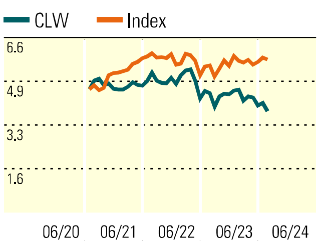
Charter Hall Long Wale REIT CLW ★★★★ (10:21PM 08-Aug-2023)

Charter Hall Long WALE REIT Earnings: Pressure Should Fade by 2027, Once Interest Costs Peak

Snapshot

Fair Value Uncertainty	Medium
Moat Rating	None
Fair Value $	5.10
Capital Allocation	Standard
Market Cap $Mil	2,747
Morningstar Style Box	
Price $ (4:00PM 08-Aug-2023)	3.80
52 Week High/Low $	4.78/3.79
Shares Issued Mil	723
Morningstar Sector	Real Estate
Morningstar Industry	REIT - Diversified
GICS Sector	Real Estate

Price vs. Market



	06/22	06/23	06/24e	06/25e
NPAT ($Mil)	207.2	202.4	188.1	185.8
EPS ¢	30.5	28.0	26.0	25.7
EPS Chg %	4.5	-8.2	-7.1	-1.3
DPS ¢	30.5	28.0	26.0	25.7
Franked %	0.0	0.0	0.0	0.0
Div Yld %	6.1	6.4	6.8	6.8
P/E x	16.3	15.6	14.6	14.8

Source: Morningstar estimates 08-Aug-2023.

Profile

Charter Hall Long Wale REIT (CLW) is involved in property investment. CLW consists of the securities of the two Australian registered schemes listed below: Charter Hall Direct Industrial Fund and its controlled entities and LWR Finance Trust and its controlled entity. It is an Australian Real Estate Investment Trust (REIT) investing in high quality real estate assets that are predominantly leased to corporate and government tenants on long term leases.

Investment Perspective By Alexander Prineas (08-Aug-2023)

CLW has one of the longest lease profiles of any REIT. This could be viewed as a drawback, given long leases are akin to bond proxies, and therefore a negative in an environment of higher interest rates. However, we view CLW's lease profile as attractive. About half the REIT's rent is linked to inflation, which means it achieves significant rental uplifts while inflation is high. And about half of the leases are triple-net, which means tenants pay the property costs. Long leases to strong tenants are also a welcome advantage should the economy enter recession.

Analyst Note (10:21PM 08-Aug-2023)

Charter Hall Long WALE REIT delivered fiscal 2023 operating earnings and distributions of AUD 28 cents per security, down from AUD 30.5 cents in fiscal 2022. This was in line with management guidance and our estimates. But we revise down our fiscal 2024 estimates by 7%, due to higher than expected operating expenses and interest costs. Our fair value estimate is unchanged at AUD 5.10 per share, with time value of money adjustment offset by higher costs.

We anticipate a moderate fall in distributions and earnings, as the REIT's hedged debt gradually expires, replaced by higher cost debt. As that process completes, we assume earnings bottom in 2027 at AUD 25.75 cents per security, then resume growth, and for earnings to exceed the 2022 peak by the end of our 10-year discrete forecast period, driven by rental uplifts built into the REIT's leases. Inflation drives 51% of leases, up from 49% a year ago, and the other half has fixed rental uplifts built in. With the REIT currently on a 6.8% 2024 distribution yield, with moderate downside to distributions, we see current pricing as attractive.

The main blemish is that gearing is higher than we'd prefer. Balance-sheet gearing of 33% is manageable, but look-through gearing including debt in underlying funds, is too high at 40%. The REIT's property values declined 5.8% over the fiscal 2023, and similar declines in portfolio valuations in fiscal 2024 could see the REIT approach banking covenant limits. However, we think that can be avoided, for a few reasons. First, management pointed out that some recent valuations did not incorporate inflation-linked rental uplifts due to come through. We expect these to be substantial, given inflation remains at 6%, and there is a lag between inflation reading and the effects on rents. We expect similar rental uplifts across in the portfolio in fiscal 2024, as the 5.1% average rental uplift achieved in fiscal 2023, which should provide support to valuations.

