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Tenant Risk Analysis

Q1 2015

PAYPROP RENTAL INDEX

State of the rental industry at Q1 2015, including a 4-year retrospective

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

JAN - MAR 2015

Q1 2015

PayProp, the largest processor of residential letting transactions in South Africa, first published the PayProp Rental Index in 2011. Since then we have analysed each quarter's performance on an ongoing basis, and published our first annual review in 2013, each time uncovering new insights.

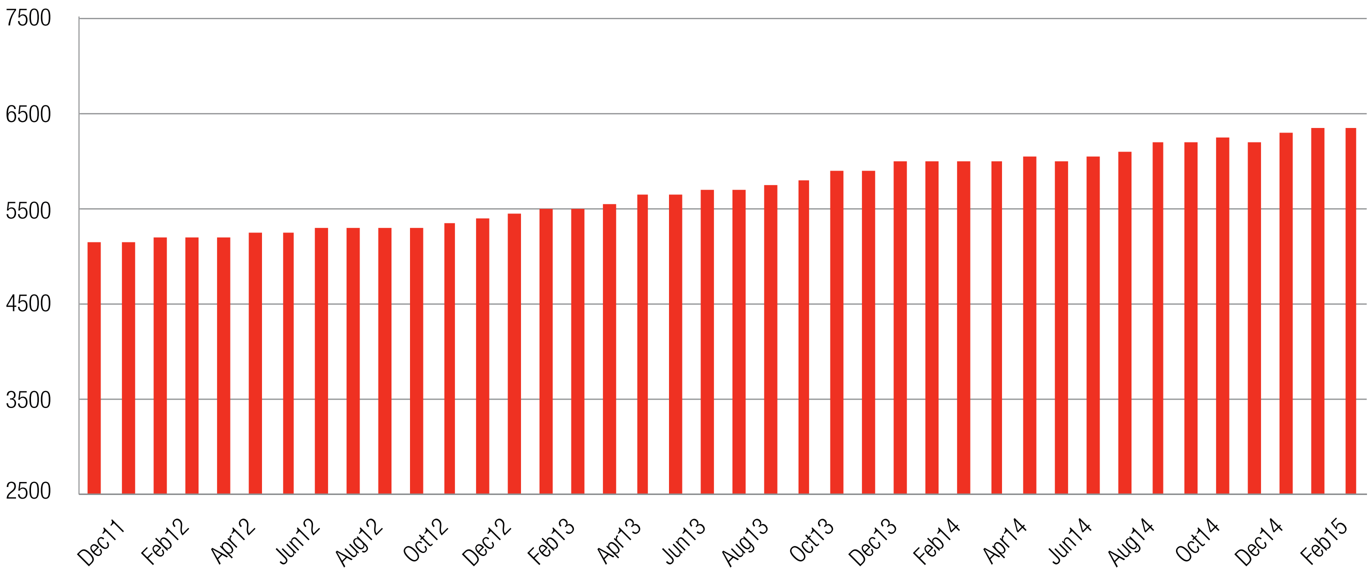
We hope you enjoy this issue.
Louw Liebenberg
CEO: PayProp

THE LONG-TERM CYCLICAL NATURE OF RENTAL INCREASES

Now in its fourth year, the Index draws on a wealth of long-term information that provides much additional scope for analysis. Coinciding with our first quarterly report for 2015, we offer you this four-year retrospective, confirming certain commonly accepted assumptions and uncovering interesting new dynamics.

One of these is the cyclical nature of rental increases. When looking at average rentals (absolute values) over time, there's not all that much to learn. The current national average rental stands at R6 354 and has been on a steady upward curve above the R6 000 mark for exactly one year.

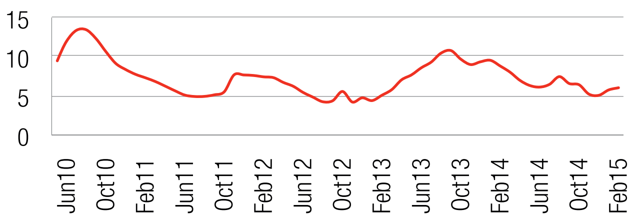
"In the latest quarter it seems as if we have hit an upward turning point at last."



Weighted national average rental
Source: PayProp

However, when looking at the rate at which the average rental increases year-on-year (e.g. April 2015 vs April 2014), we're able to see a number of underlying trends. The first and most obvious is the 2010 Soccer World Cup fever that gripped South Africa at the time, causing a spike (and quick subsequent decrease) in rental growth rates in June 2010.

More importantly, since then the market has fluctuated between fairly long (6 - 12 month) cycles of increasing and decreasing growth. In each cycle, rental growth rates reached a 8% - 10% ceiling, dropping back to 4% - 5% before turning upwards again. In essence, the cyclical swings appear to be a case of the market trying to find a balance between what tenants can pay and what landlords are demanding. As the adage goes, tenants will pay as much as they can afford and landlords will ask for as much as they can get. But this balance is both elusive and dynamic.



Long-term rental growth trend
Source: PayProp

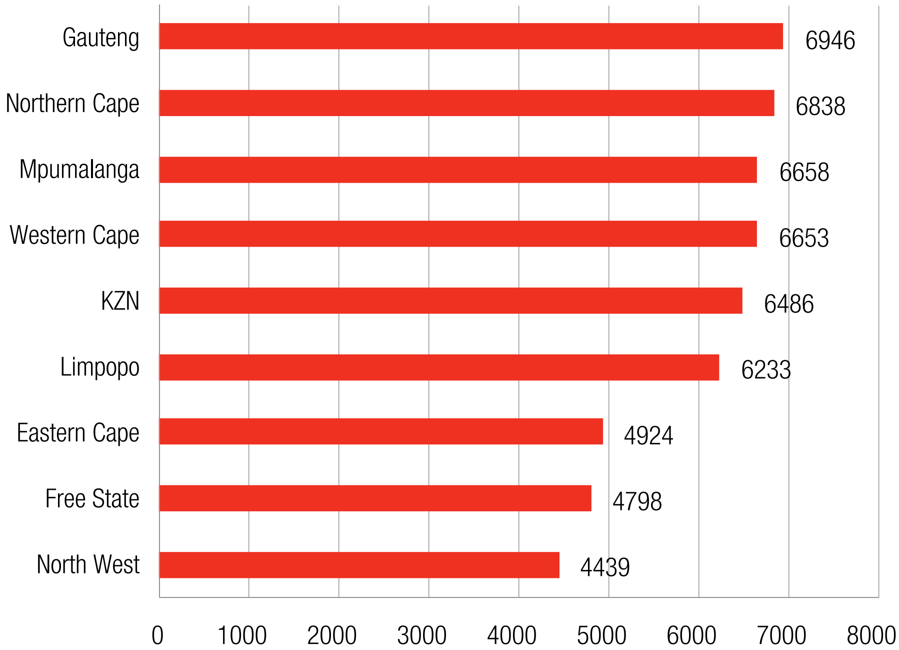
In the latest quarter it seems as if we have hit an upward turning point at last – landlords have been pushing through higher increases for the past six months, even though tenant payment risk appears to have had a dampening effect on the magnitude of increases. Later on in the Index we go into the underlying dynamics causing specific swings over the five-year period in greater detail.

