Consider this

Going offshore for property diversification: Sirius and Redefine

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M&G Investments
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Recently, as members of M&G Investments' Listed Property investment team, we paid visits to Germany and Poland to inspect some of the property assets and operations of JSE-listed REITS, including Sirius Real Estate and Redefine Properties. These companies and others like them that are listed in South Africa but also operate outside of the country are receiving more attention these days from investors interested in the property portfolio diversification qualities they can offer as a result of their hard-currency earnings and currently elevated growth potential compared to South Africa.

As valuation-based investors, we do not look at these companies purely for the sake of portfolio diversification, however – we base our decisions on their valuations and other detailed bottom-up analysis, as well as quality. These company tours can also add value to us as analysts looking to delve deeper into each business and understand what sets them apart from their competitors and makes them worthy of investment. Sometimes we are shareholders, as in the case of Sirius, and sometimes not, as with Redefine. Here we share our views and findings – which are very far apart – in the wake of our visits.

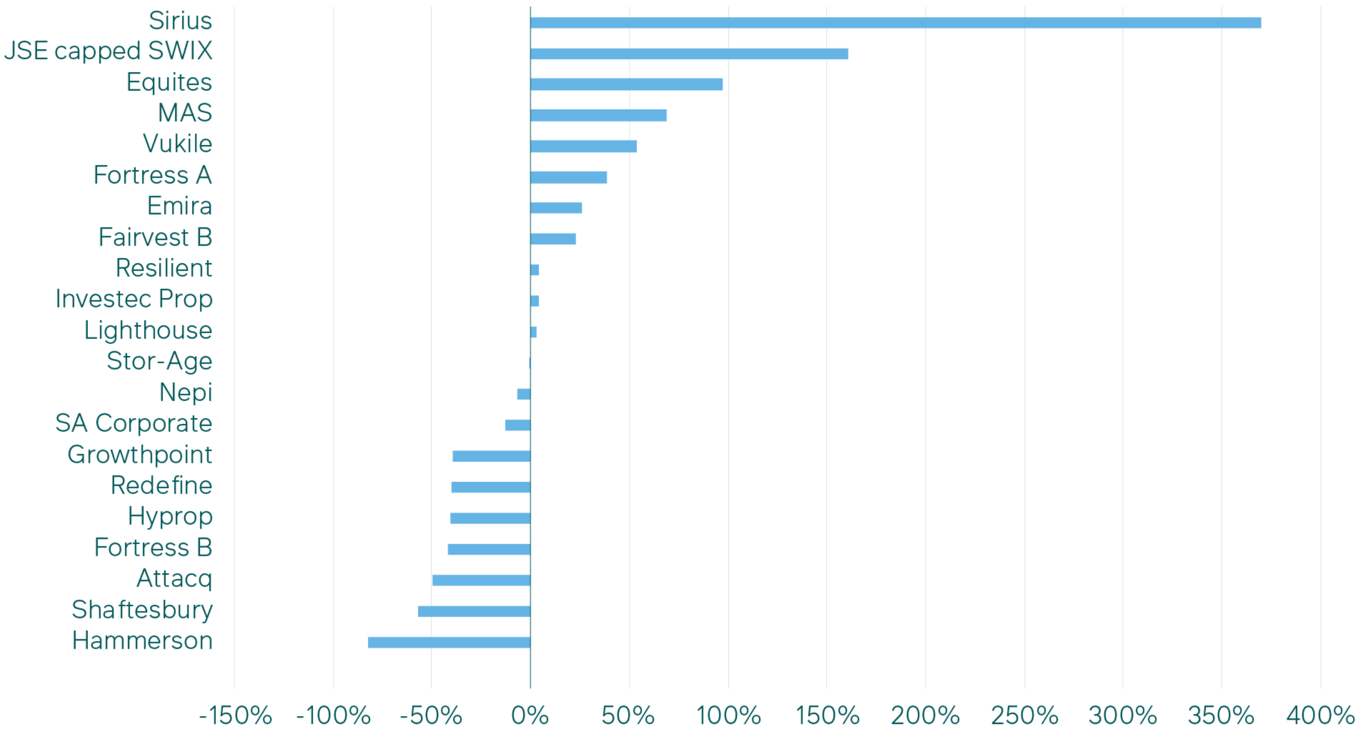
Sirius Real Estate: Serious about Real Estate

