Metope 2019 Outlook

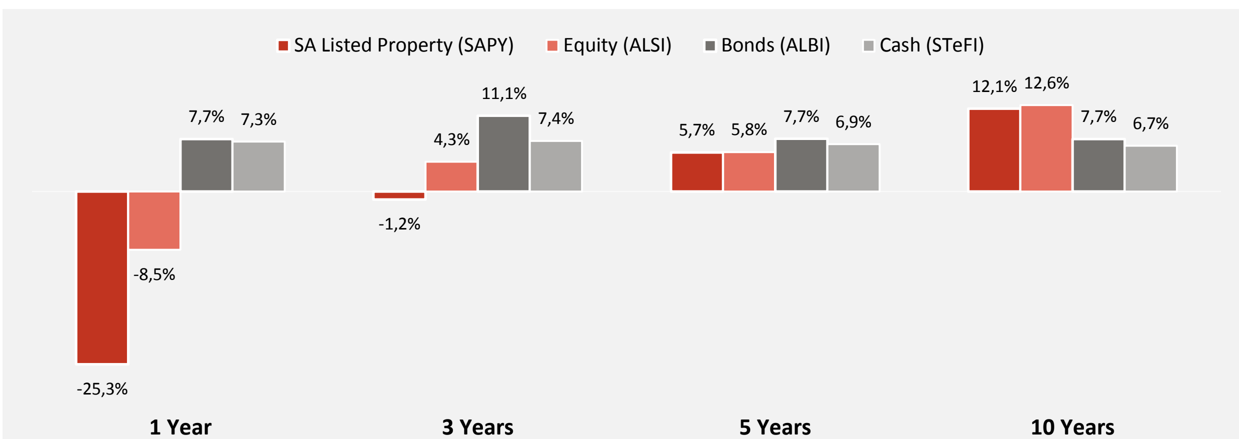
Economic Background and Context

**Please note that all forecasts in this article were made at the time of writing at the beginning of January 2019*

2018 was an inordinately challenging year and the worst year for listed property in at least 10 years. The FTSE/JSE SA Listed Property index (SAPY) ended December down 1.1%, bringing the total loss for the year to 25.3%. Listed property was the weakest asset class in the SA market for the first time since the SAPY launched in 2002. Similarly, amid US-China trade wars and global emerging market risk-off trading, South African equities followed suit with the worst annual performance in a decade. Cash and government bonds proved a safe haven over the period, delivering positive returns to investors.

Rising rates and a moderation of quantitative easing put pressure on the real estate sector globally, with all major markets tracked by the FTSE EPRA/NAREIT indices, both developed and emerging, ending the year in negative territory. SA's performance was further affected by weak growth prospects and political uncertainty at home, as well as the large sell-off in the Resilient stable of companies following a short seller's negative report. Ongoing investigations into the trading of shares in the stable and governance issues have kept prices under pressure, with most investors awaiting the outcome of the FSCA and JSE investigations.

Chart 1: Total Returns – Listed Property vs. other asset classes



Source: IRESS

Weak GDP numbers in the first two quarters of 2018 sent South Africa into a technical recession, which was then lifted in the third quarter off the low base set previously and a rebound in manufacturing and agricultural activity. Growth for the year looks likely to come in around 0.7% for 2018, revised downwards from a projected 1.7% at the beginning of the year. The South African Reserve Bank is currently forecasting GDP growth for 2019 at 1.7%, whilst the World Bank lowered its forecast to 1.3%, previously 1.8%.

Despite all of the pressure, listed property has proved itself once again by delivering a stable income return to investors. While the share prices and capital values of property stocks were hit hard, the companies continue to deliver on their income distributions, and investors in the SAPY received an annual yield of 6%. After many years of

