



see money differently

A photograph of an open book with white pages, tied with a white string bookmark. The book is positioned on the left side of the page, with the pages fanning out towards the right.

Nedgroup Investments Global Property Fund

Quarter One, 2021

Nedgroup Investments Global Property Fund

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

| Indicator | 3 months | 1 year | 3 years p.a. | Since Inception [#] p.a. |
|------------------------------------|----------|---------|--------------|--------------------------------------|
| Portfolio* | 3.60% | 23.28% | 5.68% | 4.33% |
| Performance indicator ⁺ | 5.80% | 34.68% | 5.06% | 2.85% |
| Difference | -2.19% | -11.39% | 0.62% | 1.48% |

* Net USD return for the Nedgroup Investments Global Property Fund, A class. Source: Morningstar

[#] 14 July 2016

⁺ FTSE EPRA/NAREIT Developed Index (in USD Net Ret)

Summary points

- Real estate stands to benefit from a recovery that allows consumer confidence to translate into an economic recovery that drives tenant and business demand.
- The performance dichotomy continued in 2021, with REITs that were well supported earlier in the pandemic, such as data centres and logistics, largely overlooked.
- The rotation to expected beneficiaries of re-opening, such as shopping centres, continued.
- Despite operating losses and a continued need for debt covenant waivers, hotel REITs produced the best returns of any sector.
- Stocks with higher financial leverage outperformed.
- The Fund underperformed the index as we remained largely committed to secular growth supported by strong balance sheets. The market's shift to the re-opening thematic is overly optimistic.
- Considerable increase in retail, by initiating a position in two U.S. open-air shopping centre REITs.
- Residential represents the largest sector exposure, encompassing a broad range of rental housing options, including student accommodation.
- Remain underweight office sector, despite WFH normalization noise, as tenant demand in key CBD office markets remains tepid.
- Real estate should ultimately be a beneficiary of a strong economy as it translates into greater demand for space and services.

Market and portfolio commentary

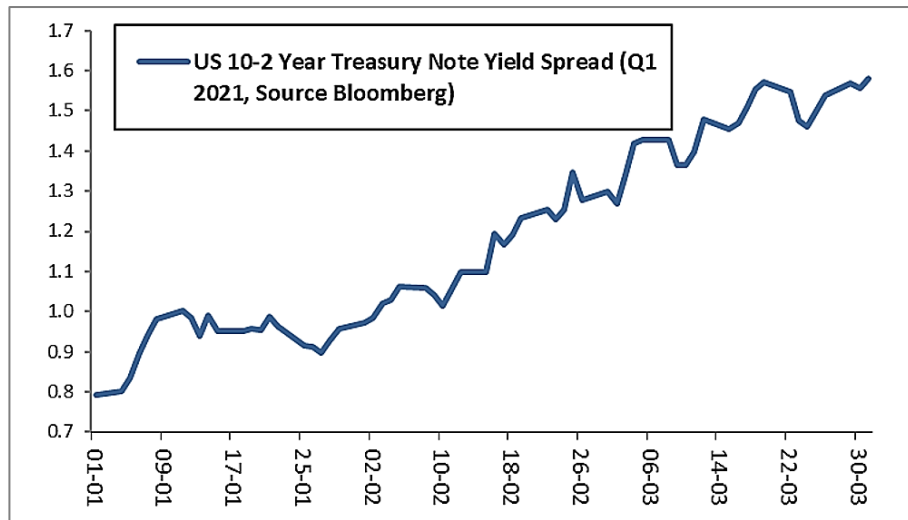
News about the Covid-19 vaccination program drove investor expectations during the quarter. As the vaccine rollout gathered momentum in key economies, financial markets began to look past the pandemic and to pivot towards more normalized social and economic behaviours.

The outlook for an economic rebound and growth in 2021 and beyond brightened considerably with the passage of massive stimulus packages in the U.S. and Europe. The new Biden administration signalled it would "do what it takes" with the enactment of a US\$1.9 trillion stimulus program to aid the recovery, and more is expected to follow with a multi-trillion dollar infrastructure program subsequently proposed. Europe is following suit with a €750 billion fiscal package, which may grow in the future as well.

