PayProp

RENTAL INDEX

THE STATE OF THE RESIDENTIAL
RENTAL MARKET IN SOUTH AFRICA

INTRODUCING: PROVINCIAL
RENTAL INVESTMENT MATRIX

ANNUAL REVIEW 2016

CELEBRATING 4 YEARS
AND 20 EDITIONS

20

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Something old, something new

INTRODUCTION

To anyone focused on making it in the new year, it's natural to want to put the old one behind us. And while it's been a fair year for rentals and a great one for automation, most people will agree 2016 has a lot to answer for. Still, let's not consign it to history just yet: the year that was holds valuable lessons for us all.

For this reason, as always, PayProp Rental Index 2016 takes great care in cataloguing and analysing the issues that defined the year under review. Drawn from transactional data relating to more than 85,000 active leases on our trust account platform, the Index is the only one of its kind and the market's leading source of rental market information.

But with this Index we're also excited to bring you something completely new – an investment model that further develops and refines our understanding of the rental market, and that we think you'll find useful.

Finally, on a personal note, this will be the last Index that I write. Having knocked out 20 of these, I think it's time to drop the mic! As from the next issue, we have the pleasure of welcoming a new editorial team, headed by Johette Smuts, PayProp SA's new head of data and analytics. Armed with superior analytical skills, Johette will be tasked with making the PayProp Rental Index better, clearer and more useful to the market. I have no doubt that this is exactly what she and the team will accomplish together!

Enjoy our Annual Review 2016.

Regards,
Louw Liebenberg
CEO
PayProp South Africa

The state of the 2016 rental market

ANNUAL REVIEW

Deceptive calm on the national front

Much of the story of 2016 can be told in flat line graphs showing stable growth and little else to get excited about. However, two dynamics spiced things up somewhat, and to us they're the real story.

The first, which we reported on in the Q3 index, was the extent of movement below the apparent calm of three quarters of 6.4% growth. Specifically, we noted the decline of the Northern Cape's dominance in rental values and growth, the resurgence of Limpopo and the migration of high-end tenants from Gauteng to the Western Cape.

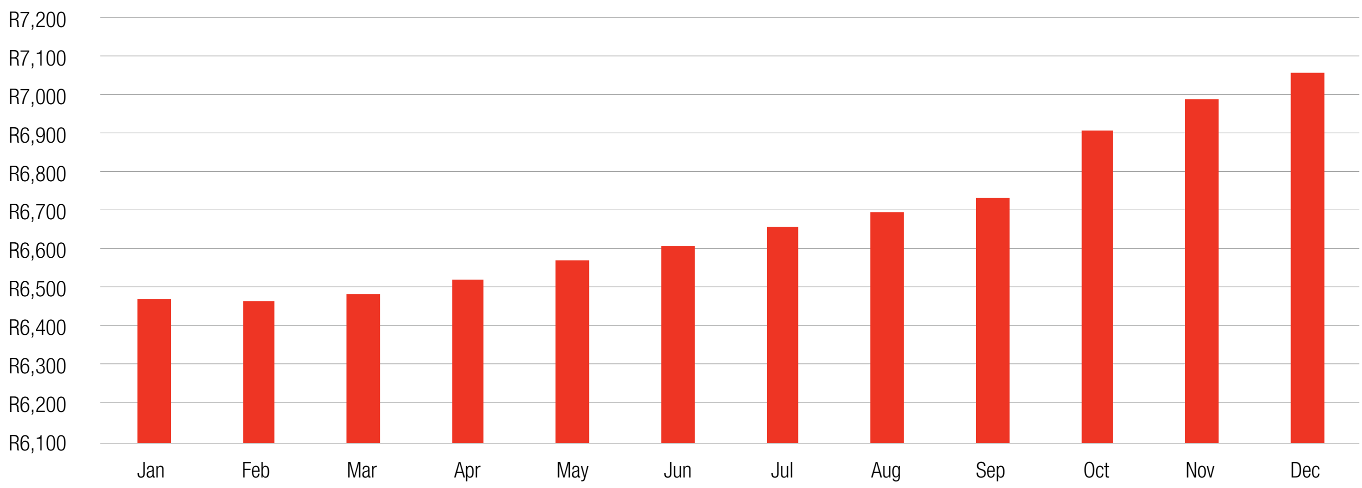
Secondly, the year ended with a surprising spike in fortunes. In the diagram, we see the average South African rent breaching the R7,000 mark for the first time, ending Q4 2016 at R7,062.91. The last leap of this significance was in March 2014, when the national average broke through the R6,000 ceiling to reach R6,005.11.

Needless to say, a similar spike showed up in year-on-year rental growth, taking the Q1 quarterly average of 6.4% to 6.6% in Q4. The highest monthly growth was recorded in December, when rents were 7% higher than 12 months before. This is remarkable, as October and November have historically recorded the highest growth rates.

Changing provincial stakes

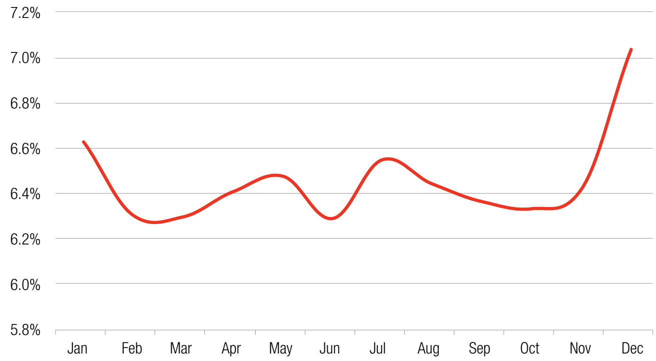
In the last Index, we predicted that the Western Cape would outgrow the Northern Cape by the time of the next edition, and so it was. Rent rises in the Northern Cape continued to decline from a high of 16.74% in Q4 2015 to just 2.11% a year later. The Western Cape, by contrast, improved further still on its steady 9%-plus growth of past months, posting double-digit growth by year-end (10.99%). ▸

The average South African rent breached the R7,000 mark for the first time to end 2016 at R7,062.91.

