Sailing the waves of the property cycle

" Not ALL treasure is silver and gold, mate."
Captain Jack Sparrow

When you invest in listed property shares, you are investing in a cyclical industry. These cycles can be decades long from peak to trough, a lengthy voyage with prolonged ups and downs. We closely monitor different cycles for investment opportunities. Often the fundamentals improve long before the market is prepared to dip a toe back in the water as old wounds have not yet healed.

When everyone was enjoying the journey

There was a time when the market was besotted with listed property. It was a stalwart in many South African multi-asset unit trusts. Net asset values (simplistically, the value of the physical properties net of debt held against them) were soaring, and dividends were flowing into investors' pockets. It felt good. So good that investors were willing to pay a lot more for listed properties than they were being valued at in the physical market. Money was cheap for these listed companies at the time: lenders were lining up and the equity market was ready to throw more in the pot. Therefore, significant profits could be made by developing real estate projects. Capital could be raised cheaply, and properties could be sold while they were in high demand. Companies sweated their balance sheets, increasing debt to buy more assets and to pay the growing dividend stream investors were expecting. There were many yachts on the water sailing with the breeze at their backs.

Then the breeze became unruly

New property supply coming to the market began to surge ahead of demand. The balance of power swung from the landlord to the tenant. Vacancies increased, rental reversions decreased, net asset values were written down, dividends were cut and property companies had to sell assets to plug the holes in their stressed balance sheets. Then COVID came along, with people avoiding shops while navigating novelties like Zoom as they settled in to work from home. Although retail footfall ultimately recovered, property companies were left with significantly weaker balance sheets and lingering elevated office space vacancies. And just when things could not get much worse, interest rates increased in response to post-COVID inflation. The perfect storm hit as banks and investors were now far less interested in providing these companies with capital. They had to suspend cash dividends, further driving down the appetite for owning their shares.

With the calm waters and gentle breeze long forgotten, property shares lost a lot of value and could only be sold at significant discounts to already written down net asset values.

