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Training for Township Renewal Initiative

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Retail & Service Sector Markets

Understanding the dynamics of township property markets

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A partnership between the NPDG, URP, SACN and DBSA to provide peer-learning opportunities for township renewal practitioners

Understanding THE ECONOMICS of TOWNSHIP property markets

OVERVIEW

The townships of South Africa are gradually transforming from dormitories to vibrant urban centres. As illustrated by the numerous shopping centres that have recently opened and which are under construction, investors are realizing the potential of these markets. Furthermore, there is growing evidence that investors interested in the township property market are considering all sectors of the commercial property market – namely the office, retail, industrial and hotel sectors. With the market also increasingly focussed on mix-use developments, it is reasonable to expect that this sub- sector of the market will, in future, form part of the Township built environment.

At the same time, the township commercial property market continues to see high levels of competition from other nodes. The include the traditional CBD's and newly created decentralised nodes. It implies that that the township market will need to develop a built environment that is competitive and attractive to investors.

These notes provide some of the economic fundamentals that a property investor and user will consider when assessing the attractiveness of a particular node.

An analysis of the property environment environment will normally occur at a micro and macro level . The micro perspective primarily relates to locational theory – namely the attractiveness of a node from a user perspective. The main question would be an assessment regarding the reasons that a user of space would consider a township as an appropriate location. At a macro perspective, one is concerned with the impact of macro economic fundaments (such as GDP growth and the inflation rate) on the property market.

It should also be borne in mind that the market occurs in an institutional environment. This environment is created through an interaction between market players and entities that formulate policy at national, provincial and local government levels. Therefore the policy environment has both macro and micro implications for the market.

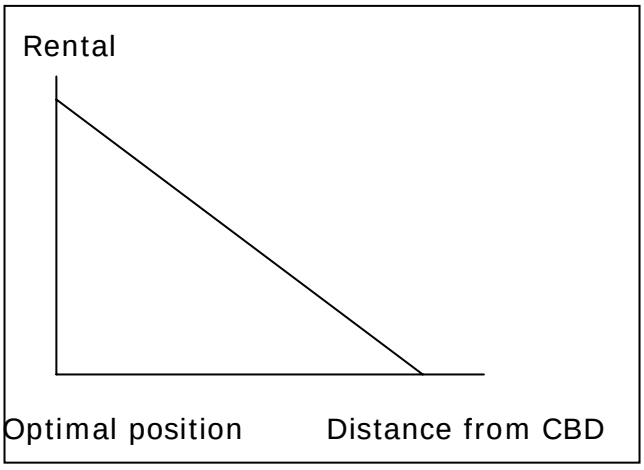
MICRO-ECONOMICS AND THE PROPERTY ECONOMICS

Urban economics or property related micro-economics is largely based on the proposition that a firm or household chooses a location that maximises profits or income.

For certain industries this means being close to resources (the mining industry would be an example of this). For other industries it is of critical importance to be closer to the market (a retail shopping centre such as the Maponya Mall in Soweto). The challenge for local government is to ensure that a node offers the necessary attributes to attract a particular user to a particular site.

From an economic perspective, much use is made of the principles that underlie the Bid rent curve.

DIAGRAM 1: THE BID RENT CURVE



The bid rent curve suggests that a firm generally pays a higher rental the closer it is to its optimal

position, as it is the point at which profits area maximised.

The concept would be applied by a shopping centre located at a site that optimises the number of shoppers that will frequent it. Although another, a less attractive site could be considered, this would not be optimum and hence the price paid for site would be lower than the amount paid for the optimal site.

Thus, if the market economy were allowed to operate freely, every erf in South Africa would be used in its highest and best use. Sites would be allocated to those who can out-bid all the other users for a site.

It means that the value of an erf is reflective of:

- What is physically possible on it?
- What is legally possible on it?
- What is financially possible? and
- What is maximally productive?
-

The concept of highest and best use is also of critical importance to policy maker. Investor driven infrastructure, town planning, and tax incentive schemes have a role to play in enhancing the highest and best use of land in a particular market.

