

Unravelling the REIT: A Deep Dive

The real estate investment trust, abbreviated to REIT, allows those of us who may not have deep enough pockets to take advantage of owning entire commercial properties – such as an entire shopping mall or tall office block in Sandton – and to reap the investment benefits. REITs do this by pooling funds from investors, combined with debt from the bank, using those funds to purchase a portfolio of real estate assets, and to pass the rent earned on these properties back to the investors after all the necessary expenses have been paid. But that is a very basic explanation, so this article will try to unravel more of the details of how a REIT works.



**Daniel
Reynard**

The real estate industry operates in a slightly different way to how many other industries operate and can become complicated very quickly when unfamiliar terms like rental reversions, weighted average lease expiry, rental escalations, and loan-to-value ratios are thrown around. But do not fear as they are not as intimidating as they may seem at first. This article aims to help demystify several key indicators

used by analysts to assess the operational robustness and financial well-being of REITS. Once read, I hope that you will feel empowered and more knowledgeable about this sector that only property analysts normally look at.

Property operating indicators

Starting with the property operating indicators, the four main indicators that gauge the strength or weakness of property operations are:

- Vacancies,
- Rental reversions,
- Weighted average lease expiry (WALE), and finally,
- Rental escalations.

Beginning with the easiest indicator to understand on this list, vacancies is a measure of the space in the property that is not currently rented out to a tenant. Vacancies may arise for many reasons, such as the rent is too expensive, or other properties have more attractive benefits. The lower the vacancies that a portfolio has, the better, as empty space is not earning rent. Typically, vacancies are measured in one of two ways – either by the lettable area that is unoccupied, or by the rental amount that the vacant space would earn if it were rented. Both measurements are reported as percentages of the property or across a portfolio of properties.

SPEED READ

- REITs are real estate investment trusts - Growthpoint and Vukile are good examples.
- There are four key property operating indicators, namely vacancies, rental reversions, weighted average lease expiry, and rental escalations.
- In addition, there are two primary financial leverage ratios – Loan-to-Value (LTV) and Interest Cover ratio (ICR).
- Finally, there are a further two operating efficiency ratios – Gross Cost-to-Income (gross CTI) and Cost of Occupancy.
- We will explain these concepts and how investors can use them to better understand a REIT's performance.

To get into the first of the more technical terms, rental reversions refer to the percentage increase or decrease in rent that is paid by the tenant compared to the previous rental amount. Rental reversions are measured when a new tenant takes occupation, or an existing tenant renews their lease. In either case, this is an opportunity to benchmark the rental to current market levels. If, over the course of a lease and due to annual contractual escalations, rentals have risen above market levels, then there will be a negative reversion as the new lease resets the rental to reflect current conditions. The opposite also applies. Positive reversions suggest strong underlying fundamentals for the property – as market rental growth has outstripped the annual escalation. A significant negative rental reversion over a prolonged period is a red flag, as it suggests that current rentals are not sustainable or realistic.

The first relationship between operating indicators to be unravelled is between vacancies and rental reversions. If a property portfolio has a large percentage of vacancies, the landlord may decide to lower the starting rent to attract new tenants to fill the space. That might result in a negative rental reversion but a lower vacancy rate. It is never ideal to earn lower rentals, but at least the space is earning rent, and contributing towards the fixed costs of running that property, so it is a balancing act for management. In favourable circumstances, if the property is very desirable and there are few vacancies, tenants may have to compete for space, using their wallets, which drives up the positive rental reversion percentage. Positive rental reversions and low vacancies are a win-win outcome for the landlord.

The third indicator, weighted average lease expiry (WALE), measures the outstanding term of all the leases across a portfolio of properties. The usual unit of measurement is years. A longer WALE is better, because it provides the landlord with more certainty over future rentals, regardless of short-term, cyclical factors. In turn, the more secure the income profile, the better the landlord can negotiate with banks for better lending terms, which can further enhance shareholder returns.

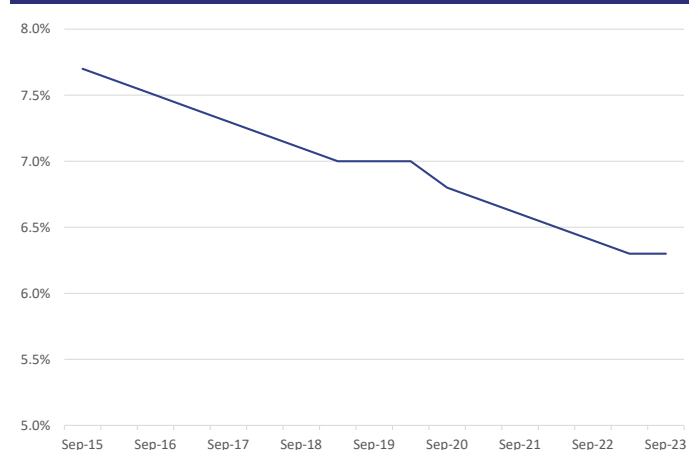
The final operating item is rental escalations. Weighted across the portfolio, escalations indicate the rate at which rentals will rise every year, which is normally agreed to in the rental agreement set at the beginning of the lease. Just like rental reversions and WALE, a higher rental escalation is better for the landlord, as that is the base for annual “revenue” growth.

