TPN-FNB RESIDENTIAL YIELDS REVIEW

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John Loos, Household and Property Sector Strategist

Tel: (011) 649 0125

Cell:083 - 453 8096

E-mail: john.loos@fnb.co.za

Website: http://blog.fnb.co.za/category/economics/

Michelle Dickens

Managing Director: TPN

Tel: 0861-876 000

Cell: 082-905 7099

Email: michelle@tpn.co.za

Website: http://www.tpn.co.za

THE TPN-FNB RESIDENTIAL YIELDS REVIEW

1. *AFTER A SHORT 1ST HALF OF 2014 RISE IN YIELDS, THE MULTI-YEAR TREND OF YIELD COMPRESSION RESUMED LATE IN 2014*

After a short uptick in the 1st half of 2014, the TPN-FNB National Average Gross Residential Yield resumed its multi-year declining trend once more, a broad trend that started back in 2012.

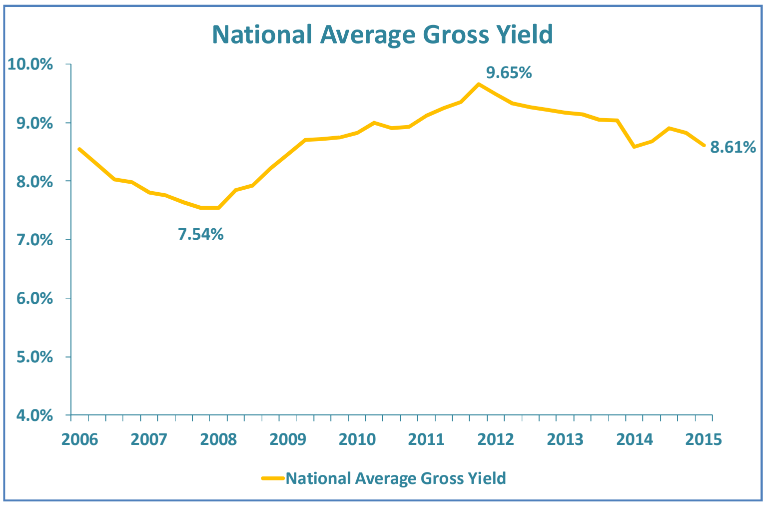
The national average yield declined from 8.9% as at the 2nd quarter of 2014 to 8.61% in the final quarter.

This appears to have been the result of some slowdown in rental inflation as 2014 progressed. Also perhaps working a little against any further improvement in the attractiveness of residential yields in the 2nd half of last year was a stalling by the SARB (Reserve Bank) in interest rate hiking after small rate hikes in January and July 2014. The broader yield compression since 2012 has seen the national average gross yield being reduced noticeably from a 9.65% high at the end of 2011 to 8.61%, a significant 1.04 of a percentage point decline.

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

2. *THE NATIONAL YIELD TREND*

Looking at the data of the TPN-FNB National Average Gross Initial Yield on Residential Property, as at the 4th quarter of 2007, the yield was estimated at 7.54%. This co-incided with a multi-decade real house price peak, following a lengthy house price boom during prior years. By the final quarter of 2011, the yield had recovered some attractiveness to measure a revised 9.65%.



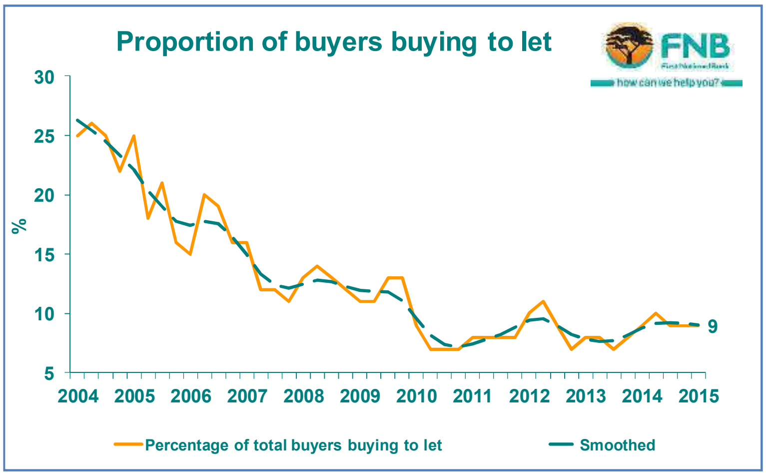
Then, from early-2012 a phase of mild compression (decline) in gross yields set in, as the Home Buying Market strengthened. By the final quarter of 2013, the estimated national average gross yield had declined to 8.58%.

