



see money differently

A photograph of an open book with white pages, tied with a white string bookmark. The book is open to a blank page, and the pages are slightly curved, suggesting it is being turned or held open. The background is a soft, out-of-focus light grey.

Nedgroup Investments Global Property Fund

Quarter Three, 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.	5 years p.a.	Since Inception# p.a.
Portfolio*	-0.08%	20.11%	7.41%	6.09%	5.58%
Performance indicator*	-0.90%	29.66%	6.18%	4.53%	4.13%
Difference	0.83%	-9.55%	1.23%	1.56%	1.44%

* 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's capacity to act as an inflation hedge and the Global REITs relative financial strength countered broader investor anxieties.
- The failure of Evergrande is unlikely to have contagion effects on fundamentally strong REIT businesses.
- Bond yields increased as markets expect reduced policy support, given current inflation dynamics and improving economic conditions.
- U.S. REIT second quarter earnings evidenced unprecedented operating conditions in numerous property sectors, including self-storage, logistics and residential.
- Office REITs continued their relative underperformance as landlords have limited visibility on post-COVID demand.
- US residential rental growth surges, but German politics imposes constraints on growth in this sector.
- Seniors housing provides a multi-year opportunity for growth with the tailwind of developed market demographics.
- Portfolio changes in the Data Centre sector, with two new additions and a benchmark reweighting of Equinix.
- Heightened level of M&A activity continued in Q3.
- Operating conditions remain supportive as vacancy rates are below historic levels, building replacement costs are rising, rent cash flows are growing and we observe sensible REIT capital management.

Market and portfolio commentary

REIT total returns were little changed for the quarter as improving underlying supply and demand property fundamentals were countered by various macro crosswinds. The Portfolio outperformed the Global REIT index for the quarter and the focus on real estate with clear pricing power was the defining feature.

Before delving into REIT specific factors, two key issues dominated the broader market's attention during the quarter: 1. the extent and consequences of inflation pressures building as a result of central planning stimulus and supply chain bottlenecks; and 2. the potential fallout from the looming failure of one of China's largest residential property developers, Evergrande (3333), with some fearing a 'Lehman's' moment for the Chinese economy and global credit markets.

Add to this list localised issues such as a redefining German Federal government election, the UK dealing with the consequences of BREXIT and conversely Hong Kong dealing with "Reunification" frictions with Mainland China, it's fair to say investors had plenty of issues to comprehend.

Pleasingly, all in all, challenges within the more established REIT markets were generally inconsequential. Real estate's capacity to act as an inflation hedge and the relative financial strength of the REIT sector provided some comfort to allay broader investor anxieties.

Nevergrande – take a chill pill

Since the U.S. sub-prime debacle just over a decade ago, and considering China's two-decade long property boom, many commentators in the West have been willing a Lehman's "you too" moment for China. In short, we view the situation very differently.

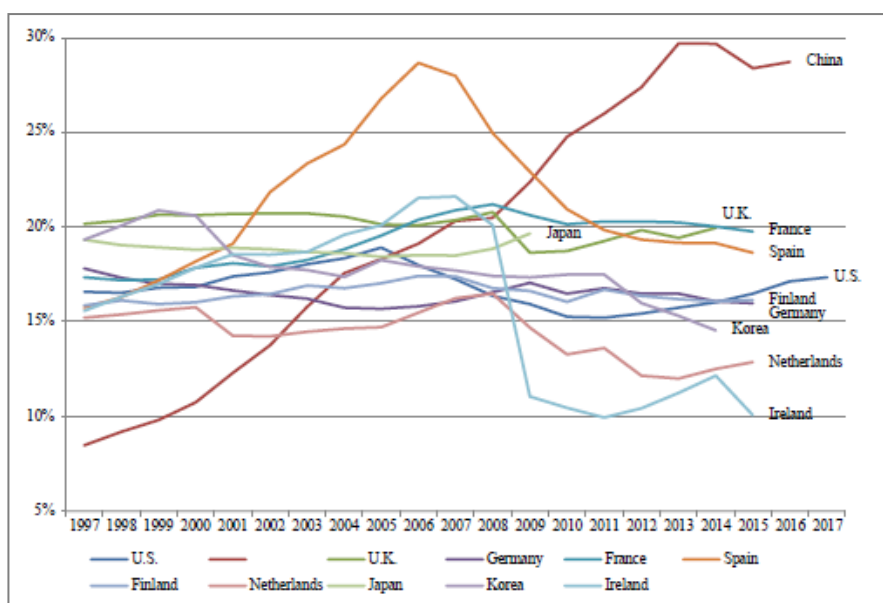
Evergrande is an excessively leveraged property developer which is being brought to account by central planners concerned about speculative activity in the residential property market and broader housing affordability issues. Furthermore, whilst we acknowledge the risks of China's shadow lending market, Evergrande's problems have not come with evidence of widespread lax lending practices to home purchasers, nor financially engineered derivative products.

