TPN from MRI Software RentalMonitor

DESPITE A HOSTILE BUSINESS ENVIRONMENT

COMMERCIAL LANDLORDS RISE TO THE CHALLENGE

IN THIS EDITION

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Latest economic indicators leave many South African businesses unsure about what the future holds

National OVERVIEW

The national mood, including sentiment in the business sector, has never been gloomier. Officially, one in three people are unemployed - or one in four, according to the expanded definition of unemployment. Yet despite formidable odds and a deteriorating business confidence, many commercial property owners have taken proactive measures to ensure long-term success through innovative approaches, agility, and unwavering commitment to the economic prosperity of the country.

The first quarter of 2023 witnessed declines in both the RMB/BER Business Confidence Index (BCI) and the SA Business Chamber of Commerce and Industry's BCI. The RMB/BER BCI declined from 38 in the fourth quarter of 2022 to 36 in the first quarter of 2023. The index, which surveys senior executives in the building, manufacturing, retail, wholesale and motor trade sectors, indicates the percentage of business people that are satisfied with prevailing conditions. Confidence in manufacturing and retail, in particular, contracted sharply in the first quarter of the year.

The SA Business Chamber of Commerce and Industry's BCI saw similar declines in the first quarter of 2023, with the index dropping by 0.6 index points to 111.3 in March from 111.9 in February. Declining business confidence is the result of the impact of high levels of load shedding, interest rate hikes, regulatory uncertainty and a state incapable of delivering basic services, amongst other factors.

The rising cost of capital is a particular concern of businesses at a time when consumers are under increased pressure from high inflation and the growing cost of living. By the end of the first quarter of 2023, the South African Reserve Bank (SARB) had hiked rates by a cumulative 425 basis points since commencing with hiking rates in November 2021 as it attempts to curb inflation to the midpoint of between 3% to 6%.

The latest economic indicators leave many South African businesses unsure about what the future holds and with load shedding and other various economic and political challenges negatively impacting business organisations, it is to be expected that this insecurity is reflected in how well commercial tenants, which includes offices, retail, industrial and storage space occupiers, pay their rent.

The commercial property asset class has seen a slower recovery than the residential property asset class for a variety of reasons. Residential tenants have recovered to pre-pandemic levels and by the end of the first quarter, 81.86% of tenants were in good standing, despite interest rate hikes which have forced residential tenants to reorganise and prioritise household expenditure.

The slower recovery in the commercial property sector has not deterred property owners and investors from providing suitable space, albeit in different forms as they adopt new and innovative business models to navigate a business landscape filled with obstacles and lacklustre initiatives by local and national government to support commercial property owners.

Many commercial property owners and their tenants have been hit by aggressive rates and tax increases aimed at keeping local municipalities afloat. Local governments are increasingly requiring commercial property owners and developers to maintain and improve surrounding municipal infrastructure, assist with providing security and support the local community, all while dealing with additional regulations, sluggish economic growth and inconsistent opportunity.

Despite these challenges, many commercial property owners have stepped up and implemented initiatives aimed at ensuring the long-term success of the areas in which they operate.

National OVERVIEW Continued

A retrospective look at previous commercial property downturns

In the last 13 years, there have been four noticeable dips in the number of commercial tenants in good standing.

