Discovery Flexible Property

Market background

July saw emerging markets (MSCI EM Index, -6.7%) underperform their developed market (DM) peers (MSCI World index), which rose 1.8%. Over recent months, we have seen an increase in outflows from EM to DM as the broader global growth narrative has come under pressure. A considerable driver of July's poor performance for EM equities was the pronounced weakness in China, stemming from Beijing's regulatory crackdown, which expanded to education firms during the month, with the tech space remaining under pressure. In yield oriented assets, the Bloomberg Barclays Global Aggregate Bond Index closed 1.3% higher for the month with investors largely pushing out the interest rate hiking cycle following somewhat dovish comments from the US Federal Reserve (Fed), notwithstanding higher prints in inflation.

Locally, the month of July 2021 will remain a dark period in the history of South Africa as we saw deadly riots in Kwazulu-Natal and small parts of Gauteng following the arrest of former President Jacob Zuma. Economists estimate that the riots will negatively impact South Africa's GDP growth rate by approximately 50 bps this year.

The ABSA PMI fell sharply from 54.7 in June to below the expansionary 50 level, coming in at 43.5 in July as the civil unrest in Kwa-Zulu Natal and Gauteng, as well as lockdown restrictions, weighed on business activity and sales orders. Headline inflation eased from 5.2% in May to 4.9% year on year in July, slightly above consensus expectations of 4.8%. The South African Reserve Bank (SARB) MPC projected a softer tone on borrowing costs as it unanimously held the main lending rate steady at 3.5% p.a. on the back of potentially peaked inflation in May, weak demand and the recent unrest.

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The South African stock market kicked off the second half of the year on the front foot, despite some strong headwinds both domestically and from China during the month. The benchmark FTSE/JSE All Share Index delivered a total return of 4.2%, while the Capped SWIX closed on a 2.7% handle. Local bonds (JSE All Bond Index, +0.8%) tracked the rand lower during the month as non-residents continued to pare back positions in SA sovereigns amid social unrest and heightened fiscal concerns. Listed property (JSE All Property Index) returned to negative territory to end the month down a muted 0.4%.

Performance review

For the month, the Fund marginally underperformed the benchmark.

The allocation to offshore companies counterbalanced the slight drawdown from the South African names, on the back of the civil unrest during the month. In particular, off- benchmark counters such as logistics play Tritax Big Box Properties and German REIT Vonovia, contributed positively to fund performance over the period.

Portfolio activity

The value rotation we have experienced since November last year continues to run its course, with the gap between the COVID winners and losers continuing to close. As such, we have continued to seek out counters offering the right combination of reasonable value, sustainable earnings, and growth. During the month, we maintained our preferred exposure to the mid-cap section of the sector, continuing to support a selective group of large and mid-cap South Africa-focused companies with attractive combinations of yield and sustainable growth, supported by solid fundamentals and track records such as SA Corporate Real Estate, Emira Property Fund, Investec Property Fund and Attacq. However, we also took the opportunity to add to some retail-focused positions which were temporarily hit due to concerns which flared amid the civil unrest.

Outlook and strategy

After what has been a testing few years for the listed property sector, the sector has shown good signs a of recovery in 2021 with a reversion back to sustainable practices. The recent civil unrest, however, threatened to be a significant blow to what looked to be a stabilising trend in the retail property asset sub sector. While undoubtedly negative, thankfully the direct and specific damage to the asset class appears to be limited.

For most property companies, the assets impacted constitute a small percentage of their overall portfolios. While the greater impact is in loss of trading rather than damage. As management teams have been able to assess the damage, it has become clear that for almost all assets, damage is more superficial - shopfronts, and inventory- rather than to building infrastructure. Property companies have confirmed that through SASRIA and private insurance, they should be fully covered for any damage. And to a large degree, coverage extends to any potential loss of rent due to the inability to trade, both through closure more immediately and during any construction that needs to take place.

The longer term impacts, however, are of greater importance. At the level of the individual retail asset, vacancies have been stabilising at reasonable levels as we transition to a post-COVID environment. Nonetheless, the destruction to smaller SMME businesses typically found in the retail assets most impacted over the last month, will see a destabilising of demand-supply dynamics for space and therefore an impact on vacancies and potentially rental levels.

While the sector is still working to recover from the impacts of the pandemic, and now the recent civil unrest, in our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward yield of 9% (10.5% for SA only) and a c.30% discount to net asset value (NAV). While dividend yields are likely to be lower due to reduced pay-out ratios in favour of liquidity and balance sheet support, they are now also likely to be more sustainable and in line with international best practice. On a sustainable earnings basis, like-for-like rental growth is forecast to trend below inflation for the next two to three years.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a more sustainable yield, together with the prospect of the sector re-rating as dividends become more regular and balance sheet structures are corrected. In the current environment, 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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