PROPERTY OVERVIEW – 4th QUARTER 2009

– No class of property has been spared the ravages of recession, but economic fundamentals are improving

HOME LOANS DIVISION

PROPERTY AND MORTGAGE MARKET ANALYTICS

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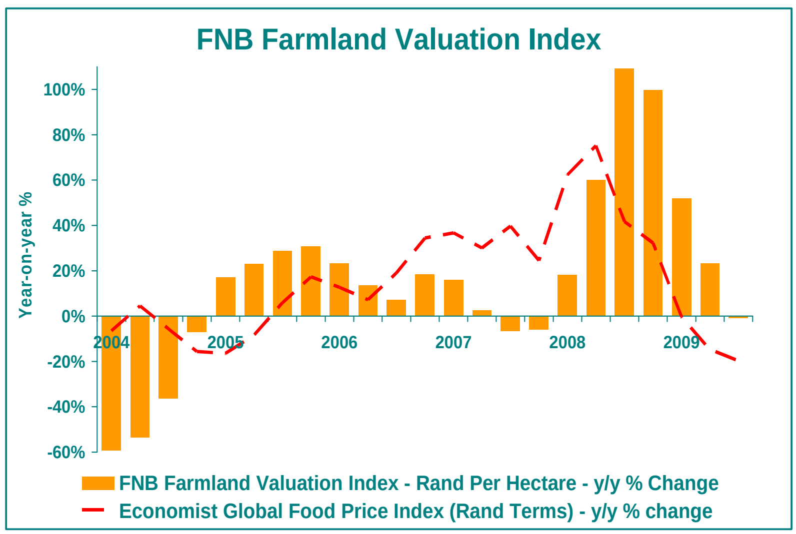
1. FOCUS POINT: THE FARM PROPERTY SECTOR – THE LAST SEGMENT TO FEEL THE SLOWDOWN?

In 2008, both residential and commercial property had already started to buckle under the strain of high interest rates of that time, rates being driven higher by a massive global commodity price spike, notably in the areas of food prices. At the same time, average farm valuations were shooting higher, arguably as a result of windfalls from this food price inflation surge, while also helped by very strong 2008 production.

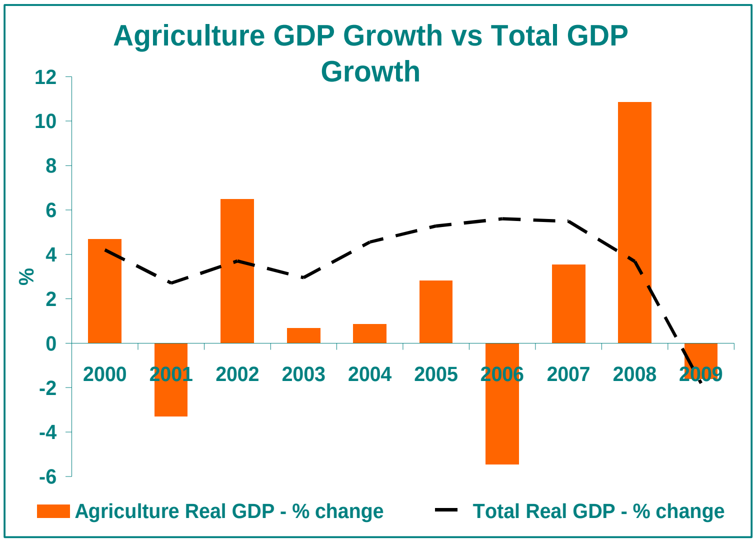
The graph below depicts inflation in average farm valuations, compiled from a combination of farm transactions as well as re-valuations data. Year-on-year, average recorded farm valuations growth reached a lofty peak of 109.3% in the 3rd quarter of 2008, around the time that the residential property market was heading towards its worst performance levels, and the commercial property sector, too, was well-into slowdown.

The major surge in valuations growth should probably not be entirely unsurprising, given the huge global food price inflation surge to a peak of 75.1% year-on-year growth in rand terms just one quarter before the farm valuations peak.



