TAYLOR COLLISON

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Desane (DGH)

24 June 2020

Update – good position

Recommendation: Outperform

Our View

In rugby league terminology – Desane has a half time lead and has the wind at its back…for the likely rough 2nd half. We retain our Outperform rating. We note that Desane is trading at a discount to NTA of $1.46 and our risk-weighted NTA upside case of $1.76. Desane has entered the downturn with a net cash balance sheet (+$7.1m cash) and surplus capital to deploy – having sold a major property at Rozelle for $78m in November 2018 (DGH realized $38.9m in NPAT).

We believe that as these proceeds are reinvested and coupled with some modest re-gearing of the balance sheet, further rental streams can be generated. Desane will aim to maintain a financially strong position during the economic cycle. Desane has projects in the planning stage, a smaller almost shovel ready project, and underutilized land on existing properties. These elements create development upside; in terms of NTA uplift and increased rental streams.

Key Points

We remain positive. Desane has a good valuation underpinned by NTA, reasonable upside, and a sound financial position to capitalize on any downturn and will continue to provide good rental income for its investors:

Rental income and project(s) upside

- We believe that the rental income from the Wacol, Brisbane property remains solid, as it is leased to the Brisbane City Council.
- We have reviewed Lane Cove West properties and believe that the tenants within these premises are in good shape to continue to pay rent.
- The 1.2Ha Penrith – Thornton St - site has valuation upside for Desane if rezoned from light industrial to medium density mixed-use/residential. We assign a reasonable probability that this is possible.
- We believe that the business could use /acquire the underlying property in an interest default event within the lending portfolio.

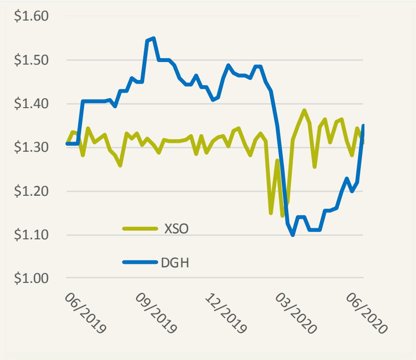
Balance sheet capacity and valuation

1. Desane has $13m in cash (less $5.9m in debt) and $6.9m in a loan portfolio (as at 31st Dec 2019). The business has $56.9m in property assets. Desane enters a potentially weakening property market with a headroom for acquisitions and development optionality.
2. We retain our Outperform recommendation with NTA of $1.46 and possibly risk-weighted NTA of up to $1.76 if some rezoning and construction (at the right price) can be secured. Outperform.

Summary (AUD)

Market Capitalisation	**$55M**
Share price	**$1.35**
52 week low	$1.095
52 week high	$1.555

Share price graph (AUD)



Key Financials (AUD)

	FY19A	FY20E	FY21E
Revenue	4.1	2.5	4.4
EBITDA	0.3	0.2	2.1
NPAT (adj)	27.3	2.7	2.2
EPS c	66.7	6.6	5.4
EPS growth	n.m	n.m	n.m
PE Ratio (x)	n.m	20.6	24.9
DPS c	4.5	2.5	3.0
Div Yield	3.3%	1.9%	2.2%
Franking	100.0%	0.0%	25.0%
EV	15.5	48.2	50.0
NTA	$1.43	$1.46	$1.49

Desane - Summary of Forecasts

DGH $ 1.350

PROFIT & LOSS SUMMARY (A$m)

