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Nedgroup Investments Global Property Fund

Quarter One, 2020

Nedgroup Investments Global Property Fund

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

Indicator	3 months	1 year	3 years p.a.	Since Inception# p.a.
Portfolio*	-19.67%	-13.94%	1.00%	-0.38%
Performance indicator+	-28.53%	-23.92%	-3.85%	-4.83%
Difference	8.86%	9.98%	4.84%	4.45%

* 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)

Summary Points

- COVID-19 has plunged the global economy into hibernation with shelter in place becoming the go to policy
- The REIT sector has been hit hard, with rent payment uncertainty being a key concern and the widening of credit spreads
- While there are "The vulnerable" underperformers (Hotels, Retail, Seniors Housing) there have been outperformers in "Stay at home" REITs (Residential, Data Centres & Towers, Logistics)
- This is not 2009, REITs have stronger balance sheets post GFC and with that came lower leverage, longer maturities, lower interest costs and better access to the corporate bond market
- Better positioned REITs may be able to take advantage of forced asset sales from unlisted funds
- The Fund maintains a focus on REITs with secure cash flows, high quality assets, low leverage and experienced/aligned management teams.

Market and Portfolio Commentary

The FTSE-EPRA NAREIT Developed Index produced a total return of -28.5% for the quarter ending March 31, 2020 in US$ Unhedged terms. On a local currency basis, the Index produced a total return of -27.5%, the second worst quarter in absolute terms in the past 15 years. The ResCap global strategy delivered the best quarter of relative performance since the global strategy was started in 2006, which provides some consolation in an otherwise disappointing period.

REITs and a global pandemic

March was the defining month in the quarter as the declaration of the Coronavirus pandemic and ensuing hastily formulated central planning response created rapid economic and social change of a magnitude not seen in living memory. With epidemiologists seemingly at the helm of policy making, the global economy was effectively shutdown to reduce the spread of the virus and mitigate the strain on health systems. Social distancing and sheltering in place became the norm, a reversal of the share economy trend that had sprouted the likes of co-working and co-living. The negative economic consequences of such policies quickly became apparent, principally in higher unemployment, and governments and central banks around the world scrambled to cushion the impact reverberating through the global economy.

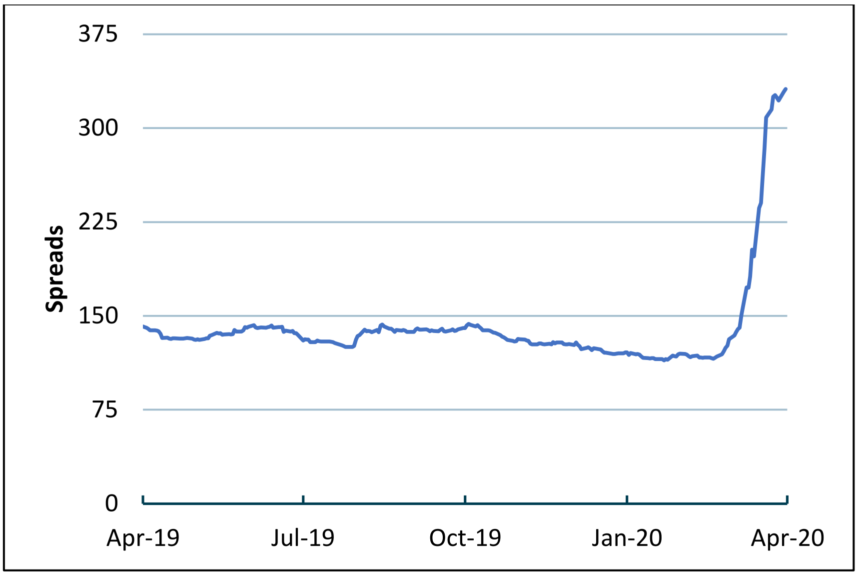
Adding to the uncertainty, an initial supply-induced shock saw oil prices collapse by 50% in March, impacting companies, cities and countries relying on oil revenues, and exacerbating the deterioration in credit markets.

