Chapter 1: State of the property market

State of the property market in quarter 3 of 2006

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

- Cap rates putting on the brakes.
- Investors in listed funds wake up to fundamentals.
- Office rentals still haven't taken off convincingly.
- Industrial boom far from over.
- Small-town houses offer the best yields.
- Building contractors' growth in profit margins slows.

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 2006:3) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2006:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	18,8	12,4
Pretoria	4,1	-1,4
Durban	14,8	8,6
Cape Town	1,0	-4,5
Prime decentralized office rentals		
Sandton CBD	10,6	4,7
Randburg Ferndale	12,7	6,6
Brooklyn/Waterkloof (Pta)	15,3	9,1
Hatfield	15,0	8,9
Berea (Durban)	20,1	13,7
La Lucia Ridge	15,7	9,5
Claremont (CT)	6,8	1,1
Tyger Valley	-0,9	-6,2

* 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 2006:3* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	10,7	4,8
East Rand	12,9	6,9
Pretoria metro	39,6	32,3
Durban metro	19,0	12,6
Cape Peninsula	15,7	9,6
Port Elizabeth	27,8	20,8
House prices (all classes)* **		
Johannesburg metro	16,7	5,9
Pretoria metro	11,9	1,6
Durban metro	11,9	1,6
Cape Town metro	9,2	-0,9
Port Elizabeth	18,6	7,6
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	6,6	0,9
Pretoria metro	-2,9	-8,1
Durban metro	7,0	1,2
Cape Town metro	8,0	2,5
Port Elizabeth	9,5	3,6

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Capitalization rates

During the third quarter of 2006, capitalization rates of all property types showed resistance to the downtrend of the last few years. This is probably, in no small measure, the result of the recent spate of interest-rate hikes, as well as the expected future hikes.

Notwithstanding this, we don't expect capitalization rates to start moving north any time soon. The main reason for this is a secularly low inflation (and, hence, interest-rate) environment, coupled with the anticipation of strong real rental growth.

Hurdle and escalation rates

Depending on the property type and, to a lesser extent, the location, investors require a total return of between roughly 14% and 17% in order to induce them to invest in a property. Low-risk 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.

Leaseback escalation rates averaged roughly 8% in the reporting quarter. The escalation rate is an attempt by the market to forecast market rentals until the expiry of a lease. Given our expectation of doubledigit rental growth over the next few years, we regard 8% to be quite conservative. The problem is, of course, that many tenants look upon the escalation rate as compensation for consumer inflation, rather than market-rental inflation.

Listed property

A less certain international economic outlook and insecurity regarding short-term interest rates continued to weigh negatively on the listed property sector during the third quarter. Notwithstanding this, the rating of listed property has improved considerably since the middle of 2006. This strengthening was precipitated by the release of some strong results by a number of listed property funds.

Despite the possibility of more interest-rate hikes in the near future, which could again adversely affect listed property's rating, underlying property fundamentals remain strong; that is, building costs are rising, vacancies are falling, and prospects for economic growth remain rosy. Thus, in the coming months, the risk of future interest-rate hikes should be counterbalanced by robust income-stream growth.

Office rentals

On the whole, nominal grade-A decentralized and CBD-office rentals continued to move north during the third quarter of the year. Prime CBD office rentals were up by a notable 13%, while decentralized office rentals grew by 7% on the same period a year earlier. Building-cost inflation (as measured by the BER BCI) is expected to have grown by 6% over the same period, implying real rental growth of roughly 7% and 1% for prime-CBD and decentralized-office rentals respectively.

Industrial market

Despite rising interest rates and the expectation of a slowdown in world growth, economists are still quite optimistic about the growth prospects for the local economy. Drivers are the planned infrastructural investments by Government, the weaker rand and bright prospects for hard-commodity prices.

One of the industries benefiting most from the depreciation of the rand is manufacturing, which has seen an increase in seasonally-adjusted sales orders, output, and employment, according to the October 2006 Investec Purchasing Managers Index.

Continued rigour from the demand side, coupled with the high cost of constructing new industrial space, is expected to keep industrial rentals under pressure in the foreseeable future.

In the third quarter of 2006, nominal rentals in Port Elizabeth (28%), Durban (19%), the Cape Peninsula (16%) and the Central Witwatersrand (11%), were substantially up on the same period a year earlier.

Nominal industrial stands in all of the major industrial areas also continued to grow robustly during the third quarter. This was fuelled by low industrial vacancies, strong demand and growing rentals, as well as a claimed shortage of serviced industrial land.

Flat rentals

Flat rentals in all of the major metropolitan areas, except for Durban, grew faster than consumer inflation over the last two years. In Johannesburg, Pretoria, Cape Town and Port Elizabeth, flat-rental growth averaged between 7% and 10% p.a. Although Durban recorded a growth rate just shy of 3,5% p.a. over the last two years, its performance over the last five years (11% p.a.) was second only to Port Elizabeth (13% p.a.).

The house market

In October 2006, national house prices were, depending on the index you prefer, 8 or 13% higher than they were a year earlier. House-price growth has been decelerating consistently since its peak in late 2004, and is expected to remain under pressure in the foreseeable future, due to affordability constraints.

According to Rode's house-price indices, lower-priced houses have been growing faster than middle- and upper-priced houses since 2004. This was, of course, the result of the latter categories growing faster in the immediately preceding years, which led to increasing unaffordability. The relatively stronger performance of lower-priced houses is confirmed by the FNB Residential Property Barometer for 2006:4, which shows that during the last year houses priced under R500.000 performed much better than their more pricey counterparts.

The building industry

Residential building activity remained robust during the first half of the year, and all signs are that medium- to high-density residential developments will keep activity in this market healthy. Non-residential building activity also showed satisfactory growth, and we expect activity in this segment to accelerate during 2007.

However, during the third quarter, the BER BCI (6%) is expected to have grown by less than the Haylett index (9%), implying that keen competition (i.e. less work) forced contractors to reduce their profit margins. Given the strong momentum still inherent in the residential property market, and with office and industrial building activity expected to continue growing, this should be viewed as a temporary phenomenon. Strong infrastructure investment over the next few years will be another factor that will keep contractors working at full capacity and, hence, enable them to stretch their profit margins again.

Absa's BCI shows that residential building-cost inflation was 10,3% during the third quarter of 2006, which is slightly higher than the expected growth of the Haylett index (9%). This suggests that residential contractors were still growing their profit margins during the third quarter. What is of importance, however, is that the rate at which contractors are able to stretch their profit margins has been decreasing since 2004, and continued to do so during the reporting quarter. ■