PRUDENTIAL PROPERTY FUND
30 JUNE 2021

PRUDENTIAL INVESTMENT MANAGERS

QUARTERLY COMMENTARY

PROPERTY

MARKET OVERVIEW

During the second quarter (Q2) of 2021, more progress in vaccine rollouts worldwide, as well as positive corporate earnings reports and economic news, continued to lift equity returns, particularly in developed markets, even as concerns emerged over high valuations. It was no coincidence that cheaper, out-of-favour equities like Listed Property were among the strongest performers, while more expensive sectors like Resources underperformed.

Economic growth surprised to the upside in South Africa as Q1 2021 GDP growth measured 4.6% q/q annualised, notably higher than the 2.5% market forecast. Despite the gradual recovery, Stats SA noted that the economy's absolute size was equivalent to that last seen in Q1 2016, five years earlier. Covid-19 vaccine supplies continued to make their way into the country and the government's vaccination programme made headway, but this progress was overshadowed in June as the third wave of Covid infections gathered pace, driven by the more transmissible Delta variant. This prompted President Cyril Ramaphosa to reintroduce Level 2, and subsequently Level 4, lockdown measures, again curtailing vital economic and social activity.

Meanwhile, the South African Reserve Bank kept its benchmark interest rate unchanged at a record low of 3.5% at its 20 May MPC meeting, warning that slow progress on vaccinations, limited energy supply and policy uncertainty continue to pose downside risks to the economic outlook. This was despite the jump in consumer inflation to 4.4% y/y in April and 5.2% y/y in May, attributed largely to the previous low base. The central bank raised its growth forecasts for 2021 from 3.8% to 4.2%, but lowered its projections for 2022 and 2023 to 2.3% and 2.4% respectively. It is also projecting two 25bps interest rate hikes in 2021.

During the quarter global credit rating agencies S&P and Fitch reaffirmed South Africa's long-term sovereign credit rating at BB-, citing an upturn in near-term economic performance and improved public finances as contributing factors. Moody's, however, postponed its review on South Africa's credit rating, which currently sits at Ba2 with a negative outlook.

The FTSE/JSE ALSI was roughly flat for the second quarter, returning 0.05%, while the FTSE/JSE Capped SWIX All Share Index, which we use as the equity benchmark for most of our client mandates, returned 0.6%. The standout sector was Listed Property (the All Property Index) with an 11.1% total return. Financials delivered 7.5% and Industrials eked out 0.8%, but the Resources Index returned -5.0%. This performance reflected the value still seen in "SA Inc" counters, which have lagged during the recovery, and the growing view that Resources shares may be reaching the end of their bull run.

PERFORMANCE

In July the Prudential Property fund will celebrate its first anniversary. Over the short term, it proved to be a good time to launch a property fund. Valuations in the sector were cheap, sentiment was (and may still be) poor and central banks were doing their best to restore liquidity to global financial markets, to the benefit of 'risk' assets like property.

For the second quarter of 2021, the fund returned 11.8% (net of fees), outperforming its benchmark by 0.7%. From inception to the end of June 2021, the fund returned 28.6% (net of fees) compared to the benchmark which returned 29.9% over the same period.

The major contributors to relative outperformance over the quarter were underweight positions to Fortress REIT, Capital & Counties and MAS Real Estate. Detracting from performance over the period were positions in more defensive companies like Stor-age, as well as more defensive positioning and underweights to over-leveraged names like Emira and Attacq.

STRATEGY AND POSITIONING

Investor sentiment can swing wildly from extreme pessimism to exuberance. At some point last year, some respected institutional investors in South Africa went so far as to declare the real estate sector as being "uninvestable" due to the lockdown regulations. The mantra was that we would no longer need shopping malls and could work from home forever. While the lockdowns have no doubt resulted in some changes to habits, we have realised a few things:

- There is still a great deal of activity at shopping malls and tenants want to retain a presence there at the right price.
- Many people would like to return to working in an office, at least for part of the week.
- There is an active, albeit thin, market for assets from private buyers in South Africa and a very robust one in Europe.
- Management teams were not prepared for the downturn appropriately given high starting loan-to-value ratios followed by the subsequent need to withhold dividends and dispose of properties.

The ability of property companies to de-lever organically (via asset sales and dividends withheld, as opposed to equity raised) has no doubt surprised the market positively, as has the fact that vacancies have held somewhat steady, with the exception of the office sector.

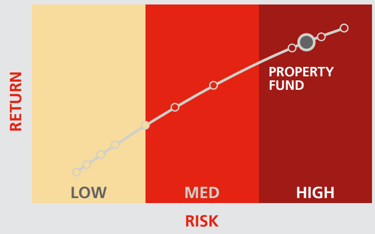
In South Africa, we are observing stable vacancies with lower rents and ongoing rent relief to affected tenants in the retail space, with some evidence of tenant failures and downsizing in the industrial space. Unfortunately, the office market has demonstrated weak demand and little pricing power. In contrast, the self-storage segment as represented by Stor-age had an exceptionally robust year as they managed to both grow rents and also occupancy by 'letting up' space.

Cheap valuations in the property sector have attracted some interest from private buyers as well as corporate activity: Growthpoint rebuffed an offer for its stake in Globalworth; Arrowhead and Fairvest announced a likely merger; and the iGroup made a compulsory offer to minorities of Emira. Tower also announced an expression of interest from RDC Properties, based in Botswana, for its entire share capital; while RDI Reit was the subject of a successful bid from Starwood Capital.

The current unrest in parts of the country will no doubt unsettle many investors in the fund. At the time of writing, we assess the immediate impact on the fund's holdings as immaterial in the short term given that landlords are fully insured for destruction and partially insured for the resulting loss of income. Further, the properties affected represent a fraction of their respective portfolios, and not all tenants within affected properties were necessarily looted. The secondary effect is that small businesses may not be able to restock given underinsurance or a lack of insurance, while the resultant loss of confidence in the country and likely higher borrowing costs are the likely long-term consequences.

The SA Listed Property Index trades at an 8.4% dividend yield for the year ahead and a 10.3% distributable earnings yield, implying an 82% payout ratio for the sector. We are therefore constructive on the valuations of the sector. Coupled with amendments made to the quantitative process, this should result in excess returns accruing to holders of the fund. ■

RISK/RETURN PROFILE:



FUND MANAGERS:
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ASISA CATEGORY:
South African – Real Estate – General

BENCHMARK:
FTSE/JSE All Property Index

INCEPTION DATE:
9 July 2020

Sources: Prudential, Morningstar & Deutsche Securities