TEXTON

PROPERTY FUND

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Quarterly Newsletter

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QUARTER 2

2018 EDITION

FUND SNAPSHOT

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Macroeconomic Overview

Since the ANC's elective conference in December 2017, the "Ramaphoria" dawn of an improved economic outlook for South Africa has waned, with issues such as land expropriation coming to the fore.

A positive development is China's commitment at the recent BRICS summit to invest $14.7 billion into South Africa. The South African Reserve Bank's revised GDP forecast on 19 July of 1.2% (previously 1.7%) adds to the glib outlook for the next 12 months. The rand remained weakened in June 2018, consistently under pressure from trade wars led by the US, which caused choppy global markets.

The UK economy regained some pace over the second quarter, after recording only 0.1% GDP growth in the first quarter. At the time of writing, second-quarter GDP data had not been released but was expected to be between 0.3% and 0.5%. This improvement has been driven mainly by a rise in services output, somewhat offset by falling output in the industrial and construction sectors.

Given the strength of Purchasing Managers' Index surveys in June, there is still scope for the economy to perform better than expected. Capital Economics has forecast GDP growth of 1.6% for 2018, slightly ahead of the Bank of England's 1.4% prediction. The improved GDP outlook has increased the likelihood that the Monetary Policy Committee will raise interest rates from 0.5% to 0.75% at its next meeting on 2 August 2018.

Brexit continues to exert significant uncertainty over politics and business. The conservative government remains deeply divided over Britain's future relationship with the EU. The prime minister recently secured the backing of cabinet to present a plan to the EU on future trade and customs arrangements, but only after the protest resignation of two leading members, David Davis and Boris Johnson. The so-called "Chequers deal" agreed by cabinet sought to maintain harmonised trading arrangements but was only passed by parliament after concessions were made to the Brexiteers, introducing more restrictive controls. The revised proposal will be less palatable to the EU and increases the probability of a "no deal" Brexit or a second referendum. We are in favour of the latter given the lack of clarity around the current referendum campaign and its consequences.

"Company Voluntary Arrangements (CVAs) are becoming a common theme globally, speaking to structural shifts in retail spending and resulting in a disconnect in property and company valuations."

NOSIPHIWO BALFOUR, *CEO*

From the Asset Management Desk

PROPERTY MARKET TRENDS

SOUTH AFRICA

Although the South African Property Owners Association (SAPOA) office vacancy rates have improved in the second quarter, market sentiments remain negative compared to the first quarter. This suggests that listed funds are focusing on the income stability of their respective portfolios due to the slow economy.

Metropolitan office vacancies remain high, especially for A- and B-grade properties. This is attributable to a surplus of commercial properties (and upcoming developments) in nodes such as Sandton, Rosebank and Waterfall; Umhlanga and La Lucia; and Cape Town CBD. Recently developed prime-grade properties have added to the oversupply in this sector. According to SAPOA's second-quarter office vacancy report, the gross lettable area (GLA) of new office developments totalled about 512 000m². This means that older properties are competing with new developments at similar rentals. However, national development activity has declined from the all-time high of 982 000m² recorded in the fourth quarter of 2015.

The retail market is facing a challenging trading environment as the consumer is forced to juggle stagnant disposable income with an increase in food and petrol prices. Although interest rates were kept on hold at the last Monetary Policy Committee meeting, it is expected that with inflation under pressure the Reserve Bank will have to make tough decisions in the first quarter of 2019 to maintain prime lending rates.

Retail sales growth, according to Statistics South Africa, rose by 1.9% year-on-year in May 2018. Competition for the market share will force shopping centres to take strategic measures to remain relevant.

Industrial properties, specifically warehousing and the light industrial subsector, located in strategic metropolitan nodes remain in demand.

UNITED KINGDOM

A steady volume of assets continues to change hands in the UK property market. The total value of commercial property investment transactions in June 2018 was £5.5 billion. This was 30% higher than May 2018, but 30% lower than June 2017. The lower volumes suggest investors are adopting a more cautious approach. We believe this to be a result of concerns about the Brexit transition programme and an increase in interest rates.

