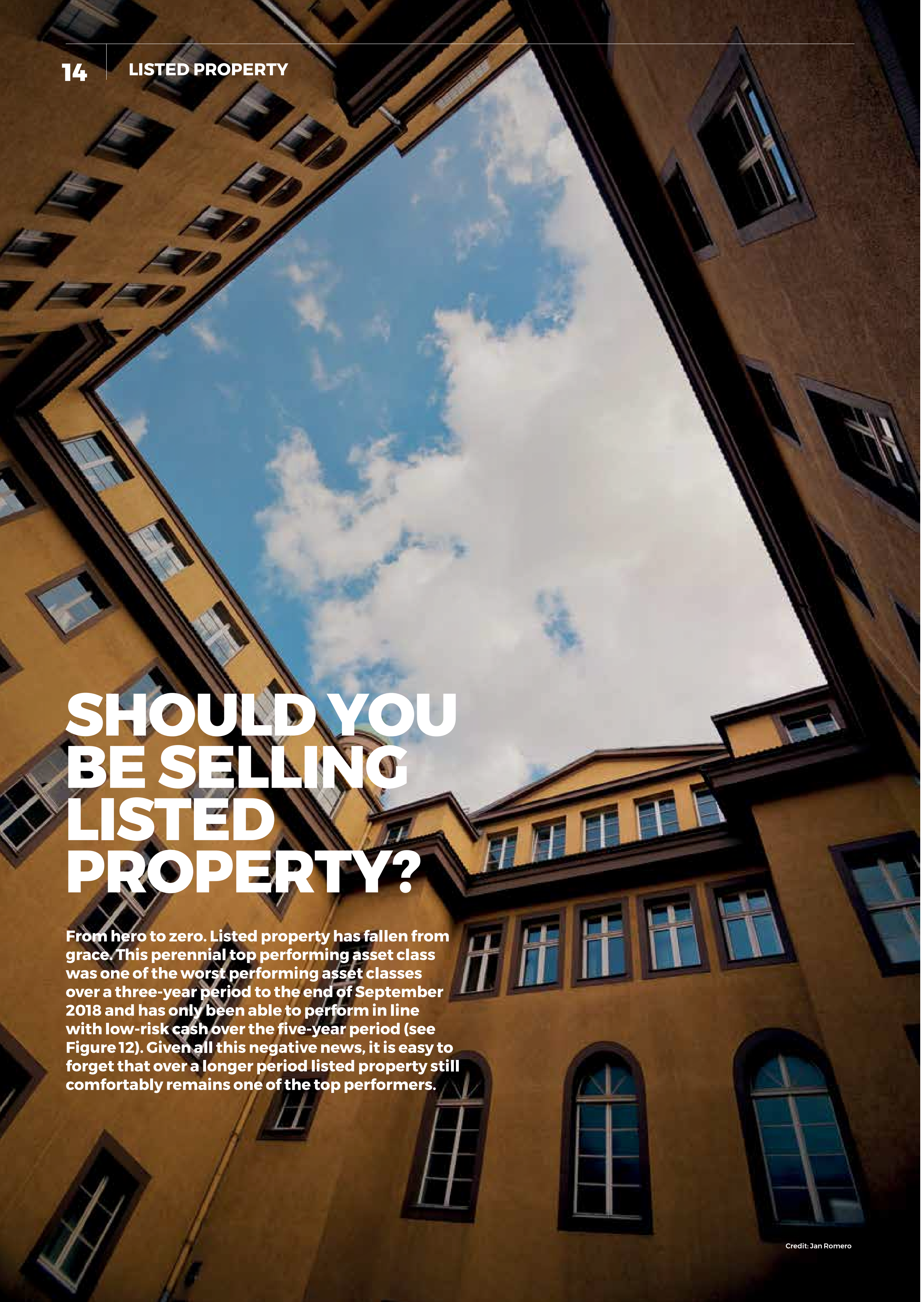


SHOULD YOU BE SELLING LISTED PROPERTY?

From hero to zero. Listed property has fallen from grace. This perennial top performing asset class was one of the worst performing asset classes over a three-year period to the end of September 2018 and has only been able to perform in line with low-risk cash over the five-year period (see Figure 12). Given all this negative news, it is easy to forget that over a longer period listed property still comfortably remains one of the top performers.

Credit: Jan Romero

EVAN ROBINS,
PORTFOLIO MANAGER

Does this recent poor performance mean you should run for the hills in 2019? Not so fast... To get some perspective, I look at what's improved and what hasn't, and why investors should not be too quick to dismiss the property sector.

01/ WHAT HAS IMPROVED: SOME MAJOR CONCERNS HAVE DISSIPATED

There are four key non-economic growth related concerns we explicitly cautioned clients about in the past that have now disappeared. In some cases, they have even turned positive. This creates a more favourable valuation and structural environment for the sector.

