The South Africa Q2 Real Estate Market

Johannesburg

City overview

The City of Johannesburg is South Africa's largest metropolitan by population size and GDP. The metropolitan hosts 5.8 [1] million residents and contributes 16% of the national economy. The city is additionally home to Africa's largest stock exchange market – The Johannesburg Stock Exchange (JSE). Johannesburg is characterized by various decentralized economic nodes – the most prominent being Rosebank, Waterfall and Sandton. The city is known for its robust finance, real estate and business services sectors. These sectors contribute 27% of the city's total GDP [2]. Subsequently, the city is known for having some of the highest quality office spaces in the country. Other important industries include manufacturing, transport and logistics, which collectively contribute 36% [2] towards the city's economy. Steady growth in the transport and logistics segments over the past decade has driven demand for quality industrial space across various nodes. In addition to being a national economic hub, Johannesburg is renowned for having some of the country's best higher education institutions. This has been a significant attraction feature driving inter-city migration.

[1] Source: Macro Trends, 2020 [2] Source: Oxford Economics, 2020

Office

10.4million [3]
Estimated stock

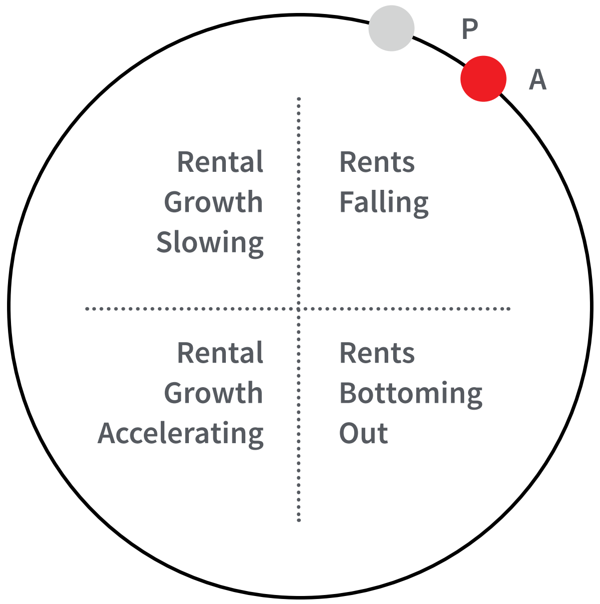
8%-8.5%
Prime yields

14.1% [3]
Vacancy rate

P = 2.1% A = -6.7% [3]
B = -0.8% C = -0.9%
Annualised rental growth

R195 - R245
Prime rent

Negative, cyclical downturn
Rental outlook



The property clock is a graphical tool developed by JLL to illustrate where a market sits within its individual rental cycle at a point in time. These positions are not necessarily representative of investment or development market prospects. It is important to recognize that markets move at different speeds depending on their maturity, size and economic conditions. Markets will not always move in a clockwise direction, they might move backwards or remain at the same point in their cycle for extended periods.

[3] Source: SAPOA, 2020

Industrial

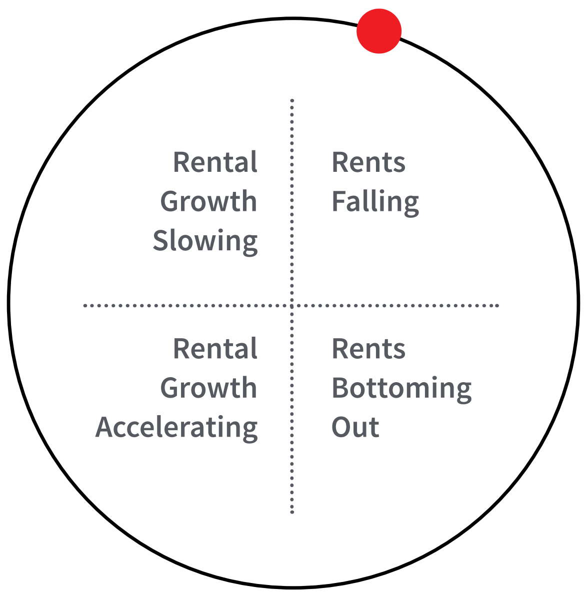
48.7m [4]
Estimated stock

7.25%-8%
Prime yields

5%-7%
Vacancy rate

R70 - R80
Prime rent

Negative, cyclical downturn ▼
Rental outlook



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[4] *Source: Comparative Market Analytics; JLL*

