TPN Lockdown Edition Commercial Rental Monitor

Sharp drop in commercial tenant performance

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Commercial tenant payment performance dropped sharply in the 2nd quarter of 2020 with retail tenants being the most under pressure of the 3 commercial property sectors.

Not surprisingly, the "COVID-19 lockdown period" brought a dramatic weakening in commercial tenant payment performance in the 2nd quarter 2020, following a far more gradual decline in prior quarters. From 77.85% in the 1st quarter of 2020, the percentage of tenants in good standing dropped to 50.36% in the 2nd quarter.

Preliminary monthly tenant payment performance data up to July showed a partial recovery starting in June and July on the back of the easing of lockdown levels. More noticeable improvements have been seen to date in the Office and Industrial Property Segments, while the beleaguered Retail Property Sector appears to be battling.

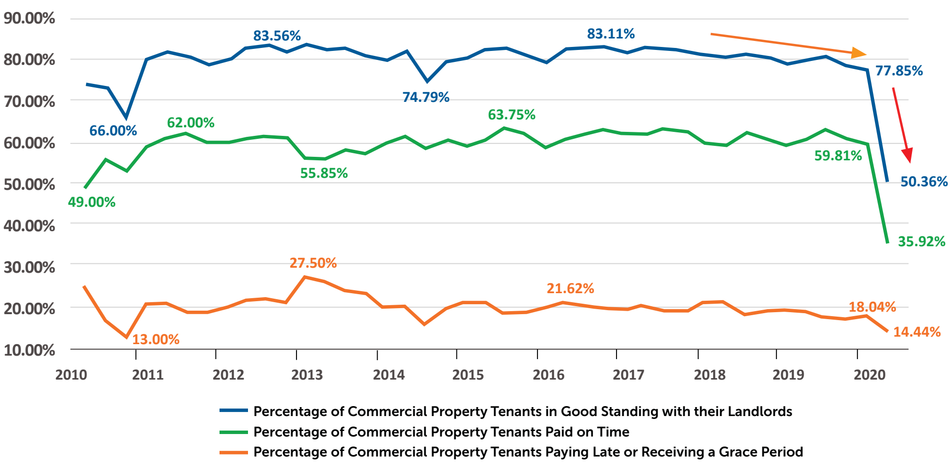
The Retail Property Sector's tenant population has been the most severely impacted during the 2nd quarter lockdown period.

While all 3 major provinces saw sharp drops in tenant payment performance, the Western Cape maintained its superior tenant performance relative to Gauteng and KZN, Gauteng showing the weakest performance of the 3 regions.

Lockdown takes a massive toll on commercial tenant population

In the 2nd Quarter of 2020, the quarter in which the "hard" COVID-19 Crisis-related "lockdown" largely played itself out, the forced shut down in both economic activity and of incomes exacted a massive toll on the commercial property tenant population.

PERCENTAGE OF COMMERCIAL TENANTS IN GOOD STANDING WITH LANDLORDS



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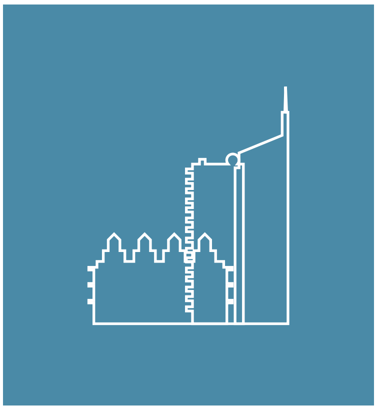
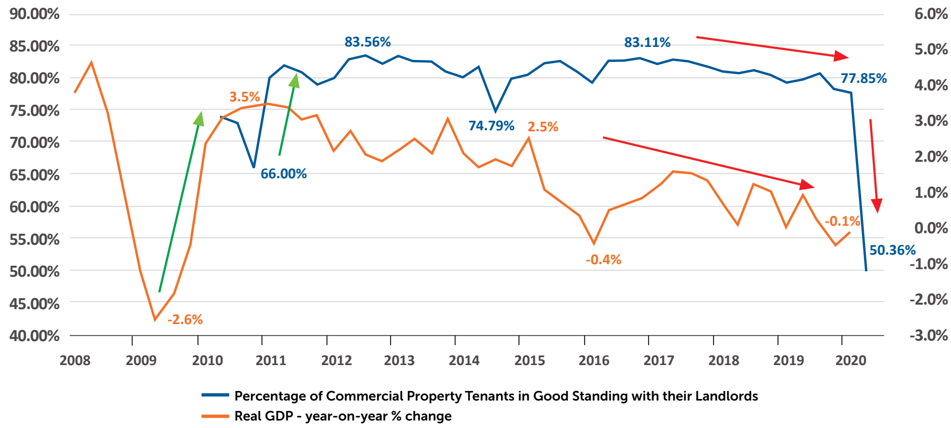


