PayProp

RENTAL INDEX

Q3 2017

- The Western Cape – king of consistency
- Consumers under pressure across the board
- Rent growth returns to inflation levels

Lifestyles of the rich and renting

Those elusive Joneses

Index

Introduction ______ 01

Consumers under pressure ______ 03

Flagging Limpopo dampens national growth ______ 04

Flash in the pan or solid gold? ______ 06

Deposit growth defies rental trends ______ 11

Keeping up with the Joneses ______ 12

PayProp out and about ______ 18

In summary ______ 20

INTRODUCTION

The holidays are upon us!

Chances are you've seen the early signs – tinsel, mistletoe, fairy lights and all kinds of other sparkly decorations in every shop you walk into. It's that time of the year when we count down the days until the holidays and dream of lazy weeks spent away in the sun or with friends and family.

It's also time for the last quarterly PayProp Rental Index of 2017. Beyond the usual updates on the residential rental market, it also offers a section on the events we hosted and attended during 2017. Knowing what goes on in the various property management sub-sectors provides crucial context for PayProp's operations and our reading of the PayProp Rental Index data, and we see it as part of our job to share that information with you.

In the last Index, we spoke about the possible effects of a recession on the rental industry. But after a remarkable recovery in the second quarter, year-on-year gross domestic product (GDP) growth of 1.1% was recorded in that quarter (2.5% for the three month-period alone). Much of this growth can be attributed to the agricultural sector, which grew by an astronomical 33.6%. Admittedly, this was off a very low base, and as the agricultural sector's performance is cyclical, we should at best be cautiously optimistic about these numbers.

Partly as a result of that, but also because of slower rental growth in most provinces, we see a return to historic similarity between rent growth and inflation.

Throughout this PayProp Rental Index, indications are that tenants and consumers remain under pressure – if not from rent growth then from inflation in general, which is currently outstripping rent growth. The rental markets in the different provinces won't all feel the same amount of pressure, though – cumulative provincial growth rates (pages 6-9 of this issue) provide the necessary long-term context that annual growth rates do not.

I hope you enjoy this issue – we'll be back in 2018 with a comprehensive breakdown of the year that was.

Happy holidays!

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Disposable income levels are expected to stay under pressure due to low job creation and possible tax increases in the near future.

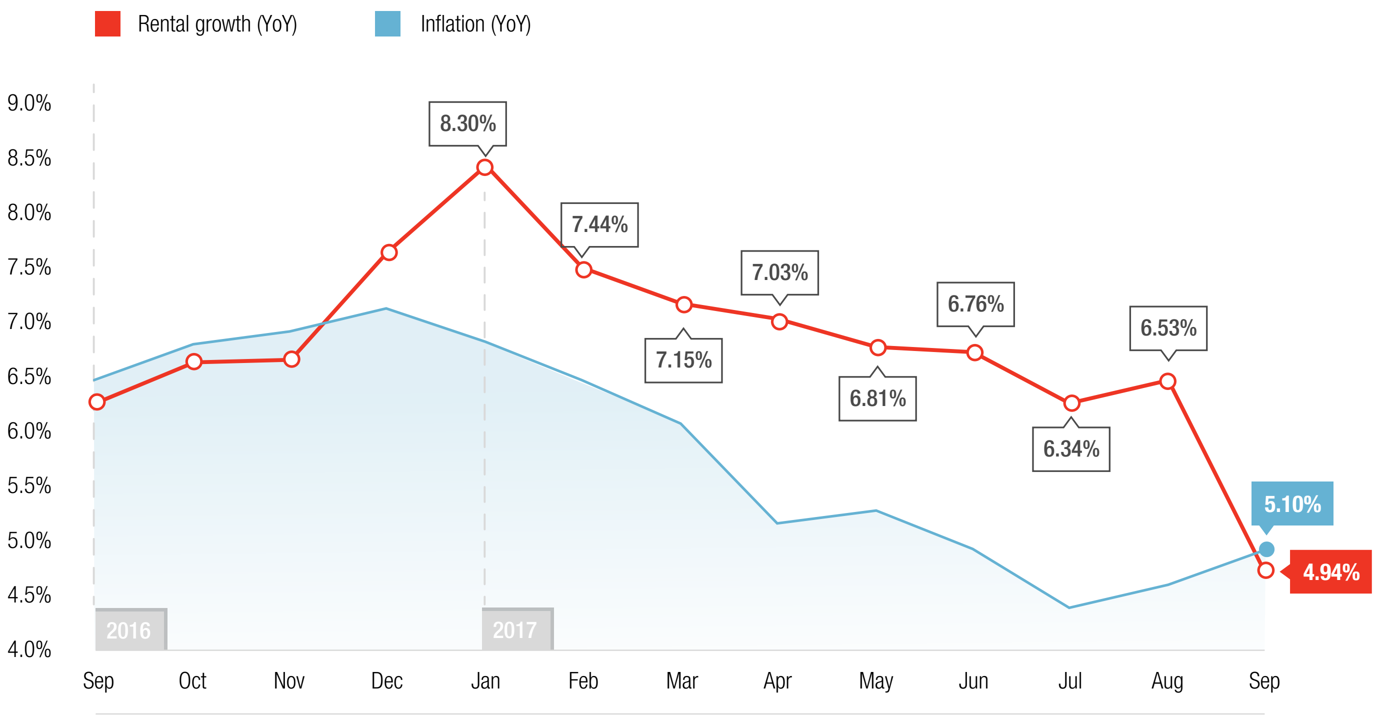
NATIONAL RENT STATISTICS

Consumers under pressure

In Q2, just after it was announced that the South African economy had entered a recession, we speculated that continued economic contraction could cause the gap between rental growth and inflation to widen.

Luckily, the recessionary woes were short-lived and, as noted above, year-on-year growth for Q2 came in at 1.1%. Unfortunately, this doesn't mean consumers will have it any easier – disposable income levels are expected to stay under pressure due to low job creation and possible tax increases in the near future.

Following the rent-inflation graph into Q3, we see a significant drop in rental growth and an increase in inflation in September, the last month of the quarter. As a result, a closing of the gap is evident as rental growth returns to levels closer to inflation growth (last seen in November 2016).

