Discovery Invest

The formula for successful investing

Discovery Flexible Property Fund update

Avoiding the pitfalls of investing in a more uncertain environment

November 2017 will mark the 10th anniversary of the Discovery Flexible Property Fund managing speciality listed property assets. The South African-listed property market has changed substantially since the turn of the century, moving from a combined market cap of less than R15 billion in 2001 to nearly half a trillion rand today, as represented by the SA Listed Property Index. We have also seen significant specialisation within the industry, coupled with increased geographic diversification. Since inception, we have delivered returns of 14.6% per year for investors, 2.3% per year ahead of the average return delivered by peer group funds. Expressed in rands, R1 million invested at inception would have grown to R3.7 million as at 30 June 2017, which is about R600 000 more than the average amount earned by peer group funds.

As the sector has grown, the team's skill set, investment strategy and risk processes have been improved to meet the greater needs of the market. A dedicated, well-resourced real estate team based in both South Africa and the United Kingdom analyses the sector, with its broader geographic footprint. The team has a complementary skill set that includes deep experience in listed and direct property, and environmental, social and governance (ESG) expertise.

Thorough risk management is the catalyst for continued relative outperformance on a risk-adjusted basis

Risk controls are often underappreciated by investors until they really count. Strong controls have been built into our investment process and these are complemented by a dedicated risk team that services our broader investment platform. Significant time is spent examining how we manage risk. Identifying these risks, and pricing them accordingly, is at the essence of what we aim to achieve.

The analysis of risk not only helps us to avoid stocks delivering negative surprises, but also aids in the discovery of attractive investment opportunities where the risks are more than discounted by the market.

Although unusual, we have chosen to highlight two companies we don't own, as these investment decisions are often underappreciated. On the other hand, as the variance in return potential increases, we have identified a number of companies that exhibit significant upside from current levels. Among the locally oriented names, Vukile Property Fund is a great example of a company offering a more focused and appealing strategy, an above-average yield, accelerating growth prospects, and below-average balance sheet risk. We believe the company provides investors with the prospect of a material rerating and outperformance going forward.

Similarly, MAS Real Estate is, in our view, an offshore name exhibiting an attractive risk-reward profile. Through its joint venture with Prime Kapital and its highly experienced, on-the-ground management team, it is best placed to understand the regional risks and opportunities of the Eastern European markets in which it operates. MAS's medium-term growth prospects are among the highest in the sector (a compound annual growth rate of c.30% over the next three years). Its premium to net asset value is half that of its regional peers (for example, NEPI Rockcastle), and its balance sheet provides plenty of scope for value-adding expansion going forward.

Overall, we believe that a well-defined and comprehensive risk process can successfully differentiate the sector winners from the rest of the pack. This gives us confidence that we can continue to build on our strong long-term track record of risk-adjusted outperformance within the listed real estate sector. As has been the case in the past, it also remains our intention to use the fund's flexible mandate whenever opportunities present themselves to drive returns.

Separating the winners from the losers in a more uncertain environment

We believe the above-mentioned attributes are essential in current market conditions. While it could be argued that the domestic and, in some cases, global real estate backdrop has become more challenging of late, we are encouraged by the continued flow of good investment opportunities we see within the locally listed real estate sector. So much so that we believe this is an environment in which active stock pickers can add significant value.

Critical to the execution of this value-add, is the existence of an effective and thorough investment risk process. Specifically, when assessing stock risks, a carefully constructed and repeatable framework is key in avoiding what could amount to large pitfalls in the current volatile economic and political climate.

Although we continue to see attractive returns from the sector, we believe there will be an increasing discrepancy between the winners and losers.

It is often the companies a fund manager chooses not to invest in that make a real difference. As an illustration, we outline two companies in the broader local real estate sector where our investment process has highlighted substantial risk for investors. As a consequence, we have avoided investing in these companies at this time, given our continued focus on downside protection.

