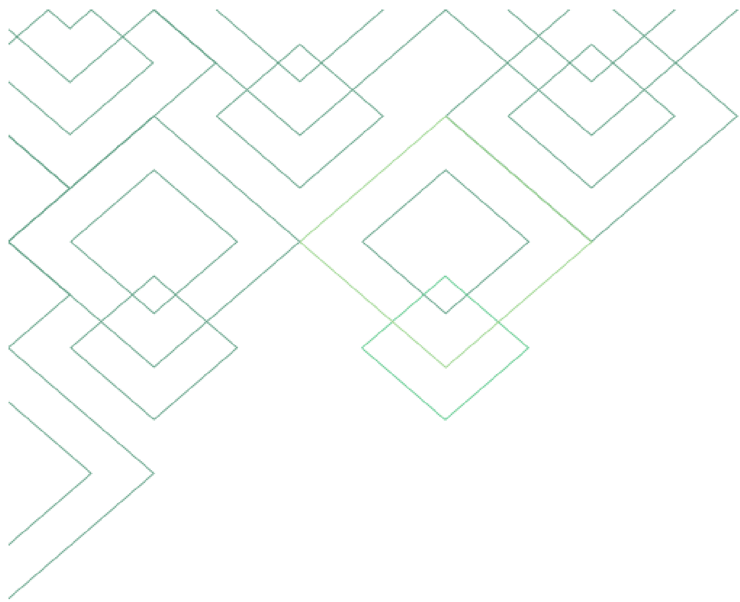


see money differently

Nedgroup Investments Global Property Fund

Quarter Four, 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*	12.0%	26.2%	14.1%	9.3%	7.5%
Performance indicator+	10.2%	26.1%	11.8%	7.8%	5.8%
Difference	1.8%	0.0%	2.3%	1.4%	1.7%

* 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

- Strong quarter for real estate as landlords were able to push rents hard, well ahead of inflation, thereby generating real rent growth.
- Performance divergence, as the top sector (self-storage) outperformed the worst (hotels) by approximately 26% and regionally, the U.S. outperformed Japan by around 20%.
- Overweight exposure to the U.S. market benefitted fund performance, as U.S. REITs were the best performing asset class in 2021, returning 43%.
- Strong contributions were generated by the portfolio's holdings in logistics and self-storage in the U.S., UK and Europe, as occupancy remains high.
- Hotels, seniors housing and office REITs underperformed in the wake of the emergence of Omicron.
- With housing accounting for 40% of the broader inflation metric, we see first-hand evidence of extraordinary rent growth that will feed into inflation over time.
- Importance placed on engagement with companies to understand how they intend to deliver on net zero targets and alignment with the Paris agreement.
- The listed real estate sector is in good shape: vacancy rates are at or below historic averages, overall new building supply is moderate and there are tentative signs of improving tenant demand
- REIT capital structures are sound with leverage low and good access to capital across multiple channels.
- Robust acquisition opportunities and de-risking development through pre-lets collectively produces solid earnings prospects for at least the year ahead when FFO per share growth should exceed 10%.
- There are risks associated with elevated earnings and multiples, but we continue to believe there is limited idiosyncratic risk to the sector.

Market and portfolio commentary

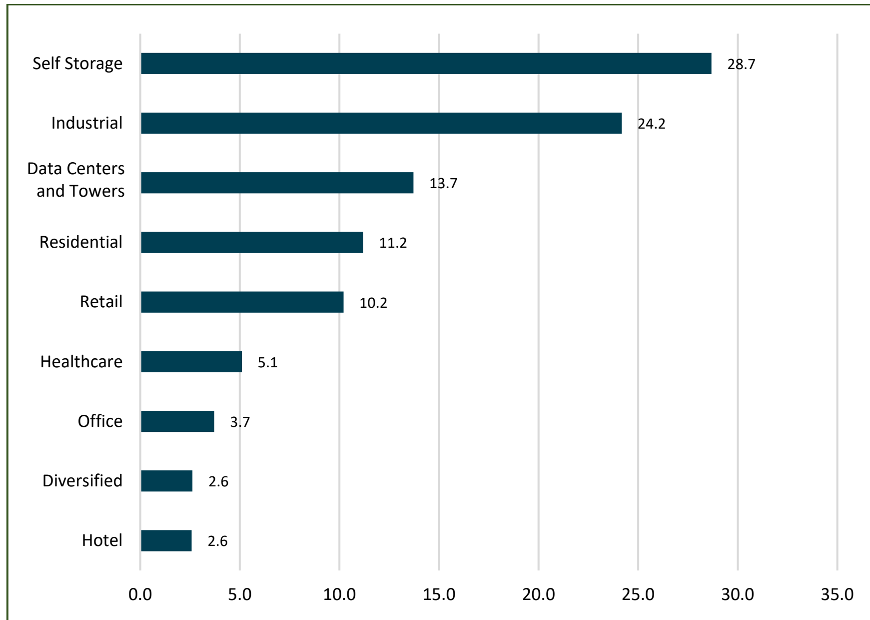
Strong performance across equities, bonds and real estate markets in the December quarter anticipated a robust recovery from the effects of the Covid pandemic and government policy responses. Nevertheless, during the quarter there were several high-profile challenges including: the emergence of the Omicron Covid variant, mounting signs of further inflation pressures, and the collapse of China Evergrande, one of the world's largest residential developers.

