# TPN Quarter 3 | 2021 Commercial Rental Monitor

*Guest contributor*
*John Loos*
Property Sector Strategist
FNB Commercial Property Finance

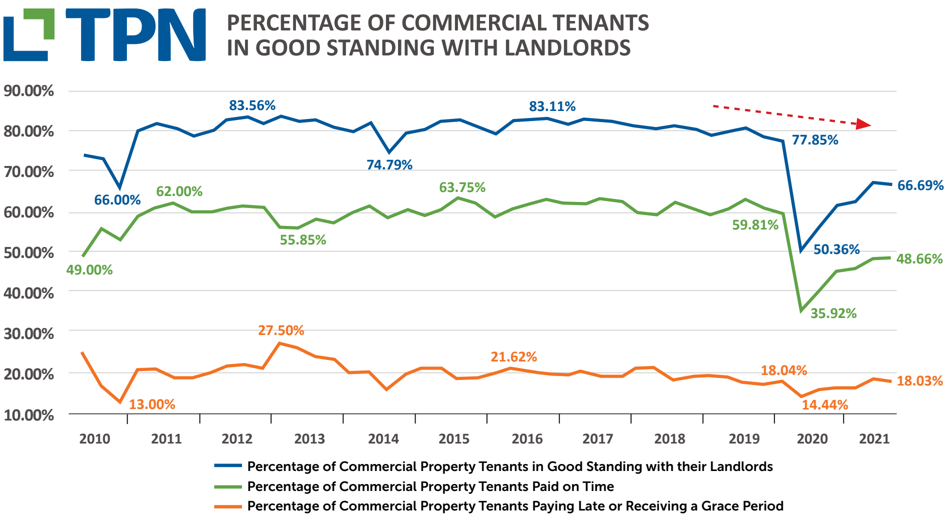
## In This Edition:



## Commercial tenant payment performance recovery stalls in the 3rd quarter of 2021 as the economy goes back into decline

- In the 3rd quarter of 2020, the commercial tenant rental payment recovery stalled, with a slight decline in the percentage of tenants in good standing. This comes on the back of 4 prior quarters of strong recovery out of 2020's hard lockdowns and deep recession.
- From a lowly 50.36% of commercial tenants being in good standing with landlords in the 2nd quarter of 2020, the level had increased to 67.12% by the 2nd quarter of 2021. In the 3rd quarter of 2021 this receded slightly to 66.69%. This percentage remains well below the pre-lockdown level of 77.85% recorded in the 1st quarter of 2020, and even further below last decade's high of 83.56% reached in 2012 before the onset of a multi-year economic growth stagnation.
- Preliminary monthly tenant payment performance data up to September showed a lack of further recovery in recent months in all 3 major commercial property classes.
- The Retail Property Sector's tenant population has been impacted the most severely through the COVID-19 lockdown period of the major 3 property sectors, and remains the weakest performer of the 3. Office tenants are the outperformer of the major 3 commercial property sectors, while the smaller Storage Sector still significantly outperforms the "Big 3" sectors.
- Of the 3 major provinces' tenant payment performances, the Western Cape maintained its superior tenant performance relative to Gauteng and KZN, Gauteng continuing to show the weakest performance of the 3 regions.

## Recovery in the tenant population's payment performance stuttered in the 3rd quarter of 2021 following a noticeable improvement since the end of 2020 hard lockdowns

