

# Why property isn't always such a safe bet



Most people are under the impression that you can't go wrong if you invest in property. However, the property market moves in cycles and can be unpredictable. At a recent series of meetings of the acsis/Personal Finance Financial Planning Club, Paul Duncan (left); an investment manager at Catalyst Fund Managers, discussed the factors that are affecting the listed and residential property sectors, and how these sectors are likely to perform in future. Neesa Moodley-Isaacs reports

Property has had a fantastic run over the past five years. The South African Listed Property index reflected an annual return of about 23 percent between June 2003 and June this year, Paul Duncan says.

However, over the past nine months to July, the listed property sector has taken a knock and there has been a dramatic decline in value.

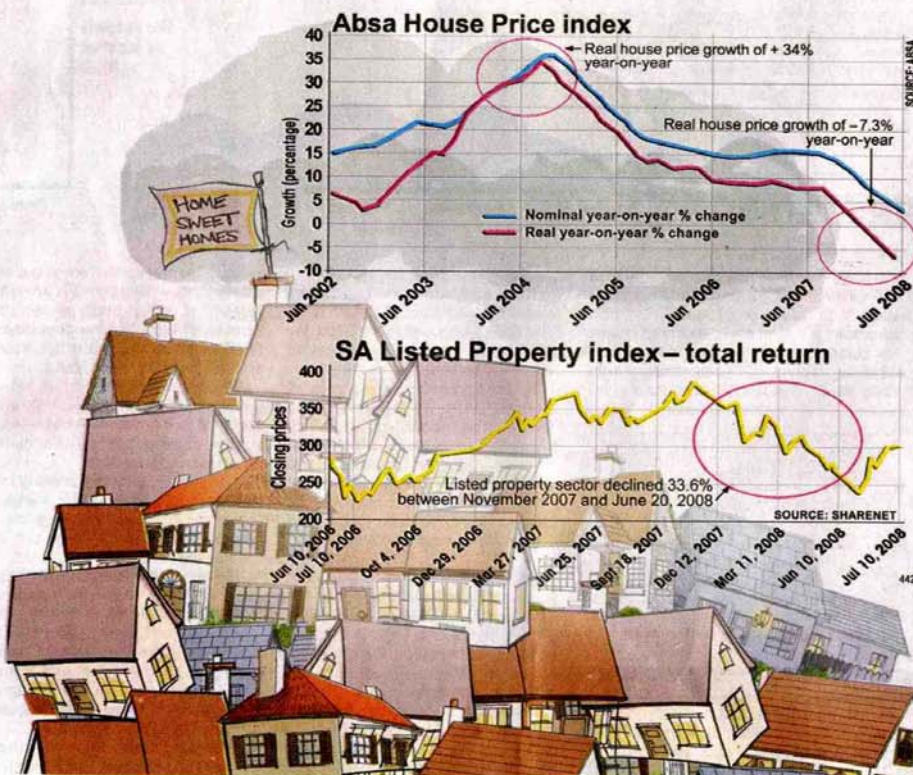
The residential property sector proved to be an investor's dream in 2003 and 2004, when there was a huge jump in prices. But growth started to slow down last year and prices now seem to be flat, Duncan says.

After adjusting for inflation, the residential market has shown price growth of minus 7.3 percent for the year to June, according to the Absa House Price index.

Several factors are responsible for the negative growth in real house prices since February this year, Duncan says. These factors include:

- ◆ An increase in the prime lending rate from 10.5 percent before the first increase in June 2006 to the current 15.5 percent. This resulted in monthly bond repayments increasing by 36 percent over the same period.
- ◆ Electricity tariff increases of 27.5 percent this year, as well as steep rises in the petrol price, have reduced the amount of money people can set aside for home loan repayments.
- ◆ Higher CPI inflation, which reached 13.4 percent in July, has reduced people's disposable income and also the amount they can afford to spend on home loan repayments.
- ◆ The National Credit Act, which came into force in June 2007, placed a greater responsibility on lenders to make sure you can afford a home loan in light of your existing credit obligations. This has had the effect of reducing the number and the size of home loans granted.

Similarly, a number of local and international factors have had a negative effect on the listed property sector, Duncan says. According to the SA Listed Property index, the sector lost 33.6 percent between November 7, 2007 and June 20, 2008.



