Discovery Flexible Property

Market background

Global financial markets rallied in November, buoyed by growing expectations that the US Federal Reserve (Fed) could change its tough position on interest rates while guiding the economy towards a 'soft landing'. Supporting this notion was the release of key economic indicators out of the US, which pointed to inflation slowing below market expectations and the US labour market showing signs of cooling. In Europe, the European Central Bank (ECB) kept rates on hold, opting to take a cautionary 'wait and see approach' despite inflation in the region starting to moderate. In South Africa, broader risk-on sentiment saw domestic government bonds and equities rally, helping the rand advance against the US dollar. The FTSE/JSE All Share Index closed the month higher, boosted by mining shares which benefited from stronger gold and iron ore prices. Meanwhile, Eskom reinstated Stage 4 loadshedding after a brief respite, with planned maintenance and increased demand expected to cause additional strain on the country's already-debilitated energy system. In other news, SA headline inflation eased to 5.5% year on year (y/y) in November 2023, down from 5.9% in October, and below expectations of 5.6%, while core inflation rose to 4.5% y/y above consensus expectations of 4.4%. The South African Reserve Bank (SARB) kept interest rates unchanged in November, noting that inflationary risks for the country remained elevated.

Performance review

For the month, the portfolio outperformed the benchmark.

Outperformance was not limited to specific sub-sectors, as sentiment improved in line with the global equity markets and contracting yields. Among the largest contributors to relative performance was the portfolio's exposure to both on- and off-benchmark international counters. The portfolio's overweight position in Merlin Properties, the Iberian real estate player, saw meaningful gains, as did the overweight exposure to other off-benchmark international counters, with the likes of Vonovia, Hammerson and Segro contributing to outperformance for the month. Among the largest detractors from relative performance were overweight positions in Burstone Group, Redefine Properties and Emira Property Fund.

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 their COVID lows. Net rental income has remained robust and even stronger than expected in some cases, resulting in reasonably resilient direct property valuations given the circumstances. Sector fundamentals continue to improve, supporting forward-looking earnings, particularly in the retail and industrial sectors. However, even the office sector shows a turning of the tide as vacancies tick steadily downwards. Higher interest rates have impacted the earnings of real estate companies to a degree. The interest rate hedging profiles of most companies have protected them from the worst of the steep rate increase seen across the globe. The negative impacts are now largely in the base. The changing tide in the global and local rates environment therefore bodes well for property. Not only stymieing the negative impacts on earnings and dividends but laying the foundation for future rating changes for the sector.

In our view, the improving fundamentals are further supported by relatively attractive valuations. The sector trades on a forward yield of c.11.4% and a c.25% 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.
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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