

# AN EMPIRICAL ASSESSMENT OF THE SOUTH AFRICAN AND UNITED KINGDOM PROPERTY MARKETS

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**Abstract:** The paper seeks to identify the key differences between the South African and United Kingdom property markets, with specific focus on the office, retail and industrial sectors. Emphasis is placed on the observation that market structures respond to specific and changing characteristics of markets, which in turn affects the structure of commercial investment funding. The chosen methodology is that of secondary data analysis. The main data sources are from reputable market reports and the Investment Property Databank (IPD/MSCI). The analysis of the data speaks to the structure of the economy, the different property sectors, owner composition, the key financial players in the market, and the current market status. It was found that the structure of the South African and United Kingdom property markets are significantly different. The difference is evident in density, decentralisation, performance and owner composition. Overall the South African property market yielded higher returns in conjunction with a lower level of volatility when compared to the United Kingdom property market.

**Keywords:** Property Markets, South Africa, United Kingdom

## 1. INTRODUCTION

In the past two decades there has been increased focus on global property market performance. This is due to accelerated growth in diversified international property portfolios. The South African (SA) and United Kingdom (UK) property markets have offered investors above average returns in comparison to other asset classes in the medium and long-term. As property investments tend to rely on a high level of debt funding, banks and other types of lenders are also closely observing the performance of property compared to other asset classes.

The main purpose of this research was to compare the performance of the SA and UK property markets. It is suggested that the performance of a property market is a function of its characteristics, which in turn influence its resilience to outside economic shocks. In order to gain an appreciation of the contrasting characteristics between the two markets, the paper describes the level of concentration and composition of the market share, the key stakeholders that operate in the SA and UK property markets, the sectorial mix, the geographic spread, and socio-economic factors that influence, and hence impact, the performance of the SA and UK property markets. Thus, this research is conducted within the context of institutional economics, which takes a macro viewpoint of “how the property game is played” in terms of accepted societal rules and norms within the market (D'Arcy and Keogh, 2002). These rules and norms support market transactions and facilitate various stakeholders to achieve their real estate objectives (D'Arcy, 2009).

Lorenz and Trück (2008) identified that economic indicators heavily impact different European property markets. The main indicators that emerged as significant contributors were GDP, the inflation rate, population growth rate, and the change in the unemployment rate. These same indicators contribute to the behaviour of the SA property market, although the combination of these contributing factors appears to be weaker than in Europe. The main difference between

the SA and UK economies is a result of political and socio-economic stability, and the maturity of the respective economies. This influences investor confidence and influences market risk, as SA has the risk profile of an emerging country. SA is a mineral rich economy, defined by a highly skewed distribution of wealth and high unemployment rates. Thus, SA is prone to social challenges that are not encountered to the same degree in the UK. This is highlighted by the contrasting unemployment rates between SA and the UK (26% and 6% respectively). This has a significant impact on the populations' ability to access finance and invest in property (TradingEconomics, 2015). The SA economy is also defined by a rapidly growing middle class coupled with increased urbanisation which continues to underpin the demand for both residential and commercial space.

The global property market is showing signs of improvement (recovery) in the aftermath of the global financial crisis (GFC) that had a direct impact on the returns on all sections of real estate. According to Jones Lang Lasalle (JLL) (2015) buoyant capital markets in conjunction with increased demand for space has resulted in significant projected growth across all the main global regions and property sectors. The research uses secondary data collected by IPD/MSCI. The data serves to indicate market performance of both SA and the UK before and after the GFC. This helps highlight the influence market characteristics have on the performance of the property industry.

Typically, property markets comprise of four predominant sectors, namely: office, retail, industrial and residential. To better identify the characteristics influencing the performance of the property markets it is necessary to breakdown the market into its constituent sectors. The residential property sector has been omitted from this evaluation as the comparative data published by IPD/MSCI relating to the residential sector has not been available for long enough to draw meaningful comparisons.

Ultimately, understanding the unique characteristics that govern the performance of a given property market will reduce the risk for investors by enabling them to make more informed decisions. Furthermore, this knowledge could be used to better insulate vulnerable economies in the developing world from external threats such as the GFC. Since property in SA was the best performing asset class in 2014 (return of 26.64%) (Sanlam, 2015), it is evident that creating a lower risk environment in the property market could have a significant impact on economic growth in South Africa.

