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. Since inception in 2008, the Group has built a strong track record in the CRE debt and equity space, with zero capital losses in loan origination.

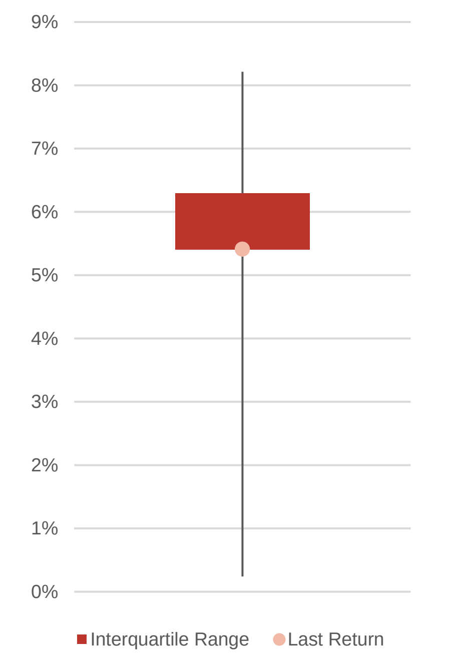
QRI is a closed-ended trust with a target return of RBA Cash Rate plus 5.0 - 6.5% per annum (net of fees and expenses), which we believe to be commensurate with the risk associated with the provision of debt funding for typically illiquid and bespoke CRE assets. The vast majority of the portfolio comprises direct loan investments, as exposure to Qualitas’ wholesale funds has been progressively reduced. As at 31 July 2021 direct loans comprised 87% of the underlying portfolio compared to 37% two years earlier. The fee structure includes a 1.50% p.a. (ex GST) of portfolio NAV management fee, and a 20% performance fee for outperformance above the 8.00% p.a. (net) hurdle rate.

Figure 1. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	0.44	0.46	0.55	0.51	0.55	0.46	0.44						**3.41**
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**

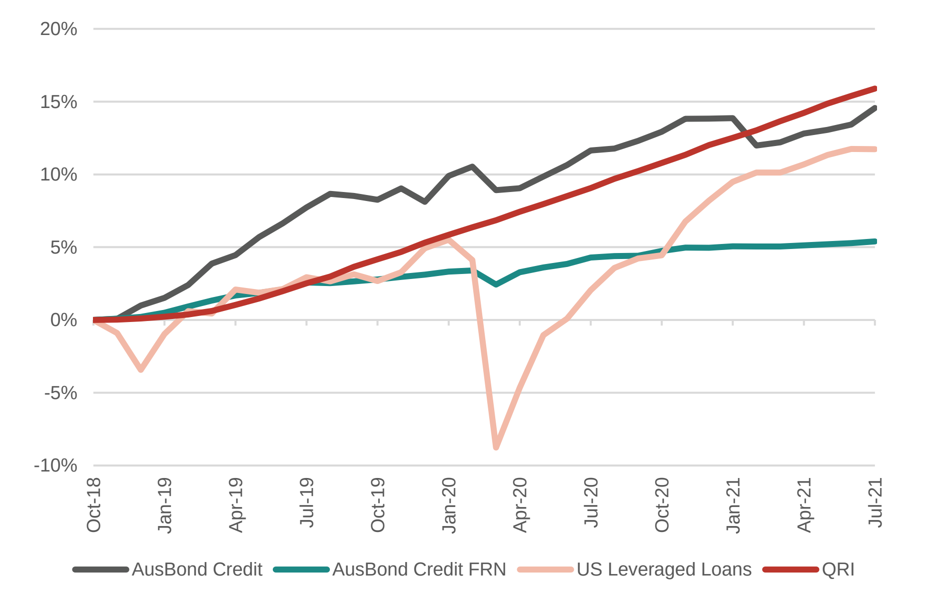
Source: BondAdviser, Qualitas. As at 31 July 2021.
** Return is monthly net total return based on daily weighted NTA plus dividends.*

Figure 2. Net Returns Distribution**



Source: BondAdviser, Qualitas. As at 31 July 2021
*** Annualised monthly returns based on daily weighted NTA since inception.*

Figure 3. Relative Cumulative Performance (NTA)



Source: BondAdviser, Qualitas, Bloomberg. As at 31 July 2021.
QRI performance is based on daily weighted NTA and assumes all distributions are reinvested.

