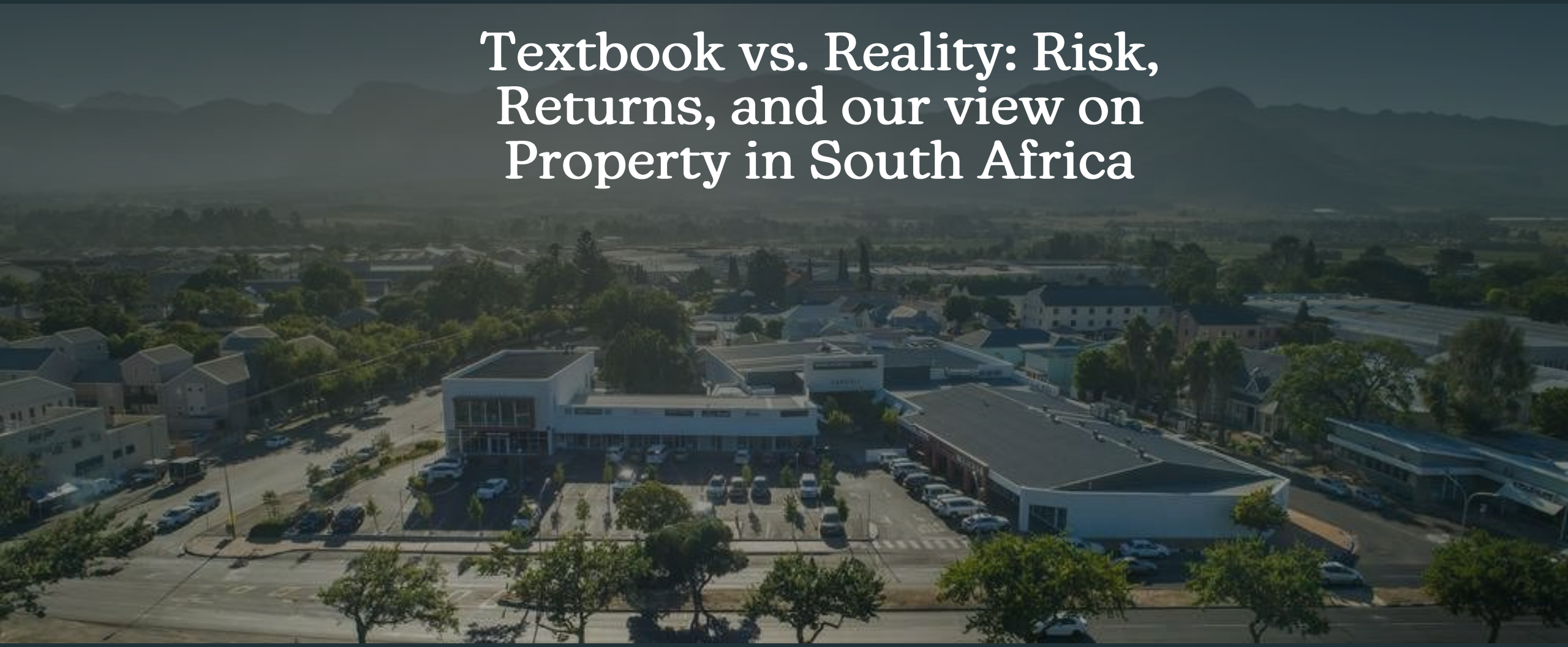
Textbook vs. Reality: Risk, Returns, and our view on Property in South Africa



