CROMWELL PHOENIX PROPERTY SECURITIES FUND

JUNE 2024 QUARTERLY REPORT

Money Management Australian Property Securities Fund of the Year Winner 2023

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

	3 Months	1 Year	3 Years	5 Years	7 Years	10 Years	Since inception (16 Apr 08)
Fund	-6.84%	11.00%	2.96%	3.36%	5.83%	8.30%	7.67%
S&P/ASX 300 A-REIT Accumulation Index	-5.66%	23.79%	5.71%	4.64%	7.83%	9.13%	5.23%
Outperformance	**-1.18%**	**-12.79%**	**-2.75%**	**-1.27%**	**-2.00%**	**-0.83%**	**2.44%**

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

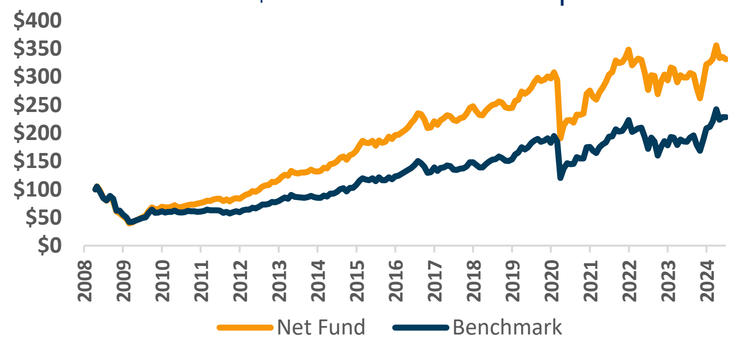
Factors influencing performance:

- The S&P/ASX 300 A-REIT Accumulation Index gave up recent gains, dropping 5.7%.
- Dominating performance, Goodman Group closed 3.2% higher. The median property stock lost 8.6%.
- Quarterly updates have been solid, but unremarkable, with the exception of weakness in office valuations.
- While Goodman Group remains a significant position in the Fund, the benchmark holding is much bigger, so was a material detractor to relative performance.
- The Fund added value in a relative sense, by not holding or having small holdings in some of the weaker stocks, including Dexus and Vicinity Centres.

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	Finbar Group Limited Peet Limited	Charter Hall Group Lendlease Group
Underweight	Goodman Group	Dexus Vicinity Centres Scentre Group

Market Commentary

The S&P/ASX 300 A-REIT Accumulation Index gave up some of its first quarter gains, falling 5.7% in the June quarter. Property stocks underperformed broader equities in the quarter, with the S&P/ASX 300 Accumulation Index losing a lessor 1.2%. Stronger than expected inflation figures led market participants to believe that any expected interest rate cuts by the Reserve Bank of Australia would be delayed, or that the next change in interest rates may even be a move higher.

Property fund managers saw quite divergent performance across the quarter. Goodman Group (GMG) led the way, rising 3.2%, significantly outperforming the broader property sector. GMG's ongoing outperformance is leading to the unusual situation in which it now accounts for almost 40% of the entire property index. The impact on benchmark returns is clear, with the median property stock in the index down 8.6%, significantly more than the reported 5.7%. Centuria Capital Group (CNI) was also an outperformer in the period, giving up only 2.9%. Alternatively, each of Charter Hall Group (CHC), Elanor Investors Group (ENN) and Qualitas Limited (QAL), meaningfully underperformed, falling 17.0%, 14.4% and 10.6% respectively.

Office property owners were underperformers in the June quarter, as transactional evidence began to filter through after a dearth of transactions in recent periods. Dexus (DXS) reported the $296.2 million sale of 50% of 5 Martin Place, a somewhat new, A grade building in the heart of Martin Place in the Sydney CBD, at an implied capitalisation rate of above 6.1%. DXS also sold B grade asset, 130 George Street in Parramatta for $69.1 million at an implied capitalisation rate greater than 10% and more than 30% below its prior book value. Whilst this sale faced some asset specific concerns and Parramatta is a weaker submarket, the transaction reflects a challenging market for secondary office assets. DXS finished the quarter down 15.4%. Mirvac Group (MGR) pleasingly announced the unconditional exchange of a 66% interest in its 55 Pitt Street office development project, with an end value of approximately $2 billion, highlighting some demand for prime office investments. MGR also announced it had delivered on previously announced sales, including 367 Collins Street in the Melbourne CBD, which faced some prior delays. MGR was down 18.2% on the quarter. Centuria Office REIT (COF) was also weak, losing 15.0%, as was Growthpoint Properties Australia (GOZ), off 10.8%.

