BondAdviser

Research Report

Report Created on 22 March 2021

Issuer Name

Centuria Capital No.2 Fund

Security Name

Secured Redeemable Notes

Security Recommendation

Subscribe

Security Risk

High

Issuer Outlook

Improving	Stable	Deteriorating

(Selected: Stable)

Key Characteristics

Product Type	Corporate Bonds	**Issue Price**	$100.00
Outstanding Amount*	$100,000,000.00	**Accrued**	$0.00
Par Value	$100.00	**Capital Price**	$100.00
Fixed/Floating	Floating	**Running Yield****	4.279 - 4.529%
Payment Frequency	Quarterly	**Yield to Maturity**	n/a
Current Distribution**	4.279 - 4.529%	**Trading Margin**	4.250 - 4.500%
Issue Margin	4.250 - 4.500%	**First Call Date**	20 October 2024
Franking Credits Incl.	No	**Legal Final Maturity**	20 April 2026
ASX Listed	Yes (ASX Code: C2FHA)	**Next Ex-Date**	[TBC]
Convertible	No	**Next Payment Date**	20 July 2021
GICS Sector	Real Estate	**Next Cash Distribution**	[TBC]

* With the ability to raise more or less. ** Based on Issue Margin of 4.25 - 4.50% plus 90-day BBSW of 0.029%. All as at 21 March 2021.

Summary

On 22 March 2021, Centuria Capital No. 2 Fund ("the Issuer", under terms and conditions set out in the Prospectus) launched an offer for Secured Redeemable Notes (ASX: C2FHA, ISIN: [TBC]) to raise $100 million, with the ability to raise more or less. The margin above 3mBBSW is guided to be between 4.25 - 4.50%. Proceeds are being used to redeem the 2021 Wholesale Notes and to support the Group's co-investment programme and acquisition activities. The Offer comprises a Broker Firm Offer, a Securityholder Offer (eligible CNI holders) and an Institutional Offer. The Notes are intended to be listed on the ASX.

These securities are structured as direct, senior secured obligations of the Issuer, which itself holds equity stakes in two listed property funds and a number of other unlisted property funds. Investors also benefit from a guarantee providing access to Group (Centuria Capital Group, ASX: CNI) cash flows (which are outside of those within the security pool) for debt servicing. Distributions are non-discretionary and paid quarterly in arrears with the first Interest Payment Date being 20 July 2021.

Investors are protected by Event of Default mechanisms (including cross-default) and a negative pledge. Secured debt cannot exceed 65% of total tangible assets. The Guarantor (CNI) is subject to a minimum interest coverage ratio (ICR) of 2.00x, when CNI wishes to incur new debt. The holder may request early redemption of the Notes on the occurrence of an Event of Default. On a Change of Control Event, the Issuer must redeem Notes at 105% of Face Value of the Notes.

The Issuer may redeem all or some of the Notes on 20 October 2024 at $101, 20 April 2025 at $100 and 20 October 2025 at $100. Final legal maturity is 20 April 2026.

Figure 1. Capital Structure[1]

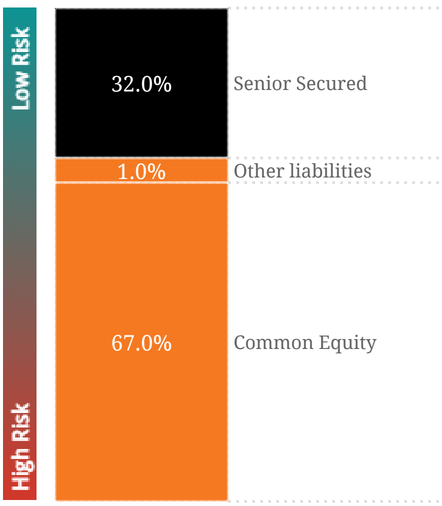
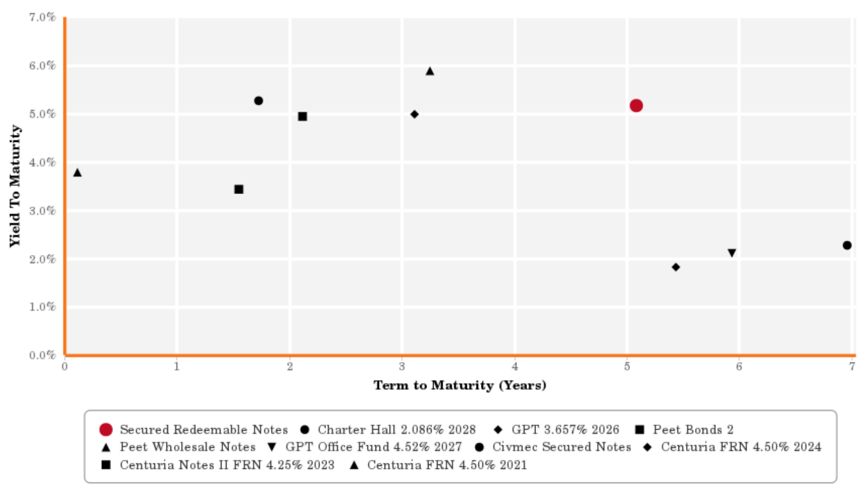


Figure 2. Relative Value



[1] Pro-forma balance sheet based on assumed $100 million capital raising.

Security Recommendation - Subscribe *as at 22 March 2021*

BondAdviser initiates coverage of C2FHA with a **Subscribe.**

Centuria has continued its growth trajectory in recent years both organically and acquisitively increasing assets under management (AuM). In light of the COVID-19 outbreak and associated uncertainty, the Group was arguably in the best position it could be given it has avoided the retail and premium office market and decreased debt at the Issuer level. Whilst it is expected that in a more certain future, CNI will engage in more accretive acquisitions; from our perspective, it is key that these acquisitions be supported by the right mix of debt and equity with consideration for the Group's broader leverage. We take comfort in the Group's past equity issuance co-occurring with any acquisition plans.

The two primary and interrelated risks to our recommendation are at the underlying fund level - rent revenue decreases and/or adverse revaluations on property. Mitigating these risks is the healthy tenant base. 27% of Centuria Office REIT's (ASX: COF) portfolio income is generated from government tenants; this increases to 81% when including listed or multinational corporations. 62% of Centuria Industrial REIT's (ASX: CIP) portfolio income is derived from tenants which are directly linked to the production, packaging and distribution of consumer staples or pharmaceuticals. Additionally, investors can be comforted by the long underlying weighted average lease expiry (WALE) profiles. COF and CIP have WALEs of 4.5- and 9.8-years respectively. At the CNI level, WALE by income for Office, Healthcare, Industrial and New Zealand was disclosed as 4.7-, 7.3-, 9.8- and 7.1-years, respectively.

The security pool largely consists of residual equity stakes, sitting behind secured debt at an underlying fund level. Underlying asset quality remains key from a credit perspective, given the dual-blow dealt in the event that distributions will decrease (or cease) at the same time the indicative value of the security pool would fall. Mitigating this risk is the convention for property trusts to distribute the majority of their income to unit holders (noting Australia does not have specific REIT distribution laws which mandate a minimum distribution percentage of income - like is common overseas). Positively, this security pool has improved as the asset base of the Issuer has increased. This has been a result of both the market value of the listed REITs and the size of the co-investment increasing. This collateral, as well as the unsecured guarantee from the parent, form key considerations to our recommendation and ultimate credit comfort.

