Discovery Flexible Property

Market background

Financial markets continued to strengthen in the second quarter of 2021, although market tension between inflation expectations and economic recovery was a source of volatility. While value continued to dominate the quarter, growth stocks staged a recovery late in the quarter and concerns around the impact of the highly transmissible Delta variant created some market angst.

Global equites consolidated gains in June, with developed markets (MSCI World Index, +7.9%) outperforming emerging market stocks (MSCI Emerging markets Index, +5.1%). Regionally, US equities benchmarked by the S&P 500 Index gained a further 8.5% over the quarter and capped their best first half performance since 1998. Bond markets (as measured by Barclays Bloomberg Global Aggregate Bond Index) ended the quarter in positive territory 1.3% higher, although inflation concerns appeared to weigh on the market.

The US economy continued recover with purchasing managers indices (PMIs) rising to record levels during the quarter, while CPI inflation reached a 13-month high 5% in May. The US Federal Reserve (Fed) continued to view inflation as transitory and while there were no policy changes over the period, the Fed's 'dot plot' (which notes individual member projections for interest rates) showed members now expecting the first interest hike in 2022 and two hikes in 2023 (previously none).

The vaccine rollout in Europe got off to a relatively slow start but quickly narrowed the gap on the US over the quarter. This has brought along improved economic data as leisure and travel activity resumes across the continent. Growth expectations for the euro zone have also improved, with the European Central Bank (ECB) raising its growth forecast for the region to 4.6% this year. GDP in the UK also beat consensus in April, printing 2.3% ahead of expectations of 2.2%.

China’s recent economic indicators showed a more stabilised outlook for the Chinese economy with official manufacturing PMIs largely stable at 50.9 in May. New orders shrank for the first time in four months as the global demand benefits of being the first economy to open post lockdowns began to wane. Although growth is likely to continue throughout the year, expectations are that it will gradually ease.

The South African economy grew by an annualized 4.6% over the first quarter. However, sentiment ebbed in June as tighter lockdown restrictions were implemented for an initial two weeks starting 27 June 2021. South Africa finds itself in the midst of a third wave of COVID infections and the current lockdown will likely impact that rate of recovery in the third quarter this year.

Although June saw a break in the 7-month winning streak for the local stock market, the first half performance has been the best since 2007 for SA equites. The FSTE/JSE All Share and Capped SWIX indices ended the quarter 0.1% and 0.6% higher, respectively. At the super-sector level, financial services were the best of the bunch, closing 7.9% higher, while industrials managed to eke out +0.7%. Resources had a tough period ending 5% lower. Local bonds managed to outperform their equity peers as more supportive domestic and global conditions allowed yields to drift lower (yields fall as prices rise). Listed property was the best-performing asset class over the month, with the JSE All Property Index rallying 11.5% over the quarter, although experiencing a small wobble mid quarter. Cash, as measured by the STeFI Composite Index, remained broadly stable at 0.3% for the month. In currencies, the rand firmed against the US dollar, euro and pound sterling over the quarter.

Performance review

For the quarter, the Fund underperformed the benchmark.

The quarter saw a strong recovery in the local property sector, driven by risk on sentiment and a relative return to normalcy in the real estate space. This was further aided by a better-than-expected results season, where dividends have largely been reinstated at more sustainable levels.

Although the Fund has been well positioned to benefit from this trend, a stronger rand and exposure to select quality offshore counters detracted from performance over the period. This includes the likes of Vonovia, a high-growth German and continental European residential Fund which continues to benefit from a strong German economy and structural trends within the German residential space.

Portfolio activity

The value rotation we have experienced since November last year continues to run its course, with the gap between the COVID winners and losers continuing to close. As such, we have continued to seek out counters offering the right combination of reasonable value, sustainable earnings, and growth. During the period we continued to add to our preferred mid-cap section of the sector, increasing exposure to the likes of SA Corporate Real Estate and Emira Property Fund.

We continue to support a selective group of large and mid-cap South Africa-focused companies with attractive combinations of yield and sustainable growth, supported by solid fundamentals and track records. These include Investec Property Fund and Attacq.

Outlook and strategy

The Listed Property sector has shown the first signs of recovery in 2021. The pandemic created an unprecedented environment, particularly for real estate markets where buildings were under enforced government shutdowns. However, data is beginning to emerge that the outcome post COVID is not as bad as initially expected, however, there will be a lasting impact on the economy and therefore the sector. A level of normalcy has returned to rental collections, whilst certain tenant categories, specifically restaurants and entertainment remain under pressure. As the lasting economic impacts of the forced shutdown takes hold, demand will be subdued across most occupational markets and will result in muted rental growth prospects. Thus far, vacancies have been well-contained but at the cost of rental declines and higher levels of concessions. These concessions continue to slow and are expected to be largely insignificant over the next 12 months.

In our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward yield of +9% (10.5% for SA only) and a c.30% discount to net asset value (NAV). While dividend yields are likely to be lower due to reduced pay-out ratios in favour of liquidity and balance sheet support, they are now also likely to be more sustainable and in line with international best practice. On a sustainable earnings basis, like-for-like rental growth is forecast to be below inflation for the next two to three years, while deleveraging will further dampen growth prospects.

We believe the sector offers attractive value over a medium- to long-term horizon, primarily underpinned by a more sustainable yield, together with the prospect of the sector re-rating as dividends become more regular and balance sheet structures are corrected. While near-term volatility is likely to persist given current macro conditions, over the medium term, we remain constructive of a return to earnings and distribution growth off a sustainable income base as the economy recovers.

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’ portfolios with the best risk-adjusted medium- and long-term outcomes.

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