Qualitas has established a strong track record with no losses of capital over its 13-year history.

Qualitas took the more prudent step of moving to a variable rate target return, rather than shifting the portfolio higher up the risk curve, in search of extra yield, at the expense of credit quality.

Product Assessment

Approved

QRI is suitable for income investors comfortable with exposure to the CRE debt market. Given the illiquid nature of the underlying assets, the LIT provides a convenient listed vehicle to invest in this asset class whilst offering a relatively high running yield.

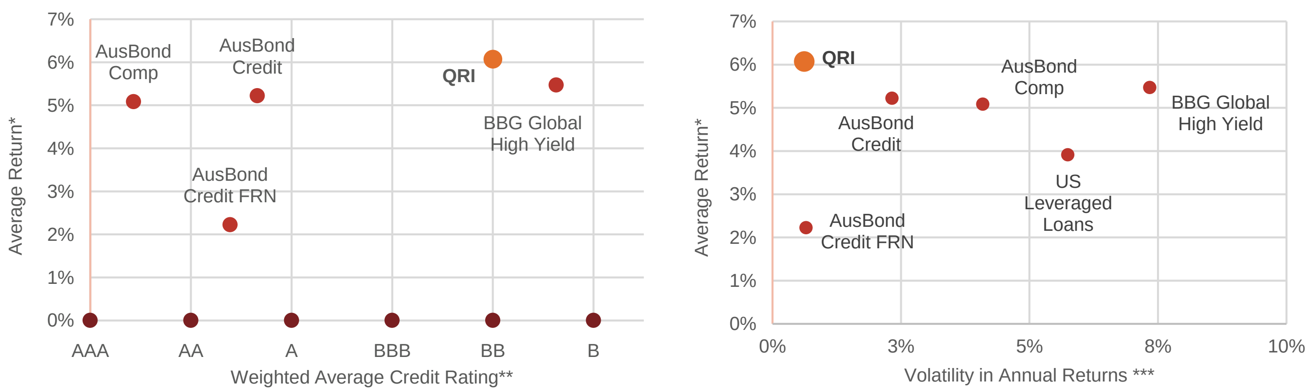
There are attractive opportunities for non-bank financiers in the Australian CRE debt market as authorised deposit-taking institutions have progressively withdrawn from this space. Operating in this sphere requires expertise as there are unique risks associated with investing in such a highly specialised area of the private debt market. In this regard, Qualitas has a strong track record with no losses of capital over its 13-year history.

The recent lockdowns have raised near-term uncertainty about segments of the property sector. While QRI's portfolio is not immune, it has limited exposure to discretionary retail and hospitality. Construction exposure represented 11% at 31 July 2021 with none in Sydney, though all is in Melbourne. The portfolio is well secured with senior ranking debt comprising 91% and there have been no material impacts on the debt pipeline to date, which remains strong. The competitive environment is increasing but importantly the manager retains a strict focus on quality and achieving the best risk-adjusted returns.

We acknowledge that QRI underperformed its initial fixed rate target return of a net 8.0% p.a set on inception of the Fund in November 2018. However, we believe Qualitas took the more prudent step of moving to a variable rate target return, rather than shifting the portfolio higher up the risk curve, in search of extra yield, at the expense of credit quality. Importantly, the implied 6.5% risk margin, at the top end of the revised target range, is consistent with original target. Since QRI changed its target return to net RBA Cash Rate plus 5.0-6.5% p.a. in July 2020, the Fund has easily met its return target. In FY21 QRI delivered a net return of 6.16% for the 12 months to 30 June 2021 (NTA based). The distribution return of 6.15% on NTA for FY21 also met guidance of at least 6.00% p.a.

