NIMBLE WISDOM GLOBAL

Higher yields, higher prices | Second Quarter 2018

SESFIKILE CAPITAL

Listed Property Investments

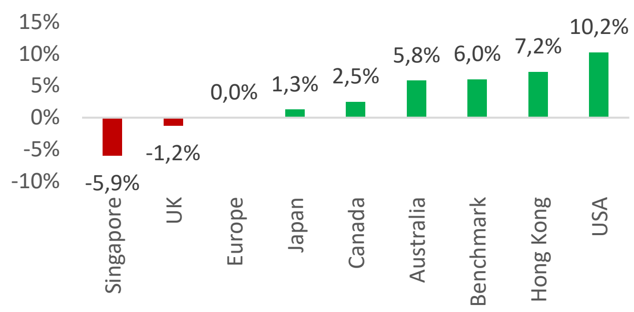
MARKET OVERVIEW

Global REITs continued to recover and closed the month of June 2.2% (11.5% in ZAR) in the green (as per the FTSE/EPRA NAREIT Developed Rental Index Net TR, USD). REITs were up 6% over the quarter. Again, REITs outperformed Equities (MSCI World Index) that fell 5 basis points (bps) over the month. Since the peak of 3.11% in May, US 10-year bond yields have been on a downward trajectory albeit with significant volatility driven by political rhetoric vs. economic data. Yields were flat over the month, closing at 2.86% despite rising to 2.96% midway through the month.

US GDP was revised down to 2% for Q1 but is expected to rebound significantly in Q2. Core Personal Consumption Expenditure (PCE) reached the Fed's 2% target for May 2018, the highest number in 6 years. The Fed hiked interest rates this June by 25bps and is expected to hike at least one more time in 2018. The US created 213k jobs in May (vs. 195k expected) and the unemployment rate rise slightly to 4% due to higher labour participation. Investors turned more bullish on real estate as 2017 may have been the most recent earnings trough, or peak in supply in major cities and sectors. After a significant rebound in share prices in Q2, global REITs are now roughly flat year to date at 0.3% in USD.

Over the quarter US REITs jumped 10.2% as the top performer followed by Japanese REITs (up 7.2%), retaining the top spot for the year. Singapore and UK REITs posted negative returns as the regional laggards.

Chart 1: Quarterly returns per region



Source: Bloomberg, as at 30 June 2018

Key Summary Points in this report

- Global REITs closed 2.2% higher in June, closing the quarter 6% higher after a massive 10.2% rally by US REITs as generalist investors turned positive. US 10-year Treasury yields were only 13bps higher over the quarter, albeit with considerable volatility; opening at 2.68%, reaching as high as 3.11% and closing at 2.86%. World equites were up 1.73%, underperforming REITs by 423bps over the quarter.
- The US Fed expectedly raised rates again in 2018 by 25bps. Consensus has quickly moved from 3 to 4 hikes for 2018. Unemployment rose to 4% (higher participation) and Core PCE reached 2% - highest in 6 years.
- We attended REITweek over the quarter and are positive on US West Coast, Logistics, Data Centres and turning more positive on Apartments due to lower supply from 2019.
- We are more positive on global property fundamentals and expect around 6-7% FFO or earnings growth over the next 2 years. The starting point of a 4.2% dividend yield (with an average pay-out ratio of 67%) is attractive, thereby giving us more conviction in our outlook for total returns in the region of 7% in USD over the next 12 months.

ECONOMIC OVERVIEW:

The US has continued on its narrative of protectionism and imposed tariffs on goods such as aluminum, steel, timber, washing machines and solar panels from the European Union, Canada, Mexico and China. All these countries intend imposing retaliatory tariffs on goods imported from the US. The US imposed tariffs on $50bn worth of goods imported from China, the Chinese introduced tariffs of the same magnitude on US imports. For now, the value of these tariffs relative to GDP is small, but investors see it a precursor to a full trade war which may have a negative short-term impact on global GDP.