Another reason we don't expect gearing to spiral is that the REIT can sell assets. Management is exploring disposals, and we think it has numerous assets that would be attractive to buyers given the long leases, many with inflation-linked rents and tenants responsible for property expenses. If management elected to sell office properties it may be forced to sell at discounts to book value, given weak sentiment toward office at present. However, it has substantial exposure to sectors benefitting from tailwinds at present, and we think it could sell properties near book value.

About one fifth of the portfolio is industrial property, which has achieved good valuation and rental growth over the last couple of years. More than a third of the portfolio is retail property, with much of it linked to inflation. The office subsector is admittedly challenged, given tepid demand due to hybrid working, and new supply still elevated. However, only about 18% of the portfolio is office property. While office property represents the shortest lease portion of the group's portfolio, it still has a 6.2 year average lease duration, longer than office giant such as Mirvac and Dexus. The REIT's entire property portfolio has an average lease length of 11.2 years,

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staying true to its long WALE strategy, and making for a predictable income stream amid a period of economic uncertainty.

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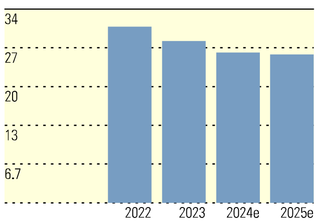
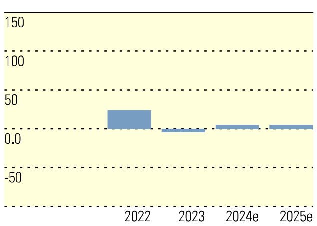
Key Valuation Assumptions

Cost of Equity %	7.5
Weighted Avg Cost of Capital %	6.9
Long Run Tax Rate %	0.0
Stage II EBI Growth Rate %	2.5
Stage II Investment Rate %	7.5
Perpetuity Year	50.0

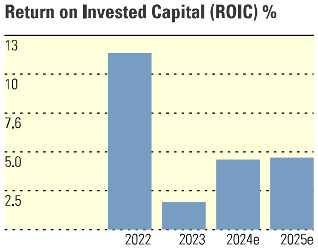
EPS ¢



Return on Equity (ROE) %



Return on Invested Capital (ROIC) %



Charter Hall Long WALE REIT Has Rental Growth, but Also Has Earnings Pressure Until Debt Costs Peak

Business Strategy and Outlook (08-Aug-2023)

Charter Hall Long Wale REIT's, or CLW's, portfolio is high-quality. Liquor retailer and pub operator Endeavour Group is the largest tenant at 19% of passing income. At least four fifths of passing income comes from tenants we view as unlikely to miss a rent payment, including Endeavour Group, government agencies, Telstra, BP, Inghams, Coles, Metcash, Arnotts, Bunnings, and Westpac. External fund manager Charter Hall has a strong track record and good relationships with tenants. Continued acquisitions may have diluted CLW's portfolio, particularly as long-WALE assets have been in high demand, and thereby came with a hefty price tag. CLW has been acquisitive, buying properties and other REITs, using debt, and issuing new equity. It issued about AUD 386 million of new equity in fiscal 2019 to fund acquisitions, including various offices, a bus terminal in Eagle Farm, Brisbane, and several agricultural logistics properties from Inghams on a sale-and-leaseback arrangement. In fiscal 2020 it issued AUD 850 million of equity to purchase telco exchanges, a Brisbane office building, Telstra's Melbourne headquarters, and BP service stations in Australia. In fiscal 2021 it issued AUD 626 million of equity, using the proceeds to purchase Telstra exchanges, a portfolio of offices, and BP sites in New Zealand, taking its BP portfolio to about AUD 500 million in Australia and New Zealand. CLW issued substantial new equity every year since its 2016 listing, with the number of securities on issue tripling from about 208 million in June 2017 to 720 million at March 2022. Higher interest rates are likely to slow the group's expansion and weigh on earnings, given the group's relatively high gearing.

