NIMBLE WISDOM MONTHLY

Results matter | February 2018

SESFIKILE CAPITAL
Listed Property Investments

MARKET OVERVIEW

The winds of change continued to blow in February as South Africa saw Cyril Ramaphosa take the highest office in the land and with it came another leg of economic euphoria. The biggest short-term driver for property was the strength in the bond market as yields compressed from 8.6% at the start of the month to a trough of 8.1% and closed the month just below 8.3%. This should have assisted the listed property sector, however the continued onslaught of the Resilient stable (Resilient, Fortress, NEPI-Rockcastle and Greenbay) told us otherwise. Despite the locally biased heavyweight counters such as Growthpoint and Redefine delivering positive returns, the South African Listed Property Index ("SAPY") retreated a further -9.90%. Bonds were strong, up +3.93% on the back of political tailwinds, while Equities were in the red losing -1.97%.

February was also a busy month for results. On average, the numbers were strained with most local operators expressing their concern around weak fundamentals, however many were cautiously optimistic about the political changes and their potential impact on the economy. We continued to see weaker quality returns, however we have also seen further unwinding of once-off revenue streams and aggressive balance sheet management. We still believe that there is likely further weakness in distribution growth over the next twelve months as more non-rental revenue is removed from the earnings base, while the lagged impact of slower offshore growth should also weigh down on some of the numbers.

THE RESILIENT STABLE VS …

Politics, economics and property fundamentals have pretty much taken a back seat this year as the market has been focused almost exclusively on the Resilient stable and the surrounding allegations. There is no doubt that these stocks looked overvalued coming into the new year, which is why we had a material underweight to the grouping. We believe prices were driven higher as the market saw safety in these companies coming into the year-end ANC National Elective Conference ("NEC"); where they had a significant offshore exposure, relatively low (and largely fixed) gearing profile and strong two-year distribution guidance. While we could understand the catalyst, we struggled to justify the relative ratings and large premiums to NAV especially after the more market friendly outcome of the NEC and the ensuing ZAR strength.

Then came the allegations... They came from several platforms in what felt like a coordinated campaign to instill fear and panic in an already jittery market. And while we have no problem with objective research and open disclosure of the facts, the various leaks seemed to straddle between fact, falsehoods and damning allegations. In the wake of Viceroy's clinical decimation of Steinhoff, the market had become extremely sensitive to any issues surrounding governance and / or aggressive balance sheet management, and with some of the more creative mechanisms the stable used to enhance returns coupled with previous allegations made several years earlier, this made them the perfect target.

The fact was quite simply that the short sellers believed that the valuations were extremely full and based off aggressive balance sheet management, whether it be the cross holdings, accretive empowerment structures or even the frequent capital raisings at significant premiums to NAV. These practices were all disclosed by the companies, however the market chose to ignore the quality of earnings and rather focus on the absolute level of growth achieved. And the longer the companies were able to sustain these 'unsustainable' growth numbers, the stronger the rating became.

One of the more damning allegations was that Resilient and Fortress were heavily reliant on capital raising in order to fund distributions – a claim we totally disagree with and one that was based on an incorrect analysis of the companies' cash flow statements. Real Estate Investment Trusts (REITs) rely on a predetermined calculation to pay out operating earnings. That which is not distributed is taxed, hence it is costly and irrational to retain earnings. Property companies rely on the market, whether through debt or equity to fund future acquisitions, so frequent capital raises are not unfounded and if said company is able to raise money at a lower cost they would be remiss not to. The fact that some of the related companies were also supporting the capital issuances (albeit largely so as to retain their relative weighting) should be a question posed to management around strategy, however they have always been transparent in answering this question. The concern was that the money raised was used to pay out the distributions as operating cash flows were not sufficient to cover this liability. There are several mismatches in this number, however the most material is the fact that these companies elected for scrip dividends (dividends in specie as opposed to cash). The shortfall funded through capital markets could effectively be seen as a delayed funding of the scrip. There have also been concerns around inflated asset valuations, however recent evidence has shown that Fortress has sold several billion Rand worth of properties over the last few years above book value and Resilient's retail portfolio has always commanded a premium and hasn't raised the eyebrows of several astute market participants we have engaged over the years.

