# State of the property market in quarter 1 of 2004

Conditions in the non-residential property market improved further in the first quarter of 2004, with the majority of property indicators showing that an upswing in *real* rentals must be close.

In the residential property market, house prices were still racing ahead, with a bubble clearly visible in the upper-priced suburbs. As far as flats are concerned, rentals were still feeling the pinch from an oversupply of rental accommodation.

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

- Capitalization rates in the CBDs decline sharply as interest in the city centres hots up.
- Hurdle rates are unchanged at 19% but we regard them as realistic when taking a 5-year view.
- The window period for listing property may be closing.
- The upswing in *real* office rentals may be close.
- Office take-up explodes.
- Industrial rentals show initial signs of a recovery in response to a growing demand for space and positive indicators for the industrial sector of the economy.
- Competition from townhouses hampers flat-rental growth.
- Upper-priced suburbs are becoming dangerously expensive.
- Builders' profit margins are still growing despite moderating building activity.

## Quantitative overview of the property market

Table 1.1 gives a statistical snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2004:1) with that collected a year earlier.

**Table 1.1**
**The property market at a glance at quarter 2004:1***
**% growth on four quarters earlier (on smoothed data)**

| | Nominal | Real** |
|---|---|---|
| Prime CBD office rentals | | |
| Johannesburg | 9,2 | 0,8 |
| Pretoria | 6,2 | -1,4 |
| Durban | -3,5 | -10,3 |
| Cape Town | -0,1 | -7,2 |

* Unless otherwise specified
** Nominal values deflated by BER Building Cost Index. However, house prices are deflated using the Hylett index.

| Table 1.1 (continued)<br>The property market at a glance at quarter 2004:1*<br>% growth on four quarters earlier (on smoothed data) | | |
|---|---|---|
| | Nominal | Real** |
| Prime decentralized office rentals | | |
| Sandton CBD | -12,3 | -18,6 |
| Randburg Ferndale | 0,5 | -6,4 |
| Brooklyn/Waterkloof (Pta) | 9,6 | 1,7 |
| Hatfield | 6,3 | -1,2 |
| Berea (Durban) | -1,9 | -8,9 |
| La Lucia Ridge | 9,5 | 1,7 |
| Claremont (CT) | -16,4 | -22,6 |
| Tyger Valley | -18,1 | -24,0 |
| Prime industrial rentals (500m² units) | | |
| Central Witwatersrand | 5,1 | -2,4 |
| East Rand | 13,5 | 5,5 |
| West Rand | 2,3 | -5,0 |
| Pretoria metro | -3,2 | -10,3 |
| Durban metro | 3,0 | -4,3 |
| Cape Peninsula | 9,3 | 1,5 |
| Port Elizabeth | 12,5 | 4,5 |
| House prices (all classes) at quarter 2003:3 | | |
| Johannesburg metro | 29,6 | 18,2 |
| Pretoria metro | 12,5 | 2,7 |
| Durban metro | 18,3 | 8,0 |
| Cape Town metro | 8,4 | -1,2 |
| Port Elizabeth | 11,3 | 1,5 |
| Flat rentals (standard quality, 2-bedroom) | | |
| Johannesburg metro | -6,8 | -13,4 |
| Pretoria metro | 5,4 | -2,1 |
| Durban metro | 32,7 | 23,5 |
| Cape Town metro | 6,7 | -0,9 |
| Port Elizabeth | 25,8 | 17,0 |

* Unless otherwise specified

** Nominal values deflated by BER Building Cost Index. However, house prices are deflated using the Hylett index.

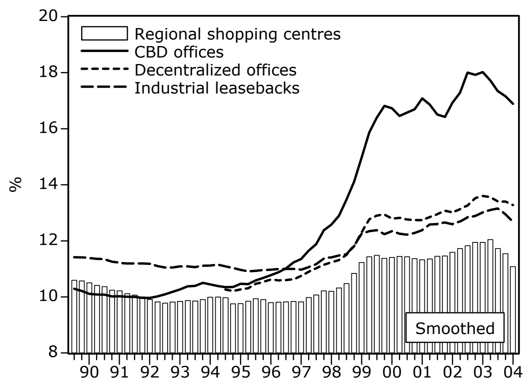
## Capitalization rates

The good turn of fortune for directly-held non-residential property continued in the first quarter of 2004, with capitalization rates maintaining their declining (strengthening) trend of the last few quarters. This means that directly-held property is being rerated in a big way.

