NEDGROUP INVESTMENTS

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Nedgroup Investments Global Property Fund

Quarter Two, 2023

Marketing Communication

Nedgroup Investments Global Property Fund

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

Past performance is not indicative of future performance and does not predict future returns.

Indicator	3 months	1 year	3 years p.a.	5 years p.a.	Since Inception# p.a.
Portfolio*	0.01	-6.81	0.86	0.77	1.48
Performance indicator+	0.24	-4.56	3.34	-0.10	0.21
Difference	-0.23	-2.25	-2.48	0.87	1.27

* 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

- REITs produced modest returns for the quarter, albeit there were clear winners (Japan Developers, US Residential) and losers (Sweden, UK), by sector and region.
- The real estate values implied by REIT prices leads to an estimate that REITs are trading at roughly 15% below estimated property values.
- Data centre REITs enjoyed heightened buying interest, as the stock market's attention was captured by developments in the fast evolving Artificial Intelligence (AI) sector.
- Listed REITs and real estate companies focused on residential rental property enjoyed sector leading returns in the June quarter, particularly in Germany, the U.S. and Canada.
- Challenges facing office property have been heightened by the increased focus on improved energy efficiency by both regulators and tenants.
- Potential default spike among private landlords now facing significantly higher finance costs and less debt availability, partly a fall out of the high-profile regional bank challenges.
- European real estate has higher financial leverage and now faces the nascent problems of asset values declining and significantly higher finance costs.
- Retail property supply and demand fundamentals are underappreciated and retail REIT pricing is attractive.
- Recent legislation and high profile tenant relocations means the UK is now a focal point for building energy efficiency, with potentially significant consequences for the London office market.
- A building does not have to be Prime to be sustainable, but it has to be sustainable to be Prime.
- Portfolio is positioned to prosper in current conditions, as the REITs held can take advantage of value accretive leasing and investment opportunities.
- Balance sheets are robust and the portfolios of underlying properties are well located and well maintained, evidenced by above average occupancy levels.

Market and portfolio commentary

Whilst the persistence of an inverted yield curve points to slower economic conditions, if not a looming recession, employment markets displayed resilience in most developed countries, goading Central Banks to continue ramping interest rates to bring inflation to heel. Toward the end of the June quarter, signs of moderating inflation in the U.S. allowed the country's Federal Reserve to pause and contemplate the timing and extent of further interest rate increases.

On top of rising interest rates, concerns surrounding the fall-out from recent bank failures and rising levels of commercial property loan defaults weighed on sentiment toward real estate. Against a backdrop of a tech stock rally, boosted by NVIDIA's (NVDA) result, some have described the lack of property transaction activity as a real estate capital market recession, reminding us a little of the conditions in the late 1990s when investors were completely enamoured by dot-com start-ups.

In this environment, on average the REIT sector produced modest returns for the quarter, albeit there were clear winners and losers, by sector and region.

Japanese listed real estate companies were among the best performers. Otherwise known as Japanese Developers, they seemed to benefit from the halo effect of signs of improved Japanese corporate governance on the back of initiatives from the Tokyo Stock Exchange and news that Berkshire Hathaway had increased its investment in the five largest Japanese trading companies.

In North America, persistent elevated jobs growth underpinned strong operational performance and investor interest in residential REITs. Our significant absolute and over benchmark weight exposure to the sector was a key positive performance contributor.

Conversely, Hong Kong listed real estate was the weakest performing region. Whilst western economies' post-Covid recovery has been robust, China's recovery is proving moribund. In stark contrast to the "unsustainable but unstoppable" narrative just over a decade ago, today, Hong Kong is on the wrong side of hawkish monetary policy setting imported from the U.S., whilst its economy is reflective of the anaemic growth conditions of greater China. The early signs of optimism we observed on our research trip to Hong Kong in March have not progressed as anticipated.

Swedish real estate stocks were weighed down by corporate governance scandals and the need for equity recapitalisation of weak balance sheets. We have no exposure to Sweden and hence this was a contributor to relative performance. Despite relatively strong balance sheets, UK REITs also underperformed, negatively impacted by stubborn inflation increasing the likelihood of more draconian interest rate increases. We are overweight the UK region, weighing negatively on the relative performance. It is worth noting our overweight exposure to the UK is driven, in part, by the UK companies' superior capital structures (i.e., lower leverage) than typically seen on the Continent.

Whilst not as testing as the situation in the UK, the Reserve Bank of Australia's aggressive interest rate increases, and the country's largely floating rate residential mortgages, threaten to curtail consumer spending. These issues weighed on the performance of our key A-REIT holdings during the quarter.

As overall real estate transaction volumes remained subdued, the spread between real estate values implied by listed real estate prices and appraised based valuations remained contentious. By our estimates, REITs are trading at roughly 15% below estimated property values.

While wide bid-ask spreads are inhibiting REITs' acquisition activity, public-to-private or in certain instances public-to-public opportunities appear more feasible. During the quarter U.S. strip centre REIT Regency Centers (REG) acquired Urstadt Biddle Properties (UBP) for $1.4bn in an all-stock deal. The deal reflected a 12.5% discount to UBP's valuation and an initial implied cap rate of roughly 7.2%. The acquisition was immediately earnings accretive and should provide further earnings support in the years ahead as REG capitalises on the under-renting in UBP's portfolio.

Some signs of life in transaction activity in other markets sparked something of a rebound in prices of some the most beaten-up segments including German residential investment companies and REITs exposed to the New York office market. Our minimal exposure to these segments facing finance issues and in the latter case, fundamentally weak operating conditions, was a key detractor to relative returns.

Elsewhere, the stock market's attention was captured by developments in the fast evolving Artificial Intelligence (AI) sector. As a consequence, data centre REITs enjoyed heightened buying interest.

