EDISON

South African industrial property fundamentals are strong

REITs share prices are not benefiting from industrial property sector exposure

By Thobelani Maphumulo

Should investors buy REITs that have exposure to the industrial property segment?

The industrial property sector has recovered well from the COVID-19 lockdowns. The warehousing and logistics segments have gained support from improved activity in manufacturing production, international trade and the domestic retail sector. According to Statistics South Africa, manufacturing production volumes increased by 1.4% year-on-year in August 2022, supported by vehicle and transport equipment production, which accounts for 9% of total manufacturing production. Between March 2022 and August 2022, the average annual increase in nominal manufacturing sales was 12%. At the same time, international trade's need for storage, logistics and warehousing has provided solid support for industrial property owners. Additionally, growth in online sales, which was – to a large degree – bolstered by COVID-19 lockdowns, continues to contribute positively to the demand for logistics space as customers demand last-mile fulfilment. Retailers and logistics property companies have been adding warehousing and distribution capacity to optimise the supply chain. In 2020, South African online retail sales (ZAR30bn) contributed 2.8% to total retail sales, according to World Wide Worx. We think there is an immense potential upside for online retail sales in the long term.

Low vacancy rates bode well for rental growth

According to our calculations, based on company reports, the current industrial property sector vacancy rate is c 4%, slightly below the 25-year average of c 4.2%. MSCI reported that in December 2021, industrial distribution centres, industrial manufacturing and industrial warehouses posted vacancy rates of 0.9%, 7.7%, and 6.4%, respectively. This means that distribution centres outperformed other industrial property segments. Over the past few years, speculative developments in the industrial property space have been muted, despite the strong demand for industrial properties. Low vacancy rates augur well for rental growth as property owners do not experience negative rental reversions when leases expire.

Strong rental growth rates underpin valuations

According to property research company Rode & Associates, nominal rental growth for 500 sqm spaces rose by 5.4% year-on-year in Q222, a significant improvement compared to 0.5% and 2.2% in Q220 and Q221, respectively. Similar nominal rental growth of 5.3% was recorded in Q322; overall growth for the year so far has been 5.1%. The combination of positive nominal rental growth rates and declining capitalisation rates has underpinned the rise in industrial property values. However, Rode & Associates points out that real rental growth has been adversely affected by rising building cost inflation, which in Q222 was already 11% higher year-on-year, according to the Bureau of Economic Research Building Cost Index. Rental growth is a function of vacancy rate and construction cost inflation.

Big South African industrial property regions have shown impressive performance

The big South African regions have delivered strong nominal rental growth rates in 2022. Durban, KwaZulu Natal province's biggest port city, was severely affected by floods and riots in 2021, which limited the supply of new industrial property stock. Nonetheless, demand for large-scale industrial properties remains strong, especially in the logistics sector. According to Rode & Associates, in the year to end September 2022, nominal rental growth was 5% year-on-year, significantly higher than the 2% growth in the previous year. In Cape Town, Western Cape province, nominal rental growth increased by 6.7% year-on-year in Q322, marginally below the 7.2% posted in Q222. Lastly, in Witwatersrand, Gauteng province, nominal rental growth was 4.4% year-on-year in Q322. Looking ahead, a major deceleration in rental growth seems unlikely given the limited supply of new stock in big metropolitan areas.

Exhibit 1: REITs' South African industrial property exposure

	Ticker	Market cap (ZARm)	SA industrial portfolio (ZARm)	Industrial % of SA portfolio	SA industrial vacancy rate
Equites Property Fund	EQU	12,500	16,300	100%	0.1%
Growthpoint Properties	GRT	45,046	12,092	16%	5.7%
Redefine Properties	RDF	29,267	11,600	20%	3.1%
Fortress REIT	FFA/FFB	17,240	16,900	58%	6.3%
Investec Property Fund	IPF	8,200	3,300	22%	1.6%

Source: Companies' financial reports

Equites Property Fund is the only logistics-focused REIT listed on the Johannesburg Stock Exchange

Equites Property Fund has a portfolio of ZAR26.3bn in logistics properties, split between South Africa (62%) and the UK (38%). In its FY23 interim results (to end August 2022), it reported a 33% jump in revenue due to strong rental growth. Net rental growth increased by 26% compared to the same period in 2021. In South Africa, management expects a warehousing space rental growth rate of 15–20% in 2022. In the UK, property consultancy Gerald Eve, forecasts 15.8% rental growth in 2022. Moreover, Equites Property Fund management's rental growth projection is 5% between 2022 and 2026.

In South Africa, the national vacancy rate for A-grade properties, eg distribution centres, is less than 1%. It is worth mentioning that Equites Property Fund has the longest weighted average lease expiry (WALE) – 13.3 years in South Africa and 15.6 years in the UK – relative to other domestic REITs' industrial property portfolios. The WALE for most industrial and logistics companies is less than five years. A-grade logistics properties account for 97% of Equites Property Fund's investment property portfolio. In the first half of FY23, Equites posted a 0.1% vacancy rate. In addition, it has a well-managed capital structure, as reflected in the loan-to-value ratio of 33%.

