



SA PROPERTY RETURN SIMULATIONS

In this note we simulate the expected returns for a fictitious property company. We vary the initial yield, the distribution growth profile and the exit yield to show how expected returns are affected. A change in the exit yield is an important contributor to returns over the medium term – the lower the initial yield, the more important the impact. In the long run, expected returns are equal to the initial yield plus subsequent growth in distributions. We conclude by calculating the range of expected returns from the SA listed property sector for different growth rates and exit yields.

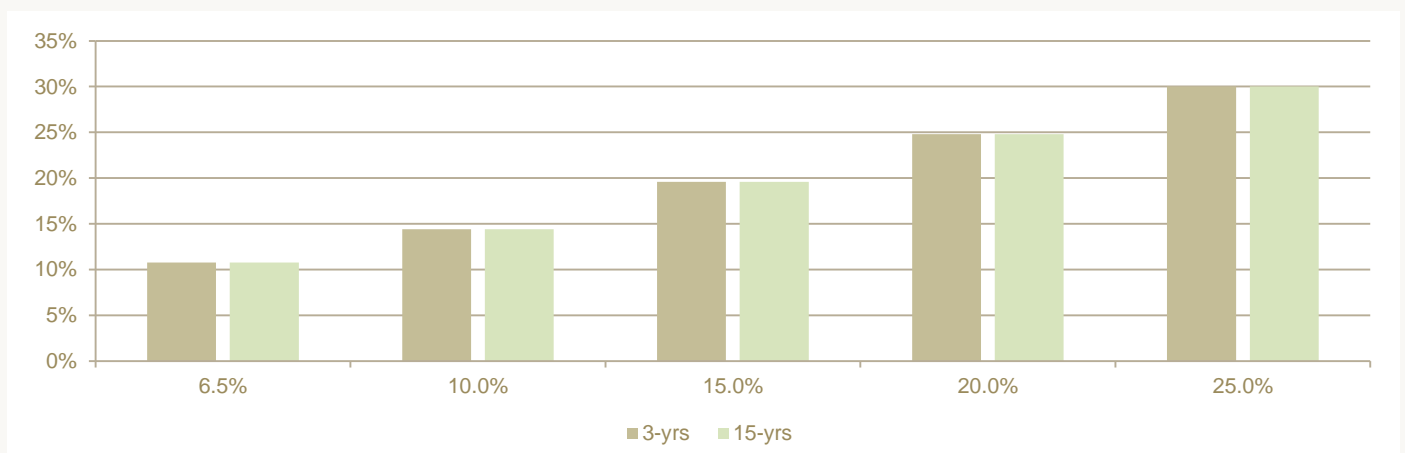
1. INTRODUCTION

We construct a notional property company with cash flows that grow at a constant rate. By varying the initial yield, the exit yield, the growth rate and investment horizon we gain important insights.

2. VALUATIONS AND EXPECTED RETURNS

In figure 1 we show the expected returns, over 3 and 15 years, assuming our notional company delivered 5% income growth and that the capital value of the property company grows smoothly – in-line with the income – so that the yield/rating (the first year income as a % of the capital outlay) remains unchanged. Unsurprisingly, higher initial yields, or lower valuations, result in superior investment performance.

