PayProp

PayProp Rental Index

Quarter 1 2014

The only comprehensive view of the state of the residential rental market in South Africa

JANUARY - MARCH 2014

Storm clouds still predicted

Our recently published *Annual Review of the Rental Market for 2013* presented a picture of “A pretty good year”, but warned that there may be storm clouds gathering on the horizon.

We concluded with the following five predictions for 2014:

1. Average rental growth will peak at 10% and gradually settle between 8% and 10% as consumer pressure starts to mount.
2. Tenant payment data will deteriorate slightly as the economy tightens.
3. Damage deposit ratios will keep growing despite plummeting affordability, as owners seek protection against tenants ending contracts prematurely, resulting in greater uptake of deposit guarantee products.
4. Property investors will not see yields above 6% this year. Counteracting the growth in rentals, they are also likely to experience an increase in the cost of ownership.
5. Growth in the Northern Cape rental market is likely to be a strong theme in the months ahead, as the combination of industrial development and property scarcity combine to drive up rentals.

Thus far, these predictions have been accurate in almost every respect, as will be clear from each of the headings below. Enjoy this issue of the PayProp Rental Index!

Louw Liebenberg
CEO
PayProp

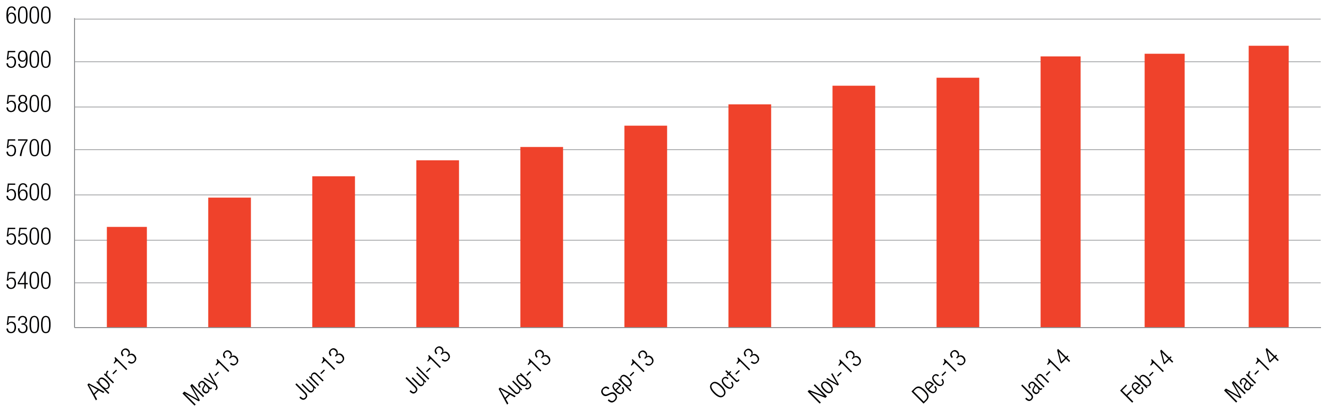
Good, stabilised growth

The weighted average national rental at the end of the first quarter was R5 934 – up from R5 867 at the end of the fourth quarter, 2013. Based on current growth rates, we can reasonably expect this value to exceed R6 000 by the end of the next quarter.

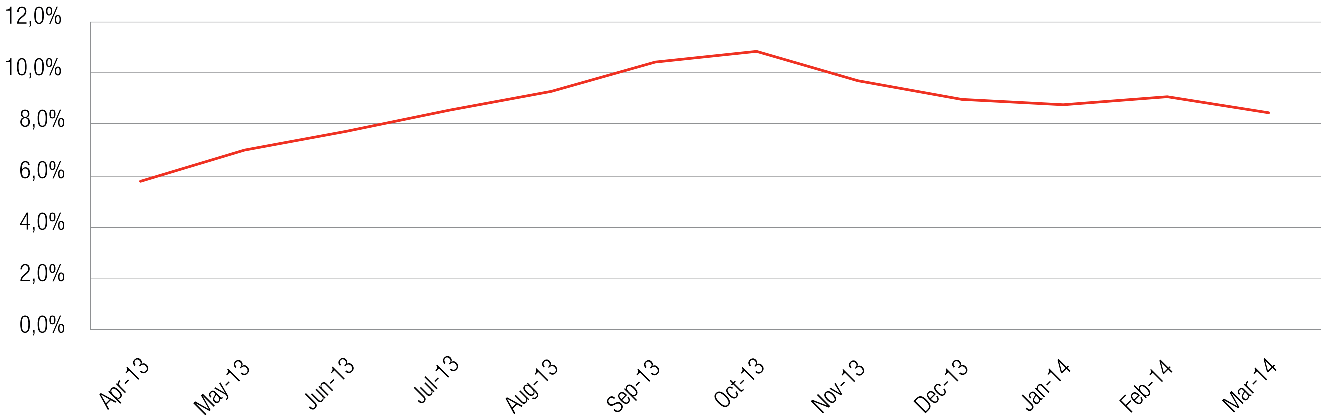
As we predicted, the growth rate peaked at a high of 10.8% in October 2013 and is starting to settle at the 8% to 10% range. When we look at the current 8.4% year-on-year change in March, this is the lowest growth rate in the last nine months and the first time in five months that we see growth below 9%.

