The worst is over, but commercial property sector remains cautious

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South Africa's commercial property market is still feeling the impact of the global and domestic economic downturn. The immediate focus is on mopping up the high vacancy rates caused by high levels of development activity in 2006/7, when the prospect of a recession appeared remote.

Therefore, the outlook for new developments remains subdued, with the developers and bankers taking a far more cautious view of the sector and its prospects.

Property economist and University of the Witwatersrand School of Construction Economics and Management Professor François Viruly says that, while the sector entered the economic downturn with relatively low vacancy rates and strong fundamentals, the economic slowdown has been intensely felt, with vacancy rates rising and optimism falling during 2009 and the first half of 2010.

This has led to dramatic pullback in developments and continued caution, despite the fact that prospects for the domestic economy are improving.

Developers are reassessing existing projects, but are also desperate to avoid exacerbating the oversupply situation, particularly in the office segment. "Although vacancy rates increased during the downturn, the slowdown in development activity will, during the course of 2010, result in a decline in vacancy rates. The strengthening in retail expenditure bodes well for a reduction in retail vacancy rates in the short term. The office sector will, however, need to wait until 2011 before seeing an improvement in vacancy rates."

South Africa's largest listed property fund, Growthpoint Properties, acknowledges that development activity remains low, owing to the surplus of available commercial space, espacially industrial and office.

Niche Opportunities

There are, however, limited opportunities for tenant-driven development, especially extensions and expansions of performing established properties.

"Relative to global listed property, South African listed property 'breezed' through the global financial storm. The sector has demonstrated its defensive qualities and has differentiated itself from cash, bonds and equities as a separate asset class," Growthpoint Properties executive director Estienne de Klerk reflects.

"However, the increased performance of the sector remains susceptible to the global and local economic recovery. Property companies continue to show top-line growth because of the escalating nature of the rental contracts in place with tenants." Multidisciplinary property services company Broll Property Group adds that market sentiment about the development pipeline is restricted by the fact that vacancies continue to rise, notwithstanding the protracted development lead times.

“We need to also remember that the development pipeline for commercial buildings has a long lead time (it could be up to four years) before the buildings are completed; hence, any new big developments currently being planned will only come on line in 2013/14,” says Broll CEO Malcolm Horne.
In fact, diversified property company Quantum Property Group (QPG) even suggests that there is a need for the development of new inventory to facilitate growth prospects that could be “around the corner”.

“There should be responsible building by developers to create the correct inventory in a joint venture with the financial institutions for the potential growth of the economy. The real reason we are paying unreasonable rentals of R100/m2 to R180/m2 is that an inventory has not been produced,” says QPG executive chairperson Chaim Cohen.

He advocates the building of 10 000-m2 to 20 000-m2 units to secure capacity for future growth.

Cohen believes that the industry has not taken full stock of the spin-off from the success of the 2010 FIFA World Cup. “We are going to see a growth driven by this exposure. South Africa is on the world stage, recognised and acknowledged by global players, which is a reason to create a responsible inventory.”

Good Rental Deals

The outlook, as well as current performance, is also relatively subsector dependent, with retail showing relative strength.

For instance, property developer Hyprop Investments CEO Mike Rodel says that, as a retail-focused listed fund, the company is pleased to see turnover growth improving since the beginning of the year. “Since we cater for the top end of the market, I think that we led the market coming out of recession and, as a result of that, we are seeing renewed interest in space. The national anchors are starting to spend again and independent anchors are looking for opportunities.”

He points out that, for anyone looking to expand or take up new sites, the time is ripe to get good rental deals. However, the window is also closing.

“Some of our properties are sitting with vacancies, so we have some opportunities but, already, within the past six months, we have concluded over 10 000 m2 of new deals, which resulted in our top centres having no opportunities at all.”

Hyprop is confident about future growth opportunities, but at lower levels than in the past. “We are expecting national retail sales growth at between 7% and 10% for the next two to three years, with our regional centres growing at up to 12%, which bodes well for future opportunities,” says Rodel.

Old Mutual Investment Group Property Investments’ (OMIGPI’s) retail view, on the other hand, has gravitated towards a ‘death-or-dilution’ scenario. Given the extent of shopping centre development ahead of the downturn, the group feels that some nodes will suffer as centres cannibalise one another’s patrons and tenants.

Its research has shown that a regionally dominant centre is far more likely to attract the spend necessary to withstand a downturn.

Vacancies in Growthpoint's retail portfolio, meanwhile, remain low at 2,7% with the bulk of its value in high-quality established regional retail malls.

Office Outlook

The office sector generally feels the brunt later than retail and is subject to a far higher substitution risk. But, currently, prospective tenants looking for good-quality office space in South Africa could pick and choose from close to one-million square metres of prime and A-grade space.

OMIGPI only expects office vacancies to start coming down in 2012. Its analysis of the South African Property Owners Association's 'Office Vacancy Survey' highlights popular development nodes, such as Sandton, where new capacity is being built. But, overall, demand remains weak.

