21 JULY 2020

Stocks Down Under

"Landlords grow rich in their sleep without working, risking or economising."

- John Stuart Mill (1806-1873), English philosopher and political economist

DEXUS

Well-run and offering an attractive yield

GRANGE RESOURCES

Savage valuation

ELANOR COMMERCIAL PROPERTY FUND

New kid on the block

DEXUS

Well-run and offering an attractive yield

Stocks Down Under rating: ★★★★

ASX: DXS
Market cap: A$ 10BN

52-week range: A$8.03 / A$13.79
Share price: A$ 9.07

Based in Sydney, Dexus is a real estate investment trust (REIT) that manages a high-quality Australia-only property portfolio valued at $33.8bn. As the former property trust business of Deutsche Bank, Dexus directly owns office and industrial properties worth $16.8bn. It manages an additional $17.0bn of properties on behalf of its third-party capital partners. The COVID-19 crisis has pressured property values and caused uncertainty around future leasing demand in the property markets. However, we believe Dexus has a strong capital position and a robust $11.2bn development pipeline that should support growth as market conditions normalize. Time for a closer look, especially since Dexus shares offer a nice 5.5% yield right now.

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Market cap: A$ 289M

52-week range: A$0.15 / A$0.285
Share price: A$ 0.25

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Share price chart

Source: Tradingview

Fixed rental increases, developments drive income growth

As Australia's largest commercial property owner Dexus gets most of its earnings from the rental income it receives from its directly owned portfolio. This portfolio is long-term oriented and includes office buildings in the central business districts of Sydney, Melbourne, Brisbane and Perth. It is largely focused on CBD office properties along the eastern seaboard where vacancy is low and the supply pipeline is expected to be modest over the next few years. Dexus also manages an unlisted $17.0bn diversified portfolio of office, retail, industrial and healthcare properties for third party capital partners. It collects management fees from this side of the business that result in a steady income stream.

In FY19 Dexus delivered 6.5% growth in adjusted funds from operations (AFFO) per security and 5% distribution per security growth. This was driven by 8.0% industrial income growth and office income growth of 3.4%. It had a return on contributed equity (ROCE) of 10.1%. Total assets under management increased 17% to $31.8bn and net tangible assets (NTA) per security was up 8.7% to $10.48.

Due to the timing of trading profit receipts, AFFO per security was down 2.9% in 1HY20 despite strong office property income growth of 8.9% and 3.5% industrial property income growth. The funds management side of the business recorded an 8.8% increase in total property FFO to $405.2m due to fixed rental increases, development completions and a pair of office property acquisitions. NTA per security rose 5.9% to $11.10.

High quality portfolio benefits from a 'flight to quality'

Dexus exercises conservative financial and operational risk management, which allows it to maintain one of the industry's strongest balance sheets. It has sufficient headroom and liquidity of $1.7bn and a diversified mix of debt that has a weighted average duration of 7.1 years. Gearing was 25.4% as at 30 April 2020, which was well below the company's targeted range of 30% to 40%. The group sets a disciplined limit of 15% of funds under management (FUM) on the amount of capital it puts towards development and trading opportunities. It has earned an 'A-' credit rating from S&P and an 'A3' rating from Moody's.

Coping with COVID-19 reasonably well

The COVID-19 pandemic has had a deep impact on the real estate sector and Dexus has been no exception. Business interruptions hit hard for many of its customers especially smaller enterprises. Introduced in April 2020, the Government's commercial Code of Conduct applicable to commercial tenancies of small and medium enterprise customers (SMEs) established a set of principles for Dexus. In turn the company began working with its SME customers including the city retailers that support its office communities to negotiate rental relief. Those tenants that requested rental relief comprised approximately 8% of total property portfolio income.

Despite the COVID-related challenges, we believe the group's property portfolio has thus far remained in good shape. This is because it entered the pandemic with 97.2% and 96% occupancy rates in the office and industrial portfolios respectively and had an overall portfolio WALE of 4.4 years. The premium nature of its assets should continue to benefit from a 'flight to quality' that often occurs in the property market during times of financial difficulty. While risks remain, including the wider adoption of flexible working arrangements, so too do opportunities such as the potential to offer flexible physical and contractual co-working arrangements to customers.