Fears of inflation's persistence prompted central banks to pivot away from using 'transitory' to describe the environment and to signal the intent to fight inflation as needed. Curiously, markets remained orderly, real interest rates remained negative in most developed markets and longer bond yields barely moved in the quarter, with the U.S. 10 year rate ending the year at 1.51%, slightly lower than three months prior.

Real estate stocks felt inflation pressures too, albeit unevenly. In some sectors such as storage, logistics and residential, landlords were able to push rents hard, well ahead of inflation, thereby generating real rent growth.

Inflation, however, can be a double-edged sword, and wage pressures in segments possessing high labour content, such as hotels and healthcare, saw mounting cost pressures eat into operating margins and profits.

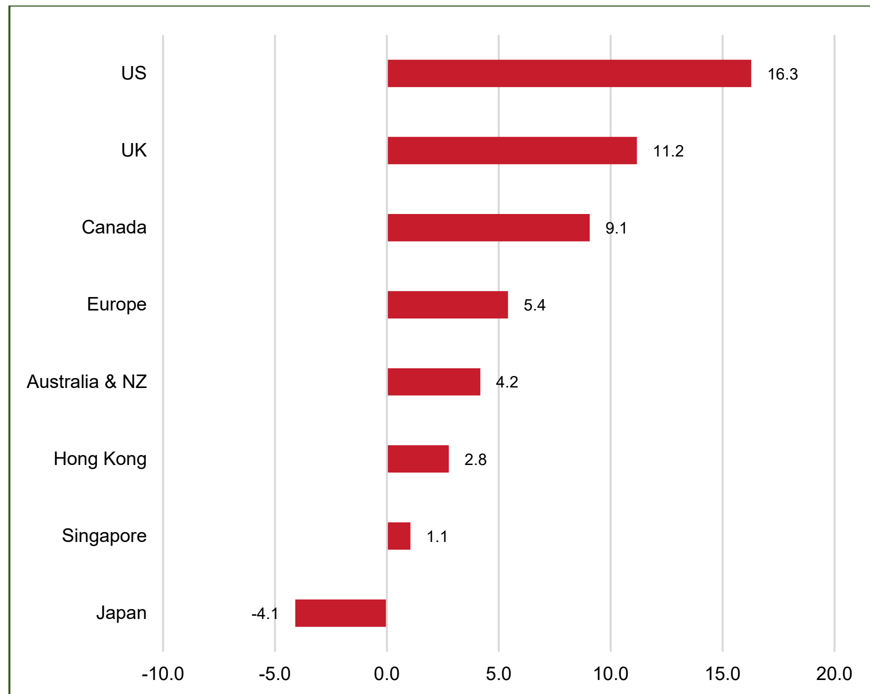
Sector returns* for quarter ending December 2021



*Local currency terms Source: FTSE EPRA/NAREIT, Factset

Global REITs experienced significant sector and regional dispersion in the December quarter with the best sector (self-storage) outperforming the worst (hotels) by approximately 26%. Regionally, the spread was also sizable with the U.S. outperforming Japan by around 20%.

