NIMBLE WISDOM GLOBAL

Bond yields scratch the ceiling | 31 January 2018

SESFIKILE CAPITAL
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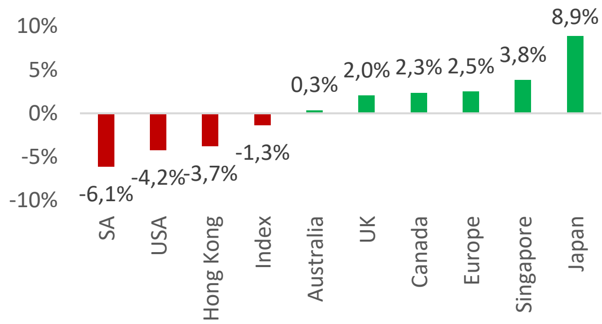
MARKET OVERVIEW

Global REITs (as per FTSE/EPRA NAREIT Developed Rental Index) saw a 1.34% correction in January, in effect reversing the 1.38% gain recorded in December 2017. REITs underperformed equities significantly (-662bps) this month as MSCI World Equities rose 5.28%. Importantly, US 10-year bond yields rose 30 basis points during the month from 2.41% to 2.71% and have continued to rise to 2.88% at the time of writing this report. Due to higher GDP and wage growth, higher inflation is being priced into the bond market.

The US Federal Open Market Committee (FOMC) met in January and kept interest rates unchanged, as was widely expected. Outgoing Fed Chair Janet Yellen's comments however did intimate that they saw US economic and labour data as solid, indicating that the Federal Reserve (Fed) was on course to raise interest rates this year. Consensus estimates remain at three to four hikes in 2018. The US added 200 000 jobs in December which was 20 000 more than expected. Importantly wages rose by 2.9%, 30bps higher than the expected 2.6% with unemployment remaining flat at 4.1%. Jerome 'Jay' Powell, the incoming Fed chair was sworn in on 5 February.

Regional performance showed Japanese REITs lead at 8.9% followed by Singapore at 3.8% and Europe at 2.5%. Other outperformers included Canada at 2.3%, UK at 2% and Australia at 0.3%. Laggards this month include Hong Kong at -3.7% and US REITs at -4.2% (all returns in USD).

Chart 1: Monthly returns per region



Source: Bloomberg, as at 31 January 2018

Key Points in this report

- Global REITs fell 1.3% in January, underperforming global equities by 662bps this month. US 10-year bond yields rose 30bps over the month from 2.41% to 2.71% and have risen further to 2.88% at the time of writing this report.
- The FOMC kept interest rates unchanged in January and outgoing Fed chair Janet Yellen indicated that economic and labour data was solid in the US. The world's largest economy added 200 000 jobs in December 20 000 above expectations and wages rose 2.9%, 0.3% higher than expected. The bond markets have priced in higher inflation driven by higher wages and GDP growth. Consensus has shifted rapidly in the short-term, but yields may have a reached a ceiling and trend lower before rising again.
- Global REITs currently trade at 4.2% yield which is a 196bps spread to bonds. Recent year end or Q4 results indicate that 5.5% FFO / earnings growth is achievable into the medium term. At these levels, total returns in the mid-single digits appear reasonable for the 2018 calendar year.

The first FOMC meeting for 2018 was held at the end of January. Even though rates were unchanged, the statement was clear that because of "solid" economic and labour data there will be further "gradual adjustments in the stance of monetary policy". As a result, the US 10-year government bond yield spiked 7bps to 2.85% on the day, equivalent to 18% since the start of the year and 108.9% since the trough on 8 July 2017. Nevertheless, market consensus remains between three and four interest rate hikes for 2018. Labour statistics for the first month of 2018 surprised on the upside. The US economy added 200 000 new jobs compared to the market consensus of 180 000 new jobs. Employment was driven by construction, food services, healthcare, and manufacturing. Importantly the data showed strong growth in the average hourly wage of 2.9% y/y compared to expectations of 2.6%. The unemployment rate and labour force participation rate remained flat at 4.1% and 62.7%, respectively.

On 5 February Jerome H. Powell was sworn in as Federal Reserve Chairman taking over from Janet Yellen after her 4-year term ended at the beginning of February 2018. As mentioned before Powell shares a similar view with 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. In his introductory speech he emphasized that monetary policy decisions will "support continued economic growth, a healthy job market, and price stability".