Soberingly, the long term trend-line is not as attractive as one might have hoped. The overall tendency is one of rental increases steadily decreasing over time. ■

PROVINCIAL AVERAGES

Over the past few years we continued to be surprised by the performance of the rental market in provinces like Limpopo and the Northern Cape – consistently among the most expensive provinces to rent in. This has been the result of short-term supply and demand mismatches in those provinces, where rapid industrial expansion has hit smaller towns. It now seems that months of consistent growth has helped Gauteng finally reach the top spot, as we always expected. For five out of the last six quarters, it has recorded rental growth in the 8% - 10% range – bringing the average rental to R6 946 in that province.

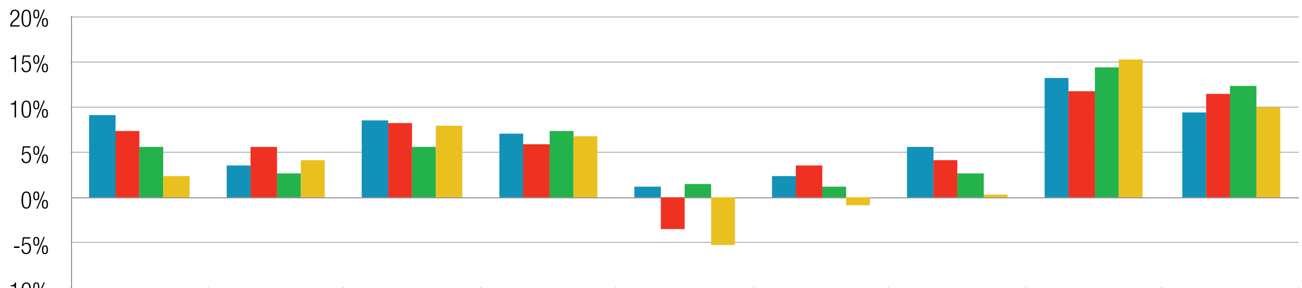
However, based on current growth in the Northern Cape, Gauteng's place at the top is likely to be short-lived. If current conditions hold, the Northern Cape should head the list again by the end of the next quarter.



Provincial average rentals
Source: PayProp

LIMPOPO FLOUNDERS

Once the toast of landlords around the country, Limpopo's growth has not just cooled down, as predicted in previous indices, but actually gone into flat-to-negative territory. We also see the same trend in Mpumalanga, another strong recent contender with 8% - 10% growth rates as recently as 2014. Both these areas re-enforce the notion that the market tends to fix short- to medium-term supply and demand mismatches over time. While we hate to view the glass as half-empty, the logical conclusion is that current growth in the Northern Cape is also likely to normalise over time, as supply catches up with demand. ■



	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
2014 Q2	9%	4%	8%	7%	1%	2%	6%	13%	10%
2014 Q3	7%	6%	8%	6%	-3%	4%	4%	12%	12%
2014 Q4	6%	3%	5%	7%	2%	1%	3%	14%	12%
2015 Q1	2%	4%	8%	7%	-5%	-1%	0%	15%	10%

Provincial growth rates
Source: PayProp

A NEW PERSPECTIVE

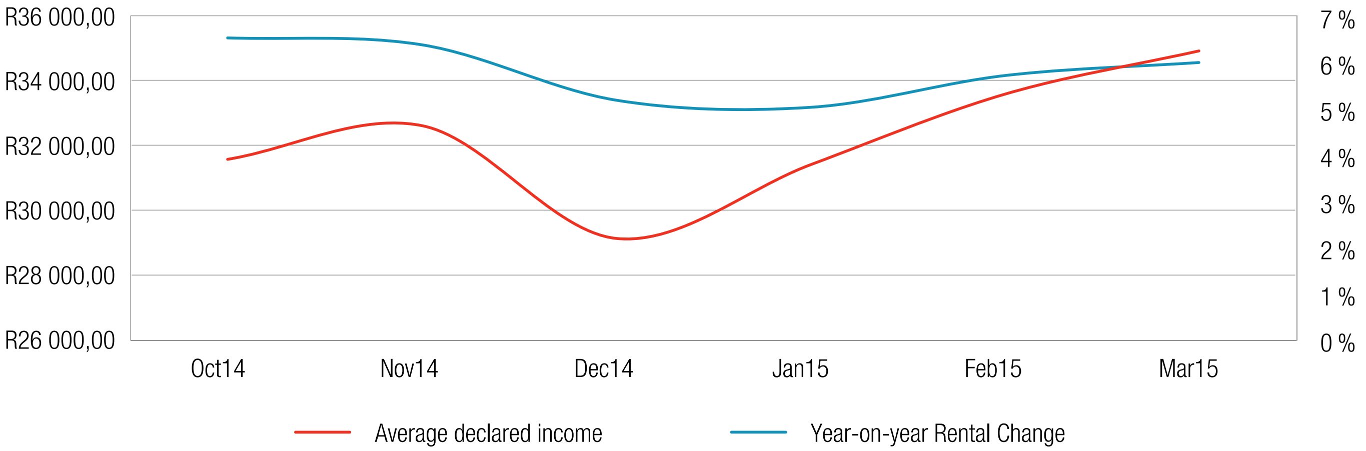
If demand and supply drive rental growth in rapidly expanding areas, what drives growth in other areas? This is where the data coming out of our Tenant Assessment Reports comes into play.

Since September 2014 our sister company, PayProp Capital, has provided our clients with a unique value-added credit check specific to tenancies. The PayProp Tenant Assessment Report is more than just a credit check, as it scores prospective tenants not only on their indebtedness, but also their ability to afford the rent, based on credit history and current levels of debt. Over the past six months, we have processed and analysed scores of data, providing us with a series of additional insights to overlay on our rental data. (While this represents a relatively short time scale, we do have a statistically valid sample, numbering thousands of records.)

The first thing we wanted to understand was the extent to which average declared income influences the pace of rental growth across the provinces. Here, a broad correlation emerges between the dips and rises in rental growth and those evident in the average declared income. Before we get into the provincial detail, there is one other important disclaimer to note. While on a national level we have enough data to draw statistically valid results, at a provincial level we have chosen to exclude the Northern Cape, Limpopo and the Free State in some of the detailed analysis to follow, due to a lack of sufficient tenant data to reach conclusions with confidence.

The chart below shows a linear relationship between rental growth and average income levels. Practically this means that areas with higher income have higher rental growth rates than those with lower incomes.

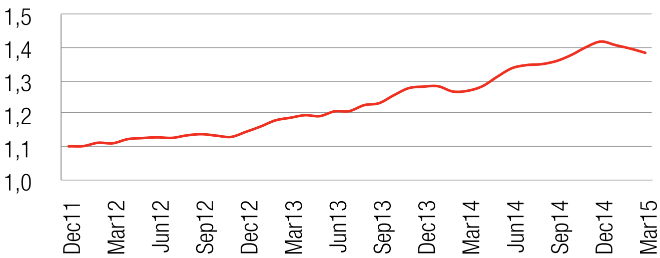
The one exception is Gauteng, where rental growth was marginally lower than the Western Cape in the past quarter, despite its average income being higher. As our data pool grows it would be interesting to monitor this ratio over time. ■



Average income and rental growth
Source: PayProp, PayProp Capital

DAMAGE DEPOSITS

This is the first Index in a while in which we see a decline in the damage deposit ratio (value of damage deposit held, relative to the value of rental invoiced). In fact, it has dropped for each of the three months in this quarter – from 1.42 times the average rental in December 2014 to 1.38 in March 2015.



