



10 March 2009

Westpac Office Trust (WOTCA): Sustainable cash flows

RECOMMENDATION:

Buy

PRICE TARGET:

\$0.38

Company Data and Ratios

Last traded price (\$)	\$0.28
Enterprise value (\$m)	\$1,077
Market cap (\$m)	\$135
\$0.5 Final call* (\$m)	\$241
Units on issue (m)	482
Free float	100%
52 week price range	\$0.53 - \$0.25
GICS Sector	Real Estate

* Final call is due in November 2011

Research

Dinesh Pillutla 612 9225 4422
dinesh@blighcapital.com.au

Sales

Adam Weir 612 9225 4455
adam@blighcapital.com.au

Relative performance



Source: IRESS

Earnings certainty in an uncertain environment

In an uncertain and extremely volatile market, capital preservation is the number one priority. WOTCA presents a robust risk adjusted investment and a good alternative to investing in cash. The portfolio metrics are solid and the operating cash flows are predictable, sustainable and in our view, low risk relative to other A-REITs through the current cycle. Around 95% of rental income comes from low default risk tenants such as Westpac Bank, Woolworths and IBM, a feature we believe supports a stable distribution profile over the medium to long term.

Trust debt covenants tied to property values

WOTCA is well within its two debt covenants (discussed in more detail later) and has sufficient headroom to deal with further asset valuation pressures. Importantly, the Trust covenants are tied to property values rather than total assets. The distinction has become all the more apparent in recent months where a number of A-REITs have breached/ come close to breaching debt covenants following material losses from derivative instruments that were marked to market.

As such, the extent of asset devaluation is a fundamental driver of WOTCA pricing in the short-term. We estimate cap rates need to soften by another 115bps for the Trust to be in breach of its debt covenant, which we view as highly unlikely.

Notwithstanding this, we do expect to see some downside to asset values in the June reporting season. Assuming a further 25bps softening in cap rates leads us to an NAV estimate of \$0.38 per instalment receipt (IR) or \$0.88 per fully paid unit.

A solid risk adjusted investment opportunity

Confidence in the sector is possibly at its lowest point in recent history and may take a while before we start to see a resurgence of investors in the sector. However, WOTCA provides a solid risk adjusted opportunity for investors to earn returns well in excess of cash over the next 12-24 months. The trust trades at a modest 28% discount to last stated NTA compared to the >40% discounts implied in its peer set (CPA, MOF and IOF). We see this as a positive and a perception of greater risk in its peer set.

Earnings forecasts

Year end June	2008a	2009f	2010f	2011f
NPAT (reported) (\$m)	(3.2)	(133.9)	35.1	36.9
NPAT (adjusted) (\$m)*	32.0	33.1	35.1	36.9
EPS (adjusted) (cps)	6.6	6.9	7.3	7.6
EPS growth (%)	192%	3%	6%	5%
PER (x)	11.7	11.4	10.7	10.2
NTA** (\$)	1.2	0.9	0.9	0.9
EV/EBITDA (x)	14.9	13.5	13.3	12.2
Dividend (¢ps)***	7.3	6.6	7.1	7.3
Yield on Instalment receipt (%)	14.3%	12.0%	13.6%	11.8%
ROE (%)	5.4%	7.7%	8.1%	8.4%

Source: Bligh Capital Securities. *excluding revaluation gains and AIFRS items, ** NTA is \$0.39 per partly paid unit, *** Dividend is on a full unit basis

Predictable earnings profile

The key strengths of WOTCA are cash flow certainty from long term leases to major tenants (mainly Westpac Bank, Woolworths and IBM), very low tenant default risk, and sustainable earnings growth. Around 95% of the rental income is sourced from these three tenants, thereby implying a good deal of predictability of future earnings. This is further supported by annual fixed rent increases averaging 3.5% pa across the portfolio, as such, demonstrating 'bond' like characteristics over the medium to long term.

With interest rates fully hedged out to 2011, we see minimal risk to forecast earnings from the Trust. This in turn supports our view of the Trust providing sustainable distributions out of operating earnings net of any maintenance capex requirements. Management also commented that future capital expenditure in the order of \$26m is fully provided for and mainly relates to upgrade works in its IBM asset.

Performance fee paid as units

The Trust manager was entitled to a performance fee having outperformed its benchmark index over the last 12 months. The benchmark index is a variant of the S&P300 Property Trust Accumulation index where each of the index constituents has a maximum 5% weighting in the index. The Trust outperformed this index by 28% delivering a performance fee of \$7.8m for the 12-month period.

