METOPE INVESTMENT MANAGERS

SA LISTED PROPERTY: BALANCING RESILIENCE AND OPPORTUNITY

IS THERE MORE TO COME?

CAUTIOUS OPTIMISM: IS LISTED PROPERTY POISED FOR FURTHER GAINS?

Listed Property had another strong year in 2024, with the All Property Index (ALPI) delivering 29.8% in total return, outperforming local equities, bonds and cash for a second consecutive year. This was as a result of a return of investor confidence to the sector after a number of tumultuous years, when the once-darling sector underperformed other asset classes over the preceding 5 years. Sentiment was buoyed by the initiation of the rate-cutting cycle, positioning the sector favourably for future growth as well as a stable political outcome in the recent SA elections which kept the positive momentum intact throughout the year. The very wide discount to net asset value ("NAV") and the high income yields at the start of the year saw some institutional flows return to the sector.

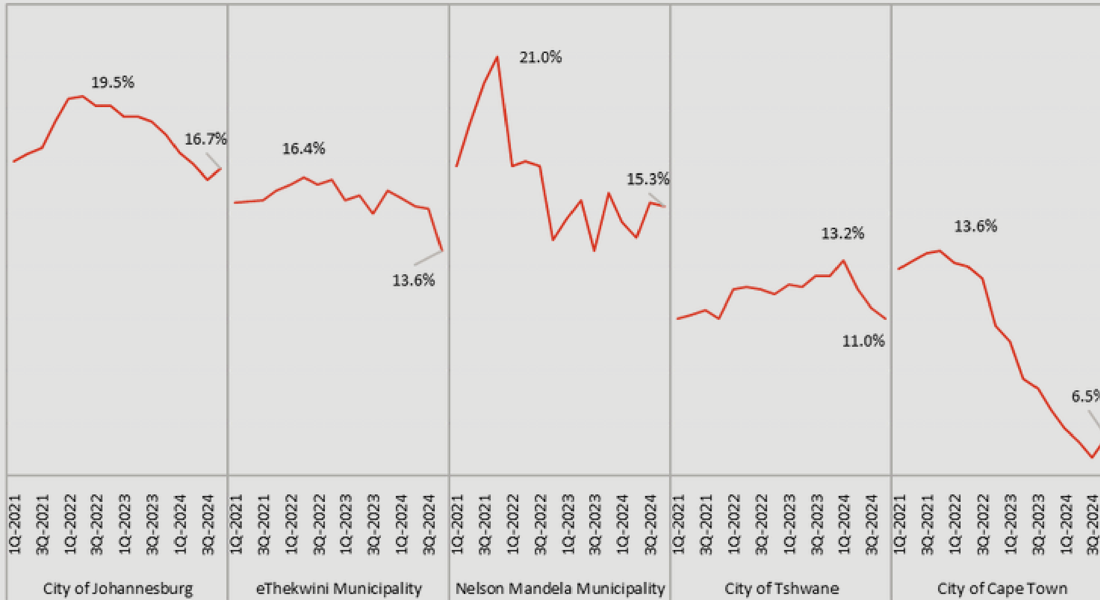
Stock performance, however, exhibited significant dispersion, with top performers delivering gains exceeding 50%, while some laggards saw returns as low as -30%. Top performers included Texton, Fortress, Attacq, Hyprop and Farivest, all of which delivered returns in excess of 50% for the year, and two of which are pure SA focussed funds, highlighting the SA Inc recovery.

While we don't expect to see a significant gains from current levels due to yield compression, we think there is further upside in earnings for the SA real estate sector if the environment for SA continues to improve and the GNU can deliver on its promises. We have already begun to see improvements in areas such as energy and ports and it appears steps being taken in the right direction to address the challenges in rail and transport infrastructure and expectations are that the new government will continue working toward resolving these issues.

