Equity | Property | South Africa

MAKE THINGS HAPPEN

NEDBANK CAPITAL

09 September 2013

Emira Property Fund

FY13 results

Emira reported distribution growth of 3.5% to 114.6cps for FY13 from 110.7cps for FY12. The company benefited from the combination of an improving portfolio composition and once-offs (share buybacks and restructuring of debt). We maintain our Hold recommendation with a 12-month target price of 1,488cps.

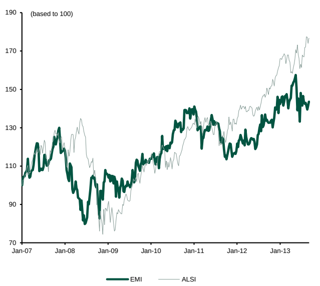
Hold

Target price
R 14.88

Price
R 14.50

Price performance

	(1M)	(3M)	(12M)
Price (ZAR)	14.50	14.71	14.00
Absolute (%)	0.00	-1.43	3.57
Rel market (%)	-2.95	-7.17	-13.75
Rel sector (%)	-0.63	-3.71	-7.90



Market capitalisation
R 7211

Average (12M) daily turnover
R 11.9m

Sector: Financials
RIC:EMIJ.J
Priced R 14.50 at close 06-Sep-2013
Source: Johannesburg Stock Exchange

Key forecasts

	FY11A	FY12A	FY13F	FY14F	FY15F
Total distributions (Rm)	557	570	607	647	687
Distribution per share (R)	1.11	1.15	1.22	1.30	1.39
Distribution growth (%)	-2.5	3.5	6.4	6.6	7.0
Distribution yield (%)	7.6	7.9	8.4	9.0	9.6
Operating expense ratio (%)	41.5	40.7	41.1	41.7	42.2
Interest cover ratio (x)	4.0	3.4	3.5	3.6	3.7
Weighted average shares (m)	504	497	497	497	497

Source: Company data, Nedbank Capital forecasts *year to Jun, fully diluted*

Initiatives bearing fruit – momentum needs to be maintained

The company has reported negative reversions on renewals in the office sector since FY11, with the largest reversion in FY13 of -8.2% (16% of office gross lettable area or GLA). This highlights the tough environment in the office sector. We expect the B- and C-grade office sector to remain under pressure in the near future given the lack of growth catalysts in the domestic economy and increased supply of premium and A-grade office space. Emira has reduced its exposure to B- and C-grade office space, now comprising 61.3% (257,813m²) of the office portfolio GLA of 420,770m² and peaking at 73.5% in FY11, but it remains a large weighting in the total portfolio at 23.2%, down from the peak of 27.5% in FY11. We are of the opinion that this portion of the portfolio will require heightened focus by management (already showing results through various initiatives), especially tenant retention and turning vacant space into income-producing space. The key issue for us will be management's ability to maintain the current momentum over the medium term in a challenging economic environment.

Risk to average funding costs as term profile is extended on shorter-term debt

We estimate that 57% of Emira's debt is up for renewal in the next 12 months, of which 30% relates to low-cost short-term commercial paper (CP) of R850m (terms less than 12 months). The high exposure to short-term CP is risky; management is cognisant of this and will look to push term where suitable. We believe it conservative to apply a higher average cost of funding for the near to medium term as CP is slowly converted into more expensive longer-dated debt (assuming a 10-15% through-the-cycle CP base). The average funding cost was 8.7%, on average funding of R3.3bn for FY13 compared to 9.3% on average funding of R2.9bn for FY12.

Hold recommendation maintained with a forward yield of 8.9%

We have marginally upgraded our distribution forecasts to 122cps (+6.4%) for FY14 and 130cps (+6.6%) for FY15 and have introduced our FY16 distribution forecast at 139cps (+7%). We maintain our Hold recommendation with a 12-month target price of 1,488cps, implying a total return of 15.2% (12-month rolling forward yield of 8.9% on the clean price of 1,400cps).

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Hard work required to maintain momentum

Emira is in better shape after reporting two years of sub-par growth marred by rising vacancies and negative reversions in its office portfolio. We discuss three key items from the FY13 results which we believe require attention:

- Vacancies down materially as management let net space of 58,000m²;
- Risky debt profile – skewed to the short term;
- Rental growth will remain a challenge from exposure to B- and C-grade office portfolio.

Key takeaways from FY13 results

The return to positive distribution growth can be attributed to a few events including: reduction in non-core assets, buyback of shares, restructure of debt profile, and reduced reliance on Eris Group (Broll performs property management function for the retail portfolio, excluding Wonderpark).

