MSCI Bi-Annual Index

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SESFIKILE CAPITAL
Property Investments

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MSCI released the results of its bi-annual index almost 2 weeks ago. The index captures the performance of the physical property market, including retail, office, industrial, and residential property, over the past six months in South Africa. For the first half of the year, the index achieved a total return of 3.6% (or 7.2% on an annualised basis). Income return continues to underpin total return at 4.0%, while capital growth was -0.4%.

Compared to the 9.1% total return in 2022, in line with slower economic output, 2023 returns indicate a deceleration. Higher levels of load-shedding and higher interest rates, as compared to last year, have severely impacted economic growth and consumer confidence this year.

On a half-on-half basis, the industrial property sector was the best-performing sector at 5.5%, although it did slow from 7.2% in the second half of 2022. Retail property delivered a return of 4.2% (vs. 5.1% in H2 2022), residential was 2.8% (vs. 5.2% in H2 2022), and office was the laggard at 1% (vs. 4.2% in H2 2022).

On a more granular level, retail returns were driven by the community centre format (+5.7%), while super-regional centres lagged at 3.5%. Annualised trading densities were 8.6%, slowing over the last few quarters but ahead of inflation.

The decline in valuations over the past five years has been largely driven by downward revisions to net operating income, while the average capitalisation rate in SA was 8.2%, up only 30bps from 7.9% in 2018.

Despite the additional costs associated with load-shedding and higher energy prices, the total cost of occupation grew by just 4% against the average inflation rate of 6.2% year on year. Net operating income grew 1.9% on a half-on-half basis. This was driven by industrial (6.1%), while office (1.9%), retail (+0.9%) and residential (-0.1%) dragged the average lower. Consequently, net operating income margins improved slightly from

56.6% to 57.1%, reflecting a strong focus on costs by property funds in a challenging market.

There is increasing evidence of accelerating rental growth in the industrial / logistics sector due to higher building costs and structural demand drivers of e-commerce growth, onshoring, and supply chain modernisation. We see limited potential for office rentals to recover in the near term, given the elevated vacancy level of 15.5%, although P-grade rentals could see a turnaround should the current downward trajectory in vacancies (currently at 9.5%) continue. We are encouraged by the low occupancy cost ratios in retail, which is already leading to rental growth in non-urban retail format centres while larger format urban centres are recovering, albeit gradually, from current negative levels.

The listed property market trades at a 40% discount to net asset value (NAV). Adjusting for debt, the market is pricing in a further 25% reduction in asset values, which we believe is not supported by independent valuations and transactional evidence. If anything, most of the recent deals have been at around book value, which supports NAVs. With fundamentals slowing but solid, we expect a change in interest rate trajectory over the next few quarters to be the key catalyst for the listed property sector.

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