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

Performance and fund positioning

The strong rebound the sector experienced in Q4-22 likely forewarned investors of a potential lacklustre start to the year, which did transpire. The sector struggled to withstand the wider forces impacting global property as the asset class continues to face tough questions globally on balance sheet and debt refinance vulnerability, especially after the US mid-size bank crisis. In addition, loadshedding remains a buzzword for the sector, with key discussion points being diesel cost recovery, trading during load-shedding and potential additional capital outlay required to secure electricity supply. This resulted in the sector delivering a total return of -4.8% for Q1-23.

As was the case for most of 2022, sector specific unit trusts continued to experience net negative capital flow. Flows recorded for this past quarter were not far behind that of the prior quarter's record net negative flow as measured since the start of Covid-19. The sector is still 14% behind the level at which it started 2020 just before the onset of Covid-19. From a relative performance viewpoint, the sector lost ground against both the FTSE/JSE All Share Index (ALSI) and the FTSE/JSE All Bond Index (ALBI) over most time periods, except over the three-year period, as the starting point of the base period is the lows experienced within the sector at the start of Covid-19 in Q1-20. The ALPI's one-year forward dividend yield is 9.3% and that of the Fund is 9.2%.

Delivering a return of -3.3% during Q1-23, the Fund outperformed the benchmark, with the bulk of the outperformance occurring in the latter part of the period under review. The Fund benefited especially from its overweight exposure to Attacq. One of the Fund's largest active positions, Attacq outperformed the sector during the quarter, returning 16.4%, after the Government Employees Pension Fund announced its intention to enter as minority shareholder at Waterfall City, the largest combination of assets for the company. Other relative positions that benefited the Fund are Resilient, Vukile, Fortress A, NEPI Rockcastle, Sirius and Growthpoint. Some value detraction came from our relative positioning in SA Corporate, Hyprop, Fairvest A, Emira and Investec Property. During the period, the largest increase in exposure occurred in MAS, Hyprop, SA Corporate, Redefine and Hammerson. The largest reduction in exposure was in Growthpoint, Equites, Fortress A and Resilient.

Results season for companies with a June or December year-end concluded in March. This set of companies delivered an improvement in earnings and dividend growth momentum compared to their results season concluded six months earlier. Distributable earnings per share growth came in at 29.4% (vs. 10.2% delivered six months prior), while dividend per share growth came in at 32.9% (vs. 11.7% six months prior). There was a marginal increase in the average pay-out ratio, now at 93.4%. However, this robust growth came as a result of a strong performance out of Central and Eastern Europe (CEE) specialists NEPI Rockcastle and MAS which delivered y-o-y rand distributable earnings per share growth of 65% and 74% respectively. When stripping out the CEE specialists, growth momentum for the South African centric stocks is slower, with distributable earnings and dividend per share growth of 7.1% and 3.8% respectively (vs. 4.3% and 4.7% six months prior), with an average dividend pay-out ratio of 88.4%). As most of the results delivered during Q1-23 was interim rather than full-year results, we expect the earnings growth momentum to slow down during the next six months and to see a closer alignment between earnings and dividend growth as most companies will declare a dividend in the next cycle (which will mostly be annual results releases).

The most noticeable headline from the sector during the quarter was the removal of Fortress's REIT status. The shareholder-initiated proposal that was on the table for a MOI adjustment that would have ensured the company pay dividends for the three financial years starting FY2022 (and thereby comply with REIT legislation) was not sufficiently supported by Fortress B shareholders. As previously mentioned, we believe there continues to be value unlock potential in Fortress A once the dividend entitlement is reached, which we view as a medium-term prospect and the timing thereof not fully reflected in the current share price. From a risk-adjusted perspective, we have however reduced our overweight position as by not paying a dividend the stock's risk profile has increased. The trajectory in terms of when the dividend entitlement is reached is now part dependent on the capital allocation decisions relating to the cash being generated and not paid over to shareholders. As such, this creates some uncertainty relating to the entitlement.

Where globally the focus is on balance sheets, debt expiry profiles, funding rates and capital requirements, the focus of investors in the local market is dominated by loadshedding. During Q1-23 the South African Property Owners Association released the results of a broadly themed loadshedding survey amongst its members. Clear from these results and the commentary from companies reporting during the quarter is the disparity in landlords' preparedness to cope with loadshedding, securing electricity supply and recuperating the costs associated with it from tenants. Noticeable responses from the survey are that 83% of respondents have generators (no mention as to what % of a portfolio), there is a disparity on what landlords are charged for diesel, 50% of landlords have some element of solar power (no mention of the % that solar makes up of the electricity supplied to a portfolio), there is a disparity in approval time for solar installations (anything from 1 to 12 months) and the majority of assets operate at 80% capacity during loadshedding.

Most landlords recover an element of the diesel used to operate generators, but this varies widely within the listed space (between 18% to 85% dependent on asset type and legacy leasing terms). Our sense is that this should settle around an average 65% - 75% recovery rate as landlords adjust legacy lease terms, more tenants sign up for back-up power and more sophisticated methods (to come at a cost for landlords) are used to secure electricity, including large-scale battery usage. It is unlikely that landlords will not face pressure from tenants to help carry the burden of these additional operating costs themselves, either by lower reversions upon lease renewals as affordability becomes an issue or passing some of the benefit of solar electricity costs on to the tenants rather than taking all the cream themselves.

Outlook

With the gradual improvement in operational metrics (recovery in retail trading numbers up to end-2022, continued lower vacancies across all three sectors, less negative rental reversions upon lease renewals) and stabilisation in property values and balance sheets post-Covid, a shift seems to have taken place for the sector to be more expansionary. Although actions remain predominantly inward focused through continued portfolio rightsizing (i.e., the internalisation of management function at Investec Property and consolidating its European logistics exposure) balance sheet management (i.e., Equites disposing of some UK logistics assets to alleviate balance sheet pressure) and amended capital spend budgets to secure electricity supply, examples have emerged of management teams shifting gear. This includes Vukile's R700m capital raise (likely to create balance sheet capacity) and SA Corporate's bid for Indluplace. However, we believe actions like these will only likely add shareholder value at the margin. The sector is rather still at the mercy of broader macroeconomic themes and therefore will likely move in tandem with other higher risk budget asset classes when these themes turn more favourable for growth, which doesn't seem to be on the horizon soon. Although it does appear on the surface that most risks are priced into the sector, there are currently more risks to the downside than upside, especially if the second-round effects of loadshedding start to negatively impact tenant demand.

Portfolio managers
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as at 31 March 2023