

Precinct Properties NZ

Better Off Alone

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OUTPERFORM

Precinct Properties (PCT) has announced that it has reached an agreement with its manager, AMP Huami Management (AHML), to terminate its management contract and become an internally-managed vehicle as of 1 April 2021. The termination fee of NZ\$215m reduces to NZ\$145m on a net basis, assuming PCT gets favourable tax treatment on the termination, in addition to the agreed cancellation of NZ\$10m of development fees owed to AHML. We think the deal has merit given its attractive AFFO accretion of +6% (albeit it is a few years out before being fully realised) and better alignment of interests, but coming at a full price. We maintain our OUTPERFORM with internalisation benefits supporting better medium term DPS growth prospects.

NZX Code	PCT	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$1.70	NPAT* (NZ\$m)	82.5	89.8	101.7	108.5	PE	27.0	24.8	24.0	23.2
Target price	NZ\$1.77	EPS* (NZc)	6.3	6.8	7.0	7.3	EV/EBIT	33.7	27.9	26.0	24.4
Risk rating	Medium	EPS growth* (%)	0.8	8.9	3.1	3.6	EV/EBITDA	33.7	27.9	26.0	24.4
Issued shares	1313.8m	DPS (NZc)	6.3	6.5	6.7	6.9	Price / NTA	1.2	1.3	1.3	1.3
Market cap	NZ\$2,227m	Imputation (%)	100	100	100	100	Cash div yld (%)	3.7	3.8	4.0	4.1
Avg daily turnover	1,148k (NZ\$1,909k)	*Based on normalised profits					Gross div yld (%)	5.3	5.5	5.7	5.8

What's changed?

- **Earnings:** AFFO moves +0.7/+4.7%/+7.7% in FY21/FY22/FY23, with higher interest expenses more than offset by tax reductions
- **Target price:** Lifted +3cps to NZ\$1.77

Bringing management in-house

PCT will pay NZ\$215m (NZ\$145m net of tax and fees on current development projects) to internalise its management functions, which is expected to result in an annual cash saving of NZ\$14.6m. The benefits stem from a fall in its management expense ratio (MER) to a sector low 0.31% (from 0.74%). PCT expects that AFFO will lift by +6.0% per share on a pro-forma basis. This accretion is fully realised once the Bowen Campus and 1 Queen St developments are complete and tax is deducted from the internalisation cost, as such near-term benefits are likely lower on an underlying basis.

Gearing back to the limit

The payment will be debt funded by a new NZ\$250m 5-year bank facility, and pro-forma gearing lifts to 36% (versus post ANZ Centre sale gearing of 26%) and towards the upper end of PCT's target range of <37.5%. The decision to internalise hinders balance sheet flexibility. With speculation that PCT is looking to purchase the downtown carpark contiguous to 88 Quay Street, and the final stage of Wynyard yet to commence, further asset sales and/or capital raise are now more likely.

Not a bargain but worth it if cost savings are realised

While we view the motivations to internalise as logical, the price paid (c.7% of AUM or 15x EBIT) is full compared to other recent transactions. The benefits of internalisation include the avoidance of lumpy performance, development, and leasing fees, as well as escalating base asset management fees that have been driven by falling interest rates over recent years. The cost savings represent a yield on gross cost of 6.8% (or 10.1% on a net basis), which looks attractive versus the alternative of purchasing or developing assets.

Precinct Properties NZ Limited (PCT)

Priced as at 29 Mar 2021 (NZ\$) **1.70**

12-month target price (NZ\$)*	1.77
Expected share price return	4.1%
Net dividend yield	3.9%
Estimated 12-month return	8.0%

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	0.77
WACC	4.8%
Terminal growth	1.5%

Spot valuations (NZ\$)	
1. DCF	1.77
2. NAV	1.75
3. n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	3,226
(Net debt)/cash	(1,021)
Less: Capitalised operating leases	0
Value of equity	2,214

Profit and Loss Account (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Sales revenue	95.3	105.8	133.6	142.4	151.4
Normalised EBITDA	79.5	92.5	118.8	130.0	138.8
Depreciation and amortisation	0	0	0	0	0
Normalised EBIT	79.5	92.5	118.8	130.0	138.8
Net interest	(1.7)	(5.0)	(29.0)	(28.4)	(30.3)
Associate income	0	0	0	0	0
Tax	(0.1)	(5.0)	0.0	0.0	0.0
Minority interests	0	0	0	0	0
Normalised NPAT	77.7	82.5	89.8	101.7	108.5
Abnormals/other	110.5	(52.3)	(66.5)	49.4	58.7
Reported NPAT	188.2	30.2	23.3	151.1	167.2
Normalised EPS (cps)	6.2	6.3	6.8	7.0	7.3
DPS (cps)	6.0	6.3	6.5	6.7	6.9