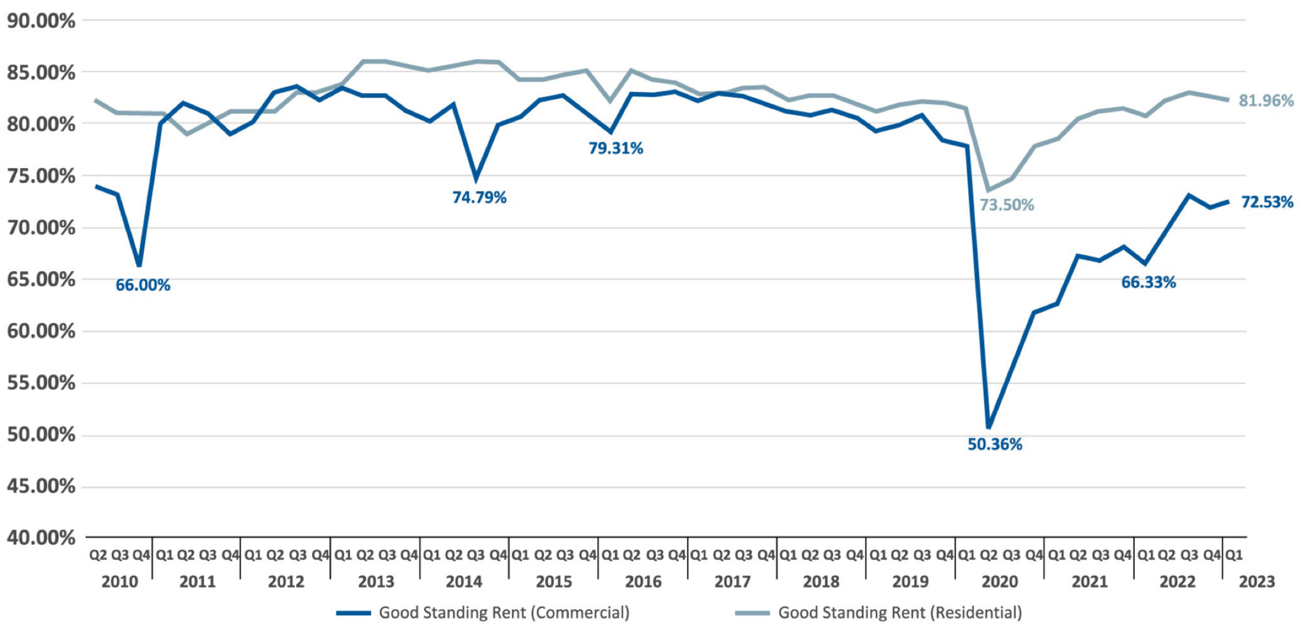
In 2010, the number of commercial tenants in good standing dropped to 66% during the global financial crisis but quickly recovered to 82% two quarters later. The second dip was in 2014 when South Africa experienced its first major xenophobic attacks, which resulted in the number of commercial tenants in good standing dropping from 81.85% (Q2, 2014) to 74.79% (Q3, 2014).

The third and less noticeable dip occurred in 2016 when South Africa's finance minister was unceremoniously replaced. Commercial tenants – always sensitive to economic uncertainty – reacted by dropping their good standing from 82.68% to 79.39%.

The fourth and most noticeable dip was during the Covid-19 pandemic when hard lockdown measures were implemented by government. During this period, tenants in good standing dropped from 80.79% (Q3, 2019) to 50.36% (Q2, 2020). Commercial property consumption changed almost overnight, leaving landlords in uncharted terrain.

The number of commercial tenants in good standing has subsequently improved to 72.53% (Q1, 2023), although this figure continues to remain below pre-Covid levels. Although the way commercial property is viewed and consumed has changed, the biggest impact has been the challenges facing tenants that are beyond their – and their landlords' – control.

