Zenith Investment Partners

Highly Recommended
Recommended
Approved
Not Rated
Redeem

# Product Assessment

## Cromwell Direct Property Fund

**Report data as at 31 Oct 2017**
**Rating issued on 04 Dec 2017**

### 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
IPD/Mercer Australian Pooled Property Fund Index

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

| | 3 yrs | 2 yrs | 1 yr |
|---|---|---|---|
| Fund | 10.99 | 9.85 | 11.49 |
| Benchmark | 11.76 | 11.76 | 11.98 |
| Median | 15.57 | 13.74 | 12.20 |

### Income (% p.a.)

| | Income | Total |
|---|---|---|
| FY to 30 Jun 2017 | 6.10 | 12.15 |
| FY to 30 Jun 2016 | 5.30 | 10.40 |
| FY to 30 Jun 2015 | 6.50 | 9.20 |

### Fees (% p.a., Incl. GST)
Management Cost: 0.70%
Performance Fee: 20% of the excess return above the PCA/IPD Australian Pooled Property Fund Index - Unlisted Retail.

### VIEWPOINT & RATING

The Fund is an direct property fund utilising an internalised Fund of Funds (FoF) structure combined with the ability to hold assets directly to gain a diversified exposure to real estate. the Fund currently has exposure to three closed-end unlisted property funds managed by Cromwell Funds Management (CFM) who also acts as the manager for the Fund. The remainder of the portfolio is held in three directly held assets. The resulting portfolio is high in quality and should be subject to minimal income variance over the medium term.

CFM is a wholly owned subsidiary of Cromwell Property Group (ASX:CMW). CMW is a specialist property investment and funds management business, with $A 10.1 billion in real estate under management, as at 30 June 2017. 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.

The Fund’s portfolio continues to have high occupancy levels being 99.4% let as at 30 June 2017. Asset quality overall is strong, with the majority of properties (95% by value) either less than five years old or currently under construction. 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 9.6 years as at 30 June 2017 which Zenith considers high for a fund of this type.

The Fund currently has no debt and carries a conservative level of look-through gearing. Current look-through gearing is 16.6% 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.

Overall, Zenith has a high conviction in the ability of the Fund to meet its objectives, supported by its robust underlying cashflows, quality assets and strong management. The combination of the FoF and direct structure creates flexibility in portfolio construction and potential liquidity management for investors. While the current portfolio is strong, longer-term outcomes 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 seven assets with a long 9.6 year WALE predominantly to strong covenant tenants.
- Fund structure gives potential for greater liquidity at the cost of diluting underlying Fund yield.
- 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 direct real estate investments encompass a range of risk/return profiles depending on the portfolio assets and fund strategy. Typically investment into unlisted real estate 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 small 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 be manifested. 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] | Description |
|---|---|
| Property Sector | Diversified |
| Unit Buy Price | $1.2234 |
| Unit Sell Price | $1.2218 |
| Distribution/Yield | 7.00 CPU / 5.72% |
| Tax Deferred FY17 | 65% |
| Minimum Investment | $10,000 |
| Fund Commencement | 2013 |
| No. of Properties (look-through) | 7 |
| Total Assets ($m) | $140.90 |
| Fund Debt ($m) | - |
| Fund Gearing (look-through) | 0% (16.6%) |
| Investment Term [2] | 2.7 |

[1] Data as at 30 June 2017 [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 continues to be a strong believer in the merits of judicious exposure to unlisted property as an asset class within a well-diversified portfolio. This is due to its traditional low correlation with mainstream asset classes and lower volatility than listed property, making it a useful diversifier even within an existing real estate allocation via property securities.

#### 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 three 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 associated with the Fund. This is not intended to include 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 between FY16 – FY20. 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 $100m in suburban locations is shallower than for assets of a similar size in core CBD locations.

**DEVELOPMENT RISK:** Assets held in underlying funds or direectly 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 2017, CMW had approximately $A 10.1 billion in real estate under management with $A 140.9 million in the Fund.

