BUY-TO-LET PROPERTY SURVEY

- *Although fundamentals have improved mildly, buy-to-let buying remains on the backburner*

FNB Property Barometer

FNB PROPERTY MARKET ANALYTICS

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SUMMARY – BUY-TO-LET MARKET REMAINS IN THE DOLDRUMS, DESPITE THE FUNDAMENTALS BEHIND IT BEING ON A LONG SLOW RECOVERY ROAD

According to the FNB Estate Agent Survey for the 2nd quarter of 2010, buy-to-let buying expressed as a percentage of total property buying reached a new low of 7%, down further from the previous quarter's 9%. Along with this decline, agent confidence in the near term prospects for this segment of the property market also deteriorated in the quarter.

Despite the buy-to-let market not setting the world alight, agents nevertheless point towards some improvement in rental market fundamentals in 2010. Noticeable is an increase in estimated average gross yields on rental properties, according to agents surveyed, and thus a rise in the percentage of properties where agents believe that the rental income can cover 100% or more of a 100% bond repayment. This is mildly better news for those buy-to-let buyers that utilize credit, although such properties don't yet constitute the majority. This improvement seems to correlate with Rode data that indicates some renewed flat rental inflation in 2010 after a 2009 slump.

Perhaps ironically, these gradual improvements in the fundamentals that underpin the buy-to-let market are probably partly the result of a lack of new rental stock coming onto the market due to weak buy-to-let buying. Such is the nature of cycles.

So why no significant buy-to-let market improvement yet, if yields are turning for the better? Probably because a significant portion of the household sector is still under financial pressure following the recent recession, and it has high levels of indebtedness to work off. In addition, we believe that many would-be buy-to-let investors focus more on capital growth than on income stream alone, and while the rate of house price increase has shown some recovery in 2010, this improvement has not been fantastic to date.

So, should potential buy-to-let buyers be buying with more enthusiasm? Well, firstly, while the rental market fundamentals appear to have been improving, suggesting an improving environment for the potential buy-to-let investor, the improvement appears mild at best. We are NOT giving advice either way, but do suggest that there are some important factors to consider for the potential buy-to-let buyer:

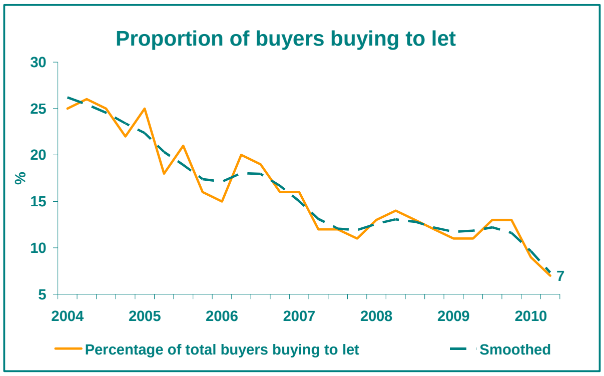
- *With early signs of slower economic growth ahead, salaried individuals should be careful not to rely too heavily on future potential discretionary rewards to fund expenditure commitments, as in many industries these can fall away in tougher times.*
- *Even should one stumble upon a property where 100% of the bond repayment can be covered by the rental income that the property can or does achieve, remember the additional costs that must be covered, including assessment rates and various maintenance costs to name but two.*
- *Tenants don't come without risks, and the risk of default on rental payments, and vandalism of property in some instances, can be an issue for a landlord.*
- *Finally, while inflation numbers don't show any major risks to inflation or interest rates in the near term, the future as always is a less than certain place. By historic standards, SA's interest rates appear to be at a relatively low part of the interest rate cycle. When at such low points, we believe it wise to do scenario planning. The past two interest rate hiking phases were by 4 and 5 percentage points respectively. So perhaps, as a rule of thumb, it would be prudent to at least calculate one's bond repayment value should rates be 4-5 percentage points higher. How much of the bond repayment would be covered by the rental income stream under such a scenario? Would a buy-to-let property then be affordable? If not, perhaps re-consider.*

THE FNB BUY-TO-LET ESTATE AGENT SURVEY

Estate Agent survey continues to point towards very weak buy-to-let demand.

We've said it time and again that the recent residential market recovery, spanning from around early-2009 to early-2010 was overwhelmingly driven by primary residential demand, with a household sector still under significant financial pressure, and thus having little time for "non-essentials".

