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

The listed property sector (ALPI) delivered a total return of 1.3% in the first quarter of 2019 (Q1-19), following a strong performance in January but subsequent reversal in February and March. This return lagged that of the FTSE/JSE All Share Index (+8.0%) and the All Bond Index (+3.8%). The correlation between bonds and listed property held up for the better part of the quarter, though dissipating somewhat in the latter part. The South African 10-year government bond yield compressed to 9.0% from 9.2% a quarter earlier, while the forward yield of the ALPI saw a decrease to 8.8% from 9.4% as at end-December 2018 (including index changes).

The historical yield of the bellwether index[1] decreased to 9.5% at the end of Q1-19, from 9.6% three months earlier. This saw the historical yield gap relative to bonds widen to 51 basis points (bps) at the end of March from 38bps as at end-December 2018.

The fund's return of 1.5% during Q1-19 was ahead of the 1.3% delivered by the benchmark, while performance over periods between three and 10 years compares favourably to peers and the benchmark. The fund's relative positioning in Hyprop, Investec Property Fund, Hammerson and Nepi Rockcastle added value during Q1-19–enough to offset the value detraction coming from the relative positioning in Liberty Two Degrees, Redefine, Resilient and Growthpoint. During the period, the fund increased exposure to Vukile, Hyprop, MAS and SA Corporate while reducing exposure to Growthpoint, Redefine, Investec Australia Property Fund and Investec Property Fund.

Companies with June/December year ends, representing just under 60% of the sector's market capitalisation, reported financial results during Q1-19, with dividend growth coming in at 1.1% for the domestic names. When including offshore-focused but locally-listed counters, dividend growth sat at 8.3%. This was supported by the weaker rand over the 12 months to end-March 2019. As was to be expected given the challenged macroeconomic environment, underlying operational results generally reflected strain, manifesting in pressure on rental growth even as vacancies for now remain generally stable. With this being a tenants' market, retailers are pressing for larger reversions and lower escalations, while on the office side, a limited pool of occupiers continues to see landlords use various avenues to compete. Following on from last year, an increase in municipal rates remain a key driver of cost growth, offsetting growth in gross rental income which is already under pressure.

Just under R1.3 billion of equity was raised in accelerated bookbuilds during the quarter. Equites was the first company to come to market for the year, raising R710 million. Stor-Age followed with a R585 million bookbuild following small acquisitions of self-storage assets in the UK. Meanwhile, in corporate activity announced during the period, Safari and Fairvest said that the parties had agreed to engage with each other regarding a potential friendly merger, though the expression of interest signed remains non-binding. After announcing an asset swap deal that would have seen Fortress acquire various shopping centres from Resilient in return for Resilient shares owned by Fortress, a stake in Lighthouse Capital and a minority stake in two shopping centres, Fortress announced that the proposed deal had been pulled, citing limited prospects of reaching consensus on all aspects of the proposed transaction. Redefine announced that it had increased its stake in listed Polish retail landlord, Echo Polska Properties, from 39% to 44%. This latest transaction will see Redefine's Polish exposure tick even higher following the acquisition of the direct logistics platform into the country during 2018.

Following limited information at the beginning of the year, Edcon finally made public its recapitalisation deal with stakeholders that will reportedly allow it a few years of breathing room. Of relevance to landlords, a handful of options are on the table. Of these, the most prevalent include a straightforward 41% rental cut for two years, with the cut accruing monthly into a trust account which will then be used to subscribe for equity in Edcon every six months. The other option is an upfront equity contribution by the landlord equal to the present value of the rental holiday, with the rental payable unchanged. It will be up to individual landlords as to how this latter option will be treated for distributable income purposes: some have indicated they would only distribute the circa 59% of rental after the 'cut', while others plan to pay out the entire amount, with the distribution adjusted by interest costs related to the debt used to subscribe for the equity.

In management changes during the month, former Hyprop CFO, Laurence Cohen was appointed as the new CFO for Vukile Property Fund. Meanwhile, Resilient announced the appointment of former Mr Price CEO Stuart Bird to its board as a non-executive director following the retirement of long-serving director, Bryan Hopkins. In sector news during the month, the Financial Services Conduct Authority announced that it had closed its investigation into allegations of insider trading against Resilient, Fortress and Nepi Rockcastle, though investigations into share price manipulation remain ongoing.

SAPOA released its quarterly office vacancy survey for the fourth quarter of 2018 during Q1-19. The release showed that office vacancies were down 17 basis points (bps) to 11.1% in December 2018 from a quarter earlier. Of the four office grades, A-grade space was the only one to show a deterioration, climbing 30 bps to 9.1%; P-, B- and C-grade space recorded declines of 60 bps, 40 bps and 70 bps respectively from the prior quarter, to end the quarter at vacancy rates of 6.1%, 13.8% and 14.7% respectively. Of the five metropolitan areas, three (Durban, Port Elizabeth and Cape Town) saw a deterioration in occupancies, while two recorded an improvement (Pretoria and Johannesburg). Growth in asking rents over the last 12 months recorded a slowdown to 4.4% (versus 5.3% in the previous quarter). Office space under development amounts to 2.3% of existing stock (with 53.2% 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 91% of all developments, with Sandton, Waterfall and Rosebank accounting for a combined 58% of total office development.

As illustrated by the recently concluded results season, numerous headwinds to organic rental growth remain in place, stemming from broad-based weakness in underlying domestic fundamentals. Across the major sub-sectors, negotiating power has tilted in tenants' favour, with the result that landlords are managing for occupancies rather than rental growth. Some uncertainty will likely remain until after this year's National Elections in May; however, a sustained rebound in the economy will be needed before fundamentals return in favour of landlords. Against this backdrop, we see selective opportunities within the domestic listed property universe, where the headwinds from muted dividend growth are sufficiently priced into initial yields.

Portfolio manager
Anton de Goede and Kanyane Matlou
as at 31 March 2019

[1] Index comprising the following counters: Growthpoint, Redefine, Hyprop, Vukile, SA Corporate and Investec Property Fund