Red Book Capital: Property Insights

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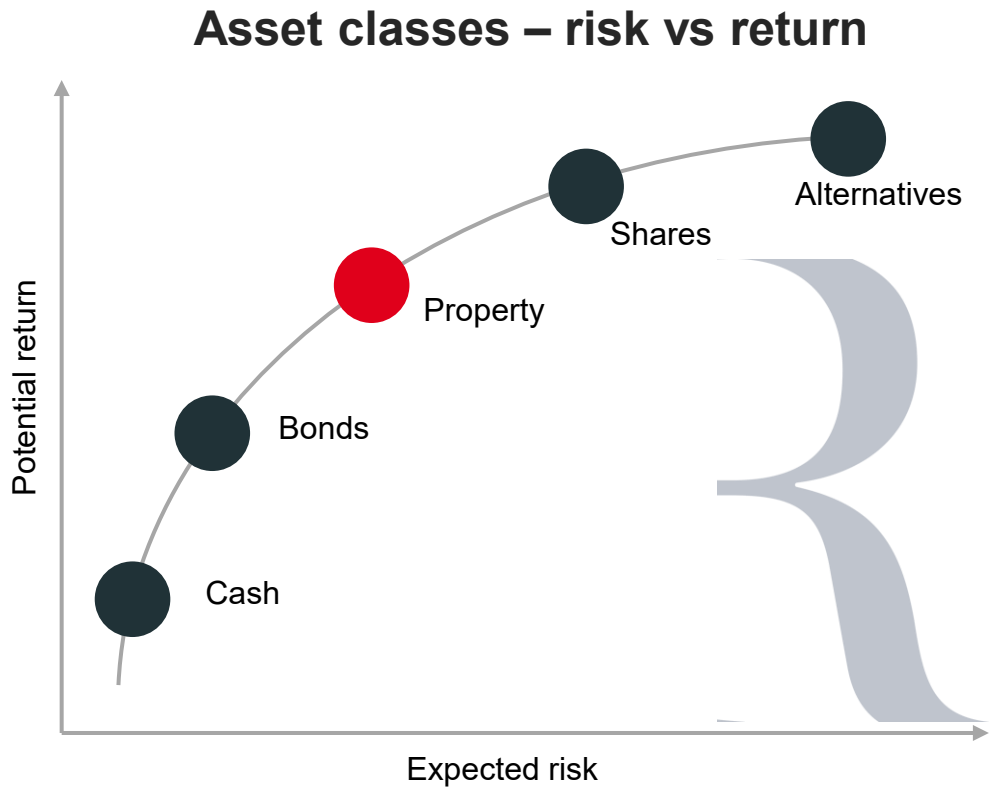
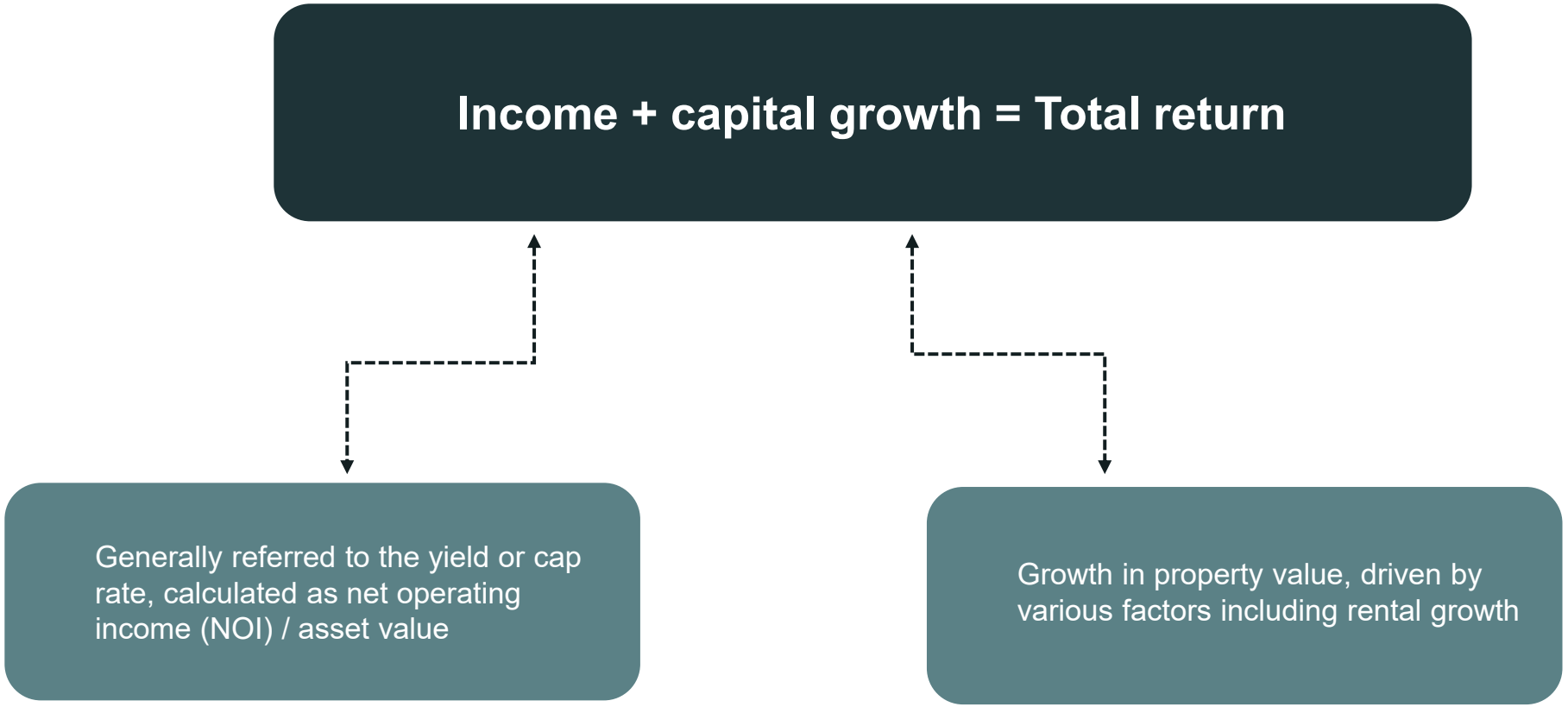
Property as an asset class

