INTUITION
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The Difference between the Macro and the Micro

Understanding the investment world is a bit like trying to repackage something you bought and want to return to the store. You never seem to get it to fit the way the experts do. Just when you think you understand how it all works, it is as if someone conjures a new rule to evaluate the situation. Part of the problem is that we live in a world with excessive information flow. It is easy today to have a platform to express your view - the writer is a case in point. We cannot begin to unravel what is a very big bowl of spaghetti in a simple article, but what we can do is use one of Harvard House's key investment building blocks to demonstrate how micro-analysis and macro-analysis pose differing viewpoints, and how that should influence your perspective of investments.

Robin Gibson

We all know that Listed Property (one of Harvard House's key investment building blocks) was the major casualty of the Covid Pandemic. Price action in the sector reflected a doomsday expectation for the future of the sector. As is most often the case, the fear appears to be worse than the reality. For South African property stocks, the Pandemic couldn't have come at a worse time. Balance sheets were stretched as local companies had diversified into European property, which were perversely the first to be shut down. This led to significant dividend cuts for some companies as management scrambled to avoid covenant breaches with major financial institutions that would have led to similar results to what European property experienced in the Global Financial Crisis (GFC) in the mid 2000s. At a Micro level, several key factors lead to the revaluation of commercial property:

1. Weighted Average Lease Expiry (WALE). As investors, we are interested in who the tenants are and the duration of the outstanding leases. Solid tenants with long leases at fixed escalations give us excellent foresight into the revenue stream of a property company. The WALE is a standardized measurement that allows for easy comparison between different companies.
2. Loan to Value Ratio (LTV). This is a key and somewhat 'slippery' metric. In essence, it is the value of all the debt divided by the current market value of the underlying properties. What makes it so slippery is that market values can plummet for multiple reasons and LTVs can therefore change drastically overnight. For example, I could owe

SPEED READ

- **Investing is often about identifying the value discrepancy between a company's micro situation amid a contrary macro environment. If the macro environment ever turns to the benefit of micro-positioning, a windfall is a serious possibility for the long-term investor.**
- **Listed property, and maybe even more specifically, South African listed property gives us the perfect example to evaluate this concept of the micro versus macro environment. As a key asset class in producing client incomes and an area where Harvard House has some nationally recognized ability, it is worth understanding why we remain optimistic about the future of this asset class.**
- **The macro problems for the listed property sector are well known. Weak GDP growth and work from home (WFH) remain headwinds for office space, load shedding is a challenge for retailers, and elevated interest rates a headwind for the sector generally. These are all issues that restrain optimism in the property sector.**
- **At a micro level, the property recovery is underway. Conservative balance sheets, recovering demand and economic activity, unique opportunities, and deft management all suggest that both income and potential capital returns could offer substantial upside with just a slightly better tailwind.**

R350,000 on a set of properties valued at R1 million, which would give a very comfortable LTV Ratio of 35%. If either a banking crisis or covid type of pandemic occurred and caused the commercial property market to revalue my property portfolio to R500,000 then my LTV will deteriorate to 70%. This generally leads to a breach of covenant with the banks which may either then be entitled to charge me a punitive level of interest or force the shareholders to put in more capital to reduce the loan!

3. Vacancy. This is fairly straightforward. Investors want vacancies to be as low as possible.
4. Rental reversions. When leases expire a process of renegotiation occurs (if the tenant wishes to stay). Since commercial leases tend to be long-term, a fixed escalation is usually negotiated at the outset. This increase can run behind or ahead of inflation over the term of the lease. In either case, the rental is adjusted to compensate for this when the new lease is signed. A landlord always wants a positive reversion (usually because he can demonstrate some added value to the tenant even if the increase had been higher than inflation). Conversely, tenants like negative reversions, effectively a drop in the renegotiated rental due to overzealous historic increases.

