NIMBLE WISDOM QUARTERLY

~~Cautiously~~ Optimistic | 2Q 2018

SESFIKILE CAPITAL
Listed Property Investments

MARKET OVERVIEW

After a dismal first quarter, the SA Listed Property Index ("SAPY") posted another disappointing return of -2.2% in 2Q18. Despite a healthy respite in April, as the 'Resilient stable' bounced off their lows, both May and June saw an array of disappointing economic indicators. And to make things worse, the quarter culminated in a material emerging market sell-off as the US and China faced-off in a possible trade war. The risk-off sentiment put both the rand and local bond yields under pressure.

Bonds delivered a negative total return of -3.8%, while Equities stood out in the green, up +4.5%, as the weaker rand buoyed several of the larger rand-hedge counters. It should also be noted that the All Property Index ("ALPI") outperformed the SAPY in Q2 with a total return of -0.5%. This was largely driven by the higher direct offshore exposure in the index. Sesfikile Capital officially moved over to the ALPI as its benchmark on 1 July 2018, as we believe this benchmark offers more choice, diversification and liquidity relative to the SAPY.

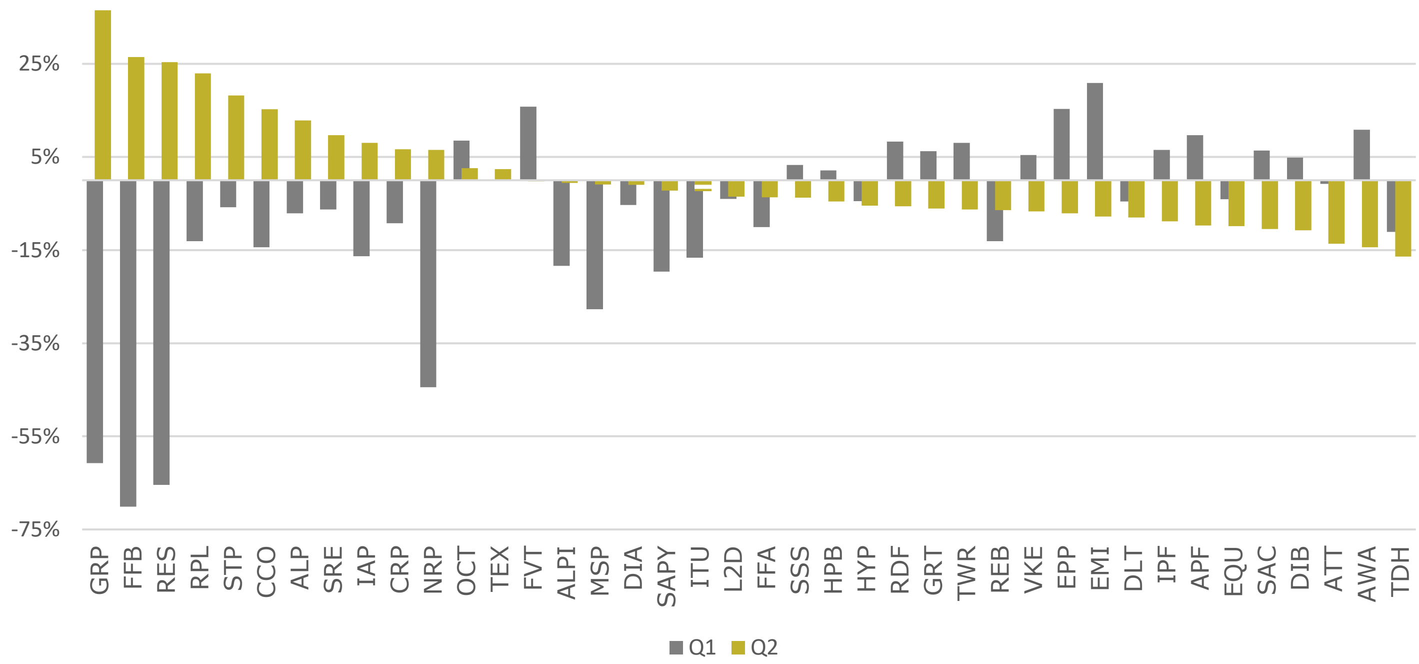
Table 1: Asset class total returns to 30 June 2018