This is expected to result in sustained higher GDP growth on the back of improved business confidence, as well as rand strength over the medium term, which is likely to drive inflation lower due to lower import prices. In addition, the improvement in energy supply, with the country having experienced over 275 days without load shedding, will do much to strengthen business confidence. Indeed, we have already seen large foreign investment flows into bond and equity markets, and we expect to see improved foreign direct investment too. Increased economic activity in turn stimulates the property sector with increased leasing and the eventual upward pressure on market rentals when vacancies are limited. We are seeing the green shoots of this in office market and particularly in the Western Cape, vacancies have fallen to below pre-Covid levels and rentals are beginning to rise.

The US central bank cut interest rates by 100bps during the last 12 months, with the dot plot indicating a further 50bps of cuts expected by policy makers in 2025 (down from 100bps previously). The ECB has also cut rates by a total of 100bps in the current cycle, with more expected to come in 2025 as inflation continues to moderate. South Africa has lagged global peers, cutting rates by only 50bps in the last year as the SARB adopts a cautious stance. With inflation continuing to moderate and the latest reading for November coming in at 2.9%, we expect to see further cuts in upcoming meetings, with a further 75-100bps of cuts pencilled in. Lower interest rates will be positive for SA real estate companies in two ways: firstly, the discount rate applied for valuations is lowered translating to higher share prices, and secondly declining interest rates will lower interest cost (albeit with a lagged effect as interest rates are generally hedged for a period) and so will help support growth in earnings.

CHART 1: OFFICE VACANCY RATES BY REGION



Source: SAPOA Office Vacancy Survey, December 2024

All of this will stimulate a narrowing of the discount to underlying NAV's and eventually we will see companies being able to raise capital which should in turn be stimulatory for the economy and so begins the virtuous upcycle and growth cycle.

However, one cannot ignore a number of potential risks that could slow the progress made. All of the above may be tempered by what happens after Donald Trump takes office on January 20th. If his mooted trade tariffs are implemented and mass deportations occur, it is possible interest rate cuts in the US will be deferred, or even rise again to mitigate the impact these policies are likely to have on inflation. Worsening geo-politics may also impact inflation through higher food and energy prices, particularly in Europe.

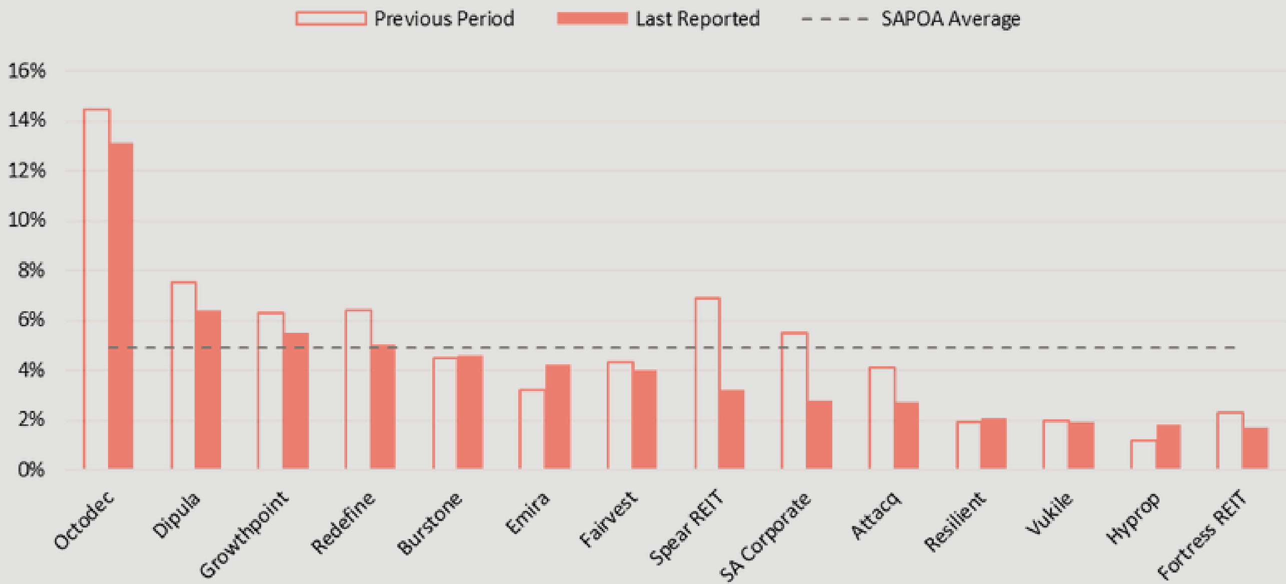
FUNDAMENTALS CONTINUE TO RECOVER

The recent results from the sector have shown how resilient the asset class has been as we weathered the sharpest rate-hiking cycle in four decades.

