CELEBRATING 20 YEARS
BKI INVESTMENT COMPANY LIMITED

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ABN: 89 615 320 262

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CONTACT ASSET MANAGEMENT

BKI is managed by Contact Asset Management
AFSL 494045

QUARTERLY REPORT

REITs – Are we at Peak Pessimism?

Welcome to the 40th edition of the BKI Quarterly Report, prepared by Contact Asset Management ("Contact").

This month marks the 20th anniversary of BKI Investment Company. We are proud of the performance of BKI over the past two decades and expand on this below.

We have increased our exposure to the Real Estate sector in recent months, having followed the sector closely for some time. In the December 2022 BKI Quarterly Report: *"REIT's – The Other Listed Investment Company",* we highlighted the need for caution in much of the sector, particularly those companies with excess leverage. In calendar year 2023 to date, REITs (Real Estate Investment Trusts) have underperformed the broader market marginally. With much of the sector trading at massive discounts to asset backing, we believe compelling investment opportunities are emerging. While there is bifurcation, the Office sector provides an interesting case study highlighting the degree to which the REITs sector has been shunned by investors. In this Quarterly Report, we also discuss the relationship between Interest Rates and REIT sector performance and outline the investment case on a new holding in the portfolio.

20th Anniversary of BKI

At 11 a.m. on Friday the 12th of December 2003, BKI commenced trading on the ASX. The IPO of shares by BKI (formally Brickworks Investment Company), closed with an underwritten amount of $120m. These funds were used to buy the investment portfolio that was held on the Brickworks Limited (ASX:BKW) Balance Sheet. BKW initially maintained a c.25% holding in BKI and the initial market capitalisation was $171 million.

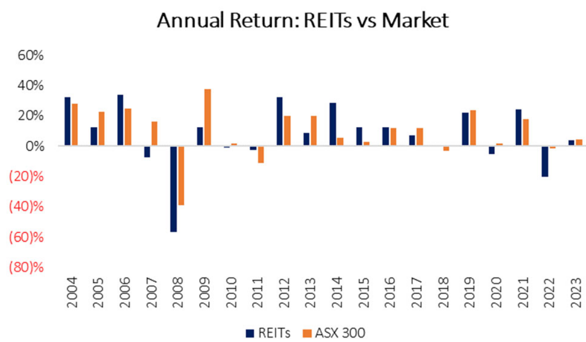
Over the past 20 years, we are proud of several notable achievements:

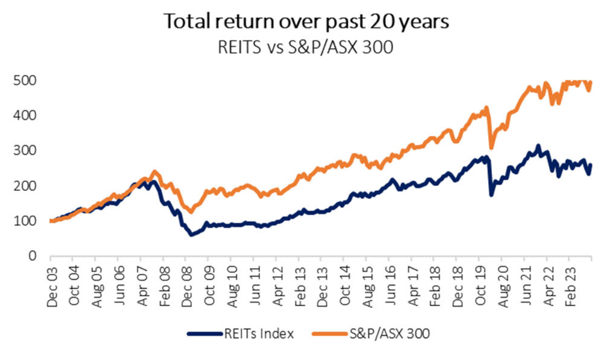
- Growth: Total Assets have grown from $171 million to $1.4 billion. In addition to growing the core investment portfolio, we have been successful in executing various corporate actions and capital raisings.
- Income: Total Dividends and franking credits paid to shareholders over the past 20 years totals $983 million. BKI has paid 11 fully franked special dividends and BKI's grossed-up dividend yield has averaged 6.8% since we began paying a dividend in August 2004.
- Shareholder returns: A $1.00 BKI share held at IPO is now worth $6.46, assuming all dividends were reinvested, and the full benefit of franking credits was utilised.
- Low fees: Our Management Expense Ratio (MER) has reduced from a peak of 0.71% in 2005 to 0.18% in 2023. The company has never charged an external portfolio performance fee.
- Endorsement: BKI has a Recommended rating from Lonsec Research, which indicates that Lonsec has strong conviction that BKI can generate risk-adjusted returns in line with relevant objectives.

REITs have the tendency to be cyclical

We've seen a few cycles during the 20-year history of BKI, and the REITs have been among the most volatile asset class. The defining event impacting the sector was the Global Financial Crisis (GFC). As depicted below, REITs have never really regained the relative value they lost compared to the broader market. The GFC led to a sharp decline in property values worldwide and Australia was not immune. The commercial property market including office buildings, retail spaces and industrial properties, experienced a decline in valuations as demand weakened and financing became more challenging.