## **2. CHARACTERISTICS AND STRUCTURE OF SA AND UK PROPERTY MARKETS**

D'Arcy and Keogh (2002) view the property market as an institution, where a set of formal and informal rules govern the actions of the various property market stakeholders. Changes that occur in the institutional environment that impact the property market take place in legal, economic, social and political spheres. The broad institutional climate will influence the perceptions and expectations of property market stakeholders. Conversely the experiences of stakeholders may impact and lead to a change in the institutional environment (D'Arcy and Keogh, 2002). These formal and informal rules are evident in both SA, and UK property markets. Hence, the research will be viewed through this institutional lens.

The structure of the SA and UK commercial property markets differ as a result of the following factors: the urban density of SA and UK cities; decentralisation; and owner composition. While

the UK urbanisation rate has declined significantly, SA rural-urban migration remains significant and continues to play an important role in the present and expected future structure of the built environment. Additionally, the last twenty years have seen increasing decentralisation away from SA's main CBDs, especially from large corporate entities that typically take out long leases for large floor areas. This move has significantly increased the demand for office and retail space in SA cities. Most urban regions in the UK are still relatively centralised, and have not witnessed the level of decentralisation experienced in SA. Furthermore, the UK property market has remained comparatively unchanged in recent years (Investment Property Databank (IPD), 2015a; 2015b). The structure of the SA property market on the other hand has seen significant change, with specific reference to the rapid growth of the listed sector.

Added to the physical differences between the SA and UK property markets are fundamental differences in informal and formal rules, most notably apparent in commercial lease structures. It is considered standard for a commercial lease in the UK to have a duration that is between ten and twenty-five years with open market rent reviews every five years. This is due to a relatively low inflation rate. UK leases also contain a security of tenure clause, which gives the tenant the right for a new lease on similar terms (accounting for adjustment to rent). Lease structures in the UK do not seem to mirror the tenants' business planning horizons, which is viewed as potentially problematic (Crosby *et al.*, 2003). In SA, commercial leases are structured very differently. The average lease duration is three to five years, where an annual escalation is agreed upon upfront between the lessor and lessee. The escalation clause covers the relatively high inflation rate in SA. Unlike in the UK there is also no guarantee to the tenant that they can renew the lease on similar terms upon lease expiry.

Investors are aware that the different sectors of the property market have differing risk profiles and that they react differently to changing market conditions. According to Yunus (2013) diversification is generally beneficial to property investors. This is due to the fact that property is considered a long-term investment and therefore there is a need from investors to understand the impact of diversification on their property portfolios (Yunus, 2013). The Capital Asset Pricing Model (CAPM) postulates that portfolio risk can be eliminated through diversification (Lorenz and Trück, 2008). It was found that in the European property market diversification is prominent in order to reduce the risk of over exposure to one sector. However, with diversification comes the acceptance that returns will be somewhat capped as European property investors tend to be more risk averse. It was also noted that the residential sector tends to be the driver for changes in demand and supply of the three commercial property sectors (Yunus, 2013).

Le and Ooi's (2012) research focuses on the financial structure of property investment companies in terms of equity and debt opportunities in the market. There is an assumption that property companies operating in countries with well-developed capital markets will have greater access to finance acquisitions and developments. In the UK the majority of property finance is administered by banks (Barkham and Frodsha, 2015). In a developing market such as SA, there is less finance available for speculative investments (Le and Ooi, 2012). It was found that property companies operating in developed markets had greater access to both equity and debt, as there are good opportunities to acquire equity from capital markets as well as secure finance from established financial institutions (Le and Ooi, 2012). It is not surprising that larger property companies with more assets on their balance sheet coupled with the potential for growth tend to take on more debt in their capital structuring (Le and Ooi, 2012). There is always an element of risk associated with lending, and financial institutions in the UK

established that loan-to-value (LTV) ratios cannot be monitored in isolation. LTV needs to be monitored in conjunction with the interest coverage ratio (ICR). The ICR should be greater than 1, and is recommended to be 1.25 in the UK market. The inclusion of the ICR lowers the LTV ratio, thus reducing the risk to the lender (Barkham and Frodsha, 2015).

