Global Real Estate Securities - 2019 Market Outlook
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The Opportunity in 2019

We believe a slower economic growth environment sets the stage for REITs to outperform broad equities and continue their Tortoise (REITs) and the Hare (General Equities/Technology) campaign in 2019 by generating an attractive total return balanced between yield and growth. The outlook is premised on five key factors:

1. REIT outperformance typically grows in magnitude and frequency as economic growth slows.
2. Global REIT earnings growth will be more resilient than global equities in 2019, setting the stage for better relative performance.
3. Global REIT valuations are attractive relative to global equities.
4. Public market valuations are attractive relative to private market valuations trading at an 11% discount to NAV.
5. Institutions are expected to increase allocations to real estate in 2019 which when combined with large unfunded commitments will be supportive of real estate valuations.

Despite being later in the cycle and the range of outcomes in 2019 feeling wider with macro-economic uncertainty higher, our bottom-up fundamental analysis currently suggests that global REITs are priced to generate a positive total return in 2019 in the range of 9–10%. This return consists of a 5% cash flow yield and 4–5% earnings growth driven by:

• Increases in annual contractual rent bumps;
• Positive releasing spreads; and
• Completion of redevelopment and development projects currently underway.

Our view is that the greater the percentage of your total return that comes from recurring income versus future growth, the higher the degree of confidence you can have in achieving that total return.

INVESTMENT OPPORTUNITIES IN 2019

United States:
• Secular growth opportunities in the world of technology
• Apartments benefiting from a slower for-sale housing market
• Triple Net Lease REITs offering attractive external growth and high cash-on-cash returns

Canada:
• Industrial REITs benefiting from e-commerce
• Outsized demand growth for Senior Housing driven by strong demographics

Europe:
• Residential opportunities in Ireland and Germany
• Office markets in Belgium and the Netherlands benefiting from Brexit

Japan:
• Small- to medium-sized Grade B office buildings located in Tokyo

Hong Kong:
• Decentralized office markets experiencing strong demand and rising rents

Singapore:
• Data centres positioned to take advantage of growth in Asia

Australia:
• Non-discretionary retail shopping centres offering resilience
• Specialty property types offering attractive yields and total returns

For further details on our top investment ideas for 2019 please refer to each regional market outlook.
# Global Real Estate Securities – 2019 Market Outlook

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2018 MARKET OVERVIEW

2018 started out as a promising year driven by synchronized global growth propelling most asset classes to new highs but quickly morphed into an unbalanced one beginning in the fourth quarter. Factors such as escalating trade wars, Brexit fears, rising interest rates in North America, slowing economic growth in China, political instability in Washington D.C., higher budget deficits in Italy and wider credit spreads, all had a hand in weighing down the markets. Investors began to doubt previous growth expectations leading to a collapse in stock markets globally, a spike in volatility, a flatter yield curve and falling oil prices for the second time in three years. So, amid all this activity how did REITs fare and what does this mean for the asset class going forward?

Global real estate securities served as a beacon of safety relative to most other sectors during the turbulent times of 2018. Specifically, in the fourth quarter, global REITs outperformed global equities by 785 basis points (bps) (-5.5% vs. -13.3%). Although global REITs underperformed our own expectations for the year (-4.7% in USD) as a result of the impact from rising interest rates and other macro headwinds, earnings growth exceeded our forecasts. This growth along with the defensive nature of the asset class allowed REITs to play catch-up in the fourth quarter.¹

Global real estate securities advanced 3.7% (CAD) in 2018 as a stronger U.S. dollar buoyed returns. In terms of specific market performance in 2018 (Figure 1), U.K. REITs suffered from rising uncertainty around Brexit which made them the worst performing REIT market while slowing economic growth in China weighed on the performance of Hong Kong and Singapore. Commodity-focused markets such as Canada and Australia or markets less dependent on Chinese growth such as Japan delivered positive total returns, benefiting from steady property fundamentals.

2019 GLOBAL REAL ESTATE SECURITIES FORECASTS

The long duration of the current economic expansion by historical standards combined with the re-pricing of growth expectations beginning in the fourth quarter of 2018 has invoked fears of a recession. We do not believe a recession is imminent, but we are cognizant that the growth trajectory is changing. With economic headwinds such as tariffs, slower growth in China, tighter monetary policy in the U.S. and Canada as well as reduced quantitative easing globally, we would be remiss to not see these factors weigh on global growth over the coming year.

