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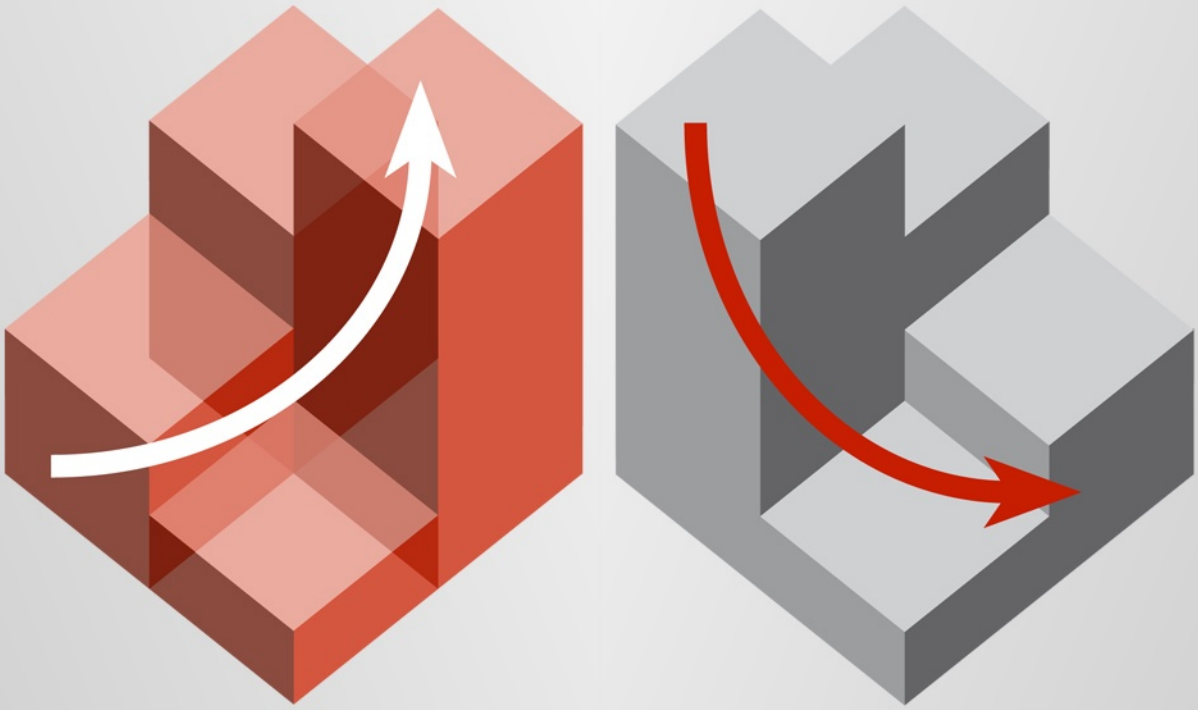
Rode's South African Property Trends

2008 - 2013



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SA Property Trends

2008 - 2013

A medium-term forecast and interpretation
of the crucial property variables

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"Economics is extremely useful as a form of employment for economists."

– John Kenneth Galbraith

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Table of contents

Executive Summary 1

Chapter 1

Rode's econometric model 2

Chapter 2

Summary of the forecasts 3

Chapter 3

Decent rental growth to result in good returns 8

Chapter 4

Where are we in the long property cycle? 12

Chapter 5

Real rentals to continue marching north 17

Chapter 6

Two pillars of support showing weakness 22

Chapter 7

Demand in the doldrums, new supply still disturbingly high 25

Chapter 8

Real house prices to enter a protracted downswing 28

Chapter 9

Cap rates have seen their best levels 30

Chapter 10

Tough times ahead for building contractors 33

Chapter 11

Distribution growth prospects remain fairly favourable 36

List of tables

Table 2.1:	South African Macroeconomic forecasts	4
Table 2.2:	Forecast summary of the critical variables	5
Table 2.3:	Forecast of real growth	6
Table 2.4:	Average percentage change	7
Table 3.1:	Forecast returns on a notional portfolio of prime office buildings	10
Table 5.1:	Forecast of prime office rentals: Nominal % growth per year	17
Table 5.2:	Forecast of prime office rentals: Real % growth	18
Table 5.3:	Forecast of grades A+, A & B office vacancies: % vacant at year-end	18
Table 6.1:	Forecast of prime industrial rentals: Nominal % growth	24
Table 6.2:	Forecast of prime industrial rentals: Real % growth	24
Table 7.1:	Forecast of real retail sales: % change on previous year	26
Table 7.2:	New shopping-centre completions	27
Table 8.1:	Forecast of house prices: National % change on previous year	28
Table 8.2:	Forecast of 2-bedroom flat rentals: National % change on previous year	29
Table 9.1:	Forecast of capitalization rates	31
Table 9.2:	Forecast of leaseback escalation rates	32
Table 10.1:	Forecast of GDCF in buildings	34
Table 10.2:	Forecast of building costs	35
Table 11.1:	Forecast of property loan stock performance	38

Foreword

Dear Reader

Welcome to the last issue of Rode's *SA Property Trends* for 2008.

Despite a weaker prognosis for the macro economy, compared to, for example, a year ago when an anticipated economic growth rate of about 5% p.a. was the norm, our forecasts, especially with regard to market rental growth, remain fairly optimistic. Hence, we expect the *real* rental upswing to continue but not to be as steep as previously expected.

As usual, I must emphasize that our model relies heavily on the macroeconomic forecasts of our expert panel of economists — the results of a survey conducted in December 2008. Note, however, that the panel is in no way responsible for the property-related forecasts generated by Rode & Associates.

We invite our subscribers to contact me, at no additional cost, regarding issues that can be dealt with over the phone. Personal presentations can be arranged at a fee.

Enjoy your reading!

John Lottering
Editor
11 December 2008

PS: For access to a wealth of information, be sure to visit our website at www.rode.co.za.

Executive summary

Written by John S. Lottering

Should economic growth not be marred too much by power shortages and a deteriorating world economy, keeping vacancies reasonably low and in the single-digits, market rentals for both office and industrial space might still be able to show decent growth rates, in excess of building-cost inflation, over the forecast period. The reader should take note, however, of our weaker prognosis of the macro economy, compared to, for example, a year ago when an anticipated economic growth rate of about 5% p.a. was the norm, and this does mean that the upswing in *real* office and industrial rentals will not be as steep as previously expected.

As for the retail property market, the weaker economic conditions and the unlikelihood that interest rates will return to their 2006 levels over the forecast period, are expected to result in moderate growth in all categories of consumer goods. Therefore, growth in retail sales is not expected to be as robust as it was over the past few years. Of course, this could translate into moderate trading densities, and consequently, sombre retail-rental growth below that of building-cost inflation. Furthermore, disturbingly high new development figures might also serve to put more pressure on rental growth from the supply side.

Over the forecast period, we expect the demand for residential space to own to remain feeble owing to sky-high prices, high borrowing costs (interest rates), stern borrowing requirements, high household debt levels and continued meagre economic conditions at home and abroad. Although the unaffordability of owning a house might lead to some substitution towards renting, this impact is not expected to be too robust. We foresee residential rental growth roughly in line with consumer inflation.

Regarding capitalization rates, the likelihood of slower economic growth, a possible reduction in demand for space, and consequently, marginally rising vacancy rates can be viewed as posing some risk to the expected cash flows from property, thereby leading to investors requiring higher minimum income returns (capitalization rates). On the other hand, the opportunity costs from not being invested in long-bonds might be kept at bay by expectations of moderating consumer inflation and interest rates, which might prevent capitalization rates from moving too far north. Having said that, a weakening rand exchange rate still poses a severe threat to inflation. Furthermore, because we do not expect interest rates to come down to their levels of 2006 over the next six years, means capitalization rates might also have seen their best levels for a long time to come.

Building activity, in both the residential and non-residential sectors, is expected to be constrained by a weaker economy and the higher cost of financial gearing. Of course, the likelihood of a slowdown in building activity does imply tough times ahead for building contractors. Therefore, with fewer new projects available to tender for, tendering competition amongst contractors is expected to be intensified, forcing them to trim their profit margins, resulting in lower building-cost inflation. ■

Chapter 1

Rode's econometric model

Written by John S. Lottering

Rode's econometric model of the South African property market forecasts crucial property variables based on historical relationships and economic fundamentals. In addition, the econometric model's forecasts assume that these relationships will continue. The model does not take into consideration any possible external shocks — for instance another sudden crash of the rand or a collapse of the US economy — which, naturally, are impossible to predict.

The benefits of the econometric model for predicting future movements in the property market are that the model:

1. identifies the variables to be used;
2. apportions weightings to the variables based on their relative contributions to the outcome; and
3. allows for the influence of the variables on one another.

The human mind is incapable of performing any of these feats — let alone all three simultaneously.

However, weaknesses of the model relate to

a. its reliance on historical relationships between the variables and its assumption that these relationships will persist in the future; and
b. the assumption that the macroeconomic forecasts that serve as inputs to the model, will turn out to be correct.

In a few instances, structural changes in the property market have made it necessary for Rode to do some of the forecasts manually. ■

Chapter 2:

Summary of the forecasts

Written by John S. Lottering

Macroeconomic forecasts

The averages of the macroeconomic forecasts of 9 economists polled by Rode in December 2008, are summarised in **Table 2.1**.

Good news has been the slight moderation in consumer inflation in September and October 2008, on the back of lower fuel prices and subsiding domestic price pressures. For these reasons, and possibly also the potential lowering impact of the new weights and the re-basing on the CPI, our panel of economists foresee consumer inflation to peak in 2008 and, thereafter, to continue on a disinflationary trend throughout the forecast period.

As with consumer inflation, our panel expects the interest rate cycle to reach an upper turning point in 2008 and to head moderately south thereafter. Note, however, that a weak and volatile rand continues to pose the greatest threat to the inflation outlook and possibly to the extent that the Reserve Bank will be willing to slash its lending rates. An average prime overdraft rate of 13,5% p.a. over the forecast period, reveals that our panel is of the opinion that interest rates are unlikely to return to their 2006 levels any time soon.

Of course, higher borrowing costs, together with tighter borrowing requirements and high household debt levels, by implication mean that we are unlikely to see another consumer splurge over the next few years. Hence, moderate growth in household consumption expenditure, and consequently, moderate economic growth can be expected over the next few years. In fact, our economists forecast *real* personal consumption expenditure — the biggest component of gross domestic product — to show average growth of roughly 3,6% p.a. over the forecast period, with consumption expenditure on durable goods expected to contract during the first two years of the forecast.

What's more, the considerable economic growth potential lost owing to the lack of sufficient electric power remains a great impediment to robust economic activity; a hindrance we unfortunately believe will still be with us for a number of years. This, together with a world economy heading for recession, which consequently means a waning in commodity demand, has led us to adjust our panels' GDP growth forecast slightly downwards. Note that we still expect *real* GDP growth to average just below 3% p.a. over the next six years.

Property market forecasts

The property forecasts, derived from the macroeconomic forecasts, are summarized in **Tables 2.2** to **2.4**.