As we have moved swiftly into the summer season, long-indexed property income opportunities have continued to attract high interest from investors. We continue to access high volumes of stock as many sellers look to complete deals before heading on summer holiday. This has proved to be an exciting time of the year, as Texton has identified a number of suitable opportunities.

Beyond the retail sector, the property outlook is pointing towards yield stability for the remainder of 2018, despite uncertainty about Brexit and the prospect of rising interest rates. The UK remains a key target market. Booming logistics and industrial activity has seen 16.4 million square feet occupied over the first two quarters of this year. This is 3.3 million square feet more than the figure for the same period last year. However, industrial deals have softened in comparison to 2017, indicating that the industrial boom may be starting to decline, resulting in yield stability and activity returning to more normal levels. There continue to be significant levels of cash for investment in the industrial sector. However, the volume of trade is limited by a lack of supply, mainly of prime industrial stock.

One of the main challenges in the first two quarters of 2018 relates to the high-profile CVAs that have come to market. Combined with rising e-commerce, shifts in landlord rent income and increased costs have put pressure on the retail sector for both landlords and tenants. Several high-profile retailers have had to resort to CVAs or administration, including House of Fraser, New Look, Poundworld, Maplin, Mothercare and Toys R Us.

E-commerce is forecast to increase over the next four years, but its growth rate has started to slow. For most retailers, physical stores remain the main point of engagement with customers. This requires retailers and landlords to determine which locations are ideal.

VALUATION UPDATE

In keeping in line with best industry practice, our entire property portfolio was independently valued for the financial year ending 30 June 2018. In valuing the portfolio, a discounted cash flow methodology was adopted for the South African portfolio and market comparable methodology for the UK portfolio. It is important for us that our property portfolio reflects fair market value. The only property that was not externally valued was Talk Talk in Warrington, which currently has heads of terms signed for a potential disposal. This sale is expected to transfer by the end of September 2018. Further detail on our portfolio valuations will be provided in September, when we release our full-year results.

Working our Portfolio

The Board of Directors have approved and adopted a revised investment strategy. The strategy's main objectives are to rebalance the Fund to achieve consistent property income streams, strong tenant covenants and portfolio optimisation.

Property assets that do not meet these investment criteria will be reviewed to ensure that a smoother distribution profile of the Fund is sustained over a longer period of time. There is the possibility of Texton increasing its asset base, focusing primarily on industrial and retail assets that fit its investment mandate.

One of our notable achievements in the first quarter of 2018 was acquiring a sizeable portfolio of industrial assets (see our acquisitions update for more detail). The appointment in June of two asset managers in Texton SA will greatly strengthen the current team, ensuring that the portfolio is rebalanced and new investment opportunities are explored.

In the UK, we have recently taken steps to streamline the asset and property management structure. This has resulted in major cost saving and allowed more work to be handled directly by the Texton UK office. A senior asset manager who joined our UK asset management team in April 2018 will ensure that the streamlining process and the implementation of the UK strategy is actioned in the next financial year.

Texton is committed to achieving the highest possible returns for its shareholders by executing its mandate.

SOUTH AFRICA

In the South African portfolio, the GLA for the second quarter is 290 754m², with a vacancy of 26 941m² or 9.3%. The current vacancy rate of 9.3% has increased from 7.9% in the first quarter (see Figure 1). This shows that our vacancies are still below market norms of 11.1% as indicated in the SAPOA office report for the second quarter. Properties with higher vacancies, like St Georges Mall, Scott Street and Xstrata, are being marketed intensively. We've seen positive results this quarter, with a decline in our larger pockets of space, particularly at Scott Street, where 2 400m² has been successfully let. The new tenant is expected to take occupation in October 2018. As we continue to reduce vacancies, a key focus is on improving the tenant covenant and increasing exposure to large/ national/listed entities (see Figure 3). In this difficult economic environment, Texton still managed to successfully negotiate and conclude seven new leases, reducing vacancies by 849m² and renewing 15 expiring leases. One of the largest renewals was for three years with a tenant who occupies 2 956.5m² at Belvedere Place in Sunninghill. All lease renewals were negotiated on favourable terms with an average reversion rate of 6.3%. This is pleasing, given depressed rental growth and high vacancies in the market.

