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Property Insights

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Cap Rates and Property Values – Is it time for a more significant move?

A few months on from the May general election, a somber mood is once again settling in in the country, and one senses that there is a feeling that structural policy reforms that had been hoped for under a new presidency are not easily going to be forthcoming.

Should this sense be correct, this would be a significant change from recent periods of "hope", and "wait-and-see" attitudes, by investors and the markets, and could mean a period of more significant market movements, including the property market.

South Africa currently finds itself in the longest business cycle downward phase on record (records dating back to just after World War 2). The current downward phase commenced in December 2013, and has not produced a severe recession to date but rather a "slow poison" that is gradually squeezing the life out of the economy.

As the economy's growth rate has slowed to near zero, the property market has seen some mild correction. This is reflected in MSCI's annual All Property Capital Growth Rate, which had slowed to 1.7% by 2018, which implies a decline in real terms (when adjusted for general inflation as measured by the GDP deflator). This real capital depreciation has been in play since 2014, albeit a gradual decline.

But during this time, we have not seen any major moves in what are still relatively low capitalization (cap) rates during this past 5-year period.

The FNB Property Broker Survey for the 1st 2 quarters of 2019 points to very little perception of any cap rate increases. We ask survey respondents whether they perceive cap rates to have risen, remained the same or declined over the 6 months prior to the survey date.

We then use the percentage of respondents in each of the 3 answer categories to compile an index of perceived cap rate direction change, through assigning a +1 rating to the "increased" responses, a zero to the "unchanged" responses, and a -1 rating to the "declined" responses.

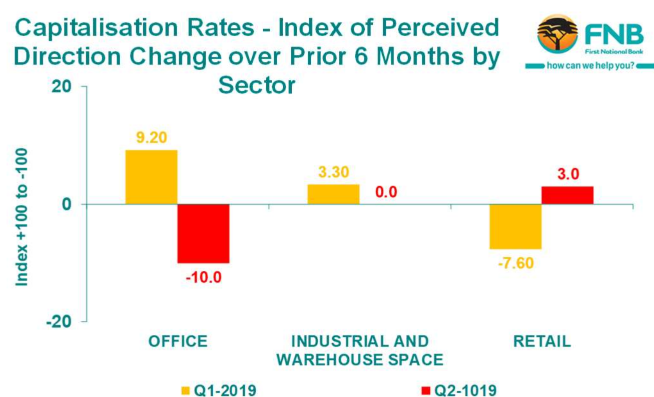
Therefore, the index is on a scale of +100 to -100, where +100 would mean that 100% of respondents pointed to an increase in cap rates in the prior 6 months, and -100 would mean 100% perceiving a decline in cap rates over the period.

In the 2nd quarter survey, the split between respondents pointing to an increase versus those perceiving a decline remained very close. In the Office Property Survey, 10 percentage points' more respondents (15%) reported a decline in Office cap rates than those reporting an increase (5%), translating into a "declining bias" in the Office Cap Rate Direction Index of -10.

By comparison, the Industrial Property Cap Rate Direction Index was zero, implying a perfect balance between those respondents perceiving an increase (5%) and those perceiving a decline (5%).

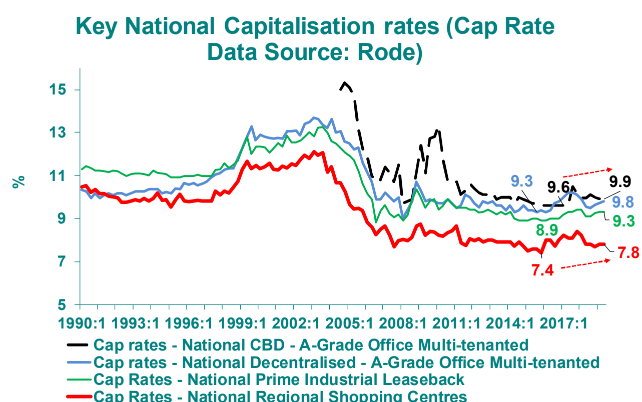
The Retail Property Cap Rate Direction Index pointed to a slight bias towards an increase, with a reading of +3, implying slightly more respondents pointing to an increase (7%) than those perceiving a decline (4%).

