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Property Insights

Retail Property's Big Consumer Challenge

The key issue currently facing the Retail Property Sector is arguably the financial condition of the consumer, although our recent broker surveys record online retail and retail space affordability challenges as noteworthy factors too. And the challenges facing the consumer are more than just about the direct economic growth impact on income.

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Over the past 20 years, the period 1st quarter 1999 to 1st quarter 2019, the consumer has cumulatively "outperformed the economy, assisting the Retail Property Market to outperform other major property sectors over much of this period.

While the size of the real economy, as measured by GDP (Gross Domestic Product) has grown by 69.3% over the 20-year period, Real Household Sector Disposable Income has increased by a more significant 81.4%, and Real Household Sector Consumption Expenditure by and even faster 86.5%.

The strong performance of the consumer over many years was key to retail Property's outperformance of the other major property sectors. Consumer performance was driven by sharp interest rate reduction post-1998, from a peak Prime Rate of 25.5% in that year to what are have been far lower rates ever since. In addition, early last decade effective personal tax rates were being reduced. Retailers were also relying on a steady decline in the household savings rates at least for the 1st 10 years of the period up until 2008. Times were good, household net wealth was growing due to strong asset price growth pre-2008, and consumer confidence was high.

But that consumer environment has changed significantly in more recent years, and we are of the opinion that the financial pressures on the consumer, along with their change in sentiment, are the key near term negative from a retail property performance point of view, with the "threat" of online retail still of lesser (though still very significant) importance.

What the FNB Property Broker Survey says about recent conditions

Our FNB Property Broker Survey has recorded the majority of survey respondents pointing to an average vacancy rate increase over the past 6 months in the Retail Property Sector.

These respondents are also least optimistic on retail property performance in the near term, compared to their expectations regarding near term market activity in the Office and Industrial Property Sectors.

When surveying near term market expectations, it was also seen that respondents for the retail Property component were less optimistic than those in the Office and Industrial Property surveys.

But while much has been made of the challenge to retail from online shopping, still a significantly higher percentage of respondents (28%) indicated that the poor state of the economy (and by implication the consumer) was a key factor in driving their near term expectations for retail property market activity, versus 22% citing rental affordability as a challenge and 13% pointing to the online retail "threat" .

Therefore, while not ignoring the importance of online retail in future, currently the state of the consumer's confidence and finances arguably deserves a lot more concern.

Retail Property's 2-decade "outperformance" over other property sectors was driven by consumption expenditure growth (and thus Retail and Wholesale GDP growth) that outperformed Industrial Property-related Manufacturing growth of Office-related Finance, Real Estate and Business Services Sector employment growth.

But it appears that this "outperformance" of the consumer is unlikely to continue, and it is more than just about the direct impact on consumer finances of a slowing economy. It is also about consumers carrying the cost of deteriorating government finances too, as well as a possible change in sentiment leading to a higher savings rate. We discuss the impact of the consumer's 3 major challenges.

3 potential sources of Pressure on consumer spend and retail.

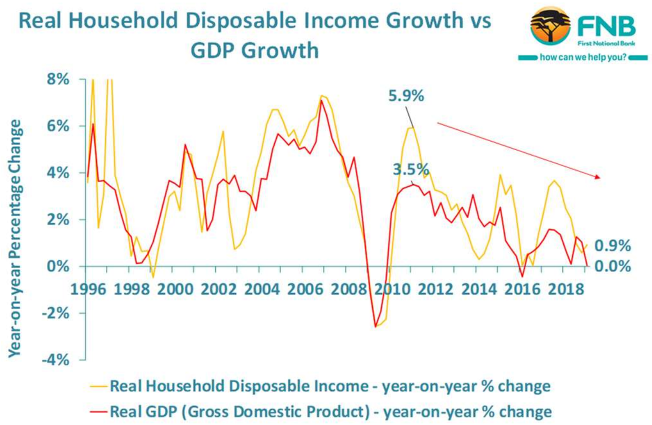
- Stagnant economic growth

The greatest influence on consumer spend is Household Disposable Income and its growth rate, with households generally using the bulk of their disposable income for consumption, and leaving very little for saving and investment by comparison.

And household disposable income growth in turn largely follows the direction of GDP (Gross Domestic Product growth. Therefore, although real disposable income growth has often outperformed economic growth, with above-inflation wage bill growth being a key influence along with relatively low consumer price inflation, its broad growth direction has been one of stagnation in line with economic growth since around 2011/12, as South Africa's myriad of structural constraints increasingly hamper economic performance.