With no recent history to frame the economic consequences of the pandemic, investors aggressively reduced risk assets, at least those that were liquid. REITs were not spared and underperformed in the quarter as capital was reallocated to sectors perceived to be less exposed to the negative effects of economic and social hibernation.

The immediate consequences for real estate markets were extraordinary with many tenants indicating that they would be unable or unwilling to honour lease commitments given the speed and extent of the economic demand shock and the inability in many cases to operate their businesses in leased premises.

Dysfunction in credit markets also impacted REITs, with credit spreads widening significantly as investors grappled with pricing the impact of lower rent collection, the quantum of lost cash flow and whether REITs could continue to service their capital providers. In these circumstances, many if not most companies withdrew earnings and dividend guidance.

US REITs BBB Spread



Source: Bloomberg

Given the rapid and unprecedented nature of the crisis, higher volatility was an inevitable feature. As long-term investors, we view short-term volatility largely as the price of liquidity, a cost more investors should be willing to pay given the challenges yet again facing unlisted real estate exposures.

Whether listed markets prices have disconnected from underlying intrinsic value or are simply a forward indicator is a moot point.

In response to investor redemptions swamping cash balances, and an inability to raise cash in non-functioning real estate transaction markets, unlisted property funds in the UK and Norway once again gated redemptions. Compounding the problem is the question of the true value of the units being redeemed. Until transaction markets become functional and the economic picture becomes more apparent (even if it is akin to a surrealist painter's landscape), investors have limited evidence to assess value. In sharp contrast, REITs continue to provide investors with daily liquidity, and share price volatility is part-and-parcel of that construct.

As is often the case, liquidity is not valued until it is required. Furthermore, the dynamics remain poorly understood: the shortcomings of appraised illiquid investments have accentuated the perceived volatility of publicly traded markets which unlisted investors are quick to criticise.

Real estate's winners and losers

Given the unprecedented dynamics and the duration of the pandemic is unknown, we are likely to be operating in an accurate information vacuum for some time. As such, we must continue to focus on real estate platforms we believe have the most robust cashflows and balance sheets in order to withstand this period of heightened uncertainty. We can broadly categorise the relative winners and losers into 2 virus related groups.

1. The Vulnerable

Real estate sectors that serve clusters of people, particularly the older cohorts, and facilitate their interactions are at higher risk of rental revenue disruption. These include retail, hotels and senior housing, each for its own nuanced reasons.

Retail is down for the count. Other than for basic needs (such as supermarkets, pharmacies, and petrol stations), physical shopping has all but stopped with the closure of a significant number of retail stores around the world. For many, particularly smaller retail operators, it is difficult to quickly shift business to an e-commerce format.

Larger retailers, with omni-channel distribution platforms, should fare better but are operating in an environment of lower discretionary retail sales and lower profitability. As such, rent collection is the top challenge for retail landlords today and is expected to suffer the worst levels of non-payment of any property sector. Early indications are not encouraging, with collections running 20-45% behind the range indicated by some UK and US retail REITs. As we will discuss later, this situation has effectively brought to a head secular issues facing retail property.

Hotels have also largely closed for business as a consequence of the global pandemic. Closed borders and widespread 'stay-at-home' directives have stopped almost all forms of commercial and leisure travel for an undetermined period. Unsurprisingly, occupancy rates have fallen from 80% to less than 20% in most markets.

Senior housing communities are home to the age cohort most at risk to the worst health impacts of the coronavirus. Most senior housing properties have stopped new residents from moving in for safety reasons during the crisis. Unfortunately, this means that occupancies will steadily fall as move-outs continue principally due to health issues.

Office property is also in a difficult position, with many buildings unoccupied as Business Continuity Plans (BCP) and shelter-in-place orders mean most employees are working remotely. Combined with a reversal of demand from the coworking sector, discussed later, the extent of business disruption on the office sector remains difficult to gauge – but the consequences are unlikely to be positive.

All of these sectors face significant operational challenges that will impair revenues and pressure cashflows. Fortuitously, apart from select office names, we held modest exposure to these segments prior to the crisis.

