Sign that long lease now!

by Erwin Rode
9 March 2001

After more than a decade of austere monetary policy, South African property players are at long last lowering their profit and growth expectations.

The latest *Rode's Report on the SA Property Market* notes that the hurdle rate for prime property has now dropped to 19% after having been stuck at 20% for more than a decade. The hurdle rate is the minimum *total* return that investors demand to induce them to invest in a property project. *Total* return comprises the income yield (capitalisation rate) plus capital appreciation.

The hurdle rate is used as a discount rate to value properties with long leases. It is also used as a benchmark for the minimum *total* return required from new developments. The implication of the lower discount rate is that some property values will rise, depending on the exact valuation method used. Furthermore, the lower return expectations will eventually make more developments financially viable (they will clear the financial "hurdle" easier, so to speak).

Capitalisation rates (the income yield) of prime properties have been rising since about 1996 when the institutions started trimming their property portfolios, and for well-located properties they now stand at between 12% and 14%. The best properties and the best locations command a capitalisation rate at the lower end of this range. The capitalisation rate is the property equivalent of the earnings yield of shares. This means that rising capitalisation rates depress property values, holding constant income.

Given a hurdle rate of 19%, the implication is that the market expects cash flow to grow at between 7% and 5% per annum in perpetuity (for example, 19% hurdle rate less 12% income yield = 7% expected capital appreciation or cash flow growth). The 7% to 5% growth rates must be compared with the current core inflation rate of about 8%, which is expected to be as low as 5% by next year.