NIMBLE WISDOM GLOBAL

Reflation trade to reach Europe | 30 April 2017

SESFIKILE CAPITAL
Listed Property Investments

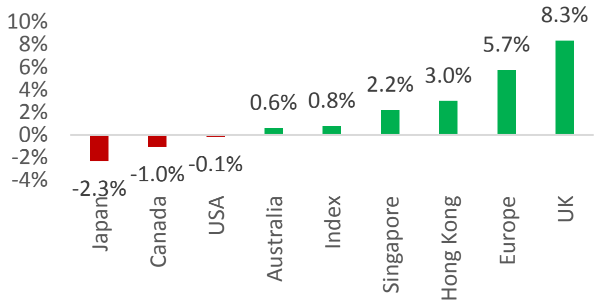
MARKET OVERVIEW

Global REITs closed the month of April +0.75% in the green. US 10-year bonds continued to rally with yields opening the month at 2.39% and closing at 2.28%. Equities (MSCI World Index) closed 1.53% in the green which was driven by European equities after the first round of the French election, and the S&P500 which rose on the back of Trump's proposed US tax cuts.

Q1 US GDP came in below expectations at 0.7% which sent US 10-year bond yields lower as investors doubted the Fed's positive view on the US economy. The first round of the French election was held, and as expected Marine La Pen made it as a frontrunner for the second round. What was not expected however was the Emmanuel Macron victory where he won 26% of the vote, versus Marine La Pen who took just over 24%. Importantly, left wing candidates who couldn't make it to the second round pledged their support for Macron which increased the odds of his victory considerably. On 7 May Macron convincingly defeated La Pen by taking 66% of the vote to become the youngest French president. In the UK, Theresa May called for an election on 8 June, and conservatives are expected to win.

Regional performance showed strong outperformance by UK REITs (+8.3%) and Europe at 5.7% which includes currency strength relative to the USD. Hong Kong and Singapore also continued to rally by closing 3% and 2.2% up respectively. This month's laggards included Australia (+0.6%), USA (-0.2%), Canada (-1.0%) and Japan (-2.3%).

Chart 1: Monthly returns per region



Source: Bloomberg, as at 30 April 2017

Key Points in this report

- REITs corrected by 1.7% in March, and gained 75 basis points this April. US Bond yields fell from 2.4% to 2.3% over the month and Equities outperformed REITs by closing 1.5% higher.
- The first round of the French election saw Emmanuel Macron take 26% of the vote versus right wing leader Marine La Pen take just over 24%. On 7 May Macron won the election convincingly by taking 66% of the vote. Theresa May proposed a UK election on 8 June which the conservative party is expected to win. US GDP disappointed at 0.7% and the Fed expectedly kept interest rates unchanged in early May. Donald Trump proposed significant tax cuts which include lowering corporate tax to 15% which sent US equities higher towards the end of the month.
- After a small rebound last month, Global REITs trade at a 4.1% forward dividend yield versus global bonds at 1.8%, offering investors a wider than average spread of 230 basis points. This gives us more confidence in our total return expectation of 7% over 12 months.

The third FOMC meeting was held on the 2-3 May 2017 and the committee decided to keep the Fed Funds Rate unchanged at between 0.75% and 1.0%. More importantly is the signals the committee has provided for possible action at subsequent meetings. Even though the most recent round of data such as the Q1 2017 GDP (0.7% vs. market expectations of 1.0%), March payroll data (98 000 jobs compared to the markets expectation on 180 000) and March core CPI (2.0% y/y vs market expectations of 2.3%y/y) all have been disappointing, the FOMC believes that this economic weakness is "transitory". The FOMC continues to expect a moderate expansion in economic activity, strengthening in the labour market and inflation to stabilize to around their target of 2% in the medium term. We continue to expect a 25bps hike during the June 13-14 Fed meeting. US payroll gains rebounded in April with nonfarm payrolls increasing by 211 000 versus expectations of 190 000. The labour participation rate decreased 10bps to 62.9% and the unemployment rate unexpectedly decreased to 4.4% from 4.5%. The average hour earnings increased 2.5% to $26.19 per hour.

There has been much focus on the Trump administration's proposed principles for tax reform. The plan, which will be refined through negotiations with Congress, aims to cut both individual and corporate tax rates. More specifically the top corporate tax rate will be reduced from 35% to 15% and the top personal rate reduced to 35%, furthermore the plan intends to repeal the estate tax (death tax) and alternative minimum tax (AMT). On the other hand, the lower tax rates would result in lower revenue and a possible increase in the budget deficit which is unlikely to initially receive Democratic support.