The most recent FNB Estate Agent Survey continues to support this view, with buy-to-let demand remaining in the doldrums when expressed as a percentage of total buying. In the 2nd quarter of 2010, the sample of agents surveyed estimated buy-to-let buying of property to have declined further as a percentage of total buying to a mere 7%, down from 9% of total buying in the previous quarter.



Weak buy-to-let demand is ironically part of the ultimate solution to a weak rental market,...

The buy-to-let percentage has slumped a long way since being estimated at around 25% back in 2004 at the peak of the residential boom. However, the low percentage of buy-to-let buying is, perhaps ironically, part of the long healing process for the rental market, and thus part of the long road back to making residential property an attractive investment once again.

The lack of buy-to-let demand implies a lack of growth in supply of new rental stock, and has arguably been a contributing factor to some signs of moderate strengthening in the residential rental market.

,....so the rental market's fundamentals are improving, albeit gradually.

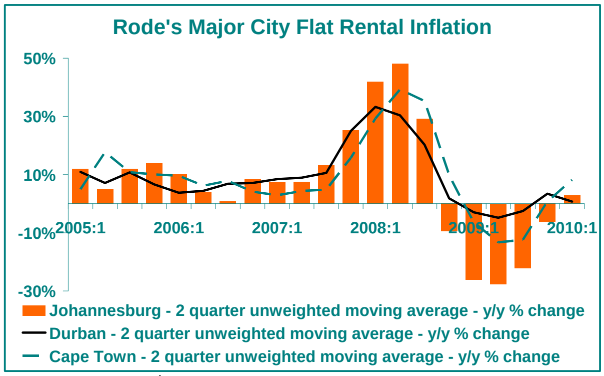
Such rental market improvement to date appears to have been a stop-start affair to say the least. Rental markets often benefit from periods of interest rate hiking, which push some would-be primary residential buyer demand towards the rental market, or keep tenants in the rental market for longer, where these households "wait it out" until times improve.

That appeared to be the case back early in 2008, that time of rising interest rates, where letting agents taking part in our rental market survey at the time indicated very strong rental demand and a shortage of stock in many areas. Rode's flat rental inflation rates at the time seemed to support the experience of those agents.

Using Rode data, we have calculated unweighted 2-quarter moving averages for all categories of flat rentals per major city. Johannesburg rental inflation peaked at a massive 48.2% year-on-year in the 2nd quarter of 2008, Cape Town at 39.2% while Durban peaked in the 1st quarter of that year at an also-impressive 41.8%.

That rental surge, however, was short-lived, and the negative impact of 2009 interest rate cutting on the rental market was seen in all 3 of these cities' flat rental markets, with sharp rental deflation setting in, as rate cuts arguably encouraged a group of households out of the .rental market and into the home-buying market.

By early-2010, we finally seem to have been finding some stability in the rental market, if flat rentals are anything to go by, with year-on-year rental growth resuming, if only at moderate single-digit rates.

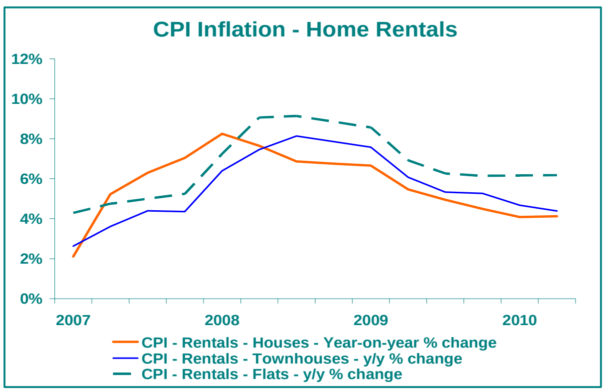


Data source: Rode

A rental market recovery can restrict future interest rate cutting.

This recent stabilisation in market rentals, and renewed rental inflation, may just be starting to influence the Consumer Price Index (CPI) for Housing, with year-on-year flats and houses' actual rental inflation starting to rise very slightly in recent months, after having de-celerated since a 2008 peak.

Important to note is that the CPI rentals indices are not market rentals, but rather the combination of market rentals and escalation rates in the rental market.



