STOCKS DOWN UNDER

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ASX Property Stocks Down Under

> *Learn every day, but especially from the experiences of others. It's cheaper.*
>
> **- John Bogle (1929-2019), American businessman**

CHARTER HALL SOCIAL INFRASTRUCTURE REIT

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Stocks Down Under rating: ★★★★

ASX: CQE
Market cap: A$1.5BN

52-week range: A$3.01 / A$4.06
Share price: A$4.00

In the two years of the pandemic, arguably no sector endured a fate so different from what had been anticipated than childcare. Investors feared the worst, but things didn't turn out as bad. Childcare operators were able to remain afloat during lockdowns thanks to subsidies and parents gradually took their children back in when case numbers declined and restrictions eased. Charter Hall Social Infrastructure REIT (ASX: CQE) is one of two ASX REITs significantly exposed to this space and it is up over 30% in 12 months. But it hasn't gained as much as its peer Arena REIT (ASX: ARF).

Share price chart

Source: Tradingview

The real Long WALE REIT?

This is the second time we've covered CQE, having last given it a look in July 2020. CQE has had one of the longer and more peculiar histories of all ASX REITs, having first listed in 2003 and having changed names or ownership several times. Charter Hall picked it up in 2018 and changed its name in 2019.

Putting the pandemic to one side, childcare is an attractive real estate asset given secure long-term leases with annual increases. Ironically, despite Charter Hall also having a "Long WALE REIT" (ASX: CLW) - which we covered a few weeks ago - CQE has an even longer WALE than CLW, at 14.6 years compared to CLW's 12.2 year WALE. Low interest rates have been the icing on the cake, increasing the appeal of assets with a secure income. In FY21, there were over $550m in long daycare centre transactions, according to data from CQE. This has only gone up in FY22 when there were $619m in sales in H1 alone.

Since Charter Hall acquired CQE, childcare has remained its focus, but management has diversified into other 'social infrastructure'. For instance, in late 2020, CQE bought the Brisbane headquarters of health operator Mater and a South Australian government emergency services command centre in Adelaide. It was a particularly active suitor in the second half of 2021, buying over 20 childcare centres in Western Australia, Queensland and Victoria, plus a property leased to pathology company Healius (ASX: HLS), for nearly $200m all up.

Today, CQE has gross assets of $1.9bn comprising of 364 properties with 100% occupancy and a passing yield of 4.9%. It has a diverse geographic and tenant profile - Goodstart Early Learning accounts for 40% of its annual rent, G8 Education (ASX: GEM) makes up 10%, but no other individual tenant makes up over 10%. 75% of leases are fixed annual increases, which are on average 3%, with the balance being CPI-linked.

Delivering valuation uplifts and cash flows

In FY21, CQE recorded a statutory profit of $174.1m, up 103.4% on FY20 and paid a distribution of 19.7 cents per share. In 1HY22 it made a profit of $207.7m and had Net Tangible Assets (NTA) of $3.78 per unit – up 16.3% thanks to revaluation of properties.

It is expecting to pay $0.172 per share. While overall less than FY21, it is worth noting the previous year was inflated by a 4 cent per unit special distribution. So, $0.172 a share would be higher than last years' ordinary distribution of 15.9 cents by 9.6%. CQE has been boosted by a $175.4m uplift in its portfolio in 1HY22. This reflected increased capital expenditure by CQE on its properties and higher yields due to favourable market conditions.

CQE has ~$500m more assets than its peer, but is valued lower

CQE's share price of $4.00 means it is trading at a premium to its NTA of over 10%. When REITs trade at a premium to their NTAs, investors are valuing the company higher than peers that trade at a discount. Evidently investors also expect strong asset management and earnings accretive activities. In some instances, a REIT trading at a premium might be a sign it is overvalued. But we would note CQE's premium is less than its peer Arena REIT (ASX: ARF), which has NTA (or Net Asset Value) of $3.02, but trades at $4.98. We also note that ARF has a market capitalisation of $200m more than CQE despite having fewer assets ($1.35bn) on its balance sheet and slightly lower EPS (it paid $0.148 in FY21 and anticipates paying $0.16 in FY22).

ARF also trades at a higher P/E ratio of 30.1x for FY22, while CQE trades at 22.2x. At Stocks Down Under, we typically prefer P/FFO to P/E to value REITs, because FFO (funds from operations) excludes depreciation (which is irrelevant in real estate, because land does not depreciate over time like machinery, for instance) plus gains or losses on the sales of assets. But we must use P/E here because neither REIT reports FFO. Still, between P/E and EV/EBITDA, P/E is far more relevant and valuable to REIT investors, because REITs almost always pay distributions that come out of net earnings

In ARF's favour, its portfolio has a higher WALE of 19.8 years, and it has some exposure to medical centres. Investor preference for healthcare during the pandemic is arguably why it reached its pre-Corona Crash peak 5 months ahead of CQE and is 49% ahead while CQE is just 6% ahead. But we still do not believe that CQE deserves a discount – at least not to the degree it has currently.

One might argue that rising interest rates will reduce interest in real estate investments. But it is worth remembering that they are coming from all-time lows and childcare (along with other 'social infrastructure') is one of the most favoured real estate asset classes given the long-term leases along with the higher income and yields. We expect CQE to continue to grow its earnings and gross assets and note that it has significant investment capacity (over $200m) to accomplish this. So, just as we did in July 2020, we give CQE four stars.

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