

Cap Rates under Pressure

Although survey results from the last quarter of 2007 do not yet show it, capitalization rates for non-residential properties are more than likely under pressure at the moment, says Erwin Rode of property economists and valuers Rode & Associates.

“With an increasingly uncertain inflation outlook, the prime overdraft rate seems set to remain elevated for some time still. And with capitalization rates of prime-quality properties as low as 8–9%, and investor demand becoming more precarious, a narrowing of the gap between interest and cap rates seems almost certain. Notwithstanding this, we do not expect a major weakening (increase) in capitalization rates, as the expectation of robust rental growth is still supporting property’s rating,” says Rode.

Commenting on the effect this may have on the listed property sector, Tony Bales of property investment company Bales Delaporte notes that following a steep rise in prices during 2007, this sector has just undergone a period of correction. Says Bales: “When you consider the pressure that rising cap rates will have on the listed versus the directly-held property sector going forward, you must remember that the listed sector is driven not only by property fundamentals but also by stock market sentiment, whereas the fixed property sector is driven predominantly by fundamentals.

“So while there is an underlying correlation between the two, it is not a direct correlation. For that reason, we’ve already seen an initial correction in the listed sector and we are now currently facing significant upward pressure on cap rates in the directly-held market.

“I think we are still going to see significant rental growth well into the future, but perhaps not at the levels that were originally anticipated. Obviously the situation has been exacerbated by a number of other factors as well – the energy crisis and the resultant clamping down on new development, plus downward pressure due to a lower GDP growth forecast.”

While there is consensus among property brokers that cap rates are expected to rise, the uncertainty lies in by just how much. Says Bales: “It’s impossible to say because there are certain sectors that will be more affected than others. Quality assets will be less affected than non-quality assets. Investors will feel happier holding on to quality assets as opposed to those that do not necessarily fit into their portfolios. And again, even the definition of a quality asset will vary from investor to investor — an ApexHi quality asset may not be appropriate for a Growthpoint quality asset, so quality is a relative term. But there’s no doubt in investors’ minds that they are going to hold on to their quality assets and hence the cap rates on those assets will not go up as much as non-quality assets.”

International market influences have also filtered through to the local market to affect cap rates. Comments Bales: “The major battering which the global market experienced in the second half of 2007 has in turn forced the South African market to think twice about our level of valuations. This time last year, we were faced with a market – on the capital value side – that was really bubbling and now we’ve had a simmering down, resulting in upward pressure on cap rates. There are significant lessons to be learnt from the trends we see overseas as we’re part of a global economy now, and although we’re partially buoyed by our resources sector, we can’t afford to ignore international fundamentals and the influence these may have on our own market.”

However, concludes Bales: “People have short memories. For a bit of a wake-up call, you just need to glance at an issue of the 2003 Rode’s Report, where you’ll see that cap rates at the time stood at 13% and 14%! Now that makes for horrifying reading!”