Previously Investec Asset Management

Ninety One Property Equity Fund

Performance review

The market moves witnessed so far this year may well be remembered for the rest of our lives. Global markets had initially downplayed the potential impact and spread of the coronavirus (COVID-19) outside of China. New cases in other regions, however, quickly dispelled that narrative as the reality of a potential health crisis began to permeate the discourse. Risk assets plunged as the virus forced an unprecedented sudden halt to large swathes of the global economy.

Globally, central banks have responded by cutting rates and introducing huge stimulus packages to aid a dwindling global economy. In South Africa, the economic shock has added to what was already a challenging backdrop. Before the outbreak, the domestic economy had slipped into its second recession in as many years, shrinking by an annualised 1.4% quarter on quarter in the final three months of 2019. This was mainly due to rolling power outages, severely constraining several industries. The weakness in the local economy will no doubt be further intensified by the strict lockdown measures implemented by government on 27 March 2020, which have sent the entire economy into hibernation, barring essential services.

In response to the negative growth shock and benign inflation profile, the South African Reserve Bank (SARB) cut the benchmark interest rate by 1% to 5.25% at its 19 March 2020 monetary policy committee (MPC) meeting. Following extensive engagement with market participants, the SARB also increased and extended the tenor of its repo operations and took the historic step to support South African government bonds in the secondary market. The SARB, however, emphasised that this was a monetary policy reaction designed to facilitate the transmission of monetary policy – not quantitative easing or the monetisation of the deficit.

Ratings agency Moody's Investors Service unsurprisingly downgraded South Africa's sovereign credit rating to one notch below investment grade at Ba1. The negative outlook was kept in place, foreshadowing the risk of a further downgrade. The move meant that South Africa will no longer form part of the FTSE World Government Bond Index (WGBI), effective 1 May 2020.

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Against this backdrop, global equities (MSCI ACWI -21.4%) recorded its worst quarter since the global financial crisis (GFC) in US dollar terms. The South African equity market followed suit, with the FTSE/JSE All Share Index losing 21.4%. Domestic bonds also retreated, largely on the back of foreign selling which saw the yield on the 10-year government bond spike upwards by around 300 basis points, with the FTSE/JSE All Bond Index shedding 8.7% over the first quarter. The listed property market was, however, the worst affected local asset class, with the FTSE/JSE All Property Index declining 48.1% over the three months.

For the quarter, the portfolio underperformed the benchmark.

Key positive contributions:

- Redefine Properties contributed positively to performance as we built an overweight position as the stock was bottoming and participated in the rebound in its share price.
- The long-standing overweight allocation to defensive German real estate company Sirius Real Estate also added to returns.

Key negative contributions:

The largest detractors of the quarter were two overweight positions in retail, namely Hyprop Investments and Hammerson. Retail landlords are likely to experience more of the immediate adverse effects of lockdowns as tenants are unable to trade. Both companies traded well below our fair values before the coronavirus crisis.

Portfolio activity

We have been actively trading to reduce risk in certain areas and to take advantage of price dislocations. The market remains very volatile, and after the initial selloff, has now mostly differentiated between higher and lower quality companies. To a large extent, the more defensive companies have now run their course in our view and offer less value but more certainty.

Our largest acquisition has been Redefine Properties, where we have moved from an underweight to an overweight position. The company has sold off 79% from the beginning of the year. Our analysis of the company balance sheet and earnings prospects, together with its valuation indicated this was unjustified. Factoring in sustainable earnings, together with room to deleverage, we believe the company will re-rate based on the aforementioned factors. As at quarter end, the counter was up 49% off its lows.

We reduced the positions in Hyprop Investments and Hammerson marginally when the crisis started; however, considering the pace of the sell-off, we stopped selling given the valuation. We continue to believe these companies offer attractive absolute and relative return prospects going forward. Although retail has its challenges, the lockdown has shown consumers' desire to not do everything from home, and to continue to go to the shops (once allowed) and engage with the rest of society in common-use areas. This plays into the thesis of both companies as they transform from being retail centric to community centric.

