NIMBLE WISDOM MONTHLY

Retail's perfect storm / April 2017

SESFIKILE CAPITAL
Listed Property Investments

MARKET OVERVIEW

The SA Listed Property Sector ("SAPY") finished the month up +0.51%, largely buoyed by positive emerging market sentiment as we saw improvements in the rand as well as the local bond yields. This came despite the recent ratings downgrades and the resultant, impending headwinds across the economy. We think the recent strength is probably a bit too ambitious considering the level of uncertainty and lack of confidence from corporate South Africa. With that said, the SAPY was by no means the star performer as Bonds and Equities returned +1.47% and +3.38% respectively. The bond market was similarly assisted by positive emerging market sentiment coupled with an attractive nominal yield, however as South African sovereign start to exit several investors' mandates (as they lose their investment grade status) there is likely to be some short-term pressure on the asset class. Equities on the other hand benefitted from strong resource prices and a recovery in the banks.

The relative calm in the market, in the month post 'Gordhan gate' has given rise to some interesting questions that have come our way. Obviously downgrades from Fitch and S&P, a pullback in the rand and a spike in bond yields is not calm; but a lot more subdued relative to what many market commentators were expecting. With this people are asking what all the fuss is about. And should we really care about the opinions of a grouping of rating agencies? The answer is that there should be a great fuss; just because the surface wound may not be as bad as one may have expected, doesn't mean the underlying damage isn't significant. The rating agencies are essentially a directory for foreign investors looking to allocate capital, and when you're effectively pushed down the pecking order, the likelihood of receiving the much-desired foreign direct investment diminishes. This dangerous cocktail of reduced offshore investment and a loss of local investor confidence results in a drop off in business activity, further job losses and weak GDP growth. So, while the immediate impact may have been slightly better than expected, the expectation is that the economy could be stuck in a period of protracted weakness.

RETAIL UNDER PRESSURE

We believe that 2017 will be a much more challenging retail environment where for the first time in a long time we will likely see an acceleration in store closures. The Edcon group is expected to rationalize its footprint by closing underperforming brands and right-sizing larger format Edgars stores. Stand-alone foreign brands like Mango, Nine West and River Island are expected to leave the country all together while Stuttafords remains on a knife's edge. At the heart of this is a simple supply / demand mismatch were super-regional and regional shopping centres have seen a lot of space added in a weak economy.

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In 2016, the Gauteng market saw the opening of Mall of Africa (+120 000m2), Centurion and Menlyn Mall expanding and Mall of the South cannibalise competing centres such as The Glen. We are also of the view that malls have been built too big (we simply don't have enough retailers to fill these Malls), and will see vacancies rise from the current 5% level. As per recent IPD figures, growth in trading densities have decelerated to around 5.3% overall, with larger centres being the laggards, showing 0.3% to 3% growth.

We have spent some time traversing the country's malls and have noticed a spike in vacancies and opportunistic tenancies. On randomly speaking to those working in stores, our views were confirmed. One common response was "if you're not on sale, no one is coming into your store". We still believe that the dominant super regional centres will come through in time as markets normalise, however in the short term the lower LSM, less discretionary offerings should fare better. So while we have been in favour of retail in recent years, we think that there will be some short-term headwinds in the sector.

RECENT RESULTS

Only one company, Rebosis, reported results in April. We provide a summary of the result below.

COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Rebosis	60.8	7.1%	First half distribution growth settled at the lower end of the 7 – 9% guidance. On face value trading was robust; the retail portfolio saw 6% reversions on renewals on a 88% success rate of renewal with trading densities up 6%. Vacancies across the portfolio were also down from 3.1% to 2.4%, however this was somewhat misleading considering the two new assets were viewed as fully let as a result of the rental guarantee. A big focus of the result was the corporate activity over the last twelve months. The Acquisition of Forrest Hill City and Baywest Mall assisted in upping the retail exposure, however we are sceptical of the price paid in relation to their relatively poor cost of capital and believe future earnings will be under pressure as a result. In addition the conclusion of the Ascension acquisition with the launch of the Rebosis A unit is also somewhat questionable as the effectively acquired more office and created an A-unit which at issue price is a very inefficient source of capital. The offshore position in New Frontier was somewhat disappointing, which could be attributed to Brexit. The operating environment was tough and significant work was done to keep the distribution flat. The balance sheet was put under pressure through the acquisition as the LTV pushed from 33.7% to 41.8%. Although management has indicated that they have lined up a significant office disposal to reduce gearing. The hedging on the cost of debt has also improved 100% hedged for an average 4.3 years. Management are still holding onto the 7 – 9% guidance, however we are somewhat more cautious considering the weakness in the retail environment at present coupled with high levels of competition in their respective markets.

LOOKING FORWARD

While this prognosis appears negative, we must still highlight two important factors around our investment universe. Firstly, the benchmark has evolved, similar to general equity, where we expect over 50% of the underlying property exposure to be offshore; with the prospects of several of the underlying opportunities being attractive. The second feature is the valuation of the local stocks; while growth is a concern, the valuations are not demanding. We do believe that short term pricing will be volatile and the sector is likely to be contained at low single digit returns; but as we rebase our bond market and get some sense of political stability we think we can break into low double digit returns into the medium to long term.

One thing we tend to forget is that property as an asset class operates within the wider local and global economy and while we tend to be quite objective on absolute valuations, we often forget the relative valuation. Several of the drawbacks we highlight often impact bonds and specific equities to the same if not a higher degree. And with this we see cash flows chasing property on a relative basis and supporting prices. In addition, let us not minimize the importance of cash flow. With an attractive initial yield supported by growth (albeit weaker in the current setting) property pays you to wait as you move through the cycle.

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