To be clear, an 8.4% growth rate is still an impressive number; however, it is our view that this is as good as it will get for the year ahead. Estate agents should see 8% as a realistic increase percentage for landlords who are currently in the market.

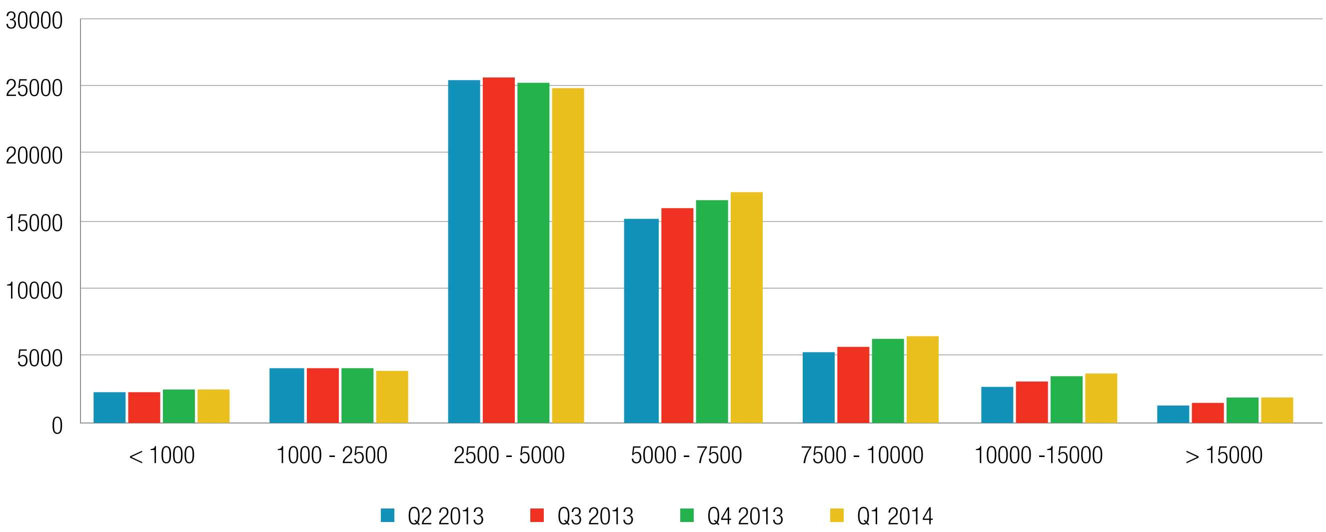
When we look at the price bands underlying the growth it is once again clear that there is a shift, from the R2 500 to R5 000 category into the R5 000 to R7 500 and R10 000 to R15 000 categories. Again it is evident that the increase in the higher categories is greater than the decline in the lower category, which means new leases in the market are coming onto PayProp at higher rates. In fact, if current trends continue over the next two years, we are likely to see fewer leases in the R2 500 to R5 000 band than in the R5 000 to R7 500 range.



Weighted average national rental
Source: PayProp



Year-on-year percentage change in rentals
Source: PayProp



Rentals by price category
Source: PayProp

Sense returns to Limpopo

From our first PayProp Rental Index in December 2011, we were amazed by the extremely high rentals that have been achieved in the area. We were specifically impressed by the town of Lephalale and how it stood as an example of what happens when industrial development comes to an area that does not have adequate rental housing capacity – resulting in off-the-charts rentals when compared to the rest of the country.

