

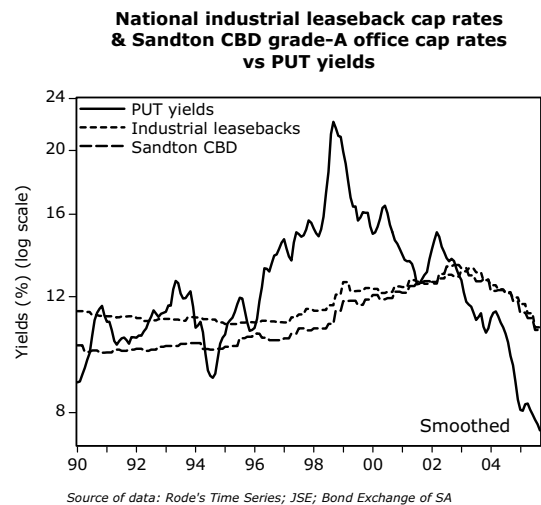
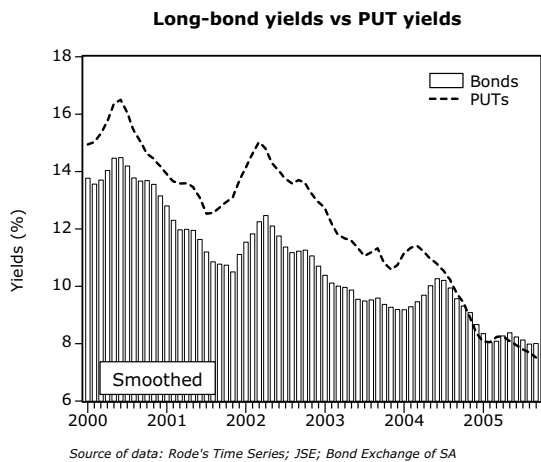
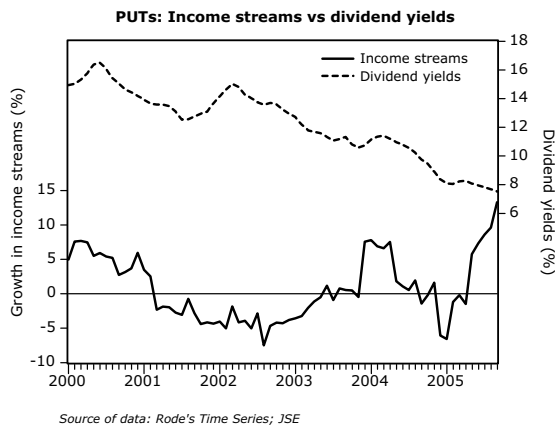
Chapter 7: Listed property

# PUT investors reap the benefits of strengthening fundamentals

During the third quarter of 2005, listed-fund prices soared further as a result of marginally declining income yields and solid income stream growth. As expected, property unit trust (PUT) income yields remained below those of long bonds as a result of the positive outlook for property fundamentals.

bond yields, and is not expected to impact negatively on listed funds' yields.

Moreover, with the non-residential property boom expected to last a number of years (remember that the property cycle has historically been a long one), and with interest rates expected to remain relatively close to their current levels over the next five years (as a result of structurally lower inflation), it is likely that listed funds' yields will remain stable. Other factors supporting low and stable dividend yields are the prospects for a cooling-off in equity markets, the peaking of the residential property cycle, and, perhaps as we have seen more recently, an increase in foreign interest in listed property. The wild card remains the future movement of gilt yields: on the one hand interest rates internationally are heading north, but on the other South Africa's treasury does not have a strong need for new issues, given its sound finances.



The expected increase in short-term interest rates later this year (or early next year), has not yet had any effect on long-

Such stability will give listed funds the leeway and the confidence to pay more for

properties and, hence, reduce capitalization rates in the process. Because capitalization rates reflect the sentiment and perceptions of *long-term* investors (of a potentially illiquid asset), these rates do not adjust to every movement of listed property yields. The accompanying graph shows that property investors only fully bought into the idea of structurally lower inflation and interest rates in around 2003.

Income streams are calculated by using the following identity:

$$\text{Price} = \text{income stream} \div \text{income yield}$$

That is, income stream is calculated by multiplying price by the income yield.

### Listed property vs directly-held property: a primer

Listed property refers to the *property loan stock (PLS)* and the *property unit trust (PUT)* sub-sectors collectively. These two vehicles give property investors the means of buying units in a portfolio of properties that are traded on the JSE. This indirect way of investing in property offers two significant benefits over direct investment:

- Diversification (that is, one invests in a portfolio of properties and hence one adheres to the age-old maxim that one should not put all your eggs in one basket);
- Increased liquidity (the units in a listed fund are traded in affordable denominations on a formal stock exchange).