The percentage of total tenants that are in good standing with their landlords with regards rental payments (i.e. either they are fully paid up, paid late or in a grace period) dropped sharply, from 77.85% in the 1st quarter of 2020 to a record low of 50.36% in the 2nd quarter.

Tenant performance is strongly linked to economic growth, as measured by GDP (Gross Domestic Product), which the SARB's forecasters believe probably declined by around -40.1% on a quarter-on-quarter annualised basis.

PERCENTAGE OF COMMERCIAL TENANTS IN GOOD STANDING WITH LANDLORDS vs GDP GROWTH

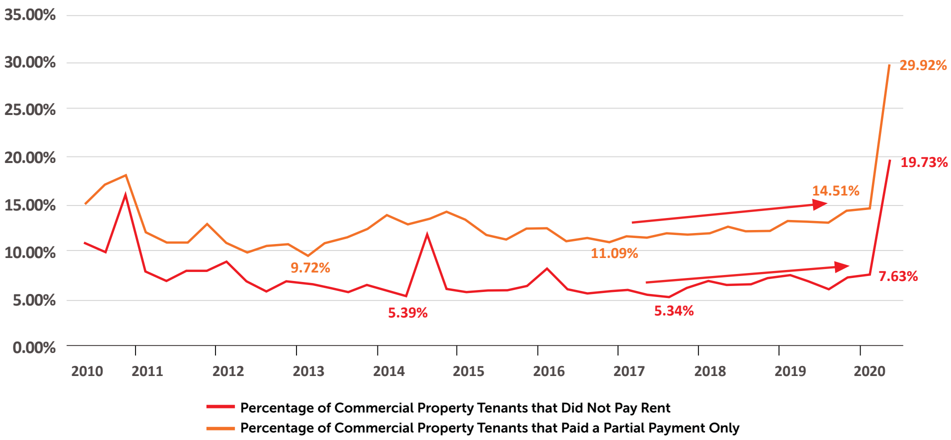


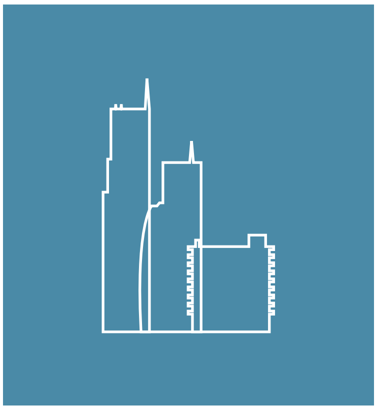
This 2nd quarter drop comes after the percentage of tenants in good standing had already been gradually declining, from an 83.11% multi-year high back in 2016 to 77.85% by the 1st quarter of 2020, on the back of South Africa's gradual long term economic growth stagnation that started back in 2012.

From a post-GFC (Global Financial Crisis) high of 3.5% year-on-year in the 1st quarter of 2011, GDP growth had gradually wound its way lower to a -0.1% contraction by the 1st quarter of 2020, the 2nd consecutive quarter of year-on-year contraction just prior to the "lockdown" quarter.

This means that aside from the fact that the percentage of tenants in good standing had already weakened before lockdown, many others would have gone into the lockdown period on a fragile financial footing due to the long preceding period of economic weakness resulting in limited financial buffers with which to weather the lockdown storm.

