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NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND

Quarter Three, 2019

For the period ended 30 September 2019

NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND

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

PERFORMANCE

The Nedgroup Investments Global Property Fund underperformed the FTSE EPRA/NAREIT Developed Index by 0.1% for the quarter ending 30 September 2019, as the index produced a total return of 4.6% in US dollar terms. The longer term performance remains strong, ahead of the index by 1.5% annualised since inception.

Indicator	3 months	1 year	3 years p.a.	Since Inception# p.a.
Portfolio*	4.52%	13.24%	7.27%	6.07%
Benchmark+	4.63%	13.00%	5.61%	4.53%
Difference	-0.11%	0.24%	1.66%	1.54%
Fund Size	US$175.4m			

* Net USD return for the Nedgroup Investments Global Property Fund, C class. Source: Morningstar
\# 12 August 2016
\+ FTSE EPRA/NAREIT Developed Index (in USD Net Ret)

MARKET AND PORTFOLIO COMMENTARY

The FTSE EPRA NAREIT Developed Index produced a total return of 4.6% for the quarter ending 30 September 2019 in US$ Unhedged terms, outperforming global equities (+0.5%)[1]. REITs, equities and asset prices more generally garnered support in the quarter as interest rates declined globally following broad-based monetary policy easing to arrest flagging economic growth.

Geopolitical uncertainty remains a cloud hanging over markets given little obvious progress on the current global issues, U.S./China trade and Brexit among them. During the quarter, additional regional tensions added to the list of investor concerns, an attack on key oil infrastructure in Saudi Arabia raised tensions in the Middle East, whilst sustained social unrest in Hong Kong provided challenges for local landlords and real estate investors more broadly. Defensive equity sectors performed well including Utilities, REITs and Consumer Staples.

Our strategy outperformed the benchmark (before management fees) led by sector overweights and stock selection in the residential, industrial and healthcare segments. Notable contributors included HCP Inc (HCP), a U.S. healthcare REIT, and Equity Residential (EQR), a U.S. apartment landlord. The prompt reduction of our exposure to Hong Kong over the last two quarters also supported relative returns as the stocks continued to underperform due to the ongoing disruption and economic impact. Stock selection in logistics was also a key contributor, including an over benchmark position in Prologis (PLD).

Having no exposure to ASX-listed Goodman Group (GMG), which underperformed prior to its removal from the FTSE EPRA NAREIT indices, also supported relative returns. GMG's removal resulted from the proportion of real estate funds management revenues, including performance fees, now exceeding the acceptable level for Index inclusion. We have mixed feelings about the removal.

[1] MSCI World Developed Index Local Currency Net TR

We acknowledge the concerns of those who argue its risk profile is not that of a traditional real estate rental model. However, its revenue is ultimately dependent upon the underlying real estate on which GMG is absolutely focused. Furthermore, it removes an outstanding logistics real estate platform with relatively low levels of debt. To us the greatest risk was not the substance of its platform or earnings mix, but the market's lofty valuation, which is the key reason we do not own the stock.

Our office exposure was the largest detractor from relative performance. As the quarter ended, office markets began to digest news that co-working operator WeWork, one of the key drivers of office space absorption globally, had experienced an abrupt reality check in its efforts to launch an IPO. Our positioning in the self-storage sector also weighed on returns.

Regionally, Japan was the strongest performing country. Our significant and long-standing underweight to this market, particularly to the better performing J-REITs, was the largest source of regional underperformance.

GROWTH VERSUS VALUE, OR JUST PLAIN VALUE?

During the quarter, equity markets whipsawed with a sharp, but seemingly short-lived, rotation into 'value' stocks evident across many developed equity markets. This reversal was a mere blip in the many years of relative outperformance of 'growth' stocks (stocks generating above average earnings growth accompanied by higher valuation multiples) vs. 'value' stocks (stocks trading at a discount to assessed value but often with less certain earnings prospects) since the Global Financial Crisis ("GFC") a decade ago.

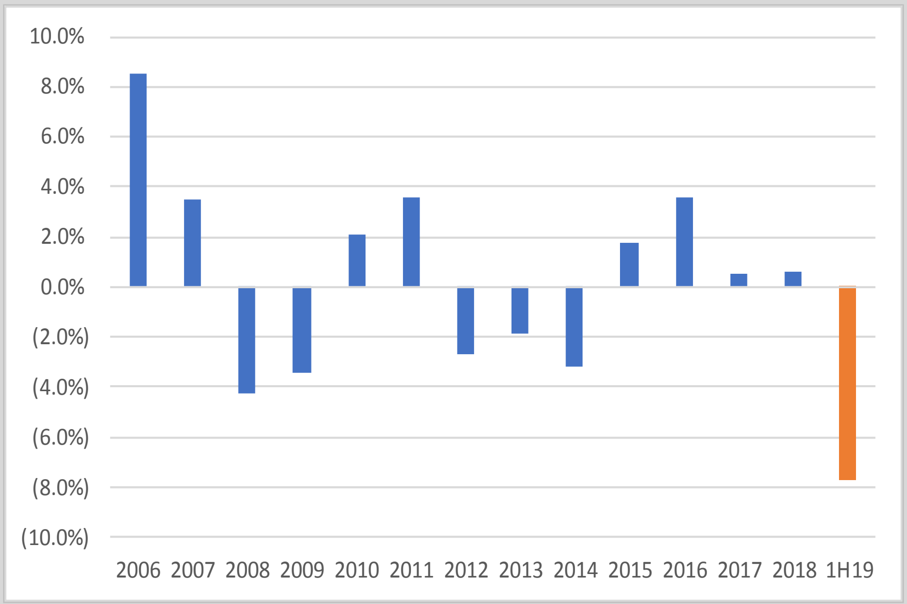
GROWTH VS. VALUE

Source: Bloomberg, RCL

REITs were not immune as the value rotation manifested in outperformance of the discounted retail and hotel REITs at the expense of 'growth' sectors with higher, albeit more fully valued earnings growth profiles (e.g., logistics, manufactured housing and U.S. multifamily). Our portfolio was not immune, and our sizeable underweights to retail and hotel property were sources of underperformance during this period. We are indifferent whether stocks are labelled 'growth' or 'value', rather we seek to allocate capital to those real estate portfolios where landlords have pricing power, capital structures are appropriate, and valuations offer potential for appreciation. Most retail and hotel REITs don't meet these criteria, hence, our relatively limited exposure.

