FUNDS ON FRIDAY
by Glacier Research

glacier by Sanlam

23 October 2020
Volume 1072

COVID as a disruptor and enabler of global listed real

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Regional performance during the quarter

The strongest performing region this quarter was Continental Europe, which on the whole has remained resilient relative to other global developed economies although it is not immune to the pandemic and its economic consequences. Hong Kong continued to underperform as tensions with Beijing remain heightened given that the newly imposed national security law threatens to undermine Hong Kong's autonomy and its appeal as a financial hub and risks of capital flight and emigrations out of Hong Kong persist. Year-to-date, Singapore is the strongest performing country, undoubtedly in part, a net beneficiary of Hong Kong's woes, while Australia remains the worst performing country.

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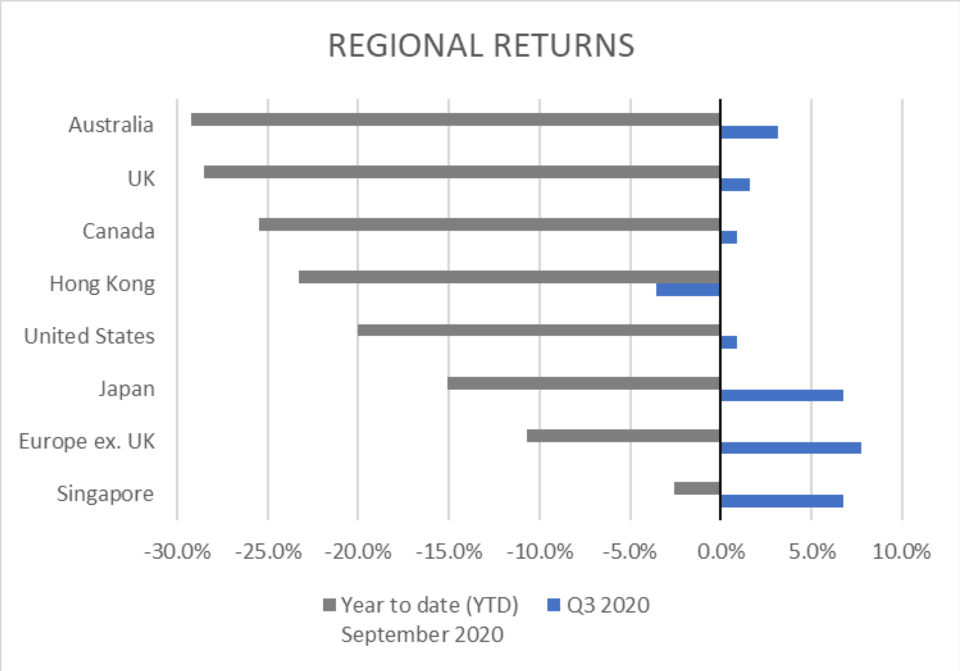
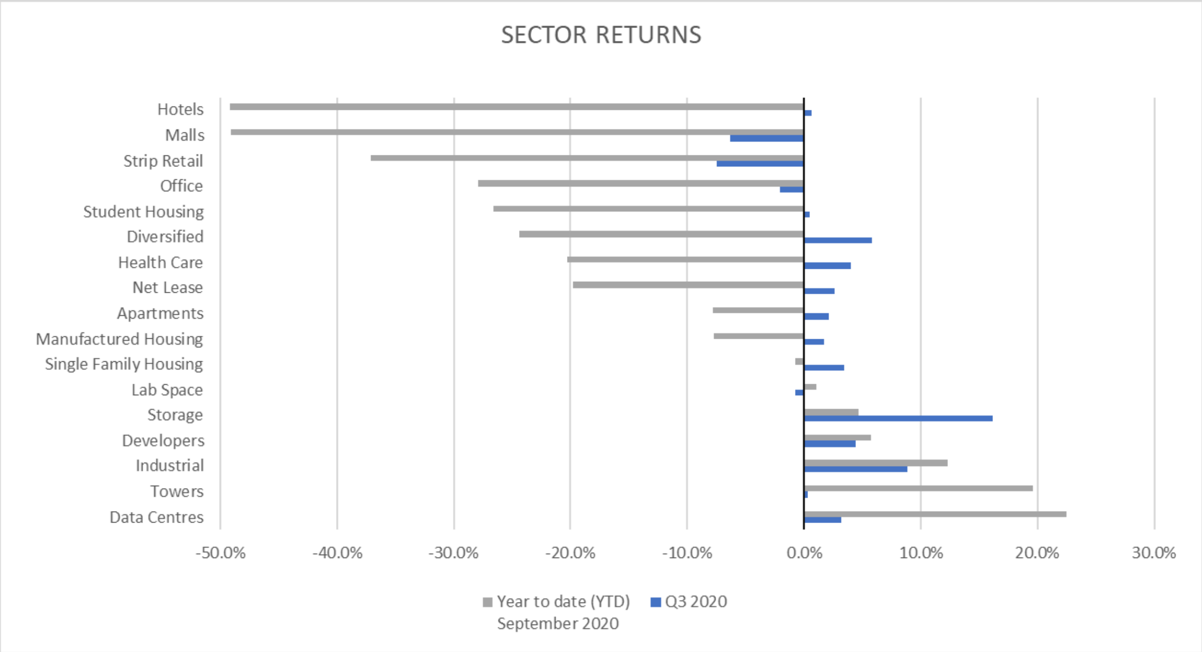