	Quarter 1	Quarter 2	1H18	April	May	June
ALPI	-18.4%	-0.5%	-18.8%	7.6%	-4.9%	-2.8%
SAPY	-19.6%	-2.2%	-21.4%	7.7%	-5.9%	-3.5%
Cash	1.8%	1.8%	3.6%	0.6%	0.6%	0.6%
Bonds	8.1%	-3.8%	4.0%	-0.7%	-2.0%	-1.2%
Equities	-6.0%	4.5%	-1.7%	5.4%	-3.5%	2.8%

Source: Bloomberg

At a stock level, the second quarter thematic was largely a reversal of the first quarter, which is clearly illustrated in Chart 1. Top performers came out of the 'Resilient stable' as they bounced off their lows: Greenbay (+36.5%), Fortress B (+26.5%) and Resilient (+25.4%) all showed strong returns but are still lagging year-to-date as the market has replaced their historic premium rating, based on market beating growth, with a discount premised on uncertainty. The laggards for the quarter were: Arrowhead (-14.4%), Attacq (-13.6%), SA Corporate (-10.5%), Equites (-9.9%) and Accelerate (-9.7%). While each of these stocks had their own headwinds over the quarter, they were all seen as SA-focused yield plays in a weak bond market, resulting in a significant sell-off. It is also worth noting that large caps Growthpoint (-6.1%) and Redefine (-5.6%) suffered a similar fate.