As a timely reminder of the challenges facing retail landlords, UK-listed REITs Intu (INTU) and Hammerson (HMSO) reported interim results in July. Intu's rental income declined by 8% over the first half of the year, while Hammerson's was down 4% (excl. outlets). This quantum of decline in rental income is unprecedented even during the GFC (chart below). That it is occurring while the UK economy is growing, albeit sluggishly with material event risk, is testament to the structural pressures facing retail landlords. Post earnings results, both stocks experienced significant selling pressure with Intu down 37% and Hammerson down 23% (both in local currency terms) in July. While this degree of underperformance may seem extreme given already depressed valuation multiples, it reflects the toxic mix of too much debt and declining cash flows.

INTU LIKE-FOR-LIKE NET RENTAL INCOME GROWTH %



Source: Company data, RCL

Whilst the issues facing the leading UK retail platforms are extreme, they are emblematic of the widely known challenges facing retail property investors globally, namely physical store tenant demand seems to be in retreat and landlords have swiftly lost rental pricing power. Consequently, there is limited capital available for this industry segment, either for existing properties or additional newly developed space. As the following chart highlights, construction of new retail space has all but ceased in the U.S.

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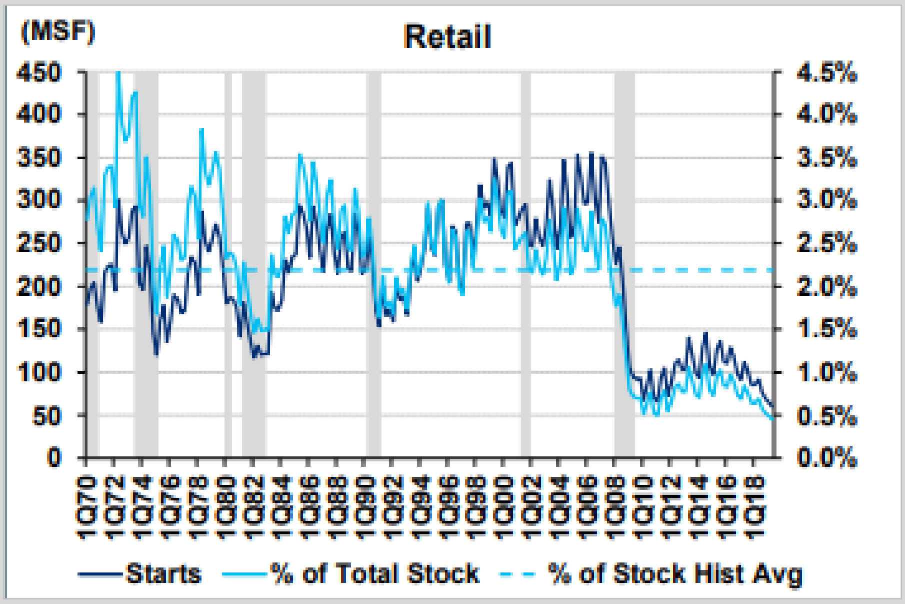
U.S. RETAIL PROPERTY CONSTRUCTION



Source: Citi Research

Furthermore, aside from small idiosyncratic transactions, since Brookfield's privatisation of U.S. mall REIT GGP in early 2018, there has been scant evidence of large-scale capital formation in the mall sector globally. For many investors in private vehicles, it is more a case of trying to exit troubled retail or dilute it by investing in other property sectors.

REIT EARNINGS – EDGING IN FRONT

U.S. reporting season in the quarter provided an update on key trends and earnings prospects across the sector. REIT earnings results were modestly ahead of expectations. In aggregate, new building supply is being met with sufficient demand to enable rents and earnings per share (FFO) to continue to grow. Comparable Net Operating Income (NOI) of 3.4% and occupancy of 94.8% both remain above the long-term average. U.S. REITs should deliver FFO growth of approximately 3.7% for the year. While more modest than recent years, it has now edged ahead of U.S. equities as macro headwinds dim the outlook for the broader economy.

At the sector level, the tailwinds continue for logistics and residential REITs where strong tenant demand continues to absorb above average levels of new building supply. Continuing recent trends, manufactured housing delivered the highest NOI growth, driven by close to record occupancy and healthy rent increases.

Performance in the retail sector was more nuanced. Mall REITs are battling elevated store closures this year which is impacting FFO growth. Through the quarter additional bankruptcies were announced, including teen fashion retailer Forever 21, which points to further rental cash flow disruption. This weighed on the sector total returns which ended the quarter down 1% (local currency terms). We remain cautious on the near-term outlook for malls, although we hold Simon Property Group (SPG) which generated total returns of 1.2%, in local currency terms, underperforming the benchmark.

Conversely, many of the strip shopping centre REITs, which have less exposure to apparel retail, have enjoyed somewhat of a reprieve from store closures. This may prove temporary but solid leasing volumes point to a pick-up in NOI and FFO growth next year should these trends persist.

In aggregate the office sector posted approximately 5% comparable NOI growth, however the range of outcomes was enormous at -9% to +14%. The tech markets on the West Coast enjoy the most favourable demand and supply imbalance. Conversely, New York and Washington D.C. continue to sag. While New York is experiencing an increase in large tech leases signed in recent months, it does not appear to be positively impacting landlord pricing power in the core midtown and downtown locations. The added uncertainty of WeWork's failed IPO and the impact on leasing demand (discussed in 'Talking REITs Q3 2019), also clouds the picture.