Regional returns* for quarter ending December 2021

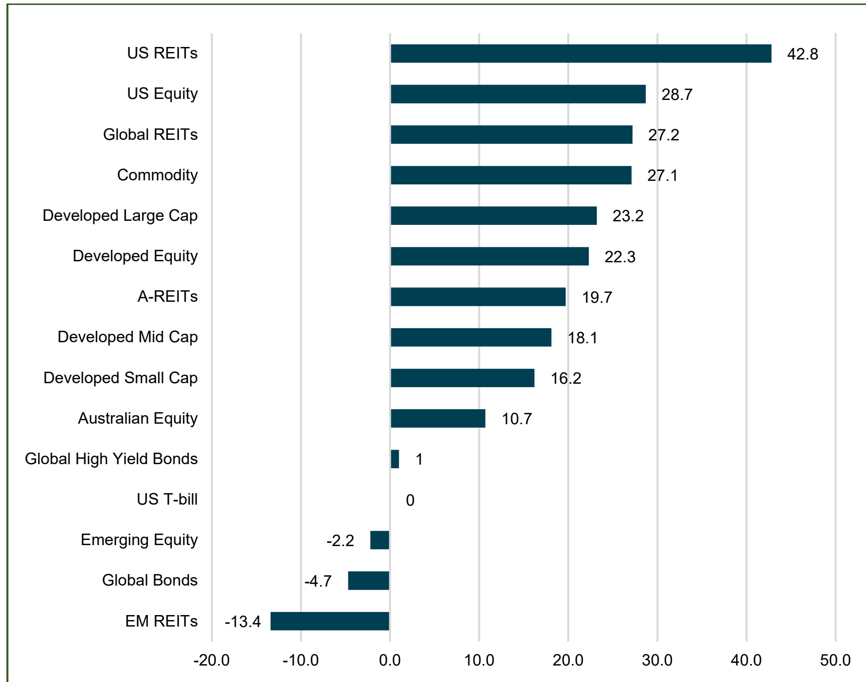


*Local currency terms. Source: FTSE EPRA/NAREIT, Factset

U.S. Aye!

U.S. REITs produced industry leading returns, gaining 16.3% in local currency terms in the quarter, topping out an outstanding year and making U.S. REITs one of the best performing assets classes in 2021 with a 43% total return. As part of third quarter results, many U.S. REITs upgraded full year 2021 earnings guidance on the back of a strengthening leasing environment. The portfolio's overweight exposure to the U.S. market benefitted performance.

One Year Total Returns (US$)



Source: Factset, FTSE, Bloomberg, S&P

Across the pond, the UK also produced strong total returns during the quarter, with the benchmark gaining 11.2%, driven by relatively high weightings to logistics and self-storage, and limited exposure to retail where property values showed signs of significant value deterioration (more on this later). The portfolio benefited from select exposure in the UK, focusing on REITs with significant pricing power in logistics and self-storage.

Returns in other jurisdictions were more muted. Continental Europe was sluggish as it weathered more tempered economic growth. Another factor might have been a case of capital market indigestion from Vonovia (VNA), the region's largest real estate stock, undertaking an €8 billion rights issue, the largest in global listed real estate history. Vonovia used the capital to partially reduce the leverage it incurred from its just completed €28 billion all-cash takeover of Deutsche Wohnen (DWNI).

Overall portfolio performance benefited from our under-benchmark exposure to the Asia Pacific region. With China's economy moderating and the collapse of Chinese residential developer Evergrande (3333 HK) casting a shadow over the region, listed Asian real estate markets were somewhat stagnant with total returns of 2.8% in Hong Kong and 1.1% in Singapore in local currency terms.

In an Asia Pacific context, Australian and New Zealand stocks performed slightly better than their northern neighbours, generating 4.2% in the quarter. Australia witnessed some notable property transactions as well as (unfortunately) some corporate governance deterioration, features we discuss later in the report.

Limited domestic investment opportunities prompted Singapore listed REITs to continue to splurge on offshore acquisitions and to undertake ill-fitting mergers in the quest for scale to remain globally relevant. In general, we view the deals as being of questionable merit for REIT shareholders, with the caveat that the growing asset pool is unquestionably positive for the external manager's interests.

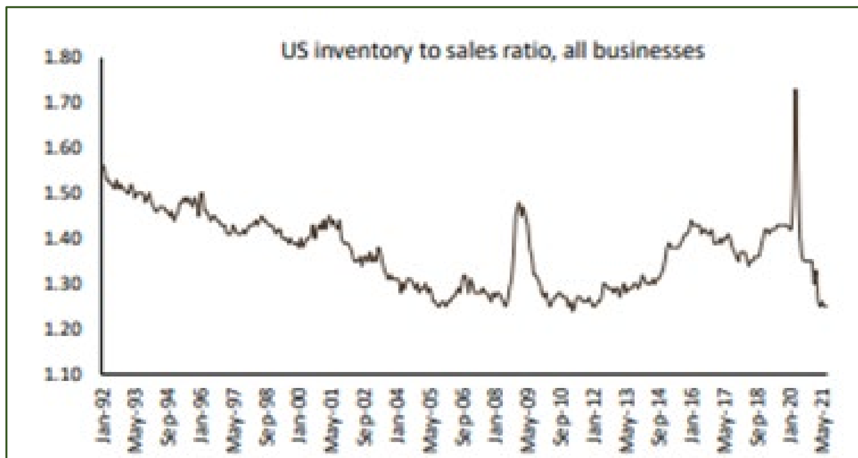
For us, the most significant event in Singaporean real estate during the quarter was the IPO of data centre REIT, Digital Core (DCRU), its portfolio entirely located in the U.S. Priced attractively relative to local alternatives, focused on technology real estate, and possessing a visible acquisition pipeline from its credible sponsor (U.S. REIT Digital Realty (DLR)), the IPO was heavily oversubscribed.

