Cromwell Phoenix Property Securities Fund

March 2022 Quarterly

Cromwell Phoenix Property Securities Fund Performance (Periods ending: 31 March 2022, Net of fees)

	3 Months	1 Year	3 Years	5 Years	7 Years	10 Years	Since Inception (16 Apr 2008)
Fund	-4.64%	22.04%	6.64%	7.96%	8.88%	13.67%	8.98%
S&P/ASX 300 A-REIT Accumulation Index	-6.72%	19.16%	5.96%	8.40%	8.52%	12.56%	5.39%
Outperformance	2.08%	2.89%	0.69%	-0.44%	0.36%	1.11%	3.59%

Fund Strategy

The **Cromwell Phoenix Property Securities Fund** invests in ASX-listed property securities including REITs, developers, fund managers and infrastructure securities.

Actively managed by Phoenix Portfolios, the Fund is benchmark-unaware, with holdings selected from a universe much wider than the benchmark, and position sizes based on long term proprietary valuation metrics.

The Fund aims to deliver a total return (after fees) in excess of the S&P/ASX 300 A-REIT Accumulation Index over three to five years with lower overall volatility of capital.

Quarter in Review

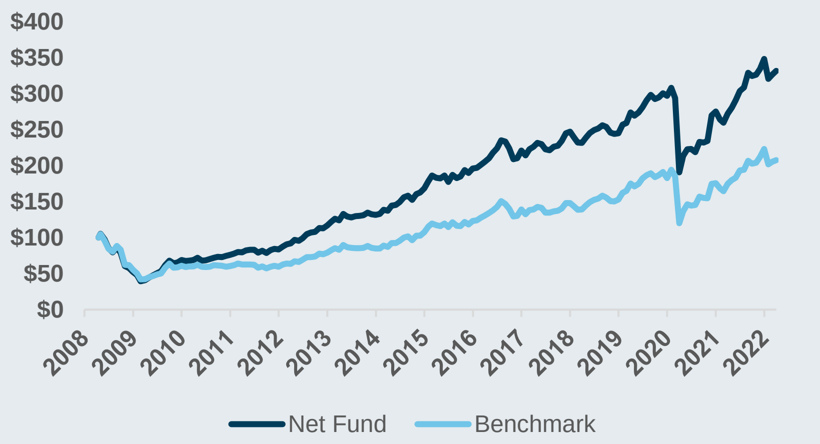
Factors influencing performance

- The S&P/ASX 300 A-REIT Accumulation Index moved sharply lower over the quarter, falling nearly 7%.
- The large cap property fund managers Charter Hall Group and Goodman Group reversed last quarter's positive returns – down 13.6% and 20% respectively.
- Reporting season in February was positive, with book values firming and guidance steady or higher.
- The Fund added value through holdings in Peet, Sunland Group, Vicinity Centres and Lend Lease.
- The Fund's position in Charter Hall Group was the key detractor.

Current Positioning

- Broadly diversified across all key property subsectors and infrastructure
- Smaller exposure to industrial, given less compelling valuation metrics
- Preference for small cap property developers over the large cap diversified stocks
- Fund likely to deliver more franking credits than

Value of $100 Invested at Inception



	Outperformed	Underperformed
Overweight	Peet Limited Sunland Group Vicinity Centres	Charter Hall Group Centuria Capital Group
Underweight	Scentre Group Stockland	Goodman Group

Market Commentary

The S&P/ASX 300 A-REIT Accumulation Index gave back much of its prior quarter's gains, falling 6.7% in the quarter ending 31 March 2022. The property index significantly underperformed the broader equity market, with the S&P/ASX 300 Accumulation Index up 2.1% in the quarter.

We have long warned that property is an interest rate sensitive sector and that has been particularly true in recent times. With a reopened, yet more unstable world, inflation pressures appear to be building. In response, interest rates have moved meaningfully higher. At the start of the quarter the Australian 10 Year Government Bond yield was 1.7%, however by the end of the quarter it moved to 2.8%. Whilst direct transaction and valuation markets have not reflected this sharp change, equity markets are somewhat more forward looking. Australian Government Bonds are considered to be a proxy for a risk-free asset. As such, many investors consider the return of risk assets relative to this yield figure. Many property investors consider the spread between capitalisation rates and this "risk-free" yield. Should capitalisation rates expand to match the move in government bond yields, valuations for properties will move backwards. All however is not lost, with many arguing that investors had not fully priced in prior bond yield compression, leading to historically wide spreads between capitalisation rates and bond yields. How much "cushion" was in those spreads will likely become apparent in the medium term.

