

FOLKESTONE EDUCATION TRUST RESULTS FOR THE YEAR ENDED 30 JUNE 2018

Folkestone Investment Management Limited as Responsible Entity of the Folkestone Education Trust ("FET" or the "Trust") provides the results of the Trust for the financial year ended 30 June 2018.

KEY HIGHLIGHTS FOR THE YEAR

- Statutory profit of \$103.1 million, a decrease of 15.1 per cent from \$121.4 million on the previous corresponding period ("pcp");
- Distributable income of \$41.9 million, an increase of 10.8 per cent on pcp;
- Distribution of 15.1 cents per Unit ("cpu"), an increase of 6.3 per cent on pcp;
- NTA per Unit of \$2.78, an increase of 10.8 per cent on pcp;
- Debt facility of \$347.0 million refinanced in August 2018 resulting in weighted average debt maturity increasing from 2.4 years at 30 June 2018 to 5.0 years¹;
- Six developments were completed, returning a completion value of \$43.1 million resulting in a final development margin of 28.3 per cent. FET's development pipeline remained constant with 29 sites² with an approximate value of \$170.3 million;
- Acquisition of 9 quality Brisbane childcare centres for a total value of \$63.2 million;
- 26 of 28, five year options were exercised, with new leasing transactions, acquisitions and completed developments, resulting in an increase of the portfolio's WALE from 9.1 years to 9.9 years; and
- 19 existing assets were sold for a total of \$45.6 million, an 8.9 per cent premium to carrying values³.

FINANCIAL SUMMARY

The following tables provide a summary of the Trust's results in comparison to the previous corresponding period:

INCOME STATEMENT SUMMARY	JUNE 18	JUNE 17	VAR. %
Total Operating Revenue (\$m)	72.3	67.1	7.7
Total Operating Expenses (\$m)	30.4	29.3	3.8
Distributable Income (\$m)	41.9	37.8	10.8
EPU ⁴ (cpu)	16.5	15.2	8.6
Distribution (cpu)	15.1	14.2	6.3
Payout Ratio (%)	91.5	93.4	(1.9)
Statutory Profit (\$m)	103.1	121.4	(15.1)

¹ As at 8 August 2018

² Including two sites with Heads of Agreements signed with an estimated value of \$12.4 million.

³ Carrying value at contract date.

⁴ Distributable income divided by weighted average number of Units.



BALANCE SHEET SUMMARY AS AT	JUNE 18	JUNE 17	VAR. %
Total Assets (\$m)	1,029.4	902.4	14.1
Investment Properties ⁵ (\$m)	985.5	861.2	14.4
Borrowings (\$m)	300.0	249.9	20.0
Net Assets (\$m)	710.7	628.8	13.0
Gearing ⁶ (%)	29.1	27.7	1.4
Units on Issue (m)	255.8	250.6	2.1
NTA per Unit (\$)	2.78	2.51	10.8

PROPERTY PORTFOLIO PERFORMANCE

Key property portfolio performance data as at 30 June 2018 is as follows:

AS AT	JUNE 18	JUNE 17	VAR. %
Value of Investment Properties (\$m)	984.2	858.8	14.7
Current Annual Income (\$m)	61.2	58.3	5.0
Average Annual Lease Income Increase (y-o-y) (%)	2.8	3.1	(0.3)
Property Yield – Freehold Properties (%)	6.1	6.5	(0.4)
Property Yield – Leasehold Properties (%)	12.9	13.8	(0.9)
Property Yield – Total (%)	6.3	6.7	(0.4)
Occupancy Rate (%)	100	99.5	0.5
Weighted Average Lease Expiry (yrs) (by income)	9.9	9.1	8.8

PROPERTY SUMMARY

The Trust's property portfolio at 30 June 2018 consisted of the following:

PROPERTY PORTFOLIO	NO. OF PROPERTIES	CARRYING VALUE (\$m)	CURRENT ANNUAL INCOME (\$m)
Australia – Early Learning	337	848.1	55.4 ⁷
New Zealand – Early Learning	50	73.2	4.5 ⁸
Total Early Learning	387	921.3	59.9
Development Sites (Settled)	23	62.9	1.3 ⁹
Total Properties	410	984.2	61.2

TRUST PERFORMANCE

FET paid distributions of 15.1 cpu for the year, an increase of 6.3 per cent from the prior year. Since 2011, FET's distributions have risen by an average 8.6 per cent per annum and its NTA has risen by an average 13.0 per cent per annum.