Residential property developers delivered mixed performance during the period, with the prospect of delayed interest rate cuts fighting against an ongoing supply/demand imbalance. There has been significant divergence in home price performance and new home sales across the country. After underperforming for many years, Perth has seen median dwelling price growth of more than 23% year over year, with some growth corridors significantly outpacing that number. Perth-based residential developers outperformed, with Finbar Group Limited (FRI) moving 21.7% higher and Peet Limited (PPC) up 0.4%. Melbourne has been significantly weaker, with new home and land sales falling meaningfully. The median dwelling value in Brisbane is now almost 10% above Melbourne and both Adelaide and Perth median dwelling values are within 3.5% of Melbourne. AV Jennings Limited (AVJ) has meaningful exposure to the Australian East Coast and dropped 19.7%. Stockland (SGP) was also a weak performer, giving up 10.6%.

Shopping Centre owners were also weak performers during the period, as consumer confidence and retail sales are beginning to show signs of fading. Some retailers including Mosaic Brands and KMD Brands (owner of Kathmandu), provided updates suggesting that conditions had been challenging in recent periods. Vicinity Centres (VCX) was a meaningful underperformer, off 13.1%, whilst Scentre Group (SCG) dropped 8.0%. Owners of smaller centres were not spared, with Charter Hall Retail REIT losing 12.4% and Region Group (RGN) finishing the quarter 9.2% lower.

Performance Commentary

Lendlease Group (LLC) ▼ 15.4%

The portfolio holds an overweight position in LLC. Its underperformance detracted value from both an absolute and relative perspective in the June quarter.

During the period, LLC presented its long-awaited strategy update. Over the past few years, the board and management team have hesitated to make wholesale changes to the LLC business model, tending to opt for incremental changes, despite the pleas of investors for something more dramatic. The strategy announced appears to present an olive branch to disgruntled investors. Most dramatically, LLC will divest and/or realise its US and European property development and construction businesses. This will be done through a "Capital Release Unit" (CRU), separately managed within the LLC business. The focus of the CRU will be realising capital from existing developments and the construction business. Where assets are wholly owned on LLC's balance sheet, or partners have agreed, the projects will be marketed for sale. For the majority of projects in joint

ventures, projects will be completed, with LLC realising its invested capital upon completion. According to LLC this CRU is anticipated to release $2.8 billion of capital by the end of the 2025 financial year.

LLC's ongoing activities will focus on the existing global funds management business and property development and construction business in Australia and Asia. This business is undeniably LLC's core operation and has been for a long period of time. LLC has been responsible for some of the nation's most iconic developments, including the Sydney Opera House, Australia Square, Adelaide Oval and the country's two largest airports. Existing projects in Australia represent a mix of quality, highlighted by an exception residential development opportunity called "One Circular Quay", on the site of the old Goldfields House. Apartments will likely have average selling prices of greater than $10 million. LLC has however committed to some problematic office developments, which will require third party investment at high prices to be profitable.

LLC performed well on the day of the strategy review announcement, up 8.0%. It however was weak earlier in the period as the Australian Tax Office was said to be pursuing the company regarding the tax owed on the sale of its retirement business in 2017. This is emblematic of the missteps and concerns LLC has faced in recent times. It also weakened later in the period as the Australian Competition and Consumer Commission delayed the sale of LLC's communities business while it completes its review of the transaction. LLC's valuation at current prices is undemanding and will be considered a bargain if the new strategy is executed as planned. There does remain significant uncertainty as to whether this management team can execute efficiently.

Finbar Group Limited ▲ 21.7%

The portfolio holds an overweight position in FRI. Its outperformance added value from both an absolute and relative perspective during the period.

Finbar is a developer of apartments in Perth and as such has faced difficult operating conditions in recent times. Even in good times, apartment development is a volatile business, with profitability recognised at the time of project settlement. Despite all of this, FRI has remained profitable in recent years, even if returns on equity have been muted. Each apartment project is structured with non-recourse debt, so that no individual project is likely to contaminate the rest of the business. Furthermore, the two principals of the business maintain large shareholdings in FRI and are well aligned to minority investors.

Difficult economic conditions have begun to abate. Perth apartment prices have increased almost 20% in the past year and sales rates are beginning to increase. FRI also enjoys the benefit of having access to construction trades, through its longstanding relationship with the leading Perth-based builder. This is said to be simply impossible for some other players in the market. In a fortuitous turn of events, FRI has unsold completed inventory and projects under development that have not been fully sold. As market prices increase, FRI will be able to increase the sales price of this inventory and subsequently achieve greater profitability than would have otherwise been the case.

