

Quay Global Real Estate

Monthly performance update

As at 31 December 2017

At a Glance

Feature	Fund facts
APIR Code	BFL0020AU
Index	FTSE/NAREIT Developed Index
Investment objective	To generate a real total return of at least 5% above CPI per annum over a 5+ year investment horizon
Portfolio managers	Chris Bedingfield/Justin Blaess
Stock number	25
Inception date	30 July 2014 ¹
Recommended investment period	Long term (5+ years)
Minimum investment	A\$20,000
Additional investment	A\$5,000
NAV (cum-dist.) ²	1.0544
Buy/sell (%)	0.30/0.25
Entry/exit fees	Nil
Distributions	Bi-annual
Management fee ³	0.82%

Year End Fund Commentary

The Quay Global Real Estate Fund delivered a -1.3% return for the month, with approximately +1.1% derived from our underlying stock exposure. Solid economic data around employment buoyed the Australian dollar, deducting -2.4%.

For the year ended December, the Fund's total return was +8.8%, surpassing our CPI +5% objective. We are particularly satisfied with the underlying stock performance of 12.9% before the currency headwind of -4.1%.

Over the year, the Fund's best performing investees (based on return contribution) were all located in the UK and Europe. Safestore (European Storage), Unite Group (UK Student Accommodation), LEG Immobilien (German Housing) and Hispania (Spanish Hotels) benefited from stronger local currencies, but also very solid underlying fundamentals.

At the opposite end of the spectrum, the laggards were all US stocks including Brixmor (Retail), EDR (Student Accommodation), ACC (Student Accommodation) and Ventas (Health).

We believe the underlying fundamentals of our US exposures are quite robust. However, local investors had

little reason to chase a sector that paid zero tax at a time of newly legislated large-scale corporate tax cuts.

Having said that, we cannot and should not ignore our under-performing stocks. While it is generally easier to discuss the wins, spending time exploring the losses is more humbling and hopefully helps the investment process into the future. With that in mind, most of this report discusses our worst performers in CY2017 and our current thinking for each position.

In contrast to our UK investees, the biggest disappointment this year was our exposure to US Student Accommodation. We trimmed EDR last year near US\$45 per share, but began to reallocate to it and ACC during 2017 as their share prices declined. A number of mis-steps during the leasing season dragged down same-store NOI growth (a Wall Street obsession), driven by pockets of supply in key markets. EDR also missed the delivery of a key project that may stymie its ability to win future 'on-campus' developments.

We see many of the issues affecting these stocks as one-off, and believe the medium-term outlook for the industry remains positive. As low and mid-level employment is replaced by technology, further education is now a must-have, but many US university campuses still offer near-obsolete accommodation. The Fund's two US exposures have meaningful re-development pipelines, expected to generate near 10% marginal return on equity (6-7% ROIC) and enjoy a near duopoly concentration at the national level. To us, it seems obvious the two will eventually merge and extract better pricing and development synergies. In the meantime, we effectively own the underlying real estate at a meaningful discount to replacement cost – a metric we believe minimises the risk of permanent capital loss.

We acquired Brixmor in the second quarter of this year, after it had fallen 25% from its recent highs. We liked its defensive exposure to food and service-based retail, and lack of exposure to department stores and fashion. However, after our purchase, the stock continued to decline as investor sentiment deteriorated following Amazon's acquisition of Whole Foods Inc.

Investing in US retail does not come without risk even if food-based. Amazon has perfected the art of the 'Jedi mind trick', able to wipe billions off the market value of an industry simply by looking at it.⁴ This makes investing based on fundamentals fraught with near-term headline risk. But the fundamental risks are real too. The US is hopelessly over-retailed, and brick-and-mortar retail obsolescence is not theoretical – it's real. Amazon may significantly disrupt food, eroding grocery margins and therefore the ability to pay rent. Further, competition from malls attempting to back-fill empty department store boxes may well target traditional shopping centre tenants like those located in Brixmor's assets.

However, we are comforted by a number of factors in our favour. The stock is very cheap (less than 8x earnings and around 10x free cash). At 65% of replacement cost, the pricing may allow for an economic change of use in a worst-case scenario (per sqm, Brixmor is cheaper than most Industrial-focused REITs). The underlying real estate is woefully undercapitalised, having been owned by Centro /

Quay Global Real Estate Fund

Monthly performance update

As at 31 December 2017

Banks / Private Equity for nearly a decade. This means the marginal return on capital is very high (a key driver for earnings growth). In addition, tenant demand remains solid, organic retail growth is consistent with inflation and the new management team is well credentialed. Moreover, if 'Big Tech' becomes subject to regulatory or break-up risk (the current US administration is already railing against Amazon⁵), 2018 tech headlines may improve sentiment.

US Healthcare remained a political football in 2017, so our decision to limit our exposure to one investee, Ventas, quarantined our losses. We have long preferred to play the aging demographic theme via Manufactured Housing and Canadian Assisted Living, both of which limits the 'stroke of a pen' risk that comes with US Healthcare regulation. We were well-rewarded for this exposure.