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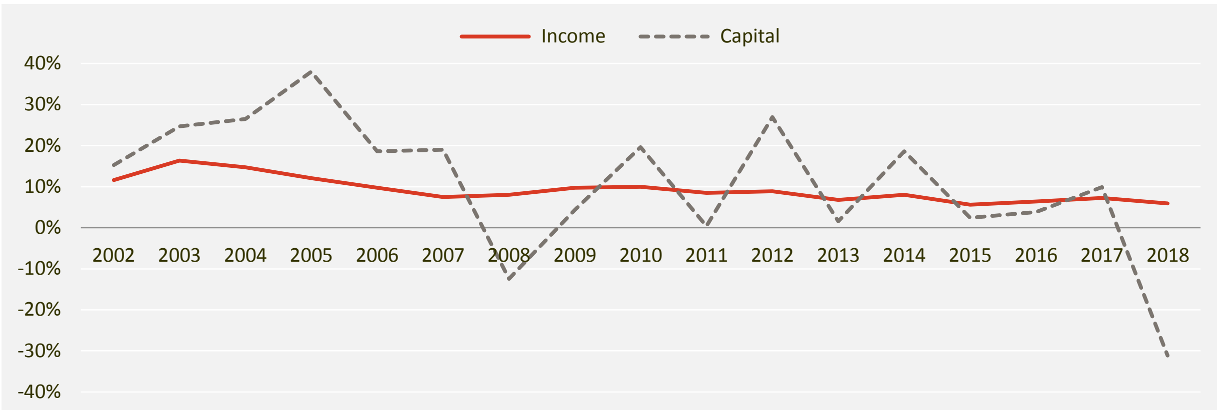
stellar performance from listed property, due in large part to offshore investment by several of the counters, investors have come to expect exponential capital returns from listed property. However, it is rather the stable, sustainable and growing income stream that is the hallmark of listed property, and what investors should look for in an investment into the sector.

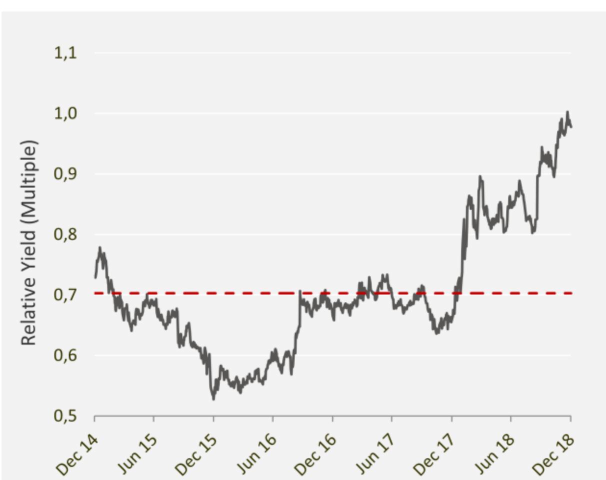
Chart 2: Annual Income and Capital Return of Listed Property



Source: IRESS

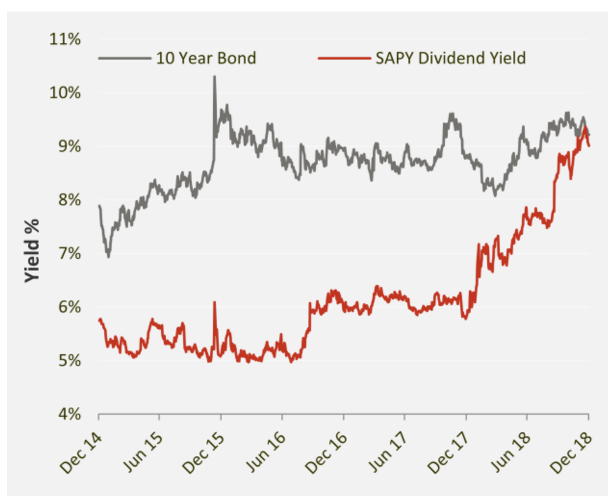
To this end, due to the significant derating in the industry and the decoupling of the listed property to government bond correlation (as a result of the Resilient group fallout), the historic yield of the SAPY ended the year at 9% (up from 5.8% at the start of the year). Looking forward, investors can expect an initial yield of around 9.5% from the sector, comparing favourably to the yield-to-maturity on the long-term SA government bond, which ended the year at 9.2%.*

