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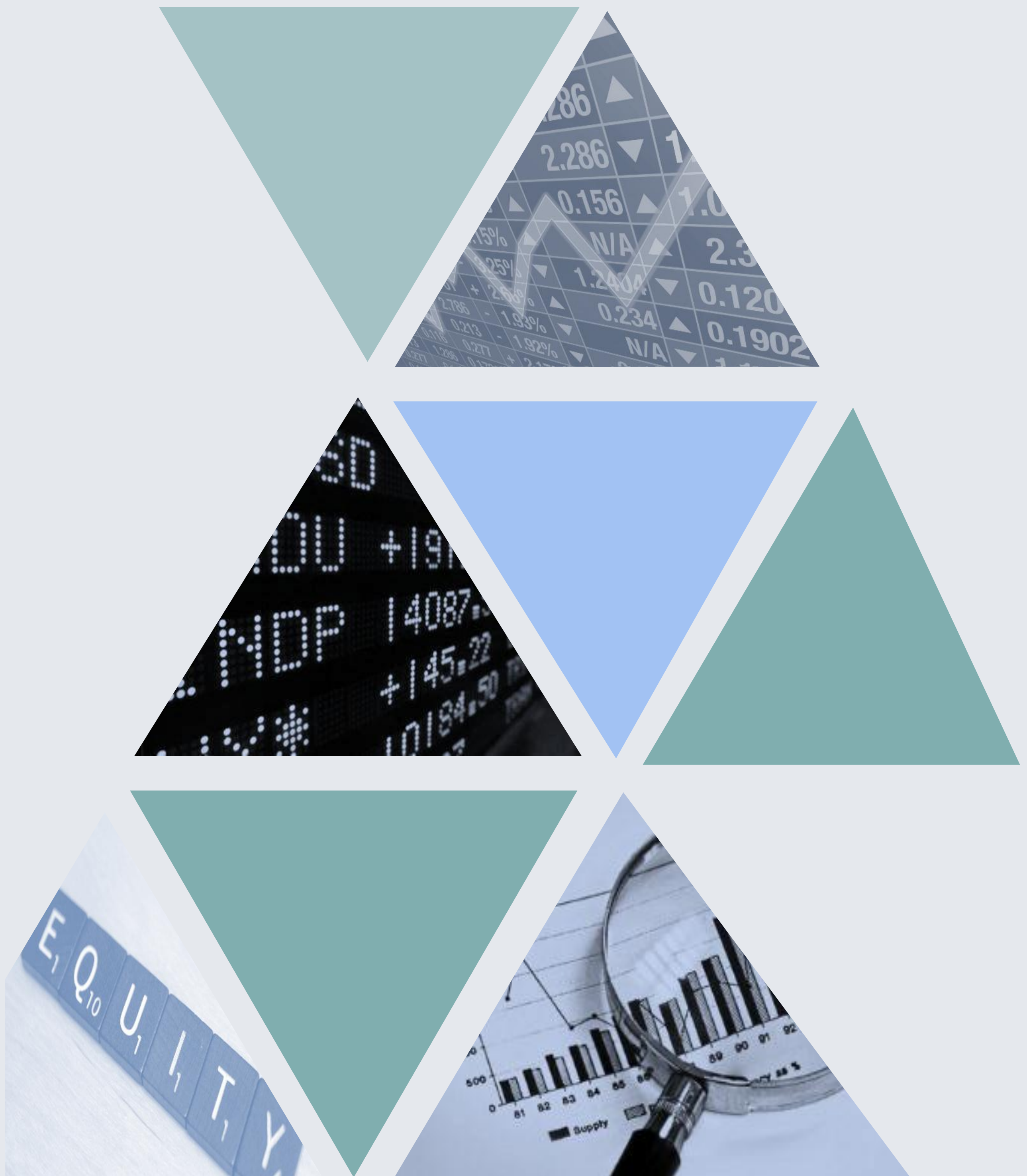

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Introduction

EAR's November report aims to provide some perspective about the listed property sector. Listed property refers to a company (or a trust) listed on the stock exchange and its main activity is to own property with the intention to earn rental income from various tenants. SA's listed property companies or funds hold properties ranging from commercial property, industrial property and residential property. SA's listed property index has transformed in recent years with the Real Estate Investment Trust (REIT) dispensation being adopted in 2013. SA changed its tax legislation so as to align to international best practice, and thus be in line with established REIT models in regions such as the USA, UK and 20 more other countries. Furthermore, JSE regulations were changed to allow for listed property funds to list as REITs. By implication, SA's listed REIT sector is fairly new (i.e. the dispensation and not the companies) and one may be tempted to think that the relatively high and consistent returns generated by these companies could be attributed to this "new investment variation".

SA's Listed Property

The JSE has two types of listed property funds. These are REITs and capital growth funds. This issue will focus on listed REITs and not capital growth funds. EAR's Issue 3 (April 2016) focused on a capital growth fund, which is similar to a REIT but does not benefit from the REIT dispensation and does not have to comply with the rules that govern REITs. Issue 3 covered Attacq, which is a capital growth fund (or listed property not listed as a REIT). This report will focus on listed REITs. Listed REITs have different features from listed capital growth funds such as Attacq. These features include the following:

- A Listed REIT must own at least R300 million worth of property
- A listed REIT must keep its debt below 60% of its gross asset value
- A Listed REIT must earn 75% of its income from; (i) rental, (ii) property owned or (iii) investment income from indirect property ownership (owning shares in any other listed REIT, whereby dividends from the listed REIT (investment vehicle) equates to 75% of distributable earnings of the main REIT receiving the dividends)
- A REIT must have a committee to monitor risk
- A REIT must not enter into derivative instruments that are not in the ordinary course of business
- A REIT must pay at least 75% of its taxable earnings available for distribution to its investors each year