Rodel also highlights pockets of strength, saying that, on the office side, the company has seen renewed interest in the offices adjacent to specific shopping centres, such as Canal Walk, in Cape Town, where vacancies have reduced in the last six months. "From an overall perspective, I think the key issue, going forward, is going to be specific nodes, which are going to be stronger than others, and a big focus for us is the Gautrain, with specific development around Sandton at the station, as well as the Rosebank precinct," he adds.

Growthpoint's De Klerk adds that existing vacancies, particularly in the office and industrial sectors, are putting pressure on rentals at renewal and the signing of new leases. However, vacant space can also represent an opportunity. "We believe that vacancies in our portfolio have peaked and we are already seeing an improvement." Meanwhile, independent property services company JHI reports an increase in demand for warehousing in Gauteng, catering for light manufacturing, distribution and storage.

An area that is strategically positioned to capitalise on this trend is Isando, located between major highways such as the R24, N12 and R21, says JHI leasing, sales and investment broker Jonathan Klimek.

"It is the central point of the industrial east region in Gauteng, being surrounded by other industrial areas, such as Jet Park, Spartan, Anderbolt, Pomona and Meadowdale," Klimek elaborates.

He says that the current demand is mainly in the range from 500 m2 to 1 000 m2, as well as for larger warehousing space of about 5 000 m2 and above.

Costs and Margins

Nevertheless, despite some niche opportunities and pockets of resilience, the overall national theme relates more to sweating existing assets than to building new ones. Another theme relates to controlling operating costs in light of strongly rising administered prices, such as municipal rates and electricity tariffs, where the increases are rising well ahead of inflation.

"The margin of operating costs to gross rentals has continued to rise from some 30%, two years ago, to some 40%, at present. High vacancy rates have also made it difficult for owners to pass these rising costs on to tenants," Rodel notes.

OMIGPI says that rentals and related escalations are largely protected by leases but remain sensitive to tenants' needs and the company has seen increased concessions and lower reversions.

It believes that the declining inflation is a double-edged sword. While it is great for the cost line, it also means a loss of pricing power, which puts pressure on trading margins when considered alongside substantial increases in electricity and municipal rates.

Horne is of the view that increases in electricity, rates and taxes are likely to continue and that, in most cases, the costs are being absorbed by the landlords. And, when they do recover these costs from the tenants, it adds further pressure on their ability to pay rent.

Turnaround Prospects

Cohen expects to see a material improvement by the third quarter of 2011, while OMIGPI is forecasting a sustained recovery in property returns.

“We are not expecting the massive increase in vacancies that characterised the previous cycle and should see the all-property vacancy rate peak in 2011,” OMIGPI research head Phil Barttram says.

“This translates into less of a slump in capital growth as the market will be able to absorb the inevitable supply hangover. With rentals largely protected by leases and the spending of capital curtailed, we also expect income growth to remain on solid ground.”

He adds that this is critical to the development outlook as developers need investment capital, and investment capital follows returns. The important factor is that banks and regulators will need a few more years before they forget the recent crisis.

“It will be some time before we see the mispricing of risk (particularly debt risk), which fuelled so much development before today,” he argues, suggesting that only essential developments and equity-backed deals will proceed in the near future.

“Given our forecast for a sustained recovery, we do not expect a repeat of the high vacancies seen during the 2002 and 2003 peak. Our analysis of both the US and Australian property sectors indicates that, during a sustained economic recovery, the retail sector tends to lead the industrial and office sectors. Should the recovery falter, then the office sector tends to lead. As with any property, though, location and building specifics are critical to income sustainability.”

Patchy Recovery

Viruly also stresses that the performance of the sector remains patchy. There are, however, indications that the performance of the retail sector is improving and that vacancies in the sector are declining.

He believes that it is likely that the retail sector will emerge first from the present recession. The industrial sector should follow, with the office sector tailing behind. While the upturn will be demand driven, market conditions will also tighten as a result of declining development activity.

“It is, however, unlikely that the sector will be out of recessionary conditions before the middle of 2011. The short-term opportunities will arise as a result of an improvement in infrastructure – this, for instance, includes opportunities around Gautrain stations and other interventions,” says Viruly.

The single most important issue in the medium term will be to ensure that operating costs are kept under control, even if vacancy rates improve; it is important that operating margins are improved.

Horne affirms that some of the major markets in Europe have started to show signs of a recovery but in no way will it be a smooth ride. Some of the African markets have been less affected and the company has signed a variety of mandates for new developments, which indicate a good growth period, but from a low base.

“In South Africa, we should see more movement in the first six months of 2011, but we anticipate that the recovery will only really gain momentum in 2012.”

Growthpoint is confident that it has already come through the worst and an improvement in the overall position is evident, and indications are that the economy is experiencing a moderate recovery.

“Our vacancies have peaked and are reducing and a slow but steady improvement in occupancy levels in the office and industrial sectors is expected in the next year,” concludes De Klerk.