GOOD STANDING: RESIDENTIAL AND COMMERCIAL RENT



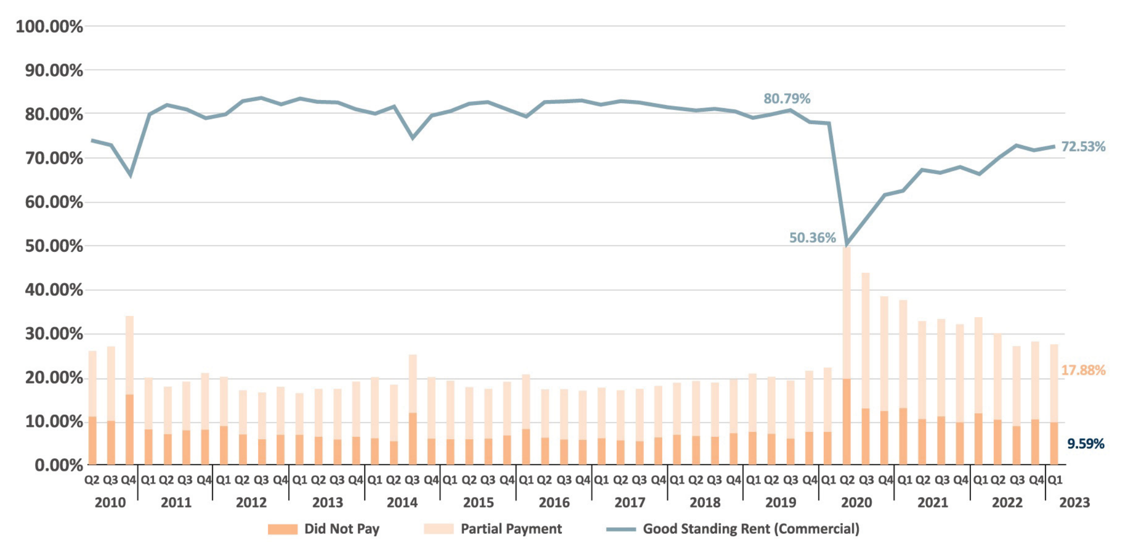
Commercial tenants are paying more as municipal and utility costs soar

Commercial tenants tend to behave predictably as a result of well-structured leases and processes implemented at the onset of the contract period by the landlord and their managing agents.

It is only during major economic shocks or political policy changes – or both – that there is likely to be a noticeable increase in the number of tenants that do not pay. However, this is usually followed by a relatively quick recovery.

However, since 2020, the ratio between 'did not pay' and 'paid on time' has remained higher than in preceding years when tenants returned to meeting their rental obligations much sooner. The number of commercial tenants that did not make payments towards their rental remained high in the first quarter of 2023 at 9.59%. During 2021, the annual average of tenants who did not make payments was 10.95% and in 2022 it was 10.27%.

COMMERCIAL TENANT PAYMENT BEHAVIOUR



In comparison, the annual average 'did not pay' profiles for 2019 was 6.98%, compared to 6.82% in 2018. Although it could be argued that this trend is a hangover from the Covid pandemic period, historically the commercial rental market has tended to recover relatively quickly. A complicating factor is that economic growth was relatively flat even prior to the pandemic.

One of the biggest challenges facing commercial landlords is municipal costs, including rates, taxes and metered utility costs. Most of these costs are recoverable from tenants putting them under additional pressure. In response, businesses have had no choice but to increase their prices which is reflected in increased consumer prices. These increases have reached record levels, reflected in operating costs taking up a greater proportion of total income.

Municipal costs now make up 61% of the total operating cost and 26.2% of the gross income generated by commercial property, according to the MSCI South Africa IMI Index. A staggering 29% of total operating costs go towards electricity, 25% towards rates and taxes and 6.7% towards water, sewerage and effluent.

As these costs continue to rise, landlords are forced to consider the total cost of occupation while balancing vacancies as well as ensuring a return for investors. This has placed additional pressure on the base rentals commercial landlords can ask for, driving down rental escalations.