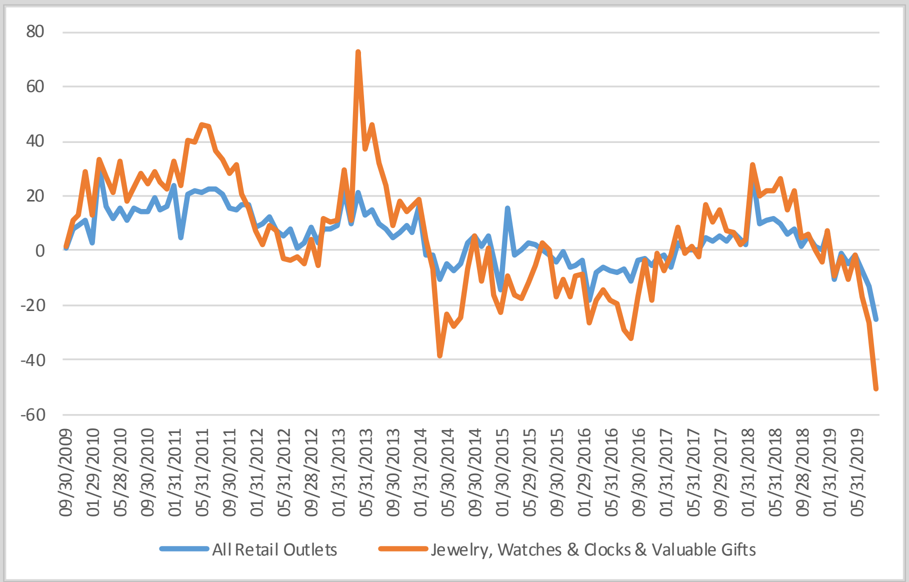
HK PROTESTS RUMBLE ON

Hong Kong continues to be disrupted by protests as locals seek to preserve Hong Kong's unique status and resist the ongoing subtle integration with Mainland China.

It's clear the disruption is adversely impacting the economy, with the sectors most exposed to tourism, hotels and retail, contracting significantly in recent months. Visitors to Hong Kong were down 5% y/y in July and 39% y/y in August. Hotel staff are taking some of the pain with hotel operators minimising cost by cutting casual labour and sending permanent staff on allocated holidays. Retail sales were down 25% y/y in August with certain luxury categories, such as jewellery and watches more severely impacted, down 51% y/y.

Press reports indicate that some retail landlords are providing rent concessions to tenants including Swire Properties (1972) at its high-end mall, Pacific Place and Hysan (14) at Times Square in Causeway Bay. For tourism-oriented properties such as Wharf REIC's (1997) Harbour City, the impact could be significant. Over half of Harbour City's sales are from Mainland tourists and 14% of rent is from tenant turnover.

HK RETAIL SALES REAL YEAR ON YEAR (Y/Y) % CHANGE



Source: Factset, Hong Kong Census & Statistics Dept.

Compounding the issue, there appears renewed efforts in recent months by several of the larger luxury brands (e.g. LVMH, Kering) to harmonise prices between Mainland China and Hong Kong. Historically one of the attractions of Hong Kong shopping was lower pricing on luxury items. With more comparable pricing in China, and recent CNY depreciation, this equation is less compelling.

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Add the current negative tone in Hong Kong toward the Mainland and it looks a challenging picture for discretionary retail in the near term. While the short-term impacts are clearly negative, the critical question is: does greater Mainland Chinese influence change the long-term attractiveness of Hong Kong as a business, investment and tourism destination?

Hong Kong has a track record of bouncing back from disruptive events, for example, the Asian Financial Crisis in 1997, SARS in 2003 and the occupy Hong Kong movement in 2014. The current flare-up does seem to represent more of an existential crisis as the handover to China in 2047 creeps ever closer. Until a path to resolution becomes more apparent, we retain a measured exposure which is principally via Link REIT (823), a conservatively financed, non-discretionary retail portfolio with over 65% of revenue from food related retailers. Link generated a total return of -10% over the quarter in local currency terms, underperforming the benchmark but outperforming its Hong Kong rivals.

OUTLOOK

REITs delivered healthy returns for the quarter, taking calendar year-to-date total returns to 20%, in sharp contrast to our view of moderating returns. As we have noted previously, we do not hold a negative view, rather we are cognisant of elevated asset prices compared to most historical benchmarks and the length of the current economic expansion. While expansions don’t die of old age, their progression tends to see imbalance and excess build up as investors extrapolate recent history and risk tolerance declines.

We have paid the price for our caution, our higher than average cash balances proving a drag on portfolio returns. However, we continue to see this as prudent in light of the various macroeconomic risks which could result in adverse outcomes and impact real estate operating conditions.

In a similar vein we continue to incrementally reduce risk in the portfolio, increasing exposure to less economically sensitive cash flows such as triple net REITs, healthcare and regulated residential markets, while reducing positions in office and diversified REITs. Our operational retail exposure continues to be selective given the sector’s many challenges.

Performance through the year attests to the value of holding REITs in a diversified portfolio. While REIT multiples are elevated, as is the case for many asset classes, with improved portfolios, lower leverage and reduced development pipelines, REITs continue to be well placed to offer diversification in a broader portfolio context.

ESG: GRETA AND GRESB

Climate change was front and centre this quarter as global world leaders gathered at the UN Climate Action Summit 2019. Perhaps no one caught the world’s attention more than Swedish teen and climate activist Greta Thunberg, as she gave an impassioned plea at the UN for world leaders to more aggressively tackle the issue of climate change.

