BIZCOMMUNITY

Pressure remains on commercial property market post-lockdown

By John Loos

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As the country emerges from Covid-19-related lockdowns, the hard lockdown having been in April and May 2020, high frequency data points to quite a lengthy road back to "full" recovery for the economy. By "full" recovery we are referring to economy-wide production levels, as measured by GDP (gross domestic product), returning to pre-Covid-19 levels. Here we are referring to GDP level and not growth rate.

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That the economy has only partially recovered to date is not unexpected. The reality is that such a severe economic shock, as the second quarter lockdown was, placed such severe financial pressure on many of the country's producers that a portion of them would not have survived. Therefore, a portion of the country's production capacity has shut down, and the potential output of the economy has thus been reduced by a magnitude not easily determinable. Therefore, it may not be possible in the short term to achieve pre-Covid-19 production levels. That may only be realistic in the medium to longer term.

'Recency bias'

Secondly, the human cognitive bias known as "recency bias" means that many business people, as well as households, are likely to base their views of the future strongly on what has happened in the recent past. With the recent past looking bleak, very weak business and consumer confidence is likely to improve only slowly at best.

And if confidence is low, costly expansions in production capacity are likely to only come with a considerable lag as many businesses adopt a cautious "wait-and-see" approach and many consumers go cautiously on their spending and borrowing.

Such a slow recovery in confidence can become a self-fulfilling prophecy, contributing to a slow recovery at best for the economy.

Thirdly, given that the world economy has been severely impacted by its own lockdowns, and will also take time to recover, SA's trade with the rest of the world will also likely not recover fully in a hurry.

Therefore, the FNB forecast for a slow multi-year return to pre-Covid-19 2019 levels of GDP appear justified. After a forecast -8% fall in GDP in 2020, the +3% and +0.5% positive growth rates in 2021 and 2022 respectively would still be insufficient to return GDP to its 2019 level.

Given that GDP levels from 2017 to 2019 were insufficient to drive enough demand for commercial property space to prevent rising vacancy rates, we would think it unlikely that even lower GDP levels than in those years could prevent this either. More likely, we think that the All Property Vacancy Rate (using MSCI data) will move higher into double-digit rates heading towards 2021, continuing to exert downward pressure on property rentals, income and property valuations.

Key economic indicators

Business confidence improves post-lockdown, but remains very weak

The BER Business Confidence Index reading for the third quarter of 2020 was noticeably higher than the second (lockdown) quarter reading. From five (on a scale of 0 to 100) in the second quarter, the reading increased to 24 in the third quarter. However, this means that only 24% of survey respondents are "satisfied with business conditions", the overwhelming majority thus not being satisfied.

The situation appears not too dissimilar in the commercial property market, where the FNB Property Broker Survey showed only 31% of respondents being satisfied with business conditions in the third quarter survey, thus also mildly improved from a 20% second quarter reading, but still very weak.

Some leading business cycle indicators also point to an "improved but weak" picture in the months after lockdown

Released earlier in October was the OECD Leading Business Cycle Indicator for August. This index's level too was significantly improved, but still lower than pre-lockdown levels, suggesting that we have some way to go before GDP returns to pre-lockdown levels.

The index for August was -1% down year-on-year, thus still negative, albeit improved from -6.5% year-on-year down as at April 2020.

The SARB Composite Leading Indicator for July (August datapoint not yet released) was down -4.2% year-on-year, which also represents an improvement of sorts from -12% year-on-year in May.

Both indices' actual index level is sharply improved in recent months but down on pre-lockdown levels.

One of the most up to date leading indicators, which is included in the SARB Composite Leading Business Cycle Indicator as a leading business cycle indicator in its own right, is the volume of new passenger vehicle sales.

This data series continues with the "improved but weak" theme. As at September, the volume of new passenger vehicle sales was -31.2% down year-on-year, which is a very weak reading but improved from -99.6% down year-on-year as at April 2020.

Other more dated high frequency releases show a similar picture. The volume of manufacturing production for August was down -10.8% year-on-year, improved from a -48.9% in April, and real retail sales down -4.2% year-on-year in August, also improved from -49.9% in April.

Listed property and bond markets remain sharply weaker compared to pre-Covid-19 times

Listed property sector remains sharply down on end-2019 levels

Some key markets, from a property point of view, have corrected sharply this year too, exerting pressure on the physical property market and its valuations.

Confidence in the listed property sector on the JSE remains extremely weak, the listed property index as at last week about -53.3% down on the end-2019 level.

