CORONATION
TRUST IS EARNED™

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

The sector started the quarter strong, erasing most of the losses experienced in the prior three months (Q2-22). However, headwinds from all fronts eventually led to a total return of -4.1%. Once again, the global backdrop was one of higher interest rates and inflation pressure as well as geopolitical risks continuing to weigh on most asset classes, both in South Africa and globally. The fund return is also reflected in the continued net negative capital flow for sector-specific unit trusts, with Q3-22 experiencing the largest net negative flow since the start of 2020. The sector is still 26% behind its starting level of 2020 just before the onset of Covid-19. From a relative performance viewpoint, the sector lost substantial ground against both the FTSE/JSE All Share Index and All Bond Index over 12 months. Over all other longer time periods (except over two years), the sector continued its underperformance, losing marginal ground against these two indices. The All Property Index's one-year forward dividend yield is 10.2%, and that of the Fund is 10.1%.

Performance and fund positioning

Delivering a return of -4.0% during Q3-22, the Fund marginally outperformed the benchmark, with the bulk of the outperformance occurring towards the latter part of the quarter. For Q3-22, the Fund benefited from its overweight positions in Attacq, Dipula, Investec Property and Hyprop and underweight positions in Lighthouse, Industrial REIT and Resilient. Some counteraction occurred, with value detraction coming from our relative positioning in the larger historical UK dual-listed companies, Fortress A, Equites and Liberty Two Degrees. UK property stocks, in particular, experienced a poor end to the quarter, with investors digesting the impact of the mini-budget announced by the newly elected government, which has put immense pressure on UK bond yields. During the period, the largest increase in exposure occurred in Redefine, Fairvest B and SA Corporate. The largest reduction in exposure occurred in MAS, Vukile and Investec Property.

Results season for companies with a June reporting date, once again delivered an improvement in earnings and dividend growth momentum. Distributable earnings per share growth came in at 10.2%, while dividend per share growth came in at 11.7% as there was a year-on-year (y/y) increase in average pay-out ratio, now at 92.8%, as companies become more confident in their balance sheets and rental collection post Covid-19. However, having a closer look at the results, SA-centric stocks only delivered below inflation distributable earnings and dividend per share growth of 4.3% and 4.7% respectively (which point to continued pressure on the local operating environment) and an average dividend pay-out ratio of 88.3%. We believe the future sector average dividend pay-out ratio is likely to settle between 80% and 90%.

The biggest news out of the sector during the quarter was the unsuccessful attempt by Fortress to gain the support of both A & B shareholders to collapse the capital structure into a single share class. Coronation supported the collapse as we saw the merit of the company moving forward as a single class and retaining its REIT status by paying a dividend. To maintain its REIT status, at least 75% of profit needs to be distributed to shareholders. The company is behold to a technical and prescriptive MOI with regards to dividend payments and currently is not allowed to pay either A or B shareholders, despite having funds available and thereby retain its REIT status. The company has until the end of October to engage with shareholders and the JSE to look at options to maintain its REIT status and potentially resolve the non-payment of dividends. The consequence of not maintaining its REIT status is becoming fully liable for corporate tax.

Some relevant direct property market data points were released during the quarter. SAPOA's office vacancy report for Q3-22 exhibited positive trends in that office vacancies on a national level have started to decrease, being 30 basis points (bps) lower to 16.4% overall. This after reaching an all-time high in Q2-22. There was positive net take-up of space across all property grades except for B-grade offices. Prime offices saw the largest improvement (120bps to 12.0%) as occupier's flight to quality is seemingly gaining momentum as the price differential between P- and A-grade offices closed over the last few years. Office development activity remains severely depressed at the end of Q3-22, with new development gross leasable area (GLA) (relative to existing GLA) being <20% of the average historical level, with almost all developments pre-let and tenant-driven (three developments account for two thirds of all the development activity). In turn, MSCI released some retail trading statistics up to June 2022, with annual trading density growth coming in at 9.8%. National retail vacancies have remained constant at 5.8% against pre-Covid levels of 4.0%. The number of shoppers visiting shopping centres is 19% higher y/y, but still at two-thirds of pre-Covid levels. After the reset of rentals, which occurred over the last few years, rental affordability levels are healthier and on par with that of 2017/2018.

Outlook

At face value, the sector looks to offer an attractive entry point at present, with most stocks offering double digit yields. However, this should be seen against the backdrop of expected three-year compound annual distributable earnings growth of (at best) inflation, if not marginally below. Although vacancies continue to improve, even in the office sector, persistent pressure on net operating income growth from negative rental adjustments upon lease renewals and operating cost growth outstripping revenue growth is keeping a lid on a strong distributable earnings growth recovery. As mentioned last quarter, the risk, especially with the current inflationary pressure and interest rate hiking cycle, is that landlords muddle through the next few reporting periods before the potential of an improved macroeconomic outlook starts to underpin tenant demand beyond the current, mostly logistics and essential retail-led, recovery. What could be a real spanner in the works is a longer and more stringent interest rate hiking cycle. It seems that landlords are not necessarily pricing this into their treasury management at present compared to our more prudent expectations, and this could surprise the market on the downside. Our assessment is that risks currently marginally outweigh the potential return expectations and would therefore be selective from a stock-specific and relative asset class point of view in gaining additional exposure.

Portfolio managers
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as at 30 September 2022