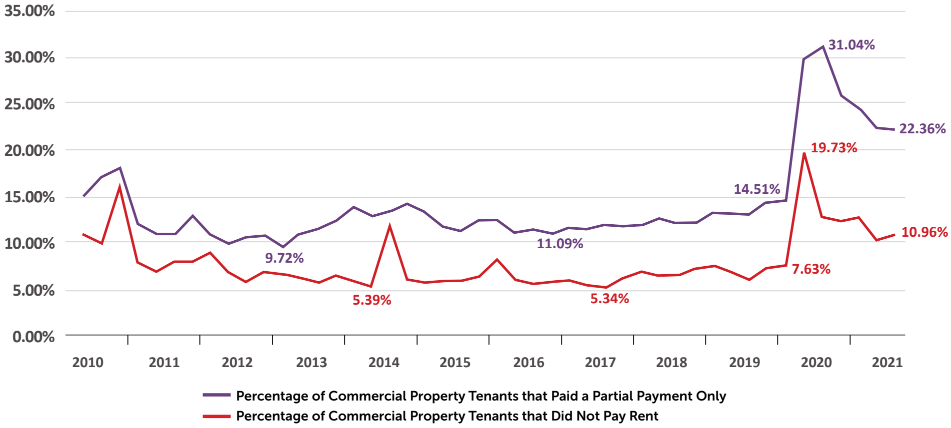


In the 3rd Quarter of 2021, the commercial property tenant population's recovery process, that commenced in the 3rd quarter of 2020 following the end of "hard" lockdowns, stuttered.

The percentage of total tenants that are in good standing with their landlords with regard to rental payments (i.e. either they are fully paid up, paid late or in a grace period) decreased slightly from 67.12% in the 2nd quarter of 2021 to 66.69% in the 3rd quarter of the year.

This remains significantly up from the low point of 50.36% of the 2nd quarter of 2020, but still well below the "before-lockdown" 77.85% level recorded in the 1st quarter of last year.

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



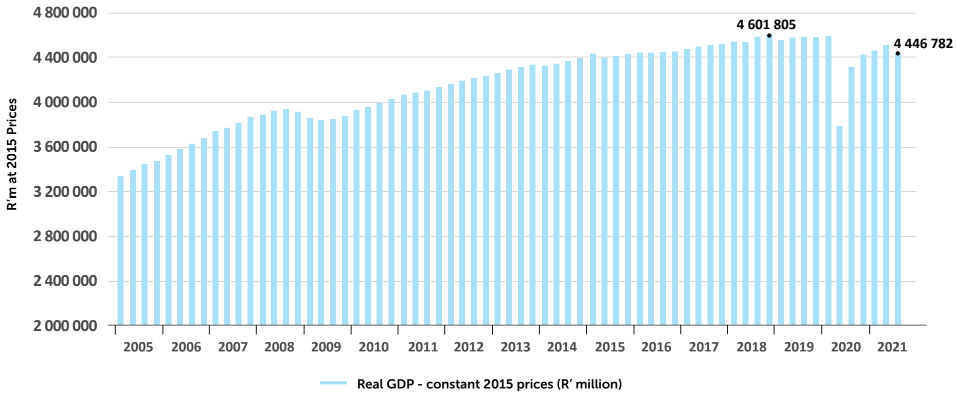

Of the tenants that are not in good standing, a sizeable portion did make partial payments, i.e. 22.36% of total tenants, while a lesser 10.96% did not pay at all. The partial payments percentage in the 3rd quarter represents a slight decline from the 22.53% of the previous quarter. The percentage that did not pay at all increased slightly from the 10.35% of the 2nd quarter, but was still significantly down on the 19.73% high of the 2nd quarter of 2020.

## Economic indicators point towards the economic recovery stalling at levels weaker than before lockdown

Tenant financial, and thus rental payment, performance is strongly influenced by economic growth, as measured by GDP (Gross Domestic Product).

After 4 consecutive quarters of growth in Real GDP following the 2nd quarter 2020 "hard lockdown dip", the 3rd quarter of 2021 saw a quarter-on-quarter decline in seasonally adjusted GDP to the tune of -1.5%. This quarterly decline had much to do with a sharp drop in Agriculture GDP, a sector that fared very well through the 2020 recession, but a big -5.5% drop in Retail and Wholesale Trade. Catering and Accommodation may also be reflecting the retail-related unrest and looting impact in KZN and Gauteng in that quarter, as well as some impact of the 3rd COVID-19 wave in Tourism and Accommodation.

