State of the property market in quarter 2 of 2004

Non-residential property's market values increased further in the second quarter of 2004, driven mainly by the continued rerating of property by investors.

On the residential side, market values also continued to climb in the last quarter of 2003, giving rise to further speculation about prices being in a bubble phase.

Next we give a short synopsis of the major trends in the property market:

- Capitalization rates continue to drop for all property types, but especially in the CBDs.
- Hurdle rates drop to levels of 17,5% (from 19%).
- The yield gap between directly-held property and listed property is eliminated.
- Real office rentals still moving down even though above-normal vacancies are being mopped up.
- Office take-up is looking healthy.
- Real industrial rentals are still growing on the back of a strengthening manufacturing sector.
- Durban and Port Elizabeth flat rentals have grown by more than 20% on a year earlier.
- House prices in upper-priced suburbs are entering bubble territory.
- Prognosis for building activity looks good.

Quantitative overview of the property market

Table 1.1 gives a snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2004:2) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2004:2*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	26,3%	18,5%
Pretoria	12,7%	5,7%
Durban	3,4%	-3,1%
Cape Town	2,4%	-4,0%

* Unless otherwise specified

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

Table 1.1 (continued) The property market at a glance at quarter 2004:2* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime decentralized office rentals		
Sandton CBD	-7,2%	-13,0%
Randburg Ferndale	-2,8%	-8,9%
Brooklyn/Waterkloof (Pta)	2,5%	-3,9%
Hatfield	0,1%	-6,1%
Berea (Durban)	-1,9%	-8,0%
La Lucia Ridge	8,7%	1,9%
Claremont (CT)	-3,9%	-9,9%
Tyger Valley	-13,4%	-18,8%
Prime industrial rentals (500m² units)		
Central Witwatersrand	9,3%	2,5%
East Rand	12,3%	5,3%
West Rand	10,1%	3,3%
Pretoria metro	-8,9%	-14,6%
Durban metro	14,5%	7,3%
Cape Peninsula	11,9%	5,0%
Port Elizabeth	16,1%	8,9%
House prices (all classes) at quarter 2003:4		
Johannesburg metro	29,7%	21,7%
Pretoria metro	16,5%	9,1%
Durban metro	24,0%	16,1%
Cape Town metro	22,1%	14,4%
Port Elizabeth	23,4%	15,6%
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	-1,9%	-8,0%
Pretoria metro	-4,5%	-10,3%
Durban metro	24,7%	17,0%
Cape Town metro	0,5%	-5,7%
Port Elizabeth	27,4%	19,5%

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

Capitalization rates

There is now little doubt that 2003 marked a major turning point in investors' perception of directly-held property as an asset class.

Given the good fortune of retailers, it is not surprising that shopping centre capitalization rates were first to fall. In fact, regional shopping centres are so highly rated that some investors are happy with yields close to those offered by government bonds.

Decentralized office capitalization rates also dropped further, showing that the recent oversupply in certain nodes is regarded by investors as cyclical and not long-term in nature. The big surprise on the office front came from CBDs, whose capitalization rates dropped sharply. Given the general decline in capitalization rates, caused by a downward adjustment in investors' long-term inflation expectations and an insatiable demand for property by listed funds and syndicators, we expected a small decline, but not to the extent that we have witnessed. In fact, Sapoa's most recent vacancy survey shows that there has not been an increase in the demand for office space in most CBDs. Hence we conclude that the hype surrounding office-to-residential conversions has created this substantial strengthening of capitalization rates in the CBDs.

Industrial property also continued to shine, supported by strong growth in real industrial rentals.

Hurdle and escalation rates

Hurdle rates for prime properties dropped by almost 2 percentage points to 17,5% in the second quarter of 2004. Given that the capitalization rates of prime-quality office buildings are, for example, currently at around 12%, the implication is that investors expect a capital growth rate of about 5,5% p.a. over the next five years.

Listed property

In the second quarter of 2004, the gap between listed property's income yields and capitalization rates continued to decrease, and has recently closed. This means that property investors now have less of an incentive to invest in listed property than in directly-held property.

Office rentals and demand

On the whole, real decentralized office rentals continued to edge downwards in the second quarter of 2004. We expect that rentals will remain under pressure in the short to medium term, as above-normal vacancy rates are being reduced. A growing economy has seen office take-up increase nicely over the last twelve months (470.551m²), which bodes well for rental growth sooner rather than later.

The CBDs displayed more of the same during the second quarter. Vacancies in Duban CBD and Johannesburg CBD are still around 20%, whereas Pretoria CBD has a low vacancy rate for no reason other than government's commitment to the city. Cape Town CBD is, as usual, the exception, showing a slight downtick in its vacancy rate. In spite of this, real rentals in Cape Town kept sliding in the second quarter of this year, whereas real rentals in Johannesburg, Pretoria and Durban continued to increase (albeit off a lower base).

Industrial market

Real industrial rentals continued to rise in the second quarter of 2004. This happened in the wake of a steady climb in manufacturing activity since the second quarter of last year.

Flat rentals

There has been a great divergence in the flat-rental growth rates of the various cities. At the one end, Johannesburg rentals have shown no growth over the past two years — albeit from a high base — whereas at the other end of the spectrum, Port Elizabeth and Durban have been growing at more than 20% per annum.

The house market

In the last quarter of 2003, house-price growth for all price classes continued to accelerate faster than building-input cost growth. Absa's house price indices suggest that this boom continued well through the first half of this year.

The upshot is that medium- and upper-priced suburbs are presently at real levels last seen in 1984. Lower-priced homes, however, have not had such good luck and are presently lower than their levels in the early 1990s, let alone the lofty levels of 1984. This suggests that lower-priced houses still have ample space for upward movement.

Upper-priced homes continue to worry, with house prices in most regions now exceeding building costs.

The building industry

Optimism about the building-construction industry continued in the second quarter of this year, with the BER's *Composite Business Confidence Index for the Building Industry* showing a further up-tick on that of the first quarter.

As office vacancies in the decentralized nodes decline and rentals eventually pick up, we should see an increase in office-building activity. Likewise, industrial building activity should increase, given the resurgence of rentals. Non-residential building input cost increases have been decelerating since the start of 2003 and continued to do so in the second quarter of this year. This downward trend in building-cost inflation comes on the back of a strong rand and moderate labour cost increases. Strengthening building activity has, however, allowed contractors to stretch their profit margins.

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