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The South African office conundrum

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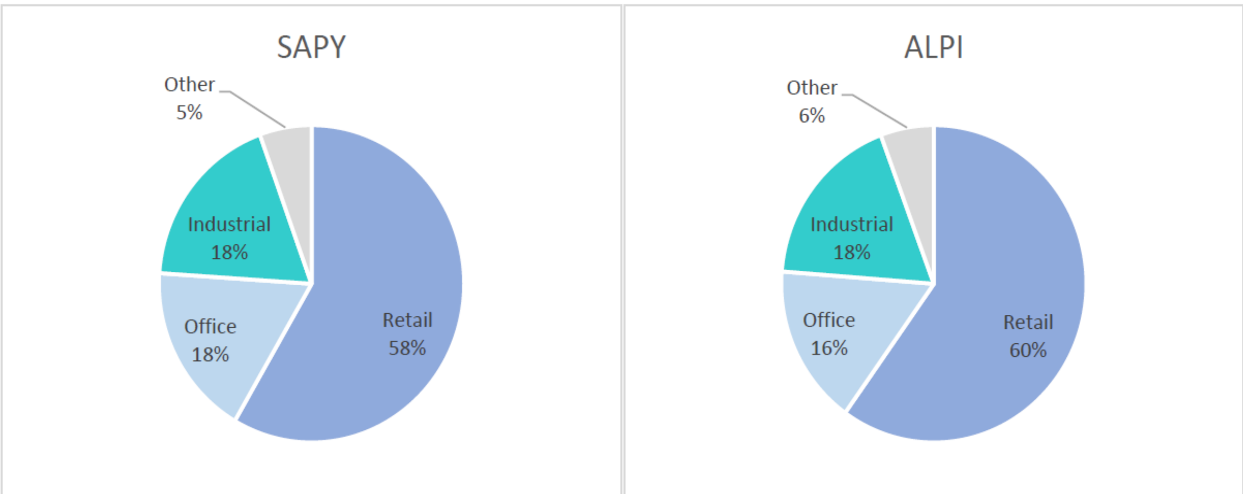
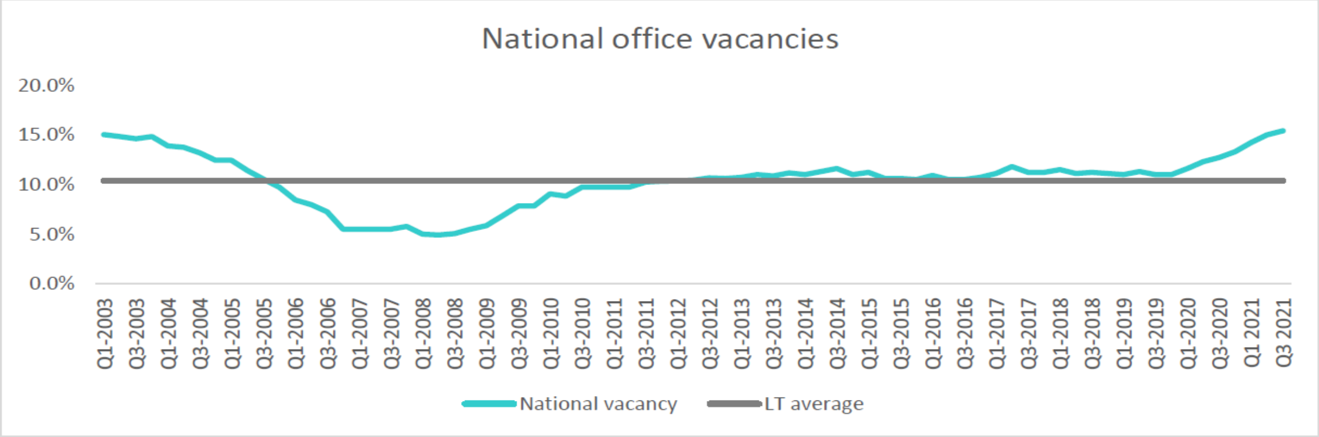
The office sector remains an integral part of the listed property opportunity set available to investors on the JSE. We estimate that the office sector represents approximately 18% of the exposure available in the SAPY (FTSE/JSE South Africa Listed Property Index) and around16% in the ALPI (FTSE/JSE All Property Index), which are the two main indices used for performance measurement for local property funds. The biggest difference between the two is that the SAPY includes the 20 largest property companies with a primary listing on the JSE, while the ALPI includes all property companies available on the All Share Index.



