INTUITION
20 OCTOBER 2023

NEPI Rockcastle: ticking along

The JSE listed property sector is facing an uphill battle given the sharp increase in interest rates over the past 18 months that has caused the cost of debt to rise at a faster rate than the increase in rental income from tenants. This has stalled the growth of distributable income per share that can be paid out to shareholders in either cash or script dividends. Coupled with other headwinds, such as pressure from loadshedding and weak economic growth both locally and globally, property companies have had little room to increase rental collections at a rate above inflation. Taken together, property companies are struggling to maintain and grow their distributable income per share. Therefore, it's a welcome relief to see NEPI Rockcastle announcing higher than expected dividend growth for the 2023 half year as well as respectable dividend growth guidance for the rest of this year on the back of a strong operating performance.

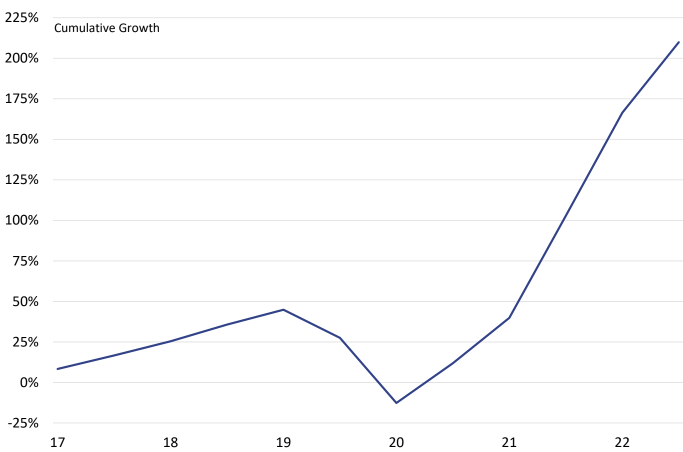
Daniel Reynard

NEPI Rockcastle focuses on efficiently managing a portfolio of dominant retail properties which are all located in Central and Eastern Europe (CEE). Both factors – location and type of property – have benefitted NEPI Rockcastle. A retail property is said to be dominant if it is large enough to satisfy consumers with the appropriate mix of stores from which to choose without the consumer having to go to an alternative retail property to get what they require. There are additional requirements to being a dominant retail property, such as location, easy access to the property as well as potentially exclusive anchor tenants or restaurants and entertainment features. Consumers are willing to travel further and / or visit these properties more frequently, increasing the time and money spent within the centre. The combination of higher footfall and higher spending benefits tenants, which ultimately feeds through to growth in rental income for the property owner, NEPI Rockcastle. In their most recent results, footfall and tenant sales increased by 9.8% and 16.3% respectively compared to the previous financial year. The chart below shows how tenant sales have now well surpassed those achieved prior to pre-pandemic.

SPEED READ

- **Nepi Rockcastle is an offshore, JSE-listed property company with a strong balance sheet, strong operating performance and which has delivered an impressive recovery in their dividend.**
- **It is the largest property company on the JSE by market capitalization at R67.6 billion.**
- **It owns 55 dominant retail properties – shopping centres and malls - with an additional 4 office and industrial properties.**
- **65% (by value) of its property portfolio is in Romania and Poland with the rest dotted across other Central and Eastern European countries.**

CUMULATIVE TENANT SALES GROWTH



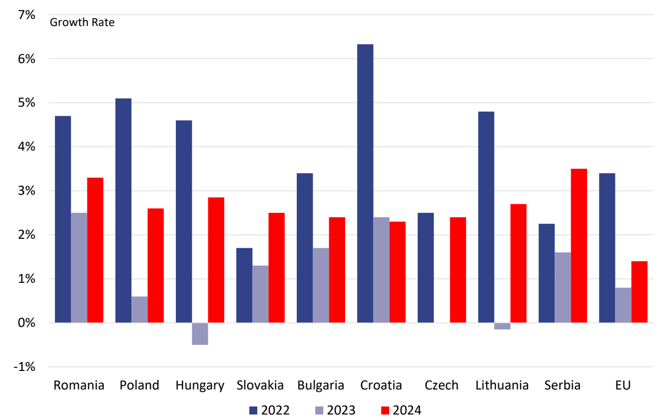
Unsurprisingly, growth in tenant sales dipped during the Pandemic as restrictions impacted activity. But tenant sales have grown strong since, testament to the recovery in that region as well as the attractiveness of NEPI's properties.

