*State of the property market*

# State of the property market in quarter 3 of 2011

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

- *Real* office rentals stutter
- Business cycle indicators losing vigour, bringing with them implications for property fundamentals
- Houses overvalued by 25%

## 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 2011:3) with that collected a year earlier.

**Table 1**
**The property market at a glance at quarter 2011:3***
**% growth on four quarters earlier (on smoothed data)**

| | Nominal | Real** |
|---|---|---|
| **A-grade CBD office rents** | | |
| Johannesburg | +1,4 | -4,0 |
| Pretoria | +13,9 | 7,9 |
| Durban | +2,0 | -3,4 |
| Cape Town | +12,3 | 6,3 |
| **A-grade decentralized office rents** | | |
| Sandton CBD | +7,8 | 2,1 |
| Randburg Ferndale | -5,7 | -10,7 |
| Brooklyn/Waterkloof (Pta) | -8,8 | -13,6 |
| Hatfield | -2,0 | -7,2 |
| Berea (Durban) | -2,7 | -7,9 |
| La Lucia Ridge | +2,9 | -2,6 |
| Claremont (CT) | -0,7 | -6,0 |
| Tyger Valley | +14,4 | 8,3 |

* Unless otherwise specified
** Nominal values deflated by BER Building Cost Index; however, flat rentals are deflated using the Consumer Price Index.

| Table 1 (continued)<br>The property market at a glance at quarter 2011:3*<br>% growth on four quarters earlier (on smoothed data) | | |
|---|---|---|
| | Nominal | Real** |
| **Prime industrial rentals (500 m² units)** | | |
| Central Witwatersrand | +4,6 | -0,9 |
| Port Elizabeth | -1,2 | -6,4 |
| Durban metro | +5,1 | -0,5 |
| Cape Peninsula | +4,2 | -1,3 |
| **Flat rentals (standard quality, all sizes)** | | |
| Johannesburg metro | +1,5 | -3,3 |
| Pretoria metro | +4,8 | -0,2 |
| Durban metro | +1,5 | -3,3 |
| Cape Town metro | +4,2 | -0,8 |
| Port Elizabeth | +3,0 | -1,9 |

* Unless otherwise specified
** Nominal values deflated by BER Building Cost Index; however, flat rentals are deflated using the Consumer Price Index.

## Capitalization rates

The South African business-cycle indicators have been losing some of their steam in recent months and, read together with what has been happening in the world economy, are prompting a growing number of economists to scale down their rather upbeat outlook for the economy. The non-residential property market is a derivative of the economy, so this development has the very real potential to impact on the rating of the property market, that is capitalization rates.

During the upswing phase of the business cycle, property fundamentals are likely to do well. In turn, this will stimulate investment demand and lead to an improvement in the market ratings of property; that is, capitalization rates are likely to fall. Should the current cooling in the composite *leading* business-cycle indicator[1] lead to an actual decline in economic activity, the outcome could be upward pressure on capitalization rates. Nonetheless, in the third quarter of 2011, capitalization rates for retail, prime office and industrial property still managed to remain at roughly the same level they were in the previous quarter. The market for prime property is still inherently healthy.

1 Published by the Reserve Bank, the index is used to *predict* the direction of the economy's movements in the months to come. In the case of South Africa, the leading economic indicator provides a guideline for economic growth for at least six months ahead.

## Office rentals

Moderating economic activity and floundering business confidence, and its debilitating effect on office demand and vacancies, at the moment do not augur well for office rentals.

In fact, in the third quarter of 2011, market rentals could — on a national basis — only muster modest growth of 4%. This comes after having achieved an unsustainable growth of about 11% in the first quarter. Meanwhile, building-cost inflation (the cost to construct buildings, as measured by the BER Building Cost Index) is again growing and is clocking about 6%. This implies that, in *real* terms, office rentals have actually contracted. Thus, we see the business-cycle slowdown is already a strong depressing force on the upswing phase of the long office cycle.

The acceleration in building-cost inflation can be explained by building contractors having now milked their profit margins dry. Therefore, they now have no option but to pass on higher input costs in the form of higher tender prices. This comes after intensive tendering competition over the past two years has forced contractors to cut their profit margins to the bone. The result of this was weaker growth in overall tender prices — which includes profit margins — relative to the growth in building-input costs (as measured by the Haylett Index).

## Industrial market

Slack in the demand for industrial space is currently displayed by the poor to moderate growth in market rentals. In the third quarter of 2011, market rentals on the Central Witwatersrand and in Durban mustered growth of 5% – the best regional performance. The Cape Peninsula followed with growth of 4%, while in Port Elizabeth market rentals were actually somewhat lower (-1%) than they were a year ago. Bearing in mind the fact that building costs grew by 6% (y-o-y), this implies that in *real* terms industrial rentals in all of these industrial areas are actually lower than they were a year ago.

Prospects for industrial rentals remain weak, this as a result of an economy struggling to find its feet amidst uncertain global economic conditions – not to mention the adverse impact that the current slowdown in manufacturing output is likely to have on the demand for industrial property.

## Flat rentals

Residential rentals continue to cruise along, showing mediocre growth below that of consumer inflation.

Although flats are still outperforming both houses and townhouses, growth remained moderate at 2% year-on-year in the third quarter of 2011. Over the same period, rentals on townhouses showed growth of about 1%, while those on houses remained at roughly the same level as a year ago. Discouraging for investors in the buy-to-let market is that these growth rates were well below the rate of consumer inflation, which stood at 5% (excluding housing) in the third quarter of 2011.

## The house market

For now, no vigorous growth in house prices can be expected until the magnitudes of the key drivers of demand change significantly. One such driver is, of course, interest rates.

In the meantime, house prices remain far above their long-term replacement-cost trend line. In fact, houses are still 25% more expensive than what is suggested by their long-term trend line. Considering that asset prices are mean-reverting, the implication is that a resumption in the down trend in *real* houses prices is inevitable – it's only a question of time and speed. A real decline in house prices does not necessarily mean the nominal prices will decline; a more likely outcome is that nominal prices might grow at, say, 2% per annum for a few years while inflation is at, say, 6%. ■