October 2016

Monthly newsletter

In this edition we review the SA equity market performance for October 2016.

As always, we welcome your feedback and look forward to assisting you with your equity portfolio.

The Legae Team

Equity Review

The FTSE/JSE AllShare (-2.6%) ended the month in negative territory for the third consecutive month. The index was dragged down by gold, platinum and construction stocks. A number of commodity producers, mainly precious metals producers, released lacklustre results for the quarter. In a trading statement, Sibanye Gold (-25.7%) said it expected improved earnings but expected higher costs and less production for the year ending 31 December 2016.

Murray & Roberts (-17.1%) was one of 7 construction companies that chose to participate in a R1.25bn voluntary settlement agreement between construction companies and the government to appease competition authority penalties and accelerate transformation in the industry. While this will settle many of the collusion claims in the industry, the companies will still be exposed to any claims brought by state-owned enterprises and public entities that are not covered by the settlement agreement.

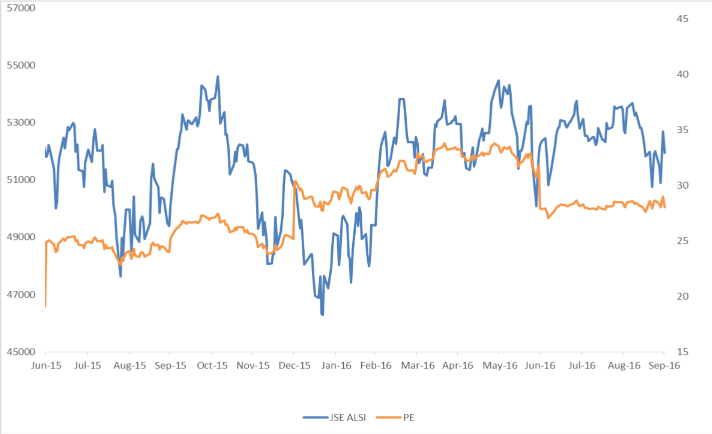
ArcelorMittal SA (+29.2%) announced plans for a R2.3bn BEE deal in which the company will issue a 17% shareholding to a specially formed black-owned company, Likamva Resources Pty Ltd. This will help the company get BEE credentials and also improve its relationship with the government.

One of the best performers this month, Net1 Technologies (+23.7%) agreed to buy a 15% stake in Blue Label Telcoms worth about R2bn. Simultaneously Blue Label announced its intention to acquire 45% of Cell C.

Kumba (+10.3%), Exxaro (+17.2%) and Assore (+22.9%) benefited from higher iron prices (+15.3%) this month. Kumba also reported a 3% increase in production in Q3 and a total sales increase of 2%. Iron prices are not expected to remain at these levels as the recent increases attracted additional supply from higher cost producers which will add to the oversupply in the iron ore market.

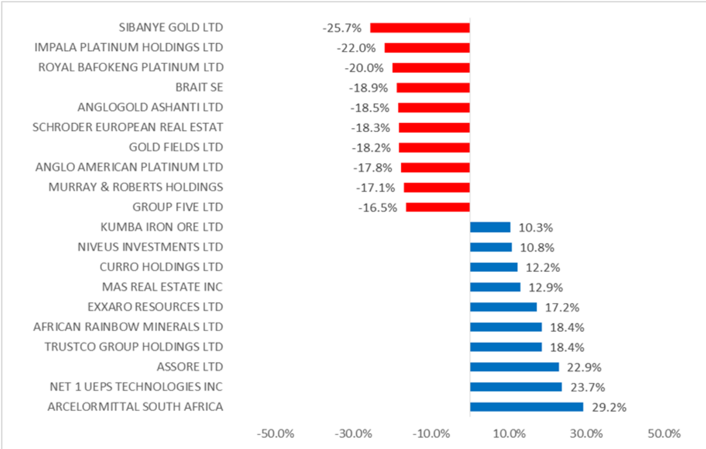
Dis-Chem announced plans to list on the JSE in November. The company plans to sell 238.4m shares, about 27.5% of the company at between R16.25 and R20.25. The Saltzmans remain the company's largest shareholders owning 66.9% of the company through the Saltzman Family Trust. Dis-Chem says the listing will result in an injection of new capital to be used to repurchase shares from the existing shareholders, repayment of existing debt and general corporate purposes.