Against the backdrop of entrenched low economic growth and another change of Prime Minister, Japan was the weakest performing country in the Global Real estate index for the quarter, with a -4.1% total return in local currency terms, largely dragged down by diversified, development-oriented companies.

Sheds, in one form or another, shine

Logistics, a portfolio overweight, fared particularly well in the quarter. Ongoing exceptional demand for warehouse space, particularly in urban in-fill locations, continues to drive substantial rent growth. A shift is underway in supply chain management along two thematics. One, the ongoing reconfiguration of distribution channels to place greater emphasis on proximity to the end consumer; and two, supply bottlenecks, symbolised by the record numbers of container ships sitting off many ports. Leading the focus of supply chains to move from efficiency to resiliency. We understand that many tenants are seeking to carry higher inventory levels than before to defend against supply chain disruption. However, current bottlenecks mean inventory-to-sales ratios are near historic lows as suppliers struggle to meet strong consumer demand (charts below). We think this portends strong tenant demand to continue.

U.S. inventories are at record lows across all businesses



Source: Federal Reserve Bank of St Louis, UBS Research. Note: Seasonally Adjusted

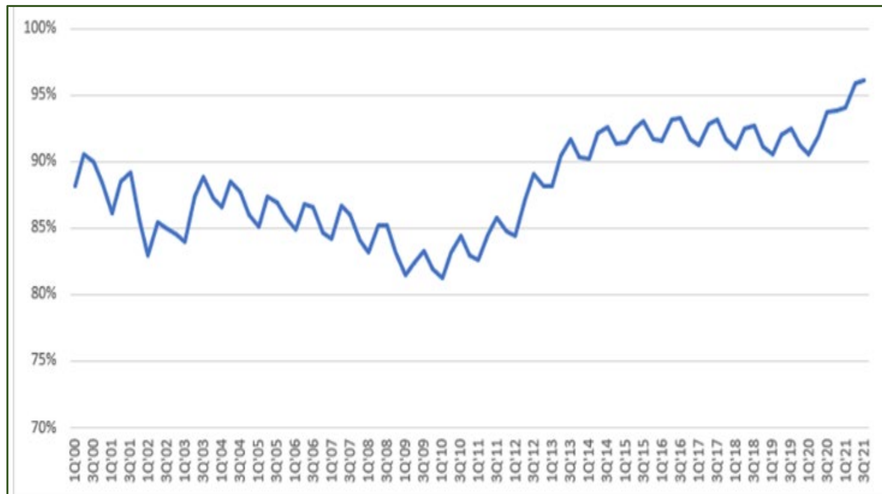
U.S. inventories shortfall pronounced among retailers

Source: Federal Reserve Bank of St Louis, UBS Research. Note: Seasonally Adjusted

Early in the quarter, the portfolio increased its position in a southern California focused REIT which continues to display considerable pricing power, with rents rising in excess of 30% on re-leasing. Strong contributions were also generated by the portfolio's holdings in logistics in the U.S., UK and Europe.

Self-storage continued to perform during the quarter, capping off an already stand-out year for the segment. Operating conditions continued to be remarkably strong with high occupancy and rate growth of 6-10% leading to 20% same store Net Operating Income growth in the previous two quarters. Tenant demand has broadened during the pandemic, driven by disparate factors such as decluttering from more people working from home and from ecommerce's local fulfilment needs. Occupancies remain near all-time highs, as the following graph illustrates for U.S. REITs, in part, because move-out volumes have been subdued.

Occupancy U.S. Self-storage REITs



Source: UBS and Company documents

Supply, ever a lurking challenge in the sector, has been comparatively tame with new projects being pushed out due to limited availability of construction finance. The Portfolio maintained its overweight exposure to self-storage during the quarter, adding to its holding.

A somewhat distant cousin to normalised sheds, data centres were another segment to perform strongly in the quarter, driven largely by M&A activity and investors looking for a hedge against the uncertainties facing office buildings. In mid-November, a KKR led private equity consortium announced the acquisition of CyrusOne (CONE) for US$15 billion, a 5% yield on the operating assets. With CyrusOne, KKR gains 8.6 million sq. ft. of data centres in the U.S. and Europe with a focus on hyperscale tenants, as well as a sizable multi-year development pipeline.