- ✓ Property is a hybrid between bonds and equities, as it exhibits both characteristics; **bond-like** (underlying contractual leases with predictable cashflows) and **equity-like** (relates to ability to drive rental growth through value-add, capex and redevelopment strategies).
- ✓ Two examples; Long term leases (>10-years) are more **bond-like** and short-term leases or properties with redevelopment potential are more **equity-like**, offering a higher risk and return profile.
- ✓ Property is therefore expected to **generate returns** higher than bonds but lower than equities.



Property return components



Unpacking NOI –key driver of a property's value

Simplified property income statement

Revenue
+ Rental income
+ Parking income (if applicable)
+ Expense recoveries from tenant
+ Alternative sources of income

Less: Operating expenses ("Opex")
- Utility costs
- Municipal costs and taxes
- Property maintenance costs
- Letting fees
- Property management fees

= Net operating income (NOI)

What is excluded from NOI?

- Maintenance capital expenditure ("Capex")
- Overhead costs (if internally managed)
- Asset management fees (if externally managed)
- Funding / financing costs
- Corporate taxes

It is important to understand how NOI is calculated, as it's a key driver of a property's valuation

What is a cap rate?

- A cap rate is a **measure of the potential return** of a property or portfolio of properties.
- The return referenced relates to the potential unlevered income yield over the next 12 month period (expected NOI / today's value), and excludes the capital return / growth of a property.
- It can also be seen as a measure of risk – properties with high cap rates suggest higher-risk investments, potentially offering greater income returns.

Example of a cap rate calculation

NOI from income statement

Example

Cashflows

R1,200,000	< --- Total revenue
- R400,000	< --- Operating expenses
= R800,000	**< --- NOI**

Valuation using a cap rate

R800,000	< --- NOI
/ 10% cap rate	< --- Cap rate
= R8,000,000	**< --- Value of property**

Implied ungeared earnings multiple: 10x

Property value = NOI / Cap rate

Beyond NOI - Capex

Property is a **capital-intensive asset class,** which requires investment capital to increase the useful life of the property, by countering physical, functional and economic obsolescence.

Maintenance capex, which refers to improvements made to the property to support rental growth, does not form part of NOI but can materially influence total returns.

For stable assets, capex as a **% of asset value could range between 0.5% and 2% of asset value** (on average), reducing the net free cashflows of the property.

Free cash flow goes beyond NOI

Revenue
Less: operating costs
= Net operating income
Less: Maintenance capex
= Free cashflows*

**Before taxes, overheads / fees, funding costs etc.*

Listed Property payout ratios
This is one of the primary reasons why JSE-listed property companies introduced payout ratios in line with global REITs – to retain a portion of cashflows for capex purposes, and to only distribute free cashflows post capital expenditure to shareholders.

Gearing and returns

- Since property is a tangible asset with contractual leases in place (income-producing properties), it is typically easy to leverage.

- High levels of gearing (75% to 85%) result in a small margin of safety, whereas gearing levels typically between 30% and 40% are considered to be conservative.

- Gearing has a significant impact on total returns, especially through the geared growth in asset value -see the next slide for calculating gearing multipliers.

Impact of gearing on net growth in cashflows

Gearing multiplier = 1 / (Equity %)

A	B	C	D = 1 / B	E = C x (D)
LTV ratio	**Equity % (1 – LTV)**	**Assumed rental growth**	**Gearing factor**	**Geared growth to equity**
20%	80%	5%	1.25x	6.3%
35%	65%	5%	1.54x	7.7%
40%	60%	5%	1.67x	8.3%
50%	50%	5%	2.0x	10%

For example, if a fund has an LTV ratio of 35%, assuming cashflows grow at 5%, geared cashflows to equity holders will grow at 7.7%, due to a gearing factor of 1.54x (1/65%).