During the GFC, to preserve cash and strengthen their financial positions, many Australian REITs were forced to cut or suspend dividend distributions. This was a significant concern for income-focused investors who had traditionally relied on REITs for relatively stable and high dividend yields. This has been one reason why BKI has traditionally been underweight the Real Estate sector. Experience has taught us that if Balance Sheets are stretched, often the first thing to be cut is the dividend.





Source: Factset, Contact Asset Management

We believe that underperformance of the REIT sector in certain periods can be attributed to specific circumstances. Here are some common reasons why REITs may underperform:

Interest Rate Sensitivity: REITs are often sensitive to changes in interest rates. When interest rates rise, the cost of borrowing for real estate companies may increase, potentially leading to higher expenses and lower profitability. Rising 10-year bond yields can impact the capitalisation rate and thus the valuations.

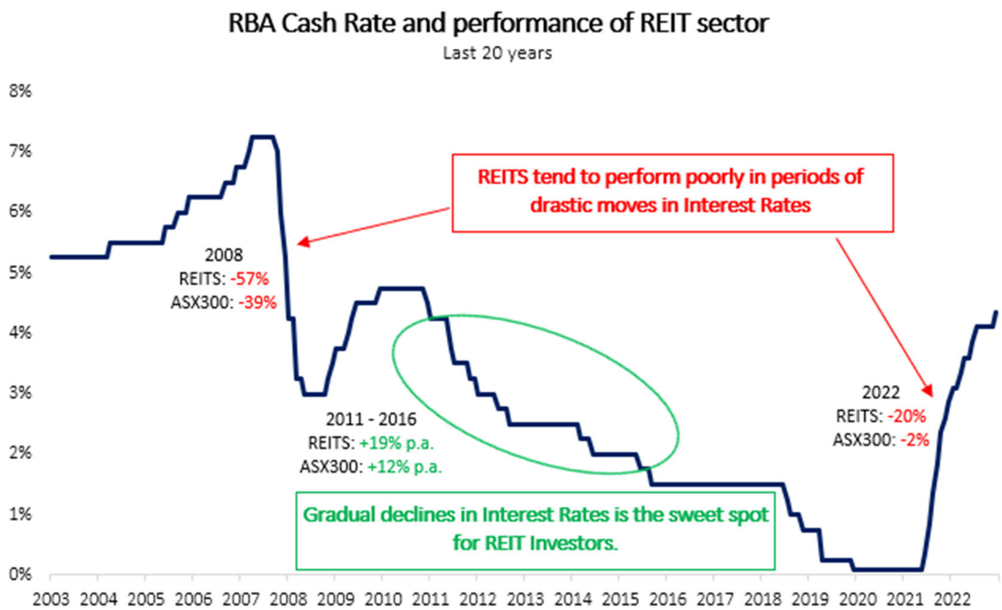
Economic Downturns: REITs, particularly those focused on sectors like commercial real estate, can be vulnerable during economic downturns. A slowdown in economic activity can lead to reduced demand for office space, retail spaces, and other commercial properties, affecting rental income and values.

High Valuations: Like any other asset class, if REITs become overvalued, they may be prone to corrections. Investors become concerned about the sustainability of rental income or property values. As it stands, the Australian REIT market has gone through ten years of cap rate compression, which has led to excessive valuations in certain real estate sub-sectors.

Leverage Risks: Many real estate companies use debt to finance property acquisitions and developments. While leverage can enhance returns in a rising market, it also amplifies losses during market downturns. High levels of debt and unfavourable financing terms can increase the vulnerability of REITs.

Supply and Demand Dynamics: Oversupply of real estate markets can lead to lower occupancy rates and reduced rental income. This oversupply issue is particularly relevant in the commercial real estate sector, where an excess of office, retail, or industrial space can negatively impact values and rental rates.

