The Challenges and Opportunities of COVID-19

First Sentier Investors

Global Property Securities

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COVID-19 has created a challenging environment for income reliant investors, with interest rates near all-time lows and expected to remain there for the foreseeable future, while in equity markets, even the most reliable dividend payers are facing mounting pressure on their dividend policies over the short to medium term.

Over the longer term, we believe that two of the most significant changes that will permeate the post COVID-19 world will relate to workplace flexibility and e-commerce, which will impact office buildings, regional malls, shopping centres and logistical warehouses.

In this piece, we explore how we have positioned our global property strategy to deliver investors both solid capital gains and relatively attractive income-based returns during this crisis and over the longer term.

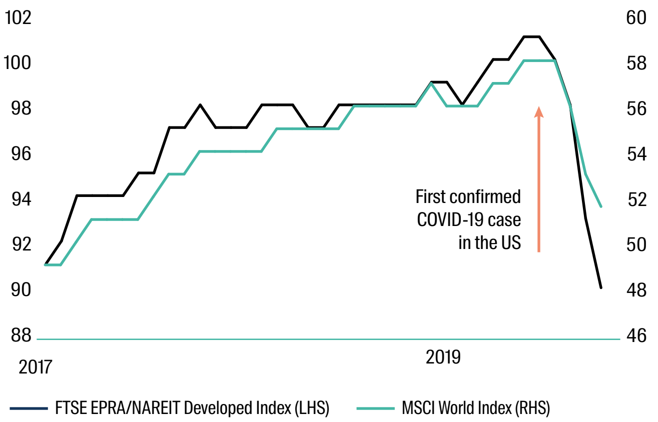
What the Virus Means for Income-Focused Investors

The Coronavirus (COVID-19) pandemic has severely disrupted economic activity due to the drastic virus containment measures that have been implemented by policy makers globally as they attempt to 'flatten the curve' of new infections.

These widespread lockdowns have effectively shut down large parts of the global economy, creating a challenging operating environment for most businesses and listed property landlords have been no exception. This has led to corporate earnings forecasts being slashed across a wide range of sectors.

Many listed companies have prudently withdrawn their earnings and dividend guidance amid the heightened uncertainty, while a growing number of names have completely suspended or reduced planned dividend payments in order to shore up their balance sheets with retained capital. In the banking sector, this has occurred at the behest of regulators and central banks.

Forward 12 Month Dividends Per Share



Source: FactSet as at 31 May 2020.

Forward Dividend per share estimates are based on FactSet consensus estimates and are measured in USD cents per share.

This has certainly created a challenging environment for income reliant investors, with interest rates near all-time lows and expected to remain there for the foreseeable future, while in equity markets, even the most reliable dividend payers like banks and REITs are facing mounting pressure on their dividend policies.

In this piece, we explore how we have positioned our global property strategy[1] to deliver investors both solid capital gains and relatively attractive income-based returns during this crisis and over the longer term.

Rent Collections across the Property Securities Sector

The income stability that REITs typically offer investors is undoubtedly under threat in the near term as COVID-19 related shut downs have hindered the ability of tenants to meet their rental obligations with landlords. This has necessitated rental discounts and deferrals for tenants in the harder hit sub-sectors.

While these headwinds are temporary in nature, depressed rent collections[2] and increased rental concessions resulting from the lockdowns will adversely affect earnings and therefore dividend payments for some landlords in the short to medium term.

However, the impacts haven't been felt evenly across the board, as some real estate sectors face extremely challenging conditions, while others have fared relatively well during the crisis.

1. The Colonial First State Wholesale Global Property Securities Fund.

2. The rent collections discussed throughout this piece are based on what has been disclosed to date by REITs and property companies within our investible universe.

Residential Housing – Apartments, Single Family Housing, Manufactured Housing

Our Exposure: 28%[3]

The residential sector has been very resilient amid the pandemic, reflecting the inherent defensiveness of housing as an essential asset class for residents. Tenants have demonstrated a continued ability to pay their rent, and accordingly rent collections have been very high as a result.

This has been underpinned by the widespread fiscal support measures that governments have introduced globally, such as enhanced unemployment benefits and welfare entitlements, as well as direct cash payments to citizens. Moreover, most residential REITs have acted as good corporate citizens amid this crisis and have typically not been passing lease renewal rent increases onto tenants. Landlords are also generally offering rent discounts and/or deferral options to tenants affected by the crisis, however, this is currently only required for a very small part of the rent roll.