Higher government long bond yields

In addition, despite the SARB having provided support for the bond market this year, undertaking its own bond buying, government long bond yields remain significantly higher than end-2019 levels. From 9.02% at the end of 2019, the average yield on government bonds 10 years and longer was 10.46% at the end of last week.

Ignoring the Covid-19 crisis-related spike in these yields to near to 13% at a stage earlier this year, the broad trend in yields since 2013 (where they bottomed at 6.64% at a stage of that year) is still believed to be a rising one.

This trend is influenced strongly by ongoing deterioration in government finance, and the rapid rise in the government debt-to-GDP ratio. By the second quarter of 2020, this ratio had risen to 69.4, the gradient of the rising curve steepening in recent quarters, and now far higher than the multi-decade low of 26 back in 2008.

This long term broad rising trend in long bond yields is expected to be a source of upward pressure on property capitalisation rates, and thus downward pressure on valuations, for the foreseeable future.

Short-term interest rates pose no pressure to the property market at present

Short-term interest rates aren't a source of pressure on the property market at the moment, however, having moved significantly lower earlier this year. Inflation remained subdued at 3.1% in August, and the SARB has been able to lower the repo rate by 300 basis points this year to 3.5%, translating into a single-digit prime rate of 7%.

These recent rate cuts, while seen as useful in alleviating some pressure, could not prevent a sharp lockdown-driven economic contraction in the second quarter, and thus a significantly negative economy-related impact on the commercial property market.

Outlook – accelerated negative capital growth in 2020

MSCI bi-annual data regarding commercial property performance was recently released, updating the property picture for the first half of 2020.

Since 2014, the commercial property market has been gradually weakening, with broadly declining half-yearly total returns that declined from a decade high of 9.6% in the first half of 2013 to a negative -1.7% by the first half of 2020.

The weakening trend was sped up by the Covid-19 lockdown shock to property income, with total half-yearly returns declining sharply from 3.6% in the latter half of 2019 to the negative -1.7% in the first half of 2020.

The capital growth component of total returns slowed sharply from an already negative -0.3% half-on-half rate in the latter half of 2019 to -5.2% in the first half of 2020.

With property incomes under severe pressure, income return also declined, from 3.9% for the final half of 2019 to 3.6% in the first half of 2020.

Severe pressure on commercial property tenants

Property values came under pressure as property income plummeted. TPN data had already shown the severe pressure on commercial property tenants. The percentage of tenants in good standing with landlords had already declined from 83.11% back at a stage of 2016 to 77.85% by the first quarter of 2020 (reflecting the mounting pressure of the long-term economic stagnation), before dropping sharply to 50.26% in the second quarter of this year.

MSCI bi-annual data thus merely confirmed what had already become obvious, i.e., that there had been a severe property impact from lockdown in 2020. Already broadly stagnating net operating income growth on commercial property plummeted sharply from a low +1.7% half-on-half positive rate in the latter half of 2019 to a sharp -9.5% decline in the first half of 2020.

Therefore, whereas we had previously earlier in the year projected a -5% negative capital growth rate for 2020, recent bi-annual data from MSCI suggests that this projection may have been too small in magnitude, given that the half-on-half-year rate of negative capital growth was already -5.2% for the first half of the year alone.

After that sharp half-yearly negative rate, we would anticipate a slower rate of decline in the second half of the year as property income bounces back in part at least.

Negative capita growth rates expected ahead

But with the All Property Average Vacancy Rate expected to continue to rise, projected to move into double digits in 2021, we expect further negative capita growth rates in the latter half of 2020 and into 2021, the projection for 2020 as a whole being put at -7%.

The average annual All Property Vacancy Rate of MSCI has been rising since the multi-year low of 5.2% reached in 2014, to reach 6.7% by 2019. 2014 was the year where GDP growth dropped to below 2% (recording 1.8%) for the first time since the 2009 contraction, and a further slowing to 1.2% in 2015 appeared to be the catalyst for the start of a rising vacancy rate trend.

It would thus appear that GDP growth, battling to reach 1% in recent years, has already been insufficient to create the level of property demand required to turn the All Property Vacancy Rate downwards. A -8% forecast GDP contraction could thus be expected to speed up the rate of increase in the vacancy rate significantly. This would likely continue to place downward pressure on rentals and property values.

Capitalisation (Cap) rates in all of the major categories of property remain on a rising trend. We would expect to see more of the rising trend in future, given that we expect the average property vacancy rate increase to speed up, weakening property income prospects, and given the weakness in the bond market.

Annual All Property Total Return (based on MSCI historic data including both capital growth and income return) is thus forecast to be sharply lower in 2020 than in 2019, from 2019’s 7.6% down to 0.4% for 2020 as a whole.

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