CORONATION TRUST IS EARNED™

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

Performance and fund positioning

This past quarter was one of catch-up, with the property sector erasing most of the losses experienced in Q2-22 and Q3-22. The sector found support from both the local equity and bond markets, while improved global sentiment towards property stocks provided further positive momentum. This resulted in the sector delivering a total return of 18.2% for Q4-22, the third best quarterly return over the last 10 years. However, this push was still not enough for the sector to deliver a positive return for 2022, with a total return of -1.9% being the eventual outcome. Despite apparent afresh institutional interest in the sector from some corners, sector-specific unit trusts continued to experience net negative capital flow, with this past quarter surpassing the record net negative flow of the last three years delivered just the previous quarter. The sector is still 13% behind the level it started 2020 from just before the onset of the Covid crisis. From a relative performance viewpoint, the sector gained ground against both the FTSE/JSE All Share Index and FTSE/JSE All Bond Index over most time periods, especially over shorter time periods less than 12 months. The FTSE/JSE Africa All Property Index's (ALPI) one-year forward dividend yield is 8.8% and that of the Fund is 8.6%.

Delivering a return of 18.0% during Q4-22, the Fund marginally underperformed the benchmark, with the bulk of the underperformance occurring in the latter end of the quarter when liquidity was limited. For the year, the Fund underperformed the benchmark by 2.0%, delivering a return of -3.9%, mostly due to our relative positioning in Fortress A and B, Equites, Investec Property, Resilient and Emira. For the quarter, the Fund benefited from its overweight positions in Fairvest A, NEPI Rockcastle and Attacq, and its underweight positions in Emira, Resilient and Vukile. Some counteraction occurred with the value detraction from our relative positioning in Investec Property, Hyprop, Fairvest B and Dipula B. During the period, the largest increase in exposure occurred in Fairvest B, SA Corporate and Hyprop. The largest reduction in exposure occurred in Equites, Vukile and NEPI Rockcastle.

Results season for companies with an August or September reporting date, delivered a marginal deterioration in earnings and dividend growth momentum compared to companies reporting during Q3-22. Distributable earnings per share growth came in at 8.9%, while dividend per share growth came in at 8.5% as there was a year-on-year decrease in average pay-out ratio, now at 83.1%, due to the once-off payment of an unrealised non-recurring foreign exchange gain by Redefine in the previous year. However, having a closer look at the results, SA-centric stocks only delivered below inflation distributable earnings and dividend per share growth of 3.9% and 2.8%, respectively (which does point to continued pressure on the local operating environment), and an average dividend pay-out ratio of 85.5%. We believe the future sector average dividend pay-out ratio is likely to settle between 80% - 90%.

Although the operating environment remains tough, there is a definite improvement in overall operating metrics being reported by most REITs. Vacancies across the board are decreasing, even on the office side (albeit marginally), which is resulting in less negative momentum in rental reversions upon renewals. In this regard, the retail sector has turned positive in many cases, with especially new tenant leases achieving strong rental growth compared to the previous passing rental. Retail trading density growth of mid-to-high-single digits are being achieved with super regional and regional centres playing catch-up with convenience retail post-Covid, therefore our increase in exposure to Hyprop.

The recovery of the office sector, still in its infancy, is being led by P-grade offices and in key nodes outside of Sandton like Waterfall, Rosebank and Bryanston. Key nodes in especially Durban and Cape Town also continue to perform well. The focus of landlords continues to be on how to reposition underperforming space, with alternative use or space upgrades being considered the most. Industrial space demand remains strong, but despite record low vacancies and some market rental growth, especially for large new logistics space, one should expect continued negative reversions as expiry rentals after long leases still tend to have outpaced market rentals. Interestingly enough, it appears that landlords are starting to move up the risk curve, with acquisitions becoming more prevalent once again, especially on the retail and industrial side.

Compared to some global counterparts, current balance sheet concerns in lieu of higher interest rates, seem to have bypassed the local sector. Asset values continue to stabilise, or in the case of some retail portfolios, have returned to capital value growth. Gearing levels have therefore remained constant. Despite the increase in base rates, the local credit market, both public and the traditional banking sector, continue to support property companies with some even reporting margin contraction. Higher base rates are however impacting overall funding rates, which are starting to squeeze those companies where hedge profiles are shorter or where less of the overall debt is hedged. Companies are increasingly utilising interest rate caps rather than swaps in their hedging profile, not wanting to lock in current high interest rates, but rather managing “blow-out” interest rate risk. It does pose the threat of further pressure on distributable earnings going forward, especially if the tightening interest rate cycle is sharper than expected.

Fortress continues to be in the headlines. The JSE indicated its intention to remove Fortress’ REIT status due to not paying a dividend for FY2022 subject to a mid-January meeting called by shareholders to vote on a MOI amendment to ensure that dividends can be paid to both Fortress A and B shareholders. Despite the inverse performance of the A and B shares in 2022, we continue to have a favourable view on the return potential of Fortress A. We believe the earnings potential of the company is underpinned by the healthy underlying operational performance being delivered by the portfolio. Even if the proposed MOI amendment is not sufficiently supported by both sets of shareholders and the company loses its REIT status, we have the view that the value in Fortress A will be unlocked once the dividend entitlement is reached, which we believe is a medium-term prospect and the timing thereof not fully reflected in the current share price.

Outlook

As we have seen this past quarter, the sector can still surprise on the upside on the back of even just borderline positive news flow or a shift in underlying risk appetite, which have a beneficial impact on all riskier asset classes. Although operational metrics are stabilising or even improving, we do not anticipate much higher distributable earnings per share growth in the short to medium term than the low- to mid-single digit growth that is currently being delivered. This growth trajectory includes the benefit of the marginal gain from lower vacancies, improved rental reversions and a stabilising interest rate profile, but excludes the impact of the prolonged and persistent load shedding of the last few months on retail trade and operating costs. Therefore, from a relative asset class viewpoint, we do not see anything that stands out from the sector from a total return prospect perspective to make us believe there is much higher relative upside. As a stand-alone asset class, barring any unforeseen external risks, the sector has probably returned to its through-the-cycle total return profile, which is 10% - 15% per annum.

Portfolio managers
Anton de Goede and Mauro Longano
as at 31 December 2022