METHODOLOGIES USED BY PROPERTY FUND MANAGERS TO EVALUATE INVESTMENT DECISIONS

A Research Report Presented

By

Glen Buchner

Student No: 79056106

Submitted to the Gordon Institute of Business Science, University of Pretoria, in partial fulfilment of the requirements for the degree of Master of Business Administration

November 2008

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

Abstract

Commercial listed property is a complex, yet potentially lucrative asset class to invest in. South Africa's property index delivered average returns of 34% for 2006/7 and was rated best performer internationally. While many of the funds in the sector as still forecasting excellent yields, some are struggling to survive in the current, difficult economic environment.

The main objective of this study was to enter the realm of the property fund manager in order to gain a better understanding of the underlying assets, the macro-economic challenges, portfolio risks and investment valuation criteria.

A qualitative research study was done with decision makers within the listed property environment using investment case studies covering the retail, office, industrial and hotel sectors.

The results of the research were developed into a framework providing insight into the investment valuation process and portfolio strategies employed by some of the leading funds and which can be used as a decision-model for potential investors.

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

Declaration

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Master of Business Administration at the Gordon Institute of Business Science, University of Pretoria.

It has not been submitted before for any degree or examination in any other university.

I further declare that I have obtained the necessary authorisation and consent to carry out this research.

Name:________________________________

Signature:_____________________________

Date:_________________________________

Acknowledgements

I would like to thank Tod Ridgway, Angelique de Rauville of Investec, Prof. Francois Viruly from Wits, Warren Dugmore from Emira and Bob Judelsohn from Credit Suisse, who helped me gain access to some really top people in the listed property sector.

At various steps in the process, it was really valuable to be given perspective on the content and direction of the research. I would like to thank the following people in this regard: Prof. Margie Sutherland, Mike Holland – my supervisor, Prof. Francois Viruly, Prof. Michael Glencross – my statistician, the people from the Investec Property Division and Dr. Dirk Prinsloo from Urban Studies.

The assistance of the Chief Executive Officers, Directors and Fund Managers from Emira, SA REIT Ltd, Redefine, Resilient, Hospitality, Sycom, Growthpoint and Hyprop, in giving me time for the interviews was much appreciated.

I would like to specially thank Jenny Keyte for her invaluable assistance with the transcription process.

A special word of thanks is owed to Magdel Naude and Beulah Muller with their assistance with finding literature items and in helping me get this document into shape.

A great debt of love and thanks is owed to my parents, Oswald and Heleen, for their support, in making this process possible.

Finally, to my wife, Allison and my little girl, Layla, who had to get on with life without me for so many months, the biggest thank you is due to you.

Table of Contents

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

List of abbreviations commonly used in the text:

PUT	Property Unit Trust
PLS	Property Loan Stock Company
JSE	Johannesburg Stock Exchange
IPD	International Property Databank
SARB	South African Reserve Bank
SARS	South African Revenue Services
REIT	Real Estate Investment Trust
DCF	Discounted Cash Flow
NAV	Net Asset Value
IRR	Internal Rate of Return
GDP	Gross Domestic Product
CPI	Consumer Price Index
BEE	Black Economic Empowerment
SA	South Africa
UK	United Kingdom
USA	United States of America
FDI	Foreign Direct Investment
CEO	Chief Executive Officer
MD	Managing Director
SAPOA	South African Property Owners Association
CBD	Central Business District
Cap rate	Capitalisation Rate

Glossary of Figures

Glossary of Tables

CHAPTER 1: INTRODUCTION

1.1 Introduction and purpose of the research?

The listed property industry in South Africa has developed significantly over the last 15 years. From a market capitalisation of R7 billion in 2000, the industry grew to R92 billion in 2007 (Viruly, 2008). In 2006 this industry delivered the highest returns for its sector in the world according to the International Property Databank (IPD), yet has lost 30% of its market value since November last year (Property Loan Stock Association, 2008).

Figure 1.1 Growth in the SA Property Sector

There are currently thirty-two funds in the listed property sector on the JSE, comprising twenty-six Property Loan Stock companies under Real Estate Holdings & Development (Index J256) and six Property Unit Trusts (PUT's) under the Real Estate Investment Trusts (Index J255). (Refer to Appendix C)

Each fund's portfolio contains a different mix of retail, office, industrial or hospitality sector properties, as well as a unique geographic mix according to that fund's particular portfolio strategy to either diversify or specialise. While some of the funds have delivered excellent recent returns in excess of 30%, others have not performed well and are likely to be absorbed in a consolidation phase currently being experienced in the sector (Property Loan Stock Association, 2008).

These are all phenomena which demonstrate the complexity of the property industry.

The focus of this research is to gain an insight into the minds of the decision makers in the industry to identify the evaluation criteria for their investment decisions, to understand what portfolio strategies they have formulated and how the macro-environmental factors impact their decisions.

This chapter creates the context for and outlines the objectives of the research and discusses the need for this specific project.

1.2 The listed property industry in South Africa

One of the most exciting developments in international property markets is the securitisation of financial assets, which continues to spread into new fields. Although still in its infancy, South Africa's Collective Investment Schemes in Property (CISPs) consisting of Property Unit Trusts (PUTs) and Property Loan Stock companies (PLSs), has from 2005 to 2007 been the top listed-property performer in the world with an average rate of return of 34% per annum (Botha, 2008).

The IPD reports that the strong return was driven by record-level capital growth, high income growth and very low vacancy levels in the SA commercial property industry. As indicated in the table below, the top performing property sector was Industrials with a total return of 33%, followed by Offices at 30.8% and Retail at 26% (Property Loan Stock Association, 2008).

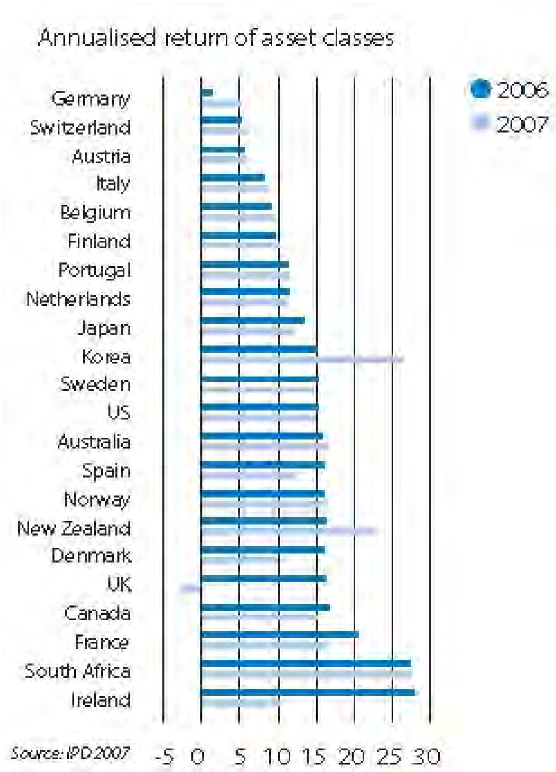
Table 1.1 SA Property sector returns

Total Property Return: IPD Index

Total Return	97	98	99	00	01	02	03	04	05	06	07
Retail	23.0	9.1	17.9	10.4	13.4	11.0	17.4	26.1	32.6	27.4	26.0
Office	12.8	1.6	9.5	12.7	7.8	5.1	8.5	16.7	25.6	24.5	30.8
Industrial	16.8	2.1	8.3	7.1	7.5	8.8	17.5	24.4	33.0	31.1	33.6
Other	18.1	5.1	24.9	16.6	10.0	20.5	25.4	27.5	24.7	22.0	25.0
Property	17.5	5.1	13.7	11.2	10.6	9.5	15.1	23.4	30.1	26.7	27.7

Source: SAPIX/IPD

Figure 1.2 Global performance of SA roperty funds



It is important to distinguish between 'direct' and 'indirect' property investment. The former category refers to physical properties held directly or actively by investors. Typically, these are owned by institutional investors, such as banks, pension funds and life insurance companies. (Doppegieter and Rode, 2002).

Indirect or passive property represents securities issued against a portfolio of properties, which are tradable as financial, not physical assets and is the subject of the research. Unlike the direct investor, the indirect investor makes no operating decisions regarding the physical property. (Doppegieter and Rode, 2002).

This securitisation of property via PUT's and PLS's has created easy entry and exits into an otherwise difficult market for the individual investor. According to the Association of Property Unit Trusts, property securitisation offers investors a number of attractive benefits, namely:

- Liquidity of investment, as opposed to direct property, which is highly illiquid;
- Access to high quality property assets which would normally have been beyond the investor's reach;
- The ability to diversify in property investments across a number of different asset types;
- Greater flexibility in responding quickly to changes in market conditions;
- Cost reduction of fund management through economies of scale.

On the negative side, the disadvantages of investing in listed property include considerable price volatility and a lack of established trading markets.

1.3 Investment in PUT's and PLS's

A listed property fund is a company that derives its income from property and property related sources. A listed property fund is an income fund because it is required by law to pay out its net income to its shareholders, while a normal listed company usually retains anything up to 80% of its income (Property Loan Stock Association, 2008). Investment in listed property is easier than buying property directly, since it does not require as much capital, is not subject to mortgage bonds, nor does it require the collection of rent from tenants or the maintenance of property.

1.3.1 Overview of Property Unit Trusts (PUT's)

PUT's are listed on the JSE, unlike ordinary equity unit trusts, however, PUT's are governed by the same laws which regulate ordinary unit trusts – the Collective Investment Schemes Control Act (CISCA).

By law, all the income earned by the PUT, less expenses, has to be paid out to investors.

SARS taxes PUT distributions in the same way it taxes interest earnings.

PUT's are allowed a gearing (debt) ratio of 30% of their market capitalisation. However, gearing ratios are typically even less than 30%.

1.3.2 Overview of Property Loan Stock Companies (PLS's)

Property Loan Stock Companies (PLS's) were introduced in the late 1980's as an alternative property investment vehicle, because at the time, the legislation governing PUT's was regarded as outdated and inflexible. PUT's were prohibited from borrowing money to acquire property and they were restricted to investing in direct property only, as opposed to also being able to invest in other listed property. (reference?)

PLS's are subject to the Companies' Act and JSE regulations, but unlike other listed companies, invest only in property. Funding is via a linked-unit, which consists of a share and a debenture (or loan). The debenture portion earns interest at a variable rate. The interest comes from the net income which the PLS derives from rentals from tenants. The share portion only makes up a nominal value of the linked unit. (reference?)

Similar to PUT's, the income from a PLS is taxed in the hands of the investors, but the income is paid out in the form of interest on the debenture portion of the linked unit.

Usually PLS's distribute all their profits, mainly through debenture interest, with the balance being paid out as a dividend. Distributions are usually paid out quarterly (Personal Finance, 2004).

1.4 Returns from listed property funds

Investors earn returns from listed property in two ways:

1. They share in a proportion of the income that is earned by the fund which is derived from rentals paid by tenants. This income is called the yield.
2. There is growth in the value of the units listed on the JSE. This is called capital appreciation.

The yield and the capital appreciation together are referred to as the total return on the investment (Personal Finance, 2004).

1.5 Ancillary services to the property funds

Listed property funds typically have the following services supplied by outside companies:

- Property management, which includes administration, letting, client renewals and retention, client migration and installation, refurbishments, rent collection and facilities management.

- Asset management, which includes monitoring of monthly returns on the properties in the portfolio and giving advice on optimal tenant mix, new acquisitions and refurbishments of existing properties.

- Property valuations, being the regular assessment of the property portfolio to determine market and replacement values.

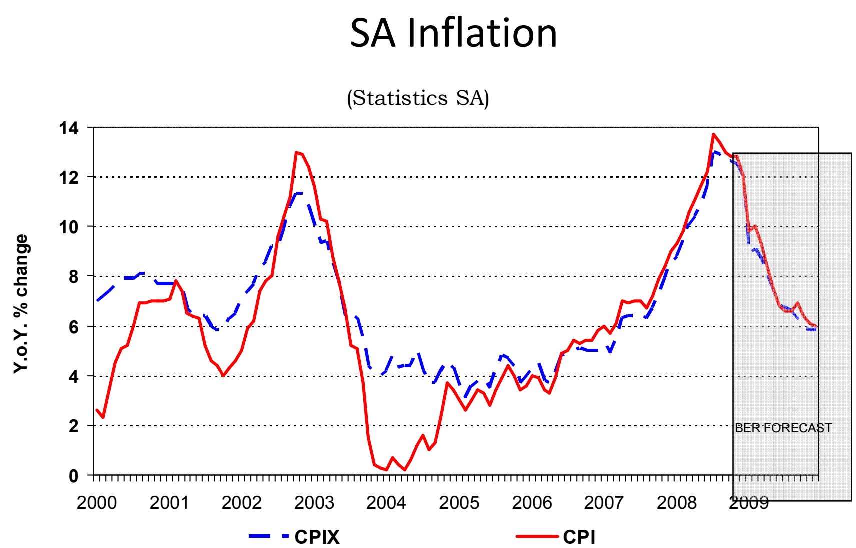
- The banks, who make debt finance available to the funds.

(Growthpoint Property Fund Annual Report, 2008)

1.6 The current listed property trading environment in SA

From a five-year run of exceptional returns, during which the annual total return for SA listed property has averaged 30%, the current global financial credit market has brought this to an abrupt end. Over the past twelve months, the turbulence in global financial markets and deteriorating global economic growth negatively affected South Africa. Domestic inflation has continued to exceed the SARB's target band, resulting in increases in interest rates. CPIX inflation rose to 11.6% in June 2008, the highest in the history of the property index. (reference?)

Figure 1.3 SA inflation trends



In a bid to curb rising inflation, the SARB has consistently tightened monetary policy by raising lending rates. The sharp decline in growth expectations appears to indicate that consumers and businesses alike are struggling to cope with tighter credit conditions, rising prices and lower business confidence (Hospitality Property Fund Annual Report, 2008).

During the past decade, the SA property sector experienced significant changes, some negative and some positive. Whereas the Property Index had shown total returns of 30.1%, 27.1% and 27,7% for the years 2005, 2006 and 2007 respectively, during a period of tremendous wealth creation, the recent inflation-fighting interest rate hikes and political uncertainty experienced in the country have brought about a considerable slowdown of this sector's growth (Property Loan Stock Association, 2008).

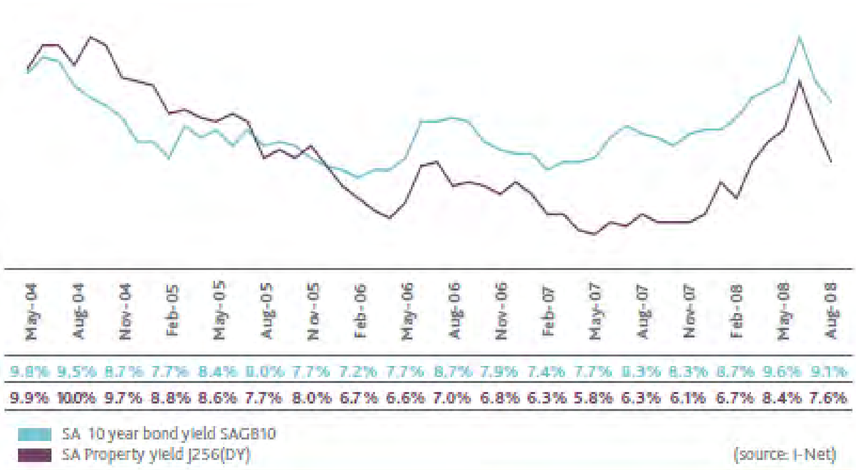
On the 16th of May last year, www.eprop.co.za reported that “Strong property fundamentals and continuing corporate activity are driving the strong performance of the listed property sector, which had recorded a total return of 24% for the year to date.” At that stage, the SA Property Index had outperformed the FTSE/JSE all share index, earning 16,1% compared to 15,1% earned by the all share index.

In May 2008, one year later, an article on the same website, entitled, “Market volatility dampens listed property,” stated that “Global market woes, local interest rate increases and inflation rate uncertainty continue to dampen the listed property sector, with South African listed property losing 4% of its value in the last month and a total of 30% since November 2007. The article went on to say that 11 of the 25 listed companies were trading under cautionary announcements relating to merger and acquisition activity. (reference)

From an investor’s viewpoint, a May 13, 2008 article on www.fin24.com indicates that “this sector now offers income chasers the opportunity to buy cash flow at massive discounts.” (reference?)

An analysis by Catalyst Fund Managers (reference?) of the listed property sector shows that the income yield on property stocks is currently 38% higher than it was six months ago, which means, in essence, that property share price values have dropped significantly, while incomes have remained the same. This has resulted in opportunities for investors to buy income-producing property at a 38% discount on November 2007 prices.

Figure 1.4 10-year SA bond and property yields



The performance of listed property tends to track the performance of bonds because they are both income-generating investments. Bond yields have moved up substantially on the back of inflationary fears which, which are linked to a surging oil price and the weakening Rand (Business Day, 10/3/2008). The article further states that the volatility in the local listed property sector reflected a lack of investor confidence in investment markets generally, and that this was caused by significant uncertainty around dynamics influencing the global macroeconomic environment.