"You can trace a timeline from that point showing all the factors that influenced the listed property sector," Duncan says. These factors are:

- ◆ December 2007 - a fourth interest rate increase since June 2006 of half a percentage point took the prime lending rate to 12.5 percent.
- ◆ December 2007 - political uncertainty due to policy changes at the African National Congress's national conference in Polokwane.
- ◆ January 2008 - Eskom announced it would be introducing

load-shedding because the country's electricity grid could not meet rising demand. "The Eskom drama caused a decline in all asset classes, including property," Duncan says.

- ◆ February 2008 - Bear Stearns, one of the largest underwriters of mortgage bonds in the United States, collapsed. The company was sold to JP Morgan at one-tenth of its share price. Because the US is the largest economy in the world, events there have a ripple effect on most markets around the world, including South Africa.

- ◆ March 2008 - the Zimbabwean elections resulted in a lack of confidence in the African and South African property sectors.
- ◆ April 2008 - a further interest rate increase of half a percentage point took the prime lending rate to 15 percent. This occurred when inflation was rising, and electricity and petrol prices were increasing.
- ◆ June 2008 - the tenth interest rate increase since June 2006 of half a percentage point increased the prime lending rate to 15.5 percent.

## Listed property losing out as high interest rates boost cash returns

The Reserve Bank's strategy of raising interest rates to curb inflation has made cash a lot more attractive as an investment option, while debt has become more costly, Paul Duncan says. "The result is that investors have fled to safety by moving their investments to cash and are focusing on short-term capital protection," he says.

In November last year, the initial yield on listed property was 7.03 percent. (The initial yield is the income distribution expected over the next 12 months divided by the share price.) The initial yield on cash was 10.5 percent.

In June this year, the initial yield on cash increased to 12 percent, while the initial yield on listed property was 11.9 percent.

Duncan says the change in the initial yield on listed property is to compensate investors for the current uncertainty in the macro-economic environment.

"It is difficult to forecast how much further property values are expected to decline, but inflation is forecast to peak in the third quarter



of this year and to be back within the three- to six-percent target band in late 2009," he says.

"Economic data show that vehicle and retail sales have dropped. So now that consumer spending seems to be under control, the market is pricing in no further interest rate hikes over the next 12 months with the possibility of the first interest rate cut in mid to late 2009," he says.

Growth in South Africa's real gross domestic product is forecast to be approximately 3.5 percent this year and about the same next

year, Duncan says. However, if any of these forecasts is worse than expected, he says, the current trend of falling property prices will be prolonged, and commercial and residential prices will not be immune from further declines.

Duncan says listed property had already shown a recovery of about 18 percent in the month of July and the initial yield at the end of July was 10.3 percent, which is higher than that of bonds. However, the returns you can earn from listed property are expected to be stronger than those from cash or bonds because there is an under-supply of commercial property.

Cash could see negative growth over the next five years, because the interest you will earn on cash will come down if interest rates fall, Duncan says. However, cash is still likely to be an attractive investment over the next year.

He says listed property yields are expected to grow over the next five years. You should aim for a return of about 14 percent over the next 10 years.

## You can expect a nine-percent growth in income

Property companies build rental increases into their contracts with tenants, and the current increase is typically nine percent a year, Paul Duncan says. This means that you, as a property investor, are already assured of nine-percent growth on your contracted income stream for the year. Those lease contracts that are coming up for renewal (that is, are not contractually increasing by nine percent), are expected to be renewed at higher lease rates than the level at which they are expiring. You could also have additional growth in your income stream if a property company leases its vacant

space, Duncan says. "Most commercial properties are fully let. However, certain sectors, such as smaller neighbourhood shopping centres, could see an increase in vacancies and bad debts as small tenants start to feel the pinch of the current economic environment," he says. Most property companies have increased their provisions for bad debts over the past year.

Dominant regional shopping centres, such as Canal Walk in Cape Town, are likely to be the most resilient to a slowdown in retail sales growth.

When leases expire, property companies look at the rentals for comparable spaces to determine if rentals are higher than the rents they have been collecting. If the expiring rental is below the current market rental, a company will have what is called a positive rental reversion when a new lease is signed because the company can increase its rent in line with the rest of the market.

Duncan says there is currently significant positive rental reversion, so tenants are agreeing to renew leases at higher rentals than they were paying previously.