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PROPERTY BAROMETER

Residential Fixed Investment Review

22 August 2011

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1. OVERVIEW – HOUSEHOLDS' OBSESSION WITH CONSUMPTION SPENDING HAMPERS RESIDENTIAL FIXED INVESTMENT GROWTH IN TOUGH TIMES

Residential fixed investment has been hard hit in recent years by the lagged impact of the 2008 recession and residential property market slowdown, which in turn was caused by a global recession along with significant interest rate hiking from 2006 to 2008.

The decline in overall residential fixed investment started back in 2007, and has continued unabated up until early in 2011, according to the Reserve Bank's (SARB) data. It is not only new building activity that has suffered but the additions and alterations market too, and sometimes even home maintenance has fallen short.

The FNB Estate Agent Survey provides evidence to this effect. The sample of agents has been of the opinion that, since the start of the survey back in 2004, there has been a broad decline in the percentage of home owners undertaking "value-adding upgrades" or "maintaining and making some improvements" on their homes. From 79.5% of total estimated homeowners in early-2004, agents see homeowners falling into these 2 categories of home investment as having declined to 41.5% of total homeowners in their areas.

This implies a major shift by a significant portion of homeowners towards "lesser forms" of home investment, namely "fully maintaining with no improvements", "only attending to basic maintenance" and "letting homes get run down".

This is reflective of tough economic times as well as an ongoing obsession with consumption, by households, in order to maintain their material lifestyle in the short term. *This propensity to consume can be seen in the SARB numbers, where saving is so low that households remain in a situation of "net dis-saving", i.e. where the little gross saving that exists is insufficient to cover the depreciation on fixed assets owned by households. In the 1st quarter of 2011, the SARB reports that real household consumption expenditure grew year-on-year by 5%, higher than real disposable income growth in the same quarter, while residential fixed investment was the victim of the need to trim expenditure, declining year-on-year by -4.9% in real terms.,*

Not only did home investment/upgrades suffer, but building of new homes has also been reduced greatly. From the peak of building completions at the end of 2005, square metres completed had dropped by -57.4% by the 2nd quarter of 2011.

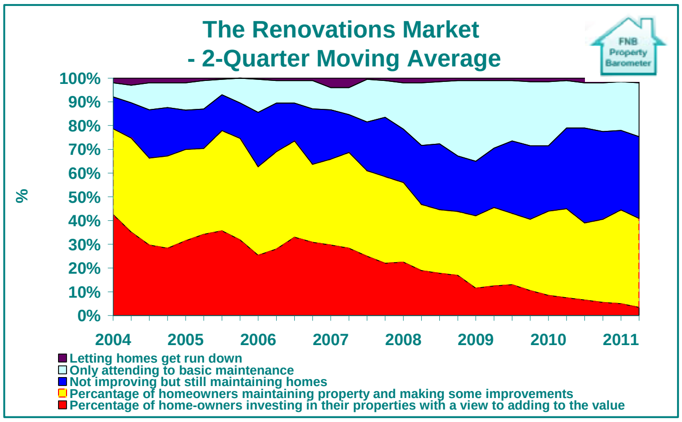
However, there is some sign of stabilization at these lower levels of building activity. In the 2nd quarter of 2011, square metres of residential buildings completed were only marginally down year-on-year by -3.2%, after far greater drops in earlier quarters. Interest rates remain low, existing residential demand has picked up since the lows of 2008/9, and one would expect building activity to respond positively to these events with a lag. However, we expect stabilization and very low growth in completions at best in 2012, as the household sector remains financially stressed, supply overhangs in many existing markets remain, and existing home bargains are still to be found. On top of this, estimated replacement costs of homes are on average 21.7 higher than existing home prices. Therefore, after a projected -0.8% slight decline for 2011 as a whole, we forecast a mild +2.4% growth rate in square metres of residential buildings completed for 2012 as a whole.

