Property poised for super performance

by Erwin Rode
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Since timing is so crucial for property investments, it is worth dwelling on the property cycle, and where we are in this cycle.

Actually there are two cycles which influence property values, namely the better known business cycle and the property cycle.

We shall first deal with non-residential property's behaviour over these cycles.

At the end of 1999 we were near the bottom of the business cycle, so let's consider the influence of the business cycle first.

During the upswing phase of this cycle demand for property space – also known as take-up – accelerates. Chances are that new supply cannot keep up with demand in the short run, resulting in rising real rentals (inflation-adjusted rents). At the tail-end of the upswing phase of the business cycle, the economy starts overheating and interest rates rise. Rising interest rates are supposed to send a message to developers to rein in the creation of new space. However, in the past the major developers in South Africa were mostly institutions, which are interest-rate insensitive. This invariably resulted in a huge oversupply developing during the downswing phase of the business cycle, when take-up simultaneously slowed down to a trickle. This would depress real rentals.

The degree of this business-cycle depression would depend on where we are in the long property cycle.

[Editor: insert the property cycle chart in here somewhere]

As the chart shows, the property cycle is a very long wave, with an average trough-to-trough duration of about 17 years in the post-World War II period. This was caused by mainly two factors:

- Institutional developers who are insensitive to movements in interest rates.
- The long gestation period of most non-residential developments, especially those erected in the CBDs, which makes the matching of demand and supply exceedingly difficult.

From the chart, we notice that real (decentralised) Johannesburg prime office rentals bottomed in the mid-1990s, which means that we are now, at the end of the 1990s, still in the upswing phase of the long property cycle. However, real rental growth is presently moderately neutralised because we are in the trough of the business cycle. So the year 2000, and the years thereafter, should see a handsome acceleration in real rentals.

We do not expect the amplitude of the swings to be as wide as in the past because:

- Interest-rate sensitive private investors will take over from the institutions as the dominant developers; and
- Decentralised developments have a much shorter gestation period than CBD office buildings, thus making the matching of demand and supply much easier.

This is another way of saying the non-residential property returns might be less volatile (less risky) in future. Nevertheless we expect ungeared prime non-CBD properties to yield pre-tax total returns of more than 20% per annum over the next few years. This must be compared with a forecast inflation rate of between 5% and 8%. A total return, by the way, is the combination of the income yield and the capital appreciation.

One implication of this long cycle is that non-residential property can be bought cheaply only twice in a working life. And now is still the time…

The residential-property cycle will be visited next time. We shall pose the question: Is this cycle dead? And if so, who is the assassin? ■