FNB-TPN RESIDENTIAL YIELDS REVIEW

7 July 2016

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THE TPN-FNB RESIDENTIAL YIELDS REVIEW

1. THE TREND OF YIELD COMPRESSION, WHICH STARTED IN 2014, CONTINUED THROUGH INTO EARLY- 2016

Moving into 2016, the FNB-TPN National Average Gross Residential Yield continued its gradual downward trend which started back in early-2014.

The national average yield declined further from 8.38% as at the 4th quarter of 2015 to 8.34% in the 1st Quarter of 2016.

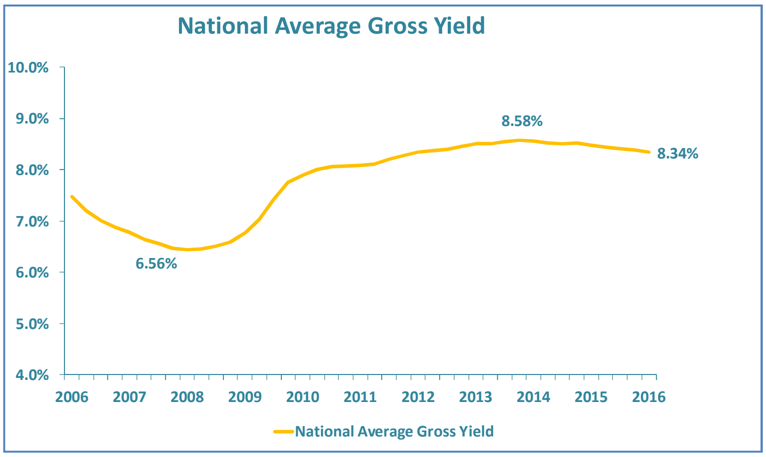
Although the Home Buying Market showed signs of broad slowing in demand growth last year, to date it has remained well balanced, even strengthening slightly early in 2016, and significant supply constraints have kept house price inflation faster than somewhat mediocre rental inflation, translating into yield "compression".

Rental inflation has surprised us on the downside in recent years, given the trend of gradually rising interest rates. But against this we have had a very weak economy, and this may have been constraining the tenant population financially, thereby limiting its ability to absorb rental increases.

The FNB-TPN 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

After the -2008/9 Recession, the housing market's gradual recovery of subsequent years finally gained enough momentum to begin to compress yields once again as from 2014.



By late-2013, home buying demand had reached what was arguably its strongest post-recession levels, with interest rates still at a multi-decade low where Prime Rate had bottomed at 8.5%.

One would perhaps have expected to see yield decline resume far sooner than 2013, given that interest rates began to fall as far back as late-2008, but while residential demand had indeed reacted quite swiftly to rate cuts, strengthening from 2009 onward, it took a lengthy time for the home buying market to build up to "full steam", with much of the demand only coming into the market once there had been sufficient evidence of market strength for a considerable period.

Such are the leads and lags.

And so, from the 1st quarter of 2014 to early-2016, we had the lagged response to earlier home buying demand build up, in the form of a period of a mild yield decline.

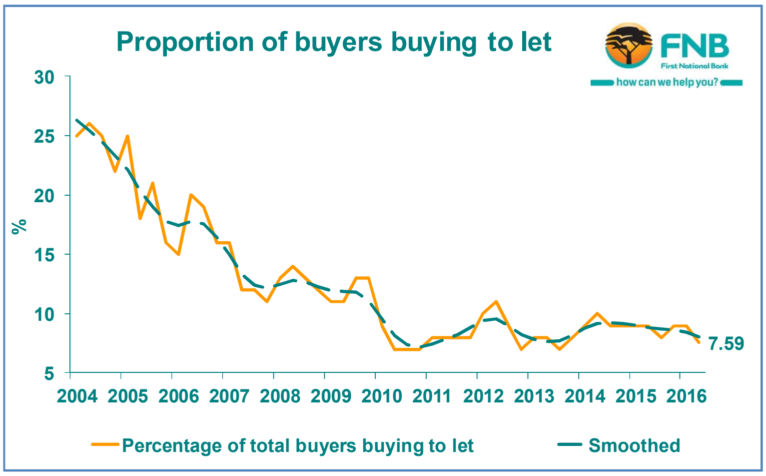
From a high of 8.58% in the final quarter of 2013, the National Average Gross Yield has declined to 8.34% in the 1st quarter of 2016.

