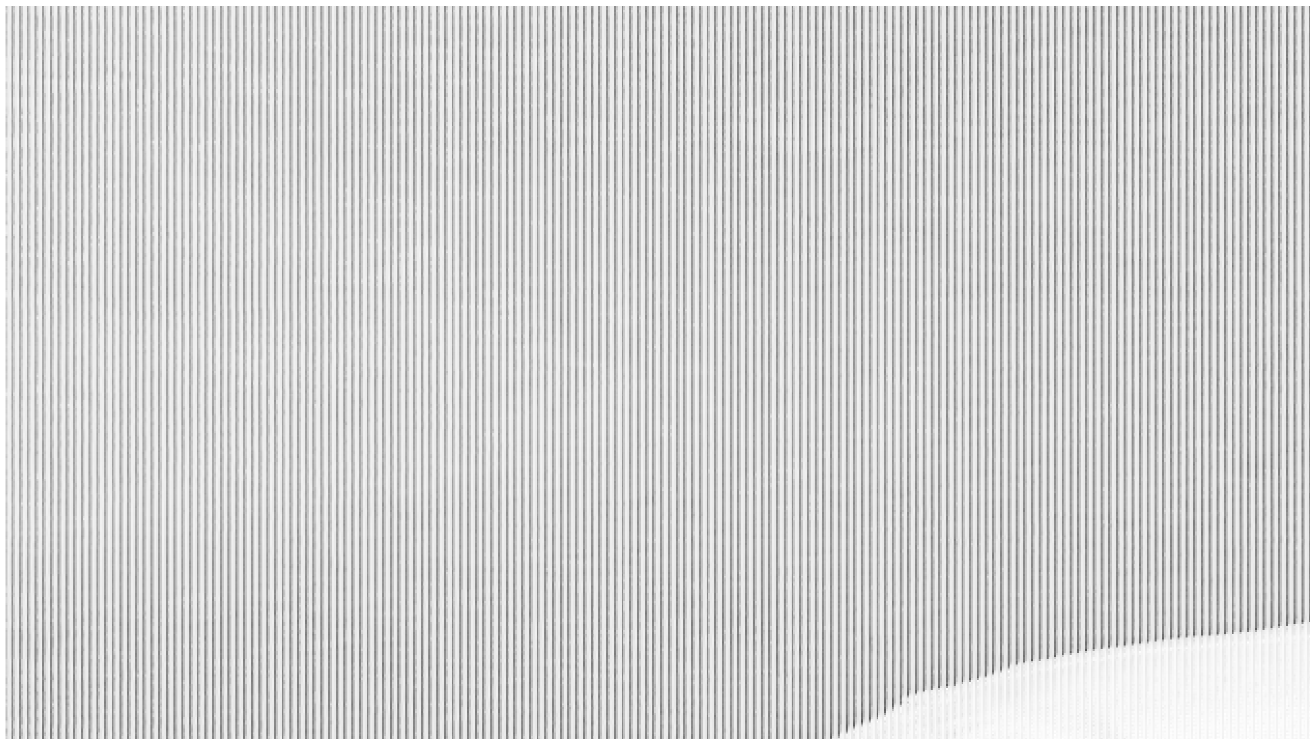
Boom or bust for property?



One of the most tangible consequences of recent developments in the economy is the Reserve Bank's decision to increase the repo rate by 0.5% in January, in an effort to prevent inflation rising above the targeted four to six percent band. The consequences of this reach far beyond consumers, who, while they are likely to feel the pinch, are not the only ones who will have to revise their purchasing decisions.

Gary Garret, head of real estate finance at Standard Bank, says the weakening rand has created pressure on inflation that could result in further interest rate hikes. This, coupled with low economic growth forecasts, has a negative impact on the economy as a whole, including the commercial property sector.

"We have already seen the effect of this, with the listed property sector generally trading at significantly lower levels than six to 12 months ago. This trend is likely to continue if interest rates continue to rise."

New property developments will be impacted by the weakening rand if specified materials are imported, driving construction costs beyond budget, and potentially making some projects no longer viable.

"Furthermore, the general economic environment will see rentals come under pressure across the sector due to lower consumer spending and tenant affordability," he says.

Paul Barrow, director at Barrow Properties, reminds that property is, to a large extent, driven by market sentiment and the current low levels of business confidence are having a damaging effect.

"The 50 basis point increase in January will place further pressure on a fragile market," he says. "However, the property market has become known for its resilience over the years, and it is more important now than ever before to stick to the basic fundamentals: quality buildings in good locations will remain in demand and will continue to attract premium rentals."

In his opinion, investors are reluctant to move their money offshore at the current exchange rates, and prime

property has become a viable alternative to the volatility of the stock market.

Tony Galetti, chief executive of Galetti Knight Frank, points out that the most critical issue in many property transactions is the cost of borrowing, which is likely to increase further over the medium term to offset the weak rand.