Office – One swallow does not a summer make

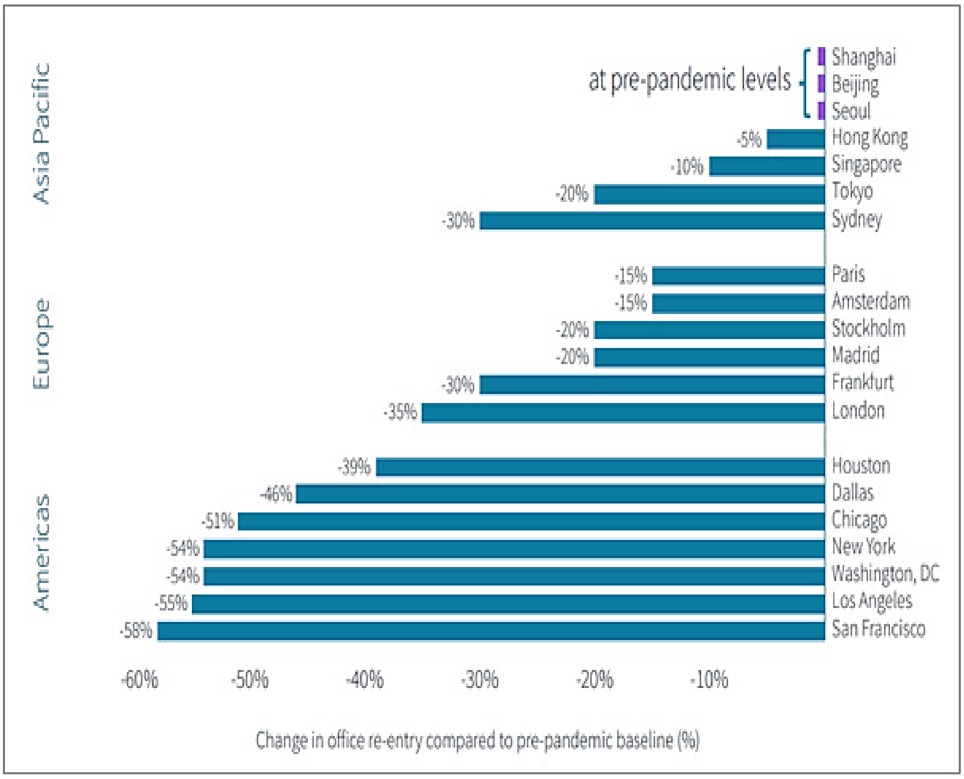
In light of the numerous challenges facing office markets, transaction evidence in the sector is perhaps the most keenly anticipated. In Sydney, the sale of Dexus' 44 Market Street, an older B-grade office building, occurred in June at a 17% discount to the December 2022 appraisal. Adjusting for quality, the Dexus (DXS) share price implies a 10-15% discount to this transactional evidence.

However, most attention is directed towards the U.S. After suffering material share price falls in recent quarters in response to persistently difficult operating conditions, with several cutting dividends, U.S. office REITs enjoyed a reprieve in the June quarter as investors found reason to believe the stocks were oversold in a much shorted area.

The market took encouragement from a couple of office REIT initiated transactions which suggest they are trading “cheap to the real estate”, dramatically driving up share prices. Case in point, SL Green (SLG) sold a 49.9% interest in 245 Park Avenue in Manhattan’s midtown east to Japan’s Mori Trust valuing the building at US$2bn, which equates to circa US$1,100 per sq ft, compared with SL Green’s implied portfolio value of circa US$550 per sq ft. We acknowledge the optics suggest SL Green is trading at a material discount however, we do not believe too much should be read into a single transaction. The well-located property is not representative of SLG’s overall portfolio quality, and we believe the lofty purchase price per sq ft partly reflects the property’s assumable below market rate debt. New York’s leasing conditions remain challenging, and SL Green still has an undercapitalised balance sheet with a portfolio that has considerable latent capex needs.

The challenges facing U.S. office are not magically resolved with one positive data point. U.S. office properties face a myriad of operational and capitalisation challenges which compress their earnings profile and will likely result in more loan defaults in the coming quarters. Office landlords are grappling with vacancy levels at multi-decade highs, lower than anticipated space utilisation/return to work figures, irregular tenant demand, higher rent concessions and increasing operating expenses. Private market asset values are under pressure, and there is considerable risk that maturing secured debt will not be able to be refinanced, thereby resulting in more loan defaults with the eventual resale of these assets at depressed levels.

Office re-entry rates vary across global regions



Source: JLL

The challenges facing office property have been heightened by the increased focus on improved energy efficiency by both regulators and tenants. This is not solely an issue facing office property, but office is already one of the most capital-intensive sectors, and the additional capital costs to improve energy efficiency are occurring while cash flows are under pressure from rising vacancy and finance costs. Many markets are introducing tighter energy efficiency standards, including New York. The issue has been most impactful in the UK. This situation requires a more detailed description which you can find in a later section on sustainability. We recommend you make a point of reading this section, sustainability cannot be dismissed as “merely” virtuous, it is becoming critical to the return prospects for commercial property, and office in particular.

I left my keys in San Francisco

During the quarter San Francisco's challenges were exemplified by high profile loan defaults triggered by listed REITs with retail and hotel investments in the city.

Park Hotels and Resorts (PK) opted to default on a US$725m non-recourse loan secured against its Hilton Union Square and Parc 55 hotels in downtown San Francisco, opting to allow foreclosure to occur on the non-recourse loan in what was a damning explanation of the city's woes:

> *"we believe San Francisco's path to recovery remains clouded and elongated by major challenges – both old and new: record high office vacancy; concerns over street conditions; lower return to office than peer cities; and a weaker than expected citywide convention calendar through 2027 that will negatively impact business and leisure demand and will likely significantly reduce compression in the city for the foreseeable future."*

