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15 May 2012

COMMERCIAL PROPERTY – 2012 TO DATE

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SUMMARY – COMMERCIAL PROPERTY BENEFITS FROM RECENT ECONOMIC STRENGTH, BUT SOFT PATCH MAY BE APPROACHING

Through the Summer Quarters, FNB's All Commercial Property Performance Indices, compiled from its valuations data (heavily pertaining to the smaller "owner occupied segment"), have pointed to something of a stronger period in the commercial property sector. The past 4 quarters have seen the All Commercial Property average price growth rate accelerating, appearing to track the direction of the FNB Residential Property Price Index quite well.

The past 2 quarters have also seen a resumption of decline in the FNB All Commercial Vacancy Rate Index, after a previous rising trend through last winter, while capitalisation rates are believed by FNB's valuers to have declined further.

Investment Property Databank (IPD) data for 2011, released in March, is supportive of the FNB indications of a late-2011 improvement, with higher total property returns recorded in the entire year compared to the IPD's earlier 1st half 2011 update, implying a stronger 2nd half.

However, whereas 2011 saw improving commercial property fortunes as the year progressed, 2012 may prove to be the opposite, with some global and domestic economic indicators starting to hint at a "softer patch" approaching.

A recent decline in the JP Morgan All Industry Purchasing Managers Index is telling in this regard, while organisations such as the IMF, the World Bank, the UN and indeed our own Reserve Bank had started the year projecting slower overall economic growth for 2012 compared to 2011. Recession talk in the troubled Europe has increased in recent weeks, while US economic growth had already slowed mildly in the 1st quarter of 2012 compared to the previous quarter.

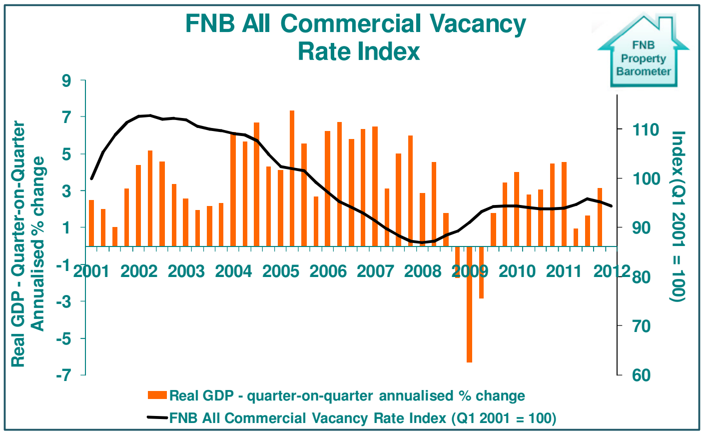
Domestically, we haven't yet felt too much in the way of the impact of a creaking global economy. However, SA's own Manufacturing Purchasing Managers Index has declined for 2 consecutive months in March and April, suggesting slowing manufacturing output growth. Accompanying this has been a mild slowing in month-on-month FNB house price growth in the same 2 months, an early hint that the economy may be starting to cool at least in the residential component already.

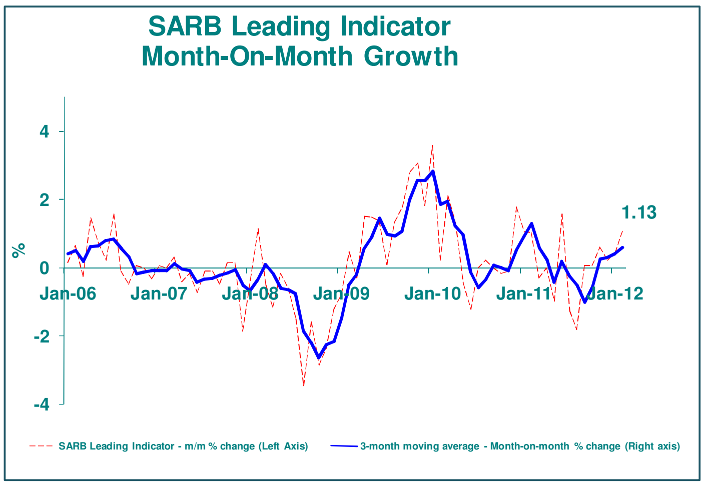
Real retail sales growth was still strong as at the 1st quarter, with the year-on-year growth rate measuring 6.9% for the 3 months to February. However, this is slightly down from its peak 7.9% year-on-year growth rate for the final 3 months of 2011, a further early hint of moderation in the economy.

