RESOLUTION CAPITAL

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Life of Brian

One doesn't want to unnecessarily add to the fear, but one shouldn't underestimate the economic and social dislocation caused by COVID-19 and the importance of the response by the authorities. Above all else, our thoughts are with the vulnerable and with those in society who will struggle to find work in the coming weeks and months. The workers in the cafes we frequent, the public transport and Qantas staff who have delivered us to the far reaches of the planet and brought us home, to the people who clean our offices and our homes. And of course, we think of our healthcare workers who are now in the trenches of the war against COVID-19.

With the economy all but shutting down, the decision for banks is deceptively simple. Such is the breadth of the problem that a significant proportion of their customers could be considered a default risk. Hence, they have no choice but to help out "in the national interest". As providers of capital to a well-functioning economy and society, REITs will need to do their part too.

It's easy to overlook the weaker oil price which adds to the challenges facing key segments of the US economy. I am reluctant to say it is an uncertain environment, it is ever uncertain. This is a massively anxious period.

GFC – a practice run

The government and central banks must now backstop the banking system. As was the case for European banks after the Global Financial Crisis (GFC), 'pretend and extend' will be the norm. It will be some time before they know which customers are worth saving and how much of their customer base will become solvent in a reasonable period. Nationalisation of industries and socialising debt will likely become part of the vernacular.

We are all waiting for our national leaders to show Churchillian composure and resolve. Perhaps the 24-hour news cycle makes this unrealistic. So far, the response of the different national leaders seems haphazard. I do not have an easy solution, my intellect can only be stretched so far with my focus currently on my family, the Resolution Capital team and our clients and service providers. But it is imperative that we have confidence that our politicians and central planners will ultimately do the right thing.

However, collectively as businesses and individuals we must all be prepared to make sacrifices which will ultimately make us better as a society.

REITs

It's fair to say that REITs globally have been hit hard. Year to date, G-REITs are down by over 30% in local currency terms. Professionally, this is the most disappointing aspect as the sector has not delivered the diversification in this short-term period that we would have hoped for. Whilst we are pleased with our relative performance, this is of limited comfort for investors worried about capital preservation. Crucially our long-term total return performance remains positive. We have always said we will periodically encounter draw downs and that investors need to have a 7-year time horizon. We stand by this principle albeit we acknowledge given the overwhelming nature of the pandemic this feels naive.

Silver Lining Liquidity

From this bleak position it's hard to be see the positives. But we believe the REITs are providing one critical attribute, liquidity. Whilst we may not agree with current global REIT pricing, at least in a relative sense, our clients can still achieve liquidity if they need it. Furthermore, this liquidity should be viewed equally as an opportunity to invest, not simply to redeem.

Many companies including REITs have withdrawn earnings guidance, and some have already reduced and/or suspended dividends. Whilst the market is operating in somewhat of an information vacuum in relation to economic data, and hence it is not fully informed or orderly, we are against the idea of closing the stock market. Arguably for some, for now at least, listed REITs have taken the heat that would otherwise be placed on unlisted investments. The stewards of this area have time to grapple with the pricing and liquidity challenges coming their way. Already UK unlisted funds have shuttered redemptions. Speaking with private equity operators who theoretically are sitting on dry powder will be revealing.

Act of God, Force Majeure, the dog ate my homework

It is easy to say that the pandemic is a unique event, but the failure to recognise the regularity of "unique events" is getting hard to ignore. Investors in REITs typically desire a long-term store of wealth with low risk of permanent impairment. Capital structures should reflect this mindset, not short-term earnings objectives of REIT management who have limited personal capital at risk in the REIT.

Unfortunately, Australian REITs once again face a particularly challenging set of circumstances, sectoral and economic. In light of REIT stock concentration, Australian household debt and the challenges facing traditional bricks and mortar retail property, we have long been concerned about too much exposure to A-REITs. Crucially, A-REITs are heavily weighted to retail shopping centres and residential development, two segments particularly vulnerable at this point in time.

Having brought the residential market under control in 2019, it was disappointing that the RBA lost its nerve and put in place the ingredients to reflate the market in late 2019 without allowing time for households to effectively get their debt under control.

Furthermore, we expect COVID-19 will accelerate the inevitable reset of shopping centre income as consumers have changed their spending patterns. Indeed, it will be interesting to see just how the COVID-19 experience further reshapes household spending patterns as was evident from the Great Depression. This is why we have: (a) strongly recommended GREITs, where there is sectoral as well as geographic diversification, and (b) converted our domestic A-REIT strategy to include global REITs and most recently infrastructure investments. Our global strategy has been managed consistent with our philosophy of effective diversification through quality real estate, strong balance sheets and strong stewardship.

We are not underestimating the challenge but believe globally many REITs have been overly discounted at least **relative** to some other segments of the equities market and other asset classes.

