# Shopping Centres Australasia - wait for more attractive entry point

## Special Report

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Woolworths (WOW) plans to spin out a portfolio of 69 existing and development assets to a new investment vehicle, Shopping Centres Australasia Property Group (SCA). We expect the proposal to be approved when it is put to vote at the WOW annual general meeting on 22 November 2012. Under the proposal, WOW shareholders will receive one SCA unit for every five WOW shares held on 30 November 2012. SCA plans to raise an additional $425m to $506m of equity via an issue of approximately 337 SCA units at an offer price range of $1.26 to $1.50 per unit. Eligible WOW shareholders get priority in the equity raising. Each SCA security will have a net tangible asset (NTA) backing of $1.58, assuming the offer proceeds.

The notional value of the SCA units to be received by WOW shareholders as part of the capital reduction is $0.32 per WOW share, relatively immaterial at around 1% of the value of WOW shares, which are trading around $29. There is a considerable uncertainty for WOW shareholders in deciding to apply for additional SCA securities, which includes variability in the SCA offer price of between $1.26 and $1.50. This uncertainty gives rise to variability in the distribution guidance range of between 6.9% and 8.3% for the first full financial year ending June 2014 (FY14).

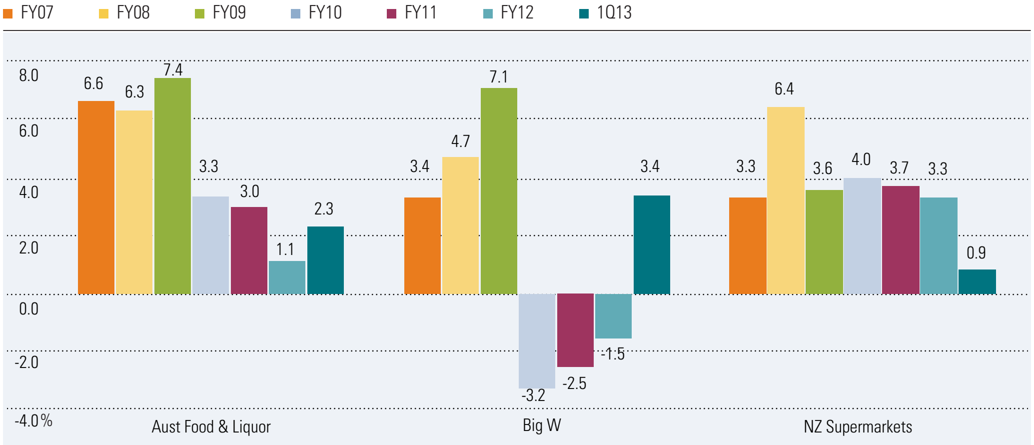
We do not believe SCA units offer good value relative to peers unless investors are able to secure units at the lower end of the $1.26 to $1.50 offer range. As the pricing for SCA securities will be determined by an institutional bookbuild after retail applications have closed, there is no assurance SCA units can be purchased at this price. With most Australian property stocks having performed strongly during 2012, largely due to falling interest rates, we recommend investors not subscribe for additional SCA units and wait for a more attractive entry point. We have a fair value estimate for SCA securities of $1.50, representing a 5% discount to reported NTA.

### Uncertainty around medium-term income growth

There is considerable uncertainty around medium-to long-term rental income growth from specialty and Woolworths tenants. For specialty tenants (around 40% of gross income), WOW is providing a rental guarantee to cover vacancies for two years from the November 2012 and for all specialty tenancies in the development portfolio for two years after completion of the development. When these specialty rental guarantees lapse over the next two to three and a half years, specialty rental income could decline by 5% or more if vacancies aren't filled or if market rents contract in the interim.