Property fund managers are particularly sensitive to interest rates and were unsurprisingly amongst the worst performers during the quarter. The strong demand for access to investment property and ever compressing capitalisation rate has been supportive for fund managers in recent years. This dynamic has led to increased base fees, as assets under management grew rapidly. Furthermore, fund managers benefited from increased performance fees and an ability to earn large sums of money on property development activity. Reflecting the more uncertain future, Charter Hall Group (CHC) fell 19.8%, whilst Goodman Group (GMG) gave up 13.6%. Smaller fund managers also underperformed, with Centuria Capital Group (CNI) losing 17.7% and Elanor Investors Group (ENN) off 8.4%.

Truly reversing recent trends, shopping centre owners were outperformers for the month. Sales within shopping centres are obviously very much linked to inflation, so recent events have been far less impactful and, in some cases, may be beneficial for shopping centre owners. Vicinity Centres (VCX) led the way, rising by 13.1%, whilst offshore firm, Unibail-Rodamco-Westfield (URW) moved 8.9% higher. Scentre Group (SCG) lost 1.2% in the quarter, however still outperformed the broader property index.

Office property owners mostly moved lower in an absolute sense but were outperformers over the period. Office rental metrics appear to have somewhat stabilised after a reasonably negative period and transactions that have taken place have been supportive of book valuations. Dexus (DXS) closed the quarter 1.5% lower, GDI Property Group (GDI) was off 1.3% and Centuria Office REIT (COF) lost 4.2%.

Elsewhere, Charter Hall Group (CHC) and entities associated with 360 Capital Group (TGP) are closing in on finalising the acquisition of dual-listed office and industrial property owner Irongate Group (IAP). The $1.90 offer price represents a premium of 21% to the prior closing price.

Performance Commentary

Peet Limited (PPC) ▲ 12.0%

The portfolio holds an overweight position in PPC. Its outperformance added value from both an absolute and relative perspective over the quarter.

Residential property prices have been incredibly strong in recent periods. Whilst completed home prices have risen sharply, the value of broadacre land tends to amplify the returns of completed residential houses. Due to an accounting quirk, companies like PPC do not report the current value of the land they own, in contrast to many other property owners who are required to revalue their properties and present these figures on their balance sheets. As such, the true value of PPC's land bank is likely significantly ahead of its book value. Furthermore, PPC operates a capital light funds management business, which earns income when completed lots are sold and is likely to underearn into the near future. Despite all of this, PPC continues to trade at approximately its book value.

Proving this point, PPC sold a property in New Beith, Queensland, to an entity associated with Frasers Property for $80 million. This price represents an 83% premium to PPC's book value. This sale is a part of PPC management's ongoing portfolio optimisation, selling non-core properties, whilst adding to their "core" landbank in capital efficient and/or opportunistic ways. Due to the long term nature of these residential subdivision projects, the impact on earnings and book values is unlikely to be seen in the short term, but the true value of the company's holdings likely remains significantly ahead of what is implied by its current share price. If management execute appropriately, PPC's true value is likely to be reflected in its share price over time.

Scentre Group (SCG) ▼ 1.2%

The portfolio holds an underweight position in SCG. Its outperformance during the quarter detracted value from a relative perspective.

Shopping mall owners have struggled in recent periods as restrictions surrounding the suppression of COVID-19 have had a significant impact on physical retail sales and rent collection from tenants. Whilst the most recent period was not absent these effects, there was some positivity for owners of shopping centres such as SCG. During the quarter SCG reported its financial results for the year to 31 December 2021. Rent collection continued to improve, particularly later in the year, with collections for 2021 $200 million higher than the previous year. Like-for-like sales in SCG's shopping centres also moved slightly higher (0.1%) for the period, despite government restrictions in New South Wales, Victoria and New Zealand. Leasing spreads represent the difference between new rent and old rent paid on the same space upon releasing. These spreads have been materially negative for shopping centres for some time. This remains the case, with spreads of -5.9%. This is however a significant improvement when compared with prior periods.

