Real commercial property capital growth expected to return to negative territory

By John Loos

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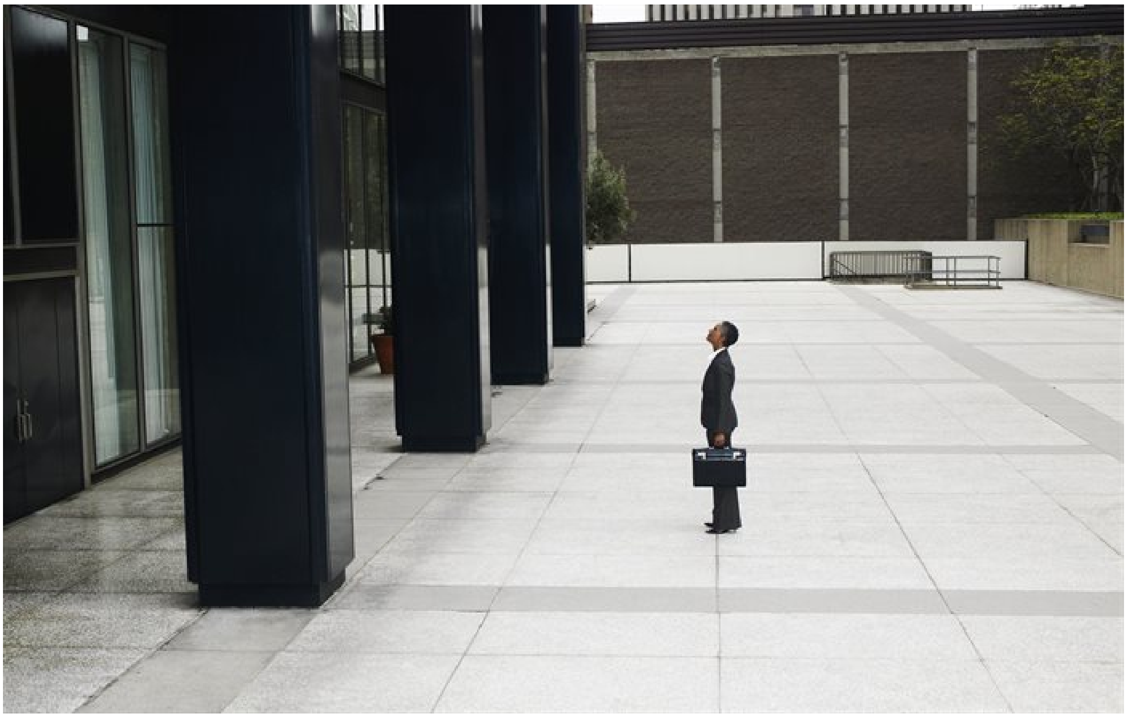
It's that time again, late in the year, when we are speculating as to what the following year may hold, in this case for the property sector in South Africa.



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After full-blown decline in average commercial property capital values through the 2020 lockdown and for much of 2021, the first half of 2022 saw a return to positive capital growth both in actual (nominal) terms as well a real (inflation-adjusted) terms.

Half yearly MSCI data for the first half of 2022 showed the All Property Average Capital Value/Square Metre rising year-on-year by 8.4%, an acceleration from the final half of 2021 which recorded a lowly 2.2%. In real inflation-adjusted terms (using a GDP deflator), the growth was positive too, to the tune of 3.9% in the first half of 2022.

Sustained recovery in real property capital values unlikely

This latest real growth rate was the first positive real rate since the small 0.2% positive rate recorded back in the first half of 2017, and the first significantly positive rate since the second half of 2015. The broad real value correction since 2015 has been significant, the most recent real all property value/sqm being -27.2% down on the second half of 2015.

The recent positive real growth in capital value/sqm begs the question as to whether the positive real growth earlier this year marks the start of a more sustained recovery in real property capital values? Unfortunately, recent economic trends suggest that this is unlikely.

More likely, we would expect a fairly quick return to low single-digit capital value growth possibly in the latter half of 2022 already, which would be below general inflation, thereby translating into renewed value decline in real inflation-adjusted terms. This is on the back of recent signs of renewed weakening in the domestic economy.

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The key reasons for this expectation are as follows:

Interest rates have risen significantly in 2022. FNB believes they are very near their peak, but their impact on property has yet to be fully felt.

In 2021, the scene was being set for renewed economic pressure, following a partial post-lockdown economic recovery. Massive global fiscal and monetary stimulus measures, back in 2020, had been implemented, aimed at supporting the demand side of the economy during widespread lockdowns that caused major supply side disruptions. These measures helped the global and domestic economy recover as lockdowns were eased. However, supply chains across the world had been disrupted in a variety of ways during the Covid-19 period, and the combination of a resurgence in demand and supply constraints caused inflation to accelerate.

By late-2021, many central banks were signalling the imminent start of interest rate hiking in response to rising inflation. In November 2021, the South African Reserve Bank (SARB) began to lift its policy repo rate too.

Impact of war in Ukraine

Then came 2022, and inflation pressures were set to receive a new source of upward pressure. The Russian invasion of Ukraine brought widespread concern in the markets around disruption and potential disruption to energy and agriculture food supply. This, accompanied by a myriad of boycotts and sanctions against Russia in response further exacerbated the global inflation problem, notably in the food and energy markets.