However, the Trust's constitution defers the payment of any performance fee until the end of the first subsequent calendar year of positive total return by the Trust. We also note the performance fee is paid in the form of fully paid units issued at the 31 December 2008 NTA (before performance fee accrual) of 91 cents per unit. At current prices, the performance fee units are priced at a 15.9% premium although the actual premium/ discount will depend on the prevalent unit price when the fee is payable.

Strong portfolio metrics

As we highlight in the table below, the Trust has a Weighted Average Lease Expiry (WALE) of 9.7 years, one of the longest lease durations in the A-REIT sector, and is well backed by low default risk tenants. This level of earnings stability mitigates the risk of breach in the Trust's ICR covenant (ICR > 1.5 times core EBITDA).

Property transactions have slowed dramatically through the crisis making it difficult to assess the extent of further decreases in asset valuations. Nonetheless, we expect the impacts on WOTCA to be less severe given the low vacancy risks and fixed rent review structures embedded in the portfolio which to a degree offsets devaluation pressures. Asset values have been written down by \$92m over 2008 equating to a 97bps softening in cap rates.

Table 1 – A defensive and quality investment grade portfolio

Building	Tenant	Valuation current (\$m)	Dec-07 valuation (\$m)	% change	Cap rate current	Passing yield	Net passing rent/sqm	Net market rent/sqm	WALE (yrs)
Westpac Place	Westpac	765	820	-6.7%	6.35%	6.28%	\$488-\$723	\$504-\$749	9.5
Woolworths NSO	Woolworths	240	270	-11.1%	7.50%	7.57%	\$290	\$290	11.8
Pennant Hills	IBM	95	93	2.7%	8.00%	8.34%	\$265	\$265	5.7
Kensington	UNSW	38	41	-7.3%	7.25%	6.75%	\$194-\$256	\$215-\$345	23.0
Cannon Hill 2	Honeywell	29	31	-7.1%	7.75%	6.80%	\$339	\$360	4.9
Cannon Hill 1	Westpac	21	23	-5.3%	7.75%	6.46%	\$220	\$360	5.9
North Ryde	Westpac	19	21	-9.9%	8.50%	9.53%	\$305	\$266	5.8
Bedford Park	Westpac	19	20	-5.4%	8.25%	8.27%	\$255	\$255	10.8
Total		1,227	1,319	-7.0%	6.85%	6.80%	\$439	\$445	9.70

Source: company data/ BCS

Balance sheet in relatively good shape

A key element of the reporting season gone by has been the emphasis on balance sheet with an intense focus on the impacts of asset devaluation and out-of-the money derivative instruments on a marked to market basis.

As Table 3 shows, the impact of derivative instruments and other balance sheet items has been far more pronounced than falling asset values. Where A-REITs have debt covenants tied into a total assets to total liabilities ratio, the effect of derivative instruments has led to some A-REITs breaching/ getting close to breaching lending covenants.

In the case of WOTCA, the lending covenants are against property values (debt/ property values) which, is a much better covenant in the current environment. Table 2 below shows the Trust is well positioned as:

- Headroom against the LVR covenant is sufficient to tolerate a further 115 bps easing in cap rate or equating to a further 14% fall in the total portfolio value, and
- The ICR covenant is sufficient to accommodate a fall in net property income of \$11.2m or equating to 21% of total net property income. Effectively either of Westpac, Woolworths or IBM need to default on rent obligations to be in breach of the ICR covenant, a highly unlikely event in our view.

Table 2 – Good headroom under debt covenants

Covenant definition	Jun-08	Dec-08	Covenant
Loan to valuation ratio (debt/ property value)	58%	60%	70%
Interest Cover Ratio (Core EBITDA/ Net interest)	1.83	1.75	1.50
Sensitivity to cap rate movements			
Weighted Average Portfolio cap rate	6.85%	7.35%	8.00%
Westpac PI	6.35%	6.76%	7.30%
WACR remaining portfolio	7.68%	8.35%	9.20%
Loan to valuation ratio (%)	60.0%	64.4%	70.0%
Portfolio valuation (\$m)	1,227	1,143	1,051
Headroom (\$m)	176	92	-

