TPN Rental Monitor

2023 Q1

Demand for rental property still strong but consumer stress showing

TPN from MRI Software

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The residential sector remains resilient despite growing consumer distress

The residential rental property market has remained surprisingly resilient in recent quarters considering the financial stress consumers are under as a result of the high cost of living and escalating interest rates.

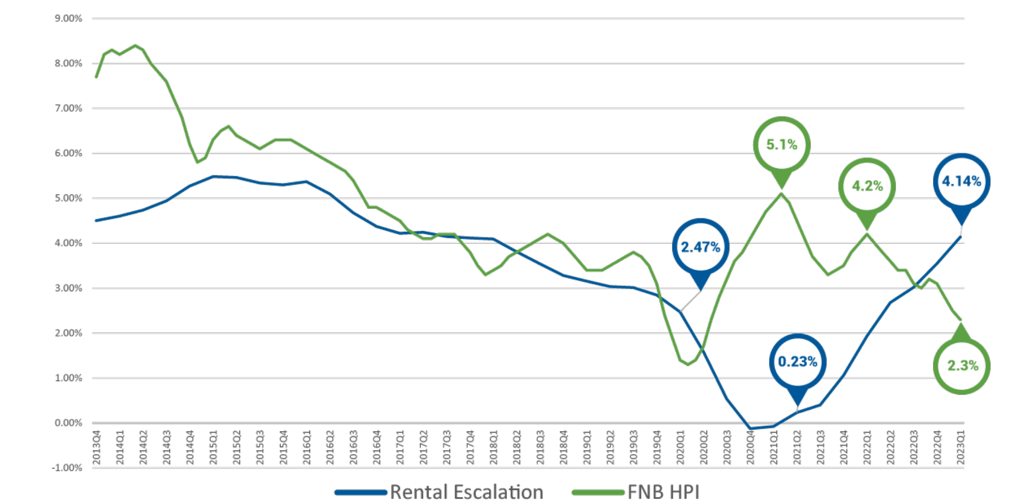
Overall, the residential market saw a faster recovery post the Covid-19 pandemic than most property sectors. The vacancy rate dropped, and most tenants were committed to paying their rent on time with rental escalations recovering steadily. The South African Reserve Bank's (SARB's) aggressive interest rate hikes and uncertainty around further hikes dissuaded many potential buyers who opted to rather rent given the greater predictability the residential rental market offers.

Low inflation and attractive interest rates in the third quarter of 2020 provided buyers with attractive value propositions which stimulated the property purchase market, resulting in the healthy growth of house price inflation, according to FNB's House Price Index. The index peaked in the first quarter of 2021 at 5.1% when interest rates were at 7% and demand was high.

The index started showing signs of slowing down in the fourth quarter of 2021 when the SARB embarked on an interest rate hike cycle, increasing rates by 25 basis points. By the end of the first quarter of 2023, the House Price Index had retreated to 2.3%. The outlook for the balance of the year is expected to remain around this number.

Rental escalations, on the other hand, only commenced their recovery in mid-2021 after two consecutive quarters of de-escalation. The gradual recovery of escalations was the result of higher demand for residential rental property, lower vacancies due to a slowdown in supply, higher debt servicing costs and the increased cost of maintenance, security, and municipal services. Combined, these issues provided property owners with an opportunity to increase rentals and play 'catch-up' with CPI, which, at the end of March 2023 was 7.1%.