We note Asian Logistics company ESR currently owns 17.11% of the CNI register, heightening the possibility of a takeover. Importantly, should this change of control eventuate, Noteholders would receive 105% of par value, identical to the 2024 Wholesale Notes, whereas the 2023 Wholesale Notes would only receive 101% of par. We note this ownership percentage has fallen from 19.93% in early 2020, indicative of a takeover not being imminent.

On a relative value basis, despite Centuria having multiple outstanding bonds, we place greater emphasis on prior primary bond transactions and the USD high yield market, compared to the Issuer curve. We currently view the Issuer curve as inefficient, due to infrequent trading and considerable spread variation. Facilitating a trade in secondary markets will be difficult in the Wholesale Notes, but current levels offer attractive value – so much so we would be incredibly surprised to see the 2023 and 2024 tranches changing hands around the 475 - 500bps trading margin range.

Additionally, with $300 million of unrated wholesale debt investor money hitting the street (WHLA redemption), there should be demand tailwinds present. Whilst we expect the Note will be very illiquid, we view the compensation as being more than adequate for this risk. We also prefer the floating rate structure, given our internal underweight duration view.

Our relative value analysis is split across four levels – all of which indicate a robust premium on offer. (1) C2FHA sits at a 2.9x multiple over our BBB band REIT curve – comparatively, in March 2020, the 2024 Exchange Offer presented a 2.4x multiple. (2) C2FHA provides a 150bps premium against Big Four listed AT1 alternatives. This is a substantive difference for a security credit rating delta which we view as being only one notch lower. (3) C2FHA sits 190bps below our Sub-IG/NR curve, however in March 2020, the 2024 Exchange Offer was 200bps rich of the curve. (4) On a cross-currency swap basis, C2FHA prices above the USD single B credit rating curve – this is indicative of exceptional value, given we view the credit profile as being significantly better. We recommend investors **Subscribe.**

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- **Return to On-Site Work**. Further progress in Australia against COVID would be favourable for Centuria. We are yet to see if there is a new normal in working from home post-pandemic, but we view a greater return to on-site work as being positive.
- **Continued Avoidance of Troubled Industries**. Centuria has largely avoided the retail and premium office space which was hardest hit as a result of the virus. We do not view either subsector as having yet fully recovered, nor do we view them favourably in the short-term. Retail, given the drop in discretionary spending by consumers, and premium office, given new excess supply in Melbourne and Sydney, intensified by a weaker outlook for professional services firms and the uncertainty surrounding office capacity.
- **Reduction in Look-Through Leverage**. Whilst operating gearing at the CNI level is low, this is not reflective of the economic leverage present due to subsidiary accounting. Equity raisings that are in surplus of acquisition quantum would be particularly well received.
- **Revenue Diversification**. Expansion of the unlisted Healthcare portfolio platform, along with the development of the New Zealand business (Augusta), will diversify revenue away from concentration to Australia and the office and industrial sectors.
- **Change of Control**. On a change of control event the Notes will be redeemed at 105% of the outstanding principal. Should ESR or any third party indicate intention to materially increase its stake in CNI we would view this as positive for Noteholders.

What factors would change the Recommendation DOWN

- **Low Quality Tenants Increase**. CNI's tenant book is impressive and one of the key factors behind our credit conviction in this uncertain environment. Should the proportion of governments and large corporates materially fall, we would review our recommendation.
- **Extension of Rent Deferral**. The Code has placed a moratorium on evictions to SMEs that is expected to lapse at the end of March 2021 (for VIC, NSW and WA). The Code also requires landlords to share the burden of weakness in trading conditions. Should COVID restrictions require continued extension of this Code, we would expect further weakness in cash, valuations and credit metrics.
- **Higher Sovereign Bond Yields**. Although CNI are hedged against interest rate risk in terms of debt repayments, they cannot hedge the implications of higher benchmark yields on capitalisation rates. In the last week of February, we saw a spike in government yields, especially at the long end, reflecting a delayed reaction to inflation. Although this has recently pulled back a touch, further increases in the 10-year yield would lead to a higher capitalisation rate, lowering property valuations in the portfolio and increasing leverage.
- **Fall in Co-Investment Value**. The security pool largely consists of residual equity stakes. Any loss in value here not only decreases expected recovery but also indicates weakness in the underlying operating entities.
- **Debt Funded Acquisitions**. Should new transactions not be supported by co-occurring equity issuance the leverage profile will deteriorate. We note Centuria has previously issued equity with any material acquisitions.

Issuer Outlook - Stable *as at 10 February 2021*

Please note that the below commentary is based on the financial results of Centuria Capital Limited ("the Guarantor", ASX: CNI / the "Group"), rather than the actual issuer (Centuria Capital No. 2 / the "Issuer") of the Notes. Due to a lack of direct visibility to the financial statements, performance of underlying holdings and management commentary of the Issuer, together with the benefits of the unsecured guarantee provided by the Group, we feel this is an optimal approach for investors on an ongoing basis.

Earnings

Centuria produced another strong financial result in 1H21 with assets under management (AuM) increasing 16% and revenue up 46.3% on the prior comparable period (pcp). The Group's business model has again proven to be COVID-resilient, despite the real estate industry being one of the most prone to the virus' effects. CNI were able to capitalise on this hard-hit industry with $1.1 billion in net acquisitions. The Group were able to collect 97.6% of rent over the half, up 7.3% from 2H20. We are pleased by this result as it reaffirms the strong tenant profile. Interestingly, receivables have doubled which is potentially indicating more generous terms with some distressed tenants, albeit this could also be a function of accrued accounting.

Noting the above, the overall strength of CNI's co-investments' (ASX: COF and ASX: CIP) tenant pool remains a positive. 81% of COF's revenue is sourced from governments, ASX listed corporates and multinational enterprises. CIP has 62% of its revenue originating from businesses exposed to non-discretionary expenditure, half of this being manufacturing.

CNI has bolstered its diverse revenue streams - a real positive for creditors, by further expanding into healthcare and New Zealand via the acquisition of the Augusta business. A third of acquisitions this half were into the healthcare sector, increasing AuM in this subsector by 29% on the pcp with Healthcare now contributing to 11% of CNI's top line. Additional to this, Centuria also have a $665 million Healthcare pipeline, pending the negotiation of anchor tenants and appropriate approvals.

Impressively, Centuria has posted an average CAGR for the past five years of 33%, meaning AuM has almost tripled since FY17.

Looking ahead, we do not see the $28 million increase in cost of sales being a long-term issue, albeit the cost base may reset. This is largely due to the Social and Affordable housing business and not COVID relief. Moving forward, cost of sales will be largely a function of the development of the Social and Affordable housing business. In contrast, for 1H20, the cost of sales was just $1.3 million.

CIP has 76.1% of its weighted average lease expiry (WALE) by income occurring at or beyond FY25. Only 3.4% of CIP's rental income has leases that expire in FY21.

COF is not as stable, with 15.2% of the portfolio's leases by income expiring in FY21 and 51.1% at or after FY25. Positively, vacancy of the portfolio was reduced from 8.5% to 1.8% last half and we expect COF to be able to reach agreements with the majority of tenants with expiring leases. CNI's combined portfolio is now weighted 79% to Australia and 21% to New Zealand.

