Discovery Flexible Property

Market background

The optimistic sentiment that characterised the second quarter of 2023, leading to a favourable climate for riskier assets, dissipated over the following three months. Investors had hoped that the pace of rate hikes would gradually decrease and eventually cease by year-end. However, persistently high inflation rates, stable employment figures, and still 'above-trend' economic growth forced the market to accept that the US Federal Reserve is likely to raise rates in November and will maintain higher interest rates through 2024.

The third quarter was negative for most asset classes, both in South Africa and globally. While September was particularly challenging amid sticky inflation in the US, UK and Europe, recession fears and the prospect of higher rates for longer. Investors are contemplating US 10-year rates of 5% or higher, and oil prices – which jumped 28% in the quarter – now anticipated to pass US$100/barrel. In China, further signals of a slowdown in economic activity continue to weigh on investor sentiment.

For the quarter, emerging markets outperformed developed markets, with the MSCI Emerging Market Index returning -2.9% and the MSCI World Index delivering -3.5% (both in USD).

In South Africa, investors remain concerned about holes in the nation's budget, which the central bank said will force local rates to remain elevated for some time to come. The country's budgetary problems have less to do with overspending and more to do with declining revenue collection. Turgid economic growth, lower commodity prices and declining exports of coal and iron ore due to infrastructure deficits have all contributed to the country's looming fiscal crunch. All eyes will be on the October mini-budget (1 November) for clues as to how this will be resolved – higher taxes or spending cuts.

Performance review

For the quarter, the portfolio performed broadly in line with its benchmark.

Both global and local counters contributed to relative outperformance over the quarter. On the local front, the portfolio's significant underweight position in Growthpoint Properties added to relative performance. Growthpoint's share price declined over the period after the company dramatically lowered its revised guidance for the 2024 financial year to a range of negative 10–15%. The portfolio's overweight position in SA Corporate Real Estate, another South African diversified property REIT, also added to relative performance. SA Corporate benefitted on the back of guided forward earnings which came in ahead of market expectations.

The portfolio's international counters told a similar diverging tale in terms of their contributions to positive relative performance. Adding value over the period was the portfolio's overweight exposure to off-benchmark German residential play, Vonovia, which benefitted from the structural undersupply of housing in the German market. Meanwhile, the portfolio's underweight exposure to Lighthouse Properties also added to relative returns. The company took a knock on the back of poorer fundamental property performance of its French retail assets, alongside suppressed cash-backed earnings due to lower pay-out ratios from investee companies.

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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