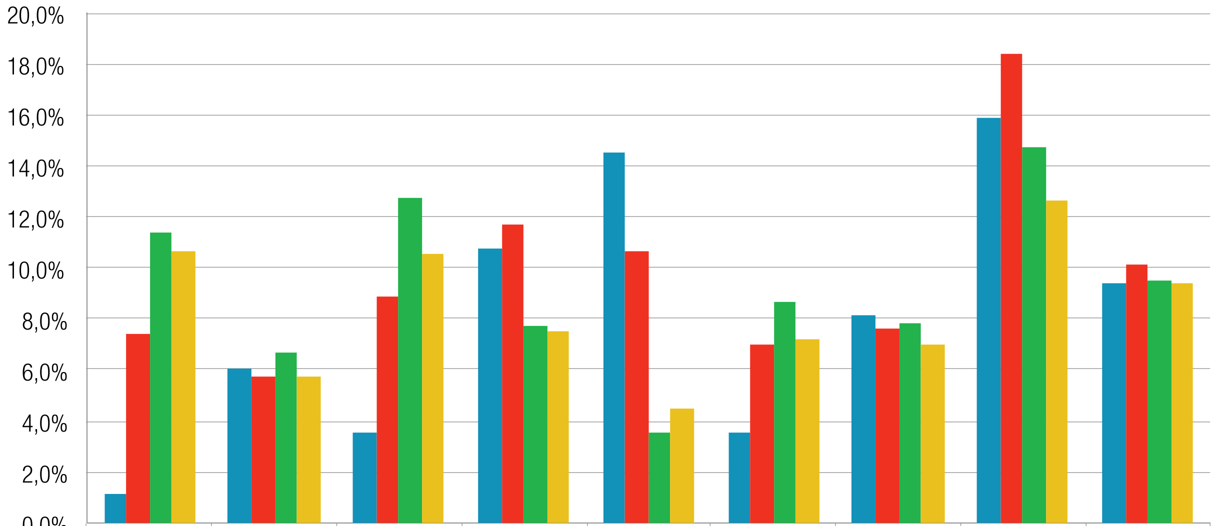
Over time, however, Mpumalanga has started to overtake Limpopo to occupy the no.1 spot, and in the past quarter we saw this happening again.

What is of interest, however, is the velocity at which rentals are growing in the various provinces. When we look at Limpopo from this angle we are seeing the first signs of a slow-down, with growth rates dropping from 14.5% in Q2 2013 to just 4.4% at the end of Q1 2014.

This slow-down is not a sudden occurrence – it has gradually filtered through in each quarter's data since the second quarter of 2013. Even though there was a marginal increase from 3.5% at the end of 2013 to the current 4.4%, the trend as evident in the last 12 months is that of a general slow-down. Our theory is that the market has in all probability corrected itself with an increase in available stock, as a response to the massive gains that were to be had. As a result of the additional rental housing capacity, some of the supply and demand mismatches have been resolved, slowly bringing down growth rates.

Mpumalanga, on the other hand, has kept up a solid growth rate of around 7% on average throughout all three quarters since Q2 2013. With the stability in the growth rate in this province, it could remain in the leading position for at least the remainder of this year. Gauteng is hot on Mpumalanga's heels with the past two quarters' growth rates both measuring more than 10%. However, this province has to make up a lot of ground before its average rental exceeds the R6 765 of Mpumalanga.

Our prediction that the Northern Cape could be the next star performer appears to be spot-on when looking at the initial quarter's results. While growth dropped slightly from 14.8% at the end of last year to the current 12.6%, it is still the fastest-growing province in South Africa for rentals. The one concern we have with regard to the province's ability to sustain this level of growth is the slow-down in property prices in the region, as recorded in the ABSA house price index. According to this index the

