NIMBLE WISDOM GLOBAL

Bullish Fed, bearish markets | 31 July 2017

SESFIKILE CAPITAL
Listed Property Investments

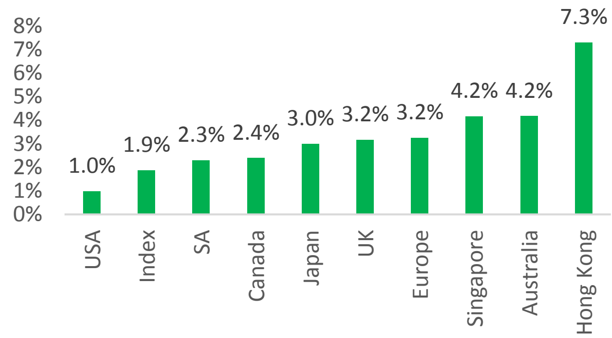
MARKET OVERVIEW

Global REITs continued their positive streak in July by closing 1.9% in the green, again underperforming global Equites (MSCI World Equities Index) that delivered 2.3% over the month. US 10-year Treasury yields closed 1bp lower over the month as projected global growth continues to undershoot, driven in the main by the US, as the Trump administration continues to lose the confidence of economists.

US GDP for the second quarter came in at 2.6% which was largely expected, and significantly higher than the 1.2% reported in the first quarter of the year. The US also added 209 000 jobs in July, significantly higher than the 180 000 expected thereby taking the unemployment rate to 4.3%. After a third attempt the US Senate declined Trump's administration's bid to repeal and replace the Affordable Care Act ('Obamacare'). In the same week, US press secretary Anthony Scaramucci resigned after just 10 days in office. Forecasters have further lowered the chances of significant tax cuts and the delivery of any major infrastructure program by the Trump administration; a key panacea for the anaemic GDP growth and failing manufacturing base in the US.

This month global REIT performance was dragged down by the US at 1% with every other region outperforming the benchmark significantly. Hong Kong REITs led at 7.3% with other regions delivering between 2% and 4.2% over the month.

Chart 1: Monthly returns per region



Source: Bloomberg, as at 31 July 2017

Key Points in this report

- After delivering a total return of 1.1% in June, Global REITs accelerated to 1.9% in July with all other regions except the US showing returns between 2-7.3% for the month.
- US second quarter GDP rose 2.6% which was better than the expected 2.1% and significantly higher than the 1.2% delivered in the first quarter. US Treasury bond yields fell by 1bps to 2.29% as market concerns about the Trump administration's inability to execute on pre-election promises elevate; the third attempt to repeal and replaced Obamacare failed.
- Second quarter results out of US REITs have for the most part been positive with most companies meeting or exceeding consensus estimates and many raising guidance due to improved operating metrics. Industrial and Strip Centres outperformed the best relative to expectations. Pan European mall REITs also posted strong results with more upbeat outlook statements.
- Global REITs trade at a 4% dividend yield and earnings growth is likely to be slightly higher than our initial expectations. The sector is on track to deliver approximately 7% in USD.

The fifth Federal Open Market Committee (FOMC) meeting for 2017 was held on the 25-26 July 2017 and as expected the committee decided to keep the Fed Funds Rate unchanged between 1.0% and 1.25%. More importantly the committee "expects to start implementing its balance sheet normalization program relatively soon". The Fed noted that inflation continues to run below the 2% target and missed market estimates in June. CPI increased by 1.6% in June compared to estimates of 1.7%. However, the economy continues to grow and job gains have been strong. US GDP for Q2 2017 grew by 2.6% annualised rate (market estimate of 2.7%), significantly higher than first quarter annualised rate of 1.2% (revised downwards from 1.4%).

The strong growth was driven by the 2.8% increase in consumer spending which makes up 69% of GDP. The US economy added 209 000 jobs in July beating markets estimates of 180 000 jobs. The unemployment rate dropped by 10bps to 4.3% driven by a 10bps increase in the labour force participation rate to 62.9%. The growth in hourly earnings remained flat at 2.5% year-on-year.