Regional PERSPECTIVES

Provincial rates and taxes and rental escalations

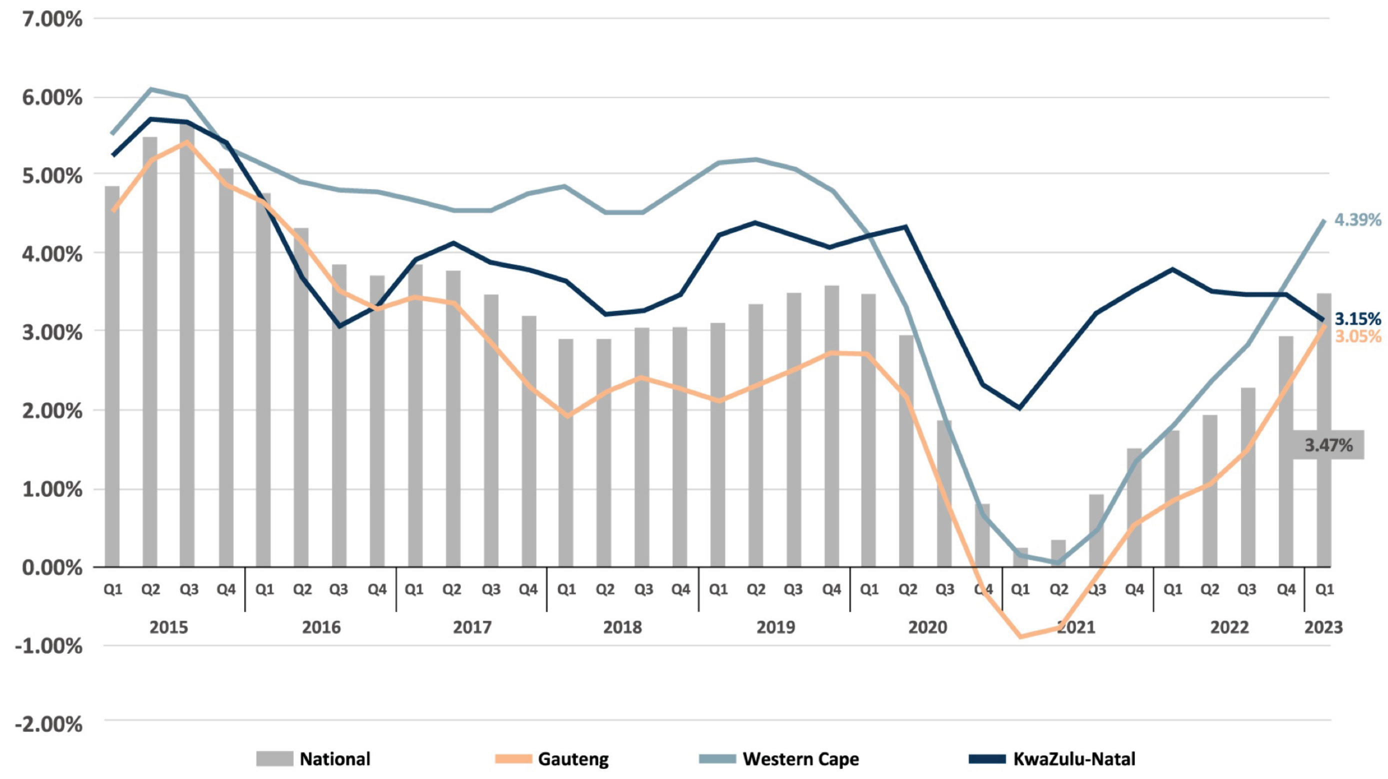
The Western Cape has the lowest rates and taxes across all three major commercial property types: retail, office and industrial. A retail centre in Gauteng pays R36.87 per square metre while a retail centre in the Western Cape pays R23.64 per square metre.

In KwaZulu-Natal, the industrial property rate is R12.39 per square metre, while the industrial property rate in the Western Cape is R3.87. These costs are partially recovered directly from tenants but are also carried by landlords (MSCI data, December 2022).

Rental escalations in the commercial sector have recovered well since 2020. TPN's data reveals that national commercial rental grew by 3.47% in the first quarter of 2023. Rental escalations in Gauteng were at 3.05% while escalations in the Western Cape were at 4.39%.