Solid development pipeline supports future growth

On 4 June Dexus announced the settlement of its joint venture (JV) acquisition of interest in the Rialto Towers in Melbourne. Dexus acquired a 50% interest in Rialto Towers for $644m that was funded from existing debt facilities. The deal, which was previously announced on 6 April, gave Dexus a 10% share of the joint venture while GIC holds the remaining 90%. More importantly, it increased third party AUM and added exposure to an iconic, prime-grade, 55-storey building in Melbourne's business district. Dexus will serve as the investment manager of the JV as well as the manager of the entire Rialto Towers complex, which at 1 March was 91.7% occupied and had a WALE of 4.6 years.

Dexus also has a strong development and concept pipeline valued at $11.2bn. This includes developments at Pitt and Bridge Street, the Waterfront Precinct, Central Place Sydney and 60 Collins Street in Melbourne. The group targets year-one yields and project internal rates of return (IRR) that are greater than what can be achieved through acquisition when identifying development opportunities. Together, we believe these projects have the potential to grow both property portfolios and enhance future returns for securityholders.

Dexus' shares haven't rebounded following the Corona Crash, because the future of commercial real estate in particular is uncertain. Will office use ever go back to the way it was before COVID-19? However, we believe this uncertainty is priced in at the current share price level. We're back to 2017 levels and at the current payout, this generates a nice 5.5% yield.

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Share price chart

Source: Tradingview

If you ever read the first book by the esteemed Australian historian Geoffrey Blainey, you'll appreciate one reason why we like Grange Resources. The Peaks of Lyell is Blainey's account of how Tasmania's West Coast grew into a significant mining province. The reader comes away impressed with how old mines, such as Heemskirk (tin), Zeehan (silver) and Mt Lyell (copper), just keep delivering, such is the mineral wealth of the neighbourhood. One mine that Blainey doesn't write about, but you can see coming, is the Savage River iron ore mine that Grange Resources has owned since 2009. The reason you can see the mine coming is right there on page 1 of Blainey's book where he recounts that just before the Dutchman Abel Tasman got to Tasmania in 1642, the compasses on his ships started to go haywire. The reason: 'Buried on the slopes of Mt Heemskirk within sound of the ocean were millions of tonnes of black magnetite, 66 per cent iron. Millions more outcropped in mountains to the north'.

A long-life resource

Those magnetite riches finally got developed three centuries later, in the mid-1960s, thanks to booming Japanese demand for the commodity. The result was a significant iron ore mine about 100 km southwest of Burnie. The original developer called it Savage River because of the nearby tributary of the Pieman River, which in turn flows out into the Southern Ocean near the small town of Corinna, 25 km from the mine. The

Savage River operation included an 85 km pipeline to Port Latta on Tasmania's north coast and a plant there to pelletise the ore into a high value product that shipped mainly to steel mills in Asia. Like other Tasmanian West Coast mining operations before it, this one was nearing the apparent end of its life before a massive resource upgrade gave it a new lease on life. That happened about six years ago. Currently, Savage River, which in calendar 2019 produced 2.1 million tonnes of pellet from Port Latta, will go beyond 2035 based on a reserve estimated in April 2020 of 113 million tonnes at 47.2% magnetite. The resource is a massive 490 million tonnes.

In 2019 Grange Resources enjoyed A$347m in revenue and $75.5m in EBITDA from this solidly run operation. The company is financially conservative and as at December 2019 held A$125m in net cash, meaning that the Enterprise Value of Savage River is only $164m. Simply assuming a repeat of 2019, Grange is on an EV/EBITDA multiple of only 2.2x. That's right, 2.2x. And given that the 2019 revenue figure was 2% lower than 2018 because of higher rainfall and some wall instability at the mine site, not to mention lower iron ore prices, it's a reasonable bet that in calendar 2020 EBITDA will be higher, even though there's no earnings forecast out there.

Southdown is not Southdown and out

It's also worth remembering that Grange is the 70% owner of Southdown, a magnetite deposit about 90 km northeast of the southern Western Australian port city of Albany. A May 2012 Definitive Feasibility Study gave Southdown a $1bn after-tax NPV at a 10% discount rate, but 2012 was not a good time to be developing new iron ore projects given the bearish conditions that continued until 2016. That doesn't mean Southdown can't attract new funding in the more buoyant conditions we're moved into. Grange is currently looking for a new equity partner for this project. Should it find one, shareholders will do well because there's arguably no value at all for Southdown in the current Grange share price.

