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PROPERTY BAROMETER – RESIDENTIAL BUILDING OUTLOOK

Growth looks set to improve mildly in the residential building sector, but addressing affordability and scarcity issues will remain important.

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HIGHLIGHTS

- ***By 2012, an increased percentage of agents surveyed in the FNB Estate Agent Survey began to report stock constraints as an issue in their lives, and existing house price growth improved mildly as a result. This, in part, has contributed to a narrowing in the housing replacement cost gap (the percentage by which rebuilding a home exceeds the value of the existing home on average) since early-2012, to 19.4% by the 2nd quarter of 2013.***

- ***Not surprisingly, there was positive growth in square metres of residential homes completed to the tune of +2.9% in 2012, the 1st positive growth in 5 years. Into 2013, and for the 1st 6 months of 2013, the growth picture was still further improved, with square metres of residential plans completed rising 6.1% year-on-year.***

- ***With building plans passed having grown by an even more impressive 14.6% year-on-year for the 1st half of 2013, the signals are for still better completions growth in the near term. We therefore project better building completions growth for the year 2013 as a whole, i.e. 7%, and a further improvement to 8% in 2014.***

- ***Despite the recent increase in building activity, the figures still reflect significant longer term affordability issues that have to be addressed. These affordability issues come in the form growing urban land and infrastructure scarcity over the long term, and sharply rising municipal rates and utilities tariffs.***

- ***Therefore, the average size of building completed for the 3 months to June 2013 was 120.78 square metres, which is significantly lower than the September 2006 boom time peak average size of 141 square metres.***

- ***In line with the trend towards smaller sized homes being built, the StatsSA Building Stats for the 1st 6 months of 2013 show a further rise in the percentage of properties completed that are "Flats and Townhouses", from 26% in 2012 to 27%.***

- ***And as the buildings built have become smaller over the long term, so many of the "frills" have been disappearing. From a peak of 49.2% of homes built in 1975-79, the percentage of homes with swimming pools has declined to only 9% for those built in the 2010-2012 period, according to the homes that FNB has valued.***

- ***The percentage of Full Title homes built with garages has also taken a noticeable dip in the 2010-12 period, while those with domestic workers' quarters have been on a long term decline since the 1960s. Our FNB data also points to a more than halving in average full title stand sizes on homes built from 2010-2012, compared to the late 1970s.***

- ***Looking ahead, growing land and infrastructure scarcity around major urban areas would suggest the need for further decline in the average size of newly completed homes, a further rise in the percentage of total completions of the flats and townhouses component, and further decline in the average full title stand size. More densification is the future of South African cities, a "mega-trend" that started back in the 1970s and looks set to continue.***

SUMMARY.

The recession of 2008/9, which brought about a sharp slowdown in the housing market, resulting in a period of nominal existing house price decline around the time and slow nominal growth thereafter, made it tough for the residential development sector to bring "competitively priced" new housing stock to the market. 2007, the year before the recession, was arguably the heyday for residential development, after some years of rampant existing house price inflation had reduced the housing replacement cost gap (the percentage by which the cost of replacing a house exceeds the existing house price) to virtually zero.

Like a car, a residential building is a depreciating asset, so one would expect the price of a new home to be higher than for a comparable existing house, in a normal healthy market. So, when existing house prices virtually caught up with new house prices in 2007, why would many people not choose rather to build their own home to the specs that they prefer?

And so, in 2007, StatsSA building stats recorded 9.327 million square metres worth of residential buildings completed, 118.2% up on the pre-building boom 2000 level. Ultimately, though, oversupplies of residential stock would develop in the existing market as interest rates rose from 2006 to 2008, a global recession built up, and residential demand slowed significantly.

From 2007, existing house price declines in 2008/9, very weak price growth thereafter, and for much of that time building costs rising, meant a widening replacement cost gap up until the 1st quarter of 2012 where it reached a very significant 26.1%. Not surprisingly, therefore, from 2008 to 2011, square metres of residential buildings completed dropped spectacularly by -50%. From the development sector's perspective, this was disastrous, but from a residential investment return point of view this was wonderful news, as it would allow residential demand to catch up with oversupplies, improving price performance.

