URBAN REAL ESTATE RESEARCH UNIT

Indicator Watch for the South African Commercial Property Market Cycle
December 2017

MSCI Capital Growth Decomposition

Cycle Position:

The following graphic (reproduced with kind permission of MSCI) provides an interesting perspective of the dynamics of the real estate cycle. It shows the IPD index in 6-month periods until June 2017. The indicators tabled below then pick up the subsequent trends.

Firstly, notice that the total return has tended downwards since 2013 picking up a bit over 2016 into 2017. The return posted for the latest 6 months is 6.1%, giving a rough annualization of 12,2%. This performance is at the levels the SA REITS sector, which is buoyed by strong offshore diversification. The direct return seems counterintuitive, given poor economic performance and stark trading conditions prevalent in the physical markets; low GDP growth, sub inflation Retail sales growth, negative Building Plans growth, increasing Vacancies across sectors, plummeting Trading Density. growth in Retail and barely positive overall Rental Growth.

What then is happening in the chart in the next page?

IPD returns include Income Return and Capital Growth. Components of growth are separated into Income Return (income over capital employed) and Rental Growth on one hand; and into the influence of Valuation on the other viz. Yield Impact and valuer Sentiment (computed as the portion of the value not explained by Rental or Yield movement).

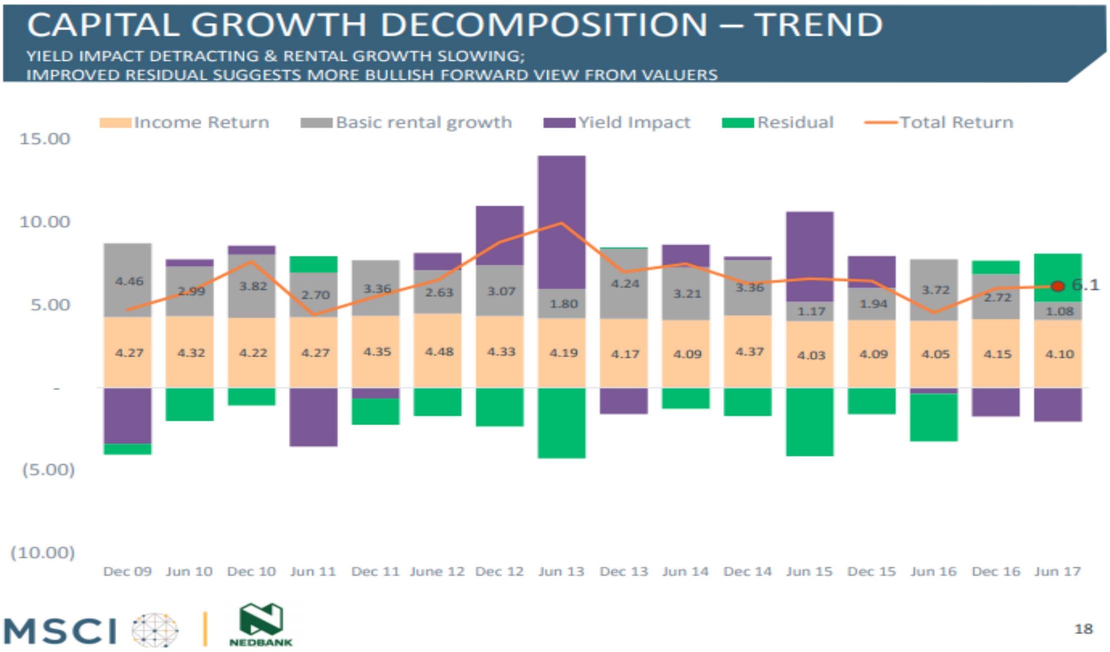
See how rental growth in the industry has plummeted over the past 18 months, and is mirrored by an ever-negative impact of yield adjustment (cap rates, discount rates) in detraction from returns over the same period.

In this environment market sentiment has moved from negative to positive over the last 2 periods and in the 6 months to June added a whopping 3% plus to the result!
The next few months will tell how justifiable such a bullish view is. To the contrary, our view is that notwithstanding a correction in confidence due to possibly more favourable political events, the cycle is still in the down phase in most markets, and the numbers below quantify the extent of the reduction.

Industry Quote:

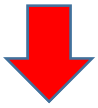
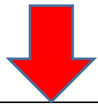
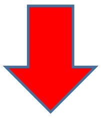
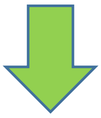
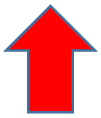
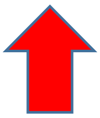
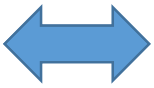
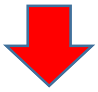
"There is significant opportunity for growth sectors of the local industry during 2018.There is a feeling of being caught in limbo while we await the outcome of December's electoral conference, but business and life must go on. We have an economy with a GDP of approximately 296 billion USD and a population of almost 60 million people to fuel it. Certain tactics need to be changed to adapt property businesses and refocus on growth nodes within the sector. "

Executive Chairman of Land Equity Group, Stuart Chait.



