FUNDS ON FRIDAY
by Glacier Research

glacier
by Sanlam

02 August 2019
Volume 1016

Listed property: stress-tested and bearing up in a very tough market

Written by: Liliane Barnard, CEO and Portfolio Manager at Metope Investment Managers

After a strong start to 2019 when listed property soared 9.2% in January, hopes for a good recovery for the sector have since been dampened. Recent company results have been disappointing, with growth in dividends slowing almost across the board, and indeed going backwards in many cases. However, on closer examination of the results to May 2019, it appears that the underlying physical property is bearing up in what is a very tough market. Negative company earnings and disappointing growth numbers are largely due to once-off and non-recurring issues, or capital items which are not reflective of the underlying property performance.

Where companies have reported sharp declines in distributable income, this has been largely due to company-specific issues. In the case of Rebosis, which has been the worst performer in the sector, year to date (-76.6% total return to June), a poor investment decision, which resulted in the company buying a stake in a retail-focused UK property fund New Frontier shortly before the UK's Brexit referendum, has been the source of much of its woes. The devaluation in the UK shopping centre portfolio has resulted in write-downs of the company's investment and, due to poor capital structuring, a severe increase in the company's loan-to-value ratio. In addition, New Frontier's decision to halt dividend payments for the foreseeable future has put pressure on Rebosis' cash flows, impacting its dividend payout.

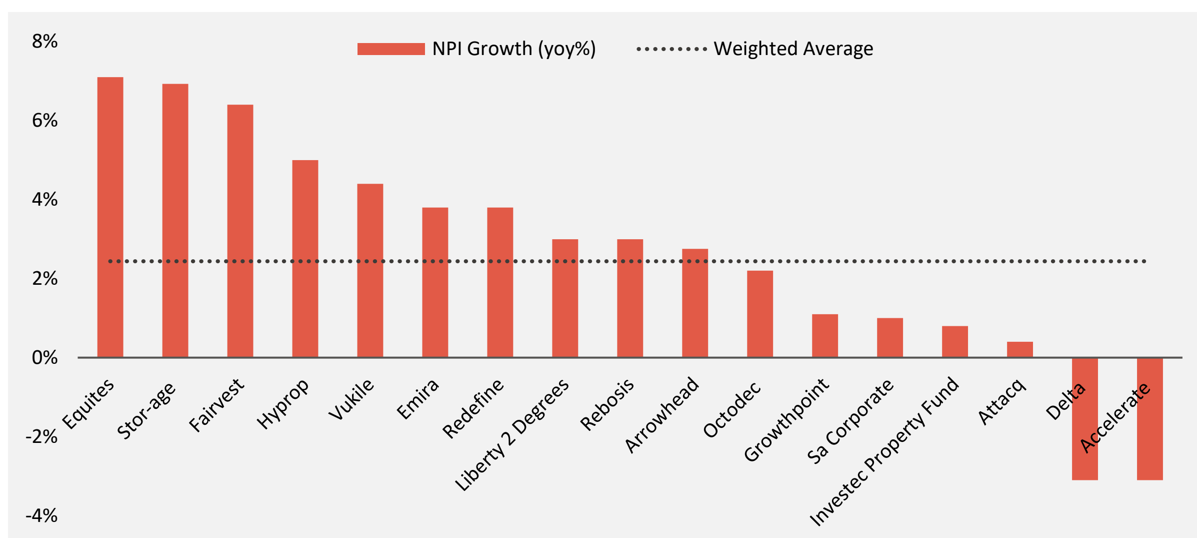
Glacier Financial Solutions (Pty) Ltd, I A member of the Sanlam Group | Private Bag X5 I Tyger Valley 7536 I Email: client.services@glacier.co.za | Tel +27 21 917 9002 I Fax +27 21 947 9210 I Web www.glacier.co.za | Reg No 1999/025360/07 I Licensed Financial Services Provider

This document is intended for use by intermediaries. The information contained in this document has been recorded and arrived at by Glacier Financial Solutions (Pty) Ltd in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to its accuracy, completeness or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be construed as the rendering of investment advice to clients.

