Return Drivers and risks in the SA Listed Property Sector

Exceptional Past Performance

In South Africa the listed property sector is one of the most contentious areas of the JSE. In the one corner you have the property bulls: long-time supporters of the notion that reliable and growing income streams out of property shares make sound long term investments, and buyers needn't be too sensitive to the valuation of the shares they invest in. Income will prevail.

Property has also found favour amongst direct investors, in their personal capacity, outside of the professional fund management domain. It is a tangible, relatively simple to understand asset class and we have just seen a 25-year bull run. This has created substantial personal wealth, in part due to increasingly low debt costs. Investor appetite has fuelled the bull argument.

In the other corner are the property bears, those fund managers who are valuation sensitive and who have for the most part avoided listed property over the past 20 years as it has escalated in price.

Needless to say, the bears have been soundly beaten by the bulls, with property by some margin the best performing asset class in South Africa over the past 25 years, with returns above inflation averaging 13 – 16% per year.

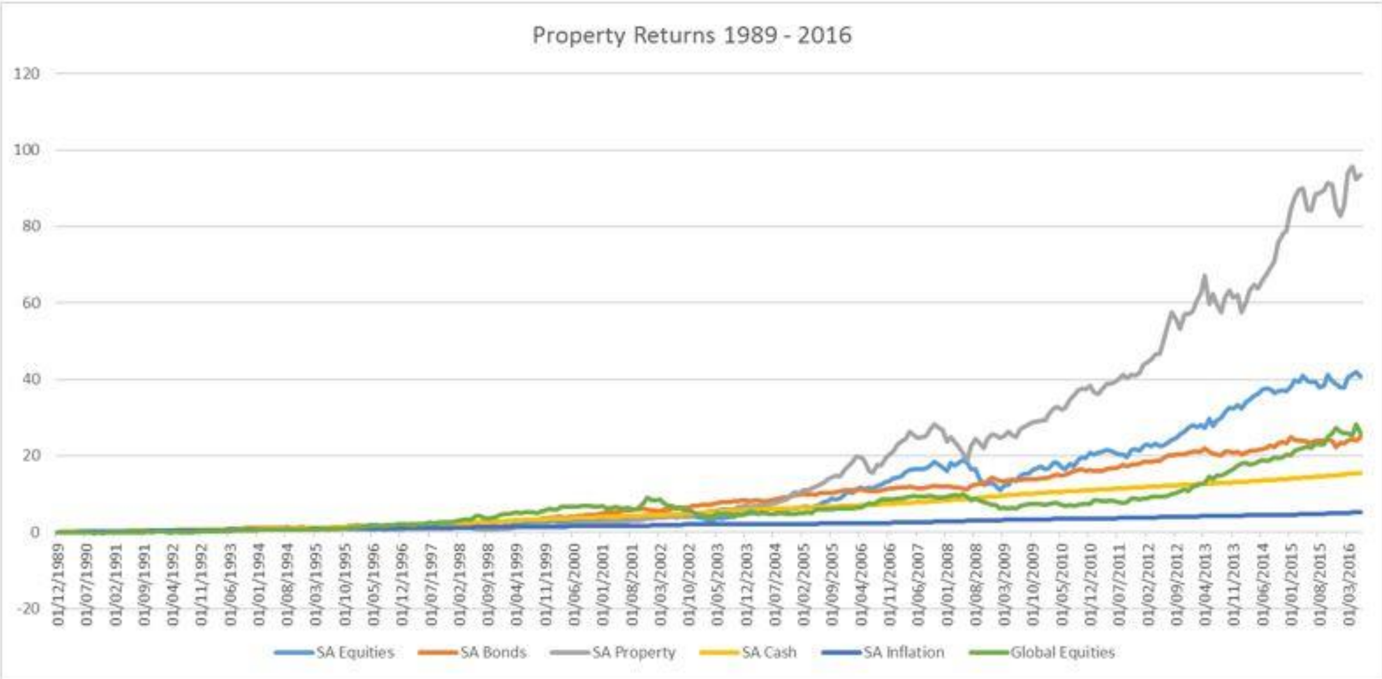

Chart 1: Total returns of asset classes

By all accounts, the property sector is now 'priced for perfection', with a record high valuation premium across the sector and income yields a fair amount below what one would receive in money market. Yet there is still a strong disagreement between the bulls and the bears. What gives?