In addition, economic growth slowdown is at hand, and the risk of a 2nd global recession is significant. Under those conditions, we would expect any residential building sector growth to run out of steam towards the latter stage of 2012.

The relative bright spot is expected to be the Affordable Housing Market, which we think should be the key driver of any building activity growth that may take place, having been the least oversupplied market following the property boom.

2. FNB ESTATE AGENT SURVEY SUGGESTS FURTHER WEAKNESS IN "VALUE ADDING UPGRADES" TO HOMES

The FNB 2nd Quarter 2011 Estate Agent Survey points to estate agents perceiving further weakness in the level of "Value Adding Upgrades" to homes. In the survey, we ask the sample of agents to give a perception of the extent to which homeowners are investing in their homes, and provide them with 5 categories of investment. Using a 2-quarter moving average, the 2nd quarter points to an estimated 3.5% of homeowners estimated to be making "value adding" upgrades to their homes. This is the lowest percentage on record, and down from the previous quarter's 5 percent of total homeowners in the areas where surveyed agents operate.



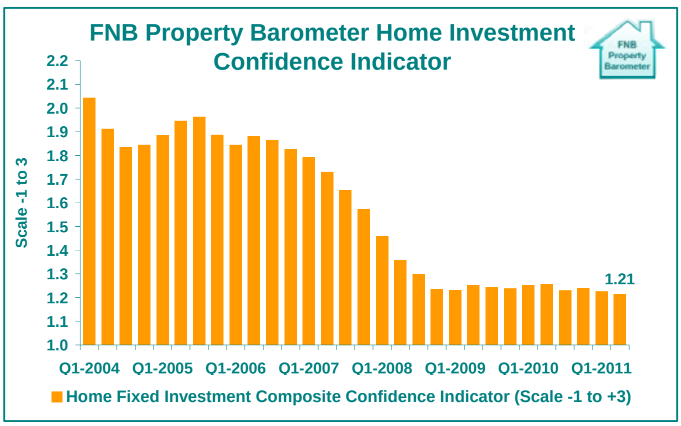
The 2nd category, namely the percentage of homeowners "maintaining their properties and making some improvements" declined from the previous quarter's 39.5% to 38% in the 2nd quarter.

When this line of survey questioning began in early-2004, these 2 top categories together accounted for an estimated 79.5% of homeowners while their total percentage is now 41.5%.

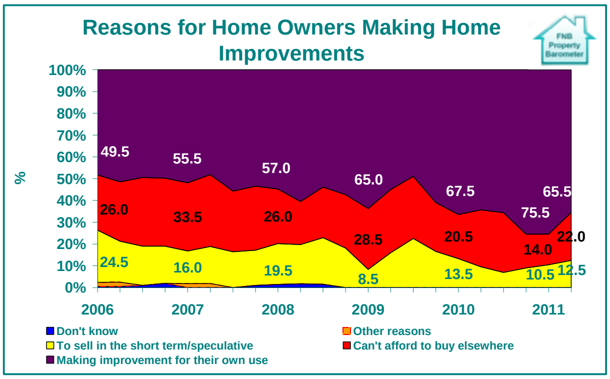
The 3rd category, namely "not improving but still fully maintaining their homes", accounts for 35%, slightly higher than the previous quarter's 33.5%, while there has been a rise in the percentage estimate for those "only attending to basic maintenance", from 20.5% in the 1st quarter to 23%. The small 5th category, namely those "letting their homes get run down", rose only slightly from 1.5% to 2%.

In order to sum up the overall shift between categories, we have compiled the Composite "Existing Home Investment Confidence Indicator". To compile it, we provide a value to each of the 5 categories of home investment with 3 being for value adding upgrades, 2 for full maintenance and some improvements, 1 for full maintenance but no improvement, 0 for only attending to basic maintenance, and -1 for letting home get run down. Each category's value is multiplied by its estimated percentage before all 5 are added together to form the index (scale of 3 to -1 and smoothed mildly with a Hodrick-Prescott function).