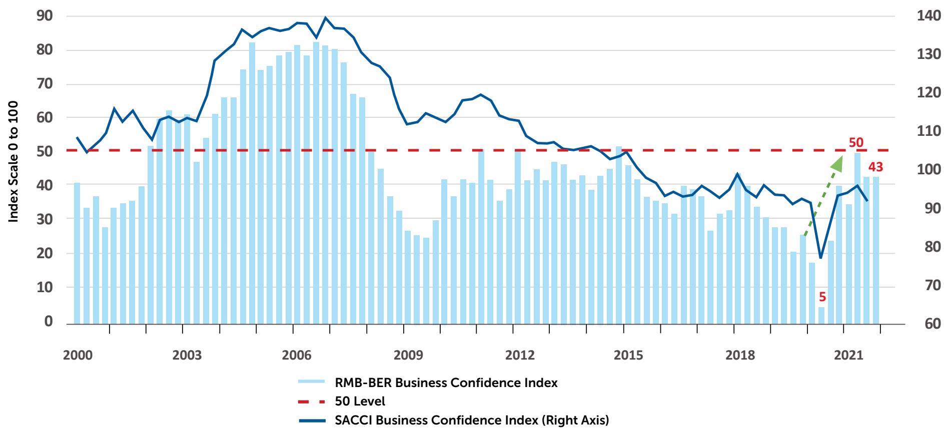
## REAL GDP (GROSS DOMESTIC PRODUCT)




This renewed decline in 3rd quarter GDP may explain the mild drop in commercial tenants in good standing, in the same quarter, after both variables had previously been showing steady recovery out of last year's hard lockdowns.

The fact that there has only been a "partial" recovery in the economy to date, since the end of hard lockdown (meaning that GDP is still noticeably lower than pre-lockdown levels), appears to also explain why the tenants in good standing percentage remains significantly below 2019 pre-lockdown levels. Ongoing financial pressure in the economy is likely also reflected in weak business confidence too.

## RMB-BER BUSINESS CONFIDENCE INDEX AND SACCI BUSINESS CONFIDENCE INDEX

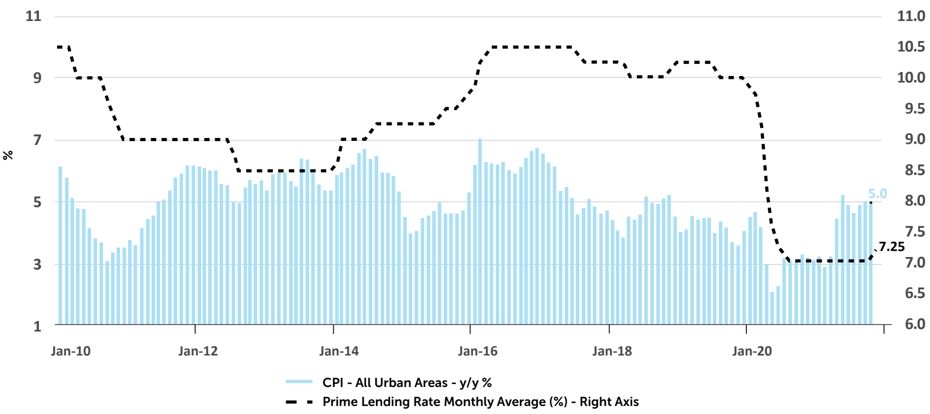



The RMB-BER Business Confidence Index rose from a very weak 5 reading in the 2nd quarter of 2020 (scale of 0 to 100) to 50 by the 2nd quarter of 2021, but has since receded to a level of 43 in the latter half of 2021.

Key economic indicators thus point to the post-lockdown economic recovery having stalled, and the economy and business conditions and confidence even weakening in the 3rd quarter of 2021, and this appears to explain why we would expect to have seen the slight weakening in commercial tenant performance in that quarter that we did.

Looking ahead, 2022 may not see further meaningful improvement in tenant performance in the near term either. The market will now have to contend with gradually rising interest rates we believe, the first rate hike in the cycle having taken place in November 2021 in response by the SARB to elevated consumer inflation now at around 5%. This not only lifts the cost of debt repayment for many businesses, but also likely keeps economic growth and the business environment constrained.