Cashflow

Despite a difficult 2020, we remain confident cash flow generation can bounce back strongly near term. Cash inflows from operations decreased by $13.8 million, a 14.6% loss from the prior comparable period (pcp). The $14.5 million increase in management fees received was outweighed by the $26.7 million loss in performance fees received from the pcp. This fall in performance fees related to the maturity of certain funds more so than any COVID impact, which is positive given the losses in the Australian real estate sector because of the pandemic. The Group recognise a performance fee upon a fund outperforming a set IRR at the time a property is sold. Given there were no properties sold above this benchmark in 1H21, it is unsurprising performance fees received fell so drastically. We expect CNI's performance fee received to bounce back as the sector, and more broadly, the economy recovers.

Payments to suppliers and employers increased by $45.1 million (105.1% rise) on the pcp – due to the bolt on of Augusta. This hike in operating costs and the deficiency of performance fees received resulted in a $22.9 million loss in net operating cashflows, down $53.2 million from 1H20.

CNI declared an EPS of 6.2 cents per share (cps) and DPS of 4.5cps for the half. Encouragingly, this represents a 73% payout ratio of earnings. We do note the Management team intend to pay a total distribution of 10cps (5.5cps in 2H20). Although the expectation for FY21 EPS is to be 11.5 – 12.5cps, we see the lower bound as conservative due to the likely resurgence in performance fees received as the economy recovers. If guidance of 11.5 – 12.5cps is correct, this would place the payout ratio at an all-time high. We are not alarmed by this as we remain confident in management being able to adjust accordingly if required.

Net cash from financing activities increased by 74.1% pcp largely due to the timing of the change in borrowings. Cash at the end of the period increased by $27.9 million, bringing total cash and undrawn facilities to a healthy $242 million.

Capital Management

CNI's credit metrics improved in 1H21, further strengthening our conviction in its credit profile. A fall in interest rates resulted in a decrease in finance costs pushing the operating Interest Cover Ratio (ICR) out to 7.5x (FY20: 6.3x, FY19: 4.9x). CNI raised $133 million in equity in 1H20, largely to finance the glass manufacturing facility owned by Visy in Auckland. With the cash position improving, the operating gearing ratio fell to just 2.4% (FY20: 3.1%, FY19: 17.5%). We expect some normalisation here into 2H21 and FY22. Look-through leverage, which includes economic interests in listed and unlisted vehicles, would be significantly higher here and although this was not provided, based on the listed vehicles, we estimate it could be around 30% - steady on 2H20.

Centuria has ~$27.8 million in bonds maturing in April 2021 which are being refinanced with this listed Note offering. The existing two Notes (one floating, the other fixed) are being termed-out with this ASX-Listed bond to replace it.

For CIP, which CNI holds a 15.1% co-investment in, credit metrics were mixed. Gearing increased to 29.6% (FY20: 27.2%, FY19: 37.4%) and ICR improved to 5.8x (FY20: 5.2x, FY19: 4.2x) – well above the covenant minimum of 2.0x.

For COF, which CNI holds a 19.9% co-investment in, credit metrics improved on the gearing side, decreasing to 33.2% (FY20: 34.5%, FY19 34.2%) on a pro-forma basis, adjusting for the proceeds from the sale of 465 Victoria Avenue. The ICR increased to 7.6x (FY20: 6.3x FY19: 4.1x) – comfortably above the covenant of 2.0x.

Outlook

As expected, Centuria's strong tenant profile and AuM growth drove its resilient performance in the face of COVID. We expect this to continue with key risks being overleverage and expansion execution risk.

Operating earnings guidance was updated to 11.5 - 12.5cps, however we consider this conservative, based on previous history and the shifting operating environment. The continued diversification of the healthcare property segment is viewed favourably as well as geographic diversification into New Zealand.

Organic AuM growth is set to continue and provide a predictable lower-bound expectation for income. Management has an aggressive target to increase FuM by 50% in the near term. Given the current run-rate, this is aspirational but possible. Although there is no strict timeline here, management stated with the right acquisition, this could be easily achieved within 18 months.

Centuria has a $1.6 billion pipeline, of which little balance sheet commitment is currently required and appears well-spaced in terms of completion expectations. Whilst there is scope for further leveraging, we would, as history has shown, expect this to be supplemented with new equity. We also note that with increased scale, comes the prospect for management to extract further efficiencies and improve margins, presenting the opportunity for this development to be a long-term net positive.

Our outlook for Centuria remains **Stable.**

Relative Value

Whilst Centuria has multiple wholesale bonds outstanding, they are traded infrequently and with considerable variation. Accordingly, we do not view the issuer curve as reflective of fair value. In light of this, we separate our relative value analysis into four comparable levels: (1) the AUD REIT / Real Estate Market; (2) AUD Unrated or Sub-Investment Grade Corporates; (3) AUD AT1 Hybrids; and (4) USD Corporates.

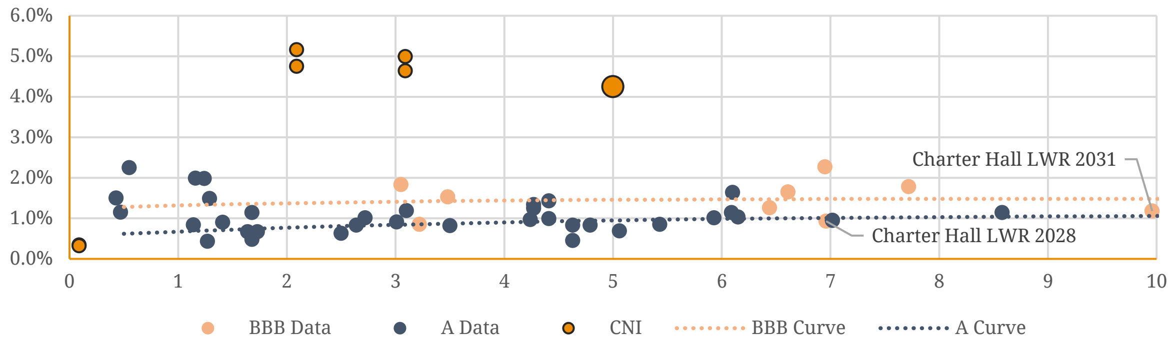
AUD REIT / Real Estate Market Comparables

Within the investment-grade universe, there is a robust amount of outstanding AUD denominated debt from Australia's REIT / real estate industry. However, there is a limited number of sub investment-grade / nonrated public bonds. In Figure 3, we show investment-grade debt by credit rating bands. We have adjusted our A band curve to exclude discretionary retail exposures, however, we have included all A band securities on the scatterplot (the excluded securities largely sit at the blue cluster at the front of the curve).

Centuria's offer with a trading margin of 425bps sits 2.9x above our BBB band curve and 4.4x against our adjusted A band curve. Comparatively, the exchange offer in March 2020 on the 2024 Notes, offered a 2.4x multiple against the BBB band curve (when including the exchange fee as part of the implicit trading margin). On this basis, the comparable value looks attractive.

Our internal shadow rating (HoldCo Secured) maps to an issuance that is just below investment grade. Given the delta of 51bps between our A and BBB curves, an extra rung down, albeit into sub-investment grade territory, appears to be attractively compensated.

