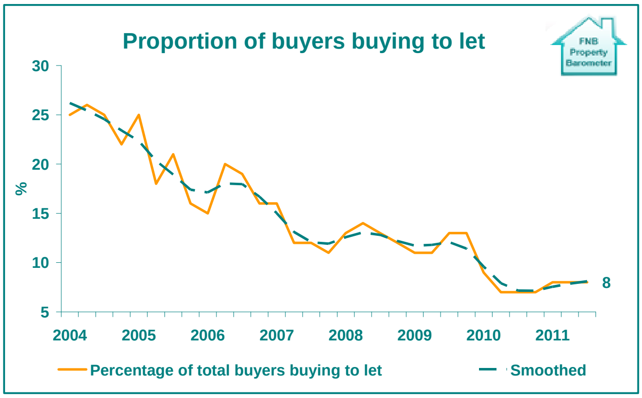
BUY-TO-LET AND RENTAL MARKETS

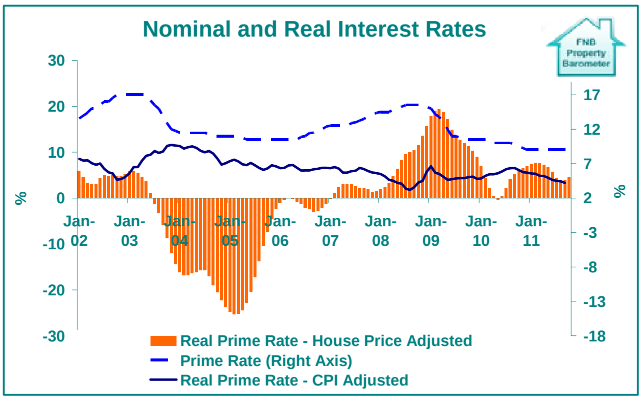
Buy-to-let buying remains flat as the rental market keeps us waiting

2 November 2011

Buy-to-let buying remains weak, according to the 3rd quarter 2011 FNB Estate Agent Survey, with both capital growth and income stream prospects on buy-to-let properties not yet looking wonderfully attractive.

BUY-TO-LET BUYING REMAINS FLAT, ACCORDING TO THE FNB ESTATE AGENT SURVEY





The FNB Estate Agent Survey for the 3rd quarter of 2011 continued to point to a slow pace of buying of properties for investment, or letting, purposes. Expressed as a percentage of total home buying, buy-to-let buying was estimated by the agent panel to be a lowly 8%, unchanged from the previous 2 quarters.

Once again this result is hardly surprising, as households try to rebuild their balance sheets by focusing more on essentials, i.e. home buying for primary residential purposes.

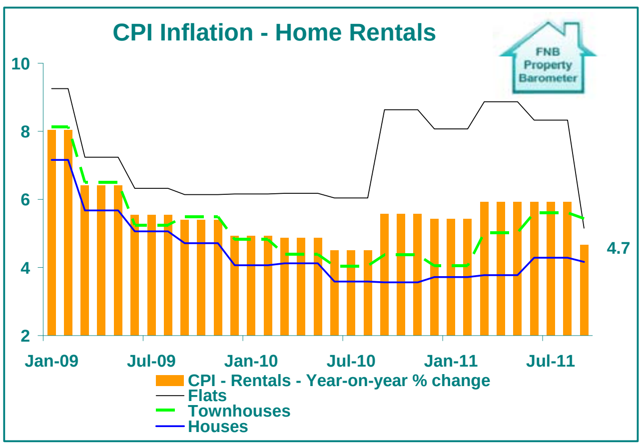
In addition, many "less seasoned investors" are attracted to investment property by their perception of capital growth prospects, and there isn't much of that on offer at present.

Although interest rates are at multi-decade lows, they remain above the even lower house price growth rate at present, keeping it unattractive for those would-be investors (speculators?) who would like to utilize credit to buy property in the anticipation that they could profit through capital growth exceeding interest rates.

Indeed, our alternative measure of real prime rate, i.e. adjusting prime rate with house price inflation (as opposed to using consumer price inflation), has shown an increase in the past 2 months, from 3.7% in August to 4.5% in October, as house price growth recedes again.

