

# Dexus

Office segment to recover; attractive yield rewards investor patience.

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Morningstar Equity Research

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# Executive Summary

Office set to recover while investors are paid to wait.

# Market Too Pessimistic and Dexus Looks Cheap

## Shares Look Cheap

Dexus' security price of approximately AUD 7.00 is about 35% below our AUD 10.80 fair value estimate, and net tangible assets, or NTA, of AUD 10.88.

## Forward Yield Attractive

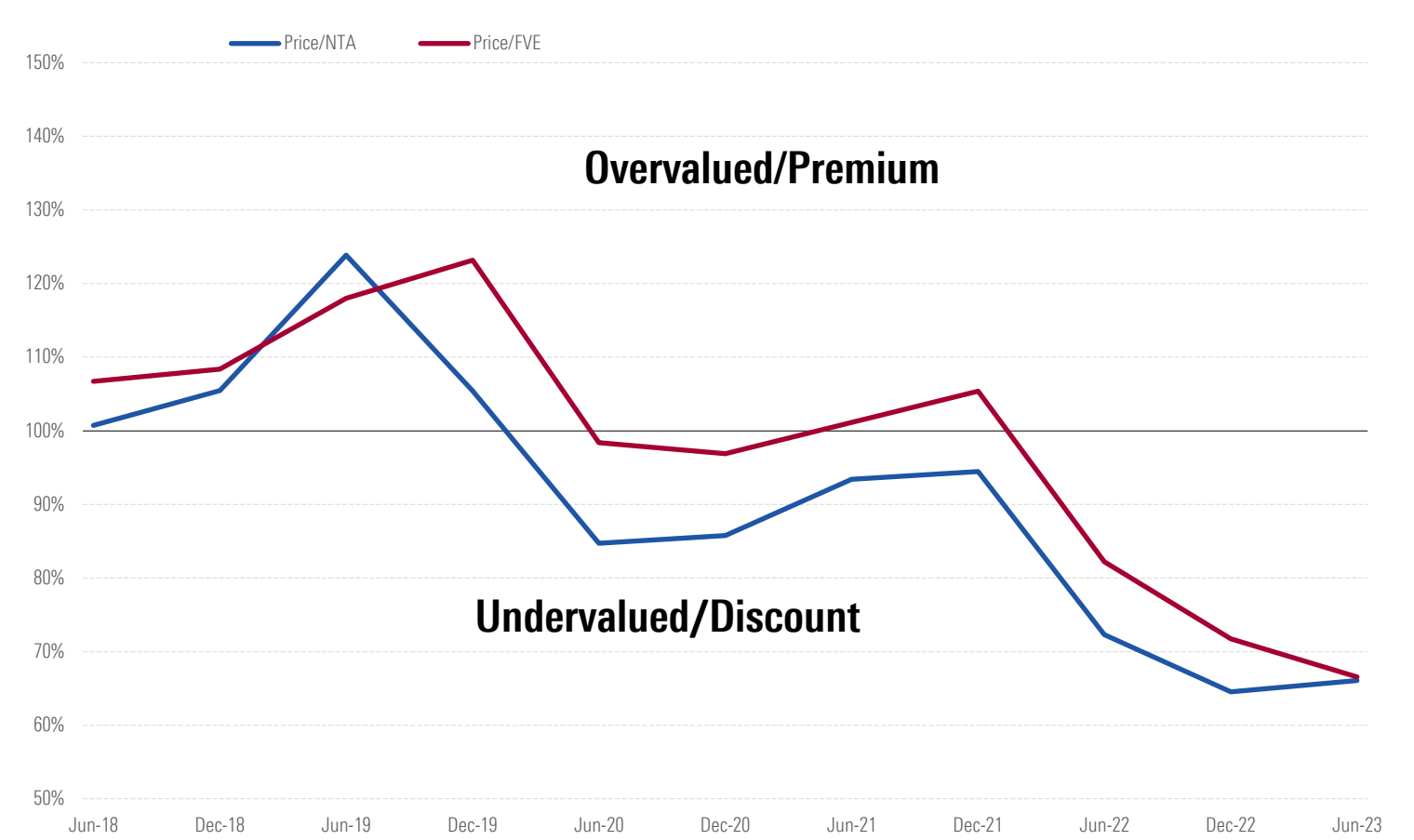
We think the around-7% fiscal year 2024 distribution yield is attractive, compared with the 10-year bond yield of about 4.5%. We assume distributions will fall 8% in fiscal year 2024, mainly on higher debt costs, then will grow at a CAGR of 2.9% a year over the decade to 2033, driven by a gradually improving office supply/demand balance, contracted rent increases baked into leases, and rising funds under management.

## Sum-of-the-Parts Valuation Scenarios Too Pessimistic

Dexus' security price implies an around-35% fall in NTA, and that intangible value in Dexus' development and funds management interests worth zero, or a 50% fall, approximately, in NTA and values intangibles on an approximate 10 times funds from operations multiple; or a dilutive equity raise. All three scenarios look too pessimistic.

## Dexus Shares Undervalued

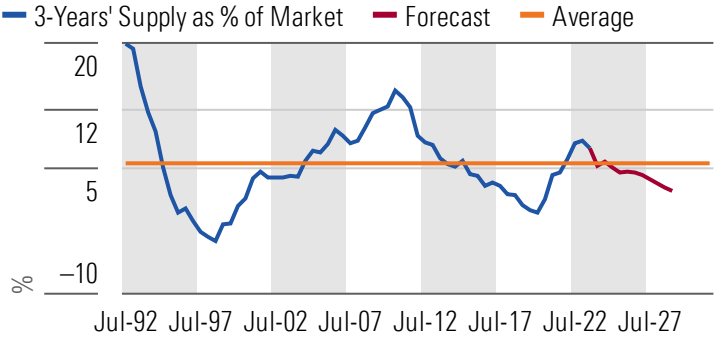
Dexus Price/Net Tangible Assets and Price/Fair Value Estimate



Source: Dexus NTA, Morningstar fair value estimates and price data. Last calculation based on FVE and security price as of Nov. 16, NTA as of June 30.

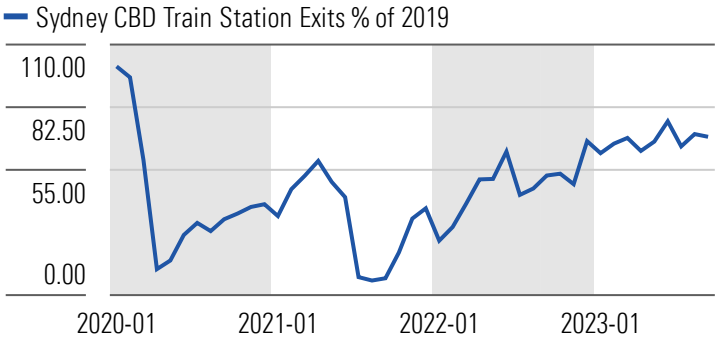
# Dexus Can Withstand the Downturn, and Leasing Conditions Should Improve

## Office Supply Waning and Further Declines Likely



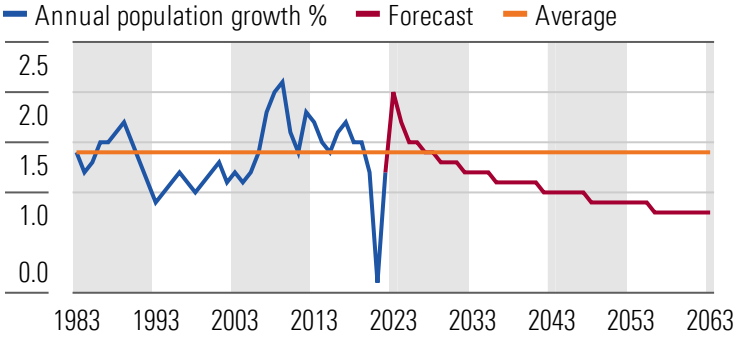
Source: PCA Office Market Report; Morningstar forecast.