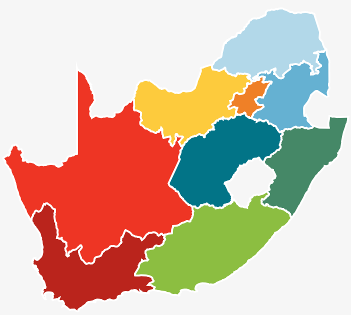


Weighted average national year-on-year rental growth vs. year-on-year inflation rates

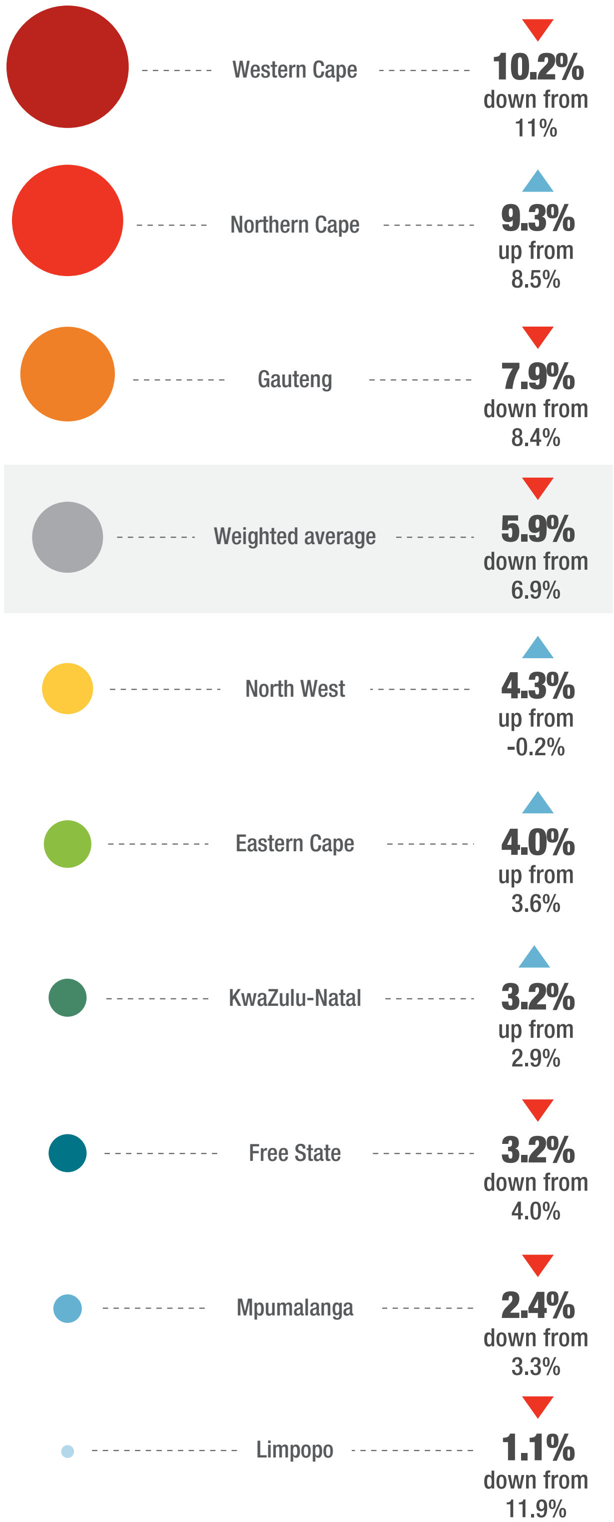
Sources: PayProp, Statistics South Africa

Flagging Limpopo dampens national growth

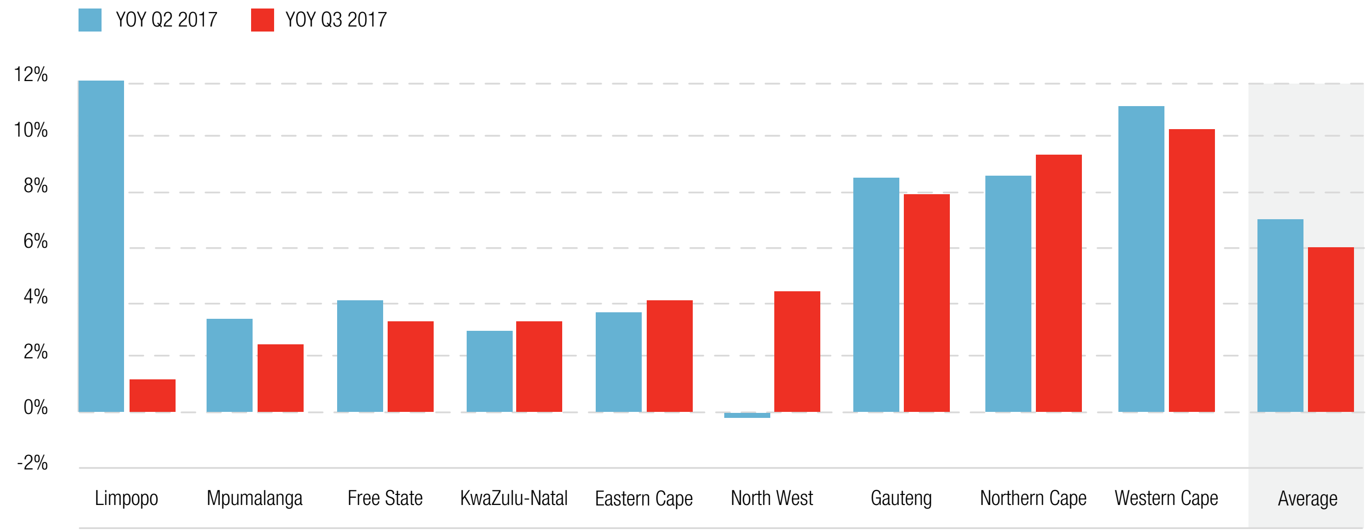
So what does rental growth look like for the quarter? If we compare the year-on-year (YoY) growth rates of Q3 and Q2, we observe that rents are currently growing at a lower pace, and if we consider growth across the provinces, we can see why. Five out of the nine provinces saw a reduction in the rental growth rate while the four provinces showing (modest) increases contribute less than a third to the total weighting of the overall growth. As a result, the weighted average YoY growth rate decreased from 6.9% to 5.9% between Q2 and Q3. ■



Currently at the low end of the scale, year-on-year rental growth in Limpopo decreased significantly over Q3 (1.1% vs. 11.9% for Q2), particularly in September. This has somewhat exaggerated the slowdown in national growth over that period.

