Metope Outlook 2022

South African listed property showed a notable recovery in 2021, with the SAPY and ALPI rebounding 36.9% and 38.6% respectively, off the -34.5% decline in 2020. The SAPY property index remains 23% below 2019 levels (on a price basis) before the onset of Covid-19 and the subsequent lockdowns and economic fallout (but still some 50% below the market peak end of 2017).

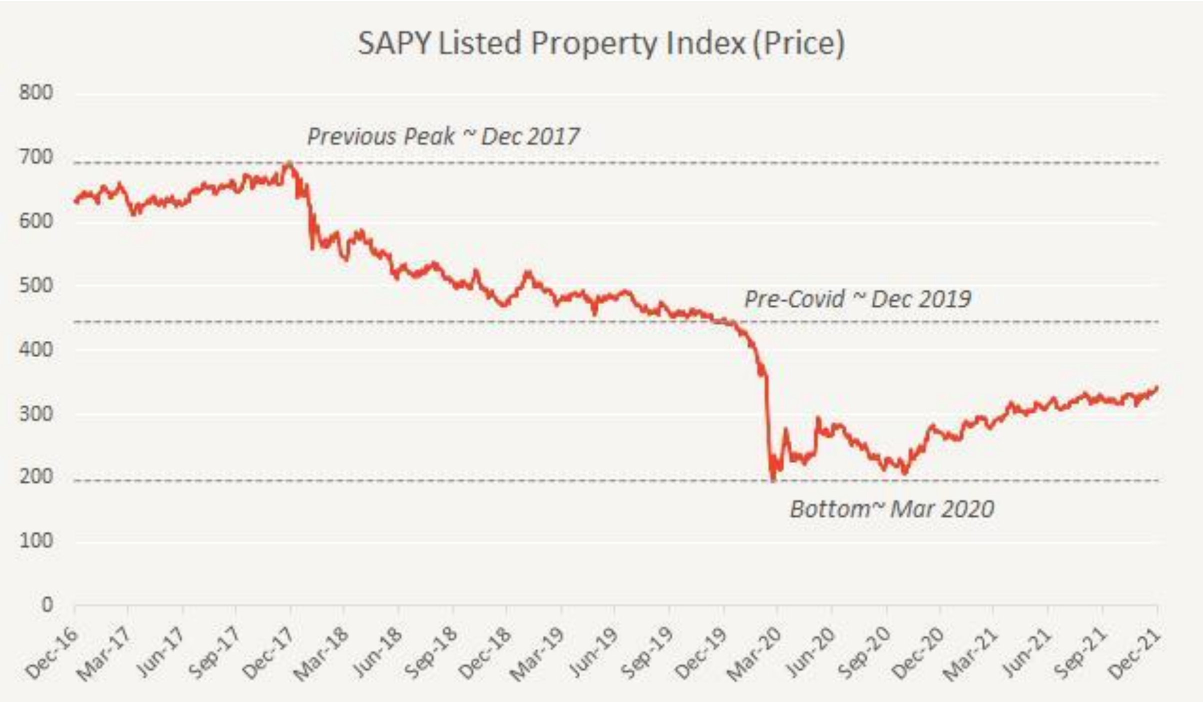

Figure 1: SAPY Index Price Chart *Source: Metope Investment Managers*

Uncertainties plaguing the market in 2020 and 2021 remain to a lesser degree and as the world adapts to a post-Covid normal, new risks including geo-political risks have emerged. 2022 will likely feature a few new expectations of sustained higher inflation globally and higher interest rates to combat this. In particular, recent comments from the Fed which point to sooner and faster action with regard to tapering mean we can expect the same for South Africa, with the possibility of a weaker currency to compensate. Listed property in SA is expected to weather this period of higher interest rates relatively unscathed given that 83% of its debt is already hedged.

Inflation is back

Historically, higher inflation has been positive for real estate and listed property, provided annual lease escalations kept pace with inflation and asset prices found an underpin in higher replacement costs. In this inflation cycle, depending on its transitory or sustained nature and at what level the rate peaks, it may be difficult for landlords (at least initially in this cycle) to prevent the erosion of real income given the high vacancies across the SA property market and current weak demand for space. Demand-driven inflation is not a feature of the market at present, and instead the country is dealing with inflation driven largely by administered prices (such as electricity and municipal property rates). These price increases become increasingly difficult for property owners to pass on to tenants, as they themselves are struggling with a slowdown in business operations or declining turnovers.

