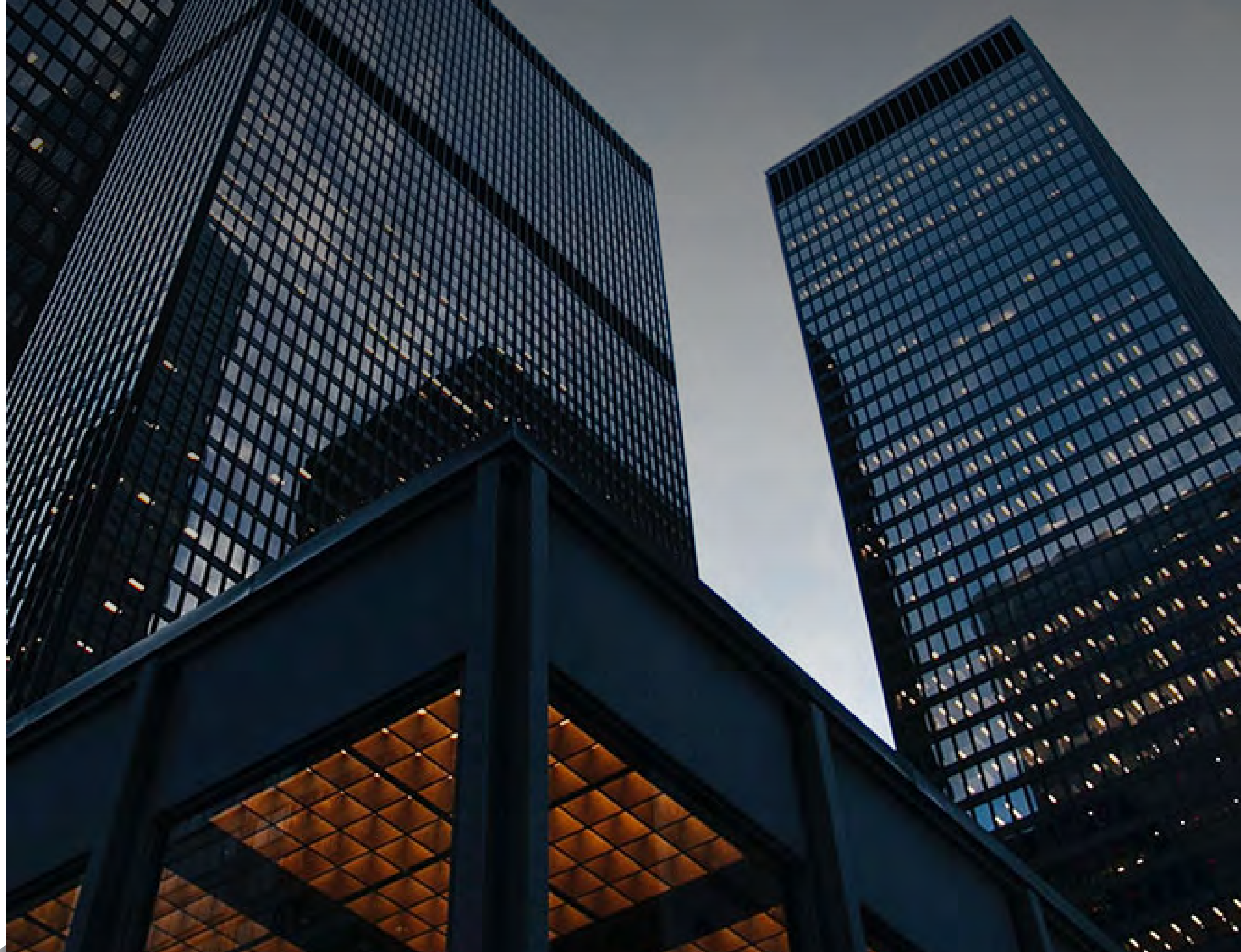
STOCKS DOWN UNDER

3 AUG 2022

ASX Property Stocks Down Under

Life doesn't give us what we want. It gives us what we need and asks what we will do with it.

