INTUITION

25 AUGUST 2023

Listed Property: a quiet revolution

Investors hardly need reminding that the past 6 years have been some of the toughest on record for the listed property sector. Having peaked in 2017, the sector has faced successive issues – state capture, weak GDP growth, Covid-19, an oversupply of office property, riots and unrest, municipal failure, loadshedding and finally, higher interest rates. That has made for a tough operating environment that has impacted distribution growth. Most of these factors are outside of managements' control, so it would be easy for them to sit back and point fingers. Yet that is not the case. REITS have done much to improve their own internal efficiencies. The foundation has been laid for better times, but interest rates must peak before the sector will benefit.

Michael Porter

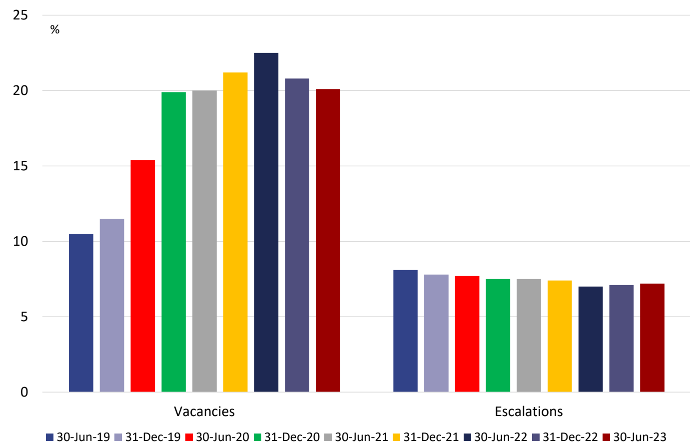
It might feel like "death by a thousand cuts" for investors in the listed property sector. It is no secret that the sector has faced numerous challenges over the past six years, each of which has dented rental growth and therefore growth in income distributions. Whilst some of the blame for the weak performance can be laid at managements' door – extended balance sheets are the most obvious one - frustratingly, many of the issues faced have been outside of managements' control. Yet rather than sulking in their corner, REITS have quietly picked themselves up by the bootstraps, making strides in areas where they do have control. Specifically, we are encouraged by a few key factors:

1. The office market. During the second quarter of 2023, SA's office vacancy rate improved again, albeit off a high base (according to SAPOA.) Prior to the Pandemic, office vacancies stood at 11%. They peaked at 16.7% late last year and have now dropped to 15.6%. That is still elevated, but the trend is moving in the right direction. Unfortunately, the improvement in vacancies is still coming at the expense of income growth as rentals continue to trend downwards. It is worth noting that on an inflation-adjusted basis, the average gross asking rental for available office space is now at the same levels as 1999. Nonetheless, this improvement in vacancies is translating into improving valuations, an important milestone for funds with office exposure. Furthermore, it appears that the work-from-home (WFH) trend is abating. There is ample evidence to suggest that companies are increasingly requiring their employees to be present in the office given poor

SPEED READ

- **The listed property sector has faced a litany of woes over the past six years, most of which have been outside management control.**
- **Far from sitting on their hands, companies have been steadily working on factors inside their control. Those measures are starting to bear fruit.**
- **There is a close correlation between the direction of interest rates (bond yields) and the performance of the listed property sector. The sector is only likely to gain traction once the market is convinced that interest rates have peaked.**

GROWTHPOINT OFFICE METRICS



Given its size, trends at Growthpoint are a good indicator of sector-wide issues. Encouragingly, both vacancies and in-force escalations (the rate at which rents will grow over the lease period) have turned more positive, but there is some way to go to reverse the damage done by the Pandemic.

service levels, poor training and cross-skilling and deteriorating culture.

2. Vacancies. Apart from office vacancies, which remain high, vacancies across other sectors are stable and falling, especially in retail and industrial properties. Furthermore, the amount of new space under development is low, given high interest rates and weak confidence. That implies that vacancies could fall further.

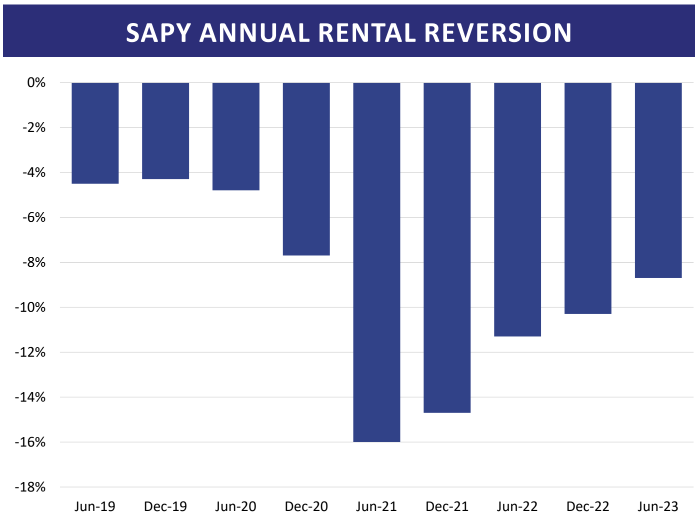
3. Reversions. Allied to the point above is reversions, or the amount by which the rental rises or falls when a lease is renewed. Given that the annual escalation is set at the inception of a lease, the actual rent paid at the end of the lease can vary enormously from market levels. In boom times, rentals are often below present market conditions, leading to a positive reversion – i.e. the rent rises to market levels when the lease is renewed. But the converse also applies. Over the past five years, SA companies have been battling with negative reversions (market rentals below the expiring rental), so rentals fall as the lease is renewed.

