NIMBLE WISDOM GLOBAL

Bond bears finally have their way | 28 February 2018

SESFIKILE CAPITAL
Listed Property Investments

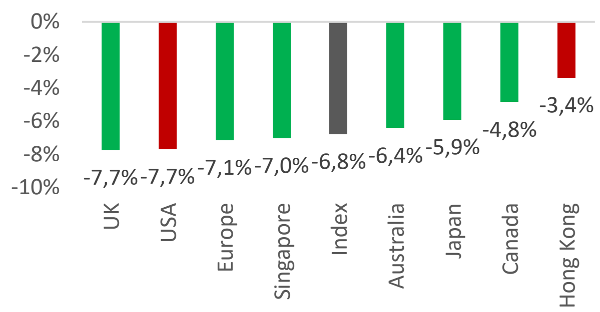
MARKET OVERVIEW

As bond yields continued to rise in February Global REITs (FTSE/EPRA NAREIT Developed Rental Index) expectedly corrected, closing -6.8% lower for the month. All regions showed negative returns with Hong Kong leading at -3.4% and the UK lagging at -7.7% (chart 1). US 10-year Treasury yields rose 16bps in Feb, peaking at 2.95% but closing at 2.86%. Despite US bonds correcting more in January (45bps) as compared to February market expectations shifted as Core PCE inflation is now expected to breach 2% towards Q4:2018, and the US Federal Reserve Bank (Fed) could hike four times in 2018; one more than initially expected.

US incoming Fed Chairman Jerome Powell also 'stoked the fire' by stating that the US economy was fundamentally strong, and that wage pressure was on the horizon, giving credence to bond bears. Europe's economy continues to recover but the political picture remains shaky; on 4 March 2018 Angela Merkel managed to secure a German coalition government with her as Chancellor for the fourth term. There is still risk in the system as Italian elections surprised with centre-right, anti-immigration parties, led by Five Star Movement faring better this round. Negotiations to form a coalition government are underway. In China, the communist party removed term limits for Xi Jinping; *worrying*.

In REIT-land recent results indicated a deceleration in fundamentals in the US and an improvement in Europe as more companies increased earnings guidance.

Chart 1: Monthly returns per region



Source: Bloomberg, as at 28 February 2018

Key Points in this report

- US 10-year bonds continued their losing streak with yields rising 16bps in February from 45bps in January. Despite a more modest bond yield correction, Global REITs fell 6.8% this month, taking year to date returns to -8%.
- German chancellor Angela Merkel managed to agree to form a coalition government and will soon begin her 4th term in office. In Italy, centre-right anti-immigration parties performed better than expected with negotiations underway for a new government. New Fed chair Jerome Powell stated that the US economy was on a strong footing and inflation was likely to rise in the medium term.
- We see a sizable shift in expectations as the market has moved from the psyche of 'secular stagnation' to 'reflation'. Core PCE (inflation) rose 1.5% in the US but is expected to breach 2% this year and a tighter labour market will likely add to wage growth in 2018.
- Global REITs offer a 4.3% dividend yield with projected 5-6% earnings growth over 2 years. Due to our higher bond yield outlook, we have trimmed total return forecasts from 7-9% to around 5% for the 2018 calendar year.

On 27 February, Jerome "Jay" Powell, the new Fed Chair delivered his first semi-annual monetary policy testimony and stated that his outlook was that the US economy has strengthened since December driven by supportive fiscal policy and stronger global growth - all leading to inflation reaching the Fed's goal of around 2% in the medium term. US bonds rose 6bps on the comments but retreated a few days later as Headline and Core PCE inflation rate (the Fed's preferred measure of inflation) for February increased 1.7%y/y and 1.5% y/y, respectively, unchanged and in line with market expectations. Recent data suggests a gradual economic recovery, however a key shift that has played out recently is a change in sentiment from "secular stagnation" to "reflation" and, importantly, this may be enough to move bond yields higher over the next coming quarters. With US employment at 4% and expected to move lower to 3.6% by year end, a tighter labour market could see wage growth above 3% this year - thus, creating a virtuous cycle of higher price adjustments that are based on expectations of higher inflation.

