Newgate

NEWGATE REAL ESTATE AND INFRASTRUCTURE FUND
NEWSLETTER

MARCH QUARTER 2020

The Newgate Real Estate and Infrastructure Fund takes long and short positions in listed securities exposed to assets such as office and industrial real estate, residential development, retail shopping centres, healthcare, airports, ports, toll roads, rail and utilities and technologies associated with these sectors

"If you think you know what is going on, you don't understand the situation very well"

Charlie Munger, Berkshire Hathaway

"Our fears are always more numerous than our dangers."

Lucius s Seneca, Roman Philosopher

Our brains are wired in such a way that we are naturally highly receptive to risks.

Anthropological history would argue this is because our ancestors were always on the lookout for predators, since their chances of being killed by animals or other human beings were once very high. A portion of the brain screens everything for negative news.

Therefore, humans are wired to pay ten times more attention to negative news than positive news."

Wolfgang Fengler, German Economist

Sector Performance

The real estate and infrastructure sector experienced a terrible quarter, **falling nearly 40%.** This rapid decline was as dreadful as anything we saw during the global financial crisis. The sector performed worse than the broader equities market, which **declined approximately 30%.**

This decline was driven by a major demand side shock. The measures taken to contain Covid:19 is expected to see **a contraction of 5-7% in Australian GDP.**

FUND PERFORMANCE AS AT 31st March 2020

TIME PERIOD	RETURN (NET)
3 month return	-23.0%
12 Month return	-24.0%
Since Inception*	4.8% p.a
Cumulative Return	36.1%
Liquidity profile	>$1bn (40%), $500mn-$1 billion (16%), (< $500mn (30%), Cash (10%)

* Net return is before taxes, but after management fees and transaction costs, income reinvested. Inception 1 July 2013. Past performance is not necessarily indicative of future performance. Investments can go up and down.

AVERAGE FUND STATISTICS

STATUS	MOVEMENT
Number of Positions:	16 positions + cash
Net Position:	98% (longs less shorts)
Total Long Positions:	98%
Total Short Positions:	0%
Gross Exposure:	98% (longs plus shorts)

NOTABLE STOCK CONTRIBUTIONS

POSITIVE CONTRIBUTORS	NEGATIVE CONTRIBUTORS
Updater (UPD)	Vicinity Centres (VCX)
	Charter Hall REIT (CLW)
	SCA Property Group (SCP)
	Sydney Airports (SYD)

Source: Newgate Investment Management

Sector Performance

In response the RBA has cut cash rates to record lows of 0.25%. The Government is also stimulating the economy, **spending 10% of GDP**. For context, a normal annual Government deficit would be 1-2% - so the stimulus is extremely large.

This stimulus will soften the blow, but **Australia will still experience a recession**, the ***first in thirty years***.

More importantly, the psychological shock to households may take some years to fade. How long will it take for spending to resume to previous levels? What will spending patterns look like? What will happen to the saving rate?

One of the major issues that will stem from the Covid:19 shock is the Government's view on **immigration.**

Population growth has been a major factor driving Australia's GDP growth over the past three years. Apart from the annual migrant intake of about 100,000, there are **1.4 million temporary workers i**n Australia – about **10% of the workforce.**

The Government relies on immigration to support GDP. They were relying on more than 800,000 new immigrants over the next three years. But because of Covid:19 It is estimated that 300,000 tourists, temporary workers and students have already departed this year.

To put this figure into perspective, over 2019 Australia's population grew by 371,000 people, or 1.5% - of which about **60% were overseas migrants.**

Any decline in population growth will have a significant impact on the economy- especially on the residential market.

Leverage is an emerging issue

The global financial crisis was a result of a mild economic downturn amplified by too much debt.

This current situation is no different, except it is a **severe** economic downturn, amplified by too much of debt. The outcome is much the same.

Debt levels globally remain high. The chase for yield over the past decade has seen large amounts of capital flow into debt products. For example, the **total consumer debt in the USA is now higher than 2008**. US Consumer debt is currently 19% of GDP compared to 17.5% before the global financial crisis. (Source: 13D)

Despite real estate and infrastructure companies having much lower levels of debt prior to the global financial crisis, the extent of this demand shock offsets that hard-won benefit.

Across the board in real estate, we expect to see a reduction in rents, increased vacancy, and ultimately asset values to fall.

The real estate securities market is already factoring in a fall in asset values of 10-30%, depending on sector. This is causing some owners of real estate to become over-leveraged.