Figure 3. Trading Margin – Australian REIT / Real Estate Debt

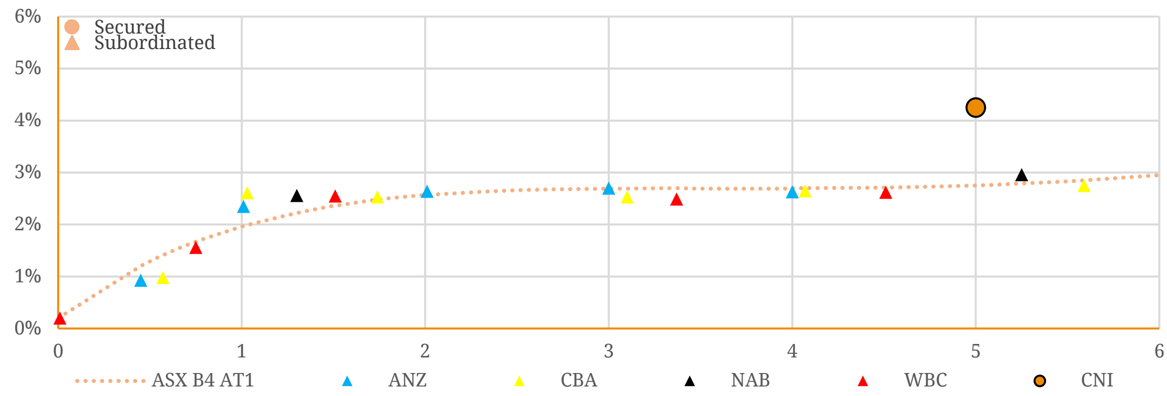


Source: BondAdviser, Bloomberg. As at 19 March 2021 (CNI wholesale secondary pricing based on BVT4 data)

AUD ASX AT1 Hybrids

Financial regulatory capital is very different to Centuria's issuance and not a like-for-like comparison, however we utilise Figure 4 to illustrate the Notes' relative value against alternative listed securities. C2FHA offers a 150bps premium to against our Big Four Listed AT1 curve. Although the Notes are not investment-grade like Big Four AT1 hybrids, the Notes are secured and are not deeply subordinated like AT1 hybrids – although are structurally subordinated from a HoldCo perspective. In a reach-for-yield environment, we expect the Notes to trade well on the implicit value together with growing issuer comfort.

Figure 4. Trading Margin – Domestic Big Four Listed AT1 Curve



Source: BondAdviser, Bloomberg as at 19 March 2021

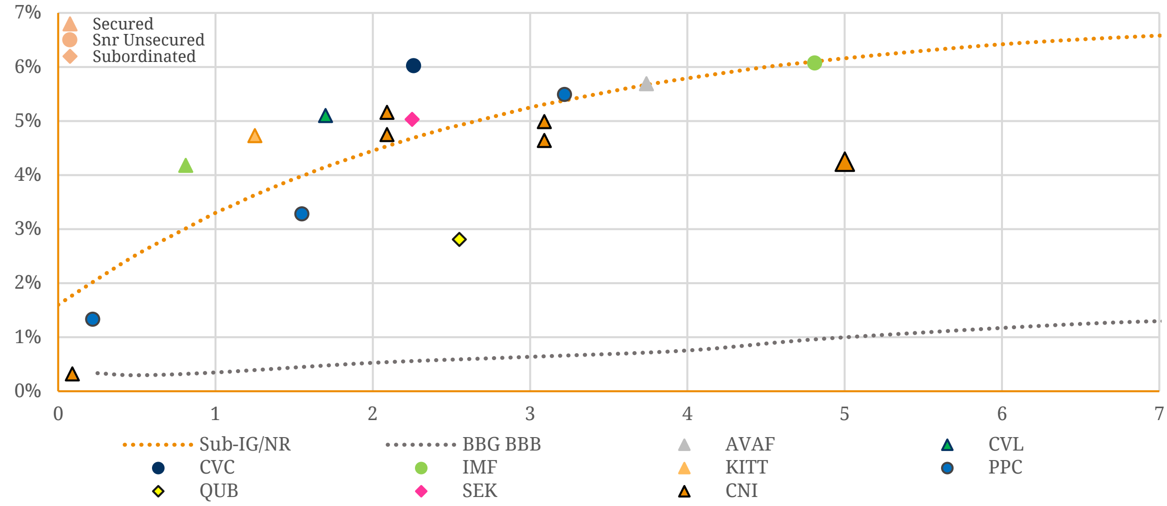
AUD Unrated or Sub-Investment Grade Corporates

Domestically, the sub-investment grade / not-rated (Sub-IG/NR) market is scattered across a range of industries, seniorities and credit quality. The COVID-19 outbreak has resulted in material widening in some securities, many of which remain above COVID lows. Many of these securities are also suffering like Centuria, in terms of frequency of trading and pricing variation.

In 2020 continuing into 2021, due to the COVID-19 outbreak, all of Centuria's Wholesale Notes have widened (trading margin). We do not attempt to downplay the uncertainty, especially with respect to property markets. C2FHA sits underneath our Sub-IG/NR curve by 190bps. Notably, the exchange deal in March sat 200bps underneath our Sub-IG/NR curve – indicating a better deal for investors this time on a relative alternative basis.

Sitting beneath the curve does not indicate immediate value, but we highlight that the Notes rank senior and are secured, whereas a large amount of our Sub-IG/NR curve is unsecured or subordinated. The Notes also offer value against listed alternatives with inferior seniority; mainly Qube's subordinated notes.

Figure 5. Trading Margin – Domestic Sub-IG/NR Corporates



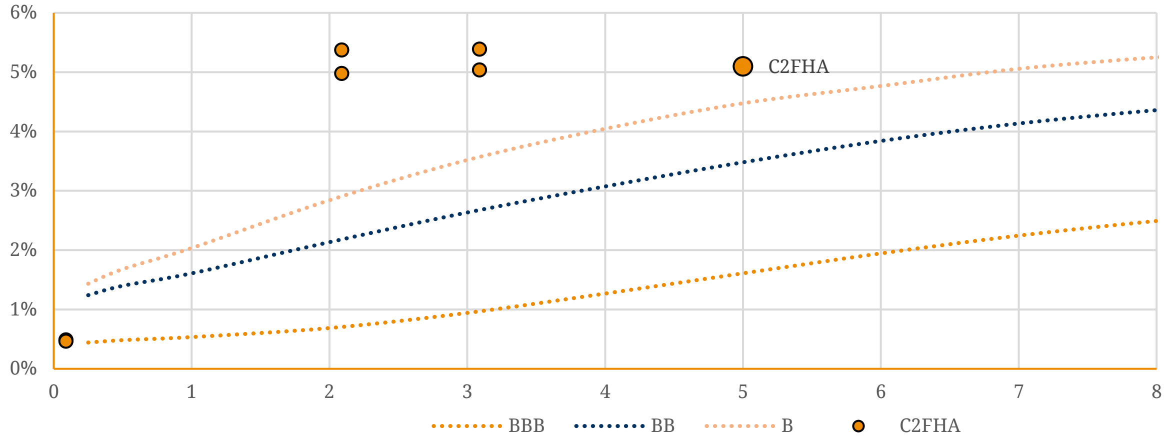
Source: BondAdviser, Bloomberg as at 19 March 2021

USD Corporates

Given the lack of confidence in the intrinsic value of our unrated curve, we turn to the US high yield market, which is far more active in secondary trading. To do so, we estimate a cross-currency swap equivalent of CNI's debt, on a yield basis (not trading margin).

