REITWAY REVIEW – EDITION 9

30 June 2015

Redefining Listed Property Investing

MARKET OVERVIEW

The REIT & Bond Tango

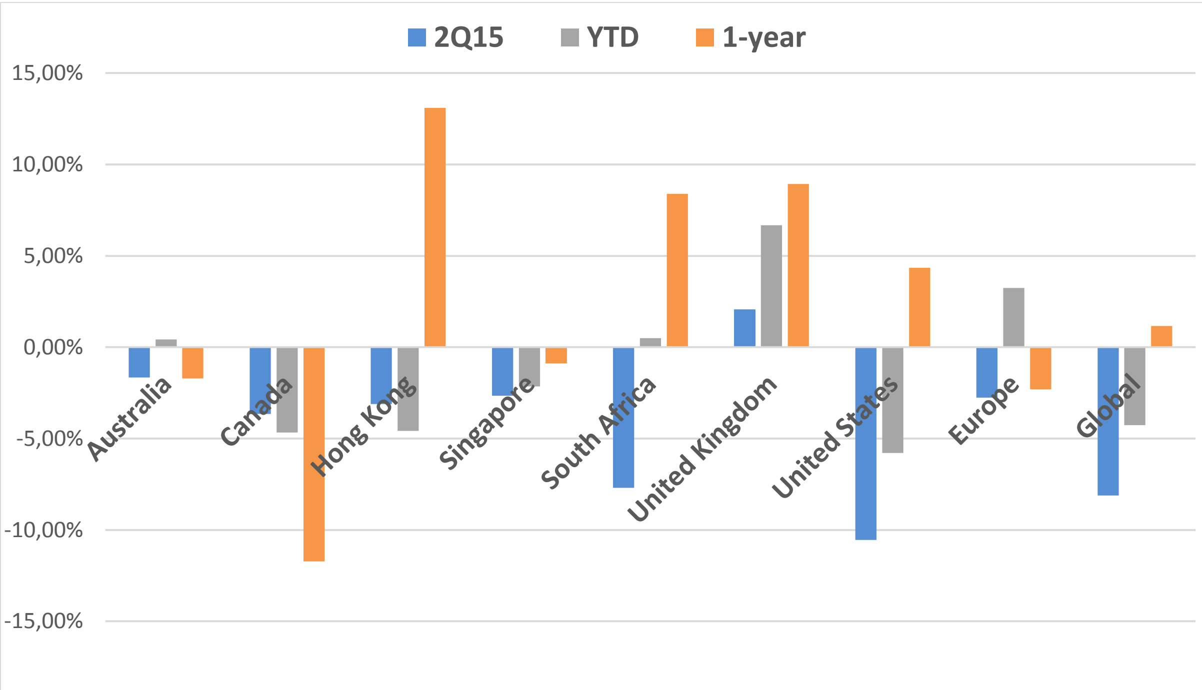
The listed real estate market continues to be influenced by movements in the bond markets and this was the main reason for the 8.12% correction by Global REITs during the second quarter.

REITs are currently more correlated with bonds than they have ever been in history. The relationship between the two assets classes has increased significantly during the past 3 years and they look as though they are dancing the tango.

The UK was the best performing REIT market during Q2 with a 2.07% USD-return, largely as a result of a 5% strengthening in the GBP/USD exchange rate. London focussed REITs delivered very strong financial results in the first half of the year, buoyed by NAV increases of more than 20% y/y. The listed market in the UK has historically been less sensitive to bond yields compared to other REIT markets, which stood it in good stead during the second quarter.

The US was the worst performing market during the first half of the year and has been under pressure due to higher US Treasury yields. The poor listed performance stands in stark contrast to underlying property level fundamentals, which remain healthy and are underpinned by the gradual recovery playing out across the US economy.

Figure 1: Regional REIT market returns as at 30 June '15 (in USD)



Source: Global Property Research. All returns includes dividends and are denominated in USD.

What could eventually break the shackles of the REIT & Bond Tango?

The Global REIT universe is now trading at a 5% discount to Net Asset Value (NAV), in-line with its 10-year average according to research from UBS. A continued pull-back in the listed sector caused by interest rate jitters, would lead to large NAV discounts and thus create the perfect environment for private equity-led take-outs.

According to UBS's research, there is unsatisfied demand for property investment from sovereign funds, pension funds and other large investors. The dry powder for private equity real estate firms for investment is elevated and access to cheap financing is plentiful. M&A and privatizations should therefore provide a floor and may be the catalyst to break the correlations between REITs and bonds.

MARKET FOCUS: UNITED STATES

As the landlord to a growing US economy, US REITs are set to benefit from continued demand for real estate during the remainder of 2015.

Our research partners in the US, Raymond James and The Cowen Group, expect Net Operating Income (NOI) to increase by 4.0% during the balance of the year. Growth in NOI is expected to be driven by contractual rent increases, positive releasing spreads and a slight increase in occupancy levels. US REITs are also benefiting from accretive development/acquisition activity and the end-result should be a 10% increase in distributions to shareholders for 2015.

On the valuation front the four major property types in the US (office, industrial, retail, multifamily) are now trading at a 5% discount to NAV after the Q2 share price correction. If the expected NOI growth for the next 12 months is factored in and no change in capitalization rates are assumed, the major property types are actually trading at an attractive 11% discount to forward NAV.

The bottom line is that US REITs are currently stuck in a tug of war between their strong recent correlations to treasury yields (impact: flat-to-negative) and an increasing supportive P/NAV discount (impact: flat-to-positive).

