NIMBLE WISDOM MONTHLY

The simple matter of an election... / November 2017

SESFIKILE CAPITAL
Listed Property Investments

MARKET OVERVIEW

The SA Listed Property Sector ("SAPY") had its ninth straight positive month in November, largely brushing off a dismal budget speech the month before and a subsequent downgrade of our local sovereign debt to sub-investment grade by Standard & Poors. One argument was that a double downgrade was expected (from Moodys as well), so the strength was a bit of a sigh of relief. The SAPY delivered a total return of +1.92% for November with Equities and Bonds trailing at +1.46% and -0.97% respectively. The relative performance between property and bonds illustrates the further re-rating of property, which was largely as a result of the offshore element entrenched in the sector.

December is usually a relatively quiet month, with the exception of a spike in volumes into the closing auction as fund managers do their final preparations to align their funds for the year ahead. While the global markets may experience a lull in activity as market participants take to their holidays, at home, we sit at a crossroads once again where the ANC (and by inference the country) will be electing a new president. While the race appears to be running neck and neck, the respective implications of the two potential outcomes are worlds apart. One being market friendly, while the other almost certainly leading to further ratings downgrades, significant currency weakness and a spike in bond yields.

RECENT RESULTS

November saw several companies reporting and on average we saw tough operating activity and a deterioration in the quality of earnings. However, in the short term this truly pales in significance to the election at hand, which will dictate whether investors truly have a Merry Christmas. We summaries the recent results below:

COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Redefine	92.0	7.0%	Operationally the local results were robust in light of the tough environment, however the greater earnings base still has a significant amount of lower quality, 'once-off' items, which should be noted in a fair yield comparison with their peers. SA operations saw like-for-like NPI up 4.1% held back by softer reversions at 4.1% coupled with a 0.4% expansion in vacancies pushing out to 7.8%, with office the only sector seeing an improvement. The retention ratio was impressive at 92.6% which is a sign that their focus on defending their current tenancies is working, albeit at a cost. The offshore operations (which now contribute 27.3% of distributions) were substantially stronger than the local business, however not quite as 'clean'. There were tailwinds from a R285 million foreign exchange gain as well as R78 million in fees, however the counter to this was the fee in the base coupled with RDI restating their dividend policy (19% lower) and a stronger Rand. Redefine has had a history of non-core revenue streams in their numbers, which we believe the market prices into to their discount relative to comparative peers. The balance sheet is relatively stretched with an LTV of 41.1% (pushing higher on the back of a weaker Net Asset Value) of which 88.7% is hedged for an average 2.7 years. On a look through basis this pushes to the 50% level considering the listed positions held. We are also cognisant of the bias of gearing on the offshore assets