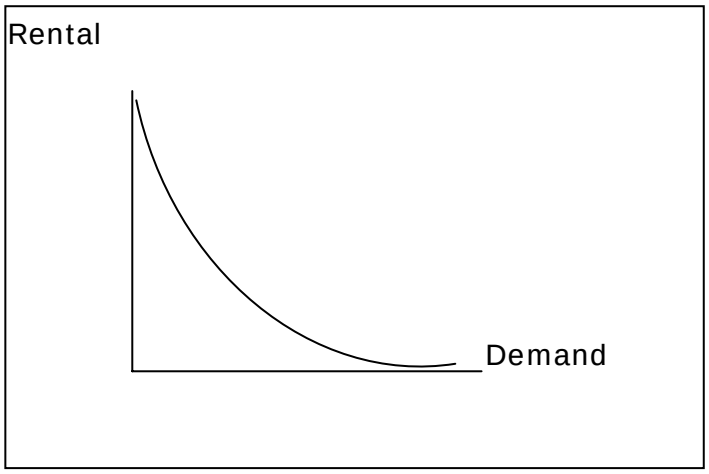
ECONOMIC ANALYSIS AND THE PROPERTY MARKET

The property market is influenced by four different markets. These are the user, financial, development and land markets.

In the user market, users of space (tenants), demand space and developers supply space. The interaction between demand and supply results in particular rentals. In the financial markets, rentals are converted to capital value. It is also in this market that rentals are capitalized in property values. Changes in Property values provide signals to the development market resulting in either a rise or decline in building activity. Finally changes in development activity are reflected in the demand for land in the land market.

In understanding how these markets work it is useful to turn to standard economic principles.
The demand curve for property space tends to be downward sloping. It can be argued that as rentals decline the demand for space increases.

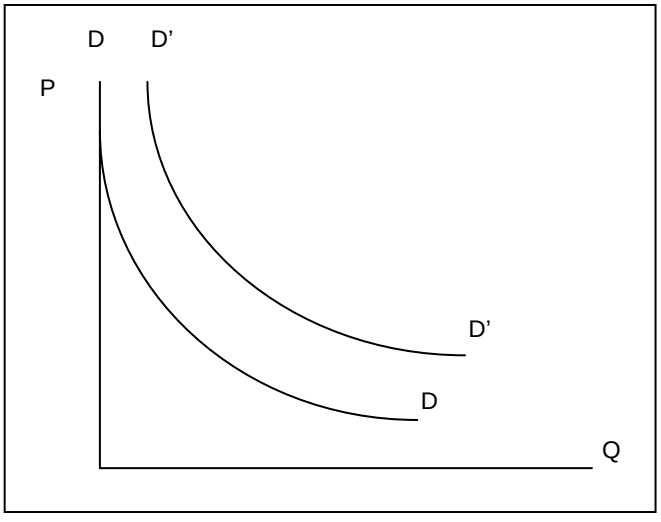
DIAGRAM 2: DEMAND FOR SPACE



While the relationship between rental and the demand for space is negative, the sensitivity of demand to a change in rentals will vary. In certain cases these relationship could be weak; this would be portrayed as an inelastic demand curve, which would be almost vertical. For instance, in an area that suffers from urban decay, reducing rentals or land values will have no significant impact on the demand for space.

An improvement in conditions in the built environment, resulting for instance from a successful urban regeneration programme, or the introduction of infrastructure has the impact of moving the demand curve upwards. This has the potential to increase rentals, capital values and development activity.

