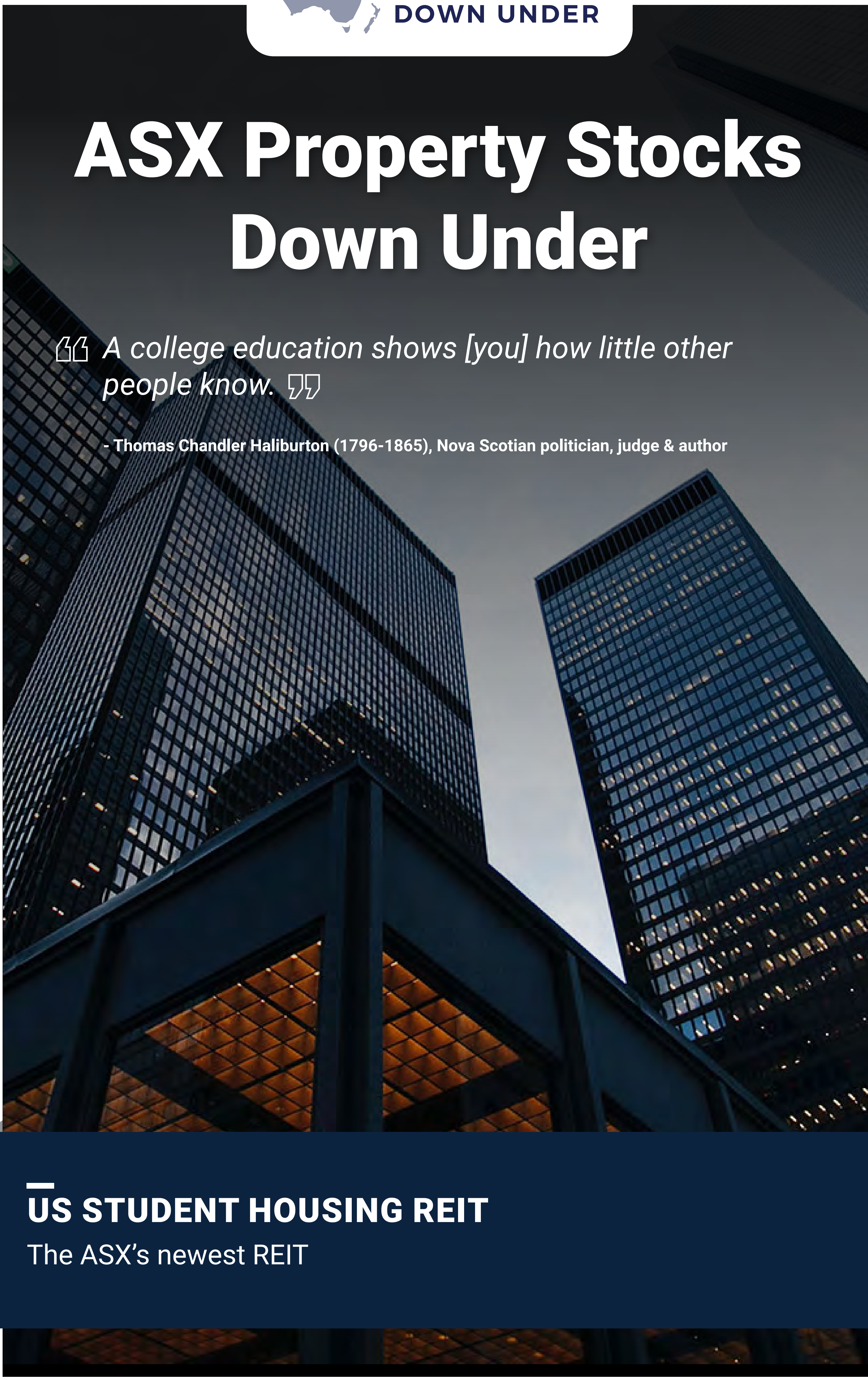
STOCKS DOWN UNDER

20 JULY 2022



ASX Property Stocks Down Under

> *A college education shows [you] how little other people know.*

- Thomas Chandler Haliburton (1796-1865), Nova Scotian politician, judge & author

US STUDENT HOUSING REIT

The ASX’s newest REIT

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Stocks Down Under rating: ★★

ASX: USQ
Market cap: A$69.2M

52-week range: A$1.06 / A$1.40
Share price: A$1.25

Today we look at the newest ASX REIT, US Student Housing REIT (ASX: USQ), which only listed earlier this year. As you may have guessed by its name, it specialises in student housing at US colleges. It listed at $1.38 per security and was bought to market by Auctus Investment Group, which is ASX-listed in its own right. The few ASX REITs to specialise in foreign property have not fared well, but could USQ be an exception?