Table 2.1
Rode survey of macroeconomic forecasts
Forecast date: December 2008 (n = 9)

	Means					
	2008	**2009**	**2010**	**2011**	**2012**	**2013**
CPI: including VAT, all items: % change	11,7	7,6	5,7	5,4	5,3	5,1
Real expenditure on GDP: % change*	3,4	0,0	3,6	3,0	3,0	3,0
Real GDE: % change	4,0	1,2	5,2	4,1	4,2	4,0
Real PCE: % change	2,8	1,6	3,6	4,1	4,6	4,7
10-year bonds (average for the year): %	9,3	8,5	8,1	8,3	8,2	8,1
Nominal prime overdraft rate (average) (%)	15,3	14,8	13,4	12,7	12,4	12,1
Real prime overdraft rate (average) (%)	3,2	6,7	7,3	6,9	6,7	6,7
Real retail sales: durable goods	-5,6	-2,2	5,1	5,8	6,2	5,8
Real retail sales: non-durable goods	2,6	2,5	3,5	3,9	4,4	4,4
Real retail sales: semi-durable goods	6,6	1,5	4,8	4,8	5,2	5,0

* *After downward adjustment by Rode*

Table 2.1 (continued)
Rode survey of macroeconomic forecasts
Forecast date: December 2008 (n = 9)

	Standard deviations					
	2007	**2008**	**2009**	**2010**	**2011**	**2012**
CPI: including VAT, all items: % change	0,2	0,5	0,7	0,5	0,5	0,5
Real expenditure on GDP: % change	N/A	N/A	N/A	N/A	N/A	N/A
Real GDE: % change	0,4	1,3	0,6	1,0	1,2	0,9
Real PCE: % change	0,4	0,6	0,6	0,7	0,3	0,4
10-year bonds (average for the year): %	0,7	0,7	0,6	0,7	0,7	0,8
Prime overdraft rate (average for the year)	0,1	0,3	0,5	0,4	0,4	0,9
Real retail sales: durable goods	1,4	2,7	1,7	1,4	0,9	2,3
Real retail sales: non-durable goods	0,6	0,7	0,8	0,7	0,5	0,7
Real retail sales: semi-durable goods	0,3	1,7	1,2	1,0	0,9	1,9

Table 2.2
Forecast summary of the critical variables
Nominal % growth per year (average for year, unless stated otherwise)

	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
Consumer Price Index	7,1	11,7	7,6	5,7	5,4	5,3	5,1	6,8
Absa's HPI	14,5	3,6	3,0	2,3	4,0	5,0	6,0	4,0
Flat rentals	9,5	10,3	7,0	5,3	6,9	7,0	7,4	7,3
BER BCI	15,0	11,3	8,0	10,6	12,2	12,1	12,5	11,1
Haylett	10,3	14,3	10,8	9,4	9,3	9,5	9,4	10,5
Industrial rentals (ave. for year)								
Central Witwaters-rand	26,4	18,8	12,0	13,7	15,1	15,5	15,6	15,1
Durban & environs	19,0	20,4	9,4	9,2	13,1	15,2	15,9	13,9
Cape Peninsula	22,4	19,0	13,5	12,5	14,3	16,6	16,9	15,5
Port Elizabeth	27,4	18,0	10,0	10,5	15,4	18,5	19,1	15,2
Prime office rentals (ave. for year)								
National: dec (weighted)	15,9	15,2	10,4	14,3	19,4	19,5	20,7	16,6
Johannesburg CBD	25,0	20,0	10,0	14,3	17,8	18,2	19,8	16,7
Johannesburg dec.	20,5	14,2	10,4	14,4	19,6	19,5	20,6	16,4
Pretoria CBD	16,2	23,0	8,5	10,8	12,9	13,8	15,1	14,0
Pretoria dec.	6,4	19,1	11,7	14,9	19,7	20,5	22,0	18,0
Durban CBD	1,4	13,7	14,4	15,7	17,6	19,1	20,6	16,8
Durban dec.	3,8	15,9	11,5	14,0	18,1	18,9	20,2	16,4
Cape Town CBD	21,4	19,0	9,3	13,7	17,5	18,2	19,9	16,3
Cape Town dec.	10,9	14,4	8,3	12,9	18,7	18,7	20,0	15,5
Office vacancy %: grades A+, A and B (average for year)								
Johannesburg CBD	14,9	9,5	11,5	11,7	12,1	12,4	12,9	11,7
Johannesburg dec.	3,5	3,0	6,6	6,3	6,4	6,2	6,5	5,8
Pretoria CBD	1,3	2,2	3,5	5,8	6,1	5,8	6,0	4,9
Pretoria dec.	1,9	1,6	3,1	3,1	2,5	2,5	2,0	2,5
Durban CBD	6,4	5,1	7,1	7,1	7,1	7,2	7,4	6,8
Durban dec.	1,9	0,9	3,7	3,7	3,8	3,9	4,1	3,3
Cape Town CBD	6,2	4,6	6,2	5,8	6,1	6,1	6,2	5,8
Cape Town dec.	2,8	4,2	4,4	4,2	4,6	4,8	5,0	4,5
Capitalization rates:	*% points change*							
Industrial leasebacks	-0,4	0,8	1,0	0,4	-0,2	-0,4	-0,2	1,3
Prime office build-ings*	-0,5	0,3	0,6	0,3	-0,2	-0,4	-0,2	0,4
Regional shopping centres	-0,6	0,8	0,8	0,2	0,0	-0,1	-0,1	1,6

*Non-CBD buildings

Table 2.3
Forecast of real growth
Rental series deflated
using Rode's forecast of the BER Building Cost Index as a deflator

	Real % growth per year							
	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
Absa's HPI*	3,8	-9,3	-7,0	-6,4	-4,8	-4,2	-3,1	-5,8
Flat rentals*	2,2	-1,2	-0,6	-0,3	1,4	1,6	2,2	0,5
Industrial rentals (average for year)**								
Central Wits	9,9	6,7	3,7	2,8	2,6	3,1	2,8	3,6
Durban & environs	3,5	8,2	1,3	-1,2	0,8	2,7	3,1	2,5
Cape Peninsula	6,4	6,9	5,1	1,7	1,9	4,0	4,0	3,9
Port Elizabeth	10,8	6,0	1,9	-0,1	2,8	5,7	5,9	3,7
Prime office rentals (average for year)**								
National: dec.	0,7	3,5	2,2	3,3	6,4	6,6	7,3	4,9
Johannesburg CBD	8,7	7,8	1,8	3,3	5,0	5,5	6,5	5,0
Johannesburg dec.	4,8	2,6	2,2	3,4	6,6	6,6	7,2	4,8
Pretoria CBD	1,0	10,5	0,5	0,2	0,6	1,5	2,3	2,6
Pretoria dec.	-7,5	7,0	3,4	3,9	6,6	7,4	8,4	6,1
Durban CBD	-11,8	2,1	5,9	4,6	4,8	6,2	7,2	5,1
Durban dec.	-9,7	4,1	3,3	3,1	5,2	6,1	6,8	4,8
Cape Town CBD	5,6	6,9	1,2	2,8	4,7	5,4	6,6	4,6
Cape Town dec.	-3,6	2,8	0,3	2,1	5,7	5,8	6,7	3,9
GDCF in buildings:***								
Residential	10,5	2,2	-7,4	-1,2	0,1	1,5	3,1	-0,3
Non-residential	12,9	9,6	1,0	5,7	5,0	5,8	6,6	5,6
Real prime overdraft rate	5,6	3,2	6,7	7,3	6,9	6,7	6,7	6,3

*Deflated by Haylett

** Deflated by BER BCI

*** Gross domestic capital formation (i.e. building construction activity)

Table 2.4 Average percentage change Past 5 years vs 6-year forecast				
	Nominal growth		**Real growth****	
	Actual 2003-2007	**Forecast 2008-2013**	**Actual 2003-2007**	**Forecast* 2008-2013**
Absa's HPI	21,2	4,0	12,5	-5,8
Flat rentals	7,7	7,3	0,0	0,5
BER Building Cost Index	13,2	11,1	-	-
Haylett	7,8	10,5	-	-
Industrial rentals:				
Central Witwatersrand	14,3	15,1	1,0	3,6
Durban and environs	18,3	13,9	4,4	2,5
Cape Peninsula	14,7	15,5	1,4	3,9
Port Elizabeth	15,8	15,2	2,4	3,7
Prime office rentals:				
National dec.	6,0	16,6	-6,3	4,9
Johannesburg CBD	9,8	16,7	-3,1	5,0
Johannesburg decentralized	6,2	16,4	-6,1	4,8
Pretoria CBD	8,4	14,0	-4,3	2,6
Pretoria decentralized	7,3	18,0	-4,9	6,1
Durban CBD	5,7	16,8	-6,5	5,1
Durban decentralized	7,0	16,4	-5,3	4,8
Cape Town CBD	9,3	16,3	-3,4	4,6
Cape Town decentralized	2,7	15,5	-9,3	3,9

** Deflators used: BER BCI, except Absa's HPI and flat rentals, where Haylett was used.

Chapter 3: Property performance index

Decent rental growth to result in good returns

Updated by John Lottering

With a multitude of new investment options currently available to fund managers, decision-making is very difficult. In order to make an intelligent and well-informed decision, fund managers need to compare the prospects for the different investment classes with one another. This is exactly what we set out to do with our property performance index for office buildings.

Our model was created to forecast the returns for the next five years on a notional grade-A portfolio of office properties in the most important office nodes in South Africa. This will assist fund managers who need to compare expected future property returns with other competing investment classes.

Method

The critical values in our model are: market rentals, capitalization rates, vacancies, operating costs, escalation rates and a depreciation factor for economic ageing. Historical data is from our Rode's Time Series database, and the relevant forecasts are from this issue of *Rode's SA Property Trends*.

A very important prerequisite for understanding and using our forecasts needs to be stated here. We assume that the investor in office buildings only invests in a dynamic, grade-A portfolio. This means that properties are constantly acquired and disposed of to keep the portfolio prime. However, we do not allow for sales commission, an omission that can rightly be criticised.

In order to understand our methodology, a few terms should be defined.

Return on an investment is divided into two components: income return and capital return. Income return (or income yield) is defined as the first year's net income, divided by the market value of the investment at the end of the previous year, times 100 (to deliver a percentage value). Capital return is the growth in the market value of the investment, from the end of the previous year to the end of the year in question. More clearly defined, it is the market value (MV) at the end of the year in question less the MV at the end of the previous year, divided by the MV at the end of the previous year, times 100, thus returning a percentage value. Total return is defined as the sum of the income and capital returns.

The index forecasts the income, capital and total returns on an investment in a typical prime office building in the seven most important office nodes in South Africa. They are the Johannesburg, Sandton and Pretoria CBDs, Hatfield, the Cape Town CBD, Claremont and the Durban CBD.

We define a typical office property as a grade-A building with four tenants, leasing equal sizes of the building, with lease renewals staggered over four years, signed at market rentals and escalating for four

Diagram 3.1: How income is calculated in Rode's property performance index

Year	1999	2000	2001	2002
Prevailing grade A market rental	R20/m²	R26/m²	R30/m²	R35/m²
Prevailing market escalation rate	10,0%	9,0%	8,0%	7,0%

Calculation of 2002 gross contractual income:

R20/m² escalated at 10% p.a.	R26,62/m²
R26/m² escalated at 9% p.a.	R30,89/m²
R30/m² escalated at 8,0% p.a.	R32,40/m²
	R35,00/m²
	R124,91/m²

years at the market escalation rate ruling at the inception date of the lease. The fact that the renewal of leases in our model is staggered over four years implies that only a quarter of the net contractual income during any particular year is signed at the ruling market rental. Another quarter of the income will be linked to the escalated ruling market rental the year before, and so forth. **Diagram 3.1** illustrates how the income portion of our model is calculated.

In order to calculate the income and capital returns on the property, one needs to establish the market value of the building at the end of each year. We calculate this value through *Rode's Valuation Method*. This method reacts immediately to changes in market rentals — albeit not proportionately, because of the retarding effect of existing leases (as demonstrated in **Diagram 3.1**). An analogy would be the share price of gold-mining companies reacting to changes in the gold price.

After calculating the market value through *Rode's Valuation Method*, an adjustment is made to the market value for the economic ageing of the building. Although we assume a grade-A portfolio, where an older investment can easily be exchanged for a younger one, we nevertheless had to provide for the effect of ageing on the market value — a factor that many in the property industry disregard. As proof of this, the reader need only consider the effect of ageing on capitalization rates, which increase, and market rentals, which decrease, with age.

This ageing percentage is subtracted from the previously calculated market value to arrive at a *depreciated* market value. The income and capital returns, as defined above, are then calculated as a percentage of this depreciated market value.

Findings

Table 3.1 summarises the output of our model, which is based on our forecasts outlined in Chapter 2.