Vacancies continue to improve, even in the beleaguered office sector, which has seen some increasing momentum in leasing enquiries and vacancy levels falling 300bps from its peak in 2022. The Western cape remains the strongest due to the ongoing "semi-gration" trend, and is seeing increased demand from BPO occupiers. Vacancies as at Q4-2024 in the City of Cape Town are currently 6.5%, compared to 11% in the City of Tshwane and 16.7% in Johannesburg, with rental growth in the province also stronger than the rest of the country. Vacancies in the retail sector have continued to improve, with the latest data showing vacancies at 4.9% compared to a peak of 7.1% in 2021.

Rental reversions, a key metric monitored by property investors, refer to the change in rental rates when a property lease expires and a new lease is negotiated, indicating whether the new rent is higher or lower than the expiring one. As a result of sharply negative reversions over the last 3-4 years, and a typical lease term of 3-5 years, rentals have now rebased from an over-rented position prior to Covid. Given the strong

CHART 2: PORTFOLIO VACANCIES PER COMPANY



Source: Metope Research, company financials, January 2025

demand for space in retail and logistics, we can expect to see inflation-related growth in rentals from these rebased levels.

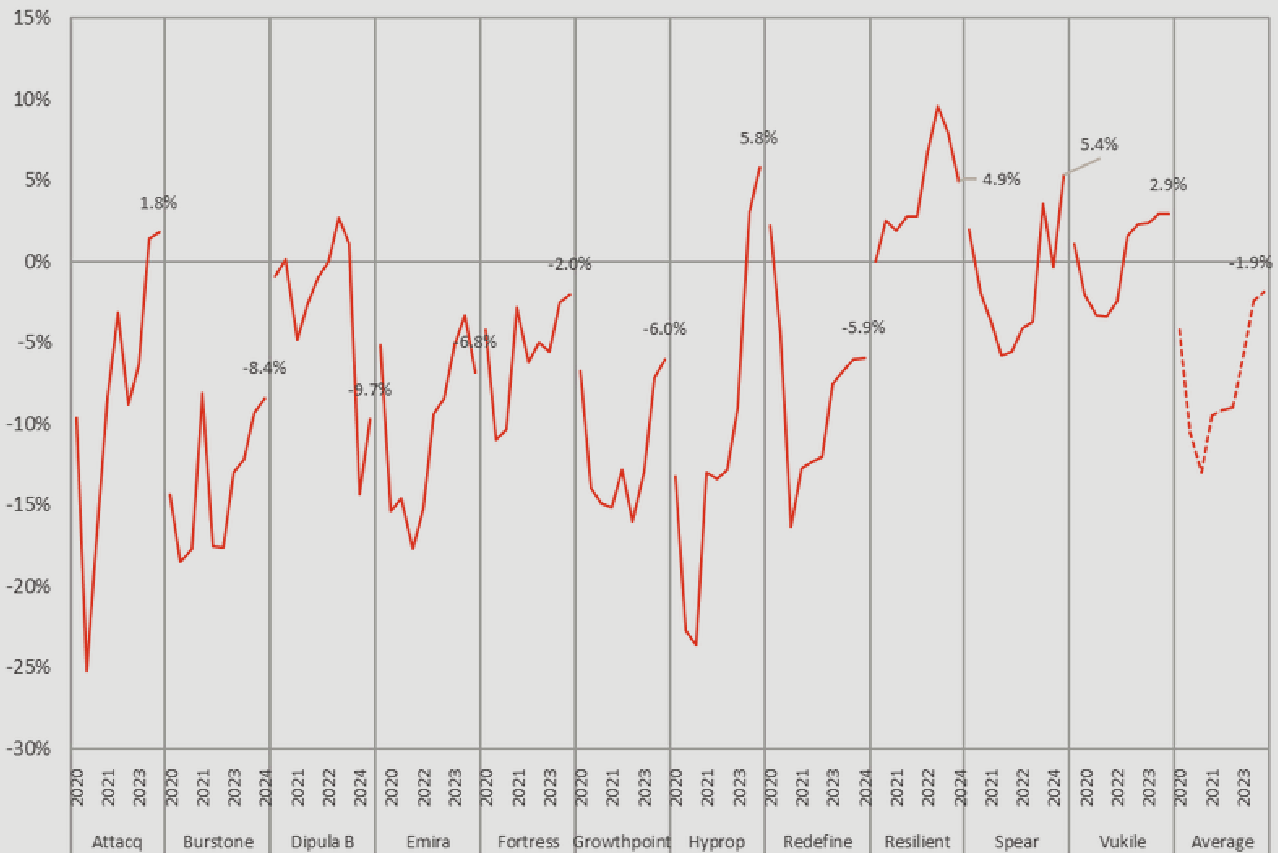
Additionally, there is further cause for optimism as retailers' Occupancy Cost Ratios (OCR), a measurement evaluating the total operating costs of a property beyond just rental expenses in relation to revenue, have fallen to pre-COVID levels. This underscores improved affordability for tenants who are experiencing robust growth in trading density amid the inflationary environment.

