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The South African Listed Sector

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He co-manages approximately R5bn in SA listed property portfolios for institutional and retail clients as well as being responsible for the Asian component of the Catalyst Global Real Estate Fund.

For the 12 months ended 31st December 2011, the SA Listed Property index recorded a total return of 8.93%. Of the four traditional asset classes, SA Listed Property (8.93%) performed best in terms of total return followed by Bonds (8.80%), Cash (5.71%) and Equities (2.57%).

Asset Class	Dec-11	12 - months
SA Listed Property ¹	2.10%	8.93%
Bonds ³	0.70%	8.80%
Cash	0.45%	5.71%
Equities ²	-2.45%	2.57%

Source: I-Net Bridge

Note: 1 SA Listed Property Index, 2 All Share Index, 3 All Bond Index

The 2011 financial year was shaped by significant credit events, political change/ indecision and natural disasters. These events contributed to significant financial market volatility in 2011. The main drivers of volatility were concerns surrounding the possibility of European sovereign debt defaults and the contagion thereof. This affected investor sentiment for the most part of 2011. Other significant events included; the impact of a U.S. sovereign credit rating downgrade, a Tsunami in Japan and political uprisings in North Africa and the Middle East.

Unlike direct property, listed property share prices are marked - to - market everyday and prices immediately reflect changes in expectations and outlook. Listed property share prices are not immune to financial market volatility. Despite this short term volatility, SA listed property exhibited its resilience as a source of stable cash flows and income growth by achieving a satisfactory total return performance in 2011. Over the long term the total return from SA Listed property will be driven by the income, plus

growth in the income. What we know is that as at the 31st December 2011 the historic rolled income yield of SA listed property was 7.93%. The question should be: What is income growth likely to be?

Simplistically the drivers of income growth are: annual rent escalations, positive (negative) reversions on lease expiries, change in vacancy levels, earnings enhancing / dilutionary property transactions, changes in operating costs and changes in debt funding costs.

1. Annual rent escalations

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Escalations continue to be the largest driver of income growth for SA listed property companies. Every year listed property companies have, on average, 80% of their existing leases contracted to escalate at a rate of between 6 - 10%, with the remaining portion being renegotiated on expiry of the lease. Despite the weakening economic environment, most SA listed property companies continue to achieve similar escalation rates on new lease contracts.

2. Positive (Negative) reversions on lease expiries in the year

Direct real estate conditions remain challenging and market rental growth over the past two years has significantly lagged escalation rates (most noticeably in office and industrial). On average, national consumption growth and trading density growth (which underpin retail rental level growth) have lagged escalation rates. Unless we see significant rental level growth over the short term, it is likely that most companies will move into a negative reversion cycle on their expiring leases.

3. Change in vacancy levels

An increase in vacancy levels across most portfolios was a significant driver of lower income growth over the past two years. The consensus is that the vacancy levels have troughed, but given the current economic climate, net new demand remains subdued. As a result, the positive effect that vacancy reduction has on distribution growth is only expected to filter beyond a 12-18 month time horizon.

4. Earnings enhancing/ dilutionary property transactions

Strong competition in the direct market has made it difficult for SA Listed property companies to do transactions that are immediately accretive to income. Most of the recent high profile transactions e.g. V&A Waterfront and Attfund Retail, have been neutral or dilutionary to income in the first year.

5. Changes in operating costs

Rising electricity costs and municipal rates (with a reduction in service delivery) has driven operating cost growth in excess of rental revenue growth over the past few years. A large portion of these costs are recoverable from the tenant but still increases the overall cost of occupancy for the tenant. This inhibits the landlord's ability to increase rental levels on expiry of the lease. This trend is expected to continue over the short term.

6. Changes in debt funding costs

SA listed property companies typically have the interest rate levels on a portion of their loans fixed for the loan period, while a certain portion is left floating. The floating portion is susceptible to short term interest rate changes. Recent low short term interest rates have led to lower interest costs for SA Listed property companies. Over the past few years fixed debt as a percentage of total debt has declined as many listed property companies have elected to leave their debt floating as fixes or swaps expire. This is beneficial in the short term, especially as short term rates are expected to stay low for longer, but does decrease the hedge against short term rate increases in the future.

The outlook for distribution growth in 2012 remains reasonable, but lower than in the past few years. Assuming distribution growth of 5% the forward yield from listed property at 31st December 2011 is 8.33%. This compares favourably to the South African Benchmark Overnight rate of 5.35% (5.34% - 31st December 2010), and the yield to maturity on long term government bond index of 8.08% (8.15% - 31st December 2010).

Assuming moderate growth in GDP over the short term (and no large external shocks) the major risk to total returns in the short term is a weakening in capital markets. Like bonds, listed property share prices are inversely related to the movement in listed property income yields. Listed property income yields are highly correlated to other fixed income yields, especially in the short term.

Listed property is a long term investment and over the long term the total return from listed property will be driven by the income yield plus growth in that income. Listed property remains an attractive alternative to cash and bonds over the long term.

Glacier Research would like to thank Paul Duncan for his contribution to this Week's Funds on Friday.

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