PRUDENTIAL **INSIGHTS**

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Opportunities seen in listed property as investment risks ease

Listed property companies have experienced a tumultuous past 18 months given the Coronavirus crisis, the slow rollout of the country's vaccination programme and July's social unrest and looting that impacted severely on properties in KwaZulu Natal and Gauteng. The depth 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 damage to 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 property fundamentals and company balance sheets are intact*. 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 maintenance of properties and 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 to 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 27.9% return over the nine months to end-September. Although investment risks have been 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 were able to buy a blue-chip counter like Growthpoint, the country's largest landlord, at extremely cheap valuations during the downturn, when the perceived risks were highest, and then take some profit from this position in the ensuing market recovery, which is ongoing.

With the highly uncertain conditions now abating and economic activity starting to accelerate, the mixed fortunes of property companies are obvious. In the retail space, we are seeing stable vacancies with lower rents and ongoing rent relief to affected tenants, while the industrial segment has some evidence of tenant failures and downsizing. Unfortunately, the office market has demonstrated weak demand and little pricing power, along with very high vacancies. In contrast, the self-storage segment (as represented by Stor-age) had an exceptionally robust year, managing to both grow rental rates and improve occupancy by ‘letting up’ space.

Despite property’s strong share price performance more recently, investors have not missed the boat. The sector continues to offer attractive long-term growth prospects, with the All Property Index reflecting a 12-month forward dividend yield at around 9% as of end-September, plus further growth expected on top of this. For example, companies with favourable long-term tailwinds like Stor-Age and Equites (logistics) are still priced attractively relative to their ability to produce growing cash flows and development profits.

However, listed property is a lagging sector in the cycle, as earnings are usually only impacted negatively once rental contracts come to an end and new rates are set at lower levels (negative reversions) – and this is still happening. While the logistics and self-storage segments have been the most resilient and are performing well, retail rents in large metropolitan malls are expiring at lower rents with stable occupancies, and the office segment is far weaker. On the positive side, new speculative developments in these segments have halted during the pandemic and the retail supply-demand balance is healthier, which should lead to improving rental growth over the medium term.

Our broad view based on the latest earnings reports is that risks in the listed property sector have improved since the beginning of the year, and our neutral weighting in our multi-asset portfolios like the Prudential Balanced Fund reflects this. As for the Prudential Property Fund’s holdings, apart from our overweights in the more defensive companies like Equites and Stor-age, we also like Nepi-Rockcastle and MAS for their Central European retail exposure, and Hyprop and Redefine for their cheap valuations and good potential for a re-rating of the companies once fundamentals stabilise.

For more information, please feel free to contact our Client Services Team on 0860 105 775 or email us at query@prudential.co.za.