In January 2014 the Reserve Bank (SARB) began to hike interest rates gradually, and has continued up until early-2016, which we had expect to boost the rental market and possibly begin to raise yields. However, the pace of interest increase has been very slow and mild in magnitude to date, and doesn't appear to have yet done much for rentals to date. In addition, we have a weak economy bordering on recession, so perhaps rental demand has been stifled as a result. Tenants and aspirant tenants also experience the negative impact a deteriorating economy.

Nevertheless, after a 2 year decline in yields at a time when interest rates have been rising all the while, we would ultimately expect a turn in the trend towards rising yields, but perhaps our expectations were a bit premature.

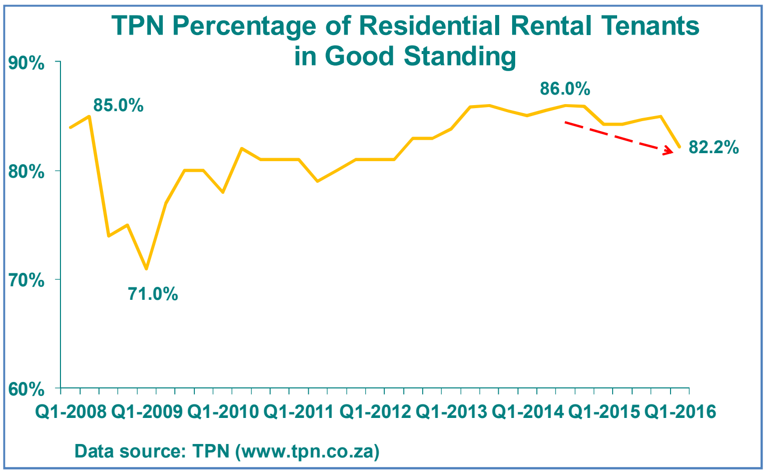
We emphasise that the yields calculated in this report are gross yields, meaning that landlord operating costs associated with the property have not yet been included in the calculation to get to a net initial yield.

Rode and Associates have in the past suggested that, as a rough estimate, one could 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 6.84%. Such a yield would, for many, still be below the cost of finance, given a most recent prime rate of 10.5%, 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 7.6% in the 2nd quarter 2016 FNB Estate Agent Survey.

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.



In this regard, we have begun to see some increase in tenant risk in recent quarters, reflecting the onset of tougher economic times.

This is reflected in the form of a decline in tenants recorded as being "in good standing" regarding their rental payments, expressed as a percentage of total tenants on the TPN system. From a post-2008/9 Recession high of 86% reached at stages of 2013/2014, the percentage of tenants in good standing has receded mildly to 82.2% by the 1st Quarter of 2016.

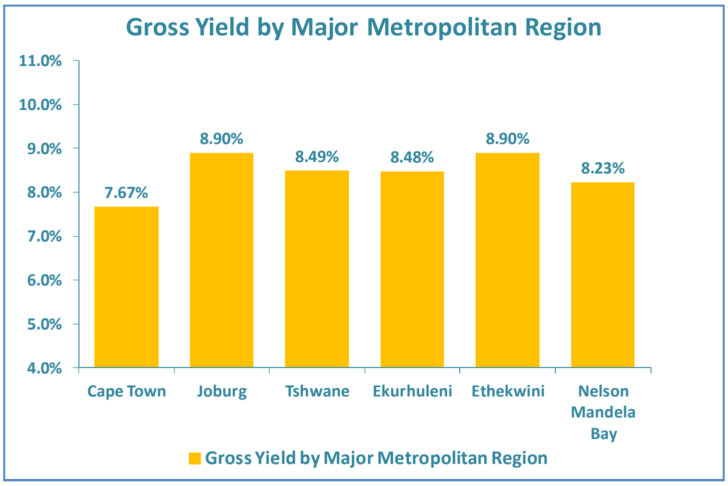
It would appear, therefore, that gradual interest rate hiking, and 4 years of broad economic growth slowdown to date, taking job creation and household income growth weaker, have begun to take a toll on a portion of the rental tenant population as could be expected.