House Price Growth and Rental Escalation

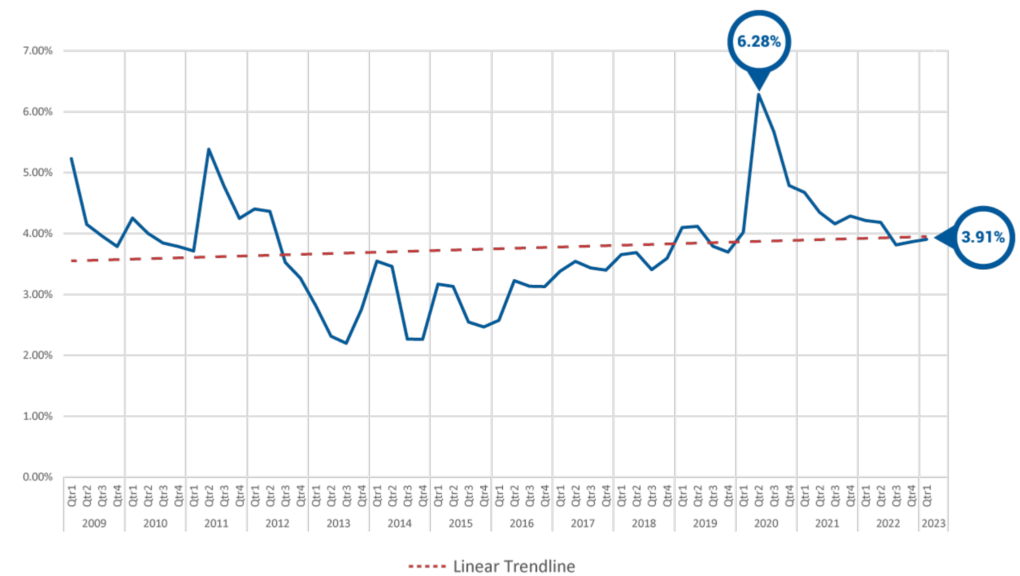


A firm stance on combating inflation by the SARB eased inflation to 6.3% in June 2023, and resulted in no interest rate hikes in the last MPC meeting. This will have provided some relief to a severely stretched consumer base. While rentals are expected to continue their gradual climb, this is predicted to slow towards the end of 2023 as the balance between rental growth and vacancies becomes a finer balancing act.

Vacancies were at 6.19% in the first quarter of 2023. Combined with a Market Strength Index of 9.14 points above the equilibrium, property professionals and owners are optimistic that the market remains strong. The TPN Market Strength Index measures perceived demand and availability of supply within the residential rental market. Equilibrium is achieved when demand and supply is equal. A strength index above 50 points means there is higher demand than supply in the current environment. At the end of March 2023, the index was at 59.14, a figure last seen in 2017.

Traditional market factors indicate that the residential rental market is buoyant with improved returns, lower vacancies and interest rates which are expected to increase by at least another 25 basis points this year. This will act to further deter property purchases and retain healthy demand for residential rental property.

TPN Market Strength Index the highest since 2017



Tenants in good standing declined to 81.86%

A critically important factor to the residential rental market is the overall financial health and endurance of consumers and, by extension, tenants. Tenants have, by and large, remained committed to paying their rental on time. In the third quarter of 2022, 82.9% of tenants were in good standing which declined slightly to 82.34% in the last quarter of 2022. Tenants in good standing declined again in the first quarter of this year to 81.86% as economic challenges continue to filter into households. Although the overall sentiment in the sector remains positive, property owners and professionals must consider how a tenant's late or no payment will impact them.

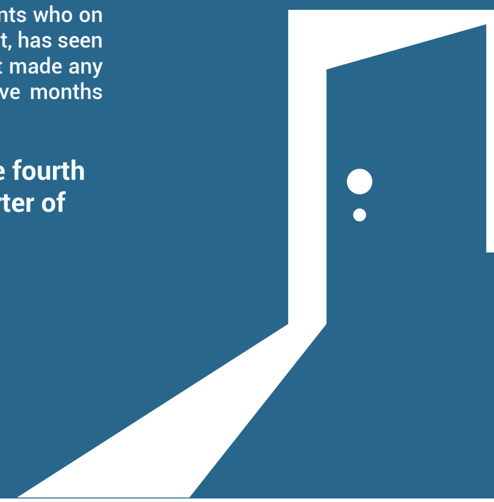
The National Credit Regulator age analysis is painting a similar picture with almost all consumer credit types in good standing deteriorating slightly in the last quarter of 2022. Mortgages in good standing decreased from 90.22% in the third quarter of 2022 to 89.58% in the fourth quarter. The overall credit good standing as at the end of 2022 was just 63.89%. The importance of consumer credit good standing revolves around the fact that consumers tend to prioritise rental payment above other credit (excluding mortgage good standing). However, a decrease in credit good standing is a predictor of rental payment rates.

Adding to the increased risk of tenants defaulting on their lease obligation is the higher cost of living and, in real terms, flat growth in household income. A concerning 36.11% of consumers have impaired credit records, which means that more than a third of credit active consumers failed to meet their credit obligations.

