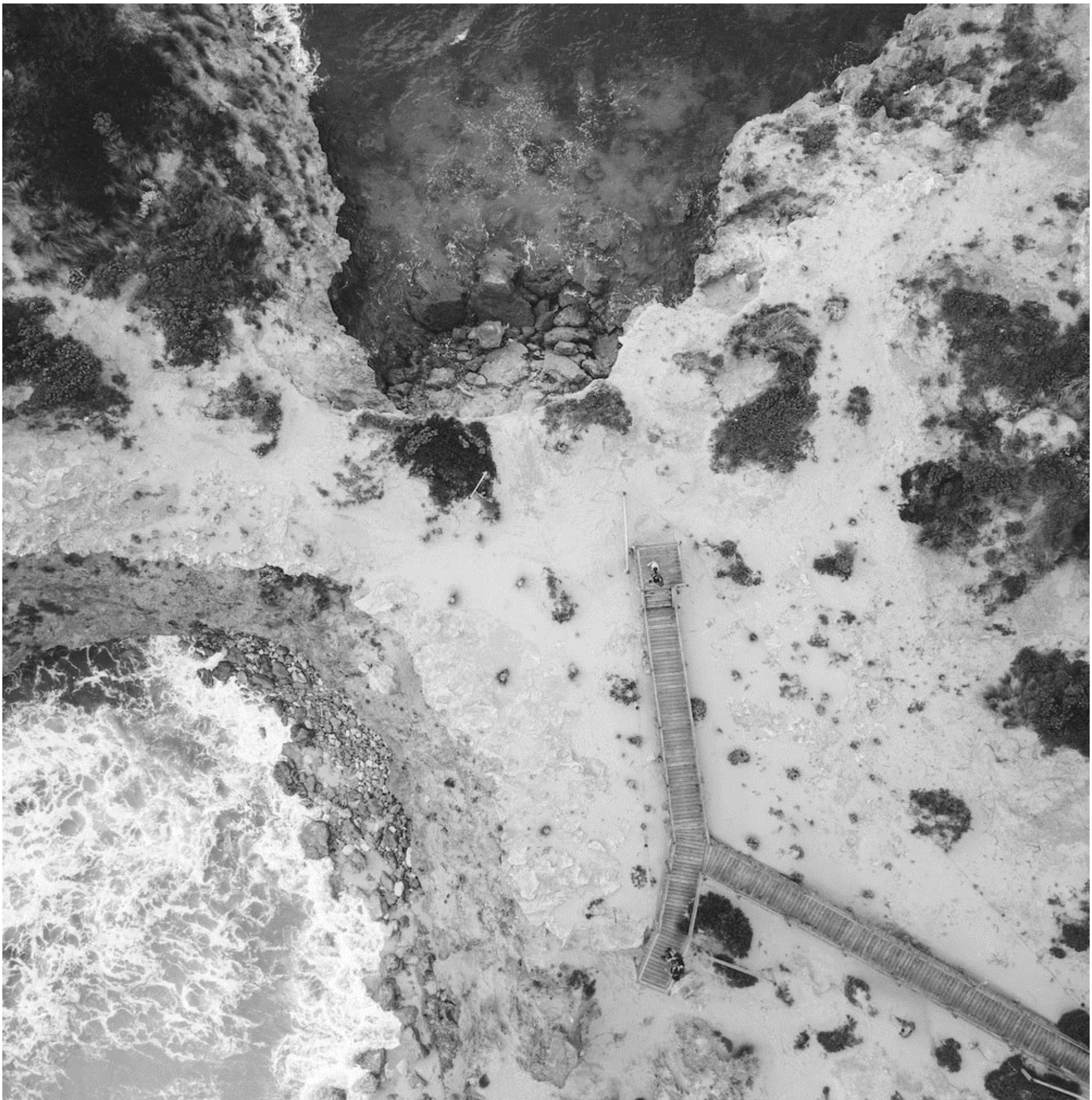
Fund Research

Qualitas Real Estate Income Fund (ASX: QRI)

