



FNB-TPN RESIDENTIAL YIELDS REVIEW

17 November 2015

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THE FNB-TPN RESIDENTIAL YIELDS REVIEW

1. THE BROAD MULTI-YEAR TREND OF YIELD COMPRESSION HAS CONTINUED THROUGH THE 1ST 3 QUARTERS OF 2015

Through the 1st 3 quarters of 2015, the FNB-TPN National Average Gross Residential Yield has continued its broad multi-year downward trend, a trend that started back in 2012, and stalled only briefly back early last year.

The national average yield declined from 8.5% as at the 2nd quarter of 2015 to 8.3% in the 3rd quarter.

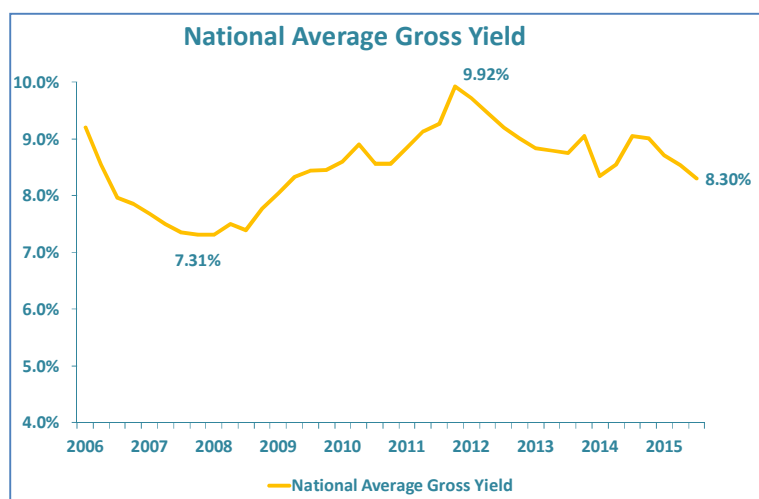
The further yield compression through 2015 has been the combined result of a supply-constrained home buying market which has held up slightly better than expected in a weak economic environment, along with a Residential Rental Market which has perhaps disappointed a little on the “downside”.

We had expected a little more in terms of rental inflation by now, given the trend of gradually rising interest rates. But against this we have had a very weak economy, and this may be placing significant financial constraints on the tenant population and 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

Looking at the data of the FNB-TPN National Average Gross Initial Yield on Residential Property, as at the 4th quarter of 2007, the yield was estimated at 7.31%. 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 (from a buy-to-let point of view) to measure a revised 9.92%.



Then, from early-2012 a phase of mild compression (decline) in gross yields set in, as the Home Buying Market strengthened. By the 1st quarter of 2014, the estimated national average gross yield had declined to 8.3%.

However, in January 2014 the Reserve Bank (SARB) began to hike interest rates gradually, which for a while seemed to be exerting additional upward pressure on already-rising rental inflation. The result was a brief rise in

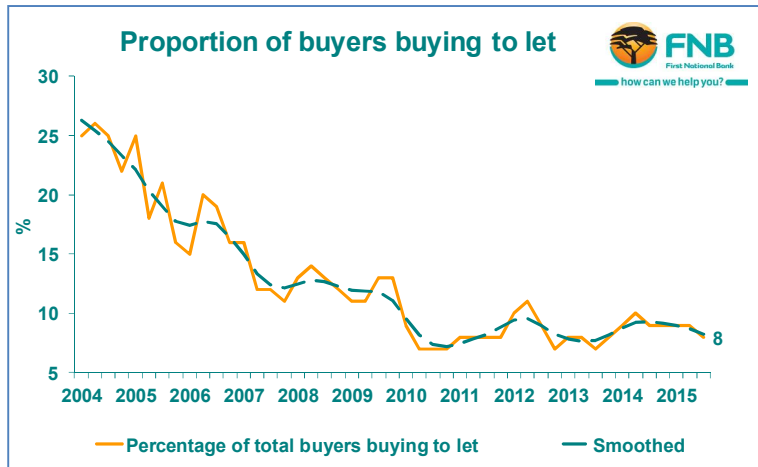
yields last year.

But rentals once more began to lose their growth momentum as 2015 approached, perhaps torn between the positive support from rising interest rates on the one hand, and a deteriorating economy and Household Disposable Income growth on the other.

This paved the way for yield compression to resume late last year, and continue through 2015 to date.

