Recovery perceived in industrial, retail markets - Q1 2021 FNB Property Broker Survey

By John Loos

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In this report, we discuss the first quarter 2021 results of the rental market component of our FNB Commercial Property Broker Survey which surveys a sample of commercial property brokers in and around the six major metros of South Africa, namely, City of Joburg and Ekurhuleni (Greater Johannesburg), Tshwane, Ethekwini, City of Cape Town and Nelson Mandela Bay.

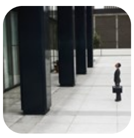
Image source: www.pexels.com

Given FNB Commercial Property Finance's strong focus on the "owner-serviced" market, a pre-requisite in selecting broker respondents is that they deal in owner-serviced properties, but a portion will also have dealings in the developer or investor markets as well as in the listed sector.

Firstly, we ask survey respondents to provide us with a rating of rental market activity as they perceive it, on a scale of 1 to 10, with 10 being the strongest level of activity. Similar to our buying/selling survey component, the rental market survey component still shows the highest levels of optimism emanating from the industrial and warehouse property market respondents. In this segment, the activity rating rose from 4.5 in the "lockdown" second quarter to 6.51 in the first quarter 2021 survey. This is the third consecutive quarter of increase in this sector's activity rating.

The retail sector has also seen strengthening in its market activity rating, from a 3.62 low in the second quarter of 2020 to 5 by the first quarter of 2021, also the third consecutive quarter of increase. However, the office sector's activity rating has declined from 3.70 as at the hard lockdown second quarter of 2020 to 3.49 as at the first quarter of 2021, leaving it by far the sector with the lowest rating of the three major commercial property sectors.

While the industrial and retail activity ratings have both improved post-lockdown, only the industrial sector has managed to recover to an activity rating above its pre-lockdown first quarter 2020 level, while the retail and, most notably, office ratings remain below pre-lockdown levels.



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Activity trend over the past six months

We ask a follow up question to the activity rating, asking respondents whether they believe that rental market activity has strengthened, weakened or remained the same since six months prior.

Out of the responses, we create an index by allocating a +1 score to an “increased” response, a zero to an “unchanged” response and a negative -1 to a “declined” response.

The scale of the “Index for direction of change in rental market activity over the past six months” is thus from +100 to -100. A score of +100 would imply that 100% of respondents perceived an increase in time on the market over the past six months and -100 would imply 100% of respondents perceiving a weakening, while a zero level would mean that those providing an “increased” response equals those responding with “decline”.

Of the three property classes, the industrial property survey returned the most positive index reading of +59, meaning that 59 percentage points more of the respondents perceived an increase in rental market activity than those who perceived a decrease.

By comparison, the readings in the retail and office markets for this response were weaker, although that of retail was not far behind on +36.7. But the reading for the office sector was significantly weaker, recording a negative reading of -17.9.

The industrial and retail sectors’ readings have improved notably, from negative readings just two quarters prior, while office has only managed a less negative reading compared with two quarters prior.

Vacancy trends

Using the same methodology as above, we compile an index on a scale of +100 to -100 for the responses as to whether vacancy rates have risen, remained the same or declined over the past six months.

Here, the office property sector comes out as perceived to be by far the weakest major property class, with an index reading of +56.4, implying that a significant 56.4 percentage points’ more respondents perceive office vacancies to have been rising in the prior six months than those respondents perceiving a decline. This is still a very strong bias in favour of rising vacancy rates, despite being mildly lower than the prior three quarters.

The retail property sector, by comparison, has a far less significant bias towards rising vacancy rates to the tune of +13.3, this bias being greatly reduced from a very high +90 just two quarters earlier.

The industrial property reading is thus the only property class of the three which shifted to a bias towards declining vacancy rates, to the tune of -18 as at the first quarter of 2021.

The aggregate perception of rising vacancy rates is thus only still very strong in the office sector.

Brokers may be pointing to a manufacturing and economy-wide inventory recovery

The strength in the industrial property market, and a perception of declining vacancy rates is “interesting”, given that, as yet, the economic sectors key to influencing industrial property performance have not all been returning strong data.

As at the final quarter of 2020, manufacturing GVA (gross value added) growth was still -2.01% down year-on-year.

Manufacturing capacity utilisation in the final quarter of 2020 was at a lowly 79.3%, down from 83.1% at a stage back in 2018 and far below the days of around 87% back in the pre-2008 economic “boom” years.

And while square metres of industrial space plans passed have declined sharply since 2018, a positive from a point of view of curbing oversupplies in future, recent new space completions remained significantly “elevated”.