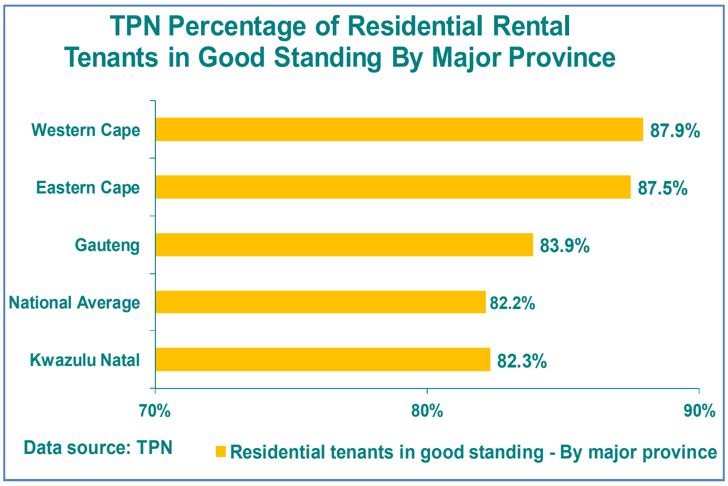
This figure is something to watch closely, because a dip to 71% of tenants being in good standing back in 2009 indicates just how sensitive tenants are to economic cycles and interest rates (interest rates having peaked at 15.5% prime in 2008 and the economy experiencing a recession through late-2008 and the 1st half of 2009). The deterioration to date this time around has been far more modest thus far. Perhaps cushioning the blow this time around is a far more gradual interest rate hiking cycle compared to that previous one. Realistically, though, many tenants cannot defy rate hiking and economic decline indefinitely, and should the country indeed fall into recession, this percentage could be expected to decline further.

3. REGIONAL YIELD COMPARISONS

Which regions have the best yields? Currently, the principle of higher risk = higher return/lower risk = lower return appears to hold some truth when comparing yields of the Western Cape's City of Cape Town and the Eastern Cape's Nelson Mandela Bay with the rest of the major regions. As at the 1st quarter of 2016, the City of Cape Town had the lowest average yield of the major Metros, at 7.67%. At the same time, the Western Cape had the highest percentage of tenants in good standing, i.e. 87.9%, reflecting a lower risk than the others. Nelson Mandela Bay had the 2nd lowest average yield of 8.23%, while the Eastern Cape is not far behind the Western Cape with an impressively high 87.5% of tenants being in good standing.

At the other end of the scale, perhaps it makes sense that Ethekwini Metro has the joint highest average yield of 8.9%, the same average yield as Joburg, given that KZN has the weakest percentage of tenants in good standing of the major provinces, to the tune of 82.3%.



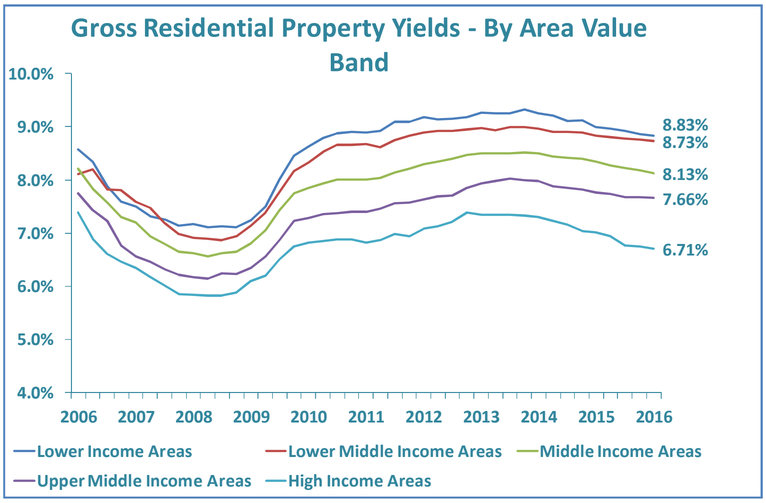


Therefore, while the correlation is far from perfect, the yields of the major regions do appear to point to some relationship between risk and return.

