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Balwin Properties

Reintroducing a rental offering

- Balwin announced a change in strategy that allows for the large scale development of rental units alongside its existing build-to-sell strategy. This is not the first time this has occurred; it launched its Green developments in FY19 to focus on rental units but by FY20 this had been amended with the rental model terminated in favour of its traditional sales approach given the popularity of the more affordable units. It consequently holds a small (circa 215 units) rental portfolio which has necessitated an infrastructure to manage this portfolio and hence one that can be scaled up. In addition, back then Balwin Rentals was only 25% owned, now its wholly owned.
- Rentals will be offered in designated developments, exclusively for rentals. These will largely appear alongside its traditional developments as existing land parcels are utilised. This will reduce the duration of its projects which has been rising given the scale of the developments, a positive for working capital The quality of finishes will be dialed down, blocks of 40 units (as with its Green Collection) will be developed to achieve economies of scale and there will be no lifestyle centres that are costly to build and maintain. This is to enhance the yields which management expects to be 12-15%, well above market.
- The strategy is largely aimed to reduce the cyclicality of its revenue streams. Rentals are anticipated to be more defensive in a high interest rate environment allowing it to continue developing. Due to a large drop in sales, it has currently reduced its construction rate significantly. Its existing annuity businesses, while growing strongly, remain immaterial at an earnings level and are many years away from providing comfort in a downturn.
- Our concerns around the strategy relate primarily to the balance sheet. The land already exists (it will be transferred to Balwin Rentals at cost or fair value) but the development costs will be carried in Balwin Rentals, and this will largely be financed. Our investment case is premised on declining working capital and debt, this moves it in the opposite direction. However, the intention is that debt will be ringfenced in Balwin Rentals with no recourse to Balwin Properties. With debt at or slightly below the prime rate, and Balwin Rental operational costs, the average yield of 13.5% currently leaves little margin in our view, especially if vacancies are 10% or greater. However, as interest rates fall and rentals escalate the profitability will rise, combined with lower vacancies as affordability improves. Vacancies will be managed by developing on a phased approach.
- What the strategy offers, is the ability to sell the completed development to a REIT or other institutional investor at a market price which would ensure a healthy investment gain whilst the holding cost is covered. It also allows continuity in construction – the current down cycle with stop and start of construction is not optimal from a cost perspective, impacting GP margins. With rental developments alongside build-to-sell developments, there will also be cost efficiencies in security, management and maintenance.
- We believe there is a big market for affordable rentals and the quality of product synonymous with the Balwin brand should see strong demand for the units. The challenge would be to find the right exit. The strategy has its benefits but is open to risk, not in execution but financially and possibly the cannibalisation of its existing buy to let investors that are key to its sales. Whilst a portfolio of 7300 is envisaged in 8-10 years, it will start slowly with a 154 unit development in JHB followed by 478 units also in JHB. JHB would be a good barometer of its success as this market is experiencing greater challenges at present. Should the strategy not work out we see it being amended/halted as was the case in FY20, limiting any downside risk.

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Price (25/07/2024):	R1.75
Market cap	R910mn
Shares in issue	519.4mn

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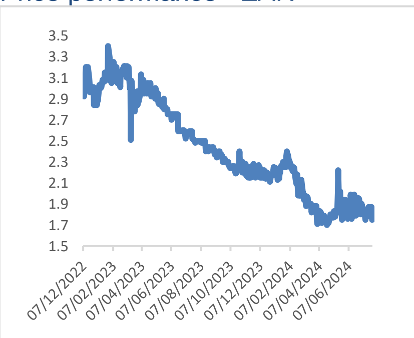
Price performance - ZAR



Source: FactSet

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