For Professional Clients Only

First State Global Property Securities Fund

Fund update

May 2013

Welcome to the latest monthly update on the First State Global Property Securities Fund, providing a review of the fund and latest outlook for the sector.

Market review

- The UBS Global Property Investors Index (sterling) fell by 4.4% in May. The UK was the strongest-performing region, followed by Continental Europe. Japan fell sharply, after strong increases earlier in 2013.
- Comments from the US Federal Reserve suggesting Quantitative Easing may be reduced in coming months, provided US economic data continues to improve, were associated with a rise in 10-year Treasury yields from 1.63% to 2.12%. Higher risk-free rates and wider credit spreads impacted high-yielding stocks, including US REITs.
- The Lehman Estate sold 53% of its holding in shares in AvalonBay and 43% of its stake in Equity Residential. These sales were valued at US$1.08 billion and US$880 million respectively, and have helped to remove a perceived overhang from both stocks.
- European GDP numbers for the first quarter of 2013 were broadly negative, although Germany managed a small quarterly increase of 0.1%. UK GDP numbers beat expectations, recording an increase of 0.3% on the quarter, and 0.6% year on year. European bond yields also rose, despite a 25 basis point cut in interest rates by the ECB. Against this backdrop, European retail REITs reported continued tough markets for their tenants, with retail sales and footfall dropping. Office markets were also generally weak, with London the notable exception.
- Japanese property securities declined sharply in May, driven more by macroeconomic developments linked to the Bank of Japan's monetary easing policy, and increases in US bond yields, than by stock fundamentals. Japanese property companies including Nippon Prologis and Nomura Real Estate Holdings have taken advantage of this year's share price rises and are embarking on equity raisings.
- In response to a rebound in Chinese home prices in recent months, additional tightening measures including increases on deposits and mortgage loan rates were announced by the Chinese government in May. Developer Cheung Kong cancelled its plans to sell HK$1.4 billion of Hong Kong hotel rooms as serviced apartments, in a further indication of official determination to dampen property speculation in the Hong Kong market.

Fund activity

- A position was initiated in Vornado Realty Trust, a high-quality US office REIT trading below Net Asset Value. The stock has underperformed over the past few years, but its simplification strategy is gaining traction. We also believe the company will benefit from New York City market rent increases in the second half of 2013 and into 2014, and from stabilising conditions in the Washington DC office market.
- The Fund added to existing positions in AvalonBay and Equity Residential following the Lehman Estate's sale of part of its stakes in both companies. AvalonBay's development pipeline of approximately US$3 billion is a potentially huge source of value creation for shareholders, as the company builds new communities at 30% to 40% below market value. Equity Residential has a best-in-class management team and operating platform, and significantly upgraded the quality of its portfolio through December's Archstone transaction and subsequent asset sales.
- The Fund also increased its weighting in UK REIT Land Securities. This followed a strong set of full year results and an excellent outlook for the markets it operates in, particularly the City and the West End of London. Highlights of its results included an adjusted NAV of 903p per share (compared to a consensus of 869p), better than expected profits from its development pipeline of £231 million, vacancy rates down to 2%, and a Loan-To-Value ratio of 36.9%, down from 38% in March 2012.
- The holding in Public Storage, the largest US storage REIT, was sold. The company's earnings growth outlook and recent results are impressive. For example, first quarter Funds From Operations per share were up 15.5% versus the same period last year, and same-property Net Operating Income was up 9.5% year-on-year. However, the good earnings growth outlook is reflected in the price.
- The Fund exited Brazil in May, selling the remainder of its holdings in Brazilian mall REIT Multiplan. This was based primarily on macroeconomic concerns including rising interest rates and slowing consumer spending growth.

Market Outlook and Fund Positioning

- A substantial component of the Fund is invested within the Americas. US economic growth is proving relatively resilient, despite fiscal headwinds. The consensus forecast is for roughly 2% GDP growth for 2013 and closer to 2.5% for next year, as impacts from recent Federal tax increases and the sequester gradually dissipate.
- Within the US, we believe shorter-term, more economically sensitive sectors, such as hotel, apartment and industrial REITs, are likely to outperform more defensive, longer lease-term sectors such as health care and shopping centres in a rising interest rate but improving economic scenario.
- The outlook for Europe remains subdued. The Fund has slightly underweight positions for Continental Europe. An overweight exposure to Central London at the expense of the rest of the UK has been maintained. The Fund favours Northern Europe over Southern Europe in the face of ongoing macroeconomic and political uncertainty.
- Although May's pullback has eased some of the more stretched valuations, we continue to view the Japanese property sector with caution. The outlook for the office sector remains challenging, whilst the residential sector appears to be close to its peak. Macroeconomic events are likely to influence the direction of the market in the near future. We expect Singapore REITs to deliver stable earnings in 2013, albeit with minimal growth.
- Overweight exposure to Hong Kong is maintained. Hong Kong landlords enjoy healthy balance sheets, investment grade assets, defensive business models, attractive valuations and the prospect of solid earnings growth. Risk adjusted return expectations from Hong Kong developers are compelling at current prices, due to the recurrent income streams generated by their investment portfolios.

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