Figure 1: AllShare Index performance (left axis) and PE (right axis)



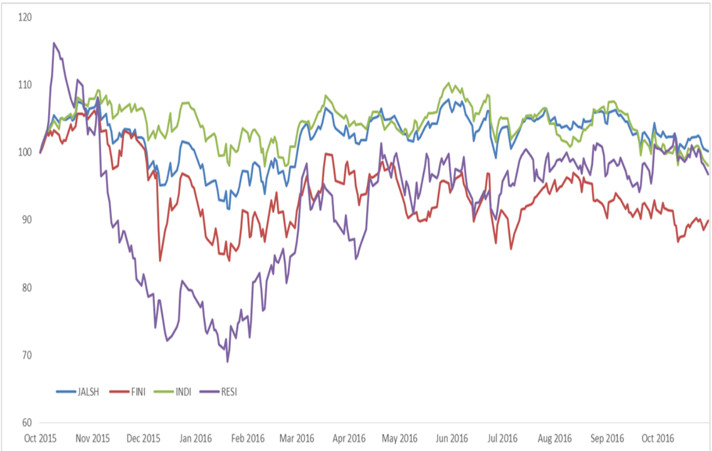
Source: Bloomberg

Figure 2: Winners and losers for the month



Source: Bloomberg

Figure 3: ALSI vs Fini15 vs INDI25 and RESI



Source: Bloomberg

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Economic Review

In his medium-term budget policy statement, Finance Minister Pravin Gordhan revised economic growth down from 0.9% to 0.5% for the year and forecast 1.7% growth for 2017. The minister alluded to a tax increase to fund the budget shortfall but gave no specifics. It is doubtful that he would've done enough to dissuade rating agencies from downgrading the country's sovereign rating.

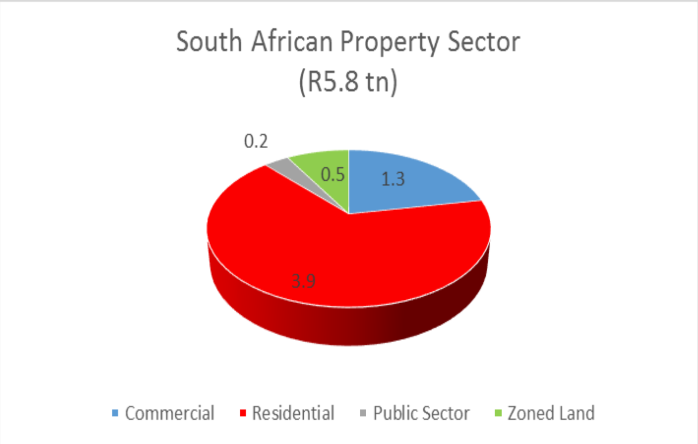
Inflation rose 6.1% (+0.2% MoM) in September as cost of transport went up at a faster pace in the month. This was below market expectation of 6.2%. The South African trade balance posted an unexpected trade surplus of R6.6bn in September compared to a deficit of R8.8bn in August, beating market expectations of R1.1bn. Exports rose by 10.1% boosted by higher sales of precious metals and chemical products. Imports however decreased 6.6%. Manufacturing PMI fell to 45.9 in October compared to a downwardly revised 48.5 in September, the lowest reading since January 2016.

South African property market keeps growing

Tepid growth has been the theme in the macroeconomic landscape this year with the latest projections by National Treasury being that economic growth is set to decline from 0.9% to 0.5% in 2016. However, the South African listed property sector has received a positive reputation as being quite robust in turbulent times, raking in impressive returns for investors inclusive of handsome dividend yields. The FTSE/JSE SA Property Index's (SAPY) 3 year average dividend yield is 5.75.

