NIMBLE WISDOM GLOBAL

One more time... | 30 September 2017

SESFIKILE CAPITAL
Listed Property Investments

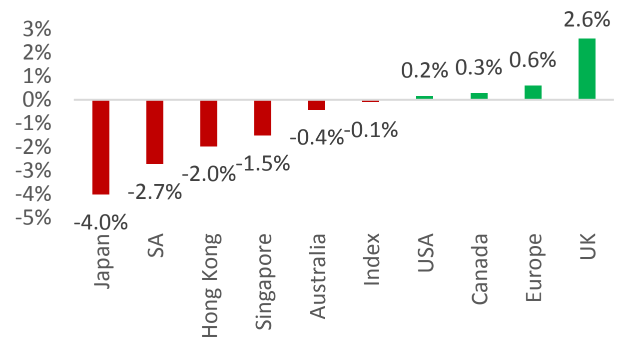
MARKET OVERVIEW

Global REITs have delivered two consecutive months of pedestrian returns with September closing 10bps lower taking year-to-date returns to 5.4% in USD. US Equities (S&P 500) closed 2.1% higher while European Equities (Euro Stoxx 600) pushed ahead closing 3.2% higher. US 10-year Treasury yields rose 22bps over the month to close at 2.33%, driven mainly by the Federal Open Market Committee (FOMC) meeting that confirmed that balance sheet normalisation would commence this October and inferred that a further interest rate hike was on the cards for 2017. This was vindicated by a revised Q2 GDP estimate of 3.1% y/y. However, 33 000 jobs were lost during September compared to the expectation of approximately 80 000 jobs being added, but much focus was on wage growth which accelerated to 2.9%.

At the end of Q3 Catalonia (Spanish province where Barcelona is located) held a referendum vote with 90% of voters choosing to exit Spain and be an independent state. The Spanish government and monarchy has deemed the vote illegal which resulted in violent clashes between the police and voters, thereby sending Spanish equities and REITs around 3-10% lower in the first week of the results.

UK and European REITs led this months' gains at 2.6% and 0.6% respectively while laggards were Japan (-4%) and Hong Kong at -2%.

Chart 1: Monthly returns per region



Source: Bloomberg, as at 30 September 2017

Key Points in this report

- Global REITs were flat again this month, closing -0.1% in the red, taking year-to-date returns to 5.4% in US dollars, lagging Equities for the year.
- US 10-year Treasuries saw negative returns with yields rising 22bps to close at 2.33%. The FOMC statement confirmed balance sheet normalisation in October and inferred one more interest rate hike in 2017. US GDP was revised up to 3.1% with wage growth accelerating to 2.9% and unemployment falling from 4.4% to 4.2%
- In this note we focus on Spain and how we see property fundamentals over the next 12-18 months. REIT results include Irish Office player Green REIT, French convenience centre REIT Carmila and diversified Spanish large cap Merlin.
- Global REITs currently trade at a 4.2% forward yield vs. global bonds at 2% (weighted average) implying a 220bps yield spread. This gives investors an approximately 70bp 'cushion' relative to the long-term spread of 150bps.

Last month the FOMC members attended their sixth 2017 meeting and expectedly kept rates unchanged. However, they decided to initiate the balance sheet normalisation, in effect shrinking the Fed's $4.5 trillion balance sheet by not re-investing securities as they mature. The FOMC statement also indicated that another interest rate hike was on the cards which saw US 10-year Treasuries rise. Q2 US GDP (final estimate) came in 10bps above consensus at 3.1% with consumer spending (65% of GDP) growing 3.3%. Due to hurricanes Harvey and Irma, which may have temporarily curbed activity, Q3 GDP may slow down and rebound in the fourth quarter. US nonfarm payroll employment for September fell by 33 000 jobs (vs. estimates of 80 000) attributed to Hurricanes Irma and Harvey. However, the unemployment rate decreased by 0.2% to 4.2% and the labour force participation rate was up 20bps to 63.1% with wage growth accelerating to 2.9%.

REIT news and results:

A focus on Spain:

