RESEARCH
Operating Cost Report
KEY FINDINGS

As at the end of December 2019, total operating costs equated to 36.5% of gross income on an All Property level. This is 50bps up from December 2018 and 50bps above its long term average of 34.9%. Gross income is the sum of base rental, fixed recoveries (operating cost recoveries stipulated in tenant leases) and variable recoveries (such as electricity and water usage).

The deterioration in the gross cost to income ratio came about as a result of total operating costs growing at 10.9% - a faster rate than gross income at 9.6% during the 12 months. Gross income growth was driven by recoveries (fixed & variable) which grew by 8.5% on the back of inflation-plus administrated price increases.

All four major property sectors saw their gross cost to income ratio deteriorate during the period with the residential sector seeing the largest decrease – a 110bp move out to 44.0%.

The industrial sector also recorded a significant increase of 60bps to end at 32.2%. The main drivers of the industrial sector’s increased cost ratio was municipal charges and electricity as well as repairs & maintenance.

Among the major property operating cost categories, municipal charges continues to make up the largest percentage of overall operating cost. Municipal charges comprises rates & taxes, electricity & other metered utility charges such as water and CID charges.

On a per square meter basis, municipal charges were up 10.8% for the 12 months ended December 2019. At the end of the period, municipal charges accounted for 62% of total operating costs.

From 2006 to 2019, municipal charges grew faster than any other operating cost category – becoming a bigger slice of a bigger pie. During this time, it effectively quadrupled in going from R10 in 2006 to R41 in December 2019 at a compound annual rate of 10.5%.

Bad debts write offs spiked in 2019 after growing by 58% from 2018- a trend which may well continue into 2020 as the Covid-19 pandemic starts taking its toll. Despite its outperformance from an investment returns perspective, the industrial sector was not spared as its bad debt write offs hit an all time high of 48 cents/sqm.

Property rates & taxes continue to be a major driver of operating costs with its sustainability still coming under the microscope – both from the landlord and tenant’s perspectives.

As at December 2019, Rates & Taxes was the fastest growing property operating cost category since 2006 – i.e. before the Global Financial Crisis and domestic recession – exceeding the growth of electricity cost and other municipal charges.

On a 5-year rolling basis, annualised growth in Property taxes has exceeded CPI since 2008. As a result, rates has grown by a cumulative 318% since 2008, compared to the 78% of CPI.
Operating Cost Trends

SAPOA OPERATING COST REPORT
OPERATING COSTS UP
50bps AS A % OF GROSS INCOME

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RATES RECOVERY POTENTIALLY NEARING A CEILING?

The overall net operating cost to income ratio weakened during the year, as total operating cost less variable recoveries, grew faster than gross rental. On an All Property level, the net income to cost ratio from 22.8% as at December 2018 to 23.7% as at the end of December 2019.

On a net basis, the industrial sector saw an improvement in its cost to income ratio. By contrast, the other major property sectors recorded increases as variable tenant recoveries grew at a slower rate than total operating cost. The net cost to income ratio of the retail sector increased by 110bps during the year.

This perhaps suggests that some landlords in the retail space may be approaching a ceiling in the level of variable costs it can recover from tenants. The graphic below shows the electricity and rates recovery ratios for the Retail sector. While the electricity recovery ratio is already stabilising, a slowing growth in the Rates recovery ratio could be an indication that – on average- retailer cost of occupancy may be becoming unsustainable.
MUNICIPAL CHARGES STILL THE LARGEST COST CATEGORY

Among the major property operating cost categories, municipal charges continues to make up the largest percentage of overall operating cost. Municipal charges comprises rates & taxes, electricity & other metered utility charges such as water and CID charges.

On a per square meter basis, municipal charges were up 10.8% for the 12 months ended December 2019. At the end of the period, municipal charges accounted for 62% of total operating costs and 23.1% of Gross Income. From 2006 to 2019, municipal charges grew faster than any other operating cost category—becoming a bigger slice of a bigger pie. During this time, it effectively quadrupled in going from R10 in 2006 to R41 in December 2019 at a compound annual rate of 10.5%.

