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# *Indicator Watch for the South African Commercial Property Market Cycle*

## April 2017

### *Cycle Position Summary*

Recent ‘political’ events and the downgrading of South Africa’s international credit rating have led to declining investor confidence. We believe these factors will have a direct adverse effect on the economy in the near term. This does not auger well for real estate markets. Both demand and supply indicators are already deteriorating, vacancies remain stubbornly high and investors are feeling the pinch, with the latest returns released by IPD well down on the previous year’ (-190bps).

The Office market has been hardest hit and though Industrials and Retails have been delivering quite good defensive performance, we expect increased pressure on all real estate markets in the months ahead.

### *Industry Quote:*

> *“The IPD index results show that the performance of the South African property investment sector continues to hold up well despite the prevailing low GDP growth environment”*

**Robin Lockhart-Ross (Nedbank CIB)**

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| INDICATOR/ COMMENT | % CHANGE/ CURRENT | MOVEMENT | IMPACT ON THE PROPERTY MARKET |
| --- | --- | --- | --- |
| **GDP GROWTH** | 0.7%<br>Q4 2016<br>YOY ∆ | **Declining** | Mining and production were the main cause of lower GDP growth for the past quarter. In the budget review of 2016, former finance minister Mr. Pravin Gordhan expected GDP in 2016 to grow by 0.9%, by 1,7% in 2017 and by 2.4% in 2018.The revised expectation is GDP growth of 1.3% in 2017 and 2.0% for 2018. This will be hard to achieve because of political and social instability and low business confidence. The third rating agency downgrade by Moody’s, lowered South Africa’s government bond rating by one notch to Baa1 from A3, with negative outlook. Standard and Poor’s had rated non-Rand foreign debt at junk while local debt was graded sub-investment with negative outlook. Fitch also downgraded SA to junk status.<br>The real estate cycle tracks the economy closely. With sentiment being as low as it is on all fronts, the Rand can weaken, there is upward pressure on inflation and interest rates, domestic demand growth can be expected to slow as well as FDI, and then employment. These factors all translate into less space required, higher vacancies, keen rent negotiation/lower rentals and higher costs, in the real estate sector. |
| **INTEREST RATE** | 10.5%<br>Prime Rate<br>April 2017 | **Same** | Since March 2017, there has been no increase in interest rates. From July 2015 to March 2016, there was an increase of 1% in the prime lending rate over 5 tranches. However, in the current economic climate, we can expect an increase in the prime rate soon. Defaults could increase as well as vacancies. An uncertain interest rate environment is not good for the real estate sector and could also result in negative adjustments to capitalization rates. |

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| **INFLATION RATE (CPI)** | 6.1%<br>March 2017 | **Increasing** | The inflation rate has surpassed the targeted range of 3% - 6%. There is upward cost pressure from transport, housing and utilities, recreation, restaurants and hotels. Costs increases were slower for food and non-alcoholic beverages, household contents and services, alcoholic beverages and tobacco, clothing and footwear.<br>In an extended inflationary environment, there is possible upside in that institutions and fund managers invest more in hard assets such as real estate as financial assets can lose ground and purchasing power is eroded. On the flip side, high inflation can lead to higher interest rates, lower consumer spending and rising capitalisation rates, meaning lower demand and lower capital values in real estate. |
| **MANUFACTURING PRODUCTION – INDUSTRIAL SECTOR** | 0.8%<br>Average year to Feb 2017<br>YOY ∆ | **Declining** | Although the average year on year change is slightly positive at 0.8%, the manufacturing sector is facing tremendous challenges. It had a negative impact on GDP in the last year and this is likely to continue unless the global market improves. The primary and secondary sector of the economy has been performing very poorly while the tertiary sector has shown growth. Mining and production activity have decreased due to the fall of commodity prices over the past five years. The price of steel dropped by almost 50% because of oversupply. The agricultural sector has been impaired by the drought and has resulted in a 15% decline since 2015. There is direct impact on Industrial property in lower overall output and in the demand/supply dynamics of goods, which in turn affects the economy. |

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| **RETAIL TRADE SALES – RETAIL SECTOR** | 1.5% Average year to Jan 2017 YOY ∆ | **Declining** | The average percentage change year on year change for the period shown is almost 2% lower than it was for the prior period. This decrease indicates intense pressure on retailers to meet the bottom line. The drop in sales was across most segments. High inflation, high debt levels, consumer confidence and online retailing are all influencing factors associated with the deterioration in retail sales in real estate outlets. Possible higher rentals and vacancies could be the consequence. |
| **HOUSE PRICES** | 4.1% March 2017 Month YOY ∆ (FNB) | **Increasing** | With our usual source, the ABSA House Price Index not being available at the time of publication, we looked to the FNB Barometer of April 2017. “The FNB House Price Index growth rate for March 2017 has shown signs of some strengthening, accelerating from 2.7% growth in February to 4.1 % in March.” However, when adjusted for CPI inflation, the growth was negative. From the past year, the FNB house price index, in both nominal and real terms, was declining at the beginning of the year and has recovered somewhat, showing growth for the past four months. The weighting of higher cost housing ion this index may be part of the reason for this. |
| **BUILDING PLANS PASSED – REAL TERMS (RESIDENTIAL)** | -0.66% Average year to Feb 2017 YOY ∆ | **Declining** | From March 2016 to February 2017, the year on year movement in building plans passed averaged -0.66%. The average year on year for the period March 2015 to February 2016 was 2.4 %. This reflects the weaker economic conditions and especially the high interest rates. |