There are a number of other benefits of investing in PUTs (see <http://www.put.co.za>) and PLSs, but these two are the main reasons why listed-property yields are often substantially less than capitalization rates and, hence, why PLSs and PUTs should trade at a premium to net asset value (NAV) — that is, the market capitalization of a listed fund is more than the sum of the individual properties' market values.

### Historic vs forward yields

A capitalization rate is a forward income yield, which means that it represents the coming year's *expected* net income (assuming the property is fully let at open-market rentals), divided by the current market value of a property.

In contrast, the PUT and PLS yields reported on in the press are historic, or trailing, income yields, which means that they are calculated by taking the previous year's *actual* net income (based on escalated rentals) per unit, **divided by the current market value of a unit.**

Hence one cannot blindly compare the two yields.

**A capitalization rate** (colloquially referred to as a *cap rate*) is the expected net operating income for year 1, assuming the entire building is let at open-market rentals, divided by the purchase price. This calculation ignores VAT, transfer duty and income tax, and it assumes a cash transaction.

When **comparing indices**, one is looking at the levels relative to the base date (which has been set at 100) and not at the actual values (levels) recorded. Thus the above analysis does not mean that the actual income streams attained by F&I 30 shares are higher than those of PUTs, but that the former's income streams have grown faster since 1990 (the base date).

Up to now we have compared capitalization rates and listed income yields, but this is strictly speaking not correct, for the following reasons:

- i. A capitalization rate is a forward yield whereas a dividend yield is an historic yield.
- ii. A capitalization rate pertains to a single property, whereas a listed yield pertains to a diversified portfolio, which makes the latter much less risky.
- iii. Listed property (paper) is much more liquid than directly-held property.

**Table 7.1** is an attempt at calculating what value one can add to the asset value of a property portfolio by listing it. We apply two methods: in method 1 our starting point is the weighted capitalization rate of the portfolio, and in method 2 our point of departure is the current dividend yields of PUTs.

We make the following assumptions:

- The notional portfolio consists of Central Witwatersrand properties, and invests in retail, office and industrial properties in a 40%:40%:20% ratio.
- The market value of the portfolio is R1000 (as if directly held).
- The tenants in the properties are, on the whole, paying slightly more than market rentals — that is, the portfolio is over-rented.
- The cost of listing a directly-held property portfolio is zero.

We adjusted the weighted capitalization rate of our notional portfolio as follows:

- We deducted 1% point for the increased **liquidity** of a listed fund.

- We deducted 1% point to take account of the decreased risk brought about by having a **diversified** portfolio.
- We deducted 1% point to cover asset management and related **fees**.
- A capitalization rate, per definition, does not take cognisance of an over-rented situation. Hence we adjusted net income of the notional portfolio upwards by 2,5%.
- A capitalization rate, per definition, assumes a fully let situation. This will never be the case with a portfolio and, hence, we incorporated a vacancy rate of 5%.
- A capitalization rate is a forward yield; hence we reduced net market income by 6% in order to calculate a trailing or historic yield.

Using the weighted capitalization rate (11,6%) of our notional portfolio as a starting point, and adjusting it for the factors listed above, we arrive at a yield of 8,2% in Model 1. This means that by listing our notional directly-held portfolio, 37% can be added to its value. Method 2 delivers an answer of 33%.

The reader is warned that our calculation in **Table 7.1** is very dependent on certain assumptions. Hence the reader should view this as an exercise in directing one's thoughts.

We use PUTs as a proxy for listed property. We could just as well have chosen property loan stocks, which are subject to similar forces as PUTs and, therefore, follow similar trends. For long-term bond data we use bonds that mature in 10 years plus, as supplied by the Bond Exchange of South Africa.

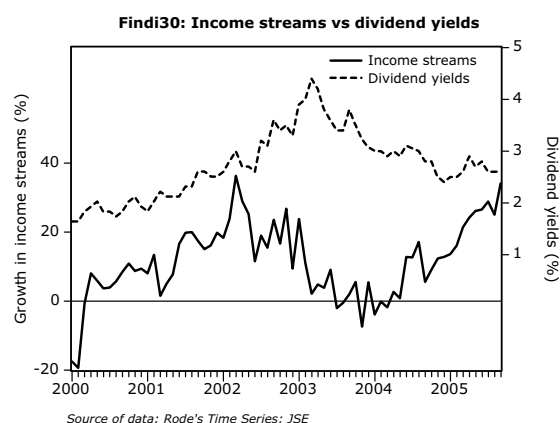
**Table 7.1**  
**Adjusting the weighted capitalization rate of a representative PUT portfolio to an equivalent dividend yield as on 30 September 2005**