Example of how asset values falling impacts leverage

To illustrate the leverage problem by an example, we review the debt position of shopping centre owner Vicinity Centres (VCX).

Leverage is generally measured as debt to total asset value.

The share price of Vicinity Centres (VCX) has nearly halved over the past few months. The market is factoring in a 30-40% reduction in asset prices. The below table shows what this reduction in asset values does to VCX's leverage level,

Vicinity Centres (VCX)

Market Capitalisation:	$5.0 billion (was nearly $10 billion two months ago)
Debt Level:	$4.4 billion
Implied Total Asset Value:	$9.4 billion (market capitalisation plus debt)
Debt to Total Assets:	47% (VCX's covenant is 50%)

VCX had a development pipeline of $3.2 billion, with them contributing $1.8 billion. They have deferred these development plans. We would expect VCX to raise up to $1 billion to repair their balance sheet.

RESEARCH NOTE

Fund Performance

The Newgate Real Estate and Infrastructure Fund did not avoid the sell-off, delivering a disappointing quarter. After the sector had fallen 20%, we moved to a reasonably long position on the back of extreme valuation support.

We bought positions in **Charter Hall Long WALE REIT (CLW**), **Viva REIT (VVR),** and some assets that appeared excellent value on a medium-term basis, for example **Sydney Airports (SYD).**

We concede we moved to early. We did not anticipate the severity of the Government response to Covid:19, nor that they would interfere with **property rights.**

In some cases, governments have set out that landlords must provide rent reductions in proportion to the reduction in the tenant's business revenue attributable to Covid-19. This is an invasion of property rights normally only seen during times of war or a national threat. Which is clearly how this virus is being perceived.

Property Rights - Background

It is abnormal for the Government to breach property law rights. The common law has long regarded a person's property rights as fundamental. The importance of property rights in the West was first recorded over 800 years ago at Magna Carta in 1215.

Famous English judge William Blackstone said in 1773:

'There is nothing which so generally strikes the imagination, and engages the affections of the individual, as the right of property'

Property rights are enshrined in Section 51 of the Australian constitution. It states that the Government can appropriate property, but only on "just terms". The question of what constitutes 'just terms' is the grey area.

"The Parliament has to the power to make laws with respect to the acquisition of property on just terms from any person for any purposes"

Regardless, the Australian government has altered property rights, which was unexpected. As a result, the real estate and infrastructure sectors have been hit hard.

RESEARCH NOTE

The recovery

The recovery will likely take 12-24 months, and some REITs will need to recapitalise their balance sheet. This recession will hit different asset classes in different ways.

Office real estate

Office real estate will experience the initial impacts of a recession – with demand falling due to weaker economic conditions. The market is heading towards factoring in vacancy rates of 10%. Vacancy rates of between 5% and 10% is considered a market in equilibrium. As vacancy rates increase over 10%, rents fall and so do capital values. It is conceivable that office asset values fall by 15-20%.

The medium-term question is structural. Will the demand for space naturally decline as the population has become more adept at using technology to work remotely? We are already seeing major corporates begin to make decisions around utilising 'working from home'.
It is highly likely coworking spaces will empty as more workers stay at home after the outbreak.
The much-vaunted company WeWork is unlikely to survive 2020. WeWork is an American commercial real estate company that provides shared workspaces for start-ups and services for other enterprises. The co-working giant has been valued as high as $US47 billion – but burns billions each year in cash and is nearly out. Its funders refuse to put more capital into the enterprise.

RESEARCH NOTE

The residential market

The greatest question is what happens to the Australian residential market. This is the largest asset class in the country, dwarfing the equities market and commercial real estate sector.
We have written at length at how precarious the residential market appears – with the market value of residential real estate at a record premium to average household incomes. The median price of a house in Australia twenty years ago was four times household income, it is now seven times (Source: ABS, CoreLogic)

The residential market has been held up by significant population growth, with the government boosting Gross Domestic Product by immigration. This has indeed supported the housing market but is has been at the expense of stagnant Australian wages, which the working population are starting to become unsettled about.
The domestic population has not worried about high immigration levels historically, but we expect this may change as we societies recover from Covidl:19. Australia's natural population growth is generally about 0.6% per annum, with immigration over the past 10 years lifting it to 1.5% per annum (ABS).

