

Fund Commentary

Performance drivers and positioning of the portfolio for the recent calendar quarter are explained below. Our investment experts also provide regular investment updates at mlcam.com.au/insights

The FTSE EPRA NAREIT Global Developed (A\$ hedged) index (market benchmark) returned 0.1% in Australian dollar terms in the quarter to 31 March 2023. The fund returned 0.5% (before fees and tax, A\$ hedged) in the quarter, which was 0.4% ahead of the market benchmark.

The first quarter of 2023 started well as Real Estate Investment Trusts (REIT's) updated investors on broadly sound results for 2022 and positive operating conditions continuing. Encouragingly, in the context of the recent significant increase in interest rates and earnings downgrades in other segments of the share market, REIT earnings guidance for 2023 pointed to further growth although marked by expected softer leasing conditions in the second half of the year.

A good old-fashioned US bank run (thanks to the troubles at Silicon Valley Bank) shook commercial real estate (CRE) markets which rely on banks for finance. Furthermore, given that commercial real estate corrections have often accompanied (or indeed caused) bank crises in the past, it is not surprising that commercial real estate and REITs came under pressure.

Small and regional US banks are important lenders to the sector, accounting for around 38% of total CRE mortgage debt outstanding. As such we expect credit conditions to tighten for the broader commercial real estate market, even if at this point, we see limited signs of excess specific to the CRE sector which would cause systemic failure.

Over the past decade most REITs have improved their capital structures materially and diversified their borrowings away from banks to a range of capital providers, particularly by accessing unsecured corporate debt markets. With few exceptions, the REITs are positioned to be good customers for financiers which continue to be in the business of lending money to good quality credits.

Self-storage was the best performing property sector with a total return of 12.4% in local currency terms driven by mergers and acquisitions (M&A) activity in the US.

Office was the weakest performing sector over the quarter with a total return of -8.4% in local currency terms. Longer term structural headwinds from hybrid working, combined with near-term concerns around the economy and the unfolding banking crisis weighed on office stocks. Most of the worst performing stocks were US office names, which fell more than 20% over the quarter and are now down 60-75% from pre-pandemic highs. The drawdowns in the US office stocks are approaching peak-to trough levels experienced during the GFC, while office REITs in other countries have not suffered to the same extent.

During the quarter, Presima, Resolution and BlackRock all outperformed.

The fund returned -22.0% (before fees and tax, A\$ hedged) in the year to 31 March 2023, which was -0.7% behind the -21.3% return of the market benchmark. Presima outperformed while BlackRock and Resolution underperformed.

Please refer to the 'Market commentary' for an overview of what happened in other domestic and global markets over the quarter.

Stock story

One of our G-REIT managers, Resolution Capital, provided the following stock story for one of the fund's holdings, which you may find interesting:

"Unite Group PLC (UTG) is the largest provider of purpose-built student accommodation (PBSA) in the UK, providing residence to ~70,000 students. UTG's £5.4bn portfolio consists of 157 properties across 23 UK cities with the largest market being London comprising 40% of the portfolio by value. London has attractive long term supply demand fundamentals as one of the most sought-after locations for students in the world but faces significant supply constraints for new development.

UTG's portfolio is currently 99% occupied and has historically been resilient during economic recessions with its occupancy remaining above 97% throughout 2008-2010. UTG benefits from having a secure income from universities and the ability to set market rents on an annual basis. Beds are either resold directly to students each year or through nomination agreements where universities lease beds from UTG and subsequently let the beds to students. Over half of UTG's beds (52%) are currently leased through nomination agreements and 63% of these benefit from annual rent increases through inflation-linked leases based on RPI or CPI or fixed escalators. For the upcoming 2023/2024 academic year UTG is expecting rental growth of 6-7% across its entire portfolio.

Supply of PBSA in the UK has been slowing, forecasted delivery of less than 15,000 units in 2023, down from a historical average of c.30,000 beds pa. Supply is constrained by increased development and financing costs as well as planning challenges (particularly in London) and is expected to remain at moderate levels. Strong demand is supported by underlying demographic trends which forecast 19% growth in UK 18 year olds by 2030 as well as rising enrolments in universities from both domestic and international students.

UTG is an active developer of PBSA, delivering £275m of fully-let projects in 2022 with a current development pipeline of +4,800 beds for an estimated development cost of £850m. In addition to their PBSA offering, UTG recently expanded into the build to rent sector with the acquisition of a 'pilot' development in London in 2022. The strategy behind this expansion is to retain graduated students as they move into the working world as young professionals.

UTG is guiding to 5-8% of earnings per share growth in 2023. The company's net debt/EBITDA stands at 7.3x with an LTV of 31%. Fixed rate debt makes up 97% UTG's debt book (4.1 years average debt maturity)."

Notes:

- As our investment managers are constantly reviewing and making changes to their holdings, this company may no longer be included in the portfolio.

- Commentary for this fund will be updated approx three weeks after the end of the calendar quarter.