In the logistics sector, rentals are being driven higher by increase near-shoring of manufacturing, increased technology requirements and space optimization. Rising building costs have also supported rentals and valuations of existing space. In the Western Cape especially, there is limited space for new developments in strategic nodes, and land prices have risen sharply, further supporting rentals for existing space.

In the Central Eastern European region, NEPI Rockcastle and MAS Real Estate have benefitted from indexation in leases, as rentals escalate by inflation each year. These companies have seen indexation of c9% in 2023. However, with inflation moderating to levels of 5-6%, we can expect net property income growth to slow somewhat in the medium term. That said, the CEE economies continue to experience real wage growth, which bodes well for consumer spending and retailers in the region.

While costs remain a concern, particularly rates and administered costs, capital expenditure on Solar PV generation is expected to lower operating costs in the future (or at the very least mitigate the above-inflation increases being passed by NERSA) and drive rentals as tenants increasingly demand energy resilience and sustainability. The 2023 base included significant diesel costs in the worst year for loadshedding on record. Given significantly lower loadshedding levels in 2024, we will continue to see significantly lower diesel spend and increased solar PV generation. In time, certain

CHART 3: RETAIL SECTOR REVERSIONS



Source: Metope Research, company financials, January 2025

real estate companies will derive income from the sale of surplus electricity to the grid. More importantly, the growing investment in renewable energy by property companies, particularly solar, will enable more sustainable access for landlords, tenants, and customers alike, while also reducing costs and minimising disruption.

INTEREST RATES AND DEBT LEVELS

The sector has successfully navigated the aggressive rate hiking cycle, with average ZAR funding costs for SA-focussed REIT's rising to 9.4% from 7.9% at the bottom of the cycle. Sales of non-core assets, earnings retention and dividend reinvestment programs ("DRIP's"), as well as some growth in underlying portfolio values have helped the sector maintain gearing at sustainable levels of below 40%. The pain of the rate hikes is largely in the base now. Due to the lagged effect of interest rate hedges, we expect the sector's debt costs to have peaked in 2024 and rate cuts implemented in 2024 and beyond will support earnings growth going forward.

