State of the property market in quarter 2 of 2005

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

- Capitalization rates for all property types are still declining, although office and industrial rates probably still have the most to shed.
- Listed property yields are expected to remain around current levels in the short to medium term.
- Vacancies in decentralized office nodes decreased further.
- Real office rentals are still diving despite respectable vacancy rates.
- Current gross market rentals in areas such as Bryanston, Fourways, and Tyger Valley, could be as much as 65% short of the rental required to make a new development viable.
- Nominal industrial rentals in most of the major industrial regions are still growing at double-digit rates.
- Robust industrial-rental growth and diving capitalization rates continue to leverage 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-price growth is decelerating sharply.
- Solid residential and non-residential building activity, coupled with input shortages, are expected to continue exerting pressure on 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 2005:2) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2005:2*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	2,2	-11,8
Pretoria	9,3	-5,6
Durban	7,3	-7,3
Cape Town	11,6	-3,4

* 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

Table 1.1 (continued) The property market at a glance at quarter 2005:2* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime decentralized office rentals		
Sandton CBD	-1,1	-14,6
Randburg Ferndale	4,3	-9,9
Brooklyn/Waterkloof (Pta)	-3,0	-16,2
Hatfield	-3,5	-16,6
Berea (Durban)	2,2	-11,6
La Lucia Ridge	-0,4	-13,8
Claremont (CT)	8,7	-6,0
Tyger Valley	13,1	-2,0
Prime industrial rentals (500m² units)		
Central Witwatersrand	14,8	-0,8
East Rand	14,9	-0,8
West Rand	24,8	8,3
Pretoria metro	18,7	2,4
Durban metro	17,0	1,2
Cape Peninsula	8,8	-6,0
Port Elizabeth	9,0	-5,6
House prices (all classes) at quarter 2005:2* **		
Johannesburg metro	20,7	11,7
Pretoria metro	25,2	15,9
Durban metro	23,9	14,6
Cape Town metro	25,6	16,2
Port Elizabeth	30,9	21,1
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	8,7	-6,0
Pretoria metro	14,0	-1,7
Durban metro	6,6	-7,8
Cape Town metro	18,1	2,0
Port Elizabeth	8,4	-6,5

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Capitalization rates

Good income growth prospects, as well as confidence in the sustainability of structurally low interest rates, continued to result in further declines in capitalization rates during the second quarter of 2005. Low interest rates are causing many investors to question the wisdom of investing in money market instruments rather than in property where, although the risk is slightly higher, capital returns are possible. As a result of this we expect that listed funds' in-

come yields will remain low, which will give them the leeway to pay more for directly-held property. In addition, property syndicators' coffers are likely to remain full, which bodes well for more aggressive buying on their part — specifically in the neighbourhood and community shopping centre markets.

Hurdle and escalation rates

Hurdle rates have been on the decline since 2003, which is about the same time that capitalization rates started falling as a result of declining interest rates. In the second quarter, hurdle rates again followed capitalization rates downwards. Hurdle rates varied from as low as 14% for regional shopping centres to as high as 17% for office buildings.

Leaseback escalation rates also declined further to just over 8%, which is about 3% points greater than the expected inflation rate over the next few years, but still much lower than our expectation of building-cost inflation.

Listed property

Given the fact that the interest rate cycle has bottomed out, or is close to bottoming out, and assuming that the market has already largely discounted the effect of the pending property boom on income streams, we expect listed yields to remain relatively flat or, at best, to edge down over the next few years. Hence all eyes are presently on the distributions of listed funds.

If listed yields remain low and stable it will give asset managers the leeway to offer vendors higher prices (i.e. lower capitalization rates) on directly-held property, which will lead to a reduction of the large premium to net asset value at which many funds are currently trading.

Office rentals and demand

Nominal grade-A office rentals in both the decentralized nodes and the CBDs ticked upwards during the second quarter of this year. This is especially apparent in the decentralized nodes, where positive movement has been lacking, yet expected, for some time now. Still, the growth in rentals in the decentralized nodes and the CBDs was not enough to beat building-cost inflation, which is expected to have grown by almost 17% during the second quarter of 2005. The result was a further decline in real rental rates. This is despite the fact that vacancy rates have come down sharply over the last year and are, on the whole, quite close to 'normal' levels.

Industrial market

Since 2003, industrial rentals have been climbing consistently as a result of an upsurge in manufacturing activity, which, probably in no small measure, was the result of the sharp decline in interest rates, which kindled the consumption boom. During the reporting quarter, rentals in most of the major industrial conurbations continued to grow at double-digit rates. However, despite the good nominal growth performance, building-cost inflation of about 17% resulted in most of the major industrial conurbations recording negative real growth.

Growing rentals and falling capitalization rates have leveraged the market value of industrial stands significantly during the last two years. During the second quarter, only Durban's stand values failed to beat building-cost inflation.

Flat rentals

Over the last two years, flat rentals in the Durban, Johannesburg and Port Elizabeth metros grew at a compound rate of 10 to 11% p.a. In contrast to this, Pretoria's flat rentals never even got off the ground, while those of the Cape Town metro registered a pedestrian 5% p.a. over the same period. Developers would be disappointed with this performance as not one region managed to beat building-cost inflation, which grew at a compound 13,1% p.a. over the last two years. Landlords will, however, be very happy because core consumer inflation grew at a meagre 3,7% p.a.

Looking at the level data, our latest surveys show that rentals for standard quality 2-bedroom flats in the Johannesburg, Durban, and Cape Town metros averaged around R2.600/month; Pretoria's average rental was about 20% lower at R2.200/month, while Port Elizabeth's was even lower at R1.900/month.

The house market

House-price growth decelerated further during the second quarter of 2005 and this process seems set to continue. Absa's national house-price index indicates that house prices in August 2005 were 19,2% higher than the same month a year earlier. However, more revealing was the fact that the annualised month-on-month growth rate was a mere 7,7% — confirming that the housing market is losing steam fast.

Also of interest is the fact that old houses are currently trading at a discount of only 6% to new houses. This is rather low, given that the average South African house is probably around 25 years old, and that houses age at about 1% point per annum relative to new. This is further evidence that houses are fully priced.

The building industry

During the first quarter of the year, residential gross fixed capital formation was at its highest level in 20 years. With building plans still growing significantly, albeit not at rates experienced over the last few years, we expect residential building activity to remain robust. Residential contractors will, however, continue to feel the pinch of a weakening demand, which should put a cap on profit-margin growth.

Non-residential building activity still has some way to go to reach its 1980s peak, but all signs are that this sector is gaining momentum. Non-residential building cost growth is expected to remain in the double-digit territory as a result of strong demand caused by a booming non-residential sector, as well as continued demand pressure caused by the residential market. All indications are that these demand-side pressures will be compounded by a shortage of skilled artisans. ■