Chart 3: Listed Property to Bond Yield Relative Ratio



Source: IRESS

Chart 4: Listed Property Historic Yield & 10-Year Government Bond Yield

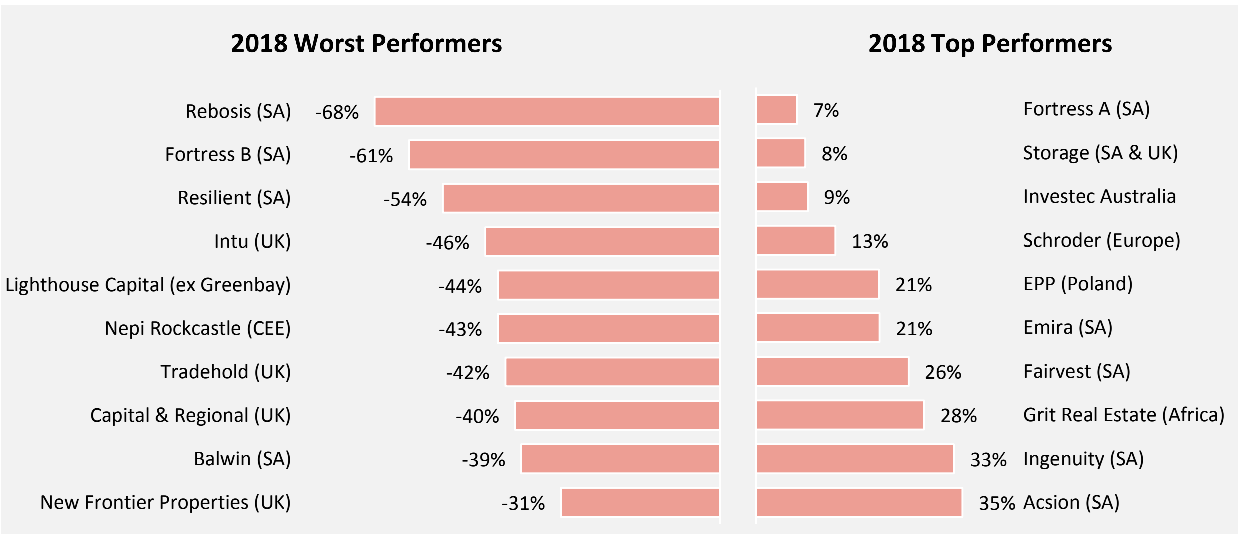


Whether the current valuation is sufficient compensation for the slowing income growth and the increased risks inherent in the sector, such as currency and the effect of rising interest rates on earnings, will depend on how the current crises at Eskom and other state-owned enterprises, as well as Edcon are managed and whether we are able to avoid a further credit downgrade to junk status. If we muddle through these potential shocks, and we have a successful election outcome, we believe the current yields in listed property present a good long term buying opportunity. Stock selection, however, will be key.

Listed Property Market

Listed property companies that delivered positive returns in 2018 were few and far between, with returns ranging from -68% (Rebosis) and +35% (Ascion).

Chart 5: Top and Bottom Performing Counters



Source: IRESS

Brexit macroeconomic uncertainty had ramifications throughout the year for locally-listed UK property companies Hammerson (-29%), Intu (-46%), Capital & Counties (-19%), Capital & Regional (-40%), RDI REIT (-9%) and New Frontier (-31%). As the pound weakened, earnings were cut and prospects dimmed with, for example, Intu seeing two takeover attempts fail, which depressed the share price and sent worrying signals for UK retail.

The UK economy is looking very weak in the face of Brexit uncertainty with the deadline approaching fast and no deal currently agreed to. Retail sales are under pressure as the consumer treads cautiously and investors adopt a "wait-and-see" approach. Some counters are trading at significant discounts to NAV, but we feel that valuations will come under more pressure in the medium term as cap rates adjust higher. As long as the Brexit uncertainty remains, we prefer to defer buying of UK retail property stocks.

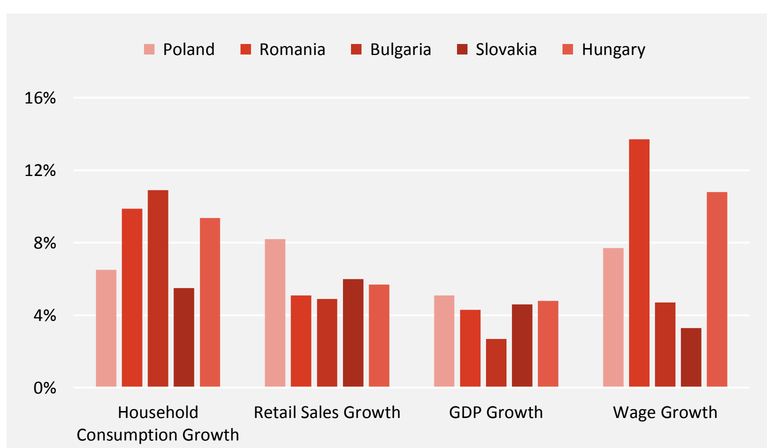
Certain SA-focused stocks also had a torrid time, as their high levels of internal debt has left them little room to manoeuvre in a weak market. There were plenty of earnings disappointments during the period, with lowerquality property portfolios struggling to retain tenants and having to compromise on rental growth in order to sign leases. A-class shares fared better due to their preferential right to income growth at 5%. Amongst SA-focused property funds, most guided towards lower growth in the upcoming financial year, highlighting the tough conditions facing the market.