Management indicated that there is currently less available space to rent compared to the pre-COVID 19 period. Equites has benefited from the strong demand for warehousing space as supply chain optimisation and e-commerce continue to gain momentum. It plans to add 288,000 sqm of warehousing space (value of ZAR2.7bn) in the medium term; and has a substantial strategic land bank. It is important to note that there is a scarcity of serviced land in South Africa and the UK. In South Africa, this has resulted in an increase in all-in development costs from ZAR10,000/m_2 to R12,000/m_2 over the past three years.

Equites is trading at a discount to NAV

Equites posted a 6.5% increase in NAV/share to ZAR18.77. The share price is currently trading at an 18% discount to NAV, the biggest discount over the past five years. Equites has a 10% dividend yield and the dividend per share increased by 4% in H123. Management expects distributable income to grow between 4% and 6% in FY23.

Growthpoint's industrial portfolio shows signs of improvement

Growthpoint's industrial properties account for 16% of the total South African investment property portfolio of ZAR78bn, located in Gauteng (62%), Western Cape (21%) and KwaZulu Natal (17%). In the year to end June 2022, Growthpoint's South African industrial vacancy rate was 5.7%. The light manufacturing segment was the worst performer, recording a 19.6% vacancy rate, while the rate for the distribution centre was 1.7% (37% of the industrial portfolio). A sizable portion of Growthpoint's properties are classified as B-grade, and this segment is currently experiencing negative rent reversions due to higher vacancy rates. Unfortunately, due to Eskom's poor maintenance of coal-fired power stations, electricity load shedding has unfavourably affected Growthpoint's industrial manufacturing tenants. The stock is trading at a 40% discount to NAV per share at ZAR21.58, with a 10% dividend yield. The large exposure to the office sector (33% of the South African portfolio), which is still in the doldrums, remains a major factor behind the large discount to NAV, in our view.

Redefine Properties' industrial portfolio vacancy rate is a mixed bag

Industrial properties account for 20% of Redefine's South African investment property portfolio of ZAR58bn (65% of the total ZAR88.9bn portfolio). According to Redefine's FY22 results (year to 31 August), the industrial active vacancy rate was 3.1%. The best-performing segments were retail warehouses (2.9%) and modern logistics (2.6%) and the worst-performing were warehousing (11%) and industrial units (7.4%). Redefine has logistics assets in Poland, with a carrying value of ZAR4.7bn. However, the bulk of its ZAR30bn platform value in Polish investment is in the retail sector following the acquisition of EPP in March 2022. In our view, Redefine's large exposure to the South African office market (37% of the South African portfolio) remains a flaw in the company. The stock is trading at a 43% discount to NAV per share of ZAR7.20 with a 10% dividend yield.

Fortress has significant exposure to industrial properties

Fortress's industrial property portfolio accounts for 58% of its South African total investment portfolio of ZAR29bn. Fortress has assets in South Africa and Central and Eastern Europe (CEE). The vacancy rate in the South African logistics segment has fallen from 4% in FY19 to 1.2% in FY22. By contrast, in FY22 the CEE logistics portfolio experienced an increase in the vacancy rate to 8.2%, from 1.5% in FY21. According to our estimates, the broader industrial sector vacancy rate in South Africa is 6.3%. It is noteworthy that Fortress has only 7% exposure to the office sector in contrast to its peers, which have significant industrial properties. On a negative note, the company is likely to lose its REIT status as a result of its failure to pay dividends, as required by South African REIT regulation. Fortress has a dual share listing (FFA and FFB). Management has not paid dividends for the last two financial years due to the

constraints imposed by its Memorandum of Incorporation, which prevents the payment of distribution where distributable earnings are less than the FFA distribution benchmark. Under the regulations, Fortress has until 30 November to declare compliant distribution. The FFA share price is trading at a 16% discount to NAV per share of ZAR12.43.

Investec Property Fund's logistics properties recorded sound performance

The industrial sector accounts for 22% of Investec Property Fund's South African investment property portfolio of ZAR14.9bn. In FY22 (year to March 2022), its industrial portfolio recorded a 1.6% vacancy rate, a significant decline from the previous year's 17.2%. The division was supported by a significant improvement in letting activity. The industrial portfolio is made up of logistics (44%), manufacturing (25%) and warehouses (17%). Unfortunately, Investec has a sizeable office portfolio (ZAR5.5bn or 37% of its South African investment portfolio). The South African office sector is currently in oversupply and suffering from the effects of low economic growth. Investec Property Fund is trading at a 40% discount to NAV per share of ZAR16.96 with a 9% dividend yield.

Outlook

We expect the industrial property sector to benefit from the strong demand for logistics and warehousing properties, as retailers demand more warehousing capacity to meet last-mile customer fulfillment despite a challenging macroeconomic environment There is a scarcity of serviced land in South Africa, and this contributes to a muted level of new development projects. We believe that rental growth, combined with stable capitalisation rates, will support NAV returns in the medium term. Equites is the only specialist logistics company listed on the Johannesburg Stock Exchange. Other REITs have diversified portfolios, and their greater exposure to the office market has led to a significant de-rating as investors are still concerned about the glut in the office market. We therefore expect diversified REITs to benefit marginally from industrial property sector exposure, although extended discounts may persist until the office market letting space is significantly reduced. By contrast, Equites has strong tailwinds as its logistics-focused portfolio is fully let.