State of the property market in quarter 4 of 2006

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

- Cap rates take a breather.
- Listed property's comeback.
- Office market accelerates but Cape Town still in doldrums.
- Industrial boom still on.
- House-price deceleration takes a break.
- Building contractors remain optimistic.

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 2006:4) with that collected a year earlier.

Table 1.1
The property market at a glance at quarter 2006:4*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	16,6	9,4
Pretoria	6,4	-0,4
Durban	18,9	11,4
Cape Town	0,0	-6,3
Prime decentralized office rentals		
Sandton CBD	11,3	4,2
Randburg Ferndale	4,7	-1,8
Brooklyn/Waterkloof (Pta)	22,7	15,0
Hatfield	10,9	3,8
Berea (Durban)	21,9	14,2
La Lucia Ridge	19,1	11,6
Claremont (CT)	10,3	3,3
Tyger Valley	5,0	-1,7

* 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 2006:4* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	16,9	9,4
East Rand	17,1	9,7
Pretoria metro	41,2	32,3
Durban metro	22,8	15,0
Cape Peninsula	14,8	7,6
Port Elizabeth	40,0	23,7
House prices (all classes)* **		
Johannesburg metro	18,7	6,6
Pretoria metro	17,5	5,5
Durban metro	10,5	-0,8
Cape Town metro	8,8	-2,3
Port Elizabeth	28,5	15,4
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	12,8	5,7
Pretoria metro	-4,8	-10,8
Durban metro	7,6	0,8
Cape Town metro	3,9	-2,6
Port Elizabeth	8,8	2,0

* Unless otherwise specified

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Capitalization rates

Capitalization rates of all property types have been on a secular downtrend since 2003; however, a spell of interest-rate hikes in the latter half of 2006 resulted in some resistance to this trend, including a slight rise. Nonetheless, the up-tick in capitalization rates could be viewed as a cyclical upward fluctuation and, hence, we do not expect capitalization rates to start moving significantly north in the future. Furthermore, capitalization rates should be kept at bay by the market's anticipation of robust real rental growth.

Hurdle and escalation rates

Depending on the property type and, to a lesser extent, the location, investors required a minimum total return of roughly 15% to 16%, in the reporting quarter, to induce them into purchasing non-residential property. Given that capitalization rates for prime decentralized office property, for example, are currently standing at about 9 to 10%, this hurdle rate implies that investors expect capital appreciation of about 6% p.a. over the next 5 years.

Leaseback escalation rates are currently stalling around the 8% mark. The reader will recall that the escalation rate is an attempt by the market to forecast market rentals until the expiry of a lease. An escalation rate of 8% isn't all that high given our expectation of double-digit rental growth over the next few years.

Listed property

During the latter part of 2006, PUT income yields rebounded from the beating they took during the middle of the year and are currently around the 6% mark. The fact that yields are at a 2 percentage point discount to long-bond yields is indicative of the market buying into the idea that fundamentals are strong and solid income growth is on the horizon. These sentiments have recently been given substance by PLS funds such as ApexiHi, Resilient, Hyprop and Growthpoint, reporting distribution growth of 15 to 20%.

Office rentals

In general, nominal grade-A CBD and decentralized office rentals sustained their positive trend during the final quarter of 2006. Nationally, prime CBD office rentals were up by 13% on the same period a year earlier, while prime decentralized office rentals increased by 12%. For the reporting quarter, building-cost inflation (as measured by the BER BCI) and building-input-cost inflation (as measured by the Haylett index) are expected to have grown by 7% and 11% respectively. This, of course, implies *real* rental growth for the CBDs and decentralized nodes when deflated by either of these indices.

Industrial market

During the last quarter of 2006, industrial rentals in all the major industrial conurbations continued to grow vigorously. Nominal rentals in the Central Witwatersrand (17%), Durban (23%), the Cape Peninsula (15%) and Port Elizabeth (32%), were all substantially up on the same period a year earlier. As building-cost inflation (as measured by the BER BCI) is expected to have grown by 7% during the fourth quarter, real rentals also continued to point north.

Moreover, the Investec Purchasing Managers index, a leading indicator of manufacturing activity, increased by 2,4 points to 57,2 index points in January 2007. Thus, despite the slowdown in growth experienced in the manufacturing sector at the end of last year, purchasing managers still remain optimistic about future prospects.

Continued strength in manufacturing activity (as well as economic growth in general), together with high building-cost inflation are likely to keep industrial vacancies low and rentals growing during 2007.

Flat rentals

During the last two years, flat rentals grew by roughly 5,5 to 7,5% p.a. in all of the major metros except Durban, where growth averaged below 3% p.a. Over this period, consumer prices grew by roughly 4% p.a.

Evaluating the performance of flat rentals over the last 10 years (10,5 to 11% p.a.), it becomes clear that in the long run the performances of the major metros tend to be similar. Over this period, rentals grew much faster than consumer inflation, resulting in a strong real upswing in rentals.

The house market

According to the latest Standard Bank data, houses prices were 6,9% higher in January 2007 than a year earlier. Absa's figures, however, showed that house prices were 15% up. Of course, these differences relate to methodology and what they respectively measure. What both sets of data have in common is that house-price growth has been moving sideways for the last few months – that is, it's neither decelerating, nor accelerating.

The relationship between new and existing house prices is currently well above the equilibrium level. This situation can be remedied by one of two things happening: house prices will grow slower than building-cost inflation during the next few years, or, in the unlikely event of the economy screeching to a halt, house prices can tumble. The most likely scenario is that house-price growth will slow down in 2007, while building-cost growth will remain robust. In this regard, it should be borne in mind that the effect of interest-rate hikes takes about nine months to be reflected in prices.

The building industry

Non-residential and residential building activity continued to grow robustly during the third quarter of 2006. Moreover, the Medium-Term Forecasting Associates' (MFA) *Qualitative Leading Indicator for the SA Building Industry* showed that, despite the interest-rate hikes, building contractors were still optimistic about the prospects for the building industry during the fourth quarter. The index is based on 24 BER business survey variables and includes the confidence levels of building contractors and sub-contractors, their workloads, employment and profitability trends, the availability of labour and materials, and the degree of competition in tendering.

In the fourth quarter of 2006, the Haylett index is expected to have grown by 11% year-on-year. According to MFA, the sharp increase in the Haylett index cannot only be attributed to buoyant demand conditions, but also to a combination of higher oil prices, a weaker rand exchange rate, and higher materials prices. The BER BCI, on the other hand, is expected to have grown by 7% during the fourth quarter, which implies that contractors' profit margins have been contracting. The latter conclusion is supported by the latest BER building-and-construction surveys that show that tendering competition amongst building contractors has increased.

As far as residential building costs are concerned, Absa's BCI shows that residential building-cost inflation was up by 11% during the last quarter of 2006, which is equal to the expected growth rate of the Haylett index over the same period. This suggests that residential contractors are no longer stretching their profit margins. In fact, residential contractors' profit margins have been decelerating since 2004, and even moved into negative territory during the third and fourth quarters of 2006.■