Chapter 1: State of the property market

State of the property market in quarter 2 of 2006

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

- Cap rates resist threat of interest-rate hikes.
- Listed property's recent blow
- Office market's vigour starts to show.
- Industrial rentals continue to grow.
- House-price growth still declining.
- Building activity set to keep pressure on building costs.

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 2006:2) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2006:2*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	11,5	4,7
Pretoria	19,1	11,7
Durban	8,4	1,7
Cape Town	7,1	0,5
Prime decentralized office rentals		
Sandton CBD	13,7	6,6
Randburg Ferndale	6,3	-0,2
Brooklyn/Waterkloof (Pta)	5,4	-0,9
Hatfield	30,9	22,7
Berea (Durban)	17,8	10,4
La Lucia Ridge	13,6	6,4
Claremont (CT)	5,0	-1,5
Tyger Valley	4,6	-1,8

* 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 2006:2* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	17,7	10,4
East Rand	12,6	5,6
Pretoria metro	42,1	33,2
Durban metro	15,6	8,4
Cape Peninsula	20,7	13,2
Port Elizabeth	15,0	7,7
House prices (all classes)* **		
Johannesburg metro	16,0	9,0
Pretoria metro	9,3	2,7
Durban metro	12,0	5,2
Cape Town metro	13,9	7,0
Port Elizabeth	4,9	-1,5
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	4,8	-1,7
Pretoria metro	8,0	1,3
Durban metro	3,7	-2,7
Cape Town metro	6,4	-0,2
Port Elizabeth	11,2	4,3

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Capitalization rates

Despite the expected deterioration in short-term inflation, and the prospects of further interest rate hikes, long-term inflation expectations are still positive. What's more, because the market anticipates strong rental growth during the next few years, it is at present unlikely that capitalization rates will experience notable upward pressure in the near future.

At worst, one may see a decrease in the number of transactions by owner-occupiers and private investors who are generally more interest-rate sensitive than fund investors.
Hence, during the second quarter of the year, capitalization rates still pointed south; furthermore, regional shopping centres were still the most highly regarded property type, with industrial leasebacks second and decentralized offices in third place.

Hurdle and escalation rates

During the reporting quarter, investors required a minimum total return of roughly 15% to 17% to induce them to invest in non-residential property. Given that the market believes secularly low inflation to remain a fact, it is unlikely that hurdle rates will increase in response to the recent interest-rate hikes, or the expected future rate hikes. The expectation of a major non-residential property boom is, of course, also aiding in keeping hurdle rates downwardly biased.

Leaseback escalation rates averaged 8,0% during the second quarter of 2006. The reader will recall that the escalation rate is an attempt by the market to forecast market rentals until the expiry of a lease. Given the rosy prospects for rental growth over the next few years, the current leaseback escalation rate may just turn out to be on the low side.

Listed property

Rising interest rates coupled with stock-market uncertainty resulted in listed property's income yields taking an ugly knock during the second quarter of the year.

Most peculiar, however, is that this occurred despite the fact that medium-term inflation prospects are still looking good, and that most market participants are expecting robust income growth in the next year or more. Even more puzzling is the fact that listed property yields weakened further relative to bond yields, which possibly implies that investors felt that property was a bit overpriced relative to bonds.

On the whole, all factors point to the fact that the down-rating of the listed-property sector was a bit overdone; this is indicative of the short-term irrationality, so customary of the stock market. With this in mind, we are positive that as the strength of property fundamentals starts to show up in the bottom line, listed yields will strengthen again (albeit perhaps not to the same lows that we have seen in the recent past).

Office rentals

Nationally, nominal grade-A CBD and grade-A decentralized office rentals continued to climb during the second quarter of 2006. CBD office rentals were collectively up by 15% on a year earlier, decentralized rentals were only 7% higher. Of course, the relatively stronger performance of the CBDs is from a much lower base (barring Cape Town CBD that is). During the same period, building-cost inflation (BER BCI) is expected to have grown by about 7%, which implies that real CBD rentals are growing positively while real decentralized rentals are in the process of turning the corner.

Industrial market

Manufacturing activity remained strong during the second quarter of 2006, mainly as a result of a weaker rand. Since the beginning of the second quarter, the rand has weakened about 16% against the dollar, allowing local manufacturers to capture a larger portion of domestic sales orders and increasing the export competitiveness of locally manufactured goods.

The manufacturing sector is expected to continue to perform well during the coming months, which will sustain low industrial vacancies and support the upswing in real industrial rentals.

During the reporting quarter, nominal rentals in Central Witwatersrand (17,8%), Durban (15,6%), Cape Peninsula (20,7%) and Port Elizabeth (15,0%), were notably up on the same period a year earlier.

Flat rentals

During the last two years, flat rentals in the Johannesburg, Port Elizabeth and Cape Town metros grew at a compound rate of 7% to 9% p.a. Flat rentals in the Pretoria metro performed the best, growing by almost 11%, while Durban could only manage 4% p.a. Developers, however, would be disappointed with the general performance of the flats market as only one region, namely Pretoria, managed to beat building-cost inflation, which grew at a compound 10% p.a over the last two years.

The house market

In August 2006 national middle-segment house prices were 13,6% up on the same period a year earlier according to the latest Absa data. This is in stark contrast to Standard Bank's house-price index (HPI) that shows a year-on-year growth rate of only 6%. Although the latest figures of the two banks differ notably due to a difference in methodology, they are in agreement that house-price growth is consistently declining.

As far as the various price categories are concerned, Rode's figures indicate that between 2000 and 2005, middle-priced houses put in the best performance followed by upper-priced and lower-priced houses.

Furthermore, Rode's figures also show that, since 2004, lower-priced houses started to grow faster than middle- and upper-priced homes. Because house-price growth exceeded disposable-income growth for a number of years, many buyers were forced to scale down, which, in turn, placed pressure on lower-priced houses.

The building industry

Non-residential building activity continued to grow robustly during the first quarter of 2006. Despite this, building-cost inflation, as measured by the BER BCI, grew by a meagre 5% during the first quarter, and is expected to grow by about 7% during the second quarter of 2006. These figures are intuitively quite low and one cannot rule out the possibility that they might be adjusted upwards when the next data is released. The Haylett index, which measures building-input costs only, grew by about 6% in the first quarter of 2006, and is expected to grow by roughly the same amount in the second quarter. The fact that BER-BCI and Haylett-inflation are almost equal, suggests that non-residential contractors have stopped stretching their profit margins. If this is so, we do not believe that this state of affairs will continue for long (that is, given that a non-residential boom is expected).

On the residential front, building activity is also expected to have been robust during the second quarter of the year. Notwithstanding this, Absa's BCI, which suggests residential building-cost inflation of 10%, intuitively sounds a bit on the high side, considering that the housing market is in its downswing phase. ■