NEDGROUP INVESTMENTS PROPERTY FUND

see money differently

Quarter Three, 2019

For the period ended 30 September 2019

Performance to 30 September 2019	Nedgroup Investments Property Fund[1]	ASISA category average	SAPY
3 months	-13.9%	-4.0%	-4.4%
12 months	-32.9%	-5.7%	-2.7%

Market Commentary

Since the end of 2017, South Africa's listed property sector has been under significant pressure as investor confidence has waned in the face of numerous headwinds. While the focus at the beginning of 2018 was on the Resilient group of companies, investors have now transferred their concerns and lack of confidence across the rest of the sector. The third quarter of 2019 proved to be no different and prices in the listed property sector continued to slide lower. A combination of factors, including a perceived lack of good corporate governance, increased vacancies, lower, or negative market rental growth, the threat posed by technological disruption and land expropriation without compensation have contributed to the sharp decline in prices since the end of 2017. While those concerns are and remain valid, current pricing in South Africa's listed property sector suggests things are going to get materially worse over the next two to three years and distributions are going to fall precipitously from current levels. Based on discussions with numerous management teams over the past quarter, that doesn't seem to be the case. Most management teams have indicated that market conditions remain extremely tough and retaining or attracting new tenants is becoming costlier through incentives like rent-free periods and higher tenant installation allowances. While this is constraining distribution growth together with increased municipal rates and utility costs, the situation is not as dire as current pricing would suggest.

Distribution growth rates slowed to just over 1% (on an annualised basis) in the third quarter and are expected to remain at these lower levels for the next two years, given the weak domestic economic backdrop. While this rate of growth is far below the 10% per annum investors became accustomed to in the 10 years leading up to the start of 2018, investors are now being compensated for this lower growth by an extremely attractive initial income yield. The FTSE/JSE SA Listed Property (SAPY) index is currently yielding just below 10%, with growth in distributions, based on a combination of Bloomberg, FactSet and IRESS consensus forecasts, of approximately 3% per annum over the next three years. The SAPY index comprises several non-South African property companies that trade on lower yields. Stripping those companies out of the index and adding back the rest of the smaller South African REITs that aren't included in the index (the index is limited to the 20 largest JSE listed property companies by market capitalisation), the one-year forward yield rises above 11%, which compares very favourably with other high-yielding asset classes, like bonds, cash or perpetual preference shares.

Portfolio Commentary

The Nedgroup Investments Property Fund had a difficult third quarter as investor appetite for smaller and medium-sized South African companies shrunk appreciably in the face of a deteriorating local and global economic backdrop. Investors in South Africa have been consistent sellers of listed property since the middle of 2018 and that selling pressure was exacerbated by more broad-based selling of South African-focussed risky assets (equities and listed property). While some of the selling pressure was of a technical nature following South Africa's lower weighting in the MSCI Emerging Markets index post the August rebalance (to accommodate Saudi Arabia and more China A shares), the tabling of the National Health Insurance (NHI) Bill in parliament during August undoubtedly undermined investor confidence in South Africa's equity and listed property markets.

The fund has significantly more exposure to South African-focused listed property companies and for this reason has been underperforming the SAPY index since the start of the year.

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[1] Net return for the Nedgroup Investments Property Fund, A class. Source: Morningstar (monthly data series).

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Some of the price action in the third quarter was reminiscent of the panic-selling that took place in South Africa's listed property sector in 1998, following the Rouble and Asian Debt Crises that saw South African bond yields spike sharply higher and listed property prices fall by more than 30% in a couple of months (with most of the selling concentrated in August of that year). Given the recent price action in many of the fund's holdings and with distributions not expected to fall by anywhere near the same magnitude, based on a combination of Bloomberg, FactSet and IRESS consensus forecasts, the fund's one-year-forward income yield (before service fees) has risen above 16%.

Top contributors and detractors for Q3 2019:

Winners	Ave.weight	Performance contribution	Losers	Ave.weight	Performance Contribution
Safari	6.44%	0.56%	Accelerate	9.40%	-3.88%
Fairvest	8.61%	0.33%	Delta	3.90%	-3.81%
Stor-Age	8.29%	0.07%	Dipula B	6.35%	-3.25%
			Octodec	9.59%	-1.16%
			Rebosis	1.01%	-0.68%

Delta's share price fell substantially after the company announced that it was considering a merger with Rebosis. Its share price hit a new low of 50 cents on 20 September 2019 due to technical selling pressure after it was removed from two FTSE/JSE property indices but has since recovered to the R1.10 level (as at 15 October 2019). Based on the information currently being made available to major shareholders, the merger deal is unlikely to get the requisite support from shareholders and in the meantime, Delta has continued to renew leases with government and improve its weighted average lease expiry, which should also result in more favourable terms from the company's main bankers. Safari remains the target of a cash offer by Community Property Fund (Comprop), although several investors believe the price (a 38% premium to price of the company's shares prior to the offer being made) represents too great a discount to net asset value and appear set to vote against the scheme should it be proposed by the board of Safari. The offer by Comprop at a substantial premium to the current share price reveals the value that exists today in South Africa's listed property sector.