Chart 2 below, shows how the property sector has rerated upwards in value since the turn of the millennium. The blue bars show how the capital gain component has dwarfed the income generated. In 2002, investors could receive 16% in annual income distributions on their capital invested; in 2016 this is closer to 5%.

Your return on investment from income is now a third of what it was in 2002. Granted we have a lower interest rate environment which explains some of the difference, however property is also now trading at a long term record premium to government bonds, with which it shares numerous return drivers.

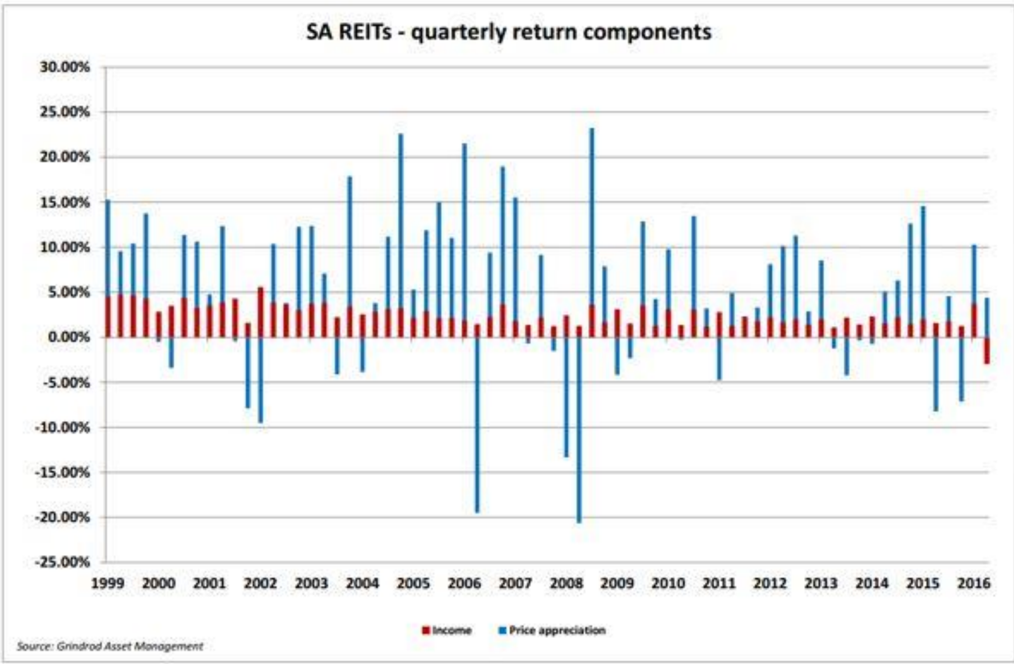

Chart 2: Income vs capital returns from property (source: SAREIT Association)

Where are we today?

To understand this exceptional performance, it is worth exploring a few traits of South African listed property in more detail. Firstly, not too long ago there wasn't a listed property sector, or rather, one with any meaningful investable assets. The property sector is relatively new, particularly within the REIT (Real Estate Investment Trust) format. Total market capitalisation of shares has risen from almost zero in 1998 to R350bn in 2016. The impact of this historic small size has been that the asset management industry has been structurally underweight property since its inception. The investable assets simply weren't there for large amounts of retail and institutional savings to invest.