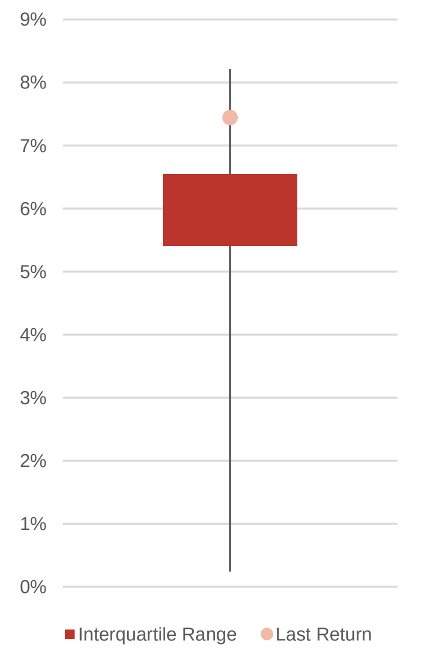


Overview

The Qualitas Real Estate Income Fund ("QRI" or "Trust") is an ASX-listed investment trust (LIT) managed by the Qualitas Group, which provides exposure to the domestic commercial real estate (CRE) debt market, predominantly through direct loan investments. The Group is a pioneer in the Australian CRE alternative asset management space and has established a strong track record over the past 14 years, with zero losses of investor capital.

QRI is a closed-ended fund targeting a net return of the RBA Cash Rate plus 5.0 - 6.5% p.a. after fees and expenses, with distributions payable monthly. This is appropriate in our view, given the risks associated with the provision of debt funding for typically illiquid and bespoke CRE assets. Fees comprise a 1.50% p.a. (ex GST) management fee based on portfolio NAV, and a 20% performance fee payable on outperformance above an 8.00% p.a. (net) hurdle rate.

Figure 1. Net Returns Distribution**



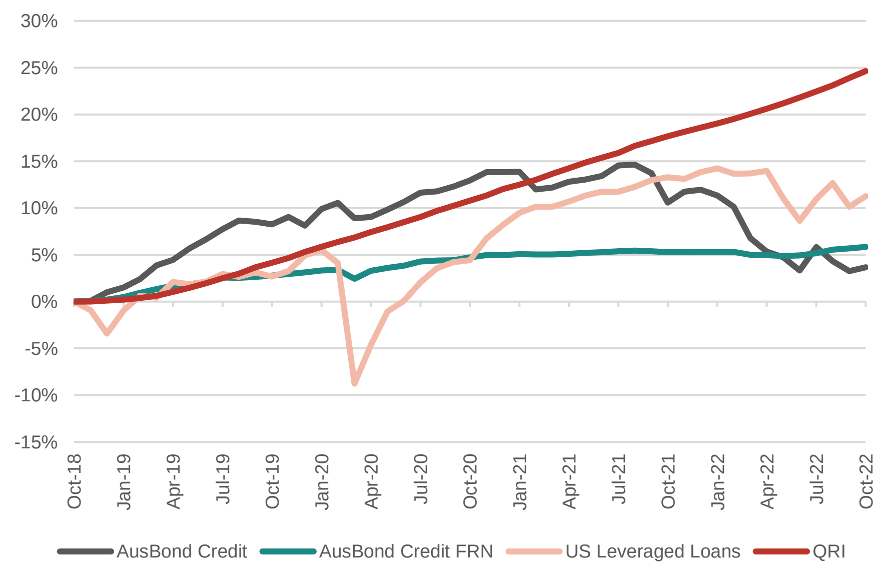
Source: BondAdviser, Qualitas. As at 31 October 2022
*** Annualised monthly returns based on daily weighted NTA since inception.*

Figure 2. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	0.36	0.42	0.45	0.45	0.50	0.49	0.53	0.54	0.60	0.60			**4.94**
2021	0.44	0.46	0.55	0.51	0.55	0.46	0.44	0.63	0.44	0.46	0.40	0.38	**5.72**
2020	0.51	0.49	0.45	0.55	0.49	0.51	0.50	0.59	0.48	0.51	0.51	0.60	**6.19**
2019	0.12	0.15	0.25	0.41	0.44	0.49	0.53	0.45	0.66	0.49	0.49	0.61	**5.09**
2018											0.02	0.08	**0.10**

Source: BondAdviser, Qualitas. As at 31 October 2022.
** Return is monthly net total return based on daily weighted NTA plus dividends.*

Figure 3. Relative Cumulative Performance (NTA)



Source: BondAdviser, Qualitas, Bloomberg. As at 31 October 2022.
QRI performance is based on daily weighted NTA and assumes all distributions are reinvested.