On a sector level, industrial property’s municipal charges make up the largest percentage of total costs at 72.9% - followed by Retail & Office with 63.7% and 57. % respectively.

The office sector continued to allocate more capital to repairs & maintenance and tenant installations with a contribution of 11.4% to the overall cost line. This is significantly higher than the retail and industrial sectors underlining the importance office landlords are attaching to both tenant retention and incentives for new tenants in the current environment.

The largest increase on a percentage basis was the Insurance, bad debts & “other costs” category. This category grew by 15.7%. Bad debts write offs spiked in 2019 after growing by 58% from 2018–a trend which may well continue into 2020 as the Covid-19 pandemic starts taking its toll. Despite its outperformance from an investment returns perspective, the industrial sector was not spared as its bad debt write offs hit an all time high of 48 cents/sqm.

Property/Facilities & Leasing fees & commissions increased by 11.5% to R7.84/sqm/month at the end of December 2019. Soft services as a category grew by 9.9%. Cleaning expenses increased by 12.6% while costs associated with security and gardens increased by 8.6% and 5.5% respectively.
MUNICIPAL CHARGES UP TO 62% OF TOTAL COSTS
LARGEST PERCENTAGE INCREASE IN BAD DEBTS AS WRITE OFFS JUMP 57%

Municipal Charges (% of Gross Income)
All Property

Composition of operating cost
Latest Reporting Period compared to Previous; Rand per square meter

<table>
<thead>
<tr>
<th>Cost Category</th>
<th>2018</th>
<th>2019</th>
<th>Change in operating cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipal Charges</td>
<td>37.32</td>
<td>41.34</td>
<td>10.8%</td>
</tr>
<tr>
<td>Soft Services</td>
<td>6.57</td>
<td>7.22</td>
<td>9.9%</td>
</tr>
<tr>
<td>Property, Facilities &amp; Leasing fees &amp; commissions</td>
<td>7.03</td>
<td>7.84</td>
<td>11.5%</td>
</tr>
<tr>
<td>Repairs/Maintenance &amp; Tenant Installation</td>
<td>4.61</td>
<td>5.11</td>
<td>10.7%</td>
</tr>
<tr>
<td>Insurance, bad debts &amp; other</td>
<td>1.12</td>
<td>4.77</td>
<td>15.7%</td>
</tr>
<tr>
<td>Grand Total</td>
<td>60.65</td>
<td>66.27</td>
<td>11.1%</td>
</tr>
</tbody>
</table>

Operating cost by Cost Category

Change in operating cost year-on-year; R/sqm & %

- Municipal Charges: 4.02 R/sqm, 10.8%
- Soft Services: 0.65 R/sqm, 9.9%
- Property, Facilities & Leasing fees & commissions: 0.81 R/sqm, 11.5%
- Repairs/Maintenance & Tenant Installation: 0.49 R/sqm, 10.7%
- Insurance, bad debts & other: 0.65 R/sqm, 15.7%
- Grand Total: 6.62 R/sqm, 11.1%
RETAIL COSTS HIGHER AS A % OF GROSS INCOME

Of the three main property sectors, Retail’s cost to income ratio remains the highest on a gross and net basis. As at December 2019, the sector’s gross cost to income was measured at 37.8% while its net cost to income ratio stood at 24.3%.

On a segment level, Super Regional (>100k sqm) & Regional centres (50k-99.9k sqm) reported the lowest gross cost to income ratio of the multi tenanted retail formats at 35.4% and 37.1% respectively as at December 2019. On a net basis, Community centres had the lowest net cost to income ratio among the retail segments.

The office sector’s gross cost to income ratio was 35.0% as at December 2019 with Prime Offices at 33.8% and Secondary Offices at 38.5%. Office Parks had a gross cost to income ratio at 36.5%. The industrial sector’s gross and net cost to income ratios are the lowest among the three traditional property sectors. However, among the underlying segments there is some variance with Warehousing being less cost intensive than the Manufacturing and Standard industrial units.

The residential sector, in many ways still in its infancy as an investable property sector in a South African context, has a higher cost to income ratio compared to the three traditional sectors. The makeup of its basket of costs are also different with a lower weighting in the Municipal Charges category and a higher allocation towards Property & facilities Management and Letting Fees and commissions.

