NIMBLE WISDOM MONTHLY

Guilty until proven innocent | January 2018

SESFIKILE CAPITAL
Listed Property Investments

MARKET OVERVIEW

Market participants returned from their December break with a very different psyche; generally more optimistic on the local political front but a lot more cautious around company specific risks post the Steinhoff debacle early December. Speculation was rife that another Viceroy report would be released and speculation spread across several companies. Ultimately it turned out to be Capitec, however it was the Resilient stable (including Resilient, Fortress, NEPI-Rockcastle and Greenbay) that was caught in the crosshairs of a combination of an aggressive shorting campaign coupled with a skittish market that makes little distinction between rumour and fact. With the stable making up just over 40% of the South African Property Index ('SAPY') at the start of January, the sector carried a sharp loss of -9.9% for the month of January, while Bonds and Equities were up +1.9% and +0.1% respectively. The Resilient stable was the obvious driver to the sector's negative returns with the likes of Greenbay, Fortress, NEPI-Rockcastle and Resilient falling -29.0%, -28.7%, -24.7% and -23.0% respectively. However, with the strong rand the likes of MAS, Echo Polska and Sirius also pulled back between -16.7% and -12.2%. It was the locally focused REITs that delivered some hope largely delivering positive returns, however not enough to pull the sector towards a respectable number.

STOCK PERFORMNACE

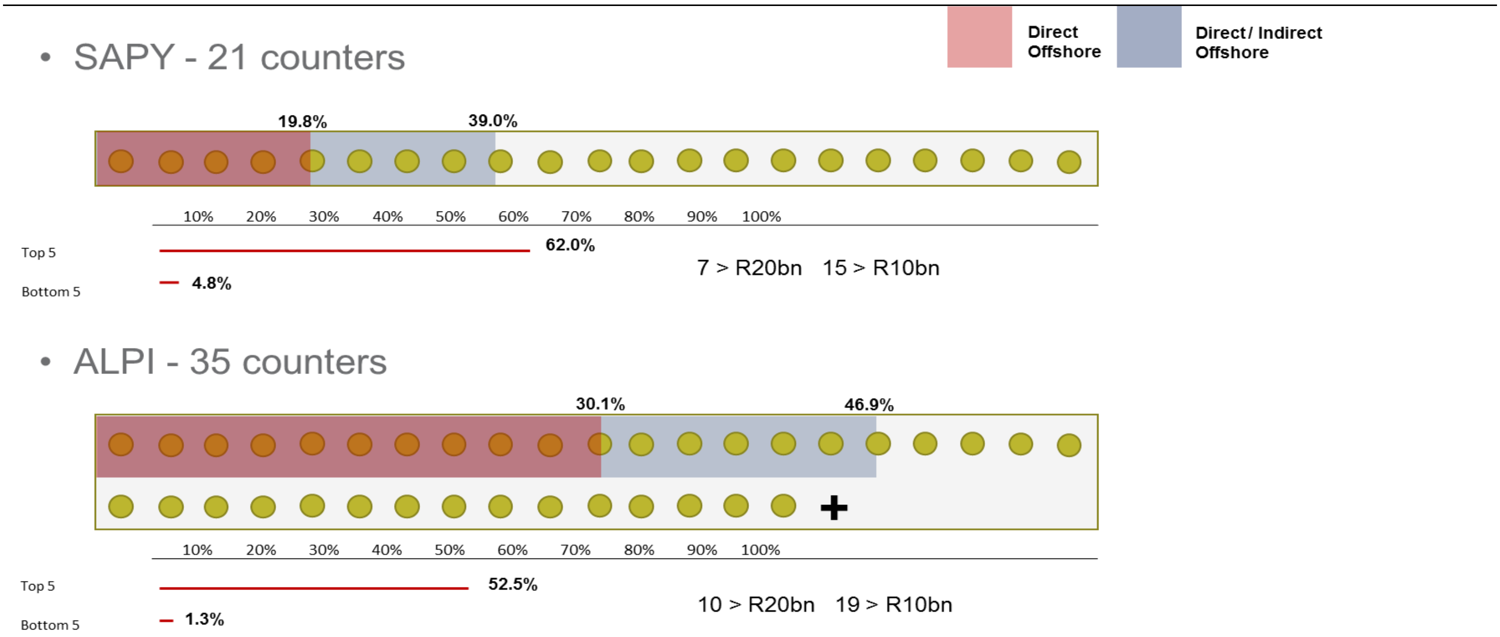
COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Resilient	306.46	13.4%	Resilient brought forward their results in light of all the negative speculation around the company in an attempt to appease a nervous market. It was a strong result, which was in-line with management's extended guidance, delivering sector beating distribution growth of 13.4%. The physical portfolio fared well in a tough operating environment seeing comparable retail sales growth up 5.3% with vacancies compressing marginally from 1.9% to 1.7%. The direct non-SA exposure in Portugal and Nigeria also traded relatively well, however the stronger rand as well as wild fires in Portugal created some headwinds. The company is still active on the local development front with R666 million of committed capex with a further R1.2 billion approved for the Irene Mall redevelopment. In addition, there is a further R576 million pipeline of further extensions. It should be noted that while these developments add to the long-term sustainability of cash flows and the quality of the portfolio, the initial yields are no longer materially ahead of the funding costs and not necessarily accretive from the outset. The company has continued to increase its listed holdings, primarily through the election to take scrip dividends in NEPI/Rockcastle and Greenbay, which is in line with their stated strategy to increase offshore exposure to a targeted 60% of total assets from approximately 46% at reporting date. Following to the half year the listed holding has come under significant pressure and has resulted in a decline in the net asset value and subsequent increase in the loan to value, however the distribution in the short term remains largely unaffected and hence guidance should be maintained. The listed exposure at half year end was at 54.5% but is likely hovering around 40% mid-February. The loan to value was at 20.1% as at 31 December, however this has likely spiked north of 25% as the listed holdings have come under pressure. This is still an undemanding gearing level, especially considering the majority of the interest rate risk is hedged out for over 5 years.