Source: Catalyst Fund Managers & Bloomberg. Returns are total returns in USD

The quarter was characterised by a reiterative pivot between risk-on and risk-off sentiments that fortuitously ended with positive performance. Real interest rates remain low (or negative) under the gravity of record economic stimulus, in turn monetising equities, incrementally sustaining livelihoods and keeping consumption afloat. The gradual re-opening of economies is constructive, while observers counterbalance this with the ever-present possibility of 'second wave' resurgences, accompanied by requisite lockdown measures, which have already transpired in select locations globally. Despite current progress towards a viable vaccine being well-received, the pandemic has unravelled a universal tapestry of socio-economic fragilities and inequalities. Likewise, in instances, it will permanently alter the way we will interact, live and work when returning to a 'new' normal.

Real estate à la carte

The benefits of diversification in enhancing risk-adjusted returns have long been espoused by the investment community. Likewise, as a real estate specialist fund manager, we are advocates of specialisation and view the merits in creating a competitive advantage as highly compelling. Fortunately, the depth and breadth of the global listed real estate universe allows for a marriage of both. The maturity and scale of the real estate sector abroad, particularly in the United States, enables active fund managers to selectively invest in companies either specialised by sub-sector or geographic exposure, and in effect create diversification within portfolios. Given the proliferation of niche real estate sub-sectors and stark intra-sector divergences in performance (exceeding 70% year-to-date), the case for active management is becoming increasingly obvious.



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Head(wind)s or tail(wind)s?

It is reasonable to ask oneself whether the vast difference in performance between sub-sectors and specific stocks warrants a re-allocation of stock holdings. When protecting and growing clients' capital, one would be remiss to succumb to the temptations of rotating capital into optically cheap sectors and stocks, as many appear cheap for good reason. The fundamentals of certain poorly performing sectors remain weak, while those that have performed exceptionally well during the pandemic enjoy strong fundamentals that may see this outperformance continue in the longer term.

