State of the property market in quarter 1 of 2006

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

- Capitalization rates and hurdle rates still falling.
- Listed property's income yields surprise again.
- Real office rentals still battling to turn the corner.
- Prospects for industrial property remain good.
- House-price growth decelerates further.
- Building-cost inflation remains high.

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 2006:1) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2006:1*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	23,0	6,7
Pretoria	-11,6	-23,1
Durban	7,1	-7,1
Cape Town	12,5	-2,3
Prime decentralized office rentals		
Sandton CBD	10,7	-3,9
Randburg Ferndale	6,2	-7,8
Brooklyn/Waterkloof (Pta)	13,0	-2,1
Hatfield	17,1	1,6
Berea (Durban)	3,8	-10,1
La Lucia Ridge	-1,0	-14,1
Claremont (CT)	0,7	-12,6
Tyger Valley	9,7	-4,8

* 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 2006:1* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	13,6	-1,4
East Rand	11,6	-3,0
Pretoria metro	36,6	18,8
Durban metro	25,9	9,5
Cape Peninsula	19,5	3,7
Port Elizabeth	1,8	-11,6
House prices (all classes) at quarter 2006:1***		
Johannesburg metro	13,4	7,0
Pretoria metro	7,8	1,7
Durban metro	17,7	11,1
Cape Town metro	17,6	11,0
Port Elizabeth	-2,0	-7,5
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	9,1	-5,3
Pretoria metro	10,8	-3,7
Durban metro	2,4	-11,1
Cape Town metro	6,1	-7,9
Port Elizabeth	8,8	-5,4

* 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

Capitalization rates

Capitalization rates of office, industrial and shopping-centres have been declining consistently since 2003, and the first quarter of 2006 was no exception. Of course, the catalyst that set this secular trend in motion was declining interest rates on the back of lower inflation expectations. Lower interest rates resulted in a concomitant decline in listed property yields, which made it possible for listed funds to be more aggressive with their pricing. Declining interest rates also allowed interest-rate-sensitive syndicators to buy at lower yields.

Although popular opinion is that interest rates have, for the time being, reached their cyclical trough, we suspect that capitalization rates still do not fully reflect long-term inflation expectations (and hence interest rates), and will thus continue to decline. Another force that will drive a further decline in capitalization rates is the anticipation of the upswing phase of the long property cycle.

Hurdle and escalation rates

Hurdle rates declined further during the reporting quarter, which is in line with a further decrease in capitalization rates. Hurdle rates for regional shopping centres were as low as 13,2% while those of decentralized offices averaged 15,2%.

Leaseback escalation rates averaged 8,7%, and were based on the opinion of 20 property professionals. As a matter of interest, we calculated the average opinion of the 6 listed funds in the sample, and arrived at a leaseback escalation rate of around 8%.

Listed property

Just when you thought listed yields could not fall any further, the market surprises you. During December 2005 PUT yields averaged 6,9% and as at March 2006 they averaged 5,6%, which means that, assuming no change in income took place, this decline in yield alone resulted in a capital gain of 23%. One of the reasons for this decline – besides the fact that shares in general did well, and bond yields declined marginally – is the bullish prospects for the physical property market and, perhaps, increasing doubts as to the sustainability of the equity boom.

The upward bias of interest rates currently poses the biggest threat to listed-property yields, whereas, on the other hand, increasing cash flows into the bond market (as a result of increased investor caution regarding equities) could result in listed yields having more space for downward movement. Bearing this in mind, we still believe that listed yields will probably remain close to their current levels in the next few years as strong property fundamentals will keep demand strong. The implication, of course, is that capital growth will mainly be driven by income growth.

(In May 2006, listed property yields, together with those of the rest of the stock market, took a knock. Notwithstanding this, returns for the year to date are still highly satisfactory.)

Office rentals

On the whole, decentralized and CBD office rentals continued to climb during the first quarter of 2006. More specifically, national decentralized office rentals were 7% up on the same period a year earlier, whereas CBD rentals grew by an average 16%. This in itself sounds pretty impressive. However, building-cost inflation is projected to come in at 15%, which implies that real decentralized office rentals are still posting negative growth, whereas real CBD office rentals are barely growing positively.

Industrial market

Although manufacturing production again took a slight dip in the early months of this year, it was still up on the same period a year earlier. Of course, the manufacturers of export goods continued to be hobbled by a strong rand, but strong local demand continued to support this sector. In the coming months, low and stable interest rates and inflation are likely to keep consumer confidence high, which should keep domestic demand robust and, in turn, keep demand-side pressure on industrial rentals. A gradually weakening rand will also hopefully take some pressure off the manufacturers of export goods. Notwithstanding this, we are of the opinion that the big driver of rentals in the coming year will be building cost (owing to both its past growth and its expected growth).

In the first quarter of 2006, nominal rentals in Central Witwatersrand (13,6%), Durban (25,9%), and the Cape Peninsula (19,5%) were substantially up on the same period a year earlier. However, in level terms, unlike Durban and the Cape Peninsula, rentals in Central Witwatersrand moved sideways in the reporting quarter. Port Elizabeth industrial rentals have been moving sideways for over a year now, and even though its rentals demonstrated a slight up-tick in the reporting quarter, its performance remains disappointing.

Flat rentals

During the last two years, flat rentals grew by just over 6% p.a. in the Durban metro, and just short of 12% p.a. in the Pretoria metro. The metropolitan areas of Johannesburg, Port Elizabeth and Cape Town registered growth ranging between 8% and 10%. Over the same period, consumer inflation was just shy of 3% p.a. and, hence, landlords achieved real rental growth. Notwithstanding this, such investors could have achieved better income growth in many listed property funds (most notably those with a high retail and industrial components).

The house market

In April of this year, national middle-segment house prices were roughly 13% higher then they were a year earlier, according to Absa. However, more interesting is the fact that house prices were only 0,5% higher than they were the month before, which, assuming house prices continue to grow at this rate, would imply house-price growth just shy of 7% in the next twelve months.

As far as the various price categories are concerned, Rode's figures show that between quarter 2000:1 and 2005:3, middle-priced houses put in the best performance, whereas the upper-priced and lower-priced suburbs tied for second place. Also interesting is the fact that lower-priced suburbs have been performing better than the more expensive neighbourhoods since early 2004. This was, of course, the result of growing unaffordability and booming new supply additions to the other categories – a situation that plagues buyers to this day.

The building industry

Non-residential and, especially, residential building activity, grew robustly in 2005, which kept building-cost inflation in the double-digits. This year we expect a repeat of last year, with building activity remaining strong — and building-cost inflation high. Nevertheless, residential building activity will probably not grow by as much as last year, whereas non-residential building activity is likely to accelerate somewhat as the upswing phase of the long non-residential property cycle advances.

During the reporting quarter, building-cost inflation (as measured by the BER BCI) is expected to be up by about 16% on the same period last year. Building-input-cost inflation (as measured by the Haylett index) is expected to post year-on-year growth of 6%. Of course, the discrepancy between these figures suggests that building contractors are still stretching their profit margins. ■