Despite pricing underneath the Issuer curve, which we attribute to market inefficiencies, Figure 6 confirms our expectations that C2FHA is pricing above single B credit rating levels. This premium is more than adequate for the expected illiquidity. Given the strength of credit profile, we view compensation being robust relative to risk.

Figure 6. Yield – USD Corporate Curves (C2FHA ASW to USD)



Source: BondAdviser, Bloomberg as at 19 March 2021

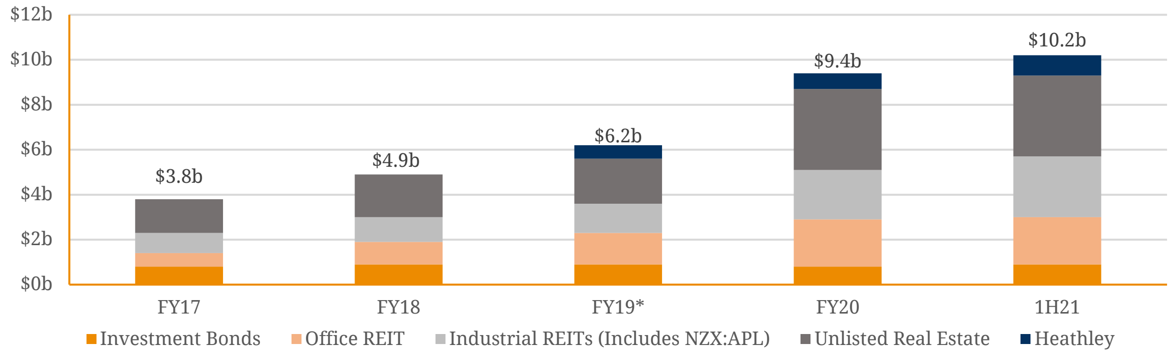
Company Background and Structure

Centuria Capital Limited (ASX: CNI) is an investment manager specialising in listed and unlisted property funds, with an additional investment bonds business. CNI derives its earnings from three main sources: (1) property funds management fees (including performance fees); (2) investment bond product fees; (3) distributions from co-investments in the properties it manages, and although uniquely structured, these co-investments have the effect of aligning interests with the investors of the underlying funds.

Centuria has a 36-year track record in a range of products and services. Since FY17, Centuria has grown assets under management (AuM) from $3.8b to $10.2b (31 December 2020). This AuM growth equates to a robust 33% compound annual growth rate (CAGR).

The Group's property platform, Centuria Property Funds, was formed in 1999. It manages over 160 properties across a range of structures. The Group manages two Australian listed REITs, Centuria Office REIT (ASX: COF, formerly ASX: CMA) and Centuria Industrial REIT (ASX: CIP), each with a sole respective focus in office and industrial property. Additionally, Centuria manage a smaller scale New Zealand based REIT, Asset Plus Limited (NZX:APL) and also manage $4.5 billion in unlisted real estate assets.

Figure 7. Assets Under Management

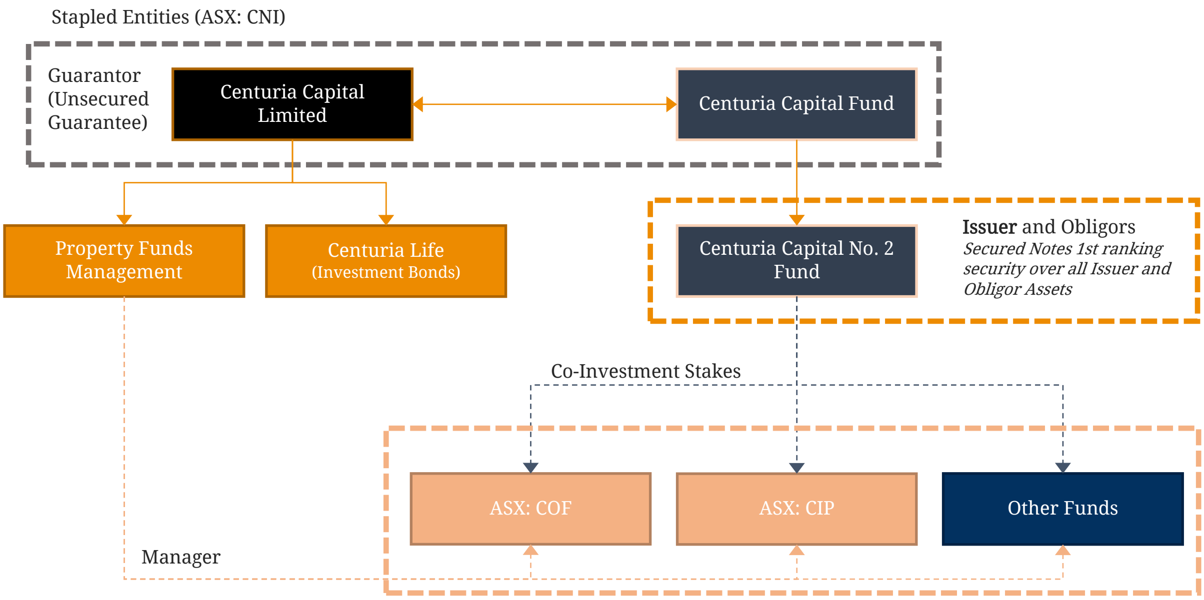


*Source: BondAdviser, Centuria. *Excludes the divestment of Pacific Highway, Chatswood, NSW and Flinders St, Adelaide, SA.*

As illustrated in Figure 8, the Group's structure looks relatively complex given the interlinkage. However, in our view, a simple way of describing the structure, is that Property Funds Management and Centuria Life are the key operating businesses, whilst Centuria Capital No. 2 Fund (the Issuer) and by extension Centuria Capital Fund are the entities that facilitate balance sheet investment (co-investment) in the property funds the Group manages.

Investors in the Notes benefit from a general security agreement (GSA) over Centuria Capital No. 2 Fund and its wholly owned subsidiaries (obligors). The issuer currently owns a 10.59% equity stake in CIP and a 14.78% equity stake in COF. These Notes also benefit from an unsecured guarantee from Centuria Capital Limited, the parent entity.

Figure 8. Group Structure



Source: BondAdviser, Centuria

Centuria Office REIT (COF) is a listed property trust, that offers Australia's largest ASX-listed pure play office REIT. As of 31 December 2020, COF had a portfolio value of $2.1 billion across 23 assets. CNI owns 14.78% of COF. Its IPO was in December 2014 and from FY15 to 1H21, the A-REIT has an impressive 42.2% CAGR in portfolio value. As of 9 March 2021, the market capitalisation was $993 million. COF has a 98.1% occupancy rate and WALE of 4.7 years, down from 5.1 in 1H20, a reflection of the impact of COVID on office leasing. COF pays quarterly distributions to securityholders and has a primary investment objective to generate sustainable and quality income streams across a portfolio of quality Australian office assets.

As illustrated in Figure 10, as at 31 December 2020, the majority of the portfolio is NSW or QLD based (collectively 49%). There is less exposure to VIC, which we view positively, given the expected oversupply in Melbourne office space expected to occur in CY2021. Given the large exposure to the Federal Government, it is not surprising to see a large exposure to the ACT relative to other office funds.

