PayProp

RENTAL INDEX

THE STATE OF THE RESIDENTIAL RENTAL MARKET IN SOUTH AFRICA

INCLUDING TENANT RISK DATA

Q2 2016 ▪ APR - JUN

In this issue:

Q2 2016

CONTENTS

A RETURN TO STABLE GROWTH

Our last PayProp Rental Index, you'll agree, wasn't the type of story anyone likes to tell. At the time, rental growth showed signs of slipping, as sluggish economic growth and increasing tenant debt levels looked to be pulling back growth.

And while it is not entirely fantastic news yet, there is a glimmer of hope: In the Q2 2016 index we once again see a return to stable growth at national level.

But while things seem tranquil on the surface, we've been in this business long enough to know there's never a dull moment in letting!

In this edition of the index we try to better understand the undercurrents that sometimes move in and can drag you down.

More specifically, we try to answer four questions that keep coming up in our client conversations:

1. Is there really a migration from Gauteng to the Western Cape?
2. Have the fabled Northern Cape growth rates come back down to earth?
3. What's going on in Limpopo?
4. Are consumers any better off?

We've waited a long time to ask these questions: Now, with access to more than 83 000 tenancy records and close to 50 000 tenant credit profiles, we are in an excellent position to provide some carefully considered answers.

Enjoy these insights and much more in this issue!

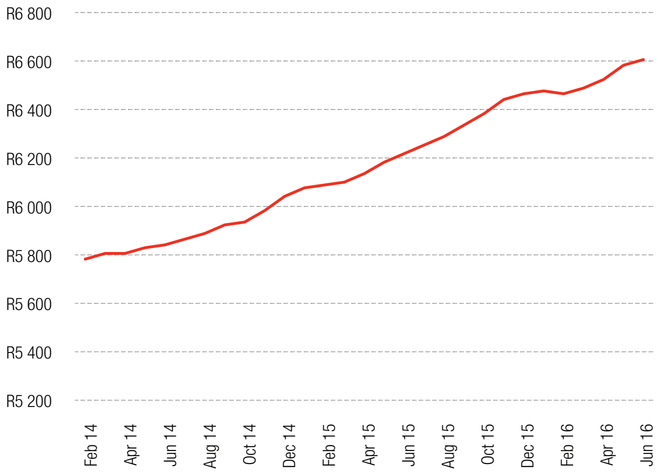
Louw Liebenberg
CEO: PayProp South Africa
087 820 7368
louw@payprop.co.za

HOW STRONG IS THE GROWTH?

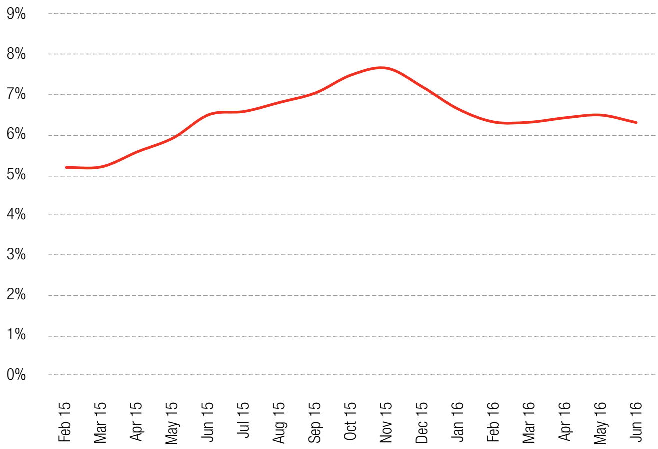
Stability makes a welcome return.

The average South African rental for Q2 2016 was R6 570.50 – R95.16 more than the Q1 average of R6 475.34 and R394.65 more than the Q2 2015 figure of R6 175.85.

The 12-month increase amounts to 6.4% – exactly the same as in Q1, and it is a welcome return to stability after a one percentage point drop from the 7.4% measured in Q4 2015. ■