Why Investors Should Take Note

The key feature and most compelling aspect about a listed REIT is that it allows a pass-through effect in terms of rental income to retail investors (investors holding shares in listed REITs). The pass-through effect is realized when listed REITs are required to distribute at least 75% of its net income (through dividends). Let us assume there is person A, who would like to own a property so as to earn rental income and decides to approach a bank for a loan to buy the property. Person A will have a liability backed by the asset (property) and person A is hoping that over some time, the property may grow in value so that this person may realize a profit on sale. The key element here is **hope**, as there is no guarantee that the property will grow in value (or at the desired rate). This type of property investment exposes the owner to other costs associated with owning physical property

such as maintenance (directly or through the agency managing the property), rates and taxes as well as other costs. In some instances, the property may be vacant and the owner may need to service the loan from his/her own pocket or may be forced to charge lower rentals to fill the space up. This could result in the owner having to cover the difference between rental income and loan repayments from his/her own pocket. Assume person A does well and buys a second property, chances are the acquisition may be leveraged again. Assume there is person B, who would like to get exposure to property without leveraging. Person B can use his/her R1, 000 (hypothetical disposal income) to buy at least 140 Accelerate Property Fund shares at R6.08 per share to gain exposure to property. The benefit in this regard; person B does not owe the bank, rather, Accelerate will owe the bank (assuming they have loans). Person B benefits from a diverse portfolio of properties and clients with industrial and commercial properties. Person B gains exposure to good clients in the form of retailers (at malls), businesses etc. Most importantly, person B will receive his/her share of rental income as Accelerate is required by law to transfer at least 75% of the net rental to person B (as a unit holder or shareholder). Person B can also take comfort from the idea that the other remaining 25% can be used to accumulate capital so as to acquire or build more properties. Moreover, person B can also get access to properties in other countries should Accelerate want to diversify. Another important element is that person B can sell whenever he/she wants without paperwork or administrative considerations. In summary REITs offer the following to retail investors (or person B):

- A regular income distribution through rental pass-through.
- A share in a REIT has characteristics of a bond instrument and equity instrument
- Exposure to high-quality office, industrial and retail properties in one investment.
- **Listed property shares as an asset class are more liquid compared to physical holding of property.**
- Transparency with regular statutory reporting.
- No taxes paid in the vehicle itself.
- Oversight from the likes of the JSE and Financial Services Board (FSB).
- Low transaction costs, especially compared with buying property in your own name.
- Investors do not pay transfer taxes (STT) when trading their REIT shares (an investor would pay transfer taxes if they had to trade shares in any other listed company). Therefore, savings' benefit on another layer of costs!
- Diversification of investment assets, as most portfolios are geographically diverse and some offer exposure to a combination of office, industrial and retail properties.
- Property and asset management is undertaken by professional managers, usually incentivised to enhance shareholder value through their participation in share options or share purchase schemes.
- REITs do not pay Capital Gains Tax (CGT); however, an investor who sells their REIT shares may pay CGT.
- The company, and not the retail investor, is leveraged (assuming some debt is used to acquire properties). However, the leverage is limited by law as REITs are required to limit debt to 60% of the gross value of the properties. Retail investors can be leveraged if they use derivative instruments such as (Contract for Difference) CFDs or Single Stock Futures (SSFs) to participate in REIT shares.

November's Theme

Following the themes EAR adopted for the months of October, November and December 2016, this month's issue takes a different approach. In October, EAR aimed to establish the merits of investing in the so-called "risky" industry by analyzing some selected construction shares and assessing if there is any

value, particularly those shares whose probable distress seemed high (as indicated by their respective z-scores). Linking to the construction industry (and it may be argued that this is a sister industry); REITs own and manage various properties that would have been constructed by the various construction firms. From a sector investment perspective; REITs may be more attractive (compared to construction companies) due to the limited cyclicality and also the annuity income that REITs generate in the form of rentals from tenants. Moreover, the net annuity income passes directly to the retail investor (at least 75%). With a different equity investment, the company can exercise its discretion on dividend distributions. In December 2016, EAR will look at another aspect of this sector-linked chain by focusing on the retail industry. Obviously the linkage to the REITs sector will mainly be on malls that some REITs own. ***So, as we go into the various shopping centres, how about we share in the income stream so as to shop with ease.***

Selection Criteria

In identifying the number of listed REITs, EAR established that there are 28 listed REIT funds. EAR narrowed the list to 10 listed REITs after applying the following selection criteria:

- Out of the 28 funds, EAR analyzed the monthly returns of each REIT fund over a 36 month period.
- From these, EAR ranked the funds based on their returns.
- In the funds that were ranked, EAR chose the 5 best performers and 5 worst performers and chose to exclude REIT funds that ranked between 6 and 23 (effectively 18 REIT funds were excluded).
- From the 10 selected REIT funds, EAR applied various analytical techniques (which are discussed below) on all 10 and the basic fundamentals of the best performing REIT fund and the worst performing REIT fund.

EAR's assessment of the industry is that this is one of the best performing industries. In standardizing the data, EAR had 24 listed REIT funds that had complete raw information in relation to the period under consideration. From the 24 listed REIT funds, average monthly returns for all 24 REIT funds equated to 21.46%. From this, 15 REIT funds recorded positive gains averaging 40.4%, whilst only 9 recorded negative gains averaging negative 10.11%. From this, one may be inclined to conclude that this is a well-performing industry. From this conclusion, EAR believes that a more narrow focus for investors who find this sector appealing may help. More so, a narrow analysis, as opposed to averages, helps in providing context as averages may distort the actual behaviour of the data. In doing so, a focus on the best and worst may help investors make a proper assessment on stock selection as the industry has been performing well and the question may arise; which companies to consider? EAR recognizes that historical returns may not be used as the basis to inform expected performance as this may mislead investors. Therefore, this report addresses the expected performance of the selected REIT funds as well as the risk that investors may be exposed to from a share performance perspective.

Risk to Reward

The listed property sector has over the years performed well relative to other sectors and the JSE All-Share index. As at 30 June 2016, the listed property sector significantly outperformed general equities. This performance was underpinned by better than expected earnings from property companies. **Table 1** below shows the total return per asset class as at 30 June 2016 (year-end of most REITs).

Table 1: Total Return per Asset Class

Asset Class	12 months to	
	30-Jun-15	30-Jun-16
SA Listed Property	26.98%	11.04%
Cash	6.27%	6.85%
Bonds	8.21%	5.24%
Equities	4.79%	3.83%

Source: Hospitality Property Fund's 2016 AFS

Given that the listed property sector outperformed the other asset classes, EAR was of the view that a different method should be explored or applied in assessing the listed property companies for this issue.

The approach that EAR took to assess the REITs was to look at the Risk-to-reward ratios of the selected REITs. The standard risk-to-reward ratio is a measure of return in terms of a single unit of risk for a specific time period. It refers to the relationship between the inherent risk in the shares and the return (reward) from the same shares. Generally speaking, a riskier share (investment), whose risk to reward ratio is greater than 1 should offer greater returns to compensate the investor for the increased level of risk. Even so, the risk to reward ratio of less than 1 (typical of high risk investments) implies that the degree of risk is in fact excessive, relative to the returns/reward. Therefore, investors stand to gain excessively should the share price performance turn in their favour. **Table 2** below provides further detail.