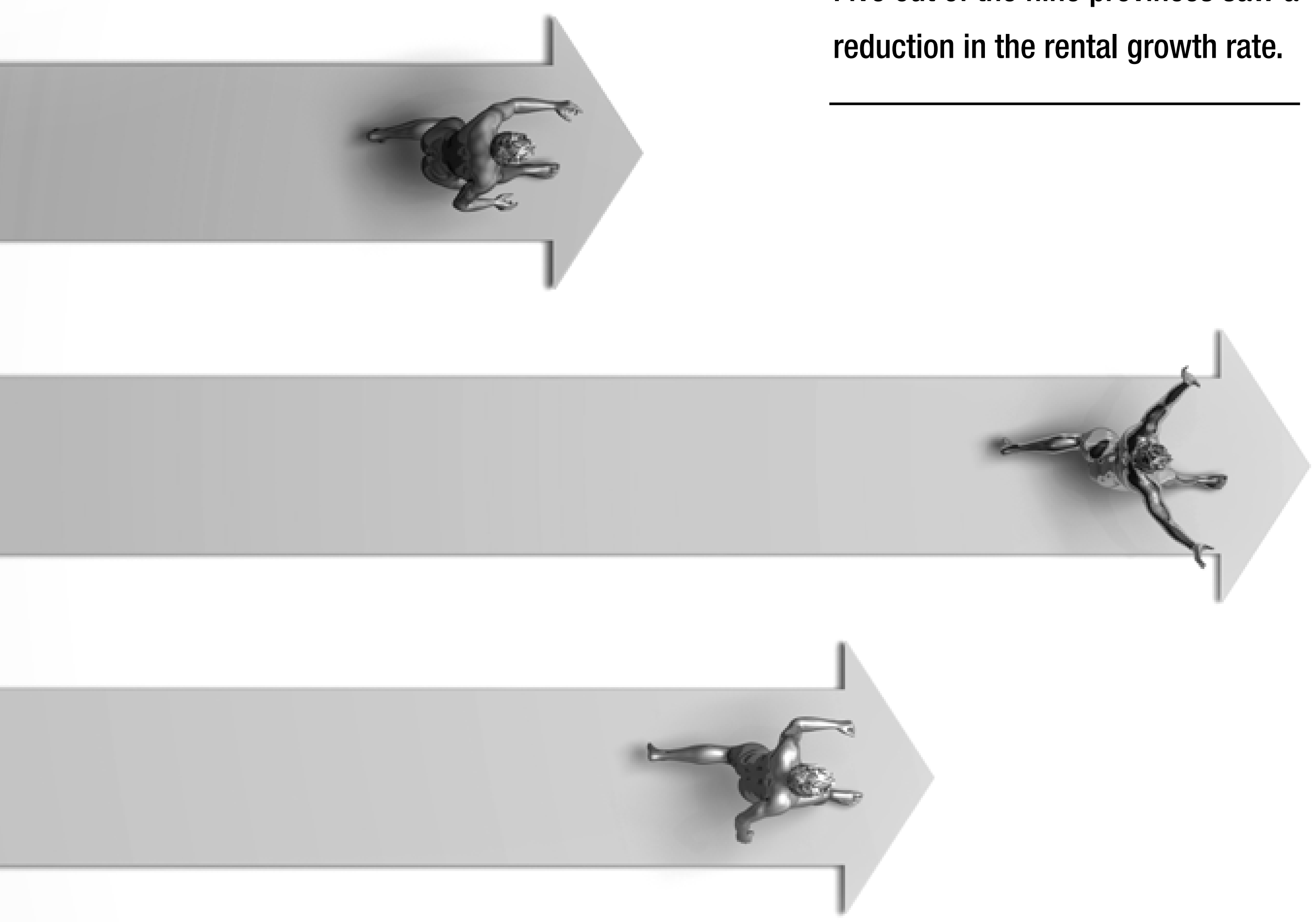


Year-on-year growth rates for Q3 2017
Source: PayProp



Year-on-year growth rates per province for Q2 and Q3 2017
Source: PayProp

Five out of the nine provinces saw a reduction in the rental growth rate.



CUMULATIVE GROWTH RATES

Flash in the pan or solid gold?

It seems as though every few months a new province steals the show with stellar rental growth rates. Unfortunately, what goes up must come down again, and in Q3 it was Limpopo's turn to fall from the dizzy heights of Q2, when YoY growth was 11.9%, to a mere 1.1%.

On the opposite end of the scale, the Northern Cape clocked YoY growth of 9.3% in Q3, up from a below-average 3.8% a mere six months before.

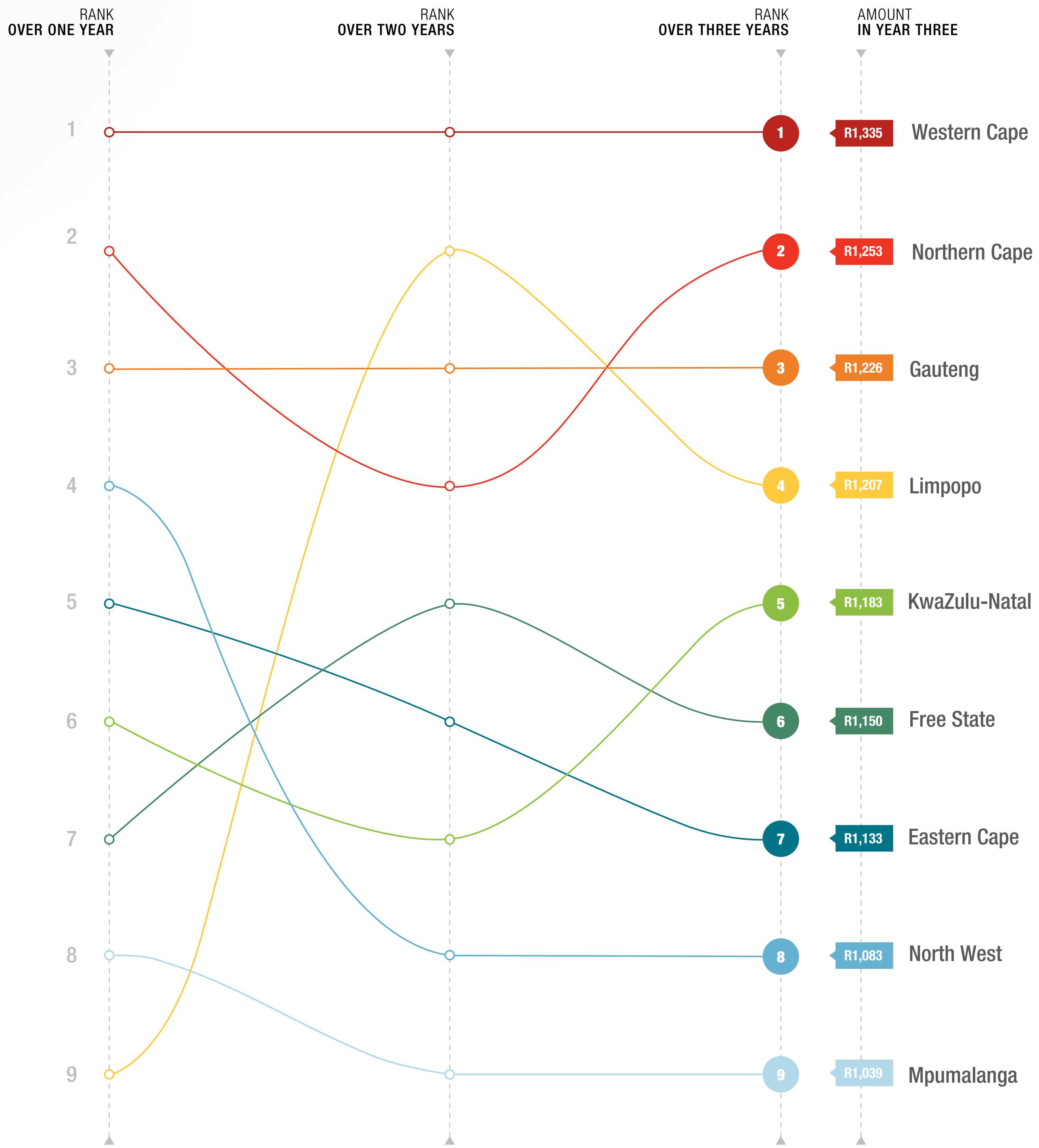
From a buy-to-let investor's perspective, it makes sense to put these ups and downs into context with the help of cumulative rental growth figures.