Despite all the political rhetoric and mini wars of words, US economic growth continues to be strong: June PMI increased to 60.2 signaling continued expansion in US manufacturing. However, due to lower net exports Q1 GDP was revised down to 2.3% from the 2.3% original estimate. US GDP for Q2 2018 is however expected to bounce back and is tracking at 3.8% as at the end of June driven by 2.9% consumption growth and benefits of tax cuts. Further evidence of an expanding economy is the upward trend in inflation. The Federal Reserves preferred measure of inflation, Core Personal Consumption Expenditure (PCE) reached the Fed's 2% target for May 2018, the highest number in 6 years. During the June Federal Open Market Committee (FOMC) meeting the Fed increased interest rates by 25bps as expected. According to the projection materials that accompany the statement, the FOMC expects inflation to potentially overshoot the 2% target (first time its proved that its target is symmetric). US employment data for June surprised the market with 213 000 new jobs created compared to expectations of 195 000 jobs. Average hourly earnings increased by 2.7% y/y similar to the prior month. The unemployment rate ticked up slightly to 4.0% due to a 20bps increase in the labour force participation rate. This persistent period of strong economic growth, low unemployment and faster inflation has shifted the Fed towards a more hawkish tone where consensus has moved to four interest rate hikes for 2018 (from three).

During June the European Central Bank (ECB) reduced the pace of its quantitative easing purchases to €15bn per month (from €30bn/month) in Q4 2018 and to end the program entirely by December 2018. The tapering of the QE program was largely expected by the market. However, the ECB's dovish forward guidance surprised the market as they noted that interest rates are "expected" to remain unchanged "at least through the summer of 2019" and "in any case for as long as necessary to ensure that the evolution of inflation remains aligned with our current expectation of a sustained adjustment path". The issue the ECB faces at the moment is that while GDP, which grew at 2.5% in Q1 continues to be strong, inflation is not showing any real signs of acceleration. Eurozone headline inflation rose to the ECB's target of 2% in June from 1.9% a month prior, largely as a result of higher energy costs. However, core inflation (which excludes volatile food and energy costs) edged lower by 10bps to 1.0%. We believe that if core inflation strengthens and unemployment continues to fall the ECB will move towards a more hawkish stance.

REAL ESTATE OVERVIEW:

REITWeek takeaways: In the first week of June we attended REITWeek, a major US REIT conference in New York and met 44 companies over three days and key sector takeaways are:

- West coast property fundamentals are outperforming all estimates in terms of job growth and tenant demand, benefiting the **Office** and **Multifamily[1] Sectors**, driven mainly by the Tech & Life Science sectors comprising c.70% of net demand. Large tech companies such as Google, Facebook and Amazon are growing and spreading into San Francisco from Silicon Valley and Seattle. Seattle has seen lower vacancies with only one building under construction with no pre-let. Downtown Los Angeles rents are rising rapidly driven by content providers Netflix, Hulu, Apple and Amazon.
- After seeing over 7 000 stores close in 2017 (highest since GFC), the **Retail sector** appears to have bottomed out in Q1. Retailers are now embracing e-commerce and spending time on reinvesting in stores and figuring out how to make money from the apparel sector. There is still risk of further bankruptcies in over-geared Leverage-buy-out (LBO) retailers (e.g. PetCo and PetSmart). Landlords have also placed Sears on the 'watch list'. In the strip mall space, 'densification' via construction of apartments and gyms around centres is the new buzzword.
- **Multifamily** supply should fall in 2018 as building costs (inflation at 9-10%) and labour shortages, coupled with higher interest rates is making developments less feasible. NYC supply is expected to fall 40% in 2019 with positive rental growth of 1-2% being reported versus budgets of -2%. Supply in coastal cities is however expected to be at least two times more than infill locations but job growth is also much higher in the gateway cities. In the **Single-Family [2]sector**, we expect rents to continue rising at around 2x the multifamily sector due to housing shortages and lack of affordability.
- Demand for more data storage via **Data Centres** still strong and accelerating as smaller companies move from own storage to cloud computing. Large enterprises appear to be gaining pricing power however where SS NOI in this category could be flat to negative. Development remains attractive with yields in excess of 9% in most US locations. In similar fashion to the logistics sector Europe seems to be early in the cycle relative to the US.
- Despite a six-year bull market the **Logistics sector** is not yet 'late cycle' as we see supply equal to demand with vacancies as low as 4.3% and SSNOI around 4%. As retailers push for quicker delivery times (now 2 hours for Amazon Prime Now) infill, which means warehouses close to large populations, is the new buzzword.
- Business travel is not reacting to higher GDP and confidence and RevPars and occupancies are still disappointing in the **Lodging[3] sector**. Further regulation on AirBnb and hotel-apartment operators is providing some reprieve to shadow supply in the sector.