Year end June	FY19A	FY20E	FY21E	FY22E
Total Revenue	**4.1**	**2.5**	**4.4**	**4.5**
EBITDA	0.3	0.2	2.1	2.2
Dep'n/Other Amort'n	0.0	(0.2)	(0.2)	(0.2)
EBIT -operating	0.3	0.1	19	2.0
Property revaluation/sale	38.9	3.4	12	12
EBIT - reported	39.2	3.5	3.1	3.2
Net Interest	(0.4)	0.4	0.1	0.1
Pre-Tax Profit	38.8	3.9	3.2	3.3
Tax Expense	(115)	(12)	(10)	(10)
NPAT Adj.	**27.3**	**2.7**	**2.2**	**2.3**
Reported NPAT	27.3	2.7	2.2	2.3
Margins on Sales Revenue				
EBITDA	7.3%	9.2%	47.7%	48.9%
EBIT	n.m	n.m	n.m	n.m
NPAT Adj.	n.m	n.m	n.m	n.m
Change on pcp				
Total Revenue		-38.2%	73.7%	2.3%
Total EBIT		n.m	n.m	n.m
NPAT		n.m	-17.0%	2.4%

BALANCE SHEET SUMMARY

Year end June	FY19A	FY20E	FY21E	FY22E
Cash	45.6	7.4	5.9	5.1
Receivables	0.1	0.1	0.1	0.1
Inventories	0.0	0.0	0.0	0.0
Other	0.3	0.2	0.3	0.3
Total Current Assets	46.0	7.6	6.4	5.5
Investment Property	43.4	517	55.1	56.1
Inventories	0.0	0.0	0.0	0.0
Property Plant & Equip	2.4	18	2.4	2.4
Intangibles	0.0	0.1	0.2	0.3
3rd party loans	0.0	15.0	10.0	10.0
Total non current assets	45.8	68.6	67.7	68.9
TOTAL ASSETS	**918**	**76.2**	**74.0**	**74.4**
Accounts Payable	10.7	0.1	0.2	0.2
Borrowings	0.0	0.0	0.0	0.0
Deferred revenue	0.0	0.0	0.0	0.0
Other	14	0.9	15	15
Total current liabilities	12.1	10	17	18
Borrowings	5.9	0.0	0.0	0.0
Provisions	0.1	0.1	0.1	0.1
Deferred tax liabilities	15.4	15.2	112	10.4
Total non-current liabilities	214	15.3	113	10.5
TOTAL LIABILITIES	**33.5**	**16.2**	**13.0**	**12.2**
TOTAL EQUITY	**58.3**	**60.0**	**610**	**62.2**

PER SHARE DATA

Year end June	FY19A	FY20E	FY21E	FY22E
EPS Adj. (c)	**66.7**	**6.6**	**5.4**	**5.5**
Growth (pcp)	n.m	n.m	n.m	n.m
Dividend (c)	4.50	2.50	3.00	2.77
Franking	100%	0%	25%	25%
NTA per share ($)	143	146	149	151

CASH FLOW SUMMARY

Year end June	FY19A	FY20E	FY21E	FY22E
EBIT (excl Abs/Extr)	**0.3**	**0.1**	**19**	**2.0**
Add: Depreciation	0.0	0.2	0.2	0.2
Change in Pay.				
Less: Tax paid			(10)	(10)
Net Interest	(0.4)	0.4	0.1	0.1
Change in Rec.				
One offs/3rd party loans	2.3	(213)		
Net working capital			-2.2	0.4
Gross Cashflows	2.2	(20.7)	(10)	17
Capex	(3.3)	0.3	(0.8)	(0.3)
Property asset sell/buy	45.3	-110	16	-10
Free Cashflows	44.2	(313)	(0.2)	0.3
Dividends Paid	(19)	(10)	(12)	(11)
Financing	(13)	32.3	15	0.9
Net Cashflows	**410**	**(0.0)**	**0.0**	**0.0**

KEY RATIOS

Year end June	FY19A	FY20E	FY21E	FY22E
Net Debt : Equity (%)	-68.1%	-12.3%	-9.7%	-8.2%
EBIT Interest cover (x)	98.0	(8.7)	(42.3)	(54.3)
Oper CF/EBITDA	n.m	n.m	n.m	n.m
Current ratio (x)	3.8	7.7	3.7	3.1
ROE (%)	46.8%	4.5%	3.7%	3.7%
Dividend Payout Ratio (%)	6.7%	38.1%	55.4%	50.0%

VALUATION MULTIPLES

Year end June	FY19A	FY20E	FY21E	FY22E
PER (x)	**2.0**	**20.6**	**24.9**	**24.3**
Dividend Yield (%)	**3.3%**	**1.9%**	**2.2%**	**2.1%**
FCF Yield (%)				
EV/EBITDA (x)	517	206.4	23.8	23.1
EV/EBIT (x)	517	765.3	25.9	25.2

SEGMENTS

Year end June	FY19A	FY20E	FY21E
Total recurring revenue	4.1	2.5	4.4
Asset sales	38.9	0.0	0.0
Revaluation	0.0	3.4	12
Total sales	**43.0**	**5.9**	**5.6**

Rental analysis – existing portfolio

We analyze Desane's rental portfolio and believe that rental income remains resilient.

The Wacol property (Brisbane) is leased to the Brisbane City Council with the clear implication that the rental default is low.

Lane Cove West - No.13 Sirius Rd is a warehouse/office that is leased to Signature Orthopedics – a medical device(s) company. Signature is in a good position to continue to pay its rent. Signature leases 2,800 m of office, space and appears to occupy the entire premises. The property is located near to major hospitals and groups of specialists such as Royal North Shore, RPA Westmead, and major private hospitals. This business was established in 2009 and manufactures, markets, and sells bespoke high-end artificial joints and other orthopedic devices used in surgery. It also exports its products.

Lane Cove West - No. 7 Sirius Road – 2 tenants This property is partly rented to Lizard Childcare – which should be a beneficiary of the federal government financial package provided to the childcare sector. Lizard Childcare leases 1,100m of space.

In the balance of 7 Sirius Rd, 1,072m is occupied by Halley & Mellowes (HMA) and this lease was renewed August 2019 with an increase in rent. HMA is an engineering and industrial machinery distributor, manufacturing business and has been in business for many years. The product range includes material handling, wear, flow, instruments, power, and geotechnical equipment. We believe that heavy industry within Australia continues to perform well with mining, heavy industry, infrastructure, and construction still open and further will benefit from government stimulus spending.

Exhibit 1 – 13 Sirius Rd, Lane Cove West, and 7 Sirius Lane Cove West

(source – Taylor Collison pictures were taken in late May 2020)

Desane – lending book

Desane also has a property lending book with $6.9m in loans as of 31st December 2019. These loans are made via a 1st mortgage over the property with reasonable LVR on the individual property deals. Often banks will not lend additional funds, due to the overall individual $ exposure issues to an individual customer ($ size of money lent to an individual group, not LVR of the property). Desane's lending book focuses on lending against property that they already understand and would be happy to acquire if the loan does not work out. This provides lending opportunities to make up this "gap" for developers with reasonable lending terms and conditions – that banks can't deliver. There are a few very well-known distributors, with relationships with Desane, that can go back decades. Some of the referrals come from ex banking staff that operates in the commercial property space and some come from past JV property owners/operator(s) with whom Desane have had success in the past. Repayment can be via the sale of the actual properties as these projects complete and are sold or via refinancing if required. We believe that this is a reasonable use of surplus capital, instead of acquisitions.

Desane is finding that the liquidity of the relevant property market is currently low. Vendors still holding pre-COVID-19 (often unrealistic) price expectations. This is likely to continue while the Job Keeper regime is in place along with government intervention remaining in the property market, with an inability to take legal action to remove tenants who refuse to pay rent and banks wary of foreclosure.