![Operating Cost as a % of Gross Income](image-url)
Focus on Property Rates & Taxes
SAPOA OPERATING COST REPORT
LONG TERM TREND: RATES & TAXES GROWTH - RELATIVE TO INFLATION AND ECONOMIC GROWTH

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On a 5-year rolling basis, annualised growth in Property taxes has exceeded CPI since 2008. As a result, rates has grown by a cumulative 318% since 2008, compared to the 78% of CPI.
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 2006 seeing it become a significant contributor to the overall basket of operating costs.

In 2005, rates & taxes accounted for 16.7% of total operating costs and by December 2019 this had escalated to 24.4% making it the second largest contributor to total operating costs — behind electricity. On an inflation-adjusted basis, property rates and taxes increased 2.5 times from 2006 to 2019. On a nominal (not inflation-adjusted) basis, this translates to a cumulative growth of 302% ahead of electricity costs which increased by 301%. At the same time, total income increased by 146% - highlighting the potential dilutionary impact of administered costs on net income.

For all three major property sectors, rates and taxes now account for well over 20% of total operating costs. For the retail sector, rates & taxes accounted for 25.7% of total operating costs as at the end of December 2019. (24.9% and 23.1% for office and industrial respectively)
RESULTS FOR THE 12 MONTHS
ENDED DECEMBER 2019.
> MAY 2020

RATES & TAXES AS A % OF TOTAL INCOME FOR THE MAJOR PROPERTY SECTORS

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

When viewed as a percentage of total income, rates & taxes increased by 40bps on an All Property level for the 12 months ended December 2019.

Of the major property sectors, only industrial property saw rates decline as a % of gross income. The retail, office and residential property sectors saw rates increase as a % of total income. Property rates for the retail sector are at a record high relative to total income having increased at a consistently faster rate.

Property rates are now equal to 9.8% of total income – i.e. a tenth of all rental and recoveries receivable. Property rates make up a smaller portion of overall costs in the residential sector. Notwithstanding, rates as a percentage of total income increased by 80bps during 2019.
RATES & TAXES RELATIVE TO TOTAL INCOME-SIGNIFICANT VARIANCE ACROSS PROPERTY TYPES

There is a significant variance in the level of rates and taxes as a percentage of total income between the various property segments.

As at December 2019, the ratio for Super Regional centres was 12.3% - up from 2014’s level of 9.1% as slowing consumer confidence and disposable income growth put the brakes on rental growth. Similarly, regional shopping centres has seen rates increase as a percentage of total income- ending 2019 at 10.4%.

Among the office segments, city decentralised offices reported a rates to total income ratio of 9.5%. This is significantly above the 6.9% ofInner City offices.

The gross cost to income ratio of the underlying industrial property segments, with the exception of Manufacturing-related property, are tightly grouped between 7.7% and 8.1% as at June 2019. Rates as a percentage of Gross Income has improved to 5.9% for Manufacturing property.
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 total income and per square meter for the three main property sectors, namely retail, office and industrial.

There was significant variance on a provincial level as at December 2019. A key driver of this was the different ‘cents in the rand’ rates levied by the respective underlying municipalities within the provinces as well as the frequency and accuracy of the respective municipal valuations.

On a provincial level, KwaZulu Natal continues to have the highest rates & taxes as a percentage of total 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 eThekweni municipality relative to the country’s other major metros. The Western Cape had the lowest ratio of rates and taxes to gross income across all three major sectors.
DO LARGER PROPERTIES MAY MORE PROPERTY RATES RELATIVE TO THEIR TOTAL INCOME?

The graphic below compares the rates & taxes as a percentage of total 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 total income ratio for different size brackets.

An interesting finding when looking at the graphic below is how the rates to total income ratio declines for larger office and industrial properties but increases for larger retail assets. This suggests that larger, prominent retail assets are subjected to higher rates relative to their total 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 rentals and lower capitalisation rates. Meanwhile, office and industrial properties could likely be more homogenous as far as these characteristics are concerned – irrespective of GLA.
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