Not only was the 2007 and 1st half of 2008 a superb period from an agricultural price inflation point of view, but 2008 was a year which reportedly saw strong output growth in the agriculture sector.

The global food price boom was said to be in part related to last year's oil price spike, where Brent Crude nearly reached $150/barrel, because of the increased potential that this gave to ethanol production, which would compete for "space" with food production.



That agricultural boom period has, for the time being, come to an end. The first 3 quarters of 2009 saw Agriculture GDP in negative growth territory, averaging -1.6% decline for the 1st 3 quarters of the year. The Economist Global Food Price Index has averaged -12.8% year-on-year decline for 2009 to date.

The FNB Farmland Valuations Index has followed suit, and for the 3rd quarter of 2009 showed mild year-on-year decline of -0.9%.

This weakening in the index from its spectacular high a year ago arguably puts farm property at the back of the South African Property Cycle, with the residential property sector's price growth peaking back early in 2005, retail property also seeing its peak in that year, while industrial and office property sector's hung on until 2007 before seeing their returns slide substantially in 2008. Admittedly, though, farm property trends are driven by very different forces, and as such would not always merely follow the trend of the other property categories.

Whereas the residential and commercial property sectors experienced the global commodity boom as largely negative, especially because of the upward pressure that these exerted on interest rates, it would appear that interest rate hikes had little effect on farm values initially, as the negative impact from these was offset by the positive gains from high agriculture prices and strong output (i.e. the part of the economy relevant to farmers). It was only, therefore, after the commodity price boom ended abruptly due to the world economy buckling under its pressure, that the farm property segment appeared to start feeling increased pressure on a national basis.

2. SOUTH AFRICAN ECONOMIC AND PROPERTY SECTOR OVERVIEW

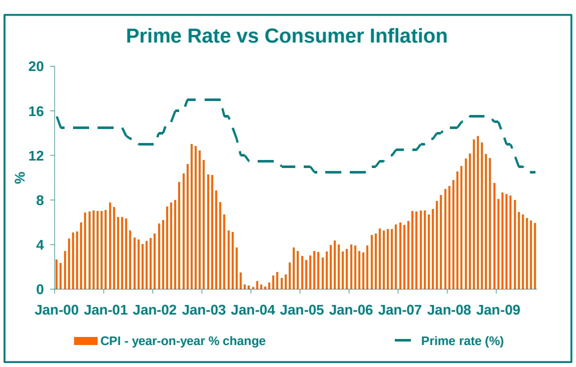
CURRENT PROPERTY SECTOR FUNDAMENTALS

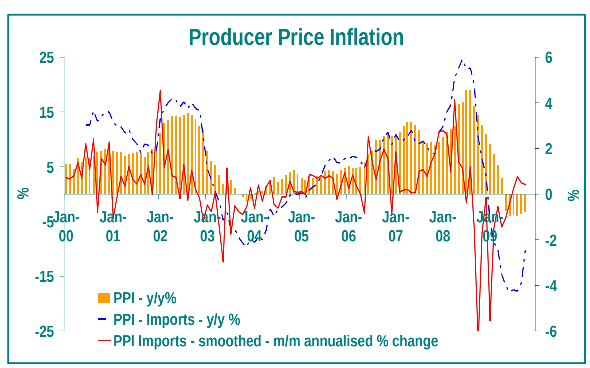
"Weak but improving economic fundamentals" is probably the best way to describe the current environment.

As we head towards 2010, general property sector fundamentals could probably be described as "still-weak but improving". The first major improvement came from 5 percentage points' worth of interest rate cuts from December 2008 to August 2009, which accompanied a steady decline in consumer price inflation. The original drivers of the inflation surge in recent years were predominantly global forces in the form of widespread commodity price inflation, most notably oil and food price spikes. Thereafter, , a sharp commodity price slump after the mid-2008 peak saw our local producer and consumer price inflation rates coming off steadily, paving the way for the series of interest rate cuts.