Hotels

34% [5]
Occupancy

R803 [5]
ADR

R264 [5]
RevPAR

[5] *Source: STR Reports, May 2020*

Office

Overview

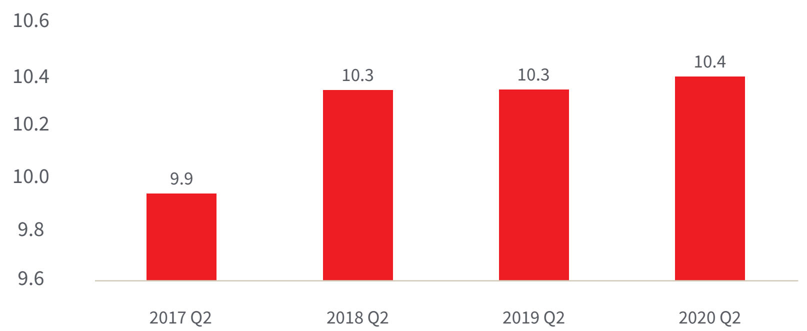
Johannesburg continues to struggle with an oversupplied office market plagued with rising vacancy rates. This has been accelerated by many businesses being forced to either close shop or scale down as a result of the nation-wide lockdown. As movement and trade restrictions ease however, many corporates are opting for employees to continue working from home. This backdrop has caused great uncertainty between developers and landlords in the office market, resulting in current projects being put on hold and pipeline projects being deferred. As new developments eventually come to market, the risk of unoccupied buildings placing further pressure on rental growth remains imminent. Rosebank, Waterfall and Sandton are particularly at risk, with the highest development activity. Over the short to medium term, it is expected that speculative office development will dampen, whilst tenant-driven, pre-let structured developments will become more prominent.

Supply

The Johannesburg office market has maintained strong developer confidence over the past 4-years, with some of the highest quality and volume of stock in the country. Currently, the metropolitan has approximately 10.4 million square meters of office stock, growing at an annualized rate of 0.8%.

Although limited new office space will be developed over the remainder of the financial year, total stock is expected to rise by 32,800 sqm, when the likes of Intaprop's "Oxford Park" and Attacq's "Corporate Campus" come to market. Developments are primarily tenant driven, with no emerging speculative schemes to speak of.

City of Johannesburg: total office stock, 2017 - 2020

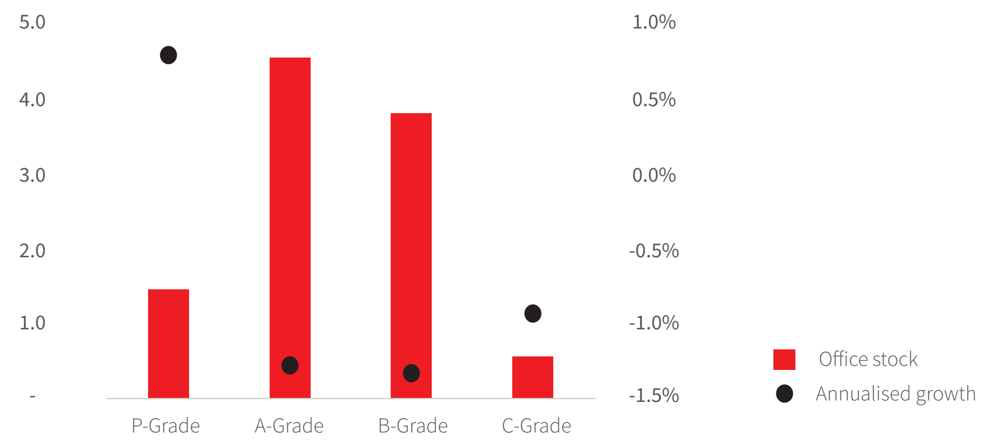


Source: SAPOA, 2020

Development activity is concentrated in Rosebank, Waterfall, Sandton and Midrand. Current developments in these nodes collectively contribute 69% of the country's total development activity (SAPOA, 2020).

