CORONATION PROPERTY EQUITY FUND

Quarterly Portfolio Manager Commentary

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

The listed property sector (ALPI) delivered a total return of -48.2% in the first quarter of 2020 (Q1-20) - a record negative quarterly return for the asset class. Initially, continued concerns of a challenged operating environment led the sector lower. In turn, these concerns were exacerbated by challenges related to Covid-19, ranging from the possibility of not receiving rental income during the lockdown to the impact this may have on funding availability in future. Liquidity, and the relative exposure to retail property, were the major drivers of the sell-off in individual stocks. Results released during the quarter also didn't provide any comfort of a potential recovery on the horizon – year-on-year (y/y) dividend growth, excluding offshore-focused companies, was -0.8%. This was accompanied at the end of the quarter by the cancellation or postponement of dividend payments that had been declared earlier with the results releases. Earnings' guidance of most companies being pulled added fuel to the fire. This quarter's poor showing versus that of both the Africa All Share Index (ALSI) and the All Bond Index (ALBI) has resulted in the sector's 12-month rolling underperformance widening further to respectively -30% (vs ALSI) and -45% (vs ALBI). The historical yield gap with the bellwether index is of little relevance now due to the extreme moves experienced within the sector. With dividend cuts likely to come, the forward yield is more relevant. We have cut our dividend expectations for the sector dramatically. Thereby, the current forward-yield of the ALPI is 14%, down from 20% prior to the dividend adjustments, with the forward-yield gap at 274 basis points (bps).

The fund's return of -48.7% during Q1-20 was marginally lower than that of the benchmark. However, the fund's performance over periods between three and 10 years compares favourably to peers and the benchmark. The fund's relative positioning in Arrowhead A, Dipula A, Fairvest and Liberty Two Degrees added value during Q1-20, while value detraction came from the relative positioning in Investec Australia, Equites, Resilient and Fortress A. During the period, the fund increased exposure to Redefine, Fairvest and Equites, while reducing exposure to Capital and Counties, Sirius, Stor-age and Fortress A, to mention some of the repositioning.

The South African Property Owners Association (SAPOA) released its quarterly office vacancy survey for the fourth quarter of 2019 (Q4-19). Vacancies remained flat, at 11.0%. At the upper end, P-grade was affected by new supply (particularly Rosebank), while, at the lower end, the C-grade segment was positively impacted by buildings converted into residential (mostly in Johannesburg). Overall asking rents increased by 2.5% y/y but were mostly driven by better-quality space coming online and lower C-grade-quality space being taken off due to conversions. A better reflection of market conditions is the 3.9% y/y decrease in A-grade asking rentals. A reprieve for the office sector is the decrease in development activity as a percentage of overall space, now at 1.3%, which is the lowest level in 13 years. Development activity is still concentrated in Gauteng, with developments in Sandton, Waterfall, Menlyn and Rosebank making up nearly two-thirds of all office developments.

Results released during the first quarter, all prior to the onset of Covid-19 in South Africa (SA) and the subsequent lockdown, confirmed that that landlords remain very uncertain about the length of the current cycle, with the economic backdrop not assisting. Company views on the introduction of pay-out ratios remain divergent.

Views are mostly split between those with balance sheet capacity and those that don't have much headroom in gearing limits. Some other meaningful trends that continue are:

- Negative rental reversions are not abating, with those in the retail sector taking another step down
- The stronger tenant demand in the logistics sector is not supporting landlords, as developers are undercutting market rental levels and longer leases up for renewal revert at larger negative spreads than in the past
- Pressure is starting to show on bad debt and arrears and, noticeably, bankruptcies are putting strain on landlords, with more traditional industrial tenant exposure
- Vacancies are starting to increase, but most landlords continue to rather take the pain through incentives and negative reversions upon lease renewals to ensure tenants remain in place
- Selective individual assets are being valued lower, but, on a portfolio level, it is still only low single-digit moves lower, with some management teams sticking to the official policy of only a third of properties to be valued independently every year
- Where there is capacity, companies are trying to gradually start weaning themselves off cross-currency swaps and introducing lower gearing ratios associated with their offshore investments, but it is a slow and arduous process, as earnings will be diluted
- Refinancing of local debt is still at least mostly neutral on earnings, if not even favourable, as any margin expansion upon refinance is being absorbed by lower base rates or improved swap rates

Even prior to the advent of Covid-19, landlords had adapted to a weaker operational backdrop, with the managing of tenancies and costs brought in line to reflect this. Covid-19 has amplified how landlords manage rent collection, cash flows and balance sheets in these testing times. All relevant industry bodies are engaging as a collective to ensure a singular approach to any unintended regulatory, legal or operational consequence arising from challenges relating to the pandemic. This includes a potential relaxation of the Real Estate Investment Trust (REIT) tax dispensation to allow for limited tax impact on earnings should dividends be held back to ensure proactive liquidity management amid uncertain times. We will support companies with legitimate liquidity concerns in their decisions to withhold dividends if this will put the company in a meaningfully improved balance sheet position. Although we do not expect independent valuers to adjust portfolio values specifically for Covid-19-related concerns, portfolio value pressure has been coming for some time, with the weaker operational backdrop of the last 18 months not yet fully reflected in companies' net asset values. This is an additional consideration in how companies approach liquidity management in the coming months. The negative move in sector share prices over the last quarter has been unprecedent. We have adjusted our dividend expectations and, in our assessment of sector value following these share price moves, are approaching expected balance sheet risk and management by individual companies in a prudent manner. We recognise that risks continue to exist, some unquantifiable, but see selective value emerging from the sector against the current backdrop.

Portfolio manager
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as at 31 March 2020