1.7 Impact of the USA sub-prime mortgage crisis

Falling property prices in the USA and UK's housing markets and the subsequent surge in defaults on sub-prime mortgages have had a major impact on global financial markets. The resulting credit crisis has brought about extensive write-downs by the large international financial institutions and a virtual suspension of credit extension by banks even to creditworthy borrowers. Coupled with a global increase in commodity prices, in particular oil and food, inflationary pressures have grown rapidly, adding to deteriorating economic growth expectations. The higher inflationary outlook coupled with increasing interest rates and a net foreign selling of bonds, has resulted in a significant rise in bond yields. Due to the rerating of the bond market, listed property prices have fallen, resulting in a substantial loss of value for the funds (Hospitality Property Fund Annual Report, 2008).

1.8 Sound property fundamentals in SA

In spite of the relatively negative macroeconomic environment, property fundamentals in SA remain positive: low vacancies and high rental increases have ensured that listed funds have continued to release good results. Growth in supply has been constrained by high construction costs and electricity supply problems, which is likely to benefit the current supply in the market. In addition to this, the increase in building costs has ensured that replacement costs are often higher than valuations, indicating that additional rent adjustments are likely. The listed property sector is expected to continue to release positive results, with distributions to shareholders and unit holders of between 8% and 12% during the next 12 months (Hospitality Property Fund Annual Report, 2008).

Figure 1.5 SA commercial property vacancy rates

South Africa has a first world financial market with a stable banking sector and well defined legal framework. Property ownership is entrenched in a national deeds registry and leases are generally structured with built-in annual rent escalation clauses, rarely found elsewhere in the world. This is as a result of the long period the country suffered under high inflation. With inflation relatively under control, although still relatively high, annual lease escalations of 8% to 10% provide excellent growth in commercial and retail portfolios. These factors, together with reasonable liquidity on the JSE, make SA a strong contender for international investment. An unintended consequence of globalisation is the fact that the performance of SA property managers will increasingly be measured on an international stage. SA's No. 1 ranking on total returns by the IPD, suggests that local fund managers can hold their own compared with others around the globe (Sycom Property Fund Annual Report 2008)

1.9 Objectives of the research

The responsibilities of the property fund manager are reflected in the complexities of the listed property sector as described above. The ambit of these responsibilities will typically involve the following: (reference?)

- While the fund applies a particular portfolio strategy to maximise return while limiting risk, research studies have shown that the various property sectors respond differently to macro-economic factors and to the movements of the economic cycle (Pyhrr, S., Roulac, S. & Born, W. 1999). Consequently, the fund manager is responsible for understanding and forecasting movements and trends in the various property sectors in line with developments in the macro business environment.

- When it comes to making a decision about an investment or entering into negotiations to purchase a property, the fund manager has to be able to identify and assess the risk and return trade-off, determine a market value for the property using one or more valuation techniques and having done a market analysis on supply and demand factors, derive a market value for the property;

- The investment needs to fit in with the overall portfolio strategy of the fund and should enhance, rather than dilute the distribution to the shareholders or unit holders of the fund. Strength of tenants is a key consideration here;

- Critical to the evaluation process is the covenant or lease, which will dictate the future income growth over the term of the lease. An over-market lease with a short term could be negotiated down by the tenant and therefore be a liability to the fund. An under-market lease with a short term could potentially be negotiated upwards and should therefore not be overlooked;

- Ongoing quality of asset management and property management will also be important to extract maximum value from the investment.

It is within the context of this complex environment of the listed property fund that the researcher wants to examine criteria for investment decision making.

The aim of this research is therefore to investigate how South African property fund managers make decisions about property investments and divestitures in the current macro economic environment, how they apply risk-management and portfolio management strategies and what factors influence their decision making.

The outcome of the research should cast light on how the listed property fund managers go about making investment and portfolio decisions to differentiate themselves and increase their competitiveness.

This should be useful to anyone considering investing in listed property and in fact, anyone interested in learning more about how property investments are evaluated.

1.10 The need for the research

There are two main reasons motivating the research, namely:

1. The researcher has a personal interest in commercial property investment, where this is being considered as a potential business environment;

2. While the literature covers various aspects of commercial property investment, including modern portfolio theory, risk management strategies and macro-environmental factors, no study has been found where these are combined within the South African listed property sector.

CHAPTER 2: LITERATURE REVIEW

2.1 Purpose of literature review

The table below indicates the structure of the literature review. The subsections have been selected to create a foundation of understanding around the scope of the research, as follows, in preparation for a qualitative interviewing process.

Sub-section	**Focus of sub-section**
2.2	Listed Property as an asset
2.3	Macro-economic influences
2.4	The property cycle
2.5	Property forecasting
2.6	Property Valuation
2.7	Risk management and portfolio diversification
2.8	Investment decision making behaviour
2.9	Conclusion to literature review

The purpose of the literature review from the researcher's perspective can be summarised by the following questions:

1. What observations and commentary can be gleaned from the literature on the subject matter?
2. What results from other research papers are available on these topics?

3. Where does the literature steer the direction of the research in terms of specific questions to be used in the interviews?

The chapter therefore contains the most important and relevant points sourced primarily from academic journal articles.

2.2 Property as an investment

Direct property as an investment has had a number of distinct disadvantages compared with financial assets, these being illiquidity, indivisibility and lack of flexibility (Newell and Fife, 1995). With the significant capital required to own a portfolio of properties, most investors have traditionally opted for investing in financial assets instead.

While the stock of commercial property has grown significantly, the value of direct? investment in property has lagged with the insurance companies and pension funds being the only significant investors in this sector as a direct consequence of their financial capabilities. (reference?)

Table 2.1 Stereotypical characterisation of major investment asset classes

Investment / Concern	Stocks	Property	Long-Term Bonds	Treasury bills
Risk	High	Med – Low	Med – Low	Lowest
Total Return	High	Moderate	Moderate	Lowest
Current Yield	Low	High	Highest	Moderate
Growth	High	Low	None	None
Inflation protection	Good in L-T	Good	Bad	Best if reinvested

Source: Geltner, Miller, Clayton & Eichholtz, 2007

Table 2.1 shows the traditional view of how various investment assets are regarded in terms of risk and return. The graph below shows how property has fared as an investment over the past 12 years in South Africa.

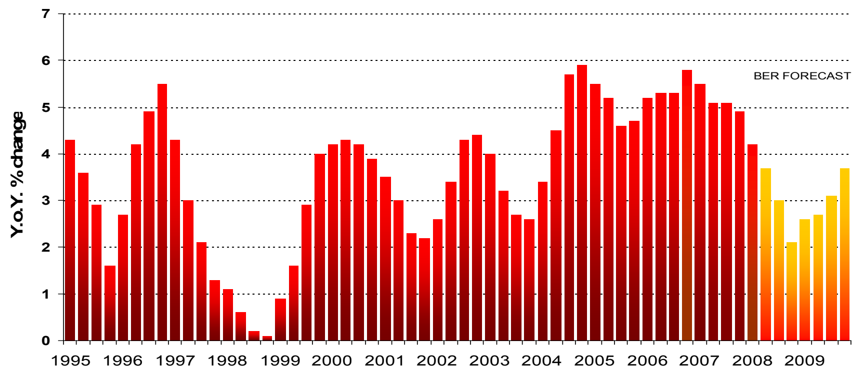
Figure 2.1 Annualised return of asset classes

2.3 Macroeconomic influences

Understanding key real estate relationships has strategic implications on real estate decision making. In addition, having a good knowledge of the relationships between the main macro-economic variables and real estate movements, can provide a useful tool set for decision making (Hoskins, Higgins & Cardew, 2004). This is important, particularly with companies increasingly seeking exposure to international markets.

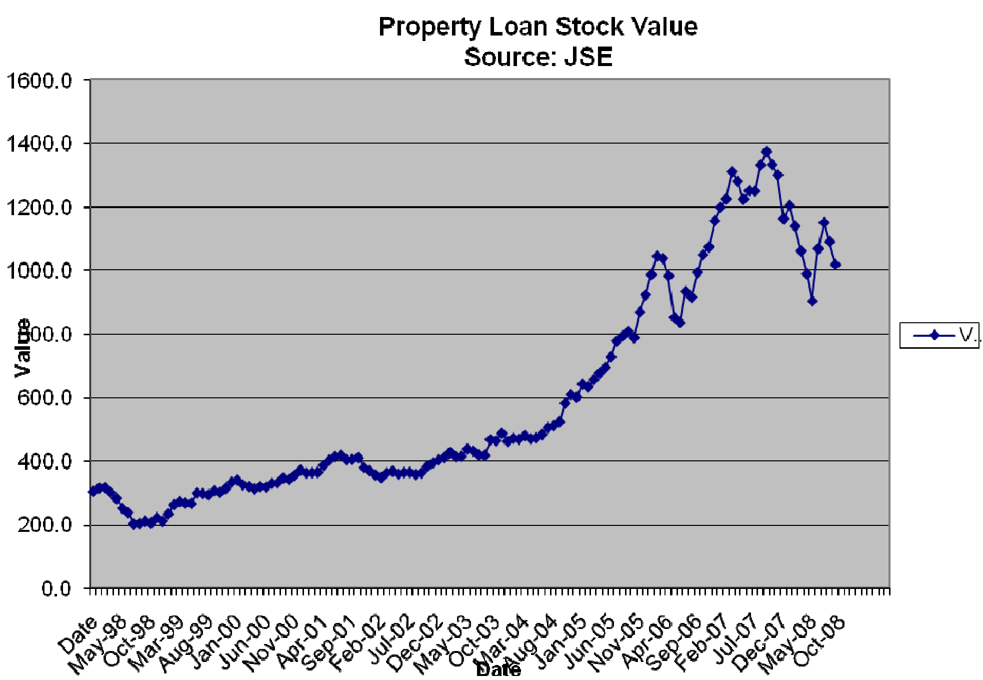
Past research has consistently shown that commercial property performance is closely aligned to changes in GDP, employment, interest rates and inflation. It is also evident that due to property supply characteristics, the property cycle lags behind movements of macro-economic variables (Hoskings et al, 2004).

Figure 2.2 GDP year-on-year growth



Source: SARB

Figure 2.3 Property market returns



The graphs above show how the returns in the property sector lag the growth in the economy.

Buetow & Johnson (2002) state that research has proved that USA Federal Reserve monetary policy influences stock and bond returns and that similar patterns exist for real estate returns. Their findings suggest that funds and investment portfolios should be weighted in real estate only during times of expansionary monetary policy and that investors should realign their portfolios in anticipation of Federal Reserve actions.

Clayton (2001) relates how real Canadian institutions' portfolios were heavily exposed to real estate at the peak of the cycle in the 1990's in Canada due to favourable returns, and then when the market turned, these funds suffered huge losses.

Economic factors impact on commercial property values primarily through a supply and demand transmission mechanism. During times of economic upswing, prices of property will increase due to increased demand for space and for the goods and services produced by the firms which occupy this space (Clayton, 2001).

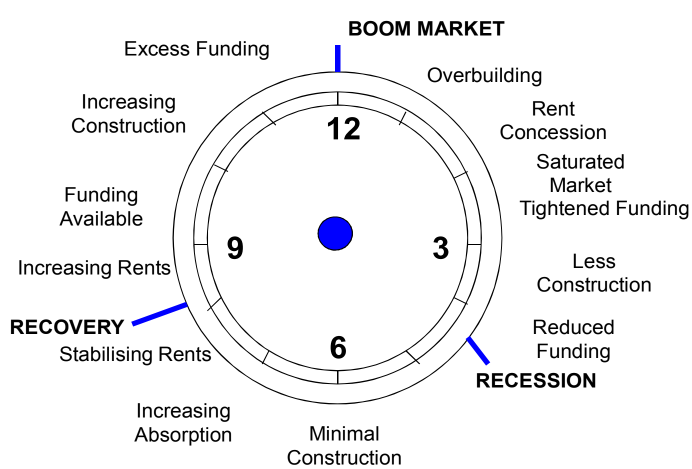
Projected property yields also impact the value of property investments. When a country enters a period of GDP growth, it is likely that yields will go up as a result of increased income projections. Investors will need to be able to give buy, or sell signals based on what projected values and prices will do. (reference?)

2.4 The Property Cycle

Prof. Francois Viruly, a leading South African property economist, tracks the property cycle for office, industrial and retail property, through Boom Market, Recession and Recovery phases and the causal factors behind these. The three sub-sectors may not necessarily always be in the same phase of the cycle. For instance, while retail could be under pressure because of rising inflation and interest rates, industrial could be producing good returns due to a scarcity of zoned land with infrastructure and long lead times on new developments because of the time it now takes to have environmental impact assessments approved by local government. (Moneyweb, 2008)

The diagram below shows the various phases which commercial properties go through in a typical property cycle.

Figure 2.4 The commercial property clock



Source: Viruly, 2008

Pyhrr, Roulac & Born (1999) suggest that virtually every phenomenon in politics, economy, business and real estate is cyclical in nature, but that most investors and analysts incorrectly view these as trends and not as cycles. The consequence of this is that many do the wrong thing, such as buying during the boom and selling during the down cycle, following the 'herd instinct' and doing what everyone else is doing.

Various studies, according to Pyhrr, et al (1999) have shown that vacancy rates are a key variable linked to rent and building cycles. The latter consistently lags the vacancy rate cycle's peaks and troughs by about one year. Furthermore, the unique aspects of construction lag, demand uncertainty and adjustment costs associated with property, offer some explanation into the mismatch between supply and demand which result in periods of abnormally high vacancy rates, followed by periods of abnormally low vacancy rates.

An alternative view on cyclical patterns put forward by Pyhrr et al (1999) is the psychological aspects of human behaviour. The authors suggest that during extended periods of prosperity, people adopt the psychology of affluence and its by-product, economic optimism. They become economic risk-takers and rationalise that what has happened, will continue to happen and thus see less risk than there actually is. Consequently, too many people become risk-takers, which in turn, creates conditions for a major adjustment.

Pyhrr, et al (1999) make three key observations on real estate cycles:

1) Many real estate professionals ignore cycles during the expansion phase because they are making extraordinary income from commissions, fees,

points and profits. They act as if the boom will never end because it is in their economic self-interest to do so;

2) On the recovery and expansion phase, the cycle usually goes up faster than is anticipated and the market then generally produces over-priced real estate;

3) Timing is the key element to successful investing and investors must be willing to make significant adjustments in their portfolios to take advantage of constantly changing property market conditions.

2.5 Property Forecasting

Geltner, Miller, Clayton & Eichholtz (2007, p. 103) describe property market analysis as "the quantitative and qualitative characterisation of the supply side and demand side of a specific space usage market that is relevant to a given decision." This analysis is designed to assist in decisions such as:

- Which geographic region and what type of property to invest in to capitalise on growing rents;
- What type and size of building to develop on a specific site;
- When to begin construction on a development project;
- What the rent and expiration term should be on a given lease;
- Where to locate new retail outlets and which stores to close.

As can be seen from the above list, some market analysis can be very specific, such as investigating the need for A-grade office developments in a specific area, or more general, such as assessing the supply of retail stock nationally.

The definition of a property market normally specifies a geographic scope and property type, being office, retail or industrial. Geltner et al (2007) mention the descriptive variables which quantitatively characterise the supply and demand sides of a property space market as being:

- Vacancy rates
- Rental levels
- Quantity of new construction started
- Quantity of new construction completed
- Absorption of new space – gross and net.

The forecasting and modelling of rents are seen as vital processes in commercial property investment. Decisions regarding potential acquisitions and portfolio strategies are made as a result of these forecasts and it is the accuracy of these models in capturing future movements that is implicitly tested in the marketplace (Chaplin, 2000). Since the real estate crash in the UK in the late 1980's and early 1990's there has been an increased focus on predictive models in that country which have attempted to understand performance indicators and in particular, those factors impacting on rents in the volatile office sector.

In Europe, the Investment Property Forum (IPF) conducts surveys of property forecasters and compiles their forecasts to provide a consensus view (Tsolacos, 2006). The consensus forecasts are averages of individual forecasts on rental growth, capital growth and total returns per property sector, produced by property consultancies, property funds and fund managers. The survey results are published quarterly and made available to IPF members (Chaplin, 2000).

In South Africa, a similar situation exists where commercial property information is compiled and supplied by South African Property Owners Association (SAPOA) and via the Rode Report to subscribers and members (Viruly, 2008).

As an important element of investment practice, all investors must implicitly or explicitly forecast yields. These forecasts have to be both justifiable and intuitive. Most rental forecasts are derived from econometric, based on economic relationships (Mitchell & McNamara,1997). The authors further suggest that, based on empirical work into the determination of commercial property rental values, models of residential property prices are readily transferable to the determination of commercial property rents. Although the focus of the residential market is capital value rather than rental value, in the long run, national real house price changes represent a positive function of real personal disposable income or real financial wealth.