After many periods of asset value declines for retail property, valuations appear to have stabilised. Transactions of large scale shopping malls were very limited for a while, however the beginning of transactional activity has been broadly supportive of existing book values of retail assets. Across the most recent six months, SCG's net tangible assets increased by approximately 0.5%.

SCG also announced a transition of its long-time Chief Executive Officer (CEO) Peter Allen. This role will be filled by current Chief Financial Officer (CFO) Elliot Rusanow. This represents a return of the Lowy family's involvement at the top of Westfield Shopping Centre's management team, with Rusanow being the nephew of Westfield founder Frank Lowy. We will closely observe any change in strategy and decision making as the new CEO takes over later in the year.

Charter Hall Group (CHC) ▼ 19.8%

The portfolio holds an overweight position in CHC. Its underperformance detracted value from an absolute and relative perspective over the December quarter.

As discussed in the market commentary, property fund managers such as CHC are highly sensitive to movements in interest rates. According to some market commentators, CHC is also suffering from negative sentiment surrounding the acquisition of equity funds management business Paradice Investment Management (PIM). The acquisition is extremely small in the context of the full CHC business and in Phoenix's view is unlikely to distract management from their core business.

Despite the more mixed macroeconomic environment, CHC's half year financial results, released in February, were excellent. After upgrading earnings guidance twice between June and December 2021, CHC once again raised operating earnings per security (OEPS) guidance, to 112 cents per security. This compares to OEPS of 61 cents per security for the 2021 financial year. Whilst much of this is driven by non-recurring elements such as performance fees, acquisition and development activity amongst CHC-managed vehicles continues to be strong. These activities will underwrite earnings into future years.

CHC's property funds under management now stands at $61.3 billion, achieving an exceptional 28.5% compound annual growth rate since June 2017. CHC continues to maintain a diversified earnings base, both by source of customer and type of property. Diversification alone will not overcome a broad shift in interest rates, but it will allow the business more flexibility in dealing with a changing environment.

Stock in Focus: Sydney Airport (SYD, née MAP)

The successful completion of the takeover of Sydney Airport in March 2022 marks the conclusion of 20 years as a listed entity. Since inception of the Cromwell Phoenix Property Securities Fund (April 2008), SYD has been a core holding and it has been a big positive contributor to the Fund's returns. The journey has been long and colourful, with many lessons learned along the way in terms of aviation, finance, governance and politics. This article tries to distil the journey into a short read – all puns intended.

Running out of runway – a turbulent first year

In the aftermath of the September 2001 terrorist attacks on the World Trade Centre and the subsequent demise of Ansett in March 2002, Macquarie Airports (MAP) listed on the Australian Stock Exchange on 2 April 2002. Timing is everything! MAP, which was many years later to become Sydney Airport, started life as an externally managed fund with a mandate to invest in airport assets in Australasia and Europe. The seed asset of MAP was a 36.7% stake in Macquarie Airports Group Limited, which gave MAP an 18.4% exposure to Bristol Airport and an 8.9% exposure to Birmingham Airport, both in the UK. The other significant attribute of MAP at inception was its participation in the Southern Cross Airports Corporation consortium which was Macquarie Bank's bidding vehicle for the privatisation of Sydney Airport.

The MAP Initial Public Offering (IPO) raised a whopping A$1bn. Partly to reflect the size, and partly to give Macquarie some flexibility, the deal was structured in the form of partly paid shares, with $500m raised up front in April 2002 at $1 per unit, and a second call of $1 per unit, payable in September 2002 to raise an additional $500m. The stock listed at a small discount to its issue price and then commenced a glide path. Unless there are extremely favourable thermals, glide paths rarely point upwards.

On 25 June 2002, the Australian Federal Government announced that the Southern Cross Airports Corporation Consortium had won the bid to privatise Sydney Airport. MAP, via its 40% direct stake in the winning consortium and also indirectly via its stake in Macquarie Airports Group, also part of the consortium, became a 44% investor in Sydney Airport.

The winning bid comprised $5.396bn for the airport, and a further $192m for the Ansett terminal. This was considered colossally high at the time and the market price of MAP reacted negatively. The price paid represented a multiple of 14.3 times forecast June 2003 earnings before interest, tax, depreciation and amortisation (EBITDA[1]) of A$377m and a forecast project level internal rate of return of 12.1%.