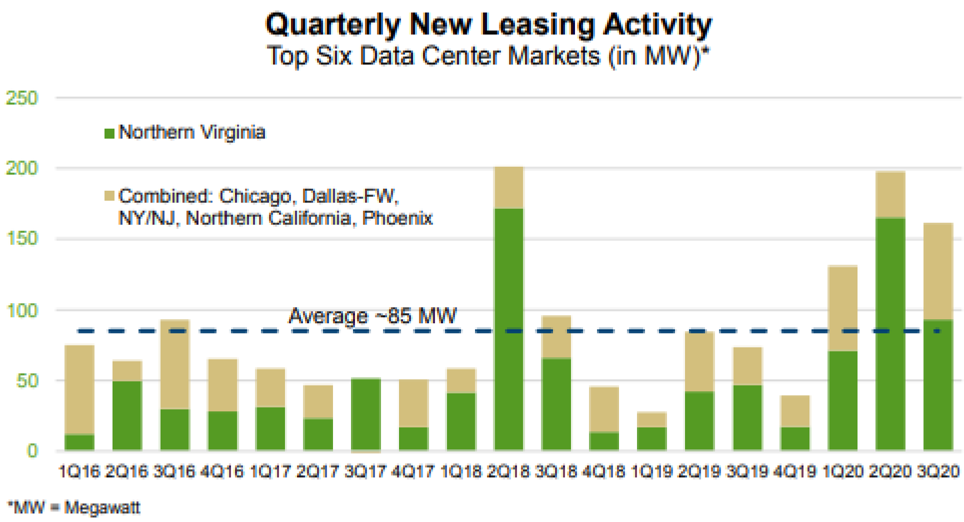
As investors grapple with a confluence of factors, including the pandemic's economic disruption and the unprecedented economic stimulus response, US-China relations, election politics, Brexit etc. volatility and uncertainty will reign supreme. Considering the often-binary nature of these outcomes, which may have far reaching unintended consequences, one would be forgiven for likening any portfolio repositioning timed in anticipation of market and sector rotations to the flip of a coin – 'heads' or 'tails'. Instead, one should take comfort in a disciplined long-term approach and process. Our preference is to remain positioned in stocks and sectors that are benefitting from structural tailwinds and avoid those that are encountering structural headwinds, caveated by appropriate pricing. The current crisis has reinforced and accelerated pre-existing structural trends.

Data centres

Initiated and amplified by COVID, the mass 'Work From Home/Anywhere' (WFH/WFA) movement has provided a jump-step in what was already exponential growth in data consumption. White collar workers are increasingly making use of software applications like Zoom and Microsoft Teams, consuming media content through platforms like Netflix, and conducting online shopping through platforms like Amazon Prime. This data is stored in servers within data centres, and these mission-critical facilities serve as the backbone supporting the secular digitisation of the global economy.

As in most cases, not all data centres are created equally. There are two distinct types: wholesale data centres and retail colocation data centres, where a subset referred to as network-dense data centres are best positioned to benefit from a more interconnected world. Wholesale data centres are commoditised, where the primary considerations for tenants are data storage capacity and cheap, bulk electricity, often satisfied in locations far from dense populations with copious land availability and low barriers to new supply. There are typically a handful of tenants occupying a wholesale facility, and their interdependence is inconsequential. Conversely, retail-centric data centres foster a 'network effect' by hosting potentially hundreds of tenants, including software providers, internet service providers, carriers, and corporate enterprises. These tenants share data amongst one another through private fibre connections known as cross-connections (or interconnections). Given the latency sensitivity and workloads of high-performance applications run in these data centres, the assets are typically proximal to city centres and a single asset may capably serve an entire metro. These factors make it challenging to replicate the tenant ecosystem in a competing location, limiting supply and the ability of tenants to relocate.

Data centre leasing in Northern Virginia, the largest data centre market in the world, accounted for over 80% of second quarter and over half of third quarter leasing across America's six primary data centre markets. Google, Amazon, Facebook etc. have leased large amounts of bulk, wholesale space for data storage requirements. While wholesale data centre landlords have benefited from a massive volume of space leasing, pricing concessions were apparent as cloud providers flexed their negotiating muscles. The likelihood of repeating similar leasing volumes in the back end of the year is questionable as cloud providers may have satisfied their capacity requirements, and landlords have depleted available inventory. In contrast, we favour retail-centric data centre owners, specifically those with global platforms, where the opportunity set to amass scale by developing at double-digit spreads to funding costs are replete.