Product Assessment

Recommended

The LIT structure of QRI allows retail investors to easily invest in a portfolio of CRE debt run by an experienced and proven manager.

QRI is suitable for income investors comfortable with exposure to the CRE debt market. The Australian CRE debt market is a growing space with attractive opportunities, as banks have progressively retreated from this segment as a result of greater regulatory capital requirements. Investing in such a highly specialised area of the private debt market also brings unique risks, so specialist expertise is required to operate successfully in this market. Consequently, manager selection is an important consideration for investors. In this regard, **Qualitas has built a strong track record with no loss of investor capital spanning its 14-year history.** Structured as a LIT, retail investors are able to access a diversified portfolio of CRE debt run by an experienced manager.

Exposure to mezzanine loans has increased from 8% a year ago to 16% as at 31 October 2022, as Qualitas sought to take advantage of attractive opportunities that emerged in 2022 as banks became less willing to fully fund deals. While this tilt adds to the returns profile of the portfolio, the loss given default for mezzanine exposure is higher than a senior secured position. Positively, there is greater diversification reflected by a significant reduction of loans in Victoria from 73% in October 2021 to 48%, an increase in the number of loan investments, and a **material reduction in average individual loan exposure by drawn amount**. While mezzanine loans are riskier than senior secured loans, they are still secured over property, but rank behind senior debt. We also note that over **99% of the portfolio is covered by personal guarantees**.

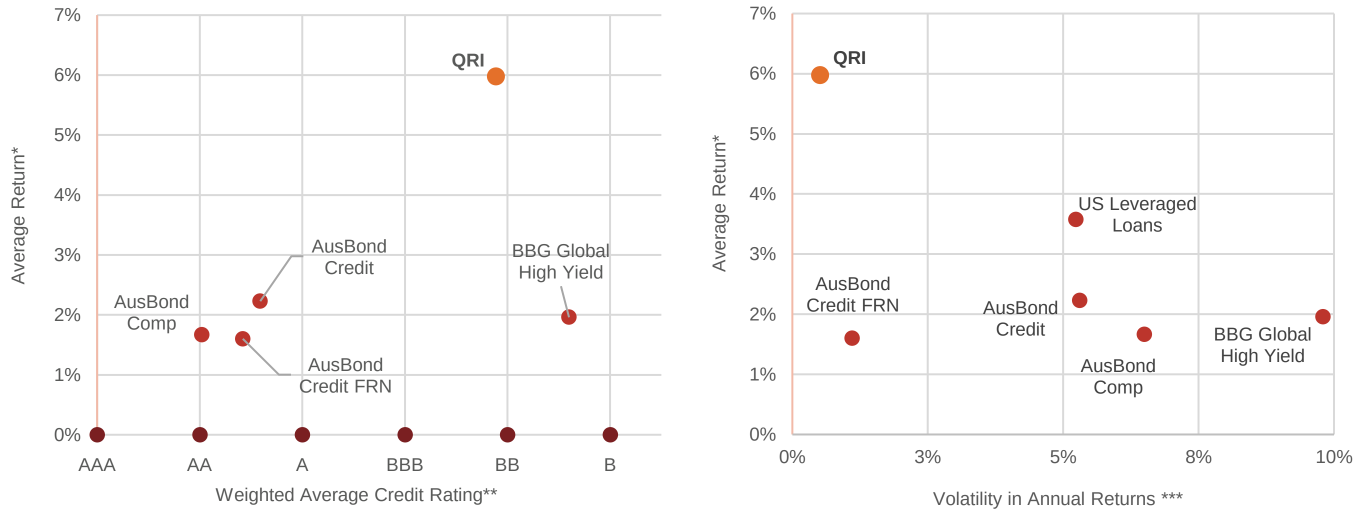
Since notching up two-years of performance under the new target in June 2022, QRI's net total return has consistently exceeded the bottom end of the target to 31 October 2022 on a rolling 24-month basis.

In July 2020, the Manager prudently moved from a fixed net target return of 8.0% p.a. (set at inception of the Fund in November 2018) to a floating target return of RBA Cash Rate plus 5.0-6.5% p.a. We viewed this as sensible as opposed to moving the portfolio higher up the risk curve in search of extra yield, at the expense of credit quality. Since then, **QRI has met its target return**. In FY21 the Fund posted a net return of 6.16% for the 12 months to 30 June 2021 (NTA based). In FY22 the net return for the 12 months to 30 June 2022 was 5.42%. This was despite some cash drag from the $172 million of new monies raised via the entitlement offer in November 2021 that increased the Fund capital by 40%.

