NIMBLE WISDOM MONTHLY

Edging into the unknown... / October 2017

SESFIKILE CAPITAL
Listed Property Investments

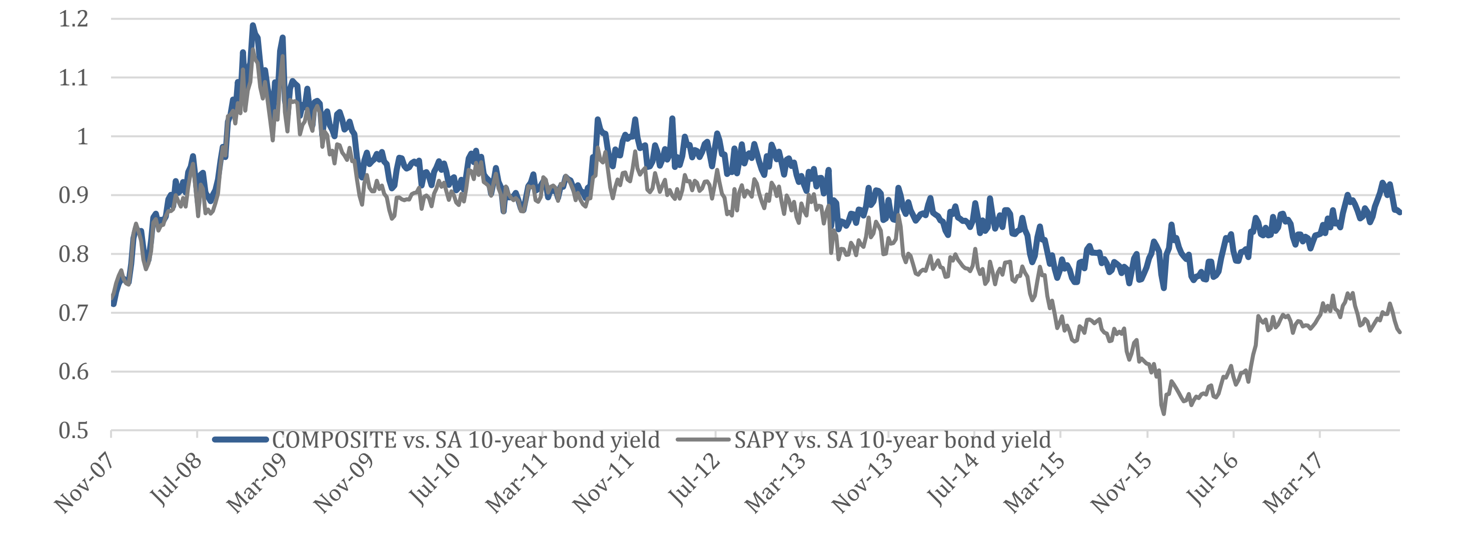
MARKET OVERVIEW

The SA Listed Property Sector ("SAPY") had another positive month despite global bond yields edging higher, local politics getting messier and a mid-term budget confirming some of our poorest economic expectations. The SAPY was up +1.99% for the month, taking the year-to-date performance into double-digits at +10.30%. The bond market seemed to have paid attention to the headlines, with the ALBI down -2.28%, while Equities had a stellar month delivering +6.12% driven primarily by the dual listed stocks.

The highlight, or rather lowlight, of the month was the dismal medium-term budget announcement, highlighting a significant funding deficit for the year ahead; and with the current political climate there appears to be no real plan or intention to deal with it in an appropriate manner. In addition, while our economy is retreating, the rest of the world seems to be on the opposite trajectory, albeit at a moderate pace. The Bank of England even saw fit to hike rates for the first time in 10 years, while the US is still calling on one more hike before year end. This coupled with the deteriorating fundamentals on the ground doesn't paint the most optimistic of pictures. With that said, the locally focused stocks are delivering on average 9.8% forward yield, which is reflecting the expected slowdown in growth. On the flip side, the offshore stocks are still showing an impressive growth profile, however the prices are once again reflecting this with several stock yields ranging from 3.8% to 4.5%.

In Chart 1 below, we illustrate the property yield relative to the 10-year bond yield; the grey line is the SAPY while the blue line uses an equal-weighted composite of 10 local property stocks. We highlight how both the SAPY and COMPOSITE actually re-rated relative to Bonds over the last month... This re-rating doesn't necessarily make property expensive relative to its historic relationship, but we struggle to see why property shouldn't feel the same headwinds as the bond market.