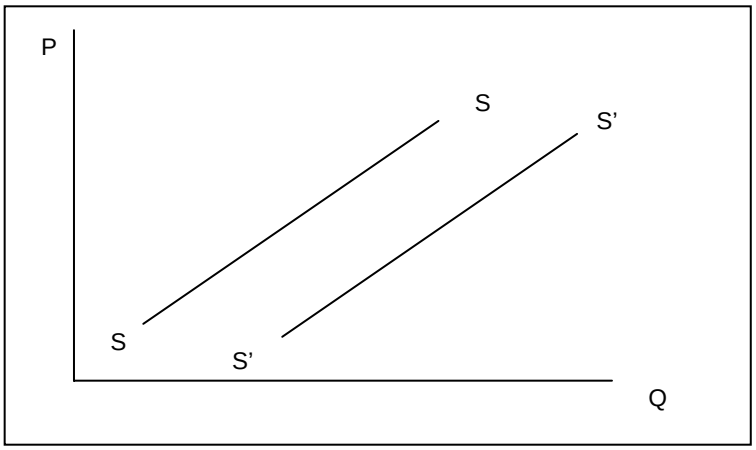
DIAGRAM 3: SHIFT IN THE DEMAND CURVE



The Supply Curve

The supply curve reflects a relationship between the amount of space supplied and rentals and capital values. Intuitively, it seems reasonable to suggest that as rentals rise and amount of space supplied in increases. A rise in rentals would result in higher capital values which should encourage developers to increase building activity. The relationship is illustrated in the following diagrams.

DIAGRAM 5: SHIFT IN THE SUPPLY CURVE

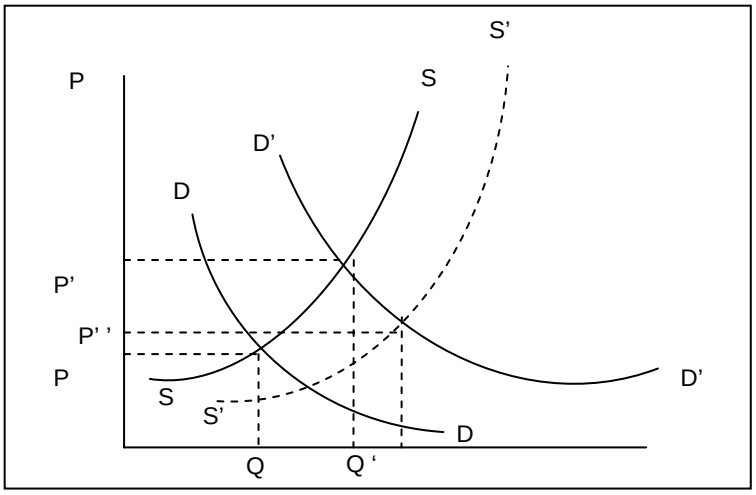


Of course there is always a risk that developers oversupply the market, resulting in an increase in vacancy rates and a decline in rentals.

Combining Supply and Demand

The property market therefore reflects a combination of the property demand and supply curves. This is illustrated in diagram 6.

DIAGRAM 5: COMBINATION OF SUPPLY AND DEMAND CURVE



The combination of demand and supply results (see above) in a rental, with demand being in equilibrium at Q.An increase in demand resulting from an economic growth, would tend to shift the demand curve outwards, (D') this will result in demand increasing to Q, and rental increasing to P'.

The important point to note is that policy formulators have the ability to influence the demand and supply side of the property market. Demand side interventions could arise from increasing the buying power of consumers through for instance voucher systems, and the provision of an effective public transport system. The supply side interventions are normally directed at developers. Typical examples include, building and investor tax incentives (such as the UDZ incentives).

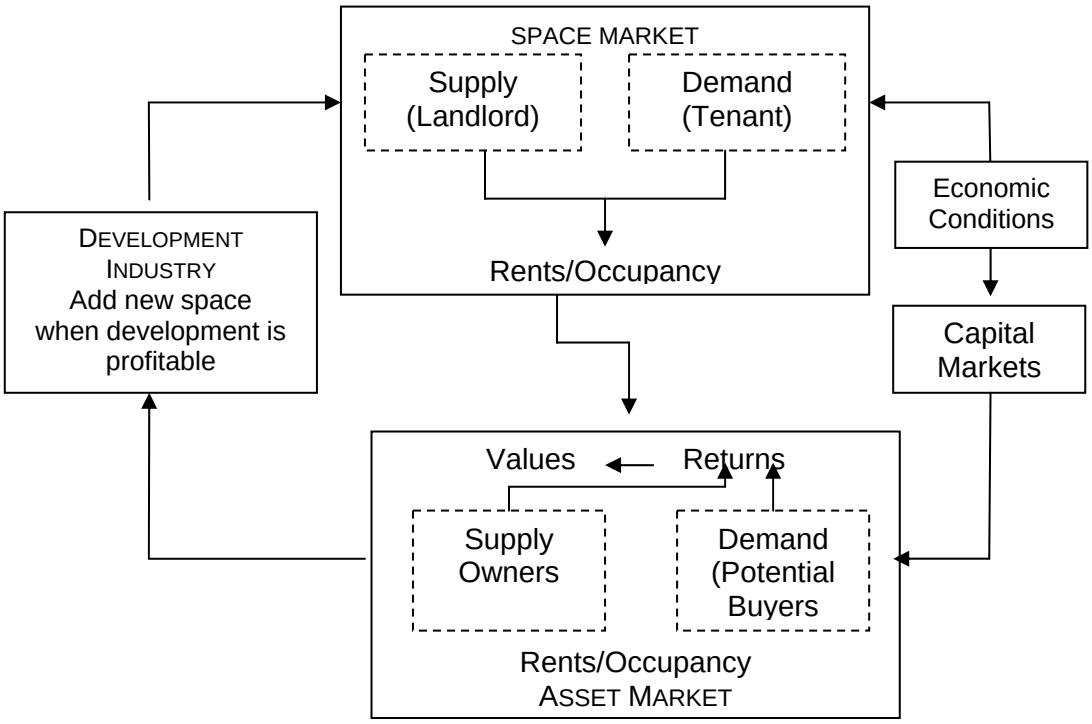
PUTTING THE PROPERTY MARKETS TOGETHER:

The previous section primarily focussed on the dynamics of the users market - namely the supply and demand for space. To gain an overall perspective of the commercial property market, consideration should also be given to the capital, development and land markets.

These markets interact with each other on a continuous basis providing the necessary signals to investors, developers and tenants.

The relationship between the different markets is illustrated in the diagram below:

DIAGRAM 7: THE REAL ESTATE MARKET



The property market can be analysed as follows;

- Conditions in the economy (e.g. GDP Growth) affect the demand for space and conditions in the capital markets.
- In the user market, an increase in demand (assuming that supply remains constant) results in higher rentals.
- Conditions in the capital market determine investor expected returns.
- In the asset market, rentals and expected investor returns (the capitalisation rate), translate rentals into property values.
- In the development industry, property provides a trigger to developers whether to develop or not. If property values rise ahead of building costs there will be a temptation by developers to provide new supply of space.
- A rise in supply changes conditions in the space market, and depending on the growth in demand, can lead to an overall supply of space which would result in a decline in rentals and property values.
- The analysis also implies that property development activity can arise either in the user, capital, or development markets. As an example, a sudden decline in interest

rates could result in lower capitalisation rates, and higher capital (property values).

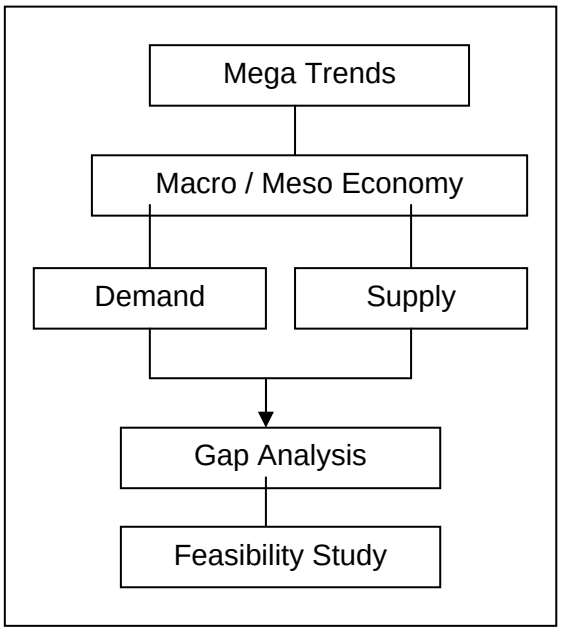
UNDERTAKING THE PROPERTY MARKET ANALYSIS

The theoretical concepts discussed in the previous section goes a considerable way towards explaining the mechanisms of the property market and where the potential for intervention in the market may exist.

From a more practical perspective property practitioners often need to form an opinion of the market. This could be to assess the potential market for a development, determine rentals, and assess the viability of an investment proposal.

The property market research process can be subdivided into specific steps. These include the analysis of mega trends, the national and local economies, supply and demand conditions, and expected returns. The process is depicted below.