1. Sector vacancies trending down with total vacancies at 5.6%

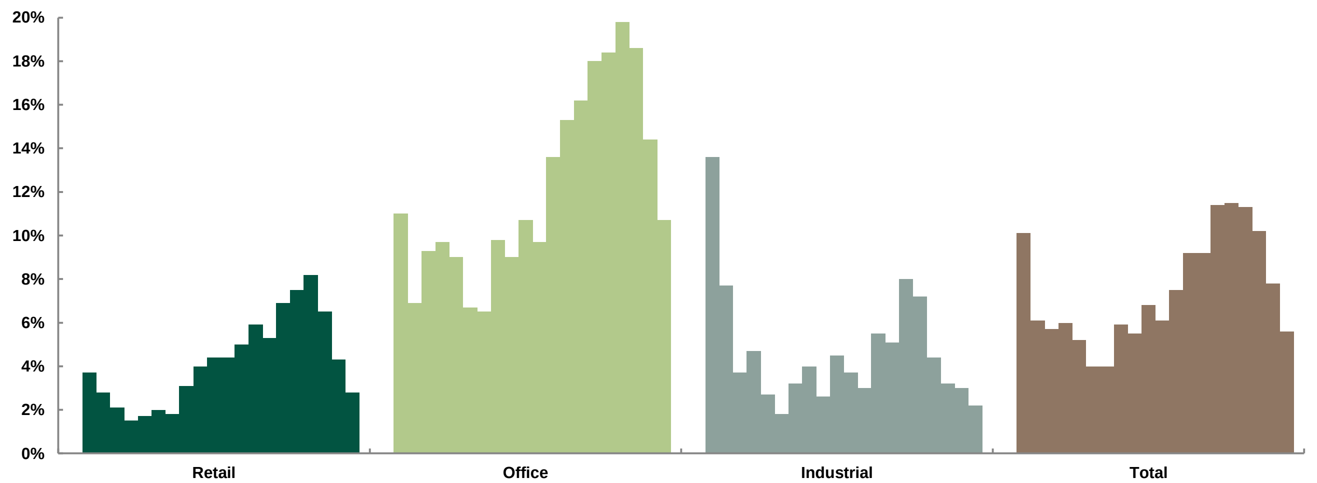
Vacancies continued to trend lower to 5.6% for FY13 compared to 10.2% for FY12:

- Office vacancies improved yoy to 10.7% for FY13 compared to 18.6% for FY12 (38% of GLA);
- Retail vacancies improved yoy to 2.8% for FY13 compared to 6.5% for FY12 (32% of GLA);
- Industrial vacancies improved yoy to 2.2% for FY13 from 3.2% for FY12 (30% of GLA).

These improvements reflected major activity on net new leases of some 58,000m², of which around 14,000m² relates to vacancies disposed of during the year. Overall we believe this is a good result in letting empty space in a challenging environment. Furthermore, a large proportion (51,088m²) relates to good quality leases averaging over 4,000m² (no need to divide space to fill vacancies) with an average duration of five years and market-related escalations.

Chart 1 shows Emira's long-term vacancy trends since FY03. Retail and industrial vacancies are nearing their historical lows, considering 0.4% development vacancy in the retail portfolio. In the results presentation management highlighted that 25% (11 leases) of FY14 expiries have been or are being renewed, leaving little concentration risk in the current portfolio. The only exclusion relates to 7 Naivasha Road Sunninghill (United Nations Development Programme) comprising GLA of 4,585m² (1.1% of the office portfolio).

Chart 1 : Sector vacancy history since FY03 (on semi-annual basis)



Source: Company data, Nedbank Capital estimates

Introducing initiatives to let vacant space and reduce risk of vacancies at expiry

Management introduced a number of initiatives to turn vacant space into income-producing space, including in-house broker consultants (four). Other initiatives include processes to identify space (over 700m²) up for renewal in the next 12 months. Management is then able to plan accordingly to reduce the risk of vacancies through redevelopments/refurbishments to retain the tenant (first win) or to defend rentals for new tenants.

Expecting flat to improving vacancy profile over forecast period

We do not anticipate a significant change to retail and industrial vacancies, while office vacancies are at risk of rising from current levels (Sunninghill exposure). This negative impact is balanced by continued momentum from recent leasing activities into FY14 and therefore keeps office vacancies flat for FY14 with slight improvements to this sector post FY14. This will provide an uplift to distributions given the better average vacancy profile applied for FY14 compared to FY13.

