State of the property market in quarter 4 of 2007

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

- Higher risk brought on by electricity shock might soon be reflected in capitalization rates.
- Pretoria and Durban decentralized office rental growth lagging behind.
- Industrial rentals continue to grow fervently.
- Exceptional growth of industrial stand values sustained by industrial rental's leveraging effect
- People of colour dominating lower-priced house market
- Non-residential building ambitions cooling off as well

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 2007:4) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2007:4*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	25,4	9,8
Pretoria	25,8	10,0
Durban	-2,0	-14,1
Cape Town	26,6	10,6
Prime decentralized office rentals		
Sandton CBD	23,8	8,0
Randburg Ferndale	25,7	9,8
Brooklyn/Waterkloof (Pta)	4,5	-8,4
Hatfield	15,5	1,1
Berea (Durban)	-6,4	-18,1
La Lucia Ridge	7,6	-5,7
Claremont (CT)	16,1	1,4
Tyger Valley	15,9	1,1

* Unless otherwise specified ** Based on Absa's house price indices
*** 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 2007:4* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500m^2 units)		
Central Witwatersrand	29,5	13,2
East Rand	23,6	7,9
Pretoria metro	4,8	-8,4
Durban metro	14,1	-0,2
Cape Peninsula	24,4	8,7
Port Elizabeth	21,7	6,4
House prices (all classes)* **		
Johannesburg metro	8,9	0,2
Pretoria metro	12,3	3,3
Durban metro	14,6	5,4
Cape Town metro	11,6	2,7
Port Elizabeth	9,2	0,5
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	13,4	-0,8
Pretoria metro	11,9	-2,0
Durban metro	13,3	-0,9
Cape Town metro	7,1	-6,4
Port Elizabeth	0,1	-12,5

* Unless otherwise specified ** Based on Absa's house price indices
*** Nominal values deflated by BER Building Cost Index. However, house prices are deflated using the Haylett index.

Capitalization rates

In the fourth quarter of 2007 the market's rating of directly-held property continued to strengthen somewhat, this despite a further deterioration in inflation and the two 50-basis-point interest-rate hikes. This optimism towards directly-held non-residential property was reflected in our capitalization rate survey results, which, barring slight upticks in industrial capitalization rates, generally still showed marginal declines from their previous-quarter levels.

But since the electricity crisis in January 2008, the investor now has to consider the implications for the economy and, hence, the property market, because of the possibility of shifting investor expectations.

Should economic growth in SA turn out to be notably lower than previously predicted, the demand for space might decelerate in tandem, and with new stock already in the pipeline coming onto the market over the next year or two, property vacancies will inevitably increase. This will increase the risk of holding property, which will force investors to require higher minimum income returns (cap rates) on property
.

On the supply side, however, the electricity shortages will also lead to a slowdown in the development of new stock with a lag of about one year. The constraint on the supply of new space, might keep the vacancy levels of existing buildings from heading north too quickly, assuming that the economy can still muster growth of about 2-3% p.a. This could, in turn, prevent investors from becoming overly pessimistic with regard to what they will be willing to pay for existing buildings.

Hence, the power crisis's impact on the market's rating of physical properties depends on which of the two impacts, the demand side or the supply side, will be greater. The risk has certainly jumped — and might soon be reflected in capitalization rates.

Hurdle and escalation rates

Notwithstanding the deteriorating inflation outlook, and soaring interest rates, hurdle rates also continued to strengthen (decrease) over the last few quarters. This is, of course, as a result of the expectation of a major non-residential rental boom, which is keeping hurdle rates of non-residential property downwardly biased. Our survey results for the fourth quarter of 2007 suggest that property investors would be happy to use a discount rate (hurdle rate) of about 15% to determine the present value of an income-producing non-residential property.

Again, since the electricity crisis in January 2008, investors now also have to consider the possible demand- and supply-side impacts of this on the future cash flows when holding property, which will influence this minimum required total return or hurdle rate.

Listed property

After moving below 6% during the beginning of the fourth quarter of 2007, listed property income yields edged above 6% again during the last two months of last year, resulting in a decline in listed property price growth over this period. This negative sentiment was felt all over the equities market, brought about by fears of a global economic slowdown, international financial market uncertainty, and deteriorating inflation and higher interest rates locally. Of more concern, however, is the fact that listed historic yields were, as at the time of writing this article, around the 7% mark, indicating increased negative sentiment towards indirectly-held property.

Despite the weakening market perceptions towards listed property, listed property yields are still trading at a discount of roughly 2 percentage points to long-bond yields, which is indicative of the market buying into the idea that fundamentals are strong and that solid income growth is still on the horizon.

Office rentals

While market rentals in the decentralized office nodes of Johannesburg and Cape Town continued to show strong growth, in Pretoria and Durban decentralized the rental performances were less impressive.

In the fourth quarter of 2007, rentals in Johannesburg and Cape Town decentralized were, on the whole, up by as much as 20% on the same period a year earlier, and easily in excess of the expected building-cost inflation rate of 15%. Pretoria decentralized put in a fair show by growing by 10%, while in Durban decentralized market rentals were down by 5% on the same period a year earlier.

