NIMBLE WISDOM MONTHLY

While the Ducks are Quacking... / July 2017

SESFIKILE CAPITAL
Listed Property Investments

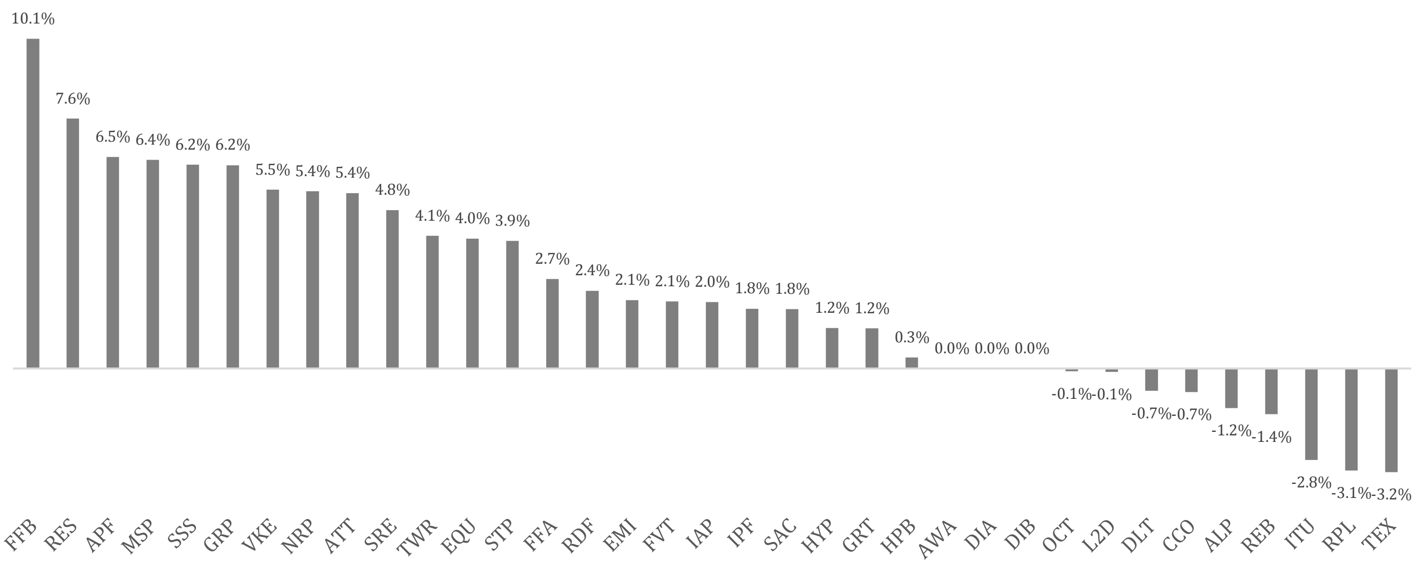
MARKET OVERVIEW

The markets started the third quarter on a high, with the SA Listed Property Sector ("SAPY") delivering a positive total return of +3.7% in July. Bonds (+1.5%) where driven higher by slight compression in the yield curve, but it was the Equity market that was rampant (+7.0%) as resources surged ahead, while the banks bounced back from their recent slump.

July could be defined as a risk on month, where property was supported by bonds, but lifted by equities. It was the flow of liquidity into the sector that drove prices as opposed to results on the ground. Equities and balanced-fund investors are still seeing an attractive yield and a comparably defensive outlook for property, which further increases the appetite for the asset class, which has been highlighted by the ease of the companies' ability to raise capital. Recent heavily oversubscribed book-builds from the likes of SA Corporate, Vukile and Greenbay managed to raise a combined R5.75 billion. In speaking of a growing sector, it is also worth noting the success and completion of the NEPI-Rockcastle merger to create South Africa's largest property listing with a market capitalization just short of R100 billion. Management have highlighted several synergies, the most significant being the potentially stronger balance sheet and access to lower funding costs; however, the short-term tailwinds will likely emanate from technical factors such as the inclusion into several local and global indices, which will create substantial demand.

The SARB's decision to cut the prime interest rate gave some respite to the sector as funding costs eased slightly, however most of the sector is relatively conservatively geared and price the marginal cost of debt off the longer-end of the yield curve. What is needed from the cut is a boost to the beleaguered consumer, however it doesn't appear that the cut will be enough to counter the weak employment figures and general levels of economic uncertainty. With that said, despite stronger prices, the local fundamentals are still slowing and show little sign of recovery as political instability creates ever growing lack of business confidence. However, gone are the days where listed property was a homogenous sector highly correlated in both price performance and earnings. So, despite a weak operating environment, several stocks are still expecting robust distribution growth, (largely supported by their global exposure) and helped prop up the strong returns for the month. Although, ironically, the bottom of the table was full of direct offshore counters as the UK property stocks took strain over the month. Once again, the diverse nature of the sector is increasingly lending itself to the use of active management to extract alpha.

Chart 1: Total returns for July 2017

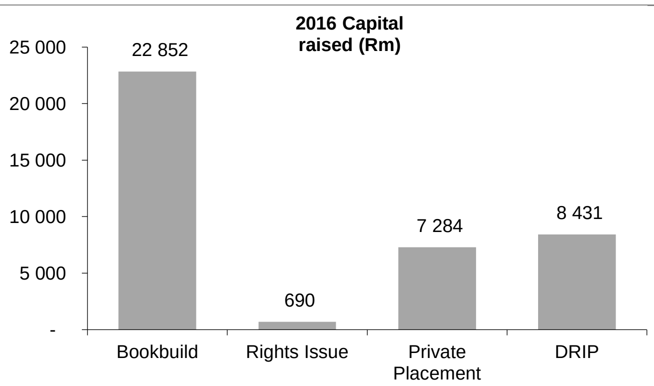


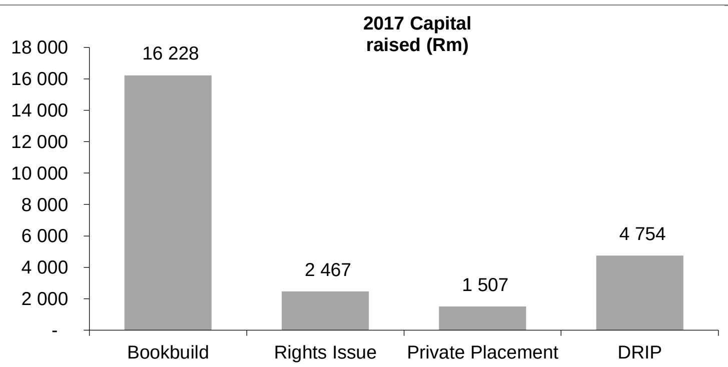
Source: Bloomberg

CAPITAL RAISING

As mentioned above, the ability of the sector to extract capital out of the equity market seems to be intact. The recent capital raises from Greenbay (R4.5 billion), Vukile (R650 million) and Equites (R600 million) were all well covered and had the ability to raise meaningfully more equity. Year-to-date, the sector has raised R25.0 billion rand, already 63.6% of last year's R39.3 billion. We believe that last year's number will be surpassed by year end with an expected R4 billion coming from further dividend reinvestment schemes (DRIPS) primarily from Growthpoint and Redefine, a couple of new listings and several more book-builds.