Further benefits from reducing vacancies through disposals are limited as the average vacancy profile is similar to that of the portfolio and reinvestment risk from proceeds.

2. Debt profile skewed towards the short term

We estimate that 57% of Emira's debt is up for renewal in the next 12 months, of which 30% relates to low-cost short-term CP of R850m. Management highlighted at the FY13 results presentation that it rolled its R400m three-month CP (expiry in August 2013) into two portions: 1) R100m three-month CP; and 2) R300m six-month CP (Table 1 and Chart 2).

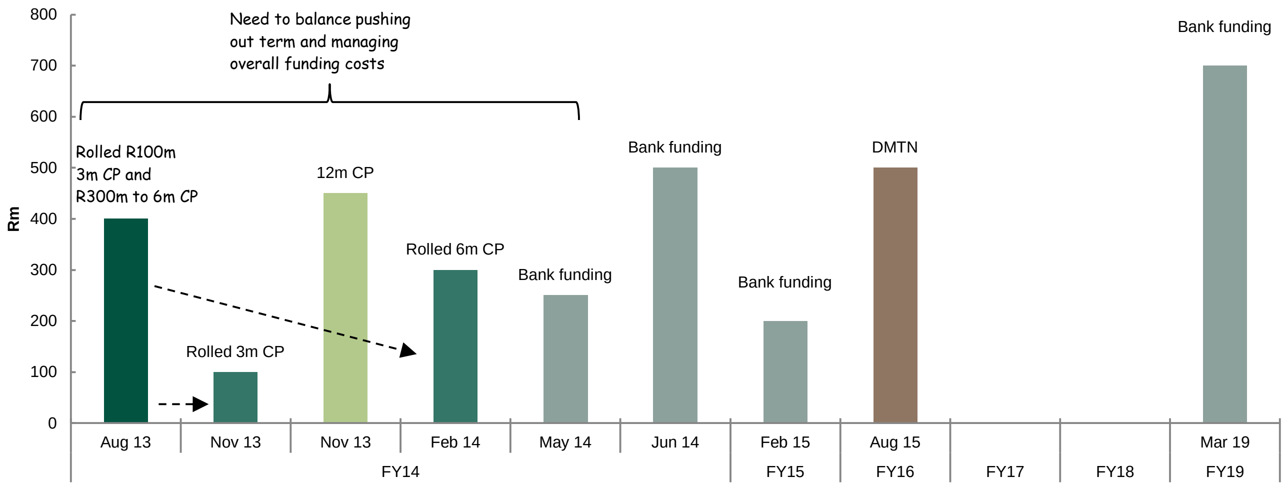
Table 1 : Recently issued commercial paper

Company	Rm	Months	3m JIBAR + (bp)
HYP	198	3	20
RES	250	3	23
EMI	100	3	21
EMI	399*	6	26
Fortress	250	12	85

*Source: Nedbank Capital monthly DCM review August 2013. * priced at 6m JIBAR with equivalent pricing of 65bp over 3m JIBAR*

The benefit of commercial paper is its relatively low cost compared to longer-dated funding, however it does increase the exposure to interest rate risk on maturity. The average funding cost was 8.7%, on average funding of R3.3bn for FY13 compared to 9.3% on average funding of R2.9bn for FY12. This was mainly due to restructuring its debt profile recently by increased exposure in development capital market (DCM) funding and a reduction in its securitisation funding structure.

Chart 2 : Debt expiry profile



Source: Company data, Nedbank Capital estimates

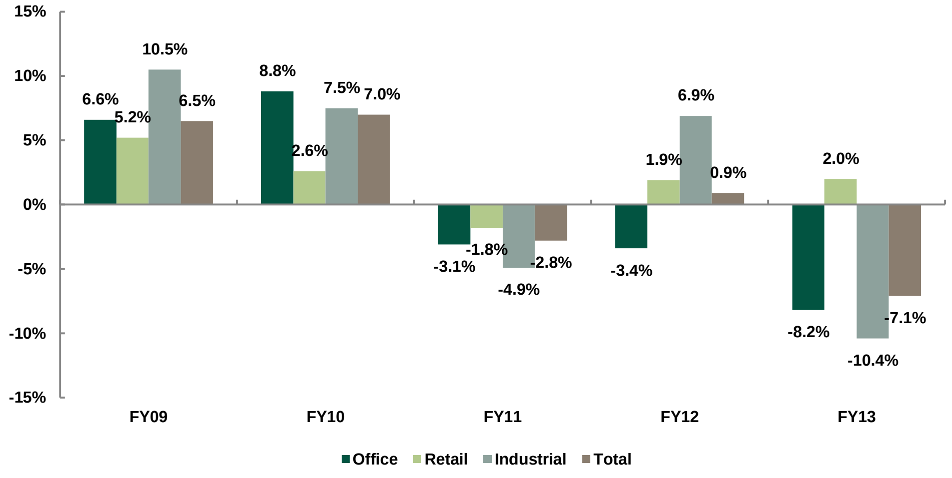
Emira's funding profile does concern us, specifically its high exposure to CP (30%). Management is aware of the risk associated with this debt profile and will look to push term where appropriate. However, extending the funding profile on the current short-term profile, specifically converting CP to either bank or longer-dated domestic medium-term notes (DMTN), will raise average funding costs (negatively affecting distribution growth). Appropriate action could include a slow transfer of CP into longer-dated debt for example; converting only a portion of the R450m 12-month CP (November 2013 expiry) to longer-dated debt instead of rolling the full amount as 12-month CP.