Having said this, REITs and their recurring income streams have proven to be a powerful solution in a slowing GDP environments. Contractual leases held within REITs and their more predictable generation of cash flow provide investors a level of reliability that many other sectors are unable to match in uncertain markets. In turbulent times markets hate uncertainty which is why you can expect more investors to shift capital towards defensive asset classes like REITs where there is a higher degree of transparency.

Having said this, we believe a slower economic growth environment sets the stage for REITs to outperform broad equities and continue their Tortoise (REITs) and the Hare (General Equities/Technology) campaign in 2019 by generating an attractive total return balanced between yield and growth. This outlook is premised on five key factors:

1. REIT outperformance typically grows in magnitude and frequency as economic growth slows.
2. Global REIT earnings growth will be more resilient than global equities in 2019, setting the stage for better relative performance.
3. Global REIT valuations are attractive relative to global equities.
4. Public market valuations are attractive relative to private market valuations trading at an 11% discount to NAV².
5. Institutions are expected to increase allocations to real estate in 2019 which when combined with large unfunded commitments will be supportive of real estate valuations.

Figure 1: 2018 Total Return by Market

Source: Bloomberg, Timbercreek. As of December 31, 2018. The representative market indices are: FTSE EPRA NAREIT Developed Total Return Index, FTSE EPRA NAREIT Hong Kong Index, FTSE EPRA NAREIT Singapore Index, FTSE EPRA NAREIT Developed Europe ex UK Index, FTSE EPRA NAREIT U.K. Index, FTSE EPRA NAREIT Canada Index, FTSE EPRA NAREIT Australia Index, EPRA NAREIT United States Total Return Index, FTSE EPRA NAREIT Japan Index. Total returns are in local currency.

¹Source: Bloomberg. The representative market indices are the FTSE EPRA NAREIT Developed Total Return Index and MSCI World Index.
²Source: UBS
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Let’s delve a little deeper into each of these factors:

REIT outperformance typically grows in magnitude and frequency as economic growth slows.

As highlighted in Figure 2a and 2b, if we take the U.S. as an example, over the past 45+ years, when real GDP growth averages between 2% and 3%, REITs outperform the S&P 500 Index 59% of the time and by over 200 bps annually, while generating an average return of +16%. We’ve seen a similar trend in Canada where Canadian REITs outperform the S&P / TSX Composite Index 53% of the time and by nearly 700 bps annually, generating an average return of +13%. In 2019, Citi estimates global real GDP growth will be around 3%. In 2020, Citi forecasts global real GDP growth to decelerate further in the U.S. and Canada (+2.0%), Continental Europe (+1.6%) and Japan (+0.4%), setting the stage for REITs to outperform.

Global REIT earnings growth will be more resilient than global equities in 2019, setting the stage for better relative performance.

Starting in 2017, markets began to soar driven by higher earnings and economic growth expectations, causing global REITs to underperform global equities by 18.1%, yet global REITs still generated a respectable 6.9% annualized total return (in USD)³. From 2014 to 2016, when growth was recovering but markets were choppy, global REITs outperformed by 783 bps averaging 7.6% annual earnings growth compared to 3.7% for global equities. We believe there is strong empirical evidence showing a positive correlation between earnings growth and share price performance. In 2019, global REITs are poised to deliver 4.7% earnings growth⁴ while global equities are expected to see their earnings growth decline by approximately 75% driven by the one-time U.S. tax cut benefit wearing off and slower economic growth (Figure 3).

Global REIT valuations are attractive relative to global equities.

As highlighted in Figure 4, global REITs are currently trading 1-standard deviation below the 10-year average on a price-to-cash-flow multiple basis. The last time global REITs traded at these relative valuation levels was mid-2017 and previous to that in 2008–2009 which marked a multi-year turnaround in relative REIT performance. We believe REITs are cheap as an asset class relative to equities and the underperformance of REITs over the past several years has created an attractive buying opportunity for investors. While the relative valuation gap has remained wide since 2016, we believe the main obstacle to a recovery in relative valuations has been the headwind of potential rate hikes in the U.S. which started in December 2015. As the monetary tightening cycle moves into its later stages, we believe this can serve as a catalyst to close the gap.

³Source: Bloomberg. The representative market indices are the FTSE EPRA NAREIT Developed Total Return Index and MSCI World Index.
⁴For the time period from December 31, 2016 to September 30, 2018.
⁵Source: UBS
Global Real Estate Securities – 2019 Market Outlook

Figure 4: Relative Price-to-Cash Flow Multiple of Global REITs vs. Global Equities

Public market valuations are attractive relative to private market valuations trading at an 11% discount to NAV\(^5\).