Before considering the results of our model, it is worth remembering that the two main drivers of non-residential property values are:

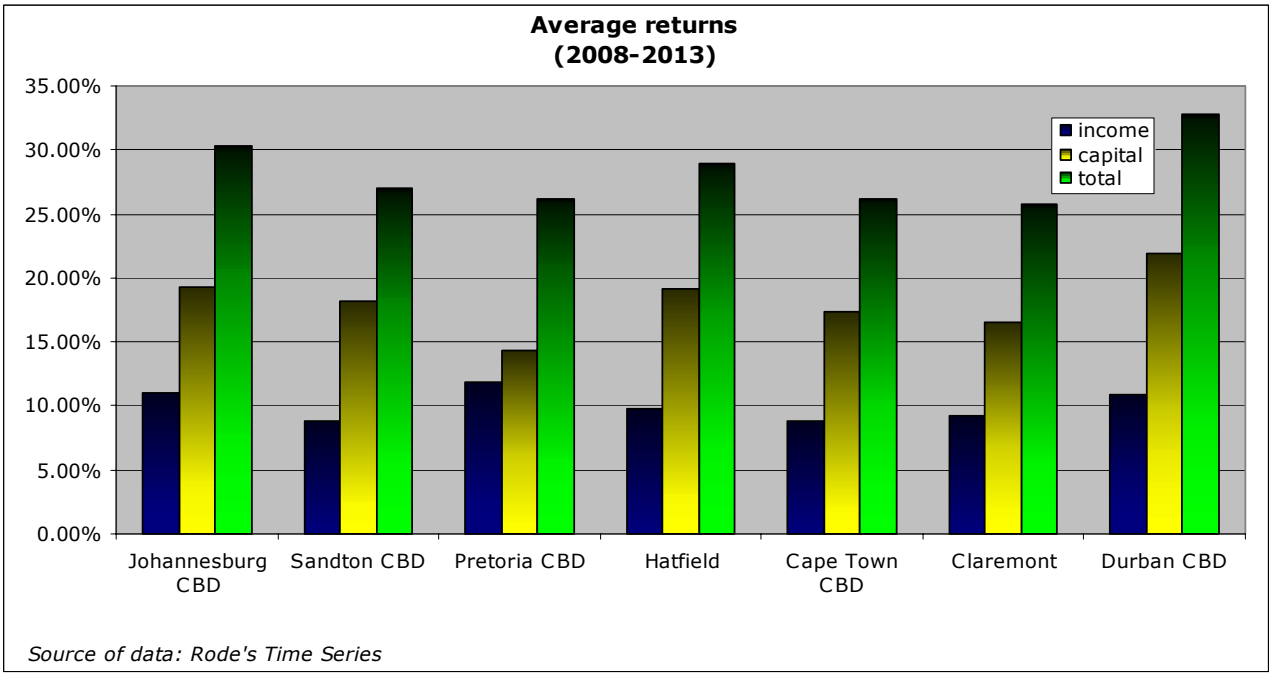
- Market rental levels
- Capitalization rates.

Should economic growth not be marred too much by power shortages and a deteriorating world economy, keeping vacancies reasonably low and in the single-digits, market rentals might still be able to show decent growth rates. This, despite some weakening in cap rates, is expected to result in good capital, and hence, total returns.

Conclusion

Our forecast of fairly strong rental growth is expected to result in strong total returns over the next few years. ■

Table 3.1 Forecast returns on a notional portfolio of prime office buildings (2008 - 2013)							
Johannesburg CBD							
Year ending	**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**	**31-Dec-13**	**2008 - 2013**
Income return	9,5%	10,8%	11,7%	11,8%	11,4%	11,0%	11,0%
Capital return	8,5%	13,6%	19,6%	24,3%	26,7%	23,0%	19,3%
Total return	18,0%	24,5%	31,3%	36,1%	38,1%	33,9%	30,3%
Sandton CBD							
Year ending	**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**	**31-Dec-13**	**2008 - 2013**
Income return	8,0%	8,7%	9,4%	9,3%	8,9%	8,6%	8,8%
Capital return	8,3%	10,3%	19,2%	24,9%	26,9%	19,9%	18,3%
Total return	16,2%	19,0%	28,6%	34,2%	35,8%	28,5%	27,1%
Pretoria CBD							
Year ending	**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**	**31-Dec-13**	**2008 - 2013**
Income return	10,4%	11,3%	12,4%	12,9%	12,4%	12,0%	11,9%
Capital return	5,2%	9,3%	13,9%	19,1%	21,3%	17,2%	14,3%
Total return	15,6%	20,6%	26,3%	32,0%	33,7%	29,1%	26,2%
Hatfield							
Year ending	**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**	**31-Dec-13**	**2008 - 2013**
Income return	9,2%	9,8%	10,3%	10,3%	9,9%	9,4%	9,8%
Capital return	9,2%	10,9%	19,0%	25,2%	27,5%	22,8%	19,1%
Total return	18,4%	20,6%	29,3%	35,5%	37,4%	32,2%	28,9%
Cape Town CBD							
Year ending	**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**	**31-Dec-13**	**2008 - 2013**
Income return	7,9%	8,6%	9,3%	9,5%	9,0%	8,6%	8,8%
Capital return	6,2%	9,9%	17,0%	23,6%	26,4%	21,2%	17,4%
Total return	14,0%	18,4%	26,3%	33,1%	35,4%	29,9%	26,2%
Claremont							
Year ending	**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**	**31-Dec-13**	**2008 - 2013**
Income return	8,8%	9,2%	9,7%	9,6%	9,1%	8,7%	9,2%
Capital return	4,8%	7,9%	17,3%	23,1%	25,6%	20,7%	16,6%
Total return	13,6%	17,1%	27,0%	32,7%	34,7%	29,4%	25,7%
Durban CBD							
Year ending	**31-Dec-08**	**31-Dec-09**	**31-Dec-10**	**31-Dec-11**	**31-Dec-12**	**31-Dec-13**	**2008 - 2013**
Income return	11,1%	10,9%	10,9%	11,1%	10,8%	10,4%	10,8%
Capital return	14,9%	15,2%	20,9%	27,5%	29,2%	24,1%	22,0%
Total return	26,0%	26,1%	31,8%	38,6%	39,9%	34,4%	32,8%



Source of data: Rode's Time Series

Chapter 4: The property cycle

Where are we in the long property cycle?

Written by John S. Lottering

Like any cycle, the property cycle can serve as an important investment tool for buyers, sellers and developers. Buyers should ideally enter the market when the property cycle is still near its trough, simply because the probability is great that from that point on, real rentals and prices will rise strongly. Sellers, on the other hand, should aim to leave the market when the property cycle is near its peak.

Developers normally enter the property market in droves during the latter phase of an upswing. This is because prices and real rentals are now high, making new developments more viable. However, to enter into new developments close to the peak could be risky, especially on the down side of the peak — the more so if the developments are done on a speculative basis.

Furthermore, knowing where we are on the long property cycle is also a way of gauging the level of systemic risk inherent in the property market. Systemic risk is risk that cannot be diversified away, for example, when the *market* is at the top end of the long property cycle.

Why such a long cycle?

The matching of supply and demand in the property market is a formidable task, for essentially two reasons. Firstly, building construction has a long gestation period. Secondly, property has a longer economic life than even durable consumer goods. This implies that, once an oversupply has developed in the property market, it will take many years to be rectified since the existing stock is consumed over decades, leaving only growth in demand to restore equilibrium. This partially explains the long cycle in property.

The property cycle/business cycle nexus

Historically, the South African long property cycle has had a duration of about 17 years from trough to trough, making it distinct from the much shorter business cycle. However, despite this distinction, the peaks and troughs of the property cycle naturally coincide with a business cycle peak or trough, albeit with a lag of one or two years. The duration of the lag depends on the degree of oversupply at the time of the business cycle trough. The upswing phase of the long property cycle might span two business cycles, and so could the downswing phase. Thus one could say that the shorter business cycles are superimposed upon the long property cycle.

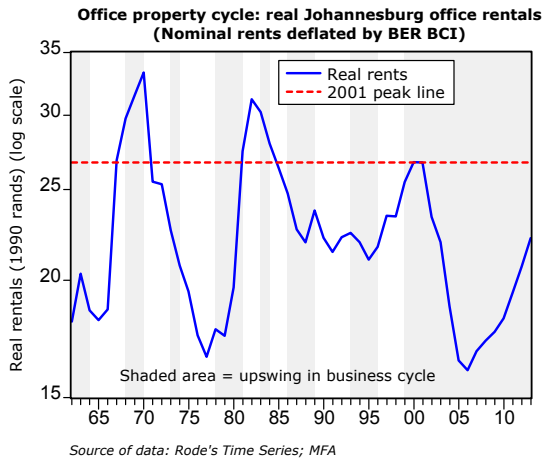
We use ***Johannesburg decentralized*** office rentals as a proxy for the South African decentralized office property cycle. Note, however, that we could just as well have used the office rentals of Pretoria, Cape Town, or Durban decentralized as they all generally move in synchrony. Of course, this is not to say that the magnitude of the change in rentals in the various areas will not differ – it probably will.

For analogous reasons, we normally consider Central Witwatersrand real rentals when studying the industrial property cycle.

i. The office property cycle

After starting on a downswing in 2002, the office property cycle began bottoming out again in 2007. The reason for the downswing, despite the fact that the business cycle was still in a strong upswing, was primarily an oversupply created by overzealous office development activity between the late 1990s and early years of the current decade. Nonetheless, owing to strong economic growth, resulting in a robust demand for office space, this excess office supply was eventually mopped up, and vacancies for prime-quality office space in the major decentralized office nodes are still below the 5% mark.

Assuming a scenario where the economy can still muster growth of about 3% p.a. over the coming years, the rental outlook remains reasonably optimistic. Growth in nominal office rentals is expected to outperform building-cost inflation, resulting in a continuation of the current upswing in the office property cycle. What's more, we do not foresee *real* office rentals surpassing the levels of the 2001 peak, thereby implying that, from a systemic-risk point of view, office property will remain a fairly sound investment during the forecast period.



Source of data: Rode's Time Series; MFA

Representing the property cycle:

Market value vs market rentals

The reader will note that we do not use actual market (capital) values, but rather real (deflated) rentals as a proxy for the office and industrial property cycles.

We can do this because market rentals are a critical determinant of market value. Furthermore, the other critical variable in determining market value, namely capitalization rates, is generally inversely related to market rentals in any case.

In fact, a strong argument can be made that rentals are a superior proxy for the property cycle, because market value sometimes reacts to a rerating of property (i.e. a change in capitalization rates), which is unrelated to underlying property fundamentals. And, of course, it is fundamentals that cause new developments to be occupied, not falling capitalization rates.

Some history: secular decline in industrial-property rentals

Since the early 1980s, South African industry has been hard hit by a number of factors. At different times, different factors played a role, but here are some of the more prominent reasons (not in any specific order):

- Deteriorating workforce productivity (output relative to fast-rising wages from the 1980s onwards);
- Low economic growth (due to, *inter alia*, sanctions, declining real commodity prices, high real interest rates to combat inflation from 1989 onwards, political instability), resulting in feeble domestic demand;
- Reduction of trade tariffs in the 1990s;
- Space-saving technological advances by industry;
- Structural swing towards the services sector (worldwide);
- Dwindling contribution of the mining industry, caused by a weakening hard-commodity cycle;
- Latterly, the rise of cheap-labour economies such as China and India.

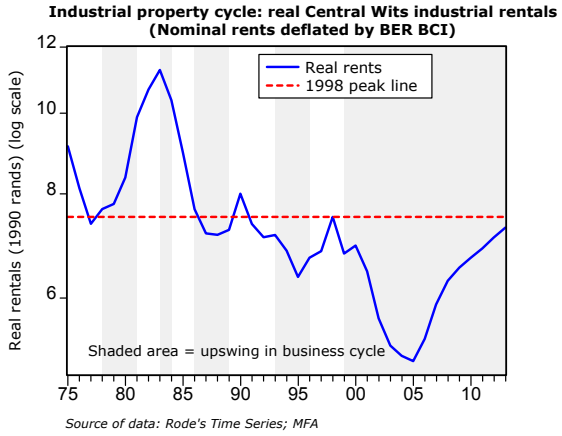
The result: a secular decline in real industrial property rentals.

ii. The industrial property cycle

The industrial property market reached its last significant peak during the early 1980s, largely as a result of a severe shortage of land created by the economic boom and government's self-sufficiency drive (demand) and probably also the government's decentralization policy (supply). Since then, *real* industrial rentals have been in a long secular decline (with two less significant peaks in 1990 and 1998).

Real rentals were only notably able to bottom out in 2005, again on the back of high replacement costs coupled with strong economic growth.

We foresee a continuation of the current upswing in the industrial property market. However, *real* industrial rentals are unlikely to surpass the extraordinary peak reached in the early 1980s, but are likely to move close to the 1998 *real* rental levels.