## Central Business District Activity Recovering



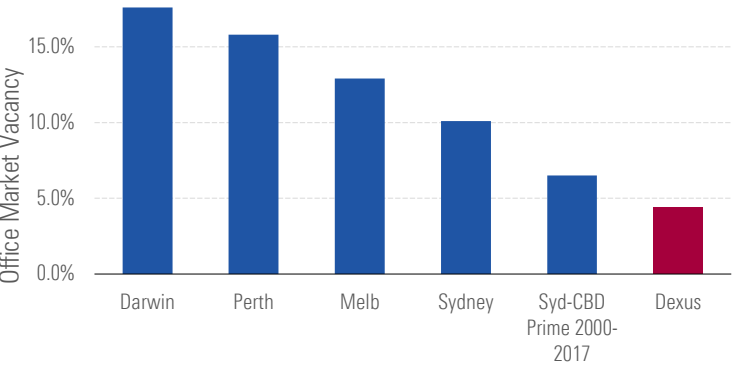
Source: Transport For NSW; Circular Quay, Martin Place, Wynyard.

## Rapid Population Growth to 2028 Will Buoy CBDs



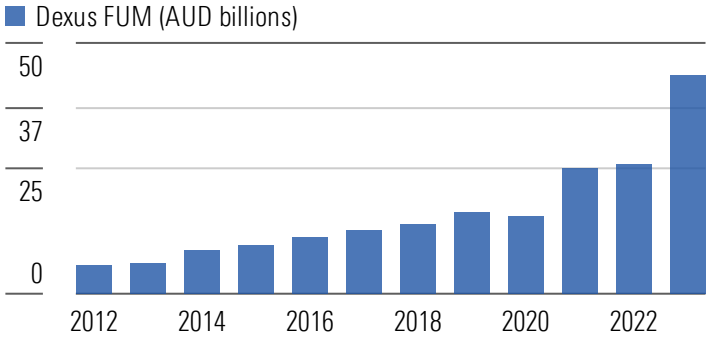
Source: 2023 Intergenerational Report.

## Vacancies for Low-Quality Assets, Not Dexus



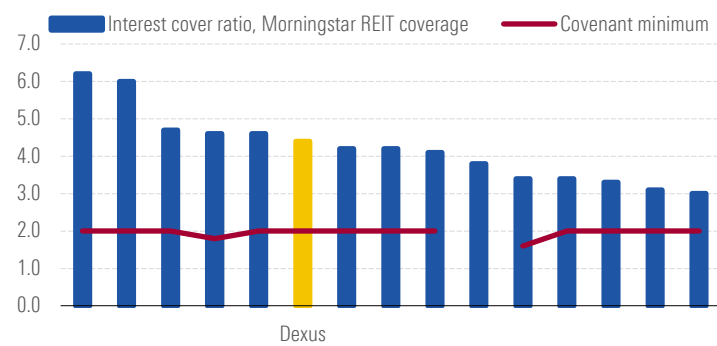
Source: PCA July 2022. Sydney CBD and Dexus vacancy as of September 2022, sourced from Arealytics and Dexus.

## Asset Management Valuable and Growing



Source: Dexus annual earnings presentations.

## Balance Sheet Solid and Equity Raise Unlikely



Source: Dexus fiscal 2023 presentation; ICR based on debt cost of 3.7%.

# Market Concerns

The market is anxious about the risk of REIT discount equity raises.

## Dexus Has a Strong Balance Sheet; Equity Raising Unlikely

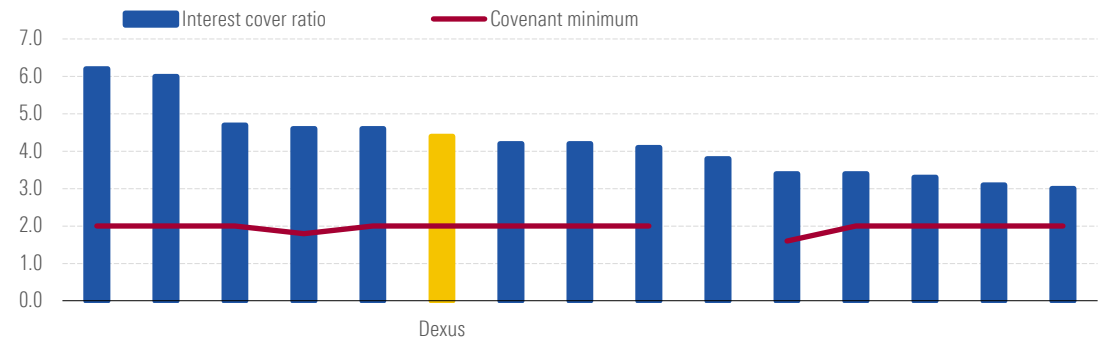
Dexus interest cover ratio of 4.4 times is at the conservative end of the sector. Admittedly, interest cover is likely to worsen over time as interest-rate hedges expire. But Dexus is well above its covenant minimum of 2.0 times.

If Dexus had to refinance its debt at prevailing rates and maintain similar debt tenure, we estimate it would cost about 6.5%, versus fiscal 2023 interest costs of 3.7%. If debt costs doubled to 7.4%, Dexus may breach its interest cover covenant, but we don't think this would occur until nearly 2029, given 86% of debt is hedged for an average 4.8 years.

This hedging gives Dexus time to adjust to a higher interest-rate regime and for revenue to grow, compensating for higher debt costs. Refinancing risks are modest too, given average debt maturity of 5.1 years, and staggered maturities.