Lastly the 'damning allegations'. A lot has been written about trading patterns of related parties as well as particular asset transactions. But these details need to be submitted to the relevant regulatory bodies to assess and conclude any findings – both the JSE and FSB are currently investigating. The Resilient board has also commissioned an independent review, headed by former Auditor General, Shauket Fakie. The nature of the offensive against the Resilient stable brings into question the motive of the accusations and has resulted in a crystallization of value destruction as the market has sold down on the shares and forced certain actions by the companies such as the unwinding of the Siyakha Education Trust. The other aspect of this conflict is that it has forced management to listen to the market and unwind a significant portion of the financial engineering, and perhaps to their credit, expose some of the marginal growth that has come from sources beyond the core property business.

As we write this we must note that Resilient and Fortress have disclosed their intention to restructure the Siyakha Education Trust and with it significantly cut their growth guidance from low double-digit to mid-single digits. They have also clearly stated that they are working on a strategy to remove the cross holdings. It should be noted that through all of this, their guided loan to value is not too demanding (relative to the sector average) and their restated growth not too far out of line with the rest of the sector. Perhaps the market has found solace in the fact that these are still decent companies – with strong underlying real estate - but will need to trade at more conservative ratings for the foreseeable future.

RECENT RESULTS

Local results were characterized largely by continued weak fundamentals with the hope for improvement as sentiment turns more positive. We are starting to see companies' willingness to go back to basics and cut non-recurring earnings out of the base. This will result in some short-term pain but will ultimately be better for the sector going forward. The offshore stocks generally fared better, but it should be noted that a significant part of distribution growth is as a result of the development pipeline, accretive acquisitions and the continued benefit of low funding costs. Core ungeared earnings are still tracking inflation around 2%, however as we start seeing inflation coming back into the global market, it may provide a tailwind for stronger core rental growth. We provide a brief summary of the various results below.

COMPANY	DISTRIBUTION (CENTS)	GROWTH	COMMENT
Fortress A	71.20	4.8%	Fortress, similar to Resilient, brought forward their results in light of all the negative speculation around the grouping of companies in an attempt to appease a nervous market. Unlike Resilient, the result wasn't quite as strong, as guidance was revised lower on the back of "weaker office fundamentals". The physical portfolio (42% of total assets) felt the pressure of the weaker economy as vacancies pushed 0.5% higher to 5.8% with the weakness reflected across all sectors. Management once again highlighted their preference for logistics and retail over office with the latter's vacancies settling just under 20%. With that said the majority of the R659 million of disposals came from the office portfolio which is now at 10.4% of the physical portfolio. We expect a further cleanout of the portfolio as management has indicated their preference to sell a significant amount of non-core assets; in addition, capital market pricing has turned against the company and with their significant development pipeline in excess of R7 billion they will look to all avenues of potential funding sources.
Fortress B	90.07	14.6%	The listed portfolio (58% of total assets) also came under significant pressure, but more from a valuation as opposed to earnings growth, as the contagion from the negative press surrounding the group was relentless. Earnings growth from the listed portfolio will likely be softer in upcoming periods as NEPI-Rockcastle has guided lower expected growth, while Resilient (much like Fortress) will be forced to restructure in light of the market call for removing the cross-holdings as well as internalising the empowerment trust (Siyakha).