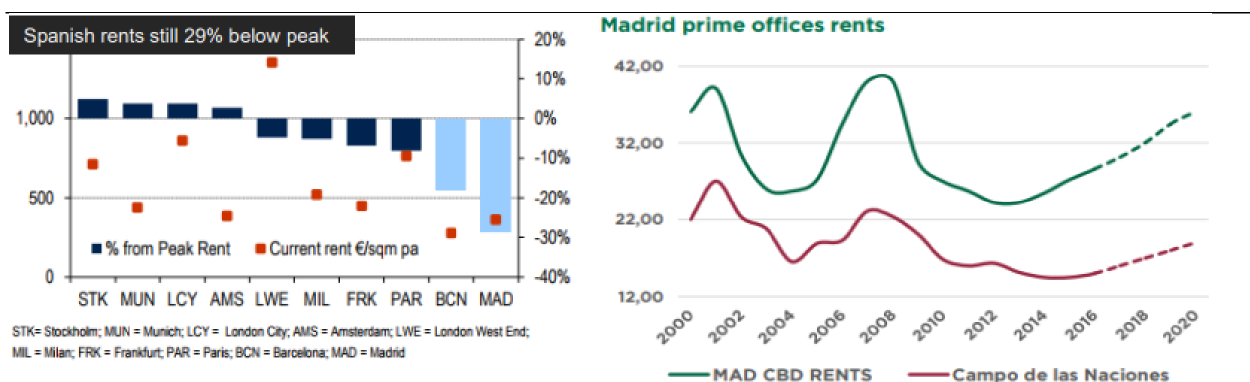
As the third quarter ended with the possible 'relief' around Angela Merkel's victory and a view that Europe's political woes were largely in the rear-view mirror, Catalonia (province where Barcelona is located) held an independence referendum which resulted in 90% of voters choosing to leave Spain and become an independent state. The Spanish government and King has ruled the vote as 'illegal' and sent riot police to confiscate ballot boxes which resulted in massive disruption. The real blow to equity markets came a few days later when the EU simply stated that the rule of law should be observed, sending Spanish equities 3% lower with some REITs falling as much as 5.6% on the day.

This month we appropriately focus on the Spanish real estate market, that, after experiencing significant cap rate compression over the last 2 years has finally started to see real evidence of rental growth. In July our locally listed Vukile Property Fund acquired a portfolio of nine retail centres in Spain for €193 million at a 6.2% yield. With a 2.7% vacancy, average lease term of 15.6 years and embedded rental growth of approximately 3% per annum (via escalations) the portfolio was not cheap but presents a platform for Vukile in a region that is poised to remain one of the fastest growing in Europe. Within 12 months of the acquisition, Vukile will list Castellana REIT (named after a famous Spanish high street) on the JSE.

Going back to fundamentals, our deep dive analysis into fundamentals does largely confirm that Spain ranks among the best European countries to invest in from a property perspective. No doubt the last 18 months saw a massive 300-400bps cap rate compression from around 8.5% for prime assets to 4-6%.

In that regard private equity funds have enjoyed 'easy' IRRs over this period as returns have been driven by yield compression where the next 2-3 years will be earnings growth driven. Importantly GDP growth is expected to be in the 2.8% region (1% above EU average) and unemployment, although high has fallen from a peak of 25.7% in 2012 to 17.3% in June 2017. Fortunately, we have started to see evidence across all sectors; **Offices** in core markets (e.g. Central Madrid and Barcelona) have seen rents rising in the region of 4% and as shown in Chart 2, are well below the 2008 peak and earlier in the cycle on a comparative basis. Overall vacancies remain at 9% in Madrid and 6% in Barcelona, but recent trends show that net office absorption is up 35% year-on-year with the highest number of leases above 2 500sqm being signed since 2008. Furthermore, Madrid only has nine buildings that offer 5000sqm and above in the A-grade category with 90% of all take up being in the A-grade office space.

Chart 2: Spanish Office rents well below previous peak, Madrid Office rents set to grow



Source: Kempen, Immobiliare Colonial

With rising incomes, employment levels and consumer confidence in the **Retail sector** has seen rental growth of 0-4.8% with higher growth being achieved in high street shops in Madrid, Barcelona, Parma and Malaga and lower growth rates recorded in other large cities such as Seville, Valencia and Zaragoza. Over the last 5 years retail parks have shown growth of 2.4-6% but have decelerated in the last 12 months, partly due to supply and competition from e-commerce which is currently lagging EU peers at 6% of all retail sales (1% in food), albeit growing at 21% per annum. Although rental growth has decelerated at malls and retail parks, tenant turnovers have been tracking 3.6% per annum (vs. retail sales at 2% per annum) over the last 12 months which is an encouraging sign for landlords. Supply is also modest, with 250 000sqm of deliveries coming in the next 12 months, importantly concentrated in six centres including Plaza Rio 2 (Madrid) at 130 000sqm, Intu's Costa del Sol (Terremolinos) additional 32 000sqm, Palmas Atlas (Seville), Torrecardenas (Almera) and Tamaraceite Sur (Las Palmas) and Designer Outlet Centre (Malaga).

In similar fashion to the rest of western and eastern Europe, the **Logistics sector** is where fundamentals are strongest and where we expect further improvement via rents and cap rate compression. 2016 saw a 45% increase in take up resulting in a massive vacancy reduction; Madrid and Barcelona are currently enjoying low vacancies of 3.4% and 2.9% respectively with an even more acute shortage of modern logistics warehouses (fit for e-commerce operations). Rental growth is expected to grow by 8% in Madrid and 5% in Barcelona over the next 12 months. Despite a strong market, supply has been slow to respond with 287 000sqm to be developed in Madrid (19% pre-let) and 398 000sqm to be developed in Barcelona (89% pre-let). Of the Barcelona focussed supply, just over 50% consists of a single 200 000sqm fulfilment centre to be occupied by Amazon in order to capitalize on the growing e-commerce market.