**CONSUMER PRICE INFLATION AND PRIME RATE**

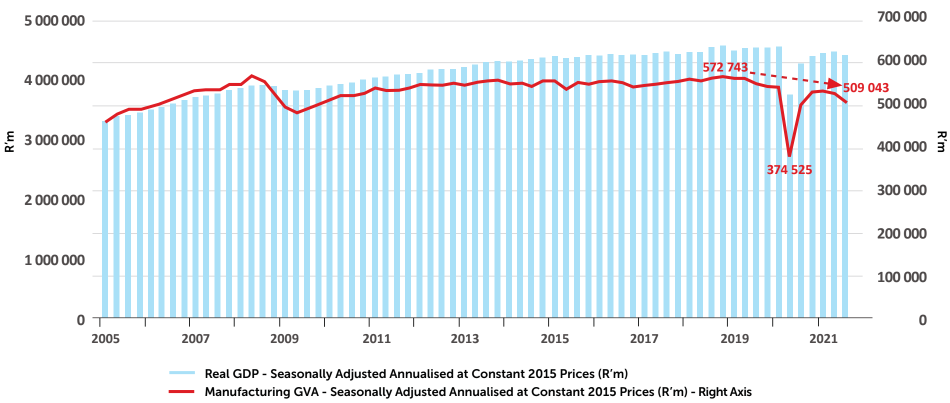



## Economic indicators in all 3 major commercial property classes suggest that tenant performance should still be battling at below pre-COVID-19 levels

Quarterly GVA (Gross Value Added) data, along with relevant employment data, suggests that tenant performance should still be weaker than pre-lockdown levels, and indeed this seems to be the case.

Even the relative outperforming property class, i.e. Industrial Property, sees the economic sectors underpinning it being significantly weaker than 2019 pre-COVID-19 levels.

**OVERALL GDP vs MANUFACTURING SECTOR GROSS VALUE ADDED**

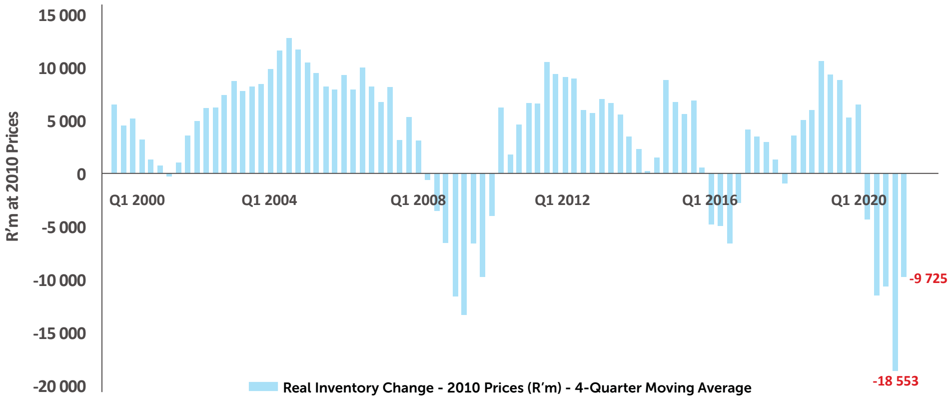



The Manufacturing Sector, and economy-wide inventory levels, are key economic drivers of demand for industrial space, along with financial performance of industrial tenants.

The 3rd quarter seasonally-adjusted Real GVA (Gross Value Added) for the Manufacturing Sector declined from the previous quarter, and despite a significant recovery following the 2020 hard lockdown remains -11.1% down on the multi-year high of the final quarter of 2018.