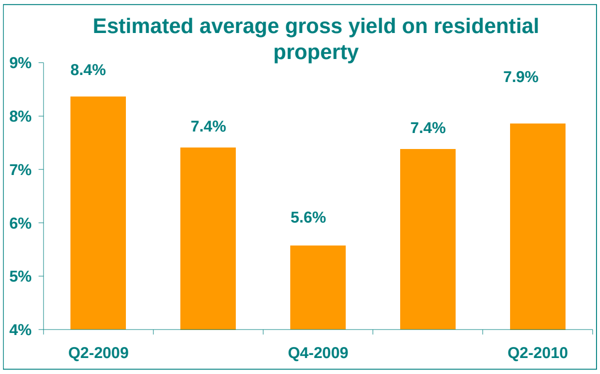
With the Housing CPI being the biggest in the overall CPI, the downside of stronger residential rentals growth is that it can have a significant influence on overall consumer price inflation and thus on interest rates, and some recovery in rental inflation could limit further inflation and thus interest rate reduction.

Agents are reporting improving gross yields on rental properties,....

Over the past decade, given the pace of house price inflation back in the boom times, yields on residential property have reached low levels, making buying-to-let an increasingly unattractive option for those investors concerned with income streams.

The 2009 slump in the rental market caused renewed yield compression according to agents surveyed, reaching an estimated low average gross yield of 5.6% by the final quarter of last year.

Encouragingly, along with Rode's data showing a return to positive rental inflation, agents have been indicating increasing gross yields over the past 2 quarters, with the average for the 2nd quarter of 2010 estimated at 7.9%.



Estimated yields remain far higher on the lower end of the market, but at dismal low of 5.2% on homes priced above R1.5m.

ESTIMATED AVERAGE GROSS YIELD PER HOME VALUE BAND	
	May 2010 (Residential Barometer
R300 000 – R350 000	10%
R360 000 – R460 000	10.9%
R480 000 – R550 000	11%
R560 000 – R680 000	8.8%
R700 000 – R795 000	8.7%
R800 000 – R890 000	8%
R900 000 – R980 000	7.9%
R1 million – R1.5 million	7.3%
R1.5 million+	5.2%

....implying an increasing number of properties achieving rentals that can cover a 100% bond repayment.

Corresponding to the reported trend towards better yields, along with interest rates having come down mildly further since a year ago, agents surveyed are reporting an increasing portion of properties where rental income can cover 100% or more of a new 100% bond.

The table below, emanating from the FNB Estate Agent Surveys shows the estimated percentages of properties where rental income can cover various percentages of a new 100% bond, implying rental inflation exceeding house price inflation in some instances, and helped on by a slight March interest rate decline.

The blocks coloured in green are those where the percentage of homes is greater than 10% of the total.

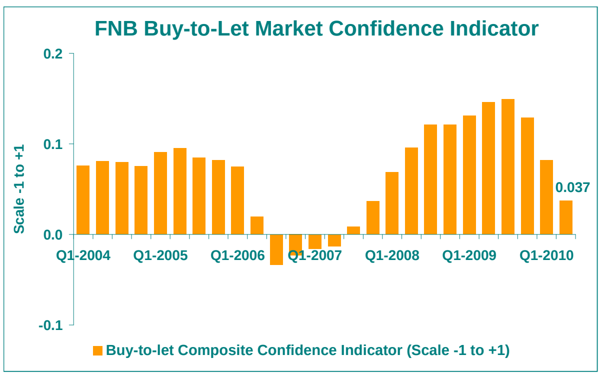
% OF OWNERS' BOND REPAYMENT COVERED BY RENTAL RECEIVED	Aug 2009	Nov 2009	Feb 2010	May 2010
20% or Less	6%	0%	8%	0%
40%	3%	2%	3%	0%
50% – 55%	21%	20%	19%	8%
60% – 65%	13%	27%	19%	4%
70% – 75%	25%	27%	19%	12%
80%-85%	17%	24%	21%	12%
90% – 95%	8%	0%	0%	19%
100%	5%	0%	11%	35%
More than 100%	-	-	-	12%

What is noticeable in the 1st two quarters of 2010 is the shift in the green "higher percentage" blocks towards 100% bond coverage or more. In the May 2010 survey, 12% of properties' rentals were believed to be sufficient to more than cover a 100% bond repayment and 35% of properties' rentals estimated to provide 100% cover of the bond repayment. Although this indicates that the majority of rentals don't yet cover 100% of 100% bond repayments, agents do point towards the situation having improved significantly.