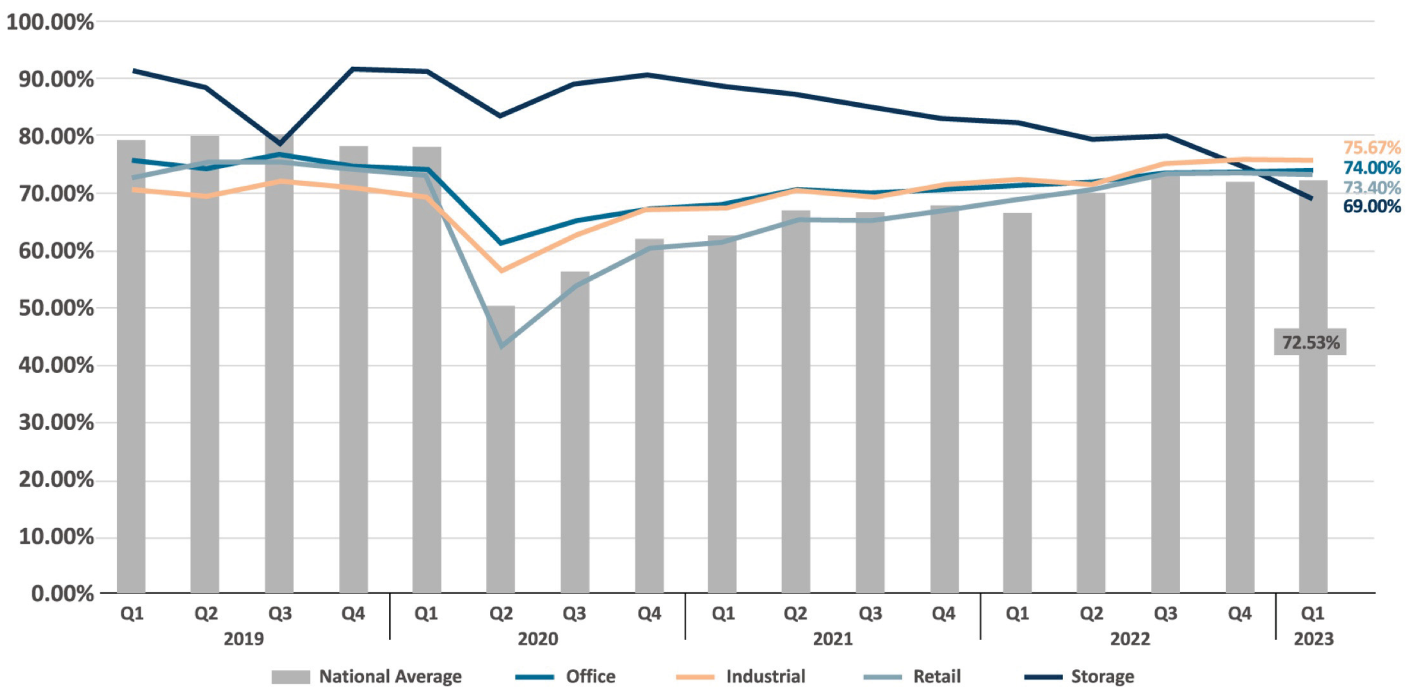
KwaZulu-Natal has seen its commercial escalations deteriorate after a slight and short-lived recovery post-pandemic. Rental escalations in the province have been dropping since the first quarter of 2022. Its commercial rentals were growing at 3.15% in the first quarter of 2023.

COMMERCIAL RENTAL ESCALATION BY PROVINCE



Office versus retail rental performance

COMMERCIAL TENANTS GOOD STANDING BY SECTOR



Retail sector tenants have had the steepest climb to recovery while office tenants continue to be spoilt for choice. Since 2020, commercial property owners have been faced with the narrative that the office is no longer in demand and that online retail will continue eating into the traditional brick-and-mortar retail space. This narrative is reflected in the decrease in good standing of office tenants and high vacancies in key nodes as tenants continue to look towards alternative hybrid models, which proved so effective during the pandemic.

