# PROPERTY: DOMESTIC & OFFSHORE

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This section first considers local and thereafter offshore property.

There are some concerning signals about the near-term prospects for South Africa:

- Standard & Poor's and Moody's executives speaking late in September painted a picture where it was unlikely we could avoid a downgrade for too much longer.
- The news that SAA received another bail out of R3bn to enable it to repay its debts is illustrative of just how deep the rot is within SOEs.
- The mid-term budget speech on 25 October looms large as an important event with all eyes on tax revenue collection given acute growth concerns. With income growing at 3% p.a., while expenses rise by 7%, we fear the undershoot may be as much as R75bn.
- As we move into the 4Q17 the ANC elective conference dominates the headlines and adds to uncertainty. It is unlikely, until there is clarity on this front, that asset markets will move strongly one way or the other, although volatility during the period is a near certainty.

All of these factors are driving both investment decisions by asset allocators, as well as capital-allocation decisions by property companies. The market is now noticeably bifurcated between local property portfolios and operators who are looking offshore, particularly in Eastern Europe.

Locally, the most striking feature is a difficult operating environment for property owners. All recently reported corporate results and updates point to this, and forecast growth rates in earnings and distributions are now c. 5.5%-6.5% - down from 7%-9% and even higher in some instances. The local property companies have de-rated, however, and yield is now a reasonable underpin to these share prices in the main.

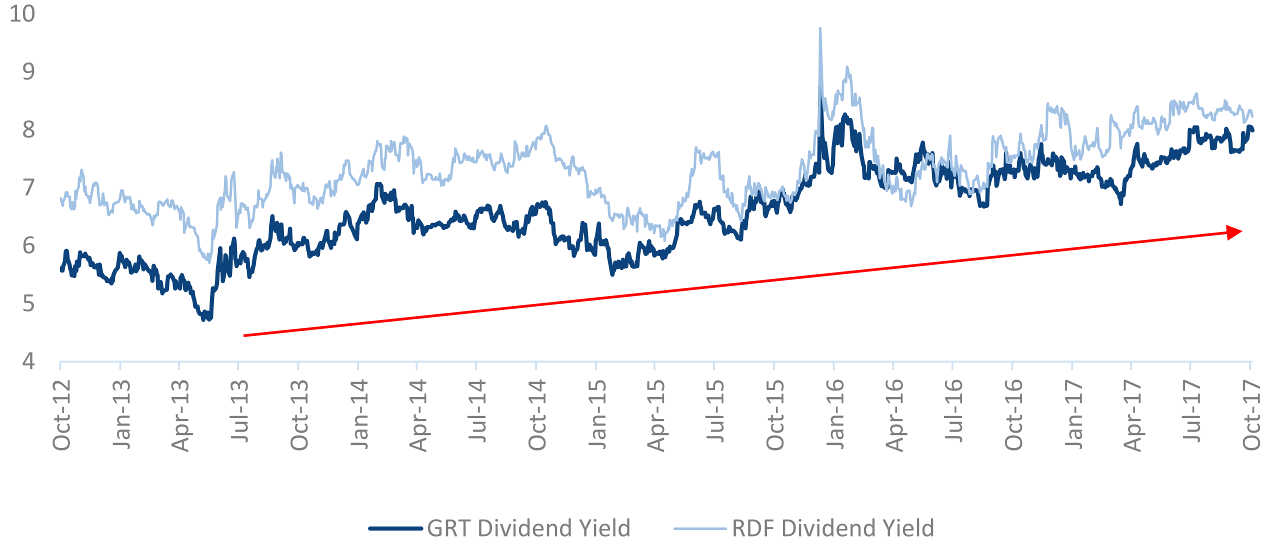
However, the appetite for investment into the Property sector for proven business models and operators, especially in geographies that are able to demonstrate improved growth prospects, remains robust. During the course of the last quarter:

- Resilient raised R2.5bn in August (and returned 6.4% in September).
- MAS Real Estate came to market to raise R500mn initially, but ended up tapping the market for R2bn, some 15% of its market cap. The share ended up 12.7% for the month of September even after this!
- Index heavyweight and Eastern European specialist, NepiRockcastle raised R5bn, again upsizing from initial indications.