Chart 1: Quarterly stock total returns



Source: Bloomberg

BOND YIELDS

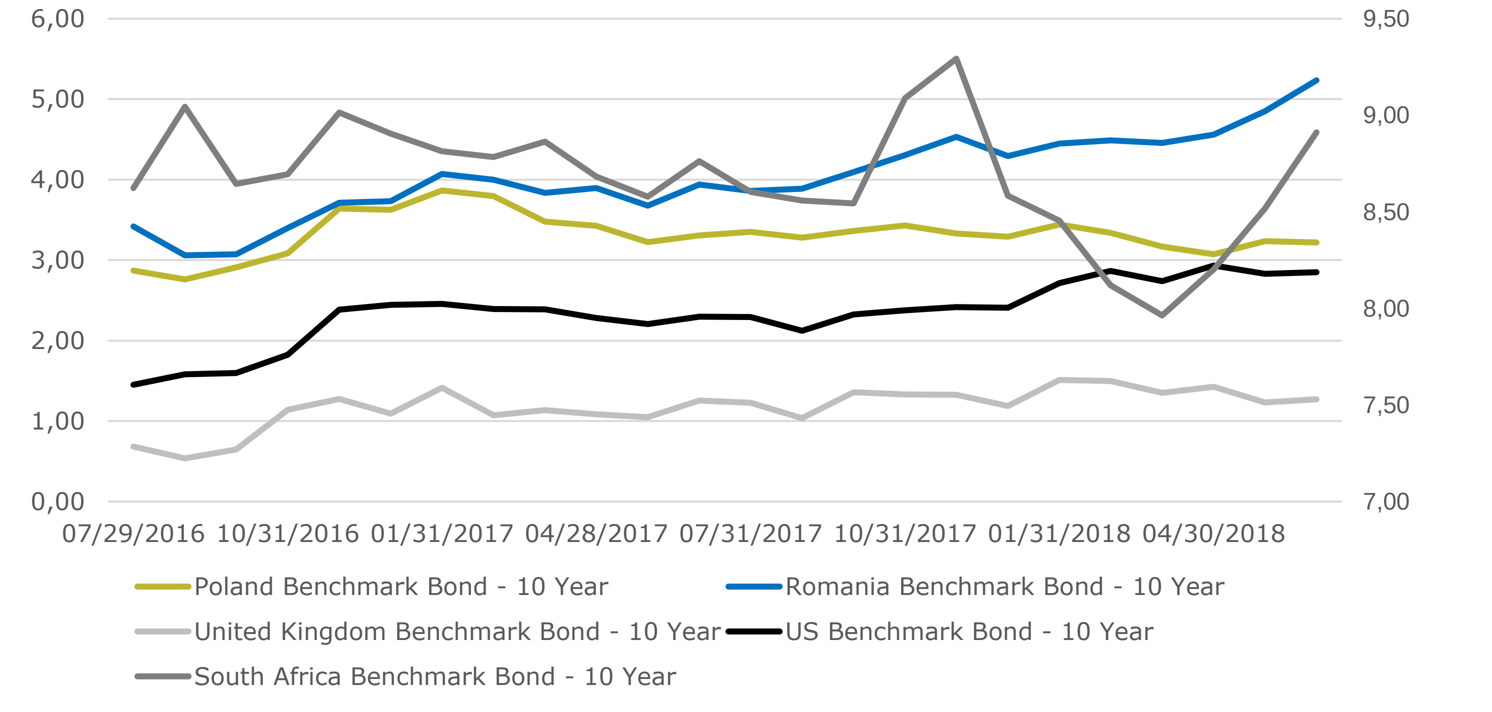
The SA 10-year bond yield started off the quarter at a low of 8.12% and weakened throughout the quarter to a peak of 9.32% in mid-June, strengthening back to 9.00% at quarter end. Local yields were initially pushed higher by a rising US 10-year yield which started the period at 2.74% and charged through 3% to 3.11% mid-way through the quarter, only to settle at 2.86% at quarter end as concerns around the 'trade war' created a flight to quality and heightened uncertainty around the extent of the US recovery. Momentum in SA bond weakness picked up further as disappointing second quarter economic indicators (primarily the second quarter GDP miss of -2.2%) hit the screens, signaling the end of 'Ramaphoria'. And finally bond yields hit their crescendo mid-June, at the peak of the emerging market sell-off, resulting in significant foreign net selling.

But to focus solely on the South African bond market would only be telling half the story as the benchmark (through the 'ALPI') has direct offshore exposure of 32.5% and a further 15.7% indirect offshore positions. The bulk of this is through the UK and Central and Eastern Europe (CEE). The UK bond yield has been threatening to track the US 10-year yield's upward trajectory, however with the complexities surrounding Brexit and the trailing growth profile, the path of the 10-year has been somewhat flat to marginally higher.

Unfortunately, this does not support rental levels as retail spend is anemic and office demand uncertain at best. It does, however create a significant carry trade to the listed market where the yields of stocks such as Hammerson, Capital & Regional, Intu and RDI range from 5% - 8%, while the 10-year bond is at circa 1.3%. In a search for yield, this is a great attribute, however the differential is most certainly pricing in a tougher operating environment on the ground.

CEE bond yields are somewhat divergent, especially considering the two major regions the ALPI is exposed to, Poland and Romania. Poland has seen its bond yield remain contained just north of 3%, despite concerns around the political environment. The yields are tending to break away from CEE levels towards those of Western European markets, which is perhaps due to the fact that Poland is set to be classified as a 'developed market' later this year. Romania on the other hand seems to be tracking a more 'emerging market' course as yields went from as low as 3% through 5% as the recent trade war resulted in risk-off selling. Both economies have been showing attractive GDP growth, but the general shift in the yield curve will likely be dictated by their major European counterparts.

