STOCKS DOWN UNDER

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ASX Property Stocks Down Under

"The right job is when you can't tell the difference between work and play."

- Jack Cowin (b. 1942), Fast food entrepreneur

ARENA REIT

Deserving of its premium

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Stocks Down Under rating: ★★★★

ASX: ARF
Market cap: A$1.4BN

52-week range: A$3.18 / A$5.18
Share price: A$4.02

Arena REIT (ASX:ARF) has been consistently trading at a premium to its NTA, even in recent months with the slowdown in the property market. We think there is good reason for this. Arena REIT's portfolio is skewed towards childcare assets, which are attractive assets due to their very long leases, the typically high underlying land value intrinsic to this sector and the fact that this sector is heavily subsidised. And unlike many of its peers, this REIT has positioned itself well to handle rising inflation and interest rates.

Share price chart

Source: Tradingview

A decade of growth

Arena REIT listed nearly a decade ago, in June 2013 when it raised $75m at $1.01 a share and held a portfolio of just over $220m. Today it has a portfolio of $1.5bn, a near 7-fold value gain in a decade and a 23% gain in FY22 alone. There are 263 properties in total, the bulk of which are childcare properties (252 properties worth $1.3bn) with the balance (11 properties worth $174m) being healthcare properties.

Queensland has the largest share of Arena REIT properties with 34%, followed by Victoria with 28% and NSW with 18%. The company has a diverse range of clients with Goodstart accounting for 25% of income, Green leaves with 17% followed by ForHealth, Affinity and Edge accounting for 9% each. ASX-listed peer G8 Education (ASX: GEM) is next with 5% of properties.

Long term leases with locked-in increases to quell inflation

As we mentioned in the introduction, childcare centres tend to be long-term leased assets and this is true for Arena's assets as well. The Weighted Average Lease Expiry (WALE) is 19.8 years, among the largest in the ASX REIT space if not the largest. Less than 4% of portfolio income is subject to expiry before FY30 and over 50% of the portfolio expires after FY39. And this does not even account for six assets added to the portfolio during FY22 that have an initial WALE of 20.8 years.

Lease deals are completed at attractive terms to Arena as the landlord with embedded income growth and inflation protection. Over 80% of the rent reviews in the next three years well be done either at CPI or an 'agreed fixed amount', whichever is higher. A further 10% of the reviews are inflation-based. So, high inflation is actually a positive thing for Arena REIT. It is not so positive from a liabilities perspective, but its gearing is reasonable at just 20.2%.

What's the payout for investors?

In FY22 it made a $334m statutory net profit (up 102%), a $56m net operating profit (up 8%) and it paid a Distribution Per Security of 16.8c, reflecting growth of 5%. Obviously, a lot of the statutory net profit was driven by investment property revaluations. But the net operating profit was increased by acquisitions, development completions and rent increases – all of which we'll see more of in FY23.

So, how will it go in FY23? Arena REIT has issued distribution guidance of 16.8c per security, up 5% from FY22. Let's assume this represents 98% of Earnings per Security as was the case in FY22 (Arena REIT does not use our preferred FFO metric), which gives us 17.1c per security and a P/E multiple of 20.5x. Its Net Asset Value (NAV) is $3.37, which is 32% higher than 12 months ago and places it at a 4% premium. This is well below where Arena REIT has been earlier this year, trading at a premium as high as 60%. But it is still above the ASX average now.

Arena REIT also has a solid ESG angle. It is already carbon neutral, having been certified by Climate Active and having a formal Climate Action plan, including greenhouse gas inventory of Arena's rebated emissions. Furthermore, it has solar renewable energy systems installed on 80% of its properties. Even if Arena REIT was not taking any of these proactive steps, you could make the argument that its portfolio was enough to make it a good ESG bet. This is because its Early Learning Centres allow parents and carers the opportunity to remain in, join or re-join the workforce and healthcare centres provide local, community-based health care services.

Any chance of a downturn?

During the Corona Crash, Arena REIT shares fell by 55% as investors feared that parents would withdraw their children from childcare en masse, that centres would be forced to close or both. This would mean less rent paid to Arena REIT. Ultimately, the impact of the pandemic has not been as bad as expected on Arena REIT, but illustrated that it is ultimately reliant on the financial health of its tenants. We observe that childcare is heavily subsidised, and the cutting of any subsidies would be another risk to tenants' health and with them Arena REIT. Another risk would be a sustained downturn in economic conditions that may cause parents to exit the workforce to care for their children.

We also acknowledge that investors are not that fond on property stocks right now and any downturn in Arena REIT's financials would not just cause a share price hit, but a reputational hit as well, in our view. In FY23, it will not have the same benefit from rising property valuations that it did in FY22. But ultimately, there are few other REITs with such long WALEs, that are expecting to grow their distributions this year and that have their portfolio and lease terms designed to withstand the impacts of inflation. Four stars from us.

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