The balancing act between the local component of the index and the offshore portion (some 40% now) remains key in reading the tea leaves. The seesaw seems perfectly balanced at the moment. Offshore stocks are expensive on a fundamental valuation basis and the Eastern European property sector, as priced by South African investors, is a global anomaly. The other side of the equation is currency and the prospect of far superior growth, not evident in South Africa, which local investors are willing to pay-up handsomely for at this point.

Currently, the sector overall is at a clean one-year forward yield of 7.15%, growing at 8.3%. All things equal this would mean a return of >15%. However, we see some marginal upside in bond yields, as well as some further de-rating of property yield relative to the bond yield. Our 12M-return projection is therefore 10.5% and, consequently, we remain at equal weight.

Figure 9.1: Growthpoint , Redefine trailing yield - Gradual de-rating of index heavyweights over the last 5 years




*Source: Bloomberg, Anchor Capital*

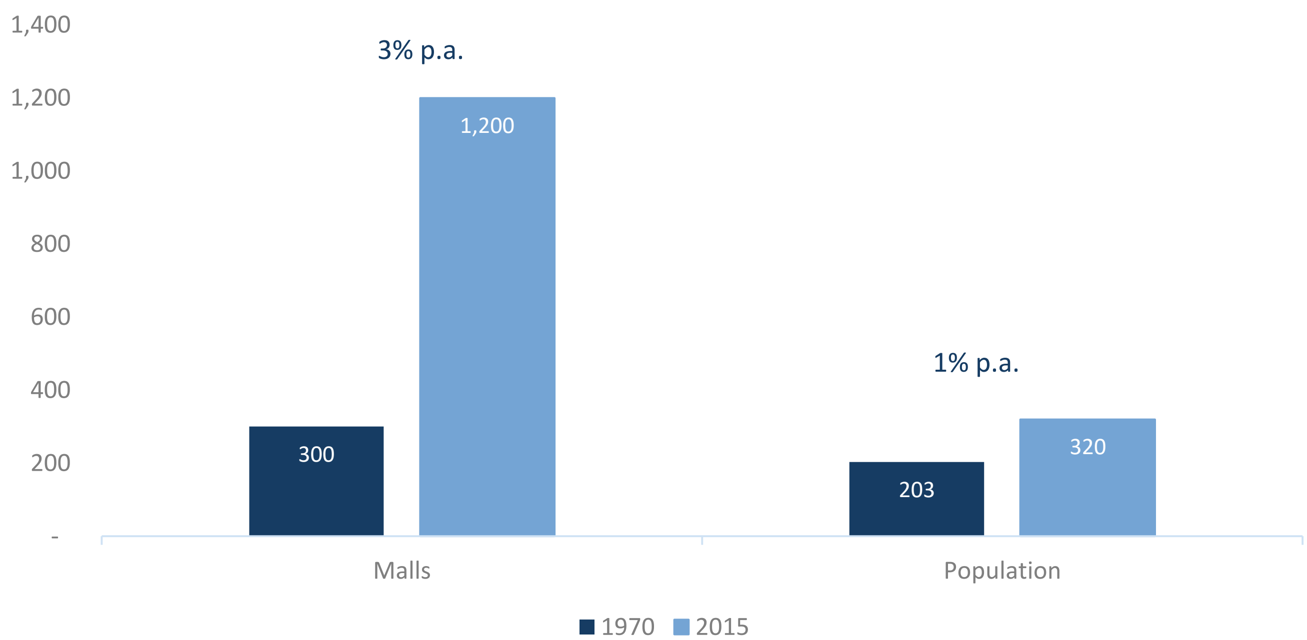
## Offshore Property

Over the last three years, global developed market real estate investment trusts (REITs) have delivered about 7% p.a. in US dollar terms, with c. 25% of the return coming from growth, 10% from re-rating and the rest from income.