The 2nd quarter survey therefore points to little in the way of cap rates increasing, with only the Retail Sector Survey category showing a very slight upward bias.



And examining key cap rate time series from Rode and associates, one sees only marginal upward movement on multi-year lows of a few years ago.

From a multi-decade low of 7.4% as at the final quarter of 2015, Rode's National Regional Shopping Centre Average Cap Rate had risen to 7.8% by the 2nd quarter of 2019.



Its National Prime Industrial Property Average Cap Rate had risen from 8.9% in the 1st quarter of 2016 to 9.3% as at the 2nd quarter of 2019, while that of De-centralised A-Grade Offices had increased from 9.3% in the 3rd quarter of 2015 to 9.8%, and CBD Offices from 9.6% to 9.9% since the 1st quarter of 2017.

Therefore, Rode's key national average cap rate categories have shown only mild increase in recent years, ranging from 0.3 of a percentage point to 0.5 of a percentage point in total.

But cap rates remain low by multi-decade historic standards, with high property values by historic standards, a situation which appears increasingly out of line with deteriorating economic fundamentals.

A key question is whether this situation can continue for much longer, or are we nearing a more noticeable "correction" in cap rates (up) and property values (down)?

What factors were in place at the time of the last big cap rate move from 2003 to 2007?

It is difficult to predict the timing of market corrections, because sentiment in the market is not always in line with the fundamentals, often being influenced more by hope, sometimes due to the market waiting for some event which may or may not happen, or due to skepticism around whether some more permanent change in economic performance has arrived or not.

A sudden change in confidence can then occur at some point where market players begin to lose faith, or gain faith that they didn't have, an event not always based on actual economic data.

Perhaps we should go back a few years and look at the last major move in cap rates and property values. This move was actually in the strengthening direction, cap rates declining sharply and property values escalating sharply, and the period I refer to was around 2003 to 2007.

Rode's National Regional Shopping Centre Average Cap Rate dropped all the way from a multi-decade high of 12.1% in the 3rd quarter of 2003 to 7.1% by the 3rd quarter of 2007. Over a similar period, the National Average Prime Industrial Cap rate dropped from 13.2% to 9.1% over a similar period, and Prime De-centralised Office Cap Rates from 13.7% to 9%.

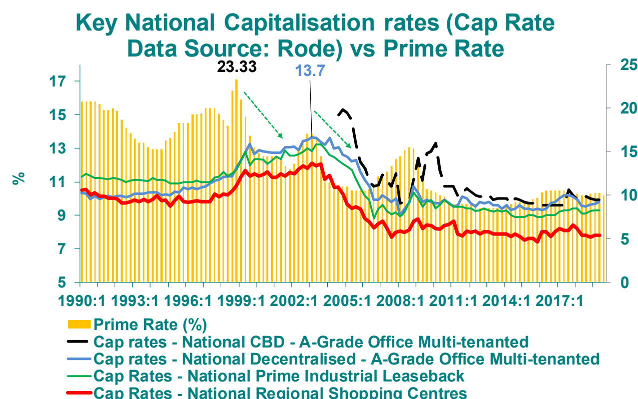
This was a big downward move in cap rates, as the All Property cumulative capital growth rate of MSCI recorded a massive 95.3% from 2003 to 2008.

However, that big "positive correction" in property values and cap rates didn't happen suddenly. It came only after some years of the fundamentals moving into place. These fundamentals began to noticeably improve in the late-1990s.