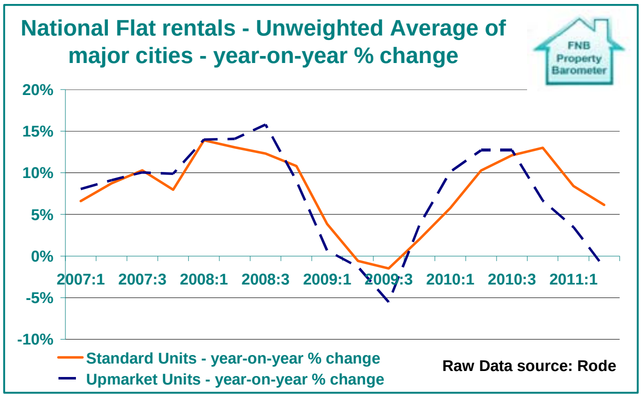
A MEDIOCRE RENTAL MARKET PROBABLY ALSO CONTRIBUTES TO WEAK BUY-TO-LET BUYING

So the limited number of buy-to-let investors are probably doing it for "the right reasons", i.e. they're in all likelihood focused predominantly on the future income stream expected to emanate from letting a property.



Here again, though, the numbers are probably limited by a rental market that appears to be stuttering along, showing periodic promise in terms of accelerating rental growth before tapering off once more.

According to the StatsSA home rental survey, after some prior acceleration in rental inflation from the 2nd half of 2010 to mid-2011, the September 2011 survey saw a significant slowing in year-on-year growth, from 5.9% in the previous quarter to 4.7%. The most significant decline off the highest level was the flat rental inflation rate, which declined from 8.3% year-on-year in the June survey to 5.2% in September. However, there were also slight declines in townhouse rental growth, from 5.6% to 5.4% over the same period, and in house rental growth from 4.3% to 4.2%.



A review of Rode's flat rental data suggests a similar picture of rental growth slowdown.

In order to illustrate this, we calculate an unweighted average of average flat rentals in the major cities. This shows both the average rental inflation of "standard" units and "luxury" units having declined from peak rates reached in the 2nd half of 2010, seemingly supportive the StatsSA survey's rental inflation slowdown.

So, after some promise in 2010, the rental market appears to have gone off the boil, which in turn implies slow progress in income stream increases, much needed to improve the attractiveness of residential property as an asset class.

IS FINANCIAL PRESSURE ON TENANTS IN THE RENTAL MARKET CURTAILING ITS STRENGTHENING?

We have been of the opinion for some time that the rental market should flourish relative to the home buying market. The reasoning has been that slow buy-to-let buying would constrain the supply of properties available to rent, whilst estate agents point to almost half of households selling properties in order to downscale due to financial pressure moving into the rental market thereafter, a factor which we had believed would drive rental demand higher.

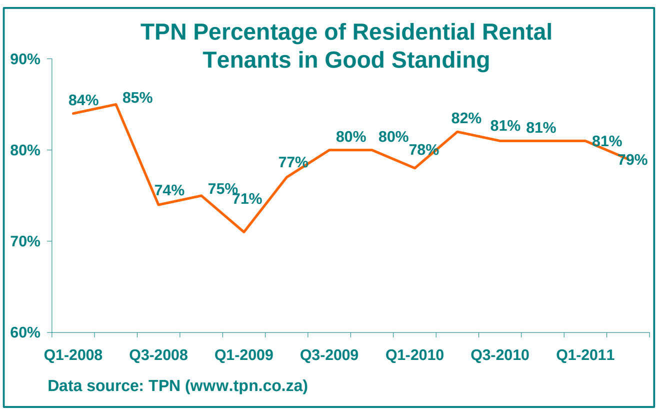
Indeed, the available rental data in SA pointed to something of a rental inflation surge in 2010. However, both the StatsSA and Rode data sets suggest that this resurgence has fizzled out in 2011, which is disappointing from the point of view of the property investor who would like to see the income from his/her property rise.

The explanation? While hazardous to generalize, it is possible that the average rental tenant is not quite as financially solid as the average homeowner (that's not to say that there aren't many financially fragile homeowners too).

In addition, tenants may not experience quite as much relief from interest rate cuts as do many homeowners, because although they also have other forms of debt, by definition they generally don't have big home loans.

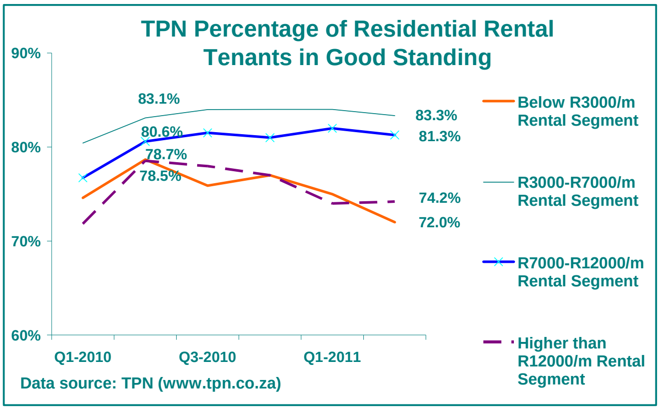
Therefore, tenants on average are arguably more sensitive to economic events that affect income, and factors affecting their cost of living than at least the mortgage-dependent homeowners. They feel the effects of the recent inflation surge in certain components of the consumer price index. Many homeowners, on the other hand, although also experiencing the impact of rising consumer prices, are also still feeling the benefits of huge interest rate cuts of recent years, which have dramatically reduced the cost of servicing their often huge home loan debt.

