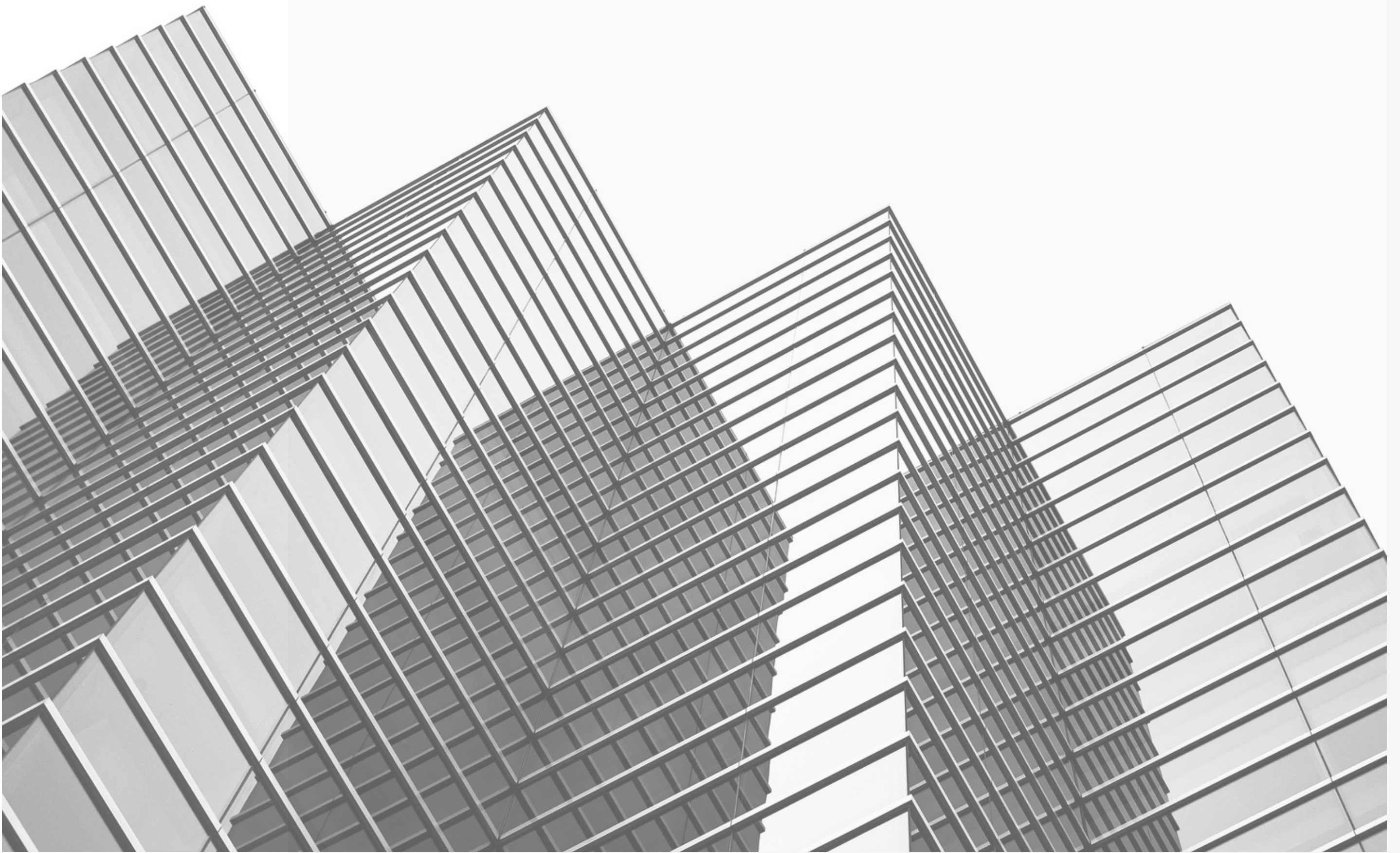
METOPE INVESTMENT MANAGERS

LISTED PROPERTY OUTLOOK: 2024



BY LILIANE BARNARD

RECAP OF 2023

2023 can be viewed as two distinct periods. The first ten months of the year were marked by the continued steep rate hiking cycle around the world, including SA. Economic indicators, including employment and retail sales remained surprisingly strong in the face of rising rates, leading the world's central banks to adopt a hawkish stance, warning of continued policy tightening. Markets discounted these higher rates leading to weak performance in both equity and bond markets. Up until the last week in October, the local listed property sector had lost 10% on a total return basis.

Since late October markets turned positive after a pivot in the tone of the Fed on the back of decelerating inflation and slowing (but still positive) job growth. As a result, rates have been kept on hold since July 2023 in the US and since May in South Africa, where inflation has been within the SARB's target band of 3-6% since June 2023. Global bond yields fell sharply on the prospect of rates having reached their peak with markets beginning to price in rate cuts in 2024. The listed property sector (the ALPI index) rallied by 23% in the last 2 months of the year to end the year with a total return of 10.7%. This was made up of an income return of 8% and capital gains of just 2.7% for the year. Listed property was the top performing asset class of 2023, eking out a marginal gain over equities (+9.3%), bonds (+9.7%) and cash (8.1%).

Among the top performers in the sector were UK and European retail landlords Shaftesbury Capital Plc, Hammerson and Nepi-Rockcastle. Shaftesbury and Hammerson saw positive results from their respective restructuring exercises, including cost reduction and, in Hammerson's case, reduced gearing due to the successful implementation of their disposal strategy, and saw some capital appreciation off a very depressed share price at the start of 2023. Nepi-Rockcastle's high-quality portfolio of dominant assets performed exceptionally well in 2023. Strong property fundamental and an excellent operational performance drove the company's strong performance in 2023 despite higher finance costs.