*EBITDA ex performance fee

Source: Company data

Table 3 - Valuing WOTCA

A-REIT	Jun-08 NTA (\$)	Asset writedown (\$)	Loss on derivatives (\$)	Other (\$)*	Dec-08 NTA (\$)	WACR (%)	Shift in cap rates	Prem/ disc to NTA
WOTCA	0.74	(0.13)	(0.21)	(0.01)	0.39	6.9%	63bps	-28%
CPA	1.62	(0.13)	(0.08)	(0.00)	1.41	7.0%	50bps	-40%
IOF	1.81	(0.19)	(0.15)	(0.17)	1.30	6.8%	50bps	-84%
MOF	1.52	(0.19)	(0.11)	(0.59)	0.63	7.0%	78bps	-86%

Source: Company data/ BCS estimates

Valuing WOTCA

We believe the key variable to focus on is the extent of asset devaluation that is likely in the current cycle. However, the task appears doubly difficult given the lack of transactional evidence and an intensely negative sentiment. As a result, we have attempted to see a valuation range under three scenarios that we expect will play out.

Our base case FY10 valuation is \$0.38 (previously \$0.45) per Instalment Receipt (IR) with a bear case estimate of \$0.22 per IR. As we alluded to before, the Trust will remain well inside its gearing and ICR covenants should this scenario play out. Given the current environment of extreme caution and capital preservation, we see this as a positive.

We see WOTCA as a true defensive play with a sustainable distribution yield over the next 12-24 months. The 875bps FY09 yield premium over the current cash rate is in our opinion an appealing risk adjusted proposition given the predictable cash flows.

Table 4 - Valuing WOTCA

	FY09* (\$m)	FY10* (\$m)	Market Cap rate (%)	FY10 Valuation (\$m)	Value per share (\$)	Scenarios	
						+0.25% inc in cap rate	+0.50% inc in cap rate
Investments	84.3	87	7.10%	\$1,227	\$2.54	\$2.45	\$2.37
Management costs				-\$6	-\$0.01	-\$0.01	-\$0.01
FY09 net debt				-\$717	-\$1.48	-\$1.48	-\$1.48
other assets/ liabilities				(78)	-\$0.16	-\$0.16	-\$0.16
Net equity valuation				\$426	\$0.88	\$0.80	\$0.72
Shares on issue (m)				483			
Less \$0.5 final instalment					\$0.38	\$0.30	\$0.22