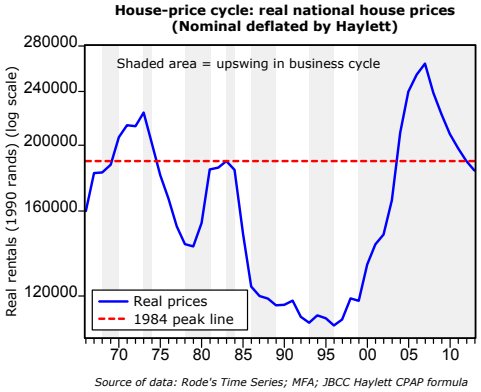


Source of data: Rode's Time Series; MFA

iii. The residential property cycle

The accompanying graph shows that after peaking in 1984, *real* prices moved in a horizontal band for about a decade and a half. From about 2000 onwards, *real* prices rocketed, propelled by a strong economy and structurally lower interest rates, and as a result rapidly approached their 1984 peak levels again. In fact, *real* prices already exceeded the 1984 levels in 2003 meaning that the residential property market has already been exposed to a high degree of systemic risk ever since then.

Over the forecast period, we anticipate nominal house-price growth to be constrained on the demand side by sky-high prices, high borrowing costs (interest rates), stern borrowing requirements, high household debt levels and weaker economic conditions at home and abroad. In short, it's all about affordability. Furthermore, given the long-cycle peak in *real* prices we have had as recently as at the end of 2007, we could be in for a protracted period of stagnating *real* prices – that is, prices growing at below inflation.



Source of data: Rode's Time Series; MFA; JBCC Haylett CPAP formula

When comparing indices, one is looking at the levels relative to the base date (which has been set at 100) and not at the levels of the actual values recorded.

The choice of deflator

Depending on what our aim is and the nature of the data, we could use any of the following indices to deflate a nominal time series:

1. Non-residential time series
    - Haylett index
    - BER BCI index

2. Residential time series
    - Haylett index
    - Absa BCI
    - CPI

These deflators are comprised as follows:

The Haylett Index is a measure of input costs in the building industry — viz. materials, capital and labour costs — and thus excludes the profit margin of contractors. This index gives one an indication of trends in underlying building costs and has application in both the residential and non-residential sectors.

The **BER Building Cost Index (BCI)** measures, over time, pre-contract non-residential building-construction prices, and as such includes the profit margin of contractors. This index is one of the best indicators of the health of the building industry. If it accelerates faster than input costs (that is, the Haylett Index), then non-residential contractors are stretching their profit margins, and vice versa. By deflating a nominal time series with the BER BCI, a developer's perspective of the viability of new projects over time is given, assuming similarly growing land values and constant capitalization rates.

The **Absa Home Building Cost Index** measures, over time, residential building-construction prices, and as such includes the profit margin of home-building contractors. It is the residential opposite number of the BER BCI. We can assume it is not as robust as the BER BCI or Haylett indices.

The **consumer price index (CPI)** measures, over time, the price of a representative basket of consumer goods and services.

In sum…

The *real* industrial and office cycles are expected to keep on heading north over the next five years — but moderated by the business cycle recession we are about to enter. The house-price cycle, in contrast, reached its apex in 2007, and is expected to trend steadily south over the next few years.

This concludes our section on the property cycle. ■

Chapter 5: The office market

Real rentals to continue marching north

Written by John S. Lottering

This chapter reviews the prospects for office vacancies and rentals during the next six years, and covers the CBDs and decentralized nodes of Johannesburg, Pretoria, Durban and Cape Town.

Tables 5.1 and **5.2** summarize our forecasts for *nominal* and *real* office rentals, whereas **Table 5.3** summarizes our average annual vacancy forecasts.

The forecasts in this publication are based on economic fundamentals and historical relationships. The *Rode* econometric model assumes that these historical relationships will continue.

In some markets, however, structural changes have taken or are taking place, which makes model building more difficult and, in fact, often leads to an apparently good model delivering unsatisfactory results. In these instances, the forecaster's experience in the property industry comes in handy with a view to hand-adjusting the model's output.

Table 5.1
Forecast of prime office rentals
Nominal % growth per year

	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
National: dec (weighted)	15,9%	15,2%	10,4%	14,3%	19,4%	19,5%	20,7%	16,6%
Johannesburg CBD	25,0%	20,0%	10,0%	14,3%	17,8%	18,2%	19,8%	16,7%
Johannesburg dec.	20,5%	14,2%	10,4%	14,4%	19,6%	19,5%	20,6%	16,4%
Pretoria CBD	16,2%	23,0%	8,5%	10,8%	12,9%	13,8%	15,1%	14,0%
Pretoria dec.	6,4%	19,1%	11,7%	14,9%	19,7%	20,5%	22,0%	18,0%
Durban CBD	1,4%	13,7%	14,4%	15,7%	17,6%	19,1%	20,6%	16,8%
Durban dec.	3,8%	15,9%	11,5%	14,0%	18,1%	18,9%	20,2%	16,4%
Cape Town CBD	21,4%	19,0%	9,3%	13,7%	17,5%	18,2%	19,9%	16,3%
Cape Town dec.	10,9%	14,4%	8,3%	12,9%	18,7%	18,7%	20,0%	15,5%

Table 5.2
Forecast of prime office rentals
Real % growth per year (series deflated by BER BCI)

	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
National: dec.	0,7%	3,5%	2,2%	3,3%	6,4%	6,6%	7,3%	4,9%
Johannesburg CBD	8,7%	7,8%	1,8%	3,3%	5,0%	5,5%	6,5%	5,0%
Johannesburg dec.	4,8%	2,6%	2,2%	3,4%	6,6%	6,6%	7,2%	4,8%
Pretoria CBD	1,0%	10,5%	0,5%	0,2%	0,6%	1,5%	2,3%	2,6%
Pretoria dec.	-7,5%	7,0%	3,4%	3,9%	6,6%	7,4%	8,4%	6,1%
Durban CBD	-11,8%	2,1%	5,9%	4,6%	4,8%	6,2%	7,2%	5,1%
Durban dec.	-9,7%	4,1%	3,3%	3,1%	5,2%	6,1%	6,8%	4,8%
Cape Town CBD	5,6%	6,9%	1,2%	2,8%	4,7%	5,4%	6,6%	4,6%
Cape Town dec.	-3,6%	2,8%	0,3%	2,1%	5,7%	5,8%	6,7%	3,9%

Table 5.3
Forecast of grades A+, A & B office vacancies
% vacant at year-end

	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
Johannesburg CBD	14,9%	9,5%	11,5%	11,7%	12,1%	12,4%	12,9%	11,7%
Johannesburg dec.	3,5%	3,0%	6,6%	6,3%	6,4%	6,2%	6,5%	5,8%
Pretoria CBD	1,3%	2,2%	3,5%	5,8%	6,1%	5,8%	6,0%	4,9%
Pretoria dec.	1,9%	1,6%	3,1%	3,1%	2,5%	2,5%	2,0%	2,5%
Durban CBD	6,4%	5,1%	7,1%	7,1%	7,1%	7,2%	7,4%	6,8%
Durban dec.	1,9%	0,9%	3,7%	3,7%	3,8%	3,9%	4,1%	3,3%
Cape Town CBD	6,2%	4,6%	6,2%	5,8%	6,1%	6,1%	6,2%	5,8%
Cape Town dec.	2,8%	4,2%	4,4%	4,2%	4,6%	4,8%	5,0%	4,5%

Office vacancies: The floor area available for leasing at any given time, irrespective of whether there is still a valid lease over the space. In most cases, office vacancies are expressed as a percentage of the stock in rentable m².

Office stock: Total rentable office space.

Office demand: Office stock less office space vacant (space on the market for renting irrespective of whether there is still a valid lease over the space). In other words, demand is office space occupied.

Office take-up: Change in office demand (space occupied) over previous year. Where take-up is positive, it can also be called growth in demand.

Using building costs as a deflator, allows the reader to interpret the graphs from a developer's point of view, which serves as a proxy for the viability of new developments over time, holding constant capitalization rates and operating costs. Note that the base year for the BER BCI and the Haylett deflator is set at 1990 (1990=100). This means that, after deflation, rental levels per square metre are expressed in 1990 rands.

Decentralized office market

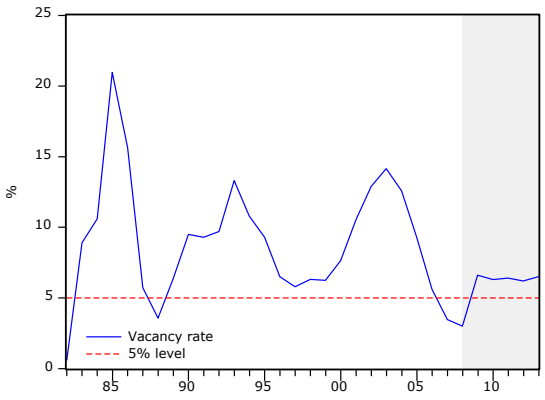
On average, prime office vacancies in all of the major metropolises were low and below the 5% mark in the third quarter of 2008. Vacancies in Durban and Pretoria decentralized averaged around 1,2% and 1,9% respectively, while vacancies in Johannesburg and Cape Town decentralized were marginally higher at 3,6% and 4,9%.

As a rule of thumb, when vacancies drop below 5%, and the economy is growing robustly, strong market rental growth can be expected.

As the accompanying graphs show, prime office vacancies in the decentralized areas dropped below the 5% level from about 2005 onwards. This, together with a robustly growing economy, later resulted in sturdy market rental growth, in most cases, in excess of build-cost inflation.

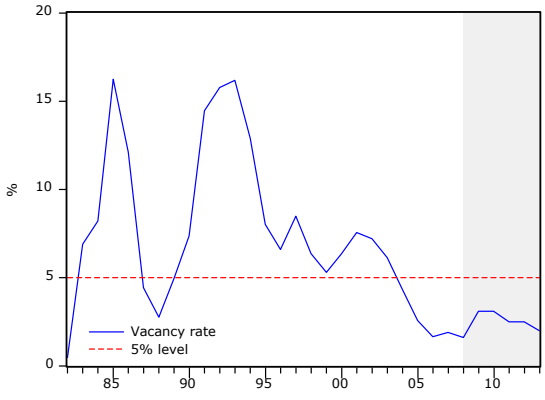
Over the forecast period, we expect a somewhat weaker economy to result in a moderation in the demand for office space to rent, thereby leading to marginally higher vacancy rates. Nonetheless, vacancies in the decentralized areas are expected to remain in a range of between 3% and 6%.

Johannesburg decentralized vacancy rate



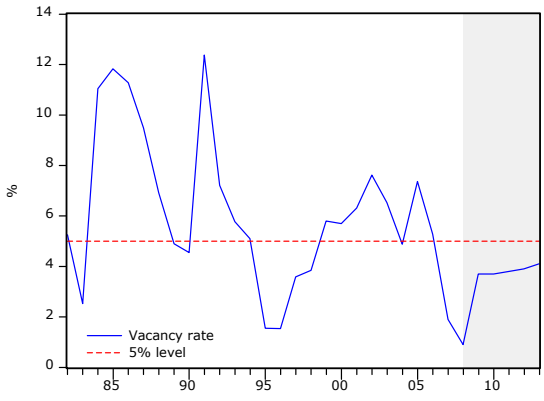
Source of data: SAPOA; Rode

Pretoria decentralized vacancy rate



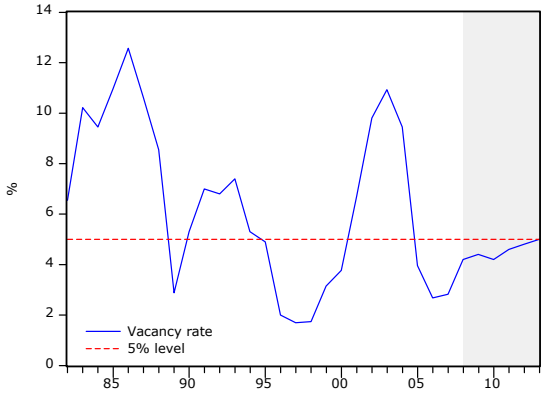
Source of data: SAPOA; Rode

Durban decentralized vacancy rate



Source of data: SAPOA; Rode

Cape Town decentralized vacancy rate

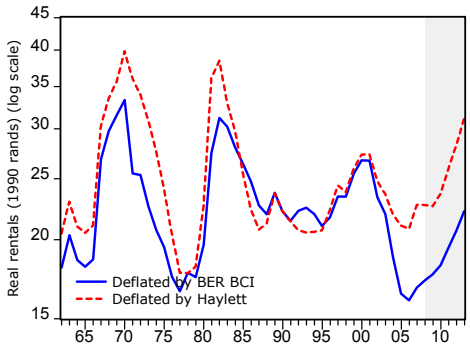


Source of data: SAPOA; Rode

The fact that growth in nominal rentals has only been able to outperform building-cost inflation since about 2007, after a number of years of relatively poor performance, means that the rental required to make new developments viable is at present still somewhat above ruling market-rental rates.