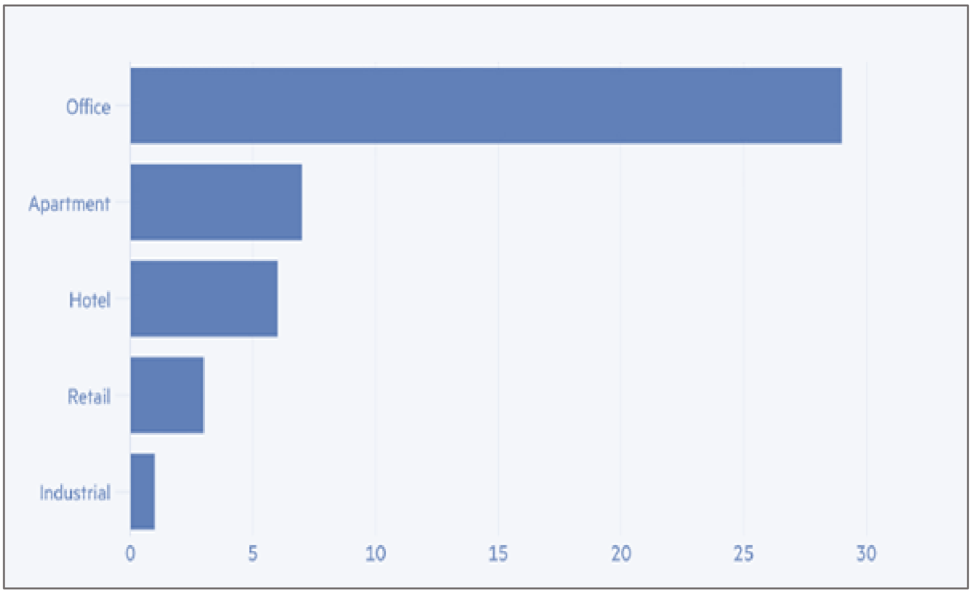
Not among Park's best performing properties pre-Covid, it should be acknowledged that these hotels were highly leveraged and in need of renovation. Hence, we believe this was a pragmatic decision which results in improved financial leverage optics for Park. According to CoStar, more than 20 other San Francisco hotels have CMBS loans that mature in the next two years, 15 of which are on the "watchlist".

Close by, Unibail Rodamco Westfield (URW) and its joint venture partner Brookfield elected to default on the $558m secured loan against Westfield San Francisco Center, a major downtown enclosed shopping mall. The decision was no doubt triggered by the decision of Nordstrom, the centre's anchor tenant, to vacate what is its second largest store in the U.S. Earlier in the year, URW also elected to default on a non-recourse loan on another smaller shopping centre, Valencia Town Centre, located in LA's outskirts. The decisions by URW and Park to default on specific assets had the effect of improving their leverage metrics. However, lenders will be more circumspect when dealing with these platforms in the future.

It is important to recognise these are asset and secured debt specific circumstances. Without downplaying the issue, we believe these defaults are unlikely to be a widespread practice among REITs for several reasons. Primarily, non-recourse secured debt is not a major source of finance for REITs. By and large, REITs have moderate leverage, by our estimates LTV is generally below 35%, and thanks to reasonable credit ratings, the debt is largely unsecured and sourced from debt capital markets. REITs that have defaulted on specific loans opted to make full use of the unusual debt structure associated with particularly troubled assets.

However, we believe these are an indicator of a likely default spike among private landlords now facing significantly higher finance costs and less debt availability, partly a fall out of the high-profile regional bank challenges. Already suffering a disproportionate level of foreclosures, highlighted in the chart below, office buildings face the greatest threat of substantial rates of default thanks to elevated vacancy rates as well as more challenging energy efficiency and tenant amenity requirements.

U.S. CRE foreclosure by property type – Q1 2023



Source: MSCI; Financial Times

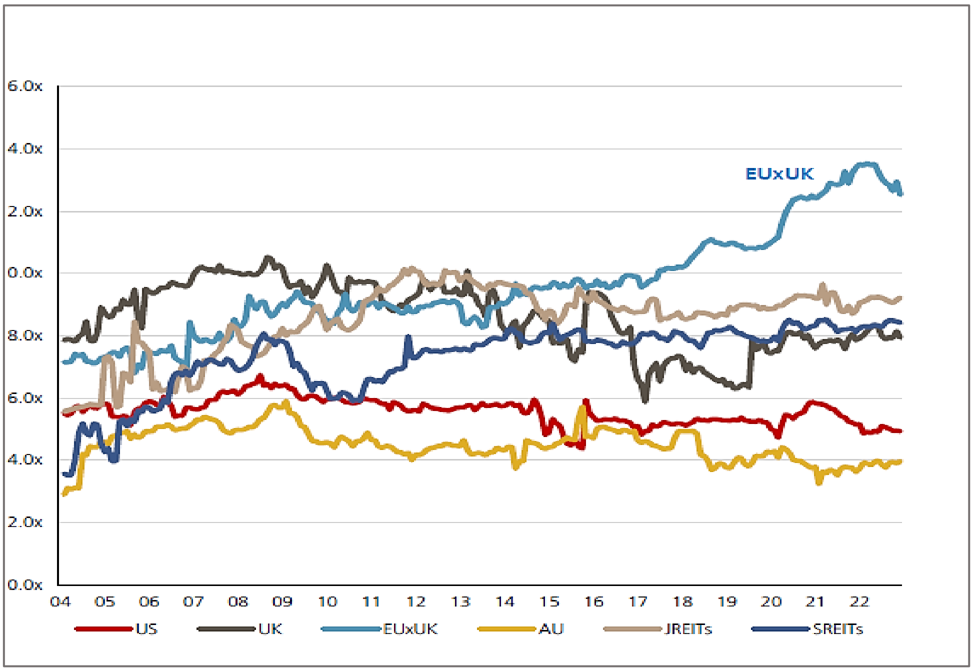
In general, we see loan default issues increasing from 2022's historically low levels, but we note many borrowers were stress tested during the pandemic. Furthermore, we see limited signs of overbuilding which would otherwise result in widespread elevated vacancy and consequent prolonged impairment to rental income.