Accelerate's share price fell significantly in September after it was removed from the FTSE/JSE SA Listed Property index following the FTSE/JSE September index changes. Accelerate was replaced by Stor-Age, which is also owned in the Nedgroup Investments Property Fund. Passive tracker funds and benchmark cognisant fund managers sold down their Accelerate positions in order to maintain their tracking of the index. Close to 10m Accelerate shares traded on the 20th of September (significantly higher than the normal trade volumes), the effective date of the index change, which placed significant downward pressure on Accelerate's share price.

The share prices of Dipula and Octodec also came under pressure in September, in line with the current lack of confidence and low investor appetite for the listed property sector. Dipula announced in August that they were withdrawing their non-binding offer to acquire SA Corporate. A consolidation of the two companies would have achieved significant improvements in their scale and diversity; and given the merged entity better leverage with its suppliers and tenants. The SA Corporate board had earlier announced that they didn't believe any of the offers they had received, including Dipula's, were in the best interests of the company or its shareholders.

Current positioning and outlook

The fund has maintained its higher exposure to South African-focused REITs that are offering investors extremely attractive entry yields and are trading at steep discounts to the underlying value of their property portfolios. The property-type and geographic splits of the fund have been adjusted over the past three years to emphasise the Western Cape as a region and lower-income mass-market retail and industrial/self-storage where property fundamentals remain stronger than the other major property types, including office and high-end fashion retail.

The price action of the past 18 months is reminiscent of what happened in 1998 when investor confidence in listed property evaporated amid a deterioration in property fundamentals that saw vacancy rates in Sandton's fledgling office market exceed 15% (a situation not too dissimilar to what is happening in Sandton today). Investors in 1998 were able to secure extremely attractive forward income yields and from the very low capital base created after a period of panic-selling, enjoy high capital returns over the next 5 to 10 years.

The current one-year forward income yield on the portfolio is in excess of 16%. In our opinion, investors are therefore being fully compensated for the risks in the South African property market which have been exacerbated by the slowdown in economic activity and the resulting deterioration in investor, business and consumer confidence. After falling in 2019, distributions are now expected to grow by between 2% and 4% per annum in both 2020 and 2021, with growth expected to accelerate above inflation beyond 2021. The growth in 2020 and 2021 is mainly due to the low technical income base created by the implementation of a reduced pay-out ratio by Delta, which significantly impacted the distributions paid to their shareholders in calendar year 2019, but which should normalise in 2020 and 2021.

Investors in the fund can therefore enjoy an extremely high initial income yield, with the prospect of inflation-beating growth in that income stream over the medium and long term.

The fund is therefore ideally suited to investors drawing an income in retirement and wanting that income to maintain its purchasing power (i.e. grow at or above inflation) throughout their retirement. The fund is also suited to investors looking to maximise the income-producing potential of their retirement savings in the years leading up to retirement. South African REITs are exempted from all forms of taxation, with the tax burden borne by the REITs shareholders. If the shareholder is also exempted from all forms of taxation, like a provident fund, preservation fund, retirement annuity or tax-free savings plan, then the shareholder is able to maximise the impact of compounding a high and growing income stream through time.

DISCLAIMER

WHO WE ARE
Nedgroup Collective Investments (RF) Proprietary Limited, is the company that is authorised in terms of the Collective Investment Schemes Control Act to administer the Nedgroup Investments unit trust funds. It is a member of the Association of Savings & Investment South Africa (ASISA).

OUR TRUSTEE
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PERFORMANCE
Unit trusts are generally medium to long-term investments. The value of your investment may go down as well as up. Certain unit trust funds may be subject to currency fluctuations due to its international exposure. Past performance is not necessarily a guide to future performance. Nedgroup Investments does not guarantee the performance of your investment and even if forecasts about the expected future performance are included you will carry the investment and market risk, which includes the possibility of losing capital.

PRICING
Funds are valued daily at 15:00. Instructions must reach us before 14:00 (12:00 for Nedgroup Money Market Fund) to ensure same day value. Prices are published daily on our website and in selected major newspapers.

FEES
Certain Nedgroup Investments unit trust funds apply a performance fee. For the Nedgroup Investments Flexible Income Fund and Nedgroup Investments Stable Fund, it is calculated daily as a percentage (the sharing rate) of total positive performance, with the high watermark principle applying.

For the Nedgroup Investments Bravata World Wide Flexible Fund it is calculated monthly as a percentage (the sharing rate) of outperformance relative to the fund's benchmark, with the high watermark principle applying. All performance fees are capped per fund over a rolling 12-month period. A schedule of fees and charges and maximum commissions is available on request from Nedgroup Investments.

DISCLAIMER
Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. Nedgroup Investments has the right to close unit trust funds to new investors in order to manage it more efficiently. For further additional information on the fund, including but not limited to, brochures, application forms and the annual report please contact Nedgroup Investments.

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