iStock-87163206

# Property investing: Going direct or listed?

Yusuf Mowlana
**PORTFOLIO MANAGER**

## KEY TAKE-AWAYS

- *A decision to invest in a buy-to-let residence for income purposes means you may be missing out on potentially superior returns in the listed market.*
- *Compared to a listed property investment where a property company could own dozens of different types of buildings and sources of income in various countries, an investment in one building offers poor diversification for a portfolio.*
- *Hidden costs can eat significantly into the returns of direct property investors who have not weighed up all the risks.*
- *Consider the three L's: leverage, liquidity and lawyers, all of which can be costly if not managed correctly in both the direct and listed markets.*

**For first-time or even seasoned** property investors, the answer to whether it is better to invest in direct (or physical property) as opposed to a share in a listed property company (or companies) on the stock market is not unequivocal. At the very least there are several differences which need to be considered independently and in conjunction with each other to assess what is best for the ultimate investor.

The most common option for the man-on-the-street in South Africa who wants to invest in a physical property for income purposes is to become a buy-to-let investor. This typically would involve buying a rental apartment, as these have low obsolescence risk, bank funding is relatively easily obtained and the price paid tends to be within reach of an individual investor. However, by forgoing an investment in the listed sector, investors may be missing out on potentially superior opportunities within property sub-asset classes they would not otherwise be able to access on their own, such a convenience retail centres, modern, triple-net leased logistics properties and self-storage units, all of which have performed robustly despite the downturn in the South African property market. If willing to invest offshore, there are even more options available on global listed real estate markets that can represent myriad opportunities and therefore high opportunity costs for the direct property investor.

Investing in direct property also results in lower levels of diversification when compared to a listed property investment. Listed companies tend to be invested across geographies, and own multiple buildings which are let to numerous tenants. Therefore, the potential adverse effects of any one neighbourhood, building or tenant going bad are reduced substantially through the benefit of diversification within a listed investment vehicle. Conversely, a concentrated exposure in a single, directly owned building may involve more risk, but that is not always the case, provided that the risk of obsolescence in the building is adequately considered. An investor should be asking themselves important questions such as: “Should the tenant vacate, will I be able to re-let the building easily?”; “Am I able to tolerate a period of vacancy in between letting”; “Do the amenities around the building support growing or shrinking rents?”

Investors should avoid "Diworseification", as coined by Peter Lynch: it would be better to buy a single, superior-quality property than a portfolio of poor ones, even if they are conveniently packaged in a listed entity. You will probably be better off buying a rental apartment close to a good university than opting for exposure to a B-grade office block with very high vacancies or risky tenants.

Hidden costs can eat significantly into the returns of direct property investors who have not weighed up all the risks. Physical properties are likely to require periodic and sometimes unexpectedly expensive repairs, risks investors often do not fully account for. Compliance with health and safety protocols, especially air conditioning and fire compliance, in commercial buildings can render older buildings less valuable than the rents suggest, and an apartment block in a sectional titled complex may have a significant unbudgeted or unfunded liability. Equally, seeing to the day-to-day operations of a property may require some of your valuable time, or otherwise there could be costs for you to employ someone to look after the building. An appropriate due diligence before purchasing is essential. Though one avoids this in a listed investment, it does not absolve an investor from "kicking the tires" of the shares they invest in, as similar risks may manifest in listed entities.

The majority of listed property companies in South Africa are Real Estate Investment Trusts (REITs), which enjoy tax-privileged status that unlisted property companies do not. One may need to consider your own tax situation and which is the most efficient ownership structure for you.

Lastly, one must consider the three L's: leverage, liquidity and lawyers, all of which can be costly if not managed correctly. Regarding leverage: banks tend to be less willing to lend against listed property than physical property, as the value of the collateral in the case of physical property is regarded as more stable. Debt can both magnify and significantly diminish returns, so it should be used with care, though property does lend itself to a greater use of debt than many other industries.

Listed property stocks are also more liquid than a physical property, in that physical property transactions may take several months to complete, whereas listed property can be bought and sold on the stock market with comparative ease. This liquidity may be a double-edged sword as, unlike a single property which requires only a single buyer, the market price of a listed share is set by hundreds of participants and there is no guarantee that a holding in a listed property entity will reflect its true net asset value. Therefore a forced sale may result in losses if the investor is unable to wait until the company reflects the value of the underlying portfolio.

Physical property transfers also involve lawyers, which add to the transaction costs of buying and selling property and may be a significant cost.

For investors who want to add property assets to their portfolio, the listed property market holds much appeal for its diversification, liquidity and hassle-free investment.. They may well find that the rewards outweigh the pitfalls of the hard work of physical ownership. ■

*Yusuf joined Prudential in October 2018 and is the joint-Portfolio Manager of the Prudential Equity and Enhanced SA Property Tracker Funds. He is also responsible for the property allocations within Prudential's multi-asset funds, as well as equities for Namibian clients. Yusuf has seven years' industry experience, and holds a B.BusSc from the University of Cape Town. He is a qualified Chartered Accountant and CFA Charterholder.*