In the US and Canada, residential landlords within our investable universe reported rent collections ranging from around 90% to 98% in May. In Europe, data from April indicates that the sector have been largely unaffected by the pandemic, with rent collections being above 99% for residential landlords. In Japan, while there is limited public disclosure of these metrics, our discussions with listed apartment landlords indicate that there has been minimal, if any, impact on rent collections to date across the sector.

Office Buildings

Our Exposure: 25%

Office buildings have been relatively resilient despite the significant disruptions to the traditional work day, as many corporate tenants have been able to effectively continue their operations from home where required. However, a larger degree of rental support has been required for ancillary tenants, such as ground-floor retail and cafes. Overall, rent collections have generally been solid amid lockdowns and stay-at-home orders.

In the US and Canada, rent receipts have typically ranged from 85% - 99% in May, with some landlords reporting that collections have been unaffected and are in line with normal levels. In Europe, to date rent collections have ranged from 70% to above 90%, though outcomes have been skewed towards the upper end of this range.

In Asia, most of the office landlords in Hong Kong and Singapore that we have spoken to have not experienced any changes to their rent collections or arrears. In Japan, while a small number of lease cancellations have transpired, which take effect after a notice period, rent collection remains strong and limited disruption has been reported to date.

Industrial – Logistical Warehousing

Our Exposure: 18%

Industrial assets including logistical warehouses have been largely insulated from COVID-19 related lockdowns. During the pandemic, the sector has also benefited from an acceleration of e-commerce demand and heightened supply chain activity from businesses deemed 'essential services'.

In the US and Canada, collections reported in May have generally been in the mid to high 90% range, though some landlords have been more impacted by the pandemic and have experienced rental receipts as low as 80% where deferrals have been offered to tenants.

In Europe, rent collections have typically been between 80% and 90% to date. In Japan, Hong Kong and Singapore, based on our discussions with management teams, listed asset owners across the sector have not experienced any material impacts on their rent collections to date.

Retail – Shopping Centres, Regional Malls

Our Exposure: 9%

Traditional 'brick and mortar' retail has been one of the major casualties of COVID-19. Retail assets have been severely affected by the mandated closure of 'non-essential' businesses, as well as by the changing behaviour of consumers who have increasingly avoided shopping in public places, particularly for non-essential items.

There has been a sizeable shift towards online shopping for both discretionary items and essentials like groceries and medicine. Widespread rental concessions will be required for tenants and we expect dividends to be cancelled or reduced significantly across the sector until trading conditions return to normal.

Retail assets can be divided into two main broad categories, shopping centres and regional malls. Shopping centres are supermarket-anchored neighbourhood centres that are typically tailored towards convenience and non-discretionary stores. On the other hand, regional malls are larger, destination retail centres that contain an eclectic mix of tenants and typically have a strong bias to discretionary retail.

Convenience oriented shopping centres are expected to be more insulated from lockdown measures than regional malls as their tenant mixes are largely oriented towards non-discretionary retailers like supermarkets and pharmacies.

In the US, most shopping centre landlords reported rent collections between 50% to 60% in May, while in April, the more heavily impacted regional malls reported collections between 10% and 30%. In Canada, where landlords are mostly exposed to neighbourhood shopping centres, rent collections have been varied, ranging from as low as 55% to more than 90% in May. In Europe, rental receipts have typically been in the 30-40% range for regional malls, although one landlord has reported collections as low as 20%.

In Asia, conditions have been mixed. Retail landlords in China have reported that rent collections have been full, as the country has now come completely out of lockdown. No rental rebates or deferments have been offered to tenants. In Hong Kong on the other hand, while there has been no disclosure of rent collections or rebates, we expect rental rebates to be substantial and widespread amid both COVID-19 and the ongoing unrest in the territory.

In Singapore, while there is limited disclosure, retail names have cut dividends in anticipation of weak tenant cash flows and are offering large rental rebates and deferments until the end of June at least. In Japan, based on our discussions, in some instances up to 50% of tenants have asked for rent deferrals / reductions for the period that stores have been closed during the country's State of Emergency. The level of support required has depended largely on the exposure of landlords to discretionary retail.

Healthcare – Hospitals, Primary Care Facilities, Senior Housing

Our Exposure: 7%

Healthcare assets include private hospitals, primary care facilities such as medical office buildings, life science facilities and senior housing communities.

3. All exposures are as at 31 May 2020 and reflect the Colonial First State Wholesale Global Property Securities Fund.

The cash flows of this sub-sector have been varied. There are some near-term risks facing the occupancy levels of certain asset types such as senior housing and aged care facilities. On the other hand, we expect hospitals, medical office buildings and laboratories to be a beneficiary of the pandemic.