[1] Multifamily = Apartment buildings
[2] Single Family = stand alone houses for rental
[3] Lodging sector = hotels and hospitality industry

US REIT Results:

Company Name	Results comment
Boston Properties	BXP reported Q1 FFO per share of $1.49 equivalent to growth of 70bps y/y. FFO missed expectations by 1c. Cash SS NOI was down -1.0%. SS office occupancy was up 40bps y/y to 90.8%. Cash releasing spreads were 8.6% driven by 43.2% in Boston, 7.7% LA/SF, 7.7% in DC and -15.6% in NYC. The company has a re/development pipeline of $3.2bn which is 83% preleased. Net debt to EBITDA ratio increased 0.33x to 6.8x at a weighted average interest rate of 3.97% with 98.9% fixed for 6.1 years. Management increased FY 18 FFO guidance 2c at the midpoint to between $6.27-$6.36 from $6.23-$6.36. SS NOI guidance was increased 25bps at the midpoint to between 1-2.5%.
Digital Realty	DLR reported core FFO per share of $1.63, beating estimates by 4c and equivalent to growth of 7.23% y/y. The total bookings signed in Q1 expected to generate $61m of annualized GAAP rental revenue which is a record quarter. The US and APAC[4] drove results and demand in EU remains strong. Rental rates on renewal leases signed during Q1 2018 rolled up 3.9% on a cash basis. Net debt-to-adjusted EBITDA ratio increased 0.4x y/y to 5.3x. Management raised 2018 core FFO per share outlook from $6.45 - $6.60 to $6.50 - $6.60.
Essex Property Trust	ESS reported core FFO of $3.09 beating consensus by 4c and equivalent to growth of 5.1%. SS NOI was up 3.6% driven by SS Rev growth of 3.3% and SS Exp growth of 2.5%. Rentals grew 2.4% y/y and occupancy increased 60bps y/y to 97.1%. In Q1 ESS repurchased $3.8m worth of shares at an average price of $224.13 per share. ESS has a development pipeline worth $1.3bn with $521m remaining to finance. With respect to its balance sheet the company's net debt to EBITDA ratio was 5.6x with a weighted average interest rate of 3.9%. Management raised FY core FFO guidance from $12.24-$12.64 to $12.28-$12.64. SS NOI guidance was increased from 1.6-3.4% to 2.0-3.4%.
Extra Space Storage	EXR reported Q1 core FFO of $1.09 (in line with consensus) and equivalent to growth of 5.8% y/y. SS NOI was up 4.5% driven by SS Rev growth of 5.2% and SS Exp growth of 6.9%. SS occupancy was up 10bps y/y to 92.1% and average rent growth increased 4.8%. EXR had a net debt to EBITDA ratio of 6.0x and a weighted average interest rate of 3.4% with a maturity of 4.5 years. Management increased FY 18 core FFO guidance to between $4.57-$4.66. SS NOI assumption was increased to between 3.25%-4.5% from 3%-4.5%.
Host Hotels & Resorts	HST reported AFFO of $0.43 beating estimates by 4c and equivalent to growth of -2.3% y/y. SS RevPAR growth was up 1.7%, driven by 1.6% growth in the US and 9.3% for offshore properties. Occupancy increased 1.7% y/y to 77.6% but the average room rate decreased 60bps y/y. SS EBITDA margin was up 60bps y/y to 27.6%. The company has a net debt to EBITDA ratio of 2.7x and a weighted average interest rate of 3.9%. Management increased 2018 adjusted AFFO guidance to between $1.67-$1.73. RevPAR is now expected to be between 1.5%-2.5%.
Invitation Homes	INVH reported core FFO of $0.29 beating estimates by 1c and growing 13.7% y/y. SS NOI grew 3.6% driven by 4.1% SS revenue growth and 5.1% SS expense growth. The company achieved SS rental renewal growth of 4.9% and new lease growth 2.5% which resulted in blended rental growth of 4.0%. SS average occupancy was down 10bps y/y to 95.7% but resident turnover was only 7.6%. The company's net debt to adjusted EBITDA ratio increased by 0.2x q/q to 9.7x. Weighted average interest rate on all debt is 3.4% with a 5-year maturity. Management re-affirmed FFO and SS NOI guidance of between $1.13-1.21 and 5-6%, respectively.
Regency Centres	REG reported core AFFO growth of 6% and beating expectations by 2c. SS NOI increased 4.0% driven by SS Rev growth of 3.8% and SS Exp growth of 6.9%. The company achieved blended rental spreads of 7.9%, with new leases growing 10.9% and renewals growing 7.2%. Box occupancy of 97.7% was down 40bps y/y, while shop occupancy was up 40bps y/y to 92.2%. REG has 19 redevelopments underway totalling $454m at yields of 7%-9%. Net debt to EBITDA of 5.6x and in Q1 REG repurchased $125m of shares as part of the $250m buyback program. The company increased the low-end of FFO guidance by $.01 to $3.49 and the low-end of the SS-NOI range by 15 bps to between 2.4-3.3%.

