NIMBLE WISDOM MONTHLY

The quarter that was... | March 2018

SESFIKILE CAPITAL
Listed Property Investments

Please note that Nimble Wisdom Monthly will be evolving into a Quarterly publication going forward with the next edition being in July 2018. We intend to enhance the product making it more relevant and substantial in the editions to come. Watch this space…

MARKET OVERVIEW

Coming out of a surprisingly positive and robust 2017, the SA Listed Property Sector ("SAPY") became engulfed in speculation concerning the Resilient stable (Resilient, Fortress, NEPI-Rockcastle and Greenbay). With the grouping comprising approximately 42% of the index, their sell-off brought the SAPY down to its worst quarterly return since inception of the index at -19.6%. While the market awaits findings from a range of independent and regulatory bodies as to the more serious allegations, they have already severely penalized the stocks on the basis of inflated valuations, the financial engineering used to generate market beating distribution growth and the cloud of suspicion the allegations have created. The SAPY weakness was ultimately stock specific as we saw their returns uncharacteristically opposing that of the bond market, which was strong for the quarter, up +8.1% (+2.0% in March), following on from the positive political momentum of December as yields continued to compress a further 0.61% to 8.12%. Equities on the other hand were less appealing, losing -6.0% in Q1, with the bulk of the losses coming through in March at -4.2%, primarily driven by Naspers and BAT.

Local bond yields started off the quarter at 8.73% showing a steady decline through the quarter as the Ramaphosa presidency made the 'right noises' from the perspective of the rating agencies as well as the market sentiment in general. This was further supported by an austere budget focused on reducing the deficit and stabilizing the SOEs. Yields touched as low as 8.02% after the Moodys rating decision, opting not to push our Sovereign rating to 'junk' and settled at 8.12% by quarter end. The local bond strength was something unique to South Africa and our political / policy shift as global yields were on the up. The 10-year US Treasury spiked +13.9% from 2.41% to 2.74%, peaking mid-February at 2.95%.

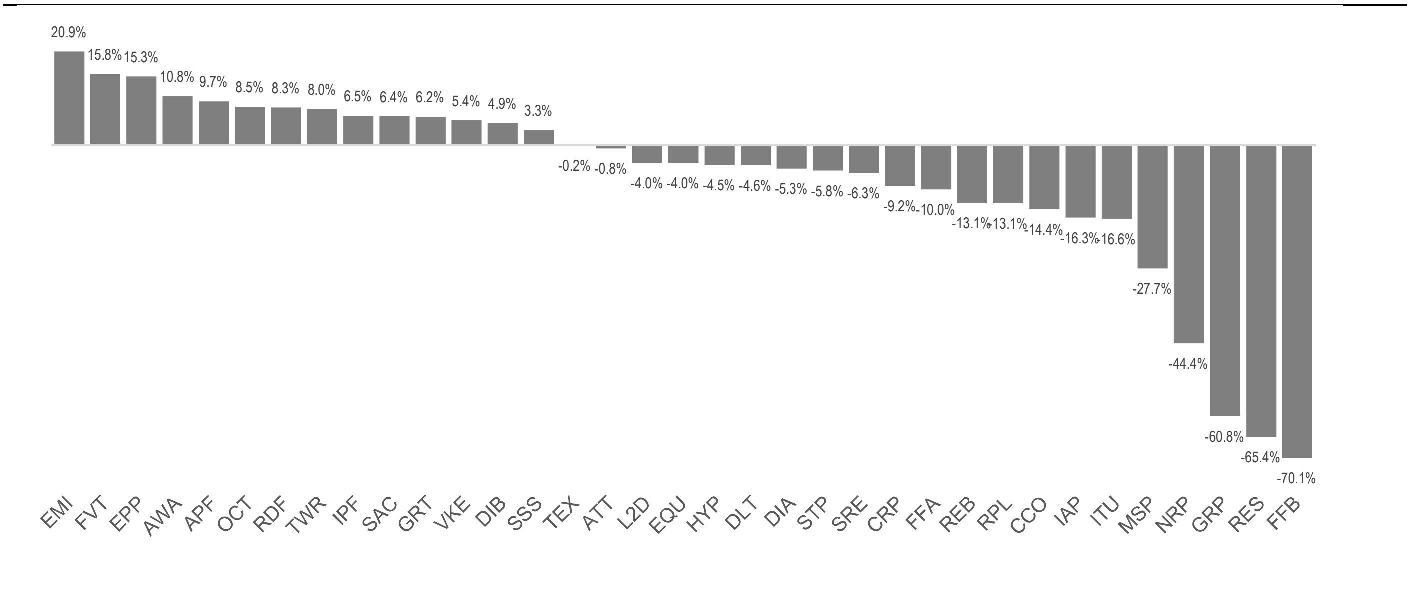
This weakness in bonds weighed down on global property as the global property index (as represented by FTSE EPRA NAREIT Developed Rental Index) fell 5.1% in USD for the quarter. This was similarly reflected in the JSE listings that are fully exposed to offshore operations, falling circa 10% on average in ZAR as the ZAR strengthened just under 5% to the USD.

STOCK PERFORMANCE

Most of the SA-inc focused stocks (REITs with a local asset bias) recorded a decent quarter, riding on the back of positive local sentiment and a stronger long bond. Top performers included Emira (+20.9%), Fairvest (+15.8%), Echo Polska (+15.3%), Arrowhead (+10.8%) and Octodec (+8.5%) with large caps Growthpoint and Redefine not too far behind. Interestingly, contrary to the drivers mentioned above, Emira, Arrowhead and Octodec bounced as a result of potentially being over penalized as they rebased earnings last year. Echo Polska was also punished towards the end of last year as an independent director was jailed and is yet to be charged (unrelated to the company) and bounced off the lows into the first quarter of 2018, also aided by a strong set of results. Fairvest delivered another set of consistent and robust results.