Clearing the windscreen and thus looking further down the road, our calculations show that US REITs are likely to achieve annualised total returns between 9% and 14% in dollar terms, over a 5-year investment period.

Table 1: Total Return scenarios* for US REITs over a 5-year investment period:

		5-year C.A.G.R. in Distributions		
		7.5%	**10.0%**	**12.5%**
US10yr Yield	**2.0%**	14.5%	17.1%	19.8%
	2.5%	11.4%	13.9%	16.4%
	3.0%	8.8%	11.3%	13.6%
	3.5%	6.5%	8.9%	11.3%
	4.0%	4.5%	6.8%	9.2%

*Calculations based on the FTSE US REIT Index Price of 101.6 and div. yield of 3.8% on 29 June; a long-term REIT premium of 1.30% over bonds; and BCA's likely scenarios for US Treasuries to 2020. Sources: Reitway Global, Thomson Reuters, BCA Research.

PORTFOLIO POSITIONING

Safestore Holdings

The top holding in our fund at quarter-end was UK Self-storage operator Safestore Holdings (SAFE). SAFE has been under new management since 2013 and the new team has managed to improve operational performance to the same level as rival Big Yellow. A recovery in occupancy levels and operating margins is now flowing through to shareholders in the form of increased dividends. Macro trends that bode well for SAFE include a sound UK economy, rising household transactions and urban densification.

SAFE released its half year results in June, meeting prior guidance and showing continued progress across the business. Occupancy levels in their stores were up 3.6% y/y and average rents up 7.5% y/y. These operational improvements resulted in an 11.4% y/y increase in EBITDA, a 27% y/y increase in Cash EPS and the interim dividend was lifted by 40% y/y.

The share price is up 29% since we initiated a position in November, with the company's forward P/E rerating from 14.8x to a current 18.2x. Yet, SAFE still trades at a discount to UK peer Big Yellow (25x), as well as the high-flying US Self-storage sector (21x).

Geographic exposure

The portfolio's geographic exposure has remained largely unchanged during the first half of 2015. As seen from the figure below, we've been purchasing in Canada during the past few months on the back of weakness in the Canadian market.

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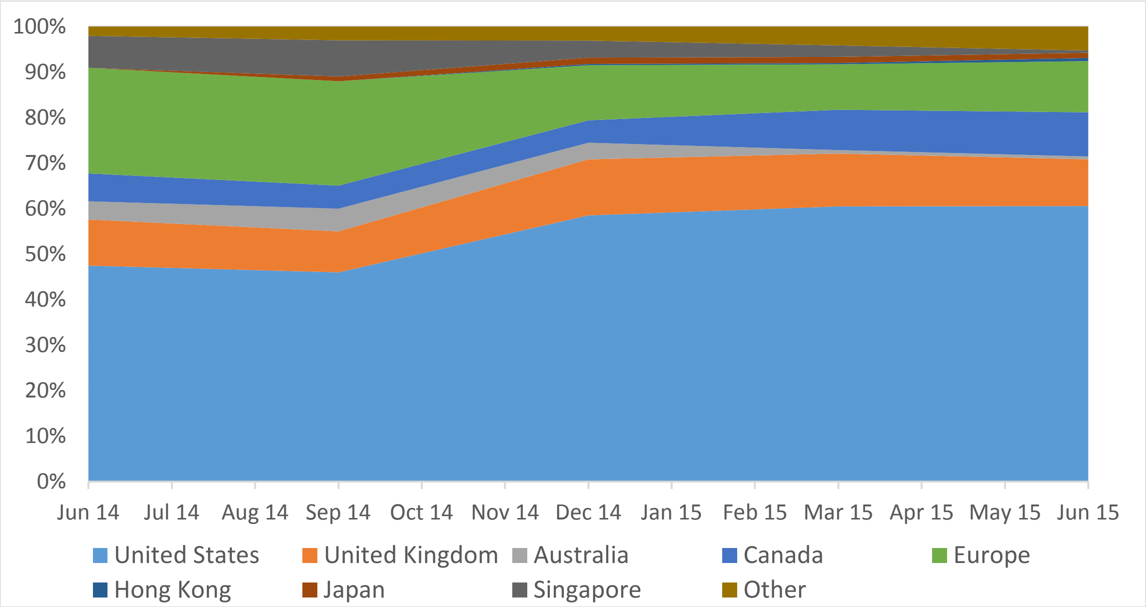
Figure 5: Evolution in country exposure during the past 12 months



Source: Reitway Global

In the US we are positioning the portfolio for an upward turn in the interest rate cycle by investing in REIT sectors that are less sensitive to the bond market, for example Hotels. Our European exposure is concentrated in the continent's best real estate markets, which provide a tailwind for operational performance and NAV growth. We have also taken advantage of depressed Russian share prices by investing in warehouse operator Raven Russia.

Conclusion

At Reitway, we believe the short-term performance of the overall REIT market will continue to be driven by the movements in bond yields. Relatively high volatility is therefore expected for the remainder of the year as the market grapples with interest rates expectations.

As our earlier analysis of the US REIT market shows, the prospects for Global REITs are definitely not as bleak as some uninformed naysayers will have you believe. The table is set for skilful active managers to generate annual returns in excess of 10%, in hard currency terms.

Regards,
The REITWAY team

For more information about the performance of our funds and our investment methodology, please visit our website at www.reitwayglobal.com.