FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

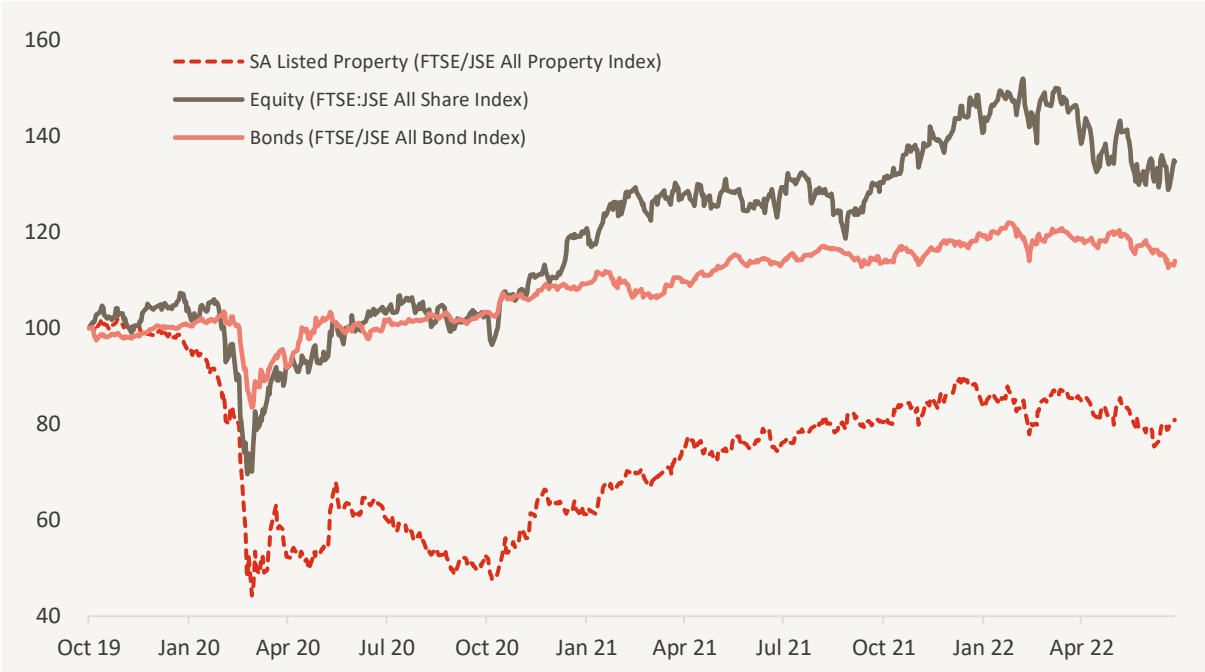
29 July 2022
Volume 1146

South African listed property in an inflationary and rising interest rate environment

Authors: Liliane Barnard, CEO & Portfolio Manager; and Aimee Glisson, Head of Operations and Performance at Metope Investment Managers

Driven by record levels of stimulus and low interest rates, global equity and bond markets recovered rapidly from the initial pandemic-induced sell-off in the first half of 2020, ending the year well ahead of pre-COVID levels. The SA real estate sector, while enjoying a strong rally in 2021 off a very low base, has not recovered to the same extent, and is still trading at levels of around 30% below 2019 levels. This dislocation raises the question of whether, in light of rising inflation and interest rates, risks are adequately priced in and whether this is an opportune time to invest in property as a long-term investment.

Chart 1: Total returns per asset class (based to 100)



Source: Company financial, SARB headline CPI forecasts

Confidence in the sector has been severely curtailed over the last few years stemming from concerns around a weak property market, gearing levels, scepticism of property valuations and the inflated risk of delinquent tenants. This pessimism has lingered and still dampens market sentiment despite results having surprised to the upside and many companies having weathered the storm remarkably well. Moreover, the recent narrative around sharply rising inflation and thus interest rates, has injected a further dose of fear into investors.