Notes:
The gearing multiplier is a high-level estimate of the impact of gearing for LTV ratios up to 50%.
The true impact of gearing in non-linear and has a significant exponential impact for LTV ratios over 50%.

Shorthand calculation for property returns

This provides a shorthand method for estimating property returns

Drivers of income *Drivers of capital growth*

Total return = [Cap rate – capex % of value] + [NOI growth + gearing impact]

Total return = [8.5% - 1.0%] + [4.0% + 2.2%] = 13.7%

In the example above, a property with a cap rate of 8.5%, with a capex budget of 1% of asset value (on average), cashflows (NOI) growing at 4%, at a 35% LTV ratio (implied gearing factor of 1.54x), is expected to generate a 13.7% total return on equity, i.e., geared return

Notes:
For this illustration, we assume that the cost of funding is equal to the net income yield.

Textbook vs reality – risks to returns

But where do property returns fall short in practice?

- **Profit margin squeeze.** E.g., although revenue (rentals) could increase by 5%, if operating costs increase by 10% (e.g., due to outsized increases in municipal charges), NOI might only increase by 3% to 4%.
- **Cap rates (especially for quality real estate) are below cost of funding.** This results in a negative impact on the yield (e.g., a property with a cap rate of 8%, financed all-in at a debt cost of 9%, results in an equity yield between 7% and 8%).
- **Overheads / JV costs / management costs.** These costs could be underestimated or not accounted for when assessing returns on a property level.
- **Lack of rental growth.** Depending on the supply & demand dynamics of the area and property class, rental growth could be flat or even negative.
- **Capex.** The capex requirement to keep the property relevant and vacancies intact, might be much higher than originally budgeted.
- **Liquidity.** Even if a property performs well, there may not always be buyers when it's time to exit, potentially leading to a discounted disposal price to support risk-adjusted returns for the new owner. This is particularly evident in secondary locations.

Except for property fundamentals improving – is there upside potential?

- **Cap rate compression.**

This refers to yields decreasing, implying a higher price paid for the same level of income. In broader investment terms, this is similar to an increase in the price-to-earnings (PE) ratio over the investment horizon.

In our view, there are potentially two key drivers of cap rate compression in the medium term:

1. A lower interest rate environment compared to the last few years;
2. A few significant property funds (listed and unlisted) are in the process of repatriating capital to South Africa, which could increase competition in the transactional market.

- **Solar PV installations.**

In South Africa, solar installations offer compelling economic benefits and have emerged as valuable alternative revenue streams. Beyond enhancing ESG credentials and ensuring energy security for tenants, they are increasingly seen as a strategic capital allocation strategy for landlords, enhancing total returns of properties. Ungeared IRRs are typically between 15% and 20%, and for some projects it could even be higher.

Ungeared property returns in SA (30-year period)

Figure 1: Income vs capital returns (SA average - ungeared)

Source: MSCI

Figure 2: Total returns (SA average - ungeared)

Source: MSCI

Figure 1 demonstrates the blend of **bond-like** (income returns in White) and **equity like** (capital growth in Red) characteristics of property

As demonstrated in Figure 2, ungeared total returns in South Africa averaged 13.2% over the last 30 years

Conclusion

- Investors should have a **realistic view of expected returns from property**, considering its hybrid characteristics - part bond-like, part equity-like.
- There are **risks in relying on "short-hand" methods to estimate property returns**, particularly given the impact of funding costs, capital expenditure (capex), and potential shifts in exit cap rates. We therefore recommend a detailed 5-to-10 year cash flow model to test a range of returns based on conservative assumptions.
- Our view is that **actual property returns over the past decade have generally underperformed projected or "textbook"** expectations of returns. This underperformance has largely been due to the pandemic and prolonged periods of subdued economic growth in South Africa.
- Looking ahead, we anticipate a **stabilisation in returns**, supported by a lower interest rate environment (relative to the last three years), gradual improvement in property fundamentals from a low base, and additional alternative income streams (e.g., Solar PV, billboards), which offer attractive marginal returns. This assumes broadly stable economic and geopolitical conditions.
- We believe that high quality real estate investments in well located areas could offer **geared returns of between 13% and 15%** (LTV ratios between 30% and 40%) and between **15% and 20%** (LTV ratios of between 65% and 80%).

Caveats & disclaimers

- This "*Property Insights*" report is not an exhaustive study on real estate returns & risk in South Africa but rather attempts to contribute to accessible property insights and thought-leadership pieces in South Africa.

- **Disclaimer:** The information provided in this document is for general information and educational purposes only. It does not constitute advice of any nature.

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