Historical Risk to Reward Ratio

The tables below provide a summary of the 10 REITs. **Table 2** provides a summary of the 5 best performers and **Table 3** provides a summary of the 5 worst performers.

Table 2: Five Best REIT Performers

	Fortress B	*Resilient*	*Hyprop*	*SA Corp*	*Accelerate*
Gain	250%	101%	56%	39%	29%
Excess volatility	6.96	2.84	3.43	2.67	3.75
Risk to reward ratio	0.350	0.331	0.144	0.118	0.060

Source: Bloomberg and EAR Workings

Table 2 above indicates that the 5 best REIT shares grew and therefore generated value for investors. Fortress Property Fund B (Fortress or Fortress B) recorded the largest gains over the past 35 months, gaining a whopping 250%! An investor who would have bought Fortress B shares on 31 December 2013 would have grown their investment (excluding dividends) by 250% by 31 October 2016. Accelerate was the 5th best REIT in terms of gains over a 35 month period with the REIT recording a 29% gain over the observed period. Fortress B reflected the highest excess volatility/kurtosis (which indicates high swings in the share price) in terms of monthly returns with a kurtosis of 6.96 (relative to an acceptable kurtosis of around 3). However, the high risk undertaken by investors in Fortress B was accompanied by higher gains, resulting in a risk to reward ratio (which measures the excess return per unit of risk) of 0.350. This implies that, the excess risk taken resulted in higher/excess returns over the past 35 months. Fortress B closed at R24.80 on 31 October 2016. Interesting to note in **Table 2** is the listed REITs with the highest returns also had relatively higher risk to reward ratios in spite of the varying degree of “risk”.

Table 3: Worst REIT Performers

	Hospitality Property Fund	*Texton*	*Arrowhead*	*Delta*	*Tower Property Fund*
Loss	-29%	-20%	-14%	-11%	-6%
Excess volatility	4.84	2.86	5.29	2.78	3.23

Source: Bloomberg and EAR Workings

Table 3 provides information on the worst performing REITs with Hospitality showing the largest loss in value between end of 2013 and October 2016. What is more concerning over and above the loss in value was the excess volatility, which was marginally high compared to the returns generated. Arrowhead’s shares also lost value, with the shares declining by 14% over a 35 month period, however, the concerning aspect is the high excess volatility of 5.29 indicating that Arrowhead’s shares were highly volatile (or too jumpy). Furthermore, the two tables (**Table 2** and **3**) indicate that excess volatility leads to either gains or losses. Therefore, volatility should not be “generalized” as bad for all investment decisions. Analysis of volatility (techniques) will feature in subsequent issues.

Shared Volatility

Some investors are of the opinion that REITs or listed property shares are positively correlated to bond yields. According to REITs SA, the shared

volatility (in the form of a correlation) indicates that the listed property index moved in the same direction with the All Bond Index (ALBI) 69% of the time between October 2011 and October 2016. For retail investors, the ALBI may not mean much as the ALBI is made up of a number of bonds which investors can invest in. To put this widely held hypothesis to test, EAR considered using the R186 government benchmark bond, which is considered the most liquid bond in the ALBI or a "blue chip" bond by some investors. The aim is to correlate it with the selected 10 REIT shares. Assuming an investor has an option to buy the R186 or any of the selected 10 REIT stocks, one concern that may be raised is the shared volatility between the R186 bond yield and the share prices of the REITs (i.e. to what degree do the two move in the same direction). EAR calculated the correlations between the selected 10 REIT stocks in terms of prices and yields. Between December 2013 and October 2016, only 2 of the selected 10 REIT shares were significantly correlated, negatively so, to the R186 bond yield (shared volatility) during the observed period. For purposes of this hypothesis, EAR deems, any correlation of 70% or above and of negative 70% or lower as extreme. Arrowhead's correlation to the R186 was negative 0.7 and Delta's correlation with the R186 was negative 0.8. This implies that the long-held view that listed REITs share positive volatility with bond yields, more so, the R186 may need to be questioned.

What EAR observed is the significant variation in the shared volatility amongst the REITs. Interestingly, Fortress B's shares had a perfectly shared volatility with Resilient's shares as reflected by a perfect positive correlation. Fortress B also shares significant positive correlations with Hyprop at 90% and SA Corp at 80%. Hospitality's share price and Accelerate's share price were moving in opposite direction 90% as indicated by a 0.9 negative correlation. This is line with the returns on the two REIT over the same period (35 month period ending 31 October 2016) as Accelerate gained by 29% whereas Hospitality declined by 29% over the same period.

Table 4: Relationship Matrix of the 10 Selected REIT Shares

	Accelerate	Arrowhead	Delta	Fortress B	Hospitality	Hyprop	Resilient	SA Corp	Texton	Tower
Accelerate	1.0									
Arrowhead	-0.2	1.0								
Delta	0.2	0.5	1.0							
Fortress B	0.6	-0.8	-0.5	1.0						
Hospitality	-0.9	0.3	0.0	-0.6	1.0					
Hyprop	0.8	-0.6	-0.3	0.9	-0.7	1.0				
Resilient	0.6	-0.7	-0.6	1.0	-0.6	0.9	1.0			
SA Corp	0.7	-0.4	-0.2	0.8	-0.6	0.9	0.8	1.0		
Texton	0.3	0.3	0.8	-0.3	-0.2	-0.2	-0.4	-0.2	1.0	
Tower	0.5	0.0	0.6	0.1	-0.4	0.2	0.0	0.1	0.8	1.0