### **3. METHODOLOGY**

The overarching research method is secondary data analysis. According to Glass (1976) secondary data analysis comprises the re-analysis of data for the purpose of addressing an original research question with different statistical techniques or answering new questions with existing data. This is consistent with Kiecolt and Nathan (1985) who state that secondary data analysis is conducting analysis within an existing data set to answer a research question not originally posed in the primary study. This is due to the fact that many studies contain more data than the principal investigators can analyse effectively, thus resulting in a variety of future projects that make use of same data set.

The main source of data was from IPD/MSCI. The researchers were granted access to the IPD/MSCI online real estate analytics portal, which is linked to the latest global property datasets. The online portal allows for the customised selection of relevant data so that analysis may be conducted between countries/regions and different property sectors. Key UK property related banking data was acquired via reputable annual industry reports, which are produced by the British Property Federation (BPF), the Investment Property Forum (IPF) and De Montfort University. One of SA's main retail banks, which have the largest market share in commercial property mortgages, provided data to allow for analyses between the SA and UK commercial property markets. The data on property markets was split into their respective sectors (with the exclusion of the residential sector) in order to gain a greater insight into the characteristics and factors that affect the different property markets.

### **4. PROPERTY MARKET DATA AND ANALYSIS**

SA commercial property has shown significant growth in terms of investment size and returns, particularly within the listed sector. Correspondingly, attention from investors and (by default) engagement with lenders has increased significantly over the last fifteen years. SA has experienced increased international investment as a result of its successful re-emergence into the international political and economic spheres in the mid-1990s. The post isolation years have resulted in an increase in economic activity culminating in Johannesburg becoming Africa's commercial hub attracting demand from international firms to establish offices, shops and warehouses. Cape Town and Durban, the second and third largest economically active cities respectively, have also shown increased demand from foreign entities, both from major global brands and private start-ups who identified SA as an untapped economy. The economic impact of SA's three largest urban nodes is such that they contribute approximately 38% to the GDP (StatsSA, 2015).

In SA consolidated returns for office, retail and industrial property was 12.9% for 2014 (IPD, 2015b). These returns outperformed other macro economic indicators, such as the prime interest rate and inflation, which is approximately 6.1% (StatsSA, 2015). Investment property, which includes the listed property sector as a major stakeholder, has been generally one of the best performing asset classes in the last decade in comparison to other major investment

options, which include *inter alia*, cash, SA equity, foreign equity, SA bonds, and the foreign exchange market. The UK property market has been relatively strong, partly due to high demand in urban areas. London, Birmingham and Glasgow have traditionally been commercial hubs, not only domestically but also within a European context. Property is constantly in demand in London as it is a densely populated city regarded as a global financial hub (Mitchell, 2014).

A number of external factors need to be considered in order to more accurately compare property related figures between SA and the UK, namely: inflation; the long bond rate; and the prime interest rate. All these factors contribute to contextualising the real value of nominal returns when conducting cross border comparisons. These factors can have varying influences on the different commercial sectors within the SA and UK property markets.

#### 4.1 Owners

The main owners of commercial property in the UK market comprises of: overseas investors (24%); insurance and pension funds (19%); collective investment schemes (16%); REITs and other listed property funds (14%); private property companies (14%); other investors (5%); traditional estates/charities (4%); and private investors (3%) (British Property Federation (BPF), 2014). The majority of SA commercial properties are owned by REITs and listed property funds (62%), while insurance and pension funds (18%), unlisted and private funds (13%), and private investors (7%) own the remaining building stock (BPF, 2014; IPD, 2015b). Figure 1 provides a graphical breakdown of property ownership and comparison of the UK and SA markets.

