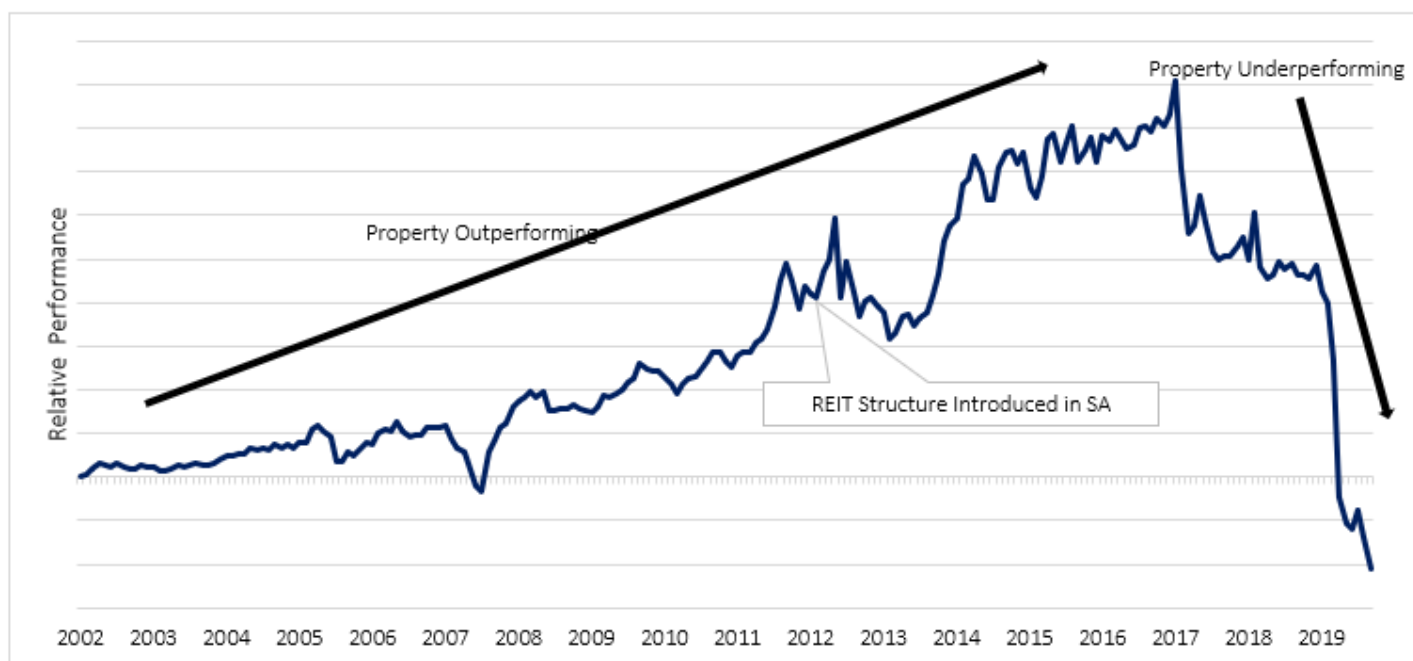


The Impact of REIT structures on Listed Property Investing

Listed property was the top performing local asset class over a period of 15 years from 2002 through to the end of 2017, outperforming the broader equity market by 5% per year over that period. The outperformance was driven by a range of factors: the listed property businesses being managed more professionally, the benefits of increased scale as additional property was added to portfolios, the introduction of the REIT (Real Estate Investment Trust) structure and in later years, investors' insatiable appetite for property investment. This excessive demand for listed property led to property companies trading at very high valuations with many investors regarding it as "a bubble about to burst" in 2016 and 2017. In late 2017, the bubble did burst on the back of concerns around the accounting practices of one of the largest property groups, Resilient, and its related companies. As one can see in the chart below, the reversal has been severe, with COVID-19 and the negative impact that has had on property companies and the economy playing its part over the last year.

Chart 1: Performance of SA Listed Property Sector relative to total SA Equity Market



As mentioned, one of the contributors to the strong property performance, as well as the subsequent sharp decline, is the REIT structure used by listed property companies and it is important for investors to understand these structures and the impact they can have when investing in listed property.