Over the last 15 years, global REITs have traded, on average, at a 5% discount to NAV and last cycle (2003 to 2007) global REITs traded at a 5% NAV premium.\(^6\) We frequently see assets and companies being sold at prices far higher than what they are trading for in the public market. For example:

- In Hong Kong, Swire Properties recently sold Cityplaza Three and Four, two Grade A office buildings, for HK$15 billion at a 2.3% cap rate yet the company trades at an implied 6.4% cap rate.\(^6\)
- In Singapore, CapitaLand Commercial Trust sold Twenty Anson, a 206,000 centres A office property located in Singapore’s Central Business District for S$516 million at a 2.7% cap rate yet the company itself trades at a 4.5% implied cap rate.\(^7\)
- In Germany, office properties in Hamburg are trading below a 3.5% net initial yield yet Allianz, with nearly one third of the company’s portfolio located in Hamburg trades at a 5.2% net initial yield.\(^8\)
- In Canada, Blackstone acquired Pure Industrial REIT for C$3.8 billion representing a 21% premium to Pure’s closing price.\(^9\)
- In the U.S., SITE Centers sold a portfolio of stabilized shopping centres to an institution for US$607 million at a 6.7% cap rate yet the company itself trades at an 8.2% implied cap rate.\(^10\)

We believe that if the public market valuation disconnect persists, private capital will look to arbitrage the difference between public and private market pricing via M&A which should effectively help to close the NAV discount.

Institutions are expected to increase allocations to real estate in 2019 which combined with large unfunded commitments will be supportive of real estate valuations.

As highlighted in Figure 5, allocations to real estate are expected to increase in 2019 by another 20 bps to 10.6%. Institutions remain underinvested across the Americas, Europe and Asia, by ~100 bps relative to their allocations.\(^11\)

Figure 5: Target Allocation to Real Estate

In addition, there is also nearly US$300 billion of unspent real estate private equity capital commitments and when levered approximately 50%, creates almost US$600 billion of dry powder (see Figure 6). Finally, there are another 634 funds in the capital raising process targeting $219 billion of incremental capital.\(^12\)

Figure 6: Real Estate Private Equity Capital Commitments

We believe that this capital will continue to support strong demand for private real estate assets and a portion of it will likely work its way into the public REIT market as well.
2019 Return Expectations

Despite being later in the cycle and the range of outcomes in 2019 feeling wider with macro-economic uncertainty higher, our bottom-up fundamental analysis currently suggests that global REITs are priced to generate a positive total return in 2019 in the range of 9–10%. This return consists of a 5% cash flow yield and 4–5% earnings growth driven by:

• Increases in annual contractual rent bumps;
• Positive releasing spreads; and
• Completion of redevelopment and development projects currently underway.

Our view is that the greater the percentage of your total return coming from recurring income versus future growth, the higher the degree of confidence you can have in achieving that total return.

We believe there are several big risks to achieving our 2019 total return forecast which include: tariffs and their economic impact on China, continued Brexit fears, U.S. interest rate policy, political instability in Washington D.C., higher levels of new supply across multiple property types and markets, higher labor costs, wider credit spreads and more restrictive central bank quantitative easing programs.

REIT operating fundamentals will be driven by changes in the direction of the overall economic environment and to the extent that growth decelerates more than anticipated. REIT fundamentals will also decelerate but should hold up better than other sectors given the high degree of contractual recurring cash flow.

All in all, we believe in a market where growth is slowing, and interest rate expectations are peaking, global real estate is well positioned to serve as a beacon of safety again in 2019. This sets the stage for outperformance compared to broad equities while generating an attractive absolute total return driven more by yield than growth.

We have identified a number of investment opportunities – across geographies and property types – for the year ahead, outlined below.

INVESTMENT OPPORTUNITIES IN 2019

United States:
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• Apartments benefiting from a slower for-sale housing market
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For further details on our top investment ideas for 2019 please refer to each regional market outlook.
REGIONAL MARKET OUTLOOKS

As we canvas key indicators entering 2019 (Figure 8), demand and supply conditions for REITs have been, and remain, supportive of steady real estate fundamentals. Although the collapse in equity prices in December does create additional uncertainty heading into 2019, we believe REITs will continue to generate steady internal growth driven by positive reletings spreads on rent rollovers and relatively stable occupancies.