2. "Stay at Home" winners

Conversely, property which facilitates the functions of working remotely, shopping remotely and basic needs of accommodation and consumption proved popular during the quarter with their cashflows likely to be more resilient for the foreseeable future.

In the short term at least, the residential rental property sector should see steady demand with reduced tenant turnover given the need to secure shelter and reluctance or inability to move in the current environment. The massive increase in unemployment is likely a risk for rent collection, and landlords have already acknowledged this challenge ahead. Nonetheless, the need to isolate and to work-from-home will increase the utilisation of housing in the coming months.

Technology oriented REITs, such as data centres & cell towers, occupy critical roles in facilitating the surge of activity to all things digital. The pandemic reinforces and accelerates a shift already underway to more activity online, including working from home, video conferencing, news, social media and tele-health services. In this environment, data centre tenants are expected to continue paying rent and may require more bandwidth to meet additional business and consumer demand.

Demand for logistics facilities benefits from changing consumer behaviour as the channel shift to e-commerce accelerates and provides structural demand growth. More production and distribution networks are likely to be restructured, and corporates are expected to raise inventory levels to protect against future supply chain disruptions. These positive forces are forecast to mitigate the negative impact of lower economic growth, pressure on traditional retail focused customers, and reduction in global trade volumes on industrial real estate.

Whilst the rapid changes in the economic outlook and global capital markets have tested our views on portfolio positioning, as we discuss below, thankfully we were well positioned in the 'shelter in place' platforms which we expected to be long term winners from secular changes in the economy.

Rental market in crisis: Will the rent be paid?

Businesses across a range of industries are facing a revenue cliff. Many businesses remain shut, and corporate executives are desperately trying to shepherd their resources by cutting any and all expenses in order to survive, including labour.

In real estate, with pandemic clauses a rarity, the sanctity of the lease contract has come into question. The very essence of visible, contractual cash flows now faces practical limitations – many tenants simply may not be able to pay rent. Such is the all-encompassing nature of the pandemic shutdown, a range of tenants, whether unemployed apartment dwellers, closed restaurants, idle airlines and tourist operators and importer/exporters, face income and revenue losses that impair their ability to pay rent in April and beyond.

Many landlords have publicly announced a willingness to work with troubled tenants in order to maintain occupancy and hope to be repaid in the future for rent deferred today. In reality they have little choice, as the prospect of finding a rent-paying replacement in the current environment is almost nil. How much rent will be deferred, forgiven, reduced or written off remains unclear. Governments have sought to provide assistance for some, particularly individuals and small businesses, but ultimately they have signalled it is now up to landlords and tenants to sit down and discuss. As one REIT described it, whilst a touch histrionic, we face an environment of sanctioned real estate anarchy.

As a result of the shock and income uncertainty, many REITs formally withdrew previous guidance for 2020 operations and earnings. From an earnings growth point of view, increasingly 2020 has become unrepresentative if not a write-off year. Focus has quickly turned to capital preservation, revenue retention and expense minimisation.

In light of revenue uncertainties, many REITs acted swiftly to preserve liquidity. Discretionary capital expenditure has stopped. Development spend has been deferred where possible, and in many instances, construction stoppages serve to elongate committed future expenditures. Management teams have also reduced staffing through layoffs and furloughs. Simon Property (SPG), which has closed all of its shopping malls in the U.S. and in Europe, has reportedly furloughed 30% of its staff, as well as requested one year delays for paying real estate taxes from various municipalities.

Companies that had been pursuing share buybacks in recent months, have put those plans on hold for now, including Scentre Group (SCG) in Australia, Capital & Counties (CAPC) in the UK and SL Green (SLG) in the U.S. This is the right decision given current market uncertainties.

Dividends impacted

It should come as no surprise that REIT dividends are likely to be impacted given the revenue and liquidity challenges many companies now face. While most REITs have not yet announced changes to their distribution policies, those experiencing the greatest level of revenue loss, such as hotels and retail, are highly likely to reduce distributions and some may choose to pay at least part in the form of scrip rather than cash, akin to a dilutive albeit modest capital raising. U.S. mall REIT Macerich (MAC) has started this push, declaring its forthcoming dividend will be paid in the form of 20% cash and 80% in shares.

