ANCHOR

THE ATTRACTION OF LOCAL PROPERTY

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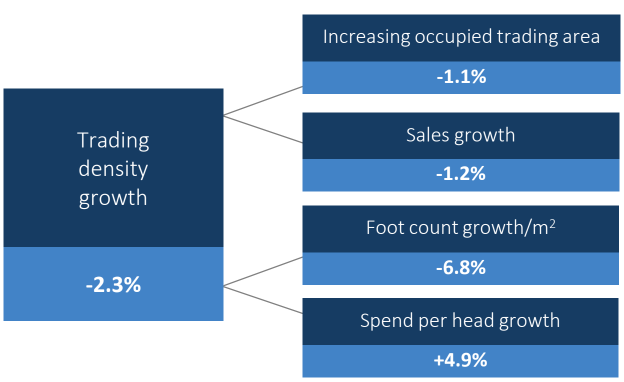
SA property

There can be no doubt that fundamentals in the SA property market are poor - worse than they have been for some time. Even the GFC largely passed SA by, relative to the carnage caused in the global commercial property market. If we analyse the three major segments of the property market, based on the South African Property Owners Association (SAPOA) findings, it is easy to spot the "speed bumps" in the road, particularly in the retail and office property sectors.

Retail sector

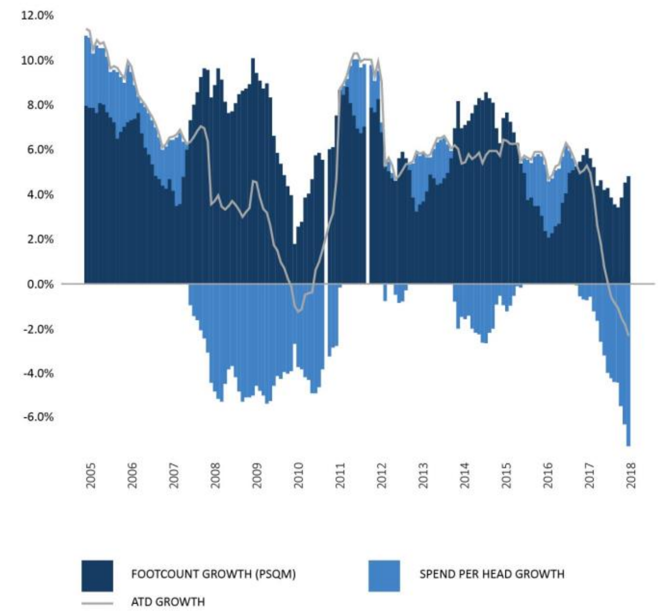
Statistics for 4Q17 show that trading densities (sales per square metre, covering 100 retail centres and 4mn sqm) fell for the fourth consecutive quarter, slowing to -2.3% YoY. Although shoppers were spending more (spend per head +4.9% YoY), this could not mitigate against the sharp drop in footfall. This meant that sales growth fell 1.2% YoY over a sales area that had increased capacity by 1.1% YoY. The overall trading density picture is worse than it was throughout the GFC.

Figure 1A: Trading density growth attribution – September 2017. Weighted contribution to trading density growth



Source: MSCI. Note: number may not add up due to rounding. This graphic illustrates the weighted contribution to trading density growth of changes in sales, trading area, number of shoppers and spend per head.

Figure 1B: Trading density growth mainly driven by spend per head growth over longer term



Source: MSCI Real Estate

Office sector

In terms of the office sector, the vacancy rate of 11.5% looks very high relative to retail (4.7%) and industrial (3.3%). However, this rate has trended largely sideways since 2011. Interestingly, development stock has fallen to 3.1% of existing stock, approximately a mid-cycle level, although pre-let developments have dropped to 50.5% at the last measurement date (end of 2017), indicating to us that slightly more speculative risk is being taken which is reversing a de-risking trend prevalent in this sector post the GFC. We note that this activity seems concentrated in the Rosebank and Sandton nodes.

Industrial sector

This sector seems in relatively good shape. Vacancies in 4Q17 show that the trend is improving, with the vacancy rate standing at 3.3%, down from 5.3% for the same period one year earlier (4Q16). In-line with this, the sector recorded rental growth of 6.7% YoY, although this has not resulted in capital growth as valuators had not materially adjusted their capitalisation rates.

