



RENTAL INDEX

THE STATE OF THE RESIDENTIAL
RENTAL MARKET IN SOUTH AFRICA

INCLUDING PROVINCIAL
TENANT RISK DATA

Q3 2016 ■ JUL - SEPT

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WHAT LIES BENEATH

WHO'LL COME UP TRUMPS?

MEET JOE SOAP, TENANT

LIMPOPO, LAND OF HAPPY LANDLORDS

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NOTHING IS CERTAIN IN LIFE OR LETTING

In the previous PayProp Rental Index (Q2 2016) we noted a return to stable growth in national rental values, but pointed to the ever-present danger of undercurrents that can turn market fortunes.

This theme is present in the current index too. While the market has remained stable on the whole, nothing is ever certain for long in the rental market. In one cliff-hanger development, two provinces are locked in a battle for supremacy while a rank outsider might just walk away with the prize.

To better understand these regional forces, we investigate tenant quality and rental yields at a more granular level, and map it to the real-life economic scenarios that appear to be playing out in the various provinces.

The implications for market sustainability will no doubt interest letting agents as well as landlords, and both should heed them in their pricing, investment and asset protection strategies.

As always, enjoy the insights in this issue!



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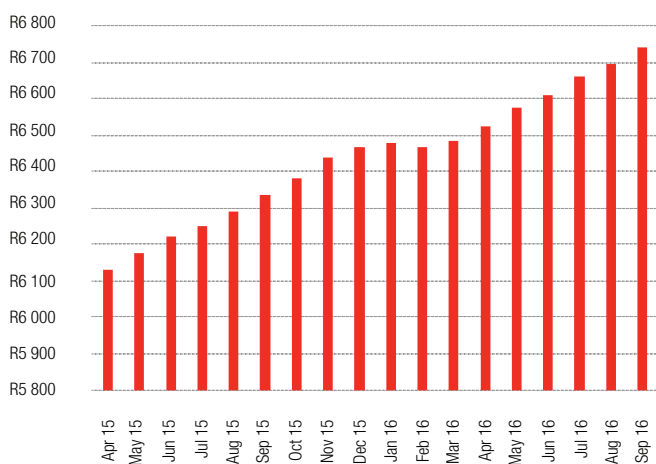


WHAT LIES BENEATH

Appearances deceive.

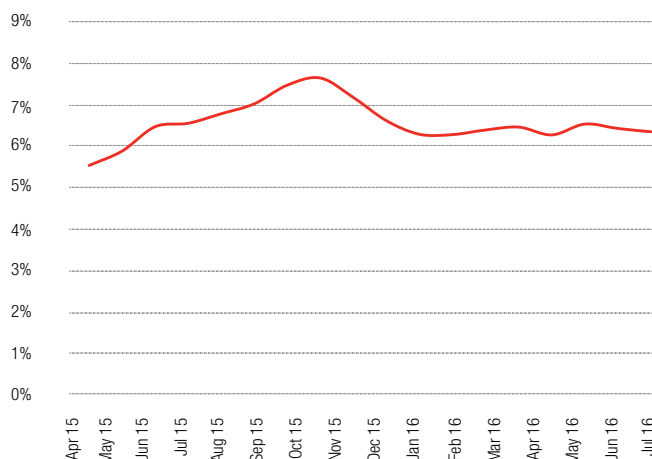
This quarter, as many times before, the true message of the PayProp Rental Index is not reflected in the headline numbers.

On the surface, the market has remained stable in terms of rental pricing and increases. Currently at R6 738.42, the average national rent has grown by 6.5% year-on-year over the quarter – not much different from the 6.4% of the year to date. But while this inflation-shadowing growth seems unsatisfyingly boring to the naked eye, what lies beneath makes for very interesting reading indeed. ■



Average national rental

Source: PayProp



Year-on-year growth in average rentals

Source: PayProp

“The true message of the PayProp Rental Index is not reflected in the headline numbers.”

THE PROVINCIAL RACE, DOWN TO THE WIRE

It's neck and neck – who'll come up trumps?