While the Fund's outperformance track record is not long enough to warrant an upgrade the rating, we recognise other improvements in the portfolio construction, processes and governance. Implementing such best practice is important as Qualitas scales, given it helps embeds high quality origination and risk standards. Improvements of note include the higher mix of direct loan investments, more frequent loan reviews, the implementation of an internal loan rating system and a better allocation policy for new debt investment opportunities. As consequence, we maintain an **Approved** Product Assessment but **upgrade** the Outlook to **Improving**.

Figure 4. Estimated Risk-Adjusted Return Comparison



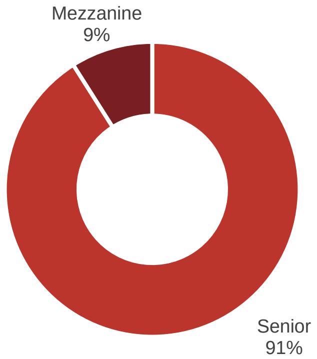
** All returns for indices, unless otherwise stated, are calculated using annualised monthly returns from November 2018 to 31 July 2021.* ***QRI return based on NTA.***
*** Calculated as at 31 July 2021. *** Calculated based on annualised monthly returns data from November 2018 to 31 July 2021.*

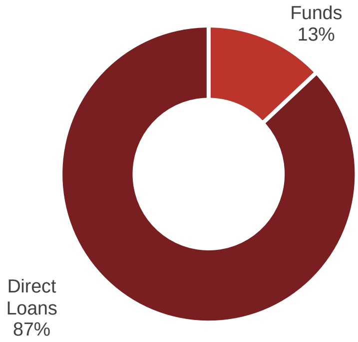
Construction and Investment Process

There have been a number of changes that have **improved QRI's Construction and Investment Process**. The Allocation Policy, which sets out how investments managed by Qualitas are allotted across its investors was changed in June 2021. The changes allow for QRI to access direct opportunities equally with other qualifying mandates in line with its strategy to invest in more direct loans, noting that previously due to QRI's fund of fund structure, it had access to direct opportunities through its investments in the wholesale funds. Additionally, the allocation process has improved with the allocation panel reviewing and making recommendations on allocation submissions, while responsibility for approval lies with the relevant investment committee. Previously, the allocation committee managed the allocation process.

The Manger has also successfully implemented its strategy of progressively increasing the mix of direct loans over indirect loan investment through Qualitas wholesale funds and Arch Finance Warehouse Trust (AFWT) notes. Consistent with this strategy the exposure to the Qualitas Senior Debt Fund (QSDF) was reduced by ~$44 million over December 2020 to January 2021 to ~$39 million, while the investment in AFWT Notes was completely exited in June 2021. Direct loans comprised 87% of the portfolio as at 31 July 2021, well up on 47% at 31 July 2020 and 37% at 31 July 2019. The benefits of investing in direct loans are that it gives the Manager more flexibility in portfolio construction and provides greater control over the loan asset.

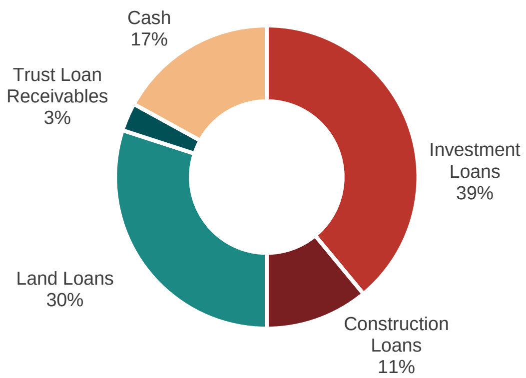
Figure 5. Loan Classification (LHS) and Investment Type (RHS)

