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

Performance and fund positioning

Despite a solid start to the quarter – at one stage in mid-August the sector was 7% higher than at the beginning of the quarter – the sector only managed to deliver a return of -0.6% for Q3-23 (and -4.5% year to date). The reversal of fortunes came amidst a much weaker local (and global) bond market in September and some negative earnings guidance surprises as part of the recently concluded results season.

Capital flows into the sector continue to be negative, although a turn in flow momentum seems to have taken place this past quarter, with a positive net flow experienced in September. Although there were signs that institutional support has returned to the sector mid-year due to the yields on offer, the certainty of dividend yield will be scrutinised more closely in the future based on what transpired during Q3-23. The yield on offer doesn't necessarily compare that favourably from a relative asset class perspective versus the recent past, making institutional capital less likely to support the sector *en masse* from an asset allocation perspective. From a relative performance viewpoint, the sector gained ground against the FTSE/JSE All Share Index and FTSE/JSE All Bond Index over all longer time periods, except over the two-year period. The ALPI's one-year forward dividend yield is 8.9%, and that of the Fund is 8.6%.

Delivering a return of -1.5% for Q3-23, the Fund underperformed the benchmark, with the bulk of the underperformance occurring in the latter part of the period under review. One of the primary reasons for the underperformance was the negative return delivered by MAS in September. The company announced as part of its FY2023 results release in early September that, for the immediate future, earnings will be retained rather than paid out to shareholders as dividends to manage the balance sheet. With no immediate balance sheet pressure from a gearing perspective, they decided to rather manage balance sheet liquidity as the company continues to have a funding commitment to the development joint venture in which it has a 40% stake. Operationally, the existing portfolio is doing well, with rental growth underpinned by indexation, low vacancies, and positive rental reversions upon lease renewals. We have, however, lowered our exposure to the company from a risk management perspective while the Fund continues to have a positive active position in the company. Other relative positions that detracted from performance include some of the larger UK-focused companies, Liberty Two Degrees, Fortress B and Vukile. On the opposite end of the spectrum, the Fund did benefit from its relative positioning in Dipula, Attacq, Hyprop, Lighthouse, Resilient and Growthpoint. During the period, the most significant increase in exposure occurred in Growthpoint after its underperformance post its FY2023 results announcement, as well as Equites and Hammerson. Besides the reduction in exposure to MAS, other significant reductions in exposure were in SA Corporate (sold down to zero post its share price run after the company's H1-23 results release), NEPI Rockcastle, Attacq and Redefine.

Results season for companies with a June reporting period concluded in September. Distributable earnings and dividend per share growth experienced a pullback compared to the recent past, similar to the companies that reported in Q2-23. While strong underlying earnings momentum out of NEPI Rockcastle and MAS (and even more so from the UK-centric stocks from a low base) supported distributable earnings per share growth for the broader sector, the South African-centric stocks delivered distributable earnings and dividend per share growth of 2.9% and -0.1% respectively. The stocks delivered a wide range of earnings growth, ranging from as high as 18% for Hyprop to -13% for Resilient. More importantly, from the results season was the guidance provided by companies. There were some downside surprises, primarily related to higher-than-expected interest rates. With the bulk of the interest rate increases experienced thus far occurring in 2022, it will take another 12 to 18 months for the increases to work themselves into the earnings bases of companies.

As per the recently released SAPOA Q3-23 office vacancy report, office vacancies continue to decline. The past quarter was the fifth consecutive quarter in which office vacancies declined. As previously mentioned, the performance of the office sector has been a worry for the last few years as it is the sector most closely aligned with underlying economic growth, which remains under pressure. Overall office vacancies are at 15.5%, which is still higher than the previous peak of 15% in 2003. However, due to an increase in overall lettable space, the previous peak equates to only half the absolute space that is vacant at present.

In turn, the retail sector is experiencing a return to a more normalised trading density growth environment after the initial powerful growth post the lows of the Covid pandemic. Q2-23 delivered annual growth of 8.6%, driven by super-regional shopping centres. However, trading density growth has slowed down in the last few months of the calculation period to mid-single-digit growth, as growth in smaller rural centres has lost some steam. Although developments are still taking place in rural areas, the size per centre is decreasing versus what was initially planned due to consumers trading down to more essential items, while especially apparel retailers are being less aggressive than in the past on space growth in these areas. Counterintuitively, more aspirational brands continue to look at rural areas, including in the food services space, which is the strongest trading category at present.

Outlook

Although there is a belief that corporate action has returned in full swing to the sector with the offer Liberty made mid-quarter to the minority shareholders in Liberty Two Degrees, it is doubtful that it will result in a slew of corporate action events which are not already directly or indirectly on the go due to majority shareholdings already in place by larger REITs in smaller peers. The biggest drivers in the short to medium term are somewhat likely to be macroeconomic and geopolitical factors, with especially the risk of higher for longer interest rates globally and the impact of existing conflicts or election outcomes on economic policy being the first that comes to mind.

On a micro-sector level, the general improvement in vacancies bodes well for the return of some level of rental tension, albeit it will likely be nodal and sub-sector specific. Reversions continue to improve; despite being negative on a sector level, it puts less immediate pressure on headline earnings. Operating cost growth remains a swing factor, but with indications of lower loadshedding, the additional pressure it provides from revenue through to cost level should abate, providing some underpin for better revenue and overall cost management.

Once again, concerns have instead shifted towards debt funding structures and potential balance sheet pressures. With higher interest rates being blamed for most of the negative earnings guidance surprises produced by companies this past quarter, any upcoming refinancing risk will likely be reflected in individual share price levels more extensively than usual, especially if there is any offshore funding involved. From a gearing perspective, the way independent valuers will approach the much higher local risk-free rate will be watched closely, as capitalisation rates could be adjusted higher, putting pressure on gearing levels. The sector, therefore, remains at a precarious junction between continued earnings pressure and what, at face value, looks like undemanding valuations.

Portfolio managers
Anton de Goede and Mauro Longano
as at 30 September 2023