However, the main risk for Healthcare appears to be diminishing. The recent Democratic electoral victory in the Senate (Alabama) has trimmed the Republican margin to one seat, so the political risk of Healthcare 'reform' is abating. Further, Senior Housing new starts are down 50% since 2015. Since it takes 24 months (on average) to complete new facilities, by 2019-20 new supply will be collapsing right when demand accelerates and the first of the Baby Boomers turn 75 – the inflection point where many begin to turn to Senior Housing accommodation. Wall Street rarely prices three years ahead and we do not think we can time sentiment. Instead we invest early, backed by a strong thematic, and remain patient.

Despite Ventas' lacklustre performance in 2017, we have conviction that, over time, the company will generate a very satisfactory total return for our investors.

Themes and thoughts for 2018

The structural constraint no-one is discussing

While many non-real estate specialists fret that rising interest rates will curtail the sector's performance, we are far more sanguine on the outlook.

The two biggest risks for real estate are recession and supply. Unfortunately, history shows these two events tend to correlate, exacerbating the real estate cycle. However, outside a few select industries, supply appears to be in check and may in fact be peaking. In our opinion, the biggest non-reported real estate story of the past 2-3 years has been US construction cost inflation. The following table highlights the most recent data.

Year	Annual change in US construction costs	Cumulative change in costs since 2012
2013	4.1%	4.1%
2014	4.4%	8.7%
2015	4.5%	13.6%
2016	4.7%	18.9%
2017	5.0%	24.9%

Source: Turner Construction, Citi Research, Quay Global Investors

The data supports what we hear from management teams, and should be viewed as generally bullish for long-term real estate investors. Despite a long cycle of rising rents and asset prices, development feasibilities are now falling short because construction costs are rising at an even quicker pace than rents (yields on new development are falling). Falling development yields at a time of rising interest rates shuts-down funding for new projects and therefore supply pretty quickly. To rephrase into our language, replacement cost is rising faster than share prices – and this augurs well for capital protection and total return.

The dual benefits of rising construction costs and limited supply are due to the structural decline in US construction industry capacity. Based on US Census data, total employment in the industry has contracted almost 15% from 2005 to 2015⁶. Today we estimate this number is closer to 10% contraction in absolute terms and a 34% contraction relative to the economy (US GDP is approximately 24% larger compared to 2005). Capacity was gutted as a result of a depressed industry in the wake of the financial crisis that dissuaded many to join the industry – a structural factor that may take a generation to reverse.

It is almost impossible to overstate the benefits of a vastly diminished construction sector for real estate investors. First, the industry's ability to overbuild (a key investment risk in real estate) is restrained. Second, it means construction inflation is greater than consumer inflation, allowing investors the benefits of relatively low interest rates and escalating capital values underwritten by the rising cost to build.

Retail – is the worst behind us?

Recent M&A and investor activism in the Mall industry (GGP Inc, Westfield, Taubman, Macerich, Intu, etc) dominated year-end news. The sector recovered part of the year's losses, as short sellers covered and investor confidence showed that perhaps values have seen the lows. For some, the big question in 2018 is whether the selling is overdone and it is time to reallocate back to the sector.

Fortunately, at Quay we are not bothered by such a task. US Malls may well 'outperform' key indices in 2018. However, we do not measure ourselves to an index, but aim to seek the lowest risk CPI +5% return. If we can achieve that over a +5 year time horizon in sectors that also have clear demographic and secular tailwind, we will be more than satisfied (with or without US Mall exposure).

In summary, it was far from a perfect year for the Fund, but some excellent results in Europe, the UK and Asia supported returns, highlighting the benefit of an unconstrained global mandate. We continue to maintain a large allocation to the US due to the relatively larger opportunity set, but also because the underlying strength of the US economy is supportive of real estate valuation from the escalation of replacement cost and solid tenant demand.

Despite recent challenges, we remain confident the global real estate market offers enough opportunities that allow us to meet our medium-term total return objective of CPI +5%.

Quay Global Real Estate

Monthly performance update

As at 31 December 2017

Performance

Timeframe	Fund return (net) ¹	Index**	Value add
1 month	-1.3%	-1.7%	+0.4%
3 months	+4.7%	+3.9%	+0.8%
6 months	+5.7%	+3.2%	+2.4%
1 year	+8.6%	+2.2%	+6.4%
2 years (p.a.)	+5.9%	+3.4%	+2.6%
3 years (p.a.)	+10.0%	+6.0%	+4.0%
Since inception (p.a.)*	+14.8%	+9.9%	+4.9%

Performance figures include dividends and are after all fees and costs and gross of any earnings tax, but after withholding tax

* Inception date is 30 July 2014¹

** FTSE/ EPRA NAREIT Developed Index Net TR AUD⁷.

How to invest

The Fund is open to investors directly via the PDS (available at quaygi.com), or the following platforms.

