FUNDS ON FRIDAY

by Glacier Research

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18 January 2019

Volume 989

Why listed property remains attractive in volatile markets

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2018 was an inordinately difficult year for listed property, with a record sell-off at the start of the year triggered by various allegations made by short sellers levelled against the Resilient group of companies (Resilient REIT, Fortress REIT, Greenbay Properties and NEPI Rockcastle). The allegations are currently still being probed by the Financial Sector Conduct Authority (FSCA) and the year ended with NEPI Rockcastle contemplating legal action against US research house Viceroy after it released a report at the end of November in which it accused the property group of inflating profits. NEPI Rockcastle management strongly refuted these allegations and called on the Financial Sector Conduct Authority (FSCA) as well as European market authorities to conduct an investigation into Viceroy.

The challenging start to the year for the sector was further exacerbated by a volatile currency at home, weak consumer spending, an economy that went into a technical recession and policy uncertainty created by the expropriation of land without compensation debate. Added to this, the flight of capital out of emerging markets, the uncertainty created by Brexit, the threat of escalating trade tensions between the US and partners, and the rising interest rate environment in the US and SA were further depressing factors.

The listed property sector is taking some time to regain investors' confidence, with analysts pointing out that a revival in business and consumer confidence is needed in SA, as well as positive GDP growth for property fundamentals to recover in 2019 and beyond. In addition, a ruling by the FSCA on its investigation into the Resilient group will help ease investors' concerns. However, industry players have noted that the correction in the sector has been overdone and a number of stocks are very attractively priced, with yields currently the highest in 10 years, making it a good time to buy selected property counters for the long term.

Why listed property in uncertain times?

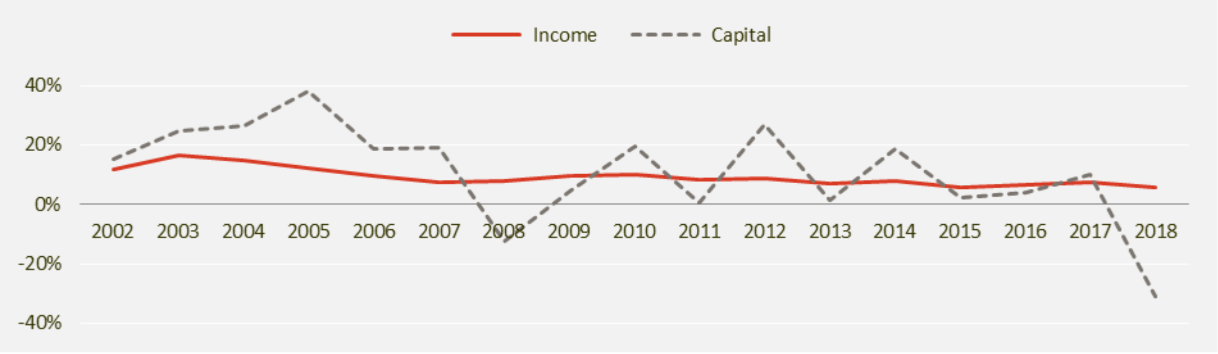
In the current environment of market volatility and uncertainty, what is the case for investors to increase exposure to SA listed property stocks as part of their wealth building and retirement savings strategies? The short answer is that, even in this challenging environment, SA listed property companies - some of which are now trading at record high yields - will continue to generate sustainable cash income for investors. In addition, investors have the ability to hedge themselves against the current negative market sentiment in SA by investing in offshore property stocks.

Key reasons

Below are some of the key reasons to invest in listed property when markets are volatile:

- Listed property returns are supported by stable, cash-based income returns as REITs pay out the majority of their net profit as dividends. Investors in listed property stocks can ride out market volatility provided they adopt a long-term buy-and-hold strategy as they will continue to receive the income that they bought into even if share prices are volatile in the short term (see chart 1 below). The income yield has historically made up about 40% - 50% of listed property investors' total returns, with the balance coming from capital growth.