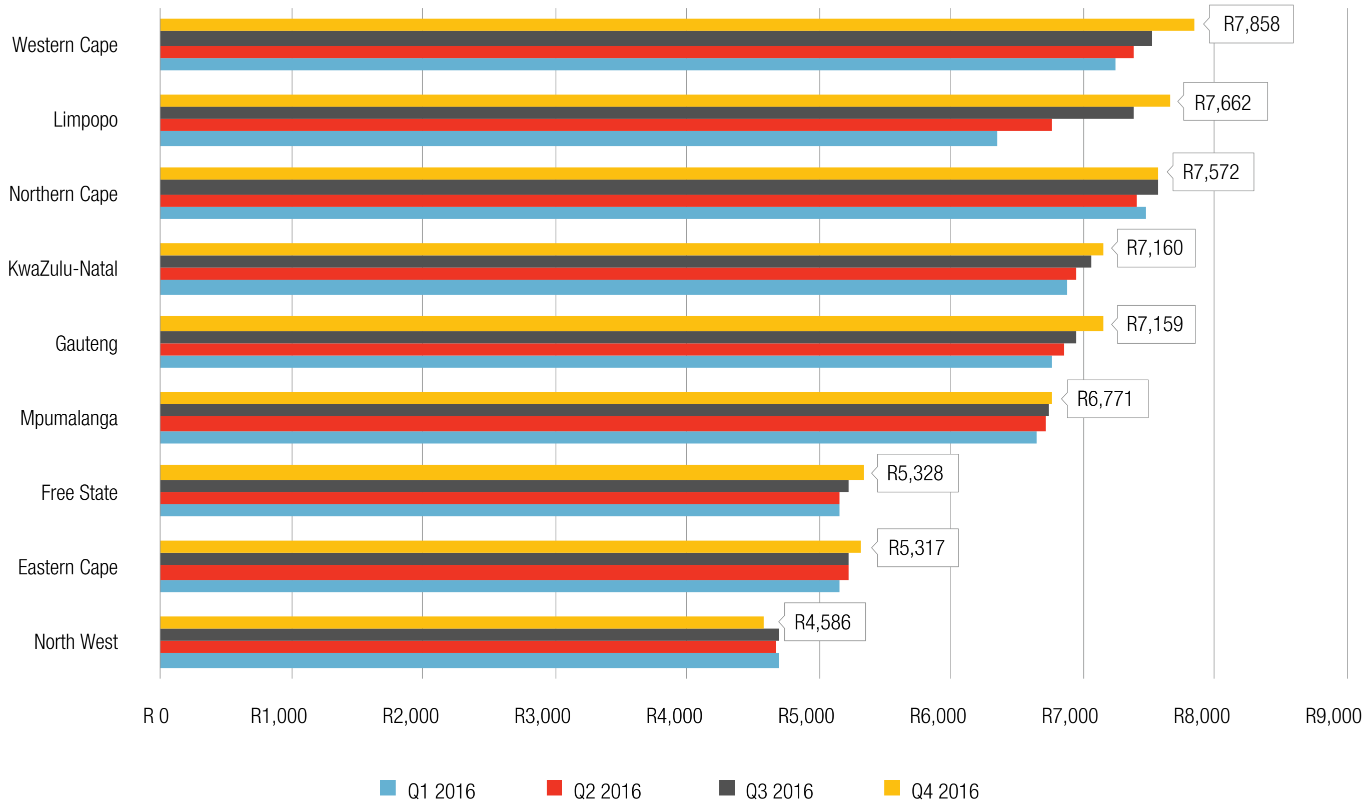


Average national rent
Source: PayProp

▸▸ And what can we say about Limpopo? It continues to surprise us. At the launch of the PayProp Rental Index in 2011 it was the most expensive province to rent in, which was unexpected enough. To our amazement, it retained this position for more than two years as industrial development boomed in the area, pushing up demand for rentals in a region with limited stock. Then, as though a switch had been flipped, it all went away. Construction in the province stopped, mines had strikes and ancillary businesses closed or left, resulting in negative growth rates towards the beginning of 2015. And still this epic hasn't run its course. In 2016, Limpopo dusted itself off and started all over again, producing steady growth, then steadily increasing growth, and finally runaway growth to the point where it currently boasts the country's fastest-growing rents.



Year-on-year growth in average rentals
Source: PayProp



Average provincial rent
Source: PayProp

High demand, high protection

SECURITY DEPOSITS

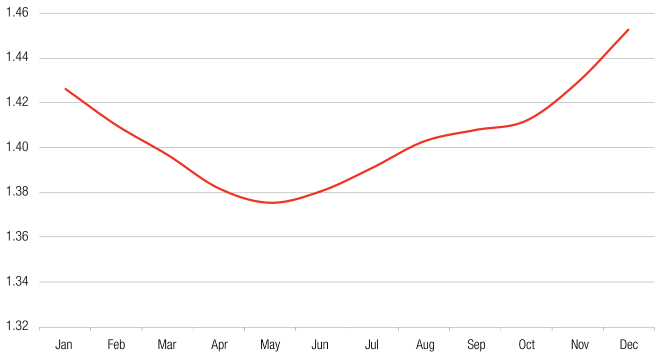
Landlords ask tenants for deposits to safeguard against damage to the property or tenants not keeping up their payment commitments. It's natural to want as much protection as possible, but the amount landlords can demand is limited by affordability (dictated by tenant income and debt commitments).

Looked at in this way, the damage deposit is simply the point at which the expectations of the owner and tenant intersect at any point in time. At the moment, the average damage deposit stands at R10,242.22 or 1.45 times the value of the average rental. Expressed in relation to the value of the rent, it is referred to as the damage deposit ratio.

This figure fluctuated slightly throughout 2016, ending the year just 0.02 higher than what it started the year with (1.43).

Fair is fair

But let's turn our attention to the cause of the upward trend in damage deposits over the last three quarters. As with much of the impetus in the property market at present, it was all down to the Western Cape.



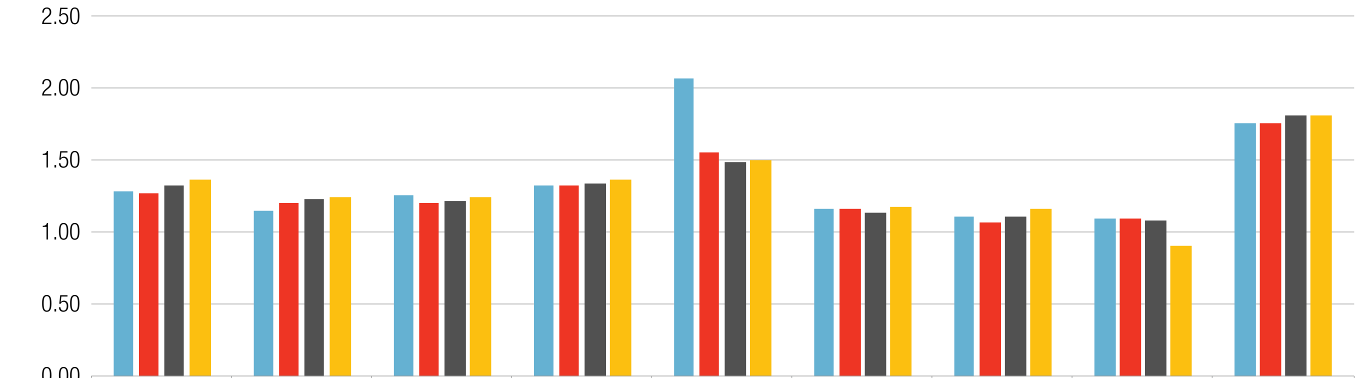
Damage deposit ratio
Source: PayProp

Prospective tenants in the Cape currently pay an average security deposit of R14,222.98 – 1.81 times the value of the average rental. So not only are those lucky enough to live in the fairest Cape paying the country's highest rents and deposits, they're paying proportionally higher damage deposits. It's only fair, we suppose.

But here we should raise the alert: A combination of high-growth rentals and deposit ratios usually signal an increase in demand for rental housing. Capetonians may well be in for even faster rental growth and more eye-watering damage deposit increases.

As we say, landlords become emboldened by demand for their stock in trade, and will take as much as they can get in deposits. Tenants, pressured by competition, will pay, but only up to a point.

Meanwhile, in the Northern Cape, a declining market put the shoe on the other foot, leaving landlords able to extract much lower and dipping deposits.



	Eastern Cape	Free State	Gauteng	KwaZulu-Natal	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Q1 2016	1.28	1.15	1.26	1.32	2.07	1.15	1.10	1.09	1.75
Q2 2016	1.27	1.20	1.21	1.33	1.55	1.15	1.06	1.10	1.76
Q3 2016	1.32	1.23	1.21	1.33	1.49	1.13	1.11	1.08	1.80
Q4 2016	1.37	1.25	1.24	1.36	1.50	1.18	1.16	0.90	1.81

Provincial damage deposit ratios
Source: PayProp

Spreading affluence or fatal ambition?

LUXURY RENTALS

As average rental values grow, it's natural that there will be a migration from lower price categories to higher ones. But usually, the proportional distribution of tenants across the lower, middle and upper brackets tends to stay the same in a stable economy.

