STOCKS DOWN UNDER

29 JUNE 2022

ASX Property Stocks Down Under

"The auto industry will change more in the next five to ten years than it has in the last fifty."

- Mary Barra (b. 1961), CEO of General Motors

CHARTER HALL RETAIL REIT

Overly vulnerable to industry headwinds

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Stocks Down Under rating: ★★

ASX: CQR
Market cap: A$2.3BN

52-week range: A$3.61 / A$4.51
Share price: A$4.02

Charter Hall Retail REIT (ASX: CQR) rounds out Charter Hall's specialty REITs. It is a landlord of convenience retailers, including shopping centres and petrol stations. These have been among the safest spaces to be invested in during the pandemic, because groceries and petrol stations were allowed to stay open as essential services. However, CQR is still below its pre-Corona Crash levels, and we fear it is particularly vulnerable to rising interest rates as well as the shift to electric vehicles.

Share price chart

Source: Tradingview

A $4bn+ portfolio

As of 31 December 2021, CQR has 51 shopping centres and 296 petrol stations that were over $4bn in value. In our view, petrol stations and most consumer staple retailers are a defensive investment that can persevere through the ups and downs of the economic cycle. 44% of the portfolio is located in NSW, while Queensland and WA account for 15% each, Victoria 12%, South Australia 7%, New Zealand 5% and the ACT 2%.

It's top three tenants are Woolworths, Coles and BP, which account for 16.1%, 15.9% and 12% of its rental income respectively. Its WALE is on the lower side at 7.3 years, compared to Charter Hall's other two niche REITs, CQE and CLW, which are 14.6 years and 12.2 years respectively. Admittedly, it's WALE is 11.2 years among its major tenants, but it's WALE among specialty and mini-major tenants is only 3.3 years.

This is the third time we have written about CQR following our articles on 2 March 2020 and 6 September 2021. The catalyst for covering CQR last time was our view that it was a steady source of portfolio income. Indeed, this was depicted in its FY21 results - CQR delivered a profit of $291.2m, up from $44.2m in FY20, operating earnings of $156.2m (up 9.5% from FY20) equating to 27.3c per unit, of which 23.4c was paid out. It provided a modest $6.7m in COVID-19 tenant support. It's NTA was $4.01 at the time but has gone up to $4.54 currently. At CQR's current share price, this represents a ~15% discount.

Good times have rolled on

Despite the Delta lockdowns, it was more of the same in 1HY22. CQR generated operating earnings of $82.1m (up 9.2%), which equated to 14.22cpu and it made a statutory profit of $368.6m (up 8% on the pcp). During 1HY22, it acquired the Butler Centre in Perth's northern suburbs and a 49% interest in a portfolio of 20 Ampol service centres for $50.5m. It has $287m in liquidity, most of which is undrawn debt facilities.

For the full FY22, CQR is expecting operating earnings of at least 28.4c per unit, which would be 3.9% growth. Distributions are expected to be at least 24.5c per unit. It has portfolio look-through gearing of 31.9% (look through gearing reflecting ratio of net borrowings to total assets) and balance sheet gearing of 25.0%.

The share is trading at a forward P/FFO ratio of just 11.4x. Its peer HomeCo Daily Needs REIT (ASX: HDN) is trading at 13.9x P/FFO, while Shopping Centres Australasia (ASX: SCP) is trading at 15.7x P/FFO. Those two REITs are also trading at NTA discounts - HDN at 13% and SCP at a narrower 4% - although the latter has announced acquisitions that will only be reflected in its NTA when the deals are complete. HDN focuses on fast-growing metropolitan markets while SCP focuses on outer suburban and regional areas. CQR's retail assets do not edge to one or the other. However, its recent Ampol acquisition has shown it is trying to focus on metro and commuter metro locations. And 95% of its Coles and Woolworths supermarkets have Click & Collect facilities.

All REITs are facing headwinds, but how vulnerable is CQR?

CQR's share price still has not returned to pre-Corona Crash levels and despite nearly making it in 2021, it has lost ground in the recent market correction. Like all REITs we think CQR has suffered from two investor perceptions. First, that it will not get the same property revaluations that it was able to record in past years.

Second, that rising interest rates will mean higher debt costs and higher debt costs will inevitably translate to lower earnings. We strongly recommend investors in any ASX REIT look for the Weighted Average Cost of Debt figure in the coming months. REITs that haven't drawn down on debt facilities may be spared, but this will mean forgoing acquisitions – at least to the extent undertaken in the zero-interest rate environment. Remember, CQR only has $17m in cash of its own, meaning it will have to draw down on external funding to undertake more M&A.

Although CQR has hedged 65% of its debt, yet Goldman Sachs estimates each 1% increase in interest rates could cut its earnings by 2%. This could be significant if you assume interest rates will rise as fast as consensus forecasts suggest. Admittedly, Goldman estimates other REITs could be impacted far worse (a 6%+ earnings reduction for each 1% hike in interest rates).

In respect of CQR, we also think investors have perceptions that the rise of electric vehicles (EV) will either make petrol stations obsolete or will require major capital expenditure to convert them to EV charging stations to prevent the former scenario from occurring. We are also concerned that there doesn't appear to be awareness of the forthcoming shift from combustion vehicles to electric vehicles. Even if CQR was not going to be affected, it would be reassuring for investors to hear it from management's mouths and how exactly it would cope. We also note that CQR doesn't have a long WALE, especially for assets that arguably should have that. Ultimately, the latter reason alone is enough to make this REIT two stars for now, even though it is reasonably valued compared to its peers.

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