Why we're *positive* on property

(although it's a little lonely out here)

As a boy growing up in Johannesburg, I used to scour the property sections in the Saturday newspaper. *(While this may sound like an unusual childhood pastime, I've been told by the team that it comes as no surprise).* Over time, I got a feel for the value of properties in different areas and could see when there were potential bargains on offer. A good number of years later I bought my first property, did some renovations and ultimately sold it.

by Tyron Green

After moving to Cape Town, it took me four years to buy a home. This was a new market I had to research – and house prices were around double those in Joburg. But I did come across a property I thought offered good potential: an old house in Newlands, which I also renovated and later sold.

Finding these properties involved a fair bit of luck. But it also required time to investigate the areas in which they were located and an understanding of market dynamics to assess if they could offer a decent return.

I'm still on the hunt today

But now as part of a research team and on behalf of the clients invested in our funds. Therefore, there are a few differences. The properties our funds invest in are owned and managed by listed companies operating under a structure known as a Real Estate Investment Trust (REIT). This exempts them from both company and capital gains tax, if they pay out most of their earnings as dividends to shareholders. Our funds own shares in selected REITs, and therefore shares of their underlying properties. These may be residential (e.g. apartments), commercial (e.g. offices), retail (e.g. shopping centres) or logistics related (e.g. warehouses).

And this is where the similarities come in. Because just as you'd consider for a personal investment (whether to buy and resell, or to buy and rent out), there are common factors to look for. Where is the property located and is there good demand from buyers or tenants? How many other developments are being built and could this dampen demand? If leasing the property out, how much is expected in rent – and could this increase over time? It is also important to consider property financing and whether this includes debt. How much of the bond repayment will rental income cover? And is there some wiggle room to provide for potentially higher instalments if interest rates aren't fixed and policy rates rise?

REITs usually buy properties using a mix of cash and debt, targeting an overall 'Loan to Value' (LTV) of around 40% (meaning that the property portfolio is 40% debt funded and 60% cash funded). To aim for stability and growth in dividends, a well-managed REIT generally tries to fix the interest rates on its debt (thereby avoiding pressure on cash flows if interest rates rise), consistently grow rentals (through contractual escalations) and keep expenses low (so that rentals grow faster than expenses). When evaluating potential investments, we therefore look for strong balance sheets (low LTVs with longer-dated and diversified sources of debt), sensible interest rate hedging policies and the ability to generate healthy cash flows that can grow. Given that we're investing in a company and not merely a building, we also conduct a thorough management and governance review.

An investment truth from both my personal and professional experience:

Property moves in cycles

Property values (and REIT share prices) move up and down in cycles, which can take years to play out. This can create opportunities as these cycles get close to peaking or bottoming, because share prices tend to be amplified around property values as extreme optimism moves to extreme pessimism (or vice versa). When times are good, interest rates are low and economies are firing, costs to finance new buildings are low and demand for property is strong. Office blocks are fuller, shops are busier and more people can afford their own place to stay. Demand outpaces supply, which results in rising property prices and higher rent. This is usually when more developers want to get in on the action and extra space is built until the supply and demand equilibrium reverses. With property in oversupply, the market becomes more competitive. Vacancies rise, rentals come under pressure as landlords try keep existing tenants, and property prices decline.

We have been in a down cycle for some time now, especially in the retail and office sectors. In retail, a longstanding narrative has been the threat posed by online shopping, with many predicting the slow but inevitable death of brick-and-mortar trade. The Covid pandemic heightened these fears as in-store shopping was restricted, accelerating the adoption of online alternatives and forcing the closures of outlets that were unable to adapt or stay afloat for long enough. Similarly, as workplaces emptied and working from home became the new normal, the values of office blocks plummeted. Given that many employers have since stuck with this model or have implemented hybrid working policies, the sector remains out of favour. Overall sentiment has been driven lower still by an environment in which inflation – and therefore living costs – are rising, while higher interest rates place growing pressure on both individual and corporate balance sheets.

When conditions seem most dire, sparks are most visible in the gloom

Many REIT management teams are commenting that they believe we are at or close to the bottom of the current cycle – and our process has uncovered what we believe to be several stand-out opportunities for outsized returns once the cycle turns. While we cannot predict when this will be and the ride may yet be bumpy if we are early, we are confident in the fundamentals of the REITS we have chosen to invest in and in the durable attractiveness of their property portfolios.