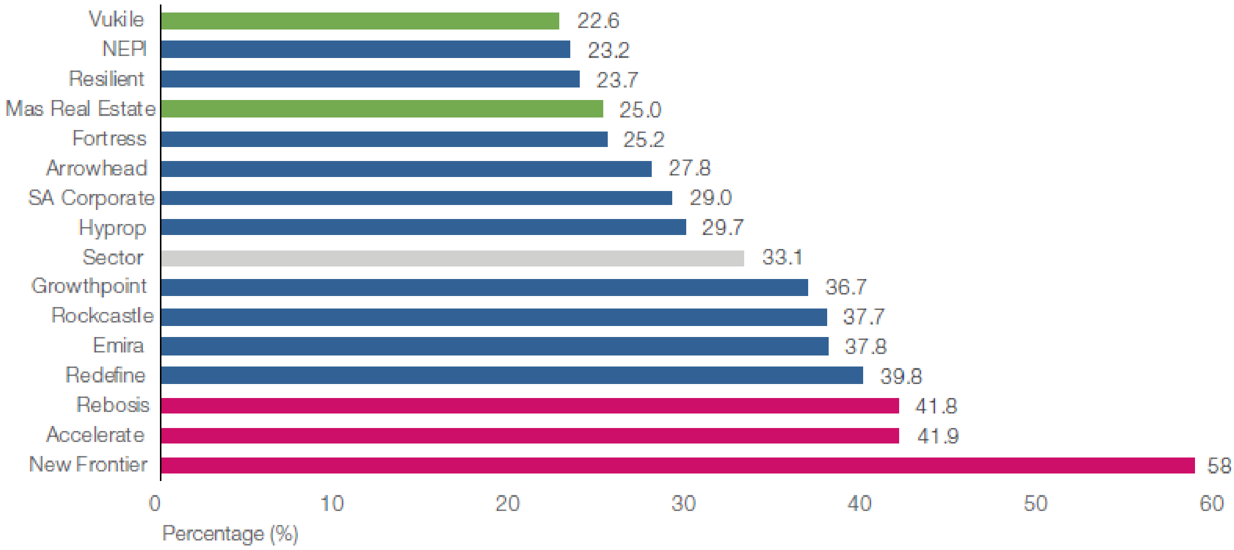
New Frontier Properties (listed subsidiary of Rebosis)

New Frontier Properties is a UK-based, highly illiquid and retail-focused counter. Because New Frontier Properties is a listed subsidiary of Rebosis (67.5% shareholding), we are concerned that they might have substantial implications for the parent company as well.

New Frontier Properties was listed in 2015 and currently owns three UK town malls valued at £273 million. Since entering the UK, the portfolio has come under pressure from both broad macro issues – such as Brexit – and sector-specific factors. These include high online retail penetration and increased competition in surrounding catchment areas, which has led to weakness in the retail sector.

New Frontier Properties' balance sheet is over-leveraged, as illustrated by its loan-to-value (LTV) ratio of nearly 60%. This gearing level is the highest in our investment universe. This was also the case with the broader UK real estate sector in 2008, which raises concerns around potential debt covenant breaches. This is especially relevant in the current environment where asset prices have the potential to fall. Rebosis is also highly geared (42% LTV with see-through gearing of 51%) and hence has a limited ability to provide equity if required by New Frontier Properties' debt capital providers. Ultimately, it is not impossible that the onus could fall on Rebosis shareholders to inject the necessary funds.

Figure 1: Loan to value % (last reported)



Source: Company financials and Investec Asset Management estimates at 01.07.17.

Accelerate Property Fund

Accelerate Property Fund is a nodal-focused, multi-sector portfolio that listed on the JSE in December 2013. It emerged from the broader asset base of the Georgiou family who has traditionally had a strong development orientation within their corporate culture. For most of its listed history, Accelerate Property Fund only had exposure to South Africa, but recently it ventured into Western Europe.

Locally, redevelopment aspirations induced the recent acquisitions of the offices occupied by Citigroup and Murray & Roberts in Sandton, Johannesburg and Foreshore, Cape Town respectively. This, along with its offshore venture, worsened what was already an elevated level of balance sheet risk to the point now where it is a material outlier (42% LTV) in the domestic real estate sector. More concerning is that further capital will be required for the development of the Fourways Mall during 2018. This means equity capital will have to be raised in future – this is likely to be value destructive given that Accelerate Property Fund's cost of capital is likely to exceed the return on that capital.

Accelerate Property Fund's share price decline could be compounded further by its possible exclusion from the South African Property Index before year-end.

Disclaimer:
The above fund update is solely the opinion of the asset managers based on their research conducted. Nothing contained herein should be construed as financial advice and it is meant for information purposes only.