Average national rental
Source: PayProp

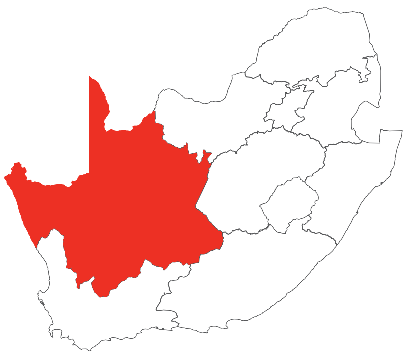


Year-on-year growth
Source: PayProp

THE NORTHERN CAPE – BARELY AHEAD

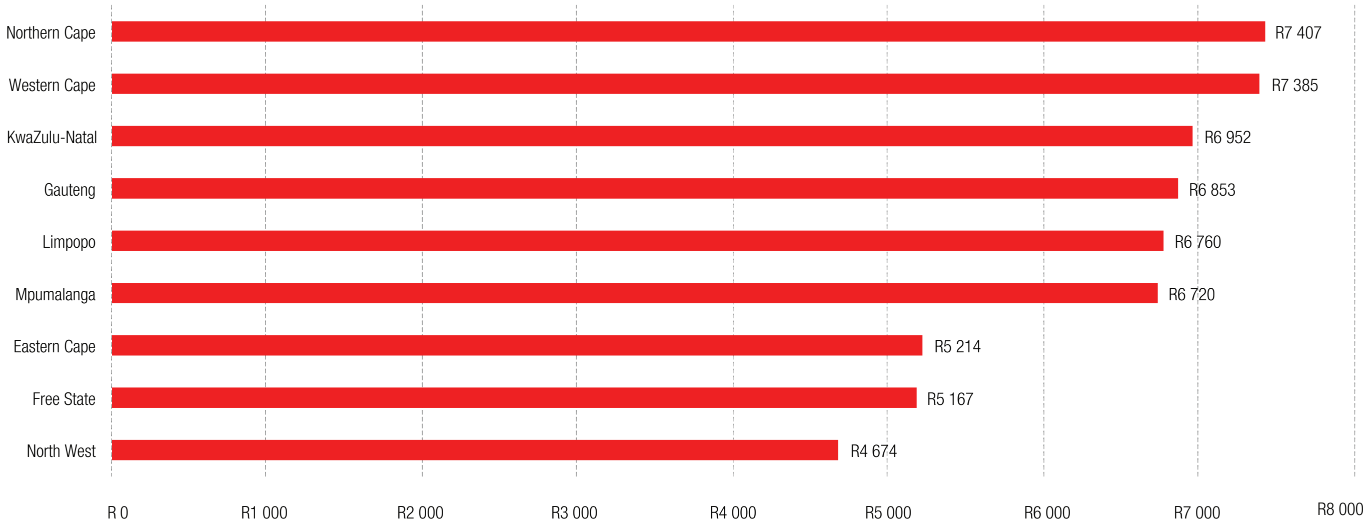
All hostile on the Western front!

Unlike Wayde van Niekerk, growth in the Northern Cape has finally slowed down. The province had just enough in the tank to finish the quarter on a high; it is still the most expensive province to rent in – the fourth successive index in which it has managed this feat after showing Gauteng a clean pair of heels in Q2 2015.



However, based on the deceleration, we do not expect to see it in the top spot next quarter. Should current provincial growth trends continue, the Western Cape will take its place at just over R8 100 per month – at least R300 more than average rentals in the Northern Cape. ■

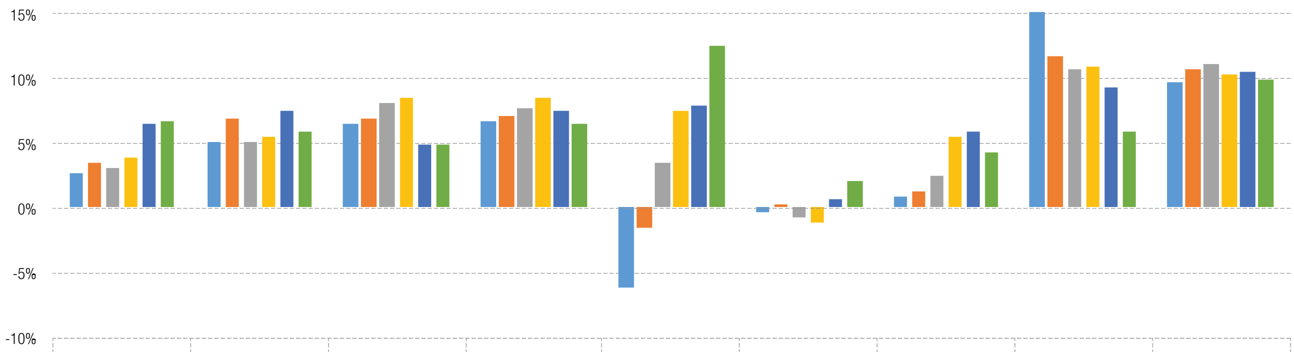
"The province had just enough in the tank to finish the quarter on a high."



Average provincial rentals
Source: PayProp

THE GREAT TREK BACK

What lies beneath the sudden growth in the Western Cape?



	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Q1 2105	2.73%	5.01%	6.50%	6.77%	-6.26%	-0.32%	0.82%	15.25%	9.72%
Q2 2015	3.59%	6.93%	6.99%	7.15%	-1.59%	0.25%	1.29%	11.65%	10.78%
Q3 2015	3.07%	5.02%	8.17%	7.72%	3.51%	-0.64%	2.43%	10.77%	11.14%
Q4 2015	3.90%	5.57%	8.54%	8.48%	7.44%	-1.19%	5.46%	11.00%	10.34%
Q1 2016	6.45%	7.51%	4.85%	7.57%	7.99%	0.60%	5.89%	9.36%	10.48%
Q2 2016	6.72%	5.90%	4.90%	6.48%	12.62%	2.02%	4.34%	5.84%	9.92%

Provincial growth rates (year-on-year)
Source: PayProp

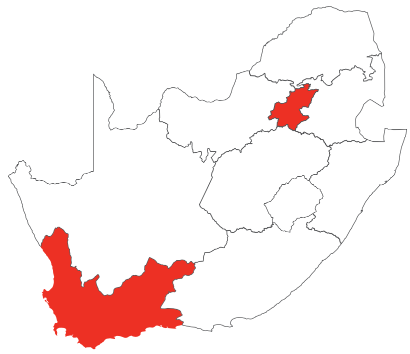
We hear it from all our clients in the Western Cape: “The Gautengers are coming, and this time it’s not just for a holiday.” Legend has it that northerners are settling in security estates all over the fairest province, and there simply isn’t enough property to go around.