Source: Company data, Catalyst Fund Managers

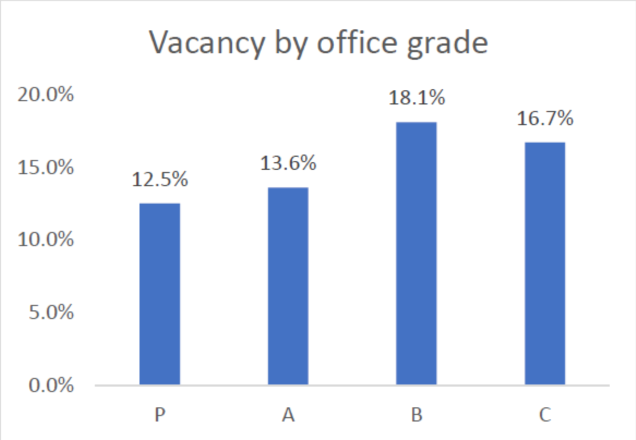
It has been tough in the SA office sector over the last few years with poor fundamentals resulting in increasing vacancies and declining market rentals. In this report, we take a deep dive into the fundamentals and look at emerging trends in the SA office market.

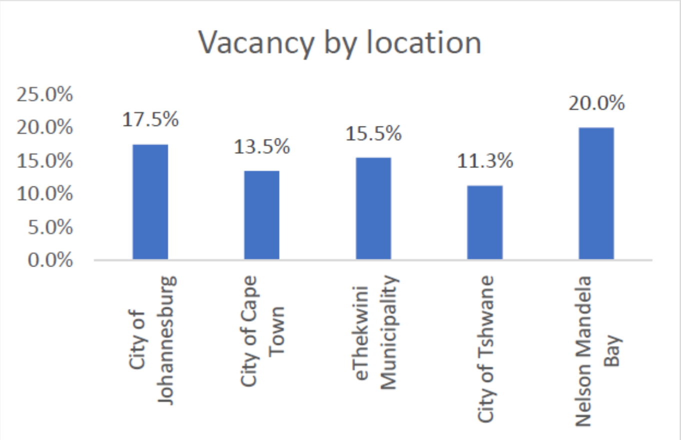
A tenant's market



Source: SAPOA Office vacancy report, Catalyst Fund Managers, 30 September 2021

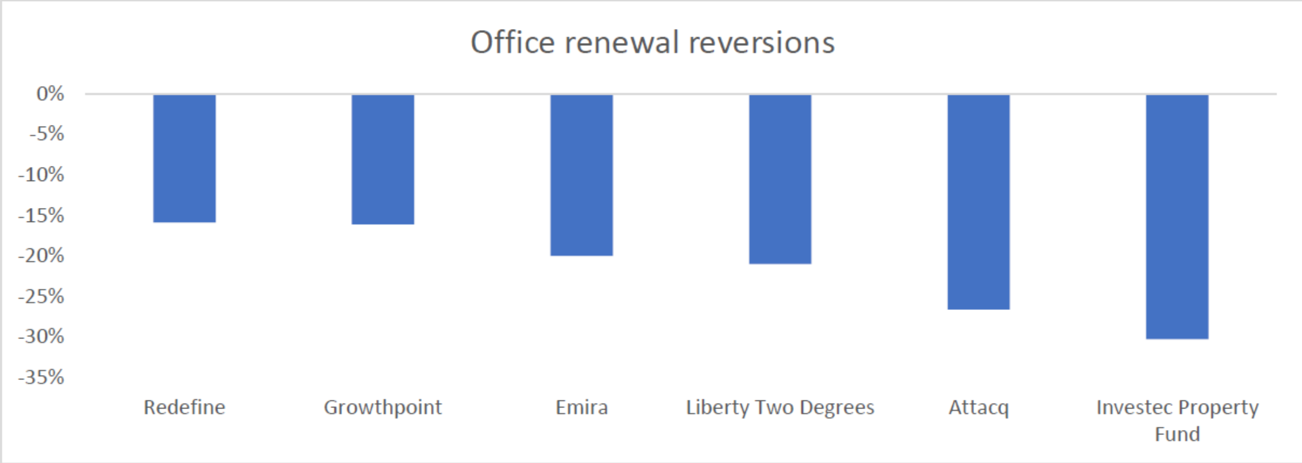
National office vacancies have been stubbornly high at over 10% for the last decade. Prior to the pandemic, the office market was characterised by an increase in new supply being met with weak demand. During this period, the new supply was absorbed by existing occupiers consolidating their operations into new and more efficient buildings, like Discovery, Sasol, PwC, Deloitte, and Bowmans amongst others. The pandemic forced many occupiers to adopt a work-from-home ("WFH") or hybrid system. This, coupled with the economic ramifications of the pandemic, has resulted in national office vacancies ballooning to 15.4% which represents the highest recorded vacancy since March 2003 (15%).





