

## South African Commercial Property Shines

South Africa's commercial property has outperformed all other property markets on a local currency basis in seven out of nine years, the Investment Property Databank (IPD) said on Thursday.

Since the last property boom started to gain traction, in 2003, nominal capital values have virtually doubled in seven years, rising by 97.4%. This includes a cumulative rise of 23% over the three years to the end of the last decade – the period when the global financial crisis struck, prompting a severe re-pricing in commercial property values in virtually all other markets worldwide.

End investor returns are also supported by strong income returns relative to most major real estate investment markets. The 10-year annualised income return or yield is 9.7%, according to the IPD South Africa Annual Property Index.

This income growth is driven by contracted rental uplifts linked to inflation and by a growing economy creating demand for space. Commercial property prices in major real estate markets, such as the US and the UK, were lower at the end of the decade than before the last boom. "That is, their entire accumulated price appreciation during the 'mid-noughties' were eroded out by the global financial crisis," the report indicates.

Indeed, in some markets they fell further still. The crucial differentiator between most major real estate markets and South Africa is inflation. "South Africa is often regarded as virtually the last bastion of inflation in the property investment world, with volatile levels peaking in double-digits throughout the last decades," it says.

More recently however, inflation has been trending downwards, and sits at 3.2% as at September 2010, at the lower end of the government's target range of between 3% and 6%. Adjusting South African commercial property values for inflation reveals a very different picture.

On a real capital growth basis, commercial property values actually depreciated in 2008 and 2009 by -4.9% and -5.6%, respectively. On a 10-year time horizon, the nominal capital return of 7.1% is almost entirely eroded to just 0.9% after taking inflation into account.

The real story of growth has been the development of the South African property market over 15 years and the steady rise in income to investors and managers. South Africa owes its boom years' success to the same dynamics which benefited many other markets – compressing yields and increases in rental values; the twin drivers of capital growth.

Net income yields compressed in four consecutive years from 2003 to 2007 by 220 basis points to 7.6% – historically the lowest levels in the 15 years of the IPD index. Despite a 50 basis points yield expansion over the subsequent two years, to 8.1%, capital growth remained positive, albeit at increasingly modest levels.

Capital appreciation has continued into 2010 – just – as a positive 20 basis points recorded for the first six months of 2010. Net income growth, a measure of rent received less costs, rose from 7.1% in 2003 to 12.6% at the end of 2007. Thereafter, the rate at which net income growth grew eased slightly to record 9.4% at the end of 2009, while over the first six months of 2010, 4.3% was delivered, based on the biannual indicator.

The availability of cheap debt to stimulate the transaction market helped to further demand and, through developments, supply. Even when the credit crunch struck in mid 2007, the South African market continued to deliver Bull Run level total returns, at 27.7%, supported by the second highest annual capital growth in the index's 15-year history, at 17.6%.

South Africa's occupier market has see-sawed in recent years. Currently, supply outstrips demand, which has brought development to a virtual standstill. In the office sector, the sector most sensitive to fluctuations in economic activity, vacancies are back in double-digits, at 10.9%.

The problem in high vacancy phases of the property cycle is that it creates fierce competition between landlords to attract tenants, pushing down rents. To bring the timeline up to date, South Africa's nominal capital growth has unsurprisingly finally fallen behind those markets for which IPD measures quarterly and biannually.

With the exception of the UK, the principal driver of performance for investors over the first half of this year – and indeed the last two years – has been income.

Investors' focus is on the preservation and growth of that income stream in the face of muted capital growth.