Hence Evergrande's failure, and potentially that of other smaller rivals, is unlikely to create lasting shockwaves for global credit markets and economies more broadly. To varying degrees lenders will be burnt, most notably foreign bond holders. But given these bonds have formed part of a high yield/high risk market should anyone be shocked? In a purely economic sense, efforts to curb emerging signs of excess could be viewed positively, which clearly central planners failed to do in the case of sub-prime lending in the U.S.

If our views prove to be naïve and the crisis deepens, we believe global REIT capital structures are in far better standing than in 2006: financial leverage is lower, there are limited material short-term debt maturities and minimal use of the CMBS market.

Nevertheless, the importance of Evergrande should be viewed in the context of crimping Chinese consumer confidence and marking the end, if not an extended pause, of the residential property boom. Real estate related activities in China account for ~30% of GDP by some estimates, hence, the key outcome is likely slower growth for the world's second largest economy.

Real Estate related activities share of GDP by country



Source: KLEMS, "Peak China Housing" Kenneth Rogoff, Yuanchen Yang

The Portfolio has no direct exposure to Mainland China property developers. In Hong Kong we have two relatively modest exposures: Sun Hung Kai (16) and Link REIT (823). Both stocks have solid balance sheets (Loan to Value of less than 20%, and Debt to Equity of less than 30%). Furthermore, they have limited short term debt refinance requirements. Link REIT is focused principally on rental income derived from convenience retail property. Sun Hung Kai's earnings are approximately equally split between development trading and rental income, mostly derived from Hong Kong, while a burgeoning China platform is predominantly focussed on office and retail rental assets. Therefore, we see limited direct financial risk to either stock from the Evergrande issue.

Perhaps reflecting the greater uncertainties emerging in its home market, late in the quarter reports emerged that Link REIT was in advanced discussions to purchase interests in three Sydney CBD retail properties including the historic landmarks The Queen Victoria Building and Strand Arcade. Rumoured to be acquiring a 50% interest for A\$550m, this represents somewhat of an opportunistic investment in CBD retail currently struggling with the absence of office workers and tourists. Whilst Link has been gradually deploying capital into Mainland China and overseas markets in recent years, and emboldened by its strong balance sheet, the mooted purchase of these assets could be viewed as a more concerted effort to achieve geographic diversification.

Re-opening Inflation – transitory for longer

Easing infection rates in many developed markets, coupled with news of the development of the first oral anti-viral pill targeting COVID-19, supported the notion that the most severe impacts of the virus could be managed.