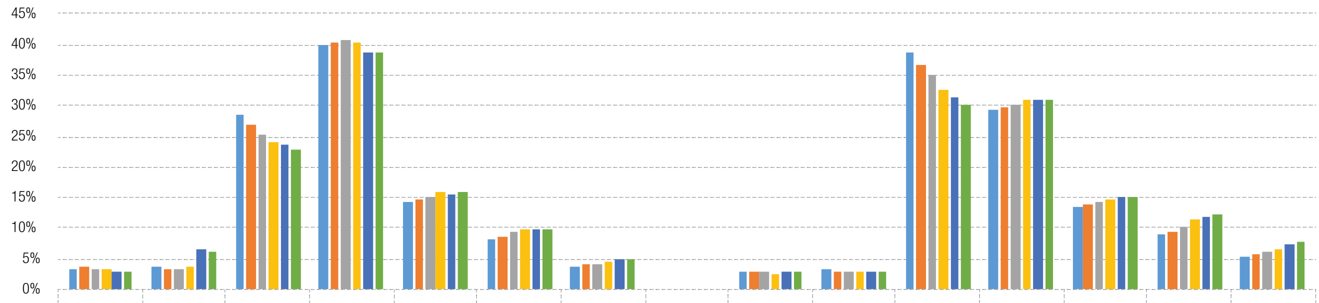
Is this borne out by the numbers?

To an extent, yes it is. Rental growth in Gauteng has been declining for some time – and corresponding increases are evident in the Cape. In economic terms, this indicates a decline in demand in Gauteng, correlating with an increase in demand in the Western Cape. If we delve a bit deeper into the rental profiles of the two provinces, we see interesting movements in the different price bands (see table below).

It is clear that rentals above R10 000 are growing at a significantly faster rate in the Western Cape (on the right), than in Gauteng (left). Assuming for the time being that there is indeed an underlying ‘migration’ from Gauteng to the Western Cape, this would seem to be driven by high-value rentals. ■

> **“The Gautengers are coming, and this time it’s not for a holiday.”**





	< 1000	1000 - 2500	2500 - 5000	5000 - 7500	7500 - 10000	10000 - 15000	> 15000		< 1000	1000 - 2500	2500 - 5000	5000 - 7500	7500 - 10000	10000 - 15000	> 15000
	Gauteng							**VS**	**Western Cape**						
Q1 2015	3.1%	3.3%	28.4%	39.6%	13.9%	8.1%	3.6%		2.7%	3.0%	38.3%	29.0%	13.1%	8.6%	5.3%
Q2 2015	3.4%	3.2%	26.5%	40.3%	14.5%	8.4%	3.7%		2.8%	2.5%	36.5%	29.6%	13.6%	9.4%	5.6%
Q3 2015	3.2%	3.1%	25.1%	40.4%	15.0%	9.2%	4.0%		2.6%	2.6%	34.8%	30.1%	13.9%	10.2%	5.9%
Q4 2015	3.1%	3.6%	23.9%	40.0%	15.5%	9.7%	4.2%		2.4%	2.5%	32.4%	30.8%	14.4%	11.1%	6.4%
Q1 2016	2.7%	6.2%	23.4%	38.4%	15.3%	9.5%	4.5%		2.6%	2.6%	31.1%	30.6%	14.7%	11.4%	7.0%
Q2 2016	2.5%	5.9%	22.8%	38.5%	15.6%	9.8%	4.9%		2.6%	2.5%	29.9%	30.7%	15.0%	11.9%	7.4%

Gauteng vs Western Cape growth profiles: Year-on-year increase in rental contracts across price bands over the last six quarters
Source: PayProp

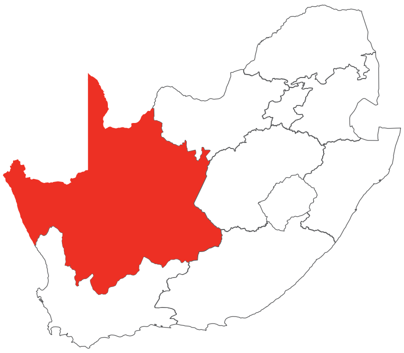
THERE REALLY WAS A WOLF

And it's eating landlords' lunch.

For months we've been feeling like the boy who cried wolf for constantly warning of an imminent downturn in the Northern Cape rental market.

The first tell-tale sign was a dip in the representation of rentals over R15 000 – which usually points to businesses not renewing leases for their employees. At the time, the province was still recording double-digit growth similar to that in Limpopo a few years back. Then, last quarter, Northern Cape rental growth dipped below 10% for the first time in more than a year. And finally, this quarter, growth is at a very muted 5.84% – below the national average of 6.4%!

It is never good to be right when the implications for the local economy could be unfavourable and, in this case, significantly so. But it goes to show that 'artificial' inflation of demand through a rapid influx of economic development can be turned around just as quickly. In this case, the boom and bust cycle was occasioned by a decline in mining activity in the area as a result of the drop in iron ore prices. To think that a commodity price decrease can have such an immediate and devastating effect on average rental values in an area is both tragic and fascinating for socioeconomic engineers. ■



"It goes to show that 'artificial' inflation of demand through a rapid influx of economic development can be turned around just as quickly."

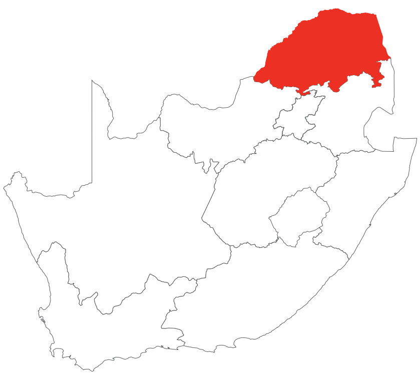
PHOENIX FROM THE ASHES

One to watch...