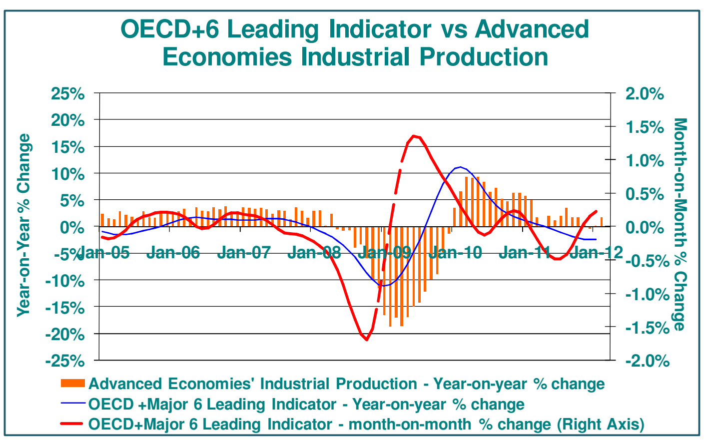
On the interest rate side, in recent days we have seen government long bond yields just a slight bit off their best levels as global jitters heighten and some capital flows to "safe havens". The impact of this has also been seen in a weaker rand moving weaker than USDZAR8.00 in recent days.

A combination of slowing economy, which could once again raise vacancy rates, and a rise in long bond yields as global economic jitters are renewed, could be expected to see capitalisation rates rise mildly towards the 2nd half of the year, exerting downward pressure on real commercial property values after a recent period of relative strength.

FNB HEADLINE COMMERCIAL PROPERTY TRENDS – STRONGER ECONOMY DURING SUMMER QUARTERS TRANSLATES INTO RECENT SIGNS OF COMMERCIAL PROPERTY MARKET STRENGTHENING







FNB Commercial Property Finance data relates predominantly to the smaller owner-occupied commercial segment with properties included below R50m in value. In the 1st quarter of 2012, our FNB All Commercial (i.e. retail, industrial and office included) Vacancy Rate Index declined slightly, for the 2nd successive quarter, after some previous rise through last year's winter quarters.

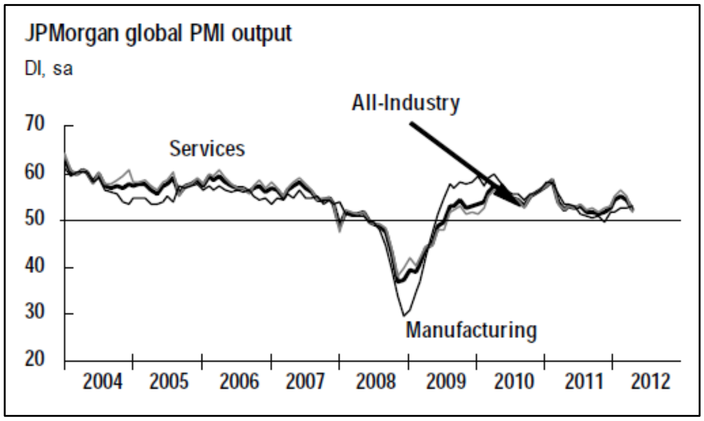
This renewed decline in the vacancy index coincides with some strengthening economic growth in the summer 2011/12 period. After 2 soft mid-2011 quarters real quarter-on-quarter annualised gross domestic product growth accelerated to 3.2% in the 4th quarter of 2011, from 1% and 1.7% for the 2 previous quarters respectively.

If one examines the SARB Leading Business Cycle Indicator, it would appear that this period of relative economic strength continued into the 1st quarter (1st quarter GDP figures not yet available), with the month-on-month growth momentum of the Indicator strengthening broadly further up until February.

Other high frequency indicators have confirmed the recent period of strength, including the RMBBER Business Confidence Index, which jumped from a 4th quarter level of 38 (scale 0 to 100) to 52 in the 1st quarter of 2012, the Manufacturing Purchasing Managers' Index which showed 4 consecutive quarters of expansion (level above 50 on scale of 0 to 100) from January to April, and real retail sales which showed continued strong year-on-year growth into the early stages of 2012.

