NIMBLE WISDOM GLOBAL

Trade wars force the VIX up & Bonds down | 31 March 2018

SESFIKILE CAPITAL

Listed Property Investments

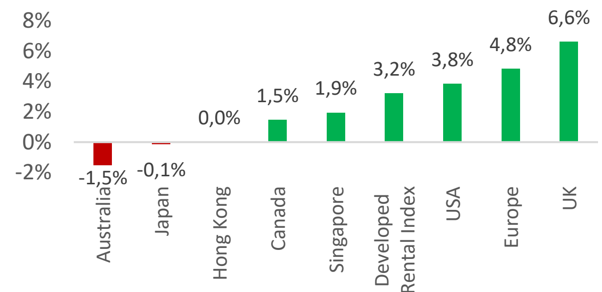
MARKET OVERVIEW

President Donald Trump used March to go on the offensive against China by announcing a 25% tariff on around $60bn worth of imports from the second largest economy. A few days later Economic Advisor Gary Cohn resigned in protest. China then retaliated by imposing tariffs on 128 US imports (totalling around $50bn) including fruit and pork; a tit-for-tat response that led to a 14% rise in the Volatility Index (VIX), global market sell-off and 12 basis point drop in US 10-year Treasury yields.

Global REITs closed the month 3.2% in the green, outperforming global Equites (MSCI World Index) that closed 2.1% in the red and closing the quarter 5.1% lower in USD. In REIT-land US Mall REIT GGP Inc's board of directors agreed to sell the company to Brookfield at a 5.7% cap rate and double-digit discount to NAV in what the market has deemed a 'soft deal'; in some ways this can be viewed as capitulation by mall operators that their assets are not worth what the balance sheets suggest. European mall REIT Unibail-Rodamco received legislative approval to go ahead with the Westfield merger.

UK REITs finished tops in March and closed 6.6% higher, followed by European REITs that closed 4.8% in the green. US REITs also outperformed the index achieving total returns of 3.8%. This month's laggards include the Singaporean (1.9%), Canadian (1.5%) and Hong Kong REITs (0.0%) with Japanese and Australian REITs the only two regions closing in the red, down -0.1% and -1.5%, respectively.

Chart 1: Monthly returns per region



Source: Bloomberg, as at 31 March 2018

Key Points in this report

- REITs (EPRA NAREIT developed rental index) closed 3.2% higher in March, clawing back some of the losses in January and February and closing the quarter 5.1% in the red. REITs outperformed Equites for the first time this year.
- Global Equites were negative in the month as US trade wars with the US and China sparked fears of a global economic slowdown. President Trump imposed a 25% tariff on Chinese imports estimated to be worth around $60bn, then China retaliated by placing tariffs on 128 US imports, worth around $50bn.
- The Fed hiked interest rates for the first time in 2018 by 25bps and, although current trade wars are increasing uncertainty and in effect pushing yields lower, we expect the Fed to keep hiking in 2018 bringing total hikes to three for the year. US Jobs missed at 103k vs. 185k expected.
- Recent M&A in the mall space has made us question if the malls are worth what the company balance sheets suggest. Global REITs offer a 4% dividend yield and we expect earnings growth of approximately 5.5% over the next 2 years. The US 10-year bond is likely to rise towards 3% over the year, taking our full year total return expectations to circa 5-7%.

During March the Fed expectedly decided to raise interest rates for the first time in 2018 by 25bps to between 1.50% and 1.75%. A more hawkish tone was given where the committee's view is "the labor market has continued to strengthen and that economic activity has been rising at a moderate rate". The committee revised its medium-term inflation forecast (core PCE inflation) from 2.0% to 2.1% for 2019 and 2020. The market is pricing in a total of three hikes for 2018, however the risk in now is on the upside. The US 10-year bond yield peaked in March at 2.90% but ended the month lower at 2.74% due geo-political tensions and fears of a trade war between the US and China.

US employment data for March disappointed the market with only 103 000 new jobs created compared to expectations of 185 000 jobs. However, February's number was revised upwards from 313 000 to 326 000 and the average hourly earnings increased by 2.7% y/y as expected. The unemployment rate remained unchanged at 4.1% with participation dropping slightly from 63% to 62.9%.

RETAIL M&A MAKES US QUESTION THE VALUE OF MALLS

On 8 March pan European mall REIT Klepierre made a friendly offer to acquire UK mall REIT Hammerson at 615p (41% premium to previous close) on a stand-alone basis. HMSO's board rejected the offer as it was deemed 'insufficient and purely opportunistic'. This offer was at a 21% discount to NAV of 776p and implied cap rate of 5.7%, higher than HMSO's balance sheet portfolio cap rate of 4.5%. On 27 March GGP Inc's board approved the 'sweetened' deal by Brookfield Property Partners (BPY) to acquire the remaining 66% of GGP at $21.89, or an implied cap rate of 5.7% and 20% discount to reported balance sheet NAV of $27.33. Although the significant premium to pre-deal prices suggest mall REITs were undervalued in financial markets, we cannot ignore the fact that offers have been below reported NAVs; **are these malls really worth what the companies suggest?**