What is a REIT?

A REIT is a company listed on a stock exchange that owns, operates, or finances income-producing property. They were first created in the United States to allow broad-based investment into property for those investors unable to afford, manage or finance the buying of property in their own name. REITs allow individuals to own a proportion or share in a collection of properties rather than having to purchase entire properties on their own. Once an individual has purchased a REIT share, they effectively earn a portion of the income produced by the portfolio of properties that the REIT owns through dividends. Since its origination in the United States, the REIT structure has been adopted by 38 other countries, including South Africa.

For a company to be classified as a REIT, it has to fulfil certain criteria which vary slightly depending on which country a REIT is listed in. In South Africa, the main criteria are that REITs:

- Must pay at least 75% of their distributable earnings out to shareholders as dividends;
- Earn 75% of their income from rental on property owned or investment income from both direct and indirect property ownership;
- Own at least R300m of property; and
- Keep their debt below 60% of gross asset value.

Even if a company meets these criteria, they are not forced to adopt the REIT structure. Instead, they are incentivised to do so by the special tax status that a REIT enjoys. This tax status allows REITs to deduct all dividends paid out to shareholders from their taxable income, thereby reducing income and company tax payable. REITs are therefore a tax efficient structure for a property company to adopt. End investors then pay tax in their personal capacity based upon the dividends they receive from the REITs. The REIT structure therefore mimics a direct investment in property for investors but in a liquid and tax efficient manner.

Local vs Offshore REITs

There are a few key differences between local and offshore REITs. These differences include the legislation governing them and the way in which they are managed. We demonstrate the main differences in the table below.

Table 1: Key Differences Between Local and Offshore REITs

| Criteria | SA | Offshore |
|--------------------------------|---|---|
| Debt levels | Locally listed REITs have historically had low levels of debt, but the debt levels have risen from approximately 20% to 40% since 2008. | The impact of the 2008 global financial crisis on global REITs was more severe as a result of the relatively high level of debt of around 50% on average. This has subsequently reduced to about 30% on average. ^[1] |
| Income Paid Out (Payout Ratio) | REITs are required to pay out at least 75% of their income in SA. Despite this, most SA REITs paid out significantly more, averaging closer to 90% of earnings. These elevated payout ratios have been reducing in recent years given the need to retain capital. | In most countries (including the United States, United Kingdom, Germany, Australia, and Japan), REITs are required to pay out at least 90% of their income. |
| Specialisation | REITs in SA tend to be diversified with holdings across office, retail, industrial and residential sectors. We have started to see some specialisation with the listing of companies such as Stor-Age (self-storage) and Equites (industrial). | Globally listed REITs tend to be more specialised and many own only one type of property e.g. only residential or only office. |

Impact of the REIT Structure

The requirement for REITs to pay out the majority of earnings means that there is minimal cash retained in the business, and the majority of retained cash is directed towards maintenance of existing properties. As a result, REITs normally need to raise capital if cash is needed for any reason (e.g. to buy new properties).

In a property bull market when the going is good, this is generally quite easy to do and is done in one of three ways:

- Raise money in the market by selling additional shares
 - In a bull market, there is significant demand for listed property which means that REITs can raise money without discounting share prices.
- Sell existing properties
 - Bull market conditions also mean that there is high demand for properties as other businesses are also looking to grow. This demand means that it is easier to sell properties if required and if so, this can be done at reasonable prices.
- Take on additional debt
 - Providers of debt are also more comfortable to provide additional debt at reasonable levels of interest when property markets are strong.