An econometric model developed by Clarke & Daniel (2006) to forecast change in residential properties incorporates eleven economic variables and according to the authors, is able to explain 78% of the variation in the South African property growth rate series. These include:

a) Movements in the ALSI,

b) Trends in building plans passed,

c) The state of the business confidence index,

d) Changes in the debt to income index,

e) Changes in GDP,

f) Movements in the gold price,

g) Changes in motor vehicle sales,

h) Changes in the oil price,

i) Changes in the prime interest rate.

In a different model which determines rental values of retail properties, Nathakumaran (1994) postulates a simple supply and demand equation which is a function of:

- consumer spending,
- the stock of retail space,
- new additions, being construction activity,
- interest rates,
- lagged rents from the immediate previous period.

Chaplin (2000) suggests that for the industrial sector, a simple model consisting of changes in two variables on the demand side, being manufacturing output and manufacturing employment, and one on the supply side, being industrial new orders, will be sufficient to forecast changes to industrial rents. His models for office and retail are similarly constructed.

Given the very different professional backgrounds of the individuals who supply the forecasts and those who consume them, there is a definite possibility that the forecasts are used relatively uncritically (Mitchell & McNamara, 1997) The table below shows differences in forecasts from two leading property forecasting companies in the UK between 1994 and 2000.

Table 2.2 Variance in forecasts by two UK specialist forecasters

Property sector	**Difference in annual average growth rate forecast by two leading property forecasting companies**
Retail	4.8%
Offices	4.3%
Industrials	2.7%

Source: Mitchell & McNamara (1997)

The absence of a clear theoretical underpinning to some models naturally diminishes the credibility attached to the forecasts. Such concerns are highlighted when, given similar macro-economic and supply-side scenarios, property market forecasts differ significantly. The failure to develop a hierarchy of common models, particularly across sectors, is a significant challenge (Mitchell & McNamara, (1997)

2.6 Property Valuation

This section introduces some important concepts and observations on property valuation.

2.6.1 Prices and yields

It is important to understand the link between the expectation of returns (or yields), which motivates investors, and the price or value of assets, which is the issue they are grappling with in the daily business of real estate investment (Geltner et al, 2007). The price an investor pays for a property determines its expected yield, since the future cash flow from the property is independent of the price paid for the property today. Geltner et al (2007) elaborate on the concept of price and yield as follows: the expected yield is inversely related to the price of the asset, because the future cash flows are constant and are determined by market factors of supply and demand. The resale price the investor can expect is determined by the future rents the next buyer can expect going forward and by the opportunity cost of capital.

2.6.2 The Capitalisation rate

The capitalisation rate (cap rate) is defined as the relationship between a property's net operating income and asset value. The cap rate is instrumental in the application of various methodologies for investment analysis (Sivitanides & Sivitanides, 1996). Typically, a market-extracted cap rate is applied to a real asset's achievable net income to provide an estimate of its current value.

Geltner et al (2007) add to this definition by saying that in real estate net operating income from an asset is the same as the yield on the asset and the effective cap rate.

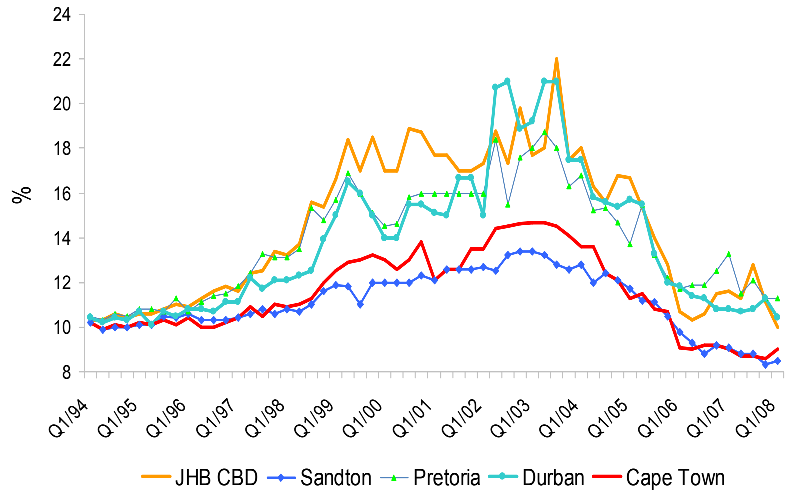
Sivitanides & Sivitanides (2007) point out that whereas it is common practice to use market cap rate, average cap rates will vary between regions and property sectors. This is particularly relevant to investors with geographically diversified portfolios.

In their comparison of cap rates and dividend yields, Doppegieter & Rode (2002) mention that both the dividend yield and cap rate are used to measure property value. Dividend yields are typically used in the listed market, while cap rates are used in the direct property market. They ask the question as to whether these should be regarded as different methods for different purposes, since both value inherently the same underlying assets and whether one should be preferred above the other.

The debate for dividend yields argues that according to the efficient-market hypothesis, listed security prices reflect all available information and the assets are constantly re-appraised in response to changing market conditions. Moreover, financial assets are more tradable than the real assets they represent, and in a far more liquid market. (reference?)

On the other hand, cap rates are inherently more subjective and are not subject to the dynamics of the financial markets. The transactions in this market are however less frequent and there will be a lag between commercial cap rates and capital market returns. The findings of Doppegieter & Rode (2002) confirm the widely-held belief that property markets are inefficient and are not completely integrated with the national capital market.

Figure 2.5 Office cap rates per region



Source: Rode & Viruly

2.6.3 Methods of Valuation

a) Discounted Cash Flow (DCF)

Accoring to Kishore (1996), the most commonly used valuation method is the multi-period discounted cash flow (DCF) valuation. He adds that a study conducted in Australia among property investors indicated that 75% used DCF consistently for valuations and 25% used it occasionally. For acquisitions, 100% of investors used it.

Why is the DCF method so important? Geltner, Miller, Clayton & Eichholtz (2007) have these points to make about this method:

1. The DCF method recognises that the valuation fundamentally depends on the future net cash flow generation potential of the asset;

2. It takes a long-term perspective appropriate in decision making in an illiquid market – typically 10 years for real estate;

3. It takes a total-return perspective, appropriate for successful investment decision making;

4. If done properly, the DCF method can keep the investor from being swept up by sentiment, especially when asset values do not reflect income stream potential.

Ward & Price (2006) give a summary of the steps in the DCF valuation approach, as follows:

- Estimate the free (net) cash flows (FCF's) into the future (10 years for real estate)

- Estimate the weighted average cost of capital (WACC), using target market values for debt and equity;

- Calculate the terminal value using TV = FCF / (WACC – growth rate)

- Discount the free cash flows and the terminal value to the present.

The discount rate serves to convert the future Rand-value of the cash flows into their present value equivalent, using a value that is appropriate to the risk. This must allow for the time value of money and for the risk in the cash flows from the investment. Total risk comprises a risk-free component and a risk premium related to the asset.

Kishore's (1996) comments that forecasting of the future direction of investment is essential, particularly if the asset under consideration is a long-term investment, which property is. The way in which discount rates are selected, however, appears to be an issue among valuers, with two main schools of thought. One school proposes that the discount rate be based on long-term bond or gilt rates, and the other, that the rate be based on the cost of the combined debt and equity capital, or weighted average cost of capital. Kishore favours the latter, since he puts forward evidence that property yields and bond yields in Australia had an inverse relationship and that it would be more appropriate to use the internal rate of return (IRR) of the investment.

b) Net Present Value (NPV)

The NPV is a simplified way of looking at the DCF approach:

NPV – Present Value (benefits) – Present Value of costs

This is done using a discount rate commensurate with the risk in the investment (Geltner, et al, 2007).

c) Direct capitalisation approach

Where valuation is required for buildings with short lease terms in less cyclical markets, a simple and quick valuation approach can be used as follows

Value – Net Operating income / Cap rate.

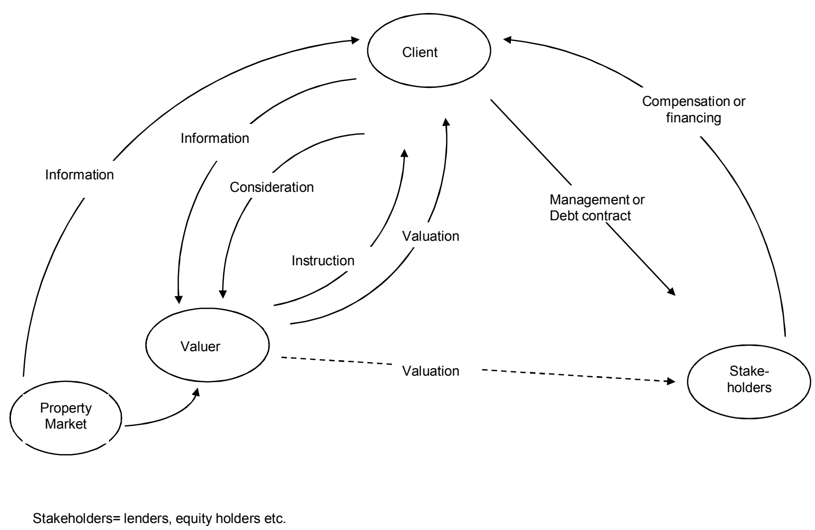
(Geltner, et al, 2007)

2.6.4 The potential influence of clients on valuations

While listed property funds typically outsource valuations to 3rd party specialists, Levy & Schuck (2005) put forward the view that valuations are at times likely to be biased estimates of market values due to the influences that clients can exercise over valuers and the valuation process. This is done via the exploitation of 'leeway' in valuers' estimation of values or the 'range of defensible values.'

The diagram below illustrates the roles of interested parties and the flows of information and compensation.

Figure 2.6 Client-Valuer relationship



Valuations are outputs of a service offered to clients on a contractual basis for which valuers receive fees. Valuations are frequently commissioned by clients who are in effect acting as agents for third parties, including lenders and shareholders who require an independent opinion of market values (Levy & Schuck, 2002). Considering the dynamics of the valuation process and the roles of the parties in the process, clients may have conflicting incentives, as well as the means to influence and the opportunities to do so.

- Conflicting incentives: Clients may have economic incentives to influence valuations in order to maximise asset-based fees or increase loan books. This conflicts with the desire of stakeholders to obtain accurate and objective valuations. Valuers want to satisfy their clients in order to avoid conflict over fees and secure repeat business.

- Means of influence: Clients have a number of power bases: (reference?)

    - expert power, where they exert power that arises from expertise in property and valuations;

    - Information power, which relates to their control over information that is relevant to valuations;

    - Coercive and reward power, which reflects their control over the payment of fees and the rewarding of future business.

- Opportunities to influence: Valuers rely heavily on private information on properties supplied by their clients. This gives the client the opportunity to influence the valuer's information set. Valuers may also be drawn into situations where they have to defend their choice of method to the client. The ability to 'opinion-shop' affords clients the opportunity to exert their power in order to obtain an 'acceptable' outcome.

In a survey conducted by Levy & Schuck (2002) several client-valuer influencing generalisations emerged:

- Sophisticated clients tend to use expert and information power

- Unsophisticated clients tend to use reward, coercive and information powers
- Expert and information power, as used by sophisticated clients, may change a valuer's original belief of a property's value
- Reward or coercive power will not change a valuer's belief of a property's value.

There was a strong perception among the clients that one of the most important incentives was to ensure that published valuations are credible in the eyes of their shareholders and in the market as a whole.

2.6.5 Due diligence procedures with investments

Ghyoot (2001) lists a number of steps in a due diligence process, to be conducted by a fund manager when a property acquisition is being contemplated. The term due diligence implies taking all reasonable measures to avoid unplanned risk exposure. The person responsible for the process should understand the market, the decision criteria and the due diligence process itself. The process comprises investigation into:

- Physical aspects such as state of repair and remaining economic life of the structure;
- Property rights such as current and previous title deeds, cadastral information and town planning restrictions;
- Location analysis, which entails assessment of transport linkages and exposure in the property's surrounding area;

- Market conditions – macro level: growth in local economy, attitudes of local government regarding development, etc. Micro level: current property management, types of leases, rental levels and vacancies;
- Leases and tenants: credit ratings of tenants and lease terms;
- Market value: to be assessed by experienced professional person, either using DCF or Scenario Analysis;
- Financial modelling, which should be a realistic model of the property as it is expected to function. Extensive risk analysis should be incorporated, including ratio analysis, benchmark comparisons and sensitivity to various scenarios;
- Qualitative information including factors such as environmental impacts, local authority politics and potential actions by pressure groups.

2.7 Risk management and portfolio diversification

2.7.1 Risk and uncertainty

Risk and uncertainty are inherent components of the property valuation process. Adair & Hutchinson (2004) emphasise this in their description of the subjective nature of property asset pricing. Property pricing as a form of investment decision making attempts to derive the present value of future income and expenditure flows. As such, the risk can be defined as the probability that a target return will not be achieved.

Adair & Hutchinson (2004) outline a Property Risk Scoring approach, as follows:

1) Market transparency risk: Volume and value of market transactions are dependent on the phase of the property cycle. In a dynamic market, there is an abundance of transactions and valuers can be confident of figures quoted. In a flat market with sparse information, the risk is greater.

2) Investment quality risk: The principle risk factors in property investment are falling net rentals, unexpected repair costs, capitalisation rate rises, lower than expected income growth and illiquidity.

3) Covenant strength risk: Since the valuer has to take a view on cash flow risk to value the property, it is vital to fully investigate the financial standing of the tenant.

4) Depreciation and obsolescence risk: Depreciation is the reduction in rental or capital value and the deterioration of the asset through the wear and tear or the impact of environmental factors as a result of passage of time. Obsolescence is defined as the decline in utility, not linked to the passage of time.

In this approach, the severity of the Property Risk Scoring is calibrated on a 5-point scale and is then assessed in terms of consistency and validity.

2.7.2 Market risk and specific risk

Through a specific investment strategy, fund managers seek to increase the returns and reduce the risks associated with their portfolio. Byrne & Lee (2000) identify total investor risk as having two components: market (systematic) risk and specific (unsystematic) risk. Market risk is based on external factors, is unavoidable and cannot be diversified away. Market risk is affected by macro-economic factors such as national economic policy, inflation, business and property cycles, recession and unemployment.

Specific or unsystematic risk is associated with a particular property's characteristics such as location, regional and local economic conditions, comparative supply of similar properties, physical design and construction, tenant's credit worthiness, lease structure, etc. Diversification can reduce much of the specific risk in a portfolio since a bad investment could be offset by a good investment.

2.7.3 Diversification and Modern Portfolio Theory

Modern Portfolio Theory (MPT) is one of the theoretical breakthroughs in financial research and has had a profound impact on the practice of investment management (Ali, 2006). The aim of applying MPT is to create a portfolio of investments that a produces a predictable return. The risk in the system is the volatility of the return on the portfolio.

Ali (2006) comments that most of the studies conducted indicated that real estate portfolio management should diversify on the basis of,

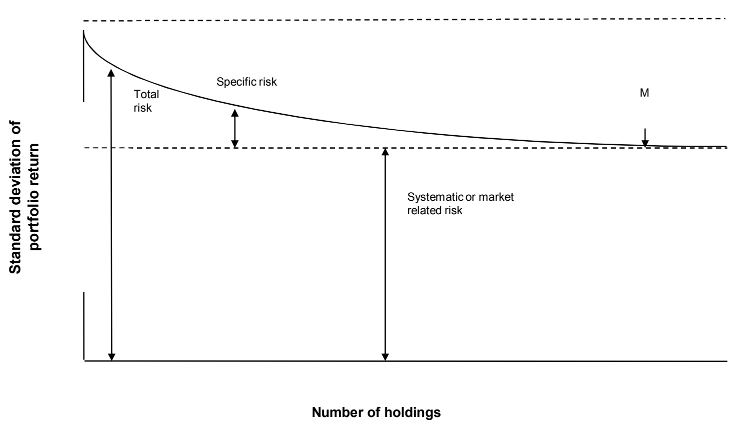
a) Geographical region

b) Asset type (retail, industrial or offices)

However, real property is highly illiquid, with substantial transaction costs and time delays, making the implementation of MPT difficult. Real Estate indices' data often lacks substance and uniformity with the result that strategic decisions on property portfolio diversification are often based on naïve intuitive judgement instead of on pure financial and economic data (Ali, Lin, Sipan and Kamaruddin, 2003).

In addition to this, fund managers who are familiar with the financial markets are often less confident in the property market and are prone to misjudge property investments, with the result that property suffers from a number of myths and misunderstandings, more so that other types of investment (Ali, 2006). Consequently, MPT should be applied primarily as a risk-management tool, rather than a return-management tool. The figure below shows that by increasing the number of investments in the portfolio, considerable risk reduction can be achieved. This is due to a bad investment being offset by a good one.