Share price chart

Source: Tradingview

Before we go any further, we need to highlight a couple of differences between the American and Australian university systems and pandemic experiences that you may or may not be aware of. First, that it is commonplace for US college students to leave home, attending college hundreds (if not thousands) of miles away. Second, that the US is far less reliant on international students than Australia is – they consist of less than 5% of enrolments compared to 27.1% in Australia. And given the less harsh border measures, 92% of those students stayed in the US amidst the pandemic.

Investing in US College student housing

OK, now that we've got those differences out of the way, we can look at the opportunity on offer to investors. USQ holds 11 properties worth US$189m with 1,827 beds between them. 4 properties are at the University of Mississippi with all the others at 7 individual universities – although one further property is in the Magnolia state, at Mississippi State University.

USQ's properties are purpose-built housing, not on-campus living. Compared to other options, these tend to be newer and priced more competitively compared to private letting options or on-campus options. It has 96.1% occupancy and a forecast yield of 6.3% assuming full utilisation of the foreign tax credit. No properties were built earlier than 2005 and this trust only began to come together in early 2021 with the acquisition of the Edge at Texas Tech University. USQ invests via Delaware vehicles into investee companies that acquire and manage assets, although it has a stake of at least 90% in each property.

Under the constitution, the responsible entity (which is the REIT itself) is entitled to 0.07% of Gross Value of Assets (GAV) less cash at bank and cash-like instruments up to $250m. This falls to 0.06% for $250-$500m and 0.05% for any amount above this above. The Investment Manager (Auctus) gets 0.60% per annum of GAV and a performance fee where an asset is realised calculated at 20% of the performance of the asset in excess of the IRR hurdle rate of 10%.

How listed life is panning out

USQ is trading slightly below its issue price and hence at a slight discount to NTA. As we observed above, there have been a number of horror stories with REITS focused on foreign property, such as US Residential REIT (ASX: URF) and Auckland Real Estate Trust (ASX: AKL). Investors haven't understood the relevant property markets as well. And this, we think, is the biggest challenge for this REIT as well.

We observe that it has zero debt and therefore no gearing. It boasts of longstanding broker and seller relationships that provide it with early access to new deals and deals that have fallen out of contract. And on 5 July, it gave an update in which it increased the valuation of a number of its properties and depicted just how it was positioned for the upcoming college season. It has 92.3% of the portfolio pre-leased with rental increases of 8% (prior year 4.3%) across the 9 assets owned by the REIT. The current pre-leasing is 16.1% ahead of the prior year.

Clearly, high inflation (9% in the USA) is not impacting the fund. It will pay dividends quarterly and has paid US$0.41 for the March quarter, which was ~7.1% annualised based on its share price at the time the dividend was declared. USQ is profitable, but not by much. For the 12 months ending 31 December, it made an estimated US$2.55m in net profit. It is worth noting that the bulk of this is distribution from investee companies and $701,794 is assumed to be a gain on fair value even though it assumed no change.

Why we're bearish on this REIT

Ultimately, we are bearish on USQ's ability to grow its share price going forward and we think USQ is a two-star stock for four reasons.

First, as we noted above, USQ is structurally disadvantaged in the eyes of Australian investors who have bitter memories of past foreign REITs. Second, REITs generally are struggling to find investment interest due to high inflation and while a 7% yield would beat inflation here, it doesn't in the USA. Third, it comes with foreign exchange risk. And fourth, we cannot ascertain the extent to which it could undertake further acquisitions. It only has US$5m on its balance sheet, a paltry amount, but it is typical for REITs to fund acquisitions through debt rather than existing cash. It has been vague on its debt levels, just saying it is targeting 60-65% gearing in relation to its existing investments. We would rather back REITs with more certainty, or simply less risk, in all of those four regards.

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