PROPERTY WEEKLY

2nd half 2019 Macro-Commercial Property Outlook

– After elections, back to "business as usual" in a stagnant economy, with slow property correction continuing

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FNB COMMERCIAL PROPERTY FINANCE

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South Africa's general election has passed, the new cabinet and parliament have begun their work, and life continues in what is a weak economic and thus property environment. Firstrand economists do project some mild strengthening in economic growth in 2020, compared to the expectation for 2019, and a repo rate cut in the near term is also anticipated. However, we do not believe that this will be sufficient to halt the rising property vacancy trend yet, nor the pressure on rental growth, and as such project further decline in real property values ("real" referring to inflation-adjusted nominal value growth). The property market will have to continue to deal with the weak state of broader Government finances, which imply upward pressure on operating costs via further above-inflation hikes in municipal rates and utilities tariffs. There also exists the risk of upward pressure on capitalization rates via long bond yield rises in potential response to rising government debt.

- South Africa's general election has come and gone, and it is back to "business as usual" for the property market, which has to deal with a weak economy and all of its structural constraints.

- Firstrand forecasts of moderate improvement in economic growth to 1.2% in 2020, from an expected 0.6% this year, based on an expectation of mild strengthening in the global economy next year, and domestically a 25 basis point interest rate cut by the SARB (Reserve Bank).

- However, this expected mild economic growth improvement is not yet expected to be sufficient to halt the rising All Property vacancy trend (using MSCI historic data), a trend that started in recent years in a similar weak economic growth environment to the one projected. Rather, we believe that growth perhaps in excess of 2% would be required to halt the rising vacancy trend in the near term.

- Further slowing in the All Property Capital Growth Rate from 1.7% (Using MSCI historic data) in 2018 to 0.5% this year is anticipated , with low nominal growth (below the economy-wide inflation rates) remaining negative in real terms through the forecast period to 2021.

- Total Commercial Property Returns are projected to remain in single digits in the process.

- Property operating costs are expected to experience further upward pressure from strong municipal rates and utilities tariff increases.

- A key forecast risk emanates from the deteriorating Government debt situation, which increases the risk that at some point bond yields, and with them property capitalization rates, will rise more significantly, exerting downward pressure on property values.

THE COMMERCIAL PROPERTY OUTLOOK GOING INTO THE 2ND HALF OF 2019

- After elections, its "business as usual" for the economy and property

The May general election has come and gone, President Ramaphosa's cabinet has been selected and trimmed in number, and the country goes back to "business as usual" in what can only be described as a stagnant economy at best, with major structural challenges.

Weak Economic Growth Persists, likely to mean ongoing gradual real property price correction

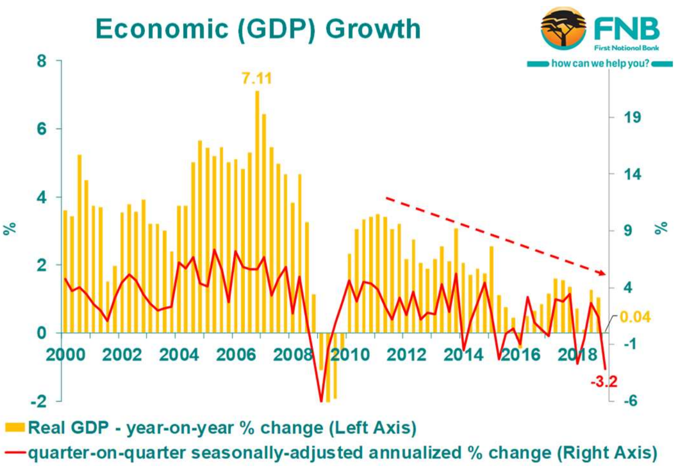
For property, this stagnant low growth economy in all likelihood means ongoing gradual correction in property values, not always meaning nominal value decline, but slow nominal capital growth below general inflation, which translates into declining "real" capital values.