So, in early-2011, Real Household Sector Disposable Income growth peaked at a strong 5.9% year-on-year, which was well above the 3.5% GDP growth peak at around the same time.

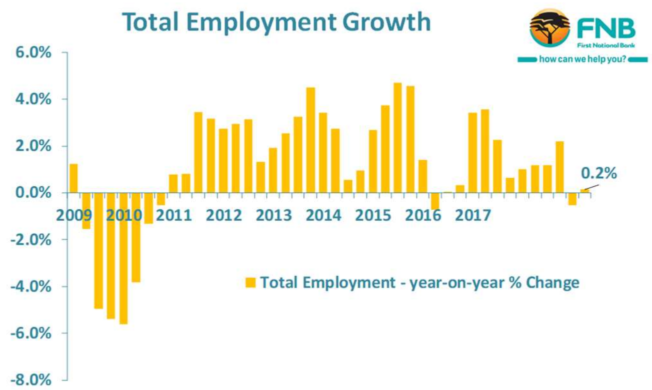
By the 1st quarter of 2019, GDP growth had slid to zero percent year-on-year, while Real Household Disposable Income growth was barely much better at 0.9%, driving Real Household Consumption Expenditure growth of a similar 0.7% rate.



And the property brokers surveyed have correctly point to retail property landlords feeling this impact.

In this weak economic environment, it comes as no surprise that the 1st quarter StatsSA employment growth rate estimate was a mere 0.2% year-on-year, while the prior quarter had shown a dip of -0.5%. In the media, reports of certain corporates retrenching of ;late doesn't go unnoticed either.

The poor employment growth and reports of job loss serve 2 purposes. Firstly, these trends have an actual direct influence on Household Disposable Income growth, but secondly they go further to create greater fear even amongst those employed, thus dampening consumer confidence and possibly causing the consumer to become a more cautious spender as a result.



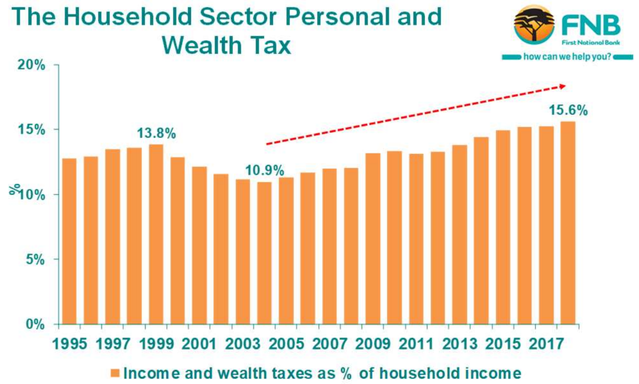
- Rising Effective Tax Rates

But the consumer has more to deal with than only the direct effect of growth on income in a weak economy.

The indirect impact of the weak economy is weak government tax revenue growth, with the government approach to the problem being to increase effective tax rates, most notably personal income tax, through a combination of higher marginal tax brackets and not fully adjusting for wage inflation tax bracket creep.

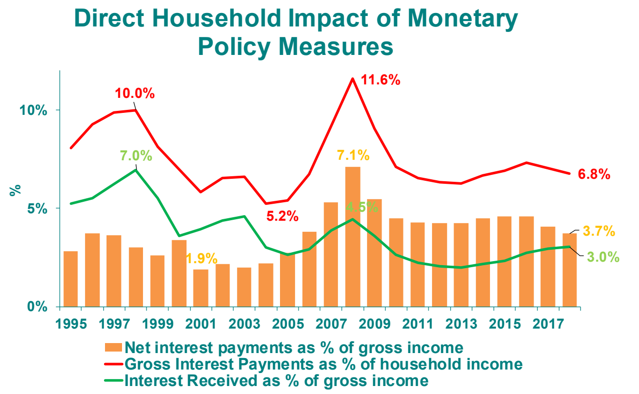
As a result, , we have seen that the total Household Sector personal and wealth tax bill has risen from

10.9% of total Household Sector income in 2004 to 15.6% by 2018, and further increase in 2019 and beyond is the most likely outcome.

