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PROPERTY SECTOR REVIEW - INFLECTION POINT

The global property sector has had a tumultuous two years since the advent of the Covid-19 pandemic. While property is traditionally considered a relatively ‘safe’ investment given the contractual nature of its leases, recent history has proven otherwise. In a desperate attempt to save lives and livelihoods, governments around the globe instituted various lockdown restrictions that challenged the sanctity of leases. Temporary trading restrictions were placed on commercial property assets, which not only resulted in loss of turnover rent, but also led to reduced contractual rent due to increased rent concessions and tenant failures. In some extreme cases, as was the case with the UK moratorium on commercial leases, landlords were prevented from evicting tenants for non-payment and from collecting any rental arrears for two years. Whilst most of these restrictions have since been lifted, the pandemic has had a long-lasting impact on the sector as it has accelerated pre-existing trends initially triggered by the onset of the fourth industrial revolution. According to the University of Oxford’s Future of Real Estate Initiative (FoRE), the common mantra in real estate circles of location, location, location is quickly evolving to location, experience, analytics. In this note we highlight some of the major themes that have emerged in recent history and how real estate markets are adapting to the changing landscape. We also provide an overview of the South African commercial property market, as well as our views on how global trends may play out in the local market.

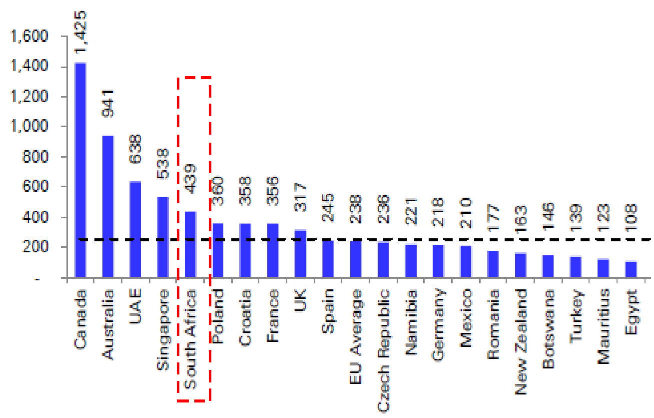
Modern Real Estate: Location, Experience, Analytics

We highlight below how technology is shaping the respective commercial property sectors. We also discuss how an increased focus on sustainability is challenging norms in the built environment.

Retail:

The impact of technology on the retail sector has most noticeably been seen in the rise of online retail and the consequent demise of secondary shopping centres globally. This underperformance of physical retail space was more pronounced in markets with excessive existing space (as measured by space/capita). A summary of space supply is provided in the chart below. Markets, like the US and UK, were also at a disadvantage because of their sizeable exposure to tenants most at risk to disruption like department stores. Early indications are showing that the most defensive retail assets will be those that either provide a convenience offering to communities (focused more on essential goods and services), and those that cater for destination shopping (focused more on brand and shopping experiences, dining, and entertainment). Retail landlords like Simon, Unibail-Rodamco-Westfield, Hammerson and NEPI Rockcastle have also been increasingly focusing on creating mixed-use precincts (live, work and play places) adjacent to their shopping centres in recognition of the changes in shopper behaviour. The increased adoption of remote working, has for instance, meant that people are shopping closer to home. Landlords are also exploring alternative income sources from advertising, brand and data services given their increased use of data and analytics in the operations of their shopping centres. Going forward, landlords will need to revisit their lease structures so they can account for online sales, and for ancillary services like data, marketing, and fulfilment. Tenants are also increasingly demanding more flexible lease terms, and in some cases shorter leases that enable them to adapt to changing customer needs. The other major trend that is shaping not just shopping centres, but the entire built environment, is the increased focus on sustainable building practices. We will discuss this topic later under offices.

Retail space supply in 2016 (m^2/ 1000 capita)

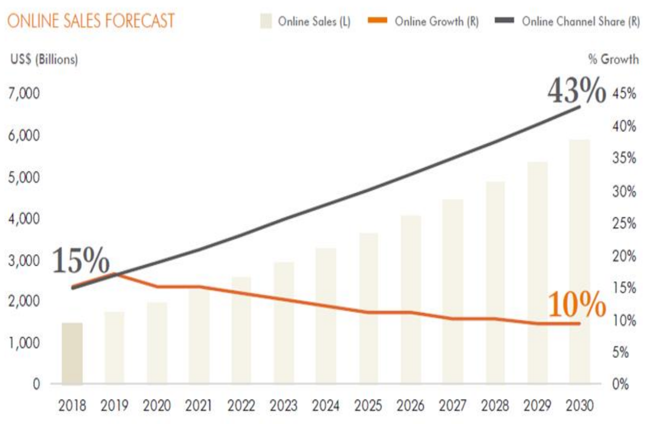


Source: Deutsche Bank, South African Council of Shopping Centres

Industrial:

The industrial sector has been the beneficiary of the rise of online retail as e-commerce requires approximately three times the space that traditional retail distribution operations need. The primary difference in e-commerce is that all the inventory sits in the warehouse until it is sold, whereas some of it would ordinarily sit in the retail store in a traditional distribution model. Online retail penetration in some countries like China and the UK, have reached double digit levels. Factors that contribute to the take up of e-commerce include a reliable postage system, an efficient transport system and the geographical landscape (densification and road infrastructure). Collectively, these factors determine the cost of delivery. South Africa's e-commerce penetration is still below 3% and is not expected to grow aggressively. There are various challenges that hamper growth, mostly related to the cost of delivery. That said, these challenges are not insurmountable. In the long run e-commerce will grow to more significant levels in line with global trends.

Global e-commerce penetration (%)



Source: CBRE (Forecast shown represents the U.S., China, Japan, India, Germany, France, U.K., Russia, Canada and South Korea)

Office:

According to the FoRE Initiative, there are four major trends driving how occupiers are using offices: 1) climate change and carbon management; 2) co-working; 3) digital data, worker performance and smart buildings and, 4) transport technology. We will unpack these trends under two topic headings below:

- *Fourth Industrial Revolution:* Technology has enabled employees in the knowledge industry to work from anywhere. The virtual workplace is therefore increasingly replacing the physical one. This shift towards remote working (otherwise known as telecommuting) is making IT infrastructure more important to businesses than physical real estate and is therefore expected to put pressure on office rentals. Offices that will prove to be resilient are those that can adapt to the modern workforce (i.e., can cater for full-time, part-time, and remote-working employees by adding features like co-working space), are technology enabled (i.e., smart buildings), and are people centred (i.e., prioritise the health and wellbeing of its occupants). Smart buildings will not only enable landlords to improve efficiencies (electricity, water, and waste management) but will also enable tenants to better monitor their space usage. More informed tenants may require less workspace going forward and may also require more flexible lease terms to cater for their fluid space requirements. Both these trends are expected to be negative for rental growth.

- *The Green Agenda:* The World Green Building Council (WGBC) is the primary driving force behind green buildings, with a focus on climate action, health and wellbeing, and resources and circularity. It aims to work alongside other organisations and governments to drive the UN Sustainable Development Global Goals. The WGBC Carbon Buildings Commitment requires all new buildings to achieve net zero carbon status by 2030, while all existing buildings need to meet net zero carbon standards by 2050. As tenants become more educated on the impact of buildings on the environment, and on their health and wellbeing, the green status of buildings will increasingly become a consideration when committing to new space. In a world of rising costs, green buildings will also increasingly become a business imperative given their improved cost efficiencies.

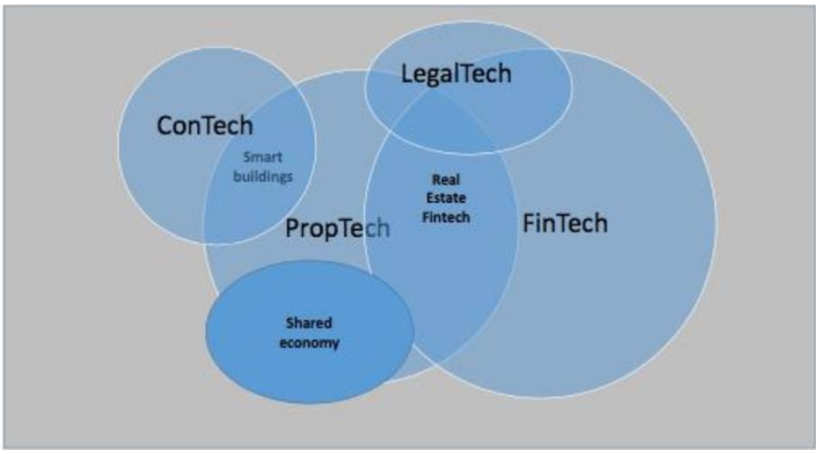
The infographic below details WGBC's assessment of the benefits of green buildings to the environment, their occupants and to landlords.

