STOCKS DOWN UNDER

28 SEP 2022

ASX Property Stocks Down Under

"Timing the market is a fool's game, whereas time in the market is your greatest advantage."

- Nick Murray (b. 1943), Financial advisor & author

SHOPPING CENTRES AUSTRALASIA

Who wins: City or Country?

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Stocks Down Under rating: ★★

ASX: SCP
Market cap: A$2.6B

52-week range: A$2.26 / A$3.16
Share price: A$2.32

After looking at Home Co Daily Needs REIT (ASX: HDN) last week, we turn our attention to Shopping Centers Australasia (ASX:SCP), or SCA Property Group. SCA is another REIT that provides space for consumer staple retailers. One critical difference with HDN is that SCA has a portfolio significantly skewed to the suburbs and regional areas, rather than metropolitan areas, and that it has a presence in all 8 Australian states and territories. So, how does it stack up against HDN?

Share price chart

Source: Tradingview

Capitalising on disgruntled city slickers

SCA has been listed for nearly a decade and boasts one of the more fascinating listing stories. It was actually created by Woolworths as a landlord for a number of shopping centres it owned outright. The supermarket giant transferred its ownership to the group and then transferred ownership in SCA to Woolworths shareholders, giving one SCA share for each 5 Woolworths shares. It listed having raised $472m at $1.44 a share, but is now run independently, with no remaining shares owned by Woolworths itself.

Today, SCA boasts 91 assets valued at $4.5bn, all of which are anchored by either Woolworths, Coles or Wesfarmers retailers. These anchor tenants generate 47% of gross rent. As we mentioned in the introduction, SCA's assets are in local communities – outer suburbs or in regional areas. To illustrate, it has 28 in NSW with only 5 in Sydney and a further 6 in Newcastle – NSW's second biggest city. In Queensland, it has 33 centers, 13 of which are in Brisbane or the Gold Coast and 20 are outside the Sunshine State's biggest region. COVID-19 resulted in many city slickers buying up property in regional areas and this has been to SCA's advantage. In the past two financial years (FY21 and FY22), its portfolio valuation grew by over $400m in both years, excluding acquisitions and divestments. The company has been an active acquirer of assets, buying $347.5m in FY22 and $250m on average over the last decade, but it also divested $307.6m in assets during FY22.

Making hay while the sun shines, but what about when it's cloudy?

In FY22, SCA made a $487.1m NPAT (up 5.2%), 17.4cpu FFO (Funds from Operation) (up 17.9%) and paid a distribution of 15.2cpu (up 22.6%). Most tenants were allowed to stay open during lockdowns and tenant sales were 10% above pre-COVID levels – inevitably because consumers had to rely on these retailers more than ever. The company's gearing was 28.3% in FY22 (down 3%), occupancy was 98.1% and its weighted average capitalization rate (the return on a property based on the income the property is expected to generate) was 5.43%. Its average cost of debt was 2.5% and weighted average debt maturity was 5.3 years.

SCA's NTA was $2.81 per unit, up 11.5% versus the year before, but that puts the stock at a 12% P/NTA discount. For FY23, SCA has given guidance of 15cpu FFO, which would be down 14% from FY22. The company itself admitted that it would be negatively impacted by increases in floating interest rates. Excluding the impact of interest rates, SCA estimates FFO would have been 16cpu, still lower, but only 7% down.

For comparison's sake, HDN expects FFO to fall as well, but only by 3.4%. SCA's forward P/FFO is 15.5x which would be on the higher end (HDN is at 14.6x). On the positive side, SCA's expected distribution for FY23 is 17cpu, which would be a yield of 7.3% - ahead of inflation. HDN is behind, but not by much, at 6.6%.

The elephants in the room

As we mentioned last week, there are a few elephants in the room that are hindering the ASX REIT sector, particularly inflation and interest rates. In relation to the latter, we observe that consumer staples are less likely to be impacted. But even though consumers may not stop shopping, they may be more price conscious about particular good and it may show in tenant's underlying sales.

One way for REITs to overcome these concerns is having leases fixed in. This is the case for SCA as its leases are locked in for the long-term with 3.9% fixed increases. But remember that this is behind inflation right now. And even if it wasn't, this is a double-edged sword because it is difficult to grow earnings strongly without acquisitions, which will inevitably only be possible through SCA raising further capital – either debt or equity. SCA's debt burden is low, but it would not be a good look in a rising interest rate environment. Whether debt or equity is chosen, it will have to make a decision if it wants to proceed with its development pipeline, which is $300m over the next five years.

The additional disadvantage

We also note an additional factor that might impact SCA's performance – property prices in rural areas. Now, property prices in the big cities are set for big declines from peak to trough. Some economists estimate house prices in Sydney could fall 25% from all-time highs. What happens in rural areas is another question considering price rises in some areas were even more extreme than in the big cities. There were a handful of areas where property prices rose more than 100% in 12 months – such as Byron Bay and Wyee in NSW as well as Charleville in Queensland. Inevitably, if prices retreat back to pre-COVID levels so will shopping centers. The extent will depend on whether or not people who sought the tree change lifestyle stick around or move back to the city. Ultimately, we think SCA is geographically diversified enough to avoid an extreme fall (>20%), but we thing valuations will inevitably drop to some extent in FY23.

In the end, we think dividend investors might be attracted to SCA because of the forecasted dividend yield that beats inflation and HDN's yield. But the lower FFO guidance by the company, the inflation-trailing lease hikes and the uncertainty around future valuations are enough to make it 2 stars for growth-oriented investors.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia

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