NEPI Rockcastle has been rewarded for their foresight in building a quality property portfolio located in Central and Eastern European countries, most of which have investment grade ratings, fast growing GDP per capita that fuels consumer spending, strong historical GDP growth rates, and strong forecasted GDP growth over the next five years compared to the wider EU region.

> *"NEPI Rockcastle's current cost of debt remained low at 2.50%, stemming from their decision to fix a large portion of their debt and the goodwill leveraged from their green credentials "*

Strong growth is important because it underpins the ability for consumers to maintain or increase their spending, which is beneficial for tenants' sales and ultimately, the landlord who can negotiate more favourable lease agreements with happy tenants. However, other macroeconomic factors – such as higher inflation and interest rates – have been just as challenging across the CEE region as they have been in SA. Fortunately, the inflation trend is reversing and consumer spending across NEPI Rockcastle's portfolio remained impressive even before considering the tougher economic period. That bodes well. The invasion of Ukraine by Russia has thankfully not spilt over into the rest of the neighbouring region as many had feared which has allowed NEPI Rockcastle to continue operations as usual.

GDP GROWTH ACROSS CEE REGION



GDP Growth is generally stronger across the CEE region than the EU and is forecast to accelerate over the course of 2024."

Good management and good opportunities

In 2022, NEPI Rockcastle purchased two Polish shopping malls for €377 million which they have had their eye on for some time. Having remained patient, the turmoil in Ukraine gave them an opportunity to purchase them on advantageous terms. Both centres were selected for their dominance in cities with strong economic fundamentals and their environmentally friendly design and operations. Both purchases have paid off handsomely so far with the most recent results boasting strong sales growth for tenants of +21% and +27% respectively compared to the prior 12-month period.

Balance sheet strength and green financing

Management has stewarded NEPI Rockcastle to a Loan-

FORUM GDANSK SHOPPING CENTRE, POLAND

NEPI has wanted to buy this property for years, but the price never made sense. Their patience was rewarded last year when turmoil from the Ukraine war gave them a golden opportunity.

To-Value (LTV) ratio of 33.4% as at June 2023. This is below management's target threshold of 35% and well below the strictest lender's covenants of 60%. Their conservative balance sheet has protected them against the full impact of rising interest rates. Despite the higher cost of debt due to increasing interest rates, conservative levels of debt have prevented the interest expense from running out of control and hurting dividends.

NEPI Rockcastle's current cost of debt remained low at 2.50%, stemming from their decision to fix a large portion of their debt and the goodwill leveraged from their green credentials because of their commitment to operating their properties in an environmentally sustainable manner. Management continues to install solar projects. 74% of the electricity consumed across the portfolio is now sourced from renewable energy sources. Consequently, MSCI ESG Ratings issued NEPI Rockcastle with an AAA rating on its green bonds.

An impressive dividend performance

The latest half year dividend per share is €0.5784, representing growth of 24.9% relative to the same period in 2022. Furthermore, the total dividend for the 2023 year is projected to be 5% greater than the dividend for 2022. Once the 2022 dividend is adjusted for once-off transactions that are not expected to recur, management project dividend growth to be 12%, which far outperforms the increase in euro-inflation. In Rands, dividend growth has comfortably grown faster than South African inflation since December 2017, a track record that not many local REITS have matched.

Conclusion

NEPI Rockcastle has successfully navigated all the challenges that the world has thrown at it over the past few years – whether it be Covid, the Russian invasion of Ukraine or higher inflation and interest rates. Encouragingly, the outlook for the fundamentals underlying the company – such as GDP growth across the CEE region - remains positive and the growth in dividends despite the challenges of recent years is a feather in the cap of management. Whilst the share price remains well off its highs reached in 2017, the company's operating metrics are consistently improving. Patient shareholders should be rewarded when the interest rate cycle turns more favourable.

Warsaw, the capital of Poland.

Our next Insight seminar will take place in December in Cape Town, Johannesburg and Howick. After an eventful 2023 which has delivered its fair share of surprises, our next seminar will take stock of the year and focus on the outlook for 2024.

Topic:	Outlook for 2024
Natal Midlands	
Date:	7th of December
Venue:	Oasis Conference Centre, 72 Main Road, Howick
Morning Time:	10am for 10.30am
Evening Time:	5.30pm for 6pm
Johannesburg	
Date:	6th of December
Venue:	Rosebank Union Church, Cnr William Nichol and St Andrews Road, Hurlingham
Time:	7am for 7.30am
Cape Town	
Date:	4th of December
Venue:	ABRU Motor Studio, Lourensford Wine Estate, Somerset West
Time:	5.30pm for 6pm

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