Even the capitalization rates for CBD offices have been coming down sharply, implying that investors' general sentiment towards offices in the city centres is improving.

The improvement in capitalization rates can be attributed to a combination of reasons. For one, capitalization rates seem to dive in the wake of the insatiable demand for directly-held non-residential property from listed funds and syndicators. Capitalization rates also seem to be benefiting from investors' realization that inflation will most probably settle at a lower rate of 5%-6%. Lastly, capitalization rates may also be profiting from the promising increase in the demand for non-residential space.

**National capitalization rates by property type**




*Source of data: Rode's Time Series*

## Hurdle and escalation rates

Hurdle rates for prime, well-located properties were still lingering around 19%, a level they have been on since the end of 2000.

According to our own investigation, using the financial market's inferred forecast for inflation and taking a 5-year view, a hurdle rate of 19% seems realistic. However, our calculations show that over the longer term, say 20 years, a hurdle rate of about 15,5% seems to be more realistic.

## Listed property

In the first quarter of 2004, listed property was trading at a market-value discount of about 11% to directly-held non-residential property. This can in the main be attributed to the sharp decline in capitalization rates following the strong demand for directly-held property from listed property and syndicators who pounced on the value opportunities offered by these assets.

## Office rentals and demand

On average, *real* decentralized office rentals were unchanged in the first quarter of 2004, after being in a downswing since early 2001 due to vacancy pressures. The sideways movement noticed in the quarter under review may be the first sign that relief is on its way. This follows on the robust office take-up (480.000m² in the past year), resulting in declining vacancies over the last few quarters.

As for the CBDs, national *real* office rentals continued to build on the increase noticed in the last quarter of 2004. The most encouraging improvement in *real* CBD office rentals was noticed in the Johannesburg CBD, albeit off a low base. Upticks were also recorded in the Pretoria and Durban CBDs, whilst *real* rentals in the Cape Town CBD moved sideways. But this recovery in rentals should not come as a big surprise, as office take-up has been healthy over the last year.

## Industrial market

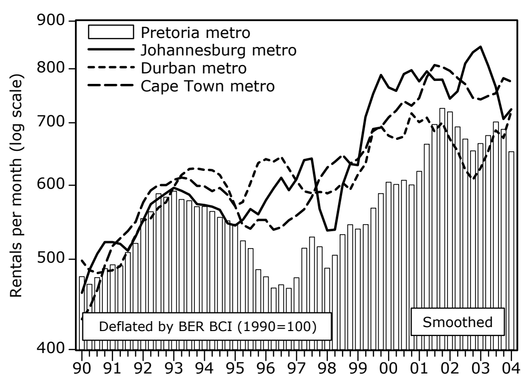
*Real* industrial rentals were still caught in their long-lasting slump, although initial signs of a recovery were noticed.

Furthermore, the BER's survey of manufacturing business-confidence and Investec's Purchasing Managers' Index show that conditions for manufacturing are improving considerably. This is an important development because the demand for locally manufactured goods is an important proxy for the demand for industrial space, which, in turn, should be positive for an upswing in *real* rentals.

## Flat rentals

It seems as if the oversupply of residential rental accommodation has left its mark on the Johannesburg and Pretoria flat markets, with average rentals, after adjusting for building-cost inflation, trending lower. However, in Durban and Cape Town, the overall trend in *real* flat rentals has been sideways.

**Real flat rentals by city**
**All sizes combined**
**1990 rands**




*Source of data: Rode's Time Series; BER*

## The house market

There seems to be no end to the exuberant growth in house prices, with upper-priced suburbs — on average — already surpassing the *real* levels last seen in the early 1980s. Worrying, however, is that *nominal* house prices of upper-priced suburbs in all the major cities are above replacement costs, which means that it is relatively more expensive to buy an existing house than to have a new one built. This is an indication that houses in the upper-priced bracket are in a bubble. However, as we saw in the mid-1980s, such a situation can last for many years.

As for the middle- and lower-priced suburbs, house prices are, on average, still below replacement costs, although the gap has closed considerably over the last few years. The exception, however, is Cape Town, with house prices in these suburbs already moving into a bubble situation.

## The building industry

Overall, conditions in the building-construction sector remained favourable in the first quarter of 2004. This was despite a softening in building activity in both the residential and non-residential sectors.

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