Setting the record straight

SA property companies are collecting increasing levels of rentals from healthy tenants renewing and signing new rental contracts with embedded escalations, and occupancy levels in many sectors have bottomed out, and in some sectors are improving as tenants find their footing in the “new normal”. There is evidence of the ability to dispose of non-core properties at or in some case above book values resulting in more streamlined and focused portfolios. There is activity in the leasing market and deals are being done in the Sandton sub-let market which chips away the large vacancies. In other parts of the market such as Cape Town industrial markets, we are seeing rental growth for the first time in five years, fuelled by tenant demand for space.

The sector has spent much of the last several years improving their balance sheets, reducing funding costs and other one-off revenue streams, as a percentage of net operating income, and are generally in better shape than they were pre-pandemic. Gearing levels among South African REITs have improved from a peak of around 43% in 2020, to a level of 39% currently due to disposals of assets and the introduction of pay-out ratios that enables them to retain some level of income in the face of rising costs of capital in both debt and equity markets, as well as some improvement in property valuations.

This puts the sector in a strong position to weather potential downturn in the coming months and years. Healthier balance sheets mean they can, and for the most part, have resumed regular dividend payments, albeit with pay-out ratios in place. This return to high yield dividends is what we believe makes real estate a good investment in inflationary times.

Property in an inflationary environment

Inflation is proving to be less transitory than was previously expected. Huge amounts of liquidity and stimulus measures coupled with a slow and patchy recovery of global supply chains is driving inflation to elevated levels, with higher inflation expectations now entrenching themselves in wage negotiations in tight labour markets. The issue has been exacerbated by China's COVID lockdowns and the Russia-Ukraine conflict's effect on global energy and food prices. Searching for an inflation hedge has been at the top of investors' minds.

During periods of low growth and high inflation, the traditional diversification benefits of equity and bonds tend to weaken. Investors who have previously turned to fixed income to offer protection from falling equity prices in a lower growth environment will unduly expose themselves to inflation and interest rate risk as yields on bonds rise.

Property, however, has some inherent inflation protection meriting a higher allocation in a balanced portfolio.

With property, an investor receives regular dividends which are underpinned by lease contracts. In South Africa, these leases include contractual escalations or terms linking it to inflation. Hence, property has an embedded inflation hedge. In recent years, we have seen tenants pushing back on above-inflation escalations as inflation trended lower. Higher levels of inflation will provide a floor for these negotiations going forward. Additionally, in a sector such as convenience or neighbourhood retail where a large portion of space is leased to discretionary retailers such as grocers, these leases often include turnover clauses which offer further inflation protection.

While in recent years we have seen negative reversions in some sectors, namely office and certain retail segments, due to escalations that have outpaced market rental growth, a well-managed lease expiry profile serves to mitigate the impact on rental growth in a given year. So, while contractual escalations may be rising between 6% and 7%, rental growth in a given year could be lower or higher depending on the economic conditions and supply-demand balance at the time of lease renewal. This highlights the need to further assess companies on a property-by-property and sector-by-sector level in order to identify risks to the growth outlook.

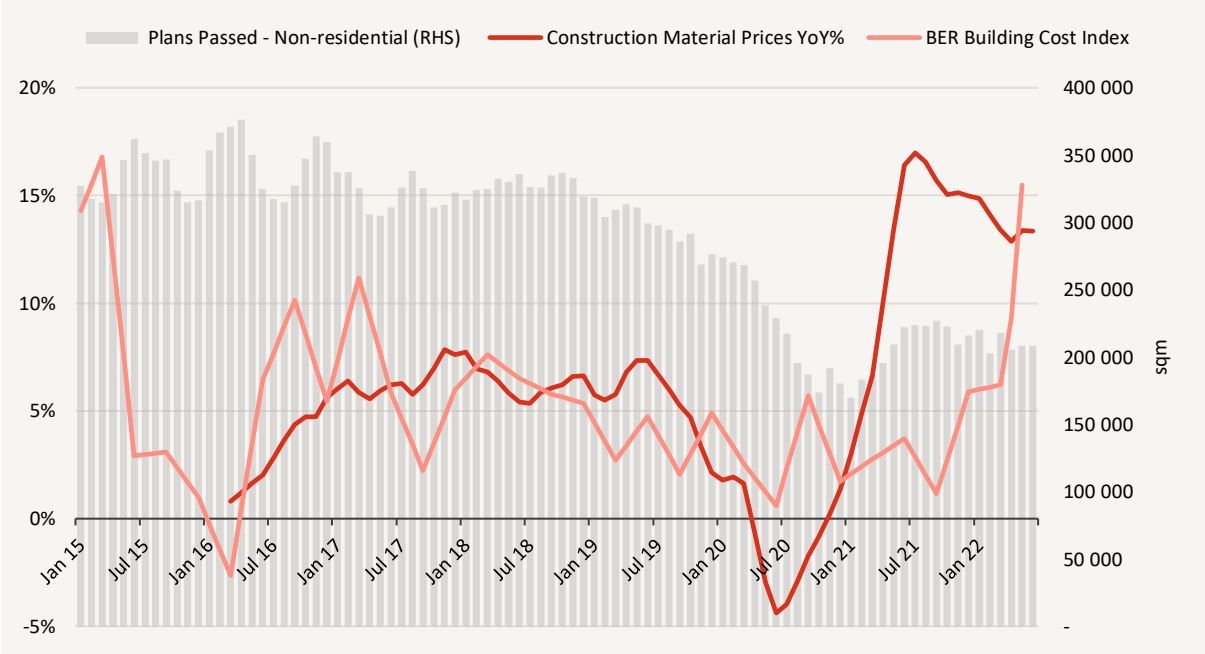
Chart 2: Contractual escalations of SA REITs provide inflation hedging