Chart 2: Relevant 10-year bond yields across invested markets



Source: Bloomberg

OPERATING CONDITIONS

South Africa

Trading conditions for the local stocks continued to be strained, especially in the retail space as discretionary spend has been vastly eroded by an array of factors, including: the recent VAT rate hikes, spike in fuel prices and increased property rates. Lackluster employment figures and the oversupply in recent years have also put a damper on trading densities (revenue per square meter). The office market remains on the back foot as the latest SAPOA data has indicated a 30 basis point hike in vacancies to 11.5%, and while the absolute level in vacancies is not out of sync with the range we have witnessed over the past few years, it is somewhat misleading as the sample set has seen lesser quality assets removed as a result of obsolescence or conversion to residential. On the positive side, rentals have gone backwards in real terms and the amount of speculative development has come off significantly, so the base is set quite low, however for any meaningful growth we would need GDP growth to support demand. The industrial sector is performing adequately considering the current economic environment.

UK & CEE

And while we speak about local fundamentals, we would be remiss not to mention UK and CEE retail fundamentals, which now comprise over a quarter of sector exposure. While CEE retail is ticking over nicely as the respective markets find an equilibrium as supply levels catch up to a growing consumer base, the UK is not quite as robust. The UK is coming under significant pressure, firstly as a result of the escalated levels of online retail penetration and secondly as a result of a cautious consumer who is feeling the pinch of the impending Brexit. We have seen a string of retailers go into business rescue or as they call it, CVA (Company Voluntary Arrangement). Brands including House of Fraser, New Look and Mothercare have all closed stores. Notably the impact across the major stocks listed on the JSE (Intu, Hammerson and Capital & Counties) is limited as the stores generally trade better across the higher quality assets. This doesn't necessarily make things 'better' as the headline risk and resulting impact on asset pricing is high; and while we think valuations are attractive, we are not underestimating the potential volatility being priced in. Cap rates will undoubtedly push higher, making valuation less appealing, creating pressure on stretched balance sheets and the potential for dilutive capital raises. This risk is most apparent in Intu, however so is the potential for corporate action and / or a significant shake up across the company and the underlying portfolio.

Capital raising activity

Another interesting area of consideration over the last six months has been the sharp decline in equity raised within the sector. Of the R6.1 billion raised, one third was through dividend reinvestments, while a further 13% was placed in off-market transactions. In effect, very little equity was offered to the market, which is more a result of fear of an 'equity raising failure' and weak ratings as opposed to a lack of a need for capital. In addition, where in recent years the majority of equity raised was from the 'Resilient stable' and for offshore stocks; none of the 'Resilient stable' came to market in the first half of the year, while only around 5% of the cash was for offshore counters.

Table 2: Total equity raised in the Property sector

	Total Raised (Rm)
2010	R 5,649
2011	R 24,737
2012	R 17,895
2013	R 37,793
2014	R 69,360
2015	R 53,484
2016	R 39,347
2017	R 48,711
1H18	R 6,123
Total	**R 303,100**

Source: Anchor Securities

COMPANY RESULTS

Sixteen companies reported results during the quarter. We summarise the key takeaways from these results below:

Accelerate – FY18

- The company is half-way through its two-year guidance of 0% growth.
- Like-for-like NOI growth of 5.3%, with vacancies weaker at 10.0% from 6.9% the previous year.
- While chunky vacancies hurt top line, cost controls assisted earnings growth as did a positive 6.2% rental increase on renewals coupled with a 7.1% escalation on a weighted lease expiry of 5.5 years.
- Still several potential headwinds, including: how to fund Fourways equalization at 8%, KPMG (7% of total revenue) headline risk, Portside guarantee thinning out and the low cost Investec funding coming to an end.
- Management prudently stepped away from Polish Industrial acquisition despite initial accretion.

- Debt levels still on the high side, 40.7% gearing, considering the potential capex needed. They have, however, earmarked a portfolio for sale to assist in reducing the gearing.