Currently, there would appear little to worry about in the way signs of a renewed inflation surge. But at the same time, it would appear that the steady downward trend may be coming to an end. The world has shown signs of moderate "re-inflation", with commodity prices well off their lows of late-2008/early-2009, the producer price index for imported goods is back in month-on-month inflation after a period of sharp deflation, and the year-on-year rate of deflation in this imported goods index is diminishing steadily.

This imported goods price turnaround is expected to limit further downside to the goods component of the consumer price index, while the services component of the consumer price index is looking rather "downwardly sticky", especially the housing sub-index whose inflation is driven not only by rental growth and escalation rates but by significant increases in





services costs, most notably electricity tariff hikes.

In short, the CPI inflation rate is expected to hug the upper limit of the 3% to 6% SARB target range, and no further interest rate cuts are anticipated by Firstrand in the current cycle.

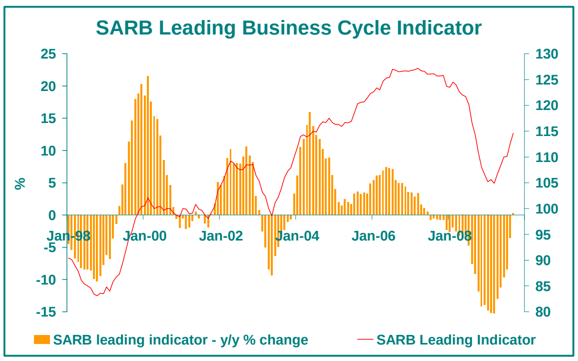
As interest rate stimulus fades in 2010, property will require increasing support from the economy.

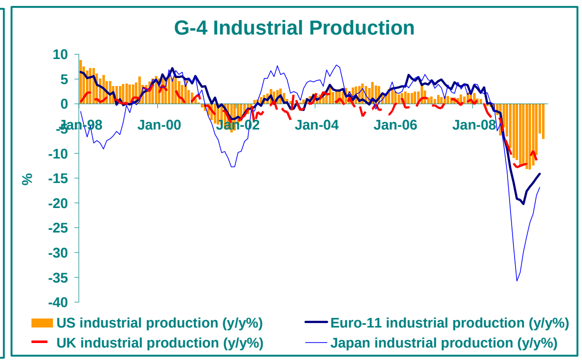
This is not to say that the stimulus to the economy and property is over yet. The entire positive effect of interest rates filters through into the economy over a considerable period of time, and it should be well-into 2010 before the full impact has been felt and the stimulus starts to wear off.

Fortunately, economic growth looks to be picking up…….

At the stage where the full impact of interest rates has more-or-less fed through into property, it will up to the economy to provide increased support for the property sector. Indeed, that already looks set to be the case, with 3rd quarter real economic growth having emerged from negative territory to record positive quarter-on-quarter annualised growth of 0.9%, while the SARB Leading Business Cycle Indicator continues to trend steadily upward on a month-on-month basis.

This improving growth environment is due in part to local interest rate cuts, but also due to an improving global economy, buoyed by a loose monetary regime in many developed economies along with a number of fiscal stimulus packages aimed at ending the global financial crisis as well as the severe economic pain. As yet, big global numbers don't look wonderfully impressive, but improvement is being witnessed, and the graph below shows G-4 Industrial Production moving steadily back towards ultimately achieving positive year-on-year growth.

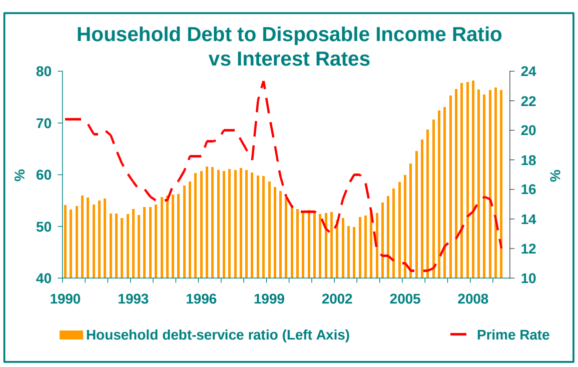




….But don't expect too much.