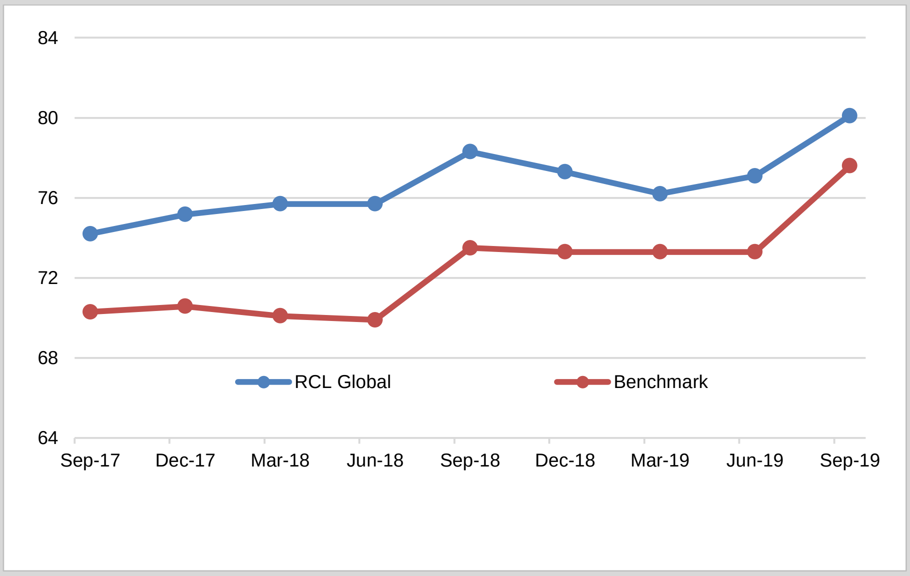
We believe the overwhelming scientific data suggests a strong link between greenhouse gas (GHG) emissions and climate change. We appreciate that weaning mankind off fossil fuels must be done in a responsible and orderly fashion, else it might create a shock to the global economy resulting in massive disruption and social unrest. Perhaps that is why some politicians seem to be downplaying the challenge. Regrettably some are merely protecting national short-term self-interest whereas for others it seems a case of none so blind as those who shall not see.

Whilst our views may matter little, our investment response is dispassionate: it is financially responsible for management to pursue property investments and property management initiatives which are environmentally sustainable. Put simply, pursuing more efficient, lower cost sources of energy, waste disposal and water consumption seems a sensible way to improve investment returns. This seems all the more compelling in light of the current low economic growth environment. As diversified A-REIT Mirvac (MGR) recently reported: "Of all our strategies, driving energy efficiency represents the best value for money."

However, to placate Greta more needs to be done. Ultimately, buying renewable energy will be by far the biggest driver of significantly (or completely) reducing GHG emissions in the property industry. Last quarter we wrote about Washington DC and New York City's new legislation which is designed to reduce GHG emissions by half in a little more than a decade and by up to 80% by 2050. We expect more of this type of legislation will be enacted in other cities and countries, though with much tighter deadlines as urgency increases in years to come. Property companies and investors should be on the front foot to future proof their portfolio, because it would be financially irresponsible to do otherwise.

One of the ways we track the 'environmental credentials' of our portfolio is to compare our portfolio GRESB score with the index. GRESB stands for the Global Real Estate Sustainability Benchmark and seems to be the benchmark for the property industry. This is a voluntary survey in which property companies need to submit an enormous amount of data to GRESB, which subsequently rates the property company.

WEIGHTED AVERAGE GRESB SCORE



Source: GRESB, ResCap

Pleasingly, more of our portfolio holdings participate in the GRESB survey than the overall index (both weighted). Furthermore, the portfolio GRESB score is better than the index (80 vs 78). However, we should and will do more do more in years to come, as this is a multi-year journey.

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The Fund and certain of its sub-funds are recognised in accordance with Section 264 of the Financial Services and Markets Act 2000.

Nedgroup Investment Advisors (UK) Limited (reg no 2627187) is authorised and regulated by the Financial Conduct Authority.

UK investors should read the Appendix for UK investors in conjunction with the Fund's Prospectus which are available from the Manager www.nedgroupinvestments.com

The Fund has been recognised under paragraph 1 of Schedule 4 to the Collective Investment Schemes Act 2008 of the Isle of Man. Isle of Man investors are not protected by statutory compensation arrangements in respect of the Fund.

The State of the origin of the Fund is Ireland. In Switzerland, the Representative is ACOLIN Fund Services AG, Leutschenbachstrasse 50, CH-8050 Zürich, whilst the Paying agent is Banque Heritage SA, route de Chêne 61, 1211 Geneva 6, Switzerland. The prospectus, the Key Investor Information Documents, the fund regulation or the articles of association as well as the annual and semi-annual reports may be obtained free of charge from the representative. In respect of the units distributed in or from Switzerland, the place of performance and jurisdiction is at the registered office of the representative. Past performance is no indication of current or future performance. The performance data do not take account of the commissions and costs incurred on the issue and redemption of units.

The Prospectus of the Fund, the Supplement of its Sub-Funds and the KIIDS are available from the Investment Manager and the Distributor or from its website www.nedgroupinvestments.com

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NEDGROUP INVESTMENTS GLOBAL PROPERTY FUND

TALKING REITs

Quarter Three, 2019

Global real estate specialist portfolio manager Resolution Capital regularly highlight important discussion topics and sectors of interest or concern within the Global REIT universe. The specialist real estate research carried out by the investment management team has uncovered the following areas over the most recent period, which we believe are important to consider.

RETAIL PROPERTY OFFERING VALUE?

