NEDGROUP INVESTMENTS

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# NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND

## Quarter One, 2018

For the period ended 31 March 2018

**NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND**

Commentary produced in conjunction with sub-investment manager, Resolution Capital

PERFORMANCE

The Nedgroup Investments Global Property Fund outperformed the FTSE EPRA/NAREIT Developed Index (USD) Net TRI by 15 basis points for the quarter ending 31 March 2018, as the index produced a total return of -4.5% in US dollar terms. Pleasingly, our longer term performance remains intact, most importantly exceeding inflation by a healthy margin.

| Indicator | 3 months | 1 year | Since Inception# % p.a. |
|---|---|---|---|
| Portfolio* | -4.38% | 6.80% | 2.00% |
| Benchmark+ | -4.53% | 3.23% | -0.91% |
| Difference | 0.15% | 3.57% | 2.91% |
| Portfolio Valuation | US$76,261,965 | | |

* Net USD return for the Nedgroup Investments Global Property Fund, A class. Source: Morningstar
# 13 July 2016.
+ FTSE EPRA/NAREIT Developed Index (in USD Net Ret)

MARKET COMMENTARY

After a relatively benign 2017, volatility picked up for equities this quarter, partly due to emerging fears of a trade war between the U.S. and China, as well as recognition of the threat of regulatory interference in e-commerce and social media. The US bond market also came under some pressure, largely attributable to emerging evidence of wage pressures.

The negative return for GREITs this quarter was dragged down by U.S. REITs in particular, which produced a total return of -7.8% in local currency terms. Whilst increasing interest rates might have had some impact, we believe the primary reason for REIT share-price weakness is part of the ongoing rotation into other areas of the equity markets, which are experiencing improved earnings growth prospects, particularly energy and banking stocks, enhanced by corporate tax cuts.

US REIT 2017 financial results released during the quarter were largely as expected. Significantly, they also typically provide management guidance for the year ahead, which was somewhat subdued. Operationally, US REITs are expected to deliver relatively muted top-line revenue growth of 2% to 3% over calendar 2018. This is circa 100bps lower than 2017, primarily the consequence of increasing levels of commercial property construction supply and the lingering effects of bankruptcies in the retail sector. Furthermore, there is evidence of mounting operating cost pressures (increasing real estate taxes, utilities and wages). Consequently, Net Operating Income (NOI), which is property rental revenue less property related expenses, is expected to increase by 2.5% to 3.0% on average.

While operating earnings are decelerating, we expect Funds From Operations (FFO), the sector's EPS equivalent, per security to increase by 4% to 5% for the current calendar year due to:

- Continuation of lower finance costs, as interest rates on the sector's debt are predominantly hedged for the medium to long term;
- The absence of some one-off costs incurred during 2017 as a consequence of portfolio recycling; and
- Earnings per security accretive share-buybacks.

This overall earnings growth is consistent with the sector's long term average, but lagging the prospects for broader equities and masks the decelerating operational earnings. Consequently, US- and Japanese-listed real estate mutual funds continue to experience outflows. According to Citi net outflows totalled US$7.6bn in Q1, following ~US$16bn of outflows in 2017.

## PERFORMANCE DRIVERS

Within the REIT sector this quarter, industrial and self-storage were the best performing property segments. Industrial rents continue to grow due to outsized tenant demand, particularly by ecommerce players, more than offsetting new supply. Furthermore, values for underlying logistics properties continue to be underpinned by strong investor demand. Self-storage REITs, predominantly a US sector, published financial results slightly better than expected in the face of increasing supply of new facilities. The portfolio currently has no exposure to storage REITs, which detracted from relative performance for the quarter.

In contrast, retail, data centres and healthcare were the weakest sectors. Our underweight exposure to US healthcare benefitted relative performance, with this segment weighed down by ongoing concerns of senior housing oversupply and tenant credit associated with some of the industry's leading senior housing operators.

Meanwhile, shopping centre related property continues to struggle in light of continued and well publicised challenges facing the retail industry, namely the impact of ecommerce and mounting store closures.

