Scentre Group 26/09/2017 **FAT-AUS-841**

SCG AUD $3.94 Core **MED.** **S**

Fat Prophets take profits

Westfield shopping centre owner Scentre Group (ASX, SCG) has tracked lower since our last review, despite what was a reasonable half year result. The company though is targeting a lower pay-out ratio as it invests capital in new projects and redevelopments. We however have concern about this strategy given what we see as a somewhat challenged outlook for the retail environment.

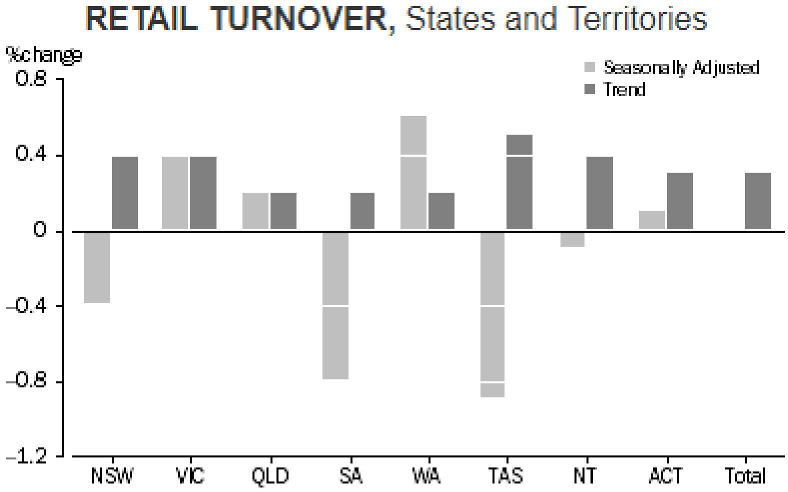
The shares have delivered a reasonable performance overall since they came into the portfolio post the demerger from Westfield, with dividend flows augmenting an overall capital gain. From a valuation perspective Scentre Group is not expensive currently, trading on 16 times FY17 forecast earnings and with a 5.6 percent dividend yield.

However, the plan to increase exposure to what is currently a very fragile retail environment, with headwinds only likely to increase, is fraught with much risk in our view. This is also clearer when looking at trends in retail sales, overlaid with our own outlook.

Data from the Australian Bureau of Statistics had retail sales coming in flat during July in seasonally adjusted terms, missing forecasts for an increase of 0.2 percent. This was the weakest result since March which was impacted by Cyclone Debbie.