## INVESTMENT PERSONNEL

| Name | Title | Tenure |
|---|---|---|
| Hamish Wehl | Head of Retail Funds Management | 8 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 was promoted to his current role in July 2016. While not as experienced as some of industry peers, Zenith regards Wehl as an impressive individual 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.

There has been several departures within the team over the past two years. Funds Management Analyst Greg Lander was made redundant in November 2015, having held a number of roles in the business over the preceding nine years, including Investment Strategy Manager, Capital Transactions Analyst, and Internal Valuer.

This departure followed that of Daryl Wilson in February 2015 and Michael Blake in December 2015. Wilson held Directorships in Cromwell Property Group and all Cromwell subsidiaries as well as operating as the effective Head of Funds Management (HoFM) and Director - Finance and Funds Management. Wilson had been replaced by Blake in the HoFM capacity. The HoFM role was subsequently operationally split with Blake taking on the sales/relationship aspects and Wehl taking operations. Following Blake's departure, the sales/relationship role has been divided between other senior members of the sales team.

Zenith believes that these departures were a net loss to the business. Wilson in particular was a highly experienced individual with long tenure in the firm. However, we acknowledge that 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. We also acknowledge the strong embedded skills on CMW's Board, Investment Committee and in Wehl. While we believe current staffing is adequate to the number of funds, we believe any increase in funds operating would warrant additional resources.

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 funds management arm. In particular, the CMW property acquisitions and property services team has 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.

Zenith also notes that in mid-2015, Damian Horton was appointed to fill the new role of Head of Property. In this role, Horton is part of the Cromwell Executive Management Group and responsible for leading CMW's team of asset managers across Australia. Given the increasing complexity of the wider business, Zenith sees Horton's appointment to consolidate and refine key processes and functions as a strong positive, given his 20 plus years in the real estate industry.

CFM has its own Board as distinct from CMW. The Board is a sub-set 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.

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 is also available with vesting arrangements in place to retain high performing members of the team.

## INVESTMENT OBJECTIVE AND PHILOSOPHY

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 aside from the maximum allocation of holding no more than 20% of issued units in any underlying 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 principal, it should be accepted that in periods of market stress, the effectiveness of this strategy may be limited.

The Cromwell Riverpark Trust reached its maturity date in June 2016. Unitholders voted to extend the Fund for a further five year term with a new maturity date of July 2021. As a result of the vote, the Fund took the opportunity to increase it's stake in the Riverpark Trust from 7% to 18% of the register.

Current asset exposures are as follows.

| Asset Allocation | Exposure [1] | Property Sector |
|---|---|---|
| Unlisted Trusts | | |
| Cromwell Riverpark Trust | 31% | Office |
| Cromwell Ipswich City Heart Trust | 6% | Office |
| Cromwell Property Trust 12 | 12% | Office/Industrial |
| **Total Unlisted Trusts** | **50%** | |
| Direct Assets | | |
| Parafield Retail Complex, Parafield, SA | 19% | Large Format Retail |
| 64 Allara Street, Canberra, ACT | 12% | Office |
| Bunnings Munno Para | 20% | Large Format Retail |
| **Total Direct Assets** | **50%** | |

As at 30 June 2017. [1] By asset value, proportional to the Fund's interest.

As opposed to most traditional diversified funds in the sector, the Fund tends to align to CFM's philosophy regarding the various commercial property segments rather than 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) | 264.0 | 114.0 | 139.0 |
| WALE by income (yrs) | 7.8 | 10.8 | 14.4 |
| Gearing % | 35.5% | 36.8% | 27.0% |
| Interest Coverage Ratio (x) | 2.5x | 2.9x | 5.4x |
| NTA | $1.85 | $1.27 | $1.27 |
| Fund Maturity Date | Jun-2021 | Dec-2018 | Oct-2020 |

Data as at 30 June 2017 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 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.

Zenith notes that the interests in the underlying funds were all originally acquired from CFM at a premium to their underlying NTA. Although not ideal, Zenith recognises that traditional closed-end syndicates are also effectively acquired by investors at a premium to their application price due to start up costs.

