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PROPERTY BAROMETER - FNB-TPN INVESTMENT PROPERTY YIELDS REVIEW

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Residential property investment attractiveness moderates mildly of late, as yields decline on the back of relatively solid house price growth relative to rental growth.

SUMMARY

After slow house price growth from 2008 to late-2011 had allowed rentals to play some mild catch-up with residential property values, a period of improved house price growth performance through 2012 and the 1st half of 2013 translated into a resumption of yield compression (decline), thereby arguably diminishing the attractiveness of residential property as an investment purchase mildly.

Looking at the data of the FNB-TPN National Average Initial Yield on Residential Property, as at the 1st quarter of 2008, the National Gross Average Yield on residential property was estimated at 7.48%. By the final quarter of 2011 it was 9.18%, where-after the upward trend lost momentum.

From early-2012 a phase of mild compression (decline) in gross yields set in. By the 2nd quarter of 2013, the estimated national average gross yield had declined to 8.87%, which is the lowest level since the 2nd quarter of 2010.

This recent renewed yield compression has been driven by the combination of more noticeable average house price inflation since early-2012, coupled with a residential rental market which, although starting to make noises of supply shortages, has yet to see any meaningful uptick in rental inflation yet.

Regarding the prospects for a stronger rental market, a potential driver of higher and more attractive yields in future, we are aware that the rental market often experiences its best times in times of high interest rates, when many aspirant entrants to the home buying market rather "wait out the storm" as tenants, and we are not there yet.

We have expected some improvement in rental inflation in recent times, on the back of gradual demand growth slowly eating into oversupplies caused a few years ago by massive buy-to-let investment back in the boom times. And rental agents are indeed pointing to mounting supply constraints. However, as yet we have not seen rental inflation fireworks, and perhaps we should be realistic about the speed at which this may happen. One should remember that the low interest rate period encourages a high level of 1st time buying, many of whom would be exiting or "skipping" the rental market to buy. In addition, the FNB Estate Agent Survey points to a lower percentage of sellers downscaling due to financial pressure these days, while of these, the estimated percentage who will be selling in order to rent, vs those selling to buy cheaper, has diminished.

Therefore, it is perhaps still not surprising to see the FNB House Price Index showing growth of 6.5% which, although not setting the world on fire remains above 5.1% estimated rental inflation as at the 2nd quarter of 2013.

In recent quarters we have begun to see some mild de-celeration in the pace of house price growth, which may mean a resumption of mild yield increases at some point within the next few quarters.

However, we'll probably have to be patient for the next significant jump in residential yields, which will probably only take place the next time interest rates rise, boosting rental inflation and subduing house price growth. And the FNB expectation is for such an event only to take place from 2015 onward, after another year of sideways movement in rates next year.

1. ***AFTER RECOVERING SOME ATTRACTIVENESS AS AN INVESTMENT FROM 2008 TO 2011, MORE RECENTLY WE HAVE SEEN SOME RESIDENTIAL YIELD COMPRESSION RESUMING.***

After slow house price growth from 2008 to late-2011 had allowed rentals to play some mild catch-up with residential property values, a period of improved house price growth performance through 2012 and the 1st half of 2013 translated into a resumption of yield compression (decline), thereby arguably diminishing the attractiveness of residential property as an investment purchase mildly.

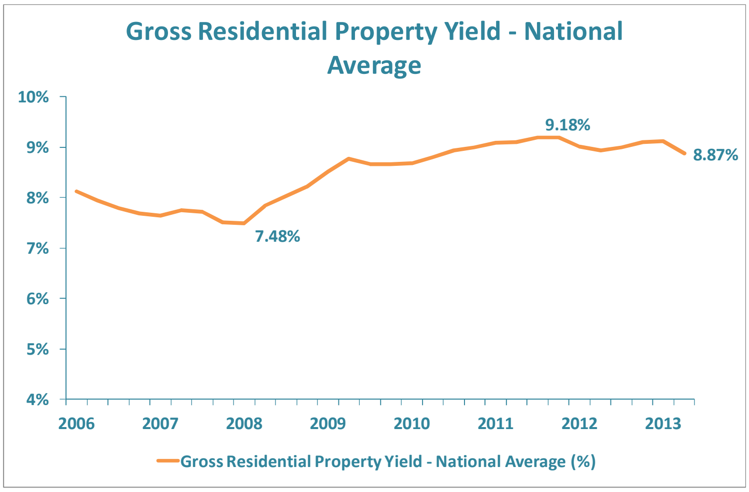
So, while homeowners would perhaps be excited by evidence of mildly stronger house price growth since early-2012 and in 2013 to date, compared to the prior few years, such news may not necessarily be as exciting for an aspirant buy-to-let investor. This is because the investor should be strongly focused on the income stream that an investment property generates, relative to the price paid, and so a far better number to focus on (than capital growth) would arguably be the "initial yield", i.e. the income expected to be earned over the next year divided by the property value.