The accompanying graph shows a very slight decline in the Existing Home Investment Confidence Indicator, suggesting that on average the estate agent panel perceived a very slight deterioration in home investment compared with the 1.22 level of the previous quarter. The low level of the index remains a far cry from the level above 2 at the start of this survey in early-2004.



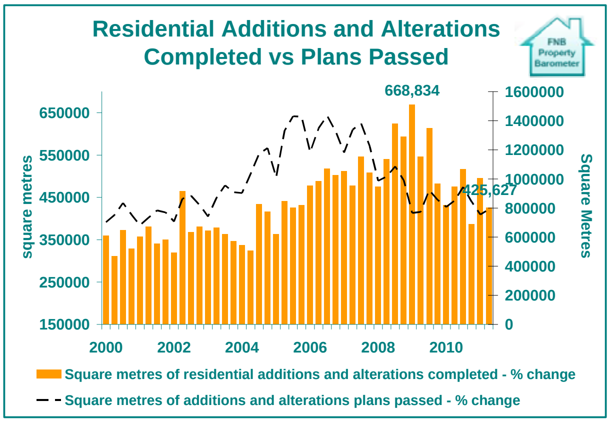
This weak state of existing home fixed investment is reflective, in the first instance, of the state of household sector finances. During tough economic and financial times, which have been in play since around 2007, households don't only cut back on non-essential expenditures as financial situations weaken. They also defer certain more essential expenditures such as full maintenance on homes (or even cars). The weak home investment situation is also to a lesser extent reflective of a lack of capital growth prospects



for property investors and speculators, who often buy homes in order to upgrade and sell at a profit. Indeed, the agents suggest that as at the 2nd quarter only 12.5% of a now small group of owners making improvements were believed to be doing this for short term speculative reasons, compared to 24.5% of a significantly larger group as at the beginning of 2006.

The weak home investment situation has implications for banks. In the current environment, certain properties prove to be poor security with which to back a home loan, partly due to a lack of overall market price growth (and sometimes property price declines), but also due to poor maintenance of properties.

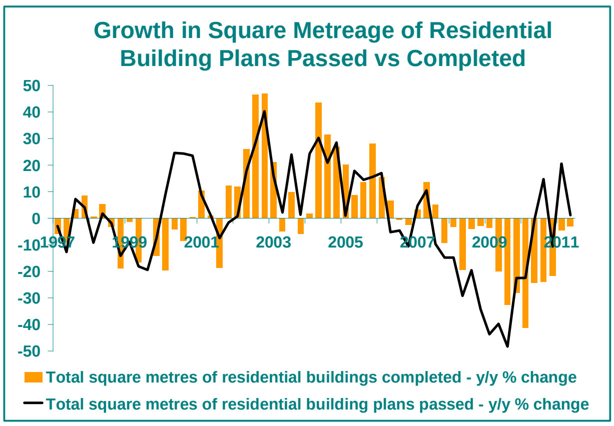
3. STATSSA BUILDING STATS PAINT A SIMILAR PICTURE, POINTING TO SIGNIFICANTLY LESS ADDITIONS AND ALTERATIONS TO HOMES COMPARED WITH A FEW YEARS AGO



2ND Quarter 2011 (June numbers being released yesterday) building statistics also point to relative weakness in the home additions and alterations market. Year-on-year, the square metreage of home additions and alterations reported as completed declined by -10.6%. This brings this building category to 425,627 square metres reported completed, which is 36.4% lower than the 668,834 square metre peak reached in the 1st quarter of 2009.

Square metres of Additions and alterations plans passed are now also well below peak levels. In the 3rd quarter of 2006 these peaked at 1.433 million square metres, and by the 2nd quarter of 2011 these had dropped -44.8% to 790,849 square metres.

