

Westpac Office Trust

A high-yield traditional A-REIT

Event

In late December, WOT announced that it had independently revalued all of the Trust's assets, which resulted in a marginal uplift in the value of the portfolio to \$1.14B. Including the market-to-market value of interest rate hedges and the sale of an asset for \$35.5M, the pro forma NTA is now \$0.83 per fully paid unit. Re-leasing of expiring tenancies has resulted in the portfolio having no major expiry risk until 2015, a strong position, in our view. Distribution guidance remains unchanged at 6.65cpc for FY10, which is also an attractive yield relative to that of its peers in the sector.

Implications

We believe WOT has a high-quality asset base that supports a sustainable and predictable income profile. Approximately 94% of its income is derived from high-quality tenants such as Westpac Bank, Woolworths and IBM, providing fixed annual growth in property income. Relative to that of its peers, the lease expiry profile is also attractive, with no major expiry risks until 2015. However, the Trust's balance sheet has above-average leverage (~60%) relative to that of its peers, although our analysis suggests low risk of breaching debt covenants. Aegis estimates that over FY10 (including income growth), cap rates need to soften a further 100bps before lending covenants come under threat. More important, interest cover is 1.8x earnings compared to the covenant of 1.5x, an adequate buffer, considering the strength of tenant covenants and cashflow generation. Finally, an FY10F implied distribution yield in excess of 8.5% at current prices represents a solid premium to its peers as well as cash deposit rates in the context of current market conditions. Following the cessation of commissioned research coverage, we move to a ST ADD and LT BUY recommendations. Our estimates have only marginally changed following the sale of an asset in Nov-09.

Investment Opinion

WOT is one of a few true to label traditional A-REITs with a high-quality portfolio; predictable and sustainable income; and a reliable distribution profile. Although the leverage is above that of its peers in the sector, we believe the Trust is able to maintain this, given low tenant default risk and long lease duration of its major tenants. Debt refinancing over the next 18 months and consequent impact on distributions is a key risk to manage, albeit in improving market conditions. Long-term BUY.

With little capital growth forecast in the direct property sector over the next 12 months, we believe the Trust's attractive distribution yield and discount to NTA provide a good opportunity for investors to invest in WOT. Short-term ADD.

Earnings Summary

Yr to Jun	NPAT Rep \$M	NPAT ¹ Adj \$M	EPS ¹ c	EPS chg %	PER x	PER rel All Ords x	PER rel Sector x	DPS c	Yield %	Franking %	Deferred Tax %
2009A	(159.5)	33.7	7.0	5.5	10.7	0.6	0.6	6.7	8.9	0	100
2010F	34.2	34.2	7.1	1.5	10.6	0.7	0.8	6.7	8.9	0	100
2011F	34.0	34.0	7.0	(0.6)	10.6	0.8	0.9	6.7	8.9	0	100
2012F	32.0	32.0	6.6	(5.8)	11.3	1.0	1.1	6.5	8.6	0	100

¹ NPAT and EPS are adjusted by removing non-recurring items. All the above statistics are derived from normalised earnings.

Key Information

Share Price	\$0.75
12 month view	ADD
12 month target return (%)	23.2
12 month target price	\$0.86
Long Term view	BUY
Long Term Target Return (% pa)	18.3
3 year target price	n/a

Price Performance



Market Statistics

Market Cap (M)	\$362
Shares (M)	482.2
% of All Ords	0.02
% of Sector	0.07
12 Month Range	\$0.69 - \$0.84
Company Risk	★★★★☆
Share Price Risk	★★★★☆☆
Ethical rating	★★★★★

Performance against indices (%)

	3 Months	6 Months	12 Months
WOT	(2.6)	(2.6)	(9.1)
Sector	(4.2)	34.7	35.7
Market	2.3	31.1	36.3

Key Assumptions

Beta:	1.2
Market risk premium (%):	6.0
Risk free rate (%):	6.3
WACC (%):	10.1
Forecast cashflow (years):	10
Residual value % of total valuation:	56.6
Nominal terminal growth rate (%):	3.0

