Discovery Flexible Property

Market background

The fourth quarter (Q4) of 2023 was a strong period for financial markets, buoyed by the prospect that the US Federal Reserve (Fed) could begin cutting rates in 2024. In the UK, inflation continued to show signs of moderating, while GDP growth edged lower, sparking concerns of a potential recession. Turning to China, sentiment fell on the back of mixed economic data, despite the government announcing various policy support measures to help spur the economy. On the local front, positive global sentiment helped lift South African assets, with additional support coming in the form of Eskom scaling back its loadshedding schedule.

Performance review

For the quarter, the portfolio outperformed its benchmark.

The portfolio's underweight exposure to Fortress Real Estate was among the largest contributors to relative performance over the quarter, as pending corporate action continued to weigh on the company's share price. Also adding value over the period was the portfolio's overweight exposure to off-benchmark offshore counters, Merlin Properties, Vonovia and Simon Property Group, with the broader sector benefitting from a more favourable interest rate outlook and improvements to the macroeconomic environment.

Among the largest detractors from relative performance was the portfolio's underweight position in Lighthouse. Markets reacted favourably to the announcement that the Malta-based investment company would sell a portion of its stake in Hammerson, and rotate the proceeds of the sale towards the acquisition of a shopping centre in Spain. Also weighing on returns for the quarter was the portfolio's overweight exposure to Hyprop. In its most recent trading update, the South African-based REIT revised its forward guidance for FY25 lower by 10 - 15%, largely on the back of the residual impact of higher interest rates.

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, and the rates outlook for 2024 has subsequently been revised lower.

In our view, the changing tide for both global and local interest rates bodes well for the property sector. These improved fundamentals are further supported by relatively attractive valuations. The sector trades on a forward yield of c.10.9% and a c.25% discount to net asset value (NAV). In terms of sector pricing, we are already starting to see the positive impact on credit ratings on the back of potentially lower interest rates. We expect the earnings impact will start to come through in 2024 but should have a more positive impact into 2025.

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.

DISCLAIMER: