NIMBLE WISDOM GLOBAL

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SESFIKILE CAPITAL
Listed Property Investments

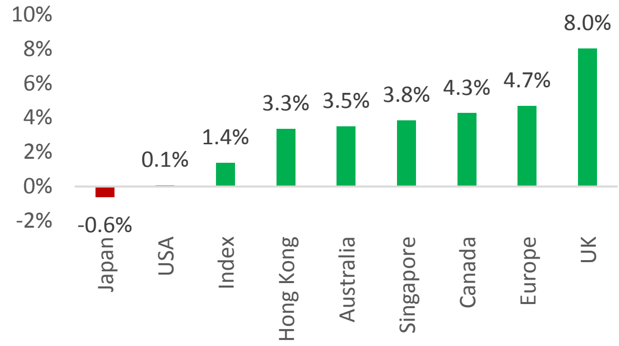
MARKET OVERVIEW

Global REITs (as per FTSE/EPRA NAREIT Developed Rental Index) rose 1.38% in USD in December slightly outperforming global Equites (MSCI World Index) that delivered 1.26% for the month. Global REITs delivered a calendar-year total return of 9.37% in USD, significantly underperforming US and global equities which achieved returns of 21.82% and 23.10%, respectively. The US 10-year bond yield started the year at 2.45%, peaking in the middle of March at 2.63% and troughed at the beginning of September at 2.04% before closing the year at 2.41%.

During December the US FOMC increased the target for the federal funds rate by 25bps to between 1.25% and 1.5%. This was largely expected and priced in. The Federal Open Market Committee's (FOMC) 'dot plot' (graph of interest rate expectations) showed that the committee expect three interest rate hikes in 2018. The FOMC expects core inflation to continue to run below the Fed's 2% target for 2018 but to stabilise "around the Committee's 2% objective over the medium term".

By region the UK REITs finished tops in December and closed 8.0% higher, followed by European REITs that closed 4.7% in the green. Other regions that outperformed the Index include Canada (4.3%), Singapore (3.8%), Australia (3.5%) and Hong Kong (3.3%) that closed in the green. This month's laggards include the US and Japanese REITs which close up 0.1% and down 0.6%, respectively.

Chart 1: Monthly returns per region



Source: Bloomberg, as at 31 December 2017

Key Points in this report

- Global REITs delivered 9.4% USD returns last year which was above our forecast of 7-8%. Equites outperformed at between 21-23% and US 10-year Treasuries closed 4bps lower at 2.41%. The Fed hiked rates in December by 25bps and the market expects between 2 to 3 hikes this year.
- Given our outlook for slightly higher bond yields in 2018 (+20-30bps) we remainconstructive on REITs. But, we must remind investors that we are later in the property cycle and earnings growth will likely moderate to 5% this year. Supply is rising in certain sub-markets such as New York, San Francisco, London and Tokyo. We favour the logistics sector broadly as e-commerce continues to be a structural tailwind and are still cautious on the retail sector in US, Europe and Australia. Taking all factors into consideration, valuations appear reasonable but certainly not cheap at current levels.
- Global REITs currently trade at 4.1% yield which is a 220bps spread to bonds. Total returns in the region of 6-7% in USD appear reasonable for the 2018 calendar year.

REVIEW OF 2017:

2016 was a year where politics and central bank activity dominated markets and 2017 started the year no different. After the UK referendum and Donald Trump winning the 'market destabilizing award' for 2016, European politics took centre-stage in bringing uncertainty to markets. 2017 was scheduled to host a string of elections in the Netherlands, France, Germany. In addition, Prime Minister Theresa May proposed a snap election UK election on 8 June and unexpectedly lost the majority she had prior.

The first quarter was dominated by President Trump's failure to repeal the Affordable Care Act ("Obamacare") which, to the market's interpretation reduced the probability of a tax cut. In March the US Fed raised interest rates for the first time in 2017 by 25 basis points to 0.75%-1%. The earlier than (initially) expected decision was based on the Fed's increased optimism about the US economy and employment, and the view that inflation will reach its target of 2% in the medium term.

On 15 March the Netherlands kicked off the string of European elections with Prime Minister Mark Rutte (leader of the People's Party for Freedom and Democracy - VVD) seeing off a challenge by the far-right anti-Islam, anti-EU Freedom Party. This was a positive precursor for the French elections which was held in Q2 (which was considered more important because it has a significant economic share of the EU pie, and even more significant portion of financial assets in Europe). The market was concerned that another far-right leader Marine La Pen was the frontrunner to win the first round of elections. Surprisingly the independent centrist Emmanuel Macron beat Marine La Pen in the first round (23.75% vs 21.53%) and then Macron won by a decisive margin (66.1% vs 33.9%) in the second round to become the youngest ever French president. French bond yields compressed, and equities and REITs rallied between 3-5%.

Turning to the United Kingdom's 'snap' election that took place on 8 June in which the ruling party (Conservative Party) suffered a humiliating blow as they lost 22 seats while leading opposition Labour Party added 21 seats to parliament. Conservatives lost the majority they previously enjoyed. The British Pound fell 2% on the results in anticipation of tougher Brexit negotiations. US economic data released in Q2 missed estimates (US Q1 GDP dropped to 1.2% and inflation represented by core PCE price index dropped to 1.5% y/y) however the FOMC stated that the relatively poor growth and inflation data from Q1 17 was 'transitory' and the committee decided to hike rates for the second time in 2017 at the June meeting.

During the third quarter, the FOMC confirmed that balance sheet normalization would commence in October, in effect shrinking the Fed's $4.5 trillion balance sheet by not re-investing securities as they mature. The FOMC also indicated that another interest rate hike was on the cards for 2017 which saw US 10-year bond yields rise to 2.33%. At the end of Q3, Germany held its Federal Elections and Angela Merkel secured a fourth term as German chancellor as The Christian Democratic Union (CDU) won 32.9% of the votes. However, the large center-right and center-left parties were dealt a big blow when the radical right-wing party Alternative for Germany (AfD) entered parliament as the third largest party by winning 12.6% of the vote (the first far right party to enter parliament in 60 years). As at the beginning of 2018 Chancellor Merkel continues to hold talks with other parties in order to form a coalition government.
Continuing with European politics, at the start of Q4 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.

During the final quarter of 2017 the Bank of England (BoE) raised interest rates by 25bps to 0.5% for the first time in decade. Although this was partly priced in a few months prior, Mark Carney's extremely dovish comments seemed to push UK Gilts lower as the rate of hikes is likely to be seldom and 'shallow' which weakened the British Pound slightly against major currencies. In the US the FOMC increased the target for the federal funds rate by 25bps for the third time in 2017 to between 1.25% and 1.5%. However, this was largely expected and priced in. President Trump announced Board Governor Jerome ('Jay') Powell as the next Federal Reserve Bank (Fed) chair starting in February 2018. Jerome Powell will be the first Fed Chair without a Ph.D. in economics but comes with 30 years of experience in investment banking, law and public policy. Powell has a similar view with Chair Yellen when it comes to the path for policy and his leadership is not likely to lead to a structural shift in the medium-term monetary policy outlook.

The highlight (or low-light if you were a US democrat!) of Q4 occurred on 22 December 2017, when President Trump signed the Tax Cuts and Jobs Act of 2017 into law delivering Trump's first major legislative victory of his first year as president. Apart from various other changes the tax reform bill reduces the corporate tax rate from 35% to 21%. The bill is a $1.4 trillion tax cut and is expected to add between 20-40bps to US GDP for 2018. As a result of the tax reform the FOMC has revised US real GDP growth for 2018 up modestly to 2.5%. Real GDP is then expected to moderate to 2.1% and 2.0% in 2019 and 2020, respectively. For US REITs in particular the tax cuts are viewed as relatively negative because these companies have little to gain because they pay no or very little corporate income tax.