⁵ Includes \$1.3 million of transaction costs in relation to properties contracted and not settled.

⁶ Gearing is calculated by borrowings / total assets.

⁷ Includes head lease rent on leasehold properties of \$1.2 million.

⁸ Based on NZD rent of \$4.9 million at an exchange rate of 1.0932 as at 30 June 2018.

⁹ Site rent charged on 5 development sites with a carrying value of \$15.7 million.



FET provided a total return of 1.8 per cent for the year to 30 June 2018, underperforming the S&P/ASX 300 A-REIT Accumulation Index (“Index”) return of 13.2 per cent for the same period. FET has outperformed the Index over three years at 14.8 per cent per annum (vs 9.1 per cent per annum), five years at 21.3 per cent per annum (vs 10.0 per cent per annum) and ten years at 24.0 per cent per annum (vs 6.3 per cent per annum)¹⁰.

FET has been the best performed A-REIT in the S&PASX 300 Index over a 10 year period and second over a 5 year period to 30 June 2018¹⁰.

PROPERTY PORTFOLIO

Rent Reviews

During the year, the Trust completed 34 market rent reviews achieving an increase of 4.7 per cent over the prior year’s rent, noting that the majority of these leases have a capped rental increase of 5.0 per cent over the previous year’s rent. The cap has restricted potential rental increases with some properties considered to have revised rents significantly below their market equivalents.

The like-for-like rental growth across the portfolio for the year was 2.8 per cent, taking into account both market and annual reviews. There are four remaining market rent reviews to be finalised for FY18, with a further 10 market rent reviews scheduled for FY19.

Lease Renewals

During the year, 26 of 28 five year options were exercised, increasing the lease term remaining on these properties from 5 to 10 years. For the two lease options that were not exercised, the strategy is to find an alternate operator on these now, rather than wait until the lease term expires. We are confident of achieving a positive outcome on these assets.

In addition, the Trust has entered into 10 new 15 year leases with new tenants for existing FET properties, resulting in a 17.3 per cent increase in rent payable.

These transactions, together with the completion of six new developments and the acquisition of nine existing centres, has resulted in the weighted average lease expiry for the portfolio increasing from 9.1 years to 9.9 years over the year. There are 11 option renewals due in FY19.

Property Valuations

During the year, a total of 355 properties in the portfolio were revalued. Of these, 127 properties were independently revalued as part of the Trust’s three year independent rolling valuation cycle, with the remainder being Directors’ valuations. The Directors’ valuations were adopted utilising the parameters drawn from the current independent valuations, to ensure consistency across the portfolio.

The outcome is an overall increase in value of \$56.7 million over the 30 June 2017 carrying values. This has been driven by yield compression, combined with income growth from annual and market rental reviews. Overall, yield compression achieved across the entire portfolio (including leasehold assets) for the year to 30 June 2018 was 40 basis points, decreasing the overall portfolio yield from 6.7 per cent to 6.3 per cent. The overall passing yield achieved on the freehold independent

¹⁰ UBS Australian REIT Month in Review – June 2018.



valuations was 6.1 per cent, a 50 basis point improvement on the passing yield recorded on these assets as at 30 June 2017.

Subsequent to 30 June 2018, a further 25 independent valuations have been completed. The valuations show an increase in value of 7.0 per cent compared with the Directors' valuations adopted at 30 June 2018.

Development Program

Six developments were completed and commenced operations during the year, with a completion value of \$43.1 million. These projects have added significant quality to the portfolio including a yield on cost of 7.2 per cent and a development margin, allowing for all costs, of 28.3 per cent.

During the year, FET settled a further 14 development sites with an aggregate expected completion value of \$83.7 million. Additionally, FET has contracted or has Heads of Agreements signed for a further 6 development sites with an expected completion value of \$37.8 million. Settlement of these sites is expected during FY19.

Folkestone Limited has invested in management expertise and capacity over the past four years, and this is evident in the quantum and quality of the development program. During FY18, satisfactory development approval was achieved for 8 sites. FET's development sites are pre-committed by highly regarded operators, in accordance with individual design briefs and specifications.