Source: Bloomberg and EAR Workings

Forward-looking Risk to Reward Ratio

To complement the forward price forecast, EAR attempted to establish a forward looking risk to reward ratio. The forward-looking risk to reward ratio indicates that the 5 best REIT shares based on historical performance are expected to underperform relative to their long-term historical risk to reward ratios, however, this is all informed by a different forward-looking risk measure different to the historical measure. This is due to some relatively lower expected returns (should markets be characterized by normal trading conditions). This is not bad considering that the forward looking risk considers some maximum loss. Over a 35 month period, Fortress B had a historical risk to reward ratio of 0.35. For the next 20 trading days, Fortress B is expected to generate a risk to reward of 0.281, representing a marginal decline in the estimated risk to reward ratio. The risk to reward of Fortress B reflects a function of some simulated expected maximum returns. The simulated maximum returns imply that over the defined period, normal returns are not expected to be greater than 17.5%, 95% of the time. The maximum expected returns would be analysed in relation to some maximum loss relative to some notional trading amount. This is helpful to assess the degree of expected maximum returns per maximum expected loss on a single REIT company. The underlying tenet of the analysis is to analyse expected excess returns per maximum amount of risk. A ratio that is greater than 1 implies that the exposure to share

price volatility that could yield to a maximum loss on some notional trading amount could be accompanied by some high expected returns. It is worth noting that this is expected of companies that do not generate excessive returns given some higher degree of risk. Therefore, the maximum loss on the notional trading amount should be compared to some expected maximum returns. SA Corp is expected to gain by only 5.67%, which may be lower than the repo rate of 7% (assuming it does not change). Resilient is expected to generate returns just above the repo rate, however, the risk to reward ratio is expected to decline significantly due to the lower returns whilst maintain high expected share return volatility. In summary, the 5 best REIT performers based on historical performance are expected to have lower risk to reward ratios compared to their historical performance. SA Corp is expected to have a negative risk to reward ratio due to the REIT expected to generate returns lower than the risk free rate.

Table 5: Estimated Gains and Estimated Risk to Reward Ratios

	Fortress B	Resilient	Hyprop	SA Corp	Accelerate
Estimated gain	17.51%	7.10%	7.32%	5.67%	8.37%
Estimated risk to reward ratio	0.281	0.003	0.010	-0.052	0.037
Historical	0.350	0.331	0.144	0.118	0.060

Source: Bloomberg and EAR Workings

Table 6 shows that Hospitality is expected to turn the corner from generating negative returns to a positive. EAR is 95% confident that Hospitality's gain may not be more than 18.5% in the next 20 days, implying that should the gain exceed 18.5% over the expected period of time, such an excess gain may not be realised for more than 2 trading days. The estimated risk to reward ratio is expected to be 0.180. Hospitality is expected to have a higher risk to reward ratio compared to SA Corp and Accelerate as shown above. Tower is expected to gain by 6.2%, although lower than the risk-free rate, 95% of the time in the next 36 trading days. As a consequence, Tower's risk to reward ratio is expected to be negative as shown in the table below.

Table 6: Estimated Gains and Estimated Risk to Reward Ratios

	Hospitality Property Fund	Texton	Arrowhead	Delta	Tower Property Fund
Estimated gain	18.51%	8.43%	12.23%	7.21%	6.18%
Estimated risk to reward ratio	0.180	0.038	0.096	0.006	-0.030

Source: Bloomberg and EAR Workings

Fundamental Analysis Part 1

Fortress B

Fortress Income Fund (or Property Fund) is a JSE listed REIT with two types of ordinary shares in terms of its capital structure. The fund has A shares and B shares, each listed separately on the JSE meaning a retail investor buying Fortress shares has an option of acquiring A or B shares. A shares have a preferential right to income distribution and capital participation should Fortress Income Fund be wound-up. In addition, Fortress A shareholders would get the first piece of the 75% minimum annual income distribution (net). Fortress B shareholders are entitled to the residual distributable income.

Fortress listed on the JSE in October 2009 following the successful private placing of 13 000 000 Fortress A linked units ("A units") and 13 000 000 Fortress B linked units ("B units") at R9,00 and R1,00 per linked unit, respectively. In total 176 592 192 A and B units were issued on listing. Upon listing, Fortress' value proposition was to offer A share investors a yield of 10.75% to the listing price, whilst the B unit shareholders would be entitled to the rest. The yield offered upon listing was not far from the average property yield of 10.8%[1]. In the same financial year, which ended on 30 June 2010, Fortress marginally exceeded its distribution targets as A shareholders received 0.5% more than what was promised upon listing and B shareholders received 5.7% more than what was expected. In

[1] Property yield refers to the annual rentals as a percentage of the cost of the property.

the first year of listing, Fortress sold 6 properties that generated average yields of 10.08% (weighted average of 10.03%) at a profit of R14.65 million and acquired 16 properties from Murray and Roberts valued at R373.4 million.

In the 2011 financial year, Fortress's strategy was to reduce vacancies and focused investment on central business districts and rural areas with a specific focus on malls. Within the same strategy, Fortress considered its industrial portfolio to be risky and opted to reduce its exposure to industrial properties. There was an expectation that 2012 might be a tough year as 31.7% of the lease contracts were due to expire, placing Fortress's R318 million net rental revenue reported in the previous financial year at risk (profit of R282.9 million). Fortress did some active asset management as they sold 16 properties at a profit of R29.5 million, which had a book value of R435 million. Within the same year, Fortress bought properties worth R942 million, registered a listed bond programme of R1 billion and issued commercial paper of R250 million. With all these activities, Fortress reduced its gearing from 24.8% to 19.4%, which was well within the company's upper limit of 35%.

The 2013 financial year was another year of excellent strategy execution where Fortress aimed to reduce its exposure to industrial properties. Commercial properties were also considered to be non-strategic as Fortress wanted to focus on retail properties, more specifically malls that were close to transport nodes. Furthermore, Fortress sought exposure to hard currency earnings which saw Fortress's US Dollar and Euro denominated investments accounting for 23.4% of Fortress's total assets. Disposals continued (22 property disposals) in which Fortress realised a profit of R46.7 million after selling properties with a book value of R658 million. Acquisitions continued, reaching an all-time high of R1.2 billion. What is interesting is that Fortress held shares in other listed property funds in the form of Resilient listed shares (valued at R666.3 million) and underwrote R150 million worth of Tower Property Fund shares (refer to **Tables 1** and **2** to see the performance of these shares).

With effect from 1 July 2013, Fortress was now a listed REIT with 97 investment properties with 88.8% in retail, 9.3% being industrial properties and 0.5% being residential. Disposals in the 2014 financial year had declined with properties having a book value of R63 million disposed.

The 2015 financial year saw Fortress having less direct property holdings in which 36.6% was direct property holdings and 51% in listed property shares of which 49.9% were off-shore based companies and 14.4% local REITs. In the 2016 financial year, the strategy was to continue gaining exposure to hard foreign currency and the REIT continued on that streak.

