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

After an initial lacklustre start to the quarter, an explosive last few weeks of the quarter-end dragged the sector lower, probably more than what the underlying operating environment warranted, as a broad-based risk-off trade occurred across all asset classes, both in South Africa (SA) and most offshore markets. Besides the unique local challenges (flooding in KwaZulu-Natal and loadshedding, which intensified once again into June), the global backdrop (higher interest rates, inflation pressure and geopolitical risks) continues to weigh on most asset classes locally as well. The sector ended the quarter with a total return of -12.1%. Returns delivered in June were the most severe at -10.5%. From a relative performance viewpoint, the sector lost substantial ground against both the JSE All Share Index (ALSI) and All Bond Index (ALBI) over 12 months. Over longer time periods, the sector was mostly stable from a relative return basis, albeit still underperforming the equity and bond indices. The JSE All Property Index's (ALPI) one-year forward dividend yield is 10.3% and that of the Fund is 11.5%.

During the quarter, MSCI released its annual SA Property Index for 2021, which gives an indication of direct property returns in the country. Total returns came in at 5.3% for 2021 versus -3.0% for 2020, with the total return split being 8.1% (income) and -2.5% (capital). In local currency terms, SA performed poorly versus global peers. However, comparing the full-year numbers to those reported for the first half of 2021 points to an improvement in momentum, with stable capital values for the second half of 2021 after being more than 10% lower the preceding 18 months. Retail has improved its showing in 2021 versus 2020, with many subsectors that performed poorly in 2020 on a relative basis reversing most of the losses of that year, including super regional and regional shopping centres. The index also pointed out a continued increase in vacancies in 2021, as the reporting of the listed landlords already indicated, led by offices, while base rental growth deteriorated further, with Covid impacting the dynamics here as landlords mostly managed for occupancies. A release on retail trading density trends for Q1-22 by the South African Council of Shopping Centres confirmed the continuous improvement in the prospects of retail landlords. Footfall continues to increase (but still a third below a pre-Covid base), while more importantly, occupancy cost ratios, which is a good barometer on the trading profitability of retailers, are at lower than March 2020 levels, driven by improved turnover levels and the rebasing of rental levels.

Delivering a return of -12.6% during Q2-22, the Fund marginally underperformed the benchmark, with the bulk of the underperformance occurring in the latter end of the quarter. For the quarter, the Fund benefited from its overweight positioning in Fairvest A, Dipula and MAS. Unfortunately, this was offset by the value detraction from our relative positioning in especially UK-based companies such as Hammerson, Capital & Counties and Sirius, as well as Fortress A, Attacq and Equites, due to a spill-over effect from weak global sentiment towards logistic and industrial landlords after Amazon reiterated its plans to cut back on its warehouse space requirements. During the period, the Fund's largest increase in exposure, once again, was in Hyprop, similar to Q1-22, and Redefine. In recent quarters, both companies have simplified the structures in which they hold their offshore exposure, thereby improving the prospects of a direct positive impact from the offshore operations on earnings growth and removing balance sheet uncertainties. The largest reduction in exposure occurred in Growthpoint, Fairvest A, Vukile and SA Corporate.

Results season for companies with a February or March reporting date, once again delivered an improvement in earnings and dividend growth momentum. Distributable earnings per share growth came in at 7.6%, while dividend per share growth came in at 9.0%, as there was a year-on-year increase in the average pay-out ratio, now at 89.3%. This as companies become more confident in their balance sheets and rental collection post Covid. As we pointed out previously, we believe the sector average dividend pay-out ratio is likely to settle between 80% to 90% in future.

Noteworthy news flow during the quarter relating to broader sector trends on capital allocation or potential corporate action relates once again to the A and B share capital structure, this time with reference to Fortress. A collapse of the share capital structure into a single class share, similar to what occurred at Dipula earlier this year, has been proposed by the company. This has initially been raised by the company at the start of 2020, but it was challenging at that time (and remains so) to find a likely middle ground for both sets of shareholders. Additional news flow includes Heriot and Safari, two smaller REITs, indicating their intention to merge; Tradehold making its intentions known to convert to a REIT with the Collins industrial and logistics portfolio as core asset; while Investec Property is nearing a potential sale of its stake in a European logistics and industrial portfolio, which represents a substantial portion of its entire investment portfolio.

Recent result releases and interaction with direct property market participants have highlighted a few noticeable changes in trends from what the sector has experienced in the last 24 to 36 months. There is a gradual reversal of the continued downward trend in escalation rates in the last few years. It seems that the higher domestic inflation is assisting in this regard. For offices, stronger economic growth is required for the sector to come back to some type of equilibrium to have sufficient tenant demand to absorb vacancies; there is a market for quality B grade office space while the most buoyant market currently is P grade space and residential conversions will not be able to pick up all the additional supply in the market. There continues to be strong tenant demand for big box logistics, with an increased interest for data centres, while there are conflicting views on both if higher construction costs will result in higher market rentals and the scarcity of zoned land, although it is becoming more difficult and taking longer to get unzoned and unserviced land ready for development. It looks like more traditional older industrial space has turned the corner as well, with affordability and general low vacancies likely the reason behind this. Within retail neighbourhood and convenience and rural retail we are likely to see development opportunities within the 5 000m² to 10 000m² space as both grocers, pharmacies and apparel traders expand into smaller store formats and previously underserviced areas.

The pressure the sector has endured into quarter-end has resulted in most stocks once again trading at, or approaching, double-digit dividend yields. Distributable earnings are back on a growth trajectory, while rising interest rates may be better absorbed by local players due to a higher starting point in existing average interest rates. Covid discounts are out of the system, while both rental and valuation levels have reset to a more sustainable level. However, there are likely differences in what can be viewed as sustainable, with the risk-off trade into quarter-end a testament to this. The risk is that landlords muddle through an environment of limited rental growth and continued operating cost pressure, all against a backdrop of rising interest rates, diminishing discretionary consumer spend and a lacklustre macro-economic performance. An alternative view is one of market rental growth starting to track inflation again, escalation pressure decreasing and true new demand for space starts to fill vacancies. It is likely that the way forward is somewhere in between these two alternatives with specific nodal exposure and asset/property specifics making the real difference for a landlord. Therefore, becoming pickier about where to gain asset class exposure will be the key for sector and asset allocation.

Portfolio managers
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