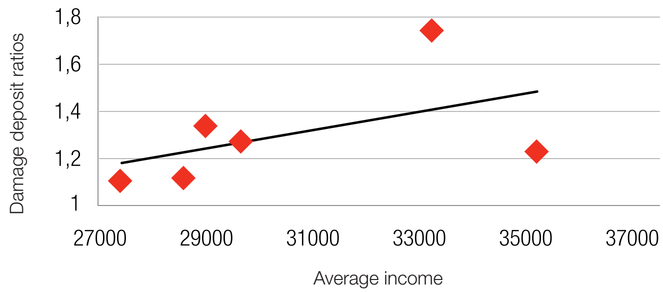
National damage deposit ratio
Source: PayProp

Provincially, the one area that has bucked the national trend is the Western Cape, where damage deposits are 1.75 times the average rental value, and deposits equal to two months' rent seem fast on their way to becoming the norm. As previously expected the Northern Cape has caught up and is the last province to join the 'more than one month's deposit' club.

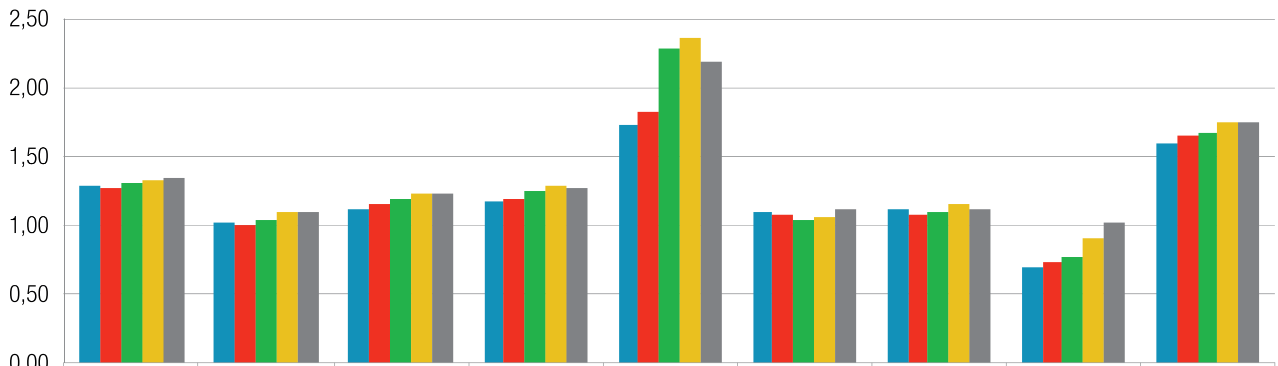
Decreases in the North West, Limpopo and KZN, combined with flat growth in Gauteng and the Free State, seem to be the reason for the national decline.

As with rental growth, the question must again be asked – what trends underlie this ratio? Conventional wisdom suggests the same two factors are at play: landlords increase deposits because they want to protect themselves from risk, while tenants pay as much as they can afford to pay and no more.

When one looks at the limited time trend data coming out of six months of the Payprop Capital Tenant Assessment Report, both do in fact exert an influence, though each prevails more strongly under different circumstances. Certainly when looking at income as the main driver of what tenants can afford to pay, the theory holds true for almost all provinces for which we have adequate data – i.e. lower damage deposit ratios are indeed in effect in provinces where people earn less. The only exception is Gauteng – here, tenant applicants earn the most on average, but the province ranks fourth when it comes to damage deposit ratios.

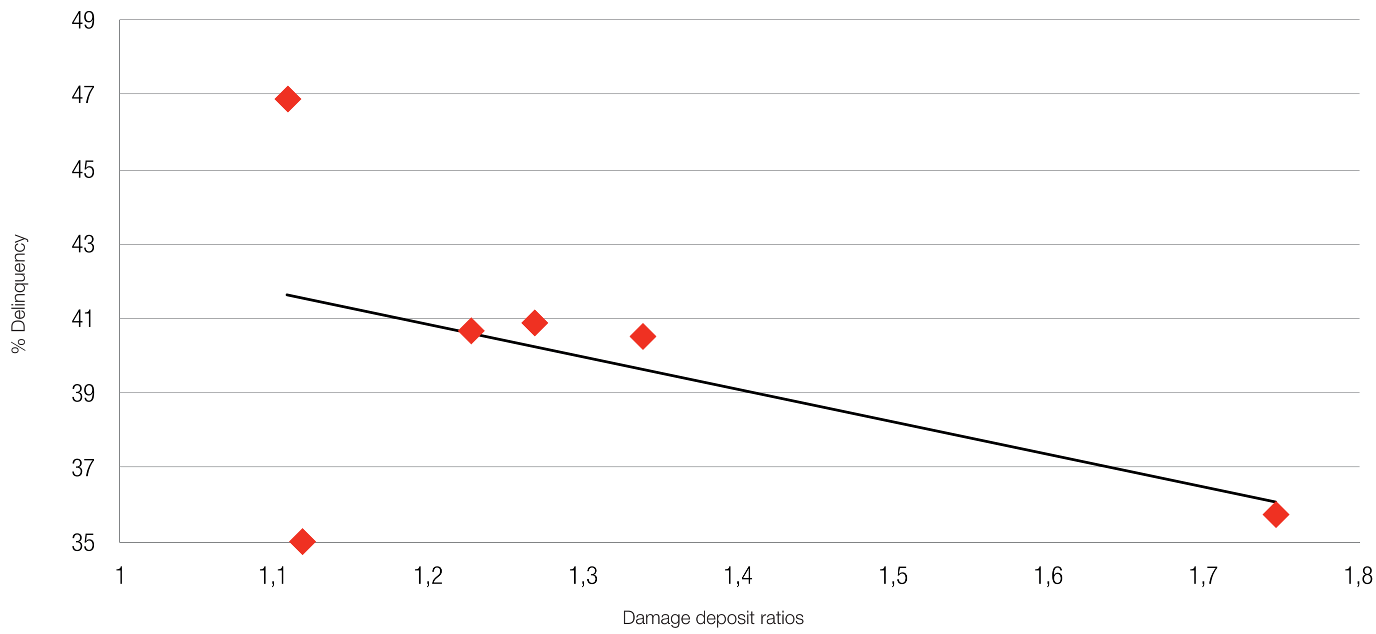


Relationship between income and damage deposit ratios
Source: PayProp, PayProp Capital



	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
2014 Q1	1,28	1,02	1,11	1,16	1,72	1,09	1,11	0,70	1,58
2014 Q2	1,28	0,99	1,15	1,18	1,82	1,08	1,08	0,73	1,64
2014 Q3	1,31	1,03	1,19	1,24	2,28	1,03	1,10	0,76	1,67
2014 Q4	1,32	1,10	1,23	1,28	2,37	1,06	1,15	0,91	1,74
2015 Q1	1,34	1,10	1,23	1,27	2,18	1,11	1,12	1,03	1,75

Provincial damage deposit ratios
Source: PayProp



Relationship between delinquency and damage deposit ratios
Source: Compuscan, PayProp Capital