PERCENTAGE OF COMMERCIAL TENANTS THAT DID NOT PAY RENT OR ONLY PAID IN PART





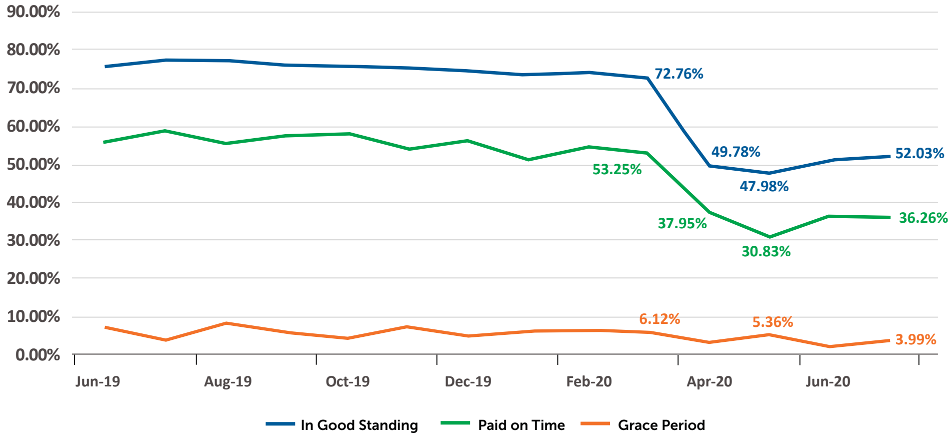
Of the tenants that are not in good standing, a sizeable portion did make partial payments, i.e. 29.92% of total tenants, while a lesser 19.73% did not pay at all. Both of these categories had risen from a previous quarter's 14.51% and 7.63% respectively.

There can thus be no doubt that the forced COVID-19 Lockdown had a major impact on tenant payment performance, reducing it to the worst level on TPN's record, the 50.36% good standing level of the 2nd quarter of 2020 being far worse than the 66% low reached in early-2010 on the back of the GFC recession.

Tenant performance by major property sector

TPN has more recently begun to extract monthly preliminary tenant data by major property sector in order to monitor the lockdown period in more detail. These run one month on from the 2nd quarter into July and point to early signs of some recovery in tenant performance in June and July, as economy-wide lockdown measures were eased.

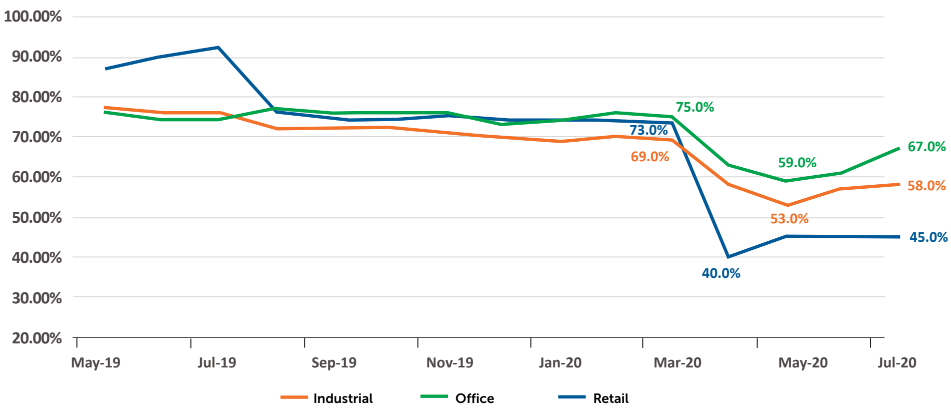
MONTHLY COMMERCIAL RENT - PERCENTAGE OF TENANTS IN GOOD STANDING

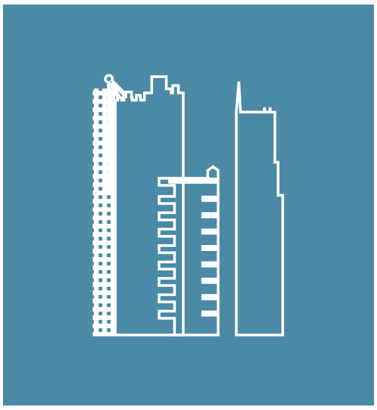


From a monthly low of 47.98% in May, the percentage of commercial tenants in good standing increased slightly to 52% in July, an improvement of sorts but still well below a pre-lockdown March percentage of 72.76%.