			Management has significantly softened their guidance for both the remainder of the year as well as for 2019 as they look to consolidate Siyakha. What was a two year double-digit growth profile has now come down to 4.5% and 5.0% for the composite. While some of the pain resulted from the crystallisation of value destruction from heavily geared listed positions and the guarantees surrounding them, a significant part is also relating to the unwinding financial engineering which has historically driven earnings.
Emira	70.65	2.5%	While several companies are only now attempting to clean out non-recurring earnings from their base, Emira is hopefully one step ahead, coming out of a period of negative growth and starting to see an earnings recovery. The core portfolio saw strong like-for-like NPI growth of 7.8%, assisted by vacancy compression from 7.0% to 4.5% (office saw the strongest improvement from 16.1% to 9.4%) combined with in-force escalations of 7.7%. The letting environment was still strained with negative renewals of -2.3%, with a satisfactory retention rate of 77%. Ultimately management did well to stabilise and grow the portfolio, albeit off a low base, in a market that could have inflicted further pain. They also spent R106.5 million at a yield of 9.3% on Knightsbridge and The Bolton, with another R85 million committed at a yield of 8.5%. Uncommitted pipeline is a further R672 million. Disposals were light, however they managed to offload six assets for R236.5 million at a yield of 7.6%. The offshore strategy evolved where the pure listed entry into Australia through Growthpoint Australia was complemented with US retail exposure. Offshore assets grew to just under 10% of total assets with the R332.2 million acquisition of a 49% equity interest into a US based retail fund. Our concerns are that there has been excessive use of cross currency swaps to enhance the initial accretion and the fund may once again be caught in a low growth scenario in subsequent year as the core rental growth is mediocre at best. We also question why the fund picked that particular sector, region and partner and what their particular competitive advantage would be. The LTV ratio increased marginally to 37.2% of which 86.8% is fixed for a period of 3.2 years. Total cost of funding reduced to 8% which is likely to be assisted further by increased cross currency swaps. Management have guided similar full year guidance for distribution growth and 2019 growth at least in line with inflation, with a potential tailwind coming from the outcome of the arbitration with Worely Parsons.
Growthpoint	101.20	6.5%	Growthpoint delivered a hard fought 6.5% distribution growth as they continued to grow ancillary avenues of cash flows, while the core business reflected the tough trading environment. Solid progress has been made in setting up their funds management business (Africa Fund and Healthcare Fund) while there has already been some traction and earnings flowing from the 3rd party development and trading with this expected to account for 1-2% of distributable earnings going forward. Like-for like NPI (on the South African portfolio) showed some improvement to 5.0%; this was almost exclusively underpinned by in-force escalation of 7.7%. Vacancies weakened from 4.4% to 5.2%, renewal success rate fell sharply to 61.9%, while growth on rental renewals was weak at -0.5%. Alongside this, defying the rest of the market, the V&A (analysed separately from the rest of the South African assets) delivered distributable income growth of 9.6% with vacancies at 1.2% and renewal growth of 4.9%. Asset disposals were muted at R478.7 million but had picked up dramatically with a further R3.2 billion transacted but not yet transferred and yet another 5% of the South African assets effectively on the market in four separate portfolios. Acquisitions and developments topped R2 billion with another R2.2 billion of commitments. The offshore strategy has continued to grow to 24% of total assets and 18.5% of distributable earnings with the subsequent €113.8 million investment into Globalworth taking Growthpoint's stake up to 29%. Gorwthpoint had stated that they are targeting a 30% offshore asset exposure, which will require further spend of approximately R10 billion. To date the offshore strategy has been very deliberate in acquiring established platforms in the respective geographies as opposed to ad hoc asset acquisitions, which has proven to be prudent and far more stable than some of their peers.