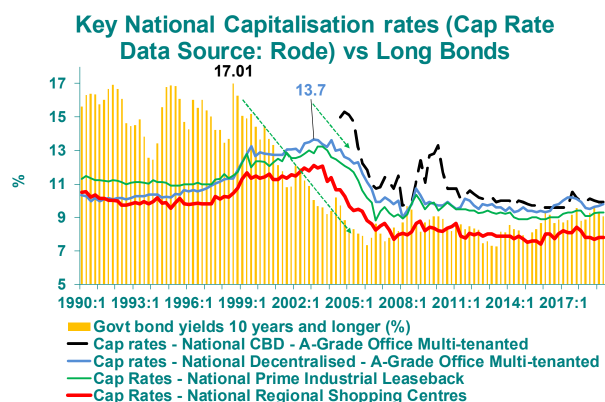
The longest business cycle upswing in the post-World War 2 era began in September 1999. Economic performance was on a long run improvement assisted by the end of boycotts and

sanctions earlier in the 90s, after the end of Apartheid and a dramatic improvement in the country's political situation.

The start of this long upswing virtually co-incided with the start of a major decline in short term interest rates, as the SARB moved away from currency "targeting" towards CPI inflation targeting, Prime Rate falling all the way from a peak of 25.5% around mid-1998 to 13% by end-2001. Then, after a brief rise to 17% in 2002, it fell further to reach 10.5% by mid-2005.



Government long bond yields also declined sharply, the 10-year and longer average bond yield declining all the way from a 17% average in the 3rd quarter of 1998 to levels below 10% by early-2003. These were helped lower by the government fiscal deficit having narrowed from the mid-1990s, and the government debt-to-GDP ratio having begun a long and impressive decline from 1995 onward.



However, through the initial phase of the upswing and rate/yield reductions, the IPD All Property capital growth rate from 1998 to 2002 was a mere 0.4% cumulatively, capital depreciation in Office and Industrial Segments being common, while cap rates broadly increased over this period. Commercial Property vacancy rates were still rising, and Business Confidence had not yet reached the levels where expansions would be sufficient to turn this trend around.

That point came in 2003. In 2002, the MSCI All Property Vacancy Rate peaked at a very high 12.7%, where-after it began to drop like a stone to reach 3.1% by 2007. The RMB-BER Business Confidence Index rose from a low of 14 early in 2009 (on a scale of 0 to 100) to reach the healthy 60s by 2002, and then on to a lofty 82 by late-2004.

Finally, around 2003, the stars were all aligned for a commercial property price boom, and cap rates shifting sharply lower in the ensuing years. Long and short interest rates had declined sharply since 1998, the longest business cycle upswing post-World War 2 was in progress, vacancy rates had started to fall sharply, and business confidence was skyrocketing. Finally, there was the confidence that an improved economic performance was not merely a "flash in the pan", but perhaps something more "permanent" or long term by nature, and why wouldn't property values adjust significantly to reflect these dramatically improved economic fundamentals?

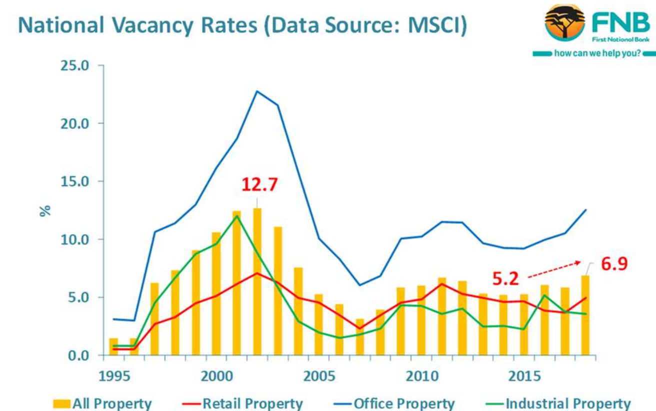
Is a big move in cap rates in the opposite direction now looming?

The last major move in property valuations and cap rates was in a sharply stronger direction, i.e. falling cap rates and rising values, from around 2003 to 2007.

Fast forward to the present time, and for quite some time we have seen the important property-influencing fundamentals going in a deteriorating direction. We are now in the longest business cycle downward phase since World War 2.

