Chapter 1: State of the property market

State of the property market in quarter 3 of 2023

The property sector experienced another tough quarter as reflected by the further decline in the share prices of listed property funds. The prices reflect the numerous challenges faced by the property industry, like the power problems, elevated interest rates, rising operating costs (including rates and taxes) and poor municipal service delivery – not to mention the global, and especially the SA, economy that faces a period of low growth.

Noteworthy is that several REITs, such as Growthpoint, have issued grim warnings for the year ahead. This explains the poor rating (elevated income yields) of listed funds. The high yields of listed properties mean REITs can only buy directly held properties at high capitalization rates (if at all), which in turn means the net asset values (NAVs) of REITs are impaired because NAV is calculated as if the properties in a fund are sold individually as directly held properties. Lower NAVs mean you get a phone call from your friendly banker because your loan-to-value (LTV) ratios are now too high. The only way to make the banker and investment analysts happy is by selling off some properties, which means more properties are thrown onto the market for sale, which further depresses market values of directly held properties, which in turn …

We discuss the domino effect in more detail in **Chapter 4.**

Analysing the market by typology, we see the industrial property market is still best placed of the major non-residential property types, and offices the worst. In the residential market, house price growth has weakened further, as expected, while the story for flat rentals remains positive. But in *real* terms, prices and rentals are still generally in negative territory.

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 2023:3) with data collected a year earlier.

Office market

The office market is still in the worst position of the three major non-residential property types due to its significant oversupply, with decentralized vacancy rates in South Africa still well above the long-term average of 9%. Encouragingly, the results of Rode's office vacancy survey show that decentralized vacancy rates of grades A$^+$, A and B space declined further in the third quarter of 2023 to 14,4%. This was better than the 16,2% in the third quarter of 2022, supported by more workers returning to office. Vacancy rates of grade-A space are comparatively lower as quality space's market rents are low relative to replacement costs.

Regionally, Cape Town decentralized saw the largest improvement over the past year in its office vacancy rate, which averaged about 12%, although it did give up some of its gains in the third quarter. Of the major cities, Johannesburg decentralized remains under the most pressure as evidenced by its vacancy rate (around 16%) remaining higher than the national average. We discuss the vacancy rates in **Chapter 6**.

Rode's *nominal market* rental data indicates a continued recovery from the low Covid levels, but increases are slowing and office rentals in *real* terms continue to look bleak. Listed property funds are also still reporting large negative rental reversion rates.

The important point remains that many companies are still working on a hybrid basis, favouring two to three days a week at an office, which means less demand for space compared to pre-Covid levels. Furthermore, office demand will not see a sustainable turnaround without much stronger economic growth.

Nationally, weighted market gross rentals for *decentralized* grade-A space increased by 2,8% in *nominal* terms in the third quarter of 2023 compared to the third quarter of 2022, slowing from 3,4% in the second quarter of 2023. This takes rental growth to 2,9% over the first nine months of 2023, which shows that nominal rentals have bottomed out after falling during the Covid pandemic. But to give perspective, the third-quarter nominal rental rate on a national level was still 2,7% below 2019 levels (that is, before the pandemic). In *real* terms, third-quarter decentralized rentals remain in negative territory, after deducting the roughly 8% estimate of building-cost inflation (BER BCI).

Regionally, Cape Town has been the clear top performer since 2022, albeit from a low base in 2021. Nominal grade-A gross rentals in the third quarter of 2023 increased by 12% in the decentralized nodes of the Mother City compared to a year earlier, even exceeding pre-Covid levels by 5%. In absolute terms, the Cape Town decentralised rents are also the highest of the major cities.

Nominal rental growth in the decentralized nodes of the other major cities averaged between 0,5% and 2%. This implies that in real terms, only Cape Town managed to record above-inflation rental growth compared to a year ago. Further detail on rental trends is provided in **Chapter 5**.