Office tenants in good standing dropped from 73.33% in the first quarter of 2020 to 61.33% in the second quarter of 2020. However, as aggressive load shedding was implemented in South Africa and home power back-ups proved to be insufficient to cope with longer periods of load shedding, the office environment, typically equipped with some sort of backup power system, drew employees back to the office. Companies keen to have their teams meet in person started introducing minimum days back in the office. This has helped the office sector to recover. However, a high rate of vacancies and increasing operating costs are preventing this sector from bouncing back to its pre-pandemic levels. According to SAPOA, office vacancies remain high at 15.8% in the first quarter of 2023, although lower than their peak in June 2022 when office vacancies were 16.7%.

The retail sector was the hardest hit by the pandemic in terms of the ability of tenants to make rental payments. Retail tenants in good standing dropped to 43.33% during the pandemic and the sector took a time to recover its good standing rate. By the first quarter of 2023, 73.4% of retail tenants were in good standing. SAPOA reports that the retail sector's vacancy rate at the end of the first quarter of 2023 was 5.4%.

The industrial sector remains the best performer in the commercial property sector as far as good standing is concerned with 75.67% of tenants in good standing in the first quarter of 2023. The vacancy rate for industrial property at the end of 2021 was just under 5%, according to MSCI, the lowest of all the commercial asset classes.

A sub-sector of commercial property, storage, performed well during 2020 but a decline in tenants paying for storage units has resulted in storage dropping below the national good standing average of 72.53% to 69%.

REGIONAL PERSPECTIVES | Continued

Western Cape tenants in good standing remain well above national average

Western Cape

The Western Cape's commercial landlords are best positioned to ensure they get their rental paid on time.

Boasting the lowest rates, taxes and utility costs of all three of the major provinces, landlords in the Western Cape can expect 82.62% of their tenants to be in good standing which is well above the national average.

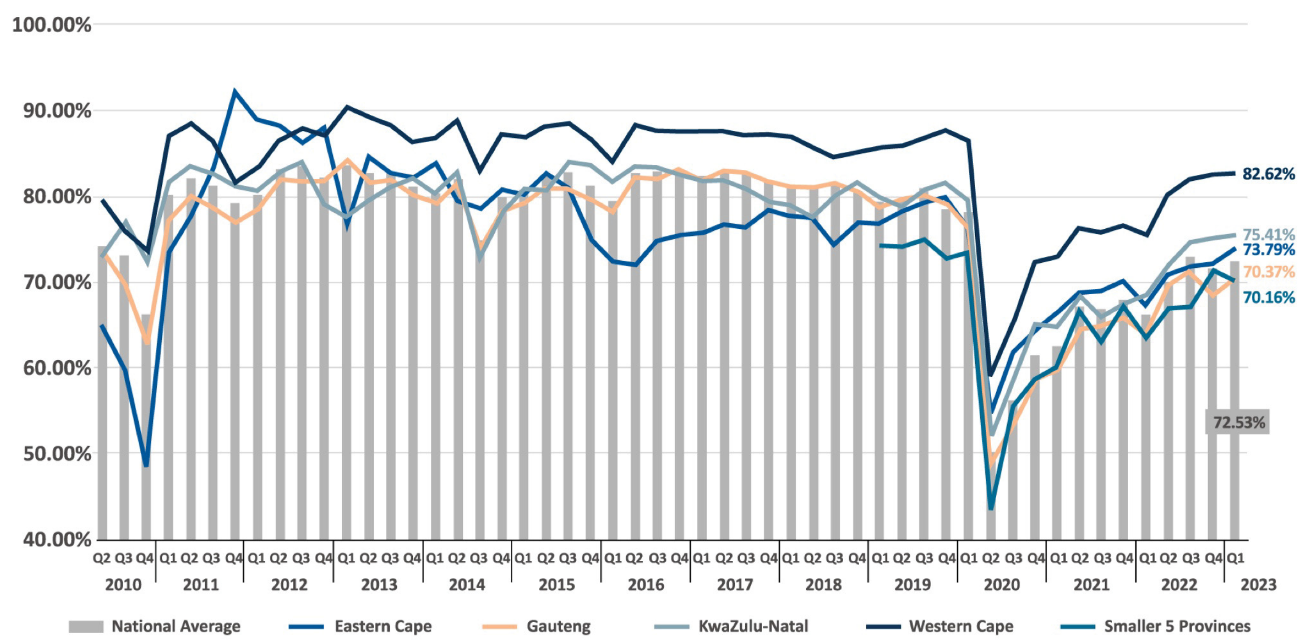
KwaZulu-Natal

Landlords in KwaZulu-Natal, on the other hand, need to pass much higher municipal costs on to their tenants. Only 75.41% of commercial tenants in KZN are in good standing.