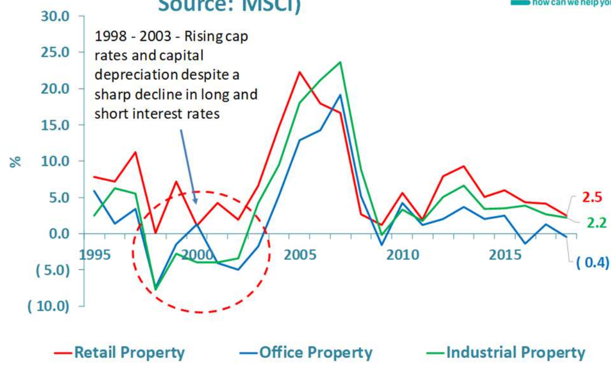
This begs the question as to whether a significant cap rate increase looms in the near future, with perhaps even nominal capital depreciation on a national average basis?

The 1st key potential driver of such a move is a rising All Property Vacancy Rate, from 5.2% in 2014 to 6.9% in 2018. Such a rising vacancy rate trend was in play from 1997 to 2002, the last period of significant cap rate increase and capital depreciation.



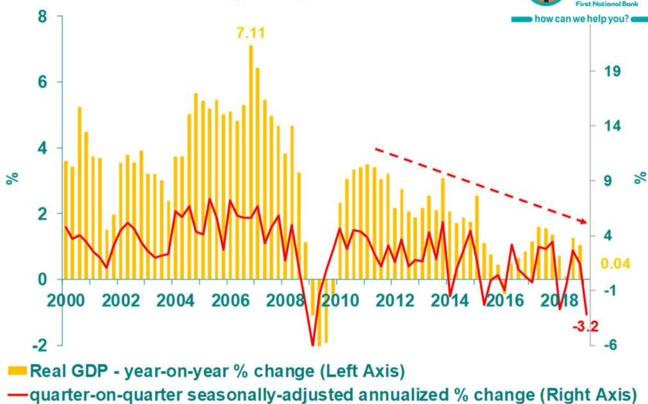
To date, the 6.9% vacancy rate of last year is not nearly as high as the 12.7% peak of 2002, but it is already at a level similar to those reached around 1997/98, and it was in 1998 that noticeable capital depreciation set in at least in the Office and Industrial Property Sectors, according to MSCI data.

Capital Growth by Major Property Class (Data Source: MSCI)



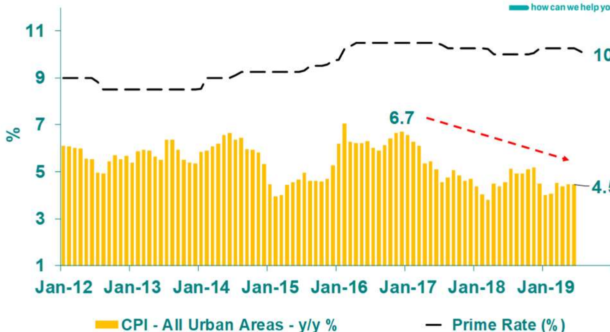
And with a multi-year economic growth stagnation in swing, year-on-year Real GDP growth having reached zero early in 2019, it appears likely that this national All Property Vacancy Rate will rise significantly higher in the foreseeable future

Economic (GDP) Growth



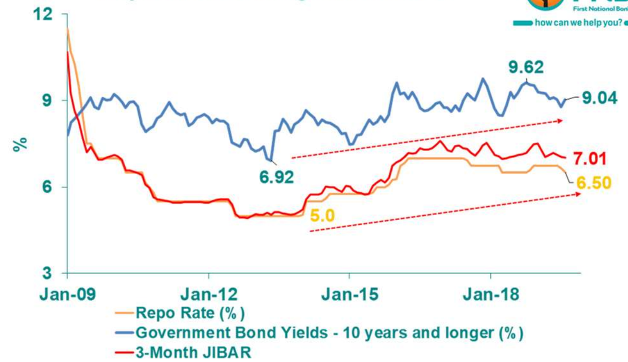
What does appear very different to 1997/98 is the level of interest rates. Prime Rate currently is 10% and short term rates are in a SARB cutting cycle (1st rate cut recently took place in July). Domestic CPI inflation hovers around 4.5%, the mid-point of the SARB target range of 3-6%, thus causing little immediate concern to the SARB, and any potential concern over interest rate differentials between SA and major economies is reduced by the US Federal Reserve's recent start of its own rate cutting cycle.