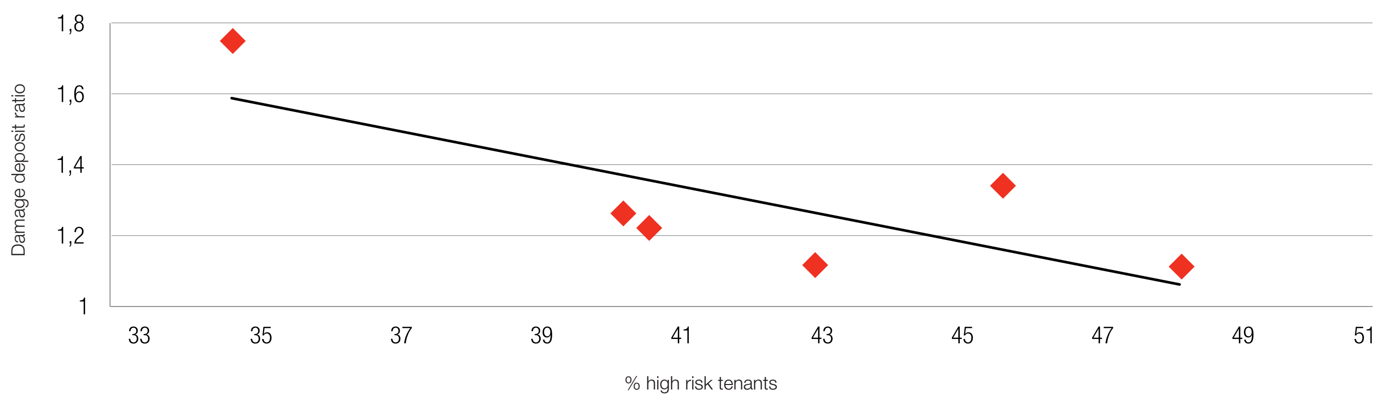
The other side of the coin would be to look at landlord risk mitigation. We have looked at two elements of risk — the first being the percentage of delinquencies and the second being the percentage of tenants rated as high to very-high risk by the PayProp Capital Tenant Assessment Report.

It was in analysing the risk component of damage deposit pricing that we uncovered the biggest surprise. In both the average percentage of major financial defaults and the Tenant Assessment Report risk ranking there was a negative correlation with damage deposit values. In other words, higher levels of risk did not automatically mean that landlords were charging higher deposits. In fact, it would seem that there is a weak correlation the other way round – i.e. the higher the risk the lower the deposit.

What does this mean?

While it is still too early to make any definitive finding on the matter, our initial analysis suggests that income is the primary factor used in determining the value of a deposit. In practical terms, once again it means that landlords will ask for as much as they can get and tenants will pay as much as they can afford.

Landlords and their agents appear not to have started to factor risk into their pricing expectations. One would hope that wider use of products like the Tenant Assessment Report will prompt the inclusion of payment risk and affordability considerations in deposit pricing. ■



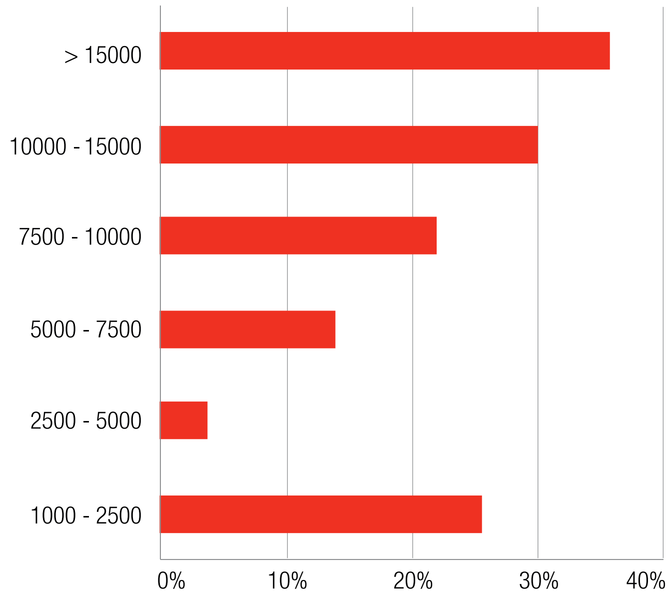
The relationship between high risk rankings and damage deposit ratios
Source: Compuscan, PayProp Capital

PRICE BANDS

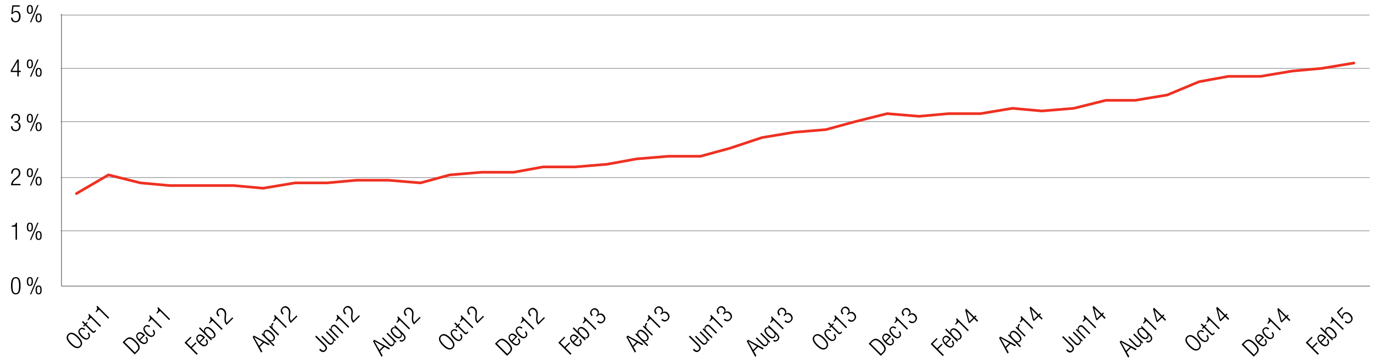
Currently 77.5% of all rentals fall in the lower-than-R7 500 price category. However, the fastest growing price bands are those above this level – with rentals above R15 000 growing at 36%; the R10 000 to R15 000 price band increasing at 30%; and the R7 500 to R10 000 growing at 22% over the past quarter.

A lot has been written in the media recently about high-end rentals – with astounding individual rental amounts being used to illustrate the extent to which luxury rentals are prevalent in South Africa.

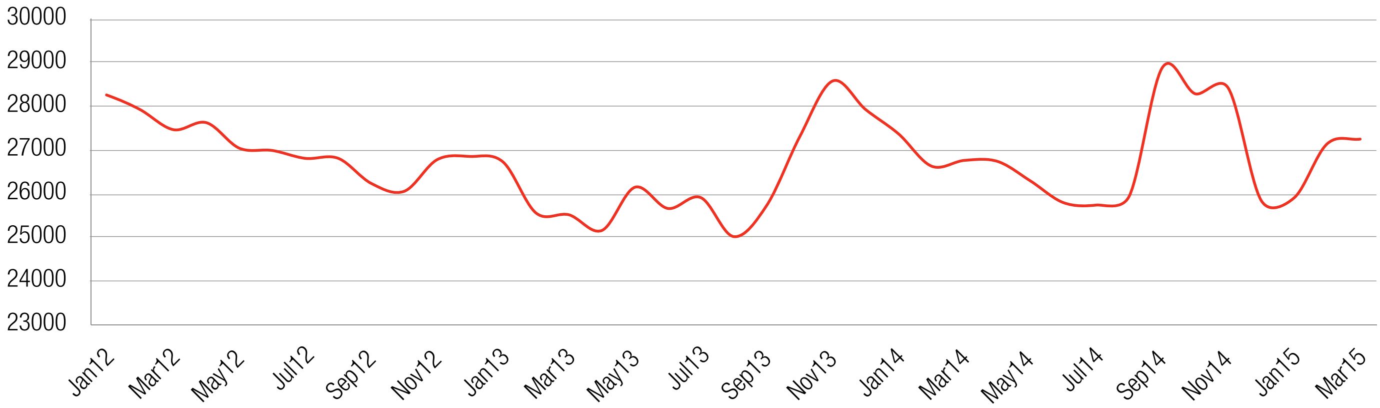
There is a definite upward trend in the percentage of rentals that fall into the more-than-R15 000 category over time, but it is important to contextualise this result. Even as the percentage of rentals in this category has more than doubled over the past four years, they still only make up 4.1% of all rentals in our current data set. When looking at the average price of a rental in this category, the value seems to fluctuate a lot over time. However, on aggregate it has stayed in the R25 000 – R28 000 per month price band. ■



