Zenith Investment Partners

Highly Recommended
**Recommended**
Approved
Not Rated
Redeem

# Product Assessment

## Cromwell Direct Property Fund

**Report data as at 31 Dec 2018**
**Rating issued on 14 Feb 2019**

### APIR Code
CRM0018AU

### Asset / Sub-Asset Class
Property
Direct

### Investment Style
Core Enhanced

### Investment Objective
Aims to provide a monthly tax advantaged income stream with potential for capital growth via a diversified portfolio of commercial real estate.

### Zenith Assigned Benchmark
S&P/ASX 300 AREIT

### Net Returns (% p.a.)

| | 5 yrs | 3 yrs | 1 yr |
|---|---|---|---|
| Fund | 10.47 | 8.54 | 7.49 |
| Benchmark | 12.53 | 7.55 | 3.26 |
| Median | 13.57 | 11.24 | 9.90 |

### Income (% p.a.)

| | Income | Total |
|---|---|---|
| FY to 30 Jun 2018 | 5.84 | 8.34 |
| FY to 30 Jun 2017 | 6.10 | 12.15 |
| FY to 30 Jun 2016 | 5.30 | 10.40 |

### Fees (% p.a., Incl. GST)
Management Cost: 0.80%
Performance Fee: 20% of the excess return above the benchmark

## VIEWPOINT & RATING

The Fund is an unlisted property fund managed by Brisbane based Cromwell Funds Management (CFM). The objective of the Fund is to provide a monthly tax-advantaged income stream and potential for long term capital growth via a diversified portfolio of real estate assets. The Fund utilises an internalised Fund of Funds (FoF) structure combined with the ability to hold assets directly to gain diversified exposure to real estate. Zenith believes that the Fund's property portfolio is high quality and the resulting income streams should be subject to minimal income variance over the medium term. While this is a positive, Zenith has lowered its conviction in the FoF structure from a peer relative liquidity perspective given that a large proportion of the Fund's assets are essentially encumbered by illiquid investment vehicles.

CFM is a wholly owned subsidiary of Cromwell Property Group (ASX:CMW). CMW is a specialist property investment and funds management business, with $A 11.2 billion in real estate under management, as at 30 June 2018. CFM has significant expertise, operating an internalised model with property and asset management in-house. This typically allows for a closer relationship with tenants and creates synergies in asset management.

Oversight of day-to-day operations of all CFM unlisted property funds is the responsibility of Head of Retail Funds Management, Hamish Wehl. Wehl has been with CFM since 2009 and has held his current role since July 2016. Zenith regards Wehl favourably with solid investment and management capabilities. With regard to his role in the Fund's operation, Wehl's role is essentially one of oversight with CMW's integrated business structure providing access to the specialist resources available from the wider group to fulfil operational requirements.

The Fund aims to exceed the total return of the PCA/IPD Australian Pooled Property Funds Index – Unlisted Retail over a rolling three-year period. The Fund's portfolio continues to have high occupancy levels being 99.8% let as at 31 December 2018. Asset quality overall is robust. Contracted rent growth continues to be very solid, underpinning earnings in the short to medium term. This is aided by the long Weighted Average Lease Expiry profile (WALE) of 9.0 years as at 31 December 2018 which Zenith considers high for a fund of this type.

The Fund currently carries a conservative level of look-through gearing of 27% against a maximum permitted level of 50%. The individual financing structures used in the underlying funds are considered appropriate by Zenith and we believe the overall level of leverage is currently at a comfortable level.

Zenith believes that the combination of the FoF and direct ownership structure creates flexibility in portfolio construction for the Fund as it potentially allows for a greater level of portfolio diversification relative to deployed capital. However, exposure to other investment vehicles which inherently have nil liquidity outside their fixed fund terms may also create issues around liquidity management for investors in the Fund. The Funds exposure to closed-end unlisted property funds is approximately 35% on a look through basis as at 31 December 2018.

Overall, Zenith has conviction in the ability of the Fund to meet its long-term objectives, supported by its robust underlying cashflows, quality assets and solid management. While the current portfolio is strong, longer-term outcomes (including liquidity aspects) will also be shaped by any additional asset exposures pursued by CFM.

## FUND FACTS

- Uses FoF structure with direct assets to gain exposure to a series of quality underlying funds and properties.
- Exposure to nine assets with a long 9.0 year WALE predominantly to strong covenant tenants.
- Monthly limited liquidity mechanism set at the greater of 0.5% of the Fund's Net Asset Value (NAV) and the amount by which cash exceeds 6% of its NAV.
- Experienced manager of real estate and funds management with strong capabilities and resources.

**ABSOLUTE RISK (SECTOR)**

VERY HIGH
HIGH
MODERATE
LOW
VERY LOW

**RELATIVE RISK (FUND WITHIN SECTOR)**

OPPORTUNISTIC
VALUE ADD
CORE ENHANCED
CORE

**INCOME DISTRIBUTIONS PER**

MONTH QUARTER 6 MONTH ANNUM

**INVESTMENT TIMEFRAME**

1-2 YRS 3-4 YRS 5-6 YRS 7+ YRS

## APPLICATIONS OF INVESTMENT

### SECTOR CHARACTERISTICS

Unlisted property funds encompass a range of risk/return profiles depending on the portfolio assets and fund strategy. Typically investment into unlisted property exhibits lower volatility than other asset classes and weak returns correlation. This is largely driven by the low liquidity of such assets with either limited opportunities to exit for open-ended funds or nil liquidity for closed-ended funds. This is in contrast to listed property funds (A-REITs/G-REITs) which in Zenith's view represent a real estate proxy as returns can often be generated by sources other than rent and property values and whose liquid nature exposes them to market trading sentiment thus heightening their correlation to equities.