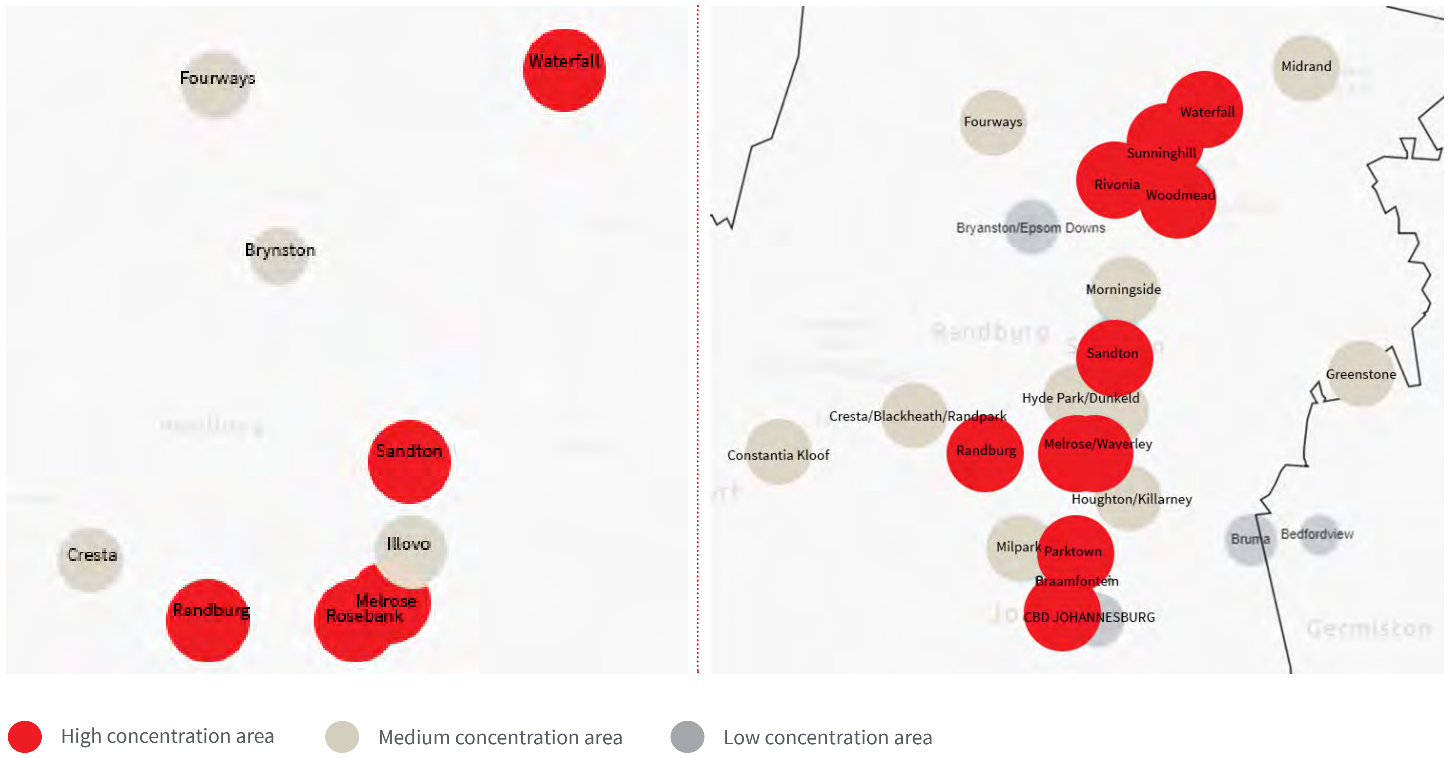
Johannesburg is dominated by A and B-grade office space, making up 80% of the city's total office stock. These spaces remain under pressure however, as office-to-residential conversions, GLA adjustments and building reclassifications/ downgrading continue to take place. This is one of the primary causes of annual stock contractions. C-grade office stock subsequently shows positive annual growth as a result of these reclassifications/downgrades.

City of Johannesburg: office stock by grade and annualised change, 2020 Q2



Source: SAPOA, 2020

P-grade office space concentration / A-grade office space concentration



Source: SAPOA, 2020; MapIT, 2020; JLL ,2020.

Source: SAPOA, 2020; MapIT, 2020; JLL ,2020.