**Figure 8: Key Indicators**

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*Source: Timbercreek As of December 31, 2018*

United States

One of our top investment opportunities for 2019 is how the world of real estate and technology is converging to create a strong secular growth story for data centers. The proliferation of mobile usage, tablets, cloud computing, internet traffic and content creation are creating enormous needs for data storage. According to Cisco, global data center traffic is forecasted to increase 27% per year through 2020. Mobile data traffic is estimated to increase 46% per annum through 2021 and global internet video traffic is increasing at a 31% CAGR driven by companies like Facebook, Netflix and Snapchat. Hyperscale cloud service providers such as Google, Amazon, Microsoft, Oracle and IBM are converting the world’s companies to the cloud, leading to robust demand for data centre space to store all this information. We believe the next leg of demand growth for the data centre sector is even more promising led by artificial intelligence, autonomous vehicles, virtual reality and the internet of things (IoT). As highlighted in Figure 9, the number of IoT units installed is forecasted to increase 34% per annum through 2020, autonomous vehicle shipments and the amount of capital being spent on artificial intelligence is forecasted to increase 37% and 76% respectively through 2025 and spending on virtual reality, some of which will be through mobile devices, is forecasted to increase 92% per year through 2020. We expect each of these additional demand drivers to lead to increased demand for data centre space, particularly in markets connected to fiber and subsea cables, such as Ashburn Virginia, Santa Clara, Dallas, Chicago and Atlanta. Despite an active supply pipeline, we expect demand to outstrip supply in 2019 resulting in strong positive net absorption.

We believe one of the most attractive sectors in the more traditional real estate space heading into 2019 is the multifamily and single-family rental markets. The thesis for both of these sectors is partially driven by the fundamentals of the single-family housing market. As a result of limited developable land, rising material costs, and a lack of skilled workers, the construction of new homes in the U.S. is currently at very low levels versus historic averages, creating a housing shortage. Home affordability has become a challenge to many perspective buyers due to strong home price appreciation, a rise in interest rates and elevated existing debt levels (student, credit card, and auto), making it difficult for households to transition from renting to homeownership, which bolsters the pool of renters. We believe in a declining economy, the demand for rental housing is more inelastic than for-sale housing, which should allow for better multifamily NOI growth in 2019, especially in a flat- to moderate-supply environment. We believe multifamily REIT valuations are currently attractive and do not fully reflect the positive fundamental environment.

Additionally, we expect the single-family housing market will also benefit from stronger job growth and household formation. In 2019, we believe the upside in NOI growth from single-family rentals should be even stronger and as shown in Figure 10, the new supply for starter priced homes have been very limited. Finally, the single-family public REIT valuations are currently heavily discounted. In 2018, many of these companies experienced operational challenges, often centered around integrating portfolios they acquired over the years, which pushed down their stock prices. We expect these challenges to be less of a headwind going forward and operations to better meet expectations. Once this occurs, we expect the discount at which these names trade to moderate.

**Figure 9: Future Data Centre Demand Drives**

*Source: Digital Reality Trust*
Canada

In 2019, we believe Canadian industrial asset values will continue to grow robustly driven by elevated demand and limited supply. On the demand side, we expect e-commerce sales growth to continue, representing a higher percentage of total retail sales over the coming years. Currently, e-commerce sales represent around 7.5% of total sales, which trails other developed countries, such as the U.S. (8.9%) and the U.K. (16.3%). As Canadians buy more goods online, we expect the demand for industrial space to increase as retailers will need more space to store and stage these goods before being sent to consumers. Supply of industrial real estate is also contained. As shown in Figure 12, national vacancy rates are under 4% and space under development totals around ~1% of current stock. We believe favourable demand and supply dynamics will be supportive of rental and capital value growth in 2019, positively influencing the share prices of industrial REITs.

We are also enthusiastic about the outlook for Canada’s senior housing sector in 2019. Similar to many developed economies, the Canadian population is aging (Figure 13). As these individuals move into their “golden years”, many will need to live in facilities that offer some level of care. The year-over-year growth rate of people 75

Lastly, we believe triple net lease REITs focused on owning gaming properties offer attractive external growth potential and high cash-on-cash returns. The ownership of gaming properties in the U.S. is highly fragmented, often tied to families or local operators looking to unlock generational wealth. REITs offer a competitive advantage as the buyer of choice by being able to use partnership units to solve complex tax situations. We believe the opportunity to consolidate the ownership of gaming properties through acquisition is robust both in terms of size (i.e. multi-billions) and return (high single digit going-in cap rates). Further, a triple net lease structure in a slowing GDP growth environment provides a highly transparent income stream (typically 100% occupied) with annual contractual rent bumps (~2%) and little downside. Most leases are long term in duration (~10 years) and have a high EBITDAR and corporate level rent coverage ratio (>2x) often backed by the credit worthiness of the operator. As shown in Figure 11, gaming revenues tend to be more resilient than other industries when economic growth slows. The maintenance capex burden falls to the operator, not the REIT, resulting in high free cash flow margins (>65%) which in turn can lead to dividend increases and/or reinvestment into new acquisitions. Finally, unlike other real estate property types there are strict legislative and regulatory controls around the supply of new casino properties resulting in high barriers of entry and minimal new supply.

