NIMBLE WISDOM MONTHLY

Out of the woods...ish | December 2017

SESFIKILE CAPITAL
Listed Property Investments

MARKET OVERVIEW

A relatively market friendly outcome at the ANC National Elective Conference saw the SA Listed Property Sector ("SAPY") push to ten straight positive months with December delivering a strong +4.2% and finishing the year at a total return of +17.2%. Bonds led the charge in December, closing up +5.6% and ending the year +10.2% higher, while Equities closed off the year with an impressive +21.0% total return. Returns across the board have been solid especially considering the continuation of disruptive political and economic data points (both local and global) that had the ability to seriously upset the applecart.

Table 1: Asset class total returns to 31 December 2017

	Listed Property	Equities	Bonds	10-year bond yield (spot 8.73%)
1 month	4.21%	-0.34%	5.60%	9.45%
3 months	8.32%	7.44%	2.20%	8.67%
6 months	14.53%	17.01%	5.93%	8.85%
1 year	17.15%	20.95%	10.19%	8.91%
2 years	29.10%	24.38%	27.18%	9.74%
2 years (annualised)	13.64%	11.54%	12.79%	
3 years	39.41%	30.92%	22.19%	7.87%
3 years (annualised)	11.72%	9.40%	6.91%	

Source: Bloomberg

Global bonds moved from 1.60% to 1.66%, weakening by a modest 6 basis points. The path the South African 10-year bond took was however anything but modest, as it moved 14.8% from peak to trough (from 8.34% to 9.57%) but starting at 8.91% and closing at 8.73%. The US 10-year treasury was only 0.7% stronger, with a meagre 0.04% yield compression. However, we saw the 10-year treasury yield bottom out at 2.04% in early November only to show a steady increase into year-end towards 2.41%, aided by Trump's tax reforms which were passed in December. The likelihood is that this will support the upwards momentum in global bond yields into the first quarter of 2018, which should create some headwinds for listed property capital returns. On the local front, it's back to the rating agencies (Moody's rating in particular), and the ability of the ANC's new leadership to appease them and avoid a 'double junk' rating. If that can be achieved, we believe our bonds still offer enough of a carry to weather the rise in global bond yields. On the ground, most company CEO's have stated that 2017 was one of the most challenging years they have experienced which is understandable given the lull in economic growth, material political and in turn business uncertainty coupled with the headwind of new retail and office building supply.

Retail seems to have lost some of its shine for the time being as a combination of heightened supply and a weak economy has taken its toll on the figures; On the ground as real trading densities were down -1% for the third quarter of 2017 preceded by a similarly soft quarter 2 up just 0.2% in real terms. This was also interesting considering StatsSA's disclosure of a 5.4% increase in real retail sales for the third quarter, alluding to the relative weakness in the shopping centres. On average spend per head was up 3.5%, however this was overshadowed by less frequent trips to the mall as indicated by the 4.4% decline in footcount. Again, not surprising considering the high unemployment levels coupled with the economic uncertainty and lack of consumer confidence coming into the end of the year.
Interestingly, Super Regional centres have been in negative territory (as per trading densities) since the first quarter and have lagged the smaller retail formats. Our view is that there has been excessive supply in this space (mainly in Gauteng) and malls/stores have simply been over-sized relative to the local trading opportunity. Super regional vacancies are now at 4.7% as compared to their long-term average of 1.6%. And while this sub-sector has been under the most pressure (primarily due to its high exposure to apparel and department stores which make up roughly 50% of space) we believe this to be a temporary occurrence, as through the cycle they have the ability to reinvent themselves and attract the feet.

Office continues to move sideways off a low base (low rentals, high vacancies). As we had stated last year, vacancies have been range bound between 10% and 12% since 2011, and are currently at 11.2%. Although vacancies are elevated at 14.9%, CBD office performed better than decentralized office (at 10% vacancy). Higher quality space is showing better occupancies with Prime, A-grade, B-grade and C-grade at 96.1%, 91.1%, 85.9% and 82.7% respectively. At 690 000m² or 3.6% of existing space (vs. the peak of 6.6% of space in 2015), new office supply has been relatively modest and residential conversions (albeit small in relative terms) have played a role in improving occupancies in key nodes. The levels of pre-let are also healthy at 69.9%, however we note that 'this is a game of musical chairs' where pre-lets are not an indication of net demand; tenants are moving from weaker nodes into stronger ones at a small premium.
On the rental front we have seen little growth in headline rents for several years, which is exacerbated by the increase in incentives (tenant fitouts, higher broker commissions, rent-free periods etc.) from landlords. Several companies have taken the view of sacrificing cash flow (giving incentives) to retain occupancy levels. According to SAPOA's database, rental levels have declined by 26% in real terms since the beginning of 2009. Rents have bottomed out, which is one of the key reasons we have become less bearish about Offices, despite current operating conditions being far from optimal.