REIT results:

This month most US REITs reported second quarter results which were generally quite impressive. Earnings misses were few and far between with most REITs meeting or exceeding estimates and guidance being maintained or increased for the full year. Key stocks that showed better than expected results were logistics REIT Prologis, strip centre REIT Kimco, Apartment REIT Essex Property Trust and A class mall REIT Simon Property Group. On the other hand, although meeting Q2 estimates, guidance reductions were announced by mall REIT GGP Inc, Apartment REIT Avalonbay Communities and hotel REIT RLJ Hospitality.

By sector we saw better than expected results from the Industrial and Strip Centre space and an overall upgrade in FFO growth estimates in 2017. Although at the beginning of the earnings season, below we also report on European first half results with pan European mall REITs Hammerson, Unibail-Rodamco and Klepierre all reporting strong results and more upbeat outlook statements. Hammerson did however express concerns about the UK retail environment with some poor sales figures in their French portfolio.

Company	Results comment
Avalonbay Communities	Apartment REIT AVB reported Q2 2017 Core FFO/share of $2.09 equivalent of 3.0% y/y growth but $0.01 lower than market estimates. SS NOI was up 2.1% driven by SS revenue of 2.5% and SS expense growth of 3.5% (SS NOI and SS Exp were worse than expected). In terms of operating expenses, property taxes, payroll and repairs & maintenance increased 33.3% y/y, 22.5% and 17.2%, respectively. SS rental grew 2.5% and occupancy remained flat at 95.4%. The company has a net debt to EBITDA ratio of 5.0x with a weighted average interest rate of 3.6%. AVB has $3.6bn worth of assets under construction at a total weighted average yield of 6.0%. Management reduced 2017 Core FFO/share guidance from $8.44-8.84 ($8.64 midpoint) to $8.50-8.70 ($8.60 midpoint). Driven by a reduction in FY 17 SS NOI expectations from 2.0-3.5% (midpoint of 2.75%) to 2.25-2.75% (midpoint of 2.5%) based on an increase in SS Expense guidance from 1.5-2.5% to 2.25-2.75%. SS revenue guidance midpoint was unchanged at 2.5%.
Cubesmart	Self-storage REIT CUBE reported Q2 adjusted FFO per share of $0.39, representing a y/y increase of 8.3% and beating market estimates by $0.01. SS NOI grew 5.0% driven by 4.2% growth in SS revenue a 2.5% increase in SS expenses. SS revenues were driven by 3.9% rental growth and 20bps y/y increase in occupancy to 94.6%. CUBE's SS advertising spend decreased 15% compared to an 40% increase for Public Storage. High debt used to be a concern with CUBE, however the net debt to EBITDA ratio is now 4.93x, which is acceptable. Management increased the low end of FY17 FFO guidance by $0.01 to between $1.53 and $1.57. Management also reaffirmed SS NOI guidance of between 4.0% and 5.0%, driven by SS revenue growth of 3.75% to 4.75% and SS expense growth of between 4.0% to 5.0%.
Hudson Pacific Properties	US West coast office REIT HPP reported FFO of $0.48 equivalent to growth of 11.6% y/y and beating market expectations by $0.01. Blended cash spreads were up 48% on a cash basis and 67% on a GAAP basis. Overall SS NOI was up 10.5% driven by 6.4% growth in SS revenues and a 1.2% decline in SS expenses. AFFO payout ratio for Q2 increased to 100.2% from 82.5% a year prior. 6-month AFFO payout ratio is at 94.7% compared to 77.5% in 2016. The company had a net debt to EBITDA ratio of 7.3x. Management narrowed its 2017 FFO guidance to $1.93-$2.01 from $1.92-$2.02 (midpoint remains at $1.97). Management expects office cash SS NOI growth of between 8.5%-9.5% (midpoint 9.0%) from 6.5%-7.5% (midpoint 7.0%). Management expects media and entertainment cash SS NOI growth of between 7.5%-8.5% (midpoint 8.0%) from 5.9%-6.9% (midpoint 6.4%).
Prologis	Logistics REIT PLD reported Q2 2017 core FFO of $0.84, equivalent to 40% growth y/y and 7.4% better than the market expectation of $0.78. Cash SS NOI increased 7.2% driven by a 11.2% increase in rentals (24% increase on a GAAP basis) and a 50bps y/y increase in average occupancy to 96.2%. US operations make up 72.8% of NOI followed by Europe at 16.1%. PLD has a $2.9bn development pipeline which is 30.5% pre-leased with an estimated weighted average yield of 6.3%. During the quarter, the company purchased $37.5m worth of assets at a 5.9% cap rate and sold $345.7m worth of assets at a 6.1% cap rate. PLD reduced its debt to EBITDA from 5.2x in Q1 to 4.9x in Q2. Management has increased its FY17 core FFO guidance 1.8% at the midpoint from $2.72 to $2.78 to $2.78 to $2.82.