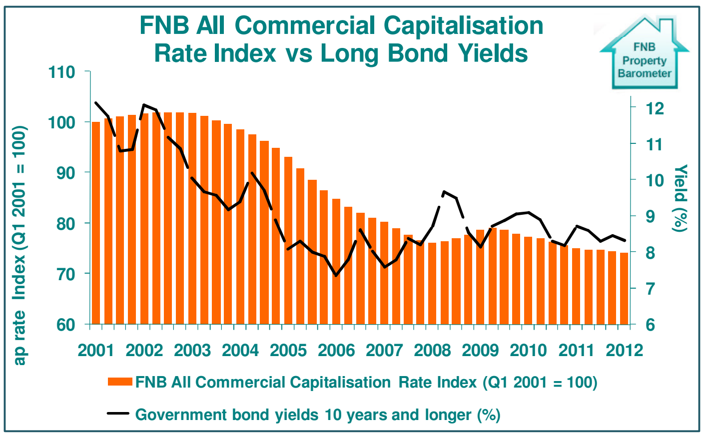
The recent stronger patch in the domestic economy and commercial property market is in turn explained by a minor uptick in global economic growth late in 2011, and indeed the Leading Business Cycle Indicator for SA's Major Trading Partner Countries was, as at February, still seen as a positive influence on a rising domestic leading business cycle indicator.

This mildly stronger economic period has been the second consecutive summer uptick, with the winter periods turning out to be slower economic growth periods even on a seasonally-adjusted basis.



However, the past week or two has begun to see a deterioration in global market sentiment, driven by some weak high frequency economic data releases, including weaker than expected US jobs data which suggest that the world's largest economy may be heading for a growth slowdown, while much attention has been focused on Europe and its debt woes. More telling, however, is that the JP Morgan Global Purchasing Managers' Index for the Manufacturing and Services Sectors has weakened for the 2nd consecutive month on April, from a February "mini-peak". The Global PMI is admittedly still above 50, which still points to expansion (growth), but 2 months of decline in the PMI suggests slowing growth to come. And indeed, US economic growth has already slowed mildly in the 1st quarter from 3% quarter-on-quarter annualised to 2.2%.

As this begins to filter into the South African economy. It may lead to the recent downward move in the FNB Vacancy Rate Index being halted in the near term.



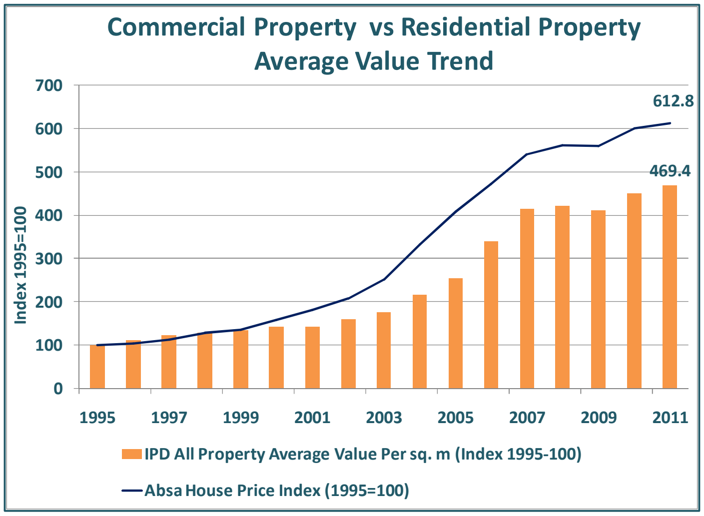
However, while the signs are there that the economy may start to slow again, this has not fed through into the commercial property market yet. Besides improved vacancies in the 1st quarter, capitalisation rates also appear to have continued their mildly improving (declining) trend in the 1st quarter of 2012 according to FNB valuers, with the FNB All Commercial Capitalisation Rate Index having declined further.

