

PORTFOLIO MANAGER COMMENTARY

Strong momentum led the listed property sector higher in the first quarter of 2012, very similar to what happened towards the end of last year. The sector was also supported by a combination of lower bond yields on the back of a stronger rand and some blanket buying that might have taken place to gain exposure to the sector. The indications are that Eskom might have driven this blanket buying to regain some exposure to commercial property through the listed sector having sold its stake in Pareto to the PIC towards the end of 2011. After recording the third highest monthly value traded in February, trading values reached record levels in March, outperforming the previous record level by approximately R1 billion, or close to 20%. These levels of trade pushed the sector to delivering a total return of 8.0% for the quarter.

The fund marginally underperformed the SA Listed Property Index (SAPY) for the three-month period, but remains top quartile over the longer three-year period. Relative share price movement remained erratic, with some of the smaller illiquid counters (which previously lagged the sector) coming through slightly stronger. It however remains very difficult to recognise any trading patterns within the sector. In addition, share prices were heavily impacted by the results released during the period, with some investors remaining prepared to pay up for defensive, more predictable revenue streams. Positive movers include Arrowhead, Resilient, Vunani, Nepi, Growthpoint, Fortress and Hyprop, whereas Hospitality, SA Corporate, Vividend, Premium and Synergy moved in a negative direction. Most of the fund's underperformance came from our relative positioning in Growthpoint, Hyprop, Hospitality A, Rebois and Dipula A, while our exposure to the non-benchmark constituents Capital Shopping Centres (CSC) and Capital & Counties (CapCo) also detracted from performance. Hospitality Property Fund recently received some negative media coverage in light of a likely rights issue and debt refinancing difficulties. We remain comfortable with our position in Hospitality A as we believe the structure of the fund into A and B units is beneficial for the holders of A-units. In addition, the current yield in excess of 10% does not reflect the long-term certainty of the income growth for A units, especially in the current improving hotel operating environment. Positive relative performance contributions came from our relative positioning in Vunani, Resilient, SA Corporate, Sycom and Premium. Trading activity within the fund includes increasing our exposure to Capital, Hyprop, Rebois and Vuikle. We also continued to reduce the fund's exposure to Acucap, Growthpoint and Investec into strength, as well as Redefine due to lack of conviction in management's current strategy.

The budget speech confirmed the alignment of the tax treatment of the property loan stock (PLS) sector with that of the property unit trust (PUT) sector with the introduction of real estate investment trust (REIT) legislation as early as 2013. This process already started back in 2007. We believe that this will have a positive impact as the sector will then be directly comparable to other international markets with REIT legislation. The PLSA indicated that at present the likelihood of a conversion charge to the new structure will be small, thereby resulting in the current deferred capital gains tax liabilities not realised and thus pushing NAV levels higher.

The take-out from the results announcements include signs of some improvement in the retail sector as well as industrial properties associated with distribution and logistics; offices, especially B-grade offices, continue to struggle; tenant retention ratios continue to decrease as many landlords compete to lease space to the few tenants that are currently looking for premises; escalation rates remain in the 8% - 9% range except for large national anchor tenants where this can be as low as 7% and the trend of operating cost growth exceeding rental income growth continues. Furthermore funding costs continue to decrease with the lower interest rate environment being used to enter into interest rate swaps and even forward starting swaps at levels below 9%. To diversify away from a dependency on traditional bank funding more funding avenues within the capital market are being sought. The results announcements also indicated that the move into so-called quality properties continues, where smaller, multi tenanted properties are disposed of in favour of larger single tenanted properties. At the moment, this move is mostly yield dilutionary as it seems some price chasing is taking place with most of the smaller properties being sold returning to the listed space through some of the smaller listings. Most of these acquisitions seem to be taking place in the office sector, while the transactions seem to be taking place with some kind of related party, or between parties where a strong established relationship exists.

Some reflection after the results season points to a number of interesting trends. Although the sector delivered a weighted average distribution growth of 7.5%, the resulting full year distribution growth of 5.7% for 2011 was the lowest since the 4.2% delivered in 2004, which reflects the challenging underlying operational environment. Pressure on top-line growth remains, with operating cost pressure making it difficult to increase rentals as tenants consider total occupancy costs. Higher tenant retention ratios have come through this reporting season, which is promising, but definitely at the expense of rentals. Tenants continue to rather negotiate on rentals than the escalation rate, which on average is staying in the 8% - 9% range. Shorter leases are still being signed. B grade offices and smaller industrial mini and midi units are taking the most strain at the moment as are a few retail centres where its position in the market is weak.

An increase in defensive capex, and on a larger scale, is being noticed to ensure that properties remain competitive in a challenging market. With A grade offices and industrial properties performing the best on a relative basis, some speculative office and industrial developments are being initiated by landlords. However, despite comments relating to construction margins being favourable, development yields are decreasing. One of the biggest trends of the current cycle continues, namely the clean-up of portfolios through the selling of smaller, higher yielding properties, while consolidation potential still exists. The latter was illustrated by the announcement of Redefine's potential acquisition of the Fountainhead management company and potential subsequent offer for all its properties. In addition, smaller new listings into the sector continue to take place with Ardor and Annuity being the first of the next prospective wave to follow the 6 new listings in 2011. The viability of some of these listings remains in question as many assets going into them are being recycled from existing listed property companies.

Although inflationary risks remain within the system, local bond yields continue to trade more in line with global bond markets, which remain at low yields. Despite operational challenges remaining within the local property market, some bright spots are emerging, which point to a potential distribution recovery in 2013. This is where the importance of management teams and their experience in operating through past property and interest rate cycles come into play for individual stock selection. These two factors will support current share price levels in the short to medium term, making tactical asset allocation decisions difficult. We see the momentum of the last few months to continue, but at a slower pace.

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