Figure 2.7 Risk reduction through the application of MPT

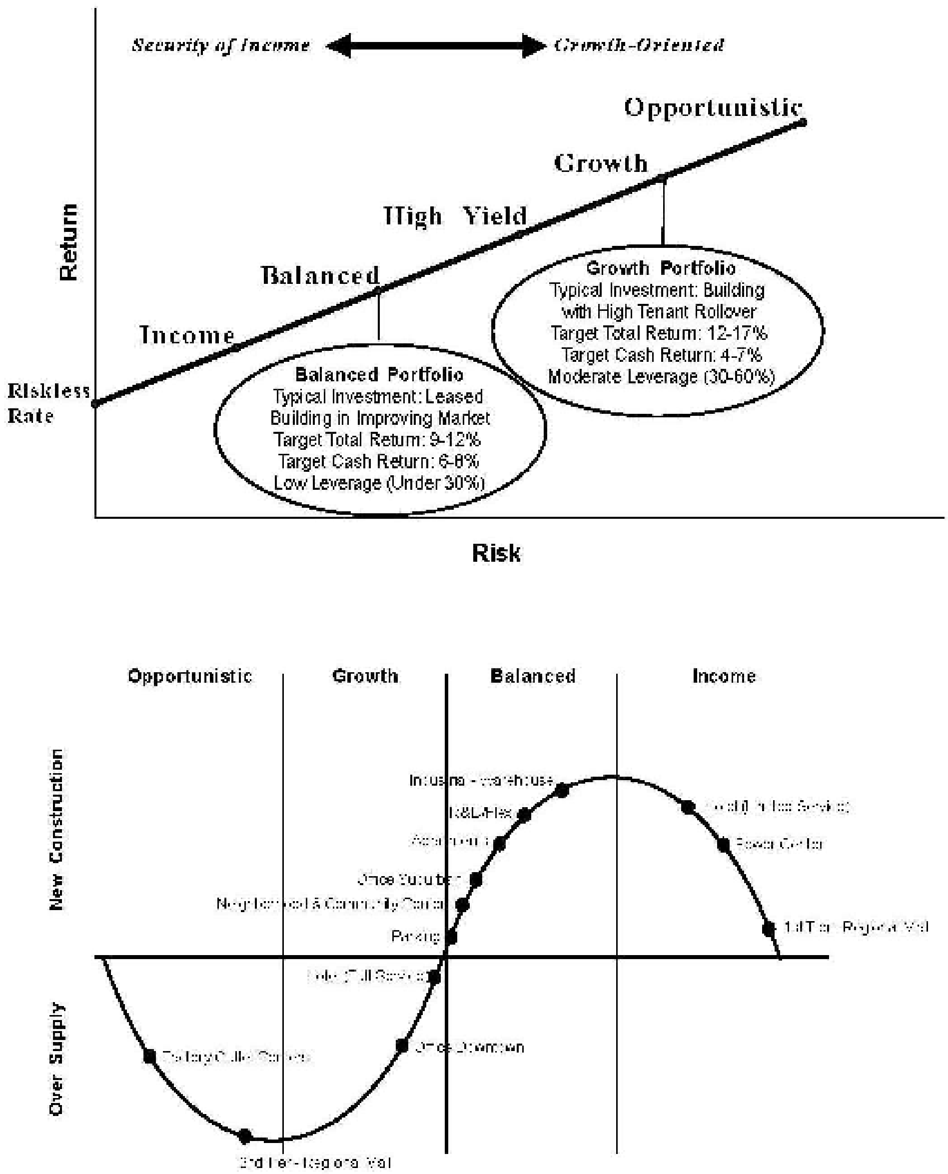


This diversification of investment has the result of reducing the portfolio volatility and the specific risk. Since investors are able to manage specific risk, they should only be left with market risk, such as changes in interest rates, exchange rates, prices of commodities and other macroeconomic factors. This is an important tenet of MPT, that the expected return of a portfolio should be directly related to the level of market risk associated with that portfolio (Ali, 2006).

2.7.4 Portfolio strategies

In the figure below, Pyhrr *et al* (1999) shows potential portfolio strategies, measured in terms of risk and reward, with the 'Income' strategy being the most conservative and the 'Opportunistic' being the most aggressive.

Figure 2.8 Portfolio strategies and the property cycle



Source: *1998 Investment Strategy Annual*, page 27, LaSalle Investment Management Research, Chicago.

The relatively aggressive strategies are linked to the down-cycle, being the Recession / Recovery phase. This phase is characterised by over-supply of space and vacancies are higher than equilibrium. With over-supply of space, prices of property should come down and this is where the ‘Opportunistic’ strategy can be effective.

At the other end of the spectrum, when the market has recovered and the cycle goes through its Expansion / Contraction phase, there is an under-supply of space and new construction typically happens. As the Contraction phase commences, which is what we are currently experiencing in SA, the more stable 'Income' and 'Balanced' portfolio strategies are able to provide acceptable returns as the down-cycle commences (Pyhhrr *et al*, 1999)

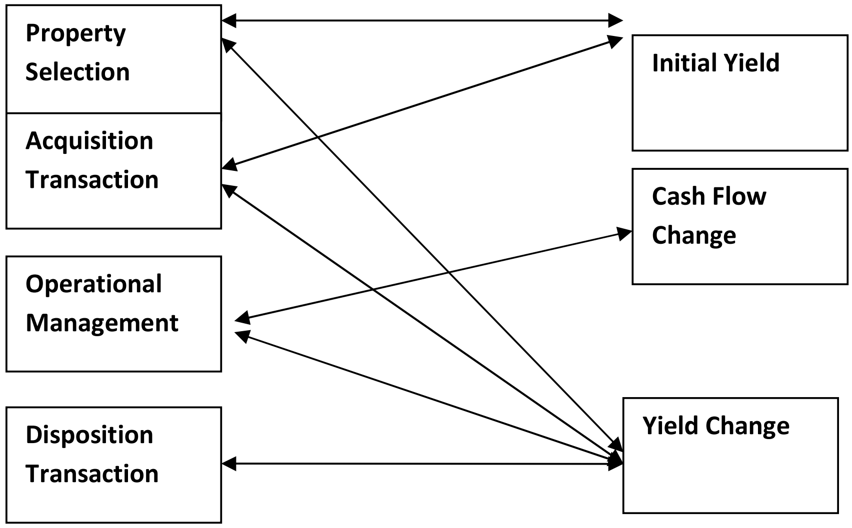
To be able to capitalise on the stages of the property cycle, funds have to be sufficiently flexible and have access to funding in order to take advantage of the opportunities which exist (Levy & Schuck, 2005).

2.7.5 Property fundamentals

At a macro level, an investment manager's objective is to attribute property-level returns of a portfolio to a) the initial cash yield (going-in cap rate), b) the growth in net cash flow (rental growth or expense reduction), and c) the effects of a change in the cash yield (cap rate) between the initial purchase and the resale or appraisal date (Geltner et al (2007). The four major functions which an investment manager performs are shown on the left-hand side of the diagram below.

As is typical with all performance attribution, it is most effective when applied in conjunction with benchmarking. Therefore, a similar portfolio of properties should be used as a basis of comparison over the same period of time.

Figure 2.9 Property investment management functions and attributes



Source: Geltner et al (2007)

2.8 Investment decision making

Property is accepted by pension funds and other institutional investors as an important instrument for diversification and as a hedge against inflation within a multi-asset portfolio (Adair, Berry and McGreal, 1994). It is becoming increasingly important for investors to therefore have access to an operational framework which will be useful in sourcing an optimal portfolio of property assets. This is a difficult process, raising the question as to which assets to select and how much capital should be committed, bearing in mind the level of risk associated with each.

2.8.1 Investment objectives

A good starting point when looking at this kind of investment decision making is to establish what the investment objectives are. At a fundamental level, there are two mutually exclusive types of investment objectives (Geltner et al, 2007). These are:

1. The growth (or savings) objective, where there is a relatively long-term approach with no immediate or likely immediate need for the cash being invested;

2. The income (or current cash flow) objective, which implies that the investor has a short-term and ongoing need for the cash generated from the investment.

Investors have either the one or the other objective, and in some cases, the same investor may define both of these objectives for different parts of a wealth portfolio.

In addition to these objectives, Geltner, et al (2007) suggest that investors also face one or more typical constraints including:

- Risk: the possibility that the future investment performance may not be consistent;
- Liquidity: the ability to sell the assets quickly and at full value;
- Time Horizon: the future time over which the investor's objectives, constraints and concerns are relevant;
- Investor expertise and management burden: how much ability and desire the investor has to manage the investment process and assets;
- Size: how large the investor is in terms of the amount of capital required for the investment;

- Capital constraint: whether the investor faces an absolute constraint on the amount of capital he has available or can obtain easily.

Hargitay and Yu (1993) define investment decision making as the commitment of resources in anticipation of future returns and specifically that property decision theory attempts to provide a framework in which investors can make property decisions to maximise their wealth. They contend that the decision itself is made on two levels, namely the strategic level, where the investment media is selected, and the tactical level, which involves the selection of specific properties. The objectives of the decisions can be further analysed as top-down processing, being research-driven stock selection and bottom-up processing, driven by stock availability, respectively.

2.8.2 Comments on investment decision making behaviour

Gallimore & Gray (2001) comment that normative literature on investment decision making identifies certain key behaviours exhibited by investors at environmental, strategic and tactical levels, namely:

- Definition of goals and objectives
- A comprehensive search for alternative projects
- The formulation of a well-defined investment strategy, generated from environmental sources of information
- Assessment of cost and availability of funding
- Development of target rates of return

A selection of potential investments which meet the criteria are then reviewed and the most suitable ones selected, with timing and market conditions taken into consideration.

In a study on the decision process underpinning disposals by property fund managers, MacCowan and Orr (2008) make two important points on property fund management. Firstly they mention that while neo-classical economics rests on the assumptions of a) independent actions by individuals armed with full and relevant information, b) decision making based on rational preferences, and c) behaviour motivated by profit maximisation, fund management in practice seems to contradict these assumptions. They mention that studies on the stock market demonstrate that judgements are often sub-optimal and investment behaviour often regarded as irrational.

Secondly, while information in property markets is not always perfect or adequate, there is evidence to suggest that fund managers are subject to heuristics and biases and that their behaviour patterns often follow trends.

Gallimore & Gray (2001) mention that fund managers are prone to overreact to current information and to incident-based information. For example, information received from personal contacts may have a greater impact than general market information and the ease of recall will add a false impression of importance to incident-based information.

Roulac (1996) has criticised investment decision behaviour, citing that investors often exhibit “myopic loss aversion” in that they fail to consider long-term investment prospects in favour of short-run forecasts. An evaluation while the investment is showing a loss can in this instance have the effect of terminating long-term vision.

Normative models of investment decision making behaviour also presume that fund managers will keep on assessing various alternatives until the optimal opportunity is found (Galllimore & Gray, 2001). The opposite of this behaviour is called satisficing, where the fund manager selects the first opportunity which meets the minimum investment criteria and stops looking for better alternatives. The latter is often the norm.

Adair et al (1994) contend that most institutional investors are known for their conservative behaviour in trying to maintain a management policy which will enhance the performance and reputation of their funds. Consequently, they will strive to combine the highest level of return with the lowest level of risk. While a property portfolio evolves over a longer period of time than its financial counterpart, property fund managers will typically not jeopardise the fund by investing in high-risk, high-return projects. Instead, more conservative approaches are usually followed. Fund managers will also want to diversify by property type and by geographical area.

With a relatively less efficient marketplace where information on risk and return of various property assets is limited, the search for suitable properties can present serious problems to the management of the fund. In a study conducted on London-based property investors, Adair, et al (1994) found that the diversification of investors' portfolios were skewed in favour of a) traditional investment niches and b) markets for which they had good quality information and which were known to them. The result of this was that there was often a mismatch between investment activity and the sectors that were currently performing best.

2.8.3 The role of personal sentiment in investment decision making

According to Gallimore and Gray (2001), prospective investments, after identification, are compared to benchmark criteria by fund managers and decisions are made on whether the attributes of the property will enable achievement of those criteria. These decisions are often supported by forecasting models.

As mentioned above, property market data is often inadequate due to the variability in prices and diversity of property attributes. Where this is the case, investors' behaviour often departs from rigid decision making strategy and relies more on sentiment via 'insights' into market trends. Without accurate data on what the market is actually doing, investors turn to 'indirect' market signals, as found in published market analyses and commentaries.(reference?)

In financial markets this practice is severely frowned upon and is referred to as 'noise trading.' However, property investors will be inclined to supplement their limited market information with investor sentiment by paying heed to the indirect market signals.

2.9 Conclusion

The aim of the literature review was to examine in relative detail, the ambit of the property investment decision making environment and what key points of debate and observations have been postulated by previous studies.

What has become clear from the literature is that property is a complex asset and the realm of investment and portfolio management requires an experienced and informed approach. It will therefore be interesting to see how the research corroborates the opinions espoused in the literature and what other views emerge.

CHAPTER 3: RESEARCH QUESTIONS

The scope of the literature review was developed to create a foundation of knowledge about the decision making realm of the listed property fund managers, who function in a relatively complex environment.

In order to understand the methodologies employed in evaluate property investment decisions, the following questions will be explored:

3.1 Which criteria are considered to be the most important in the evaluation of a property investment decision?

3.2 What valuation methods are used by the fund to determine property values?

3.3 Which macro-economic factors are most influential on property investment decisions?

3.4 How is portfolio risk managed and what are the strategies employed to mitigate this risk?

The questionnaire designed for the qualitative research, which appears in Appendix B, will seek to identify the context of each investment decision and attempt to draw out as much relevant information around the decision making process. This will then give a good idea of the investment evaluation framework.

CHAPTER 4: RESEARCH METHODOLOGY

In the light of the above-mentioned literature review and research scope, the research methodology was designed and executed as follows:

4.1 Research method

A three-phased, qualitative research approach was conducted, where in-depth interviews with a selection of the decision makers from the PUTs and PLSs were conducted. The three phases were planned as follows:

Table 4.1 Research approach

Research Phase	Main Objectives	Data Collection Method	Sampling Technique	Sample Size
Phase 1	Exploratory research: Develop frame of reference and literature review of key points	Semi-structured, elite interviews	Purposive	6
Phase 2	Pilot interviews: test draft questionnaire and fine-tune approach	Semi-structured, narrative enquiry interviews	Purposive	2
Phase 3	Final in-depth interviews with key decision makers of listed property companies	Semi-structured, narrative enquiry interviews	Snowball	8

Berry (1999) suggests that in-depth interviewing is used by researchers to "elicit information in order to achieve a holistic understanding of the interviewee's point of view or situation. The data of qualitative inquiry is most often people's words and actions and thus requires methods that allow the researcher to capture language and behaviour."

The in-depth interview approach was ideal for the purpose of this research, since a deeper understanding was required as to:

- how fund managers developed decision criteria for investments made;
- how they perceived business, industry and portfolio risk;
- how they viewed environmental factors and situational challenges within the context of their investment decisions;
- what strategies they employed to mitigate investment and portfolio risk.

A quantitative analysis would possibly not have given sufficient insight to these questions.

4.2 Population of relevance, sampling and unit of analysis

The population of relevance consisted of the companies listed under the 'Real Estate' sector of the JSE main board, comprising six listed property unit trust funds and twenty-six property loan stock companies. The research objective was to interview eight of these entities.

The target interviewees were key decision makers directly involved in the property investment decisions within PUT's or PLS's. These decision makers could be executive or non-executive directors, fund-managers, members of the investment committees or persons responsible for acquisitions.

A snowball sampling approach was employed (Zikmund, 2003) for both the exploratory and final research phases, whereby referrals from prominent industry specialists opened the doors for the initial interviews. From these interviews further referrals were obtained for the rest of the interviews.

Four exploratory interviews were conducted and these included two with financial institutions, one with a leading South African academic in the field of property investment and finance and one with the CEO of a PUT.

The final interviewees included three CEO's, three directors and two fund managers from two PUT's and six PLS's.

The unit of analysis was a significant, recent buy or sell decision made where the interviewee was personally involved.

In each case the annual report of the PUT or PLS was scrutinised before the interview and one of the investments made during the financial year was selected and put forward to the interviewee to be used as a case study for the purpose of the research.

Two interviews were conducted in Cape Town and six in Johannesburg.

4.3 Interview design and preliminary testing

The objectives of the exploratory and pre-test research phases were the following:

a) To get better insight into the dynamics and functioning of the commercial property industry in South Africa;

b) To gain an understanding of the challenges and environment facing property industry decision makers and thus also direct the course of the literature review;

c) To develop questions which would elicit answers to the research questions, within the business context of each decision maker;

d) To test the content and sequence of questions in the questionnaire;

e) To test the length of the interview and the optimal number of questions.

Numerous adjustments were made to the questionnaire during the exploratory and pre-test research phases to produce the final document. (Refer to Annexure B for final questionnaire.)

4.4 Data Collection approach

Two authors provided useful guidelines for the process of structuring the interview, collecting useful and relevant data and analysing the data.