In an unusual coincidence, on the same day as the CyrusOne news, another data centre REIT, CoreSite, announced it would be acquired by American Tower (AMT) in a US$10 billion all cash transaction. American Tower, the largest cell tower owner in the world, explained it wanted to own and operate data centre assets to augment its communications real estate platform. Demand for ultra-low latency wireless data (for example, autonomous vehicles and remote health diagnosis/telemedicine) is expected to require more computing activity that typically occurs inside a data centre to be pushed to "the edge" of the network (i.e. adjacent to cell towers). Essentially, AMT wants to offer a comprehensive suite of communications infrastructure to a wider customer base. We, however, view the CoreSite portfolio as being more operationally intensive with a higher cost structure, minimal near-term synergies and as having more required cap ex than the Tower sector.

Omicron's real estate victims

We do not believe it is unrelated that hotels, seniors housing and office REITs underperformed in the wake of the emergence of the Covid Omicron strain.

Hotels edged higher a modest 2.6%, to be the weakest performing sector in the quarter. Whilst hotel operating conditions continued to improve as the year progressed, the new Covid wave pushed out the timeframe for business travel to normalise. Leisure travel, a bright spot, has led the lodging recovery with volumes exceeding pre-pandemic levels in many markets. That said, confidence remains brittle. Anecdotally, hotel operator Accor highlighted that 50% of all bookings is for travel within 7 days.

Omicron also delayed the return to the office for many which creates further uncertainty over tenants' changing space needs. Hesitant office leasing demand coupled with vacancy rates in several major U.S. office markets being well above historic trend, has crimped landlords' ability to reduce concessions and firm rents.

We are inclined to believe that most office markets have likely bottomed, but that the road to recovery remains a long one. Early signs suggest that sublease space is gradually being withdrawn from the market, a first step in reducing availabilities. However, with elevated vacancies in many markets, and the risk of building obsolescence heightened by environmental standards and changing workplace dynamics, the need for selective exposure is paramount.

Bridging the office and healthcare sectors, Life Science related real estate, otherwise known as lab space, was a star performer for the quarter. Alexandria Real Estate Equities (ARE), a long-time Portfolio holding, is well positioned in the life science segment, with a nearly US$40 billion portfolio concentrated in key submarkets.

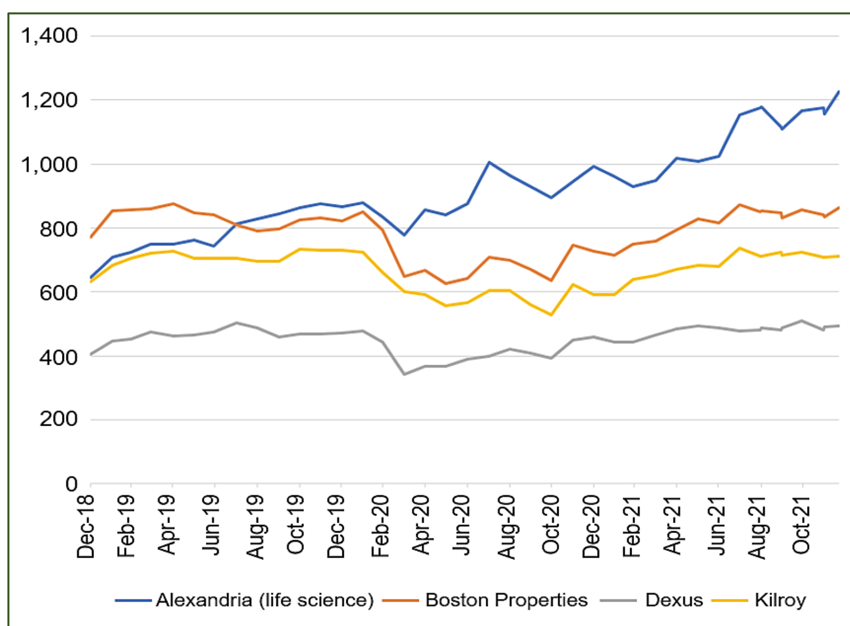
Scientific advances in biology, chemistry and genetics, and the confluence of these three disciplines, have super charged investor interest in life science companies and in lab-concentrated markets. As ARE's CEO noted in the company's Q3 commentary:

"The biotech boom and historic life science demand driven by the strong industry fundamentals is evident. The 21st century is really the biological century, as biology is in transition from an empirical science of trial and error to really an engineerable science with much more predictable and scalable outcomes. We're witnessing the Industrial Revolution in biotech."

Rents in life science clusters possessing deep talent pools, such as Cambridge/Boston, South San Francisco and North San Diego have grown significantly in recent years. Vacancies in these locations are frictional, and even increasing development levels are barely keeping pace with surging tenant demand.

Not surprisingly, the sector has attracted significant investor interest and values have risen with rents and investor appetite. The following chart illustrates the increase in ARE's implied value per sq. ft. in the past three years while traditional office companies have seen stagnant values.