Prime office space is largely clustered in the Waterfall, Sandton and Melrose/ Rosebank nodes as reflected in the stock concentration maps. Total prime stock summates to 1.4 million square meters.

Approximately 4.4 million square meters of A-grade office stock can be found across the metropolitan. These spaces are far more evenly spread across the city, ranging from the northern suburbs of Midrand and Fourways, down to the southern suburbs of Milpark/Parktown and Johannesburg CBD.

Supply

Currently there is very little growth potential in the market, with businesses unlikely to expand their physical footprint in the short to medium term. Consequently, speculative developments and tenant requests for expansion fit-outs are unlikely to occur. Many pipeline developments are being put on hold as a result of subdued demand, as high volumes of available space remain on the market. Much of the available stock comes from new buildings which were completed in Q3/Q4 of 2019. Furthermore, many big corporates are reconfiguring their workspace models, opting to scale down on footprint and space requirements. Consequently, businesses are anticipated to start selling portions of their portfolios in a drive to streamline and save costs.

Calls for a rotational staffing model whereby employees alternate working from home and the office is likely to take place. It is anticipated that the demand for traditional office space will contract by up to 20% over the long-run, as businesses employ a combination of work-from-home, flexi-space and traditional office in their business models. Whilst the cost saving benefits associated with working from home are evident, the unique energy utility constraints faced in South Africa poses a huge risk to businesses. The advantage of corporate office spaces being equipped with the necessary infrastructure to ensure business continuity remains critical.
Prolonged energy constraints could see businesses being forced to migrate back from home-based operations to traditional office spaces.

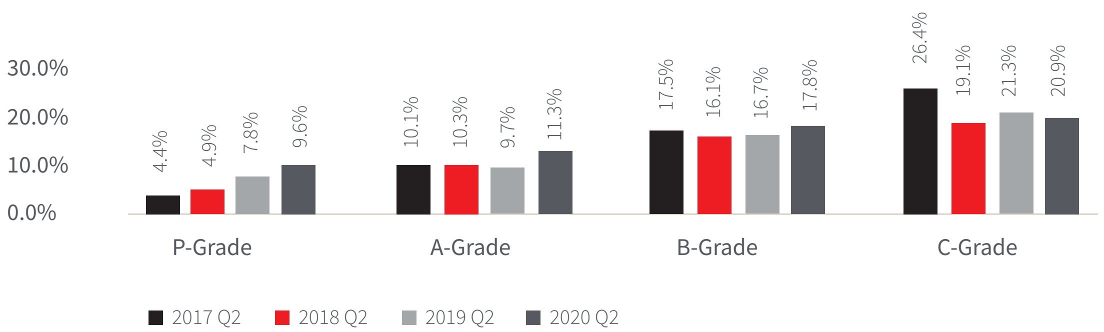
Peformance

Performance of Johannesburg's office sector is set to continue softening over the medium term, with an over-supply of stock accompanied by a weak business environment. This places pressure on vacancy rates and rentals. These challenges are not unique to Johannesburg, as the impact of the nationwide lockdown has been largely felt throughout corporate South Africa. Johannesburg's aggregate vacancy levels stand at 14.1%, with P-grade vacancies at 9.6% (SAPOA, 2020). Prime space vacancies experienced a 23% increase from the previous year's equivalent period.

Simultaneous building completions within a weak commercial environment is one of the key factors causing supply of prime stock to outstrip demand. Vacancy rates in key nodes like Sandton, Rosebank, Sunninghill, Illovo and Midrand remain close to multi-year highs (SAPOA, 2020). In contrast to prime, A and B-grade vacancy trends, C-grade office space experiences a marginal annual decline. This is a result of mixed-use residential conversions and GLA adjustments taking place in the market (reducing underutilized stock).

Johannesburg's rising vacancy trend is likely to continue over the medium term, as new office stock comes to market. Vacancy escalations will likely accelerate as corporates focus on scaling down and streamlining their workspace requirements. In response to this challenge, many landlords have started negotiating lease periods as short as 18 months to assist tenants in balancing risk. Interestingly, these deals are being made at discounted rental rates.