We believe it conservative to apply a higher average cost of funding for the near to medium term as CP is slowly converted into longer-dated debt (assuming a 10-15% CP base). A key event to note will be the two CP maturities in November 2013 (R550m).

3. Renewals will remain a challenge in the near to medium term

The company has reported negative reversions on renewals in the office sector since FY11 (Chart 3), with the largest reversion in FY13 of -8.2%. This reflects the difficult environment in the office sector, which is a function of: 1) macro factors such as the poor economic environment; and 2) company-specific factors of exposure to lower-quality B- and C-grade office space.

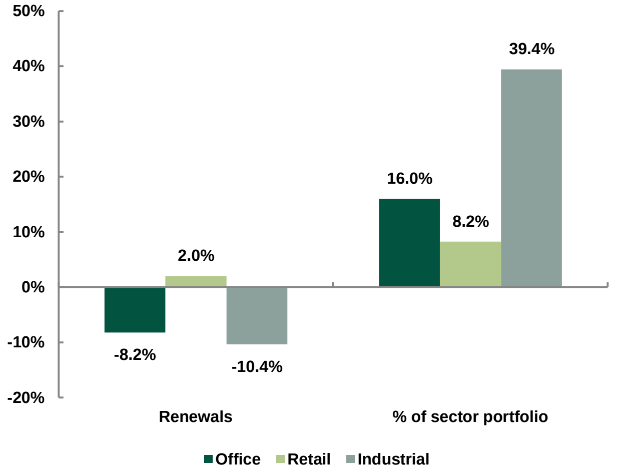
Chart 3 : Renewal history (excludes new lettings)



Source: Company data, Nedbank Capital estimates

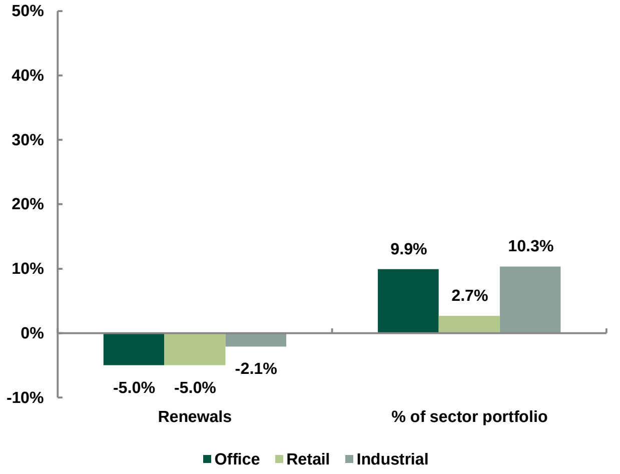
The FY13 office reversion (on renewals) of -8.2% relates to 16% of the office portfolio, while the -10.4% reversion on the industrial portfolio relates to 39.4% of industrial GLA.

Chart 4 : Renewals on current space for FY13



Source: Company data, Nedbank Capital estimates

Chart 5 : Renewals on new lettings for FY13



Source: Company data, Nedbank Capital estimates

Industrial reversions (on renewals) included a 60,000m² reversion on the RTT lease, resulting in a new net rental of R49/m² (R55.37/m² as per FY12 annual report) escalating at 5% per annum.

B- and C-grade still a large proportion of portfolio mix, but decreasing

We expect the lower-grade office sector to remain under pressure in the foreseeable future due to a lack of growth catalysts in the domestic economy and increased supply of premium and A-grade office space in Gauteng and the Western Cape.

