Discovery

Discovery Flexible Property

Market background

Global financial markets were broadly negative in October, after stronger-than-expected economic data in the US raised concerns that interest rates would remain higher for longer. This sparked a sharp sell-off across global bond and equity markets.

In the US, preliminary estimates showed the US economy expanded above market expectations for the third quarter (Q3) of 2023, while a sharp uptick in nonfarm payrolls pointed to a tighter labour market. Both manufacturing and services PMI data also came in stronger than expected for September, while retail sales continued to advance, underscoring the resilience of the US consumer despite higher prices and rising borrowing costs.

Although the UK's economic recovery has been significantly less robust compared to that of the US, monthly GDP numbers for August pointed to positive growth, in line with market expectations and outpacing the contraction recorded in July. Market participants consequently began pricing in the likelihood that the Bank of England would keep interest rates at elevated levels in November, placing additional pressure on equity markets. Meanwhile, in the Euro Area, the now-familiar narrative of lower growth and stubbornly high inflation continued its momentum into the month. Against this backdrop, the European Central Bank maintained its key interest rate in October, opting for a 'wait-and-see' approach as it attempts to rein in inflation without pushing the already fragile economy into recession.

Arguably the biggest news out of China in October was the announcement that the government would issue 1 trillion yuan in supplementary bonds for disaster relief and infrastructure enhancements. Other positive news came in the form of the country's Q3 GDP numbers, which showed the economy advancing above consensus forecasts for the quarter, largely driven by the raft of monetary stimulus measures over the past three months.

South African equities tracked their global peers lower, with some support coming in the form of stronger precious metals prices, particularly gold, but this was not enough to offset the broader risk-off

sentiment. Domestically, concerns over the country's fiscal outlook continued to weigh on investors, as did comments from the South African Reserve Bank Governor Lesetja Kganyago, who noted that local interest rates were likely to remain higher for longer to help curb inflationary pressure.

Performance review

For the quarter, the portfolio performed marginally underperformed its benchmark.

Among the largest detractors over the month were overweight positions in Hammerson and Vonovia, as rising treasury yields in Europe and the UK placed pressure on property counters with exposure to those regions. The portfolio's overweight exposure to Nepi Rockastle also weighed on performance, after the share price fell on the back of potential corporate action that would essentially see additional Nepi Rockastle shares enter the market. Despite the short-term noise, we are still constructive on the counter and believe that current valuations present us with a compelling investment opportunity.

Among the largest contributors to performance over the month was the portfolio's overweight position in American Tower. The stock benefitted from a stronger US dollar relative to the rand, in addition to the release of strong financial results and promising updates for its core businesses. Domestically, overweight exposure to Redefine and SA Corporate also added value, as property investors sought relative stability in a rising yield environment. Both companies have produced strong results of late, and are currently offering investors dividend yields in excess of 12%.

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. 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. Base effects of the direct costs, diesel and otherwise, are now in the base. Loadshedding therefore should have muted impacts on growth expectations looking forward, assuming the recent historical loadshedding experience prevails.

In our view, the improving fundamentals are further supported by relatively attractive valuations. The sector trades on a forward yield of c.11.9% and a c.30% 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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