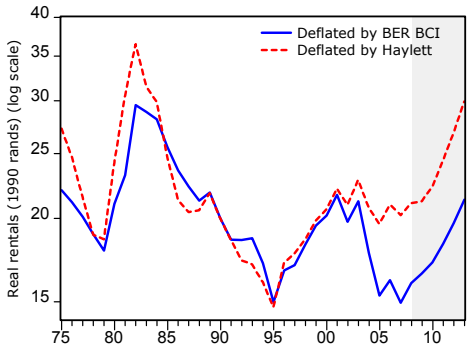
Therefore, should economic growth not be marred too much by power shortages and a deteriorating world economy, keeping vacancies reasonably low and in the single-digits, market rentals might still be able to show decent growth rates, in excess of building-cost inflation over the forecast period. As the accompanying graphs show, we foresee the continuation of the upswing in *real* rentals over the forecast period.

Real office rentals: Johannesburg decentralized (Spliced with Johannesburg CBD data)



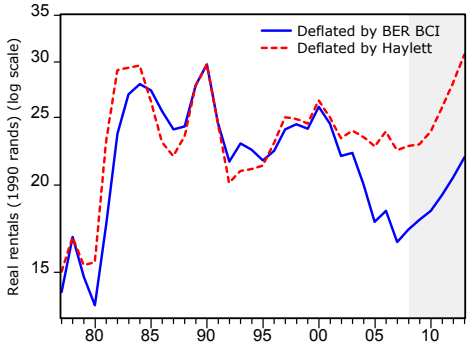
Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

Real office rentals: Pretoria decentralized (Spliced with Pretoria CBD data)



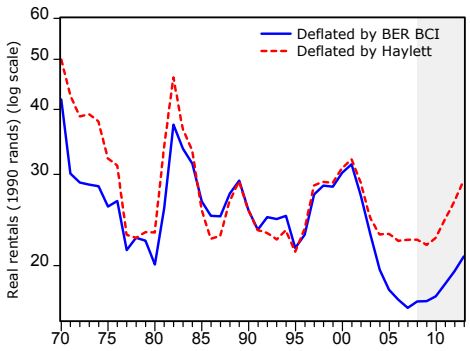
Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

Real office rentals: Durban decentralized (Spliced with Durban CBD data)



Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

Real office rentals: Cape Town decentralized (Spliced with Cape Town CBD data)



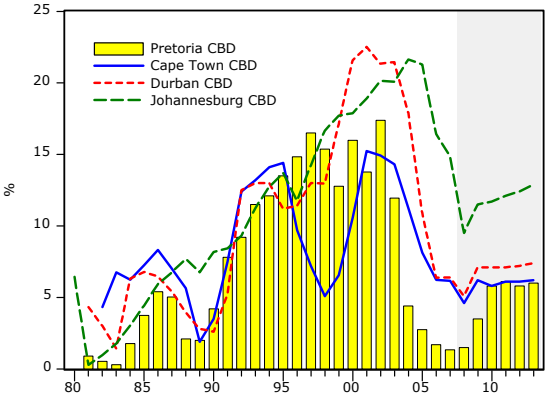
Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

CBD office market

Currently, vacancies are amazingly low in the CBDs. As at September 2008, vacancy rates were standing at about 2% in the Pretoria CBD, followed by Durban (4%), Cape Town (5%) and Johannesburg (7%). However, the reader should note that these rates apply to grades A and B, and that no new buildings have been built in most CBDs for about 15 years. Thus we are looking at low vacancies but at an ever-shrinking inventory of grades A and B. (As a rule of thumb, office buildings slip down a grade for every decade of ageing.)

As with the decentralized office nodes, we expect somewhat weaker economic conditions to result in a moderation in the demand for space, and this might lead to upticks in prime (grades A and B) vacancies in the CBDs.

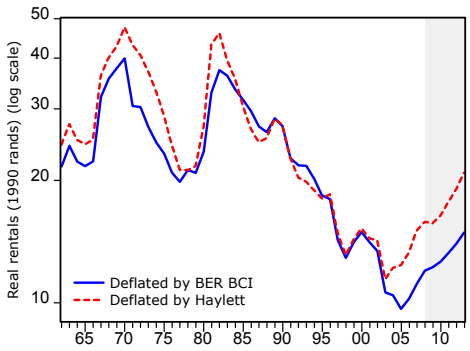
CBD office vacancies Grade A+, A and B combined



Source of data: SAPOA; Rode

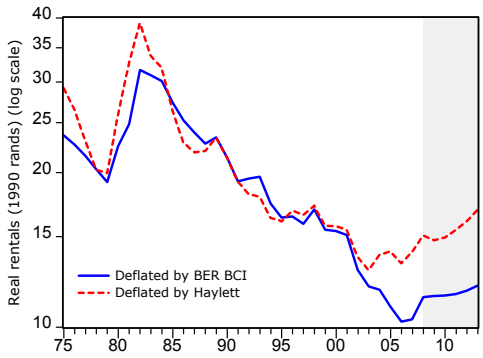
As for the projected rental growth rates, our models forecast nominal rental growth in excess of building-cost inflation in the CBDs as well.

Real office rentals: Johannesburg CBD



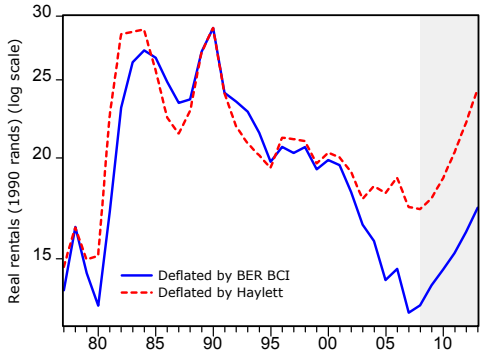
Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

Real office rentals: Pretoria CBD



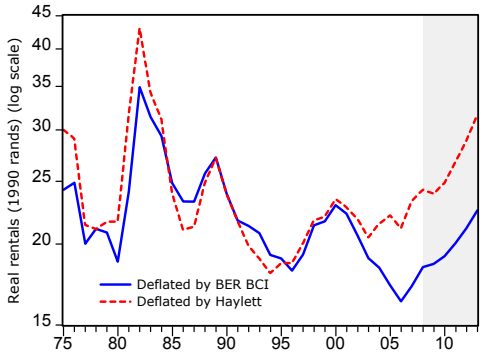
Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

Real office rentals: Durban CBD



Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

Real office rentals: Cape Town CBD



Source of data: Rode's Time Series; MFA; JBCC CPAP Haylett formula

The forecasts in this publication are based on economic fundamentals and historical relationships. The Rode econometric model assumes that these historical relationships will continue.

In sum …

Low vacancies, coupled with modest economic growth, is expected to continue to drive *real* rentals in the decentralized office nodes as well as the major CBDs north. Our weaker prognosis of the macro economy, compared to, for example, a year ago when an anticipated economic growth rate of about 5% p.a. was the norm, does mean that the upswing will not be as steep as previously expected. ■

Chapter 6: The industrial market

Two pillars of support showing weakness

Written by John S. Lottering

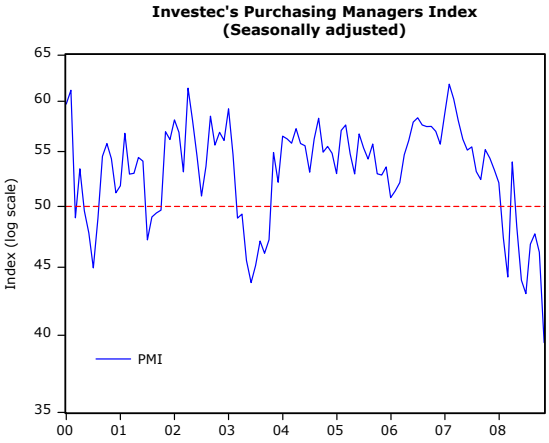
The industrial property market has enjoyed a very good run over the past few years, steered by high replacement costs and robust demand for space on the back of a strong economy.

However, the two pillars of industrial property, retail trade (incorporating both warehousing and distribution) on the one hand, and manufacturing and production on the other, are currently under severe economic threat.

Source of data: Statssa; SARB

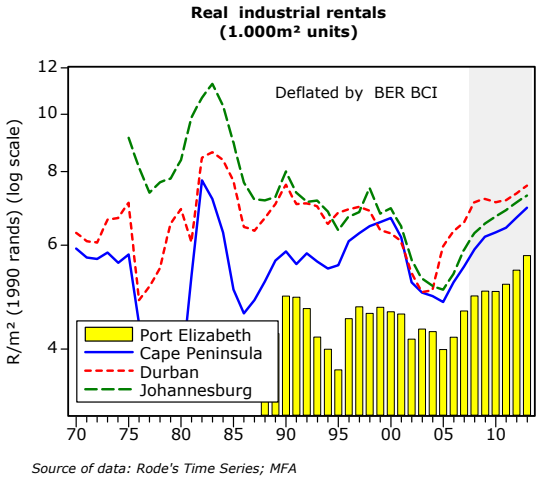
September 2008 marked the fifth consecutive month of contracting *real* retail sales growth, and the *real* value of sales going through the tills was roughly 5% lower than the same month a year earlier. As a matter of fact, the growth in real retail sales has been heading sharply south since the second half of 2006, triggered by rising interest rates intended to curb spiralling inflation.

On the manufacturing side, things are not looking too rosy either, with manufacturers seemingly feeling the pinch of waning domestic demand. Even exports to a world that is stalling are under threat in spite of the lower external value of the rand. The Investec Purchasing Managers Index (PMI), a very good indicator of conditions in the manufacturing sector, has been below an index value of 50, the cut-off point between contraction and expansion, for nine of the 11 months of 2008, after having already been heading steadily south since the beginning of 2007.



Source of data: Investec; BER

Of course, the softer economic conditions of the past year or so, and the likelihood that this would persist over the next few years, does note bode well for rental growth from the demand side. Furthermore, on the supply side, weaker economic growth often also presages reduced building activity.



Source of data: Rode's Time Series; MFA

This in turn could lead to increased tendering competition amongst contractors, decelerating tender prices, and lower building-cost inflation, one of the key drivers of rental growth over the long term. Evident from the accompanying graph is the good run *real* rentals had between 2005 and 2007, supported by a strong economy and high building-cost inflation.

Over the forecast period, we expect the upswing in real industrial rentals to continue, but at a less energetic pace.

Our nominal and *real* (BER BCI-deflated) growth forecasts are summarized in **Tables 6.1** to **6.2**.

Forecasts in this publication are based on economic fundamentals and historical relationships. The econometric model assumes that these relationships will continue.

Some history: secular decline in industrial-property rentals

Since the early 1980s, the South African manufacturing industry have been hard hit by a number of factors. At different times, different factors have played a role, but here are some of the more prominent reasons (not in any specific order):

- Deteriorating workforce productivity (output relative to fast-rising wages from the 1980s onwards);
- Low economic growth (owing to, *inter alia*, sanctions, declining real commodity prices, high real interest rates to combat inflation from 1989 onwards, political instability), resulting in feeble domestic demand;
- Reduction of trade tariffs in the 1990s;
- Space-saving technological advances by the industry (which was good for manufacturers and distributors but bad for property);
- Structural swing towards the services sector (worldwide);
- Dwindling contribution of the mining industry, caused by a weakening hard-commodity cycle.;
- Latterly, the emergence of cheap-labour economies such as China and India.

The result: a secular decline in real industrial property rentals.

Table 6.1
Forecast of prime industrial rentals
Nominal % growth

	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
Central Wits	26,4%	18,8%	12,0%	13,7%	15,1%	15,5%	15,6%	15,1%
Durban & environs	19,0%	20,4%	9,4%	9,2%	13,1%	15,2%	15,9%	13,9%
Cape Peninsula	22,4%	19,0%	13,5%	12,5%	14,3%	16,6%	16,9%	15,5%
Port Elizabeth	27,4%	18,0%	10,0%	10,5%	15,4%	18,5%	19,1%	15,2%

Table 6.2
Forecast of prime industrial rentals
Real % growth (deflated by BER BCI)

	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
Central Wits	9,9%	6,7%	3,7%	2,8%	2,6%	3,1%	2,8%	3,6%
Durban & environs	3,5%	8,2%	1,3%	-1,2%	0,8%	2,7%	3,1%	2,5%
Cape Peninsula	6,4%	6,9%	5,1%	1,7%	1,9%	4,0%	4,0%	3,9%
Port Elizabeth	10,8%	6,0%	1,9%	-0,1%	2,8%	5,7%	5,9%	3,7%

By using building costs as a deflator, the reader can interpret the graphs from a developer's point of view, i.e. they can serve as a proxy for the viability of new developments over time, holding constant capitalization rates and operating expenses.