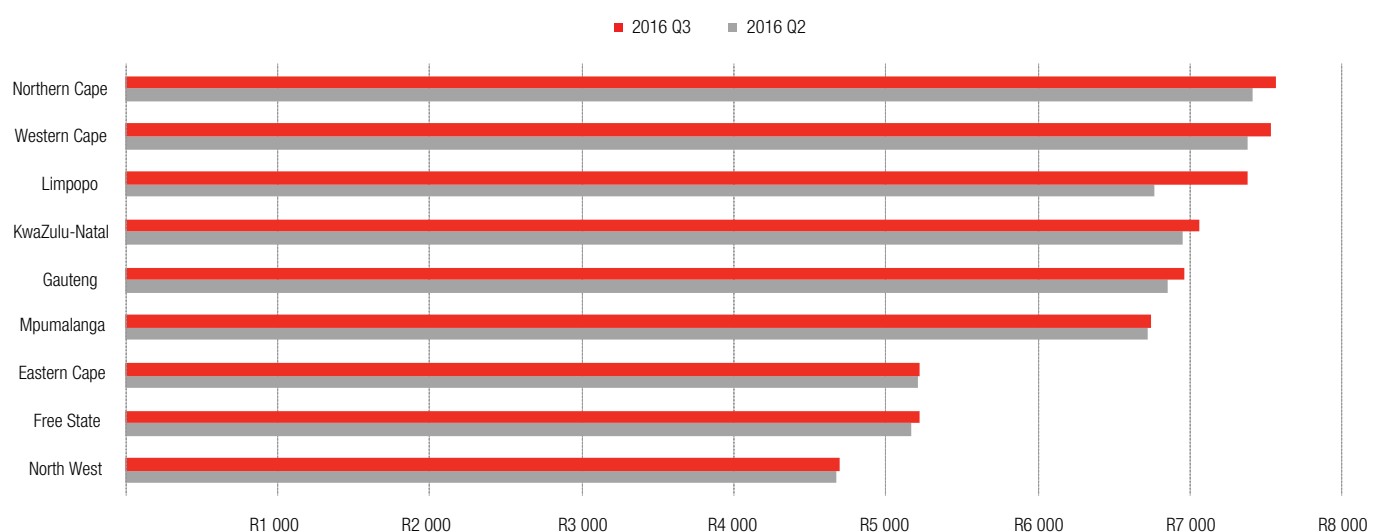
It's when we look at the constituent parts of those smooth line graphs that we get to the meat of the index – the dramatic spikes and troughs of provincial fortunes before the data is pooled and averaged out.

Last quarter, we stuck our necks out and predicted that the Western Cape would overtake the Northern Cape as the most expensive province to rent in. And to be fair, it was close. However, the Northern Cape remains in first place this quarter, with rentals at an average R7 562 – all of R33 more than the Western Cape! Now that our status as all-seeing oracles is in tatters, we can safely state the obvious – that in the next quarter, the Western Cape should indeed be more expensive than the Northern Cape to rent in.

It's not much of a reach considering the average rent in the Western Cape grew by 9.32% in the third quarter, compared to 4.74% in the Northern Cape. (But will the Western Cape be **the most** expensive province to rent in? It doesn't seem that clear-cut. More about that further down.)

“What’s interesting about the Northern Cape is not just its meteoric rise but its eventual decline.”

What's interesting about the Northern Cape is not just its meteoric rise but its eventual decline, as predicted in previous indices. When we consider that rentals were growing at 15.25% in the first quarter of 2015, the extent of the decline is painfully obvious. ►



Average provincial rentals

Source: PayProp

► The wild card...

Once the most expensive province to rent in (due to a shortage of rental stock caused by rapid industrial development), Limpopo has subsequently experienced an economic contraction, causing rentals to decline as quickly as we're currently seeing in the Northern Cape.

But have we relegated this province to the ash heap too soon? Albeit from a low base, its fortunes seem to be rising again, like the proverbial phoenix from the ashes. It is currently the third-most expensive province to rent in, and has now had two successive quarters of double-digit growth. Making a move for the number one spot? Most certainly.

More outliers

Even the Eastern Cape is getting in on the action. While it is not exactly fireworks yet, with rents growing at a steady 6.19% year on year, it's a long way up from the 2% it managed six quarters ago. Moreover, it has maintained 6%-plus growth for three consecutive quarters – a truly impressive feat.

There is also an uptick in the performance of the traditionally weak Free State, which has been matching average national growth of 6.4% for the year to date – a percentage point increase over last year. But house prices are what make this province interesting to watch. According to the ABSA house price index, Free State prices increased by 11.2% over the same quarter last year – the highest of all the provinces, even the Western Cape. That means strong rent growth can't be far behind. We'll watch this one closely!

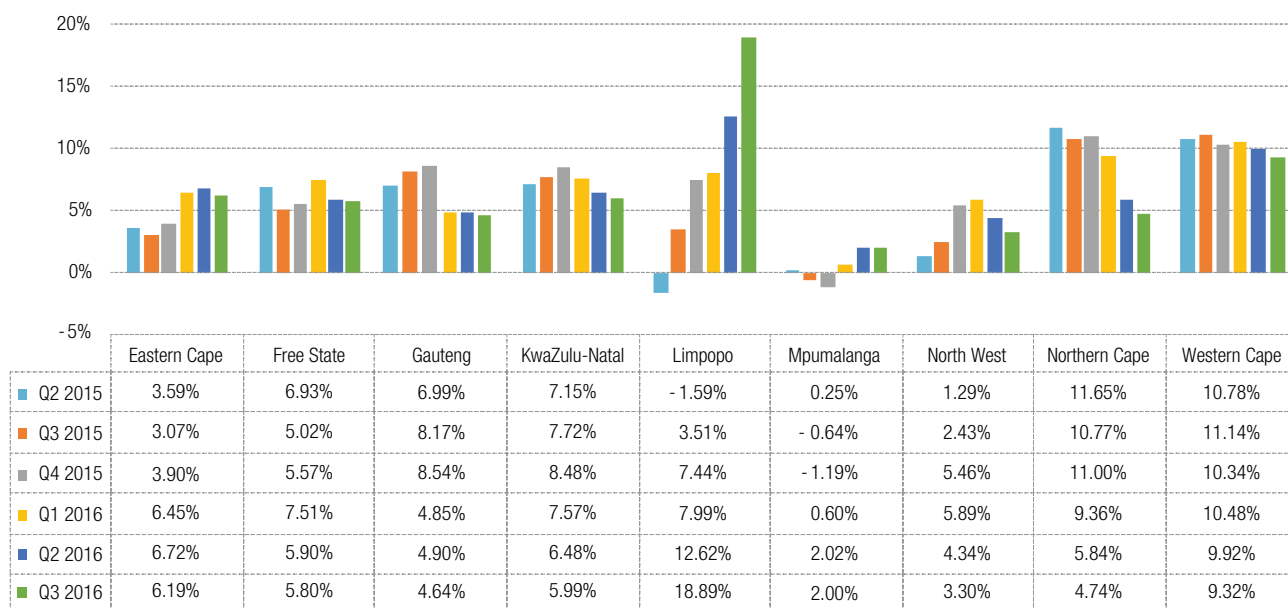
Gauteng, where are you?