The Dividend Story

One compelling aspect about REITs is the income distribution or dividends. REITs are required to make regular income distributions to shareholders based on their taxable income. As indicated, REITs provide a mixture of a bond instrument with some form of "coupons" (even though these vary) and equity variation. When Fortress listed on the JSE in 2009, Fortress listed two types of shares that offered retail investors two different risk and reward propositions. The A units offered (and still offer) retail investors dividends on a preferred basis, that escalated at 5% per annum for five years and at the lower/minimum of CPI growth and 5% thereafter. These shares had (and still have) preferential entitlement to income distributions and to capital participation on winding up. The remaining distributable income accrues to the B shareholders.

When Fortress listed, the A shares were offered at R9 whilst the B shares were offered at R1. Fast forward to 2016, the A shares closed at R15.98 on 15 November 2016 whilst the B shares closed at R29.18 per share. Over a 5 year period, the A shares gained only by 31.52% whilst the B shares gained by 475.54%. The question is why? In EAR's view, the B shares may be trading on the potential upside of the

dividends. **Tables 7** and **8** show the historical dividends of the two share classes and in the 2016 financial year, the B dividends were higher than the A dividends. Upon listing in 2009, the growth in A dividends was capped at 5% (and now capped at the lower of CPI growth or 5% since the 2015 financial year). By doing that, a huge upside in Fortress's distributable earnings benefits B shareholders more compared to A shareholders. In effect B shareholders assume more risk than A shareholders in terms of the variation in distributions but benefit much more when Fortress' net rental increases, thus translating into distributable earnings growth.

Table 7: Historical Fortress A Distributions

Fortress A dividends	2010 Annualised	2010	2011	2012	2013	2014	2015	2016
Rands	***0.97***	0.73	1.02	1.07	1.12	1.18	1.23	1.29
Growth in dividends			40%	5%	5%	5%	5%	5%

Source: Bloomberg and EAR Workings

Table 8: Historical Fortress B Distributions

Fortress B dividends	2010 Annualised	2010	2011	2012	2013	2014	2015	2016
Rands	***0.09***	0.07	0.13	0.19	0.29	0.43	0.70	1.38
Growth in dividends			77%	52%	49%	51%	63%	95%

Source: Bloomberg and EAR Workings

The question is how does an investor go about choosing which class? It is important to note that a retail investor is exposed to the same company when buying Fortress shares. What drives the class selection is the individual investor's risk appetite and potential return. Fortress distributed a total of R574.1 million to A shareholders in the 2015 financial year and R1.437 billion in the 2016 financial year. B ordinary shares were allocated R328.3 million in 2015 and R1.395 billion in 2016. If one assumes that inflation may reach 6%, it means the A share dividends may grow by 5%, as the policy is that growth is based on the lower of 5% or CPI growth. By implication, the A dividend per share may only grow to R1.35 per share. This multiplied by the number of A shares outstanding equates to a total capped distribution of R1.502 billion in the 2017 financial year (assuming inflation growth exceeds 5%). Fortress reported total distributable earnings of R2.831 billion in the 2016, representing a growth of 213.8% in distributable earnings. If one applies a conservative estimated growth of 5% in line with the A dividend growth cap, earnings may amount to R2.973 billion. R2.973 billion less/minus the R1.502 billion that has to be allocated to A shareholders in terms of their entitlement leaves R1.471 billion available for B shareholders, resulting in a dividend per share of R1.45 per share in the 2017 financial year (growth of 5.1%). By implication, a mere growth of 5% in Fortress's earnings may likely result in 5.1% growth in dividend distributions for B shareholders. Any growth in excess of 5% in distributable earnings implies that the B shareholders benefit from the additional growth.

In light of these, it may be clear why Fortress B shares have high risk to reward ratios. This may be because Fortress B shareholders assume a significant risk as there is a possibility that they may not share in the earnings should all the distributable earnings be transferred to A shareholders in terms of their entitlement. However, the additional risk comes with the additional returns for B shareholders, especially when Fortress performs well in terms of distributable earnings. EAR's view is that Fortress' model is exciting and provides a variation of property-focused investment holding firm through their listed holdings and direct property holdings. The strategy of targeting hard currency listed assets presents a risk (and a potential reward). The risk is that Fortress may be exposed to price risk on the foreign listed REITs and currency risk when translating the investments and dividends from these investments to local currency. It is therefore important to establish any existence of shared volatility between the share price and the relevant foreign exchange rates to which this REIT is exposed. Also, for those investors who might consider holding either A or B shares; it is important to quantify the extent to which these two are correlated.

In EAR's view, the dividend policy may affect the shared volatility of Fortress B shares against the currencies (i.e. USDZAR and EURZAR) As mentioned, investors holding Fortress B shares are exposed to a higher potential upside as long

as the distributable earnings grow by 5% or more. Any excess growth (meaning any growth in excess of 5% based on the calculations performed by EAR) may prove good for Fortress B shareholders as they may likely experience higher distribution growth compared to A shareholders. The shared volatility between Fortress A and B shares since being registered as a REIT on 1 July 2013 was 40%, which means that Fortress A and Fortress B shares moved in the same direction only 40% of the time since the company was considered a listed REIT. Since the end of 2013, shared volatility between Fortress A and Fortress B shares weakened to only 40% as reflected in table 9. What is interesting is Fortress B's shared volatility with the US Dollar, which was at 90%. The shared volatility between the B shares and the Euro was 50%, which indicates that Fortress B shares shared some form of linear relationship with the US Dollar and the Euro and not its "higher ranking" sister shares. Contrary to popular belief, Fortress shares (both classes) reflected some low shared volatility (both positive and negative) with the most liquid government bond, the R186. Fortress A shares moved in the opposite direction with the R186 government bond yield, only 40% of the time since December 2013 as reflected by a negative 0.4 correlation.

Table 9: Correlation Matrix between Fortress Shares and Other Instruments

	Fortress A	Fortress B	R186 Bond	USD/Rand	EUR/Rand
Fortress A	1.0				
Fortress B	0.4	1.0			
186 Bond	-0.4	0.4	1.0		
USD/Rand	0.2	0.9	0.7	1.0	
EUR/Rand	-0.2	0.5	0.9	0.8	1.0

Source: Bloomberg and EAR Workings

EAR's view is that the shared volatility between the Fortress B shares and the US Dollar (90%) as well as the Euro (50%) may be attributable to Fortress's investments in international listed REITs denominated in foreign currencies. Fortress's combined US Dollar denominated and Euro denominated investments in listed REITs equated to 42.5% of the total investments in REIT assets as at 30 June 2016 (after conversion). The value of shares in listed REITs denominated in US Dollars amounted to 22.3% of the total REIT assets in Fortress's portfolio whilst Euro shares equated to 16.4%. The Rand's weakness against these two major foreign currencies in recent years has so far been favourable for Fortress B shareholders. The Rand declined by 30.1% against the US Dollar since December 2013 and only 2.5% against the Euro over the same period. The dividend cap on class A shares has indeed been to the benefit of B class, due to the uncapped upside potential. Therefore, EAR believes that the B shareholders may have taken the Rand's weakness into consideration, hence the continued gains.