Benefits of Green Buildings

Source: World Green Building Council

The broader use of technology in the built environment is now more commonly known as Proptech. The term describes all the technology used in the buying, selling, management and valuation of real estate. The graph below illustrates how Proptech is a confluence of various innovations that have converged to impact the built environment.

Proptech Roots, 2020

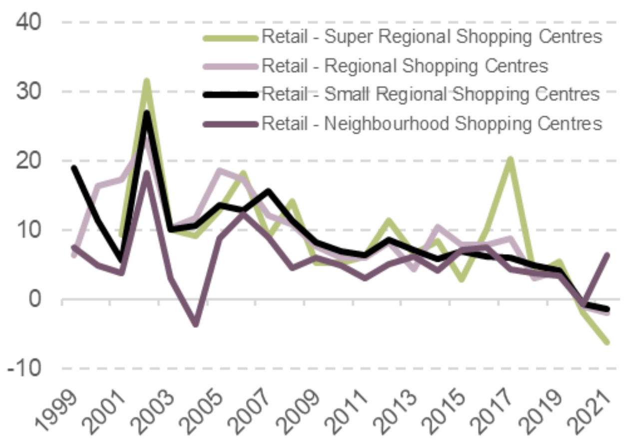


Source: Oxford Future of Real Estate Initiative

SA Property Snapshot

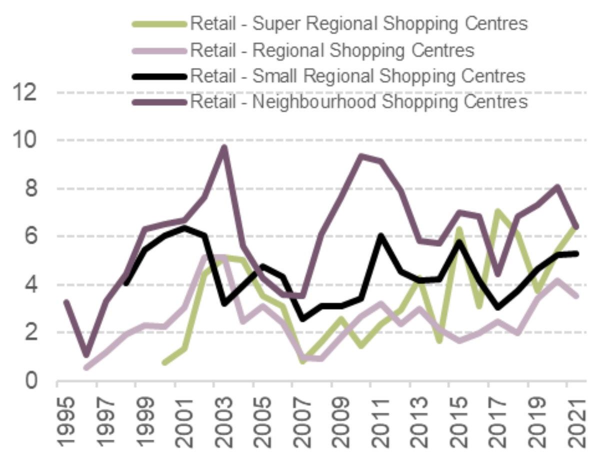
The SA commercial property market has been under pressure for several years due to oversupply and to lack of new demand given the sluggish economic backdrop. Rental growth has been trending downwards in most sectors of the industry, while operating costs have been increasing more than inflation. Cost pressures have mostly been seen in administered costs. Landlords have been proactive in managing operating costs through adopting various green building initiatives such as the use of photovoltaic (PV) solar panels and of energy efficient lights, and increasingly through the adoption of smart building technologies.

Retail: Base rental growth (%)



Source: MSCI

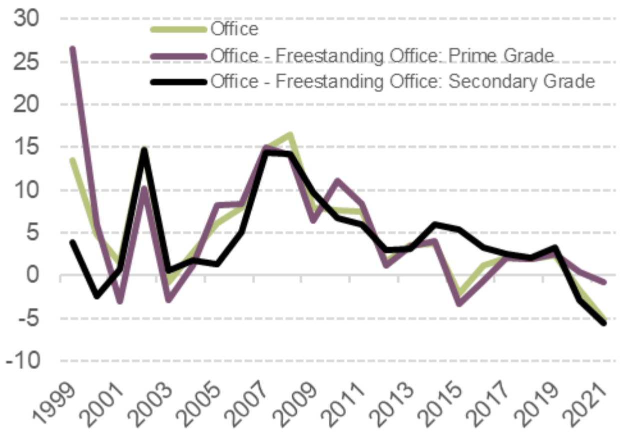
Retail: Vacancies (% GLA)



Source: MSCI

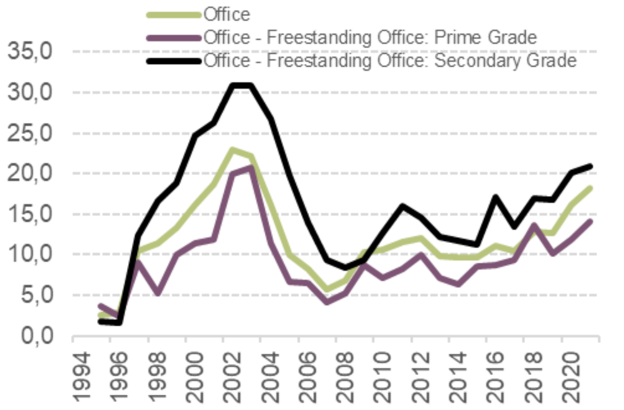
The retail sector has seen a persist increase in supply over the years as retailers have sort to increase their market share through space growth. SA's retail supply now ranks amongst the highest in the world as illustrated earlier in the figure on retail supply. Segments of the sector that have proven to be defensive during the pandemic were the smaller format shopping centres with a convenience element. The larger format shopping centres struggled over the past two years but there are signs that they may be on a path to recovery. That said, negative rent reversions persist in the retail sector as pricing power hasn't been restored. The outlook for retail property in SA remains challenging, as more aggressive economic growth is required to absorb excess supply. E-commerce is still in its infancy in SA, it is therefore reasonable to expect that further pressure will be exerted on physical retail once online shopping increases to more meaningful levels. On the other hand, increasing building cost inflation is expected to be positive for the sector as it is supportive of rental growth.

