State of the property market in quarter 3 of 2003

Finally! Non-residential property appears to be over the worst. The best evidence of this can be found in the decline of capitalization rates in quarter 2003:3, which was noticed for all non-residential property types, except industrials.

In the residential property market, *nominal* house prices were still on the up, albeit at a slower rate then the feeding frenzy seen since 1999. As for the flat-rental market, the upswing continued.

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

- Capitalization rates decline on increased demand from listed property funds.
- Hurdle and leaseback escalation rates dip in response to lower inflation.
- Directly-held property gaining ground on listed property.
- *Real* decentralized office rents could be close to their nadir.
- Healthy office take-up noticed in the CBDs and the suburbs.
- Recovery in industrial property market may be just around the corner.
- *Real* flat rentals grow despite the flood of rental accommodation.
- The recent home-buying frenzy spills over into the lower-priced suburbs.
- Building-construction conditions improve.

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 2003:3) with that collected a year earlier.

The property market at a glance at quarter 2003:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	-24,9	-31,3
Pretoria	-4,6	-12,7
Durban	1,7	-6,9
Cape Town	4,4	-4,5

* 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 2003:3* (continued) % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime decentralized office rentals		
Sandton CBD	-10,3	-17,9
Randburg Ferndale	13,3	3,5
Brooklyn/Waterkloof (Pta)	17,7	7,6
Hatfield	11,6	2,1
Berea (Durban)	4,8	-4,1
La Lucia Ridge	10,4	1,0
Claremont (CT)	-24,8	-31,2
Tyger Valley	-7,5	-15,4
Prime industrial rentals (500m² units)		
Central Witwatersrand	-1,3	-9,8
East Rand	10,3	0,9
West Rand	3,8	-5,0
Pretoria metro	2,9	-5,9
Durban metro	-3,0	-11,4
Cape Peninsula	4,4	-4,5
Port Elizabeth	9,1	-0,2
House prices (all price classes) at quarter 2003:1		
Johannesburg metro	17,6	2,4
Pretoria metro	13,4	-1,0
Durban metro	17,5	2,4
Cape Town metro	5,2	-8,2
Port Elizabeth	2,4	-10,7
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	9,9	0,6
Pretoria metro	11,4	1,8
Durban metro	23,9	13,3
Cape Town metro	5,4	-3,7
Port Elizabeth	14,2	4,4

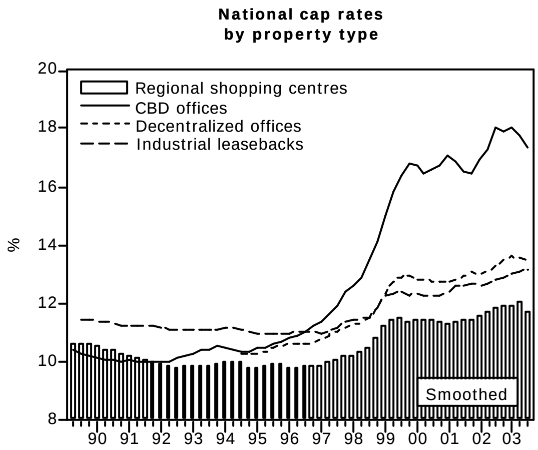
* Unless otherwise specified

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

Capitalization rates

Capitalization rates appear to be softening, fuelled by listed property funds' insatiable demand for non-residential directly-held property. This improving trend seems evident for all types of non-residential property, except industrials.

Word in the market is that because of listed property's premium trading position relative to directly-held property, listed property funds can afford to pay more for good-grade unlisted non-residential property and still realize a profit on listing. Even positive gearing is now possible on buying properties for a listed fund. Hence the decline in capitalization rates.



Source of data: Rode's Time Series

Hurdle and escalation rates

Hurdle rates are edging lower, an indication that the market may finally be realizing that the current high levels are unrealistic in a disinflation environment.

The industrial leaseback escalation rate declined further in quarter 2003:3, reaching 9,2% compared to the previous quarter's 9,5%. This brings the total decline since the first quarter of this year to 1,1% points. The downward trend in the leaseback escalation rate of course corresponds with the currently lower inflation rate as well as the improved long-term outlook for inflation.

Listed property

At the end of quarter 2003:3 the listed property sector held on to its premium trading position relative to directly-held property. But the value gap is narrowing, and this time round it is not because of a positive rerating of listed property — as has been the case since the beginning of last year — but rather because of the rerating of directly-held property. As already mentioned in the section on capitalization rates, the rerating can be attributed to growing demand for directly-held property by listed property funds.

Office rentals and demand

All the signs for an imminent upswing in *real* decentralized office rentals are there. Office take-up gained further momentum in quarter 2003:3, slowly mopping up the oversupply brought on by over-eager building following the high *real* rentals of the late 1990s. And capitalization rates, which reflect investors' income expectations, are coming down (strengthening).

The first fruits of this improvement were already evident in the decentralized office markets of Pretoria and Durban, with higher *real* rentals achieved in quarter 2003:3. However, in Johannesburg's north and in the suburbs of Cape Town, the pressure from the oversupply of space was still being reflected in *real* rentals.

Notwithstanding the positive office take-up noticed in the CBD office market, *real* rentals continued on their secular (long-lasting) downward trend.

Industrial market

Our analysis of industrial rentals for quarter 2003:3 shows an uptick in the *real* rentals for the Cape Peninsula and Port Elizabeth, whilst on the Central Witwatersrand the movement was sideways. Although it would be premature to call this the first signs of a turnaround, there are indications that the local industrial market is slowly starting to lift its head. Recent months have been characterised by a substantial lowering in interest rates, which should further boost consumer spending, which of course underpins the manufacturing, storage and distribution sectors. This is a key development, because demand for manufactured goods is an important proxy for the demand for industrial space.

Flat rentals

On average, *real* flat rentals in the major metropolitan areas continued their good run of recent quarters. The odd one out is the Johannesburg flat market, where *real* rentals are still backtracking. However, in the light of the *real* increases noted elsewhere, we expect Johannesburg *real* flat rentals to follow suit soon.

Still, the increase in *real* rentals does seem somewhat odd, especially since the market for rental accommodation has been flooded with new townhouses to satisfy investors' appetite in the buy-to–let market.

House market

In general, *nominal* house-price growth in the main cities of South Africa slowed further in quarter 2003:1. However, this slowdown must be seen against the backdrop of a very buoyant performance since 1999. A possible reason for the slowdown could be the lagged effect of the steep rise in the prime interest rate from 14% in February 2002 to 17% in September the same year. Nevertheless, on average the price of a house was still growing in excess of 10% p.a.

The exception, however, is the lower-priced suburbs, which have shown accelerated *nominal* annual growth for the year ended quarter 2003:1. With hindsight, it was only a question of time before prospective buyers caught on to the relatively better value of houses in the lower-priced suburbs. Furthermore, the accelerated performance could also have been fuelled by the growing investor interest in the buy-to-let market. This can be explained by the fact that investors can enter the market in lower-priced suburbs at a higher income yield than in the more pricey suburbs.

The building industry

All in all, conditions in the building-construction industry are upbeat. Although the growth spurt in residential building activity has slowed down somewhat over the last few months, activity in this sector is expected to remain strong, benefiting from the string of interest rate declines over the last few months. Despite this, it is highly unlikely that home-builders' profit margins will continue growing at their present sky-scraping rates.

As for non-residential building-construction, the future also seems more positive, with indications that the oversupply of space from overenthusiastic building is gradually being mopped up.

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