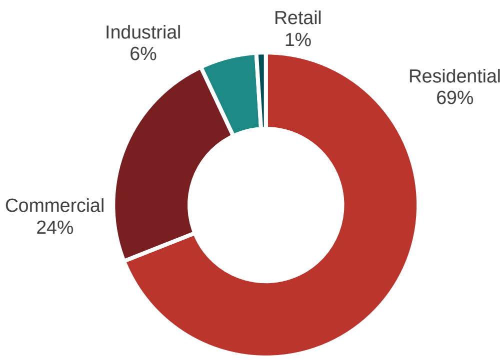




Source: BondAdviser, Qualitas. As at 31 July 2021.

Figure 6. Portfolio Composition (LHS) and Sector Diversification (RHS)





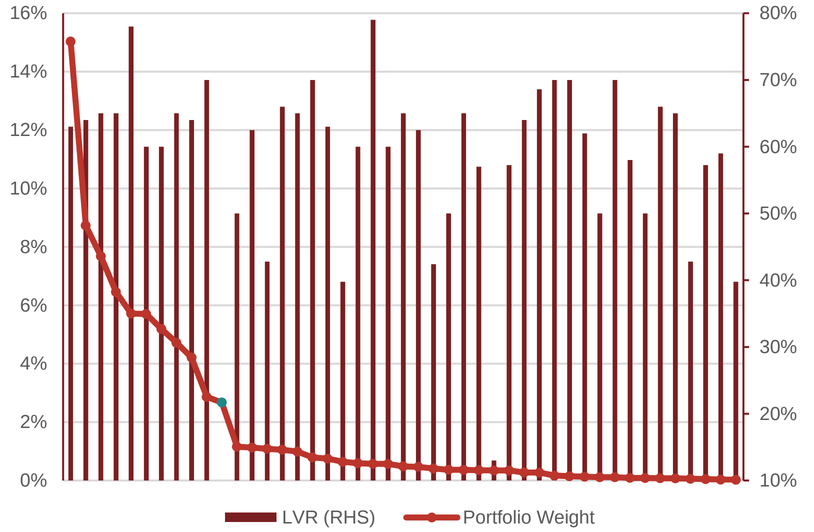
Source: BondAdviser, Qualitas. As at 31 July 2021.

Portfolio Risk Management

QRI's **portfolio risk management has been enhanced** with more frequent loan reviews. The onset of COVID-19 in 2020, saw the Fund move from 6-8 week, to monthly, loan and impairment assessment reviews. From June 2020 onwards, QRI moved to weekly NAV reporting to increase transparency. These changes were formalised as part of improvements to Governance, as discussed below. The increase in frequency of loan reviews improves the ability of the Manager to get ahead of any potential issues with the underlying loan investments in the portfolio.

Additionally, an internal risk grading model / methodology, developed in-house, was implemented in June 2021. This provides a more consistent approach to assess loan investments at approval and post settlement.

Figure 7. Counterparty Diversity and LVR



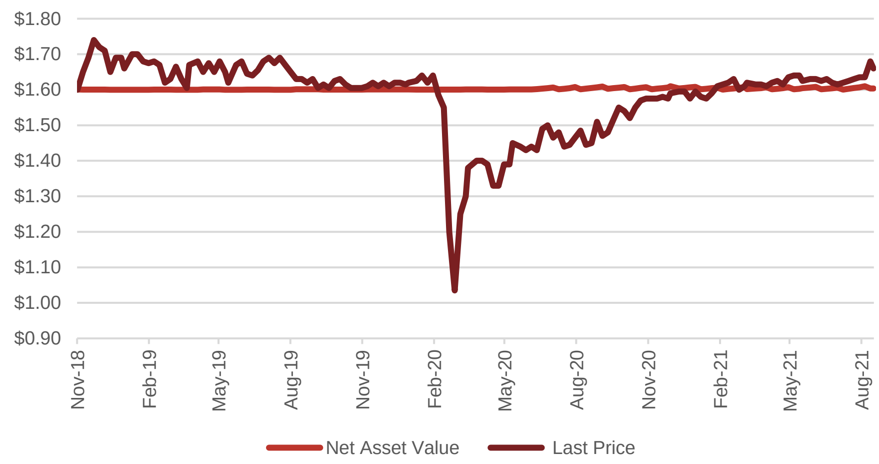
Source: BondAdviser, Qualitas. As at 31 July 2021. ***Blue dot*** *represents manager loan exposure, which does not have a corresponding LVR. Weighting of portfolio includes value of any cash positions, which are not displayed in this chart.*