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** | | | **37.3%** | | | | |
| Energex House | Fund | OF | 31.0% | 237.0 | 6.84% | 8.3 | 5.5 |
| Ipswich City Heart | Fund | OF | 6.3% | 114.0 | 8.04% | 11.3 | 4.5 (4.0) |
| **SA** | | | **42.5%** | | | | |
| Rand Distribution Centre | Fund | IN | 3.9% | 41.7 | 7.48% | 18.7 | - |
| Parafield Retail Complex | Direct | LF | 19.0% | 27.6 | 8.14% | 13.6 | - |
| Bunnings Munno Para | Direct | LF | 19.6% | 28.5 | 6.45% | 11.6 | - |
| **VIC** | | | **8.6%** | | | | |
| ATO Dandenong | Fund | OF | 8.6% | 92.5 | 6.28% | 13.0 | 4.5 [3] |
| **ACT** | | | **11.6%** | | | | |
| 64 Allara St, Canberra | Direct | OF | 11.6% | 16.9 | 8.98% | 3.0 | |
| **Total/Weighted Average** | | | **100%** | **558.2** | **7.15%** | **9.6** | |

[1] Key: Industrial (IN), Office (OF) Lareg Format Retail (LF). Data as at 30 June 2017.

The underlying portfolio comprises a selection of generally 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.

The following section provides a brief summary of the assets to which the Fund is exposed.

**Existing Portfolio**

*Energex House (CRT)*

- Purpose built, A grade accommodation with large floor plates and high environmental ratings.
- 92% leased to a government owned utilities provider.
- Secondary office location, was directly impacted by 2011 Brisbane floods, albeit relatively minor.

*Ipswich City Heart (ICH)*

- New A grade equivalent accommodation with large floor plates and high environmental ratings.
- 90% leased to QLD Government.
- Suburban office location, floor plates easily divisible.

*Rand Distribution Centre (C12)*

- New purpose built industrial warehouse with significant additional land for potential expansion.
- Tenant is a subsidiary of an ASX listed company on a long term lease with parent guarantee.
- Secondary, albeit emerging, industrial location with good transport access.

*ATO Dandenong (C12)*

- Purpose built, high grade office accommodation targeting high environmental ratings, completed September 2015.
- Strong rental cash flow on long lease to government tenant.
- Capable of being converted to multi-tenants fairly easily which will provide additional appeal in a suburban office market.

*Parafield Retail Complex*

- Multi-tenanted bulky goods/retail facility completed May 2016 with a WALE of 13.6 years.
- Location is well positioned, located in a commercial precinct dominated by bulky good usage.
- Property comprises a leasehold interest (as opposed to freehold), with 30 years remaining plus a 49 year option to renew.
- Original development was pre-committed (by income) by three tenants (Masters, 73%, Officeworks, 10% and Hungry Jacks, 6%) with a five year rental guarantee from the developer on the remainder. CFM is currently considering options for the Masters space (lease guaranteed by parent entity Woolworths Ltd). All other tenants are now trading at the site.
- Lease agreements provide for solid annual rental growth across all tenancies which will be CPI at minimum which will offset ground rent payable by the Fund.

*62 Allara St, Canberra*

- Modern A Grade office building in a CBD fringe location, constructed in 2008 with a current 3.5 star NABERS Energy rating.
- Building is 100% occupied with a WALE of 3.5 years.
- Proactive lease management will be required to maximise value given significant near term lease expiries.
- Leases in place are mostly gross of outgoings. Current building outgoings are considered above market average, therefore there is the possibility for cost savings going forward.

*Bunnings Munno Para*

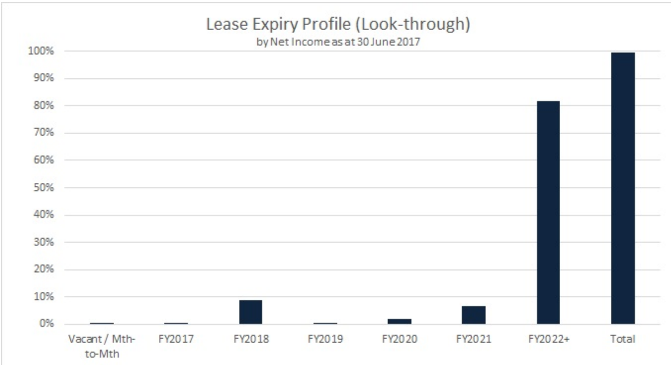
- Newly developed single tenant, large format retailer, completion in 2016
- Positioned to capitalise on the progressive development of the surrounding area. Further development should strengthen the location which is currently on the urban fringe and predominantly rural.
- Lease term of 12 years from completion with six options of six years each.
- Lease provides for annual fixed rent reviews commencing in year two.