Price band growth
Source: PayProp

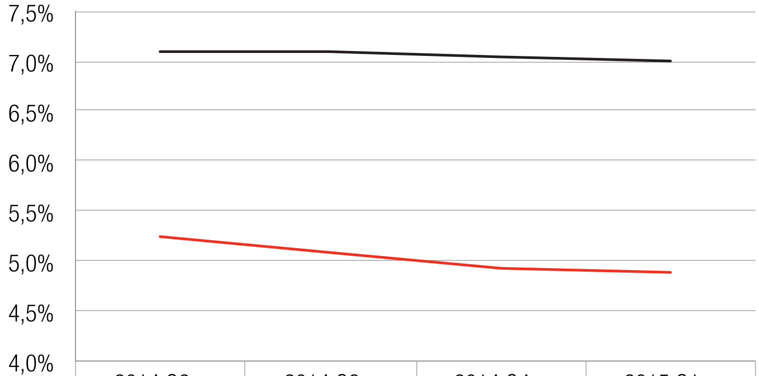


Percentage of rentals >R15000
Source: PayProp



Average value of >R15000 rentals
Source: PayProp

SHOW ME THE MONEY...



	2014 Q2	2014 Q3	2014 Q4	2015 Q1
Gross yield	7,1%	7,1%	7,0%	7,0%
Net yield	5,2%	5,1%	4,9%	4,9%

National yields
Source: PayProp

For landlords, all this analysis leads to one ultimate question – how much money do they stand to make from their investment in rental property?

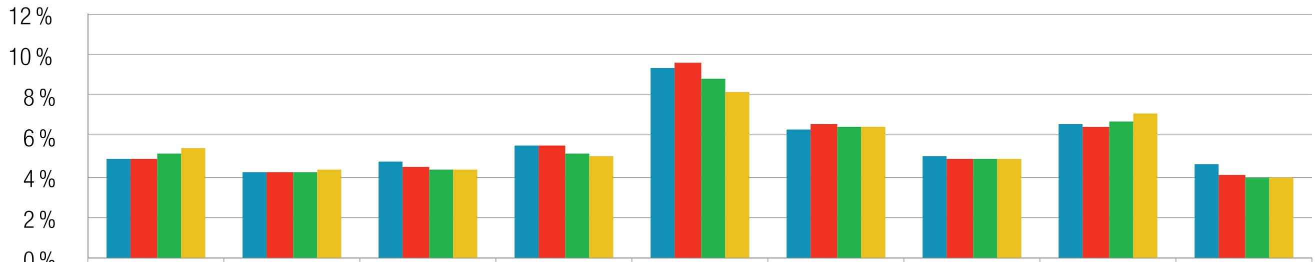
Yield represents the return a property generates relative to its current value, and refers to a given point in time. This means that over time, your yield is likely to improve as the capital cost of the property remains fixed but the rental increases. On that basis the current gross yield is just over 7% and has been in that region for the past year.

The net yield represents the actual money received by the owner after all costs (agent commission, repairs, rates & taxes, etc.) have been deducted. Based on the actual monies paid to owners, the current net yield for an average property is just under 5%.

As rentals have been growing at a fairly steady pace over the past year, the only conclusion one can make is that the cost of owning and maintaining a property is increasing at a faster rate than the rate at which landlords are increasing rental values. This drop in net yields over the last quarter could explain why landlords have again started to increase the rate of rental growth.

Provincially, despite the slow-down in rental growth, Limpopo still remains one of the most lucrative provinces to own a property in. This province is closely followed by the Northern Cape and one would expect it to eventually generate higher returns than Limpopo. For the rest of the country, returns hover in the 4% - 5% ratio – basically matching money market investment returns.

However, it is important to remember that over time, as rentals grow, buy-to-let investors should generate gains in both the capital value of the property and in the effect of increased rental, while the cost of capital remains bound to prevailing interest rates. ■



	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
2014 Q2	4,8%	4,3%	4,7%	5,5%	9,4%	6,3%	5,0%	6,5%	4,6%
2014 Q3	4,9%	4,2%	4,4%	5,6%	9,6%	6,5%	4,8%	6,4%	4,1%
2014 Q4	5,2%	4,2%	4,3%	5,1%	8,7%	6,4%	4,9%	6,7%	4,0%
2015 Q1	5,4%	4,3%	4,3%	5,0%	8,1%	6,5%	4,8%	7,1%	4,0%

Provincial net yields
Source: PayProp

See your tenants in a new light.

Our Tenant Assessment Report looks beyond payment defaults to also consider affordability.

To get started visit www.payprop.co.za or email us at support@payprop.co.za.

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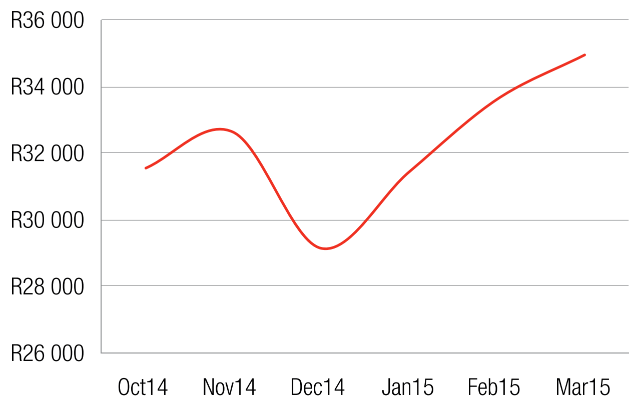
HOW ARE TENANTS DOING?

Now that we understand landlord motivations better, it's time to turn our attention to tenants. Since we have been analysing Tenant Assessment Report data, we have also been able to form a better idea of the average person who applies to rent a property through an estate agency.

