

Covid-19 and the commercial rental market in SA

By [Richard Walker](#)

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Like many industries, real estate and construction has been hard hit by the effects of Covid-19 and the national lockdown after a year of a solid growth of 9% in 2019. Distributable earnings from the sector continue to diminish, with many REITs withholding their dividends as they focus on preserving liquidity. Many tenants will have had their sales impacted by the economic and trading restrictions of lockdown, leading to requests for relief in the form of payment holidays, rental reductions and deferrals.



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Payment arrangements

Organisations like the newly formed Property Industry Group, an alliance of retail property landlords, have tried to guide the sector on how payment relief should be applied to SMMEs, but this guidance has not always been taken. And when both tenant and landlord become bullish about who should pay what and when, relief and goodwill become difficult even as legal experts urge parties to demonstrate *ubuntu* as a recognised principle of doing business.

Landlord cashflows will need to be remodelled in light of weaker expected rental collections. Property portfolios with a good mix of government and municipal tenants may fare better with collections, but the state's coffers are not endless - there may be future payment delays. Luthuli House, for instance, already announced [late salary payments](#) for June as a result of the national crisis.

Valuations become difficult in this environment. Does rental on a per square metre basis still make sense at a time when tenant turnover is so unstable? Rentals are only material if they're actually being paid, and in a recessionary environment ([GDP has already fallen by 2%](#) in the first quarter of 2020)

landlords may prefer a tenant who negotiates terms rather than vacates a space altogether.



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Impact on vacancies

The South African Property Owners Association's (SAPOA) latest [Office Vacancy Report](#) shows that the national vacancy rate is 11.6%, which is 60bps higher on the previous quarter. A small increase, to be sure, but SAPOA says these figures are purely a result of South Africa's fragile economic environment rather than the impact of Covid-19, which will take several quarters to filter through into the office sector's vacancy rate.

But rental growth already shows signs of significant decline (0.7% compared to 2.5% in December 2019) and we know anecdotally that consumers and businesses are facing intense pressure to meet their debt commitments in a deteriorating national economy and a zero-growth environment. Businesses are in distress (especially in sectors like hospitality), and job creation and retention remain uncertain. Additionally, many companies are reconsidering the role of the office in their operating structure: the rise of flexible workspaces and a decentralised workforce will only dampen the commercial rental

market further.



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Effects on dividend distributions

All of this naturally affects dividend distributions. We expect a number of JSE-listed REITS will want to distribute less than their 75% mandatory minimums as they prioritise liquidity and try to consolidate weaker balance sheets. The JSE needs to be approached directly for a relaxation here, and this may require a legislative change. Alternatively, REITS may try to raise provisions in their balance sheet before dividends are declared. From a corporate governance perspective, boards must discharge their duty to ensure that the businesses under their care remain a going concern, even as lower distributions affect shareholder confidence and impact income-sensitive consumers like pensioners who have historically relied on REITS for their dependable performance.



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Looking to the future

We expect very little commercial development uptake in the near term for rental and construction SMMEs. Any opportunities that arise will be for the large corporates to consider. For now, the most urgent risk for the sector is the effect of decreasing property values on loan-to-value ratios. Although the repo rate reductions should unlock some liquidity for landlords, the relief will be diluted since it is common practice for REITS to hedge their credit risks through floating and fixed interest rate agreements.

We also expect a shift in the way rental agreements are structured, with tenants asking for shorter leases with more flexibility. This is not to say landlords have no bargaining power. There is still strong investment interest in certain segments of the market like healthcare and logistics assets. Consumers may be shopping online, but stock is physical and has to be stored in warehouses and facilities.

The overall risk landscape of property companies may not change within the near future, but certain risks would have accelerated the run rate, such as the degree of operational resilience to the current pandemic. The challenge is to anticipate future risks and determine a consistent and effective management approach. For example, a shift toward shorter

leases with more flexibility may mean a greater emphasis on Know Your Customer (KYC), which will in turn change operating models, business processes and supply chain reliance. The most important thing is to be adaptable to the changing needs of the consumer and corporate markets.

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