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Covid-19 learned resilience and flexibility paves the way for the SA property market
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The listed property/Real Estate Investment Trust (REITs) market has been tumultuous these past few years, with the onset of Covid-19 adding to the sector's challenges. For an extended time before that, listed property shares were the best performing asset class on the Johannesburg Stock Exchange (JSE), paying consistently high dividends and enjoying strong capital appreciation.

However, the sector's fortunes changed around 2018, following the debacle surrounding Resilient REIT and its associated companies, which sent shares in the sector tumbling. Since then, the listed property sector has been trying to shake off the dust and return to its heyday.

Tough times made worse by the onset of Covid-19
A closer look at fundamentals suggests that trouble in the sector has been brewing for a while. The commercial property market has been in oversupply for a while now, with the office sector worst hit. Supply has been increasing over the past decade, while demand has not been able to keep up. Poor economic growth has led to tenants downsizing and consolidating office space. Then Covid-19 has accelerated structural shifts in the sector and contributed to the office segment's uncertain future.

Growthpoint Properties Ltd (Growthpoint), South Africa's largest office property owner, recently reported a vacancy rate of 20.9% in their office portfolio. The challenge for Growthpoint and other property owners is that smaller tenants are struggling with affordability. Some face uncertain futures, making it hard for them to commit to long-term leases.

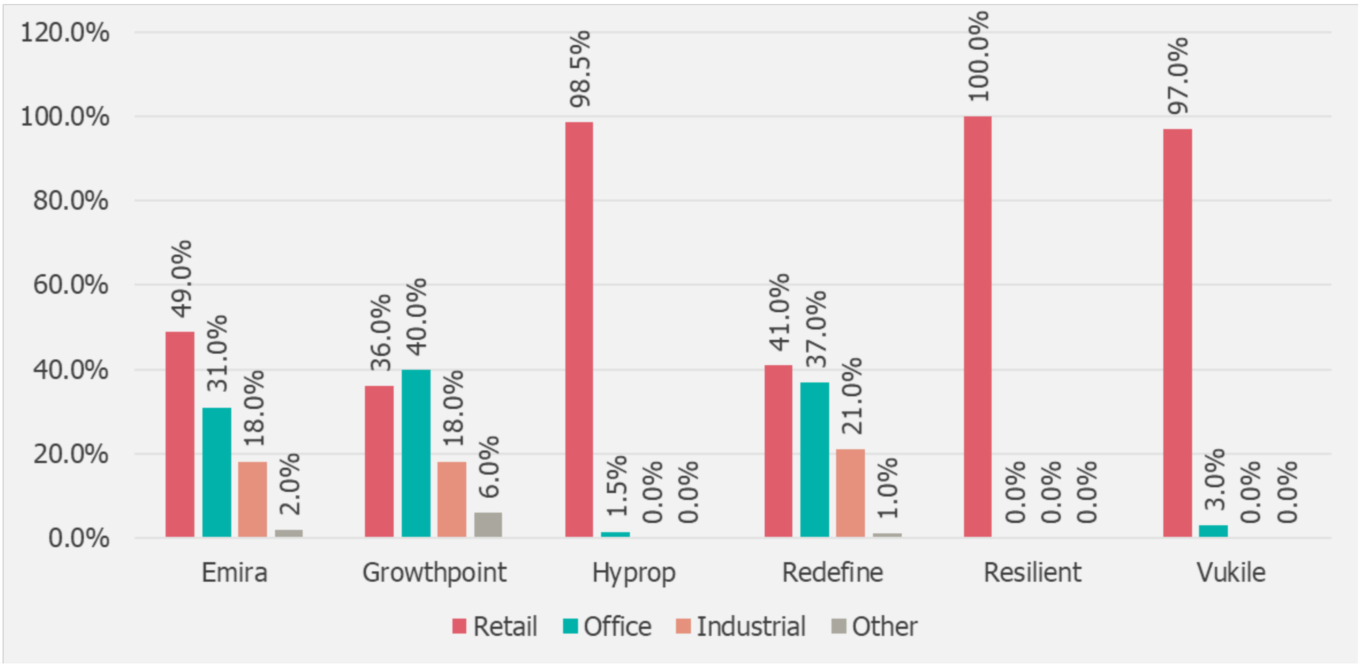
In addition, companies' work-from-home (WFH) policies in response to the pandemic have forced many companies to reconsider their office space requirements. Although WFH has allowed many companies to operate through these challenging times, there is no denying the benefits of employees working from the same place, such as increased collaboration, innovation and experiencing the lived benefits of a company's culture.

Covid-19 will be behind us at some point, and companies will return to the office. But office working arrangements are not likely to change. Companies are expected to shift to a hybrid model, allowing employees to alternate between their offices and homes. There could also be an increase in shared office spaces and hot-desking. For the needle to really move for the property sector, there needs to be convincing economic growth to help drive up demand for office space.

Behavioural shifts will determine the retail property winners
Retail property has experienced its fair share of difficulty over the past few years, with trading densities gradually decreasing and vacancies trending upwards. Lockdown restrictions further amplified this, and although the sector is showing signs of recovery, trading density is still below pre-Covid levels. Data from the South African Property Owners Association (SAPOA) indicates that shoppers visit malls less often but spend more money per visit. This behaviour change has skewed consumption towards supermarkets and pharmaceutical retailers while restaurants and entertainment companies suffer.

SAPOA data also indicates that smaller format malls (community and neighbourhood centres) have been outperforming regional malls as consumers opt to shop closer to where they live. This trend has favoured REITs with high exposure to neighbourhood centres, such as the Vukile Property Fund. For the sector to make a full recovery, footfall needs to increase, but, as we have seen over the last two years, footfall moves in tandem with lockdown restrictions. With the threat of Covid-19 still with us, a full recovery may well take longer than anticipated.