Westpac Office Trust

12M Recommendation¹: ADD

12M Target: \$0.86

Long Term Recommendation²: BUY

Long Term Target Return: 18.3% pa

Year end Jun. All figures in A\$M

Profit & loss summary					Ratio analysis				
	2009A	2010F	2011F	2012F		2009A	2010F	2011F	2012F
Operating revenue	97.9	95.5	98.1	100.6	Revenue growth (%)	12.6	(2.4)	2.7	2.5
Invest & other income	(6.9)	(6.0)	(6.1)	(6.1)	EBITDA growth (%)	0.1	(1.8)	2.8	2.6
EBITDA	81.0	79.6	81.8	83.9	EPS growth (%)	5.5	1.5	(0.6)	(5.8)
Depreciation/Amort	0.0	0.0	0.0	0.0	EBITDA/Sales margin (%)	82.7	83.3	83.4	83.4
EBIT	81.0	79.6	81.8	83.9	EBIT/Sales margin (%)	82.7	83.3	83.4	83.4
Net Interest	(47.3)	(45.4)	(47.8)	(51.9)	Tax rate (%)	0.0	0.0	0.0	0.0
Pre-tax profit	33.7	34.2	34.0	32.0	Net debt/equity (%)	172.9	167.4	168.6	168.6
Tax expense	0.0	0.0	0.0	0.0	Net debt/net debt + equity (%)	63.4	62.6	62.8	62.8
Minorities/Assoc./Prefs	0.0	0.0	0.0	0.0	Net interest cover (x)	1.7	1.8	1.7	1.6
NPAT	33.7	34.2	34.0	32.0	Payout ratio (%)	95.1	93.8	94.3	97.3
Non recurring items	(193.2)	0.0	0.0	0.0	Capex to deprec'n (%)	0.0	0.0	0.0	0.0
Reported profit	(159.5)	34.2	34.0	32.0	NTA per share (\$)	0.86	0.86	0.87	0.87
NPAT add Goodwill & Pref	0.0	0.0	0.0	0.0	ROA (%)	6.4	6.8	7.0	7.2
Adjusted profit	33.7	34.2	34.0	32.0	ROE (%)	7.2	8.2	8.1	7.7
Cashflow summary					Multiple analysis				
	2009A	2010F	2011F	2012F		2009A	2010F	2011F	2012F
EBITDA	81.0	79.6	81.8	83.9	Market cap (M)	362			
Working capital changes	0.8	0.0	(0.0)	(0.0)	Net debt (\$M)	696.1			
Interest and tax	(45.6)	(45.4)	(47.8)	(51.9)	Peripheral assets (\$M)	(0.0)			
Other operating items	(4.3)	0.0	0.0	0.0	Enterprise value (\$M)	1,057.7			
Operating cashflow	31.9	34.2	34.0	32.0	EV/EBIT (x)	13.1	13.3	12.9	12.6
Required capex	0.0	(13.0)	(10.0)	(1.0)	EV/EBITDA (x)	13.1	13.3	12.9	12.6
Maintainable cashflow	31.9	21.2	24.0	31.0	EV/EBITDA All Ind (x)	7.7	7.1	6.4	6.0
Dividends	(32.8)	(32.1)	(32.1)	(31.7)	EV/EBITDA rel All Ind (x)	1.7	1.9	2.0	2.1
Acq/Disp	(16.4)	30.0	0.0	0.0	P/E (x)	10.7	10.6	10.6	11.3
Other investing items	(0.2)	0.0	0.0	0.0	P/E rel All Ind (x)	0.6	0.7	0.9	1.0
Free cashflow	(17.5)	19.2	(8.1)	(0.7)	P/E rel All Ind ex banks (x)	0.6	0.7	0.8	1.0
Equity	0.0	0.0	0.0	0.0	P/E sector (x)	17.7	13.5	11.7	10.4
Debt inc/(red'n)	(0.5)	(19.2)	8.1	0.7	P/E rel sector (x)	0.6	0.8	0.9	1.1
Balance sheet					Assumptions				
	2009A	2010F	2011F	2012F		2009A	2010F	2011F	2012F
Cash & deposits	27.8	10.0	2.0	2.0	GDP growth (%)	0.50	0.00	1.40	1.80
Inventories	0.0	0.0	0.0	0.0	Interest Rates (%)	4.88	3.94	4.88	5.50
Trade debtors	0.5	0.4	0.5	0.5	Inflation (%)	3.65	2.50	2.50	2.50
Other curr assets	1.1	1.1	1.1	1.1					
Total current assets	29.4	11.5	3.5	3.6					
Prop., plant & equip.	0.0	5.5	5.5	5.5					
Non-curr intangibles	0.0	0.0	0.0	0.0					
Non-curr investments	1,172.4	1,149.9	1,159.9	1,160.9					
Other non-curr assets	0.0	0.0	0.0	0.0					
Total assets	1,201.8	1,167.0	1,169.0	1,170.0					
Trade creditors	13.3	13.3	13.3	13.3					
Curr borrowings	3.9	0.0	0.0	0.0					
Other curr liabilities	31.7	31.7	31.7	31.7					
Total current liab.	48.9	45.1	45.1	45.1					
Borrowings	739.2	706.1	706.2	706.9					
Other non-curr liabilities	0.0	0.0	0.0	0.0					
Total liabilities	788.1	751.1	751.2	752.0					
Minorities/Convertibles	0.0	0.0	0.0	0.0					
Shareholders equity	413.7	415.8	417.7	418.0					