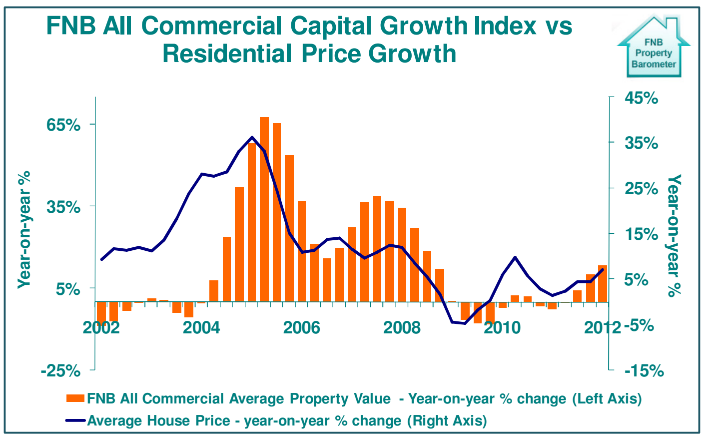
Two important factors are important in driving this. Firstly, slightly lower vacancy rates would suggest slightly improved rental growth on commercial property, while lower long bond yields in the 1st quarter partly reflect improving (declining) inflation expectations emanating from slowing year-on-year inflation in global commodity prices, lowering short term interest rate hiking risk. From 8.46% average in the final quarter of 2011, average yields on government long bonds of 10 years and over declined to 8.33% in the 1st quarter.

One would expect, however, that a renewed "soft patch" in the global economy could heighten Emerging Market concerns, leading to net foreign capital outflows, and a resultant rise in long bond yields along with rand weakening. This in turn could exert upward pressure on commercial property capitalisation rates and downward pressure on property values.

COMMERCIAL PROPERTY DOESN'T APPEAR AS OVERPRICED AS RESIDENTIAL, BUT RESIDENTIAL PRICE TRENDS MAY BE GOOD LEADING INDICATOR FOR COMMERCIAL PROPERTY PRICE TREND DIRECTION.

Although we are of the opinion that the residential property market underwent a bigger "overshoot" during the property boom in the last decade prior to 2008, the direction of the respective segments' trends do not appear to differ materially, with similar economic factors driving both.





Reidential rental and yield data is hard to come by, but one gets the impression that residential yields are generally lower than in the commercial property segment. This would make sense, as we are of the opinion that a strong culture of home ownership in SA (with yields not being a major consideration), along with a group of less sophisticated investors prepared to pay a premium for a residential property which they perceive as easier to understand and manage (compared to a commercial property), has probably driven residential yields to lower levels.

The result was that, although both residential and commercial property both had spectacular price booms over the past decade or more, the residential boom was somewhat more spectacular. From 1995 to 2011, the average house price (Absa Index) rose cumulatively by 512.8%, while the IPD's All Commercial per square metre property value rose by a lesser 369.4% over the same period. This probably translated into less yield compression for commercial property than in the case of residential property.

Nevertheless, the directions of price growth trends have tracked each other fairly well over the past decade, with residential often leading commercial property trends.

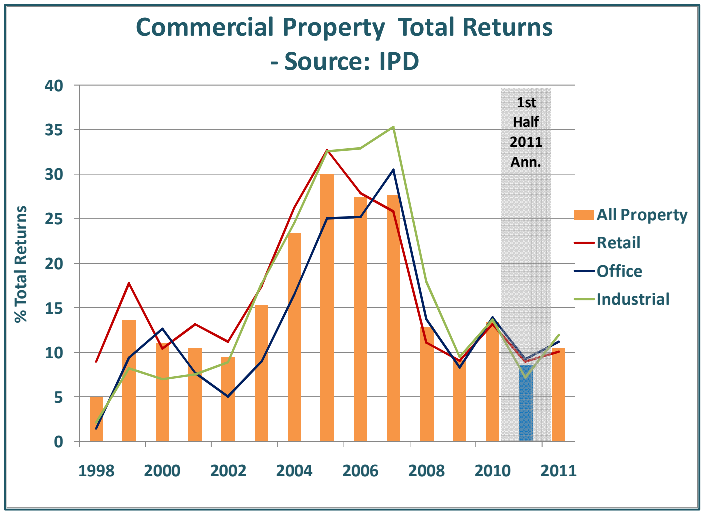
This is borne out by examining the FNB All Commercial Capital Growth Index in comparison to the FNB House Price Index. The FNB All Commercial Capital Growth Index is compiled on a basis not dissimilar from the FNB House Price Index, i.e. it reflects the average value of properties and not the per square metre value.