* FY09 and FY 10 income adjusted for Westpac Bank RVA

Source: BCS estimates

Table 5 - Financial summary

Westpac Office Trust					Share Price (A\$)				0.28
As at					Market Cap (A\$M)				135
10-Mar-09									
PROFIT AND LOSS					VALUATION DATA				
Y/e June 30 (\$m)	2008a	2009f	2010f	2011f	Y/e June 30	2008a	2009f	2010f	2011f
Net property income	78	87	89	91	Net profit adj (\$m)	32.0	33.1	35.1	36.9
Other income	-	-	-	-	Operating EPS (c)*	6.6	6.87	7.29	7.64
Total operating revenue	78	87	89	91	EPS growth	191.9%	3.4%	6.1%	4.9%
Management fee/ Trust expenses	(6)	(6)	(6)	(6)	P/E ratio (x)**	11.7	11.4	10.7	10.2
EBITDA	72	81	83	85	CFPS (c)	5.4	7.2	7.3	7.6
Depreciation	-	-	-	-	NTA (\$)	1.2	0.9	0.9	0.9
EBIT	72	81	83	85	DPS (c)	7.3	6.6	7.1	7.3
Net interest	(40)	(48)	(48)	(48)	Cash distribution to investors (cps)	4.0	3.4	3.8	5.6
Pre-tax profit	32	33	35	37	Distribution yield (%)***	14.3%	12.0%	13.6%	11.8%
Tax (expense) / benefit	-	0	-	-	Payout ratio	109%	96%	97%	95%
Net Profit	32	33.1	35.1	36.9	Tax deferred	100%	100%	100%	200%
SCEQ adj profit	32	33	35	37	EV/EBIT	14.9	13.5	13.3	12.2
AIFRS items	(35)	(159)	-	-					
Performance fees*	(1.4)	(7.8)	-	-					
Reported net profit	(3)	(134)	35	37					
* Performance fees paid as fully paid units					** Grossed up by \$0.5 final call to determine ratio				
CASHFLOW					*** Yield calculated on partly paid unit				
Y/e June 30 (\$m)	2008a	2009f	2010f	2011f	LEVERAGE RATIOS				
EBITDA	72	81	83	85	Y/e June 30	2008a	2009f	2010f	2011f
Interest/ tax paid	(51)	(55)	(48)	(48)	Net debt/ equity (%)	117.4	166.8	167.5	207.2
Other	-	-	-	-	Net debt/ net debt + equity (%)	54.0	62.5	62.6	67.4
Operating cashflow	26	35	35	37	Net interest cover (x)	1.8	1.7	1.7	1.8
Capex	-	(15)	(10)	(5)	PROFITABILITY RATIOS				
Asset (acquisition)/disposal	(168)	(7)	-	-	Y/e June 30	2008a	2009f	2010f	2011f
Other	-	7.8	-	-	Return on assets (%)	5.2%	6.4%	6.5%	6.7%
Investing cashflow	(168)	(30)	(10)	(5)	Return on equity (%)	5.4%	7.7%	8.1%	8.4%
Debt increase/(reduce)	170	3	7	3	Return on funds empl'd (%)	5.4%	6.9%	7.0%	9.2%
Equity raised	1	-	-	-	Dividend cover (x)	0.9	1.0	1.0	1.1
Dividends paid	(35)	(33)	(33)	(34)	PORTFOLIO BY INCOME				
Other	-	-	-	-		2008a	2009f	2010f	2011f
Financing cashflow	137	(30)	(25)	(32)	Westpac PI	48.3	49.3	50.3	51.3
Net change in cash	-5	-26	0	0	Woolworths NSO	17.8	18.3	18.8	19.3
					IBM Centre	6.3	9.8	10.0	10.3
					Other assets	6.4	9.4	9.6	10.0
					Total	78.8	86.7	88.7	90.9
BALANCE SHEET					INVESTOR CASH YIELD ANALYSIS				
Y/e June 30 (\$m)	2008a	2009f	2010f	2011f		2008a	2009f	2010f	2011f
Cash	46	20	20	20	Distribution (cps)	7.3	6.6	7.1	7.3
Receivables	-	-	-	-	Instalment interest payable (cps)	3.3	3.3	3.3	1.6
Other	48	2	2	2	Net cash to investors (cps)	4.0	3.4	3.8	5.6
Current assets	94	22	22	22	implied pre tax yield (%)	14.3	12.0	13.6	11.8
Investments	1,281	1,237	1,247	1,252					
Other assets	-	-	-	-	*FY07 numbers understate profits by \$13.4m due to interest costs relating to construction that were not capitalised. Also, rental income was received for part of the year.				
Non-current assets	1,281	1,237	1,247	1,252	DCF Assumptions				
Total assets	1,375	1,258	1,268	1,273	Risk free rate	3.2%			
Payables	-	-	-	-	Risk premium	10.0%			
Debt	747	740	747	750	Beta	70.0%			
Provisions	-	-	-	-	Cost of debt	6.7%			
Other liabilities	30	87	87	87	Discount rate	9.2%			
Total liabilities	777	827	834	837	Long term growth	3.0%			
Shareholders' equity	597	431	434	436					
Minorities	-	-	-	-					
Total shareholders funds	597	431	434	436					
W/A diluted shares on issue	481	482	482	482					

Source: BlighCapital Securities estimates

Recommendation structure

Buy:	Absolute price performance upside of 15% on a 12-month view
Accumulate :	This is a tactical and switching idea where we expect the stock to outperform against index on a 3-6 month view
Sell :	Absolute price performance downside of 15% on a 12-month view.
Reduce :	This is a tactical and switching idea where we expect the stock to underperform against the index on a 3-6 month view

Contact	Sector	Phone	Email
Equities Research			
Dinesh Pillutla	Real Estate	+612 9225 4422	dinesh@blighcapital.com.au
Tim Mann	Industrials	+612 9225 4478	tim@blighcapital.com.au
Vishal Gada	Industrials	+612 9225 4433	vishal@blighcapital.com.au
Equity Sales			
Adam Weir	Institutional sales	+612 9225 4455	adam@blighcapital.com.au
Vijay Nandan	Sales Execution/ Trading	+612 9225 4411	vijay@blighcapital.com.au
Sarah Coffey	Executive Asst./ admin	+612 9225 4489	sarah@blighcapital.com.au
Corporate Advisory			
David Ledger	Resources/ Industrials	+612 9225 4477	david@blighcapital.com.au
Justin Dethridge	Industrials/ Technology	+612 9225 4444	justin@blighcapital.com.au

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