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New property giant on the block

The merger of two listed property companies has created a compelling leader in the market. But, bigger is not always better, and can the returns be sustained?

July 12 marked the start of trading on the JSE of NEPI Rockcastle, the product of a merger between listed property companies New Europe Property Investments (NEPI) and Rockcastle Global Real Estate. With a market capitalisation of just over R100 billion, the merged company is now the largest constituent of the FTSE/JSE SA Listed Property Index (SAPY) by full market capitalisation. It overtook the previous heavyweight of the sector, Growthpoint, at R72 billion, and is substantially larger than the third-largest group, Redefine, at R60 billion.

Despite being larger than Growthpoint on a pure market capitalisation basis, NEPI Rockcastle's weighting in the current and proposed property indices will be smaller because of the free-float methodology FTSE/JSE employ – a company's market capitalisation weight is adjusted up or down according to the percentage of freely trading shares it has in issue. NEPI Rockcastle's free-float is relatively low at only 58%, while

Growthpoint’s is 95%; hence Growthpoint retains its position as the largest free float factor share in the current SAPY Index with a weighting of 17.2%, while the newcomer is second-largest at 14.9%.

Offering Central and Eastern European retail exposure

NEPI Rockcastle’s dominance of the South African property sector is somewhat ironic in that the new company has absolutely no exposure to the local market, although it has a dual primary listing on the JSE. Both constituent companies specialise in retail shopping mall investments in Central and Eastern Europe (CEE): the lion’s share of their combined portfolio by market value is made up of retail malls (at around 90%) and the balance mostly in office space. As shown in the accompanying chart, it offers direct exposure to properties in Romania (47%) and Poland (28%), with additional assets across Slovakia (9%), Croatia (6%), Bulgaria (5%), the Czech Republic (4%) and Serbia (1%). The latter is the only non-EU-member country where it has a presence.

The region offers attractive growth prospects. CEE economies have developed faster than those in Western Europe in recent years. Rapid economic development together with low unemployment rates provide a solid base for retail sales growth. The prospects for retail property in the region are also supported by relatively low levels of shopping space per capita when compared with GDP per capita. NEPI Rockcastle targets markets which show the strongest levels of growth, often among the highest in the European Union. More specifically, the group’s “core” property portfolio is made up of 42 retail properties, seven office properties and two industrial properties, with a combined market value of just over €4.0 billion. The group also owns a listed share portfolio inherited from Rockcastle valued at €1.1 billion at the time of listing, and is pursuing a development pipeline which exceeds €1.3 billion. Over time, it plans to use the proceeds from the sale of the share portfolio to help fund development projects. Its current projects are focused on Romania, Poland and Serbia.

NEPI Rockcastle is not only large by South African standards – it is also the biggest listed property company in the Central and Eastern European (CEE) region and the seventh largest in Europe as a whole, measured by market capitalisation. And its other primary listing, on the Euronext Amsterdam, may further improve the liquidity of its shares.

With NEPI Rockcastle having a significant weighting in three of the four South African property indices (it is excluded from the SA REIT Index), investors interested in listed property have good reason to understand the business and the potential risks and benefits it brings to a portfolio. Apart from having the second-largest weighting in the SAPY, it could also have the third largest weighting in both the All Property and Tradable Property Indices (behind Growthpoint and Redefine). Some investors may want this exposure to the CEE region, while others may not.

Valuation on the expensive side

From a valuation perspective, NEPI Rockcastle has been trading at expensive multiples compared to many other companies in the sector. The group's valuation premium may be attributed to several factors. Both NEPI and Rockcastle have delivered double-digit earnings growth in hard currencies since listing. The combined management team also has an enviable track record of successfully allocating capital to developments, which have achieved exceptionally high investment returns.

Going forward, however, given the scale of the group's portfolio and rising levels of investment competition in the CEE region, NEPI Rockcastle may be hard pressed to sustain previous levels of earnings growth. Historically, a significant component of the group's growth was derived from property developments and acquisitions. Both companies were able to complete these at rental yields that far exceeded their respective cost of capital. As competition drives rental yields lower, or to the extent that tighter EU monetary policy raises debt funding costs, the contribution of acquisitions to earnings growth may decline.

With NEPI Rockcastle trading at an 80% premium to trailing net asset value per share, we are concerned that the stock's valuation is over-anticipating earnings growth prospects. These are just a few of the reasons we have opted not to overweight the stock in the Prudential Enhanced SA Property Tracker Fund, seeing better opportunities elsewhere in the sector.

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

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