City of Johannesburg: vacancy rate by grade, 2017-2020



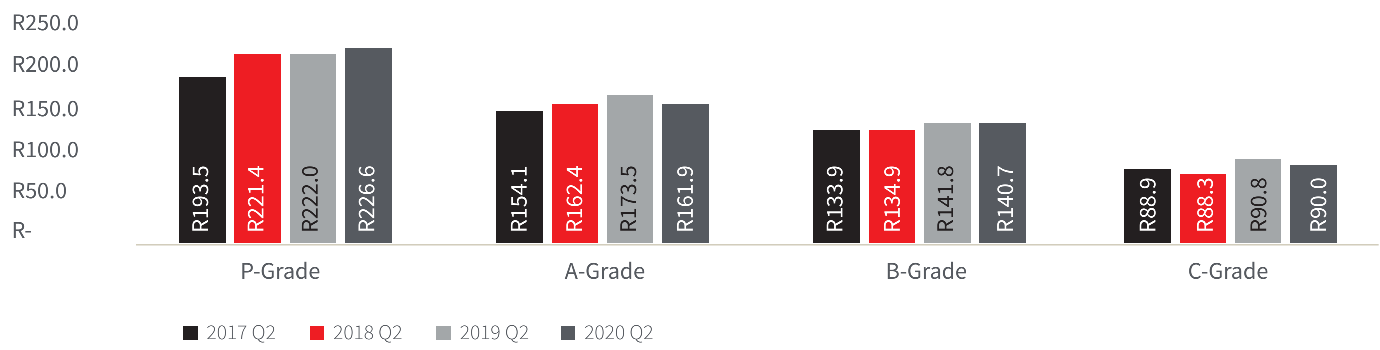
Source: SAPOA, 2020.

The months of April and May saw landlords receiving as little as 40%-50% of their rent. This was driven by the nation-wide lockdown, restricting trade and forcing many corporates to close their operations. To assist corporates in reentering the market, landlords have started offering rental relief packages to help businesses stay afloat.

Some of these relief packages include rental deferrals, discounts and holidays. Although these packages will likely improve tenant retention, rental escalations are expected to come under severe pressure over the short to medium term.

Average gross asking rentals have continued to move sideways over the past four years, with annual growth well below inflation levels. To date, P-Grade office space is the only segment which reflects positive annual growth (2.1%) in gross asking rentals, averaging R226.6/sqm. A-grade rentals have experienced the most pressure, declining by 6.7% to R161.9/sqm. This can be attributed to a spike in supply along with dampening corporate demand, as tenants move to higher quality spaces whilst older prime space is downgraded. This trend will be exacerbated by businesses streamlining space requirements, driving up supply of leasable space and curbing demand. Whilst prime space is expected to show the highest rental growth resilience, negative corrections can be expected across all other segments over the medium term.

City of Johannesburg: average gross asking rental by grade, 2017-2020

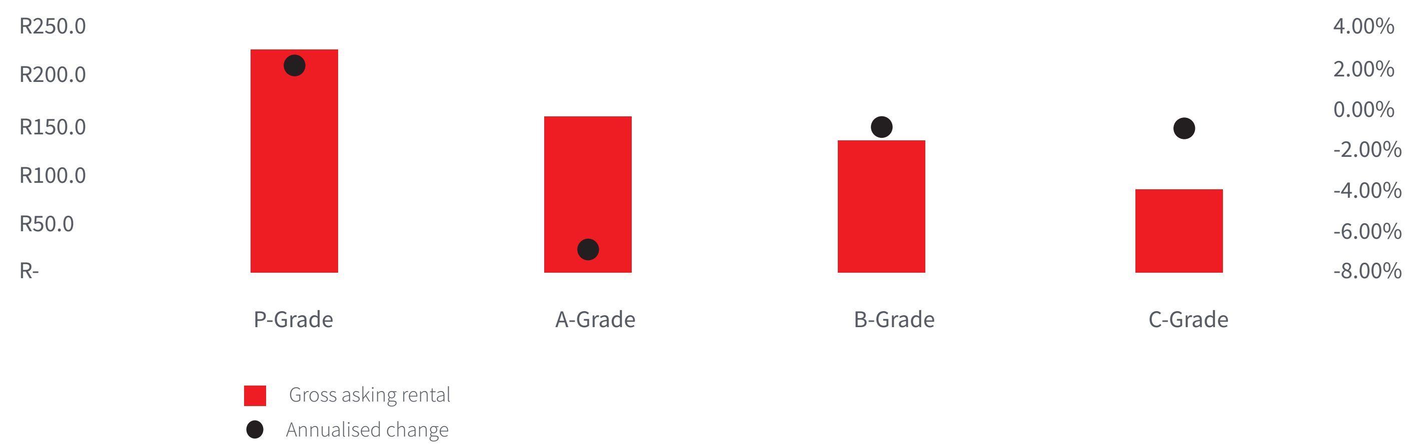


Source: SAPOA, 2020.

