

Chapter 1: State of the property market

State of the property market in quarter 3 of 2020

We predicted the obvious in the previous *Rode Report*, namely that the South African property market will soon start to show the impact of Covid-19 as transaction volumes increased after the lockdown. Indeed, our third-quarter report shows that the office, industrial and retail property markets have weakened further. However, it is not to say the whole market is in dire straits. Some segments, such as logistics and shopping centres in communities/neighbourhoods and low-income areas, have proven rather resilient. The same can be said about the residential market, with house prices surprising on the upside, but the rental-flats market is in deep trouble.

The weaker performance of the property industry is reflected in the roughly 50% decline in listed property prices on the JSE from January to end September. Share prices fell due to investor concerns about the substantial non-residential oversupply, which has been worsened by Covid-19. The pandemic has accelerated online shopping (bad for malls but a positive for distribution centres) and the work-from-home trend (harmful for office property).

The latest company financial results up to June 2020 provided in **Chapter 4** unsurprisingly continue to make for bleak reading as they incorporate the severe second-quarter lockdown period. The results are characterized by sharply falling or zero distributions, downward rental reversions, rental remissions, higher operating expenses, rising vacancies,

sharply decreasing property valuations and consequent higher loan-to-value ratios. These factors contribute to a lower bottom line, with contracting distributions for shareholders. Several companies again decided to refrain from, or delay, declaring distributions to bolster their balance sheets – not to mention preserving working capital.

Indeed, the property industry is playing from the rough. And thick rough it is.

A summary of the main findings by property type follows.

Quantitative overview of the property market

Table 1.1 on the next page provides a snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2020:3) with data collected a year earlier.

Office market

The office market is in serious trouble due to a swelling oversupply, with vacancy rates hitting highs last seen in 2003 amid weak demand and even weaker prospects (see **Chapter 6**). The demand for office space has contracted because of the recessionary economic conditions since the third quarter of 2019 and the accelerating work-from-home trend as discussed in more detail in **Chapter 5**. News of more

companies closing, shrinking in size, or delaying expansion has become more widespread. The large amount of available space is giving tenants the upper hand in lease negotiations, with the latest Rode data showing rentals are heading south.

Nationally, rental growth for grade-A decentralized office space declined by 2% year on year in the third quarter of 2020, after still growing by 1% in the second quarter. This portends serious negative rental reversions on lease renewals. This is a trap for ill-informed investors when they capitalize in perpetuity lofty, escalated contractual rentals without considering the (much lower) market rentals.

The pain was spread all over the country in the third quarter. Grade-A rentals of decentralized office space decreased by 3% in Johannesburg and by about 2% in both Cape Town and Pretoria compared to the third quarter of 2019. Rentals remained roughly the same in Durban. This implies that no major city managed to record above-inflation rental growth. Rentals also mostly headed south in secondary cities, such as Bloemfontein and Port Elizabeth. As the current recession unfolds, we expect much more of the same.

Two positives for the office market are the sharp downturn in construction activity and superior rental collections as we already alluded to in the previous *Rode Report*.

Industrial market

The industrial market is feeling the pinch of the recession, with rentals failing to grow in the third quarter of 2020. Rode's survey results provided in **Chapter 7** indicate that national industrial rentals were unchanged

compared to the third quarter of 2019, but fell by 1% from second-quarter 2020 levels as vacancy rates continue to move higher from a low level. This implies that rentals declined in *real* terms after deducting building-cost inflation (BER BCI) of around 3%. The market still appears to be on a better footing than the office and retail property markets where the oversupply is more substantial.

Nominal rentals for prime industrial space of 500 m² fell by 4% year on year in the Central Witwatersrand – the worst performance of the major conurbations. Rental levels stayed roughly the same in the East Rand and the Cape Peninsula. Rentals surprised by growing by 2% in Durban, but we doubt this is sustainable as vacancies have increased to about 5%. This implies that rentals in all major regions that Rode tracks have declined in *real* terms.

Residential market

House prices surprised on the upside in recent months. Nominal house price growth reached 2,8% in August 2020 compared to August 2019, which is up from the 1% growth seen earlier in the year. However, prices still declined in *real* terms after having taken out inflation. We ascribe the recent increases to pent-up demand (as the initial hard lockdown restricted sales), limited available supply on the market and record low interest rates. This lifted price growth for the first eight months of 2020 to 1,6%. However, we have our doubts about the sustainability of rising house prices over the medium term as the house market is tightly tied to the fortunes of the economy (see **Chapter 10**).

The sharp decline in interest rates brought the monthly cost of owning versus renting closer to equilibrium, favouring buying a house or flat in some instances. This, and the dire state of the consumer's finances, contributed to a spike in flat vacancy rates, which reached 11% in the third quarter, up from 7% in the second quarter of 2020, according to Rode's survey data shown in **Chapter 9**. High and rising flat vacancy rates have led to weaker rentals. The oversupply of flats is also linked to huge increases in new rental stock in 2018 and 2019. We

believe flat vacancy rates will rise further in the short term as more tenants run into financial trouble. And then there is the very real possibility of a second Covid-19 wave ...

Yes, the dramatic 300 basis points drop in interest rates engineered by the SA Reserve Bank has made owning a house more affordable for market entrants.

But the risk facing these investors is of course the future path of interest rates in the light of the fiscal cliff SA is facing. ■

Table 1.1		
Rental performance as at quarter 2020:3		
% change from four quarters ago (on smoothed data)		
	Nominal	Real*
A-grade decentralized office rentals		
Sandton CBD	-3,7	-6,3
Rosebank	-1,7	-4,3
Randburg Ferndale	-4,1	-6,6
Centurion	2,5	-0,2
Menlyn	-5,8	-8,3
Berea (Durban)	-16,4	-18,6
La Lucia/Umhlanga Ridge	-1,0	-3,6
Claremont Upper	4,8	2,0
Tyger Valley	-4,1	-6,6
Century City	0,5	-2,2
Prime industrial rentals (500-m² units)		
Central Witwatersrand	-3,8	-6,3
East Rand	-0,1	-2,7
Durban	2,4	-0,3
Cape Peninsula	0,0	-2,7

*Nominal values deflated by BER Building Cost Index (2016 = 100)