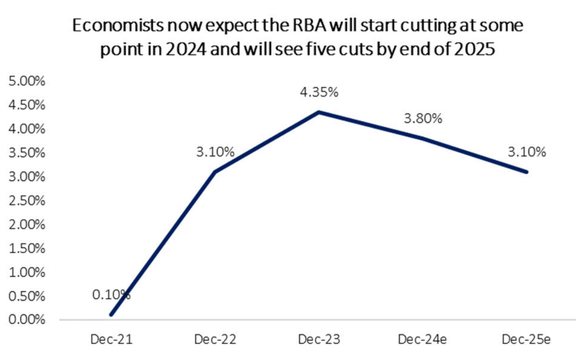
Of the list above, the sensitivity to rates is the big one. Markets hate uncertainty. Global REITs have underperformed on global interest rate worries and the consequent implications for valuations and yields. Again, if we look back over twenty years, we see some interesting patterns. REITs don't just underperform when rates increase. It seems to be that the velocity of the change in rates and the prevailing uncertainty are bigger concerns. The sweet spot seems to be a gradual and orderly decline in Central Bank rates.

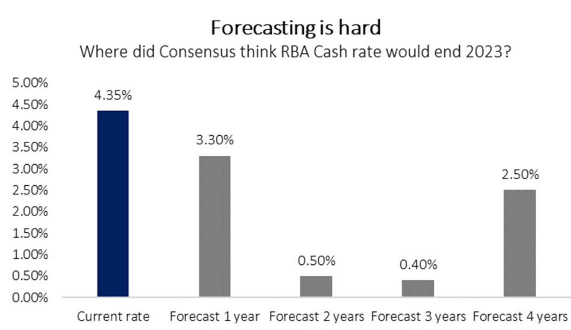


Source: Factset, Contact Asset Management

If we see a gradual decline in rates, then REITs are likely a Buy.

Economists now predict that we are likely at peak rates (or very close to it). If the economists are right and rates start to gradually decline in an orderly manner (two big ifs!), then REITs are likely a Buy. The following chart highlights the current consensus estimates of where rates will be at the end of calendar year 2024 and 2025. However, take this with a grain of salt. Two years ago, that same consensus said that the RBA Cash Rate would be 0.50% in December 2023. It is 4.35%. Forecasting is hard.



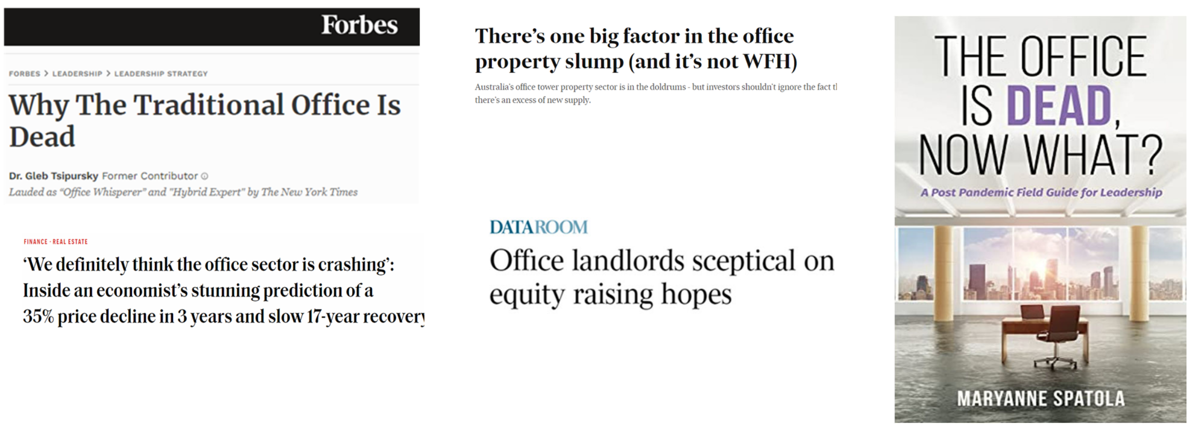


Source: Factset, Contact Asset Management

The Office Market provides an insight into how much REITs have been shunned.

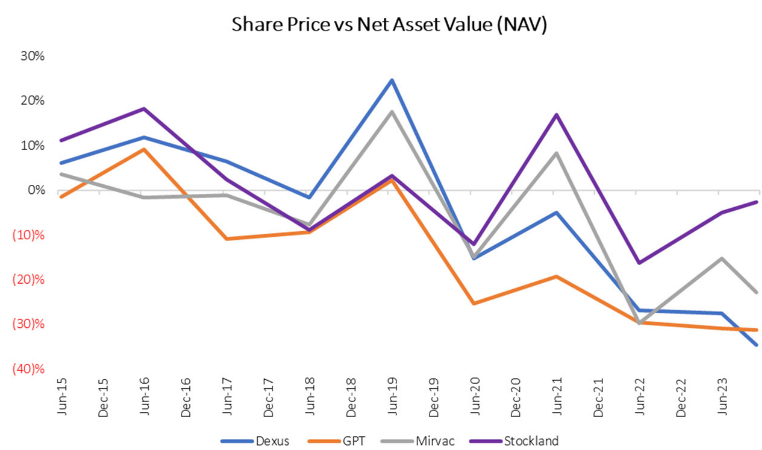
Office REITs and those with a substantial allocation to office properties have felt the negativity more than the broader REIT sector. COVID obviously had a huge impact of the potential ways we can work. Employees have embraced the option of a hybrid workspace and this combination of work-from-home / time in the office could potentially mean that the world will need less office space. This has led to investors showing caution towards Office REITs, so they are trade at larger discounts to NTA.