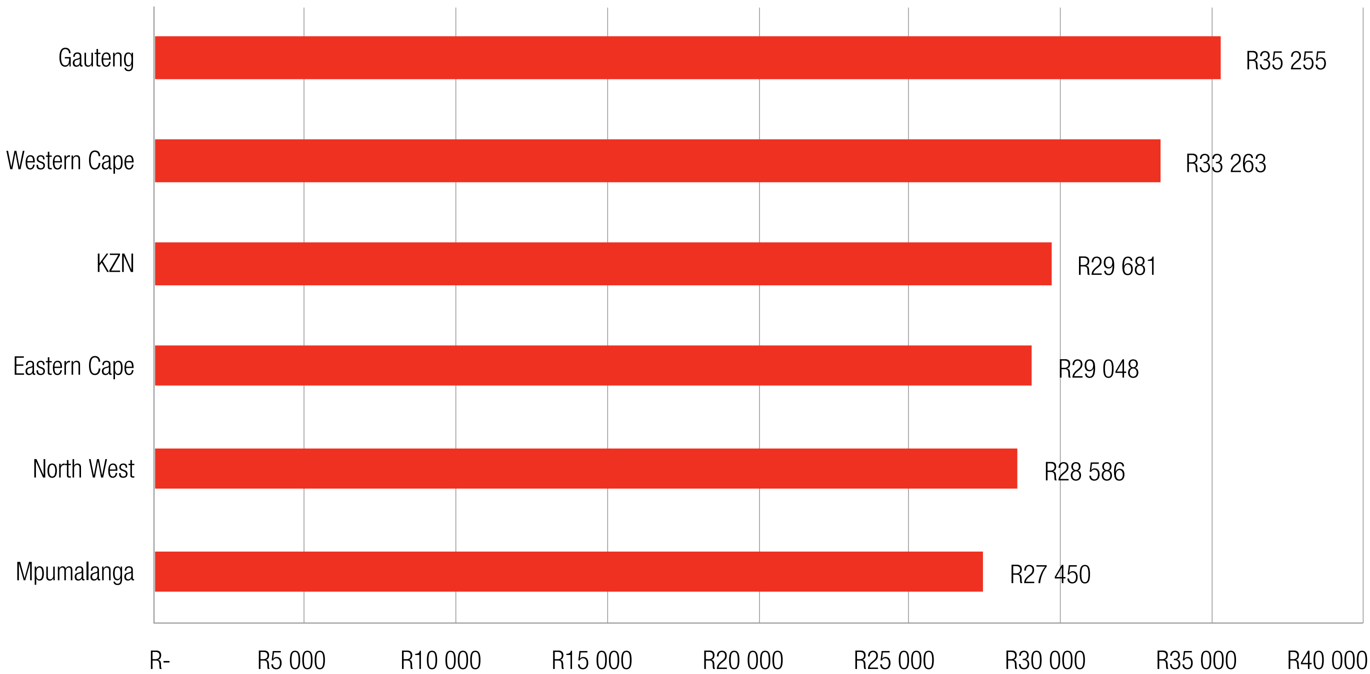
As stated previously, PayProp Capital data is confined to tenants who use an estate agency as opposed to renting directly from a landlord. In all likelihood this means the company's figures exclude much of the informal and lower-value rental markets, resulting in average income figures that are higher than those of the average South African.

Currently, the average tenant applicant earns a monthly income of just under R35 000 before tax, based on self-declared figures. While it is still too early to have a view on a long-term trend, this quarter has shown an increase since our first release of similar data up to December 2014.

Provincially it is no surprise that Gauteng applicants earn more than the rest, followed by the Western Cape and KZN. Again, we have not included those provinces where we do not feel confident that the amount of data we have is sufficient yet. ■



Weighted average self-declared gross income
Source: PayProp Capital



Provincial declared income
Source: PayProp Capital

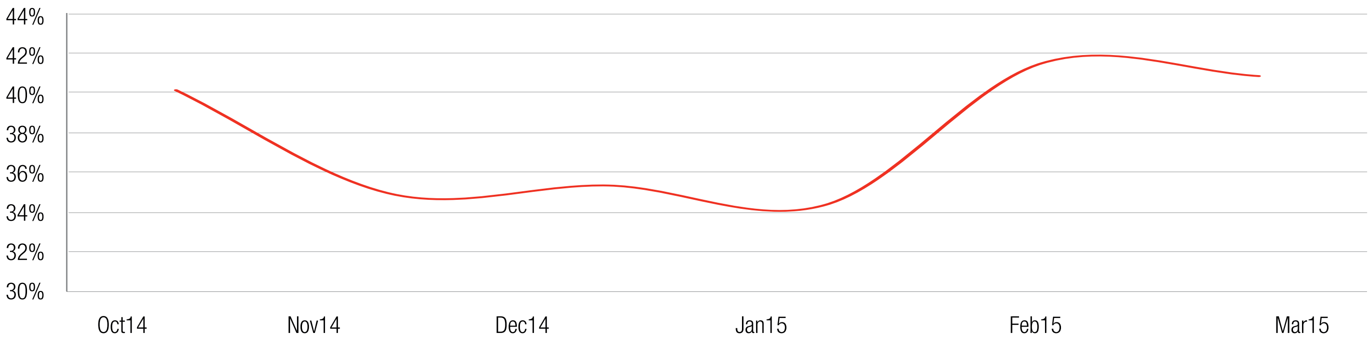
LEVELS OF RISK

The overriding concern of any landlord is the risk of non-payment. It is great that tenants are earning more, but are they fundamentally better off? PayProp Capital and its data partner Compuscan use an advanced algorithm to combine various aspects of an individual's profile into a financial and behavioural risk rating.

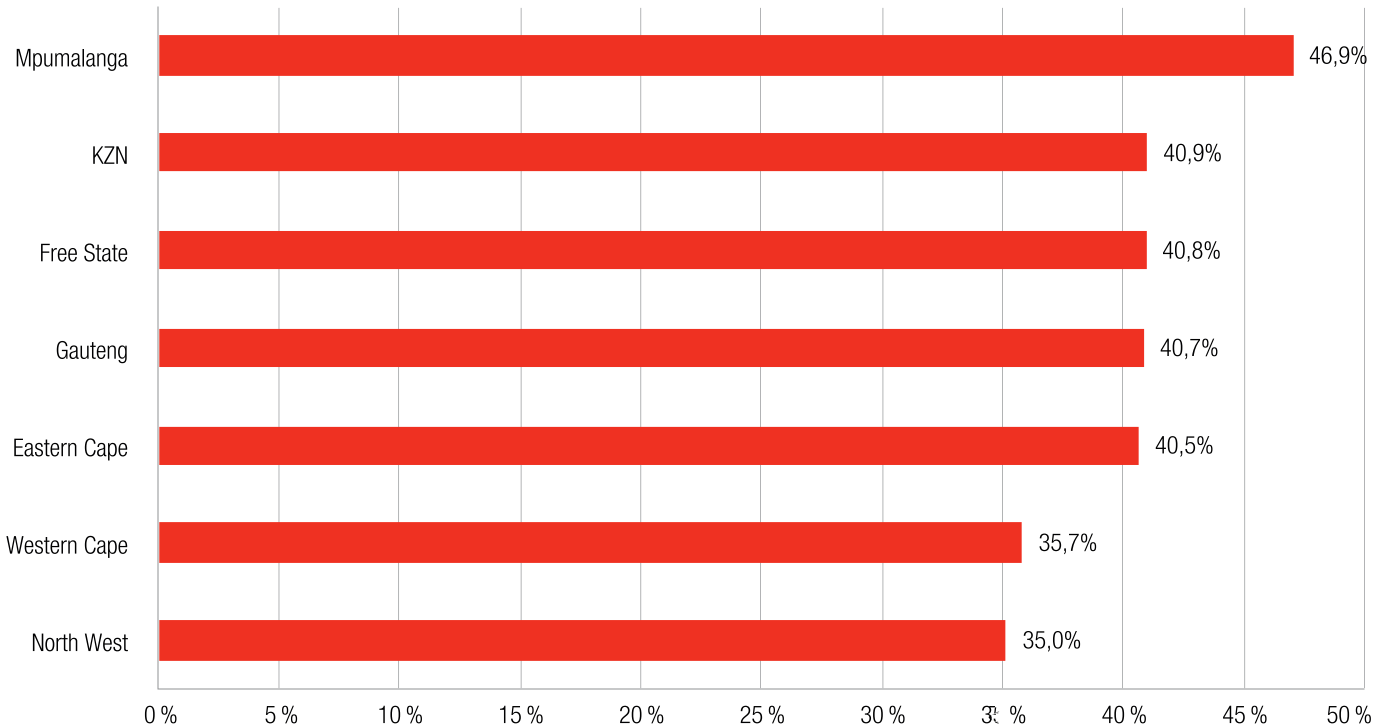
When we isolate the percentage of all tenants who fall into the high and very high-risk categories, new data from the PayProp Capital Tenant Assessment Report shows us that pre-festive season bonuses and post-festive season spending appear to have a significant 'hangover' effect. In other words, having the extra cash and doing the seasonal spending significantly skews the risk profile of the average tenant in this quarter.