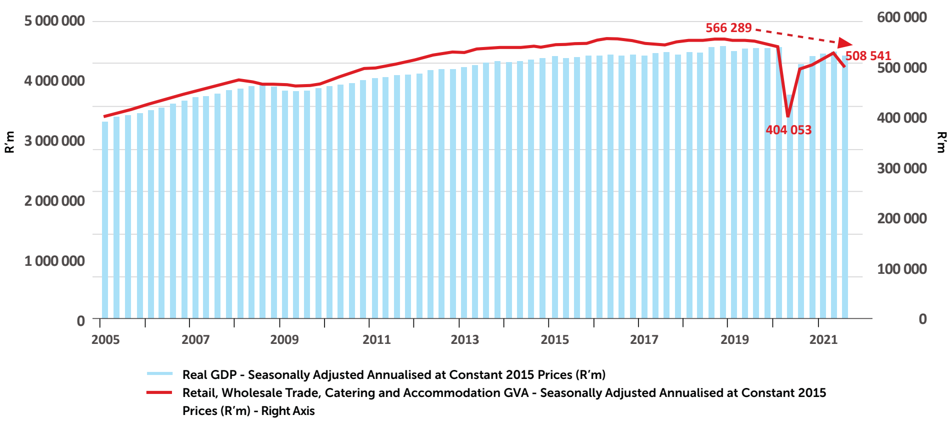
Along with this, the drop in economy-wide inventory levels have been dropping sharply and almost constantly since late-2019.

**REAL INVENTORY CHANGE - 2010 PRICE (R'M)**
**4-QUARTER MOVING AVERAGE**




The part of the economy related to the Retail Property class appears similarly weak. Despite a significant recovery in the "Retail and Wholesale Trade, Catering and Accommodation" Sector since 2020 hard lockdown, this sector's GVA remains -10.2% down on the end-2018 high.

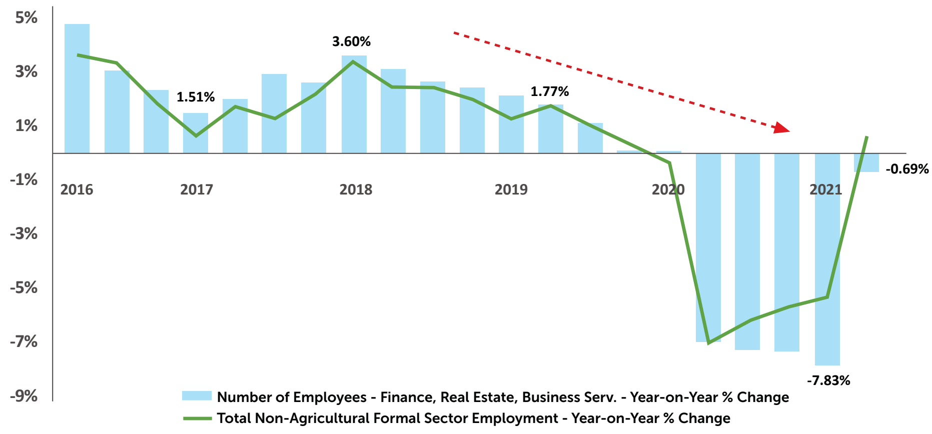
**OVERALL GDP vs WHOLESALE AND RETAIL TRADE**
**CATERING AND ACCOMMODATION GROSS VALUE ADDED**




And finally there's the Office Market-related economic fundamentals, the most significant being the employment trends in the sector that is a major driver of office space demand and performance, namely the "Finance, Real Estate and Business Services" Sector (FREBS).

For 4 consecutive quarters up until the 1st quarter of 2021, this sector's employment number was dropping by year-on-year rates in excess of -7%. Only in the 2nd quarter of 2021 did this rate begin to stabilise near to zero, but that prior drop in employment reflects a major financial impact on this heavily office-bound sector, and would in all likelihood mean that the office tenant population has experienced a significant economic and financial knock.

