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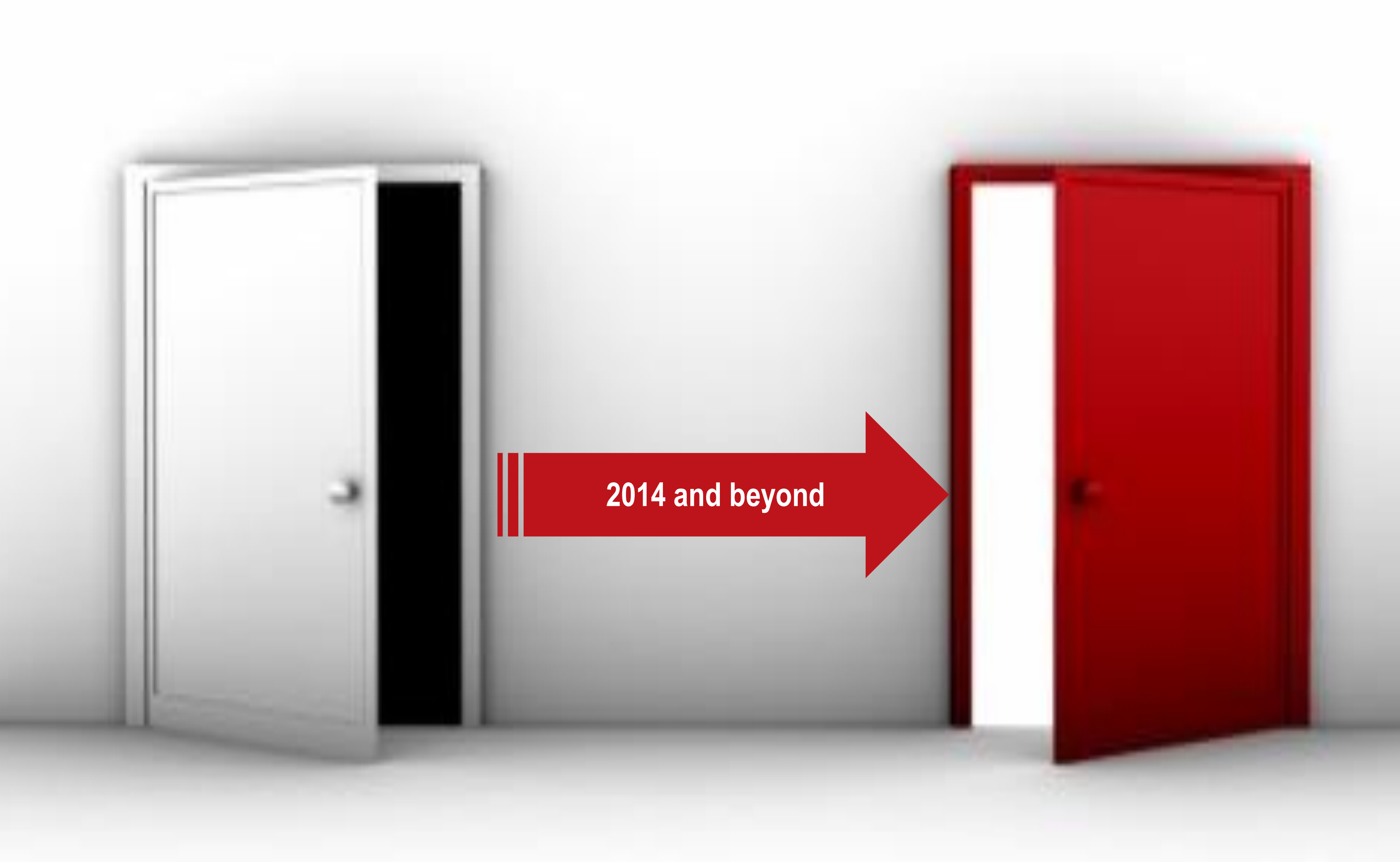