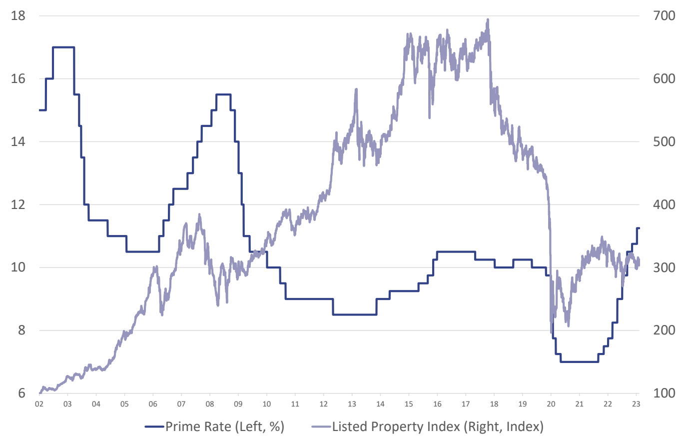
This is not an exhaustive list of data we consider at a micro level, others may include payout ratios, and average rental per square meter to name just a few. Most importantly, the starting yield will be a big consideration. This is calculated as the dividends paid expressed as a percentage of the market value and is generally a direct comparison of what an investor could secure in another income-paying investment like a fixed deposit. This is where the Macro environment starts to come in.

The biggest group of investors with regular new money to invest is the pension fund industry. Every month employees the world over deduct a portion of their pay and transfer it into some form of pension pot. These pots are the lucrative objective of most asset managers. Sticky assets with substantial regular contributions! Usually, pension funds are tax agnostic. The funds are exempt from tax, so capital gains, interest, and other tax events are of no consequence in the investment decision. This has big consequences for the property sector since its most attractive quality is its income payment coupled with the potential of modest capital growth. Since asset managers spend a lot of time managing risk (because believe it or not, we don't know what tomorrow holds) they will weigh up the property yield against other income yields available for different levels of perceived risk. This is usually the Bond Market, which is fundamentally driven by interest rates. If investors feel that they can get an equivalent yield with lower risk by investing in bonds rather than property, then that is where they will allocate their money. This is an example of the Macro factor trumping the Micro factors.

With interest rates at elevated levels because of global inflation, asset managers can invest in a range of bonds across different maturities that will offer a better, safer return than that currently offered by the listed property sector which comes with risk attached.

The property sector is in the midst of a decent recovery at a micro level. While the office sector is still the worst-performing property sector as WFH remains significant (and will do so until the excess supply is mopped up,) for the rest rental demand is strong, balance sheets have reset and reversions are improving, suggesting that rental rates have bottomed. Pension fund investors will stick with bonds as long as interest rates stay elevated. For the private client who is more tax-sensitive with who requires a long-term escalating income, the property sector is looking more appealing. However, it is unlikely that the market will reflect these underlying improvements until interest rates start to fall, thus providing the tailwind required to entice pension fund managers to reallocate capital towards property.

PRIME RATE VS LISTED PROPERTY INDEX



This chart demonstrates that when the micro factors (property fundamentals) are in reasonable shape then the primary determinant of listed property prices is the trajectory of interest rates – strongly demonstrated by the periods 2003-2018 and 2022-2023. When the property fundamentals overtake the macro conditions (interest rate trajectory) then the relationship deteriorates (2018-2022).

The difference between an investor and a capital allocator is the time horizon. Capital allocators are interested in the next 6 months (largely because they expect significant new money to allocate on an ongoing basis), whereas investors are positioning for the next 5 to 7 years (largely because they probably aren't adding new money regularly). This is the primary difference between a private client and a pension fund. It implies that the private client will be best served from a market value perspective when the pension fund perspective coincides. One must remember that short-term resistance to your investment position does not make it a poor long-term investment decision. Listed Property remains the best option to secure sustained increasing income with the added benefit of long-term asset growth for the individual. Interest rates seldom remain elevated for sustained periods. This cycle too, shall pass. The Micro is normalising fast, the Macro will duly follow in time.

Our next Insight seminar will take place in June and provide an update on what has driven markets over the first six months of the year, and what might lie ahead for the balance of the year. We are very excited to be expanding our seminar program to Cape Town.

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Topic:	Mid Year Market Update
Natal Midlands	
Date:	Thursday, 22nd June 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	Tuesday, 13th of June
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	Wednesday, 14th of June
Venue:	To Be Confirmed
Time:	To Be Confirmed

CONTACT DETAILS:

For more information on the range of products and services offered by Harvard House Investment Management and its associated companies (including Harvard House, Chartered Accountants), or for any financial advice, please contact the Company at:

HARVARD HOUSE GROUP

3 Harvard Street, Howick, 3290, South Africa

P.O. Box 235, Howick, 3290, South Africa

+27 (0) 33 330 2164

+27 (0) 33 330 2617

@ admin@hhgroup.co.za

W www.hhgroup.co.za