Source: SAPOA Office vacancy report, Catalyst Fund Managers, 30 September 2021

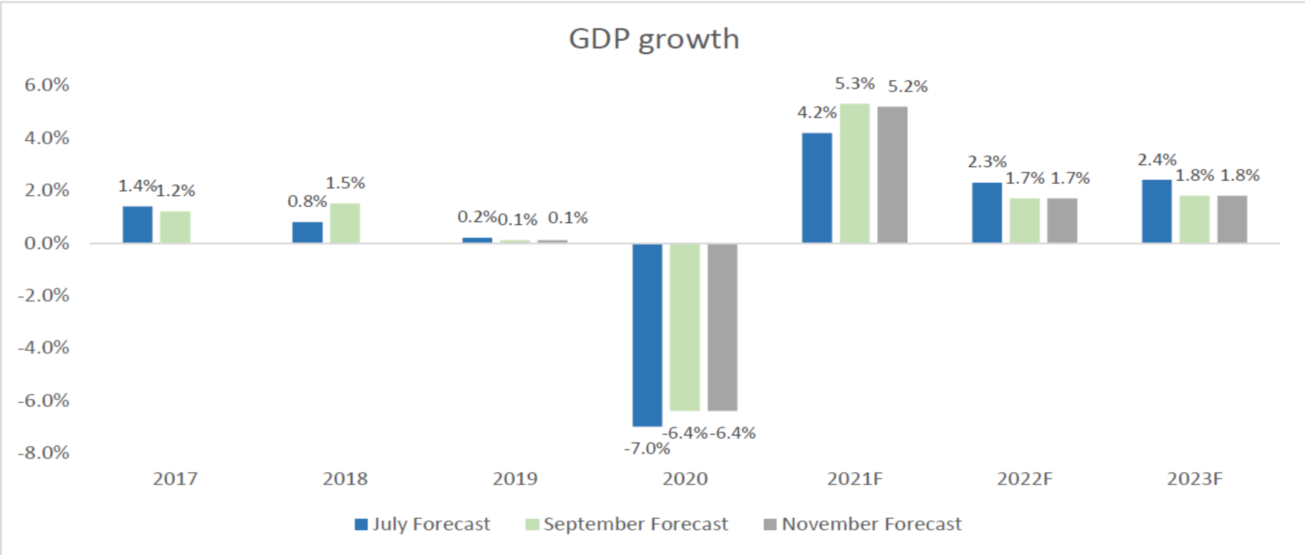
The above graphs highlight that the supply glut is evident across all office grades, and it is not geographically concentrated in a particular location. P grade is defined as top-quality, modern spaces which have the highest green star ratings. It is evident that the oversupply has even affected the newest office buildings in the country.



Source: Company data, Catalyst Fund Managers

Negative reversions have become the norm as contractual annual rent escalations of between 6% to 8% have resulted in expiring rentals exceeding market rentals when those leases conclude. Negative reversions refer to the downward adjustments to rentals that occur when those leases are renewed, or a new tenant moves into that space. It is not uncommon to see negative reversions exceeding 15%. In some instances, companies like Investec Property Fund, took a larger negative reversion in return for longer leases with their tenants.

