Think Big When It Comes To Property

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John Loos, property economist for First National Bank, bemoans the fact that South Africa is in an era of under-forecasting when it comes to property as he is of the opinion that the "booms could be far greater than we can imagine".

"On its own, 6% economic growth means little to property returns. It is the direction of growth that counts, and economic growth on an accelerating path towards 6% is vastly different from 6% growth but on a decelerating path," he says.

"This is because certain industries easily run into capacity constraints when the country is on an accelerating growth path as looks to be the case in the construction and property sectors, and this has huge implications for property performance."

Loos advises that the future role of the residential property market in driving up commercial property valuations and vice versa should be acknowledged, and that neither residential nor infrastructure projects should be looked at in isolation from commercial property. "They all compete to a greater or lesser extent for resources, and this competition between the sectors is expected to increase significantly towards the end of the decade," he says.

According to Loos, demand growth for housing in the coming years could be significantly more rapid than GDP growth. This is because middle-to-upper income people tend to spend a higher percentage of their disposable income on housing/accommodation than do the poor. "In Randburg (arguably the country's most affluent magisterial district), 12% of household expenditure is on accommodation. In Soweto (far poorer), only 7,7% is on accommodation. That is the reason for getting excited about an emerging black middle class, which should drive strong growth in housing demand. That, in turn, is expected to exert significant upward pressure on building costs in the coming years, as materials and skills in construction remain in relatively short supply for some years," he says.

Furthermore, Loos believes that the Reserve Bank and other commentators' concerns regarding the level of household debt are overdone. "In an economy moving towards lower long term average interest rates, one should expect a move towards higher household-debt-to-disposable income ratios due to the decline in debt service ratios that interest rate reductions bring," he says.

middle class growth. "In brief, after some further slowdown in 2007, the residential market is expected to recover from 2008 when interest rates decline mildly once more," he says. "I expect residential property prices to be around 85% higher by the end of 2010 compared with the end of 2005."

He points out that despite significant building activity in the area of commercial property to date, vacancy rates have been on a declining trend for some years. "Even in the area of retail space, where there has been significant new supply coming on stream during the consumer boom years, there would not appear to be a major oversupply of retail space looming," he says.

"And even though it may seem that there is some sort of oversupply, building statistics suggest that this is not the case – and that it was probably far more the case in the 1990s."

Loos explains that if the oversupply issue is not a problem in retail, the office and industrial space categories are moving towards significant shortage of space. "It is important to understand that in an accelerating economic growth environment, property and construction downswings could be expected to be shorter and upswings longer and more extreme than would be the case in a stagnating growth environment. In the 1980s and 1990s we experienced an 'abnormally' long slump, with economic growth on a stagnating path," he says.

Therefore Loos suggests that people don't base their expectations regarding the property and construction cycles on "those dark days".

"We need to get around the mind set that drives us to believe that because we've had a major boom there now essentially has to be a long slump. Rather, keep in mind that cyclical downturns could be far shorter than upswings in an accelerating growth environment because spare space is difficult to create and gets taken up relatively quickly," he says.

"I expect us to be back to 6% economic growth in a few years time, with interest rates still moving downward to get more into line with inflation rates. This would suggest that income prospects are very promising from a commercial point of view.

"These expectations lead me to believe that property performance as measured by capitalisation rates may well be lower than the levels of the high growth-low inflation in the 1960s."

Therefore, when formulating a view on property and construction, Loos starts with the 1960s as a benchmark and with accelerating growth in mind. "Think big, think 1960s, and let supply side constraints, which are the legacy of a very long 1980s and 1990s slump (along with 2010 preparations), make you think even a little bigger," he says.

He concludes by stressing the following:
-Mounting materials and skills shortages are expected to drive double-digit building cost inflation in the remaining years of the decade.

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-After a very long slump of the 1980s/90s, the construction and materials sector has limited capacity, which is expected to be the cause of high building cost inflation.

-Urban land values and congestion are far more of an issue today than in the 1960s, suggesting that land price inflation will also support overall, property price inflation.

-Capitalisation rates are believed to be moving back to the 1960s and possibly beyond.

-Average industrial rental inflation forecasts are around 10 to 15% (perhaps closer to 15%) per annum from 2006 to 2010. This is based on 4 to 5% real GDP growth, which is not unrealistic. Accelerating path growth of 6% can prolong double-digit rates, possibly until 2015.

-Office space rental inflation is accelerating towards double-digit figures, ie 10 to 15% per annum, which is not unreasonable either.

-On only 10% per annum on average, 2015 rentals will have risen 159% on those of 2005. On 15% per annum, this would amount to a staggering 305%.

"If you think that property is expensive today, given the prospects for strong demand growth and severe supply side constraints in the coming years, you ain't seen nothin' yet." – Kara Michaels

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