Integrity Transparency Conviction

Folkestone at a discount, but for how long?

Thursday, March 23rd, 2017

As time allows the potential of their business strategy to be demonstrated, we see a growing scope of opportunity for real estate focused fund manager and developer Folkestone Limited (ASX: FLK). Led by a high-quality team of industry veterans, FLK continues to add breadth to its operations, which now covers several property sub-sectors.

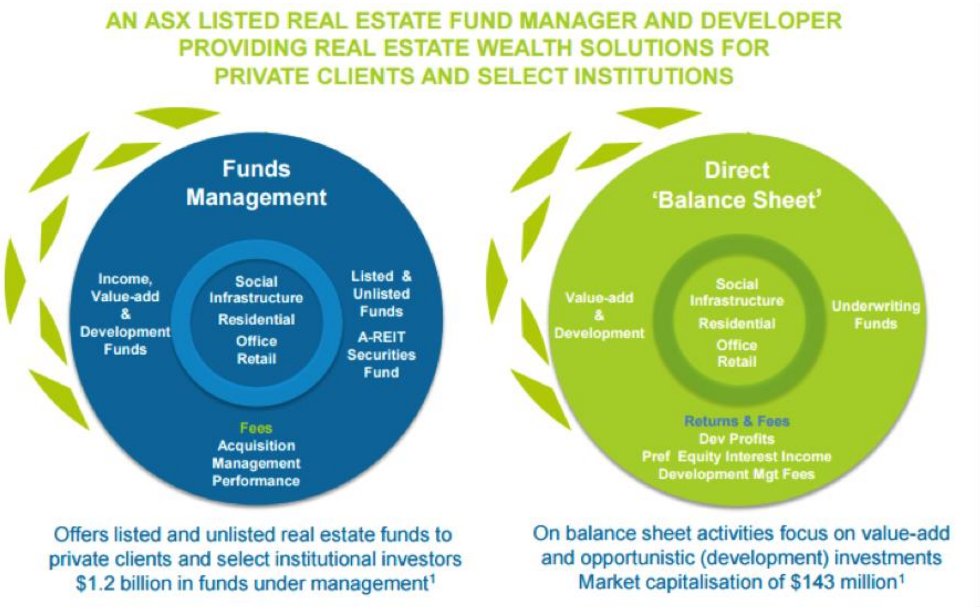

Figure 1: FLK Overview. Source: 1H2017 Results Presentation

FLK offers a diversified exposure to childcare, seniors living and retirement, income focused commercial property, hotel and accommodation property, as well as development operations that encompass a suite of residential and non-residential projects.

We see the most meaningful component of FLK's business as currently being its childcare focused AREIT, Folkestone Education Trust (FET). FLK is the external manager of FET, a trust that has grown to become the largest listed childcare focused REIT on the ASX with assets under management of around $830m. Given FET's solid development pipeline, we believe it is likely that AUM within this specific vehicle will exceed $1bn within the next 3 to 5 years.

Having noted the above, we believe FLK is well placed to also drive growth via several other avenues in the coming 3 years. FLK recently launched the Folkestone Seniors Living Fund, effectively initiating a platform that will take advantage of the growing level of demand for high quality retirement focused properties over the next decade.

Source: http://www.clime.com.au/investing-report-archive/folkestone-discount/?omhide=true&utm_source=clime&utm_medium=email&utm_campaign=ir-230317&utm_content=champion-title

FLK also has an established platform of income focused commercial property syndicates. Such has been the recent success of these unlisted funds that all are currently in a position to generate performance fees for the manager. An illustration of the embedded value held within such syndicates has been recently demonstrated by the sale of the single asset relating to the Oxley Retail Fund ('Folkestone Real Estate Income Fund at Oxley'). The Centre was sold for $43.5m, a 26% premium to the April 2014 purchase price. According to management, 'The sale price reflects an excellent outcome for our investors who have received an internal rate of return of 14.5 per cent per annum since inception of the Fund and validates Folkestone's active management of its unlisted funds.' As a result, FLK will receive a performance fee of $0.8m in the second half of FY2017.

FLK's balance sheet remains in a strong position, with cash reserves totaling $11.8m, undrawn debt facilities of $12.5m and total borrowings of $17.7m. Gearing remains low at just 8.7%.

Delving more deeply into the balance sheet also reveals why we believe FLK looks to be good value at current levels. As manager of the listed AREIT FET, FLK sensibly has a significant co-investment in the trust. This not only aligns the manager with minority investors, it represents a substantial store of value for the group and concurrently pays out a steady (and growing) income stream to FLK.

As it stands, FLK owns 30.7m securities in FET, which at current prices equates to a market value of around $80.0m. All other net assets, mainly comprising property and cash, totals $65.0m. In aggregate, this provides a net asset backing of about $145m, or $0.98 per share. For context, FLK's market capitalisation is currently $147m, a very small margin above the group's net tangible asset backing.

As such, the broader market appears to be placing little to no value on FLK's $1.2bn of funds under management and future potential of this business. Furthermore, we believe a number of development style assets held on FLK's balance sheet (either directly or indirectly) are very likely worth more than the book value currently attributed to them.

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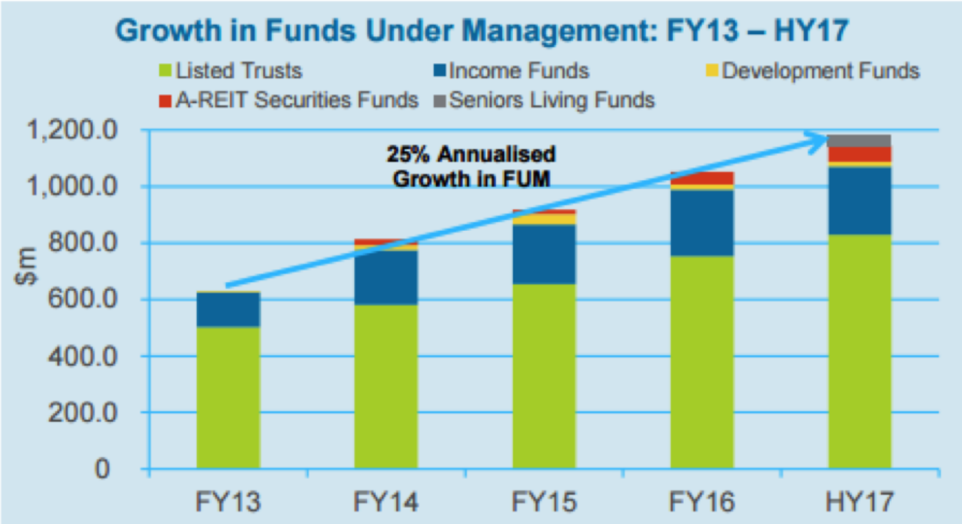

Figure 2: FLK FUM Growth 2013 – 2017. Source: 1H2017 Results Presentation

It is our view that this discount to value will gradually unwind as FLK continues to drive meaningful growth in both profit and profitability over the coming years, largely driven by ongoing growth in group Funds Under Management (FUM). Management are guiding to a stronger second half while we believe the group is well positioned to again deliver sound compound growth in FY2018 and FY2019. This view is ultimately captured in our FY2018 and FY2019 forecast valuations of $1.18 and $1.26 respectively.

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