In our previous index we found evidence of more frequent Gautenger sightings in the Western Cape. We saw this in the decline of high-end rentals in the country's economic powerhouse and a pick-up of similar proportions in the Western Cape.

Over the past quarter we saw signs of this trend continuing: At 4.64%, Gauteng growth has been well below the inflation rate – a disappointment in a province that historically provided stable growth of around 8%. ■



"Free State house prices increased by 11.2% last year – the highest of all the provinces."



Provincial growth rates (year-on-year)

Source: PayProp

PROVINCIAL TENANT FUNDAMENTALS

Inflated expectations

The Western Cape tenant

By all accounts the Western Cape is currently the strongest-performing rental market. It has the second-highest rents in the country, growing at just under 10%. It also has the highest percentage of rentals in the above-R15 000 category, and landlords are able to extract deposits of 1.8 times the rental value from tenants.

How is this possible? For a start, Cape Town tenants earn more than their fellows in most other provinces. Also, they have fewer accounts and credit cards, and manage their credit admirably, having used only 66% of their available credit to date (compared to a national average of 70%). They also spend less of their income on servicing debt (57% versus the norm of 68%). Consequently there are fewer tenants with major delinquencies (32% vs the national average of 42%), and the lowest percentage of high- and very high-risk tenants.

Compared to Gauteng tenants

It's not as if Gauteng tenants earn less while spending proportionally more on rent than their Western Cape counterparts. But they do have more store accounts and credit cards, and also manage them with less circumspection, having used 71% of their maximum credit in the year to date. Moreover, 40% of Gauteng tenants have had a major delinquency in the past 12 months. This is why 41% of them are considered to be high- or very high-risk!

"The Western Cape has the highest percentage of rentals above R15 000."

Growth pains in the Northern Cape

The problem with the massive growth in Northern Cape rents is that it didn't come from tenants who have gone up in the world and can now afford better and more expensive rental homes. It occurred on the back of large companies flocking to economic opportunity in that province and renting accommodation for itinerant staff. The Northern Cape now has the second highest percentage of rentals above R15 000, but when corporate rentals disappear in time with flagging regional fortunes, we're left with the tenants who were there in the first place – and it's clear they don't have the means to support the type of growth landlords have grown accustomed to.

Spare a thought for the tenants in this province, who earn less than the national norm and spend the largest proportion of their income on rental (27%). As a consequence, they have the most National Loan Register accounts in the country, as well as the highest percentage of high- and very high-risk tenants. ■



KNOW YOUR TENANT

It's important to understand to what extent tenant quality influences the numbers we're seeing in the provinces. Below is a summary guide to how good or bad the tenant market really is.



AVERAGE AGE

Eastern Cape	38
Free State	38
Gauteng	37
KwaZulu-Natal	39
Limpopo	34
Mpumalanga	37
North West	41
Northern Cape	36
Western Cape	39



AVERAGE INCOME

Eastern Cape	R21 023
Free State	R27 574
Gauteng	R30 910
KwaZulu-Natal	R32 114
Limpopo	R31 302
Mpumalanga	R31 044
North West	R31 523
Northern Cape	R27 606
Western Cape	R32 318



AVERAGE RENTAL

Eastern Cape	R5 226
Free State	R5 225
Gauteng	R6 961
KwaZulu-Natal	R7 061
Limpopo	R7 382
Mpumalanga	R6 748
North West	R4 697
Northern Cape	R7 562
Western Cape	R7 529



DEBT REPAYMENT RELATIVE TO INCOME

Eastern Cape	44%
Free State	41%
Gauteng	42%
KwaZulu-Natal	40%
Limpopo	47%
Mpumalanga	43%
North West	47%
Northern Cape	38%
Western Cape	39%



RENTAL TO INCOME RATIO

Eastern Cape	0.25
Free State	0.19
Gauteng	0.23
KwaZulu-Natal	0.22
Limpopo	0.24
Mpumalanga	0.22
North West	0.15
Northern Cape	0.27
Western Cape	0.23



DAMAGE DEPOSIT VALUE

Eastern Cape	R6 873
Free State	R6 427
Gauteng	R8 448
KwaZulu-Natal	R9 414
Limpopo	R10 997
Mpumalanga	R7 654
North West	R5 199
Northern Cape	R8 144
Western Cape	R13 571



DAMAGE DEPOSIT PAYOUT %

Eastern Cape	65%
Free State	84%
Gauteng	66%
KwaZulu-Natal	57%
Limpopo	67%
Mpumalanga	67%
North West	76%
Northern Cape	75%
Western Cape	57%