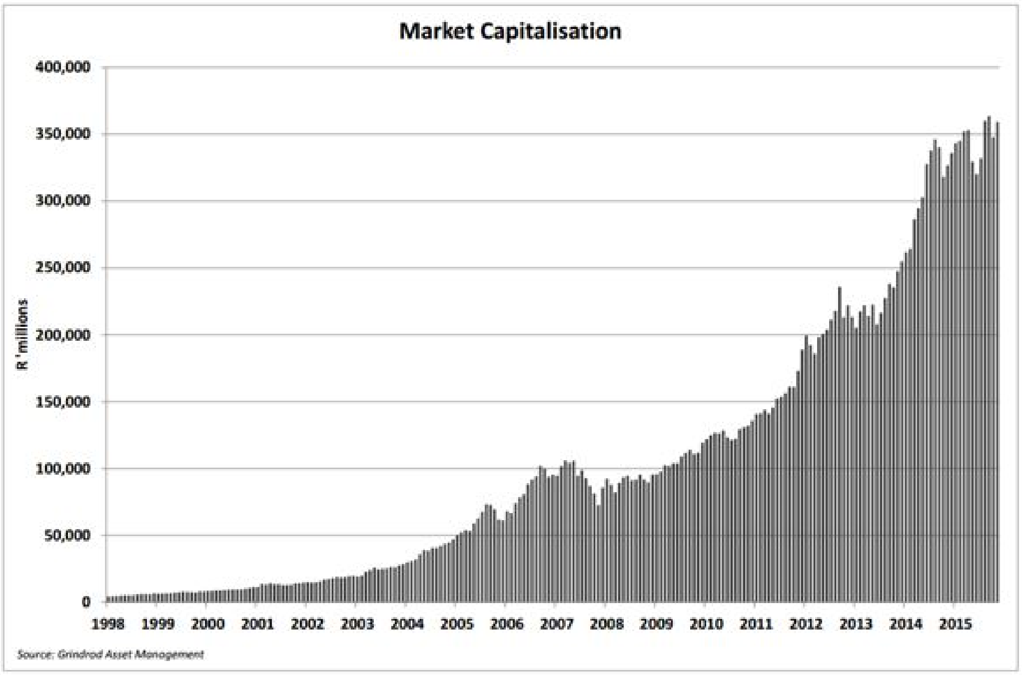

Chart 3: Market Capitalisation growth of the property sector (source SAREIT Association)

The outcome of this is that there appears to have been a substantial underpin to property share valuations, as asset managers are pushed to hold even a nominal position across their portfolios. Demand outstrips supply, and as with any tradeable instrument, the price is inclined to go up not down.

There are also a substantial number of new listings which have entered our market over the past few years. With local investors prepared to pay record high valuations for property, SA has found itself as a leading destination for inward listed companies looking to raise capital. Interestingly, much of this new capital finds a home outside of SA, in regions like Eastern Europe where it is ultimately invested.

The rerating of the sector however has been the main driver of this, as investors are prepaid to pay more and more for the 'reliable and growing' income streams attached to bricks and mortar investments.

For the most part, local property companies have built bigger, better, quality diversified portfolios of shopping centres, commercial use and residential assets, and they have delivered on the distribution growth to investors, in line with inflation over the period. Given this improvement, some level of rerating is justified, but how much?

What are the risks?

This imbalance of supply and demand, in addition to record high valuations, need to also be taken in context. South Africa at present is far from a safe, strong and growing economic environment, and property is typically a pro-economic asset class. With record high valuations, what are the risks?

- Risk # 1: Earnings support for the 'reliable and growing' income streams. Property company earnings are a lot less stable than the average investor may expect. The ability to leverage through debt, develop new assets and expand offshore means underlying earnings are quite variable. The property investor expects stability though, and as such the companies are under pressure to manufacture these safe looking income streams. Increasingly, this poses risks in terms of how companies are able to maintain attractive income streams in the face of growing economic pressure on earnings. It's at times like this we tend to see more 'financial engineering'. See Chart 4 to gauge how variable earnings are converted into 'safe' distributions.

Chart 4: Earnings: a variable underpin to 'safe' distributions: 2002 - 2016

- Risk # 2: The use of newly raised capital: many local companies have seen Eastern Europe as a destination which is attractive, particularly given we in SA have an emerging market environment, and are more comfortable with the relative risks. It does seem to us that this is not all it appears to be, with certain segments posing substantially higher capital risk to investors relative to the income streams derived.

- Risk # 3: Stock Index changes have also had a major impact on the market. Again due to the relative small size of property, it is quite evident that stocks are bought and sold in size as they enter or depart the relevant stock index. This serves to push up the value of large index stocks, and push down the value of smaller non-index stocks.

Prospects

At current yields of around 6% on a 12-month forward basis, the aggregate sector poses substantial capital risk to investors. Particularly as earnings come under pressure, the ability to pay strong, growing income streams becomes increasingly harder. Investors need to expect a large component of capital growth to justify the valuations, and this is hard to see. If distributions start to disappoint, we may see much of the 'property premium' rerate downwards. There has been some evidence of this already.

There are however a smaller set of domestic oriented shares which have not been caught up in the hype, and have in fact been sold down as they exit the respective index and fall off the radar. This basket of shares can trade at up to double the income yield of the total sector, providing decent valuation support and a lower risk earnings and income profile with stronger growth. It does mean heading into the smaller shares though, not the domain of most fund managers with substantial assets to invest, and as such, as in the past, most investors will miss out.