Given the change in sentiment, markets have priced in a 100% probability of a 25bp Fed hike this March, followed by 3 more hikes in 2018 (up from a total of 3). Bond yield views have also adjusted accordingly with most estimates suggesting US bond yields could move higher than the initial expectations of 2.75% to around 3.25%. Given nominal US GDP of 4.5-5% for 2018 and a long-term nominal GDP-Bond yield spread of 1.4%, bonds could indeed settle around 3.35% **although we see downside risk to this as the ECB continues to stimulate and the Bank of Japan continues with its 'target 0%' policy control measures.** A bit further down the horizon the ECB is expected to start hiking in the second half of 2019 which puts upward pressure on EU bonds in the medium term. *So, in some ways after many false starts the* ***bond bears*** *but may finally have their way in 2018.*

LOOKING FORWARD

In simple terms, higher than initially expected bond yields are not good for REIT returns in the short term. And, the 6.8% REIT share price correction in February, despite a modest 16bp rise in bond yields, suggests this has partly played out. Recent studies show that each 50bp hike in bond yields translates into a 4-5% correction on REIT share prices, and a change in sentiment results in a large knee-jerk correction followed by a significant recovery 3-6 month after. From our standpoint REITs show value offering a 4.3% dividend yield with 5-6% earnings growth over the next 2 years, but, with a higher year end bond outlook (from 2.8% to 3.3%) we have to trim back our calendar year returns from 7-9% to approximately 5% in USD; *just because we love the sector, doesn't mean it's always pretty.*

As more company results pour in its becoming more vivid that US fundamentals are 'longer in the tooth'; more REITs simply met guidance this quarter (Q4:17) and worryingly more missed forward-looking growth estimates. On the other hand, European names seem to be outdoing even bullish expectations and upgrading growth numbers on a forward-looking basis. A key standout across the board is the logistics sector where rents continue to rise, cap rates compress further, and demand outstrips supply.

RESULTS COMMENTS:

Company Name	Results comment
Essex Property Trust	Apartment REIT ESS reported core FFO of $11.91 for FY17, equivalent to 7.9% growth. Same Store Net Operating Income (SS NOI) was up 3.4% driven by Same Store Revenue (SS Rev) growth of 3% and Same Store Expenses (SS Exp) growth of 2%. Revenue in Seattle grew of 4% with Southern California and Northern California growing 2.9% and 2.5%, respectively. ESS has a net debt to EBITDA ratio of 5.6x with a weighted Average interest rate of 3.8%. Management guided FY 18 core FFO of between $12.24-$12.64 implying a midpoint growth of 4.5%.
Extra Space Storage	EXR reported Q4 core FFO of $1.12 (beating by 3c) and equivalent to growth of 8.7% y/y. SS NOI was up 5.7% driven by SS Rev growth of 4.9% and SS Exp growth of 2.9%. SS occupancy was up 40bps y/y to 91.9% and average rent growth increased 4.1%. The company had a net debt to EBITDA ratio of 6x down 0.5x y/y and an interest rate of 3.28% with a maturity of 4.7 years. Management guided FY 18 core FFO of between $4.55-$4.65, 5.0% at the midpoint. SS NOI assumption of between 3%-4.5%.
Healthcare Trust of America	Medical Office Building (MOB) focused HTA reported Q4 normalised FFO of $1.63, equivalent to growth of 1.2% y/y. Total acquisitions for 2017 was $2.7bn at 5.2% yield. The company achieved SS NOI growth of 2.8%, driven by 1% SS Rev growth and a 6.2% decrease in SS Exp. Occupancy was down 20bps y/y to 91%. HTA had a net debt to adjusted EBITDA of 5.9x and a weighted average interest rate of 3.5%. The company issued $124.3m worth of stock in the quarter.
Hudson Pacific Properties	West coast office REIT HPP reported Q4 FFO of $0.52 (2c more than consensus) and equivalent to 8% growth y/y. Office cash SS NOI was up 7.9% driven by SS Rev growth 12% and SS Exp growth of 21.1%. Media cash SS NOI was up 15.5% driven by SS Rev growth 4.2% and SS Exp growth of -4.5%. Office occupancy was up 10bps y/y to 95.3%. The company achieved blended releasing spreads of 17.1%. Management guided FY 18 FFO of between $1.87-$1.95 (midpoint of 1.91 in line with consensus).
Kimco Realty	Strip mall REIT KIMCO reported adjusted FFO of $0.39 (1c above consensus) equivalent to growth of 2.6%. SS NOI was up 1.2% and 1.7% for the quarter and FY17, respectively. Quarterly SS NOI was driven by SS Rev growth of 1% and SS Exp growth of 0.6%. Q4 new leasing spreads of 13.2% and renewals of 7.9% resulting in a blended growth rate of 9.2%. Same store occupancy was up 60bps y/y to 96%. The company had a net debt to adjusted EBITDA ratio of 5.9x with a weighted average interest rate of 3.84%. Management guided FY 18 FFO of between $1.42-$1.46 (midpoint of $1.44 compared to consensus of $1.49, 3.5% lower). SS NOI assumption of between 1.25%-2.0%.
Rexford Industrial Realty	Infill logistics REIT REXR reported Q4 core FFO of $0.26 (1c ahead of consensus) equivalent to 13% y/y growth. Cash SS NOI was up 8.7% and 9% for the quarter and FY17, respectively. Quarterly SS NOI was driven by SS Rev growth of 8.9% and SS Exp growth of 8.7% (GAAP). SS occupancy was up 120bps y/y to 98.1%. The company achieved blended cash lease spreads of 18.9%, based on 30.1% growth in new lease rents and 15.5% for renewals. The company has a redevelopment pipeline worth $150m with stabilized yields of around 7%. REXR had a net debt to EBITDA ratio of 5.4x with an average interest rate of 3.45%. Management guided FY 18 core FFO of between $1.01-$1.04 consensus is at $1.08 with a SS NOI assumption of between 6-8%.