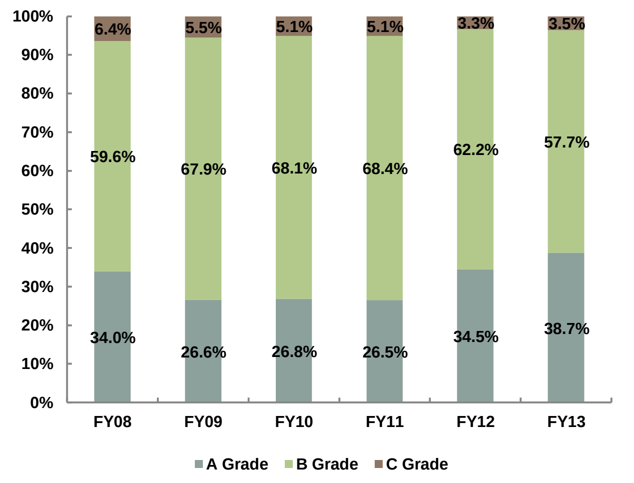
Emira has reduced its exposure to B- and C-grade office space, now comprising 61.3% (257,813m²) of the office portfolio GLA of 420,770m², down from the peak of 73.5% in FY11 (Chart 6).

B- and C-grade office space remains a large weighting in the total portfolio at 23.2%, after peaking at 27.5% in FY11 (Chart 7).

This portion of the portfolio will require heightened focus by management, specifically tenant retention and turning vacant space into income-producing space. As noted, management introduced a number of initiatives to improve tenant retention (78% for FY13 vs 54% for FY10) which we agree needs to be the priority in a portfolio composition such as Emira's.

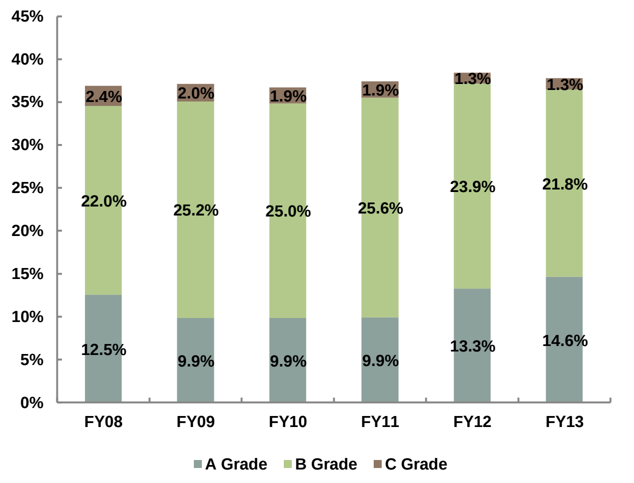
The key issue for us will be management's ability to maintain this momentum over the medium term in a challenging economic environment.

Chart 6 : Office grading mix (GLA)



Source: Company data, Nedbank Capital estimates

Chart 7 : Office grading mix relative to total portfolio (GLA)



Source: Company data, Nedbank Capital estimates

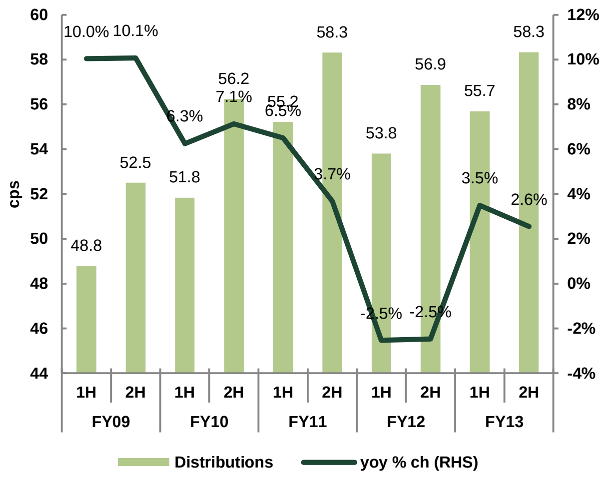
Tenant incentives paid out only post installation

There has been much discussion over tenant incentives (TI), specifically in the office sector, as funds lure tenants into their vacant space. We asked management about its policy on TI in the current environment. Management indicated that it adopts an industry-accepted TI programme which generally includes one month's rental free for every year signed.

