State of the property market in quarter 2 of 2008

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

- Cap rates showing a weakening (increasing) trend.
- Office rentals continue to grow impressively.
- *Real* house-price cycle topping in
- Levelling-off in office and industrial building plans passed.

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 2008:2) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2008:2*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	29,8	17,2
Pretoria	58,0	39,6
Durban	8,6	-1,8
Cape Town	10,1	0,3
Prime decentralized office rentals		
Sandton CBD	9,3	-0,8
Randburg Ferndale	17,2	5,7
Brooklyn/Waterkloof (Pta)	22,6	10,9
Hatfield	17,9	6,6
Berea (Durban)	14,2	3,2
La Lucia Ridge	13,6	2,8
Claremont (CT)	42,9	29,5
Tyger Valley	7,5	-2,8

* 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 2008:2*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	18,1	6,9
Pretoria metro	7,8	-2,5
Durban metro	26,6	14,5
Cape Peninsula	17,5	6,5
Port Elizabeth	11,0	0,1
House prices (all classes)***		
Johannesburg metro	5,3	-8,2
Pretoria metro	1,2	-11,8
Durban metro	-7,0	-19,0
Cape Town metro	4,4	-9,0
Port Elizabeth	4,4	-9,0
Flat rentals (standard quality, all sizes)		
Johannesburg metro	9,0	-0,7
Pretoria metro	15,0	3,8
Durban metro	14,0	3,5
Cape Town metro	10,4	-0,1
Port Elizabeth	11,0	0,8

* Unless otherwise specified
** Nominal values deflated by BER Building Cost Index; however, house prices and flat rentals are deflated using the Haylett index and the Consumer Price index respectively.
*** Based on Absa's house price indices

Capitalization rates

In the second quarter of 2008, the expected weakening (rising) trend in capitalization rates, especially those for prime office and industrial property, became more and more evident, now possibly revealing the side-effects of the lagged impact of rising interest rates on capitalization rates.

The reader should remember that capitalization rates are not determined only by interest rates (or yields on alternative assets), but also by investment demand and capital return prospects. Fortunately, when interest rates started to rise in the second half of 2006, property fundamentals were still strong, which meant good prospects for capital appreciation.

Thus, despite the rising opportunity cost of not being invested in less risky alternative assets or the increasing cost of financial gearing, investors remained willing to sacrifice some of their income returns, that is, buy at lower cap rates, in the hope of making decent capital returns on their non-residential property investments.

Nonetheless, robust market rental prospects, barring a severe economic slowdown, which can lead to increasing vacancies, should prevent capitalization rates from moving too far north. In addition, the now improved outlook for inflation, brought on by the reweighing and rebasing of the index, as well as lower oil and food prices, as well as the “base effect”, might also help in keeping capitalization rates at bay. Having said that, a weakening rand exchange rate poses a severe threat to inflation. Thus we do not expect interest rates to come down to their levels of 2006 any time soon, and cap rates might have seen their best levels for a long time to come.

Hurdle and escalation rates

Hurdle rates required by investors to induce them to invest in property remained unchanged in the second quarter of 2008.

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

Listed property

After the severe knock listed property prices took during the first four months of 2008, prices have rebounded, seemingly buoyed by improved inflation expectations.

Between October 2007 and June 2008, deteriorating inflation expectations resulted in a severe de-rating of listed property. Higher expectations about inflation, means the possibility of rising interest rates to curb inflation. This in turn means higher opportunity costs to listed property investors of not being invested in alternative less-risky assets, and ultimately, investors requiring higher income returns to be induced into holding listed property units. Of course, higher required minimum income returns mean lower prices.

Interestingly, as soon as inflation expectations started to improve from July 2008 onwards in response to the future re-weighting of the consumer price index, and the concurrent drop in crude oil prices and a firmer rand, the market’s sentiment towards listed property also improved. Between the end of June 2008 and August 2008, inflation expectations improved from about 9% p.a. to 6,7% p.a., while net income yields on PLSs strengthened (decreased) from about 9,5% to 7,6%.

Office rentals

During the reporting quarter, market rentals in the decentralized office nodes of the country continued to record impressive growth. Nominal rentals in Pretoria, Cape Town and Johannesburg decentralized were, on average, up by as much as 21%, 16% and 13% respectively, outperforming building-cost inflation which we expect to have grown by 10%. In Durban decentralized, market rentals were, on the whole, only 4% higher than a year ago. Currently, low vacancies (below 5%) are being observed in all of the decentralized nodes, including Durban, which together with high replacement costs — should continue to result in robust nominal market rental growth. Note, however, that a moderation in economic activity, which is still a likelihood despite the rebound in the second quarter of 2008, could, conversely, lead to a possible reduction in the demand for rental space and, consequently, rising vacancy rates and slower rental growth.

Industrial market

In the second quarter of 2008, vigorous rental growth was once again recorded in all the big industrial conurbations.

In Durban, prime industrial rentals were as much as 26% up on the same period a year earlier, while rentals in the Central Witwatersrand and the Cape Peninsula grew by about 18% over the last year. Port Elizabeth recorded the weakest rental growth, with rentals only 11% higher compared to the same quarter a year earlier. Nonetheless, nominal rental growth in all of the major industrial conurbations grew in excess of building costs, which we expect to have increased by about 10%. This implies higher real rentals over the last year in all of these industrial areas.

Despite the rebound in economic growth during the second quarter of 2008, many economic commentators still believe that we are not completely out of the woods, as yet. Growth is still expected to ease to about 3% p.a. over the next 2 to 3 years. This is much lower than the 5% p.a. we have been enjoying since 2004. Naturally, lower economic activity could lead to a possible reduction in the demand for rental space and, consequently, rising vacancy rates and a moderation in the vigorous rental growth rates of the past few years. On the other hand, the electricity constraint is retarding the growth in new supply.

Flat rentals

In the second quarter of 2008 nominal flat rentals grew by yearly rates of about 15% in the Pretoria metropolis and 14% in Durban. In the metropolitan areas of Port Elizabeth, Cape Town and Johannesburg growth rates of 11%, 10% and 9% respectively were achieved.

Over the same period, consumer inflation grew by approximately 12% and hence, only landlords in Pretoria and Durban are expected to have achieved *real* rental growth over the last year.

The house market

In August 2008, house-price growth continued on its decelerating trend, with houses in the middle-segment of the market only 1,7% up on the same month a year earlier. Compared to December 2007, price levels have actually been drifting lower.

The building industry

As one would expect, building activity in the residential sector is decelerating, driven by slowing house-price growth. Surprisingly, the most recent statistics on building activity in the non-residential sector show that activity in this sector has also decelerated somewhat. Maybe Eskom and confidence played a role here.

After showing good acceleration for about ten consecutive quarters, real non-residential gross fixed capital formation (GFCF)[1] showed marginally lower year-on-year growth of about 12% in the second quarter of 2008. In contrast, residential GFCF is now growing at only 4% (real, y-o-y) — its lowest growth rate in about six years.

Of course, the likelihood of a levelling off in non-residential building activity does mean increased tendering competition amongst building contractors for the fewer new projects available. This might force them to lower their profit margins and, consequently, lead to lower building-cost inflation, as measured by the BER Building Cost Index (BCI). ■

[1] Bricks and mortar being put in place