VALUE OF DAMAGES

Eastern Cape	R2 381
Free State	R1 038
Gauteng	R2 872
KwaZulu-Natal	R4 052
Limpopo	R3 678
Mpumalanga	R2 544
North West	R1 261
Northern Cape	R2 042
Western Cape	R5 802



% OF TENANTS WITH MAJOR DELINQUENCY

Eastern Cape	47%
Free State	47%
Gauteng	40%
KwaZulu-Natal	37%
Limpopo	49%
Mpumalanga	43%
North West	37%
Northern Cape	49%
Western Cape	32%



AVERAGE CREDIT SCORE

Eastern Cape	624
Free State	629
Gauteng	628
KwaZulu-Natal	631
Limpopo	626
Mpumalanga	624
North West	633
Northern Cape	620
Western Cape	637



CURRENT USAGE OF MAXIMUM CREDIT

Eastern Cape	73%
Free State	72%
Gauteng	71%
KwaZulu-Natal	68%
Limpopo	61%
Mpumalanga	75%
North West	72%
Northern Cape	63%
Western Cape	66%



NUMBER OF CPA ACCOUNTS

Eastern Cape	6.8
Free State	8.8
Gauteng	8.2
KwaZulu-Natal	8.5
Limpopo	10.0
Mpumalanga	8.6
North West	8.1
Northern Cape	7.9
Western Cape	7.6



NUMBER OF NLR ACCOUNTS

Eastern Cape	3.5
Free State	3.9
Gauteng	3.9
KwaZulu-Natal	3.4
Limpopo	4.5
Mpumalanga	4.6
North West	3.7
Northern Cape	5.5
Western Cape	2.4



% OF HIGH- AND VERY HIGH-RISK TENANTS

Eastern Cape	52%
Free State	39%
Gauteng	41%
KwaZulu-Natal	36%
Limpopo	46%
Mpumalanga	41%
North West	37%
Northern Cape	53%
Western Cape	31%

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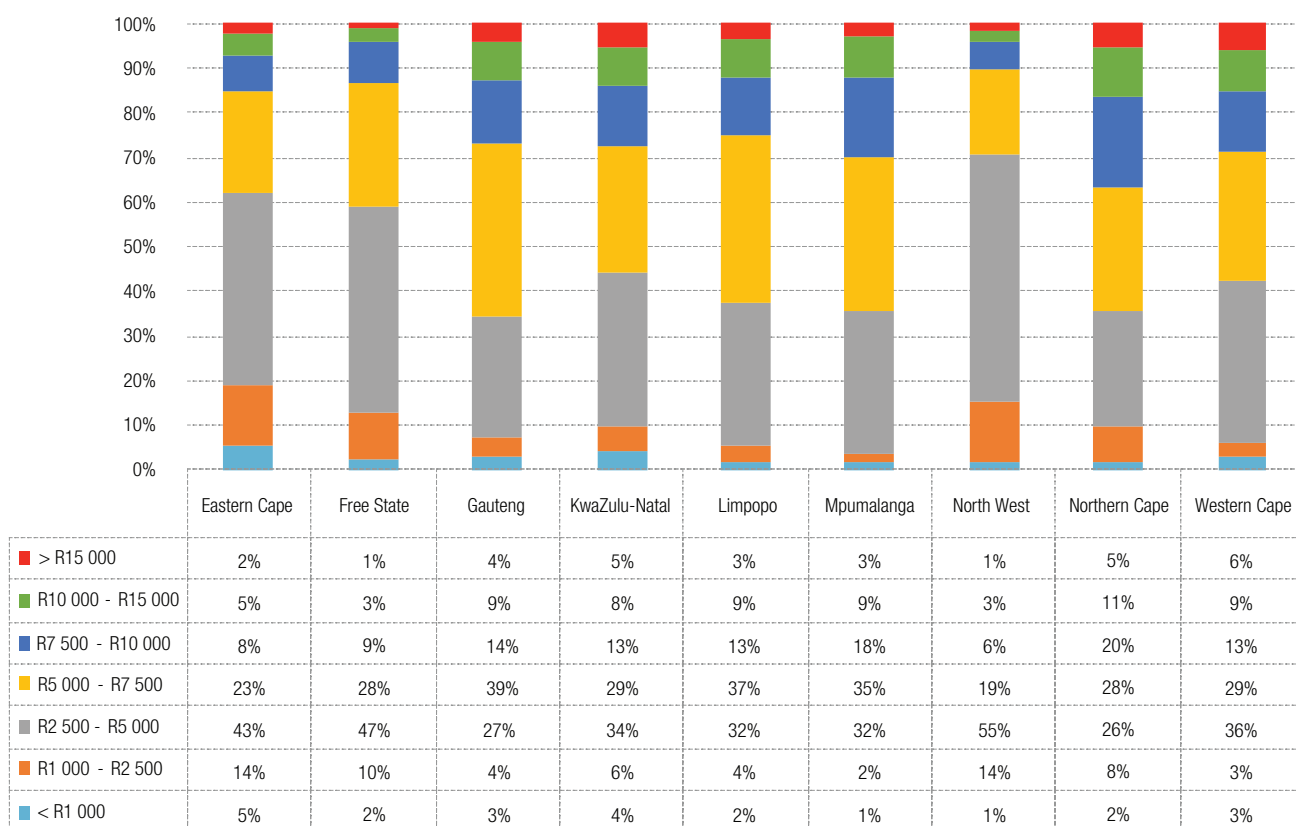
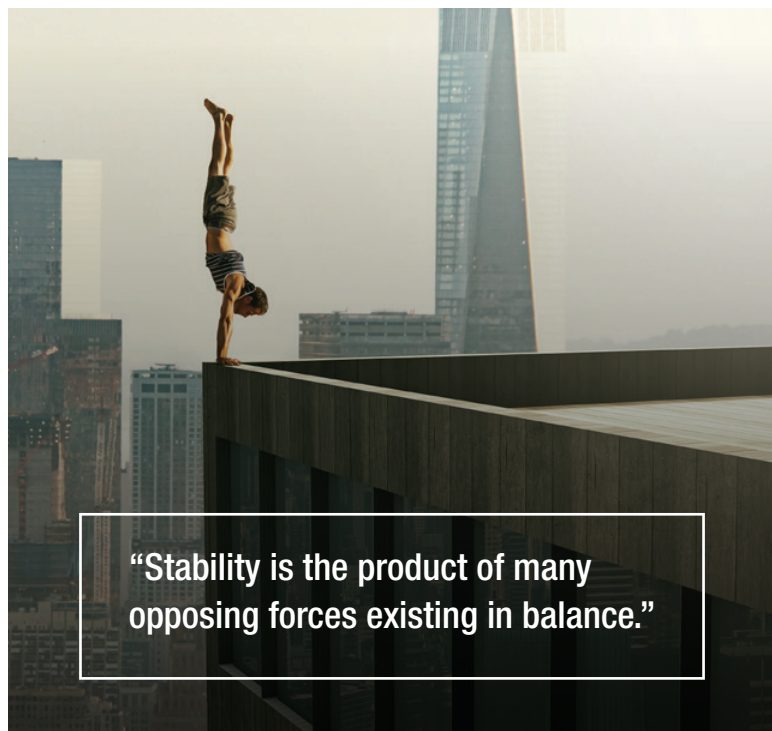