Figure 9. COF Portfolio Value

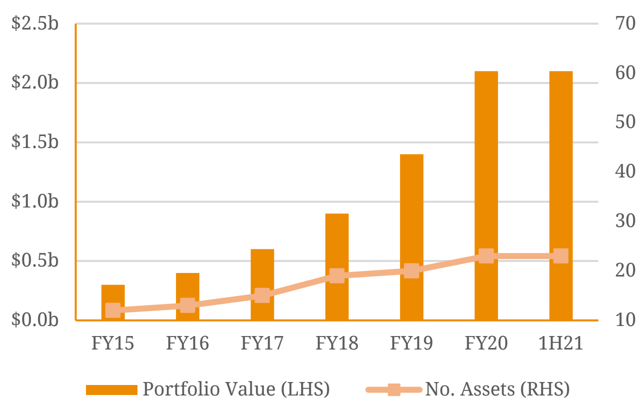
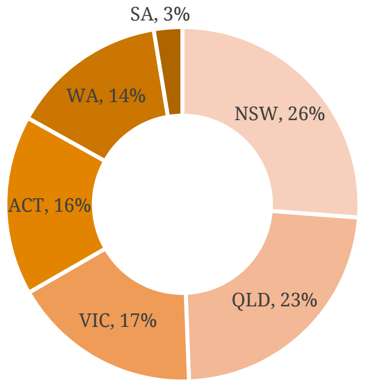


Figure 10. COF Geo. Diversification



Source (both): BondAdviser, Centuria. May not add to 100% due to rounding.

Centuria Industrial REIT (CIP), like COF, is a listed property trust. It is the largest ASX-listed pure play Industrial REIT. As of 31 December 2020, CIP had a portfolio value of $2.4 billion across 59 assets. CNI owns 10.59% of CIP. Since FY15, CAGR has been 33.0%, which although not as robust as COF, is still impressive. As of 9 March 2021, the market capitalisation was $1.64 billion. CIP pays quarterly distributions to securityholders and has a primary investment objective to generate predictable and stable income streams. It has strong occupancy of 97.7% and a WALE of 9.8 years, up from 7 years in 1H20.

The portfolio is heavily skewed to the Eastern seaboard states, with NSW, QLD and VIC accounting for 89% of the portfolio. Although relatively concentrated, this is unsurprising and, in our view, not concerning, given the both the population and manufacturing skew to this area of Australia.

Figure 11. CIP Key Portfolio Value

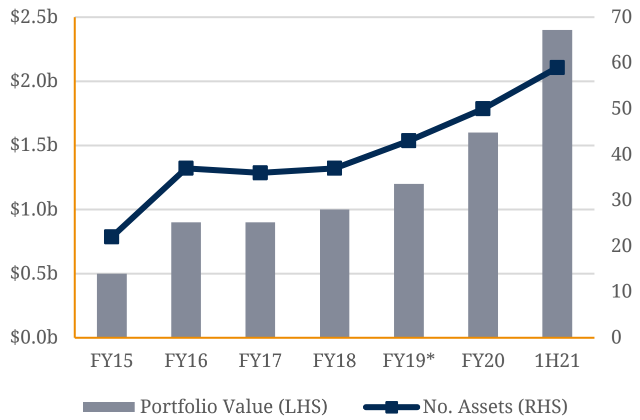
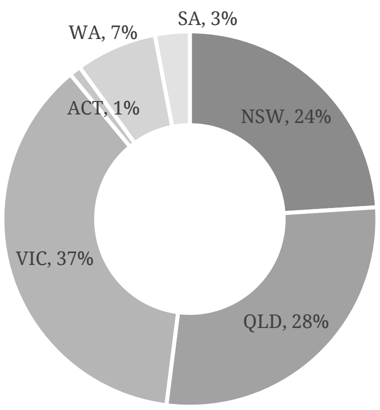


Figure 12. CIP Geo. Diversification



Source (both): BondAdviser, Centuria. May not add to 100% due to rounding.

Credit Profile

Based only on distribution guidance for CIP and COF, even when conservatively excluding any expected distributions from cash and the co-investments in unlisted funds, the 19.9% and 15.1% stake in COF and CIP respectively are expected to return ~$27.2 million in cash to the Issuer, equating to a FY20 interest coverage of ~1.7x (at the Centuria Capital No. 2 Fund level). This also explicitly excludes the unsecured parent guarantee from CNI, which itself had an ICR of 5.8x in 1H21. On this basis, even with volatile conditions going forward, there is ample debt serviceability capacity.

Growth in AuM has been primarily funded through new equity issuance. Since 2017, ~$1,365 million in new equity capital has been raised between CNI, COF and CIP. As creditors, it is positive to see any acquisition, be it asset managers or real estate assets, supported by additional equity capital – rather than over levering.

Volatility due the COVID-19 outbreak initially saw Noteholder collateral fall; however, this was less severe than broader equity markets overall, which we attribute to the stable recurring revenues associated with prudently managed property funds. Notably, the rebound has been less pronounced and unit prices for CIP and COF remain below COVID highs. Should unit prices return to early 2020 levels, Noteholder collateral will improve significantly.

Since the initial 2017 wholesale notes transaction, the security pool LVR has fallen significantly. As of 31 December 2020, the LVR was 20.8%, down from 56.1% in 1H17. We importantly note this LVR accounts for any mark-to-market loss in COF and CIP that occurs. The pro-forma LVR is well below covenant limit of 65%, providing a considerable buffer for any adverse property revaluations. We note in Table 1 the June 2019 LVR was elevated due to the on-market acquisition of PropertyLink (ASX: PLG). This takeover was ultimately unsuccessful, and the stake was sold, resulting in the de-levering. Should this transaction have been completed, we would have expected additional equity funding to the effect of reducing leverage.

The pro-forma collateral pool value has improved on 2H20, largely due to an increase in financial investments and cash line items. We expect some of this cash to be deployed by means of increasing the stake in CIP. The asset over-collateralisation is a key consideration to our recommendation, and we expect this security to perform more than satisfactorily, should an increasingly unlikely worst-case scenario occur for domestic real estate.

Table 1. Centuria Capital No.2 Fund / Security Pool Metrics**

	Pro-Forma	31-Dec-20	30-Jun-20	30-Jun-19
Assets				
Cash	166	96	53	68
Receivables	14	14	11	72
Financial Assets at FV	619	619	528	117
Adjustments to Security Pool*	74	74	103	348
Total Security Pool Assets	872	803	695	605
Assets Outside Security Pool	115	114	98	112
Total Fund Assets	987	917	792	717
Liabilities				
Other Liabilities	91	178	122	152
Security Pool Debt	237	167	168	203
Total Fund Liabilities	328	345	290	355
Net Fund Assets	659	572	503	362
LVR	27.2%	20.8%	24.1%	33.5%

*Note: Pro-forma assumes a $100 million raising, generating cash proceeds of $97.5 million. *Adjustments include the addition of (1) investments in controlled properties at fair value, (2) property held for development and (3) equity accounted investments. Subtracts investment properties not part of the security pool. ** Summation may not equal due to rounding.*
Source: BondAdviser, Centuria.

The Issuer only has a nominal amount of direct expenses ($2.7 million in cash payments for 1H21) and pays no tax, given all tax obligations are upstreamed to CNI. CNI in 1H21 had an operating gearing ratio of just 2.4%, COF and CIP had respective gearing ratios of 33% and 30%. Whilst these may increase owing to possible adverse property revaluations, there is sufficient covenant headroom and we are comfortable from a credit perspective.

