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FNB Commercial Property Finance

Property Insights

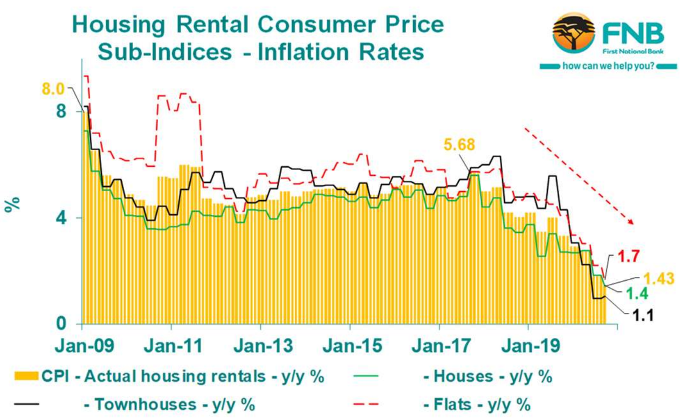
Residential Rental Market still pressured by weak economy, and low interest rates swinging things in favour of a strong home buying market – The result is further slowing in CPI Rental inflation in the September CPI survey.

While the Home Buying Market is buoyant, still being driven by sharply lower interest rates this year, the September CPI (Consumer Price Index) inflation numbers continue to point to a battling Residential Rental Market, hampered by a tenant population financially pressured by a deep recession, and "outcompeted" by the home owner market due to a dramatic reduction in interest rates earlier this year.

While the Property Industry reports a very strong Home Buying Market, CPI data confirms that the rental component of the residential market remains in the doldrums.

This week's CPI data release for September 2020 confirmed the ongoing relative weakness in the Residential Rental Property Market.

The rental survey is done every 3 months, and the September survey showed a further slowing in year-on-year actual rental inflation from 1.8% in the June survey to 1.4%.



This continues a broad slowing rental inflation trend since a high of 5.68% back in September 2017.

All 3 rental subsegments have seen a significant multi-year slowing in rental growth. In the September 2020 survey, the segment with the weakest rental inflation was the Townhouses segment, recording 1.1% year-on-year. The Houses segment was slightly stronger, recording 1.4%, while the most affordable Flats segment was the strongest, recording 1.7%.

The key source of pressure on the rental market in recent years, prior to COVID-19 lockdowns, has been the long term stagnation in growth in the South African economy.

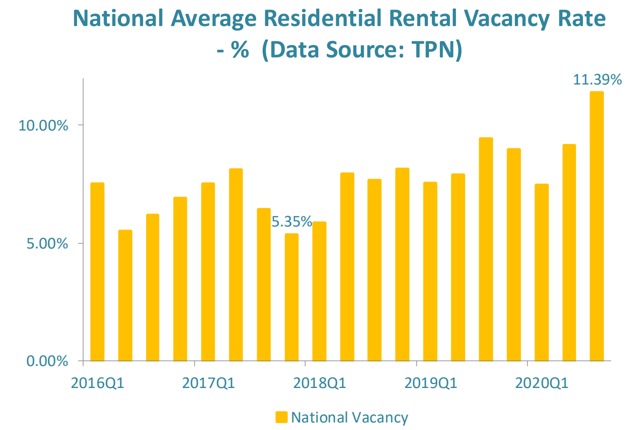
This source of pressure constrains the finances of existing rental tenants, thereby curtailing their ability to pay rent timeously and absorb rental escalations. This was reflected in the multi-year trend in TPN's percentage of tenants that are in good standing with their landlords, which declined gradually from a decade high of 85.95% as at the 3rd quarter of 2014 to reach 81.52% by the 1st quarter of 2020, a multi-year gradual decline that started well prior to the economic shock from the 2020 COVID-19 lockdown.

Then came the more severe economic dip of the 2nd quarter, caused by the lockdown period, and the percentage of tenants in good standing dropped more sharply to 73.5%.

We believe that these economy-related pressures have contributed to a greater oversupply of rental space relative to demand, with new household formation slowing and a portion of existing households "shutting down", as reflected in a rising residential rental property vacancy rate.

From a low of 5.35% in the final quarter of 2017, the TPN National Average Vacancy Rate has drifted broadly higher over the past few years to reach 11.39% by the 3rd quarter of 2020.

This increase in rental property oversupply has translated into slowing rental inflation through this period.



More recently, sharp interest rate cuts may have also had a dampening impact on the rental market

The second key influence on the rental market is recent sharp interest rate cuts, although the overall impact of this is less clear than the GDP recession impact.

There has been a large reduction in interest rates during 2020, with Prime Rate declining from 10% at the start of the year (10.25% at a stage of 2019) to 7%.

The overall impact of this interest rate cutting cycle on the rental market is unclear. On the one hand it has cushioned the blow of lockdowns on the economy, and the magnitude of recession may have been worse had it not been for rate cuts. That may have been even harsher on rental tenants than the recession with the actual rate cuts. However, the sharp rate cutting gives highly credit-dependent home buying a greater competitive advantage over the rental option, encouraging a portion of tenants to leave the Rental Market in favour of buying homes.