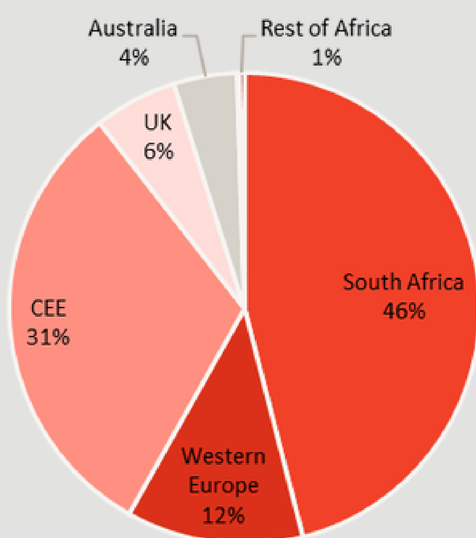
VALUATIONS

Metope believes there is further upside in our SA listed property share prices, due in part to the discount rate used in valuing certain shares in the sector. We believe that what is often not fully appreciated by the market is that the sector as a whole is largely exposed to offshore assets, both directly via dual listed or inward listed counters such as Nepi Rockcastle, Lighthouse, MAS, Hammerson and Sirius, as well as indirectly via SA REIT's investments in offshore ventures, such as Redefine's investments in EPP in Poland;

Growthpoint's investments in Australia and CEE; Vukile's retail assets in Spain and Portugal and Resilient's assets in France and more recently in Spain. This is often not considered when calculating an appropriate discount rate, as the starting point in determining the discount rate is usually the country-specific government bond yield.

When looking at the ALPI index, for example, an investor is essentially investing 46% in South Africa, with a government bond yield of 10.5%, while the remaining 54% is invested in Europe, Australia and the UK, with government bond yields of 2.5-5%. When looking at offshore vs SA focused companies, offshore counters appear fairly valued and in many cases are trading at or near to NAV, while SA counters are still trading at higher discounts to NAV (c.25% compared to offshore counters of c.8%). This implies that investors are being overly punitive on SA valuations (especially in the case of hybrid funds that have offshore exposure).

CHART 4: LOOK-THROUGH GEOGRAPHIC EXPOSURE OF THE ALPI INDEX



Source: Metope Research & JSE as at January 2025

CONFIDENCE RETURNING TO SECTOR

There is evidence that investor confidence is returning to the sector in recent capital raises, increased utilisation of DRIP's and deals being reached, for example Vukile, Spear, Nepi Rockcastle and Lighthouse all raised capital in 2024 for various investment deals. In addition, we have seen new listings on the JSE of UK healthcare funds Assura and Primary Healthcare Properties, providing investors with access to new sub-sectors and further diversification. This is further indication that we may have reached the bottom of the cycle. The sector is still trading at an attractive discount to NAV of c.20%, while NAV's appear to have bottomed out. We expect capital raises to remain well below the averages seen in the previous decade because of tight capital markets and dilutive nature of such issuances.

Instead, capital required for maintenance capex likely to come from retained earnings and dividend re-investment programmes, which can also be used to reduce debt and fund acquisitions and is supportive of NAV's over the longer term.

CONCLUSION

Expectations are for economic growth in South Africa of just under 2% in 2025 as a result of our positive political outcome and an improvement in the stability of our electricity supply. SA is also expected to come off the Greylisting in September 2025 which will improve investor confidence. These factors will have a positive effect on the South African property market which we expect will continue to see increased occupancies, improving rentals and lower operating costs ratios. We anticipate further interest rate reductions in the next 12 to 18 months, both locally and abroad, albeit somewhat less than what was expected prior to Trump's election win, which will positively

impact earnings for many property companies, particularly those with higher leverage.

South African property companies are in a far stronger financial position when compared to five years ago. Many companies have adopted pay-out ratios on the income distribution which enables retained cash flow to be utilised for maintenance and capital expenditure, acquisitions or a reduction in debt. Some companies will increase the payout ratios going forward as the need to hold back cash lessens, so boosting the growth in dividends of the sector and increasing overall returns.

The sector is currently trading on a forward dividend yield of around 7.5%, or an earnings yield (which excludes the effect of pay-out ratios) of 8.9%, with expected growth of 5-6% pa over the next 3 years, offering investors an attractive combination of yield, earnings growth and potential capital growth.

Looking ahead, we anticipate the sector to continue delivering double-digit total returns over the medium term. , Selective stock picking will remain a critical determinant of out-performance, underscoring the importance of a disciplined and thorough investment approach.

DISCLAIMER

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