In total, current conditions are resulting in:

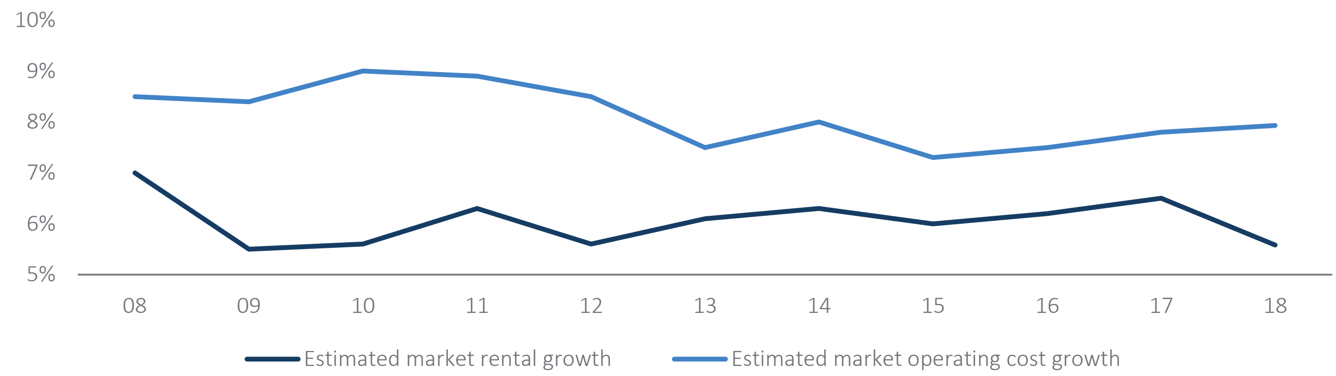
- Lower rental reversions when leases are due for renewal;
- deal lead strategies to fill vacant space when it arises. Evidence suggests that rent-free months (normally 3- to 6-month periods) are being offered, particularly in A- and B-grade office space; and
- lower transactional values as investment into the sector is either put on hold, or negotiations become protracted.

Overall though valuators have not materially altered the cap rates at which they are valuing property assets. To the extent that properties have changed hands, exit cap rates are in-line with those shown in the table below:

		MARKET CAP RATES	MARKET RENTAL GROWTHS
RETAIL	Super regional shopping centres	6.48%	5.75%
	Regional shopping centres	7.00%	5.80%
	Neighbourhood shopping centres	9.51%	5.92%
	Retail warehouses	9.92%	4.33%
OFFICE	CBD Johannesburg offices	9.92%	4.77%
	CBD Cape Town offices	8.89%	6.93%
	Non CBD Prime offices	9.24%	5.04%
	Non CBD Secondary offices	9.86%	4.87%
INDUSTRIAL	High Tech Industrial	9.60%	4.09%
	Standard Industrial units	9.95%	4.46%
	Aggregated average market cap rate	9.40%	
	Estimated market rental growth rate		5.08%

The aggregate average cap rate of 9.4% has not moved from the last SAPOA stats produced in May and those at the end of last year. However, there is evidence that market rental growth rates are trending downward and landlords are not able to contain costs in proportion to this. Thus, “negative jaws” are impacting income statements and distribution growth.

Figure 2: SA property market: Rental growth vs operating cost growth



Source: MSCI Real Estate, SAPOA

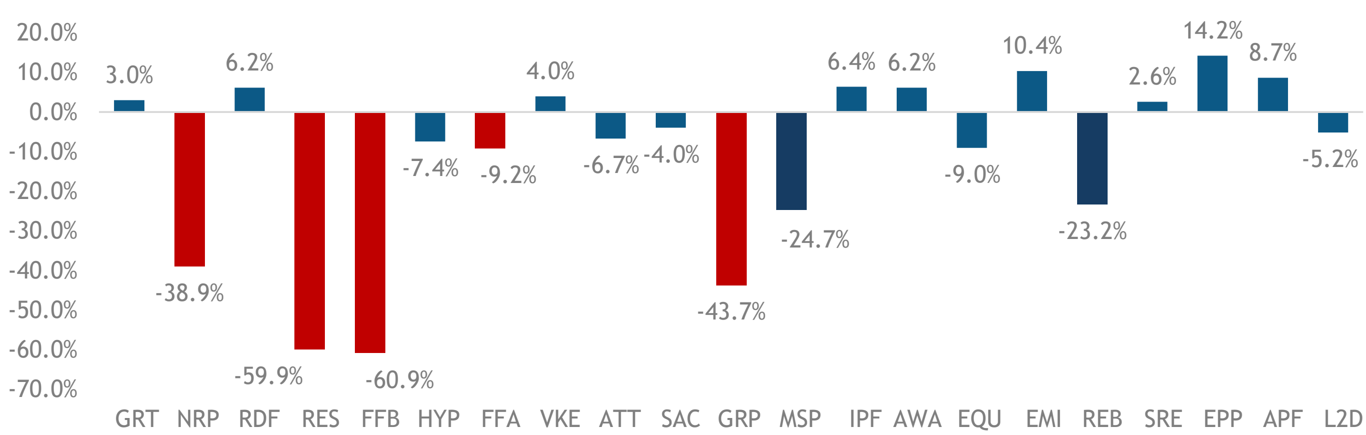
Based on these fundamental issues, combined with the fact that up until the end of 2017, listed property was a top-performing asset class over most measurement periods, some de-rating could have been forecast.

