State of the property market in quarter 3 of 2009

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

- Cap rates moving sideways
- Uptrend in office vacancies striking
- Flat landlords under huge stress
- Nominal house prices turning the corner

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 2009:3) with that collected a year earlier.

Table 1
The property market at a glance at quarter 2009:3*
% growth on four quarters earlier (on smoothed data)

	Nominal	Real**
Prime CBD office rentals		
Johannesburg	2,3	4,6
Pretoria	8,8	11,6
Durban	16,7	19,8
Cape Town	4,6	7,0
Prime decentralized office rentals		
Sandton CBD	-6,3	-4,2
Randburg Ferndale	4,5	7,1
Brooklyn/Waterkloof (Pta)	3,6	6,0
Hatfield	12,4	14,9
Berea (Durban)	8,1	11,1
La Lucia Ridge	0,9	3,2
Claremont (CT)	-13,3	-11,2
Tyger Valley	18,4	21,4

* 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 2009:3* % growth on four quarters earlier (on smoothed data)		
	Nominal	Real**
Prime industrial rentals (500 m² units)		
Central Witwatersrand	2,0	4,3
East Rand	4,6	7,0
West Rand	-15,8	-14,0
Pretoria metro	-7,5	-5,3
Durban metro	-4,9	-2,7
Cape Peninsula	0,5	2,8
House prices (all classes)* **		
Johannesburg metro	5,1	6,7
Pretoria metro	-1,5	0,0
Durban metro	-10,9	-9,5
Cape Town metro	0,1	1,7
Port Elizabeth	-15,3	-14,0
Flat rentals (standard quality, all sizes)		
Johannesburg metro	2,0	-4,8
Pretoria metro	-0,4	-7,1
Durban metro	4,9	-2,1
Cape Town metro	1,7	-5,1
Port Elizabeth	-0,1	-6,8

* 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

At the moment the biggest risk to the capitalization rate outlook remains scaled-down expectations regarding the direction of *real* rentals. This, naturally, could see property investors requiring higher income returns from property because of deflated capital return prospects.

In the third quarter of 2009, capitalization rates on all non-residential property types, barring prime office buildings in the CBDs, moved sideways from their previous-quarter levels.

Office rentals

No doubt, the highlight in the third quarter of 2009 was the 'technical' emergence of the economy out of the recession, bringing with it renewed hope for the office property market.

Nonetheless, Johannesburg and Cape Town decentralized have been feeling the pinch of weak economic conditions so much so that yearly growth in market rentals has waned to below 2%. In Durban decentralized, growth averaged 9%, while in Pretoria decentralized market rentals were still up by 12%. However, over the same period, building-cost inflation is expected to have contracted by about 2%, implying real rental growth — on the whole — in all of the decentralized areas.

Industrial market

The effects of softer economic activity on the demand for industrial space to rent, and consequently market rentals, are becoming strikingly evident.

As in the third quarter of 2009, industrial vacancies in the major industrial conurbations increased to between 2 and 3,5 on the Rode scale of 0 to 9. This equates to percentage vacancies of roughly between 3,5% and 8,2%. In light of rising vacancies it comes as no surprise that the growth in market rentals was generally poor as well. The best growth was recorded in the East Rand, where rentals grew by about 5%; this was followed by the Central Witwatersrand (2%) and the Cape Peninsula (1%). In Durban (-5%) and the West Rand (-16%), however, market rentals were lower than they were a year ago.

As mentioned, building-cost inflation — as measured by the BER BCI — is expected to have contracted by about 2%, thereby nevertheless implying *real* rental growth in all of these industrial areas, barring the West Rand and Durban.

Flat rentals

At the moment there remains not much for flat landlords to be chuffed about, as rentals continue to show lacklustre growth.

In the third quarter of 2009, Durban (+5%) managed the best yearly growth, followed by Johannesburg and Cape Town where flat rentals were up by a meagre 2%. In Pretoria and Port Elizabeth rentals remained roughly at the same level they were a year ago. Naturally, these growth rates do not augur well for flat owners considering that CPI (excl. housing) was up 6% over the same period. On the contrary, the subdued growth in residential rentals does bode well for those interested in the probable direction of headline inflation and interest rates, given the sizeable weight of residential rentals in the CPI basket.

The house market

After continuing on its deceleration trend — which started in 2004 — growth in nominal house prices seemingly bottomed in April, turning the corner to such an extent that in November house prices were roughly 5% up on the same month a year earlier.

However, given the grim financial conditions of many S.A. households — read rising unemployment, poor growth in disposable income, high debt levels — it remains highly unlikely that the recovery in nominal house prices will soon be robust enough to result in a change in the direction of *real* house prices as well.

The building industry

Building-input costs and tender prices continue to decelerate on the back of weak building activity levels.

In the second quarter of 2009, *real* gross fixed capital formation in residential buildings contracted by 8%, while the growth in non-residential building activity decelerated to 7% — its lowest yearly growth rate in almost four years.

Of course, it follows that weak building activity will lead to reductions in demand for building-inputs and increased tendering competition amongst building contractors for the fewer new projects available. As a consequence, the Haylett Index (which measures building-input costs) and the BER BCI (which measures both building-input costs and contractors' profit margins) are decelerating at an alarming pace. In fact, contractors are currently being forced to trim their profit margins so much that the BER BCI is expected to have contracted by 2% in the third quarter of 2009. Seemingly, the demand for building input — labour, materials, plant & machinery and equipment — has also faded to such an extent that building-input prices are expected to have contracted by about 1%.■