4. SEGMENT YIELD COMPARISONS

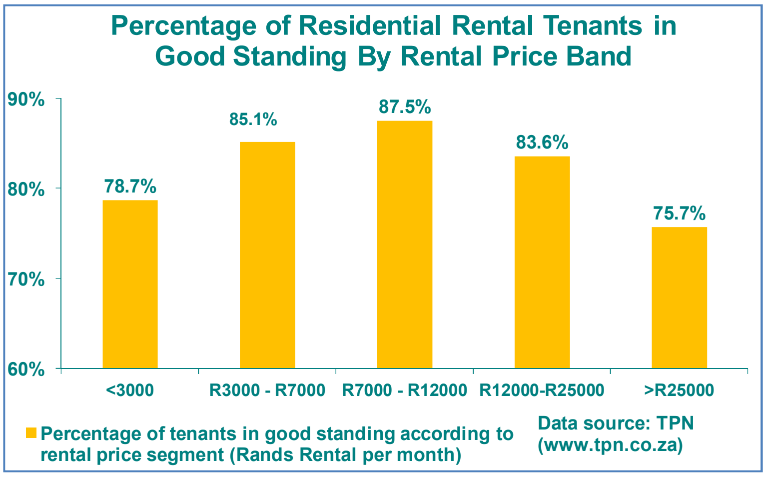
To gauge comparative yields by price segment we have segmented suburbs based on the average value of the homes in them, into 5 "area value bands".

In Lower Income Areas (average home value below R600,000), the Median Yield was estimated at 8.83% for the 1st quarter of 2016. In Lower Middle Income Areas (Average home value from R600,000 to R900,000), the yield was slightly lower at 8.73%, followed by a yield of 8.13% for the Middle Income Areas (average home value between R900,000 and R1.2million), and 7.66% 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 6.71%.



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 showing 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 78.7%, thus indeed appearing to be one of the highest risk segments. Therefore, having the highest yield appears justified in order to make it attractive for the investor. Many of these homes probably fall within so-called "Affordable" or "Lower Income" Areas. Moving up to the next rental band, homes with rentals between R3,000 and R7,000 per month show a significantly better 85.1% 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 87.5% 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. This risk should be reflected in lower yields."



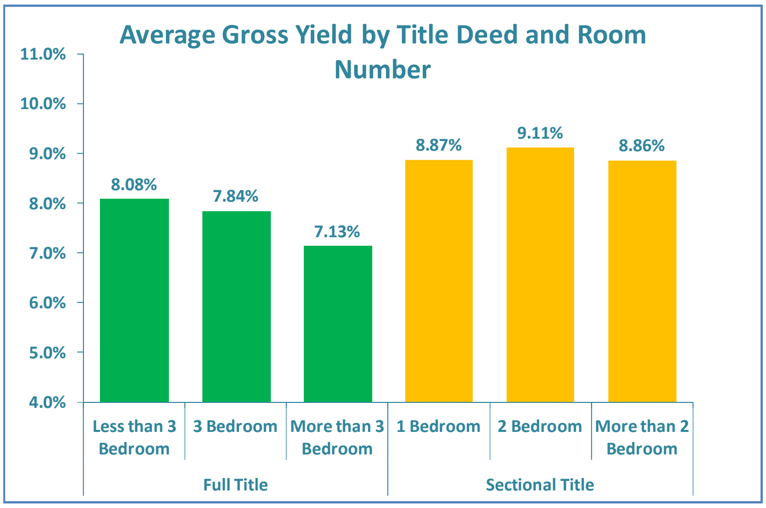
However, moving higher, the risk-return correlation theory no longer appears to hold, with the R12,000-R25,000 monthly rental band showing a lower percentage of tenants in good standing to the tune of 83.6%, which gets even worse in the R25,000+ monthly rental category at only 75.7%. Many homes in these 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-Middle to Middle Income Area Value Bands, and where many rentals probably fall between R3,000 and R12,000/month.

Some tenants can be difficult in other ways, too, however, and we admittedly don't have data regarding 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, but there is no clear cut "winner" when it comes to Sectional Title sub-segments at present. "1 Bedroom and Less" Sectional Title appears a moderately stronger market with slightly less attractive yields (8.87%) than the "2 Bedroom" Segment (9.11%), and very similar to the "More than 2 Bedroom" (8.86%) Segment.



One would normally expect the 1 Bedroom and Less Segment, being the lowest in average value of these 3 segments, to have the highest average yield. However, this segment has recently had a very strong run with regards to buying demand and price inflation, causing some relative decline in the attractiveness of its yields.