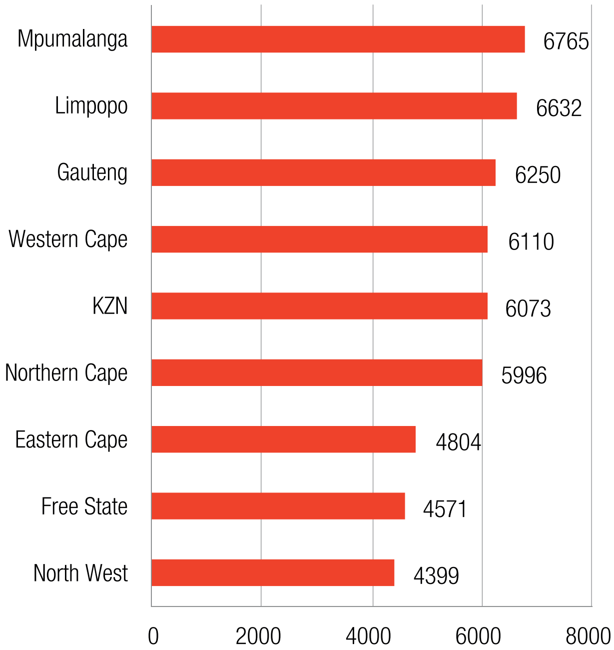


	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Q2 - 2013	1,1%	6,1%	3,6%	10,7%	14,5%	3,6%	8,1%	15,9%	9,4%
Q3 - 2013	7,4%	5,7%	8,9%	11,7%	10,6%	7,0%	7,7%	18,4%	10,2%
Q4 - 2013	11,4%	6,7%	12,7%	7,7%	3,5%	8,7%	7,8%	14,8%	9,5%
Q1 - 2014	10,7%	5,7%	10,5%	7,5%	4,4%	7,2%	7,0%	12,6%	9,4%

Provincial growth rates
Source: PayProp

average price in the Northern Cape dropped from R1 019 759 at the end of Q3 2013 to R936 303 at the end of Q4. This could be an important leading indicator, as we have started to see similar trends in the Limpopo market before the start of the slow-down.

The other province to watch is the Eastern Cape. When we look at the long-term dataset we see a province that has emerged from a negative growth rate in average rental values in 2011 to one now growing at 10.7%. Granted, this growth is from a much smaller-than-average base, with the current average rental standing at R4 808, but nonetheless it is an impressive performance from a province in which the rental market is starting to recover.



Provincial average rentals
Source: PayProp

Top towns

Lephalale once again retains its top spot on the board as the town with the highest rental in South Africa. Lower down on the list there has been minimal movement, with most of the 'usual suspects' retaining their position. There has, however, been a new entry, that of Wierda Valley, with an average monthly rental of R8 837.

Top Towns	2013 Q2	2013 Q3	2013 Q4	2014 Q1
Lephalale	R 15 465	R 16 003	R 19 052	R 19 811
Bryanston	R 24 925	R 22 752	R 16 655	R 16 948
Musina	R 13 356	R 16 523	R 16 052	R 16 621
Sea Point	R 12 246	R 14 645	R 16 332	R 16 249
Umhlanga Rocks	R 12 542	R 13 451	R 14 436	R 12 787
Belfast	R 8 408	R 10 179	R 12 431	R 12 372
Hout Bay	R 12 149	R 12 127	R 11 771	R 11 740
White River	R 8 100	R 8 637	R 10 641	R 10 914
Green Point	R 11 889	R 13 311	R 10 145	R 10 208
Claremont	R 8 733	R 9 080	R 9 567	R 9 925
Hillcrest	R 7 484	R 8 179	R 8 579	R 9 722
Nahoon	R 8 945	R 9 259	R 9 252	R 9 373
Sandton	R 8 713	R 8 331	R 8 403	R 9 252
Wierda Valley	R 8 376	R 8 669	R 8 676	R 8 837

Top towns
Source: PayProp

Okay, we may have missed this one

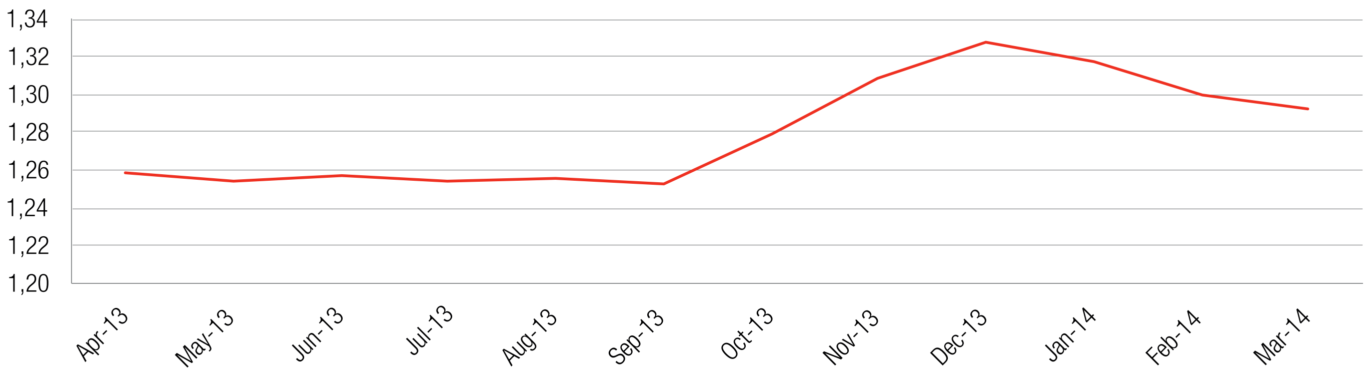
One of our predictions was that damage deposit ratios would continue to grow and that this would result in an increase in the use of deposit replacement products like the PayProp DepositGuarantee. While we were right about the massive increase in consumer uptake of the PayProp DepositGuarantee, we did not expect to see damage deposits as a percentage of monthly rental drop back. To some degree, we admit, we should have seen this coming…

