How the real estate sector has performed in a high-inflation environment

According to Madibana Letsoalo, listed property equity analyst at Momentum Investments, the South African real estate sector has benefited from above-inflation escalations. Although some sectors are still battling the impact of a post-Covid market.

Madibana Letsoalo, listed property equity analyst at Momentum Investments

Speaking during a recent webinar, Letsoalo said the downward trend in escalations, as well as negative reversions in the broader market have put some pressure on base rental growth in the current rising inflation environment relative to historic periods.

Coupled with this, she said direct property costs have seen above-inflation growth with rates and taxes, for example, having increased by 341% on a cumulative basis since 2006. “This has undoubtedly put pressure on net property incomes growth,” said Letsoalo.

Having said that, she noted since the early 2000s, direct property has provided total returns of 13.8% on average compared to the average inflation rate of 5.5%.

Capital returns not keeping up with inflation

Property income has consistently averaged 9% during this period while capital returns have not been able to keep up with inflation over the long term.

Capital returns turned into negative territory in 2019 and were further exacerbated by the impact on property value during the pandemic. “We have started to see valuations trough in some of the listed property companies, although some sectors such as the office market may continue to see declining valuations in the short to medium term.”

Letsoalo said listed property, on the other hand, has outperformed direct property since 2002, achieving total returns of 16.1% and real returns of 10.6%. In the past 20 years, the sector has only had four periods of negative real returns including year-to-date 2022. Until the end of 2019, listed property consistently outperformed bonds, cash and equities, having only underperformed the equity market in the wake of Covid-19 as property companies were some of the hardest hit stocks in the market.

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Pressure on consumers

“There is no doubt that a high inflation and high interest rate environment is likely to add pressure on the consumer’s wallet,” said Letsoalo.

She said this is particularly true for lower to middle-income earners who spend roughly 25% of their income on nondiscretionary items such as food and personal care. “Consumers are likely to start shopping down the value curve and we will potentially see smaller basket sizes with smaller proportion of the consumer’s budget to discretionary spend.”

Letsoalo said investors continue to favour convenience shopping centres with a greater proportion of essential services, as well as rural and township and township centres with exposure to value brands compared to larger shopping centres.

With improving trading figures and footfall returning to these centres post the lockdown restrictions, she notes that larger shopping centres are making a comeback.

New report notes 263% growth in Lagos short-let market following pandemic
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Vacancies remain sticky in office market

In the office market, Letsoalo said vacancies remained sticky at 16.7% in the second quarter of the year, having increased sharply from the pre-Covid level of 11% in December 2019.

“This equates to roughly 1.1 million square metres which has been vacated in the past two and a half years,” said Letsoalo. “The high vacancy rate continues to put pressure on office rentals as the sector grapples with oversupply and very little new demand for office space.”

She said green office spaces generally do outperform non-certified prime and A-grade offices on all metrics measured by the Green Buildings Council of South Africa. “Vacancies in green buildings outperformed their counterparts by 70 basis points, indicating tenant interest in green buildings.”

Building cost inflation likely to keep development bay

From a development activity perspective, Letsoalo has seen building cost inflation also increasing significantly in the current cost environment, having increased by 12.9% year-on-year in April 2022. “This is likely to keep development activity at bay, limiting new development coming into the market in an oversupplied sector such as the office and retail market.”

Industrial developments are still breaking ground with some landlords having the ability to pass building increases to their tenants. “The favourable demand and supply dynamics in the rental market is likely to drive rental growth going forward.”

Overall, Letsoalo said the windshield for property is certainly getting a lot clearer. “A year or two ago, the sector was marred with a lot of uncertainty. Having passed through one of the toughest operating environments in property sector history, we believe earnings have troughed and anticipate a recovery in earnings going forward.”