   Broadly speaking, reversions are still negative if one looks across the sector, but these mask many areas of improvement. The office market is still weak, but even there, where negative reversions were as high as 25%, they are now trending back into single digit declines. On the other hand, retail reversions are positive, as evidenced by recent results from Resilient, Vukile, and Liberty 2 Degrees. Furthermore, and unsurprisingly, the Western Cape is performing better than Gauteng, so funds with higher exposure there are showing better results.

   In our opinion, there is ample evidence to suggest that the negative reversionary cycle is coming to an end, especially as most leases signed during the boomy period up to the end of 2017 expire. As I have already mentioned, retail reversions have already turned, industrial reversions are mixed (company-specific), with only office still lagging. A return to positive reversions will mark an important milestone for sentiment towards the sector.

> *"Over the past two months, there has been the first hint of "Spring" in the bond market. "*

4. Loadshedding response. Loadshedding has hit the property sector hard. Essentially, extra diesel costs cannot be fully recovered from tenants, so property expenses rise whilst rents remain unchanged, squeezing margins. Fortunately, renewables are not only gaining traction, but are also margin-accretive for most companies. Recent results from Resilient confirm both the investment case for renewable energy and the acceleration in approvals from municipalities. The REIT sector will be a major beneficiary of reduced loadshedding in 2024 and 2025, as summarized in our recent Insight seminar.



Whilst reversions are still negative for the sector, this masks pockets of strength. Nonetheless, the trend is improving, and we expect sector-wide reversions to turn positive within the next 18 months.

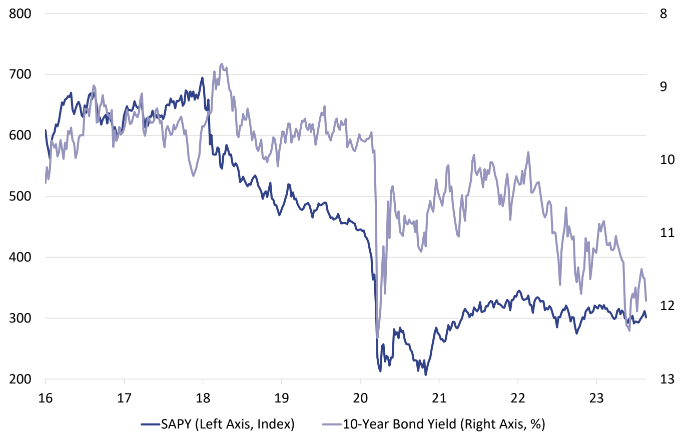
This all sounds like good news. It is, but why then have share prices not reacted more positively? After all, the SAPY Index is still trading about 50% lower than the level prior to Covid. Unfortunately, it can be summed up in two words – interest rates.

Before I delve into the impact of interest rates, it is worth noting that there has been a substantial improvement in overall debt metrics across the sector. Whilst a generalization, debt levels were too high before Covid. Loan-to-Value (LTV) ratios were well in excess of 40%. That excess has been corrected – across the sector LTVs are now 37%, no small feat considering that it's been virtually impossible to raise new equity funding given the level of share prices. REITS are now on a far more stable footing.

Nonetheless, interest rates negatively impact property in two ways. Firstly, property companies tend to have a reasonable amount of debt so higher interest rates imply a rising amount of interest paid on that debt. This is deducted from rental income, and hence higher interest payments directly affect profits and distributable income. The SARB started raising our interest rates in October 2021 – we are almost two years into the cycle – and rates have risen by a cumulative 4.75%. We have commented before not only on the duration of the tightening cycle, but also on its pace. REITS have faced an increasingly strong headwind for the past two years.

Secondly, an investment in property is often compared to an investment in bonds. Both are income-focused investments, so they tend to perform in a similar manner. This is how global trends manifest in local valuations. US interest rates and bond yields have been rising, and hence so have ours.

SAPY VS BOND YIELDS



Listed property tends to move in tandem with bond yields, given that they are both income-focused investments.

There is a negative correlation between bond yields and REIT share prices – the higher the yield, the lower the price. Bond yields have been weakening since early 2022, which has in turn dampened the performance of listed property. This is clearly illustrated in the chart below.

Over the past two months, there has been the first hint of "Spring" in the bond market. As we articulated in our recent Insight seminar, US interest rates are very close to a peak, which offers interest rates and bond yields in other countries some respite. Local bond yields rallied from 12.3% to 11.5% - although they have weakened again since. Initially property was slow to react, but the SAPY Index rose almost 10% in the space of just a few weeks. There has since been a partial reversal, in line with yields over the past few days.

Nonetheless, this episode highlights the potential available within the listed property sector when markets become convinced that interest rates have indeed peaked. We are greatly encouraged by the improvement across a multitude of metrics that are within management control. In addition, the sector is positioning itself well to take full advantage of falling interest rates when they do come, which will immediately enhance distribution growth. If our thesis holds that 2024 could see a combination of reduced loadshedding and lower global (and local) interest rates, both of which will be beneficial for the Rand and local inflation, then the outlook for property is the brightest in years.

The property market is looking perkier, and not just in the hub of Cape Town.

Our next Insight seminar will take place in September in Howick and Johannesburg. This seminar will delve a little deeper into our economic statistics to challenge some common misconceptions.

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Topic:	Stats vs Facts
Natal Midlands	
Date:	21st of September 2023
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	19th of September
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	n/a
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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