- Jennifer Nielsen (b. 1971), author



HOTEL PROPERTY INVESTMENTS

You can still raise a glass to this property market

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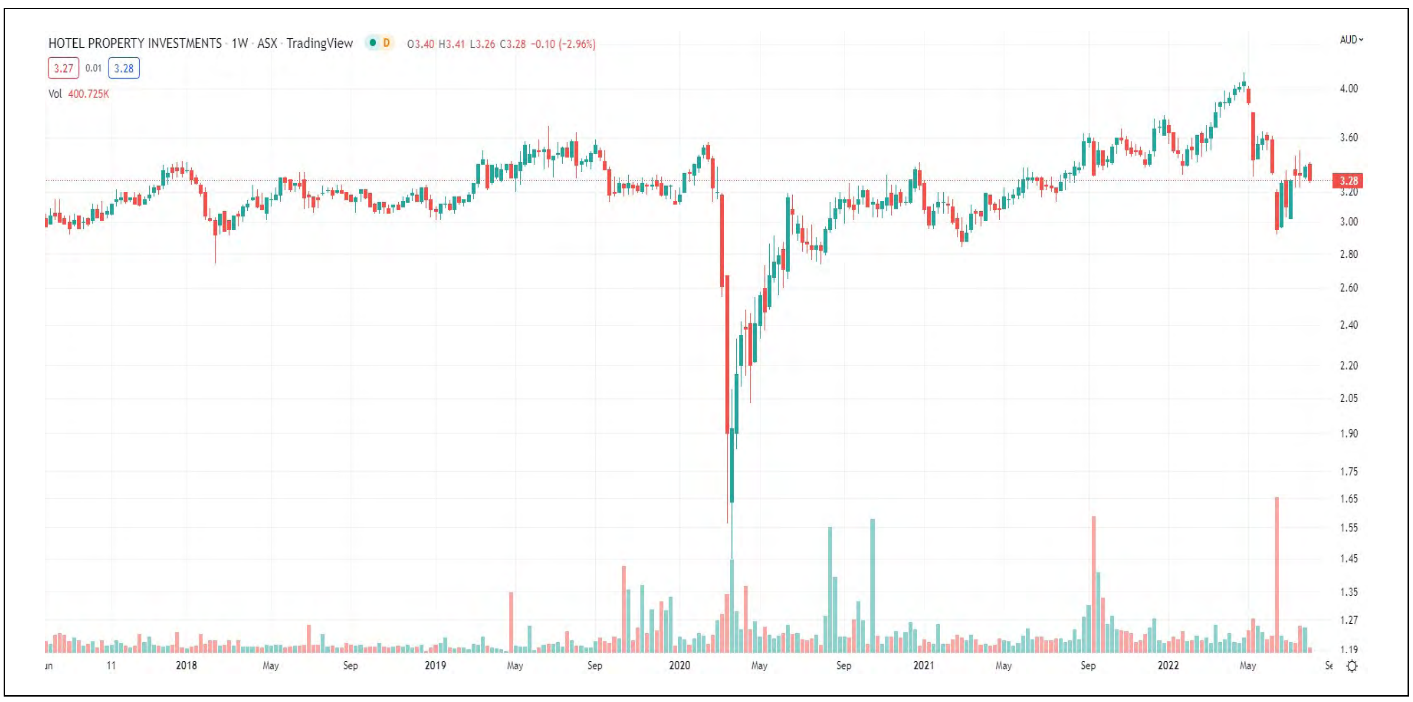
Stocks Down Under rating: ★★★★

ASX: HPI
Market cap: A$634.7M

52-week range: A$2.92 / A$4.14
Share price: A$3.29

Rising interest rates have hit many segments of the property market, but pubs are not one of them. Pubs rarely change hands, but would-be buyers have to pay up when they do. This is because of their long WALE, landlord favourable leases and high underlying land value. 2021 was a record year for pub transactions and 2022 is actually more of the same. One prominent broker, HTL, sold more pubs between mid-June and mid-July than any 4-week period in the country's history (~$300m). And since the privatisation of Redcape, Hotel Property Investments (ASX:HPI) is one of the few options left on the ASX for investors wanting to play this segment.