In Europe, we saw the first round of the French election go off without a glitch. In fact, to the market's delight right wing leader Marine La Pen came second but made it to the run-off election on 7 May. Similar to the Dutch elections, and surprisingly, the polls were right! Voters came in their numbers to vote for left wing pro-Euro candidate Emmanuel Macron who gained 26% of the votes, finishing 2 percentage points above La Pen. Furthermore, the remaining left wing candidates immediately pledged their support for Macron, thus easing fears of a La Pen presidency to the markets. French bond yields fell 9bps while German Bunds rose 10bps on the day, and we saw French equities and REITs rally between 3-5%. On 7 May poll predictions were confirmed by a convincing win by Emmanuel Macron who finished with 66% of the vote. This Macron result in our view certainly clears the way for the EU to be front-footed on both being tough on negotiations with the UK regarding Brexit, and returning to macro-economic, or interest rate normalisation. With inflation around 1.9% and the latest Eurozone GDP at 1.7%, it becomes difficult to see how the ECB can continuously remain extremely accommodative – European bond yields below 0.50% seem to indicate complacency in the bond market although tapering could be around the corner.

LOOKING FORWARD

Towards the end of April, we saw the first round of US REIT results and some of our views have been confirmed; specifically, we see a slight slow-down in earnings growth and a slight widening in guidance comments, illustrating higher variability in fundamentals. What has surprised is that Self-Storage and Multifamily results have been slightly better than expected, and A-class malls have posted good results but continue to face significant headline risk from Department store closures and a bearish view on US brick-n-mortar retail. During a recent visit to the US we noted anecdotally that the US has too many malls, strip centres and shopping centres, and Department stores are mostly trading poorly and occupy large boxes in regional malls. Vacancies in large centres appear minimal, and judging by the recent results in GGP Inc, Macerich and Simon Property Group, upward reversions on new leases are in the double digits, confirming that retailers still demand high productivity malls. In addition, it has become well documented that e-commerce works in conjunction with physical presence especially in with clothing retailers. However, the difficulty will be in predicting then the market will separate earnings of 'malls' and 'retailers' and we believe a significant re-rating in A-class malls will occur on this occurrence. The logistics sector continues to do well, despite early warning signs of a catch up in supply. A common theme is that European logistics fundamentals are improving and are potentially two years behind the US. Office results have also been impressive, with the likes of New York focussed SL Green showing upward reversions of 19%.

Global REITs have had a turbulent four months but have held up well by closing 2.1% in the green. The sector offers now trades at a 4.1% forward dividend yield versus global bonds at 1.8%, offering investors a wider than average spread of 230 basis points. This gives us more confidence in our total return expectation of 7% over 12 months. As the second round of the French election looms, markets have become more confident of a Macron win which, if the polls a right and he is indeed elected, will clear the path for European bond yields to rise considerably in anticipation of tapering by the ECB towards the end of this year. A few months ago, we stated that there is significant complacency in the EU bond yields, and with inflation at around 1.7% and GDP higher than 1% across the board, bond yields could double from current levels – the reflation trade will cross the shores from the US to Europe and this will hurt share prices of bond sensitive European counters.

REIT results:

Company	Results comment
Alexandria Real Estate	ARE reported Q1 2017 FFO/share growth of 10.5% y/y to $1.48 beating the market consensus by $0.03. The company achieved SS NOI growth of 5.5% on a cash basis with occupancies down 1.8% y/y to 95.5%. New and renewal leasing spreads were up 17.7% on a cash basis and 27.8% on a GAAP basis. ARE has $1.25bn worth of properties in its future and under construction development pipeline. Developments to be delivered by the end of 2017 are 78% pre-leased at an initial stabilised cash yield of 6.9% which will increase annualised NOI by $79m - $89m. Management raised its 2017 FFO/share as adjusted guidance by $0.02 at the midpoint to $5.97-6.07.
Boston Properties	Office REIT BXP reported Q1 FFO of $1.48 (-9.2% y/y growth) missing the market estimate by $0.02. Overall SS NOI was up 2.0% with office SS NOI up 2.6%. Occupancies decreased by 50bp y/y to 90.4%. Gross leasing spreads for second generation space were up 13.0% on a cash basis with San Francisco/LA delivering +46%, however New York saw a decrease of 9%. Included in the $2bn development pipeline, BXP finalized a 100 000ssf lease at Salesforce Tower, which brings the project to 69% occupied. The low end of 2017 FFO guidance was increased by $0.02 to $6.15-$6.23. SSNOI guidance was reduced by 50bps to +1.0%-3.0% from +1.5%-3.5%.
Duke Realty	Industrial REIT DRE's 2017 Q1 core FFO of $0.32 beat market expectations by $0.03. SS NOI grew 5.2% driven by 3.8% growth in SS revenues and 0.4% in SS expenses. Industrial SSNOI was up 5.7% and Medical Office Buildings ('MOBs') up 3.2%. The overall occupancy rate improved by 2% y/y to 97.7. Renewal spreads were up 23.5%, higher than the 15.2% increase in Q4 2016. DRE has a $875m development pipeline which is 73% pre-leased at an initial yield of 6.4%. At the beginning of May 2017 Duke completed its transition into a pure-play industrial REIT with the sale of its MOB portfolio to Healthcare Trust of America (HTA) for $2.8bn. Due to this sale, management lowered its guidance to $1.16-$1.24 from $1.24-$1.30. The $2.5bn of net cash proceeds will be used to repay $1.2bn of debt, fund $0.5bn-$1bn of developments/acquisitions, and pay a $0.70-$2.00 per share special dividend in late 2017.
Essex Property Trust	West Coast Residential REIT ESS reported 1Q Core FFO/share of $2.94, which was $0.06 above the consensus estimate of $2.88. SSREV was up 5% with expenses remaining in line with guidance at 3.5% resulting in 5.6% SSNOI growth. Management raised guidance on operating metrics with SSREV expected to rise 3.7% from 3.35%. Essex also acquired its joint venture partner's 50% interest in Palm Valley for $183 million. Palm Valley has 1 098 apartment homes within four communities on 37 acres and is located in San Jose, California. The company sold Jefferson at Hollywood for $132.5 million. The community, which is located in Los Angeles contains 270 apartment homes. Full year FFO guidance was raised to $11.56-$11.96 from $11.48-$11.88/share.
Education Realty	EDR reported core FFO/share of $0.60 beating the market consensus by $0.03. SS NOI declined 1.2% driven by a 0.9% increase in SS revenue and a 5.0% increase in SS expenses. The primary driver of the company's SS expense growth was a 16.4% increase in real estate taxes. Pre-leasing for the 2017/2018 school year is at 78.1% (about 1.3% ahead of last year) with rate growth expected to be between 2.5% and 3.5%. The UK portfolio (15% of the total portfolio) is 96% applied for versus 108% last year at this time. Management reaffirmed 2017 core FFO per share guidance of $1.90 to $2.00.