Damage deposits are an interesting figure, as they give an indication of the quantum of capital a landlord can extract from a tenant as security. As such it gives us insight into what is happening in terms of supply and demand in the market. The theory is that it is always in the landlord's best interest to maximise the deposit amount, because it maximises his security. By the same token it is always in the best interest of the tenant to commit as little as possible as it ties up money that could be better used elsewhere. So in a market where there is limited rental stock one would expect to see damage deposit ratios increase when multiple tenants compete for limited stock. We certainly thought so and put it forward as a clear trend at the end of 2013.

However, there seems to be a point where consumers are stretched to such an extent that they simply cannot commit more – and this is what we are starting to see now. The drop has not been massive, just a move from 1.33 times the rental at the end of Q4 2013 to 1.29 times at the end of Q1 2014. However, the consistency of the data over all three months of this quarter shows there is definitely a ceiling to what tenants can afford in the current economy – and we seem to have reached it.

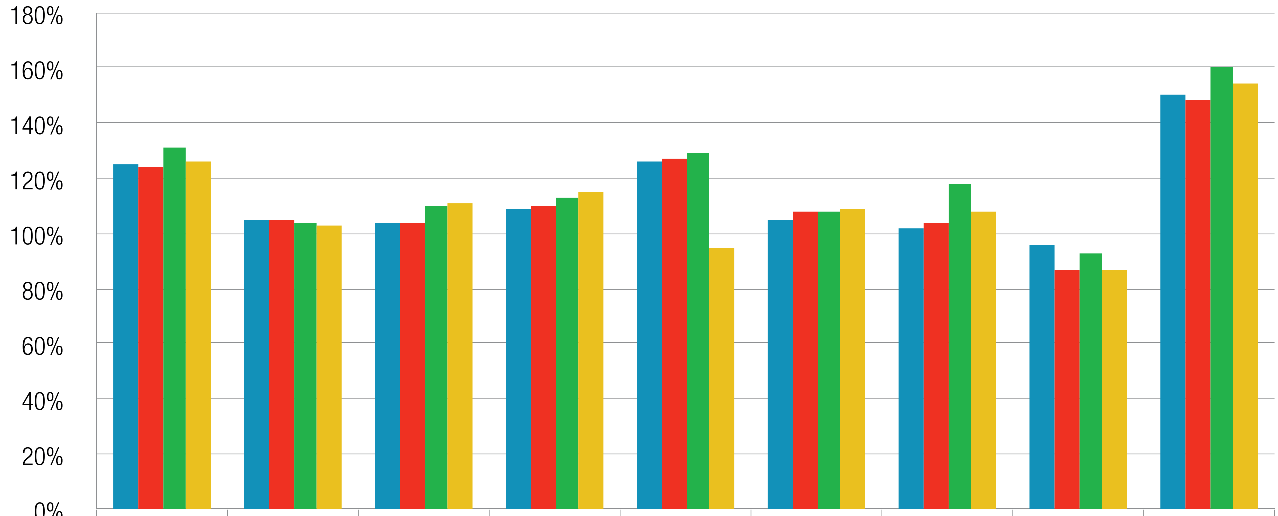
According to Colin Habberton, CEO of PayProp Capital which offers the Deposit Guarantee via PayProp, "From our market feedback, tenants are finding it increasingly difficult to raise increasing amounts of capital to meet demands for higher deposit collateral. In line with international trends, we expect economic circumstances to remain tight for the foreseeable future, which leaves landlords and tenants caught in the stand-off between cover vs. available capital".

The Western Cape is still the province that is able to extract the greatest level of deposits, followed by the Eastern Cape, KZN and Gauteng. Note the drop in Limpopo and the fluctuation in the Northern Cape.