DIAGRAM 8: MARKET ANALYSIS



Mega Trends: In this step of the research process, the researcher attempts to ascertain life style and other trends that could have an impact on the property market.

It could encapsulate town planning policies, interactions between home, work and play, and the impact of transport related issues. Thus, for

example the growing use of information technology can have a profound impact on locational decision making. For instance, developments in information technology could well open possibilities of the development of call centres in South African townships.

It is also of importance for the researcher and the policy maker to understand the changing investor environment. In recent years the South African investor climate has experienced the following;

1. A shift from investments by pension funds to listed funds;
2. a move from " green" to " brown field Investments". This means that land held by the public sector grows in importance;
3. debt finance grows in importance;
4. a focus on mixed use developments;
5. a lack of appropriate infrastructure in certain nodes.

Macro/Meso Economy: A property market analysis always needs to be placed within the context of the economy. This entails the analysis of macro economic trends. These are influenced by economic growth, employment, the inflation rate and interest rates. These factors impact on the user, asset and development markets.

The researcher and policy maker should also understand conditions in the local economy and their potential impact on the property market. As an example a property in the Western Cape would be more prone to the performance of the tourism sector than a similar property in Gauteng. Similarly the recent upturn in the commodity price cycle is having a positive impact on may small towns across South Africa.

An understanding of drivers in the property market can influence whether a public sector is intervention is successful or not. Appropriate policy timing can determine whether interventions occur at the top or bottom of a property cycle.

Supply and demand Trends; The third step of the research process requires the researcher to understand demand and supply conditions in a particular sector of the market.

Essential data that the researcher needs to collect includes the:

- Vacancy rate
- Rent price level
- Building plans passed and completed, and
- Absorption of new space
- These market indicators are discussed below.

Vacancy Rates

The vacancy rate offers a good indication of conditions in the property market. The figure is carefully considered by developers wishing to assess whether a market could accommodate an increase in supply.

The accuracy of the vacancy rate will vary from one sector to the next. At present South African townships are poorly represented in official statistics . The improvement of such information has a critical role to play in attracting investors to these nodes. SAPOA (www.sapoa.org.za) provides quarterly vacancy rates for the office sector. In the case of the industrial sector it is useful to turn to the Rode Report (www.rode.co.za). For the retail and industrial sector these figures are more difficult to acquire although useful annual figures are available from the Investment property data bank – IPD (www.ipdindex.co.za).

The vacancy rate is normally quoted as a percentage. It calculates the ratio between the square meters of vacant space and the total lettable space in the market. Thus, a vacancy rate of 10% implies that 10% of total space in a market is vacant and available for letting.

Rent and Price Level

The outcome of demand and supply will be reflected in rentals and ultimately property valuers. Thus, when the vacancy rate declines, one should expect rentals to start rising.

The researcher can turn to numerous sources to ascertain rentals. These include property investors, brokers and researchers. SAPOA, the IPD, and the Rode Report are useful sources of information. In analysing property values software packages make it increasingly easy to access

deeds registry transaction data (e.g. Property 24, SPI services).

The Analysing of Building Plans Passed and Completed

Statistics SA(www.statssa.gov.za) regularly releases surveys of building plans passed and completed. While building plans passed and completed illustrates present conditions in supply, building plans passed provides an indication of future supply.

Absorption of New Space

The absorption rate provides the researcher with an indication of the quantum change in space demanded. The gross absorption rate is an indicator of the total amount of new space that becomes occupied during a specific time period. The net absorption rate is defined on the net change in the amount occupied in a specific market in a particular time frame.

The net absorption rate is illustrated in the table below:

TABLE 1: NET ABSORPTION RATE 2006

A & B grade office space lettable	500,000 sqm
A & B grade vacant space	100,000 sqm
Thus: amount of space occupied	400,000 sqm

TABLE 2: NET ABSORPTION RATE 2007

A & B grade office space lettable	600,000 sqm
A & B grade vacant space	150,000 sqm
Thus: amount of space occupied	450,000 sqm

TABLE 3: TAKE UP RATE 2006/2007

A & B grade occupied	2006	400,000 sqm
A & B grade occupied	2007	450, 000 sqm
Thus: A & B grade absorption	2006/07	50,000 sqm

The market researcher needs to ascertain whether new supply reflects the market segment absorption rate, or whether the risk exists that additional supply may lead to supply exceeding

demand - resulting in higher vacancy rate and possibly a decline in rentals and capital values.

