Key macro impacts of government finance on commercial property market

By John Loos

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In the recent Medium-Term Budget Policy Statement (MTBPS), National Treasury laid out its GDP (gross domestic product) growth projections to 2023. GDP growth is forecast to decline by -7.8% in 2020, before "partly recovering", growing 3.3% in 2021, 1.7% in 2022 and 1.5% in 2023. This implies that the level of GDP (the most popular measure of economy-wide production) is forecast to remain below the pre-Covid-19 2019 level through to 2023. Given that 2019 levels of GDP were already insufficient to prevent rising average property vacancy rates, an even lower level of GDP is likely to imply lower demand for space (than 2019), and a further rise in average vacancy rates through the forecast period.

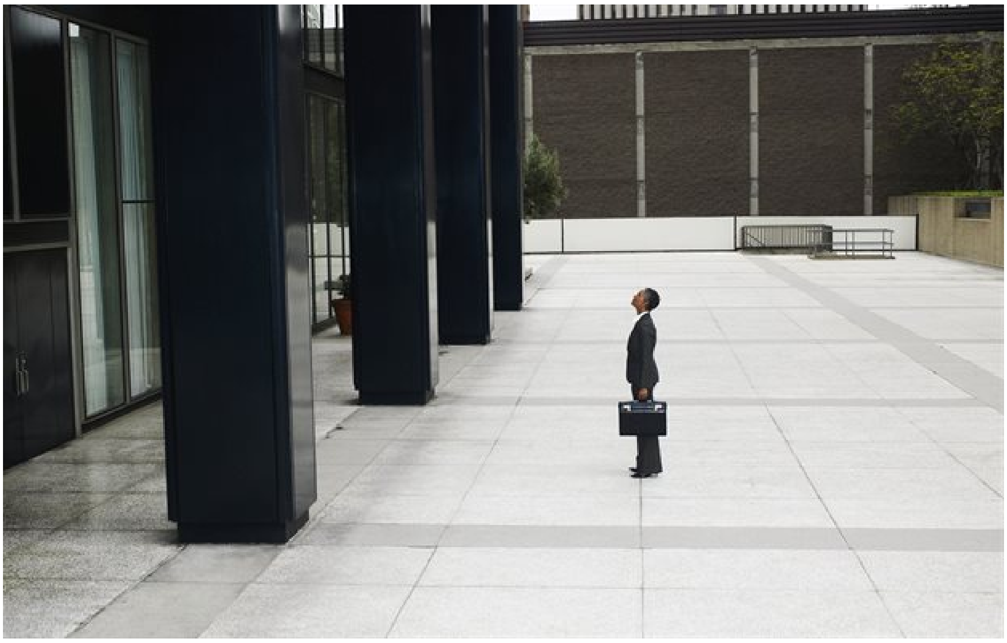

Image source: Gallo/Getty

The MSCI All Property Vacancy Rate had begun to rise back in 2016, exerting pressure on property income growth, so we think it unlikely that Treasury’s lower-than 2019 GDP forecast level through to 2023 would halt the weakening trend.

High and rising government debt burden a key property market negative

Via the influence of long bond yields on capitalisation rates

Treasury projects the government debt-to-GDP ratio to continue rising further in the coming years through the medium-term expenditure framework (MTEF) period and beyond.

In the short term, it is forecast to rise from 63.3% of GDP at the end of the 2019/20 fiscal year to 81.8% by the end of the 2020/21 fiscal year. Thereafter, further increase is projected to a peak of 95.3% of GDP in the 2025/26 fiscal year.

By the second quarter of calendar year 2020, one quarter into the 2020/21 fiscal year, the debt-to-GDP ratio had jumped from 63.3% in the first quarter (end of fiscal 2019/20) to 69.4%. Should this projection play out, it promises to exert some further downward pressure on property values due to upward pressure on property capitalisation rates through pushing government long bond yields still higher, given the partial relationship between the two.

Already, a noticeable rise in long bond yields has been witnessed since 2013, and in more recent years we have seen key property cap rates begin to rise more noticeably too.

Government average bond yields for bonds 10 years and longer rose by 3.13 percentage points from the second quarter of 2013 to the third quarter of 2020.

And Rode's cap rate data has shown some apparent response. Average national regional shopping centre cap rates as at the third quarter of 2020 were 1.4 percentage points higher since a low in the fourth quarter of 2015, A-Grade de-centralised office space cap rates were up 1.2 percentage points since the third quarter of 2015, and prime industrial cap rates were up 1 percentage point since the first quarter of 2016.

Pressure remains on commercial property market post-lockdown
John Loos 16 Oct 2020

Via the drag of government finance of economic growth and property demand

However, the influence of rising long bond yields is not the only mechanism via which government finance can influence property valuations.

