OLD MUTUAL MULTI-MANAGERS

IS THE SA LISTED PROPERTY RECOVERY TOO GOOD TO BE TRUE?

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DO GREAT THINGS EVERY DAY

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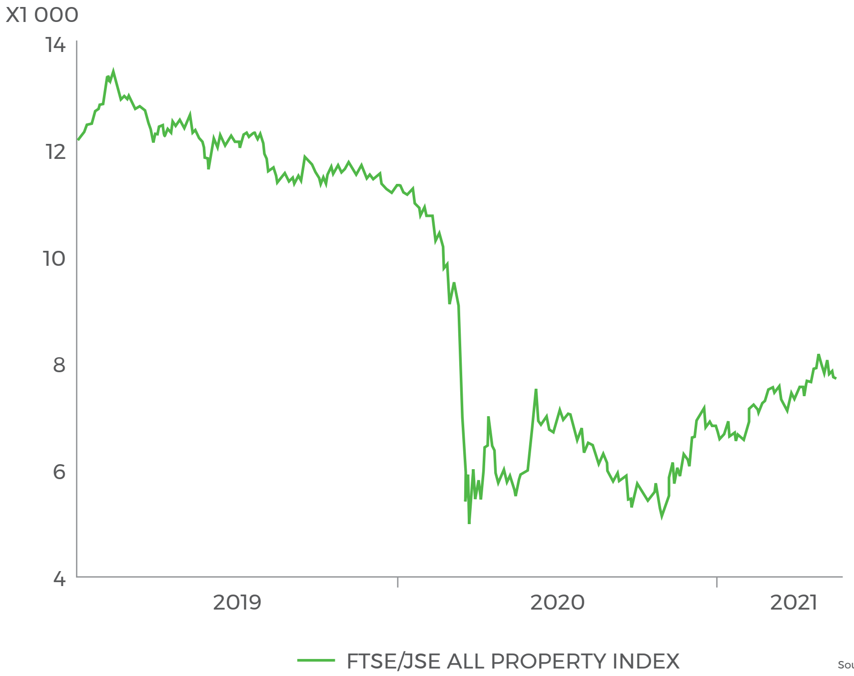
It has been over a year since the lows seen in March 2020 when the local listed property market plummeted with the advent of COVID-19. As the global growth outlook deteriorated, so too did the outlook for property company earnings. The vaccine announcement in November last year saw hopes rise for the end of the pandemic, and a strong rally across listed markets ensued, including across South African listed property shares. To the surprise of many, the local listed property market has continued to enjoy strong price momentum year-to-date as shown by the graph below, despite the challenging fundamental backdrop. Why is that?



Source: Refinitiv Datastream/Old Mutual Multi-Managers

POSITIVE RESULT SEASON

This is partly due to better-than-expected results in the latest reporting season given the overly pessimistic expectations placed on the sector, but also the improvement in retail trading densities (increase in mall foot traffic and spend per head). Overall retail trading density has improved from the 65% fall recorded during the peak of lockdown. However, despite the recovery seen from the depths of the lockdowns, retail trading densities are still down about 13% on average. Non-urban and rural retail markets have been more resilient throughout Covid-19, benefiting from behavioural changes such as consumer preference for shorter distance and closer-to-home shopping. This retail segment has also benefited from social grants and the thriving agricultural and mining sectors. Overall, retail has proven to be more resilient than expected, with retail vacancies averaging 6.9% (although these are on the rise across segments).

OFFICE OVERSUPPLY

The same cannot be said for offices, as remote working continues to put further pressure on the sector. The gradual increase in office vacancies is a concerning trend, with national vacancies currently 13.3% on average, their highest level since 2004. Tenant affordability is on the decline, with office tenants consolidating and reducing space requirements. This has seen negative rental reversions averaging at 15%. The current weak local macro environment, oversupply of office space and the uncertainty around the impact of remote working (and when businesses will go back to the office) will likely continue to put pressure on the sector. Our managers expect a 10% -15% structural drop in demand for offices. On the bright side, new supply coming to market is currently constrained and will likely remain muted over the short-to-medium term given the amount of space readily available. This bodes well for the outlook for office fundamentals should demand recover in the longer term.

Industrial vacancies, on the other hand, remain low at 4% and around 2% for modern logistics warehouses, benefiting from the increase in ecommerce. Industrial is better positioned from a growth perspective relative to retail and office, with closer to inflationary growth in market rents.

CENTRAL AND EASTERN EUROPE

The growing exposure of the sector to Central and Eastern Europe (CEE) provides diversification benefits, although this exposure is still largely retail-oriented. As such, the trading environment in CEE is still challenged as a third wave of the pandemic sweeps the region. While there has been some easing of restrictions in some parts of the region, they remain broadly in place until further notice. Despite the current challenging trading conditions, CEE offers good medium to long term prospects given the strong fundamental drivers it enjoys on the back of undersupply of space, low unemployment rates, and a strong recovery in growth anticipated through 2021 and 2022, and the positive impact of this on retail spend.

CURRENT TRADING CONDITIONS

Rental collections for the local listed property sector are running at close to 100% levels, compared to the average collection rate of 80% in 2020. The sector lost less than two months of rental income on average in 2020, which was better than initially anticipated during the depths of the lockdowns. Arrears as a percentage of revenue are running at 3.5% and decreasing. Rental discounts being offered to tenants are also on a declining trend.

The impact of the pandemic has reset earnings 10 to 15% lower for the property sector as a whole, while an increasing trend in cost-to-income ratios across the sector does not bode well for the outlook for future earnings. Early evidence, however suggests a strong contraction in future supply, which should bode well for the sector and stabilise market rentals and vacancies should demand recover. The latest valuation write-downs have thus been mild relative to the first-round adjustments, with most landlords now having enough headroom to their debt covenant levels. The outlook for further write-downs to net asset values is limited and expected to be 5% at most.

FIXING BALANCE SHEETS

Debt and gearing were key concerns for the sector especially at the peak of the crisis, as loan to values (LTVs) increased, and were close to breaching covenant levels for some companies. The worry at the time was that companies would need to raise capital at a time when market sentiment and confidence was very low. What has transpired since is that there has been a concerted effort by landlords to reduce debt via asset disposals and retained earnings. The fear of debt covenant breaches has thus subsided. This has been a materially positive development which has seen confidence in the sector improve. However, volatility remains high, particularly given the possibility of a third wave in South Africa and the impact that further potential lockdown measures could have. As such, our managers' cash holdings remain above their long-term averages, with the intention being to deploy this as mispricing opportunities arise.

PREFERENCE FOR GLOBAL PROPERTY

In the main, SA property companies have weathered the COVID-19 pandemic better than many people anticipated. Leverage risks have been managed and as the outlook has improved, so too have market prices. The sector however still has fundamental challenges. No meaningful recovery in earnings is expected in 2021 and it is unlikely that we will get back to 2019 earnings levels in the medium term.

Local listed property offers an attractive forward distribution yield of over 9%, even post the recent rally. The risk is that current expectations regarding earnings and distribution growth aren't met. Currently we prefer select property exposure via our fixed income and equity building blocks, rather than directly increasing exposure via the property building block.

In our funds, we continue to prefer global property over local property. Valuations globally also offer value and our global property exposure not only provides regional diversification, but also the opportunity to invest in diverse industries and sectors across the global economy. This includes meaningful exposure to sectors such as residential, data centres, industrial and logistics that have been beneficiaries of the circumstances created by the global pandemic. Property company balance sheets global are generally in better shape than local companies, with positive earnings growth and dividend yields above inflation.

We encourage you to contact us should you have any questions in this regard.

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