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

The property sector maintained its momentum of the first quarter of 2021 (Q1-21) into the second quarter, delivering a return of 11.1% for Q2-21 and resulting in a year-to-date return of 20.1%. With the initial Covid-19 sector recovery occurring in Q2-20, the 12-month return was lower than at the end of the prior quarter but still came through with a strong showing of 25.6% at end-June. Despite the continued recovery, the sector is still down 22.6% since the start of 2020, illustrating the severity of the initial selloff. From a relative performance point of view, the sector is gradually gaining ground against both the JSE All Share Index and All Share Bond Index over the medium term and is even positive against both indices over a 12-month period. The All Share Property Index's one-year forward dividend yield is 7.8%.

The sector continued to benefit from the economic recovery trade, which has boosted listed property markets globally. However, the continued strong return was better than our expectations as the vaccination rollout in South Africa (SA) has been much slower than in many developed countries, where the bulk of the recovery trade has been experienced. In addition, this strong return was despite sector specialist unit trusts mostly experiencing negative capital flows. Stocks that outperformed this quarter were mostly larger, more liquid names or those most exposed to the recovery, especially those companies exposed to retail properties. In addition, some of those companies that outperformed did so on the back of better-than-expected results.

With a return of 11.9% during Q2-21, the Fund outperformed the benchmark, gaining marginal ground against the benchmark over the one- and five-year return periods. The Fund benefited from its overweight positioning in most of the A-shares and Attacq and Investec Property. We also have a non-benchmark position in Spear REIT that performed strongly after a good set of results. Our relative positioning in Resilient, SA Corporate, Fortress A and Fairvest detracted value during Q2-21. During the period, the largest increase in exposure occurred in Growthpoint, Capital & Counties and Equities. We did reduce our exposure to Capital & Counties to zero in Q1-21, but the speed at which the UK is benefiting from its vaccination rollout made us reconsider our view and initiate a position once more. The largest reduction in exposure occurred in Redefine, NEPI Rockcastle and MAS.

Those companies with February and March reporting periods reported results mostly in line with expectations, and as already mentioned, some even a touch better, especially those related to essential and convenience retailing. The reported weighted-average distributable earnings per share came in 8.3% lower, supported by a few offshore domiciled names. The dividend per share and the payout ratio was 2.7% lower and sitting at 86.9% for those companies that actually declared dividends, as many companies with interim reporting periods are waiting for their full-year results before deciding on declaring a dividend. Note that although Covid-19 rental discounts are much less than initially granted at the height of the first lockdown in SA, the comparable period on which distributable earnings growth is calculated is still predominantly pre-Covid-19.

After very little news on the corporate action front due to Covid-19, the quarter saw a resurgence in potential activity. Fairvest is looking to merge with Arrowhead after acting on approaches by Arrowhead B shareholders due to their disapproval of management accountability. In turn, Tower is entertaining an offer to be acquired by RDC Properties, which, despite being Botswana-listed, already has exposure to SA property. I-Group, the largest shareholder in Emira, and Resilient, the largest shareholder in Lighthouse, have both breached shareholding percentages, which triggered mandatory offers of 915c and 713c per share, respectively. These offers are part technical and opportunistic in nature, like the mandatory offer Texton made to shareholders in 2020, but it did provide an underpin to the respective share prices.

MSCI released its annual SA Property Index for 2020 during April, which gives an indication of direct property returns. Although it is backward-looking, it does provide a good barometer of the health of the SA property market. Total returns for direct property came in at -3.0% versus 7.9% for 2019, the worst year on record since the index started in 1995. The total return is split 7.2% income return and -9.6% capital (vs. 8.1% income and -0.3% capital in 2019). Per tertiary sector, total returns were industrial at 1.1%, followed by office at -1.8%, residential at -3.0% and retail at -4.4%. All Property vacancies increased from 7.0% to 8.7%, with most sub-categories increasing.

In turn, SAPOA published its Q1-21 office vacancy survey. Nationally, vacancies increased from 13.3% to 14.2% over the quarter (net negative absorption of 187 000 square meters [sqm]) and increased from 11.6% to 14.2% year on year (y-o-y). Most regions and grades increased vacancies over the quarter except for Durban and Port Elizabeth. From a grade level, Premier grade vacancies are now at 11.7%, up from 4% in 2016. Sandton, with a vacancy rate of 20.2%, makes up 15% of all the office vacancies in SA. Median rentals increased 0.8% y-o-y to R127/sqm while developer asking rentals increased by 4.8% y-o-y to R236/sqm. Development under construction is at 43 000 sqm - this is just 0.2% of existing stock and has come down from the previous high of 6% in 2015. With the weak tenant market, it is not surprising that speculative stock makes up only 36% of the development under construction.

In the short term, the sector should find support in a short-term bounce in earnings as the base effect of the Covid-19 discount works itself through. Discounts provided in the last few months have been noticeably less than at the start of the pandemic, but the most recent third wave-related lockdown and associated pressure on especially entertainment and hospitality tenants could result in a small spike in discounts once more. Low interest rates provide some reprieve for distributable earnings, which could continue for another two- to three years as interest rate swaps entered during a higher interest rate cycle roll-off. The broader concern is that the operational earnings pressure the sector is under due to Covid-19, be it from discounts, operating cost pressure or increased vacancies, will not dissipate hastily. Therefore, it will require another round of results, even beyond the ones expected in Q3-21, to judge the sustainability of the distributable earnings recovery post-Covid-19.

While listed property peers globally, especially in the US, Europe and the UK, continue to benefit from the positive economic recovery trade, the local economic recovery is still in second gear. A stronger economic boost is required for the sector to forge ahead from current levels, but it seems to have found some base level after what could be deemed a somewhat surprisingly strong quarter.

Portfolio manager
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as at 30 June 2021