FRI also completed its $435 million Civic Heath Project in South Perth at the end of the period and has begun settling properties. This is an iconic project taking up a prominent block, adjacent to the Perth Zoo and just a 7-minute drive to St Georges Terrace in the CBD. The project is just over 60% presold and should at the very least return significant cash to FRI's balance sheet and may generate substantial profits. After Civic Heart and other soon to be completed projects finish, FRI has indicated that shareholders are likely to receive a meaningful capital return.

Charter Hall Group (CHC) ▼ 17.0%

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

Whilst CHC is a somewhat diversified property fund manager, as at February 2024, its largest subsector was office property, which represented approximately 40% of property assets under management. As described in the Market Commentary section of this report, transactional activity in Australian offices is beginning to emerge. In prior periods, the limited transactional evidence allowed office valuations to be revised slowly downward. As current transactions finalise, there will be ample evidence for more meaningful devaluations in the short term. CHC will not be immune and will likely take a meaningful devaluation in its office property portfolio, which reduces both assets under management and therefore future period earnings. It is worth remembering that CHC manages other non-office property, including more than 37% of its assets under management in industrial and logistics property (as at February 2024). It also retains optionality with regards to entering new scalable subsectors, aided by existing relationships with a bevy of global investors and multiple sales channels.

What's in a Cap Rate

Capitalisation rates, commonly known as "cap rates", are a fundamental metric in Australian property investing. When a commercial property is sold, two pieces of information will be widely reported. Firstly, the amount the property sold for and secondly, the cap rate. Often properties will be compared by their respective cap rates. Reports will often comment on the "implied cap rates" of different property securities. However, this seemingly simple and ubiquitous measure can be far more complex to use when comparing different types of properties.

What is and isn't in a cap rate

Whilst different market participants may mean different things when referring to a cap rate, the Property Council of Australia (PCA) defines a cap rate as a property's net operating income (NOI) divided by its property value estimate. For example, if a property generates an annual NOI of $500,000 and is valued at $10 million, the cap rate would be 5%. A purchaser might assume that they would receive a cash flow yield of 5% plus any rental growth that may occur. This isn't necessarily the case and ignores key considerations.

Capital Expenditure (Capex):

Commonly, properties require meaningful ongoing investment, which isn't reflected in the NOI used to calculate cap rates. This investment is known as capex and comes in many different forms. It may be maintenance capex, which refers to significant replacements or additions to maintain the standard of an existing building. For office properties, this may include replacing lifts or air conditioning units, each of which may need a full replacement as often as every 15 years. For shopping centre properties, capex may include items such as escalators or shared facilities such as bathrooms. Maintenance capex is not directly reflected in increased rent and is commonly used to "maintain" the relevance of an existing building. This amount is often referred to as a percentage of a building's value. For example, if a building worth $100 million requires maintenance capex of $500,000 per year, it is common to say it requires 0.5% (or 50 basis points) of maintenance capex.

Leasing Incentives:

To attract and retain tenants, commercial property owners often provide "incentives" to prospective and renewing tenants. These incentives can take many forms, but are commonly provided as rent-free periods, or contributions to a tenant's fit-out. The size and form of incentives varies greatly between different property types. Incentives are commonly quoted as a percentage of the total rent to be paid over the tenant's lease period. For example, if a tenant agrees to a 10 year lease for $100,000 per year, a 20% incentive would mean that $200,000 of benefits are provided to the tenant. Rent, less any incentives is called "effective rent" and in the above example effective rent would be $80,000 per year. Rent excluding incentives is called "face rent". It is typically face rent that is used to calculate the NOI used in a cap rate.

Whilst not the subject of this article, it is worth noting that lease structures including term and rent reviews, as well as tenant quality are not considered in a cap rate. Buildings with longer leases, higher fixed rent increases and better tenant quality tend to attract lower cap rates than the alternative.

Now and then

In a past generation, institutional grade commercial property primarily consisted of office, retail and industrial property. Approximate leasing incentive and maintenance capex amounts across these subsectors 15 years ago can be seen in the table below:

Property Type	A Grade Melbourne CBD Office Building	A Grade Melbourne Shopping Mall	Modern Melbourne Industrial Facility
Leasing Incentives	20%	0%	5%
Maintenance Capex	0.5%	0.5%	0.3%

Whilst there are some differences between the amount of cash flow leakage, the difference between property types is not enormous. Whilst industrial properties faced limited cash flow leakages, market rental growth had been extremely low for a long period. It may not have been perfect but comparing cap rates across these property types 15 years ago was not a terrible way to assess relative value.

Beyond any changes to leasing incentives and maintenance capex requirements, today's listed property sector is much broader than it used to be. Alternative property types such as healthcare, social infrastructure, petrol stations and long WALE sale-and-leaseback properties are all part of the institutional investment landscape. Many of these property types are commonly leased in an owner favourable "triple-net" manner. A triple-net lease means a tenant is responsible for property taxes, building insurance and maintenance capital expenditure across the life of the lease.