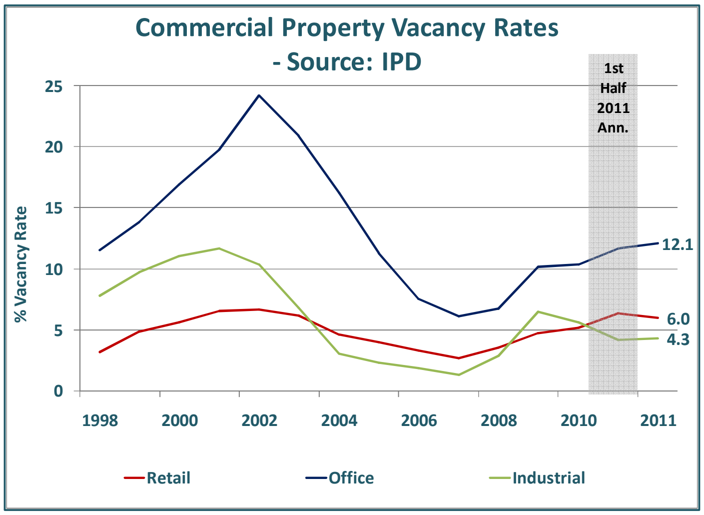
After a commercial price growth boom from 2004 to 2008 which resembled the shape of the residential price boom (only starting a little later than the residential boom), the All Commercial Index, like the residential price index, showed year-on-year price decline from early-2009, followed by a mini-recovery in 2010, and a dip late in early-2011.

Then, since the 2nd quarter of 2011, both the indices have to shown a 4 quarter year-on-year growth acceleration, the average house price growth rate reaching 7.1% in the 1st quarter of 2012, and the average commercial property value reaching 13.4% growth in the same period.

Should this broad correlation in direction of price growth between the two property categories continue to hold, a recent resumption of slowing in month-on-month house price growth in March and April, which would ultimately lead to slowing year-on-year price growth should it continue, could point to commercial property value growth about to follow suit. 2 months of residential growth slowing, however, makes it too early to draw conclusions regarding a slowing price growth trend.

SEGMENT DATA POINTS TO OFFICE SPACE BEING MOST OVERSUPPLIED





Investment Property Databank (IPD) data for 2011 as a whole had shown a weakening in commercial property total returns on 2010, (income and capital growth) in all 3 of the major commercial property sub-segments, in very similar style to the residential market following the mini-recovery of 2010. However, the total returns figures for 2011 imply something of an improvement in the 2nd half of 2011, as the annualised rates of return for the 1st half of last year were all lower than the figures for the year as a whole.

Total returns for Office Space in 2011 measured 11.2% (up from a 9.2% annualised rate for the 1st half of 2011), retail 10.1% (up from 9% annualised returns for the 1st half of 2011) and 11.9% for industrial and warehouse space, up from 7.2% annualised for the 1st half of 2011.

The IPD figures thus appear to support our own FNB valuers' results that point to a general strengthening in the commercial market in the latter parts of 2011.

Lower returns for 2011 as a whole, compared to 2010, were accompanied by higher vacancy rates in retail and most notably office space, while only the Industrial Property category showed some improvement on 2010. However, retail property did show some vacancy decline in the 2nd half of the year it would appear, with the IPD reporting a lower 2011 average vacancy rate for this segment than what it had reported for the 1st half of 2011 alone. Office space would thus appear the "odd man out" in terms of vacancy trends, having shown further noticeable rise in vacancy rates in the 2nd half of 2011.

Having improved noticeably in 2010 and again in 2011, industrial property found itself with the lowest average vacancy rate of 4.3% last year, followed by retail with 6% and office space with a rather high 12.1%. Small wonder that the Industrial Property Segment achieved the highest total returns, according to the IPD.

CONCLUSION – AFTER A GOOD PERIOD LATE IN 2011 AND EARLY-2012, THE ECONOMY MAY BE ENTERING A "SOFT PATCH" ONCE AGAIN, WHICH COULD LEAD TO SOME MILD PRESSURE ON THE COMMERCIAL PROPERTY SECTOR.

Recent economic indicators suggest that, after a short period of strength in the economy in the summer of 2011/12, we may once again be entering a "softer patch". The recent decline in the JP Morgan Purchasing All Industry Managers Index is telling in this regard, while organisations such as the IMF, the World Bank, the UN and indeed our own Reserve Bank had started the year projecting slower overall economic growth for 2012 compared to 2011. Recession talk in the troubled Europe has increased in recent weeks, while US economic growth had already slowed mildly in the 1st quarter of 2012 compared to the previous quarter.