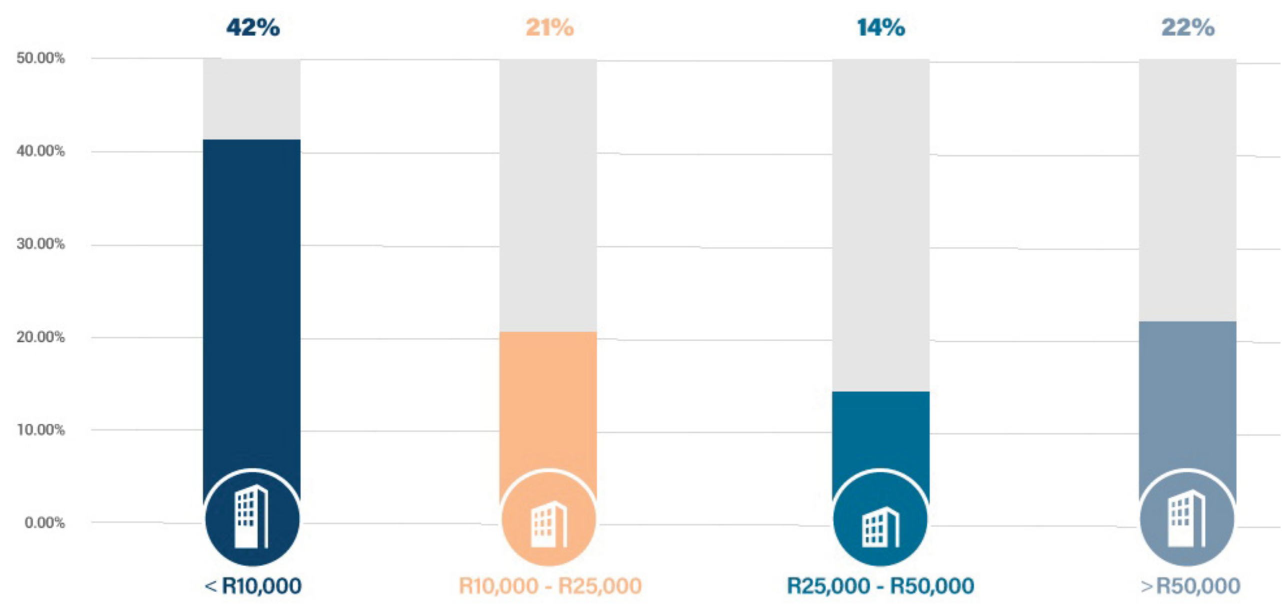
Gauteng

In Gauteng, 70% of commercial tenants were in good standing in the first quarter of 2023 compared to an annual average good standing rate of 82.33% in 2017.