Within that industry there are two distinct stories playing out, predominantly around the market-share gains of online retailing. Retail REITs are comfortably the biggest sector of the REIT market, making up about 25% of global REITs' market cap and it's become fairly apparent that there is a vast glut of oversupply (predominantly in the US) around the same time as the demand for offline/mall shopping is being eroded by online shopping. Over the last 45 years the number of malls in the US grew three times faster than the number of people.

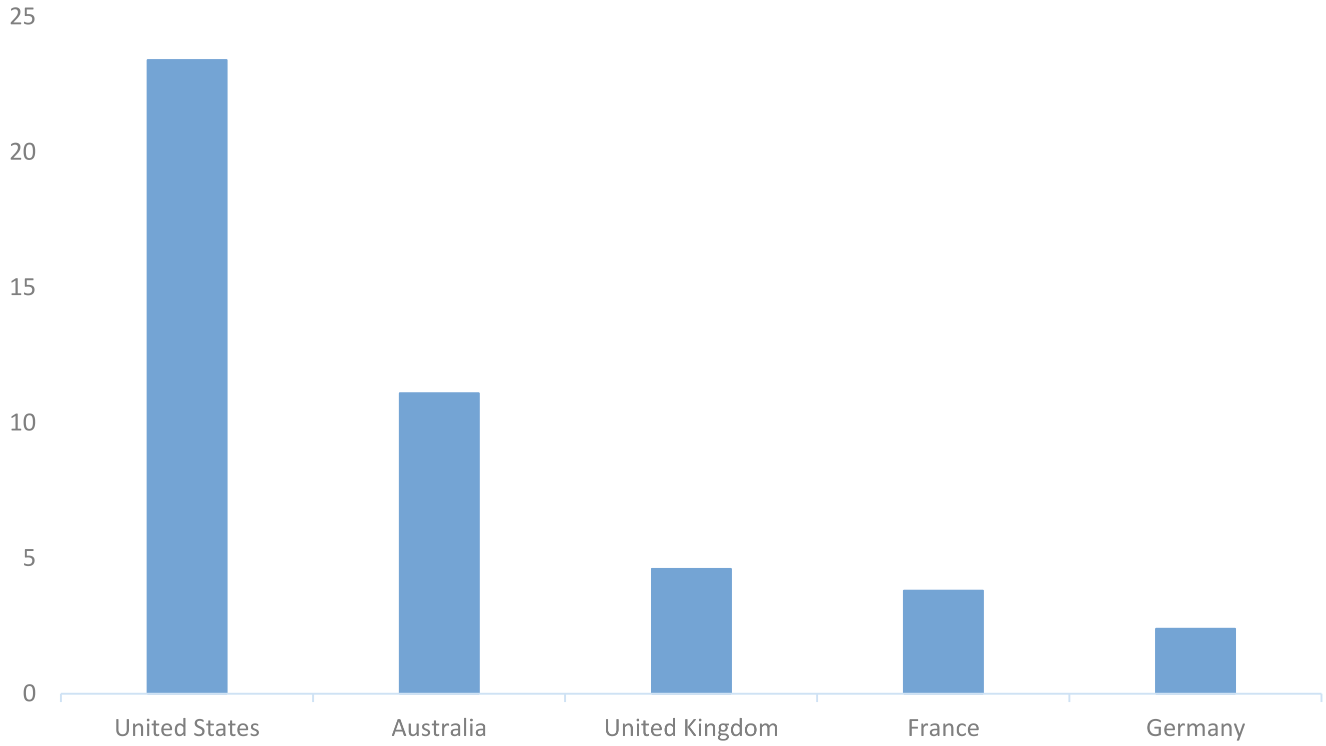
This has left the US with way too much mall space at a time when shoppers are switching to do some of their shopping online.

Figure: 9.2: Growth in the number of US malls vs. population growth




*Source: ICSC, Bloomberg, Anchor Capital*

Figure: 9.3 Retail floor space per person, 2016 (square foot)




*Source: Cowen and Company, Anchor Capital*

Some estimates suggest that a quarter of US malls will need to close to bring supply and demand back in line.

On the other end of the spectrum, the warehouses and data centres needed to service the rapidly growing online ecosystem are experiencing stellar demand growth. A study commissioned by Seagate suggests that the amount of data that requires storage will grow at 29% p.a. over the next 10 years.

