

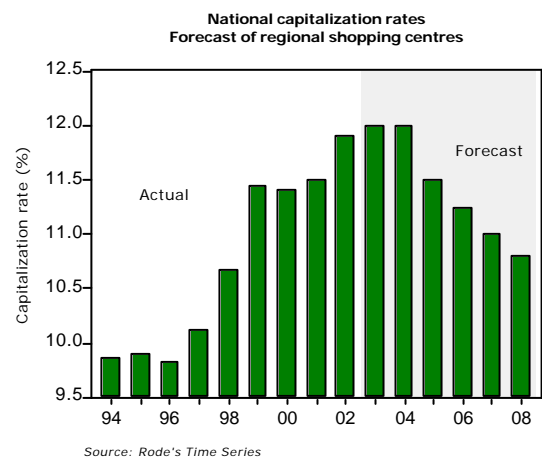
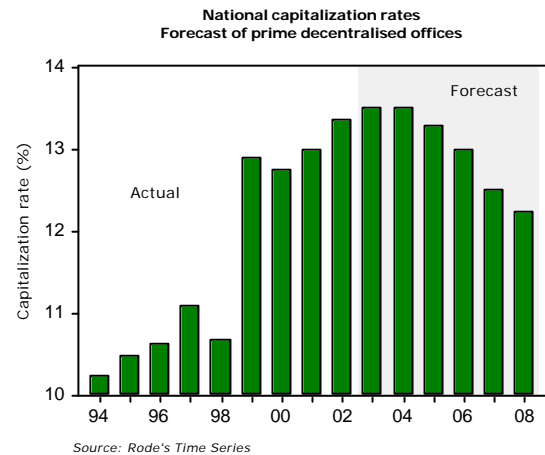
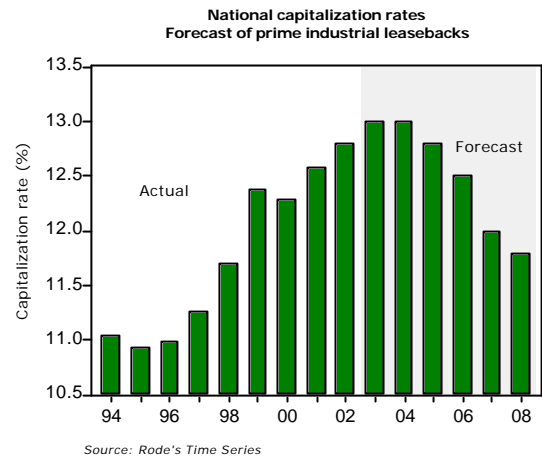
Cap rates expected to strengthen from 2004

This chapter reviews the forecast of capitalization (cap) rates and escalation rates on a national basis.

The latest *Rode's Report* — reflecting data for quarter 2003:1 — shows that, on average, cap rates are still unmoved from their rising (weakening) trend, which has been evident since 1996. This negative trend implies that investors' perception towards non-residential property is still worsening which, in turn, is a reaction to the current oversupply of space. In this environment it thus makes sense that our forecast predicts cap rates to be higher in 2003.

But the tide in cap rates is expected to turn from 2004 onwards as supply and demand for space in the non-residential market start balancing out, thereby pushing up real rentals. This process should gain further momentum from the increase in property listings, which will take the pressure off institutional owners to sell into the conventional market. Already the listed property market (property unit trusts & property loan stock companies) has grown from a market capitalization of around R5 billion to almost R18 billion in under five years. Furthermore, our calculations show that, on average, listed property is currently trading at a premium to directly-held property portfolios, enhancing the motivation to list, as an instant capital profit will be realised by doing so. The proviso is that directly-held portfolios are correctly valued at present.

The other crucial determinant of cap rates is long-bond yields, which must surely be at their cyclical bottom for some time to come, so no relief for cap rates can be expected from this source.



Because of all these factors, no econometric model is able to predict movements in capitalization rates. Therefore, the forecasts given in the accompanying table, as well as those used in the graphs, are hand adjusted by *Rode*.

Table 1 gives the forecast national capitalization rates for the different kinds of property as well as the expected year-on-year percentage points change. It shows that, on average, cap rates are predicted to drop by around 1,2% points from 2003 to 2008.

Escalation rates

The leaseback escalation rate is forecast to continue on its secular downward trend, which has been evident since 1992. This is in line with the expectation of lower inflation over the forecast period. However, our predictions are slightly less bullish than our forecast published in the *Trends* issue of December 2002. This is due to the lagged effect brought on by the higher short-term inflation pressures. *Rode's* research shows that leaseback escalation rates lag the decline in inflation by five to six years. The reason for this long lag is that it takes a long time for market rentals to respond to changes in inflation.

The leaseback escalation rate serves as a proxy for the market's expected rental growth rate over the next ten years

Table 2 shows our model's forecast of esc-

alation rates for industrial leasebacks until 2008.

Table 2: Forecast of escalation rates (%)	
Average for year	
2002	10,1
2003	9,6
2004	9,3
2005	9,0
2006	8,8
2007	8,6
2008	8,4

In sum...

In a nutshell, cap rates are forecast to increase (weaken) further in 2003 as a result of the current oversupply of space in the non-residential property market. However, cap rates are set to come down (strengthen) from 2004, as supply and demand for non-residential property space move closer to equilibrium. Cap rates should also be boosted by the flood of property listings, which should relieve the pressure to sell properties into the conventional market.

Leaseback escalation rates are predicted to continue trending down in line with lower expected inflation.

This concludes our section on capitalization and escalation rates. ■

Table 1: Forecast of capitalization rates

	2002	2003	2004	2005	2006	2007	2008
Prime industrial leasebacks							
Average rate for year	12,8	13,0	13,0	12,8	12,5	12,0	11,8
Percentage points change	0,2	0,2	0,0	-0,2	-0,3	-0,5	-0,2
Grade A office buildings*							
Average rate for year	13,4	13,5	13,5	13,3	13,0	12,5	12,25
Percentage points change	0,4	0,1	0,0	-0,2	-0,3	-0,5	-0,25
Regional shopping centres							
Average rate for year	11,9	12,0	12,0	11,5	11,25	11,0	10,8
Percentage points change	0,4	0,1	0,0	-0,5	-0,25	-0,25	-0,2
* Prime decentralised nodes							