Indeed, real decline in values has been the trend in recent times, and our expectation that the economy will continue to battle to exceed 1% GDP (Gross Domestic Product) growth leads us to expect more of the same for the foreseeable future.

Globally, key themes have been US Federal Reserve interest rate hiking and the US trade war most notably with China, factors that can slow the global economy. Indeed there have been signs of a slowing global economy, and the IMF (International Monetary Fund) projects global economic growth slowing from 3.6% in 2018 to 3.3% in 2019. This all impacts on the very open South African economy.

Domestic economic and economy-related events directly after the election have served to make any post-election euphoria short-lived. Eskom's well-regarded CEO Phakamani Hadebe resigned from the troubled electricity parastatal, with the equally troubled SAA's CEO, Vuyani Jarana, resigning his position just days later.

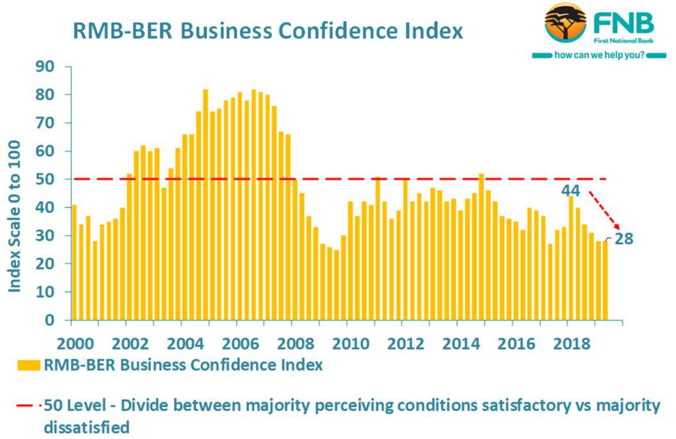
Recent data releases have confirmed the very weak economic environment. 1st Quarter GDP (Gross Domestic Product) numbers showed a quarter-on-quarter seasonally-adjusted annualized contraction of -3.2%.



This will serve to keep speculation regarding the possibility of another recession (a minimum of 2 consecutive quarters of negative growth).

The 2 most up to date monthly data releases paint a weak picture having likely continued into the 2nd quarter, June New Passenger Vehicle Sales (which is used in the composition of the SARB Leading Business Cycle Indicator) declined year-on-year by -3.3% and the Manufacturing New Sales Orders Index within the Absa Purchasing Managers Index (also a SARB Leading Indicator component) came in at 46.2 in June on a scale of 0 to 100, thus remaining below 50 to signal the possibility of a Manufacturing Sector contraction.

2nd Quarter Business Confidence remained unchanged at 28 (on a scale of 0 to 100), indicating that only 28% of survey respondents were satisfied with business conditions in the 2nd quarter, a lowly level similar to levels last seen in 2009, around the time of the "Great Recession".

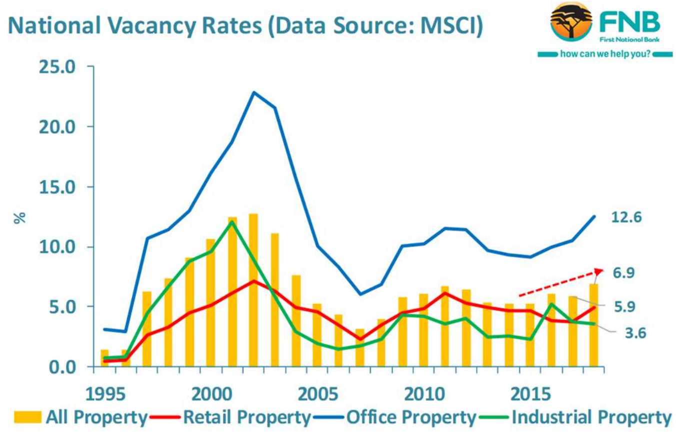


Looking ahead, there is a widespread expectation that the US Federal Reserve may begin to cut interest rates in the US, which would provide some mild stimulus to the global economy, but the outcome of the trade war remains uncertain.