So if you are looking to place tenants in November or December, bear in mind that their risk ratings for that particular period might seasonally deviate from the norm. More to the point, this improvement will be short-lived. An analysis of their financial behaviour over a more extended period – something which the Tenant Assessment Report source date provides – would be recommended to mitigate risk.

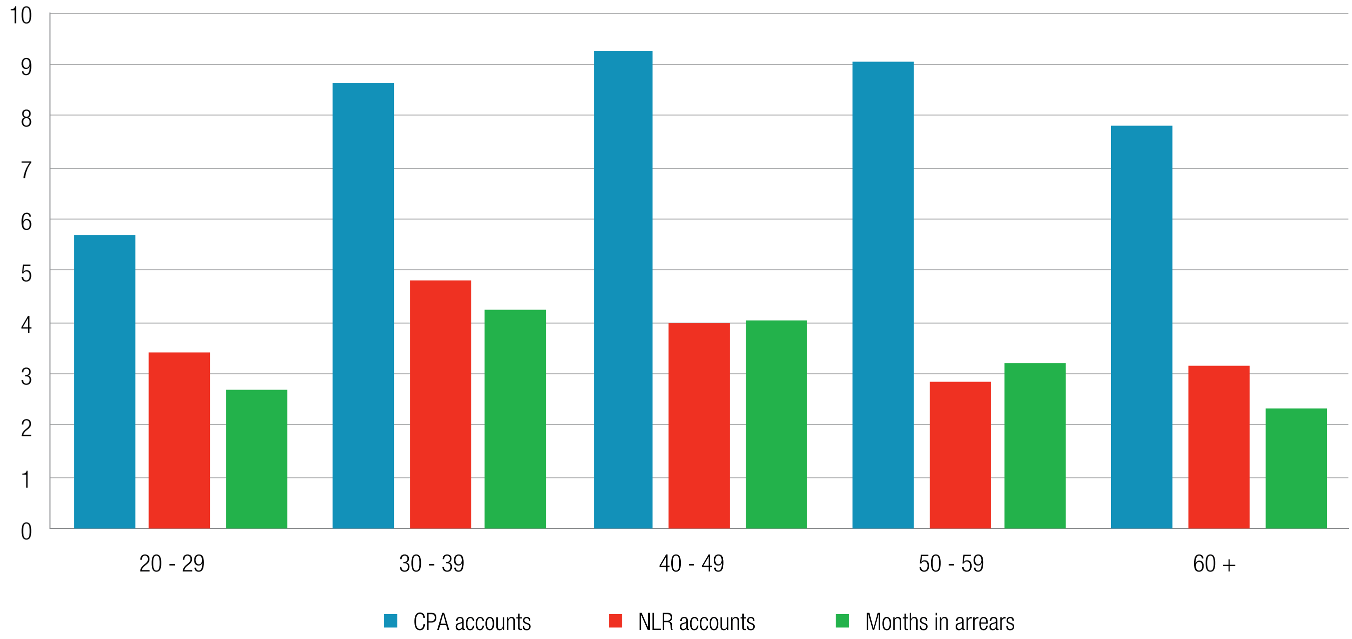
Provincially, the highest-risk region is Mpumalanga, and the lowest-risk provinces are the North West and the Western Cape.



High and very high-risk tenants
Source: Compuscan, PayProp Capital



Provincial % of high and very high-risk tenants
Source: Compuscan, PayProp Capital



Accounts and arrears
Source: Compuscan, PayProp Capital

"Provincially, the highest-risk region is Mpumalanga, and the lowest-risk provinces are the North West and the Western Cape."

One of the primary determinants of tenant risk is an applicant's exposure to debt and the extent to which its repayment limits his or her ability to meet their other financial obligations. When we look at the number of accounts tenants have, it is clear that tenants in the 40 - 49 year-old category have the highest number of Credit Provider Association (CPA) accounts – at an average of 9.3 accounts per tenant. Tenants in the 30 - 39 year-old category, on the other hand, have more National Loan Register (NLR) accounts – a key indicator that they are struggling to manage their financial situation, as these often consist of short term and personal loans.

For the average 30 - 39 year-old, the longest they have been in arrears over the last 12 months is 4.3 months. We consider 3 months to be a major delinquency and a disqualification under the eligibility criteria for PayProp Capital's DepositGuarantee product. Our advice is therefore to do your checks on prospective tenants carefully; there is significant risk in not delving deep into the detail that our Tenant Assessment Reports go into. ■

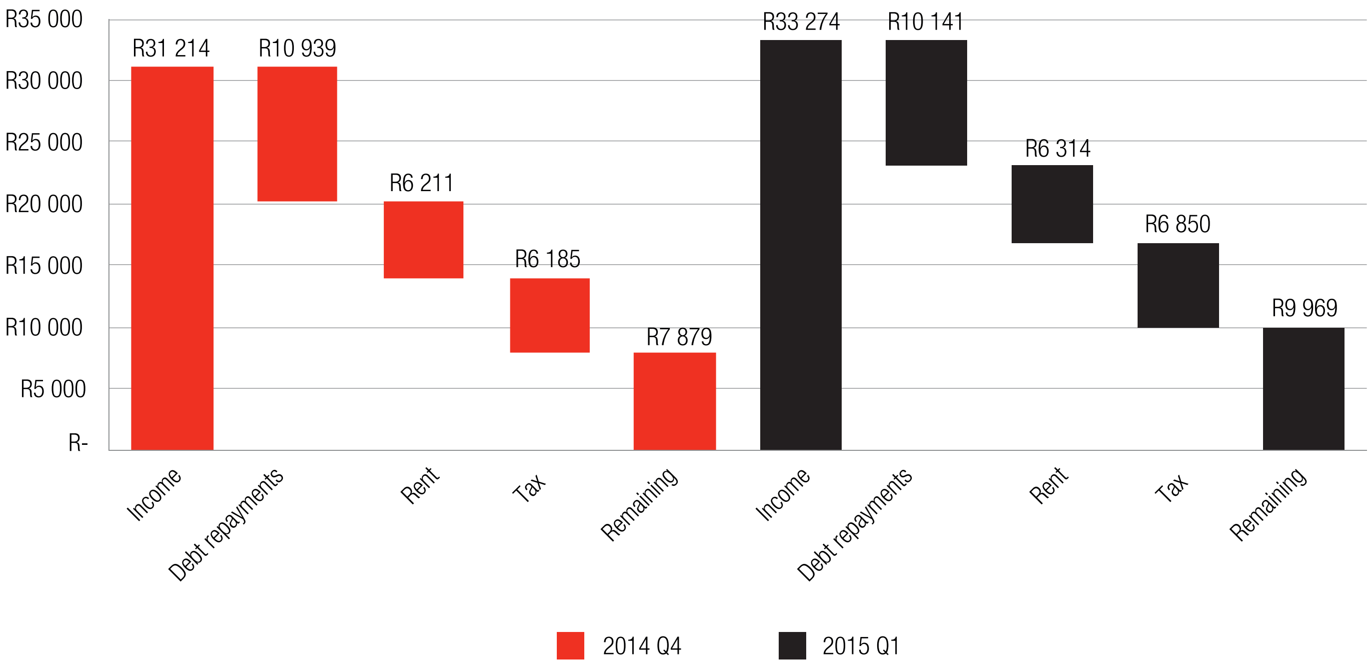
REPAYING DEBT

Another interesting ratio is the value of debt repayment a tenant is committed to, versus declared income. Currently the average tenant is committed to the tune of 36% of reported income. As shocking as it sounds, this ratio is actually in decline from a high of 45% in December 2014!