<b>Model 1</b>			
	<b>%</b>	<b>Market value</b>	<b>Income stream</b>
Base capitalization rate	11.6%	R1,000	R122.13
<b>Adjustments:</b>			
LESS: Vacancy provision	5.0%		-R6.11
ADD: Over-rented	2.5%		R2.90
MINUS: Conversion of forward yield to historic yields	6.0%		-R7.14
Net trailing cash flow			R111.79
Normalised trailing income yield before adj. for risk/liquidity <b>(a)</b>	11.2%		
DEDUCT: Liquidity premium	-1.0%		
DEDUCT: Diversification benefit	-1.0%		
DEDUCT: Asset management and related costs	-1.0%		
Unlisted property's listed equivalent income yield <b>(b)</b>	8.2%		
<b>Model 2</b>			
ACTUAL PUT income yields	7,4%		
ADD: Asset management and related costs	1.0%		
ACTUAL PUT income yields <b>(c)</b>	8,4%		
Value added/lost by listing (using our model's income yield)	37% = (a/b) - 1		
Value added/lost by listing (using actual income yields)	33% = (a/c) - 1		

We will now briefly consider the performance of listed property relative to financial & industrial shares.

The accompanying graph shows that the income streams of financial & industrial shares have continually gained momentum since the start of 2004. This, together with slightly declining dividend yields, resulted in big capital gains for investors. There is, however, speculation amongst some market players that the equity boom of the last while might be coming to an end. This is so because the expected interest-rate hike in the next few months does not bode well for the rating of financial & industrial shares. However, given the continued strong growth in demand in the economy, the

fundamentals still look solid. Listed property seems to be in a similar situation.



Share prices do not always reflect fundamentals (the movement in income streams). Instead, market perceptions (as measured by income yields or price-earnings ratios) play a major role in the shorter term.

**Table 7.2** shows the individual performance of PUTs and property loan stocks (PLSs) for different periods to the end of September 2005.

This concludes our section on listed property. ■

**Table 7.2**  
**Rates of return on property unit trusts & property loan stocks**  
**to September 2005:**  
 Lump sum investments

Property unit trusts	1 year		3 year		5 year		12 year	
	RNK	%	RNK	%	RNK	%	RNK	%
Capital	1	66,02	1	54,57	4	28,01	4	19,89
Grayprop	3	57,11	3	44,14	1	33,37	2	24,15
Martprop	5	48,77	4	40,00	5	27,23	—	—
Prima	2	59,85	2	47,28	2	32,35	1	24,75
Sycom	4	51,45	5	37,01	3	30,18	3	22,39
Property loan stock	1 year		3 year		5 year		12 year	
	RNK	%	RNK	%	RNK	%	RNK	%
Acucap	5	78,76	7	47,43	—	—	—	—
ApexHi-A	13	59,40	12	39,94	—	—	—	—
ApexHi-B	10	71,55	4	59,18	—	—	—	—
Atlas	12	60,81	10	42,93	5	37,93	2	27,28
Emira	9	72,19	—	—	—	—	—	—
Growthpoint	6	75,60	9	44,63	7	33,36	—	—
Hyprop	8	75,42	5	49,90	4	38,80	3	26,85
IFour	16	53,36	8	46,51	—	—	—	—
Lib-Int	17	51,80	—	—	—	—	—	—
Metprop	2	89,96	14	35,23	9	28,85	—	—
Miccprop	14	56,88	—	—	—	—	—	—
Octodec	15	56,20	2	70,36	3	46,39	1	28,52
Oryx NM	1	107,35	—	—	—	—	—	—
Panprop	3	85,01	6	49,16	8	30,89	4	25,74
Paraprop	4	83,86	15	26,10	10	19,39	5	15,57
Premium	11	69,37	1	90,30	1	64,01	—	—
Redefine	7	75,59	11	41,09	6	35,10	—	—
Resilient	5	78,76	—	—	—	—	—	—
SA Retail	13	59,40	13	38,51	—	—	—	—
Spearhead	10	71,55	3	62,03	2	48,76	—	—

Source: Marriott Asset Management

### Drivers of listed-fund prices

In the short to medium term, the prices for PUTs and PLSs are determined by mainly three factors:

#### 1. Expected earnings

Earnings are driven by property *fundamentals* such as:

- Rental growth
- Vacancy rates (or alternatively, expected take-up in relation to new supply)

#### 2. Performance of long-bonds (or long-term interest rates)

It is general knowledge that listed-property yields closely mimic the behaviour of long-bond yields, implying that investors view them in a similar light. Why? Firstly the risks are similar in that a listed property portfolio is, in one sense, nothing but a bundle of contracts, which by their nature lend a strong degree of *predictability* to future earnings — similar to those of bonds. Secondly, it is a fair assumption that the cash flow of listed property will grow — albeit moderately — in contrast to that of bonds. Thus, the risk and growth prospects tend to cancel one another out, and investors, therefore, see them as close *substitutes*.

#### 3. Short-term interest rates

Most PUTs and especially PLSs have some degree of gearing and, hence, a rate hike or decline could influence earnings. The fact is, however, that many fund managers hedge against interest-rate changes, a course of action that ameliorates or even counteracts the influence of interest-rate changes in the short term.