Connsider This

What's next for South Africa's listed property sector

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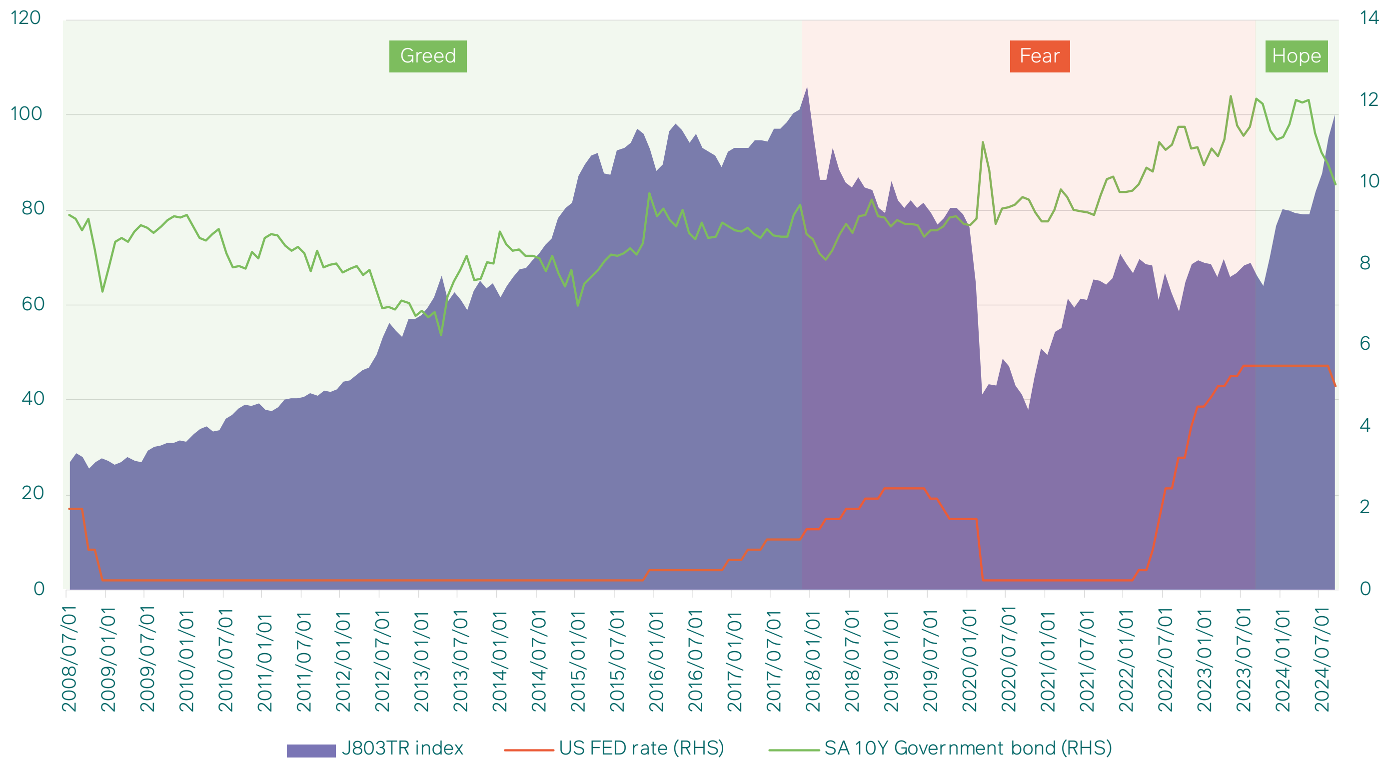
South Africa's (SA) listed property has made a tremendous comeback in 2024, delivering a 52% total return over one year to 30 September. This performance has outpaced both SA bonds and SA equities, which returned 26% and 25%, respectively. For investors who were initially skeptical and missed the rally, the question now is whether it's too late to re-enter the listed property market. In this article, we explore the reasons why we believe it still offers a compelling opportunity to invest.

Context of the rerating

Graph 1

SA All Property Index Vs. SA Bonds and US Fed Rate



Source: M&G Investments

Stand-out buyers have been the PBOC and Chinese investors during the period from November 2022 to date, when the PBOC resumed reporting on its gold reserves. The Chinese central bank saw its official gold tonnage increase by some 14% over this period, including strong buying in Q1 2024. At the same time, Chinese investors have turned to gold investments like ETFs and gold coins amid the country's economic slowdown and financial instability resulting in a crisis in the property sector, a weaker yuan and equity market losses: Chinese and Hong Kong stocks lost nearly US$5.0 trillion in market value in the past three years (according to CNBC).

Meanwhile, this Asian demand for gold ETFs appears to have helped offset sales of gold ETFs from Western investors. Historically, the rising price of gold has generally corresponded with higher ETF purchases in developed markets, but this has noticeably not been the case in the most recent period, resulting in another breakdown of historic relationships.

