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ASX Property Stocks Down Under

You can't wait till the music stops. You have to make preparations.

- Rajiv Jain (b. 1968), Founder & CEO of GQG Partners (ASX:GQG)

ELEANOR COMMERCIAL FUND

One of the best in its sector, but in a poor sector

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Stocks Down Under rating: ★ ★

ASX: ECF
Market cap: A$296M

52-week range: A$0.91 / A$1.14
Share price: A$0.94

There are only about a dozen or so ASX REITs expecting growth in FFO (Funds from Operations) in FY23. One of those is Elanor Commercial Fund (ASX: ECF) that we last covered in July 2020. This REIT is unique, not just in its operator, but in that it is an office REIT expecting FFO growth. It is only 1% growth, but when you consider the average ASX office REIT expects a 3% decline, you'd take that. But what gives Elanor's management cause for optimism?

Share price chart

Source: Tradingview

Charter Hall and Dexus, move over

The Elanor Investors Group might not be as familiar with ASX investors as industry heavyweights Charter Hall or Dexus. But Elanor has $2.7bn in funds under management and has two listed ASX REITs (the other being the Retail Property Fund (ASX: ERF) along with a listing for the parent company. Elanor's investment strategy is to seek assets with unique value propositions, clear points of difference in their respective markets, superior long-term rental growth and occupancy.

Now of course, no REIT manager will say that it is not looking for properties without any of these traits. In a market where investors are bearish on the office space, convincing the market is no easy feat. The share price decline of 15% in CY22 would suggest management hasn't convinced investors. But this doesn't appear as bad when you consider that the ASX 200 REIT Index has lost 27% this year. ECF is trading at a P/NTA discount of 23%, but this is slightly ahead of the average among all REITs (-25%) and well ahead of the office REIT average (-36%).

A solid portfolio

Elanor Commercial Fund has only 9 properties, 5 of which are in South East Queensland (4 in Brisbane and one on the Gold Coast). Sydney, Canberra, Adelaide and Perth account for the remaining four properties, with one in each of those cities. This is not the biggest portfolio in the sector by any means, but it stands out for

other reasons. We think that in Queensland, Elanor picked a good market to be exposed to given the higher office occupancy in the Sunshine State amidst the pandemic, not to mention the 2032 Olympics, which will likely benefit the property market. And it boasts properties that are regularly upgraded, have large flexible floor plates and strong ESG credentials (with high energy star ratings).

There are three additional factors that make it stand out compared to its peers. First, it has less reliance on individual tenants with none accounting for over 40% of income. The two largest are CIMIC and CBA, which account for 27% and 13% each. Second, it has increased exposure to multi-tenanted buildings, now having a majority of its buildings with more than three tenants. And third, it has less exposure to any individual industry sectors with none accounting for over 28% of income. We also observe that all of these have significantly improved in the last 12 months. This was thanks to the acquisition of its properties on the Gold Coast (50 Cavill Avenue) and Sydney (19 Harris Street at Pyrmont) - although the latter is only 49.9%-owned.

FY22 results and FY23 outlook are good

In FY22, ECF made FFO of 10.94 per security, slightly ahead of guidance, and paid out 9.4c per security. This represented an impressive yield of 9.4%. It has a total portfolio value of $609m, up 58% from 12 months ago. For FY23, the company is expecting 11c FFO (up 1%) and a distribution of 9.4cps. The latter would represent an impressive yield of 10% at the current share price of 94c while the former represents a P/FFO multiple of 8.5x. This guidance was first given at the release of the company's FY22 results in August and reiterated just a month later when the company provided a quarterly update.

Investors might be concerned that ECF's portfolio occupancy is at 95.6% and the WALE is just 3.4 years. We observe that occupancy is above the market occupancy of 86% and it has less than 6.5% of leases (by income) expiring in FY23. Looking to its debt position, the company has a gearing of 30.8% and a hedged interest rate exposure of 97.3%. Both of these metrics mean that ECF should not be impacted too much by rising interest rates.

But the sector, not so much

Then there's the issue of investor sentiment towards office REITs. Office REITs have never recovered from the pandemic as office attendance plunged and hasn't recovered yet, even over two and a half years on. Research from the Property Council has persistently shown this. Even in the most recent survey in September, Melbourne office occupancy was only 41%, Sydney's was 52% and Brisbane, Adelaide and Perth were between 70 and 78%.

Investment bank Barrenjoey has a base case that office utilisation in Sydney and Melbourne won't surpass 70% in the next five years. And this doesn't account for the prospect of a recession next year, which could cause even the biggest of companies to cut back on office space, let alone the fact that market rents are roughly 10% lower than pre-pandemic levels.

The truth is that some office buildings are fully occupied, but others are eerily empty. We like that ECF is expecting FFO and distribution growth in FY23, not to mention its high occupancy levels. But we don't think it owns the most sought-after assets in the market, with assets typically outside CBDs. And ultimately, we would still avoid the office sector for now. Therefore, it's two stars from us.

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