Figure 12: Canadian Industrial Vacancy Rates

Source: Scotiabank

Figure 13: Canadian Senior Housing Demographics

Source: Scotiabank

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years and older is growing at an increasing rate. From 2013 to 2018, this demographic cohort grew at 2.7% annually and it is expected to grow at 4.1% annually between 2018 and 2023. This demographic dynamic should create outsized demand for senior housing in 2019 and beyond. We believe well-managed operators are skilled at generating additional revenue through added service packages or room pricing adjustments. A room located near the elevator, for example, might be charged at a higher rate compared to one located at the end of the hall. Facility optimization should allow REITs that own senior housing properties to produce attractive NOI growth in 2019. Although we acknowledge that this sector could be vulnerable to short term headline risk in brief periods when elevated amounts of supply disrupts rental growth, we think Canada will struggle to construct enough beds over the long term in order to meet the needs of an aging population.

United Kingdom

Due to continued uncertainty around Brexit, U.K. operating real estate fundamentals weakened throughout the year although much less than what valuations of listed REITs would imply. We also believe a large component of the weakness in 2018 was due to the future outlook on asset values.

Entering 2019, we find the U.K. a relatively unattractive place to invest with several critical questions to be answered:

• What if U.K. financial services are not able to cater to EU clients anymore?
• What if U.K. based corporations move entire operations to the EU due to avoid complicated trade barriers?
• How will border customs effect the movement of goods and people in and out of the country?

Growth is slowing, and rates continue to increase although the spread between Gilt and property yields remain above historical averages. Residential and retail real estate fundamentals continue to remain under pressure (Figure 14) and at best have a very low growth scenario ahead. There is clear value in central London office locations, but rents have peaked, and demand is likely to slow further. Our expectation for 2019 is that like-for-like growth rates will be less than half of that on the Continent, although London is increasingly becoming its own market of micro locations with a large dispersion in rental rates, creating pockets of opportunity for skilled management teams.

Over the past 12 months some REITs have taken a conservative approach by being net sellers of assets, especially given that private market prices have held up better than discounted REIT share prices, creating immediate shareholder value. Net initial yields for prime London real estate are still around 3.5-4%, with similar REIT portfolios trading at a 15% discount to NAV. Public REITs have reduced their leverage making the sector less vulnerable if cost of capital were to change, however, we find the fundamental environment entering 2019 treacherous and fraught with risk. Nevertheless, we will continue to monitor the market and be ready to take advantage if prices get discounted to levels that are too attractive to pass up.

Continental Europe

Although Continental Europe was not able to achieve a positive return in 2018, the spread of performance between countries, sectors and companies was significant, highlighting that opportunities exist although on a selective basis. From our point of view, urbanization, sustainable cash flows and specialty themes with low correlations to the broader market offer the best risk-adjusted investment opportunities for 2019.

Multifamily rental income has proven to be one of the most resilient throughout cycles while the cost of owning and financing your home is likely to increase further in 2019 exasperating the housing shortage. Population trends based on job opportunities and quality of life is likely to favour certain locations (Figure 15), although on a micro level we favour assets that cater to the affordable renter rather than ultra-high-end units.

![Figure 14: U.K. Footfall and Sales](source: UBS)

![Figure 15: Forecasted Population Growth Rate, 2017 to 2023](source: Barings, Oxford Economics)
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We believe Germany and Ireland’s multifamily residential markets offer a compelling opportunity to earn outsized returns in 2019. We believe the public REITs owning and operating multifamily properties in Dublin are mispriced, trading well below private market values. Fundamentals look attractive characterized by very strong demand and fueled by high immigration and job growth coupled with a lack of new rental supply (Figure 16). In Germany, there is a similar demand-supply imbalance due to a lack of new multifamily units. Replacement costs make multifamily development largely unprofitable, further suppressing new supply. For this reason, we believe the growth potential in Germany is very attractive and we currently prefer higher yielding assets in attractive micro locations because of its income security profile rather than high profile assets that are more exposed to uneven demand trends.