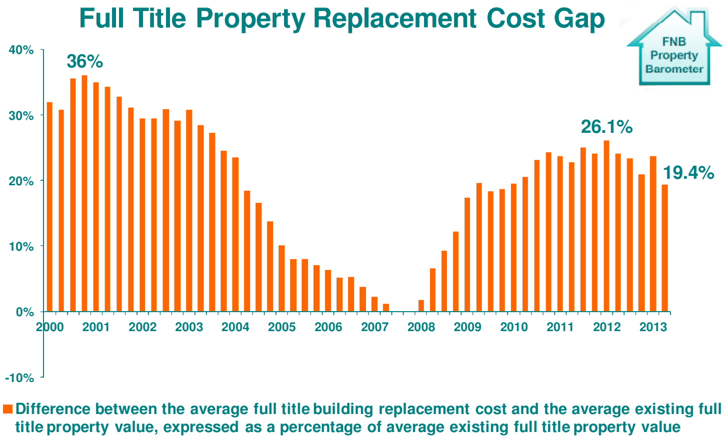
Indeed, this is exactly what began to happen. By 2012, an increased percentage of agents surveyed in the FNB Estate Agents Survey began to report stock constraints as an issue in their lives, and existing house price growth improved mildly as a result. This, in part, has contributed to a narrowing in the replacement cost gap since early-2012, to 19.4% by the 2nd quarter of 2013. Not surprisingly, there was a mildly positive growth rate in square metres of residential homes completed to the tune of +2.9% in 2012, the 1st positive growth in 5 years. In the 1st half of 2013, the growth has been still better, reaching 6.1%.

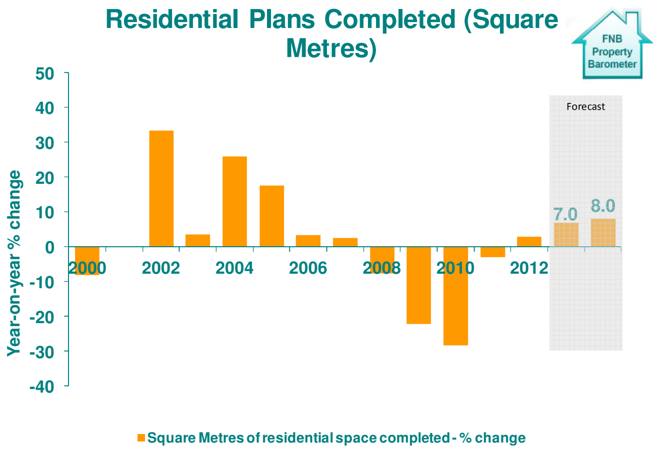
With building plans passed having grown by an even more impressive 14.6% year-on-year for the 1st half of 2013, the signals are for still better completions growth in the near term. We therefore project better building completions growth for the year 2013 as a whole, i.e. 7%, and a further improvement to 8% in 2014. While improved, such forecast growth rates remain moderate compared to the period 2002-2005, but that reflects the constrained economic times that we live in. The South African economy currently battles to grow at 2%, and there seems little prospect for further interest rate stimulus from the SARB in the near term.

Nevertheless, our forecast is for an improvement, and this may just in part alleviate existing residential stock constraints, thereby containing real house price growth. This could mean that another longer term trend could resume, i.e. real house price decline, which begun in 2008 but has stalled in 2012/13. We remain of the opinion that real house prices are due for further decline in the current "super-cycle", being high by recorded history standards, and higher levels of new development would contribute to that possibility.

But despite the recent increase in building activity, the figures still reflect significant longer term affordability issues that have to be addressed. These affordability issues come in the form growing urban land and infrastructure scarcity over the long term, and sharply rising housing related costs such as municipal rates and utilities tariffs. Therefore, despite slightly better times for overall building activity, building stats continue to show a broad trend towards smaller average size of building completed, and an increase in the percentage of homes that are flats and townhouses, the more land efficient category. FNB's own building data also points to long term declines in average residential building size, as well as in average full title stand sizes, while many of the frills such as swimming pools, domestic workers' quarters and even garages are becoming scarcer.