However, the move back to positive growth has been sluggish. The typically interest rate sensitive sectors such as residential property and vehicle retail have shown some improvement, but not the type of improvement that 5 percentage points' worth of interest rate cuts would have had 5 years ago as it did in 2003/4, while export sectors are making heavy weather of it. Two of the usual suspects have been singled out, namely the banks for "not lending" as well as the "strong rand".

While the allegations regarding the latter appear somewhat spurious, because the strength of our currency is questionable, the allegations against the former suspects have some substance in the sense that banks are definitely far more conservative in their retail banking lending practices compared with a few years ago. This is partly due to the National Credit Act but also due to an economic environment that looks substantially worse than a few years ago, and an environment which is still exerting severe financial pressure on the household sector. This has meant that the household sector has made limited progress in kickstarting the downward part of its debt cycle towards a lower household debt-to-disposable income ratio, and therefore, at a high 76.3% of disposable income its debt ratio limits its ability to respond to the recent interest rate cuts with "aggressive borrowing" growth. It would thus appear unrealistic from the banks in terms of kickstarting growth, while the rand is not really something over which anyone has major significant control. Rather, with a host of home-



grown domestic structural impediments (high household debt being just one), the SA economy and thus its property market remains highly exposed to global economic developments.

IMF points to moderate Global recovery and abundant policy challenges to tackle.

Speaking of global economic developments, what does 2010 appear to have in store for us? In its World Economic Outlook of October 2009, the International Monetary Fund (IMF) painted a distinctly improved picture compared with the dismal performance of 2009, but nevertheless one that is still weaker than that of a few years ago in the boom times, while also highlighting a number of risks to the outlook.

It sees the United States economy growing positively by 1.5% in 2010, significantly more moderate than the 3.6% and 3.1% growth rates for 2004 and 2005 respectively at its best point of the decade, but better than the -2.7% expected for the current year, while the "Advanced Economies" grouping is projected to improve from -3.4% contraction in 2009 to +1.3% growth in 2010, also still significantly worse than levels around 3% a few years ago. Fiscal stimulus is expected to remain important in the likes of the US, reflected in government consumption expenditure growth projections significantly higher than the consumption expenditure growth of a household sector still under pressure after a hefty bout of job-loss. Global economic growth is projected at 3.1%, supported in part by the higher growth in emerging and developing economies, with China and India not surprisingly playing a prominent role. Once again though, this forecast remains slower than +5% global growth as recently as 2007. The good news that accompanies a moderate global growth scenario is that the IMF also anticipates only a moderate rise in inflation in the advanced economies.

IMF Economic Forecast Summary				
	2007	2008	2009	2010
Advanced Economies	2.7	0.6	-3.4	1.3
USA	2.1	0.4	-2.7	1.5
Eurozone	2.7	0.7	-4.2	0.3
Japan	2.3	-0.7	-5.4	1.7
UK	2.6	0.7	-4.4	0.9
Emerging and Developing Economies	8.3	6.0	1.7	5.1
Total World	**5.2**	**3.0**	**-1.1**	**3.1**
Global Commodity Prices – Oil (% Change)	10.7	36.4	-36.6	24.3
Global Commodity Prices – Non-fuel (% change)	14.1	7.5	-20.3	2.4
Consumer Prices – Advanced Economies (% Change)	2.2	3.4	0.1	1.1

Beyond 2010, the IMF points to major policy challenges, most notably how to get the timing right for the withdrawal of the huge monetary and fiscal stimuli granted by certain countries' central banks and governments (importantly, the US), so as not to scuttle the global recovery. At the same time, carry on with fiscal stimulus for too long and one compromises on long term fiscal sustainahbility. In addition, there is the challenge of re-balancing the global economy, with many countries having been "savings surplus" countries, relying on demand for their exports from current account deficit (savings deficit) countries, demand that may not be at the same levels for some time. The surplus countries will thus need to stimulate their own demand to higher levels to replace a portion of foreign demand. This is not to mention the challenges surrounding the reform of financial sectors following the crisis. So it is clear that global policy challenges (and thus risks) are abundant over the next few years.