There is a potential downside to B shareholders in that; any weak performance in the REIT holdings in Fortress's portfolio as well as the US Dollar and Euro weakening against the Rand may adversely impact Fortress B shareholders. This is because the Rand's strength against the major currencies may translate to lower distributions to Fortress from the foreign REITs after conversion. By implication, Fortress B shareholders may suffer the most as Fortress A shareholders rank first in their distributions. It can also be expected that a strong Rand against the major currencies may result in Fortress B shares trading on this potential downside. EAR therefore emphasises that the potential upside on Fortress B shares, especially in light of historical trends, should be assessed and weighed with the potential downside.

Conclusion

Fortress, as a REIT, provides an interesting value proposition for retail investors interested in REITs. Firstly, the two share classes benefit Fortress as a REIT should there be a need to raise capital, especially using the B-class shares (Fortress B). For Fortress A and B investors, the underlying assets are the same as both classes relate to one company with one portfolio as no portfolio is ring-fenced to any class of shares. However, any upside moves benefit Fortress B shareholders. Fortress A shareholders get the

benefit of ranking first, however, such a benefit comes with limited gains and investors aiming for Fortress A need to be mindful of that. Effectively Fortress A distributions are much more predictable compared to Fortress B distributions. Fortress B may appear more exciting as the potential variation comes with huge losses or huge gains.

The model Fortress applies as a REIT is also interesting to note. Over the years, the REIT has transformed from property fund holding a majority of physical properties to having a balance between tangible assets and investments in listed shares. The new model has a significant bearing on Fortress B shareholders relative to Fortress A. Therefore, Fortress' increased exposure to market risk in the form of currency variation and price variations in the listed REIT investments will impact B shareholders more. EAR anticipates the Fortress B shares to trade at weaker levels over the next 20 trading days compared to a closing price of R32.06 in October. The average trading price on Fortress B is expected to be R31.99 over the next 20 trading days. Fortress's forecasted share price is shown below together with other shares. The relatively lower trading price is also expected to contribute to the forecasted risk to reward ratio of 0.281, implying that the expected returns may not compensate for the expected risk in the same proportion.

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Fundamental Analysis Part 2

Hospitality Property Fund

Hospitality Property Fund (HPF) is a specialist REIT that invests exclusively in real estate assets in the hospitality and leisure industry. HPF listed on the JSE in February 2006. HPF listed a dual-class (unit) structure comprising of Hospitality A (HPA) and Hospitality B (HPB) at share prices of R10 for each share type. A dual-class (unit) is not uncommon amongst REITs as shown under the Fortress fundamental analysis. HPF has 25 hotel and resort properties in its portfolio that stretch across the country and is diverse in terms of; market mix (low income to high income earners), star grading(4 start to 5 star), brands and location (urban area, town or secluded area; farms etc.). HPF Group has 7 subsidiaries namely:

- Hospitality Property Fund Limited (the fund or company)
- HPF Properties Pty Ltd (HPF properties)
- HPF Management Pty Ltd (HPF management)
- HPF Employee Incentive Trust (the Trust)
- Hospitality Property Fund Managers (HPF Fund Managers)
- Hosbrook Ventures Pty Ltd
- Nib 35 Pty Ltd

HPF was awarded REIT status by the JSE from 1 July 2013. HPF is a specialist property fund on the JSE solely investing in hospitality and leisure sectors as mentioned above. The investment in hospitality and leisure sectors is achieved through:

- Investing in select portfolio of hotels and leisure properties, increasing the focus on large properties in major metropolitan cities;
- Implementing an active asset management strategy and continually reviewing the composition of the portfolio so as to maximize the return on assets; and
- Ensuring that revenues generated from the hotel operations and which flow to the fund as rental income, are optimised.

Property Portfolio and Lease Types

HPF's portfolio consists of 15 hotel and leisure properties. The property leases are concluded with tenants (i.e. ***hotel operators***) after a formal process to establish best fit between hotel properties, tenant and the appropriate brand.

According to HPF, one of the major risks that the fund faces is tenant default (non-payment by tenants). It should be noted that tenant default risk is not only unique to HPF, it's a common risk faced by all REITs but HPF considers it one of the most significant risks for its business. HPF manages this risk by monitoring the trading conditions and building long-term relationships with tenants to develop an understanding of the tenants' businesses and performance and obtaining sufficient collateral (in the form of cash deposits and bank guarantees) from the tenants (cash tenant deposits).

There seems to be some concentration risk in terms of the revenue earned by HPF and the resultant receivables. 41% of revenues earned by HPF for the year ended 30 June 2016 were generated from two leased properties. The total credit risk exposure for the year just ended was R56.11 million (outstanding debts). The tenants and related trade receivables are continuously assessed by Hospitality for impairment. HPF's management is of the view that default risk is low, even though concentration risk is high. Default risk may be considered low due to the effective monitoring of trading conditions of the tenants and the collateral HPF has.

Hospitality's properties are categorised as ***Traditional***, ***Conference*** and ***Properties held-for-sale***.

The Traditional Portfolio

The Traditional portfolio comprises of 13 properties namely; Radisson Blu Waterfront, Arabella Hotel & Spa, Crowne Plaza Johannesburg – Rosebank, Holiday Inn Sandton – Rivonia Road, Inn on the Square, Mount Grace Country House & Spa, Protea Hotel Edward, Protea Hotel Marine, Protea Hotel Victoria Junction, Radisson Blu Gautrain, Westin Cape Town and Champagne Sports Resorts. The Traditional portfolio recorded gross rental income of R410.3 million, accounting for 86% of total rental income for the year ended 30 June 2016.

The Conference Portfolio

The Conference portfolio comprises two properties namely; Birchwood Hotel and OR Tambo Conference Centre and Kopanong Hotel and Conference Centre. Both conferencing properties have F&V leases[2].The Conference portfolio recorded gross rental income of R64.3 million, accounting for 14% of total rental income for the year ended 30 June 2016.