Property companies are clearing up their distributions and excluding non-recurring and non-property items such as profits on sales of assets, gains on cross-currency and interest rate derivatives, as well as other non-core items, such as transaction fee income. As a result, we have seen a number of companies rebase their earnings over the past few reporting periods, essentially eliminating these items. While this has resulted in a number of funds reducing their distribution growth in the short to medium term, it will allow them to grow distributions at a sustainable rate more in line with underlying net property income growth in the future.

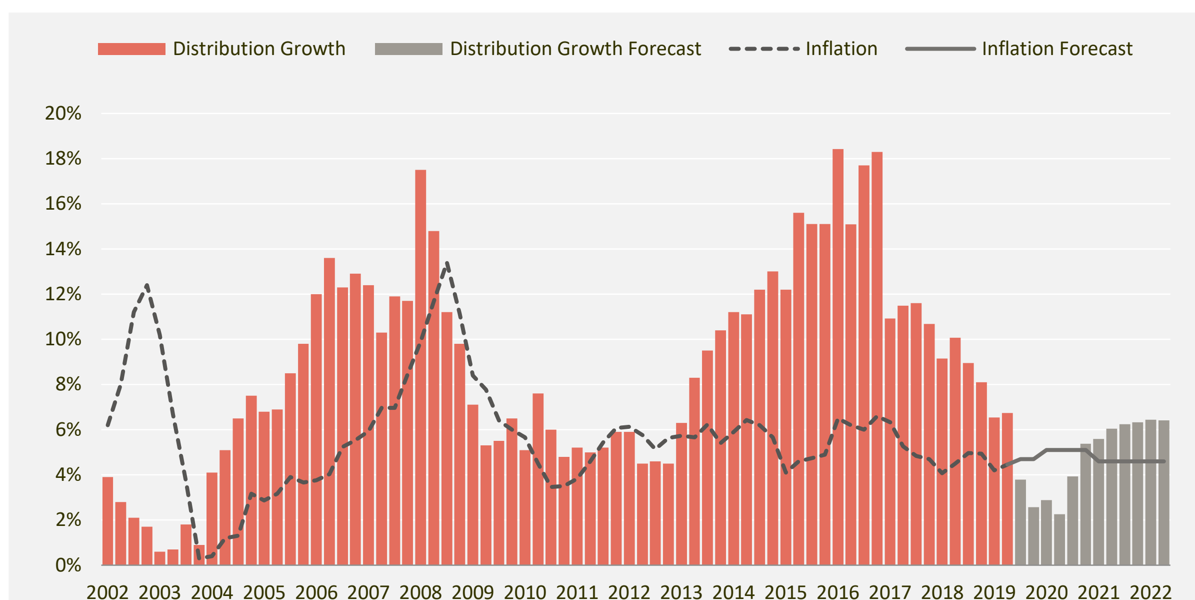
South African REITs are seeing modest growth in net property income of around 2.5% (calculated as the weighted average of the funds that report NPI growth, weighted by portfolio size) which, although below inflation, is commendable in the current economic environment. Where long-dated leases have escalated to above market levels, they may revert downwards on renewal, or with a new tenancy. While new leases are being signed at lower rentals, escalations of around 6-8% per annum on remaining leases ensure that the effect of negative reversions in any one year on the fund's income growth is moderated, as not all leases expire at the same time.

Chart 1: Year-on-Year Net Property Income (NPI) Growth at last reporting period (up to March 2019)



Source: Company Financials

Chart 2: Rolling 12 month distribution growth vs Inflation



Source: IRESS, Metope Investment Managers

Gearing levels in the overall sector remain well-managed, with average gearing of SA REITs at 37%. While there are a few companies whose gearing levels have reached higher levels, such as Rebosis (*57% as at Feb 2019*) and Delta (*45% as at Feb 2019*), the remainder of the sector is well-managed in terms of debt and interest rate management. Additionally, approximately 83% of the sector's debt is hedged against interest rate increases for an average of three years. Property asset valuations would still be able to decline by a further 42% before gearing reaches the 65% mark - at which level a company would lose its REIT status, which shows that there is robustness in the sector.

South African companies with offshore investments have been able to use cross-currency interest rate swaps (CCIRS) to partially hedge their asset exposure to currency fluctuations, as well as to reduce their average debt costs to 7.5% p.a. (compared to around 9% offered by South African banks). Offshore debt costs are typically lower than those achievable in South Africa and this provides the temptation for companies to increase offshore debt, lower SA debt, and still maintain overall gearing levels. However, this strategy increases the gearing risk and many companies now have offshore gearing greater than 60% of their offshore asset values. Companies investing in markets where there are downside risks to valuations (such as Brexit in the UK) are most at risk when adopting this strategy.