Therefore, looking ahead, measures to improve housing affordability won't just be about declines in real values of homes over time. Growing land and infrastructure scarcity around major urban areas would suggest the need for some real house price increase in the very long term (when looking past the current super-cycle) Therefore, part of the "affordability adjustment" in 2013/14 is expected to be further decline in the average size of newly completed homes, a further rise in the percentage of total completions of the flats and townhouses component, and further decline in the average full title stand size. More densification is the future of South African cities, a "mega-trend" that started back in the 1970s and looks set to continue.





1. HEIGHTENED BUILDING ACTIVITY REFLECTS RECENTLY SOLID EXISTING HOUSE PRICE GROWTH, AND A RESULTANT NARROWING IN THE REPLACEMENT COST GAP…..

The recession of 2008/9, which brought about a sharp slowdown in the housing market, resulting in a period of nominal existing house price decline around the time and slow nominal growth thereafter, made it tough for the residential development sector to bring "competitively priced" new housing stock to the market. 2007, the year before the recession, was arguably the heyday for residential development, after some years of rampant existing house price inflation had reduced the housing replacement cost gap (the percentage by which the cost of replacing a house exceeds the existing house price) to virtually zero.

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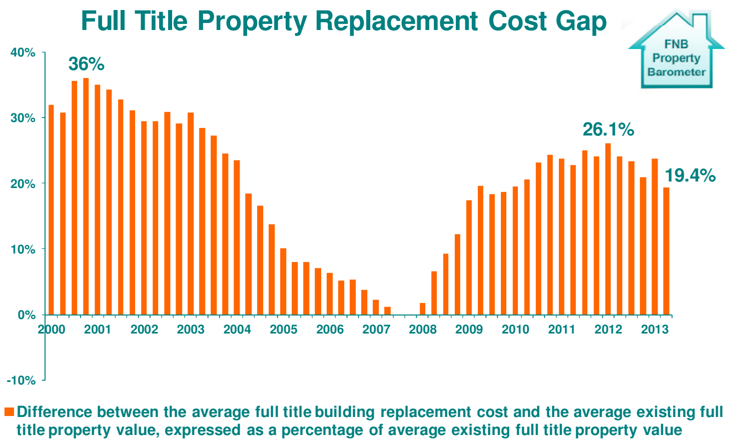
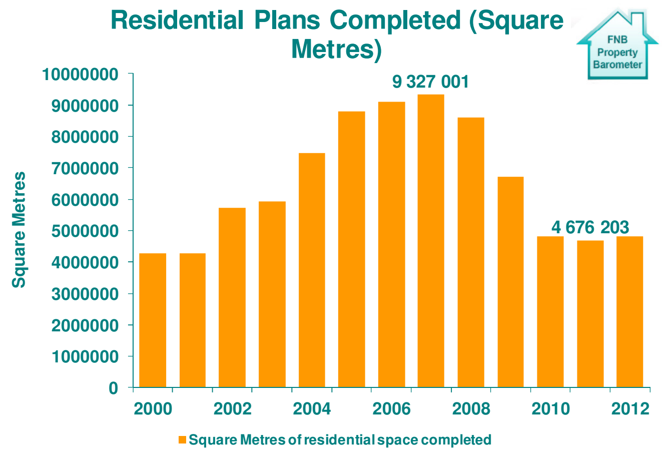
And so, in 2007, StatsSA building stats recorded 9.327 million square metres worth of residential buildings completed, 118.2% up on the pre-building boom 2000 level. Ultimately, though, oversupplies of residential stock would develop in the existing market as interest rates rose from 2006 to 2008, a global recession built up, and residential demand slowed significantly.

From 2007, existing house price declines in 2008/9, very weak price growth thereafter, and for much of that time building costs rising, meant a widening replacement cost gap up until the 1st quarter of 2012 where it reached a very significant 26.1%. Not surprisingly, therefore, from 2008 to 2011, square metres of residential buildings completed dropped spectacularly by -50%. From the development sector's perspective, this was disastrous, but from a residential investment return point of view this was wonderful news, as it would allow residential demand to catch up with oversupplies, improving price performance.