Company Name	Results comment
Green REIT	Dublin focussed Office & logistics operator Green REIT delivered a strong interim result with 23.4% EPRA EPS growth driven by a 19% increase in net rental growth. NAV rose 2% to 168cpu implying that the shares trade at a 11% discount to NAV at current prices. Dividends rose by a modest 2% in line with company policy to pay 3% of NAV. Core operations were strong with SS NOI rising 5.5% and new lettings, driven by upward reversions of 11% taking the lease expiry profile to 8.3 years. Group LTV remained low at 22% at an all-in cost of 1.8%. Green REIT completed One Molesworth Street and is in the process of completing 5 Harcourt Road (central Dublin), Building 1 at Central Park and 4 pre-let warehouses Horizon Logistics Park (Dublin airport). Green REIT acquired an additional 28 acres at the horizon logistics park at €2.8m taking total holdings to 300 acres as the group moves towards expanding its logistics portfolio.
Hammerson	European mall (57% UK exposure) REIT HMSO delivered 6.5% EPS growth resulting in 6.3% growth in dividends for the full year. NAV growth was 5% to 776p placing the shares at a 42% discount to NAV. Management reported record volume of leasing up 34% and the lowest vacancy in 17 years. SS NOI was 4.4% with France recovering at 2.6%, Ireland up 7.4% and premium outlet malls up 15%. UK shopping centres and retail parks lagged at 1.8% and -2.5% SS NOI respectively, reflecting the tough retail environment. HMSO’s balance sheet remains conservative at 36%, 78% fixed at a weighted average cost of debt of 2.9%. HMSO has £216m in near term projects at a 9.7% yield. Management has guided 6% growth for the full year. If approved the merger with INTU will be complete by Q4:2018.
Merlin Properties	Diversified Spanish Soccimi (REIT) Merlin Properties delivered 15% FFO growth to 46cpu for the full year. SS NOI rose 2.7% driven by logistics at 8,4% followed by Shopping Centres (3.6%), Offices (2.9%) and high street shops at 0.9%. Releasing spreads rose 13% in logistics followed by Shopping centres at 4.7% and offices at 3.4%. Key developments in the pipeline including Toree Glories (Barcelona) at €142m at a 6.5% yield, Torre Chamartín (Madrid) at €31m at a 6.3% yield, €89m in retail refurbishments and €307m in logistics ground-up developments at an 8% yield. Merlin’s balance sheet LTV is above European peers at 44%, 78% fixed at an average cost of 2.23% for 6.1 years. Guidance is for 9% FFO growth for FY18.
Segro	Logistics REIT Segro delivered 5.9% EPS growth and 6.1% dividend growth for FY17. Driven by developments and cap rate compression the company NAV grew 16.3% to 556p. Over the year Segro invested £1.1bn (£414m in developments) and sold £535m in properties. Vacancies fell to a historic low of 4% and SS NOI rents grew 2.6%. Balance sheet LTV was 30% (from 33%) at year end at an average cost of 2.1% (from 3.4%) fixed for 6.2 years. Segro has a £266m development pipeline, 74% titled towards European urban warehouses at a yield of 7.6% with 80% already pre-let.
Tritax Big Box	UK logistics REIT Tritax Big Box (BBOX) delivered 5.1% EPS growth and 3.2% dividend growth for the full year. NAV grew 10.3% to 142.2p driven by significant value uplift on the standing portfolio that is now 100% let. BBOX acquired 11 warehouses in 2017 for £435m and a 5.5% yield, taking the portfolio WALE to 14.7 years. Balance sheet LTV stood at 27%, fixed for 9 years at an interest rate of 2.66%. post balance sheet acquisitions totalled £221m taking the total number of assets to 50. Management has guided 4.6% dividend growth for 2018.
VGP Industrial	European logistics developer VGP delivered 5.3% profit growth to €5.17/share. The company declared a maiden dividend of €1.70/share after the IPO in Q4:2017. 17 projects totalling 350 000m2 were delivered with another 450 000m2 expected to be delivered in 2018. Vacancies fell from 1.8% to 0% across the portfolio. Group LTV rose from 32% to 43% as new developments were added. VGP continues to grow its footprint in key European locations including Germany, Spain and Romania.

Evan Jankelowitz
BCom (Hons), CFA

Mohamed Kalla
BCom, CFA

Kundayi Munzara
BSc (Hons), CFA

Anil Ramjee
MCom. (EconSci), MSc. (Property)

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