Industrial / Warehousing space is trading somewhat differently to both retail and office, as occupancies are near peak territory at 96.5% as at June 2017 vs 95.1% as at December 2016 (note that Industrial data comes out semi-annually with the last reported date being the 30th June 2017). Despite strong occupancy figures, rental growth was disappointing at 2.9%.

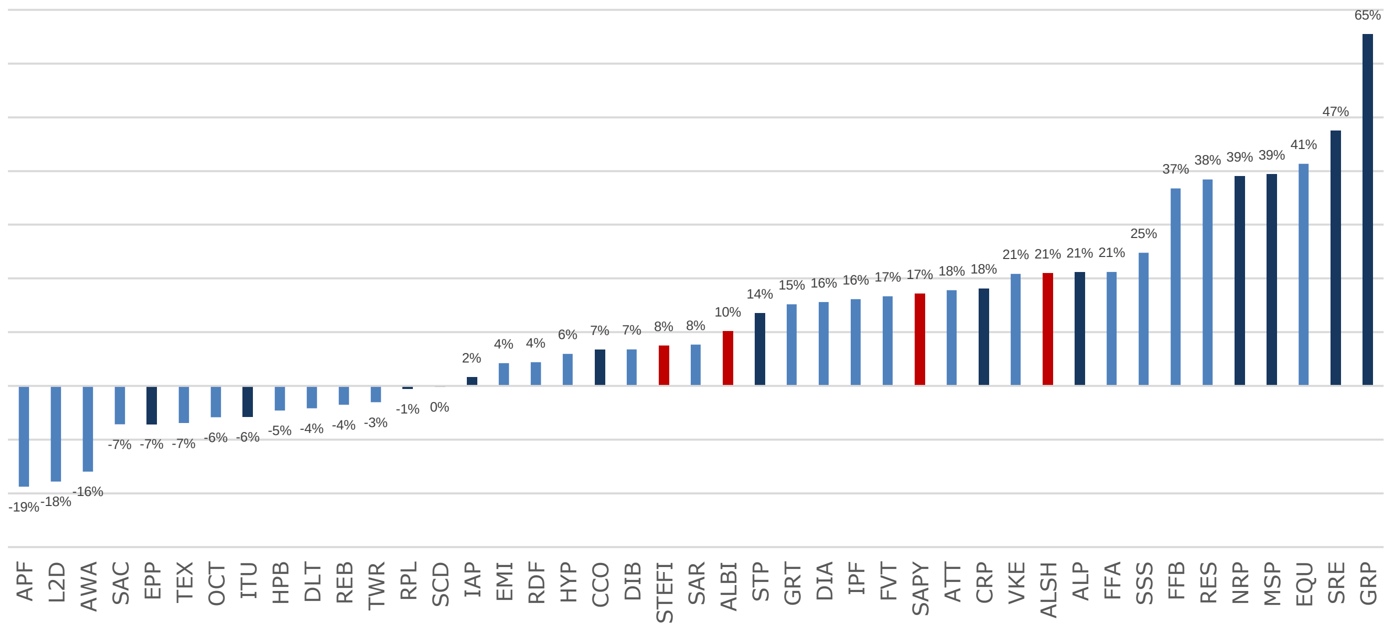
Our explanation is that relatively low replacement costs and short construction periods (10-12 months) keep a lid headline rents and we have seen an uptick in building plans passed from the listed players with the likes of Growthpoint, Redefine, Fortress and Equites to deliver sizable developments. It should also be noted that the sample set is roughly 50% warehouses, forming the majority of the listed exposure. This category performed in line with the sector average, while light manufacturing underperformed and high tech industrial outperformed. In general, the sector still looks relatively robust with the risk of excess supply coming on-line in the next 12-24 months.