On the back of unprecedented fiscal stimulus coupled with continued monetary accommodation, inflation expectations grew in the quarter. Consequently, interest rates rose while the yield curve steepened. Long rates began to price in higher inflation while short rates remain anchored by central banks' monetary accommodation as illustrated by the steepening curve in the following chart.

In the U.S., 10-year rates reached 174 bps at the end of March, nearly doubling from the beginning of January but still close to historic lows in a longer-term context.

Yield curve steepening



Source: Bloomberg

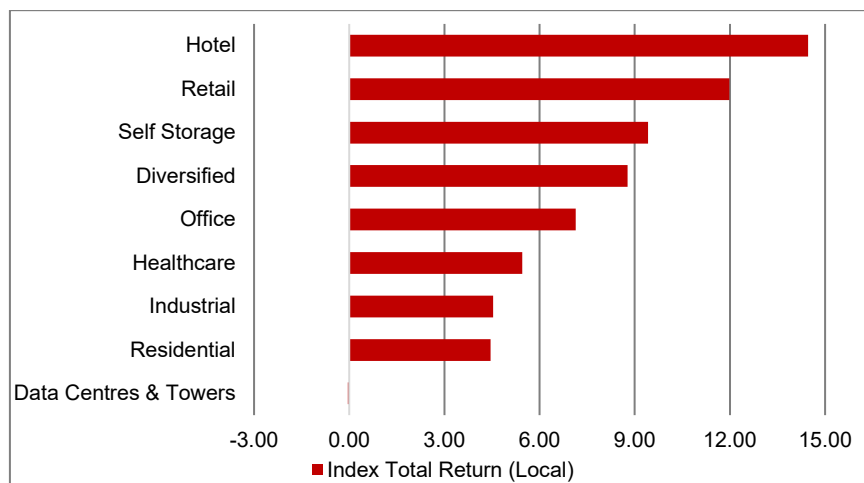
Worrisome signs of excess and a seeming lack of investor discipline also manifested themselves across the equity spectrum in the quarter. Retail investors banded together via social media and online trading platforms such as Robinhood, to pump stocks and squeeze hedge fund shorts. Rampant investor enthusiasm also allowed blind pool vehicles, known as SPACs, to raise \$97 billion in the quarter, more than all of 2020 and the preceding years combined. When externally managed blind pools can raise money hand over fist, we worry that markets are being driven by thematics instead of valuations and fundamentals.

Equity markets continued their rotation from growth to value started in the previous quarter. Higher interest rates only served to amplify this shift, violently at points.

In the March quarter, rotation also continued to drive REIT performance as investors jostled to position for a post pandemic recovery. Real estate stands to benefit from a health recovery that allows consumer confidence to translate into greater spending and an economic recovery that drives tenant and business demand more broadly. However, this will play out at speeds that vary by sector and by market.

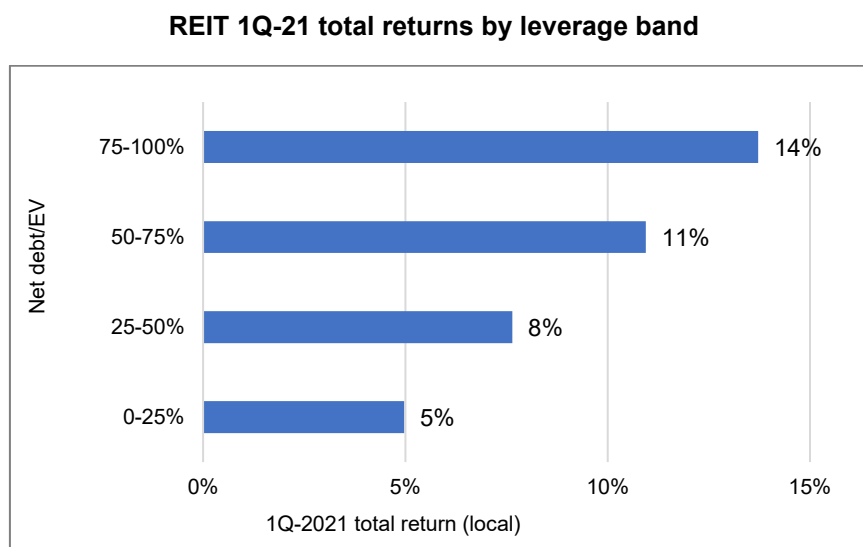
The performance dichotomy witnessed in Q4 2020 continued into 2021. REITs that were well supported earlier in the pandemic because they offered visible and stable earnings growth (such as data centres and logistics) were seemingly discarded or largely overlooked in the race to expected beneficiaries of re-opening such as shopping centres. Despite many continuing to incur operating losses and relying on debt covenant waivers, hotel REITs were deemed to be facing a vastly improved earnings outlook, producing the best returns of any sector.