Lastly the **Lodging (hotels) sector** has continued to grow; tourist arrivals saw an all-time high of 10.4m visitors in H1:2017 (up 4%), tourist spending up 7% with hotel occupancies up to 86% and Revenue Per Average Rooms (RevPars) growing 8%. Developers are still seeing attractive double-digit yields (approx. 13% for listed REIT Hispania) and it is expected that the sector will see continued improvement in fundamentals as the EU economy grows (24% of tourists) and employment levels improve. The impact of a slower UK economy due to Brexit (22% of tourists) remains a key risk.

REIT news:

- **SL Green**, New York City's largest office property owner and private investor RXR Realty have agreed to acquire a 48.7% stake in a Class A, trophy asset located in Midtown Manhattan called One Worldwide Plaza valued at $1.7bn at a 5.25% yield. China Investment Corporation (CIC) is reportedly bidding for a 49% stake in SL Green owned 1515 Broadway in a deal that could value the office tower located in Midtown New York at $2.0bn at a 4.0% yield. This could provide an attractive capital recycling opportunity for SL Green.

- **Toys 'R' Us** is filing for bankruptcy protection under Chapter 11, which allows the company to use the bankruptcy proceedings to right size its unsustainable debt load, that was put in place following a $6.6bn private equity buyout in 2005. The market was surprised the company did not wait till after the holiday season to file for bankruptcy protection, however suppliers were tightening payment terms and the company lacked the working capital necessary to invest in inventory for the holiday season. Prior to the bankruptcy announcement, US REIT Vornado (VNO) wrote off its 32.5% ownership stake in Toys 'R' Us and will not be financially impacted by the filing.

- US Single-Family-Residential REITs **American Homes 4 Rent (AMH), Invitation Homes (INVH) and Starwood Waypoint (SFR)** disclosed that the SEC has issued subpoenas to each of them requesting information to assist an ongoing investigation of Green River Capital LLC a third-party provider of broker price opinions (BPOs) used for institutional single-family rental securitizations. The market believes that there is very little risk of legal recourse against the REITs as they were clients of Green River Capital.

REIT results:

Company	Results comment
Carmila	European convenience centre REIT Carmila (CARM) delivered 8.8% rental growth and 10% net operating income growth (NOI) over the last 12 months (IPO'd in 2017) with recurring earnings per share (EPS) rising 14.4%. NAV rose 5.8% to €27.34/share driven by cap rate compression and rental growth. Like-for-like (LFL) rents rose 3% across the portfolio with upward reversions up 7.6%, driven by French and Spanish portfolios while Italy was a drag. Vacancies fell to 3.6%, flat in France and Italy and 160bps lower in Spain due to new tenant demand. CARM has a €1.5bn development pipeline via 34 extensions and upgrades between 2017 and 2022 at an 8.5% yield. The balance sheet remains relatively stretched at a 41% LTV, with Cost of Debt at 2.1%, 83% fixed for 6.7 years. CARM expects to deliver 9% EPS growth per annum over the next 3 years.
Green REIT	Dublin focused Office (81% of assets) and Industrial REIT Green REIT (GRN) delivered 31% EPS growth and 9% NAV growth to €1.66/share. The portfolio valuation rose 8% (driven by cap rate compression) with LFL rents rising 3% over the period. GRN reported -€11m in net acquisitions and developments include Central Park (Dublin Office) at a 7.9% yield for €47m and Horizon Logistics Park (Warehouses next to Dublin Airport) at a development cost of €204m at an estimated 8.3% yield. GRN's balance sheet remains well positioned with a 20% LTV, 1.8% average cost of debt, 72% fixed for 2.8% years. The Dublin office market remains well positioned as an alternative for Brexit affected companies, and with 92% of new office developments pre-let, it's likely that rents will continue rising into the medium term.
Merlin Properties	Large cap diversified SOCIMI ("REIT") Merlin delivered 5.7% Funds-from-Operations (FFO) growth and reiterated guidance to deliver 15% growth for the full year. Dividends grew 4.6% with NAV growing 6% to €11.89/share over the period. Operational performance was impressive with LFL rents rising 2.7% driven by Logistics at 6.9%, Shopping centres at 3% (good see through for Vukile), Offices at 2.6% and dragged by high street shops at 0.9%. Upward reversions were up 16% in logistics and 6% in shopping centres. Merlin acquired €176m at a 7% yield and confirmed €130m in developments (mainly logistics) at an 8% yield. Merlin's balance sheet appears stretched at a 46% LTV, with 78% of debt fixed for 6.2 years at an average cost of 1.6%.

LOOKING FORWARD

After a relatively flat month global REITs now trade at a 4.2% forward yield, at a 224bps spread over global bonds that trade at 1.95% (weighted) in the 10-year space. The long-term average spread is 150bps which gives investors an approximate 70bps 'buffer' against rising bond yields. Last months' 22bps rise in US and UK bonds in particular did not result in a drop in REIT prices, thereby making a case for the valuation argument. With global developed economies lifting, we expect good property fundamentals to hold resulting in FFO/earnings growth of 5-6% per annum over the next 2 years with low forecast risk to this number. Europe continues to surprise on the upside and other key markets such as Sydney (office), West coast USA (all sectors), UK logistics showing an acceleration in rental growth.

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