THE SUSTAINABILITY GAME

Local conditions are paramount.

No fast-growing rental market is sustainable if the tenant pool cannot support it. In other words, if tenants don't make enough money or don't manage their credit well enough, rents cannot continue to increase because tenants are fundamentally not in a position to afford it.

Why is this self-evident truth so important to highlight? As said above, abstracted national growth figures tend to give the impression that everything is stable everywhere, but in reality stability is the product of many opposing forces existing in balance. A landlord may win here but lose elsewhere. And since the underlying gains and losses are peculiar to each area, one cannot take a view on how rents should increase in one area by looking at national performance. It simply does not take local economic performance into account. ■



Provincial distribution of price bands

Source: PayProp

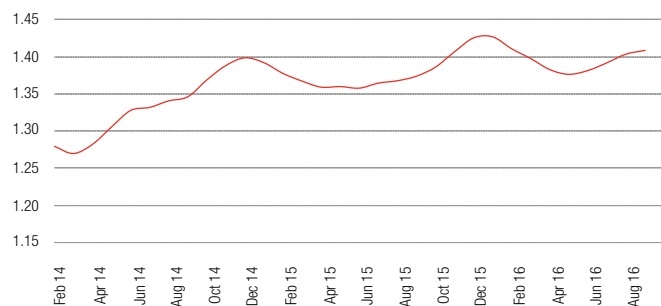
WHAT'S THE DAMAGE?

We mean that literally.

Damage to property is one of a landlord's biggest nightmares. If the national damage deposit ratio is anything to go by (average damage deposit expressed in relation to average rental value), landlords are increasingly protecting themselves with larger deposits. Currently at 1.41 times the value of the average rental, the average deposit (R9 445.34) is a big jump from Q1 2014, when it was R7 403.30, then 1.28 times the value of the average rental.

Not surprisingly, this ratio follows the trend in differing significantly by province. The Western Cape is able to extract deposits of 1.8 times the rental value, while the Northern Cape can only manage a figure of 1.08.

In an interesting correlation with its big house price increases, the Free State also posted a large increase in the damage deposit category recently. Damage deposits usually increase when there is high demand for rental properties and agents are able to play tenants off against each other for higher deposits. This leads us to conclude that the Free State's modest rent increases of late may yet follow in the footsteps of its massive house price and damage deposit increases. Watch this space and remember, remember, the index of November...



Damage deposit ratio

Source: PayProp

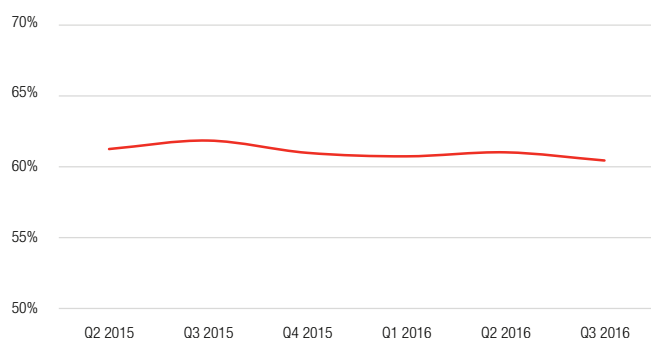


"Landlords are increasingly protecting themselves with larger deposits."