Clearly, any change to immigration policy will have a major impact on demand for housing.
The other mechanism for causing issues with the housing market is the economy. High unemployment may cause an increase in household size (spare rooms filling up) which can have an enormous leverage on demand for rental properties, causing rents to decline. This can then flow through to house prices.

The average household size in Australia is approximately 2.5 people (Source: ABS), in the USA it is 3.1. Average household size in Australia was 4.5 people in 1910.

There are about 10 million households in Australia. If we assume an increase to 2.6 people per household, there is only a requirement for only 9.6 million households. The demand for housing in the short to medium term could be severely impacted if this form of thrifting occurs. For context, the Australian building industry produces about 200,000 homes per annum.

If residential landlords are unable to lease their property up and they have leverage against this property they could be forced into selling. This potential risk is reduced by the Government ensuring banks cooperate and provide leniency to landlords. In turn landlords are being asked to provide leniency to tenants. Nonetheless, forced selling remains a potential risk.

The key variable to watch is credit growth. History shows that when credit growth turns negative, the value of residential properties likely follows. The Australian recession will be materially worse if Covd:19 contracts the pool of credit and causes an Australian housing crisis.

RESEARCH NOTE

Industrial Market

The industrial market may perform well over the medium to long term. Ecommerce was already driving strong demand for industrial space, with ecommerce tenants requiring up to three times more space than traditional tenants due to robotics and automation. This trend should continue, if not accelerate from here.

Added to this dynamic is the likelihood that Governments are likely to deglobalise. This may see more manufacturing and logistics occur domestically, potentially increasing demand for industrial real estate. This is very much the potential case, given the reliance Australia has on offshore manufacturing. Western countries are highly likely to reduce reliance on China.

Retail

Retail landlords have been the hardest hit, with foot traffic down and some retailers either shutting their stores down or refusing to pay rent. The outlook for large scale shopping centres appears difficult. A quick recovery is highly unlikely.

Shopping centres have been implementing restaurants, food, and beverage into their centres to offset the negative impacts of ecommerce. Global restaurant booking cancellation went from 2% in March 2020, to 100% by the end of the month (OpenTable).

We have written extensively about our concerns about bricks and mortar retail. These concerns are only amplified as Ecommerce trends accelerate from here.

Some major shopping centre are going to experience leverage issues. With implied leverage much higher than 'book leverage'. We have highlighted the issues with Vicinity Centres (VCX).

RESEARCH NOTE

Student Housing

Growing university campuses in Australia was excessive for the past decade, with international students using universities in Australia not just for an education, but also a pathway to residency in Australia.
Now, universities across the country are closed and students and parents are seeking room and board refunds. Student housing managers rely on student levels. If immigration is reduced, or simply population mobility impaired, then universities and in turn student accommodation will suffer.

Childcare Sector

The childcare sector has been perceived historically as one of the least risky of all real estate asset classes.

It was always prone somewhat to higher unemployment – with one parent at home to take care. But the market supposed that the trend to both parents working as well has the high level of government subsidy to encourage it – would ensure demand remained relatively stable.

To highlight the way in which Covid:19 can drastically alter risk, we have undertaken a research piece on Charter Hall Social Infrastructure Fund (CQE), which mainly owns childcare centres across Australia.

RESEARCH NOTE

Charter Hall Social Infrastructure Fund (CQE)

The childcare sector has been hit particularly hard. To highlight the difficulty, we review Charter Hall Social Infrastructure Fund (CQE). CQE an ASX listed REIT that invests primarily in childcare centres

Key details	
Shares on issue:	302 million
Current Share Price:	$1.50
Current Book Value:	$3.05
Book value cap rate:	6.3%
Implied Book rate:	8.5%
Market Capitalisation:	$500 million
Trading Volume:	$1-$2 million per day
Number of properties:	420
Portfolio Valuation:	$1.3 billion
Occupancy:	99.8%
Weighted Average Lease Expiry:	11.7 years
Current running yield circa:	9.5% (guidance withdrawn)


CQE Centre, Highett, VIC

Location	Properties	Value ($ million)	% of portfolio	Passing yield
NSW	78	$230	22.0%	5.6%
QLD	121	$346	33.1%	6.0%
VIC	68	$269	25.8%	5.6%
SA	23	$63	6.0%	6.4%
WA	18	$49	4.7%	6.4%
TAS	4	$9	0.9%	6.0%
NZ	46	$77	7.4%	6.0%
Total Freehold		$1,043		
Leasehold Properties		$34		
Developments		$104		
Total Value of Real Estate		**$1,181**		

Situation

Real estate exposed to the childcare industry has been considered some of the safest from income volatility perspective.