Company	Results comment
Simon Property Group	US mall REIT SPG grew comparable FFO per share for Q2 2017 7.6% to $2.47 beating market estimates by $0.03. SS NOI grew 4.4% with ABR increasing 3.3% y/y to $52.10. Most importantly, blended leasing spreads for the TTM was $8.13, an increase of 12.9%. Total portfolio occupancy dropped 70bps y/y to 95.2% and total sales per square foot (SQF) increased 1.8% to $618/SQF. SPG's share of the costs of all new development and redevelopment projects under construction was approximately $1.3bn with an expected stabilized rate of return of 8%. FFO guidance is now between $11.14 and $11.22 per diluted share. This represents an increase of $0.04 from the midpoint of the range provided in Q1, after giving effect to the $0.36 per diluted share charge on the extinguishment of debt.
Store Capital	STORE Capital reported Q2 2017 AFFO of $0.44 (29.5% y/y growth), $0.01 ahead of market consensus. STOR has a weighted average rental escalation of 1.8% and occupancy was down 30bps y/y to 99.5%. The company made acquisitions of $184m in Q2 at a weighted average initial cap rate of 7.8%. Total investment activity for H1 was $604.6m with an initial weighted average cap rate of 7.8%. STOR had a net debt to adjusted EBITDA ratio of 4.9x and management expect the ratio to be between 5.5x and 6.0x by year end. Management reduced its FY AFFO guidance by $0.05 at the midpoint to between $1.69 to $1.71 from $1.74 to $1.76 – this was due to the 10% share issue to Berkshire Hathaway (no near-term plans to issue additional equity). Management re-affirmed net acquisition guidance of $900m.
Hammerson	Pan European Mall REIT Hammerson delivered 5.6% EPS growth with dividends up 5.9%. SSNOI came in at 3.4% led by Ireland and premium outlets at 12%, with UK retail parks (strip centres) lagging at -3%. NAV was up 4.3% to 771p placing the price at a 24% discount. HMSO reported £400m in disposals (25% retail parks) in 2017 with £300m in new developments to be deployed between 2017-2021. Balance sheet LTV stood at 37%, 80% of debt is fixed at an average cost of 3%. EPS Guidance expected to be 6-8% per annum with key rivers being 1) driven 2% LFL per annum from current portfolio, 2) developments at 6-8% yield and 3) lower funding costs via upcoming refinancing.
Klepierre	Pan European mall REIT Klepierre (LI) showed 4.9% EPS growth with 6.1% NAV growth to €37.00. SSNOI growth was 2.7%, outperforming indexation by 200bps driven by Scandanavian assets up 4.2% with Germany lagging at 0% growth. Underlying retailer sales were up 1.8% (led by CEE & Turkey up 6.9%, Hungary at 11.6%, Spain at 4.8%, Portugal at 4.4% with laggards being Scandanavia (-0.3%), Germany (+0.6%), France (-0.3%) and Italy (-1.2%) – interesting UL did a lot better in France and Germany but worse in CEE. The group LTV moved down 1% to 38% with an average cost of 1.9% (down 10bps) fixed for 6.3 years. LI bought back €344m of shares at a VWAP of €35.87 – management has capacity to go to €500m in terms of the Buy-Back program. Disposals were €242m at an exit yield of 5.9% slightly above book values and the development pipeline is €3.3bn at an average 6.5% yield. Guidance increased from €2.35-2.40 to at least 2.45/share.

