

Discovery Flexible Property

Market background

Global equities were broadly positive in July, buoyed by the prospect that the US Federal Reserve (Fed) could bring inflation under control without driving the US economy into a recession. In China, officials pledged support to lift the country's economy and support the struggling property sector, improving sentiment towards the nation's equities and commodities. The Bank of Japan, meanwhile, surprised markets by loosening control of its 10-year yield, effectively allowing rates to rise to a maximum of 1.0%, well above the previous 0.5% limit. Turning to South Africa, inflation continued to show signs of moderating towards the South African Reserve Bank's (SARB's) target range, supporting the central bank's decision to pause its monetary policy tightening. In commodity news, oil had a particularly strong month following production cuts by OPEC+, while gold rallied on the back of growing sentiment that the Fed was nearing the end of its hiking cycle.

Performance review

For the month, the portfolio underperformed the benchmark.

The portfolio's underweight exposure to small cap, illiquid counter, Liberty Two Degrees (L2D) was the largest detractor from relative performance over the month. The counter rallied on the back of news that Liberty Group, part of the Standard Bank Group, would buy out L2D minority shareholders and essentially consolidate its real estate assets. The price per share for the transaction offers a material premium on L2D's weighted average price, thereby narrowing the discount to net asset value.

Outlook and strategy

The sharp increase in interest rates over 2022 and into 2023 resulted in a steep derating of the listed property sector, both locally and abroad. These negative impacts, however, have been offset by a significant recovery of earnings from the COVID lows. Earnings have remained robust and even stronger than expected in some cases, resulting in reasonably resilient valuations given the circumstances. Sector fundamentals continue to improve, supporting forward-looking earnings particularly in the retail and industrial sectors. While higher interest rates will impact real estate companies to some degree, the effect is muted, as most real estate companies did not benefit from lower interest rates over the last two years as a result of debt being hedged at historically high levels. While loadshedding weighs on both revenue generation and costs, the listed real estate sector has been ahead of the curve, as most companies have the majority of their portfolios covered by backup power or renewable energy.

In our view, the improving fundamentals are further supported by relatively attractive valuations. The sector trades on a forward yield of c.11% (c.11.5% for SA only) and a c.35% discount to net asset value (NAV). While dividend yields have been reduced due to pay-out ratios in favour of liquidity and balance sheet support, they are now more sustainable and in line with international best practice. In 2022, companies showed a return to consistent dividend payments which were more sustainable as their cash flows and balance sheets are largely restored.

We believe the sector offers attractive value over a medium- to long-term time horizon, primarily underpinned by a more sustainable cash-covered yield, together with a supportive valuation that reflects near-term operational and balance sheet concerns.

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 with the best risk-adjusted medium- and long-term outcomes.

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