Now more than ever it pays to be contrarian and selective in the property sector. Buyer beware.

31 July 2016

Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol[1]	10yr Vol[1]
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.1%	5.5%	4.5%	11.8%	14.5%	12.9%	11.2%	15.2%
FTSE/JSE SA Listed Property	ZAR	0.8%	13.2%	9.0%	17.2%	18.9%	19.4%	14.0%	16.1%
SA All Bond Index (ALBI)	ZAR	4.7%	13.7%	6.4%	7.4%	8.1%	8.5%	7.9%	7.5%
SA Cash Index (SteFI)	ZAR	1.8%	4.1%	6.9%	6.2%	5.9%	7.3%	0.2%	0.6%
Balanced Benchmark [2]	ZAR	1.1%	5.1%	7.5%	12.4%	14.9%	12.7%	6.3%	6.3%
SA Inflation (1 month lag)	ZAR	1.6%	4.5%	6.3%	5.9%	5.7%	6.2%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	3.6%	4.9%	-0.5%	6.6%	7.9%	4.8%	13.2%	16.5%
Emerging Markets Equity (MSCI EM)	USD	5.2%	11.8%	-0.7%	-0.3%	-2.7%	3.9%	19.0%	23.6%
Global Bonds (Barclays Global Bond Index)	USD	2.3%	9.8%	9.4%	2.6%	1.5%	4.4%	4.3%	5.7%
Global Cash	USD	0.1%	0.3%	0.4%	0.2%	0.2%	1.3%	0.0%	0.5%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.1%	5.5%	4.5%	11.8%	14.5%	12.9%	11.2%	15.2%
Global Equity (MSCI World)	ZAR	1.3%	-6.1%	9.4%	19.2%	24.8%	12.3%	13.0%	13.8%
Emerging Markets Equity (MSCI EM)	ZAR	2.8%	0.0%	9.1%	11.5%	12.4%	11.4%	12.7%	15.7%
SA All Bond Index (ALBI)	ZAR	4.7%	13.7%	6.4%	7.4%	8.1%	8.5%	7.9%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	0.0%	-1.8%	20.3%	14.8%	17.4%	11.9%	12.9%	14.5%
COMMODITIES									
Gold (US Dollars)	USD	5.0%	27.3%	24.0%	0.4%	-3.8%	7.7%	19.4%	19.3%
Gold (Rands)	ZAR	2.6%	13.9%	36.3%	12.3%	11.3%	15.5%	20.1%	21.6%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	-2.2%	-10.5%	9.9%	11.8%	15.6%	7.2%	15.2%	16.6%
Rand / GBP Pound	ZAR	-11.4%	-19.4%	-6.5%	7.0%	10.8%	3.6%	13.8%	15.0%
Rand / Euro	ZAR	-4.6%	-7.9%	11.2%	5.6%	10.0%	5.8%	12.9%	13.7%

Spot Rates

31-Jul-16		3-Aug-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Rand/US$	Rand	13.92	14.70	12.17	6.76	7.15	4.33
Rand/GBP	Rand	18.53	19.56	19.07	10.83	13.22	6.71
Rand/EUR	Rand	15.52	16.31	13.54	9.80	9.09	5.14
Rand/Aus $	Rand	10.56	10.97	9.36	7.24	5.31	3.42
Libor 6m $	US$	1.14	0.92	0.44	0.40	5.59	N/a
Prime	Rand	10.50	10.50	9.25	9.00	11.00	20.50
Repo Rate	Rand	7.00	7.00	5.75	5.50	7.50	N/a
All Bond Index Yield	Rand	8.71	8.84	8.51	8.72	10.00	13.72
Gold ($/oz)	US$	1,364.02	1,321.86	1,172.97	1,500.91	614.25	381.15
Palladium	US$	706.00	589.00	677.00	761.00	312.00	132.35
Platinum	US$	1,167.50	1,023.00	1,078.00	1,725.00	1,227.50	389.00
Oil (Brent Crude) $	US$	42.96	50.06	63.35	111.85	72.85	19.05
SA Inflation	Rand	N/a	6.30	4.70	5.00	4.90	6.90

data provided by Profile Data Analytics and INET BFA