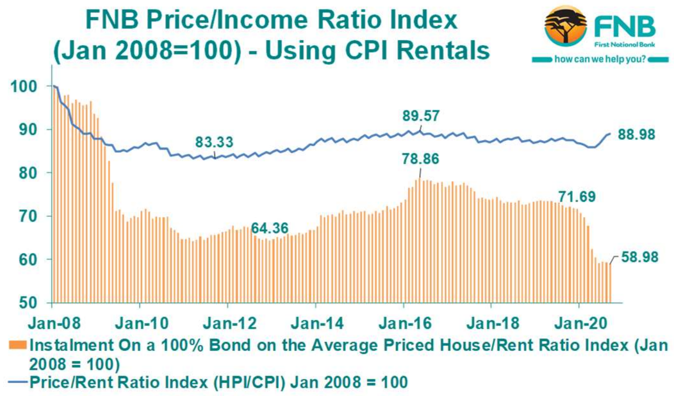
Households are required to choose between the home ownership and home rental option, the former option being a far more interest rate sensitive decision due to the fact that many households use a mortgage loan to finance this. Therefore, all other things equal, a sudden reduction in interest rates increases the attractiveness of the home buying option relative to the rental option.

Many commentators place much emphasis on the Average House Price/Average Rental Ratio, the argument being that if house prices increase at a more rapid rate than rentals, leading to a rise in the Price/Rent Ratio, this at some stage should ultimately lead to the rental option winning greater appeal relative to home buying as home buying affordability deteriorates relative to rentals. This in turn would contribute to a cooling off in the home buying market. The converse is true when this ratio declines.

We compile an Average House Price/Rental Index (Jan 2008=100) to track this trend, and in recent years have found house price inflation generally not quite keeping pace with rental inflation, which translated into a cumulative -3.6% decline in this index from May 2016 to March 2020 .

This was not a major decline. And what appeared to be a mild "competitiveness" improvement in the home ownership market relative to the rental market was mostly reversed from March 2020 to September 2020, with this index rising by +3.6% over the period as house price growth began to outpace rental inflation.

However, given that many households utilize mortgage credit to purchase a home, an index that we feel makes more sense to monitor is the "Instalment Value on a 100% new home loan on the average priced home/Average Rent Ratio" Index.



This 2nd index is thus not only driven by house price and rental trends but also by interest rate moves. And with the very significant interest rate reduction, it has plummeted by a massive -25.2% since a decade high recorded in May 2016.

This points to a very significant improvement in the appeal of home buying relative to the rental option, all other things equal, much of this relative change coming in 2020 due to sharp SARB rate cutting.

This improvement in the affordability of home buying relative to renting, not so much due to relative price-rent ratio change but more due to a sharp drop in the cost of borrowing, appears to have boosted home buying demand strongly while leaving the rental market to continue its weakening path.

The recent home buying strength has been indicated by many players in the Residential Property Sector, while also having been seen in various responses in the FNB Estate Agent Survey, From the 2nd quarter to 3rd quarter 2020 surveys, perceived home buying market activity jumped sharply, while the average estimated time of a home on the market prior to sale fell to 10 weeks and 6 days, the lowest average time since the pre-2008 boom years.

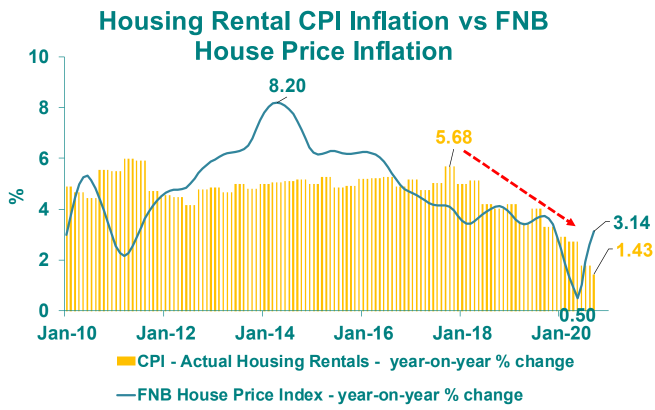
And with the estimated level of 1st time buyers at 24% of total buying in an expanding market in the 3rd quarter survey, up from 19% a year prior, it is plausible that the home buying market has taken a portion of tenants away from the rental market of late.

Conclusion

In recent years, we had assumed the likelihood that economic and home buying market "stagnation" would see the home rental market outperform the home owner market, rental inflation thus outpacing house price inflation, and ultimately rising income yields on residential property.

And indeed, from around 2016/17 until early-2020, a mild outperformance of the rental market over the home owner market was seen. In recent months, however, a home buying surge has rendered the rental market the relative underperformer.

Average rental inflation has slowed all the way from 5.7% year-on-year in 2017 to 1.4% in the most recent September CPI survey. This 1.4% is now slower than the FNB House Price inflation rate which has accelerated to 3.14% year-on-year as at September.



A still-rising residential rental market vacancy rate hints at the likelihood of further rental market weakness in the coming months, and the possibility that a period of average rental deflation will take place in 2021.

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