Examining the results by major sector, the picture is particularly alarming for the Retail Property Sector, although the lockdown impact on the Industrial and Office Property Sectors was nevertheless severe.

MONTHLY COMMERCIAL RENT GOOD STANDING: BY MAJOR PROPERTY CLASS





The Retail Property Sector led the way as weakest in terms of tenant payment performance in April as the impact of lockdown hit home. From 73% of tenants in good standing in March, this sector saw the sharpest drop to 40% in April. In May, its percentage recovered marginally to 45%, whereafter it moved sideways in June and July.

By comparison, the Industrial Property Sector saw a less severe drop in tenants in good standing, from 69% in March to a low of 53% in May, before some mild recovery for 2 consecutive months to 58% in July.

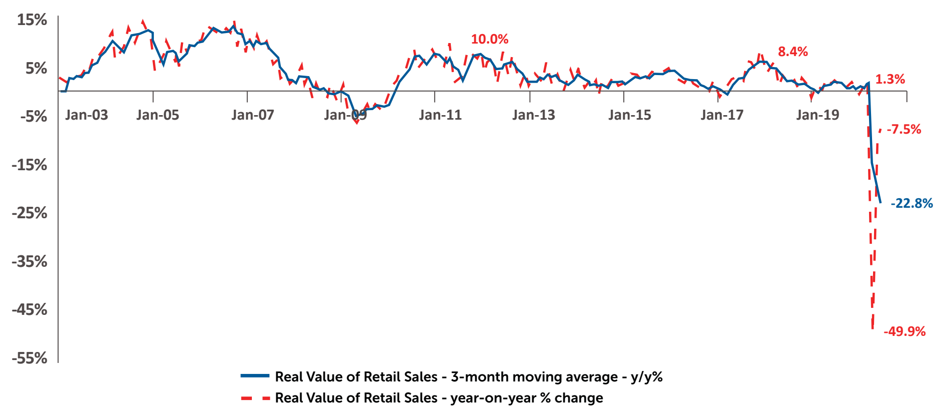
The best performing tenant population of the 3 major property sectors has been the Office Property Sector, whose percentage of tenants in good standing fell from 75% in March to a low of 59% by May, before showing the most noticeable recovery for the 2 consecutive months to July to measure 67%.

Not only has the Retail Property Sector's tenant percentage in good standing dropped far more sharply than those of Industrial and Office Property, it has also recovered significantly less to date. While the Industrial and Office Property percentages continued to improve in July, the Retail percentage has remained stuck on 45% for 3 consecutive months, only 5 percentage points higher than its April low of 40%.

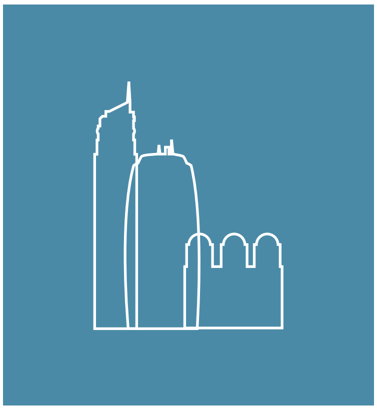
This appears to reflect on the financial frailties of the Retail Property Sector's tenant population relative to Office Industrial Property. It isn't clear that the lockdown was notably worse for Retailers than what it was for Industrial Property tenants, the latter being strongly tied to Manufacturing and Logistics.

Both monthly Manufacturing Production and Retail Sales data pointed to similar year-on-year declines during the hard lockdown months.