STOCK PERFORMNACE

The range of returns from best performer, Greenbay Properties (+65.5%) to worst, Accelerate Property Fund (-18.8%) was a staggering 84.3%. A few themes came through over the period, firstly, Rand-hedge was back in favour after a weak showing in 2016. 2017 didn't see the Rand rally to the same extent, and as a result we can only understand it as a 'fear trade' as there was a large disparity between the global stocks with a primary listing in their respective countries and those with a primary listing in South Africa. Intu, even with the takeover bid from Hammerson only managed a -5.8% total return for the year; while the likes of Greenbay and Nepi-Rockcastle returned 65.5% and 39.1% respectively.

It could also be said that the affinity for earnings certainty was also a theme, as so many stocks disappointed, the confident earnings guidance from Resilient, Fortress, Equites and Vukile put them in good stead. The third theme, which is somewhat related to the second, was earnings disappointments. We have been saying for some time now that property earnings quality has deteriorated in the sector via non-core, non-recurring, financially engineered and once-off numbers that have been disguised as annuity income streams. There is obviously value in the ability to generate these earnings, but the market has not always made the distinction between once-offs and rental income, in effect overvaluing companies. In the final quarter of 2017 we saw several companies effectively rebase their distributions and show flat and even negative growth. It is somewhat comforting to work off a clean base, however we can see that the majority of the weaker performers have been those who have missed earnings guidance statements. Unfortunately, we still believe that there is more to come in the sense that some earnings are still contaminated with 'non-rental income'.

Chart 1: 2017 Total Return Breakdown

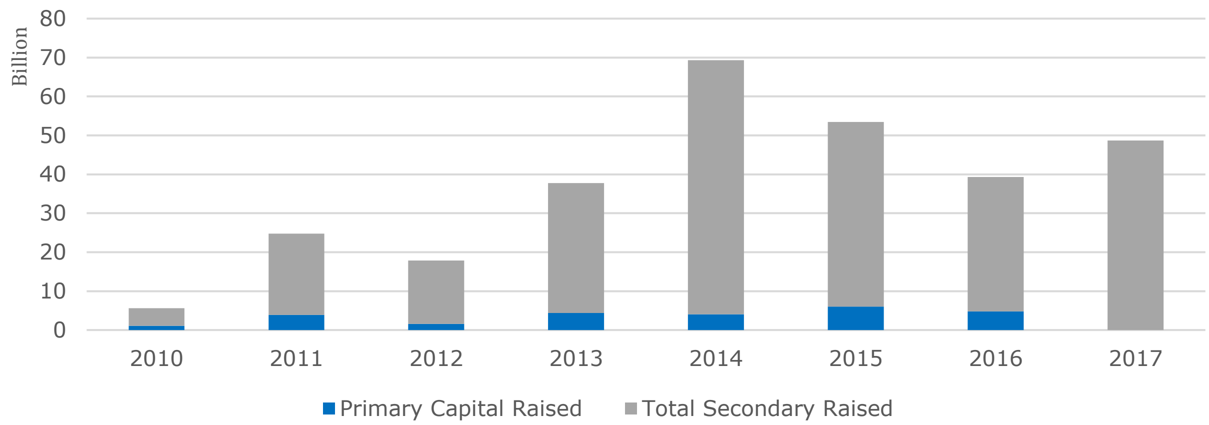


Source: Bloomberg

CORPORATE ACTIVITY

- Amazingly there was not one notable new listing, but rather a reshuffling of assets as it seems. We did see the rise of Gemgrow, as it spawned out of a transaction between Vukile and Arrowhead, but no new assets, ideas or subsectors in the property space.
- We did see the short-lived concept of a developer in our sector come to an end as Redefine completed the acquisition of Pivotal earlier in the year, while Attacq announced that it will convert to a REIT in 2018.
- We also saw a couple of name changes as Redefine International and Mara-Delta both opted to shake off the weight of their founding sponsors and are now known as RDI (Real Estate Diversified Income) REIT and Grit Real Estate respectively.
- The most significant transaction was the merger of NEPI and Rockcastle into what is now the biggest primary listed property stock on the JSE. The market appeared to have liked the deal as the combined entity returned +23.2% from the 12th of July until year end.
- Corporate advisors were kept busy though as capital raising was still rife, especially amongst the offshore players. Even in cases where the local stocks raised money, it was generally to fund a foreign asset with the likes of Vukile, Equites and Stor-Age all raising for offshore acquisitions. Last year was another big year where just under R49 billion was raised in the secondary market.