LOOKING FORWARD

Despite the US core personal consumption expenditure (Core PCE, the Fed's measure of inflation) remaining at 1.5% and below the Fed's target of 2%, the bond markets have declared that inflation is on the rise. Consensus quickly shifted in January, but we have seen a correction in global risk assets (and 76% rise in the Volatility Index (VIX)) in the early days of February. Bond yields may fall before they rise further.

Global REITs have corrected further in February (to 12 Feb 2018) to deliver a year to date return of -8.21% in USD. On a forward yield basis REITs have adjusted for the spike in global bonds and now trade at 4.2%, a 196bps spread to global 10-year bonds on a weighted average basis. This spread is wider than the longer-term average of 130bps, however it is narrower than last month's spread of 220bps, implying global REITs have re-rated relative to global bonds. That being said we remain constructive on global REITs at these levels as an improved economic outlook has an immediate positive impact on demand, in turn earnings as supply takes a bit longer to catch up. Higher wage growth in particular is immediately positive for US apartments and offices. Although early in the global results season we have seen more REITs meet guidance than beat, which was the case six months ago. We still expect operational earnings growth of 5.5% from REITs which, even if bond yields stay elevated should translate into mid-single digit total returns for the calendar year ended December 2018.

RESULTS COMMENT:

Company Name	Results comment
Equity Residential	EQR reported normalized FFO per share of $0.83 beating expectations by $0.02 and equivalent to 5% growth y/y. SS NOI was up 2.1% driven by SS Rev growth of 2.2% and SS Exp growth of 2.5%. SS occupancy remained flat at 96%. Average rental growth of 2% was driven by NYC (-0.3%), Seattle (6.1%), San Diego (4.7%) and Orange County (4.2%). EQR has a debt to EBITDA ratio of 5.6x and a weighted average interest rate of 3.97%. The company guided FY 18 SS NOI growth of between 0-1.5% driven by Rev growth of between 1-2.25%. Management expect FY 18 normalized FFO of between $3.17-$3.27 equivalent to 2.9% growth at the midpoint (1% lower than consensus $3.22 vs $3.26).
GGP Inc.	GGP reported Q4 FFO of $0.48 equivalent to 11.6% growth and beating expectations by 2c. The company achieved SS NOI of 1.3% and 1.6% for the quarter and FY17, respectively. SS leased percentage was down 50bps y/y to 96.7%, however releasing spreads grew 13.0%. NOI weighted sales/sqf grew 1.7% to $703/sqf. GGP has a net debt to EBITDA ratio of 8.4x and a weighted average interest rate of 4.21%. Management have not issued guidance because of the Brookfield proposal. Brookfield’s partners in the transaction are the Abu Dhabi Investment Authority and Future Fund Board of Guardians (Australian Government Pension Fund). All 3 exercised rights to buy 84m shares.
Kilroy Realty	KRC reported FFO of $0.85 beating expectations by $0.01. Cash SS NOI grew 0.6%, the slow-down was expected and due to a 2.6% y/y drop in occupancy to 96.9%, however FY17 cash SS NOI was up 3.2%. Cash rentals for new leases grew 5.5% and 10.5% on second generation space. KRC has $1.2bn worth of developments under construction (62% preleased) and another $990m in their near-term development pipeline. Furthermore, Dropbox has leased 100% of The Exchange. The company has a net debt to EBITDA ratio of 5.05x and a weighted average interest rate of 4.25% with only 3.4% of debt expiring in the next 2 years. Management guided FY 18 FFO of between $3.45-$3.65 (2% lower than consensus) equivalent to growth of 4.1% at the midpoint. Cash SS NOI is expected to be between 0-1% (slowed by known move outs).
Prologis	PLD reported core FFO of $0.67 beating estimates by $0.01 and equivalent to growth of 6.3% and 9.3% on a quarterly and yearly basis, respectively. The company achieved cash SS NOI growth of 5.5% led by the US at 6.8%. Rentals grew at 8.8% on a cash basis and 19% on a GAAP basis (led by US at 29.8%). Occupancy as at year end was 97.2%, with the US at 98.0% occupied. The Asia region saw the biggest gain in occupancy of 1.5% to 97.3%. Customer retention was down 10bps y/y to 79.7%. PLD has a total development pipeline of $3bn of which 37.8% is built to suit with weighted average stabilize cap rate on developments of 6.2%. The debt to adjusted EBITDA was down 0.2x to 4.6x. Management provided 2018 core FFO guidance of between $2.85-$2.95 equivalent to growth of 3.2% at the midpoint.