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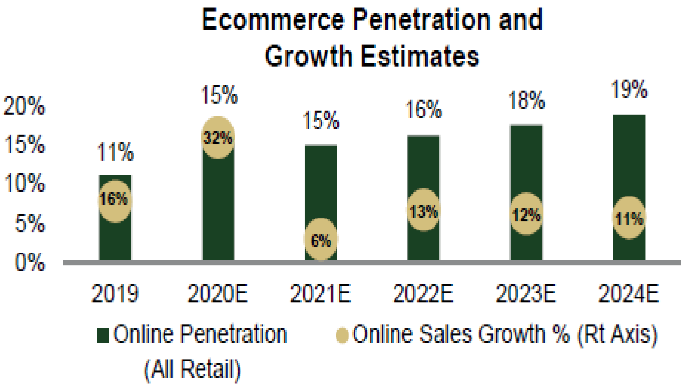
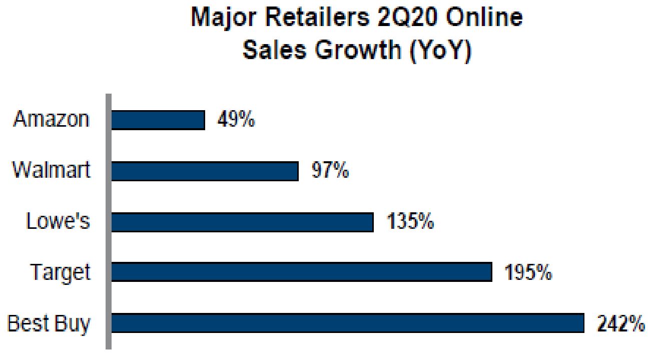
Source: Greenstreet Advisors

Industrial and retail

The advent of e-commerce and its growth in recent years has spurred an overhaul and reconfiguration of supply chains to fulfil deliveries of purchases made online. While relevant retailers who have proactively embraced omni-channel retail and adapted accordingly, may navigate the retail sector's headwinds, the same may not be said for those who displayed inertia in moving away from pure bricks-and-mortar strategies. COVID-19 has compressed years of future online sales growth into the span of a few months, with consumption remaining surprisingly resilient as it was simply redirected away from physical into online channels. This will exacerbate the challenges facing retail tenants, leading to protracted tenant bankruptcies and store closures.





Source: Greenstreet Advisors

The proverb, "what is one's loss is another's gain," is apt as industrial landlords enjoy surging tenant demand for industrial storage and distribution facilities. E-commerce requires approximately three times the space of traditional throughput distribution due to the inherent spatial inefficiencies involved in sorting, separating, and packaging goods, accessibility and turning points for trucks, not to mention reverse logistics (receiving returned goods).

During the early stages of the pandemic, excessive purchases of select goods (toilet paper, sanitary products etc.) fuelled by fear and hysteria, coupled with global supply chain dislocations, resulted in inventory shortages and delays in delivering goods to end users. This exposed flaws in current industry practices, bringing 'just-in-time' models under greater scrutiny and introducing an evolutionary step to 'just-in-case' models, where retailers and manufacturers are expected to hold an incremental proportion of 'safety stock' in warehouses, granting them flexibility to adapt to fluctuations in demand and potential supply chain disruptions. E-commerce behemoth Amazon has taken steps so as not to repeat the backlogs previously experienced during the early onset of economic lockdowns. Prior to this, Amazon mostly had a presence in urban peripheries, but in order to rival competitors like Walmart, are now employing a more direct approach of seeking out urban locations in cities for last-mile delivery. Anecdotes suggest that Amazon is looking to increase their logistics and fulfilment square footage by approximately 50% this year.

Offices

The office sector remains challenged due to declining corporate profits and business confidence, which have curtailed expansion plans, led to retrenchments of staff and lowered office-using job growth. Compounding the impact on office demand is the large-scale WFH/WFA adoption taking place. This is not to say that business employees will not return to office locations. However, WFH will undoubtedly be more commonplace, and commutes into offices will increasingly be reserved for meetings and social staff interactions. In order to facilitate this and ensure that stricter health and safety provisions are in place, it is likely that while fewer workspaces may be required, greater emphasis will be placed on additional space per desk, common areas and meeting rooms – a marginal reprieve for office landlords. That said, a net impact of a permanent shrinkage in office space requirements of 10%-15% does not seem unlikely. Additionally, it is well advised to keep a watchful eye on space being sub-let by tenants, as this may mask weakness in fundamentals that could subsequently manifest as additional vacancies over time.