A revised table approximating today's leasing incentives and maintenance capex, including triple-net properties, can be seen below:

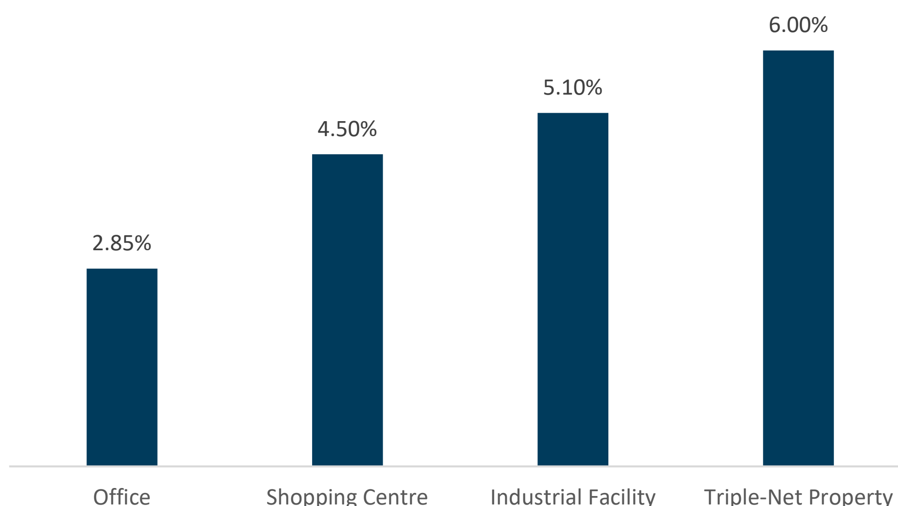
Property Type	A Grade Melbourne CBD Office Building	A Grade Melbourne Shopping Mall	Modern Melbourne Industrial Facility	Triple-net Property
Leasing Incentives	42.5%	15%	10%	0%
Maintenance Capex	0.6%	0.6%	0.3%	0%

Mind the Gap

It is clear when comparing the above tables, that the dispersion in incentives and capex has widened materially. In the case of an A grade office building, the gap between the building's cap rate and its true cash flow yield is vast. The chart below demonstrates this visually for an office building with a 6% cap rate:

As can be seen, the cap rate in no way resembles the true cash flow of owning an office building, with more than half of the NOI received (used in calculating the cap rate) lost to capex and incentives.

Consider the four assets in the above table. In this example, each has a cap rate of 6%. The chart below shows the cash flow yield of each:



What to do?

Phoenix actively considers the factors affecting cash flows (among others) and explicitly forecasts longer term capex and incentives that property owners will be required to pay. It is these cashflows that determine value, not next year's dividend or simply observing a cap rate.

A comparison of Dexus (DXS) and Charter Hall Social Infrastructure REIT (CQE) shows the importance of looking beyond headline cap rates and how this affects how Phoenix manages the portfolio. DXS is predominantly an owner of high quality office properties across Australia. CQE is predominantly an owner of smaller properties leased to childcare providers on triple-net leases. CQE's cash flow is boosted by a lack of incentives and capex. Childcare property rent is also an income stream heavily supported by the government, with support for funding of the sector a politically bipartisan issue. As at period end, DXS' office cap rate implied by its share price was greater than 8.3%. CQE's implied cap rate was more than 6.8%. If one were to merely compare cap rates, DXS would be the more attractive investment opportunity. It however faces significant cash outflows (in the form of capex and incentives) beyond what is measured in a cap rate. As such, Phoenix has held no position in DXS for some time and holds an overweight position in CQE.

The Detail is Important

Cap rates have the benefit of being simple. In the past they were also a reasonable way to compare property. As incentives and capex levels have diverged between different properties, merely looking at cap rates has become a less appropriate way to consider the relative attractiveness of different properties. By developing a more nuanced understanding of what's truly "in a cap rate", investors can make more informed decisions. Remember, the devil is always in the details, and in real estate investing, those details often lie beyond the simple cap rate calculation.

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
Abacus Storage King
Centuria Industrial REIT
Charter Hall Group
Dexus Convenience Retail REIT
GPT Group
Goodman Group
Mirvac Group
Peet Limited
Stockland

	Fund
Cash	5.2%
ASX 300 A-REITS	82.6%
Other ASX Listed Securities	12.2%

	Fund	Benchmark
Office	15.1%	10.5%
Retail	23.0%	29.7%
Industrial	35.8%	52.6%
Infrastructure	0.0%	0.0%
Other	20.9%	7.2%
Cash	5.2%	0.0%
Total	100.0%	100.0%

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