Since notching up two-years of performance under the new target in June 2022, QRI's net total return has consistently exceeded the bottom end of the target to 31 October 2022 on a rolling 24-month basis. This combined with improvements in portfolio construction, processes, and governance since the Fund was launched, warrants an **upgrade** to a **Recommended** Product Assessment.

To maintain our upgraded assessment, we would expect in line with best governance practices that the Manager will take material action to narrow the unit price discount to NAV over the next 12 months. This discount is now large (~9%) hence necessitating this action. We would also view negatively from a governance perspective a scenario whereby unit price converges to NAV and further capital is raised shortly thereafter – this would be viewed opportunistically on our end, and we would prefer to see at least six months of unit price equality or premium to NAV before further capital is raised. To be clear, this is not our base case, and we expect both: (1) outperformance to target to continue and (2) unit price convergence to NAV over the next year.

Figure 4. Estimated Risk-Adjusted Return Comparison



** All returns for indices, unless otherwise stated, are calculated using annualised monthly returns from 30 November 2018 to 31 October 2022.* ***QRI return based on NTA.***
*** Calculated as at 31 October 2022. *** Calculated based on annualised monthly returns data from 30 November 2018 to 31 October 2022.*

Construction and Investment Process

There have been **no material changes** to QRI's portfolio construction and investment process.

QRI's Construction and Investment Process improved following changes to the Allocation Policy in July 2021, as outlined in a prior report (see page 4 of the QRI Report dated 15 September 2021).

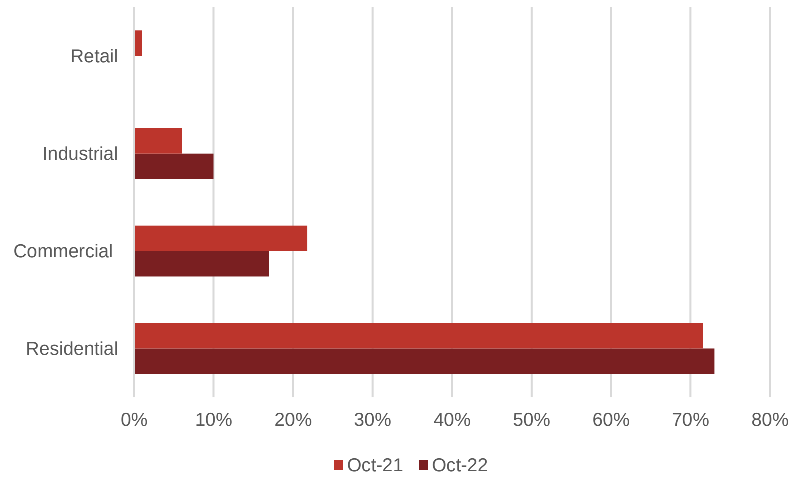
The Manager has continued to increase the mix of direct loans over indirect loan investment through Qualitas Wholesale Real Estate Income Fund from 87% of the portfolio as at 31 July 2021 to 93% at 30 September 2022 (31 July 2020: 47%; 31 July 2019: 37%). The benefits of investing in direct loans are that it gives the Manager more flexibility in portfolio construction as well as providing greater control over the loan investment.

Portfolio Risk Management

QRI's portfolio risk management has been enhanced by: more frequent loan reviews following the onset of COVID-19 in 2020; the move to weekly NAV reporting from June 2020; and the implementation of an in-house developed internal risk grading model / methodology in June 2021, as outlined in a prior report (see page 5 of the QRI Report dated 15 September 2021).