In his book, *The Long Interview*, McCracken (1988) outlines the data collection and analysis process as follows:

a) *An exhaustive review of the literature*, whereby the researcher embarks on a critical process which "makes the investigator the master of previous scholarship. It is a review and deconstruction of the scholarly literature." This helps define the research problems and interview questions. (p.31)

b) *Self examination*: This gives the investigator a more detailed and systematic appreciation of his personal experience with the topic of interest – associations, incidents and assumptions. This helps identify cultural relationships and categories that become the basis of question formation and helps distance the investigator. (p32)

c) *Developing a questionnaire*: The questionnaire will consist of a set of grand-tour questions with floating prompts, including "contrast," "category," "special incident" and "auto-driving" questions. This provides a rough itinerary without rigidity. (p.37)

d) *Analysis of the data*: The object of analysis is to determine categories, relationships and assumptions which inform the respondent's view of the world in general and the topic in particular. The investigator must be prepared to use all, or none of his material to see what exists here. (p.42)

To elaborate on McCracken's approach, Guion (2006) suggests several key characteristics of in-depth interviews. These include:

- Questions should be open-ended so that the respondents cannot simply answer yes or no, but have to expound on the topic.
- The interview should be semi-structured with some pre-planned questions, while allowing for a natural free flow of conversation and questions.
- Seek understanding and interpretation of what you are hearing. Search for a deeper understanding from the respondent throughout the interview.
- Conversational style, but your role is that of a listener.

- Record responses with an audio tape and note pad.
- Record observations of non-verbal nature to supplement and contextualise audio tape.
- Record your own reflections – your views and feelings immediately after the interview.

Some of the specific tactics employed by the researcher to enhance the value of the interview included:

1) Establishing rapport with the interviewee by discussing elements of mutual interest, including people in the industry, state of the economic or political environment or interesting aspects about the property industry, the person's business activities or background;
2) Getting the energy and enthusiasm of the interviewee to a high level by asking them about their company and personal involvement therein;
3) Being well-armed with background information on the interviewee's company and its activities so that minimal time would be spent on discussing background or context elements;
4) Bringing some humour into the interview and generally trying to make it an interesting experience for the interviewee;
5) Being punctual, courteous and asking permission to record the interview.

4.5 Data analysis approach

As far as the data analysis is concerned, an interpretative, phenomenological analysis was applied. This involved the recording of the key interpretations and observations, allowing the researcher to understand the structure and essence of experience of the interviewees within each case discussed (Medico, 2005).

The tape recordings of the interviews were transcribed into printed documents which were analysed with reference to the research objectives.

A colour-coded system was applied to highlight content which related to each research question.

The colour-coded segments were then collated and distilled to main themes around the research questions.

Common responses and themes were identified and interesting and unusual findings were noted.

4.6 Limitations to the research

In terms of the scope of the research, the following limitations need to taken into consideration:

1) No explicit comparison is made between financial assets and property assets, although property as an asset was discussed.
2) No detailed analysis on the various valuation methods used in the industry was explored. It is important to note here that in all cases, valuation of assets is outsourced to third party specialists.
3) The aspect of property securitisation and its role in the international financial crisis was not part of the research.

4) The relationship between investment decisions and macro economic factors on the share prices of the PUT's and PLS's was not a primary focus, rather, the criteria behind direct property investment was the focus.
5) The fund managers interviewed were from within listed property funds only.

4.7 Comments on the actual interviews

A number of interesting comments and observations are worth noting:

- Being well-prepared is critical to a successful interview. This includes background knowledge of the interviewee and making sure the recording equipment works;
- Arriving early for the interview and setting up in the boardroom before the interviewee arrives allows for better control over the process;
- The majority of the interviews continued well past the one hour target length, mainly due to the fact that there was good rapport and that the discussions were extremely interesting and enjoyable;
- It was imperative to have a well-prepared template for note-taking as a back-up to a tape-recorder, since the latter sometimes delivers a less-than-ideal result.

CHAPTER 5: RESEARCH RESULTS

5.1 Introduction

A summary of the important answers and observations stemming from the eight interviews are presented in this chapter by question and by respondent.

As mentioned earlier, case studies were discussed with each interviewee, which included the four different property sectors, namely, retail, office, industrial and hotels.

5.2 Overview of the interviews, companies and case studies

Table 5.1 provides an overview of the characteristic, size and activities of the property funds in the sample. Most of the funds are also involved in their own property development in addition to property and asset management.

Some funds' portfolios include investments in other property funds, in which case they are referred to as hybrid funds.

Table 5.1 Description of the companies in the research sample

Company	Market Cap (R millions)	No of Props.	Portfolio Description	Direct property only or hybrid fund	Develops own properties
A PLS	450	20	Offices	Hybrid	Yes
B PUT	4 410	168	Diversified	Direct prop. only	No
C PLS	5 034	103	Diversified	Hybrid	Yes
D PLS	4 516	40	Retail	Hybrid	Yes
E PLS	1 910	22	Hotels	Direct prop. only	Yes
F PUT	3 425	14	Retail	Hybrid	Yes
G PLS	16 024	463	Diversified	Hybrid	Yes
H PLS	5 898	5	Retail	Hybrid	Yes

Information about the interviewees and the interview locations are shown below. With the exception of one interview, the interview environments were ideal for the research data collection. The interviewees were all investment decision makers in their funds.

Table 5.2 Information on the interviews

Company	Interviewee	Interview Location	Interview conducted
A	CEO	Cape Town	Main boardroom
B	Director	Cape Town	Hotel lounge
C	Fund Manager	JHB	Meeting room
D	MD	JHB	Main Boardroom
E	Fund Manager	JHB	Main Boardroom
F	Director	JHB	Private residence – lounge
G	Director	JHB	Meeting room
H	CEO	JHB	Main boardroom

For each in interview, an investment was selected to be discussed as a case study. Details of these are presented in Table 5.3 below

Table 5.3 Description of case study selected in each interview

Company	Case Study Sector	Value (R millions)	Description of asset invested in
A	Offices	700	Building refurbishment, Cape Town CBD
B	Industrial	200	Development of warehousing complex, East Rand
C	Retail	8	Acquisition of large retail store, Newcastle
D	Retail	100	Investment in regional mall, Nelspruit
E	Hotel	400	Acquisition of hotel, Sandton
F	Retail	150	Development of regional mall, Vaal Triangle
G	Offices	150	Acquisition of office park, Midrand
	Retail	300	Addition to prestige shopping centre, Hyde Park

For ease of presentation and analysis, the findings are grouped by property sector and sequenced as follows:

Table 5.4 Data analysis sequence and grouping of case studies by sector

Company	Case Study Sector	Value (R millions)	Description of asset invested in
A	Offices	700	Building refurbishment, Cape Town CBD
G	Offices	150	Acquisition of office park, Midrand
B	Industrial	200	Development of warehousing complex, East Rand
C	Retail	8	Acquisition of large retail store, Newcastle
D	Retail	100	Investment in regional mall, Nelspruit
F	Retail	150	Development of regional mall, Vaal Triange
H	Retail	300	Addition to prestige shopping centre, Hyde Park
E	Hotel	400	Acqisition of hotel, Sandton

5.3 Research question 1

Which criteria are considered the most important in a property investment decision?

a) The Office Sector

Company A: Building reconstruction and refurbishment – Cape Town CBD

The developer had the following comments to make about investment criteria and their business approach:

“We look for capital growth opportunities, not just income-producing ones.”

“You have to understand your ultimate business purpose and see if the opportunity is in kilter with that.”

“Location and perceptions are important. This building is in the new financial hub of the Cape Town CBD, next to Investec.”

Company G: Acquisition of office park - Midrand

The key criteria mentioned were:

1. An assessment of the physical property to give a view on the sustainability and potential growth in the future, including:
    - The quality of the asset
    - The location and surrounding area it is in
    - The market rentals in the area
    - Our view on that node
2. The covenant (the lease): "Is it above or below market rates? What is the length of lease? Because you're locked in at specific rentals, it will have implications in the future."
3. The credit-worthiness of the client
4. Cost per square meter and replacement cost

b) The Industrial Sector

Company B: Development of warehouse complex – East Rand

The following criteria were mentioned relating to industrial investments:

1. Strength of lease. (A fully repairing and insuring (FRI) lease is ideal)
2. Positive yields. Rent must be higher than the cost of debt
3. Initial yield has an impact on the appreciation or dilution on the fund by the investment

4. Strength of tenant – credit-worthiness

5. Versatility of site, flexibility of the property and growth prospects.

The following comments were made in this regard:

"That extra piece of land on the site, providing extra bulk, sealed it for us."

"Low operating costs on the property has made industrial more lucrative. Industrial is not like retail, which is a business. Once you have the lease in place, you collect the rent every month, that's it. The yields can be very good."

c) The Retail Sector

Company C: Acquisition of large retail store - Newcastle

The gist of this decision was that it was motivated by the desire to own more of a growing retail node. The following comments were made:

"This was a strategic purchase to improve critical mass in a particular location. We already owned the space used by another large national retailer next door. Critical mass enhances revenue growth and property management cost containment for us."

"This is a busy hub and a growth area which will sustain that type of tenant. We are always looking for new high-growth nodes."

"Retail needs critical mass. If you have all the base retailers – the national chains, which make it worthwhile for a shopper to do all their shopping there, the other retailers follow suit. This is the power of the mall."

"Strength of tenants in a retail decision is critical."

“Market-related rental growth and escalations are very important.”

Company D: Investment in regional mall - Nelspruit

This investment decision was underpinned by three key factors, namely regional dominance, location variables and timing. The interviewee had this to say about the criteria for the investment:

“The Illanga shopping centre in Nelspruit is a strategic investment for us – the location is superior and the growth potential is high. It plugs straight into the affluent market and the N4 highway runs straight past it.”

“The four main national retail anchors are all there.”

“Regional retail is the most exciting part of the retail property category and it is also the lowest risk. This is what our business is all about.”

“Timing is critical. We saw where the market was going and bought a lot of our regional property at 10% yield when the market was at 11%. So we forward-purchased and locked them in at 10% and today you cannot buy or develop them at 10’s. We fore-bought a whole lot schemes and the cap rates kept going past the 10’s and now they’re at 11. So we took a calculated risk and it worked.”

Company F: Development of regional mall – Vaal Triangle

Some really important considerations for investment in retail and development of shopping centres were touched on in this interview.

Firstly, relating to Issues of the macro and micro location, the following important criteria were listed:

- Accessibility and visibility of the centre

- Demographics – how good is the residual market share?
- Looking at the competition – will the centre be the dominant player in the short and longer term? This is imperative.
- Is the centre predominantly covered by national retailers? 70% - 80%. This has risk implications.
- Are the rents market-related?
- Initial yield of investment must be yield-enhancing for the fund
- Are there management economies of scale

Secondly, relating to the function and identity of the centre. Market segmentation is done according to three types of retail centres. It is important to decide what your location and your demographics allow you to be, for instance:

  - Regional shopping centres: Regional and community usually rely on higher income groups who can get there by car;
  - CBD shopping centres: Typically lower income group – commuters using public transport which start or terminates there, will shop there;
  - Convenience shopping centres: easily accessible for those daily purchases.

Thirdly, in view of the identity and function of the centre, it is important to assess the tenant mix:

- Some tenants are not appropriate for a particular location because of the centre's function and identity;

- Energy or activity brought about by frequency of visits. Some tenants like furniture stores have once-a-lifetime purchases and are bad for the energy level of a centre because of relative inactivity. These can sterilise a shopping centre.

Company H: Addition to prestige shopping centre – Hyde Park

This fund has for some time, had a static portfolio of five large malls in prestigious areas and regard the following as important criteria for their investments:

- Location in prime, upmarket areas;
- Constant enhancement and preservation of the quality of the asset by upgrading

d) The Hospitality sector

Company E: Acquisition of hotel – Sandton

The fund manager enumerated the following core variables as important investment criteria:

- Location in growth nodes
- Further development potential, like development rights and zoning for bulk ratios, which will enhance critical mass and economies of scale
- Intrinsic property value

- Short-term effect on shareholders / unit holders – is the investment enhancing or diluting distribution?
- Asking price versus replacement cost

5.4 Research Question 2

What valuation methods are used by the fund to determine property values?

a) The Office Sector

Company A: Building reconstruction and refurbishment – Cape Town CBD

When asked about valuation methods used, the developer had the following to say:

“We go on gut-feel, but then apply sophisticated techniques and valuation formulas like DCF and NAV”

It must be added that this person is the CEO of the company, is a chartered accountant and has a team of ‘hard-core property professionals’ on his board. He has been in property for 20 year and is exceptionally hands-on in his management style. The comments about going on ‘gut-feel’ have to be seen within this context.

Company G: Acquisition of office park - Midrand

Although valuations are done by external third parties on behalf of all the funds, the following methods were regularly applied by this fund when contemplating investments:

- Initial yield;
- Simple perpetual yield valuation and escalation potential ;
- DCF method;

- Top-slice valuation – if the lease is over-market, the top 'slice' is taken off and the yields projected forward;
- Bottom slice valuation – similar approach as top slice, in order to achieve a more realistic view of the future yields.

b) The Industrial Sector

Company B: Development of warehouse complex – East Rand

The perspective given by the director of this large PUT was that industrial valuations are relatively simple compared with the other property types. The following points were mentioned:

- Initial yield (1st year income/price) is a good indicator;
- DCF method;
- Replacement cost.

A comment about valuations: "You have to get in your car and go and see the property to get a feel for the site, the area, the buildings, etc. Gut-feel counts here!"

c) The Retail Sector

Company C: Acquisition of large retail store - Newcastle

Two ways approaches were mentioned, relating to the case study:

1. first year income return;
2. proper DCF analysis.

Other comments included:

"Weigh up how good the property is from a strategic point of view: it may be cash-negative initially, but then cash positive and is a very good property. Our investment committee sat and debated the issues."

"Where leases are over-market, to cap just the first year could be dangerous. When the lease expires, the rate may be adjusted downwards. That is why the price has to be punished. You have to be realistic."

"There is so much subjectivity in the valuing of property. The valuers have the ranges for discount rates and cap rates, which we then all agree on. They do a more thorough job of actual valuing than we can."

"The discount rate is worked out scientifically – basically it is your long bond rate. A premium is put on of about 3% or 4% depending on the type and location of the property."

"In the past, guys would get management fees based on values that had been inflated. They would sit down at a table and just apply a value to the property. There is much more transparency in the industry now."

Company D: Investment in regional mall - Nelspruit

This developer did not have specific comments about valuation methods, except to say:

"External valuations are done throughout. The main reason for this is that we are looking for maximum credibility with the market and with the banks. The banks are very particular as to whose valuations they will accept.

Company H: Addition to prestige shopping centre – Hyde Park

Although this fund has had a small, high-value, blue chip portfolio which has not changed over the past four years, their properties are valued regularly by external specialists. The following comments were made:

"DCF all the time."

"Independent valuers value every 6 months."

"Interest rates and long bond yields are the benchmark."

d) The Hospitality Sector

Company E: Acquisition of hotel - Sandton

This specialist fund in hotels have a slightly different set of benchmarks to the other property types. The following points were stated:

"We do a market and financial analysis which would involve the following steps:

- A 5 to 7-year analysis. This is then extrapolated to a 20 year projection;
- Factoring in of complex environments;
- An assessment of Key revenue drivers;
- A projection of occupancy rates;
- A DCF analysis;
- A distribution (yield and growth) projection."

Other elements in their process include:

- Comparisons with other funds – cap rate analysis;

- Assessment of lease default risk;

- Scrutiny of the monthly financials of the tenants.

5.5 Research Question 3

Which macro-economic factors are most influential on property investment decisions?

a) The Office Sector

Company A: Building reconstruction and refurbishment – Cape Town CBD

The following comments on interest rates and inflation were made:

"There is a direct correlation between interest rates and the property market. Fortunately we're not overexposed to gearing."

"The high interest rate is a factor we just have to manage. This is not a short-term business; interest rate cycles are long."

"Lease escalations, in a way, take care of inflation."

Company G: Acquisition of office park - Midrand

Interest rate exposure, the ability to raise finance, liquidity, the property cycle and shortage of stock were the important macroeconomic factors raised by this fund:

"Up until recently, we have had a strong bull run in SA with political stability. Our biggest issues were around the client's business, their ability to grow and the sustainability of the revenue stream. Now, managing interest rate exposure is absolutely critical. It boils down to cost of capital."

"The ability to raise finance is currently a very big issue in our lives and we are looking at new sources outside of SA – Middle East and Far East."

"Liquidity is the one issue most companies have to deal with. Regulation stipulates that funds cannot retain income, so they cannot build up a capital base."

"The boom and bust nature of the SA property cycle. We see massive over-development and then massive vacancies for a while. Three constraints are however changing that in SA and dampening an oversupply:

- Shortage of zoned land;
- High cost of debt;
- Construction inflation."

"There is no tradable property stock. Everything that is being built is for a specific client. There is no speculative development happening."

b) The Industrial Sector

Company B: Development of warehouse complex – East Rand

Whereas the regional economy and demographics are not as important in the industrial sector as they are in the other property sectors, the points raised included:

"In an environment where cap rates are falling and interest rates are higher, there is difficulty in finding tradable property stock."