Fund Governance

We consider QRI's **fund governance to have strengthened** with Fund Performance Meetings (FPM) replacing the Portfolio Asset Management Committee (PAMC) in June 2020. It comprises representatives from across Qualitas, including the executive team, research, risk, finance and legal and compliance (by invitation). The FPM is a more formalised and dedicated meeting held monthly compared to the 6-8 weeks frequency of the PMCA and has wider ranging oversight of the Fund involving:

- Strategy
- Portfolio construction and performance
- Investment pipeline and fund deployment
- Capital and liquidity
- Loan review sign-offs
- Impairment assessment
- Finance, compliance and administration
- Marketing and investor relations

Figure 8. Net Asset Value Against Unit Price



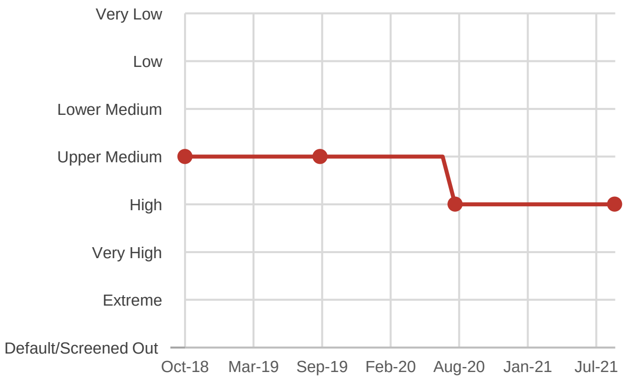
Source: BondAdviser, Bloomberg. As at 13 September 2021.

In line with other LITs, the QRI unit price fell considerably during the height of COVID in March 2020 and traded well below NAV. However, the price recovered and has largely traded at a modest premium to NAV since early 2021, unlike some peers.

The Fund can be geared up to 10% of NAV, but as at 31 July 2021 there was no leverage in QRI.