Chart 2: Capital raise 2016 / 2017 ytd

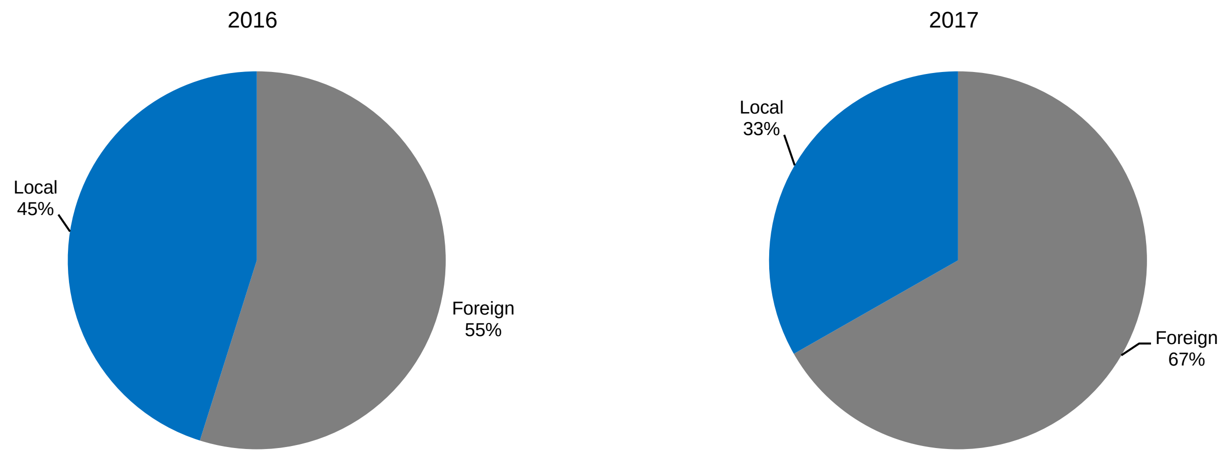




Source: Macquarie Research

The balance, to take this year's tally beyond that of last year, lies in the potential for new listings. We know of potentially three new entrants, which could be substantial with regards to market capitalization. With local market fundamentals on the back-foot, the world trying to re-enter a higher interest rate environment and political uncertainty; the capital allocators have become somewhat particular as to what they are willing to accept. The market is demanding scale, differentiation and a definite preference for offshore. 55% of the money raised last year went directly offshore, however if you analyse this further you would notice that a large component of the local money raised indirectly funded foreign ventures. Between Growthpoint, Redefine, Resilient and Fortress, around R8 billion was raised and found its way to their respective offshore ventures. 2017 is no different as two thirds of the capital has been allocated directly to globally focused stocks, while the indirect flows are still finding their way abroad, most recently Vukile's Spanish operation.

Chart 3: Local / Offshore splits on equity raised



Source: Bloomberg

RECENT RESULTS

June was a relatively quiet month on the result front with only three companies reporting. We provide a brief summary of the results below.

COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Liberty Two Degrees (L2D)	30.0	n.a.	Operating metrics were robust, especially considering the struggling economy and weary consumer. Vacancies compressed from 4.6% to 3.3%, reversions on rent renewals were up 5.4% and cost were well contained at 30.5% as a ratio to income. There were however headwinds as Stuttafords will vacate their Sandton and Eastgate stores, while several global brands are exiting South Africa, leaving empty boxes in their wake. The quality of their portfolio will put them in good stead as they have managed to fill most of the vacating space and should be more defensive in a slower trading environment. Despite adequate trading metrics, they have already guided distribution down for the first full financial year. A significant contributor to this has been the post balance sheet acquisition of a further 9% of the Liberty portfolio taking L2D's holding to 31%. L2D spent R2.5 billion of their R2.9 billion cash holdings at a yield of 6.8% replacing circa 8% yield from the cash and thus diluting distributions by 2.5c/unit or 3.9%. We struggle to see how this was not implied in the initial guidance set out just over half a year prior. It was always the intention to deploy the cash, and the pricing (in order to maintain the current quality of the portfolio) would not have differed materially. Our concern is that Liberty have the ability through a 'put' to push further stakes of the portfolio onto L2D where further dilution is possible and probable. The balance sheet is still ungeared, which one may say is conservative, however not sustainable; and it is difficult to see how debt levels increase in the current rate environment without putting further stress on distributions. Management have guided 62.35c/unit distribution, 3.9% below guidance premised on the dilutive acquisition, while holding all other variables constant, which may be a tough task in light of the operating environment weakening further.
Hammerson	NAV 771p Distribution 10.7p	4.3% 5.9%	On face value, the first half result was strong; adj EPS and distribution grew 5.6% and 5.9% respectively, while NAV growth (80% of which was driven by earnings) was up 4.3%; all generated in a sombre economic environment. However, questions must be asked around the weakness of the UK consumer as well as the relative underperformance across their French centres relative to their peers. Ultimately it has been the result of strong capital allocation from management (through their diversification into Ireland and the outlet centre business) that has kept the momentum in place. Like-for-like net rental income excluding the Irish Malls and the outlet centres was a mere 0.7%. Retail sales falling in both their UK and French assets by -3.9% and 3.1% respectively, which was materially weaker than their European peers. Despite this weakness, letting activity peaked to record levels, with increases of 5% on expiry and 8% ahead of December ERVs (Estimated Rental Value). This talks more to the theme of omni-channel retailing that utilises both brick and mortar as well as online to drive sales. Including the Irish and outlet business' the like-for-like net rental income was 3.4% higher. The LTV was stable around 37% with 80% hedged. Total committed capital expenditure sits at £103 million, however the pipeline of future development is significantly larger, specifically in Brent Cross and Croydon. Disposals for the period totalled £97 million, however this should reach £400 million for the full year. The operating environment is getting more difficult around the traditional UK and French portfolio; however, management still has levers (primarily their development pipeline) to maintain current earnings growth. We still believe that they will maintain earnings growth within their guidance of between 6 -8%.