Absent a severe recession, we would view elevated defaults as a potential positive for investment returns for REITs in the medium term. Many REITs, and a hallmark of our Portfolio, currently have low to moderate levels of debt and, unlike private investors, listed REITs typically have more avenues to access finance, most significantly from public debt and equity capital markets. Hence, REITs are in a strong position to capitalise should discounted opportunities arise. Furthermore, a silver lining of a tighter, more expensive lending environment will be the curtailment of new property construction supply. We believe many if not most of our REITs are in a position to benefit on both fronts.

InContinents

Continental Europe stands out as an exception to the notion that listed REITs have solid capital structures. As the chart below illustrates, listed continental European real estate has higher financial leverage and now, largely as a consequence, faces the nascent problems of asset values declining and significantly higher finance costs.

Net debt/EBITDA – Pan-European real estate



Source: UBS Global Real Estate valuation metric database, Datastream.
Note: Based on IBES consensus data, Net Debt and EBITDA are rolling 12 month forward consensus estimates.
Market cap weighted of individual stocks.

We attribute this anomaly to a number of factors, primarily that Continental European REITs were encouraged to leverage up following the forbearance of European banks in the GFC, combined with the subsequent extraordinary judgement-distorting environment of negative interest rates. Given the region's relatively modest economic growth, adding low interest rate debt was a means of enhancing short term return on equity and generating earnings growth. The recent significant increase in interest rates, an energy crisis and downward pressure on asset values has left many on the Continent in a precarious position.

In order to improve liquidity and reduce debt, a range of initiatives have been launched including cutting dividends, expediting property sales and, where practical, raising equity. Listed Swedish real estate companies were at the forefront of these efforts, Castellum (CAST) launching a well telegraphed equity rights issue, although the corporate governance scandal plagued SBB abandoned its equity raising plans. SBB is perhaps the biggest victim to date of excessive leverage, with the vehicle now under investigation by the Swedish Financial Supervisory Board for valuation and accounting irregularities.

Other less vulnerable European REITs prudently moved to shore up their finances with pre-emptive equity raisings including healthcare property focused Aedifca (AED) and logistics owner AB Sagax (SAGA). Aedifica issued €374m of new capital at a deeply discounted level to reduce its declared LTV from 44% to 37%. In fact, we view this capital raise as providing an important defensive buffer against future declines in portfolio value.

Healthcare Convertibles

Elsewhere, U.S. healthcare REITs enjoyed strong total returns for the June quarter, particularly those with exposure to seniors housing. Performance was aided by upgrades to earnings guidance and capital management initiatives.

Welltower Inc (WELL) was a case in point. The company announced it is experiencing better than expected revenue and expense conditions in its senior housing operations, representing two-thirds of its income, underpinned in part by limited availability of development finance for new competing senior housing facilities. Separately, WELL issued US$1 billion of convertible debt at attractive terms which enabled it to bank the capital needed for its 2024 debt maturities. The convertible was issued with a 2.75% coupon and a convertible strike price 25% higher than where the stock was trading. Welltower was the first U.S. investment grade REIT issuer of convertible debt in many years. The low coupon makes the debt cost accretive relative to its intended use, and the company essentially did a 5 year forward equity raise 25% above its current share price and at a premium to its 2023 NAV. We see this as smart capital management which further reduces the company's floating rate debt exposure from 14% to 8%.

Notably soon after, listed healthcare rival Ventas (VTR), issued US$863m of 3.75% convertible debt with a convertible strike price that was only 22% higher than where the shares were then trading. Also, whereas WELL's convertible had a 5-year term, VTR was only able to issue at 3-year term. Ventas faces $1.8b of floating rate and maturing debt in 2024, and so, it 'needed' to get this bond issuance done, hence the less favorable terms.

It is reasonable to expect we will see more convertible securities issued as management view their stock prices as underpriced and cost of debt at least temporarily over-priced. However, it is not likely to be a major source of funding, more of a stop gap measure until conditions become clearer.

Life Science – Bumpy Road

Life Science real estate leasing fundamentals came under pressure during the quarter. Leasing activity slowed considerably from frenzied levels in 2021 and 2022 as tenants became more cautious about the availability of capital. The failure of Silicon Valley Bank and the ensuing regional banking crisis adversely impacted capital availability for early-stage companies in general (i.e., "pre-revenue"), including those in the life science research sector. Leasing activity markedly slowed during the June quarter, which had already started to slow earlier in the year, and leasing terms began to soften with more landlord cap ex, shorter lease terms and longer times to consummate lease agreements all weighing on the space.

Life science utilization came under additional scrutiny late in the quarter when an activist hedge fund published a short thesis about sector leader Alexandria Real Estate (ARE) that posited lower space utilization in lab buildings in the pandemic would result in reduced leasing needs. Note, we sold our long held position in ARE earlier in the year. That said, we see the outlook for life science real estate as more nuanced. The science that occurs at lab benches cannot be done remotely and requires a permanent lab presence. Although accounting, marketing, and other traditional office personnel are certainly able to work from home, this is unlikely to be a major determinate of space needs for life science tenants. The typical fit-out in many life science buildings is 50% lab and 50% office, and a portion of the office space is dedicated to scientific researchers. These activities are likely the key determining factors in life science leasing demand.