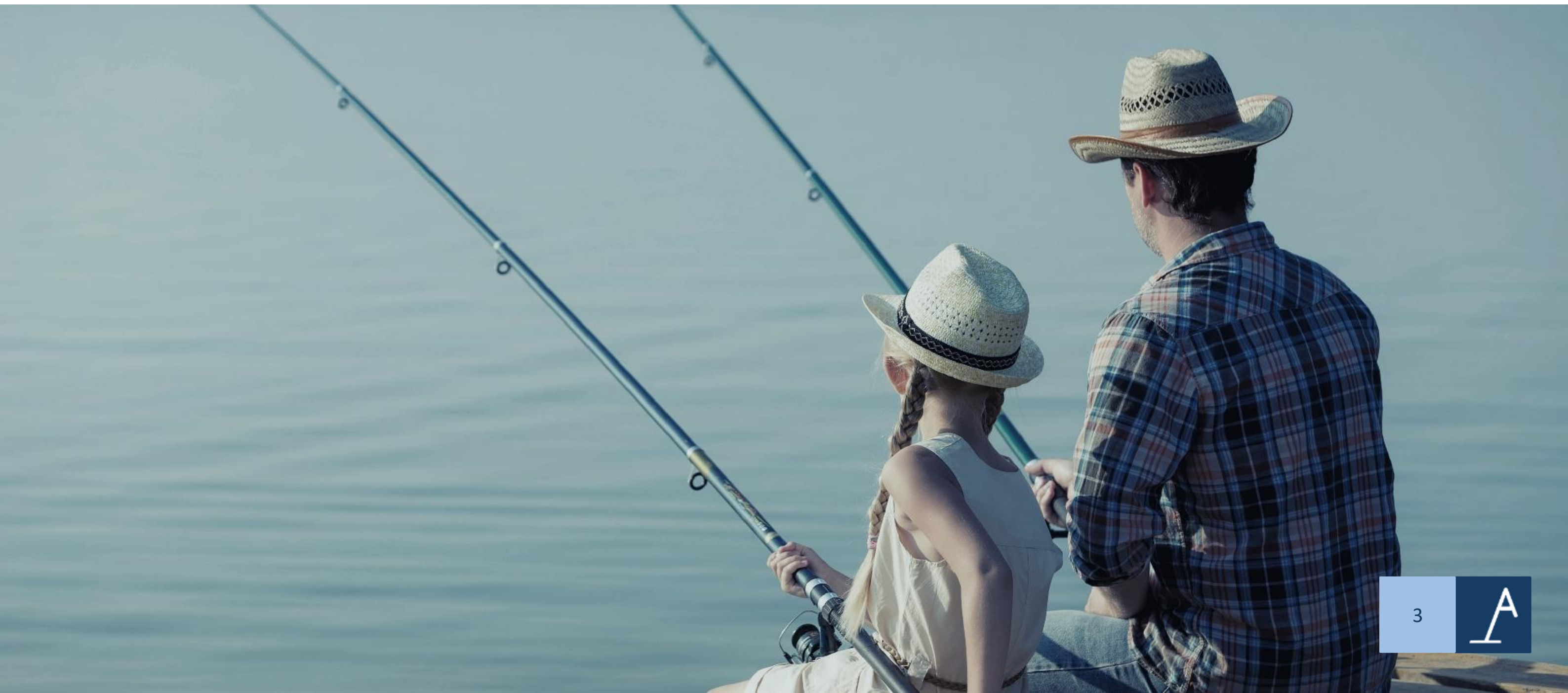
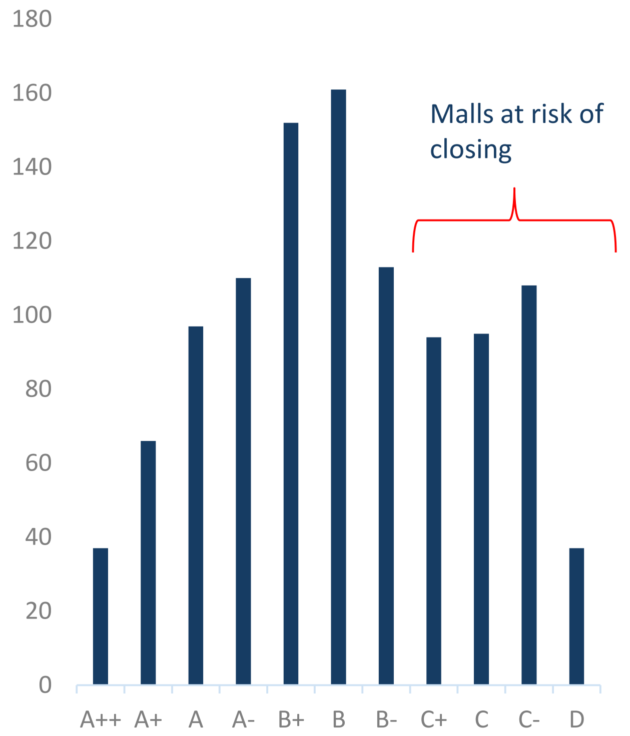
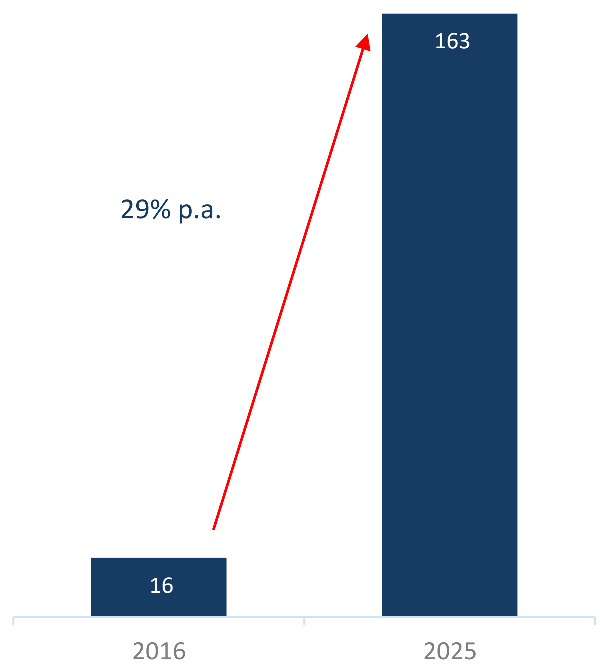