## 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.

### Tenancy Profile

The Fund's portfolio is constrained by number of tenants (25) compared to more traditional diversified portfolios. However the tenancy schedule is predominantly exposed to 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 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 | Cromwell Riverpark Trust | Cromwell Ipswich City Heart Trust | Cromwell Property Trust No.12 | CDPF Direct Borrowings |
|---|---|---|---|---|
| Loan Maturity Date | Aug-21 | Jun-19 | Jun-20 | Jul-19 |
| Drawn ($m) | 99.3 | 48.0 | 41.0 | $0.00 |
| Hedged | 100% | 100% | 100% | 0% |
| Current LVR | 37.6% | 42.1% | 29.6% | 0.0% |
| LVR Covenant | 60.0% | 55.0% | 55.0% | 50.0% |
| Sensitivity to LVR Covenant | -37.3% | -23.4% | -46.2% | - |
| Gearing | 39.5% | 41.3% | 28.9% | 0.0% |
| Interest Coverage Ratio | 2.5 | 2.9 | 5.4 | - |
| Interest Coverage Ratio Covenant | 2.0x | 2.0x | 2.0x | 2.0x |
| Sensitivity to ICR Covenant | -67% | -54% | -76% | - |

[1] As at 30/6/17 unless stated otherwise.

Zenith believes that the debt structures on the underlying funds are appropriate. The Fund’s look-through gearing in the underlying funds is 16.6% as at 30 June 2017 with an Interest Coverage Ratio of 7.8x. Exposure to leverage via the underlying funds does provide a staggered refinancing profile which lowers overall refinancing risks across the portfolio.

## INVESTMENT FEES

The Fund charges a management cost made up of 0.60% p.a. based on the Gross Asset Value (NAV) which is inclusive of the effects of gearing, and an administration cost of 0.20% p.a. of Net Asset Value (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.

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 for holdings in CHT, CBT 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.

Performance fee is 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.

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 [1] | Sector Average |
|---|---|---|
| Acquisition Costs | Up to 2% | 2.44% |
| Management Costs p.a. (% of NAV) | 1.40% [2,3] | 1.54% |
| Management Costs p.a. (% of GAV) | 0.70% [2,3] | 1.03% |
| | **Description** | |
| Performance Fee | 20% of excess return over benchmark [4] | |
| | **Buy Spread** | **Sell Spread** |
| Buy/Sell Spread | 0.00% | 0.00% |

*[1] As at 30 June 2017. [2] Reduced proportionately to these fees in underlying funds charged by CFM. [3] Based on maximum gearing of 50%. [4] Benchmark is the PCA/IPD Unlisted Retail Property Fund Core Index.*

## PERFORMANCE ANALYSIS

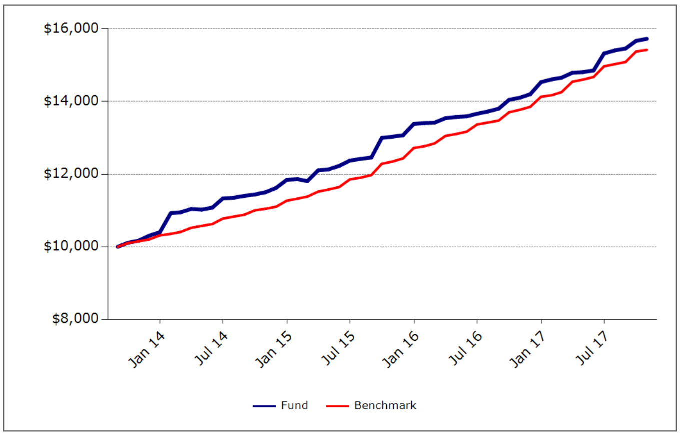
Report data: 31 Oct 2017, product inception: Sep 2013