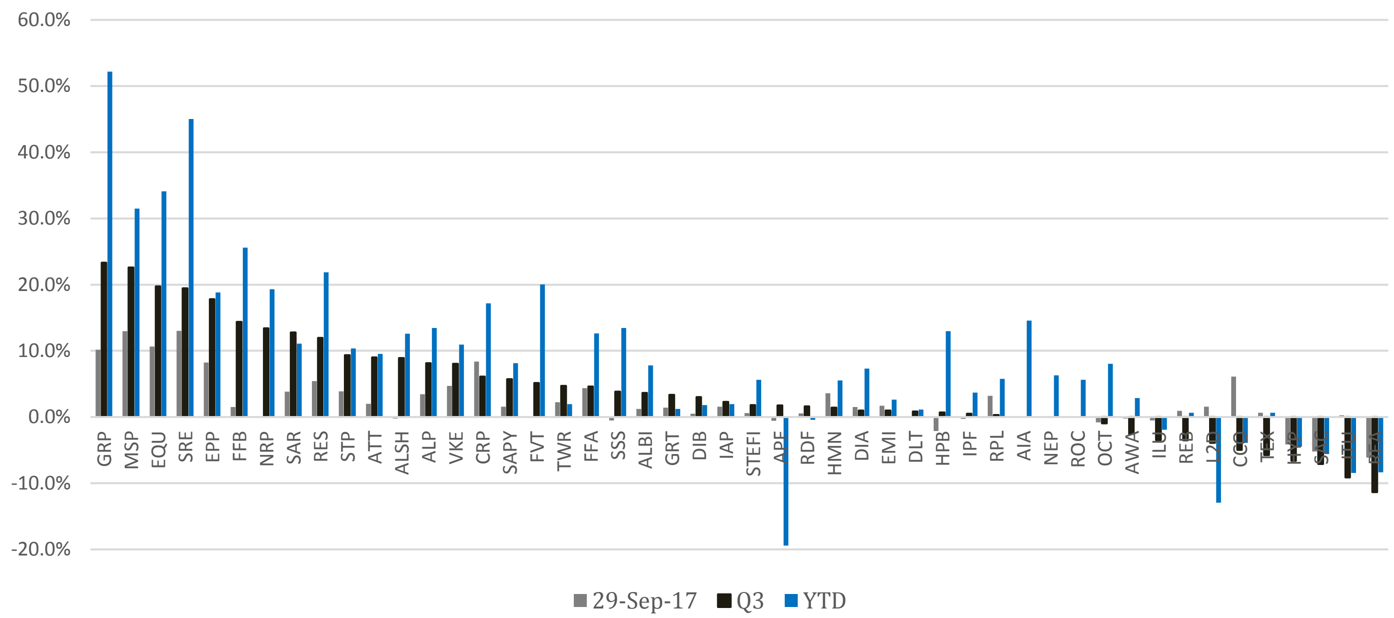
Chart 1: Listed property rating relative to Bonds



Source: Sesfikile Research

There is no doubt that last month's return was driven primarily by the offshore stocks, with the likes of MAS and NEPI delivering 9.1% and 7.5% respectively (and interestingly now make up 16% and 2% of the SAPY); but we once again saw local stocks with clear, positive earnings guidance such as Resilient, Fortress and Equites also increase the average. Local small cap stocks generally came under pressure as well as those companies that have been guiding flat / negative growth numbers, despite relatively attractive yields. This is telling us that the market has become more conservative with an appreciation of growth over pricing, a trend we see continuing into December. We breakdown the returns of the various stocks in Chart 2 below.

Chart 2: Total returns to 31 October 2017



Source: Sesfikile Research

RECENT RESULTS

Three funds reported results during October in what we can only sum up as the good, the bad, and the potentially ugly...

COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Equites	61.0	12.0%	Equites is still delivering distribution growth last seen in the sector's heyday with half year distribution up 12.0%. The company is in the rare position where they are exposed to multiple tailwinds in the current environment, with the benefit of a management team that is able to capitalise on the opportunity set. On the local front (72% of portfolio) vacancies are down to 0%, in-force escalations are at 7.95% with very little in the way of expiries over the next 4 years. Including their 4 UK assets (28% of portfolio), the WALE is 7.2 years with 73% expiring beyond 5 years. In addition, 91% of tenants are classified as A-grade (Large international, national or listed). The fund further enhanced its UK portfolio with the acquisition of the Keuhne and Nagel facility for £41 million on a 15-year lease as well as the announcement of a post balance sheet date acquisition of a £9.7 million piece of land in Reading with a further £15.9 million to be spent on developing a 'last mile' site for DHL on a 15 year lease. The UK acquisitions are generally at lower yields and don't display the same escalations seen in South Africa, however the activity at home has seen them more than compensate for this with the strong local development pipeline and recent completions. Our one concern would be that we are starting to see several new 'warehouse schemes' from various competitors increasing supply materially. They have also been active in selling off non-core (primarily office assets) with the sale of 3 building in the current period for R324 million with the last two office asset under discussion. The balance sheet is in good shape at a LTV of 19.8% of which 97% is fixed for a term greater than 4 years. We would however point out that the UK assets are almost fully geared with direct funding at 50% and a cross currency swap on the balance; therefore, reducing cost of debt. Their cost of issuing equity has dropped significantly allowing them to raise just over R1 billion at a price of R17.20 as compared to the R1 billion raise approximately 8 months earlier at R14.50. Guidance for the full year is maintained at 10-12%.
Octodec	203.1	0.8%	Octodec reported a disappointing full year distribution of 0.8% with an equally disappointing 0% guidance for FY18. Although we had expected a slowdown, the results came in worse than the market had anticipated. Like-for-like net property income growth was relatively robust at 5.3% with most sectors exceeding inflation, however it was the 29% exposure to retail that pulled the numbers down at 2.5%. In addition, core vacancies on the retail portfolio spiked from 3.6% to 7.2%. Although a material amount of the unlet space was as a result of bringing new supply to market (Sharon's Place in particular), there are also the headwinds from other new supply in the market coupled with tenant strain as affordability puts pressure on both occupancies and rental levels. The development pipeline will continue to be a detractor to near term distribution growth as letting is difficult / slower in the current environment, while interest will be expensed as soon as the asset comes to market, regardless of occupancy levels. The balance sheet is also cause for some concern in that the average term of debt is at 1.4 years with 82.1% hedged for only 1.6 years. The LTV is not stretched at 37.1% however the term is concerning. Guidance is flat for 2018 as the fund faces some strong headwinds in a challenging macro environment.
Delta	46.4	1.0%	Delta reported 1% distribution growth for the first half, however the real story has been how the company plans to restructure, re-let, refinance and stay afloat. The fund is in a very difficult place with the DPW (Department of Public Works) not availing themselves to extend the duration of their leases (75.9% of leases are sovereign backed), leaving the WALE at 1.8 years; while at the same time the balance sheet at 42.3% gearing has an average weighted expiry profile of 1.6 years. This

			leaves the company at ransom to a BEE deal in order to get the Empowerment ownership to above 50% in order to appease the banks and ensure that they can roll over their debt. While the empowerment deal is essential for the company to remain a going concern, it comes with a cost; the capital raise and subsequent deployment of funds will likely be materially earnings dilutive, while at the same time the lease renewals along with debt refinancing are also likely to be earning negative. While corporate positioning is dominating the headlines, vacancies have pushed 0.6% higher to 11.3%, net cost to income has increased from 10.2% to 11.0% and the net asset value has declined from R9.91 to R9.74. In-force escalations are still at 7.3%, but loses some of its shine when you consider 26% of the rental stream is on a month-to-month basis with a further 10% coming up for renewal over the next 4 months. Management has not been idle, they have sold 4 assets for R254.1 million and been renewing several leases, however the current predicament they find themselves in is overshadowing the hard work on the ground. Management have guided towards flat growth for the full year and we are likely not to see any growth for the subsequent year as well.

LOOKING FORWARD

It's very difficult to look forward without being all consumed by the ANC National Elective Conference in December. It is an event that will have a dramatic impact on the direction of the market over the short to medium term. In reality, it is probably easier to forecast long term returns for the property sector. As we have stated several times, the outcome is binary to both valuations as well as the operating environment that will ensue. And while we are all focused on December, we should not overlook the fact that a further ratings downgrade is likely towards the end of November. This would be a material downgrade that will result in our local debt attaining a sub-investment grade status and causing a material sell down in our bond market, putting pressure on both bond yields and currency. Many commentators have said that this is partially priced in, however there is sure to be a knee-jerk reaction and further weakness from where we are, even if only for the short term.

The foreign stocks are still showing robust growth into the foreseeable future, while there are pockets of value on the local front despite operating concerns. Valuations are showing relative value to bonds, but we are weary as to where bond yields may settle. It is a tough environment and one that will be volatile, but one in which we are looking to position ourselves to capitalize from tactical trading around the volatility, while holding a core that should remain somewhat more resilient than the sector average.

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