			which has the benefit of lower rates, but creates an element of risk in matching the debt to assets in the same currency. Redefine has been actively enhancing their portfolio through R11.2 billion of acquisitions (dominated by the Pivotal transaction R10.7 billion) and R1.7 billion in disposals. They completed R3.1 billion in developments, are active in a further R5.3 billion and have R3.0 billion in further commitments. The most interesting deal was how they managed to exit their Delta holding through extending a loan to fund the transaction to an empowerment consortium, and mange to avoid distribution dilution. The concern is that there is still counterparty risk on an asset base which has some problems of their own. Management have guided 2018 distribution growth of 5 – 6%, which if achieved will be a strong result, and will need to find another significant once-off transaction to facilitate the result.
Investec Property	61.0	12.2%	Investec delivered a solid result with distributions up 12.2% year on year, however the normalised number (excluding antecedent dividends from Investec Australia) was 7.2%. Operationally the numbers softened slightly, but were more than acceptable. Net Property Income was up 6.1% year-on year supported by escalations at 7.6%, while reversions came in at 2.4% and a higher cost ratio pulled the number back. Note that the cost ratio will be under a bit of pressure as the asset management costs on the Zenprop acquisition begin to be charged from the 2018 financial year and escalate toward the 0.5% level in 2021. Vacancies shifted out slightly from 1.4% to 2.6%, however post balance sheet lettings have already brought this number back to 1.6%. Loan to value sits at 35.2% with very little refinancing in the short term; 92% of the debt is also hedged for a decent term of 4.1 years. The effective gearing on the offshore portfolio through cross currency swaps is 44%, which is not too dramatic a difference to how they fund local operations. The offshore has now expanded to the UK, albeit relatively small at the moment. We expect this to grow in a relatively short space of time as management have explicitly stated that they are happy to move from the current 7.8% offshore exposure towards 20%. Investec Australia has been a bit of a drag on earnings as the rand was stronger over the period and the tax shield within Investec Australia reduced. However, both offshore ventures have quality tenancies, relatively long lease expiry profiles and management teams on the ground with a strong alignment to the group. Full year normalised guidance is 7 – 8%, which in the current market and considering the nature of the earnings profile, is exceptionally strong.
Investec Australia Property	AUD 4.95c pre withholding tax AUD 4.64c post withholding tax	3% - pre withholding tax 0% - post withholding tax	The post withholding tax growth was disappointing as the tax shield starts to erode, however operationally management is doing well as we see them more active as the WALE (weighted average lease expiry) comes in. Vacancies sit slightly higher, but still very low at 1.6%. The WALE is still at a healthy 4.6 years with management pre-empting future expiries with signed heads of agreement for 8% of the portfolio as far forward as 2021. Also positive is that near term expiries are concentrated in the booming state of NSW. On the long WALE also stands an in-force escalation of 3.4%. The quality of the portfolio was assisted by the post balance sheet acquisition of The Majestic Centre (office tower) in Wellington New Zealand at a yield of 7.1% on a WALE of 6.6 years for NZD123 million. The asset is considered blue chip and management believe that it to be under rented. A AUD22 million industrial precinct in Victoria was also acquired with a WALE of 7.8 years, further adding to the defensive nature of the portfolio. The gearing has pushed higher to 33.8%, but is still relatively prudent especially considering the 88% hedge for a lengthy 7.2 years. Management have guided 3 - 4% pre-withholding tax distribution growth; however, we are more focused on the post withholding tax number and where the relative tax rate settles.

Arrowhead	87.5	6.0%	Arrowhead achieved the bottom end of their guidance for the year, however the 2018 guidance shocked the marked going negative 6.5%. Operationally the portfolio was caught in the economic headwinds as vacancies spiked from 7.8% to 12.1%, pulling the like-for-like net property income down to 1.5%, however on average escalations were still above 8%, while reversions were 5% positive. The physical portfolio is now only 47% of earnings, with the balance in the four listed holdings. The controlled holdings in Gemgrow and Indlu Place contribute 22% and 21% respectively; and expect their distributions to grow 7 - 9% for Gemgrow and 4 – 7% for Indlu Place. While these are respectable figures we question why they will not be faced with similar headwinds as Arrowhead has been subjected to. The passive holdings in Rebosis (10% of earnings) and Dipula (1% of earnings) are also under pressure and expect around 5% growth as a whole; we suspect Arrowhead is actively looking for a means to unwind their passive stakes. At an LTV of 28.2% the balance sheet isn't stretched, however at a group level it edges a bit higher to 31.5% of which 69% is fixed. The debt expiry profile is short and it will be interesting to assess the ease and term of refinancing. The 2017 distribution met guidance purely as a result of once-off earnings including underwriting fees and dividend stripping. Management has disclosed that they will no longer distribute these non-core earnings and have thus guided the distributions off the current inflated base will be negative 6.5%.
Vukile	72.7	7.4%	Vukile managed a strong interim number with the local fund largely repositioned towards their favoured retail sector (91% of local assets) and now pushing ahead with their global strategy into the UK and Spain. The local portfolio had relatively strong like-for-like net property income growth of 6.1% as renewals came in at 5.4%, while in-force escalations settled at 7.3%. Further contributing to the strong trading number was the 0.5% compression in vacancies to 3.7% (based on rent) and a stable cost to income ratio. The growth in trading densities was at 3.4%, trading ahead of the national average, with an undemanding rent to sales ratio of 5.9%. And while the focus of the period appears to be on the offshore expansion, R837 million was spent on further enhancing the portfolio across four separate assets at a combined yield of just over 8%. The offshore component at balance sheet date was 24% of total assets. The UK strategy, through Atlantic Leaf, grew by R407 million through a capital raise to acquire an accretive portfolio. UK is approximately 6% of total assets. Most of the action took place in Spain with the initial allocation to Castellana and the subsequent post balance sheet acquisition of two further retail parks for a sum of €65.3 million at an ungeared yield of 6.6%. The initial indication is that the funding will be 50% debt and reduce the Spanish portfolio gearing, assuming no further cross currency swaps are utilised. The loan to value for the group is not demanding at 30.5% (35.1% on a see-through basis) especially considering 93.6% is fixed for 3 years. And while only 45% of the Spanish portfolio is funded through in-country debt, we must highlight the use of cross currency swaps on the balance of the Spanish asset value, which has contributed to the low cost of debt. Vukile has guided 7 – 8% for the full year, with at least 8% for 2019. And while they are benefitting from the accretive offshore acquisitions, the quality of earnings and the expressed strategy of the company going forward is comfortably ahead of the market average.
Rebosis	128.4	7.4%	At face value a strong result, and operationally holding doing alright; however, the base was inflated from the recent Billion transaction and continues to be with the once off income from profit on asset sales and the fee income on the BEE deal. Like-for-like net property income of 6.6% and 6.5% for retail and office respectively was a solid result and positive reversions were also encouraging. Vacancies on the retail portfolio were well contained at 3.1% and 5.9% on the respective retail and office portfolios, with the retail portfolio showing a 4% increase in trading densities (above the IPD average of less than a percent). The core portfolio has a weighted