Real estate strategies can range from stabilised assets to opportunistic real estate development. Stabilised portfolios have existing, tenanted assets and tend to produce low volatility income streams with low to moderate capital growth. Value-add and opportunistic strategies are higher risk, often involving real estate development or assets with delayed or impaired cash flows. It should be appreciated that even within stabilised strategies a wide range of risk/reward scenarios can occur. When taking into account portfolio construction issues and asset class classification, unlisted direct property funds are generally considered by Zenith to share the characteristics of direct property ownership while being open to different levels of risk. The asset class is considered to pose moderate to high risk characteristics. Investors should also be aware of the consequences of an allocation to what is an inherently illiquid asset class in their investment portfolio.

### PRODUCT FEATURES

| Key Features - Cromwell Direct Property Fund [1] | |
|---|---|
| Property Sector | Diversified |
| Unit Buy Price | $1.2550 |
| Unit Sell Price | $1.2474 |
| Distribution/Yield | 7.00 CPU / 5.58% |
| Tax Deferred FY18 | 63% |
| Minimum Investment | $10,000 |
| Fund Commencement | 2013 |
| No. of Properties (look-through) | 9 |
| Total Assets ($m) | $258 |
| Fund Debt ($m) | $47 |
| Fund Gearing (look-through) | 18% (27%) |
| Investment Term [2] | 1.4 |

[1] Data as at 31 December 2018 [2] Years remaining until scheduled expiry of the initial 7 years term in July 2020.

### PORTFOLIO APPLICATIONS

In Zenith's opinion, the Fund may be suitable for investors seeking exposure to commercial real estate which is generally typified by long-term, low volatility income streams with a capital growth component. Investors in the Fund must be able to accept the risks of gearing and potentially low liquidity in order to achieve this aim.

The Fund should be used within a well diversified portfolio owing to the long term nature of the asset class. Although the Fund has a moderate level of diversification across property types and locations, Zenith recommends that higher diversification could be achieved by blending with other real estate sectors to reduce sector risk. While commercial real estate as an asset class is traditionally income orientated, investors should be aware that open-ended funds may experience variations in income due to the impact of equity flows.

Zenith believes that a measured exposure to unlisted property within a well-diversified portfolio can have advantages. This is due to its historically low correlation with mainstream asset classes and lower volatility than listed property. Zenith believes that this makes unlisted property an effective diversifier, even within an existing real estate allocation via listed property.

#### Liquidity

The Fund offers a monthly limited liquidity facility where the amount available to meet withdrawal requests in any month will be the greater of an amount equal to 0.5% of the Fund's NAV or the amount by which the Fund's cash exceeds 6% of its NAV. To date, all redemption requests have been met.

A full withdrawal facility will be offered following the end of the initial seven-year term expiring 1 July 2020. CFM will seek to fulfil withdrawal requests within 6 months. If withdrawal requests are fulfilled within six months, CFM will continue to offer a full withdrawal facility every five years under the same terms (Zenith notes that this has been recently altered from every three years under the previous PDS which was replaced on 1 September 2016). If withdrawal requests cannot be fulfilled within 6 months or requests exceed the maximum 50% of units on issue, CFM will wind up the Fund and distribute the net proceeds. If unitholders approve the extension of the Fund term, any subsequent terms will be for five years continuing with the same liquidity mechanism in place.

Overall, investors should consider liquidity in the Fund to be low given the underlying assets are by their nature illiquid. Investors need to recognise that property funds which invest in direct assets do not offer the same level of liquidity as listed real estate securities (although with lower volatility).

However, Zenith accepts this as a generally unavoidable feature of unlisted property funds and as such we do not view this as a negative when considered in the context of appropriate planning and asset allocation. However, it should be considered that any severe confidence shock in the Fund or the asset class may overwhelm the current liquidity mechanisms and the Fund may become illiquid. Zenith recommends investors assume a seven-year investment term.

## RISKS OF THE INVESTMENT

### SECTOR RISKS

Funds within the "Direct Property" sector are exposed to the following broad risks:

**MARKET & ECONOMIC RISK:** A significant risk to performance is a sustained downturn in the real estate markets. Supply and demand balances of assets (and leasing opportunities) will also impact outcomes. In addition, changes in economic, social, technological or political conditions, as well as market sentiment could also lead to negative fund performance.

**VACANCY RISK:** The risk of a tenant vacating a property, failing to meet their rental obligations or failing to renew a lease can have a detrimental impact on rental returns.

**VALUE RISK:** Property values are influenced by location, supply and demand, rental agreements, occupancy levels, obsolescence, tenant covenants, environmental issues and government or planning regulations. Changes to these drivers may affect the end value of the property.

**LEVERAGE RISK:** Investors should be aware that the effects of gearing can magnify gains as well as losses. In a loss scenario this may result in potential impairment of values and forced disposal at a time when markets may not be ideally placed to recoup the equity position.

**STRATEGY RISK:** Real estate strategies can vary from stabilised 'core' strategies which are generally low risk to opportunistic plays on development or distressed assets which can have complex and severe risks associated with them. Potential investors should have a clear understanding of the individual strategies posed by real estate investments.

**MANAGEMENT RISK:** Management risks encompass a wide range of factors relating to personnel (key person risk), counterparty risk (risk of management not being able to fulfil their duties due to insolvency) and skillset (ability to effectively and efficiently carry out strategies).

**ILLIQUIDITY RISK:** Investment in direct real estate investment funds can be prone to liquidity dislocations owing to the fundamentally illiquid nature of the underlying assets. Long duration illiquid assets means investors typically have limited ability to react to any changing conditions by reducing or redeeming their investments. Regardless of any liquidity mechanisms present, investors may face circumstances where available liquidity dries up.