Figure 1: Expected returns for different initial yields/valuations

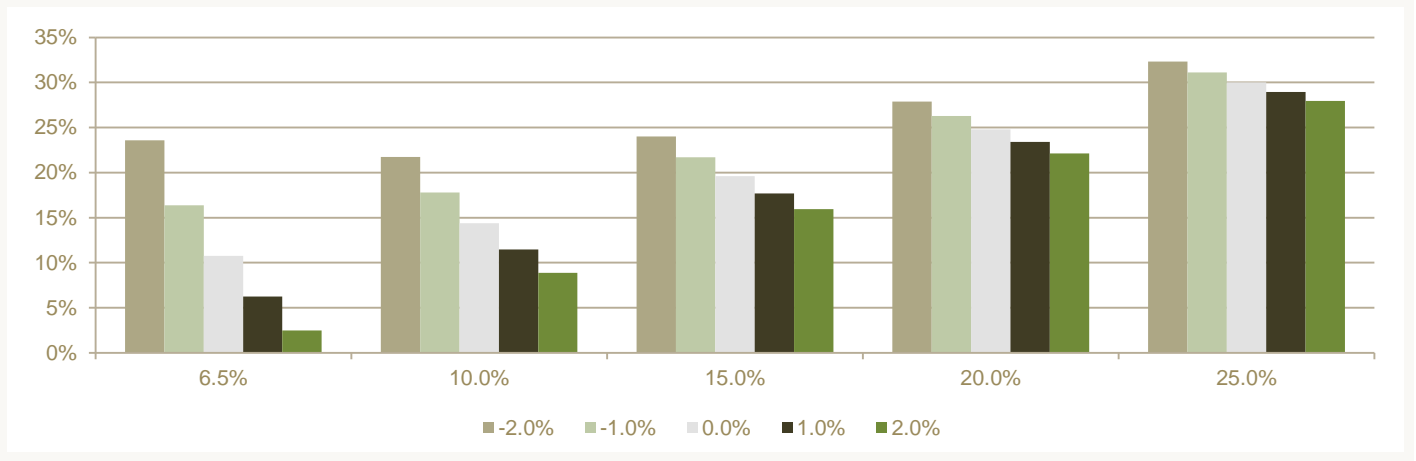


Source: Nedbank Private Wealth Investment Research and Fund Management

In figure 2 we relax the assumption that capital values grow in-line with income. Instead, we simulate the impact on returns (for a 3-year investment holding period) if you sell your property share at yields 1% or 2% lower, and higher than at the date of purchase. Higher yields mean that every R1 of income is worth less than before. Conversely, lower yields mean that income is more valuable than before. Therefore a rise in yields is associated with capital losses and declining yields with capital gains.

Figure 2 shows that the impact of valuation changes (or changes in yields) are more severe the higher the initial price. I.e. a 1-2% change in the rating of a company on realised returns, are far bigger at lower initial yields. In our notional investment, a rise of 2% from an initial yield of 6.5% impairs total returns severely. Had the yield remained unchanged the investor would have earned a return of ~11%. However, 3-years later as the yield increased to 8.5% the investor's realised return is ~3%. However, had the yield declined to 4.5% the investor would have earned ~24% from the investment.

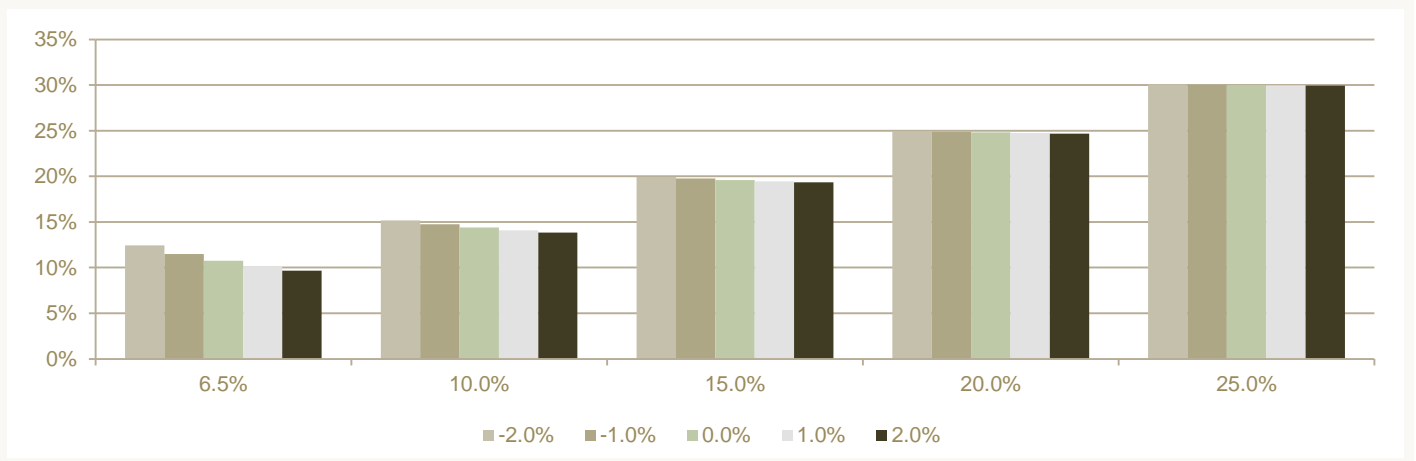
Figure 2: Three year expected returns – different initial yields/valuations & changes in exit valuations



Source: Nedbank Private Wealth Investment Research and Fund Management

Figure 3 repeats the analysis for a 15-year investment holding period. Figure 3 shows that in time, the effect is muted as growth in distributions offset the impact of short-term capital gains/losses caused by changes in ratings. Previously, the range of expected return from an initial yield of 6.5% was ~3-24%. For the investor that held the investment for 15-years, the range of returns is much more muted at ~10-12%. Investors that purchased at an initial yield of 25% earned returns of ~30%.

Figure 3: Fifteen year expected returns – different initial yields/valuations & changes in exit valuations



Source: Nedbank Private Wealth Investment Research and Fund Management

3. DISTRIBUTION GROWTH AND EXPECTED RETURNS

Table 1 shows the impact of faster or slower distribution growth on returns for different initial yields (we assume capital values grow in-line with income). In all instances, faster income growth results in superior returns.