The future (or lack thereof) of Edcon was a major focal point throughout the period, as landlords attempted to rationalise and take back space ahead of possible business rescue or total business failure. The departure of Stuttafords from the market in 2017 served to provide space in malls for new entrants and international retailers, a fortune that is unlikely to befall landlords this time around as demand for space from both local and international retailers has weakened. In addition, Stuttafords held a much smaller national retail footprint than Edcon, which is a feature of almost every mall in South Africa and employer of close on 27,000 staff (at the time of closure, Stuttafords had nine stores in South Africa and employed 950 staff). Edcon is expected to reduce its footprint by 250,000sqm in the medium term, or roughly 1% of total shopping centre space in SA. While some centres may be able to rent the space at higher rentals and improve the tenant-mix, the overall effect on the sector is expected to be negative. A complete liquidation and closure of all stores could see income in the sector decline by 2%, however Edcon is currently in talks with major landlords to negotiate a “rent holiday’ while they restructure, which would minimize the impact on income to c.1%. These negotiations will need to be carefully managed by landlords so as not to set a precedent for other retailers.

We expect local rental growth to remain under pressure due to an oversupply in many sectors and weak economic growth dampening demand. Vacancies in the retail sector have increased, while the rent-to-sales ratio, a measure of affordability for tenants, remains at all-time highs in the larger retail formats as rental growth has outpaced retail sales growth. This indicates that there could be further pressure on rental growth as tenants are unable to absorb higher costs without supportive retail growth. Most companies reported slower like-for-like income growth in 2018 compared to previous years and we expect this trend to continue in 2019.

Central Eastern European countries, in which a number of JSE-listed funds are Invested, continue to offer better property fundamentals than in SA and many developed markets. The region is expected to have delivered 4.2% GDP growth in 2018, as well as strong growth in wages and household income, which is in turn driving strong retail sales growth in the region. On an absolute basis, consumption and income per capita still lags Western European countries, thus supporting further growth in spending power.

Chart 6: Central Eastern European economic indicators



Source: IRESS

Brexit plays well into these economies
hands as migrants return from the UK, given the uncertainty there. Growth in the back office and services sector

has seen a demand for office space. While we are mindful of a number of political concerns faced by the region, particularly growing far-right rhetoric in Poland and Hungary and concerns over corruption and a weakening rule of law in Romania, we expect funds in the region to continue to provide strong distribution growth as fundamentals remain supportive for real estate.

The Chinese economy is cooling and growth is expected to be lower than the growth of over 6.5% seen over the past few years. Demand for resources may therefore slow and this will further impact the South African and Australian economies.

Outlook

At the end of 2017, the short-term outlook was focused on the ANC December conference, and similarly in this period we look toward the National Elections in May 2019, where a strong mandate for the incumbent president will allow for greater clarity on land reform, corruption and budget issues. South Africa continues to be hamstrung by the capital demands of State-Owned Enterprises, and a continuation of December's load shedding will undoubtedly affect GDP growth.

Looking forward to 2019, we expect to see continued pressure on rental renewals and new leases across all sectors of the property market. Counters with a long-dated lease expiry profile will be protected, as well as those with some diversification to offshore jurisdictions.

After raising rates by 100bps in 2018, the US Federal Reserve appears to be taking a less hawkish stance for 2019. Given the volatility in markets in the latter part of 2018 and concerns over global growth, trade policies and some weaker economic and inflation data out of the US towards the end of 2018, we expect the Fed to slow the pace of rate hikes as it reaches the lower end of its perceived 'neutral' interest rate target band. This would somewhat ease the pressure for emerging markets, including SA, to raise interest rates and could see some support for the Rand. However, with the SARB targeting inflation 12-18 months out, and given that the current petrol price cuts will likely reduce inflation in 2019 - creating a base effect for rising inflation in 2020 - as well as the likely larger electricity tariff increases, we could see the SARB raising rates in the latter part of this year.

Given the uncertainty in the growth trajectory of the SA market, we believe the high cash income yield of 9.5% offered by listed property remains very attractive in an uncertain global environment and portfolios should have a significant weighting in listed property. In addition, with the decoupling of the listed property correlation to bonds, the asset class now offers greater diversification benefits to a balanced portfolio, increasing the risk-adjusted return outlook.

While 2018 provided a barrage of shocks to the sector and a flight of capital out of the sector and out of the country, and there might well be further volatility, we do expect to see some stabilisation in yields and possibly a recovery in 2019 as investors regain confidence in the sector's ability to deliver growing income streams. An announcement by the JSE and FSCA on their investigations into short selling activity and the allegations against the Resilient stable would help to ease investors' concern over corporate governance in the sector and could drive a recovery in valuations. In addition, more policy certainty following the upcoming budget and elections, as well as details around President Ramaphosa's economic recovery plan and land expropriation policies will alleviate some uncertainty in SA markets.

End