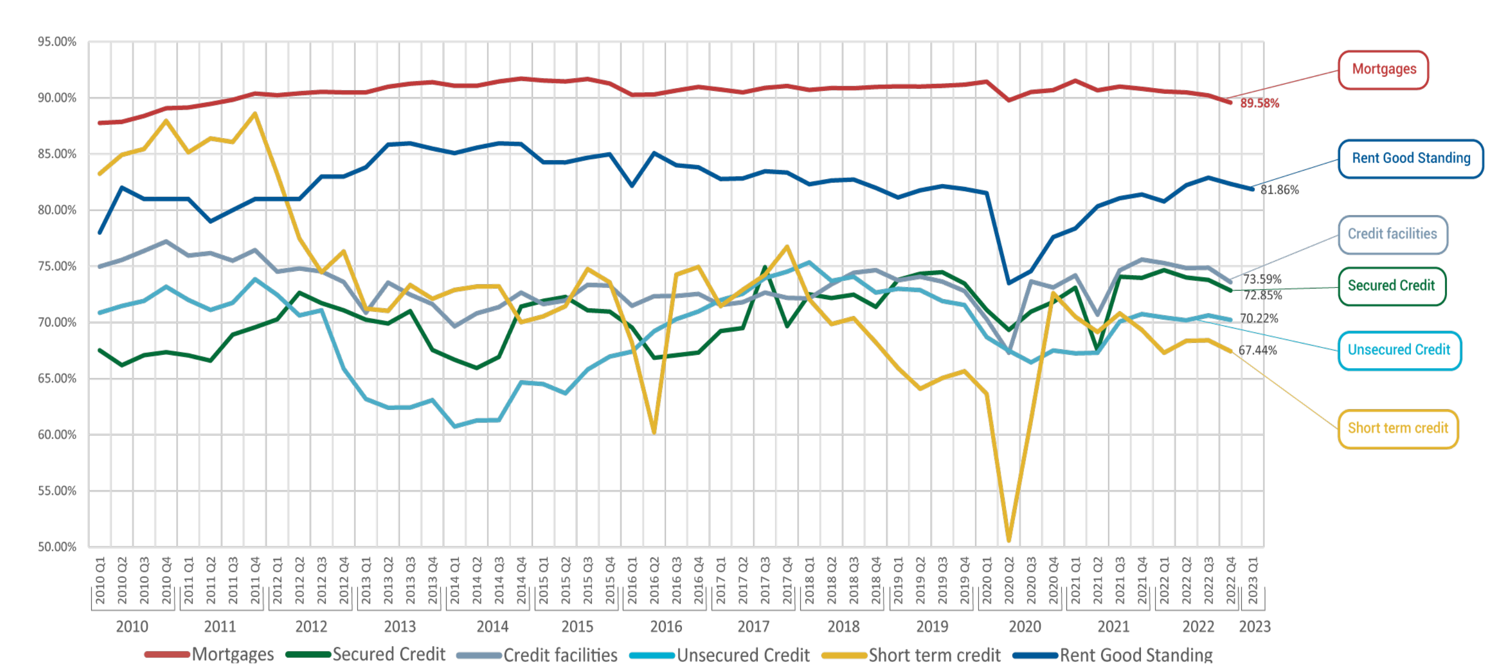
4 out of 100 tenants classify as squatting

TPN's Squat Index, defined as the number of tenants who on a monthly basis fall into a category of non-payment, has seen an increase in the number of tenants that have not made any payment towards their rental for three consecutive months and still occupy the property in the fourth month.

This number increased from 3.81% in the fourth quarter of 2022 to 3.91% in the first quarter of 2023.



Good Standing: Rental compared to main categories of consumer credit



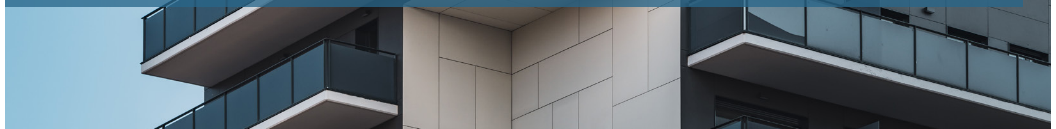
This means that almost four out of a hundred tenants are now classified as squatting. These tenants pose a severe risk to the ability of landlords to collect and recover rental due with possible legal costs adding to the potential loss. Landlords are advised to act proactively and utilise the various legal tools available to them to collect outstanding rental and list delinquent tenants to prevent abuse of the legal system.