Residential value simple

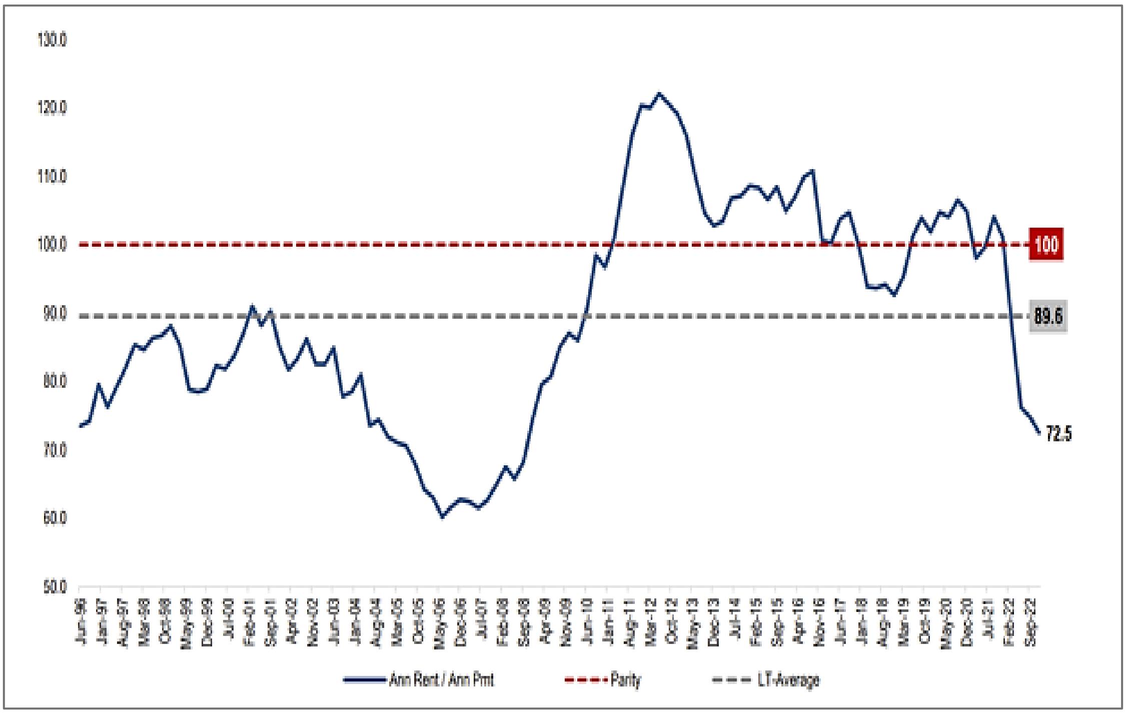
Residential affordability is a sensitive topic in many countries around the world. Whilst living preferences have changed, including smaller average household sizes creating more aggregate unit demand, we attribute the housing shortage primarily to undersupply in terms of total stock and product aimed at various prices points in a range of locations. This undersupply, or perhaps mismatch, is a consequence of numerous factors including more disciplined capital for development post GFC, bottlenecks in labour and materials availability, as well as restrictive zoning/town planning policies which have strangled more affordable options and extended the development process.

In response to rapidly rising rents, political opportunists continue to promote the idea of rent restrictions, including rent freezes. Common sense and experience in markets such as Edinburgh and Mumbai demonstrate these restrictions invariably serve only to exacerbate the crisis and lead to underinvestment in cities' infrastructure more broadly.

Whilst affordability can be seen as a natural mechanism of cities to self-regulate their growth, ultimately cities that do not create diverse, affordable, and liveable environments are at greater risk of excessive social inequity and ultimate demise. There is no obvious effective quick fix: those overseeing planning for our cities need to expedite the marriage of housing supply, including encouraging a range of housing types, with social and transport infrastructure. Of course this downplays the challenge of curbing sub-optimal urban sprawl whilst overcoming self-interest against greater density in established communities.

Whilst U.S. rental growth is moderating versus Covid re-opening 2022 spike levels which were fuelled by Covid-related distortions, the sector is benefiting from strong underlying leasing dynamics, underpinned by low home ownership affordability and continued employment market strength. As the following chart highlights, renting has become far more financially palatable than buying.

U.S. Residential Affordability analysis – time to rent



Source: ISI, Realpage, Top 50 MSA;s.

Against this backdrop, listed REITs and real estate companies focused on residential rental property enjoyed sector leading returns in the June quarter, particularly in Germany, the U.S. and Canada.

In the single-family housing rental market, new home completions are lower in an already undersupplied market and there has recently been a dramatic reduction in existing homes for sale, thereby limiting the ability of people to shift from renting to owning.

Also noteworthy, Southern California finally lifted tenant eviction moratoriums and non-paying tenants have either found the means to pay rents owing or have vacated faster than expected now that they can no longer live rent free. This has meant that the bad debt for California REITs has improved, and they are able to generate cashflow growth faster than previously expected.

Meanwhile, after significantly underperforming in 2022, stock prices of the debt-laden German apartment companies enjoyed some respite for the June quarter. Having taken action to retain cash, including cutting discretionary capex and suspending or reducing dividends, the vehicles also managed to achieve some asset sales, albeit in some cases on terms generally favourable to the buyers. Regulation and government policy changes continue to complicate matters. In late June, a government commission found that it would be legally permissible for German government entities, such as the City of Berlin, to expropriate housing units, provided appropriate compensation, which could be less than appraised values, was provided to protect property rights. We view widespread expropriation as impractical due to the financial costs involved, in addition to political considerations.

Retail's changing dynamics

Retail property continues to represent a significant position in the Portfolio. Despite ongoing systemic concerns about the growth of ecommerce and cyclical concerns about the prospect of waning retail sales and increased tenant bankruptcies, we believe retail property supply and demand fundamentals have been underappreciated and that retail REIT pricing is attractive.