However, few would have expected the extent of the fallout as the benchmark has retraced by over 21% in the first six months of 2018. Analysis reveals that most of the pain has centered around a particular group of companies, who we will refer to as The Resilient Group. The individual companies in this stable – namely Resilient, Fortress, Nepi Rockcastle and Greenbay – had enjoyed tremendous success making accretive acquisitions, investing offshore in listed companies, and developing and acquiring property assets in growth markets in Eastern Europe, up until then unexplored. High ratings i.e. low dividend yields, meant that they could raise cheap equity capital and deploy it into markets where the cost of borrowing was below property stock yields, unlike SA where the reverse is true.

These stocks at one stage accounted for 42% of the benchmark index as their market caps grew significantly faster than any other local companies. However, in early 2018, reports emerged around their internal cross-holdings, capital raises and the accounting treatment of their BEE trust.

This coincided with offshore analysis (by the same organisation that had come to prominence during the Steinhoff scandal) casting aspersions on Capitec Bank's accounting principles. As SA investors became much more corporate-governance focused – and shy of headlines for the wrong reasons – these stocks sold off significantly. Figure 3 shows the extent of the pain during the course of 2018 until the end of May 2018.

Figure 3: JSAPY constituents performance (Resilient Group stocks highlighted in red)

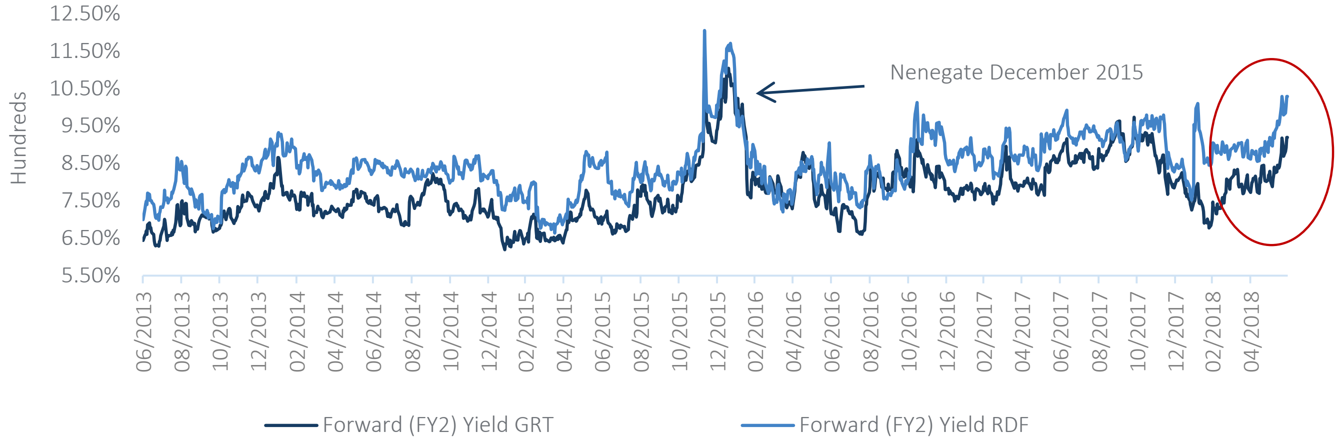


Source: Reuters, Anchor

All of the above-mentioned factors have conspired to make 2018 the toughest six months this sector has had to endure.

Although the hangover may last a while (because the party was a long one), the yields available to investors in the sector have seldom been more attractive. In addition, the derating in the listed property sector is disproportional to the valuations in the physical market. A good way of illustrating this is that when we compare the forward dividend yields of Redefine and Growthpoint they are similar to, or better than, the aggregate average across the industry (9.4%). Indeed, the forward yield of Redefine (10.2%) is higher at this point than it has been for the last five years, apart from the carnage that ensued following the firing of the Minister of Finance Nhlanhla Nene by ex-President Jacob Zuma in late 2015. The argument for these two index heavyweights and bellwether SA property stocks is that they have above-average quality portfolios of SA assets and also have offshore exposures in growth regions outside SA.

Figure: 4: Growthpoint (9.2%) and Redefine (10.3%) forward dividend yields



Source: Bloomberg; Anchor estimates

Although there may not be any "quick fixes" for the sector, and the losses sustained by the Resilient Group are probably a permanent impairment of capital, our conclusion is that this is a very good entry point for investors. Catalysts that we would look for that would gradually re-rate the sector over the next 6–12 months include:

- Property companies being transparent in their reporting and paying distributions out of recurring, genuine, rental and property income.
- The controversies surrounding the Resilient Group fading with the passage of time, including an all-clear from the regulators still investigating certain dealings and capital raises.
- Corporate actions. Apart from some property companies in their own right being able to do yield-enhancing deals, it is possible that private equity and investment companies will begin to take a long, hard look at listed-property assets given current yields.

In conclusion, although fundamentals currently favour tenants, not landlords and growth in distributions are under pressure as a result, we believe that investors with a 12- to 24-month time horizon will be rewarded.