# State of the property market in quarter 2 of 2003

On average, the majority of our non-residential property indicators for quarter 2003:2 still pointed to a market under siege. As for residential property, house prices were still firmly nestled in their upswing, whilst *real* flat rentals were consolidating.

Here is a short synopsis of the major trends in the property market:

- Capitalization rates weaken (increase) further.
- The leaseback escalation rate dips at last, whilst hurdle rates remain sticky.
- Listed property continues to grow in prominence.
- *Real* office rents are still reeling from an oversupply of space.
- Office demand in the decentralized office areas is picking up, with especially Pretoria decentralized putting in a robust performance.
- Conditions in the industrial property market remain strained.
- Oversupply of rental accommodation is still tugging on *real* flat rentals.
- Despite their frothy growth, house prices remain way below replacement (building) costs.
- Residential building-construction faces a slowdown.

## Quantitative overview of the property market

The following table gives a statistical snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2003:2) with that collected a year earlier.

| The property market at a glance at quarter 2003:2* % growth over four quarters earlier (on smoothed data) | | |
|---|---|---|
| | Nominal | Real** |
| Prime CBD office rentals | | |
| Johannesburg | -22,6 | -31,4 |
| Pretoria | -2,0 | -13,4 |
| Durban | 12,4 | -0,7 |
| Cape Town | 6,0 | -6,3 |
| Prime decentralized office rentals | | |
| Sandton CBD | -4,7 | -15,8 |
| Parktown | -8,4 | -19,1 |
| Brooklyn/Waterkloof (Pta) | 15,1 | 1,8 |
| Hatfield | 10,2 | -2,6 |
| Berea (Durban) | 10,5 | -2,2 |
| La Lucia Ridge | 11,0 | -1,8 |
| Claremont (CT) | -15,2 | -25,0 |
| Tyger Valley | -2,4 | -13,7 |

* Unless otherwise specified
** Nominal values deflated by BER Building Cost Index. However, house prices are deflated using Absa's home-building-cost index.

| The property market at a glance at quarter 2003:2* (continued)<br>% growth over four quarters earlier (on smoothed data) | | |
|---|---|---|
| | Nominal | Real** |
| Prime industrial rentals (500m² units) | | |
| Central Witwatersrand | 0,0 | -11,5 |
| East Rand | 6,0 | -6,4 |
| West Rand | 13,5 | 0,5 |
| Pretoria metro | 0,8 | -10,9 |
| Durban metro | -1,0 | -12,4 |
| Cape Peninsula | 2,4 | -9,5 |
| Port Elizabeth | 7,9 | -4,6 |
| House prices (all price classes) at quarter 2002:4 | | |
| Johannesburg metro | 15,3 | 1,2 |
| Pretoria metro | 19,6 | 5,1 |
| Durban metro | 14,6 | 0,5 |
| Cape Town metro | 13,4 | -0,1 |
| Port Elizabeth | 7,7 | -5,2 |
| Flat rentals (standard quality, 2-bedroom) | | |
| Johannesburg metro | 24,3 | 10,1 |
| Pretoria metro | 7,4 | -5,1 |
| Durban metro | 9,0 | -3,7 |
| Cape Town metro | 6,0 | -6,2 |
| Port Elizabeth | 10,9 | -1,9 |

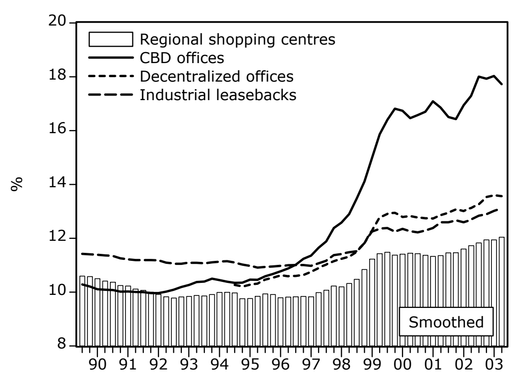
* Unless otherwise specified

** Nominal values deflated by BER Building Cost Index. However, house prices are deflated using Absa's home-building-cost index.

## Capitalization rates

Nationally, CBD office capitalization rates finally seem to be levelling off at the 18% level. However, it is highly unlikely that CBD office cap rates will improve (come down) substantially from these levels. This is so because, for most of the CBDs (barring Cape Town), there is little hope of a drastic turnaround from the decay. Rather, these CBDs will have to transform themselves into mixed-use nodes catering for the emerging petit bourgeoisie.

**National cap rates by property type**




*Source of data: Rode's Time Series*

For the other property types, there was still no deviation from the increasing (weakening) trend, which has been evident since 1996. This, of course, implies that investors' increasingly negative perception created by the current oversupply in non-residential space has not changed.

## Hurdle and escalation rates

Hurdle rates for prime properties saw little change from their ±19% level in quarter 2003:2, the level they have been at for many years. However, our own calculations — using the financial market's inferred forecast of inflation — indicate that the hurdle rate should in actual fact be closer to 17%.

At the same time, the leaseback escalation rate seems to be slowly moving back into its secular downward path, after having shown a slight uptick since quarter 2001:4. This uptick was, of course, the result of higher inflation, caused by the rand's strong devaluation at the end of 2001.