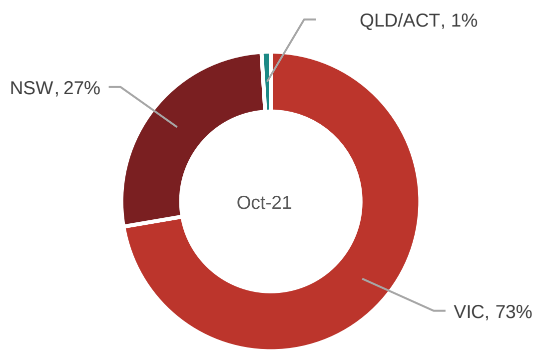
The Qualitas Risk Grading Model has now been applied to all portfolio investments. The advantage of using such a model is that it provides a more consistent approach for assessing loan investment opportunities and undertaking post settlement reviews. **We have reviewed this model and internal credit papers and view them to be in-excess of market standard in terms of depth of diligence.**

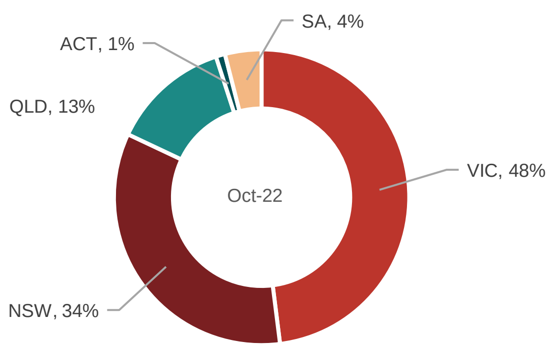
Figure 5. Portfolio Composition – Property Sector



Source: BondAdviser, Qualitas. As at 31 October 2022.

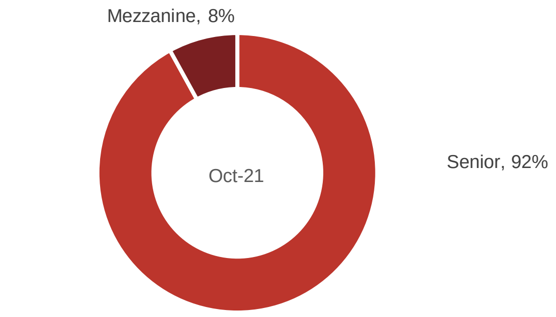
Figure 6. Portfolio Geography Mix

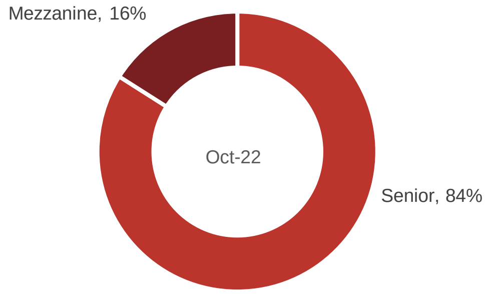




Source: BondAdviser, Qualitas. As at 31 October 2022.

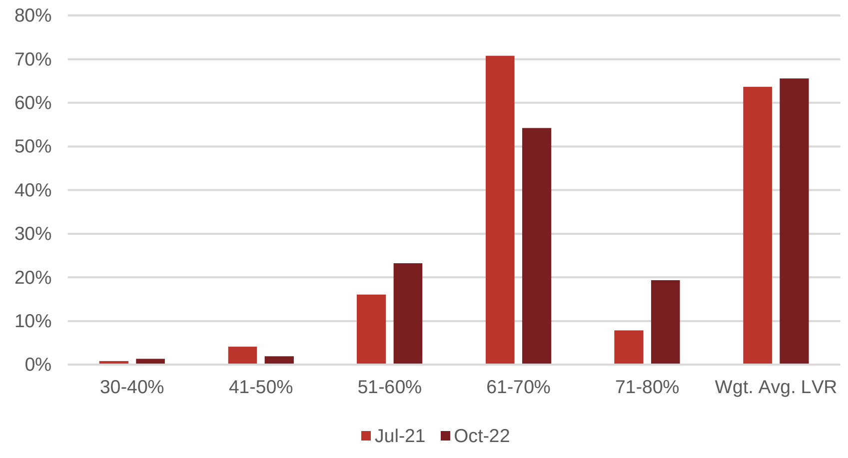
Figure 7. Portfolio Loan Classification*