However, despite improving rental market fundamentals, buy-to-let agent confidence remains weak. Is this justified?

In the FNB Estate Agent Survey, we ask them for their expectations regarding the near term expectation for the buy-to-let market, i.e. do they expect strengthening (a rating of 1), weakening (a rating of -1) or unchanged demand (a rating of zero). We combine their ratings into an index, which runs on a scale from 1 (most optimistic) to -1 (most pessimistic).

Over the past 3 quarters, we have seen a steady decline in the FNB Buy-to-let Confidence Indicator, from a 3rd quarter 2009 high of 0.15 down to a 2nd quarter 2010 level of 0.037.



Given what we've said, and indeed have been told by certain agents, about improving fundamentals in the letting market, does this decline in confidence in the buy-to-let market by agents make sense? Is it justified? We believe that it is. Rather, what was probably misplaced was their significantly improved expectation of strengthening in the buy-to-let market from early-2008 to mid-2009.

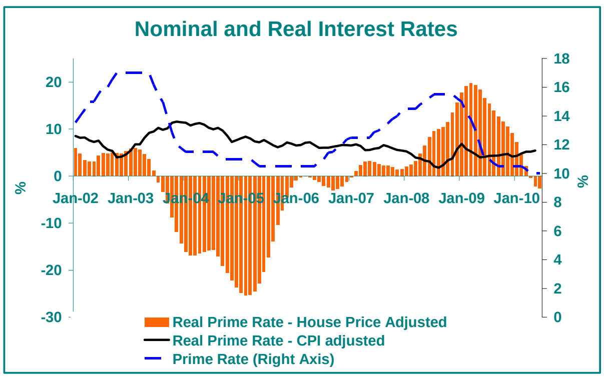
Those initial improvements in buy-to-let confidence were probably based on rental market and yield improvements, combined with declines in interest rates making credit-driven buy-to-let buying more affordable.

We think their weakened expectations are justified in the near term, given a household sector still under significant financial pressure,...

However, what agents perhaps didn't reckon with was the level of financial pressure that the household sector remains under, and will battle to grow credit-driven buy-to-let investments when the household debt-to-disposable-income ratio is still not far from its all time high, recording 78.4% in the 1st quarter of 2010. The reality, too, is that many buy-to-let buyers in the boom years could probably have been classified as "speculators" rather than "investors", in many cases looking to use cheap credit to make very quick capital gains, as opposed to the longer term investor who would be more interested in a steady rental income stream. For the speculator around 2004, yield and rental income may have meant very little. And why should it have? With average house price inflation in excess of 30%, the "quick buck" was there to be made from riding the capital growth trend.

.... the speculative portion of buy-to-let investors don't have the cheap credit and huge capital growth to spur them on currently,...

The graph below illustrates the environment of the time. The regular method of calculating real prime rate would, simply put, be to take the difference between prime rate and the consumer price inflation rate. Here, the SARB's interest rate policy is designed to maintain a positive real prime rate over the years. Not so when one uses an alternative measure of real prime rate, i.e. using the difference between prime rate and house price inflation. By this measure, one can see a great speculative opportunity back around 2004/05, where this measure of real prime bottomed at a -25.3% negative real prime rate in February 2005, due to house price inflation far outstripping interest rates on mortgage loans.

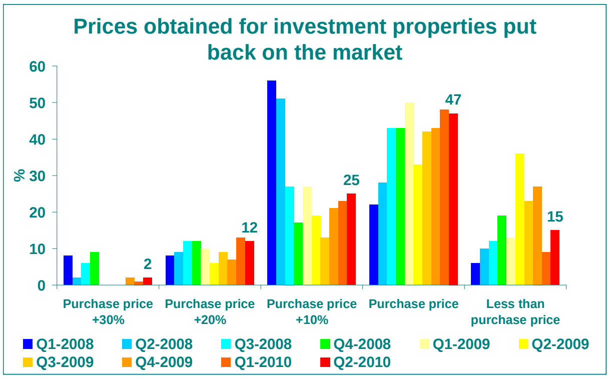


By comparison, recent real prime rates have only recently become marginally negative to the tune of -2.6% in June 2010, insufficient to encourage speculative activity in a market where transaction costs are high.