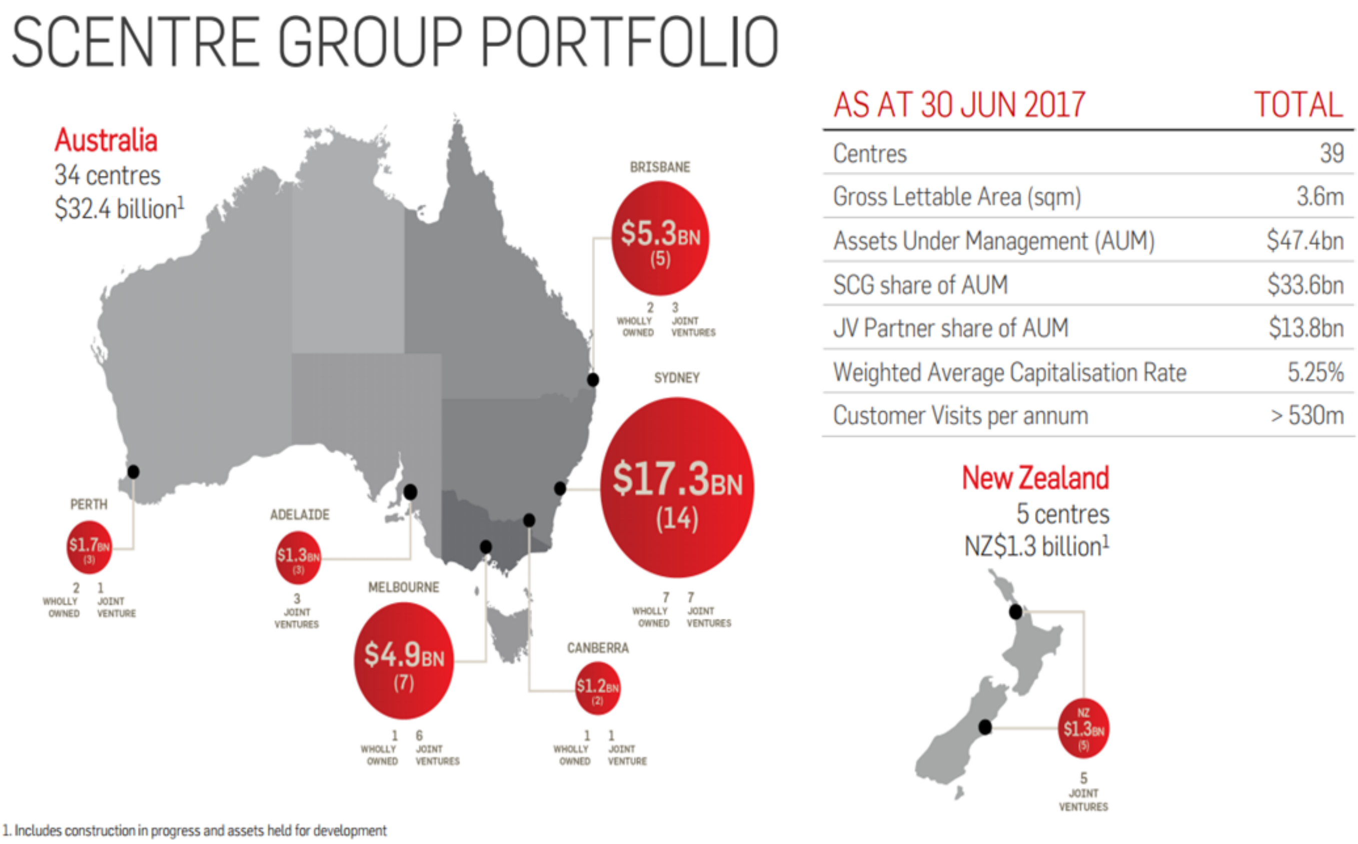
Even more noteworthy was that weakness was led by department store sales which fell some 2.8 percent. We believe this situation is likely to get worse before it gets better, with the 'Amazon effect' seeing more sales move online, which will likely put further pressure on existing bricks and mortar retailers, with flow on effects to leasing rates and occupancy levels.

A sign of the times has also been evident in Myer's decision not to renew leases at Belconnen in Canberra or Hornsby in New South Wales. Both complexes are owned by Scentre Group.



Source: ABS

<u>By state, the trends are even more interesting, and particularly relevant to Scentre Group.</u> New South Wales saw retail sales in July fall 0.4 percent on a seasonally adjusted basis in July. The group's seven Sydney centres account for the lion's share of assets under management (AUM), coming in at a total of $17.3 billion at 30 June 2017.



Source: Company Presentation

<u>In addition to online disruption, our other concern about the outlook for retail sales in Australia is two-fold, and related</u> on both counts. The consumer is already cash strapped, and particularly in the property hot spots of Sydney and Melbourne due to elevated levels of debt. <u>With lending rates already on the rise, the 'pinch' is going to be increasingly felt in our view, and potentially more so should a correction arise in the property market.</u>

Source: Company Presentation

We are therefore mindful at this point to exercise caution and reduce exposure to a retail facing (albeit high quality and diversified in terms of industry and geography) stock. **We therefore recommend that Members sell their holdings in Scentre Group.**

Half year results

Looking at the group's half year results, these were relatively solid, with Funds From

Operations (FFO) coming in at $638 million, or 12.01 cents per security, up 3.5 percent. The distribution per security increased 2 percent to 10.86 cents. For the six months to 30 June 2017, profit was $1.4 billion, underpinned by $929 million in revaluation gains on the back of operating income growth, and the completion of the company's $355 million Chermside redevelopment.