An important study made by the Property Sector Charter Council this year valued the South African property sector at R5.8 trillion. The study builds on baseline research that measured the size of the property market in South Africa at R4.9 trillion at the end of 2010. Thus there has been an almost R1 trillion increase in the value of the sector in four years.

Size of SA property sector



Source: SA Commercial Property News

The property sector can be cut cross-sectionally and viewed as the commercial, office and industrial, retail, and residential markets. With regards to commercial property, there is an oversupply of space in the South African metropolitan office nodes. The pressure on operating costs, particularly rates and electricity, are pushing firms to think more about green developments. This will likely result in high initial capital outlay, but will contribute to long-term cost reduction. In the office market, there's seemingly a gravitation towards prime quality premises with modern features and a focus on sustainability.

The retail market has seen the completion of the Mall of Africa, one of the largest in the continent, in a difficult trading environment. This sector is likely to suffer tighter margins with consumers in a tight spot amid an interest rate hiking cycle and rising consumer inflation. Lastly, residential property sales were lively earlier in the year despite uncomfortable economic headwinds. However, activity in the lower and mid-value markets is expected to decelerate, due to economic pressures being felt by the lower market segment.

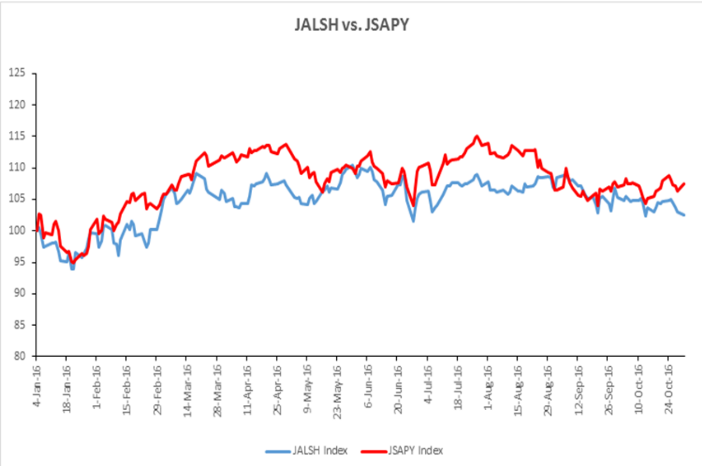
Many local property players have sought growth in Eastern European countries such as Romania, Poland and Serbia to name a few. There is a case to be made for the eastern European bloc. Eastern Europe contributed to four of the five fastest growth rates in the European Union in the 2nd quarter as consumer spending offset a drop in investment. Redefine Properties made a foray into Poland this year as they bought a 75% stake in Echo Prime Properties. Hyprop Investments Limited have also made a move into Europe. They made an acquisition through an offshore joint venture company and acquired an interest in two shopping malls situated in South-Eastern Europe shopping malls.

New listings on the JSE though have slowed somewhat this year with a form of a consolidation occurring in the sector. Recent prospective listings include retail-focused Liberty Two Degrees and a UK-based property play by global asset manager Schroders. The third is a R1.4bn Western Cape-based portfolio owned by entrepreneur and former Redefine Properties director Mike Flax, named Spear Properties.

Property Sector Performance

From a performance perspective, the SAPY has returned 8.8% YTD on a total return basis beating the JSE All Share index, which gave the investor 3.1% in comparison. The property sector has been a stellar performer for a number of years, however its performance has started to wane in recent times. The SAPY had a 7.9% total return in 2015 which came in more than three times lower than in 2014. The first quarter of this year helped secure a large proportion of the gains we see in the sector which came in at 10%.

Investors poured a lot of their money into property searching for yields in the midst of volatility in the 1st quarter following the dismissal of Nhanhla Nene in December. This performance is in sharp contrast to the losses suffered by the sector in quarters 2 and 3, which came in at a disappointing −0.4% and −0.7%, respectively.