THE EXTREME VALUATION OF THE RESILIENT STABLE IS OVER

The companies in the Resilient stable, which comprised over 40% of the listed property benchmark at the start of the year, were much too expensive. Given their weight in the FTSE/JSE SA Listed Property Index (SAPY), this posed significant sector risk if (and when) their prices normalised. This occurred in early 2018 (Figure 13 on the following page), and much more aggressively than we anticipated – contributing substantially to the current sector malaise. By way of comparison, at the time of writing property heavyweight Growthpoint's total return was down 7% over 2018. By contrast, the SAPY benchmark index, which has a heavy weighting to the Resilient stable, was down 23%. Resilient stable companies' share prices roughly halved in value this year.

The Resilient stable's share price overvaluation concerns are now behind us. There could even be upside if market concerns are alleviated.

BOND YIELDS ARE NO LONGER LOW

Listed property yields tend to follow government bond yields. If yields rise, prices fall. A couple of years ago there was a substantial capital risk to listed property prices if global and South African bond yields were to rise from their then historic multiple-decade lows.

Bond yields in the United States and in South Africa have now risen significantly (see Figure 14 on the next page). Indeed, in MacroSolutions we now believe that SA bonds are cheap and yields are more likely to fall than rise. Buying listed property now offers the prospects of an opportunity for capital gain if yields fall, and less probability of a loss from rising SA bond yields.

THE MARKET IS NO LONGER UNREALISTICALLY SANGUINE

We were of the view that the SA market and property companies were too backward looking, under-estimating the gravity of future economic and property deterioration.

Our sense is that the market and companies are now cognisant of how difficult conditions are and the downside risks involved. Companies are reducing growth guidance and make no secret of how difficult things really are. Expectations now are more reasonable. This does not mean conditions will be easier or that they can't get worse, nor does it mean that there won't be nasty surprises.

It just means that market expectations and pricing are now more realistically taking this into account. One of our preferred relative valuation measures, the spread between SA REITs and the inflation-linked bonds, is now at a level last seen during the global financial crisis.

FIGURE 12: ASSET CLASS RETURNS: LISTED PROPERTY RANKS TOPS OVER THE LONG TERM

1-YEAR RETURNS to end of September									RETURNS to end of September 2018					
Sep 10	Sep 11	Sep 12	Sep 13	Sep 14	Sep 15	Sep 16	Sep 17	Sep 18	H1 2018	YTD	3-year	5-year	10-year	15-year
SA Real Estate 24.6%	SA Real Estate 6.2%	SA Real Estate 32.6%	SA Equity 22.7%	SA Real Estate 14.9%	SA Real Estate 25.3%	SA Bonds 7.5%	SA Real Estate 8.8%	SA Cash 7.3%	SA Cash 3.6%	SA Cash 5.4%	SA Bonds 7.6%	SA Real Estate 6.8%	SA Real Estate 12.0%	SA Real Estate 16.2%
SA Equity 17.2%	SA Bonds 6.0%	SA Equity 19.9%	SA Real Estate 10.8%	SA Equity 13.9%	SA Cash 6.3%	SA Cash 7.2%	SA Cash 7.8%	SA Bonds 5.9%	SA Equity 2.3%	SA Bonds 4.8%	SA Cash 7.3%	SA Cash 6.8%	SA Equity 9.7%	SA Equity 14.7%
SA Bonds 15.0%	SA Cash 5.7%	SA Bonds 15.8%	SA Cash 5.1%	SA Bonds 6.0%	SA Bonds 6.1%	SA Equity 6.4%	SA Bonds 6.9%	SA Equity 1.1%	SA Bonds -3.0%	SA Equity -3.8%	SA Equity 6.7%	SA Bonds 6.5%	SA Bonds 8.1%	SA Bonds 8.2%
SA Cash 7.2%	SA Equity 3.4%	SA Cash 5.5%	SA Bonds 3.3%	SA Cash 5.5%	SA Equity 2.0%	SA Real Estate 2.7%	SA Equity 4.3%	SA Real Estate -13.5%	SA Real Estate -3.2%	SA Real Estate -22.2%	SA Real Estate -1.4%	SA Equity 5.4%	SA Cash 6.8%	SA Cash 7.3%

Source: FactSet. SA Equity represented by FTSE/JSE Shareholder Weighted All Share (SWIX) Index

LISTED PROPERTY YIELDS ARE HIGH

Three years ago, we cautioned clients that a forward yield of as low as 6% was very expensive. Today, at a forward yield approaching 10% for the SAPY Index and SA REITs, the valuation environment is completely different: it's cheap. Dividends can fall by a third and you will receive the same yield as was offered three years ago! Property yields were last at these levels during the global financial crisis.

02/ WHAT ARE OUR CONCERNS?