SA REIT's had a more challenging year with the lacklustre rental growth and rising finance costs weighing on distribution growth. The SA REIT Index, which includes only SA domiciled REIT's, returned just 2% for the year.

MACRO OUTLOOK

In the coming year, we anticipate a continued, yet gradual improvement in the South African property market based on a combination of key economic indicators and industry-specific factors.

The key issues expected to drive markets (both globally and in SA) include any changes in the growth, inflation and interest rate expectations, a potential escalation of global conflicts which are affecting global supply chains and elevating inflation and other risks, and the pace of recovery in the Chinese economy. Domestically, improvements in structural issues hampering economic activity and a positive outcome of the election would improve economic activity and confidence.

Global growth is expected to slow from levels achieved in 2023 as a result of the sharp increases in interest rates in the last 18 months. The World Bank projects that global economic growth will slow to 2.4% this year from an estimated 2.6% in 2023. South Africa's growth remains further constrained by local issues such as persistent load shedding, port congestion and poor service delivery, and is estimated at 1% for 2024.

On the positive side, we expect a continued easing of inflationary pressures after reaching a peak in mid-2023. This is expected to be accompanied by a reduction in both global and South African interest rates, although levels are projected to remain somewhat elevated compared to recent years. In terms of 10-year government bonds, yields have fallen c150bps from their highs in the first half of 2023, however are still trading