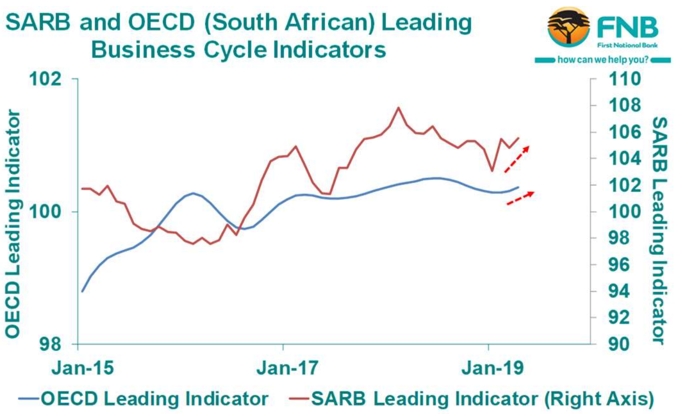
On the assumption that the trade war will be resolved this year, and on the back of US Fed stimulus, we anticipate some improvement in global economic conditions towards 2020, assisting the South African economy to mildly stronger GDP growth of 1.2%, from a forecast 0.6% in the current year.

Even with some mild growth improvement next year, however, we would not see a 1.2% growth rate as sufficient to end the gradual rising trend in the national vacancy rate, as depicted by the MSCI All Property Vacancy Rate.

This vacancy rate has risen from a multi-year low of 5.2% in 2014 to 6.9% in 2018. During this period, real economic growth has ranged from a lowest rate of 0.4% in 2016 to a highest rate of 1.4% in 2017. Similar growth projections through our forecast period, 1.2% being the highest rate forecast in any year to 2021, are thus expected to lead to further mild increase in the All Property Vacancy Rate.



Is there evidence of any growth improvement to come, in the data, yet? Nothing strongly convincing yet, but both the SARB and OECD Leading Business Cycle Indicators have risen off their low points in recent months, which may point to slightly stronger economic growth approaching in the near term as anticipated by Firstrand economists.

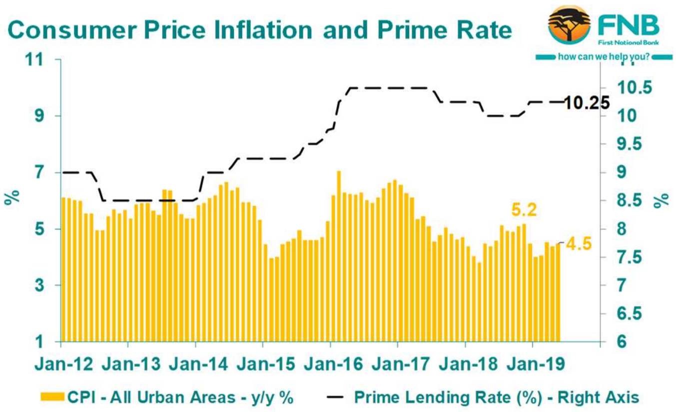


The general inflation environment remains benign, suggesting possible interest rate reduction…a mild property positive.

While the economic growth environment remains "property negative" when considering its impact on property market strength, the general inflation and interest rate environment would appear mildly "property positive" at present.