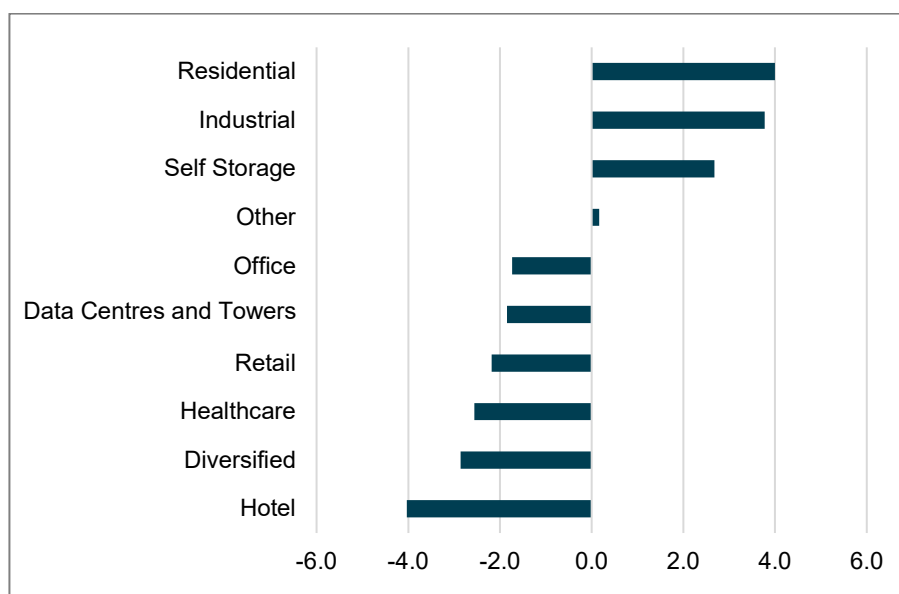
However, compared with pre-pandemic, key areas of the economy have become somewhat distorted. Broad-based input cost pressures are increasingly evident as (over) stimulated demand faces a myriad of production and supply bottlenecks. From record gas prices in Europe, power shortages in China, price spikes in various building materials, and ballooning shipping costs to global food prices increasing 33% y/y - it appears the global economy is enduring a period of Covid induced indigestion. Labour markets, supply chains, various commodities, and asset prices are experiencing abnormal supply and demand conditions as a direct result of Covid related shutdowns and various policy measures enacted to support economies through the pandemic. While some pricing pressures will abate as economies fully reopen and spending patterns revert, the question on the persistence and extent of the transition to 'normalisation' remains.

Bond yields increased as markets began pricing in an expectation of reduced policy support given current inflation dynamics and improving economic conditions. Indeed, many emerging markets' Central Banks including Russia, Brazil, and Mexico are already lifting policy rates, with several developed markets, including Poland and New Zealand, also doing so toward the end of the quarter for the first time in many years.

Real estate operating conditions continue to improve. Thanks to more progressed reopening, U.S. REIT second quarter earnings results evidenced unprecedented operating conditions in numerous property sectors, notably self-storage, logistics and various forms of residential property.

Reflecting overweight exposure to these segments, the Portfolio outperformed the benchmark over the quarter. Relative returns were also enhanced by underweight positions in the office, hotel and diversified sectors which underperformed the benchmark. These segments appear to be suffering their own forms of "long Covid".

REIT Sector Total Returns (%)



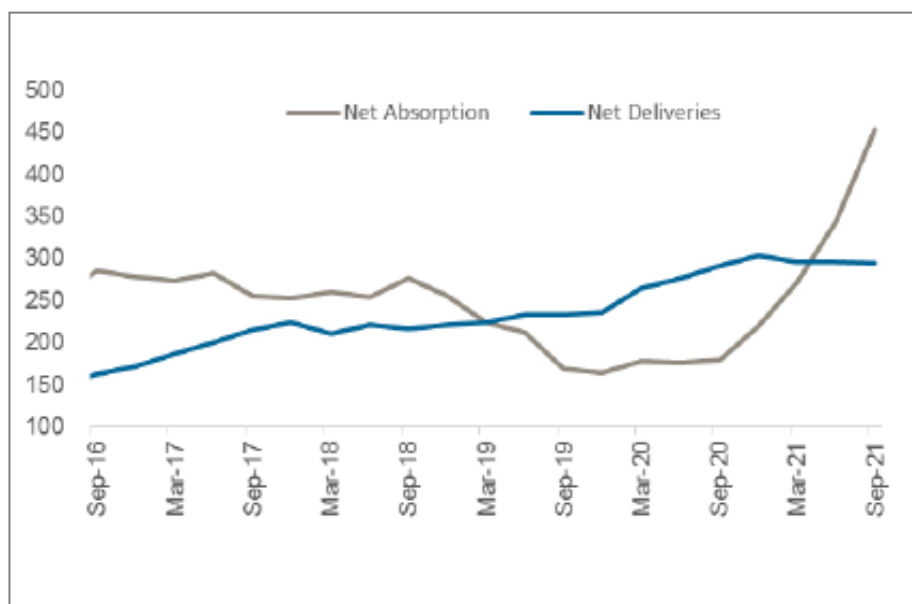
Source: Factset; FTSE EPRA Developed Hedged

U.S. residential was the best performing sector as rental growth continues to recover in coastal and accelerate further in sunbelt markets. The operating environment and outlook for various residential segments is discussed later in the commentary.