### FUND RISKS

Zenith has identified the following key risks of the Trust. Although Zenith believes the risks noted are all significant, we have listed them in order of importance. In addition, we have not intended to highlight all possible risks.

**KEY PERSON RISK:** Zenith believes Fund Manager Hamish Wehl is integral to the success of this Fund. We do however acknowledge the integrated nature of CMW's operations lessens key man risk as operations are sourced across the business. The continued presence of key individuals within CMW is essential and any material departures of Wehl or other key team members would result in Zenith re-assessing its rating on the Fund.

**FINANCE RISK:** The Fund is exposed to leverage both directly and indirectly via underlying funds into which the Fund invests. Existing debt facilities are due to expire in FY2022. There is no guarantee that the availability or terms of finance on expiry will be similar to the facilities currently secured. Some underlying funds are also exposed to a level of interest rate risk during their loan terms.

**RETURNS DILUTION RISK:** Funds dealing with real assets that have low liquidity are generally unable to deploy capital as rapidly as investment strategies operating in liquid markets. Accordingly, rapid inflows of equity into a fund or significant delays in acquiring assets may result in dilution of returns (i.e. cash drag) to existing investors until capital is deployed.

**ASSET POSITIONING RISK:** There is some exposure to underlying assets which combine a suburban location with a high monetary value. Typically, the available pool of buyers for assets greater than $A 100 million in suburban locations is shallower than for assets of a similar size in core CBD locations.

**DEVELOPMENT RISK:** Assets held in underlying funds or directly may be exposed to development risks including risks of cost overruns and completion delays. While these risks should be adequately catered for due to the structuring of development agreements, development risk cannot be mitigated entirely.

**FUND-OF-FUND RISK:** The Fund's investment in other property trusts means investors will not have voting control (i.e. a majority), over the underlying funds. In addition, the ability of the Fund to divest underlying fund interests may not be as easily accomplished as the facilitation of a direct property sale.

**EXTENSION RISK:** Investors in funds utilising closed-end, target maturity date structures may be exposed to a variety of risks associated with having a fixed maturity date. These risks may encompass:

- Re-investment risk: Risk that market conditions or declining asset quality over time may not be as favourable if a subsequent investment term is elected.
- Election Risk: An extension of investment terms must generally be approved by a majority unitholder vote. Individual investor's wishes may be eclipsed by the voting majority which may trigger (il)liquidity and/or taxation events.

## QUALITATIVE DUE DILIGENCE

### ORGANISATION

Cromwell Funds Management is a wholly owned subsidiary of listed REIT Cromwell Property Group (ASX:CMW). CMW is a specialist property investment and funds management group.

CMW has significant expertise and resources and maintains an internalised business model, operating not only as a fund manager but also with a substantial property portfolio via the stapled structure of the REIT. As CMW (and its subsidiaries) invest in real estate across a wide spectrum of values and strategies, the underlying business divisions operate as centralised service providers to the assets spread out across the various holding funds.

CMW maintains all elements of property management in-house, including tenant relations, leasing and facilities management. This is also supplemented by dedicated teams who undertake project management, property transactions, capital management and environmental management. This typically allows for a closer relationship with tenants and creates greater efficiencies in asset management. Zenith views CMW/CFM favourably as the manager given the organisations extensive experience, resources and skill set.

As at 30 June 2018, CMW had approximately $A 11.2 billion in real estate under management.

As at 31 December 2018, the Fund has assets of $A 258 million.

## INVESTMENT PERSONNEL

| Name | Title | Tenure |
|---|---|---|
| Hamish Wehl | Head of Retail Funds Management | 9 Yr(s) |

Oversight of day-to-day operations of all CFM unlisted property funds is the responsibility of Head of Retail Funds Management, Hamish Wehl. Wehl reports directly to CMW's CEO Paul Weightman. The investment team is supported by dedicated teams in Distribution, Market/Investor Relations and Registry Services.

Wehl has been with CFM since 2009 and has held his current role since July 2016. Zenith regards Wehl favourably with solid investment and management capabilities. With regard to his role in the Fund's operation, Wehl's role is essentially one of oversight with CMW's integrated business structure providing access to the specialist resources available from the wider group to fulfil operational requirements.

Operationally, CMW's integrated business model allows for a more collaborative approach rather than having large teams in dedicated business silos. Allowing key personnel such as Wehl access to the range of specialist resources available from the wider group to fulfil operational requirements, arguably this can allow for a materially reduced headcount in funds management operations.

While we acknowledge the strong embedded skills on CMW's Board, Investment Committee and in Wehl, we believe any material increase in the number of funds operating of direct assets in the Fund would warrant additional resources to support Wehl. While we note the appointment in 2018 of a full-time operational resource to support Wehl with regard to some of the broader administrative aspects of his role and see this as a positive.

The CMW divisions with operational input to the Fund are;

- Cromwell Funds Management (Responsible Entity function);
- Cromwell Property Services (Property Management, Facilities Management, Leasing);
- Cromwell Projects & Technical Solutions (Property Projects, Due Diligence); and
- Cromwell Capital (Debt Management).

The breadth and scope of CMW's property operations are extensive, which provides significant resources to the fund management arm. In particular, the CMW property acquisitions and property services team have significant experience in managing delivery and construction programmes to project completion. This is particularly important given the increased use of development projects within the Fund and the underlying syndicates in recent years which is likely to continue in the future. The asset acquisition due diligence process is also highly robust and there is a strong capability in treasury, finance and compliance within the business.

CFM has its own Board as distinct from CMW. The Board is mostly a subset of the CMW Board and is supplemented by the presence of an Investment Committee (IC). Both the CFM Board and IC are majority independent. IC members have an average of 10 years' experience with Cromwell as well as a diverse range of real estate experience.