The key risk for us is that generally TI is spent by new tenants in their businesses, for example using it for working capital. This risk is reduced in Emira as the TI will only be provided if the money is spent on the building and only paid out once all invoices are received and verified. This ensures the money is spent on improving the property

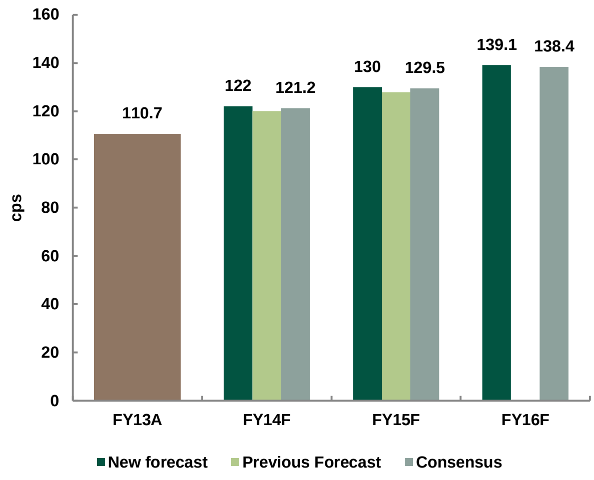
Distribution and portfolio snapshot

Chart 8 : Historical distribution forecast



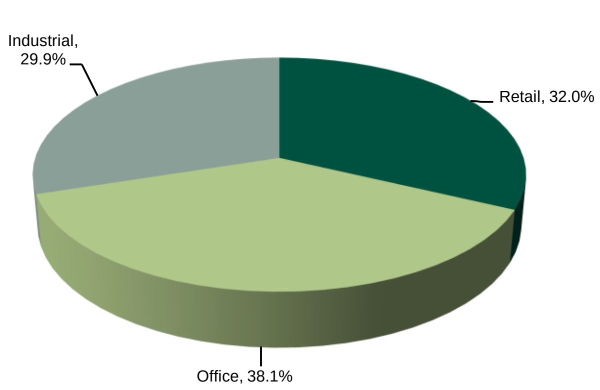
Source: Company data, Nedbank Capital estimates

Chart 9 : Forecast distributions



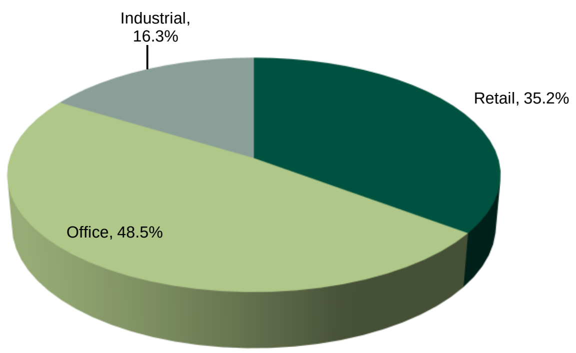
Source: Company data, Nedbank Capital estimates

Chart 10 : Portfolio by GLA (1,133,818m²)



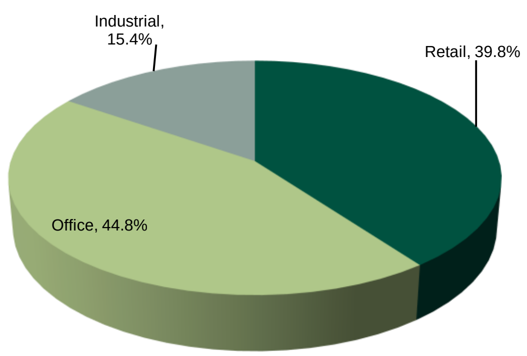
Source: Company data, Nedbank Capital estimates

Chart 11 : Portfolio by value (R9.4bn)



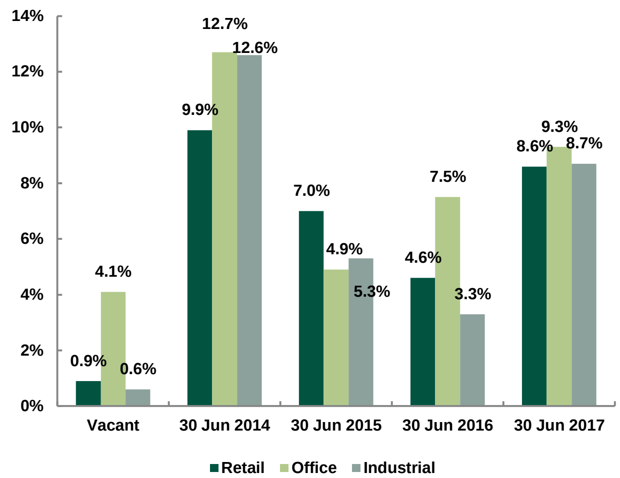
Source: Company data, Nedbank Capital estimates

