

Lower-Priced Houses Still Offer Best Yields

The growing wealth in South Africa's leafy suburbs is now definitely trickling down to lower-priced neighbourhoods, including townships. Evidence to support this conclusion is that lower-priced houses continued to grow faster than those in the middle- and upper-priced sectors during the third quarter of 2006, according to the latest Rode's Report on the state of the property market.

The relatively stronger performance of lower-priced houses is confirmed by the FNB Residential Property Barometer for 2006:4, which shows that during the last year, houses priced under R500.000 performed much better than their more pricey counterparts.

"This is the result of unaffordability, of course, as the middle and upper-priced categories grew faster in the immediately preceding years. The upshot is that the best yields are still to be found in the lower-priced segment of the market", says Rode & Associates CEO Erwin Rode.

Residential building activity remained robust during the first half of the year, and all signs are that medium- to high-density residential developments will keep activity in this market healthy.

Non-residential building activity showed satisfactory growth during the third quarter of 2006, and the Rode team expects activity in this segment to accelerate during 2007. Building contractors' capacity will be stretched in the new year by continuing growth in office and industrial demand as well as strong infrastructure investment in preparation for the 2010 soccer World Cup. The strain placed on contractors' resources will result in less keen tendering competition, which will enable them to stretch their profit margins. The fact that construction shares have performed so well over the last year is indicative of the market's expectation thereof.

Impacted by recent interest-rate hikes as well as expected future hikes, capitalization rates are starting to show resistance to the downtrend of the last few years – especially in interest-rate sensitive segments of the market. Capitalization rates are the property equivalent of the forward earnings yield of shares.

Considering South Africa's secularly low inflation (and, hence, interest-rate) environment, coupled with the anticipation of strong real rental growth, the Rode team does not, however, expect cap rates to significantly move north any time soon.

The latest Rode's Report indicates that depending on the property type and, to a lesser extent, the location, investors required a total return of between roughly 14% and 17% during the reporting quarter to induce them to invest in a property. Total return is a combination of income yield and capital return. The Rode analysts found that low-risk regional shopping centres tended to be on the low side of this spectrum, whereas non-leaseback office buildings tended to be on the higher side.

Leaseback escalation rates averaged roughly 8% in the reporting quarter. The escalation rate is an attempt by the market to forecast market rentals until the expiry of a lease.

Says Rode: "Given our expectation of double-digit rental growth over the next few years, we regard 8% to be quite conservative. The problem is, of course, that many tenants look upon the escalation rate as compensation for consumer inflation, rather than market-rental inflation."

A less certain international economic outlook and insecurity regarding short-term interest rates continued to weigh negatively on the listed property sector during the third quarter. Notwithstanding this, the rating of listed property has improved considerably since the middle of 2006, a strengthening precipitated by the release of some strong results by a number of listed property funds.

Given the strong underlying property fundamentals such as rising building costs, falling vacancies, and rosy prospects for economic growth, Rode expects the possibility of future interest-rate hikes to be counterbalanced by robust income-stream growth.

On the whole, nominal grade-A decentralized and CBD-office rentals continued to improve during the third quarter of the year. Prime CBD office rentals were up by a notable 13%, while decentralized office rentals grew by 7% on the same period a year earlier.

With building-cost inflation (as measured by the BER BCI) expected to have grown by 6% over the same period, real rental growth of roughly 7% and 1% for prime-CBD and decentralized-office rentals respectively, was achieved.

Manufacturing benefits more than most sectors from the depreciation of the rand and according to the October 2006 Investec Purchasing Managers Index the sector has seen an increase in seasonally-adjusted sales orders, output, and employment. Rode's Report 2006:3 sees the boost to manufacturing as boding well for industrial rentals for the foreseeable future as demand for space continues to grow and the cost of constructing new industrial space remains high.

In the third quarter of 2006, nominal industrial rentals in Port Elizabeth (28%), Durban (19%), the Cape Peninsula (16%) and the Central Witwatersrand (11%), were substantially up on the same period a year earlier.

Values of industrial stands in all of the major industrial areas also continued to grow robustly during the third quarter. The drivers are low industrial vacancies, strong demand, growing market rentals, and a shortage of serviced industrial land.

Flat rentals in all of the major metropolitan areas, except for Durban, grew faster than consumer inflation over the last two years. In Johannesburg, Pretoria, Cape Town and Port Elizabeth, flat-rental growth averaged between 7% and 10% p.a. Although Durban recorded a growth rate just shy of 3,5% p.a. over the last two years, its performance over the last five years (11% p.a.) was second only to Port Elizabeth (13% p.a.).