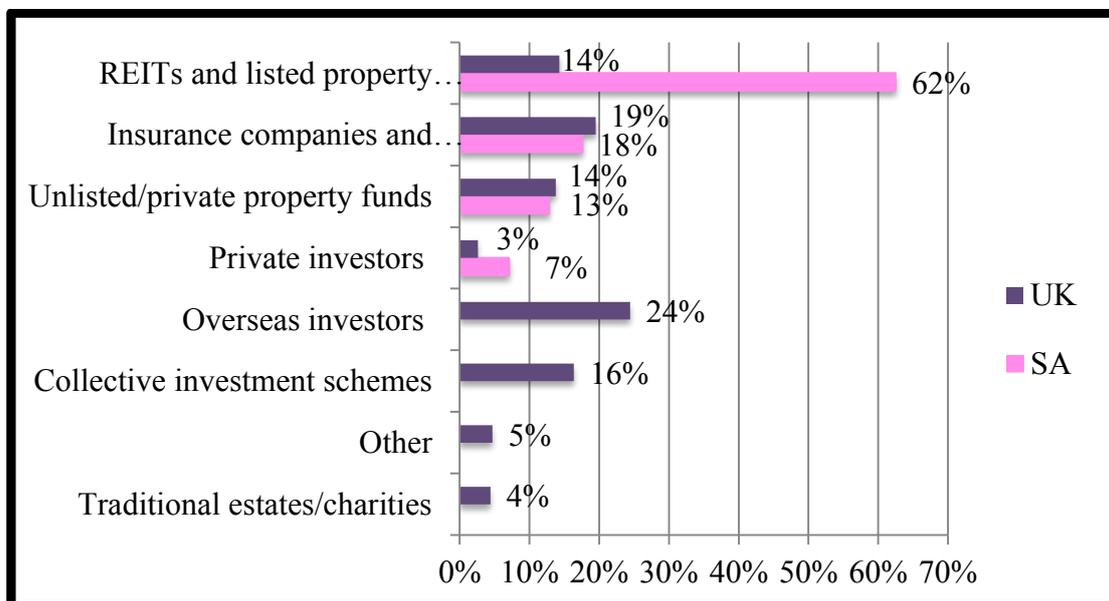


Figure 1: Ownership breakdown of SA and UK property markets (Source: BPF (2014) and IPD (2015a))

#### 4.2 Office

Nominal returns for the office sector in SA and the UK in 2014 are significantly different, yielding returns of 12.08% and 22.66% respectively (IPD, 2015b). The UK market has much

higher returns as it offers a reputable and stable market which provides consistent returns, thus making it attractive for both local and foreign investors. However, the SA office sector continued to operate under sustained pressure from the market due to a range of macro economic factors, the main factor being weak GDP growth. The SA office sector has five and ten year annualised returns of 12.39% and 16.22% respectively, while the UK office sector has returns for the same periods of 13.03% and 7.84% (IPD, 2015a; 2015b).

The main take-up of office space in SA is concentrated on A-grade space or prime property, with specific focus on working environments that offer the benefits of green building features and initiatives (GBFIs). Older buildings, and properties located in secondary nodes are struggling to attract long-term tenants, thus resulting in vacancy rates that are negatively impacting the sectors performance. This can also be attributed to an increase in decentralisation from CBDs to up-market residential nodes by blue chip companies. Office development tends to be focused on high demand, low risk nodes.

Re-developments are on the increase as there is a limited supply of adequate land zoned for office use, which in turn has resulted in above market rentals (Broll, 2014). Despite this, SA's office sector is still very attractive for foreign companies when compared to typical European rentals that range between R220-300/m<sup>2</sup>/month, and premium London rentals that exceed R700/m<sup>2</sup>/month (Broll, 2014). The South African Property Owners Association reported an increase in speculative development, thus indicating that there is improved confidence in the office sector. It was also noted that there has been a concentrated increase in demand for office space from the financial services and banking sectors (Broll, 2014).

### **4.3 Retail**

Originally SA's retail property model mirrored the traditional European model, which comprises shops on a high street. Since 1994 there has been a rapid emergence of shopping centres both in historically wealthy suburban areas and large townships. There are currently eight super regional shopping centres in SA, with five of these centres located in Gauteng. There has been significant growth in the retail sector. In 1994 there were 2,616 retail buildings in South Africa, compared to 20,103 in 2014 (IPD, 2015a). Whereas retail properties in the UK have remained relatively constant over the last fifteen years, growing from approximately 3,000 to 3,500 buildings (IPD, 2015a).

Nominal returns for the retail sector in SA and the UK in 2014 are similar, yielding returns of 13.29% and 14.23% respectively (IPD, 2015b). The SA retail sector has performed consistently well in recent years with five and ten year annualised returns of 14.28% and 17.59% respectively, compared to the same figures for the UK retail sector of 9.61% and 5.06% (IPD, 2015a; 2015b). Online retail is making an impact on the SA retail property market, as there has been increased market share with this industry contributing approximately R4.5 billion to GDP. However, challenges around technological infrastructure has meant that online retail in SA has had a smaller impact on the retail property market than it has in the UK (Broll, 2014).