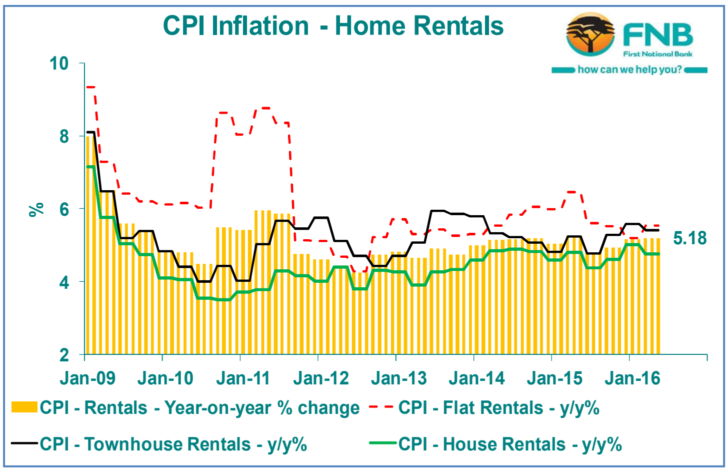
All of these 3 segments show considerably higher yields than the Full Title sub-segments though.

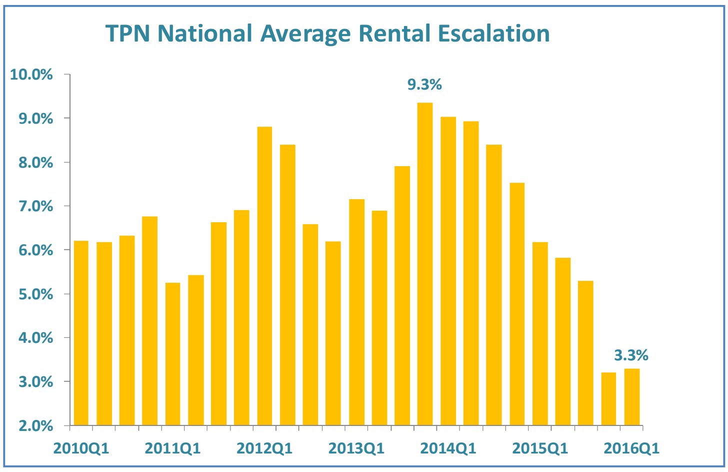
Of the Full Title categories, "smaller appears more attractive" from a yield point of view, with the "Less than 3 Bedroom" sub-segment having the highest yield (8.08%), followed by the "3 Bedroom" (7.84%) and "More than 3 Bedroom" (7.13%) sub-segments.

6. OUTLOOK

With regard to the direction of residential yields in 2016, much will depend on the movement of interest rates. In the very near term, given that our estimate of national house price inflation has recently been around 7% year-on-year, while StatsSA still puts average rental inflation at a lower 5.18%, yields could still decline a little further.

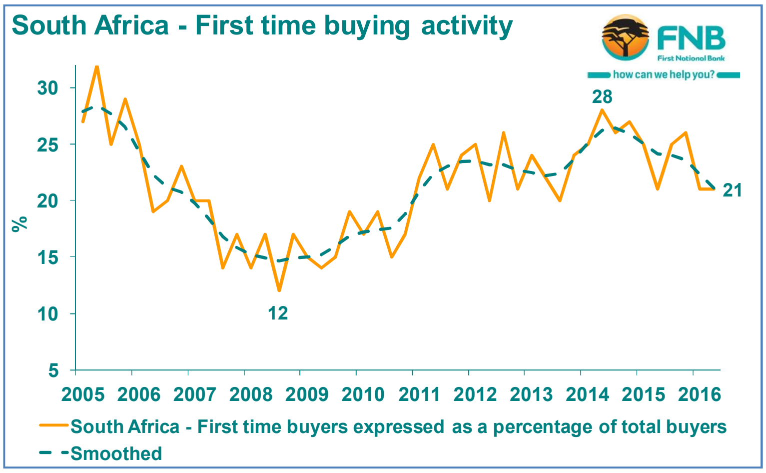
In addition, TPN's National Average Rental Escalation rate was a lowly 3.3% year-on-year in the 1st quarter of 2016, supporting the possibility that decline in the National Average Yield is not quite over yet.