Texton's lease expiry profile (by GLA) has seen a rewarding decline since the June 2017 quarterly report, which indicated that 42% of existing leases would be expiring in 2018. We are pleased to report that as of June 2018 this figure is now below 5%, with terms agreed and the remaining tenants in possession of the agreements for signature. The biggest contributor to the June 2019 expected renewals is a sizeable occupier that is currently on a short-term lease and that we expect to renew for a longer lease in the coming financial year. This will improve the lease expiry profile from 37.0% to 29.0%. Between July 2017 and February 2018, 59 leases were concluded. This equates to a GLA of 48 131m², which is 16.5% of the total South African GLA (see Figure 2).

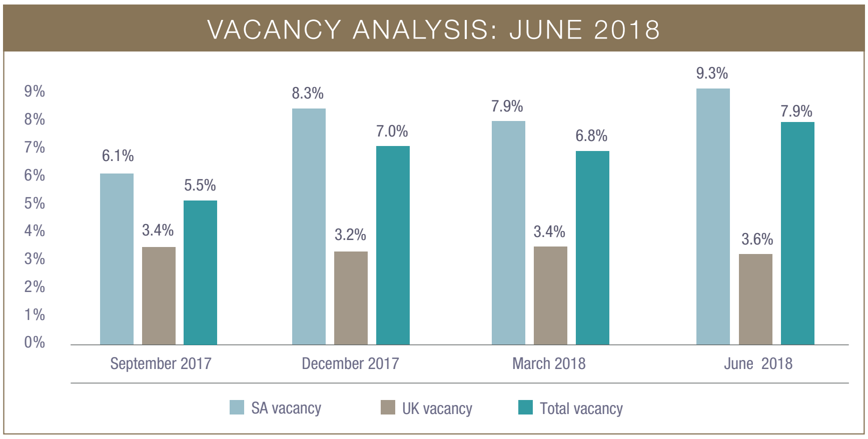


Figure 1

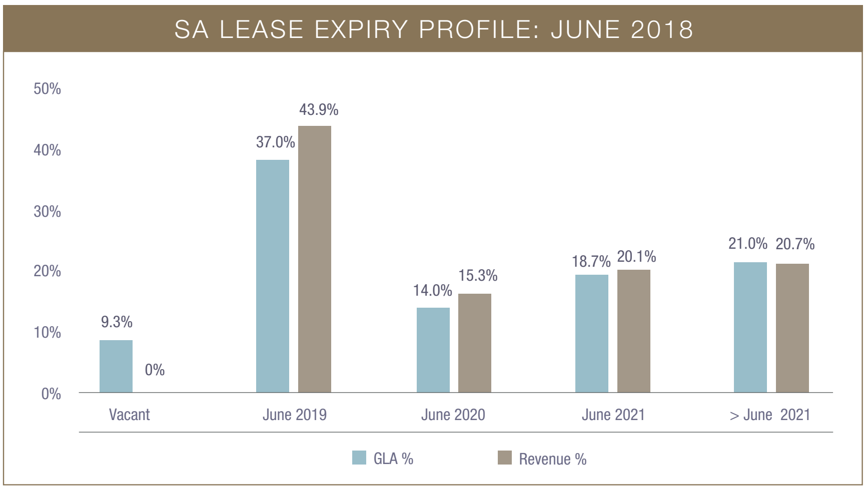
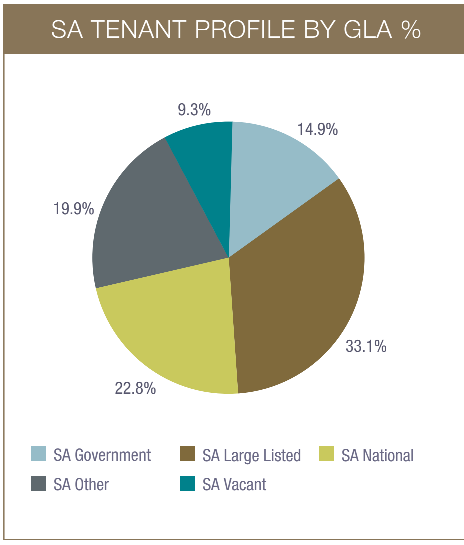


Figure 2

UNITED KINGDOM

The past two quarters have been a busy time for our team. Texton completed a new financing facility with HSBC on the 2016 acquisitions, which will allow Texton UK to capitalise on new investment opportunities.