Thankfully, the other provinces mostly performed true to form, with one notable surprise. The Western Cape powered ahead with solid, stable growth; the Free State and North West both remained muted but stable; Mpumalanga recorded marginally positive growth and the Eastern Cape continued on its road to recovery.

But the one that stood out was Limpopo. A year ago we recorded negative growth in rental values, and then a slight improvement into positive territory. The trend then started to gain momentum, with average year-on-year growth jumping from 3.51% in Q3 2015 to 7.44% in Q4 of that year. From there, it just kept going, with increases of 7.99% in Q1 2016 and 12.62% in this quarter.

Based on the fact that most of the growth is in the higher price brackets, we suspect there may be a resurgence of industrial activity in the region. We will be watching this one with great interest! ■



Don’t overdue it.

PAYPROP – MAKING THE COMPLEX SIMPLE

All PayProp clients have access to our integrated letter of demand service. At the click of a button, you can now select a tenant in arrears and request that a legal demand letter be sent to them, greatly shortening and simplifying the normal process.

To find out how PayProp can change your letting life, contact us today by visiting www.payprop.co.za or e-mail us at support@payprop.co.za.

PayProp

HOW TENANT DATA MAPS TO GROWTH

Time to bust a few affordability myths.

Underlying any index tracking rental performance is the financial circumstances of tenants. Quite simply, if tenants are over-burdened by debt, they cannot pay high rents, thus depressing market prices. Studying affordability data is therefore important for understanding the 'why' behind performance.

In our reading of tenant and market data, we've formulated three key principles that experienced estate agents understand instinctively. They seem self-evident, but bear further analysis.

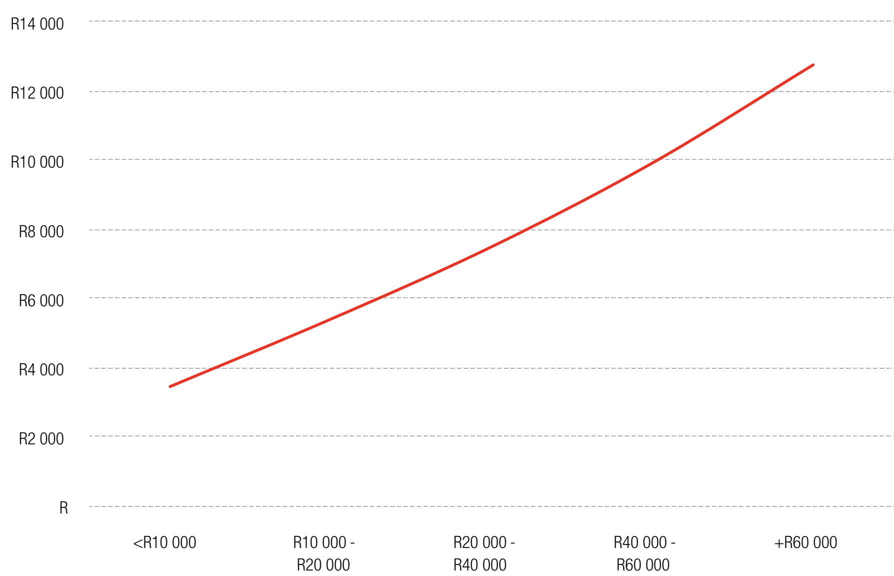
The first (remember, they're obvious) is that tenants who earn more pay higher rentals. And indeed, this is evident in the data under review. No rocket science there, but it gives us the right benchmark and validity measure for the rest of the data!

The second tenant variable correlating with rental values is the life stage of tenants. When plotting age relative to rental paid, the facts once again underscore the expectation to some extent – between the ages of 20 and 40, people are increasingly willing and able to pay higher rents (probably to accommodate a growing need for space). This levels off when tenants are in their 40s, while a downward trend becomes evident at 50-plus, both in affordability and inclination to absorb increases.

The third assumption is that people who earn more should be better at managing their debt. Well, yes and no.

In the period under review, tenants who earn below R10 000 per month indeed used up more of their available credit than other tenants. But from this point onward the trend line flattens out until the R40 000 pay bracket – which is not as one would expect. The data shows that 'in-the-middle' consumers are all equally indebted – and that tenants' use of available credit only really dips when earning above R60 000 pm. Considering that tenants earning between R20 000 and R40 000 typically rent for R6 000 to R10 000 pm, and that 89% of all rentals are for less than R10 000 pm, the 'sweet spot' of the rental market is where the problem of over-indebtedness occurs. ▶

> **"In our reading of tenant and market data, we've formulated three key principles that experienced estate agents understand instinctively."**