» What happens to the deposit?

PayProp client deposits are safely held in a dedicated Article 32(2) trust account that provides visibility and a full audit trail of all parties' actions.

When the tenant moves out, it is generally agreed, a certain portion of the deposit can be used to pay for any damages and outstanding obligations that can be attributed to the tenant. On average, this figure is 40%, meaning the average tenant costs the landlord R3 778.14 in damages each year!



Quarterly damage deposit payout percentages

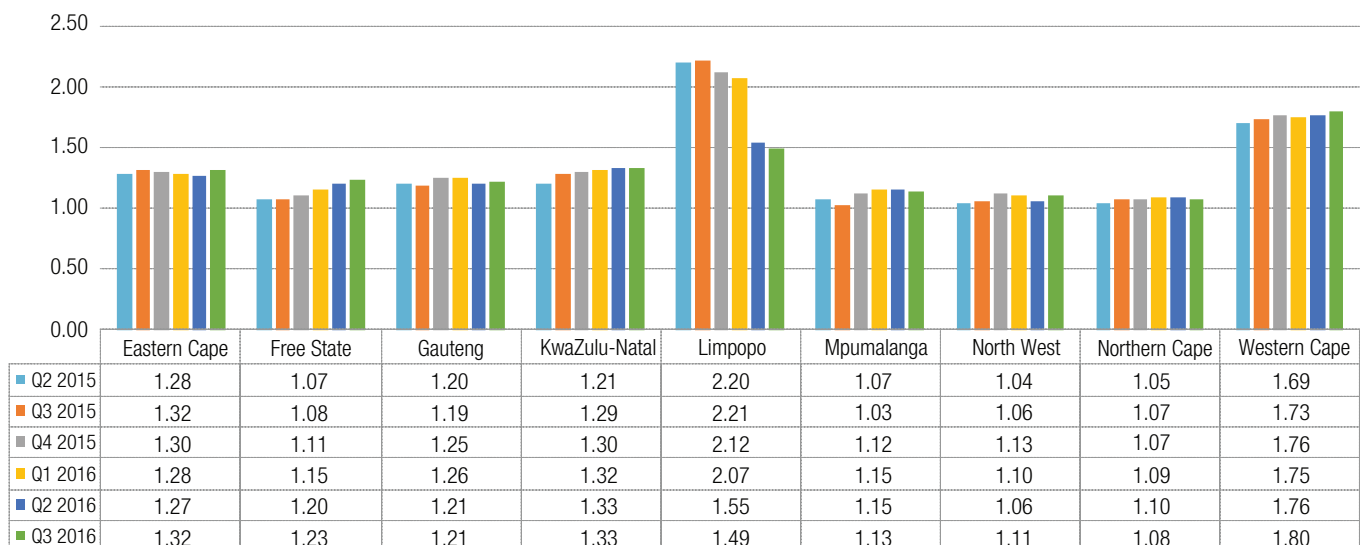
Source: PayProp

PayProp Capital's unique DepositGuarantee product replaces traditional damage deposits. Funded by small monthly premiums paid by tenants, it covers landlords for up to 2.5 times the rental value. DepositGuarantee is underwritten by RMBSI and has been in the market for three years.

The latest DepositGuarantee claim data demonstrates how badly the market needs products like it: For starters, the average damage claim to a property is R3 894 per month. And then there's the fact that 14% of tenants do not pay their last month's rent...

A quick note on provinces

Are there also regional differences in how much tenants see of their deposits at the end of their tenure? Absolutely. Western Cape tenants not only pay higher deposits, they also receive the smallest proportion of their money back. At only 57% of the deposit value, they do not compare well to the average Free State tenant, who receives 84% of his deposit back. It must be all that good, clean country air. ■



Provincial damage deposit ratios

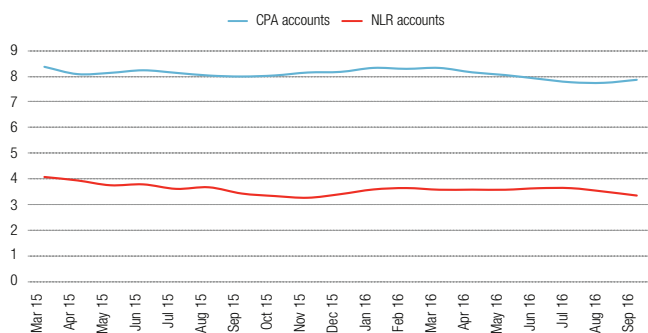
Source: PayProp

NATIONAL TENANT FUNDAMENTALS

Meet Joe Soap, tenant.

Having touched on tenant fundamentals in the provinces, we now turn our attention to the national stage. Are the underlying trends healthy at this level?

Let's start off with indebtedness. Since our last index, the average South African tenant still has roughly eight store (CPA) accounts at this stage of the year. As regards loan accounts (NLR), this has gone down marginally to just below four, but it's not significant enough yet to conclude that tenants are becoming more responsible.