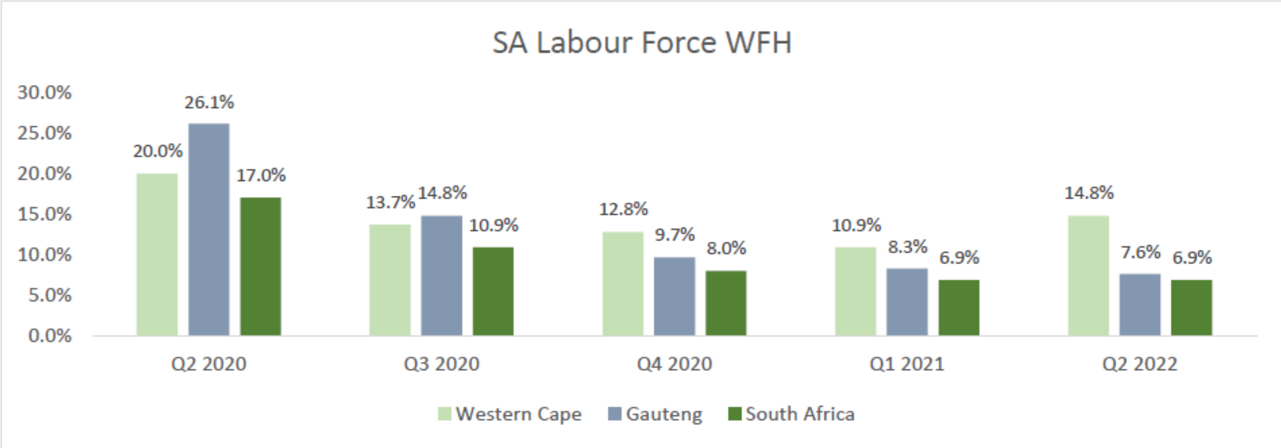
Subdued demand



Source: SARB July 2021, September 2021 and November 2021 forecasts

Economic growth and investor confidence are key drivers of demand for office space. In the September 2021 MPC meeting, GDP growth expectations for 2021 were pleasantly upgraded from 4.2% to 5.3%. However, it was cautioned that the bulk of the recovery has already taken place and the committee lowered 2022 and 2023 forecasts to 1.7% and 1.8%, respectively. There was only a minor revision to forecasts in the recent November MPC meeting. The RMB/BER Business Confidence Index (BCI) reduced to 43 points in the third quarter after surging to 50 points in the second quarter. Part of the decline is attributable to the third wave of COVID-19 infections, stricter lockdown restrictions and the unrest in parts of KwaZulu-Natal and Gauteng. We believe that a sustained strong business confidence indicator coupled with economic growth is required to increase demand for office space.

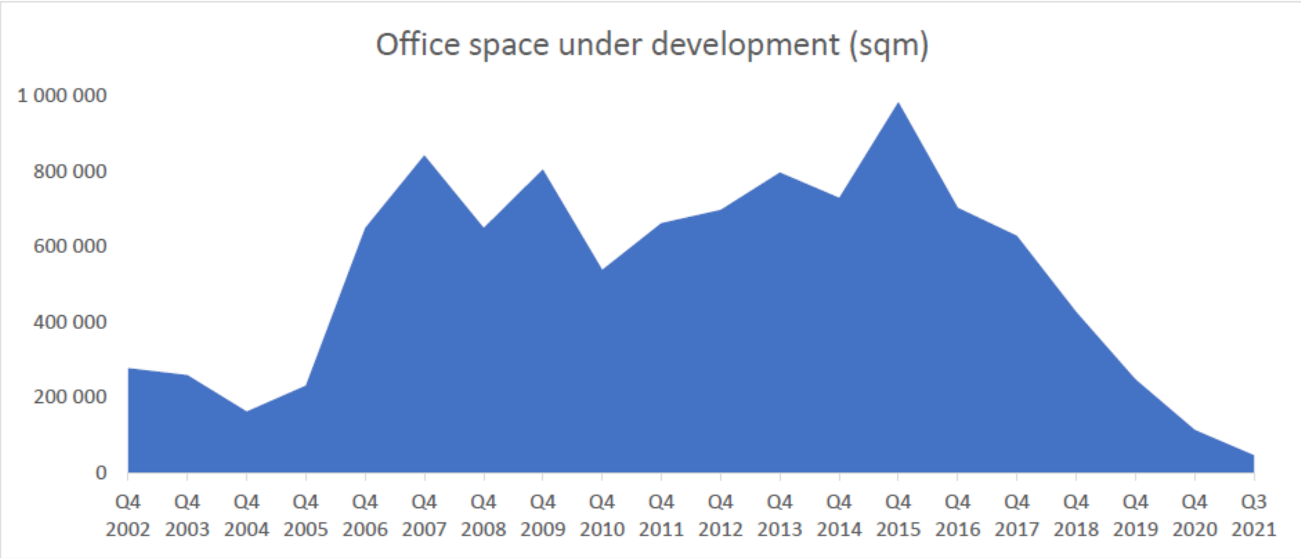
The uncertain future



Source: Stats SA, latest data from 24 August 2021.