Average rental by tenant income bracket
Source: PayProp Capital and Compuscan

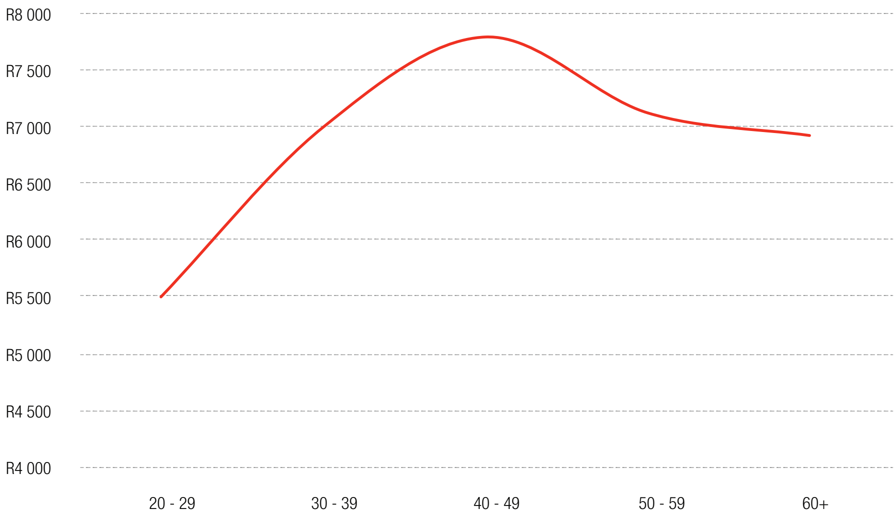
▶▶ The consequences of dipping deeply into credit is evident in the strong correlation with tenants who've had a major delinquency in the preceding 12 months (defined as a debt that has remained unpaid for more than 90 days). The scary part of this is, firstly, that 40% of applicants for a tenancy have a major delinquency skeleton in their cupboard (fortunately, our Tenant Assessment Report sniffs these out quickly). And then there is the sobering realisation that this only drops significantly once a tenant earns more than R60 000 per month.

Generally, this seems to mean that tenants who earn more are a safer bet for landlords, since they can afford more and tend to use credit more wisely. But this is not always a useful approach.

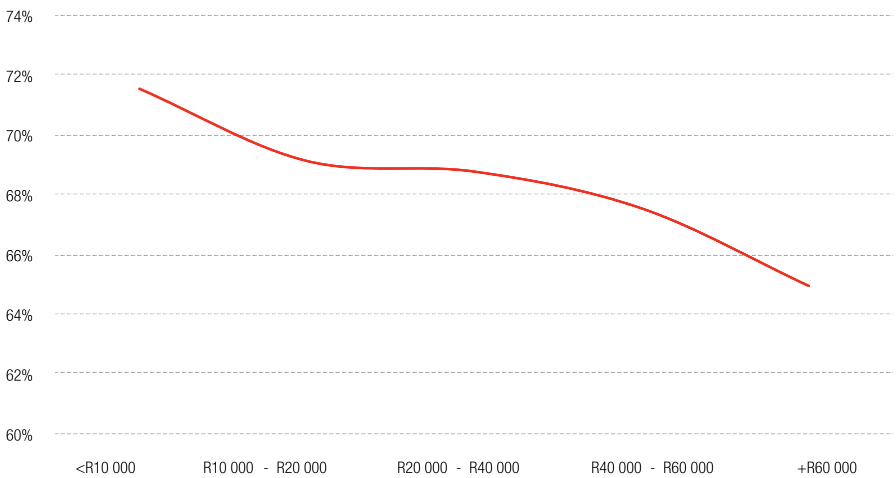
Note, for example, the staggering amounts involved, the higher we go up the pay scale (in spite of marginal decreases in percentage debt levels). Whereas 70% of R10 000 amounts to R7 000, 65% of 60 000 equals a whopping R42 000! Apparently, sophisticated tenant risk management is par for the course, whatever the fortunes of your market.

When we further adopt an expansive risk definition (tracking debt-to-rent ratio and credit profile data in addition to traditional variables) the percentage of high- to ▶

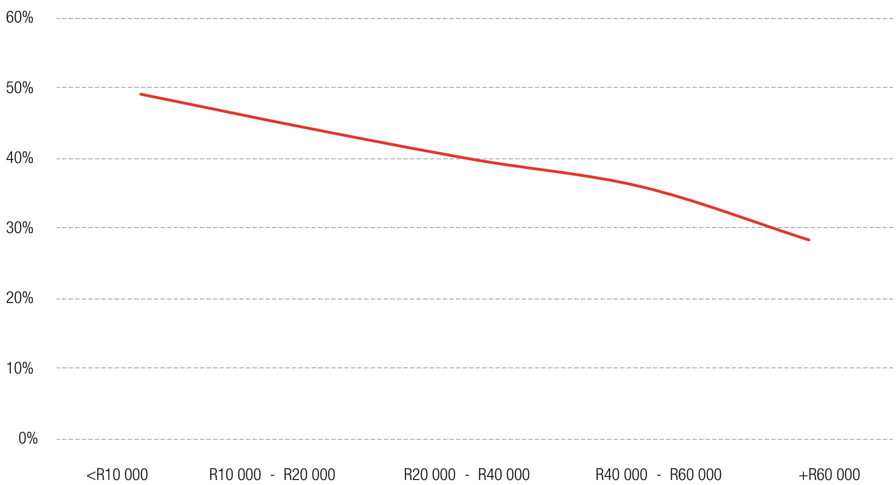
"The 'sweet spot' of the rental market is where the problem of over-indebtedness occurs."