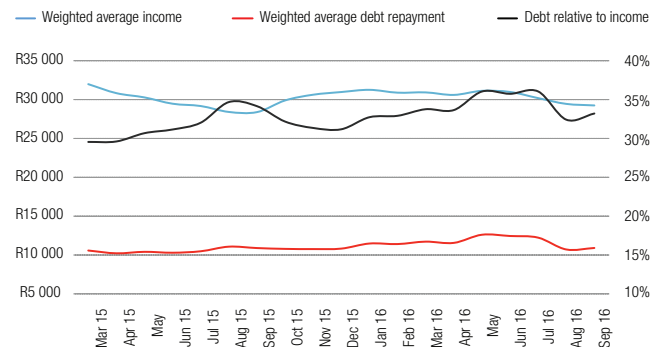


Average number of CPA and NLR accounts
Source: PayProp

The average proportion of income spent on debt repayments is shockingly high (38%), and has remained constant over time. But what is even more concerning is the sheer value of this monthly commitment relative to rental value.

On average, tenants pay R11 234 per month on servicing debt while the average rental is R6 738.42. This means that for every R1 in rent, the tenant pays R1.67 in debt – a sobering thought if you're still working on the traditional principle that 'rent payments must equal one third of income'.

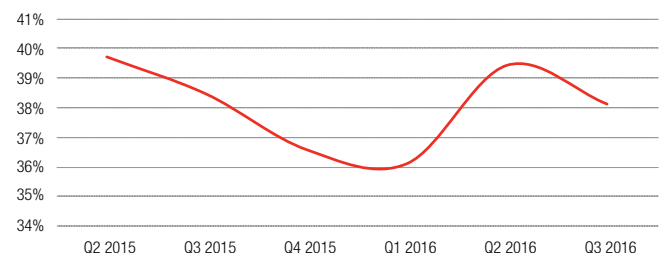
Ultimately what this means is that a large proportion of tenants will be viewed as high- and very high-risk tenants.



Average income vs average debt repayment
Source: PayProp

PayProp, in collaboration with CompuScan, have developed a unique way of measuring the underlying risk of tenants, which includes a range of rental-specific variables that help agents predict if a tenant will be able to pay their rental in future. Candidates scored as being high- or very high-risk would, as per the categorisation, not be safe bets as tenants. Worryingly, 38% of tenants fall into this category.

As can be expected, a seasonal trend is evident. Tenants build up bad ratings after the festive season, then spend the rest of the next year improving. In other words, they over-spend during Christmas and are then forced to miss a few commitments whilst playing catch-up until March the next year – only to repeat the cycle later the same year. ■



Percentage of high- and very high-risk tenants
Source: PayProp

“For every R1 in rent, the tenant pays R1.67 in debt.”



THE STAR OF THE SHOW

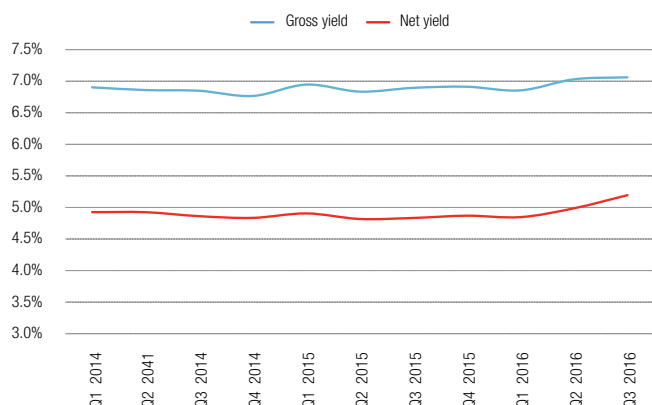
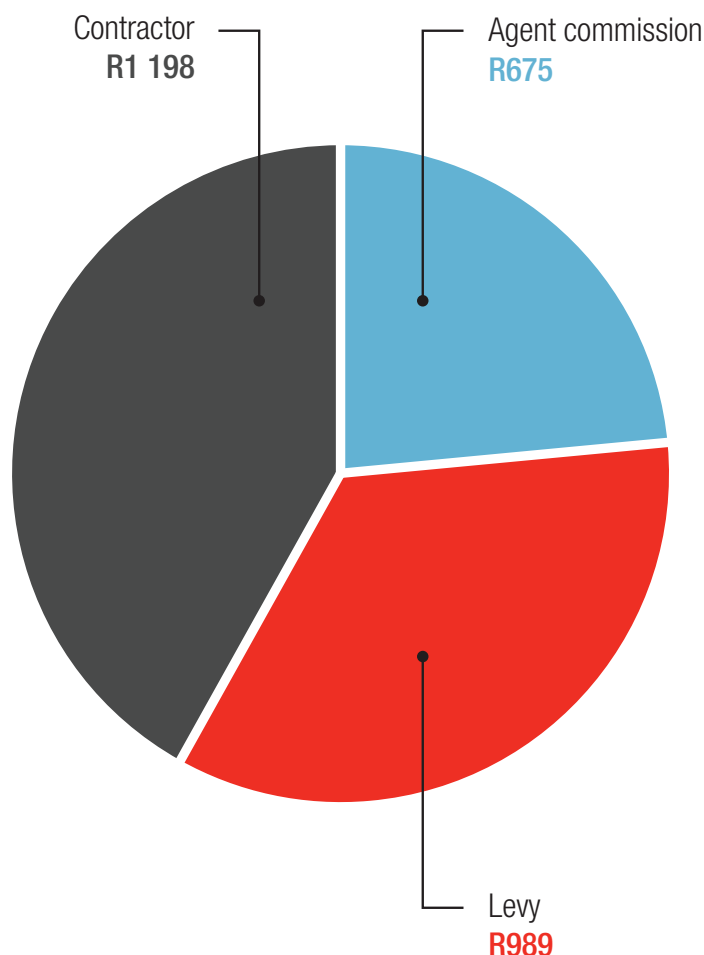
Spending money to make money.