National damage deposit ratio
Source: PayProp

"From our market feedback, tenants are finding it increasingly difficult to raise increasing amounts of capital to meet demands for higher deposit collateral. In line with international trends, we expect economic circumstances to remain tight for the foreseeable future, which leaves landlords and tenants caught in the stand-off between cover vs. available capital."



	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Q2 - 2013	125%	105%	104%	109%	126%	105%	102%	96%	150%
Q3 - 2013	124%	105%	104%	110%	127%	108%	104%	87%	148%
Q4 - 2013	131%	104%	110%	113%	129%	108%	118%	93%	160%
Q1 - 2014	126%	102%	111%	115%	95%	109%	108%	87%	154%

Damage deposit ratios
Source: PayProp

So let's talk about tenants

Our prediction that we will see a deterioration in tenant payment data, as the high rental increase levels towards the end of 2013 were in our view not sustainable, was unfortunately right as well. Quite simply, these increases were not supported by comparable growth in the economy.

In the final quarter of 2013 the Tenant Profile Network (www.tpn.co.za) reported worsening tenant payment performance for residential rentals. The percentage of tenants in good standing dropped from 86% to 85% in the last two quarters of 2013, and there has been a greater deterioration still in the percentage of tenants who have paid their rentals in full. This is likely the result of over-indebtedness. We do not expect this trend to improve in the foreseeable future, as the rental growth rates (although lower than last year) are still well above inflation and occur within an economy that is characterised by increases in essential costs coupled with extremely low growth rates.

Our advice to estate agents is to focus, now more than ever, on screening tenants before entering into lease agreements. Most importantly, they should not only rely on historic credit data of a tenant, but take a more forward-looking view, placing more emphasis on aspects such as affordability.

How are owners doing?

Yields drive the rental market as they represent the expected financial return an owner will get on an annualised basis for his property investment. It is important to take into account that the yield calculation is based on the current purchase price of existing properties and excludes the likely capital gain that owners will experience as their property increases in value over time.

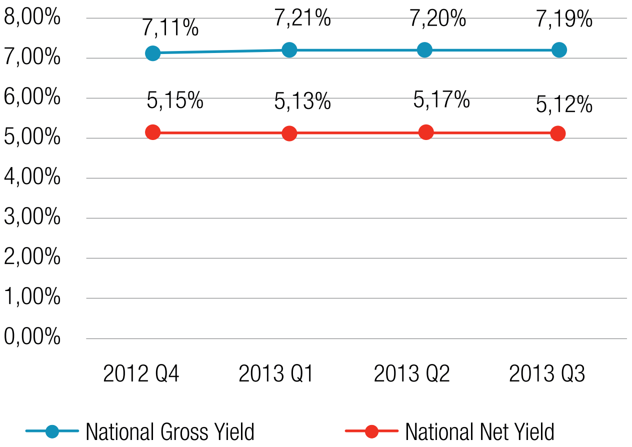
At a national level both gross and net yields have been stable despite the increase in rentals. On the gross yield side, that is because property value growth largely kept pace with rental inflation. On the net yield side, this is because owner expenses also grew in line with the growth in average rental values.

It seems, based on the performance of the first quarter, that we are unlikely to see net yields of above 6%. Our prediction for the year therefore holds true.

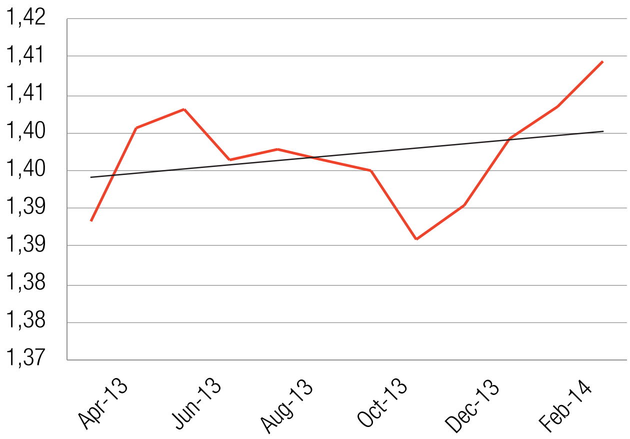
At a provincial level, the gross and net yield data largely mirrors other indicators. The Northern Cape, for example, has taken the top spot as the province that offers the highest gross and net returns in the country. It is followed by Limpopo and Mpumalanga.