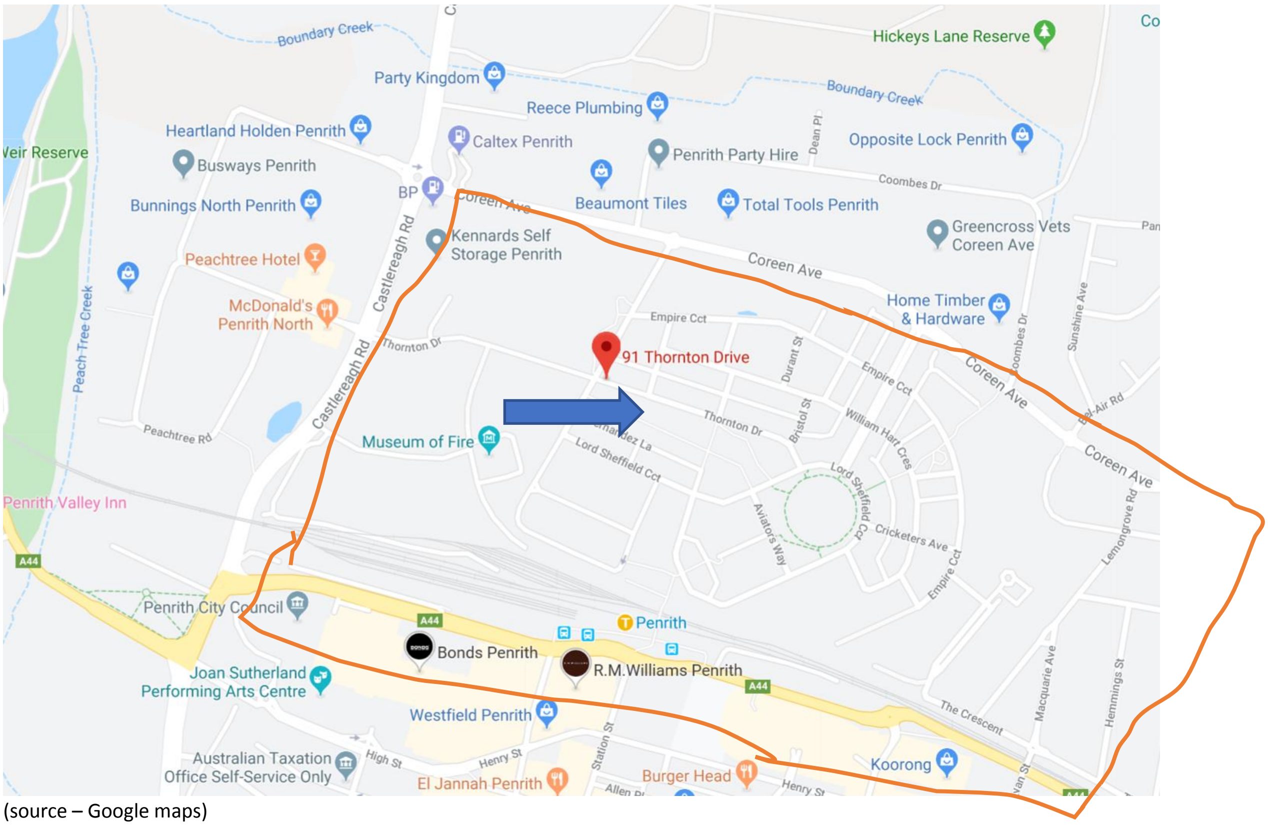
Desane is happy to play the long game for now and wait. They still prefer capital city light commercial/mixed-use/rezoning opportunities and are not about to "change lanes" into markets that they don't know well – for example, strip retail shopping.

Penrith - 91 Thornton Drive (North) Penrith

A brief recap …Thornton Drive was purchased from Urban Growth NSW for $3.9m in 2017. A planning proposal has been lodged with Penrith Council in June 2019 to rezone the site from light industrial to mixed-use. Desane is hoping to get this site rezoned and then construct a substantial set of apartments and mixed-use related buildings. Penrith Council has, in the past released a master plan for this precinct (refer to our initiation report in December 2019). The Penrith Council is seeking to expand the Penrith City area by 25,000 people by 2031 with 1/3 of new housing in the City Area (near public transport and the retail area) set to be medium and high density.