COMMERCIAL TENANT GOOD STANDING BY PROVINCE



PERCENTAGE OF COMMERCIAL TENANTS BY RENTAL VALUE



Small businesses are struggling in the current economic climate

GOOD STANDING
By Rental Value

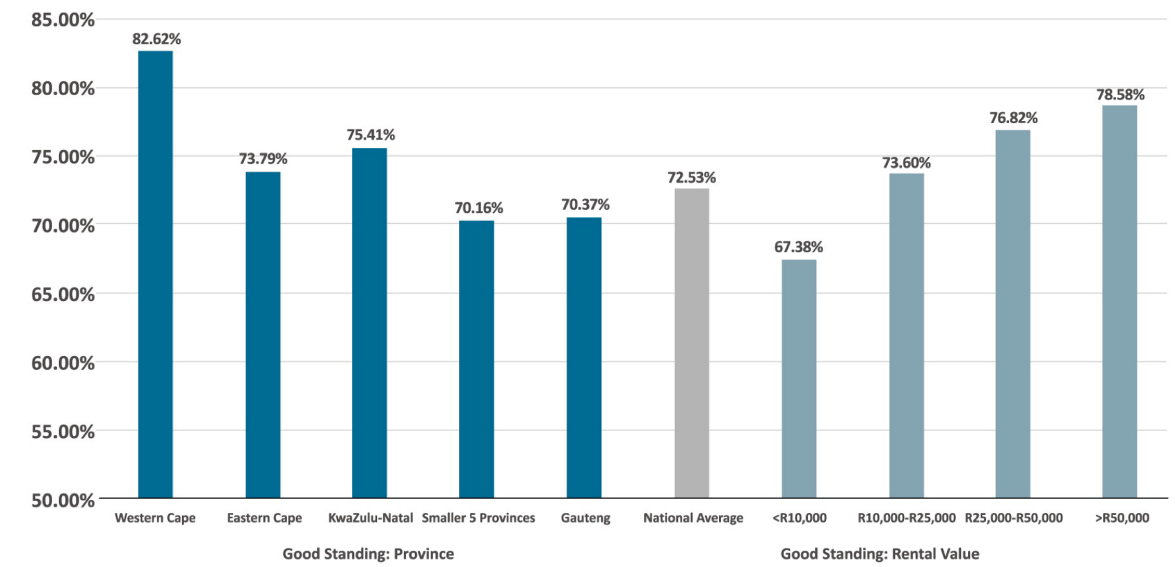
Small businesses, especially those in Gauteng, are struggling to pay rent in the current economic climate. A total of 42% of commercial tenants pay less than R10 000 per month rental and have the lowest good standing ratio at only 67.38%.

The rest of the market is made up of 21% of commercial tenants paying between R10 000 and R25 000 per month rental, 14% of commercial tenants paying R25 000 to R50 000 and 22% of commercial tenants paying R50 000 or more per month.

The highest rental bracket has the best good standing ratio at 78.58%, followed by R25 000 to R50 000 at 76.82%.

TPN data indicates that the larger the rental, the higher the probability of commercial tenants meeting their obligations. This indicates that established and larger occupiers still offer commercial landlords a more assured and secure rental income.

COMMERCIAL TENANTS GOOD STANDING: 2023 Q1



CONCLUSION

Despite multiple challenges, the commercial property sector soldiers on

Commercial landlords are faced with an increasingly hostile environment. In addition to sluggish economic growth, municipal service delivery is failing around the country. This, coupled with extraordinarily high municipal costs, is impacting the demand for commercial space.

Businesses are facing high levels of regulatory uncertainty while corruption across all spheres of government remains a significant concern. Although the private sector has stepped up to drive efficiencies in its own businesses, they are having to navigate increasing - and ever changing - regulations.

Commercial landlords continue to pay rates and taxes despite not receiving value for their money and where possible, have resorted to fixing failed infrastructure to protect their investments and tenants. Capital is increasingly being directed to providing alternative power supply so that communities can access services, albeit that the services are only provided on their own premises.

Rising interest rates are negatively affecting consumers. A weak and volatile currency combined with higher utility and municipal costs is helping to further fuel inflation. Property owners with fixed-term lease agreements are having to carefully consider their return on investment.

The construction sector continues to be plagued by a lack of competitors which is driving construction costs higher and increasing risk above tolerable levels. This is inhibiting additional commercial property stock from coming online. In the long term, it risks the development of new buildings which will reduce capital formation.

And yet against all odds, the commercial property sector soldiers on with the total returns by South African REITS remaining above the JSE All Shares due to their innovation, agility and fierce commitment to South Africa and its economic success.