CORONATION PROPERTY EQUITY FUND

Quarterly Portfolio Manager Commentary

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

The listed property sector delivered a total return of -19.6% for the first quarter of the year, lagging both the All Bond Index's 8.1% and the All Share Index's -6.0% return. The correlation between bonds and listed property broke down during the quarter due to sector-specific developments around Resilient and its sister companies. The SA 10-year government bond yield decreased to 8.2% at end-March from 8.8% a quarter earlier following a 25 basis points (bps) interest rate cut by the South African Reserve Bank, while the forward yield of the SA listed property sector saw an increase to 9.3% from 7.9% at the end of December. The historical yield of the listed property index (SAPY) increased to 7.3% at the end of the quarter, from 5.8% three months earlier. This saw the historical yield gap relative to bonds compress to 91 bps at the end of March from 304 bps at end-December.

The fund's return of -12.7% during the quarter was better than the -19.6% delivered by the benchmark, with the fund gaining momentum relative to the benchmark over all time periods. The fund's performance over periods between three and 10 years compares favourably to peers and the benchmark. The outperformance during the quarter was due to the fund's relative exposure to the Resilient group of companies, which saw share price declines of between 40% and 70% during the quarter. These were enough to offset the value-detraction coming from the fund's relative positioning in Equites, Vukile, Sirius and Growthpoint. During the period, the fund increased exposure to Nepi Rockcastle, Hammerson and Echo Polska Properties, while reducing exposure to a handful of names, including Growthpoint, Emira and Vukile.

Unlike in the past, where companies came to the market with ease to raise equity, the first quarter saw muted activity on this front given the turmoil in the sector. Only three companies came to the market with placements, raising just over R5 billion between them. Growthpoint did a secondary placement of R4.5bn worth of shares (5.4% of shares outstanding) on behalf of its BEE shareholder, Southern Palace Properties, while Sirius Real Estate came to the market with a R580 million equity raise. Stor-Age did a small placement of R52 million to fund a recent acquisition.

With the topical developments around the Resilient group of companies, news flow out of the stable remained steady throughout the quarter. Most notable was the announcement of the decision to set up an independent review of trading in the companies' shares since July 2017, the results of which will be made public to address allegations of share price manipulation. Additionally, the companies also announced a restructure of the Siyakha Education Trust following the adverse movements in the Trust's assets (i.e. the shares in the companies). Due to the restructure, both Fortress and Resilient adjusted distribution growth guidance lower owing to the loss of the bulk of interest income from the Trust. Both companies also indicated that their respective loan-to-values would remain below the 35% level (compared to c.20% as at December 2017) because of the restructure.

Meanwhile, Tsogo announced its intention to split its operations into an operating company ('opco') and a property company ('propco'), with the propco to be sold into Hospitality Property Fund in return for Hospitality shares. Subsequent to that, Hospitality shares would be unbundled to Tsogo shareholders. This transaction will require shareholder approval. In other activity, Redefine announced a sell down of the bulk of its stake in Australian-listed fund Cromwell to ARA (a Singaporean investor), with Redefine left holding 3% of the company (from over 20% before). The company intends to use the proceeds to reduce gearing. Stor-Age acquired a small asset in Cape Town's Northern Suburbs, further increasing its scale and presence since listing and post the expansion into the UK. Equites, in the meantime acquired its fifth asset in the UK, this being a forward agreement for a DSV development in Peterborough, while Schroder European Real Estate widened its footprint in Europe with the acquisition of a data centre in the Netherlands.

Remaining offshore, Hyprop announced the acquisition of two shopping centres in Croatia via its JV vehicle, Hystead, for €280m (for a 90% stake). This transaction takes Hystead's asset base to €740m, and brings it closer to its own listing, which management has already started preparing the market for via an early look roadshow. Still in Eastern Europe, Tower Property Fund announced that Oryx (the Namibian fund) has invested R300m in the offshore vehicle housing Tower's Croatian exposure. Tower will utilise part of the proceeds to pay down debt with the rest going to increase the offshore vehicle's asset base.

SAPOA released its quarterly office vacancy survey for the fourth quarter of 2017 during the quarter. The release showed that office vacancies remained unchanged at 11.2% in December 2017 from a quarter earlier. Of the four office grades, there was an even split between those that deteriorated and those that improved; P- and B-grade space recorded increases to 4.9% and 14.4% respectively from the prior quarter, while A- and C-grade space improved to 8.8% and 16.4% respectively. Of the five metropolitan areas, three (Durban, Port Elizabeth and Cape Town) saw a deterioration in occupancies, one an improvement (Pretoria) while Johannesburg was flat. Growth in asking rents over the last 12 months recorded a slowdown to 2.0% vs. 2.7% in the previous quarter. Office space under development amounts to 3.6% of existing stock (with 69.9% of this pre-let). As has been the case for some time now, a high degree of concentration remains, with 10 out of 53 nodes accounting for 92% of all developments. 31% of this space is in the Sandton node.

The past quarter also saw the first reporting season of the year. The results were in general mixed, illustrating that the positive sentiment following changes in the country's leadership is yet to filter through to the underlying economy. DPS growth of 7.8% (excluding locally-listed offshore counters) was reported, while DPS growth excluding counters with the highest offshore exposure came in at 6.3% (these compare to 9.5% and 6.8% respectively for the reporting season in the second half of last year). Underlying trends still indicate challenging conditions across the various sub-sectors, with a recovery in economic growth key to seeing a return in demand (though some supply pressures have also contributed to weakness in some sectors).

While the SAPY has shown substantial weakness at the headline level in the first quarter of the year, this has generally been limited to a few (but sizeable) names; the rest of the sector has to some extent rerated in line with other geared plays on the SA economy as positive sentiment abounds following changes in the Presidency. Notwithstanding, there remain some SA-focused companies that continue to trade on attractive initial yields, with distribution growth prospects that should at least equal inflation over the medium term. These should see some support from the favourable interest rate cycle. As a result, we still see the sector providing double-digit total returns that should exceed those coming from cash and government bonds through the cycle.

Portfolio manager
Anton de Goede
as at 31 March 2018