TEXTON
PROPERTY FUND

WATCH THIS SPACE
Quarterly Newsletter

CONTENTS

FUND SNAPSHOT

SHARE CODE: TEX (JSE) | TEX: SJ

SHARE PRICE: R5.91

MARKET CAP: R2 222 554 587

NO. OF PROPERTIES: 46

SHARES IN ISSUE: 376 066 766

QUARTER 1 **2018** EDITION

Block C, Investment Place
10th Road, Hyde Park
Johannesburg, Gauteng, 2196
Tel: +27 (0)11 731 1980
www.texton.co.za

The first quarter of 2018 was a period of mixed sentiment for South Africa and the property sector. The news that Moody's Investors Service would not change its rating of the country's debt status was well received, as was the decision by the South African Reserve Bank to cut interest rates by 25 basis points.

Coupled with a tough but hopeful budget, this indicates that the Ramaphosa presidency is making positive changes. However, the period also brought challenges for the REIT sector, with a sell-off causing the SAPY index to drop to an all-time low. The outlook is mediocre as we continue to operate in a challenging environment with weakened property fundamentals.

In the UK, progress continued to be made towards Brexit. Provisional agreement was reached on the rights of UK and EU expat citizens after Brexit, a divorce payment to the EU of up to £39 billion, parameters around the Northern Ireland border and a 21-month transition period. Talks have moved on to the nature of the permanent post-Brexit relationship. However, a range of matters still need to be agreed on and documented before the deadline of 29 March 2019.

"Given lower interest rates and more attractive lending margins in the UK, we are well poised to take advantage of property opportunities. This will allow us to not only improve our capital management but also shore up our balance sheet."

NOSIPHIWO BALFOUR, *CEO*

FROM THE ASSET MANAGEMENT DESK

There has been a clear shift in the property sector to industrial logistics and warehousing. With globalisation and businesses starting to ship their products outside their regions, logistics has become a significant part of many companies. As harder manufacturing struggles, listed property groups are pursuing clean industrial properties focused on light manufacturing, warehousing and distribution.

Despite weak economic growth in South Africa, experts believe that this sector offers great potential for growth, especially in developing specialised warehousing and distribution centres. In Cape Town, industrial vacancies are at an all-time low, with a notably strong uptake of medium to large boxes measuring 3 000–5 000m². These seem to be flavour of the month, enabling owners to negotiate favourable lease terms. There has been a steady release of new industrial development to the market, which has prevented an oversupply of stock. Texton is actively engaging with its network of principals, developers, brokers and end users with a view to further diversifying in this sector.

The other noticeable shift has been in the retail sector. Globally, there has been a consumer trend of greater online shopping. Given that South Africa's online platform lags slightly behind that of its global counterparts, we don't see this having a major impact on retail letting. Global online conglomerates like Amazon are investing in physical stores to capture further market presence. Texton's retail properties are fully let and we remain positive about this sector.

The office sector remains under significant pressure. There has been little improvement to overall vacancy rates, which remain at an all-time high. Contributing to this is the significant oversupply of stock as new developments (approximately 175 000m² in the fourth quarter of 2017) continue to reach completion in popular office nodes like Sandton, Rosebank and Waterfall. We are seeing incremental year-on-year escalations in Grade P rentals, while Grade A and B rentals are realising marginally higher uplifts.

As previously noted, Texton is looking to generate additional revenue from non-gross lettable areas. Terms have been finalised with a premier outdoor advertising company to implement a digital billboard at Investment Place in Hyde Park, Johannesburg. All income derived from advertising will be split between the parties by way of a profit-sharing model. Texton will pursue similar initiatives at other sites which offer the same potential.

The UK property market remains resilient. It continues to show positive returns, although the gradient of the growth is forecast to soften. Colliers is forecasting total commercial property returns of 6.1% in 2018, down from 10.2% in 2017. Income is forecast to deliver a 4.9% component of the 2018 total return, with the remaining 1.2% comprising capital growth.

The UK investment market enjoyed a flying start to 2018, with £13.6 billion of assets changing hands – the second-highest first-quarter volume in a decade. Growth is being driven by the weight of money targeting the sector and the high spread between property yields and Gilts. Total UK investment volumes exceeded £65 billion in 2017, up by more than a quarter from £52 billion in 2016. The main downside risks are around the pace and extent of future interest rises and political uncertainty. It is important to note that the market averages mask high variability across the different sectors of the UK commercial property market. The industrial sector is forecast to continue to be the star performer in 2018. Colliers predicts industrial total returns of 12.5%, comprising capital growth of 7.4%, income return of 4.8% and a residual of 0.3%.