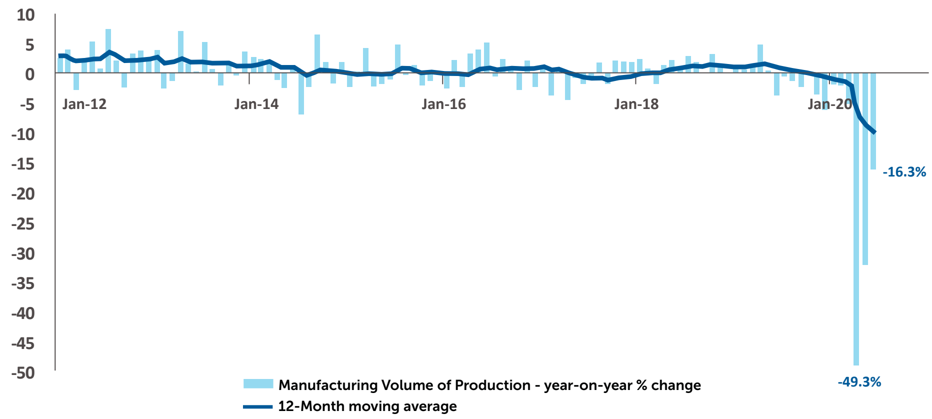
REAL RETAIL SALES GROWTH (2008 PRICES)



In April, real retail sales declined by -49.9% year-on-year, before seeing lesser magnitudes of year-on-year decline in subsequent months.



MANUFACTURING OUTPUT GROWTH



Manufacturing Production declined by an almost identical -49.3% year-on-year in April too, before seeing year-on-year decline start to diminish.

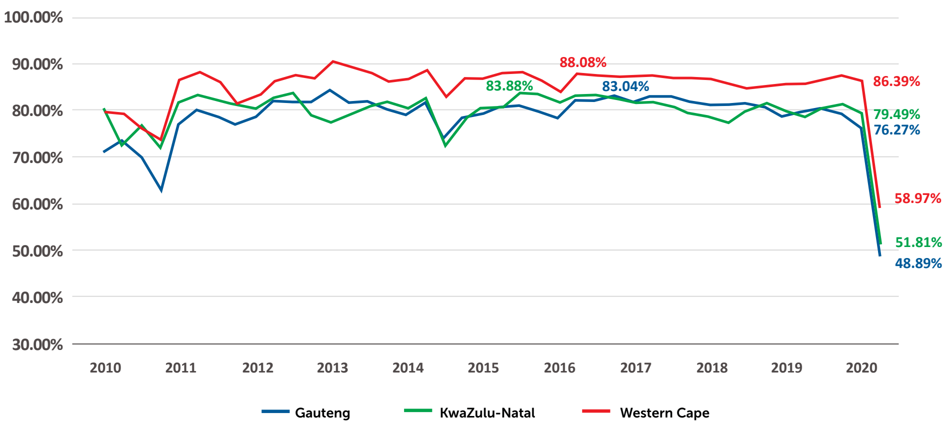
Office Property tenant performance is strongly tied to the performance of the major Finance, Real Estate and Business Services Sector, for which there is no monthly high frequency data. However, a sizeable portion of this sector, notably the Financial Sector, was able to continue to operate throughout the hard lockdown period with staff working from home, so it is not surprising that Office Property tenants have been the best rental payment performers on average through the COVID-19 Lockdown period.

Tenant Performance by major province

While all 3 major economic provinces experienced sharp deteriorations during Lockdown, the Western Cape remains the province with the highest percentage of commercial tenants in good standing, to the tune of 58.97%, down from the prior quarter's 86.39%.

Since the Commercial tenant data history started in 2010, the Western Cape has had the highest percentage of tenants in good standing of the Big 3 Provinces for most of the time, reflecting well on its longer term relative economic strength as far as South African economic regions go.

TPN COMMERCIAL RENT GOOD STANDING: BY MAJOR PROVINCE



Gauteng, with 48.89% of tenants in good standing, as at the 2nd quarter of 2020, was noticeably lower than the Western Cape, as well as experiencing a weaker tenant performance than KZN's 51.81%.