Table 1: Expected returns – different initial yields & income growth

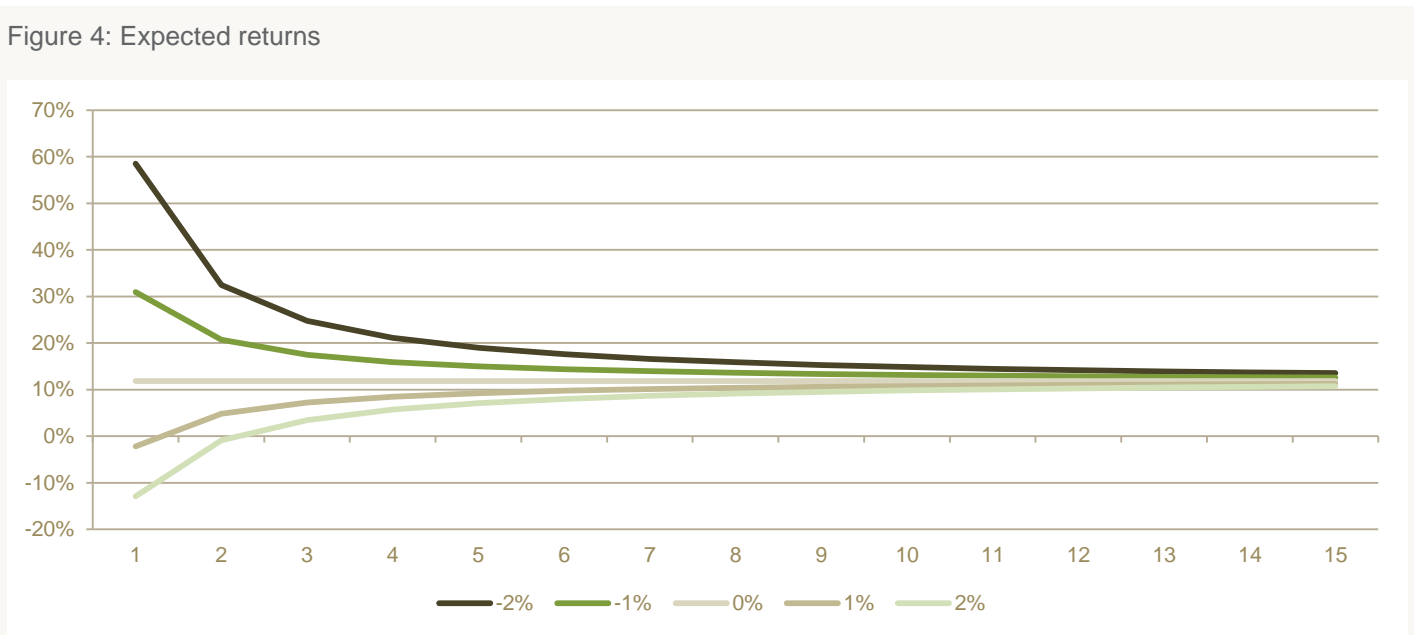
		distribution growth				
		2.0%	4.0%	6.0%	8.0%	10.0%
initial yield	6.5%	8.6%	10.8%	12.9%	15.0%	17.2%
	8.5%	10.7%	12.8%	15.0%	17.2%	19.3%
	10.5%	12.7%	14.9%	17.1%	19.3%	21.5%
	12.5%	14.7%	17.0%	19.2%	21.5%	23.7%
	15.0%	17.3%	19.6%	21.9%	24.2%	26.5%

Source: Nedbank Private Wealth Investment Research and Fund Management

4. LONG RUN EXPECTED RETURNS

In figure 4 we plot the annualised return earned by an investor that acquired the property company (growing income at 5% over time) at an initial yield of 6.5%. We show that ratings matter – an investor whose shares trade at a yield of 4.5% (2% lower than at purchase) one or two or three years' later earn a substantial premium in the short run. While an investor whose shares trade at a yield of 8.5% subsequently (2% higher than at purchase) underperform. Over the long run, however, investor returns converge as the underlying distributions growth rates are the same.

The maximum return earned by investors equal the initial yield plus the subsequent growth in distributions. In this instance ~12% (6.5%+5%).



Source: Nedbank Private Wealth Investment Research and Fund Management

5. EXPECTED RETURNS

Following the recent losses in the listed SA property market, the sector now trades on a historic yield of 6.7%. Assuming an exit yield of 7% (consistent with our market P/E assumption of 14x), we estimate that pre-tax returns from the property sector will again match returns available from general equities over the next 3-5 years.

Table 2: Modest expected returns

		distribution growth				
		2%	4%	6%	8%	10%
Exit yield	5.0%	17%	20%	22%	24%	27%
	6.0%	11%	13%	16%	18%	20%
	7.0%	6%	8%	10%	13%	15%
	8.0%	2%	4%	6%	8%	10%
	9.0%	-1%	1%	3%	5%	7%

Source: Nedbank Private Wealth Investment Research and Fund Management

MADALET SESSIONS

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