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| **BUILDING PLANS COMPLETED - REAL TERMS (RESIDENTIAL)** | 1.1% Average year to Feb 2017 YOY ∆ | **Declining** | The rate of percentage change in building plans completed for residential buildings experienced a decline of over 10% - from 11.5% for the period March 2015 to February 2016 to 1.1% for the period March 2016 to February 2017. This is a declining trend and relates to the slowing of building plans passed. |
| **BUILDING PLANS PASSED (NON-RESIDENTIAL) REAL TERMS** | 4.88% Average year to Feb 2017 YOY ∆ | **Declining** | Non-residential building plans also suffered a huge average year on year deterioration in the rate of percentage change (by over 50%). This was mainly due to very large retail projects in the previous period in the Gauteng and KZN areas. Such levels of Non-Residential plans passed are not anticipated in the foreseeable future. |
| **BUILDING PLANS COMPLETED – REAL TERMS (NON-RESIDENTIAL)** | 36% Average year to Feb 2017 YOY ∆ | **Increasing** | Non-residential building plans completed displayed the opposite to plans passed with the average year on year change increasing from -16.29% in the previous year to 36% presently. This was led by large increases in office and banking space in Gauteng as well as an overall increase of Industrial warehouse space. It can also be ascribed to the completion in shopping space planned previously. It does indicate a measure of improvement in some markets despite the macro economic environment. |
| **MFA/BER BUILDING COST INDEX** | 6.70% Q1 2017 YOY ∆ | **Increasing** | Building costs for Q1 increased by 1.1% on the same quarter last year. The Building cost increase is higher than the CPI which could mean scarcity of some materials and/or a degree of overbuilding. Increasing building costs can reduce demand and squeeze contractor margins, affecting the feasibility of projects. |

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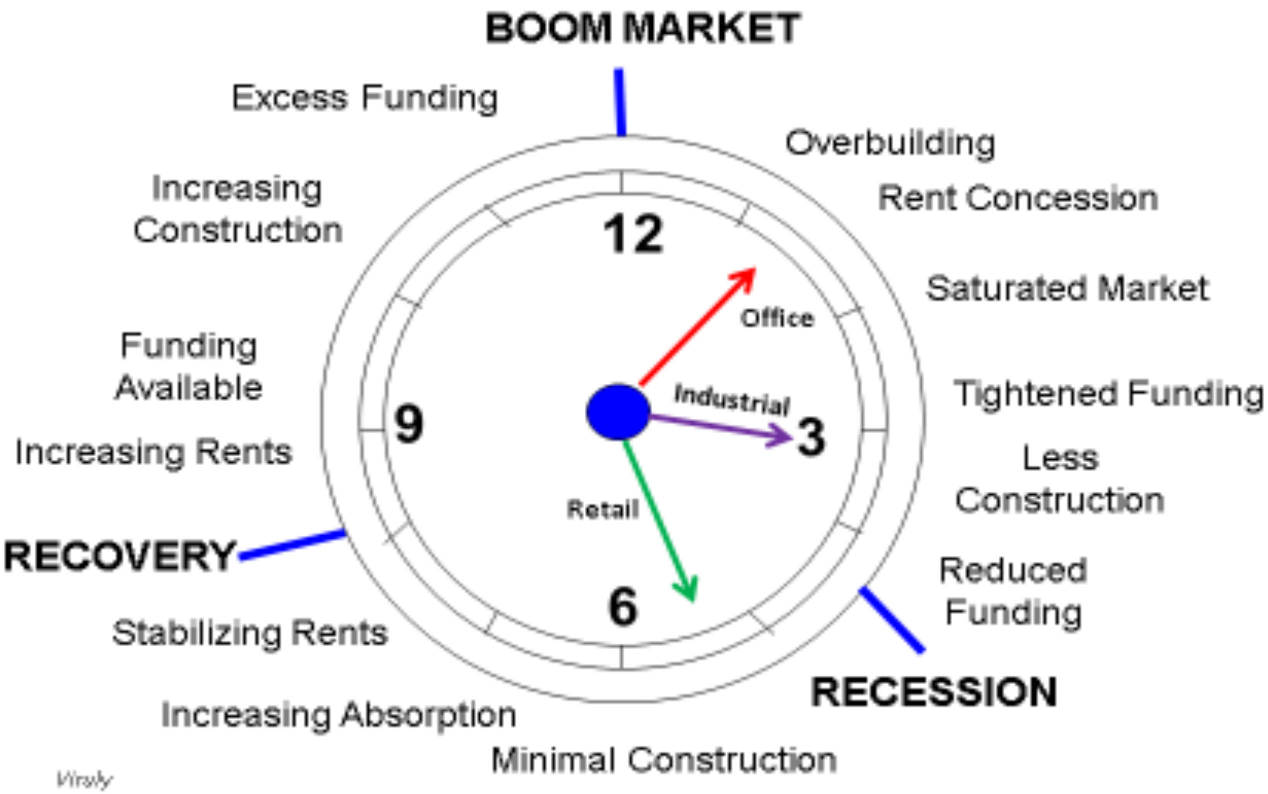
## *Movement of the Property Clock*

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.