Chart 12 : Sector split by gross rentals (R1.35bn)



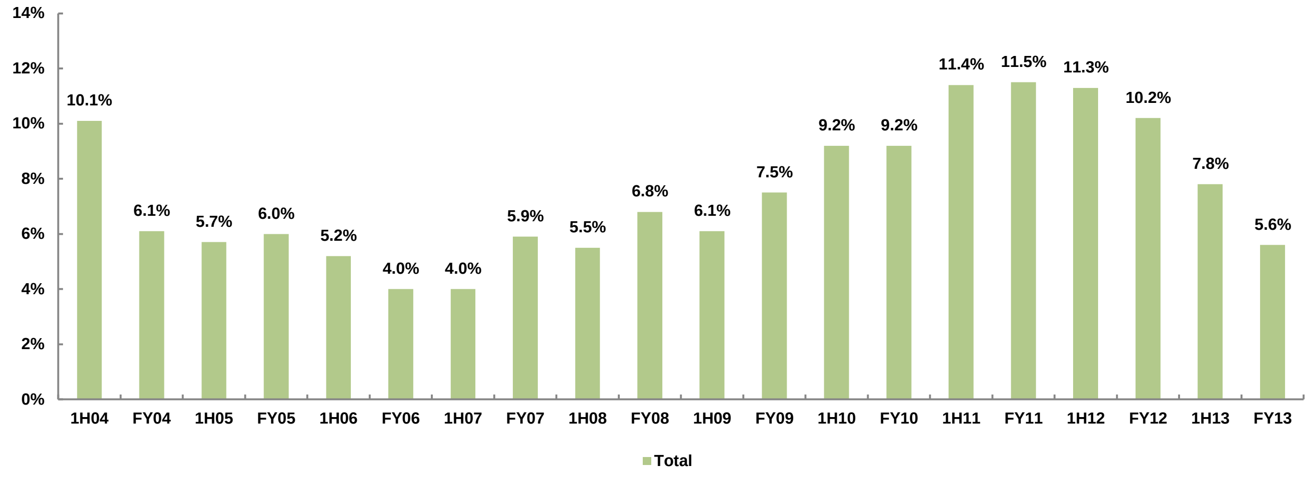
Source: Company data, Nedbank Capital estimates

Chart 13 : Lease expiry profile



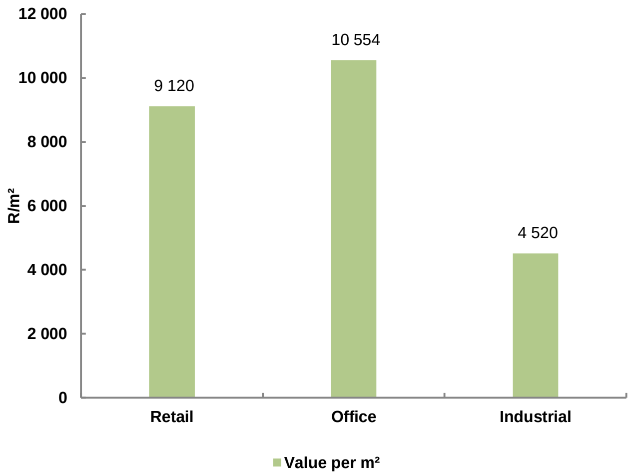
Source: Company data, Nedbank Capital estimates

Chart 14 : Historical vacancy data



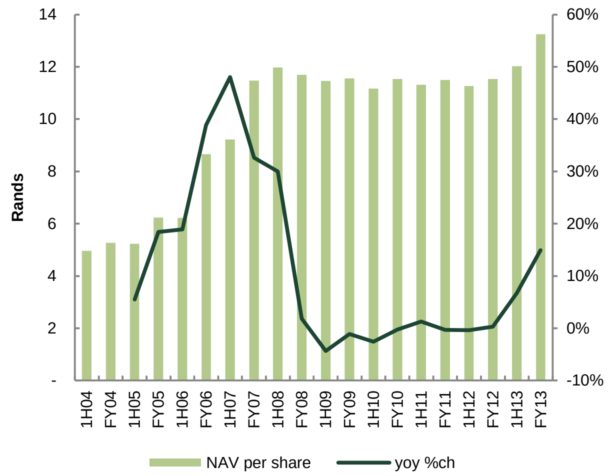
Source: Company data, Nedbank Capital estimates

Chart 15 : Sector value per m²



Source: Company data, Nedbank Capital estimates

Chart 16 : NAV per share history



Source: Company data, Nedbank Capital estimates

Company description

Emira Property Fund is a property unit trust established in November 2003. The company owns a diversified portfolio skewed towards the office sector.