			Management has held guidance for the full year at 13% with 12% for the 2019 financial year. With this guidance one would think that the their would be more positive mood around the company, however the constant barrage of allegations has created caution around the stock and investors have been questioning whether the valuations justify the 'risk'.

NEW PROPERTY INDICES

Last month we revisited what we view to be the most appropriate of the newly proposed indices namely the All Property Index' ('ALPI'). We thought it would be interesting to give a visual comparison of the 'index elect' against the 'incumbent index', the SAPY.

Graph 1: SAPY vs ALPI breakdown



Source: Sesfikile Research

While the SAPY has served its purpose, we believe ALPI is the most representative and diversified index with enhanced liquidity relative to the current SAPY and at present has 33 constituents (which we believe should be 35 by the next index review) as opposed to 21 in the current SAPY. In addition, there is a single stock cap of 15% to assist in reducing single stock concentration risk.

We see the benefits of the ALPI over the incumbent benchmark index being the SAPY as stated below:

- Greater diversification as the SAPY is limited to 20 companies with no limit on the ALPI
- Enhanced liquidity mainly driven by dual listed Capco, Hammerson, Intu
- Larger opportunity set with more stocks to potentially allocate towards
- Reduced single stock concentration risk given the limit of 15% per company
- Lower grouped exposure to the top 5 constituents (however it does have a longer tail with several smaller stocks in the index)