Implied value per sq. ft. (US$)

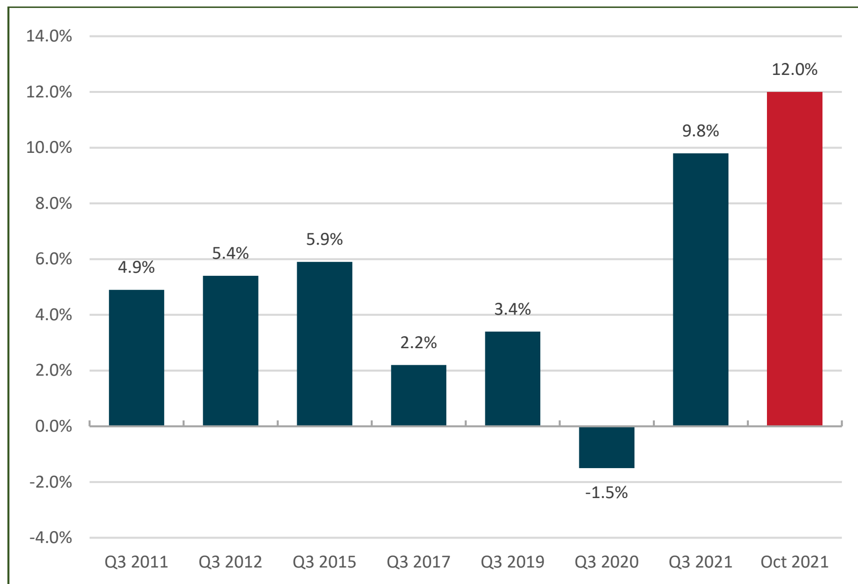


Source: Resolution Capital

Residential Rents Rev Higher

The U.S. residential sector is becoming a significant contributor to the increases in measured CPI (Consumer Price Index), with housing accounting for around 40% of the broader inflation metric. We see first-hand evidence of extraordinary rent growth that will feed into inflation over time. As the chart below illustrates, through the pandemic, rents have risen considerably faster than in the past decade, and this pace is unlikely to be alleviated in the near term.

U.S. Residential Rents: Inflation bellwether



Source: RCL & company reports. Rental rate growth average includes data for AVB, EQR, CPT, ESS, MAAM UDR, CSR, AMH, and INVH

With historically low vacancy rates, dramatically rising residential rents is the outcome of multiple factors: several years of muted supply, construction bottlenecks, worsening housing affordability combined with strong demand fuelled by rising employment, and new household formation.

Retail – vacc'ed for growth

Unlike at the onset of Covid, retail REITs have not been hard hit by the latest variant. The operating outlook for retail landlords has improved in the past year, albeit selectively. First, it seems that retailer tenant credit has been stress tested and cleansed. Second, the market does not expect a repeat of widespread prolonged lockdowns. Third, investors increasingly appreciate the important role that well located bricks and mortar stores play as part of omni-channel marketing and the distribution of goods and services.

In the U.S., Federal Realty (FRT) upgraded 2022 guidance and provided preliminary targets through 2024 of circa 5-10% FFO per share growth. This is a notable 3-year forward look in our opinion that suggests the operating environment has stabilised and growth is visible. FRT owns a portfolio of supermarket-anchored and mixed-use open air shopping centres which often include office, residential and hotels. Indicative of the amenities provided, during the quarter Federal secured a 105,000 sq. ft. (10,000 sq m) lease for Choice Hotels' new head office at its Pike & Rose centre in Bethesda, Maryland.

Transaction activity amps up

Investors returned to retail real estate in the December quarter with notable transactions in Australia, the UK and Europe. These transactions demonstrate debt capital markets remain supportive and provide important evidence on asset values.

Furthermore, in the more challenged areas such as retail property, transactions point to market clearing progress, as well as suggesting that institutions which were previously overweight retail property, may now have achieved target portfolio weightings.

Thanks to solid balance sheets and supportive equity markets, REITs were active buyers during the quarter. In Australia, portfolio holding Link REIT (823 HK), the Hong Kong based retail REIT referenced earlier, paid A$528m for a 50% stake in the Queen Victoria Building, the Galleries and the Strand Arcade, three well known assets in the Sydney CBD, from GIC at an estimated 5.5% yield. The price was ~3% below the level Vicinity Centres (VCX) acquired its stake for in 2017.

