

Charter Hall Long WALE REIT Stapled Secs Cons of 1 DIF + 1 FSPT + 1 Finance Tr

CLW ★★★★★ A\$3.15 | +0.01 | 0.16%



Morningstar Fundamentals ⓘ

Last3.15	Fair ... -5.10	Uncer... Medium	1-Star... > 6.89	5-Star... < 3.57	Economi... None	Capital All... Standard
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Sustainability ⓘ

ESG Risk Rating Asse...	Controvers... -	Top Material ESG Issue... ESG Integration
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Investment Style -	Sector 🏠 Real Estate	Industry REIT - Diversified	Day Range 3.14 - 3.17	Year Range 3.11 - 4.75	Market C: 2.2773 B	Volume / Avg 463.6 k / 1.7 Mil	Price / Sales 10.28	Price / Book 0.56
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Morningstar's Analysis ⓘ

- Summary
- Competitors
- Bulls Say/Bears Say

Charter Hall Long WALE REIT Has Rental Growth, but Also Has Earnings Pressure Until Debt Costs Peak



Alexander Prineas
Equity Analyst

Business Strategy and Outlook | by Alexander Prineas [Updated Aug 08, 2023](#)

Charter Hall Long Wale REIT's, or CLW's, portfolio is high-quality. Liquor retailer and pub operator Endeavour Group is the largest tenant at 19% of passing income. At least four fifths of passing income comes from tenants we view as unlikely to miss a rent payment, including Endeavour Group, government agencies, Telstra, BP, Inghams, Coles, Metcash, Arnotts, Bunnings, and Westpac. External fund manager Charter Hall has a strong track record and good relationships with tenants. Continued acquisitions may have diluted CLW's portfolio, particularly as long-WALE assets have been in high demand, and thereby came with a hefty price tag. CLW has been acquisitive, buying properties and other REITs, using debt, and issuing new equity. It issued about AUD 386 million of new equity in fiscal 2019 to fund acquisitions, including various offices, a bus terminal in Eagle Farm, Brisbane, and several agricultural logistics properties from Inghams on a sale-and-leaseback arrangement. In fiscal 2020 it issued AUD 850 million of equity to purchase telco exchanges, a Brisbane office building, Telstra's Melbourne headquarters, and BP service stations in Australia. In fiscal 2021 it issued AUD 626 million of equity, using the proceeds to purchase Telstra exchanges, a portfolio of offices, and BP sites in New Zealand, taking its BP portfolio to about AUD 500 million in Australia and New Zealand. CLW issued substantial new equity every year since its 2016 listing, with the number of securities on issue tripling from about 208 million in June 2017 to 720 million at March 2022. Higher interest rates are likely to slow the group's expansion and weigh on earnings, given the group's relatively high gearing.

Economic Moat | by Alexander Prineas [Updated Aug 08, 2023](#)

We do not attribute a moat to Charter Hall Long WALE REIT, or CLW, as we don't believe significant barriers to entry exist for rivals. The REIT owns some attractive properties, and its strategy of seeking long, triple-net leases from strong tenants has been prescient. Large tenant bankruptcies faced by rivals during the pandemic were a non-issue here, plus the relentless decline in interest rates rewarded Charter Hall's long duration assets. Looking ahead though, with strong tenants sought by most landlords, it's hard to envisage such favourable tailwinds being maintained. There is little to prevent rivals from acquiring or developing similar properties, or adopting the same strategy of seeking solid, long-lease tenants.

In most of the industries Charter Hall operates in, rival properties and landlords are abundant, especially in retail, office, and industrial property. The retail and office sectors face structural demand headwinds from online retail and flexible working respectively. Industrial property has structural demand tailwinds from online retail, however, we think supply can accommodate this via multistorey and urban fringe developments, and efficiencies such as robotics reducing the required footprint for logistics property. A strong tenant book means the REIT should earn the rent and uplifts that are baked into existing lease contracts. But upon lease renewal it will be subject to market forces of supply and demand, which will be driven by economic conditions outside its control.

Ownership in property markets is almost invariably fragmented. Charter Hall is one of Australia's most dominant convenience retail owners (through CLW and other Charter Hall entities), but it controls less than 10% of that market. New convenience retail is regularly added, for example, via retail space allocated within new apartment and public transport developments. Competition from e-commerce hampers rental growth for physical retail property, including convenience retail assets, and notably, CLW's department store sites, tenanted by Myer and David Jones. The REIT is protected by long leases, but department stores are seeking to reduce space and pay less rent; dynamics that will play a part in negotiations when leases expire. CLW also owns pubs, where regulations permit small bars and online liquor delivery services. In office, even in Sydney, Australia's most concentrated market, the largest operator controls less than 20% of high-grade CBD offices. Other markets are far less concentrated, and in all markets there is a tail of small landlords. Industrial property ownership is even more fragmented than office and retail. In response to currently elevated demand, dozens of REITs and other real estate operators in Australia are currently acquiring and developing industrial property.