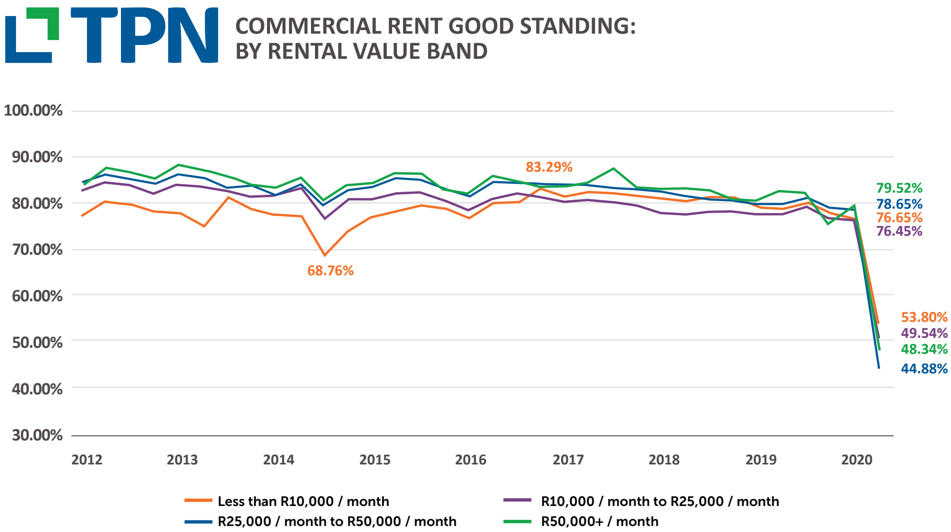
These 3 relative regional tenant performances appear to be a replication of the relative performances during the last crisis period, the aftermath of the 2008/9 GFC recession, where Gauteng was the weakest performer by a noticeable margin too.

Tenant performance by Rental Value Band

We were previously of the view that smaller tenants in the lower rental/month value bands may be the most vulnerable on average to a deep recession. The segmentation of the data in this way only began in 2012, so it is not possible to properly assess the relative performances of the segments' tenants back in the 2008/9 GFC recession and immediately thereafter.

However, in 2012 the lowest rental segment, i.e. the "Less than R10,000/month segment was the weakest performer, while the highest "R50,000+/month segment was the top performer by a small margin. We suspected that the relative order of segment performances was a legacy from the impact of the GFC a few years prior, was a legacy from the impact of the GFC a few years prior. It was likely that the lowest rental/month segment, which would house on average the smallest sized businesses, was the most vulnerable to recession.

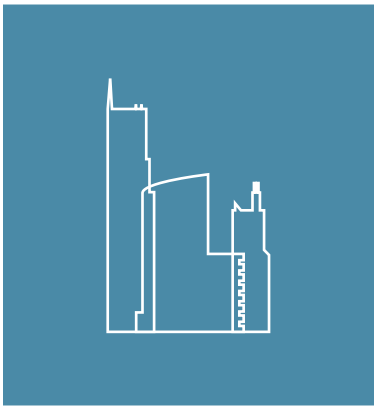
To date, 4 quarters into the current recession, this does not appear to be the situation so far.



While all 4 segments have suffered a severe drop in tenants in good standing percentages in the 2nd quarter, the lowest rental value segment, less than R10,000/month, recorded the highest percentage of tenants in good standing to the tune of 53.8%.

This was followed by the R10,000-R25,000/month segment with 49.54%, the R50,000+/month segment with 48.34% and the R25,000-R50,000/month segment with the lowest percentage of 44.88%.

At this stage, therefore, it appears that the highest 2 rental value segments have the worst tenant performance during the 2020 COVID-19 shock, but it is probably too early to draw any hard conclusions as to relative performances.



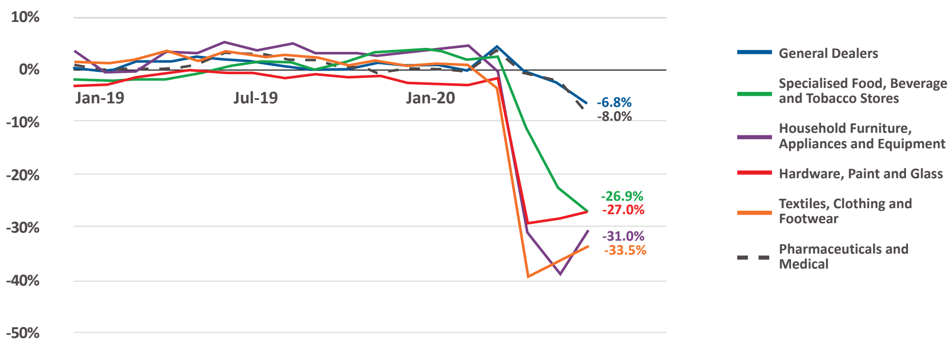
Retail tenants remain the biggest concern

Over the past 2 decades or more, the Retail Property Sector has seen the affordability of its rentals, operating costs and values deteriorate the most of the 3 sectors over this period, and in recent times has appeared due for a bigger correction than the other 2 sectors, with the far more affordable Industrial Property Sector being seen as perhaps the least at risk in the long economic downturn.