Despite the dire outcomes resulting from the pandemic, one positive emergence is the enablement of flexible, hybrid working and living arrangements. It has added impetus to a reversal of precedingly protracted urban densification, particularly in coastal gateway markets in the United States. This is expected to continue in part through outmigration from high barrier, tax-heavy markets to more tax-benign and lower cost-of-living suburban markets, disproportionately located in America's Sunbelt. It is anticipated that as businesses and people relocate, the result will be an incremental demand requirement for real estate in these locations. However, not all is doom and gloom for the office sector in gateway markets. The West Coast technology-centric office markets are expected to enjoy stronger demand for space than their East Coast counterparts who are oriented towards the financial sector. Coupled with lower new supply from developments, the overall supply-demand construct for West Coast offices remains favourable relative to the East Coast and the former should achieve superior market rental growth. All considered, it will be key in the ensuing near-term to remain cognisant of any behavioural shifts from users of office space, particularly in the technology sector, where companies are arguably more able and willing to accommodate flexible work solutions.

Corporate activity and significant events

During the quarter, social media company Pinterest announced the cancellation of a 490,000 square foot lease at a 1000,000 square foot planned development on 88 Bluxome Street in South San Francisco. The site is owned by Alexandria Realty (ARE), a lab space specialist, and construction was planned to commence in the first quarter of 2021. Fortunately, ARE's exposure to general technology tenants is de minimus and Pinterest's hefty termination fee of around $90m sufficiently compensates ARE, particularly in lieu of the site having been acquired by ARE in 2017 for $130m, and the high likelihood of backfilling the pre-lease with another tenant in a tight office market. While this is a single data point, it gives credence to concerns of tenants rethinking their office requirements amidst WFH.

In September, Sun Communities (SUI) announced the acquisition of Safe Harbor Marinas, the largest owner of marinas in the US. This represents a meaningful entry into the marina business for SUI, who currently own manufactured housing and recreational vehicle assets throughout the US. The deal consideration of $2bn is to be funded by a mixture of existing debt assumption, new debt, cash, OP units and a large-scale forward equity offering that priced strongly, evidencing investor support for a sector exhibiting robust underlying fundamentals. Time will tell whether the change in strategy away from its core sector focuses, as well as the economics of the deal, sufficiently compensate for the incremental risks taken on. That said, SUI has earned a reputation as an adept capital allocator.

Strong, well-capitalised companies in favoured sectors continue to enjoy accessibility to capital markets for raising funds for growth purposes. Unfortunately, the same cannot be said for overly indebted companies in troubled sectors experiencing headwinds, who continue to shrink. Unibail-Rodamco-Westfield (URW), an owner of mostly 'A+' grade shopping malls, concentrated in Continental Europe (~70%) with the remainder in the US (~23%) and UK (~7%), announced a €9bn euro "RESET" deleveraging programme. The four facets of the programme encapsulate a €3.5bn capital raise via an upcoming rights issuance likely in the fourth quarter of this year pending shareholder approval (a US and EU REIT record), a €4bn asset disposal programme, €1bn retained earnings through lower effective cash dividend pay-outs and lastly the rationalisation of non-essential organic and inorganic capital expenditures. Given that shares of URW trade at eye-watering discounts to underlying net asset value, the equity raise will be deeply dilutive and crystallize permanent value destruction for shareholders. As such, for existing shareholders the “RESET” plan is more reflective of an ‘erase’ plan. Unfortunately, assuming the deleveraging plan can be executed, it will not be the panacea for a troubled balance sheet that will remain highly levered and is another example that further illuminates the dangers of excessive leverage in the context of declining asset values.

Conclusion

The COVID pandemic has stress-tested countries and their varying economic policy responses worldwide. Dislocations in stock markets will arise as investors proact and react to macro-political flux. The outcome will be mispricing for certain stocks and sectors as performance divergence remains vast and changes over time; introducing additional dimensions to stock and sector selection; and opportunities for astute active managers. Those with robust investment processes and investment philosophies will have a solid foundation and platform to identify and capitalise on opportunities as they arise, and deliver attractive risk-adjusted property returns in a

Glacier Research would like to thank Lance Bezuidenhout for his contribution to this week's Funds on Friday.

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Lance joined Catalyst Fund Managers in November 2015 as an Investment Analyst. He is a Chartered Financial Analyst (CFA) charter holder. Before joining Catalyst Fund Managers, he worked for Standard Bank in their Corporate and Investment Banking Real Estate Division. Lance graduated from the University of Cape Town (UCT) with a BSc in Property Studies and a BCom (Honours) in Financial Analysis and Portfolio Management awarded in the First Class (distinction).