Also in Australia, two local superannuation funds combined to acquire majority interests in Pacific Fair Mall on the Gold Coast and Macquarie Centre in Sydney for A$2.2 billion and an estimated mid-4% yield. Separately, a Dexus (DXS) sponsored unlisted fund bought a 50% stake in Westfield Warringah Mall for A$400m at a 5% yield. We view this evidence as supportive of comparable public REIT pricing, such as Scentre Group (SCG), which trades at a nearly 6% implied cap rate. During the quarter, the Portfolio increased its position in Scentre Group, the leading mall portfolio in Australia.

UK Retail – evidence points to massive value losses

If one wishes to see evidence of the biggest collapse in commercial property values in the past decade, look no further than UK retail.

In one of the first sizable retail transactions in a couple of years in the UK, Hammerson (HMSO) and Canadian pension fund CPPIB, sold Silverburn Shopping Center near Glasgow for £140 million at a 9.3% yield and a modest 4% discount to the June 21 book value. And no, this is not a typo – the pricing was greater than a 9% yield, a level rarely seen since the last century. The sale represents a valuation 53% below the £297m price paid back in 2009, which then reflected a 6% yield.

In December, LandSec (LAND) announced the acquisition of a further 25% stake in Bluewater, a dominant shopping mall east of London, bringing its stake in the property to 48.8%, after a concurrent partial sell-down to another investor. The £172m price reflects an 8.2% yield. However, because the property is believed to be nearly 20% overrented, i.e. the in-place rents are approximately 20% above current market levels, the reversionary yield would more likely be in the mid-6%s. The £688m imputed property value represents a remarkable 70% decline in the seven years since LAND acquired its initial 30% stake for £696m. Yikes!

Highlighting the divergent paths that industrial and retail have been on in the past few years, in the December quarter, Prologis bought out its 85% partner's stake in its £1.3 billion UK Logistics Venture at a 3.5% yield. The pricing represents approximately a 60% appreciation in value since this logistics fund was established 4 years ago, which stands in stark contrast with the plummet in UK mall values.

More in Store for Self-Storage

Self-storage assets were well bid by REITs and private investors in the quarter, which provided numerous points of solid pricing evidence.

Portfolio holding Public Storage (PSA) paid US$1.5 billion for All-Storage, a 7.5 million sq. ft. portfolio, located in Dallas/Fort-Worth and Phoenix, which brought its acquisition deal volume to over US$5 billion in 2021. PSA intends to grow the skinny 2.6% initial yield to 5.5-6.0% by bringing occupancy from 75% to 95% in the next four years. While the upgrade to PSA's asset quality is welcomed, the company has essentially paid today for future growth that it will reap over the next 3-4 years. Fortunately, PSA immediately locked in funding costs with a US$1.75 billion bond issue at a blended 1.88% coupon over a 7.2 year average term. Yet, even with 100% debt financing, the accretion was skinny to say the least.

Separately, CubeSmart (CUBE), another portfolio holding, purchased the StorageWest portfolio for US$1.7bn. In this instance, the deal's 3.7% yield is on a stabilised portfolio that presents limited outsized growth opportunities. The acquisition does expand CUBE's operations in California and the Southwest, adding more geographic balance. CUBE issued US$850 million of equity to fund the transaction, effectively locking in its cost of capital.

However, publicly traded REITs did not have it all their own way, highlighting fierce competition for self-storage assets. Belgium based Shurgard (SHUR) failed in a bidding war to acquire 24Storage (STOR24), a small, listed Swedish self-storage company that would have added to the company's operational scale in the Nordics. Also, the super-prime Manhattan Mini portfolio in NYC was sold to a private operator for US$3 billion.

Meanwhile, Blackstone entered the Australian self-storage market in 2021 first with the A$84m purchase of the Perth-based Keepsafe portfolio and then with the A$400m acquisition of the Melbourne-based Fort Knox portfolio at an estimated 4.4% initial yield.

Office – only have eyes for new (and leased)

In the office sector, investors returned on a very selective basis. New assets with good lease terms found buyers at lofty prices. In London, an Asian pension fund has agreed to buy the 6 year old UBS headquarters at 5 Broadgate for £1.25 billion, a 3.7% estimated yield. While in New York, a Blackstone entity is rumoured to be buying a 49% stake in Brookfield's One Manhattan West for US$2.8 billion or US$1,350 per sq. ft. The 2.1 million sq. ft., newly constructed building is basically fully leased with a 16 year remaining average lease term and good proximity to Penn Station and Hudson Yards. We estimate the yield to be in the mid-3%s. If modern, well leased offices can command massive prices and mid-3% yields, what does that indicate about the outlook for much of the rest of the office market, populated with older assets having greater on-going cap ex needs?

ESG: Seeing the Forest Through the Trees

We're not usually enthusiastic supporters of property landlords adding exposure outside their core competency, however, in the case of Alstria's (AOX) recent foray, we put aside our usual scepticism for an acquisition that helps secure the supply chain in the face of growing environmental demands.