![Figure 16: Residential Supply in Ireland is 50% below Demand](source: Goodbody, CSO)

In 2019, we believe office markets in Europe will benefit from Brexit and strengthening fundamentals based on two main factors. First, the fallout from Brexit should enhance the appeal of international cities like Frankfurt, Amsterdam, Luxembourg and Brussels, thereby increasing demand for office space in these markets. We expect market rents to rise further, driving vacancy rates and prime yields lower. Second, new supply is limited driven by slow planning procedures while existing office stock is being converted to residential uses with flex office spacing rising across most European cities, including Amsterdam, Brussels, Paris and Madrid (Figure 17).

![Figure 17: Demand from Flex Office Space](source: Rempen)

We are also optimistic on Sweden’s logistic market. We believe Sweden offers an attractive growth profile supported by both immigration and migration trends. Urbanization continues to play out in this market and we see opportunities in the logistics sector based on structural changes to consumption patterns geared more towards e-commerce which is driving significant demand for industrial space. For example, Post Nord, with over 50% market share in parcel services, announced their intention to double their Terminal Capacity over the next five years.

Finally, we like the European self-storage sector heading into 2019 driven by its steady demand profile that tends to be less cyclical in nature and more life-oriented. Self-storage properties also trade at attractive going-in yields, have a low maintenance capex profile and enjoy limited new supply. The sector can also benefit from logistic trends bridging the gap for last mile delivery for online businesses.

**Japan**

The combination of rental growth, further cap rate compression and buying support from the Bank of Japan (BoJ) which spent roughly half (~63%) of its JPY90 billion annual purchase program budget on J-REITs pushed the listed Japanese REIT sector higher in 2018 by 0.8%, while Japanese C-corps fell by 10.9%. \(^{16,17}\)

Fundamentals in Japan are strong characterized by record low office vacancy rates across major and regional cities propelling rental growth. Further, the influx of completed large floor plate office properties saw a surprisingly healthy take-up with no negative impact on Tokyo vacancy rates. Japanese C-corps underwent several corporate actions with deeply discounted equity raises, take-overs, privatizations and occasionally improved willingness for shareholder alignment through share buybacks.

In 2019, we believe small- to medium-sized Grade B office buildings located within Tokyo’s 23 Wards are well positioned to experience further rental growth driven by record-low unemployment rate, steady economic growth and strong property fundamentals. Demand for Grade B office buildings is strong as a large share of Japan’s GDP is produced by small- to medium-sized firms who are unable to afford rent levels above Yen 20,000 per tsubo per month in the Central 5 Wards of Tokyo, creating a natural demand pipeline for space. This growing demand is driving down office vacancy rates in Tokyo to record levels at 1.98% (Figure 18) and pushing up asking rents 8.8% year-over-year in November. From a supply point of view, new supply of small- to medium-sized office properties is very constrained due to high construction cost, a lack of available land and market rents that are 50% below new large size office properties. Despite the strong take-up of large Grade A office properties throughout 2018, we remain cautious on this segment of the market in 2019 due to a stream of new supply leading up to the 2020 Olympics.
E-commerce penetration in Japan is low at 7% and we believe Japan’s logistics sector is poised to benefit from moderating new supply due to higher land prices and rising online sales, which are forecasted to increase 9.5% annually over the next five years. Finally, we are also keeping an eye on the hotel sector in 2019 after it underwent a sharp correction due to a series of natural disasters in the autumn of 2018. Public market hotel valuations are attractive and should be further supported by the recently introduced strict private lodging rules (Minpaku law) and several upcoming events (2019 Rugby World Cup, 2020 Olympics).

We expect accretive acquisition activity to remain challenging in 2019 due to the continued low cap rate environment. We favour active management teams focused on internal growth initiatives such as accelerating asset rotation programs to unlock value and enhance portfolio quality.

**Hong Kong**

Entering 2019, we favour companies that own office buildings in decentralized areas of Hong Kong. Office rents in the central business district (“Central”) continued to push up in 2018 as Chinese firms selected that submarket in order to establish a beachhead operation outside of China. These firms were attracted to Central as a result of its prestige. Additionally, most of these firms are backed by large Chinese corporates, which gives them the ability to pay a rent that is much higher than what other tenants in the market would be willing to pay. This is causing local firms to relocate from Central to other decentralized submarkets around Hong Kong in search of affordable rents. Island East is a submarket that has benefited noticeably from this trend. In order to attract tenants looking for an option outside of Central, the area has been redeveloped with new office towers, outdoor public space, as well as bars and restaurants. One and Two Taikoo Place are two large office towers that are currently under development in that submarket. Both have experienced robust preleasing to date as firms such as Facebook, Ernst and Young, and Baker McKenzie have decided to relocate to the area to take advantage of its new amenities. We think that the ongoing gentrification in Island East will cause rents to grow at an outsized pace going forward, benefiting the companies who own assets there (Figure 19).