Woolworths tenants contribute around 60% of gross income. Tenants pay base rent plus turnover rent if

**Chart 1: Like-for-like sales growth of major Woolworth divisions (%)**




Source: Woolworths

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**Chart 2: Forecast rental income by category (%)**


Source: SCA

sales exceed an undisclosed threshold. For most of the Woolworths tenants [Supermarkets (65), Big-W (9) and Dan Murphy's (5)] the product disclosure statement (PDS) provides little insight into how much rents will grow. For 37 of the supermarkets and Big-W stores, base rents rise by a minimum of 5% at 5-yearly reviews (equivalent to 1% per annum). This is very low compared to escalation in typical specialty leases of around 4% per annum or CPI plus 1.5%. For these 37 WOW stores, rent growth could exceed the 1% minimum if sales exceed an undisclosed threshold and turnover rent is payable. For the remaining 42 WOW stores, it appears that rents only increase if sales exceed the threshold and turnover rent is payable. The main takeaway is that rental growth from these stores is highly correlated to the tenant's revenue growth and, unfortunately, recent trends in same store sales are subdued.

We have reviewed like-for-like sales growth of the three major Woolworths tenants occupying SCA's shopping centres, and the sales performance has waned considerably for Woolworth's Australian supermarkets, turned negative for Big W, while been reasonably strong for the New Zealand supermarkets. There has been a strong turnaround in sales performance in 1Q13 for its Australian supermarkets and Big W in particular, but it's too early to tell if this will persist. This slowing sales growth trend for Australian Woolworths supermarkets makes it less likely that anchor tenants will pay turnover rent. Hence our earnings forecasts are based on rental growth for Woolworth tenants of 1.6% per annum.

If we assume rental growth for Woolworths businesses of 2.2% per annum and 4.2% for specialties in a more bullish scenario, our SCA fair value estimate increases to $1.60 per unit. In a more bearish scenario with Woolworth store rent growth of 1.1% per annum and specialty rent growth of 2.8% per annum, our fair value estimate would be $1.30 per SCA unit.

The forecast FY14 distribution yield in SCA's prospectus of 6.9% to 8.3% is slightly inflated by the rental guarantees over vacant specialty stores.

If we exclude the effects of the rental guarantee (by assuming a specialty vacancy rate of 5%), FY14 distributable income falls 2% and distribution yield would be between 6.8% and 8.1% and the PE ratio would be between 10.9 and 13.0. The mid-point of this forward FY14 PE range is consistent with that of SCA's closest peer, Charter Hall Retail (CQR), implying investors will be getting a good price only if they were able to purchase SCA units for under $1.35, towards the bottom of the $1.26 to $1.50 offer range.

**Portfolio and asset values relative to peers**

Most of SCA's 56 operating properties are newly built, with the remaining 13 properties under construction. The low average age of 2.1 years means maintenance capital expenditure will be low for the medium-term. The portfolio is weighted towards smaller neighbourhood and freestanding centres at 52% and 18% of assets respectively. The 30% balance is sub-regional centres, which typically range from 10,000 to 30,000 sqm and have up to 40 specialty shops.

We are generally positive on Australian REITs focussing on non-discretionary retail, as we believe these assets will be less impacted by online competition and consumer deleveraging. However, we have a preference for the sub-regional malls over the smaller neighbourhood and free standing centres. We believe smaller centres anchored by supermarkets will have a higher average vacancy rate than the larger sub-regional centres. The is because the expanding product range of the supermarket chains into areas historically provided by specialty tenants (bakers, butchers, florists, green-grocers, hardware, newsagents) has reduced the pool of prospective tenants and hence specialty rents.

**Bull Points**

- Distributions are relatively secure, underpinned by the fact that over 60% of income is sourced from quality anchor tenants with long lease terms.
- A sustained improvement in retail conditions from rate cuts positions SCA to benefit from solid turnover rent growth from anchor tenants and higher growth in specialty rents.
- Quality anchor tenants supports relatively high occupancy for specialty space.

**Bear Points**

- Assets in the portfolio are located in regional Australia, which has historically experienced slower population growth and hence sales growth that more built up areas.