In sum …

The industrial property market is already in its upswing phase of its long cycle. We expect this to continue over the forecast period, although, as with the office property market, we expect the upswing phase to be less precipitous than previously expected.

This concludes our section on the industrial market. ■

Chapter 7: Retail property

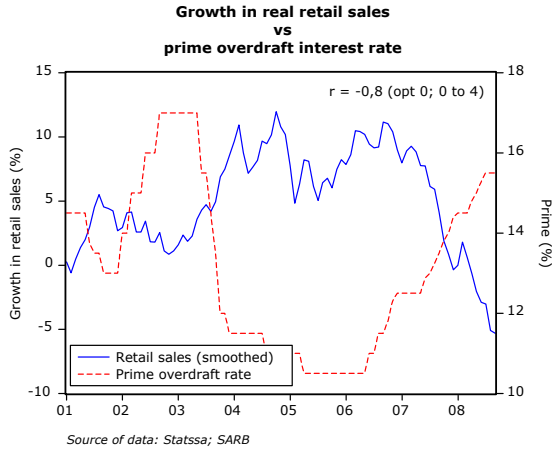
Demand in the doldrums, new supply still disturbingly high

Written by John S. Lottering

This chapter *does not* cover any quantitative retail-property forecasts, as the retail property market is too heterogeneous. We do, however, try to sketch a qualitative prognosis by considering factors that are likely to impact on demand and supply over the next six years.

Demand

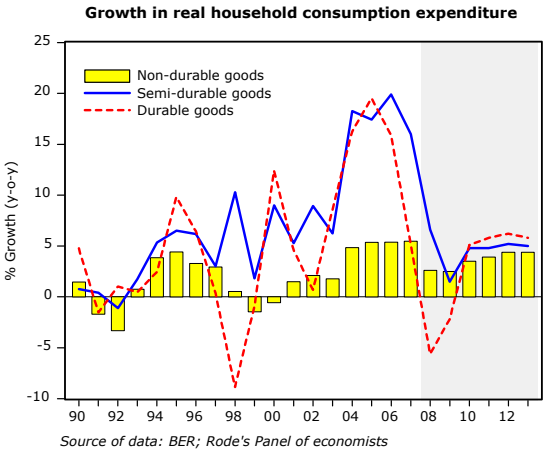
The growth in retail sales has been losing steam for some time now, with the figures for September 2008 revealing that *real* sales (actual volumes of sales) were down by nearly 5% on the same month a year earlier.



Source of data: Statssa; SARB

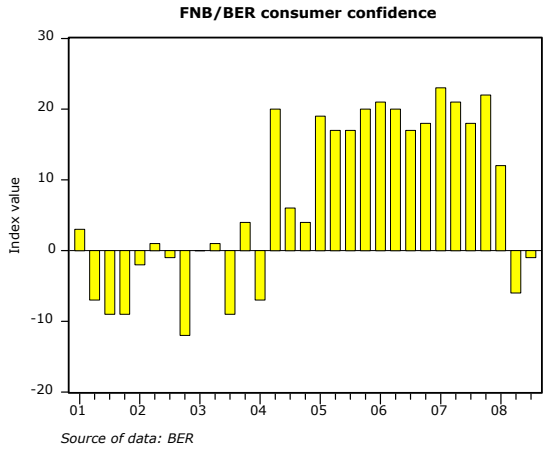
As a matter of fact, September 2008 marked the fifth consecutive month of contracting real sales growth, after already having decelerating steadily since about the second half of 2006. The decline was triggered by rising interest rates and rocketing indebtedness of the consumer.

The graph which follows shows the growth performance of the various categories of consumer goods. Evident is how the growth in the durable category was the first to decelerate, followed by the semi-durable category, when interest rates started to rise in 2006. *Real* household consumption expenditure on non-durable goods continued to grow at roughly 5% p.a. Logically, in tough economic times purchases of durable and semi-durable goods — like motorcars and white goods for example — can always be deferred. Evidence of this postponement of purchases is currently observable in the contracting vehicle and household furniture sales growth.



Source of data: BER; Rode's Panel of economists

Furthermore, given that consumer confidence levels are still in the red, as illustrated by the corresponding graph, it is highly unlikely that retail sales would receive a boost by a change-around in shopper sentiment in the near future. Consumers are, at the moment, still being bogged down by high interest rates, tighter credit conditions, the reduced wealth affect (i.e. waning asset prices) and a deteriorating world economy.



Source of data: BER

Some good news for battered consumers, however, has been the slight moderation in consumer inflation, primarily as a result of lower fuel prices and subsiding domestic price pressures. This, of course, could mean interest rate cuts. However, the greatest threat to the inflation outlook remains the weak and volatile rand, something the Bank still has to consider before cutting rates. What's more, the Bank is faced with the conundrum that cutting too soon could mean very low or negative *real* interest rates, which could deter much-needed short-term portfolio inflows. On the other hand, not cutting could mean dismal or even contracting growth, which might discourage foreign direct investment. But can we really afford another consumer splurge based on unrealistically low interest rates? The answer is 'no'. Therefore, we do not expect drastic cuts proportionate to the expected sharp drop in inflation.

Our growth forecasts for household expenditure on durable, semi-durable and non-durable goods are given in **Table 7.1**.

Note the hammering that durables are expected to receive in 2009.

Table 7.1
Forecast of real retail sales
% change on previous year (VAT excl)

	Non-durables	Semi-durables	Durables
2007	5,5%	16,0%	5,2%
2008	2,6%	6,6%	-5,6%
2009	2,5%	1,5%	-2,2%
2010	3,5%	4,8%	5,1%
2011	3,9%	4,8%	5,8%
2012	4,4%	5,2%	6,2%
2013	4,4%	5,0%	5,8%
2008 - 2013	3,5%	4,6%	2,5%

Source: Rode's panel of economists

The forecasts of retail sales, as well as the other macroeconomic forecasts made by our panel of economists, are done on the basis of a relatively stable economic environment going forward. Hence, they do not provide for unforeseen shocks like the drastic depreciation of the rand in 1998 and at the end of 2001.

Table 7.2
New shopping-centre completions (m²)
Excluding refurbishments and minor extensions to centres smaller than 5.000m²

			Provisional	
	2006	**2007**	**2008**	**2009**
Cape Peninsula	47.812	13.500	49.700	41.000
Durban	39.300	37.400	73.000	83.000
Port Elizabeth	0	0	25.000	10.000
Pretoria	124.500	55.000	104.000	39.000
Pietermaritzburg	24.200	0	0	0
Reef	145.171	282.834	249.200	107.500
Other	271.900	157.980	285.481	193.450
Bloemfontein	0	0	45.300	0
Total	**652.883**	**546.714**	**831.681**	**473.950**

Source: Rode's Retail Report

Supply

Table 7.2 shows a breakdown by geographic area of new shopping centres larger than 5.000m² that are either completed or under construction. The table also includes major extensions (5.000m² or greater) to existing shopping centres.

The table suggests that 2008 was another bumper year for shopping-centre developments. However, looking beyond 2008, as the provisional data for 2009 shows, the moratorium on electricity certificates and political uncertainty might result in new developments starting much later than previously expected, thereby hopefully benefiting trading densities of existing shopping centres. Nevertheless, the 2009 figure of 470.000 m^2 is still disturbingly high, no doubt the aftermath of the terminated consumer fest.

In sum ...

Weak economic conditions and the unlikelihood that interest rates will return to their 2006 levels over the forecast period, is expected to result in moderate growth in all categories of consumer goods. Therefore, growth in retail sales is not expected to be as robust as it was over the past few years. Of course, this could translate into moderate trading densities, and consequently, sombre retail-rental growth. Furthermore, disturbingly high new development figures might also serve to put more pressure on rental growth from the supply side.

This concludes our section on the retail property market. ■

Chapter 8: The residential market

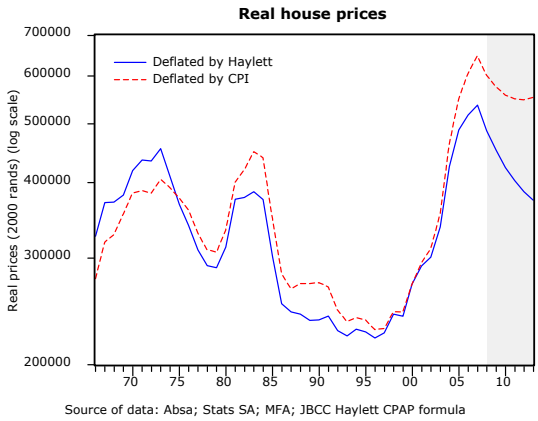
Real house prices to enter a protracted downswing

Written by John S. Lottering

Our review of prospects for the residential property market includes forecasts of house prices as well as flat rentals, both on a national basis. The house-price movements are based on Absa's House Price Index (middle segment), whilst the flat rentals are for two-bedroom standard-quality units ex Rode.

House prices

The *real* house-price cycle reached its latest zenith in 2007, and is expected to enter a protracted downswing over the next few years.



Source of data: Absa; Stats SA; MFA; JBCC Haylett CPAP formula

Growth in nominal prices has been decelerating since 2004, but in spite of this, still managed to beat both consumer and building-input-cost inflation. This, logically, meant a continuation of the upswing which started in 2000, driven by a robust economy and structurally low interest rates (see accompanying graph). Furthermore, from the graph it is also evident that *real* house prices entered the 'over-priced' territory around 2003, when it surpassed its previous historic peak (in 1983), and in so doing, possibly setting in motion the deceleration in nominal price growth which started a year later.

Over the forecast period, however, we expect the demand for residential space to remain feeble owing to sky-high prices, high borrowing costs (interest rates), stern borrowing requirements, high household debt levels and continued feeble economic conditions at home and abroad. Therefore, nominal growth is unlikely to outperform consumer and building-cost inflation, meaning a downswing in *real* home values.

Table 8.1
Forecast of house prices: National
% change on previous year

	Nominal	Haylett-deflated
2007	14,5%	3,8%
2008	3,6%	-9,3%
2009	3,0%	-7,0%
2010	2,3%	-6,4%
2011	4,0%	-4,8%
2012	5,0%	-4,2%
2013	6,0%	-3,1%
Average: 08-13	4,0%	-5,8%

Our forecasts, summarised in **Table 8.1,** show that we expect nominal growth to be in the single-digits, and below building-input cost inflation, over the forecast period.

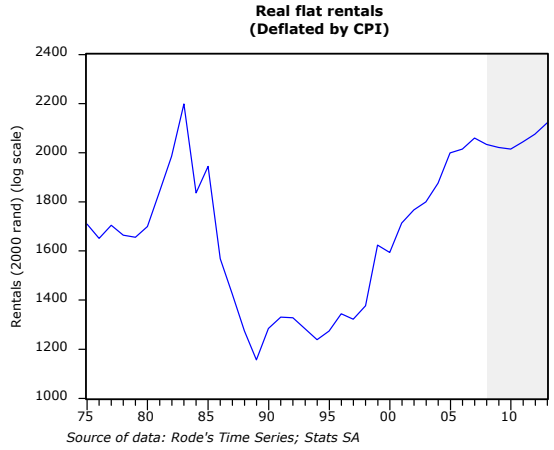
The forecasts in this publication are based on economic fundamentals and historical relationships. The econometric model's forecasts assume that these relationships will continue.

Residential rentals

Even though some upward pressure on residential rentals should be expected owing to the shift away from owning residential property towards renting, as a result of the increased unaffordability of the former option, we expect the impact of this substitution to be modest. The reason for this is twofold:

First, during tough times 'doubling up' (e.g. children moving back to their parents, and so on) happens on a large scale, thereby keeping demand in check.

Secondly, the supply of rental housing (buy-to-let) has grown robustly over the past few years.



Hence, we expect residential rentals to grow roughly in line with consumer inflation in the coming years.