In addition, we continue to closely monitor Hong Kong’s listed developers heading into 2019. Despite the discounted valuations at which these real estate companies trade, we believe they carry an elevated level of risk, thereby warranting caution unless certain conditions develop. Valuations of the Hong Kong developers are often linked to sentiment surrounding the local housing market. At the moment, many market prognosticators are expecting a weakening in home values as a result of elevated price levels and rising interest rates. Although a weakening is plausible, a crash is unlikely given that the market is undersupplied, and demand is robust, supported by immigration from China. China’s housing market also influences Hong Kong developers as each company has exposure to that market. In early 2016, the Chinese economy started slowing and policymakers decided to boost the economy through a stimulus package that included a massive government financed home buying program (Shantytown redevelopment) as well as instructing state owned enterprises (SOEs) to increase their investments in fixed assets. These policies worked as the economy expanded and home prices appreciated. The current speculation is that the effects from this economic boost are diminishing, which is concerning when combined with the country’s elevated corporate and local government debt levels. Although Hong Kong developers are currently trading at cheap levels, we would like to see monetary and fiscal stimulus unleashed or signs of a stabilizing economy before building a position in 2019.

**Singapore**

In 2019, we believe Singaporean-based data centres offer an attractive opportunity to earn outsized returns with secular growth characteristics. In Asia, Singapore acts as a major data centre hub due to its close proximity to Asia’s large population base, stable power grid, and excellent connectivity from a multitude of subsea cables linking it with Europe and North America.
Global Real Estate Securities – 2019 Market Outlook

As highlighted in Figure 20, approximately 60% of the world’s population lives in Asia, and by 2021 is projected to use twice as much mobile data as people living in North America and Western Europe combined. Advancements in 5G, internet of things, artificial intelligence, and self-driving cars will only add to data storage needs in the future. Looking forward, we feel companies who own data centres in Asia’s major data centre hubs such as Singapore will experience outsized growth, as data consumption patterns exponentially increase.

**Figure 20: Asia Pacific Mobile Usage**

Additionally, we see an attractive investment opportunity in Singapore-listed REITs trading at discounts to intrinsic value while generating above average dividend yields and return potential. These include REITs that own industrial properties located in Singapore where yields are high and fundamentals are bottoming as well as REITs that own assets outside Singapore. We feel many of these companies are being unfairly discounted by local investors due to their unfamiliarity with the markets they are invested in and the assets they own. In particular, we have seen private market transactions for tier 1 regional malls in China at 3-4% cap rates, versus listed companies that own similar assets trading at implied cap rate valuations of 6-7%.

**Australia**

Australia offers an attractive quality of life balance sought by younger generations, which is fueling strong demand for urban space with nearly 75% of future population growth taking place in Sydney, Melbourne and Brisbane (Figure 21). An offshoot of this trend is the self-storage sector which we believe is poised to benefit from rising demand driven by the densification of Australia’s cities as well as higher cost of living and smaller living spaces. We believe new self-storage supply should moderate in 2019 as lenders take a tougher stance by implementing more stringent underwriting standards. Unproven new entrants into the sector are finding it more difficult to obtain financing, which should mitigate future supply risk. Further, innovative technologies implemented across large operating platforms have shown the ability to enhance profitability and make new acquisitions which are accretive to the bottom line.

**Figure 21: Expected Population Growth**

Another specialty theme we believe is poised to deliver outsized total returns in 2019 are Kindergarten REITs. Yields are compressing in the childcare sector driven by increasing investments by institutional international private equity firms, investment banks and wholesale fund managers that are looking to acquire large portfolios (Figure 22). According to Peritus, childcare centres traded at an average cap rate of 5.9% in 2018, which screens favourably compared to office cap rates below 5%. We believe the child care sector has many positive attributes such as long-term leases with annual rent bumps, limited maintenance capex requirements which enhances free cash flow and barriers to entry due to regulations. These factors should be a winning formula for the sector in 2019.