And even many "non-speculative" buy-to-let buyers focus heavily on capital growth, which they don't see much of at present.

In addition, would-be buy-to-let buyers, many of whom are often focused on capital growth, would in many instances be taking their cue from the recent history of investment property performance. Agents surveyed are suggesting little in the way of capital gains for those investment properties placed back on the market in recent times.

Agents estimate that 15% of investment properties returned to the market have been sold at below their previous purchase price, while as much as 47% of these properties are sold at their previous purchase price. In other words, those achieving capital growth are believed to be in the minority at present.



And so, after improved rental market conditions haven't translated into significantly improved buy-to-let activity, agents surveyed are moderating their expectations to reflect the reality that the "healing" process may take quite a bit longer.

Finally, some considerations for would-be buy-to-let buyers.

It is difficult to promise "heaven on earth" scenarios at a stage where there are early signs that domestic economic growth looks set to slow, and talk of a "double-dip" global recession has been mounting, because the property market is driven by the economy. On top of this, a currently highly-indebted household sector cannot support the market with the strong credit-driven spending of a few years ago, hence a fairly mediocre recovery in the residential property market this time around.

So, for those potential buy-to-let investors, we don't believe that now is the time to expect rapid capital growth on properties in general.

That doesn't necessarily make buy-to-let investment a bad thing. Certainly, it can be a lot better than spending one's money on consumer items, which is the alternative for many of SA's low-saving households. Buying as asset using credit often enforces greater financial discipline.

But buy-to-let investment these days should be seen as more about buying into a rental income stream. And on this note, the FNB Estate Agent Survey, along with other rental market data, suggests that the rental market has shown some moderate improvement early in 2010, and that yields are rising, in some instances to a level where rental income can cover 100% bond repayments. The buy-to-let "opportunity" thus appears to be mildly improved despite buy-to-let activity still remaining weak.

However, deteriorating economic conditions should mean that one should "proceed with caution and consider the following:

- If one is a salaried individual in a corporate, it can be risky to rely on discretionary rewards (bonuses and share options) to finance expenditure or debt obligations in weaker economic times, because they often fall away temporarily.
- Should one stumble upon a property where the rental income can cover 100% of a new 100% bond, one must not forget the costs on top of the bond repayment, i.e. municipal assessment rates and maintenance costs to name two categories.
- Like most things in life, tenants do not come without risks, and some provision has to be made for this. During the past few years of tough economic times, some tenants, like some homeowners, have also felt the financial pressure. According to TPN Credit Bureau, as at the 1st quarter of 2010, 78% of tenants on their records were "in good standing" with regard to rental payments, implying that 22% were not.
- Finally, and very importantly, remember that SA currently finds itself at relatively low interest rate levels. While the current inflation numbers suggest little in the way of near term threats regarding interest rate hikes, the fact is that when it comes to interest rates it is a case of "what goes down must go up" and vice versa, and often unexpectedly. In recent years, the typical interest rate hiking cycle has been 4 to 5 percentage points in magnitude. It is always prudent to do some sort of scenario planning in this regard, especially when rates appear to be nearer to the bottom of the cycle, as would seem is presently the case. The rental may cover the bond at current interest rate levels, but would it if rates were to unexpectedly rise in the near term? See the instalment table below.

