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# FIRST STATE GLOBAL PROPERTY SECURITIES

## Strategy Update

November 2019

Global economic growth continues to grow at a moderating pace. We expect global GDP growth to continue to slow into 2020 along with the Chinese economy. High Chinese Local Government debt, moderating terms of trade and a sluggish domestic economy continue to weigh on growth. Countries reliant on China for export income such as the ASEAN[1] countries and Japan will likely experience ongoing headwinds. For developed countries, unemployment remains very low, which is typically coinciding with good wage growth especially in the US, the UK and Germany. Consequently, household fundamentals remain solid with consumption remaining elevated in most developed countries. Business investment growth is stalling with the increased uncertainty of slowing economic growth and the US and China trade negotiations. Interest rates remain very low globally, with Central Banks' extraordinarily accommodative monetary policies expected to remain in place for an extended period. With very low unemployment levels and inflation typically at reasonable levels, Central Banks are typically sighting external risks as the primary factor driving the atypical policy settings. While we do not believe we are heading towards a global recession, but rather a moderate slowdown, risks of an accelerated slowdown bear monitoring. The risk of China's domestic economic fragility and their reliance on external trade, all further deteriorating, may tip the scales. With Central Banks having very few levers to pull, this may very well lead to another global recession. While this is not our base case, we do remain cautious which is reflective of the strategy's[2] positioning.

### Annual Performance (% in GBP) to 31 October 2019

| Period | 12 mths to 31/10/2019 | 12 mths to 31/10/2018 | 12 mths to 31/10/2017 | 12 mths to 31/10/2016 | 12 mths to 31/10/2015 |
|---|---|---|---|---|---|
| First State Global Property Securities Fund B GBP Acc | 21.87 | 4.30 | -1.76 | 20.01 | 10.90 |
| FTSE EPRA/NAREIT Developed* | 18.78 | 4.24 | -2.43 | 30.46 | 6.36 |
| FTSE Australia WGBI 7-10 years TR | 14.13 | 3.05 | 0.70 | 5.05 | 8.37 |
| FTSE Canada WGBI 7-10 years TR | 10.32 | -2.26 | -3.93 | 4.40 | 6.50 |
| FTSE Germany WGBI 7-10 years TR | 6.20 | 0.73 | -0.20 | 3.84 | 3.73 |
| FTSE Japan WGBI 7-10 years TR | 2.54 | -0.02 | -0.76 | 2.88 | 2.14 |
| FTSE UK WGBI 7-10 years TR | 8.07 | 1.32 | 1.12 | 7.30 | 4.76 |
| FTSE US WGBI 7-10 years TR | 14.55 | -3.21 | -1.67 | 4.68 | 3.92 |

These figures refer to the past. Past performance is not a reliable indicator of future results. For investors based in countries with currencies other than the share class currency, the return may increase or decrease as a result of currency fluctuations.

Performance figures have been calculated since the launch date. Performance data is calculated on a net basis by deducting fees incurred at fund level (e.g. the management and administration fee) and other costs charged to the fund (e.g. transaction and custody costs), save that it does not take account of initial charges or switching fees (if any). Income reinvested is included on a net of tax basis. Source: Lipper IM / First State Investments (UK) Limited.

[1] Association of Southeast Asian Nations.
[2] The strategy refers to a composite of First State Investments global real estate securities funds.
* The benchmark changed from UBS Global Real Estate Investors on 20/05.2013

**RISK FACTORS**

This document is a financial promotion for The First State Global Property Securities Strategy. This information is for professional clients only in the EEA and elsewhere where lawful. Investing involves certain risks including:

- **The value of investments and any income from them may go down as well as up and are not guaranteed. Investors may get back significantly less than the original amount invested.**
- **Currency risk:** Changes in exchange rates will affect the value of assets which are denominated in other currencies.
- **Single sector risk:** Investing in a single sector may be riskier than investing in a number of different sectors. Investing in a larger number of sectors helps spread risk.
- **Single country / specific region risk:** Investing in a single country or specific region may be riskier than investing in a number of different countries or regions. Investing in a larger number of countries or regions helps spread risk.
- **Charges to capital risk:** The fees and expenses may be charged against the capital property. Deducting expenses from capital reduces the potential for capital growth.
- **Property securities risk:** Investments are made in the shares of companies that are involved in property (like real estate investment trusts) rather than property itself. The value of these investments may fluctuate more than actual property.
- **Emerging market risk:** Emerging markets may not provide the same level of investor protection as a developed market; they may involve a higher risk than investing in developed markets.

Reference to specific securities or companies (if any) are included to explain the investment strategy and should not be construed as investment advice, or a recommendation to invest in any of those companies.

