Global Property Securities

Quarterly Review and Outlook

As at September 2014

Key Highlights

- Global property securities declined during the September quarter.
- Expected rise of the Federal Funds overnight rate could put further pressure on longer-term rates and hence on property securities' valuations.
- Canada's macroeconomic environment of positive growth combined with a benign interest rate outlook remains favourable for property securities.
- We remain cautious on Continental Europe due to its high unemployment, persistently low inflation and high valuations for the region's property securities.
- In contrast, the UK economy and Japanese office market fundamentals continue to improve.

Market Insights

Global property securities declined during the September quarter. Growing interest rate risk weighed on the sector ahead of the scheduled completion in October of the US Federal Reserve's (the Fed) Quantitative Easing (QE) program. US REITs issued approximately US$2 billion of equity during September, representing a further headwind to sector performance.

The US economy continued to perform well. Second quarter Gross Domestic Product (GDP) growth was revised up from 4.0%, first to 4.2% and then to 4.6%; and at least 200,000 new jobs were created in the US each month between February and July. US REITs are also supported by healthy property market fundamentals. During second quarter earnings announcements, 54% of US REITs surpassed consensus earnings expectations, compared to just 14% which missed estimates.

UK GDP surpassed its previous 2008 peak as the UK economy continued to demonstrate robust growth. UK retail REIT **Hammerson** announced first half results. Hammerson announced strong results, driven by its exposure to the improving UK retail environment. Its Net Asset Value (NAV) rose 6.8% on the back of positive revaluations for its UK assets, while UK tenant sales rose by 2.5%. Results from **Derwent London** confirmed continued strength in the London office market. Keen tenant demand was reflected in rental growth rates of between 6% and 8%.

European GDP growth was flat in the second quarter, and weaker than expected. Inflation expectations continue to decline, increasing the pressure on the European Central Bank to introduce stimulatory measures.

The Japanese economy shrank by a larger than expected 6.8% on an annualised basis during the second quarter, following the introduction on 1 April of a sales tax increase. Despite this, property market conditions continued to improve. The Tokyo office market continued to strengthen. Vacancy rates fell from 6.20% to 6.02% in August and average asking rents rose by 2.8% year-over-year. A clear trend of accelerating rental increases is emerging, with year-on-year rental growth rates having advanced from 0.2% in May to 1.4% in June and 2.2% in July.

A-REIT full year earnings results announced in August were largely in line with forecasts. Market fundamentals remain relatively subdued in the office, retail and industrial sectors, while the residential sector continues to perform strongly on sales increases, margin improvements and high pre-sales levels.

Strategy Activity

A position was initiated in US retail REIT **Kite Realty.** Concerns that its recent merger with non-listed REIT Inland Diversified may result in selling pressure from shareholders in the new joint entity triggered a period of underperformance, presenting an appealing entry point. In our view this transitory issue is outweighed by the benefits offered by potential merger synergies and the larger market capitalisation of the new entity.

Holdings in US document storage company **Iron Mountain** were sold. The company received a positive Internal Revenue Service ruling in June allowing it to convert to REIT status. Following the realisation of this major catalyst, the stock appears relatively less well-positioned against a backdrop of potentially rising interest rates, due to modest internal growth prospects.

Holdings in Hong Kong developers **Sun Hung Kai Properties** and **Wharf Holdings** were sold on recent pricing strength. The companies' respective share prices had risen following the recent relaxation of the government's double stamp duty tightening measure.

Market Outlook and Strategy Positioning

US REIT valuations have improved following September's declines, but remain at the high end of their historical range. The sector's forward Adjusted Funds From Operations (AFFO) multiple is currently 19.5x, having risen from 17.7x at the start of this year. This compares to a long-term average of 15x.

We expect the planned conclusion of the Fed's QE program in October to lead to modestly higher US Treasury yields. The Fed is also expected to start increasing the Federal Funds overnight rate from 0.25% in 2015, which could put further pressure on longer-term rates and hence on property securities' valuations. Against this backdrop the portfolio's US holdings are focused on higher growth sectors including CBD office; Class A regional malls; data centres and apartment REITs.

Canada's macroeconomic environment of positive growth combined with a benign interest rate outlook remains favourable for property securities. While valuations are attractive, and the sector yields an average 5.1%, we remain concerned about the level of new office supply and modest earnings growth.

Continental Europe continues to experience high unemployment and persistently low inflation. This, combined with high valuations for the region's property securities, means we remain cautious on the region, and have maintained the strategy's underweight exposure.

In marked contrast, the UK economy continues to strengthen. The strategy's European holdings are based around the stronger markets such as London, which is benefitting from underlying growth, and the German residential sector, which generates highly defensive, resilient earnings.

Japanese office market fundamentals continue to improve, while supply constraints in the residential market are proving supportive of condominium prices and margins. We have become increasingly selective towards J-REITs as valuations have increased, seeking to own only those trading at the most compelling valuations, and with opportunities for earnings growth.