State of the property market in quarter 1 of 2008

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

- Industrial-leaseback and shopping-centre capitalization rates feeling the pinch, but no need to panic yet.
- Vacant prime office space remains a rare commodity.
- Industrial stands taking a break from triple-digit-growth rates.
- More heavy blows expected in the residential property market.

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 2008:1) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2008:1*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	22,3	1,7
Pretoria	42,5	18,4
Durban	-4,8	-20,8
Cape Town	27,7	6,2
Prime decentralized office rentals		
Sandton CBD	27,1	5,6
Randburg Ferndale	16,5	-3,1
Brooklyn/Waterkloof (Pta)	9,1	-9,3
Hatfield	14,7	-4,6
Berea (Durban)	18,0	-1,9
La Lucia Ridge	15,5	-4,0
Claremont (CT)	18,9	-1,1
Tyger Valley	9,8	-8,7

* 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 (continued) The property market at a glance at quarter 2008:1* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Central Witwatersrand	27,0	5,6
East Rand	28,0	6,4
Pretoria metro	3,6	-13,9
Durban metro	21,9	1,3
Cape Peninsula	23,6	2,7
Port Elizabeth	14,3	-4,9
House prices (all classes)* **		
Johannesburg metro	10,0	0,7
Pretoria metro	7,7	-1,4
Durban metro	7,4	-1,7
Cape Town metro	7,9	-1,2
Port Elizabeth	10,0	0,7
Flat rentals (standard quality, 2-bedroom)		
Johannesburg metro	38,7	15,3
Pretoria metro	6,8	-11,3
Durban metro	11,2	-7,6
Cape Town metro	2,7	-12,1
Port Elizabeth	9,2	-9,2

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*** Based on Absa's house price indices

Capitalization rates

While capitalization ("cap") rates for prime office property still showed some strength in the first quarter of 2008, capitalization rates on industrial leasebacks and shopping centres seem to have started to feel the pinch of deteriorating investor sentiment. But there's no panic.

Evidence provided by property dealmakers already suggests that for some properties, which were formally valued at 8% cap rates nine months ago, the sellers are now willing to settle at prices equivalent to 9%-plus cap rates. The non-residential property market has been a seller's market since 2003, when declining interest rates, together with listed funds' insatiable demand for non-residential properties, resulted in rising selling prices, and consequently, diving capitalization rates.

Should deteriorating inflation expectations, rising interest rates, a strong de-rating of listed funds and lower economic growth prospects result in weaker investor demand for property,

and hence, lower prices and higher cap rates, the market could turn to being a buyer's one. But, the prospects of strong rental growth could still be the lifeline for sellers' negotiating powers.

Hurdle and escalation rates

Our survey results for the first quarter of 2008 suggest that property investors require a total return (income return plus capital appreciation) of roughly 15% to 15,5% on their property investments.

One of the ways of determining the value of an income-producing property is by discounting the future expected income stream by a required hurdle (opportunity-cost) rate. Thus, the sharp deceleration (or strengthening) in hurdle rates since 2000 serves as an indication of how favourable investor sentiment was towards non-residential properties. This was not only as a result of the fact that the South African economy had just started out on a strong business-cycle upswing (the promise of low vacancies and, hence, good rental growth) but also as a result of the belief in structurally low and stable inflation and interest rates (the promise of lower risk-free opportunity costs).

Should the electricity crisis be perceived as causing increased uncertainty in future cash flows, or should rising inflation expectations and concomitantly rising interest rates result in substitute assets yielding higher returns, investors might soon require higher minimum income and total returns to induce them to acquire directly-held property. A straw in the wind is the sharply deteriorating market rating (de-rating) of listed property funds.

Listed property

Notwithstanding steady income-stream growth, listed-property prices continue to be plagued by weakening market sentiment.