4. NEW BUILDING ACTIVITY ALSO CONTINUES TO REFLECT HOUSEHOLD SECTOR FINANCIAL PRESSURE (AS WELL AS EXISTING HOME MARKETS BEING WELL-SUPPLIED)



The financial pressure on the household sector and resultant weak demand for new homes is also partly reflected in the statistics regarding the building of new homes, but supply overhangs, too, must be partly blamed for weak activity. In the 2ND Quarter, the square metreage of residential buildings completed declined year-on-year by -3.2%. While still negative, this smaller rate of decline, compared to -5% in the previous quarter, does suggest that after a sharp decline, the level of building activity is at least stabilizing.

Square metreage of plans passed, too, points towards stabilization, having risen year-on-year by a slight +1.2%, the 2nd consecutive quarter of positive growth.

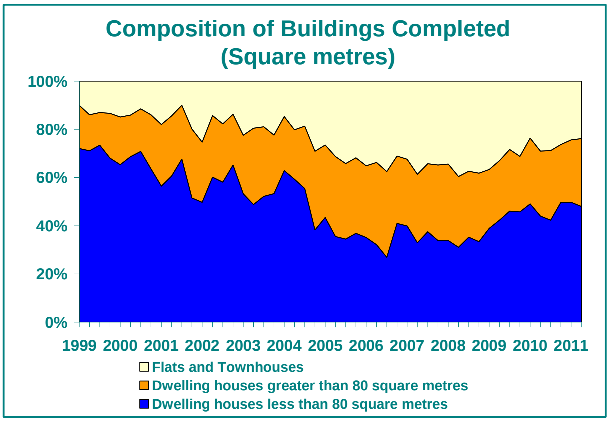
Square metres of plans completed are, however, -57.4% lower than the peak level reached in the final quarter of 2005.

*By comparison, measured in **number** of residential units completed, there was slight year-on-year growth of +0.8% in the 2nd quarter. Positive growth in number of units versus negative growth in square metreage completed implies a **relative shift to smaller size units**. And indeed, breaking up building completions into the 3 categories specified by*

StatsSA, we see the fastest growth in completions of +9.9% year-on-year in the size category "dwelling houses smaller than 80 square metres, +5.1% in the category "dwelling houses larger than 80 square metres, and -17.2% decline in the category "Flats and Townhouses".

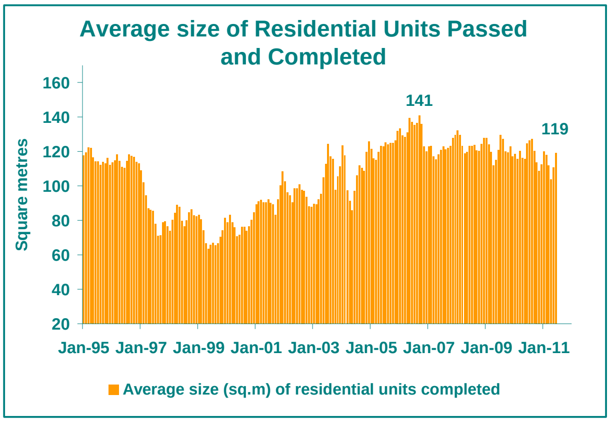
The relative performances in the 3 building categories were also largely expected, as we believe that it is the lower income "affordable" housing segment which should see superior growth to the others, and that this segment is driving building activity growth in the two "dwelling houses" categories, especially the "smaller than 80 square metre" category.

The relative weakness of the "flats and townhouses" category also comes as no surprise. Especially the sectional title component of the suburban markets was arguably the most oversupplied after the residential and building boom, resulting in the slowest building growth in the "flats and townhouses" category through 2010 and 2011.



The relative adjustment in composition of building activity has been taking place gradually since around 2009, from when the "flats and townhouses" segment's share of total building completions declined from 38.2% in the final quarter of 2008 to 23.8% by the 2nd quarter of 2011.

Over the same period, the share of "dwelling houses (free standing houses) less than 80 square metres in size" increased their share from 33.4% to 48% of total completions, probably reflective of the ongoing affordable housing drive. The "dwelling houses larger than 80 square metres" category showed the most stable relative performance of the 3 categories in recent years, with its share of the building activity at 28.2% in the 2nd quarter of 2011 virtually unchanged from the 28.4% at the end of 2008.