			The balance sheet is geared at 34.5% of which 78.4% is fixed for 3.7 years. The use of cross currency swaps and foreign debt has reduced the average cost of debt from 9.1% to 7.5%; where we must point out the mismatch of effective gearing on the European and Australian assets as being 98% and 48% respectively versus the group at 34.5% Management believe that the 6.5% first half growth should be sustainable for the full year. Despite local sentiment improving, they believe they are only likely to see the tangible benefit in two years, while at the same time the distribution from Growthpoint Australia will be muted by increased withholding tax. Globalworth is expected to assist as further accretive expansion and strong local dynamics are supportive to distributions; as are the new business ventures (alluded to above) piloted by the company off a relatively low base.
SA Corporate	44.92	4.4%	SA Corporate disappointed with full year FY17 growth of 4.4% coupled with flat 2018 guidance. Core operations were acceptable; however, we believe that the fund has lost focus with several diverse acquisitions over the last few years. Like-for-like NPI growth held up relatively well at 5.7%, however residential showed only 0.9% growth. Vacancies on the traditional portfolio stabilised at 2.3% with only industrial showing some weakness, however office (despite being relatively small saw the most weakness on rent renewals at -12.3% versus the average of 0.8%. AFHCO saw strong vacancy compression from 8.7% to 7.0% (5.7% if you exclude acquired vacancies), however there was almost no growth on renewals and admittedly the residential sector is proving to be a tougher proposition than initially expected. Core asset management was accretive with executed acquisitions and pipeline of R3.1 billion coming in at a yield of 10.2%, with a further R1.2 billion of committed developments expected at 10.5%. Executed and contracted disposals of R1.5 billion were sold at a yield of 8.6%. We commend this aspect of asset management, but question the need to acquire self-storage, listed holdings, Zambian assets and several different residential vehicles. The LTV ratio was 3.4% higher at 32.4% with 70.1% hedged for 3.3 years. The company increased the marginal cross currency swap to assist in reducing interest costs and assisting earnings. Guidance for 2018 was a poor 0% growth and then reverting to at least inflation in 2019. The disappointment is a function of several once-off earnings in the base, including lease cancellation fees, mismatched dividends from Safari and a structuring fee from the storage acquisition, while 2018 is also expected to see the income from Zambia come off materially.
Liberty 2 Degrees	59.22	-9.0% behind listing guidance	The company missed guidance for a second time since its listing, which is a combination of external pressures, poor guidance at the outset and what appears to be a conflicted management company. The full year distribution missed the initial listing guidance of 65.07c by 9.0% and guided a mere 1.3% growth for 2018, which is 7.8% behind what they expected to achieve the year before. Headwinds came from all sides: Stuttafords' demise pushed retail vacancies out by 3.1% taking retail vacancies to 4.6% and total vacancies to 4.6% as the Century City office saw vacancies spike to 22.8%; a sharp spike in municipal rates at Eastgate Shopping Centre was unforeseen and general trading conditions across most of the country's regional and super regional centres were tough. Trading densities turned negative nationwide with Liberty at -1.7% growth to December. Retail rent renewals were marginally positive at 3.6% with in-force escalations at 7.8% on an average lease expiry profile of 3 years; aside from the Stuttafords fallout the retail assets performed relatively well. Office assets were not as strong, under pressure from negative rental reversions of -5.3%, but supported by 7.2% escalations albeit on a very short lease expiry profile of 2 years. The most significant headwind came from the early allocation of circa 31% of their assets that was held as cash used to acquire more of the Liberty policyholder portfolio.