Landlords who are in it for the long run seek out sustained growth potential over longer periods, to help them distinguish flash-in-the-pan investments from solid gold returns. ▸▸

In Q3 it was Limpopo's turn to fall from the dizzy heights of Q2, when YoY growth was 11.9%, to a mere 1.1%.

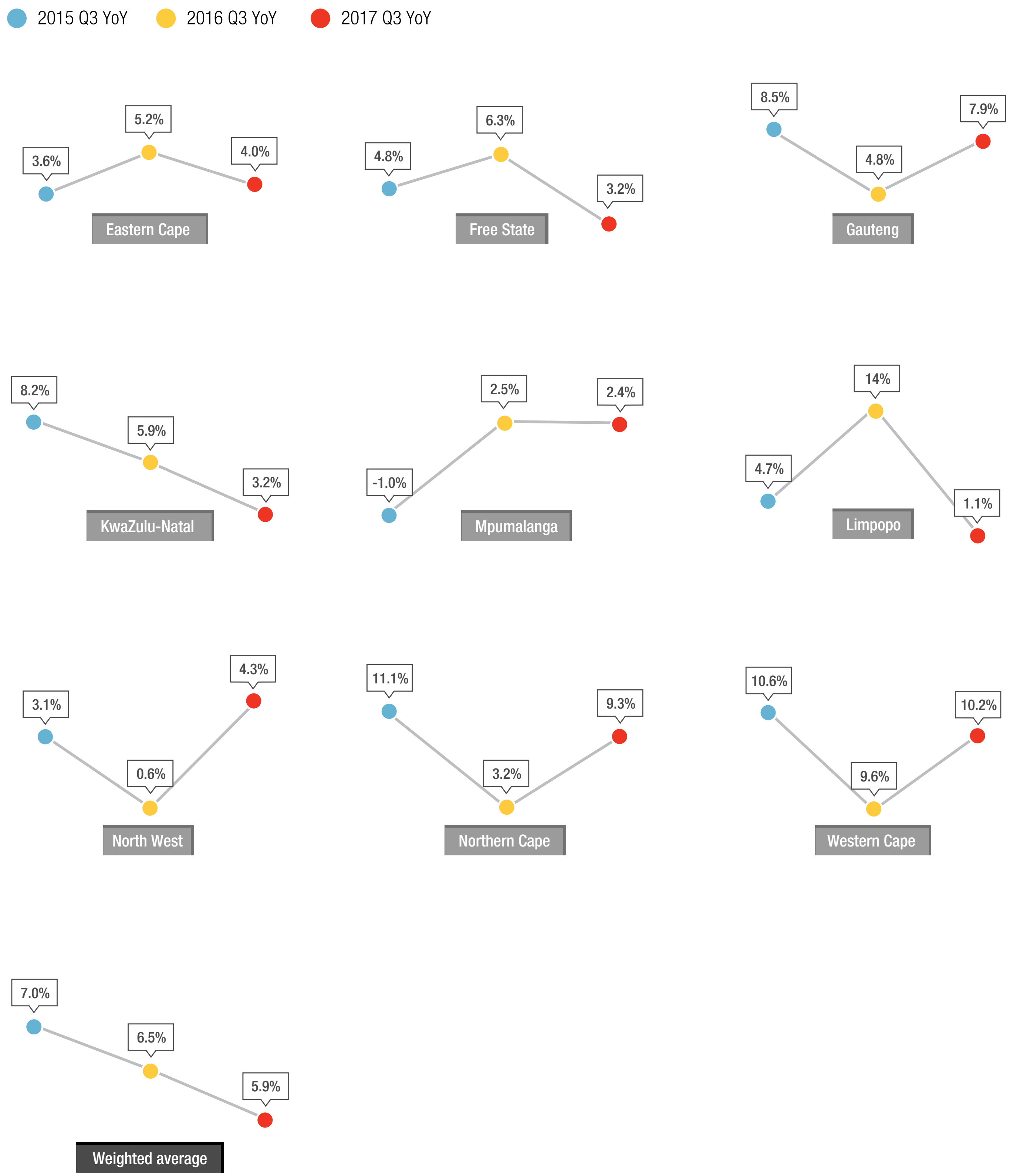
> Cumulative growth looks at growth over multiple years and takes growth on growth into account.

We can illustrate cumulative growth at the hand of a hypothetical example: if rent in all provinces were R1,000 at the same starting point, where would they be now, and which province would show the best rental growth over one year, two years and three years?



Provincial rankings based on cumulative growth rates over the last year, two years and three years

Source: PayProp



Provincial year-on-year growth rates over three years for Q3

Source: PayProp

Limpopo is a great example of the effect of fluctuating growth rates and the importance of cumulative growth rates to track real rental performance over time. While this province had the lowest YoY growth from Q3 2016 to Q3 2017 (1.1%), it featured the highest growth for the year before that (14%). As a result, rental income over the past year may have increased only marginally, but if we consider two years' increases together (cumulatively), Limpopo ranks second-highest for rental growth.

