24 November 2022

FNB Commercial Property Finance

Property Insights

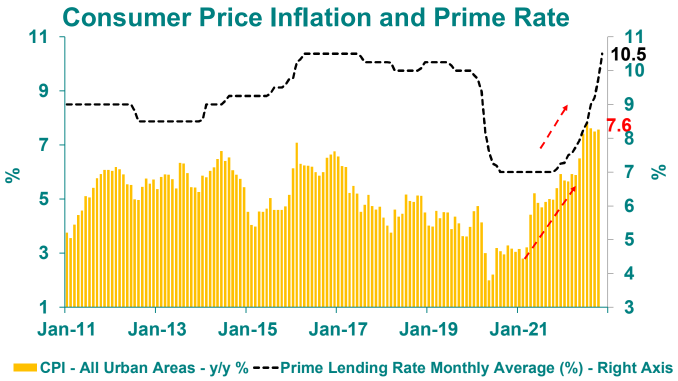
November SARB Interest Rate Decision and the Main Implications for Property Markets.

SARB hikes rates by a further 75 basis points, in an attempt to reign in consumer inflation that remains well-above the Bank's upper target limit. Cumulative hiking of 350 basis points since late-2021 is expected to broaden the near-term property demand slowdown, while sustaining the downward pressure on real property values. The Residential Rental Market could continue to receive some mild support, however.

Further interest rate hike, along with lagged impact of past ones, is likely to sustain slowing commercial property market trend into 2023

Today, the SARB decided to hike its policy repo rate by a further 75 basis points in response to an earlier inflation surge that has left CPI (Consumer Price Index) inflation at 7.6% year-on-year as October. The inflation surge has been largely driven by a global oil price spike that caused domestic petrol prices to rise sharply earlier in the year, along with a globally influenced food price inflation spike. Much of this has to do with the Ukraine conflict and the supply uncertainties for fuel and food that this created.

The SARB's inflation target range is 3-6%, so the recent inflation rates are unacceptably high.

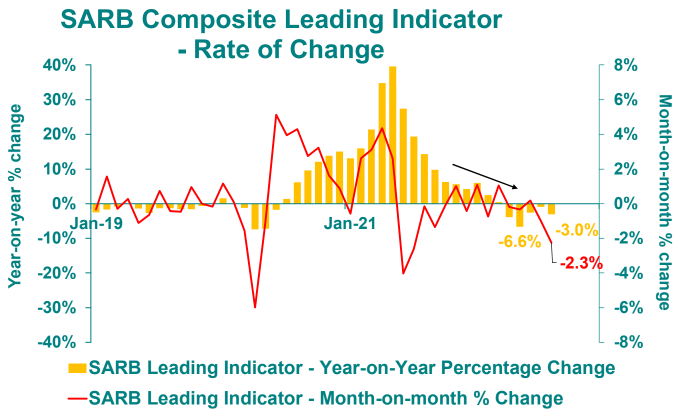


The SARB's latest 75 basis point interest rate hike brings the cumulative amount of interest rate hiking since November to 350 Basis points, with Prime Rate set to rise to 10.5% as a result.

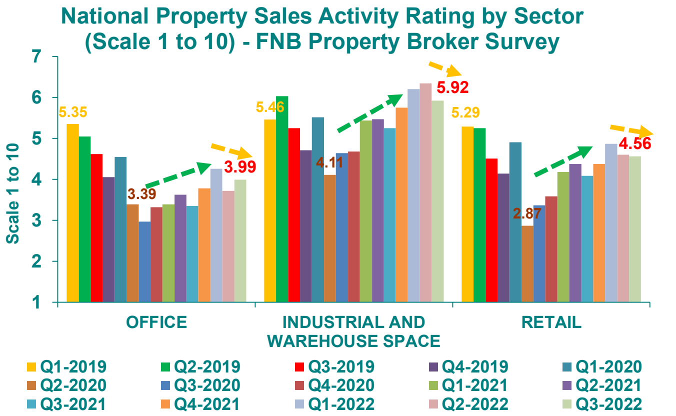
Further interest rate hike likely to sustain a market "weakening" trend into 2023,