The office sector is forecast to deliver a 4.7% total return in 2018, comprising 0.5% capital growth and a 4.2% income return. Central London offices are expected to underperform on a relative basis due to subdued rental growth. This is the segment of the UK occupier market that is arguably most exposed to Brexit. Offices outside of London are expected to be more resilient.

Overall, the retail sector is expected to struggle in 2018 against the shift to multi-channel shopping and weak consumer confidence. Colliers forecasts total returns of 3.5%, comprising income returns of 5.3% and negative capital growth of 1.7%. Within the sector, there is again likely to be a wide disparity in the performance of different assets. Most at risk are secondary shopping centres and unit shops in weaker towns providing outdated space; "right-sized" space in high-footfall trading locations with a brand offering that fits the catchment population are expected to fare much better.

We believe that Broad Street Mall, with its clear brand proposition, compelling tenant mix and location in fast-growing and robust Reading, will continue to capture trade from its large catchment area.

Quarterly UK GDP growth slowed in the first quarter of 2018 to 0.1%, down from 0.4% in the fourth quarter of 2017, according to data from the Office for National Statistics. Manufacturing output has been increasing but the positive impact has been offset by political uncertainty and subdued consumer spending. Positive news on inflation and employment suggests the first quarter GDP figures may have been skewed by adverse weather.

Despite recent falls, the pound has appreciated significantly against the dollar since UK base rates were increased to 0.5% in November. The pound is likely to strengthen further when additional interest rate rises are delivered. Annual consumer price inflation fell to 2.7% in February, down from 3% in January and at its lowest level since July 2017. Falling inflation and real wage growth should help support consumers.

Much of the future UK economic performance will depend on the extent to which consumer spending rebounds. Oxford Economics has predicted GDP growth will improve to around 1.9% in 2020.

Working our portfolio

SOUTH AFRICA

Texton continues to own and manage a diverse and realigned property portfolio in South Africa. Although the operating environment remains tough with higher office vacancies across the property sector, Texton remains focused on its core objectives of tenant retention, cost rationalisation and innovative ways to increase its bottom line.

Our proactive, hands-on approach to leasing has resulted in a further reduction in Texton's lease expiry profile by gross lettable area and revenue. In June 2017, it was reported that 42% of leases (by revenue) expire in the 2018 financial year. By December 2017, this figure decreased to 14.3% and in March 2018 dropped to 8.2% (see Figure 2). We expect this figure to be well below 5% by June 2018.

Texton's gross lettable area in South Africa remains at 291 169m² with a vacancy of 16 227m². This vacancy translates to 7.9% of the total vacancy in South Africa, which is marginally down since December 2017 (8.3%) (see Figure 1) and still well below market norms. The recently vacant Scott Street and St George's Mall properties are being aggressively marketed via innovative mediums in the hope of securing quality tenants.

Between January and March 2018, Texton successfully negotiated and finalised ten new leases. In the same period, 23 lease renewals were concluded, equating to 16 087m², illustrating that this aspect of our business remains a priority. Particularly pleasing was the long-term lease renewal of an international blue-chip tenant who occupies 7 066m² of office accommodation at Belvedere Place in Sunninghill. This tenant took up an additional 850m², which had previously been a longstanding vacancy at the property. This has resulted in an occupancy of 98.6% across Texton's Sandton office portfolio, which is very satisfying given the office-sector vacancy rate and the massive development projects being completed in the greater Sandton node.