The Penrith area has good regional facilities, big shopping centres, a train line, improving expressway and road network, an ability to go South or North easily using ring roads (appealing to industrial businesses), access to the Blue Mountains, and an adjacent river with water activities. Major infrastructure construction activity includes rail, road, bus, and 2nd airport linkages and associated infrastructure – some of which are being accelerated by the state and federal government(s).

Exhibit 2 – Google maps – 91 Thornton Drive



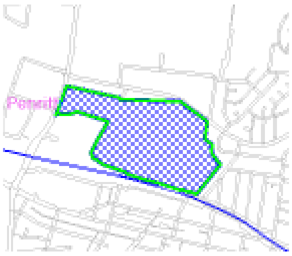
(source – Google maps)

We have taken a google map drawing of the Thornton drive site and marked in red the proposed Penrith City planned strategy for these are to be rezoned mostly residential. It is in North Penrith – north of the train station.

Exhibit 3 – Penrith City Council – Urban Study

5.22.2 North Penrith Urban Area

The site is generally bounded by Coreen Avenue to the north, the Main Western Railway Line to the south, Castlereagh Road to the west, and Lemongrove residential area to the east. The site area is about 50 hectares. The proposed development includes 9.5 hectares of employment precinct, 1.5 hectares of urban village precinct, 29 hectares of residential home



(source – Penrith Urban Study – pg 391 and 404)

The Thornton site has yet to be rezoned from light industrial to a mixed-use/medium density zoning. We view rezoning possibility as quite likely given the site's proximity to public transport, infrastructure, and the future need to cater for the increased population. Penrith needs cost affordable housing. We believe it is well located to benefit from rezoning given our analysis of Penrith City Council planning and urban strategy releases.

Exhibit 4 – 91 Thornton drive Penrith – concept image of ideal future

(source – Desane presentation)

The proposed development is 500m from transport and is designed to reflect the *Penrith Progression 2015* and *Penrith New West 2018* plans from the Penrith City Council.

Table 1 – is a "what if" analysis – if the Thornton St site is approved – with some probability-weighted outcomes - it could provide a material uplift for Desane, relative to its current market cap. It is a medium-term prospect.

Table 1 – probability-weighted "what if" value add analysis for Penrith site

Property	Thornton Drive Penrith		
Cost $m	4.15	4.2	4.2
Action	Contribute to master plan - get DA approved		
Units - No	150	200	250
Construction cost per unit $k	200	200	200
Construction cost $m	30	40	50
Sale per unit $k	400	400	400
Proceeds $m	60	80	100
Profit $m	26	36	46
Probability %	50%	25%	25%
Probability based value $m	12.9	9.0	11.5

(source – Taylor Collison analysis)

We have modelled three outcomes. Either 150 units, 200 units, or 250 units get approved, $200k per unit construction cost, and a sale price of $400k per unit (perhaps this could be higher for both construction and final re-sale value).

We then probability weight the various outcomes. Our view is the upshot is conservatively between $9m - $12.9m in "option value "within the project. We note the current plan is to build 246 units (plus 27 low-cost housing units).

Leichardt - 159 Allen St – has a D. A. The key to unlocking this value to be the build at the right price and then sell at the right time. Desane is prepared to wait for the right time to execute the plan.

Desane overview

Desane is a Sydney based property investment and property development (residential and mixed-use) business. The business method is to be integrated (both investment and development). The focus is on commercial real estate (with value-added potential) and high quality commercial and residential development projects with a medium to longer-term focus. Desane has been listed for over 30 years and this makes it one of the longest continuously operating listed operating (property) businesses on the ASX.

We have in December 2019, issued an initiation report that is available on request.

Desane – risks

Risks include (but are not limited to) – loan risk for lending portfolio, retention of tenants, development approval risk, property acquisition risk, construction cost risk, value-added strategy execution risk, government policy risk, taxation risk, macro-economic risk, regulatory and statutory body risk and loss of key personnel.

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