While noting that Wehl has responsibility for the Fund, Zenith notes that turnover within the business continues to relatively elevated. Several staff which Zenith deemed integral to the Retail Funds Management business departed the firm during 2015. In addition, we note that CMW's Head of Property, Damian Horton departed in February 2018 to be replaced by Head of Leasing, Bobby Binning. Zenith will maintain a watch on personnel turnover as we believe a period of stability is warranted.

Staff remuneration is structured with a combination of fixed and performance-based incentives. Performance takes into account the personal achievements of the individual, the investment returns of CFM's funds and the profitability of the business. The investment performance of an individual fund is a key input in driving performance-based incentives that a fund manager is eligible to receive. Performance rights over CMW stock are also available with vesting arrangements in place to retain high performing members of the team.

## INVESTMENT OBJECTIVE, PHILOSOPHY AND PROCESS

The objective of the Fund is to provide a monthly tax-advantaged income stream and potential for long term capital growth via a diversified portfolio of real estate assets. The Fund aims to exceed the total return of the PCA/IPD Australian Pooled Property Funds Index – Unlisted Retail over a rolling three-year period.

CFM focusses on major metropolitan markets with a current bias toward the office sector. The focus is on assets with strong tenant covenants, preferable government or other blue chip businesses on long term leases. Potential acquisitions are sourced and assessed by the property transactions team, which operates on a group-wide basis. This allows the flexibility to source assets and then determine which of CMW's funds it will be most suited to in terms of size, attributes and investor type.

Asset selection is fundamentally a bottom-up process overlaid with Cromwell's top-down market views. Acquisition targets that meet these objectives are subject to initial due diligence from the property transactions team which is then followed up with a formal due diligence review by the IC. Once an acquisition is made, the IC will continue monthly high-level asset reviews with full reviews done every quarter to determine if the holding remains appropriate.

## PORTFOLIO CONSTRUCTION

The FoF structure combined with the ability to hold direct assets is aimed at providing greater diversification and flexibility compared to traditional unlisted property funds which typically own assets directly. Gaining exposure through fund units rather than direct assets can limit transaction costs such as stamp duty and reduce commitment size, making portfolio construction easier. This however typically comes at the cost of loss of ownership control.

The Fund will also hold cash where it is deemed appropriate.

Portfolio construction will also be influenced by the investment objective, specific risk tolerances and return requirements. Strategies are reviewed annually and tactical allocations quarterly.

## Asset Allocation

Unlike many diversified property funds, there is no formal asset allocation policy for the Fund. Zenith would also prefer to see some guidelines around at what point the Fund would cease making asset acquisitions prior to the completion of the initial seven-year term, as there is no certainty that the Fund would not be wound up at this point. There is no maximum allocation to cash however management will attempt to balance the cash allocation between the need to meet liquidity and not create undue cash drag on returns.

The ability to hold direct assets creates the potential for an additional mechanism to facilitate liquidity through a direct asset sale rather than seeking to divest underlying funds units. While Zenith agrees with this in principle, it should be accepted that in periods of market stress, the effectiveness of this strategy may be limited. In addition, Zenith has taken a more conservative view on having a large part of the portfolio held in closed-ended, fixed term funds with no formal liquidity.

Current asset exposures are as follows.

| Asset Allocation | Exposure (by asset value) | Property Sector |
|---|---|---|
| Unlisted Trusts | | |
| Cromwell Riverpark Trust | 21% | Office |
| Cromwell Ipswich City Heart Trust | 6% | Office |
| Cromwell Property Trust 12 | 8% | Office/Industrial |
| **Total Unlisted Trusts** | **34%** | |
| Direct Assets | | |
| Masters Parafield Airport, Parafield, SA [1] | 10% | Retail |
| 64 Allara Street, Canberra, ACT | 7% | Office |
| Bunnings Munno Para [1] | 11% | Retail |
| 433 Boundary Street, Spring Hill, QLD | 15% | Office |
| Flinders Street Townsville | 23% | Office |
| **Total Direct Assets** | **66%** | |

As at 31 December 2018

The Fund tends to align with CFM's philosophy regarding the various commercial property segments rather than utilitising diversity for diversity's sake. While Zenith supports CFM's considered decision making process with regard to asset allocation, it does mean that the Fund may frequently lack the broader diversification of some peers.

To facilitate access and exit from positions in underlying property funds, CMW purchases and holds these units on their own balance sheet to match equity flows from the Fund. CMW also tends (where possible) to warehouse direct assets across all its funds on balance sheet to facilitate the process.

While the Fund has the ability to invest in underlying funds outside those issued by CFM, management has indicated that their hurdle for selection is significantly higher and sees this course of action as unlikely.

Underlying fund details are as follows.

| Underlying Funds | Cromwell Riverpark Trust (CRT) | Cromwell Ipswich City Heart Trust (ICH) | Cromwell Property Trust No.12 (C12) [1] |
|---|---|---|---|
| Launched | Feb-2009 | Dec-2011 | Oct-2013 |
| No. of Properties | 1 | 1 | 2 |
| Property Value ($m) | 273.0 | 123.0 | 144.2 |
| WALE by income (yrs) | 6.9 | 9.6 | 13.0 |
| Gearing % | 27.0% | 37.0% | 27.0% |
| Interest Coverage Ratio (x) | 4.5x | 3.5x | 5.0x |
| NTA | $1.97 | $1.43 | $1.33 |
| Fund Maturity Date | Jul-2021 | Jun-2023 | Oct-2020 |

Data as at 31 December 2018 unless otherwise stated.