Rahgib Davids
Equity Analyst

Sirius Real Estate is a leading owner and operator of German and UK mixed-use, branded industrial business parks located on the outskirts of major cities. Since its establishment in 2007, the company has aggressively pursued growth opportunities by acquiring portfolios of undermanaged industrial parks with significant value unlock potential. Having listed on the London Stock Exchange in 2007 and subsequently on the Johannesburg Stock Exchange (JSE) in 2014, Sirius has become a remarkable success story, outperforming its property peers and delivering exceptional returns to its investors as Graph 1 illustrates.

Graph 1: Sirius outperforms SA property peers

Cumulative total returns 2015-2023

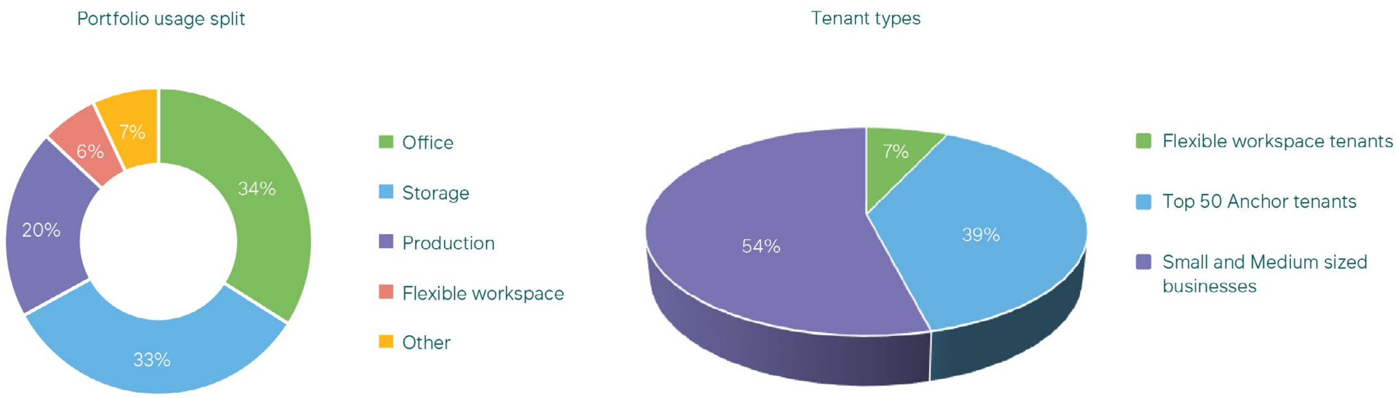


Source: Bloomberg data to 27 June 2023

The portfolio at a glance

At present, Sirius owns and operates an impressive portfolio of 140 industrial parks, accommodating approximately 9,000 tenants across Germany and the UK. Germany alone contributes to 75% of the company's net operating income, while the balance comes from the UK. These industrial parks cater to the diverse needs of small to medium-sized enterprises (SMEs), offering flexible lease lengths ranging from 0.5 to three years. This flexibility allows Sirius to actively manage its tenant base and capture rental growth opportunities. Furthermore, the affordability of rentals, typically 30% cheaper than other alternatives, creates room for rental increases without significant tenant resistance.

Graph 2: Lower risk due to diversified usage and tenant profiles



Source: Company data

One of the key strengths of Sirius's portfolio lies in its diversified usage and low tenant concentration risk. While the top 50 anchor tenants, comprising blue-chip corporations and government departments, contribute 39% of the company's revenue, the remaining revenue is spread across 8,950 tenants. This balanced distribution mitigates the risk associated with reliance on a small number of tenants and enhances the stability of Sirius's income streams.