Another way to make sense of the yield data is to look at the cost of ownership in each province. What percentage of the rent received is paid out to contractors, agents, municipalities etc. before the owner is paid? What is interesting when one looks at this data is that the high yield provinces (Northern Cape and Limpopo) have the lowest costs of ownership because the rental values achieved are so far above the norm. Conversely, the Free State has the highest cost of ownership because it also has one of the lowest average rentals – therefore fixed costs like rates and taxes, repairs etc. are a greater proportion to the rental received.

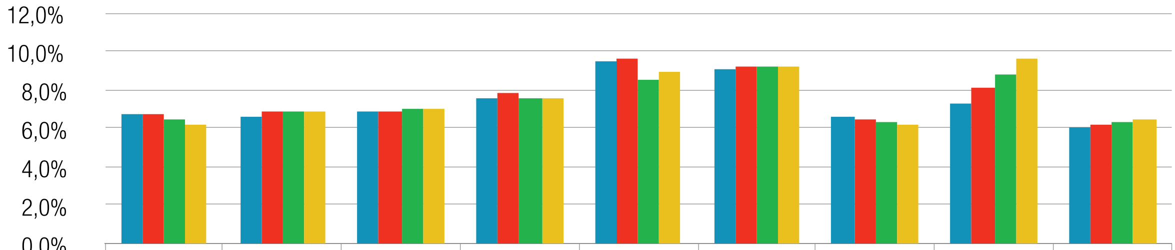
At PayProp we also keep track of the average number of properties linked to each owner on the system. This gives us an indication of the size of the average private investor's portfolio. At the moment, the average investor has a portfolio of 1.4 properties each, up from 1.3 two years ago. While the shift does not at first glance seem significant, it is important to view it in the context of the volume of properties that PayProp deals with. In our full portfolio the difference between 1.3 average properties per owner and 1.4 means there are 3 300 fewer owners required to achieve the same volume of properties. This shows that more and more private property investors are starting to acquire additional investment properties over time.



National gross and net yields
Source: PayProp

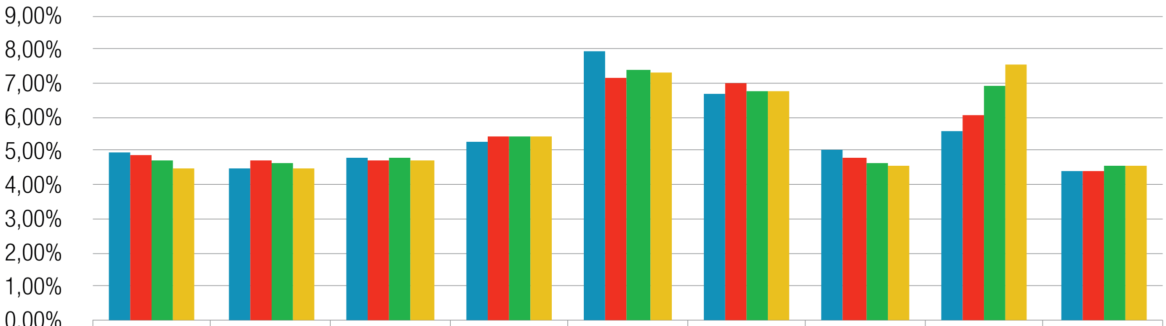


Average properties per owner
Source: PayProp



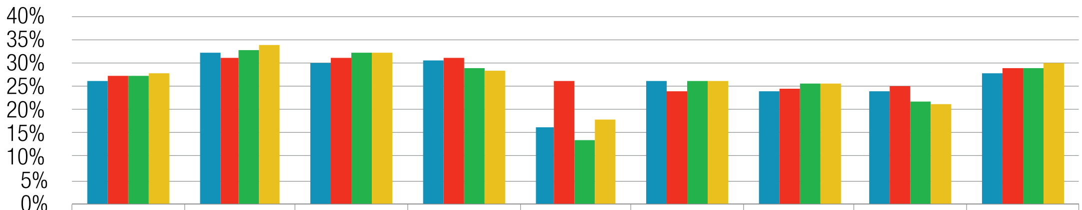
	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Gross yields 2013 Q2	6,7%	6,6%	6,8%	7,6%	9,5%	9,0%	6,6%	7,3%	6,1%
Gross yields 2013 Q3	6,7%	6,8%	6,9%	7,9%	9,6%	9,2%	6,4%	8,1%	6,2%
Gross yields 2013 Q4	6,5%	6,9%	7,1%	7,6%	8,5%	9,2%	6,3%	8,8%	6,4%
Gross yields 2014 Q1	6,2%	6,8%	7,0%	7,6%	8,9%	9,2%	6,2%	9,5%	6,5%