Outlook

In summary, the commercial market is weak, and will remain tenant driven over the next 18-24 months. Rentals will stay under pressure, as vacancies rise and demand for traditional office space contracts over the short to medium term. Landlords will be driven by tenant retention strategies, looking at structuring deals and incentives to accommodate unique business circumstances. As a result, there will be growing pressure on rental growth. Many businesses will reconfigure their workspace requirements model, incorporating a combination of traditional office, flex space and home-based setups.

City of Johannesburg: average gross asking rental by grade & annual change, 2020 Q2



Source: SAPOA, 2020.

Industrial

Overview

Industrial rentals and vacancies are strongly linked to the performance of the manufacturing and retail sectors (Rode, 2020). South Africa's manufacturing sector however, has fallen under severe strain over the last 24-months. This is a result of weak local and global demand, national power utility constraints, and most recently, a 5-week nationwide lock-down. This has placed increased pressure on manufacturing spaces, resulting in slowed rental growth and escalated vacancy rates. Historically one of the best performing market segments in the industrial landscape, manufacturing spaces will likely see vacancy rates moving towards the 2% mark over the medium term.

In contrast, sentiment towards retail and supply chain driven warehousing and logistics spaces maintain a positive outlook moving into the second half of 2020. With that said, the logistics and warehousing segment has not been immune to the effects of the global pandemic. Historical prioritization of minimizing costs, optimizing supply chains and enhancing asset utilization has limited the degree to which businesses are able to absorb and adjust to market disruptions. The effects that Covid-19 has had on local and global supply chains reveals these vulnerabilities. In response, businesses throughout the supply chain industry are moving towards diversifying their supplier portfolios, mitigating future risk and price dominance in the sector. The use of data analytics, machine learning and block chain technology have become critical cost reduction and security tools used throughout the supply chain environment. This comes off local and global drives to digitalize the industrial space.

Supply

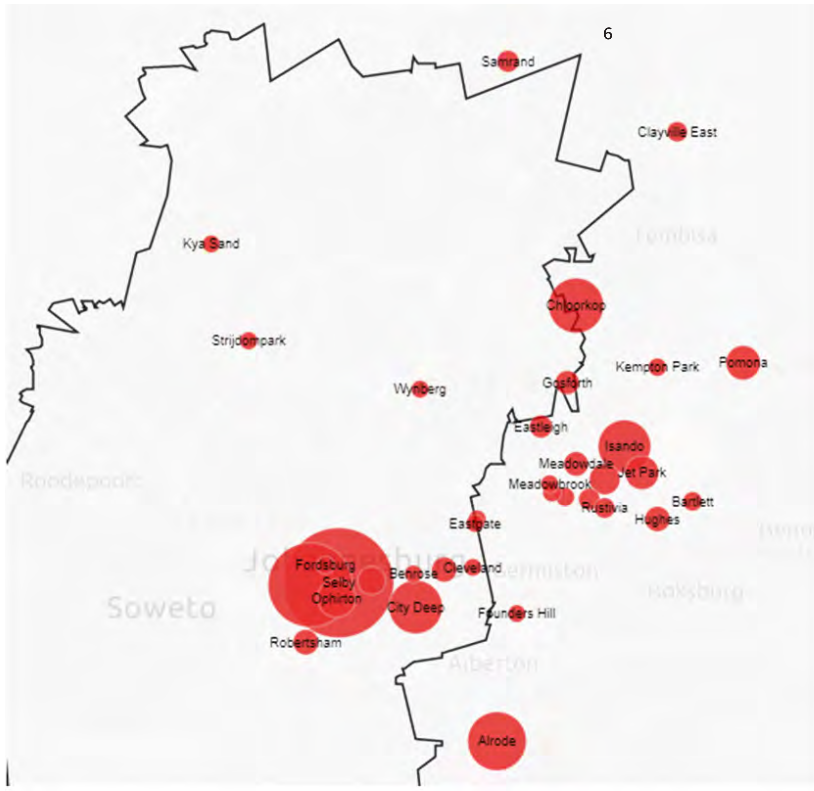
Demand for logistics space in Johannesburg has remained resilient, as its e-commerce consumer base steadily grows year-on-year. Accordingly, there is a greater requirement for quality logistics space with emphasize on stock-holding requirements. Covid-19 has shifted the focus of businesses and institutions on future proofing in anticipation for potential shortages in stock. We anticipate a drive towards on-shoring products, ensuring a reliable supply chain of goods locally. Currently, Johannesburg holds large tracts of developable land, however increasing vacancies and slowing rental growth erodes the viability of these industrial blocks being developed.