Leases are triple net and twenty years in length, the revenue is 50-75% backed by government subsidies and occupancies are generally 90%+. The listed childcare operators CQE and Arena REIT (ARF) is low. The lack of income volatility is illustrated by CQE's twelve-year rental income profile below:

Leverage

CQE has $180 million of undrawn debt capacity to fund existing property acquisitions of $46 million and their future development pipeline ($73 million).

There are no debt maturities until February 2023, weighted average debt maturity is 4.3 years. The all-in cost of debt is 4.1% with a hedge maturity of 3.9 years.

Goldman Sachs note that CQE has funding capacity to meet its interest payment obligations for 32 months, while Arena REIT (ARF) is 85 months.

The Future

The impact of Covid-19 and the associated isolation demands are impacting the operators of childcare centres severely. It is highly likely that many of these operators will be unable to make rental payments.

The isolation demands so far do not include childcare, but this should be expected to change. In any case, parents may decide to keep their children at home without a government dictate.

"The industry body, the Australian Childcare Alliance, suggests that there had been anywhere between 15 and 50 per cent drop in occupancy, with some childcare operators experiencing a 90% drop in occupancy"

ABC News, 26th March 2020

Childcare centres across the country are closing, with one industry body saying the number of children being pulled out of care due to the threat of COVID-19 is "startling".

There may be some government support, but this is unlikely to be enough to stem solvency issues for operators.

Anecdotal feedback suggests operators are trying to get rent relief from the Government. They are vying for the government to pay half of the rental liability, while they pay the other half.

"Grants ranging from $10,000 to $50,000 are available for childcare providers through the Community Child Care Special Circumstances Fund to help cover business costs, including wages, to ensure services impacted by COVID-19 can continue to operate."

ABC News, 26th March 2020

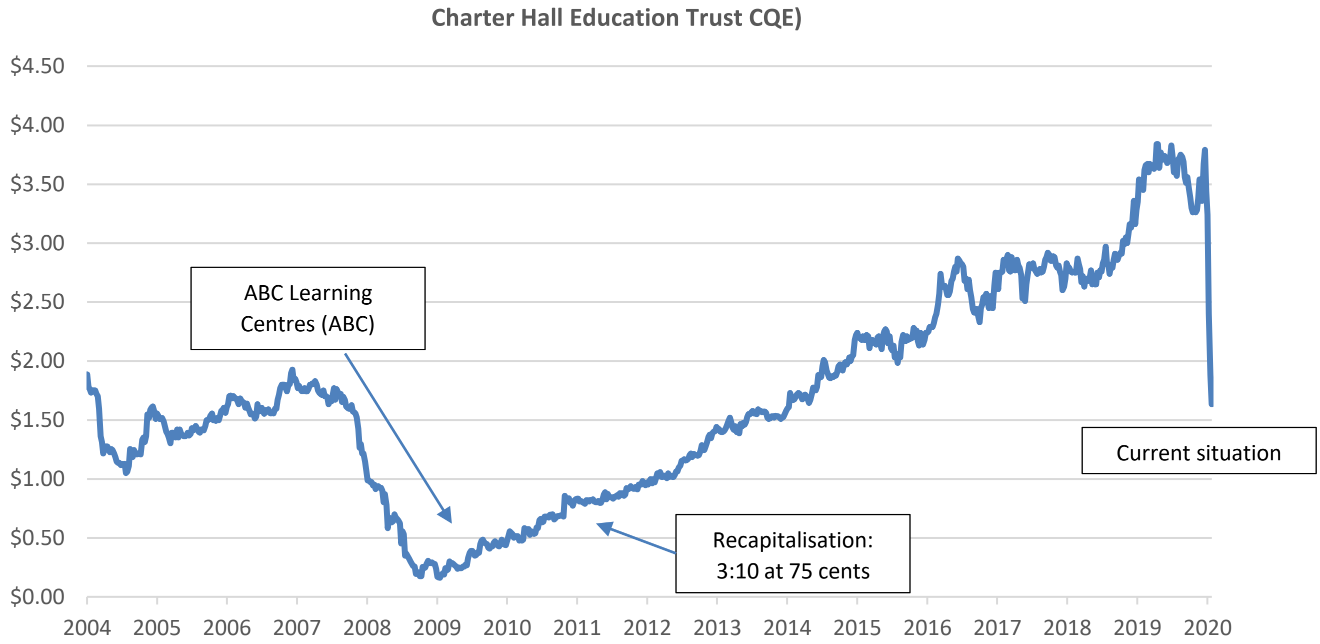
There is a high likelihood that several tenants (childcare operators) of childcare centre owners will become insolvent - unable to survive the occupancy hiatus. Not only do operators have rent commitments, the average operator is leveraged 30%.