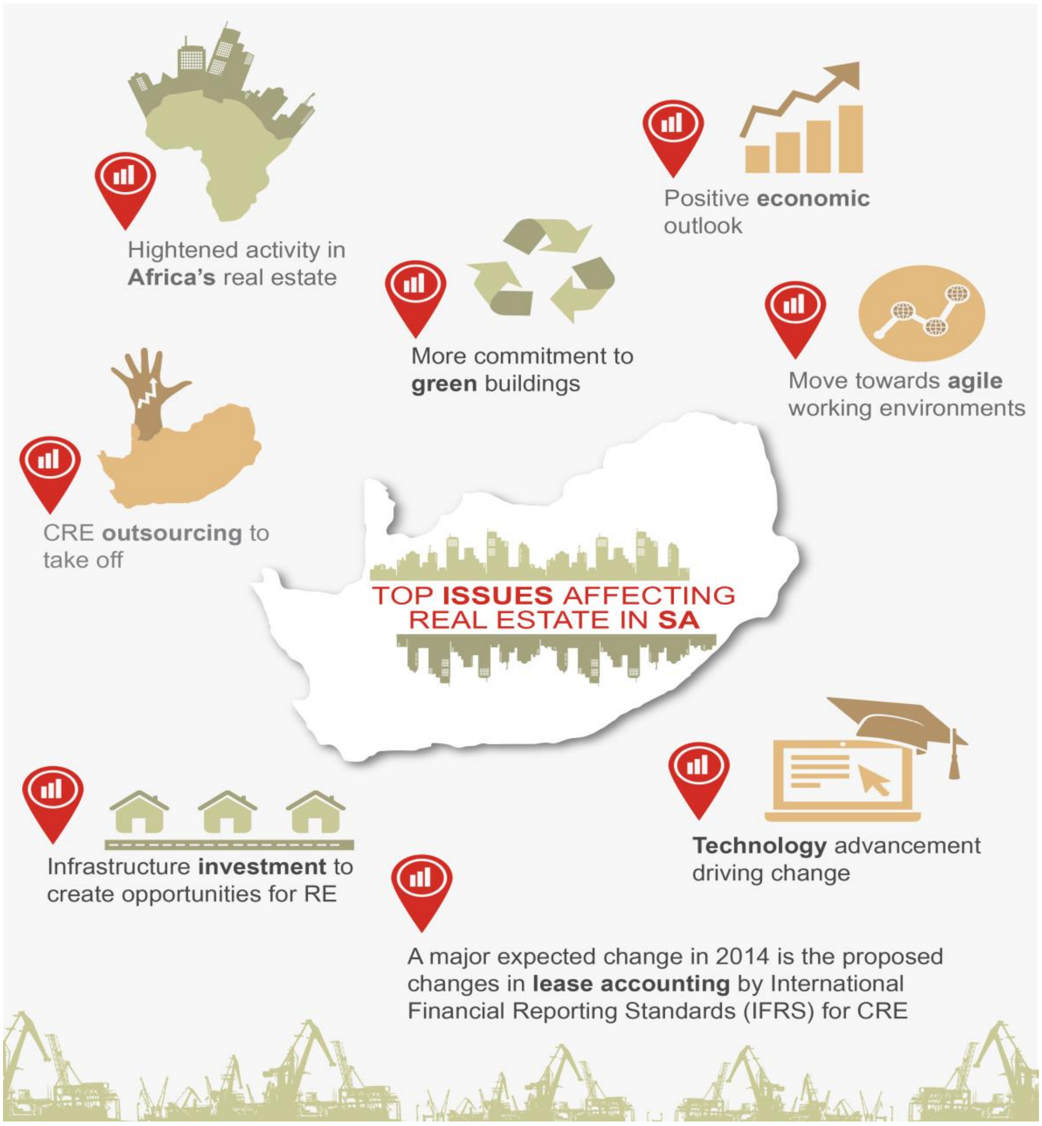
Top Issues Affecting Real Estate Trends in South Africa



