Property's promising performance

by Erwin Rode
May 2002

This article is an update on a paper that was read by Erwin Rode, CEO of Rode & Associates, at the Rode Conference in Johannesburg in 2000.

The South African government sold the first inflation-indexed long bond in March 2000. 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%. The second inflation-linked bond, the R197 (maturing in 2023), was issued in May 2001 and initially traded at a yield of about 5,7%.

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

Well, 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 these yields is that it now gives us an idea (albeit a tentative one) of what the market thinks the inflation rate will be until 2013 and 2023 respectively. This we can calculate by comparing the yield of the JSE Actuaries Long-Bond Index for bonds maturing in 2013 and 2023 with the R189 and R197 respectively.

Inflation-exposed bonds maturing in 2013 (11 years' time) yielded about 12,6% as at 23 April 2002, whilst the R189 stood at 5,2%. So the market's implicit expected inflation rate until 2013 is 12,6% minus 5,2%% = 7,4% per annum. The present headline inflation rate, as recorded for March 2002, is 6,6%.

As for inflation-exposed bonds maturing in 2023 (21 years from now), the yield on 23 April 2002 stood on about 12,1%. The inflation-linked R197 was at 5,0%. Thus, the difference of 7,1% is the market's implicit expected inflation rate until 2023. Note, these calculations show that the market expects inflation for the longer period until 2023 (7,1%) to be lower than up to 2013 (7,4%).

We regard 5% as a realistic real risk-free rate. For instance, over the past 20 years or so institutionally-held property yielded a real total return of about 5% to 6% per annum. However, 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

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 19%. 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 19% or better. After deducting our expected inflation rate of 7,4% until 2013, we get an expected *real* total return of about 11,6%. Deduct another 3% points for property's risk, and we get an expected risk-adjusted real total return of about 8,6%. This compares very favourably with the real risk-free return of 5% for gilts.

In the case of the R197 the *real* total return will be 11,9% (19% minus 7,1%). Deducting the 3% for the risk associated with property gives us an expected risk-adjusted *real* total return of 8,9%. This compares even more favourably with the risk-free return of 5% for gilts.

One concludes that either the 19% 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 19% 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 19%? The answer is about 6,5% per annum (19% minus 12,5%). If inflation is expected to be about 7,4% until 2013 or 7,1% up to 2023, then a cash flow growth of 6,5% over the next 11 and 21 years respectively 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 do the exercise again : a total expected nominal return of 17% (my more sober fundamental hurdle rate) less expected inflation of 7,4% up to 2013 (7,1% until 2023), less property's risk premium of 3% points equals an expected risk-adjusted *real* total return for prime property of about 6,6% and 6,9% respectively. In both cases this happens to be higher than the real risk-free rate.

So, at worst, property's expected risk-adjusted real return is slightly higher than 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. ■