STOCKS DOWN UNDER

21 SEP 2022

ASX Property Stocks Down Under

"The more advocates you have, the fewer ads you need to buy'."

- Dharmesh Shah (b. 1967), Co-founder and CTO of HubSpot

HOMECO DAILY NEEDS REIT

Serving Australia's Three Biggest Cities

HOMECO DAILY NEEDS REIT

Serving Australia's Three Biggest Cities

Stocks Down Under rating: ★★★★

ASX: HDN
Market cap: A$2.6BN

52-week range: A$1.18 / A$1.64
Share price: A$1.24

It's been just over six months since we last covered HomeCo Daily Needs REIT (ASX:HDN). It is managed by Home Consortium and listed in 2020 at $1.33 per share after being spun out of its parent company. Since early March it has declined 4%, but still significantly outperformed many of its peers. Eerily similar to the broader market, investors have been less bearish on consumer staple property stocks. Still, they don't appear to have given much attention to HDN's FY22 results. Should they have?

Share price chart

Source: Tradingview

Exposed to nearly half of Australia's population

As its name implies, HDN leases its properties to retailers that meet everyday needs. And its properties are focused on fast-growing metropolitan areas – 74% of properties are located in Greater Sydney, Greater Melbourne or Greater Brisbane. Nearly half of Australia's population lives within a 10km radius of one of HDN's properties.

HDN's portfolio is worth over $4.6bn, is 99% occupied and has an average gross rent of $349/sqm. 73% of rents are fixed with a further 19% being linked to inflation, and the balance comprising of supermarkets with their own confidential deals. Although the WALE is on the lower end among ASX REITs, at 4.9 years, over 52% of leases expire after FY27.

HDN has three subsectors. Firstly, neighborhood tenants (which make up 33% of its gross income) that includes Woolworths and Coles as well as fast food retailers KFC, Guzman & Gomes and Oporto. Bunnings, Chemist Warehouse, BWS and Petbarn are also in this category. The second is larger format retailers (49%), which includes mostly furniture and outdoor equipment outlets, including Harvey Norman, the Good Guys, JB Hi-Fi and Rebel Sport. The third one is Health & Services (18%), which includes Centrelink, Service NSW and RSPCA. No tenant makes up more than 4% of gross income, with Coles, Bunnings and Woolworths being the three largest, accounting for ~3.7% each. The top 10 tenants only make up 25% of gross income between them.

HDN actively manages its portfolio through tenant remixing, development, acquisitions and disposals. Since purchasing Aventus earlier this year, it has been quiet times as far as purchasing other listed REITs is concerned.

What investors missed in its FY22 results

HDN's FY22 results were positive. It generated Funds From Operations (FFO) of 8.9 cents per unit (cpu), or $105.6m all up, which was 30% higher than FY21 and exceeded the company's guidance. It paid a Distribution Per Unit (DPU) of 8.28cpu, up 18% from FY21 and represented a payout ratio of 93%. It's NTA per unit is $1.52, which places it at an 18% discount to NTA.

Looking to FY23, the company is anticipating FFO of 8.6cpu and a DPU of 8.3c, which would reflect a 97% payout ratio. This would represent a P/FFO multiple of 14.6x and a dividend yield of 6.6%, which would be roughly in line with inflation at present.

Why haven't investors embraced the company? In one sense, investors actually have embraced the company given it has still outperformed many of its peers. But the share price is still in negative territory for the current calendar year. We see four reasons, all but the first of which are issues not unique to this entity. The first is that as you might have seen above, its FFO and dividend are forecast to go backwards. There's no shortage of companies in other sectors that expect to grow earnings in the coming year. The remaining three are investor concerns about development plans, debt and leases. Let's look at each of these in turn.

Set to stand out

Regarding development plans, HDN completed $37m of developments in FY22 with a ROIC of 10%. In FY23 it is doubling its expenditure to >$75m and is expecting a ROIC of ~7% - a figure still ahead of inflation but, like FFO and DPU guidance, is lower than FY22. Obviously, it inherited projects from Aventus, but the construction sector has endured supply chains and labour issues. None of these have impacted HDN, but it appears investors are fearing the worst even if they are hoping for the best. Bear in mind that these are not new sites altogether, rather these are extensions that are typically minor. The 'biggest' project in FY22 was a 3,120sqm centre extension at Gregory Hills to accommodate Aldi, costing $12m. The bulk of projects are minor expansions although one exemption is South Nowra where the company is repurposing an ex-Masters site into a lifestyle precinct.

Looking at debt, REITs are facing increasing costs of debt due to rising interest rates. All sectors can take on debt to fund capital expenditure or acquisitions. But REITs are at another level, basing their entire existence on leverage. And during the golden years of record low interest rates, many REITs opted for floating interest rates, thinking interest rates would stay low for the longer term. UBS estimated that in FY23, 48% of debt will be unhedged compared with 20% three years ago. HDN is not as vulnerable to rising interest rates with gearing of just 30.6% and 73.5% of it hedged, and a liquidity position of $380m.

As for the third issue, leases, investors are concerned that rising inflation costs will cause tenants to give up the leases or force down REITs margins. We concede this is a legitimate concern if leases are linked to inflation, but not necessarily if leases are fixed and HDN is in the latter category - it has 73% of REITs with fixed annual 3.3% hikes. Yes, there is the risk that tenants could give up the lease as costs begin to bite. But we think that is less of a risk for HDN given the quality of tenants and that they know what they're getting into when they sign a lease.

We accept that HDN's share price may struggle to grow while the ASX REIT sector is in the doldrums. But we think HDN will continue to outperform the sector and that when investors who have 'tuned out' of the sector return, they will likely see HDN as one of the standout opportunities given its high yield, resilience to rising interest rates and inflation (relative to its peers) as well as its exposure to consumer staples. Four stars from us.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia

Stocks Down Under gives you an information advantage to better invest and trade in ASX-listed stocks!

Stocks Down Under (Pitt Street Research AFSL 1265112) provides actionable investment ideas on ASX-listed stocks. The Content is financial advice but is not (and cannot be construed or relied upon as) personal financial advice. No investment objectives, financial circumstances or needs of any individual have been taken into consideration in the preparation of the Content. Please make sure that investing in such products is suitable for your circumstances, and ensure you obtain, read and understand any applicable offer document.

Financial products are complex, entail risk of loss, may rise and fall, and are impacted by a range of unpredictable market and economic factors.

Stocks Down Under/Pitt Street Research directors and staff may own shares in the companies mentioned in our articles, videos, reports and analyses.