners. That includes CDP's major owner and operator SCG and its competitor Vicinity Centres (VCX). Their relative share price returns over the past year can be seen below.



To put numbers around it, SCG has returned 55.3%, VCX has returned 37.3%, whilst CDP has returned a much lesser 20.7% over the past year. When sentiment shifts, it is not uncommon for large stocks to react first and react in a larger way than their smaller counterparts. Over time this has proven to not be perpetual as all the factors benefitting VCX and SCG, also benefit CDP. In both a demographic and a competitive sense, it is even reasonable to say Westfield Carindale may be a bigger beneficiary than the median SCG or VCX asset.

Any way you cut it, owning CDP at current levels presents attractive risk-adjusted returns, especially when considering it is simply the ownership of a single strong performing, well located, regional shopping centre.

Simply wrapping up

No future return is ever guaranteed, but the investments discussed in this article are far more forecastable than most. When the market presents simple, relatively low-risk investments at attractive prices… we are happy investors. The portfolio has been a happy buyer of each of the three C's listed above (CIP, CQE and CDP) in recent periods.

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 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. More recently, interest rates have reduced and strong returns have been seen in property securities. The August reporting season saw stocks providing solid updates, with meaningfully more optimistic outlooks, based on the assumption that interest rates may have peaked and begun to come down. 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 momentum may continue.

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 2% in many markets. Strong rental growth has offset capitalisation rate expansion in recent periods resulting in flat valuations and capitalisation rate spreads to government bonds more in line with long-term norms.

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 and share prices moving sharply higher. 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 Storage King
Centuria Capital Limited
Centuria Industrial REIT
Charter Hall Group
Charter Hall Social infrastructure REIT
GPT Group
Goodman Group
Mirvac Group
Peet Limited
Stockland

	Fund
Cash	3.2%
ASX 300 A-REITS	84.9%
Other ASX Listed Securities	11.9%

	Fund	Benchmark
Office	15.8%	11.1%
Retail	22.4%	29.7%
Industrial	36.7%	51.8%
Infrastructure	1.0%	0.0%
Other	20.8%	7.4%
Cash	3.2%	0.0%
Total	100.0%	100.0%