In order to arrest the unsustainable increase in government debt, and so prevent an ultimate default and all its consequences, government will likely have to keep the effective tax rate of the country on its long-term rising trend, i.e., a rising tax-to-GDP ratio, and lower the spending-to-GDP ratio in order to lower the fiscal deficit-to-GDP ratio. This process, while crucial to growth prospects in the long term, would be a drag on economic growth in the shorter run, and thus on property space demand in the MTEF period.

The fiscal deficit as a percentage of GDP is projected to decline from -14.6% in the 2020/21 fiscal year to -7.3% by the 2023/24 year. The plan is to achieve this with a modest rise in tax revenue as a percentage of GDP, from 22.6% to 24.9% over the same period, and a decline in expenditure as a percentage of GDP from 37.2% to 32.3% over that time.

These measures would not yet arrest the rising trend in the debt-to-GDP ratio, but slow the pace of increase during the medium-term budgeting period.

Therefore, the budget at high level is believed to impact on property via upward pressure on long bond yields exerting upward pressure on property cap rates, as well as through greater projected austerity constraining economic growth and thus dampening property demand growth, sustaining rising vacancy rates and downward pressure on property incomes in the short to medium term.

Rise in sale and leaseback transactions to free up cash flow

25 Sep 2020

Weak infrastructure spend a further key long-term economic growth constraint

Low levels of government fixed investment, with that area of budgeting at all levels of government having been to a significant degree “crowded out” by a strong government consumption expenditure, has been a major short-coming in recent decades.

General government fixed investment spending on economic infrastructure, key in facilitating economic growth, slumped from as far back as the late-1970s. It slowed sharply from a multi-decade high of 7.3% of GDP in 1976, and has never strongly recovered, recording a mere 1.5% of GDP level in 2019. Over three decades later, infrastructure shortages are a drag on economic growth, and this government finance-related negative thus becomes a key property market negative.

Local government and parastatal finances also impact heavily on property

The national government debt situation is not the only level of government finance that is currently a key constraint on the commercial property market. Local government fiscal constraints and those of certain utilities play a key role too.

While these areas of government are not part of the national government budget, they are impacted in the sense that national government has very limited financial resources for potential so-called “bailouts” of other areas of broader government such as parastatals. So although Eskom has received some assistance from national government, it will still likely attempt to boost its stagnating revenues through above-inflation rate tariff hikes in the coming years, something which has already exerted huge upward pressure on property operating costs over the years.

Municipal rates and other utilities tariffs are not far behind, also applying above-inflation hikes.

Although the Consumer Price Index' rates and tariffs sub-index relates to residential rather than commercial property, it provides something of a picture, with the electricity component showing 6.01% year-on-year inflation as at September, and the “water and other tariffs” component (which includes municipal rates and other utilities tariffs) inflating at 6.03%. These two inflation rates are about double the 3% overall CPI inflation rate.

According to MSCI data, the All Commercial Property Electricity Cost/Property Income per Square Metre ratio almost doubled from a low of 5.4 in 2002 to 10.5 by mid-2019 (albeit having tapered marginally in more recent years). The Municipal Rates, Charges and Non-Electricity Utilities Tariff Cost/Property Income per Square Metre ratio also increased considerably, from 7.5 in 2000 to 11.4 by mid-2019. Municipal rates, charges and utilities tariffs (including electricity) make up over 60% of total all property operating costs, having been not far above 40% back in 2000.

Conclusion

In short, we believe there are four key constraining macro impacts of broad government finance on commercial property market performance currently:

- Rising government debt exerting upward pressure on long bond yields and thus on property cap rates.
- Attempts at government fiscal deficit reduction, while absolutely essential, can be seen as a constraint on medium-term economic growth and thus a constraint of domestic demand for commercial property space.
- Low government capital expenditure budgets over the past few decades are a long-term economic growth constraint, and thus a constraint on long-term demand for commercial space.
- Above-inflation municipal rates and utilities tariff hikes (part of broader government and not of national government’s budget) continue to exert upward pressure on property operating costs.

Nevertheless, these constraining factors should not be seen as an argument against greater fiscal discipline. The alternative, i.e., a far faster than projected expenditure growth rate and resultant faster rise in the government debt, could ultimately end badly, with the economic growth consequences of a debt default being significantly worse.

But from the current situation, where government and its parastatals have become highly indebted, there is no easy way out. Allowing the situation to continue to rapidly deteriorate comes with likely severe longer term economic growth consequences, while planned moves towards greater fiscal discipline can be short-to-medium term growth constraining, but have longer term benefits.

For the time being, therefore, we would expect government finance trends to effectively be a constraint on commercial property market performance, and for the market to remain on its multi-year “correcting” path.

ABOUT JOHN LOOS

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