Chart 1: Annual income and capital returns of listed property (FTSE/JSE SA Listed Property Index)

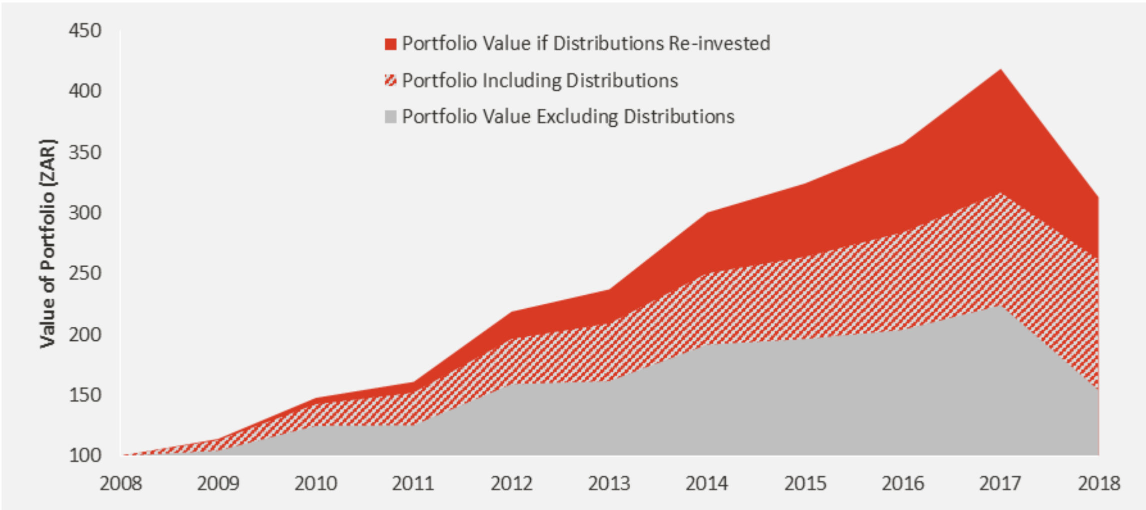


Source: IRESS, Metope Investment Managers

- The sector's income growth is supported by contractual rental escalations. Landlords sign leases of between three and 10 years with tenants that will include provisions on rental escalations, usually increasing in line with inflation. This supports the growth in income that REITs pay out to investors. In periods of weak economic growth, such as SA faces at the moment, income growth may be lower or even negative in extreme cases, but investors can generally always expect an income return. In comparison, traditional equity companies may cease dividend payments completely in times of negative economic growth.

- The effect of compounding and growing SA listed property income over the long term is powerful. By reinvesting distributions, investors can enhance returns through compounding. The higher the yield at which the investor can reinvest, the more the investor benefits from compounding. As shown in chart 2 below, investors who invested R100 ten years ago would have grown their portfolio to R154 today (or 4.4% p.a.) excluding distributions, or R261 (10.1% p.a.) including distributions. Investors who reinvested those distributions would have a portfolio of R313 today (a return of 12.1% p.a.). By reinvesting distributions, their portfolio would be 20% higher than if they had withdrawn the income.

Chart 2: The effect of compounding distributions



Source: IRESS, Metope Investment Managers

- In addition to the local property market, investors have access to a wide range of offshore assets by investing in the JSE Real Estate sector, both directly through dual- and inward-listed offshore funds, and indirectly through SA property funds that have some offshore assets. By diversifying geographically, investors can partially hedge their exposure to local market fundamentals and rand weakness.

What are the concerns?

Rental income

One of the concerns for investors seeking to increase exposure to listed property in the current market is whether rental income can take a knock. Rental income is contractual, and therefore generally secure in the hands of the landlord during the tenure of the lease. South African leases are typically structured with an annual escalation in the region of 6% - 8%. In recent years, as inflation has declined to between 4% - 5% and property fundamentals deteriorated due to the low GDP environment and oversupply in some sectors, rental escalation has at times outpaced that of inflation and market rentals.