In the US, rent collections were generally between 95-100% in May, and no US names in our investable universe reported levels below 90%. In Canada, rental receipts reported in May were generally in line with typical months, while the lowest level reported was in the mid 80% range. Meanwhile, the healthcare names that we cover in Europe have not reported any materials impacts on rent collections to date.

Data Centres
Our Exposure: 5%

Data Centre REITs, which own specialist assets that house the infrastructure required to power modern internet usage like cloud computing, have been very robust in recent months. The sub-sector has been unaffected by lockdowns and is actually poised to benefit from a growing reliance on cloud-based technology and accelerating data consumption in an increasingly digital economy.

It is unlikely that landlords will have to offer considerable rent discounts or deferrals because the largest data centre tenants are typically large investment grade tech and cloud computing companies.

In the US, major asset owners haven't reported any significant impacts to their rental receipts to date. Rent collections were reported between 97% to 99% by two landlords in May, while other names in the sector have anecdotally stated that rent collections have been either unchanged, or are marginally lower / higher than usual.

Self-Storage Facilities
Our Exposure: 3%

Self-storage facilities have also demonstrated their defensiveness during the pandemic, as the sub-sector has been relatively insulted from COVID-19 shocks. In the US, where most listed self-storage names are domiciled, landlords have reported rent collections in the mid 90% range during April and May.

Hotels
Our Exposure: 2%

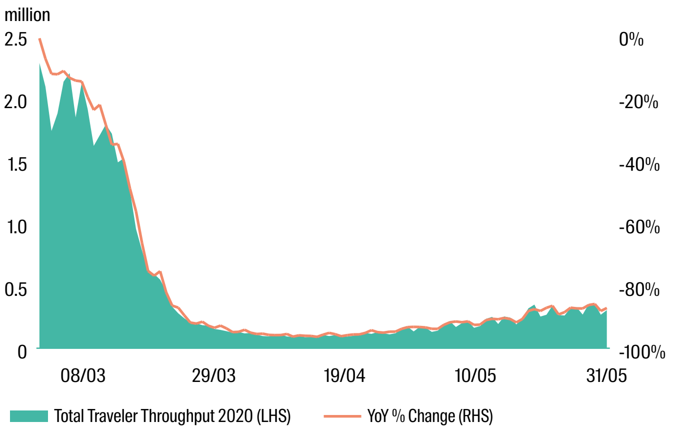
Hotels have undoubtedly been the hardest hit of all real estate sub-sectors as they face severe disruptions resulting from the unprecedented travel restrictions in place around the world.

Many hotels have closed temporarily, while those that remain open are experiencing dramatically lower levels of occupancy. Where a head lease is in place, rent discounts and deferrals have been offered to operators, with some reportedly paying as little as zero fixed rent.

We expect minimal rent collections and dividend payments in the near term, as earnings are likely remain severely challenged for the foreseeable future, and the focus of landlords and operators will be on shoring up balance sheets to avoid insolvency.

We have already witnessed a number of hotel operators filing for bankruptcy, and more insolvencies are likely in the coming months as tourism related sectors are expected to be the last component of the global economy to re-open.

US Air Travel Volumes – 2020



Source: Transportation Security Administration as at 31 May 2020. Chart reflects TSA checkpoint travel numbers.

How our Global Property Strategy is Positioned

While lockdown measures are now being progressively eased in a number of countries, which should see most businesses start to re-open, we believe the ability of tenants to meet their rental obligations will remain challenged in the months to come, at least. Some tenants in certain sub-sectors could be re-paying deferred rents for years to come.

Nevertheless, we believe our strategy is well positioned for the near term challenges because most of our portfolio is concentrated in highly insulated sub-sectors where rent collections have been robust, including residential housing, office buildings, logistical warehouses, data centres, healthcare assets and self-storage facilities.

Our strategy has limited exposure to retail overall, although we do hold selective exposures to the sector globally. We are primarily positioned in supermarket anchored neighbourhood and sub-regional shopping centres, as well as well-managed regional malls, which were recently introduced into the portfolio after they were materially oversold during this crisis.

We also have de-minimus exposure to the embattled hotel sector.