Average rental by age category
Source: PayProp Capital and Compuscan



Percentage of maximum credit balances used by tenant income bracket
Source: PayProp Capital and Compuscan



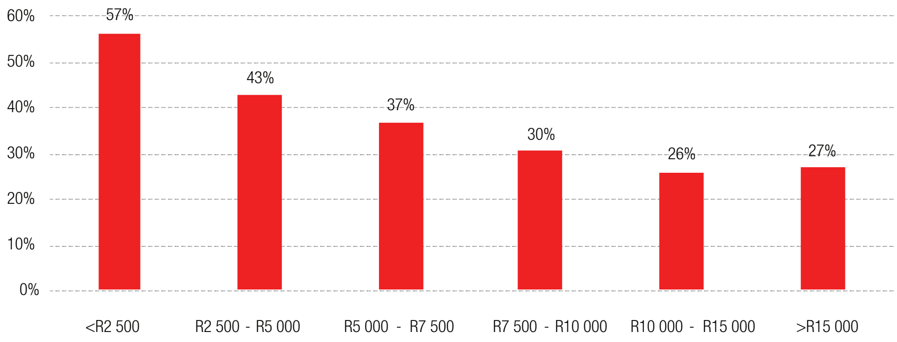
Delinquencies by income
Source: PayProp Capital and Compuscan

“I’d like our competitors to use PayProp’s Tenant Assessment Report, because it is a great product, but I don’t want them to use it because I don’t want them to have what we have.”

MEGAN LADBROOK

Only Rentals, Johannesburg North

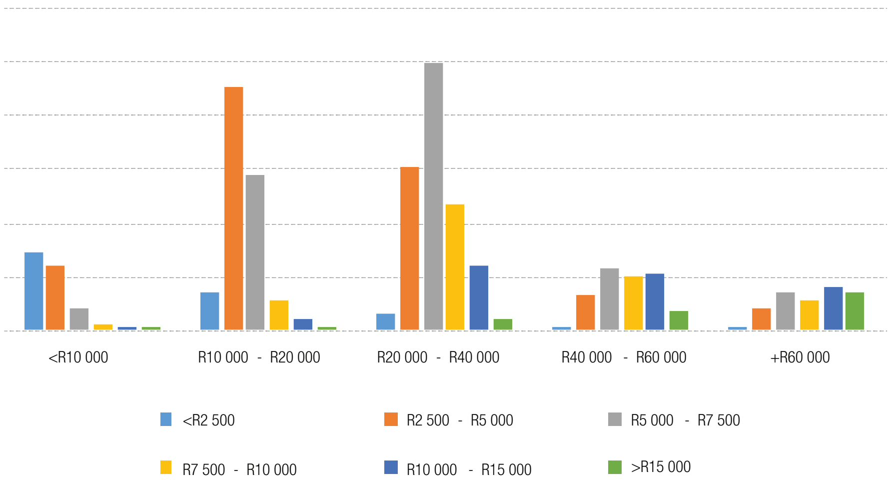
> "Sophisticated tenant risk management is par for the course, whatever the fortunes of your market."



High- and very high-risk tenants by rental price band
Source: PayProp Capital and Compuscan

very high-risk tenants does decrease for tenants renting in higher price brackets. But this only applies to contracts of up to R10 000 – after that, risk actually increases (in rentals above R15 000).

Why is this? The simple answer is that tenants who earn below R60 000 tend to rent in price categories that are not affordable to them. Below we see that 9% of tenants earning R40 000 to R60 000 rent at above R15 000 pm. This is disproportionately high compared to the 2% of tenants earning R20 000 to R40 000 who rent for that much.