The UK portfolio continues to offer a robust income stream and a lengthy weighted average lease expiry profile. The combination of strong covenants and long income profiles has provided a steady and consistent income stream.



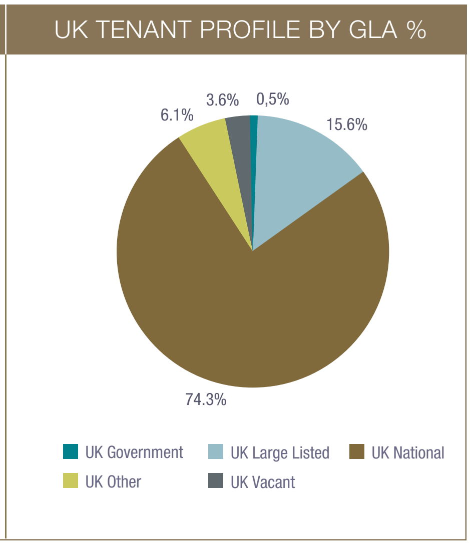


Figure 3

Broad Street Mall still poses a challenge, given the depressed retail trading environment. The mall saw a decrease in footfall for June. Nonetheless, our two main anchor tenants, TK Maxx and Wilko, experienced a large increase in footfall, with TK Maxx doing particularly well. Food retailers continue to perform well in the centre. Poundland has managed to attract a lot of trade due to the Poundworld closure. Poundworld most likely left at the expiry of its lease because of its impending CVA.

Terms have been agreed and legal negotiations are progressing well with two high-profile national brands to take occupation of the former Argos and Poundworld stores. Securing these two lettings demonstrates that the mall continues to appeal to occupiers. One of these brands is Iceland and as such will drive footfall to the mall.

REFURBISHMENTS AND REDEVELOPMENTS

South Africa

The refurbishment of Bryanston Gate Office Park was completed this quarter. The refurbishment had a projected initial yield of 17.7%, which included a 5% vacancy assumption. It is expected that when the project is completed, rentals will be stable and there will be an improvement in letting.

At the Babcock Bedfordview property, capital expenditure has been used to build a canteen and pause area. In return, the tenant has agreed to extend their lease to 2021 on the same terms as the existing lease, with no negative reversion in rentals.

At Investment Place in Hyde Park, Texton will be converting an unused area into an eatery and has concluded a lease with a quality operator. This is an example of our initiatives to add value by generating income from non-gross lettable areas.

United Kingdom

At Broad Street Mall, heads of terms were agreed during the quarter for a 101-bedroom hotel with Premier Inn for a new 25-year lease subject to CPI uplifts (capped at 4% p.a.) and a tenant break after 20 years. The hotel development proposals have been positively received and the scheme has generated significant residual value. Excellent progress has also been made with the wider residential plans to develop over 400 units above the shopping centre. The arrival next year of Crossrail (the new high-speed rail link connecting Reading to central London and the eastern suburbs) will have a positive effect on the Reading residential market. The development team have been value engineering the design and we aim to submit a planning application in the fourth quarter. As previously mentioned, the additional Broad Street Mall kiosk at the Oxford Road entrance is now complete. The tenant completed their fit out and had their soft opening in early July.

We are working with architects to explore the possibility of adding accommodation above our property located at Lower Parliament Street in Nottingham. These plans are still in their initial phase and financial feasibility has to be determined. The potential optimisation of this asset is extremely positive given that Nottingham is a major university town with an active budget hotel market and capacity for more student accommodation.