Sector Exposures (on a "look-through" basis)

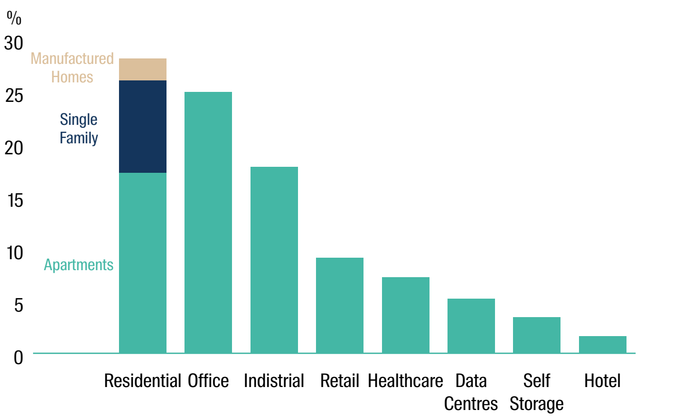


Chart reflects the Colonial First State Wholesale Global Property Securities Fund. 'Look through' exposures represent the portfolio's actual exposure to underlying property types, without reference to GICS or other classification standards. Source: First Sentier Investors as at 31 May 2020.

Accordingly, in the shorter to medium term we expect our strategy to experience higher rent collections than the broader property securities sector, while being less hampered by widespread rent discounts and deferrals.

We therefore believe the strategy has a stronger near-term earnings outlook than the broader sector, which should result in it delivering investors more secure dividends and capital returns during this crisis.

This highlights a key strength of our active and largely benchmark unaware approach, which focuses on allocating capital efficiently through rigorous bottom-up research and disciplined portfolio construction, rather than simply replicating an index.

The strategy is also highly diversified across a range of sub-sectors and regions, reducing the risk that idiosyncratic or country/sector/asset specific challenges could materially hinder the portfolio's overall performance.

Based on our internal modelling, our strategy has a forecast 1 year forward dividend yield of 3.8%[4] as at 31 May 2020.

The Longer Term Impacts of COVID-19

While COVID-19 will materially affect earnings and dividend payments across the sector in the near-term, which we believe we are well positioned for, our overarching focus is on how the pandemic is likely to impact listed property markets over a longer time horizon.

To consistently deliver investors a combination of capital growth and recurring income-based returns, we put the greatest emphasis on medium to long-term cash flow growth. As active investors, we are continuously considering how the pandemic - and all macro trends - will change the way we operate as a society, and how this could in turn affect real estate fundamentals.

We believe that two of the most significant changes that will permeate the post COVID-19 world will relate to workplace flexibility and e-commerce, which will most directly impact office buildings, regional malls, shopping centres and logistical warehouses.

The Rise of Remote Working

To comply with COVID-19 lockdowns and promote worker health and safety, companies across the world have increasingly adopted flexible work arrangements, which has seen an unprecedented number of employees working from home temporarily.

As many companies have successfully adopted remote working in this period, a broader discussion has emerged regarding how work arrangements could be structured going forward and a number of well-known companies have now flagged the possibility that flexible working could be implemented permanently. For example, Facebook CEO Mark Zuckerberg recently said the company could possibly see about half of its employees working from home over the next 5 to 10 years. A US oriented survey by research and advisory firm, Gartner, found that nearly three quarters of companies intended to permanently shift at least some of their workforce to remote working.

While it is highly uncertain how significant these shifts will be, this thematic could dramatically reduce the need for office space over the long term. Businesses that are able to shift parts of their workforce off-site with unchanged or improved levels of productivity will realise economic benefits as they reduce their office footprints. More flexible work arrangements can also help businesses foster greater work-life balance for employees. It should be noted, however, that office occupancy costs for many services businesses are low, meaning the potential cost savings of downsizing offices are not likely to be substantial.

Nevertheless, given the potential benefits for businesses, we do expect a greater adoption of remote working in the future, which clearly points to structurally lower levels of natural office demand over the medium to longer term.

In the medium term, this could lead to office buildings experiencing lower levels of occupancy and reduced market rents on average. Over time, we believe that levels of office supply will adjust for the lower natural levels of tenant demand, leaving office markets in equilibrium, particularly in the world's most bustling cities.