			The yield on acquisition was significantly lower than the cash yield that they forecasted to receive and hence distribution dilutive. We question the reason why this transaction was done so soon after listing, as it essentially meant that the initial funders paid a premium for cash which was subsequently used to buy assets from a related party. The balance sheet is still unencumbered with no debt, which from one aspect can be seen as conservative, however the risk is that they feel the need to gear-up and dilute earnings further as their marginal acquisitions are likely at a lower yield than the cost of debt. As we stated above, the 2018 guidance of 1.3% is extremely disappointing. We believe the management company structure doesn't work for Liberty 2 Degrees shareholders, and while we wanted to give them the benefit of the doubt with regards to independence, the initial dilutive acquisition revealed the true conflict.
Echo Polska	€c 10.87	6.6% (pre-tax) ahead of listing guidance	Echo's pre-tax distribution beat guidance by 6.6%; however, it should be noted that the tax regime had changed resulting in increased tax leakage and an after-tax miss. The net asset value also showed a marked improvement by 16% to €1.32 (although the base was restated 2% lower). Operationally the retail fund ticked over nicely with footfall increasing by 4.6% which reflected in the increase of sales by 7.0% for the period. Increased activity also assisted the positive move in the rent-to-sales ratio from 11.0% to 10.3% and operational cost ratio from 14.5% to 13.5%. Retail vacancies compressed to 1.4% reflecting the solid trading environment, while office vacancies also pushed slightly lower to 4.0%. The acquisition trail was also in full swing with €334 million acquired during the period, which excludes the 32 7% stake in the 81 900m² Mlociny development in Warsaw. It also excludes the M1 transaction which commits Echo to a €692 million deal to acquire 12 assets in three tranches, the first of which was concluded in January 2018. This makes them a dominant retail player across Poland, but it also puts pressure on their balance sheet. The fund has been disposing of non-core office properties and has raised €160 million in December through sales. At year end, the LTV ratio actually decreased below 50% to 47.4% of which 83% was hedged, however with the payment of the first M1 instalment, the gearing level has once again pushed beyond 50%. Management has guided distribution growth between 6.7% and 8.6%, with several potential headwinds and tailwinds to justify the range. The legislation against Sunday trading (albeit tapered) will likely have an impact on trading, as will the volatility in tax law which has already dented earnings. While on the positive front, a REIT legislation could provide a tax tailwind, however this is not expected in the near term.
Hammerson	£p 25.5	6.3%	European mall (57% UK exposure) REIT Hammerson delivered 6.5% EPS growth resulting in 6.3% growth in dividends for the full year to December 2017. NAV growth was 5% to 776p placing the shares at a 42% discount to NAV. Management reported record volume of leasing up 34% and the lowest vacancy in 17 years. Same store net operating income (SS NOI) was up 4.4% with France recovering at 2.6%, Ireland up 7.4% and premium outlet malls up 15.3%. UK shopping centres and retail parks lagged at 1.8% and -2.5% SS NOI respectively, reflecting the tough retail environment, however management has guided a recovery in retail park performance to positive LFL growth in the next 12 months. HMSO's balance sheet remains conservative at 36% LTV, 78% which is fixed at a weighted average cost of debt of 2.9%. The fund has £264 million in near term projects at yields between 6-8% including the extension of Brent Cross in north London at £97 million and Cergy and Italie Deux in France at £107 million. Management has guided 6% growth for the full year. In the fourth quarter of 2017, HMSO proposed to merge with INTU, which, if approved would create a dominant UK mall operator with approximately £21 billion in gross assets. Management has guided £25m in cost synergies and a re-evaluation of the Intu

