PROPERTY MARKETS

The FNB Commercial Property Finance Division's Building Cost Indices – First Quarter 2009

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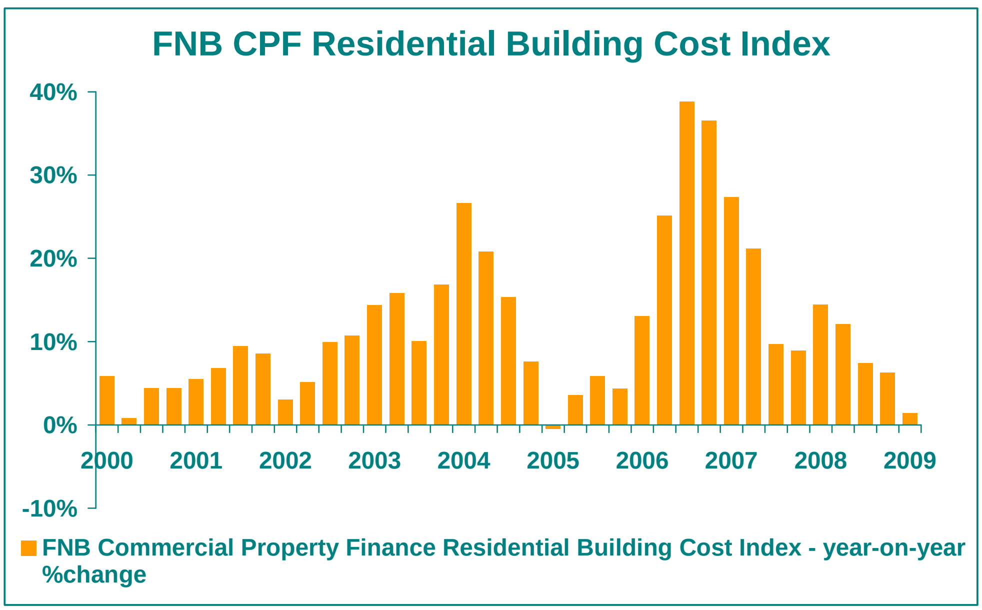
RESIDENTIAL BUILDING COST INFLATION CONTINUES MODERATING TREND EARLY IN 2009, BUT STILL INSUFFICIENT TO PROVIDE RELIEF TO THE BUILDING SECTOR

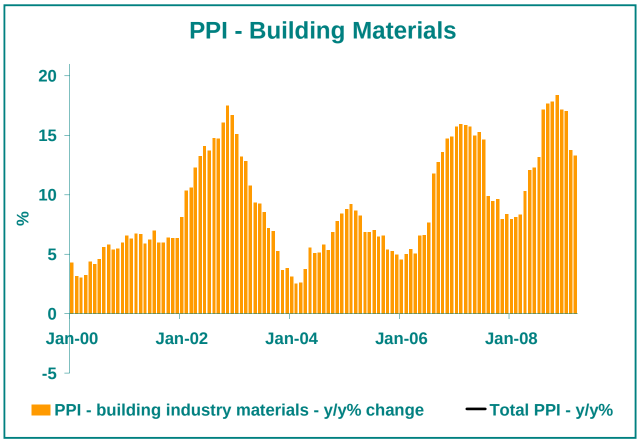
FNB Commercial Property Finance's (CPF) revised Residential Building Cost Index for the first quarter of 2009, constructed by Industryinsight, indicates ongoing decline in residential building cost inflation.

The index reflects the average building cost per square metre, as charged by building contractors when winning tenders in the formal residential property sector. It should thus be seen as reflective of the combination of contractors' pricing power, as determined by market conditions, and their input costs. It excludes affordable and so-called "RDP" housing. The average building cost per square metre was measured at R5,941 for the first quarter of 2009.

Year-on-year, building cost inflation measured 1.4% for the 1st quarter, slightly down from a revised 6.3% in the previous quarter. The inflation rate in the 1st quarter is now a far cry from the 38.8% recorded at the last major peak in the third quarter of 2006. The slowing pace of inflation is partially reflective of very weak residential demand, average house prices moving into price deflation territory, and thus low contractor pricing power. Also contributing to the lower inflation rate has probably been a general decline in commodity prices globally, which should place downward pressure on price inflation of certain building materials.