VACANCY ANALYSIS: MARCH 2018

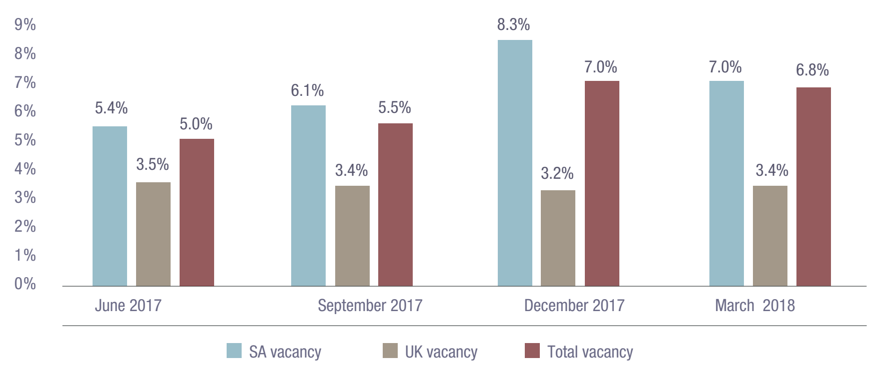

Figure 1

SA LEASE EXPIRY PROFILE: MARCH 2018

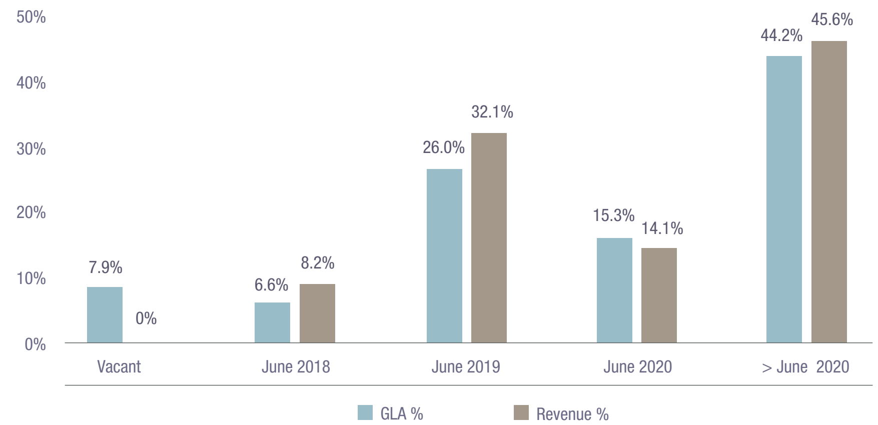

Figure 2

REFURBISHMENTS AND REDEVELOPMENTS

The refurbishment at Bryanston Gate Office Park is due to be completed by mid-May 2018. The refurbishment includes plastering and painting external walls (previously facebrick); painting roof tiles, window frames, gutters and air-conditioning grills; installing external floor tiles; creating a new entrance to each building and at the main gate; and erecting new signage. There has been a notable uptake of space at the property (10 new leases since commencement in May 2017). As a result of the improved office accommodation, Texton has managed to retain existing tenancies on favourable lease terms.

ACQUISITIONS AND DISPOSALS

Texton is not seeing much in the way of impressive acquisitions, and the pipeline for quality retail and industrial assets remains relatively small. This is not only pertinent to Texton but the industry in general. Texton remains a discerning buyer and is confident the right opportunities will present themselves as we develop our networks with principals, developers and brokers. The disposal of Rynlal and Parthenon Park is in progress and transfer is expected before the end of August 2018.

UNITED KINGDOM

Broad Street Mall continued to operate within a challenging retail environment. Efforts and creative planning need to be maintained to ensure footfall continues to rise and is converted into sales. Bad weather over this quarter added to the strain on the retail sector, with snow and ice causing major disruptions to transport.

Nonetheless, Broad Street Mall has remained steady for the first quarter of 2018 and has performed well in comparison to local, regional and national figures. In February, footfall was 0.6% up from the previous year, raising our cumulative total from -3% to -1.3%. This is far better performance than retail trends for February, which sat at -20.7% locally, -4.0% regionally and -1.4% nationally.

We are pleased to announce that the vacant Argos space is now under offer to a British supermarket chain. Solicitors have been instructed and Heads of Terms have been agreed. With limited supermarket chains in the town centre, it is expected that having a major supermarket anchor in the mall will lead to a rise in footfall.

Four serviced operators have expressed an interest in the entire Quadrant House office space that is due for refurbishment. The remaining floor of Fountain House is being considered by one of our existing tenants. If the tenant occupies this space, then Fountain House will be fully occupied.

Commercialisation initiatives such as marketing promotions continue to increase mall income. These, together with the big screen advertising at the mall's main entrance, mean that we are in line to meet our non-GLA income targets. The promotions are proving to be successful and we will continue to engage in these events to generate additional footfall and create a lively trading environment.