The second relationship between operating indicators to be unravelled is between WALE and rental escalations. This relationship forms due to a clash of interests between the tenant and the landlord. The tenant wants to pay a low rental and remain flexible, while the landlord tries to maximise the rent over the long term. Therefore, there must be a compromise between the landlord, who generally wants the tenant to sign a lease with a long WALE with high escalations, and the tenant who has the opposite goal. Successful landlords will find a happy compromise that maximises the benefit over the long term, rather than trying to maximise the short-term gain. Bear in mind that a long WALE coupled with a high annual escalation can lead to a sting in the tail. If rent escalates at a faster rate than prevailing market conditions over a long period, then it raises the risk of a significant rental reversion at the end of the lease. That is why these indicators need to be studied in tandem with each other, rather than in isolation.

Financial Health Indicators

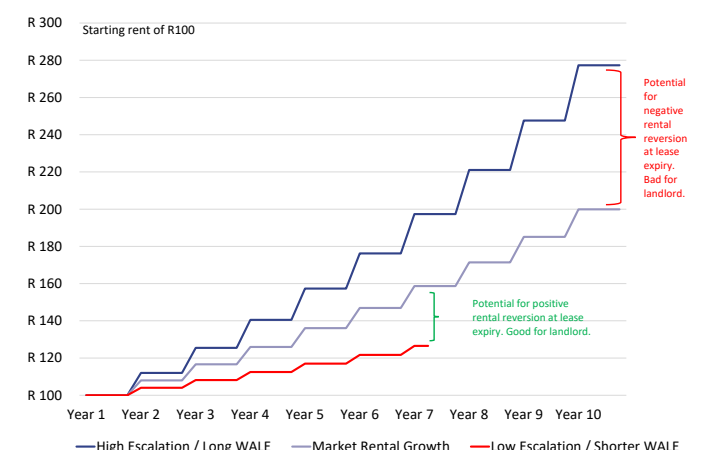
A differentiating factor between a REIT and other equity companies is the greater degree of financial leverage - financial leverage being defined as the ratio of debt from lenders and equity paid in by shareholders - that investors are comfortable with on a REIT’s balance sheet. Two quick reasons why a REIT can cope with greater financial leverage are the relative stability of property values and the tangible nature of real estate assets, which both lower the risk to the lender. Nevertheless, it is still important to monitor financial leverage in a REIT.

EXAMPLE: VUKILE RENTAL ESCALATIONS



This chart shows the contractual escalations for Vukile Property Fund over the past eight years. Contractual escalations – the rate at which rents across their entire portfolio will rise each year – have been falling, a sign of tougher times but also lower assumed inflation. We expect this to start rising again given recent inflationary pressures.

RELATIONSHIP BETWEEN WALE & ESCALATIONS

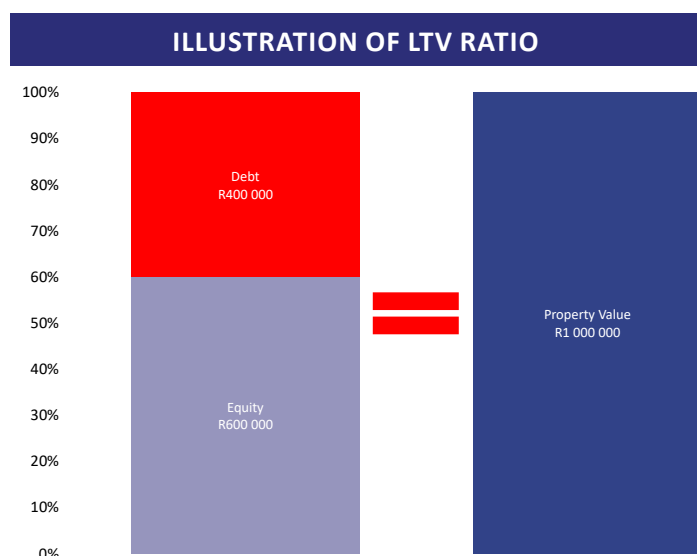


A long lease term with high built-in escalations may seem like a landlord’s dream, but it can lead to sharp falls in income when the lease expires if market rentals have not kept pace with those escalations over time. The converse is also true.

