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SA REITs: Repositioning for the future

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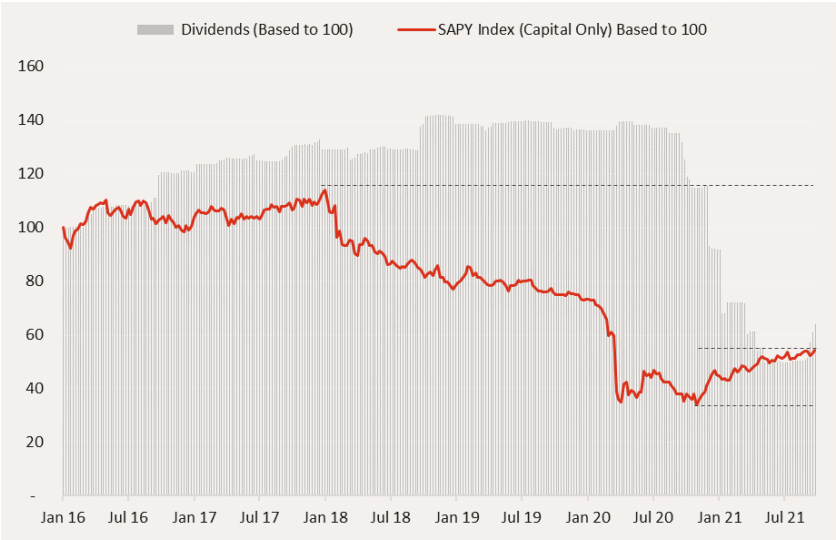
The local listed property sector was priced for failure not too long ago with a multitude of fears and uncertainty placing it in an onerous position. Undoubtedly, remaining rational and adhering to an investment strategy grounded in in-depth research were requisites during this challenging time which was punctuated by much negative noise. The recent civil unrest in KwaZulu Natal and parts of Gauteng added to the negativity, but the sector came off relatively lightly with much of the damage covered by insurance claims and most retailers up and running after a few weeks.

A long runway ahead

There has been a recovery in prices in the sector since October 2020 lows with the SAPY Index gaining over 60% off a very low base. This substantial return was tethered to a broad-based economic recovery on the back of vaccine announcements and the hope of a return to normalcy. Listed property remains below pre-COVID levels and over 50% (in price terms) off the previous peak reached in 2017. As companies' performances diverge from peers, we believe that navigating the short- to medium-term environment, which is not without its risks, requires thorough research and knowledge of property market dynamics. Coupled with a long-term view, opportunities remain in the sector.

Chart 1: SA listed property performance

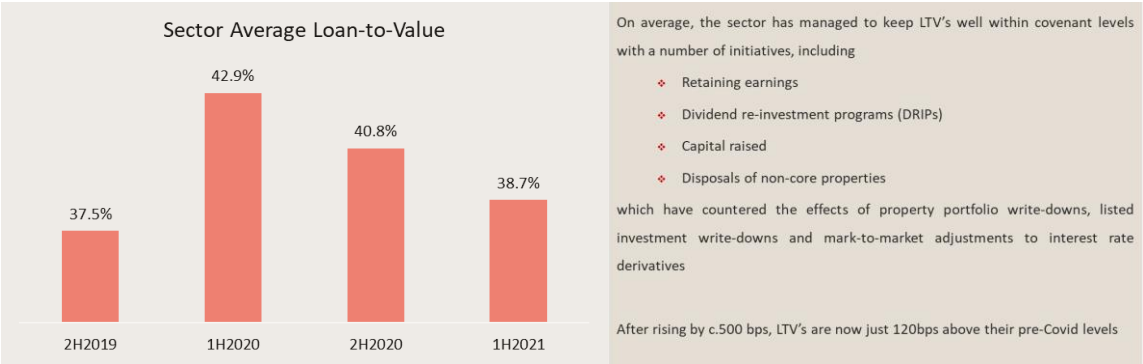


Source: Iress

Fertile ground for an extended recovery

Delving into the current environment, there are a few areas which support our cautiously optimistic long-term outlook on the local listed property sector. Regarding loan-to-value ratios (LTVs), the sector has handled deleveraging far better than the market expected. During the initial lockdown phases, banks were lenient on loan covenants and continued to extend credit and roll over debt. This meant there were fewer forced sellers and disposals of non-core assets occurred largely at or close to book value. A lower interest rate environment lent support to buyers. Currently, with valuations bottoming out and a few starting to increase, the loan-to-value of the sector as a whole is at a more sustainable level of around 39%. This was accomplished without highly dilutive discounted equity issues or the holding back of entire distributable earnings on a sector level.

Chart 2: Sector LTVs peaked mid-2020



Source: Company Financials, Metope Research

Considering the uncertainty over the past 18 months, many funds made the decision to apply payout ratios in order to shore up balance sheets and improve liquidity. Payout ratios could remain in place but will most likely trend upwards from the 75% minimum. In the interim, not all earnings generated will equate to dividends, but retained earnings will serve to strengthen companies' balance sheets. As payout ratios trend upwards and some growth is experienced, there will be an increase in dividends which means realised value creation for the investor. Observing REITs as property rental pass-through vehicles, the REIT dividend is now also cleaner, comprising mostly property income whereas previously non-recurring or non-core items filtered to the bottom line. The cash

generative nature of REITs remains post-pandemic with more stable, less risky revenue streams now contributing to dividends.