**Table 1: SCA distribution yield and PE relative to peers**

| | SCA | SCA | SCA | SCA | CQR | BWP | CRF * |
|---|---|---|---|---|---|---|---|
| SCA offer price / share price ($) | 1.26 | 1.34 | 1.42 | 1.50 | 3.60 | 2.08 | 2.15 |
| FY14 Distributable income (excl. rent guarantee) | 11.6 | 11.6 | 11.6 | 11.6 | 30.3 | 14.4 | 16.8 |
| Payout ratio forecast (%) | 88 | 88 | 88 | 88 | 91 | 100 | 82 |
| Distribution forecast (cpu) | 10.2 | 10.2 | 10.2 | 10.2 | 27.5 | 14.4 | 13.8 |
| FY14 foreast PE ratio | 10.9 | 11.6 | 12.3 | 13.0 | 11.9 | 14.4 | 12.8 |
| FY14 forecas distribution yield (cpu) (%) | 8.1 | 7.6 | 7.2 | 6.8 | 7.6 | 6.9 | 6.4 |

* sourced from broker consensus

**Table 2: Key Dates**

| Event | Date |
|---|---|
| Woolworth Retail Shareholder, broker firm offier, general public offer open | 15-October-2012 |
| Woolworth Retail Shareholder, broker firm offier, general public offer close | 20-November-2012 |
| AGM proxy forms to be lodged with Woolworths registry | 20-November-2012 |
| AGM voting record date | 20-November-2012 |
| Woolworths AGM | 22-November-2012 |
| SCA units commence trading on ASX on a conditional and deferred setltlement basis | 26-November-2012 |
| Allotment of SCA units to Woolworths participants | 11-December-2012 |
| Allotment of SCA units under the offer | 11-December-2012 |
| Unconditional and deferred settlement trading of SCA units on ASX | 12-December-2012 |
| SCA units trade on ASX on a normal basis | 19-December-2012 |

- The assets in the SCA being relatively small do not benefit from entry barriers and as such are susceptible to new competition in the catchment area.
- Consumer deleveraging could result in subdued like-for-like sales growth for anchor tenants and hence very low rent growth rates.
- A continuation of the weak retail conditions will result in further softness in market rates for specialty retail.

**Growth**

Earnings over the two years post listing are underpinned by leases to Woolworths businesses and a Woolworth rental guarantee. Beyond that we expect relatively low rental growth, particularly for anchor tenants for which leases are reviewed every five years, with some upside in the interim if sales exceed a predefined, but undisclosed hurdle. Market rents for specialty retailers declined during 2012 and with retail sales still weak, we expect modest annual specialty rent growth of between 3% and 3.5% per annum in the long-term.

**Risk and competitive threats**

We see few competitive threats for SCA's anchor tenants, all with established brands and compelling product offerings. SCA's key earnings risks include slow rental growth for anchor tenants and hence limited growth from the receipt of turnover rent. Rents for specialty tenants and occupancy is likely to be volatile. The shopping centres in the SCA portfolio are in smaller regional areas of Australia, where strip malls are common. These regional malls frequently have vacant stores and hence less rental pricing tension. The regional location of SCA's assets means there is often numerous sites for competitors such as Coles, Aldi and IGA to establish competing centres.

**Financial health**

Following payment for the shopping centres that are currently under development, proforma gearing (net debt/tangible assets) is 34%, which is in SCA's target gearing range of 25% to 40%. This gearing is at the higher end of Australian REIT's but not a concern given secure earnings underpinned by long leases to high quality anchor tenants. Reflecting the low market rates, borrowing costs will be low around 5.3% over the next three years. Interest coverage will be solid at around 4.0 times.

**Management**

SCA management are experienced executives from within the Woolworths property division. Interim CEO, Anthony Mellowes has held a number of senior property related roles within Lend Lease, Westfield and Woolworths and is currently acting as head of asset management and group property operations. Incoming CFO, Kerry Chambly is a chartered accountant with board experience in property finance and was previously in the role of manager capital transactions for Woolworths.

The seven member SCA board comprises well credentialed executives with experience in corporate finance, law, commercial property, retail and property development. Five of the seven board members are independent.