Growth Rates	2019A	2020A	2021E	2022E	2023E
Revenue (%)	0.0	11.0	26.2	6.6	6.3
EBITDA (%)	-6.6	16.4	28.4	9.5	6.7
EBIT (%)	-6.6	16.4	28.4	9.5	6.7
Normalised NPAT (%)	1.4	6.2	8.9	13.2	6.7
Normalised EPS (%)	-1.5	0.8	8.9	3.1	3.6
Ordinary DPS (%)	3.4	5.0	3.2	3.2	2.4

Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E
EBITDA	79.5	92.5	118.8	130.0	138.8
Working capital change	(8.0)	7.9	0	0.0	0.0
Interest & tax paid	(7.3)	(17.7)	(29.0)	(28.4)	(30.3)
Other	0	0	0	0	0
Operating cash flow	64.2	82.7	89.8	101.7	108.5
Capital expenditure	(271.9)	(297.1)	(102.0)	(145.2)	(72.5)
(Acquisitions)/divestments	188.2	67.3	177.8	80.0	0
Other	(2.1)	(6.1)	(215.0)	0	0
Funding available/(required)	(21.6)	(153.2)	(49.3)	36.5	36.0
Dividends paid	(75.1)	(81.8)	(84.7)	(96.0)	(101.4)
Equity raised/(returned)	149.3	(0.1)	0	0	0
(Increase)/decrease in net debt	52.6	(235.1)	(134.1)	(59.5)	(65.4)

Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E
Working capital	(33.2)	(8.7)	(8.7)	(8.7)	(8.7)
Fixed assets	2,793.7	2,990.7	2,914.9	3,029.5	3,160.7
Intangibles	0	0	0	0	0
Right of use asset	0	0	0	0	0
Other assets	44.2	104.0	104.0	104.0	104.0
Total funds employed	2,804.7	3,086.0	3,010.2	3,124.8	3,256.0
Net debt/(cash)	751.5	1,021.1	1,155.2	1,061.7	1,127.1
Lease liability	0	0	0	0	0
Other liabilities	127.2	179.7	179.7	179.7	179.7
Shareholder's funds	1,926.0	1,885.2	1,675.3	1,883.4	1,949.1
Minority interests	0	0	0	0	0
Total funding sources	2,804.7	3,086.0	3,010.2	3,124.8	3,256.0

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

Valuation Ratios	2019A	2020A	2021E	2022E	2023E
EV/EBITDA (x)	37.5	33.7	28.0	26.1	24.4
EV/EBIT (x)	37.5	33.7	28.0	26.1	24.4
PE (x)	27.3	27.1	24.9	24.1	23.3
Price/NTA (x)	1.2	1.2	1.3	1.3	1.3
Free cash flow yield (%)	-9.3	-9.6	-0.5	-1.9	1.6
Net dividend yield (%)	3.5	3.7	3.8	3.9	4.0
Gross dividend yield (%)	5.0	5.3	5.5	5.6	5.8

Capital Structure	2019A	2020A	2021E	2022E	2023E
Interest cover EBIT (x)	46.8	18.5	4.1	4.6	4.6
Interest cover EBITDA (x)	46.8	18.5	4.1	4.6	4.6
Net debt/ND+E (%)	28.1	35.1	40.8	36.0	36.6
Net debt/EBITDA (x)	9.5	11.0	9.7	8.2	8.1

Key Ratios	2019A	2020A	2021E	2022E	2023E
Return on assets (%)	2.8	3.0	3.9	4.1	4.2
Return on equity (%)	4.0	4.4	5.4	5.4	5.6
Return on funds employed (%)	2.7	2.7	3.7	4.1	4.3
EBITDA margin (%)	83.4	87.4	88.9	91.3	91.7
EBIT margin (%)	83.4	87.4	88.9	91.3	91.7
Capex to sales (%)	285.3	280.8	76.3	101.9	47.9
Capex to depreciation (%)	n/a	n/a	n/a	n/a	n/a
Imputation (%)	100	100	100	100	100
Pay-out ratio (%)	96	100	95	95	94