Company	Results comment
Equity Residential	EQR achieved normalized FFO for Q1 2017 of $0.74 per share compared to $0.76 per share in Q1 2016 in line with market expectations. SS NOI increased 2.1% driven by a 2.6% increase in SS revenues (in line) and a 3.9% increase in SS expenses (better than expected). Revenue was driven by a 2.6% increase in the average rental rate and occupancy was unchanged at 95.6%. Revenue growth in NYC was positive at 0.3% y/y and San Francisco achieved 2.9% revenue growth in Q1 versus 3.6% in Q4. Management kept FY 2017 guidance unchanged with 2017 normalized FFO/share of $3.05-$3.15 and SS NOI growth of between 0.0% and 2.0%.
GGP Inc.	A-class Mall REIT GGP Inc delivered Q1 FFO/share at $0.22 which was $0.01 below consensus estimates but resulted in 16% dividend growth for the first quarter. SSNOI was slightly below mall peers at 2.9% (excluding apartments) q-o-q and 5.1% on a y-o-y basis. Vacancies remained flat at 3.9% across the portfolio. GGP bought back $60m worth of stock at $23.16/share but has limited capacity to buy back more due to relatively high gearing. Releasing spreads remained healthy at 10.5% with trading densities rising 0.6% to $519/sq. foot and underlying tenant sales growing 1.8%. The development pipeline remains at $1.3bn at yields between 6-10% and $900m already under construction. GGP lowered the top end of guidance by 1 penny to $2.60/share but the midpoint remains at $2.58/share.
Prologis	Q1 2017 Core FFO increased 3.3% y/y to $0.63 and was $0.01 ahead of market consensus. Cash SS NOI grew by 7.1% with US operations up 8.0%. Occupancy increased by 50bps y/y to 96.6%. Releasing spreads grew 8.2% y/y on a cash basis and 19.6% on a GAAP basis (led by the U.S. at a record 29.2%). Tenant retention dropped by 10.3% y/y to 74.1% (and dropped 5.7% sequentially). The company has a total development pipeline of $2.5B at PLD share (33% pre-leased) which is expected to yield approximately 6.5%. During the quarter, PLD sold $485m at share at a 5.6% weighted average stabilized cap rate. Management increased FY 2017 core FFO guidance to $2.72 to $2.78 from $2.60 to $2.70 ($0.10 increase at the midpoint). Management also increase PLDs share of net effective SS NOI to between 4.5% to 5.3% from 4.0% to 5.0%.
Simon Property Group	A-class Mall REIT Simon Property Group delivered first quarter FFO of $2.74/share which was $0.01 below consensus. Operating metrics were strong with SSNOI rising 3.8% and releasing spreads on new leases closing 13% higher with 20% of 2018 leasing already completed. Trading densities rose slightly and remained high at $613/sq. foot. SPG’s development pipeline remains significant at $1.7 at an estimated yield of 8% with $750m of that pipeline dedicated to Outlet Mall developments. Guidance was maintained at$11.45-11.55/share with consensus estimates remaining above this as SPG is known for delivering above initial guidance.
Realty Income	Tripple Net REIT Realty Income reported Q1 2017 AFFO of $0.76 (8.6% y/y growth) and $0.01 ahead of market consensus. The company achieved SS rental growth of 1.6% and occupancies remained flat at 98.3%. Realty acquired $371m worth of assets at a 6.1% initial average cash cap rate and raised $792m via issuance at a weighted average price of $61.77 per share. Management maintained its 2017 FFO guidance of $3.00-$3.06. Underlying assumptions were also unchanged including acquisition guidance of $1bn and dispositions of between $75-$100m.

Evan Jankelowitz
BCom (Hons), CFA

Mohamed Kalla
BCom, CFA

Kundayi Munzara
BSc (Hons), CFA

DISCLAIMER