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

Local property, in line with its offshore counterparts, took a breather this past quarter against the backdrop of higher interest rates, inflation pressure and geopolitical risks following the outbreak of war in Ukraine. After some recovery into the quarter-end, the sector delivered a total return of -1.6% for the three-month period. This resulted in the sector still being 12% lower since the start of 2020 from a total return perspective, illustrating the severity of the initial sell-off in the first quarter of 2020 (Q1-20). From a relative performance viewpoint, the sector continues to gradually gain ground against both the JSE All Share Index (ALSI) and All Bond Index (ALBI) over the medium and long term. The JSE All Property Index's (ALPI) one-year forward dividend yield is 8.6% and that of the Fund is 8.3%.

Initially, the most anticipated events during the quarter were hold-over corporate actions, with shareholders approving both the Arrowhead/Fairvest merger and Redefine's takeover of EPP. Post quarter-end, Dipula shareholders approved the collapse of its A andB structure into a single share structure. Increasingly, companies are starting to exhibit their expansionary intent. Most notably, Vukile (through its Spanish subsidiary Castellana) acquired a 21.7% stake in Spanish-listed retail landlord peer Lar Espana. Other noteworthy corporate actions were Hyprop announcing the collapse of the Hystead structure (which holds its south-eastern Europe assets). Hyprop will be acquiring four of the assets out of Hystead, while the final asset should be sold independently by Hystead. In addition, the board of Irongate (previously Investec Australia Property Fund) approved the takeover offer by a Charter Hall-led consortium, the fourth takeover offer the company has received since October 2021, with the shareholder vote anticipated during June 2022.

Delivering a return of -3.0% for Q1-22, the Fund underperformed the benchmark, with the bulk of the underperformance occurring in the latter end of the quarter. For the three-month period, the Fund benefited from its overweight positioning in Vukile, Equites and MAS. The overweight positions in the A shares also supported performance, although the illiquid nature of Fairvest A makes for volatile trading, especially around month-ends, this time impacting the Fund negatively on the day. Our relative positioning in Emira, Redefine, Resilient, Attacq, Sirius and NEPI Rockcastle detracted value during Q4-21. During Q1-22, the largest increase in exposure occurred in Hyprop, SA Corporate, Sirius and Vukile. The largest reduction in exposure occurred in NEPI Rockcastle and Growthpoint. We sold out of our positions in Irongate and EPP prior to the takeover by Redefine becoming effective.

Results season, with many companies releasing interim FY2022 results, delivered an improvement in earnings and dividend growth momentum compared to FY2021. Excluding the traditional UK inward listed large caps, distributable earnings per share growth came in at -3.7%, while dividend per share growth came in at -2.1% with an average pay-out ratio of 77%. When excluding the stocks in the universe with 100% offshore exposure from the calculation, the growth figures are positive (distributable earnings per share growth of 5.5% and dividend per share growth of 8.3%). It seems that companies are prepared to increase their pay-out ratios as the uncertainty of property value write downs and cash flow dissipate. The sector average dividend pay-out ratio is likely to settle between 80% - 90% in the coming years.

Very few new operational observations have come about from the results season. As expected, Covid-related rental discounts and deferrals were at the minimum, still mostly related to hospitality, entertainment and leisure linked tenants. Vacancies continue to be well managed through lower rental levels agreed on upon lease expiries. Surprisingly, despite the pick-up in reported year-on-year retail sales growth of mid-to-high single digits, most retail landlords continue to report double-digit negative rental reversions. The containment of operating cost growth that was seen through Covid-19 is starting to slip as operations return to normality and administered pricing once again turns out to put pressure on total tenant occupancy costs. In this regard, most sector landlords are upping the roll-out of their solar capabilities and even testing new battery technologies on a larger scale.

The current global situation has again created uncertainty and, in general, lowered investor risk appetite, just shortly after some stabilisation has returned post-Covid. Besides how global inflationary pressure and higher interest rates may impact local consumer sentiment, the sticking point for the broader prospects of the sector remains that of the office sector. Office vacancies are at 16%, the highest levels since 2003, despite development activity and new supply being at the lowest levels since 1993. With retail tenants having settled and space demand coming through from grocers, pharmacies and value apparel, as well as industrial tenants (despite long lease expiry renewal risk), offices remain the outlier sector. Although it seems that some of the negative momentum with regards to offices may be turning around, as the work from home dynamic has shifted back towards being more office bound in the future than what was expected at the height of Covid-19 lockdowns, a period of tenant consolidation should be expected rather than an expansionary leasing trend.

All-in, we believe the earnings bases of most companies are at a much more sustainable level, while vacancies should continue to be well contained at the expense of reversions, which should start to moderate as the sector moves beyond its three- and five-year renewal cycles post 2018/2019, when the current reversion cycle started. Although most of this is already priced into the sector, the speed at which the interest rate cycle plays out may surprise some investors, with the likelihood of increases being front end loaded now much more of a base case than late last year. Despite this risk on the horizon, after the slight pullback in prices we have experienced this past quarter, we believe the sector is at an even keel with the expected yield fairly intact.

Portfolio managers

Anton de Goede and Mauro Longano

as at 31 March 2022