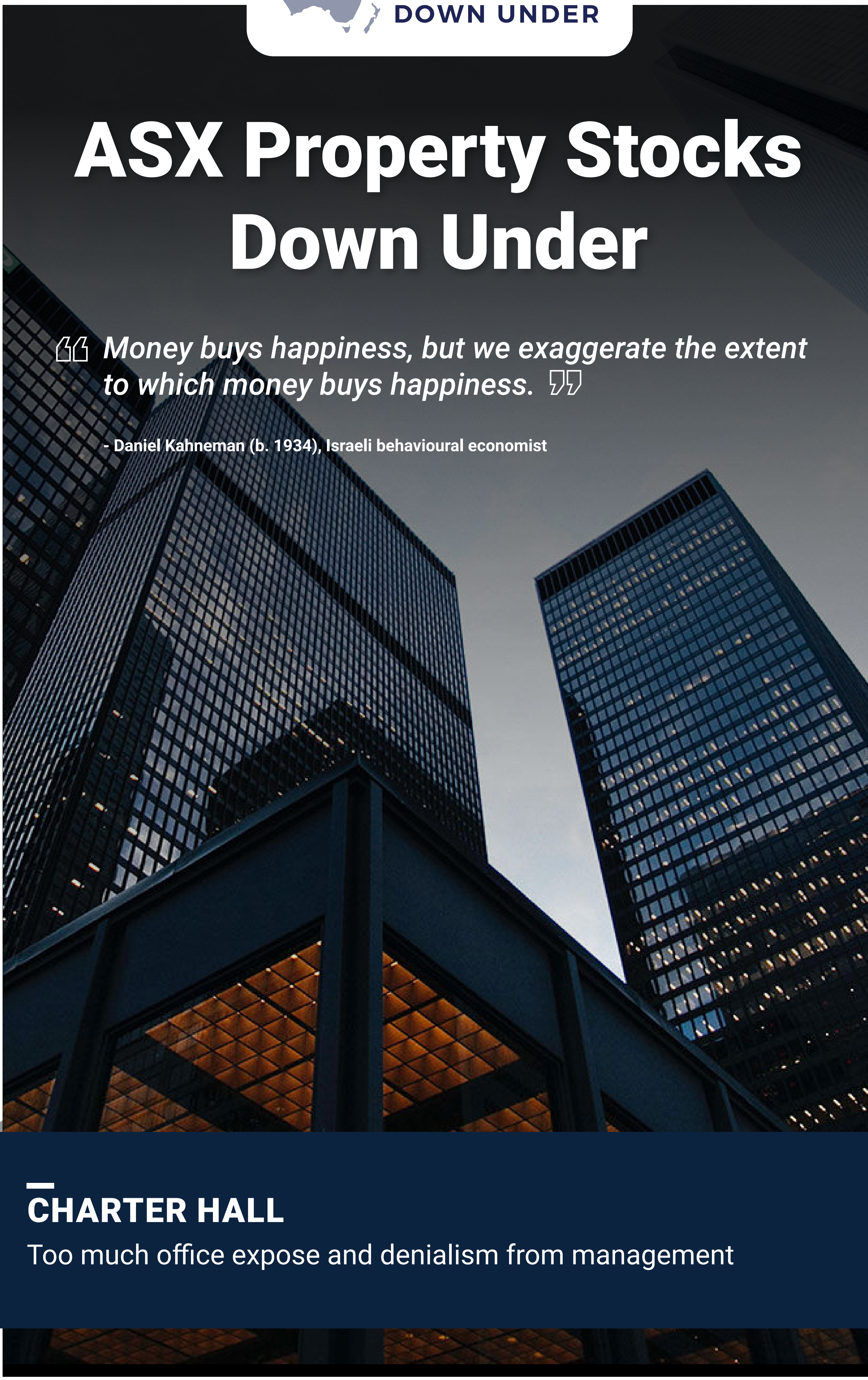
STOCKS DOWN UNDER

21 DEC 2022



ASX Property Stocks Down Under

> *Money buys happiness, but we exaggerate the extent to which money buys happiness.*
>
> **- Daniel Kahneman (b. 1934), Israeli behavioural economist**

CHARTER HALL

Too much office expose and denialism from management

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Stocks Down Under rating: ★★

ASX: CHC
Market cap: A$5.9BN

52-week range: A$10.50 / A$22.14
Share price: A$12.33

We've given Charter Hall's REITs a lot of love in 2022, but little attention to the company managing these funds. This company is an owner and operator of property and property funds. It is one of the ASX's biggest property stocks, capped at over $6bn, but it has also suffered a 40% share price plunge in light of the declining property market and rising interest rates. Will 2023 be a better year for the company?

