Chapter 1: State of the property market

State of the property market in quarter 2 of 2023

This issue shows that the industrial property market is still best placed of the major non-residential property types, but is also showing signs of slowing down, such as weaker rental and stand value growth. This was to be expected, given the state of the economy and in particular the pressure on the manufacturing and retail sectors. Of course, the electricity crisis is also a large negative factor.

The retail property market made a strong comeback in 2022 but has been under pressure so far in 2023 as demonstrated by the weaker retail sales performance and higher mall vacancy rates. This is reflected in the higher capitalization rates of regional shopping centres.

The office market is still worst placed but is showing some improvement with vacancies declining further.

House prices have come under renewed pressure, while flat rentals are showing the opposite trend.

A summary of the main findings by property type follows.

Quantitative overview of the property market

Table 1.1 on the next page provides a snapshot of how the property market has performed over the past four quarters by comparing the latest information (quarter 2023:2) with data collected a year earlier.

Office market

The office market remains in the worst position of the three major non-residential property types due to its significant oversupply. Encouragingly, Rode's second-quarter 2023 data continues to point to an improvement in vacancy rates, while *nominal* market rental growth remains in positive territory. However, REITs are still generally reporting large negative office rental reversions as *contractual* rentals have escalated by much more than the growth in market rentals.

The outlook for the office market is clouded by the poor economic outlook and the remote-working trend. However, the momentum seems to be shifting towards returning to the office in larger numbers – see **Chapter 5** for trends in America. That said, hybrid working policies, for example three days in an office, remain the popular choice, which means less demand compared to pre-Covid levels.

Nationally, weighted market gross rentals for *decentralized* grade-A space increased by 3,5% in *nominal* terms in the second quarter of 2023 compared to the second quarter of 2022. This comes after growth of 3,2% year on year in the first quarter of 2023, which shows that nominal rentals have bottomed out after falling sharply during the pandemic.

But to give perspective, the second-quarter nominal rental rate on a national level was still 3% below 2019 levels (that is, before the Covid pandemic). In *real* terms, second-quarter decentralized rentals fell further into negative territory after deducting the BER's roughly 10% estimate of building-cost inflation.

Regionally, Cape Town has been the clear top performer over the past few quarters, after a serious rental dip of 10% in 2021. Nominal grade-A gross rentals increased by 13% in the decentralized nodes of the Mother City compared to a year earlier. In Pretoria, these grew by 3,6% and by 1,6% in Johannesburg. In *real* terms, only Cape Town managed to record above-inflation rental growth compared to a year ago. Durban decentralized rentals *fell by* 1,1% – the second consecutive quarterly year-on-year decline, but some nodes like La Lucia Ridge/Umhlanga still performed well.

The results of Rode's office vacancy survey show that vacancy rates in South Africa improved further during the second quarter of 2023. We found that the average vacancy rate of grades A^{+}, A and B space combined was 14,5% in the second quarter of 2023, lower than the 14,9% in the first quarter of 2023, largely thanks to less vacant space in Cape Town and to a lesser extent in Johannesburg. We discuss the vacancy rates in **Chapter 6**.

Table 1.1
Office and industrial rentals: Performance as at quarter 2023:2
% change from four quarters earlier (on smoothed data)

	Nominal	Real*
A-grade decentralized office rentals		
Sandton CBD	1,9	-7,3
Rosebank	1,5	-7,5
Randburg Ferndale	-4,9	-13,4
Centurion	12,7	2,6
Hatfield	8,6	-1,3
Menlyn	-4,0	-12,7
La Lucia/Umhlanga Ridge	1,9	-7,3
Berea	-9,9	-18,0
Tyger Valley	21,2	10,4
Century City	10,9	0,9
South Africa	**3,5**	**-5,8**
Prime industrial rentals (500 m² units)		
Central Witwatersrand	3,2	-6,0
East Rand	6,0	-3,4
Durban	2,2	-6,9
Cape Town	7,0	-2,6
South Africa	**4,1**	**-6,7**

*Nominal values deflated by BER Building Cost Index

Industrial market

The results of Rode's second-quarter 2023 survey show that the industrial property market is still best placed of the three major non-residential property types thanks to its relatively higher rental growth and low vacancy rates. However, the market is starting to slow down as shown by weaker rental and stand value growth and lower building activity.

Nominal gross industrial market rentals for space of 500 m^2 grew by 4,1% in the second quarter of 2023 compared to the second quarter of 2022. This is slower than the 5,1% year-on-year growth recorded in the first quarter of 2023 and was the second consecutive quarter of weaker growth. In *real* terms, rentals are still declining after deducting building-cost inflation.

Regionally, nominal rental growth was the strongest in Cape Town and the East Rand at 7% and 6% respectively. Both these conurbations saw an improvement in vacancy rates in the first half of 2023 to 2,0 points on Rode's scale (from 1 to 9) or 3,4%. In fact, most conurbations in South Africa have seen lower vacancy rates compared to the first half of 2022, averaging less than 5%. The exceptions were Bloemfontein and Gqeberha where vacancy rates average 6%-7%. Nominal rental growth in the Central Witwatersrand and Durban was slower at 3,2% and 2,2% respectively.

We are surprised that industrial vacancy rates remain low and that they even declined further during the second quarter of 2023 to an average of 3,9% on a national level. Perhaps landlords have kept vacancy rates low at the expense of rentals as reversion rates on new leases have been negative for most REITs. Remember that *contractual* rentals have escalated by more than market rentals.

It can also be that landlords have decided to not be too hard on tenants due to the extra money the latter need to fork out for power, such as diesel for generators. Growthpoint, the largest SA REIT, said in June that "load shedding severely affects manufacturing and production tenants, raising their costs, straining occupancy affordability and contributing to more tenant failures". We believe rising vacancy rates could well start to show in the coming quarters.

Residential market

The housing market continues to slow down due to lower effective demand for property due to the weakening economy, the higher cost of living and rising interest rates. Nominal prices grew by 1,9% in May 2023 compared to May 2022, the slowest growth rate since July 2020, based on FNB data. Prices grew by 2,3% in the first five months of 2023 compared to the same period in 2022. This indicates a slowdown from mini-boom levels during the Covid pandemic, when the prime interest rate fell as low as 7%. In *real* terms, house prices in the first five months of 2023 fell sharply after deducting the consumer inflation (CPI) rate of 6,8%.

Interest rate hikes started to affect prices and sales activity more materially in the second quarter of 2023, especially in Gauteng, and the impact thereof is not over yet. More sales have also occurred due to the owners experiencing rising financial pressure.

Turning to flats, vacancy rates on a national level averaged 6,9% in the second quarter of 2023, unchanged from the first quarter of 2023, according to Rode's residential survey data. This is better than the 8,3% average of 2022. However, vacancy rates are still slightly above the 5,3% average recorded in the three years from 2017 to 2019 that preceded the pandemic.

The improvement in national vacancy rates since 2021 has supported flats' rental growth. Official data from Stats SA shows that nominal flat rentals in South Africa in the first quarter of 2023 increased by 2% compared to a year earlier, in line with the 1,9% growth in the fourth quarter. PayProp data shows that nominal rental growth lifted to an even higher 4,2% in the first quarter of 2023 − the fastest growth since the fourth quarter of 2017. However, reduced affordability is negatively affecting the sales of flats, with several brokers reporting a quiet market. All in all, house prices and rentals are still declining in *real* terms in most parts of the country. ■