For this purpose, we have attempted to estimate a yield data series for the country as a whole, along with key regions and segments.

This FNB-TPN Residential Yield dataset is the combined result of TPN rental data, along with FNB's house price data and its Automated Valuation Models (AVMs). In short, the approach has been to take all of the properties for which TPN rental data exists, utilise the AVM to estimate a current value on the property, and then to calculate the yield on all such properties.

2. ***THE NATIONAL YIELD TREND***

Looking at the data of the FNB-TPN National Average Initial Yield on Residential Property, as at the 1st quarter of 2008, the National Gross Average Yield on residential property was estimated at 7.48%. By the final quarter of 2011 it was 9.18%, where-after the upward trend lost momentum.

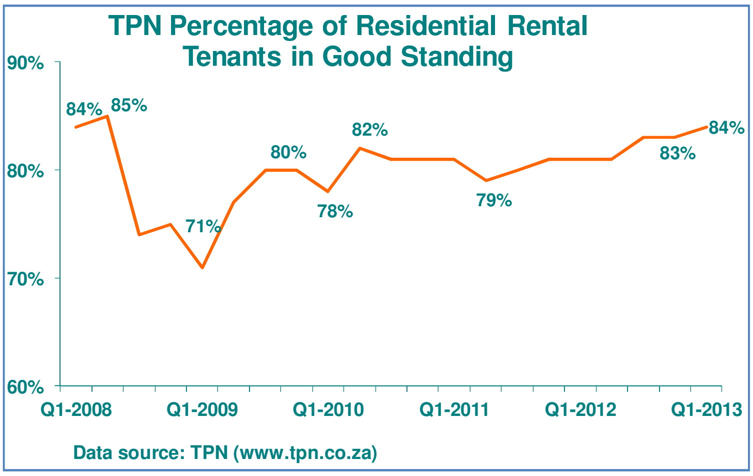


Then, from early-2012 a phase of mild compression (decline) in gross yields set in. By the 2nd quarter of 2013, the estimated national average gross yield had declined to 8.87%, which is the lowest level since the 2nd quarter of 2010.

This recent renewed yield compression has been driven by the combination of more noticeable average house price inflation since early-2012, coupled with a residential rental market which, although starting to make noises of supply shortages, has yet to see any meaningful uptick in rental inflation yet.

These yields are still gross yields, meaning that landlord operating costs associated with the property have not yet been included in the calculation to get to a net initial yield. At this stage, net yields remain work in progress, until such time that we have satisfactory operating cost data. While a gross yield trend provides useful insights, the "holy grail" is to have net yields data from which total returns on residential property can be calculated.

How attractive is an 8.87% gross initial yield? This is debatable, being a little less attractive than a year and a half ago, but still significantly better than the early-2008 low. However, we would venture to say that this is not yet *highly attractive yet. Rode and Associates suggest that as a rough estimate one can take 1.5 percentage points off the gross yield to estimate a net yield. If one were to do this, that would leave the net yield at around 7.37%. Such a yield would, for many, still be below the cost of finance, given a prime rate of 8.5%.*