Chart 2: 2010 - 2017 Total Equity Raised Breakdown



Source: Anchor Capital, Sesfikile Research

NEW PROPERTY INDICES

A topic we had discussed at length in 2017 was the proposed new property indices which finally became a reality in 4Q17. While the JSE had initially intended to migrate the SAPY into one of the three proposed indices (ALPI, SA-REIT or Tradeable), it ultimately decided to leave the SAPY in its current form and allow the market to decide if and when to adopt a new benchmark. This is a bit of an anti-climax in our view as there will likely be a lot of inertia from the market given the administrative burden of changing a benchmark in client mandates.

Of the new indices, the J803 (All Property Index / ALPI) is the most representative and diversified index with enhanced liquidity relative to the current SAPY and at present has 33 constituents as opposed to 21 in the SAPY. In addition, there is a cap of 15% per company which reduces single stock concentration risk. One of our criticisms of the ALPI was the see-through offshore exposure which currently stands at 50% - we had suggested capping non-SA REITs to 5% to lower the concentration but this was not accepted by the JSE. It is worth noting though that the see-through offshore exposure of the SAPY has increased from 36% to 41% in 2017, as two SA stocks (Delta and Octodec) were replaced by two offshore stocks (Greenbay and Sirius), taking the SAPY a few steps closer to the ALPI in terms of geographical exposure.

SECTOR OUTLOOK

Given the vast geographical exposure of the SAPY, it has become a lot more difficult to provide a top-down total return expectation of the sector. We have therefore derived out total return expectations through a detailed bottom-up assessment taking into consideration the following 1) bond yield expectations by geography, 2) distribution growth expectations per counter including earnings disappointment risk and 3) yield relative ratings. Key assumptions below:

- **Bond yields:** With reduced political risk on the local front we believe that the macroeconomic climate should be relatively stable and improve into 2018. Despite a weaker global bond market, the combination of greater policy certainty and benign domestic inflation expectations (driven by a stronger Rand) balance out the risks more evenly and should see a relatively flat bond yield over 2018. US 10-year bond yields started the year at 2.4% and are likely to rise by 20-30bps to 2.7% driven in the main by 1) rising inflation 2) a tightening fed 3) possibly higher levels of business investment driven by the recent Trump tax cuts. Global bonds however are likely to rise, but at a more modest pace as inflation remains stubbornly low, forcing prolonged monetary accommodation by the European Central Bank and the Bank of Japan.
- From here we look at the **valuation of property relative to bonds** and how the fundamentals are expected to fare:
  - While the **local stocks** look relatively cheaper, we do caution as to the quality of earnings they have been delivering. A few stocks have already rebased earnings in 2017, an admission of unsustainable earnings paid out in prior years, but they remain in the minority, implying there may be more to capitulate. There is an array of small to mid-cap stocks offering yields in excess of 12% and deep discounts to NAV, however many of these companies have either balance sheet issues, unsustainable earnings or both. We are still seeing better value in the mid to large cap space with the exception of the 'hybrid' funds that have been chased up to unrealistic valuations in the pursuit of double-digit growth.
  - The **offshore stocks** (JSE listed with offshore assets) too exhibit a range of possible outcomes, where the market will have to decide whether it is still willing to pay such a premium for double-digit growth or would rather acquire a more mediocre distribution growth profile at a discount. Another factor is that local investors tend to group anything offshore into the same basket. Our market offers primarily Eastern / Central Europe and UK exposure, which come with their own particular set of challenges and opportunities. We have been concerned for some time about the valuation gap between the primary listed offshore stocks (expensive) sector vs. the pure dual listed stocks (stocks) and have adjusted our relative rating expectations accordingly.

The locally focused stocks do offer value, trading around an 8% forward yield, with a wide range from 4.5% to 13.5% while some of the global opportunities, we believe, are offering significantly less value and have taken full advantage of the South African pessimism when it comes to politics, the economy and currency. When building our total return forecast our starting point is a 1 year forward yield of 6.75% that will be supported by 8.5% distribution growth. However, we see the sector de-rating to the bond market on a weighted basis (bottom-up), in large part due to the normalisation of some steamy valuations in the offshore and hybrid space. The net impact is a slightly negative capital return of -0.85% for the sector. Taking all into account, we expect a calendar year total return of 5.9% for the SAPY. Perhaps more than ever, the progression of this return will not be linear and more importantly, stock picking will be key in 2018. In summary the domestic and global political environment has improved and business confidence and investment in SA is likely to rise. However, property always lags the business cycle and fundamentals could get a little worse before they get better – we are feeling a little more confident but not completely out of the woods yet.

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