LOOKING FORWARD: OUTLOOK FOR 2018

Region	Outlook
United States	The US commercial property market is relatively late in the cycle and the slowdown in earnings growth began in 2017. That being said supply did not affect SS NOI to the extent that was initially expected. We see the most significant rise in supply occurring in Senior Housing, Multifamily (apartments) and the Office sector with higher levels of new supply occurring in coastal markets such as New York, San Francisco and Seattle (although Seattle demand remains high). Our FFO growth estimate is approximately 5% led by Data Centres, Manufactured Homes, Single Family Residential, Logistics and Class-A Malls. Laggards over the medium term will likely be Self-storage, Healthcare and Triple Nets with other sectors hovering around the 5% mean. Corporate action in the retail space may continue, but the market is still unsure about the level of store closures to come with Macys and Sears announcing further store closures, and cap rates looking slightly higher than initially expected at 5.5-6% for Class A malls. US REITs are trading roughly in line with NAV with high growth sectors trading well above and Class A malls still around 25% discount to NAV. Balance sheets are in good shape and credit markets are abundant which leaves us with little concerns about financial risk in the sector. As earnings slow-down high growth sectors could remain expensive and possibly outperform the cheaper sectors.
Canada	Due in part to (1) the lag effect in Resource based local economies, (2) earnings impact of deleveraging and (3) latency between capital raising and deployment, earnings growth of -3% for Canadian REITs was very soft in 2017, despite strong share price performance. Underlying SSNOI was much better at 1.4% and FFO growth should accelerate to 4% in the coming year. By sector Apartments still lead at 5% FFO growth and 6.5% SSNOI growth driven by prohibitively high house prices, migration in major cities like Toronto and limited new supply. Retail will be affected by e-commerce and the Sears Canada bankruptcy which may cause a few quarters of indigestion; albeit SSNOI could still reach 2% this year with FFO growth reaching 3%. After showing -3% FFO growth in 2017, the logistics sector earnings should track SSNOI in the region of 1.6% with cap rates expected to fall further.
United Kingdom	Despite an 8% rally last month, the UK remains one of the cheapest regions globally, but with prolonged Brexit uncertainty a massive re-rating may be difficult to see. Recent meetings with UK REITs confirm that management teams ard being cautious are expect rents to moderate over the next 3 years with office supply rising in 2020. The consumer has been resilient but with higher inflation and weak job growth the retail environment is looking the most 'shaky'. With e-retailing at 17% of all sales, growing demand for Amazon and retailers changing their offering towards online, limited land use rights due to Green-belt policies the UK is the best logistics market globally. Supply remains at 1.2m m² versus projected demand at 2m m² and no vacancies in large warehouses above 100 000m². Strong rental growth is expected to continue in this sector.
Europe	Most of the political risk in the EU (post Dutch, French and German elections) has receded where investors can focus on the economy. GDP growth is improving but remains benign with forecasts of 1.6% for 2018. CPI has remained stubbornly low which has pushed out expectations of ECB tapering towards Q4:2018. The property sector has had a 3-year bull market driven primarily by massive cap rate compression: Office cap rates in prime locations of Germany and France and other key capitals have fallen below 3%. Vacancies across most sectors have also compressed by some 300bps to 5-7%. REIT earnings have averaged 4-6% over the last 2 years with German residential leading at 17%. Our analysis however shows, that, aside from German Residential at 3.5%-4% SSNOI growth, organic growth has been anaemic at best at 1% p.a. where earnings drivers have been 1) debt refinancing from 4% to sub 2%, 2) yield enhancing acquisitions showing a 450bps funding spread and 3) development activity. Looking forward, debt costs cannot go much lower, and cap rates have compressed thereby leading to lower funding spreads – the easy money has been made and returns will now be driven by earnings growth which is only really existent in German residential, Spanish office and industrial and Irish offices.