Johannesburg's total industrial stock is estimated at 48.5 million sqm (Comparative Market Analytics, 2020; JLL, 2020). The metropolitan's manu-facturing industrial stock is primarily clustered around the center of Johannesburg, specifically Selby, Crown Mine and City Deep. Other notable manufacturing industrial nodes east of Johannesburg include Alrode, Isando and Chloorkop. Warehousing and logistics spaces on the other hand, are predominantly clustered in the Midrand, Limbro, Germiston and Kempton Park industrial nodes. Industrial stock concentration by segment is reflected in the figure on the next page[6]:

Logistics stock concentration

Source: CMA, 2020; MapIT, 2020; JLL ,2020.

Manufacturing stock concentration



Source: CMA, 2020; MapIT, 2020; JLL ,2020.

[6] *Manufacturing and logistics clusters reflect the large majority of nodes but do not account for all industrial zoned land parcels. Furthermore, illustrated clusters may include any combination of the following: 1) developed land, occupied or unoccupied; and 2) tenant driven, undeveloped land (industrial zoned land planned for development).*

Peformance

The modern logistics space remains the preferred property asset class for listed property funds such as Fortress and Equites. This segment of the industrial sector has been protected to some degree against the impact of Covid-19. Specifically, retail-driven e-commerce growth and the added pressure of fast-moving consumer goods (FMCG) supply chain requirements, have sustained demand for logistics spaces.

Whilst more traditional manufacturing industrial spaces will typically achieve yields in the region of 9%, high-tech modern logistics spaces meeting global standards will likely achieve yields of 7.25%-7.75% (depending on the covenant of the occupier). The average gross asking rental range for multi-tenant industrial blocks in Johannesburg currently ranges between R70-R80/m2. Traditional industrial manufacturing space continues to experience the lowest vacancy rates, ranging from 1.6% - 2%. These spaces have seen annualized rental growth declining to levels below 5%. Industrial warehousing and logistics spaces have shown a spike in national vacancy levels, increasing from 3.0% at the end of 2018 to 5.1% by the end of 2019 (SAPOA, 2020). Johannesburg industrial spaces have shown similar performance trends, with average vacancy levels in the logistics and warehousing space ranging between 5% - 7%.

Outlook

At this point, the market remains tenant orientated. Landlords are having to become more flexible and aggressive with their industrial lease and transactional offers. In certain instances, tenant relief packages in the form of rental deferrals, tenant installation allowances, reduced escalation rates and rent deductions are being offered. The stand out performers in the industrial market remain the bespoke logistics centers. These facilities are being built to much greater heights, allowing for improved stock volumes. Businesses may seek to diversify their supplier portfolios, increasing both the demand for space and price competitiveness in the market.

It is anticipated that price corrections will take place across all industrial segments. Smaller, speculative spaces will see rises in vacancies, whilst larger blocks will seek to consolidate and improve operational efficiency. There is however, great opportunity for new-generation warehousing and distributions spaces. This will be driven by the anticipated increase in suppliers operating within the market, where outdated current industrial stock may require upgrading to meet new specifications.