Headquarters
3 Gwen lane Sandton Johannesburg

Website
www.emira.co.za

Shares in issue
497.3 m

Free float
87 %

Majority shareholders
Tiso Group 8.4%, MMI 8.3%, PIC 5.8%

Competitive position

Supplier power
Gives tenants access to diverse property portfolio, weighted towards office by GLA.

Barriers to entry
Access to funding and high-quality assets.

Customer power
Tenants have little power due to rental agreements. Tenant renewal reversions depend on prevailing economic conditions.

Substitute products
Other diversified property companies.

Rivalry
High – competitive landscape among listed and direct property investors.

SWOT analysis

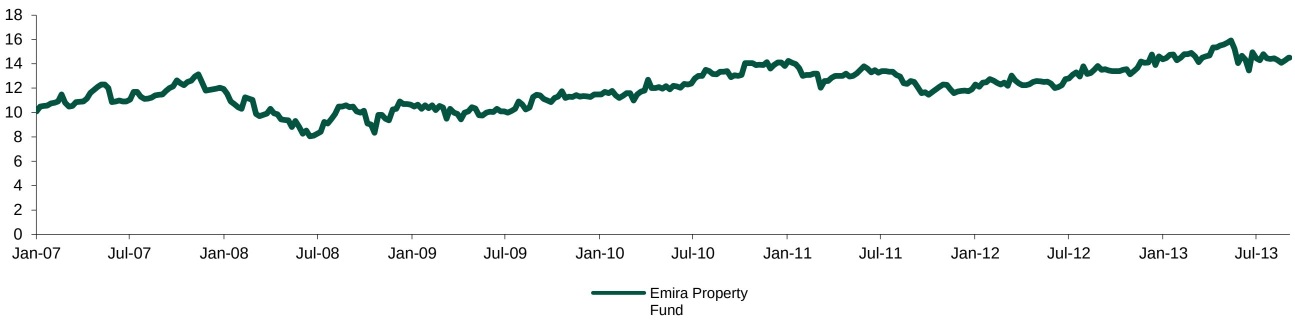
Strengths
Focused on improving quality of portfolio to make it more resilient in downturns.

Weaknesses
More susceptible to distribution volatility from change in economic conditions due to high weighting of office portfolio.

Opportunities
Shifting portfolio towards higher-quality office space.

Threats
Continued increase in vacancies from office portfolio.

Share price (R)



Source: JSE, Nedbank Capital

Recommendation structure

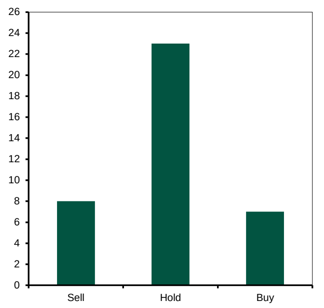
Absolute performance, long term (fundamental) recommendation: The recommendation is based upon total return, ie, the estimated total return of capital gain, dividends and distributions received for any particular stock over the investment horizon. A Buy implies upside in excess of 10%, A Sell implies an expected return less than -10%, and a Hold implied a return between 10% and -10%.

Performance parameters and horizon: Given the volatility of share prices and our pre-disposition not to change recommendations frequently, these performance parameters should be interpreted flexibly. Performance in this context only reflects capital appreciation and the horizon is 12 months.

Sector relative to market: Overweight/Underweight implies upside/downside of 10% or more and Neutral implies less than 10% upside/downside.

Fair value: The fair value is the level the stock should currently trade at if the market were to accept the analyst's view of the stock and if the necessary catalysts were in place to effect this change in perception within the performance horizon. In this way, therefore, the fair value abstracts from the need to take a view on the market or sector. If it is felt that the catalysts are not fully in place to effect a re-rating of the stock to its warranted fair value, the fair value may be interpreted as a target price to be attained at some point in the future, namely in 12 months time, unless a different time frame is specified.

NedCap's ratings universe



Source: Nedbank Capital

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Valuation and risks to fair value

Emira Property Fund (RIC:EMIJ.J, Rec:Hold, CP: R14.50 FV: R14.88). We apply a DCF valuation utilising our forecast earnings with key assumptions of 1) risk free rate of the 10 year rolling bond , 2) generic property risk premium (weighted bond and equity premium), 3) we apply a company relative risk premium to each company as well as a 4) gearing adjustment to calculate the discount rate. Risks to valuation include greater than forecast vacancies and lower rentals.

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