Region	Outlook
Japan	Japan's GDP is likely to accelerate to 1.6% and inflation tracking closely due to labour shortages that have finally started to cause inflationary pressures. The office sector has enjoyed 3 years of persistent vacancy reduction to 3.1% (sub 2% in five central wards) and subsequent rental growth in the region of 4%. However, due to elevated 2018 supply at 1.6m m² and a low level of pre-commitment at 18%, rents will likely peak and possibly turn negative towards Q4. With e-commerce penetration at 5% and 3.6% of all logistics space comprising fit-for-purpose modern warehouses, the industrial sector (mainly Class A) is likely to continue to show outperformance. Supply has responded to 3.2m m² but demand is expected to exceed this at 4m m². Despite a strong consumer and low e-commerce penetration, the retail sector is likely to show muted 0-1% rental growth.
Singapore	S-REITs outperformed in 2017 achieving 40.9% USD return as rental declines decelerated across the board, furthermore, we expect Office and Industrial rents to bottom out in 2018. A-grade office rents could rise by 2% this year but vacancies remain relatively high at 8%. The logistics sector saw a sharp rise in supply last year to 10% of existing stock which will tapper to 1% this year. That being said rents will likely fall further as vacancies remain elevated at 11.4%. The retail sector is still faced with supply headwinds and increased disruption due to e-commerce activity forcing negative reversions and higher-than-average tenant churn as occupancy costs in large malls have peaked at 19% of turnover. Market rents are likely to fall by 4-5% p.a. over the next 2 years. The hotel sector is also likely to see soft RevPar growth due to higher supply of rooms and fewer travelers due to a stronger SGD. Fundamentals have improved but remain challenged, and valuations may have gone a bit ahead of themselves.
Hong Kong	After a 44.6% USD rally in 2017 we are still constructive on HK REITs as they are still trading at a 4.4% yield and 270bps spread over HK bonds. Importantly property fundamentals have started to improve across all major sectors and we see an acceleration in office rents from 3% to 5% as vacancies have compressed to 6% (sub 3% in core central locations). Driven by the Chinese corruption crackdown in 2014 retail sales have been negative until Q2 when they rose 2.5% and accelerated to 12% in Q3:2017. Luxury retail sales have also started to recover considerably which should translate to positive rents in 2018 after -1% last year. REITs have rallied but still trade at significant double-digit discounts to NAV.
Australia	Australia's GDP is set to slowdown from 2.7% to approx. 2% with CPI set to remain around 2%. Property fundamentals have been strongest in Sydney Office with vacancies at 3% and incentives down to 10-15% (or 0% in smaller buildings) where market rents are up 18% y/y. 2018 will likely see some deceleration but strong growth in the 8-10% region is still achievable. Brisbane is playing catch up where incentives have come in from 30% to 20% and Melbourne is set to show 5% rental growth this year. The retail sector is where we still have concerns as e-commerce continues to disrupt, and apparel retailers are failing to sustain already low margins. Occupancy cost ratios for major malls have peaked at 18% which puts downward pressure on new rents. Although vacancies have stayed low, major malls have expanded significantly over the last 2 years which may lead to higher vacancies over the next 12 months.

Global REITs outperformed our 7-8% forecast last year, and given our outlook for slightly higher bond yields in 2018 (+20-30bps) we remain constructive on REITs. Global economies appear to be synchronizing with respect to GDP growth and inflation which is positive for property fundamentals. We must remind investors that we are later in the property cycle and earnings growth will likely moderate to 5% this year. Supply is rising in certain sub-markets such as New York office and residential, San Francisco office, Singapore hotels, London housing and office and Tokyo offices. We favour the logistics sector broadly as e-commerce continues to be a structural tailwind and are still cautious on the retail sector in both US, Europe and Australia. Taking all factors into consideration valuations appear reasonable but certainly not cheap at current levels. Global REITs currently trade at 4.1% yield which is a 220bps spread to bonds. Total returns in the region of 6-7% in USD appear reasonable for 2018.

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