

## Industrial Property Still Steaming Ahead

Strong economic growth and rising building costs and low vacancy rates ensured that the industrial property market kept up its grand performance during the last quarter of 2006. This is according to the latest issue of the authoritative Rode's Report on the SA Property Market.

Nominal rentals in all the major industrial conurbations recorded double-digit growth during the fourth quarter of 2006. What's more, rental growth was higher than building-cost inflation over the same period, meaning that rentals grew in real terms as well.

Capitalization rates – the property equivalent of the forward earnings yield of shares – showed a marginal up-tick in the final quarter of 2006; this should be viewed as a cyclical upward fluctuation around a long-term downtrend which has been in play since 2003, says Rode & Associates CEO Erwin Rode.

"The structurally low inflation environment, together with the market's expectation of robust real rental growth, is unlikely to result in capitalization rates moving significantly north in the foreseeable future."

During the last quarter of 2006, investors required a minimum total return – income return plus capital growth – of roughly 15% to 16% to prompt them to purchase a non-residential property. Given that the capitalization rate for prime decentralized office property, for example, is currently standing at about 9 to 10%, this hurdle rate implies that investors expect capital appreciation of about 6% p.a. over the next 5 years. "This is a very modest expectation", says Rode.

Leaseback escalation rates – an attempt by the market to forecast market rentals until the expiry of a lease – stood at 8% during the reporting quarter, "which is also not that high considering the rosy rental-growth outlook".

Listed property rebounded from the beating it took during the middle of last year, with income yields of property unit trusts currently trading as low as 6%.

The Rode team sees the fact that yields are at a notable discount to long-bond yields as indicative of the market buying into the idea that fundamentals are strong and solid income growth is on the horizon – sentiments recently substantiated by funds such as ApexiHi, Resilient, Hyprop and Growthpoint, reporting distribution growth of 15 to 20%.

On the whole, nominal grade-A CBD and decentralized office rentals sustained their positive trend during the final quarter of 2006, in aggregate growing by 13% and 12%, respectively. A notable exception was the Cape Town CBD, which showed no growth.

During the last two years, flat rentals grew by 5,5 to 7,5% p.a. in all of the major metros except Durban, where growth averaged below 3% p.a.; consumer prices grew by roughly 4% p.a. over the same period.

Rode's Report found the relationship between new and existing house prices – depreciated for age – currently to be well above the equilibrium level.

"This situation can be remedied by one of two things happening: house prices will grow slower than building-cost inflation during the next few years, or, in the unlikely event of the economy screeching to a halt, house prices can tumble", says Rode. He says bearing in mind that the effect of interest-rate hikes takes about nine months to be reflected in prices, the most likely scenario is that house-price growth will slow down in 2007, while building-cost growth will remain robust.

During the last quarter of 2006, building-input-cost inflation (as measured by the Haylett index) was as high as 11%. According to Medium-Term Forecasting Associates this was not only the result of a buoyant building industry, but also higher oil prices, a weaker rand exchange rate, and higher materials prices. The BER Building Cost Index, which includes building input costs as well as contractors' profit margins, grew by 7% during the reporting quarter. The fact that the latter index grew faster than the Haylett index suggests that building contractors, due to a reduction in tendering competition, have reduced their profit margins during the last quarter of 2006.