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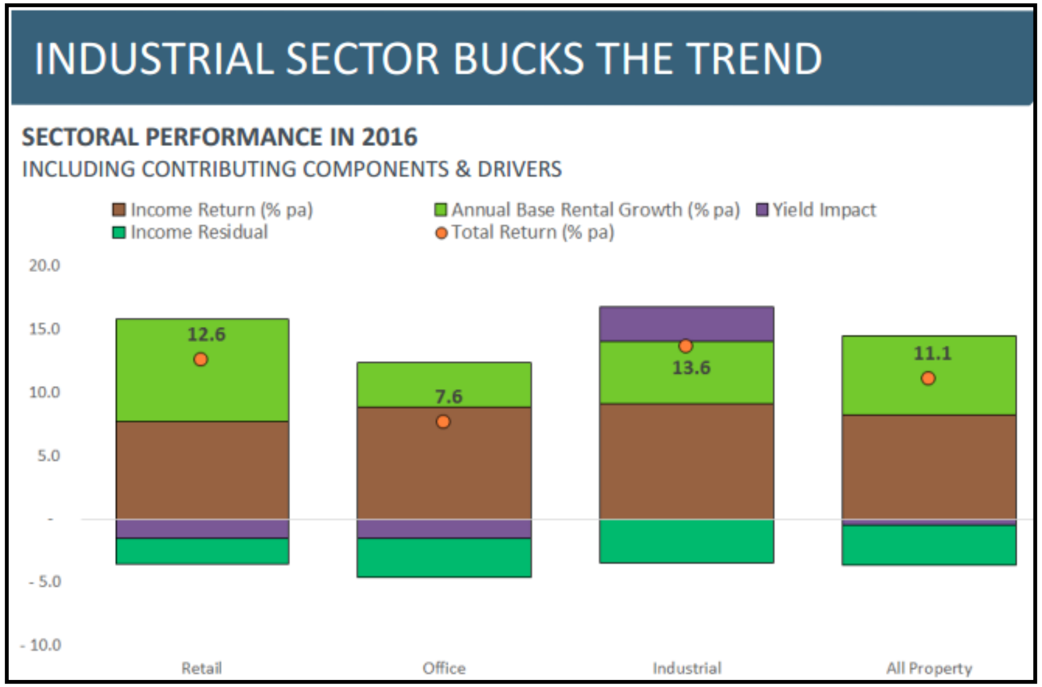
*Topic of the month: The MSCI 2016 Index Results*

MSCI recently released the IPD South Africa Annual Property Index for 2016, which shows an ungeared total return of 11.1%. This was down from 13.0% in 2015 and the lowest recorded return since 2009. Nevertheless, given protracted poor economic conditions, investors can take heart from this respectable double digit return. It was due to strong and stable income returns at above 8% and base rental growth of 6.2% slightly up on the 2015 figure. Capital growth was down to 2.6%, well below 2015 capital growth of 4.4%.

Direct property outperformed all major asset classes in 2016, including listed property at the equity level. Valuers have become very cautious, with both yields and sentiment offsetting the fairly strong rental growth.

Phil Barttram, Executive Director at MSCI commented that "...returns benefitted from stable incomes, founded on the sectors' contractual income base and aggressive cost management. Even given the decline in total returns, the sector has once again proven its resilience by providing real returns in 2016".



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The **Industrial** sector put in the best performance at 13.6% total return, buoyed by yield impact rather than pure rental growth. We look forward to learning more about the reasons for these dynamics, though we know that High Tech Industrials returned a stellar 18,1% return and that Warehousing and Light Manufacturing were also well up there. The total **Retail** return was 12.6%. Unsurprisingly given the shopping patterns we are familiar with, Neighborhood centers did very well and the large Super Regionals underperformed the average. The **Office** markets continue to lag managing only 7.6% total return in 2016. The decentralized offices are now joining the inner-city offices, with sub-standard investment achievement.

It must be said however, that the IPD index results predate the turmoil of the early part of 2017, including the cabinet reshuffle and replacement of the finance minister and other senior figures, the rating agencies downgrades of the South African economy and subsequent civil action against the President particularly. This has led to serious loss of investor confidence locally and abroad, which in turn is likely to have a telling negative affect on real estate fortunes in the months ahead.

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