Property Statistics	2015A	2016A	2017A	2018A	2019A
Key metrics					
No. properties	15	13	12	12	14
Net lettable area (000sqm)	304	226	224	225	232
Average lease term (years)	5.0	6.3	8.7	6.9	7.6
Occupancy rate (%)	98	98	100	99	99
Cap rate (%)	7.0	6.5	6.2	5.8	5.7
Initial yield (%)	7.0	6.7	6.5	5.8	5.2
Over / (under) renting (%)	(1.8)	(3.6)	(4.7)	(6.4)	(5.2)

Total portfolio (NZ\$m)					
Investment properties	1,612	1,514	1,535	1,488	1,871
Properties held for sale	76	0	0	191	0
Development properties	0	190	509	838	923
Total	1,688	1,704	2,045	2,517	2,794
NTA per share (NZ\$)	1.11	1.17	1.24	1.40	1.47

Internalisation overview

Internalisation 101

In our view, an internalised management structure has better alignment between managers and shareholders. It removes the inherent conflict of interest in an external contract where management is incentivised to grow assets under management to increase fees. This is a key positive of the agreement. Including PCT, there are now 5 internally managed LPV. Others include Argosy (ARG), Kiwi Property Group (KPG), Property for Industry (PFI) and Stride Property (SPG).

Under an internally-managed structure, LPVs directly employ staff to carry out the various property and asset management functions. All employee costs are recognised as corporate overhead. As a result, the property management and leasing functions for internally managed vehicles are effectively recognised as a corporate expense and not a direct property expense (to the extent these are not outsourced). Outside of the property and asset management functions, accounting under internal and external management is practically the same.

The downside of internally-managed structures is that (1) it can cost a lot to internalise, (2) declining asset values do not result in lower management costs, and (3) it is not feasible unless the vehicle is at scale.

Key terms of the deal

- PCT will make a gross payment to AHML of NZ\$215m. As a result of this transaction, NZ\$10m of fees on current development projects are no longer required to be paid. PCT has also applied for a binding ruling from the IRD to confirm the termination payment is deductible for tax purposes. The net cost to PCT is expected to be NZ\$145m
- All existing executives and employees have entered into new employment contracts with PCT
- There is no shareholder vote on the matter, with PCT obtaining an NZX waiver to act without a vote given short time frames and competing parties for the contract
- The termination payment will be debt funded through a new 5-year NZ\$250m facility, with additional funding expected from the sale of further non-core assets (c.NZ\$90m)
- PCT's largest shareholder will retain their 17.3% stake and board seat

Breaking down PCT's cash savings

PCT expects the internalisation to lower cash costs by NZ\$14.6m. However, some of these fees are typically capitalised to asset values such as development management (NZ\$4.0m) and acquisition and disposal fees (NZ\$0.5m). Excluding these fees we estimate the P&L cost savings are NZ\$10.1m and will be offset by higher interest costs with the internalisation payment being debt funded. Lower capitalised costs should ultimately materialise in higher yields on development; we estimate +12bp.

Figure 1. PCT's pro forma cash saving breakdown

Description	NZ\$m	PCT comment
Management fee	14.8	Based on NZ\$3.5bn portfolio size
Performance fee	1.5	10-year average
Leasing fees	3.2	10-year average
Development management fees	4.0	Based on \$100m of development p.a.
Acquisition and disposal fees	0.5	Assumes 3% portfolio turnover p.a.
Retail and Generator management fees	1.4	MSA agreed cost
Recoverable staff cost	4.8	Current cost
Total	30.2	0.74% MER
Internal cost	(15.6)	0.31% MER
Pro forma cash cost saving	14.6	

Source: Forsyth Barr analysis

Price of termination versus historical transactions

As per the table below, we estimate PCT is paying 6.9% of FUM and 14.7x EBIT to terminate its management contract. This is at the higher end of recent comparable transactions, reflecting (1) a lower expected return environment, (2) more competitive bidding given the popularity of the management asset class, and (3) the tax benefit which PCT should achieve (relative to a 3rd party acquirer).

To calculate the EV/EBIT multiple of 14.7x, we have assumed the NZ\$14.6m pro-forma cash cost saving PCT expects to achieve is broadly in line with the EBIT margin generated by the current manager.