The mean escalation rate came in at 9,5% in quarter 2003:2, compared to the preceding quarter's 10,3%. Again, our own research shows that a leaseback escalation rate of ±7% would be more realistic, so there is still ample scope for further declines.

## Listed property

According to our updated analysis, listed property traded at a premium of about 9% to directly-held property at the end of quarter 2003:2. But, July and August 2003 saw the listed property sector come down slightly, implying that listed property has, since the end of quarter 2003:2, lost some of its trading premium relative to unlisted property.

Still, we do not expect that this will deter directly-held property portfolios from listing, because being part of the JSE increases these portfolios' liquidity dramatically. As it stands, some major institutions — Absa, Sanlam, RMB and Old Mutual — are reportedly considering listings over the next 12 months.

## Office rentals and demand

*Real* office rentals in the decentralized areas of Johannesburg and Cape Town were still firmly nestled in their downswing, whilst in Durban and Pretoria decentralized, it seems as if *real* rentals could be levelling off. Interesting, though, is that the rental gap between the cities' decentralized areas is closing, with especially the Pretoria suburbs catching up.

The relatively better performance of Pretoria decentralized *real* rentals can be explained by the strong office demand in the area, which, according to our calculations (based on Sapoa data), showed a take-up of 140.000m² in the twelve months to the end of June 2003.

Office demand generally seems to have taken a turn for the better, which, if it continues, can only spell good news for the office property market. We can say this because we view office demand, and not office vacancies, as the most crucial indicator when determining the inherent health of the office market.

Turning to the CBDs, *real* office rentals — barring Cape Town — remained locked in a declining secular trend, with the Johannesburg and Pretoria markets the hardest hit.

## Industrial market

The quarter under review saw no change from the depressed state the industrial property market has been in since at least 1990, with *real* rentals and stand values continuing on their secular downward path.

However, in *nominal* terms, Port Elizabeth seems to be the only industrial conurbation where an improvement has been noticed over the last year. Port Elizabeth's steady increase can in all likelihood be attributed to heightened activity in the motor-vehicle and related sectors.

## Flat rentals

*Real* flat rentals in the major metropolitan areas were still in a consolidation phase in quarter 2003:2, although some cities started showing signs of an upturn. As for Johannesburg, it seems as if *real* rentals may finally be slacking off, as we predicted in the previous *Rode's Report.* It just did not make sense for *real* flat rentals in the Johannesburg metro to steam ahead while all the other cities' *real* rentals were declining.

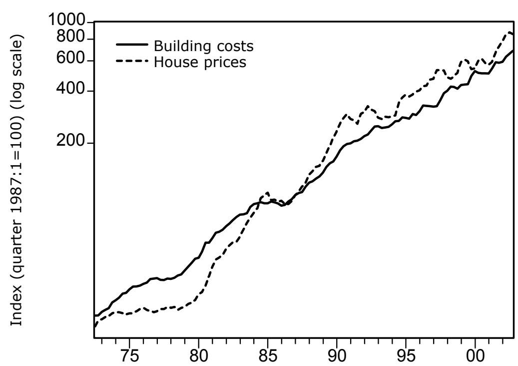
The most likely reason for the slowdown in *real* flat rentals is an oversupply of rental accommodation brought on by the increased townhouse-building activity to satisfy the growing investor interest in the buy-to-let market. This in turn has been caused by the bear markets on SA and foreign bourses. But note that this is only a slowdown — we are still seeing *real* growth in flat rentals.

## House market

On average, *real* house prices were still firmly in an upswing in quarter 2002:4, with the upmarket suburbs putting in the best performance.

Despite this, our calculations show that, on average, national *nominal* house prices were still well below replacement (building) costs in the last quarter of 2002. The only exception is Cape Town, where the *nominal* prices of upmarket suburbs have been above building costs since the late 1980s. A possible explanation for this is that supply is inelastic (supply does not respond readily to the growth in demand) because of the scarcity of available land for development, especially on the Atlantic Seaboard and in the Southern Suburbs. With this in mind, it seems highly unlikely that house prices will dip below the building-cost trend line.

**Nominal Cape Town house prices vs building costs**
**Upper-priced suburbs**
**(Indexed to quarter 1987:1=100)**




*Source of data: Rode's House Price Index; Absa Home BCI; BER BCI*

As for middle- and lower-priced suburbs in Cape Town, nominal house prices and replacement costs were on par.

## The building industry

The home-building construction sector faces a possible slowdown in its frenetic activity. Signs of a slowdown have already been noticed in Statistics SA's building-construction data as well as business-confidence levels of home builders, as surveyed by the Bureau for Economic Research.

This could be an indication that the lagged effect from the four percentage-point interest-rate hikes of 2002 was starting to filter through and/or that residential overbuilding was starting to make itself felt. Fortunately, interest rates are on a downward path again, which means that the adverse effects of last year's interest rate hikes should not be felt for too long. But that still leaves us with buy-to-let houses that are increasingly standing empty.

As for the non-residential building-construction sector, conditions remain strained, although a recovery was expected to come from steady, increasing public-sector infrastructure expenditure. Declining interest rates should also underpin this sector, although any significant benefits are only expected to start flowing through from 2004 onwards, as the broader economy starts accelerating and vacancies are mopped up.

This concludes our section on the state of the property market. ■