With respect to the office sector, the New York office leasing market has been going sideways for a number of years partly due to supply coming online from the Hudson Yards development project, located on the west side of Midtown. However, this quarter the traditional core part of Midtown East got a shot in the arm with J.P. Morgan Chase announcing that it intends to demolish its current HQ at 270 Park Avenue in order to build a new one double the size. This is confirmation of Park Avenue's long-standing attraction as a business centre and the growth of the major financial institutions. As a consequence, it will also lead to leasing demand in this submarket as J.P. Morgan must vacate the 1.25m square feet tower for a five-year demo/construction period, starting in 2019.

The data centre sector, the star performer of 2017, underperformed over the quarter. For several years data centre REITs have enjoyed strong earnings growth driven by robust tenant demand and accretive developments. This has been particularly true for network dense data centres, our preferred segment of the market. While demand conditions remain robust, data centre REITs provided relatively disappointing forward earnings guidance as part of their most recent financial results.

In the case of Equinix (EQIX), the global leader in network-dense data centres, this was due in part to a decision to increase its capex program to include an element of 'hyperscale' development for large cloud service providers. Equinix has traditionally shunned this segment of the market as it has lower barriers to entry and lower returns. However, the large cloud service providers (Amazon Web Services, Microsoft, Google etc.) are increasingly growing in importance as anchor tenants around which the ecosystem evolves, thus the connectivity focussed data centre REITs such as Equinix are being drawn into this space. Equinix also announced the unexpected resignation of its CEO "after exercising poor judgment with respect to an employee matter". While disappointing, the company appears to have acted decisively and appointed its executive chairman, who was formerly CEO of the company, as interim CEO. The Board has commenced a formal process to appoint a new CEO.

Meanwhile, another data centre REIT, QTS Realty Trust (QTS), disappointed the market with materially lower earnings guidance as it announced it would exit its 'managed services' business. This business line is unique to QTS and is one reason we have avoided the stock. QTS also announced it would incur higher overheads as it pursued more hyperscale tenants. QTS had already lagged its data centre peers during 2017 and delivered a total return of -32% for the quarter.

## PULLING LEVERS FOR NAV DISCOUNTS

For those that believe that REITs are trading at a discount to NAV, there seems to be two major courses of action:

- M&A; and
- Share buybacks.

A trend that emerged in 2017 continued this quarter saw a raft of REITs move to take the second avenue. Most notably, Park Hotels announced it would buy back US$348m of its shares as part of the aforementioned decision by HNA to sell its holding in the company. Due to the buyback, Park increased its full year earnings guidance by 5.6%, but its leverage will increase from 3.5x Net Debt/EBITDA to 4.5x, elevated (for a hotel REIT) but not excessive.

It was not only in the US where this initiative is being pursued. In Hong Kong, Link REIT (823 HK) is implementing its substantial share buyback program, whilst Singapore exchange listed Hong Kong Land (HKL SP) announced it had acquired a US$86m block of its shares. Elsewhere, retail A-REIT Scentre Group (SCG) joined the buyback horde, after announcing board approval for an A$700m initiative. Other A-REITs to launch programs during the quarter included Mirvac (MGR) and Dexus (DXS).

Despite trading at material discounts to NAV, it is notable that several UK REITs, including portfolio holding Derwent London, have elected to make special dividends rather than share buybacks because of the scale of their asset disposals.

We view buybacks as one arrow in the REITs quiver of capital management which can enhance investor returns. However, it is unlikely to be game changing, more a signal of the relative value arbitrage opportunity, and most importantly it should be financed from asset sales which prove up the remaining value of the portfolio. Critically, adding to the last point, given that commercial property is typically trading above replacement cost, true value creation is limited and it should not simply be a means to increase ROE through higher leverage, which increases risk at this point in the cycle. Cynically, it might simply help management teams meet short term earnings targets as part of performance driven remuneration.

Indeed, the case for buybacks is not universally supported by many seasoned investors who claim the NAV discounts are exaggerated, and hence the discounts are not sufficiently material to make this a worthwhile option. Chief proponent Sam Zell (chairman of the Equity stable of vehicles) argued it is best to preserve capital liquidity and 'option' value of a strong balance sheet for more material investment opportunities.