Figure 2. Transactional evidence

Date	Target company	Type	EV	FUM	EV/FUM	EV/EBIT
Mar-21	Precinct	Internalisation	215.0	3,102	6.9%	14.7
Jun-20	Augusta (final offer)	Acquisition	91.1	1,834	5.0%	13.6
Jan-20	Augusta (first offer)	Acquisition	111.2	1,954	5.7%	16.6
Sep-18	Folkestone	Acquisition	59.5	1,555	3.8%	8.0
Aug-18	Aventus Retail Property Fund	Internalisation	143.1	2,000	7.2%	8.6
Jun-17	Property for Industry	Internalisation	42.0	1,083	3.9%	10.6
May-17	Armada Funds Management	Acquisition	30.7	800	3.8%	6.5
Nov-16	360 Capital Investment Management	Acquisition	91.5	1,395	6.6%	10.1
Jun-16	Generation Healthcare	Acquisition	58.5	439	13.3%	5.1
Apr-16	GPT Metro Office Management Platform	Acquisition	9.0	439	2.0%	7.0
Nov-14	Arena	Internalisation	11.5	411	2.1%	10.5
Dec-13	Kiwi Property Group	Internalisation	72.5	2,188	3.3%	6.3
Oct-13	GDI Property Group	Internalisation	18.5	742	2.5%	3.7
Internalisation		High			7.2%	14.7
		Average			3.6%	9.6
		Low			2.1%	3.7

Source: Company data, Forsyth Barr analysis

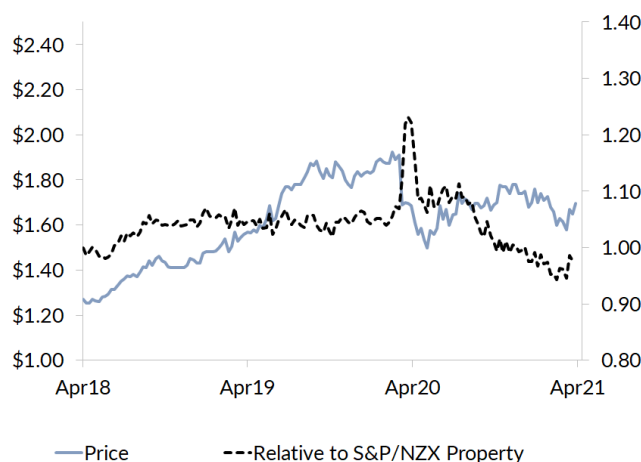
Earnings changes

We adjust our earnings forecasts for (1) internalisation of management and associated cost savings, and (2) the sale of an NZ\$90m asset. The large lift in our FY23E AFFO reflects tax deductions from the internalisation payment. This tax deduction totals NZ\$60m and as such it will take a number of years for PCT to return to a tax paying position. We have made more modest adjustments to our DPS to reflect this one-off tax benefit.

Figure 3. Earnings estimate changes

	2021E			2022E			2023E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Net income	133.3	133.6	0.2%	143.2	142.4	-0.5%	154.0	151.4	-1.6%
Corporate costs	(15.6)	(14.8)	-5.4%	(15.2)	(12.4)	-18.6%	(15.8)	(12.6)	-19.9%
EBITDA	117.7	118.8	0.9%	128.0	130.0	1.6%	138.2	138.8	0.4%
Net interest	(27.4)	(29.0)	6.0%	(22.5)	(28.4)	26.2%	(26.1)	(30.3)	16.3%
Current tax	(1.1)	0.0	n/m	(8.3)	0.0	n/m	(11.4)	0.0	n/m
NPAT (underlying)	89.2	89.8	0.6%	97.1	101.7	4.7%	100.7	108.5	7.7%
Amortisation of incentives and leasing costs	8.2	8.2	0.2%	9.2	9.2	-0.7%	10.4	10.2	-2.0%
FFO	97.5	98.1	0.6%	106.4	110.8	4.2%	111.1	118.7	6.8%
Incentives and leasing costs	(6.0)	(6.0)	-	(3.4)	(3.4)	-0.5%	(4.2)	(4.1)	-1.7%
Maintenance capex	(5.4)	(5.4)	-	(5.7)	(5.6)	-1.5%	(6.2)	(6.0)	-2.9%
AFFO	86.0	86.6	0.7%	97.3	101.9	4.7%	100.7	108.5	7.7%
EPS (cps)	6.79	6.84	0.6%	6.73	7.05	4.7%	6.78	7.31	7.7%
AFFO (cps)	6.55	6.59	0.7%	6.74	7.06	4.7%	6.78	7.31	7.7%
DPS (cps)	6.50	6.50	-	6.68	6.71	0.5%	6.78	6.87	1.3%

