Guest Speaker Spotlight: Paul Brunker

The SMF was pleased to welcome Paul Brunker as a guest speaker on the 19th of April 2021. Paul is a Director at Optar Capital, responsible for covering the Energy, Telecommunications, Building Materials, Consumer Discretionary and Real Estate sectors. Paul has over 28 years' experience in financial markets, both in the UK and Australia. Before joining Optar Capital, Paul was a Managing Director at J.P. Morgan, serving as Head of Equity Research and as an analyst with coverage of Equity Strategy and Telecommunications. Paul has a degree in Modern History and Economics from the University of Oxford and a Masters in Economics from the University of London.

The session with Paul was based around Q&A with the SMF team, largely focused on the real estate sector. Some of the key insights that Paul shared with the SMF are summarised below.

1. In the real estate industry, if there is a dispersion between the private market valuation and the public market valuation, do you see this as an arbitrage opportunity?

Disconnect between the two markets has happened before. Private markets are usually more optimistically priced and also take longer to adjust than public markets. However, this does not mean that public markets are always correct as there is potential for them to overshoot during adjustments. With the impacts of the COVID-19 pandemic and the working from home phenomenon, face rents (which support official valuations) and rental incentives (effectively what people pay) have diverged significantly in the past 6 months. Private market valuations may not have factored in the decline in effective rents, both actual and expected.

If a stock can be bought at a discount to NTA, a company in principle could sell assets at their private market valuation, therefore receiving accretion to their stock price value overnight. This is best seen as an arbitrage opportunity that the public market could exploit. However, any such arbitrage opportunities will ultimately diminish by the virtue of valuations coming down.

2. In terms of the leverage risk in the real estate industry, what points should investors pay attention to?

While a high leverage ratio is an alarming factor in most industries, it can be less significant in the real estate sector. Within the industry, leverage is traditionally looked at relative to assets on the basis that in a worst-case scenario the lenders can realise a high proportion of book value since the assets are liquid and reasonably generic. This is in contrast to other industries, where assets hold limited usefulness to others and in the circumstance of business failure are likely to be severely impaired. The constant dilemma for lenders in real estate is how secure the asset values are. Typical listed real estate leverage at a maximum is around 30-35% debt to debt plus equity, which is an appropriate level for lenders to absorb a big draw down from asset values. Companies seem to be able to get more leverage in the unlisted market compared to public markets. However, this seems hard to rationalise given that listed companies typically have more diversified assets and ready access to equity from the public market. Provided the market is stable or rising, expansion in real estate values will likely lead to more being borrowed for the purchase of additional assets.

3. What will brick-and-mortar retail businesses look like 15 years from now?

It is difficult to forecast the specific landscape 15 years from now. However, it is possible to get a few years ahead by looking at other developed economies like the US, UK and Canada which are ahead of Australia in online commerce, which is the main threat to retail property values. It can be argued that there are specific barriers to online penetration in the Australian market, such as the geography and demography. However, in practice these are probably insufficient to stave off some pressure on brick-and-mortar businesses, given what we see overseas.

The online trend will continue to grow. The industry generally agrees that Australia is heading for higher online penetration and ultimately a shared ecosystem between brick-and-mortar and online, though it is unclear where the tipping point sits. Brick-and-mortar will play a role in the ecosystem through showrooms for products, with many purchases ultimately finalised online. There should be a shift from the traditional store rollout strategy to a smaller retail footprint and space. As the physical retail space shrinks, a greater concentration of retail property in high traffic locations would lead to the survival of high-quality stores. Conversely, it can be argued that lower rental rates eventuate because the value of square metres is continually falling. In any event, the possibility of retail assets running into trouble is real.

4. Are there any business characteristics that you look to assess whether a brick-and-mortar retailer is taking the right approach in competing with the online giants like Amazon or Alibaba?

Brick-and-mortar retailers must be skilled in the online space as well. There are not too many examples where a company has maintained their competitive advantage from relying solely on a brick-and-mortar strategy. Successful companies like JB Hi-Fi essentially use the physical and online channels to support each other, allowing customers to make purchases through click and collect and using stores as fulfilment centres. Promising aspects to look out for include whether the company is focusing on customer experience over piling lots of products into one square metre, whether they have dedicated display areas for brands, and whether there is enough space for customers to walk around the store. It also depends on the product breakdown, and whether the retailer is developing their own online strategy. Brick-and-mortar retailers are losing 'attachment' revenue (add-ons to the main purchase) as customer patterns change towards buying what they specifically planned to buy via online search. Therefore, stores that carry a greater product mix may be less vulnerable to online competition if they can still generate some impulse purchases.

5. What are your thoughts on the future prospects of ESG Investing? Do you think there is a possibility for the market to correct itself naturally, or do you think government intervention is required?

The potential for market failure will persist without strong government intervention because investors have a fiduciary duty to seek returns on behalf of their stakeholders. Investors constantly face the question about how ESG factors may impact on returns. Although some academic views show that ESG has helped rather than harmed returns, investors will eventually encounter a point where investment considerations conflict with ESG objectives. For example, all major hydrocarbon producers now have some degree of ESG in their rhetoric, yet they are still pursuing flat or growing production. Should investors buy these stocks if they are cheap?

Companies facing pressure from shareholders may prefer government intervention, as it would serve to level the playing field within the industry. Shareholders would consequently be able to choose investments with a degree of certainty about the trade-offs between ESG and financial returns. Further, government intervention may be viewed favourably as companies realise environmental risk in particular is not an issue that can be addressed at an individual level. Further, some may decide not to act without government intervention due to the risk of market failure, where each company individually believes other companies should be doing more. In the future, it is likely the government will eventually increase its role, especially if the private sector starts to argue for it.

Prepared by Julie Lin (Relationship Officer)