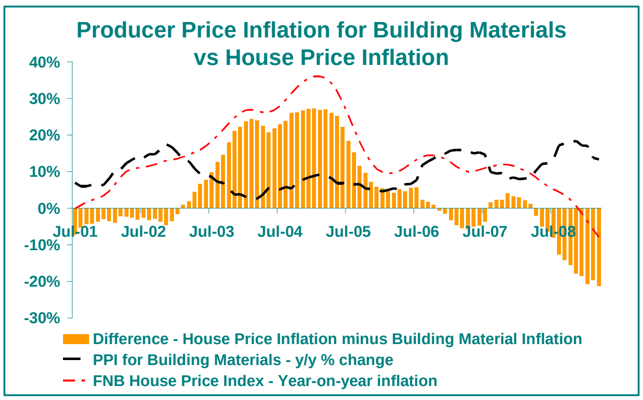


INPUT COST INFLATION MAY SUBSIDING



In 2008, On a monthly basis we saw a massive rise in the year-on-year inflation rate of the producer price index (PPI) for building materials from 7.9% in January to 18.4% in November. Since November, however, we have seen some decline to a still-high inflation rate of 13.84% as at March.

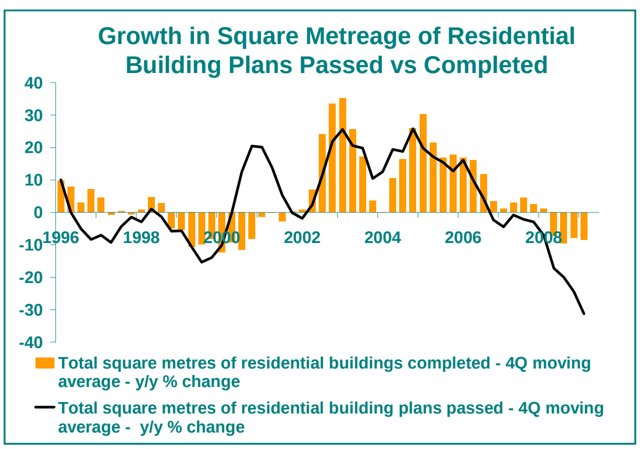
2 related events may be exerting downward pressure on input cost inflation in 2009. Firstly, we had a sharp decline in global commodity prices in the second half of 2008, which should be flowing through into producer prices for building materials in part. Secondly, the prospect for non-existent economic growth in SA in 2009 is exerting some cooling effect on the overall construction sector, thereby reducing the high levels of competition between construction sub-sectors for scarce resources.



Nevertheless, despite such a decline in input cost increases, alleviation of the pressure on residential contractors is probably still some way off, because house prices remain in steady deflation (FNB House Price Index showing -10.2% year-on-year deflation for April 2009), and as a result the large differential between input cost inflation and house price change continues.

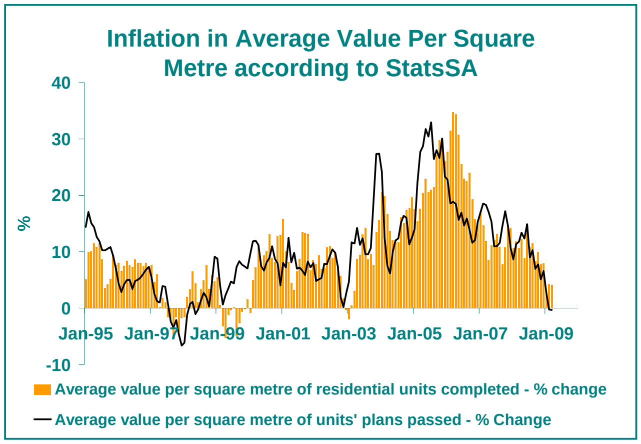
The graph above shows the continuation of a wide gap between materials cost inflation and house price inflation/deflation last year, which measured 21.3 percentage points as at March 2008.

While contractors should be having their profit margins squeezed, as they are forced to carry some of the input cost increases in such a time of weak demand, there are limits to how much they can be squeezed. Hence the inflation rate of the FNB Building Cost Index remaining somewhere between input cost inflation and house price deflation, i.e. higher than the worsening house price deflation rate but lower than the inflation rate of the PPI for building materials.



While we do believe that 2009 should see some improvement in residential demand, that is only expected to translate into renewed national house price inflation in 2010 after considerable levels of oversupply in the market have been "mopped up".