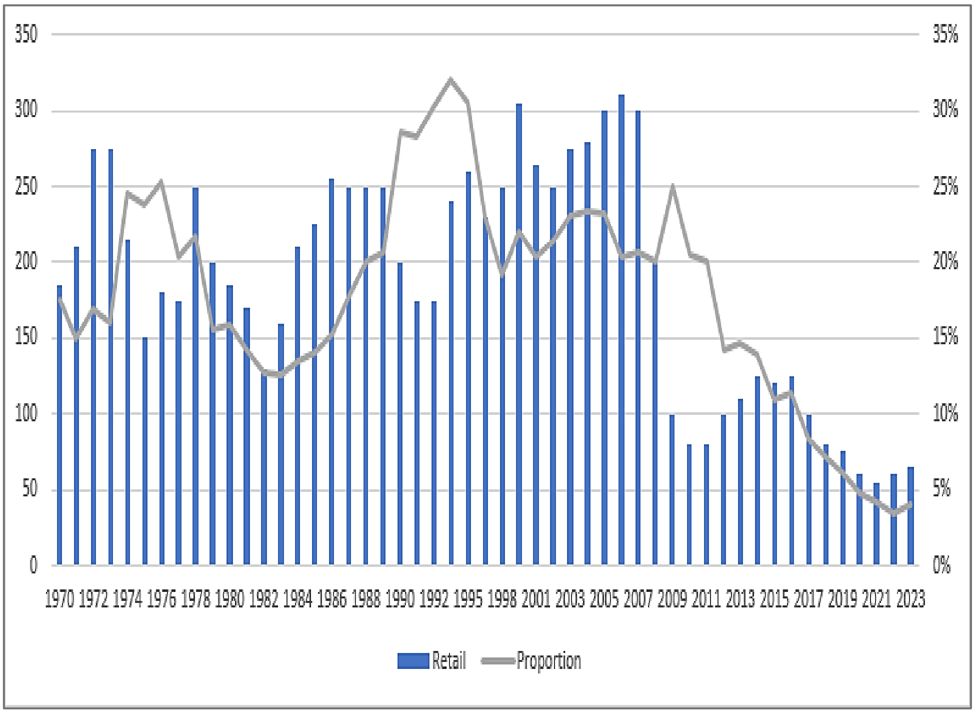
Our U.S. exposure focuses on strip centres, principally open-air shopping centres where stores front directly to the car park. Their tenant base is typically essential goods/services oriented but also comprises thriving discretionary retailers which are taking market share from malls and department stores. In response, traditional mall-only retailers are opening off-mall concepts.

Retail tenant bankruptcies are an inevitable consequence of creative destruction caused by ongoing competition and changing consumer spending patterns. Whilst department stores remain problematic for mall landlords, the rise of e-commerce and impacts of Covid have cleansed the retail landscape of many uncompetitive retailers, leaving the survivors seasoned to deal with now established on-line competitors (many of which ironically are opening physical stores).

During the quarter, U.S. retail landlords reported a continuation of solid leasing conditions. Most seemed unfazed by the collapse of some high-profile retailers such as Bed Bath and Beyond (BBBY) and remain confident in replacing derelict retailers. This conviction was most recently demonstrated by the outcome of the initial round of BBBY store auctions in late June (retailers/landlords bid to assume the lease): of 153 stores auctioned, 109 sold – the vast majority to retailers in store growth mode capitalising on below-market rents.

Importantly, the new retail building supply picture has changed greatly, which is reducing market vacancy and increasing landlord pricing power. In the U.S. in particular, the development of additional retail space has experienced a seismic downshift over the past decade. As highlighted in the chart below, in the 40 years to 2010, an average of 225 million sq ft of retail space was built each year. In comparison with other commercial real estate, the amplitude of supply was relatively low, perhaps reflecting the comparative stability of consumer spending. However, in the past decade, new construction averaged less than 90 million sq ft pa or just under 1% of total supply today, a 60% reduction. This dynamic is not expected to change in the near-term given construction cost inflation has meaningfully outpaced rental growth, with some landlords commenting rents would need to increase >25% for development economics to stack up.

U.S. Retail – construction vs aggregate commercial property construction (m sq ft)



Source: Citi

The combination of these factors has driven down U.S. retail vacancy rates to more than 15-year lows, and positions landlords favourably to endure any softening of retail spending in a slowing economy.

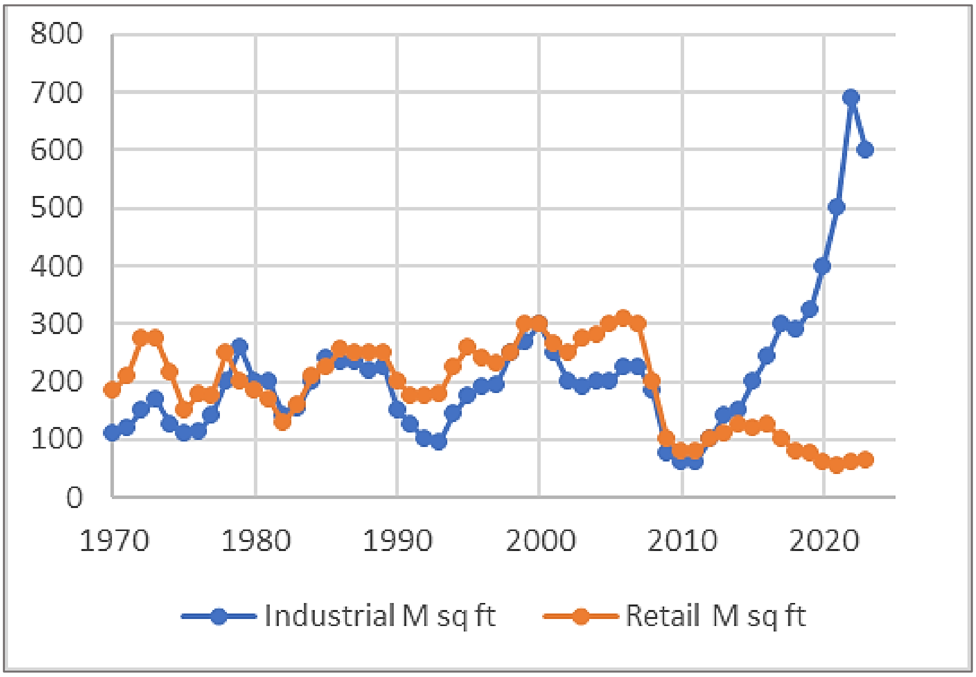
Outside the U.S., retail supply also remains subdued in most other developed economies. Focussing on Australia, our next largest regional concentration within our retail allocation, we note that few Australian shopping centre landlords are currently undertaking expansions let alone development on new greenfield sites. The expansion, including mixed-use densification, of Chadstone shopping centre in Victoria is one of the few currently underway as this property continues to create its own ecosystem seemingly immune to broader structural/cyclical factors. Whilst Australia's planning laws have ensured more limited supply, the overall lack of redevelopment is made starker when one considers historic relatively elevated supply conditions including during the throes of a major economic recession in the early 1990s.