[4] APAC – Asia Pacific

Company Name	Results comment
Rexford Industrial	REXR reported 17.4% y/y FFO growth in the first quarter. Cash SS NOI was up 8.3% and occupancies were up 110bps y/y to 97.5%. The company achieved releasing spreads of 14.9%, based on 18.1% growth in new lease rents and 13.8% for renewals. REXR has a redevelopment pipeline worth $125m at yields of c.6%. Net debt to EBITDA ratio is down 0.6x to 5.0x with an average interest rate of 3.39%. Management increased FY18 core FFO guidance 1c at the midpoint to between $1.02-$1.05. SS NOI guidance increased to 6.5-8.5% from 6-8%.
Simon Property Group	SPG reported Q1 FFO of $2.87, beating expectations by 4c and equivalent to growth of 4.7%. SPG repurchased 1.5m shares during the quarter for $228m (~$154.72 per share). SS NOI was up 2.3% (full year guidance of "at least 2%"). Occupancy was down 1% to 94.6% with occupancy costs down from 13.2% to 13%. Base rentals grew 3.2% to $53.54 and sales per sq. ft increased 4.2% to $641/sq. ft. The company achieved leasing spreads of 12.6%. SPG has a development pipeline of $721m (at share) with an expected stabilized RoR of 8%. SPG has a net debt to NOI of 5.5x and a weighted average interest rate of 3.46%. Management increased FY 18 FFO guidance by 4c at the midpoint to between $11.95-$12.05 from $11.90-$12.02.
Store Capital	STOR reported Q1 AFFO of $0.44 beating estimates by 1c and equivalent to growth of 2.3%. The company bought assets worth $320m at an average cap rate of 7.8%. It achieved annual rental growth of 1.8% and occupancy was up 10bps y/y to 99.6%. The company's balance sheet remained strong with a net debt to EBITDA ratio of 4.1x, however the long-term target is between 5.5x and 6x. Its fixed charge coverage ratio of 2.1x was flat q/q and y/y. Management reaffirmed 2018 AFFO guidance of between $1.78-$1.84 based on acquisitions of $900m.
Sun Communities	SUI reported Q1 core FFO of $1.14 (in line with consensus) and growing 3.6% y/y. SS NOI was up 5.3% driven by SS Rev growth of 5.7% and SS Exp growth of 6.6%. SS occupancy increased 2.2% to 97.6%. Total home sales volumes increased 1.3% to 837 homes, with new home sales up 39.5% y/y. Monthly base rent for manufactured homes grew 3.8% and recreational vehicles grew 4.6% resulting in blended rental growth of 3.8%. With respect to its balance sheet its net debt to EBITDA ratio was down 0.1x to 6.2x with an average interest rate of 4.45% (90.6% fixed). Management reduced SS NOI guidance 25bps on both ends to between 6.75-7.25%. Core FFO guidance remains between $4.48-$4.58.
Welltower Inc.	WELL reported normalized FFO of $0.99, in line with estimates and equal to -5.7% growth. This was due to disposals which have been increased from initial guidance of $1.3bn to $1.9bn for 2018. SSNOI growth was 1.8% based on the senior housing operating portfolio (SHOP) growing 0.6%; triple-net senior housing growing 3.0%; medical office buildings (MOBs) growing 2.9% and post-acute growing 2.4%. SHOP performance was driven by an occupancy decline of 190bps y/y, offset by rate growth of 3.5% and moderate expense growth of 2%. WELL in an 80/20 JV with ProMedica acquired the skilled nursing/post-acute focused REIT Quality Care Properties for $20.75 in cash. The transaction will increase WELL's leverage from 5.4x to 5.6x net debt to adjusted EBITDA. Management re-affirmed 2018 normalized FFO guidance of $3.95 to $4.05 and an average blended SSNOI growth of between 1.0%-2.0%.