The staggered maturity date of the funds should allow the Fund to exit underlying exposures progressively. However, maturity may be dependant on the votes of underlying unitholders and the Fund unitholders will have limited power to exercise control on these investments. If the underlying funds continue to have their terms extended and the Fund wished to rationalise holdings, the Fund may need to employ other alternatives such as CFM/CMW purchasing the units. There is no guarantee that this will occur in practice.

Underlying property details are as follows.

| Property Details (Lookthrough & Standalone) | Ownership Structure | Type [1] | DPF's Portfolio Exposure | Current Valuation ($m) | Property Passing Yield | Lease expiry (yrs) | NABERS Energy *(Water)* |
|---|---|---|---|---|---|---|---|
| **QLD** | | | **64.5%** | | | | |
| Energex House | Fund | OF | 20.7% | 273.0 | 6.31% | 8.8 | 5.5 |
| Ipswich City Heart | Fund | OF | 5.7% | 123.0 | 6.98% | 11.8 | 4.5 (4.0) |
| Flinders Street Townsville | Direct | OF | 22.9% | 63.5 | 7.29% | 9.5 | 4.5 |
| 433 Boundary Street, Spring Hill, QLD | Direct | OF | 15.2% | 42.0 | 6.62% | 9.7 | - |
| **SA** | | | **23.8%** | | | | |
| Rand Distribution Centre | Fund | IN | 2.7% | 49.0 | 6.82% | 19.2 | - |
| Parafield Retail Complex | Direct | LF | 9.8% | 27.3 | 7.96% | 11.5 | - |
| Bunnings Munno Para | Direct | LF | 11.3% | 31.3 | 6.07% | 12.0 | - |
| **VIC** | | | **5.2%** | | | | |
| ATO Dandenong | Fund | OF | 5.2% | 95.2 | 6.02% | 13.5 | 4.5 |
| **ACT** | | | **6.5%** | | | | |
| 64 Allara St, Canberra | Direct | OF | 6.5% | 18.0 | 7.12% | 3.5 | 4.0 (5.5) |
| **Total/Weighted Average** | | | **100.0%** | **722.3** | **6.82%** | **10.6** | |

[1] Key: Industrial (IN), Office (OF) Large Format Retail (LF). Data as at 31 December 2018.

The underlying portfolio comprises a selection of medium to high quality assets. These properties are generally in keeping with the strategic aims of the Fund (and CFM) favouring new or near new properties with long-term leases to strong covenant tenants. The majority of properties (70% by value) were either new or still undergoing completion when purchased by the Fund. This has the added advantage of minimising capital expenditure requirements in the medium-term while also maximising tax deferred income benefits.

Since our last review, the Fund has acquired the following assets:

*420 Flinders Street, Townsville, QLD*

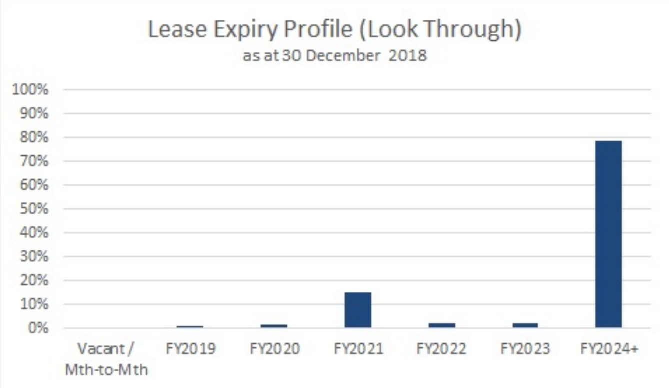
- A-Grade office tower completed in 2013 with 7,927 sqm net lettable area, situated in a prominent corner location in the Townsville CBD
- 100% leased with a 9.5 year WALE
- 92% leased to Energy Queensland Limited, a Queensland Government-owned electricity provider, on a 15-year lease. National Australia Bank and Energy Shot Pty Ltd occupy the remaining tenancies.
- Strong rental growth with annual rent reviews ranging from 3.5% - 4.0% p.a.
- Purchased on a passing yield of 7.3%.

Zenith views the acquisition of the property as being a solid acquisition in keeping with the fund's mandate and being accretive to fund earnings and lease profile.

### Tenancy Profile

The Fund's portfolio has a limited number of tenants (33) compared to more traditional diversified portfolios. However, the tenancy schedule is underpinned by government and ASX listed tenants, creating a robust tenant covenant. The long lease expiry across the majority of the portfolio is of particular note, as it is relatively rare to be able to access a diversified portfolio of assets with such a long WALE outside of core industrial portfolios.

While typically lease renewals generate opportunities for managers, given that leasing markets are exhibiting softness in a number of areas which will continue to impede effective rents in the short to medium term, the lack of near term expiries are potentially an advantage. The portfolio tenancy schedule remains robust with long leases subject to minimal variation in gross rents and expiries over the medium-term.




Rental uplifts for the underlying assets is solid over the short to medium-term, particularly when taking into account the long lease expiry profile. The majority of the assets subject to fixed rent increases in excess of current CPI. Given the minimal incidence of rent reviews in the interim, this should ensure effective rental growth remains robust across the bulk of the portfolio during this period where high tenant incentives remain in many markets and CPI growth is benign.

Examination of the underlying building rents across the portfolio indicates that there is some degree of exposure to negative rental reversion in some assets as leases expire. This will provide some challenges to management in terms of new leasing deals depending on the individual lease expiry profiles.

### Debt Analysis

Use of leverage at the Fund level is restricted to security over directly held assets and limited to a maximum 50% Loan to Value Ratio (LVR) at acquisition. Leverage at this level would be considered reasonable by Zenith for most assets, albeit the upper end of our comfort level. The appropriateness of gearing at this level will ultimately be dependent on the nature of the properties purchased.