The property tour

In May 2023, we had the opportunity to attend a Sirius Property Tour in Berlin. The tour encompassed visits to four industrial parks located on the outskirts of the city, followed by a tour of the company's new head office, where we were given valuable insight into their operating platform. The property tour aimed to showcase Sirius's investment philosophy, which revolves around the acquisition of undermanaged industrial parks from institutions lacking the necessary expertise, vision, and willingness to unlock their full value. In the words of the CEO, it can be described as "buying other people's problems."

The platform

"The Platform" is Sirius's fully integrated system that combines the back-end operational data of existing properties, leases, and tenants with the front-end marketing and sales interface. Notably, Sirius's marketing team operates with a consumer-oriented approach rather than a traditional property-centric mindset. The platform generates 90% of the company's sales leads, eliminating the need for costly property brokers and agents. Through advanced data analysis, search engine optimisation, and AI capabilities, Sirius monitors and capitalises on real-time customer demand patterns, enabling targeted marketing of vacant space based on high-demand preferences. The versatility of Sirius's business parks allows for easy conversion of vacant spaces into various uses, including storage, offices, workshops, and even retail spaces, at a minimal cost. By leveraging this data-driven approach, Sirius efficiently allocates capital to space types that offer the highest returns.

Upon receiving a customer inquiry, Sirius's call center promptly responds within 30 seconds to arrange viewings and take necessary steps to finalise a deal. The system facilitates the entire process, from lead generation to leasing, billing, collections, and even re-marketing available spaces if tenants choose to vacate. This innovative platform serves as a vital source of competitive advantage in a market typically dominated by bureaucratic brokers and agents.

B1 Business Park

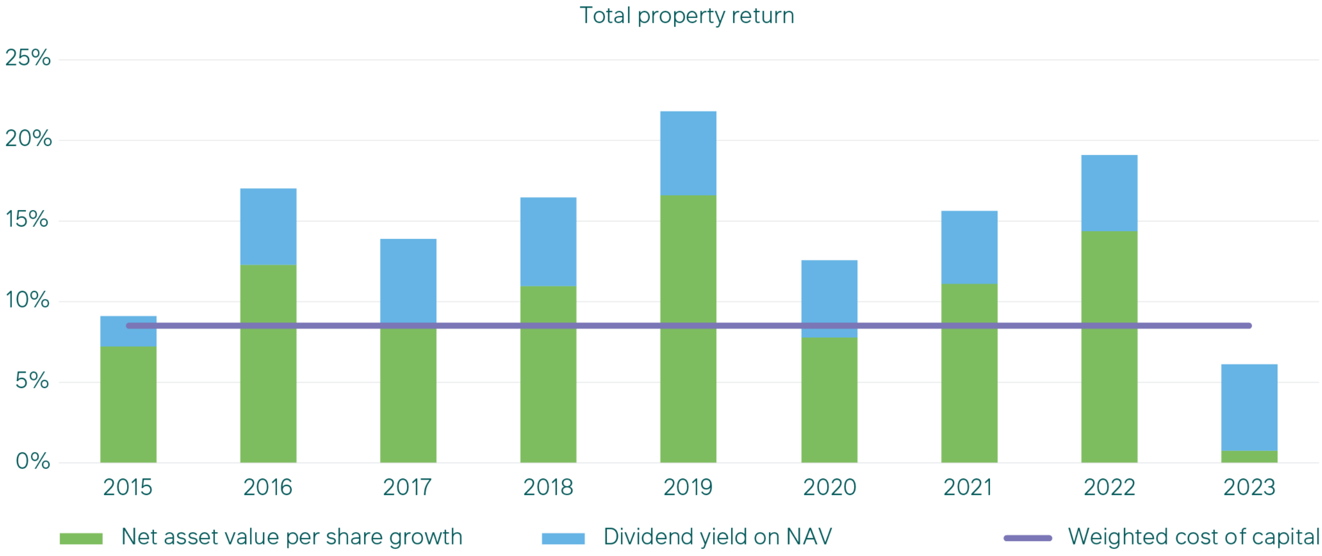
During the property tour, we had the opportunity to visit the B1 Business Park, which exemplified Sirius's investment philosophy. Built in 1990 on the outskirts of Berlin, this asset had been deemed underperforming and unattractive by property brokers. Sirius acquired the initial 29,000m2 of the park in 2014, followed by another 13,000m2 in 2017. With a vacancy rate of 28%, half of which was considered unlettable, Sirius acquired this space at a significantly discounted price. The challenge lay in the fact that the vacant space was suitable for larger office tenants requiring 2,000 to 3,000m2, which had little demand in that area. However, utilising the insights provided by the platform, Sirius invested €3.3 million (or 12% of the total purchase price) in capital expenditures to convert the vacant space into mini offices (catering for small businesses who prefer flexible short-term leases) and storage. The once "unlettable" space is now fully occupied, generating rents 40% higher per square meter than the rest of the park. The photos below show how these spaces look today:

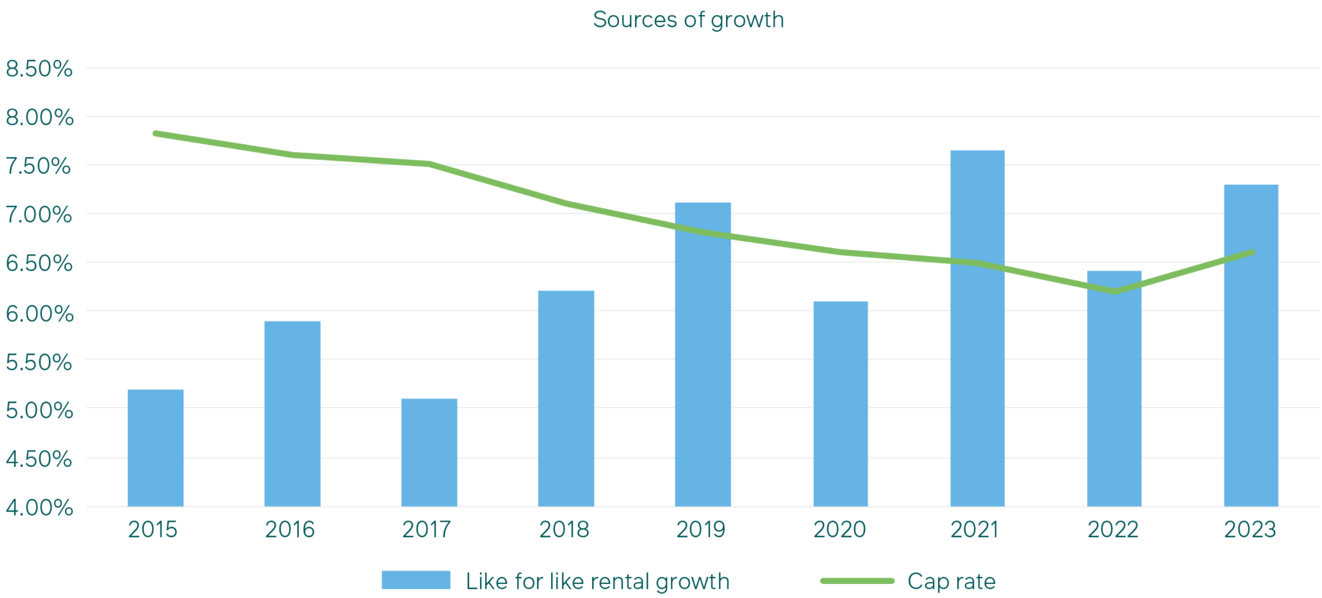
By the end of 2022, the vacancy rate of the B1 Office Park had been reduced to an impressive 2%. This significant reduction was accompanied by a remarkable 85% growth in net operating income. As a result, the asset's value soared from an all-in cost of €29 million to €66 million, translating into a cumulative return on investment of 227%. This outstanding performance equates to an exceptional ungeared internal rate of return (IRR) of 20%.

The success of the B1 Business Park is indicative of the broader portfolio's exceptional performance. As shown in Graphs 2 and 3 below, Sirius has consistently delivered total property returns that have exceeded the cost of capital in eight of the last nine years, primarily driven by robust rental growth rather than capitalisation rate compression.