Properties Held-for-Sale

Two properties were held for sale by Hospitality at year end (30 June 2016), namely the Protea Hotel Hazyview and Kopanong Hotel and Conference Centre. During the financial year that just ended the company disposed of its interest in seven other previously held properties namely Protea Hotel The Richards, Protea Hotel Hluhluwe and Safaris, Premier Hotel King David and Protea Hotel Imperial, Protea Hotel The Winkler, The Bayshore Inn and the Protea Hotel Richards Bay. The sales of these properties yielded net proceeds of R189.9 million. Their total gross rental income amounted to R13.5 million for the year ended 30 June 2016.

Capital Restructure

As mentioned above HPF has a dual-class/unit listing on the JSE (HPA shares and HPB shares). This dual-class listing resulted in differing rights to distributions of net income of the company. This is because HPA

[2] F&V leases are fixed and variable leases. Fixed lease is a rental agreement in which the lessee (renter) agrees to stay and pay rent for the period of time indicated in a written contract. Variable lease is lease agreement that allows for increases in the rent during the lease period. A common variable lease is a graduated lease which provides for specified rent increases at set future dates.

shareholders had a preferential right to net income distributions (i.e. dividends) made by HPF. HPB shareholders had a right to only the portion of HPF's net income distributions that remained, following the payment of a fixed amount due, in respect of the HPA shares. This structure resulted in the shareholders not having equal rights. In view of this, a restructure was proposed by the board of Hospitality to align the objectives of all the shareholders. In the past differing objectives of the HPA and HPB shareholders caused an impediment on company strategy and growth. EAR is of the view that the restructure was not only done to provide equal rights to the current HPA and HPB shareholders, but was part of the bigger scheme of things. The transaction to acquire 10 Tsogo hotel properties by HPF was conditional on the restructure of HPF's dual-class capital structure into a single share capital structure.

The capital restructure was implemented through a corporate action that required a special resolution from both A and B shareholders. The resolution required the approval of the amendment of the authorised share capital of the company by the consolidation of the B shares in a ratio of 3.5:1.

What this effectively meant is that the HPA shares discontinued trade on the JSE. This implied that 3.5 B ordinary share were swapped for every 1 A ordinary share. Once the consolidation of shares was done, the A shares were converted to B shares by way of a scheme of arrangement[3]. This resulted in HPF's capital structure changing to a single class share of "B shares".

The potential benefit that may result from the share restructure includes better coordination between the company and shareholders. Furthermore, all shareholders have the same rights to the distribution of earnings and thus share the same objectives. This led to better operation of the company as impediments that the old capital structures created were removed.

The Tsogo Transaction

The Tsogo transaction became effective on 1st September 2016. The transaction is expected to yield long-term benefits for the Hospitality Property Fund. The transaction increased Hospitality's property portfolio by 10 successful established hotels without Hospitality having to raise additional capital. This was accomplished through issuing more shares in exchange for properties. On completion of the transaction, Tsogo's holding in Hospitality increased to more than 50% of Hospitality's ordinary shares. The Tsogo properties are expected to improve the spread of the Hospitality's assets across the hotel grading spectrum, thus broadening the earnings base of HPF. The company's earnings base is expected to become more stable through the exposure to predictable cash flows generated by the Tsogo portfolio. As the transaction was completed free of debt, the transaction brought about a reduction in Hospitality's gearing ratio from 32.6% as at 30 June 2016 to 24.4%. This was due to the increase in the value of properties through adding additional 10 properties.

Borrowings

HPF is funded by different debt instruments ranging from loans with financial institutions, and secured and unsecured corporate bonds. The bonds are mix of floating rate notes and one fixed income (vanilla) bond – the HPF05, which is discussed and analyzed in detail in this month's fixed income note (http://www.earesearch.co.za/FIReports.html) focusing on the bond's interest rate sensitivity measures (modified duration and dollar value of a basis point (DV01)).

Total outstanding debt as at 30 June 2016 was R2.04 billion, with listed bonds making up R970 million of the debt (47.48%). The HPF05 makes up R200 million of bond portfolio (20.62%). Furthermore, 63% of total debt is hedged

[3] Scheme of arrangement is an arrangement between a company and its shareholders of any class of security/share, to reorganise the share capital (capital structure) of the company. Scheme of arrangement must be terms of section 114 and 115 of the Companies Act, 71 of 2008.

through swaps[4] from different financial institutions. The HPF05 bond is secured by HPF's hotels (underlying collateral).

Property Portfolio Performance

The rental income that HPF receives is fixed & variable (a combination).. The fixed rental income is determined under fixed contractual lease agreements with inflation-linked (CPI) annual escalations. Fixed & variable rental income is determined as 50% fixed with inflation-linked increases. The other 50% is variable, with the variable portion determined as 90% to 98% of EBITDA of hotel, less the fixed lease component. Variable rental income is determined as the share of EBITDA generated by the hotel. Thus, the performance of the hotel and leisure properties have a direct impact on the revenue (rental income) generated by HPF. **Table 10** below shows the relationship between average daily rate (ADR)[5], revenue per available room (RevPAR)[6] and HPF rental income. The correlation matrix in **Table 10** was calculated in order to show/highlight the influence that the changes in ADR, Occupancy and RevPar of HPF's hotel properties have on the changes of HPF's rental income (revenue). Considering that the combination of fixed & variable component is influenced by the financial performance of the hotel properties.

Table 10: Correlation matrix between HPF revenue drivers and rental income

	Rental income	*Occupancy*	*ADR*	*RevPar*
Rental income	1.0			
Occupancy	-0.4	1.0		
ADR	0.7	-0.1	1.0	
RevPar	0.1	0.8	0.6	1.0

Source: Bloomberg & EAR workings

The correlation matrix shows that rental income had a strong relationship with ADR, with a positive correlation of 70%. This means that rental income and ADR moved in the same direction (increase or decrease) 70% of the time. Therefore it can be concluded that if the ADR rate increases then the rental income might increase 70% of the time (provided the underlying distribution holds). Occupancy and RevPar had a strong relationship as indicated by the correlation of 80%. This means that occupancy and RevPar moved in the same direction 80% of the time. This highlights that the occupancy rate influenced the revenue generated per available room (RevPar) more than ADR; as the correlation between ADR and RevPar is positive 60%

Performance of the property portfolio was based on occupancy levels, ADR and RevPAR. Compared against the rest of the market through STR Global South Africa Hotel Review, Hospitality outperformed the market in all aspects. **Table 11** shows the year-on-year change of the variables.