The Fund's exposure to direct and indirect leverage is as follows.

**Financing Details [1]**

| Underlying Fund | CRT | ICH | C12 | CDPF |
|---|---|---|---|---|
| Loan Facility ($m) | 99.25 | 48.00 | 41.00 | 55.0 |
| Maturity Date | Jul-21 | Jun-19 | Sep-20 | Dec-21 |
| Weighted average loan expiry (Yrs) | 2.5 | 0.4 | 1.7 | 3.0 |
| Drawn ($m) | 99.25 | 48.00 | 41.00 | 47.1 |
| Hedged | 0% | 0% | 0% | 0% |
| Weighted average interest rate (on drawn debt) | 3.42% | 4.62 | 3.86% | 3.95% |
| Current LVR | 36% | 39% | 28% | 24.8% |
| Facility LVR [2] | 36% | 39% | 28% | 30.2% |
| Loan to Value Ratio (LVR) covenant | 60% | 55% | 55% | 50.0% |
| LVR sensitivity to covenant | -40% | -29% | -48% | -42% [3] |
| Gearing | 35% | 37% | 28% | 18.2% |
| Interest Coverage Ratio (ICR) | 4.5x | 3.5X | 5x | 10.1x |
| ICR covenant | 2.0x | 2.0x | 2.0x | 2.0x |
| ICR sensitivity to covenant | -55% | -42% | -61% | -80.0% |

[1] As at 30/12/18 unless stated otherwise. [2] If fully drawn. [3] Sensitivity to initiate a covenant breach on drawn debt.

Zenith believes that the debt structures on the underlying funds are appropriate. The Fund's look-through gearing in the underlying funds is 27.3% as at 31 December 2018 with an Interest Coverage Ratio of 10.1x. Exposure to leverage via the underlying funds does provide a staggered refinancing profile which lowers overall refinancing risks across the portfolio.

## RISK MANAGEMENT

The Fund has no formal risk constraints. Risk management is centred around the due diligence process regarding asset selection and acquisition. These processes include use of independent valuations, physical, technical, financial and legal due diligence and the experience of the investment team in asset selection. Zenith believes that the risk management processes for the Fund are thorough and of high quality.

Zenith notes that while the Fund does not have any specific Environmental, Social and Governance (ESG) exclusions in the traditional sense, ESG as a consideration forms part of CMW's investment decision-making process across its funds. Where applicable, CFM utilises measures such as the National Australian Built Environment Rating System (NABERS) to measure operational impacts across the Fund's properties on the environment. CMW has also adopted the Global Reporting Initiative (GRI) guidelines as the framework for reporting on the Group's wider ESG performance.

CMW also adopt the Responsible Investment Association Australasia (RIAA) Charter on responsible investing. Two of the underlying trusts within the Fund (CRT, ICH) are RIAA certified.

## INVESTMENT FEES

The sector average management cost (in the table below) is based on the average management cost of all Property - Direct funds surveyed by Zenith. These include calculations for both Gross Asset Value (GAV) and Net Asset Value (NAV), which are principally influenced by a funds leverage.

The Fund charges a management cost made up of 0.60% p.a. based on the GAV which is inclusive of the effects of gearing, and an administration cost of 0.20% p.a. of NAV, which is ex-gearing. Investors should be aware that the effective cost of investing in the Fund is significantly higher when assessed over the NAV, that is, the net cost will increase with a higher level of gearing.

Performance fees are calculated and paid quarterly in arrears. The performance fee structure has a high watermark structure which we favour. However, its attractiveness is degraded by several issues. There is no positive return hurdle, meaning that performance fees can be taken even if the Fund incurs negative returns that are above the benchmark. There is also no mechanism to prevent double dipping on performance fees. Given that the underlying funds have performance fee thresholds based on absolute return benchmarks, the Fund is potentially able to earn a performance fee on its index based benchmark even if the underlying fund(s) do not trigger their absolute return thresholds.

In addition, the Fund has an acquisition fee of up to 2% on both direct property assets or units in any subsequent unlisted property trusts acquired. While this fee has been collected with respect to the CRT holdings, CFM has indicated that no acquisition fee was applied to the original purchases in CHT or C12. Under the terms of the PDS dated 29 September 2017, this fee will now only be charged if the NTA is above the initial unit price of $1.00. While appropriate fees on direct property transactions are seen as acceptable, Zenith is generally opposed to including this fee on the acquisition of units in other CFM funds and we would prefer to see this structure removed.

Ongoing annual management fees and costs for the Fund are lower than peer funds. Effectively, Fund fees are subsidised by the fee structures in the underlying CFM funds as the management fees for the Fund are proportionately reduced as an offset to underlying fees (i.e. no 'double dipping'). The lack of a buy/sell spread is attractive to those seeking to make regular contributions, even though this is attenuated by it being partially priced into the cost of underlying fund units.

CFM had in the past agreed to bear any normal ongoing administrative and operating costs above 0.20% p.a. for the period to 30 June 2017. Post this date, while not currently formalised, CFM has indicated its intention to continue cost coverage, albeit at a lower level than previously.