Self-storage REITs also generated another quarter of impressive absolute and relative returns. While some leasing seasonality is returning, landlords continue to experience close to record occupancy and pricing power as pandemic-related disruption supports increased occupier demand. The strength in operations remains broad-based and evident in all markets in which the Portfolio has exposure, including the U.S., UK, and Europe. During the quarter we also re-initiated a position in an Australian self-storage operator which is benefitting from similar supportive operating conditions.

Industrial and logistics REITs again performed well, positively contributing to portfolio returns. The operating environment for inner suburban infill industrial markets continues to strongly favour landlords. Tenant demand exceeds supply (chart below), vacancy remains low and rental growth is accelerating. Market rent growth rates of high single digit levels are not uncommon in many major metropolitan markets as logistics companies try to position closer to the end consumer. The strength of the market was encapsulated by commentary from U.S. REIT Prologis (PLD) during their second quarter earnings presentation where management noted that demand for space and market conditions remain the strongest in the 38-year history of the company. Prologis generated total returns of 5.3% (in local currency terms) and was the second largest contributor to relative Portfolio returns.

U.S. Industrial Supply & Demand (m sq ft)



Source: Costar, JP Morgan Asset Management

Capitalising on favourable conditions, industrial REIT Rexford Realty (RXR) raised US\$575m of equity to fund acquisitions in its core Southern California market. Like Prologis, Rexford's portfolio is benefitting from extraordinary conditions, with vacancy below 2% and rents increasing 25% for new leases signed. In some instances, the company is marketing space for lease with no guided rent as demand is so dynamic that each lease agreed is often well ahead of underwriting and setting new record rent levels. Given such strong dynamics, capital continues to be drawn to the logistics sector. In the quarter, Blackstone (BX) agreed to acquire Canadian Industrial REIT WPT Industrial (WPT). The all-cash transaction valued the portfolio at US\$3.1bn, the price of US\$22/share representing a 17% premium to undisturbed price and a 32% premium to market consensus NAV.

Office REITs continued their relative underperformance in the quarter as the delta wave delayed the return to the office in many markets and investors struggled to make a positive case for the longer-term dynamics. In the U.S., office utilisation (i.e., the proportion of leased space re-occupied) continues to be low, averaging around 35% according to Kastle systems 10 city average of major U.S. markets. Many office tenants are still figuring out the appropriate post Covid operating model, hence landlords continue to have limited visibility on demand.

It was thus notable in the quarter that accounting and consulting firm, PWC, announced it will allow all 40,000 U.S.-based service employees to work virtually from anywhere in the U.S. This is the first of the 'Big 4' professional services firms in the U.S. to provide this degree of flexibility for its workforce. Until now such pronouncements were more common from the larger tech firms. The months ahead will provide more visibility on office demand with a return to office slated for early 2022, while mounting evidence suggests a hybrid office / WFH model is likely for many businesses.

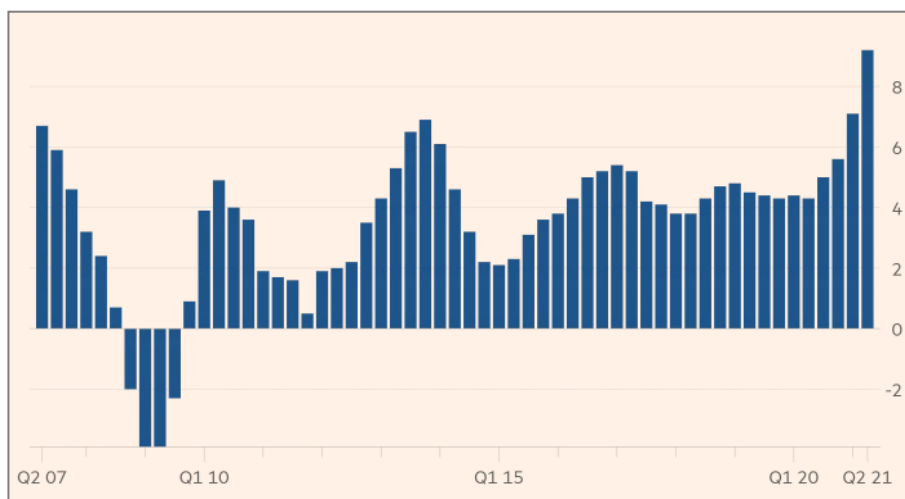
In the UK, the return to the office is further advanced. Prime Minister Boris Johnson's gamble on reopening the economy despite surging Covid infection rates thus far seems to have been a reasonable bet. The UK population appears to be sticking to its long-held mantra, 'keep calm and carry on'. Office utilisation in London is above 50% and the buzz of the city is gradually returning. Office leasing dynamics are improving and results from Derwent London (DLN) in the quarter indicate that leasing economics are firm for better quality buildings and values are holding up. Derwent is benefiting from its concentration in smaller unique buildings in the supply constrained West End and Tech Belt – a segment we believe is better positioned to adapt in the post-pandemic world. Derwent generated total returns of 4.7% (in local currency terms), outperforming the benchmark for the quarter.