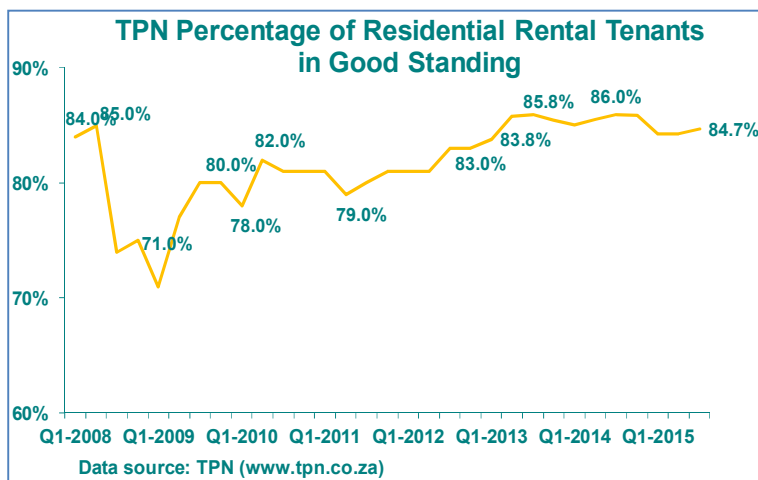
We emphasise that these yields are still gross yields, meaning that landlord operating costs associated with the property have not yet been included in the calculation to get to a net initial yield.

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 6.8%. 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.



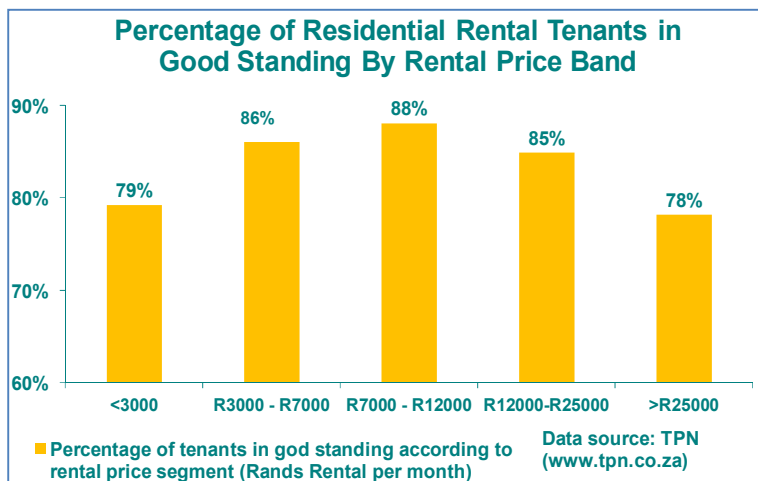
This perhaps explains why the estimated percentage of home buyers being buy-to-let buyers remains mired in single-digits at 8% in recent FNB Estate Agent Surveys.

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 saw significant broad improvement from 2009 to 2014, with a significant decline in tenant risk following the Recession of 2008/9. This was reflected in a rise in the percentage of tenants in good standing with their landlords, to 86% as at late-2014, a big improvement since the huge dip to 71% as at early-2009, around the time of the recession.

More recently, however, while still remaining high, the percentage of tenants in good standing has begun to slide slightly in 2015, declining to 84.7 by the 3rd quarter. It is a bit early to draw hard and fast conclusions, and the slide to date is a minor one, but we believe that this decline could reflect the early stages of the impacts of the economic “slow puncture” being experienced in South Africa, gradually making life tougher for households.

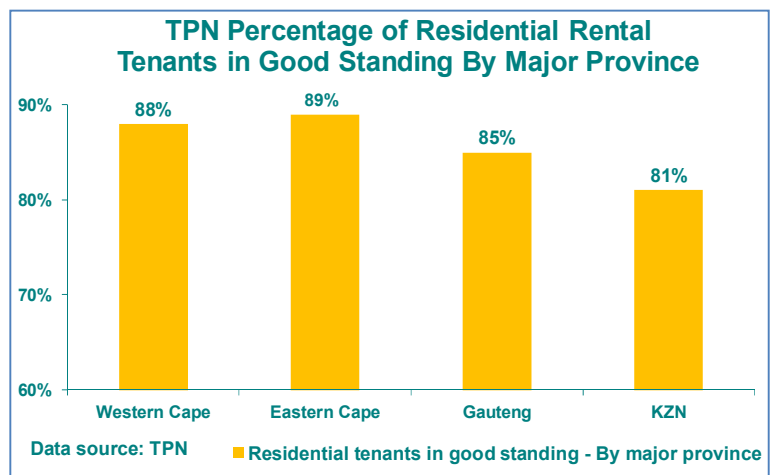
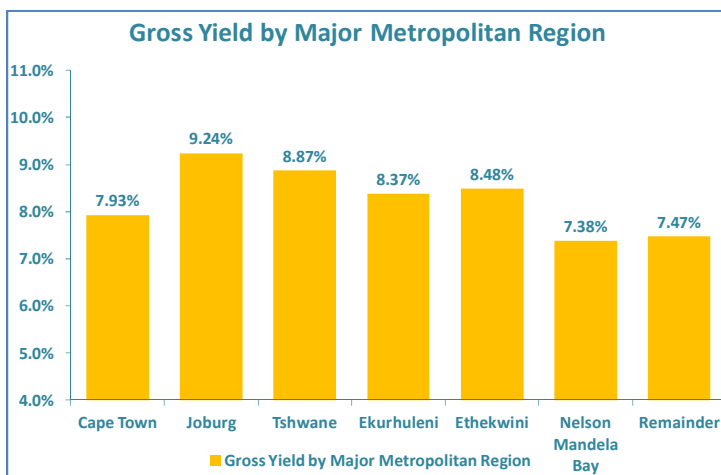


