BUSINESS DAY (Late Final)
27 Feb 2013, p.7

Property acquisitions attractive for listed funds as cost of capital falls

THE cost of capital for property funds has fallen significantly, due to the decline in bond and listed property yields that have accompanied falling interest rates, but by contrast, direct property prices have done little.

This makes property acquisitions more attractive to listed funds and these deals can be income-enhancing from the outset. Real Estate Investment Trust legislation could provide rollover tax relief to direct property vendors, making an exit via a sale for shares to a listed fund more attractive.

As property companies' interest rate swap contracts locking in fixed rates expire over time, they are reset at lower interest rates. This gives the companies extra cash, so they should be able to enhance distributions by about 1% a year, assuming a five-year swap profile and a 100-basis-point drop in the interest rate charges.

Furthermore, many funds are now replacing some of their bank funding with debt capital market funding at a lower margin.

But the only challenge for the market which is awash with cash and cheap credit is that despite the demand created by low interest rates, there is a lack of supply of investment grade properties.

Old Mutual Property Fund fund manager Evan Robins says that this should put upward pressure on direct property prices and create transactional evidence that will filter into valuations and result in higher net asset values for companies.

"For example, Redefine Properties and Vukile recently purchased East Rand Mall at a lower yield (higher price) than Growthpoint purchased the trophy V&A Waterfront.

"Many larger funds would like to increase their gearing levels, but the lack of attractive properties is the factor holding them back from borrowing more. As a result of the tight demand and limited supply, the gap between prime and plentiful secondary quality property prices could widen further," Mr Evans says.

"This theme is positive for the listed sector, as long as funds do not overpay for acquisitions."

Despite interest rates remaining the lowest for decades, thus making it easy to raise capital, funding remains a major challenge for property investors and developers as the banks are now giving their time to seasoned players. Paragon Lending Solutions CEO Gary Palmer says property investors and developers are upbeat about the domestic commercial property sector this year, despite analysts' and property professionals' expectations that the market will remain sluggish.

"Our research has revealed that clients are actively exploring property deals again and are forecasting steady growth in their respective businesses," Mr Palmer says. There has been mixed feelings by industry experts on the outlook for this year with the general consensus that the commercial property market is only really expected to start picking up next year.

However, Mr Palmer says that with interest rates remaining unchanged, which is good for raising capital, the current economic climate is providing opportunities for developers and investors, but they need funding to start.