### **4.4 Industrial**

The industrial sector behaves slightly differently to other property sectors. This is partly due to how changes in the economy can affect the timing of the demand for industrial space in

comparison to the demand for office and retail space. Both the SA and UK industrial sectors experienced favourable returns in 2014 of 14.34% and 23.32% respectively. Furthermore, annualised five and ten year returns for the two markets were 14.48% and 19.61% for SA; and 11.26% and 6.54% for the UK (IPD, 2015a; IPD, 2015b). The manufacturing industry in the UK has remained resilient since the GFC. However, the SA industrial property sector has been directly affected by a slowdown in manufacturing output, which resulted in a decrease in GDP growth and a continued weakening of the Rand. A number of sociological, political and economic factors have contributed to negatively impacting the industrial sector, these include: strike action; above inflationary increases in electricity; electricity blackouts during business hours; and a lack of skills in key areas (Broll, 2014).

#### 4.5 Market comparisons

Total index returns are used as a more accurate form of comparison due to the fact that nominal returns are misleading when comparing the SA and UK property markets. Figure 2 shows the consolidated real returns for the SA and UK property markets. The UK property market outperforms the SA market up to 2007, where there is sudden upsurge in the SA market. Unlike the UK market, the SA property market appears to be unaffected by the GFC. This could be due to three reasons, namely: (1) SA banks were prohibited from investing in foreign banks, and therefore their exposure to the collapse of certain financial institutions was limited; (2) SA was awarded the 2010 Soccer World Cup in 2004, which resulted in major built environment and infrastructure projects that were completed during the GFC. These projects kept the SA economy relatively buoyant, which in turn generated benefits that filtered into the property market. Lastly, (3) UK valuers drastically reduced values reflecting the market conditions as a result of the GFC, while their SA counterparts were more moderate when valuing during that period of time.

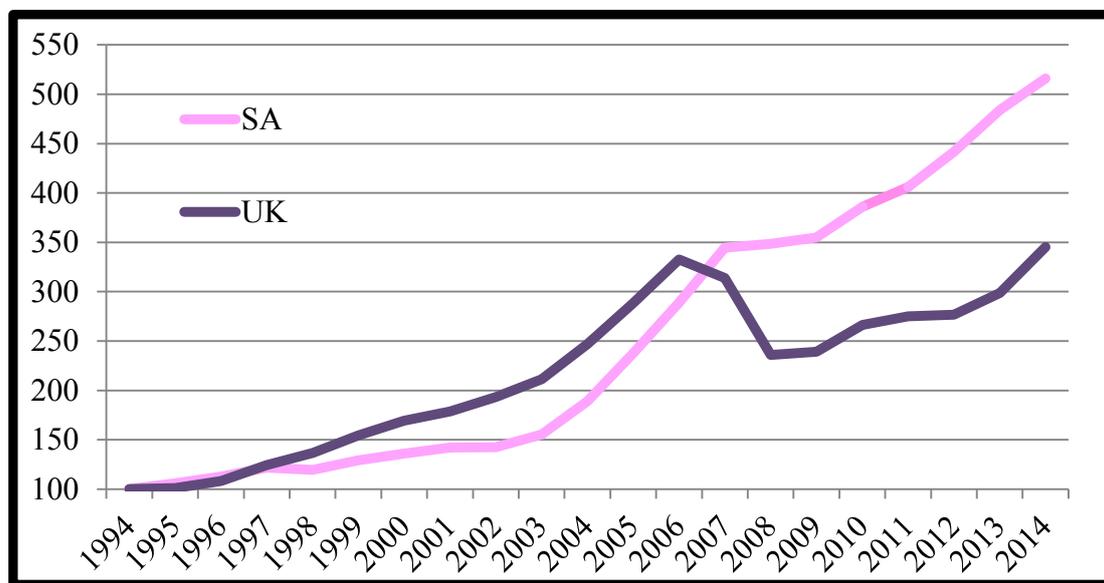


Figure 2: Consolidated real index returns for SA and UK property markets (Source: IPD (2015b))

For the period 1997-2007 the UK's real index was greater than SA. This is due to SA's comparatively high inflation during this period. SA's consolidated total index returns surpassed the UK in 2007 as a result of a boom in the SA property market. The gap between the two

markets increased from 2007 due to the GFC, which resulted in a sharp decline in the UK property market followed by a mild recovery.