A tenant is classified as 'squatting' if they have not made any rental payment for three consecutive months and continue to occupy the property in month four. The TPN Residential Squat Index has been rebased from four months to three months.

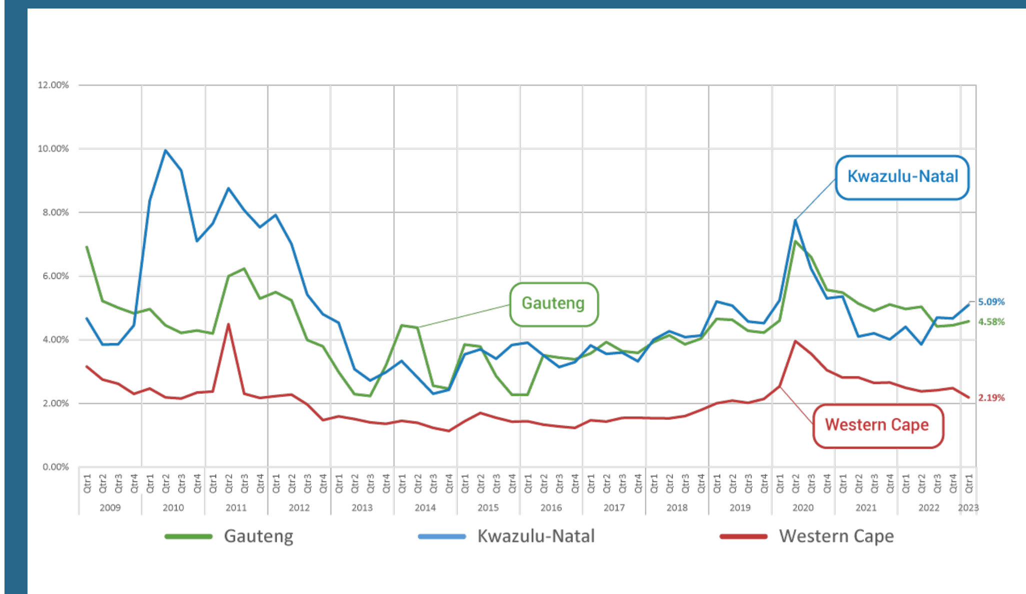
Western Cape tenants are the most committed to paying their rental

From a provincial perspective, it is clear that tenants in the Western Cape are committed to paying their rental. This province has seen a decrease in the number of tenants classified as squatting from 2.48% in the fourth quarter of 2022 to 2.19% in the first quarter of 2023. KwaZulu-Natal, however, has seen a concerning increase in squatting tenants to 5.09%, up from 4.67% in the fourth quarter of 2022. Figures relating to previous major economic downturns in 2010 and 2011 reveal that KwaZulu-Natal tenants are the most sensitive in all provinces to economic downturns.

At the height of the downturn in 2010, one in ten tenants in the province was classified as squatting. The province also had the highest number of squatting tenants during the pandemic in 2020. Gauteng tenants have a squat index of 4.58%, which is marginally up from the 4.45% recorded in the fourth quarter of 2022.



TPN Residential Squat Index by Province



Although a lower vacancy rate and higher escalations are a move in the right direction, a successful property investment ultimately relies on the ability of tenants to pay their rent. Early signs indicating that consumer credit repayments are slipping combined with lackluster economic growth cloud the positive outlook for the residential rental market for the rest of the year. The current economic landscape means that the risk of defaulting tenants is more likely.

Landlords and property professionals therefore need to take immediate action sooner rather than later. As the saying goes: prevention is better than cure. In the property sector it means that proper background checks and vetting is now more important than ever.

Rental payment performance by rental band

The lowest rental bracket, tenants paying R3 000 or less a month, has yet to recover from the pandemic. A strained economy continues to impact this value band which saw a deterioration in good standing to only 67%, from 69.22% in the fourth quarter of 2022. This rental bracket represents 13.9% of the formal rental market . It's also the market segment with the lowest margins to absorb increasing maintenance, security, and municipal costs, forcing property owners to increase their rental. Rentals in this bracket grew the most at 4.57% year-on-year. The national average escalation in South Africa for the same period is 4.14%. Vacancies are not extreme in this rental band with 6.73% of rental units standing vacant which is slightly above the national average of 6.19%. Tenants that did not make any payment towards their rental are currently the highest in this rental bracket at 17.34%.