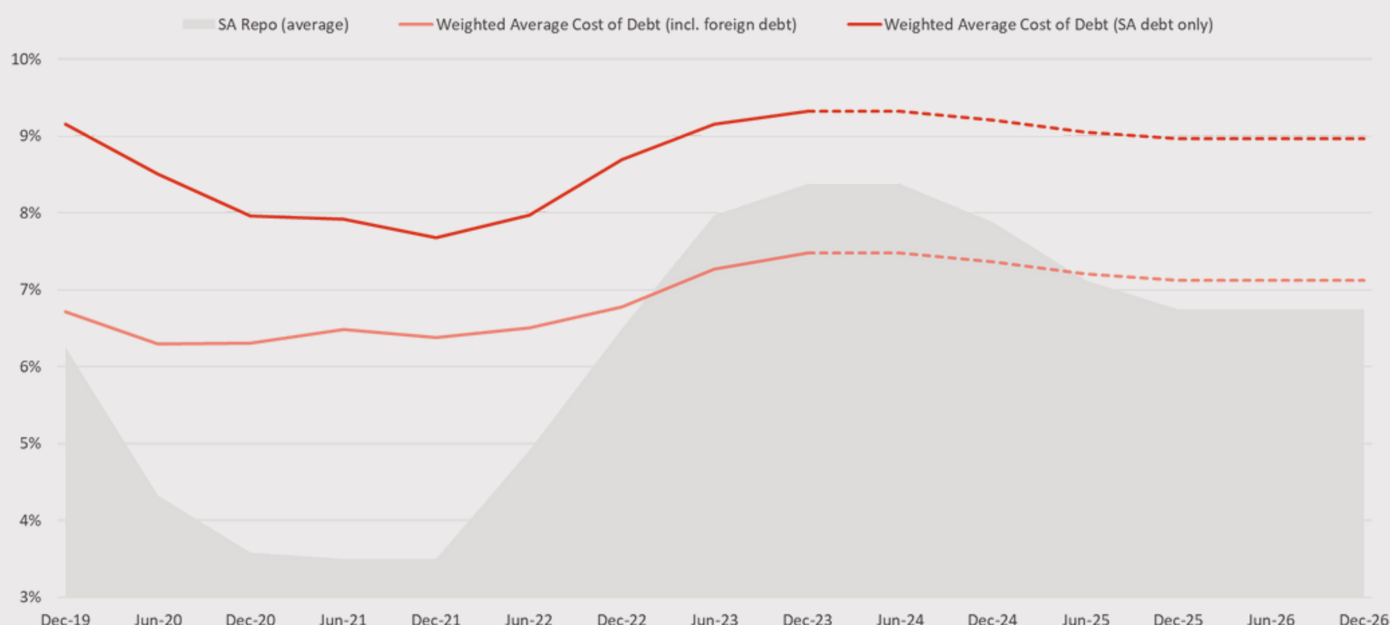
at yields of c.100bps higher than 2019 levels. This has and will continue to trigger revaluation processes in real estate globally and to a lesser extent in South Africa, as elevated interest rates have led investors to command higher risk premiums for real estate.

Additionally, elevated interest rates will influence borrowing costs and credit availability. Global property markets could face greater volumes of forced selling, with banks increasingly reluctant to refinance troubled or lower quality assets as there is uncertainty in the value of the collateral. Elevated interest rates on new debt or when hedges expire render debt unfavourable in relation to unlevered yields and increasing cap rates have caused covenants to have to be renegotiated where the lender has the appetite. This will be more prevalent globally than compared to South Africa due to the higher relative interest rates in relations to prior decades of very low rates. Given that South African REIT's have meaningful investments in offshore assets; investors need to understand the underlying asset fundamentals and credit markets to which our sector is exposed.

Structural issues impacting the economy are expected to ease, fostering a more robust foundation for the property market. SA property companies have been proactive through investment in infrastructure and security which eases larger structural issues on their business and tenants' businesses. As underlying tenants

Chart 1: Finance costs of SA Listed Real Estate sector

Interest rates are expected to have peaked and are expected to remain at current levels for the first half of 2024, followed by a reduction in the 3rd quarter. Given that the sector has hedged c78% of debt, debt funding costs will likely only fall marginally from current levels. Those companies that currently have less interest rate hedging in place, for example Vukile and Attacq, or Resilient which employs caps in addition to swaps, will stand to benefit from the anticipated lower interest rates in the medium term.



fare better, demand for properties is expected to increase, especially in the properties which are resilient (for example those that have backup power supply). South Africa still has impactful structural issues like Eskom and Transnet where it is difficult to gauge if progress has been made on alleviating issues. Any positive reforms will drive tenant business which should translate to increased demand and therefore rentals.

