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Build up not out

by Richard Stutley, CFA

Congratulations to England's Lionesses, who beat Germany yesterday to win Euro 2022, the country's first major trophy at senior level since 1966.

I met with one of our underlying global listed property managers last week and I thought some of the discussion points were worth repeating here. Until such time that we all live in the metaverse, what is happening with physical space remains important, with implications for investors beyond dedicated property buyers.

From a sector perspective, we discussed the supply outlook for industrial/logistics space, following Amazon's announcement earlier this year that they plan to mothball several new warehouse projects and sublet excess space. Amazon front-loaded securing new space in the immediate aftermath of the pandemic, to ensure they did not run into capacity issues further down the line, and now they are refining their plans. Despite Amazon's size, the impact of this change is expected to have only a modest impact on the supply of logistics space[1]. Is there scope to double or triple existing space by building premises up and not out? As unlikely as it sounds, Prologis have tried exactly this in Japan, but the fact that the initiative appears to have run out of steam suggests the build costs are uneconomical at present.

In terms of global listed property fundamentals, data tends to be less timeous compared to other asset classes, but we can nonetheless make certain observations based on what we have seen so far this year: rental growth is accelerating for most property types, led by industrial and apartments, which are enjoying close to record rental growth[2]. Driving that strong rental growth is ultra-low vacancies: vacancy rates are now at historic lows in several sectors, with the exception of offices[3]. Taken together, demand-and-supply dynamics are leading to lower vacancies, higher rents, and higher prospective earnings.

Debt is a great way to ruin a good investment (the business may endure, but your ownership will not). Property companies are lowly levered by historical standards[4] and that debt is extremely easy to service[5] at present.

Interest coverage ratios have improved across the vast majority of companies[6], rather than just at the headline level, hence there is less risk of contagion from a reasonable-sized cohort of distressed companies. What about rising interest rates? Companies have extended the maturity of debt[7], buying them time should we be about to enter a prolonged period of higher interest rates. They also have access to more diversified sources of financing (primarily public debt markets and other non-bank lenders, like private equity debt funds) and are therefore less reliant on the traditional banking sector.

With regards to inflation, looking at the average company's cost base[8], they are relatively insulated from rising costs of goods and services. Instead, taxes are the biggest part of costs, which are linked to property prices, which in turn are linked to demand and supply. If demand strength is leading to increases in your costs, then it stands to reason that you can pass those costs on in the form of higher rents.

Overall, fundamentals look good in our assessment. However, armed with this information alone, one still does not know whether global listed property is a good investment. Critically, a reasonable amount of the deteriorating macroeconomic outlook appears to be in the price (2.4 standard deviations cheap on the basis of price to book[9]), although prices are still some way above crisis troughs like in Q1 2020. Further rises in real interest rates would pose a challenge to the sector, as would a derating on par with those kinds of crises, but the asset class looks reasonable value from a top-down perspective today, with more opportunities for active managers under the surface.

Sources

1 "the amount of space that Amazon is expected to sublease equates to 0.2% of total industrial inventory and would increase available supply growth from 2.6% to 2.8% in 2022". Catalyst Fund Managers Quarterly Fund Commentary 2022 Q2
2 CoStar, NAREIT. Data as of 2022:Q1
3 CoStar, NAREIT. Data as of 2022:Q1
4 S&P Capital IQ Pro, NAREIT T-Tracker®
5 S&P Capital IQ Pro, NAREIT T-Tracker®
6 S&P Capital IQ Pro, NAREIT T-Tracker®
7 FactSet, NAREIT, Federal Reserve Economic Data (FRED), Raymond James research
8 Catalyst Fund Managers
9 S&P Global Property USD Total Return Index, as seen on Bloomberg. Daily data from 15/04/2013 to 28/07/2022. Trimmed mean excluding top and bottom 10% of observations

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