Significantly, while retail supply has declined in many markets, capital is being re-allocated for additional space elsewhere in the property spectrum. Most significantly, in the U.S. in the 40 years to 2010, new retail space represented 20% of all commercial property construction. Today it represents less than 5%.

A New Paradigm – changing supply dynamics

The shift, highlighted in the chart below, has been the outcome of increased demand for industrial logistics warehousing over retail store footprints.

U.S. Construction – the shift from Shop to Shed



Source: Citi, FW Dodge

Elevated supply of industrial space has largely been absorbed over recent years, resulting in record low vacancy rates and strong industrial market rental growth across multiple markets. However, during the quarter early signs began to emerge of an upwards shift in vacancy rates in the Southern California logistics market, particularly larger sized distribution warehouses. This was not entirely unexpected, although attention was also drawn to potential disruption emanating from port workers' union wage negotiations in the busy Southern Californian ports which we see as a tertiary issue. We note that industrial vacancy rates remain low by historical standards (still below 4% in the U.S.) and that construction starts have recently decelerated from elevated levels, reflecting rising development costs and lower risk appetite to fund speculative development.

Prologis (PLD), which is no stranger to larger acquisitions, announced a US$3.1 billion deal towards the end of the quarter. The deal involves the acquisition of a 14 million sq ft U.S. portfolio of industrial properties from Blackstone managed opportunistic real estate funds, expanding Prologis' footprint by ~2.4%. The acquisition represents a ~4% cap rate, or ~$220 sq ft, which is lower than the implied yield of some U.S.-listed industrial REITs, including Prologis itself. The portfolio is reportedly 30% under rented, suggesting a path for the investment yield to improve to above 5% with some re-leasing over time.

While transactions of this size have been limited in the industrial space (and global real estate markets), and the pricing provides a timely update on industrial values, we have some reservations on the strategic rationale of the acquisition. The income metrics do not appear to be superior to PLD's existing portfolio and we understand it is skewed towards the Sunbelt markets that are experiencing softening conditions with elevated construction deliveries and rising vacancy rates.

ESG – Sustainability is no longer just a pretty word

Flight to sustainable quality in London driven by EPC regulations and tenant demand

Thanks to recent legislation and high profile tenant relocations, the UK is now a focal point for building energy efficiency. This has the potential to have significant consequences for the London office market in particular.

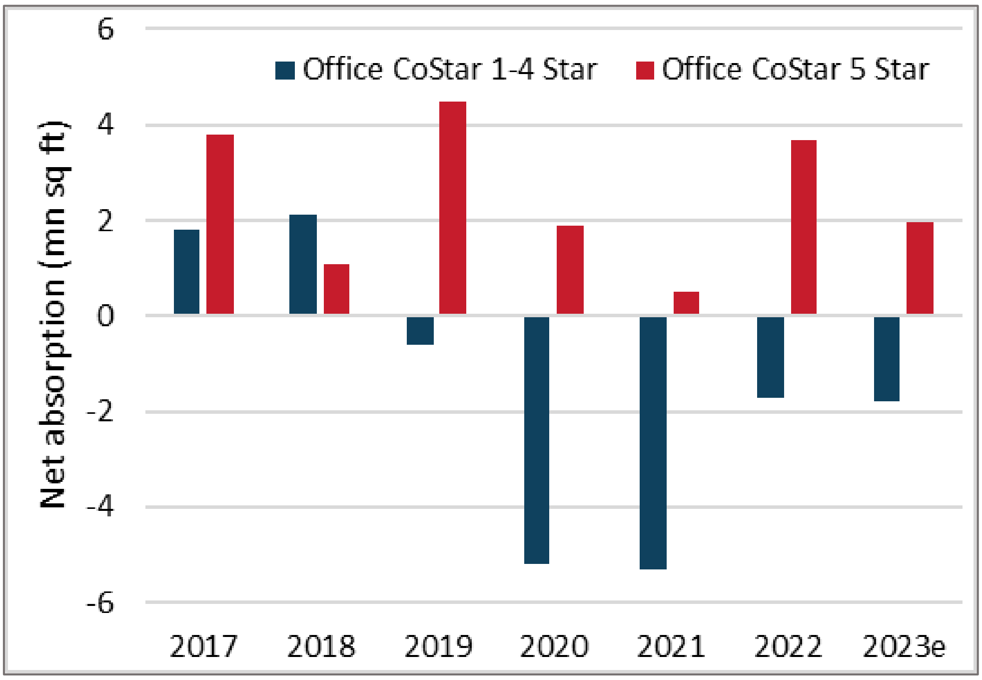
Under legislation in the UK, every building for sale or lease must obtain an Energy Performance Certificate (EPC), which is a measure of a building's energy efficiency. The properties are measured in a range from the most energy efficient (A), to the least energy efficient (G). In 2018, the UK government announced the Minimum Energy Efficiency Standards (MEES) legislation to improve the energy performance of buildings so that the property sector could contribute its fair share to the country's decarbonisation targets.

Initially, the MEES regulations set a minimum requirement of EPC E for buildings to be sold or leased, which came into force in April this year. Part of this regulation is to increase the minimum requirements in two stages. Currently, the proposals are for a minimum EPC C by 2027 and EPC B by 2030 for buildings to be sold or leased. These are much more ambitious levels and require significant forward planning by building owners. At the end of 2022, approximately 80% of office properties in London have EPCs below the 2030 requirement for EPC B and will have to undergo a significant level of refurbishments to improve their performance to achieve this level in the next 7 years.