Hotel REITs was the weakest performing sector, extending their relative underperformance from the prior quarter. Concerns about the impact of the delta variant weighed on the group, but as infection rates inflected in the U.S. the sector recovered ground. While business demand will take time to recover, the leisure segment has been strong with resort and drive-to experience properties hitting record pricing. As more normal business operating patterns resume in the new year, we anticipate increasing demand as businesses look to reconnect with staff and customers.

No place like home

The challenges facing China's residential market in relation to housing production and affordability are by no means isolated. House prices around the world have increased substantially during the pandemic as low interest rates, buoyant savings and a lack of alternative spending options have seen capital flow into housing. At the end of the second quarter, house prices globally were growing at the fastest rate since 2005, while U.S. house prices grew at the fastest rate in ~30 years.

Global house prices (12 mth to end of Quarter y/y change)



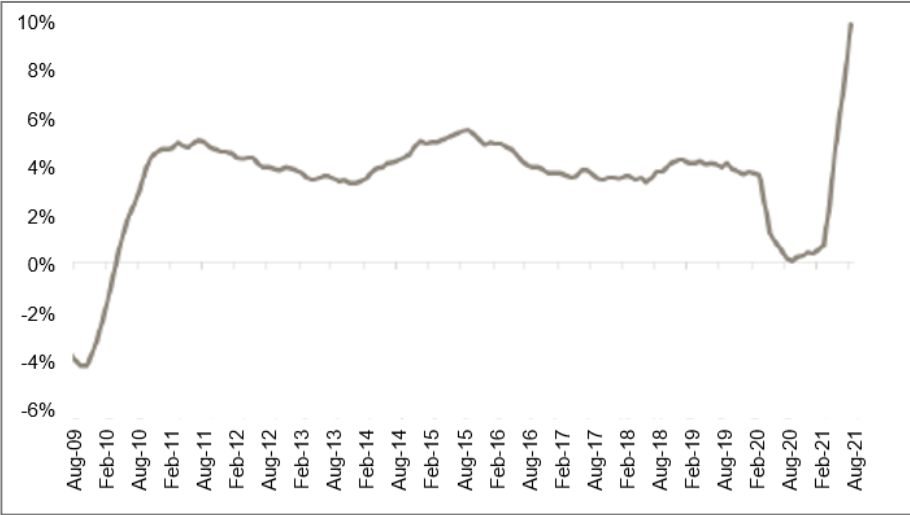
Source: Knight Frank / FT

Affordability is becoming increasingly strained as rising prices require larger deposits and mortgages for new entrants to the market. Low interest rates have enabled borrowers to service ever larger mortgages provided interest rates are fixed on a long-term basis or remain low. The latter is of particular importance in markets, such as Australia, where mortgages are predominantly variable rate.



While house prices boom around the world, residential rents in less regulated markets such as the U.S. have also surged. Effective rental growth for U.S. apartments accelerated through the quarter increasing 12% y/y in September. Effective rents in all major REIT markets except for San Jose and San Francisco are at or above pre-Covid levels and in many cases double digit percentages above (based on Realpage data). Demand is being driven by new household formation, decoupling from Covid era accommodation, return to the office and relative affordability as house prices march higher.