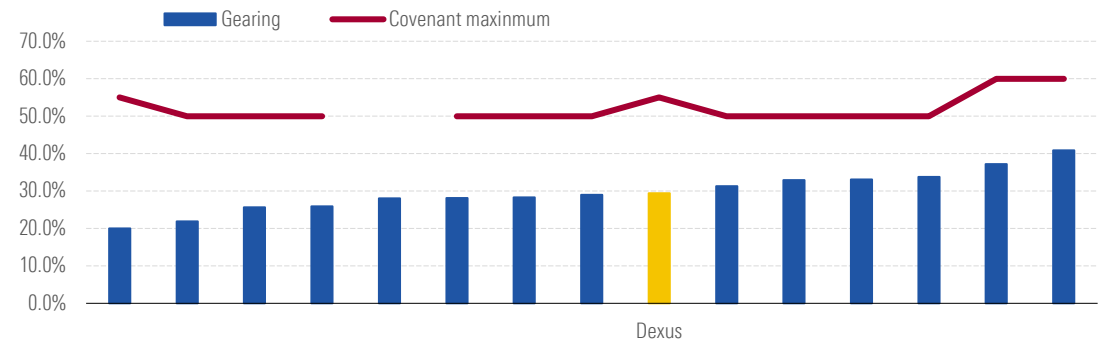
Dexus' covenant gearing of 29.4% is also well below the covenant limit of 55%, which itself is a more generous limit than most REITs. Dexus further strengthened its balance sheet by settling on about AUD 1.3 billion of property divestments since June 30, 2023, at prices around June 30 book values. This is significant, considering it only has about AUD 5.3 billion in debt. These divestments should reduce gearing to about 27%.

### Reasonable Interest Cover Across Sector; Dexus at Cautious End of Sector



Source: Company earnings presentations for period ended June 30, 2023.

### Falling Office Values Will Push Up Gearing, But Dexus Has Ample Buffers



Source: Company earnings presentations for period ended June 30, 2023

## Dexus Has a Strong Balance Sheet; Equity Raising Unlikely

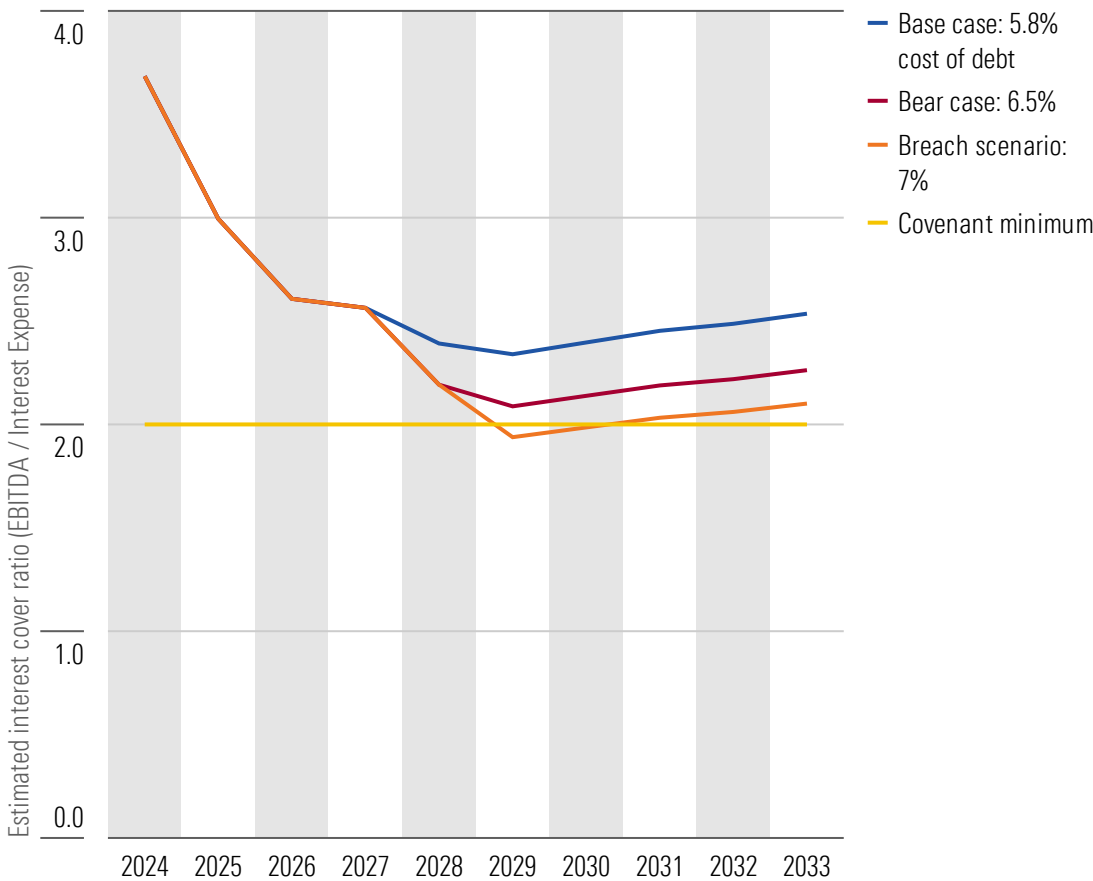
Interest costs for the next few years are reasonably predictable for Dexus, as 86% of Dexus debt is hedged for an average maturity of five years, as of June 30, 2023. As these hedges expire, debt costs are likely to rise, depressing the REIT's interest coverage ratio, or ICR. A covenant breach can't be ruled out, but we think it's unlikely.

This chart shows that if interest costs rise to our base-case long-term debt cost of 5.8%, or to current market rates of around 6.5%, we think Dexus would still be above its ICR minimum, other things equal. If debt costs rose to 7%, we estimate it would breach the covenant. However, this scenario of higher rates would likely be accompanied by stronger economic growth, which would likely flow through to better office rents than we've assumed in this 'other-things-equal' analysis. Dexus also has other ways to reduce debt, including reducing or delaying development spend, or selling assets. We see good prospects that Dexus brings capital partners into some of its developments, given iconic locations such as Brisbane's CBD waterfront, and a development proposal that combines several buildings at the corner of Pitt and Bridge streets in the core of Sydney's CBD.

Dexus had a committed spend of AUD 2.3 billion as of June 30, 2023, but to help fund this and ameliorate financial pressure, Dexus has settled on approximately AUD 1.5 billion of disposals since 2023 fiscal year-end, supporting our view that it can and will sell assets where necessary to fund developments or moderate financial pressure.

### Interest Cover Ratio to Worsen For Dexus, But Reasonable Buffer To Covenant

Estimated Interest Cover Ratio Over Time



Source: Morningstar estimates.