## **4.6 Banking**

According to the BPF (2014) the overall level of gearing in the UK commercial property market is less than half of the total current asset value (approximately 44%). Traditionally, finance providers in the UK were banks and building societies. However, since the GFC there has been a wider range of debt sources, including insurance companies, debt funds and foreign banks (BPF, 2014). The level of authorised commercial property finance has decreased year on year since the GFC crisis in the UK. From 2008 to 2013 the loan book experienced an average decrease of 6% per annum (Maxted and Porter, 2013). This highlights UK bank's reluctance to expose themselves to risk following the GFC. This is in contrast to one of SA's main retail banks, which experienced an annualised growth of their loan book for the period March 2014 to February 2015. This is due to the fact that the SA commercial property market did not experience the level of downturn experienced in the UK resulting from the GFC.

In the UK over 57% of new lending in the first half of 2013 was undertaken by six organisations, with 72% of new loans being undertaken by twelve organisations. Of the twelve institutions, only five were UK banks. The remaining seven were foreign financial institutions. The lending breakdown is similar in South Africa where five prominent banks provide the majority of real estate finance. However, there is one significant difference; the SA property market is not exposed to the international banking market (Maxted and Porter, 2013). This disconnection from foreign financial institutions enables SA to be relatively insulated from economic shocks that take place outside the country.

## **5. CURRENT MARKET STATUS**

### **5.1 Global markets**

The current status of the global property market is one of relative optimism, as there is an indication of growth from markets that were heavily impacted by the GFC. Most regions, with the exception of the Europe, Middle East and Africa (EMEA) experienced growth. This is due to an increase in available liquidity, similar to the levels of 2006 that were experienced in the US and Asian markets (JLL, 2015). There has also been a general increase in direct investment since the GFC, which indicates that investor confidence regarding property as an asset class has been continuously improving (JLL, 2015).

### **5.2 South African market**

The SA property market has shown greater signs of volatility since the GFC. The listed sector continues to perform exceptionally well, with returns exceeding 40%. Ung geared property has not been performing to the same of level as the listed sector, resulting in relatively large changes in year on year total returns. In 2013 consolidated total returns for the three main commercial sectors were 17.72%, while in 2014 consolidated returns had decreased to 12.9% (IPD, 2015b). The decrease in returns can be attributed to various macro economic reasons that

are unique to SA, such as the value of the Rand in relation to major currencies, and foreign investor confidence. This is influenced by the perception of increased political instability.

### 5.3 United Kingdom market

The UK market has been moderately volatile, other than during the GFC (2008-2010) where the market yielded negative returns, but recovered relatively quickly. Consolidated returns for all three commercial sectors and the residential market range between 10% to 25% for the period 1994 to 2014. Figure 3 shows that from 1996-2003 the UK property market outperformed the SA market. In 2004 the SA property market started to significantly outperform the UK market, even during the GFC. From 2009-2014 the SA market was relatively stable showing gradual growth. However, the UK market performance was hugely volatile during that same period of time (IPD, 2015a).