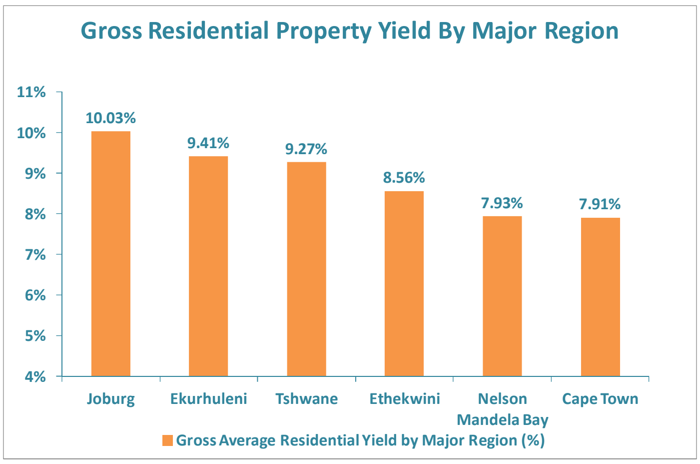


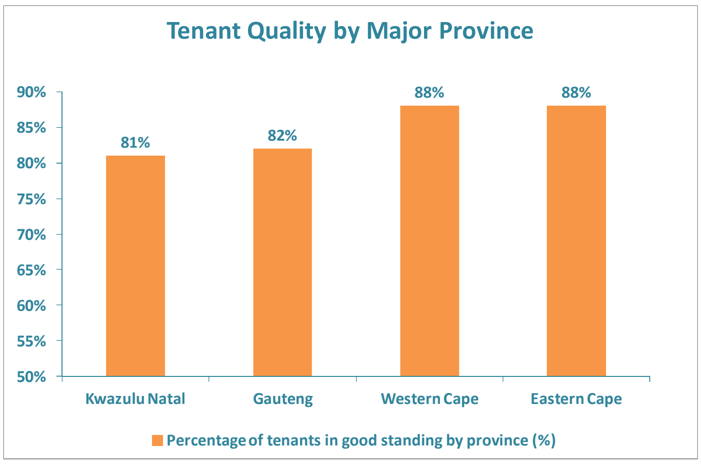
However, while renewed yield compression may point to mild decline in attractiveness in buying-to-let, it is also important to evaluate the yield versus the investment risk. A decline in yield may, to a certain degree, be in line with further decline in tenant risk, as reflected in a further rise in the percentage of tenants in good standing with their landlords as at the 1st quarter of 2013. This percentage rose from a previous quarter's 83% to 84% in the 1st quarter, and is now back to levels last seen prior to the 2008/9 recession, after a huge dip to 71% as at early-2009.

So, one could perhaps argue that the market may be working as it should in recent times, with declining tenant risk now being accompanied by yield compression. .

3. REGIONAL YIELD COMPARISONS

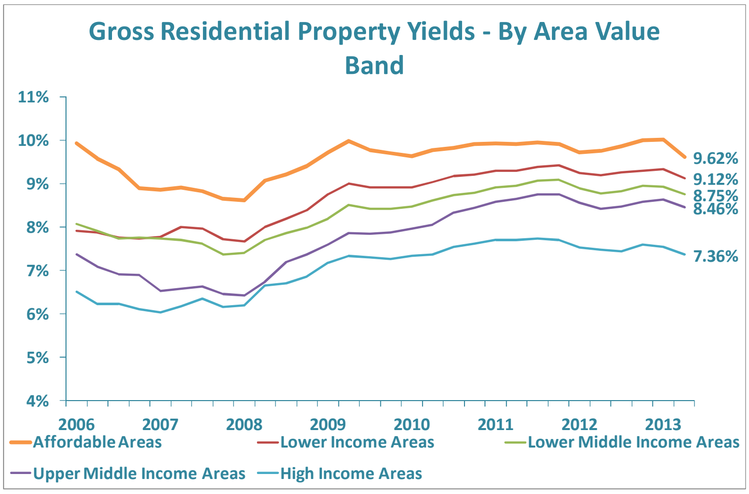
Which regions have the best yields? Broadly speaking, it would appear that the principle of higher risk=higher return more-or-less holds true when comparing yields by major region. As at the 2nd quarter of 2013, the 3 Gauteng metros, namely City of Joburg (10.03%), Ekurhuleni (9.41%) and Tshwane (9.27%), had the highest yields, followed by Ethekwini metro (8.56%) in KwaZulu-Natal. At the same time, we see KZN and Gauteng Provinces recording the poorest payment performance by tenants of the Big 4 provinces, with 81% of tenants in good standing in KZN and 82% in good standing in Gauteng. By comparison, Nelson Mandela Bay (7.93%), the largest metro in the Eastern Cape, and City of Cape Town (7.91%), which forms the lion's share of the Western Cape Province, have the lowest gross yields of the major metros. Simultaneously, the Eastern and Western Cape have a significantly higher percentage of tenants in good standing, to the tune of 88%. Better tenant performance implies lower risk, and perhaps investors are prepared to pay a premium for this in the Eastern and Western Cape regions.





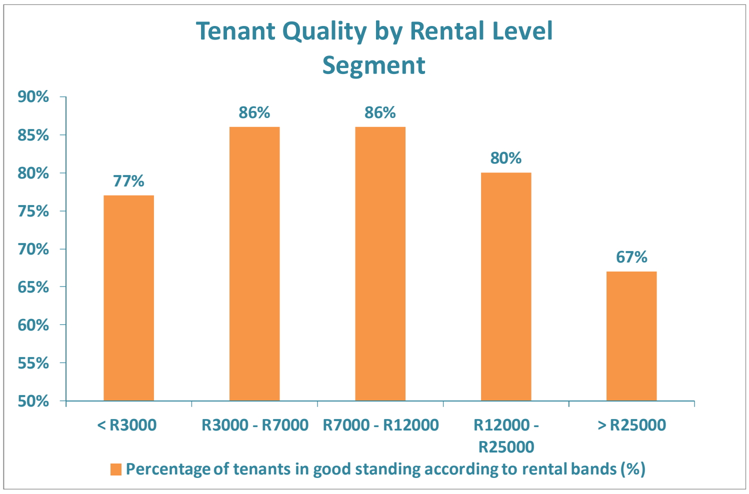
4. SEGMENT YIELD COMPARISONS

What then of comparative yields by price segment? To gauge this, we have segmented suburbs based on the average value of the homes in them, into 5 "area value bands".



