Income that will let you sleep at night

Our investment view on SCG is that it owns the best retail portfolio in Australia and New Zealand in a sector that continues to have higher barriers to entry (for quality retail assets like SCG's) compared to other core real estate sectors such as office and industrial.

Financially, the risks are minimal. SCG has a very sustainable debt to gross assets ratio of 30.6%, with an average cost of debt of 4.25% that is expected to improve further, providing a tail wind to earnings growth. They enjoy long term debt facilities that average 4.5 years and 96% of their debt is hedged. As expected, SCG continues to offer a balance sheet that allows you to sleep well at night.

SCG's extraordinary income/tenant diversity provides high levels of earnings security. SCG's current distribution yield of 6.0% is 1.4% higher than the AREIT index average of 4.6%. It's also a staggering 5.05% higher than the Australian 10-year bond yield – an attractive return for those investors seeking relatively defensive income, backed by strong property fundamentals. At a time when a decent yield is hard to come by, APN is happy to collect income of this quality.

Key takeaways

The result showed the sustainability of the portfolio's earnings in the face of extremely difficult retail conditions and the Group's ability to deliver high quality development projects with good returns which remains unparalleled. Westfield Newmarket in Auckland ($750m) is on track for completion in the fourth quarter, with a pipeline of potential future developments of >$3b.

Pleasingly, shopping centre upgrades to enhance the retail experience and satisfy consumer needs remains a key focus. Westfield Woden in Canberra ($21m) and Westfield Doncaster in Melbourne ($30m) both underwent upgrades, with several others to follow in 2020.

Keeping shopping centres relevant is a key focus for landlords and few do it better than SCG. Over 40% (and growing) of their stores are now experienced based – meaning retailers are offering an experience that can only be consumed on site (code for "limited online competition"). This is a sound management strategy that the market is currently not recognising.

The changing mix of retail tenants has been occurring at Westfield centres for decades. The emergence of online shopping is requiring retail landlords to make a step change in positioning their centres. Dining, entertainment, health, fitness, education and beauty services are now the on-trend retail categories which are attracting shoppers to centres. Few managers have the management expertise and capital to keep ahead of these trends like SCG.

Looking at some of the key metrics SCG provided for the half year:

- Funds From Operations (FFO) was up 3.0%. This is forecast to grow 0.7% for the full year due to the impact of first half asset sales – 50% of Westfield Burwood in Sydney for $575m, at a 4% premium to book value and the $1.52b sale of its Sydney CBD office towers. Excluding the impact of these sales would result in forecast FFO growth of 3.0% for the full year to Dec 19.
- SCG has announced a buy-back of up to $800m of securities which should have a positive impact on earnings, especially considering the stock is currently trading at $3.84, a 14% discount to its NTA of $4.49. The AREIT sector currently trades at a 50% premium to NTA, with is primarily a function of Charter Hall and Goodman Group which are trading at around 200% premiums to NTA! Clearly there is value in SCG.
- Comparable Net Operating Income (NOI) growth of 2.3%. This is down from 2.5% a year ago but is not a surprise, with SCG's leases generally having annual rent growth determined by a mix of CPI and fixed increments. Obviously, CPI has been falling and it remains an extremely tough environment for the retail sector. Domestic and global economic uncertainty, low wages growth and weak residential sentiment has been weighing on consumers' willingness to spend for some time. A stabilising residential market combined with tax cuts and low interest rates could be a catalyst for an improvement in retail sales, but this will take time to play out.
- Portfolio occupancy 99.3%. Pleasingly this is the same level as FY18 but has historically been 99.5%. It highlights management's focus on leasing and retailers desire to be a Westfield Shopping Centre tenant. 118 new brands were introduced to the portfolio over the half, with 117 existing retailers increasing their store network. These are good signs that quality shopping centres have a place in the retail landscape.
- Total annual sales $24.2b, up $1.2b or 5.2%. This metric reflects the quality of SCG's portfolio, with most centres being destinations that dominate their catchment area. Over 65% of the population live within a 30-minute drive of the 41 centres SCG owns across Australia and

New Zealand. These centres attracted over 535 million customer visits, capturing more than 7% of all retail sales in Australia. There is no other retail landlord that matches this level of penetration in Australia.

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