For a full description of the terms of investment and the risks please see the Prospectus and Key Investor Information Document for each Fund.

**If you are in any doubt as to the suitability of our funds for your investment needs, please seek investment advice.**

Direct property valuations remain elevated at cyclical highs with required returns at very low levels. Property capitalisation rates have typically ceased firming in most markets with property valuation increases moderating. The only exception being shopping centres with the uncertainty of ecommerce disruption leading to continuing falls in valuations. Direct property market fundamentals remain healthy with high occupancy rates, typically few supply concerns especially in global cities where barriers to entry are high. Market rental growth is continuing at moderate levels, driving cash flow growth. Expense pressures continue from wage inflation and land taxes, however operating margins are being maintained. Tenant demand continues to remain elevated for logistics assets in all markets as retailers, etailers and wholesalers continue to invest in their supply chains in order to increase efficiencies to maintain operating margins, to counter the deflationary impacts of an increasingly transparent market place. Online retail sales continue to gain market share putting pressure on shopping centre foot traffic and sales. This is particularly noted in the UK when market rents and occupancies are under significant pressure. Office market fundamentals remain varied, with co-working being a significant driver of office market net absorption over the past few years, now likely to wane given office landlord caution over tenant covenant quality given WeWork's woes.

A publicly traded landlord sold an office building located at 220 East 42nd Street, Midtown Manhattan for $815m. The sale price was low at $715 (sqf) and an estimated 5.0% capitalisation rate. The building is 97% occupied with tenants including Omnicom Group, WPIX and the United Nations. The 37 storey art deco tower was originally developed in 1930, the property has been upgraded and is LEED[3] Gold – certified. The sale price provides further evidence that New York office building valuations have fallen.

While the New York City office market has low vacancy by historical standards, market rental growth has been benign for going on 5 years growing on average 2% p.a. The rise of the Hudson Square submarket of Midtown south through the development of the latest modern skyscrapers has attracted tenants from elsewhere in the city and those new to the New York market. Google just finalised a 1.3m (sqf) lease for the St John's Terminal building, which is currently under development in the Hudson Square precinct, the largest lease deal in the New York market this year. However, the Midtown sub-market has a large amount of supply currently under development totalling 12.4m (sqf), which will likely continue to put a ceiling on rental growth without strong tenant net absorption to maintain the exiting vacancy rate. With co-working being the biggest driver of tenant demand in the New York office market over the past few years, co-working now represents 3.5% of the total New York market. With WeWork's cash flow and debt issues reigning in future expansion plans, tenant net absorption may very well into 2020.

The property securities market continues to trade at direct private market values. Sector total return dispersions continue to remain at cyclical highs, with the greatest pricing anomalies in shopping malls and shopping centres, which are trading at substantive discounts to private market values. However, we are expecting direct property shopping centre valuation falls to accelerate over the next few years. This is in stark contrast to logistical warehousing which is trading at meaningful premiums to private market values. By geography, large pricing anomalies continue to exist in Asia, particularly Hong Kong where the publicly traded landlords are trading on large valuation discounts on concerns over the civil unrest with continued demonstrations, uncertainty of US trade negotiations outcomes and the Chinese economy continuing to slow further. We expect sector valuations to remain at current levels given the very low interest rate environment and the flat yield curves indicating that interest rate normalisation will likely not occur for an extended period. Any change in inflationary expectations may give rise to a steepening of the interest rate curves and sector volatility could increase as a result. The publicly traded landlords continue to take advantage of robust capital markets through equity issuance and selling non-core assets, further improving the quality of their portfolios. Proceeds are typically being used for deleveraging and funding development/redevelopment pipelines. Many landlords have ceased returning capital back to shareholders via stock buyback programmes with the reductions in the discounts to private market values. High occupancy rates, market rental growth and redevelopment are driving higher internal rate of returns and are cementing future cash flow growth over the medium term. The team continues its focus on urban infill assets in the world's major cities where barriers to entry are high and commerce levels remain elevated. The strategy's current implied valuations are above private market and replacement values with total return expectations moderating to below through-the-cycle returns.