Quarter Ending 31 March 2021 REIT Sector Total Returns



Source: FactSet, RCL, FTSE EPRA Developed Index (local currency)

It was also a feature that stocks with higher financial leverage outperformed. As seen in the following table, companies in the higher leverage bands, on average, had better total returns than companies with lower debt levels.



Source: FactSet, RCL

The Portfolio underperformed the index over the quarter as we remained largely committed to secular growth supported by strong balance sheets. We were too conservative, however we believe that the market's shift to the re-opening thematic is overly optimistic.

In relative terms, performance was negatively impacted by stock selection in retail, exposure to data centres & towers, and a lack of exposure to hotels, the posterchild for the vaccine bounce.

Portfolio returns were positively impacted by holdings in residential and industrial property vehicles which offer steady, visible earnings growth and should benefit from an economic recovery. Simon Property Group (SPG) was the single biggest detractor to quarterly performance as the stock soared 33.4% on enthusiasm for consumer-focused stimulus beneficiaries. We discuss our retail positioning later, but safe to say, we significantly increased the exposure to retail but in a manner intended to position for sustainable growth not a snap back driven by post-pandemic optimism.

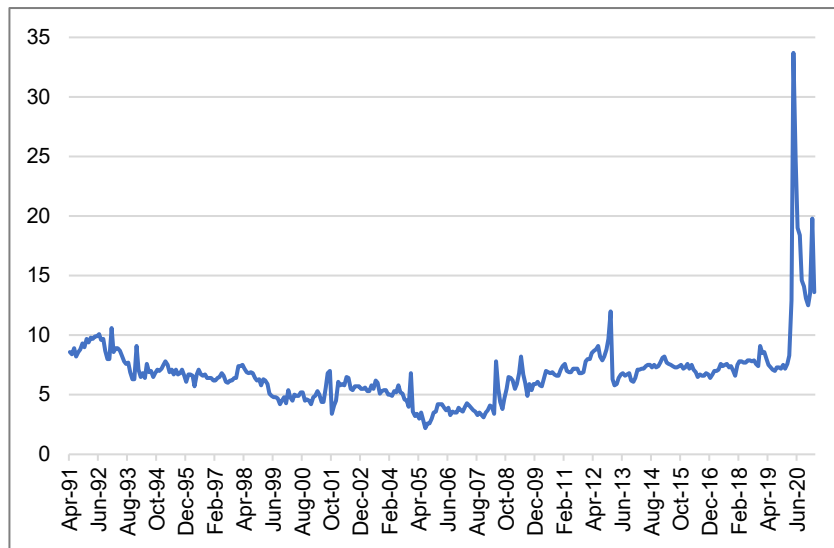
Regionally, the portfolio's holdings in Japan and Hong Kong enjoyed double-digit total returns. Stocks in the U.S., even though adding 6.4% in local currency terms, experienced relative underperformance due to the exposures to data centres & towers and no exposure to hotels or SPG as discussed earlier. In Continental Europe, the portfolio fell 1.3% in local currency terms, outperforming the benchmark's 3.0% decline, pulled lower by its larger exposure to retail.

Retail rebound

The retail landscape brightened during the quarter as behaviour patterns made early, albeit uneven, steps toward pre-pandemic norms. As vaccine distribution grew, more jurisdictions allowed stores and restaurants to reopen. Markets in the U.S. appear to be earlier in the recovery phase than many in Europe where a resurgence in Covid infections caused additional lockdowns in countries such as France, Germany and Italy. In Asia-Pacific, retail properties are trading normally in Australia, and in Hong Kong, local oriented shopping has proven relatively resilient. Having plummeted an estimated 70% in the past two years, retail rents in Hong Kong seem to have stabilized, and sales should benefit when mainland Chinese visitors return.

