M&G Insights

Listed property: Tailwinds on the horizon

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After several difficult years, listed property is likely to benefit from favourable tailwinds in 2024 and beyond. These include lower levels of inflation and the growing prospect of interest rate cuts. Property offers investors valuable diversification through both income and the potential of capital growth, with unique risks when compared to other equities.

As property companies typically employ more leverage than the average listed company, the interest rate cycle is of particular importance to their performance. Hence, in an upward rate cycle like we've experienced since late 2021, they tend to underperform other sectors.

However, with major central banks signalling the potential for rates to decline in the second half of the year, the rates headwind that has plagued the sector is likely to abate; but this comes with the caveat that rate changes do take time to filter through to earnings.

As regards market volatility, levels may be high over the short term and perhaps even higher than other equities given the uncertainty around the quantum and pace of rate cuts. This is because there is both a ratings impact from interest rates and an earnings impact. Property investors typically hope for a level of volatility that is lower, closer to that of bonds, at least over the longer term, because the effect of a re-rating and the short-term impact of interest rate changes can be smoothed out, and basically eliminated, through time. In practice this hasn't always been the case, however, as over-leveraged companies and those with poor fundamentals have experienced massive volatility. Indeed, some like Intu Properties have seen shareholders lose all of their money. On the other hand, UK medical REITs with low levels of asset obsolescence have been much more stable investments.

What's perhaps less clear is the effect the economy will have on property fundamentals. There remains the prospect of a slowdown globally or in South Africa, or both, the depth and length of which will determine the extent of the impact on the sector.

Property sub-sectors diverging

It's important to remember that there are a number of different sub-sectors within property, both locally and globally, with different characteristics and drivers of fundamentals. While our focus in our funds is SA-listed property, we also invest in locally listed offshore names with strong fundamentals, such as NEPI Rockcastle, Sirius Real Estate and Hammerson.

In the office sub-sector, occupancy rates are dependent on the economic outlook, and currently tenants retain some reticence in committing to longer-term leases, except in rare cases of new developments. In the retail sub-sector, large national tenants are likely to commit to the normal lease length, as they have enjoyed favourable leasing terms over the last few years, especially in metropolitan malls, and are thus aware that the tables are turning in favour of landlords. With conditions remaining subdued, we have been avoiding companies with significant exposure to the office sub-sector.

On the other hand, residential property has been a good place to "hide away" from the malaise in the office sector, with rentals and vacancies recovering gradually. The shorter leasing terms of residential leases mean that passing or current rentals are always at market levels, thus preventing a situation where an investor is met with a negative surprise at the conclusion of a long-term lease which expires above market-level rentals. As such, we have opted for property companies with residential exposure like SA Corporate and Octodec, which have yielded higher than the sector average but with below-average downside risk to cash flows.

SA Property vs bonds

One of the major headwinds facing the property sector is high bond yields, which currently exceed 11% in South Africa. Given that we regard listed real estate to be riskier than bonds, our total return expectations for the sector would need to exceed the risk-free rate by a margin that would make property attractive relative to bonds, compensating for the perceived and actual risks involved such as tenant, leverage and capital allocation risks, among others. The low levels of GDP growth in South Africa coupled with South Africa's deteriorating fiscus and infrastructure may negate the potential benefits South African bond yields may enjoy from a lower global interest rate environment. The prospect of our long bonds rallying to, say, 8% or 9% is a bit lower than the chances of 10-year US Treasury yields rallying from their current levels. Therefore we prefer offshore names, as there is better current support for valuations and also superior demand and supply dynamics in the property sectors.

We could also see an increase in mergers and acquisition activity in the sector, something companies have been reluctant to engage in during the COVID and post-COVID periods. As valuations and fundamentals begin to improve with tail risks abating, we could see M&A emerging as a theme, especially as some companies hope to gain scale and investor support.

When investing in property, diversification, property fundamentals and valuation support from the risk- free rates all need to be considered. As a result, currently there is better value on a risk-adjusted basis offshore. As such, within our South African portfolios we have preferred some of the offshore names, together with some of the higher-yielding mid-cap companies, as these arguably compensate an investor appropriately relative to holding SA bonds.

To conclude, with the overriding theme of the last couple of years for the listed property sector being interest rates, and with these starting to abate over the next year or so, there is the prospect of some stability in valuations, and hopefully some measure of outperformance for listed property versus other asset classes. Much will depend on the path of interest rates, and we have already seen the sector start to re-rate slightly as the possibility of interest rate cuts becomes more certain and draws nearer, both globally and at home.

*These views were shared as part of the Asset TV Outlook 2024 Panel on Listed property:
https://www.assettv.co.za/video/outlook-2024-i-properties-panel