The cumulative impact of SARB interest rate hiking, accompanied by interest rate hiking globally that is cooling off the global and domestic economy, is believed to be having both direct and indirect "cooling" impacts on the commercial property market. Today's interest rate hike adds to the weakening market trend already believed to be in play, the cumulative direct and indirect impact on the market from 350 basis points' worth of hiking since November 2021 expected to become significant now:

- The "direct" impact on property buying demand comes from the fact that the market is highly credit-driven, and the cost of servicing debt is rising.
- The "indirect" impact is happening via the weakening impact on the economy that local interest rate hiking is having. This constrains new business growth and existing business expansion, containing commercial tenant demand for rental space as well as commercial property buying. It comes at a time when the global economy has also been slowing, impacting further on SA's economy via the trade effect. Indeed, the recent accelerating month-on-month rate of decline in the SARB Leading Business Cycle Indicator points to near term economic weakening to come.



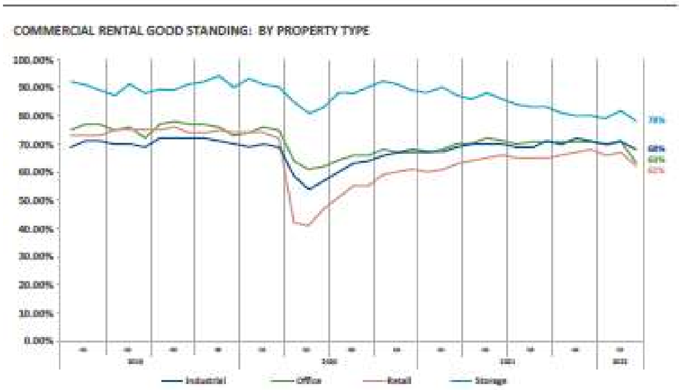
In the FNB Property Broker Surveys, we have already seen both property buying activity levels as well as rental market activity levels in all 3 major markets (i.e. Office, Retail and Industrial) down from their post-lockdown highs reached earlier in 2022, so this latest SARB interest rate hike can likely add to the slowing trend in market activity already believed to be in play, and likely extend the slowdown into 2023.



Further weakening in commercial rental tenant payment performance likely.

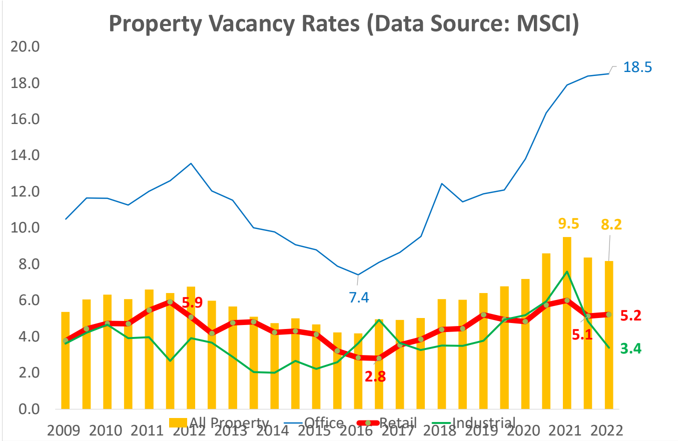
The interest rate hike also potentially heightens the financial pressure for the existing commercial tenant population, whose payment performance early in 2022 had already begun to show signs of renewed weakening in all the major commercial property classes. While tenants don't necessarily have mortgage debt, they often have other business debt that becomes more costly to service as interest rates rise.

COMMERCIAL RENTAL TENANTS IN GOOD STANDING (SOURCE: TPN)



Vacancy rates in office and retail property space may rise further, with Industrial possibly also set to start to rise too.