On a look-through basis, COF has no debt maturing until June 2022 and had $176 million in drawable facilities (on a pro forma basis including proceeds from sale of 465 Victoria Avenue) from its $880 million multi-bank facility. It had period end gross debt of $749 million and net debt of $717 million.

CIP has no debt maturing until FY22 and had $146 million in drawable facilities from its $880 million bank facilities. As at 31 December 2020 it had a gross debt of $734 million and net debt of $713 million.

Property Profile - COF

It is well documented that the COVID-19 outbreak caused many businesses to close temporarily as the Commonwealth and respective State Governments implemented travel and living restrictions. While the office sub-sector of the real estate industry was hard hit by the effects of COVID-19, the majority of Centuria's prime tenant mix was able to withstand headwinds. This is a testament to the Group's approach in ensuring it has a portfolio of high-quality lessees.

As at 31 December 2020, COF has a 91.5% occupancy rate and 4.5-year WALE. This is a deterioration on FY20 where occupancy was at 98.1%, however, we view it as a strong result relative to the industry. Although we have seen some adverse revaluations and lower FFO, we are not concerned from a credit perspective as the slight weakening is manageable. COF's tenant mix is still strong, and occupancy is still high.

The maturity timeline for leases provides expectation for an improving WALE. 8.5% of the portfolio is vacant while only 10.7% of the portfolio expires before FY23. By FY23 we expect far more clarity in the office sub-sector of the industry and with ~81% of leases expiring in a period of far more certainty, we view the mid-term of COF to be more favourable than it may seem ostensibly.

Figure 13. COF Tenant Mix (1H21)

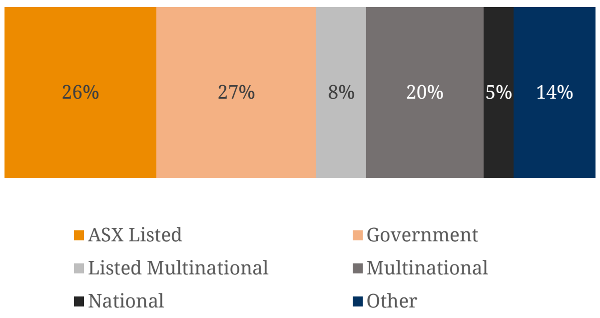


Table 2. COF Portfolio Snapshot

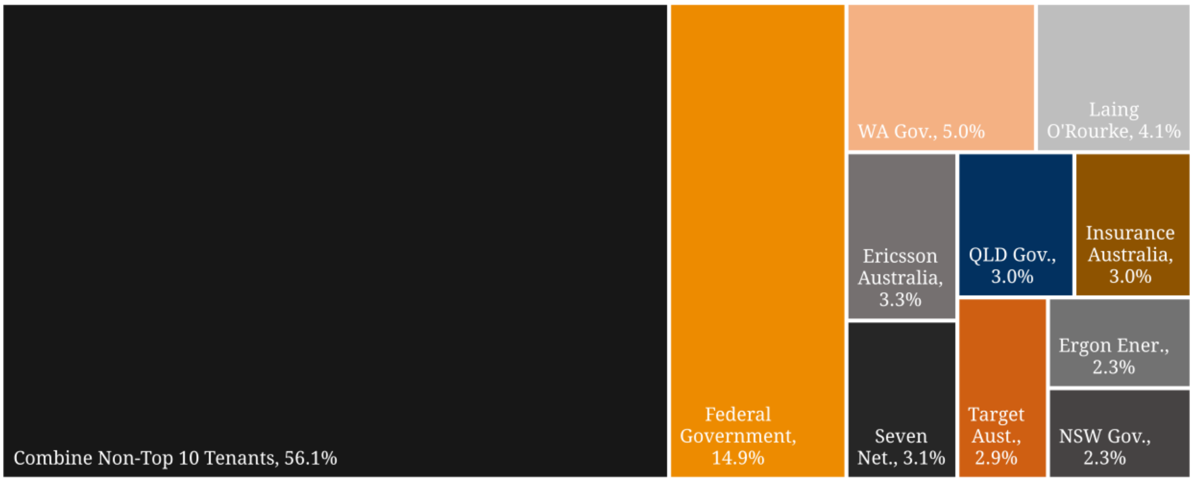
	1H21	FY20
Number of Assets	23	23
Book Value	$2,032m	$2,053m
WACR	5.90%	5.93%
NLA	304,413sqm	304,586sqm
Occupancy by Area	91.5%	98.1%
WALE by Income	4.5y	4.7y
Avg. NABERS Energy Stars	4.80	4.80
Avg. Building Age by Value	16.4	15.9

Source (both): BondAdviser, Centuria.

The Commonwealth Government represents ~15% of tenant income, with the WA and QLD state governments collectively representing ~8%. As illustrated in Figure 14, although Seven Network is experiencing weakness, the remaining top 10 tenants appear well placed to manage any temporary impact. Collectively, the top 10 tenants make up ~44% of COF's gross income. Although concentration is arguably a weakness, in our view, given this is government concentration, it becomes a valuable positive in uncertain times.

In analysing the property compendium, the vast majority of tenants look well placed to manage any continued impact of COVID-19. Contrastingly, we highlight some of the weakest tenants to demonstrate that while there will be adverse impact, the portfolio should be resilient. We perform a rough calculation of percentage gross income by asset multiplied by asset book value to demonstrate the small impact expected. Versus total book value, we estimate, on a gross income basis, ~4.5% of book value is collectively rented by Carnival PLC, Forever New Clothing, WeWork, Palace Cinema and Wilsons Parking. Whilst we are not confident on the exact figure, we have confidence that the exposure here is small, which is positive from a credit perspective.

Figure 14. COF 1H21 Top Tenants by Gross Income



Source: BondAdviser, Centuria.

Property Profile - CIP

The impact on the broader industrial property market has been very unique to the underlying tenant. Whilst Australia did enter a recession, some sectors such as pharmaceuticals and non-discretionary spending, were resilient, while logistics and supermarkets benefitted from the downturn due to an inelastic demand profile.

As seen in Figure 15, distribution centres and transport logistics make up 51% of the portfolio's gross income, while 32% of CIP tenants fall within the manufacturing industry. Given the broad range of manufacturers, we have analysed the property compendium to better understand what exposure to vulnerable businesses CIP has. Again, we perform a rough calculation, which is business GLA divided asset GLA, multiplied by asset book value. Versus total book value, we estimate on a GLA basis, 17% of the portfolio is collectively rented by possibly vulnerable businesses. Such discretionary spending-based names include Garmin, Regent RV, Boardriders, E&S Trading and Yamaha. While 17% is high, we are not concerned as government rent relief packages ensured occupancy was able to be maintained at high levels. With the navigation of the altered operating environment no longer a new issue, we expect these businesses to return to regular operations as demand returns to pre-COVID levels.