Hotels

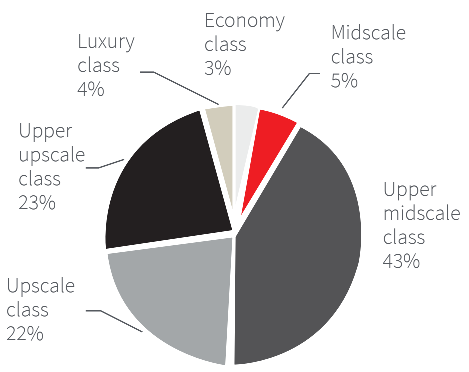
Overview

Johannesburg is a mature hotel market in a regional context, dominated by the presence of local owner operators, who appeal to domestic corporate demand. However, the market is increasingly attractive interest from international operators, buoyed by their desire to grow a regional portfolio. As at December 2019, Sandton and Surrounds[7] had 10,500 keys, of which the majority (43%) are categorized as Upper Midscale Class.

In Q1 2020, two hotels with a total of 390 keys entered the market. These openings were the Johannesburg Marriott Hotel Melrose Arch (123) and the MEA Johannesburg Melrose Arch. Hotels have only recently received the green light to resume trading, for domestic business demand.

While this represents the majority of demand for a market like Johannesburg, the recovery is expected to be slow and last well into 2021. Travel for business is expected to be non-discretionary, and hotel operators are cautiously considering their own re-opening timeline from a demand perspective, despite regulation no longer being the determining factor. Despite this backdrop, multiple hotel groups have continued to operate during lockdown levels in line with essential service provisions and this has served as valuable respite for the sector.

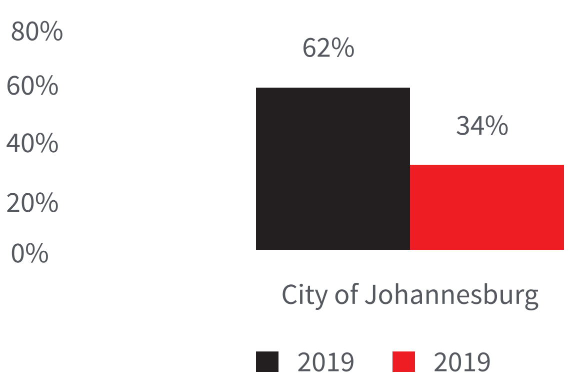
Sandton & surrounds supply by segment (2019)

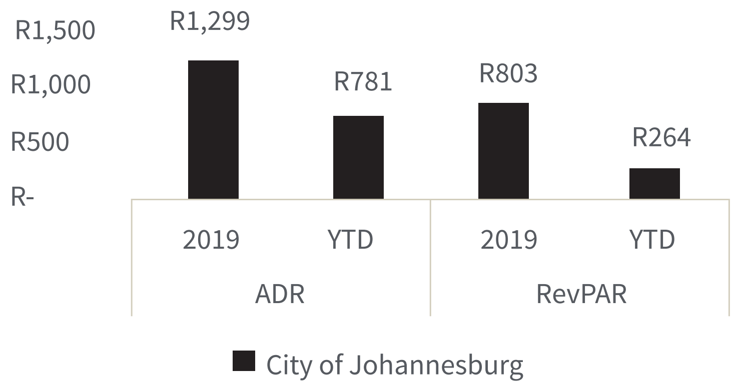


Peformance

Hotel occupancy levels in the City of Johannesburg reached levels of 34% by the end of June 2020. This equates to an annualized contraction of 45%, declining from 62% in May 2019. Average daily rate (ADR) and revenue per available room (RevPAR) experienced similar pressure, respectively declining by 40% and 67% over the same period.

COJ occupancy comparison / COJ ADR & RevPAR comparison: YTD





Source: STR May Reports, 2020.

[7] *Sandton and surrounds representative of the major hotel stock in Johannesburg.*

Contact us

JLL Sub-Saharan Africa
Johannesburg

3rd Floor, The Firs
Cnr Biermann & Cradock Ave
Rosebank, South Africa, 2196
Phone: +27 11 507 2200

With other regional offices in Dubai, Abu Dhabi, Riyadh, Jeddah, Al Khobar, Cairo, and Casablanca

Michael Scott
Analyst: Research
JLL Sub-Saharan Africa
+27 11 507 2200
michaelc.scott@eu.jll.com

www.jll.co.za

Associate Contact Details:

Ian Lambie

ian@lambiespark.co.za

Mike Spark

mike@lambiespark.co.za

www.lambiespark.co.za

JLL