COVID-19 has affected everyone and has had an impact on all sectors of the economy. In the local listed property sector, we witnessed an acceleration of structural changes that were present prior to the pandemic. In retail, e-commerce purchases and penetration accelerated while the logistics sector saw additional demand to cater for this surge as retailers optimised their supply chains. In the office environment, we saw the emergence or re-emergence of the WFH concept. Prior to the pandemic, globalisation resulted in many of us conducting meetings/calls/webcasts over the internet with our counterparts either in different provinces and/or different countries. This was traditionally limited to a particular event or meeting but it paved the way for what was to come when lockdown restrictions were imposed. Many traditional office occupiers were then forced to experiment with a version of the WFH or hybrid concept.

Based on data from Stats SA, the highest proportion of workers who worked from home corresponded to the second quarter of 2020, which coincided with the harshest lockdown restrictions. In subsequent quarters we have seen this trend downwards and it has remained constant at 6.9% over the last two quarters. There is also a noticeable difference between the provinces with the Western Cape and Gauteng (representing the largest office markets in the country) having a greater proportion of their workforce working from home compared to the national average. In the short term, this is likely to be volatile as companies assess what is the most optimal system to adopt, the risk of future lockdown restrictions and the vaccination rates of their staff members. Publicly, we have seen large corporates, including Discovery and Sanlam, requiring staff to vaccinate. This might provide an indication that corporates are planning for staff to return to their offices in some capacity.



Source: SAPOA Office vacancy report, Catalyst Fund Managers, 30 September 2021

We have seen future supply or developments under construction decrease significantly due to the excess stock already available and uncertainty on tenant demand. Developments as a percentage of existing buildings is at 0.2%, close to its all-time lows. Future new developments are likely to be driven by tenant demand rather than speculative activity.

Source: Businesstech.co.za

To throw a further spanner in the works, we have seen the emergence of a potentially large sublet market. A sublet situation occurs when a tenant who occupies a large proportion of an office building wants to reduce their space requirements but is typically locked into a long-term lease. Rather than incur penalties by breaking their lease or giving space back, they would then look for other tenants to sublet from them. Data on this trend is limited and actual national vacancies are likely higher than 15.4% if available sublet space is included. An example of the sublet situation is Sasol. The Sasol head office in Sandton was completed in 2016 by developers Alchemy Properties and the Sasol Pension Fund. It has a lettable area of 67 000sqm and is five-star, green-rated. Based on data from the Broll Properties website, they have 19 000 sqm of space available for sublet.

Source: Anchor Stockbrokers

Due to the excess supply available, the next key consideration is whether the available space can be repurposed into something other than offices. We have seen isolated evidence of this occurring. An example would be the conversion by Africrest of the former PwC office park in Sunninghill into residential space. Africrest invested R400m to convert the office park into The Apollo (Pictured). While this trend has gained more traction, not all office buildings are feasible for a conversion. The bulk of the office buildings in the listed sector would be unfeasible from a cost perspective. The main stumbling blocks relate to the design, floor plates and the initial acquisition cost. In addition to the acquisition cost, a developer would need to factor in the cost of conversion and a realistic profit margin on their investment.

Conclusion

Companies are still in limbo as they await more clarity on which model will work for their workforce and this is likely to hold back major office decisions. We are likely to see lower quality office buildings being repurposed. We have already seen a significant contraction in development activity. This subdued development activity needs to be maintained over the medium term and, in addition, decent GDP growth will be required to allow for incremental demand to mop up the available space. Until demand and supply conditions improve, we are likely to be faced with a challenging local office market for the foreseeable future.

Glacier Research would like to thank Imdaad Nana for his contribution to this week's *Funds on Friday*.

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Imdaad started his career at JP Morgan as a valuations administrator. Imdaad then moved to Oasis Group Holdings as an investment analyst. He then joined Avior Capital Markets as an equity analyst. During his time at Avior, Imdaad was a top-rated listed property analyst. Imdaad has been with Catalyst Fund Managers since September 2018. He joined the team as a senior local listed property analyst. Since January 2021, Imdaad has been co-managing Catalyst Fund Managers' flexible property solutions alongside Zayd Sulaiman and Ryan Cloete.