Source: Company financial, SARB headline CPI forecasts

Often overlooked is the effect of rising building costs on property valuations. Building costs have risen substantially over the last 18 months due to rising costs of materials such as steel and concrete, as well as labour, thus increasing the replacement costs of existing properties and providing support to capital values.

Therefore, not only is the income hedged against inflation, but over the long-term capital values should rise too.

Chart 3: Building costs rising ahead of inflation, new development slowing



Source: Bureau for Economic Research, StatsSA

In the current environment of higher building costs and higher funding costs for new projects, property development activity is expected to slow further, leading to less supply coming onto the market in the foreseeable future which further creates a supportive environment for property values as well as occupancy levels.

Property in a rising interest rate environment

In response to inflation, central banks around the world have been embarking on rate hikes. While rates in many countries are still below their pre-COVID levels and well below long-term averages, investors are right to be concerned about the impact that rising rates have on all asset classes. Although interest rate changes affect the pricing of many financial assets, including property, REITs can and do mitigate the risks to their distributable income of rising funding costs using interest rate hedges. On average, the sector has hedged around 80% of interest rate exposure for a period of three years, with a number of companies hedging 100% of current and committed funding. With average gearing levels of around 35%, this means that a 100bps rise in interest rates, translates to a decrease in earnings of 1.2% - 1.5%.

Additionally, inflation can improve balance sheet strength by eroding the value of fixed debt amounts against rising property valuations.

Is this an opportune moment to invest?

The outlook for the South African economy is far from rosy, with many challenges laying ahead. There is a significant risk premium priced into most local assets, but we believe the discounts priced into the listed property sector are overdone. The sector is currently trading on a discount to NAV of around 30%, thereby offering a significant margin of safety on capital values. Dividend yields of over 10% for the sector are at the highest levels seen in 15 years, offering an attractive entry point for long-term investment with the opportunity of compounding income.

Glacier Research would like to thank Liliane Barnard & Aimee Glisson for their contribution to this week's *Funds on Friday*

Liliane Barnard
CEO & Portfolio Manager,
Metope Investment Managers

Liliane is the CEO and portfolio manager of Metope Investment Managers. Liliane has over 30 years' experience in listed property and investment management. Liliane previously headed up asset management at Old Mutual Properties (Pty) Ltd and was also head of listed property at Old Mutual Asset Managers (now OMIGSA) for 15 years. Liliane previously served as independent non-executive director of a number of JSE listed property companies.

Aimee Glisson
Head of Operations and Performance,
Metope Investment Managers

Aimee is Metope's head of operations, and is responsible for client reporting, portfolio performance and risk analysis, and provides research assistance to the investment team.
Aimee worked as an equity research analyst before joining Metope in 2013 where she covered industrial stocks. She earned her CFA designation in 2015 and has completed the CT1 course in financial maths from the Actuarial Society in the UK.