In terms of companies' ability to cover debt costs, we have evaluated the sector on interest cover ratios, both on an earnings basis (using net property income before interest and tax) and a cash flow basis (using cash flow from property operations) and find it to be in a healthy position. On a cash flow basis, operating cash flows amongst the average of South African REITs are sufficient to cover interest payments by over five times, and cash flows could fall by over 50% (either through lower rentals or increased costs) before the interest cover ratio falls below 1.6 times - a level which banks would view as worrying.

Naturally, while it is useful to assess the sector as a whole to get an average perspective, we prefer to invest in companies that have a higher margin of safety in their gearing levels and interest cover ratios. For example, Equites has maintained conservative gearing at 27% and can withstand a 57% decrease in valuations before reaching 65% LTV. Its interest cover ratio is 8x on an earnings basis and over 12x based on cash flows, giving it a large buffer.

In addition to the above factors, we believe the yields in the sector are still attractive as there are number of funds on track to deliver inflation-beating distribution growth. Many of these funds are exposed to the Central Eastern Europe region, which is currently experiencing high wage and consumer spending growth. NEPI Rockcastle, for example, is expected to deliver 6% growth in distributions for the 2019 financial year, while MAS have stated an intention to grow their dividend by 30% over the next three years. Specialist logistics fund Equites, which has investments both in South Africa and the UK, is forecasting 8-10% pa growth in dividends.

With reference to criticisms levelled against the industry, one has been that properties are overvalued. We have seen the likes of Fortress REIT, Growthpoint and Emira, amongst others, selling off their office assets as they move to reposition their portfolios. Whether through a portfolio deal or single asset transactions, by and large these have been done at book value, thus giving confidence to the valuations.

Another criticism has been that companies do not have enough cash to pay dividends. In general, we have found this not to be the case. However, there are notable company-specific issues, such as in the case of Rebosis. Other critics have focused on companies' potential inability to roll over debt. Following Moody's recent downgrade of NEPI Rockcastle and Hyprop due to concerns over the companies not being able to roll over their debt, NEPI Rockcastle placed a €500m unsecured corporate bond, maturing in 2023 at 2.625%, and Hyprop successfully refinanced over R4 billion of external debt. The sector has historically been able to refinance debt with little difficulty and, all things being equal, we are confident of its ability to do so going forward.

Conclusion

The listed property sector has been through an exceptionally challenging period since the start of 2018. The sector has derated significantly over the past 18 months (from a forward yield of 6.2% in January 2018 to 9.2% currently) and we believe there are a number of opportunities which look attractive.

While economic growth locally is expected to remain weak in the short to medium term, a number of local listed companies (for example Equites, Spear, Stor-Age and Vukile) and inward listed offshore companies (for example EPP, NEPI Rockcastle and MAS) are trading at attractive yields, offering a good buying opportunity for long-term investors looking for a high yield and a growing income stream - albeit moderate compared to the recent past.

In the current challenging market, stock selection is key in order to reduce exposure to company-specific risks and to manage systemic risks. We prefer to invest in conservatively managed companies that will be able to weather the weak economic environment and potential further shocks in the form of a potential rating downgrade and Eskom and Edcon failures, and provide sustainable growth in distribution over the medium to long term. Additionally, we further diversify with exposure to offshore property markets that are currently experiencing a different cycle and different market drivers to local funds.

The Metope Property Prescient Fund has been able to deliver 6% income yield (which has grown by 9.5%) and 0.9% in capital growth in the 12 months to 30 June 2019, resulting in a total return of 6.9%, while the SA Listed Property index has seen a total return of 0.8% for the period.

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

Liliane Barnard, CEO and Portfolio Manager at Metope Investment Managers

Liliane is the CEO and portfolio manager at Metope Investment Managers. She has more than 30 years' experience in listed property and investment management and was previously the head of Listed Property Asset Management at Old Mutual, and also headed up asset management at Old Mutual Properties (Pty) Ltd. Liliane previously served as an independent non-executive director of JSE-listed property companies Emira, Redefine and ex-Pangbourne Properties Ltd.