An attractive investment opportunity
In our view, Sirius Real Estate currently represents an attractive investment opportunity. Trading at a price-to-book (P/B) ratio of 0.9x and offering a 9% hard currency earnings yield, the company presents a compelling proposition. With a market cap-implied net operating income yield of 10%, there is sufficient margin of safety in the face of rising funding costs. Furthermore, the company has the potential for sustained long-term growth due to both its affordable rentals, which are 30% cheaper than comparable alternatives, and the high cost of building new assets, which act as a deterrent for potential new developments. With its innovative platform and successful investment strategy, Sirius Real Estate is well-positioned to deliver ongoing value to its investors, making it a core holding in the M&G Property Fund's portfolio.

Graph 3: Producing impressive returns from strong rental growth





Company data, M&G Investments

Redefine: Polish growth potential attractive, but what about the risks?

Stefan Swanepoel
Equity Analyst

We recently visited some of the Polish assets of SA listed property group Redefine. Poland makes up approximately 37% of Redefine's property assets under management, with retail assets comprising R29.4bn through EPP, the largest shopping centre manager in Poland with over 1 million square metres (m2) under management. Redefine has a further R5.1 billion in Polish logistics assets held mainly via European Logistics Investment (ELI).

Despite current pain, a positive medium-term outlook

While Poland's macroeconomic environment remains supportive in the medium term, for now the country is experiencing a downturn in the general economic cycle -- no different to the rest of the world. With the war in neighbouring Ukraine, energy prices have increased, resulting in inflation remaining persistent at around13%, and interest rates that are elevated at 6.8%. The consumer is under pressure, impacting on retail sales. Despite the bad news, as investors we like the fact that Polish unemployment levels remain low at 5.1%, especially when compared to South Africa at 32.9%, but even with reference to the Eurozone at 6.5%. We think that this, together with a stronger GDP growth outlook, bodes well in the longer term. We expect inflation and interest rates to normalise in due course and retail spending to start trending back upwards. In the short term, however, we are seeing pressure on retail spending and consequently on regional malls.

While the higher inflationary environment and increased interest rates add to the pressure on the consumer and hence retailers through a decline in disposable income, the fact that many of the retailers have had to endure Covid restrictions has meant that the average retailer is much more resilient than at the start of previous economic downcycles. Many of the weaker players have already fallen over, and those that have survived have built up sufficient cash buffers that should assist them in dealing with the current weakness. Nevertheless, we would still expect some increases in vacancies as part of the normal cycle, albeit to a lesser extent than in previous downturns. At present, vacancies within EPP at approximately2.9% are lower than the 4.9% industry average. We see upside risk to both in the short term.

Rents drop, debt levels high

The operating environment has remained challenging, but higher inflation has had some benefits for property owners as rental increases are typically priced in a particular year based on inflation in the prior year. As inflation remains robust, EPP has been able to push through the higher inflationary levels onto tenants. While this was easily absorbed into 2022, we think it could become somewhat more problematic in 2023 if inflation remains elevated. We have seen evidence of this through the substantial negative reversion that EPP reported on new leases at -6.7% in the first half of its 2023 financial year.

Current debt levels remain a cause for concern for the market, as these are elevated in both the EPP entity as well as its joint ventures. At this stage the loan-to-value (LTV) ratio on its foreign assets and debt is around 53%. Although this important metric has been declining, it remains high given where we are in the cycle. With interest rates elevated and its debt only hedged out for 1.7 years, this will translate into higher finance costs as the lower-rate fixed debt matures.

Better options

Due to the above factors, we believe there are better, less risky, ways to gain exposure to the attractive potential of the Polish retail market than Redefine, and elect to take our exposure via Nepi Rockcastle. That company expects shorter-term dividend growth of around 4% and is currently trading on a dividend yield of 10%, providing an attractive total return package in the short term. In the medium term we think that as Polish fundamentals improve, it is better placed to take advantage of the growth opportunities presented by Eastern Europe.

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