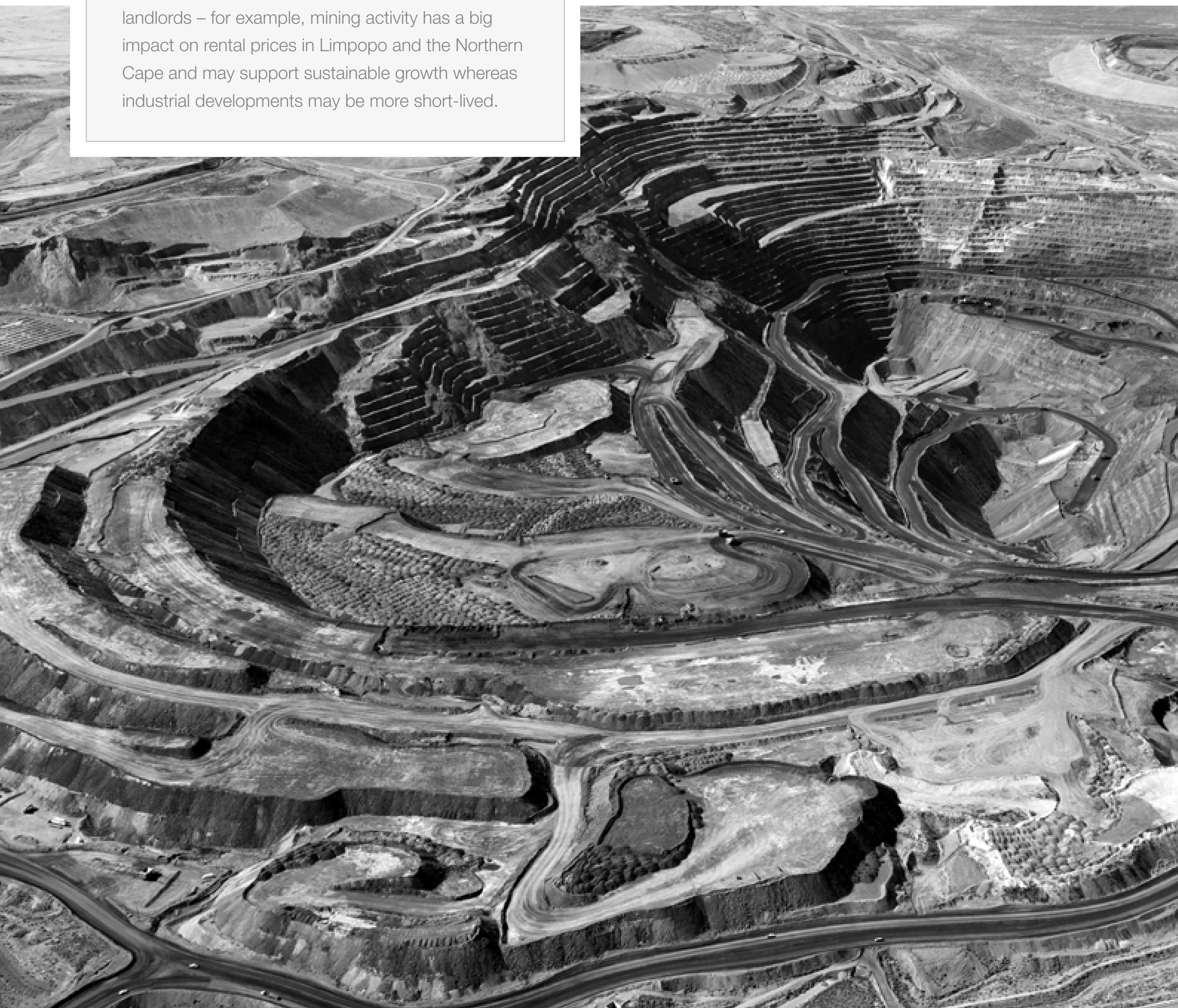
North West Province bounced back recently after very low growth the previous two years. So even though the province had the fourth-highest rental growth over the past year, it still has the second-lowest cumulative growth ranking over two and three years, respectively.

> Knowing what drives supply and demand of rental stock in your province is very important when looking at the bigger picture and communicating with landlords – for example, mining activity has a big impact on rental prices in Limpopo and the Northern Cape and may support sustainable growth whereas industrial developments may be more short-lived.

By contrast, Gauteng and the Western Cape, which have shown high, more consistent growth, are in first and third place respectively over a one-year, two-year and three-year period.

The Northern Cape slipped from second position to fourth after weak growth for the period Q3 2015 to Q3 2016, but above-average growth over the last year has secured second place for this province over a three-year period.

At the top of the pile, rents in the Western Cape have risen by a third in three years, far outperforming the weighted average cumulative growth over the same period (20.8%). The worst-performing province was Mpumalanga, showing a barely-noticeable increase of 3.9% for the three-year period. ■



Mpumalanga has had the highest cumulative growth rate in damage deposits over the past three years.

DAMAGE DEPOSIT DATA

Deposit growth defies rental trends

Is there a correlation between damage deposit size and growth rates? That is, we know the average deposit is highest in the Western Cape, driven mostly by high demand for rental properties. Does that mean it also has the highest damage deposit growth rates? And what about the correlation with damage deposit ratio growth?

When we look at the cumulative growth rate in the damage deposit ratio for the past three years, there clearly isn't any correlation with rental growth rates.

Damage deposit ratios increase or decrease for other reasons than rent levels.

A few damage deposit insights:

Mpumalanga has had the highest cumulative growth rate in damage deposit ratio over the past three years, although it started from a very low base. The damage deposit ratio is currently at 1.13, still below the weighted average of 1.28.

Limpopo's damage deposit ratio decreased by almost 6% over the past three years, from 1.32 to 1.24, and is now closer to the average ratio.

The Western Cape still has the highest ratio by far, currently sitting at 1.66 and increasing slowly. ■

> Note that, even if the damage deposit ratio stays constant, the damage deposit amount grows by the same percentage as the rent over that period. This is why growth in the damage deposit ratio is so low – to grow at all, it must grow in addition to growth already occurring in the damage deposit amount.

Three-year growth rank	Province	Three-year cumulative growth rate in deposit ratios	2017 Q3 damage deposit current ratio
1	Mpumalanga	10.20%	1.13
2	Western Cape	8.42%	1.66
3	Free State	7.13%	1.20
4	KwaZulu-Natal	3.72%	1.23
5	North West	3.56%	1.11
6	Eastern Cape	2.88%	1.33
7	Gauteng	1.84%	1.22
8	Northern Cape	-0.82%	1.03
9	Limpopo	-5.81%	1.24

Provincial three-year growth ranking, three-year cumulative growth rate and current damage deposit ratios