Financial leverage in a REIT is measured by the Loan-to-Value Ratio (LTV), and a REIT’s ability to service the interest on that debt is measured by the Interest

Cover Ratio (ICR). The LTV Ratio measures the ratio of debt financing compared to the value of the underlying properties. Broadly, it is an industry norm for this ratio to range between 25% and 45%. If the LTV rises too high, there is the risk that the value of the loan becomes greater than the value of the property, which is too much risk for the lender to bare. That can result in the loan being called in, which can cause immense financial stress for the REIT.

The ICR measures how many times the REIT's operating profit covers the interest expense on the REIT's debt. The greater the ICR, the better. If the ratio falls towards the 1x level, there is a growing risk that the operating income falls below the interest expense, leaving the REIT unable to service its debt. In addition, a low ICR implies that most of the profit goes towards servicing debt, leaving little left for shareholders.



In the example above, R1 million of property has been financed by R400,000 of debt and R600,000 of equity. That implies an LTV Ratio of 40%.

Like the operational metrics, these ratios need to be considered in conjunction with each other. Over the past five years, listed REITs have focused much of their energy on improving these metrics, which is one of the reasons why we believe that the sector holds a brighter future.

Operating efficiencies

Finally, it goes without saying REIT must be efficient in converting rentals collected into distributable income. The two most common ways to assess this efficiency are gross cost-to-income (gross CTI) and tenant occupancy cost.

The gross CTI measures the operating and administrative costs related directly to property operations as a percentage of total revenues collected from tenants. Operating costs refer to property taxes and other municipal charges as well

as minor maintenance expenses, while total revenues from tenants includes contractual rentals and recovery of utility expenses. Administrative costs include all the expenses that management incur while running a REIT on daily basis such as salaries, IT costs, legal fees etc. Clearly, the lower the CTI, the better.

The cost of occupancy looks at efficiencies from the tenant's perspective and measures the cost to the tenant of occupying the space. This would include the rental, as well as any extras, such as electricity, water and other charges such as security. In tough economic circumstances, tenants can reach a breaking point, above which they simply cannot afford to remain in the space. An issue that has faced SA landlords and tenants has been the exorbitant increases in municipal costs. Whilst a landlord might claim that these are simply passed onto the tenant, if the cost of occupancy gets too high, the landlord will either have to accept the vacancy when the tenant leaves or offer a lower rental to relieve the total cost pressure. Ultimately, the more efficiently the landlord can manage the properties and the more innovative they can be with providing cheaper utility (solar, boreholes etc), the higher the rental can be as a proportion of total occupancy costs.

Unravelling complete: the conclusion

Although this article has covered many important factors to consider when analysing a REIT, there are lots of others that also need to be considered – for example, tax implications, valuation metrics, net asset value, capitalization rates and so much more. For many, that might sound like the perfect cure for insomnia. Fortunately, we find it fascinating, and are here to unravel the mysteries of property on your behalf. Despite the travails of the last five years, property remains a core element of any successful income strategy.



The Sandton skyline in Johannesburg



By the time of our next Insight seminar, our election will be out of the way. We will take the opportunity to review market performance for the first five months of the year, and look ahead to what the second half might hold.

Please note that we will be hosting both a morning and evening presentation in Cape Town. The venues will be communicated once finalised.



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Topic: **Taking Stock: Mid Year Update**

Natal Midlands

Date: 20 June, 2024

Venue: Oasis Conference Centre,
72 Main Road, Howick

Morning Time: 10am for 10.30am

Evening Time: 5.30pm for 6pm

Johannesburg

Date: 11 June, 2024

Venue: Rosebank Union Church, Cnr
William Nichol and St Andrews
Road, Hurlingham

Time: 7am for 7.30am

Cape Town

Date: 13 June, 2024

Venue: To be confirmed

Time: 5.30pm for 6pm

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



www.hhgroup.co.za

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Performance figures quoted for the portfolio is from Morningstar, as at the date of this document for a lump sum investment, using NAV-NAV with income reinvested and do not take any upfront manager's charge into account. Income distributions are declared on the ex-dividend date. Actual investment performance will differ based on the initial fees charge applicable, the actual investment date, the date of reinvestment and dividend withholding tax. Performance fees do not apply to any funds managed by Harvard House. The manager does not provide any guarantee either with respect to the capital or return of the portfolio. A schedule of fees, charges, and maximum commissions are available on request from the manager.

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