Intu	NAV 403p Distribution 4.6p	-0.2% 0%	First half Distribution growth was flat, with like-for-like net rental income retreating 1.5%. Management have highlighted that the impact from rent reviews, lettings and turnover was 2.5%, with average lettings up 7% from expiry. The weakness came from a combination of the space given back by BHS and units closed for development. Retail sales were also down 2.1%, however this was stronger than Hammerson's -3.9% on their UK shopping centres. The development pipeline is looking healthy with £679 million of spend through to 2020 at a rough yield of 6.5% with a further £99 million optional spend at similar yields. In addition, they also have the €750 million development in Costa del Sol (at a 7% yield) which would give further significance to their Spanish expansion which is already in excess of €1.3 billion through their initial 3 malls. They have however already finalised the disposal of 50% of Xanadu to assist in funding the development. Spain currently represents 8% of total assets. At 45.8% the loan to value looks stretched, especially considering the scale of the future pipeline. As mentioned above 50% of Xanadu has been sold and management expect a further £300 million of disposals, however this still change the gearing levels by much. The weighted average debt maturity is reasonable at 7.1 years with decent headroom to both interest cover and loan to value covenants, but this doesn't do enough to alleviate the concern around debt levels. Full year guidance for net rental income is now flat (implying a positive second half) from an expected 2% at the beginning of the year. And while the distribution is likely to be flat, management has alluded to growth should fundamentals improve.

LOOKING FORWARD

Global growth uncertainty is still putting a cap on bond yields and the various central banks' ability to 'normalize' monetary policy. This puts focus on the significant yield carry offered by South African bonds that is still overshadowing the political uncertainty and the damage it is having on our economy, and thus South African bond yields have remained somewhat resilient. Further downgrades and exclusions from global indices may test this argument, even if only for a short period of time as investors rebalance their portfolios. Lower bond yields will continue to support listed property, however the potential for headwinds is relatively high, whether it be in the form of further local credit downgrades or any semblance of green shoots of global growth.

Local property fundamentals remain strained in the absence of any political will to support the economy. There are pockets of strength, namely in logistics and warehousing, however supply in this space is picking up at a rapid pace. On the positive side, foreign earnings are still growing at a reasonable rate and gearing across the sector is relatively conservative and well hedged. In addition, the sector is becoming more diverse. Pricing on the conventional local counters has not rallied in line with the sector and still offer value despite waning earnings; while high growth stocks such as Resilient and Fortress look expensive, but justify this through their consistent double-digit distribution growth. Then there's is an array of pure offshore counters, which are geared to a completely different set of variables abroad.

The recent rally has taken some of the optimism out of our short-term estimates as we believe that we may have been too conservative in our forecast of the bond yield. We think that mid-single digit returns are plausible over the upcoming twelve months, however the path will be highly volatile. The medium to long term outlook is still settling between 10% - 12% and ironically enough we have more confidence on the longer term outlook due to ability to look through the short term noise and rely on the initial forward yield and inflation linked growth to drive earnings.

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