

South African real estate – rebuilding its asset class profile

FROM THE DISCOVERY FLEXIBLE PROPERTY FUND MANAGERS AT



Real estate has a unique return profile: it offers investors the income feature of fixed-income assets while still providing a growth path that is only slightly lower than that of its equity counterparts.

Investors benefit from a stable income yield with income growth typically above inflation, and the potential for capital appreciation. These characteristics generally make this investment class an appropriate building block in a diversified or multi-asset portfolio. Many property companies that manage real estate are listed on our stock exchange, providing a convenient entry point into the asset class. Investors in listed property stocks not only enjoy the unique return profile of real estate, but they also have the added benefit of greater diversification, liquidity and management expertise.

However, over the past decade, the South African listed real estate market has diverged significantly from the typical return profile investors have come to expect from this asset class. The sector has been plagued by unsustainable earnings, governance issues, ever-increasing debt levels, and deteriorating local conditions, culminating in the highly visible sectoral decline. Although the past five years have been rather tumultuous for the listed real estate sector, we believe a return to more sustainable business practices should result in risk–return characteristics that mirror that of direct property. Listed real estate companies have had to employ a number of turnaround strategies. This process started even before the impact of the COVID-19 lockdowns.

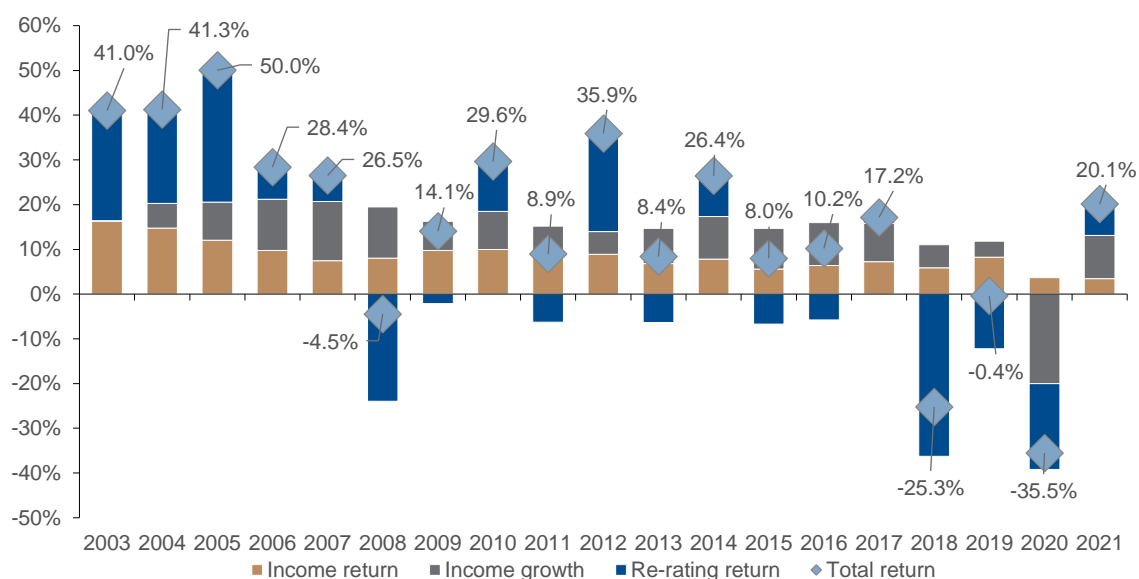
Although the process will likely continue to be slow, listed real estate companies are focusing on creating sustainable businesses rather than once-off fixes that fail to resolve the core issues. We

believe the sector is well positioned to again produce the risk–return characteristics that have made it a key building block of multi-asset portfolios on a global basis:

1) Stable income return

The key characteristic of real estate is the stability of income streams. While the COVID-19 crisis has caused a break in this long and stable history, 2021 is likely to show the return of this income underpin.

Figure 1: Return components of South African listed real estate over time



The latest statistics from property companies show a strong recovery in rental collection levels to 95%, and in some cases, in excess of 100% in a particular month. While we have seen an increase in vacancies and negative rental reversions, at least 80% of income generated from real estate companies is stable and growing in line with inflation. In many cases, income growth is much higher than inflation. The listed real estate space is offering an attractive yield of around 9% (after the introduction of payout ratios) and is likely to grow handsomely over the next 12 months driven by the depressed COVID-19 earnings base.

