11 July 2019

Property Insights

The Economic Fundamentals don't make picking "winning" major property classes easy

Retail Property's long run relative outperformance appears to be explained by relevant economic fundamentals, with its "driving economic sector" having broadly outperformed those that drive Industrial and Office Property since the mid-1990s. But this has changed of late.

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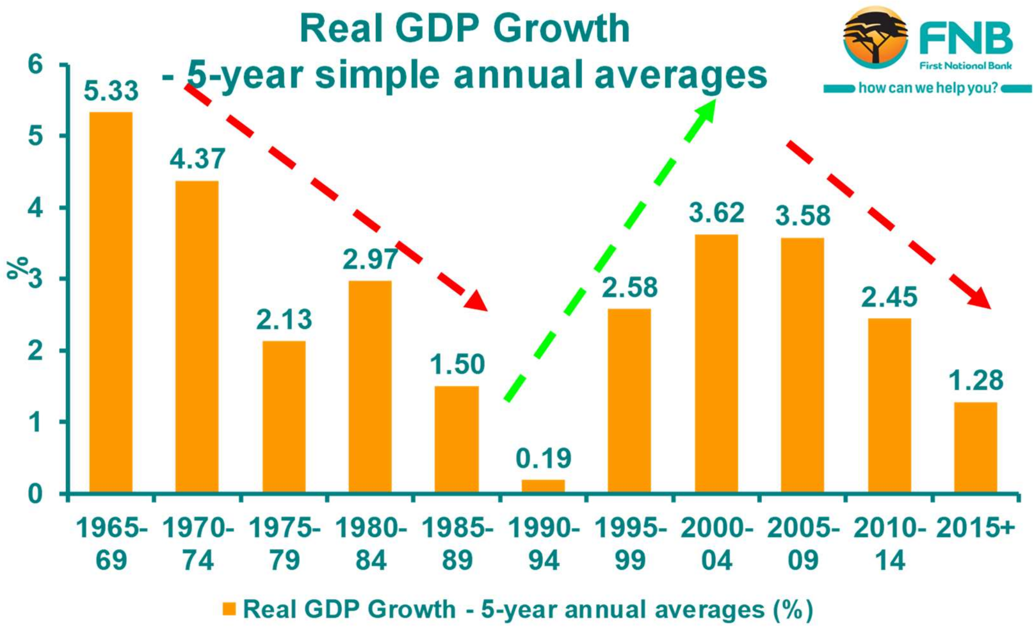
Through the current economic "super-cycle" to date, the Retail Property Class has been the relative "outperformer" compared with the other major sectors, i.e. the Industrial and Office classes.

I am of the belief that the current economic super-cycle" began its upswing in the early-to-mid 1990s following the move to democratic government and the end of South Africa's economic isolation (via boycotts and sanctions) from the rest of the world. It continued to gain momentum during last decade, prior to 2008, fueled further by a major downward adjustment in interest rates following a high peak where Prime Rate reached 25.5% around mid-1998. This drove a major Household Sector consumption and housing demand boom. If the consumer culture wasn't firmly established in South Africa yet, it was after that, and assisted economic growth in reaching rates of above 5% (very high by SA standards), from 2005 to 2007, and averaged above 3.5% per annum for the decade 2000-2009.

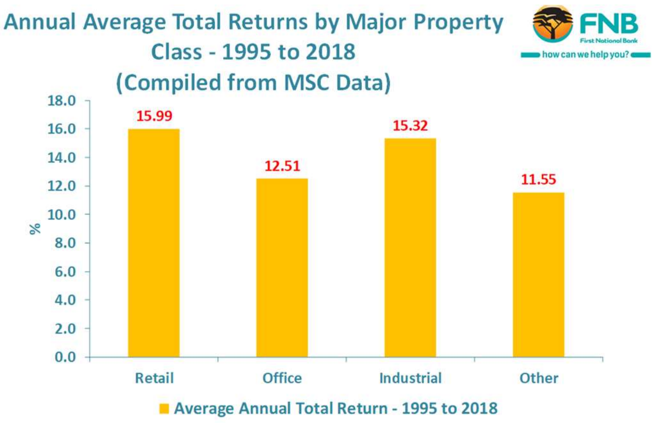


The broad super-cycle stagnation arguably commenced from 2008 onward, despite some stimulus package-driven "mini-recovery" in economic growth in 2010 and 2011 before the longer run growth stagnation really set in.

Retail has thrived, especially in the pre-2008 consumer boom

It is not surprising, given that a credit-driven consumer spending boom was a key driver of the super-cycle upswing, that Retail Property has outperformed on an annual average basis using MSCI data dating back to 1995.

A simple annual average for total returns from 1995 to 2018 puts Retail Property at 15.99%, Industrial Property at 15.32%, and Office Property at a noticeably lower12.51%.



This begs the question as to whether these relative performances all seem "rational" from an economic fundamentals point of view.?

The answer appears to be, at a macro level, yes.

A look at the main economic sectors driving demand for major property classes.