The recent dip in the Retail Property Sector's tenant performance to a lowly 45% of tenants in good standing suggests that it was indeed more vulnerable than Office and Industrial Property, and that concerns around its vulnerability were perhaps justified.

Given the likely significant financial pressure of households, even post-lockdown, the financial pressure amongst tenants is likely to be more severe in the areas of retail that supplies non-essential goods and services or those goods and services purchases that can be postponed. In terms of retail sales performance, the lockdown period has already impacted more on such less-essential sub-sectors of retail than on the more essential retailers, some of whom largely avoided lockdown. While the post-lockdown period promises to be less severe than lockdown, we would expect the retail sales of less essential goods and services to continue to underperform on high frequency essentials such as food and groceries.

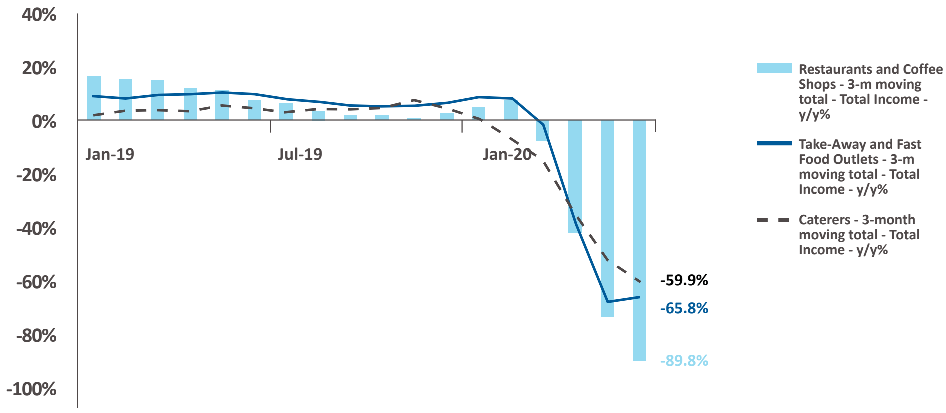
RETAIL SALES GROWTH - MAJOR RETAILER CATEGORIES - 3-MONTH MOVING AVERAGE - YEAR-ON-YEAR PERCENTAGE CHANGE



StatsSA Real Retail Sales by major category of retailer, smoothed on a 3-month moving average basis, confirm General Dealers (where food, beverages and tobacco sales dominate) along with Pharmaceutical and Medical Retailers as being by far the least impacted by lockdown, with year-on-year declines of -6.8% and -8% year-on-year respectively for the 3 months up to June 2020.

Specialised Food, Beverages and Tobacco Retailers were less fortunate, experiencing a decline of -27%, with similar severe declines for Hardware, Paint and Glass Retail (-26.9%), Household Furniture, Appliances and Equipment (-31%) and Textiles, Clothing and Footwear (-33.5%).

RESTAURANT, TAKE-AWAY AND CATERING SALES



However, one of the worst hit segments of the retail property tenant population was likely that of Restaurant, Take-Away and Catering Sales, a segment that experienced very severe lockdowns that dragged on for longer than many others too.