ACQUISITIONS AND DISPOSALS

South Africa

Texton continues to act on its investment strategy of acquiring complementary and portfolio-enhancing properties which offer long-term distribution and capital growth underpinned by strong contractual cash flows.

We have reiterated our intention to pursue industrial opportunities with sound fundamentals, particularly warehousing and logistics properties in main metropolitan nodes. In this regard, we were pleased to advise our stakeholders via SENS announcement in reaching terms to acquire a portfolio consisting of four industrial properties in the Western Cape for a purchase consideration of R205.3 million at a proposed acquisition yield of 9.4%.

The properties are single tenanted with a weighted average lease term of 4.4 years. Details are shown in the Table 1 below.

Property name	Location	GLA	Value (R'000)
Execujet Hangar	Airport Industria	5 347	91 500
Crossroads	Milnerton	2 880	48 400
Montreal Road	Airport Industria	3 800	40 000
Madrid Road	Airport Industria	3 000	25 400
		15 027	**205 300**

Table 1

United Kingdom

We are in the process of disposing of our Talk Talk building in Warrington. This will open up an opportunity to repatriate these funds back to South Africa to reduce our gearing and grow our UK portfolio with the remainder of the proceeds.

Texton has been an active bidder on potential targets over the course of the second quarter but has maintained pricing discipline and not yet entered into any acquisition. The asset classes that best fit our investment mandate are industrial, big box retail and student accommodation.

High Finance

In the financial year to 30 June 2018, Texton refinanced all of its expiring borrowings, with the exception of Nedbank facilities of R66 million. R55 million was repaid in May using existing facilities and the remaining Nedbank facility of R11 million will be repaid on expiry in September 2018. These share-backed facilities (used for the Texton Share Incentive Scheme Trust) were linked to the prime rate and were costlier than the remaining facilities. After the first quarter fallout in the South African REIT sector, share-backed facilities fell out of favour with the banks and significantly higher share coverage ratios were required. As we have implemented a new share incentive scheme which is cash settled rather than equity settled, we decided to repay the Nedbank facilities. The treasury shares will be retained for the foreseeable future.

We have made progress on our capital management strategy of matching South African assets with South African debt. We have reduced the amount of British pound facilities secured by South African assets to £10 million, from £19 million in 2017. Texton continues to work towards a target of financing and securing all South African facilities with South African assets and UK facilities with UK assets.

No new interest rate hedges were entered into and we remain 82.47% hedged as at 29 June 2018. Texton has set a minimum hedging level of 80% exposure to interest rates on drawn-down facilities.

All but one of our South African facilities bear interest at rates linked to the Johannesburg Interbank Average Rate (JIBAR), which was 6.96% at

29 June 2018 compared to 7.342% at 30 June 2017. Given the volatility of interest rates in the South African market, where the inflation targets set by the South African Reserve Bank are affected by the fluctuating oil price and currency exchange rates, it is expected that, at best, interest rates will maintain their current levels. However, it is more likely that they will rise in the 2019 financial year.

The majority of Texton's UK facilities bear interest linked to the London Interbank Offered Rate (LIBOR). LIBOR was at 0.67% at 29 June 2018 compared to 0.31% at 30 June 2017. Brexit concerns and the reduction of quantitative easing make it likely that LIBOR will rise in the 2019 financial year. Fixed rate borrowings make up 28% of Texton's UK borrowings, while the UK-based floating rate borrowings have been fully hedged via interest rate swaps.

Texton continues to follow a conservative approach and hedge its exposure to currency risk on net rental income from its UK-based properties on a six-month forward basis. We exercised our currency put option at 29 June 2018 at R19.50, resulting in a gain of R4.1 million. A new currency put option was entered into with Standard Bank, hedging £2.9 million of forecast net rental income at R19.25.

> ***"There's a chance policymakers will play it safe and wait for firmer signals that the UK economy is on the right track before risking raising borrowing costs."***
>
> **INGE PICK,** *CHIEF FINANCIAL OFFICER*

OUR FOCUS

OPTIMISE
OUR PORTFOLIO

SECURE
STRONG INCOME STREAMS

STRENGTHEN
CAPITAL MANAGEMENT

REDUCE
GEARING

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