Figure 15. CIP Tenant Industries (1H21)

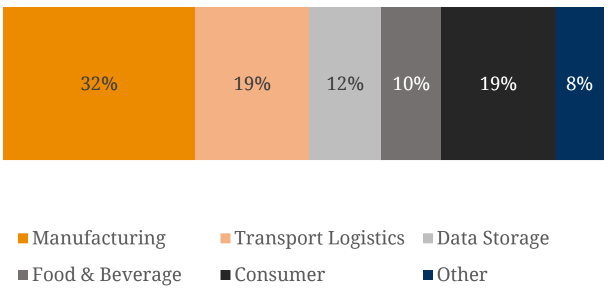


Table 3. CIP Portfolio Snapshot

	1H21	FY20
Number of Assets	59	50
Book Value	$2,339m	$1,602m
WACR	5.42%	6.05%
GLA	1,047,685sqm	945,611sqm
Average Asset Size	17,757sqm	19,298sqm
Occupancy by Income	98%	98%
WALE by Income	9.8y	7.2y

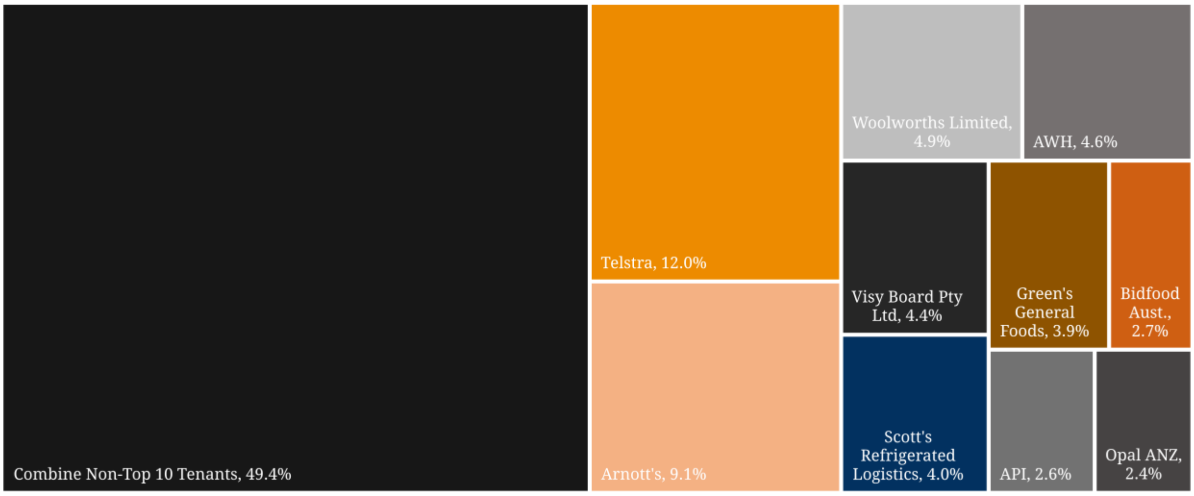
Source (both): BondAdviser, Centuria.

As at 31 December 2020, CIP, by income has a 98% occupancy ratio and ~10-year WALE. Positively, against FY20, book value has increased by ~$730 million and the WALE was extended by ~3-years. Telstra is the largest single tenant, accounting for 12% of the portfolio's gross income.

Telstra lease a data centre complex that incorporates 10 buildings and has a WALE of 29.7 years. Given the exceptional credit rating (A2/A-) and implied government support (critical operating and defence infrastructure), we are comfortable with this high weight to Telstra.

Arnott's, the iconic biscuit market, owned by global private equity firm KKR, represents 9% of gross income of CIP. This was largely a result of a sale lease-back transaction post KRR acquisition, a common strategy implemented by private equity firms to unlock cash. Whilst 9% is a large amount of the portfolio concentrated in a single name, we are comforted by the strength of the operating business and equity support.

Figure 16. CIP 1H21 Top Tenants by Gross Income



Source: BondAdviser, Centuria.

Centuria Capital No.2 Fund: Financial Summary

Centuria Capital No.2 Fund: Financial Summary **Recommendation Summary** **Subscribe**

22 March 2021

Profit or Loss	**1H21**	**2020**	**2019**	**2018**
Note: Unsecured Guarantor (CNI)				
Funds Management ($m)	85.4	105.0	68.0	66.4
Investment Bonds ($m)	4.1	10.1	10.3	10.8
Co-Investment ($m)	17.7	32.2	28.6	20.7
Corporate ($m)	2.8	4.3	3.4	2.8
Operating EBIT ($m)	47.2	41.8	70.8	67.2
Finance Costs ($m)	-7.5	-18.6	-15.8	-10.6
Underlying Pre-Tax Profit ($m)	39.7	23.2	55.0	56.6
Taxation ($m)	-5.7	-1.1	-9.4	-11.5
Underlying Net Profit ($m)	34.0	22.1	45.7	45.1

Balance Sheet	**1H21**	**2020**	**2019**	**2018**
Note: Unsecured Guarantor (CNI)				
Cash & Liquids ($m)	202.5	174.4	87.8	76.4
Receivables ($m)	119.1	68.7	65.7	17.2
Financial Assets ($m)	839.6	773.4	472.7	326.0
Intangible Assets ($m)	280.9	280.1	157.7	157.1
Total Assets ($m)	1,736.5	1,601.4	789.6	578.7
Payables ($m)	53.0	76.5	35.7	33.4
Borrowings ($m)	277.2	265.1	210.8	132.0
Total Liabilities ($m)	771.7	770.3	282.0	186.9
Net Assets ($m)	964.8	831.1	507.6	391.8

Source: Company data, BondAdviser estimates.

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Every research report prepared by BondAdviser includes a clear recommendation on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

The guide below may help you understand our research opinions. For further information on our research approach, you can refer to our RG79 statement by **clicking here**.

Research Opinions key

- **Buy** - Over the next 12 months, the analyst expects the security to outperform the current yield due to credit spread tightening or favourable movements in the underlying yield curve.
- **Hold** - Over the next 12 months, the analyst expects the security to provide stable returns broadly in line with the current yield but with little credit spread tightening.
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- **Not Rated** - A security that has not been assigned a formal recommendation.
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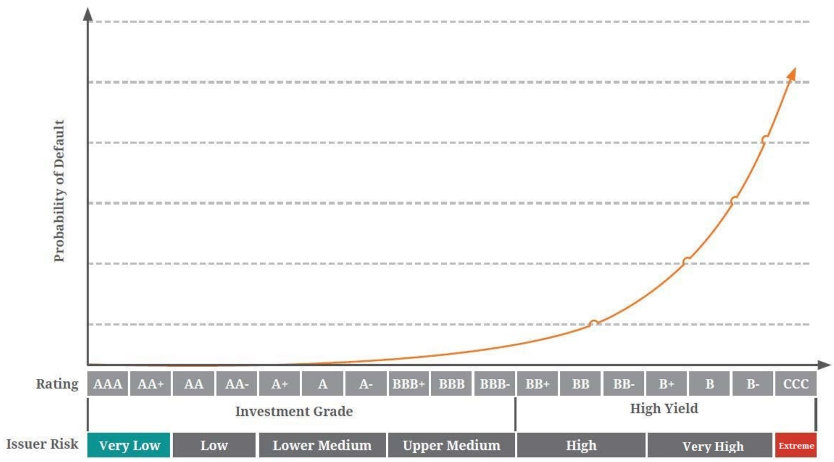
This security risk assessment has a respective measure of default or conversion which is shown in the orange line. This curve is an extension of the APRA (Australian Prudential Regulation Authority) PAIRS (Probability and Impact Rating System) model which has been successfully managing regulated entities in Australia since October 2002.



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