## HEALTHCARE IN THE SICKBAY

The big three US healthcare REITs Ventas (VTR), Welltower (WELL) and HCP Inc. (HCP), all continued to struggle this quarter. This is an industry which has heavily promoted indisputable demographic demand drivers (i.e. the ageing population) but has failed to acknowledge the supply response and operational and regulatory challenges inherent in a broad, disparate industry.

The US major healthcare REITs are generally too diversified and exposed to segments facing excess supply (e.g. senior housing) and/or cost pressures (e.g. skilled nursing facilities). As a consequence of these dynamics, tenant credit has been a major concern. Consequently, the space has generally disappointed investors over the long term.

However, given their significant underperformance, combined with steps taken to address some platform concerns, such as reducing and/or restructured exposure to some challenged senior housing operators as well as the casting off of skilled nurse facilities, we are starting to see some value emerging in select platforms.

## NOT WITH A BAM

Last quarter we wrote that Brookfield Asset Management (BAM) listed real estate subsidiary Brookfield Property Partners (BPY) had made a bid for the 66% of the shares it didn't own in US mall REIT GGP (GGP). This quarter BPY slightly improved its offer, primarily by increasing the cash component from a maximum of 50% to 61%, and GGP's independent directors have recommended that shareholders approve the transaction.

GGP traded *down* post the improved offer as investors had been expecting better terms and the scrip component comprising securities in externally managed BPY is not considered attractive. The offer values GGP's malls at an approximate 6.0% implied cap rate. Whilst a dearth of transactional evidence makes it difficult to pinpoint exactly where US mall values are, it is likely they have fallen at least 10% in the last 12 months. Nevertheless, the bid price for GGP is still around a double-digit discount to Gross Asset Value (GAV).

In this light the Lowy family received a solid price for Westfield Corporation (WFD). Initially the deal valued Westfield's portfolio on a mid-4% cap rate. However, due to Unibail Rodamco's (UL) shares being under pressure Westfield is currently trading on a 5.0% implied cap rate. This is reasonable compared to GGP as the Westfield portfolio is higher quality, though it ascribes a full price for Westfield's future developments in what is an increasingly difficult environment to be developing.

## LEFT AT THE ALTAR

In the previous quarter we wrote about the proposed merger of UK REIT's Hammerson (HMSO LN) and Intu (INTU LN). In our opinion it put Hammerson in play, because Hammerson seems to have the better assets and geography mix: e.g. less UK.

Late in the quarter it was leaked that European shopping centre REIT Klépierre (LI) had made an offer for Hammerson. However, management of the latter quickly dismissed the offer (prematurely in our opinion) without disclosing it to the market. Whilst the offer price was around 20% below appraisal NAV, it was 41% above where the shares were trading.

There seems evidence that property values for UK retail parks and shopping centres are softer than what appraisers currently assume. For Hammerson shareholders, doubling down on UK shopping centres in a highly geared wrapper is far from attractive. Highlighting the point, in both its full year results, and in defending its dismissal of the Klépierre offer, Hammerson touts its outlets, Irish and Continental European assets. No mention of the attraction of UK assets, despite this still being the bulk of their exposure.

Shareholders seemed to believe a formal bid for Hammerson was forthcoming, or at least the proposed merger with Intu called off, as former outperformed Intu by around 24% this quarter. At quarter end, Intu was trading at a 20% discount to the proposed merger terms. For David Simon, the Chairman of both U.S. mall REIT Simon Property Group (SPG) and Klépierre, this must be cause for some schadenfreude as Intu rejected Simon's 425p indicative offer in early 2011. Intu's share price was half that at the end of the quarter.

Subsequent to quarter end, Klépierre announced it would not proceed with a formal bid, perhaps it was happy just to have caused mischief for a competitor at their wedding. The ramifications were significant, because following this it was reported that some Hammerson shareholders expressed 'substantial concerns' about the merger. This resulted in Hammerson's board calling off the nuptial, stating that "heightened risks associated with the Intu acquisition outweigh the long-term rewards." In addition, Hammerson noted retail conditions in the UK had softened since the start of the year and retailer bankruptcies/restructurings have increased. The deteriorating investor perception of the broader UK retail property market "led to a disconnect between the company's share price and the fundamental value of its business and prospects."