Our flat-rental forecasts are reported in **Table 8.2**.

Table 8.2
Forecast of 2-bedroom flat rentals: national
% change on previous year

	Nominal	CPI-deflated
2007	9,5%	2,2%
2008	10,3%	-1,2%
2009	7,0%	-0,6%
2010	5,3%	-0,3%
2011	6,9%	1,4%
2012	7,0%	1,6%
2013	7,4%	2,2%
Average: 08-13	7,3%	0,5%

In sum …

Over the coming years, the unaffordability constraint is expected to keep nominal house-price growth low and below building–input cost inflation.

Although the unaffordability of owning a house might lead to some substitution towards renting, this impact is not expected to be too robust. This would result in rental growth roughly on a par with consumer inflation.

This concludes our section on the residential market. ■

Chapter 9: Capitalization and escalation rates

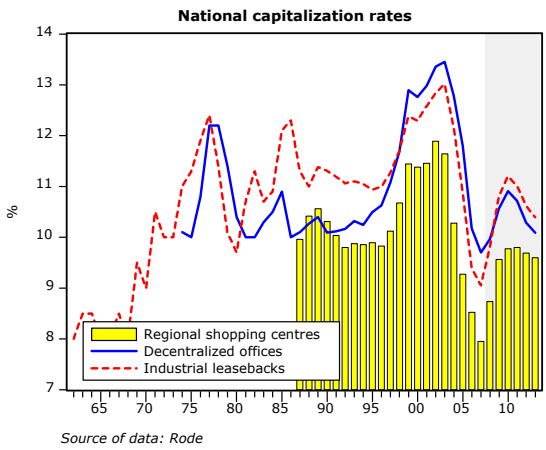
Cap rates have seen their best levels

Written by John S. Lottering

After reaching an apex in 2008, capitalization rates have made a steep descent, driven mainly by two factors: firstly, the realization amongst property investors that low inflation and interest rates are here to stay and, secondly, an unquenchable demand from listed funds and syndicates in turn also spurred by low interest rates.

Fortunately, when interest rates started to rise in the second half of 2006, property fundamentals were strong, which meant good prospects for capital appreciation and, hence, a continuation in investment demand. This resulted in capitalization rates remaining somewhat resistant to the rising interest rate trend. Therefore, despite the rising opportunity cost of not being invested in less risky alternative assets or the increasing cost of financial gearing, investors remained willing to sacrifice some of their income returns, that is, buy at lower cap rates, in the hope of making decent capital returns on their non-residential property investments.

Over the forecast period, the likelihood of slower economic growth, a possible reduction in demand for space, and consequently, marginally rising vacancy rates can be viewed as posing some risk to the expected cash flows from property, thereby leading to investors requiring higher minimum income returns (capitalization rates). On the other hand, the opportunity costs from not being invested in long-bonds might be kept at bay by expectations of moderating consumer inflation and interest rates, which might prevent capitalization rates from moving too far north. Having said that, a weakening rand exchange rate poses a severe threat to inflation. Thus, we do not expect interest rates to come down to their levels of 2006 during our forecast period, meaning capitalization rates might have seen their best levels for a long time to come.



Source of data: Rode

Our forecasts for capitalization rates are summarised in **Table 9.1**.

Table 9.1 Forecast of capitalization rates							
	2007	2008	2009	2010	2011	2012	2013
Prime industrial leasebacks							
Percentage points change	-0,4%	0,8%	1,0%	0,4%	-0,2%	-0,4%	-0,2%
Grade A office buildings*							
Percentage points change	-0,5%	0,3%	0,6%	0,3%	-0,2%	-0,4%	-0,2%
Regional shopping centres							
Percentage points change	-0,6%	0,8%	0,8%	0,2%	0,0%	-0,1%	-0,1%
* Prime decentralised nodes							

Total return = income return + capital return

Investors normally demand a higher income return (or capitalization rate) from properties with poor net-income-growth potential, as such properties have poor prospects for capital growth. The converse also holds true.

Main drivers of capitalization rates:

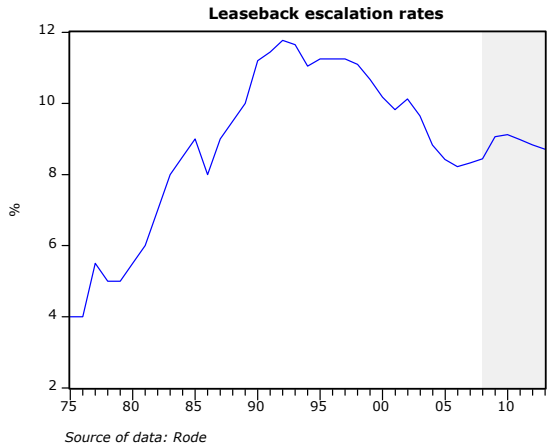
- Specific attributes of the subject property that impact on its ability to grow and sustain its income (e.g. age, location, type, quality of finishes, parking ratio, term till expiry, and covenant of the lease). These are factors specific to a property.
- Phase of the property cycle (i.e. upswing or downswing). This applies to the market as a whole.
- Capital-market yields (yields on competing investments (i.e. close substitutes)).
- Investment demand (e.g. whether the investment herd likes property at a specific point or not).

Characteristics of escalation rates:

- Escalation rates of office and industrial properties are generally the same. Moreover, escalation rates are roughly similar across regions, although stagnating areas tend to have slightly lower escalation rates.
- Escalation rates can differ significantly from consumer inflation in the short to medium term. Why? The ruling market escalation rate is an attempt by the market to forecast the growth in market rentals over the duration of the lease, and is not aimed at compensating landlords for short-term inflation.
- Historically, escalation rates have been a poor predictor of future market-rental growth.
- Consumer inflation and escalation rates are linked in the long run. Moreover, research by Rode & Associates suggests that escalation rates lag consumer inflation by up to six years. How is the influence of consumer inflation transmitted to escalation rates? Answer: Escalation rates are largely determined by expectations regarding market-rental growth, which in turn is, in the long run, driven by inflation expectations. As a result, escalation rates are generally much less volatile than consumer inflation.
- One normally distinguishes between a non-leaseback and a leaseback escalation rate. In a nutshell, a leaseback escalation rate relates to a long lease, usually 10 years or longer; a non-leaseback escalation rate refers to a lease contract of fewer than 10 years, usually 3 to 5 years in length. Hence, a leaseback escalation rate, for example, is the rate that the market expects rentals to grow at over the next 10 years.

Escalation rates

The corresponding graphs and **Table 9.2** shows that the lagged affect of higher inflation is expected to result in marginally rising escalation rates during the first half of our forecast period, but as inflation improves so to will rental escalation rates.



Furthermore, the reader should note that the escalation rate is an attempt by the market to forecast market rentals until the expiry of a lease. Given the still fairly optimistic prospects for market rental growth over the forecast period, the expected average escalation rate of 9% over the next few years implies that many a tenant will be paying less than market rent during the next few years — i.e. a number of landlords will have under-rented buildings.

Table 9.2
Forecast of leaseback escalation rates (%)
Average for year

2007	8,3%
2008	8,4%
2009	9,1%
2010	9,1%
2011	9,0%
2012	8,8%
2013	8,7%

In sum …

Over the forecast period, weaker economic growth and its possible negative impact on vacancy rates can be viewed as posing risk to the expected cash flows from non-residential property, thereby leading to marginally higher capitalization rates. With that said, improved inflation might keep capitalization rates from moving too far north.

As for market escalation rates, we expect them to head slightly north during the first half of our forecast period as a result of the lagged affect of rising inflation. Thereafter, we expect escalation rates to follow inflation south again.

This concludes our section on capitalization and escalation rates.■

Chapter 10: Building activity and building costs

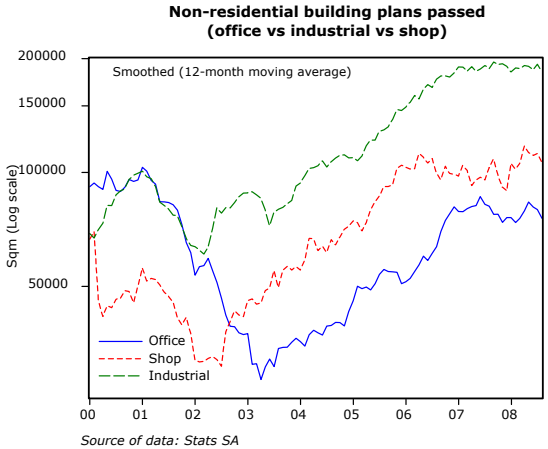
Tough times ahead for building contractors

Written by John S. Lottering

This chapter analyses residential and non-residential building activity, and its consequent effect on building-cost inflation over the next few years.

Building activity

As expected, building activity in the residential sector is decelerating, driven down primarily by waning house-price growth. Unexpectedly, however, the most recent statistics on building activity in the non-residential sector show that activity in this sector has also decelerated somewhat despite fundamentals for non-residential development, especially the development of office and industrial space, at the moment still being fairly robust.



Source of data: Stats SA

Furthermore, the levelling-off in non-residential building plans passed, which is usually a fairly good harbinger of future building activity, does paint a picture of a further slowdown in activity.

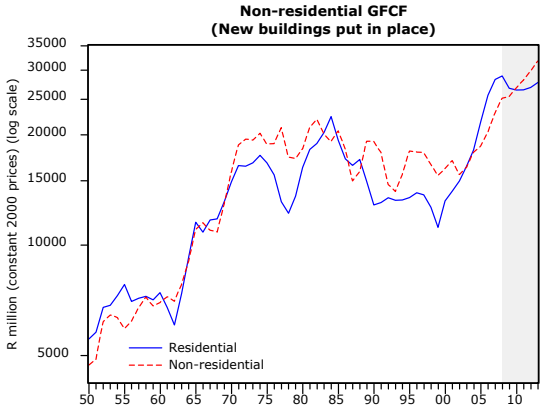
Naturally, the levelling off in non-residential building plans being passed can be the result of a number of factors, namely:

- The moratorium on electricity certificates
- Reduced confidence in the economy
- Increased political uncertainty
- The higher level of interest rates
- The dominance of listed property funds (which are interest-rate sensitive) as the chief drivers of non-residential building activity. Note that listed funds are only indirectly sensitive to interest rates, as their market rating is negatively affected by rising long interest rates (on the back of rising inflation expectations).

Nonetheless, over the forecast period, we expect residential building activity to continue to be pulled down by a stagnating house market. Moderate economic growth, together with the factors previously mentioned to explain the levelling off in non-residential plans being passed, is likely to keep a lid on non-residential building activity. However, the growth in non-residential building activity is still expected to outperform the growth in residential building activity.

The Haylett index is a measure of all input costs to the building industry, especially material and labour costs.

The BER BCI, on the other hand, is an index that measures pre-contract non-residential prices and as such includes the profit margin of contractors. This index is one of the best indicators of the health of the building industry, because it accelerates faster than Haylett when the property cycle is in an upswing, as contractors are then able to stretch their profit margins. During the downswing phase, the opposite applies. As a result, the BER BCI tends to be much more volatile than the Haylett index.



Source of historic data: SARB

Our forecasts are summarized in **Table 10.1**.

Table 10.1
Forecast of GDCF in buildings
% real growth

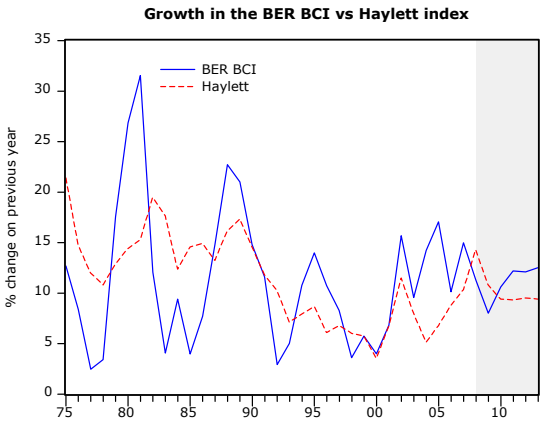
	Residential	Non-residential
2007	10,5%	12,9%
2008	2,2%	9,6%
2009	-7,4%	1,0%
2010	-1,2%	5,7%
2011	0,1%	5,0%
2012	1,5%	5,8%
2013	3,1%	6,6%
08-13	-0,3%	5,6%

The reader is reminded that gross fixed capital formation represents an increase in stock, and hence our growth forecast indicates an acceleration (or deceleration) in new stock.

