# State of the property market in quarter 1 of 2007

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

- Cap rates on an even keel.
- Double-digit income-stream growth for listed funds.
- Cape Town and Pretoria office markets battle to turn the corner.
- Industrial rentals still steaming ahead.
- House prices still showing little impact of interest-rate hikes.
- Residential contractors' profit margins are contracting.

## 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 2007:1) with that collected a year earlier.

**Table 1.1**
**The property market at a glance at quarter 2007:1***
**% growth on four quarters earlier (on smoothed data)**

| | Nominal | Real** |
|---|---|---|
| **Prime CBD office rentals** | | |
| Johannesburg | 20,8 | 10,0 |
| Pretoria | 5,1 | -4,3 |
| Durban | 11,1 | 1,1 |
| Cape Town | -0,2 | -9,2 |
| **Prime decentralized office rentals** | | |
| Sandton CBD | 22,6 | 11,7 |
| Randburg Ferndale | 7,9 | -1,8 |
| Brooklyn/Waterkloof (Pta) | 11,5 | 1,4 |
| Hatfield | 10,4 | 0,5 |
| Berea (Durban) | 17,5 | 7,0 |
| La Lucia Ridge | 15,6 | 5,2 |
| Claremont (CT) | 5,2 | -4,2 |
| Tyger Valley | 9,2 | -0,6 |

* 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)<br>The property market at a glance at quarter 2007:1*<br>% growth on four quarters earlier (on smoothed data) | | |
|---|---|---|
| | Nominal | Real** |
| **Prime industrial rentals (500m² units)** | | |
| Central Witwatersrand | 23,1 | 12,1 |
| East Rand | 22,5 | 10,3 |
| Pretoria metro | 35,3 | 23,1 |
| Durban metro | 19,4 | 8,6 |
| Cape Peninsula | 14,8 | 4,4 |
| Port Elizabeth | 35,1 | 23,0 |
| **House prices (all classes)*** ** | | |
| Johannesburg metro | 19,0 | 6,0 |
| Pretoria metro | 17,9 | 5,0 |
| Durban metro | 9,0 | -2,9 |
| Cape Town metro | 9,6 | -2,4 |
| Port Elizabeth | 22,0 | 8,6 |
| **Flat rentals (standard quality, 2-bedroom)** | | |
| Johannesburg metro | 10,5 | 0,6 |
| Pretoria metro | 6,8 | -2,7 |
| Durban metro | 10,6 | 0,6 |
| Cape Town metro | 3,9 | -5,4 |
| Port Elizabeth | 10,3 | 0,4 |

* 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

A less certain interest-rate outlook resulted in a marginal weakening (i.e. increase) of capitalization rates in the latter half of 2006. However, survey data for the first quarter of 2007 shows a marginal strengthening of capitalization rates. This strengthening was more notable and widespread in the shopping-centre and industrial markets than in the office market. This positive movement is consistent with the fact that the market not only expects the low-inflation and low interest-rate climate to persist, but also that income streams are likely to continue growing robustly. (The current spike in short interest rates should be viewed as a little spike in the otherwise structurally low-inflation environment.)

## Hurdle and escalation rates

Our data suggests that property investors base their calculation on a total return ranging from roughly 15% to 18,5%.

Over the last few years, regional-shopping-centre hurdle rates have descended much faster than office hurdle rates. Over the last few quarters, however, regional-shopping-centre hurdle rates ticked up significantly. As a result, regional shopping-centre and office hurdle rates have converged. Perhaps this is some indication that investors are seeing relatively more risk in the shopping-centre market over the next few years. This is not inconceivable, as shopping centres' best performance is probably behind us.

The general rise in hurdle rates over the past year tells us that the opportunity cost of not owning property has risen — in line with bullish expectations regarding cash-flow growth. Thus, in a viability study, accelerating cash flows would be offset by a hike in the hurdle rate.

The average leaseback escalation rate was once again around the 8% mark. The reader should note that the escalation rate is an attempt by the market to forecast market rentals until expiry of a lease. Hence, given our buoyant prospects for rental growth over the next few years, the current leaseback escalation rate may just turn out to be on the low side. Having said that, ten years is a long period.

## Listed property

During the month of March, PUT income streams grew at a double-digit rate of roughly 14% over the same month a year earlier. More revealing, however, is the fact that PUT income streams last recorded double-digit growth more than a year ago. This, of course, could be indicative of the fact that the strong fundamentals currently inherent in non-residential property are starting, once again, to filter through to the income streams of listed funds.