Zenith has examined the structure of the underlying fund fees and believes that on the whole overall fees are broadly in-line with direct property fund peers.

| Fee Type | Fund | Sector Average |
|---|---|---|
| Management Costs p.a. (% of GAV) [1] | 0.60% | 0.92% |
| Management Costs p.a. (% of NAV) [1] | 1.40% | 1.57% |
| | Description | |
| Performance Fee | 20% of excess returns over benchmark [2] | |
| | Buy Spread | Sell Spread |
| Buy/Sell Spread | 0.00% | 0.00% |

*[1] Based on maximum gearing of 50%. [2] PCA / IPD Australia Unlisted Retail Property Fund Core Index.*

## PERFORMANCE ANALYSIS

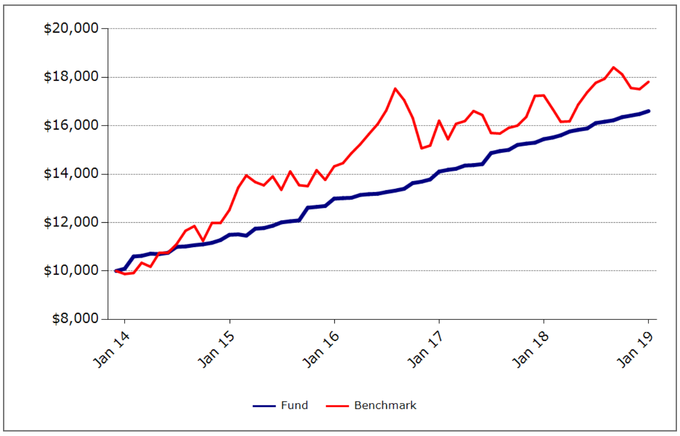
Report data: 31 Dec 2018, product inception: Sep 2013

### Monthly Performance History (%, net of fees)

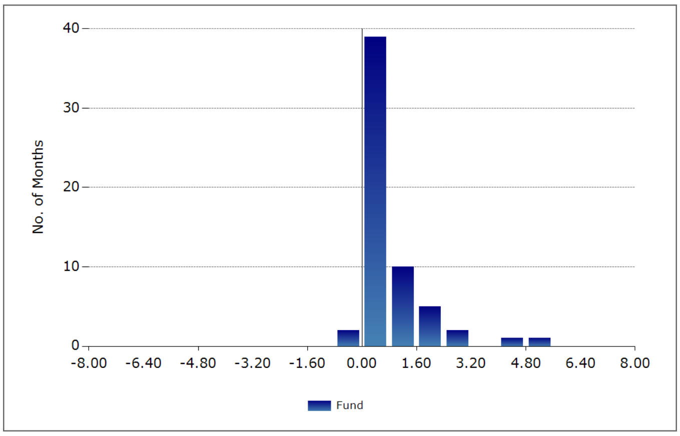
| | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC | FUND YTD | BENCHMARK YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **2018** | 0.42 | 0.60 | 1.00 | 0.44 | 0.35 | 1.41 | 0.35 | 0.36 | 0.80 | 0.40 | 0.40 | 0.73 | 7.49 | 3.26 |
| **2017** | 0.52 | 0.31 | 0.93 | 0.11 | 0.31 | 3.15 | 0.55 | 0.34 | 1.36 | 0.36 | 0.24 | 0.98 | 9.51 | 6.45 |
| **2016** | 0.17 | 0.10 | 0.90 | 0.24 | 0.14 | 0.52 | 0.45 | 0.56 | 1.77 | 0.42 | 0.68 | 2.35 | 8.61 | 13.18 |
| **2015** | 0.16 | -0.47 | 2.51 | 0.23 | 0.81 | 1.17 | 0.39 | 0.30 | 4.34 | 0.26 | 0.29 | 2.39 | 13.00 | 14.38 |
| **2014** | 5.01 | 0.25 | 0.84 | -0.17 | 0.52 | 2.27 | 0.16 | 0.47 | 0.32 | 0.56 | 1.02 | 1.92 | 13.88 | 26.79 |

Benchmark: S&P/ASX 300 AREIT

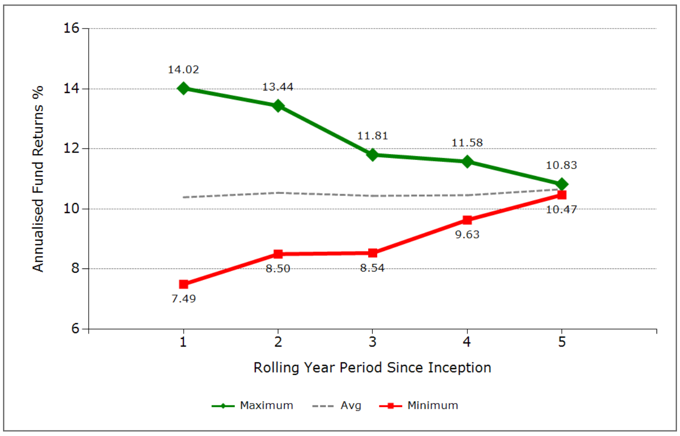
### Growth of $10,000




### Monthly Histogram




### Minimum and Maximum Returns (% p.a.)




### ABSOLUTE PERFORMANCE ANALYSIS

| Return | Incpt. | 5 yr | 3 yr | 1 yr |
|---|---|---|---|---|
| Fund (% p.a.) | 10.60 | 10.47 | 8.54 | 7.49 |
| Benchmark (% p.a.) | 11.59 | 12.53 | 7.55 | 3.26 |
| Median (% p.a.) | 13.44 | 13.57 | 11.24 | 9.90 |
| **Ranking within Sector** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Fund Ranking | 4 / 4 | 14 / 20 | 20 / 28 | 25 / 32 |
| Quartile | 4th | 3rd | 3rd | 4th |
| **Standard Deviation** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Fund (% p.a.) | 3.35 | 3.45 | 2.18 | 1.10 |
| Benchmark (% p.a.) | 11.55 | 11.74 | 11.04 | 8.64 |
| Median (% p.a.) | 6.63 | 4.94 | 4.73 | 3.11 |
| **Downside Deviation** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Fund (% p.a.) | 0.21 | 0.22 | 0.00 | 0.00 |
| Benchmark (% p.a.) | 5.90 | 6.01 | 6.44 | 4.69 |
| Median (% p.a.) | 0.83 | 0.07 | 0.00 | 0.00 |
| **Risk/Return** | **Incpt.** | **5 yr** | **3 yr** | **1 yr** |
| Sharpe Ratio - Fund | 2.51 | 2.41 | 3.03 | 5.08 |
| Sortino Ratio - Fund | 39.56 | 37.89 | | |