Notes To Accounts

Our adjusted NPAT eliminates non-operating AIFRS adjustments such as asset revaluation and gains or losses realised on derivative instruments.

Notes: 1. The 12M recommendation rates stocks on a 12 month, absolute basis based on the total return (capital and dividends). BUY denotes an expectation of 30% or more total return; ADD within the range of 15-30%; NEUTRAL within the range 0%-15%; REDUCE less than 0% down to -15%; SELL -15% or less. ACCEPT OFFER relates to a situation where there is a public offer for shares and our view is to accept that offer.

2. The Long Term Recommendation rates stocks on a long term, absolute basis based on the average total return per annum (capital and dividends). BUY denotes a long term expectation of 4% or more above the cost of equity (also known as the required return, which measures the return required by investors given the company's risk); ADD within the range of 1%-4% above the cost of equity; NEUTRAL within the range 1% above and 2% below the cost of equity; REDUCE within the range 2%-5% below the cost of equity; SELL more than 5% below the cost of equity. ACCEPT OFFER relates to a situation where there is a public offer for shares and our view is to accept that offer.

Westpac Office Trust

December 2009 Portfolio Update

Valuations

All of the Trust's assets were independently revalued during 1H10, resulting in a marginal increase across the whole portfolio, as shown in the table below. The portfolio cap rate of 7.39% was largely similar to the stated cap rate as at June-09. As we have commented over the past few months, we believe that the asset devaluation cycle has troughed in the office sector. In particular, values of assets with high-quality income streams, such as the ones owned by WOT, have stabilised and appear to be in good demand, according to recent market evidence.

Asset sales

In November 2009, the Trust sold an asset for \$35.5M, which represents a small discount to book value of \$36M. The 100% leasehold interest in this UNSW asset was considered non-core.

NTA

As a result of revaluations and asset sales, management anticipates its pro-forma NTA as at December 2009 to be \$0.83 per unit (or \$0.33 per instalment receipt). The Trust continues to trade at a discount to its NTA and based on recent prices, the discount is just under 10%. We believe this discount will continue to narrow through 2010 as further evidence of stability in property valuations is available and investment activity improves across the sector.

Debt refinance

Following the sale of its University of NSW asset for \$35.5M, the Trust has approximately \$706M in debt, which is due for refinancing in 1H12. We anticipate that the current all-in interest rate of 6.5% will increase at the time of refinancing. We have assumed that the all-in rate will be 7.5% in our forecasts.