REITs engage in all of these capital raising activities during the good times. Continued growth ensures that rights^[2] issues are often oversubscribed and demand for shares in the listed REITs is ever-present which in turn pushes the share prices higher. The momentum behind these companies can lead to inflated share prices as was seen in 2017. When the property market slows down, or experiences a negative shock, this can reverse quickly. If earnings fall, companies usually rely on capital retained in their business. In the case of a REIT, the majority of the capital is paid out every year under the rules governing the structure. At the point where capital is needed to see the business through a difficult period, it is then very difficult to raise capital:

- REITs find it difficult to issue additional shares without negatively impacting existing shareholders
 - In order to attract investors to take part in a rights issue REITs have to issue shares at lower prices (i.e. offer a discount) than the prevailing market price of their shares. This places share prices under pressure and existing shareholders can be negatively impacted.
- REITs find it more difficult to take on additional debt
 - Low share prices and subdued growth expectations mean that debt providers (such as banks) are now concerned about balance sheet risks. These providers are less inclined to provide funding and where they do, demand higher interest rates from the REITs which makes it costly to take on additional debt.
- It is difficult to sell individual properties
 - In a market downturn, many companies are looking for capital at the same time. This increased supply results in depressed prices which, in turn, makes it unattractive for REITs to dispose of properties. REITs generally don't want to sell properties even when property prices are high so these low prices make it even less likely that REITs will engage in the disposal of properties.

In this environment REITs find it difficult to finance ongoing maintenance costs, let alone add additional properties to their portfolio. This negative feedback loop results in REITs facing increasing balance sheet risks the longer the negative cycle continues, adding pressure to already depressed share prices. A good example of this is the Covid-19 pandemic. It arrived at a time when the local property market was already under pressure. The resultant lockdowns, ability to work from home and increased adoption of online shopping added cash flow constraints and reduced growth prospects for the sector.

Local and global listed property can fulfil an important role in long term wealth creation while also providing diversification from equities. In addition, the REIT structure has good attributes in that it provides investors with liquid access to property exposure and a regular income stream in a tax efficient manner. However, it is important for investors to understand the risks associated with property including how the REIT structure can exacerbate risk during adverse market conditions.

^[1] Source: Catalyst Fund Managers

^[2] A 'rights issue' is a term used to describe the issuance of new shares by a company to the stock exchange.