The US Federal Reserve cut interest rates 0.25% to 1.5% - 1.75% and sighted a comfort in interest rates at current levels. US non-farm payrolls increased by 136,000 in September. Unemployment fell by -0.2% to 3.5%, the lowest level since 1969. Wages growth continued to be healthy increasing 2.9% (yoy) and encouragingly the participation rate remained at 63.2%, a six year high. US core inflation in September is in line with the Federal Reserve's target rate, increasing 2.4% (yoy). US GDP increased 0.43% in the September quarter, driven by personal consumption, increasing 0.73% (qoq). Annual GDP increased 2.0% (yoy). Very low unemployment and wages growth continue to drive very healthy household fundamentals, which is flowing through to retail sales. US retail sales grew strongly in September increasing 4.1% (yoy), driven by non-store which increased 15.6% (yoy) as ecommerce continues to gain market share. US industrial production for September fell -0.1% (yoy), impacted by the auto sector strikes. The growing domestic economy continues to support direct property market fundamentals where occupancy rates remain very high for apartments, single-family housing and logistics. While the late cycle supply response is well in train for these sectors, strong tenant demand for apartments and single-family housing are being driven by the strong household fundamentals, the falling home ownership rate, technology, urbanisation, demographic and cultural change. The strong growth of ecommerce market share in the US and etailers and retailers seeking to reduce delivery times is continuing to support robust tenant demand for logistics assets as supply chains continue to be rejigged. Self-storage and hotels are experiencing pockets of elevated supply with revenue growth at moderate levels. Although hotel fundamentals have been further affected by falling business investment, with hotel group business down. Office market fundamentals are strongest on the West coast and Boston, although the Sunbelt office markets are improving on strong employment growth. The strategy has a 53.8% exposure to the US with concentrations in single-family housing, apartments, health care assets and logistical warehousing.

[3] Leadership in Energy and Environmental Design

The UK economy continues to grow moderately, with BREXIT uncertainty continuing to impact private investment. The household sector remains very healthy, although UK employment did fall by 56,000 jobs over the past 3 months to August. While the first three monthly fall since 2017, it was due to a fall in part time workers. The unemployment rate increased by 0.1% to 3.9%, with wages continuing to grow strongly, increasing 3.8% (yoy). Low unemployment and wages growth continued to drive UK retail sales is September, which increased 3.1% (yoy). Core inflation remained broadly in line with the Bank of England's target at 1.7% (yoy), just shy of three yearly lows. Shopping centre fundamentals continue to weaken as market rents continue to fall and vacancy rates increase, in spite of improving broader retail sales as online sales continue to take market share. Further pressure is being put on shopping centre landlords as an increasing number of insolvent retailers are seeking commercial voluntary agreements (CVA's) in order to get large rent reductions. It is likely to be many years before shopping centre cash flows stabilize. The London office market remains broadly stable with low new supply and low tenant demand as business investment continues to flounder due to Brexit uncertainty. The industrial property markets remain strong particularly in London driven by ecommerce growth, although the Midlands north of London are starting to experience over-supply pressures. The fledgling institutional apartment market and the more established student accommodation markets remains strong with high occupancy rates and continued market rental growth. With the UK now going to an election in December, the election risk bears monitoring given the opposition Labour Party's excessive left wing policies and the implications for potential further apartment and student accommodation regulations. The strategy has an 8.5% exposure to the UK consisting solely of apartments, industrial warehousing and student accommodation assets.

Western European economic growth is continuing to slow at moderate levels with Eastern Europe continuing to grow strongly. The European Central Bank left rates unchanged at -0.5% and maintained their quantitative easing programme. The Norges Bank of Norway, the National Bank of Poland, the National Bank of Romania and the Riks Bank of Sweden all left rates unchanged at 1.5%, 1.5%, 2.5% and -0.25% respectively, with the Riks Bank of Sweden indicating an interest rate raise in December. Consistent with economic growth Eastern Europe, inflation is tracking higher than Western Europe. Core inflation in September for Czech Republic, Romania and Poland was 2.9%, 2.6% and 2.3% (yoy). The Netherlands, Norway, Sweden, Germany and Switzerland core inflation was 2.7%, 2.2%, 1.6%, 0.9% and 0.1% (yoy) respectively. Unemployment across Europe remained at low levels in September Switzerland 2.1%, the Netherlands 3.5%, Norway 3.7%, Finland 5.9% and Sweden 7.4%. Industrial production (IP) is weak in Germany at -4.0% (yoy) in August, driven down by auto production. France and the Netherlands IP was also weak at 1.4% (yoy) and -0.6% (yoy). The slowing growth is contrary to real estate fundamentals, particularly for the office markets, which continue to remain robust in Berlin, Madrid, Barcelona, Amsterdam, Rome, Oslo and the Central Paris office markets, with strong market rental growth and very low market vacancy rates. The logistical warehousing market continues to experience strong demand, while supply continues to meet demand. In a marked change, broad moderate market rental growth is now starting to be experienced in most markets. While it's difficult to generalise, shopping centre fundamentals continue to slow, while occupancies remain generally high and moderate retail sales growth continues. Retailers are taking longer to sign leases and are pushing back on rent increases as they address their business models focusing on omni-channels to reach the consumer. Our expectation is for shopping centres fundamentals to continue to soften and market rental growth to continue to come under pressure. The strategy has a 13.0% exposure to Europe with concentrations in "A" grade offices Oslo, Madrid and Paris and apartments in Finland.