**EMPLOYMENT GROWTH IN FINANCE, REAL ESTATE AND BUSINESS SERVICES SECTOR**

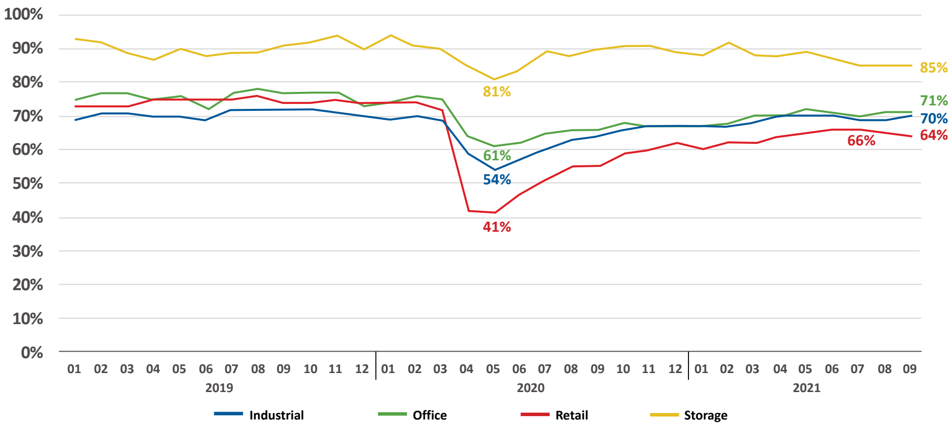



Therefore, it is not surprising to see that the major property classes' tenants have battled to make any further progress in improving their rental payment performance, and 2 out of 3 remain below pre-lockdown levels of good standing with landlords.

The Office Sector recorded 71% of tenants in good standing in September 2021, still below the 75% of March 2020 just prior to lockdown. The Retail Sector recorded 64% of tenants in good standing, still well below the 72% as at March 2020.

The Industrial Sector, however, recorded 70% of tenants in good standing, which is back at the pre-lockdown level of 70% in February 2020. This may be partly the result of this sector's rentals being the most affordable of the 3 property classes, while also perhaps benefiting from the structural change towards greater online retail.

**COMMERCIAL RENTAL GOOD STANDING BY SECTOR**




So, while manufacturing is weak and economy-wide inventories low, the shift towards greater online retail at the partial expense of in store retail may have been the boost for industrial property demand, and for some tenants' performance. Although its tenant performance is not strong, it is back to its pre-COVID 19 levels unlike the other 2 sectors.

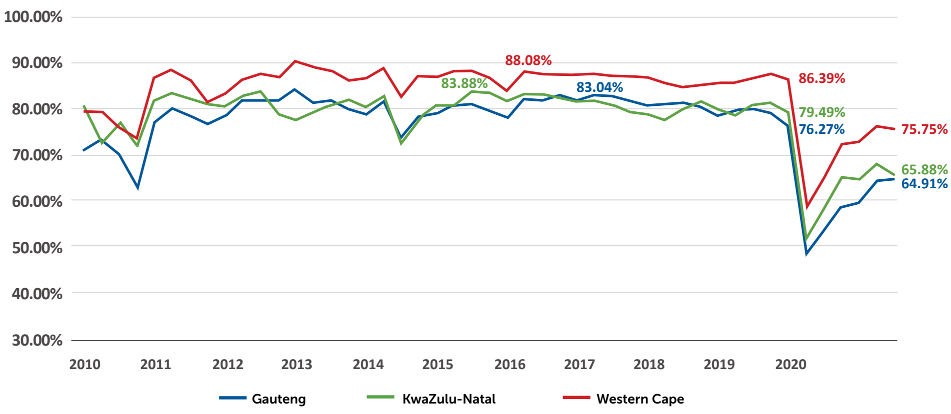


## Major province tenant performance

The Western Cape remains the province with the highest percentage of commercial tenants in good standing, to the tune of 75.75%, but this was slightly lower than the province's prior quarter at 76.27%.

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




Over the past 2 decades or so, the Western Cape has built itself a reputation as a well-managed province with a combination of good lifestyle and major economic opportunity, thereby attracting skilled and affluent "semi-grants" in large numbers from elsewhere in the country while also retaining skills better than most. Its services-dominated and skills-dependent economy appears to have benefited from this, making it increasingly resilient, and enabling it to weather economic "storms" such as its major drought a few years ago, and now COVID-19, perhaps better than many others.

