NIMBLE WISDOM MONTHLY

Hiiting the final stretch into Q4... / September 2017

SESFIKILE CAPITAL
Listed Property Investments

MARKET OVERVIEW

The SA Listed Property Sector ("SAPY") had a strong quarter, with all three months in the green, delivering a total return of 5.73%. Notably around 40% of the return was from distributions. Year-to-date the SAPY has returned 8.15% of which 5.50% was from distributions, 67% of total returns, giving credence the attractiveness of income in a volatile environment. Equities on the other hand displayed the volatility associated with the reliance on capital swings delivering 8.91% for the quarter, pushing it ahead of the other asset classes year-to-date at 9.73%. Bond yields compressed by a further 18 basis points, assisting bonds up 3.68% for the quarter, although showing some weakness in the latter days of September as developed economies displayed a more hawkish tone, while local data points continued to weaken. Despite that, the September returns across the spectrum were positive resulting in a surprisingly positive and consistent looking return profile for the year to date as disclosed below:

Table 1: Asset class returns to 30 September 2017

	1 month	YTD	Q1	Q2	Q3
Property	1.6%	8.2%	1.4%	0.9%	5.7%
Equity	-0.2%	12.6%	3.8%	-0.4%	8.9%
Bonds	1.2%	7.8%	2.5%	1.5%	3.7%
Cash	0.6%	5.6%	1.9%	1.9%	1.8%