2) Inflation hedge

The built-in contractual escalation in leases has come under pressure over recent years as inflation has declined and the economy has struggled to generate growth. While the 8 – 10% escalation seen historically is now largely in the past, we continue to see escalations of 5– 7%, still well ahead of inflation.

As noted, vacancies and negative rental reversions are likely to detract from growth. However, they make up less than 20% of the earnings base. While certain subsectors are likely to have

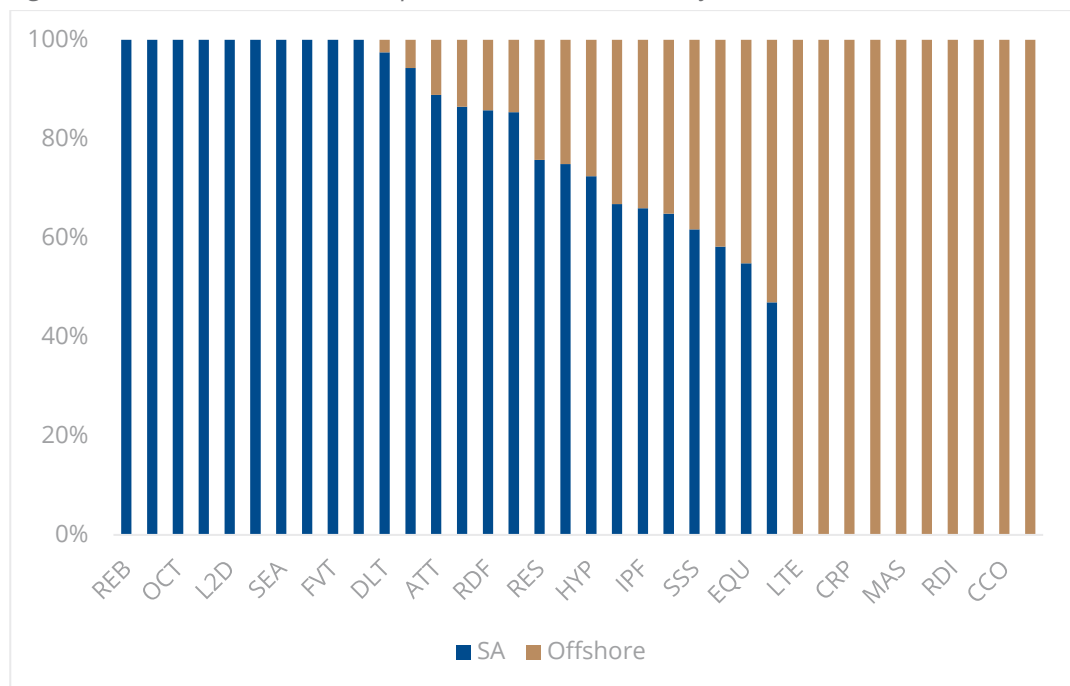
greater growth challenges because of structural issues or oversupply, diversification within the sector means the inflation hedge characteristics remain intact.

3) Risk diversification and liquidity

The South African listed real estate universe continues to be well diversified. Approximately 45% of the sector has international exposure either via direct asset exposure or other listed holdings. The universe is also diversified from a subsector perspective, with representation across retail, office and industrials. More niche sectors such as storage, residential and hospitality properties are also represented, albeit to a lesser extent.

This broad opportunity set helps to diversify risk and also provides attractive investment opportunities. As the market stabilises, we should see some sector consolidation. We are supportive of corporate action that further increases liquidity to the sector.

Figure 2: Local vs international exposure within the South African listed real estate universe



4) Access to quality assets and well-aligned management expertise

The current global trends have seen a shift in preference away from the traditional subsectors, including office and retail, to other subsectors such as logistics and storage. Shifts in subsector preferences typically happen when the cycle changes.