			capex program, currently at £434m over the next two years. Excluding the merger EPS growth has been guided at 6.5%.
Intu	£p 15.0	0%	Intu delivered 1.7% NAV growth to 460p for FY17. Net income grew 2.9% over the year, in part driven by 0.5% like-for-like rental growth with vacancies remaining low at 3%. Dividends remained flat at 15p for the full year. Over the year the company acquired spent £58 million on bolt-on acquisitions in the UK, £63 million on the redevelopment of Intu Watford and £89 million on tenant fitout costs. In Spain Intu acquired Xanadu in Madrid for €530 million to be rebranded Intu Xanadu in 2018. Leasing activity was relatively strong over the year with 217 leases signed at upward reversions of 7%, however it took a knock from the liquidation of BHS represented across their portfolio. Compared to UK and European peers, Intu's balance sheet appears stretched at an LTV of 45.2%, fixed for 6.6 years at an average debt cost of 4.2%. Near term capital expenditure is £585 million over the next 2 years which in part will be funded by asset disposals. Management has shown their ability to sell with three separate disposals, however we question the demand in the current environment where retail is very much out of favour. Management has guided that LFL rents will likely rise by 1.5-2.5% for 2018 and 2-3% beyond that. The real focus is the potential take out offer from Hammerson, which should unwind several synergies and value traps in a portfolio that has been unloved for quite some time.
NEPI / Rockcastle	48.2	17.1%	Nepi-Rockcastle posted strong dividend growth of 17.1% to 48.26cpu for the full year. Over the period, the group acquired €827 million of properties including Serdika Centre (Sofia, Bulgaria), Arena Plaza (Budapest, Hungary) and Paradise Centre (Sofia, Bulgaria). Post the merger with Rockcastle in 2017, NRP has become somewhat of a 'hybrid' property company with 56 income producing properties (45% in Romania and 27% in Poland), large development pipeline and listed property holdings including but not limited to Unibail-Rodamco, Hammerson, Klepierre, Simon Property Group and Westfield Group. In line with peers with portfolios in Central and Eastern Europe (CEE), NRP showed strong tenant sales growth of 7.2% on a weighted average basis. Like-on-like NOI growth is estimated to be in the region of 3-4% in the portfolio with vacancies remaining very low at 3.5%. Management has held the view that the €1.2 billion in listed holdings will be used to fund acquisitions and developments of physical properties in the medium term. NAV grew 11% over the year to €7.10 (R103.50/share) although the portfolio is still conservatively valued at an overall cap rate range of 6.9-9.8%. Near term developments total €1.25 billion over the next 2 years. The balance sheet remains conservatively geared at and LTV of 26%, lower than Western European peers between 30-40%, with 100% of debt hedged for 5.1 years at an average interest rate of 2.2%. Importantly as at 31 December 2017, the group had a strong liquidity profile, with €196 million in cash, €380 million in available unsecured revolving facilities and minimal debt expiries for the next 2 years. Management has also guided that NRP's share price has seen an unprecedented 35% correction in 2017 (to 15 March 2018), largely driven by its association with the Resilient stable. On a pure valuation basis, the company was trading at an approximate 106% premium to NAV. In our experience companies that have higher than average earnings growth, undervalued standing portfolios and large development pipelines can justifiably trade at a premium to NAV, although at +100% it was fully priced. In light of this, NRP's shopping centre portfolio is valued at a conservative cap rate of 6.94%, has a development pipeline of approximately 21% of gross assets which is higher than comparable peers.
MAS	€c 3.58	34.6%	Mas Real Estate delivered 34.2% distribution growth, ahead of the guided 30% growth. NAV grew 9% to €1.37/share. Revenue grew 67% as more income producing assets were developed and came on stream. Cost to income ratios rose from 19% to 28% as the company increased its mall exposure.