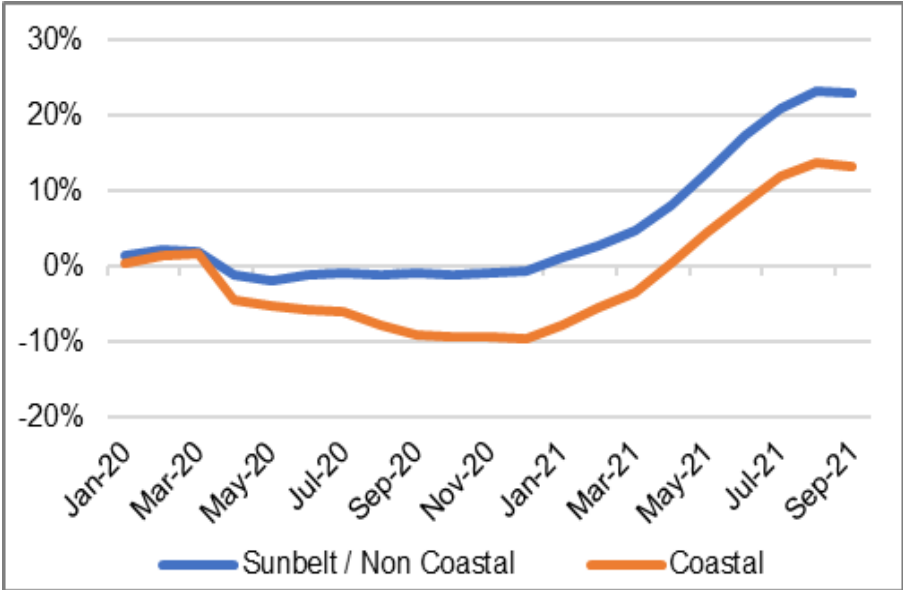
U.S multifamily rent growth y/y



Source: JP Morgan Asset Management, Axiometrics

The standout in the U.S. residential sector continues to be the sunbelt markets (e.g., Georgia, Texas, Florida and Arizona) which have experienced higher job creation and residents migrating from larger more expensive urban coastal markets. Rents were barely impacted during the worst of the pandemic and have continued to surge as demand outstrips supply. Rents signed for new leases accelerated through the quarter and increased over 20% y/y in September. Coastal markets, which suffered as the bigger urban centres depopulated during the pandemic, are now recovering strongly as residents return to cities with new leases being signed approximately 13% higher y/y.

U.S. New lease rent change y/y



Source: Realpage, Evercore ISI



Reflecting these strong fundamentals, the Portfolio has a sizable exposure to U.S. residential property including single family homes, coastal and sunbelt apartments. The sector performed strongly in the quarter and while rental growth will moderate from these elevated levels, we believe it remains well positioned to generate competitive returns.

Wohnen Für Alle

Politics and regulation were again front and centre for German residential landlords in the quarter with elections taking place across the country and a referendum on expropriation occurring in Berlin.

Landlords, tenants, and investors were keenly focused on the Federal election as the outcome could eventually lead to changes in the regulatory framework governing rent increases and the returns achievable on modernising apartments – both key profit drivers for landlords. Fortunately, for landlords and investors at least, the feared outcome of an all-left coalition did not eventuate. Hence, the worst possible outcome appears to have been avoided, for now at least.

While risks at the Federal level appear to have eased, Berlin landlords face ongoing opposition from large sections of the community in a city dominated by renters. The referendum on expropriating apartments from private real estate companies in Berlin which own over 3,000 apartments, received 56% of votes in favour. This non-binding vote will only become law if tabled and passed by the Berlin Senate and then it would likely face significant legal challenges. Whilst expropriation is probably neither feasible or legal, a view publicly shared by Franziska Giffey, the head of the Berlin SPD party and likely new Mayor of Berlin, voters continue to send the government a clear message. It seems a reasonable prospect that Berlin landlords will face further attempts to restrict rental growth unless other solutions to improve housing supply and affordability in that city are pursued.

Interestingly, the political and regulatory environment has not slowed investment in German residential or indeed the Berlin market. The takeover of Berlin focused landlord Deutsche Wohnen (DWIN) by peer Vonovia (VNA) passed the key 50% control threshold during the quarter, and it exceeded 60% post quarter end. Subject to the extent of final acceptance levels, Vonovia will launch a substantial rights issue of between €2bn-€8.5bn which is expected to occur in the coming quarter. While generally supportive of the transaction we remain concerned on the debt levels Vonovia has taken on to fund the takeover in advance of raising equity.