Source: Bloomberg

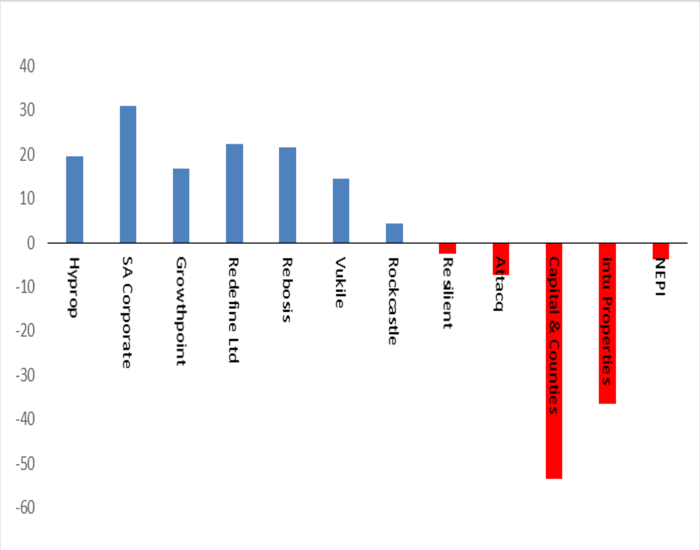
The listed property sector has managed to outperform other equities but has been outdone by bonds during 2016. Bonds were the top asset class with a return of 11.7% while property has returned 8.8%.

It has been a trend lately for local property companies and for local investors to favour offshore property exposure. Since property is sensitive to bond yields, if bond yields are going to pick up internationally on the back of rising interest rates, property is not going to escape that pain. Locally, we're probably at the top of an interest rate cycle, whereas globally we're at the bottom of the interest cycle. So therefore it may be time to move from global property into South African property.

The recent financial reporting period showed that dominant, large shopping centres were the most resilient subsector, while offices have struggled this year to date. Industrial property is experiencing similar headwinds to offices with regards to weak reversions but demand for good quality modern facilities remains.

SA Corporate Real Estate has been the best performer up 20.2% year-to-date, having reported 9.1% distribution growth for the six months to June and achieved a total return of 12.3% YTD. Hyprop Investments, a shopping centre owner, also performed strongly, achieving a total return of 19.4% YTD. Redefine Properties has also been a strong performer this year, with a total return of 22.4% YTD. Its performance has been buoyed by acquisition activity and solid performances by its blue chip assets, such as Centurion Mall in Pretoria and Blue Route Mall in Cape Town.

Individual company Total Return YTD



Low economic growth has been the major hurdle for the sector and the status quo has been to buy offshore property stocks and ETs. However, with the Brexit in June, JSE listed Capital Counties and Intu Properties have come off a great deal. The companies' total return has declined substantially YTD. This may present a buying opportunity but until the political issues around Brexit are resolved it is difficult to estimate the full impact it may have on the UK property sector.

Final Thought

The US Federal Reserve is expected to raise interest rates in December. Economic data from the US has been supportive of a Fed hike even with the current political instability ahead of the presidential elections. The US dollar has been strong subsequently, which has weighed heavily on commodities. Emerging markets still seem resilient even with the expected capital outflows should the Fed raise rates.

Locally, the currency has been strong in recent months when compared to other EM currencies. Local political factors have been the main driver of Rand weakness in recent months. However, with the sovereign rating downgrade almost imminent in coming months there may be a pullback in the currency.

Inflation has been largely subdued in the past few months, however oil price and currency fluctuations are likely to keep inflation above 6%. The Reserve bank is not expected to raise rates for the rest of the year.

This month, we largely focused on the property sector. The sector looks set to outperform the All Share yet again and still offers value in an interest rates rising environment. Perhaps the biggest headwind to the sector is the low economic growth which will hurt earnings.

As previous results show that the larger shopping centres are the most resilient we are inclined to favour companies with substantial exposure to retail and specifically larger shopping centres. Thus Hyprop, Growthpoint and Redefine are the most favourable.