Battle hardened

To survive the period of fear, the listed property sector required a drastic transformation, which entailed:

- Debt reduction: Overleveraged companies were compelled to repay debt as property values came under pres sure. Funds were raised through asset disposals, equity issuances and earnings retention.
- Earnings quality improvement: To rebuild market trust, companies improved earnings quality by adopting a con servative cash-backed distribution policy combined with implementing a pay-out ratio to ensure capital expendi ture was sustainably self-funded.
- Improving resilience: Significant investment into solar power and water supply resilience to bolster self-suffi ciency in the face of poor public service delivery.

As a result of these measures, listed property companies have rebased earnings and net asset values to sustainable levels, positioning themselves to grow as anticipated tailwinds materialize.

Anticipated tailwinds

We are attuned to the reality of SA's weak economy and therefore don't rely on an economic turnaround to drive growth. The listed property sector has endured several years of headwinds, including negative reversions, rising vacancies, ballooning property expenses and higher interest rates. However, we believe that we are now at the bottom of the property earnings cycle and look forward to a period of growth as previous headwinds begin to turn into tailwinds. This includes:

- Declining interest rates

We are in the early stages of an interest rate cutting cycle, where SA interest rates are down 25bps and are expected to fall another 125bps over the next 12 months. Lower interest rates boost profits and stimulate transactional activity, which bodes well for asset pricing (property valuations).

- Property expenses expected to decline

SA property companies have absorbed excessive costs relating to loadshedding, such as diesel, generators and extra repairs and maintenance caused by intermittent power supply. With the loadshedding-free outlook to date, these excessive costs of ensuring uninterrupted power supply no longer weighs on these companies. Significant investment in alternative power sources, like solar, reduce the reliance on expensive Eskom supplied power, further reducing energy expenses.

- Improving SA property fundamentals supportive of future net rental growth

Retail property rentals have rebased as the reversionary cycle saw occupancy cost ratios fall to decade lows. Shopping centers are now well-positioned to deliver rental growth.

Elevated office vacancy rates have peaked and have started to decline. Development activity is limited to pre-leased developments only, keeping the supply of new space in check. The outlook for growth is mixed depending on regional fundamentals. Gauteng office nodes remain over-supplied, and rentals are expected to remain under pressure while vacancies are slowly absorbed. Coastal regions, such as the Western Cape, have enjoyed favorable demand dynamics supported by 'semigration' and call center expansion, that have kept vacancies low and supported rental growth.

Industrial property has benefitted from strong demand, limited supply and rising construction costs, which has been a key driver of rental growth. We anticipate that this trend may continue.

- Attractive offshore exposure in the SA listed property sector

Approximately 60% of the SA listed property stock assets are located offshore, including high growth regions, such as Central Eastern Europe and Spain, where property fundamentals are robust. This diversification helps to mitigate the impact of South Africa's underwhelming economic performance.

Is it still worth getting back into listed property?

The sharp rerating came off a very depressed base and, therefore, post-rally valuations still look reasonable. The SA All Property Index trades at an 8% dividend yield (on an 85% pay-out ratio) and 0.7 times price-to-book ratio. The yield spread relative to the SA 10-year government bond (government bond yield – listed property dividend yield) has stabilised around historical averages of about 200 basis points. We estimate that SA listed property is priced to deliver 5% nominal growth – an achievable target given the low earnings base and growth tailwinds previously mentioned.

The expected dividend yield and growth equates to a total return package of around 13%, a fair return for equity investors. For income-seeking investors, listed property has re-emerged as a reliable source of income yield with inflation hedge potential.

In summary, we believe it is a good time to re-enter the listed property market. This asset class is reinvigorated and possesses a unique risk-return profile reflective of both bonds and equity – worthy of inclusion in any diversified portfolio.

Outlook and positioning

The widespread rerating of listed property stocks led to a convergence in valuations across the sector. The earnings yield differential between high-risk and low-risk property companies has narrowed, indicating that we are no longer sufficiently compensated for risk. Consequently, we have adopted a more cautious stance on stock selection, concentrating on high-quality companies that are trading at fair valuations. These companies typically exhibit strong free cash flow, healthy balance sheets, and portfolios that are well-positioned for growth in income and net asset value.

We prefer to hold South African mid-cap stocks with minimal office exposure, as well as retail property stocks exposure to South Africa, Central Eastern Europe, and Spain. We also like niche sectors, such as affordable residential and self-storage which stand to benefit from long-term structural growth drivers like population growth and urbanization.

The M&G Property Fund is committed to delivering long-term value to our clients. We are proud to have won the 2024 Raging Bull Award for straight performance over three years. This recognition reflects the effectiveness of our robust investment philosophy and process, which we believe will continue to deliver value for clients as we position our fund for growth on entering a new chapter in the South African listed property sector.