DEVELOPMENT SITES	NO. OF PROPERTIES	UPON COMPLETION VALUE (\$m)
Settled as at 30 June 2017	17	107.2*
Settled FY18	14	83.7
Less completed development sites FY18	(6)	(43.1)
Less not proceeding and subsequently sold	(2)	(15.3)
Net Settlements as at 30 June 2018	23	132.5
New Sites Contracted / HoA executed	6	37.8
Total "Upon Completion"	29	170.3

* Includes uplift in value of 6 completed centres from \$34.5 million to \$43.1 million.

The current development pipeline of 29 sites has a forecast total value of \$170.3 million and is expected upon completion, to add approximately \$10.6 million per annum of net rental income, an increase of 17.4 per cent on FET's existing FY18 lease income.

In addition to the above, two development sites were disposed of during the year due to unexpected planning constraints. The developments have been sold with the proceeds covering all costs incurred by FET in relation to these sites.

The average overall yield on cost for the development pipeline has remained steady at 7.3 per cent through disciplined adherence to our acquisition strategy and diligent management of developments. Quality locations, more efficient designs and building methodologies as well as an improved 'speed to market', make them leading opportunities for quality childcare operators. These transactions are expected to provide a positive arbitrage for equivalent on-market transactions for completed centres.

FET's development pipeline as at 30 June 2018 and its completion program is estimated as follows:

PERIOD	NO. OF EXPECTED COMPLETIONS	UPON COMPLETION VALUE (\$m)	RENTAL VALUE (\$m)	EXPECTED YIELD ON COST (%)
Contracted Transactions				
FY19	8	38.6	2.5	7.2
FY20	13	80.9	5.0	7.6
FY21	2	13.0	0.8	6.3
Sub Total	23	132.5	8.3	7.4
Agreed Terms				
FY20+	6	37.8	2.3	7.1
Total	29	170.3	10.6	7.3

FET continues to target new opportunities based on strategy, as opposed to opportunity alone. The strategy is based upon a strong understanding of the respective childcare markets, a focus on selecting high quality real estate, knowledge of operators and a sound appreciation of early learning demand and supply factors in each location.

The developments are consistent with FET's strategy of enhancing the quality of the property portfolio, in locations that should provide a greater probability of rental and capital value growth, thereby increasing earnings as well as providing higher long term alternate use value.

Acquisitions

During the year, FET acquired nine quality Brisbane childcare centres for a total value of \$63.2 million. The centres were purchased on a sale and leaseback arrangement with Avenues Early Learning (Avenues). The acquisition provides quality additions to FET's portfolio and is consistent with FET's strategy in securing the "best site, best lease, best operator". The leases are consistent with our triple-net structure, long term commitments (20 year terms with further options), fixed annual rent reviews and provide appropriate security provisions.

Avenues has a distinguished track record in childcare operations, reflected in quality centres, locations, continued high occupancy levels, financial strength and customer satisfaction levels. FET's due diligence of the business operations indicated exceptionally high performance levels on all indicators. The Avenues childcare model is built around the advancement of quality childcare outcomes through education, quality staffing and development and a range of programs and initiatives beneficial to children and families.

FET has entered into an agreement with Avenues to provide new development opportunities within defined geographical areas that suit FET's objectives as well as Avenues' target catchments and growth aspirations. Our partnership with Avenues adds to other existing FET partnerships with Australia's best childcare operators. These relationships bring not only opportunity, but innovation and give FET a significant competitive advantage in a market where quality opportunities remain highly sought after.

Disposals

FET's capital and portfolio management strategy includes the selective sale of non-core properties, with proceeds redeployed to new property purchases and/or developments.

FET contracted the disposal of 19¹¹ properties during the year, totalling \$45.6 million of gross proceeds, at an average yield of 6.3 per cent and an 8.9 per cent premium to carrying values as at the contract date.

This included the disposal of the Melton Medical Centre (inclusive of excess land) for total gross proceeds of \$15.97 million. The yield achieved on the disposal of this asset was 4.8 per cent, resulting in a 14.4 per cent premium to the carrying value as at the date contracted.

Of the 19 properties contracted for the year, 18 settled before 30 June with the remaining centre settling in August 2018.

Since 2014, FET has sold 47 properties for gross proceeds of \$83 million at an average yield of 6.7 per cent, generating a premium to book value of 15.3 per cent or a gross profit of \$11.04 million. These funds have been recycled into FET's acquisition and development program in substantially stronger metropolitan locations which are consistent with FET's "best site, best operator and best lease" strategy.