Provincial gross yields
Source: PayProp



	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Net yields 2012 Q4	4,92%	4,46%	4,77%	5,26%	7,97%	6,69%	5,02%	5,59%	4,40%
Net yields 2013 Q1	4,87%	4,70%	4,75%	5,41%	7,13%	7,01%	4,82%	6,04%	4,41%
Net yields 2013 Q2	4,72%	4,66%	4,80%	5,42%	7,40%	6,79%	4,65%	6,89%	4,54%
Net yields 2013 Q3	4,47%	4,51%	4,72%	5,44%	7,34%	6,80%	4,58%	7,55%	4,58%

Provincial net yields
Source: PayProp

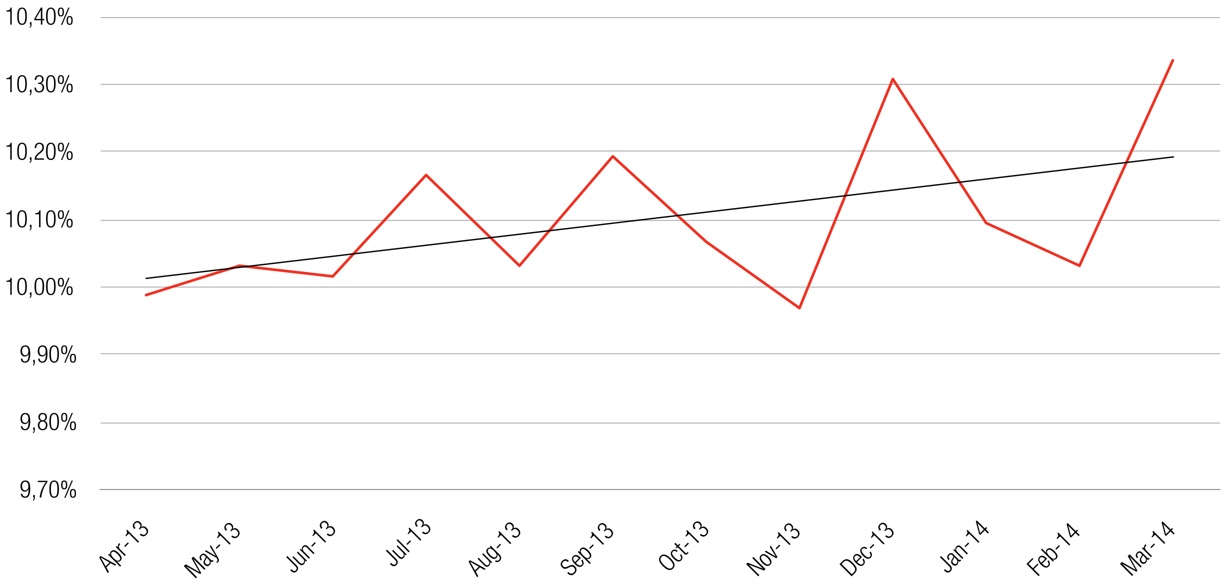


	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Cost of ownership 2012 Q4	26%	32%	30%	30%	16%	26%	24%	24%	28%
Cost of ownership 2013 Q1	27%	31%	31%	31%	26%	24%	25%	25%	29%
Cost of ownership 2013 Q2	27%	32%	32%	29%	13%	26%	26%	22%	29%
Cost of ownership 2013 Q3	28%	34%	32%	28%	18%	26%	26%	21%	30%

Provincial cost of ownership
Source: PayProp

Agents continue to defend their commissions

There was a period when we were concerned that agents were sacrificing their commissions in order to attract more business or buffer declining owner yields. It is encouraging to see that, nationally, estate agents have reversed that trend and have been sticking to their guns over the past twelve months. While there has been limited growth in the number, the long term stability of the 10% commission threshold is important because agents would want to avoid the decline in commissions that they have seen in the sales environment over the past few years.



National average commission
Source: PayProp

In summary

While the rental market is still growing at healthy levels, our caution to the market remains that tenants are under increasing pressure. In this context we feel that estate agents who want to succeed in this market will be the ones who carefully screen their tenants, ensure that tenants can afford the leases they sign for and keep owners informed of trends in the market so that annual increases remain market related.

PayProp Rental Index

The PayProp Rental Index is a quarterly guide on trends in the South African residential rental market, and is compiled from actual transactional data collected by PayProp, the largest processor of residential letting transactions in South Africa. This edition details market conditions for the first quarter of 2014.

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