The Japanese economy continues to weaken, with the large manufacturer very exposed to external risks, particularly from China. As expected, the Bank of Japan left interest rates at 0.1% and the target 10 year bond rate at zero. Industrial production weakened further in August falling -4.8% (yoy). The unemployment rate remained at a low 2.2% in August, which is partly a function of an aging population and increased female participation in the work force with household fundamentals remaining challenged. Consumer confidence fell to the lowest level since 2011 and wages growth was weak with labour cash earnings -0.2% (yoy) in August. Core inflation increased 0.5% (yoy) materially lower than the Bank of Japan's target rate. However, retail sales rose strongly in September increasing 9.1% (yoy), with sales brought forward with the increase in sales tax from 8% to 10% effective in October. The Tokyo office market has yet to be affected by the economic slowdown and continues to remain robust with the vacancy rate in September falling to a very low 1.6%, driven by continued strong tenant demand. Market rental growth continued at healthy levels at 6.9% p.a. 2020 sees a large spike in supply at approximately 1.9m (sqm), almost double the long-term average. With the Japanese economy slowing, corporate investment may pull back, leading to lower tenant demand into 2020. We expect the Tokyo office market vacancy rate to rise in 2020, but is still expected to remain at low levels. Shopping centre fundamentals remain benign, but are at risk of experiencing increased vacancy levels as consumption weakens and online sales continue to grow rapidly. The logistics warehouse markets remain broadly in check, tenant demand remains robust and coincides with large amounts of new supply and new development completions remaining elevated in 2019. Our expectations are that higher barrier to entry markets such as the Tokyo Bay area may start experiencing market rental growth into 2020 in the event that new supply subsides. The strategy has a 9.8% exposure to Japan with concentrations in Tokyo office and logistical warehousing in Tokyo and Osaka.

The strategy is focused on high quality urban infill assets in high barrier to entry markets in the world's most bustling cities. The strategy has a 36.8% exposure to residential buildings, with concentrations in apartments and single family housing in US coastal gateway cities and the Sunbelt, London, Finland and Germany, and student accommodation in the US and the UK. The strategy has a 19.7% exposure to logistical warehousing in the US, UK and Japan. The strategy has a 19.7% exposure to premium and "A" grade office buildings, with concentrations in Tokyo and across Europe. The strategy has a 6.3% exposure to shopping centres, with concentrations in Canada. The strategy has a 2.2% exposure to hotels and all-inclusive resorts in Europe and the Caribbean. The strategy's cash flows are very secure, underpinned by contracted rental income streams with a weighted average lease term of 3.8 years, including the strategy's 41.4% exposure to shorter dated residential, self-storage leases and hotels. Additionally, positive rental reversions of 6.0% are driving embedded cash-flow growth. Given the strategy's exposure to very high quality assets in high barrier to entry urban locations, we estimate the projected three year dividend compound annual growth rate (CAGR) may be 6.0%.

Developed country sovereign bond yields fell in October. The US 10-year Treasury yield rose to 1.69%; the German 10-year Bund yield rose to -0.41%; the 10-year UK Gilt yield rose to 0.63%; the Japanese 10-year Government Bond yield fell to -0.12%; and the Australian 10-year CGS yield rose to 1.09%. The 10-year Canadian Bond yield rose to 1.42%.

In US dollar terms, the global property securities market as measured by the FTSE EPRA NAREIT Developed Total Return USD Index returned 2.5% in October and 23.7% year-to-date. The strategy refers to a composite of FSI global real estate securities funds. If the stocks in the portfolio move from their current market price to reach their assessed valuations over time, the strategy has a total return expectation of -3.0%[4], versus our screened investment universe's total return expectation of -0.7%. The strategy's cash weighting is 1.47%. The strategy's premium to Net Asset Value is 9.5%, with look-through gearing at 29.7%. The interest coverage ratio is 6.0 times, with an average debt maturity of 5.8 years. The number of stocks held increased to 45, with non-benchmark exposure at 6.5% and active share at 77.5%[5].

[4] Total return expectation measures the portfolio weighted average discount of the market valuation to the fair value estimate of the current portfolio holdings. It is not a measure of actual portfolio performance and is not a forecast of portfolio returns.

[5] Active share is a measure of how much the position of holdings in the portfolio differs from the benchmark index.

Source: All data is sourced from First State Investments and Bloomberg and is expressed in local currency unless otherwise stated.

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