

Fundamentals supporting the Reit sector are particularly strong at the moment, claim First State's Andrew Nicholas and Marco van Bussel

# It's the Reit way forward



For Andrew Nicholas, Head of the Property Securities team at First State Investments and manager of the First State Global Property Securities Fund, the fundamentals supporting the real estate investment trust (Reit) sector are particularly strong at the moment, providing investors with the opportunity to enjoy good returns. The inflationary environment, which is proving to be a challenge to central banks and fund managers alike, is making Reits particularly attractive due to their ability to protect their income through inflation-linked rental agreements. What is more, company balance sheets are proving to be in better shape than many commentators anticipated, while the business models supporting these companies have also changed for the better since the financial crisis.

Mr Nicholas says: "The Reit sector globally has become much more focused. A lot of the 'wilder' business models built on debt or spurious ideas have disappeared now, which stands the sector as a whole in a much better position". Marco van Bussel, Senior Portfolio Manager on Mr Nicholas's team, adds that being listed vehicles, Reits were able to access capital in the downturn. "The companies that were not listed often found themselves in deep waters, over-leveraged and unable to sell assets to improve liquidity. Meanwhile, the listed sector could raise equity and strengthen their balance sheets, re-emerging in the aftermath of the global credit crisis in a much stronger position", says Mr Van Bussel.

For the First State Global Property Securities Fund, the challenge now is finding the best ideas to furnish its portfolio which typically comprises 65-70 stocks. This is achieved through a bottom-up stock selection process, which focuses on identifying certain key characteristics.

"First of all there must be a compelling reason to own a particular stock and secondly we look at whether it is in the type of market we want to access," Mr Nicholas explains. "If any stock becomes troubled by low liquidity we sell it at once".

"Our selection process is very 'hands-on', so on our company visits not only do we meet top management, 'talk heads' at the corporate head office, but also those second tier managers who often tend to be closer to every-day operational running of the business. So we do our due diligence using as many sources as possible, including people running the shopping mall or office, for example, and making sure that what they are saying concurs with the message from head office.

"The next stage is valuation of stocks, which comprises of various valuation metrics that we adjust for each region. We rank stocks within their respective regions by quartile and that gives an overall valuation ranking."

This process is supported by Mr Nicholas's 13-strong team, who draw some market information from Colliers International, a leading commercial real estate specialist, which provides additional research to First State on an exclusive basis.

The First State Global Property Securities Fund is currently underweight North America chiefly due to the team's view on the US market, with the managers believing that the strong run over the past 12 months, when the market rose by 24 per cent, has resulted in many stock valuations now looking stretched on a price to earnings basis. However, this is compensated in some part by an overweight in Canadian companies, where the managers are still finding plenty of opportunities. The fund also holds a "substantial overweight" position in Brazil.

Elsewhere, the fund remains slightly underweight Japan, although that position has been added to recently with the hope that Reits may profit from the rebuilding that is taking place following the earthquake and tsunami earlier in the year.

"We think Australia is looking quite cheap at the moment, but the headwinds of rising rates mean it is not a great environment to be in," Mr Nicholas adds. "Meanwhile, Reits continue to do well in Hong Kong and we have exposure to both the office and retail subsectors in that market."

However, outside of Hong Kong the managers remain wary of mainland China where, although stock valuations look relatively attractive, uncertainty prevails over where the government is going to take its fiscal policy next.

"We are looking for the right time to enter the market, but based on what we know from our analysts in that region we are still reluctant to commit our investors' money," Mr Nicholas adds.

Meanwhile, the European component of the fund, which is overseen by Marco van Bussel, is dominated by overweight positions in the UK and Finland.

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He says: "From the valuations perspective, the UK looks particularly attractive, especially London focused companies, where we continue to see good demand for both retail and office properties. There is a good total return picture.

"We also favour Finland given that its economy is doing well and the level of unemployment is relatively low compared to other parts of Europe, which is important when considering the outlook for rents. Finland's economic downturn was not as sharp and deep as it was in some other countries on the Continent."

In terms of sector exposure, the fund is underweight retail, office and diversified and overweight residential, industrials and hotels, although this is mainly a function of the stock-specific decisions the team has made. Indeed, the sector split from country to country is very varied.

"Some of the Reits we have bought in the retail sector are growing income at 3-4 per cent a year. In spite of market conditions, people are still spending money in shops, particularly in those located in strong catchment areas and with quality tenant mix" Mr Nicholas says. "With offices, the picture more depends on the region. Many of the so-called gateway cities in the US are doing quite well, while outside of these key cities we often see major oversupply issues. In Asia Pacific, as a whole, offices have performed relatively strongly, although Japan has been struggling.

On a stock level, the top fund holding is Simon Property Group, America's largest real estate group, which at 6.5 per cent is almost twice as big as the second largest holding, Equity Residential, another big US property company.

"Simon Property is a big stock, so it is not surprising it features prominently," Mr Nicholas says. "It has exposure to a lot of interesting areas of the market and has a particularly strong outlet business. Also, it is run by outstanding management in our view."

The fifth largest holding Unibail Rodamco also provides retail exposure, across Continental Europe and has delivered strong performance since it was added to the fund. It also has some exposure to the French office sector and French exhibition centres.

Tapping into the London theme, Derwent London Reit also features in the fund as the team likes its management's proactive approach and the focus on capital returns, along with a solid income platform. As Mr Van Bussel says: "It is a medium-sized company, so when it makes an acquisition it has significant impact. The group's focus is on London's office sector, with its core business in the West End."

Looking forward, the managers are keen to find companies which have an active approach and look well placed to benefit from market trends. The fund avoids companies which employ a "buy and hold" strategy, or conglomerates that are too big to be able to move quickly when the market environment changes. "We need some of these benchmark style stocks to reduce volatility, but we are trying to avoid having an excessive exposure to them," Mr Nicholas adds.

Overall, the strategy which the managers have been employing since the launch of the fund in 2006 has certainly been paying off. Over that period it has returned 17.2 per cent on a cumulative basis, compared with a benchmark return of 14 per cent and a sector average loss of 17.6 per cent. Not only is it a top quartile fund over one and three years, but also the top performing fund in its peer group over 3 years.

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