We focus on the US that has 1600 shopping Centres or 760m sqm of retail space where only 8% are considered quality. Furthermore, the top 100 malls constitute around 44% of the total value of shopping centres implying quality is concentrated in a relatively few centres. Focussing on listed mall REITs, there is a considerable bifurcation on productivity where A malls (Simon Property Group, GGP, Macerich and Taubman) have average trading densities of $654/sq. ft vs B malls at around $399/sq. ft. Historic performance has also shown that quality malls have shown strong like-for-like rental growth of 2-3%, high occupancies of around 96% (vs. market at 92%) and double digit upward reversion of 10-14%. On this basis we believe A malls will remain in demand from tenants, thereby deeming their inflation beating earnings growth sustainable into the medium-term. Based on recent transactions and offers (GGP, Klepierre for HMSO in particular) however, we question the current 'embedded value argument' that states that the malls are trading at significant discounts to NAV. Given that valuers typically defend their

values based on comparisons, current NAVs in mall REITs could be overstated and at least 'behind the curve'.

RESULTS COMMENTS:

This month we focus on Germany where most companies under coverage released year end (FY17) results. In line with last month's comments, European companies are seeing acceleration in property fundamentals especially in the office and logistics sectors – take up continues to rise in line with business confidence. German residential remains well under-supplied with rent controls curbing supply as new developments are well below project feasibility rents. Like-for-like (LFL) rents are expected to accelerate in 2019 as vacancies have fallen below 3% in most cities - we remain constructive.

Company Name	Results comment
Ado Properties	Berlin focused Ado delivered 11% FFO growth driven by €233m in acquisitions, 18% in upward reversions and 25% NAV growth to €45.10/share driven by 17% portfolio value growth. LFL rent growth came in slightly below guidance and expectations at 4.8% as tenant turnover came in lower than expected. Vacancies rose slightly to 2.1% over the period with average rents rising 4% year on year. Balance sheet LTV stood at 39.6% (43% post acquisitions) at an average cost of 1.8% fixed for 6 years. Management has guided at least 5% LFL rent growth for 2018.
Aroundtown	Diversified German property company Aroundtown (AT1) delivered 44% FFO growth driven by €3.7bn in acquisitions, almost doubling the portfolio over the period. LFL rents rose by a strong 5.1% with 3.3% pure LFL and 1.8% from lower vacancies that fell to 9.4%. NAV growth was strong at 33% to €6.50/share. AT1 has sufficient liquidity to execute on more acquisitions with a relatively low at LTV at 36%, at a cost of 1.6% fixed for 7 years. Although no specific guidance was given, AT1 is expected to show strong FFO growth over the medium term driven by 1) LFL rental growth driven by the shortage of quality space in Germany, 2) reduced vacancies 3) yield enhancing acquisitions and 4) lower funding costs.
Deutsche Wohnen	DWNI delivered another set of strong results with 13% FFO growth which was 2% above guidance. This was driven by 4.5% LFL net income growth (5.3% in Berlin which is 78% of assets) and yield enhancing acquisitions as the company bought 6000 units and nursing homes at a total cost of €1bn. Vacancies rose slightly to 1.8% (up 30bp) with tenant turnover reported at 8%. NAV growth was strong at 20% with 80% driven by cap rate compression. At year end, group LTV stood at 34.5%, 88% fixed at a cost of 1.3% for 7.8 years; no debt expires until 2020. Management has guided 9% FFO growth for 2018.
LEG Immobilien	LEG reported 10% FFO growth for 2017. Vacancies continued to fall over the year to 2.8% (-20bps) with LFL rents rising 3.3%, lagging peers. NAV rose 24% over the year to €84.58/share mainly driven by portfolio upgrades as capex rose 23% over the year. Relative to peers, LEG's balance sheet appears stretched at a 42% LTV, 94% fixed at an interest rate of 1.78%. Going forward the company has guided 8.5% FFO growth driven by c. 3% growth in rents on a same-apartment basis.
Grand City Properties	GCP delivered a sector lagging 7% FFO growth resulting in similar dividend growth for FY17. LFL rents grew 3.5% (1.2% due to higher occupancies) with management guiding above 3% for 2018. NAV grew 23% over the year to €20.20/share due to cap rate compression in the underlying assets. GCP's balance sheet remained conservative at a 36% LTV, 99% fixed at an average interest rate of 1.6%. Management has guided 7.6% FFO growth for 2018.
Vonovia	Large cap German apartment player Vonovia delivered a sector leading 16% FFO growth for the full year driven by strong LFL growth of 4.2% (from 3.3% in 2016), €779m in acquisitions (11 780 units), greater efficiencies and upgrades and the benefit of lower funding costs. Vacancies rose 0.1% to 2.5% and is expected to remain below 2.5% over the next 12 months. NAV growth was also the highest among peers at 25%, 58% driven by yield compression with the balance being in asset upgrades. Management expects to spend €1bn on acquisitions and upgrades over the next 12 months which is fully funded given a balance sheet LTV of 39.8% at an all-in interest rate of 1.4%. In early March 2018 the company secured 74% support to acquire BUWOG for €5.2bn, further increasing VNA's scale. FFO growth is expected to be modest at 5% for 2018 with significant upside risk to this forecast.

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