Looking ahead, we believe the consumer is in a strong position to resume more traditional spending activities as shopping centres reopen. Consumer balance sheets appear to be healthy with net wealth and savings metrics notably higher than pre-pandemic.

U.S. Personal savings rate



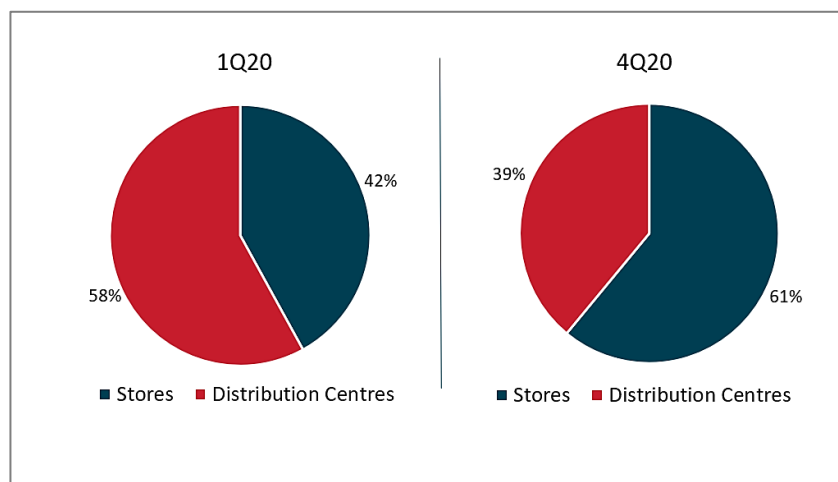
Source: FactSet, U.S. Census Bureau of Economic Analysis

While we are optimistic on the consumer's ability and desire to spend, we remain selective in our retail property exposure given the continued growth in e-commerce and the impact on certain retail formats. The reopening of retail properties around the world will show to what extent shopper behaviour patterns have been permanently altered. E-commerce sales surged during the pandemic as consumers transacted online out of necessity. In response, many retailers adapted and invested in their online platforms and fulfilment capabilities. While reopening will see some spending revert to physical shopping, particularly early in the recovery due to pent-up demand and "cabin fever", the improvements retailers have made to the convenience of transacting online will endure.

Many retailers are increasingly acknowledging the critical role physical stores have in their digital operations given the proximity to the communities they serve and the cost efficiencies which can be achieved. Brian Cornell, CEO of US retailer Target Inc, stated that "75% of our digital sales were fulfilled by our stores... this store as-a-hub model is the foundational element of our strategic plan."

Kimco Realty's CEO, Connor Flynn, noted the evolving role of shopping centres when he said the "major takeaway from this pandemic is that the physical last-mile store has never been more valuable... the retailer has evolved to make the last-mile location of their stores be, using their words, fulfillment epicenters."

Estimated online fulfilment by format



Source: Company data, Goldman Sachs Research

In simple terms the pandemic has reinforced the value of the physical store.

Open air shopping centres are best positioned to capitalise on these trends. With a tenant mix more focused on necessity goods (e.g. grocery, pharmacy) and services (e.g. hair salons, banks, etc) they are more resilient to ongoing growth in e-commerce and the physical layout is more conducive to digital or curb-side fulfilment.

In comparison, U.S. enclosed malls face continued challenges and a more fashion / apparel skewed tenant base with an environment of higher occupancy costs than found at open air properties.

Reflecting these dynamics and the positive consumer backdrop, leasing activity has been more robust for open-air retail landlords as tenants look to position for the post pandemic environment.

In the quarter, the Portfolio increased the exposure to retail considerably, initiating a position in two U.S. open-air, strip shopping centre REITs. However, we avoided higher leveraged companies and segments having more challenging prospects, such as U.S. enclosed malls. These segments bounced hard in the quarter, which detracted from performance.

Additional lockdowns in Europe kept many retail stores closed, weighing on the performance of mall REITs. Portfolio holding Klepierre, rose 8.1% in local currency terms, comparatively underperforming its major U.S. peer and shareholder Simon Property Group.

Also during the quarter, the Portfolio exited STORE Capital (STOR), a net lease retail REIT. A strong performer from its early pandemic lows, the stock's valuation no longer reflected the risks associated with large tenant concentrations in education and health clubs. We took the opportunity to exit the name as rent collections improved above 92% in the recent quarter.

