Big Property – where to now?

CENTURY CITY: I was recently part of a series of panel discussions on the merits of property as an investment class for South Africa's major auction house. As the lone opponent of property on a panel of listed property specialists, I hope I did the equity market justice however, the debates did provide some great food for thought. After these discussions, I have even more concerns about property investments than I did before. I think property is facing some severe headwinds and prospective investors should be very cautious.

LARGE PROPERTY INVESTMENTS HAVE DONE VERY WELL RECENTLY

Over the last three calendar years, commercial and industrial property has certainly been the best performer of the major asset classes. This is illustrated in Table A below - you would have earned nearly 6% a year more from property than the stock market over the three years to February 2011. If you had been in listed property in 2010, your average return would have been near 30% for the year. This was substantially better than other asset classes: the share market returned 18%, the bond market 15% and cash, a meagre 6.5% for the year. This situation changed dramatically in the first part of this year with shares comfortably outperforming property again.

TABLE A: RETURNS OF SHARES, BONDS AND PROPERTY TO FEB 2011

	Year to date	1 year	3 years Per year	5 years Per year	10 years Per year
All Share Index Total Return	0.59%	23.59%	4.58%	14.09%	17.16%
Domestic Real Estate Unit Trusts*	-4.68%	13.14%	10.42%	11.46%	18.83%
Domestic Bond Unit Trusts*	-1.74%	10.27%	9.82%	7.30%	10.92%

Source: Morningstar Inc
* Average returns of the sector

WHAT DRIVES PROPERTY?

All property investments are heavily influenced by interest rates. When interest rates fall substantially, property prices usually increase a great deal. Similarly, when interest rates increase, property prices suffer. A country's economic growth has a major influence on property although the effects of this influence are often delayed. If the economy grows substantially, it normally drives property prices upwards but there are major lag times between this growth and the resulting price appreciation. Similarly, the economy could stagnate and property could still continue to go up in price. Last year was a great example of this, our economy was struggling yet listed property returned more than 29%! Most large properties or developments are valued according to the level of income they generate rather than the actual value of the land or of the building. Any factors that hamper rental income are likely to have a direct impact on large prices of commercial and industrial properties. Other factors such as population growth, electricity costs, the political environment, legislation changes, crime and sentiment are also factors that affect property prices.

WHAT IS GOING TO HAPPEN TO PROPERTY NOW?

The last year was pretty tough for property companies. Normally, they have more than 90% of their properties rented at all times, this is called occupancy rates. Last year, 15% of their properties were vacant, nearly double the average. In addition, the rate of Eskom increases has started to impact their tenants and this has made rental increases more difficult. So tenants have more negotiating power as there is an oversupply of property meaning rental increases are lower than in previous years. Going forward, it is going to be very difficult for landlords to justify 10% rental increases when there is low inflation and an oversupply of property. These problems will be compounded by the prospect of interest rate increases in the near future. Some property economists are anticipating that inflation pressure might result in rising interest rates by the end of the year. If this does not happen, potential property investors will still start to factor interest rate increases into their calculations which will dampen property prices. The Eskom price increases will also continue this year which will add to the pressure on tenants and this will have a knock-on effect on property prices.

I think the cheap money that flooded our economy due to the lowest interest rates in 34 years created an artificial boost to the listed property market in particular. Cheap money always makes investors too bullish as evidenced by the strong performance of listed property last year. The correction that we saw in the first two months of this year was justified but there is still room for more downside.

CONCLUSION

I have always preferred listed property to residential property for long term investors. I like the diversification benefits of this asset class however; I am concerned about growth prospects for the next three years. I think there might be some good buying opportunities once interest rates start rising. If you have a short investment horizon i.e. less than 5 years, I think there are better places for your capital.