Whether the preference lies in super regional shopping centres or storage facilities, the growth of the property sector over the past two years has consolidated the best-in-class assets under these listed umbrellas. The sector is likely to see a substantial slowdown in asset growth in the near term, but the quality of the current asset base should remain intact.

CAPTURING THE UNFOLDING RETURN OPPORTUNITY

Over the past six months, the listed property sector has shown the first signs of recovery. The COVID-19 crisis has created an unprecedented environment, particularly for real estate markets where buildings were under enforced shutdowns. Fortunately, the data indicates that the fallout from COVID-19 will not be as severe as was initially expected. However, there will be a lasting impact on the economy and therefore the sector.

In our view, the challenging fundamentals are offset by supportive valuations. The sector trades on a forward yield of +9% (10.5% for South Africa only) and a 30% discount to net asset value (NAV). Dividend yields (DYs) are expected to be lower due to reduced payout ratios, as companies seek to preserve liquidity and strengthen their balance sheets. However, DYs are now likely to be more sustainable and in line with international best practice.

We believe the sector offers attractive value over the medium to long term, primarily underpinned by a more sustainable yield, together with the prospect of the sector rerating as dividends become more regular and balance sheet structures are corrected. Given current macro conditions, near-term volatility is likely to persist. Over the medium term; however, the sector remains constructive of a return to earnings and distribution growth off a sustainable income base as the economy recovers.

HOW HAS THE DISCOVERY FLEXIBLE PROPERTY FUND PLAYED THIS THEME?

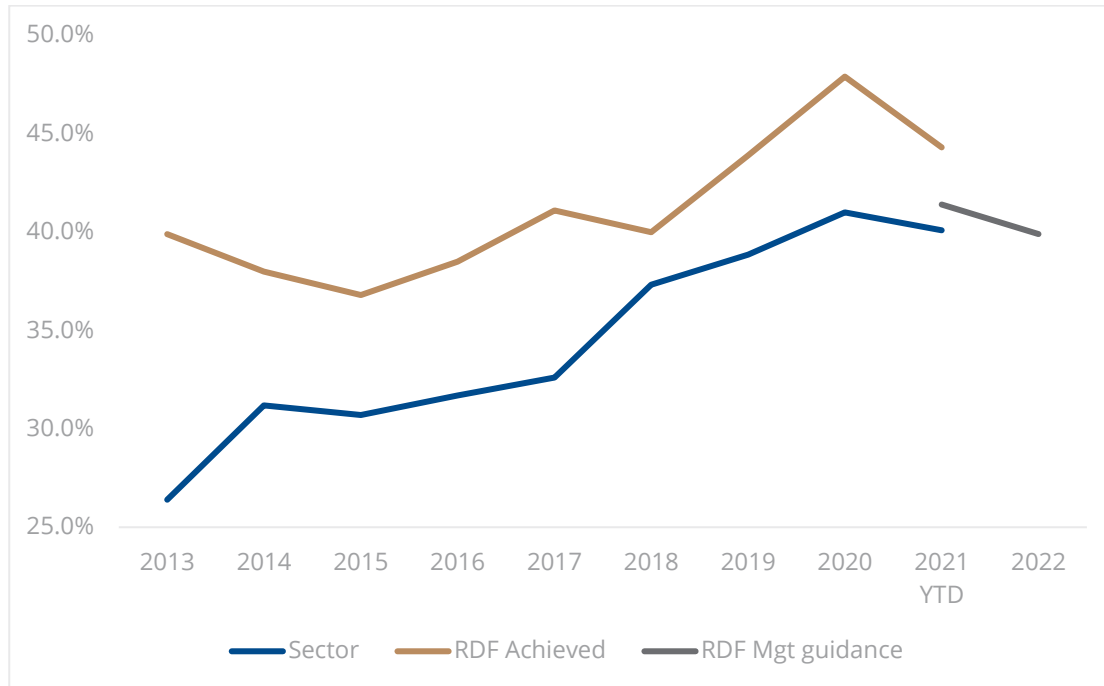
Counters that have fully embraced addressing these sectoral issues at a company-specific level have seen significant recovery over the past year as the market has better appreciated the diminishing risks due to management and board actions. They are now well positioned to capitalise on improving corporate structures and a reset earnings base.