For the retail developer, research plays a critical role in identifying retail development opportunities. This requires the identification of potential demand as well as existing and future shopping facilities that could be developed. The researcher then needs to undertake a site or trade area analysis.

The size of a retail catchment area will be influenced by its demographic and economic profile. The research process requires the researcher to assess how much of the retailing potential is already being met by existing facilities and the quantum of the trade area that the subject property could capture.

When determining the potential trade area of a retail development, the researcher will take account of for instance, advantages associated with clustering (the fact that retailers selling similar goods may attain advantages of being situated in close approximately). Moreover, a regional shopping centre may serve a relatively large catchment area and attract shoppers from an extended area. For the policy maker, the question needs to be asked whether a the development of a shopping centre could have negative implications for other sectors of the market. Thus it is possible that a new shopping centre may reduce the demand for retailing in the CBD. It may also provide increased competition for smaller retailers – e.g Township Spaza shops.

PROPERTY RETURNS

In making property decisions, the investor will always be cognisance of the expected returnsthat can be generated. Property returns are influenced by the expected rentals that a property can secure (the yield) as well as the capital growth that can be generated. The total return that an investor expects is influenced by the perceived risk. If the risk/ return equation of an investment is inappropriate (too high), the investment will not be undertaken.

Property related risks are of a physical, functional and economic nature.

Physical risk or obsolescence relates to the fact that a property's financial return is affected by its physical condition. While urban policy interventions have some influence on the physical condition of properties, the mitigation of this risk largely falls in the hands of the investor. Functional risk is determined by whether a property still reflects user requirements. Thus a property may be in good physical condition, but has become functionally obsolete because of a lack of parking. As functional obsolescence tends to be property specific , mitigation again falls in the hands of the investor. It is however in the sphere of economic obsolescence that public policy has the greatest role to play. Economic obsolescence occurs when a property no longer meets required returns because of changes in local market conditions resulting in a rise in vacancy rates, a rise in operating costs, or a decline in rentals. Economic obsolescence is often the result of urban degeneration. At the same time, effective urban regeneration programmes can revitalise areas to such a degree that economic obsolescence is overcome and properties that where written off once again become viable.

The Investment property data bank (IPD) – (www.ipdindex.co.za) is a good source for an indication of South African commercial property returns. The properties that make up the index are valued at some R 100 bn (estimated to be equivalent to 65% of the total market) . The index provides an indication of total returns for the sector as a whole, as well as the retail, office and industrial sectors.

SUMMARY

The analysis of property markets requires an understanding of the macro and micro economic and policy environment.

Property markets are the result of an interaction between the user, financial, development and land markets. From a policy perspective it is fundamental that the mechanism which co-ordinates these markets is understood. For example an intervention in the user market can have significant implications for the development

market. Moreover, interventions in the financial market have the potential to influence both the user and development market.

There is growing evidence that investors are showing interest in township property markets. However, investment decisions rely on a careful balance between expected risk and returns which is influenced by public sector interventions. Such interventions can have a supply or demand side bias.

Appropriate demand and supply side policies, based on an understanding of market dynamics, have the potential to create an institutional environment that fosters property development and investment.

FURTHER READING :

A. Books

1. Jack Harvey & Ernie Jowsey. *Urban land Economics* (London Palgrave, 2004)
2. Michael Ball, Colin Lizieri and Bryan D. Mac Gregor . *The Economics of Commercial Markets (* London: Routledge, 2001)

B. Magazines

1. Commercial & Industrial Property News (Malnor)
2. The South African Property Review (SAPOA)

C. Web Sites

1. SAPOA (www.sapoa.org.za) – Vacancy rates and Rentals and News
2. E prop (www.eprop.co.za) – Property news
3. Property 24 (www.property24.com) - Property news
4. Rode (www.rode.co.za) – Rode Report
5. StatsSA (www.statssa.gov.za) – Building Statistics
6. South African Reserve Bank (www.resbank.co.za)