Commercial Property Rates & Taxes

A comparison across Property Sectors, Segments and Municipalities
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Key Findings

- As at December 2018, Rates & Taxes became the fastest growing property operating cost category over a ten year period – overtaking electricity.

- For the ten year period ended December 2018, rates & taxes increased by 133% - translating into a compound annual growth rate of 8.8% versus the 8.5% of Electricity over the same period.

- Municipal rates & taxes have consistently increased at a faster rate than inflation since the early 2000’s. For the period 2000-2005, rates & taxes grew at an annualised rate of CPI+3.7%, accelerating to CPI+5.3% for 2005-2014. For the period 2014 to 2018, it continued to grow at a similar rate at CPI+5.0%.

- In 2000, rates & taxes worked out to 17.4% of total operating costs and by December 2018 this had escalated to 24.7%. On a weighted basis, rates & taxes remains the second largest contributor to total operating costs – behind electricity.

- Over the long term, rates & taxes have tended to move in line with property capital values. However, in the short term, significant dislocations between the two series are common as municipal valuations are generally slow to respond to shifts in the property cycle given the processes involved.

- The 12 months to December 2018 saw rates & taxes move significantly clear of property capital values when viewed on an index basis.

- During the period 2010 to 2015, capital values were also outpaced by Rates but caught up within 5 years. The current cycle is somewhat different in that base rental growth is unlikely to increase significantly and there is limited room for yield compression. This could see the gap between property capital values and rates persist beyond the short term before getting back to equilibrium levels.

- While there was significant variance between the different sectors for the period 2000-2007, they have converged since then and as at December 2018 were within 160bps of each other.

- On a sector level, the biggest change from 2007 can be seen in the retail sector as it went from being the best placed sector in 2007 to the worst in 2018 as rates & taxes continued to increase at a faster rate than gross income (driven by the larger format centres).

- Over the same time period, industrial property saw a reduction in its gross cost to income, going from 8.5% in 2007 to 7.9% in 2018.

- The industrial property recorded the lowest growth in its rates & taxes in 2018 – ending the period 90bps up compared to the retail and office sector’s increases of 140 and 130bps respectively. Rates & taxes are fairly consistent between 7 and 9% across the different property segments. Large retail centres seem to be the exception to the rule with Super Regionals recording a gross cost to income ratio of 12.7% as at December 2018.
Long term trend: Rates & Taxes growth – relative to inflation and economic growth

As at December 2018, Rates & Taxes became the fastest growing property operating cost category over a ten year period – overtaking electricity.

For the ten year period ended December 2018, rates & taxes increased by 133% - translating into a compound annual growth rate of 8.8% versus the 8.5% of Electricity over the same period.
As illustrated in the graphic below, municipal rates & taxes have consistently increased at a faster rate than inflation since the early 2000’s. In fact, the inflation-adjusted growth in rates & taxes has kept accelerating through the period.

For the period 2000-2005, rates & taxes grew at an annualised rate of CPI+3.7%, accelerating to CPI+5.3% for 2005-2014. For the period 2014 to 2018, it continued to grow at a similar rate at CPI+5.0%.
The accelerating growth in rates post-2007 have coincided with a lower level of economic growth. This has seen rates become a larger portion of overall operating costs and gross income – increasingly weighing on net income growth. It has also outstripped the growth in property capital values.

Source: MSCI Real Estate
Rates & Taxes now the fastest growing property operating cost category over a ten year period – overtaking electricity.