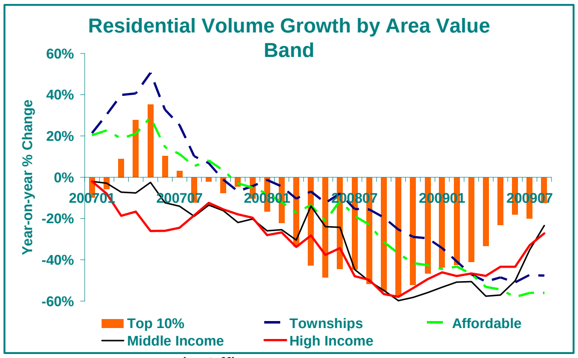
Moderate Global recovery expectation equates to moderate domestic recovery projection.

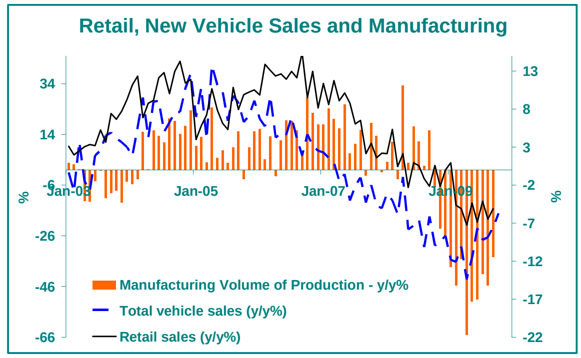
The expectation of a moderate global recovery in 2010, coupled with high household indebtedness and little prospect of major economic policy improvements locally, leads to the expectation of a moderate South African growth recovery too. The Firstrand projection of real GDP growth for next year as a whole is thus around 2-2.5%, and while mediocre is nevertheless significantly better than the average year-on-year negative growth of -1.8% for the 1st 3 quarters of 2009.

And what of interest rates? Our view is that prime rate will stay rooted at 10.5% for a lengthy period until the 2nd half of 2010, starting to rise late in the year as global inflationary pressures mount, ending 2010 50 basis points up at 11%.

Mild economic recovery - there's something in it for all property segments, but how quickly will the impact be felt?

Despite warning against over-expectation, the improving economy brings something for both the residential and commercial components of property. Interest rates are driving mortgage-backed residential buying to higher levels, the slow turn of retail sales and manufacturing output for the better bodes well for the retail and industrial property sectors (industrial property performance strongly linked to manufacturing as well as the warehousing of manufactured goods), while a general economic growth improvement should normally see the demand for office space also rise. But what leads and what lags?





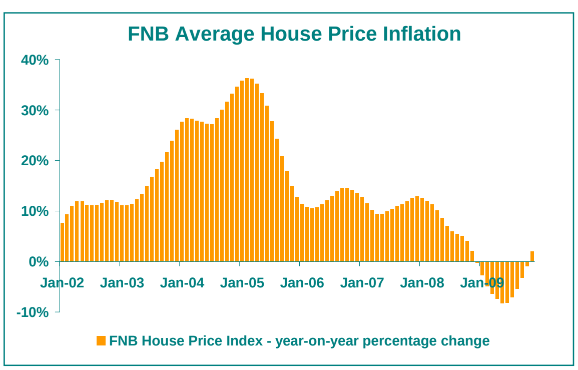
Data source: Deeds Office

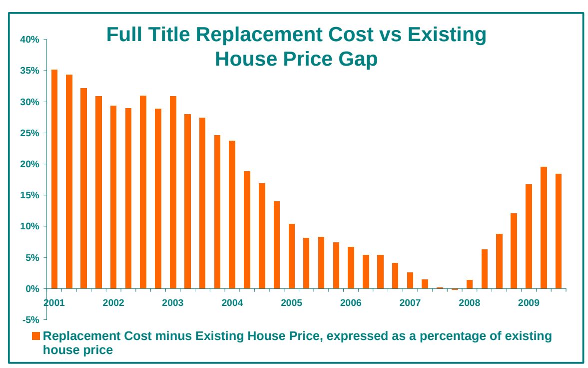
Residential Property appears to be leading the turnaround off a very low base

Residential property looks to be leading the cycle as one would expect. Households make decisions more quickly than the commercial sector, and when interest rates come down demand for residential property starts to rise pretty soon, albeit not the most impressive of recoveries admittedly. While deeds data points towards year-on-year decline across all 4 major value bands, that year-on-year decline is diminishing, with volumes having started to grow positively on a month-on-month basis earlier in 2009.