The impact was clearly visible in the South African CPI (Consumer Price Index), the CPI inflation rate for the transport sub-index surging to 25% year-on-year in July (the fuel sub-component of this index rising as high as 45.5% year-on-year in that month), while another major sub-index, i.e., the CPI for food and non-alcoholic beverages, also saw a surge to reach 12% year-on-year by October 2022.

This saw the overall CPI inflation rate rise to 7.8% as at July 2022, having come all the way from 2% in May 2020. Being well-above the Sarb’s 3-6% inflation target range, the bank has hiked rates by 350 basis points to date, with the prime rate rising from 7% late in 2021 to 10.5% by November 2022.

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Light at the end of the tunnel

There is light at the end of the tunnel, however. Global oil prices have come off their highs a little, a weakening global economy assisting in dampening fuel demand, and domestic fuel prices have followed lower. This, along with rising fuel price base effects from a year ago, have lowered fuel price inflation year-on-year, and the CPI for transport has seen its inflation rate slow to 17.1% by October 2022.

This, in turn, has assisted in slowing CPI inflation slightly from its July 7.8% high to 7.6% as at October 2022. The FNB expectation is that CPI inflation will now broadly trend lower, and after averaging 7.2% for 2022 as a whole, will slow back into the target range to average 5.3% for 2023.

This moderation of inflation is expected to bring about the imminent end to Sarb interest rate hiking early in 2023, with the prime rate being expected to peak at 10.75%, only 25 higher than its current 10.5%.

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2023 expected to yield slower growth than 2022

The expected end of interest rate hiking, however, may not immediately bring about a noticeable economic growth rebound. There are considerable leads and lags involved, with the domestic economy having been slowed not only by the domestic rise in inflation and interest rates, but also by a slowing global economy impacting on SA via trade and capital flows.

As at the second quarter of 2022, South Africa's real GDP growth had slowed to a mere 0.2% year-on-year, from 2.7% year-on-year in the first quarter. With the full impact of the global slowdown and local monetary tightening still to feed through, the FNB projection is for 2023 annual GDP growth to be a mildly slower 1.5%, from 1.9% forecast in 2022, only strengthening once more on an annual basis in 2024.

Weakened commercial tenant payment performance

The apparent impact of rising interest rates and renewed economic pressure was starting to become visible in TPN's commercial rental tenant performance data early in 2022. The percentage of tenants in good standing with their landlords, regarding rental payments, had made only a partial post-lockdown recovery at best, but in the first quarter of 2022 began to decline slightly once more from the prior quarter, recording a mediocre 66.33%. This percentage remains far below levels nearer to 80% around the middle of last decade, having been a victim of a long-term economic stagnation.

Renewed rise in average economy-wide vacancy rate expected

This renewed pressure on tenants is likely to dampen property income growth via weaker rental income as well as likely weaker demand growth for commercial space. As a result, the recent mild decline in the all property vacancy rate is expected to revert to increasing once more in 2023, and possibly even late this year already.

This average vacancy rate on all commercial property remains high, but declined mildly from a multi-year high of 9.5% in the first half of 2022 to 8.2% in the first half of 2022. This was part of the partial recovery in the wake of a deep 2020 lockdown recession, but at 8.2% this remains higher than pre-2020 lockdown vacancy rates.

Second quarter MSCI retail data had already begun to see a resumption of vacancy rate increases in some of the retail centre size categories, and in the first half of 2022 it was only industrial property that kept the overall all property vacancy rate declining.

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Capitalisation rates may continue their multi-year upward drift into 2023

Rising short-term interest rates in 2022 have been a source of upward pressure in property capitalisation rates (cap rates) either directly or via the upward pressure that they exert on long bond yields too.

This source of pressure may begin to ease in 2023 should the Sarb indeed end its rate hiking in the current cycle soon. However, weaker perceived property income prospects in 2023 may still be a source of upward pressure on cap rates.

In addition, cap rate moves do appear to lag long bond yield movements considerably, so the upward drift in long rates in recent years, and recently the rising short-term rate hiking cycle may not yet have fully impacted on cap rates.

The most recent multi-year upward drift in cap rates perhaps illustrates the lag. Whereas long bond yields began their multi-year broad rising trend in 2014, Rode cap rates only began to drift broadly higher later on from around 2016. Cap rates could thus conceivably continue their upward drift in 2023, exerting some pressure on real property values.

FNB Property Broker Survey points to weakened property market since earlier in 2022

The property market is perceived by brokers participating in FNB's Property Broker Survey to have been weakening. We have seen all three major property classes (office, retail and industrial) showing third quarter sales activity ratings as well as rental market activity ratings that were down from their earlier-2022 highs.

And in our broker business confidence survey, the percentage of brokers satisfied with business conditions has declined from 47% in the first quarter of 2022 to 33% by the third quarter. We believe that this weakness could be setting the market up for weaker capital growth in 2023.

Outlook for property values

Given all of these indications pointing to recent weakening in economic and key property market fundamentals, and given the lag time often required for these factors to fully be reflected in property valuations, the forecast is for slower growth in average commercial property value per square metre.

From a forecast annual average capital value/square metre growth rate of 6% in 2022 (which would still end up below general economy-wide inflation), a slowdown to 2% is anticipated in 2023 as the impact of a slower economy and higher interest rates feeds through.

The longer-term correction in values in real inflation-adjusted terms is thus expected to continue in 2023.

ABOUT JOHN LOOS

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