In keeping with this observation, we saw a drop in the R2,500 to R5,000 bracket and a marginal increase in the R5,000 to R7,500 band (from 31.5% in Q1 to 31.6% at the end of the year). The next bracket, R7,500 to R10,000, also grew minimally (0.7 basis points from 13.6% to 14.3%) and the R10,000 to R15,000 category grew 0.9 from 9% to 9.9%.

However, the category exceeding R15,000 bucked this trend, making a significant jump from 4.8% to 5.9%.

To sum up, the upper price brackets have been getting bigger while the middle ones have not grown as fast as can be expected.

Why is this? Are we getting richer or dying trying? Sadly, we are mere property geeks and cannot speculate about the economics.

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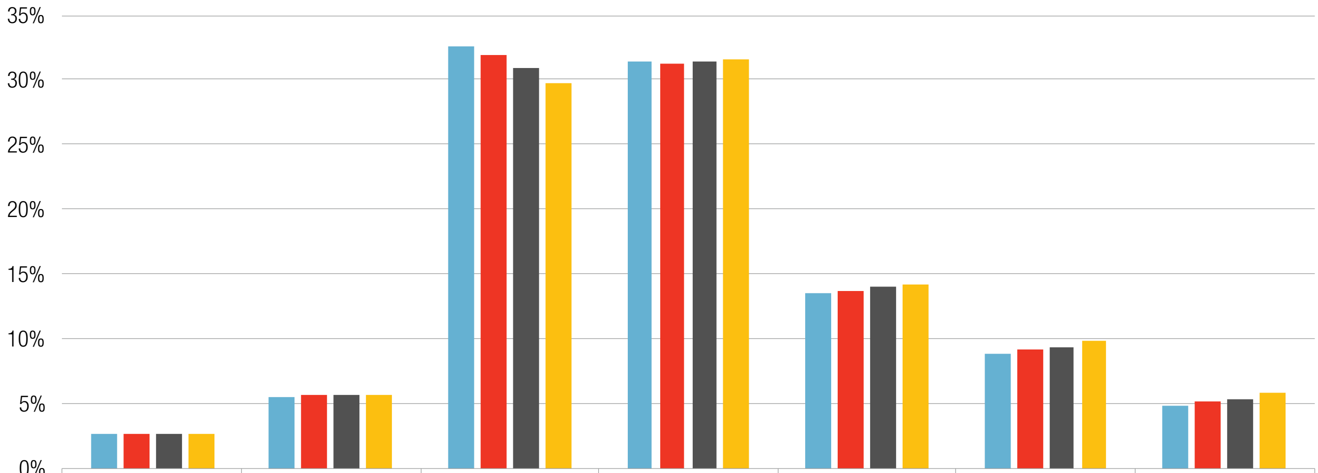


	< R1,000	R1,000 - R2,500	R2,500 - R5,000	R5,000 - R7,500	R7,500 - R10,000	R10,000 - R15,000	> R15,000
Q1 2016	2.8%	5.6%	32.6%	31.5%	13.6%	9.0%	4.8%
Q2 2016	2.7%	5.7%	32.0%	31.3%	13.8%	9.2%	5.2%
Q3 2016	2.7%	5.8%	31.1%	31.5%	14.1%	9.5%	5.4%
Q4 2016	2.7%	5.8%	29.9%	31.6%	14.3%	9.9%	5.9%

Distribution of rentals within price bands

Source: PayProp


Portfolio growth
250K
200K
150K
100K
50K
0K
Jan
Mar
May
Jul
Sep
Nov
15K
10K
5K
0K
Payments received
Commission income
Tenants
11
173
R8,516.10

Work wherever you want.

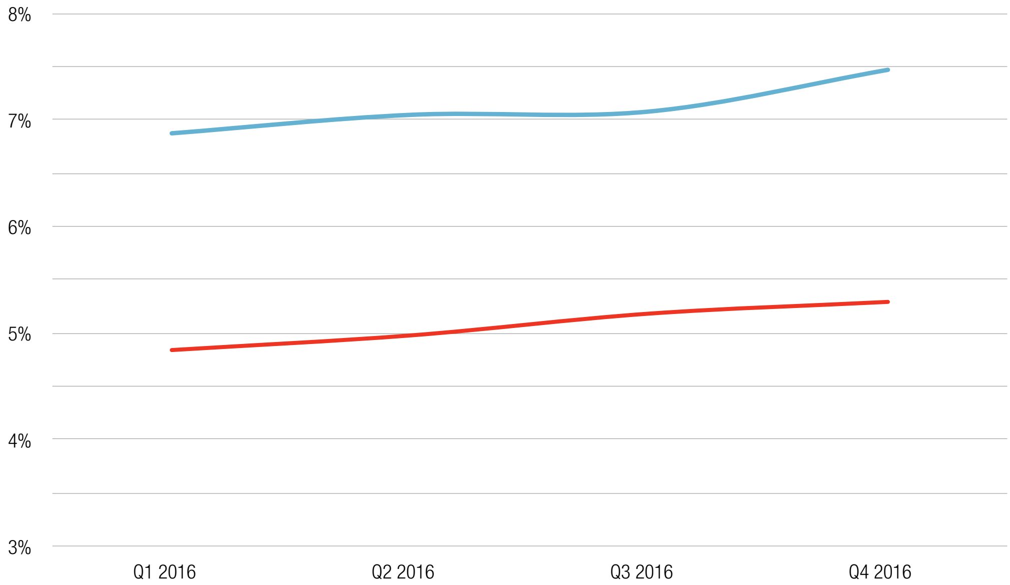
What's in it for owners?

RETURN ON INVESTMENT

When tenants spend more and property values stay the same or even diminish, owners slowly become better off. And indeed, gross yield (rental income relative to property value before expenses) rose from 6.9% at the end of Q1 to a solid 7.5% at year-end. It's been a year since we've seen gross yields above 7%, and it's a welcome relief to note three consecutive quarters of it in one year.

In truth, the growth was partly due to weakening property values – but on the positive side, a low asset value does make it easier for buy-to-let investors to enter the market.

Once costs have been accounted for, net yields for the year still showed growth, reaching 5.3% at year-end. But while gross yields grew by six basis points over the year, net yields only grew by five points, indicating that the cost of owning a property increased marginally faster than the growth of rentals.



National gross and net yields
Source: PayProp

How are tenants doing?

TENANT RISK

It would seem tenants navigated the festive season with caution. There was only a slight increase in the number of store or CPA (Credit Providers Association) accounts and a decline in the number of national loan register (NLR) accounts.

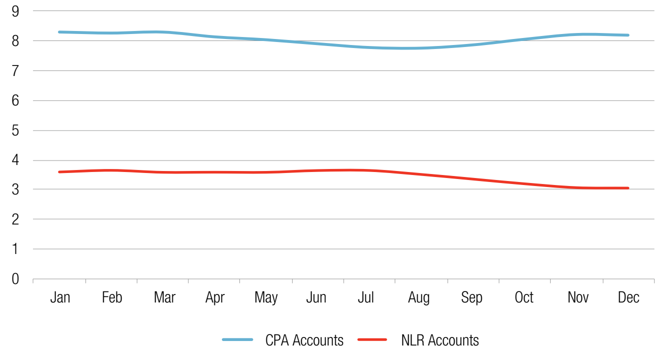
While average declared income remained flat, there was a drop in tenants' debt repayment obligations, from R11,430 per month at the beginning of 2016 to R10,772 at year-end. From spending 37% of their disposable income on debt, tenants brought this figure down to just 35% at year-end.