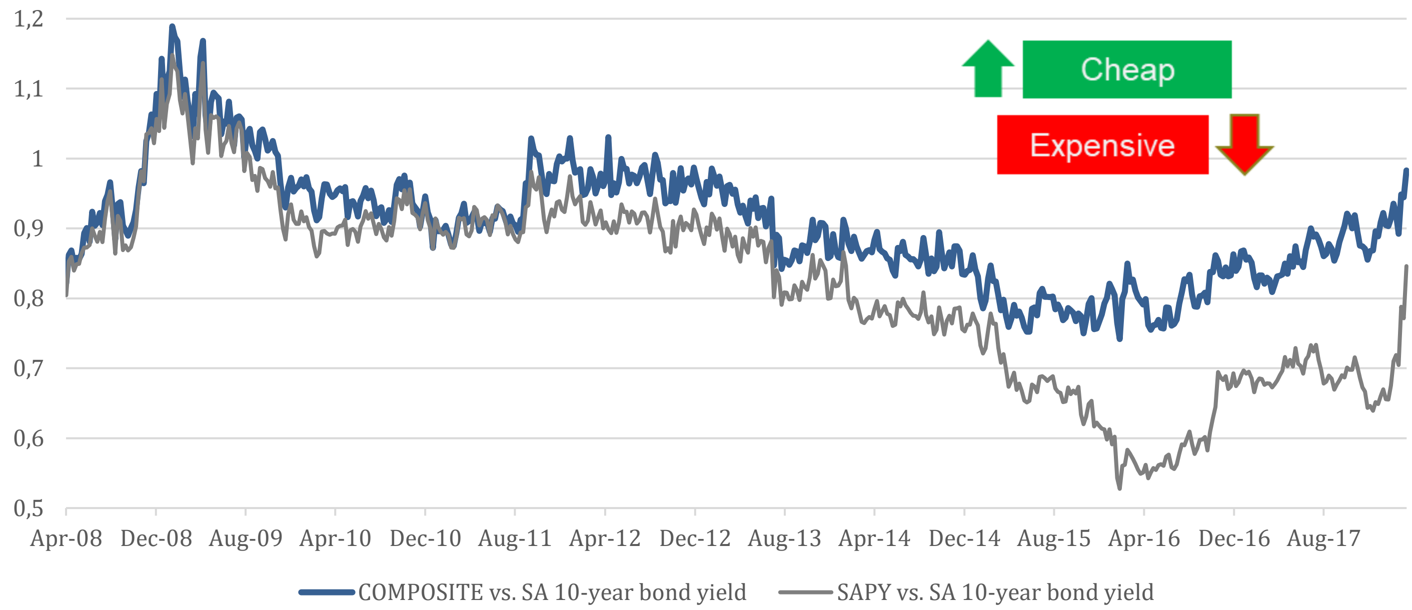
			The company has approximately €785 million in developments over the medium term, 76% allocated to the retail sector with a greater focus on CEE. Key developments include 11 value centres totalling 126 000m² and Avalon Estate, a 767-unit residential development in Bucharest (Romania). MAS's LTV remains conservative at 26% with an additional €187m in cash, €61 million in commitments funded and €200m in listed REITs. Management has guided 30% distribution growth over the next 2 years which, if necessary will be supplemented by trading profits. The listed property holdings have come under pressure, while the acquisition / development pipeline may be a bit slower than initially expected as pricing has run ahead, so we wouldn't be surprised if the achieved growth is slightly lower than 30%. With that said we are happy that they grow the asset base responsibly and we appreciated the fact that they walked away from a somewhat complicated development in Slovenia.

SECTOR OUTLOOK

With the sharp pull back over the last two months, the sector is no doubt looking more attractive, especially considering the yield compression across the bond market. Property is now trading cheaper relative to bonds both on a nominal basis and relative to the 10-year average; however, some of this is justified as a result of lesser quality earnings in the current base and weaker short-term earnings growth. While we think that some of the recent pain felt across certain stocks is structural and won't revert to their previous ratings, we do believe that through time the asset quality relative to current pricing will justify some correction. There will most certainly be more noise across these stocks in the coming months, however we do believe that the sector should be able to deliver mid to upper single-digit total returns for the next 12 months as we work our way through the volatility.

We have used the graph below for some time to give us a rough indication of the valuation of the sector versus the bond market. The lines represent the SAPY dividend yield divided by the SA 10-year bond yield. The SAPY being the index as it has changed over time, while the COMPOSITE is an equally weighted index of 10 stocks that have been around for the 10 year sample period, which tends to eliminate the frequent index changes as well as reduce the exposure to the offshore counters as well as the developers which tend to distort the index by making the yields look a lot tighter. What is evident from this update is that the SAPY as well as the COMPOSITE have become significantly cheaper relative to bonds over the last two months as local bonds strengthened and the Resilient stable fallout hurt the property sector.

Chart 1: SAPY / Sesfikile COMPOSITE yield relative to SA 10-year bond yield



Source: Sesfikile Research

Even if we believe the current rating is fair as opposed to cheap, it provides a platform for decent medium to long term returns. With a forward yield of 8.4%, the cash flow alone makes the investment proposition attractive and as we rebase earnings the growth platform should once again push ahead of inflation. The two concerns we have in the short term are: on a micro level, the unwinding of non-core earnings and the extent of the impact on growth and pricing; while on a macro level global bond yields are trending higher and when does that start filtering through into local bond yields.

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