This is something to watch closely, because

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 appears intent on raising interest rates further in order to “normalise” them. Realistically, this could cause a further decline in the percentage of tenants “in good standing” 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 3rd quarter of 2015, the 2 major Gauteng metros, namely City of Joburg (9.24%) and Tshwane (8.87%) had the highest yields, with Ekurhuleni a bit lower (8.37%). 3rd Highest was Ethekewini metro (8.48%) 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 81% of tenants in good standing in KZN and 85% in Gauteng. By comparison, Nelson Mandela Bay (7.38% yield), the largest metro in the Eastern Cape, and City of Cape Town (7.93% yield), which forms the lion’s share of the Western Cape Province, have the lowest gross yields of the major metros. The Eastern and Western Cape also have a higher percentage of tenants in good standing, to the tune of 89% and 88% respectively. Better tenant performance implies lower risk, and while the correlation between yield and tenant performance is far from an exact science, investors appear on average to pay a premium for superior tenant performance in the Eastern and Western Cape regions.

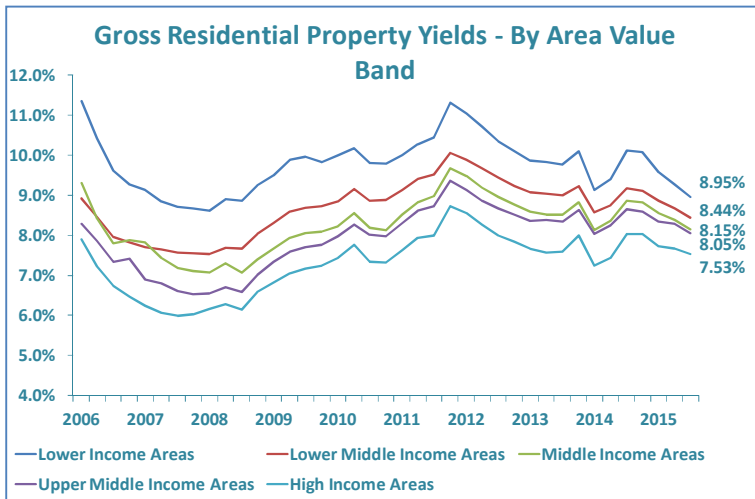


4. SEGMENT YIELD COMPARISONS

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 8.95% for the 3rd quarter of 2015. In Lower Middle Income Areas (Average home value from R600,000 to R900,000), the yield was slightly lower at 8.44%, followed by an average yield of 8.15% for the Middle

Income Areas (average home value between R900,000 and R1.2million), and 8.05% 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 7.53%.



