

Please note that the commentary is for the retail class of the Fund.

Performance and fund positioning

Local listed property experienced a quarter of two halves. The period started with the sector being in a holding pattern, with investors likely only prepared to actively engage with the sector once clearer signs were visible on the extent and speed of interest rate cuts. This has also been the overarching theme of listed property markets in most other jurisdictions, especially in developed markets. However, with bond investors applauding the election outcome and formation of a Government of National Unity, local listed property followed suit and delivered a similar strong performance to the bond market since the start of June, resulting in a quarterly return for the All Property Index (ALPI) of 6% and a return of 26% over 12 months.

Although the past strong correlation between bond and property yields has been waning in the past few years since Covid, most of the sector's return for June can be explained by the decrease in bond yields. This has resulted in local listed property, in both local currency and US dollar terms, being one of the strongest property sectors globally year to date, defying the wait-and-see approach investors have been taking to the asset class in major global markets post the rally at the end of 2023.

Unit trust-linked capital flows into sector-specific funds continued to be negative on a quarterly basis, although the turn in flow momentum continued to gather steam, resulting in June experiencing positive net flows. From a relative performance viewpoint, notwithstanding the good quarterly return, the sector lost ground against the FTSE/JSE All Share Index (ALSI) and FTSE/JSE All Bond Index (ALBI) but continues to outperform these indices over most relevant time periods shorter than five years. The ALPI's one-year forward dividend yield is 8.6%, and that of the Fund is 8.4%.

Delivering a return of 4.6% for Q2-24, the Fund did not fully keep pace with the market, thereby underperforming its ALPI benchmark. This resulted in a deterioration of the Fund's relative performance to the benchmark over 12 months, which was positive for most of 2023. Relative positions that detracted from performance include most of the overweight positions in offshore-centric counters such as NEPI Rockcastle and Hammerson; also, the relative positioning in names like Emira, Redefine, SA Corporate and Vukile. On the opposite end of the spectrum, the Fund did benefit from its relative positioning in Growthpoint, Spear REIT, Resilient and Hyprop. During the period, the largest increase in exposure occurred in Stor-Age and Burstone. The largest decrease in exposure occurred in Equites, Growthpoint, Fortress and Fairvest A.

The results season of companies with either a February or March reporting period concluded in June. This results season did not bring many surprises, with most companies delivering distributable earnings growth within guidance. Distributable earnings per share growth for this reporting season came in at 2.1%, while dividend per share growth came in at 2.2%, with an average payout ratio of 83.0%. If offshore names are excluded from these numbers, the SA-centric names delivered distributable earnings per share growth of 0.5%, while dividend per share growth came in at -1.2% with an average payout ratio of 87.2%. What is key when assessing the SA-centric stocks is that we are seeing a marginal shift in distributable earnings growth momentum. Albeit still only marginally positive, the base effect of increasing interest rates in a reporting period is gradually working itself out of the earnings cycle and even if rates remain at the current elevated level, just the fact of not having increases will have a positive impact on distributable earnings growth potential.

Although no real surprises came through on the earnings front, a market surprise during the quarter was the news that inward-listed UK retail landlord Capital & Regional (Growthpoint is a 68% shareholder) may be in play, with Vukile at one stage publicly being a suitor (and subsequently withdrawing its interest). Another potential bidder is NewRiver REIT, a specialist UK neighbourhood retail landlord, which has until 18 July 2024 to make a formal offer. The potential corporate action comes at an opportune time with the Capital & Regional CEO indicating he will leave the company to become the CEO of another UK REIT, while operationally, the portfolio has started to recover post-Covid.

MSCI released its annual SA Property Index for 2023, which is the best barometer of direct property returns in SA. Direct property delivered a return of 8.6% in 2023 versus 9.1% delivered in 2022. There was a smaller capital return delivered in 2023 versus 2022 (0.4% in 2023 and 1.0% in 2022). Per sector, industrial came out best at 11.2%, followed by retail at 9.7%, residential at 6.7% and lastly office at 4.8%. Retail was the only sector that performed better in 2023 versus 2022.

SAPOA released its Q1-24 office vacancy survey. This most recent quarter was the seventh consecutive quarter that marked a decrease in office vacancies in South Africa, now at 14.7%, down from the most recent high of 16.7% as at Q2-22. Cape Town has the lowest vacancy of the major cities at 6.8%, down from 10.1% a year earlier.

Outlook

The sector has returned to a more natural balance relative to the four years post-Covid and should provide investors with through-the-cycle type annual returns of 10% - 15%. The strong showing of the sector over the last 12 months was led by a general rerating of the asset class globally towards the end of 2023 and more recently by the rerating of bond yields, not necessarily by the underlying growth fundamentals of the sector itself, which underpin the expected through-the-cycle returns referenced.

With every new reporting season, the operating environment for landlords continues to improve. Some level of rental tension has returned, even for the office sector, with rental reversions upon renewals edging closer to flat and, for many retail landlords, positive. The operating cost creep that has been a constant in the sector for the last five to 10 years is gradually being replaced with improved cost recoveries, with especially the capital spend on solar bearing fruit. The crunch point, as being exhibited once again with this reporting season, remains higher interest rates. The negative impact of higher interest rates will likely start to dissipate in the next 12 to 18 months when the current higher rates have been in place for two full reporting periods. Any potential interest rate cuts will immediately benefit most companies as, through the current cycle, many property companies have moved to a higher portion of debt being on variable interest rates than in the recent past (going beyond the traditional average 25% variable debt).

An additional key observation from recent management interactions is that most companies are in expansionary modes. Most of the active strategic deleveraging has taken place, and further disposals are likely to be at the margin. The end of the sector's active deleveraging has resulted in the sector's average loan-to-value (LTV) settling at 40%, which in the past would not have been tolerated by many key investors in the sector. The tolerance for higher gearing ratios may be indicative of where we are in the interest rate cycle and views on existing asset values. However, interest cover ratios have moved on average to 2 to 2.5 times, which are much lower than pre-Covid and close to the most common covenant level of this measure at 2 times, so it needs to be closely watched. This higher average gearing ratio will likely result in companies coming to the market for equity, either directly or indirectly, as has already been seen, to fund any expansionary activity.

Portfolio managers

Anton de Goede and Mauro Longano
as at 30 June 2024