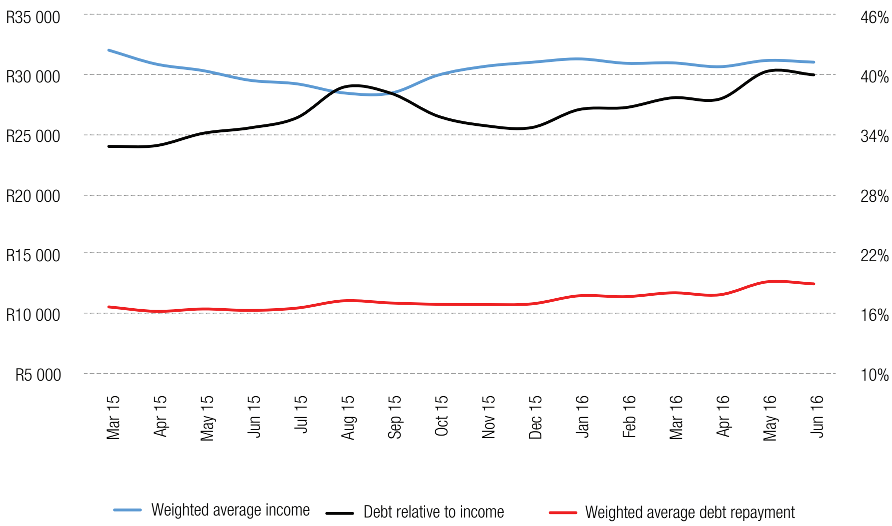


Rental value relative to income
Source: PayProp Capital and Compuscan

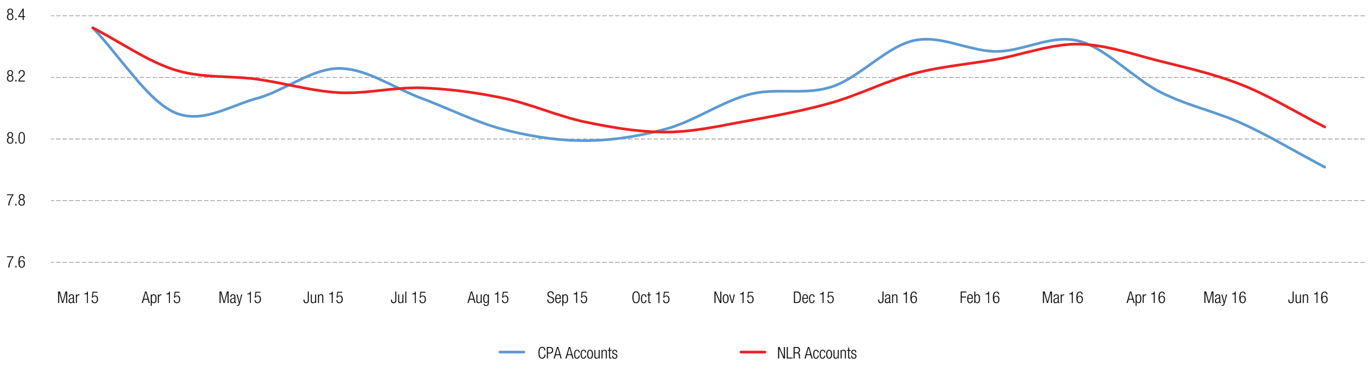
Another way to measure tenants' over-extension is the proportion of debt repayments relative to disposable income. Currently, tenants owe on average 40% of their pre-tax income to credit providers. That is up from 33% in March 2015 – a dismal worsening of matters over time.

Right now, the average tenant has eight National Loan Register (NLR) accounts and eight Credit Providers Association (CPA) store accounts. On the graph below we can see a clear increase in these numbers over the festive season, and, fortunately, a decrease after the big holiday splurge.

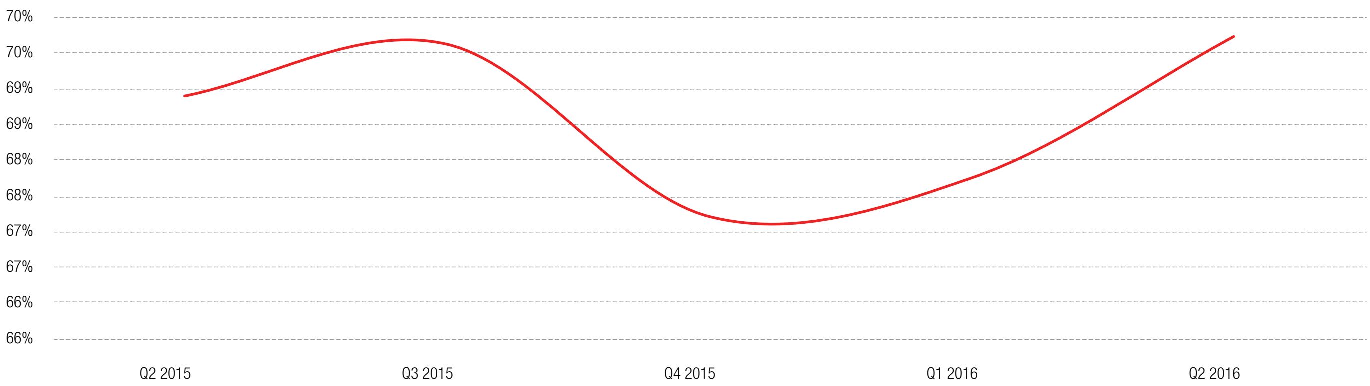
However, while tenants marginally reduced the number of accounts they managed, they did not succeed in reducing the money owed on these. The average South African tenant has by now used up 70% of all credit available to them. This leaves an extremely small manoeuvring space for tenants to absorb 'life shocks' that may come at them – potentially causing defaults. ■



Average income vs average debt repayment
Source: PayProp Capital and Compuscan



Average number of CPA and NLR accounts
Source: PayProp Capital and Compuscan



Current credit balances as % of maximum credit
Source: PayProp Capital and Compuscan

SO WHAT CAN WE LEARN FROM THIS?

Agents must refine their affordability metrics.

1. The average tenant is vulnerable.
The average tenant renting for R6 000 to R7 000 is earning R20 000 to R40 000 per month. Of this, they spend 40% on servicing debt – and they currently only have 30% left of the credit available to them.

2. Consider the salary-to-rent ratio.
Occasionally, tenants apply for rentals that are above their means. Nothing stops them from doing so, because traditional credit scoring methods do not measure the income-to-rental ratio, increasing the risk of non-payment. Debt obligations and spending patterns need to be analysed in detail.

3. Look beyond income to debt management.
As noted above, there isn't a straight line correlation between increased income and reduced risk. Look beyond salary to the way an applicant manages his debt. In other words, apply the rental affordability rule of thumb (30% of gross income) with caution. ■

> "There isn't a straight line correlation between increased income and reduced risk."

ARE INVESTORS MAKING MONEY IN THIS CLIMATE?

Proactive risk management is the answer.

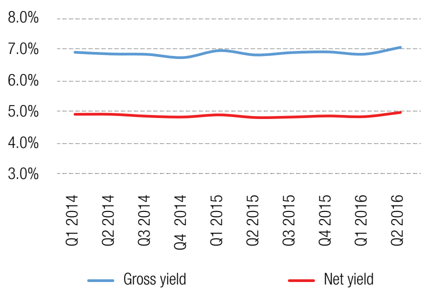
Yes they are, but profitability in the current market is directly related to proactive risk management. The above analysis might easily be misconstrued as a bit gloomy, but in reality it is just sober risk assessment. Owners are more likely to do business with estate agents that possess the proper analytic tools that support excellent placement decisions. They're definitely more likely to avoid losses than those who just look at credit checks or declared income statements.