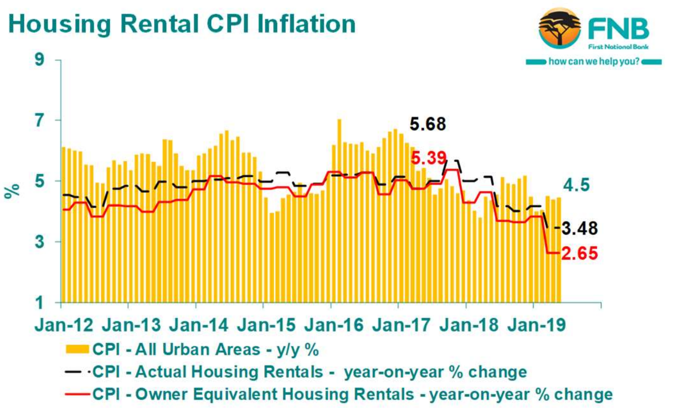
Given the SARB's 3-6% inflation target range, the most recent May CPI (Consumer Price Index) inflation rate of 4.5%, right in the middle of the target range, encourages Firstrand to expect a 25 basis point interest rate cut by the SARB in the 2nd half of 2019.

The most recent inflation rate is down on the 5.2% rate of November 2018 that led to a late-2018 25 basis point repo rate hike, and indeed the SARB in its most recent Monetary Policy Statement of May 2019 pointed to an "improved inflation outlook". A forecast of 4.5% average CPI inflation for this year drives a model-driven (the SARB's econometric model) endogenous interest rate forecast for a 25 basis point cut in the policy Repo Rate by the 1st quarter of 2020. And indeed, 2 out of 5 MPC members voted for a rate cut in May, 3 voting for keeping rates unchanged, so the bias towards rate cutting appears to be mounting.



The property market has been a contributor to lower CPI inflation, with both Actual as well as Owner Equivalent Residential Rentals CPI's (key sub-indices within the overall CPI) seeing their year-on-year inflation rates having slowed from 5.68% and 5.39% respectively as at November 2017, to 3.48% and 2.65% respectively as at May 2019.

So a weak residential rental market may play an important role in an expected interest rate cut later in 2019.



The SARB also flagged slow food price inflation as a key inflation positive recently, and indeed at 3.2% year-on-year the Food and Beverages CPI "behaves" relatively well. In addition, recently troublesome petrol price inflation has slowed from 12% year-on-year in May to a deflation year-on-year of -1.2% for July (Gauteng pump price).

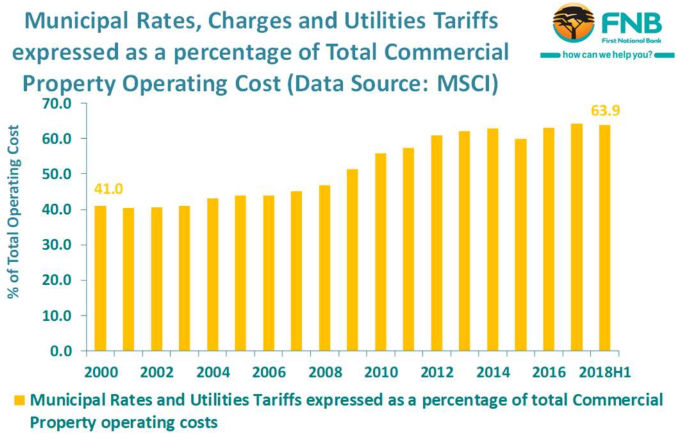
A near term rate cut is thus a plausible expectation, and is a very mild source of support for property. We wouldn't, however, expect one isolated 25 basis point cut to offset the economic negatives and lead to any significant property market strengthening at this stage.

The Property-Related cost inflation situation, however, appears less positive, exerting upward pressure on operating costs.

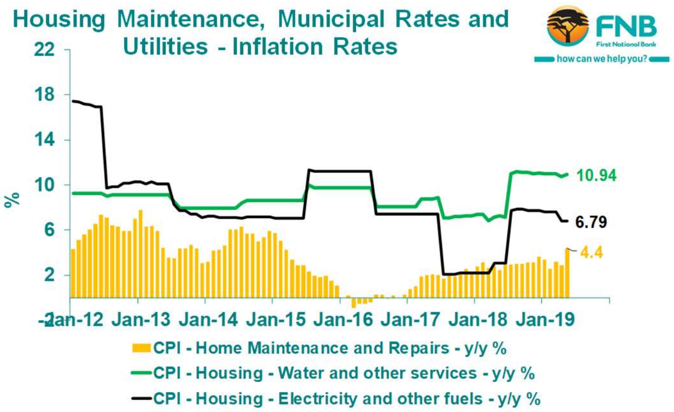
When we refer to the more property-related cost inflation situation we are referring most notably to the spiraling costs of municipal rates and utilities tariffs.