Share price chart



Source: Tradingview

Cheers to industry outperformance

HPI has a property portfolio of hotels, pubs and motels across Queensland, South Australia, New South Wales and Victoria. It has historically been heavily weighted towards the Sunshine State although recent acquisitions have increased its exposure to South Australia. This has meant it was able to avoid the worst impacts of COVID-19 – namely long lockdowns. All up, HPI has over 50 properties in a portfolio that is worth nearly $1.2bn and has an average capitalisation rate of 5.39%.

This edition of Stocks Down Under is the second time we have looked at HPI – the first was 28 May 2020. Since then, HPI has gained 19%, which is well ahead of the ASX 200 REIT Index's 14% gain in that time. And although shares have come down in 2022, the decline is little over barely half of the ASX 200 REIT Index. In fact, HPI shares were in positive territory for 2022 up until early May. Because the company had no announcements around that time, we cannot blame it on operational issues. Early May was the time when the market correction was in full swing. We also think since Woolworths (ASX: WOW) spun out its hospitality assets into Endeavour Group (ASX: EDV), investors wanting exposure to pubs have seen this company as more attractive because of Endeavour's larger portfolio and liquidity. And, as we noted above, HPI's former peer Redcape was taken private, leaving HPI standing almost on its own.

A reasonable valuation

Still, HPI shares have recovered from recent lows and now sit at $3.29. This is still a discount to its NTA of $3.82 – by ~16%. It is targeting distributions of 20.5c per security for FY22. Given that it typically pays out 100% of FFO, it is trading at a P/FFO multiple of 16x, which is slightly below the ASX average.

In FY21 it generated $60.1m in revenue, which was up 11% from FY20, thanks to both rent increases of 2.5% on average and 11 asset acquisitions. Both were more than enough to offset ~$3m in rent reductions for eight of its properties. Its Adjusted Funds from Operations (AFFO) was $32.5m, up from $30.3m in the year before. A statutory profit of $84.7m was made, thanks to a $51m fair value gain. 1HY22 saw revenue of $35.4m, up 23% from the prior corresponding period, AFFO of $19.2m (up 24%) and a statutory profit of $120m with $100.7m being a fair value gain.

Debt could be a problem

Are there any potential downsides with HPI? We think the most obvious one is its debt position. HPI has a relatively high gearing at 36.2%. The bulk of REITs we have covered this year have been in the low 30s, some even lower. Furthermore, it has hedged 48% of its debt as at 31 December 2021 and is overly vulnerable to interest rate rises. Goldman Sachs has estimated each 1% increase in interest rates could hit its earnings by 5.8%, more than double the 2.6% average across its peer group. The only two with more are HomeCo Daily Needs REIT (ASX: HDN) and Scentre Group (ASX: SCG), which are estimated to be vulnerable to hits of 6% and 6.9% respectively – for each 1% rise interest rates.

We also note it has just $3.7m in cash and $436.1m in loans drawn with just $93.9m in undrawn debt facilities. When HPI last went on a shopping spree (snapping up its newest South Australia assets in the second half of last year), it raised $50m in fresh capital from shareholders and we imagine it would look to do so again if it wanted to undertake further acquisitions.

Assuming, however, that it doesn't go on an acquisition spree, we are prepared to back this company and give it four stars. As observed earlier, the market for pubs has not been affected by interest rate rises to the extent other markets have, particularly residential and offices. This is because pubs are long-leased assets and the worst of the pandemic is behind them. Considering all this, and its reasonable valuation, it is too difficult to resist this stock. We do note that ESG investors may not be a fan of this company, at least if they continue to practice what they have preached in loathing gambling and alcohol. Their pressure was the very reason why Woolworths spun out Endeavour. For investors looking only for long term asset growth, we think this stock deserves four stars and is one of the more worthy in the ASX property sector.

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