What to know before investing in collective investment schemes (unit trusts)

What the investment is

This Fund is a Collective Investment Scheme (also known as a unit trust fund) regulated by the Collective Investment Schemes Control Act, 45 of 2002 (CISCA). Collective investment schemes in securities are generally medium- to long-term investments (around three to five years).

Who manages the investment

Discovery Life Collective Investments (Pty) Ltd, branded as Discovery Invest, is the manager of the Fund. Discovery Invest is a member of the Association of Savings and Investment South Africa (ASISA).

You decide about the suitability of this investment for your needs

By investing in this Fund, you confirm that:

- We did not provide you with any financial and investment advice about this investment
- You have taken particular care to consider whether this investment is suitable for your own needs, personal investment objectives and financial situation.

You understand that your investment may go up or down

- The value of units (known as participatory interests) may go down as well as up.
- Past performance is not necessarily an indication of future performance.
- Exchange rates may fluctuate, causing the value of investments with international exposure to go up or down.
- The capital value and investment returns of your portfolio may go up or down. We do not provide any guarantees about the capital or the returns of a portfolio.

How we calculate the unit prices and value the portfolios

1. We calculate unit trust prices on a net-asset value basis. (The net asset value is defined as the total market value of all assets in the unit portfolio, including any income accrued and less any allowable deductions from the portfolio, divided by the number of units in issue.)
2. The securities in collective investment schemes are traded at ruling prices using forward pricing. (Forward pricing means pricing all buy and sell orders of units according to the next net-asset value).

3. We value all portfolios every business day at 16:00, except on the last business day of the month when we value the portfolios at 17:00.
4. For the money market portfolio, the price of each unit is aimed at a constant value. This means that all returns are provided in the form of a distribution and that a change in the capital value will be an exception and only due to abnormal losses.
5. Buy and sell orders will receive the same price for that day if we receive them before 11:00 for the money market portfolio and before 14:00for the other portfolios.
6. We publish fund prices every business day, with a three-day lag, on www.discovery.co.za

About managing the portfolio

1. The portfolio manager may borrow up to 10% of the portfolio’s market value from any appropriate financial institution in order to bridge insufficient liquidity.
2. The portfolio manager can borrow and lend scrip.
3. The portfolio may be closed in order to be managed according to the mandate (if applicable).

Fees and charges for this investment

There are fees and other charges for this investment.
The fees and charges that apply to this investment are included in the net asset value of the units and you do not have to pay any extra amounts. These fees and charges may include:

- The initial fund management fee
- Commission
- Incentives (if applicable)
- Brokerage fees
- Market securities tax
- Auditor fees
- Bank charges
- Trustee fees
- Custodian fees

You can ask us for a schedule of fees, charges and maximum commissions.

The total expense ratio

1. Total expense ratio means a measure of a portfolio's assets that have been expended as payment for services rendered in the management of the portfolio or collective investment scheme, expressed as a percentage of the average daily value of the portfolio or collective investment scheme calculated over a period of a financial year by the manager of the portfolio or collective investment scheme.

2. A percentage of the net asset value of the portfolio is for fees and other charges relating to managing the portfolio. The percentage is referred to as the total expense ratio (TER).
3. A higher TER does not necessarily imply poor return, nor does a low TER imply good return.
4. The current TER is not an indication of any future TERs. If fees go up, the TER is also expected to increase.
5. During any phase-in period, the TERs do not include information gathered over a full year.

Transaction cost

1. Investors and advisers can use transaction cost (TC) as a measure to work out the costs they will incur in buying and selling the underlying assets of a portfolio.
2. The transaction cost is expressed as a percentage of the daily net asset value of the portfolio calculated over three years on an annualised basis. (This means the amount of interest an investment earns each year on average over three years, expressed as a percentage.)
3. Transaction cost is a necessary costs in administering the Fund. It affects the Fund's returns. It should not be considered in isolation as returns may also be affected by many other factors over time, including:
    - Market returns
    - The type of fund
    - The investment decisions of the investment manager
    - The TER.
4. Where a fund is less than one year old, the TER and transaction cost cannot be calculated accurately. This is because:
    - The life span of the fund is short
    - Calculations are based on actual data where possible and best estimates where actual data is not available.
5. The TER and the TC shown on the fund sheet are the latest available figures.