First State Investments

Global Property Securities

Quarterly Review and Outlook

As at December 2016

Key Highlights

- Global property securities declined in the December quarter.
- While property securities tend to underperform general equity markets in rising rate environments, they could still generate positive returns for investors.
- We remain concerned about Continental Europe, where supportive central bank measures have raised property security valuations but have so far not translated to materially higher economic growth rates.

Market Insights

Global property securities declined in the December quarter. The FTSE EPRA/NAREIT Global Developed Index (USD) fell by 5.4% against a backdrop of financial market volatility.

Property securities in Asia ex-Japan underperformed. Singapore's office and retail sectors remain affected by over-supply and soft fundamentals. Hong Kong developers lagged on concerns that the current stringent policy measures and rising US interest rates could dampen housing demand.

The US REITs held up relatively well on an improving outlook for the US economy. Japanese property securities were supported by robust property fundamentals. The vacancy rate for Tokyo's five central wards in November was 3.75% - well below the perceived equilibrium level of 5%.

Strategy Performance

In SGD terms, the strategy fell by 0.6% in the quarter, 89 bps behind its benchmark index.

Drivers of relative outperformance included overweight holdings in Japanese developers with exposure to central Tokyo office skyscrapers, such as Mitsui Fudosan and Mitsubishi Estate. These stocks were supported by undemanding valuation multiples and strong fundamentals of the Tokyo office market.

Positions in US office REIT Hudson Pacific Properties and residential REIT Essex Property Trust were significant positive drivers of relative performance. Both stocks gained higher US economic growth expectations following the US presidential election result. A holding in US retail REIT Equity One also buoyed relative performance. The stock gained on the news that it would be acquired by peer Regency Centers, in a deal which will create a pre-eminently US grocery and community shopping center REIT with an enterprise value of approximately US$15.6 billion.

Detractors from relative performance included exposure to Singapore's CapitaLand Mall Trust, which lagged on concerns that weaker retail sales may reduce its ability to increase rental rates.

Strategy Activity

The strategy initiated a position in Dream Global Real Estate Investment Trust. The company is listed in Toronto, Canada but owns over C$3 billion of primarily good quality German offices. Dream Global trades at a discount to Net Asset Value (NAV) of over 20%, and an implied net cap rate of 7.2%. This compares to similar companies, listed on the Frankfurt Stock Exchange, that currently trade at premiums to NAV, and net cap rates of less than 5%. This mismatch between the company's Canadian investor base and German assets represents an appealing investment opportunity, particularly following Dream Global REIT's dual-listing on the Munich Stock Exchange in October.

A position was initiated in UDR, a leading US apartment REIT, after YTD share price underperformance created an attractive entry level. UDR has a US$16 billion portfolio of class A and B apartment communities, favourable geographic focus (higher-quality, larger US coastal and sun-belt markets) and an attractive development pipeline. US apartment REITs are likely to benefit from higher US GDP growth, tighter labour markets and less new apartment supply.

Unibail Rodamco, which owns and manages shopping centres across Europe, was reduced in December on the view that European political uncertainty could represent a headwind to this stock. Italy's December referendum on constitutional reform was rejected. Rising populism and voter discontent may also play a decisive role in the upcoming French presidential and German federal elections.

Market Outlook and Strategy Positioning

While property securities tend to underperform general equity markets in rising rate environments, they could still generate positive returns for investors. Higher interest rates are typically due to higher growth and/ or increased inflation expectations. Many property sectors are positively leveraged to higher GDP growth, while future rents often include an element of inflation protection (albeit as an indirect, partial offset).

Since the US election, exposure to more economically sensitive US names and sectors has been increased. Some more defensive and lower beta holdings, which had the benefit of performing relatively well YTD, have been reduced.

The portfolio's UK exposure remains focussed on high quality retail malls and student accommodation. Even after December's rally, valuations remain relatively appealing. We remain concerned about Continental Europe, where supportive central bank measures have raised property security valuations but have so far not translated to materially higher economic growth rates. The strategy's European exposures are focussed on the retail and German apartment sectors.

In the Asia-Pacific region, the strategy's has maintained its exposure to Singapore. Despite a subdued macroeconomic backdrop, Singapore's retail property sector includes a number of REITs trading at relatively attractive valuations and generating defensive, recurring cash flows. The strategy's Japanese holdings consist of large property developers that are set to benefit from continued rental growth and the opening of new properties; and smaller J-REITs with appealing investment cases.