Introduction

The real estate sector is constantly affected by change either through the economy, legislation, innovation or operational factors. Increasingly, the current environment dictates that business should be cautious of costs; therefore, the various trends noticed in the real estate sector are geared towards managing and reducing costs. The sector reacts in response to these changes by either consolidation or expansion of operations.

Many of the issues discussed in this paper affect multiple industries, but it is the commercial real estate impact that this paper aims to highlight in order to mitigate real estate challenges by considering opportunities for future portfolio strategies. Whilst it could be argued that there may be a number of issues impacting the real estate sector and business in general, we have selected eight issues that we believe will reshape and influence trends in the real estate sector in 2014 and beyond.



1. Positive economic outlook

Real GDP growth forecast (%)	2013	2014	2015
World	2.2	3.0	3.3
Europe	-0.6	0.9	1.5
China	7.7	8.0	7.9
South Africa	2.0	3.0	3.8
Sub-Saharan Africa	4.9	5.2	5.4

Source: World Bank

In the past few years, many of the world's key economies have endured long periods of slow growth and South Africa has not been immune to this trend. The South African economy was particularly affected by the volatile Rand exchange rate, high oil prices, low demand for exported goods, deteriorating business and consumer confidence, high administrative charges as well as highly indebted consumers who are faced with high cost of living and unemployment.

This pedestrian growth has affected the various commercial real estate markets, with the IPD Benchmarking index showing slightly lower annualised returns in the past years (13.0% for a 3 year average) compared to returns seen in the prerecession period (18.2% for 10 year average).

However, global and local economists are optimistic about the turn of events for a number of economies, expecting a moderate improvement in the world output, including South Africa's major trading partners.

As the economy improves, the following impact on the various sectors of the real estate market expected:

- Retail: The previous years saw the development of a number of shopping centres in and around townships and rural areas in order to address the shortage of retail facilities. There are still a few small regional, neighbourhood and convenience shopping centres under development; however this market will soon reach saturation. Even with the positive outlook, we do not foresee future development of prime large and regional retail assets as there is lack of robust demand to justify further assets. Consumers are feeling the strain of the high cost environment and need to address the high indebtedness before robust spending. Funds are expected to continue refurbishing their large retail assets in order to attract demand.
- Industrial market: The industrial market has been resilient in the past, with demand for quality big box space mainly characterising the market, although the smaller units have been struggling with vacancies in the secondary market. The anticipated positive outlook in the economy could see renewed interest from the small business sectors who occupy mini and midi units. The demand for distribution centres will be driven by the imminent positive growth trajectory in the African market, population growth as well as the projected cargo growth[1].

[1] Jones Lang LaSalle, locations dynamics for Distribution Centres in Johannesburg. 2013

- The office sector: Currently the most active office areas in the country are undergoing heightened building activity resulting in an influx of quality supply to the market that has been in much need of additional good quality office assets. These "new square meters" will leave large vacancies in existing buildings, particularly in the secondary market. The economic upturn in the next 12 to 18 months is not expected to result in massive employment especially in the business sector, which is a major driver for demand for offices, and therefore the consolidation phase by corporates into quality new and redeveloped buildings is likely to continue. Property owners of secondary buildings in primary and secondary areas are likely to battle in closing high vacancies with limited rental growth. Also, gross rentals for prime offices are not expected to increase significantly as additional supply provides a choice of office accommodation in the market. The prevailing tenant driven market is likely to continue towards the end of 2015 in Johannesburg and possibly to 2016 in Cape Town and Durban as indicated by the Office RAG indicator below.

Office RAG Indicator	2013	2014	2015	2016	2017
Cape Town	●	●	●	●	●
Johannesburg	●	●	●	●	●
Durban	●	●	●	●	●

Source": Jones Lang LaSalle

RAG indicator denotes the following market expectations :

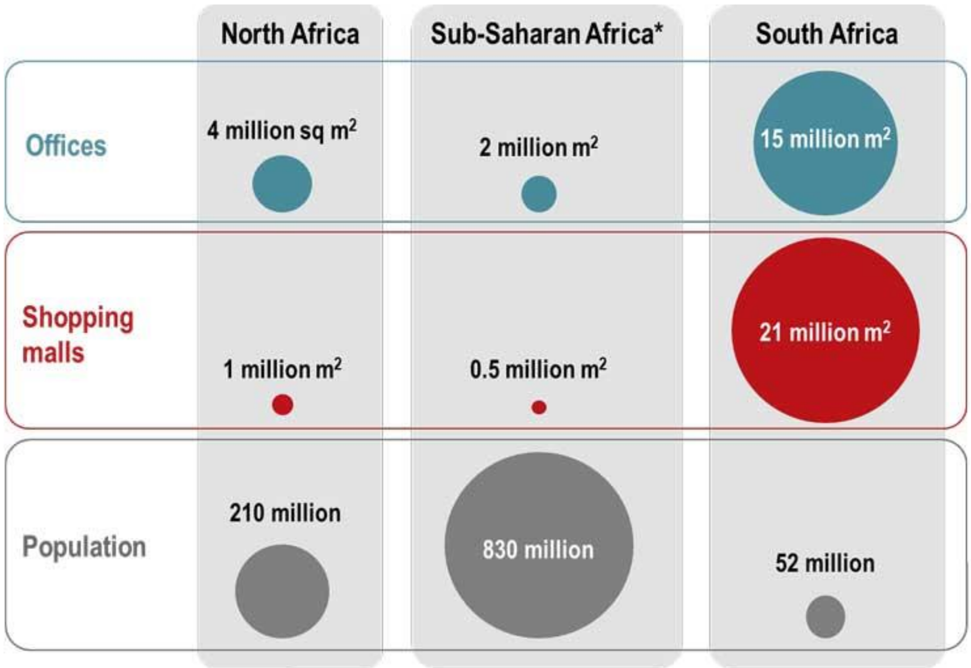
Green - Tenant-favourable: - Occupier demand and take up slow, flat or falling, availability of space plentiful, rents falling or flat