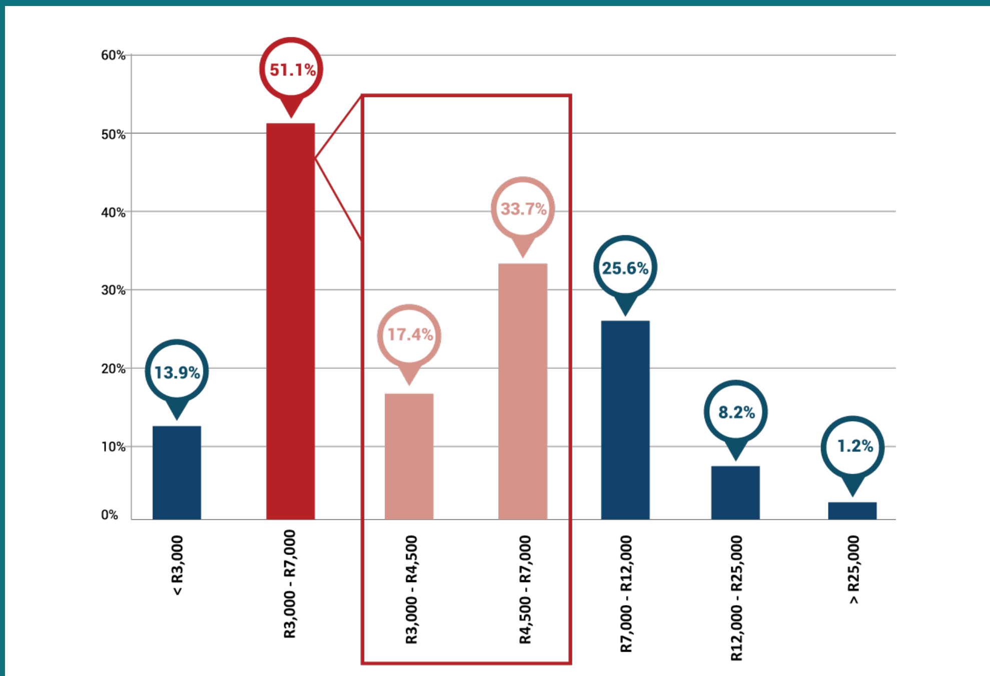
Tenants paying between R3 000 and R7 000 are in a better good standing position with a rating of 82.39%. This has been slipping since the third quarter of 2022, but still remains slightly above the national average. This rental value band has the lowest rental escalation at 3.29% with vacancies at 6.54%, down from 8.44% in the fourth quarter of 2022. However, although there is strong demand for this rental band, rental growth is slower for these units.

Residential units achieving a rental of between R7 000 and R12 000 per month have the most tenants committed towards paying their rent, achieving a good standing rating of 87.62%. This rental band, which represents a quarter of the total formal rental market in South Africa, has remained the best performing since 2014. Rentals in the first quarter of 2023 were growing at 4.4%, a slowdown compared to the previous quarter. It's also the value band with the lowest number of vacant properties with only 5.06% of these units standing vacant. With a healthy good standing rating, these tenants are the most committed to making payment and boast the lowest number of tenants that did not pay. Less than 4% of these tenants did not make any payment towards their rental during the first quarter of 2023.

Units with a rental of between R4 500 and R7 000 represents a third (33.7%) of the rental market with a good standing rating of 84.11%. The lower side of this rental value band, units with a rental price of R3000 – R4500 have 79.05% of tenants in good standing and represent 17.4% of the market.

Higher value bands – rentals between R12 000 and R25 000 per month – are the second-best rental bracket with 86.93% of tenants honouring their rental commitment at the end of the month. It makes up 8.2% of the total formal rental market. Escalations were 4.35% in the first quarter of the year. This sector of the rental market is struggling to fill vacant space with a vacancy rate of 7.16%. However, given that this value band has seen double digits vacancies since 2018, it is in a much better space than prior to the pandemic and has managed to maintain relatively lower vacancies since the start of 2022.