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

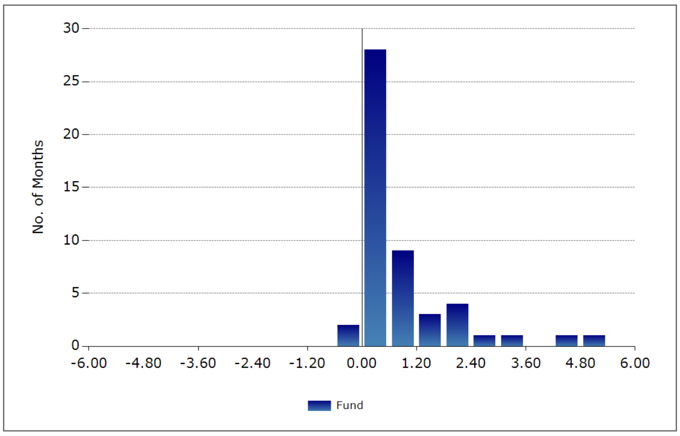
| | JAN | FEB | MAR | APR | MAY | JUN | JUL | AUG | SEP | OCT | NOV | DEC | FUND YTD | BENCHMARK YTD |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2017 | 0.52 | 0.31 | 0.93 | 0.11 | 0.31 | 3.15 | 0.55 | 0.34 | 1.36 | 0.36 | | | 8.20 | 9.13 |
| 2016 | 0.17 | 0.10 | 0.90 | 0.24 | 0.14 | 0.52 | 0.45 | 0.56 | 1.77 | 0.42 | 0.68 | 2.35 | 8.61 | 11.11 |
| 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 | 12.87 |
| 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 | 9.26 |
| 2013 | | | | | | | | | 1.09 | 0.59 | 1.34 | 0.92 | 4.00 | 3.13 |

Benchmark: IPD/Mercer Australian Pooled Property Fund Index

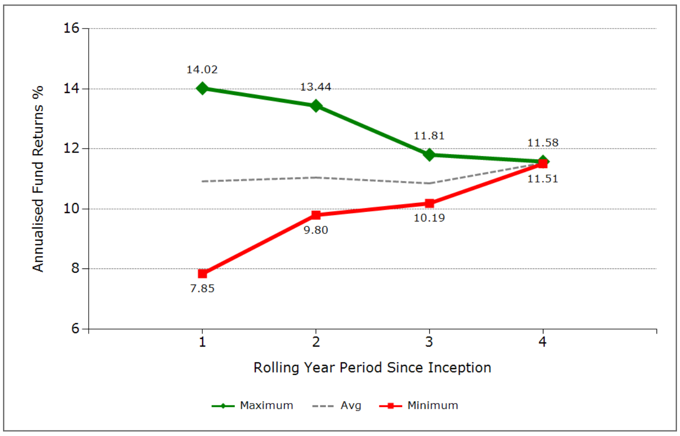
### Growth of $10,000




### Monthly Histogram




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




### ABSOLUTE PERFORMANCE ANALYSIS

| Return | Incpt. | 3 yr | 2 yr | 1 yr |
|---|---|---|---|---|
| Fund (% p.a.) | 11.48 | 10.99 | 9.85 | 11.49 |
| Benchmark (% p.a.) | 10.96 | 11.76 | 11.76 | 11.98 |
| Median (% p.a.) | 13.15 | 15.57 | 13.74 | 12.20 |
| **Ranking within Sector** | **Incpt.** | **3 yr** | **2 yr** | **1 yr** |
| Fund Ranking | 12 / 19 | 17 / 23 | 18 / 28 | 17 / 30 |
| Quartile | 3rd | 3rd | 3rd | 3rd |
| **Standard Deviation** | **Incpt.** | **3 yr** | **2 yr** | **1 yr** |
| Fund (% p.a.) | 3.71 | 3.43 | 2.79 | 3.10 |
| Benchmark (% p.a.) | 2.12 | 2.36 | 2.38 | 2.53 |
| Median (% p.a.) | 6.70 | 4.92 | 5.41 | 5.25 |
| **Downside Deviation** | **Incpt.** | **3 yr** | **2 yr** | **1 yr** |
| Fund (% p.a.) | 0.24 | 0.27 | 0.00 | 0.00 |
| Benchmark (% p.a.) | 0.00 | 0.00 | 0.00 | 0.00 |
| Median (% p.a.) | 0.68 | 0.00 | 0.00 | 0.00 |
| **Risk/Return** | **Incpt.** | **3 yr** | **2 yr** | **1 yr** |
| Sharpe Ratio - Fund | 2.49 | 2.59 | 2.83 | 3.14 |
| Sortino Ratio - Fund | 38.43 | 33.24 | | |