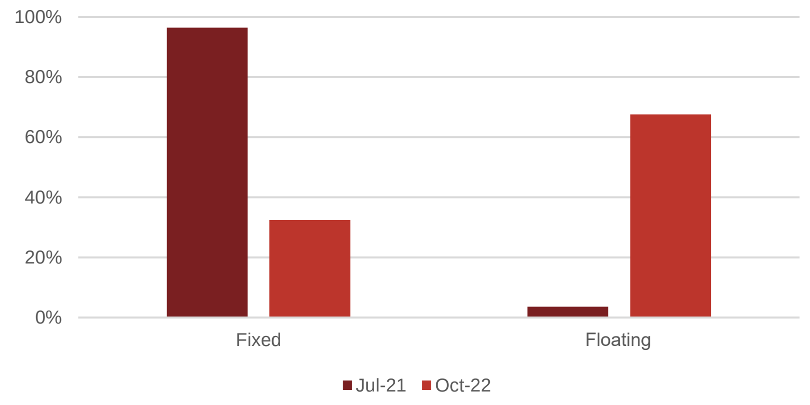
*Source: BondAdviser, Qualitas. As at 31 October 2022. *Excludes cash and trust loan receivables.*

Figure 8. LVR Exposure Over Time*



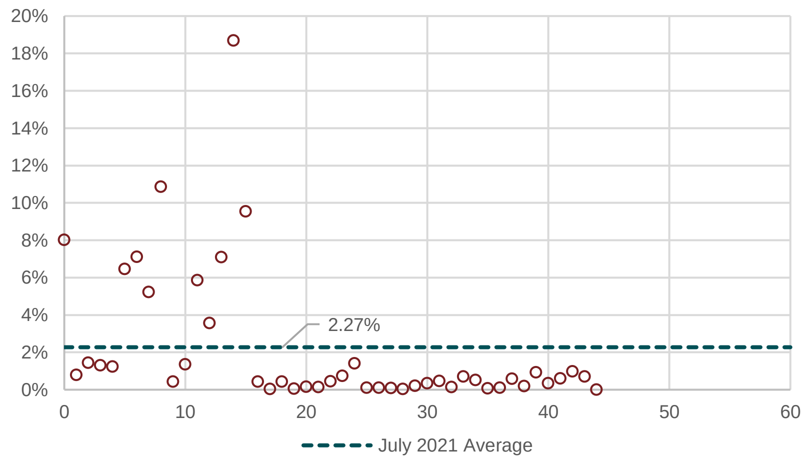
*Source: BondAdviser, Qualitas. As at 31 October 2022. *Excludes cash and trust loan receivables.*

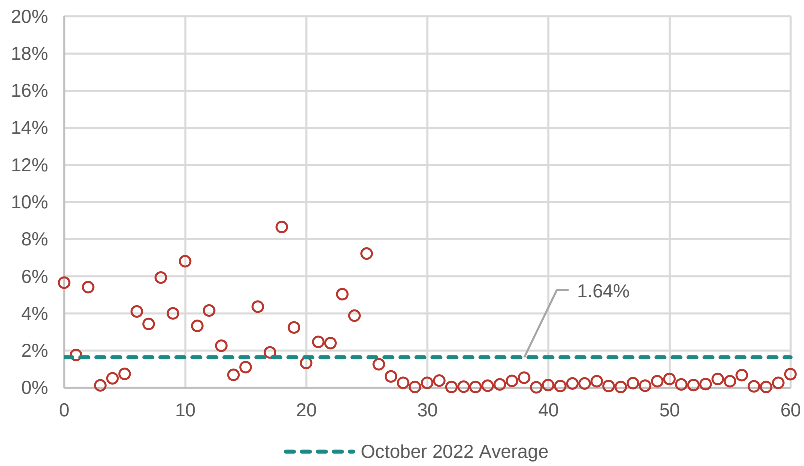
Figure 9. Loan Rate Type Exposure*



*Source: BondAdviser, Qualitas. As at 31 October 2022. *Excludes cash and trust loan receivables.*