Figure 9.4: Number of US malls by quality




*Source: Green Street Advisors*

Figure 9.5: Size of global datasphere in zettabytes




*Source: Seagate, IDS, Anchor Capital*

The question now is whether REIT market pricing has already accurately factored in all this information. Retail REITs now trade at a price/FFO multiple of about 15% below the industry average, having de-rated by c. 10% in the last three years. They now trade at a 5% forward dividend yield, which seems attractive, but could be quickly eroded if vacancies increase and defaults continue in this space. There is also pressure on rental rates in anything but the premium malls.

On the flipside, industrial and specialised REITs have been growing their FFO at around 15% p.a. over the last 3 years and still trade at a forward dividend yield of c. 3.5% (industrials) and 4.2% (specialised). However, with price/FFO multiples at a premium they also run the risk of overshooting on supply, losing their pricing power and disappointing on growth. There are already some signs that data centre tenants are gaining more leverage in their negotiations for space. The balance seems delicately poised at this point and it's probably too early tell how far we are through the shift from online to offline. Supply in retail is starting to adjust and that will also prove helpful. Competition is increasing in the warehouse and datacentre market and that will start to become a headwind.

At the industry level, it seems to us that there is probably still some derating that needs to happen to reflect a slightly lower demand for yield as global rates start to edge higher. It's unlikely that we're going to see earnings growth significantly above inflation at the industry level, with growth in industrial and specialised REITs earnings being largely offset by shrinking Retail REITs earnings. So, the expectations for returns in the industry are going to be largely a function of current yields plus inflation. By our calculations this should give investors in global DMs listed property a total return of around 6% in US dollar terms over the next twelve months.

# Disclaimer