We are actively engaging with the retail occupier market to retain existing tenants and draw in new ones. Unfortunately, during this quarter New Look entered into a Company Voluntary Arrangement (CVA), proposing the closure of up to 60 of its 593 stores nationally. Reading was on the list, including Broad Street Mall and the Oracle New Look stores. Reading is under the B3 category, which means that New Look would look to reduce their rent by 60% with effect from 23 March 2018. They will continue to occupy the store for six months on that basis. Discussions with New Look were well under way before the CVA release and have subsequently continued. Although nothing could be agreed prior to the arrangement, it was important for us to gauge their intentions, given their operating concerns. They have indicated a willingness to extend occupation beyond six months and we are awaiting their response to our proposal.

We are also exploring other options to fill the space if New Look does vacate after six months. The news of the CVA was, of course, disappointing, but the decreased rental has a minimal impact on Texton's income forecast. The difference amounts to around 2% of the total budgeted Broad Street Mall rental income for the 2019 financial year.

We maintain constant communication with existing tenants to ensure they are performing in line with their own expectations and goals. As part of this, we investigate reconfiguration options. We currently have a handful of tenants who are looking to move from their current position to a different space that is either better positioned or more suitably sized for their offering. These requirements are in line with the short- and long-term goals that we have in place at Broad Street Mall.

The UK portfolio benefits from an increasing income profile driven by fixed uplifts at rent review on 19% of the portfolio and inflation-linked uplifts on 18% of the portfolio. Most of the remaining rent reviews are on an upward-only basis, where the rent is reviewed to the higher of passing or market rent. Two rent reviews have been assessed over the course of the quarter on a flat basis, including one of our significant retail assets in Camborne known as B&Q (pictured below). The strong financial standing of our UK tenants continues to underpin the security of the income streams and ensure excellent collection statistics. Other than Broad Street Mall and Fountain House vacancies, the remaining UK portfolio is fully let and income producing.

B&Q, CAMBORNE, UNITED KINGDOM

REFURBISHMENTS AND REDEVELOPMENTS

As previously mentioned, there was the intention to build another kiosk at the Oxford Road entrance to Broad Street Mall. This is well under way and the unit is almost complete. New Asia Limited, trading as Mooboo, is ready to fit out the kiosk and take occupation on completion. This will be a new five-year lease with no breaks at a rental of £15 000 per annum. We look forward to seeing the positive results we believe this kiosk will deliver, not only as additional income but driving footfall to this entrance and area of the mall.

As final arrangements are made for the urban market concept at the undeveloped South Court of Broad Street Mall, ideas for the different stacking of the units are being discussed. The idea is to have a courtyard fronting onto South Court and Dusseldorf Way/Hosier Street side, with a rooftop level and a small event stage. This development will certainly enhance the offering of the mall, creating a new hub for visitors to enjoy as well as giving small businesses new opportunities.

ACQUISITIONS AND DISPOSALS

Texton continues to look at opportunities to enhance the profile of the UK portfolio through selective disposals and acquisitions. Earlier discussions to sell Stanford House, Warrington, were put on hold following the immediate impact of the Brexit referendum. Following the renewed momentum in the regional office market, discussions have resumed and a preliminary offer has been received to acquire the asset at above book value.

High Finance

With the stable outlook, Moody's unchanged Baa3 sovereign rating and the interest rate cut of 25 basis points, there is cautious optimism for the recovery of the South African economy. The property sector's recovery generally lags behind that of the economy.

The significant flux within South African REIT markets in 2018 has been reflected in prices across the JSAPY index. At 31 March 2018, Texton was trading at a yield of 19.4%. As discussed in our interim results, we have embarked on an active capital management process to match South African debt with South African assets and UK debt with UK assets. This, together with reducing our loan-to-value ratio, remains a priority.

We have successfully engaged with the banks on the renewal of facilities of R50.5 million and £19 million expiring before June 2018. The terms of the renewed facilities are being finalised. It should be noted that the rates are higher than the expiring facilities, with the banks charging higher margins.

Texton remains adequately hedged at 85% at 31 March 2018 and is actively managing its hedging profile.

OUR FOCUS

- TENANT RETENTION AND REDUCED VACANCIES
- EFFICIENT CAPITAL MANAGEMENT
- SUSTAINABLE DISTRIBUTION GROWTH
- PORTFOLIO-ENHANCING ACQUISITIONS
- PROACTIVE ASSET MANAGEMENT

> ***"A strong balance sheet is an asset in periods of market volatility. Through our capital management plan, we continue to focus on reducing our loan-to-value ratio."***

INGE PICK, *CHIEF FINANCIAL OFFICER*