In the 1st half of 2022, we saw mild increases in the average office and retail vacancy rates nationally, with only Industrial Property showing a decline in its vacancy rate, according to MSCI data. I would expect the vacancy rates in office and retail to continue to rise into 2023, while Industrial's vacancy rate decline may end and begin to move higher in the near term too. The rising vacancy rate move is thus expected to broaden.

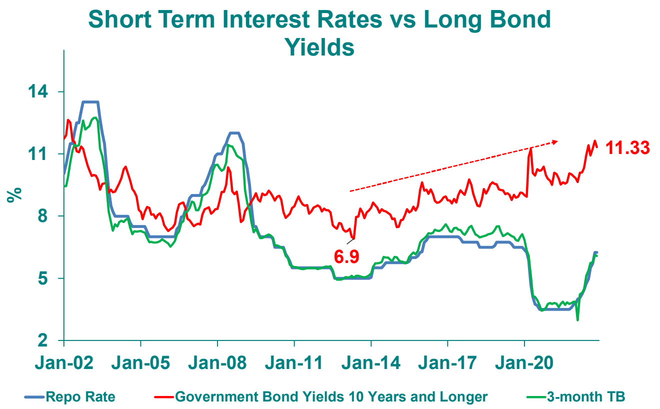


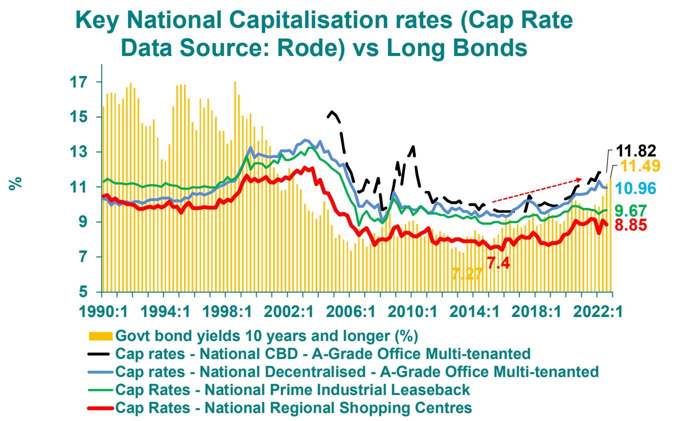
Near term rental deflation in retail and office property is an increasing possibility, although the stronger industrial market with its lower vacancy rates may avoid this.

Upward drift in capitalisation rates and decline in real values expected to continue into 2023 .

Further increase in interest rates is a potential additional source of upward pressure on commercial property capitalisation rates, and the multi-year upward drift in the major property classes' capitalisation rates is expected to continue in the near term.

Not only do short term rate hikes directly exert upward pressure on capitalization rates, but they also exert upward pressure on long bond yields, the latter also influencing capitalization rates.

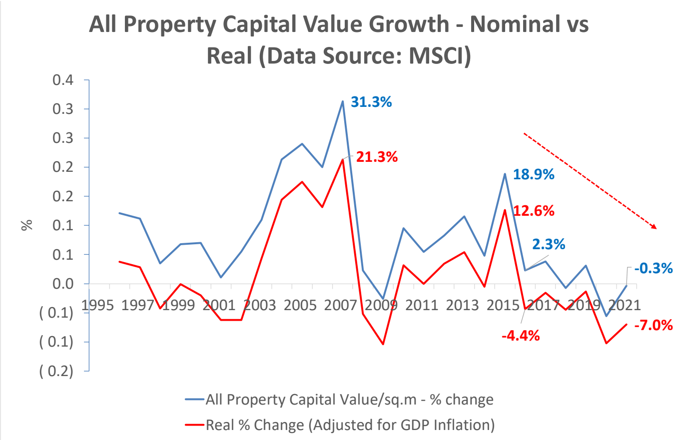




This in turn leads to the expectation that the All Commercial Property capital value/square metre will continue to decline in real (inflation-adjusted) terms.