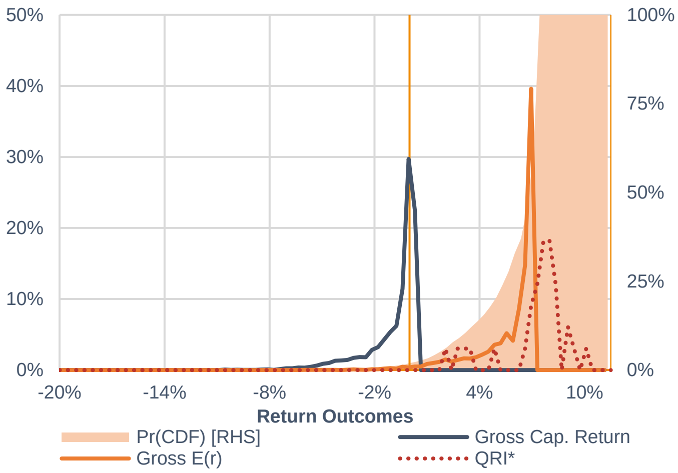
Quantitative Analysis

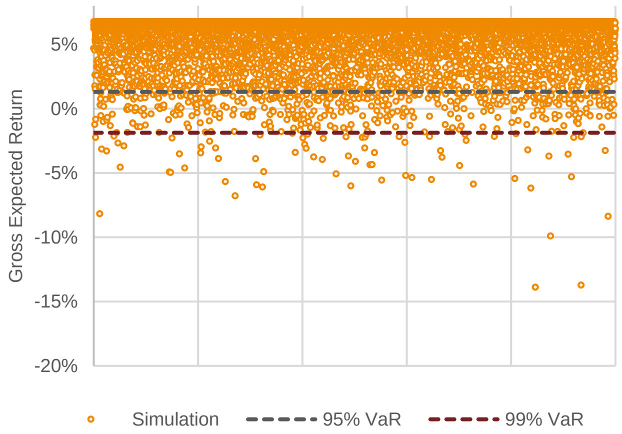
Figure 9. Risk Score



The **portfolio performs very well in our stress testing.** This is materially influenced by a substantial cash anchor worth 17% of the portfolio, preventing large negative outcomes in our modelling. This has historically been the case for QRI, with our last four reports all noting a cash anchor >10%. Our baseline modelling assumes 34% of the portfolio as investment grade (IG), including cash. This is based on an adjusted CMBS LVR mapping scale. We note the weighted average LVR is 64%. Our stressed modelling assumes all loans are sub-IG, however, given the cash anchor, short-tenor to maturity and secured ranking of the loans, the portfolio remains resilient – as was demonstrated during COVID-19. Further counter-party diversity would be required for our risk score to be upgraded.

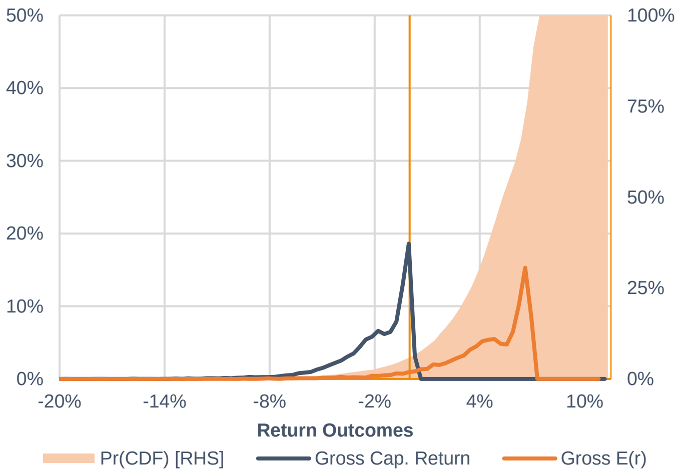
Scenario 1. Baseline Underlying Asset Assessment

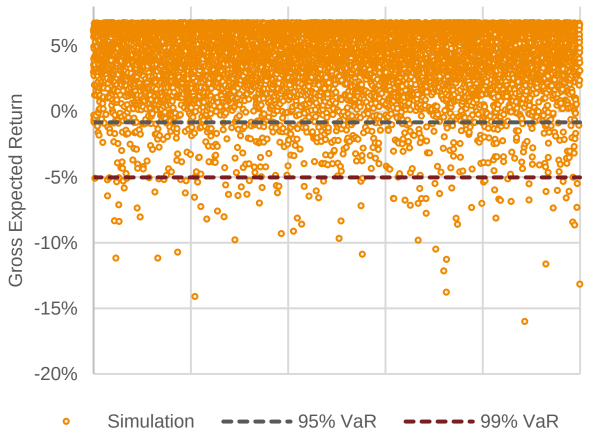




Source: BondAdviser Estimates. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated. **** QRI calculated as estimated gross return (adding back fees of 1.54% to net returns), based on past performance.***

Scenario 2. Stressed Underlying Asset Assessment





Source: BondAdviser Estimates. 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 – 27 August 2020]

[QRI Entitlement Offer Report – 10 September 2019]

[QRI Report – 8 October 2018]

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Report created on 15 September 2021.