# Office Supply/Demand

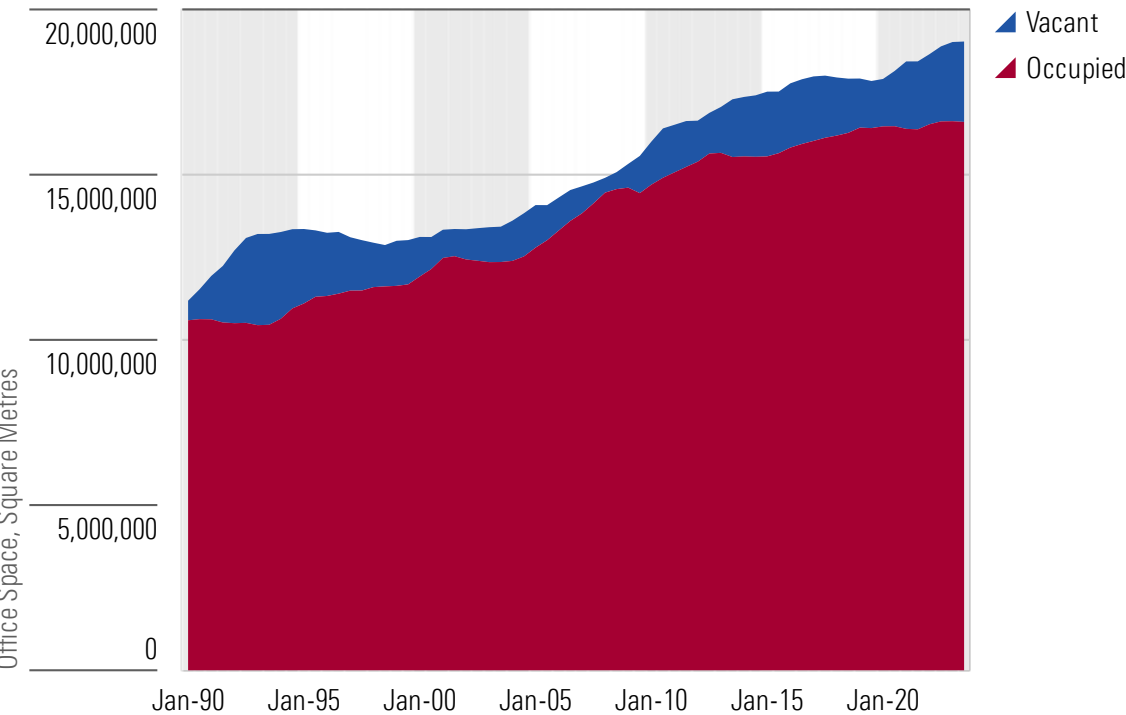
Supply waning while population growth supports demand.

# Prepandemic Projects Mostly Finished While New Projects Struggle

New office supply is peaking, and projects started prior to the pandemic are now largely complete. We expect supply to moderate with fewer projects in planning, capital and construction costs onerous, and as some inferior offices convert to alternative uses such as hotels, apartments and data centres. Despite work-from-home, there is now more Australian CBD office space occupied than in 2019. We attribute that to higher vacancy in low-grade offices outside of CBDs, as tenants favor prime CBD assets such as those owned by Dexu.

## Despite the Gloom, Office Demand is Growing

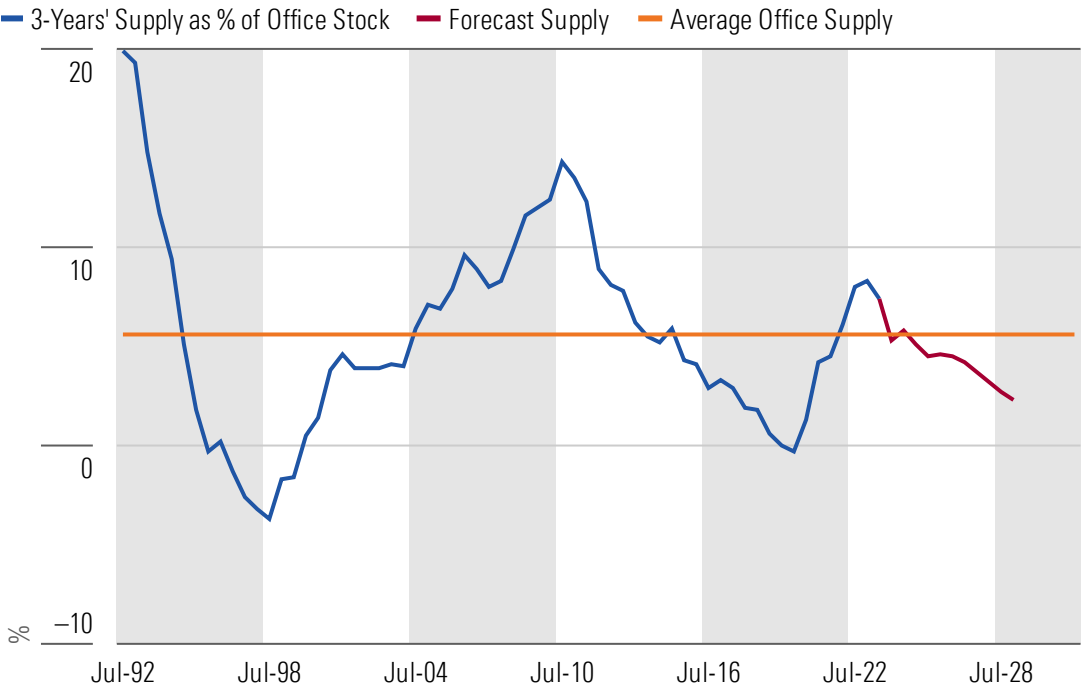
CBD Office Space: Occupied vs Vacant



Source: Property Council of Australia, Office Market Report, July 2023.

## Supply Glut Modest and New Supply Waning

Historical and Forecast Office Supply



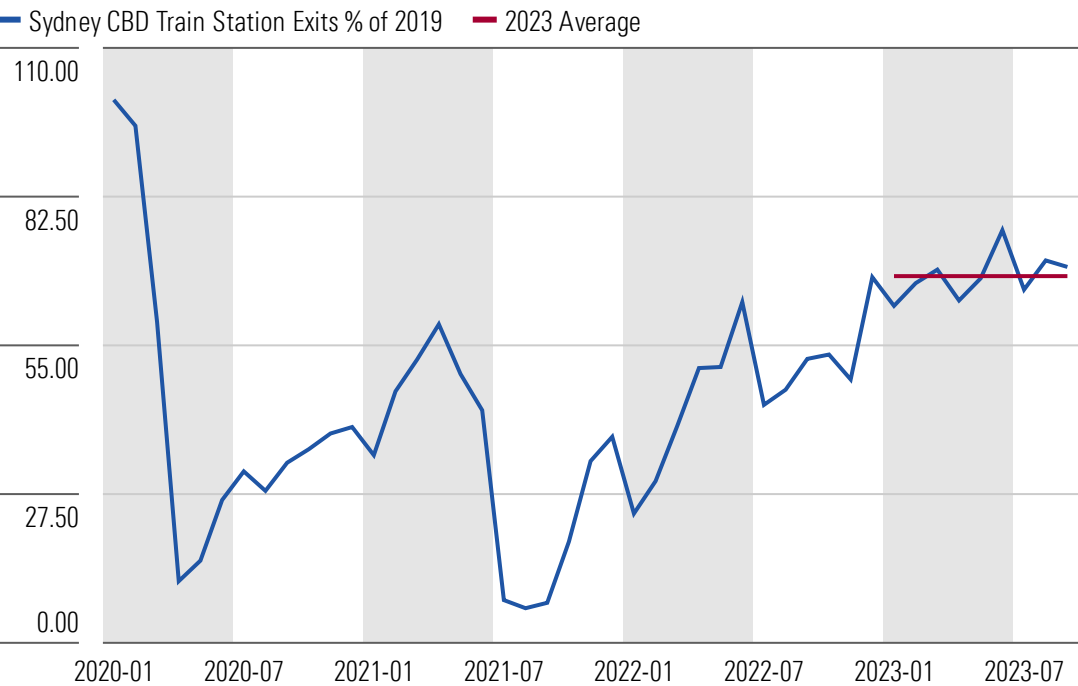
Source: Property Council of Australia Office Market Report July 2023; Morningstar forecast based on PCA mooted projects data.