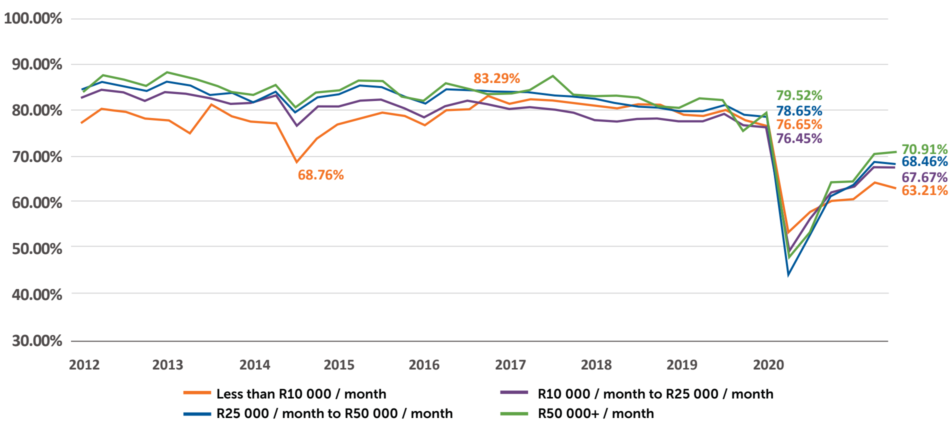
Gauteng, with 64.91% of tenants in good standing, as at the 3rd quarter of 2021, was noticeably lower than the Western Cape, as well as experiencing a weaker tenant performance than KZN's 65.88%, although all 3 provinces have seen noticeable improvement since the 2nd quarter 2020 hard lockdown low.

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 have previously been of the opinion 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, however, 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.

**TPN COMMERCIAL RENT GOOD STANDING: BY RENTAL VALUE BAND**




From 2012 to 2016, 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 by a small margin the top performer over much of that period. We suspected that the relative order of segment performances was a legacy from the impact of the GFC a few years prior, and that it was likely that the lowest rental/month segment, which would house on average the smallest sized businesses, would be the most vulnerable to recession, and suffer weakness for quite some time thereafter as a result.

Through the COVID-19 recessionary period, the "winners and losers" by size category were not initially that clear. But more recently, it would appear that the lowest segment has become the underperformer, battling the most to claw its way back to better performance following last year's hard lockdown.

All 4 segments saw severe drops in the tenants in good standing percentages in the 2nd quarter of 2020, and all have only "partially recovered", i.e. they are not yet back to pre-lockdown levels of performance.

On the dip, it was the second highest rent/month categories, the R25,000/month category (44.8% of tenants in good standing in the 2nd quarter of 2020), and the R50,000+/month category (48.34% tenants in good standing in the 2nd quarter of 2020) that bottomed with the weakest tenant performances.

On the recovery, by the 3rd quarter of 2021 the relative positions appear to have switched to the lowest "Less than R10,000/month" category being the weakest at 63.21% of tenants in good standing. This is followed by the R10,000-R25,000/month category at 67.67% of tenants in good standing, then the R25,000-R50,000/month category with 68.46% of tenants in good standing, and the highest R50,000/month category with the best performing 70.91% of tenants in good standing.

At this stage, therefore, it appears that the higher rental/month segments have dragged themselves up from the bottom positions, with the weakest performance being shown by the lowest rental/month segment.

## Conclusion – Recent slight weakening in the tenant market appears to reflect renewed economic weakening

In the 3rd quarter of 2021, the TPN commercial tenant payment performance data showed a slight weakening from the 2nd quarter, after prior noticeable improvement coming out of last year's hard lockdowns and deep recession.

The slight weakening appears to be reflecting the economy's direction, with Real GDP in the 3rd quarter having declined after 4 prior quarters of positive growth.

Improvement in both the economy and tenant performance from current levels will likely be hard to achieve in 2022, with the start of an interest rate hiking cycle expected to pressure the economy mildly.

Both GDP and the tenants in good standing percentage have so far failed to get back to the pre-lockdown performance levels of 2019.