Given the geared structure of the consortium, the direct equity cost to MAP for its 40% stake in the consortium was $815m.

Not deterred by a slumping unit price, on 16 Jul 2002, MAP, announced a second large acquisition, also via a Macquarie consortium, for the purchase of a 28% stake in Aeroporti di Roma which owned 100% of the Rome airports Fiumicino and Ciampino. Given the acquisitions of stakes in both Sydney and Rome in quick succession, and not to mention Macquarie's appetite for fees, the transaction also required a further capital raising, this time at $1.50 per unit on a fully paid basis (compared to the $2 initial price, paid over two instalments)[2].

[1] One measure of value for infrastructure assets, is to look at the ratio of Enterprise Value (EV) to Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA). The EV looks through the capital structure to consider the total value of an asset, irrespective of how it is financed. EBITDA is a proxy for the cash generation of the asset, prior to funding costs. Care must be taken when looking at these types of metrics because items such as maintenance capital expenditure which represent real cash outflows are not accounted for.

[2] The $670m of capital raised was largely done via a priority entitlement underwritten by Macquarie Bank and UBS Warburg. There was a shortfall that was taken up by the underwriters.

While still digesting the Rome acquisition and to further add to MAP's woes, Rome's profit for the half year to June 2002 was initially poorly received by the market (albeit a little misunderstood) sending the MAP unit price lower, ahead of the final call of the initial IPO stock. The day before the call was due, the unit price hit 16.5c, with many investors very worried about what had happened to their original $1 investment. So much so, that approximately 58m of the original 500m units failed to make the second payment, and Macquarie Equity Capital Markets was forced to take up the stock and sell it into the market.

As we subsequently moved into calendar 2003, the effects of SARS (the first one) and the Iraq War combined to drive MAP lower. At its low, the $2 fully paid IPO stock touched 80c before commencing what would ultimately become a staggering rally.

In July 2003, Macquarie Bank, in recognition of the tumultuous journey that investors had been on since listing, announced a waiver of performance fees due in respect of MAP. Furthermore, future performance fees would also be waived until such time as investors had accumulated returns above the Morgan Stanley Capital Index World Transportation Infrastructure Index (the Benchmark). A mark of confidence indeed.

While the MAP share price had not climbed above its fully paid IPO price by the time of the first full year results call in August 2003, the company was able to demonstrate that Sydney Airport's EBITDA figures were in line with the assumptions made on acquisition, despite international traffic impacted by SARS and the Iraq war. The underlying performance of the assets was crucial to management credibility and to support the strategy of developing a portfolio of airport stakes.

In for the long haul – how the mix changed over time

Over the next decade, MAP, along with partners, predominantly other Macquarie vehicles, bought a portfolio of airport stakes with positions peaking in assets including Rome Airports (34.2%), Brussels Airport (62.1%) and Copenhagen Airports (53.7%). However, the jewel in the crown, the position in Sydney Airport continued to grow, and by the end of December 2011 MAP controlled 85% of Sydney Airport and through a series of transactions the position had become the sole asset in the portfolio. The table below sets how the stakes changed through time.

	Sydney Airport	Copenhagen Airports	Brussels Airport	Bristol Airport	Japan Airport Terminal	Rome Airports	Birmingham Airport	Mexico
31-Dec-02	44.7%			18.3%		28.0%	8.8%	
31-Dec-03	53.0%			20.1%		28.8%	9.7%	
31-Dec-04	55.5%		53.3%	30.8%		33.6%	14.9%	
31-Dec-05	55.8%	52.8%	52.0%	32.1%		34.2%	15.5%	
31-Dec-06	55.8%	53.4%	53.9%	32.1%		34.2%	15.5%	
31-Dec-07	72.1%	53.7%	62.1%	32.1%	14.9%	0.0%	0.0%	
31-Dec-08	72.1%	26.9%	36.0%	35.5%	14.9%	0.0%	0.0%	
31-Dec-09	74.0%	30.8%	36.0%	0.0%	0.0%	0.0%	0.0%	16.0%
31-Dec-10	74.0%	30.8%	39.0%	0.0%	0.0%	0.0%	0.0%	0.0%
31-Dec-11	84.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
31-Dec-12	84.8%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
31-Dec-13	100.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