Figure 10. Individual Loan Exposure*





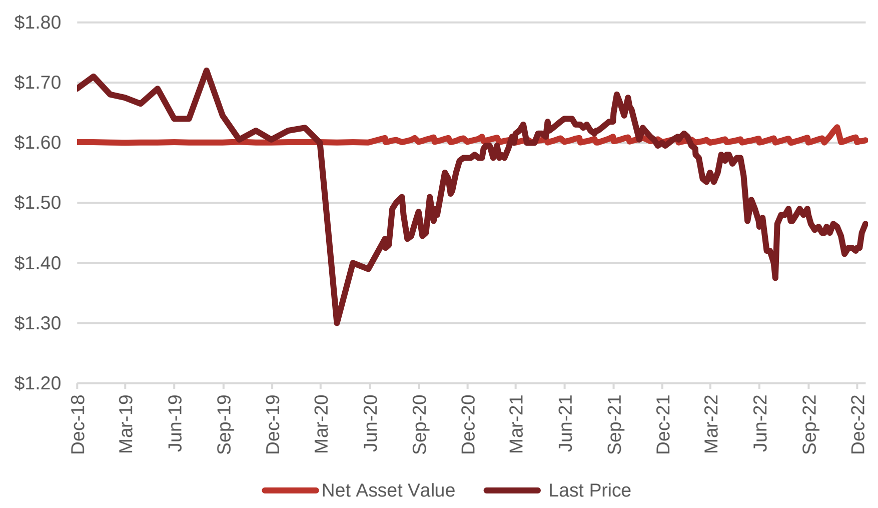
*Source: BondAdviser, Qualitas. As at 31 October 2022. *Excludes cash and trust loan receivables.*

Fund Governance

There have been **no material changes** to QRI's fund governance.

Governance was strengthened in 2020 with Fund Performance Meetings replacing the Portfolio Asset Management Committee, as outlined in a prior report (see page 6 of the QRI Report dated 15 September 2021).

Figure 11. Net Asset Value Against Unit Price



Source: BondAdviser, Bloomberg. As at 16 December 2022.

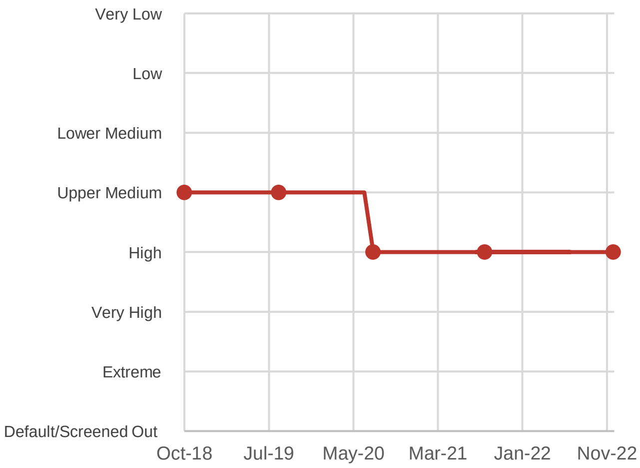
In early 2021 the unit price initially began trading at a premium to NAV, however this reversed at the beginning of 2022 when global markets sold off as a result of inflationary fears. The collapse of numerous domestic builders and developers during the year has also contributed to negative sentiment for funds with real estate development exposure. Rates have increased rapidly since the RBA (belatedly in hindsight) kicked off the tightening cycle in May 2022. Clearly the credit cycle has turned, bringing increased credit risk. Unsurprisingly, these factors have impacted QRI's unit price, which has been a common theme amongst listed credit funds. Looking through the uncertainty at the peak of COVID uncertainty, QRI's NAV has remained relatively steady at or above $1.60 per unit since listing, which is to be expected given the portfolio is composed of unlisted private credit instruments. Importantly, loans are reviewed monthly and as at 31 October 2022, no loan investments are in arrears or impaired.

QRI's Entitlement Offer and Shortfall Offer closed on 28 October 2021, raising $171.6 million, representing ~29% of QRI's FuM post raise. While all LITs suffered from market-related selling pressures, we view this capital raise as having been a contributing factor to the significant unit price and NAV bifurcation. The unit price to NAV discount was 8.7% as at 16 December 2022. The Manager has strategies in place such as providing regular investor communications and marketing to financial advisers, in order to improve liquidity and demand. These are positive, but we would also like to see more definitive action such as an on-market buy-back or garnering the support from a new institutional investor.

The Fund can be geared up to 10% of NAV, but as at 31 October 2022 there was no leverage in QRI or any underlying Qualitas Funds.