The timing of dividend payments is also expected to be impacted. SL Green (SLG), a New York City office owner, has moved to a monthly dividend, which is a bit of a gimmick meant to obfuscate an eventual cut. We expect some companies to move to an annual dividend, which allows them to defer the dividend to late in the year while enabling them to maintain the distribution requirements for REIT status.

Singapore REITs have achieved permission to extend the timeline to distribute the required 90% of taxable income from 3 to 12 months (and increase the leverage limit from 45% to 50%) to maintain REIT qualification. In 2020, we expect dividend policy changes across sectors and markets.It will not be universal, as plenty of companies continue to have strongly positive cash earnings, but it will be widespread.

This is not 2009 - REITs have stronger balance sheets

There is no doubt that most REIT capital structures are greatly improved since the GFC a little more than a decade ago. The group's financial leverage profile is stronger today:

U.S. REIT leverage metrics 2009 & 2019		
	Dec 2009	**Dec 2019**
Debt / Asset Value	46%	31%
Debt / EBITDA	7.0x	5.9x
Average Maturity (years)	5.0	7.0
Average interest cost	5.4%	3.8%

Source: Morgan Stanley

Since the nadir of the GFC in 2009, U.S. REITs have improved their overall leverage profile, including debt level, term, cost and serviceability. REITs in most markets have moved to strengthen balance sheets, with Europe, Japan and Singapore remaining the stubborn exceptions. A stretched capital structure coupled with challenging operations is a toxic combination that can obliterate equity value – witness the demise of Intu (INTU) in the UK, down 95% in the past 12 months.

However, almost no capital structure in any industry was designed to withstand multiple quarters of significantly diminished cash flow. Today's economic freeze will have capital structure ramifications tomorrow. The duration of the recession will determine the depth of the problem. The longer that revenue collection is impacted, the more reliant on leverage that all companies, not just REITs, will be.

Crucially, debt markets remain open, but the total cost of accessing debt capital has risen. Two recent offerings illustrate the change in cost in a short time.

Alexandria Real Estate (ARE) priced US$700 million 10 year bonds at 4.90% in late-March at a 414 basis point spread to the US 10 year treasury bond rate. Alexandria proved that debt capital was available, but it paid a comparatively steep price. Less than three weeks earlier, Healthcare Realty (HR) had issued similar term paper at only a 141 basis points spread, and HR was a notch lower credit rating than ARE. ARE's March issuance was also 215 basis points more expensive than its September bond offering, illustrating softer pricing in the credit markets in the past six months.

At the end of the quarter, Unibail-Rodamco-Westfield (URW) priced €600 million 2.125% 5 year bonds and €800 million 2.625% 10 year bonds. Fortunately, URW still has access to the unsecured market, and reportedly demand for its bonds exceeded €3.3 billion. Yet in a sign of just how much debt markets had changed in a few months, the pricing was significantly higher than the company's October 2019 issuance of €750 million 0.875% coupon 12 year bonds.

Notable transactions; direction, timing and judgement

Given the gestation period of property investment transactions, deals that concluded during the quarter will not likely provide a good read into market values in a post COVID-19 environment. Nevertheless, there were a few notable transactions that demonstrate either the direction in which things were heading and/or unfortunate timing and judgement.

U.S. mall bellwether Simon Property (SPG) executed what was probably the most unfortunately timed M&A transaction of recent years with the agreement to acquire mall peer Taubman Centres (TCO) in early February. The deal was struck at a 51% premium to TCO's undisturbed price, representing an implied cap rate for TCO's 27 asset portfolio of 6.2%. While the US$3.6billion acquisition price is not significant in the context of SPG's overall scale (EV of US$48.7billion) the pricing now appears from another era with SPG itself trading at an implied portfolio cap rate of ~10%. Time will tell whether SPG can make money at this entry price but the road ahead for U.S. malls looks particularly challenging.