However, the rental market had been gradually strengthening through 2013, and with it rental escalations, too, and by early-2014 the rental inflation was strong enough to bring about a short period of yield increase.

Through 2014, however, rental inflation began to slow again, and by the 2nd half of the year yields were back on the decline, with the home buying market still proving solid.

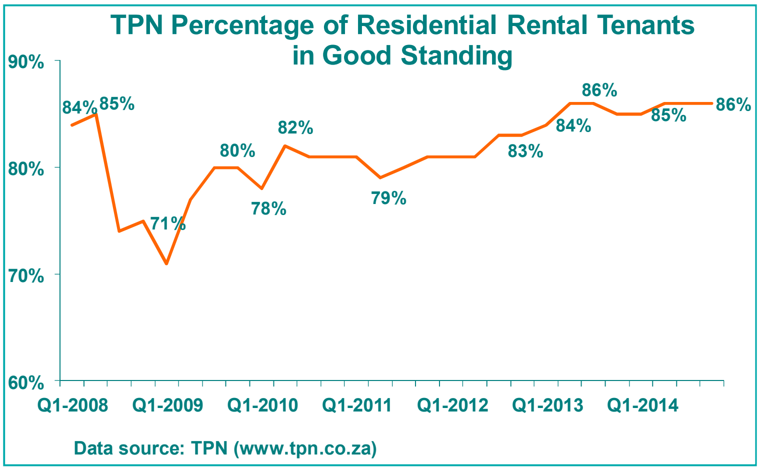
The short-lived yield rise earlier last year also co-incided with a brief period of SARB interest rate hiking, but since July last year the SARB has stalled on rate hikes, and yield compression reverted to its declining trend.

We emphasise that 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.



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, it would leave the net yield at around 7.1%. Such a yield would, for many, still be below the cost of finance, given a prime rate of 9.25%" and the average home loan rate somewhere above prime, and therefore perhaps still not overly attractive.

This perhaps explains why the estimated percentage of home buyers being buy-to-let buyers remains mired in single-digits at 9% in recent FNB Estate Agent Surveys.



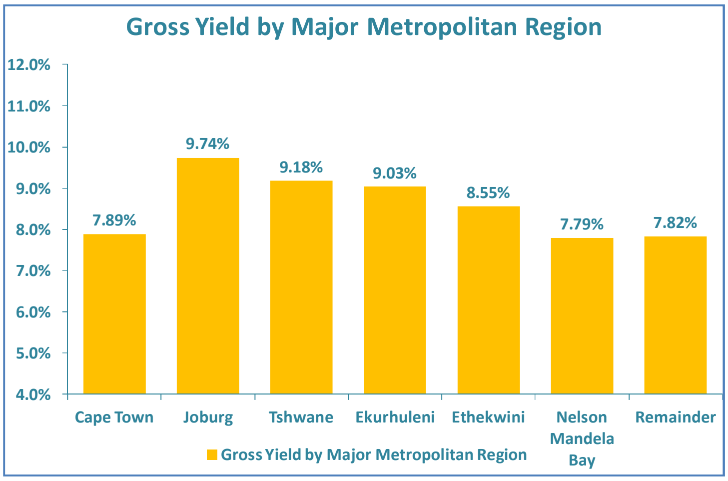
However, the yield versus interest rate on mortgage credit is not the only variable determining buy-to-let attractiveness. It is also important to evaluate the yield versus the investment risk. Here, we have seen some improvement in recent years, with a significant decline in tenant risk since the Recession of 2008/9. This is reflected in the rise in the percentage of tenants in good standing with their landlords to 86% as at the 4th quarter of 2014.