Building costs

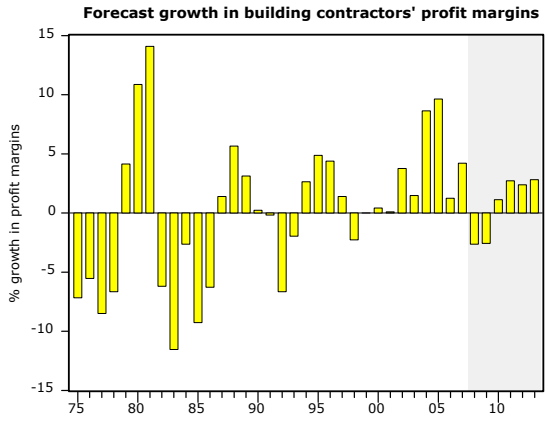
Of course, the likelihood of a slowdown in building activity does imply tough times ahead for building contractors. The fewer new projects available would logically lead to increased tendering competition amongst contractors, forcing them to lower their profit margins and, consequently, result in lower building-cost inflation.

In fact, during the first two years of our forecast period we foresee building-input cost inflation, as measured by the growth in the Haylett index, to accelerate faster than the BER BCI, which measures pre-contract non-residential building-costs (including the profit margins of contractors).



Source of data: BER; JBCC CPAP Haylett Formula; Rode

Thereafter, as building activity starts to pick up, affording contractors the room to stretch profit margins again, we expect the growth in the BER BCI to outperform the growth in the Haylett index.



Source of data: BER; JBCC CPAP Haylett Formula; Rode

Our building cost forecasts are summarized in **Table 10.2** .

In sum …

Over the forecast period, we expect building activity, in both the residential and non-residential sectors, to be somewhat limited by higher interest rates and a weaker economy. This would, of course, increase tendering competition, lead to a reduction in profit margins, and result in lower building-cost inflation.

This concludes our section on building activity and building costs.■

Table 10.2
Forecast of building costs (VAT excl.)
% growth per year

	2007	2008	2009	2010	2011	2012	2013	Average: 08-13
BER BCI	15,0%	11,3%	8,0%	10,6%	12,2%	12,1%	12,5%	11,1%
Haylett	10,3%	14,3%	10,8%	9,4%	9,3%	9,5%	9,4%	10,5%
CPI	7,1%	11,7%	7,6%	5,7%	5,4%	5,3%	5,1%	6,8%

Chapter 11: Listed property

Distribution growth prospects remain fairly favourable

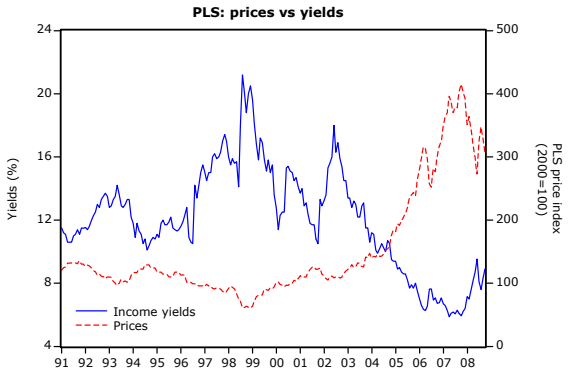
Written by John S. Lottering

This chapter forecasts the listed property market. The forecasts are done for PLSs' income ("dividend") yields, prices and income ("dividend") streams but also apply to those of PUTs.

Listed property has two major drivers:

- Income growth prospects (i.e. property fundamentals)
- Bond yields (i.e. the return on substitute investments)

Sine the end of 2007, historic net income yields on listed property weakened (increased) from roughly 6% to above 8% in the latter months of 2008, resulting in sharp yearly price contractions during most of the year.

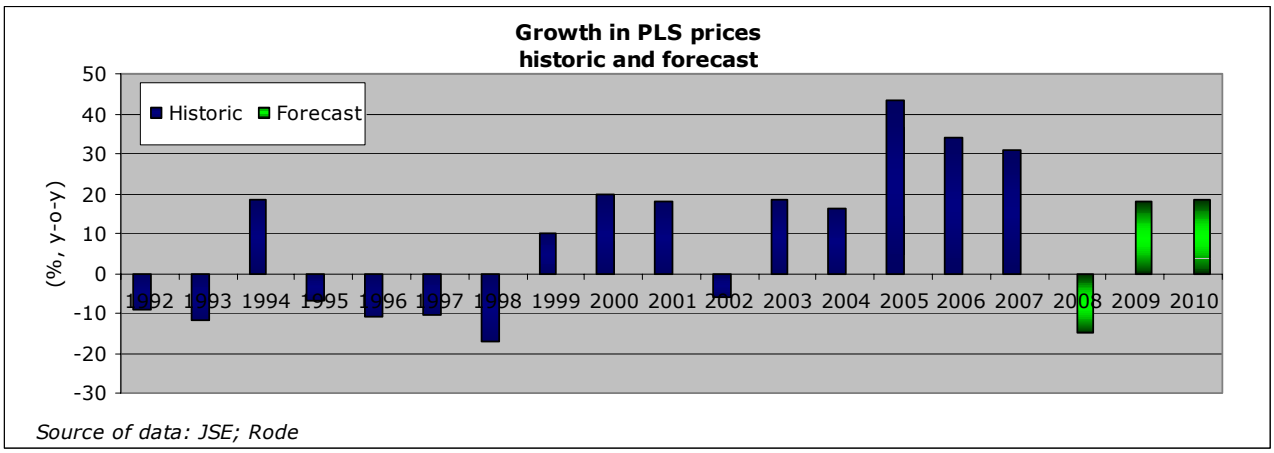


Source of data: JSE

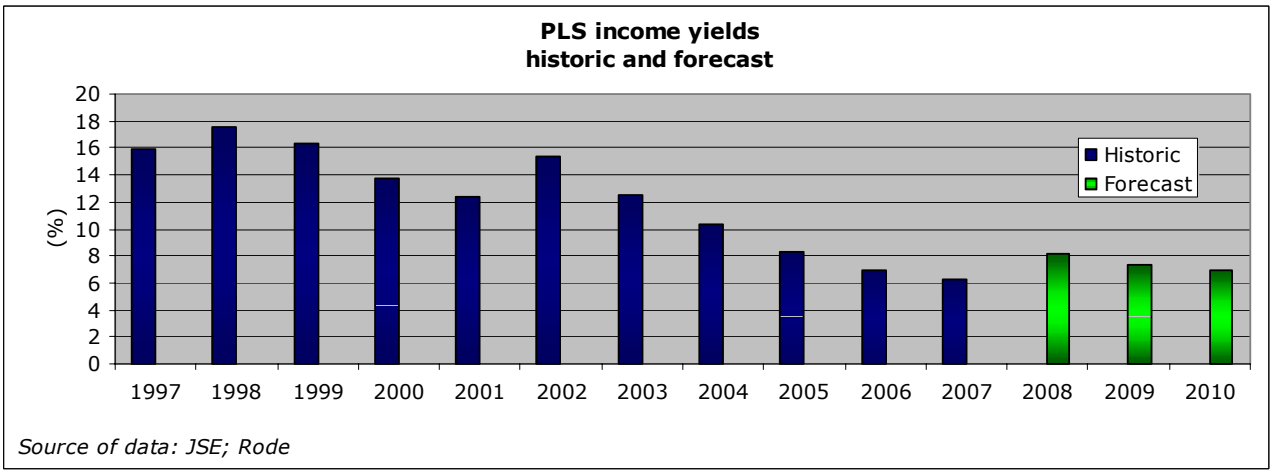
Of course, the de-rating of listed property, and its associated adverse effect on prices, can almost certainly be attributed to emerging market risk aversion, on the back of world-recession fears and continued financial market turmoil, especially in the larger developed economies. This is especially so when one considers that income streams managed to show fairly robust growth throughout the year, possibly indicative of the fact that the strong property fundamentals inherent in non-residential property over the last few years have filtered through to the income streams of listed funds.

Barring a severe economic slowdown, and its consequential effects on the demand for non-residential space and rental growth, the distribution-growth prospects for listed funds, especially those heavily weighted in office and industrial property, remain favourable. In addition, should a weak and volatile rand not mar inflation expectations too much, concomitant interest rate cuts could serve to reduce the income returns on alternative (substitution) investments like long bonds. This could, in turn, result in investors requiring lower income returns to hold listed property, leading to stronger price growth. Having said this, shopping centres are most definitely entering a period of 'consolidation', and many will soon be overrented (escalated contractual rentals above market or sustainable levels).

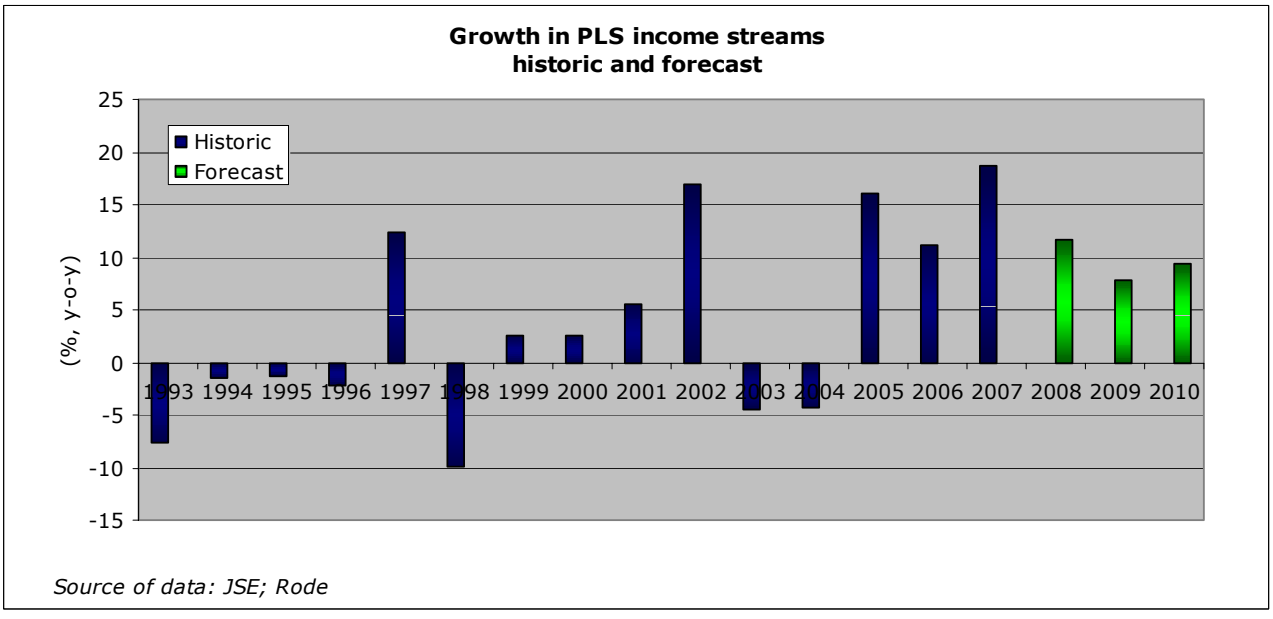
Our forecasts for income-stream growth, yields and price growth are summarized in **Table 11.1**, while the accompanying graphs give a visual perspective to our forecasts relative to the historic growth rates/ levels.



Source of data: JSE; Rode



Source of data: JSE; Rode



Source of data: JSE; Rode

In sum …

Despite the weak price performance during 2008, relatively strong property fundamentals (viz. rental growth, building-cost inflation, vacancies), should result in healthy income-stream growth. This together with the expectation of strengthening (decreasing) long-bond yields, should result in fairly robust price growth during 2009 and 2010. ■

In our analyses we use property loan stock (PLSs), but we could just as well have chosen property unit trusts, which are subject to the same forces as PLSs and, therefore, follow similar trends.

The forecast for listed property is done only until 2010. The reason for this is that players in this market are not interested in the longer time horizon because of the high tradability of listed assets.

Table 11.1
Forecast of property loan stock performance (standing portfolio)
(averages for the year)

	2006	2007	2008	2009	2010
Percentage growth in income streams	11,1%	18,7%	11,7%	7,8%	9,4%
Percentage growth in PLS prices	34,1%	31,0%	-15,2%	17,9%	18,3%
Trailing (historic) income yield (%)	6,9%	6,2%	8,2%	7,4%	7,0%