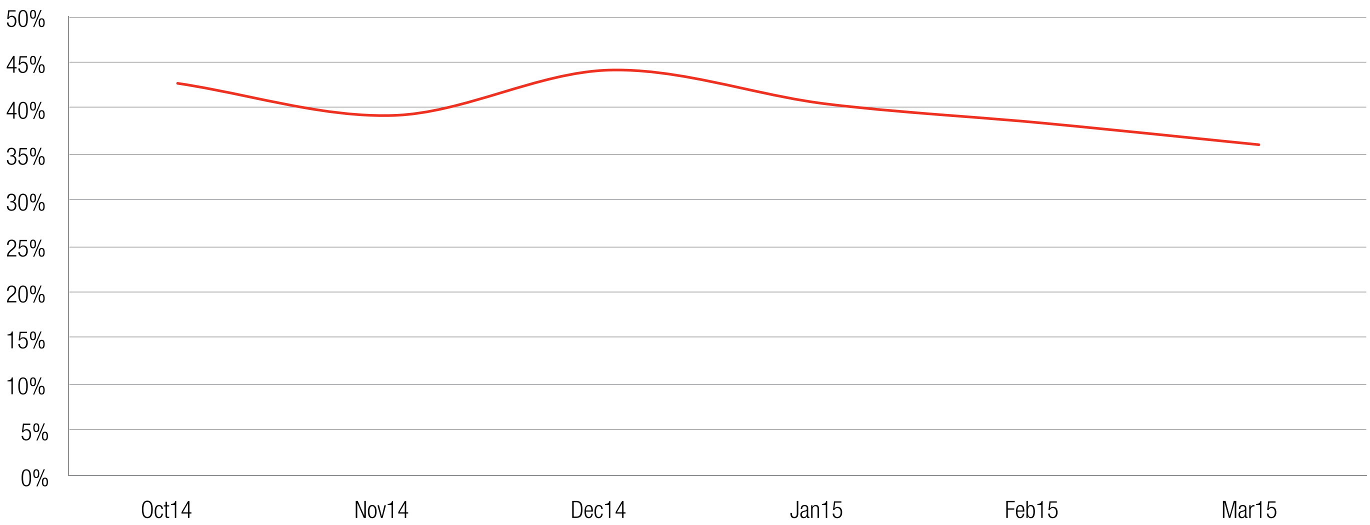
When analysing tenant cash flow, we look at the total declared income and subtract the registered debt repayments, average rental and calculated income tax as per the SARS tax tables.

In the previous quarter, tenants had on average just less than R8 000 in disposable income, whereas at the end of this quarter they were much better off, with just under R10 000 in their pockets.

Two primary differences have helped bring about this state of affairs – higher declared income in this quarter versus the last, and lower amounts owed under debt agreements. ■



Tenant cash flow
Source: PayProp, PayProp Capital, Compuscan



Debt repayments relative to income
Source: Compuscan, PayProp Capital

IN CONCLUSION

The normal rule with rental values is that landlords will always try to increase rentals while tenants will always seek to balance increases against their ability to pay their bills.

This axiom has been proved once again in the latest Property Rental Index. If tenants are pushed too far in the level of rentals and damage deposits extracted from them, their ability to meet their financial commitments – including their rent – decreases, and they are exposed to ever increasing levels of financial distress, in turn amplifying the landlord's risk of non-payment.

Accordingly, landlords are prepared to accept lower increases in exchange for 'good tenants', but only until they realise that their cost of owning the property is increasing faster than their rental income – and so the pendulum swings in the opposite direction again, driving increases in rentals once more. This dance between tenants and landlords plays out over time and is not foreseeably going to change.

What is also clear from the data is that supply and demand can have a role to play in determining which party is able to negotiate harder – but the long-term trend of the data shows that neither party wins all the time.

Our observation, based on the data and our experience, is that a 'good' tenant that pays their bills will most likely prioritise their rental commitments and look after your landlord's property. This, in our opinion, is the most important factor in optimising returns in rental property investments. Our recommendation is to look after good tenants when you find them and to carefully consider their merits at the outset before pushing them away with marginal gains on rental increases and limited deposit options. ■

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 2015.

Contact details

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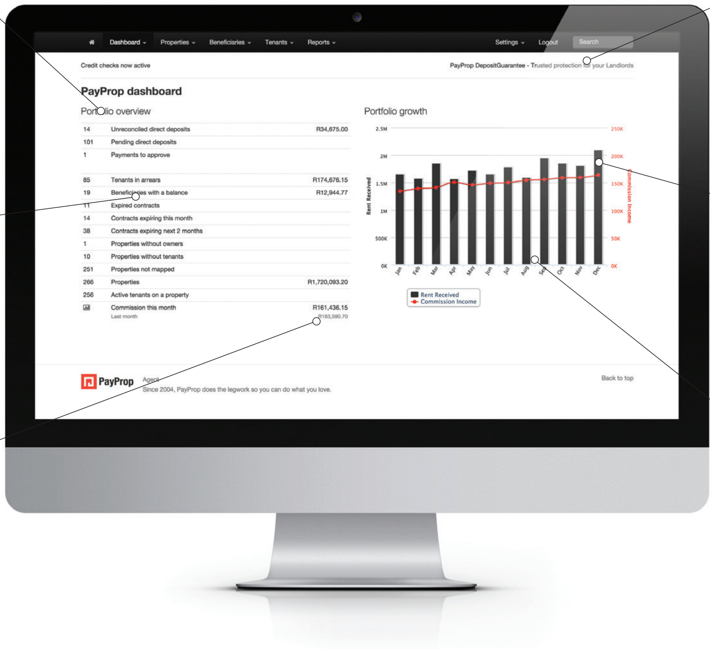
SAVE TIME
Complete overview of your rental business. See who has been paid, and who needs to be paid.

TRUSTED ACCOUNTING
Full transparency of your trust account. Auditors will love you for it.

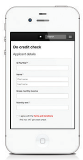
EFFICIENT
Tenant invoices, receipts and statements issued automatically every month. Reconciling rent payments is a breeze.



AUTOMATION
PayProp automates all your outgoing payments. And best of all, amounts are cleared daily.

SECURE
Your clients' money and tenant deposits are safe in our audited trust environment.

GROW
PayProp takes care of the admin and allows you to focus on what is important – growing your business.



Cloud-based
PayProp works on all devices, so you can approve payments from your mobile device, wherever you are.

Regulatory compliance
Using PayProp ensures that your trust account complies with EAAB requirements.

Tenant Assessment Report
PayProp Tenant Assessment Reports combine tenants' historic payment behaviour with their future propensity to pay – delivering deeper insight into tenant risk.

Unlimited users
PayProp allows you to customise user permissions for as many users as you need, at no additional cost.

Free leases
All PayProp clients have access to complimentary lease agreements, mandates and tenant application forms – for life.

Training & support
PayProp clients enjoy access to free unlimited training and webinars. We'll help you get your rental book on our system in no time, and our dedicated support team is only a phone call away.