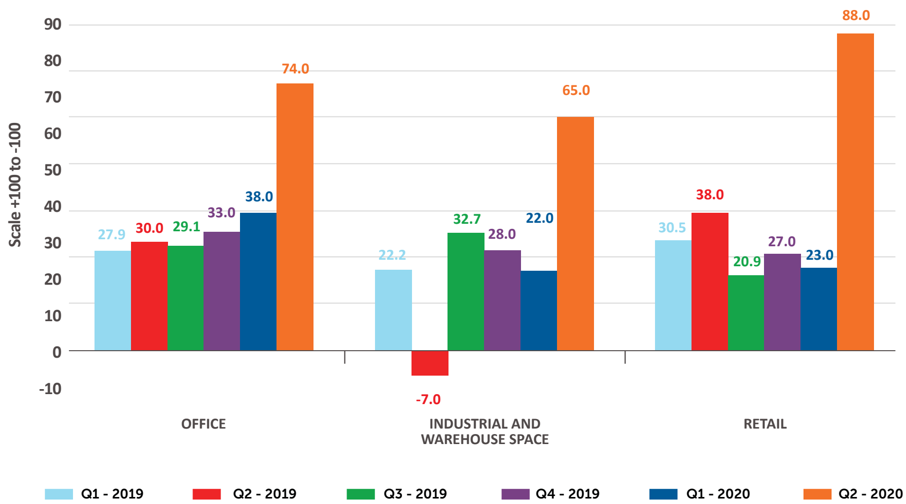
For the 3 months to June, Restaurant and Coffee Shop sales were virtually non-existent, declining by -89.8% year-on-year. Take-Away and Fast Food Outlet Sales declined by -65.8% and Caterers' Sales by -59.9% over the same period.

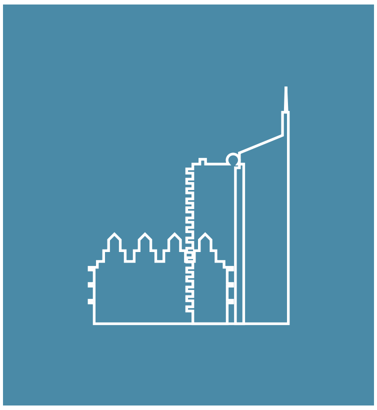
Finally, from the most recent FNB Property Broker Survey it would appear that tenant financial pressure may be taking its toll on vacancy rate trends too.

When surveying the sample of commercial property brokers, one of the questions asked is whether they perceive a rise in, fall in, or unchanged average vacancy rates in each of the 3 major property sectors from 6 months prior to the survey.

Out of the responses we create an index by allocating a +1 score to an "increased" response, a zero to an "unchanged" response and a negative -1 to a "declined" response.

INDEX FOR DIRECTION OF CHANGE IN VACANCY RATES OVER THE PAST 6 MONTHS (Source FNB)





The scale of the “Index for direction of change in vacancy rates over the past 6 months” is thus from +100 to -100. A score of +100 would imply that 100% of respondents perceived an increase in vacancy rates over the prior 6 months and -100 would imply 100% of respondents perceiving a decline, while a zero level would mean that those providing an “increased” response equals those responding with “decline”. Out of the responses we create an index by allocating a +1 score to an “increased” response, a zero to an “unchanged” response and a negative -1 to a “declined” response.

Here, there is little to choose between the property sub-sectors, with the respondents in all 3 sectors strongly biased towards a rising recent vacancy rate trend. In prior quarters, all 3 sectors’ respondents were also biased towards rising vacancy rates but to a far less extreme degree.

However, the brokers as a group were more pessimistic on Retail Property vacancy rates than those of Industrial and Office, which is very much in line with Retail Property having the weakest tenant performances too.

The Retail Property Sector had the most extreme 2nd quarter reading of +88, sharply up from the prior quarter’s +23, indicating that 88 percentage points’ worth more of respondents perceived vacancy rates to have risen than those perceiving a decline.

The Industrial Property reading of +65 was the least extreme of the 3 sectors, while the Office Property reading was the 2nd highest with +74.

The aggregate perception of rising vacancy rates is thus very strong across all 3 property sectors, which appears to reflect a significant weakening in tenant financial situations and payment performance.

Conclusion

In short, there can be little doubt that the 2nd quarter Lockdown period, and resultant drop in economic activity, had a severely negative impact on commercial tenant payment performance. Retail Property was the worst hit of the major 3 property sectors. However, monthly data does show a mild improvement in tenant performance in June and July as lockdown restrictions have eased, most notably in the Office and Industrial Property Sectors.