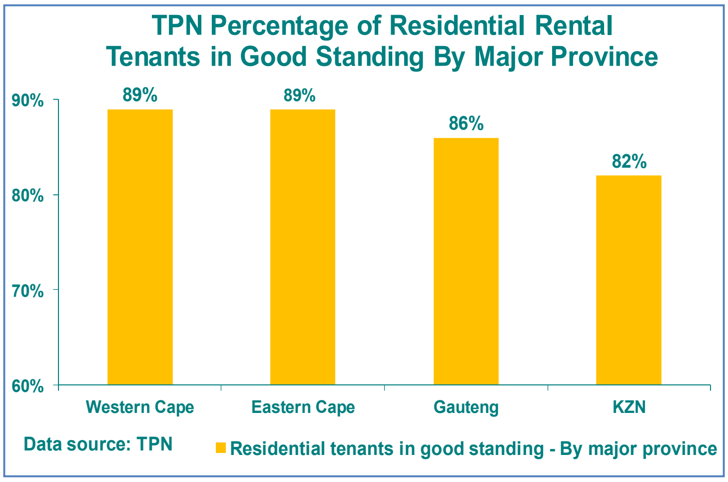
This percentage was unchanged from the prior quarter, and is now back to around levels last seen prior to the 2008/9 recession, after a huge dip to 71% as at early-2009.

A caution should be issued in this regard, however. While tenant payment performance is currently good, the dip to 71% of tenants being in good standing back in 2009 indicates just how sensitive tenants are to economic cycles and interest rates (interest rates having peaked at 15.5% prime in 2008 and the economy experienced a recession through late-2008 and the 1st half of 2009). Currently, we have a stagnant growth economy, and the SARB is intent on raising interest rates further in order to "normalise" them. This may imply, therefore, that an 86% "in good standing" percentage is "as good as it gets, and that we may have some deterioration in the near term.

3. REGIONAL YIELD COMPARISONS

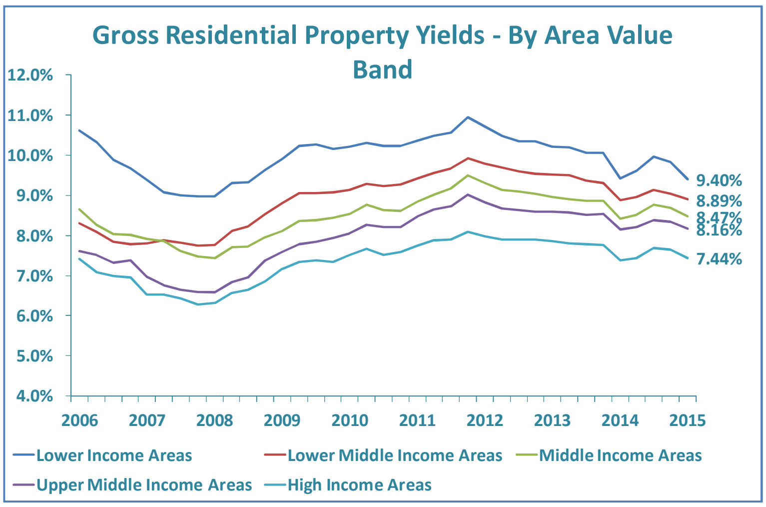
Which regions have the best yields? Broadly speaking, it would still appear that the principle of higher risk=higher return vaguely holds true when comparing yields by major region. As at the 4th quarter of 2014, the 3 Gauteng metros, namely City of Joburg (9.74%), Tshwane (9.18%) and Ekurhuleni (9.03%), had the highest yields, followed by Ethekwini metro (8.55%) 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 82% of tenants in good standing in KZN and 86% in Gauteng. By comparison, Nelson Mandela Bay (7.79%), the largest metro in the Eastern Cape, and City of Cape Town (7.89%), which forms the lion's share of the Western Cape Province, have the lowest gross yields of the major metros. The Western and Eastern Cape also have a higher percentage of tenants in good standing, to the tune of 89% respectively. Better tenant performance implies lower risk, and perhaps investors are on average prepared to pay a premium for this in the Eastern and Western Cape regions.