The financial pressure that the household sector still faces to the present day serves to moderate the pace and magnitude of recovery, but has not managed to entirely offset the good work of interest rates in boosting demand. As a result, oversupplies appear to be gradually diminishing and house prices have headed back into national year-on-year inflation in November, for the 1st time in almost a year, to the tune of 2% as at November.

Assisting in slowly bringing the oversupply under control is a now sharp decline in building completions, down about 30% year-on-year in terms of square metreage for the 3rd quarter. The decline in building activity was arguably hastened by strong input cost inflation in 2006/07, which served to widen the gap between replacement cost and the value of existing house prices. This implied a diminishing ability of developers/contractors to bring competitively-priced stock to the market.



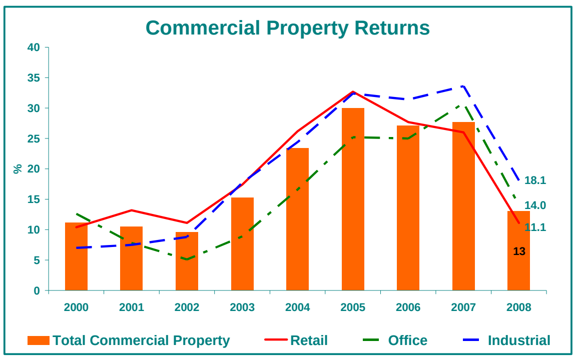


Commercial property seemingly behind residential property in the cycle,.......

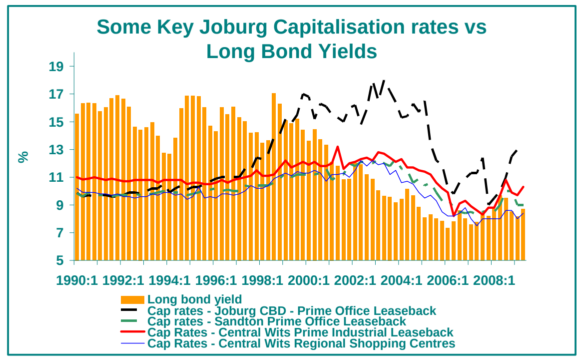
The commercial property sector has for long been seen as the sector holding up significantly better than the ailing residential sector, which had its best period in 2004 to early-2005. The truth is, though, that not all has been well in the commercial sector, which also (according to the IPD) had its best year of returns as far back as 2005. The “not well” part of this sector has, for some time been the retail sub-sector, which saw total returns peak in 2005, and since then has been on a sliding trend as oversupplies of retail space started to increase.

From peak returns of around 30% in 2005, total commercial property sector returns had slid to 13% for 2008, and with the full force of recession on the sector arguably only having been felt in 2009, it is likely that total returns for 2009 will be even lower. Indeed, the IPD reported a lowly total return for the Commercial Property sector of only 3.4% for the 6 months to June 2009, and like its residential counterpart at the time, capital growth was believed to be in negative territory.

Capitalisation rates (Cap rates) showed a mild rise from 2006 to about mid-2008, in tandem with a short term rate and long bond yield rise up until mid-2008. But thereafter, they predictably declined once more as long yields declined in anticipation of a lower inflation and interest rate era, with the World having slid into recession and the commodity price boom over.



