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New choices in listed property investing

Discover what you can expect from the three new indices to be launched for the listed property sector in the last quarter of 2017

Two recent developments in South Africa's listed property sector that investors need to be aware of are the impending introduction of three new indices by the JSE, and the merger of New Europe Property Investments (NEPI) and Rockcastle Global Real Estate Company to form the sector's largest property company by market capitalisation (see our accompanying article by Albert Arntz on the latter). Both give investors reason to review their property exposure and make sure they are appropriately positioned to take advantage of the income and capital growth the asset class can offer.

Responding to market evolution

Since 2004, when the current South African Listed Property Index (commonly abbreviated to SAPY) was introduced, the listed property sector has changed dramatically. At the time it was a small, specialised grouping of companies on the JSE largely invested in local South African property – Liberty International was the only company with offshore holdings. The sector was also illiquid, making share trading in large amounts relatively difficult. This constrained interest (to a certain extent) to specialised investment managers like Prudential, insurers and property enthusiasts.

Some 13 years later, however, the sector has grown to over 50 listed companies with a market capitalisation totalling in excess of R750 billion, thanks partly to improving liquidity and the offshore expansion of local companies, as well as the globalisation of financial markets that has led to numerous new foreign listings on the JSE. Currently there are at least 10 listed property companies with no South African property exposure whatsoever, representing pure offshore plays. With more investors recognising the value of including listed property in their portfolios, and the strong returns it has offered investors over the past decade, property investing has become much more popular among the public and investment specialists alike.

The SAPY includes only the top 20 largest property companies with their primary listings in South Africa, and features a mix of property developers and real estate investment trusts (REITs). Index weightings are determined by both a company's market capitalisation and its free float of shares, so those with a higher percentage of freely tradeable shares (not part of any strategic or long-term holdings) have a higher weighting. At least 15% of a company's total shares must be freely tradable to be included in the index. The index construction methodology results in the exclusion of a large number of smaller companies and, importantly, foreign property companies with their primary listings overseas. Consequently, the SAPY's foreign exposure, at 35%, is somewhat lower than it would otherwise be. Growthpoint has long dominated the SAPY Index and currently has a weight of 17.2%, followed by the newly merged NepiRockcastle (NRP) at 14.9%.

While it was appropriate for its time, the many changes in the listed property market – and financial markets in general – have made the SAPY increasingly unrepresentative as a sector benchmark. Yet because indices are often used to benchmark the performance of active investment managers like Prudential, as well as by passive index tracking funds, it has become even more important that they be an accurate reflection of markets.

Recognising growing investor concerns, in March 2015 the JSE initiated a consultative process with investors to compile their suggestions for improvements. Then in December last year, following an unusually large response from the market, the JSE came out with a proposal based on investor feedback to offer three new property indices, allowing investors and investment managers to choose the most suitable benchmark for themselves. And most recently, in July the JSE also decided to retain the SAPY in its current form for those investors who prefer to maintain the status quo.

Examining the new property indices

The three new property indices proposed by the JSE comprise the SA REIT Index, the All Property Index and the Tradable Property Index. The accompanying table provides a basic comparison of their principal characteristics. We examine each one in more depth below.

SA REIT Index

The new SA REIT Index will appeal to investors who would like focused exposure to the South African property market, as it will comprise only companies classified as a South African REIT by the JSE. All foreign-domiciled property companies will be excluded. Each company's weight will be based on its full free-float market capitalisation, and not screened for local shareholder weighting. Looking at its composition, it is anticipated that 15 companies would qualify for the index, and Growthpoint dominates with a weight of around 24%. This makes it the most concentrated of the index options. The JSE has said it would consider capping large stocks at a specific weight in order to make the index less concentrated if necessary.

According to Prudential's analysis, the SA REIT Index will have a foreign exposure of approximately 20% - the lowest of the four indices. This is important, as in our valuation framework we assign a higher property risk premium to SA property, resulting in it having a higher assumed prospective return than offshore property over the long-term. This means that the SA REIT index may have the potential to produce slightly higher returns than the current SAPY due to its greater weighting to higher-returning SA property.

At the same time, however, the SA REIT Index is likely to have higher risk when measured against the SAPY (according to its standard deviation) than the other new indices – other indices have more diversification from having more exposure to foreign property holdings. Adding to this risk is the index's relatively lower liquidity: the least liquid constituent stock is Accelerate (as determined by its share turnover), which constrains investors' ability to trade a portfolio benchmarked against the index.