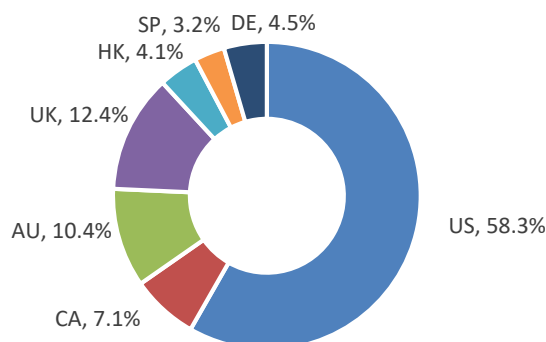
Platforms

Hub24 Super
Macquarie Wrap

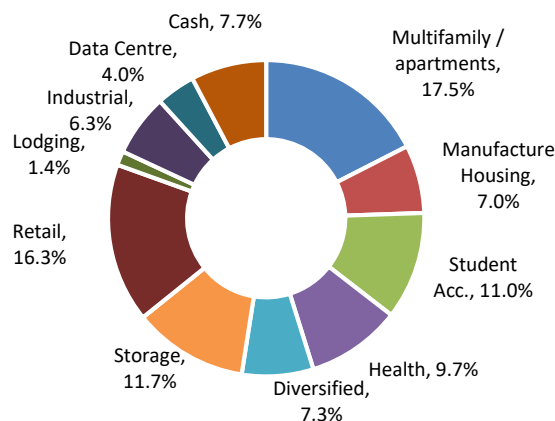
Contact details

For more information, please call 1800 895 388 (AU) or 0800 442 304 (NZ) or visit quaygi.com

Geographic Weightings



Sector Weights



¹ The Quay Global Real Estate Fund was launched 31/1/2016 (The Daily Series). Performance information before this date relates to the strategy (Series 1), which was launched 30/7/2014. For those who are invested in the Daily Series, please contact Client Services (1800 895 388 (AU) or 0800 442 304 (NZ) or client.services@bennelongfunds.com) to request your performance history.

² Adjusted for expected withholding taxes.

³ The management fee does not include fund expenses, which are capped at 0.10% per annum on net asset value, or the performance fee. Any performance fee payable is 15.375% of the excess return over the greater of CPI and the FTSE/EPRA NAREIT Developed Index (net) Total Return (AUD). All fees quoted include GST net of reduced input tax credits. For more information, refer to the Product Disclosure Statement (PDS) dated 1 February 2017 (ARSN 610 224 381).

⁴ Quote from Professor Scott Galloway recode.net/2017/9/11/16284754/amazon-nordstrom-fashion-scott-galloway-prime-squared-recode-decode-podcast-kara-swisher

⁵ independent.co.uk/news/business/news/donald-trump-amazon-value-5-billion-drop-off-shares-tweet-social-media-jeff-bezos-a7896266.html

⁶ statista.com/statistics/187412/number-of-employees-in-us-construction/

⁷ Source: FTSE International Limited ("FTSE") © FTSE 2017. "FTSE®" is a trade mark of the London Stock Exchange Group companies and is used by FTSE International Limited under licence. "NAREIT®" is a trade mark of the National Association of Real Estate Investment Trusts and "EPRA®" is a trade mark of European Public Real Estate Association and all are used by FTSE under licence. All rights in the FTSE indices and / or FTSE ratings vest in FTSE and/or its licensors. Neither FTSE nor its licensors accept any liability for any errors or omissions in the FTSE indices and / or FTSE ratings or underlying data. No further distribution of FTSE Data is permitted without FTSE's express written consent.

The Fund is managed by Quay Global Investors, a Bennelong Funds Management boutique.

Disclaimer: This information is issued by Bennelong Funds Management Ltd (ABN 39 111 214 085, AFSL 296806) (BFML) in relation to the Quay Global Real Estate Fund. The information provided is general information only. It does not constitute financial, tax or legal advice or an offer or solicitation to subscribe for units in any fund of which BFML is the Trustee or Responsible Entity (Bennelong Fund). This information has been prepared without taking account of your objectives, financial situation or needs. Before acting on the information or deciding whether to acquire or hold a product, you should consider the appropriateness of the information based on your own objectives, financial situation or needs or consult a professional adviser. You should also consider the relevant Information Memorandum (IM) and or Product Disclosure Statement (PDS) which is available on the BFML website, bennelongfunds.com, or by phoning 1800 895 388 (AU) or 0800 442 304 (NZ). BFML may receive management and or performance fees from the Bennelong Funds, details of which are also set out in the current IM and or PDS. BFML and the Bennelong Funds, their affiliates and associates accept no liability for any inaccurate, incomplete or omitted information of any kind or any losses caused by using this information. All investments carry risks. There can be no assurance that any Bennelong Fund will achieve its targeted rate of return and no guarantee against loss resulting from an investment in any Bennelong Fund. Past fund performance is not indicative of future performance. Information is current as at the date of this report. Quay Global Investors (ABN 98 163 911 859) is a Corporate Authorised Representative of Bennelong Funds Management Ltd (BFML), ABN 39 111 214 085, Australian Financial Services Licence No. 296806.