State of the property market in quarter 4 of 2004

On the non-residential front, the office market is still battling in places, but solace is to be found in the industrial property market, which is still in fifth gear. Anecdotal evidence suggests that the residential property market was still growing at a firm pace in the first two months of 2005, which is what we expect it to do for the remainder of the year, albeit not at the same tempo as in 2004.

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

- Capitalization rates for all property types are still moving south.
- Listed fund yields were below those of 10-year bonds in the reporting quarter, implying that investors expect strong income growth.
- Vacancies in decentralized office nodes are still declining and, in many instances, are at normalized (or natural) levels.
- CBD office vacancies are showing a surprisingly strong decline.
- Nominal office rentals in decentralized nodes are still underperforming, despite declining vacancies.
- Real industrial rentals are still growing at a rate that beats building-cost-inflation.
- Industrial stand values are being driven up on the back of low industrial vacancies and strong rental growth.
- In the last two years, Port Elizabeth was the best performing flats market as far as rental growth is concerned. Second, but much further behind, was Durban, and then Johannesburg.
- The Cape Peninsula's house prices have performed the best, in all price categories, since 2000. Furthermore, upper-priced homes generally performed better than middle- and upper-priced homes over this period.
- Building activity in the residential and non-residential markets is expected to remain strong in 2005, which will keep building-cost inflation in double-digit territory.

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 2004:4) with that collected a year earlier.

Capitalization rates

Capitalization rates of all categories of property continued to fall in the last quarter of 2004. This decline in capitalization rates and, hence, the increase in property values, was driven by strong investment demand. Strong demand, in turn, was underpinned by a rosy prognosis for non-residential property, a strong drive among listed funds to grow their portfolios, and low long term inflation expectations, coupled with low gearing costs.

Table 1.1 **The property market at a glance at quarter 2004:4*** **% growth on four quarters earlier (on smoothed data)**		
	Nominal	Real**
Prime CBD office rentals		
Johannesburg	3,9	-8,0
Pretoria	12,1	-0,7
Durban	9,9	-2,8
Cape Town	13,9	0,7
Prime decentralized office rentals		
Sandton CBD	-1,9	-13,2
Randburg Ferndale	4,8	-7,3
Brooklyn/Waterkloof (Pta)	-4,0	-15,1
Hatfield	-3,1	-14,3
Berea (Durban)	4,6	-7,5
La Lucia Ridge	3,2	-8,7
Claremont (CT)	8,4	-4,1
Tyger Valley	7,6	-4,8
Prime industrial rentals (500m² units)		
Central Witwatersrand	16,6	3,2
East Rand	11,1	-1,7
West Rand	29,3	14,3
Pretoria metro	-5,9	-16,8
Durban metro	19,1	5,4
Cape Peninsula	9,0	-3,5
Port Elizabeth	14,4	1,2
House prices (all classes) at quarter 2004:3		
Johannesburg metro	22,4	16,7
Pretoria metro	25,4	19,6
Durban metro	31,1	25,1
Cape Town metro	40,4	33,9
Port Elizabeth	35,2	28,9
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	13,6	11,1
Pretoria metro	-6,9	-8,9
Durban metro	17,9	15,3
Cape Town metro	1,7	-0,6
Port Elizabeth	6,3	3,9

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

On the industrial and office side, capitalization rates are currently at levels last seen in the late 1990s. As far as retail is concerned, the national regional shopping centre capitalization rate is currently a whole 2,5 percentage points lower than it was at the beginning of 2003. With strong consumer demand, a growing black middle-class, and low and stable interest rates and inflation expected, demand for regional shopping centres will continue to put downward pressure on capitalization rates in 2005. Furthermore, the scope for viable, new, regional centres is quickly diminishing, which will make the competition for a piece of the pie so much fiercer.

Hurdle and escalation rates

Our fourth-quarter survey shows that, depending on the property type, investors require a total return of between 16,5% and 17,5% in order to induce them to invest in a prime property. Given that the capitalization rate for prime office properties is about 11% at present, this hurdle rate implies that investors expect capital appreciation of about 5,5% to 6,5% per annum over their investment horizon.

Listed property

In the last quarter of 2004, PUT yields fell below those of long bonds for the first time since 1997.

Furthermore, although capitalization rates declined, PUT yields fell even faster, resulting in a negative yield gap. This can be ascribed to increased demand for listed property due to rosy income-growth prospects.

Office rentals and demand

As a result of declining nominal office rentals in the decentralized nodes of Pretoria, and sideways-moving rentals in the decentralized nodes of Cape Town and Johannesburg, *real* rentals continued to slide in the last quarter of 2004. Nominal rentals in Durban decentralized fared marginally better, but still did not do enough to beat building-cost inflation.

On the whole, vacancies in the decentralized nodes of Johannesburg, Pretoria, and Cape Town continued to fall in the reporting quarter. Durban, on the other hand, has had a spike in its vacancy rate, amongst other things, due to a large tenant vacating in Umhlanga/La Lucia. In December 2004, the aggregated vacancy rates for prime-quality space in the major office conurbations were as follows: Johannesburg decentralized (12%), Pretoria decentralized (3,0%), Durban decentralized (6,9%), and the Cape Peninsula (7,2%).

Turning to CBDs, its was noted that nominal office rentals in the Johannesburg CBD grew at a mediocre 3,8% in the last quarter of 2004, whereas the city's counterparts in Pretoria, Durban, and Cape Town put in a solid 12,1%, 9,9% and 13,9% respectively. However, with building-cost inflation of about 13,0%, only Cape Town CBD managed to post positive real rental growth.

Vacancies in the CBDs of Durban, Cape Town and Pretoria have been declining steadily since early 2003. Pretoria CBD has been helped by government's commitment to the city, whereas Cape Town has been resuscitated by, amongst other things, the Central City Improvement District. Johannesburg CBD's vacancy rate continued to hover around the 20% mark.

Industrial market

Low vacancies and almost 4% growth in manufacturing volumes, led to robust industrial rental growth in 2004. This manufacturing growth took place in spite of the strong rand, because domestic demand was driven by increased consumer confidence, caused by low interest rates, subdued inflation and rising asset prices (residential property specifically, but also equities).

The strong consumer demand manifested itself in booming retail sales, which, in turn, probably also put upward pressure on the rentals of warehousing and storage space — because new storage space has to be built at today's building costs. Given the rosy prospects for economic growth in 2005, and the momentum already in the economy as a result of an upswing that is already in its 7th year, we expect industrial rentals to post good growth in 2005.

Given the relatively low industrial vacancy rates, it is no surprise that both industrial stand values and industrial rentals performed so smartly in 2004.

Flat rentals

Port Elizabeth and Durban showed the strongest flat-rental growth over the last two years, recording compound annual rates of 18,3% and 10,4% respectively. This must be compared with consumer and building–cost inflation over the same period, which were 1,3% and 11,3% respectively. However, over a ten-year and five-year period, Johannesburg metro put in the best performance, with Cape Town close on its heels.

The house market

According to Absa, house-prices continued to soar in the fourth quarter of 2004, growing at almost 35% on a year earlier. Moreover, according to the bank's statistics, old-house prices are currently outpacing new-house prices by a wide margin. Put another way, old-house prices are growing faster than building costs. Why are old-house prices growing faster than new-house prices? It all boils down to demand and supply:

- Firstly, there is the normal lag between accelerating demand and the time it takes for supply to catch up.
- Secondly, an exacerbating factor may be bottlenecks at municipalities that are preventing developers from rolling-out new developments fast enough to meet demand.

Thus demand and supply are not in equilibrium.

The building industry

With the residential-property cycle close to its apex, builders were extremely busy during the last quarter of 2004, and are expected to remain so in 2005. As a result, Absa's (residential) Building Cost Index grew at a lofty 15,4% in the reporting quarter.

Turning to the non-residential property market, general consensus is that building activity will take off in 2005 as fundamentals strengthen. This will exert further upward pressure on the BER Building Cost Index, which we expect had grown by 13% in the last quarter of 2004.

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