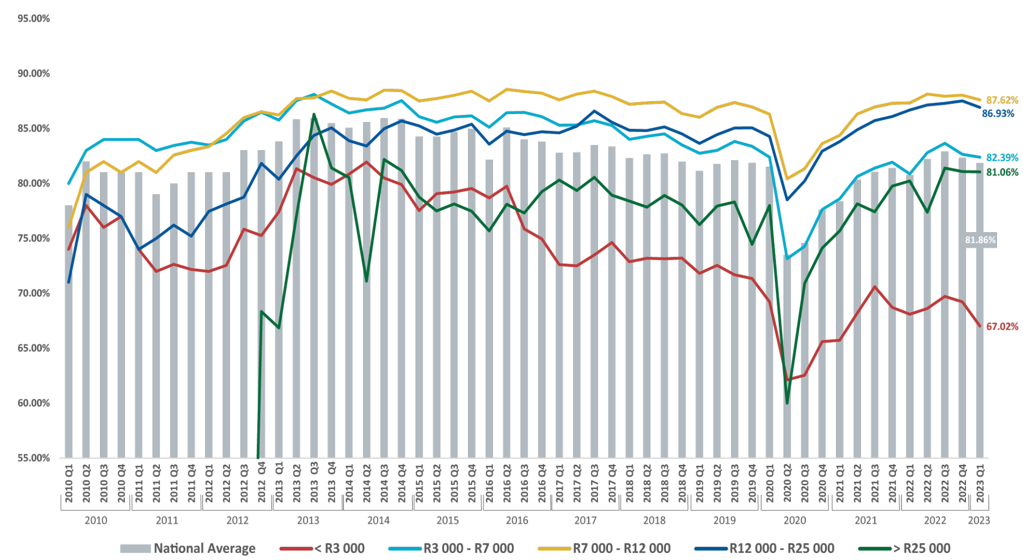
Residential Rental Market Distribution by Value (2023 Q1)



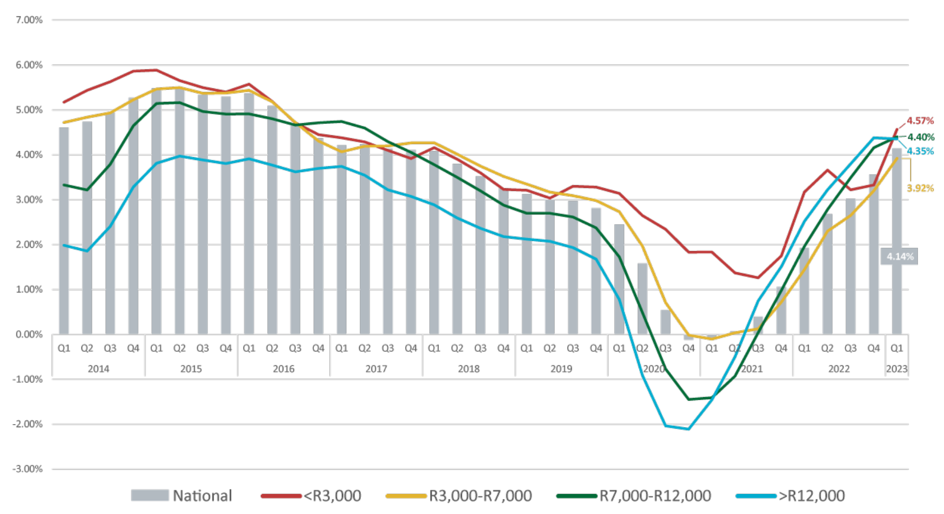
The luxury market, defined as rental properties over R25 000 per month, has the most units vacant with a vacancy rate of 11.83%. It represents only 1.2% of the formal rental market. The luxury market has historically struggled with high vacancies, although a notable trend is that vacancies reduce during the last quarter of each year as a result of holiday rentals. The only exception to this trend was during the fourth quarter of the pandemic years when harsh travel bans made it difficult for property owners to fill space, particularly in the coastal regions.

Tenants occupying these rental value band units had a good standing rating of 81.06%. Around 25% of these tenants either pay late or make partial payment towards their rental with only 5.98% not making any payment towards their rental. Owners can therefore expect some cashflow, albeit that payment may be late or is only partially paid.