## Population Growth and Transport Infrastructure Beneficial

The upswing in CBD activity has slowed, but we anticipate further growth on improved public transport, greater acceptance of return to office and population growth. Dexu properties are set to benefit from the Sydney Metro in 2024, which adds two new CBD stations and a 67% increase in peak train movements; the Melbourne Metro Tunnel in 2025, which adds rail capacity and two new CBD stations; and Brisbane Cross River Rail in 2026, which adds a second line and second station in Brisbane's CBD.

### Sydney Recovery Moderating but Still Positive

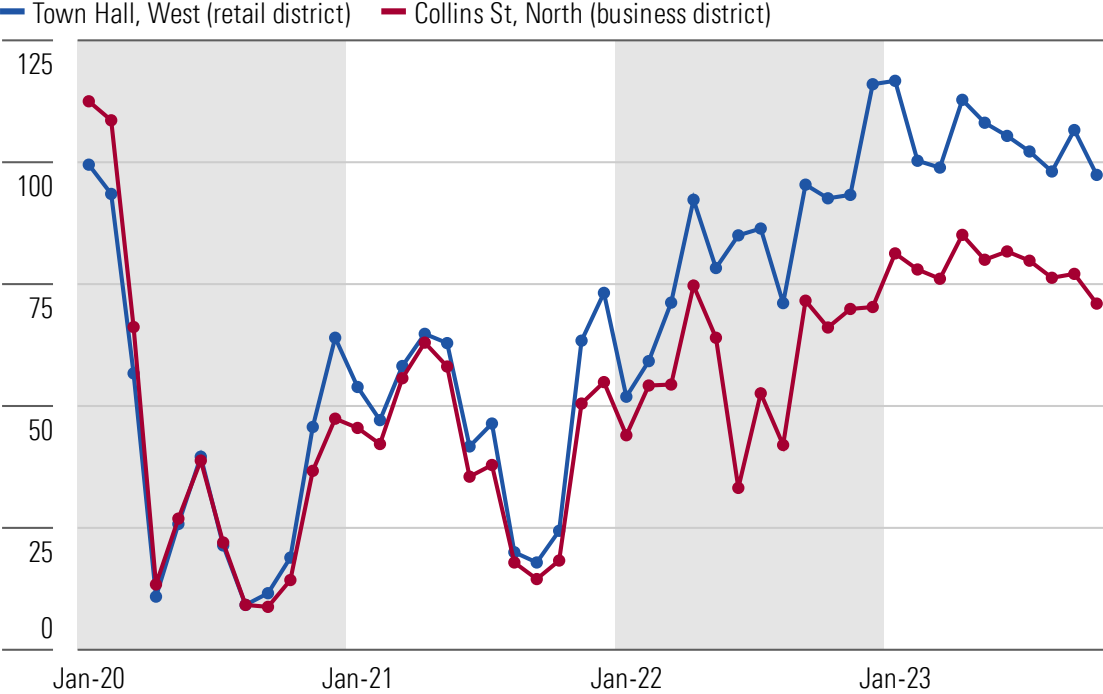
Sydney CBD Monthly Train Passenger Exits as Percentage of 2019.



Source: TransportForNSW; Circular Quay, Martin Place, Wynyard. Morningstar. Data as of Sept. 30, 2023.

### Upside in Melbourne From Population and Transport

Melbourne Monthly Pedestrian Movements as Percentage of 2019



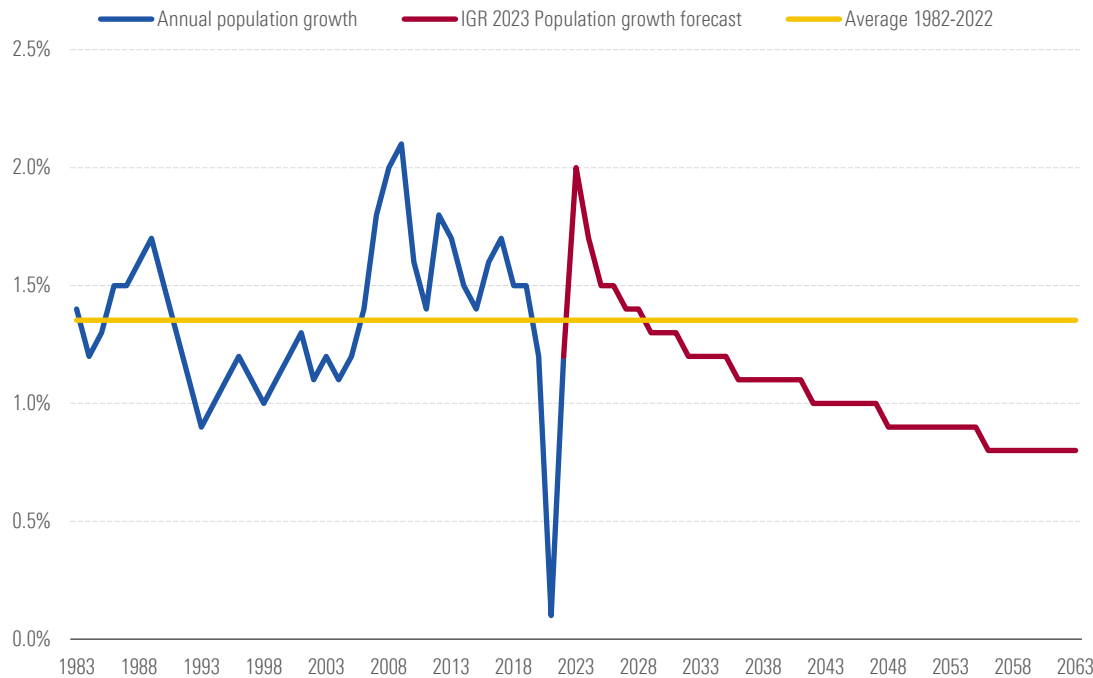
Source: City of Melbourne pedestrian data to Oct. 31, 2023; Collins St North and Town Hall West locations selected by Morningstar as indicative of activity in Dexu asset locations.

## Rapid Population Growth to Mitigate Hybrid Working Headwind

Australia's population is forecast to rise 15% from 2023 to 2033, according to the 2023 Intergenerational Report, or IGR. Particularly rapid growth is expected in the five years to 2028. We note that historical IGRs underestimated long-term population growth, and even if political pressure slows the pace, recent data suggests current population growth exceeds the recent IGR projection. Migration supports demand for quality offices, and spurs conversion or replacement of low-grade offices to residences, hotels and data centers.

