Chapter 1: State of the property market

State of the property market in quarter 1 of 2023

This issue's front page depicts South African house prices that in *real* terms are deflating. This is being caused by the sharp rise in the prime interest rate to 11,25% by end March 2023 from 7% in October 2021, as well as a moribund economy. This comes after the mini-boom during Covid when prices were lifted by the sharp interest rate drop at the time.

Many homebuyers have been caught off guard by the extent of the interest rate hikes, despite warnings by many that interest rates will eventually have to rise. Vigilant readers will remember the front page of *Rode's Report 2021:3* that read "Beware the coming interest rate hikes".

That said, a positive for the property market is that the top of the current upward cycle of interest rates is close, with interest rates likely to move lower towards the end 2023 or in 2024 − at least, that seems to be the consensus opinion among economists. A wild card is the impact of the surge in the oil price at the beginning of April and the eventual outcome of the Putin war.

Apart from higher interest rates, the huge electricity crisis is also top of mind of property companies and tenants. The cost to keep properties running during load shedding is enormous. As not all cost can be recovered from tenants, this will negatively impact the earnings and ultimately dividends declared by REITs. Of course, this also adds to the tenants' cost of occupancy, which eventually reduces their ability to absorb rental hikes.

The property sector also faces numerous other challenges, such as high vacancies, rising operating costs and a lack of municipal service delivery – not to mention the global, and especially the SA economy, that faces a period of low growth.

Encouragingly, the recent financial results for the period ended December generally did look better, especially for REITs exposed to retail and industrial property. The oversupplied office market remains a drag on the results of REITs and other funds that are heavily exposed to this sector.

A summary of the main findings by property type follows.

Quantitative overview of the property market

Table 1.1 on the next page provides a snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2023:1) with data collected a year earlier.

Office market

The office market remains challenging due to its significant oversupply. However, Rode data shows that vacancy rates have moved lower from higher levels, while nominal market-rental growth has also picked up from a low base. That said, REITs are still generally reporting large negative rental reversion rates as rentals have escalated by much more than market rentals.

The outlook for the office market is clouded by the poor economic outlook and the remote-working trend, with hybrid working models proving popular. The electricity crisis has worsened prospects for the economy and office demand.

Nationally, weighted gross market rentals for decentralized grade-A space rose by 3,2% in *nominal* terms in the first quarter of 2023 compared to the first quarter of 2022. This shows that rentals have bottomed out after falling by 5,2% in 2021 and by 1,2% in 2020. But to give perspective, the first-quarter national nominal rental rate was still 3% below 2019 levels (that is, before the Covid pandemic). In *real* terms, rentals are still in negative territory after deducting the BER's roughly 6% estimate of building-cost inflation. The positive is that the cooling of building-cost inflation will generally result in a smaller decline in *real* rentals than that seen in 2022.

Regionally, Cape Town has been the clear top performer over the past few quarters. In the first quarter of 2023, grade-A nominal rentals increased by 13% in Cape Town decentralized compared to the first quarter of 2022. Decentralized rentals rose by 2,3% in Johannesburg and by 1,7% in Pretoria. Durban took a turn for the worse, with decentralized rentals *down* 2,3%. For readers it is important to understand that these increases are year on year, meaning the first-quarter 2023 level is compared to the low level of the first quarter of 2022. In *real* terms, only Cape Town managed to record above-inflation rental growth compared to a year ago. The Mother City's rentals now also exceed the average 2019 level.

Industrial market

Rode's first-quarter 2023 survey results show that the industrial property market is still best placed of the three major non-residential property sectors thanks to its superior rental growth and low vacancy rates. However, there are signs that the market is starting to slow, such as a weaker cap rate and slower rental growth. This is not surprising given the state of the economy and resultant hits to the manufacturing and retail sectors.

Table 1.1 Rental performance as at quarter 2023:1 % change from four quarters earlier (on smoothed data)		
	Nominal	**Real***
A-grade decentralized office rentals		
Sandton CBD	1,1	-4,4
Rosebank	4,0	-1,7
Randburg Ferndale	-1,1	-6,4
Centurion	14,2	7,9
Hatfield	0,9	-4,6
La Lucia/Umhlanga Ridge	-2,1	-7,4
Berea	-4,9	-10,1
Tyger Valley	21,2	14,6
Century City	11,7	5,7
South Africa	**3,2**	**-2,4**
Prime industrial rentals (500 m² units)		
Central Witwatersrand	4,6	-1,1
East Rand	7,4	1,5
Durban	3,5	-2,1
Cape Town	4,9	-0,8
South Africa	**5,1**	**-0,6**
*Nominal values deflated by BER Building Cost Index		

Nominal gross market rentals for space of 500 m^2 in the first quarter of 2023 grew by 5,1% compared to the first quarter of 2022. This is slower than the 5,7% growth recorded in the fourth quarter of 2022. In *real* terms, rentals are still declining, but only slightly as building-cost inflation (BER BCI) was estimated to have cooled to about 6%.

The industrial market has been boosted by continued low vacancies. It is puzzling that vacancy rates have not worsened given the poor economic environment – perhaps landlords have kept vacancy rates low at the expense of rental levels as reversion rates on new leases have been negative for most REITs. Vacancy rates are low, especially for warehouses linked to logistics, thanks to strong online sales.

Regionally, the East Rand surprised on the upside, with rental growth of 7,4% compared to the first quarter of 2022. The East Rand struggled during the pandemic with nominal rental growth of only 1% in 2020 and 2021, which implies that it is playing catch-up. Nominal rental growth in Cape Town and the Central Witwatersrand was also relatively strong at about 5%, while growth was slightly slower at 3,5% in Durban.

Residential market

The housing market continues to slow down due to lower effective demand for property as a result of the weakening economy, the higher cost of living and rising interest rates. Nominal prices grew by 2,5% in the first two months of 2023 compared to the same period in 2022, based on FNB data. This indicates a slowdown after growth of 4,2% in 2022 and 3,5% in 2021. Thus, in *real* terms, house prices are still declining sharply, after deducting the consumer inflation (CPI) rate of close to 7%.

In this issue, we explain that the interest rate hikes have started to affect prices and activity levels more materially and the impact is not over yet.

Turning to flats, vacancy rates on a national level averaged 6,8% in the first quarter of 2023, unchanged from the fourth quarter of 2022, according to Rode's residential survey data. This is better than the 8,3% average of 2022. However, vacancy rates are still slightly above the 5,3% average recorded in the three years from 2017 to 2019 that preceded the pandemic.

On a regional level, the Western Cape continues to stand out with its low flat vacancy rate of 2%, down further from 3,2% in the fourth quarter of 2022 and well below the national average. In contrast, Gauteng (flats in Johannesburg and Pretoria) saw its vacancy rate worsen to 10,1% from 8,2%. KwaZulu-Natal's vacancy rate also worsened to 14% from 10,8%. All in all, house prices and rentals are still declining in *real* terms in most parts of the country. ■