Residential Rental Good Standing by Rent Value



Residential Rental Escalation By Value Band



Rental property and tenant performance by province

The start of 2023 saw a deterioration in the number of tenants in good standing in all provinces, illustrating the financial stress that consumers are under and revealing the impact that sluggish economic growth is having on the performance of the residential rental market. A closer look at each province reveals different market factors impacting on the ability of tenants to meet their rental obligations.

KwaZulu-Natal had the second highest number of vacancies with one in 10 properties standing empty in the first quarter of this year.

Only 60% of this province's tenants were paying their rent on time. After four consecutive quarters of decline in tenants in good standing, KwaZulu-Natal has the lowest good standing rating of the four largest rental-orientated provinces. At the start of 2023, only 75.82% of tenants had met their rental obligation and 15.4% had only made partial rental payment. Rental escalation rates dropped as landlords tried to balance high vacancies with returns. Rental escalations slowed to 4.49% in the first quarter of 2023, which is above the national average. Interestingly, KwaZulu-Natal is home to the highest average sectional title rental value. A sectional title unit in this province will achieve an average rental income of R9,279 per month while a full title unit achieves an average R9,312 per month.

Average rentals are based on the largest number of tenant records in South Africa, ensuring better data for better decision making. Rental data is also collected from a diverse range of investors, property managers and single landlords to ensure accuracy and to provide a holistic and realistic view of the residential rental market

Rental escalations in Gauteng have been on a path of recovery since 2021, albeit that the province has maintained a lower escalation rate, preferring to have occupied inventory as opposed to higher vacancies.

The province's rentals are now growing at 3.45% and landlords can expect to get an average rental of R7,532 for a sectional title property and R9,330 for a full title property. Gauteng's full title units are the second highest priced in South Africa.

A lower escalation rate has resulted in a vacancy rate of 7.31% in the first quarter, still above the national average, but substantially lower than the previous quarter.

Tenants in good standing remains slightly above the 80% mark (good standing includes all tenants who have settled their account by the end of the month whether they paid on time, paid late, or paid in a grace period) with 63.79% of tenants in this province ensuring they make rental payment on time and in full. Landlords owning property in this province should make provision for 7.17% of their tenants not making any rental payment.

Click here to better understand the TPN Rental Payment Profile indicators.

The Western Cape's rental market has been in a strong position for several quarters.

Rentals are growing at 6.22% and are expected to continue on a positive trajectory for the foreseeable future as demand remains extremely strong compared to other provinces. The high demand is reflected in a very low vacancy rate of only 1.66%. Rental increases have yet to negatively impact on tenants' ability to make rental payment.

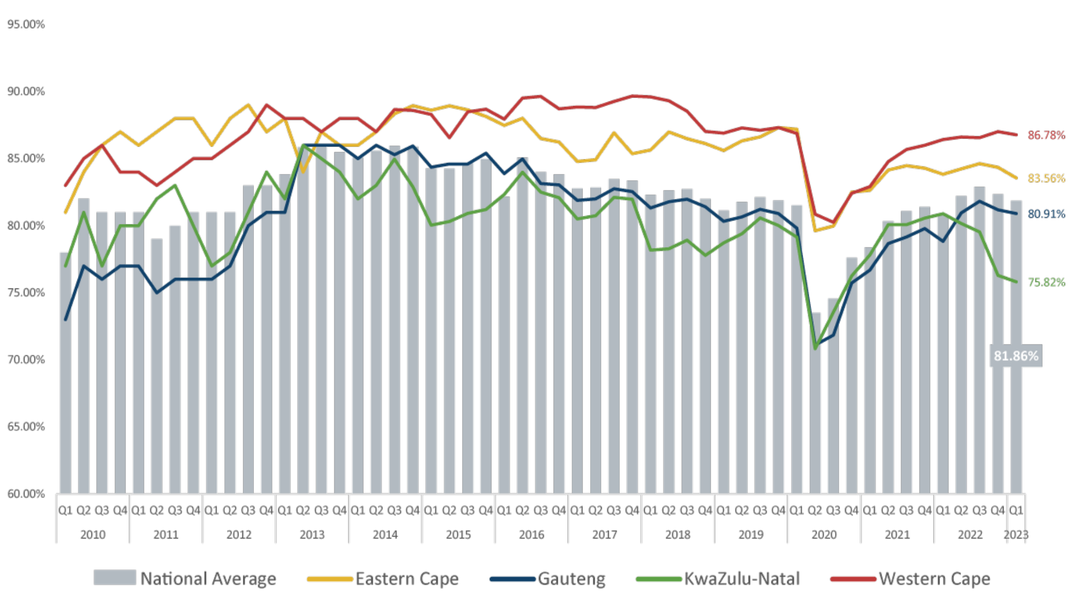
The good standing rate in the Western Cape is at 86.78%, the best in South Africa. Three-quarters of tenants are ensuring they pay their landlords on time and only 4.26% are not making any payment towards their rental obligation. Landlords in the Western Cape are typically less lenient and afford tenants with little grace period within which to make payment. Only 2.73% of tenant payments fall within a short 'payment grace period' that is granted in certain instances to allow for payments to clear. The Western Cape is home to the most expensive full title rental properties. Landlords on average achieve a rental of R12,213 per month for standalone properties. Sectional title property owners can expect to receive an average rental of R9,021 per month.