M&A and corporate action gains momentum:

With global bond yields relatively elevated and REITs trading at discounts to NAV, M&A gained momentum over the quarter with substantial demand coming from private equity funds, led as expectedly by Blackstone:

- **Private Equity funds look to the real estate market:** Private Equity giant Blackstone turns to REITs and buys Spanish Hotel REIT Hispania for €1.9bn, US logistics triple net REIT Gramercy for $7.6bn at a 15.6% premium to the price before the announcement and US hotel REIT LaSalle for $4.8bn at a 35% premium to pre-deal price. Private equity firm Greystar Real Estate Partners agreed to acquire Education REIT EDR for $4.6bn at a 14% premium to the pre-deal price in conjunction with the deal a JV between Greystar and Blackstone purchased 10500-bed EDR student housing portfolio for $1.2bn. The recent deals highlight that listed real estate is relatively undervalued compared to direct real estate by around 10%, and the current balance sheet NAVs can be defended for the most part.
- **Prologis seeks densification in its key nodes:** In a $8.4bn all share deal (1.02 PLD per DCT share) large cap global logistics REIT Prologis agreed to buy DCT Industrial at a 16% premium to its pre-announcement closing price. In line with PLD's plan to entrench itself further in coastal markets both companies have a footprint in key industrial real-estate markets such as Southern California and Northern California's Bay Area, New Jersey, Atlanta and Chicago, where demand is up as e-commerce companies and others set up warehouses closer to major population centers.
- **DDR spins off its tail as RVI:** Strip centre REIT DDR completed the spin-off of 50 lower quality centres (38 US, 12 Puerto Rico) into newly listed Retail Value (RVI) with a $690m market cap. The REIT has assets in less dense, lower income locations vs. the post-deal DDR portfolio.
- **Tritax expands the franchise to Europe:** Tritax, the manager for UK large warehouse REIT Tritax Big Box successfully raised £300m in an oversubscribed IPO to list Tritax Eurobox which focuses on prime big box facilities in continental Europe with a focus on key markets such as Germany and France. Management has targeted a 4.75% dividend yield in the first 12 months.
- **Unibail-Rodamco adds Westfield to its name:** Unibail (now Unibail-Rodamco-Westfield) completed the acquisition of Westfield for €18.4bn on 7 June to be the second largest REIT with €62bn in assets with 70% European exposure following by the US at 22% and UK at 8%. Through their focus on flagship malls Westfield's US portfolio is now the most productive with trading densities of $833/sq. ft. versus Taubman at $782/sq. ft. and Simon Property Group at $735/sq. ft.

HOW WE SEE THINGS GOING FORWARD:

- **US REIT fundamentals slowly improving:** After a relatively difficult 2017 driven mainly by elevated supply in coastal apartments and New York offices, and the impact of e-commerce (and other factors) that saw a stores closures rise to a 15-year peak of more than 7000 (64% apparel), we are a bit more positive on US property fundamentals; demand remains steady and better than expected in the West Coast across all sectors due to higher wage and job growth. Tenant bankruptcies and store closures are much lower than 2017, and importantly supply is expected to drop significantly in 2019/20 particularly in malls, New York office and apartments (40% drop in apartments to be built). We expect FFO[5] growth of around 5.5% p.a. over the next 2 years.
- **UK Retail in the eye of the storm:** the UK retail market is challenging, characterized by lack of real wage growth, economic uncertainty, rising labor costs & business rates for tenants and pressure from online retailing and discounters. CVA[6]s have been announced by retailers House of Fraser (closing 31 of its 59 stores), Byron Burger, Poundworld, Poundland (both closing 25 stores), Carpetright, Mothercare, The Original Factory Shop, New Look, Select and now most likely DIY retailer Homebase. Overall retail sales are down 3% while shopping centres have seen their sales fall by 0.5% with occupancies remaining at around 95%, indicating bifurcation in performance of malls versus the general retail space. Cap rates for all asset classes are however expecting to rise as seen by Land Securities' 11% write-down of flagship centre Bluewater (Kent) as cap rates rose 50bps – we remain concerned that NAVs in the mall sector could be overstated. The office sector has held up relatively well with London vacancies rising only slightly to 4.8%, take up increasing 15% to levels higher than the 10-year average, driven by tech sectors and serviced offices. With online sales consisting 18% of non-food retail sales, logistics demand continues unabated with market rents rising 4-5%. On average however, coupled with strong balance sheets and conservative leverage at 28% (88% fixed), the UK REITs are expected to show strong earnings growth with a 2-year CAGR[7] of 7.5%.
- **Selective value in Europe, but Logistics is early cycle:** With an improved economic outlook European property has seen significant yield compression in the past, but now we expect growth to accelerate, although in limited pockets such as Madrid, Barcelona, Amsterdam, Munich and Berlin (office and residential) where vacancies have compressed to between 2-4% and rental growth is expected to accelerate to 7-9% p.a. over the next 2 years. Paris office fundamentals continue to improve with CBD vacancies falling to 1.4%, pre-lets for new supply is now at 84% and rents are set to start growing – *we view Paris as 'Madrid without the hype' and believe we are early in the cycle.*

