

State of the property market in quarter 3 of 2005

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

- Shopping-centre capitalization rates take a breather.
- Income-stream growth drives listed funds' prices.
- Nominal rental growth shows promise, but is still not close to beating building-cost inflation.
- Industrial rentals still racing ahead.
- House prices still losing steam.
- Building-cost inflation still strong as a result of robust building activity.

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 2005:3*		
% growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime CBD office rentals		
Johannesburg	6,5	-8,7
Pretoria	9,2	-6,5
Durban	7,1	-8,2
Cape Town	4,6	-10,4
Prime decentralized office rentals		
Sandton CBD	3,6	-11,3
Randburg Ferndale	1,2	-13,2
Brooklyn/Waterkloof (Pta)	-1,6	-15,7
Hatfield	6,4	-8,9
Berea (Durban)	-1,7	-15,7
La Lucia Ridge	0,6	-13,8
Claremont (CT)	4,1	-10,8
Tyger Valley	4,7	-10,3
* 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 2005:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	14,6	-1,8
East Rand	15,2	-1,3
West Rand	7,6	-7,8
Pretoria metro	30,1	11,4
Durban metro	25,7	7,6
Cape Peninsula	14,9	-1,6
Port Elizabeth	6,8	-8,5
House prices (all classes) at quarter 2005:3***		
Johannesburg metro	18,2	10,7
Pretoria metro	18,6	11,0
Durban metro	16,9	9,4
Cape Town metro	25,6	17,5
Port Elizabeth	23,0	15,1
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	11,1	-5,1
Pretoria metro	20,3	2,7
Durban metro	3,6	-11,5
Cape Town metro	13,0	-3,3
Port Elizabeth	12,9	-3,6
* 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		

Capitalization rates

On the whole, capitalization rates continued trending down during the third quarter of the year. The only exception was regional-shopping-centre capitalization rates, which took a breather. However, with long-term inflation expectations remaining within the Reserve Bank's target range, and the prognosis for income growth remaining good, capitalization rates are likely to continue on the down path in the coming quarters.

Hurdle and escalation rates

Hurdle rates varied from as low as 14% for regional shopping centres to around 16% for office and industrial buildings. Given the current level of capitalization rates of these property types, it would seem that investors expect roughly 5% net-income growth (and hence capital growth, assuming no change in cap rates) on their investments (the hurdle rate less the capitalization rate \approx 5%).

The average leaseback escalation rate was 8,4% during the third quarter of 2005. The escalation rate is an attempt by the market to forecast market rentals until the expiry of the lease.

Hence, an escalation rate of 8% isn't all that high given our bullish view on rental growth over the next few years. The problem is, of course, that many players out there — especially tenants — look upon the escalation rate as compensation for consumer inflation, rather than rental inflation. We must nevertheless bear in mind that leaseback terms are typically 10 years, and that a compounded growth of 8% p.a. over this term is high when consumer inflation is expected to run at, say, 5% p.a. For leases of 3 to 5 years, 8% is — in our opinion — not a bad stab at the future movement of market rentals.

Listed property

During the third quarter of 2005, listed-fund prices soared further as a result of marginally declining income yields and solid income-stream growth. As expected, property unit trust (PUT) income yields remained below those of long bonds as a result of the positive outlook for property fundamentals.

The expected increase in short-term interest rates later this year (or early next year), has not yet had any effect on long-bond yields, and is not expected to impact negatively on listed funds' yields.

Moreover, with the non-residential property boom expected to last a number of years (remember that the property cycle has historically been a long one), and with interest rates expected to remain relatively close to their current levels over the next five years (as a result of structurally lower inflation), it is likely that listed funds' yields will remain stable. Other factors supporting low and stable income yields are the expected peaking of the residential property cycle, and, perhaps as we have seen more recently, an increase in foreign interest in listed property. The wild card remains the future movement of gilt yields: on the one hand interest rates internationally are heading north, but on the other, South Africa's treasury does not have a strong need for new issues, given its sound finances.

Such stability will give listed funds the leeway and the confidence to pay more for properties and, hence, reduce capitalization rates in the process. Because capitalization rates reflect the sentiment and perceptions of *long-term* investors (of a potentially illiquid asset), these rates do not adjust to every movement of listed property yields.

Office rentals

The good news is that grade-A office rentals climbed further during the third quarter of 2005. On the whole, decentralized rentals were up 5% on a year earlier, while CBD rentals were almost 12% higher than at the same time last year. The bad news is that building-cost inflation (as measured by the BER Building Cost Index) is expected to have grown by a frightening 17% during the reporting quarter, whereas input costs to the building construction industry (as measured by the Haylett index) are expected to have grown by 6,7%. The implication is, of course, that real rentals have continued to decline.

Industrial market

Manufacturing production has been decelerating since the start of the year, which is reflected in a decrease in manufacturing capacity utilization. Things are, however, not all that bleak: manufacturing capacity utilization is still at healthy levels, and if economists' forecasts are correct, it should remain healthy over the next few years.

This healthy condition has continued to support strong rental growth in the Central Witwatersrand, the East Rand, the Cape Peninsula, and Durban. All of these areas managed double-digit year-on-year growth during the third quarter of 2005. A disappointing performance came from Port Elizabeth, whose rentals have been moving sideways for the last few quarters.

During the reporting quarter, industrial vacancies continued on their long-term down path, which commenced in the late 1990s.

Flat rentals

Over the last 10 years, flat rentals grew at nearly double the rate of inflation. Johannesburg, Pretoria and Cape Town showed an increase of approximately 12% per annum, Durban about 10%, and Port Elizabeth 9%. This trend was, however, reversed during the last five years, with the laggards catching up and registering 12% growth.

As for rental levels, 2-bedroom rents in Johannesburg are currently the highest at around R2.800 per month, while Port Elizabeth has the lowest at R2.000. Pretoria, Cape Town, and Durban's 2-bedroom rental are in-between, at about R2.500 per month.

In all the cities tracked by Rode, *real* rentals are now well below the highs of the 2000–2002 period. Moreover, given our expectation of strong building-cost inflation over the next two years, it is questionable whether these levels can be reached soon again.

The house market

House prices during the third quarter of 2005 were still almost 20% higher than they were a year earlier. However, growth continued to lose steam, as evidenced by the fact that house prices in the reporting quarter were only 3% higher than the previous quarter — that is to say, annualised quarter-on-quarter house-price growth was a contrasting 12,4%. This deceleration is likely to continue on the back of increased unaffordability coupled with, we believe, a limited ability by consumers to significantly alter their spending patterns. In other words, real house-price growth is currently demand constrained.

Moving on to the various price categories, Rode's figures show that during the first quarter of 2005, the prices in lower-priced suburbs were still growing faster than those of middle-priced and upper-priced suburbs. A R100 invested in a lower-, middle-, and upper-priced house at the beginning of 2000 would have grown to R186, R217, and R205 respectively by quarter 2005:1. Hence lower-priced houses still have some catching up to do. Whether they will in fact, is a different matter.

The building industry

Gross fixed capital formation in residential and non-residential buildings, although still growing at robust rates, continued to lose steam during the second quarter of the year. Nonetheless, optimism in the building industry — both residential and non-residential — remained elevated during the second and third quarters, according to recent surveys. This is supported by solid growth in the number of buildings completed and plans passed during this period. The upshot was continued upward pressure on building costs. ■