Amber - Neutral or balanced - : Supply and demand relatively balanced. Take up at average levels or rising, availability of space mixed or declining, rental growth forecast between 0.1% - 3%

Red – Landlord-favourable: - Occupier activity strong, availability of space limited, rental growth forecast above 3%

2. Heightened activity in Africa's Real Estate

Africa's commercial Real Stock



Excluding South Africa.
Relates to modern offices and shopping malls
Source: Jones Lang LaSalle, Emerging Markets Consultants, SACSC, IHS Global Insight

Despite the positive economic outlook going forward, the world's biggest economies are still facing various economic challenges which include recent downgrades on credit rating, and a debt crisis, with some struggling to exit the prolonged recession. International corporates are seeking investment opportunities in various emerging markets with high growth and many of the Sub-Saharan African economies are presenting such opportunities. The African Cities research programme has identified Africa as having favourable demographics, a young working population, rapidly urbanising and expanding middle class, amongst other factors.[2] Many local and international corporates are starting to put some African cities on the investment and expansion map. International capital is beginning to move into Africa and as investors seek to access these growth prospects.

A number of real estate funds have been created to focus on the commercial property market on the continent, with South African capital taking the lead. Retailers are pioneering many of these markets as they seek first mover advantage.

The above chart shows that there are substantial real estate opportunities in all sectors as reflected by the disproportionate amount of office and retail real estate stock in relation to the population figures. In particular, prime quality office assets are in short supply; therefore there is an urgent requirement for quality office assets to meet this strong demand from a broad range of growing corporate sectors – such as finance, outsourcing, oil and commodities, manufacturers and telecoms.

Many multinationals have already established significant footprints across the continent, and are facing the typical challenges of operating in 'frontier' markets, such as poor transparency, bureaucracy, high costs, skill shortages and an absence of suitable real estate.

We estimate that there is less than 2 million square metres of 'Grade A' stock across Sub-Saharan Africa (excluding South Africa), of which approximately half is located in just four cities - Nairobi, Lagos, Luanda and Port Louis. We believe that South African real estate investors seeking to diversify their portfolios will possibly direct more investment into the continent through the listed development funds.

[2] Jones Lang LaSalle, Africa Cities research, Twelve pillars of Africa's Future Success

3. Move towards the agile working environment

Agile working is defined by various literatures as “the new ways of working or smart working”. It means more than flexible hours, hot desking or home working, but includes utilising benefits gained from changing work practices. It is about bringing people, processes, connectivity and technology, time and place together to find the most appropriate and effective way of working to carry out a particular task. [3]

Cost optimisation and productivity may be the main reason for adopting an agile working environment as the current economic climate demands costs control for corporates to stay in business. This has led to many businesses having to consider new and alternative ways of designing work environments with workplace strategies that emphasise greater density, technology and efficient use of space.

Space sharing is also a key element of agile working. The mobility of the modern workforce means that it is not necessary to assign a desk per employee due to more flexible working hours and the ability to be connected out of the office.

Research shows that the benefits of flexible working include.[4]

- Productivity – reduced absenteeism, extended business hours, improved personal performance, and enhanced team-working. An effective workplace strategy can influence business productivity by driving collaboration, high employee engagement and output. Various research also points to an improved team oriented environment;
- Personal – reduced travel time and cost, improved work–life balance, better office environment;
- Business continuity – reduced business disruption due to weather, security issues, travel problems;
- Enticement –increased staff attraction and more enticing to next generation of workers; and
- Efficiency – space savings and reduced property costs.