*For performance analysis purposes, Zenith benchmarks all funds in Property - Direct category against the IPD/Mercer Australian Pooled Property Fund Index. It should however be noted that the benchmark for the Cromwell Direct Property Fund is the PCA/IPD Unlisted Core Retail Property Fund Index.*

*All commentaries below are as at 31 October 2017.*

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.

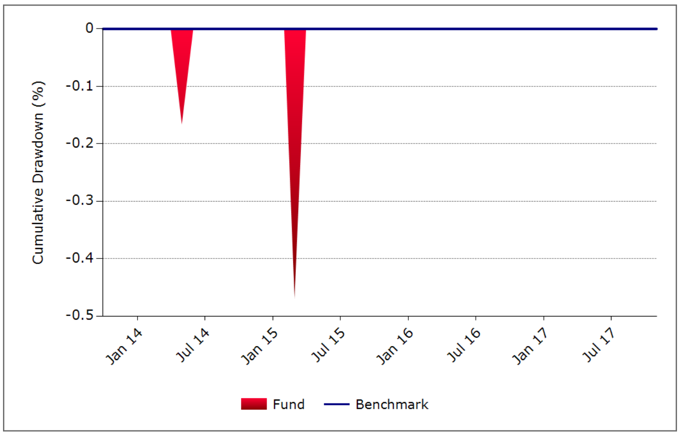
The Fund has generated solid returns in an absolute sense to date. However it has struggled to keep pace with its own benchmark and the median fund manager. Contributing factors have been cash drag and the FoF structure which adds a layer of operating costs which the benchmark does not have. In addition, the majority of peer funds in the universe and the benchmark operate 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 | |
| Months in Max Drawdown | 1 | |
| Months to Recover | 1 | |

| Worst Drawdowns | Fund | Benchmark |
|---|---|---|
| 1 | -0.47 | |
| 2 | -0.17 | |
| 3 | | |
| 4 | | |
| 5 | | |




*All commentaries below are as at 31 October 2017.*

Fund drawdowns to date have been minimal given the combination of short time-frame since inception and buoyant property markets. It should be recognised that funds with exposure to direct real estate will not only react to valuations of physical assets but also to the mark-to-market valuations of financial instruments such as interest rate hedges.

## INCOME/GROWTH ANALYSIS

| Income / Growth Returns | Income | Growth | Total |
|---|---|---|---|
| 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: 4 Dec 2017

| Role | Analyst | Title |
|---|---|---|
| Author | Dugald Higgins | Senior Investment Analyst |
| Sector Lead | Dugald Higgins | Senior Investment Analyst |
| Authoriser | Andrew Yap | Head of Multi-Asset & Income Research |

## ASSOCIATIONS & RELATIONSHIPS

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**As at the date this report was issued, a related party of which provides financial planning services is, or has been, a subscriber to Zenith's research services within the last 12 months.**

## RATING HISTORY

| As At | Rating |
|---|---|
| 4 Dec 2017 | Highly Recommended |
| 13 Sep 2016 | Highly Recommended |
| 17 Jul 2015 | Highly Recommended |
| 22 Jul 2014 | Highly Recommended |

| As At | Rating |
|---|---|
| 6 Sep 2013 | Not Rated - Declined |
| Last 5 years only displayed. Longer histories available on request. | |

## DISCLAIMER AND DISCLOSURE



Zenith has charged Cromwell Funds Management Limited a fee to produce this report.