Consumer Price Inflation



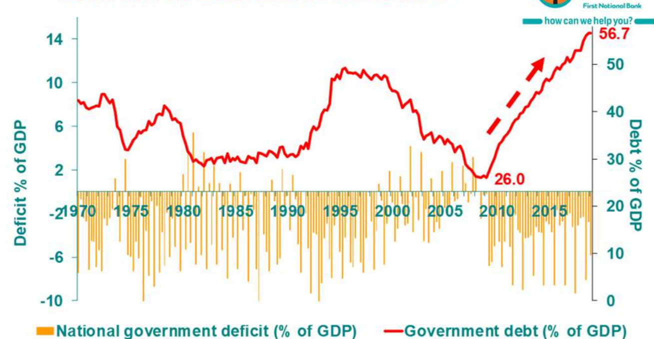
So, whereas the big property valuation surge and cap rate decline of 2003 to 2007 was preceded by major interest rate drops from extremely high levels a few years prior, the current environment is not yet exactly the opposite of then, in the sense that we have yet to see major interest rate increases. The SARB's policy repo rate at 6.5% currently is mildly up from its multi-decade low of 5% back around 2013, while Government 10 Years and Longer Bond Yields at just above 9% are also up from lows below 7% back in 2013. But these upward moves can not yet be seen as extreme.

Repo Rate vs Long Bond Yields



However, arguably the big elephant in the room is the deteriorating state of Government finance, and the resultant rise in the Government Debt-to-GDP Ratio. At 56.7, this debt-to-GDP ratio is at its highest level in recorded history. In addition, it does not include the mountain of often government-backed debt of state owned enterprises (parastatals), most notably that of Eskom, the country's battling power utility, for which an increasing need for National Treasury bailouts makes it almost certain that the debt-to-GDP ratio will rise significantly further.

Government Debt and Fiscal Deficit



The Government debt problem is exacerbated by weak tax revenue growth in a near-zero growth economy.

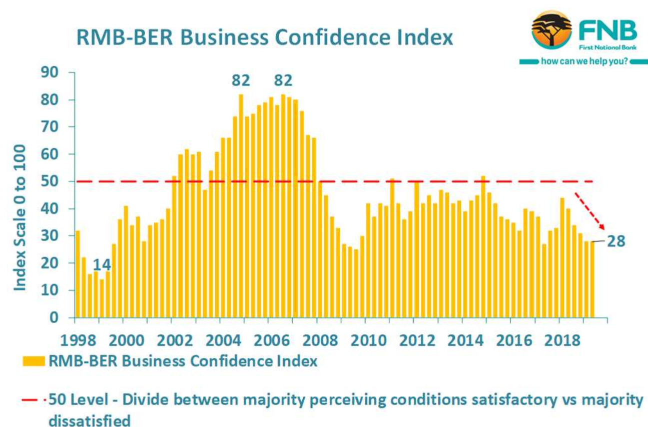
This heightens the risk that bond yields could rise significantly at some stage should fears of a Government default increase substantially.

The risk goes further, though, to potentially impacting on economic growth should investors increasingly come to the conclusion that structural economic reforms aimed at fixing these problems, are unlikely. Broader net capital flows could then conceivably deteriorate to such an extent that a significantly weaker rand exerts upward pressure on import prices, CPI inflation, and ultimately short term interest rates too.