More good news for the listed property sector is that income historic yields managed to stay close to the 6% mark since the beginning of the year. Two factors could have contributed to this, viz stable long-bond rates and bullish prospects for fundamentals.

## Office rentals

Nominal grade-A decentralized and CBD office rentals continued to march north during the first quarter of 2007. Both decentralized and CBD office rentals for grade-A office space were up by 15% on the same period last year. Building-cost inflation (as measured by the BER BCI) is expected to have grown by 10% over the same period, implying *real* rental growth of roughly 5% for prime decentralized and CBD office rentals.

## Industrial market

Manufacturing activity remained strong during the first quarter of 2007, mainly as a result of a somewhat weaker rand exchange rate and buoyant domestic demand conditions. For the month of February, manufacturing production grew by 7,2% year-on-year, up by 1,5% from its downwardly revised growth rate of 5,7% in January. Furthermore, purchasing managers are still optimistic about the future prospects for the manufacturing industry. The Investec Purchasing Managers index, a leading indicator of the health of the manufacturing sector, increased in March by 3,3 points to 60,5 from 57,2 in January.

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

## Flat rentals

Flat rentals in all of the major metropolitan areas grew faster than consumer inflation over not only the last two and five years, but also over the last decade. This means that investors had a ball, not only reaping solid income growth (and returns), but also experiencing strong capital growth with the recent residential boom.

Over the last two years, flat rentals in the Johannesburg metro grew by 5,3% p.a., in Pretoria by 4,6%, Durban metro by 4,5%, and the Cape Town metro by 4,9%. The Port Elizabeth metro was the top performer with flat-rental growth of 6,7% p.a. over the last two years (refer to **Table 13.1** in the *Rode's Report on the SA Property Market* 2007:2).

It is worth noting that, over the longer period of ten years, rentals performed on a par with the BER Building-Cost Index.

## The house market

In May of this year, national house prices were roughly 15% higher then they were a year earlier, according to the latest Absa data. Standard Bank's figures show that national house prices grew by about 11% over the same period. Interestingly, Absa's method of tracking mean house prices shows that house prices were in May 0,8% higher than the month before. Standard Bank's method of tracking median sales, showed 3% growth over the previous month.

Standard Bank attributes the relatively robust house price growth recorded in May to be as a result of pre-emptive actions, by some of the players in the market, prior to the implementation of the National Credit Act (NCA). Therefore, the strong growth rate is not necessarily a true reflection of the fundamentals driving the property market.

## The building industry

Non-residential and residential building ac-ativity grew vigorously in 2006, which in turn also resulted in strong building-cost inflation over the year. For 2007, we expect more of the same. Residential building activity will most likely not grow as much as it did over the last couple of years; but non-residential building activity is expected to accelerate somewhat as the long non-residential property cycle enters its upswing phase.

Our optimism for building activity is supported by Medium-Term Forecasting Associates' *Composite Leading Indicator for the SA Building Industry (CLIBI)*. In the reporting quarter, the index closed at 62 points, meaning that 62% of the respondents are still optimistic about building conditions.

For the first quarter of 2007, the Haylett index is expected to have grown by 12% year-on-year. According to MFA, the sharp rise in building-input costs was once again as a result of a number of factors, namely higher oil prices, a weaker rand, higher material prices and buoyant demand conditions.

As far as building costs are concerned, the BER BCI — which measures building-input costs plus the profit margins of contractors — is expected to have grown by 10% during the reporting quarter, implying that non-residential contractors' profit margins are expected to have continued to contract during the reporting quarter. This is the implied situation when input costs (+12%) accelerate faster than contract prices (+10%). Why would contractors' profit margins be shrinking in such a buoyant climate? The only possible explanation we can think of is that supply is catching up with demand— and that is a good sign.

Moving on to residential building costs, Absa's figures suggest that residential building-cost inflation has been on a decline since 2004, which corresponds with the cooling-down stage of the residential cycle. Nonetheless, residential building-cost inflation was still around 11% during the final quarter of 2006, while building-input-cost inflation as measured by the Haylett index also showed a 11% growth rate over the same period.

During the first quarter of 2007, Absa's BCI was still up by roughly 11% on the same period a year earlier. Given that the Haylett index is expected to have grown by about 12%, implies that residential contractors were unable to stretch their profit margins, possibly as a result of increased tendering competition amongst them. In fact, the quarter under review represents the second quarter of contracting profit margins. ■