Domestically, we haven't yet felt too much in the way of the impact of a creaking global economy. However, SA's own Manufacturing Purchasing Managers Index, while being above the crucial 50 level which signals expansion, has declined for 2 consecutive months in March and April, suggesting slowing manufacturing output growth. Accompanying this has been a mild slowing in month-on-month FNB house price growth in the same 2 months, an early hint that the economy may be starting to cool at least the residential component already.

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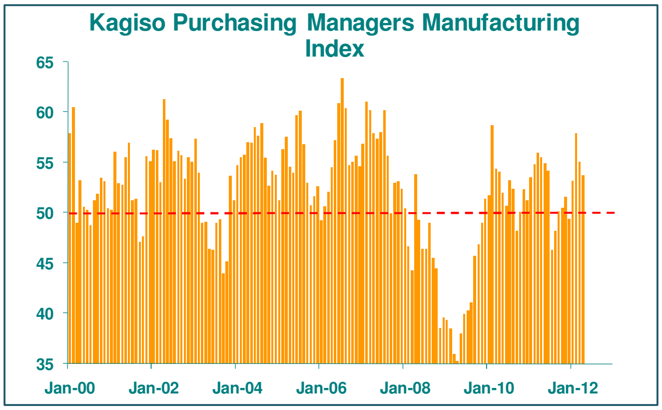

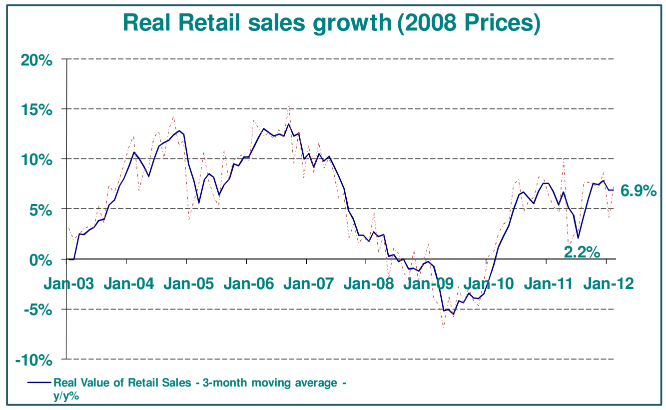

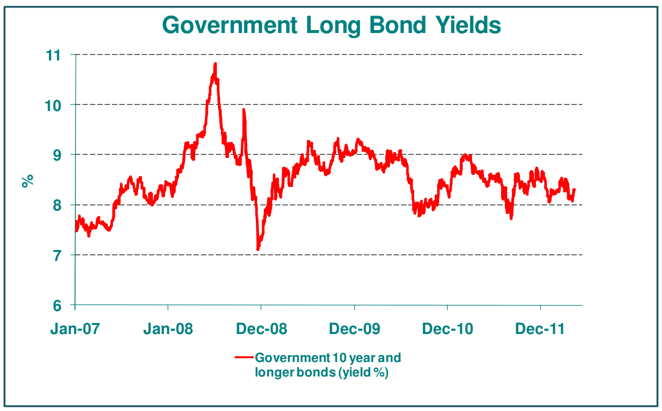

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A combination of slowing economy, which could once again raise vacancy rates, and a rise in long bond yields as global economic jitters are renewed, could be expected to see capitalisation rates rise mildly towards the 2nd half of the year, exerting downward pressure on real commercial property values after a recent period of relative strength.

So, whereas 2011 saw the commercial property sector appearing to strengthening as the year progressed, it looks as if 2012 may see the opposite, with the 1st half of the year proving the stronger half of the year, as the global economy comes under pressure as the year progresses.

During this period, if one could generalise, it would appear that prime properties and areas look set to hold up better than the "less illustrious". Already, the IPD has reported a significantly more rapid rise in office vacancies of Central Business Districts (15.4% in 2011) compared to de-centralised nodes (11.1%). Similarly, in the case of retail, it has been the smaller community (8.4%) and neighbourhood (8.9%) shopping centres that have seen more noticeable rises in vacancy rates, while regional (2.7%) and super-regional (3.3%) shopping centres remained at far lower vacancy rates in 2011.