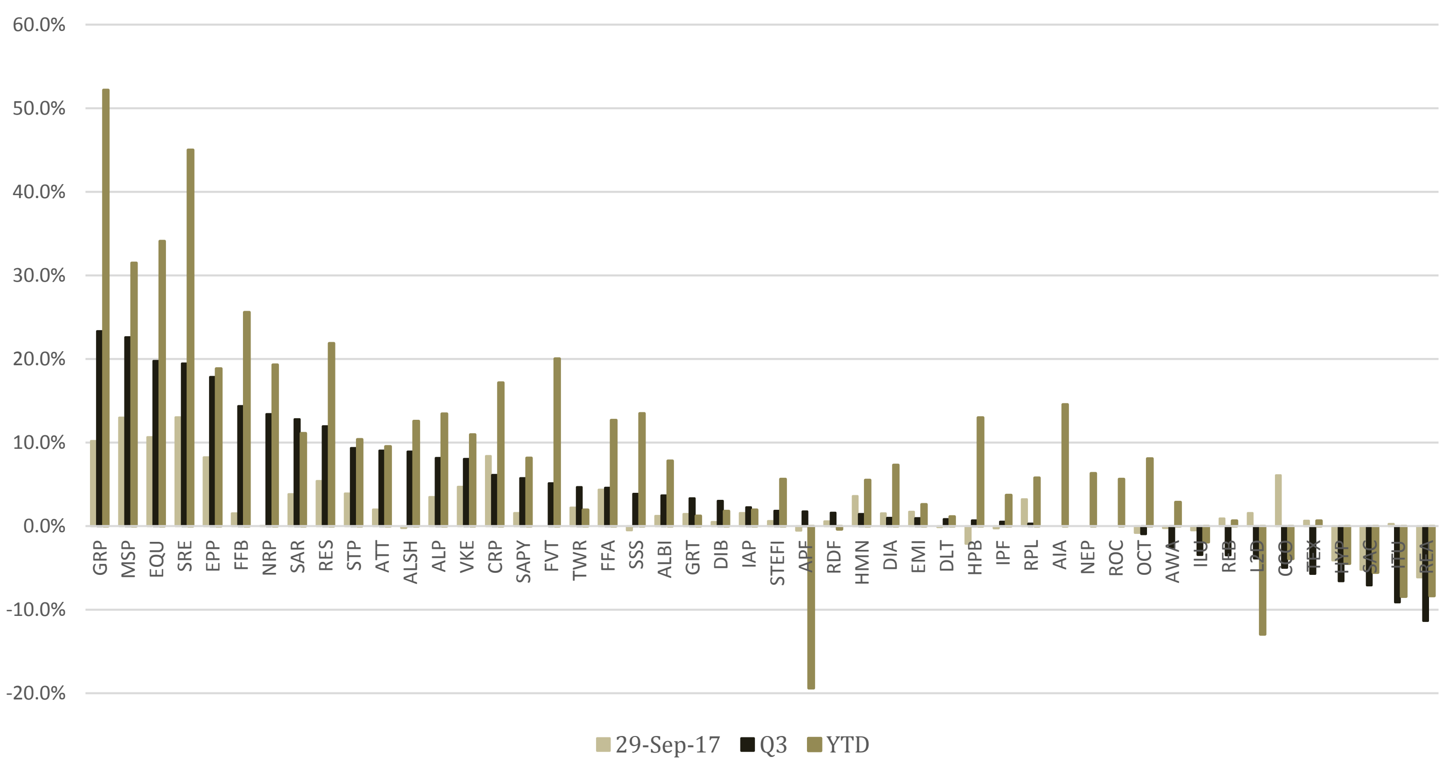
Source: Sesfikile Research

On face value it appears as if listed property re-rated marginally to bonds, however in reality it was the stocks with an offshore bias that supported the sector while locally biased ones once again lagged on the back of weakening fundamentals and a lack of confidence surrounding the South African political, and by consequence economic, outlook. Four of the top five performers for the third quarter were offshore counters, headed up by Greenbay (+23.3%) and MAS (+22.6%) with Sirius (19.5%) and Echo Polska (+17.8%) not far behind. Equites was the stand-out local stock (+19.7%) as management's clear strategic direction to achieve double digit growth (within a weak economic backdrop) was clearly appreciated by the market as the rating improved drastically. It is also important to note that apart from Echo Polska, these stocks appear fully priced, however they all offer a more robust growth profile as compared to the rest of the sector, which is something the market is willing to pay a premium for. We also saw this affinity for certainty in the price appreciation of Resilient (+12.0%) and Fortress B (+14.4%), which both guided robust distributions two years out (primarily as a result of their circa 50% offshore asset exposure).

But not all offshore shone over the quarter; the UK secondary listings Intu (-9.1%), Capital & Counties (-5.0%) and Hammerson (+1.4%) all struggled despite a 6.7% appreciation of the Sterling against the Rand. Other stocks of significance that propped up the bottom of the pack included SA Corporate (-7.1%) on the back of poor results combined with an unclear strategy, and Hyprop (-6.6%), Liberty 2 Degrees (-3.9%) and Rebosis (-3.5%) considering the deteriorating consumer strength and heightened supply.

Our portfolio position continues to reinforce a preference towards quality as opposed to yield. This strategy naturally leads us to an offshore bias *due to* better fundamentals and growth prospects abroad. We also continue to caution the local retail sector and have cut our holdings in Liberty 2 Degrees, Rebosis and Accelerate to 0% and maintained an underweight in Hyprop despite the valuations starting appealing relative to its recent history. We have also taken a view to cut several illiquid positions in our portfolio, thus putting a greater premium on tradability in volatile markets.

Graph 1: Stock returns to 30 September 2017



Source: Sesfikile Research

RECENT RESULTS

Once again, the offshore stocks performed well with local pressure persisting, however Fairvest bucked the local malaise with a strong set of results and equally impressive expectations.

COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Attacq	NAV R19.84	3.1%	Key to results was the announcement of the conversion to a REIT, where the focus will be shifted from NAV to earnings. This however doesn't take away from the disappointing 3.1% NAV growth. Their previous expectations of NAV growth 20% through the cycle was long forgotten as a combination of write-downs in Africa and Germany, higher cap rates for Brooklyn Mall and Newtown Junction and a stronger rand all put pressure on the number. There was also a significant catalyst lacking as Mall on Africa was already in the base and the current economic climate is not conducive to neither cap rate compression nor re-stocking their pipeline. Looking ahead the short-term prospects for NAV growth aren't much better as the base has increased while the relative pipeline beyond 2018 has shrunk and the existing standing portfolio is facing the challenges of operating in a stagnant economy. The conversion to a REIT is likely to remove the attention of the NAV and onto distribution. Management have guided a 2018 distribution of 73c growing by 20% per annum for the following three. Despite the attractive growth profile, the forward yield still makes the stock relatively expensive as compared to the local peer group. There is also the fact that this growth profile is dependent on several assumptions that are by no means guaranteed. Management has alluded to the fact that just taking a forward yield ignores the non-income generating assets which currently sits around 18% of total assets as compared to the roughly 5% of the sector; however, we argue that the utilisation of these assets are needed to generate the bloated growth expectations. Management has been active in streamlining the company going forward through R1.9 billion of sales of non-core assets and the presentation of the 'four value drivers' of the business being: 'Quality South African Portfolio', 30.6% MAS holding, Waterfall development and 'Rest of Africa'. However, we do feel that they will likely offload 'Rest of Africa' should they get the opportunity. The 'Quality South African Portfolio' saw vacancies increase by 0.6% to 3% and notably saw trading densities flat year-on-year, however it is a strong portfolio and with a weighted lease expiry profile of 6.4 years and an in-force escalation at 7.5% is should weather the weak local backdrop relatively well. On the development front four buildings (70 914 m²) were completed during the year. Attacq stated that they have 1 million m² of bulk in the centre of Gauteng of which 608 000 m² is serviced. At present they have six developments under construction totalling 142 921 m² with a further 89 084 m² classified as 'current' (including the 42 500 m² Deloitte head office). Loan to value has reduced to 37.1% of which 90.8% is hedged. The question now comes from the fact that they are not able to retain earnings (as a REIT) and still have a material pipeline, which may put pressure on the balance sheet. We expect them to carry on selling off non-core assets and potentially Africa and should the price of equity improve they are likely to come to market.
Echo Polska Properties	€5.40	n/a	Poland focussed Retail and Office fund Echo Polska Properties (EPP) delivered 7.6% growth in distributable earnings to €36.6m but DPS (distributions per share) fell from €5.80/share to 5.40/share including antecedent dividends over the period. NAV per share rose 18.3% from €1.04 to €1.23/share due to further cap rate compression on Polish malls. Total assets rose from €1.2bn to €1.bn driven by €19m in capex and €229m in acquisitions including €145m in Blackstone assets, A4 Phase 3 and Zakopianka for €56m. EPP has one of the largest mall development pipelines in CEE including Towarowa 22, an urban retail development in Poland with an estimated cost of €420m at a yield of