[5] Funds from Operations is the figure used by REITs to define the cash flow from their operations. FFO is calculated by adding depreciation and amortization to earnings and then subtracting any gains on sales.

[6] Company Voluntary Arrangements – the UK version of Business rescue of Chapter 11 Bankruptcy where creditor claims are frozen while the company reorganises is finances.

[7] CAGR – compounded annual growth rate

With e-commerce lagging US and UK, European logistics is set to show improved returns and capital flows in the medium term with key locations such as Germany, France and the Netherlands likely to see strong rental growth for modern warehouses with vacancies currently below 3%. The German residential sector has seen strong fundamentals over the last 5-7 years with like on like growth rising at 3-5%p.a. and vacancies falling to 2-3%. We however believe there is much more to go in the cycle, driven by limited supply and increasing demand fueled by strong migration into major cities such as Berlin. The retail sector remains stable with rents growing above 2% on a like on like basis, where lower supply and limited department store exposure is mitigating a US-style disruption.

- **S-REITs looking for DPU[8] growth in all places:** Despite improved vacancies and limited supply of speculative developments, market rental growth of 8-10% in 2018 is not yet translating into DPU growth at S-REIT level. Management teams are turning offshore for earnings growth with a focus on Australia, Japan and Europe where cap rate to debt costs spreads are still relatively wide, with better fundamentals. Office REITs are also trading at a 10-15% discount to NAV which is accelerating buy backs – all three main office REITs have approved buy-back programs.
- **Japanese office and logistics supply is over-hyped relative to demand:** the Tokyo office market has been recovering since 2012 and rental growth is still at 4% with vacancies in the central wards down to 2.57%. Going forward supply is catching up and vacancy is likely to be above 3% within 12 months, peaking to around 5% by 2020. Despite supply worries rental growth could continue given improved GDP, CPI and a still accommodative BoJ. The logistics market has seen supply outstrip demand in 2018, but new construction is concentrated in 4 projects in Osaka thereby skewing numbers significantly. With 3.9% of space being Class A (or Prime) and e-commerce in its infancy at 4.8% of sales (vs. 18% UK, 10% US, 8% Europe), we remain positive on the sector.
- **Australia undervalued relative to fundamentals:** With Sydney and Melbourne office vacancies below 4% and falling further A-REIT fundamentals are close to 20-year highs. The retail sector is set to recover due to improved house prices and consumer confidence – the relaunch of Amazon in 2017 could spoil the party in the mall space. The Logistics sector is stable with demand largely matching supply with Residential margins improving for developers. DPU growth should accelerate to 3-4% p.a. over 2 years.

Investors turned more bullish on real estate in Q2 (relative to equities) as 2017 may have been the most recent trough in fundamentals, or peak in supply in major cities and sectors. After a massive 23% rebound in the second quarter of 2018, and driven by the weaker ZAR, global REIT returns have been respectable at 11.4% for the first six months of the year. In USD the returns have been flat where the sector has delivered 0.3%. We are more positive on property fundamentals and expect around 6-7% FFO or earnings growth and with a starting dividend yield of 4.2%. Our US Dollar total return outlook of approximately 7% for the full year remains unchanged.

[8] DPU – distributions per unit

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