Rent collections, a barometer of tenant health, have rebounded for all three sectors and are on a sector level closer to 100%. During the hard lockdown, retail was under severe pressure which saw collection rates dip below 50% during the pandemic but these are now back above 90%. The quantum of relief provided to tenants in the form of rental discounts and deferments, particularly to retail tenants, has also decreased substantially in 2021 in line with less severe lockdown restrictions.

The market's attention has now turned to rental reversions, a sign of the weak fundamentals underpinning some property portfolios and of the bottoming out of a sector-specific property cycle which is usually accompanied by oversupply. The poor demand and supply fundamentals have been exacerbated by the pandemic too. In some property portfolios, especially those exposed to office and retail, negative reversions are expected to continue in the medium term. What one must remember is that these reversions are linked to new rental contracts which are being negotiated in the current poor business environment. As the economy recovers, the negative reversions will subside too. Having a well-managed and diversified lease expiry profile and a strong leasing team assists in lessening the impact of weak fundamentals on the overall portfolio.

Accelerated secular trends

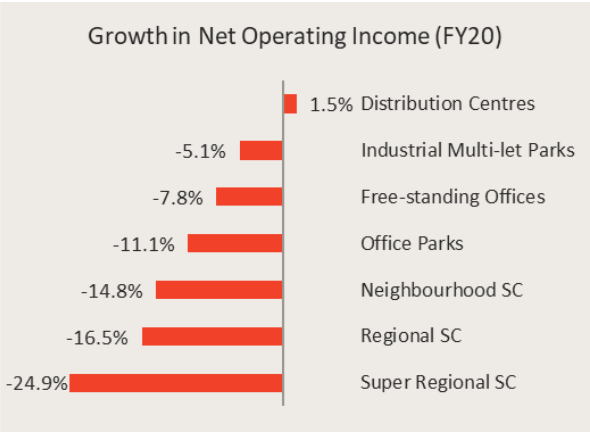
The hard lockdowns in 2020 had a pronounced negative impact on the property market. With direct short-term impacts subsiding, the pandemic has accelerated material trends that will place pressure on the future of the retail and office sectors. The narrative explains that movement to online sales will drive foot traffic away from retail spaces and working from home will lower the need to utilise office space. Companies are aware of these threats that concern investors and are adapting their strategies and portfolios by attempting to convert potential issues into value accretive opportunities.

The growth in e-commerce appears to place the focus on the logistics sector and takes the spotlight off retail space. However, the two are not mutually exclusive and can complement each other. Shopping centres still offer customers two important things that e-commerce has yet to master:

1. the need to interact with products before making purchasing decisions, and
2. an entertainment atmosphere and community-driven experiences.

Similarly, landlords will start to focus on how they can improve customer experience either through tenant selection or recreational activities.

Chart 3: Secular trends creating diverging returns



Source: MSCI

In addition to customer experience, shopping centres will serve as ideal facilities for last-mile delivery with close proximity to consumers and improved efficiency through mitigating travel time from warehouses on city peripheries. In rural areas, e-commerce penetration is still experiencing its challenges but, as they are overcome, a similar model will be adopted. It is unlikely that new logistics developments will be built in these areas as established shopping centres already possess the infrastructure for last-mile delivery operations.

The office sector is still expected to face slightly more pressure with a low absorption rate and a large supply overhang resulting in rentals remaining weak in the short term. While working from home has granted flexibility to companies and employees, it is not the end of the road for physical office space. The office space is a location for companies to develop a relationship with their employees through facilitating collaboration, imprinting their culture and offering employee experiences that cannot be substituted by replacing an office desk with a home office.

Many companies are reluctant to adopt a strict long-term, work-from-home policy as they risk losing these components and are expected to move towards a hybrid workspace model. Granting employees flexibility in their schedule will assist in maintaining a healthy work-life balance which is likely to benefit both parties. Prospective tenants will focus on amenity orientation to maintain a positive relationship with employees, and property companies will focus on non-core asset disposal and tenant retention to optimise their office exposure. The office sector will still form a part of the built environment and remain relevant in a South African property context.

Opportunity based on fundamentals

We currently see a combination of inexpensive valuations and divergences in the outlook for local listed property companies, a function of a sector which has become less homogenous as foreign asset and debt exposure, leverage levels and specialist REITs have created a more nuanced industry. The distinctions are becoming clearer, and the environment has become more difficult to navigate. This strengthens the case for an actively managed portfolio in which in-depth bottom-up research and stringent risk management produces long-term outperformance.

Glacier Research would like to thank Kelly Ward for her contribution to this week's Funds on Friday.

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Kelly gained experience in property risk and lending at Investec Private Bank before qualifying as a professional associate valuer with the SA Council for Property Valuers Profession. Prior to joining Metope, she focused on the listed property sector during her time at Old Mutual Property and later at Old Mutual Investment Group South Africa (OMIGSA).