Why is Grange so inexpensive? Well, it's perceived by many to be run merely as a subsidiary of its major shareholder, a privately held Chinese steel company called Shagang, based in the Jiangsu industrial city of Zhangjiagang. Shagang owns just under half the stock and with other interests is believed to control more than 50%. Grange's 2018 decision to put a small amount of capital into Melbourne's most exclusive residential property market hasn't helped the company shake the view that this is not a serious mining company.

However, we also think that there's more than just the Shagang factor at work here. Remember, it wasn't too long ago when iron ore was just US$40 a tonne, so you can't blame investors for being shy of this one. Still, with iron ore doing well in 2020 we think an EV/EBITDA of less than 3x is probably a little undervalued. Remember, Australia's leading iron ore company, Fortescue, is currently on an EV/EBITDA multiple of 5.5x forecast FY21 earnings. That's why Grange Resources is Four Stars from us.

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Fund includes well known ASX listed tenants

Elanor Commercial Property Fund is an externally managed listed real estate fund focused on commercial properties in Australia. It invests in properties that are located in major metropolitan areas or established commercial precincts. The portfolio currently includes seven properties located in Perth, Adelaide, Brisbane and Canberra that have a combined value of $378m.

The fund aims to generate income from high quality commercial properties. Government (21%), multinational (20%) and ASX-listed tenants (46%) together account for 87% of portfolio income. The multinational tenants include DXC Technology, Optus, Clemenger and Panasonic while the ASX-listed tenants include CIMIC, Bunnings (Wesfarmers), Coles and NAB.

The COVID-19 crisis has had a significant impact on the commercial property market. Property owners such as Elanor have had to negotiate rent reductions and deferrals with tenants whose businesses have been severely disrupted by the pandemic. Meanwhile property portfolio values have faced downward pressure resulting from limited new tenant demand and heightened uncertainty around an economic recovery. Elanor management has thus far managed the crisis well and continues to monitor the potential impact of Fund of Government announcements and market conditions on its properties.

Garema Court, Bunnings renewal strengthen portfolio

In February 2020 Elanor completed the acquisition of Garema Court, an A-grade office building with ground floor retail for $71.5m. Located in a premium location in the Civic precinct of Canberra, the property has a net lettable area of 11,438 sqm. The purchase gave Elanor exposure to a precinct that is benefiting from significant amenity and public transport including the new light rail terminus. Occupancy at Garema Court is 99.2% and the WALE is 4.2 years.

The group has also had some recent success on the leasing front. It renewed the Bunnings lease at Nexus Centre in Upper Mount Gravatt for an additional four years through October 2024. This key tenancy, which includes the Bunnings' Queensland state head office, extended the portfolio WALE to 4.3 years. It is expected to deliver upside to funds from operations (FFO) for FY21. As at 24 June the fund's FY20 earnings forecast was FFO of $13.4m for an annualised FFO yield of 9.3%, which was 9% above the product disclosure statement (PDS) forecast of $12.3m.

Low gearing, high occupancy

Elanor maintains a conservative capital structure with a target gearing range of 30% to 40%. In its early days as a listed ASX company it has maintained a low level of gearing, which is an attractive attribute from an investment standpoint. As at 31 December 2019, gearing of the fund was 18.5%. It has since risen to approximately 35% but remains within the targeted range. In Q4FY20 the group implemented a new debt facility with an average tenor of four years, which reset the fund's debt at an average interest rate of just 2.1%.

Another positive characteristic of the fund is the high occupancy rate of the properties. Based on net lettable area (NLA) the fund had occupancy of 97.3% as at Q4FY20. This included 100% occupancy rates at Campus DXC in Adelaide, NEXUS Centre in Mount Gravatt and 34 Corporate Drive in Cannon Hill. The high occupancy rate is supported by long leases to blue chip tenants that provide reliable and rising income to the fund through fixed contractual rental increases. We believe the quality nature of the Elanor portfolio and opportunities for further value-added acquisitions make the shares an appealing investment. Additionally, we see upside to the current 5.3% dividend yield as the company expands its property portfolio going forward.

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Pitt Street Research Pty Ltd is founded on more than 40 years of combined experience researching companies in a range of different sectors.

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