In the 13 year history of our global listed real estate investment strategy our aggregate exposure to traditional retail property (i.e., excluding net-lease REITs) has never been lower, currently totalling less than 9% of the portfolio. Given the underperformance, and relative valuations, we continue to look for select platforms which we believe have the portfolio quality, capital structure and management team to navigate the ongoing challenges. An example is Scentre Group (SCG), the owner of Westfield branded centres in Australia and New Zealand and, on many measures, the dominant mall landlord in Australia. Furthermore, following the recent A$1.5bn sale of a Sydney office tower that sits above one of its malls, its capital structure is one of the more conservative in the global mall sector. While we expect a muted earnings profile for SCG, its current valuation to a degree reflects this outlook.

WILL 'WE' WORK?

Coming out of the financial crisis a decade ago, the co-working concept grew rapidly as office tenants sought greater flexibility in their accommodation whilst individuals and smaller enterprises were encouraged to leave homes and garages in search of a more dynamic workplace environment without having to make a major capital outlay. Fuelled by an abundance of capital, WeWork was the most visible and aggressive in its expansion. Many similar platforms have followed and co-working has become the largest tenant demand segment in many global office markets in recent years.

It is hard not to be impressed by WeWork's slick and energetic approach but at the end of the day the market has seen this dynamic before: long-term liabilities (property leases) with short-term cash flows (customer memberships) is a dangerous combination. Furthermore, this is a business that, despite rapid growth for almost 10 years, does not generate profits. Whilst it has tried to associate itself with the technology set, presumably to enjoy the lofty valuations, ultimately it is just a new iteration/generation serviced office operator like Servcorp (SRV) and Regus (IWG) which has used technology more effectively to improve customer service and flexibility. Putting it crudely, it is an office sub-leasing business. The challenge now is to demonstrate its profit potential, not just its ability to grab market share.

While we view the reality check on WeWork as a positive dose of discipline for office markets, reigning in what has been a major tenant growth driver which was threatening to become disproportionate, there is likely to be some fall-out. In most markets, co-working operators occupy less than 4% of office buildings (London, Singapore & Amsterdam are exceptions at circa 5-6%, markets to which we have limited or no exposure). However, it has been one of the most substantial absorbers of space in the past 5 years and in some markets, WeWork has become the largest single private sector tenant. As WeWork reassesses its business model, and capital providers to the co-working sector go through a period of reflection, we expect a reduction in leasing demand in many global office markets.

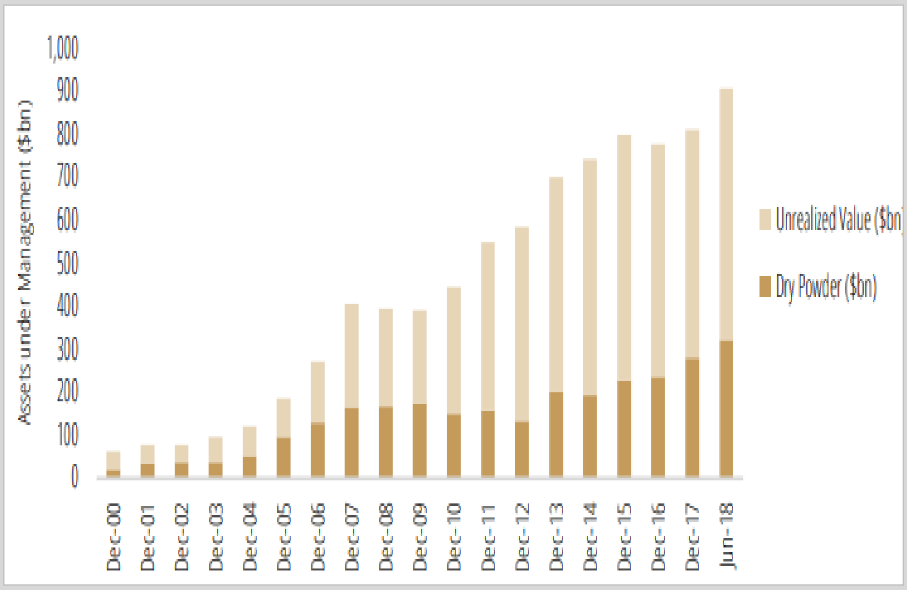
In aggregate our exposure to WeWork is limited at <0.3%, however we are cognisant of the second order effects given how prolific co-working operators have been in leasing space.

FEEDING THE GORILLA(S)

Private equity has played an active role in global real estate markets for many years, but its scale and influence has grown significantly since the GFC. Every quarter it seems we are analysing another significant transaction executed by private equity behemoth, Blackstone, or one of its many peers.

Blackstone is clearly the 800lb gorilla of the industry with its global real estate business controlling over US$150bn in AUM. Their most recent global real estate fund secured equity commitments of US$20.5bn, the largest private real estate fund ever raised. While Blackstone is the largest, it is certainly not alone. Real estate private capital vehicles have ballooned since the GFC, now accounting for close to US$1tn in AUM.