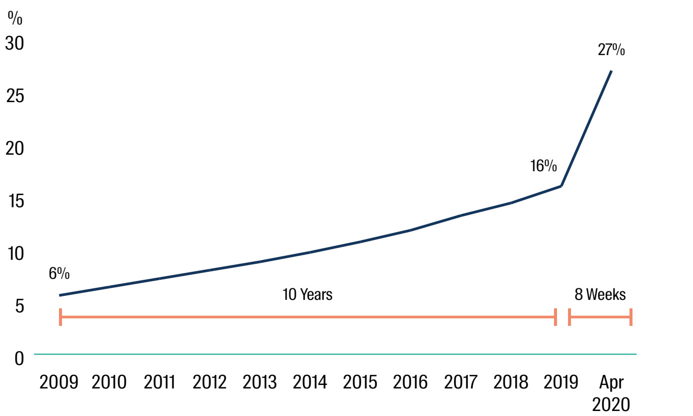
At present, given the extent of the recent sell-off across the sector, office valuations are attractive despite expected headwinds. We believe that office buildings will deliver solid economic returns over time, as they will continue to play an important role for businesses. It is also worth remembering that most office markets entered this crisis in a robust position, with very low vacancy rates and strong rates of market rental growth.

Increased Adoption of Online Retail

The structural shift towards e-commerce and away from traditional 'brick and mortar' retail has been underway for many years now, however, COVID-19 related lockdowns and social distancing measures have seemingly fast-tracked this trend.

Many consumers have been forced to buy goods online due to physical store closures, or have voluntarily shopped online as a means of social distancing. This has seen e-commerce penetration surge at unprecedented rates across the world.

US Ecommerce Penetration (% Retail Sales)



Source: Bank of America, U.S. Department of Commerce, ShawSpring Research. Data as at April 2020.

While e-commerce penetration could moderate from current elevated levels in the post COVID-19 world, it appears likely that current trends in consumer behaviour will persist and see e-commerce penetration remain high. This is partly because a number of demographic groups will have become more accustomed to e-commerce during this period and may shop online more frequently going forward as a result. In any case, it is clear that e-commerce will make up a considerable part of the future retail landscape.

Even prior to the pandemic, the rising adoption of e-commerce was having an appreciable impact on mall landlords globally and a growing number of well-known retailers had already announced store closures and in some cases bankruptcy / voluntary administration. It is our expectation that these challenges will be intensified by COVID-19, which is likely to see further insolvencies arise in the near term.

4. The 1 year forward dividend yield is based on forecasts of future dividend payments, which are predictive in nature and therefore not guaranteed to occur. The metric may be affected by inaccurate assumptions, known or unknown risks and uncertainties and may differ materially from results ultimately achieved.

Over the longer term, we expect the fundamentals of regional shopping malls to deteriorate and for assets to carry structurally higher vacancy rates and lower rents, as retailers increasingly shift their stores online and demand for physical shopfronts declines. Our strategy had a very low exposure to shopping malls coming into this crisis and we currently hold only selective exposures to well-managed malls located in the world's most bustling cities. These positions were recently introduced into the portfolio after they had been materially oversold in recent months.

The outlook is more optimistic for smaller convenience and sub-regional shopping centres. These centres are far less exposed to the risks associated with the greater adoption of e-commerce as they typically have tenant mixes tailored towards non-discretionary uses, like supermarkets and pharmacies, and services that cannot be replicated online, such as hairdressing and beauty services. It is our view that shopping centres will continue to be a viable part of the retailing landscape for decades to come and we therefore maintain select exposures to quality landlords within this sub-sector.

On the other hand, the major beneficiary of the increased adoption of e-commerce will be industrial assets such as logistical distribution centres, which play a vital role in the fulfilment of goods purchased online. In recent years, logistics assets have already benefited significantly from increased demand from e-tailers, retailers and wholesalers, which has caused vacancy rates to fall and market rents to rise across the sector.

We expect e-commerce penetration to continue its upward trend over the medium to longer term and for this to bolster future demand in the sector. We also believe businesses will continue to invest heavily in improving supply chains to better meet customer needs, particularly after the panic buying that was experienced at the start of the pandemic, which put supply chains under significant stress in a range of sectors and meant many businesses were unable to meet customer demand.

This thematic should underpin a continuation of the currently robust fundamentals in the sector. Accordingly, we remain heavily invested into industrial assets like logistical warehouses.

Outlook

The global property securities sector faces significant challenges in the near-term, which will be reflected in depressed earnings and dividends in upcoming reporting periods. Over the longer term, we will see a range of structural changes take hold and affect real estate fundamentals across different sub-sectors to varying degrees.

However, we believe our global property strategy is very well suited to the current market conditions, benefiting from an active investment style that has an overarching focus on rigorous bottom-up stock-selection based on medium to long term fundamentals.

Our experienced team is continually recalibrating its views of both the near-term and longer-term implications of COVID-19 for listed real estate securities, and is actively positioning our portfolio accordingly.

We are confident that our strategy is well positioned to deliver investors attractive risk adjusted returns amid COVID-19 and over the long term.