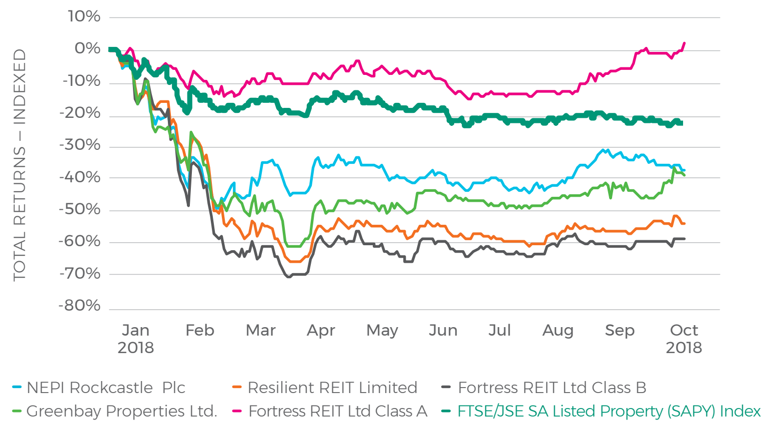
It's "the economy, stupid", as the saying goes. Conditions for property companies are very difficult and could deteriorate further. New rentals are often being signed at lower levels and there is a strong possibility that vacancies may increase. The longer it takes for conditions to improve, the worse the damage. The economic crisis affects all South African companies and industries. In a poor environment, listed property should be more defensive than most other domestic local equities.

Macroeconomic conditions aside, there are still issues that worry us within the property sector. These include:

DIRECT PROPERTY VALUATIONS COULD FALL

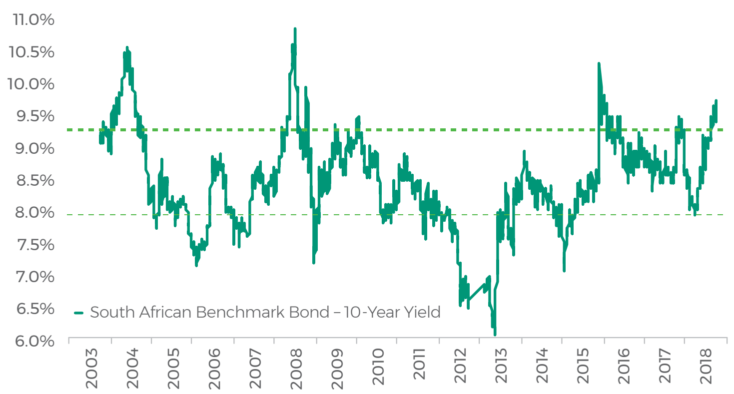
Considering the state of the economy and the level of bond yields, we are surprised that direct physical property capitalisation rates (a measure used to value physical properties) have held up so well. We would have expected cap rates to have widened by 100 to 200 basis points (bps), which

FIGURE 13: ANNUS HORRIBILIS – RESILIENT STABLE DRAGS THE SECTOR DOWN (THICK LINE)



Source: FactSet

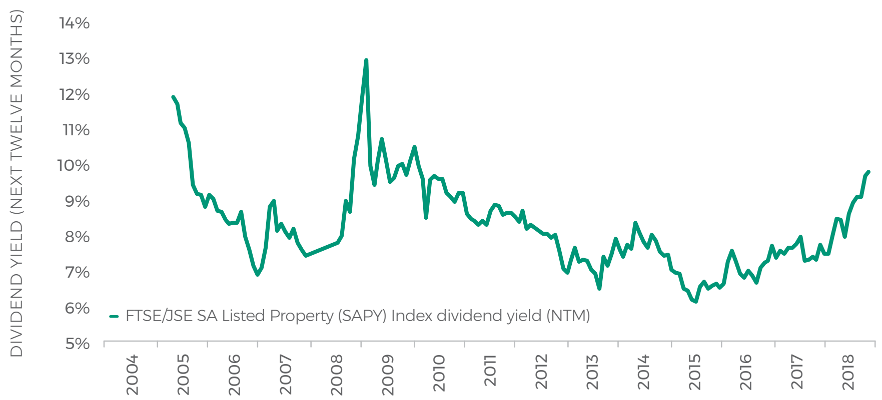
FIGURE 14: ELEVATED SA GOVERNMENT BOND YIELDS, GOOD FOR PROPERTY IF THEY FALL



Source: FactSet

> WE WERE OF THE VIEW THAT THE SA MARKET AND PROPERTY COMPANIES WERE TOO BACKWARD LOOKING, UNDER-ESTIMATING THE GRAVITY OF FUTURE ECONOMIC AND PROPERTY DETERIORATION.

FIGURE 15: VALUE? SA LISTED PROPERTY INDEX FORWARD YIELD



Source: FactSet

implies buildings' values fall by over 10%. If this occurred, company net asset values (NAVs) would fall by more than this because balance sheets are geared. This will make loan-to-value ratios more stretched.