All Property Index

The new All Property Index will represent the broadest benchmark. It includes all property companies in the All Share Index, regardless of primary listing status, offering the widest diversification for investors. Each company's weight will be determined by its shareholder-weighted market capitalisation, adjusted for its free float. This will lower foreign companies' weighting in the index, preventing them from dominating the index, as they will be measured by the proportion of their shares listed on the SA register only, excluding all foreign shareholdings. The All Property Index is expected to include 29 companies, of which Growthpoint would be the largest, but at a lower weighting than the SAPY of approximately 15.8%. Capping is also a possibility, the JSE has indicated.

According to Prudential's analysis, the All Property Index will offer foreign exposure of around 42%. Because of its higher offshore exposure compared to the SAPY, its potential returns may be slightly lower than the current index (again, due to the lower property risk premium we assign to foreign property). This results in a lower assumed prospective return. However, its greater diversification (from having more foreign property exposure) means that it will likely be less risky as well. Active investment managers will also have greater opportunities to add value by underweighting and overweighting stocks, given the higher number of companies in the index compared to the others. And the inclusion of the smaller companies gives specialist managers with in-depth knowledge of the sector additional opportunities to add value. However, the inclusion of smaller companies does make the index less liquid than the Tradeable Property Index: For example, Tradehold's low daily share turnover at only R222 million makes it the largest constraint on trading.

Tradable Property Index
The third new index, the Tradable Property Index, will be made up of all 14 of the large and mid-cap property companies, excluding the 15 small-cap companies whose shares are less easily tradable in order to create the most liquid index possible. They will also be weighted by shareholder-weighted market capitalisation, and capping of the weights is possible. The JSE has indicated that one of the spin-offs of creating the Tradable Property Index could be the development of derivative markets (such as futures contracts) referencing the index.

The research done by Prudential shows that this index does live up to its name, in that it is likely to be two to three times more liquid than the other indices. This is due to Vukile being the constituent with the lowest share turnover, which is actually relatively high at R476 million per day. This makes it relatively easier to buy and sell a portfolio tracking the index. Like the All Property Index, it may have slightly lower potential returns than the SAPY and SA REIT Index - again because of its higher foreign exposure, which we estimate at approximately 44%. This higher foreign exposure adds to diversification, making it potentially less risky than the SAPY (as measured by its standard deviation). However, its smaller number of constituents adds to single stock-specific risk (due to its higher concentration across the constituents) compared to the All Property Index.

Which index to choose?
Investors will soon have four indices to choose from to serve as benchmarks for their listed property investments. The JSE has indicated that the three new indices will be launched early in the fourth quarter of this year, but has not yet specified the launch date or final details of the index methodologies.

Certainly the wider choice of benchmarks is a very welcome development for the South African market, although it must be noted that their different characteristics are likely to produce only modest variations in risk and returns for investors.

Investors wanting more focused South African property exposure with its slightly higher-yielding returns for income purposes may opt for the SA REIT Index. The exclusion of property developers with their higher risk profile and lower distribution pay-out ratios could also be appealing for many. At the same time, this index could prove attractive for foreign investors with already-diversified portfolios who would like to add specific South African property exposure. On the other hand, as the index with the lowest liquidity, some investors may be deterred from adopting it.

Others, meanwhile, may prefer the broadest possible diversification offered by the All Property Index. Its potential for marginally lower returns compared to the SAPY could very well be offset by the diversification advantages it provides, giving South African investors valuable exposure to potentially faster-growing markets offshore – and importantly without having to use their offshore allowance.

Larger investors may choose the Tradable Property Index for the extra liquidity it provides, so that they are able to trade into and out of the asset class easily. They may also want to avoid the extra risks that come from investing in small-cap property stocks with less diversified underlying property portfolios. And still others may want to stick with the existing SAPY as a well-understood benchmark with a consistent methodology and approach and a long track record that combines characteristics of all of the new indices to represent a solid "middle of the road" option.

No matter which index one chooses, the addition of listed property to an investment portfolio offers significant diversification benefits for South African investors, as well as the potential for inflation-beating returns. For example, over the past 10 years to 31 July 2017, the Prudential Enhanced SA Property Tracker Fund has returned 14.7% p.a. (net of fees) for its investors.

To invest in the Prudential Enhanced SA Property Tracker Fund (either in a unit trust or tax-free investment), complete an online application form.

https://prudential.co.za/insights/articlesreleases/new-choices-in-listed-property-investing/