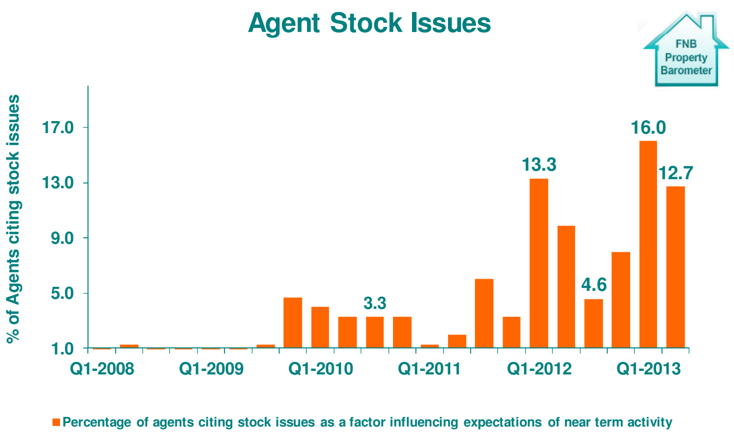


Source: FNB Valuations Database

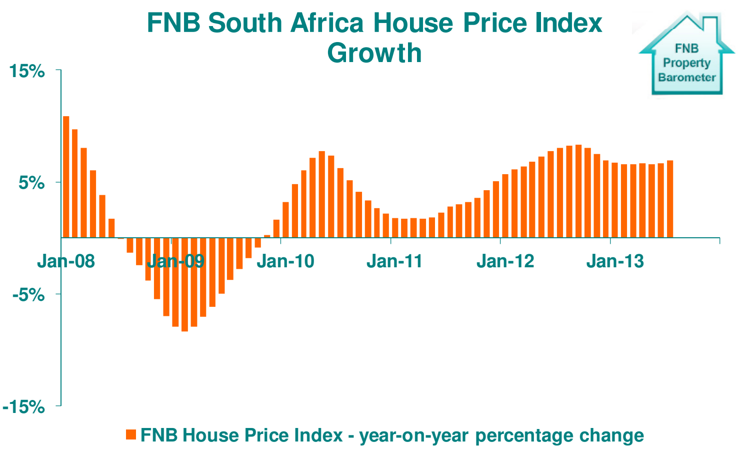


Raw Data Source: StatsSA

Indeed, this is exactly what began to happen. By 2012, an increased percentage of agents surveyed in the FNB Estate Agent Survey began to report stock constraints as an issue in their lives, and existing house price growth improved mildly as a result. This, in part, has contributed to a narrowing in the replacement cost gap since early-2012, to 19.4% by the 2nd quarter of 2013. Not surprisingly, there was a mildly positive growth rate in square metres of residential homes completed to the tune of +2.9% in 2012, the 1st positive growth in 5 years.

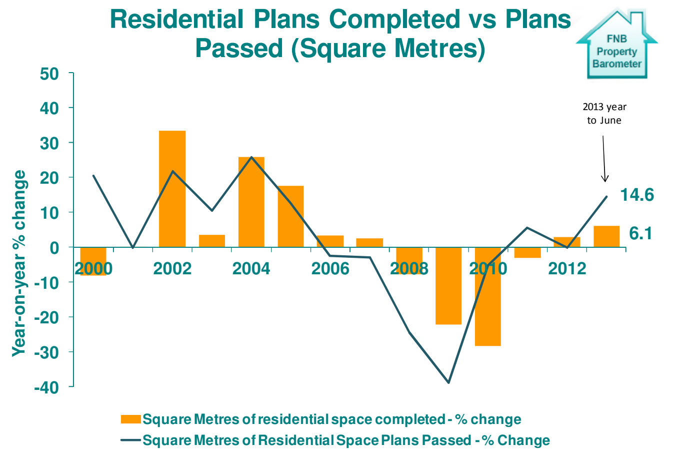


Data Source: FNB Estate Agent Survey



Data Source: FNB

Into 2013, and for the 1st 6 months of 2013, the growth picture was still further improved, with square metres of residential plans completed rising 6.1% year-on-year.



For the 1st 6 months 2013, square metres of residential buildings completed grew year-on-year by +6.1%, and a +14.6% growth rate in building plans passed suggests that in the near term the completions growth could be even stronger.