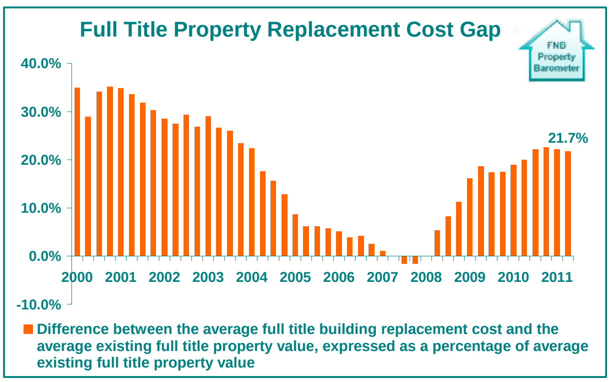


The net result of these relative shifts in activity has been a gradual decline in the average size of homes being built over the last few years, a reflection of a broad household sector affordability drive.

From a peak size of 141 square metres in September 2006, the average size of homes completed has declined to 119 square metres as at June 2011.

This average size, however, still remains significantly larger than the low point of 63.4 square metres reached in May 2009,

5. THE COMBINATION OF A WIDE REPLACEMENT COST GAP AND WEAK HOUSEHOLD SECTOR FINANCES SHOULD LEAD TO A CONTINUATION OF THE DECLINE IN AVERAGE SIZE OF HOMES COMPLETED



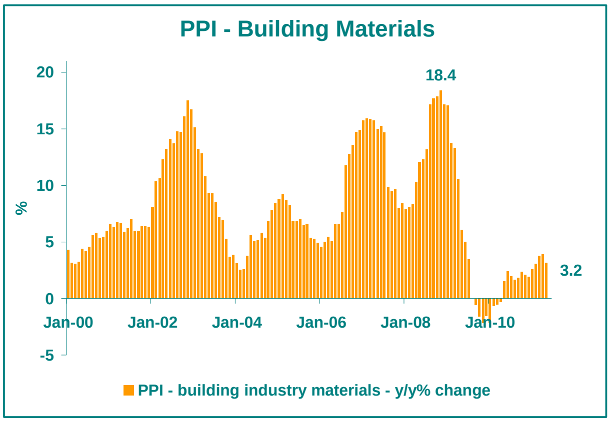
Building costs continue to remain a key challenge for the industry in its bid to bring more stock to the markets. While these do not appear to have risen much in recent years, they are competing against soft price levels in the existing home market. This is reflected in our Full Title Replacement Cost Gap which was estimated at 21.7% as at the 2nd quarter of 2011. The gap represents the difference between the average replacement cost of full title buildings valued by FNB valuers and the price of the existing homes, expressed as a percentage of the average existing home value.

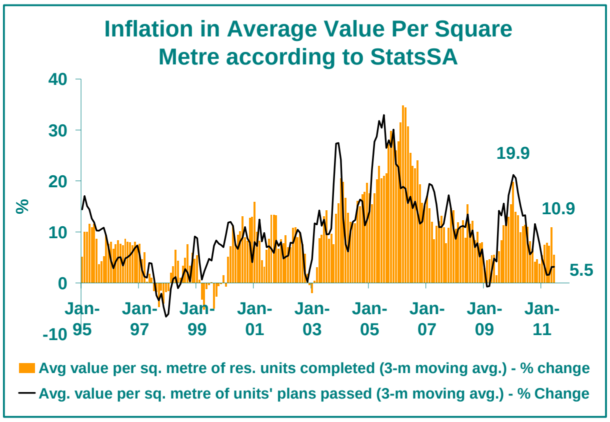
Whilst it is normal to have this significant replacement gap most of the time, it implies weak building activity in weak economic and financial times, because many households are more focused on cost control, and existing homes offer the opportunity for that.