**Operating Cost growth over last 10 years**

<table>
<thead>
<tr>
<th>Measure</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rates and Taxes</td>
<td>133% (8.8% CAGR)</td>
</tr>
<tr>
<td>Municipal Charges</td>
<td>132% (8.8% CAGR)</td>
</tr>
<tr>
<td>Electricity</td>
<td>127% (8.5% CAGR)</td>
</tr>
<tr>
<td>Building Management</td>
<td>91% (6.7% CAGR)</td>
</tr>
<tr>
<td>R&amp;M: Building Fabric</td>
<td>80% (6.1% CAGR)</td>
</tr>
<tr>
<td>Tenant Installation Costs</td>
<td>71% (5.5% CAGR)</td>
</tr>
<tr>
<td>Cleaning</td>
<td>70% (5.4% CAGR)</td>
</tr>
<tr>
<td>Gardens</td>
<td>68% (5.3% CAGR)</td>
</tr>
<tr>
<td>R&amp;M: Elevators/Escalators</td>
<td>55% (4.5% CAGR)</td>
</tr>
<tr>
<td>Other Operating Costs</td>
<td>52% (4.3% CAGR)</td>
</tr>
<tr>
<td>Security</td>
<td>60% (4.1% CAGR)</td>
</tr>
<tr>
<td>R&amp;M: Air Conditioning</td>
<td>42% (3.6% CAGR)</td>
</tr>
<tr>
<td>Insurance</td>
<td>29% (2.6% CAGR)</td>
</tr>
<tr>
<td>Letting Fees and Commissions</td>
<td>11% (1.1% CAGR)</td>
</tr>
<tr>
<td>Management Costs</td>
<td>6% (0.6% CAGR)</td>
</tr>
<tr>
<td>Bad Debts</td>
<td>-38% (-4.7% CAGR)</td>
</tr>
</tbody>
</table>

Cumulative Growth

Source: MSCI Real Estate
Rates & Taxes as a % of total operating cost
- now a larger slice of a larger pie

Rates & taxes, as a cost category, has grown faster than all other operating costs since 2009 seeing it gradually increase as a proportion of total operating cost over time.

In real (inflation-adjusted) terms, rates and taxes amounted to R2.1/sqm in 2000. By December 2018 this had increased to R4.9/sqm—a 2.5x increase in real terms.

In 2000, rates & taxes worked out to 17.4% of total operating costs and by December 2018 this had escalated to 24.7%.

This translates to a cumulative, nominal growth in rates & taxes of 534% over this period—behind electricity which saw a cumulative increase of 626% since 2000. At the same time, gross income increased by 333% - highlighting the potential dilutionary impact of administered costs on net income.

On a weighted basis, rates & taxes remains the second largest contributor to total operating costs – behind electricity.

For all three major property sectors, rates and taxes now account for over 25% of total operating costs. For the office sector, rates & taxes accounted for 26% of total operating costs as at the end of December 2018. (25.1% and 25.0% for retail and industrial respectively)”}

Source: MSCI Real Estate
Rates & Taxes - significantly up in last two and a half years after remaining flat in 2014 & 2015

On a per square meter basis, rates & taxes increased by R2.84 year-on-year to December 2018. This is the largest rand increase since the R1.53/sqm increase recorded in 2015.

Several major metros including Johannesburg and Cape Town had general valuations (GVs) performed during 2018 which would have influenced the upward move as a result of the re-rating during the year.

Rates & taxes - period on period change
All Property; 2000-2018; Rand per square meter

Progression of rates & taxes since 2001
Change relative to previous period; Rand/sqm

Source: MSCI Real Estate
Has the growth in Rates & Taxes been consistent with the growth in property values?

Over the long term, rates & taxes have tended to move in line with property capital values. However, in the short term, significant dislocations between the two series are common as municipal valuations are generally slow to respond to shifts in the property cycle given the processes involved. The 12 months to December 2018 saw rates & taxes move significantly clear of property capital values when viewed on an index basis.

As at December 2018, the ‘over recovery’ in municipal rates amounted to 25.9% - the largest gap yet. During the period 2010 to 2015, capital values were also outpaced by Rates but caught up within 5 years. The current cycle is somewhat different in that base rental growth is unlikely to increase significantly and there is limited room for yield compression. This could see the gap between property capital values and rates persist beyond the short term before getting back to equilibrium levels.

Municipal general valuation (GV) rolls are legally required to be updated only once every 4 years. However, there are still bound to be variations on a metro level since the major metros aren’t synchronised in the timing of their GV’s.

Supplementary valuation rolls, while more frequent, are still based on market conditions as at the effective date of the GV.

Another factor to bear in mind is that rate increases (particularly the “rate-in-the-rand”) are determined by cities’ budgetary requirements rather than the state of property fundamentals and levels of capital growth.

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**Growth in Rates & Taxes relative to increase in Commercial Property values**

All Property: 2000-2018; 2000=100

- **2005-’09** Under-recovery as capital values grow faster than Rates
- **2010-’15** Over-recovery: capital value outpaced by Rates but catch up within 5 years
- **2016-2018** Over-recovery widens again as Rates accelerate while capital growth remain muted

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Source: MSCI Real Estate
Rates & Taxes as a % of gross income for the major property sectors

When viewed as a percentage of gross income, rates & taxes increased by 120bps on an All Property level for the 12 months ended December 2018.