What's more, they managed to use less of their available credit over time! By the end of Q2, tenants had used up 70% of the credit granted to them. But despite the pressures of the festive season, they achieved the seemingly impossible by settling some of this debt, and ended the year having used only 68% of their available lines of credit.

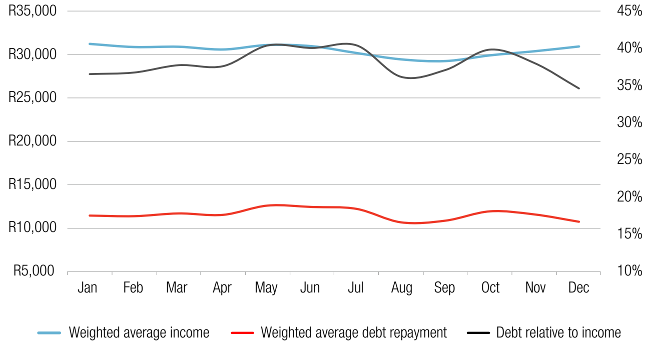
This has meant a decline in the percentage of tenants who are deemed high- and very high-risk. We like this new responsible tenant!

Our data corroborates reports of subdued expenditure over the festive season. Far from discouraging, it's a relief that the goose that lays the golden egg is a survivor. Landlords and agents should be extremely happy about their charges living within their means.

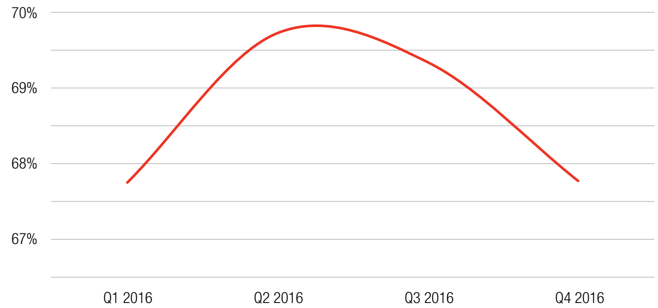
Despite the pressures of the festive season, over-extended consumers achieved the seemingly impossible by settling some of their debt.



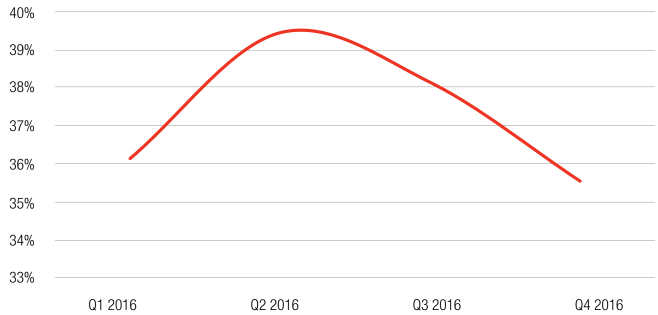
Average number of CPA and NLR accounts
Source: PayProp



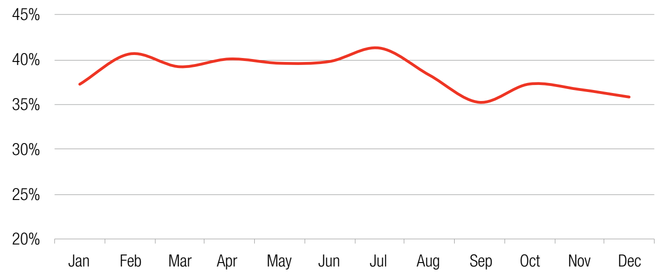
Average income vs average debt repayment
Source: PayProp



Current credit balances as % of maximum credit
Source: PayProp



Percentage high- and very high risk tenants
Source: PayProp



Percentage tenants that had delinquencies
Source: PayProp

But what does all this mean in the grander scheme of things? How, for instance, does growth in one province relate to credit scores in another? Well, we think we may have found a unifying theory.

Based on the fundamental objectives of investment, i.e. to generate the highest possible return at the lowest possible risk, we've developed a rental investment scoring matrix that takes into account provinces' ability to generate a return for owners as well as the level of risk posed by tenants.

For the income component, we scored provinces across four dimensions – average rental value, rental growth, net yield and property appreciation. Points were awarded based on the ranking that a province achieved in each of these categories, and the result added up to give us an indexed income score.

Looking at tenant risk, we tracked average credit score, average percentage of income spent on settling debt commitments, consumption of available credit and percentage of tenants rated as high- and very high-risk.

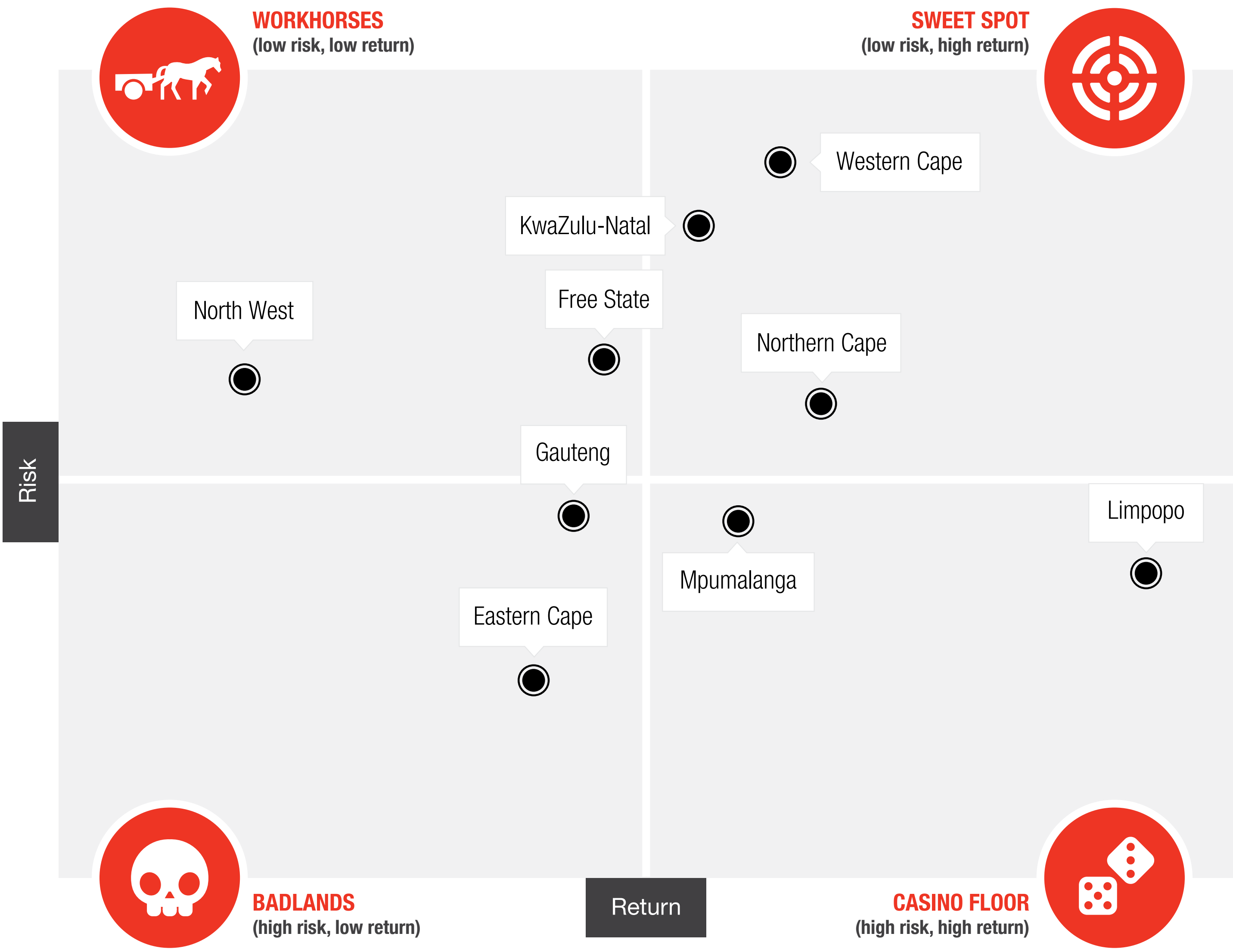
When plotting the income and risk scores for each province on a matrix, a model emerged that is very useful for understanding how the provinces stack up against each other.