All's WELL

With the delta variant surging in parts of the U.S., concerns about the impact to seniors housing residents understandably arose in the quarter. Fortuitously, Welltower (WELL) provided a business update in September confirming that occupancy in its seniors housing portfolio continued to increase despite the delta surge. In contrast to the earlier stages of the pandemic where occupancy fell by approximately 1200bp, high vaccination rates in Welltower's communities is providing protection for residents and enabling the properties to function relatively normally. With vaccination rates over 90% it is often safer for a resident to be in a seniors housing facility than the broader community where vaccination rates are often much lower.

One note of caution relates to labour in its communities. Seniors housing is a labour-intensive business with staff costs recently accounting for 60% of operating expenses. The availability of labour is currently a challenge in the U.S. for many service-oriented businesses which is creating short-term cost pressure. We expect labour availability will improve in coming quarters given the recent Federal vaccination mandate for healthcare workers and the impending cessation of Federal Covid payments. That said, in the short-term rising labour costs may dilute the profitability of the occupancy gains currently being achieved. Beyond these reopening frictions we believe seniors housing will benefit from a multi-year period of demand growth as the U.S. population ages.

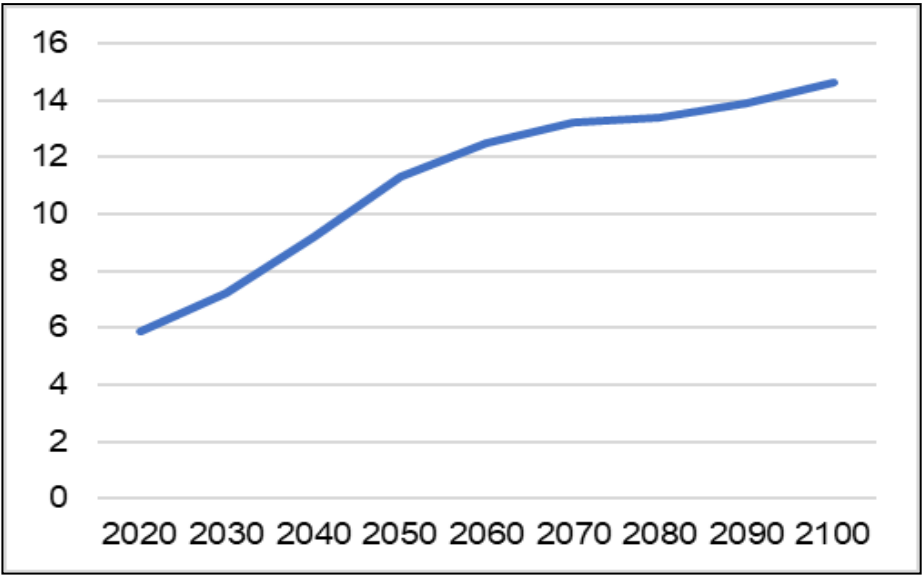
Turning to Europe, we initiated a position in a European healthcare REIT which has been on a multi-year transition to focus solely on seniors housing / healthcare property. The European seniors housing sector offers several attractive investment attributes and is highly fragmented providing opportunity for consolidation.



The lease structures are also favourable. Operators lease the properties on long-term (12 to 20 years) net leases, where the operator pays most, if not all, operating and maintenance costs during the lease term. Rents are indexed annually to inflation and have a degree of government backing given social support payments to residents.

In addition, the sector will experience decades of increasing demand as the percentage of the European population over 80 will almost double in the next 30 years. Significant investment will be required to maintain capacity for healthcare services and related real estate and a greater share is likely to fall on the private sector given strained fiscal positions of many European governments. Provided the regulatory framework remains amenable, this should provide a reasonable backdrop for landlords to generate appropriate returns on capital.

% of EU population 80+ years



Source: Eurostat, Resolution Capital

Data centres

Over the quarter we broadened the Portfolio's data centre exposure by initiating two new positions in U.S. data centre companies.