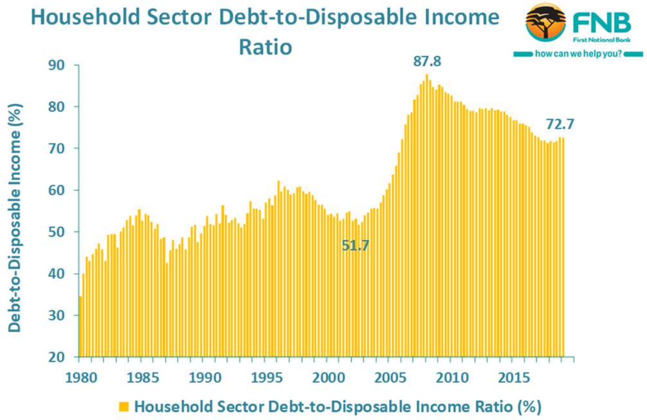


While some may point to low interest rates as a factor that "offsets" the negative impact of rising effective personal tax rates, this is questionable. Indeed, taking annual SARB data of the total household interest bill, we see that total interest paid by households on their debt has dropped from the multi-decade high of 11.6% of total household income in 2008 to 6.8% as at 2018. However, one must also take into account interest income on deposits lost through lower interest rates, and interest received as a percentage of total household income is also down from 4.5% of household income in 2008 to 3% in 2018.

This means that Household Sector "Net Interest Paid" (interest paid on debt minus interest received on deposits) is down from 7.1% of total income in 2008 to 3.7% in 2018.

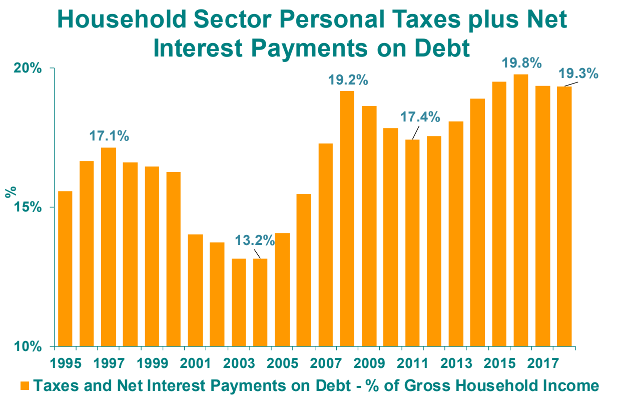


This decline is the result of the combination of significantly lower interest rates, with Prime Rate just above 10% last year down from 15.5% as at the 2008 peak, and a decline in the level of household indebtedness as per the debt-to-disposable income ratio from 87.8 early in 2008 to recent levels near 72.

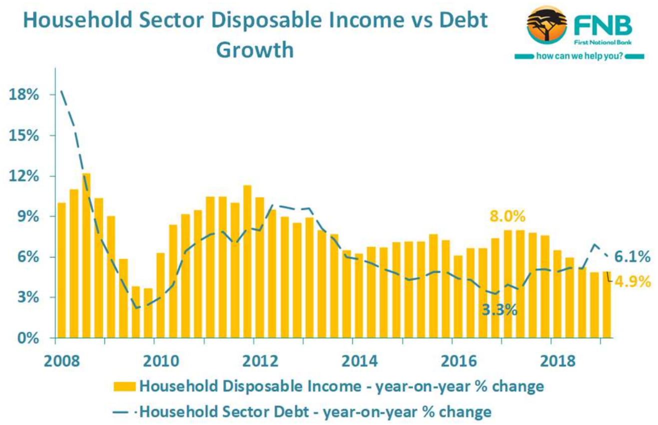


However, the total direct impact of interest rate and tax changes does not point towards an easier position for the household of late. To the contrary, It points to a tighter squeeze compared to 2008 and prior years. We illustrate this through calculating the total value of personal/wealth taxes and net interest payments, expressed as a percentage of total Household Sector income.

In 2018 this percentage was 19.3% which, while down on the multi-decade high of 19.8% in 2016 (helped lower by slightly lower interest rates since then), was still slightly higher than the 2008 percentage of 19.2%, and 2008 itself was considered to be a year of severe "policy pressure" on the household. And this 19.3% dwarfs the lowly 13.2% low reached as at 2004, around the time that the great consumer spending boom was under way.