If we look at the actual money landlords are making relative to the cost of buying a property, things are looking pretty good in the circumstances:

While gross and net yields seem fairly flat, it is encouraging to see gross yields edge above 7% (from 6.9% in Q1 2016) and net yields above 5% (from 4.8%). This is largely due to stable growth in rents combined with slower growth in average house prices (the latter grew by less than 5% in Q2 versus 6.3% for the former).

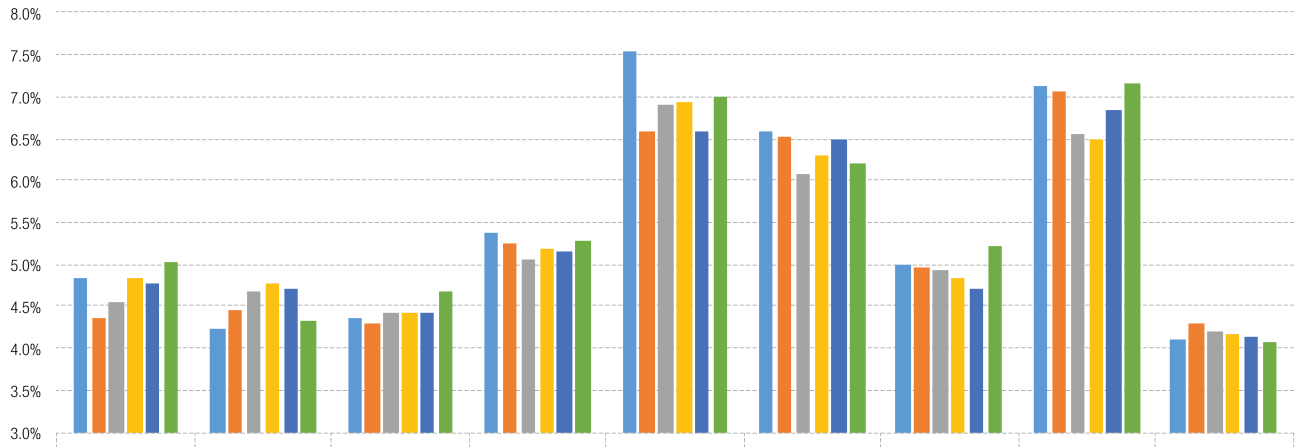
Provincially, the Northern Cape still offers value. Despite the fact that rental growth has declined, actual values are still high. This, when compared to scant growth in the average house price (5.7%), is what keeps earning investors a good return.

And while yields in the Western Cape are low (due to high house price growth), they remain stable. ■



National gross and net yields
Source: PayProp

> "Owners are more likely to do business with estate agents that possess the proper analytic tools that support excellent placement decisions."



	Eastern Cape	Free State	Gauteng	KZN	Limpopo	Mpumalanga	North West	Northern Cape	Western Cape
Q1 2015	4.85%	4.24%	4.38%	5.39%	7.57%	6.59%	5.01%	7.13%	4.13%
Q2 2015	4.37%	4.46%	4.31%	5.26%	6.59%	6.53%	4.99%	7.08%	4.30%
Q3 2015	4.56%	4.70%	4.45%	5.07%	6.91%	6.10%	4.94%	6.56%	4.21%
Q4 2015	4.84%	4.77%	4.43%	5.20%	6.94%	6.32%	4.84%	6.49%	4.18%
Q1 2016	4.77%	4.72%	4.44%	5.16%	6.60%	6.51%	4.71%	6.87%	4.16%
Q2 2016	5.04%	4.33%	4.67%	5.30%	7.01%	6.21%	5.22%	7.18%	4.07%

Provincial net yields
Source: PayProp

IN SUMMARY

Things aren't always what they seem.

This has been an extremely interesting quarter to watch – one in which we've learnt three things:

1. The stabilisation of rental values gives no clue of the underlying movements between the provinces, including a migration to the south, a faltering economy in the Northern Cape, and possible industrial resurgence in Limpopo.

2. Digging deeper than ever into tenancy dynamics we've come up with three guidelines for agents when selecting tenants:
   a. Your average tenant is far more financially vulnerable than you think.
   b. Tenants may sign for rentals that are higher than what they can afford.
   c. Higher income does not always equal lower risk, in fact, it could be the exact opposite.

2. We have seen yields improve, but this is probably a function of low house price growth versus stable rental growth. On the bright side, it does mean lower-priced homes make for great investment opportunities!

On the whole, sound investment and risk strategies can still make owners and agents money and protect landlord assets without excluding lower-earning tenants that possess the right risk profile. ■

> **"On the whole, sound investment and risk strategies can still make owners and agents money."**

PayProp Rental Index

The PayProp Rental Index is a quarterly guide on trends in the South African residential rental market, and is compiled from actual transactional data collected by PayProp, the largest processor of residential letting transactions in South Africa. This edition details market conditions for the second quarter of 2016.

Contact details

This publication has been produced by PayProp South Africa. PayProp South Africa is operated under licence from Humanstate. PayProp and the PayProp logo are registered trademarks of Humanstate.

For enquiries, please contact:

Louw Liebenberg
CEO: Property Payment Solutions (Pty) Ltd
Email: louw@payprop.co.za
Tel: 087 820 7368

The PayProp Rental Index is available from the PayProp web site at www.payprop.co.za.

Sign up to PayProp

If you would like to know more about using PayProp to manage your rental portfolio, please visit www.payprop.co.za.