Time to break Fortress's A-B impasse

There may be gains galore from Fortress's logistics push if issues about its complex dual capital structure can be resolved

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Fortress Reit CEO Steve Brown. Picture: SUPPLIED

If Fortress Reit can successfully unwind a complex dual capital structure this year, it may be on track to resume dividends — placing the stock firmly back on investor radars.

Its B shares are up 13% from January 3, making it the JSE's best performing property counter year to date. That compares with a 3% drop in the SA listed property index over the same period.

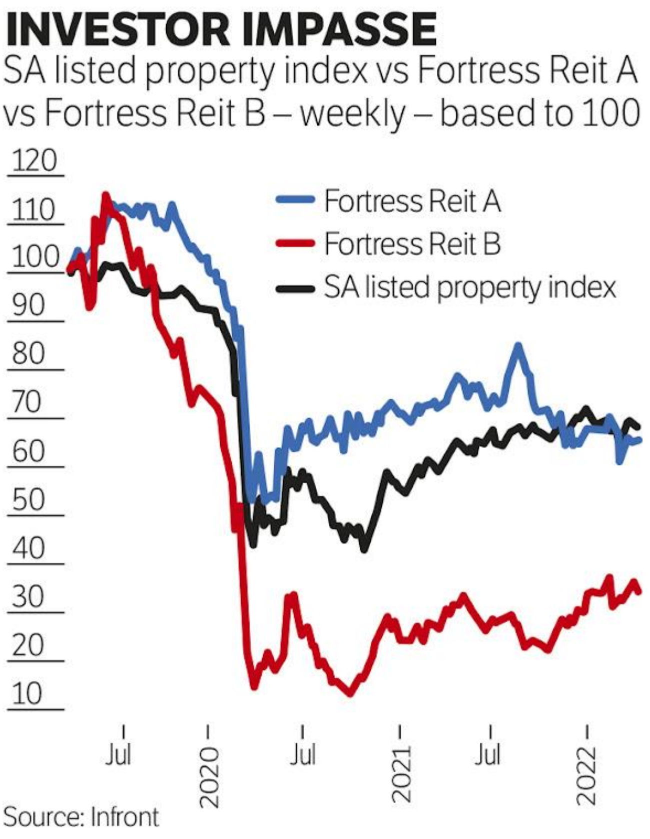
The rebound follows a dismal performance of the B shares on both the capital and dividend growth front in recent years. In fact, B shareholders haven't received any dividends over the past two years and the share price is still down nearly 90% over a five-year period.

Analysts say the dual A and B capital structure is partly to blame as A shareholders have a preferential right to dividends. B shareholders only get a dividend if there's anything left in the distributable income pot after A shareholders have been paid.

According to the company's memorandum of incorporation (MOI), dividend payouts to A shareholders increase annually by the lower of CPI or 5% a year. The problem is that the distribution threshold for A shares has over the years risen to a level that cannot always be matched by the distributable income.

As such, management last month asked shareholders to approve a change to the MOI to allow the payment of an interim dividend to A and B shareholders on a *pari passu* basis (split equally) for the first half of the financial year to the end of December.

However, A shareholders were clearly not prepared to give up their preferential right to dividends. A resounding 72% voted against the proposal. But at least 75% of both A and B shareholders have to approve amendments to the MOI. It means no interim dividends can be paid to either A or B shareholders.



Approval of the *pari passu* proposal would no doubt also have paved the way for Fortress to collapse its dual structure, which also needs the nod from at least 75% of A and B shareholders. Besides Rebosis, Fortress is the only JSE-listed Reit that still has the unpopular split share structure after a recent vote by Dipula shareholders to scrap its two share classes.

The unsuccessful attempt to dismantle this situation means something of a stalemate. It's possible that no dividends will be paid for the full year to June, too, given the likelihood that distributable income levels again won't meet A shares' distribution threshold. That could put Fortress's Reit status in the balance.

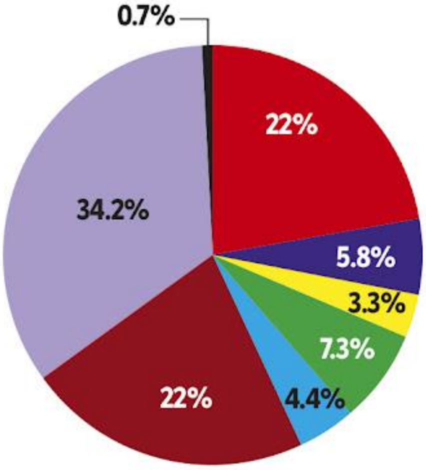
The problem, as Kelly Ward, head of research and portfolio manager at Metope Investment Managers, points out, is that the impasse has become a key detractor from Fortress's underlying business, which she says is in good shape.

She notes that management has positioned the portfolio quite defensively over the past few years with 37% of assets now invested offshore in Central and Eastern Europe, primarily via a R15.3bn stake in Eastern European Mall owner Nepi Rockcastle. The portfolio also has a 22% exposure to commuter-orientated retail properties in SA.

And management has made continued headway to ramp up exposure to the Covid-proof logistics sector. About a third of the company's R44.9bn portfolio already comprises logistics properties across SA, Poland and Romania (see graph).

FORTRESS ASSET SPLIT

Property value = R44.9bn



- SA Logistics: **22.3%** = R10bn
- SA Logistics Development Pipeline: **5.8%** = R2.6bn
- CEE Logistics: **3.3%** = R1.5bn
- SA Industrial: **7.3%** = R3.3bn
- SA Offices & Land: **4.4%** = R2bn
- SA Retail: **22%** = R9.9bn:
- Nepi Rockcastle: **34.2%** = R15.3bn
- Other: **0.7%** = R0.3bn

Source: Fortress Reit Interim Results Dec 2021

In fact, Fortress is SA's largest logistics developer and owns 1.2-million square metres of modern warehousing, storing and distribution depots. In the six months to December alone, nearly 100,000m^2 of newly developed logistics assets were added to its SA portfolio.

The development pipeline (under construction and planned) comprises another 250,000m^2 worth R2.6bn. The latter includes a new 164,000m^2 distribution centre for Pick n Pay at Fortress's flagship Eastport Logistics Park near the OR Tambo Airport on the East Rand.

The Pick n Pay property is the largest distribution centre ever to be built in Africa. Fortress also owns a R1.5bn directly held portfolio of newly developed logistics properties in Poland and Romania.

As its development pipeline is rolled out over the next three years, the plan is to reach a 66% weighting towards logistics, which has become one of the hottest real estate sectors globally on the back of the rapid adoption of online shopping during the pandemic.

Unfortunately, says Ward, management has been far from clear on how it will resolve the A-B issue — and keep its Reit status.

“While Fortress is sufficiently generating income, the capital structure is preventing the flow-through of dividend income to shareholders in an efficient manner. As a result, the A shares are no longer the low-risk investment that they once were,” she says.

Fortress CEO Steven Brown tells the FM that the company continues to engage with shareholders to try to find the best outcome for both A and B shareholders — and is now waiting for their feedback on whether they would like to alter the equity capital structure of the business.

“Ultimately it is up to shareholders to vote on any changes or MOI amendments so their input is key,” he says.

Fortress will have until end-October to pay out at least 75% of its distributable profits to shareholders or risk losing its Reit status. “That won’t be in anyone’s interest,” Brown says.