### Rapid Population Growth Likely to at Least 2028

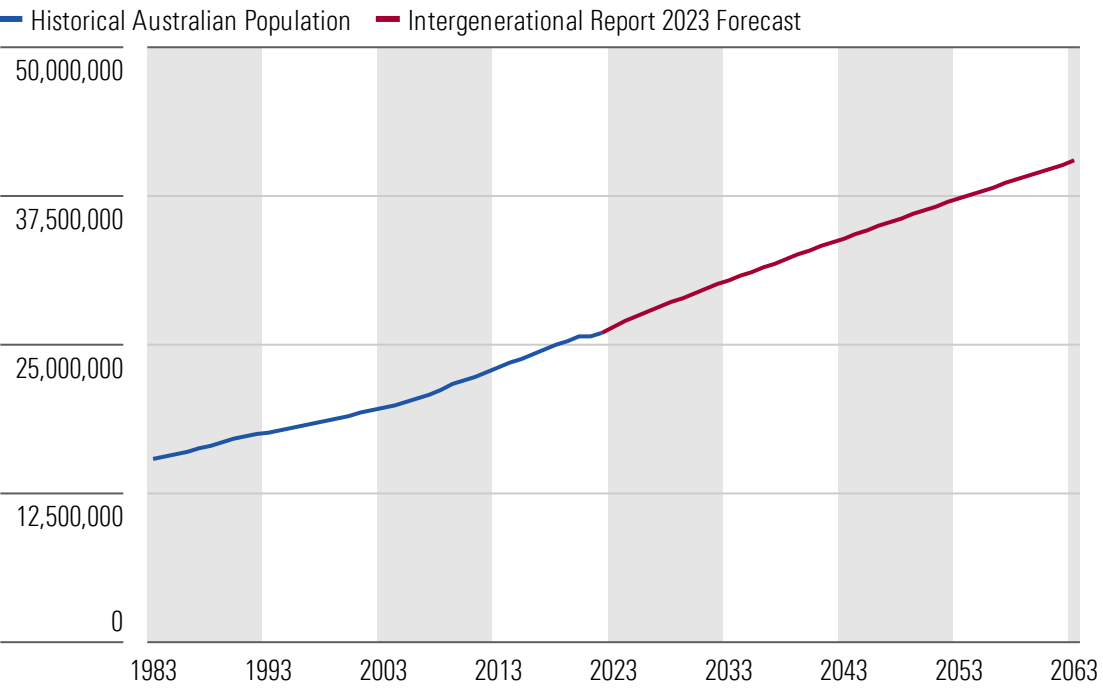
Historical and Forecast Population Growth According to 2023 Intergenerational Report



Source: Intergenerational Report 2023, Federal Budget, Morningstar.

### Australian Population Set to Grow 15% by 2033

IGR Predicts Rate of Growth to Slow, but Numerical Population Growth to Stay High



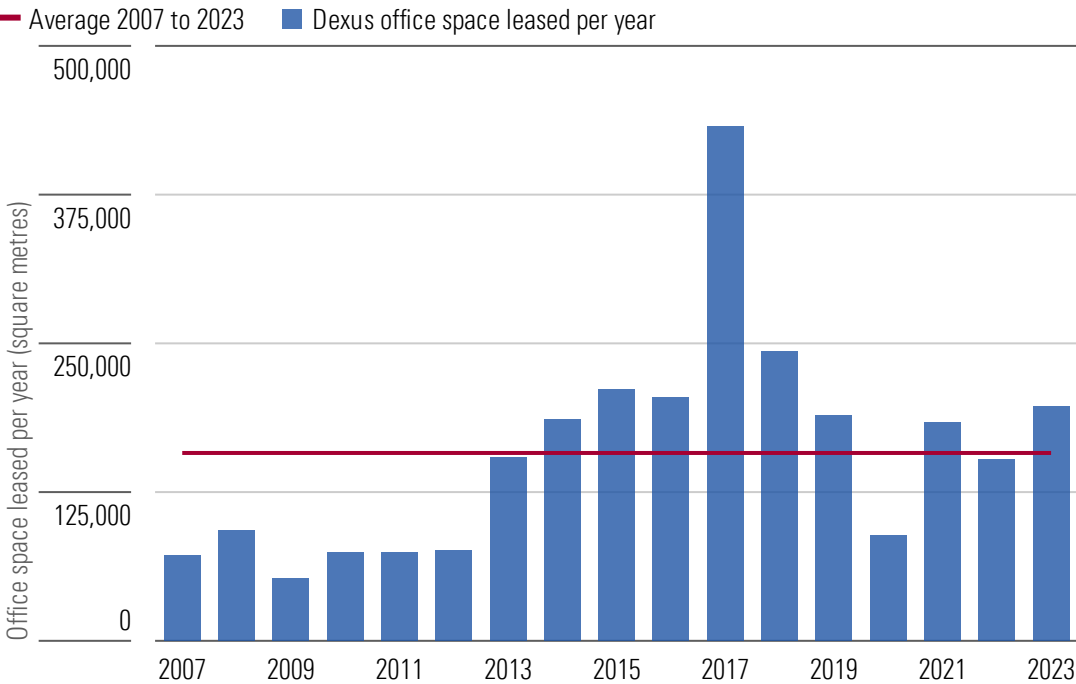
Source: Intergenerational Report 2023, Morningstar.

## Dexus' Medium-Term Leasing Requirements Modest

Ongoing tenant demand means Dexus leased a robust amount of space each year since the pandemic, aside from the 2020 nadir. Existing vacancies and looming expiries suggest leasing requirements are relatively modest for the next few years. Given modest leasing requirements, waning rival supply, and improving demand in the medium term, we think office rents are at or near the lows and see limited downside for Dexus revenue.

### Dexus Achieved Respectable Leasing Volumes 2021-23 Despite Pandemic

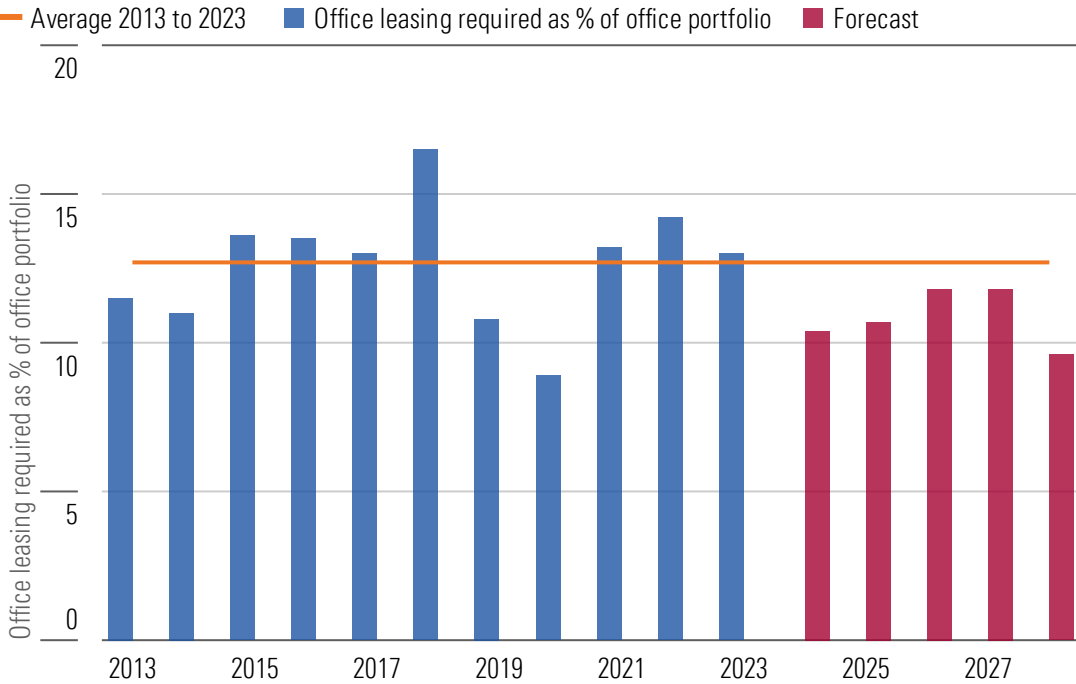
Historical Dexus Leasing Volumes per Year



Source: Dexus annual earnings presentations and annual reports.