Share price chart

Source: Tradingview

The Jack of all trades

As we mentioned in the introduction, Charter Hall has ownership of properties both outright and through unlisted property funds it operates. It has a $72.1bn property portfolio, consisting of 1,619 properties and a $16bn development pipeline. It has investments in offices, industrial, retail and social infrastructure properties, with an occupancy of 98.1% and a WALE of 8.3 years.

It has strong ESG credentials, targeting Net Zero by 2025, already boasting 100% renewable energy use – thanks to a group-wide power purchase agreement with global renewable energy giant ENGIE that runs through to 2030 – and it invested over $1.8m in social enterprise, community and crisis support initiatives during FY22 (such as Foodbank).

Still growing

Charter Hall's total Funds Under Management (FUM), including jointly managed funds, is $86.3bn, making it the largest diversified portfolio in Australia. Over the last five years it has increased its operating earnings by 26.4% CAGR on a per security basis and its distributions by 6%.

In FY22, it made operating earnings of $542.8m ($1.16 per security), paid 40.1cps to shareholders. Its Return on Equity was 31.4% and statutory profit amounted to $911.1m. Operating earnings and profit were both roughly double that of FY21, something that can be attributed to the performance of the property market. For FY23, Charter Hall has guided to post-tax operating earnings of no less than 90c per security and distribution guidance of 6% growth over FY22. A worst-case earnings scenario would be a 23% decline on FY22.

Consensus estimates are for 95c per security on a normalised basis, down 18%. However, given that Charter Hall paid out barely over a third of its earnings, it is very well possible it could pay a higher distribution.

But the Master of the wrong trade

Of the $72.1bn in outright owned properties, $30.1bn (41.7%) is in the office sector, while $23.5bn (32.6%) lies in the industrial sector. Let's address the office sector first. Investors have been particularly bearish on this sector, thinking that less office occupancy will mean lower rents and lower property growth relative to the rest of the market. All property companies with exposure to the office sector have acknowledged this, but most have tried to argue that their portfolios are less affected because they are of superior quality.

For Charter Hall, that goes without saying. Its office assets include No. 1 Martin Place, Chifley Tower, Citigroup Centre in Sydney, a handful of assets belonging to Western Sydney University out near Parramatta, Coles' headquarters in Melbourne, BankWest Place in Perth, Brisbane Square in Brisbane and the ATO's new headquarters in Canberra. Where investor concern lies, in our view, is that Charter Hall appears to be in a degree of denial about the 'new normal'.

This has been evident in applying for new developments, the most notable of which is a new 37-storey skyscraper at Chifley Square, but also in public comments by CEO David Harrison. At the Australian Financial Review Property summit he said,' If we keep having to deal with a lack of productivity and people saying "I want to work from home" once unemployment rises, I think we will see jobs replaced by robots'. Implicitly, people will come back simply because of this fear. We acknowledge that office occupancy is higher than it was a year ago, but still below pre-COVID levels (especially in Melbourne), and there's doubt as to whether or not it will reach those levels again. For office landlords, this means deals that are shorter-term, for less space and potentially cheaper than it otherwise would be. They will also have to provide greater amenities and worker perks to encourage workers to return. We also observe the WALE is just 6 years for Charter Hall's offices.

Better signs in other sectors, but still not a rosy picture

Other property sectors aren't faring as bad - at least from a demand perspective. There is significant demand for industrial and social infrastructure property amongst tenants. However, we think the decline in the property market hasn't been reflected in these sectors just yet. Pricing in the industrial sector was particularly ridiculous – even Goodman Group was getting outbid for some properties it aspired to purchase by 100%. Knight Frank has estimated property prices rose by 84% during the pandemic. There will still be cash flows from these properties, but investors will be spooked as deals occur at lower valuations than during the pandemic. And we don't think that we will enter another boom (similar to that during the pandemic) as the current rate hiking cycle ends.

None of what we have said is an indictment against any of Charter Hall's individual REITs – particularly its Social Infrastructure REIT (ASX:CQR), which we covered earlier this year. But we believe property stocks with prominent exposure to office space, such as Charter Hall, will lag for some time to come, even when interest rates stop increasing. Two stars.

Pitt Street Research Pty Ltd

3 Spring Street, Sydney, NSW 2000, Australia

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