**Figure 22: Childcare Property Transaction Volume and Price**

Lastly, we believe non-discretionary retail shopping centres offer a compelling opportunity to generate above average dividend yields in 2019 supported by resilient cash flow. From our point of view, slower consumer spending is already priced–into public REIT valuations but the difference in multiples between the different retail formats is still too narrow and does not properly reflect the impact of online shopping. For example, the outlook for supermarkets is improving as the sector is less impacted by omnichannel sales. However, we believe discretionary retail spending is more at risk in 2019 driven by a slowing housing market while traffic and cash flows at non-discretionary retail shopping centres is more resilient.
CONCLUSION

We believe a slower economic growth environment sets the stage for REITs to outperform broad equities and continue their Tortoise (REITs) and the Hare (General Equities/Technology) campaign in 2019 by generating an attractive total return balanced between yield and growth. The outlook is premised on five key factors:

1. REIT outperformance typically grows in magnitude and frequency as economic growth slows
2. Global REIT earnings growth will be more resilient than global equities in 2019, setting the stage for better relative performance
3. Global REIT valuations are attractive relative to global equities
4. Public market valuations are attractive relative to private market valuations trading at an 11% discount to NAV.
5. Institutions are expected to increase allocations to real estate in 2019 which when combined with large unfunded commitments will be supportive of real estate valuations.

Despite being later in the cycle and the range of outcomes in 2019 feeling wider with macro-economic uncertainty higher, our bottom-up fundamental analysis currently suggests that global REITs are priced to generate a positive total return in 2019 in the range of 9–10%. This return consists of a 5% cash flow yield and 4–5% earnings growth driven by:

• Increases in annual contractual rent bumps;
• Positive releasing spreads; and
• Completion of redevelopment and development projects currently underway

Our view is that the greater the percentage of your total return that comes from recurring income versus future growth, the higher the degree of confidence you can have in achieving that total return.

A summary of our top investment ideas for 2019 are as follows:

**United States:**
- Secular growth opportunities in the world of technology
- Apartments benefiting from a slower for-sale housing market
- Triple Net Lease REITs offering attractive external growth and high cash-on-cash returns

**Canada:**
- Industrial REITs benefiting from e-commerce
- Outsized demand growth for Senior Housing driven by strong demographics

**Europe:**
- Residential opportunities in Ireland and Germany
- Office markets in Belgium and the Netherlands benefiting from Brexit

**Japan:**
- Small-to medium-sized Grade B office buildings located in Tokyo

**Hong Kong:**
- Decentralized office markets experiencing strong demand and rising rents

**Singapore:**
- Data centres positioned to take advantage of growth in Asia

**Australia:**
- Non-discretionary retail shopping centres offering resilience
- Specialty property types offering attractive yields and total returns
The Timbercreek Approach

Founded in 1999, Timbercreek (together with its affiliates) is a global alternative asset class manager with over $8.5 billion (CAD) in assets under management*. Timbercreek employs a value-oriented investment philosophy and specializes in providing conservatively managed, risk-averse alternative asset class investment opportunities to investors.

Our core competency is our ability to accurately value cash flows based on a comprehensive analysis of the quality and sustainability of a property’s current and future revenue streams. This fundamental ‘bricks-and-mortar’ approach is critical to identifying attractive investment opportunities across our three key business lines:

- global real estate securities,
- private equity investing and
- customized mortgage solutions and other debt secured by real estate.

By combining these strategies Timbercreek is able to deliver an integrated approach to real estate investing.

Global Real Estate Securities Investing

Timbercreek invests in publicly listed real estate companies that own investment-grade real estate around the world. We focus on achieving a superior risk-adjusted return through investments that own high quality real estate across all asset types that we assess to be undervalued. Our investment objective is to deliver stable distribution and a compelling total return while limiting volatility and protecting capital.

Timbercreek has cultivated an experienced and proven team of real estate professionals strategically located in key global markets including Canada, the United States, Europe and Hong Kong. We believe our comprehensive ‘feet on the ground’ presence allows for a deep understanding of local markets, enabling us to accurately and efficiently source, underwrite and monitor global real estate investments. Our key investment strategies include Core and Income and are offered to both institutional and retail audiences through a range of public and private vehicles.

* Includes syndicated debt under administration. As of September 30, 2018.

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Corrado Russo is responsible for managing the global securities platform including the Timbercreek Global Real Estate Income Fund and the Timbercreek Four Quadrant Global Real Estate Partnership. Mr. Russo has over 20 years experience in the investment management field, having held positions in portfolio management, equity research and direct real estate investments. Mr. Russo holds an MBA from the Schulich School of Business at York University in Toronto and holds the Chartered Financial Analyst designation.

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