### Modest Future Leasing Requirements\* Bodes Well for Dexus Rents

Future Leasing Requirements Modest Compared With History for Dexus



Source: Dexus earnings presentations. \*Annual requirement = vacancy plus first-year expiries. Excludes development.

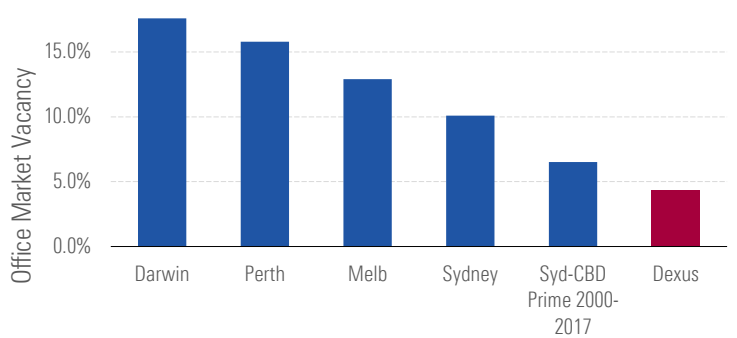
# Vacancy Pain for Smaller Cities, Secondary and Suburban Assets, but Not for Dexus

An Arealytics analysis from mid-2022 showed fewer vacancies in CBDs, in high-grade assets, and in newer buildings constructed since 2000. We think this helps to explain Dexus' low office vacancy of 5.3% as of Sept. 30, 2023. We expect Dexus office occupancy to remain stable until 2026, and improve to 99% by 2028, and we forecast low-single-digit annual percentage rental growth for Dexus offices over the next decade.

Dexus' office portfolio is almost entirely CBD, with a small amount of CBD fringe and suburban offices. Superficially, Melbourne could be viewed as the weak link, given that it has higher vacancy among eastern seaboard cities and sluggish return-to-office numbers in Victoria. However, Dexus is well-positioned within Melbourne's CBD, given the proximity of its assets to new Town Hall and State Library train stations, set to open by 2025.

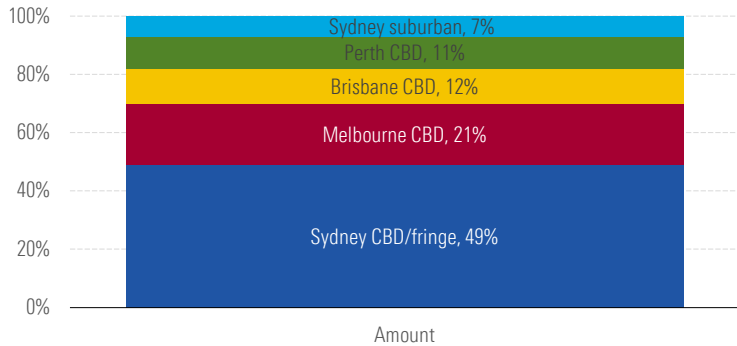
We expect the postpandemic trends to continue, of tenants favoring newer buildings in attractive locations, usually in CBDs, and preferring high-quality buildings with good energy efficiency. We expect vacancy pain to remain acute for lower-grade or poorly located assets, but for high-grade CBD core assets to remain popular, which favors Dexus.

Dexus Office Portfolio Better Placed Than Average



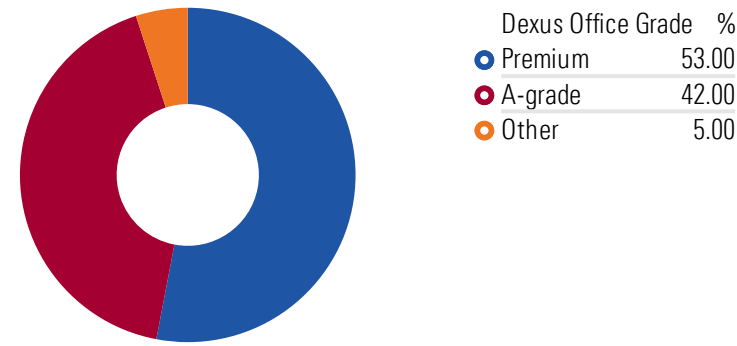
Source: Property Council of Australia, July 2022. Sydney CBD and Dexus vacancy as of September 2022, sourced from Arealytics and Dexus.

Dexus Is Focused on CBD Offices, Not Suburban



Source: Dexus annual earnings presentation June 30, 2023.

Dexus Office Portfolio 95% Prime, Mostly Premium



Source: Dexus annual earnings presentation June 30, 2023.

# Valuation

The market is ignoring asset values and management earnings.

# We're Positive on All of Dexus' Business Segments

## Morningstar Outlook on Key Dexus Business Segments

### Office

High occupancy and long leases with fixed rent increases of 3.5%-4% per year mitigate weak current conditions. Earnings growth should resume as market rents recover.

### Industrial

We see earnings upside given high occupancy and contracted annual rent increases of 3.0%-3.5%. Rapid market rental growth likely to slow, but Dexus rents are about 14% below current market rents. Population growth supportive longer term, via infill demand and alternative uses such as residential and data centers.