All other variables remaining constant, this reduces the amount of distribution available to unitholders. However, we expect the Trust will be able to maintain its current level of distribution as a result of rent growth to an extent, offsets the negative impacts of interest rate increases.

Capital structure

WOT has a high leverage of around 60% (against a covenant of 70%) relative to that of its peers. However, we believe the Trust can support this level of leverage, given the highly predictable nature of its cashflows and strong tenant covenants mitigating the risk of default. Nonetheless, we believe there is the opportunity for the Trust to move to a more optimal capital structure (reduce debt) to pursue acquisition opportunities that can increase portfolio scale and diversity. This could be potentially through the injection of new equity, which would not only diversify its investor base but also improve the liquidity of the Trust.

Outlook and Guidance

As with a number of its peers, management has a policy of distributing cash profits after provisioning for operating capex and re-leasing costs. On this basis, management provided gross distribution guidance for FY10 to be 6.65cps or 3.4 cents per instalment receipt, which is the same amount paid over FY09.

Following the successful capital restructure, we anticipate the Trust should attract a broader range of institutional investors seeking traditional A-REIT exposures. If successful, this could potentially position the Trust to capitalise on accretive acquisition opportunities.

TABLE 2: ASSET REVALUATION SUMMARY

Building	Tenant	Valuation 31/12/2009 (\$M)	Valuation 30/06/2009 (\$M)	Valuation Movement (\$M)	Valuation Movement %	Cap Rate 31/12/2009	Cap Rate 30/06/2009	Cap Rate Movement %
Westpac Place	Westpac	720.0	730.0	-10.0	-1.4%	7.00%	6.88%	0.12%
Woolworths	Woolworths	240.0	234.0	6.0	2.6%	7.75%	7.75%	0.00%
Pennant Hills	IBM	96.3	93.0	3.3	3.5%	8.50%	8.50%	0.00%
Cannon Hill 2	Honeywell	23.0	25.8	-2.8	-10.7%	9.00%	8.25%	0.75%
Cannon Hill 1	Westpac	17.8	18.3	-0.5	-2.7%	8.75%	8.25%	0.50%
North Ryde	Westpac	22.3	17.5	4.8	27.1%	7.50%	9.10%	-1.60%
Bedford Park	Westpac	17.8	18.0	-0.2	-1.1%	9.00%	8.75%	0.25%
Total		1,137.1	1,136.5	\$0.6	0.05%	7.39%	7.32%	-0.07%

Source: Company/Aegis Equities

Westpac Office Trust

Investment summary

WOT is one of a few true-to-label traditional A-REITs with a high-quality portfolio; predictable and sustainable income profile; and a reliable distribution profile. Although the leverage is above that of its peers in the sector, we believe the Trust is able to maintain this, given low tenant default risk and long lease duration of its major tenants. WOT also remains well within all its debt covenants, which is further supported by stabilising property valuations.

With little capital growth forecast in the sector over the next 12 months, we believe the Trust's attractive distribution yield and discount to NTA provide a good opportunity for investors to invest in WOT. Our price target of \$0.86 essentially reflects a small premium to its pro forma NTA.

NAV Sensitivity

In addition to our primary DCF valuation method, we have undertaken a NAV sensitivity analysis using property values as a variable to demonstrate where the market is currently pricing WOT. As the analysis below shows, it appears the market is factoring around a 30bps softening in cap rates relative to the last reported valuation results. Although not extreme, we believe further evidence of stability in asset values should provide a meaningful basis for WOT to trade closer to its NTA.