Arrowhead – 1H18

- 6.5% decline in DPS with a similar decline expected for the full year as the once-off items unwind – in line with guidance.
- Operating performance reflective of tough environment, but leasing seems to be going relatively well with positive releasing spreads while trading density on the retail portfolio has been positive.
- Vacancy declined from 12% to 10.6%, however softer leases seem to be facilitating this with higher incentives and lower escalations being offered.
- The biggest concern has been the listed holdings (now the dominant source of distribution) and the possible headwinds, most notably Rebosis.
- Gearing of 36.8% at group level of which 80% fixed; however see-through gearing slightly higher as a result of listed holdings.

Delta – FY18

- Flat distribution for the year despite 5.2% like-for-like NOI growth.
- Vacancies stretched at 11.8% with over 20% on month-to-month leases and lease expiry term at mere 1.5 years as management await a recapitalization transaction to improve empowerment and lease duration.
- Debt levels high at 41.2% with 85.4% fixed for only 1.5 years; however more concerning is the short expiry term of only 1.5 years, which is now dependent on extending the lease terms.
- R644 million in disposals helped keep gearing levels relatively stable, however significantly more capital is needed for defensive capex as well as to reign in gearing levels.
- Management have been alluding to a significant capital injection to improve empowerment levels, extend the lease term and de-risk the balance sheet, however they are cutting it fine as they will have to start renewing debt and are yet to appease the bank with a concrete solution.

Dipula – 1H18

- A hard fought 4.6% distribution growth, with full year guidance dropped slightly to 4% - 5% as a result of tougher operating environment, higher bad debt provisions and delayed acquisitions.
- Vacancies were up 1.2% to 10.4%, with the biggest impact being GM leaving SA and with an 18 000m² industrial unit. Tenant retention at 80%, renewals came in 3.6% higher, while the balance of the portfolio increased by 7.6% in-line with the escalation profile.
- Dipula acquired R1.5 billion of new properties, of which R1.25 billion came after period-end taking the weighted lease expiry to 4 years. The deal was accretive at 11.8%, funded through R480 million of new debt and R790 million of new equity, which was an achievement considering recent failed capital raises.
- The management company was also internalized at the beginning of the period for R150 million.
- Gearing levels remained flat at 39% of which 91% was hedged for 1.7 years.

Equites – FY18

- 12.2% distribution growth, supported by like-for-like NOI growth of 9.0% on the local portfolio, coupled with some accretive UK acquisitions. 2019 guidance still attractive between 10% - 12%.
- UK portfolio is now 16% of revenue and around double that in terms of percentage of assets. Portfolio is high quality and has potential to display strong capital growth, although rental growth will be staggered and reflective of a lower inflation economy.
- Vacancies are low at 2% and the balance of the portfolio has an average expiry of 7.9 years and an escalation of 7.9% on the South African portfolio.
- Gearing pushed slightly higher to 23.5%, which is expected to increase with further acquisition. It must, however be noted that funding costs were lowered as a result of the bias towards UK funding (through additional cross currency swaps and conventional funding).

Greenbay – 1H18

- DPS up 25%, however payout ratio increased from 98.0% to 101.1% to achieve the target.
- NAV per share was up 1.8% over the twelve-month period, supported by accretive capital raising; however, it is down 8.0% over the last six months as the geared exposure to their listed holdings has been negative.
- In addition to raising equity, the fund has geared up significantly over the last twelve months from 6.5% to 31.3%, which has also been significantly yield accretive.
- Direct property has been diluted to 14% of the portfolio, however this will increase with the acquisition of the remaining 50% of the two Portuguese assets.
- Direct infrastructure opportunity appears to be harder to achieve than initially anticipated and management will look to move up the risk curve to achieve better returns.
- Management have guided distribution growth of 25% for the remainder of 2018 as well as 2019, which will be largely supported by selling down lower yielding listed stock to fund higher yielding physical assets.

Investec – FY18

- 6.1% core distribution growth for the period with 6.5% - 7.5% guided for 2019 - this includes the accretion from the European industrial acquisition.
- Like-for-like NOI growth of 5.7%, supported by in-force escalations of 7.6% on a weighted lease expiry of 3.6 years, while hampered by core vacancies pushing out from 1.4% to 4.0%.
- Tough operating conditions locally has shifted management to compromise on incentives granted to retain occupancies.
- Management has increased its offshore exposure to 11.7% of assets with a €74.2 million Pan European industrial acquisition (42.9% stake in 22 assets across six countries) - this exposure should pick up to 16% as the balance of the committed capital (€75.8 million) is allocated.