Rebosis A	240.8	5%	lease expiry profile of 3.6 years and an in-force escalation of 7.6%, however the concern is that the two Billion assets acquired are showing the highest vacancies of the retail portfolio and the distribution guarantee falls away at the end of the 2018 financial year. This could possibly create a major headwind into 2019. During the period they reduced their exposure in New Frontier (NFR) from 67.6% to 36%, with the disposal to a broad-based BEE vehicle to which they will provide funding at prime plus 1%. NFR distribution went back 5% in sterling for the year and have proven to be a poor investment. Their gearing has moved to 62% and need recapitalisation urgently. The risk is that Rebosis may still be forced to commit further capital and despite selling down their investment, they still effectively hold all the credit risk. The balance sheet is over geared at 45.6% with R4.2 billion (43% of total debt) expiring in 2018. 83.5% is hedged for 4.3 years. They will find de-gearing difficult as their equity rating has come off significantly. Management have guided 4 – 6% distribution growth for 2018, however there will need to some non-core earnings to supplement the inflated base.
Accelerate	28.8	0.0%	Accelerate is 6 months into their 24-month 0% guidance outlook on the back of an inflated base, softer trading expected ahead, dilutive portfolio positioning and an expected step up in finance costs. Operationally they held up quite well with like-for-like net property income up 6.4% with reversions and in-force escalations at 3.1% and 7.5% respectively on the local portfolio. There was a spike in vacancies to 8.4% on core-vacancies, which was primarily centred in office. The portfolio is proving to be relatively strong and they have been continuously enhancing through the Fourways precinct redevelopment (expected third quarter 2018), the mixed-use project at Charles Crescent and development at the Cape Town Foreshore. Similarly, they have been progressing well on filling acquired vacancies at Portside, Citibank and Eden Meander. While we appreciate the strong work at asset level, we are concerned about the balance sheet. The gearing is high at 42.8%, despite the 82.3% hedge for the next 2.1 years. A R1.6 billion low swap (at a rate substantially below current refinancing) from Investec expires in March 2019 which will put further pressure on the interest payable. The considerable pipeline ahead is also putting pressure on debt levels and the current cost of equity isn't strong enough to substitute as a funding mechanism. Management have disclosed a planned de-leveraging strategy; however, we are concerned that a R2.2 billion disposal plan (including the BEE deal) is too ambitious in our view. Accelerate is also planning to add to their 5.6% European exposure with and entry into Polish industrial assets. The existing 9 OBI assets in Austria and Slovakia appear to be trading in-line with expectations and have achieved attractive initial yield accretion through the low cost of offshore debt, but the escalations going forward are materially lower than the South African proposition and will pull back on growth. And while we have no reason to criticize the initial offshore venture, we struggle to see the alignment of the Polish portfolio to the existing European assets and what real value can be added. We think management have been prudent in guiding 0% for the remainder of the year as well as 2019; and believe that should they achieve their de-leveraging into 2019 with the disclosed pipeline completed, they should be in a far better position.
StorAge	47.0	9.3%	The company continues to push ahead in-line with their ambitious targets set on listing. Like-for-like net operating income was up 11.6% driven by an 8.7% increase in rental levels and 1.5% compression in vacancies and a tighter cost ratio reflecting the synergies of their growth. Bad debts were also contained at 0.5% of revenue despite the weak economic environment. In addition to the solid operating model, there has been significant activity on the acquisition front. Locally they spent R662 million on 11 new properties from three vendors, with 13 properties still in the managed portfolio as a potential pipeline. The