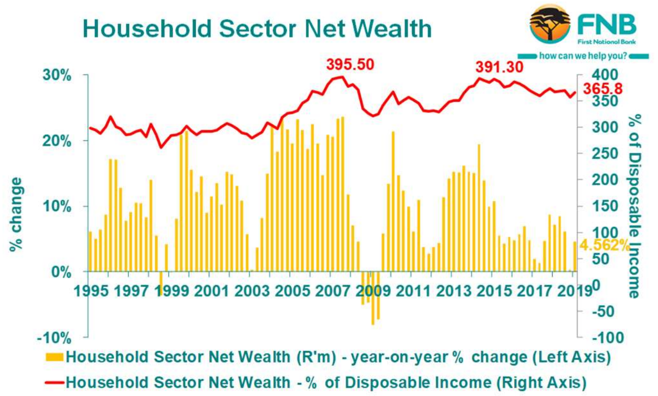
And with nominal Household Disposable income growth at a very slow 4.9% year-on-year in the 1st quarter of 2019, below household credit growth of 6.1% in the same quarter, the debt-to-disposable income ratio is likely to rise, further limiting any possible decline in the interest bill due to interest rate cutting, should such rate cutting take place.



- A potential rise in the savings rate

Thirdly, retail could potentially be further constrained by an increase in consumer caution and the savings rate, emanating from weak sentiment and poor growth in net wealth.

Weak asset growth in recent years (along with low saving) has contributed to a decline in the Household Sector Net Wealth-to-Disposable Income Ratio from a multi-year high of 391.3 early in 2015 to 365.8 by early-2019.

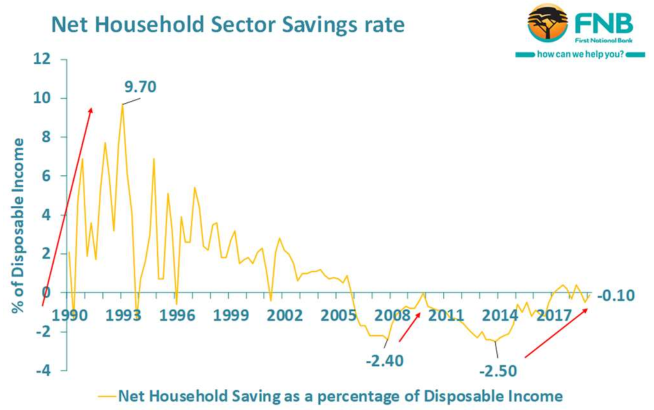


We would expect that a response to weak asset price growth curbing net wealth could be for households to lift the savings rate to compensate for this.

In addition, poor economic news and weak employment growth contributes to greater concern by households regarding their financial future, and this too could lead to some increase in the savings rate.

This typically happens in times of greater economic pressure and uncertainty, and indeed it has vaguely begun to happen in recent years again. From a low of -2.5% of disposable income late in 2013, the net "dis-savings" rate (gross savings minus depreciation on fixed assets) has at least diminished to -0.1% by early-2019, implying some mild improvement in the savings rate. But given the proliferation of bad economic news recently, it is possible that the rise in the still-low savings rate may go noticeably further.

An increase in the household savings rate would be a key positive in the longer run, with savings key to funding domestic investment. But in the near term, should it happen, it would be a constraint on retail sales growth and retail space demand.



Conclusion

In short, the "outperformance" or Retail Property over Industrial and Office Space was due in large part to the outperformance of the consumer over many years.

But this outperformance was due to some key policy and sentiment-related positives. From the late-1990s, interest rates dropped to far lower levels, which assisted a pre-2008 consumer boom. In addition, up until 2004 government was lowering the effective tax rate on households, while the Household Sector was lowering its savings rate all the way into "Net dis-saving".

However, in more recent years, the challenges to the consumer have mounted. Stagnating economic growth has curbed employment and income growth. But there's more to it, with this growth slowdown also slowing government tax revenue growth, and government attempting to address the problem by raising effective personal tax rates.

The result today is that the combined household personal and wealth tax burden along with net interest payments, expressed as a percentage of household income, was higher in 2018 than in 2008, even though 2008 was a year in which interest rates were far higher than in 2018.

With more increase in the effective tax rate this year and likely beyond, the stimulatory impact of small interest rate reductions such as the 25 basis points in July will likely be offset by the fiscal effect.

And on top of this, there exists the possibility that the savings rate of households could rise further due to weak asset price and net wealth growth, along with heightened concern amongst consumers about their own financial future in a deteriorating economic environment.

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