The graphic below illustrates the long term trend in the ratio of rates & taxes to gross income both on an All Property level and per sector.

While there was significant variance between the different sectors for the period 2000-2007, they have converged since then and as at December 2018 were within 160bps of each other.

On a sector level, the biggest change from 2007 can be seen in the retail sector as it went from being the best placed sector in 2007 to the worst in 2018 as rates & taxes continued to increase at a faster rate than gross income (driven by the larger format centres).

Over the same time period, industrial property saw a reduction in its gross cost to income, going from 8.5% in 2007 to 7.9% in 2018.

The industrial property recorded the lowest growth in its rates & taxes in 2018 – ending the period 90bps up compared to the retail and office sector’s increases of 140 and 130bps respectively.

**Rates & Taxes as a % of Gross Income – per sector 2000–2018 and last 3 years**

Source: MSCI Real Estate
Are Rates & Taxes consistent with property values across property types?

Looking across the different property segments, rates & taxes are fairly consistent when expressed as a % of gross income- ranging from 7-9%.

Large retail centres seem to be the exception to the rule with Super Regionals recording a gross cost to income ratio of 12.7% as at December 2018.

Regional shopping centres and decentralised offices also report rates as a % of gross income ratios at the higher end of the spectrum.

Smaller format retail centres and inner city offices have the lowest rates expense as a % of gross income with likely factors influencing this being UDZ benefits for selected inner city areas and higher yields relative to other property types.

The gross cost to income ratio of the underlying industrial property segments are tightly grouped between 7.8% and 8.0% as at December 2018.

### Rates and Taxes per Sector and Segment

<table>
<thead>
<tr>
<th>Rates &amp; Taxes; % of Gross Income</th>
<th>Rand/sqm; % of Gross Income; Period ending December 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>All Property</strong></td>
<td>All Property</td>
</tr>
<tr>
<td>Retail</td>
<td>All Property</td>
</tr>
<tr>
<td>Retail Super Regional Shopping Centres</td>
<td>26.16 (12.7%)</td>
</tr>
<tr>
<td>Retail Regional Shopping Centres</td>
<td>20.01 (9.5%)</td>
</tr>
<tr>
<td>Retail</td>
<td>13.47 (7.1%)</td>
</tr>
<tr>
<td>Retail Small Regional Shopping Centres</td>
<td>10.01 (7.7%)</td>
</tr>
<tr>
<td>Retail Community Shopping Centres</td>
<td>9.92 (7.3%)</td>
</tr>
<tr>
<td>Retail Neighbourhood Shopping Centres</td>
<td>19.06 (9.4%)</td>
</tr>
<tr>
<td>Retail Other Retail</td>
<td>18.06 (9.4%)</td>
</tr>
<tr>
<td>Office</td>
<td>All Property</td>
</tr>
<tr>
<td>Office Decentralised Office</td>
<td>15.58 (7.7%)</td>
</tr>
<tr>
<td>Office Provisonal Office</td>
<td>11.61 (7.5%)</td>
</tr>
<tr>
<td>Office Inner City Office</td>
<td>8.30 (6.9%)</td>
</tr>
<tr>
<td>Industrial</td>
<td>Industrial Standard units / Workshops</td>
</tr>
<tr>
<td>Industrial</td>
<td>6.64 (8.0%)</td>
</tr>
<tr>
<td>Industrial</td>
<td>5.36 (7.9%)</td>
</tr>
<tr>
<td>Industrial</td>
<td>5.32 (7.8%)</td>
</tr>
<tr>
<td>Industrial High tech industrials</td>
<td>5.22 (7.8%)</td>
</tr>
<tr>
<td>Others</td>
<td>Other segment</td>
</tr>
<tr>
<td>Others</td>
<td>6.31 (7.8%)</td>
</tr>
</tbody>
</table>

**Source:** MSCI Real Estate
Are Rates & Taxes consistent across provinces for similar property types?

This section analyses rates and taxes by sector, comparing South Africa’s three major provinces in terms of their rates & taxes as a % of gross income and per square meter for the three main property sectors, namely retail, office and industrial.

