Analysis

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The travails of SA listed property in 2022

Key take-aways

- Concerns over rising inflation and interest rates, plus slow growth and loadshedding, drove listed property to record another year of underperformance in 2022, returning -3.6% year-to-date versus 6.0% from SA equities and 4% from SA bonds.
- Property companies with UK and European exposure fared worse than their more localised peers due to their higher starting valuations, which were sharply devalued amid the aggressive rate hikes.
- We have preferred companies owning diversified, SA-focused portfolios where rents are affordable, and with balance sheets strong enough to allow dividend payments and fund maintenance capex.
- Our stock picks led to outperformance of the M&G Property Fund versus the FTSE/JSE All Property Index for the year to 15 December, with a roughly flat return versus -4.0% for the benchmark – or 4% alpha.

We entered 2022 hopeful that listed property would enjoy a strong post-pandemic recovery as the world returned to normality, although there was lingering uncertainty about how the pandemic would structurally impact the demand for property (such as work from home, the acceleration of online retailing, and the onshoring of supply chains to avoid global blockages).

This optimism was largely overshadowed by a new wave of risks brought on by the Russian invasion of Ukraine in February and the war's far-reaching and protracted negative impacts. Concerns of high inflation, rising interest rates (and bond yields) and the possibility of a global recession overwhelmed an already-battered listed property sector and continued to do so for much of the year.

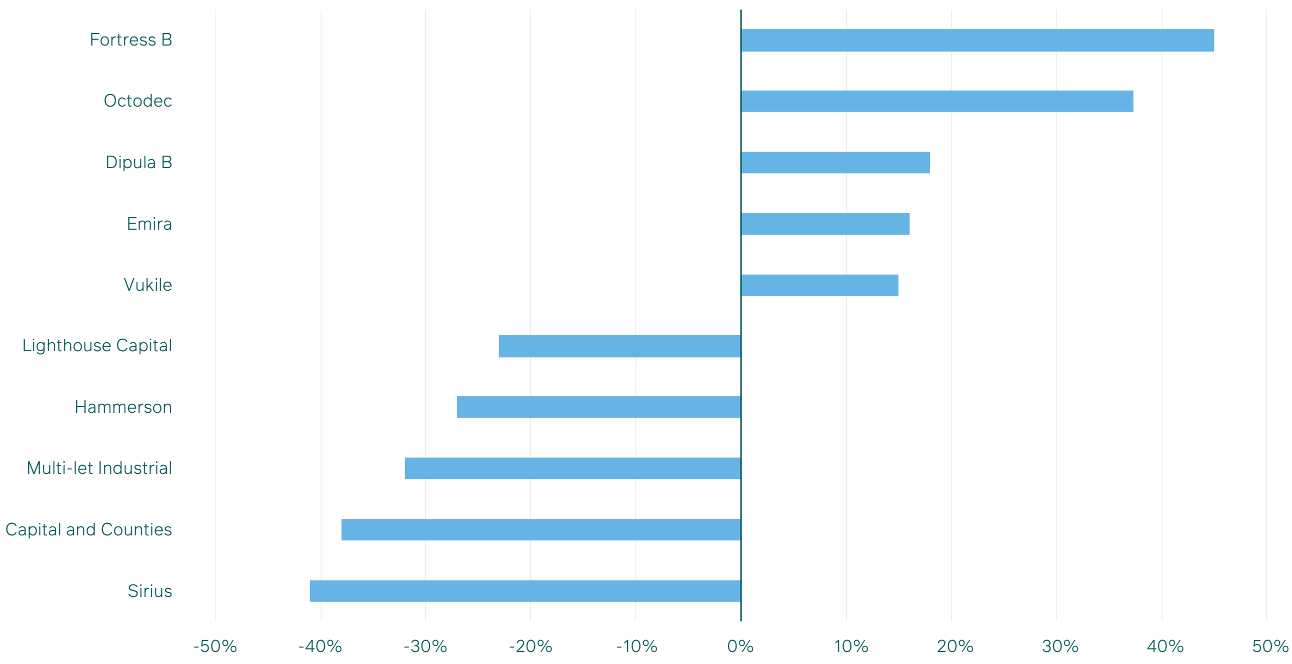
Graph 1: SA listed property underperforms equity and bonds in 2022

Source: Bloomberg, data as of 15 December 2022

As shown in Graph 1, market turmoil led to another year of underperformance. While equities and bonds delivered total returns of 6% and 3.7% respectively, listed property (represented by the FTSE/JSE All-Property Index) was down 3.6%. Despite the resumption of dividend payments that produced a 7% income yield, an 11% share price de-rating sent property into negative total returns.