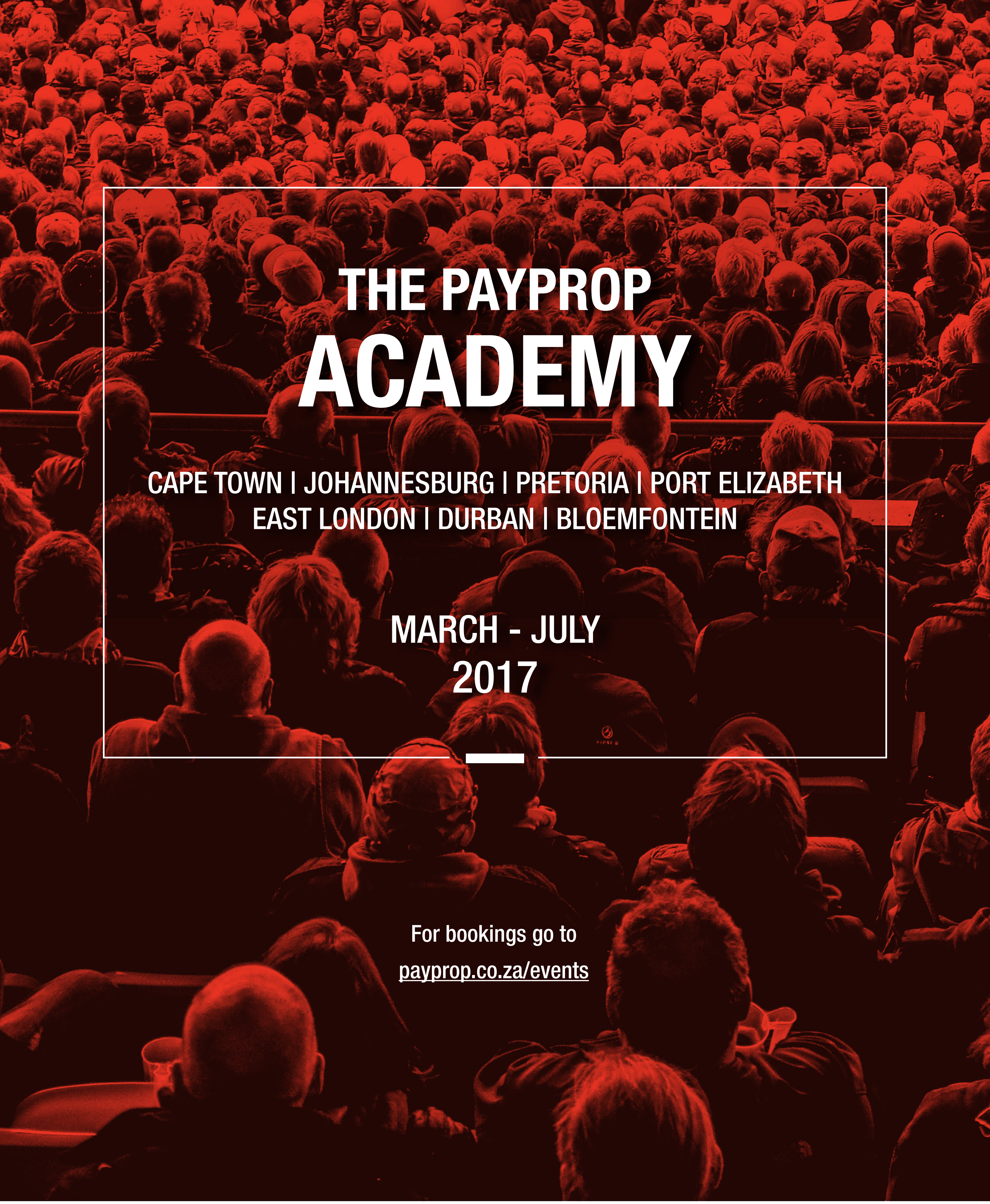
Provincial rental investment matrix

RISK & REWARD

For easy reference the graph is divided into four quadrants, indicating relative investment attraction:

- The Sweet Spot refers to provinces where returns are higher and risk lower than the norm;
- The Workhorses are those provinces where returns are low, but so is the risk, making for an uninspiring but safe investment;
- The Casino Floor is a scary place where the returns look fantastic, but the underlying risk is high, making this a risky but potentially profitable proposition;
- The Badlands are those areas where returns are low and risks high – never a great combination.





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X marks the Sweet Spot

Made up of the Western Cape, the Northern Cape and KZN, this group's attraction speaks for itself. In rental values, these provinces rate first, third and fourth respectively. What's more, Western Cape average rental values grew 10.18% during the year, with KZN rocking 6.28% (the Northern Cape lagged behind the national rate of 6.4% with 5.51%).

But the kicker is these provinces' net yields. Despite its most recent downturn, the Northern Cape still managed to produce a figure of 7.02%. However, we must acknowledge that this was mostly because property prices declined, artificially inflating returns. KZN unfortunately had the same situation, where property prices declined marginally against average rental growth rates.

The Western Cape on the other hand produced a low, yet well-balanced return. The net yield of just 4.47% was balanced by solid growth in property values, pointing to income from both rental and asset appreciation. On the tenancy side, the Western Cape performed by far the best. Tenants boasted the highest credit scores (637), third-lowest level of debt repayments relative to income (36%) and the lowest level of credit consumption (only 65% of available credit by year-end). In addition, the province had by far the lowest percentage of tenants ranked high- and very high-risk, at only 31%.

KZN's second ranking was just as tidily composed, with tenants in this province sporting the second-highest credit scores (632), second-lowest debt proportional to income (35%) and second-lowest credit usage, at only 68%. It also had a fairly low percentage of high- and very high-risk tenants, at 35%.

The Northern Cape ranked significantly lower on the tenant risk side, with fair-to-low credit scores (626), a fair-to-good debt-to-income ratio (39%) and credit usage of just 65%, putting it in joint first place in the country along with the Western Cape. However, 45% of Northern Cape tenants were rated high- and very high-risk.

The Western Cape was therefore our clear overall winner, followed by KZN. In our view the Northern Cape won't be in this quadrant for much longer. Its decline in rentals, if unchecked, will catch up with it and push it into Workhorse territory as rental and property values continue to decline. ▸

In our view the Northern Cape won't be in this quadrant for much longer.

Giddy-up!

▸▸ The Workhorse provinces share the dubious distinction of the country's lowest rentals, with North West at the very bottom, and the Free State just above it.

In the North West, rents have been growing at low rates (2.8%) while property values declined. The drop in prices however pushed yields up to 6.25%, but these are 'hollow' victories based on devaluing assets, not income-producing ones.

The Free State is a different kettle of fish (or should we say kraal of cattle). While rentals are still fairly low and have been growing at an average rate (6.3%) it is the increase in the value of property here that will give this province some momentum to move out of this group. Yields are 5% but we expect this to change in the not-too-distant future.