Indicator:

INDICATOR/ COMMENT	% CHANGE/ CURRENT	MOVEMENT	IMPACT ON THE PROPERTY MARKET
GDP GROWTH	0.8% Q3 2017 YOY ∆		GDP growth however small, technically takes the economy out of recession anc gives hope. It could indicate things are going to look better for the coming year Interestingly, over this quarter, the manufacturing sector, car sales and agricultur showed a good growth. With an increase in GDP, retailers and industries will perforr better and this bodes well for real estate.
INTEREST RATE	10.3% Prime Rate December 2017		There has been no change to the interest rates and there is no major pressure tc increase rates.
INFLATION RATE (CPI)	4.8% October 2017 YOY ∆		The year on year change in inflation rate for October 2017 was 4.8 %. Inflation has diminished a bit, but while the governor of SARB has implied that there won't be any interest rate hike, some economists fear the contrary.
RETAIL TRADE SALES – RETAIL SECTOR	1.9% January to September 2017 YOY ∆		Retail sales growth dropped slightly again and is now well below inflation. Falling wholesale trade brought down the whole trade industry by -0.4%. Black Friday gained traction this year, which could be positive for the November figures and. Mall owners would have benefited.

HOUSE PRICES	+4.6% November 2017 YOY growth rate (FNB)		While October and November showed growth rates above 4,5%, the year's average is nearer to 3%. This is a big decrease from the average of 4.7% for 2016. Rising inflation played a big role in the overall decline over this year. Declining prices can be a double-edged sword for the property sector.
BUILDING PLANS PASSED – REAL TERMS (RESIDENTIAL)	-6.8% January to September 2017 YOY ∆		Interestingly the number of dwellings <80 m^2 increased by 8.2% YOY, while dwellings >80 m^2 decreased by -4.4% There was a YOY decrease of -4.2% for flats and townhouses and a decrease of 69% for the relatively small "other' buildings. Intentions to build are now turning down sharply signifying less demand.
BUILDING PLANS PASSED (NON-RESIDENTIAL) REAL TERMS	-18.2% January to September 2017 YOY ∆		The greatest drop in the square meterage on a YOY basis was that of shopping centers, followed by other non-residential building and ending with offices, at -55.3%, -21.0% and -16.8% respectively. Industrial and warehousing increased by 9,1% YOY sqm and 16,4% YOY value. Oversupply and the poor economy directly impacts this real estate.
MFA/BER BUILDING COST INDEX	2.2% Q3 2017 YOY ∆		The average change in building cost has accounted for 2.2% this quarter while sitting at 8.59% in Q3 of 2016. This provides relief for developers and contractors and generally spurs activity.
OFFICE VACANCY RATES	10.5% Q3 2017		An interesting perspective from SAPOA is that to reach the 5% equilibrium vacancy rate, 1.1 million square meters of vacant space needs to be let. The CBD's of Johannesburg and Durban are showing vacancy at around 17%, while Pretoria and Cape Town are at around 10%. In the decentralized nodes the vacancy rates are: Cape Town 4.5%, Durban 6.3%, Pretoria 10.6% and Johannesburg 11.2%.
RETAIL VACANCY RATES	3.6% June 2017		The FNB/BER consumer confidence index dropped to – 9 in line with lower household consumption expenditure. In this recessionary environment, centers which are well managed will benefit and outrun their competitors. Cost management and good recoveries are crucial in this hostile environment.
INDUSTRIAL VACANCY RATE	3.6% June 2017		Building plans passed underlie the relatively better performance of Industrials. However, current global economic pressure and lower commodity prices could slow growth in the near term. Warehousing and standard units have outperformed other segments.
RETAIL TRADING DENSITY GROWTH	0.3 % June 2017 YOY ∆		Retail sales dropped by 4% as well as occupied floor space by 4.3%. "The performance of individual centers varies significantly as they are subject to different factors of competition and different growth drivers and characteristics." SAPOA 2017.
RENTAL GROWTH ALL SECTORS	1% June 2017		Rental growth is punishing in all sectors. The Industrial sector is showing growth of 2.1% while Retail rental growth has decreased to 1.0 and Office rentals are growing at a mere 0.5% The overall rental growth from June 2017 vs June 2016 decreased sharply from above 3% to 1%.

Sources:

ABSA, FNB, C&CI, BER, MFA, MSCI/IPD, SAPOA, Stats SA, SARB, URERU,

** Note that some data where the movement is described as 'Lower' or 'Declining' could indicate an improvement in the situation (e.g. Interest rates, building costs, cap rates, vacancies) depending on the perspective i.e. if 'buyer' or 'seller' the converse also holds true*