Investec Australia – FY18

- DPS growth came in at 3.0% pre-withholding tax (WHT) and a mere 0.6% post-WHT.
- Operations were steady with vacancies at 1.5%, while escalations and the lease expiry profile both showed an improvement (to 3.3% and 5.2 years respectively), primarily as a result of acquisitions.
- Three new assets where acquired with the most significant being the NZ$123.2 million Majestic Centre in Wellington at a yield of 7.1%.
- Loan-to-value pushed higher to 35.8% with 87% is fixed for 6.2 years.

- Management looking to do an Australian listing in the short term and will raise equity on that exchange to facilitate liquidity. It will also come with a change in how distributions are determined and likely see a negative rebase.

Octodec – 1H18

- 3.0% DPS decline for the period, however management reiterated flat year-on-year DPS for FY18.
- Management guided for slower growth as substantial new residential schemes are let up to a normalized level.
- Letting at Sharon's Place was ahead of expectations.
- Core vacancy increased marginally to 10.8% with only residential showing an improvement, while CBD retail remained flat. Like-for-like rental income growth was soft at 3.2%, but reflective of trading conditions.
- Loan-to-value static at 37.1% of which 97.5% is fixed for 1.6 years.
- Management looking to reduce gearing and have been selling non-core assets to facilitate this.

Stenprop – FY18

- Dividend +2.5% in sterling as guided, however FY19 guidance -15.6% as they rebase in-line with structural change in strategy and portfolio from commercial UK/German/Swiss portfolio to UK Multi-Let Industrial ('MLI').
- Biggest headwinds to earnings are from the winding down of third party management business which contributed circa 20% to earnings, as well as reducing well priced debt levels.
- Some tailwinds from selling higher quality lower yielding assets and reinvesting into higher yielding MLI opportunities.
- Loan-to-value has come off 5% to 49.2%, with the intention to reduce to 40% over the two years.
- MLI exposure currently sits at 23% with a two-year target of 60% - 65%. Risk currently lies in ability to acquire as prices across UK MLI have rallied and management also committed to the transition by acquiring a highly regarded platform / expertise, while having sold off trophy assets (admittedly ex-growth).

RDI REIT – FY18

- DPS up 3.9% in sterling off the reset EPRA base, while NAV per share was up 2.2%. Guidance only came through a medium-term EPS target of 3% - 5%, however we think they would look to increase cash cover and likely deliver 2% - 3% distribution growth.
- Operationally a decent set of numbers with like-for-like gross rental income growth of 2.1%. Weighted average lease term of 6.2 years with 25.9% indexed increases.
- Retail still biggest challenge, but still 97.3% occupied with only 0.4% exposed to recent UK retailer failures. Management still has two retail assets they would look to dispose of, retail still 45% of asset value.
- Good asset recycling with £211.8 million in disposals (strategic and opportunistic) with £284.9 million in acquisitions, including an entry into serviced offices (10% of portfolio).
- Leverage at 48% of which 99.2% is fixed/hedged, total loan-to-value covenant average at 71.2%.

Rebosis – 1H18

- Soft 4.4% distribution growth, but still supported by once-off earnings.
- Reasonable performance on retail with like-for-like NOI up 7.1%; this is expected to reverse in FY19 as guarantee falls away on Baywest and Forrest Hill.
- Office also held up well at 5.5% like-for-like NOI growth.
- New Frontier has performed poorly and while a significant portion has been moved off balance sheet, Rebosis still has ultimate exposure through vendor funding and guarantees.