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

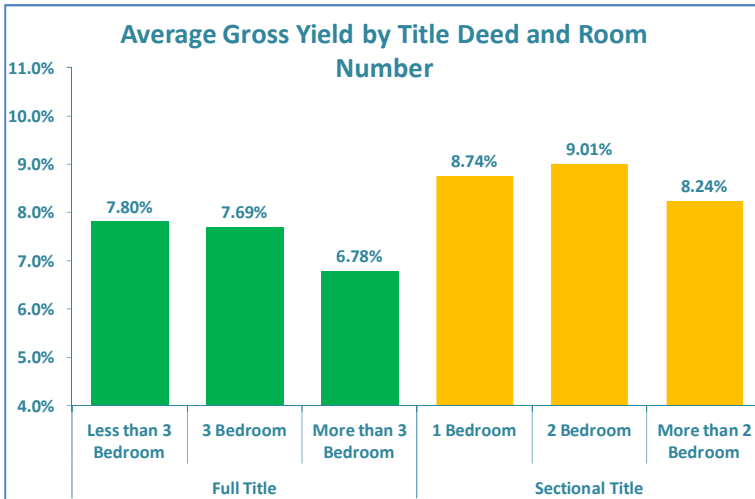
low percentage of tenants in good standing, to the tune of 79%, thus indeed appearing to be one of the highest risk segments. Therefore, having the highest yield appears justified in order to make it attractive for the investor. Many of these homes probably fall within so-called “Affordable” or “Lower Income” Areas. Moving up to the next rental band, homes with rentals between R3,000 and R7,000 per month show a significantly better 86% 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 88% 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 78%. 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.

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



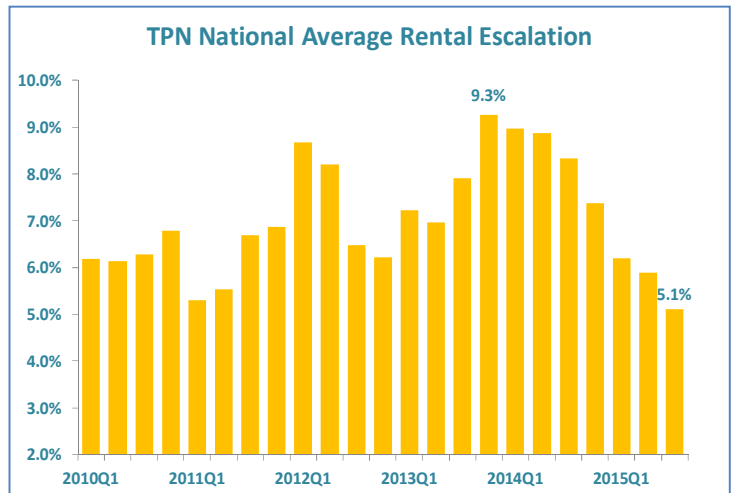
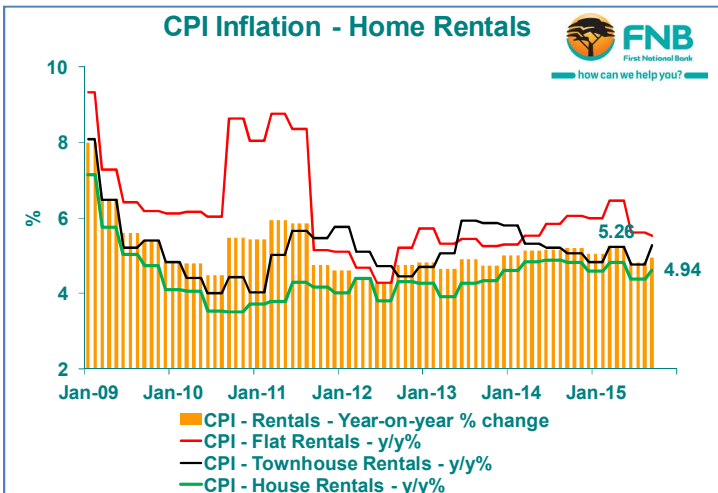
When Gross Yields are estimated by Title Deed and room number, it is Sectional Title that generally looks to be the most attractive, and “smaller generally appears to be a bit better”. 2 Bedroom Sectional Title tops the table with a 9.01% yield, followed by 1 Bedroom Sectional Title with 8.74% and More than 2 Bedroom Sectional Title on 8.24%.

Of the Full Title categories, Less than 3 Bedrooms appear marginally most attractive with a yield of 7.80%.

6. OUTLOOK

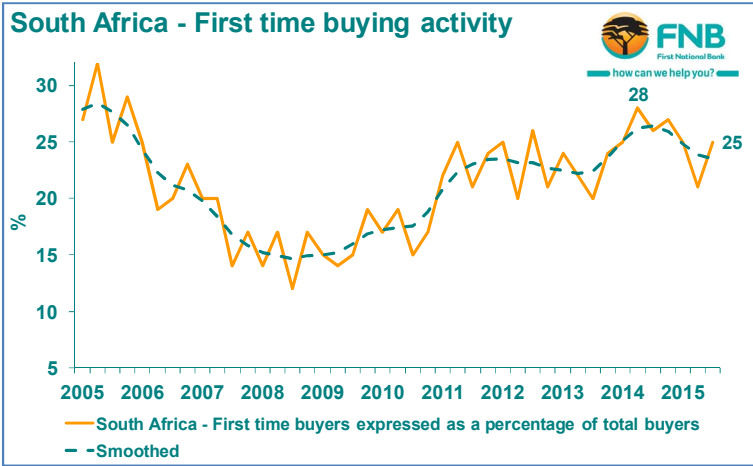
With regard to the direction of residential yields as we move towards 2016, much will depend on the movement of interest rates. In the near term, given that our estimates of national house price inflation are nearer to 7%, while rental inflation appears noticeably lower, we expect further yield compression (decline).

