URBAN REAL ESTATE RESEARCH UNIT

Indicator Watch for the South African Commercial Property Market Cycle

September 2017

Cycle Position Summary

Conditions in real estate have seldom been more confusing and uncertain. Recent 'political activity' has been bizarre to say the least, as opposition parties try to unseat a president while government leaders retain the status quo for disparate reasons; none satisfactory, given allegations of massive corruption and 'state capture' which are now quite credible. Yet delivery of services and jobs to the poor is not improving.

The economy has been downgraded to junk by international agencies. Foreign and local real estate investment is at an all-time low as is confidence. Controversial commentators speak of an 'investment strike' and 'capital flight'.

Close to 60% of the REITS sector in South Africa has invested abroad whether in physical property or indirect investment. REITS, in turn, account for more than 60% of all investment property in SA. Our sector has discovered far better prices and yields abroad and therefore much more lucrative deals. There are limited opportunities in the rest of Africa.

Real estate trends have been deteriorating for a number of years and the statistics below mostly indicate this is continuing, and will probably accelerate.

The office market still appears to be the hardest hit. Industrials are showing cracks as the manufacturing sector and the economy contract. Some Retails continue to deliver good defensive performance, but we expect increased pressure on all real estate markets in the months ahead, with a poor economy, oversupply, loss of confidence and lack of productive regulation and resources.

In our view, all major real estate sectors are squarely in recession mode, with only a few niche markets performing well.

Industry Quote:

"When the economy slows, the property market is going to suffer too, by which I mean the non-residential property market as well, retail especially. Consumers are under pressure; unemployment is not going to come down. Shopping centres won't be as attractive an investment in the next few years as they have been in the past 40 years"

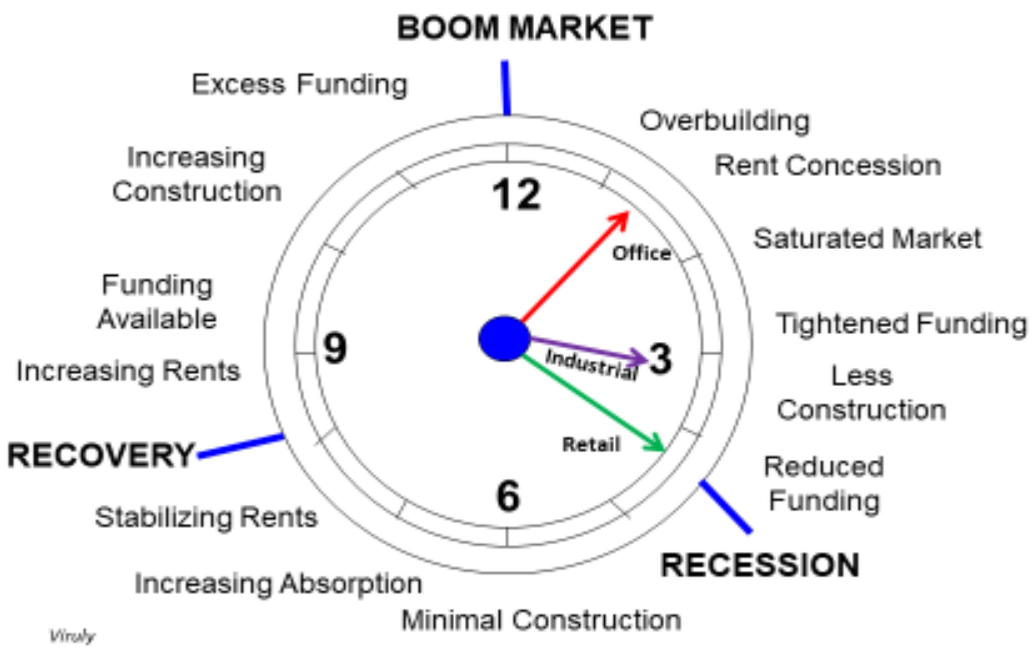
Erwin Rode, CEO of Rode & Associates, Quoted by SA Investing, 14 June 2017