4. SEGMENT YIELD COMPARISONS

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

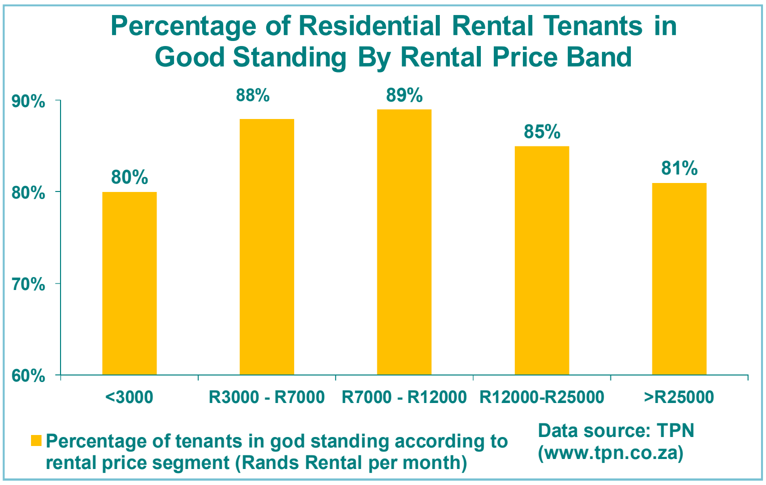


In Lower Income Areas (average home value below R600,000), the Median Yield was estimated at 9.4% for the 4th quarter of 2014. In Lower Middle Income Areas (Average home value from R600,000 to R900,000), the yield was slightly lower at 8.89%, followed by an average yield of 8.47% for the Middle Income Areas (average home value between R900,000 and R1.2million), and 8.16% 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 Upper Income Areas (average home value above R1.5m), whose gross yield is a relatively lowly 7.44%.

Therefore, cheaper areas on average offer higher gross yields, whereas the high end areas appear less attractive. However, it is important to evaluate the return versus the tenant risk posed in the different segments.

Using TPN data regarding 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 80%, thus indeed appearing to be the highest risk segment. Therefore, having the highest yield appears justified in order to make it attractive for the investor. Many of these homes probably fall in so-called "Affordable" or "Lower Income" Areas. Moving up to the next rental band, homes with rental between R3,000 and R7,000 per month show a significantly better 88% of tenants in good standing, many of such homes probably falling in the Lower-Middle Income Area Value Band. The percentage is still higher at 89% in the R7,000-R12,000 monthly rental band, with many of these homes probably in the Middle Income Areas, supporting the view up 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."

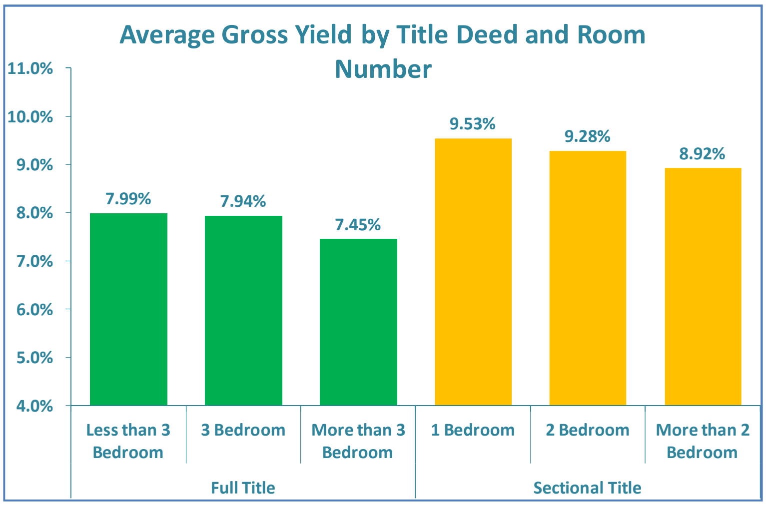


However, moving higher, the risk-return correlation theory no longer appears to hold, with the R12,000-R25,000 monthly rental band showing a lower percentage of tenants in good standing to the tune of 85%, which gets even worse in the R25,000+ monthly rental category at only 81%. Many homes in these highest 2 rental categories would fall into the Upper Income Area Value Bands, suggesting that this top area value band is a somewhat tougher place to operate for a landlord, while yields are not compensating for this apparent higher risk.

