

Property research paper

The pricing of the Australian commercial property market: an update

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Executive summary

→ Recent developments

- The credit crisis has adversely impacted listed and direct property investments.
- So far direct property has lagged the listed market with returns moderating to 14% over the year to June 2008, compared to a 36% decline in total returns for the A-REIT market for the same period.

→ Short-term outlook

- Further softening in direct property returns due to; weaker rental growth in the face of a weakening economy, and rising discount rates, especially for secondary-grade assets, reflecting a widening in the risk-premium.
- Good quality (core) assets with secure income streams are likely to see discount rates between 8.5% and 9.5%.
- Generally, investors will retreat towards defensive products with core assets.

→ Opportunities

- Seek investment portfolios comprising of high quality assets with secure income streams, supported by quality managers.
- Funds poised to take advantage of buying opportunities from the fall-out.

→ Risks

- Avoid high leveraged investments with poor quality assets with insecure income streams and opaque financial structures.
- A marked slowdown in global economic growth associated with the negative fall-out of the credit crisis.

1. Introduction

The period between early 2000 and the middle of 2007 saw commercial property markets post attractive returns across both the listed and direct property segments. This period was characterised by a buoyant investment climate, underpinned by strong space market fundamentals (i.e. tightening vacancy rates and rising rentals) and favourable capital market conditions (i.e. low and stable interest rates and excess liquidity).

The exceptionally positive market sentiment attracted new players into the sector, triggering a proliferation of investment vehicles in the alternative investments space. Many of the new products offered a range of investment styles beyond those of core holdings aimed at providing exposure to higher return (and higher risk) assets. In all, strong capital flows coupled with relatively loose credit conditions led to a compression of property investment yields across the grade spectrum during this period.

However, the performance of all aspects of property investment has deteriorated since August 2007 - especially the listed property sector, mainly as a result of the global credit crunch and a re-focus on risk. A lack of credit liquidity and higher domestic interest rates led to a re-rating of investment risk across all asset classes. This, coupled with a looming slowdown in global economic growth, has put pressure on space market fundamentals, predominantly on the demand side.

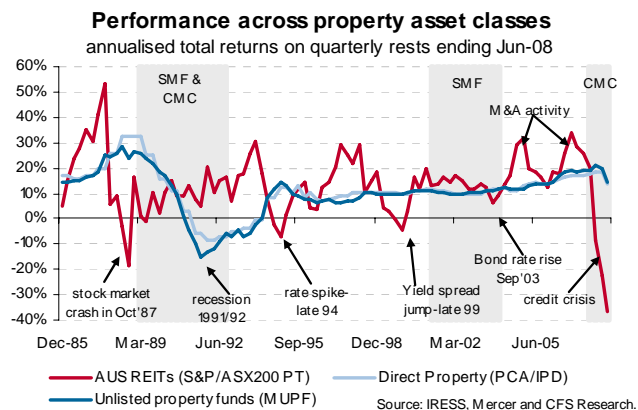
Looking forward the important question to ask is: How are current market conditions going to impact the outlook on pricing of commercial property? In this report we address this question and outline a number of key factors pertinent to the short-term prospects for the sector.

2. Snapshot on investment performance

Focusing on real estate investment performance, Figure 1 shows rolling annual returns for S&P ASX200/All Property index (A-REITs), direct property and unlisted wholesale core property funds.

Prior to 1994/95, the return series are characterised by pronounced swings. This coincides with a period that saw adverse space market fundamentals (SMF) such as excess supply conditions and a contracting economy, as well as unfavourable capital market conditions (CMC) characterised by high interest rates). The long term bond rate has moved from a relatively high rate (average 13.1% in the late 1980s) to a moderately low rate, currently hovering around 6%.

Figure: 1



Around the early 2000's, the property market experienced sluggish SMF due to subdued demand conditions as a result of the bursting of the tech 'bubble' and the terrorist attacks in the US. However, investment returns remained solid due to very favourable CMC, i.e., strong investor demand for property as an investment class.