Source: Forsyth Barr analysis

Figure 4. Price performance


Source: Forsyth Barr analysis

Figure 5. Substantial shareholders

Shareholder	Latest Holding
Haumi	17.7%
ANZ NZ Investments	9.8%

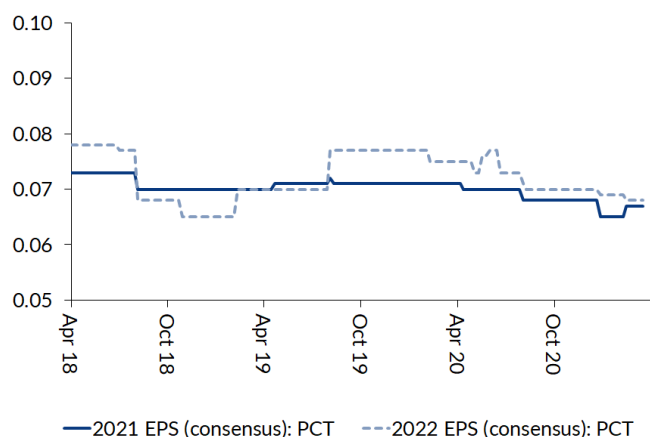
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 6. International valuation comparisons

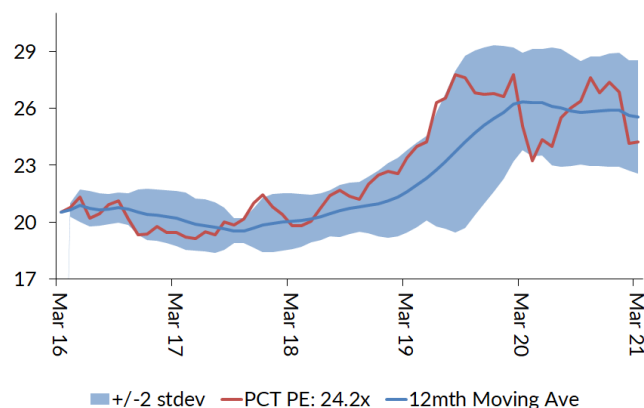
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect PCT's balance date - June)										
Precinct Properties NZ	PCT NZ	NZ\$1.70	NZ\$2,227	24.8x	24.0x	27.3x	25.0x	27.3x	25.0x	4.0%
ARGOSY PROPERTY *	ARG NZ	NZ\$1.46	NZ\$1,218	19.4x	19.7x	21.0x	19.7x	21.0x	19.7x	4.5%
GOODMAN PROPERTY TRUST *	GMT NZ	NZ\$2.24	NZ\$3,116	33.4x	33.0x	27.2x	25.9x	27.2x	25.9x	2.4%
INVESTORE *	IPL NZ	NZ\$2.07	NZ\$762	26.1x	24.0x	21.4x	19.7x	21.4x	19.7x	3.8%
KIWI PROPERTY GROUP *	KPG NZ	NZ\$1.25	NZ\$1,962	20.1x	17.9x	19.2x	17.0x	19.2x	17.0x	4.9%
ASSET PLUS *	APL NZ	NZ\$0.33	NZ\$121	16.2x	25.5x	23.0x	29.7x	23.0x	29.7x	5.5%
PROPERTY FOR INDUSTRY *	PFI NZ	NZ\$2.82	NZ\$1,415	30.8x	30.9x	25.7x	26.5x	25.7x	26.5x	2.8%
STRIDE PROPERTY *	SPG NZ	NZ\$2.20	NZ\$1,040	20.3x	20.8x	29.6x	26.5x	29.6x	26.5x	4.5%
VITAL HEALTHCARE *	VHP NZ	NZ\$2.92	NZ\$1,512	26.4x	24.8x	25.7x	23.7x	25.7x	23.7x	3.2%
Compco Average:				24.1x	24.6x	24.1x	23.6x	24.1x	23.6x	4.0%
PCT Relative:				3%	-2%	13%	6%	13%	6%	0%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (PCT) companies fiscal year end

Figure 7. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 8. One year forward PE (x)


Source: Forsyth Barr analysis

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