

Property's promising performance

By Erwin Rode
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The South African government recently sold the first inflation-indexed long bond. Bids ranged from 10% to 5%, and only a small amount of nearly R500 million of the R189 – maturing in 2013 – was allotted at the cut-off price of 6,5%.

You might very well ask, what has this got to do with property?

Well, although the evidence is still thin and tentative, we now have a better idea of what the market regards as the required real (inflation-adjusted) risk-free rate.

Question is, how does property stack up against this?

The intriguing thing about this yield is that it now gives us an idea (albeit tentative) of what the market thinks the inflation rate will be until 2013. This we can calculate by comparing the yield of the JSE Actuaries Long-Bond Index for bonds maturing in 2013 with the R189. At the date of allotment, inflation-exposed bonds maturing in 13 years' time yielded 14%. So the market's implicit expected inflation rate until 2013 is 14% minus 6,5% = 7,5% per annum. This more or less equals the present core inflation rate.

I regard 6,5% as a generous real risk-free rate. For instance, over the past 20 years or so institutionally-held property yielded a real total return of about 5% per annum. In comparing the two, bear in mind that property is by no means risk free, and we must add a risk premium of 2 to 3 percentage points to property's returns to enable us to compare properties with gilts on a risk-adjusted basis.

Market hurdle rate

However, we can also approach this problem from a different angle. We can say, what does the property market *expect* real returns will be?

According to market surveys published in *Rode's Report*, the current hurdle rate for the acquisition of prime property is about 21%. This means that property investors claim they will not invest in prime property unless their expected total nominal return is equal to the hurdle rate of 21% or better. After deducting our expected inflation rate of 7,5%, we get an expected *real* total return of about 13,5%. Deduct another 3% points for property's risk, and we get an expected risk-adjusted real total return of about 10,5%. This compares very favourably with the real risk-free return of 6,5% of the R189.

One concludes that either the 21% market hurdle rate of property is a fictional one, or property's expected total returns look very promising indeed.

Fundamental hurdle rate

One way of checking the market hurdle rate of 21% is by asking ourselves, if we buy a prime property today at an income yield of 12,5%, what is the required cash flow growth rate in order to attain a total return of 21%? The answer is about 8,5% per annum (21% minus 12,5%). If inflation is expected to be 7,5%, then a cash flow growth of 8,5% over the next 13 years seems too high. This is so given the fact that an individual property ages, which implies that an individual property's cash flow growth cannot in the long run be expected to keep up with prime rentals or with inflation. Under this scenario, a cash flow growth of say 4,5% seems more plausible, resulting in an expected nominal total return or hurdle rate of 17% (a capitalisation rate of 12,5% plus 4,5% cash flow growth). So maybe the property market is a bit optimistic.

The 17% expected total return could be called a *fundamental* hurdle rate because it is calculated *subjectively*, that is it is not directly derived from the market.

Now let's redo the exercise: a total expected nominal return of 17% (my more sober fundamental hurdle rate) less expected inflation of 7,5% less property's risk premium of 3% points, equals an expected risk-adjusted real total return for prime property of 6,5%. This happens to equal the real risk-free rate of the R189.

So, at worst property's expected risk-adjusted real return equals that of the real risk-free rate of bonds. At best it is much better. This makes property a worthy contender for the funds of investors. ■