Future proofing the listed property sector

New Zealand listed property stocks look cheap. The sector has had a rough ride, underperforming the benchmark NZX50 index over 2016, 2017 and so far in 2018.

The net asset backing per share relative to the sector's market value is at its highest since 2011, which is a good sign. According to recent First NZ Capital Securities research, for each $1.00 you spend on the overall sector you get $1.03 of property exposure.

The dividend yield from listed property – the amount an investor receives in dividends each year as a proportion of the share price – has been around 7%. That's a significantly better return than leaving money in the bank.

Of course, listed property company dividend yields and bank deposit rates are not directly comparable. Property stocks have different risks to banks – returns could fall because of portfolio quality, vacancies, interest rate changes or management failure to execute on development opportunities.

Each risk can impact the sustainability of future earnings and dividends.

Investors are asking themselves whether potential upside outweighs these risks and whether the sector will start to outperform the wider NZX market.

For the first time all New Zealand listed companies are – under the NZX Corporate Governance Code - obliged to report on how they interact with the environment and society, as well as how they are governed. These are called ESG (Environmental, Social and Governance) factors.

For investors in listed companies, including listed property, ESG is a valuable new information source.

Environmental reporting includes energy efficiency, water efficiency, waste and emissions. Buildings that are energy efficient and provide healthier workplaces attract and retain better tenants, earn higher rentals and are ultimately easier to sell.

Social reporting covers a wide range of factors including health and safety, staff training and community engagement. A property company that designs its shopping centres with the wider community in mind attracts more customers and builds stronger branding, which in turn means a more successful and profitable development. Similarly, any company (not just listed a property company) that values and upskills its workforce will have more productive and committed employees.

Governance reporting shows the robustness of structures and processes for protecting shareholder interests. This includes board skills, independence, diversity and managing conflicts of interest. Again, the need for good governance is not limited to just listed property companies. Some of New Zealand's highest profile cases of shareholder value destruction, from finance companies to Fletcher Building, can be attributed to governance failures.

ESG analysis is not the silver bullet for investors. There are many risks that an ESG analysis does not capture, for example retail property faces a massive challenge from online retail. Physical retail assets that can't offer a unique consumer experience may get crushed by online retailers like Amazon. Strong governance is critical to navigating this disruption.

But ESG is a good indicator of long term company resilience. ESG factors are essentially non-financial risks that, when they go wrong, can turn into very large financial costs.

New Zealand's listed property companies have some work to do assessing and disclosing ESG risks. Sustainalytics, a leading independent global provider of ESG and corporate governance research and ratings, has reported on seven New Zealand listed property stocks. Half were labelled "average" and half as "laggards" when compared to global peers.

Common failures were around environmental policies, environmental management systems, green building investments, carbon disclosure and ESG reporting. Much of the failure may prove to be poor reporting in the past by the companies, rather than poor practices. With the NZX focus on ESG, we are about to see a big step up in transparency.

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