Data Source: StatsSA

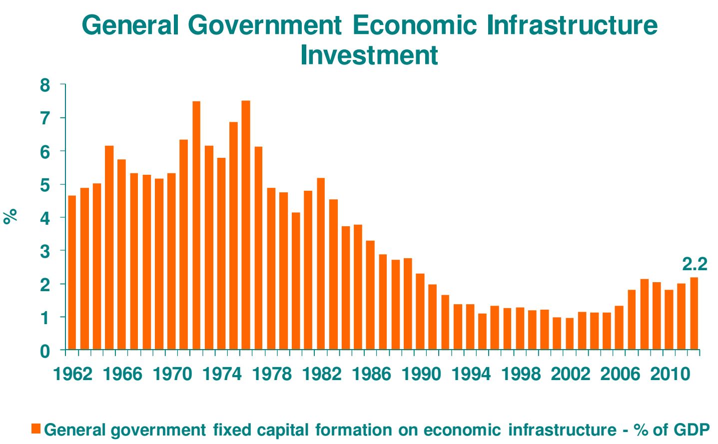
2. BUT, WHILE PROPERTY TIMES ARE RELATIVELY GOOD, THE RESIDENTIAL DEVELOPMENT SECTOR STILL HAS TO ADDRESS LONGER TERM AFFORDABILITY AND SCARCITY CHALLENGES

The return to positive growth in residential building activity also reflects the ability of the development sector to address the much needed housing "affordability drive" through providing more smaller sized residential units. The reality is that the composition of South Africa's housing stock is outdated, with too many of the homes being too large and too expensive to operate.

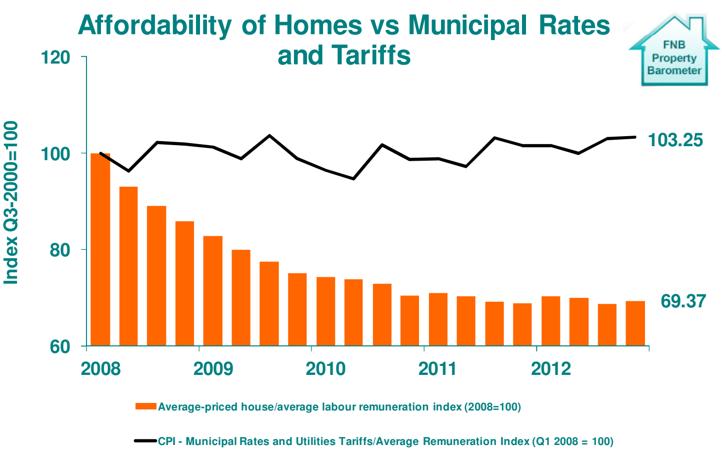
Following a peak in general government fixed investment around 1974, at 7.5% of gross domestic product (GDP), a deterioration in the "internal and external security situation", driven by a deteriorating political environment, along with a deteriorating economy at the time, greatly weakened government finance at various levels. This contributed to a sharp deterioration in general government fixed investment to levels through the late-70s and 1980s. Later on, it was social spending backlogs which became the "bottomless put" for general government finance, while urbanization has exerted more significant pressure on urban infrastructure too. So, even with some improvement in recent years, general government infrastructure investment remains weak having only recovered marginally to 2.2% of GDP, and the pressures on ageing economic infrastructure around major cities is highly visible.

The time has thus come in the last few years, however, to find funding for many of these various expenditure backlogs, and the result has been sharp increases in municipal rates and utilities tariffs, most notably electricity tariffs in recent years.

So, whereas we see that, while the average house price/average employee remuneration ratio (in index for in the graph below) points to an improvement in affordability since 2008, the same cannot be said for the cost of municipal rates and utilities tariffs/average remuneration ratio, whose index has continued to rise since 2008.



