Discovery Flexible Property

31 July 2025

Market background

Global markets remained upbeat in July, buoyed by easing trade tensions, robust economic data and strong corporate earnings.

US equities rose for a third consecutive month (+2.2%), led by the tech sector after a strong earnings season and subsiding tariff concerns. The Nasdaq hit fresh record highs. European equities also gained, supported by strength in banks and exporters and optimism around a potential US/EU trade agreement. Japanese equities rebounded mid-month as auto tariffs were scaled back and risk appetite returned. Chinese equities rallied on the back of policy stimulus, earnings momentum and improving investor sentiment.

In South Africa, equity markets ended the month in positive territory, supported by a strong performance from precious metals. On the monetary side, the South African Reserve Bank (SARB) cut its key interest rate by 25 basis points to 7%, as expected. However, a surprise announcement from Governor Lesetja Kganyago, indicating that the SARB would lower its inflation target to 3%, sparked controversy. The timing appeared to catch National Treasury off guard, prompting Finance Minister Enoch Godongwana to release a statement rejecting the validity of the move, stating that such changes require Treasury's approval. Despite the political tension, bond markets responded positively: the 10-year government bond yield fell to around 9.6%, its lowest level since January.

Performance review

For the month, the portfolio outperformed the benchmark.

Within the portfolio's domestic exposure, overweight positions in Vukile and Hyprop were among the largest contributors to relative performance. We continue to favour both counters for their strong bottom-up fundamentals and attractive valuations. Having lagged some of their South African peers over the course of this year, they present opportunities for supportive valuation growth going forward. In contrast, our underweight positions in Growthpoint and Resilient detracted from performance. While Growthpoint's operational performance has shown signs of improvement, we remain cautious. It is a large business that is typically slow to pivot, and over the past five years, it has consistently underperformed peers on both growth and fundamental metrics. Resilient, meanwhile, has a compelling growth story, but in our view, its valuation is stretched. We have therefore maintained an underweight position, reallocating capital to companies such as Vukile and Hyprop that offer similar return potential and robust fundamentals, but at more attractive valuations.

From an offshore perspective, our overweight exposure to Merlin Properties was another key contributor after the company released strong financial results. There was a notable uplift in net tangible assets, driven by valuation increases from its data centre development pipeline. The market responded positively, as the core portfolio (offices, logistics, and retail) outperformed expectations. While moderation was anticipated, like-for-like growth in net rental income exceeded 3%, and valuations in the traditional portfolio were stable to slightly higher. Merlin is one of the few opportunities to gain meaningful data centre exposure in Europe, given the absence of pure-play listed options.

With a well-secured and funded development pipeline, the investment sits lower on the risk curve. This, combined with its niche positioning in a high-growth sector, underpins its role as a core offshore holding within the portfolio.

Outlook and strategy

It has been a relatively strong first half of the year for listed property, and we expect much of this performance to continue for the remainder of the year. While most of the rerating has probably already occurred, fundamentals for the sector appear reasonably favourable. Prospects are closely tied to the anticipated economic recovery in South Africa, which is continuing to make progress. Fundamentals have shown clear signs of improvement with positive reversions and lower vacancies now entrenched in performance across most counters. Sectoral performance has also held up relatively well, with the office environment showing signs of having potentially turned a corner. Dividend sustainability has also improved, with many companies restructuring their balance sheets and current dividend streams well covered by operational income. Against moderately declining local interest rates, this should provide a favourable environment for decent returns in 2025. With anticipated income returns in excess of 9% on average, which is likely to be bolstered by some growth and marginal rerating, we see low double-digit returns as an achievable target for the sector this year. We continue to see select opportunities in domestically orientated names exposed to retail and industrial subsectors, while the UK retail names also offer an attractive combination of yield, growth, strong balance sheets and accelerating improvement in fundamentals.