The North West and Mpumalanga will be in the Workhorse stable for the long haul while the Free State is destined for greener pastures.

What further excites us about the Free State is the substance of its tenants. The Free State tenant managed an average credit score (630), spent just 36% of his income on servicing debt and used up 70% of the credit on offer (fourth lowest). The province's high- and very high-risk tenant cohort made up 45% of the total. This tells us there may be enough grit here to back the launch of this province into the Sweet Spot group.

In a nutshell, we believe the North West and Mpumalanga will be in the Workhorse stable for the long haul while the Free State is destined for greener pastures over the next few quarters. ▸

Winners gamble responsibly

The Casino Floor is certainly an interesting place to be, if not always a particularly comforting one. Smack in the middle of it we find Limpopo and Mpumalanga. Once the darlings of the rental industry, they've since lost much of their sheen, dropping into negative growth territory, only to come back with a bang. Sounds a bit like roulette to us…

For both, all seems well on the surface. Limpopo boasts the country's second-highest average rentals, stratospheric double-digit growth and the highest yield in SA (8%) on the back of property values growing at 4%. Mpumalanga rentals are a far cry from that, coming in sixth overall with growth of just over 2%. But average property prices grew by 6.2%, which is well above the norm. Still, there's the small issue of underlying tenant risk. Limpopo has been ticking all the wrong boxes – its tenants returned the country's lowest credit scores (624), highest debt-to-income ratio and above-average credit consumption (69%). It's a picture of high growth tainted by serious sustainability issues.

Mpumalanga tenants returned equally low credit scores (624) and high levels of credit consumption (73%), but boast a lower percentage of income spent on servicing debt (as their tenants declared the second-highest level of average income).

Our verdict? Both these provinces depend on the continued presence of outsider firms – and we have seen what can happen when businesses pull up their pegs and leave. This is definitely one for investors with a high risk appetite. ▶

Limpopo ticked all the wrong boxes – tenants with the country's lowest credit scores, highest debt-to-income ratio and above-average credit consumption.

Where it helps to be badass

▸▸ It's probably not the most flattering description we could find, but it does shout low returns and high risks like no other moniker. There's no shame in looking elsewhere to put your money, especially since others already doing it are worsening the stampede.

However, the investment profile of the Badlands also means buy-to-let properties can be had for less, making Gauteng and the Eastern Cape the perfect place for never-say-die investors biding their time.

The decline in Gauteng's fortunes has been tracked across various past Indices. Once one of the most expensive provinces to rent in, it attracted only mediocre rents (the fifth-highest in SA). Growth was under 5% per annum, and the net yield was just 4.64% on the back of property value growth of 3%. That's what we call moribund.

Add average tenant credit scores of 629, credit usage of 70% and a flicker of relief in debt-to-income levels (36%), and the picture does not inspire a lot of confidence. Who's to say it won't get worse? However, property being the sought-after, scarce commodity that it is, our feeling is that, over time, there's only one way this can go: up. Timing is the only unknown.

The Eastern Cape is similarly positioned, but for different reasons. It performed badly in average rentals (the lowest in the country), but showed fair annual growth (6.01%) and net yields (5.06%). Property values grew by 2%, which, in conjunction with all the other income metrics, places the province well below the national norm.

The Eastern Cape also underperformed in underlying quality of tenant profiles. Eastern Cape tenants sport credit scores of 624, a high percentage of income spent on servicing debt (41%) and similar levels of credit consumption (70% of available credit), making this a risky regional investment.

Should Gauteng's tenants improve their risk profile, the province could make its way into Workhorse territory. Once there, only time will tell if it has enough in the tank to reach the Sweet Spot. The Eastern Cape, we're afraid, may be staying put for a while yet. ■

Know your tenant

PROVINCIAL BREAKDOWN

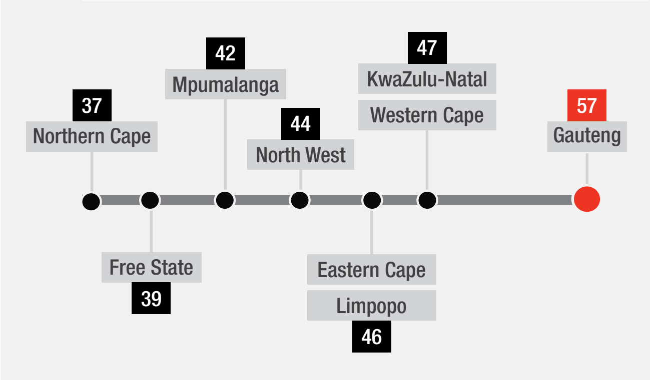
With a fast-growing body of tenant data we were able to delve into provincial specifics and extract valuable decision support for investment across the different regions.