The Eastern Cape is also home to tenants committed to paying their rental with 83.56% of tenants in good standing within this province and 69.47% of tenants making payment on time and in full. Rental growth, however, has slowed considerably from 3.85% in the previous quarter to 2.94% in the first quarter of 2023.

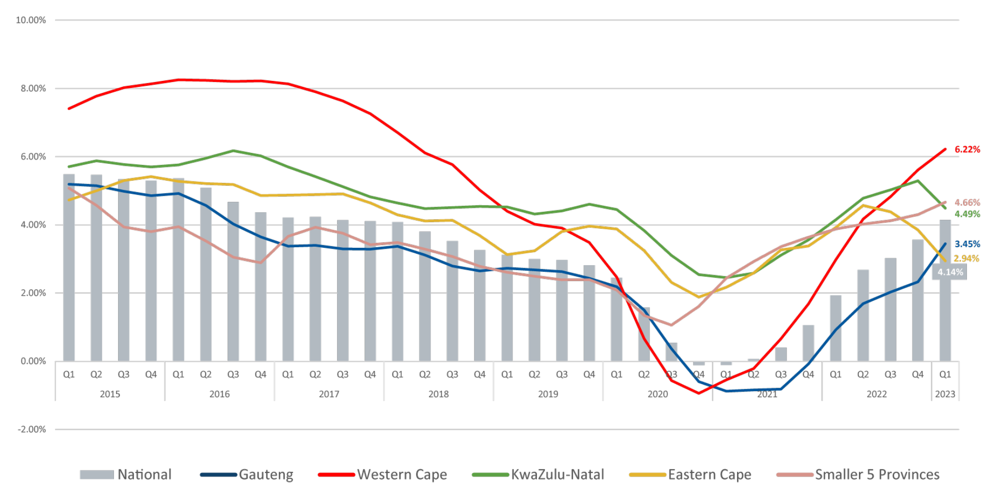
Slower rental growth has not reduced the number of vacancies in the Eastern Cape with one in 10 units standing unoccupied.

Average rentals for full title properties are R7,683 while sectional title units can expect to achieve an average rental of R6,421.

Residential Rental Good Standing by Province



Residential Rental Escalations by Province



Conclusion

Residential property investors have seen remarkable resilience in the market, primarily due to high interest rates which has dissuaded potential buyers. The expectation to see additional interest rate hikes will only act to further retain a healthy demand for residential property.

Although rental growth clearly continues to improve, we are starting to see a crack in an area that investors need to keep a close eye on, consumer financial health. Escalations should be considered cautiously as a result - consumers are under extreme and ever-increasing pressure - with the credit repayment rate slipping an early indicator of tenant rental collection risk.

Overall, the demand for residential rental property is expected to remain strong. Landlords are encouraged to take advantage of the market strength, but also to ensure that adequate tenant risk monitoring is implemented to mitigate the risk of an increase in defaulting tenants. Critical to future planning is the awareness that there has been an upward trend in tenants that classify as squatting. Needless to say, the right tenant in the right rental bracket is gold right now.