State of the property market in quarter 2 of 2007

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

- Cap rates are tending south again.
- Johannesburg's office rentals are leading the upswing on the back of low vacancies.
- Office-zoned stands have great investment potential
- The industrial market is still booming
- The house market is still decelerating
- The future belongs to non-residential contractors

Quantitative overview of the property market

Table 1 provides a snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2007:2) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2007:2*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	20,8	8,6
Pretoria	-3,7	-12,9
Durban	2,2	-8,1
Cape Town	22,6	9,4
Prime decentralized office rentals		
Sandton CBD	30,8	17,2
Randburg Ferndale	6,7	-4,1
Brooklyn/Waterkloof (Pta)	19,5	7,0
Hatfield	0,8	-9,4
Berea (Durban)	4,2	-6,3
La Lucia Ridge	7,9	-3,1
Claremont (CT)	4,3	-6,5
Tyger Valley	14,3	2,5

* 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 (continued) The property market at a glance at quarter 2007:2* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	17,0	5,1
East Rand	26,8	13,7
Pretoria metro	28,0	14,9
Durban metro	19,3	7,1
Cape Peninsula	17,3	5,1
Port Elizabeth	28,3	15,1
House prices (all classes)* **		
Johannesburg metro	16,6	4,1
Pretoria metro	16,4	3,9
Durban metro	14,9	2,5
Cape Town metro	9,9	-1,9
Port Elizabeth	11,9	-0,2
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	10,6	0
Pretoria metro	3,2	-6,6
Durban metro	10,0	-0,5
Cape Town metro	2,6	-7,2
Port Elizabeth	2,0	-7,5

* 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

Despite the deterioration in the inflation outlook, and the concomitant rise in short-term interest rates, capitalization rates on all property types continued to strengthen during the second quarter of 2007 — albeit marginally so in most cases. This reflects investors' continued optimism about the income-growth prospects for directly-held property. In relative terms, regional shopping centres still had the lowest capitalization rates, reflecting their relatively more stable income streams and, hence, risk. Offices, especially those in the derelict CBDs, still had the highest capitalization rates, due to their higher risk and weaker income-growth prospects.

Hurdle and escalation rates

During the second quarter — depending on the property type and, to a lesser extent, the location — investors required a hurdle rate of roughly 11,5% to 15,2% to entice them into pur-

chasing a prime non-residential property. The hurdle rates on the lower side of the range seem a bit on the low side given the optimistic prognosis for income-stream growth.

Leaseback escalation rates have been staying close to the 8% mark since early 2005, and the second quarter of 2007 was no exception. Given our forecasts of robust market-rental growth over the next few years, many landlords currently signing lease agreements at market escalation rates may find their properties being under-rented in the next few years.

Listed property

Property Loan Stock (PLS) income yields weakened slightly during the second quarter of 2007 and averaged 6,2%. Despite the volatility on the JSE, PLS stocks held up well and historic yields were around 6,3% by the end of August. This reflects the market's perception that fundamentals in the non-residential property market are still very much intact.

The recent spate of interest-rate hikes is generally believed to be cyclical (as opposed to structural) in nature, while the prospects for rental growth are still as rosy as ever. As a result, we expect listed yields to remain in close proximity to their current rates during the latter half of this year. This, of course, implies that capital returns will mainly be driven by income growth rather than by a change in market rating.

Office rentals

Office rentals in Johannesburg decentralized seem to be leading the much-anticipated upswing in the office-property cycle. During the second quarter of 2007, rentals in Johannesburg decentralized were, on the whole, up by 20% on the same period a year earlier, which is much higher than projected building-cost inflation (12%) over the same period. Cape Town decentralized (9%) and Durban decentralized (10%) also put on a fair show, but Pretoria decentralized disappointed by showing hardly any growth over the last year.

On the CBD front, nominal rentals in most of the major CBDs moved sideways during the last year. An exception was the Cape Town CBD, which, after moving sideways for most of the last year, jumped by 20% year on year during the reporting quarter. The result is declining *real* rentals in all of the CBDs with the exception of Cape Town.

Industrial market

Robust growth in building costs and land values, coupled with low vacancy rates and ravenous demand, pushed industrial rentals even further north during the second quarter of 2007. Industrial rentals in Port Elizabeth (28%), Durban (19%), the Cape Peninsula (17%) and the Central Witwatersrand (17%) were all significantly up on the same period a year earlier. What's more, building-cost inflation (as measured by the BER Building Cost Index) is expected to have grown by 12% over the same period, which translates into real–rental growth in all of these industrial areas.

Industrial vacancies in most of the major industrial regions pointed downwards during the reporting quarter. And although Durban's showed an uptick, its vacancy rate was still the lowest in the country.

As a result of fast-growing rentals, industrial stand values in the Cape Peninsula (103%) and Durban (112%) have more than doubled during the last year. Likewise, stand values in Port Elizabeth (85%) and Central Witwatersrand (75%) grew at a rate more than double that of rental growth over the same period.

Flat rentals

Over the last 10 years, the *compound* growth in flat rentals was about double that of consumer-price inflation. More specifically, flat rentals in all of the metros — i.e. Port Elizabeth, Johannesburg, Durban, Pretoria and Cape Town — recorded compound growth rates of 10 to 11% per annum, whereas consumer inflation only measured around 5% per annum. However, with building-cost inflation over the last decade at 11% per annum, it is not surprising that developers hardly ever build flats to rent — the income yields are too low. Flats' performance was unimpressive during the last two years, as rentals did not manage to keep up with either consumer or building-cost inflation.

The house market

It is a well-reported fact that houses at the lower end of the market still have more steam than those at the upper end. Notwithstanding this, lower-priced houses are also losing momentum and, arguably, the extent to which this market still offers value has been exaggerated by some. The reason for this is that buyers are increasingly feeling the combined effect of extraordinary house-price growth relative to disposable-income growth, and, more recently the impact of increased interest rates — i.e. affordability is placing a constraint on growth. We expect to see a sharp downswing in real (building-cost-inflation adjusted) house prices — all categories — over the next few years.

The building industry

Despite its deceleration over the last several quarters, new *residential* building activity was still up by some 9% on a year earlier during the first quarter of 2007. This is remarkable, given the high base from which it is growing. However, higher interest rates, declining house-price growth, and more stringent lending criteria, are likely to see growth decelerate further during the next few years. But the real star was non-residential building activity, which accelerated at a rate of 18% over the same period. Strong expenditure from Government, the current upswing in the office property cycle, and the continued strength in industrial building activity, are set to drive non-residential building activity even higher.

As far as building-cost inflation is concerned, during the second quarter of this year, the Haylett index — which measures building-input costs only — was 12% higher than a year earlier. Over the same period, the Absa BCI, which includes contractors' profit margins, grew by roughly the same rate, which implies that residential contractors are no longer stretching their profit margins. During the next year or more residential contractors will probably start *contracting* their profit margins as tendering competition gets fiercer during the downswing phase

of the residential property cycle. Non-residential building-cost inflation, as measured by the BER BCI, was also 12% higher than a year earlier. The fact that this index has again caught up with the Haylett index, after lagging it the previous two quarters, shows that non-residential contractors may start stretching their profit margins again soon — a situation that we see continuing for the rest of the year. ■