see money differently

NEDGROUP INVESTMENTS PROPERTY FUND

Quarter Four, 2019

For the period ended 31 December 2019

NEDGROUP INVESTMENTS PROPERTY FUND

Performance to 31 December 2019	Nedgroup Investments Property Fund[1]	ASISA category average	SAPY
3 months	0.7%	1.1%	0.6%
12 months	-22.3%	-0.1%	1.9%

Market Commentary

The South African listed property sector managed to squeeze out a small gain in the final quarter of 2019. Investor sentiment towards South African-focused companies listed on the JSE Limited remains extremely low and has contributed to a period of prolonged underperformance by the listed property sector in South Africa. Property fundamentals remain quite weak in the face of historically low levels of business and consumer confidence. Vacancy rates have been rising steadily since the beginning of 2018 and the cost of retaining or attracting new tenants is rising as higher commissions are paid to brokers and bigger incentives, like rent-free periods, are offered. Distribution growth rates for South African real estate investments trusts (REITs) have fallen to an average level of below 1% year-on-year in the fourth quarter, having averaged almost 15% in 2016 and 2017, before the Resilient group of companies were forced to restructure their cross-holdings and unwind their black economic empowerment deal (the Siyakha Education Trust).

Having become accustomed to high distribution growth rates and the resultant strong capital gains, investors appear to be having a hard time adjusting to a low or even negative distribution growth outcome for South Africa's listed property sector. We have always argued that the high growth rates between 2015 and 2017 were unsustainable and engineered and that investors should expect the bulk of future returns to come from the income produced by the listed property sector and not from capital gains. However, the substantial capital declines over the past two years, particularly in the smaller and medium-sized South African-focused companies, have created a base from which investors should anticipate high single-digit or low double-digit annual capital returns once investor confidence returns to the sector. At the same time, initial income yields across the sector have increased substantially and many of those smaller and medium-sized companies that offer the prospect for good capital gains in the medium-term are also offering investors starting income yields of 15% or more, very reminiscent of the third quarter of 1998.

The one year forward income yield on the FTSE/JSE SA Listed Property (SAPY) index has now risen to 9.8%, while distribution growth expectations have been lowered to approximately 2.2% per annum. These numbers are based on forecasts from Bloomberg, FactSet, IRESS and Bridge Fund Managers. Stripping out the non-South African companies from the SAPY index and adding the smaller and medium-sized South African-focussed companies to the index, the one year forward yield rises above 11%, while the distribution growth forecast remains unchanged.

Portfolio Commentary

The Nedgroup Investments Property Fund (the Fund) marginally outperformed the SAPY index in the fourth quarter of 2019 as a result of strong outperformance in December. The biggest detractor from performance in the fourth quarter was Safari Investments, after the offer by Community Property Fund (Comprop) was rejected by shareholders representing more than 25% of the issued shares in issue. It is difficult to understand why shareholders would have rejected the offer price of 590c plus the final dividend (effectively around 614c per share), which represented a 43% premium to the share price at the time of the offer and a 56% premium to the current share price of 395c. Safari detracted more than 1% from the Fund's total return in the fourth quarter. In response to concerns raised by Bridge Fund Managers regarding the independence of certain non-executive

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

directors and following a period of engagement with the board and management by Bridge Fund Managers, two new independent non-executive directors have been appointed to the board of Safari, including a new chairman.

Merger talks between Delta Property Fund and Rebosis Properties remain ongoing, with both parties engaging major shareholders and funders to obtain support for a potential capital raise that would lower gearing levels to below 40%. Following a period of significant share price underperformance, Redefine Properties is now offering value and a small position was built up during the quarter, with the intention of increasing that position as and when relative value presents itself. Many of the larger listed property companies experienced large price declines in December and are now offering reasonable value, so are being considered for inclusion in the Fund as and when relative value presents itself.

The distribution for the fourth quarter of 2019 of 4.7cpu was substantially lower than what had previously been forecast for two reasons:

- Firstly, Accelerate Property Fund reported their FY2020 interim results just over a week later than usual and as a result, have had to pay their interim dividend in the first quarter of 2020 and not the fourth quarter of 2019.

- Secondly, Delta Property Fund took the decision to pay out 40% of their distributable earnings for the six months ended 31 August 2019, given the investment required for capital commitments aligned to lease renewals following a period of substantial progress in renewing leases with the Department of Public Works (DPW). The company has indicated that the full year pay-out ratio will be 75% in order to maintain their REIT status.

As a result of these two technical factors, the Fund distribution for the full year 2019 was approximately 1 cent per unit (cpu) below what we forecast in July in our “low-road scenario” (10.24 cpu received for the A-class for 2019 versus our forecast of 11.20 cpu). Under the low-road scenario we assumed that Rebosis would pass its FY2019 dividend, Delta maintained their pay-out ratio at 75%, Community Property Fund offer for Safari Investments fell through and interest rates were maintained (i.e. no further cuts expected). The low-road scenario did not include an assumption that Accelerate would delay the payment of their interim dividend until the first quarter of 2020, nor did it predict the *way* that Delta would achieve their pay-out ratio of 75%.

Top 5 winners and losers for Q4 2019:

Winners	Ave. weight	Performance contribution	Losers	Ave. weight	Performance Contribution
Stor-Age Property	7.68%	0.77%	Safari Investments	7.03%	-1.09%
Delta Property Fund	3.39%	0.73%	Indluplace Properties	7.16%	-0.49%
Spear REIT	5.11%	0.67%	Tower Property Fund	8.55%	-0.43%
Arrowhead ‘B’	10.25%	0.49%	Grit Real Estate	7.96%	-0.16%
Dipula ‘B’	5.39%	0.37%	Redefine Properties	0.86%	-0.07%
		3.03%			**-2.24%**

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 as well as to lower-income mass-market retail and industrial/self-storage, where property fundamentals remain stronger than in office and high-end fashion retail.

Several of the larger and more liquid property companies are now offering extremely attractive initial income yields relative to their historic averages and some of the smaller and medium-sized property companies in the Fund. While there are still concerns around the way these larger companies have funded their offshore expansion, we believe that current prices and forward yields now adequately capture these risks. Over and above the current position in Redefine, other larger companies (like Growthpoint) are also being considered for inclusion in the Fund now that their relative valuations look more favourable and are expected to contribute meaningfully to the Fund's objectives of a high initial income yield, inflation-beating distribution growth and long-term capital appreciation.

The price action of the past two years 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 five to 10 years.

Based on a combination of Bloomberg, FactSet and IRESS forecasts, the current one-year (gross) forward income yield on the portfolio now exceeds 16%. We believe that investors are therefore being 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 by just over 30% in 2019, distributions are expected to recover by more than 22% in 2020 and grow between 0% and 2% in 2021. The high growth in distributions in 2020 is due to the same technical factors which resulted in Fund distributions declining in 2019 i.e. receiving three dividends from Accelerate Property Fund (versus just one in 2019) and the way Delta Property Fund has gone about achieving their 75% pay-out ratio in FY2020 (a lower interim dividend received in 2019 with a higher final dividend which will be received in 2020).

Given its attractive yield, the Fund remains 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, irrespective of the number of years they spend in retirement. Importantly, 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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