The Case for REITs

What investors need to recognise is that:

- Relative to direct property, REIT pricing now is compelling. If you believe direct property values will hold up, then it could be argued that REITs should immediately de-list and investors should be advised only to sell at "Stated NTA" as is the case with unlisted real estate funds. Of course, this is nonsense. We argue that the spread is a combination of under-priced REITs and overvalued direct property prices. This poses major challenges for trustees of direct property funds, something that is already being borne out, once again, with several unlisted UK funds freezing redemptions for at least the third time in the past decade. More on this and index funds at a later time.
- The majority of the REITs in which we invest have not necessarily been irresponsible in their capital management, debt levels will prove manageable unless we have a complete breakdown of the economy. But the issue needs to be asked: what is an appropriate level of financial leverage for long-term real estate investment vehicles? It seems today any leverage is an

extreme risk. But if one believes a large swathe of REITs are at risk of defaulting on their loans then this suggests the banking and corporate bond sectors are facing significant losses. Hence, investors need to be consistent across other capital stacks in their fears.

- Ironically through QE central planners had been encouraging more borrowing (we believe low interest rates was a function of low inflation). To their credit, most REITs did not eat too much of the bait. On some measures many REITs have been reducing leverage in recent years and improving the tenure of their borrowing facilities and limiting borrowing covenants. Hence, with some key exceptions, REITs are unlikely to face significant near-term refinance risk. Of course, as we noted earlier, at least some banks have already indicated they will not be calling in debt in the near term.
- REITs are landlords to a range of tenants including operating businesses. For many businesses real estate is an essential input without which they cannot generate revenues (even the seemingly intangible cloud computing industry finds it necessary to lease large quantums of physical space ie real estate). In effect REITs can be thought of as ranking equally, if not in front of the tenant's shareholders and creditors, including banks. If rents are not paid, the business is unable to be conducted in the leased property. If the business is not able to conduct its business, it cannot pay its creditors including its banks nor can it pay its shareholders dividends. Hence, as long as the real estate is well located and appropriately capitalised, REITs should be in a position to endure economic cycles, service their debt, and pay distributions.
- We often describe REITs as 'landlords to the global economy'. Many REIT tenants are public companies. Hence, if there are major tenant defaults, then both the REITs and equities market is in trouble and the combination of these factors would mean the banking sector is in significant trouble. For the record, the biggest single tenant in our underlying portfolio generates 2% of the income. Our portfolio has exceptional tenant diversity.
- REITs own tangible assets. This is a notable point in itself as equities markets have grown to be dominated by intangibles. The underlying land component of REIT portfolios can, in many respects, be considered a better means to store wealth compared with other investments such as gold as land can be improved to produce cash flows. This land, provided it is well located, will be attractive to existing businesses and individuals and, should they vacate, the properties will attract a new batch of occupiers.
- The case against real estate revolves around the extent of increased vacancy rates and the extent to which management of real estate is assumed by creditors. Landlords including REITs, are at risk of losing pricing power for an extended period.
- We expect the value of liquidity through the stock market will become more greatly appreciated in the next 12-18 months. It will be seen as a means of liquidating direct real estate redemptions. We hope Resolution Capital's capability will be valued in this event.

All that said, bottom line rents are a function of supply and demand. Whilst supply is moderate in most regions, economic contraction will translate into reduced tenant demand. Hence, we expect property vacancy rates will rise and rental income will be under pressure. REIT distributions will be reduced. Following last year's civil unrest, Landlords in Hong Kong have already provided tenants with rent holidays, and we expect this will become widespread in many developed markets as a consequence of measures to slow/curb the spread of the virus. The extent and duration of the pressure is difficult to predict but current prices suggest the cuts will be material. But REITs will, through good corporate citizenship or economic necessity, be forced to provide concessions.

In the short term at least, we expect continued price volatility as we are operating in an information vacuum and the depth of the recession is unknown. Much rests on central planners responding appropriately to controlling the speed of the spread of the virus, the nature of the fiscal and monetary response and the development of an effective vaccine. We believe the issues with QE highlight the measures need to be targeted and limited in timing. Brexit negotiations and the US Presidential elections create further areas of uncertainty.

Longer term we can be constructive that the economy will experience significant change which will generate new forms of tenant demand. Companies are likely to diversify the supply chain. Pleasingly technology infrastructure has provided the means by which many industries can carry on to some extent by enabling workers to operate remotely. Whilst too slow for some, the economy has shown some evidence of increased flexibility.

Nevertheless, there is a multitude of unknowns: What will be the medium-term impact on inflation and interest rates? How will it alter the political landscape, and will it sow the seeds or exacerbate regional tensions? How long will the virus last and what will be the impact on demographics (births and deaths)?

As an organisation Resolution Capital is prepared to help, however we can whilst continuing to focus on what is within our area of specialty: investment in listed real estate securities which have relevant well located real estate, financed by robust balance sheets and aligned management. We are holding higher levels of cash than we would otherwise but our mandate is to be relatively fully invested (in most cases >90%).

We thank our clients for their composure and perseverance in these extraordinary circumstances. As has always been the case, expect the unexpected, good and bad, but have faith in the system's ability to adapt and hope for an effective vaccine as soon as possible. We urge you to stay the course and maintain a quality REIT exposure as part of a quality diversified portfolio.