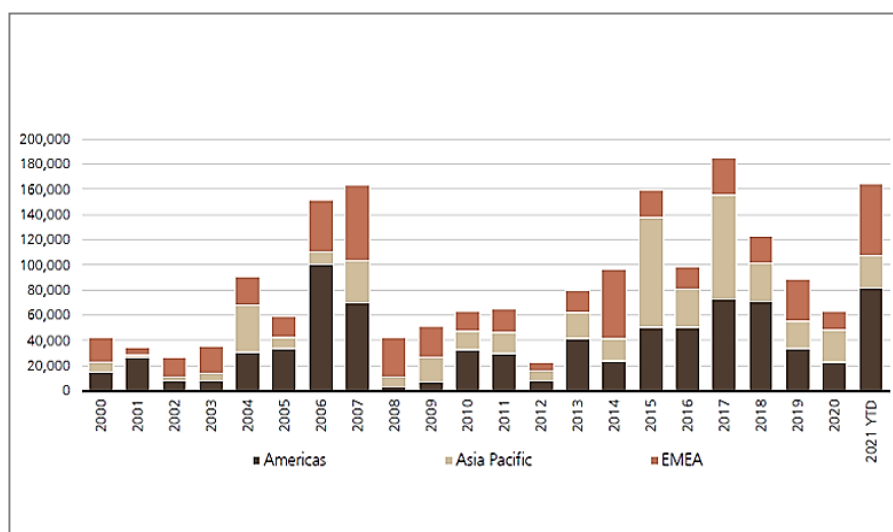
Another notable change in data centre exposure occurred late in the quarter as Equinix (EQIX) was upweighted in the benchmark making it the second largest stock in the FTSE EPRA NAREIT Real Estate index. Given recent share price appreciation we did not increase our existing position meaning our relative position compared to the benchmark has reduced. EQIX generated total returns of -1.3% for the quarter (in local currency terms), modestly underperforming the index.



M&A update

Significant real estate M&A transactions have been a feature in 2021 and this quarter was no different, albeit the parties involved were not in our Portfolio.

Listed real estate M&A volume (US\$ m)



Source: Dealogic, M&A Analytics. As of Sep 2021.

Outlook

Ultimately the current phase of Covid-related economic indigestion will pass, reducing many of the distortions impacting broad segments of the global economy. Much of the dislocation appears to be driven by supply side abnormalities. We expect that as economies fully re-open and as spending patterns normalise, many supply chain and pricing pressures should ease.

In the interim, elevated inflation presents new challenges for policy makers, consumers, and businesses. “Transitory” is the generally proffered catchphrase, but the extent and duration are undefined and open to misinterpretation. As the emergence from the pandemic becomes more synchronised around the world, the significant Covid-era stimulus will be withdrawn, raising the prospect of instability as the world comes to terms with the ‘new’ normal.

From our perspective, real estate operating conditions remain supportive, generally commercial property vacancy rates are below historic levels, building replacement costs are rising and rent cash flows are growing. Combined with sensible REIT capital management, we believe the asset class is capable of providing a hedge against inflation pressures.

While inflation and interest rates may dominate the discourse for the months ahead, we remain focused on underwriting the things that matter for real estate returns: demand, supply and access to capital. We continue to position the portfolio in select REIT platforms best placed to demonstrate pricing power and unlock latent value in the underlying real estate. This will enable the Portfolio to generate competitive risk adjusted returns and fulfil its role in a diversified investment portfolio.

ESG Engagement

We engaged with two North American residential REITs over the quarter as they did not meet the standards outlined in our Engagement and Responsible Investment policies, namely:

1. Adequate carbon emissions reporting
2. Paris aligned carbon emissions reduction targets

Our first step was to speak to the head of sustainability at each company to talk through the issues and ensure we understood the unique characteristics that may complicate reporting GHG emissions and implementing a reduction target. While both companies did arguably have some mitigating factors, we were nonetheless disappointed by the lack of urgency and reticence to give us a clear time frame for when we could expect improvements to environmental reporting and targets. We subsequently formalised our feedback to the respective CEOs and arranged a follow up meeting with management to reiterate our concerns.

Whilst it's still too early to ascertain the impact of our engagements, our follow up meetings with management were promising. Both companies acknowledged the need to improve and their intention to disclose better data and implement a GHG reduction target. We will follow up in 6 months to ensure that progress is being made and continue to apply pressure.

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FEES

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NEDGROUP INVESTMENTS CONTACT DETAILS

Tel: toll free from South Africa only 0800 999 160

Email: helpdesk@nedgroupinvestments.com

For further information on the fund please visit: www.nedgroupinvestments.com

OUR OFFICES ARE LOCATED AT

First Floor, St Mary's Court
20 Hill Street, Douglas
Isle of Man
IM1 1EU