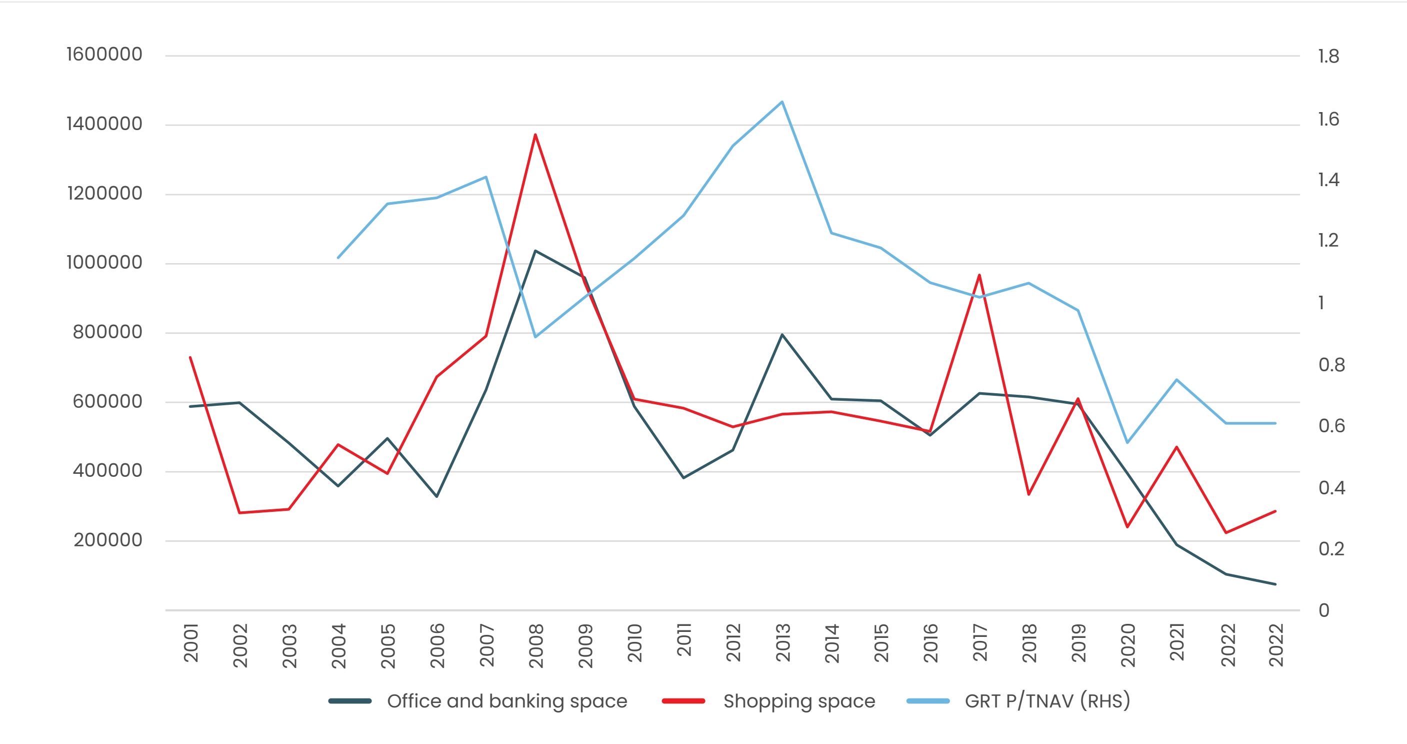
Growthpoint offers access to a well-managed, diversified income stream

Growthpoint is South Africa's largest REIT with exposure to retail, industrial and office space in South Africa; industrial and office space in Australia; and the retail sectors in Europe and the UK. The company is also involved in property development and has started a local fund management business focused on the healthcare and student accommodation sectors. This means that an investment in Growthpoint provides diversification across sectors and geographies, along with a solid asset underpin: properties have already been subject to significant write-downs and are currently recognised at below replacement cost on Growthpoint's balance sheet.

In line with broader trends, Growthpoint's property portfolio – and share price – have come under pressure in recent years. The value of its office portfolio alone has declined by 24% since its peak in 2018, while its retail portfolio is down 20% and its industrial portfolio down 10%. Its share price currently trades 56% below its 2018 peak. However, in its last reported results for the period ending December 2022, valuations in all three sectors had turned positive.