Source: PayProp

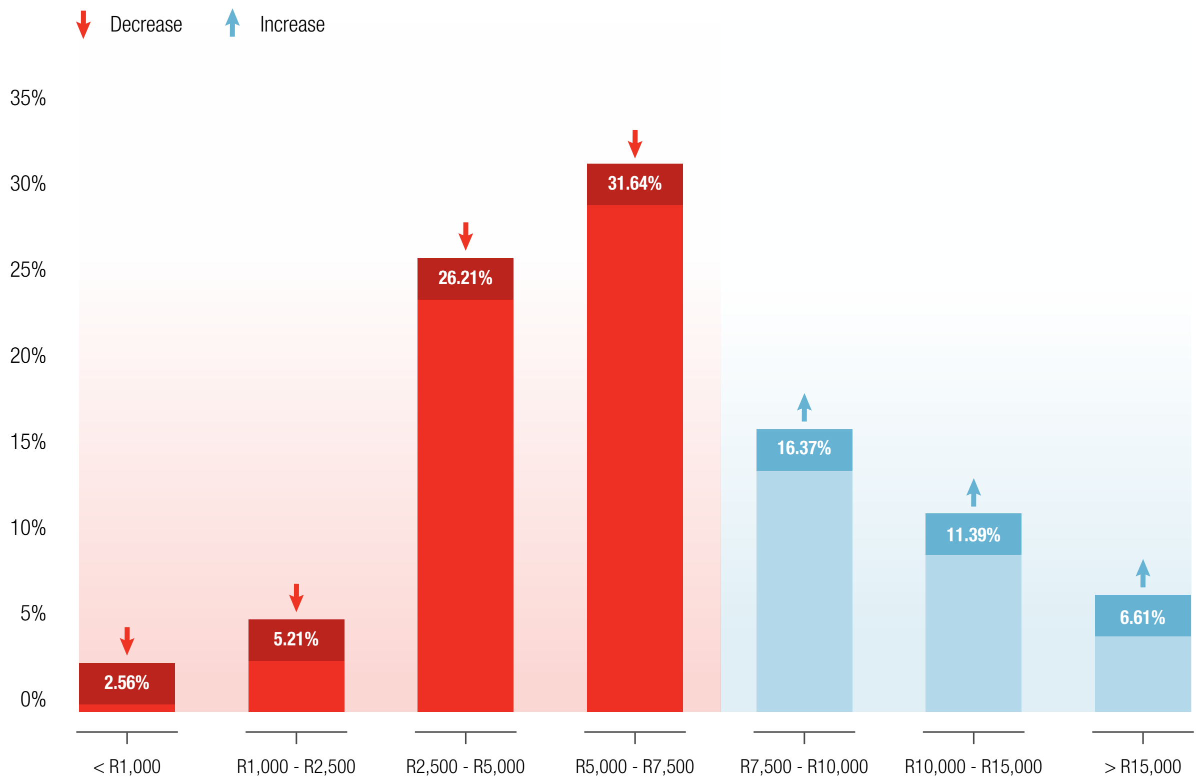
RENTAL PRICING

Keeping up with the Joneses

From the previous Rental Index, we know that almost a third of tenants rent for between R5,000 and R7,500. We also know that the proportion of tenants in the higher brackets (R7,500 and higher) go up over time, while those in the lower rental brackets diminish.

The question we need to ask is this: is this shift driven by demand from tenants or rising rental prices? To answer this question, we need to look at the kinds of tenants who rent in these bands. ▸▸

Income data originates from Tenant Assessment Reports generated by our clients. Net income is not necessarily verified, and the percentage of income spent on rent should not be seen as the sole indication of the cost of living in a province.



Percentage of rentals per price band for Q3 2017

Source: PayProp

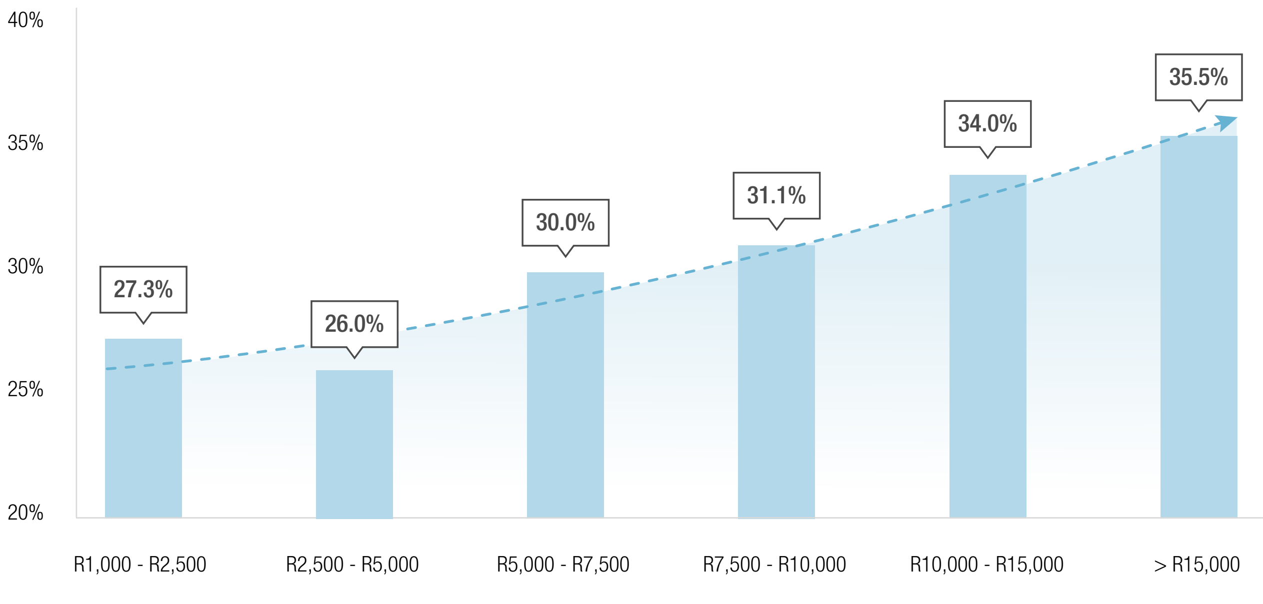
Somehow, high earners spend disproportionately more on rent.

The common assumption is that tenants who rent more expensive properties have higher incomes and higher levels of financial sophistication, and for the most part, the facts bear this out.

When we consider average income per rent bracket, indeed we see that tenants who rent more expensive properties have higher incomes. Average credit measures tell a similar story – tenants who rent for more and have higher incomes also have better credit scores and lower debt-to-income ratios. A smaller percentage of these tenants are therefore high-risk clients.