While these cost items are too small within the overall CPI to be a major influence on interest rates, they do make up a large part of total operating costs of commercial property.

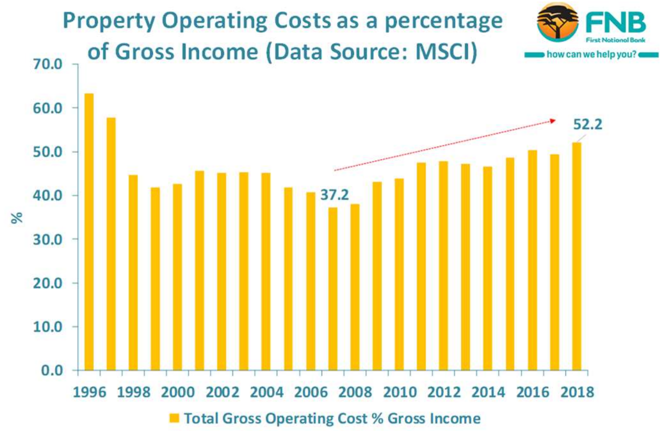
From 41% of total operating cost in the year 2000, Municipal Rates, Charges and Utilities' Tariffs have increased to 63.9% of total operating costs by the 1st half of 2018, the most noticeable increase in this share coming around the years 2008 to 2012 around the time that Eskom was implementing its most extreme tariff hikes.



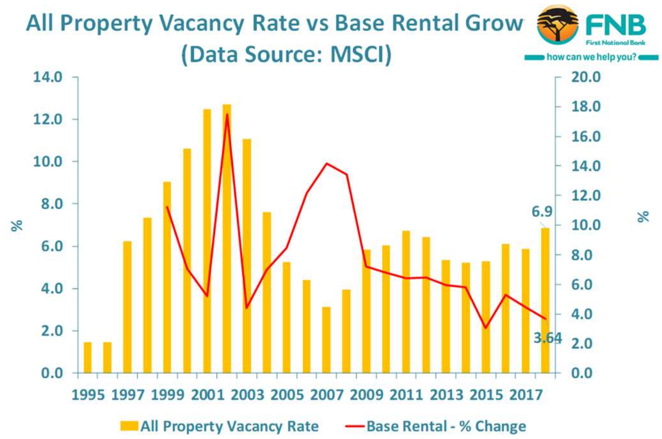
While monthly CPI data for rates and tariff increases applies to households, obtained from the CPI, it should give a broad idea of the economy-wide rates and tariffs problem. The CPI for "Water and Other Services", which includes municipal rates and non-electricity tariffs, recently has been inflating by 10.94%, whilst the CPI for Electricity rose by 6.79%, both sub-indices remaining well above overall CPI inflation, and given the weak state of parastatal and general government finances, this looks set to remain the case for the foreseeable future (Eskom having recently obtained NERSA approval for another 13.81% electricity tariff increase).



This rates and tariffs environment promises to exert upward pressure on total operating costs as a percentage of Gross Income, this percentage already having risen from 37.2% in 2007 to 52.2% by 2018 (using MSCI data).



Such cost increases for tenants, in a weak economic and rising vacancy rate environment, could exert further slowing pressure on landlord "pricing power" and thus on rental growth, with Base Rental growth already recording a lowly rate of 3.6% in 2018 (using MSCI data).