However, we would argue that some of the headlines associated with the negativity around Office are extreme.



Source: All the above Headlines appeared between July and November 2023 in various publications including the AFR, The Australian, Forbes and Fortune Magazine

This negativity has translated into the REITs (with Office exposure) trading at discounts to Net Asset Value as illustrated in the following chart.



Source: Factset, Contact Asset Management

We do not dispute that there is still valuation risk to property assets. It is plausible that revaluations in December 2023 will be worse than June 2023. The big worry is for those REITs that are overly leveraged. If assets are devalued and gearing ratios start to breach covenants, we could see a series of highly discounted rights issues, which would be disastrous for the sector. However, many REITs have robust Balance Sheets and high-quality

assets are arguably very compelling at current prices (discounts). In fact, while B-grade Office is struggling, there are assets being traded at reasonable prices. For example;

> Mirvac AGM*: "We have now settled on the 60 Margaret Street and the MetCentre in Sydney, which sold for $389 million in line with our June value book value. The sale of these assets also improves the quality of our office portfolio, which is now 98% weighted to prime grade assets."*
>
> From AFR 4 October: *"The acquisition of the 19-storey building at 1 Nicholson Street from a Charter Hall-run fund was struck below its book value. Charter Hall has not disclosed the size of what is understood to be a single-digit percentage-point discount."*

We recently added Mirvac to the BKI Portfolio

We have increased our exposure to the Real Estate sector in recent months, having followed the sector closely for some time. We have held long-standing positions in Goodman Group (GMG) and Stockland Group (SGR). We have added to Stockland and established a new position in Mirvac Group (MGR).

As highlighted above, Mirvac continues to trade at a substantial discount to its asset backing. Importantly, the business is diversified beyond Office. It has significant exposure to Residential, Retail and Industrial and is now targeting growth through the emerging Build to Rent (BTR) asset class.

As detailed at a recent Mirvac Investor Day, there is a big opportunity BTR given the addressable market opportunity. In the US, BTR accounts for 12% of all housing stock, while Australia is only 0.4%. It is immature domestically, with only 13 assets available. It is not beyond the realms of possibility for this asset class to surpass Office, Retail and Industrial based on only 3% penetration into the market. MGR has pioneered the BTR sector in Australia and been going for 6 years now. There are no other listed REITS within the space.

Beyond BTR, there are some enormous tailwinds for Mirvac's residential business, which has always had a great reputation for quality. Now, with record migration and a looming housing shortage, MGR is well positioned.

Source: Mirvac Living Sector Investor Day 2023

The chart above shows historical dwelling completions and targets (blue stacks), the dark blue dotted line is what is actually required to hit the 1.2 million required dwellings! To put this in perspective, Australian home builders and REITS need to deliver 250k dwellings per annum for 6 straight years. The best the market has ever done is 225k back in 2017. As we know there is already a record low vacancy rate and the cost of renting is sky high. The demand / supply dynamic is in Mirvac's favour. We rate the Mirvac management team highly, led by Campbell Hanan, and consider that the expansion into the Living Sector asset class will reap rewards.

From a valuation perspective, we are positive on the investment case. As noted above, Mirvac is trading at close to a record discount to its asset backing. The dividend yield is 5.2% (unfranked) and is expected to grow to near 7% by FY26. We believe that an investment in Mirvac based on current fundamentals is compelling for the long-term investor.

Conclusion

We have been long term investors at BKI for 20 years, often willing to buy stocks that are out of favour or seem to be viewed as unattractive during certain economic cycles. The current period facing the REIT's appears to be no different. With much of the sector trading at significant discounts to asset backing, we believe compelling investment opportunities are emerging in the sector and are looking to buy and hold for the long term.