Discovery Flexible Property

Market background

Global financial markets were broadly negative in August, driven lower by the possibility of further interest rate hikes in the US and continued signs of sluggish economic growth out of China. Developed markets outperformed emerging markets for the month, with the MSCI World Index delivering -2.4% and the MSCI Emerging Markets Index producing -6.2%.

In terms of key global events, the US Treasury announced that it would increase the size of its quarterly bond sales to help finance its growing budget deficit, triggering a global sell-off across bond and equity markets. Further weighing on market sentiment was the prospect of more interest-rate hikes, after minutes from the US Federal Reserve's (Fed's) July meeting highlighted the potential need for further policy tightening to curb inflationary pressure. Towards the end of the month, softer US economic growth and labour-market data raised hopes that the Fed could pause its rate-hiking cycle for the remainder of the year. However, the bounce in sentiment was insufficient to offset losses from earlier in the month. Turning to China, further signs of a slowdown in economic activity weighed on investor sentiment. The government offered some reprieve over the month in the form of various support measures, aimed at lifting investor confidence and boosting economic growth.

In South Africa, domestic equities tracked their international counterparts lower to close the month in the red, with a weaker rand further weighing on investor sentiment. The All Property Index (+0.8%) was among the standout performers, producing positive growth over the period, albeit from depressed valuations. Rising bond yields and the prospect of 'higher rates for longer' served as a tailwind for the sector.

Performance review

For the month, the portfolio outperformed the benchmark.

Among the largest contributors to relative performance for the month were underweight positions in Resilient REIT and Lighthouse Properties. Resilient's share price fell on the back of poorer financial results, partially due to a lack of income distribution from underlying holdings in Hammerson plc and Lighthouse, as well as the lagged benefits of having increased its renewable energy capacity within the portfolio. The combination of these factors resulted in negative income distribution growth over the period, which is likely to detract from future income distributions going forward. The company is only expected to return to a reasonable level of income distribution in the next 12 -24 months.

Meanwhile, Lighthouse's performance fell as the recovery within its French portfolio was below expectations. Further weighing on the company's performance was the lower investment payout from its underlying holdings in Hammerson, which contributed to the distributable income per share falling considerably lower, with the implied guidance for the next 12 months showing further deterioration.

The portfolio's underweight position in Growthpoint Properties was another contributor to relative performance for the month. The company's Australian business has historically been a major growth vector for the group, however, the compound effect of rising interest rates within the region has started to negatively impact the company's earnings outlook. In its latest annual report, the Australian business guided to double-digit declines in its funds from operations (FFO) and income distributions for the 2024 financial year.

Our overweight in NEPI Rockcastle was another contributor to relative performance in August. The region in which the company operates has shown good growth in terms of retail demand and spend, which has been largely driven by strong turnover ahead of inflation. In addition, the company has been able to transfer the cost of inflation to tenants, while still keeping affordability intact. The company recently announced better-than-expected financial results, reflecting excellent revenue growth and a healthy dividend payout to shareholders.

Among the largest detractors from relative performance in August was the portfolio's underweight position in Fortress Real Estate. Fortress is a stock that we actively do not hold in the portfolio due to a range of associated uncertainties. The company has been overshadowed by news of a potential corporate action regarding the collapse of its dual-shareholding structure, which will consequently impact the distribution of future income. In addition, the company is trading at a significant premium relative to the rest of the sector when taking both A and B share classes into account, all of which make it very difficult to make a fundamental case for owning the stock.

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.11.5% (c.12.4% 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.

Disclaimer: