State of the property market in quarter 4 of 2005

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

- Capitalization rates continued their decline
- Leaseback escalation rates seem fair
- Income-stream growth of listed funds holds key to future returns.
- Real decentralized office rentals continued to decline.
- Rentals in most of the major industrial conurbations continued to grow.
- Flat-rental growth still not beating building-cost inflation.
- House-price growth still has some momentum.
- Building-cost inflation expected to remain robust.

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 2005:4) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2005:4*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	17,4	5,8
Pretoria	4,4	-5,9
Durban	2,0	-8,0
Cape Town	11,1	0,1
Prime decentralized office rentals		
Sandton CBD	10,4	-0,5
Randburg Ferndale	4,2	-6,1
Brooklyn/Waterkloof (Pta)	-2,1	-11,7
Hatfield	13,1	1,9
Berea (Durban)	-6,9	-16,0
La Lucia Ridge	-1,8	-11,4
Claremont (CT)	-0,2	-10,0
Tyger Valley	4,5	-5,8

* 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 2005:4* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	12,8	1,7
East Rand	15,3	3,9
Pretoria metro	41,5	27,5
Durban metro	34,0	20,9
Cape Peninsula	17,0	5,5
Port Elizabeth	0,6	-9,2
House prices (all classes) at quarter 2005:4* **		
Johannesburg metro	14,9	7,2
Pretoria metro	11,5	4,1
Durban metro	16,2	8,4
Cape Town metro	22,2	14,0
Port Elizabeth	4,4	-2,7
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	7,3	-3,2
Pretoria metro	20,4	8,6
Durban metro	0,6	-9,3
Cape Town metro	8,1	-2,5
Port Elizabeth	12,8	1,7

* Unless otherwise specified
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*** Based on Absa's house price indices

Capitalization rates

Capitalization rates of office and industrial buildings continued on their downpath during the last quarter of 2005, while shopping-centre capitalization rates also declined after taking a breather during the previous quarter. What is more, expectations of relatively low and stable interest rates, coupled with a belief in the widely advanced notion that the non-residential property market is on the brink of a major upswing, are expected to keep capitalization rates moving south.

Hurdle and escalation rates

Assuming a 5-year time horizon, hurdle rates of office buildings, industrial leasebacks and regional shopping centres varied from roughly 14% to 16%. Lower-risk, flavour-of-the-month regional shopping centres tend to be on the low side of the spectrum, whereas non-leaseback office buildings tend to be on the higher side. Given that capitalization rates on good regional shopping centres are currently around 7% to 8%, the implication is that investors are expecting net-rental growth (and capital growth for that matter) to average around 6% to 7% per annum.

The average leaseback escalation rate was 8,4% during the last quarter of 2005. Given our expectations of double-digit rental growth over the next few years, this does not sound too high at all.

Listed property

PUT income yields edged further south during the latter part of 2005, and averaged a low of 6,9% in December. The further decline was probably related to the increased likelihood that interest rates would not be hiked. Also contributing to the low yields was double-digit income-stream growth during the fourth quarter of 2005, and upbeat prospects for income-stream growth in the coming year.

With prospects for income growth remaining upbeat and interest rates expected to remain close to their current levels, PUT yields should stay close to the 7% mark for the rest of this year. This implies that capital returns will be driven by income-stream growth rather than declining income yields in the next few years.

Office rentals

Nationally, nominal grade-A decentralized office rentals took a slight dip, while nominal grade-A CBD office rentals climbed further during the fourth quarter of 2005. As a result of double-digit building-cost inflation, real decentralized rentals continued to decline. However, with vacancy rates currently at or close to normalized rates, it is just a matter of time before rentals make a huge correction.

Industrial market

Manufacturing remained strong during the last quarter of 2005, mainly as a result of a strong domestic economy. This sector is expected to remain robust during 2006, which will support the current upswing in real property rentals experienced in most of the major industrial conurbations.

During the reporting quarter nominal rentals in Central Witwatersrand (10,9%), Durban (32,6%), and the Cape Peninsula (20,0%), were up notably on the same period a year earlier. Port Elizabeth (3,1%), where rentals have been moving sideways for the last year, put in the worst performance. The poor performance of Port Elizabeth is a bit baffling, as recent conversations with players active in the market revealed that this area currently has a chronic shortage of industrial space. This may be a weird prelude to growth to come.

Flat rentals

During the last two years, flat rentals in the Durban, Cape Town, Port Elizabeth and Johannesburg metros grew at a compound rate of 7% to 9% p.a. Flat rentals in the Pretoria metro performed best, growing by 11% p.a. Developers, however, would be disappointed with the general performance of the flats market as not one region managed to beat building-cost inflation, which grew at a compound 11,6% p.a. over the last two years.

As at December 2005, rentals for a standard-quality 2-bedroom flat were the highest in the Johannesburg metro at around R2.700 per month. This was followed by Cape Town (R2.600), Durban (R2.500), Pretoria (R2.400) and Port Elizabeth (R1.900). In real terms, only the Cape

Town and Pretoria metros showed upward movement in flat rentals in the fourth quarter of 2005. However, real rentals are still well below the highs of the 2000—2002 period. Moreover, given Rode's expectation of strong building-cost inflation over the next two years, it is questionable whether these levels can be reached again any time soon.

The house market

In the fourth quarter of 2005, national middle-segment house prices as tracked by Absa were still 15,7% higher then they were a year earlier. More revealing, however, is the fact that house prices in January 2006 were only 1% higher than the month before, which means that annualized month-on-month house price growth was 12,4%. Given the already overheated status of much of the house market, this suggests that house-price growth is unlikely to exceed 12% in the next year. More likely, however, is that the market will lose further steam and end up growing by anywhere from 5% to 10% in the next 12 months.

Moving on to the various price categories, Rode's figures show that in the first quarter of 2005, the prices of lower-priced houses were still growing faster than those of middle-priced and upper-priced houses. We suspect that this trend has continued subsequently. Moreover, with the increase of the transfer-duty-free threshold from R190.000 to R500.000 in the 2006/2007 budget, demand for lower-priced houses is bound to get some additional impetus. Middle-priced and upper-priced house prices are already overheated and are, therefore, not expected to react noticeably to the new transfer-duty concessions.

The building industry

Non-residential gross fixed capital formation still has some way to go to match its previous highs of two decades ago. However, the trend in the last three years has been up, and with office and industrial vacancies quite low and the economy set to continue booming, it is expected to gain momentum in the coming year. The continued strength of building activity has resulted in building-input costs (as represented by the Haylett index) growing at a steady rate of approximately 7% during 2005. In contrast, the BER BCI, which includes building-input costs as well as the profit margins of contractors, has been losing steam during the course of the year. Notwithstanding the aforementioned, we do not expect building-cost inflation to decelerate much further, as the current non-residential property boom is sure to keep it under pressure.

In the third quarter of 2005, residential gross fixed capital formation was around its highest level since the early 1980s, and was still pointing north. The growth in residential building plans passed during the last 12 months suggests that residential building activity should remain solid in the coming months. As far as residential building costs are concerned, Absa's figures suggest that residential building-cost inflation has been declining for the last two years. This makes sense as this period represents the mature stage of the residential boom. Nonetheless, residential building-cost inflation still remained high at around 13% during the last quarter of 2005, which was substantially higher than input costs as represented by the Haylett index. This implies that residential building contractors are still stretching their profit margins. ■