Data source: IPD



Data source: Rode

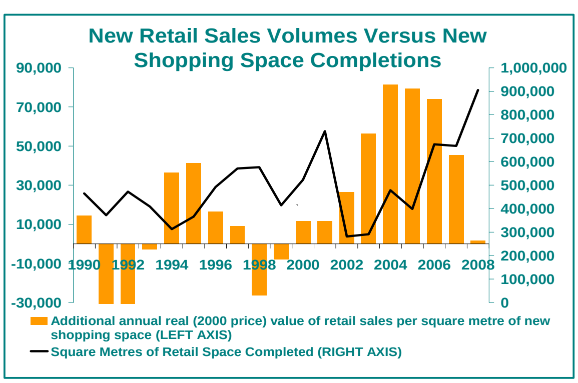
…..with the retail property sub-segment having deteriorated steadily as oversupplies of space have mounted.

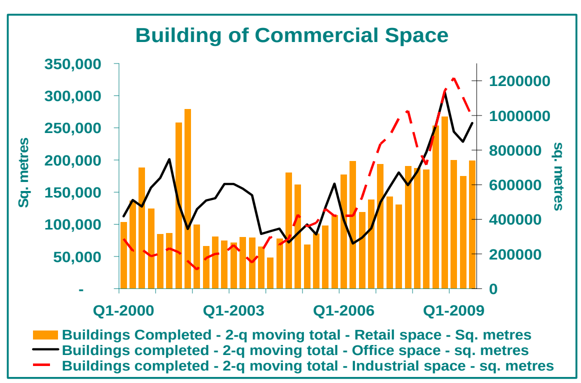
Retail property is arguably in the worst state of the 3 main commercial property segments, with supply of new space having been driven too far by one of the country’s biggest consumer booms, as well as by an important economic structural change in the form of the transformation of the townships from dormitory towns into more mixed use areas.

From returns in excess of 30% in 2005 (according to IPD figures), this sector’s total returns had slumped to 11.1% in 2007. The slump was the combination of sharply slowing real retail sales, along with steady growth in square metres of new building space being completed.

The accompanying graph below shows one way of indicating new demand relative to supply of new space, using the ratio of real value of additional retail sales per year/square metre of new shopping space added in that year. As at 2004, the rampant growth in retail sales made it incredibly difficult for an oversupply to be created at that stage, despite building activity in the segment picking up steadily. In the region of R81,000’s worth of new retail sale at 2000 prices was being done per additional square metre. In 2009, when we receive the 4th quarter statistics, this ratio will in all probability be far into negative territory, indicating new space completions far outstripping new retail sales, because retail sales have been been declining in real terms for some time.

Although looking to be slowing, 533,366 square metres worth of space reported as completed for the 1st three quarters of 2009 is significant, especially against the backdrop of year-on-year decline in real retail sales by -4.8% for the same period.



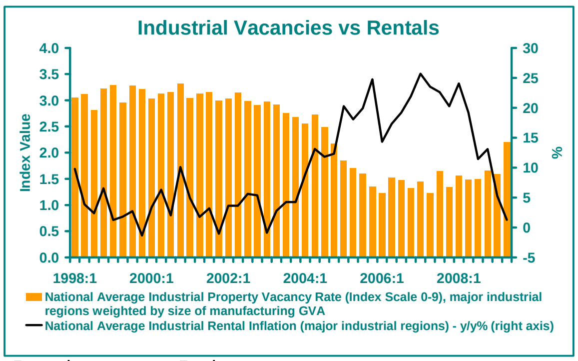


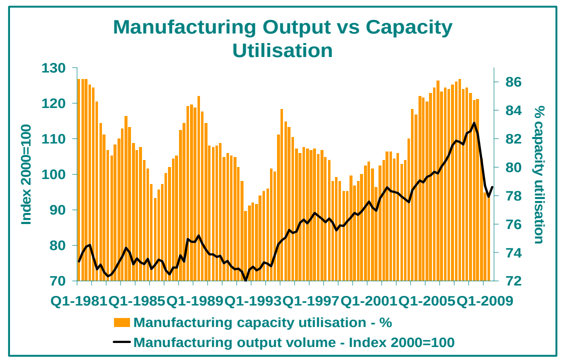
Even commercial property's two "star performing segments" have not escaped the global and local recession.