Table 11: Year-on-year change

	Occupancy	ADR	RevPar
Hospitality Traditional Portfolio	↑ 5.20%	↑ 8.10%	↑ 13.70%
Hospitality Conferencing Portfolio	↑ 13.30%	↑ 13.80%	↑ 29.00%
STR Hotel Review (rest of the market)	↑ 3.20%	↑ 8.00%	↑ 11.40%

Source: Hospitality Property Fund AFS June 2016

Hospitality's two property categories outperformed the rest of the leisure sector in the growth of occupancy levels, ADR and RevPAR. **Table 12** below shows the comparison between the actual numbers for occupancy, ADR and RevPAR.

Table 12: Hospitality comparison to rest of the market

	Occupancy	ADR	RevPar
Hospitality Property Fund	69.10%	R 1 457	R 1 007
STR Hotel Review (rest of the market)	64.60%	R 1 133	R 733

Source: Hospitality Property Fund AFS June 2016

Hospitality properties had higher occupancy levels than the rest of the market. The average

[4] A swap is a derivative in which two counterparties exchange cash flows of the one party's financial instrument for those of the other party's financial instrument. A swap is used to hedge certain risks like interest rate risk.

[5] Average daily rate is average rental income/rate per paid occupied room in a given time period

[6] RevPar is a performance metric used in the hotel industry and is calculated by multiplying (x), a hotel's average daily room rate (ADR) by its occupancy rate. RevPar is used to assess the hotels ability to fill its available room at an average rate.

daily rate and revenue per available room was higher than the markets'. This means that the properties (hotels) generated more revenue on average from room occupants (tourists). This therefore translates to higher income for Hospitality through the fixed & variable lease contracts.

Conclusion

The tourism and hospitality sector as a whole (including HPF properties) were impacted by the introduction of new VISA requirements for international tourists wanting to gain entry into South Africa. This affected both (adults) as well as minors. Consequentially, it led to a decline in foreign leisure travelers visiting South Africa. The Department of Home Affairs is in the process of modifying these regulations which could, hopefully, benefit the hospitality industry and HPF's properties alike. A slump in occupancy rates as well as daily rates (in Rands) achieved by the hotel brands occupying HPF's hotel properties have a direct impact on the revenue (rental income) generated by HPF through the fixed & variable lease agreements.

Acquisition of the 10 Tsogo hotels has the potential of improving the revenue streams of HPF. Tsogo hotels are prestigious and are located in prime holiday and business locations. These could attract a mix of customers and add to HPF's rental income. HPF will also leverage off Tsogo's well-established sales and branding network. The hospitality sector still faces a lot of pressure due to people spending less on luxuries such as holidays, overnight stays in hotels. Furthermore, government departments reduced spending on hotel stays and conferences for officials. The hospitality sector and HPF may benefit should South Africa host sporting events such as; the Commonwealth Games and Formula One (which is planned to be hosted in Cape Town on an annual basis once approved).

The HPF was the worst performing REIT when looking at returns generated over the past 35 months. The capital restructure has the potential of reversing this downward trend. Potential investors will not have to choose between two classes of shares and they will share in HPF's distributions equally. This could improve investor sentiment. The restructure also allowed HPF to attain a strategic shareholder in Tsogo. Tsogo being a majority shareholder could lead to some changes within the organisation. This could help improve HPF's performance through its wide and in-depth knowledge of the hospitality and leisure sector.

EAR anticipates HPF's share to grow. As the share price is expected to grow, EAR is 95% confident that HPF shares may not generate returns in excess of 18.5% in the next 20 trading days.

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Expected Share Price

In this month's report, EAR forecasted the share prices of the 10 selected REITs using a Simple Exponential Smoothing forecasting technique. ***The technique is used to forecast time series data when there is no trend, mean reversion or seasonal pattern on the historical data***. In EAR's case, the technique was applied on REIT share prices. It is important to note that the historical average within the technique slowly changes over time. One of the properties of this forecasting method is that it assigns more weight to the most recent observations; implying that in forecasting future share prices, the immediately preceding price is more relevant than, say the trading price of some three months ago. The technique does not account for diffusion processes brought about by some degree of volatility. Furthermore, this technique is highly sensitive to historical outliers in the data set.

This technique was utilised to determine the average share price for the end of the next period (22 trading days). **Table 13** below shows

the forecasted average share price for next period and the expected returns for the next period.

Table 13: Forecasted average share price for the next month

	APF	ART	DLT	FFB	HPB	HYP	RES	SAC	TEX	TWR
Historical average share price (Last price)	6.70	4.55	7.69	32.06	13.07	119.70	111.57	5.53	7.73	7.71
Forecasted Average share price (Next month)	6.64	4.57	7.71	31.99	13.06	119.42	111.27	5.48	7.82	7.74
Expected return/ (loss) in for the next period	-0.92%	0.39%	0.20%	-0.23%	-0.06%	-0.23%	-0.27%	-0.91%	1.15%	0.42%

Source: Bloomberg & EAR Workings

Arrowhead (ART), Delta (DLT), Texton (TEX) and Tower Property Fund (TWR) are expected to generate positive average returns at the end of the next period. This means if an investor buys the shares of these companies today; they are expected to grow the value of their initial investment, excluding transactions costs. This implies that the respective levels of the different share prices are expected to gradually change to the upside over the month. This is free of any jumps in volatility levels.

Accelerate (APF), Fortress B (FFB), Hospitality Property Fund (HPB), Hyprop (HYP), Resilient (RES) and SA Corp (SAC) are expected to generate negative average returns at the end of the next period. FFB is expected to experience some muted performance over the next 22 trading days, which may resemble the poor performance observed in the past 6 months with negative returns of 21.37%. Be that as it may; on a 3 year (historical) returns' period, FFB has been the standout REIT in this sector with positive returns of 250%. SAC is expected to be the worst performing REIT in the following period.

An interesting thing to note is; 4 out of the 10 companies that are expected to generate positive returns in the next period are historically the worst performing shares out the 10 selected REITs. The top performing companies (as per the historical risk to reward measure) are expected to experience some minor drop in their respective share prices. Noteworthy, the drop in the share prices is expected to be small (not more than 1%). This somewhat links to the forward looking risk to reward ratios presented in **Tables 6** and **7**.

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