RESULTS OVERVIEW

	FIRST HALF 2017 RESULTS
Funds From Operations (FFO)	$638 million, 3.5% growth
FFO per security	12.01 cents, 3.5% growth
Distribution per security	10.86 cents, 2% growth
Comparable NOI	2.6% growth
Developments Commenced	$900 million
Assets Under Management (AUM)	$47.4 billion, 3.6% growth
SCG share of AUM	$33.6 billion, 4.0% growth
Profit	$1,412 million
Gearing	33.9%

Source: Company Presentation

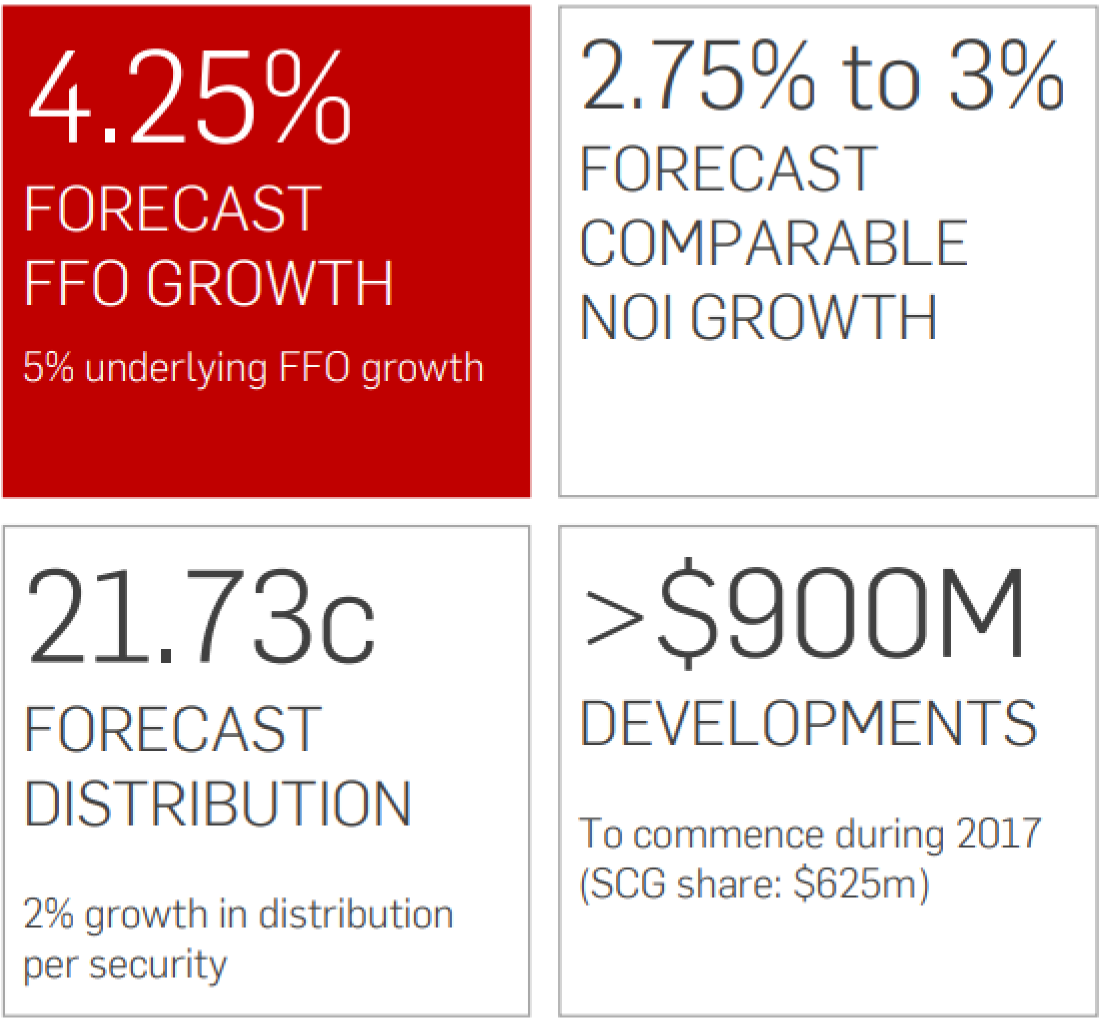
Comparable net operating income increased 2.6 percent for the six months, driven primarily by contractual rent increases. Management maintained a forecast range of 2.75 - 3.0 percent growth for the full year. Occupancy levels (at this stage) are now a concern, with the portfolio more than 99.5 percent leased.