Table 1.1 Office and industrial rentals: Performance as at quarter 2023:3 % change from four quarters earlier (on smoothed data)		
	Nominal	**Real***
A-grade decentralized office rentals		
Sandton CBD	0,5	-6,8
Rosebank	-0,4	-7,6
Randburg Ferndale	0,3	-7,1
Centurion	8,1	0,4
Hatfield	8,9	1,1
Menlyn	-1,7	-8,6
La Lucia/Umhlanga Ridge	6,2	-1,4
Berea	-4,9	-11,6
Tyger Valley	16,8	8,3
Century City	8,1	0,2
South Africa	**2,8**	**-4,6**
Prime industrial rentals (500 m² units)		
Central Witwatersrand	5,2	-2,3
East Rand	4,7	-2,8
Durban	3,3	-4,1
Cape Town	6,0	-1,6
South Africa	**3,8**	**-3,6**
*Nominal values deflated by BER Building Cost Index		

Industrial market

Of the three major non-residential property types, the industrial property market is still best placed. This is thanks to its low vacancy rates, resulting in stronger rental growth. *Nominal* gross market rentals for space of 500 m^2 grew by 3,8% in the third quarter of 2023 compared to the third quarter of 2022. This is slower than the 4,1% year-on-year growth recorded in the second quarter of 2023 and was the third consecutive quarter of weaker growth. This was to be expected, given weaker economic growth and in particular the pressure on the manufacturing and retail sectors. In *real* terms, rentals are still declining due to high building cost inflation.

Regionally, nominal rental growth was the strongest in Cape Town at 6%, albeit slower than the 7% year-on-year growth in the second quarter of 2023. Cape Town has performed the best of the major conurbations over the past few years, with rentals up by 17% compared to the pre-pandemic 2019 levels. Nominal rentals grew by 5% in the East Rand and the Central Witwatersrand. Both these conurbations saw an improvement in vacancy rates to just above 3% in the first nine months of 2023.

We continue to be surprised by the resilience of the industrial property market, which is particularly evident in its low vacancy rate of only 3,7% on a national level. Looking at the bigger picture, vacancies are lower than pre-Covid levels and below the long-term average of 4,2% since 2000. However, there is a risk of higher vacancies and lower rental growth in the short term, given the sustained level of low business confidence. We must also emphasise that this is not due to excessive building activity, but rather weaker economic growth. In fact, building activity has declined so far in 2023 (see **Chapter 11**). No doubt the resilience of the industrial property market will be tested again.

Residential market

The housing market continues to slow down due to lower effective demand for property as a result of the weakening economy, the high cost of living and elevated interest rates. Nominal **house prices** grew by 0,8% in August 2023 compared to August 2022, based on FNB data. This took house price growth to 2% in the first eight months of 2023, well below the 3,6% growth achieved in calendar year 2022. In *real* terms, house prices fell by about 4% in the first eight months of 2023, after deducting the consumer inflation (CPI) rate of 6,1%.

Interest rate hikes have started to affect house prices and sales activity levels more materially in 2023 and the impact is not over yet as interest rates will remain high for longer than previously thought. The reason for this prognosis is that inflation is not yet at the central bank targets, despite having declined substantially. So far in 2023, a growing number of sales have also occurred because owners are experiencing increased financial pressure.

Turning to **flats**, vacancy rates on a national level averaged 6,9% in the third quarter of 2023, unchanged from the second quarter of 2023, but lower than 7,8% in the third quarter of 2022, according to Rode's residential survey data. Regionally, the Western Cape continues to stand out with its low flat vacancy rate of 2,9% in the third quarter of 2023, albeit up slightly from 2,1% in the second quarter of 2023.

The decline in national vacancy rates since 2021 has supported rental growth. Official data from Stats SA shows that in the second quarter of 2023 nominal flat rentals in South Africa increased by 2% compared to a year earlier, thus continuing their sideways trend since the fourth quarter of 2022. PayProp data shows that the nominal rental growth rate for housing lifted to an even higher 4,4% in the second quarter of 2023 – the fastest growth rate since the fourth quarter of 2017. However, of concern is that the number of tenants in arrears rose in the second quarter of 2023. All in all, house prices and rentals are still declining in *real* terms in most parts of the country. **Chapters 9** and **10** provide more detail on national and regional housing market trends. ■