Economic Moat

We do not attribute a moat to Charter Hall Long WALE REIT, or CLW, as we don't believe significant barriers to entry exist for rivals. The REIT owns some attractive properties, and its strategy of seeking long, triple-net leases from strong tenants has been prescient. Large tenant bankruptcies faced by rivals during the pandemic were a non-issue here, plus the relentless decline in interest rates rewarded Charter Hall's long duration assets. Looking ahead though, with strong tenants sought by most landlords, it's hard to envisage such favourable tailwinds being maintained. There is little to prevent rivals from acquiring or developing similar properties, or adopting the same strategy of seeking solid, long-lease tenants. In most of the industries Charter Hall operates in, rival properties and landlords are abundant, especially in retail, office, and industrial property. The retail and office sectors face structural demand headwinds from online retail and flexible working respectively. Industrial property has structural demand tailwinds from online retail, however, we think supply can accommodate this via multistorey and urban fringe developments, and efficiencies such as robotics reducing the required footprint for logistics property. A strong tenant book means the REIT should earn the rent and uplifts that are baked into existing lease contracts. But upon lease renewal it will be subject to market forces of supply and demand, which will be driven by economic conditions outside its control. Ownership in property markets is almost invariably fragmented. Charter Hall is one of Australia's most dominant convenience retail owners (through CLW and other Charter Hall entities), but it controls less than 10% of that market. New convenience retail is regularly added, for example, via retail space allocated within new apartment and public transport developments. Competition from e-commerce hampers rental growth for physical retail property, including convenience retail assets, and notably, CLW's department store sites, tenanted by Myer and David Jones. The REIT is protected by long leases, but department stores are seeking to reduce space and pay less rent; dynamics that will play a part in negotiations when leases expire. CLW also owns pubs, where regulations permit small bars and online liquor delivery services. In office, even in Sydney, Australia's most concentrated market, the largest operator controls less than 20% of high-grade CBD offices. Other markets are far less concentrated, and in all markets there is a tail of small landlords. Industrial property ownership is even more fragmented than office and retail. In response to currently elevated demand, dozens of REITs and other real estate operators in Australia are currently acquiring and developing industrial property. In the

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social infrastructure and agricultural logistics categories, rival sites don't always exist nearby. However, similar sites can be adapted or new assets developed. In some cases these assets are established by the tenant and purchased by Charter Hall in a sale-and-leaseback arrangement. Examples include Telstra telecommunications assets and Inghams poultry distribution facilities. The advantage of a sale-and-leaseback for Charter Hall is that it avoids development risk. However, it also means it pays market rate for a mature income stream, competing with rival property fund managers, multi-national private equity shops, and the many rival REITs that have an external management platform. Some of Charter Hall's properties have unique physical characteristics, such as proximity or connections to telecommunications nodes for the REIT's telco exchanges. However, these are a small portion of the portfolio. In any case such specialisation also comes with the risk of technological or business obsolescence. In summary, when CLW's leases expire, new rents will be governed by market supply and demand, in a competitive market environment.

Fair Value and Profit Drivers (08-Aug-2023)

Our fair value estimate for Charter Hall Long WALE REIT, or CLW, securities is AUD 5.10 per security. Our fair value is derived using a discounted cash flow valuation with a 6.9% weighted average cost of capital. Our valuation implies a forward fiscal 2023 P/E ratio of 20, and enterprise value/EBITDA ratio of 21 times.

CLW's property income over the next decade is visible given revenue is underpinned by long leases to strong tenants. Outgoings are modest due to the triple-net leases, where tenants are responsible for most costs, but interest costs are a substantial cost that could vary depending on inflation and bond markets. Our base case assumes rental growth of 2.8% over our 10-year discrete forecast period, 2.5% earnings before interest growth during our 40-year stage 2, and that total returns are equivalent to weighted average cost of capital of 6.9% during stage 3.

To accurately represent CLW's recurring cash flows, we exclude maintenance capital expenditure from operating earnings. For maintenance capital expenditure we add an allowance for costs at the end of an asset's life, for example, a sizable refurbishment or redevelopment of the entire site. This is substantially higher than maintenance capital expenditure numbers quoted, which typically only allow for day-to-day maintenance.

Risk and Uncertainty

Charter Hall Long WALE REIT's Morningstar Uncertainty Rating is Medium. Earnings are fairly predictable over the next decade due to the REIT's long leases to strong tenants. But CLW's look-through gearing is a high 40%, so relatively stable unleveraged earnings are amplified via financial leverage. About two thirds of our valuation is based on the stage two fade and stage three terminal value, by which time current leases will expire. Economic and property market conditions well into the future will therefore play a part in the valuation, and the assumed discount rate is a significant swing factor in terms of valuing this REIT.