INDICATOR/ COMMENT	% CHANGE/ CURRENT	MOVEMENT	IMPACT ON THE PROPERTY MARKET
GDP GROWTH	1.10% Q2 2017 YOY ∆	⇧	GDP has increased in this recessionary environment. Though heralded politically as ‘the end to the recession’, the rise was heavily influenced by the agricultural sector’s 33% increase and the contribution of mining and the financial Institutions. However, demand and confidence indicators point to subdued growth. real estate activity is closely connected to GDP.
INTEREST RATE	10.25% Prime Rate September 2017	⇩	Contrary to all expectations, interest rates decreased by 25 basis points. The reason for this was that the Rand remained resilient, though still vulnerable to global monetary policy and credit rating downgrades. This brings some relief to home owners as it has been the only interest cut in the past five years.
INFLATION RATE (CPI)	4.66% July 2017	⇩	Inflation reduced to 4.66% for July 2017. It is the lowest it has been for the past two years. This can be attributed to the slowdown in manufacturing, cost of food, lower electricity prices and some decline in fuel prices.
MANUFACTURING PRODUCTION – INDUSTRIAL SECTOR	3.63% January to June 2017 YOY ∆	⇧	There has been a small nominal increase in manufacturing over the 6 months, though when adjusted for inflation, the change is more than 2% negative. The rate of nominal growth slowed markedly in Q2 vs Q1. This was mainly due to lower production in petroleum chemical products and several other heavy industries. With plants slowing down, facilities could close thus creating vacancies. These conditions can also impact design of industrial space favoring smaller units to larger ones.
RETAIL TRADE SALES – RETAIL SECTOR	0.61% January to June 2017 YOY ∆	⇧	Retail business, was lower over the first part of the year, but bounced back somewhat in the second quarter to +2.18%, resulting in a slight improvement over the first half of the year. The Q2 economic improvement would have contributed to this. However, retailers and landlords are plagued by high consumer debt levels, lower foot counts, declining trading densities, pressure on rentals and rising vacancies. Indisputably many areas are overtraded and tech-retailing is changing shopping patterns as well as the dynamics of space and lease negotiations; which the sector is still adapting to.

HOUSE PRICES	3 % January to August 2017 Ave YOY growth rate (FNB)	⟷	The FNB house price index showed a 3% year on year growth from January to August 2017, this is in consonance to the 3% growth forecasted for the entire 2017 period. However, when prevailing inflation is accounted for, the year on year decline was -3.1%. August house prices improved slightly but at a decelerating rate. It seems that the market will struggle until rescued by economic improvement.
BUILDING PLANS PASSED – REAL TERMS (RESIDENTIAL)	-12.60% January to June 2017 YOY ∆	↓	The percentage year on year growth for Q1 2017 has been -8.07% while Q2 was -16.41 %.The trend is therefore downwards and the outlook is negative, reflecting inter – alia, the poor economic climate, precarious finances of individuals and relatively high interest rates.
BUILDING PLANS COMPLETED - REAL TERMS (RESIDENTIAL)	11.26% January to June 2017 YOY ∆	↑	While building plans passed decreased, New supply buoyed completions which increased sharply for the period Jan to June 2017. Q1 showed an 16.51% increase while the rate of change slowed but was still positive at 6.82% over Q2.
BUILDING PLANS PASSED (NON-RESIDENTIAL) REAL TERMS	-35.42% January to June 2017 YOY ∆	↓	Across all metros, building plans have been declining and were more than 35% down YOY over the 6 months to June 2017. This is despite inordinately high developments in some areas over the medium term*. BPP are an indicator of future investment, and this drop dramatically quantifies the impact of offshore investment, oversupply, and the generally poor political and economic climate. * note: apparent overdevelopment in some nodes is due to companies wanting to locate to quality space in sought after areas (e.g. Rosebank) but the space currently vacant in that area is ex corporate and generally lower grade, hence the new development. It is expected the space will in time be taken up by residential conversions and other corporates. In this sense, we refer to it as 'corrective' development though ultimately there is vacancy created elsewhere.
BUILDING PLANS COMPLETED – REAL TERMS (NON-RESIDENTIAL)	4.73% January to June 2017 YOY ∆	↑	Buildings completed increased over the 6 months to June due to a hefty increase YOY in Q1. However, Q2 weakened by 9.41% vs. the previous period. These figures reflect large projects that have been in the pipeline for some time and have now been constructed

MFA/BER BUILDING COST INDEX	6.70% Q1 2017 YOY ∆	↔	Building costs for Q1 (latest data) increased by 1.1% on the same quarter last year. This is higher than the CPI possibly due to scarcity of some materials while 'overbuilding' is taking place, both speculative and 'corrective' demand. However, continuing rising costs will squeeze contractor margins and reduce demand down the line.

Property Clock September 2017



Viruly Clock, September 2017

Movement of the Property Clock

Our view is that conditions in the property markets are tightening and there is no broad or decisive move towards recovery. The concern is that continuing deficient performance will exert further negative impact on the take up of space. The supply side will then slow accordingly, and lead to a more protracted downturn than previously expected.

We have moved the Retail hand of the clock back to the rim of recession: the construction that has been taking place has not been rooted in fundamental improvement and we are far off absorption and rents stabilizing or increasing..

Sources:

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

** 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) depending on the perspective i.e. if 'buyer' or 'seller' the converse also holds true.*