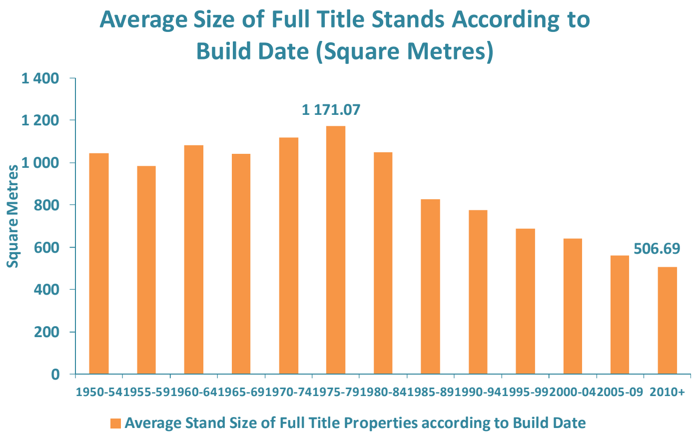
Data Source: SARB

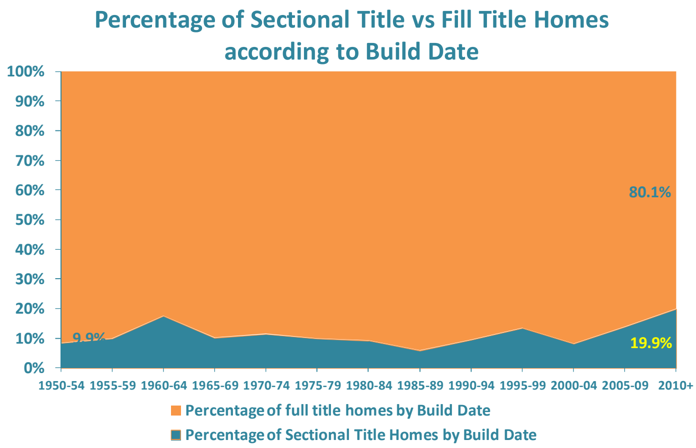


Data Sources: StatsSA/FNB/SARB

A rise in the costs of lack of expansion and upgrades of urban housing-related and transport infrastructure has also created something of an effective land scarcity, and the development sector has been adjusting for many years through reducing the average stand size for new home built, as well as reducing some of the frills. Co-inciding with the general government *infrastructure slump from the late-1970s, the average stand size of full title homes built in the 1975-79 period (according to the many homes that FNB has valued over the past 13 years) peaked at 1171 square metres, but thereafter declined steadily to a mere 506.7 square metres by the period 2010-2012.*

In addition, more recently we have also been seeing a rise in the percentage of homes that are Sectional Title. During the 2010-2012 period, of the homes that FNB has valued, 19.9% of the homes built in this period were Sectional Title. This is significantly higher than the 13.9% recorded in the 2005-09 period.