Let's not forget who we're compiling the Rental Index for!

The entire premise of the residential letting market is that stock is created by landlords who invest in properties in order to generate a financial return. If they can't make money they won't invest. For a healthy rental market, it is therefore necessary to maintain a good supply of well-priced, affordable properties that yield good returns.

Landlords are currently making a gross yield (before costs) of 7.1%, and a net yield of 5.2%. The net yield is up from 4.9% in Q3 this time last year – a good sign for investors.

With rental growth being flat, where does the upturn come from? Sadly, nothing much happened on the income side of the equation. The truth is that average property pricing in South Africa is growing much slower than rentals.



National gross and net yields
Source: PayProp

Annual growth in property values has slowed to just 2.7% in the last quarter, which is nothing like the 7.8% we've seen in earlier quarters.

The other part of the equation is understanding the expense stream. Currently owners sacrifice on average 1.9 percentage points of their return on costs associated with owning the property.

Broken down by category, repairs to the property are the most expensive, followed by levies and then commission. ►►



» Provincial yields

Provincially, we see large variances in net yield. Interestingly, the Western Cape offers the lowest yield, despite boasting one of the highest provincial rentals. This is because property in the Western Cape is unashamedly more expensive than elsewhere in South Africa. The ABSA house price index shows that the average property in the Western Cape now sells for R1 685 963, while the national average is just over R1.2 million.

The inverse of this has occurred in the Northern Cape, with the result that yields have gone up. Here, average house prices have actually declined by around 2%, and because rental values have not declined at the same pace, net yields still look attractive at 7.02%. However, this should decline in the long run.

Another interesting case is that of Limpopo. House prices have been steadily increasing (6.8% this quarter compared to the last), but rentals have been increasing faster. Therefore, yields in this province have been showing tremendous growth. At more than 8%, Limpopo is a flag bearer for the type of yield that makes for a good investment. Take a bow, Limpopo! ■

“For a healthy rental market, it is therefore necessary to maintain a good supply of well-priced, affordable properties that yield good returns.”

IN SUMMARY

So maybe this was not such a bland quarter after all!

Having looked under the hood into provincial and tenant fundamentals, we've pulled out the following important insights for would-be investors:

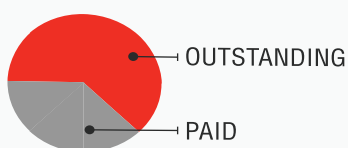
1. Understand the underlying dynamics of market shifts beyond the national numbers. Just knowing that rentals are growing at a stable 6.4% is not enough. As we've seen this quarter, a lot can go unnoticed beneath calm waters.
2. Understand the underlying quality of the tenant you are placing. Yes, tenants are under pressure, but there are some really good ones out there. To identify which ones will help you protect your income and safeguard your business reputation, you need sophisticated tenant scoring and landlord protection measures. Traditional methods such as the 'rule of a third' don't come close to helping you understand if the tenant has the ability and propensity to pay the rent reliably.
3. Understand the 'why' behind the yield number. Just because the Northern Cape has a 7% yield, it doesn't mean its underlying tenant base is strong enough to support it through thick and thin.
4. Before investing in a high-yield investment, understand if this figure is higher because the asset has depreciated, or because rental income has increased. The difference over the long term will be vital. ■

"Understand the underlying quality of the tenant you are placing."



Take control of your rental portfolio

1 See who has paid and who hasn't, in real time



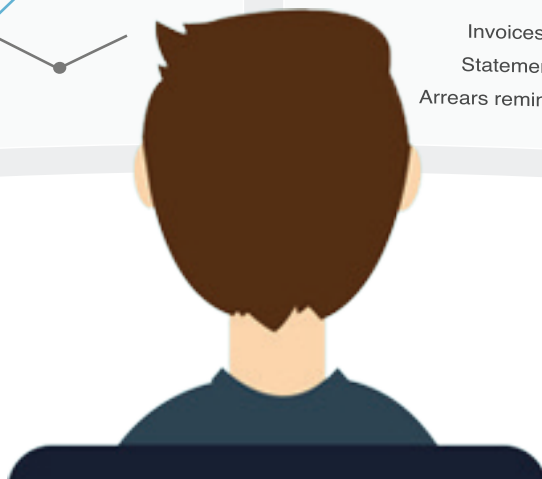
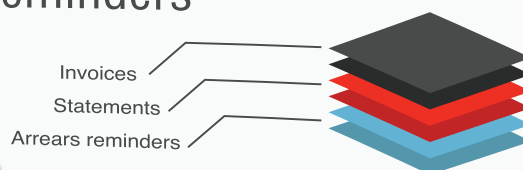
2 Approve bulk payments for commissions, contractors and landlords



3 See your portfolio growth over time



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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 third quarter of 2016.

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