RISKS TO THE OUTLOOK

While the outlook is positive, potential risks are not to be overlooked, particularly in the context of the 2024 elections. South Africa is likely to enter unchartered territory in terms of political landscape with a coalition government increasingly likely given weakening ANC support. Local and global investors remain wary of the policy uncertainty this could create going forward. However, heightened social unrest and conflict and policy uncertainty are no longer solely associated with developing economies like South Africa. Social unrest and protest action related to policy decisions and political conflict amongst parties has gripped many European economies which has in turn increased risk premiums in their capital markets.

There are still many local challenges to deal with before SA can reach its full potential in terms of growth and job creation. The turnaround of Eskom and Transnet and failing infrastructure in many municipalities will take many years to address.

Global geo-political events further threaten price stability and economic growth which is negative for developing nations as these could manifest in social unrest. Furthermore, lacklustre growth in China, with its own property market woes and pressures on its financial stability are concerning for South Africa as a large trading partner.

Of the many global geopolitical events transpiring, South Africans, especially investors and business owners, should be well informed as to the changes in the evolving outcome of AGOA, the conflict between Palestine and Israel and the effect the war between Ukraine and Russia has on trade and risk appetite for investors. Staying abreast of these events and predetermining the effect various outcomes will have on a business's operation is an invaluable exercise in order to manage risk.

LISTED PROPERTY OUTLOOK

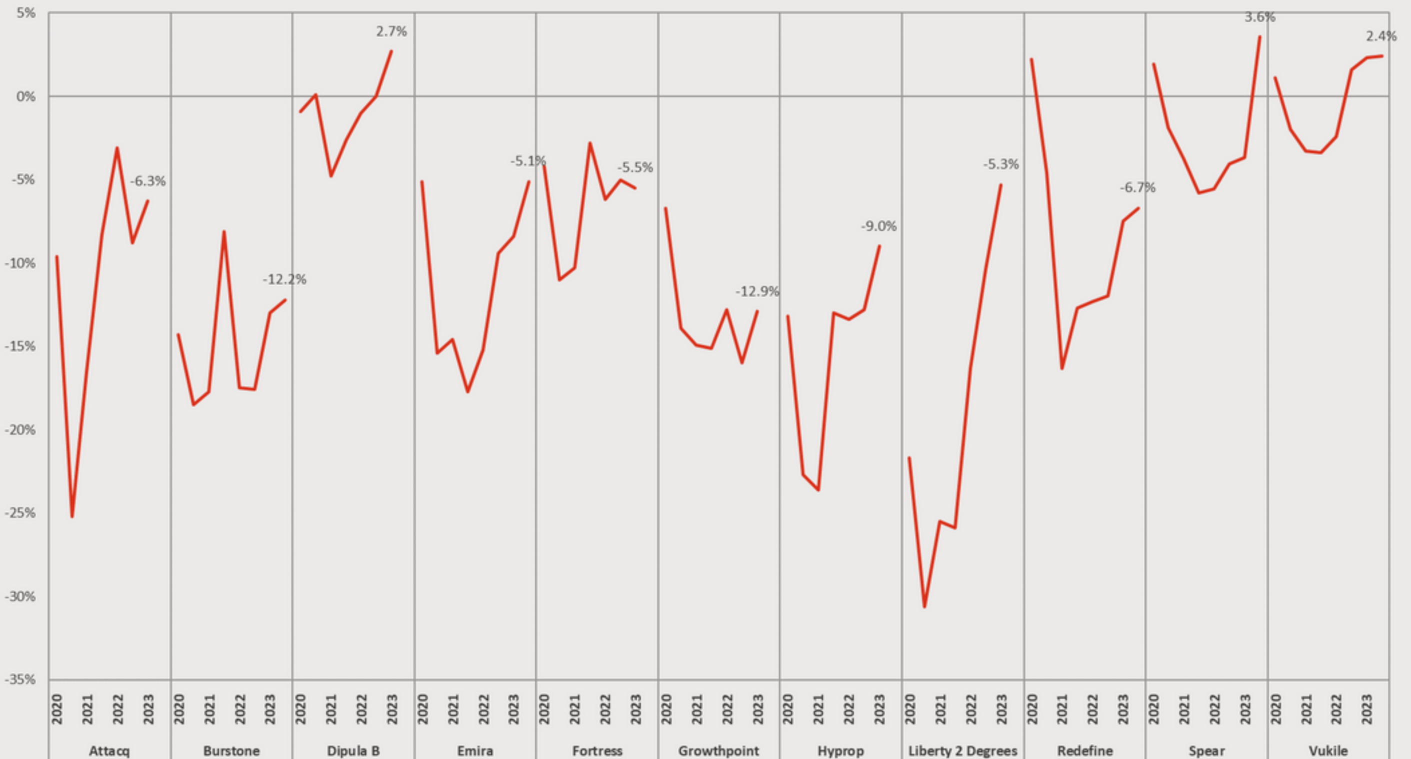
Despite the risks to the global and local outlook, there are a number of positive trends that we expect to see play out in the property market. Notable among these are the recalibration of rental levels after large reversions over the last 3 years; a consistent uptick in occupancy rates driven by a recovery in demand and a limited new supply coming on stream; fixed escalations which have bottomed out and debt costs which are likely to peak in the next reporting period and are expected to lower from current levels. In addition, with the reduced forecasting risk and gearing levels that have consolidated at levels close to pre-pandemic levels, companies will feel more confident to increase payout ratios, and certainly we have already started seeing this. These factors collectively contribute to a more favourable environment for property investors.