Whilst property owners can expect central banks to increase interest rates as a tool to fight inflation, inflation can also erode the value of debt, providing the asset owner with a hedge mechanism against the ravages of inflation.

Property trends

The work-from-home or hybrid working model trends that have been a feature of the pandemic have caused elevated vacancies in office space, which landlords will look to address through lower rentals, conversion to another use or lower-density accommodation. We believe only a few businesses will choose to go fully remote and therefore there will still be a need for office space, albeit on a smaller scale. This could for example result in companies looking to add smaller satellite offices closer to people’s homes, rather than the corporate headquarters of the past. Landlords will have to remain flexible and accommodate the needs of tenants in order to retain their occupancies as well as add on additional services to enhance the user’s stay.

Change of use from office to residential will happen where the conversion model makes financial sense and hopefully provides more affordable housing for people to access economic hubs in South Africa. We expect more opportunities for investment into the residential space through SA Reits, as the housing sector has shown its resilience throughout the pandemic. Indluplace and Transcend remain the only focused residential Reits, while several diversified Reits (including SA Corporate and Octodec) offer exposure to the sector.

Currently escalations above inflation remain written into property leases in South Africa but new leases are reverting significantly lower from the expiry levels, meaning the growth in income in the office sector is expected to be flat at best. Office remains our least-preferred sector going into 2022 and we would look to invest with caution in this space, expecting it to underperform both retail and industrial.

Logistics remains the darling of the market, and specialised fund Equites is one of the few South African-based shares that has exceeded its pre-Covid 19 share price. We expect to see continued interest in this sector and believe it offers appropriate risk-adjusted returns given the long weighted average lease expiry, low debt and blue-chip tenancies.

With little to no further formal "lockdowns" impacting the South African economy in 2022, we expect retail to rebound as we move through the pandemic. Tourism-related assets such as Growthpoint's V&A Waterfront for example, as well as traditional malls, should see an increase in distributable income with all tenants trading and curfews lifted. However, the effects of the pandemic remain and can be seen in the loss of tenants due to either business failure or business rescue. We continue to favour malls where non-discretionary spend forms the basis of the income, as inflation worries may serve to dampen South African consumers' disposable income.

Despite this, and while rental income remains under pressure, we expect improved distributions from listed property in 2022 as Covid relief wears off, deferments granted in previous periods come due and payout ratios inevitably increase to longer term sustainable levels.

Deleveraging continues to be a theme of listed property going into 2022 as Reits strengthen their balance sheets through a combination of asset sales, retained income (payout ratios) and equity raises. While balance sheets are in a much better state than at the height of the pandemic with the loan-to-value across the SA Reit sector averaging 36.5%, 35% or lower appears to be the magic number that investors are comfortable with.

As these themes play out in the local market, there are the global market concerns to contend with. A debt implosion among Chinese property developers, with Evergrande leading the charge, is likely to impact Chinese economic growth and may knock confidence in corporate bond and investment markets globally. This could in turn impact South African economy with lower exports of steel, cement, and other supplies to the Chinese building industry. Russia amassing troops along the Ukrainian border could have implications for real estate players invested in Central Eastern Europe, and even further afield in Germany and beyond.

In the meantime, the upgrade in Fitch's rating for the South African sovereign is welcome news and may ease the pressure on bond yields somewhat. In the absence of an Evergrande collapse or a Russia/NATO war and South Africa performing better than anticipated, South African bond yields may remain unchanged or, dare we say it, could even trade lower in spite of higher US Bond yields, which will be positive for South African listed property.

Looking ahead

While much of the "easy" money was made in 2021, rebounding off the low base set by Covid-19 in 2020, there are still opportunities to be had in listed property. Whilst real household disposable income is expected to grow further, albeit at a very low rate of 0.2% in 2022, it should provide support for retail spending and consequently assist shopping malls to further recover.

We believe it is crucial to remain invested in the sector in order to take advantage of any sharp gains to be had, and to position oneself for an improved dividend flow that is set to come from an upturn in the sector, along with a recovery of capital values, many of which are still below pre-pandemic levels. Investors can enter the sector at an attractive dividend yield of 7.2% and may look forward to a degree of capital growth (in the region of 5-10%) to sweeten the total return.

It is important to note the earnings yield of ~8.3%, which differs by the payout ratios of the individual funds, and that a portion of earnings retained will serve to strengthen the heavily discounted net asset values.

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