Data Centres & Towers – technology wanes

The technology-oriented REITs underperformed during the quarter. While data centre companies expect robust leasing to continue in 2021 for both hyperscale and enterprise environments, the growth outlook is somewhat moderated by competitive pricing pressures impacting revenue growth, particularly in the U.S. Also, expansion related provisioning costs are expected to increase as portfolio holding Equinix adds to its services offering to maintain its competitive position. Net-net, operating margin expansion remains elusive, which is moderating growth expectations slightly.

Separately, telecom towers are poised to benefit from increasing levels of capital expenditure as telecom carriers provision for the rollout of 5G technology.

The direct market remains active for data centre REITs. During the quarter, portfolio holding Digital Realty (DLR) sold a portfolio of 11 European data centres to Ascendas, a Singaporean listed REIT, for US\$680 million and a 5.7% cap rate. This transaction of older properties represents DLR's first large sale of European assets following its acquisition of Interxion in 2019.

The Portfolio continues to hold investments in both data centre and tower stocks with the view that the earnings profile, even if slightly lower than in recent years, will still be in the top quartile of all REITs. These companies will benefit from structural tailwinds of the digitization of the economy and mobile communications for many years to come.

Residential – a multifaceted approach pays off

Residential property represents the largest sector exposure in the Portfolio, encompassing a broad range of rental housing options, including multifamily, single family, student accommodation and manufactured housing communities.

U.S. apartment REITs were strong performers in the quarter as the vaccine rollout led to hopes that tenants would return to central urban environments. Management commentaries were constructive and suggest operations were broadly troughing as occupancy and rental concessions stabilize and there were early signs of improved leasing traffic in front of summer peak leasing season in the Northern Hemisphere.

Equity Residential (EQR), Essex (ESS) and Camden Property (CPT) all provided double-digit total returns in the quarter.

One of the Portfolio's largest positions and best performers in 2020, U.S. single family REIT Invitation Homes (INVH), trailed the multifamily REITs and the index. We believe INVH is well positioned for continued solid earnings growth driven by a fundamental undersupply of housing combined with affordable rents. Its valuation compared with replacement costs and alternate home prices remains undemanding.

More defensively oriented residential segments, such as student accommodation and manufactured housing, also had more muted positive performance, consistent with the trend of selling defence to pivot to offense as the economy reopened. American Campus Communities (ACC) saw its Board reshuffled following an activist investor's sabre rattling. We do not expect any material change in the company's strategy which remains focussed on developing modern on or near campus housing for university students. Along with UK listed student housing provider, Unite Group (UTG), the vaccine rollout should motivate more students to return to campus with the commencement of a new school year in September. As such, we see student housing operations largely normalizing later this year.

In Europe, German residential apartment companies underperformed the benchmark in the quarter as their defensive appeal waned as investors rotated to more economically sensitive exposures. Vonovia (VNA), the largest listed real estate company in Europe, produced a total return of -6.8% in local currency terms. Operationally, the company is stable and its growth profile remains intact.

Investors in German residential properties await the Supreme Court's ruling on the constitutionality of Berlin laws which severely limited and even rolled back rents in many instances. A decision is expected in the next few months. Passed in 2019, the current law was intended to ensure rent levels remained modest for Berliners. In practice, however, the housing shortage has been exacerbated. In the past 1-2 years, the supply of available apartments in Central Berlin has dwindled as many landlords held vacant units off the market hoping for a sale or perhaps a reversal of the rent legislation. Landlords have also reduced the capital spend for their Berlin properties because the current rent law limits the ability to recoup the expenditure through improving the rents.

Industrial – demand shifting into next gear

Industrial REITs modestly outperformed in the quarter. Share price strength reflected tenant demand that continues to surprise on the upside as the reconfiguration of supply chains gain further traction.