Diving into the various sectors, industrial (including logistics) and neighbourhood and convenience retail sectors remain the top performing sectors, while the office sector continues to struggle with weak demand and oversupply issues, though these have eased somewhat.

In the industrial sector, long term demand drivers like e-commerce, reshoring, deglobalisation, retailer efficiency coupled with inelastic supply of land continue to drive growth in rentals. The fundamentals are still strong, but pressure has come from the repricing of the cost of debt upwards which when coupled with low yielding assets which are also under pressure from a valuation perspective, means there could be pressure on prices of quality assets.

Chart 2: Rental reversion rates for SA companies

Reversions have recovered from the large negative reversions seen in 2020-2022. As rentals have reverted to the new lower market rentals, we are now seeing some growth in rentals coming from certain sectors, in particular smaller-format retail and logistics and industrial.



In retail we've seen improvement across the spectrum of asset types. Footfall and tenant turnover have continued to improve. Reversions are turning positive in smaller retail formats, while in larger format malls is still negative but improved. The elephant in the room, E-commerce, while still growing, is still in its infancy in South Africa. With Amazon expected to fully launch in SA the online retail sales market share could move up significantly in the medium- to long-term. While this is an important development to watch considering their success in other countries, we do not see this as an existential risk to brick and mortar retail.

Although SAPOA office vacancies peaked in 2022 at 16.7% and have steadily improved to 15.5%, the office sector shouldn't be entirely painted red.

There has been a large dispersion in performance which will likely continue. Quality office properties in great locations whose asset management teams have aligned the property to the type of office space tenants are demanding and improved the property from an ESG standpoint are expected to perform better. However, a lackluster economy and structural changes in the form of WFH or hybrid working make it difficult to have a high degree of certainty around expectations. For this reason, is it essential to understand the sector on a more granular level. For instance, Gauteng is facing oversupply challenges while the Western Cape is seeing strong demand, with vacancies in Johannesburg more than double those of Cape Town.