The StatsSA estimate of Residential Rental inflation is 4.94% year-on-year, down from 5.26% in the 2nd quarter of 2015. TPN’s National Average Rental Escalation rate was 5.10% year-on-year in the 3rd quarter of 2015, and slowing too.

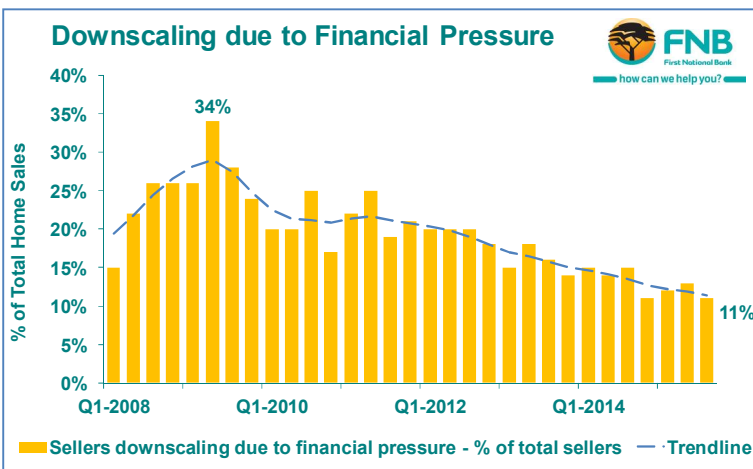


By comparison, the FNB House Price Index was still inflating at 7.7% year-on-year as at October 2015.

While we ultimately anticipate slower house price inflation, given the multi-year weakening in economic and disposable income growth, for the time being those areas of residential demand that can significantly swing between rental and home buying still appear to be biased in favour of home buying.

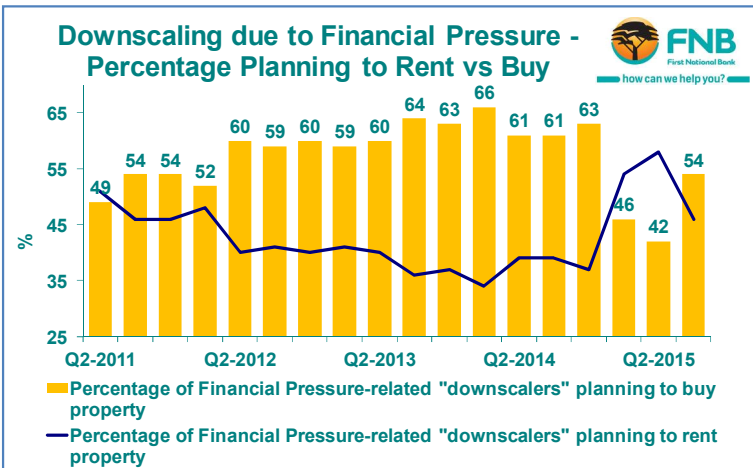


The 1st such area of demand is that of 1st time buyer demand. In tougher times, aspirant 1st time buyers can hide out in the rental market in larger numbers, such as around 2008/9, where we saw very low percentages of 1st time home buying. However, while starting to perhaps show signs of having peaked, 1st Time Buying at an estimated 25% of total home buying, as at the time of 3rd quarter FNB Estate Agent Survey, remained a strong number....arguably still negative for rental demand.



A 2nd potential source of rental demand emanates from households under financial pressure. Here too we don't yet see major support for rental demand yet.

Those sellers selling in order to downscale due to financial pressure remain low at an estimated 11% of total sellers.



In addition, in the 3rd quarter 2015 survey, the agents estimated a rise in the percentage of such sellers whom they believed would "buy down" as opposed to "rent down". This came after 2 prior quarters in which the estimated "rent down" percentage had risen somewhat.

In the current quarter, therefore, we believe that the average residential yield may

compress further.

With confidence levels still significant in the Home Buying Market, it looks like we may have to wait at least until well into 2016 for signs of an upward turn in Residential Yields.

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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