The lack of a gap in 2007, brought about by rampant existing home price growth in the few years prior to that, enabled the development sector to easily supply competitively priced new homes to the market, and an oversupply was arguably created as a result. That situation is currently being reversed, which is tough for the development sector but good from a market balance and ultimately from a market performance point of view.

Nevertheless, we have seen the replacement cost gap just narrowing very slightly in recent quarters, from a peak of 22.6% in the final quarter of 2010 to its 2nd quarter 21.7%. Some further narrowing of the gap in the coming quarters is expected, in response to what are now seemingly very stagnant building input costs.

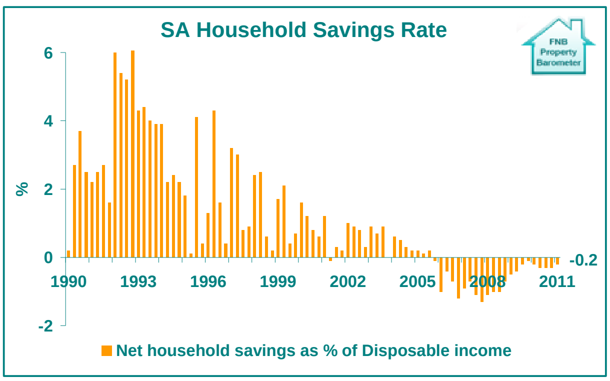
Using the Producer Price Index for Building Materials, one sees a meager 3.2% year-on-year inflation rate. Simultaneously, the StatsSA building stats tell us that the average per square metre value of residential buildings completed rose by a lowly 5.5% year-on-year in the 2nd quarter of 2011, well down from the 10.9% growth for the 3 months to May. The residential development sector thus appears to be raising costs slowly. However, in these weak household financial times, some cost declines are arguably needed to spur volumes in the building sector in the absence of any significant price growth in the existing home market.



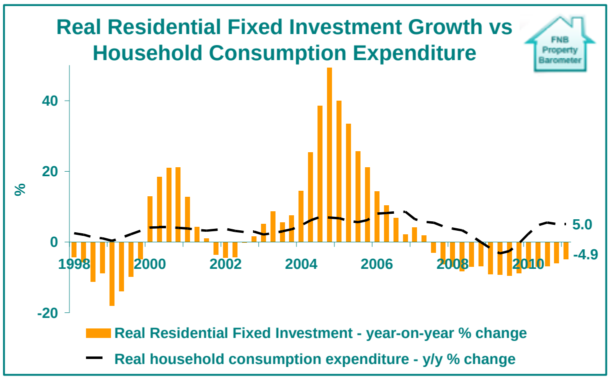


6. THE COMBINATION OF SLOW HOUSEHOLD INCOME GROWTH, HIGH LEVELS OF INDEBTEDNESS, AND THE PRIORITY GIVEN TO CONSUMPTION, IS KEY IN CURBING RESIDENTIAL FIXED INVESTMENT

While some would be quick to blame either weak income growth in a weak economy, or alternatively the banks for not lending, the truth is somewhat more complex. Much has to do with SA households' obsession with consumption and very poor savings culture. When tougher economic and financial times come, as they have for many from 2008 onward, attempts to sustain the lifestyle through consumption continue, savings remains weak, and fixed investment expenditure suffers most. This is clear from SARB savings and expenditure statistics as well as from our Estate Agent Survey which shows how home fixed investment has gone backwards according to agents.