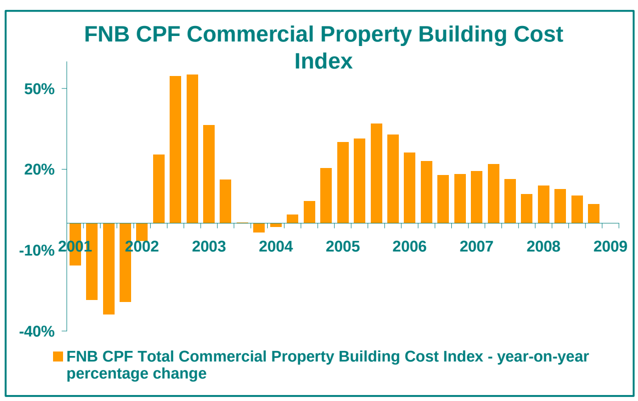
Therefore, even a significant decline in input costs could take some time to alleviate the current contractor pressures in the *residential market, and as a result 2009 as a whole is expected to be another year of declining building completions as well as plans passed. The recent release of March Building stats pointed to an ongoing residential building slump, and for the 1st quarter as a whole the square metreage of residential buildings completed declined by -10%, while square metres' worth of plans passed signalled possibly a more substantial drop in completions to come in 2009, falling by a massive -44.6% year-on-year.*

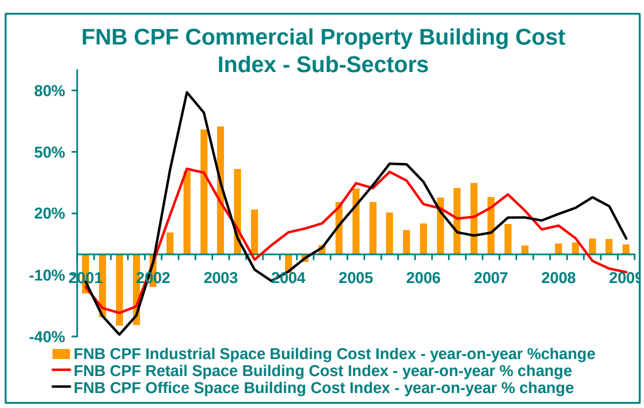


StatsSA building statistics appear to support the notion of positive, although declining, building cost inflation persisting despite a very weak market, and in March the average value per square metre of completions still rose by 4.1%, while the average value per square metre of plans passed had just dipped into negative growth territory to the tune of -0.3% year-on-year.

COMMERCIAL BUILDING COSTS

On the commercial property side, overall building cost inflation continues its decline too, having recorded insignificant year-on-year price inflation of 0.01%.





Commercial property returns must have been coming under pressure as the economy slides weaker, much the same as the residential sector.

Breaking the building cost index down into the sub-indices for office, industrial and retail space, the office sector's building cost inflation recorded 7.7%% year-on-year (down from 23.5% revised previous), industrial building cost inflation was 4.7% (down from 7.4% revised previous), while retail projects' cost deflation at -8.6% (down from -6.9% revised previous) pulled the overall building cost index inflation rate down.

CONCLUSION

While the FNB Residential Building Cost Index's year-on-year inflation rate of 1.4% is moderate, important is that it appears to still be well-above existing house price deflation, which according to the FNB House Price measure runs at -10.2% in April. In the context of existing house price deflation and very weak demand, even this low house price inflation becomes very significant in exerting pressure on the building industry's performance.

Given the expectation that national house price deflation may remain in place for most of 2009, the differential between input cost inflation and house price deflation may only start to narrow towards 2010, making it extremely tough for contractors to deliver new stock to the residential market. The negative aspect to this is obviously from a developer/contractor point of view. However, the positive side to it the maintaining of a higher replacement cost of housing (i.e. the cost of acquiring new houses) relative to the price of existing property is crucial in keeping the market in some sort of balance, of at least slowing supply until demand can catch up to restore the balance.

The result of the expected continuation of some sort of differential between input cost inflation and house price deflation in 2009 is expected to be further decline in the volume of residential buildings completed, as contractors battle to reduce input costs in order to keep up with expected ongoing house price deflation for most of the year.

On the commercial property building side, overall one can see the signs of a general market weakening too. While office and industrial space have held up relatively well until not so long ago, it is likely that these sub-sectors will all see downward pressure on their building cost inflation rates as the whole commercial sector slows on the back of the current economic recession.