Figure 1: Sectoral exposure



Sources: Futuregrowth & Company Investor Reports

The industrial and logistics sector stand to benefit from online growth
However, it's not all doom and gloom in the property market. The industrial sector has been resilient these past two years, particularly the logistics industry. MSCI data indicates that while the South African property market delivered a total return of -3% in 2020, distribution centres were the best performing segment, delivering a total return of 5.1%. Although the performance was largely accelerated by adaptation to Covid-19, the sector still has significant long-term potential as companies are expected to increase investment into their online platforms and supply chain efficiencies.

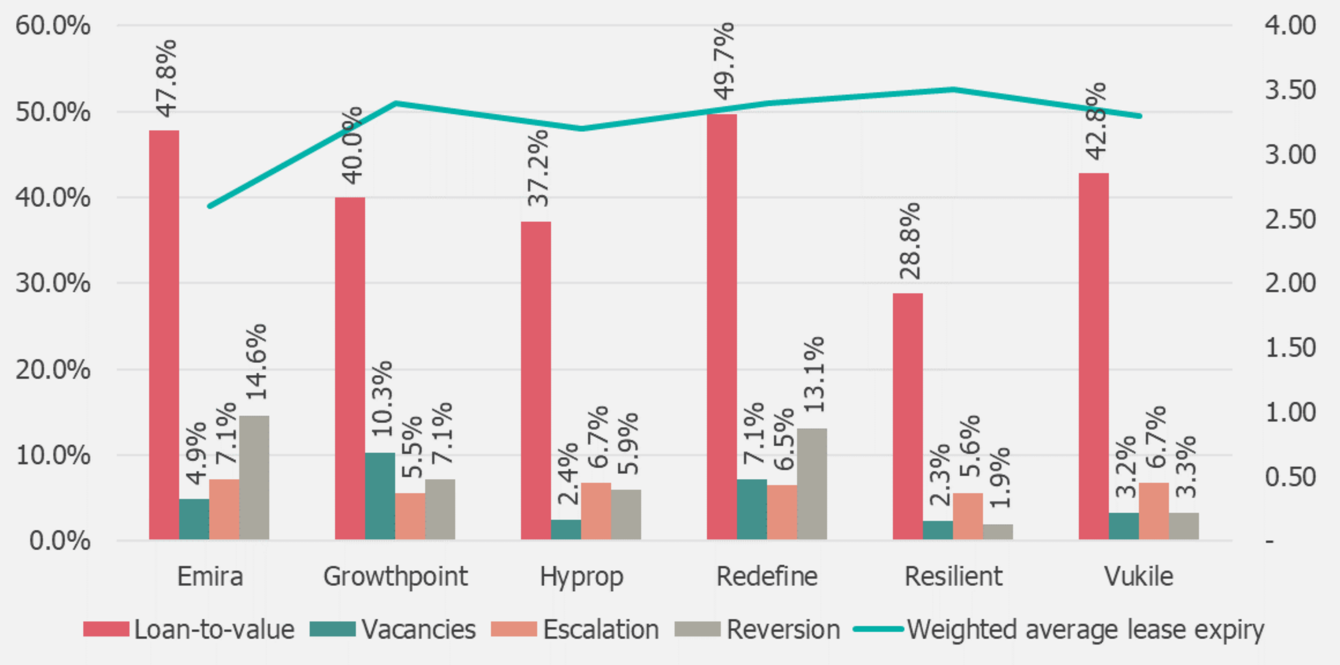
South Africa's e-commerce is still in its infancy, and online sales account for a tiny percentage of total retail sales. For instance, Woolworths and The Foschini Group have indicated that online sales contribute approximately 4% only towards their total sales. As online sales grow so will the need for warehousing space and, in the short term, some of the demand in warehousing will be driven by supply chain optimisation.

What do these forecast trends mean for debt investors?
The onset of the pandemic saw a rapid deterioration in property fundamentals, ultimately putting pressure on property valuations. Many REITs' loan-to-value ratios (a measure of gearing levels) rose to record high levels. As vacancies increased and tenants sought rental relief, earnings came under pressure, increasing the risk of default.

What was encouraging was the extent to which REITs engaged with stakeholders. Property owners engaged with tenants to find solutions that would sustain operations to the benefit of both parties. They also engaged with investors, sharing how they planned to ensure stability in their businesses. In practical terms, this meant:

- securing rental income, sometimes at lower rates;
- granting flexibility in lease agreements;
- retaining as much capital as possible using internal means such as withholding dividends;
- disposing of non-core assets; and
- reducing debt levels.

Figure 2: Performance metrics



Recent results released by REITs suggest that their plans have been successfully executed over the past year. Market players were able to increase balance sheet flexibility, which, in turn, improved their ability to withstand any shocks that may arise over the medium term. The trajectory of credit spreads over these two years suggests that investors are being fairly compensated for the elevated risk and confirms that investors are still exercising caution.

Although the outlook for the listed property market remains uncertain, we believe that the market still offers a few gems, particularly companies with a bias towards defensive sectors, namely community/neighbourhood retail centres and the logistics and industrial sector. The community retail centres' operating fundamentals have been resilient, with lower vacancies and relatively higher footfall and trading densities. Meanwhile, the logistics sector offers the certainty of future cash flows, with longer lease expiries and stable valuations.

Growth expectations for the sector remain muted, and thus REITs with geographically diversified property portfolios are also expected to perform better than those operating in South Africa alone. The sector is not out of the woods yet, and, as such, it will be a while before it returns to its heydays. We will be monitoring letting activity and property fundamentals closely now more than ever but hope to see the resilience showed by the sector to date pay off for investors over the next couple of years.

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