Government's financial situation poses a significant risk to property capitalization rates

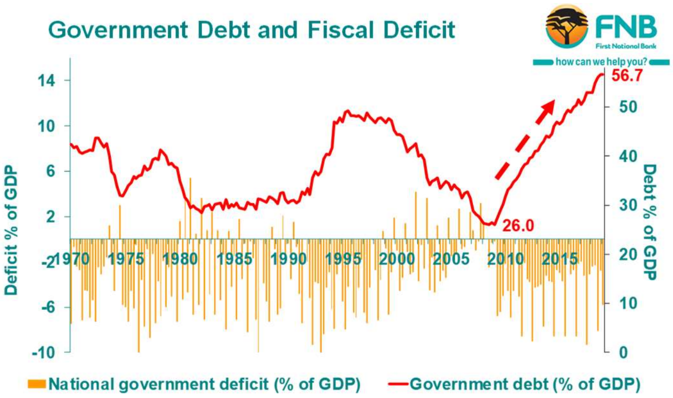
The parlous state of Government and Eskom Finances threatens the performance of the property market in a few ways. We have already mentioned its impact via above-inflation municipal rates and tariff increases, exerting significant upward pressure on property operating costs.

In addition, rising government and parastatal indebtedness makes future scope for fiscal stimulus for the economy less possible, thus constraining economic growth and the demand for commercial property.

But a further key risk is that at some future point the bond investors become far more concerned with the possibility of Government default on its debt, exerting far more significant upward pressure on bond yields. And higher long bond yields can exert upward pressure on property capitalisation rates,.

The high levels of parastatal debt, most notably the high level of Eskom debt at a time when its electricity sales battle to grow, with the utility reportedly having over R400bn worth of debt and rising, add to risk, because Treasury has already been required to support Eskom with taxpayer money in recent months. Far more such support is planned, with the sharp electricity tariff hikes not being sufficient.

The Government Debt-to-GDP Ratio has risen from 26% early in 2009 to 56.7% by the 1st quarter of 2019, with further increase seemingly set to come after Eskom support began in the 2nd quarter of 2019.



The prospect of short term interest rate reduction both in SA as well as in the US can contain long bond yields and thus capitalization rates. However, this is based on the assumption that the bond market won't meaningfully alter its risk perception of South African Government debt. But as Government debt rises, the risk is that yields will at some stage rise more significantly in response to this.

The mid-2019 forecast summary.

In short, even a forecast of moderate improvement in economic growth to 1.2% in 2020 , after a projected 0.6% in 2019, is not yet expected to be sufficient to halt the rising All Property vacancy trend, a trend that started in recent years in a similar weak economic growth environment to the one projected. Rather, growth in excess of 2% is believed to be required to halt the rising vacancy trend in the near term.

An expected 25 basis point interest rate hike, too, is not believed to be sufficient to strengthen the property market in such a weak economic environment.

Further slowing in the All Property Capital Growth Rate from 1.7% in 2018 to 0.5% this year is anticipated , with low nominal growth (below the economy-wide inflation rates) remaining negative in real terms through the forecast period to 2021.

Total Returns are projected to remain in single digits in the process.

Property operating costs are expected to experience further upward pressure from strong municipal rates and tariff increases.

The key forecast risk, however, emanates from the deteriorating Government debt situation, which increases the risk that at some point bond yields, and with them property capitalization rates, will rise more significantly, exerting downward pressure on property values.

Forecast Summary	2018	2019	2020	2021
GDP Growth (4-quarter average) - %	0.8	0.6	1.2	1.2
CPI Inflation (12-month average) - %	4.6	4.4	4.7	4.8
Prime Rate (Period end) - %	10.25	10.00	10.00	10.00
Commercial Property				
- Income Return - %	8.00	7.80	7.50	7.50
- Capital Growth - %	1.70	0.50	-0.10	0.10
- Total Return - %	9.80	8.30	7.40	7.60
- Vacancy Rate - %	6.90	7.20	7.50	7.50