Essentially, agile working reduces space requirements. This is becoming increasingly important as was observed in the Jones Lang LaSalle global Corporate Real Estate survey[5], in which it was revealed that 75% of respondents reported increasing demands to reduce direct real estate costs and 49% are facing growing demand to reduce portfolio size. A research by survey CoreNet Global revealed that the amount of office space per worker globally has decreased from 46.4m² in the 1970s to 18.5m² in 2013. This is estimated to reduce further to 9.29m² by 2017. This dramatic shift in the office utilisation will be driven by fewer assigned desks and individual offices.

In the South Africa context, the concept of agile working is still in its infancy stage. Space per employee remains high with large corporates incorporating facilities in their buildings that include concierge services, gym facilities, in-house children’s day care and health and wellness centres in an effort to ensure that employees report for work daily.

An additional benefit that could be realised from embracing agile working, particularly in South African real estate context, would be a reduction in parking requirements which are currently very high, primarily due to the lack of quality public transport. Perhaps the new generation of employees will create some significant change towards more flexible working in South Africa, but embracing this concept will require a significant mental shift from employers and responsible employees.

[3] The Agile organisation - 2013
[4] Workplace Unlimited, Occasional paper - 2012

[5] Jones Lang LaSalle, Corporate Real Estate Trends report - 2013

4. Technology advancement to drive change

Major advancements in technology have been a key feature of business for the past two decades with all industries having embraced the advent and advancement of technology including the health sector, media (online news), financial services (mobile banking), insurance (online quote and claims), the retail sector's online shopping, the government (e-government and e-filing), to name a few. In terms of the real estate industry we have observed the growth of online marketing of properties.

Technology has changed from simply providing companies with a competitive advantage to being a necessity with the vast majority of businesses in South Africa using either a website, Twitter handle, YouTube, Facebook or LinkedIn (if not all) to communicate key messages with their target audience.

International research shows that in 2012, approximately 90% of prospective buyers used the internet to search for properties and with 52% indicating that the internet was the first step taken during the property buying decision process[6]. The same research shows that 70% of buyers and sellers found their agent on the internet with a significant percentage, listing photos and detailed property information as the information they would like to see when conducting a real estate search.

Indicated by the amount of smartphones in use, the current era can be said to be a post-PC revolution. An estimated 1 billion smartphones were sold in the last 16 years globally and that figure is expected to increase by another 1 billion in the next two years. Google estimates that more people will use mobile phones than PCs in the future.[7] In 2013 more than 20 million smartphones were sold in Africa[8]. By 2016, mobile commerce is expected to grow 5 times more than its current size and by 2015 global mobile transactions is expected to increase to more than US$ 1 trillion.

The Jones Lang LaSalle office 2020 report revealed that technology will change the way people work and the amount of space they require as corporate occupiers strive to get the most out of space, while investors and developers search for future value. Some of the technological advancements that are most likely to be enable change in the next decade include:

- Green technology: enabling energy efficiency and cost savings.
- Cloud computing: removing the need for costly fixed server space and support teams
- Collaborative technology: increasing adoption of high and low tech solutions.
- Mobile technology: delivering more mobility, flexibility and productivity of users.

South African Real Estate implications

Technology advancement has many benefits and for the real estate sector in particular, it means:

- Mobile phones are revolutionising the technology space, thus companies should embrace the use of Apps, social media and related technology as a medium of communication with clients.
- In future, we foresee technology minimising face to face interaction between agents and potential occupiers, due to available property 3D and virtual viewing systems in the market which enable potential occupiers to view building specifications.
- Technology is changing the workplace with more companies possibly reducing space requirements to factor the agile environment. This could present opportunities for developers to consider 'plug and play' meeting areas outside the offices and other innovative workspace technologies.
- For retail and e-commerce, technology will form part of every retailers and shopping malls' strategies. However, we do not foresee a reduction in physical retailing space in South Africa in the short to medium term as majority of customers still use shopping malls for entertainment and experimental shopping hence there is still development pipeline for traditional retail stock.