Nominal rentals in all of the CBDs, except for the Durban CBD, showed robust double-digit, building-cost-inflation beating growth in the reporting quarter. In the CBD of Cape Town, nominal rentals were as much as 27% higher than they were a year earlier, resulting in growth averaging roughly 20% for the calendar year of 2007. The CBDs of Pretoria and Johannesburg followed, with growth rates of 26% and 25% respectively, but growing off low bases of course. In the CBD of Durban, market rentals for prime office space were roughly 2% lower than a year ago.

We believe that the Eskom moratorium on electricity certificates for new developments has the potential to support the rental growth in a year from now. This is so because it will constrain the new supply whereas demand might still grow — albeit at a more mundane pace.

Industrial market

Notwithstanding a slowdown in manufacturing towards the end of 2007, prime industrial space was still hard to come by, which, combined with high replacement costs, resulted in sustained fervent industrial-rental growth. Replacement costs consist, of course, of the cost to construct the building and the cost of the stand.

Of concern, however, is the fact that the interruptions in power supply have already started to impact on the mood of local manufacturers. As at January 2008, the Investec PMI (a leading indicator of the health of the manufacturing sector) was down by more than 2 basis points from its previous month's level, with the main cause of the drop being a notable deterioration in expectations in the manufacturing industry, partly as a result of the power interruptions. Of course, sustained pessimism amongst manufacturers does not bode well for the sector, and consequently, for industrial vacancies and market rental growth.

During the fourth quarter of 2007, nominal rentals in the Central Witwatersrand (30%), the Cape Peninsula (24%), Port Elizabeth (22%), and Durban (14%), were once again noticeably up on the same period a year earlier. But all these were pre-Eskom, and the risk for all concerned is substantially higher today.

Having said that, the Eskom moratorium on electricity certificates for new developments should in a year's time also constrain the new supply of industrial space significantly — thereby supporting rental levels, even should the economy decelerate sharply.

Flat rentals

After a decade of impressive, inflation-beating growth, flat rentals performed disappointingly over the last two years.

Over this period, rentals in only Johannesburg and Durban were able to record growth in excess of consumer inflation. Thus, in the other metropolitan areas of Cape Town, Pretoria and Port Elizabeth, the *real* value of flat rental income was somewhat lower than what it was a year ago. This is, of course, disappointing news to owners of flats in these three metros, since it means that over the last two years the purchasing power of their rental income actually diminished. In other words, they can now buy fewer goods and services from their rental moneys then they could two years ago.

The house market

An interesting analysis of the racial profiles of home-buyers, shows that black buyers are currently dominating the lower-priced segment (houses up to R 700.000). The FNB Barometer survey reveals that during the fourth quarter of 2005, 36% of the houses in lower-priced areas were bought by black buyers, and during the fourth quarter of 2007, this had increased to more than 50%.

Fascinatingly, Rode's lower-priced HPI, which also measures the movement of prices for houses up to R 700.000, similarly showed a sharp acceleration in price growth between 2001 and 2005. Apart from the fact that the economy was growing steadily over this period, the robust price growth can, most likely, also be attributed to an increase in demand for houses in this segment, brought on by an influx of people of colour into the lower-class segment.

Regarding the latest house-price data, it seems that price inflation continues to be constrained by the increased unaffordabi-lity of houses, compounded by higher interest rates and stricter financing requirements. According to Absa, national houses prices were in February 2008 only 9% higher than the corresponding month a year earlier, while Standard Bank's data showed that there was no growth (0%) in houses prices over the year to February 2008. This represents the third consecutive month of 0% year-on-year growth in Standard Bank's house-price index. Despite these differing growth rates, what both sets of data have in common is that house-price growth has been decelerating over the past few years.

The building industry

Although residential building activity has been decelerating for some time now, non-residential building activity has, in contrast, been posting higher yearly growth rates. However, evidence in the form of the square meterage of building plans passed seems to be suggesting a possible future cooling-off in activity in both these sectors.

Furthermore, this deceleration in building plans passed was noticed before the January 2008 Eskom electricity shock and before Eskom's moratorium on electricity certificates for new developments, which might further dampen the moods of developers.

Moving onto building-input costs, in the fourth quarter of 2007, the Haylett index is expected to have grown by roughly 9% year-on-year. According to MFA, high oil prices seem to be at the root of the cost inflation of key construction materials, whilst the prevailing shortages in skilled labour are also adding further upward pressure on labour costs.

The BER BCI is expected to have grown by about 15%, calculated on smoothed data, during the fourth quarter, which suggests that contractors were, over this period, still able to stretch their profit margins. However, considering the possibility of diminishing non-residential building activity, which will again increase tendering competition amongst contractors, it is likely that the rate at which contractors are able to stretch their profit margins will decrease. This would most certainly more than cancel out cost-push factors like soaring steel prices.■