There are sources of near-term uncertainty too. It has substantial exposure to office properties, which face structural change arising from work-from-home flexibility. Even once immediate cyclical issues are resolved, hybrid working is likely to give more bargaining power to tenants, because it allows employers to inflate or deflate the amount of office space required, by adjusting the number of employees working from home. Most employers will likely have a long-term target in mind for their office requirements, but this flexibility will allow them to delay office expansions. For example, during periods of office undersupply a firm could opt to delay moving into a larger office.

CLW also has substantial exposure to retail assets. These include service station assets, which in the long run could be disrupted by a switch to electric vehicles. The sites are typically well located in dense urban areas, so we believe alternative uses could be developed for the sites in that scenario, given the long lead-time likely for substantial EV adoption.

Financial Strength

CLW's financial health has weakened in the face of rising interest rates. Interest cover is 3.4 times, compared with a covenant of two times. To breach

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that, earnings would have to fall by about a third, other things equal, unlikely given revenue is underpinned by long leases. A breach arising from increased finance costs is also unlikely, as it would require finance costs to roughly double. That sounds like a massive increase, and while we view it as unlikely, it's not impossible considering a low average cost of debt of 3.9% as at June 30, 2023. However, we expect management will sell assets over the next 12 months, keeping a lid on gearing. Admittedly, asset sales could be at lower prices than book value, given the higher property capitalisation rates that would be implied by substantially higher interest rates, however we think the REIT has properties in currently attractive sectors such as industrial property that it could sell at near book value.

Reassuringly, CLW has debt locked in with an average maturity of 4.5 years, and maturities are well staggered, with no outsize expiries until fiscal 2027. About 80% of existing debt is fixed or hedged, which limits the impact of interest rate moves on finance costs for the next two years.

The group has additional debt and covenants pertaining to underlying joint venture vehicles. The largest exposure is a debt facility that funds the BP Australia portfolio, with an LVR of 39.6%, versus a covenant of 60%. That implies the asset values would have to fall by one third for a breach, unlikely in our view.

All that said, a rise in interest rates could increase finance costs, and pressure valuations on CLW's long-lease assets. That means gearing is likely to elevate just as buying opportunities might arise in property markets, limiting opportunity to buy assets during any looming property downturn, or limiting income growth.

Capital Allocation (08-Aug-2023)

We assign CLW a Standard Morningstar Capital Allocation Rating, based on a sound balance sheet, fair investment strategy and mixed views on the distribution payout. On-balance-sheet gearing of 33% (measured by net debt to total assets) is toward the upper end of the REIT's target range of 25% to 35%. We'd prefer not to see gearing rise further given rising debt costs. Look-through gearing (including debt in underlying vehicles and JVs) was 40% as at June. 30, 2023. That's high, but CLW's balance sheet can cope thanks to a very long average lease length of over a decade, and strong tenants, most of whom we view as unlikely to miss a rent payment. We view the investment strategy as fair. CLW's strategy of seeking strong tenants and locking them into very long leases has been prescient. It helped the REIT side-step vacancies during the pandemic, and unitholders have benefited from the relentless decline in interest rates, which favoured CLW's long-duration assets. While we applaud the REIT's adherence to its strategy, many of the purchases were executed when rates were low, and now rates are higher, putting pressure on the prices for long-duration assets. The long WALE strategy doesn't leave a lot of flexibility, meaning CLW's prospects will wax and wane with the prospects for long-duration assets. We have mixed views on the level of distributions paid out. CLW is mainly a vehicle to collect rent on its long-lease assets and pass the income through to investors. It doesn't undertake a large amount of development. So we think it's appropriate that a high proportion of income is paid as distributions. However, we note that the REIT paid out 100% of operating earnings from fiscal 2018 to 2023. That leaves nothing for replacement or expansionary capital expenditure, which means future distributions, or growth, could be affected if capital expenditure requirements increase.

Bulls Say

► With markets pricing in substantial interest rate rises, listed long-duration assets are looking better value than in recent history.

► Long WALE REIT has very long leases to strong tenants, many with inflation-linked rental uplifts baked in.

► Charter Hall's scale and track record of managing sale-and-leasebacks puts CLW in a strong position to acquire similar assets in future.

Bears Say

► CLW is sensitive to interest rates, in terms of valuations on its long-duration assets, and finance costs. Significant interest rate rises could undermine income, and CLW's valuation.