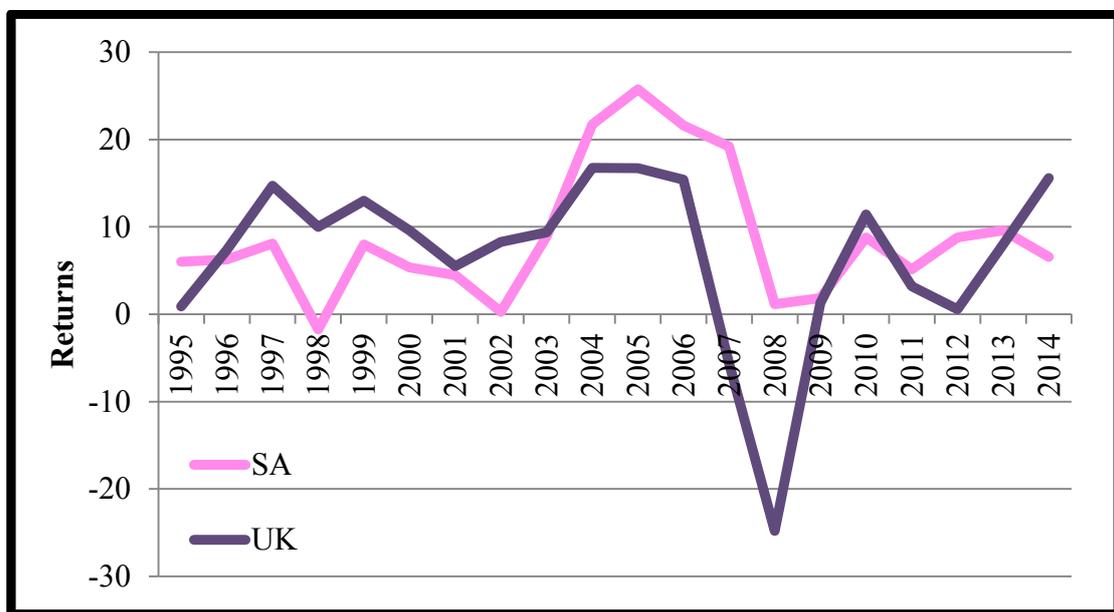


Figure 3: Comparison of SA and UK consolidated real returns (Source: IPD (2015b))

### 5.4 International return comparisons

Table 1 provides a numerical breakdown of the average returns, volatilities (standard deviation), and a risk/return ratio (standard deviation divided by average return) for the periods 1995-2014 and 2012-2014.

Table 1: Property market returns data (Source: IPD (2015b))

Period	1995-2014			2012-2014		
	Average Return	Volatility (Std Dev)	Risk/Return	Average Return	Volatility (Std Dev)	Risk/Return
SA	15.5%	6.5%	0.42	14.6%	1.2%	0.08
UK	9.1%	9.3%	1.01	10.6%	5.9%	0.55
Global	10.2%	6.1%	0.60	10.1%	1.3%	0.13

The average return of the SA property market for the period 1995-2014 was 15.5%, compared to the UK of 9.1% and the global average of 10.2%. The UK's market volatility is relatively high when compared to the risk/return ratio of the global market. The SA property market has the lowest volatility in the last three years. However, the UK property market has a higher risk/return ratio in comparison to the global property market (IPD, 2015a).

## 6. CONCLUSIONS

Both the SA and UK property markets have experienced periods of mixed property returns. This has been attributed to the performance of the global economy and market specific variables that have affected investor confidence. Since the collation of property data by IPD/MSCI in the mid 1990s the UK has been a more volatile market compared to the SA property market. The SA market has also performed better than the UK property market in terms of inflation adjusted index returns. The differing levels of maturity and transparency of the SA and UK property markets determine the institutional environment, which in turn determines the actual transactional environment for investors.

External and internal economic factors that make up the respective markets are unique to each of these countries. SA has some of the characteristics of an emerging economy, while the UK is a well-established mature transparent economy. While the performance of property markets is defined by its ability to compete against other asset classes, it is equally important to consider social, demographic, infrastructural and political parameters that affect property markets. The research has highlighted that property performance can equally be affected by these characteristics and how they dictate how the market will respond to an event. Most notably the GFC was identified to illustrate this point. The SA economy is more restricted/protected from exposure to foreign markets. The UK economy has a higher exposure to global investors and therefore needs to compete against global market trends. This minimal exposure to foreign markets benefited SA during the GFC as the economy was not as heavily impacted as the UK economy.

Despite this, economic traits and market conditions alone do not explain the function of property markets, and there are many other factors that can be considered. The physical structure of the two property markets in terms of population density, and decentralisation within the main urban regions contributes to the demand for different types of commercial properties. There is a vast difference in the number of retail properties and the catchment areas that they serve. The SA retail property sector has been consistently the best performing commercial sector, while in the UK it has been the worst performing. This can be linked to the impact of the GFC in the UK, and its resulting impact on consumer behaviour. In SA the retail sector has largely been underpinned by the opportunity to meet the needs of under-serviced townships.

The research has highlighted the need for further examination into market structures, and their characteristics. The differing market structures of developed and emerging economies have vastly different implications on the commercial real estate market, which in turn results in certain levels of volatility and return. Gaining a greater understanding of these characteristics will enable a safer environment for investment.

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