Company	Results comment
Segro Plc	UK Logistics REIT Segro showed 5.4% NAV growth and EPS growth of 3.2% (diluted by rights issue) and dividend growth of 5% to 5.25p. SSNOI rose 3.9% (5.7% in the UK & 2.2% in Europe). LTV came down to 29% (from 33%) at an average 3.1% (down 30bps) with 2yrs added to the average maturity. Segro ramped up its development pipeline and has 40 projects at £597m with an ERV of £46m (66% pre-let) at a yield of 7.7% funded at marginal cost of debt of 1.9%.
Unibail Rodamco	Pan European large mall REIT UL showed 6.7% EPS growth and reaffirmed 6-8% guidance for 2017. NAV was up 5.4% to €206.20. SSNOI rose 3.7% with offices up 7.8%, malls (82% of NOI) up 3.4% and the exhibition business (7% of NOI) up 2.5%. UL sold 5 assets at €597m, 17% above book value at a 4.1% yield. Proceeds will be redeployed towards the development pipeline at €8.1bn (19% offices, 81% retail, 34% in France) at yields of 7-9%. Key developments opening in 2017 are Wroclavia in Poland, 80 842sqm, 97% pre-let (oct 2017), Centrum Chodov in Prague, 42k sqm, 98% pre-let (oct 2017), Carresenart in France, 29k sqm extension, 83% pre-let (oct 2017), Glories in Barcelona, 11k sqm extension to 70k sqm, 98% pre-let – city centre mall (Nov 2017). Balance sheet LTV down 2% and now 33%, fixed for 7.4 years at an average cost of 1.4%.
Unite Group	UK Student accommodation REIT Unite showed 10.4% growth to 18p with dividend growth of 22% to 7.3p. NAV up 4% to 669p. SS NOI rose 5% but management has guided 3-3.5% for 2017. UTG sold £472m in assets in H1 at 3% above book value and bought £227m in properties adding 2000 beds to the portfolio, taking the portfolio to 45% London and 73% in top 10 student markets, 85% aligned to mid to high end Universities with average portfolio age of 8 years. The company confirmed a development pipeline of 7213 beds at £521m at an 8.2% yield – the expected margin on developments is 29% which will add 14-16p of EPS (88% of current EPS base) and add 46p of NAV (7% of base NAV) if they don't get any more value uplift. The balance sheet remains in decent shape at a 30% LTV (down 4%) with a cost of debt still high at 4.2%, 93% fixed for 5.2 years with less than £30m expiring in 2017. UTG has 91% of bed reserved for the next 2 years and 59% of that are from the universities on 6-year leases on UK RPI.

LOOKING FORWARD

As noted from the relatively small sample set of results above, Q2 earnings were impressive relative to consensus estimates, particularly in US Industrial and Strip Centre REIT space. Furthermore, based on guidance statements we will likely revise FFO ('earnings') growth numbers up for 2017 as demand has managed to broadly keep up with elevated supply in most sectors and regions. Despite this, in general terms, its evident that commercial real estate globally is a bit later in the cycle but we continue to argue that the spread between forward dividend yields and bond yields is wider than the long-term average, implying the market is discounting a rising interest rate environment - a decent 80bp margin of safety. We still see value in the asset class at current levels where investors should achieve high single digit returns over the medium term.



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