## ESG – SHAREHOLDER RIGHTS?

US REITs are typically internally advised and there is usually reasonable alignment between management and shareholders. However, many REITs are incorporated in Maryland, a state which is not very shareholder friendly. For example, the Maryland Unsolicited Takeover Act (MUTA), allows companies to stagger their boards on a moment's notice, making board changes a multi-year process, as only a few directors come up for election each year. Only a minority of REITs have opted out of MUTA. In addition, Maryland law permits the board to have exclusive power to amend the bylaws and propose directors. Of our portfolio 78% of US REITs are Maryland incorporated, similar to the index.

Of late, there are two issues which are gaining increased attention[1]:

- Shareholder ability to put forward binding resolutions to change bylaws; and
- Proxy Access (gives shareholders the opportunity to use corporate proxy materials to nominate directors).

We believe both are fundamental shareholders rights. An increasing number of REITs are granting shareholders these rights. However, some put significant restrictions in place for shareholders to use these rights, primarily:

- Shareholding needs to be >3% (max 20 shareholders in a group); and
- Shares need to be owned continuously for >3 years.

Management states that these restrictions need to be put in place because the shareholder rights are often hijacked by special interest groups and are wasteful in terms of time and resources. Whilst there seems evidence to support that statement we think the 3% and 3-year restriction is excessive.

[1] In 2017 Proxy Advisor ISS started recommending withholding votes for all nominating and corporate governance committee members of companies that don't allow shareholders the power to amend the bylaws.



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This Proxy season we will see best in class REITs AvalonBay (AVB) and Equity Residential (EQR) proposing to lower the threshold for changing the bylaws to 1% and 1 year. We applaud these changes.

Currently 42% of our US portfolio holdings have Proxy Access and less have the ability to change the bylaws. This year we will engage with portfolio holdings who don't grant Proxy Access or the ability to change the bylaws or have restrictions greater than one percentage and / or one year.

We encourage clients and peers to join us in this effort. Unfortunately, the trend to passive doesn't help in this respect, as the index funds don't have a track record of engagement or voting against management.

## OUTLOOK

We haven't suggested that Global REITs are compelling outright value for some time, as they are trading at premiums to replacement cost, construction activity is responding, and the earnings growth prospects in the short to medium term are lagging equities.

However, we maintain our conviction in the case for diversification, versus fixed interest and broad equities, and the quality of the underlying portfolios and capital structures are in great shape. Furthermore, listed REITs certainly appear to represent value relative to unlisted property, particularly given the liquidity they provide.

Our portfolio is exposed to REITs with high quality property portfolios which are underpinned by contractual medium to long term inflation linked income streams and balance sheets appear to us to be in reasonable, if not strong, shape. Investment strategies remain disciplined, we see limited evidence of hubris or complacency by REIT managers. In this environment, REIT stewards will look to earn their keep through superior property operating performance and value enhancing capital management initiatives.

As for new construction supply, whilst it has increased, it is not excessive and is in response to several years of undersupply. Many expect construction activity will be capped by supply bottlenecks such as the shortage of skilled labour and materials, much of which is being directed at public sector infrastructure projects. The impacts of technology on shopping centres is not to be taken for granted, but we still believe leading malls are adapting to changing consumer spending patterns. Clearly there are challenges with this transition and highly leveraged capital constrained retailers are not helping the cause.

Share buybacks will provide some support and the greatest positive surprise is likely to come from M&A activity and in particular, companies being taken private given the sectors apparent discount to direct or unlisted fund alternatives. Shareholders must decide if the price is sufficient to warrant selling out to the private equity marauders or reject their approaches which undervalue the long term returns.

We continue to stay the course, sticking with REITs owning quality property portfolios, with robust balance sheets able to take advantage of emerging value opportunities and management capable of extracting value for REIT security holders.

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