TABLE 3: IMPLIED MARKET PRICING

	Proforma NTA	NAV
	1H10	implied market pricing
Westpac Place cap rate	7.00%	7.20%
Other Assets WACR	8.06%	8.90%
Total market weighted average cap rate	7.39%	7.67%
Investment Property Value	1,137.1	1,095.5
Other Assets	22.4	22.4
Total Assets	1,159.5	1,118.0
Total Borrowings	697.9	697.9
Other Liabilities	60.0	60.0
Total Liabilities	757.9	757.9
Equity	401.6	360.1
Assumed cost of transaction	-	6.1
Management Fee Ongoing	-	11.5
Net Equity	401.6	342.5
Value per unit	0.83	0.75
Change	-	-10.3%
LVR (debt/prop val)	61%	64%

Source: Company/Aegis Equities



Aegis Equities Research

Peter Leodaritsis
Managing Director
Phone: 61 2 8296 1100
peter.leodaritsis@aegis.com.au

Mamun Rashid
Chief Operating Officer
& General Counsel
Phone: 61 2 8296 1160
mamun.rashid@aegis.com.au

RESEARCH

John Kessell
Head of Investment Research
Phone: 61 2 8296 1152
john.kessell@aegis.com.au

Sharon Loaiza
Research Manager
Phone: 61 2 8296 1131
sharon.loaiza@aegis.com.au

SALES

Craig Northey
Head of Sales
Phone: 61 2 8296 1114
craig.northey@aegis.com.au

Nigel O'Brien
Business Development Manager
Phone: 61 2 8296 1166
nigel.obrien@aegis.com.au

CLIENT SERVICES

Mandy Depangher
Manager Client Services,
Research and Model Portfolios
Phone: 61 2 8296 1159
mandy.depangher@aegis.com.au

INFORMATION TECHNOLOGY

Evan Ferris
Chief Technical Officer
Phone: 61 2 8296 1116
evan.ferris@aegis.com.au

Disclaimer & Disclosure of Interest

This publication has been prepared by Aegis Equities Research Pty Limited ("Aegis") (ACN 085 293 910), an Australian Financial Services Licensee (AFSL no. 225072). Whilst the information contained in this publication has been prepared with all reasonable care from sources, which Aegis believes are reliable, no responsibility or liability is accepted by Aegis for any errors or omissions or misstatements however caused. Any opinions, forecasts or recommendations reflects the judgement and assumptions of Aegis as at the date of publication and may change without notice. Aegis and its officers, agents, employees, consultants and its related bodies corporate, exclude all liability whatsoever, in negligence or otherwise, for any loss or damage relating to this document to the fullest extent permitted by law. This publication is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. Any securities recommendation contained in this publication is unsolicited general information only. Aegis is not aware that any recipient intends to rely on this publication or of the manner in which a recipient intends to use it. In preparing our information, it is not possible to take into consideration the investment objectives, financial situation or particular needs of any individual recipient. Investors should obtain individual financial advice from their investment advisor to determine whether recommendations contained in this publication are appropriate to their investment objectives, financial situation or particular needs before acting on such recommendations. This publication is not for public circulation or reproduction whether in whole or in part and is not to be disclosed to any person other than the intended recipient, without obtaining the prior written consent of Aegis. Aegis its officers, employees, consultants or its related bodies corporate may, from time to time hold positions in any securities included in this report and may buy or sell such securities or engage in other transactions involving such securities. Aegis and its Directors and associates declare that from time to time they may hold interests in and/or earn brokerage, fees or other benefits from securities mentioned in this publication.

Aegis, its officers, employees, consultants and its related bodies corporate have not and will not receive, whether directly or indirectly, any commission, fee, benefit or advantage, whether pecuniary or otherwise in connection with making any recommendation contained in this report and/or on this web site. Aegis discloses that from time to time, it or its officers, employees and its related bodies corporate may have an interest in the securities, directly or indirectly, which are the subject of these recommendations; may buy or sell securities in the companies mentioned in this publication; may effect transactions which may not be consistent with the recommendations in this publication; may have directorships in the companies mentioned in this publication; and/ or may perform paid services for the companies that are the subject of such recommendations. However, under no circumstances, has Aegis been influenced, either directly or indirectly, in making any recommendation contained in this report and/or on this web site.

The information contained in this publication must be read in conjunction with the Legal Notice that can be located at <http://www.aegis.com.au/Public/Disclaimer.aspx>

For more information regarding our services please refer to our website www.aegis.com.au