Redefine Properties, which has been a key position in the *Discovery Flexible Property Fund* over the past year, is one such example seeing significant share price gains. Before the COVID-19 pandemic, the board and management team had already embarked on an ambitious plan to streamline the company profile and, in doing so, create greater sustainability in earnings and; therefore, in distributable income as well as reduce gearing and introduce more appropriate currency asset and liability matching. The events of 2020 saw an acceleration in the execution of this plan, resulting in a more focused international investment platform, cleaner distributable earnings, and good progress on a glide path to achieving a significant loan-to-value (LTV) reduction to below 40% and in line with the sector average.

Even though the Redefine share price has seen significant gains recently, the counter still presents attractive value given its improved standing with balance sheet risk metrics trending closer to sector averages. The counter trades at an attractive low double-digit trailing distributable income yield that includes the full impact of COVID-19 relief as well as no income from international investments. As South African rental income normalises and elements of international investment income return, Redefine Properties' distributable income yield is likely to realise 1.3 times that of the sector (on a sustainable basis), suggesting both an attractive income return as well as the potential for continued

re-rating as risks continue to normalise to come in line with sector averages. The counter currently trades at 44% discount to NAV.

Figure 3: Redefine Properties LTV converging to sector average for the first time in recent history



WHAT ARE THE POTENTIAL IMPACTS OF RECENT CIVIL UNREST?

The events, including civil unrest, since early July are no doubt a blow to what looks to be a stabilising of the retail property asset subsector. However, while undoubtedly negative, currently the direct and specific damage to the asset class is limited and we believe the thesis articulated above remains intact. While the full extent of the short- and long-term impacts are not yet fully understood, a few key items should be highlighted.

First, for most property companies, the assets impacted constitute a small percentage of their overall portfolios. Companies such as Resilient REIT and Vukile Property Fund that only have retail exposure and, more specifically, significant exposure to non-metropolitan and township assets have only reported damage to a handful of assets, if that; although, many retail assets are currently closed as a precautionary measure. These types of assets have always demanded a higher return due to their risk profile, even though they have enjoyed superior growth over the past few years. The fund is underweight in both these counters.

Secondly, the greater impact is in loss of trading rather than damage. As management teams have been able to assess the damage, it has become clear that, for almost all assets, damage is more superficial – shopfronts, and inventory – rather than to building infrastructure.

Thirdly, property companies have confirmed that, through SASRIA and private insurance, they should be fully covered for any damage. The extent of coverage for any potential loss of rent due to the

inability to trade both through closure more immediately, and as any construction needs to take place is; however, currently uncertain. It is understood that should companies have elected for this cover, SASRIA will provide insurance compensation against loss in this regard. Most companies have indicated that they are covered to the greatest degree; however, granular detail is still incoming.

Fourthly, the longer-term impacts are of greater importance. At the level of the individual retail asset, vacancy levels have been stabilising as we transition to a post-COVID-19 environment. However, the destruction to smaller small and medium enterprises typically found in the retail assets most impacted over the past week will see a rise in vacancy rates, albeit from a low level as these assets have been reasonably resilient over the past 18 months. More broadly, for all retail assets, is the impact on logistics for the country as a whole. Inventory declines and reduced trading results in lower turnover, which, in turn, leads to higher rent-to-sales ratios. This metric is a key input in arriving at rental levels; the higher the ratio, the less affordable rent becomes and as such potentially needs to be adjusted downwards over time in order to retain tenants.

Fifthly, additional longer term impacts could see a rise in the cost of capital for the types of retail assets affected, and for retail assets more generally in the country. Although this may be seen as more of a systemic risk than a specific risk.

The market reaction although negative has been modest, suggesting that the market is looking through the unrest and factoring in the limited extent of damage and the insurance available to offset the majority of more direct and immediate loss. Since the onset of the unrest, the All Property Index has fallen approximately 4%, while trading flat month on month. Although the next few months ahead will require careful navigation, in the main the sector should be able to absorb the events of the past few days, providing the unrest does not continue. The longer term prospects continue to be bound to the country's.

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