[6] Real Estate Tech trends, Properties Online, 2013
[7] Ecommercenews.co.za
[8] Mail and Guardian Today, 2012

5. More commitment to Greener buildings

Research by McGraw-Hill is proving that green building practices are growing across the globe and are being viewed as long term business opportunities. A recent survey showed that there will be more commitment to green building projects from surveyed construction practitioners, who are anticipating that more of their work will be green by 2015 compared to previous years.[9] In 2009, only 2% of large building projects involved green practices and this is expected to increase to 51% in 2015 (See Figure 2).

South Africa is showing signs of improvement with respect to the general attitude towards greening with companies seeing it both as a business imperative and as a potential cost saving mechanism (i.e. in consumption charges).

Factors that are most influential on future green building activity in South Africa are primarily related to reducing energy consumption and protecting natural resources. Other reasons attributed to green buildings are; being the right thing to do, complying with environment regulations and reducing operating costs – in view of the high cost environment and the cost of running inefficient buildings.

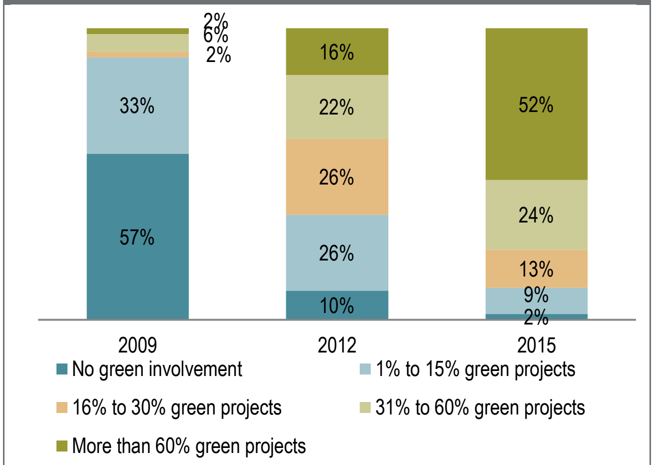
"Green leases" are a new form of enforcing environmentally friendly practices through a contractual agreement between occupier and landlord. The primary benefits of green leases include the following: [10]

- They improve environmental performance of the leased space by securing a commitment from both the landlord and the occupier,
- Financial incentives can be aligned so that both parties benefit from adopting green measures.
- They enable improved environmental data reporting transparency to measure success against agreed-upon goals.

For South African Real Estate:

- The demand, by both international and national corporates, for "Green Buildings" is increasing, being driven primarily by the need to decrease the overall cost of occupation.
- More efficient buildings allow developers to potentially earn higher net rentals, as tenants pay more focus on overall occupation cost in greener buildings.
- Enforcement of green leases will gain momentum in the future as both landlord and occupiers realise the benefit of going green. South Africa saw its first green lease signed in 2013, at the new mixed use development in Alice Lane, Sandton. However, the Green Building Council of South Africa cautions that due to the absence of regulation governing the operational energy use of buildings, performance driven green leases with penalties are unlikely to be widely adopted in the short term.

Figure 2: Activity by firms involved in Green Building projects in South Africa



Source: McGraw-Hill Construction, 2013

[9] World Green Building Trends, Smart Market Report, McGraw-Hill Construction, 2013 – Construction practitioners that responded to the survey include architects, engineers, contractors, building owners and building consultants around the globe.

[10] Jones Lang LaSalle, perspectives on sustainable tenant strategies, 2013

6. Infrastructure investment to create opportunities

Despite the many economic challenges facing the country, South Africa continues to invest in infrastructure projects with benefits realised across industries, including real estate.

Large infrastructure projects

Durban Port:

The National Ports Authority is anticipating significant growth in the number of containers handled by the Durban Port (from 2.7 million 20-foot equivalent units (TEU) of cargo currently to an estimated 12 million (TEU) of cargo by 2040). This is due to the increasing demand for goods locally and in neighbouring countries. This has resulted in the government committing funds estimated at R75 billion to the development of the Dug-out Port in the Durban's old airport in the South Basin. The spill over from this development will continue to open opportunities for industrial property market in Durban and Gauteng.

