State of the property market in quarter 3 of 2007

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

- Cap rates' mixed reaction to interest-rate hikes.
- Top decentralized office nodes show strong nominal growth.
- Industrial *real* rental upswing phase now strongly entrenched.
- Industrial stand values continue to surge.
- House prices still growing at double-digit rates; but for how long?
- Non-residential contractors more upbeat about future building conditions than their residential counterparts.

Quantitative overview of the property market

Table 1.1 provides a snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2007:3) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2007:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	30,3	16,5
Pretoria	11,6	-0,2
Durban	1,9	-9,1
Cape Town	44,1	28,6
Prime decentralized office rentals		
Sandton CBD	24,3	10,6
Randburg Ferndale	17,2	4,8
Brooklyn/Waterkloof (Pta)	13,7	1,5
Hatfield	13,1	0,9
Berea (Durban)	4,7	-6,6
La Lucia Ridge	10,0	-1,9
Claremont (CT)	12,0	-0,1
Tyger Valley	14,1	1,6

* Unless otherwise specified
** Nominal values deflated by BER Building Cost Index. However, house prices are deflated using the Haylett index.

Table 1 (continued) **The property market at a glance at quarter 2007:3*** **% growth on four quarters earlier (on smoothed data)**		
	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	27,7	13,9
East Rand	23,5	10,1
Pretoria metro	11,4	-0,8
Durban metro	18,4	5,7
Cape Peninsula	21,2	8,0
Port Elizabeth	25,4	11,7
House prices (all classes)* **		
Johannesburg metro	12,4	2,8
Pretoria metro	16,6	6,7
Durban metro	19,7	9,5
Cape Town metro	11,0	1,5
Port Elizabeth	11,3	1,7
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	11,9	-0,0
Pretoria metro	10,2	-1,8
Durban metro	13,8	0,8
Cape Town metro	5,4	-6,6
Port Elizabeth	-2,9	-13,4

* 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

The recent flurry of interest-rate hikes seems to have resulted in some mixed capitalization rate reactions, as our research for the third quarter of 2007 shows. Capitalization rates on some property types, in particular community and neighbourhood shopping centres, showed marginal increases from their previous-quarter levels. In contrast, regional-shopping-centre and office and industrial capitalization rates, generally, moved sideways or south. Nonetheless, our overall view remains that the market's anticipation of robust real rental growth, especially in the office and industrial markets, should keep capitalization rates from moving significantly north in the future.

Hurdle and escalation rates

Our latest survey results suggest that — depending on the property type and, to a lesser extent, the location — property investors base their present-value discounting calculation on a hurdle rate of roughly 15%.

Regarding escalation rates, our data shows that during the third quarter of 2007 market escalation rates on leaseback rental contracts averaged around the 8,4% mark. The standard deviation of 1%, however, suggests that leaseback escalation rates can be as low as 7,4% or as high as 9,4%. Given the rosy prospects for market-rental growth over the next few years, even the upper limit escalation rate of 9,4% may still turn out to be on the low side.

Listed property

Financial market uncertainty, as a result of the sub-prime mortgage-bond ignominy, a deteriorating short-term inflation outlook and higher interest rates, weighed equities down during the reporting quarter. Nonetheless, listed property shares remained resilient despite all of this, with income yields moving sideways and remaining around the 6% mark over the period.

In spite of the likelihood of more interest-rate hikes in the near future, which might adversely affect market ratings, and hence, listed property unit prices, underlying non-residential property fundamentals are expected to remain strong. That is, building costs should continue to rise, vacancies remain low and the economy should continue to record satisfactory growth, which all bodes well for rental and, thus, income-stream growth.

Office rentals

Prime office rentals in most of the country's top decentralized office nodes showed strong double-digit nominal growth during the third quarter of the year. What's more, this growth was in excess of building-cost inflation (as measured by the BER Building Cost Index), which is expected to have grown by roughly 9,6%. Interestingly, it seems as if Johannesburg and Cape Town decentralized will be leading the pack into the office market boom, with nominal rentals collectively up by 23% and 17%, respectively. On a collective basis, Pretoria and Durban decentralized could only manage nominal growth rates of 6% and 3% respectively.

