M&G Property Fund

Property

Q1 2023

Market overview

So far in 2023, global financial markets have experienced wild swings – particularly in the normally less volatile fixed income markets – dictated by the guessing game over the path of US interest rates, inflation and growth.

January's sentiment was relatively bullish, dominated by expectations of a weaker US economy going into 2023, which would have increased the likelihood of softer inflation, lower-than-expected interest rates and a relatively imminent pause to the US Federal Reserve's rate hiking cycle. This was all up ended in February by surprisingly strong economic data, including more widely embedded inflation than previously thought. With the Fed signalling its intention to continue hiking, this sent market uncertainty higher and global asset prices lower, an environment that continued well into March.

Then the emergence of banking sector turmoil sparked by the sudden failure of specialist Silicon Valley Bank and the engineered buyout of Swiss banking giant Credit Suisse by UBS shocked markets even further, with swift central bank and government interventions preventing contagion to other sectors. Gold benefited and risk-off sentiment prevailed as global financial stocks sold off.

Central banks suddenly had an even tougher policy balancing act, having to choose between their duties of fighting inflation, safeguarding national banking systems and supporting growth and employment. Ironically, this led back to more positive expectations of lower interest rates and sooner-than-expected rate pauses.

The US Fed hiked by a measured 25bps in March, as expected, as did the Bank of England (BOE), while the European Central Bank (ECB) and SA Reserve Bank (SARB) announced relatively robust 50bp increases given their higher inflation threats.

Looking back, investment managers have rarely seen such sharp changes in market views in such a short period of time. US Treasury bonds, for example, experienced high volatility of around 10%, with the 10-year UST yield falling by 50bps from around 4.0% to 3.5% between February and March – an exceptionally big move in that market.

While the growth outlook improved in several key economies, making equities more attractive, risk aversion still made itself apparent over the quarter. Global property stocks continued to generate among the weakest returns, with the FTSE EPRA/NAREIT Global REIT Index returning 1.4% (US$).

South Africa

In South Africa, the equity market was dented by risk aversion and weakness in Listed Property and Resources stocks during the quarter but buoyed by Industrial shares. The FTSE/JSE All Share Index (ALSI) returned 5.2% in Q1, while the more locally exposed Capped SWIX delivered 2.4% (both in rands). Industrial counters returned 13.6%, while Financials produced 0.4%, Resources -4.4% (Resources 10 Index) and the All Property Index -4.8% (all in rands).

In South Africa, the SARB surprised with a larger-than-expected 50bp interest rate hike on 30 March, citing strong inflationary pressures from food, administered prices and a depreciating rand. February CPI came in at 7.0% % y/y, aided by substantial increases in food, transport and medical services prices. Many had thought the Bank would follow the US and UK with a 25bp rise, especially given very weak local economic growth: Stats SA reported that Q4 2022 GDP contracted by 1.3%, more than expected, due to intensifying load-shedding. At the same time, National Treasury revised downward its projection for annual real GDP growth, now expected to average 1.4% from 2023 to 2025, versus 1.6% previously.

The 50bp rate increase did help to reinforce the SARB's global credibility, while the rand reacted by strengthening below the key R18/1USD level, at least temporarily. The SA forward rate market is now pricing in a further 50bps in interest rate hikes from the SARB this year before the central bank pauses and then starts cutting rates again. Meanwhile, S&P Global downgraded the sovereign credit rating outlook to stable from positive, citing load-shedding and the fragile economy as the primary drivers.

Also during the quarter, investors welcomed the 2023 National Budget's improved fiscal trajectory and the government's plans for Eskom debt relief, as markets reacted marginally favourably. Eskom remained in the spotlight for much of the period as its departing CEO reported high levels of corruption within the utility, prompting more intensive investigations from journalists and the government.

Meanwhile, South Africa was grey-listed by financial watchdog FATF, so that more scrutiny of the country's international transactions is necessary to root out money laundering and financing of terrorism. Higher costs and administrative hurdles will likely result, experts said, and banking shares fell 2% in reaction to the announcement. Bonds and the rand were little moved, however.

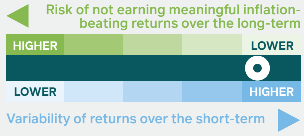
Performance

The M&G Property Fund returned -3.7% for the quarter with the All Property Index down 4.8%. For the 12 months to 31 March, the Fund delivered -1.9% compared to the benchmark's -5.1%, producing outperformance of 3.2%.

Top contributors to performance for the quarter were overweight positions in Hammerson, Fortress A and Sirius, as well as underweight positions in Redefine, Resilient and Investec Property Fund. Underweight positions in Attacq and Emira detracted from performance, as did overweight positions in SA Corporate, Vukile and Stor-Age.

Annualised performance	A class	Benchmark	D class
1 year	-1.9%	-5.1%	-1.6%
2 years	12.5%	9.5%	12.8%
Since inception	15.1%	13.5%	-

Risk profile



Fund facts

Fund managers
Yusuf Mowlana

ASISA category
South African – Real Estate – General

Benchmark
FTSE/JSE All Property Index

Inception date
9 July 2020

Fund size
R151 401 820

Sources: M&G Investments, Morningstar & Deutsche Securities

Global property markets are currently being impacted by a multitude of factors, many of which are interrelated. Higher interest rates, refinancing risk and cost pressures, whether energy or municipal, are conspiring to significantly depress property valuations.

Strategy and positioning

Interest rates impact real estate companies disproportionately when compared to general equities. Real estate companies tend to make much more extensive use of debt when compared to non-real estate companies. Debt multiples of EBITDA in the sector can range from a 'conservative' 4x for some companies in South Africa to as much as 15x for some Scandinavian companies. The debt multiples of EBITDA for South African companies are much lower because the valuation yields, or cap rates, used to value the properties are far higher than European counterparts, given the interest rate differentials. A cursory look at loan-to-value ("LTV") ratios can often paint a very different picture of a company's indebtedness especially when the 'V' in LTV is overstated. Interest rate normalisation in many European property companies will result in some companies becoming distressed and having to dispose of properties to reduce debt and refinancing on substantially less favourable terms.

Importantly for the fund, the debt metrics of core holdings such as Nepi Rockcastle, Sirius and Shaftsbury Capital (the new entity into which Capital & Counties merged) do not face likely refinance risk. Hammerson, another holding in the fund, retains sufficient cash and facilities to repay its near-term expiring bonds up to 2025. In South Africa, LTV ratios and debt to EBITDA metrics are all well within covenant levels and banks have generally demonstrated appetite to refinance existing debt. To the extent that South African-listed companies have reflected discounted valuations for the aforementioned issues, we have generally seen it as an opportunity to add to positions.

Cost pressures continue to mount. Many foreign landlords either had the foresight to hedge their energy costs prior to the outbreak of the war in Ukraine or have been able to pass on most of the higher energy costs to their tenants. The cost problem is more acute in South Africa where administered costs (rates, electricity and other municipal services) will increase at double-digit rates. The relentless cost pressures may well offset any benefits to landlords from the post-Covid recovery in retail sales.

We see good value in the sector, albeit with some headwinds holding sector returns back. The currently attractive SA 10-year bond yield is likely to prevent the sector from significant re-rating in the near-term, due to near-term cost pressures for South African companies. It's likely that the outcome will be low double-digit returns in rand terms for the sector as a whole.

The Property Fund's key overweights are Sirius, Stor-age, SA Corporate and Fortress A shares.

M&G Investments

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Application forms

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