Not surprisingly, the laggards for the quarter included Fortress B (-70.1%), Resilient (-65.4%), Greenbay (-60.8%), NEPI-Rockcastle (-44.4%) and MAS (-27.7%), with MAS being the only stock not part of the Resilient stable. In addition to the accusations surrounding most of the laggards we must note they all have a strong bias to offshore earnings that become worth slightly less with a stronger ZAR. With higher global bond yields and a stronger ZAR we saw offshore property under pressure – including the likes of Intu, Investec Australia, Capital & Counties and RDI, which were all down over 10% over the period.

Chart 1: 1Q18 Total Returns



Source: Bloomberg

Despite the momentum surrounding the local stock prices, we still see a tough operating environment, especially across the retail sector. Trading densities across the board were disappointing and are unlikely to show much improvement as the tax increases (particularly VAT) filter into the system and put further pressure on an already beleaguered consumer. The Edcon group is of concern to us as their recent results indicated an operating loss, which needs to show signs of improvement before debt reviews later this year. We believe that office has to some extent rebased over the years as real rental growth has been flat and the amount of speculative supply has slowed down in recent years, although pre-let space is still pulling tenants from secondary buildings as net new demand has been negligible. Logistics space has been the strongest sector of late, but we have seen a supply response which is putting pressure on vacancies and a ceiling on rent growth.

RECENT RESULTS

In the recent spate of company results we witnessed most management teams downplaying general optimism and indicating that there's still a lot of hard work ahead, but at least we are now moving in the right direction. The tail end of results season saw a strong result from Fairvest, which is credit to a focused management team who has stuck to their strategy. Hyprop also posted a decent number, but we are cautious as to the year ahead with potential headwinds emanating from balance sheet restructuring and poor retail dynamics.

COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Hyprop	376.3	8.3%	Hyprop delivered strong interim distribution growth and upped their full year guidance range from 7-9% to 8-10%, however we believe that this is creating an artificially high base off which to grow, especially considering the dilution they are likely to face as they list Hystead and unwind the low-cost bridging facility. The core retail portfolio grinded ahead in a tough trading environment with like-for-like Net Property Income (NPI) growth of 2.1%, which was muted by redevelopments and the recycling of Stuttafords' space, which if excluded would have been a more respectable 5.2%. Trading density growth was anaemic at 1.4% which is likely to put pressure on future rental growth. On the positive side, retail vacancies were reigned in from 1.9% to 0.9%, while expiring leases were let 4.1% higher on renewal. Africa (ex-SA) and South-Eastern Europe now each represent around 11% of total assets. Africa (ex-SA) is a mixed bag with under and over performers with average vacancies settling at 6.5%. The earnings guarantee to Hyprop protects the distribution for now, however operational performance will become significantly more important as we near the conclusion of the guarantee at the end of 2019 calendar year. South-Eastern Europe exposure through Hystead has started off on the front foot as trading has been ahead of expectations, while the portfolio continued on its accretive growth path acquiring two centres in Zagreb, Croatia of which Hyprop's exposure is €77.5 million. There has however been concern as to their ability to list Hystead in the current environment, which is imperative to free up Hyprop's balance sheet and allow for the Hystead portfolio to grow. The LTV declined marginally to 28.5%, where the local funding is just over 100% fixed for 3.9 years, while the USD debt is 67.1% fixed for 2.6 years and the Euro debt is not fixed at all due to the short-term nature of the facility coupled with the impending corporate activity. We are concerned with the heavy reliance on low cost offshore debt relative to the actual asset exposure and the headwinds that will arise from refinancing the Euro bridging facility to normalised rates.

			Guidance has been increased for the full year, however we caution the impact of the Hystead listing as well as the ensuing weak local retail environment on future growth.
Fairvest	9.8	9.5%	Fairvest delivered a stand-out performance in a tough environment. Like-for-like NPI increased 11.8% as vacancies compressed from 4.7% at financial year-end to 3.2%, reversions on renewals were at 6.1% and in-force escalations were steady at 7.5%. Tenant retention was also strong at 88.5%, although it was a small sample set for the period. Furthermore, the average rent to sales was low at 2.4%, putting them on a steady platform to push rentals going forward. Gearing levels spiked from 22.4% to 32.6% on the back of two acquisitions totalling R495 million, of which only 46.5% is hedged for 12 months. A post balance sheet date capital raise brought the LTV back towards a more conservative mid-20% level. Guidance for the full year is still above market ranging between 9% and 10% with relative conservative assumptions.

SECTOR OUTLOOK

Our outlook is somewhat mixed in that despite confidence levels picking up, we believe there is a level of ‘austerity’ that needs to take place and we don’t necessarily expect the operating environment to pick up in the short term. This, coupled with the fact that a few more companies need to clean out their distribution base and reduce the reliance on unsustainable earnings makes us cautious on growth. There will likely be more earnings downgrades than upgrades during the year.

With that said, valuations are not demanding as the SAPY has de-rated materially relative to bonds in Q1, and companies have already begun resetting their earnings to more workable levels. The Resilient stable is looking particularly cheap, however we do not see these stocks re-rating until the cloud of uncertainty is lifted, most likely with the release of the JSE and FSB independent investigations. As we move through this ‘purple patch’ we see the potential for stronger returns into the medium term as a combination of attractive initial yields and inflationary type distribution growth drive returns.

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