Quantitative Analysis

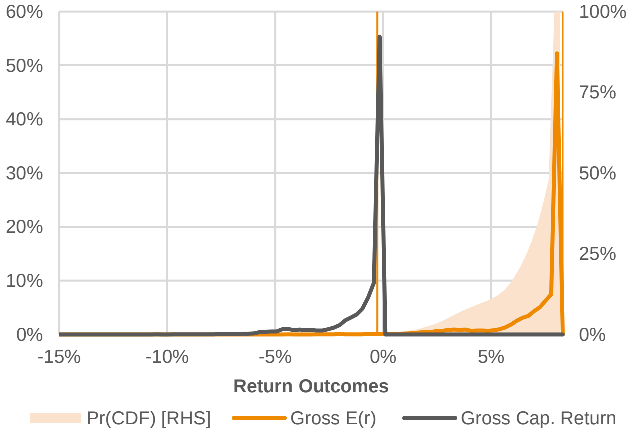
Figure 12. Risk Score

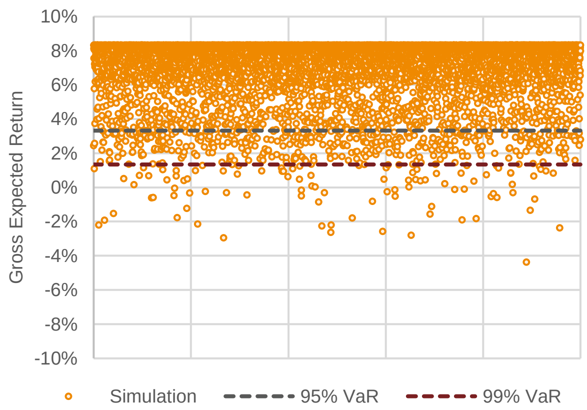


The **underlying portfolio performs well under our quantitative modelling**. When tested against our baseline scenario, the average expected return has improved from 5.47% in 2021 to 7.30%. This can be attributed to the combination of a switch to floating rate loans in a rising rate environment and an increased weighting to higher yielding mezzanine loans. This has seen the 99% VaR improve from -1.87% VaR in 2021 to 1.34%.

Despite the doubling in exposure to mezzanine loans versus when the portfolio was last modelled, **increased counterparty diversification has markedly reduced expected value at risk under our stressed modelling.** Less extreme simulated losses relative to our 2021 modelling are illustrated by an improvement of the 99% VaR from -5.02% to -2.37%. Our Risk Score remains **"High"** or "BB" equivalent.

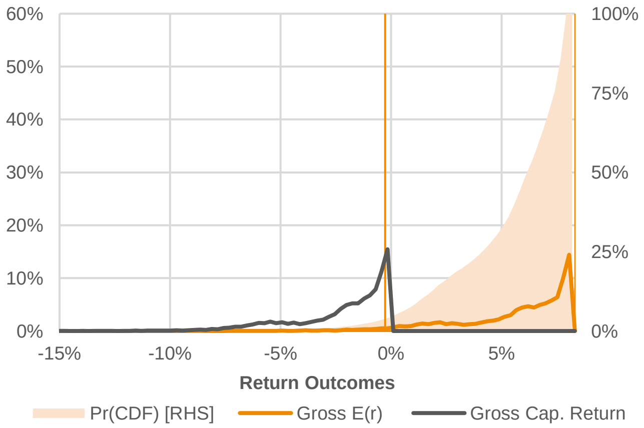
Scenario 1. Baseline Underlying Asset Assessment

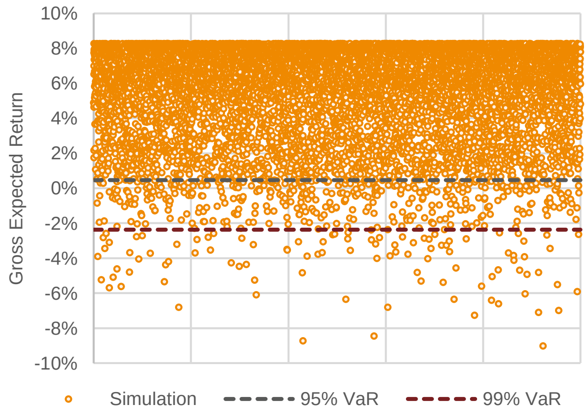




Source: BondAdviser Estimates. Data as at 31 October 2022. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated.

Scenario 2. Stressed Underlying Asset Assessment





Source: BondAdviser Estimates. Data as at 31 October 2022. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated.

Reporting History

QRI Report – 15 September 2021

QRI Report – 27 August 2020

QRI Entitlement Offer Report – 10 September 2019

QRI Report – 8 October 2018

Alternative Investment Fund Research Methodology

Click here to view

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Report created on 20 December 2022.