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

The All Property Index (ALPI) delivered a total return of -4.2% in the third quarter of 2019 (Q3-19). Although this resulted in an outperformance of the FTSE/JSE All Share Index (-4.6%), it continues to lag the performance of the All Bond Index (0.7%). As has been increasingly the case in recent months, the correlation between bonds and listed property continues to weaken, with the increased offshore exposure in the sector. The South African 10-year government bond yield moved 20 basis points (bps) out to 8.9% over the quarter, while the forward yield of the ALPI saw an increase to 9.4% from 8.9% as at end-June 2019, despite some support for UK property stocks late in the quarter as rotation into value property stocks occurred globally. The historical yield of the bellwether index (comprising Growthpoint, Redefine, Hyprop, Vukile, SA Corporate and Investec Property Fund) increased to 10.8% at the end of Q3-19, up from 9.9% three months earlier. This saw the historical yield gap relative to bonds move out to 181bps at the end of September from 126bps as at end-June 2019.

The fund's return of -4.2% during Q3-19 was in-line with the benchmark, while performance over periods between three and 10 years compares favourably to peers and the benchmark. The fund's relative positioning in Redefine, Hammerson, Nepi Rockcastle and Capital & Counties added value during Q3-19, while value detraction came from the relative positioning in Resilient, Investec Australia, Hospitality and Accelerate. During the period, the fund increased exposure to MAS Real Estate, Equites Property Fund and Redefine, while reducing exposure to Nepi Rockcastle, Resilient and Fortress A.

Post completion of Q3-19 reporting, the underlying local operational performance continues to be reflective of the broader challenging economic backdrop. Reported year-on-year (y/y) dividend growth came in at 0.8% compared to 0.9% in the first half of 2019 (H1-19). Excluding the black economic empowerment deal rebasing of Resilient and Fortress, y/y dividend growth was 2.7% compared to 2.3% in H1-19. Including offshore counters, dividend growth averaged 3.6% y/y compared to 4.3% in H1-19, supported by Nepi Rockcastle and MAS. Operationally, pressure on net property income (NPI) growth remains, as reversions weigh on top line growth while cost pressures increase. Operating cost increases are driven by higher municipal rates and tenant incentives, although this is partially offset by improved general service cost management and the benefit of more greening initiatives, especially solar. Landlords continue to manage for occupancies rather than rental growth, although this is becoming more difficult due to the poaching of tenants, especially within the office sector, putting even more pressure on reversions. Balance sheet strain is starting to visibly show with a high probability that this will continue in the short to medium term. Property values should come under pressure, while degearing through sales is difficult in a buyer's market, with few buyers actually able to raise funding.

Within the retail sector, trading density growth continues to be under pressure at low single-digit growth. Retailer cost of occupancy is increasing due to escalations and higher municipal rates and taxes outpacing trading performance. Reversions are trending down to low single-digits and even negative growth rates, while escalation rates of national retailers are moving closer to 5%-6.5%. With this as a backdrop, vacancies actually remain fairly well managed. Despite attention-grabbing headlines, we have seen limited space rationalisation of banks in shopping centres thus far, although this could pick up in future. In turn, there seems to be sufficient appetite to accommodate Edcon space rationalisation. National fashion retailers are, however, using the Edcon deal as bargaining tool for lease negotiations despite landlords stating no actual rental reduction (as per the lease agreement) has taken place. Each landlord is treating the equity investment differently, with most either writing value partially down or to zero. Massmart is starting to become a concern, and although it pays a lower rental relative to percentage gross leasable area occupied, box format and size will make it difficult to release, especially post the Edcon space absorption.

Offices remain under pressure, especially in certain nodes in Johannesburg. The national office vacancy of 11.3% is masking underlying challenges in the sector, as no new tenant demand exists to absorb vacant space coming about from space consolidation and backfill space. Landlords are not only experiencing pressure on reversions, but also higher leasing commissions and incentives – there is evidence of up to 12 months' rent-free on three-year leases for challenging properties, although market practise remains one month for every one year of lease length. One promising fact is that development activity has slowed to a 13-year low to 2% of existing stock. Activity is still concentrated in Sandton, with a quarter of all development activity in the country – the development is led by proximity to the Gautrain station rather than the historic Sandton core. Flexible office space has gained in popularity, with WeWork coming to South Africa (three leases) and landlords' own initiatives, but the mode does challenge traditional office space lease structures.

Despite positive market dynamics for industrial properties, limited market rental growth continues as space consolidation and development activity are keeping a cap on rentals. There is a continued trend of large negative reversions on long-term 10-year leases coming up for renewal, which will likely take another three to five years to work out of the system. Big box tenants are pushing hard for contractual escalations closer to consumer price inflation – we are seeing this especially for logistics space users, who are also demanding shorter lease lengths.

The state of the economy remains the biggest challenge for the sector. The interest rate cut this past quarter will likely be insufficient to kickstart the economy. The lacklustre economy remains the biggest challenge for the sector, together with an increasing cost base, which is becoming more difficult to recover from tenants, resulting in property operating margin erosion. The most recent reporting season mostly cemented the trends landlords have experienced the last 12-18 months. An issue coming more to the fore is how real estate investment trusts (REITs) will treat dividend pay-out ratios going forward. REITs may choose not to pay out 100% of profits to shareholders to mainly preserve balance sheets in the current cycle. With these uncertainties still being the backdrop, the current lacklustre sector performance may continue in the short to medium term.

Portfolio manager
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as at 30 September 2019