State of the property market in quarter 3 of 2004

All indications are that the focus will shift from residential to non-residential property over the next few years. Notwithstanding this, the residential property market is expected to lose steam only slowly. Hence, next year will probably be a good year for property all round.

The following are significant findings or conclusions made in this issue of *Rode's Report*:

- Capitalization rates or all property types are still plunging, providing owners with windfall capital returns.
- Escalation rates now probably accurately reflect expected medium-term market-rental growth.
- After catching a free ride on the back of falling bond yields, listed property will continue to perform, but this time round as a result of stronger earnings.
- Nominal market rentals are growing, but still not faster than (accelerating) building-cost inflation.
- Above-normal office vacancies are still being mopped up.
- Real industrial rentals are flying, which will increase the attractiveness of industrial developments.
- In the last two years, only Durban and Port Elizabeth's flat rentals have grown faster than building-costs. Johannesburg and Pretoria's flat rentals did not even manage to outpace headline consumer inflation.
- Most houses in South Africa (barring some lower-priced homes perhaps) have probably grown by as much as 30% to 40% in 2004. This party is expected to *slowly* play itself out over the next year or two.
- Building activity in residential and non-residential markets will boom in 2005, dragging building-cost inflation up with it.

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 2004:3) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2004:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	18,5%	5,9%
Pretoria	24,5%	10,8%
Durban	9,4%	-2,3%
Cape Town	7,9%	-3,6%
Prime decentralized office rentals		
Sandton CBD	-2,0%	-12,5%
Randburg Ferndale	2,7%	-8,5%
Brooklyn/Waterkloof (Pta)	-4,5%	-14,7%
Hatfield	-1,8%	-12,3%
Berea (Durban)	1,2%	-9,7%
La Lucia Ridge	6,5%	-4,9%
Claremont (CT)	4,6%	-6,6%
Tyger Valley	-0,1%	-11,0%
Prime industrial rentals (500m² units)		
Central Witwatersrand	16,7%	4,1%
East Rand	11,2%	-0,7%
West Rand	22,9%	9,6%
Pretoria metro	-12,4%	-21,7%
Durban metro	21,6%	8,7%
Cape Peninsula	10,7%	-1,0%
Port Elizabeth	12,8%	-0,8%
House prices (all classes) at quarter 2004:1		
Johannesburg metro	30,1%	25,3%
Pretoria metro	25,2%	20,6%
Durban metro	35,8%	30,8%
Cape Town metro	39,5%	34,3%
Port Elizabeth	38,2%	33,1%
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	8,3%	-3,4%
Pretoria metro	-9,2%	-18,9%
Durban metro	15,1%	2,9%
Cape Town metro	-0,5%	-11,2%
Port Elizabeth	19,7%	7,0%

* Unless otherwise specified

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

Capitalization rates

In line with Rode forecasts, capitalization rates for all property types continued to fall during the third quarter of 2004. This decline continued on the back of — by now — firmly entrenched lower inflation expectations, combined with property's newfound status as investors' "flavour of the month". The decline was assisted by fierce bidding for properties on the side of the listed funds as well as the syndication fraternity. The latter has become a significant force in the non-residential property market.

We predict that capitalization rates will continue to fall, but this time the decline will mainly be driven by fundamentals — viz. declining vacancy rates and growing real rentals.

Hurdle and escalation rates

Hurdle rates for prime office and industrial properties remained at a highly plausible rate of about 17,5%, whereas that of regional centres was slightly lower around 16,5%. Given that the capitalization rates of prime-quality office buildings are, for example, currently at around 11%, the implication is that investors expect a capital growth rate of about 6,5% p.a. over the next five years — plausible indeed.

Historically, escalation rates have lagged inflation by more than 5 years. Given the credibility of the Reserve Bank's inflationtargeting monetary framework, we are likely to see escalation rates dropping much further over the next few years.

Listed property

There has been a phenomenal decline in listed property yields since the late 1990s, mainly on the back of falling bond yields. The upshot is that PUTs and bonds are currently trading at similar yields — around 8,4% at the time of writing.

With the non-residential property engine just warming up it is quite possible that listed yields could fall even more. That is to say, this time round capital appreciation will be driven by fundamentals rather than falling bond yields.

