*Please note that the commentary is for the retail class of the Fund.*

The All Property Index (ALPI) delivered a total return of -15.4% in the third quarter of 2020 (Q3-20). After the partial recovery experienced in the second quarter of the year, results releases and trading updates during Q3-20 were in line with general expectations. However, negative management commentaries relating to the uncertain economic backdrop and when a likely return to pre-Covid-19 distributable earnings levels will materialise spooked the market. In addition, discussions between the SA Real Estate Investment Trust (REIT) Association, the JSE and Financial Sector Conduct Authority (FSCA) on any potential leniency on REIT status qualification paying out lower than the required 75% of distributable profit to still qualify could not be resolved. Despite being already wide at the start of Q3-20, the sector's 12-month rolling underperformance vs. the All Share Index (ALSI) and All Bond Index (ALBI) widened even further to -49% (vs ALSI) and -51% (vs ALBI). The current forward yield of the ALPI is 13.2%, assuming dividend payments from most REITs, which we previously anticipated might be cancelled across the sector, albeit with the introduction of dividend pay-out ratios.

With a return of -17.4% during Q3-20, the Fund underperformed the benchmark, resulting in some ground being lost on most time periods between 12 months and 10 years. The Fund's relative positioning in Fairvest, Fortress A and Investec Property added value during Q3-20, while value detraction came from the relative positioning in NEPI Rockcastle, Investec Australia Property, Dipula A, RDI REIT, Stenprop and Attacq. During the period, the largest increase in exposure occurred in Fortress A, Redefine and Spear, while the largest reduction in exposure occurred in Capital & Counties, Fortress B and Hyprop.

Due to the impact of Covid-19, distributable earnings for the companies that reported during the quarter was 25.6% lower year-on-year in reporting currency, with the number being -22.4% if the offshore focused stocks are excluded. The six-month period that included trading under Covid-19 lockdown restrictions experienced distributable earnings going backwards by 38.3%. Dividend growth was lower, with those companies declaring dividends (rather than pushing the decision out to a full year results release) producing dividend growth of -33.6%. Lower-than-average rent collection is the biggest culprit behind the negative growth, with most companies providing more rental discounts than deferrals for tenants not able to optimally trade during the Covid-19 lockdown period. Last quarter, we referred to rental collections during the lockdown period ranging between 70% and 80% compared to contracted rentals. Collections post June have improved to mostly beyond 90%, while small discounts continue to be provided for tenants having practical limitations to trade even under lockdown level 1 i.e. cinemas, some food and beverage services and associated office or industrial tenants operating in the broader hospitality or travel industries.

Looking at the results releases and trading updates of the last quarter, it is interesting to see how the companies approach reporting, with Covid-19 relief (especially deferrals) either coming through as revenue and debtors or loss of income. Some broader sector trends prevalent from the results releases are:

- After the sale of individual elements of Edcon, most existing Edgars and Jet stores are being kept on by Retailability and The Foschini Group, the respective acquirers, with a mixed bag on the relative rentals vs. previous Edcon-negotiated rentals. The few stores not being taken on by the new owners are being taken up by national grocers, pharmacies or specialist retailers such as OBC or Studio 88;
- Significant single-tenant exposure and new lease deals on a portfolio level could have a negative impact on rentals and vacancies. Massmart has been keen to do single portfolio deals in exchange for what seems mostly lower rental renewals for mostly new 10-year leases;
- As seen globally, more rural and secondary-located retail with a convenience element is performing much better than urban and larger regional shopping centres;
- Debt funding remains available, even in the Domestic Medium-Term Note market, but more selectively than traditional bank funding, while margins are expanding by circa 50 basis points;
- Portfolio values are down 5%-15%, depending on the sector profile and exposure within a sector; most of the pain is being taken on the discount cash flow input variables and short-term cash flow impact from Covid-19 rather than capitalisation rates;
- Most REITs are now including all derivative liabilities in loan-to-value calculations, making it a more robust ratio, especially when it comes to cross-currency swap balance sheet risk when these expire;
- REITs continue to simplify the earnings base on which dividends are based, with the gradual potential exclusion of capitalised interest cost in distributable earnings. Also, there is some propensity not to increase cross-currency swap exposure, but rather decrease or exit it as the differential between local and offshore interest rates makes it less attractive for the currency risk being taken on;
- Black economic-empowerment deals are under severe pressure where any third-party funding was provided, with either the company standing in as guarantor or the original funders becoming the holders of the equity.

Although uncertainty still exists on how individual REITs will approach dividend payments, the decision by the FCSA that no leniency will be provided to REITs in terms of the minimum payout ratio of distributable profit required to qualify as a REIT does put a peg in the sand. Companies remain undecided in how they will approach dividend payments, but our expectations are for dividends to be 30% lower in FY2020 vs. FY2019. Most REITs will likely work towards maintaining REIT status and, therefore, it does provide some underpin to the sector in terms of at least income return expectations. Referencing the results announced in this quarter, most rental discounts and deferments seem to be in the earnings base, although the certainty of this remains fluid. What remains key is where asset values will settle. With the economy under pressure, further valuation adjustments beyond that already announced in the recent results season may come, which could put further pressure on already stretched balance sheets. We are selectively positive on a few individual companies where we deem this specific risk/return payoff to provide potential upside from current share price levels, but it remains a broader sector risk, which will continue to put a dampener on short-term upside.

Portfolio manager
Anton de Goede
as at 30 September 2020