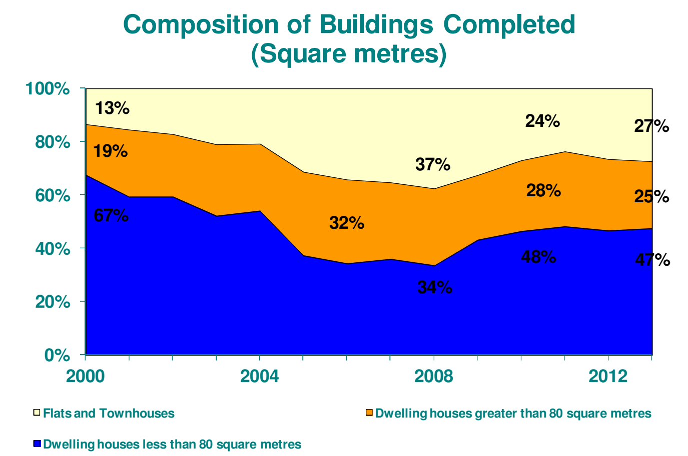


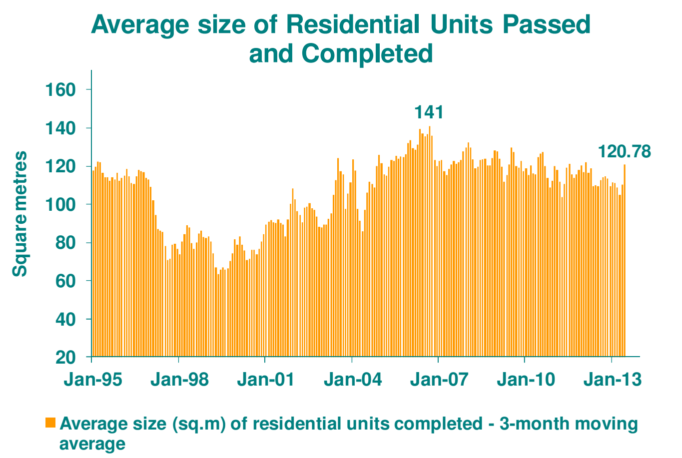


Source: FNB Valuations Database

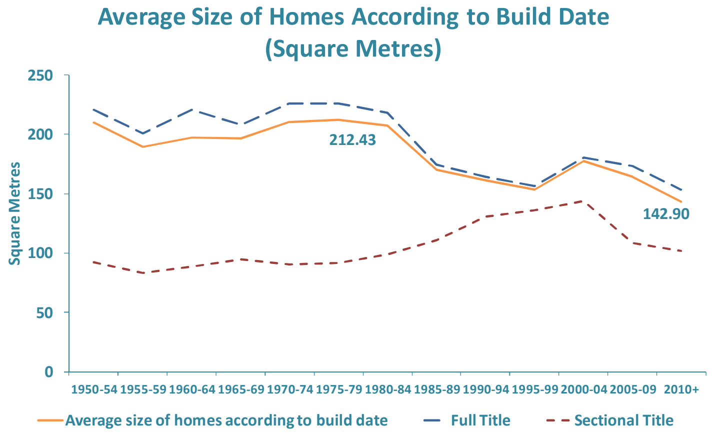
In line with the trend towards a greater percentage of Sectional Title homes, perhaps, the StatsSA Building Stats for the 1st 6 months of 2013 show a further rise in the percentage of properties completed that are "Flats and Townhouses", from 26% in 2012 to 27%.

Since the end of last decade's property boom, we have also seen StatsSA building figures showing a resumption in the decline in the average size of home built. Although somewhat erratic from month to month, the average size of building completed for the 3 months to June 2013 was 120.78 square metres, which is significantly lower than the September 2006 boom time peak average size of 141 square metres. Although the average size actually increased temporarily during the earlier part of last decade as the property boom raged, the post-2006 decline in average size is the resumption of a longer term multi-decade declining trend.





According to our own valuations data (which returns slightly different average sizes to the building stats of StatsSA), after homes built in the 1975 to 79 period averaged 212.43 square metres, there was a broad decline all the way to 142.9 square metres in the 2010 to 2012 period, with a brief stalling in this trend after a rise in average size during the 2000-2004 period.



Source: FNB Valuations Database

And as the building built have become smaller, so many of the "frills" have been disappearing. From a peak of 49.2% of homes built in 1975-79, the percentage of homes with swimming pools has declined to only 9% for those built in the 2010-2012 period, according to the homes that FNB has valued.

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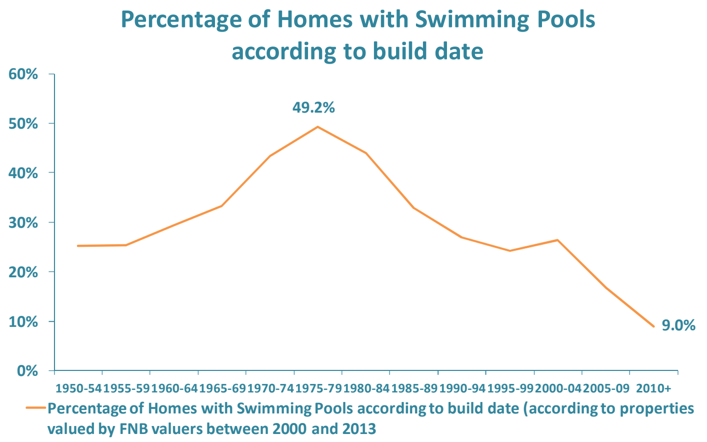