We believe that the Gross Value Added (GVA) for the "Retail and Wholesale Trade, Catering and Accommodation" Sector would be the main driver of retail property demand and thus a key influence on the Retail Property Sector's performance.

As mentioned, the Retail Property Market has been the average "outperformer" over the past 2 decades or so, its value growth and total returns outpacing the other major property classes of Industrial, Office and even Residential.

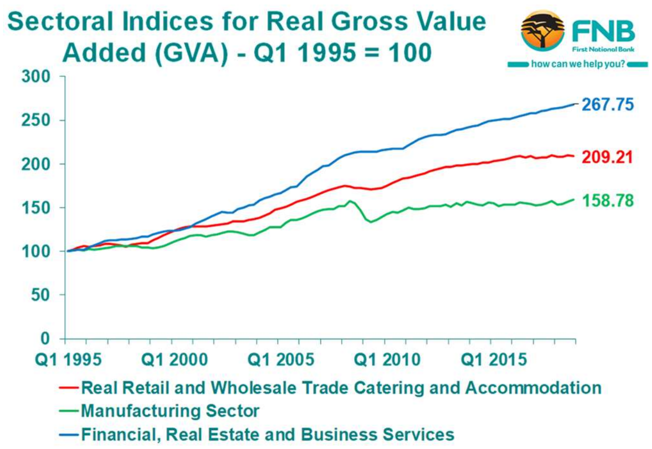
The Office Property Class's demand is influenced strongly by that major services sector, the "Finance, Real Estate and Business Services" Sector. However, unlike Retail, it is less this sector's GVA that matters and more the employment trend in this sector.

The Industrial and Warehouse Property class would be strongly influenced by the large Manufacturing Sector. However, the warehousing part would also be strongly influenced by economy-wide demand for products that require warehousing space during their journey to their final destination. Retail and Wholesale Sector strength would thus also be important to Industrial and Warehouse Space, and we also pay attention to the estimated level of economy-wide inventory build-up.

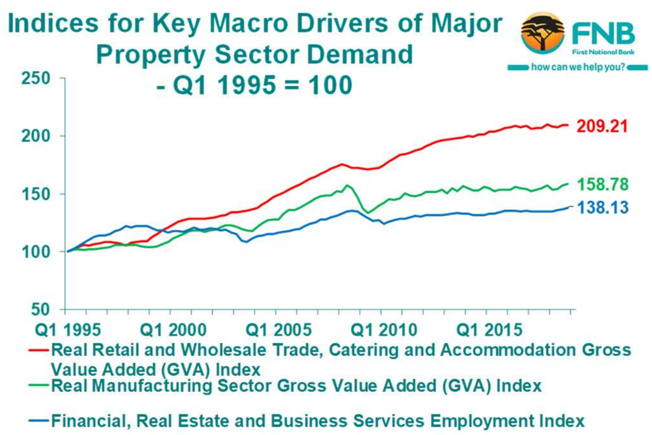
Viewing the 3 relevant economic sector GVA's, that we've identified as being most influential, we actually see that, since 1995 (compiling GVA indices with Q1 1995 = 100), it has been the Finance, Real Estate and Business Service Sector that has outperformed by miles, growing its GVA cumulatively by 167.75% in real terms from Q1 1995 to Q1 2019.

This is far ahead of the Retail and Wholesale Trade, Catering and Accommodation Sectors' 109.21% growth over the period, or the Manufacturing Sector's even slower 58.78%.

Using GVA measures, therefore, the Office Sector's demand fundamentals would have appeared strongest.



However, when substituting the Finance, Real Estate and Business Services GVA with the SARB's employment index for that sector, things start to make sense. Employment in that sector has only risen 38.13% over the 23 year period, far slower than the Manufacturing Sector GVA or the Retail and Wholesale Trade Sector GVA.



Now the long term macro economic fundamentals make sense, Retail Property's key driver having been the strongest, Industrial Property's 2nd, and Office

Property's key driver a poor 3rd.

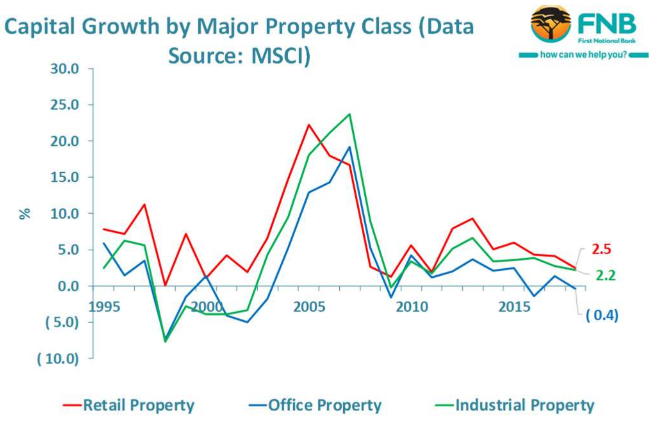
While there is much talk of technological advancements and their "disruptive" potential for the Retail and Retail Property Sector through the advent of online shopping, the Office Sector has arguably been feeling the impact of technological advancement for a few decades to date. This comes through in the major discrepancy between Finance, Real Estate and Business Services' GVA growth vs its employment growth, reflecting massive productivity improvements in the sector (many technology-driven), containing the growth in demand for office space.