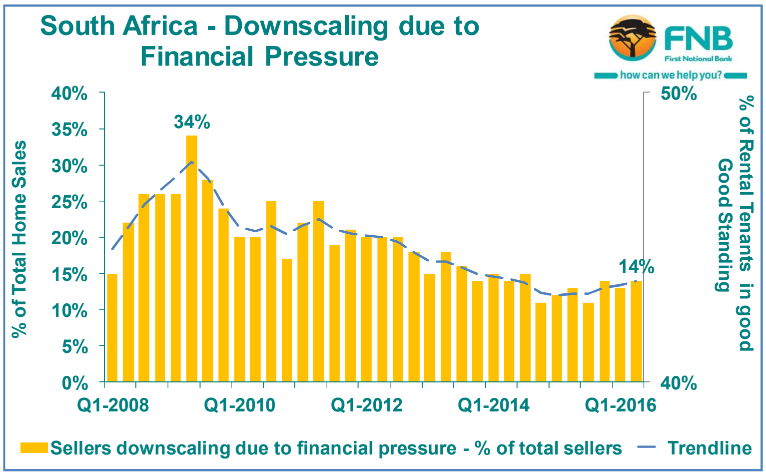
However, we would ultimately expect some lagged response of the market to rising interest rates, in the form of a rise in yields, in the not too distant future. We are not of the view that average house price growth can sustain levels around 7% under current economic conditions, and would expect it to recede to low single digits as we head nearer to 2017.

In addition, there are some signals emanating from our FNB Estate Agent Survey that rental demand could be strengthened in the not too distant future.

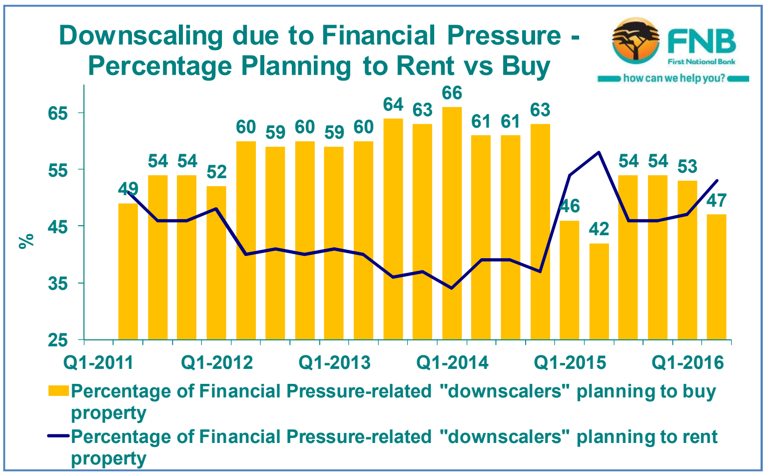


The 1st such signal emanates from 1st time buyer demand. In tougher times, aspirant 1st time buyers can hide out in the rental market in larger numbers, such as happened around 2008/9, where we saw very low percentages of 1st time home buying. This may just be starting to happen, with 1st Time Buying at an estimated 21% of total home buying as at the time of 1st quarter 2016 being noticeably lower than the 2014 high of 28%.

While 21% is still a high percentage for 1st time buying, the broader trend unfolding appears to be a declining one.



A 2nd potential source of rental demand emanates from households under financial pressure. Here, too, we may be starting to see signs of increasing support for rental demand. Those sellers selling in order to downscale due to financial pressure remain relatively low at an estimated 14% of total sellers. However, this remains up from lows of 11% reached at stages of 2014 and 2015, and may be an early hint of the start of a rising trend.



In addition, in the 1st quarter 2016 FNB Estate Agent survey, the agents estimated that the percentage of such sellers whom they believed would "rent down" as opposed to "buy down" has risen to 53%.

In short, rental demand's time doesn't appear to have come in a significantly bigger way just yet, but there are signs that we may seem some strengthening to come. We would also expect some weakening in home buying demand and therefore house price growth.

Therefore, while in the immediate future we may see a further decline in average yields, towards 2017 this declining trend may slowly begin to turn, as one would ultimately expect in lagged response to over 2 years of rising interest rates.

7. 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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