## Best performing tenants, but the Office Market remains the most troubled

While the Office Property Market still shows the best tenant payment performance of the 3 major commercial property sectors as at the 3rd quarter of 2021, that is not to say that significant financial constraints on this sector do not exist. However, it appears likely that a portion of the financial pressure in the Office Sector is to be seen in tenants downscaling on their office space needs, translating into an ongoing rising vacancy rate.

Businesses occupying office space can take greater advantage of the work from home shift, following the impact of lockdowns which forced much of the Services Sector into a highly successful remote work "experiment".

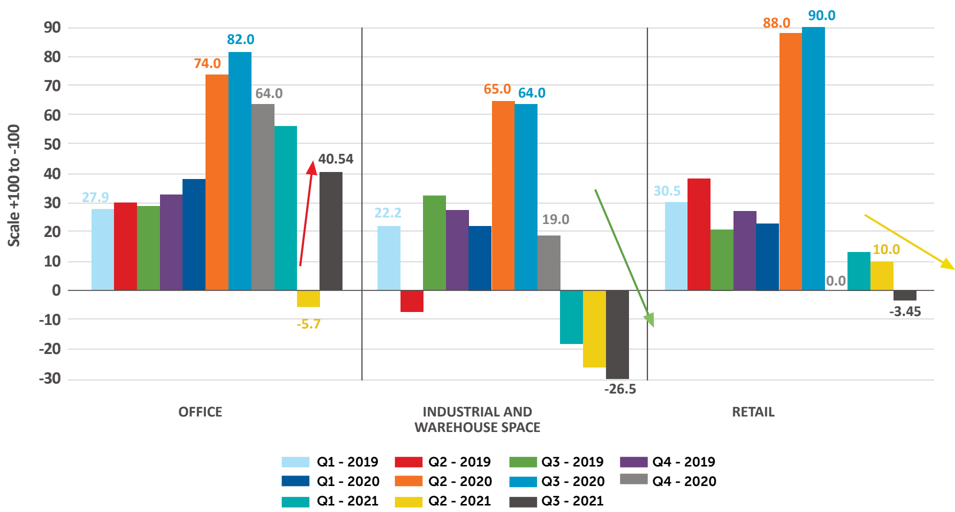
As always, a part of tenant financial pressure is reflected in the percentage of tenants in good standing, and a part of it in vacancy rate trends - the most sharply rising vacancy rate being in the Office Market, suggesting that the tenant population in that sector may not be financially the strongest.

We take a look at the FNB Property Broker Survey for indications of vacancy trends. When surveying the sample of commercial property brokers regarding these vacancy rate trends, one of the questions asked is whether they perceive a rise in, fall in, or unchanged average vacancy rate 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.

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.

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




Here, the most recent 3rd quarter 2021 survey shows the Office Property Sector as likely to be the weakest one of late.

The respondents in the Office Property Sector are very strongly biased towards perceiving rising vacancy rates, 40.54 percentage points worth of respondents indicating a rise in vacancy rates (i.e. a +40.54 index reading) in this sector than those pointing to a decline.

Industrial Property, by comparison, was perceived to have a declining vacancy rate, with a negative reading of -26.5, while Retail Property's 3rd quarter index reading was a slightly negative -3.45.

Therefore, the brokers as a group were significantly more pessimistic on Office Property than on the other 2 classes. So while office tenants didn't experience the severe financial shock of hard lockdowns that many retail tenants experienced, and their good standing percentage remains the strongest, financial pressure is likely significant enough to see many businesses downscaling on office space, which in turn is reflected more in a rising vacancy rate than in a weak tenants in good standing percentage.

In short, although Office tenants still show the highest percentage of tenants in good standing, this is not to say that this property class has the least tenant financial pressure. Financial pressure in the Office Sector is significant, and we believe that a portion of tenants are scaling down on office needs, opting for greater levels of remote work since working from home became more fashionable and achievable with the commencement of lockdowns. This is likely to be reflected in ongoing increases in average office vacancy rates, whereas the Industrial and even Retail Sectors appear significantly less pressured from a vacancy rate trend point of view.