The graph below provides one illustration of how the property cycle has played out in South Africa since 2001. We've focused on the retail and office sectors, as this is where Growthpoint's primary exposure is. When considering the number of building plans completed, we can see clear spikes and troughs as property has moved in and out of favour (with construction activity following suit). The downward cycle observed over the past five years is evident. We have also included Growthpoint's share price relative to the Net Asset Value (NAV) of its portfolio (i.e. total property values less debt). In good times, the share price trades at a premium to NAV, with positive property trends and sentiment resulting in the company being valued at more than its asset base. Currently, its shares are trading at a discount to NAV – even though property values have been written down significantly. Furthermore, data show that building activity has pulled back meaningfully, vacancies are reducing and rentals are stabilising.

Figure 1: Growthpoint share price/NAV vs. building plans completed (sqm)



Sources: Statistics SA, S&P Global Ratings

Unibail and NewRiver:
Retail is not dead

Two of our global investments are focused on retail properties: Dutch-domiciled Unibail Rodamco Westerfield (Unibail) and UK-based NewRiver. While Unibail operates and manages large retail shopping malls primarily based in Europe (72%) but also in the US (22%) and the UK (6%), NewRiver focuses predominantly on value retail outlets and community shopping centres in its home country. Both have been caught in the negative narrative surrounding the retail sector but have managed to hold up due to attractive property fundamentals (with proximity and ease of access being a key priority). They have also each undertaken reforms to position themselves more favourably once conditions improve.

Having weathered significant property write-downs of as much as 54%, Unibail has taken decisive action to strengthen its balance sheet. Under new management it cut its dividend in favour of reducing debt and is running its balance sheet more conservatively. Now, Unibail holds a significant proportion of long-dated debt, has sufficient liquidity to cover all debt maturing in the next three years and has implemented a long-dated interest hedge, which will provide a buffer in a rising rate environment. Sales in its malls have returned to above pre-pandemic levels (exceeding the national average across all its regions) while rental income – which in Europe, is based on the inflation index – looks set to grow and management is guiding towards resuming dividends.

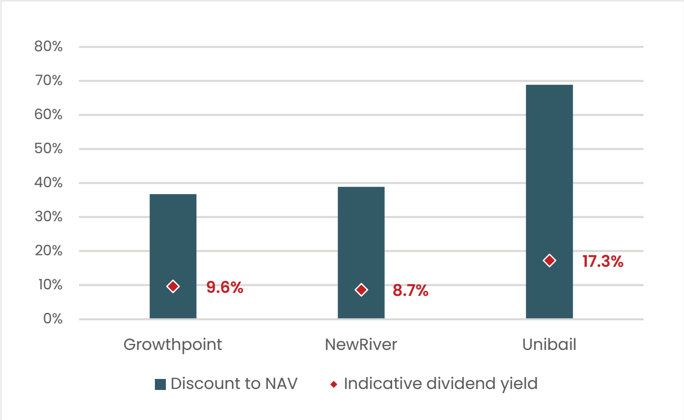
NewRiver revised its strategy at the end of 2021, selling its former pubs portfolio to focus exclusively on retail and using the proceeds to pay down debt. Despite meaningful asset write-downs in 2020 and 2021, occupancy rates and tenant retentions remained high and steady throughout Covid – evidence of both the attractiveness of NewRiver's retail space and of strong tenant relationships. Valuations have since started to stabilise (with the valuations of core properties ticking up slightly) and rental income is back close to pre-pandemic levels. In addition, the company's balance sheet remains robust, with a low LTV of around 33%, no debt maturing in the next five years and interest rates fixed for the next five-and-a-half years.

We're comfortable to take a longer-term view

We believe that the REITs we have invested in offer a margin of safety, evidenced by their rental yields and the discounts to NAV at which their shares are trading. It is worth highlighting that these NAVs are based on property values that have been written down significantly – in many cases, to below what it would cost to rebuild the properties. Ultimately, the cycle will turn as there is no incentive to build new properties but rather to pay up for existing property. With supply becoming more constrained, vacancies should fall and rentals should increase. And as property values start to reflect these improved fundamentals, so too should REIT share prices.

I am currently renting a home and rather investing in REITs, both through our funds and directly to increase my exposure further. The much unloved prices of listed property look like a stand-out opportunity to me. I expect that the cycle will turn but I'm in no rush, because I am a happy tenant and will be the recipient of a generous dividend stream from my listed property investments while I wait. And that is really why I wrote this note to our clients: please be prepared to wait with us. Our investments in property could pay off very handsomely, but it will take time.

Figure 2:
Attractive valuation buffers



Sources: Company reports

Granate is a people business.

We are committed to creating a rich and rewarding culture through our shared values. Granate is configured thoughtfully and intentionally so that our team can thrive for the benefit of our clients. We care about the same things you do and are *relentlessly* **committed to protect and grow your savings**.