In addition, quarterly GDP data has been recording sharp drops in economy-wide inventory levels through 2019 and 2020, a typical trend during weak economic and recessionary periods, but something that would likely dampen warehousing demand if anything. But perhaps the brokers are experiencing early signs of the start of a re-stocking of inventories through the economy, driving manufacturing back into positive growth territory, resulting in expansion plans by some. The one up-to-date leading indicator pointing to some strengthening is the Manufacturing Purchasing Managers Index (PMI) New Sales Orders Sub-Index, which has risen markedly in the last three months to a healthy level of 60.4 - a level well back into “expansionary” territory (50 being the dividing line between expansion and contraction).

The property broker survey for industrial property may be reflecting what the most recent manufacturing PMI readings have been telling us, i.e., that stronger times are at hand.

While Rode data showed industrial property year-on-year rental inflation nearing zero late in 2020, the most recent broker survey suggests the possibility that industrial rental growth may begin to turn the corner before venturing too far into negative territory.

The same, however, cannot be said for office rentals, with Rode data already having reached -4.47% year-on-year decline in de-centralised A-grade office rentals by the final quarter of 2020. The survey suggests more office rental deflation likely to follow in the near term.

Near-term expectations – Covid-19 impact still features prominently on the list of issues

Near-term activity expectations amongst survey respondents have most often in prior surveys been biased towards strengthening, when we ask them to provide their six-months ahead expectations for rental market activity (i.e., increase, decrease or remain the same).

In the first quarter 2021 survey, a bias of the group of respondents towards higher near-term market activity was recorded in all three major property classes. Interestingly, though, was that the aggregated expectation for industrial property was not overly strong.

The industrial property respondent group’s index reading was a positive +20.5. This was virtually the same as the +20.5 reading recorded for office property, and mildly ahead of the +16.7 reading for retail property.

The office property reading comes as the surprise, given the very weak actual situation portrayed by the group of brokers.

It must be pointed out that brokers may have an inherent bias towards the positive, when coming to the future expectations part of the survey, in much the same way that economic forecasters are often hesitant to forecast recessions that take place periodically, opting to project low positive growth rates often instead. Such biases do exist. However, we would have expected a stronger positive reading for industrial property than for office property at this stage.

Key factors that drive near-term activity expectations

The main factors that brokers cite as key influences on their near-term market activity expectations are often insightful, and indeed have proved to be interesting in the office sector survey for the first quarter.

The Covid-19 lockdown impact was strongly on brokers' minds, and in this survey a still very significant 38.5% of the brokers still see companies re-evaluating office space needs and in many instances either downscaling their amount of office space required or planning to do so, in part due to greater levels of employees working from home perceived.

12.82% only perceive prime office space being sought after. Against the above major negative influencing factors, there is a group of more optimistic brokers, 15.38% of brokers, expecting small business interest in office space to pick up.

Those were the main influencing factors cited by broker respondents in the office rental market.

A significant 30.77% of the industrial property survey respondents pointed to expected small business demand for space, which perhaps makes sense given its relative affordability in tough economic times, while also being the most adaptable property class.

10.3% of respondents point to increased need for warehouse space as online retail grows. 10.3% of respondents perceive manufacturing to be picking up, with fewer imports taking place. However, 10.3% perceive only prime space to be in demand.

Interestingly, in the retail market 40% of retail property brokers expect positive development in terms of small business interest in space as well new businesses starting up.

13.33% also see rentals being reduced to keep or attract tenants, while 6.67% perceive landlords still charging unrealistic rentals. But 16.67% of respondents are still concerned with the economic impact from Covid-19. Interestingly, only 3.33% of respondents point to online retail as a key factor reducing centre footfall. We would have expected a higher percentage here.

Conclusion

In short, brokers surveyed in the first quarter 2021 FNB Property Broker Survey perceived further noticeable strengthening in the industrial and retail rental market activity levels from the prior quarter, but a slight decline in office market activity level.

The activity rating of industrial property is the only one to have surpassed the pre-lockdown first quarter 2020 level. In industrial property, the brokers as a group perceive vacancy rates to have declined since six months prior, which they don't perceive yet for either the retail or office markets.

Their perceptions are that the office rental market is by far the weakest of the three, both in terms of activity levels as well as vacancy trends. We thus expect average office rentals to continue their deflation in the near term, with Rode data already having recorded noticeable year-on-year deflation in recent quarters.

Examining near-term market activity expectations, in all three property categories the broker group is "moderately" biased towards strengthening.

Concerns related to Covid-19, and its impact on the economy and property, remain strong. In the area of office property, the biggest factor influencing expectations is still how companies revise their office space needs as remote working increases in importance, but recession-related employment decline is also a factor here.

In retail property, interestingly enough the brokers point to a significant level of new business startups, while surprisingly few point to online retail as a key issue. The state of the economy and the consumer remains a more significant issue for the group.

ABOUT JOHN LOOS

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