Therefore, whereas we have not yet seen any noticeable rise, as of late, in our significantly improved home loan arrears and non-performing loans situation, TPN data has begun to show a mild deterioration in the percentage of rental tenants who are "in good standing" with their landlords. After the 2008/9 recession, the total percentage of tenants in good standing rose from a low of 71% as at the beginning of 2009 to 82% by the 2nd quarter of 2010, and the mild rental market recovery tracked this trend with a bit of a lag.



Since mid-2010, however, the percentage in good standing has begun to decline once more to 79% by the 2nd quarter of 2011, suggesting gradually increasing financial pressure, and rental growth appears to have slowed too.

The financial pressure appears to be worst at the lower end of the rental market, with the "Less Than R3,000/month" Rental Segment showing the percentage of tenants in good standing having dropped back from 78,7% in the 2nd



quarter of 2010 to72% in the 2nd quarter of 2011. The other segment showing almost as much deterioration lies at the top end of the market, i.e. the "Higher Than R12,000/month" Segment, which has seen the percentage of tenants in good standing decline from 78.5% to 74.2% over the same period. The two segments in the middle, i.e. the R3,000-R7,000/month Segment and the R7,000-R12,000 Segment, have both more-or-less held their own over the period, showing virtually no change after significant improvement prior to the 2nd quarter of last year.

Some of the potential sources of financial pressure are highly visible in the sub-segments of the Consumer Price Index(CPI). Food price inflation, a major expense for the lower end of the rental market, has been rising steadily, reaching 8.7% year-on-year by September, while utilities are piling on the charges for property-related services, visible especially in electricity price inflation which averaged 17.3% in September. But the major cost increase has been in the area of private transport running costs, which showed 21.7% year-on-year inflation due largely to rising petrol prices.

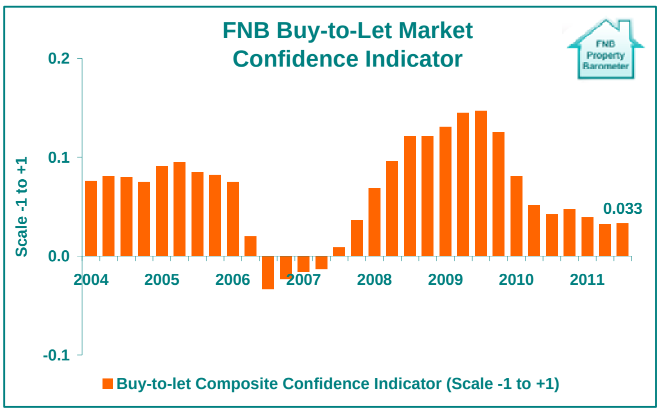
Such cost of living item increases may well be having a significant impact on the financial state of rental market tenants as a group, and may well explain what appears to be a disappointing rental growth performance as of late.

CONCLUSION – BUY-TO-LET BUYING LOOKS SET TO REMAIN WEAK IN NEAR TERM

In the absence of any significant capital growth in the residential market, buy-to-let investment probably takes place largely for "sound reasons" these days, i.e. based on income stream prospects.

While we have previously expected these to improve significantly due to an expectation that the rental market would strengthen significantly, last year's rental inflation promise appears to have fizzled out for the time being. This may well be due to increased financial pressure on tenants as a group due to a weak economy, along with significant rises in key cost of living items such as transport, electricity and food costs.

Therefore, in the near term it would not be surprising to see many aspirant buy-to-let investors remaining on the sidelines for the time being, and the buy-to-let buyers as a percentage of total home buying remaining at the current relatively low levels.



What do the surveyed estate agents say? In the survey we ask them to state whether they expect buy-to-let demand to increase (which gets a rating of +1), stay the same (rated as zero) or decline (rates as -1). The FNB Buy-to-let Market Confidence Indicator is the average of these different ratings, and the 3rd quarter survey came out slightly positive at 0.033, virtually unchanged from the previous quarter. This would suggest that the survey panel as a group are biased slightly towards strengthening buy-to-let demand in the near term, but the level suggests no expectation of "fireworks", having declined from a peak of 0.147 back in the 3rd quarter of 2009.

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