Since the end of last year, historic income yields on listed property weakened (increased) from roughly 6% to above 8% during May 2008. This resulted in price growth averaging -6%, year-on-year, during the first four months of 2008. Over the same period, 10-year bond yields moved up from 8% to almost 10%. Of course, this deterioration in market rating, and the related fall in prices, can largely be attributed to the contagious effect of the current uncertainty in global financial markets and soaring inflation coupled with rising interest rates domestically.

Worsening inflation figures certainly spell more bad news for listed property, as concomitant hikes in interest rates, intended to restrain inflation and inflation expectations, at the same time increases income returns on alternative (substitute) investments like long bonds. Thus, investors now demand higher income returns to hold listed property, leading to price declines.

Office rentals

In the first quarter of 2008, rentals in Johannesburg decentralized were collectively up by 16%, while rentals in Pretoria and Cape Town decentralized grew by 15% over the last year. Market rentals in Durban decentralized showed the poorest growth, growing by only 2% on the same period a year earlier. In contrast, building-cost inflation, as measured by the BER BCI, is

expected to have grown by an astonishing rate of 20%. This implies that none of the decentralized office nodes could, collectively, achieve positive *real* rental growth over the last year.

Industrial market

Industrial rentals in the larger conurbations sustained their robust growth momentum during the first quarter of 2008.

Nominal rentals for prime industrial space in the Central Witwatersrand were up by an impressive 27% on a year earlier, followed by the Cape Peninsula (+24%), Durban (+22%) and Port Elizabeth (+14%). Even though building-cost inflation (as measured by the BER BCI) is expected to have grown by 20% over the same period, we nevertheless still had real-rental growth in all of these industrial areas, barring Port Elizabeth.

Flat rentals

In the first quarter of 2008, there was at last some rental magic in the Johannesburg metro. Year on year, nominal flat rentals in this metro ended on average 26% higher, thereby far exceeding the growth rate in consumer inflation of 9%. However, in the other metros, growth was more pedestrian, with Durban up by 13%, whilst Pretoria, Cape Town and Durban grew by roughly 8%.

Over the last 10 and 5 years, however, the rental performance looks much more impressive, with nominal rentals in all of the major cities growing in excess of consumer inflation. Of course, this implies that over these periods landlords' purchasing power of their nominal rental incomes was actually sustained.

The house market

In May of 2008, national house prices in the middle segment of the market were only 4% higher than a year earlier. More revealing, however, is the fact that house-prices were 0,1% lower than they were the month before. This implies – assuming house prices continue to decline at this rate – a contraction of about 2% over the next twelve months.

But considering that it can take up to three quarters for interest rates to have a significant impact on house prices, the full blow of the October and December 2007 interest-rate hikes, as well as the April 2008 hike, still has to filter through the economic system. Thus, more declines should be expected. We are of the opinion that average prices could contract by up to 10% compared to their peak in December 2007.

The building industry

Cement sales, a good proxy for building-construction activity because only a small percentage goes into civils, seem to be painting a picture of a likely slowdown in the building-construction industry.

Since the beginning of last year, the annual growth in daily cement sales has consistently declined, easing from a yearly growth rate of +16% in January 2007 to -4% in May 2008. Naturally, decelerating cement sales can be interpreted as meaning reduced building activity, which means tighter tendering competition amongst contractors, lower profit margins and ultimately waning building-cost inflation. Non-residential building activity, as represented by *real* gross fixed capital formation (GFCF), was up by an impressive 14% in the final quarter of 2007, while residential GFCF, which has been decelerating since the end of 2005, grew by 6,4%.

As far as building-cost inflation is concerned, in the first quarter of 2008 the BER BCI is expected to have grown by as much as 20%, while the Haylett index is expected to have recorded growth of 9%. This, of course, implies that contractors were still able to widen their profit margins during the last twelve months.

The possibility of dwindling non-residential building activity does, however, imply keener tender prices amongst contractors for the fewer new building projects available. This would lead to tender-price growth at rates similar to building-input-price growth, and ultimately, contracting profit margins.■