Alstria is on the front foot on sustainability issues and we have previously written about the company's innovative "green dividend" proposal. This quarter, the company announced that it had purchased its first-ever forest, totalling 218 hectares in Germany.

The company explained that it was motivated to buy the forest by a desire to secure its supply chain as demand for timber is poised to grow in coming years as environmental regulations demand its increased use in construction and refurbishment of buildings. The intention was not to cut down trees in the owned forest for use in their buildings, but rather, to hedge the exposure to a commodity where supply constraints were considerable, and where demand is expected to increase as the global economy decarbonises.

Already we are seeing this thesis play out: in France, public buildings are required to be built with a least 50% timber content. Moreover, planning codes from New York to Finland are being changed to accommodate the increasing use of cross-laminated timber. But demand isn't just coming from the top down. One of the key ESG issues we have focused on this year is that of Paris Alignment and net zero targets for our portfolio holdings. In our discussions with those companies who have development capabilities, a recurring element of net zero plans was the use of lower carbon construction materials, including timber.

The key advantages of timber over concrete and steel include, of course, a negative carbon footprint but also a much simpler supply chain if construction takes place close to sources of timber. The use of mass timber in construction also has the potential to cut into the more than 600m tons of mostly non-recyclable waste material produced by the U.S. construction industry every year (more than twice that of all municipal waste!).

The obvious environmental benefits of timber and the move by AOX reinforces conviction in our position in Rayonier (RYN), a U.S. timber REIT primarily involved in the ownership of timberlands. It also highlights the potential gap between setting a net zero target, which is easy, and putting in place contingency plans today that may take many years to come to fruition. Hence, the importance we place on engagement with companies to understand how they intend to deliver on net zero targets, not just whether they have them.

Conclusion

Weighing up the myriad of exogenous risks – geopolitical, government policy, health and environmental – creates challenges which frankly, transcend REITdom. We focus on key drivers to be our guide – real estate able to exhibit sustainable pricing power, balance sheet strength and good stewardship – with measured diversification through exposures to segments where the underlying land has a higher and better use than the buildings currently offered.

The share market rally in Q4 2021, coupled with bond market stability and heightened levels of corporate activity, suggested investors were comfortable with the path of Covid and the well-telegraphed prospects of elevated inflation and gradually rising interest rates.

Peeking into 2022, January's volatility provides a sharp reminder that significant risks remain in the market, the economy and society overall. We should not assume that the full effects of Covid, both direct and indirect, have completely played out. Importantly, it is unclear how the inflation story progresses, and this uncertainty appears to be unsettling markets. We are cognisant of these broader risks, while also believing in the strong current position of listed real estate.

The listed real estate sector is in good shape: vacancy rates are at or below historic averages, overall new building supply is moderate. Never certain, there are tentative signs of improving tenant demand. Hence, we expect to see rent growth at least matching inflation in key, but not all, segments of the commercial real estate market. Meanwhile REIT capital structures are sound with leverage low and good access to capital across multiple channels.

Robust acquisition opportunities and de-risking development through pre-lets collectively produces solid earnings prospects for at least the year ahead when FFO per share growth should exceed 10%.

Valuations are always on our watch list, and when traditional indicators such as high multiples meet elevated earnings, caution is warranted. Yet we do not see an unusual amount of equity raisings; even Vonovia's large €8bn equity raising wasn't enough to replace the Deutshe Wohnen equity it had recently acquired. Other signs of hubris are also not evident – speculative building supply is not widespread. Disciplined finance, rising construction costs and onerous development entitlements, both zoning and environmental, have limited construction supply levels. Where development is occurring, it is tilted to areas of the economy experiencing the strongest tenant demand.

The emergence of inflationary pressures and changed posturing by central banks should rightly be expected to create some upheaval. While we acknowledge the risks associated with elevated earnings and multiples, we continue to believe there is limited idiosyncratic risk to the sector. Hence, we believe the REIT sector is positioned to serve as a useful component of a diversified investment portfolio over the medium to long term.

With the industry tagged with the "REITs are a yield play" over much of the life of our Global REIT strategy, we are amused to hear "a hedge against inflation" now being re-introduced to the narrative. This change in dynamics will provide a new set of challenges and opportunities for investors. Across markets, we continue to believe the focus should be on credit availability and pricing power to drive real cashflow growth. It will be underlying real estate fundamentals, principally building supply and tenant demand, that will ultimately determine all important cash flows and the fortunes of REIT investors, particularly relative to other investment options.

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This is a marketing communication. Please refer to the Prospectus of the UCITS Fund and the KIID before making any final investment decisions

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FEES

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