### Management Operations

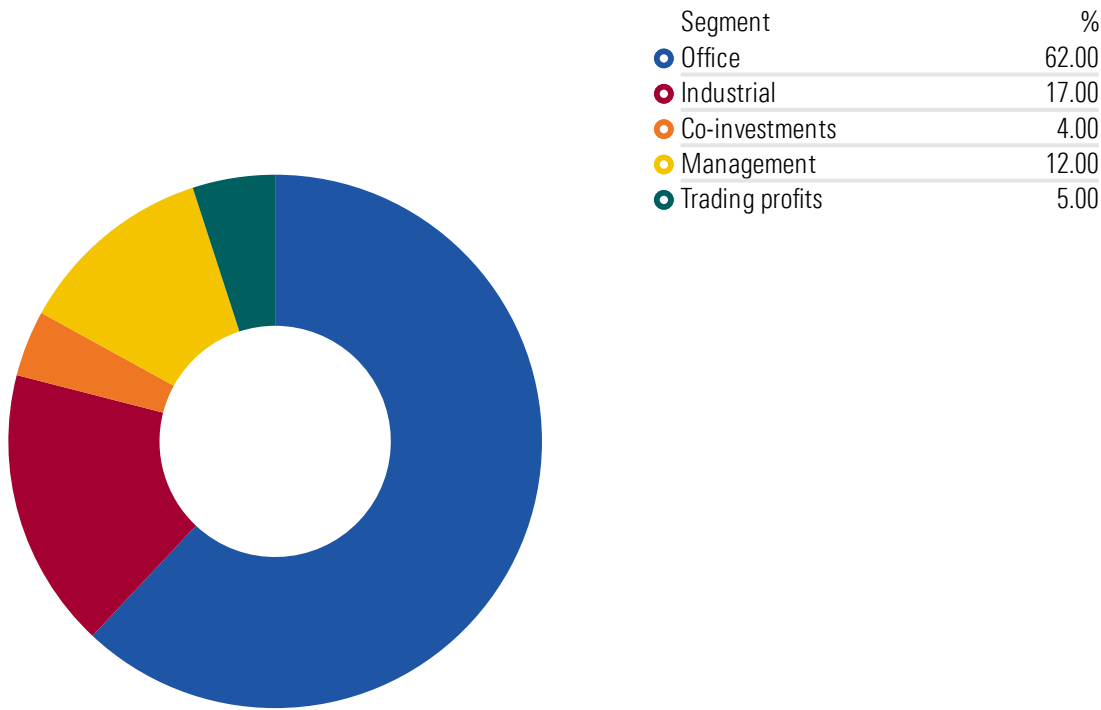
Downward pressure on commercial property valuations is likely to weigh on inflows and performance fees for the next few years, but longer term, we expect Dexus to win market share from smaller fund managers. We expect mid-single-digit annual percentage revenue growth once Collimate is integrated.

### Summary

Leases with fixed rental increases underpin much of Dexus' revenue, and cost inflation is slowing, so it's hard to see much earnings downside. Office leasing conditions are weak, but we expect improvements as impact fades from lockdowns, extreme weather, public transport interruptions, and excess supply. The rest of Dexus' business looks robust. Valuation looks attractive, and investors are paid a compelling approximate 7% yield while waiting for recovery.

## Dexus Business Snapshot

Revenue Contribution to Dexus Fiscal-Year 2023 AFFO by Segment



Source: Dexus fiscal-year 2023 earnings presentation; Morningstar.



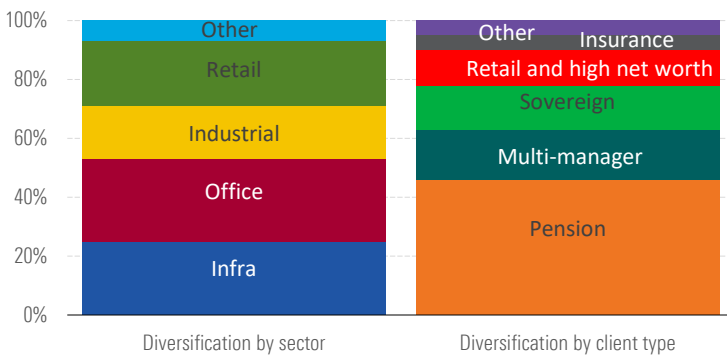
VALUATION

# Market Underappreciates Dexus' Fund-Management Business, Which Is Robust and Valuable

Dexus' approximately 35% discount to NTA seems punitive, given it sold a major office building in 2023 at around a 17% discount, and sold other assets near, and even above, book value. It also has valuable intangible businesses, including development and fund management. Management operations generated about one fifth of fiscal-year 2023 adjusted funds from operations and they make up a similar portion of our fair value estimate. The fund-management business is growing and diversified by sector and client, which mitigates outflow risk. Apart from clients that exited after the Collimate Capital acquisition from AMP, we assume FUM is reasonably sticky, given lockup periods, and Dexus' favorable investment track record.

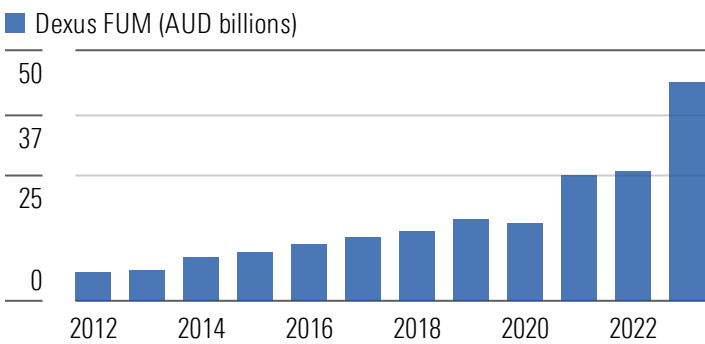
The lower-left chart shows that Dexus trades at a substantial discount to NTA of around 35%, while other fund managers with comparable FUM trade at lesser discounts, or at premiums to NTA. The lower-right chart shows the fiscal-year 2023 OEPS multiple for Charter Hall, Goodman, and Lendlease. It also shows the implied FFO multiple for Dexus' management operations, assuming a 50% fall in Dexus' NTA. Dexus' multiple looks undemanding versus rival fund managers.

Dexus Funds Business Diversified By Client and Sector



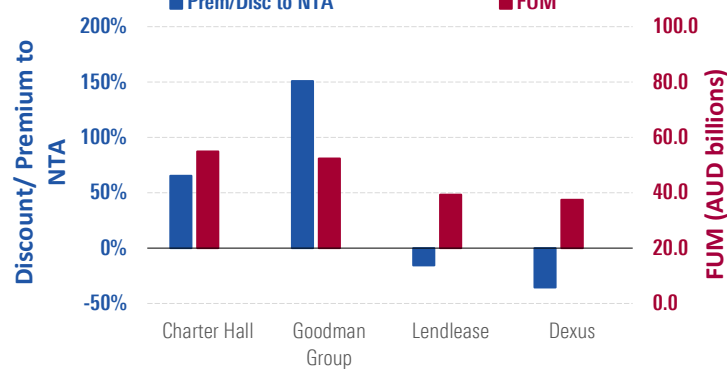
Source: Dexus earnings presentation June 2023.

Dexus is Growing Its Funds Under Management



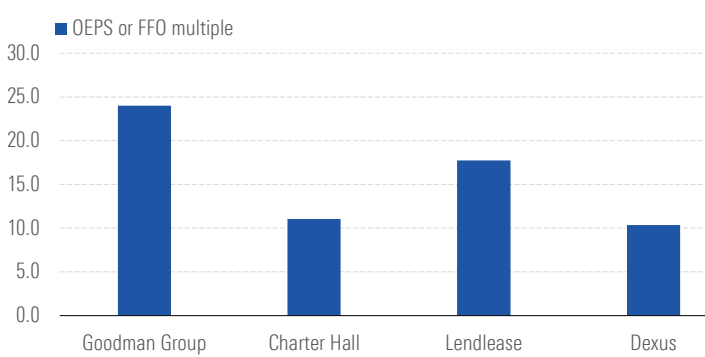
Source: Dexus earnings presentations.

Dexus FUM Comparable to Rivals, Yet Discount to NTA



Source: FUM and NTAs from company data as of June 30, 2023; share prices from Morningstar, Nov. 30, 2023

Dexus Funds Implied Earnings Multiple Below Rivals



Source: Security price as of Nov. 30, divided by fiscal-year 2023 operating EPS, and Dexus fiscal-year 2023 management FFO.

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