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February 2021

data provided by Reuters and Datastream

MARKET REPORT

28/02/2021

| | | 3m | YTD | 1yr | 3yr pa | 5yr pa | 10yr pa | 5yr Vol1 | 10yr Vol1 |
|---|-----|--------------|--------------|---------------|---------------|--------------|--------------|----------|-----------|
| LOCAL MARKET INDICES | | | | | | | | | |
| FTSE/JSE All Share Index (ALSI) | ZAR | 16.1% | 11.4% | 33.2% | 7.6% | 9.2% | 10.7% | 15.4% | 13.4% |
| FTSE/JSE SA Listed Property | ZAR | 19.5% | 5.1% | -15.8% | -13.5% | -7.6% | 4.6% | 25.7% | 20.7% |
| SA All Bond Index (ALBI) | ZAR | 3.2% | 0.8% | 8.3% | 7.1% | 9.8% | 8.5% | 8.1% | 7.8% |
| SA Cash Index (StefI) | ZAR | 0.9% | 0.6% | 4.8% | 6.4% | 6.9% | 6.3% | 0.3% | 0.3% |
| Balanced Benchmark | ZAR | 10.0% | 6.9% | 21.7% | 8.9% | 8.8% | 11.1% | 10.6% | 8.9% |
| SA Inflation (1 month lag) | ZAR | 0.5% | 0.3% | 3.1% | 4.0% | 4.5% | 5.1% | 1.3% | 1.3% |
| GLOBAL MARKET INDICES BASED TO USD | | | | | | | | | |
| Global Equity (Datastream World) | USD | 5.9% | 1.6% | 30.0% | 11.4% | 14.7% | 10.0% | 14.8% | 14.0% |
| Emerging Markets Equity (Datastream EM) | USD | 11.6% | 3.9% | 36.5% | 6.7% | 15.7% | 4.8% | 17.3% | 17.8% |
| Global Property | USD | 3.8% | 1.4% | 3.5% | 6.5% | 7.4% | 6.7% | 14.7% | 14.7% |
| Global Bonds (Barclays Global Bond Index) | USD | -2.4% | -3.7% | 3.4% | 3.3% | 3.1% | 1.9% | 5.4% | 5.1% |
| Global Cash | USD | 0.1% | 0.0% | 0.4% | 1.7% | 1.4% | 0.9% | 0.2% | 0.2% |
| MAJOR INDICES BASED TO RANDS | | | | | | | | | |
| FTSE/JSE All Share Index (ALSI) | ZAR | 16.1% | 11.4% | 33.2% | 7.6% | 9.2% | 10.7% | 15.4% | 13.4% |
| Global Equity (Datastream World) | ZAR | 3.7% | 4.8% | 25.1% | 21.0% | 13.8% | 19.0% | 16.9% | 14.5% |
| Emerging Markets Equity (Datastream EM) | ZAR | 9.2% | 7.1% | 31.4% | 16.0% | 14.7% | 13.3% | 14.4% | 13.3% |
| Global Property | ZAR | 1.6% | 4.6% | -0.3% | 15.7% | 6.5% | 15.3% | 16.7% | 14.4% |
| SA All Bond Index (ALBI) | ZAR | 3.2% | 0.8% | 8.3% | 7.1% | 9.8% | 8.5% | 8.1% | 7.8% |
| Global Bonds (Citigroup) | ZAR | -4.4% | -0.7% | -0.5% | 12.3% | 2.3% | 10.2% | 16.3% | 14.4% |
| COMMODITIES | | | | | | | | | |
| Gold (US Dollars) | USD | -2.7% | -9.0% | 8.9% | 9.4% | 7.0% | 2.0% | 13.2% | 16.1% |
| Gold (Rands) | ZAR | -4.7% | -6.1% | 4.8% | 18.9% | 6.1% | 10.3% | | |
| CURRENCIES | | | | | | | | | |
| Rand / Dollar | ZAR | 2.1% | -3.1% | 3.7% | -8.7% | 0.8% | -8.1% | 17.0% | 15.5% |
| Rand / GBP Pound | ZAR | -2.5% | -5.5% | -5.4% | -9.2% | 0.8% | -6.5% | 17.7% | 14.7% |
| Rand / Euro | ZAR | 0.7% | -2.3% | -6.4% | -8.5% | -1.4% | -6.7% | 15.3% | 13.6% |

| Spot Rates | | 26-Feb-21 | Latest Quarter | 1 Year Ago | 5 Years Ago | 10 Years Ago | 20 Years Ago |
|----------------------|------|-----------|----------------|------------|-------------|--------------|--------------|
| CURRENCIES | | | | | | | |
| Rand/US\$ | Rand | 15.15 | 14.69 | 15.73 | 15.78 | 6.94 | 7.78 |
| Rand/GBP | Rand | 21.16 | 19.88 | 20.09 | 22.00 | 11.29 | 11.21 |
| Rand/EUR | Rand | 18.38 | 17.97 | 17.28 | 17.15 | 9.58 | 7.07 |
| RATES | | | | | | | |
| Libor 6m \$ | US\$ | 0.20 | 0.26 | 1.40 | 0.89 | 0.46 | 5.04 |
| Repo Rate | Rand | 3.50 | 3.50 | 6.25 | 6.75 | 5.50 | 12.00 |
| Prime | Rand | 7.00 | 7.00 | 9.75 | 9.75 | 9.00 | 14.50 |
| All Bond Index Yield | Rand | 9.75 | 9.62 | 9.62 | 9.79 | 8.71 | 9.74 |
| COMMODITIES | | | | | | | |
| Gold (\$/oz) | US\$ | 1 727.44 | 1 897.77 | 1 586.71 | 1 232.88 | 1 415.05 | 263.25 |
| Platinum | US\$ | 1 204.00 | 1 068.00 | 871.00 | 919.00 | 1 804.00 | 604.00 |
| Oil (Brent Crude) \$ | US\$ | 66.08 | 51.89 | 50.52 | 36.43 | 113.26 | 26.07 |
| INFLATION | | | | | | | |
| SA Inflation | % | 3.2 | 3.1 | 4.6 | 7.0 | 3.6 | 9.4 |

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