In the social infrastructure and agricultural logistics categories, rival sites don't always exist nearby. However, similar sites can be adapted or new assets developed. In some cases these assets are established by the tenant and purchased by Charter Hall in a sale-and-leaseback arrangement. Examples include Telstra telecommunications assets and Inghams poultry distribution facilities. The advantage of a sale-and-leaseback for Charter Hall is that it avoids development risk. However, it also means it pays market rate for a mature income stream, competing with rival property fund managers, multi-national private equity shops, and the many rival REITs that have an external management platform. Some of Charter Hall's properties have unique physical characteristics, such as proximity or connections to telecommunications nodes for the REIT's telco exchanges. However, these are a small portion of the portfolio. In any case such specialisation also comes with the risk of technological or business obsolescence. In summary, when CLW's leases expire, new rents will be governed by market supply and demand, in a competitive market environment.

Fair Value and Profit Drivers | by Alexander Prineas [Updated Aug 08, 2023](#)

Our fair value estimate for Charter Hall Long WALE REIT, or CLW, securities is AUD 5.10 per security. Our fair value is derived using a discounted cash flow valuation with a 6.9% weighted average cost of capital. Our valuation implies a forward fiscal 2023 P/E ratio of 20, and enterprise value/EBITDA ratio of 21 times.

CLW's property income over the next decade is visible given revenue is underpinned by long leases to strong tenants. Outgoings are modest due to the triple-net leases, where tenants are responsible for most costs, but interest costs are a substantial cost that could vary depending on inflation and bond markets. Our base case assumes rental growth of 2.8% over our 10-year discrete forecast period, 2.5% earnings before interest growth during our 40-year stage 2, and that total returns are equivalent to weighted average cost of capital of 6.9% during stage 3.

To accurately represent CLW's recurring cash flows, we exclude maintenance capital expenditure from operating earnings. For maintenance capital expenditure we add an allowance for costs at the end of an asset's life, for example, a sizable refurbishment or redevelopment of the entire site. This is substantially higher than maintenance capital expenditure numbers quoted, which typically only allow for day-to-day maintenance.

Risk and Uncertainty | by Alexander Prineas [Updated Aug 08, 2023](#)

Charter Hall Long WALE REIT's Morningstar Uncertainty Rating is Medium. Earnings are fairly predictable over the next decade due to the REIT's long leases to strong tenants. But CLW's look-through gearing is a high 40%, so relatively stable unleveraged earnings are amplified via financial leverage. About two thirds of our valuation is based on the stage two fade and stage three terminal value, by which time current

leases will expire. Economic and property market conditions well into the future will therefore play a part in the valuation, and the assumed discount rate is a significant swing factor in terms of valuing this REIT.

There are sources of near-term uncertainty too. It has substantial exposure to office properties, which face structural change arising from work-from-home flexibility. Even once immediate cyclical issues are resolved, hybrid working is likely to give more bargaining power to tenants, because it allows employers to inflate or deflate the amount of office space required, by adjusting the number of employees working from home. Most employers will likely have a long-term target in mind for their office requirements, but this flexibility will allow them to delay office expansions. For example, during periods of office undersupply a firm could opt to delay moving into a larger office.

CLW also has substantial exposure to retail assets. These include service station assets, which in the long run could be disrupted by a switch to electric vehicles. The sites are typically well located in dense urban areas, so we believe alternative uses could be developed for the sites in that scenario, given the long lead-time likely for substantial EV adoption.

Capital Allocation | by Alexander Prineas [Updated Aug 08, 2023](#)

We assign CLW a Standard Morningstar Capital Allocation Rating, based on a sound balance sheet, fair investment strategy and mixed views on the distribution payout.

On-balance-sheet gearing of 33% (measured by net debt to total assets) is toward the upper end of the REIT's target range of 25% to 35%. We'd prefer not to see gearing rise further given rising debt costs. Look-through gearing (including debt in underlying vehicles and JVs) was 40% as at June. 30, 2023. That's high, but CLW's balance sheet can cope thanks to a very long average lease length of over a decade, and strong tenants, most of whom we view as unlikely to miss a rent payment.

We view the investment strategy as fair. CLW's strategy of seeking strong tenants and locking them into very long leases has been prescient. It helped the REIT side-step vacancies during the pandemic, and unitholders have benefited from the relentless decline in interest rates, which favoured CLW's long-duration assets. While we applaud the REIT's adherence to its strategy, many of the purchases were executed when rates were low, and now rates are higher, putting pressure on the prices for long-duration assets. The long WALE strategy doesn't leave a lot of flexibility, meaning CLW's prospects will wax and wane with the prospects for long-duration assets.

We have mixed views on the level of distributions paid out. CLW is mainly a vehicle to collect rent on its long-lease assets and pass the income through to investors. It doesn't undertake a large amount of development. So we think it's appropriate that a high proportion of income is paid as distributions. However, we note that the REIT paid out 100% of operating earnings from fiscal 2018 to 2023. That leaves nothing for replacement or expansionary capital expenditure, which means future distributions, or growth, could be affected if capital expenditure requirements increase.

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