Monthly Home Loan Instalment Calculator

Bond Value (20 years)	**Monthly instalment value according to interest rate charged on a 20-year bond**											
	16.0%	15.0%	14.0%	13.0%	12.0%	11.0%	10.5%	10.0%	9.5%	9.0%	8.5%	8.0%
R 300,000	R 4,174	R 3,950	R 3,731	R 3,515	R 3,303	R 3,097	R 2,995	R 2,895	R 2,796	R 2,699	R 2,603	R 2,509
R 400,000	R 5,565	R 5,267	R 4,974	R 4,686	R 4,404	R 4,129	R 3,994	R 3,860	R 3,729	R 3,599	R 3,471	R 3,346
R 500,000	R 6,956	R 6,584	R 6,218	R 5,858	R 5,505	R 5,161	R 4,992	R 4,825	R 4,661	R 4,499	R 4,339	R 4,182
R 600,000	R 8,348	R 7,901	R 7,461	R 7,029	R 6,607	R 6,193	R 5,990	R 5,790	R 5,593	R 5,398	R 5,207	R 5,019
R 700,000	R 9,739	R 9,218	R 8,705	R 8,201	R 7,708	R 7,225	R 6,989	R 6,755	R 6,525	R 6,298	R 6,075	R 5,855
R 800,000	R 11,130	R 10,534	R 9,948	R 9,373	R 8,809	R 8,258	R 7,987	R 7,720	R 7,457	R 7,198	R 6,943	R 6,692
R 900,000	R 12,521	R 11,851	R 11,192	R 10,544	R 9,910	R 9,290	R 8,985	R 8,685	R 8,389	R 8,098	R 7,810	R 7,528
R 1,000,000	R 13,913	R 13,168	R 12,435	R 11,716	R 11,011	R 10,322	R 9,984	R 9,650	R 9,321	R 8,997	R 8,678	R 8,364
R 1,100,000	R 15,304	R 14,485	R 13,679	R 12,887	R 12,112	R 11,354	R 10,982	R 10,615	R 10,253	R 9,897	R 9,546	R 9,201
R 1,200,000	R 16,695	R 15,801	R 14,922	R 14,059	R 13,213	R 12,386	R 11,981	R 11,580	R 11,186	R 10,797	R 10,414	R 10,037
R 1,300,000	R 18,086	R 17,118	R 16,166	R 15,230	R 14,314	R 13,418	R 12,979	R 12,545	R 12,118	R 11,696	R 11,282	R 10,874
R 1,400,000	R 19,478	R 18,435	R 17,409	R 16,402	R 15,415	R 14,451	R 13,977	R 13,510	R 13,050	R 12,596	R 12,150	R 11,710
R 1,500,000	R 20,869	R 19,752	R 18,653	R 17,574	R 16,516	R 15,483	R 14,976	R 14,475	R 13,982	R 13,496	R 13,017	R 12,547
R 1,750,000	R 24,347	R 23,044	R 21,762	R 20,503	R 19,269	R 18,063	R 17,472	R 16,888	R 16,312	R 15,745	R 15,187	R 14,638
R 2,000,000	R 27,825	R 26,336	R 24,870	R 23,432	R 22,022	R 20,644	R 19,968	R 19,300	R 18,643	R 17,995	R 17,356	R 16,729
R 2,100,000	R 29,216	R 27,653	R 26,114	R 24,603	R 23,123	R 21,676	R 20,966	R 20,265	R 19,575	R 18,894	R 18,224	R 17,565
R 2,200,000	R 30,608	R 28,969	R 27,357	R 25,775	R 24,224	R 22,708	R 21,964	R 21,230	R 20,507	R 19,794	R 19,092	R 18,402
R 2,300,000	R 31,999	R 30,286	R 28,601	R 26,946	R 25,325	R 23,740	R 22,963	R 22,195	R 21,439	R 20,694	R 19,960	R 19,238
R 2,400,000	R 33,390	R 31,603	R 29,844	R 28,118	R 26,426	R 24,773	R 23,961	R 23,161	R 22,371	R 21,593	R 20,828	R 20,075
R 2,500,000	R 34,781	R 32,920	R 31,088	R 29,289	R 27,527	R 25,805	R 24,959	R 24,126	R 23,303	R 22,493	R 21,696	R 20,911
R 2,600,000	R 36,173	R 34,237	R 32,332	R 30,461	R 28,628	R 26,837	R 25,958	R 25,091	R 24,235	R 23,393	R 22,563	R 21,747
R 2,700,000	R 37,564	R 35,553	R 33,575	R 31,633	R 29,729	R 27,869	R 26,956	R 26,056	R 25,168	R 24,293	R 23,431	R 22,584
R 2,800,000	R 38,955	R 36,870	R 34,819	R 32,804	R 30,830	R 28,901	R 27,955	R 27,021	R 26,100	R 25,192	R 24,299	R 23,420
R 2,900,000	R 40,346	R 38,187	R 36,062	R 33,976	R 31,931	R 29,933	R 28,953	R 27,986	R 27,032	R 26,092	R 25,167	R 24,257
R 3,000,000	R 41,738	R 39,504	R 37,306	R 35,147	R 33,033	R 30,966	R 29,951	R 28,951	R 27,964	R 26,992	R 26,035	R 25,093

**Note: The above rates are indicative only. Actual instalment values can differ mildly depending on the method of calculation applied by a lending instituion*