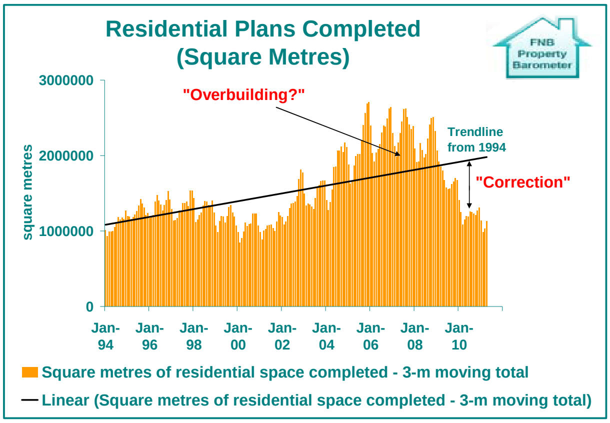


So, as at the 1st quarter of 2011, SARB household statistics showed SA remaining in net dis-saving to the tune of -0.2% of disposable income. This implies that what little gross saving takes place is insufficient to cover the depreciation on fixed assets owned by the household sector, so it comes as little surprise that agents see home maintenance and investment levels so weak.



The accompanying graph shows real year-on-year growth in household sector consumption expenditure at 5% in the 1st quarter of 2011, exceeding the real disposable income growth rate of 4.9%. Yes, what gets earned must virtually all be spent. How does residential fixed investment then take place? To a large extent through borrowing, but this option is currently almost as unattractive as saving, because banks are more conservative these days, and many households are highly indebted already. So, real residential fixed investment estimates by the SARB continue to show year-on-year decline which measured -4.9% as at the 1st quarter of 2011.

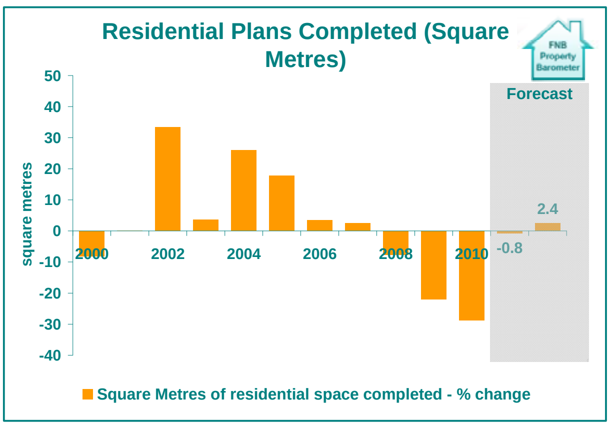
7. OUTLOOK – THE "CORRECTION" AFTER THE "OVER-BUILDING" PERIOD IS EXPECTED TO CONTINUE, LEAVING BUILDING ACTIVITY TO GROW VERY SLOWLY AT BEST IN 2011/2012



To put things in perspective, the levels of reported building activity as per StatsSA have not ground to an absolute halt. Rather, the level of completions has sunk back to a level very similar to those around 2000/01 prior to the massive building boom. Admittedly, one would think that building activity today should be somewhat higher than a decade ago, because the economy is considerably bigger, and real household disposable income considerably higher, than early last decade. However, given the magnitude of the 2002-2008 building boom, current slow economic growth, and our perception that there was a considerable level of "over-building", it is arguably appropriate that new completions go relatively slow for some years until the demand-supply balance in the residential market is healthy again.

The strong supply relative to demand in the existing market looks set to continue to suppress existing house prices for the foreseeable future, and, indeed, in 2012 we are not expecting any growth in house prices for the year as a whole.

Therefore, closing the replacement cost gap will be slow going at best, and improvements in the development sector's ability to bring competitively-priced new stock to the market will thus be mild at best.



The result of this mild improvement, along with a lagged response to significantly lower interest rates since 2009, is expected to bring about a very slight improvement in 2012 to the tune of +2.4% growth in the number of square metres of residential buildings completed. This is after a very slight projected decline of -0.8% for 2011 as a whole. However, it is not expected to be the start of any significant acceleration yet, because the housing market looks set to have to contend with a slowing economy, with the risk of a global recession being high,

Of the 3 building categories, more of the same is expected in terms the relative performances through 2012. Completions of "Dwelling houses smaller than 80 square metres" are expected to be above the average completion growth rate, "dwelling houses larger than 80 square metres around the average, and "flats and townhouses below the average.