Another ill-timed acquisition from SPG was its participation in the rescue of US fast fashion retailer Forever 21 from bankruptcy. Forever 21 operated around 800 stores and was one of SPG's largest tenants. Given the enormous challenges facing even strong retailers in the current crisis, the turnaround of Forever 21 seems a remote prospect.

In a sign that some lenders were already becoming more cautious in late March, the US$815m sale of SL Green's former NY Daily News HQ collapsed after the private buyer's (Jacob Chetrit) financing fell apart.

Covivio (COV), a French-listed diversified property company, announced the takeover of German office landlord, Godewind Immobilien AG (GWD) for €6.40 per share in cash. The transaction price implies a mid-3% yield for the company and an 18.5% premium to reported EPRA Net Asset Value. The Portfolio completed its divestiture of COV during the quarter.

Conclusion – 'Un-underwriteable'

The global health pandemic elicited an unprecedented policy response that quickly pushed many parts of the world into a sharp recession. We are very much in uncharted waters as business, employment and social activities have shut down and major economies around the world are in hibernation. It is fair to say that we have experienced quite a shock which we are trying to put in perspective.

Governments and central banks have moved quickly and with unprecedented scale to inject liquidity into the system with the hope that this would bridge the hibernation period. However, few expect a rebound to pre-corona levels for some time. The critical question is whether it will be a V, U, W or L shaped recovery, and from what base. The IMF, albeit notorious for its poor forecasting, expects the worst global recession since the Great Depression. Strong government intervention at an early stage probably limits this likelihood at this point, but it will come at a cost to future growth.

The disruption to the economy from shuttered businesses and soaring unemployment removes the visibility of REIT earnings. Landlords will be challenged to enforce lease contracts when tenants simply cannot pay the rent. Sorting out those who can't and those that won't will be a challenge, but we fully expect REITs will provide assistance to those suffering genuine distress. Companies will go through a rebasing of earnings over the coming quarters as they seek to maintain occupancy, even if it means doing so with tenants at lower rates.

The current crisis is one of cash flow not capital structure. Fortunately, balance sheets are a source of REIT strength today compared with the GFC and at this point debt markets remain functional. The duration of the crisis will dictate the extent to which the sector increases leverage to deal with the cashflow disruption. Equity calls are likely for those which entered the crisis with too much debt. We continue to steer the portfolio away from these vehicles.

Looking ahead, we expect REIT profitability to be diminished this year. Our longstanding focus on competitive assets with strong cash flows, conservative capital structures and capable management teams should serve us well.

The current crisis presents good opportunities to invest in companies that will survive and thrive. We have reduced exposure to speculative development and to companies with external capital needs in order to focus on resilient cash flows with lower operational risk. We remain optimistic for a recovery, but realistic that it will be a testing period.

ESG: Rent forgiveness for the greater good

Social pressures from the COVID-19 crisis are front of mind for many REITs. With tenants' rent paying ability impaired, how much pain sharing between tenant and landlord will take place?

Apartment REITs in Germany and the U.S. have shown leadership in clearly addressing the problems facing tenants due to the coronavirus. These landlords demonstrate they understand the unforeseen pressures many of their tenants may be facing. With clearly articulated company directives, U.S. and German apartment landlords confirm the value of the landlord-tenant relationship sometimes can extend beyond the lease parameters.

LEG Immobilien in Germany put forward a policy intended to support its residents who were struggling as a result of the coronavirus shutdown. Several U.S. multifamily REITs, including Essex Property and Equity Residential, soon issued similar directives.

These policies are designed to enable residents to remain in their homes. Evictions and lease terminations have been halted on a temporary basis. Lease renewals are being done with no rent increases in an effort to allow existing residents to stay. Additionally, apartment landlords have signalled a flexibility to work with tenants on a payment plan for those who may have lost their jobs or fallen ill as a result of the crisis. Finally, the apartment landlords also mention helping their commercial tenants and small businesses through these challenging times with rent assistance as needed.

The apartment landlords surely realize that it is in everyone's best interests for residents to be able to stay in their homes during the coronavirus health crisis. The policies they have put forward also illustrate that being socially responsible and economically motivated are not mutually exclusive, rather they are mutually dependant today.

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FEES

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