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Despite tough times, Listed Property still a sound investment

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KEY TAKE-AWAYS

- *Despite the shorter-term headwinds facing SA Listed Property, it remains a sound investment due to its diversification benefits and the combination of steady income and capital growth that it can offer over time.*
- *Valuations are attractive now, but some companies carry more risk than others due to higher debt levels or exposure to the harder-hit market segments like office space, among others.*
- *Investors therefore must tread carefully and opt for high-quality companies with low debt and earnings diversification, like those held in the Prudential Property Fund*

Listed property companies have experienced a tumultuous past 18 months given the Coronavirus crisis, the slow rollout of the country's vaccination programme and, most recently, the social unrest and looting that have impacted severely on properties in KwaZulu Natal and Gauteng. The severity of the resulting downturn was made worse by the weak fundamentals prior to the onset of the pandemic. However, it is important for investors to distinguish clearly between longer-term, secular trends (such as the growth of online retail), medium-term cyclical trends (such as fluctuating vacancies and rents) and events which are hopefully once-off and non-recurring, such as the recent destruction of property in two of South Africa's main economic hubs and the Coronavirus pandemic.

Although we are under no illusion that many short-term events may have significant longer-term implications for the Listed Property sector, these developments should not result in investors abandoning a focus on asset valuations or the diversification benefits Listed Property offers investor portfolios over the longer-term.

As a reminder, over five-year periods or longer the asset class has the ability to deliver growing distribution streams that provide regular income under many conditions, with distributions based on underlying rental contracts usually incorporating inflation-linked increases over time. This can make certain Listed Property market segments beneficiaries of higher inflation. Capital growth is a bonus for investors, and although it comes with volatility, the relative consistency of distributions makes property stocks somewhat less risky than other equity sectors if the property fundamentals and balance sheets are intact.

"Capital growth is a bonus for investors"

Property companies structured as Real Estate Investment Trusts (REITS) are required to pay out 75% of their distributable income to shareholders, which allows some retention for future growth. For this reason, our recommended investment horizon for investing in Listed Property, including the new Prudential Property Fund, is five years or longer, rather than seven years for other equity-only funds. However, investors must be willing to accept some shorter-term volatility in exchange for longer-term outperformance.

Latest valuations remain inexpensive

For Prudential, the last year has proved to be a rewarding time to invest in the sector due some of the attractive valuations that have been available for careful investors. Listed Property has been the best-performing sector (and asset class) on the JSE so far this year, recording a 20.1% return over the six months to end-June. Although investment risks are high for some property companies due to either large exposure to the weakest segments of the property market, unsustainable levels of debt or insufficient diversification in their underlying holdings, certain other companies with strong fundamentals have been offering good value. For example, we have been able to add a high-quality company like Growthpoint to our client portfolios at very cheap valuations. In addition, companies with favourable long-term tailwinds like Stor-Age (self-storage) and Equites (logistics) are priced attractively relative to their ability to produce growing cash flows and development profits.

As of 20 July 2021, the SA Listed Property Index was trading at a 9.0% dividend yield for the year ahead and an 11.0% distributable earnings yield, implying a dividend payout ratio of 82% for the sector. The ability of property companies to strengthen their balance sheets by de-levering organically (via asset sales and dividends withheld, as opposed to equity raised) over the past year has no doubt surprised the market positively, as has the fact that vacancies have held somewhat steady during the course of 2020 and 2021, with the exception of the office sector. Coupled with attractive income yields, we are therefore constructive on the sector's valuation in absolute terms, given reducing risks.

Currently, the mixed fortunes of property companies can be evidenced by stable vacancies with lower rents and ongoing rent relief to affected tenants in the local retail space, and some evidence of tenant failures and downsizing in the industrial market segment. Unfortunately, the office market has demonstrated weak demand and little pricing power. In contrast, the self-storage segment as represented by Stor-age had an exceptionally robust year as they managed to both grow rental rates and also occupancy by 'letting up' space.

One sign of cheap valuations is that the sector has been attracting significant interest from private buyers as well as corporate activity in recent months. For example, Growthpoint rebuffed an offer for its stake in Globalworth; Arrowhead and Fairvest announced a likely merger; and the iGroup made a compulsory offer to minorities of Emira. Tower also announced an expression of interest from RDC Properties, based in Botswana, for its entire share capital, while RDI Reit was the subject of a successful bid from Starwood Capital.

The current unrest in parts of the country will no doubt unsettle many Listed Property investors. At the time of writing, we assess the immediate impact on Prudential Property Fund's holdings as immaterial in the short term. The facts supporting our view include:

- Landlords are fully insured for physical damage and largely insured for the resulting loss of income;
- The properties affected represent a fraction of companies' respective portfolios;
- Not all tenants within affected properties were necessarily looted; and
- The majority of retail rents are paid by large national tenants.

Of greater concern to us are the secondary effects, especially the likelihood that small businesses may not be able to restock given underinsurance or a lack of insurance. The likely loss of confidence in the country and associated higher cost of capital and of doing business due to additional security measures are further long-term consequences.

Prudential Property Fund has attractive active positions

We would like to remind investors that in May we added the Prudential Property Fund to our selective range of unit trusts. The new active fund is Prudential's response to the changing fundamentals and greater company divergence in South Africa's Listed Property sector.

The globalisation of the sector in the past decade, with both foreign property companies choosing to list on the JSE and local property companies expanding offshore, has introduced greater complexity into what was previously a somewhat homogenous industry. On top of this are the longer-term trends of greater competition from online shopping, increasing popularity of work-from-home models and changes in consumer behaviour, all adding pressure to landlords in the sector and leading to different company strategies and new investment opportunities. Consequently we are observing widely diverging company valuations and fundamentals, which create opportunities for active investment managers like ourselves to take advantage of. This was our foundation for offering investors a fund with a more active approach, allowing clients to benefit from the value now available in Listed Property, alongside our existing Enhanced SA Listed Property Tracker Fund.

Although this is a new fund, it is managed based on the same investment principles and processes that we have been successfully employing for over 20 years now – our valuation-based, risk-cognisant approach. Just as with Prudential's other equity funds, stock selection and portfolio construction are carried out according to a team-based process. And this active methodology already has a strong track record: it has been used in actively managing the Listed Property exposure within our multi-asset funds like the Prudential Balanced Fund and Prudential Inflation Plus Fund since the beginning of 2019. The fund's benchmark is the All Property Index, so that investors have access to the largest possible universe of property stocks available in South Africa.

The Prudential Property Fund is available directly to retail investors for a minimum R500 investment. For more fund details, visit the Prudential website. ■

Yusuf joined Prudential in October 2018 and is the joint-Portfolio Manager of the Prudential Equity, Enhanced SA Property Tracker and Property Funds. He is also responsible for the property allocations within Prudential's multi-asset funds as well as equities for Namibian clients. Yusuf joined Prudential from Allan Gray where he spent five years as an investment analyst, covering companies across various sectors, with a special focus on Listed Property. He currently has eight years of industry experience. Yusuf holds a B.BusSc from the University of Cape Town, is a qualified Chartered Accountant and CFA Charterholder.