Corridor development Projects[11]:

During the opening of parliament in 2013, the president announced various Strategic Infrastructure Projects (SIP), which include:

- Durban-Free State- Gauteng corridor (SIP2): this involves the construction of a High speed Rail from Johannesburg and Durban as well as the creation of a logistics hub in the periphery of Johannesburg for a mixed use container depot and industrial area. The logistics hub is expected to provide varied opportunities for the industrial investors and options for occupation for distributing companies.
- Saldanha- Northern Cape development corridor (SIP5): The Saldanha Bay development project is aimed at port and rail integration and is expected to result in back of port industrial capacity.

Gautrain extension project (Gauteng):

The Gautrain Management Agency recently announced future plans for the extension of Gautrain rail link to additional areas in Johannesburg to link with the current network. This extension is expected to see a reduction of cars on the already congested Johannesburg road network. This project is expected to open further opportunities for real estate development in some new commercial nodes as has been seen in the areas like Sandton and Rosebank. Development activity for will not be limited to commercial real estate. We believe that the Westgate Station in the Johannesburg CBD will see renewed interest for residential, retail and office accommodation due to available infrastructure. Fourways, Randburg and Honeydew are already established residential and office nodes and this is likely to give further boost to these areas.

Municipal projects

Aerotropolis in Ekurhuleni

The Ekurhuleni municipality is planning on heavily investing in one of the "Strategic Infrastructure Projects" around the south east of the OR Tambo International Airport, named the Aerotropolis. This will see the authorities committing around R850 billion over the next 3 years in infrastructure projects. The plan includes a mixed use precinct with commercial, hotels and residential development. Commercial real estate developers, investors and occupiers will be presented with further opportunities and accommodation choice, particularly in the industrial market, although development will only take off in a few years to come.

City of Johannesburg infrastructure investment

The City of Johannesburg has committed more than R110 billion on infrastructure investment over the next 10 years. These projects include:

- Inner City clean-up: R450 million has been channelled towards addressing crime and grime, poor urbanisation and overcrowding and safety. This should attract investment back into the city by the private sector and large occupiers could reconsider moving back into the city.
- Corridors of Freedom: the project seeks to introduce high-density residential development as part of the Transit Orientated Development (TOD) and reverse the current spatial development which raises urban sprawl. This should primarily affect the residential sector initially and the office sector could follow.

[11] National Infrastructure Plan - 2013

7. Corporate real estate (CRE) outsourcing to take off

Intensified by the emergence of a broader strategic CRE agenda, capacity limitation and skill gaps within many in-house Corporate Real Estate (CRE) teams have in turn fuelled growth in the CRE outsourcing market. Gaining momentum since 2011, this tendency will continue over the next three years and is now moving at a much faster pace. This is a view from Jones Lang LaSalle global research on corporate real estate trends, a finding from the survey conducted amongst 565 corporates globally.