Most landlords seek a six-month bank guarantee. So, landlords have some time before rental risk manifests itself. This is assuming no change to government dictate. The Government is using broad powers now, which are extreme enough to push into property rights.

RESEARCH NOTE

Recent share price reaction

This chart illustrates what happened last time there was an issue with a tenant. From 2004 to 2009, CQE was known as Australian Education Trust (AEU). It owned about 400 centres at this stage. By 30th June 2009, 360 of its centres were under the control of McGrath Nichol.



The last time this CQE experienced a condition like this was when major tenant, ABC Learning Centres went into voluntary liquidation in 2008. ABC was ultimately purchased by not for profit operator, Goodstart, which still represents circa 50% of CQE's tenant base.

The key is that if a tenant cannot pay, it can be evicted and replaced by another well capitalised tenant – possibly at higher rates. The tenant cannot operate its business without the real estate. Alternatively, the property could be sold to a residential developer if it is deemed a higher and better use.

Tenant Case

While the majority of CQE's tenants are high quality. For example, CQE's tenant base is 50% Goodstart, a not-for-profit organisation operating 644 childcare centres nationwide. Another 25% of their tenant base appear to be reasonably well capitalised operations.

The issue is the **25% of the tenancy base** are single centre and semi-professional operators that may fall into operational difficulty and may become insolvent.

But if occupancy falls due to social isolation, tenants move quickly into loss making territory. Further amplifying this issue is that tenants have often used debt to purchase the childcare operating business.

G8 Education (GEM)

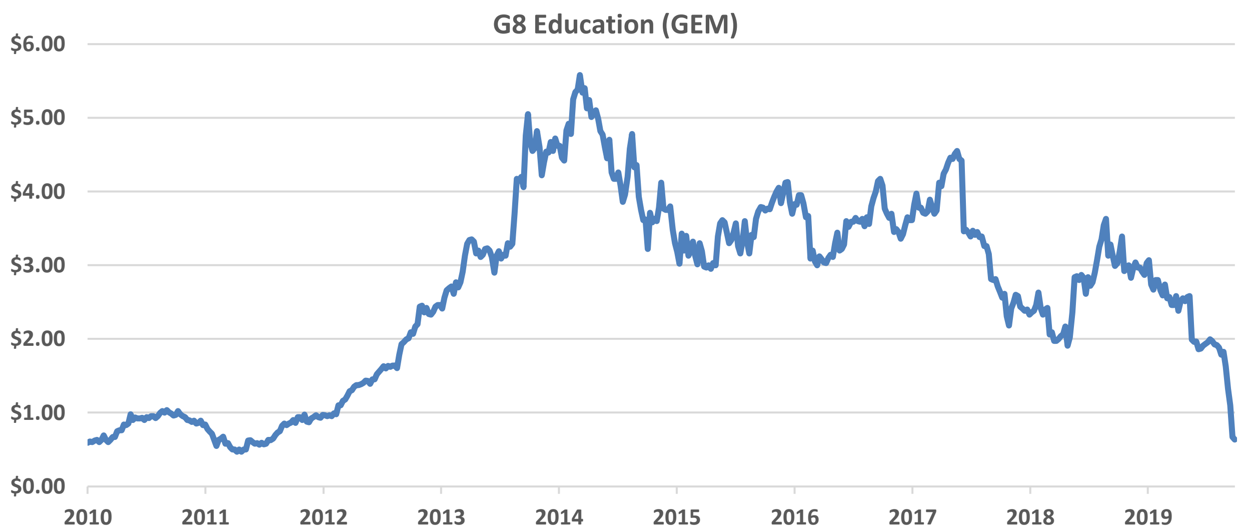
GEM operates 475 childcare centres in Australia and 17 in Singapore. These centres provide a total combined licensed capacity of more than 40,000 places.