Office: Base rental growth (%)



Source: MSCI

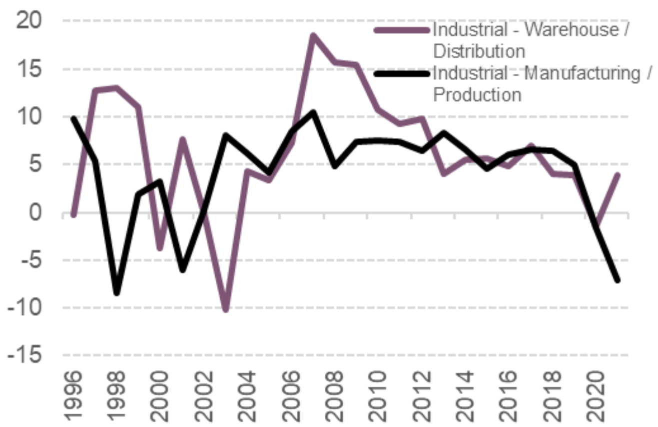
Office: Vacancies (% GLA)



Source: MSCI

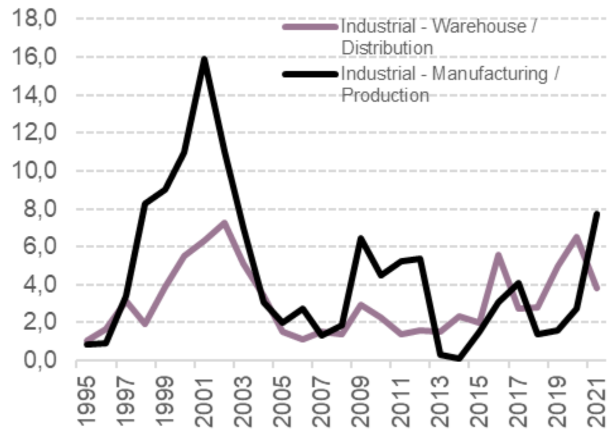
The office sector has been plagued by oversupply for some time. Office vacancies remain stubbornly high, especially in the B-grade segment. Negative reversions persist and are expected to not turn positive for some time given that demand for space has been further weakened by the acceleration of telecommuting. Increasing building cost inflation is expected to provide some support to rental growth, although not enough to counter the impact of excess supply.

Industrial: Base rental growth (%)



Source: MSCI

Industrial: Vacancies (% GLA)



Source: MSCI

The industrial sector is a story of two halves: warehouse space and manufacturing facilities. The manufacturing related assets have been under pressure for some time given the negative impact of rising costs (primarily electricity) on the underlying tenants. The warehouse space, on the other end, is primed to benefit from the increasing take-up of e-commerce in SA. Rental growth in SA has however not been as aggressive as initially anticipated as e-commerce hasn't taken off as much as it has in other markets for reasons outlined earlier. As with the other two commercial property segments, increasing building cost inflation is expected to provide some support to rental growth.

Concluding thoughts:

The property sector is at an inflection point due to technological advancements that are redefining how societies live, work and play. The future of the sector looks promising as it can benefit from innovations such as Proptech and sustainable building practices that make it more efficient, and therefore more resilient. Digital disruption will however put pressure on segments of the property sector that are not future-fit, further adding pressure to already weak fundamentals. There is much work to be done by the industry to adapt present lease structures to an omnichannel world, this process may prove challenging as introducing flexibility in leases undermines the certainty of cashflows that traditional property investors have become accustomed to. While most indicators point to continued pressure on rentals, persistently high building cost inflation may however be supportive of rental growth in the medium to long-term. Overall, landlords that are proactive in aligning their portfolios to the changing landscape will be rewarded going forward.

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