Of course, with historic income yields currently at 8,4% there is no reason why listed funds cannot become more aggressive in expanding their portfolios. You don't need to buy a property at 12% income return if your investors are happy with 8,5% — yes?

Office rentals and demand

It's hard to believe, but nominal CBD rentals have been growing consistently since 2003 while decentralized rentals have been moving sideways. In real terms, however, rentals are declining across the board.

As most of our readers are aware, the poor performance of decentralized office rentals over the last few years is the result of overzealous development that left a glut of supply. With the business cycle being in its six year of its upswing, and economic growth of 3% to 4% forecast for the next few years, we are comfortable that the excess stock will quickly be mopped up, after which strong rental growth will again set in. Our analysis of Sapoa figures shows that in the twelve months to September 2004 some 472.000m² of prime (grades A and B) decentralized office stock was taken up. This is equivalent to just over 6% of the national decentralized office stock, or about six Carlton Centre office blocks. National decentralized vacancies of prime-quality (grades A and B) office buildings have also come down to around 10%, which is approximately 2% points lower than its level a year ago.

At first glance, the growth in national nominal CBD rentals is a bit of a mystery as net take-up of office space over the twelve months ended September 2004 was a negative 37.000m². National CBD vancancies have, however, come down by about 2% points in the last year, and is currently at the 15,5% mark. There are mainly two reasons for this. Firstly, vacancies in Cape Town CBD and especially Pretoria CBD decreased nicely. Secondly, the office stock in some cities reduced as a result of office-to-residential conversions. Note, however, that fundamentally not much has happened in the Johannesburg CBD, which makes up about 50% of the prime-quality CBD office stock.

Industrial market

We have been singing the praises of industrial property for a while now, and the third quarter has again shown that real rentals are still gaining momentum. With industrial vacancies at its lowest levels in years, and solid economic growth predicted for the next few years, industrial property may just break out of its depressing secular downswing (in which it has been trapped for the better part of the last 20 years).

Flat rentals

The residential boom has certainly had a dampening effect on many flat markets. More specifically, declining interest rates has made housing more affordable, while the boom in prices has seen every Tom, Dick, and Harry jump on the buy-to-let bandwagon (which offered a great ride of course), which in turn pushed up the stock of lettable accommodation which, by implication, offered the lessee a greater choice.

Over the last two years, in the metros of Johannesburg, Pretoria, and Cape Town, flat-rental growth did not keep up with building cost inflation. There were, however, two stars: Port Elizabeth and Durban.

The house market

House prices continued to skyrocket in 2004 and all indications are that homeowners will enjoyed growth of between 30% and 40% in 2004 — depending on the location and the category of housing.

An interesting phenomenon is that the growth in lower-priced houses, which lagged behind that of upper and lower-priced home for years, continued to accelerate nicely. However, a R100 spent on a lower-priced house in 1985 would only have grown to R467 in the first quarter of this year, whereas the same money would have grown to respectively R657 and R801 had you invested it in a middle- or upper-priced home.

The building industry

Contractors surely had a great 2004 and we predict that the party will continue in 2005, both for residential and (increasingly) non-residential contractors.

On the non-residential front, building plans passed for offices (13,1%), retail (10,9%) and industrial (34,2%) property has increased nicely in the 12-month period ended September 2004. It is interesting to note that in terms of square meterage, 59% of the plans passed were for industrial, 27% for retail, and only 12% were for office buildings. As far as plans passed is concerned, the figures show that industrial and retail buildings have actually increased in significance in the last year. Turning to non-residential construction-input costs, we note that after decelerating between late 2002 and 2003, building-cost inflation has continued to increase in the reporting quarter. The continued buoyancy in the building industry, coupled with a shortage of skilled artisans, has allowed contractors to further stretch their profit margins in the reporting quarter.

Residential statistics for the 12-months ended September 2004 show that building plans passed for houses greater than 80m² (22,1%), and flats and townhouses (37,7%), grew sharply. Absa's home-building-cost index showed that building-cost inflation in the residential industry continued grew by almost 17% in the third quarter of 2004. Just like their non-residential counterparts, residential contractors are still stretching their margins, although the rate at which they are doing so has decreased slightly.

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