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PROPERTY MARKETS

Residential Property in 2008 – What could the “Eskom Effect” be?

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When one looks back over the years of economic or property data, it is possible to identify certain spikes or troughs which may be associated with a certain event. The early-1980s house price surge could be termed the “Gold Boom Effect”, or one could call one of the slumps in the rand in the late-1990s the “Emerging Markets Crisis Effect”. A recent issue that begs consideration is, when we look back at 2008 property data in years to come, will an “Eskom Effect” be visible?

The recent series of “rolling blackouts” has certainly got many tongues wagging, and has caused much anger. But apart from the general irritation caused by the power cuts, what could the real impact on property market performance conceivably be?

There are two obvious ways in which the electricity production and distribution shortages could conceivably impact upon the property market.

Firstly, the crisis has the potential to impact negatively via its negative impact upon economic growth. Slower (than would have been the case in the absence of an electricity shortage) economic growth would negatively impact on job creation and household disposable income growth numbers, thus slowing the growth in demand for residential property as well as consumer demand. And consumer demand is crucial in driving the demand for, and returns on, retail property.

Slower economic growth would also negatively affect the demand growth for office and industrial space.

Simplistically, the above would suggest that property returns across the board should suffer at the hands of the power shortage due to its negative effect on demand for all of the various categories of property.

But as we know, the real world is never that simple.

Offsetting the negative effect either partly or wholly is the impact that electricity capacity constraints could conceivably have on the supply of new property stock. My expectation of growing supply-side constraints as 2010 approaches, as the economy grows faster, and as the fixed investment boom accelerates, has been a cornerstone in my view that property returns will excel in the coming years, and

that even residential property can make a comeback. The latest electricity crisis just adds to this belief.

While we will need to wait for more detailed crisis plans to emerge in the coming days and months, it seems clear that for some years, electricity supply constraints will be a reality in SA. This will require a demand management programme, involving a set of incentives and controls aimed at improving the efficiency of South Africa's consumption, and indeed much of the talk in recent days has already been focused on the need to slash power consumption.

Under these conditions, it is difficult to foresee new property developments being able to secure new electricity supply at the same pace as in the recent past. My guess is that it will be priority to first make sure that existing installations are able to operate relatively free of disruption (i.e. an end to rolling blackouts), and that demand management programmes first free up capacity, before allowing a proliferation of new electricity-guzzling projects.

It is also conceivable that there could be some type of prioritisation for new projects when allocating electricity supply, and my guess here would be that commercial and industrial property developments, much needed to facilitate an ever-expanding economy, could receive priority over residential developments for a while, especially given the low levels of vacant commercial and industrial space. Even developments in these categories, however, could experience limitations for some time

All of this spells possible gloom from a property developer point of view. However, the positive side is that the more severe the constraints on the supply of new stock (and all other things equal), the better for property returns.

So in Eskom's woes we have a double-edged sword for property returns, the negative side emanating from the negative impact of an electricity supply shortage on demand for property via the economic impact, and the positive side coming from the impact on curbing supply of new property stock.

The big question in determining the overall impact on property is which of the 2 impacts will be the most pronounced?

While we'll need to wait for the outcome of deliberations by the task team set up to address the current energy crisis, it is probably fair to say that power scarcity is a relatively new phenomenon to South Africans. As such, “gutfeel” would suggest that there is significant potential for improvements in the efficiency of electricity use, both in business as well as in SA's household sector.

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To achieve major energy savings, Eskom may have to do more than put out appeals to save power on national TV. It may have to adjust the pricing structure, and rationing has been discussed. But I suspect we'll all be amazed by how much energy efficiency can improve when push comes to shove.

While tough to quantify the energy saving potential, if one buys into the view that it is significant, then at this stage we should probably not entertain the view that business and economic growth will be brought to a grinding halt (though admittedly there must be some negative impact)

Efficient utilisation of space, be it residential space or space in the workplace, is also an area where South Africans are arguably well-behind many countries in the world due to a relative abundance of it in bygone years.

While we have witnessed a gradual improvement in space utilisation as scarcity grows and rentals accelerate, the potential effect of Eskom in constraining new property development may well serve to accelerate efficient space utilisation, driving densification in both work and living space (although admittedly this is not always an easy task and often takes the redesigning of facilities).

In conclusion, therefore, while the potential impact is almost impossible to quantify due to the amazing ability of humans to adapt (so take the various financial estimates of the Eskom effect with a pinch of salt), it is fair to say that there has to be some negative impact on business and economic growth. However, because SA is relatively new to demand management both for electricity as well as for space, my feeling is that the business growth ceiling that Eskom places on South Africa is perhaps a little higher than what the alarmists would have one believe, for the time being at least. As a result, my view is that the "Energy Crisis" will have a greater negative impact on the supply of new property stock in next few years than on business and economic growth.

The net effect of all of this, I believe therefore, will be positive for both commercial and residential property returns.

From a property development point of view, however, I am far less optimistic, and the negative impact on the supply of new stock could be significant. This doesn't necessarily mean negative growth in new developments but merely slower positive growth than would otherwise have been the case.

Not all would be lost for the building construction industry, however, as a greater focus on alterations and additions to existing buildings could be stimulated by the power issue, as the drive towards "greener" buildings and better space utilisation is stepped up.

There is as always, however, a key risk to this view. I haven't touched on how confidence levels both in SA as well as abroad towards SA have been affected by all of this.

Realistically, we need to anticipate various supply side constraints during an accelerating economic growth phase, and during a major fixed investment boom. Such constraints are fairly normal in most booms, as it is seldom that all suppliers increase their capacity to supply in sync. We've already

experienced some periodic shortages in materials, now power, and I expect that this will not be the last.

But, unfortunately, many people don't understand the normality of some of this, and interpret these periodic shortages as just another sign of a country going backwards. Will this contribute to a rise in emigration rates after a seeming decline a few years ago? Will foreign investment be curbed not only by actual power constraints but due to perception issues (misplaced or not)?

Such questions cannot be answered yet, as much depends on how Eskom makes amends to its handling of the issue in the weeks and months to come. The more significant the negative impact on residents' and investors' confidence is, the more the scale tips towards the net impact on property returns being negative.

At this stage, though, I take the early view that the sword (net effect of the energy shortage) will be double-edged, i.e. positive for property returns but negative for new property development.