"High interest rates have an impact on a decision because of financing – your returns are no longer as good and sometimes it is better to do nothing and just ride it out."

"Currently, the investment climate is a bit more challenging – yields have risen and cap rates haven't moved down, so no deals are really taking place at the moment."

"The economic uncertainty internationally is going to have a negative impact – certainly on peoples' risk appetite."

c) The Retail Sector

Company C: Acquisition of large retail store - Newcastle

The comments from this fund manager on retail investments included:

"The industry is very sensitive to interest rate fluctuations and sentiment, mainly because of gearing and debt. We have pretty low gearing, so we are not that exposed."

"There seems to be an 18-month lag on rising interest rates and actual yield coming down. The down-cycle has not been so bad. The sentiment has been "let's sit tight," so prices have not yet moved that much, but slowly we are seeing yields moving up again which is pushing prices down."

"The market is still strong in terms of tenancies, lease escalations and vacancies. That is keeping the industry going."

"Inflation and interest rates are impacting on consumer spending, but so far, we have not had any major tenant casualties."

"Politics have not had a huge effect."

"The global financial crisis has not had the negative effect here as we have seen overseas, where it has caused widespread liquidations. Our property market fundamentals are still strong and holding up the market."

Company D: Investment in regional mall – Nelspruit

The comments from this predominantly retail fund were essentially around the ability of large, good quality retail centres to maintain value in a high interest rate environment:

"Retail is holding its value and is still relatively safe. At most of our centres we've got national tenants waiting for more space. Some of the other funds have secondary retail space, which is good while the market is buoyant. However, when interest rates go up, these retailers close shop."

"Although a decline in disposable income affects turnovers, we have not had the big retailers default yet. On the contrary, they still seem to be looking for more space."

"We chose not to get involved in manufacturing (industrial) because we don't think South Africa will ever be a manufacturing country. We have an expensive and militant workforce in a market which is ruthlessly competitive."

Company F: Development of regional mall – Vaal Triangle

The interviewee in this case study is regarded as one of the most experienced retail property professionals in South Africa. His comments were slightly different to those of the other retail funds and revealed a great deal about the macro-environment which shopping mall developers currently find themselves in:

"Developers have been jockeying for prime positions and trying secure leases with the large retailers by offering them all kinds of deals. Only 10 – 15% of these developments are materialising. So credibility and delivery by developers has become an issue."

"Interest rates are such that you cannot buy income-producing property at less than the cost of debt. "The funds now have to sweat their existing portfolios to get growth and that's difficult under these conditions. They also can't issue paper because they are trading at such a discount on their NAV's that it is not a proposition."

"Escalating building costs put developers under huge margin-pressure. There is therefore no incentive to currently do anything. On the other hand, you also have to understand the asset class you're dealing with – it is a long-term process."

"The second-tier property market, the institutional investors are not listed, nor regulated and are taking advantage of the inability of the listed sector to buy. They are using their cash reserves and getting sharper yields. Because the listed sector has to distribute all its earnings, it has no ability to create reserves or to be financially nimble. This limits their ability to function in a tight market."

"Consumer confidence affects revenues of particularly the smaller retailers."

"Political instability will manifest itself in the long run. This interparty scrapping is doing nothing for investor confidence."

"Infrastructure and services availability and delivery are becoming serious delay factors for developers."

"Our exposure to the international sub-prime and financial crisis has been limited. Our financial system is sophisticated and our regulatory system is sound."

"The country's population has grown from 47 million in 2006 to 57 million. That means a lot more consumers. So, although the disposable income is down, the consumer base is growing."

Company H: Addition to prestige shopping centre – Hyde Park

The CEO of this fund which owns 5 upmarket shopping centres listed the common factors which are currently impacting negatively on business as being:

- High interest rates
- High inflation
- Decreased consumer spending
- High fuel prices
- Slow GDP growth

He then qualified this by saying, "Hyde Park is a bit of an exception in that the upper income groups are not that affected by the negative macro economic factors, the result of this being that our revenues are largely unaffected."

On the positive side, he listed the following factors:

- Growing middle income market;
- Growth in salaries

- Government investment in infrastructure

Two other interesting points mentioned were:

"A formalised property regulatory structure, like the new proposed REIT structure, properly controlled and in line with the rest of the world could be a good thing for international investment into our property sector."

"A major constraint in the SA retail sector is the relatively small variety of national retailers. We have 200 and the UK has 600."

d) The Hospitality Sector

Company E: Acquisition of hotel - Sandton

The important points macro-economic factors which are relevant to this fund included:

- Tourism trends and forecasts
- Interest rates, in that they:
  - Are a bond proxy – debt to bond yield which affects property stocks;
  - Impact on the ability to raise capital and buy properties;
  - Impact on discretionary income which has a bearing on the leisure spend;
- The conference environment
- Limited tradable stock of properties. Supply is the constraint

5.6 Research Question 4

How is portfolio risk managed and what are the strategies employed to mitigate this risk?

a) The Office Sector

Company A: Building reconstruction and refurbishment – Cape Town CBD

This company tends towards being a specialised fund, both by geographic region and by property type, as can be gleaned from the following comments:

"I have found a niche in rebuilding and upgrading properties to produce blue-chip investments in prime locations, mainly office developments in the Western Cape."

"We focus on specific nodes, such as the financial hub of Cape Town."

"Some of the developments are so-called 'brown-fields', or refurbishment projects."

"We strive for capital growth and stability of income from quality assets."

Company G: Acquisition of office park - Midrand

This large fund has the strategy of acquiring A-grade property and being the dominant player in the industry, as can be seen from their comments:

"We focus on A-grade properties and A-grade clients – the bulk of the value is in the high-end of the market. We've divested from the CBD's."

"We're multi-focused. Each sector has its own management team and a divisional director."

"Of the 55 retail properties in our portfolio, 66% of the value comes from 12 properties – regional malls. They are all in reasonably affluent areas. We have the best retail portfolio in SA. Retail has been the best performing sector over the past 20 years. We will get rid of the smaller retail units."

"Historically, the industrial portfolio was small, but increased through our acquisitions of two other funds. Industrial is now showing the strongest returns."

"With office space it is very nodal – we have focused on Sandton,Umhlanga and Claremont."

Comments on strategy in general included:

"In SA the listed property industry is very new and there has traditionally been a tense and often hostile relationship between owners and tenants. We see our tenants as our clients and there is a big opportunity to drive more of a client-centric approach in our business where they are aware of our abilities and partnering with us so that we can help them grow."

b) The Industrial Sector

Company B: Development of warehouse complex – East Rand

This director of a multi-billion Rand PUT had this to say about their portfolio strategy:

"Diversification happened along the way – attractive opportunities presented themselves and acquisitions were made. There is now an even spread between the retail, office and industrial sectors."

"A recent focus has been to look for dominant retail centres."

“The majority of our investments are in Gauteng. Cape Town has seen significant growth in recent years, but off a small base.

c) The Retail Sector

Company C: Acquisition of large retail store - Newcastle

This large fund has essentially grown through acquisitions of other property funds and is looking to restructure their portfolio. The interviewee is responsible for portfolio acquisitions and raised the following points:

“We are a true hybrid fund – our ratio of direct property and shareholdings in other funds is 50/50.”

“Our portfolio strategy is to increasingly diversify geographically and to the various sectors.”

“We also would prefer to have fewer, but larger assets. We will dispose of those not meeting our portfolio requirements, where possible. The minimum sizes that we would regard as a threshold are:

- Shopping centres: 20 000 sq m
- Offices: 4 000 sq m
- Industrial: 10 000 sq m

“The sectors don’t all perform in the same cycle: there is now virtually an oversupply of office space, while industrial is booming and retail is slowing down. It is a good time to buy now – while we are in the down-cycle.”

"Our differentiating factor is quality assets and a good tenant profile which brings sustainability of property income going forward We have to focus on what we do well and not try to be something that we're not. We also have a small investment offshore in a German retail group.

Company D: Investment in regional mall - Nelspruit

The portfolio strategy outlined by the MD of this fund was remarkable and unusual:

"We have a specific strategy of owning dominant regional shopping centres in small cities and regional capitals where there are strong mineral resources underpinning them – coal, platinum, iron ore, chrome and manganese."

"A good example of this is Burgersfort, which is a very exciting place – nine new platinum mines and one of the highest mineral deposits in the world. We have a nice chunk of land there."

"We are waiting for Escom power and will build a big centre there. But at the moment it is still very much a boom town – something we are very wary of. Ellisras is another opportunity for us. It sits on the biggest coal deposit in the country."

"Regional retail is the most exciting part of the retail property category. It has always had the lowest risk and always will have. Getting into that is first prize."

"We don't want to own more than 15 properties, so we will add at the top and sell off the bottom. We have not bought into the manufacturing (industrial) sector because we don't believe that SA will ever be a major manufacturing country."

"Regional retail is very hard to come by. Institutional ownership is so big, there is just nothing available – it never trades. That is why we develop our own stock."

"We are totally hung up on dominance – we don't want to be no. 2 anywhere."

"We invest in other funds for two reasons:

1. To store cash while we are developing
2. When it is opportunistic. At the moment it is cheaper to buy listed than physical stock. Periodically the market dislocates violently and that is when we make money. We have a R700 million facility with the bank, so we keep ourselves in a powerful position to move on opportunities."

Company F: Development of regional mall – Vaal Triangle

The senior director of this predominantly retail fund had the following to say about their portfolio strategy:

"Our primary focus is regional retail centres and then office parks. There is no industrial component."

"We have a limited appetite for development. We would rather buy guaranteed yield and pay a premium for getting it."

"Looking at risk management, you have to understand where the consumer spend is going. The risk is in the discretionary items – cars, furniture, etc. You can delay replacing them. These type of retailers take a knock during the down-cycles."

"Many of the funds in the property sector are run by ex corporate or merchant banking people. Most of them have little or no property skills although they have good deal-making skills, but some of them have made horrendous property decisions. You have to have the right skills for the job. As Warren Buffet said, you have to understand the asset to unlock the growth."

Company H: Addition to prestige shopping centre – Hyde Park

The CEO of the fund with the five super retail centres had this to say about his portfolio:

"We have the right assets at the right yields."

"We also have sizable assets in the right locations and our property fundamentals are good – the leases, tenants, etc"

"There is no specific diversification strategy – we have five large shopping malls catering for the top end of the market and the yields are good. Our focus is on sustainability of income, not growth, *per se*."

"Property management done internally and our focus is on tenant operations. We talk to our customers about their businesses, their revenues and their plans. We are very hands-on with our tenants."

"We interact with all the national retailers twice a year and we go to al their road shows."

"We do have international aspirations if we can find the right partners. We have international benchmark funds like Westfields in Australia, The Simon Property Group (USA) and Liberty International (UK & USA)."

d) The Hospitality Sector

Company E: Acquisition of hotel - Sandton

The fund manager in charge of acquisitions had this to say about portfolio strategy:

“Hospitality is a speciality fund, focusing on owning majority shares in hotels.”

“The hotel industry in SA is very small, but we don’t want to rush into acquisitions simply to bulk up the portfolio. It is all about quality assets.”

“Our strategy is very focused on acquiring and developing units in particular growth nodes. We also want to capitalise on our existing portfolio to maximise shareholder value.”

“Diversification for us is about:

- Market segmentation: foreign, domestic, corporate and conference markets
- Location
- Source markets
- Star Grading

We look to actively manage our investments and increase our shareholding in the various groups. That is why we have 22 people looking after 22 assets. They all have excellent operational skills in the hotel industry and can step in should there be a problem with a particular unit.”

5.7 Conclusion

The key findings of the qualitative research process are presented above. The important comments from each interviewee were recorded and grouped under each of the four research questions.

In the next chapter, these findings will be analysed and compared with viewpoints from the literature review in chapter 2.

CHAPTER 6 DISCUSSION OF THE RESEARCH FINDINGS

6.1 Introduction

The purpose of this chapter is to interpret the findings from the data analysis in the light of the literature review.

The major themes have been identified and are compared with the relevant literature for each of the four research questions. A conclusion is presented after each research question.

For ease of reference, the case studies are shown again below with the property sectors indicated.

Table 6.1 Description of case study selected in each interview

Company	Case Study Sector	Value (R millions)	Description of asset invested in
A	Offices	700	Building refurbishment, Cape Town CBD
B	Industrial	200	Development of warehousing complex, East Rand
C	Retail	8	Acquisition of large retail store, Newcastle
D	Retail	100	Investment in regional mall, Nelspruit
E	Hotel	400	Acquisition of hotel, Sandton
F	Retail	150	Development of regional mall, Vaal Triangle
G	Offices	150	Acquisition of office park, Midrand
H	Retail	300	Addition to prestige shopping centre, Hyde Park

6.2 Research question 1

Which criteria are considered to be the most important in the evaluation of a property investment?

6.2.1 Findings from the research

The most important themes which emerged from the research data relating to criteria for investment decision making, are the following:

a) Physical aspects and rights of the property

An assessment of the physical quality of the property is important, particularly for the sustainability and future income growth. (Office park in Midrand)

If there is additional land for future development or expansion, this is a significant benefit. (Warehousing on the East Rand)

Similarly, zoning and property rights could allow for additional development or additional bulk, such as in the case of the hotel in Sandton. This is a very important criterion.

It is important to have a look at the surrounding area in terms of vacancies and property grading. A physical inspection is crucial, particularly for office and retail property.

Older premises imply lower operating costs, which industrial property holdings will take advantage of.

Accessibility and visibility are key physical factors, as emphasised by the developer of the Vaal Triangle mall.

b) Location

The Cape Town office block developer, puts location as the most important criterion. “We are in the new financial hub of Cape Town, next to Investec. Perceptions are important.”

The aspect of a ‘growth node’ was a popular theme. This was relevant to all the sectors apart from industrial. The funds will develop a view on a node, specifically to market rentals and growth opportunities in that area.

Strategic location decisions were mentioned by all the retailers interviewed. Two funds mentioned “wanting to own a greater share of a growing retail node.”

A second strategic location consideration was the presence of the large national retail anchors, which draw consumers and various smaller retailers. This is the power of the mall. (As mentioned by the regional mall developers of the Newcastle and Nelspruit centres)

Dominance was mentioned by all the retail funds. This was a singular objective of regional mall developments in Nelspruit and the Vaal Triangle. “We want to be in the small cities and regional capitals where we can be the dominant player.” (Company D)

A very interesting location strategy also came from Company D, who indicated that they want to be in areas where there is a strong natural/mineral resource base, such as coal, manganese and platinum. Hence, their investment in places such as Burgersfort and Ellisras.

Company F, the developer of the mall in the Vaal Triangle, and arguably the most experienced property professional, mentioned a unique criterion. He stressed the importance of understanding the identity and function of a retail centre. If the design, function and tenant mix is confused, or inappropriate for the centre, revenue growth may not be sustainable. Some developers confuse the functions and identities of malls, community shopping centres and convenience centres.

c) Demographics

For the retail sector demographics is critical. This was emphasised by the Vaal mall developer, who would typically ask, "What is the competition doing? How good is our residual market share?"

The asset must then conform to the market and the demographics in terms of function and identity (Co. F)

d) The lease or covenant

The office and retail sectors emphasised the strength and terms of the lease: "Is the lease market-related? What is the length of the lease? Above or below market rate has implications, because these can be renegotiated when the lease expires and changes the whole financial scenario."

Market-related rental escalations are very important.

For the industrial sector the type of lease has implications for ongoing property management. An FRI lease – fully repairing and insuring is ideal for the fund.

An often quoted criterion was that the initial yield must be yield-enhancing for the property fund.

e) Tenants

The creditworthiness of the tenant was emphasised by virtually all the funds. In the case of retail this is vital, due to the fact that they usually deal with large numbers of tenants in one property. The retail funds would typically assess the businesses of their tenants, their revenues, future prospects and profit margins.

Tenant mix is very important for retail funds, particularly where an investment is being considered in an existing centre. Company F mentioned that the energy which a store contributes to a centre is an important consideration. This correlates with the frequency of purchases linked to the tenant. For example, daily purchases at supermarkets bring a great deal of foot traffic and energy, while furniture stores draw far less traffic and can sterilise a centre.

f) Fit with business strategy

A number of specific business or portfolio strategies were mentioned. The interviewees stated that it was important that the potential investment supports their overall strategy. These included:

- Regional dominance
- Larger, higher quality centres
- Being in new growth nodes

6.2.2 Important points from the literature

The article on due diligence procedures relating to property acquisitions by Ghyoot (2001) succinctly summarises the criteria for investment decision making. The term due diligence implies taking all reasonable measures to avoid unplanned risk exposure. The following components are suggested:

1. Physical aspects such as state of repair and remaining economic life of the structure;
2. Property rights such as current and previous title deeds, cadastral information and town planning restrictions;
3. Location analysis, which entails assessment of transport linkages and exposure in the property's surrounding area;
4. Market conditions – macro level: growth in local economy, attitudes of local government regarding development, etc. Micro level: current property management, types of leases, rental levels and vacancies;
5. Leases and tenants: credit ratings of tenants and lease terms;
6. Market value: to be assessed by experienced professional person, either using DCF or Scenario Analysis;
7. Financial modelling, which should be a realistic model of the property as it is expected to function. Extensive risk analysis should be incorporated, including ratio analysis, benchmark comparisons and sensitivity to various scenarios;

8. Qualitative information including factors such as environmental impacts, local authority politics and potential actions by pressure groups.