In 2009, after the Global Financial Crisis demonstrated some of the conflicts of externally managed vehicles, the board set out a proposal to pay Macquarie Group $345m to internalise MAP. This was highly controversial, given that shareholders could theoretically terminate Macquarie by a majority vote, and alternative proposals were put forward. However, the board persisted with the plan arguing the need for Macquarie's co-operation to avoid triggering change of control and pre-emptive rights clauses in debt facilities and shareholder arrangements. Ultimately the internalisation occurred, with the chairman at least being forced to acknowledge that there was no legal obligation to pay Macquarie, just a moral obligation. A very expensive "moral" obligation in our view.

Despite the bumpy path, by the end of the 2013 calendar year, MAP had internalised to become SYD, the business was simplified, a tax dispute settled with the ATO, and ownership of Sydney Airport had moved to 100%. Form a share market perspective, simple is good.

Despite early turbulence, the vision was clear

From the early days, Macquarie was clear on the potential upside of airport investments. Airport ownership provides a myriad of opportunities to invest in commercial activities, particularly via the unregulated retail, car parking and property opportunities, which combined can often represent a greater proportion of airport revenues than aeronautical activities.

With respect to aeronautical activities, the privatisation of Sydney Airport was accompanied by the removal of price controls on aeronautical charges enabling more flexible arrangements between airlines and the airport allowing for the provision of services to meet the demands of airlines.

Accounting tricks aside, airports require lots of capital and it is often difficult to determine what is regular maintenance capital and what capital is required to grow revenue. However, on acquisition of Sydney Airport, we were able to take comfort that it had been the recipient of lots of capital in the process of getting Sydney and its infrastructure ready to host the Sydney 2000 Olympics.

Another appealing feature of Sydney Airport has always been the monopolistic nature of the asset. In a geography as vast as Australia's, unlike in Europe, there really is only one way to efficiently travel between major capital cities. This is somewhat supported by the Sydney-Melbourne route being the third most busy airline route in the world. Furthermore, the only moderate level of future competition was in the form of Western Sydney Airport, where Sydney Airport always had the right of last offer to participate. With light-handed regulation and a focused management team, good things happened.

Aggressive financial structure in the early days

Love it or loath it, MAP started life as a complex triple stapled structure that invested in other complex structures making the accounts opaque and difficult to understand. Couple that with a new asset class and many investors struggled. In MAP's early days, financial leverage was also considered to be high, particularly for an asset with plenty of operational leverage. The initial Southern Cross Airports Corporation consortium that won the bid for Sydney Airport was aggressively structured as shown in the table below. Less than a third of the capital to fund the acquisition was pure equity.

Sources	***$m***	***Uses***	***$m***
Senior Debt	3,744	Acquisition Price	5,396
Convertible Preference Share	600	Ansett Terminal	192
Equity	1931	Cash (Reserves)	500
		Other Costs	187
	6,275		**6,275**

Correct flight path

Recall at the time of acquisition that Sydney Airport was forecast to grow EBITDA to $377m. In the 2002 calendar year, the company's cash generation before interest was sufficient to cover its interest bill by 1.2 times. That provides very little margin of safety. By contrast, that same ratio was over 3 times by the end of the 2019 calendar year. The steady improvement in balance sheet strength enabled the company to weather most storms, including the Global Financial Crisis. Only the devastating impact of Covid resulted in an equity issue to bolster the balance sheet.

The decision to focus on Sydney Airport stands the test of time. Based on Phoenix calculations, setting aside recent Covid-impacted financials, for the 18 years ending December 2019, Sydney Airport generated a cumulative annual growth rate in revenue of 8.5%, and given margin expansion throughout the period, an EBITDA growth rate of 10.3% pa.

This didn't come for free. Phoenix estimates over $5bn has been spent over the last 20 years on various capital projects, that have facilitated passenger growth and contributed to the spectacular EBITDA growth. In addition, a further $2bn of capital was injected into the business by shareholders to cope with the difficulties thrown up by Covid. However, offsetting this, has been a steady and robust stream of distributions.