Off we set

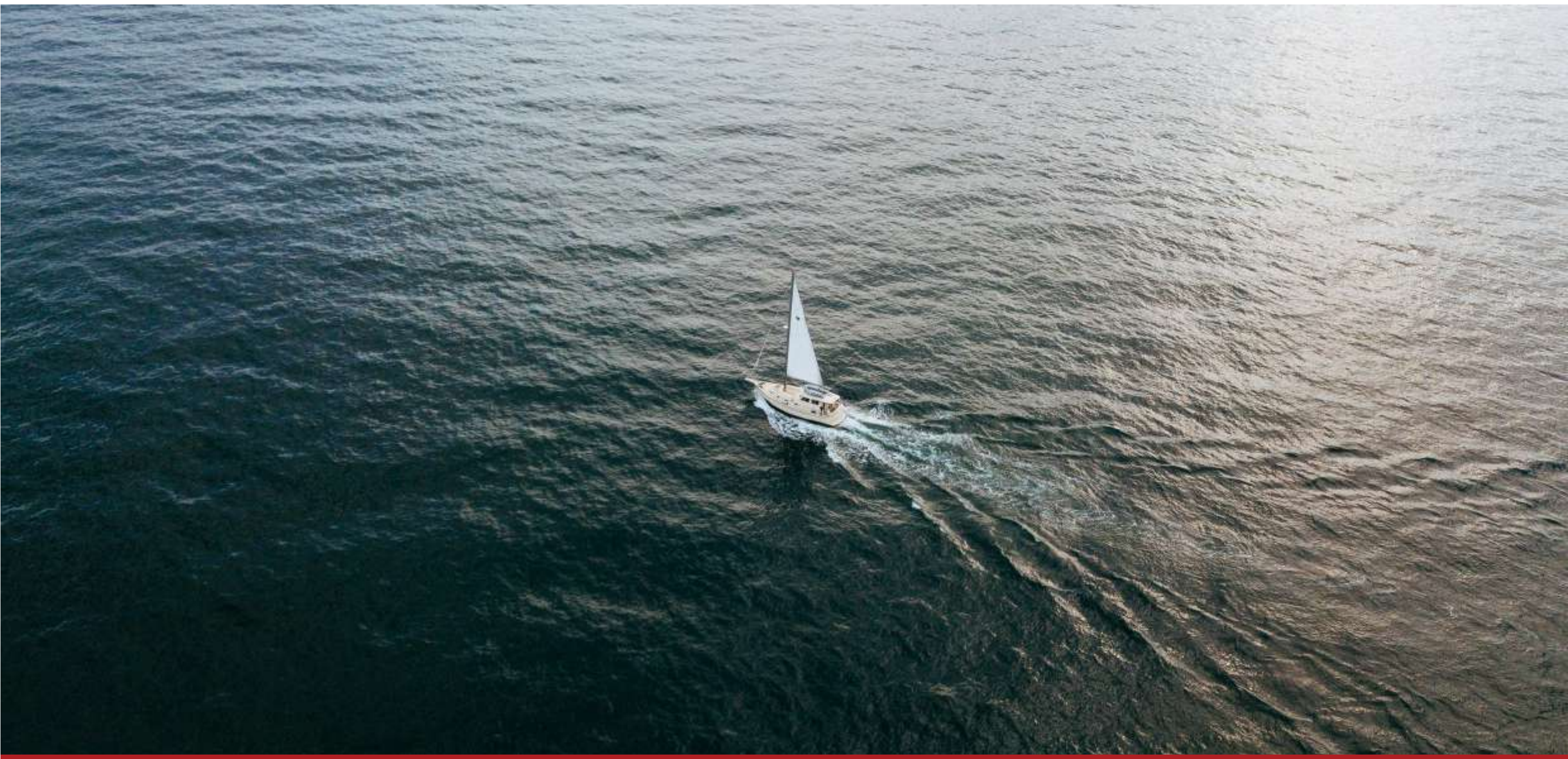
Near the end of 2022, signs emerged that things were starting to improve in the much-maligned sector. Increased demand (in the shadow of very limited new properties being built) prompted stabilising-to-improving vacancies in office space, and a healthy recovery in retail property demand. However, headwinds remained in the form of elevated interest rates, highlighting the importance of discerning stock selection. It was time for us to set sail. We started buying property shares that matched our very specific criteria. Conditions could remain testing, so we only had interest in the best properties with the strongest balance sheets. Fortunately, all listed property names were trading at deep discounts, so we could buy the best without paying up.

It was hard to spot many other yachts leaving the harbour. We were embarking on a lonely passage. Fortunately, cash dividends started to return in some of our investments, providing some comfort in solitary seas. Perhaps we were also silently hoping someone would tell us we were not completely bonkers. Few obliged.

"Are you reducing exposure?"

Over the past 12 months we have witnessed marginally increasing investor appetite for property shares. This has had a positive price impact, driving property to be one of the better performing asset classes over the period. Considering these positive returns, we are frequently asked if we are now reducing our property exposure and banking some profits.

The answer is no. Quite the opposite. Our property exposure in the Granate BCI Balanced Fund has increased from 15.6% in May 2023 to 17.7% in April 2024.



Exposure in the Granate BCI Flexible Fund has increased from 10.7% to 16.9% over the same period. This increased investment is due to three simple reasons.

Firstly, while some of our property holdings have delivered strong returns, most haven't. For instance, Growthpoint's share price is still securely moored to the jetty of pessimism. Secondly, we are building higher conviction in the shares we own as we see encouraging evidence of a continued recovery in their results. Lastly, for the shares we own that have appreciated in value, we think we are only at the start of a long journey. The share price of Unibail-Rodamco-Westfield, which owns well-located malls in the UK, Europe and USA, has increased from €44 to €79 over this time. It remains one of the largest holdings in the funds as it continues to trade at almost half of its net asset value. In the heydays, it traded at 70% above its net asset value. The odyssey could indeed only just have begun.

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