There are mitigating factors. Unlike direct physical property, listed property prices have weakened and are trading below NAV, so the listed market is priced for property values to fall. The South African listed market, erroneously in our view, pays scant attention to NAVs, which means that a fall in direct valuation would have a muted effect on prices. Most property funds' gearing levels are not elevated, so if prices fall, sector gearing would move from a comfortable level to the limits of the comfort zone. There are always those companies who would be under great pressure.

EXCESS PHYSICAL PROPERTY SUPPLY IN A LOW DEMAND ENVIRONMENT

There is a structural over-supply of office and retail property. This is not new news. Developers and corporates are still building additional offices and shopping centres despite the absence of incremental new demand from job creation or retail sales. If the economy was stronger this would be naturally absorbed, but in this environment it pushes down rentals and occupancies. The level of new development is slowing, but there is still an overhang from projects in progress.

Shopping centres face additional challenges. Edcon is under grave pressure and most other nationals and line stores are facing flat or declining sales per metre of shop floor. Rent-to-sales ratios having deteriorated markedly. There is only so much low trading density growth the sector can absorb before there is a downward step change in the sector. It is still early days in the generalised retail deterioration, but a prolonged slowdown will be painful and novel for the sector.

LOW QUALITY EARNINGS, NON-SUSTAINABLE DRIVERS OF EARNINGS GROWTH AND NEGATIVE SURPRISES

- Low quality/inflated earnings base: With their backs against the wall, some management teams look for any source of income, no matter how fleeting. If these sources are depleted, earnings may need to be rebased downwards, which is what some companies have already done. This is less of an issue than some believe as this type of income is not substantial. The risk here lies with the companies that have not disclosed the extent of low-quality income they distribute.
- Non-sustainable earnings growth drivers: There are deals that provide a one-off boost to growth. This often dovetails with a flood of SA property companies investing offshore (see box alongside). The problem is not that the sustainable earnings base of the company is overstated, but that investors get distorted expectations of potential earnings growth. Eventually capacity to do these deals is exhausted. Investors may get a negative surprise when companies are left "naked", having to rely on scanty organic growth to drive earnings upwards.
- Negative surprises: In a difficult environment, every results season will see some companies suffering unexpected negative surprises – for instance, a major tenant unexpectedly leaves or fails. While, in aggregate, this may only make a small difference, it can result in materially poor performance for the REIT concerned and sour general sentiment.

The concerns we delineated that have receded are predominantly structural or valuational in nature. The concerns that remain are functions of our low growth environment, which could get worse before it gets better for property companies. If the economy improves, these concerns dissipate.

Another important new concern is the excessive gearing levels and currency and interest rate structures of many offshore acquisitions. This has front-loaded growth and increased the risk of a nasty outcome if these investments or structures sour, while also being distribution-detrimental to unwind. (These issues need a separate article to explain.)

There are no easy catalysts for a recovery in listed property, but the high return on offer provides a cushion. If general conditions continue to deteriorate, domestic property is a value trap (cheap, but at risk of getting worse), but the property sector would not be alone.

The economy and property are cyclical. The most money is made buying at cycle bottoms and selling at cycle tops. If investors were happy to hold property at a 6% forward yield, it is not obvious they should be in a hurry to sell at a 50% higher income return of over a 9% yield. Bear markets can clear out some of the excesses created in the cycle highs. We have shown how some of this has occurred in the property sector, creating a healthier backdrop for the recovery whenever that occurs.

OFFSHORE INVESTMENTS: EXAMPLES OF NON-SUSTAINABLE GROWTH DRIVERS

Most domestic property companies have been aggressively investing offshore to diversify away from a tough local economy, look for other sources of growth and benefit from property yields well in excess of funding costs (unlike in SA). Consequently, listed property performance and price today are less of a function of South African-specific factors. A prolonged strong rand could actually be bad for the distribution growth rate of domestic REITs with high offshore exposure.

A consequence of the move offshore, deliberate or not, is often a one-off boost to earnings growth. Here are two scenarios to illustrate this:

- **A South African property company buys assets overseas that yield 7% and it funds these entirely with debt at an offshore currency rate of 3%. Immediately, earnings will rise by 4% (7% - 3%) times the value of the acquisition. This can be very material to that year's earnings growth. The company will need to do another deal of a bigger size next year to replicate that growth rate effect.**
- **A local company may have funded a past offshore acquisition with SA rand debt at say 10%. If it swaps this into foreign currency denominated debt at say 3%, the company can reduce its interest costs by 7% (10% - 3%) times the value of the debt. A major one-off reduction in interest expenses leading to an earnings boost, but less rand-hedge protection as assets and liabilities are now in the same currency.**