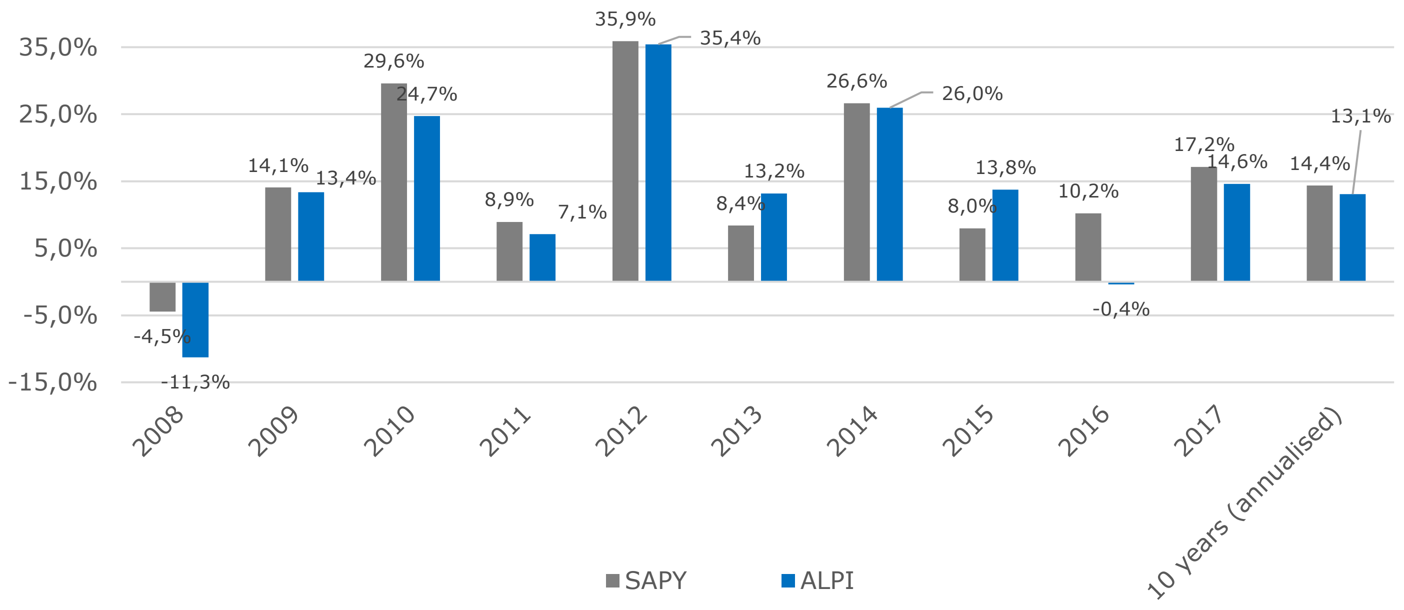
In addition, we also see this as a benefit for smaller local property companies that currently struggle to make it into the SAPY's top 20 companies, as larger offshore companies have taken advantage of the local appetite for foreign earnings and pushed their way into the SAPY. This will effectively create demand for the smaller local stocks and enable them to raise capital at competitive rates. We believe that this will be positive for the local property industry who has been starved of equity capital over the last few years.

Investors must however be aware that the ALPI has more offshore exposure (+9% relative to SAPY) and the approximate 12% British Pound allocation across a string of companies including Hammerson, Intu, Capital & Counties, Capital & Regional and RDI REIT. This does introduce some relative currency exposure that isn't as directly apparent in the SAPY. In addition, while we as a nation have been somewhat critical and focused on local politics, we should not forget that other regions have their own issues to deal with and the matter of BREXIT is still to be concluded.

With that said the SAPY has been evolving into a more offshore focused benchmark over time. Despite the current standing where the ALPI has a higher direct and indirect offshore exposure, we believe this could reverse in the years to come as foreign stocks are still looking for a primary listing in South Africa, immediately allowing them SAPY inclusion, which would likely result in smaller local stocks falling out. While the ALPI already includes several offshore counters, they allow for many more stocks into the index, so inclusion of one stock does not necessarily result in the exclusion of another.

Looking back the relative performance has not differed too much, however it should be highlighted that 2015 saw the ALPI outperform in light of the fallout around NeneGate, while 2016 saw a reversal as Brexit hurt the ALPI which has approximately 12% more UK exposure.

Graph 2: SAPY vs ALPI returns



Source: Sesfikile Research

SECTOR OUTLOOK

Looking ahead we expect the change in sentiment after the recent political movements to push the sector back towards a more optimistic outcome, however this will not change overnight, and we expect a slow grind into a more positive environment. In addition, there are still a lot of once-off earnings hidden in the bases of several company earnings and we see some negative surprises as they 'shake these out' and rebase distributions for the years ahead. Despite the material loss we witnessed in the recent month we haven't changed our 12-month rolling outlook of mid-single digit returns as we think it may take some time as the nerves settle and the market re-establishes their confidence in several of these under performing stocks.

In truth the outlook is filled with potential swings and roundabouts.

- Local bond yields threaten to tighten or at least remain flat with a more economic friendly political outlook, while globally bond yields have already shown a readiness to 'normalise' and follow an upward trend as inflation looks to be returning to the global arena.

- With the potential of a political U-turn, local confidence appears to be finding some momentum, which creates letting activity, the willingness of businesses to enter longer leases and consumers to spend. In general, economic activity increasing is positive for the sector, particularly offices that are more sensitive to the business cycle.

- We are concerned that there are still companies hiding once-off earnings in their base, which the market hasn't sufficiently accounted for, however several companies have already cleared out non-recurring earnings and are showing considerable value.

It is going to be a busy year as conflicting market forces engulf our sector, however with the steep pullback that we have already experienced combined with above average uncertainty across several platforms we still believe that we can achieve real returns over the next 12 months with slightly better returns into the mid to longer term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