- Leverage at 48.3% but likely to push towards 50% on see-through basis - key target for the company in the short term will be the disposal of R3 billion in office assets to reduce gearing.
- Management will no longer pay out non-recurring items in FY19, while Baywest and Forest Hill guarantees fall away – this will likely result in a significant rebasing in distributions.

Redefine – 1H18

- 5.5% distribution growth of which core distribution growth was 6%. Non-recurring earnings still amount to R116 million being 4.6% of distribution, which is down from R117 million the year before.
- Like-for-like NOI up 5.1% driven by in-force escalations of 7.4% and a slight compression in vacancies to 7.4%; however, there was very little growth on renewals and cost ratios deteriorated slightly.
- LTV at 40.1%, with significantly higher gearing on foreign assets lowering finance costs. 84.5% of debt is hedged for 2.5 years.
- Management have stated their desire to reduce gearing below 40%, which will be a challenge considering R5.6 billion of developments in progress. To their credit they have recycled R2.6 billion in assets and have earmarked several other disposals.
- The offshore assets contributed 25% to distribution, however the mix is constantly evolving with the disposal of the majority of Australian assets and subsequent acquisitions in Poland.

Sirius - Fy18

- Euro distribution up 8.2%, however this entailed increasing the payout ratio from Funds From Operations (‘FFO’) from 65% to 75% to balance significantly dilutive asset rotation - FFO was 6.7% lower.
- €103 million of mature assets, yielding 6.2%, were sold while €163.7 million was acquired at a yield of 5.1% despite being 42% vacant.
- Like-for-like rental growth was up 6.2%, while like-for-like occupancies were 2.7% higher to 82.5%.
- Gearing slightly lower at 38.6% at an average cost of 2% with weighted expiry of 5.2 years; this was brought lower through a combination of NAV accretion and two equity raises of a combined €40 million.
- Asset valuations in the market have made value-add opportunities more difficult, however management is confident in their identified pipeline and have €120 million of balance sheet capacity from which to execute.

Stor-Age – FY18

- 11.1% distribution growth aided by SA portfolio with 11.8% like-for-like NOI growth and 10.6% ending the year with occupancies at 85.2%. 12-month guidance is still robust at 9% - 10%.
- Newly acquired UK property portfolio (through Storage King) performed 6.5% ahead of management’s initial forecast.
- UK portfolio roughly 35% of total value, but has significant scale to grow and increase efficiencies through South African platform.
- South African portfolio of 35 assets still has strong acquisitive potential with 13 properties coming through the managed portfolio as well as a further 10 assets in the development pipeline.
- Conservative 16.0% loan-to-value with a bias to lower-cost UK funding taking the effective interest rate to 6.5%; with 100% of debt fixed for 2.5 years.