PRIVATE REAL ESTATE ASSETS UNDER MANAGEMENT US$



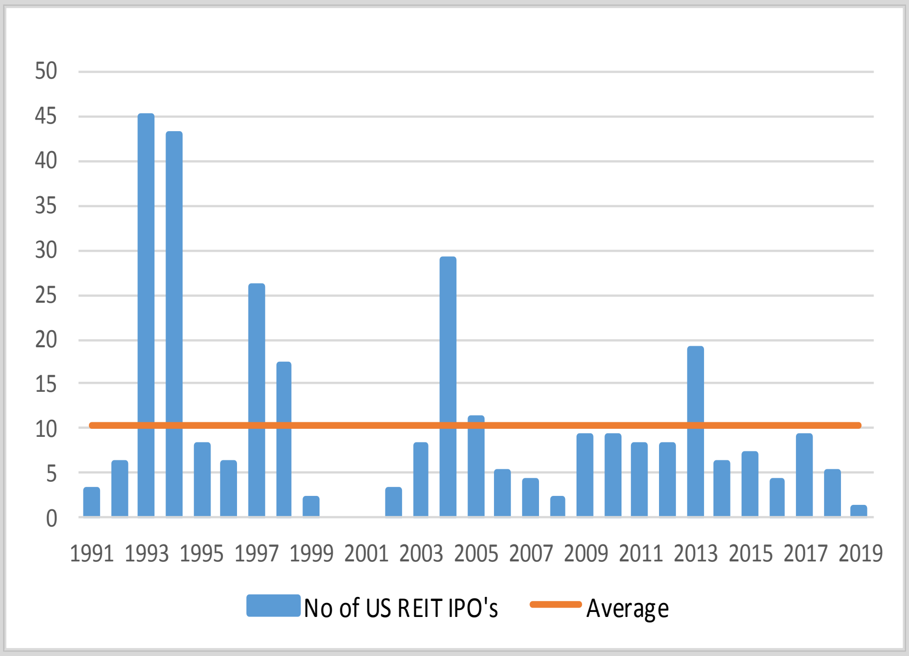
Source: Eisner Amper, Prequin Pro

The significant volume of capital and its concentration among larger platforms has consequences for real estate markets. Investment themes pursued by these large players experience significant volumes of capital, for instance Blackstone's significant bet on logistics real estate which has led to US$24bn of acquisitions in the U.S. in the last two quarters alone. The concentration of such large pools of capital on specific themes and sectors has clear implications for pricing in both the private and listed markets.

The scale of these private equity funds requires ever larger deals to efficiently deploy capital. Many large portfolio transactions not completed by the traditional corporate M&A route are now completed by private equity. Once a key liquidity provider for large-scale portfolios, the listed market's role has been weakened by private equity funds providing an alternative path to monetisation, often without the execution risk of taking a company public.

Adding to the mix, listed real estate markets have provided a fertile hunting ground for private equity funds looking to acquire assets. 14 REITs have been privatised in the U.S. by private equity funds in the last 10 years. While this provides a back stop to listed valuations, it reduces the opportunity set for investors at a time when U.S. real estate IPOs are running close to historic lows.

U.S. EQUITY REIT IPOS



Source: NAREIT, RCL. NB: Excl. Farmland REITs.

Given the significant private capital still available for deployment, the greatest since 2000 per the chart above, the feeding frenzy is likely to continue as long as real estate operating conditions remain supportive.

A PRIVATE DREAM

To further illustrate the point, after a brief hiatus, Blackstone launched another REIT privatisation with the agreement to acquire Dream Global REIT (DRG) for €4.2bn. Dream Global is an externally managed, Canadian-listed, portfolio of predominantly office buildings, located across Germany, Austria, Belgium and the Netherlands. The agreed price reflects a 9% premium to Dream's EPRA Net Asset Value, a 4.5% implied cap rate, and an 18% premium to the prior close before the announcement.

The transaction is notable not for what it says about the attractiveness of European office markets, but more what it implies about the unattractiveness of the severely discounted retail REITs. With discounts as wide as 70% to NAV (admittedly a rubbery number given the lack of transactions and cash flow pressure) and distress evident in the UK and possibly on the horizon in Europe, Blackstone clearly sees better long-term value in acquiring office and industrial property at a premium to recent valuations than deal with the operational and financial uncertainty of the current set of retail opportunities. We tend to agree and retain no pure-play retail exposure in Continental Europe given the sub-par capital structures and potential for further operational pressure.

GETTING AROUNDTOWN

Another transaction of note was announced in Germany, in this case a public-to-public merger. TLG Immobilien (TLG), a €4bn diversified REIT, acquired a 13% interest in European diversified REIT, Aroundtown (AT1). The two firms have commenced merger discussions with the intention of creating one of the largest European platforms focused primarily on office and hotel property.

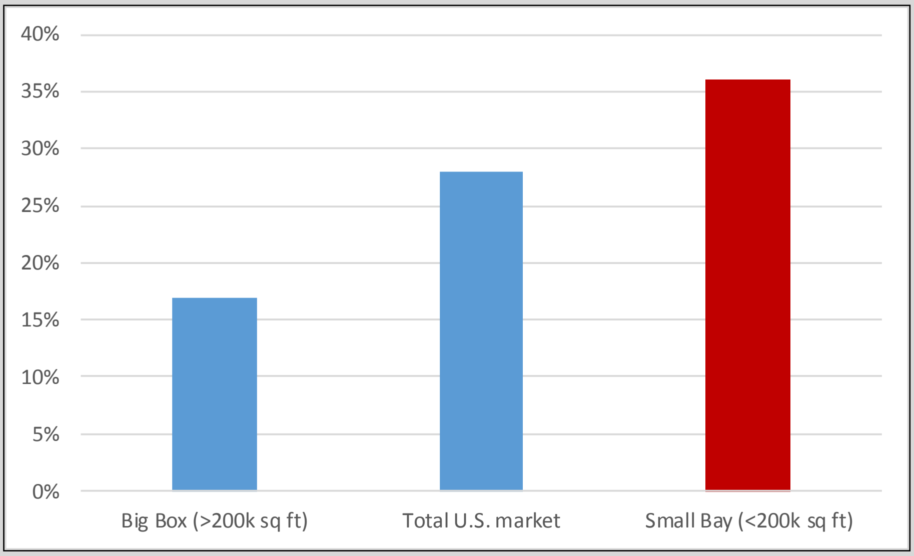
Aroundtown has been a prolific acquirer of real estate in recent years both directly and via two minority positions in listed property companies. We have been sceptical of the platform given its diversified asset base and the pace at which the portfolio was assembled. Following the announcement the market has seemingly concurred, with both stocks underperforming in the quarter. While the combination may create a larger company, in fact the third largest REIT in Europe, we see few synergies from the combination and therefore little value creation from the merger. At this point we are comfortable observing from the sidelines.