Scentre Group is though targeting significant expansion, with $900 million (SCG share: $625 million) in developments commenced during the period, including projects at Westfield Carousel in Perth, Westfield Plenty Valley in Melbourne and Westfield Coomera on the Gold Coast.

The group now has assets under management of $47.4 billion. During the period the Group issued US$500 million (A$650 million) of bonds and refinanced and extended $3.6 billion in committed bank loan facilities. The balance sheet though is robust, with gearing of 33.9 percent at 30 June 2017.

The group has a development pipeline in excess of $3 billion with expected total returns of more than 15 percent. The flipside though is that, to fund growth, management plan to increase distributions at a slower pace than earnings until the pay-out ratio reaches 85 percent of FFO.

In terms of the outlook, management have reconfirmed forecast FFO growth for the 12 months ending 31 December 2017 of approximately 4.25 percent. The forecast distribution growth is 2 percent to 21.73 cents per security.



Source: Company Presentation

Turning to the charts, medium-term downward momentum remains at play due to the bearish moving average crossover present since October 2016 (where the 50-day moving average red line crosses below the 200-day moving average green line). In order for the short-term technical landscape to improve, a decisive break above overhead resistance sighted at the September intra-month high of $4.13 (horizontal red line) is required. Should this occur, then an advance towards the 200-day moving average (green line) of $4.25 is viable. A sustained clearance of this indicator, would be the precursor in shifting medium-term momentum north.

With reference to the monthly chart, near-term support is evident at the August low of $3.81 as marked by the horizontal thin-blue line. Should the bears drag prices below this level, then an additional zone of support is sighted between $3.51 and $3.57. This is made up of the August 2015 low as represented by the horizontal solid-blue line and the 78.6% Fibonacci retracement respectively. It is important that prices stabilise above this price range as this would encourage a period of price stabilisation to follow. Should this favourable scenario unfold, then this would increase the probability of an essential basing-formation to evolve.

Summary

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Disclosure: Scentre Group is held within the Fat Prophets Australian Share Income Model.

Snapshot SCG

Scentre Group

Latest Closing Price: $3.94

Scentre Group Limited manages, develops and has an ownership interest in Westfield branded shopping centers in Australia and New Zealand. The Company has a portfolio of approximately 38 Westfield shopping centers in all metropolitan cities and some regional centers. The Australian portfolio has around 11,135 retail outlets in 3.4 million square meters of retail space. The Company has an interest in nine centers with over 1,400 retail outlets in excess of 379,000 square meters of retail space. Its Westfield Chatswood is located in the affluent Northern Suburbs of Sydney, approximately 11 kilometers from the CBD. Westfield North Lakes is located 25 kilometers north of Brisbane’s CBD. Its Westfield Kotara is located six kilometers south-west of Newcastle’s CBD.

Market Capitalisation:$20.8b

	FY1	FY2
Price to Earnings	16.5	15.7
Dividend Yield (%)	5.6%	5.6%
Price to Book	1.02	0.98
Return on Equity (%)	6.93%	7.12%