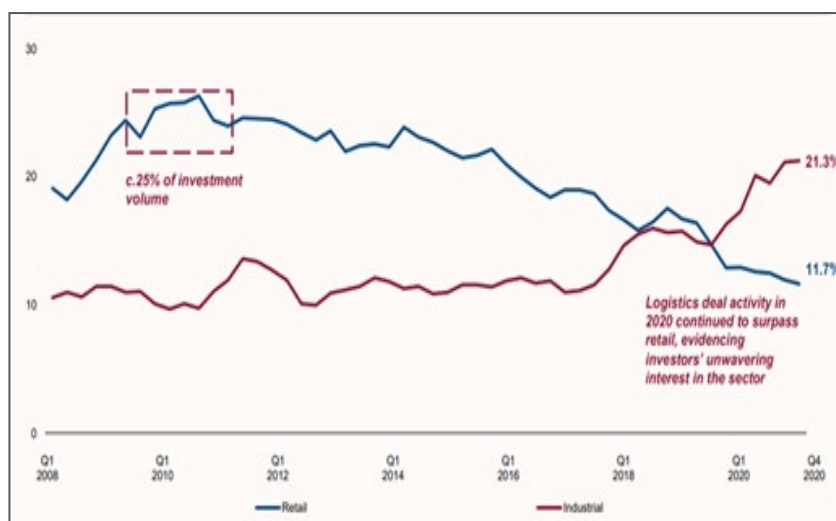
The leasing environment for industrial property remains favourable for landlords as robust growth in tenant demand outweighs competitive supply being developed. In the U.S., landlords have been achieving 10-20% rental rate growth on renewals in supply constrained urban locations. Coastal markets with physical supply constraints and which are located proximate to major urban areas provide the greatest rent growth prospects.

Tenant demand is proving to be deeper and broader than had been expected. In addition to accommodating growth in ecommerce, greater resiliency is also being incorporated into the supply chain. International trade tensions and Covid-related production delays have shifted the narrative from 'just-in-time' to 'just-in-case' inventory management.

There is also a shift underway to increase 'on-shoring' of production. In part, this is in response to global trade frictions, as it seeks to reduce transport risk across production and supply chains. Disruption to global shipping caused by a vessel recently becoming jammed in the Suez Canal only served to highlight the issue. Both trends, carrying greater inventory levels and shifting production closer to the final market, further strengthen tenant demand for industrial property.

Investor appetite for industrial property has been strong, and as the chart below illustrates, industrial sales exceed retail property sales, reflecting shifting investor appetite.

Retail and Industrial global transaction volumes %



Source: ESR Cayman, Real Capital Analytics

During the quarter, Warehouse de Pauw (WDP) raised €200 million to fund additional developments in its core markets of Benelux and Romania in Europe. In Japan, Nippon Prologis (3283) raised ¥35.4 billion (US \$343 million) in the first Green Equity raise by a JREIT. The Green Equity raise requires the proceeds to be invested in properties possessing high environmental standards as measured by CASBEE or BELS ratings. In this instance, Nippon Prologis acquired three newly constructed properties in Greater Tokyo that meet the necessary environmental standards.

Also in the quarter, there was an IPO of Netherlands domiciled CTP NV (CTP), owner of a €5 billion Central and Eastern European industrial platform. The majority of the company's assets are in the Czech Republic, Slovakia and Hungary. Management is aligned, with the founder maintaining an 82% stake in the company. The IPO proceeds will be used to fund land acquisitions and developments that will nearly double the size of the company in the next 3-5 years. CTP provides the first listed pure-play opportunity to invest in modern logistics facilities in major Central and Eastern European markets which provide tenants with cost advantages relative to Western Europe.

Self-storage – landlords regain pricing power

Occupancy in self-storage properties has remained surprisingly strong as the pandemic morphs into a recovery. In the U.S., occupancy levels are near all-time highs, and in Europe, they continue their steady, upward march.

The growth outlook for self-storage continues to strengthen as high occupancy is restoring landlord pricing power. The biggest surprise remains that move-out volumes have not normalized from the depressed levels seen during the pandemic lockdowns. Mobility has returned to the market as new tenants continue to lease space, resulting in low availability levels.

Landlords have resumed rate increases for existing customers, an important driver of rental growth. Furthermore, for the first time in years in many markets, new leases are seeing positive rental reversion.

Finally, investor demand for self-storage assets remains strong, and private market evidence is supportive of public valuations. As a result, the Portfolio maintains an overweight position in storage in both the U.S. and European markets.