6.2.3 Conclusion to criteria for investment valuation

The journal article by Ghyoot (2001) is a comprehensive framework of criteria for evaluating a property investment decision and was supported by the findings from the data analysis.

Some of the interesting points not explicitly covered in the literature, but mentioned in the interviews include:

Location strategies

Concentrating on new growth nodes, for example, the emergence of a financial hub in Cape Town.

Being the dominant retailer in 'small cities' and regional capitals, particularly where mineral resources are set to bring about growth.

Tenants

The close scrutiny, and in the case of retail, close involvement with the tenants, specifically to monitor their business activities and revenues.

The concept of energy-contribution by a tenant to a centre, in the form of frequency and volume of foot traffic.

Identity and function of retail centres

The importance of understanding the function and identity of a retail centre, and therefore the appropriate tenant mix.

6.3 Research question 2

What valuation methods are used by the fund to determine property values?

6.3.1 Important points from the data analysis

Although valuations are done by external third parties on behalf of all the funds, the following methods were mentioned by the funds, when assessing property investments:

Table 6. 2 Valuation approaches cited

Valuation method	Office	Retail	Industrial	Hospitality
Initial yield	2	1		
DCF	2	2	1	1
NAV	1			
Simple perpetual yield valuation	1			
Top slice / bottom slice	1	1		
Replacement cost	1		1	
Market & Financial analysis				1
Cap rate analysis				1
'Gut Feel'	1		1	

Apart from mentioning the various methods used, some of the important comments made about valuations can be categorised under the following headings:

a) External Valuations

"External valuations are done throughout. The main reason for this is that we are looking for maximum credibility with the market and with the banks. They do a more thorough job of actual valuing than we can." (Company D)

"In the past, guys would get management fees based on values that had been inflated. They would sit down at a table and just apply a value to the property. There is much more transparency in the industry now." (Company C)

"There is so much subjectivity in the valuing of property. The valuers have the ranges for discount rates and cap rates, which is then accepted." (Company D)

b) Putting 'gut-feel' into perspective

When gut-feel was mentioned, it was done so in conjunction with a whole range of sophisticated techniques and valuation formulas like DCF and NAV.

The importance of fund managers getting into their cars to physically go and see the property to get a feel for the site, the area and the buildings was deemed to the time when gut-feel would be important.

c) On the assessment of leases

Leases should be viewed from a strategic point of view: a lease may be cash-negative initially, but then through escalations, become cash positive and become a very good potential investment.

d) On the discount rate used in valuations

Company G said, "The discount rate is worked out scientifically – basically it is your long bond rate. A premium is put on of about 3% or 4% depending on the type and location of the property."

e) On hotel valuation

This specialist hotel fund has a slightly different set of benchmarks to the other property types. The following points were stated:

"We do a market and financial analysis which would involve the following steps:

- A 5 to 7-year analysis. This is then extrapolated to a 20 year projection;
- An assessment of key revenue drivers;
- A projection of occupancy rates;
- A DCF analysis;
- Tenant default risk assessment

6.3.2 Information from the literature

The literature mentioned some important concepts regarding property valuation, namely:

a) Methods of Valuation

The literature states that the most commonly used valuation method is the multi-period discounted cash flow (DCF) valuation. Kishore (1996) states that a study conducted in Australia among property investors indicated that 75% used DCF consistently for valuations and 25% used it occasionally. For acquisitions, 100% used the DCF method.

b) Discount rates

Kishore's (1996) comments that the way in which discount rates are selected appears to be an issue among valuers, with two main schools of thought. One school proposes that the discount rate be based on long-term bond or gilt rates, and the other, that the rate be based on the cost of the combined debt and equity capital, or weighted average cost of capital (WACC).

c) Prices and yields

It is important to understand the link between the expectations of returns (or yields), which motivates investors, and the prices or values of assets, which is the issue they are grappling with in the daily business of real estate investment. Geltner et al (2007) elaborate on the concept of price and yield: the expected yield is inversely related to the price of the asset, because the future cash flows are constant and are determined by market factors of supply and demand.

d) Potential influence of clients on valuers

Levy & Schuck (2002) outlined the relationship between clients and valuers and mentioned that abuse can occur where clients put pressure on valuers via their positions of power to produce the results which would suit them.

6.3.3 Conclusion on valuation methods used

The following points summarise the important overall conclusions reached:

1. **The DCF approach** is the most popular and widely used valuation approach. This is most likely due to the observations made by Geltner et al (2007) that it:
    a. Recognises that valuation depends on the future net cash flow generated by the asset;
    b. Takes a long-term perspective, appropriate to property;
    c. Has a total-return perspective.
2. Whereas Kishore (1996) states that **the discount rate** can be derived from either long-term bonds or the WACC, the data analysis points to the former as the method of choice in the SA listed property industry.
3. **External valuations** have become the modus operandi in the listed property industry for two reasons:
    a. It lends credibility to the valuation results;
    b. It provides greater transparency, since there were cases of valuation abuse in the past.
4. The importance of **leases** in the valuation process. Leases have a major bearing on the yield of the investments and if they are not market-related, there could be negative implications for the fund. This is where professional valuers, who deal with properties on a daily basis, become important.

6.4 Research question 3

Which economic factors are most influential on property investment decisions?

6.4.1 Results from the data analysis

Table 6.3 Summary of views on impact of macro-economic variables

Macro-economic factor	A Off	B Ind.	C Ret.	D Ret.	E Ho.	F Ret.	G Off.	H Ret.
Interest rates								
High cost of gearing	*	*	*	*	*	*	*	*
Inability to raise finance			*		*	*		
Cannot develop or purchase property	*	*	*	*		*		
Cannot issue shares: trading at discount to NAV						*		
Inflation								
Impacts on consumer spending & revenues			*	*		*		*
Weaker GDP growth		*	*		*	*		
Investor sentiment								
The strong bull run in SA is over			*					
Consumer confidence impacts on the retailers			*			*		
Property prices and fund share prices declining			*			*	*	
SA Property fundamentals still strong	*	*	*	*		*	*	*
Regulation								
Funds cannot retain income -> liquidity problem			*			*		
Property Cycle								
Oversupply dampened by shortage of zoned land						*		
Oversupply dampened by construction inflation						*		
Shortage of tradable stock of property								
High int. rates -> no speculative development						*	*	
Pension funds cash flush & taking available stock		*	*	*		*		
Global economy								
Uncertainty impacting on appetite for risk taking			*			*		
Uncertainty impacting on obtaining finance	*	*	*		*	*	*	*
Tourism: propensity to travel to SA					*			
Political environment								
Politics have not had a big impact	*			*		*	*	
Instability will manifest itself in the long-run						*		

Comments and observations on the results

a) Impact of interest rates

All the funds cited interest rates as a key factor. High interest rates have a direct negative impact on the listed property industry in that they stifle business growth through

- Increased cost of debt
- Erosion or eradication of profit margins
- A decrease in the financial viability of investments or developments

b) Shortage of tradable stock

This was a frequently-mentioned point. Supply is a major constraint. In SA there is neither the choice of investments, nor the volumes that are found in the UK and USA.

In addition to this, the large financial institutions like the insurance companies and pension funds have invested in relatively large holdings of property, which they generally do not release back into the market.

c) General sentiment and property fundamentals

The general sentiment of the interviewees towards the macro business environment was very positive. On the whole, there was little concern expressed over the political uncertainty in the country, nor the global financial crisis, nor the high inflation rate. No-one mentioned the fact that the property index on the JSE had shed around 30% of its value since the previous year.

Several interviewees mentioned that ‘property fundamentals in SA were still sound. These being low vacancy rates, strong tenants and inflation-beating escalation clauses built into the leases.

d) Regulation on distribution of earnings by listed property funds

By law PUT’s and PLS’s have to distribute their net earnings. The consequence of this is that they cannot accumulate reserves. If they could, they could potentially be in a better position to a) absorb some loss-making investments and b) buy property at the bottom of the cycle when prices are low and cost of capital is high. There were a number of comments about this fact.

6.4.2 Relevant points from the literature

The following extracts highlight the corresponding opinions from writers on the subject of macro-economic influences:

a) Macroeconomic influences

Past research has consistently shown that commercial property performance is closely aligned to changes in GDP, employment, interest rates and inflation. It is also evident that due to property supply characteristics, the property cycle lags behind movements of macro-economic variables (Hoskings et al, 2004)

Buetow & Johnson(2002) state that research has proved that USA Federal Reserve monetary policy influences stock and bond returns and that similar patterns exist for real estate returns.

b) The property cycle and lags

Various studies, according to Pyhrr et al (1999) have shown that vacancy rates are a key variable linked to rent and building cycles. The latter consistently lagged the vacancy rate cycle's peaks and troughs by about one year.

Another view on cyclical patterns put forward by Pyhrr et al (1999) is the psychological aspects of human behaviour. The authors suggest that during extended periods of prosperity, people adopt the psychology of affluence and its by-product, economic optimism. They become economic risk-takers and rationalise that what has happened, will continue to happen and thus see less risk than there actually is.

c) Forecasting

In his model determining rental values of retail properties, Nathakumaran (1994) postulates a simple supply and demand equation which is a function of:

- consumer spending,
- the stock of retail space,
- interest rates

6.4.3 Conclusion to macro-economic influences

Most influential macro-economic factors

The literature supports the main points coming from the data analysis, namely that factors such as interest rates, vacancy rates and availability of stock have a direct impact on the industry.

Evidence of extremely positive dispensation exhibited by interviewees

The most interesting observation however, is the fact that almost without exception, the interviewees were all very positive about their business performance and future prospects. This, in a macro-environment where discretionary income has been significantly eroded, global investor confidence is at an all-time low, share prices have lost one-third of the value and the country is in a state of political uncertainty.

Did the research witness manifestations of the property cycle lag?

One possible conclusion to this phenomenon is that the researcher witnessed the characteristics of the lag which Pyhrr *et al* (1999) speak about above. The SA listed property industry has just had an extended period of immense prosperity and it could just be possible that the psychology of affluence and its by-product, economic optimism still has momentum and is evidenced by the attitudes of the interviewees.

The lag is the result of a slow period of mental adjustment to the new realities of the current macro-economic environment which is arguably in a recession.

6.5 Research Question 4

How is portfolio risk managed and what are the strategies employed to mitigate this risk?

6.5.1 Important observations from the research

Table 6.4 Portfolio representation by sector

Co.	**Offices**	Industrial	Retail	Other
A	80%. Offices in Cape Town CBD and Claremont	8% Cape Town	12% Cape Town	
B	45%	17%	38%. Want to grow region retail sector	
C	53%. Want more A-grade Properties	19%. Want to increase proportion	28 %. Want to increase proportion	Have offshore investment in German retailer
D			100%. Own dominant regional malls	
E				100%. Hotels and hotel groups in growth nodes
F	43%. Focus on office parks		57%. Focus on egional malls	
G	42%. Focus on A-grade property	23% . Focus on A-grade property	35%. Want to grow this sector	
H			100%. Only 5 large malls in upmarket areas	Wants to diversify offshore if the right opportunity comes

The table shown above gives a snapshot overview of the relative holdings and investment activities of the eight funds interviewed.

The table below gives insight into the portfolio strategies of these funds, with comments from each of the interviewees.

Table 6.5 Specific Portfolio Strategies

Co.	Comments on Portfolio Strategy
A	Focusing on growth nodes in Cape Town: new financial hub in the CBD and Claremont. Our goal is value-add, capital growth; not just income. Doing some 'brown-fields' developments: upgrading old properties to blue chip investments in prime locations.
B	Even spread of properties. Portfolio grew spontaneously – attractive opportunities presented themselves and acquisitions were made. Looking to acquire dominant retail centres.
C	True hybrid fund – 50/50 split between direct property holdings and investments in other listed funds. Want to restructure our portfolio to have fewer, but higher grade assets. The various sectors are performing differently in this stage of the cycle. Also have a share in a German retail group. Good time to buy now.
D	Our strategy is to own dominant retail centres in regional capitals or 'small cities.' This is the best part of the retail sector to be in. We particularly look for places where strong mineral resources are present and driving growth in the area. We don't want more than 15 good properties.
E	Hospitality is a true specialist fund. The industry is small and we are focused on acquiring and developing units in particular growth nodes. Very intensive property management is required.
F	Our primary focus is regional retail centres, then office parks. One has to understand where the consumer spend is going. (Avoid discretionary spend-retail in this economic climate.) Understand your asset!
G	Acquiring A-grade properties only and being the dominant fund in SA. 2/3rd of our retail revenue comes from 12 properties. Concentrating on the high-end of the market. No CBD's. Each sector has its own focus and own divisional director. Grew industrial portfolio through acquisition of another fund. Now best performing sector.
H	We have the right assets at the right yields. We have sizable assets in the right locations – upmarket areas.

Some interesting points and observations from the summary of portfolio strategies:

1. **Growth nodes** seem to be a primary focus of most of the funds

2. The **underlying reasons for growth** in an area range from capitalising on upper-income markets, to the anticipation of growth due to the presence of mineral resources and a commodities price boom.

3. The importance of owning **regional malls** was apparent. Those who did not own regional retail, were on the whole, very keen to acquire this type of investment.

4. **To have more assets in the portfolio** should not necessarily be a goal. Three of the funds are deliberately limiting the number of assets and want quality rather than quantity.

5. Although the majority of the funds are diversified, apart from two large funds – Companies B and C, they all appear to have **very specific portfolio strategies**.

6. The retail sector in particular, and to a lesser degree, the office sector, appear to be **targeting the upper-income areas**. The segmentation of this market has been a focus for Companies A, F, G and H.

7. Surprisingly, only one fund had **offshore holdings** and this was limited to 5% of the value of their portfolio.

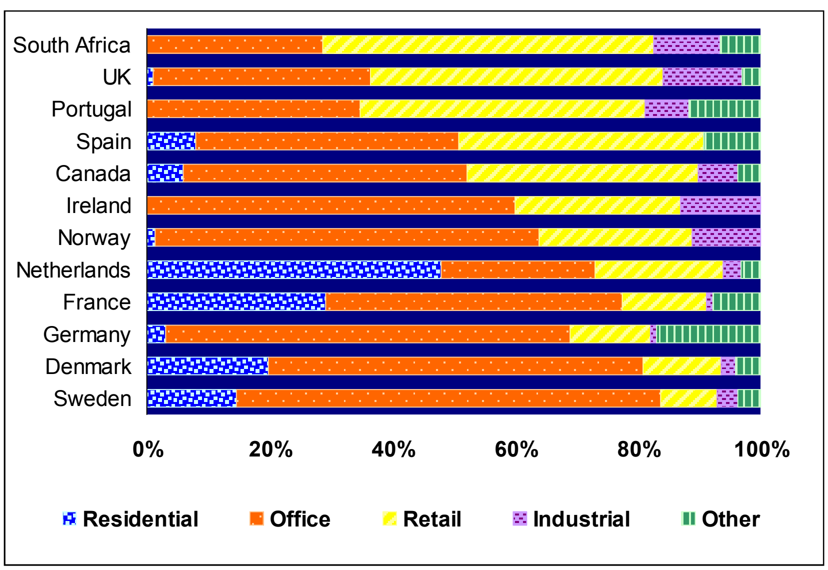
8. Following on from point 7 above, Company F commented that it is important to **understand your asset**. He previously mentioned that

many of the property fund managers are ex-bankers of financial asset managers, who do not always make good property market decisions.

9. Only one mention was made about capitalising on the **stage of the property cycle**. The reasons for this could be the high cost of capital or the fact that the funds are not sufficiently nimble to take advantage of property cycle stages.

Having had a look at relative property sector holdings in the listed industry, it is interesting to see the corresponding situation in the unlisted property industry in the table below. The size of the retail segment in SA gives some indication of the relative importance of this sector, a fact supported by the research.

Figure 6.1 Global direct property holdings by financial institutions



Source: SAPIX / IPD

6.5.2 Relevant extracts from the literature on portfolio strategy

In returning to the literature to see what previous research has uncovered, the following main points are relevant:

a) Diversification and Modern Portfolio Theory

The aim of applying MPT is to create a portfolio of investments that a produces a predictable return. The risk in the system is the volatility of the return on the portfolio. Byy increasing the number of investments in the portfolio, the specific risk is reduced (Ali, 2006).

b) Understanding of property assets by fund managers

Fund managers who are familiar with the financial markets are often less confident in the property market and are prone to misjudge property investments, with the result that property suffers from a number of myths and misunderstandings, more so that other types of investment (Ali, 2006). Consequently, MPT should be applied primarily as a risk-management tool, rather than a return-management tool.

c) Investment and Portfolio strategies

A good starting point when looking at investment decision making behaviour is to establish what the investment objectives are. At a fundamental level, there are two mutually exclusive types of investment objectives (Geltner et al, 2007). These are:

- the growth (or savings) objective, where there is a relatively long-term approach with no immediate or likely immediate need for the cash being invested,
- the income (or current cash flow) objective, which implies that the investor has a short-term and ongoing need for the cash generated from the investment.