On an All Property level, rates & taxes equates to 8.8% of gross income and R14.10/sqm. This is 120bp up on 2017 when rates & taxes equalled 7.6% of gross income.

However, there is significant variance on a provincial level, driven by different ‘cents in the rand’ rates levied by the respective underlying municipalities within the provinces, timing of the respective general valuation rolls and municipal valuation accuracy relative to actual valuation.

On a provincial level, KwaZulu Natal continues to have the highest rates & taxes as a percentage of gross income for all three main property sectors being Retail, Office & Industrial.

For all three major property sectors, KZN has a higher rates ratio driven by the relatively higher ‘cents in the rand’ rates tariff levied by the eThekwini municipality relative to the country’s other major metros.

The Western Cape and Gauteng are more evenly matched when analysing rates & taxes as a percentage of Gross Income.

Rates and Taxes per Sector and province
Rand/sqm; % of Gross Income; Period ending December 2018

Source: MSCI Real Estate
Are Rates & Taxes consistent across properties in different size bands?

The graphic below compares the rates & taxes as a percentage of gross income for different ranges of gross lettable area across the three main property sectors.

While the cents-in-the-rand tariff that apply to property rates & taxes are the same for properties of a similar use (i.e. Business/Commercial or Industrial), there is significant variance in the rates to gross income ratio for different size brackets.

An interesting finding when looking at the graphic below is how the rates to gross income ratio declines for larger office and industrial properties but increases for larger retail assets.

This suggests that larger retail assets are subjected to higher rates relative to their gross income notwithstanding the higher base rental and operating cost recoveries associated with large retail centres.

The reason for the higher rates ratio in larger malls could at least in part be explained by its higher capital value per square meter—courtesy of higher value finishes and infrastructure relative to smaller malls as well as higher land values.

Meanwhile, office and industrial properties could likely be more homogenous as far as these characteristics are concerned – irrespective of GLA.

### Rates and Taxes for GLA size bands per Sector

<table>
<thead>
<tr>
<th>Rates &amp; Taxes; % of Gross Income</th>
<th>All Property</th>
<th>Retail</th>
<th>Office</th>
<th>Industrial</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All Property</td>
<td>All</td>
<td>All</td>
<td>All</td>
</tr>
<tr>
<td></td>
<td>Retail</td>
<td>All</td>
<td>All</td>
<td>All</td>
</tr>
<tr>
<td></td>
<td>Office</td>
<td>All</td>
<td>All</td>
<td>All</td>
</tr>
<tr>
<td></td>
<td>Industrial</td>
<td>All</td>
<td>All</td>
<td>All</td>
</tr>
<tr>
<td></td>
<td>All</td>
<td>2,501 - 5,000 sq m</td>
<td>5,001 - 10,000 sq m</td>
<td>10,001 - 25,000 sq m</td>
</tr>
<tr>
<td></td>
<td>7.1%</td>
<td>7.5%</td>
<td>7.1%</td>
<td>10.1%</td>
</tr>
<tr>
<td></td>
<td>9.6%</td>
<td>8.8%</td>
<td>8.9%</td>
<td>8.0%</td>
</tr>
<tr>
<td></td>
<td>9.1%</td>
<td>9.9%</td>
<td>7.8%</td>
<td>7.2%</td>
</tr>
</tbody>
</table>

Source: MSCI Real Estate
How much variance is there in the Rates & Taxes charged to individual properties?

This analysis groups properties into percentiles based on their rates & taxes per square meter. In summary, the analysis shows a large spread in the level of rates charged to individual properties (both as a % of total operating costs and as a % of gross income).

The top 10% of properties in terms of their rates psqm had an average rates expense of R33/sqm compared to the overall average of around R14/sqm.

As a % of gross income, properties in the top decile had a rates expense equal to 11.7% of gross income – compared to the 8.8% of the average property.

The second graphic shows rates as a % of total operating costs relative to rates as a % of gross income per sector for the average as well as the top & bottom decile and balance of properties.

On a sector-level, Office property has the largest variation between the rates and taxes of properties in the top and bottom deciles.

Office properties in the top decile had a rates/sqm of R34.25 compared to the average office property of R15.61.

Large spread between bottom and top 10% of properties (based on Rates psqm)
Period ending December 2018

Source: MSCI Real Estate
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