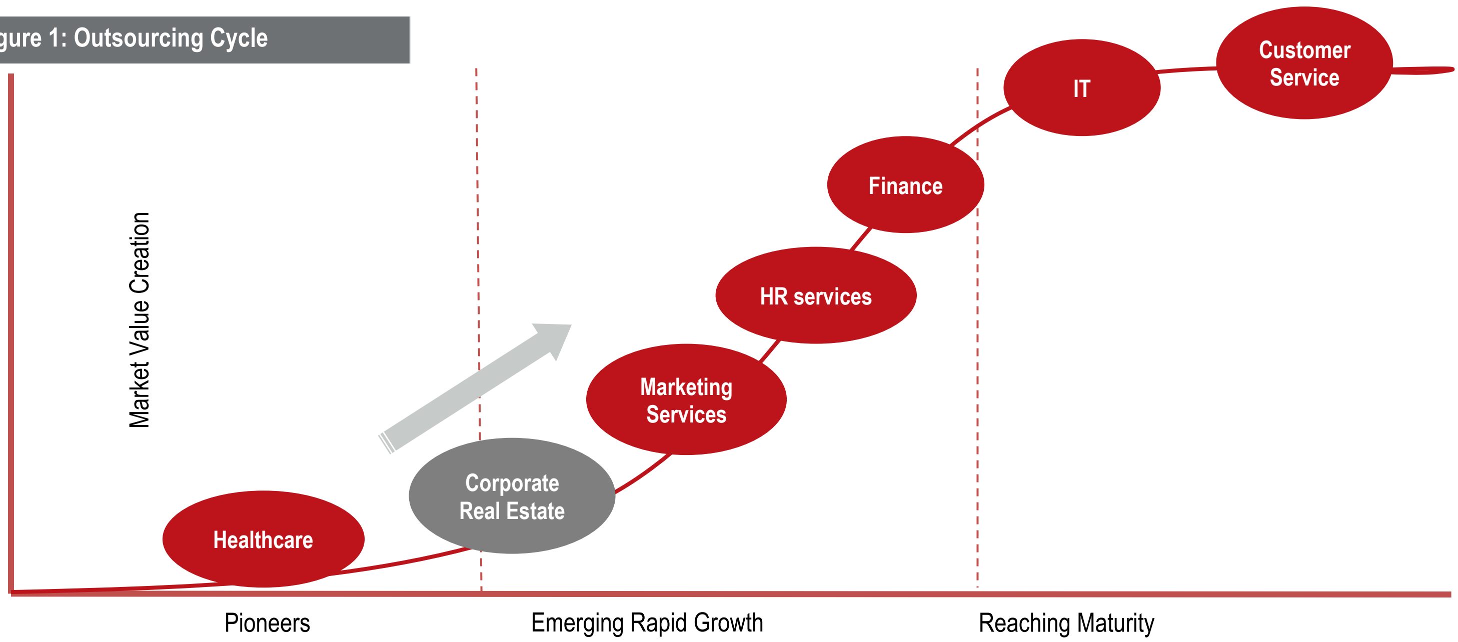
According to the survey, CRE outsourcing is gaining traction across many countries, industries and corporations with only 8% of companies having not outsourced any aspect of their CRE function, a big drop from 24% in 2011. This indicates that CRE outsourcing is quickly catching up with other outsourced functions such as IT, HR and finance (See figure 1 below).

Research further indicates that more and more corporates are considering outsourcing the real estate function with most companies' firmly viewing outsourcing as a long-term strategic relationship, seeking to add value rather than a price driven tactical transaction. Globally the balance of services performed in-house or through an outsourced model is changing with specialist and resource intensive services remaining most likely to be outsourced. [12]

How much do South African corporates outsource and what functions are outsourced? This area is yet to be tested but there are functions such as facilities management and property management that are widely outsourced. South Africa could be at the pioneering stage of the curve in terms of real estate outsourcing, but as competition for real estate services intensifies and becomes more strategic, a number of corporates will see value from expertise and resources not available in-house.

Global trends show that companies usually outsource to draw upon expertise and skills set that are not available within their own organisation and release internal capacity to focus on addressing strategic pressures. Whilst research on attitudes towards CRE is not available in South Africa yet, we are of the view that outsourcing of corporate real estate will follow global trends in the future.

Figure 1: Outsourcing Cycle



[12] Jones Lang LaSalle Global Corporate Real Estate Trends report - 2013

8. Changes in lease accounting

A major expected change in 2014 is the way in which leases are accounted for in terms of the International Financial Reporting Standards (IFRS) for commercial real estate. According to the proposed changes, the new standard requires that all leases that are 12 months or longer to be accounted for as **financial leases.**

If tenants sign leases longer than 12 months, which is the norm in South Africa, they will need to recognise leases on the balance sheets as a liability. This is designed to improve transparency on leverage and will change the expense classification and recognition profile with rent expenses replaced by a combination of interest expense and depreciation expense.

The impact of this proposed change could potentially see tenants negotiating different rental arrangements, for example lower base rents, shorter lease terms and/or longer rent free periods.[13] This may impact the landlord's property valuation as shorter lease terms with more frequent reversions to market rentals could negatively impact property valuation.

The upcoming changes will require significant investment of time and resources to properly analyse, plan and implement an effective strategy plan. To be ready, that means organisations should:

- Understand the magnitude of the changes that are imminent
- Position to lead and manage a cross functional team that will conduct thorough assessments and due diligence.
- Build and maintain the organisational structure and resources to manage the demands of the new standards on an on-going basis.[14]
- Landlords should review the framework for negotiating new leases as tenants may demand other terms and conditions and ensure those involved in lease negotiations understand how tenant leasing decision will be impacted.
- Landlords should assess what data will need to be provided to tenants and where this information is currently captured.

[13] PWC, IFRS Standards in motion - 2011

[14] Jones Lang LaSalle – lease accounting changes preparedness checklist

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