The graph above relating to commercial building statistics shows both industrial and office space completions having increased dramatically from about 2004. This was in response to economic growth around 5% in earlier years of the decade. The industrial property sector has a strong link to manufacturing and warehousing of a variety of manufactured goods, in other words it is arguably the most exposed to a sharp global and local manufacturing output contraction.

Of the major sectors of the South African economy, manufacturing has been the hardest hit, being heavily exposed both to dwindling global export demand until not so long ago as well as to the local consumer goods slowdown, especially in the area of durable consumer goods. It therefore comes as little surprise to have seen Industrial Property Vacancy rates having ticked up since 2007, the year in which manufacturing production started to come under pressure while building completions remained strong.

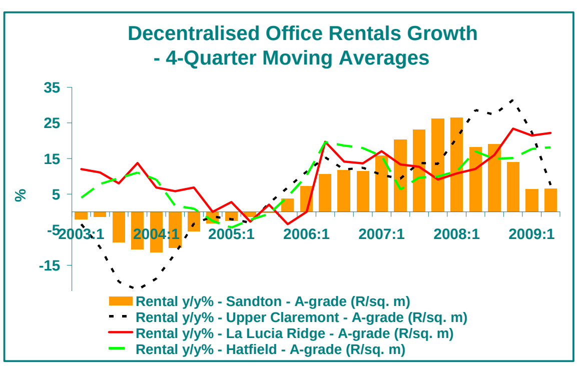
Rising vacancy rates implies declining rental inflation, and the left hand graph below, which shows a national average rental inflation rate constructed from Rode data for 1000 sq.m industrial properties, indicates a sharp fall in average rental inflation on for SA's major industrial regions to low single-digit inflation from rates up near 25% in 2007.

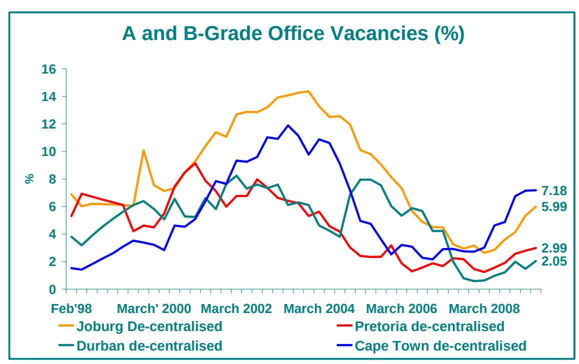




Raw data source: Rode

A similar trend is observed in the office property segment, with a broad rise in vacancy rates since 2008, but the major de-centralised regions of the country suggest that vacancy rates have not yet reached problematically high levels, still being generally being in single-digit territory as at mid-year. Nevertheless, this rise in vacancy rates has been sufficient to bring about a general slowdown in rental inflation rates.





Data source: Rode

3. IN SUMMARY

All major sectors of the property market have felt the impact of, firstly, a major global commodity price inflation surge and its resultant impact on interest rates up until 2008, and secondly, the impact of the recession that set in during the latter stage of 2008. Residential price growth had been broadly slowing since early-2005, leading the overall property cycle. By the 1st half of 2009, the FNB House Price Index was showing price deflation.

By the first half of 2009, the IPD was reporting deflation in commercial property valuations too. Of the 3 commercial property sub-sectors, the retail sector has seen its performance slow since 2006, whereas industrial property and office space remained strong until as recently as 2007, and as such are seen as “laggards” in the property cycle. Ultimately, though, these two sectors could not defy economic realities in the form of recession, and experienced a sharp drop in total returns in 2008.

Finally, comes farmland, which appeared to experience its best year as recently as 2008, with a major price valuations surge, accompanying the combination of a strong growth year in agricultural output as well as a huge global and local food price inflation surge. In 2009, however, the farm property valuations inflation rate has also move steadily lower, following the end of the food price boom as well as an agriculture sector recession setting in.

Recently, we have seen the residential market turning for the better in response to lower interest rates. The commercial property sector should benefit from lower interest rates too over time, while both sectors are set to experience some additional support from an improving economic growth rate as 2010 approaches.