In Affordable Areas (average home value below R600,000), the average national yield was estimated at 9.62% for the 2nd quarter of 2013. In Lower Income Areas (Average home value from R600,000 to R900,000), the yield was slightly lower at 9.12%, followed by an average yield of 8.75% for the Lower Middle Income Areas (average home value between R900,000 and R1.2million), and 8.46% for Upper Middle Income Areas (average home value from R1.2m to R1.5m). There then exists a more significant gap in yield between Upper Middle Income and High Income Areas (average home value above R1.5m), whose gross yield is a relatively lowly 7.36%.

In short, cheaper areas on average offer higher gross yields, whereas the high end areas appear less attractive. Admittedly, the counter argument which could be used by those fans of higher end properties would be that lower income areas carry a higher risk, and thus should come with a higher yield.



However, this story doesn't entirely appear to hold true. Using TPN data for the percentage of tenants in "good standing" regarding their rental payments, we do indeed see that the lowest TPN rental band, i.e. homes with monthly rental below R3,000, has a relatively low percentage of tenants in good standing, to the tune of 77%. Many of these homes probably fall in so-called Affordable Areas. Moving up to the next rental band, homes with rental between R3,000 and R7,000 per month show a significantly better 86% of tenants in good standing, many of such homes probably falling in the Lower Income area value band. This percentage stays relatively high at 86% in the R7,000-R12,000 monthly rental band, with many of these homes probably in the Middle Income Areas, supporting the view to this point that as one moves up the property/rental value ladder the tenant risk diminishes, and that this risk should be reflected in lower yields.

However, this line of reasoning goes awry in the next rental categories up, with the R12,000-R25,000 monthly rental band showing a lower percentage of tenants in good standing to the tune of 80%, which gets even worse in the R25,000+ monthly rental category at only 67%. Many homes in these highest 2 rental categories would fall into the High Income area value bands, suggesting that this top area value band is a somewhat tough place to operate for a landlord, while yields are not compensating for this apparent higher risk.

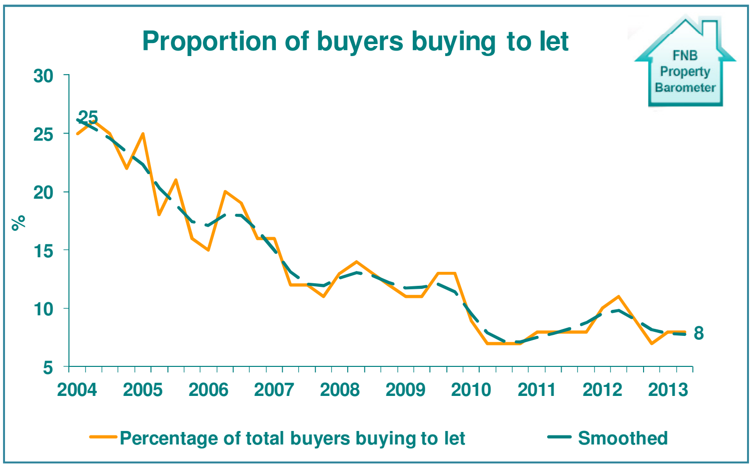
Therefore, the "sweetspot" from a landlord risk/yield point of view appears to be in the Lower-to-Middle Income area value bands, and where many rentals probably fall between R3,000 and R12,000/month.

However, one aspect we admittedly don't have data for at this stage is regarding just how well the different segments' tenants treat/look after the home, incidences of vandalism, and which segment's tenants trouble landlords in other non-financial ways.