The portfolio's largest exposure in Europe is residential landlord, Vonovia (VNA), the largest listed owner of German apartments, and it also has broader residential exposure in Austria and Sweden, which provide the stability associated with regulated markets. In the quarter, Vonovia announced the acquisition of a majority stake in Hembla (HEM) for €1.14bn, further adding to its Swedish exposure. Hembla controls 21,000 flats concentrated in greater Stockholm worth €3.1bn. Together with Vonovia's existing portfolio, a successful acquisition of Hembla would increase Vonovia's Swedish asset base to €5.4bn or 9% of total assets. Vonovia will achieve accretion through debt finance, and we expect permanent financing in due course. Vonovia delivered a total return of 11% for the quarter in local currency terms.

INFILLING THE CENTRE

We have long viewed infill industrial property as possessing strong investment merit. The sector enjoys favourable operating conditions given land supply constraints and robust tenant demand. Logistics supply chains continue to move closer to consumers to enable faster delivery, driving ongoing demand for infill warehouses. As a result, infill industrial rental growth is far outpacing that of larger warehouses less proximate to population hubs.

U.S. INDUSTRIAL RENTAL GROWTH 2014-2019



Source: CBRE Research; CBRE Econometric Advisors, RCL, Q2 2019

Reflecting these dynamics, our industrial exposure is skewed toward infill landlords including Terreno (TRNO), a US$3bn portfolio concentrated in infill locations in six U.S. coastal markets, which we have held since 2012. The portfolio's other industrial exposures, principally Prologis and Segro, also maintain strong infill credentials.

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Given our positive stance on the sector, we note with interest the news of Blackstone making a big push via its launch of ‘Mileway’, an €8bn pan-European ‘last-mile’ logistics platform. Mileway will own around 1,000 logistics assets totalling over 9m sqm, making it the largest of its kind in Europe.

Portfolio holding Prologis was also active in Europe in the quarter, acquiring a logistics portfolio from Spanish office REIT Colonial (COL). The portfolio comprised high quality distribution facilities in several of Spain’s leading logistics markets including Madrid, Guadalajara and Barcelona. Prologis acquired the portfolio on behalf of its Prologis European Logistics Fund. While pricing has not yet been disclosed, the transaction was heavily bid and we understand provided a solid benchmark for European logistics property values. Our portfolio’s principal European logistics exposure is via UK-listed Segro which generated 12% total returns for the quarter in local currency terms.

Back in the U.S., Prologis continued to deploy capital, closing the acquisition of a private industrial portfolio, Industrial Property Trust for US$4bn. Encouraging to see that large scale transactions are not the sole realm of well-funded private equity platforms. The portfolio consists of 236 properties of which 96% are in existing PLD markets. The transaction is a continuation of Prologis’ clustering strategy which it argues enables a 100-200 bps incremental return above other assets in the sub-market when they own 20 or more assets in a 5 mile radius.

OFFERING OPPORTUNITY

We used several large equity offerings in the quarter to add to existing portfolio holdings and to build positions in more recent additions.

We increased our exposure to Invitation Homes (INVH) through a secondary offer as founding shareholder, Blackstone, sold around half their remaining holding. Post the sale Blackstone holds a residual approximate 10% stake and we expect a complete exit over time. The operating fundamentals of the single-family rental sector remain attractive with healthy rent increases the result of modest supply growth, visible barriers to home ownership and supportive demographics. We acknowledge INVH is not an operating platform proven through economic cycles, in comparison to the US multifamily peer group, and have sized the position accordingly. INVH generated total returns of 11.3% for the quarter, in local currency terms.

Also in the U.S., net-lease landlord VEREIT (VER) took perhaps the final step to redemption with the announcement of settlement terms for the outstanding litigation relating to the misdeeds of the former management team. The current management team, led by Glenn Rufrano, has done an admirable job in returning the company to an investible platform which can now return to growth. To fund the litigation compensation, VEREIT raised ~US$900m of equity and we took the opportunity to add to our position.

The addition to the portfolio of VEREIT, together with existing holding STORE Capital (STOR), takes the portfolio’s aggregate exposure to net-lease REITs to around 5%. The appeal of the net-lease sector is the diversity of property and tenant types and minimal capital costs (e.g., maintenance capex and tenant incentives) required to maintain the portfolio. While the portfolios do include retail property, it is typically convenience, service-oriented or restaurants, and importantly contains minimal exposure to apparel tenants, the segment causing many headaches in the wider retail sector. While the net-lease sector is not immune to bankruptcy and cash flow disruption, it has typically proven more defensive than many other property sectors. VEREIT and STORE performed well in the quarter, generating total returns of 10% and 14% respectively in local currency terms.

JAPAN M&A – IT'S NEVER STRAIGHT-FORWARD

We have long lamented weak governance practices and unfocussed investment strategies in the Japanese listed property sector. It is no co-incidence that Japan has traditionally been a market where hostile takeovers have been extremely rare for a multitude of reasons including the existence of poison pills and the fact that Japan's restrictive employment policies make it difficult to extract synergies. In effect poor management and inefficient or underperforming companies have been shielded from the threat of M&A that is often a catalyst for change in other jurisdictions. Therefore, it has been a revelation that the Japanese listed property sector has seen two recent hostile M&A transactions. Of course, this being Japan, it's never straightforward.

The first deal involves two small-cap externally-managed J-REITs battling it out, the target eliciting a competing proposal from a white knight and subsequently launching a legal challenge after losing the vote. Nevertheless, it appears that the aggressor, Star Asia Investment Corporation (3468) has succeeded in its bid to have its nominated director appointed to the target, Sakura Sogo REIT (3473), with a view to ultimately merging the two entities. If successful, the combined vehicle would have a market capitalisation of approximately ¥94 billion (A$1.2 billion), so relatively small, and both parties have overseas sponsorship to varying degrees so this was not a case where 'national interests' were at stake. Furthermore, REITs don't directly employ many people therefore the emotive employee issue was largely neutered. Nevertheless, the case is significant for its hostility and (thus far) its success.