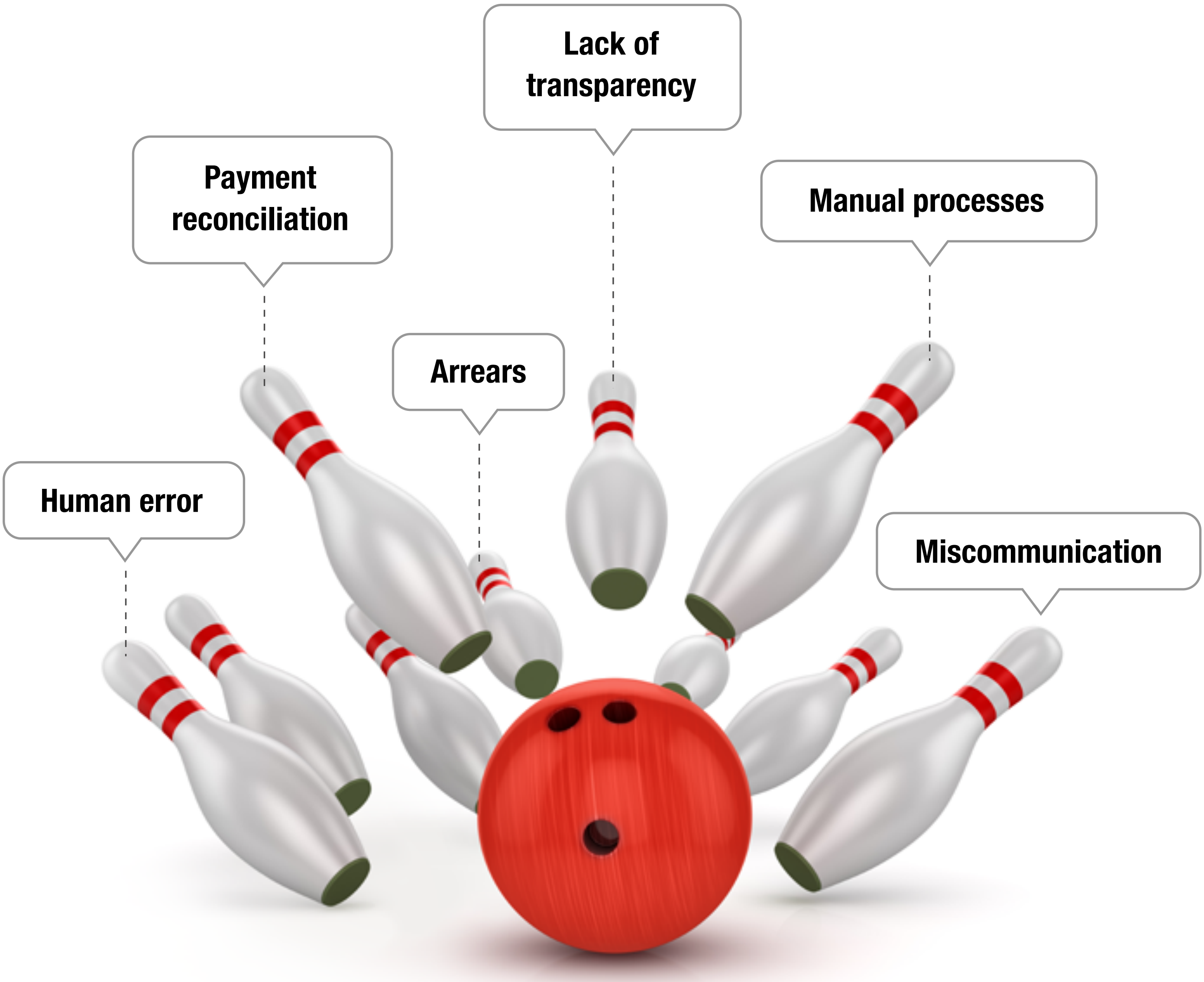
But this doesn't mean tenants with higher income spend any less – quite the contrary. Such tenants tend to have more CPA accounts (day-to-day accounts like retail accounts and cellphone contracts) and higher debt repayments, but their debt as a percentage of income is lower.

There is, however, one very interesting statistic in all of this: the percentage of income spent on rent tends to increase as income increases. Somehow, high earners spend disproportionately more on rent than lower-income earners.



Rent-to-income ratio per rental bracket, including a trend line
Source: PayProp

A new spin on rental management



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Renters in the higher rental brackets are aspirational, that is, they try to 'keep up with the Joneses'.

▸ Why is that?

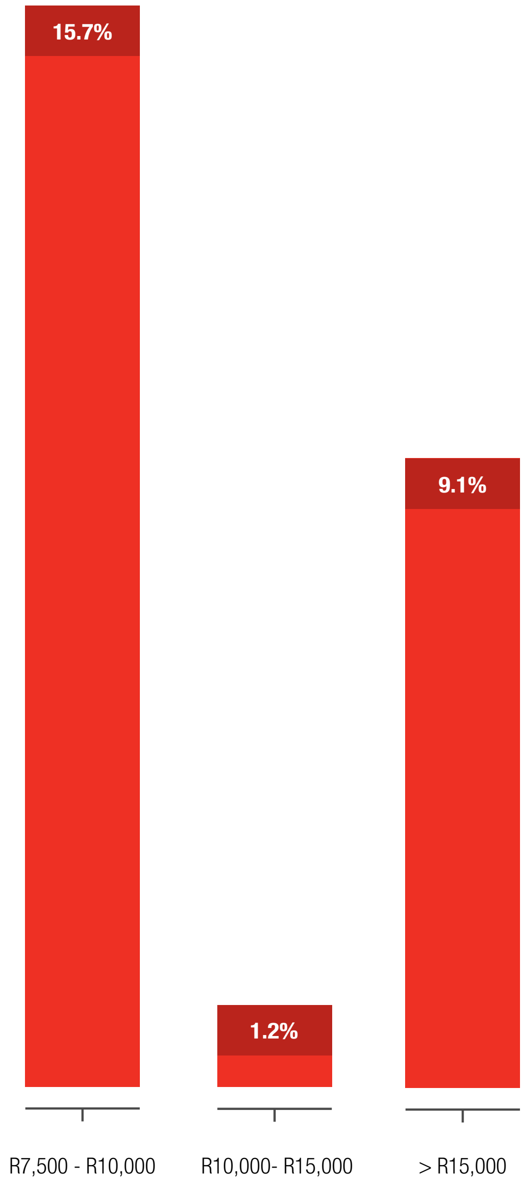
By all appearances, renters in the higher rental brackets are aspirational, that is, they try to 'keep up with the Joneses'. The more a tenant earns, the higher the desire to display that fact.

But higher levels of rent (and more CPA accounts) could mean these tenants are spending more money than necessary. Can they afford it? Is their behaviour sustainable?

From our analysis of the available data, it appears that tenants at the lower end of the more expensive rental bands (properties renting for R7,500 to R10,000) struggle to keep their heads above water.

