State of the property market in quarter 4 of 2008

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

- Capitalization rates could be peaking.
- Listed yields strengthen on back of stronger long-bond yields.
- The house market: Recovery or kaput in 2009?
- Cement sales remain in the red.
- Inflation expectations nose-diving.

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 2008:4) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2008:4*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	15,9	6,2
Pretoria	18,4	8,7
Durban	21,7	11,3
Cape Town	7,4	-1,3
Prime decentralized office rentals		
Sandton CBD	9,1	0,4
Randburg Ferndale	10,0	0,9
Brooklyn/Waterkloof (Pta)	21,4	11,4
Hatfield	13,8	4,3
Berea (Durban)	37,4	26,1
La Lucia Ridge	25,4	14,9
Claremont (CT)	31,9	21,0
Tyger Valley	6,5	-2,0

* 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 2008:4*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime industrial rentals (500m² units)		
Central Witwatersrand	8,7	-0,2
Pretoria metro	10,5	1,4
Durban metro	18,5	8,7
Cape Peninsula	6,5	-2,2
Port Elizabeth	-0,9	-8,9
House prices (all classes)* **		
Johannesburg metro	-1,8	-15,5
Pretoria metro	-6,7	-19,7
Durban metro	2,9	-11,5
Cape Town metro	-2,6	-16,3
Port Elizabeth	1,4	-12,9
Flat rentals (standard quality, all sizes)		
Johannesburg metro	8,0	-3,5
Pretoria metro	10,5	-1,3
Durban metro	10,2	-1,6
Cape Town metro	9,3	-2,4
Port Elizabeth	10,8	-1,1

* 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

After showing some weakness over the past few quarters, signs are emerging that capitalization rates might be in the process of peaking.

Worldwide, equity earnings yields have been moving north. Given the substitution principle, one would have expected fixed-interest yields to have followed a similar trend. Yet, they have been heading in the opposite direction. This tells us that investors are scared of equity and are fleeing to a safe haven - good old risk aversion. What's more, historically, the income yields of listed property funds in South Africa have had a pretty close correlation with bond yields, and the question arises whether under this new regime of extreme uncertainty and risk aversion, listed property has continued to follow in the footsteps of bonds. Our research shows that this was the case during the fourth quarter of 2008.

Of course, the strengthening (decrease) in listed-property yields also bodes well for the minimum income returns (capitalization rates) required by investors on directly-held property, considering that listed funds are potentially the greatest buyers of direct property. Thus, the marginal uptrend in capitalization rates might be peaking.

Hurdle and escalation rates

Our survey results for the fourth quarter of 2008 show that, depending on the property type and to a lesser extent, the location, investors required a minimum before-tax hurdle rate of roughly 13,5% to 15% to induce them to purchase non-residential directly-held property.

Listed property

While the financial market's rating of shares in general has been deteriorating over the past few months, the yields on listed property has been able to follow long-bond yields south. With inflation expectations having nose-dived, and with the *real* economy in disarray, more interest rate cuts to revive a weak economy remain a possibility in 2009. This would bode well for long bonds and listed property, their substitute.

Office rentals

On average, in the decentralized nodes of Durban (+27%), Pretoria (+21%), and Cape Town (+11%), nominal rental growth above the expected growth in building costs (+9%) was achieved. In Johannesburg decentralized rentals on the whole grew in line with building-cost inflation.

Given a GDP growth rate of -1,8% (q-o-q, annualized) in the fourth quarter of 2008, and with economic prospects still looking down, a moderation in these rental growth rates, owing to waning demand, is a likelihood that must be considered. Furthermore, slower replacement-cost growth might also serve to put a lid on market rental growth from the supply side.

Industrial market

The industrial property market has enjoyed a very good run over the past few years, steered by high replacement costs and robust demand for space on the back of a strong economy. However, the two pillars of industrial property, retail trade (incorporating both warehousing and distribution) on the one hand, and manufacturing and production on the other, are currently under severe economic threat.

Already, in the final quarter of 2008, only nominal rentals in Durban (+19%) exceeded the expected growth in building-cost inflation (+9%). Nominal rentals in Central Witwatersrand grew by 9%, in the Cape Peninsula they were up by 7%, while in Port Elizabeth nominal rentals contracted by about 1% point. Logically, one can attribute Port Elizabeth's poor rental performance to the misfortunes of the motor-vehicle manufacturing industry.

Flat rentals

Over the past year, flat rentals in the big metropolises were unable to show impressive growth when compared to consumer inflation. In the fourth quarter of 2008, rentals in Johannesburg (+8%), Pretoria (+10,5%), Durban (+10,2%), Cape Town (+9,3%) and Port Elizabeth (+10,8%) all grew at mediocre annual rates short of consumer inflation. This, of course, meant contracting *real* (consumer-price-deflated) rental growth in these metropolises. Not good news at all from a landlord's point of few.

The house market

When compared to the recent boom years, 2009 does look like a year of puny or even contracting house-price growth. At the start of 2009, the outlook for the economy is bleak. Since March 2008, the composite-leading business cycle indicator has been heading steadily south, while *real* economic growth contracted by 1,8% in the fourth quarter of 2008. Although interest rates have come down, and more cuts can be expected during 2009, this is unlikely to boost the demand for housing, simply because houses are at the moment still highly unaffordable. What's more, high household debt levels (75% of disposable income), the New National Credit Act (NCA) and the uncertainty within the global banking system means banks might be a bit more reluctant to grant mortgage financing. Already, in the first month of 2009, on a national basis, house-prices showed absolutely no growth (0%) when compared to the first month of 2008.

The building industry

Cement sales, a good proxy for construction activity, continue to paint a picture of a slowdown in the building industry. Since the start of 2008, the annual growth in daily cement sales has been contracting, after already being in deceleration mode since beginning 2007. In January 2009, the annual growth in daily cement sales was down by 1%, after being down by 5% in December 2008.

Naturally, contracting 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. (Note that civil construction contributes a small proportion to cement sales.)

As a matter of fact, in the fourth quarter of 2008, building-cost inflation, as measured by the BER BCI, is expected to have waned to a rate of roughly 9% (calculated on smoothed data), while build-input-costs, as measured by the Haylett index, are expected to have grown by about 17%.■