The company's primary costs are Employment (55% of total revenue), occupancy (10% of total revenue) and interest expense (10% of total revenue)

Their balance sheet comprises $2 billion of assets - $600 million from (right of use of childcare centre assets) and $1.2 billion of goodwill. On the liability side, the company owes $390 million to financiers and has $640 million in lease liabilities.

Total liabilities are $1.2 billion versus total assets of $2 billion, leverage of over 60%.

The current market capitalisation is $290 million – which holds up $390 million in debt, and $640 million in lease commitments.



FUND PROFILE	
Fund Inception	1 July 2013
Trustee:	Equity Trustees Limited ABN 46 004 031 298, AFSL 240975
Fund Manager:	Newgate Investment Management ABN 63 613 481 968
Administrator	Mainstream BPO
Custodian:	Mainstream BPO, JPMorgan
Auditors and Tax	PricewaterhouseCoopers
Legal:	DLA Piper, CNM Legal
Regulator:	Australian Securities and Investment Commission (ASIC)

IMPORTANT DISCLAIMER

Equity Trustees Limited ("Equity Trustees") (ABN 46 004 031 298), AFSL 240975, is the Responsible Entity for the Newgate Real Estate and Infrastructure Fund. Equity Trustees is a subsidiary of EQT Holdings Limited (ABN 22 607 797 615), a publicly listed company on the Australian Securities Exchange (ASX: EQT).

This report has been prepared by Newgate Investment Management Pty Ltd (ABN 63 613 481 968), to provide you with general information only. In preparing this, we did not take into account the investment objectives, financial situation or particular needs of any particular person. It is not intended to take the place of professional advice and you should not take action on specific issues in reliance on this information. Neither Newgate Investment Management, Equity Trustees nor any of its related parties, their employees or directors, provide and warranty of accuracy or reliability in relation to such information or accepts any liability to any person who relies on it. Past performance should not be taken as an indicator of future performance. You should obtain a copy of the Product Disclosure Statement before making a decision about whether to invest in this product.

This document has been prepared without consideration of any specific client's financial situation, particular needs and investment objectives, you should consult your investment adviser before any investment decision is made. While this document is based on the information from sources which are considered reliable, Newgate Investment Management Pty Ltd, its associated entities, directors, employees and consultants do not represent, warrant or guarantee, expressly or impliedly, that the information contained in this document is complete or accurate. Nor does Newgate Investment Management Pty Ltd accept any responsibility to inform you of any matter that subsequently comes to its notice, which may affect any of the information contained in this document. This document is a private communication to clients and is not intended for public circulation or for the use of any third party, without the prior approval of Newgate Investment Management Pty Ltd. This is general securities advice only and does not constitute advice to any person.

Disclosure of Interest: Newgate Investment Management Pty Ltd, Newgate Capital Partners Pty Ltd and its associates may hold shares in the companies recommended.

The individual fund performance figures are based on an investment in the Fund's June 2013 Series made on July 1st, 2013, the date of the Funds' inception. The performance numbers are based on the net asset value of the Fund and are calculated net of management fees, brokerage commissions, administrative expenses, and accrued performance allocation, if any, and include the reinvestment of all dividends, interest, new issue income or loss, and capital gains. Certain information provided herein is based on third-party sources, which information, although believed to be accurate, has not been independently verified. The Firm assumes no liability for errors and omissions in the information contained herein. This report is for informational purposes only and may not be reproduced or distributed without the prior consent of the Firm.

Volatility is calculated by using the annualised standard deviation of monthly returns since inception of Newgate Real Estate and Infrastructure Fund. Standard deviation measures the distribution of returns around the mean return. Low standard deviations reflect low variation in monthly results; higher variability is usually interpreted as higher risk. Standard deviations are based on monthly results, and then annualised. The Sharpe Ratio is the ratio of "excess return" to volatility. Excess return is defined as the annualised rate of return less the risk-free rate, using monthly returns since inception. The volatility measure is the annualised standard deviation of monthly excess returns since inception.

Any investment in the Funds is speculative and involves substantial risk, including the risk of losing all or substantially all such investment. No representation is made that the Funds will or are likely to achieve their objective, that any investor will or is likely to achieve results comparable to the estimated performance shown, will make any profit at all or will be able to avoid incurring substantial losses.

Past performance is not necessarily indicative of future results. Comparisons of the performance of actively managed accounts such as the Funds with passive securities indices involved material inherent limitations. Performance estimates are presented only as of the date referenced above and may have changed materially since such date.