At a positive yield arbitrage, the recycling program provides upside to investors in addition to substantially superior real estate with lower long term risk. Retaining ownership of these assets would result in a slightly higher distribution growth however, their disposal positions the Trust in a considerably stronger long term position. It is these new locations where demand, rental and capital growth and underlying land values are expected to be significantly stronger.

Innovation

FET's development management capabilities have continued to produce higher quality centres, in stronger demographics, at better yields to investors. Innovations such as the completion of FET's first pre-fabricated centre in under seven months from land settlement, created a quality centre with a time saving of approximately five months, relative to conventional construction methodologies.

Investors are invited to take a video tour of some of the newly completed centres developed by FET. Videos of new centres recently completed, include centres at Hawthorn (VIC), Highett (VIC) and Northcote (VIC) which is a finalist in this year's Master Builders Association Construction Awards. Each centre's design varies to reflect their respective operating and demographic environment. The videos are available on FET's website at <http://educationtrust.folkestone.com.au/centre-tours-2/>.

CAPITAL MANAGEMENT

Debt Funding

As at 30 June 2018, FET's debt facilities totalled \$347 million, comprising bilateral facilities with Australia and New Zealand Banking Group Limited and Hongkong and Shanghai Banking Corporation Limited. The facilities are drawn to \$300 million as at 30 June 2018. The facilities are

¹¹ This excludes the two developments sites which were disposed of during the year

split into separate tranches with maturities between September 2019 and June 2022, with a weighted debt maturity of 2.4 years.

The Trust has significant headroom under its debt covenants with gearing at 30 June 2018 of 29.1 per cent, which is below the Trust's targeted long term range of 30 to 40 per cent.

Subsequent to 30 June 2018, FET has refinanced its debt facilities, resulting in debt maturities being extended to between September 2021 and August 2025 and a weighted average debt maturity of 5.0¹² years. As part of this refinancing, AustralianSuper has provided a \$100 million 7 year institutional term loan. This diversifies FET's funding sources and secures long term debt funding consistent with FET's lease profile. The arrangement will see AustralianSuper accede into FET's existing finance structure as a secured senior lender. The facility will be drawn down in August 2018 and will be utilised to partially repay existing and shorter term bank facilities. FET mandated ANZ, who assisted in negotiating and arranging the transaction with AustralianSuper.

FET's debt facilities have remained at \$347 million with \$47 million of debt capacity remaining with the existing bank financiers to fund existing developments and future opportunities.

Hedging

Consistent with FET's interest rate management policy, FET has staggered hedging positions through to June 2023. Additional hedging positions were put in place in conjunction with the debt refinancing in August 2018, resulting in an average hedged position of 56 per cent based on the existing debt of \$300 million at an average rate of 2.87 per cent per annum (30 June 2017: 2.95 per cent per annum). For FY19, FET has hedged 69 per cent of its interest rate exposure at a hedged rate of 2.4 per cent per annum.

Cost of Debt

Following the debt refinancing and hedging put in place in August 2018, FET's cost of debt will be 4.1 per cent per annum (30 June 2017: 4.2 per cent per annum), which is based on current interest rates, swap arrangements and bank margins. The all-in-cost of debt will be 4.4 per cent per annum (30 June 2017: 4.5 per cent per annum) which includes the amortisation of deferred borrowing costs.

EARLY LEARNING MARKET

The new Government funding package for childcare has been a catalyst for industry self-examination as the sector contemplated the impact of the new regime together with the typical economic and demographic pressures that influence its financial performance.

As forecast in February 2018, childcare trading conditions have been impacted by a combination of two key factors:

- increased competition in some locations due to the supply of new centres; and
- increased cost of living (including childcare), combined with the diminished effectiveness of the \$7,613 per annum childcare rebate, since replaced with the new Childcare Subsidy ("CCS").

The changes brought on by the CSS, effective 2 July 2018, has compelled operators to recalibrate the childcare affordability equation for customers. The new scheme replaces the old rebate cap (for

¹² As at 8 August 2018



families earning under \$186,710 per annum). It is expected to be a positive impetus to the sector as the new package is designed to offer a greater benefit to families earning less than c. \$310,000¹³, and particularly encourage families in the dual income range with a means test measure, effectively reducing the barriers of entry to the workforce. From that threshold onwards, the level of available funding diminishes and ultimately falls away at \$351,000 per annum¹⁴. The CCS is designed to reduce the out of pocket expenses to parents who meet the activity test, based on income levels and utilisation. It is recognised that the CCS does not address the educational aspects of childcare.

