

Office properties likely to produce great returns over next five years

Updated by Garth Johnson

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 buildings 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, capitalisation rates, vacancies, operating costs, escalation rates and a depreciation factor for economic ageing. Historical data are from our database Rode's Time Series, 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 Johannesburg CBD, Sandton CBD, Pretoria CBD, Hatfield, Cape Town CBD, Claremont and Durban CBD.

We define a typical office building 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 years at the market escalation rate ruling at the inception date of the lease.

In order to calculate the income and capital returns on the building, one needs to es-

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. An analogy would be the share price of gold-mining companies reacting to changes in the price of gold.

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 capitalisation rates, which increase, and market rentals, which decrease with age. We calculated that the market value of grade-A office buildings in the Johannesburg CBD and Cape Town CBD age at a compound 4,7% and 4% per annum respectively. Office buildings age at 3% per annum in the other nodes that are valued in our forecasts.

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

The following table demonstrates that the average forecast total return on an investment in prime office buildings in South Africa's most important office nodes will vary between 23% and 30% over the next five years.

The performance of Johannesburg CBD, Pretoria CBD and Durban CBD are expected to mimic each other, with an average total return of approximately 28%. These nodes will show positive, yet modest capital

growth, even though cap rates are expected to remain on the upward. More specifically, market values will be driven by strong rental growth and low operating cost growth (as proxied by future CPI inflation forecasts), that outweigh the negative impact of increasing cap rates.

The Cape Town CBD is expected to deliver similar total returns to that expected in the Johannesburg CBD, Pretoria CBD and Durban CBD. The difference, however, lies in the composition of total returns. Whereas most CBDs in South Africa are expected to deliver income returns far in excess of capital returns, this is not the situation in the case of the Cape Town CBD where capital returns will be almost as high as income returns. Intuitively this makes sense, given the cautiously optimistic prognosis for the Cape Town CBD. Cape Town has seen a spate of new building activity in the last year or so. It has also witnessed the opening of the *Cape Town International Convention Centre* and the adoption of the New York City idea of inner-city living (which will no doubt also have a positive impact on street-front shops). As a result of the aforementioned, we are currently witnessing the stabilisation of the Cape Town CBD office market, whereafter we expect cap rates to start descending - hence the rosy outlook for capital growth.

The decentralised nodes of Johannesburg, Cape Town and Pretoria are expected to show solid performance over the next five years. Pretoria decentralised will, however, outperform its counterparts on the back of exceptionally strong growth in market rentals over the next five years.

Note that the total returns in the table must be compared with the hurdle rates reported every quarter in *Rode's Report*. The forecast magnitude of total returns do indeed seem high for most of the nodes comprising our notional portfolio - that is, given expectations of lower future inflation. This buoyancy is indicative of the fact that the anticipated move to lower capital returns (as a result of lower long-term infla-

tion) is a process that is unlikely to play itself out within the next five years.

Conclusion

Prime quality properties are expected to

yield good total returns in most office nodes, including the CBDs of Johannesburg, Pretoria and Durban, over the next five years. In fact, the CBDs are expected to outperform most decentralised nodes by some margin. Given the general inverse relationship between risk and return, such an outcome does make sense. ■

Table 6: Forecast returns on a notional portfolio of prime office buildings

Forecast returns on a notional portfolio of prime office buildings (2003 - 2008)							
Johannesburg CBD							
Year ending	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	2003 - 2008
Income return	22,6%	22,7%	22,3%	22,7%	22,2%	21,5%	22,3%
Capital return	-0,9%	6,1%	4,7%	9,5%	14,4%	5,2%	6,5%
Total return	21,6%	28,8%	27,1%	32,2%	36,6%	26,6%	28,8%
Sandton CBD							
Year ending	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	2003 - 2008
Income return	16,0%	16,4%	15,5%	14,4%	13,5%	12,5%	14,7%
Capital return	0,1%	5,8%	9,7%	11,8%	17,1%	6,3%	8,5%
Total return	16,2%	22,1%	25,1%	26,1%	30,6%	18,8%	23,2%
Pretoria CBD							
Year ending	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	2003 - 2008
Income return	23,9%	24,2%	22,8%	22,4%	21,5%	20,8%	22,6%
Capital return	-2,4%	3,8%	3,9%	10,5%	15,0%	3,7%	5,7%
Total return	21,4%	27,9%	26,7%	32,9%	36,5%	24,5%	28,3%
Hatfield							
Year ending	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	2003 - 2008
Income return	15,6%	15,1%	14,2%	13,7%	13,0%	12,1%	14,0%
Capital return	7,3%	12,4%	13,8%	17,3%	22,5%	14,4%	14,6%
Total return	23,0%	27,5%	28,0%	31,0%	35,5%	26,5%	28,6%
Cape Town CBD							
Year ending	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	2003 - 2008
Income return	17,1%	17,0%	16,1%	15,4%	14,6%	13,8%	15,7%
Capital return	4,8%	14,8%	13,6%	17,8%	21,5%	14,0%	14,4%
Total return	21,9%	31,8%	29,6%	33,3%	36,2%	27,8%	30,1%
Claremont							
Year ending	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	2003 - 2008
Income return	15,8%	15,9%	15,1%	14,2%	13,1%	12,1%	14,4%
Capital return	0,2%	6,8%	9,8%	15,1%	20,0%	8,8%	10,1%
Total return	16,0%	22,8%	24,8%	29,2%	33,1%	20,8%	24,5%
Durban CBD							
Year ending	31-Dec-03	31-Dec-04	31-Dec-05	31-Dec-06	31-Dec-07	31-Dec-08	2003 - 2008
Income return	20,9%	21,3%	21,3%	21,7%	21,5%	21,2%	21,3%
Capital return	4,8%	7,7%	5,2%	9,6%	12,8%	6,8%	7,8%
Total return	25,7%	29,0%	26,6%	31,3%	34,3%	28,1%	29,1%