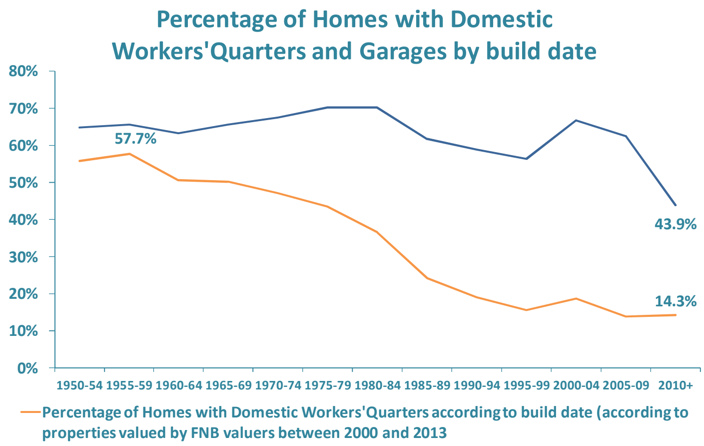

Source: FNB Valuations Database

3. OUTLOOK

Judging by some mounting residential stock constraints in the existing home market, accompanied by a resumption of moderate house price growth in real terms (adjusted for CPI inflation) and a narrowing in the Residential Replacement Cost Gap, the residential building sector has probably been due for a slightly better run.

We therefore project slightly better building completions growth for the year 2013 as a whole, i.e. 7%, and a further improvement to 8% in 2014. While improved, such forecast growth rates remain moderate compared to the period 2002-2005, but that reflects the constrained economic times that we live in. The South African economy currently battles to grow at 2%, and there seems little prospect for further interest rate stimulus from the SARB in the near term.

Nevertheless, our forecast is for an improvement, and this may just in part alleviate existing residential stock constraints, thereby containing real house price growth. This could mean that another longer term trend could resume, i.e. real house price decline, which begun in 2008 but has stalled in 2012/13. We remain of the opinion that real house prices are due for further decline in the current "super-cycle", being high by recorded history standards, and higher levels of new development would contribute to that possibility.

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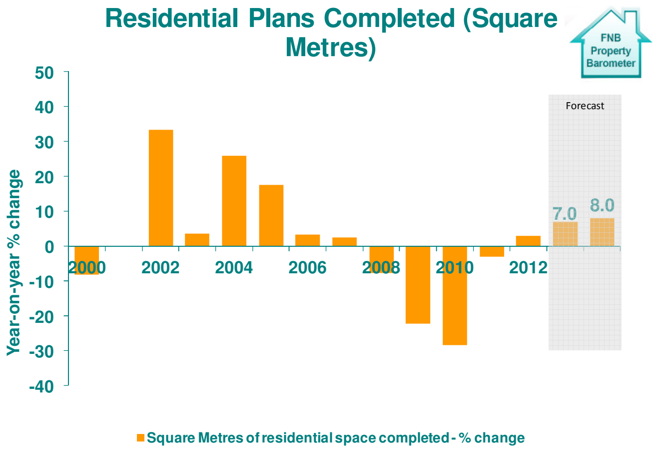
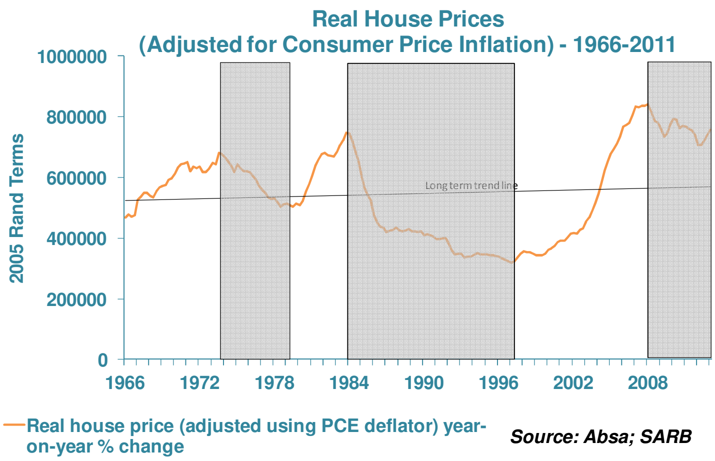


Data source: StatsSA



Data Sources: Absa/SARB