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4 key factors driving recovery in SA's office market

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"SAPOA reports the overall office vacancy rate for this quarter at 14.7%, down 50 basis points from the previous quarter a a full 2% lower during the peak of 16.7% in Q2 2022," shares John Jack, CEO of Galetti Corporate Real Estate. "This mar the seventh consecutive quarter of improvement and is a sure sign that the innovative strategies landlords have had to ado to contend with huge challenges like high interest rates, the ongoing energy crisis and higher operational costs are paying off."

Looking at Galetti's uptake in the office sector, Jack notes that there's sustained and growing demand for office space in South Africa's major metro areas. "Companies are starting to invest and grow their staff numbers again. In the Western Cape and the Northern suburbs of Johannesburg for instance, office space is now hard to come by."

What's driving the uptick?

Jack believes that lowered office vacancy levels are the result of four key factors:

1. The upside of a decline in real rental growth

While news of lowered vacancies is music to a commercial landlord's ears, these gains have come at a high cost – the decline of real rental growth.

Accounting for inflation, SAPOA's Q1 2024 report shows a -6.2% year-on-year decline in office rentals nationally.

This decline is further substantiated by Rode's Report, which found that listed property funds still report large negative ren reversion rates – a concept whereby tenants pay a lower rental upon lease renewal than they did.

“Some landlords are attempting to combat oversupply by promising tenants substantially discounted rentals on both new leases and lease renewals,” comments Jack. “While this may not be a financially viable strategy in the long run, it is clear having its desired effect by drawing more people back to the office.”

He shares that other unconventional methods landlords are using to attract tenants include flexible lease terms, shared workspaces and investment in off-grid energy systems to ensure uninterrupted operations.

2. Increased demand for less expensive A and B-Grade office space

The SAPOA Vacancy Survey found that while vacancy rates for A, B and C-Grade office space improved in the first quar of 2024, vacancies in ‘Prime’ or P-Grade office space declined slightly, by ten basis points. “P-Grade buildings have the highest classification and are often considered iconic landmarks, boasting Green Certification, 24/7 security, cutting-edge design and finishes,” says Jack.

"However, P-Grade buildings are also the most expensive, and in the challenging economic environment, many tenants ar opting to downsize by relocating to A or B-Grade offices. These still offer many of the benefits of a P-Grade building, but without some of the luxury ‘bells and whistles’."

Galetti’s data shows that the price per square metre for A-Grade rentals in the key Johannesburg business node of Rosebank is up to R100 cheaper than that of P-Grade office space in the same area. In Cape Town’s CBD, the gap is smaller, with P-Grade office space charged at around R35 more per square metre than A-Grade space.

3.The continued dominance of Cape Town

Cape Town has been instrumental in recovering both the commercial and residential property sectors, with SAPOA’s data illustrating its major contribution to improved national vacancy rates.

The City of Cape Town’s vacancy levels are the lowest recorded since 2009. As further evidence of the City’s title as the t performing office market in the country, the latest Rode Report found that Cape Town was the only major node in the coun to record above-inflation rental growth last year, at a rate of 10% for 2023.

4. Headline inflation easing downwards

The Reserve Bank’s target range for headline inflation is between 3%-6%, with the midpoint ideal as 4.5%. “The Reserve Bank recently revised their outlook of achieving this midpoint in the second half of 2024, pushing the expected return to th midpoint to the target band to the last quarter of 2025,” says Jack.

“However, the good news is that the Bank expects headline inflation to moderate this year to an average of 5.1%, down fro 6% in 2023. Once headline inflation is curbed, the long-awaited rate cuts will come to pass, bringing significant relief to South Africa’s biggest commercial property landlords.”

He shares that the current elevated rate environment has resulted in higher funding costs and significantly lower Distributa Income Per Share (DIPS) rates, which is one of the primary methods of calculating financial performance for listed properties. “Critically, a high-rate environment also has a detrimental impact on the asset value of properties within a landlord’s portfolio.

Jack feels once headline inflation is curbed and rate cuts are implemented, major landlords will be able to capitalise on emerging positive trends, including lowered vacancies and higher company share prices, and begin to increase their expenditure and investment in the office sector.

“While external factors like the energy crisis and high municipal costs continue to compound the challenges facing the embattled sector, rate cuts will be instrumental in easing the financial burden landlords are facing,” he concludes.