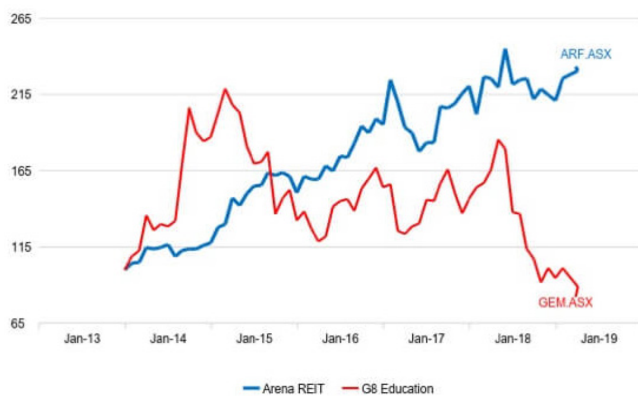
# Owning the landlord instead of the tenant

OCTOBER 2018

Here's a share price chart that may confound you. The red line below shows the share price performance of former market darling and childcare operator G8 over the past 5 years. The blue line shows the share price performance of Arena REIT (ASX:ARF) over the same period.

**Share Price Performance (Indexed)**




Source: IRESS, APN FM

The divergence, especially this calendar year is both striking and revealing, for reasons we'll soon explain.

APN's AREIT Fund took a position in ARF, a specialist owner of social infrastructure real estate with a strong bias towards childcare, five years ago. Population growth, increasing female workplace participation and government support, without exposure to the direct risks associated with a childcare operating business, made for a compelling investment.

But here's the thing: A portion of the rents accruing to ARF come from G8 Childcare. And yet that company's collapsing share price, and the sector-wide trouble it foretells, appears to have had little impact on Arena REIT's share price at all. How so?

Persistent reports of oversupply of childcare services, increased competition and changes to funding support have led to declining profitability for childcare operators. Landlords like Arena REIT, meanwhile, have continued to receive the contracted rent payable to them.

It's an important point, especially for investors that prefer the security and stability of income over a share price rollercoaster. As long as a real estate asset is supported by attractive market fundamentals and a favourable lease structure, landlords are relatively insulated from the tenant's operating performance.

The chart is a visual representation of this point. An investment in the early learning sector through landlord Arena REIT delivered to investors a total return of 23.7%[1] a year over the last five years. Investors in G8 Childcare, meanwhile, achieved 9.3% p.a., and maybe a few heart murmurs.

For income-focused investors like ourselves, the growth in ARF's distribution of 8.1%[2] p.a. is especially attractive, comparing favourably with annualised distributions from G8 falling by 3.2%. The variability of returns (measured by the standard deviation of share price performance) for Arena REIT, meanwhile, has been roughly 50%[2] lower than that of G8 over the same period. In analytical terms, that's what a good night's sleep really looks like.

There are three structural differences between landlords and tenants that contributes to the performance divergence and a peaceful rest:

## 1. Revenue certainty over uncertainty

Childcare assets offer a relatively high level of income certainty to landlords because rent is contracted and leases are usually subject to long initial terms (15+ years) with annual increases of at least CPI. Occupancy across the ARF portfolio was 100%[3] in June this year. Childcare operator revenue, on the other hand, is far more cyclical. Occupancy across the G8 portfolio of 546 early learning centres was 70.1%[3] in June this year. But each one of those centres still had to pay 100% of its rental payment.

Childcare centre landlords also lease their premises on a triple-net basis, which means the tenant is responsible for paying all (or almost) the rates, taxes, operating expenses and maintenance costs. As a result, the rental income received is a cash return.

## 2. Predictable costs over unpredictable costs

For landlords, items like business administration and interest costs, of which about 70%[4] is locked in over the next five years, are highly predictable. Childcare operator costs, however, are far more variable. Right now, childcare operator profit margins are contending with increasing maintenance and staffing costs, which can run at about 60% of total revenues. Rental costs constitute a much smaller component of total expenses for an operator (generally 10-15% of gross revenue) and are highly certain by comparison.

These factors mean childcare centre landlords enjoy a predictable cost base while the operators face a competitive market and a highly variable cost base.

## 3. Stable value over a moving target

Childcare properties are generally located in convenient, accessible locations within urban metropolitan and regional centres. That means that in the event of the operator vacating the premises alternative residential or commercial uses are available. The value of the property asset, therefore, is tangible, and can be appreciated by potential tenants from different sectors.

The value of a childcare business is subject to less tangible factors, including branding, operating efficiency and the length of the real estate lease. This last one is especially important. Much of an operator's "goodwill" is linked to its ability to conduct its business from high-quality, well located premises. That makes a long lease term critical. But the benefit also accrues to the landlord, via predictability of income and property value.

These three factors explain the divergence in performance in the above chart. What at first seems confusing is in fact entirely rational, once one understands the bigger picture.

It also makes the case for owning the landlord ahead of the tenant, especially for investors that want high income certainty with lower relative risk, while also getting exposure to a compelling investment theme.

1 Bloomberg. Past performance is not an indicator of future performance.
2 IRESS, APN FM. Past performance is not an indicator of future performance.
3 Company published information.
4 Company published information, APN FM.

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