During the quarter, Public Storage (PSA), the largest owner of self-storage globally with a US\$50 billion portfolio, refreshed its board of directors, lowering its average age and increasing gender diversity, following pressure from a high-profile activist. Moreover, the company appears intent on improving its capital structure efficiency by issuing lower cost unsecured debt instead of the high coupon perpetual preferred equity it relied on historically.

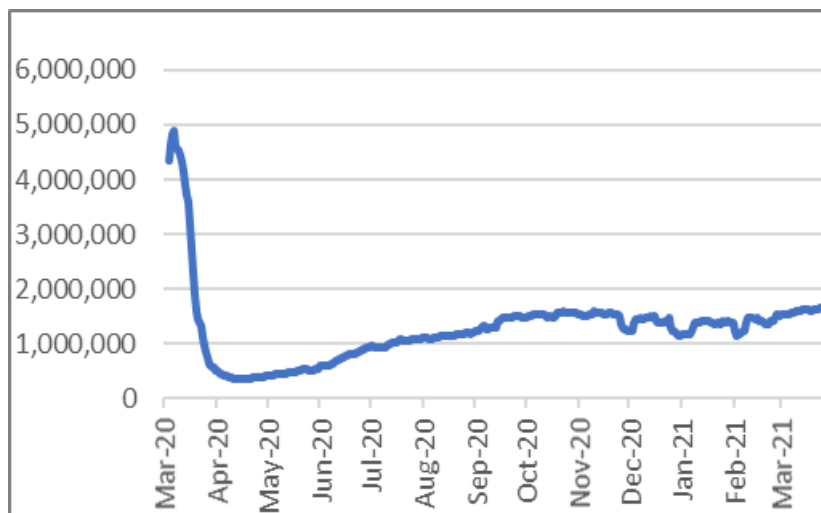
While PSA may have needed perpetual preferred securities when it was a smaller company post IPO in the 1990s, now that it is a US\$50 billion enterprise with a A2/A rating and there is a well-established unsecured bond market for REITs, it has good access to senior debt whose lower coupon will free up cash flow for the company and equity shareholders. We estimate there could be 200bp saving in interest expense when using 10-year bonds instead of perpetual preferred equity.

Office – a conundrum of false hope

As the world begins to normalize, we expect the locus of employment to revert to more time spent in offices and less time working from home (WFH). Undoubtedly, the timing and extent of this shift will occur unevenly across industries and markets. We have heard of large tenants, such as Salesforce, pull back from preleases in San Francisco, while in London, landlord, Derwent London, notes tenant interest is “hotting up.” In Sydney, office trends appear to be stabilizing, albeit at lower effective rents.

The Portfolio remains underweight the office sector because when you cut through the WFH normalization noise, tenant demand in key CBD office markets remains tepid. In New York, leasing activity is at 20-year lows, and large employers in financial services are consolidating rather than expanding their space requirements. The graph below shows the daily ridership of the New York City subway in the past year. We view this as illustrative of activity in major urban areas that has not really recovered from the Covid pandemic.

New York City daily subway ridership



Source: JP Morgan

New York and other major markets, such as San Francisco, along with suburban Paris, are beset with sublease availability. In light of these soft conditions, it is somewhat bewildering to see New York office REITs have a blistering March quarter, rising 15-20%, depending on the vehicle. We expect the road to recovery in office will be long and expensive, and we remain highly selective about the office exposure in the Portfolio.

Office REIT Kilroy Realty (KRC) was involved in a noteworthy asset sale during the quarter. The company sold The Exchange in the Mission Bay submarket of San Francisco for US\$1.1 billion or \$1,440 per sq. ft. Having developed this project for \$585 million in 2017 and fully leased it to DropBox for 15 years, this sale, allows Kilroy to pocket nearly \$500 million in profit. We understand the buyer, private equity shop, KKR, intends to convert the building to life science use, which its location next to the UC San Francisco Hospital lends itself to.

Mitsubishi Estate (8802) provided strong performance as the stock rose 17.7% during the quarter. Following a year of disappointing performance, Japanese developers rebounded strongly on the reflation thematic in Japan. WFH is perceived to be less practical due to small housing units in Tokyo. Further, the office market is reasonably balanced, with low vacancy, not much sublease availability and limited developments expected in the next two years. Mitsubishi Estate provides exposure to the largest concentration of high quality office assets in central Tokyo.