Financial amounts

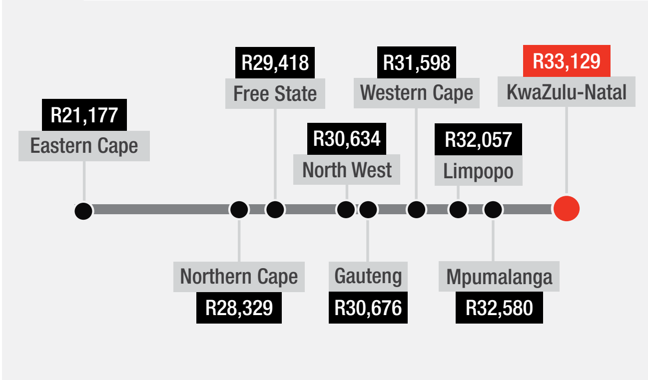
Numeric values

Percentages/ratios

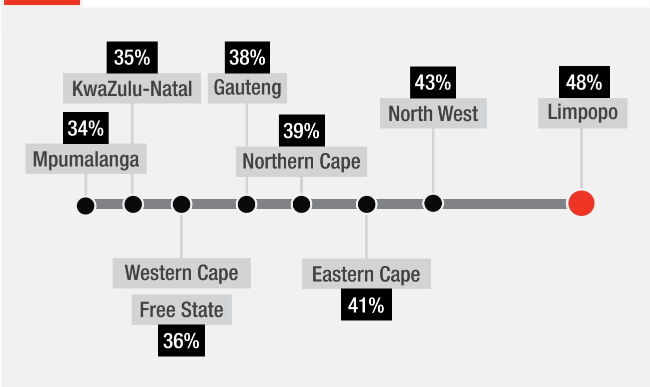
AVERAGE TENANT AGE



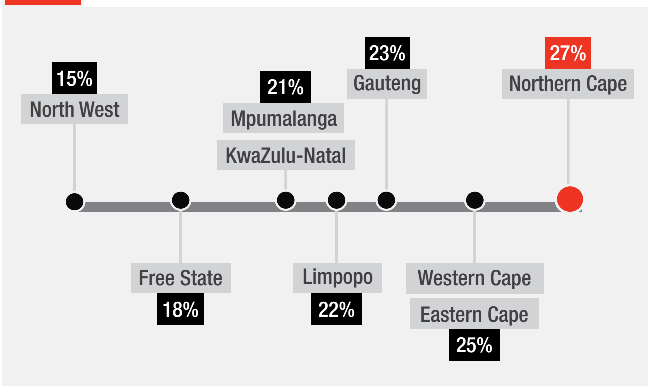
AVERAGE INCOME



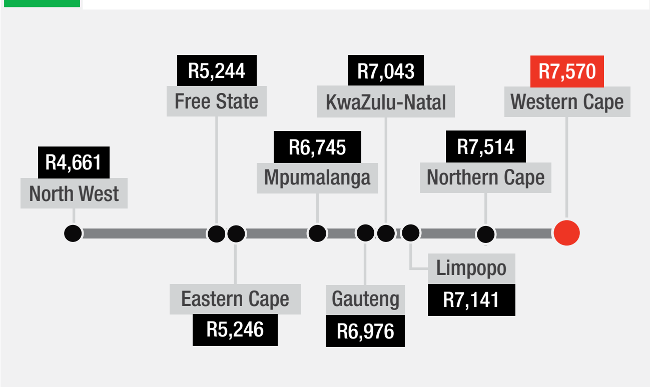
DEBT REPAYMENT RELATIVE TO INCOME



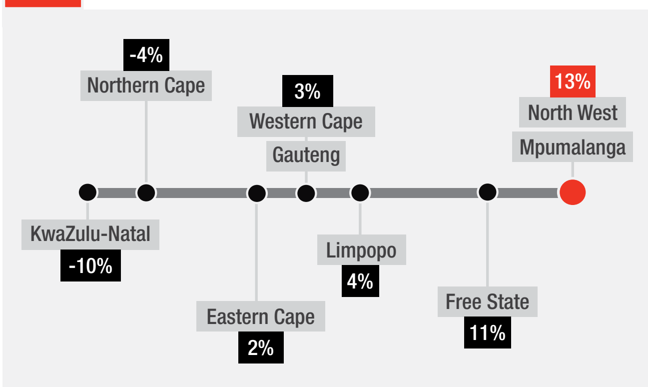
RENT-TO-INCOME RATIO



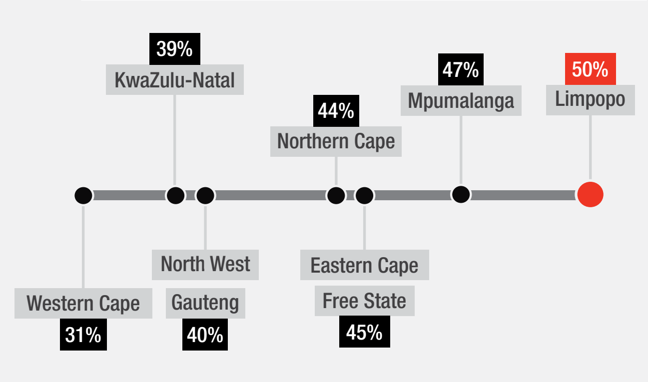
AVERAGE MONTHLY RENT IN 2016



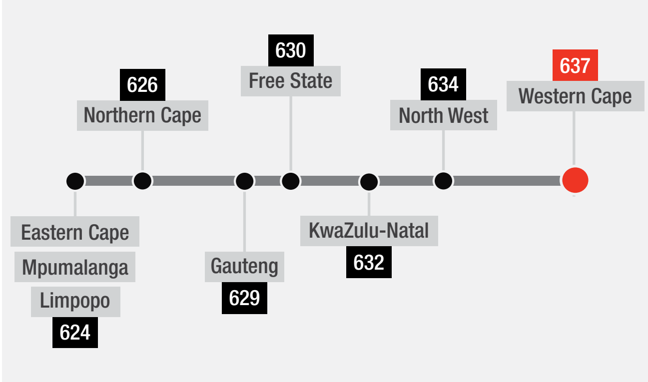
PROPERTY VALUE GROWTH



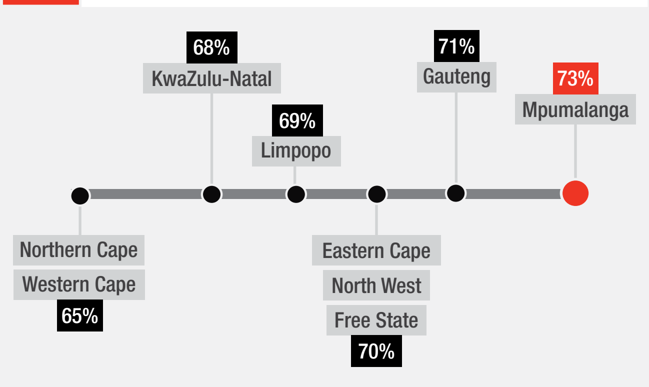
% OF TENANTS WITH MAJOR DELINQUENCY



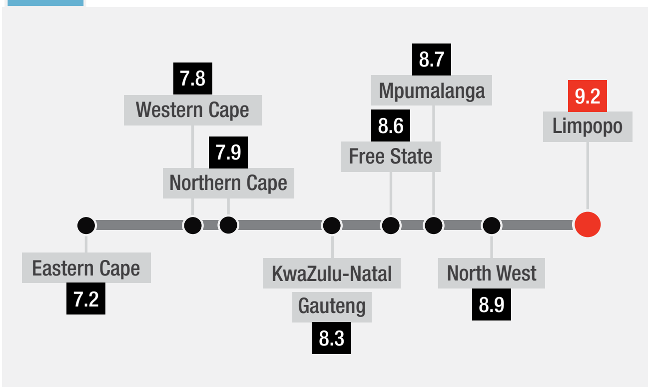
AVERAGE CREDIT SCORE



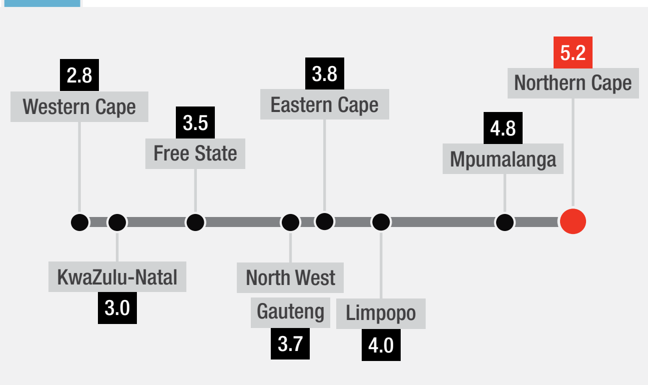
CURRENT USE OF MAXIMUM CREDIT



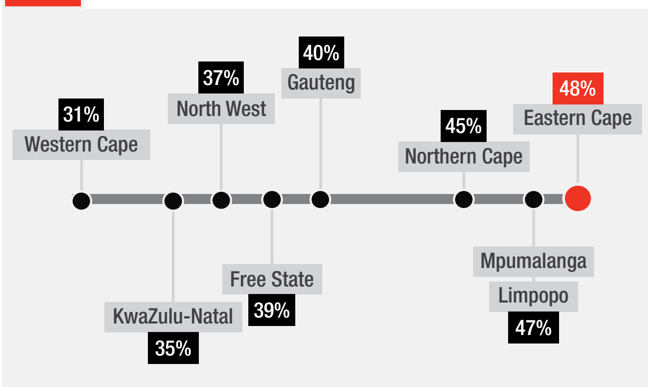
NUMBER OF CPA ACCOUNTS



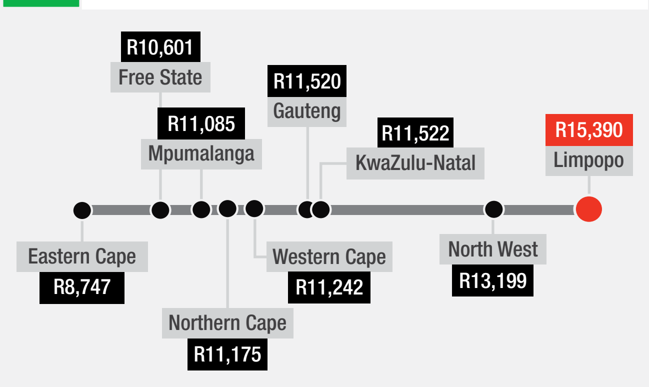
NUMBER OF NLR ACCOUNTS



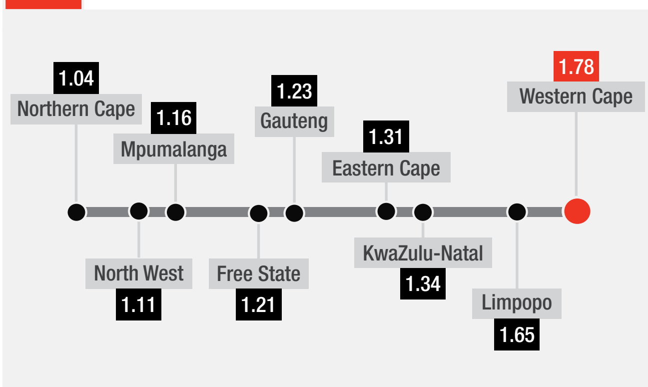
% OF HIGH/VERY HIGH-RISK TENANTS



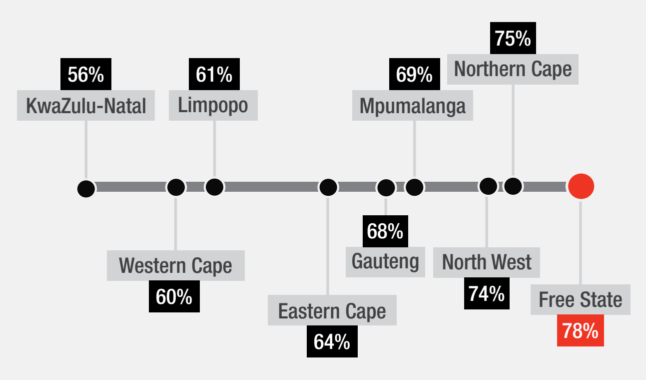
AVERAGE DEBT REPAYMENT



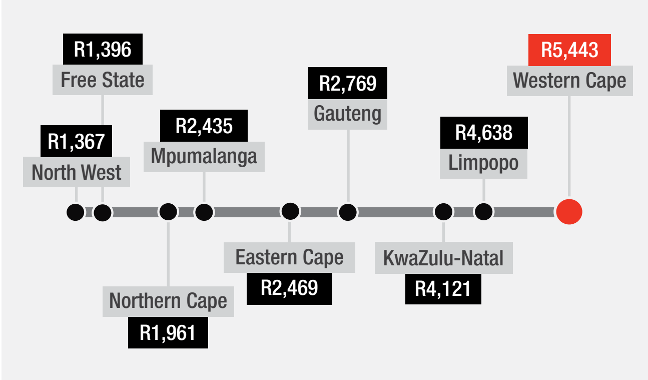
DAMAGE DEPOSIT RATIO



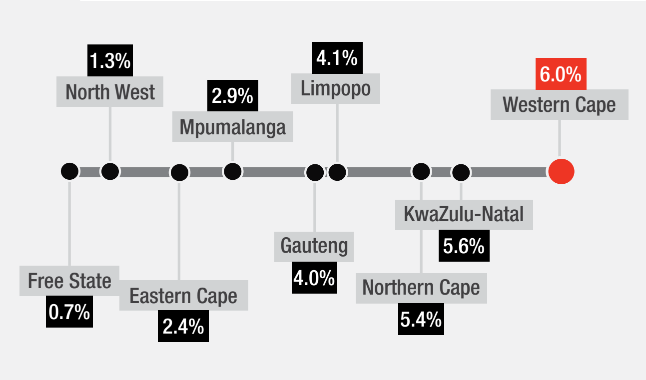
DAMAGE DEPOSIT PAYOUT PERCENTAGE



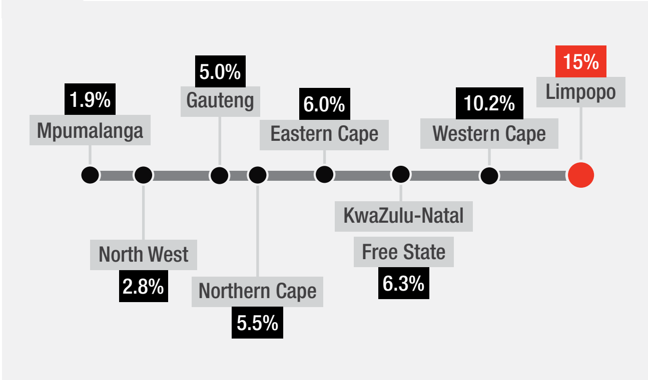
VALUE OF DAMAGES



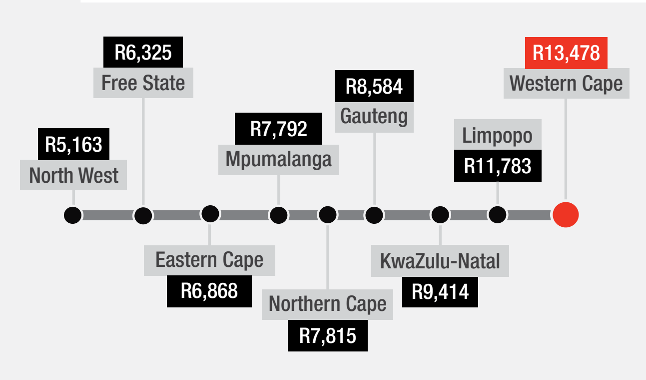
PERCENTAGE OF RENTALS >R15 000



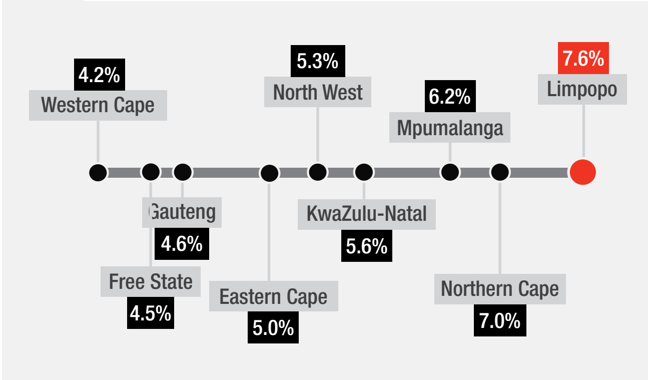
AVERAGE RENTAL GROWTH



DAMAGE DEPOSIT VALUE



NET YIELDS



Roll on, 2017!

MARKET OUTLOOK

They don't call it "hazarding" a guess for nothing, but we'll risk an educated guess about what the year will bring.

1. Tenants, while still under financial pressure, will continue to manage their affairs better as they become more and more aware of the impact of negative credit ratings.
2. Rentals will continue to grow in the 6% to 8% band as consumers do not have enough cash left at the end of the month to afford massive rental increases.
3. The only exception will be the Western Cape, where an increase in demand for letting stock will continue to push up rental prices and damage deposit ratios.
4. The Northern Cape will continue its decline over time as the market fundamentals point downwards – and move its way into the Workhorse category.
5. The Free State is showing signs of growth and will slowly head into the Sweet Spot on the back of solid risk fundamentals and upward growth indicators.

For the rest, it is too close to call. Gauteng may move and Limpopo could fix its fundamental underlying risk metrics – but we won't bet on it just yet.

PayProp Rental Index

The PayProp Rental Index is a quarterly guide outlining trends in the South African residential rental market, and is compiled from transactional data collected by PayProp, the largest processor of residential letting transactions in South Africa. This edition details market conditions for the four quarters of 2016 combined.

Contact details

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The PayProp Rental Index is available from the PayProp website at www.payprop.co.za.

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