Pyhrr *et al* (1999) discusses five potential portfolio strategies, being:

1. Income
2. Balanced
3. High-yield
4. Growth
5. Opportunistic

These are measured in terms of risk and reward, with the 'Income' strategy being the most conservative and the 'Opportunistic' being the most aggressive.

The relatively aggressive strategies are linked to the down-cycle, being the Recession / Recovery phase, which is characterised by vacancies being higher than equilibrium. With over-supply of space, prices of property should come down and this is where the 'Opportunistic' strategy can be effective.

When the cycle goes through its Expansion / Contraction phase, there is an under-supply of space and the more stable 'Income' and 'Balanced' portfolio strategies are able to provide acceptable returns as the down-cycle commences (Pyhhrr *et al*, 1999)

d) Financial agility

To be able to capitalise on the stages of the property cycle, funds have to be sufficiently flexible and have access to funding in order to take advantage of the opportunities which exist (Levy & Schuck, 2005).

e) Criticisms of investment decision making literature

Satisficing

Normative models of investment decision making behaviour also presume that fund managers will keep on assessing various alternatives until the optimal opportunity is found (Galllimore et al, 2000). The opposite behaviour is called satisficing, where the fund manager selects the first opportunity which meets the minimum investment criteria and stops looking for better alternatives.

Investing in ‘comfort zone’ assets

In a study conducted on London-based property investors, Adair, et al (1994) found that the diversification of investors’ portfolios were skewed in favour of a) traditional investment niches and b) markets for which they had good quality information and which were known to them.

6.5.3 Conclusion to portfolio risk management

To summarise this section, the following points summarise a comparison of the research results with the literature:

1. The size of the SA market is relatively small, hence portfolio specialisation is not the norm. This was substantiated by the Hotel fund manager. Most of the funds are diversified, although, when one looks at

their strategies, such as Company D's, which is focused primarily on owning dominant shopping malls in towns where there are rich mineral resources, this strategy does have its own specialisation characteristics.

2. With the market being so small and stock being so limited, the notion of 'satisficing' becomes less relevant. Virtually all the funds mentioned that there is no tradable stock available.

3. Taking advantage of phases in the property cycle seems beyond the SA funds ability. Firstly, no-one mentioned it in the discussions, and secondly, there were comments about not being 'sufficiently financially nimble' in order to take advantage of opportunities, because of liquidity issues, due to the distribution of profits, and the cost of debt.

4. There appears to be a massive demand for dominant retail centres, particularly those in upper-income areas. Those funds and financial institutions who own such assets, seem to be enjoying normal good returns in spite of the economic down-cycle.

6.6 Conclusion to the discussion on the research findings

The four research questions elicited a wealth of interesting information from eight experienced property industry professionals. The overall assessment of the depth of knowledge gained by the researcher from the interviews held compared with the literature review can be regarded as follows:

Table 6.6 Research Evaluation

Research question	**Comments**
Property investment criteria	A much broader understanding of the criteria was gleaned from the interviewing process than was gained from the literature review. Substantially supported by the literature.
Methods of valuation	The research revealed precisely what the literature had indicated.
Macro-economic influences	A much broader scope of factors was revealed by the research. Using case studies was valuable to create context.
Risk / portfolio management strategies	The SA property industry is unique and the interviews revealed this. Some really innovative strategies were shared by the fund managers and decision makers.

A comprehensive conclusion will be presented in Chapter 7.

CHAPTER 7 CONCLUSION AND RECOMMENDATIONS

7.1 Review of the research project

As a backdrop to the conclusion, a brief review of the main objectives and scope of the research is appropriate.

The stated objective of the research was to look at methodologies used by property fund managers to evaluate investment decisions.

The unit of analysis was a direct property investment by a listed property fund.
A sample of eight decision makers or fund managers were selected by means of snowball sampling from a population of 32 Property Unit Trusts or Property Loan Stock companies.

A recent investment by each fund was used as a case study in the interviews to create context and relevance.

The recordings and notes were transcribed, analysed and the key findings compared to the literature review.

This chapter gives a final conclusion to the research project, makes recommendations on property investment and suggests areas for further study on related issues.

7.2 Summary of key points and decision-model

The following table provides a summarised and condensed overview of the key points gleaned from the literature and the data analysis on the four research questions. This framework represents a good decision-model for the evaluation of property investments by fund managers and investors.

Table 7.1 Decision-model for the evaluation of property investments.

Co.	**Summary of key considerations from the research project**
Criteria for property investment	Physical property quality and rights investigated. Location analysis – in a growth node? Tenants – creditworthy and must be in close relationship with property manager (retail). Demographics – how good is the residual share of market? What is the identity and function of the centre? Is it in line with tenant mix (retail)? Investment must fit with portfolio strategy.
Valuation methods used	External valuers used for accuracy and market credibility. Gut-feel and physical inspection very important. DCF method the most appropriate. Good lease terms – must be market-related.
Macro-economic factors	High interest rates impact on gearing and ability acquire finance. Regulation regarding distribution of profits limits liquidity & agility (to capitalize on investment opportunities.) Shortage of tradable stock. (small market & tight holdings by financial institutions) The Property Cycle lags the economic cycle by about 1 year. (Building inflation, power supply constraints and a shortage of zoned land will dampen an over-supply of space in current cycle.) Global financial crisis not a big factor, but will impact risk appetite. Consequence of political turmoil may manifest in lower sentiment. Property fundamentals like low vacancies still strong. A-grade property in good locations appear to maintain performance throughout economic down-turns. Properties with good lease escalations are a great inflation-hedge.
Risk & Portfolio management strategies	Crucial to understand the asset you're investing in. (Experienced property professionals should be the decision makers.) Look for growth nodes. Assess the underlying reasons for the growth. Funds are not generally investing in offshore property. Dominant regional malls are in huge demand – good returns. (Important to assess the function and realistic identity of a retail centre and its optimal tenant mix.) Industrial property showing the best returns at the moment. (Cost bases are lower since properties are generally older.) Understand market segmentation in retail. (Upper-income large retailers appear to be most resilient against economic down-turns.)

7.3 Recommendations for further research

A number of questions arose around areas closely related to the subject of the research, but not within the scope of this project. The topics would be worthy of further research, particularly since no literature on these subjects was noted.

7.3.1 What is the relationship between bond yields and listed funds' market capitalisation? Mention was made by the interviewees of a relationship. What are the tenets behind such a relationship?

7.3.2 Do clients still exert undue influence over property valuers? What are the typical power bases common to this relationship?

7.3.3 How do UK and USA property funds take advantage of the property cycle to capitalise on good investment opportunities? Is there something there that SA property funds can learn from?

7.3.4 A similar research project to this one aimed at the unlisted property sector to understand their evaluation of investment decisions would be an interesting comparison.

7.3.5 To what extent are the stock market and the property market integrated? What correlation is there between movements in the ALSI and the property index?

7.3.6 What are the characteristics of this property cycle in comparison with previous cycles? Are the supply-side constraints we currently experience limiting the intensity of the cycle change?

7.4 Concluding remarks

7.4.1 The influence of the original reference source in the snowball sampling process.

What became evident to the researcher during the course of the project, was that the interviewees largely represented the successful funds in the industry. The views and sentiment of these decision makers were surprisingly positive, particularly in the light of the 30% loss of market cap value within the last 12 months.

Whereas the origin of the snowball sampling process was a high-profile figure in the property industry, this translated into referrals to people of similar standing. If the original source was a less successful figure and the other individuals of similar position, would the results of the qualitative research have reflected differently?

7.4.2 Growth and development of a relatively young industry

One of the interviewees appears on the board of four of the listed property funds. At 38, she has 17 years of property experience and is regarded as a 'seasoned professional in the listed property industry.' Her comments to me were that few people currently in the industry had the opportunity of working in the property division of one of the large insurance companies in SA.

The research process has brought a new perspective to the researcher and this includes the potential that exists within the industry for possible expansion of listed property funds into specialist areas in SA such as wine farms and private game farms.

7.4.3 Seeing the dynamics of the property cycle lag in action

Pyhrr *et al* (1999) mention the psychology of affluence which can infuse those who have been in an extended period of economic prosperity: “They rationalise that what has happened, will continue to happen. This mass psychology of optimism, once set off, takes on a life of its own and continues until people become excessively optimistic.”

The researcher’s personal response after many of the interviews was one of amazement and almost disbelief at the extreme positive sentiment evident in the meeting, while the news media is full of warning signals about an economic recession. The disconnect between the two realities gives an impression that a major adjustment in the listed property industry will happen. It is just a matter of time.

This possibly explains why there is often a lag between an economic and a property cycle change.

7.4.4 The privilege of spending time interviewing leaders of eight top listed companies

Finally, what a privilege it was to be able to spend time with the decision makers and leaders of eight top listed companies, hearing them share about their business strategies!

APPENDIX A: REFERENCE LIST

Adair, A. & Hutchinson, N. (2003) The reporting of risk in real estate appraisal property risk scoring. *Journal of Property Investment & Finance*. Vol. 23 No. 3, 2005 pp. 254 – 268

Adair, A., Berry, J & McGreal, W. (1994) Investment Decision Making: A Behavioural Perspective. *Journal of Property Finance*, 9(4) 32 – 42

Ali, H. Is there any opportunity for real estate portfolio? *Malaysian Journal of Real Estate*. 2006. Vol.1, Issue 1, pg. 14 - 26

Ali, H., Lin, L., Sipan, I. & Kamaruddin, N. (2003) An analysis of Portfolio Allocation for Listed Property Trusts: The Malasian Experience. *International Convention on Urban Development and Management*. 7 – 9th July 2003. Langkawi, Malasia.

Berry, S. (1999) Collecting data by in-depth interviewing (Internet) Hong Kong. Available at http://www.leeds.ac.uk/educol/documents/000001172.htm

Botha, E. *The REIT Stuff*. The Property Magazine, Gauteng, January 2008 Edition. Johannesburg: Media Nova.

Buetow, G. & Johnson, R. (2001) The real estate asset allocation decision: monetary policy implications. *Journal of real estate portfolio management*. Vol. 7 No.3, p. 215

Byrne, P., & Lee, S. (2000) The impact of market risk on portfolio risk reduction. *Journal of Property Investment & Finance*. Bradford: Vol. 18, Iss. 6, pg. 613

Chaplin, R. (2000) Predicting real estate rents: walking backwards into the future. *Journal of Property Investment and Finance*. Bradford: 2000. Vol. 18, Iss. 3: pg. 352

Clarke, A. & Daniel, T. (2006) Forecasting South African house prices. *Investment Analysts Journal*. No. 64, 2006

Clayton, C. (2004) Earn Income from Property without the hassle. (Internet) Available from http://www.persfin.co.za/index.php?SecttionId=733&fArticleID=2288745

Accessed 24/5/2008

Clayton, J. (2001) Market Fundamentals, Risk and the Canadian Property Cycle: Implications for Property Valuation and Investment Decisions. *The Journal of Real Estate Research,* 12 (3) 347 – 367

Doppegieter, J. & Rode, E. (2002) Capitalisation rates and property yields: An analysis of the South African commercial property market (Internet) Bruschal, Germany: Department of Finance, School of Business Administration, International University. Available from http://www.i-u.de/nav-main/faculty-research/school-of-business-administration/working-paper-series.html (Accessed 28/5/2008)

French, N. (2006) Value and worth: scenario analysis. *Journal of Property Investment & Finance.* Vol. 24 No. 2, 2006 pp. 176-179

Gallimore, P and Gray, A. (2001) The role of investor sentiment in property investment decisions. *Journal of Property Research*, 19(2) 111 – 120

Geltner, D., Miller, N., Clayton, J. & Eichholtz. P. (2207) *Commercial Real Estate Analysis and Investments.* Mason, Ohio: Thomson South-Western.

Guion, L. (2006) Conducting an In-depth Interview (Internet) University of Florida. Available from http://edis.ifas.ufl.edu/FY393

Growthpoint Property Fund Annual Report (2008) Johannesburg Stock Exchange, Sandton.

Hargitay, S. & Yu, S-M. (1993) Property Investment Decision-making: A quantitive approach. E&FN Spon Publishing, London

Hoskins, N., Higgins, D. & Cardew, R. (2004) Macroeconomic variables and real estate returns: an international comparison. *The Appraisal Journal*; Spring 2004; Vol. 72 No. 2, p. 163

Hospitality Property Fund Annual Report (2008) Johannesburg Stock Exchange, Sandton.

Kishore, R. (1996) Discounted cash flow analysis in property investment valuations. *Journal of Property Valuation & Investment*. Vol. 14 No. 3, 1996, pp 63-70.

Levy, D. & Schuck, E. (2005) The influence of clients on valuations: the clients' perspective. *Journal of Property Investment & Finance*. Vol. 23 No. 2, 2005 pp. 182-201

McCracken,G. (1988) *The long interview*. Newbury Park, CA: Sage.

MacCowan, R. & Orr, A. (2008) A behavioural study of the decision processes underpinning disposals by property fund managers. *Journal of Poperty Investment and Finance*. Vol 26, No. 4, 2008 pg 342 – 361

Medico, D. (2005) Introduction to qualitative analysis of in-depth interviews (Internet) Geneva. Available from http://www.gfmer.ch/PGC_RH_2005/pdf/Qualitative-analysis.pdf

Mitchell, P. & McNamara, P. (1997) Issues in the development and application of property market forecasting: the investor's perspective. *Journal of Property Finance*. Vol. 8 No. 4, 1997, pp. 363 – 376

Moneyweb (2008) Interview with Francois Viruly, property economist (Internet) Johannesburg. Available from http://www.momeyweb.co.za/mw/view/mw/en/page38/oid=207352&sn=Detail

Nathakumaran, N. (1994) Models of retail rents. Royal Institute of Chartered Surveyors Cutting Edge Conference, University of Aberdeen, Aberdeen

Newel, G and Fife, A. (1996) Major property investor attitudes to property securitization. *Journal of Property Finance*, Volume 6 (2), 8 – 19

Reit structure considered for South Africa (2007) South African Loan Stock Association (Internet) Available from http://www.propertyloanstock.co.za/reits (Accessed 23/5/2008)

Roulac, S. (1996) Strategic implications of information technology for the real estate sector. *Journal of Property Finance*. Vol. 7 No. 2, pp. 28 – 44.

Sivitanides, P. & Sivitanides, R. (1996) Office Capitalisation Rates: Why do they vary across metropolitan markets? *Real Estate Issues*. 1996, Vol. 21 No. 2, p. 34

SAPOA Annual Conference. 2008. Cape Town. (2008) The State of the South African Property Industry. Viruly, F. Johannesburg: University of the Witwatersrand.

South African Real Estate still tops, according to IPD. (2008) South African Loan Stock Association (Internet) Current News. Available from http:www.propertyloanstock.co.za/index.php?option=com_content&task=blockcategory (Accessed on 23/5/2008)

Sycom Property Fund Annual Report (2008) Johannesburg Stock Exchange, Sandton.

Tsolacos, S. (2006) An assessment of property performance forecasts: consensus versus econometric. *Journal of Property Investment & Finance*. Vol. 24 No. 5, 2006

Ward, M. & Price, A. (2006) Turning vision into value. Paarl: Paarl Press

Wilson, N. (2008) Listed property index takes a slide. *Business Day* (10/3/2008)

Wilson, N. (2008) Listed property 'doing well' (Internet) I-net Bridge. Available from http://www.eprop.co.za/newsarticle.aspz?idArticle=10068 (Accessed on 6/2/2008)

Wilson, N. Market volatility dampens listed property (Internet) I-net Bridge. Available from http://www.eprop.co.za/newsarticle.aspx?idArticle=8822 (Accessed on 6/2/2008)

Zikmond, W. (2003) *Business Research Methods*. Thomson: Mason

UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA

APPENDIX B: RESEARCH QUESTIONNAIRE

Qualitative questionnaire for property fund managers to evaluate investment decisions

1. Please provide a brief overview of your responsibilities regarding property investments on behalf of the fund.

2. In the last portfolio buy or sell decision you made, taking Property X as an example, what were the most important decision criteria relating to the property itself?

3. What approach/approaches did you employ to come to a value for the property?

4. What were the macro economic factors most relevant to this decision?

5. How does your company view the medium-term profitability of this sector (and the other property sectors) in the light of the economic and political climate in South Africa?

6. What is the risk management approach applied in the composition of your fund?

7. How do you collect/assimilate information on properties and how is this used in your organisation?

8. What role does personal sentiment play in your decision making?