And as corporates start to ponder a greater portion of their workforce working remotely in the near future, aided by great leaps in communications technology, the growth in demand for office space can conceivably remain under pressure.

Office Space, perhaps not surprisingly therefore, has been more prone to average capital depreciation during weak property periods, having dipped into deflation in 5 out of the 6 years from 1998 to 2003, again in 2009 and more recently in 2016 and 2018.

By comparison, Industrial Property also experienced periodic average capital depreciation, including in the 5 years from 1998 to 2002, and in 2009, but not more recently.

Retail Property, while also experiencing short term slowdowns in line with short run interest rate, or economic, cycles, has not recorded a year of average capital depreciation in the 1995 to 2018 period, according to MSCI data.



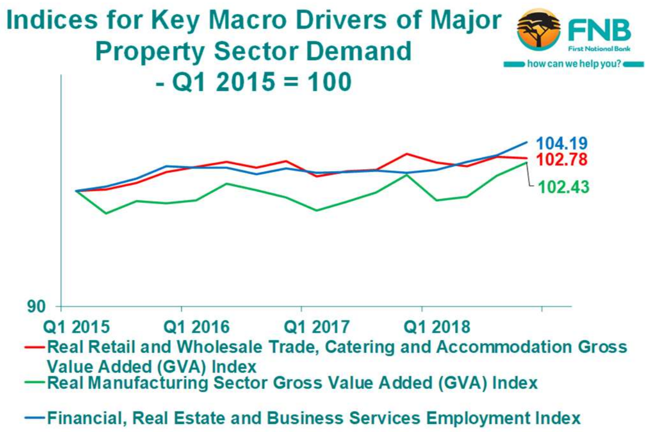
The Fundamentals going forward...no clear outperformer

The continued outperformance of Retail Property appears unlikely. The consumer is no longer a confident person, and increasingly financially stretched.

By South African standards, households experience low income growth in a weak economy, remain highly indebted and at a very low savings rate, not the consumer environment conducive to strong consumer and retail demand growth.

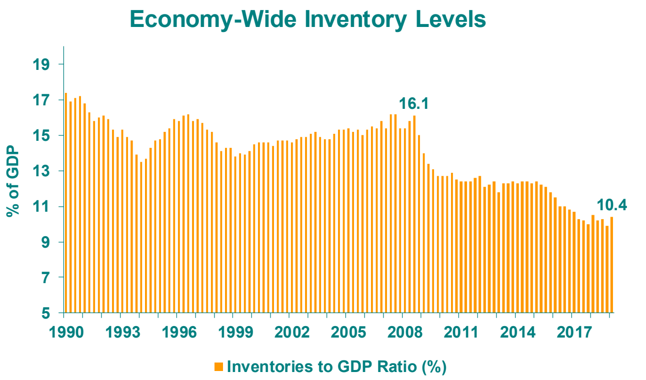
We next the major 3 indices again, but with a more recent base of the 1st quarter 2015 (Q1 2015 = 100).

Now we see a different relative picture in which there really is no clear winning sector. Finance, Real Estate and Business Services Sector Employment took 4 years to grow a meagre 4.19%. Real Retail and Wholesale Trade, Catering and Accommodation GVA grew by a lesser 2.78%, while Manufacturing GVA grew by a lowly 2.43%....everything thus in the doldrums and narrowly grouped together.



Some believe that the Industrial and Warehouse Property class is the future "winner", set to outperform. A portion of it where specialized warehousing is required as online retail expands? Perhaps. But the overall sector has both economic and technological challenges of its own, and hasl also been weakening.

The Manufacturing Sector's growth is pedestrian, for one. In addition, though, has information technology improved inventory management, thereby lowering the level of inventory build-up relative to economic activity levels? Examining the SARB's "Inventory-to-GDP (Gross Domestic Product) Ratio, we see that it has declined from 16.1% back in 2008 to 10.4% a decade later. At a stage back in 1990 this percentage was above 17%, and even in a major 3 year recession in the early-1990s it didn't go below 13%. So while recessions can bring drops in inventory levels, this broad decade long drop in the inventory-to-GDP ratio appears to be a little more than just that.



Conclusion

In short, all major property sectors have both economic and likely technological change challenges to adapt to.

The Office Property class still appears set to remain the underperformer of the 3 major classes for the time being. But whether the Retail or Industrial class will be the "winner" is a tough call to make.

The economic fundamentals for Industrial as a whole don't appear any better or worse than those of Retail Property.

Why then would we perhaps see Industrial and Warehouse Space as likely to mildly outperform Retail Property in the near term? Perhaps because the former remains far more affordable than the latter, Retail having become very costly from both a capital value, rental and operating cost point of view.

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