Therefore, the "sweet spot" 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, the 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. YIELD BY TITLE DEED AND ROOM NUMBER



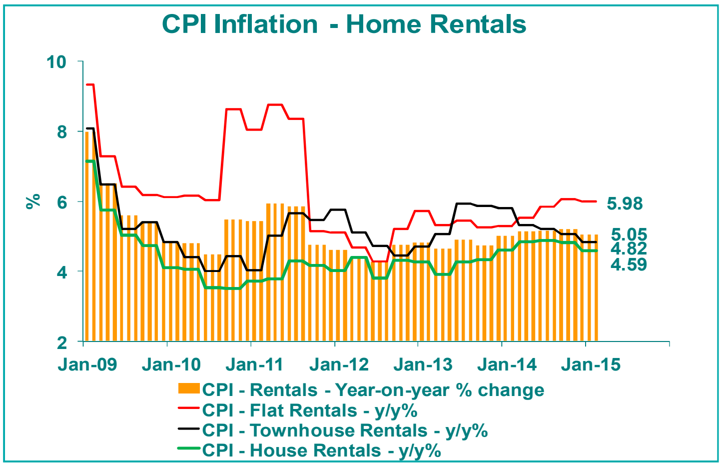
When Gross Yields are estimated by Title Deed and room number, it is Sectional Title that generally looks to be the most attractive, and "smaller generally appears to be better". 1 Bedroom Sectional Title tops the table with a 9.53% yield, followed by 2 Bedroom Sectional Title with 9.28% and More than 2 Bedroom Sectional Title on 8.92%.

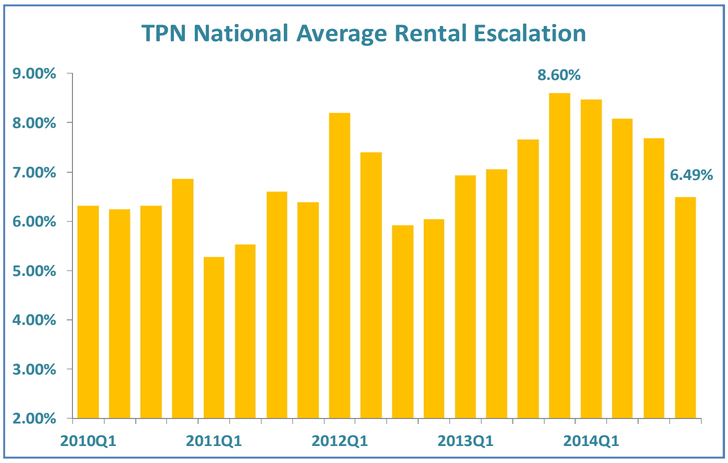
Of Full Title, Less than 3 Bedrooms appear marginally most attractive with a yield of 7.99%.

6. OUTLOOK

With regard to the direction of residential yields in 2015, much will depend on the movement of interest rates. In the near term, we expect further yield compression (decline). Although house price inflation is slowing, so too is rental inflation according to the TPN rental escalations measure as well as the StatsSA CPI for rentals, and it is a question of which will slow the fastest.

We believe, however, that the capital growth on letting houses could moderately exceed rental inflation in the near term, with interest rates not yet expected to rise, and home buying demand looking set to remain solid albeit not growing strongly any more. This could change late in 2015, when we expect to see CPI inflation rising as the disinflationary impact of the recent oil price fall diminishes, and interest rate hikes resume in the final quarter of the year. That could be expected to cool 1st time buyer demand, and strengthen rental demand, resulting in stronger rental inflation and slower house price growth, translating into rising yields from late this year.





Notes:

Data Sources: TPN and FNB

Yield Compilation Methodology:

After including a few "data cleaning filters", the estimates of initial yields on residential properties have been produced. Because rental variations appear to vary far greater from the mean than house prices do (possibly due to the absence of professional valuer guidance in the rental market), we find it better to use median yields than average yields for rental segments.

The national average yield is therefore a combination of mean and median. We start by compiling median yields for property area value bands in the major rental regions, i.e. the 6 major metros and "the rest of SA", by area value bands. The value bands are:

- Lower Income Rental Areas: Areas with average home value below R600,000
- Lower-Middle Income Rental Areas: Areas with average home value between R600,000 and R900,000
- Middle Income Rental Areas: Areas with average home value between R900,000 and R1,2million
- Upper-Middle Income Rental Areas: Areas with average home value between R1.2m and R1.5m
- High Income Rental Areas: Areas with average home value higher than R1.5m.

The median yields of the regional segments are then rolled up into regional and national weighted averages based on weightings determined by the rental volumes in the segments and regions.

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