5. OUTLOOK

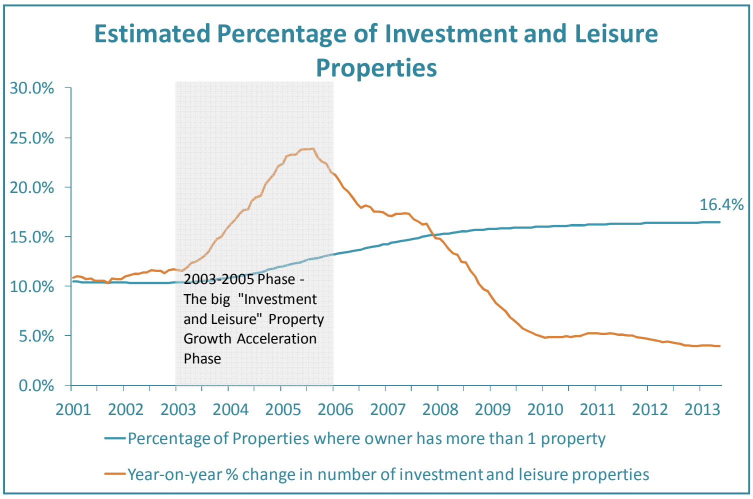
Regarding the prospects for a stronger rental market, a potential driver of higher and more attractive yields in future, we are aware that the rental market often experiences its best times in times of high interest rates, when many aspirant entrants to the home buying market rather "wait out the storm" as tenants, and we are not there yet.

However, we have expected some improvement in rental inflation in recent times, on the back of gradual demand growth slowly eating into oversupplies caused a few years ago by massive buy-to-let investment back in the boom times.



Currently, buy-to-let house buying remains slow, implying slow growth in available properties for prospective rental tenants. The most recent FNB Estate Agent Survey for the 2nd quarter of 2013 continued to show a weak pace of buy-to-let buying estimated at a mere 7% of total home buying. This is a shadow of the glory years around 2004, where at a stage the percentage reached 25%, and we would expect that at some stage it would lead to greater rental property stock constraints, which in turn should translate into higher rental inflation.

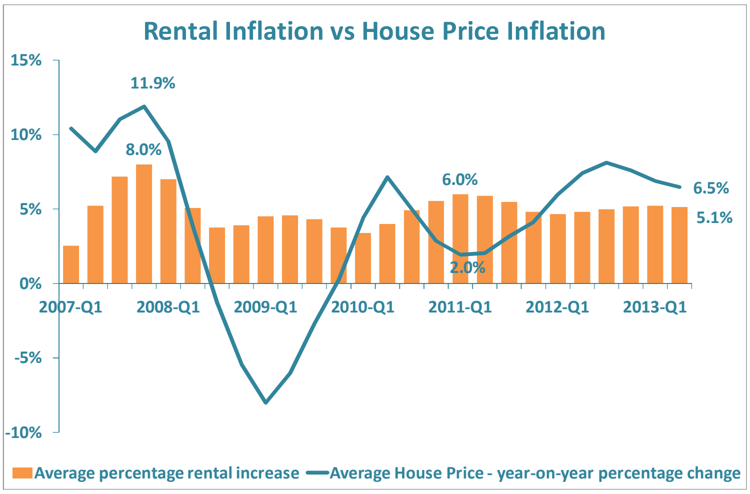
Indeed, an early-2013 survey conducted by TPN amongst rental agents did point to significant rental property supply constraints. In fact, 94% of respondents indicated a shortage of rental properties. In the same survey, rental agents pointed to 38% of tenants being "first time tenants", 35% of tenants moving to down-scale, and 27% of tenants moving to up-scale. The fact that a greater percentage were estimated to be downscaling than upscaling, however, still points to landlords not being able to "have it all their own way" with regard to asking rentals.



And in a separate FNB study of deeds data relating to transactions by individuals, it has also estimated the number of properties in the database where the owner has one or more other properties. This number grew sharply from 2003 to 2005. However, the rate has slowed dramatically since 2006, and recorded a mere 3.8% as at June 2013.

While some of these properties probably relate to leisure property as opposed to buy-to-let property, we believe that this gives a reasonable picture of the trend in buy-to-let buying, which has been pedestrian for some years.

All in all though, while we have for some time anticipated a stronger rental market, and rental agents are indeed pointing to mounting supply constraints, perhaps we should be realistic about the speed at which this may happen. One should remember that the low interest rate period encourages a high level of 1st time buying, many of whom would be exiting or "skipping" the rental market to buy. In addition, the FNB Estate Agent Survey points to a lower percentage of sellers downscaling due to financial pressure these days, while of these, the estimated percentage who will be selling in order to rent, vs those selling to buy cheaper, has diminished.



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In recent quarters we have begun to see some mild de-celeration in the pace of house price growth, which may mean a resumption of yield increases at some point within the next few quarters.

However, we'll probably have to be patient for the next significant jump in residential yields, which will probably only take place the next time interest rates rise, boosting rental inflation and subduing house price growth more noticeably. And the FNB expectation is for such an event only to take place from 2015 onward, after another year of sideways movement in rates next year.