Grounded, but ready for take-off again

Sydney Airport has enjoyed some magnificent tailwinds through the last 20 years, which combined with an active management approach has grown EBITDA by 350%. The robustness of the cash flows, along with steadily declining interest rates, has facilitated high multiples to be used when valuing such assets.

On 5 July 2021, Sydney Airport received a proposal from a consortium of infrastructure investors called Sydney Aviation Alliance to acquire, by way of scheme of arrangement and trust scheme, 100% of the stapled securities in Sydney Airport. The Consortium comprised:

- IFM Investors (Nominees) Limited as trustee for IFM Australian Infrastructure Fund,
- Conyers Trust Company (Cayman) Limited as trustee for IFM Global Infrastructure Fund
- QSuper Board as trustee for QSuper
- Global Infrastructure Management, LLC (on behalf of its managed and advised clients and funds).

This transaction was ultimately consummated on 9 March 2022 with a payment of $8.75 per stapled security. This reflected an Enterprise Value for Sydney airport of approximately $32bn. As shown in the table below, we believe this transaction fully values the asset.

	Jun-02	***Mar-22***
Enterprise Value ($bn)	5,400	32,300
Projected EBITDA (2003)	376	
Historic EBITDA (2019)		1,333
EV:EBITDA	14.4	24.2
10 Year Bond Rate	6.00%	2.88%

Going forward, Sydney Airport must navigate its way out of the covid pandemic, deal with potential structural changes to the aviation market, contend with rising interest rates and the opening of Western Sydney Airport. We absolutely believe these challenges can be managed, but the returns are unlikely to be as robust as the last 20 years.

Phoenix estimates the internal rate of return of an investment in Sydney Airport from the IPO to the sale in March 2022 was approximately 17.9%. By comparison, the S&P/ASX 300 REIT Accumulation Index returned 6.5% over the same period. Since the inception of the Cromwell Phoenix Property Securities Fund, the SYD holding has delivered an annualised return in excess of the property benchmark by approximately 10%.

Market Outlook

February's reporting season was broadly positive for property stocks. Investment property valuations moved higher, although the rate of change has most certainly slowed. Earnings were also solid across all sub-sectors and outlook statements remained robust.

The industrial sub-sector continues to be the most sought after, given the tailwinds of e-commerce growth, the potential onshoring of key manufacturing categories and the decision by many corporates to build some redundancy into supply chains to cope with current disruptions. All of these factors will support ongoing demand for industrial space.

The jury is still out on exactly how tenants will use office space moving forward, albeit demand for good quality well located space remains robust, and transactional activity of office assets continues to provide ample evidence of value.

We remain cognisant of the structural changes occurring in the retail sector with the growing penetration of online sales and the greater importance of experiential offering inside malls. Recent events will likely accelerate these changes. As Australia re-opens, physical retail sales are likely to pick up and tests new highs, as seen during sporadic periods of more limited restrictions. These factors are well understood and the trajectory to a new "normal" is only now beginning to reveal itself. This explains why retail stocks have been the most volatile of all property sub-sectors.

The recent increase in bond yields does present a headwind for all financial assets, and particularly yield based sectors such as property. However, with key large capitalisation REITs trading at a discount to the value of their underlying assets, with no value ascribed to embedded active businesses, we believe the sector offers value, particularly in comparison to unlisted property.

Phoenix has for some time discussed the risk of inflation, given the enormous fiscal stimulus and extreme monetary policy setting that we now live with. In very recent times, commentators and bond markets have begun to react to the presence of such a risk. In this environment, long leases with fixed rent bumps, which were previously in high demand, may become relatively less attractive. Historically, real assets such as property and infrastructure have performed well during inflationary periods.

Portfolio Detail

Top 10 Holdings (In Alphabetical Order)
Centuria Capital Group Charter Hall Group GPT Group Growthpoint Properties Australia Mirvac Group Hotel Property Investments Peet Limited Stockland Sunland Group Vicinity Centres

	Fund
Cash	3.2%
ASX 300 A-REITS	73.6%
Other ASX Listed Securities	23.2%

	Fund	Benchmark
Office	24.9%	18.8%
Retail	28.1%	32.4%
Industrial	18.7%	41.4%
Infrastructure	3.1%	0.0%
Other	21.9%	7.4%
Cash	3.2%	0.0%
Total	**100.0%**	**100.0%**