This would imply very low capital growth that doesn't keep up with general price inflation in the economy, thus declining in what economists call "real" terms. Real declines are expected most in the office and retail property classes. Given the very significant magnitude of rate hikes in the current cycle now, full blown negative capital growth into 2023 can't be ruled out.

Using MSCI All Property capital value/sq.m data, and inflation-adjusting using GDP inflation, real value decline has taken pace annually for the past 6 years, and we expect a continuation of this trend into 2023.



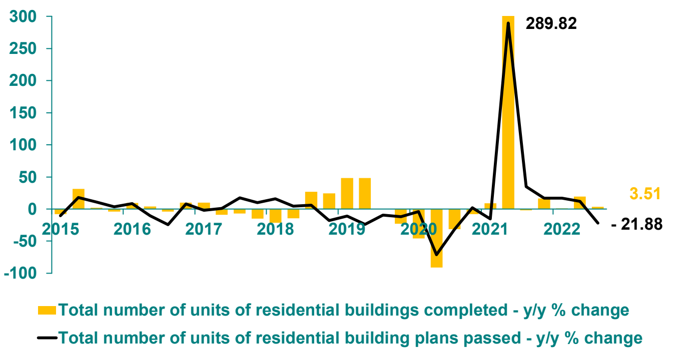
Decline in building activity expected.

We have seen weak levels of commercial space building plans passed and completed for some time already, on the back of a long-term economic stagnation.

However, residential building activity had a reasonably strong period following the end of 2020 lockdowns.

But residential building planning activity began to decline year-on-year in the 3rd quarter of 2022, and rising interest rates are believed to be the main reason. Further decline in the near term in residential plans passed, and ultimately thus in completions too, is foreseen.

Growth in Number of Units of Residential Building Plans Passed vs Completed



Slowing new commercial mortgage lending growth .

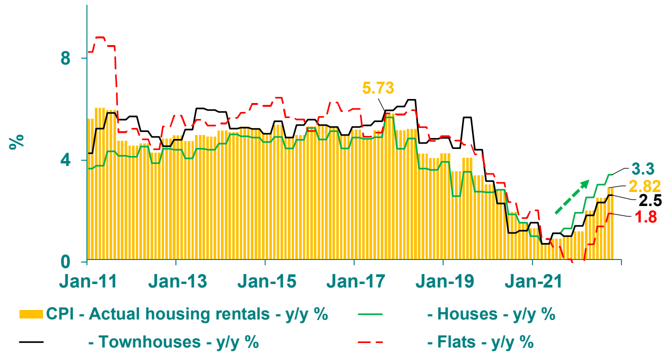
Near term decline in new mortgage loans granted and registered is a likely possibility due to interest rate hiking. It is not clear whether commercial mortgage advances growth will slow from its recent low single digit growth rate though. This is because, while new lending may decline, the speed at which capital repayments on existing loans are made may also slow due to the higher cost of debt servicing.

Residential rental market expected to strengthen mildly further.

We expect a greater portion of aspirant credit-dependent home buyers to delay home purchases while interest rates are rising, and wait it out in the rental market.

This is expected to lead to further decline in residential rental vacancy rates, and a mild near-term rental inflation acceleration.

Housing Rental Consumer Price Sub-Indices - Inflation Rates



Contact:

John Loos:

Property Strategist

FNB Commercial Property Finance

Tel: 087-312 1351

Email: john.loos@fnb.co.za

Disclaimer

First National Bank **A division of FirstRand Bank Limited**. An Authorised Financial Services and Credit Provider (NCRCP20).

Disclaimer: The information in this publication is derived from sources which are regarded as accurate and reliable, is of a general nature only, does not constitute advice and may not be applicable to all circumstances. Detailed advice should be obtained in individual cases. No responsibility for any error, omission or loss sustained by any person acting or refraining from acting as a result of this publication is accepted by FirstRand Group Limited and / or the authors of the material.