			8% scheduled for completion in 2021. Furthermore, EPP is underway in the development of Galeria Mlociny, currently 55% leased to majors H&M, Zara, KT Maxx and New Yorker scheduled for completion in mid-2019 at a total project cost of €295m at a 7.1% yield. Further to this is the 15 150m2 extension of Galaxy and 3 800m2 extension of Outlet Park Szczecin both scheduled for completion in Q4:2017. Post reporting date, EPP announced the disposal of four office towers for a total of €160 million. In addition, the company entered into an agreement to acquire a retail portfolio in Poland valued at €692m and would effectively double their current retail portfolio size in three separate tranches. Essentially PIMCO, Oaktree and Redefine (25% shareholder) will acquire a large retail portfolio in Poland and subsequent to the conclusion of that transaction, they will then carve out 8 shopping centres and four retail parks which will then be sold to EPP in three tranches. The first tranche is expected to be concluded in Q1 2018, the second by June 2019 and the third by June 2020 at an acquisition yield is c.7% Despite a large development and acquisitions pipeline, EPP's balance sheet with an LTV of 51% (from 52.7%) remains a significant concern. The Cost of Debt also rose over period from 1.85% to 2.04% as the company took a conservative approach to fix more debt (91%) against interest rate increases to 4.4 years. The large retail portfolio deal could raise the LTV to 56% within the next six months. EPP continues to guide high single digit dividend growth over the next 12 months.
MAS	€5.85c	30.0%	Distribution growth of 30% on face value is exceptional, however this, along with 30% per annum growth forecast the following 2 years, was guided to previously and does come off an exceptionally low base. This distribution is also not fully covered by operating earnings with 7% coming through from reserves. And while we are cautious as to earnings quality, we are mindful of the strategy that the company is following and executing to perfection. The growth profile over the next few years is based primarily on the ability to utilise their strong balance sheet and ability to raise capital at relatively low yields and apply the proceeds to a higher yielding portfolio. The cost of drawn debt is at 2.35% with the most recent equity raise of R1.98 billion below 5%; while the yield on developments / acquisitions has ranged between 7% - 11%. With the pipeline on secured projects of €756 million and a further €230 million of potential developments, the potential earnings accretion is significant, especially considering the relatively low asset base of €559 million. In addition, there is a pipeline of €235 million on acquisitions. 83% of the pipeline is through the Prime Kapital joint venture to which MAS has a €100 million investment and a further €350 million of capital commitments. The bulk of the Prime Kapital exposure is retail with a relatively small residential development. There is also a focus on organic value add through asset management on acquisitions and the existing portfolio, which has already been displayed through cost savings at Galleria Burgas, seeing the yield on acquisition of 8.5% move up to 10%. There is the obvious execution risk with such an ambitious growth profile, however Prime Kapital CEO has proven (through his previous leadership at NEPI) that he is able to deliver. While the activities surrounding Prime Kapital are the key focus at the moment, we shouldn't lose sight of the progress made in the balance of the portfolio and in particular the 25-year lease with the UK government at phase 2 New Waverly as well as the disposal of 4 non-core Aldi let assets. But the real value add is how they have positioned their balance sheet at 26.3% loan to value, assisted by asset disposals, positive asset revaluations (NAV picked up 10% in 2017) and capital raises (€158 million over the year, with another €125 million raised post balance sheet date). With an appetite to take the gearing levels to 40%, MAS has significant headroom to support the stated pipeline. Management is still comfortable with the 2-year guidance and believe that they have enough in the pipeline to extend the extraordinary growth profile beyond 2019.

Fairvest	18.3c	10.0%	A strong result, testament to solid physical property skills and hard work delivering in a tough market. Like-for-like net property income was 9.3% higher with top line increases driven by 7.4% escalations and 7.5% reversions on expiries, however vacancies did push 0.9% higher to 4.7% and arrears were marginally higher as well. The big drive to operations was cost containment with net cost to income ratio down to 15.5% from 17.3%. The balance sheet is also in better shape with the loan to value down from 29.7% to 22.4%, with fixes up 30% to 87.0%. The term of the fixes is however on the shorter end at 18 months, however the lower gearing levels mitigates much of this risk. Management has guided distribution growth for the 2018 financial year between 9 and 10%. Achieving this would be a great result. There is no doubt that further local headwinds with prove challenging, however their niche in the retail sector is relatively less exposed to the potential near term pressure.

LOOKING FORWARD

The South African economy may have bounced back out of its brief technical recession, however the level of business confidence and activity on the ground suggests otherwise. The recent spate of company results highlighted this fact with the majority of locally focused stocks guiding a slowdown in distribution growth and an increased focus on their respective 'offshore' strategies. However, as we have stated before, certain companies have positioned themselves relatively better than others and are still managing to deliver respectable earnings: Fairvest was a beneficiary of such positioning and delivered 10% distribution growth from a purely local retail portfolio.

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, they 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 market is always going to be vulnerable to the return of 'normalised' global bond yields as global growth and inflation continue to threaten; however, the fourth quarter is likely to be all about the local political climate and the successor that emerges from the ANC National Elective Conference in December. Markets appear to have a strong preference for one candidate over another, implying a binary outcome, which would either see the sector rally or a significant retreat in prices.

With no real middle ground in sight it is difficult to position the portfolio on what is really an evenly matched binary outcome, therefore we have reverted to our skill set, and position ourselves premised on property fundamentals and look beyond event risk towards long-term earnings potential, with the potential to tactically trade around short-term mispricing. The longer-term outlook is still fair and valuations are not demanding, however it would be remis for us to ignore the short term pending volatility.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