State of the property market in quarter 1 of 2005

Demand for industrial and office space continued to strengthen during the first quarter of 2005. However, the office market is still lagging the industrial market on some fronts.

Even though house-price growth decelerated during the reporting quarter, it is still growing at an awesome rate.

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

- Capitalization rates for all property types are still declining.
- PUT yields and long-bond yields are still on par, and diving faster than capitalization rates.
- Vacancies in decentralized office nodes decreased further.
- Real decentralized office rentals are, however, still on the down, despite a large decline in vacancy rates.
- Nominal industrial rentals in many nodes are still growing at double-digit rates.
- Industrial rental growth had a leverage effect on industrial stand values.
- Port Elizabeth and Durban's flat rentals were the best performers over the last two years, and over the last five years.
- House prices are still growing at phenomenal rates, with lower-priced houses probably still being the top performer.
- Strong residential and non-residential building activity continued to fuel building-cost inflation.

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 2005:1) with that collected a year earlier.

Capitalization rates

Strong investment demand for non-residential properties — whether in the form of direct acquisition or indirectly via a listed fund — continued to exert downward pressure on the capitalization rates of all categories of property during the first quarter of 2005.

With investors well aware of the rosy prognosis for property fundamentals, and with dropping short-term interest rates pushing down the returns on cash, and the uncertainty surrounding oil prices causing some doubt as to the wisdom of investing in equities, investment demand for property seems set to maintain its momentum. Furthermore, irrespective of any other factor, capitalization rates have some way to go to reach the levels that reigned before 1997 — the exception being fully-priced regional shopping centres.

Table 1.1 The property market at a glance at quarter 2005:1* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime CBD office rentals		
Johannesburg	-2,4	-14,3
Pretoria	10,2	-3,4
Durban	5,2	-7,7
Cape Town	16,0	1,7
Prime decentralized office rentals		
Sandton CBD	-3,3	-15,1
Randburg Ferndale	1,8	-10,6
Brooklyn/Waterkloof (Pta)	-4,1	-15,8
Hatfield	-3,9	-15,7
Berea (Durban)	2,4	-10,1
La Lucia Ridge	2,4	-10,3
Claremont (CT)	8,2	-5,1
Tyger Valley	20,0	5,1
Prime industrial rentals (500m² units)		
Central Witwatersrand	13,8	-0,1
East Rand	12,0	-1,8
West Rand	38,9	21,6
Pretoria metro	8,7	-5,0
Durban metro	22,3	7,1
Cape Peninsula	8,5	-4,9
Port Elizabeth	14,9	0,8
House prices (all classes) at quarter 2005:1* **		
Johannesburg metro	26,5	17,7
Pretoria metro	30,3	21,1
Durban metro	22,9	14,3
Cape Town metro	30,0	20,9
Port Elizabeth	41,0	31,2
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	10,8	-2,8
Pretoria metro	3,6	-9,3
Durban metro	7,2	-5,8
Cape Town metro	10,9	-2,9
Port Elizabeth	3,8	-9,0

* Unless otherwise specified
** Nominal values deflated by BER Building Cost Index. However, house prices are deflated using the Haylett index.
*** Based on Absa's house price indices

Hurdle and escalation rates

Depending on the property type and, to a lesser extent, the location, investors require an expected total return of between 15% and 17% in order to induce them to invest in a property. Given that the capitalization rate for prime properties is about 11% at present, this hurdle rate implies that investors probably expect average capital appreciation of about 4% to 6% per annum over the next few years, which sounds plausible.

Leaseback escalation rates continued to decline during the first quarter of 2005, and as long as the market still firmly believes that the Bank is committed to maintaining its 3% to 6% inflation target, escalation rates will experience downward pressure.

Listed property

PUT and bond yields have been at similar levels since the last quarter of 2004. Given that property is regarded as a more risky investment than bonds, and therefore justifies a greater income return, this convergence is probably reflective of the, by now, general expectation that non-residential property fundamentals will strengthen during the next few years. The steep fall in listed funds' income yields, in turn, has and will continue to pull capitalization rates further south.

Office rentals and demand

On the whole, nominal grade-A office rentals in both the decentralized nodes and the CBDs moved sideways in the first quarter of 2005. Compared with the same period a year earlier, however, our national decentralized office-rental index was down 4%. In contrast, CBD rentals climbed nicely in the last year, with the national CBD rental index up a substantial 8% on a year earlier.

Looking at the real picture we see that decentralized and CBD rentals have been falling for a number of years and continued to do so in the reporting quarter. Moreover, given accelerating building costs, nominal rentals will have to grow significantly for real rentals to buck this trend. With vacancies fast decreasing and economic growth expected to remain buoyant, this is exactly what we expect will happen.

Sapoa's latest vacancy survey shows that prime-quality office vacancy rates continued to decline during the first quarter of the year, and in many of the major decentralized nodes vacancy rates are now at levels that we deem normal. This bodes well for rising rentals and increased office development.

Industrial market

Industrial rentals showed solid growth during the first quarter of 2005, even though manufacturing production has been declining consistently since the last quarter of 2004. Nonetheless, the economy's fundamentals look good — interest rates are at record lows, inflation is low and stable, GDP is growing at a reasonable rate, and the rand exchange rate is relatively stable and strong. These scenarios, coupled with government's more stimulatory fiscal stance, low industrial vacancies, and rising building costs, are expected to continue to drive industrial rentals north.

Low industrial vacancies, and strong demand for industrial space, further boosted industrial stand values during the reporting quarter.

Flat rentals

Fifteen years ago, the levels of flat rentals in all the major national metros were roughly similar. Since 1995, however, Port Elizabeth's rental growth, and to a much lesser extent, Pretoria's, started lagging behind that of the rest. Durban was not left unscathed either, and in the late 1990s its rental growth also started to lag behind that of Johannesburg and Cape Town. In the last two years, however, we have seen Durban's and Port Elizabeth's rentals growing at a double-digit rate. The upshot is that, today, a standard-quality 1-bedroom flat in Durban, Cape Town and Johannesburg costs, on average, R2.000/month. In Pretoria the same flat is somewhat less at R1.600/month, whereas in Port Elizabeth it is even lower at R1.500/month.

On the whole, all the major metros, except Port Elizabeth, showed positive inflation-adjusted rental growth during the 1990s. The double-digit building-cost inflation of the last few years has, however, caused a turnaround in this trend, and real rentals have declined quite sharply over the last approximately two years.

The house market

According to Absa's house-price index, national house prices during the first quarter of 2005 were almost 29% up on the corresponding period the previous year. Although still high, this is a whole 5 percentage points lower than the growth rate in the fourth quarter of last year, which once again confirms that the housing market is losing steam. Waning house-price growth coupled with accelerating building-cost inflation, resulted in a further decline in real house-price growth.

Furthermore, during the first quarter of 2005, old-house prices continued to grow at more than double the rate of new-house prices. This is not unexpected as there is normally a lag between accelerating demand and the time it takes for supply to catch up. Furthermore, the situation may be exacerbated by bottlenecks at municipalities that are preventing developers from rolling out new developments fast enough to meet demand.

Rode's figures show that lower-segment prices continued to grow faster than those of middle- and upper-priced homes during the third quarter of 2004. Because house-price growth has exceeded disposable income growth for a number of years, many buyers were forced to scale down, which, in turn, exerted upward pressure on lower-priced houses. What's more, the general consensus is that the interest-rate cycle is close to or in a trough, which means little interest-rate relief can be expected. So in all likelihood, the prices of lower-priced houses will continue to grow faster than those of the more expensive houses.

The building industry

House-price growth may be decelerating, but residential building activity is still on a roll, resulting in Absa's residential building-cost index (Absa's BCI) growing at 14,7% in the first quarter of 2005. Non-residential construction, while still gaining momentum, has been on the up for a number of quarters, which has resulted in an expected growth of 14,1% in the BER BCI for the reporting quarter. These growth rates include the profit margins of building contractors, and should be compared with the Haylett index, which measures input-cost growth to the building construction industry. The Haylett index is expected to have grown by about 7,2% in the first quarter of 2005. From this we see that builders are still stretching their profit margins. ■