Company Name	Results comment
Regency Centres	REG reported 7% core FFO growth at $3.69 for FY17 which was in line with consensus. SS NOI grew 3.5% for the year. Box/anchor occupancy was up 30bps to 98.6% and shop occupancy was down 50bps to 92.5%. The company achieved blended cash spreads of 6.0% driven by 2.2% increase in new leases and 7.1% increase in renewals. REG has a development pipeline of $354.5m, 80% leased at a yield of 7.3%. REG has a strong balance sheet with a net debt to EBITDA of 5.4x and a weighted average interest rate of 4%. The board authorised a $250m share buyback program. Management has guided Core FFO of between $3.76-3.83 (midpoint growth of 2.8% y/y) and SS NOI growth of between 2.25-3.25%.
Simon Property Group	SPG reported Q4 FFO of $3.12 in line with consensus and 7.2% higher than Q4 16. FFO for the year was $11.21 up 6.4% y/y on a comparable basis. SS NOI was up 2.2% for the quarter and up 3.3% for the year. Occupancy was down 20bps to 95.6%. Base rentals grew 2.9% to $53.11 and trading densities rose 2.3%. Releasing spreads were up 11.4% and occupancy costs increased 10bps y/y to 13.2%. SPG has a development pipeline of $658m (at share) at a 9% yield. Net debt to EBITDA was reported at 5.5x, 94% debt fixed at a weighted average interest rate of 3.4%. The board declared a dividend of $1.95, 11.4% up y/y. Management guided FY 18 FFO of between $11.90-$12.02 lower than the market consensus of $12.12.
Eurocommercial	ECP delivered earnings growth of 8.4% driven by 4.1% SS NOI growth. Underlying retailer sales were slower than peers at 1.9% mainly due to Italian sales at 1.4%. NAV grew by a modest 4.3% to €44.87/share. Portfolio vacancies fell to 0.7% with occupancy cost ratios remaining low at 8.4%. Management sold a portfolio of shopping centers for €367m and acquired Woluwe Shopping Centre in Brussels for €468m at an initial yield of just under 4%. ECP has a €165m development program spread across four projects at yields of 6-7%. Balance sheet LTV rose slightly to 39%, 87% fixed for 6 years with a weighted cost of debt of 2.6%. No guidance was provided in the results.
Klepierre	European mall REIT Klepierre put out a good report for FY17 as EPS grew 7.4% at €2.48; 8 cents higher than the top end of management guidance. SSNOI grew 3.2% over the year with upward reversions of 12.9% reported. Vacancies down 30bp to 3.2%. The board declared dividend growth of 7.7% and the NAV was up 8% to €39.60. Klepierre opened two malls in the second half of the year including Val'd Europe (east of Paris) and sold €568m of assets and will redeploy proceeds between 40% developments and 60% share buybacks. The development pipeline has been confirmed at €761m concentrated in three malls at a yield of 7.6%. Balance sheet LTV stood at 36.9% at a cost of debt of 1.8%. Management has guided for 3.6-5.6% EPS growth for the full year ended December 2018, which is likely to lag key peers in the mall space.
Unibail Rodamco	Unibail posted 7.2% eps growth within the guided 6-8% range. NAV rose 8% to €211/share and SSNOI rents up 4.3% driven by 7.6% in the Nordics. Office SS NOI was 13% and exhibition space was down 7%. Tenant sales were up 4.6% which was the highest since 2013 and 181bps above indexation and releasing spreads rose 14.7% from 17% last year. New developments completed worth €934m at a 7.7% yield, and acquisitions were €364m at 6%. The group reported disposals of €710m at 4.6% and they have identified €3bn of shopping centres to sell in the next few years. Balance sheet LTV stood at 33%, 1.4% cost of debt fixed for 7.2 years. Management announced a near term development pipeline of €700m at a yield on cost between 7-8% and guided 5.8-7% eps growth for FY18. The proposed merger with Westfield merger to be closed by Q2 2018.

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