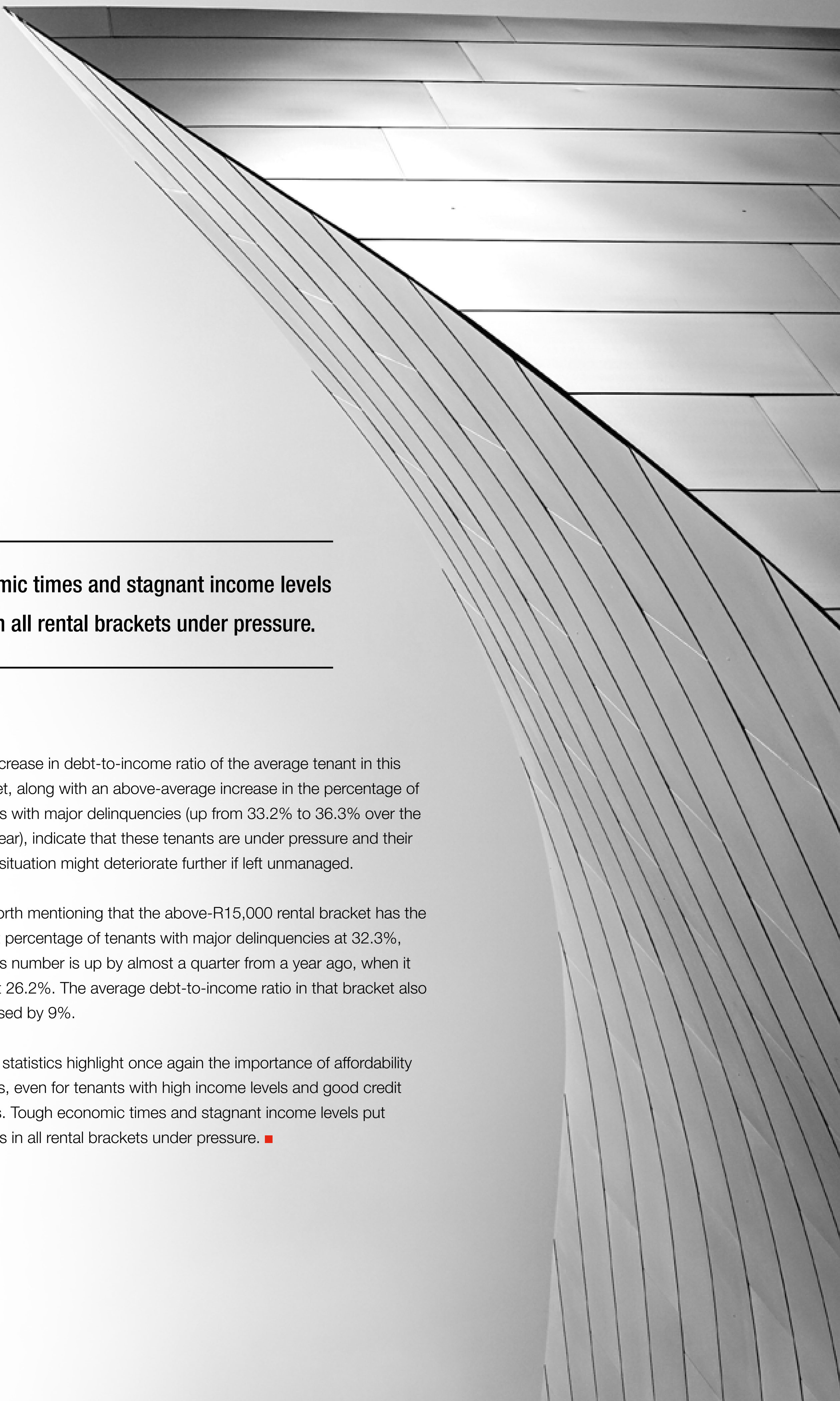
While there was no decrease in credit scores in the past year in any of the upper three rental brackets, there has been a noteworthy increase of almost 16% in the debt-to-income ratio in the R7,500 – R10,000 bracket. This is due to a high increase in debt repayments (13.6%), coupled with a decrease in nominal income over the same period (2.3%). ▸▸

Real vs. nominal: A nominal increase in income is an increase in the rand amount. Real income subtracts the effect of inflation. Consequently, if your income increases by 5% and inflation is 7%, your nominal income is 5% more, but your real income decreased by 2%, meaning that you can only afford 98% of your usual purchases, even with your new salary.



Increase in debt-to-income levels for the three upper brackets from 2016 Q3 to 2017 Q3

Source: PayProp



Tough economic times and stagnant income levels put tenants in all rental brackets under pressure.

- The increase in debt-to-income ratio of the average tenant in this bracket, along with an above-average increase in the percentage of tenants with major delinquencies (up from 33.2% to 36.3% over the past year), indicate that these tenants are under pressure and their credit situation might deteriorate further if left unmanaged.

It is worth mentioning that the above-R15,000 rental bracket has the lowest percentage of tenants with major delinquencies at 32.3%, but this number is up by almost a quarter from a year ago, when it was at 26.2%. The average debt-to-income ratio in that bracket also increased by 9%.

These statistics highlight once again the importance of affordability checks, even for tenants with high income levels and good credit scores. Tough economic times and stagnant income levels put tenants in all rental brackets under pressure. ■

PayProp out and about

PayProp Academy 2017

We took the ever popular PayProp Academy to seven different cities around the country this year, and again we were lucky to have the esteemed company of the award-winning rental law expert, Marlon Shevelew. Our focus for the 2017 Academy was risk, an important and often overlooked element of letting – and the response has been great.

Over 350 principals and agents attended our events to learn about various aspects of risk, including tenancy risk, legal risk and fraud prevention.

We are already hard at work planning the 2018 event (hosted in February), and with hot topics around technology and the future of property as well as some exciting PayProp news, this promises to be an even bigger and better event. We hope to see you there!

NAMA Indaba

In September, PayProp participated in the NAMA Indaba, the annual event of the National Association of Managing Agents, hosted at Emperors Palace.

As a Gold Sponsor we showcased our new Unit Management platform to delegates and sponsors. Take the virtual tour for a look at our stand!

PayProp Unit Management gives full visibility to agents and trustees alike, with a wide range of reports including budget vs. actual, in seconds. It's the power of PayProp for sectional title and other multi-dwelling developments.

Moving into the unit management market gives us invaluable insights into large-scale rentals, an increasingly important part of the rental market. We look forward to delving into that part of our data set in future issues. ■

IN SUMMARY

Cash-strapped consumers

Overall, this quarterly Index presents an arresting snapshot of the industry in a changing economic climate.

Year-on-year rental growth slowed over the past quarter, culminating in a return to historic similarity between rental growth and inflation.

Rental growth may be declining due to various reasons, including affordability, while higher inflation levels could indicate higher prices due to increased input cost, effectively pushing prices up from a supply side. We’ve seen that incomes in general are decreasing, at least in real terms, which means tenant income is worth less now than a year ago.

The rent-to-income ratio showed an interesting and unexpected upward trend, as tenants with higher income levels spend a larger proportion on rent.

However, the tendency of tenants in higher income brackets to rent bigger and better houses might not be a sustainable option if income levels remain flat over time. Tenants of all income levels are affected by the current economic climate. ■

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 third quarter of 2017.

Contact details

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