“As the cost of borrowing goes up, the value of property goes down,” he says. “So over the medium term we are expecting prices to come down a bit as the interest rate goes up. We are already seeing this in the market, as the prime capitalisation rate for investment property is moving out, which means values are decreasing.”

He adds that higher interest rates affect affordability, and those who own commercial property and are highly geared may be forced to sell assets as the properties come close to cash flow negative, and they cannot afford holding costs. “This, coupled with some panic selling by commercial property owners who want to take money offshore, could put further downward pressure on property values,” he says.

However, it’s important to remember that commercial property is a slow-moving asset class normally tied to long-term lease agreements, which give landlords the peace of mind that their income is consistent over a period of time — the sector is less affected by short-term blips, and rather follows long-term trends.

Galetti emphasises that the listed property sector is for the most part secure, with low gearing and consistent income. “While the property funds may see some decrease in asset value, the underlying fundamentals on income shouldn’t change much,” he says. “Now is not the time to panic, rather tread cautiously. Don’t over-expose yourself to high-interest borrowing. It’s going to be an interesting few years, and patience will be key.”

With interest rates affecting consumer spending power, Mark Kleynhans, national head: Commercial at Aucor, believes marginal retailers will take the biggest strain in the coming months, although the greatest impact will be felt 12 to 18 months hence as the knock-on effects of food inflation rumble through the economy.

In contrast to Barrow, he believes there has been a shift in buyer sentiment, with many of Aucor’s wealthy private clients who previously bought local hard assets now choosing to spend their money on property offshore.

“It’s not just private buyers doing so — many of the listed funds have diversified with purchases in Australia, Europe and the US,” he says. This means there is a larger pool of stock locally, with great opportunities in the market that would have ordinarily been snapped up by parties that are now looking abroad to invest.

He notes that if non-institutional buyers are buying, they’re pricing conservatively, which creates a challenge for sellers to match their view for deals to be closed.

He agrees with Barrow and Galetti, however, that in spite of the trying conditions that undoubtedly lie ahead, commercial real estate as an asset class — particularly in the listed sector — is commonly viewed as a bulletproof investment, as long as buyers are able to look past short-term volatility.

“The smart investors that make the serious money are the ones that buy good assets in volatile markets — the people who do their homework, hold their nerve, stay calm and don’t get sucked into negative garbage will pick up gems and when the market settles down, they’ll have great portfolios. It’s imperative to look past the emotion of the moment, because property is a very sterile, hard asset, considered to be a safe haven in volatile times.

“You need to take a long-term view though,” he says. “It’s a great time to buy phenomenal assets, but you have to take the view that you’re going to ‘buy it and park it’.”

When it comes to the construction side of the market, and new assets coming into play, Patricia Zvarayi, senior corporate analyst at Global Credit Ratings says the outlook for the construction industry is negative due to factors such as regulatory uncertainty, low levels of public infrastructure spending and declining global commodity prices.

Furthermore, the two most crucial areas for new workflow — public infrastructure projects and the mining sector — remain very weak.

“The slump in commodity prices has significantly curtailed private sector demand, while falling fiscal inflows will force the South African government to scale back on its much-promised infrastructure spend,” she says. “Although the larger contractors have been successful at augmenting their order books internationally, muted global growth prospects have seen several large projects in sectors such as oil and gas pushed out significantly.”

Despite the many challenges facing the sector, Zvarayi says the many obstacles along the way have also contributed to positive developments. “Some of the major positive outcomes of the difficult market conditions include enhanced management oversight, streamlined operations and improvements to risk management. Despite the tough economic conditions and the negative outlook, companies with robust contingency plans are likely to maintain their positions in this difficult cycle.”

William Johnston, regional director at WSP|Parsons Brinckerhoff, also has a balanced view of the current climate, emphasising that there is a direct link between the stability of an economy and ongoing development and it’s not surprising that SA’s construction and engineering sector took a severe knock in the second half of 2015.

“This was largely influenced by the regressive growth in the country’s GDP in the second half of the year, as well as political interference, labour concerns and planning bureaucracy, particularly on major projects,” he says. “Looking ahead, this lower growth in the construction and engineering sectors is expected to continue at least into the first quarter of this year. There is, however, room for optimism.”

Johnston says that despite the possibility of a possible recession, further ratings downgrades and imminent slower growth in the construction and engineering sectors, there is still ample activity in the built environment to keep these sectors viable.

“For instance, major government and/or public-private partnership led infrastructure projects are either under way or coming through the pipeline,” he says. “There is still significant interest and activity in the property space as well, which established developers recognise and have the track record and solid financials to leverage. Based on our work and environment exposure, we anticipate the following trends will create opportunity for the construction and engineering sectors in the short to medium term.”

It’s clear that while leading players in the sector disagree on some of the finer points, their overall sentiment is that commercial property remains a sound, solid option for investors willing to take a long-term view. Looking past the noise and the clutter of the current environment and sitting tight on well-considered assets will yield excellent returns in time.