Residential overall has performed well in 2023 and the locations which have good municipalities, adequate service delivery and good security will continue to be the beneficiaries of the semi-gration trend. There are questions marks as to the lag effect of interest rates on the residentials sector going into 2024. However, currently residential has performed better than most expected considering the pressure from rising rates and inflation on your average South African.

Strategic investments in solar and water assets are anticipated to yield operational benefits by curbing the rate of operating cost increases. This move aligns with broader industry trends emphasizing sustainability, potentially enhancing property values over the long term. As the real estate sector continues to evolve and adapt to the evolving demands of an environmentally and socially conscious world, real estate investors who remain well-informed about ESG drivers and certification systems will be better positioned to navigate the complexities of the market. Sustainable properties are gaining popularity due to their environmental and financial benefits. The wide dispersion in performance between desirable and undesirable assets opens the opportunity to realign assets with ESG factors. Asset management will be key to generate outperformance. Climate change is another unravelling risk, which is difficult to manage for property as it is exposed to the physical world. The risk is difficult to spread or retain and investors are less able to transfer risk too. Hence, avoiding what would be deemed a stranded asset because of extreme weather conditions in an area or trying to mitigate would be the only two viable options. However, mitigating risk would be best explored by public entities that can improve climate risk mitigating infrastructure.

EXPECTED RETURNS & STOCK PICKS

Real estate remains a highly cash generative asset class, and we expect this to be an attractive proposition for investors in 2024 as bond yields and interest rates come down. The sector is currently trading on a forward dividend yield of 8%, which, when considering expected dividend growth over the medium term, compares favourably to the bond yield. Accounting for payout ratios, the income being generated by the sector is closer to 92%.

The sector is still trading at a large discount to net asset value of c.30%, and while we don't expect the gap to narrow completely, we do expect to see some additional capital growth as discount rates fall in line with global interest rates.

Our stock picks follow our strategy of focusing on owning and buying quality companies at reasonable prices that will generate sustainable cash flows over the long term. Sirius and MAS, our offshore selections, are currently trading at a discount to fair value. Sirius's platform, developed over many years, which incorporates holistic asset and property management, allows them to understand their market better, drive leasing activity and add value to assets, giving them a competitive advantage. Their business model is based around acquiring assets at reasonable prices, improving assets and superior holistic property management. They retain capital and recycle for growth, reducing their reliance on external capital sources and have been aggressively seeking opportunities created by the current macro environment.

MAS recently made the decision to pause dividend payouts, a decision taken because of the heightened cost of capital and their sizable funding commitments. The market had a knee jerk reaction to this, likely driven by the soft or hard requirement of many managers around companies not paying dividends. MAS has a high quality, growing portfolio and there are macro-economic tailwinds which should reward a patient investor that believes the capital retained is beneficial to the value of the company over the long term.

Locally we favour Stor-Age for its defensive and differentiated business model that exhibits counter cyclical traits. It is successfully completing its development pipeline and continues to grow its management platform, harnessing its market leading data analysis for an asset-light income stream. Another local favourite, Spear REIT, continues to benefit from its exposure to the Western Cape and the demographic tailwinds, which has driven demand for their assets. Lastly, we like Vukile whose portfolio is now weighted 44% to urban, commuter, township and rural malls across South Africa and 56% to Spanish retail assets. The company's high-quality SA assets are well managed and the offshore exposure provides a rand hedge to a quality retail portfolio which Vukile is continuously improving. Vukile is also leading the way in data analytics, using research of shopper behaviour to further enhance their portfolio.

CONCLUSION

In conclusion, the property market outlook for 2024 is marked by positive indicators, including a gradual reduction in inflation, lower interest rates, and a robust performance across various property segments. Stakeholders are encouraged to capitalize on these opportunities while remaining vigilant to potential risks, especially those associated with the ESG or structural issues. A dynamic and informed approach will be crucial in navigating the evolving landscape of the South African property market in the coming year. The current market could be an opportune time for investors with dry powder to take advantage of the dislocation by acquiring high-quality REITs at valuations not seen in recent times.

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