Outlook

The Covid pandemic is a global health event that has altered human behaviour around the world, the permanence of which will only be clear in the years ahead. For real estate, it rapidly caused a significant pause in economic activity. We expect activity patterns to normalize over time, but at speeds that vary by sector and by market. The vaccine news in November may have been the starting gun towards economic re-emergence, but not every sector will progress at a similar pace.

Recovery from the economic disruption that ensued is being supported by extensive government and central bank interference. Ambitious fiscal programs are providing support across a wide range of industries and employment segments. Expansionary central bank monetary policy has backstopped credit and led to a rapid compression in spreads globally. Because of these actions, asset prices have increased. Importantly for real estate, the levels of distress anticipated early in the pandemic have yet to materialise.

The pandemic has accelerated numerous secular trends. Changing consumer behaviour pulled forward several years of e-commerce growth and magnified the value of select physical retail locations as critical distribution points. Demand for industrial property has surged as inventory supply chains are reengineered to carry higher stock levels located closer to the end user. On a more cautionary note, office utilisation has declined as technology enabled workers to disconnect from location-based activities and still maintain adequate productivity. We expect offices to eventually be repopulated, but we also believe that greater flexibility in layout and uses will be needed in the future.

Strong economic growth, boosted by government policies, looks to be laying the groundwork for inflation and interest rates to rise in the coming months and quarters. While it has been some time since we last saw such conditions, those of us old enough to experience them recall real estate as being well sought after as an inflation hedge. While we acknowledge that some sectors of the property market have longer duration cashflows which will take longer to respond to higher inflation and rates, real estate should ultimately be a beneficiary of a strong economy as it translates into greater demand for space and services.

Generally, we are constructive for REITs going forward. The pandemic was ostensibly an exogenous aberration and the road to repair is underway. Tenant demand is returning, balance sheets – for the most part – are sound, and private market values backstop REIT prices, with few noteworthy exceptions. M&A is reappearing in various markets as capital looks to take advantage wholesale of a rebound in operations. We have pivoted prudently to position for a multi-year rebound in operations and above trend earnings growth.

ESG

The property industry has tended to focus its climate efforts on controlling and reducing operationally generated Green House Gas (GHG) emissions – i.e., carbon that is emitted from building operations. The industry has made commendable strides in increasing energy efficiencies and incorporating more renewable energy supplies. Carbon emissions are being reduced and buildings are being run more efficiently as windows, insulation and on-site generation systems are being upgraded over time.

However, there is another important but less talked about source of GHG emissions associated with buildings: embodied carbon. Embodied carbon consists of all the GHG emissions associated with building construction, including those that arise from extracting, transporting, manufacturing and installing building materials on site, as well as the operational and end-of-life emissions of those materials. Embodied carbon emissions are a significant contributor to property-related emissions. In fact, circa half of the whole life carbon emissions of a new building relates to its construction.

Hence, embodied carbon should be a priority for property companies looking to reduce carbon emissions consistent with the goals outlined by the Paris Agreement. We note that the inclusion of embodied carbon (otherwise known as ‘Scope 3’ emissions) in the net zero targets promulgated by companies remains unfortunately, a rarity in the property industry.





There have been a few encouraging developments on carbon neutral construction recently from UK and Continental European property companies. For example, student accommodation landlord, Unite Group (UTG) outlined its new sustainability strategy during its 2020 earnings results. It stated its intention to become a net zero carbon business by 2030 for both its existing building operations and its development activities, which would be in accordance with Scope 3 of the Paris Agreement. This is particularly notable because development is a large part of UTG's business, comprising nearly 10% of the company's total assets. The full strategy will be fleshed out during its capital markets day later this year, and we look forward to hearing (and learning) more.

Also in the quarter, UK diversified REIT British Land (BLND) delivered a net zero carbon development at 100 Liverpool Street in London. It did so through a combination of retaining 50% of the previous structure on-site, by employing low carbon materials where possible, and through the purchase of carbon offsets involving reforestation in Mexico and land restoration in Tibet.

We will explore net zero development in more detail in future commentaries. This is a complex and potentially highly contentious issue. Currently, we do not yet know where the line between net zero development and greenwashing lies. We are looking forward to understanding the issue better through discussions with companies at the forefront of this development.



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FEES

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