Outlook and strategy

The property sector has suffered from a number of setbacks over the last few years, including deteriorating fundamentals, governance and reporting-related concerns, rebasing of earnings, and the introduction of pay-out ratios. Prior to COVID-19, the South African property sector was on a slow road to recovery as many items appeared to be captured in valuations and reflected expectations of more sustainable earnings profiles.

The current crisis is, however, unprecedented, particularly for real estate markets where buildings are under enforced shutdowns. In our view, the obvious near-term impact is on the retail and hospitality sectors given the inability of many businesses to trade, but we have no doubt it will impact all sectors over time.

Beyond the near-term impacts of a forced shutdown, the crisis is bound to have a longer-term and lasting effect on the economy and all property sectors. Demand will be subdued across most occupational markets and will result in muted rental growth prospects. Vacancies are likely to increase as lower quality tenants fail. The office sector is vulnerable over the medium term, with already high vacancy rates of 12% across the country and 20% in Sandton. Rentals are likely to remain under pressure for some time as supply continues to be digested.

Our initial analysis indicates an approximate 20% fall in earnings for the sector over the next 12 months, which reduces to an 11% drop in earnings for the following 12-month period relative to pre-pandemic estimates. Dividends are likely to be cut by more than earnings over the near term as this is the most efficient way of preserving cash and deleveraging at current valuations. Unsurprisingly, numerous companies have already withdrawn or postponed dividends. This, however, will need to be considered relative to the minimum 75% pay-out requirement to preserve the REIT tax status, unless any dispensations are given by the regulators (which are being sought). As the lockdown is eased and ultimately lifted, we expect the defensive characteristics of real estate to come to the fore, owing to the contractual revenue nature and real asset underpin. Notwithstanding a potential short-term income gap, the long-term income-generating ability of the underlying assets remains in place.

During this time, balance sheets are of obvious concern. The sector is at its highest leverage level over the past decade and a half, with an average loan-to-value ratio (LTV) of 37% and interest coverage ratio (ICR) of 3.7x. We have, however, conducted stress testing on all of the companies in the sector. A 20% drop in asset values would raise the sector LTV to 44%, which on average is below covenant levels. These range from 45-70%. Additionally, ICRs remain above covenant levels, which are in most cases 2x. Our analysis also shows limited near-term liquidity or refinancing issues, and to date, both the banking and bond markets have remained open and continue to actively provide liquidity. Our analysis does not indicate a systemic debt issue for the sector, and particularly for companies in the portfolio. Although the LTV ratios are high relative to history, they are still within comfortable levels and all companies can continue to service interest payments. Additionally, pay-out ratios and/or skipping of dividends could reduce debt levels if need be.

In our view, the poor fundamentals are offset by an appealing valuation. The sector trades on a historical yield of 20% and a 55% discount to net asset value (NAV). Our forecast one-year forward earnings yield is 16%. Our year-two forecast earnings yield is 18%, as rental concessions are rolled out of the base. Dividend yields are likely to be lower given pay-out ratios and, in some instances, dividends may be withheld to retain cash. On a sustainable earnings basis, like-for-like rental growth is forecast to be below inflation for the next two to three years, while deleveraging will further dampen growth prospects.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by yield, together with the prospect of the sector re-rating as more clarity on operational and financial metrics is ascertained. We believe near-term volatility is likely to persist given current macro conditions. Over the medium term, we remain constructive of a return to earnings and distribution growth off a sustainable income base as the economy recovers.

While markets and economic conditions remain fluid, we continue to assess the portfolio risks and actively screen for opportunities that market dynamics such as these are likely to offer. Ultimately, we aim to provide our clients' portfolios with the best risk-adjusted medium- and long-term outcomes.

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