Graph 2: Top and bottom property performances in 2022 (YTD)

Total return



Source: Bloomberg, data to 15 December 2022

Property is thought of as a homogenous asset class, but a look at the underlying property stocks (in Graph 2) shows a meaningful divergence in performance. There were clear winners and losers, reflecting the diversity within the SA listed sector that makes it a fertile ground for stock pickers looking to generate alpha for clients. The M&G Property Fund did well this year to produce roughly flat returns, outperforming its benchmark of the SA All-Property Index, which was down 4%. While luck played its part, we believe our robust investment process made us luckier by shaping our stock positioning to be defensive (avoiding losers) and opportunistic (owning some winners).

Picking winners

Our investment process is anchored on deep-dive, fundamental valuation-based analysis. Property companies are highly geared businesses, often carrying substantial levels of debt compared to their cash holdings, and so we spend a lot of time gaining comfort over balance sheet strength. This is overlayed with a broad understanding of market trends and supply-demand dynamics; we also leverage our dynamic valuation screening tools that allow us to spot opportunities as they arise.

At the start of 2022 our portfolios were broadly positioned for a general upturn in growth and markets, in line with the consensus outlook at the time. Our process led us to start the year with a bias toward high-yielding, deeply discounted, SA-focused mid-cap stocks, and an opposition to then low-yielding offshore stocks. Our preferred picks were SA Corporate, Dipula and Octodec, all of whom own diversified, SA-focused portfolios where rents are affordable, and have balance sheets strong enough to allow dividend payments and fund maintenance capex.

Dipula and Octodec were among the top performers in 2022, driven by starting valuations that were extremely depressed. When earnings expectations supporting their high yield materialised, we were paid a very handsome dividend yield. Octodec performed exceptionally well, re-rating 20% off the back of the demand prospects for their inner-city residential accommodation showing continued improvement, as people returned to Johannesburg and Tshwane for work and study.

Unfortunately, we missed the biggest winner, Fortress B shares. As we wrote in the Q3 2022 edition of Consider this, Fortress B has been subject to an ongoing battle with their A-shareholder counterparts over how the troubled dual-share structure will be collapsed. A shareholders have a preferential right to income as determined by the company's Memorandum of Incorporation (MOI); B shareholders get the residual income (if there is any). The big contention is around the ratio at which A shares will be swapped for B shares. With no progress toward resolution, it is difficult to offer a fundamental reason as to why Fortress B shares have done so well. As it stands, they are not entitled to any income and only have a right to a share in net asset value upon liquidation (which is unlikely to happen). Without a fundamental underpin, it's likely that the share price gains have largely been driven by speculation over a positive deal rather than anything of substance.

The losers

Sirius Real Estate, Capital and Counties, Hammerson, Multi-let Industrials REIT, and Lighthouse Capital were the biggest losers of 2022, producing losses of as much as -41%, as Graph 2 highlights. Their commonality is their exposure to UK and European property, which was hardest hit by the aggressive rise in inflation and interest rates from historically low levels. The UK/European listed property sector experienced drastic share price declines, reflecting market expectations that property values would fall. The mechanics behind these expectations can be understood from the following:

- The ultra-low interest rates of the past had the effect of indiscriminately inflating property values by allowing investors to buy property at low net income yields* (high prices) and still make a profit because their cost of debt was that much lower. However, with interest rates rising from 0% to 3% in such short space of time, investors now required a higher net income yield (lower property prices) to make those same deals profitable.

- Rising interest rates meant higher government bond yields, the risk-free rate component of discount rate used to value property. Higher discount rates resulted in lower property valuations.

Despite also suffering from rising inflation and interest rates, South African-focused property funds were relatively less impacted by these dynamics. That is because they are more accustomed to a high interest rate environment, with property values already reflecting high discount rates and share prices already trading at deep discounts to book value.

We believe the broad-brushed de-rating across the UK and Euro property sector is somewhat overdone, and we see opportunities in certain stocks we think will prove more resilient than what is implied by their depressed valuations.

*Net income yield = Net rental income/ Property value.

Two current opportunities:

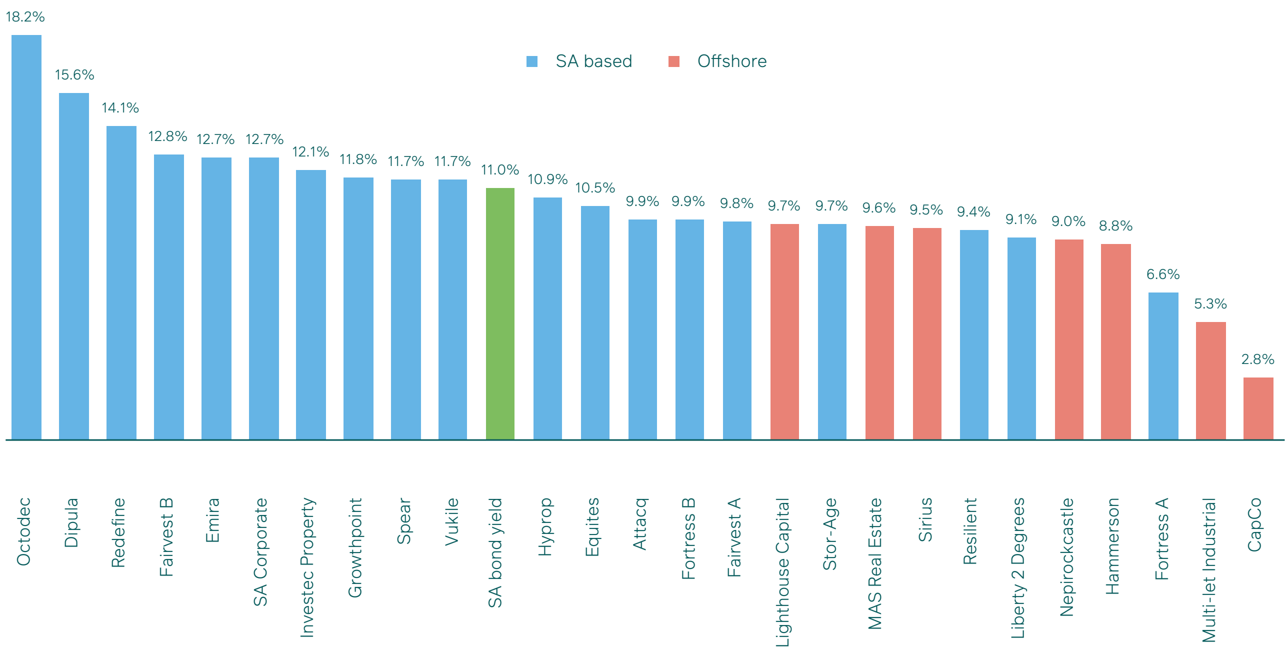
- Sirius Real Estate owns branded, mixed-use multi-let industrial parks across Germany and the UK. Their flexible short-term leasing model is advantageous in the current environment, allowing them to pass on inflationary increases in rentals and continue to grow earnings despite rising costs of debt. Their business model is driven by a robust leasing platform that facilitates active asset management and is a powerful marketing tool to attract new tenants. Management has an excellent operational track record and has consistently created value for shareholders. Following the fall in Sirius's valuation from a 1.8X price-to-book value ratio to 0.84X, we think the current share price offers an attractive entry point.

- Hammerson owns prime shopping centers in the UK, France and Ireland. Over the last five years, they have survived a retail property apocalypse that involved online retailers stealing market share, big department stores going bust and pandemic-induced lockdowns that debilitated operations. Property values and rental income were decimated, and desperate measures were implemented to stabilise the business, which included a rights issue and substantial asset disposals. The business is now stable and is backed by three large institutional shareholders that are actively in engaged in unlocking further value, that if successful, offers compelling upside from the current undemanding valuation.

Looking forward into 2023

We enter 2023 bearing the weight of uncertainty born in 2022. We don't know when inflation will ease and where interest rates will settle. In South Africa, the property sector is struggling with weak economic growth, high unemployment, and a deteriorating power supply that has been destructive for businesses. The office market remains oversupplied with corporates rationalising their space needs as they adapt to work-from-home policies. Retail property enjoyed a strong post-pandemic recovery in trade and is set to benefit from national retailers' ambitions to open new stores; however, severe consumer strain dampers the prospects for near-term rental growth.

Graph 3: SA listed property distributable income yields vs SA bonds



Source: Bloomberg, data as of 15 December 2022

Industrial property has outperformed, primarily due to logistics property where demand continues to be robust, driven by retailer optimisation of supply chains and a growing SA import sector.

In Graph 3 we can see there are 26 stocks to choose from in the SA listed property universe. For 2023, we prefer stocks that are best positioned to pass high inflation on to tenants, and thereby grow rents sufficiently to offset rising costs of debt. This includes stocks with exposure to:

- Central Eastern European retail where consumer spending is resilient; and
- Actively managed, flexible, short-term leases underpinned by affordable rents that offer near- term opportunities for repricing – this includes self-storage, multi-let industrial and residential.

Where inflationary growth is not possible, we retain our preference for high-yielding, mid-cap SA- focused stocks that offer a yield well above SA bonds (with the 10-year bond now around 11% as illustrated in Graph 3), compensating us for lack of growth. Lastly, we believe there is opportunity for substantial value unlock in deeply discounted offshore stocks and stocks facing special situations – such as Fortress A shares. With this positioning, we are looking forward to another year of alpha generation for our clients.

Rahgib joined M&G Investments as an Equity Analyst on 1 July 2020, and is responsible for select coverage of the Listed Property Sector. Prior to joining M&G Investments, Rahgib completed his CA(SA) articles at PwC before taking up a position at Kagiso Asset Managers as an Equity and Property Analyst. He currently has five years of industry experience. Rahgib holds an Honours Degree in Business Science and Accounting from UCT, a Post-Graduate Diploma in Accounting, and is also a qualified chartered accountant and CFA charterholder.