State of the property market in quarter 3 of 2008

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

- Capitalization rates' tide turning.
- Office market continues to enjoy double-digit rental growth.
- Cooling industrial rental growth.
- Stalling house prices.
- Building-cost inflation collapsing?

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 2008:3) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2008:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	20,0	7,3
Pretoria	26,3	12,7
Durban	8,3	-3,1
Cape Town	9,6	-1,6
Prime decentralized office rentals		
Sandton CBD	16,8	5,0
Randburg Ferndale	14,8	2,8
Brooklyn/Waterkloof (Pta)	34,4	20,6
Hatfield	14,1	2,2
Berea (Durban)	21,2	8,7
La Lucia Ridge	14,4	2,6
Claremont (CT)	37,2	22,7
Tyger Valley	9,2	-2,1

* 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 2008:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	12,0	0,3
Pretoria metro	11,1	-0,6
Durban metro	27,1	13,9
Cape Peninsula	10,1	-1,3
Port Elizabeth	21,3	8,6
House prices (all classes)* **		
Johannesburg metro	-0,5	-15,2
Pretoria metro	-6,9	-20,6
Durban metro	-1,5	-16,0
Cape Town metro	1,2	-13,7
Port Elizabeth	7,0	-8,7
Johannesburg metro	9,1	-2,8
Pretoria metro	14,6	2,2
Durban metro	13,6	1,2
Cape Town metro	10,1	-1,9
Port Elizabeth	11,4	-0,7

* 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

The non-residential property market is still going through a period of price discovery, with few transactions taking place. This is so because the potential sellers are generally under no pressure — in contrast to Anglo-American markets. Nevertheless, it looks as if the tide has now finally turned, with capitalization rates on all non-residential property types pointing sharply north in the third quarter of 2008.

What with the prospects of making respectable capital returns, especially on industrial and office property, still looking fairly favourable, the deterioration in market sentiment can most likely be attributed to a reduction in investment demand. Naturally, a drop in investment demand, on the back of increased uncertainty (read economic/financial/political), and the now higher cost of financial gearing, without a concomitant reduction in investment supply, will lead to a drop in prices, which per definition, would result in rising market capitalization rates.

Hurdle and escalation rates

Our survey results for the third quarter of 2008 show that, depending on the property type and to a lesser extent, the location, investors required a minimum before-tax total return of roughly 14% to 17% to induce them to purchase non-residential directly-held property.

Listed property

After strengthening (decreasing) between June and August 2008, and buoyed by improved expectations regarding domestic inflation, net income yields on property loan stocks (PLSs) once again weakened (increased) in September and October 2008.

This time, the reversal in market sentiment, and its adverse effect on share prices, can most likely be attributed to emerging market risk aversion, on the back of world recession fears and continued financial market turmoil, especially in the larger developed economies. Between the end of August and October, PLS yields weakened (increased) from about 7,6% to about 8,9%, consequently resulting in a contraction in prices of about 11,5%. What's more, when compared to the same month a year earlier, prices in October 2008 were as much as 26% lower, while income yields were up by nearly 3% points.

Office rentals

In the third quarter of 2008, nominal rentals for prime space in most of the country's top decentralized areas once again showed robust growth. On average, nominal rents in Pretoria (+21%), Durban (+16%), Johannesburg (+13%) and Cape Town (+13%) all grew by double-digit rates in excess of the expected building-cost inflation rate of 12%. Naturally, one can infer that this strong rental growth was still supported by low office vacancy rates and high and rising replacement costs.

Industrial market

After accelerating impressively off a low base over the past few years, growth in industrial rentals seems to have started to cool down more recently. The exception is Durban.

Over the past few years, robust demand for industrial space (on the back of a strong economy) and high replacement costs resulted in accelerating double-digit rental growth in all of the major industrial conurbations. Moreover, in most cases this growth was consistently above that of building-cost inflation. However, in recent quarters growth has started to moderate. In the third quarter of 2008, for example, only Durban (+21%) was able to outperform the expected growth in building-cost inflation (+12%). In the Central Witwatersrand, the Cape Peninsula and Port Elizabeth, rental growth rates of 12%, 10% and 9% respectively were achieved.

Flat rentals

Nationally, over the past three years the growth in flat rentals has been roughly in line with consumer price inflation. More specifically, flat rentals in the metropolises of Johannesburg, Pretoria and Cape Town all recorded growth rates akin to those of CPI (+9% p.a.) over the past three years, while in Durban (+12% p.a.) and Port Elizabeth (+11% p.a.) the nominal rentals marginally outperformed inflation.

The house market

Until the magnitude of the drivers of house prices changes significantly, no turn-around is in sight for the stagnating house market. However, no crash in nominal prices is on the cards either because for this to happen banks would have to go on a serious foreclosure spree.

In October 2008, house-price growth continued to trend south with prices only 1,2% up on the same month a year earlier. House-price growth has been in deceleration mode since 2004 largely owing to the affordability constraint. This was brought on by house prices growing for a number of years at a rate well in excess of disposable incomes as well as rising interest rates. Despite the Monetary Policy Committee's decision to keep interest rates on hold at their last two meetings, the demand for residential space to own is expected to remain weak owing to the un-affordability of houses, brought on by high borrowing costs (interest rates), sky-high *real* prices, stern borrowing requirements, high household debt levels and weaker general economic conditions at home and abroad.

The building industry

An interesting observation in recent quarters has been the acceleration in building-input-cost inflation, while building-contract-cost inflation has been decelerating. From a building contractor's point of view, this sounds like "stagflation".

The Haylett index, which is a measure of all input costs in the building industry, especially materials and labour, has since the end of 2007 entered an accelerating growth trend, while in contrast the growth in the BER Building Cost Index (BCI), which measures pre-contract non-residential building-costs (including the profit margins of contractors), has started to decelerate. In the third quarter of 2008, for example, building-input-cost inflation (Haylett) is expected to have grown by about 16%, while building-cost inflation (BER BCI) is expected to have recorded growth of roughly 12%. The BER's *Building & Construction* survey for the third quarter of 2008 shows that tendering competition amongst non-residential contractors has, since the second quarter of 2007, started to increase on the back of a moderation in building activity. Naturally, keener tendering competition does imply that building contractors now have to trim their profit margins, which in turn can lead to lower building-cost inflation. What's more, a quarter-on-quarter annualized growth rate of -9% in the BER BCI, does serve to reveal the current weakness in the building-construction industry, implying a tumbling in building contract costs compared with the previous quarter. This figure, although provisional, is supported by anecdotal evidence. ■