Childcare's typical drivers of population growth (Australia and New Zealand up 1.6 per cent and 2.1 per cent respectively in the 12 months to December 2017) as well as jobs growth (Australia up 403,000 in 2017, NZ up 32,000)^{15,16}; the increasing child participation rate and appropriate real estate conditions has resulted in an increase in the construction of new childcare centres. This has added to a long term under-supplied market and in our view, is consistent with the increase in demand over the medium term. It is expected that some locations will have oversupply pressures which typically have centres built and operated on speculation as opposed to vigorous planning and due diligence.

For calendar year 2017, there was a net increase of 318¹⁷ new centres across Australia (+4.0 per cent) inclusive of 27 centres that closed operations. Growth for 2018 and 2019 is anticipated to be similar taking account of the number of projects currently in construction. However, anecdotal evidence indicates that beyond 2019, growth in supply will moderate as operators have reduced their expansion plans to more specific locations and numbers.

Furthermore, lending criteria for debt funding, for both operators and developers has tightened. As a result, we expect the supply of new centres to revert to long-term growth rates in line with demand requirements.

Our industry analysis indicates that over the last 5 years, less than 50 per cent of all sites that receive a formal Development Approval for childcare are ultimately constructed. It is likely with added development pressures that a number of projects with Development Approval may have their delivery delayed, deferred or cancelled.

Outlook

Industry data indicates that childcare fees have risen by an average of approximately 6 per cent per annum (dependent upon location) since 2013. The rising cost of childcare together with, the deferral of the Government's new funding package to July 2018 (originally proposed for July 2017), has seen the \$7,500 per annum per child rebate limit reached earlier this year compared to previous years. When instigated in 2007, the rebate was to be indexed annually to inflation.

The rising cost of living, combined with low wage growth in recent years and the increasing cost of childcare, may force some parents into a purely financial decision regarding their childcare activities. We expect to see some parents withdraw from services as a result. However, the increased funding at the middle and lower end of the income spectrum may provide much needed relief.

¹³ Folkestone Company Data

¹⁴ Australian Government Budget 2018-19

¹⁵ ABS

¹⁶ New Zealand Government

¹⁷ Canaccord data



Alternatively, as the cost of living rises, we expect that more families may seek a second income which is incentivised under the CCS. This could add to childcare demand.

These factors have led to marginally softer occupancy levels in the latter part of the year for some, the impact varying between locations and operators. Those operators prepared to reinvest in staff, systems and premises appear to be having greater success, with many centres/operators lifting occupancy for the year. The CCS will reset the previous funding cap and is expected to provide a further impetus to the sector, particularly in the less than \$140 per day category. In the meantime, we expect some pricing pressure linked to the increased cost of living and its impact on household disposable income.

OUTLOOK AND DISTRIBUTION FORECAST

The FY19 forecast distribution is **16.0 cpu**. This is a 6.0 per cent increase on FY18 distributions and is based on continued tenant performance. FET will continue to pay quarterly distributions.

FET continues to execute its strategy to be recognised as the leading provider of early learning accommodation and together with quality operating partners, focusing on providing a healthy and safe learning environment for future generations. Investors benefit from predictable and secure long term income with the opportunity for capital growth.

FET is committed to active management of its portfolio to capitalise on future growth prospects. Unitholders should note that any investment opportunity is assessed with respect to its consistency with the Trust's characteristics and overall investment objectives.

INVESTOR TELECONFERENCE

Management invites investors to join a teleconference where the Trust's results and presentation will be discussed. To register, please follow the registration details below.

Date: Wednesday, 8 August 2018
Start time: 2:30pm AEST
Register attendance: To register your attendance please **click here**

Once you have registered, you will be provided with dial-in numbers and a passcode.

For further information contact:

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FURTHER INFORMATION

Folkestone Education Trust

The Folkestone Education Trust is the largest Australian ASX listed (ASX:FET) real estate investment trust (A-REIT) that invests in early learning properties.

www.educationtrust.folkestone.com.au

About Folkestone

Folkestone (ASX:FLK) is an ASX listed real estate funds manager and developer providing real estate wealth solutions. Folkestone's funds management platform, with more than \$1.5 billion under management, offers listed and unlisted real estate funds to private clients and select institutional investors, while it's on balance sheet activities focus on value-add and opportunistic (development) real estate investments. www.folkestone.com.au