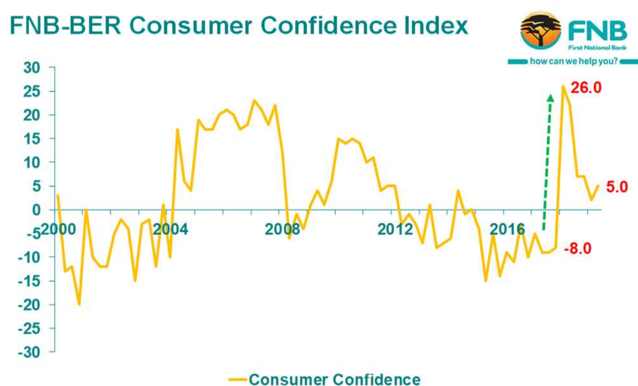
But has something perhaps been partially preventing such a market correction from happening?

Important in this regard has been the change in the ruling party's leadership late in 2017, and the country's president shortly thereafter, with Cyril Ramaphosa taking over from Jacob Zuma. And then there was the national election of May 2019.

The bounce in sentiment early in 2018 was dubbed "Ramaphoria". It appeared visible in the RMB-BER Business Confidence Index, which jumped noticeably from 33 in the final quarter of 2017 to 44 (scale of 0 to 100) in the 1st quarter of 2018.



A similar bounce was seen in the FNB-BER Consumer Confidence Index, from -8 in the final quarter of 2017 to +26 in the 1st quarter of 2018.



However, both these indices showed that the "Ramaphoria" was short lived. It was based on the hope of major positive policy changes, and with few such changes forthcoming in a short space of time after the leadership change, both confidence indices receded significantly, the Business Confidence Index back to a lowly 28 by early this year, and the Consumer Confidence Index recording a far lower +5 as at the 2nd quarter of 2019.

But there was arguably one more event which had sustained some hope, and the perhaps a "wait-and-see" approach of certain investors. This event was the May 2019 election. Various theories did the rounds prior to this election, including the opinion of some that a good ANC election showing would give President Ramaphosa the mandate and the powers that he needed to implement much needed structural economic reforms.

However, the 2 confidence indices' early-2018 bounces, and quick subsequent declined thereafter, showed us that a leader has very little time to act before confidence recedes sharply.

We are now in mid-August, around 3 months on from the May election, and one senses that the hope of positive action may be fading.

Government Bonds 10-years and Longer have seen their average yields increase noticeably from 8.62% as at 19 July to 9.15% by 13 August, a not insignificant 53 basis point rise in a relatively short time, while the trade-weighted Rand index has depreciated by a significant -7.5% since 23 July.

While a weakening global economy, and heightened Emerging Market concerns, is believed to have played a role in this recent weakness, locally there has been much talk of looming ratings downgrade, uncertainty around an Eskom turnaround strategy, the new and costly National Health Insurance (NHI), possible future IMF bailouts, internal ruling party battles and a lack of concrete structural reform announcements.

And if the financial markets are beginning to correct more substantially, in the face of a lack of positive policy reform, the possibility of a more significant move in property values (down) and cap rates (up) must surely also become a stronger possibility

In Conclusion

If the longest business cycle upward phase since World War 2 brought about an ultimate property price boom back around 2003 to 2007, then it is possible that the longest business cycle downward phase since World War 2 could bring about a significant property market correction.

The environment today, however, is not exactly the opposite to what it was at the time during and preceding that boom.

Indeed, economic growth is stagnating and property vacancy rates rising currently, which is the opposite to those pre-2008 boom times. However, we are currently not yet experiencing a major rise in interest rates, whereas we had seen sharp declines in short and long term interest rates prior to last decade's boom.

Currently we have a benign inflation environment, and short term rates remain low and even declining slightly of late.

But the risks of this interest rate environment changing must surely have been increasing recently, with Government's financial situation continuing to deteriorate as it starts the Eskom bailouts, which could ultimately cause investor confidence in government bonds to deteriorate, while investor

confidence in SA in general may be starting to wear thin as it becomes increasingly apparent that structural economic reforms may be some way of.

3 months after the election, hope of positive structural economic reforms may be dwindling. Recent rand weakness may in part reflect this. How far does sentiment decline? Tough to predict, but such a sentiment decline can lead to a decline in property values and a more significant rise in cap rates than we have seen in a while.

These are the risks at present.

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