While these latter stages of the MEES requirements have not yet been legislated, tenant demand for sustainable space is still pushing REITs to improve the sustainability credentials of their properties in line with increasing EPC ratings and with net zero carbon/energy performance. Recent announcements by professional services companies regarding office relocations to offices with higher levels of environmental performance are excellent examples of this "flight to sustainable quality" in the London Office market. In the last 6 months Pimco and Clifford Chance have both announced agreements to move to buildings in developments with higher EPC ratings and sustainability credentials to better align with their own corporate level net zero carbon goals. Most recently, HSBC announced that it is vacating its long-term head office in Canary Wharf to take up a smaller and more energy efficient tenancy closer to central London that would also help meet its corporate net zero target.

The chart below highlights the emerging bifurcation between low and high sustainable quality buildings, as those with 5 Star CoStar ratings have much higher net absorption than lower rated buildings.

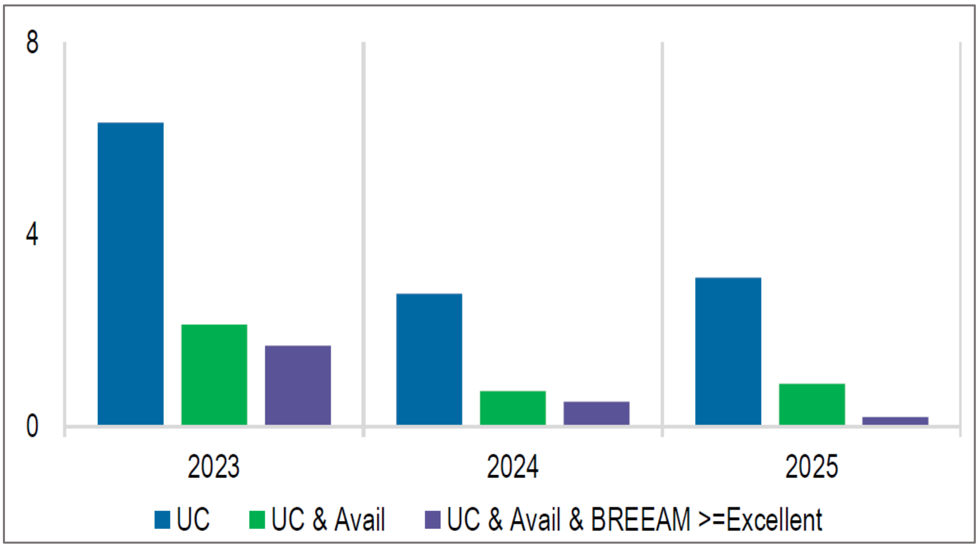
Two tier office market in London showing recent flight to sustainable quality



Source: British Land, 2023

This effect is being compounded by the low levels of highly sustainable office space under construction becoming available between now and 2025, shown in the chart below.

London offices:
Area (m sqft) under construction (UC), area available and area with high BREEAM ratings



Source: JP Morgan, CoStar, 2023

In recent trips to London, our team has been inquiring how companies are preparing for this increasing shift to sustainable properties driven by both increasing regulations and tenant demand. We visited Derwent London (DLN), Shaftesbury Capital (SHC), Unite Group (UTG), Grainger (GRI), as well as Land Securities (LAND) and Great Portland Estates (GPE).

Each of these companies saw this shift approaching and were preparing for both the EPC B requirement in 2030 and for the demand by tenants for highly sustainable spaces that is happening now. These preparations include quantifying the capex required to lift the environmental performance of their properties, ranging from GBP 20m to GBP 135m, formulating asset level decarbonisation plans and internal carbon prices that are used to fund these expenditures.

We were left with the message that encapsulates the issue: a building does not have to be Prime to be sustainable, but it has to be sustainable to be Prime.

Conclusion and Outlook

More than 12 months after the U.S. Federal Reserve launched its attack on above target levels of inflation, investment markets are still trying to understand the nature and duration of elevated inflation, the ramifications of central bank responses, negative interest rate dynamics and the consequent impacts on economic growth.

Despite the ongoing macro concerns, our numerous management meetings and asset tours during the quarter continue to evidence healthy operating conditions for most real estate sectors. That said, prudently, most REIT managers are preparing for weaker tenant demand conditions in the year ahead.

The enthusiasm for private market real estate appears to have waned as capital has become more expensive if not scarce, and better value has emerged in listed REITs and other asset classes. Real estate transaction markets should become increasingly active as unlisted funds are forced to meet investor redemption requests and levered owners deal with less supportive lenders, particularly for assets facing declining income and/or requiring additional capital.

Fortunately, we see limited evidence of over building which suggests real estate should experience a relatively soft landing, although loan defaults emanating from increased office building obsolescence poses the greatest threat to the overall industry.

Whilst not currently enjoying a clear cost of capital advantage, the REIT sector is well positioned to deal with whatever scenario unfolds.

Overwhelmingly our Portfolio is positioned to endure if not prosper in these conditions in terms of the REITs taking advantage of value accretive leasing and investment opportunities. Notably our Portfolio holdings display outstanding characteristics:

- Balance sheets are robust in terms of overall leverage (<6x Net Debt/EBITDA, or Loan to Value less than 35%), with limited debt refinance risk, multiple sources of capital, and dividend pay-out levels that are covered by operating earnings after recurrent maintenance capital expenditure;
- Portfolios of properties are well located and well maintained, evidenced by above average occupancy levels;
- Real estate industry leading sustainability expertise which places them in a position to take greater market share in terms of leasing activity;
- Currently producing earnings growth of circa 4.5%;
- Trading at a discount to medium/long term average multiples and at a discount to appraisal based real estate valuations, providing investors with a margin of safety.

Disclaimer

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Fees are outlined in the relevant Sub-Fund supplement available from the Investment Manager's website.
The Sub-Funds are valued using the prices of underlying securities prevailing at 11pm Irish time the business day before the dealing date. Prices are published on the Investment Manager's website. A summary of investor rights can be obtained, free of charge at www.nedgroupinvestments.com.

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Isle of Man: The Fund has been recognised under para 1 sch 4 of the Collective Investments Schemes Act 2008 of the Isle of Man. Isle of Man investors are not protected by statutory compensation arrangements in respect of the Fund.

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