As far as the CBDs are concernced, nominal market rentals for prime office space in the Johannesburg and Cape Town CBDs were up by a rip-roaring 30% and 44% respectively, resulting in robust *real* rental growth in both these CBDs. In terms of rental levels, our survey results show that average market rentals in the Cape Town CBD were about R95,00/m^2/month, compared to R59,00/m^2/month in the Johannesburg CBD. Thus, there is still a big difference between what the market is willing to pay for prime office space in these two CBDs. The Johannesburg growth is of course off a low base. In the CBD of Pretoria, rentals were, on the back of low vacancies, 12% higher than they were a year ago, while the CBD of Durban could achieve growth of only 2%.

Industrial market

Strong demand for industrial space, coupled with high and robustly growing replacement costs, continued to keep upward pressure on market rentals. Vigorous, 20%-plus year-on-year rental-growth rates were recorded in all of the big industrial areas, barring Durban, where market rentals for prime industrial space were up by 18% on the same quarter a year earlier.

Since building-cost inflation was expected to have grown by 9,6% during the third quarter, solid positive real rental growth was recorded in most of the major industrial conurbations. In fact, real rentals have been moving steadily north since 2005, implying that the industrial upswing phase is now entrenched. This is, of course, good news to developers for the viability of new industrial developments.

During the reporting quarter, vacancies in the foremost industrial areas remained low. On our vacancy scale of 1 to 9, Durban scored 1,2 (which we estimate is roughly equivalent to 0,7%); Central Witwatersrand scored 1,5 (roughly 2,5%); the Cape Peninsula scored 2 (about 3,5%) and Port Elizabeth had the highest score of 2,2 (about 4,1%).

Flat rentals

Although flat vacancies continue to be very low across all of the regions, there is still no magic in terms of rental growth. During the last two years, flat rentals grew by about 9% p.a. in the Durban metro and by roughly 7% p.a. in the Johannesburg metro. In the metropolitan areas of Pretoria, Cape Town and Port Elizabeth, two-year compound growth rates of more or less 4% p.a. were recorded. Over the same period, consumer inflation was just short of 6% p.a. and, hence, only landlords in Durban and Johannesburg could achieve real rental growth.

The house market

Despite the general consensus of a cooling-off of the residential property market, national house prices still continued to grow by double-digit rates during the month of October 2007. According to Absa, national house prices were in October still about 14% higher than they were a year ago, while Standard Bank's house-price index recorded a growth rate of 10%.

House-price growth has, in general, been trending south since its peak in 2004, and is expected to remain under pressure in the foreseeable future, largely due to the affordability constraint. Furthermore, the lagged effect of continued higher interest rates and now tighter borrowing requirements through the National Credit Act should dampen the demand for housing, which could result in house-price growth of less then 10% in the not too distant future.

The building industry

Building activity in the residential and, especially, non-residential sector continued to grow energetically in the second quarter of the year, which in turn kept building-cost inflation growing strongly. Over the next few months, however, we expect most of the activity to take place on the non-residential side, as the long commercial property cycle resumes its upswing phase,

making the development of new commercial buildings more viable. Our view of non-residential building activity is corroborated by surveys conducted by the Bureau for Economic Research (published by Medium-Term Forecasting Associates), which shows that non-residential contractors are more optimistic about future building conditions than their residential counterparts.

Concerning building-cost inflation, the BER Building Cost Index — which measures building-input costs plus the profit margins of non-residential contractors — is expected to have grown by 9,6% during the reporting quarter. The Haylett index, which only measures building-input costs, is expected to have grown by 9,4%. Of course, the insignificant difference between these two indices means that contractors were unable to stretch their profit margins much during the reporting quarter. ■