Chapter 1: State of the property market

State of the property market in quarter 2 of 2022

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

- The property sectors, like many others, are being negatively affected by increased worries about global and South African economic growth amid even higher inflation and interest rates that were expected in *Rode's Report* of 2022:1. Some forecasters are even talking of a coming recession. In fact, on 6 July the head of the IMF said the outlook for the global economy had "darkened significantly" since April and she could not rule out a possible global recession in 2023 given the elevated risks.

- The industrial property market still continues to look best placed, but it may be close to a peak given the weakening economic backdrop, which may also curb the sharp growth of logistics through weaker online sales.

- The retail market, although not covered in detail in this publication, made a strong recovery in 2021 and the beginning of 2022. However, the outlook for consumer spending is poor, which will hinder the recovery (see our sister publication *Rode's Retail Report*).

- The fundamentals of the office market have improved somewhat, but are still poor.

- Flat vacancy rates and rentals have improved, but *real* rentals, like house prices, are still in negative territory.

- Building-cost inflation has spiked into double digits, which makes it almost impossible for rentals to grow in *real* terms. This significantly reduces the feasibility of building new projects, which might not be a bad thing for property fundamentals.

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 2022:2) with data collected a year earlier.

Office market

The office market continues to be in the worst position of the three major non-residential property types due to its severe oversupply characterised by high vacancy rates and lower rentals. However, the results of the latest Rode survey show that vacancy rates improved slightly in the second quarter of 2022, while the decline in nominal rentals is generally less than seen before. In other words, fundamentals are poor but improving somewhat. It is too early to tell if this positive move will be sustained, but do not get too optimistic, given the general expectation of slow economic growth and the work-from-home trend.

Nationally, gross market rentals for decentralized grade-A space decreased by 1% year on year in ***nominal*** terms in the second quarter of 2022. Encouragingly, the decline in rentals has eased gradually since the middle of 2021 when rentals fell by around 6% compared to a year earlier. This probably means that the worst is over as rentals are stabilising at lower levels as more workers return to offices, albeit in many instances in a hybrid way, with Covid becoming less of an issue. However, there is one caveat: the above rentals are *nominal* rents, meaning no rental remissions, tenant installation allowances or a number of months rent-free are assumed. Maybe we should call these façade rentals because we do not know for sure what is happening behind this wall!

In ***real*** terms, rentals fell by more than 10% after deducting building-cost inflation (BER BCI), which accelerated to about 13% in the second quarter, driven by double-digit increases in the prices of steel and copper.

Regionally, Cape Town has been the best performer of late, with nominal rentals (+1,2%) rising to above those of a year ago. However, rentals for all the other major cities were either unchanged or declined compared to the second quarter of 2021, indicating that the office market is still largely feeling the pain. This implies that no major city managed to record above-inflation rental growth. In fact, with the sharp rise in building cost, *real* rentals have dived into double digits.

Industrial market

Relatively speaking, the industrial property market continued to shine in the second quarter of 2022, with nominal rental growth for space of 500 m^2 picking up to 5,4% year on year thanks to continued low vacancies. The 5,4% can be compared with growth of 0,5% in 2020 and 2,2% in 2021. However, the story is not so bright in real terms given the spike in building-cost inflation.

This means the industrial sector is still comfortably the best placed of the major non-residential sectors, where vacancies are much higher and above their long-term average, especially office properties. One of the key reasons for the outperformance of industrial property is the largely non-speculative nature of developments. Another driver has been the superior performance of logistics due to the online sales boom, which has accelerated during the pandemic as shoppers preferred to shop online to reduce the risk of contracting the virus.

However, one must wonder whether the fundamentals in this sector are close to peaking, given the weakening economic backdrop, which will also curb the sharp growth of logistics and warehousing demand through weaker online sales. Perhaps the weaker first-quarter 2022 financials of Amazon provide a clue of what is to come.

Table 1.1 Rental performance as at quarter 2022:2 % change from four quarters earlier (on smoothed data)		
	Nominal	**Real***
A-grade decentralized office rentals		
Sandton CBD	-1,0	-12,0
Rosebank	0,1	-11,1
Randburg Ferndale	-0,4	-11,6
Centurion	-9,1	-19,1
Hatfield	-1,2	-12,1
La Lucia/Umhlanga Ridge	-1,1	-12,2
Westville	0,0	-11,2
Tyger Valley	2,0	-9,4
Century City	3,2	-8,3
South Africa	**-0,5**	**-11,6**
Prime industrial rentals (500 m² units)		
Central Witwatersrand	5,8	-6,1
East Rand	2,4	-9,1
Durban	6,6	-5,4
Cape Town	7,2	-4,8
South Africa	**5,4**	**-6,4**
*Nominal values deflated by BER Building Cost Index		

Nominal rentals for prime space of 500 m² grew by 7,2% year on year in Cape Town in the second quarter of 2022, remaining above pre-Covid levels, as the demand for space exceeds supply. This was the strongest rental growth of the major industrial conurbations. The Mother City's vacancy factor continued to decline, reaching 2,8 (on our vacancy scale), which implies a vacancy percentage of below 5%. This has been the lowest vacancy rate since the third quarter of 2020.

Nominal rentals in Durban and the Central Witwatersrand also continue to perform well, with growth picking up to 6,6% and 5,8% respectively. Fundamentals in Durban are looking better as the July 2021 looting and floods in 2022 have created a shortage of space in some areas, with the Rode vacancy factor declining to 2,31, which equates to a vacancy rate of just under 4%, better than the national average. Rental growth was more subdued in the East Rand (+2,4%).

Residential market

The housing market had a steady start to 2022, with *nominal* prices growing by about 4% year on year in the first five months, albeit marginally slower than the 4,2% growth for the full 2021, based on FNB data. However, in *real* terms the story does not seem so rosy, with house prices falling by about 2% so far in 2022 due to the sharp rise in the average consumer inflation rate to 5,9%. Turning to the latest monthly data, nominal prices increased by 3,7% year on year in May, slowing from 4% in April, and well below the inflation rate of 6,5% in the same month.

At this stage, the impact of interest rate hikes is not significantly slowing prices and volumes, but it will increasingly play more of a role in curbing effective demand as it increases towards its pre-pandemic level of 10% sooner rather than later. Looking ahead, we expect house prices to grow at a slower rate over the next year or two due to the weak economy, characterised by high unemployment, and as interest rates rise further, thereby putting further pressure on the consumer, who is also facing high inflation. Therefore, *real* house price growth is still a few years away.

Turning to flats, vacancy rates in South Africa averaged 8,8% in the second quarter of 2022, down from 9,9% in the first quarter of 2022, according to Rode's residential survey data. The improvement in vacancy rates has led to slightly better-performing nominal rentals.

However, rentals are still declining in *real* terms. This means landlords are generally feeling the heat as total costs, including items like rates and taxes and maintenance, are rising faster than their rental income. It is significantly more expensive to maintain a home than, say, a year ago due to hefty prices of metals, such as steel. Higher interest rates of course are also lifting bond instalments.

We are not too excited about the outlook for flat-rental growth in the near future as it will be difficult for landlords to pass on sharp cost increases to tenants in the current difficult and worsening economic environment. A realistic scenario is that nominal rentals will probably continue to rise slowly in the next year or so, but at a rate lower than the consumer inflation rate. ■