Therefore, at the expiry of a lease, it can be the case that the expiry rental is significantly higher than that of market rentals, and the landlord will have to revert to lower rentals in order to renew the lease or attract a new tenant. In this case, we could see the property income drop (currently between 3% and 4%), but the new lease would then escalate from the new market-related base.

Tenant failures

In times of economic weakness, landlords are subject to the risk of tenant liquidation. As investors, it is important to assess these risks and ensure that landlords are well diversified and not over-exposed to a single tenant or sector of the market. For example, currently there is a risk of Edcon going into liquidation and closing stores which will have a negative impact on earnings in the near term. However, over time the space will be leased out to new tenants and could even serve to create a better offering in certain malls.

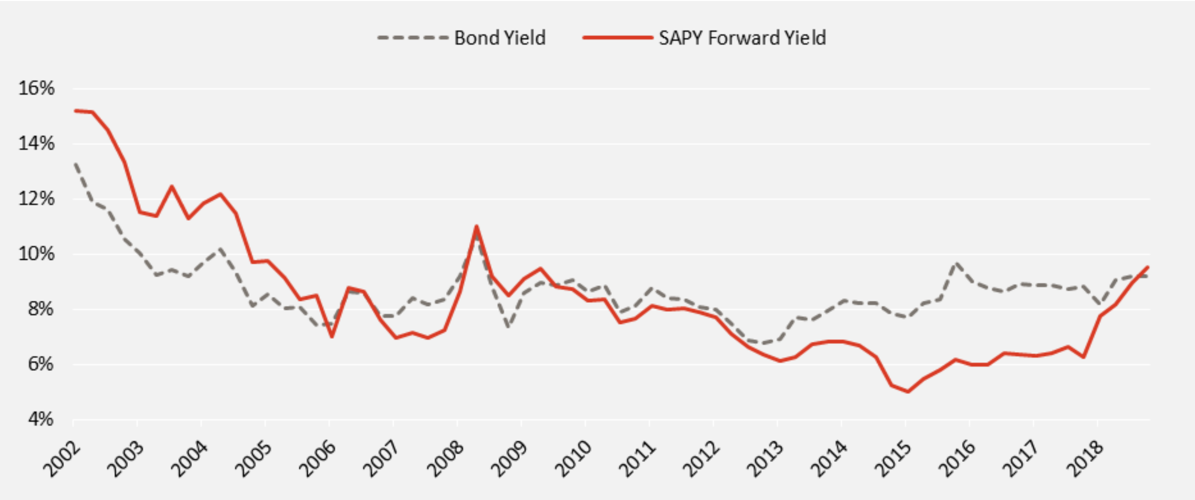
Companies re-basing their earnings

For several years now the quality of earnings from some listed property companies has started to decline. In order to maintain their distribution growth trajectory, these companies have boosted income from once-off sources such as trading and capital profits, underwriting or development fees and foreign exchange gains. Responding to concerns raised by investors and analysts, several funds took the opportunity in 2017/2018 to 'rebase' their dividends, thereby setting themselves up for future sustainable, higher quality earnings at the expense of lower, short-term dividend growth.

Conclusion: Listed property offers an attractive entry point at current valuations

While demand for SA listed property stocks is currently weak, the sector will continue to generate hard cash income for investors. In addition, investors are able to hedge themselves against negative sentiment in the country by investing in SA-focused property stocks with partial offshore exposure, or pure offshore property stocks. For the first time since 2009, the SAPY forward yield is higher than long-term bond yields, representing a very attractive entry point for listed property. (see chart 3 below)

Chart 3: SAPY forward yield in line with bonds for the first time since 2009



Source: IRESS, Metope Investment Managers

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

Liliane Barnard – CEO and Portfolio Manager

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