

## ECONOMY

# Listed property crawls through the fog of miserable growth

**Thobelani Maphumulo**

Since late 2017, the listed property market has suffered major setbacks due to the anaemic domestic growth environment. This poor growth has contributed to an increase in vacancy rates and tenant failures, negative rental reversions, rising costs of occupancy and a deceleration in income distribution growth rates.

Property is an economic-sensitive asset class whose fundamental drivers closely track the country's GDP. In 2018, the SA listed property index (Sapy) recorded a negative 25% total return, the worst listed property index return since 1995. Year to date, the sector has posted a 3.1% total return, underperforming SA equities (8.7%), SA bonds (9.4%) and SA cash (5.7%).

The listed property market has three main sectors: retail, office and industrial. The retail sector has been adversely affected by a slowdown in trading density (sales divided by square metre) growth.

Furthermore, retail sector vacancy rates of 4.2% are above the long-term average of 2.9%. Vacancy rates directly reduce rental income and contribute to the decline in income distribution growth. Basic rental growth has slowed from 5.5% in 2017 to 4% in 2019.

The retail sector's cost of occupancy – gross rental to sales – has been rising over the past four years, especially in super-regional and small regional shopping centres. Community and neighbourhood centres have fared better. The increasing gap between gross rent and sales has squeezed operating income and lessened the demand for space, contributing to negative rental reversions at lease expiry.

The office sector's vacancy rate is about 12%, a massive drag on rental income and income distribution growth. There's certainly a glut of office space in the market. Against this backdrop, the increase in new office developments in the Johannesburg north node is perturbing. In addition, low business confidence does not bode well for the office sector, in the near future at least.

Unfortunately, the public sector has not been a great tenant to its landlords. For example, Delta Property Fund recently distributed 75% of its earnings, due largely to the slow pace of lease renewals by the department of public works. Real estate investment trusts are supposed to distribute 100% of their earnings to shareholders.

The industrial sector is a better performer than retail and office. Vacancies declined from 3.7% in 2017 to 3.6% in 2018. Counters that have high exposure to industrial properties have, to a great extent, weathered the storm. Equites Property Fund is the

only listed company that gives investors perfect exposure to logistics and warehouse assets; 98% of the portfolio is in industrial properties. It is noteworthy that most counters' industrial sector weightings range between 10% and 30%. Evidently, the listed property sector is dominated by retail and office.

Property companies' operational performance has been made worse by rising costs due to escalating municipal charges. Since 2005, operating costs have increased 8.8% on a compound annual growth rate basis. Operating costs account for more than 50% of base rentals and 35% of total income (after adding tenant recoveries).

There is some good news for long-term investors.

First, according to Stanlib listed property head Keillen Ndlovu, the sector is trading at a 15% discount to net asset value, below the long-term average of 10%. Second, the sector dividend yield (9.5%) is higher than the 10-year bond yield (9%), and this could lead to yield compression in future. That said, it is important to stress that bonds are basically long-term fixed deposits that provide guaranteed coupon payments. By contrast, property dividends are derived from company earnings. On a risk-adjusted basis, the comparison has shortcomings.

## PROPERTY COMPANIES ARE NOT HIGHLY INDEBTED. THE LOAN-TO-VALUE RATIO, AT 37%, SHOULD NOT CAUSE PANIC

Third, local property companies have 47% exposure to offshore assets (Eastern Europe, Central Europe and the UK). Poland, Romania and Bulgaria and others are benefiting from decent economic activity.

By contrast, the UK economy is in the doldrums but it is a subsector bet: warehouses, logistics and storage assets are performing better than retail.

Fourth, property companies are not highly indebted. The sector's loan-to-value ratio, at 37%, should not cause panic. It is well below debt funders' 50% threshold.

Despite these positive factors, there's still a fog on the road. The listed property sector is not likely to outperform risk-free asset classes – bonds and cash – against the backdrop of pedestrian consensus GDP growth forecasts.

● *Maphumulo, a former fund manager and author of a book on investment, is executive director at TMGI Property Investments.*