The more intriguing case involves Unizo (3258), a Japanese property company with an equity market capitalisation of ¥165bn (A$2.3bn) that owns a portfolio of predominantly office buildings in Japan and the U.S. In July the company received an unsolicited tender offer from an existing shareholder, H.I.S. Co (9603) seeking to increase its stake from 5% to 45% at ¥3,100 per share, a 50% premium to last – but circa half the underlying asset value. Unizo management promptly found a white knight in private equity group Fortress who made a 'friendly' bid at ¥4,000 per share. Around this time activist investor Elliott Management appeared on the register and built a 13% stake in Unizo. Subsequently the company announced it had received a 'legally binding' ¥5,000 bid from an unidentified party (referred to as 'one of the largest investment funds in the world' with press speculating that it is Blackstone). In a bizarre twist Unizo then rejected both the 'friendly' Fortress bid and the subsequent ¥5,000 bid on the basis that both proposals did not meet its newly adopted 'policy for handling acquisition proposals' which requires the board to consider employee interests as well as those of shareholders. In effect it appears that Unizo has reverted to the bad old days, establishing a poison pill to stymie M&A.

Pushing credulity, Unizo not only demanded continuity of employment, but also that the bidders cede strategic control of the company to current management and allow management to dictate the timing and manner of exit of the acquiror's investment. Unizo defended its stance by taking a broad interpretation of references to 'corporate value' in the Japanese corporate governance code which, ironically, has been a focus of Prime Minister Abe in his attempt to encourage M&A.

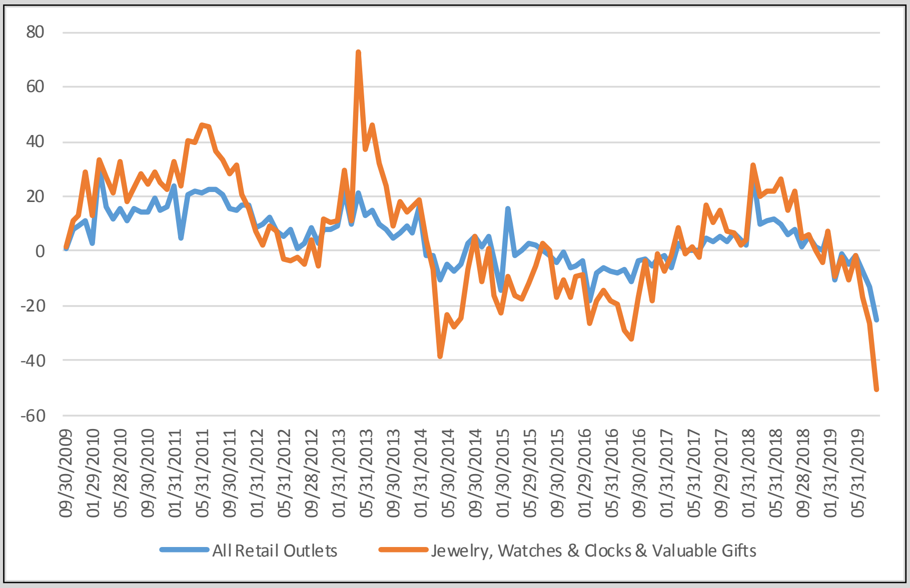
The twists and turns in this case are disheartening and test our conviction in the investing environment in Japan. We remain hopeful that common sense and sound corporate governance eventually prevail.

AWAITING THE SILVER TSUNAMI

Healthcare REITs performed well in the quarter, driven by a combination of defensive investor positioning and resurgent acquisition activity, particularly for U.S. REITs capitalising on recent improvements in their cost of capital.

In September, the National Investment Centre (NIC) Fall conference took place, the semi-annual kumbaya for the U.S. seniors housing sector provides an opportunity to review the supply and demand fundamentals across the country. With a favourable demand profile and relatively defensive characteristics, U.S. seniors housing has some appealing attributes. However, relatively low barriers-to-entry and plentiful available capital have led to new building supply outpacing demand since early 2015. The latest NIC data indicates supply is moderating and industry participants are suggesting fundamentals will improve through 2020 and 2021. Both senior housing operators (including Brookdale) and REITs (such as Ventas) are suggesting a significant improvement in their NOI over the next 3-5 years. We are more circumspect on the outlook and see few reasons why supply will not reaccelerate to meet the demand spike as the peak of baby boomers turning 80 occurs in the mid 2020's.

GREYING AMERICA



Source: U.S. Census Bureau / RCL

In that context, it was interesting to see Ventas (VTR) downgrade near-term growth expectations from its senior housing operating portfolio. At the investor day in June, Ventas articulated conviction that NOI growth would accelerate and average 4-6% p.a. by 2024, predicated on moderating supply, improving demand and higher penetration rates. Such a near-term reset of the outlook raises questions as to the credibility of the longer-term forecasts. Our remaining exposure to U.S. senior housing is held via HCP Inc., a diversified healthcare REIT, where it represents around 35% of the asset base. The majority of HCP's portfolio consists of life science and medical office buildings, which are enjoying more favourable operating conditions.

Alexandria Real Estate Equities (ARE), was also active in the life science sector after being selected to develop the 'Mercer Mega Block' in the South Lake Union submarket of Seattle. ARE acquired the development site for US$144m with approval to construct two 13-story office/lab towers. Upon completion the project will expand ARE's footprint in Seattle to close to 3m sq ft (280,000 sqm or 9% of ARE's portfolio). Alexandria performed well in the quarter, delivering total returns of 10% in local currency terms.

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