Vukile – FY18

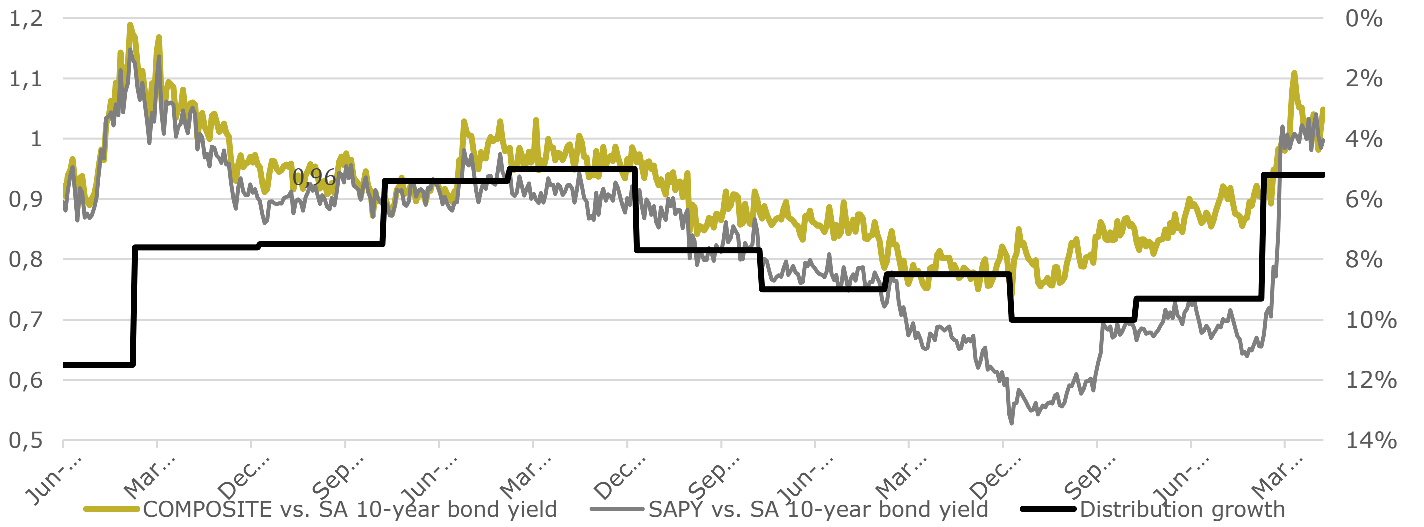
- 7.7% distribution growth in-line with guidance, with healthy 2019 guidance ranging between 7.5%-8.5%.
- Relatively strong trading on local portfolio; vacancies at 3.7% with like-for-like NOI up 6.5%.
- Despite outperforming the average, the local retail environment remains fragile and is likely their biggest hurdle in meeting guidance.
- Spanish expansion gained significant traction to 21% of total assets while UK sits at 5%.
- Leverage comfortable at 29.6%, however there is a skew to lower cost foreign debt.

SECTOR OUTLOOK

The year-to-date pull back has been significant and in fact the worst in recent history. The weakness is not completely unfounded as operational performance remains weak while income statements are fraught with once-off items. This has and will continue to put pressure on distribution growth. In addition, with political and economic instability coupled with a global push in interest rates, a pull-back can be justified; however, we think that the recent carnage has been overdone.

Chart 3 shows the SAPY and COMPOSITE (yield of ten SA property stocks weighted equally over the past 10 years) relative to the SA 10-year bond. The graph also shows the distribution growth of the SAPY (which is inverted). So, despite the composite ratio increasing sharply (getting cheaper), it was somewhat justified in the context of growth which has slowed to levels last seen in 2012, when coincidently the relative yields were at similar levels. However, this relationship broke down towards the end of Q1, where both the SAPY and COMPOSITE continued to de-rate relative to Bonds and even flirt with levels last seen around the global financial crisis. It is on this basis, that we are currently seeing value in Property relative to Bonds from a top-down perspective.

Chart 3: SAPY / COMPOSITE relative to SA 10-year bond yield vs. Distribution growth



Source: Bloomberg, Sesfikile Research

Our bottom-up expectations are premised on the SA 10-year bond exiting at of 8.7%, while we have global bond yields marginally higher. We have also weakened the rand by 3% across the 32.8% direct offshore exposure, which we think is a neutral view. We have been conservative on initial yield / distribution growth expectations and have also set aside an adequate margin of safety for stock specific risks. Therefore, we have not made too many aggressive re-rating assumptions on a stock level. Putting it all together, we expect the ALPI to deliver a weighted average total return of 14.2% over the next 12 months. On this basis, we are currently seeing good value in the sector, however the caveat is that there are some very specific risks within certain companies, so careful stock selection will be of primary importance.

EVAN
JANKELOWITZ, CFA

MOHAMED
KALLA, CFA

KUNDAYI
MUNZARA, CFA

SESFIKILE CAPITAL (Pty) Ltd

First Floor, 30 Melrose Boulevard
Melrose Arch, Johannesburg. 2076
Suite 334, Private Bag X1, Melrose Arch, 2076

sesfikilecapital.com
info@sesfikilecapital.co.za

An authorised Financial Services Provider. FSP: 39946