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			UK acquisition was the most interesting where they acquired 97.3% of Storage King holding 13 assets for £53.3 million; with the assumption that it will yield around 8% geared at 50%. The assets have been growing rentals between 2 and 4% in recent years, while vacancies are at 78.9%, which should create a reasonable platform for future growth. In addition, they locked in the currency on acquisition at an attractive R17.5/£ and funded the cash portion through a successful equity raise for R1.28 billion. At balance sheet date the gearing level was at a modest 13.9%, however post the Storage King acquisition this went up to around 24%. It should be noted that with a further £20 million cross currency swap the effective Sterling gearing to Sterling assets is around 85%. This would have the impact of a pushing short term earnings quite significantly. Management have guided full year growth of 11 – 12%, which is as a result of the combination of strong operational growth and the accretion from the UK acquisition.
Dipula A Dipula B	101.3 95.5	5.0% 6.7%	The composite grew distributions by 5.8%, which was an adequate result for one of the few companies that is still a 'focused local rental collector'. Vacancies were flat year on year at 8.5%, with retail and industrial lettings clawing back the loss from offices that saw vacancies spike from 12.8% to 18.7%. The top line was supported by in-force escalations of 7.7% and positive reviews on renewals and new leases of 4.6% and 8.6% respectively; while net costs to income deteriorated. The retention ratio was a healthy 80%. The positive in the portfolio was commuter retail which performed well with a 6.25% trading density growth across their portfolio (significantly ahead of sector average) and explains the vacancy compression and positive renewals across the sector; however our concern in 2018 is that we will see significant re-letting in their industrial portfolio (42%) coming up for renewal with passing gross rents of R55/m² (average across the portfolio) against recent renewals and new leases signed between R39/m² and R49/m². Dipula has been somewhat quiet on the transactional front over the past few years, however they have lined up two material acquisitions which are 22% of the current portfolio. The cost is R1.5 billion at a yield 11.4%, and, as per management, enhances the quality of the portfolio. They have also been a seller of 28 properties for R335 million at an exit yield of 10%. And while we can't criticize the respective transactions, we are concerned as to how they fund them. Dipula has not been particularly successful in raising equity (no fault of their own) and have a loan to value of 38.9%. 90% of the debt is fixed for 2.2 years, which softens some of the near term risk, but we would be concerned if they push gearing too much higher from these levels. Management have guided distribution growth for next year (before accounting for the acquisitions) between 5 and 5.5%, which is clean, realistic and reasonable in the current environment.

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LOOKING FORWARD

We must revert to what we were saying at the start of the year; the quality of earnings across the sector has been deteriorating. As the business environment has come under strain, companies have on average chosen a path of 'patch up' with lesser quality earnings streams as opposed to disclosing weaker growth numbers. This has created a scenario where many of these companies have to start re-basing as the once-off earnings are harder to come by or the sheer size is impossible to replicate. And interestingly enough the political and economic climate has exacerbated this trend. Money has all too often gone offshore without too much discretion as to the price being paid and what was being paid for. There are many successful offshore strategies in our sector, however there are also several exceptionally poor ones. This once again will create a chasm between the company performances and stock picking will be crucial. 2018 will be a difficult year for the asset class, in either political scenario.

EVAN
JANKELOWITZ, CFA

MOHAMED
KALLA, CFA

KUNDAYI
MUNZARA, CFA

SESFIKILE CAPITAL (Pty) Ltd

First Floor, 30 Melrose Boulevard
Melrose Arch, Johannesburg. 2076
Suite 334, Private Bag X1, Melrose Arch, 2076

sesfikilecapital.com
info@sesfikilecapital.co.za

An authorised Financial Services Provider. FSP: 39946

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