*Zenith benchmarks all funds in Property - Direct category against the (S&P/ASX 300 A-REIT Index). It should be recognised that Zenith's sector benchmark is intended as a broad market indicator only. Returns characteristics of unlisted property funds should be expected to vary materially at different points in the investment cycle given their inherently lower correlation to liquid benchmarks. Zenith noted that CFM benchmarks the Fund against the PCA/IPD Unlisted Core Retail Property Fund Index.*

*All commentaries below are as at 31 December 2018.*

The Fund aims to deliver a total return (after fees) in excess of the PCA/IPD Unlisted Retail Property Fund Core Index over rolling three year periods. Zenith notes that the benchmark index was changed in September 2016 from the PCA/IPD Australian Pooled Property Fund Index – Unlisted Retail in order to more closely align with the investment strategy of the Fund. Considering the nature of the Fund and its constituents, Zenith does not see this as unreasonable.

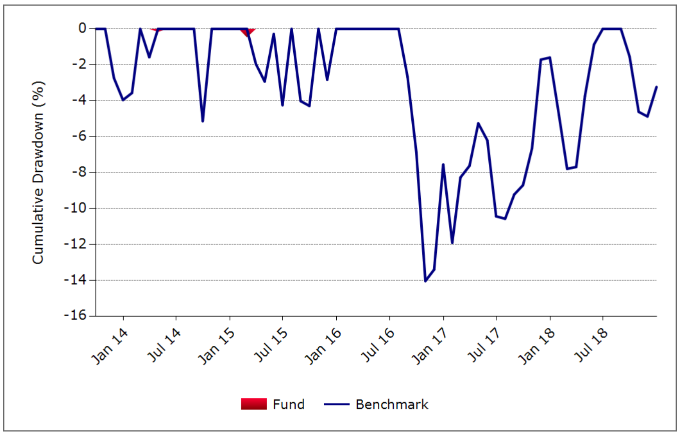
To date, the Fund has failed to meet its performance objective. It has also delivered returns below the median manager. Contributing factors have been cash drag and the FoF structure which adds a layer of operating costs which the benchmark does not have. In addition, the majority of peer funds in the universe and the benchmark operates under higher leverage. Consequentially, Zenith believes that the Fund is likely to exhibit lower downside volatility in the event of a market pullback than the benchmark Index.

## DRAWDOWN ANALYSIS

*Drawdown analysis assesses the relative riskiness of a Fund versus the benchmark, in reference to capital preservation. The maximum Drawdown is recorded as the percentage decline in the value of a portfolio from peak to trough (before a new peak is achieved). All Drawdown analysis is calculated commencing from the inception date of the Fund in question, and Drawdown analysis for the Fund and benchmark(s) are calculated independently. That is, the largest drawdown for the Fund and benchmark(s) will not always refer to the same time period.*

| Drawdown Analysis | Fund | Benchmark |
|---|---|---|
| Max Drawdown (%) | -0.47 | -14.04 |
| Months in Max Drawdown | 1 | 3 |
| Months to Recover | 1 | 20 |

| Worst Drawdowns | Fund | Benchmark |
|---|---|---|
| 1 | -0.47 | -14.04 |
| 2 | -0.17 | -5.14 |
| 3 | | -4.88 |
| 4 | | -4.29 |
| 5 | | -4.25 |




*All commentaries below are as at 31 December 2018.*

Fund drawdowns to date have been minimal given the combination of short time-frame since inception and buoyant property markets. Given Zenith's sector benchmark is highly liquid, it is expected that drawdowns by the benchmark will be more frequent and greater in scale than that of the Fund.

## INCOME/GROWTH ANALYSIS

| Income / Growth Returns | Income | Growth | Total |
|---|---|---|---|
| FY to 30 Jun 2018 | 5.84% | 2.49% | 8.34% |
| FY to 30 Jun 2017 | 6.10% | 6.05% | 12.15% |
| FY to 30 Jun 2016 | 5.30% | 5.10% | 10.40% |
| FY to 30 Jun 2015 | 6.50% | 2.70% | 9.20% |
| FY to 30 Jun 2014 | 6.00% | 7.16% | 13.16% |

Investors should be aware the Fund does not target a specific income level. Distributions will be made monthly where possible.

Investment into direct commercial property as an asset class over the long-term is typically evidenced by a bias to the majority of returns being generated by stable income with low to moderate capital growth. While capital growth levels may be significantly boosted by astute asset selection and management, stable income returns are the key to this asset class.

## REPORT CERTIFICATION

Date of issue: 14 Feb 2019

| Role | Analyst | Title |
|---|---|---|
| Author | Dugald Higgins | Head of Property & Listed Strategies |
| Sector Lead | Dugald Higgins | Head of Property & Listed Strategies |
| Authoriser | Bronwen Moncrieff | Head of Research |

## RATING HISTORY

| As At | Rating |
|---|---|
| 14 Feb 2019 | Recommended |
| 4 Dec 2017 | Highly Recommended |
| 13 Sep 2016 | Highly Recommended |
| 17 Jul 2015 | Highly Recommended |
| 22 Jul 2014 | Highly Recommended |
| Last 5 years only displayed. Longer histories available on request. | |

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