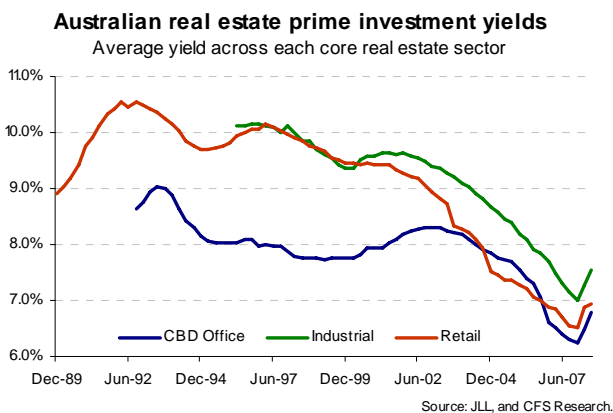
More recently, the current property market is characterised by the opposite situation: deteriorating CMC while SMF remain relatively favourable. The historically strong performance of the listed property sector has recently evaporated with the unfolding of the credit crisis; the A-REIT sector posted a negative total return of 36% over the year to June 2008. So far direct property has been relatively moderately affected by current market conditions, recording an annual total return of 14% over the year to June 2008, compared to 17% annual return over the year to June 2007. However, capital returns are weakening with appraisal-based valuations starting to incorporate the increased cost of debt, as well as (some) expected softening in rental growth, and rising risk premia.

3. Movements in discount rates and yields

Figure 2 shows trends in average prime equivalent yields for the office, retail and industrial sector markets. While yields have been firming (i.e., trending down) over the last decade, more recently they have softened across the three sectors, largely triggered by the global credit crisis. This softening is based on appraisal assessment in light of a lack of significant transactional sales evidence. Even so, yields are still ranging between 6.5% and 7.5%; well below their historical averages.

The drivers of this yield firming include: i) cyclical favourable space market fundamentals; and ii) strong investor demand for real estate investment. This latter point is underpinned by: i) a re-rating of risk (investor expectations of risk is down weighted against traditional asset classes); and ii) the weight of capital phenomena (supported by superannuation levy).

Figure: 2



The current period of rising yields, marked by the interplay of inflationary pressures, credit crisis and slowing economic activity, is different from previous periods of market downturn of the late 1980s and the early 2000s. While the current slowdown is mainly demand driven, the late 1980s were characterised by excess supply and rising vacancy rates at a time of economic recession. In contrast, when space market conditions also turned sluggish in the early 2000s, the favourable capital market and economic conditions generally kept yields on a downward path.

The softening in yields also reflects a flight to quality which should restore the spread in the

risk-premium across asset grade; i.e., greater softening in yields for secondary grade than prime assets.

It is worth noting that to date the softening in yields has not reflected the secondary spill-over effects; the impact on the real economy, and subsequently, space markets.

4. Drivers of investment performance

Key drivers to investment performance include: expectations of rental growth, the risk-free rate and the risk premium and investor demand factors.

Expected rental growth

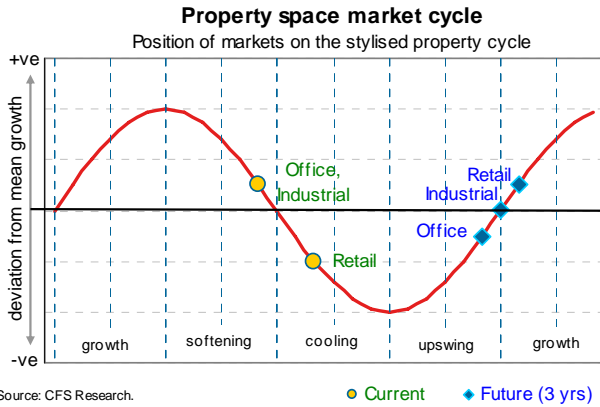
The early 2003 to mid 2007 period saw favourable space market fundamentals, reflected in declining vacancy rates and positive rental growth. More recent data, however, indicates a reversal of this trend, with the latest figures for the June quarter 2008 showing increases in office vacancy rates across all capital cities, bar Melbourne and Adelaide.

A stylised diagram of the property cycle in Figure 3 shows the present positions of core sectors and their expected standing in three years time. Currently, all core sectors have passed the peak in the cycle and are now positioned in either the softening (office and industrial markets) or cooling (retail market) phases. In the near term (12 months), we anticipate rental growth to moderate in line with slowing net absorption and rising vacancy rates (although vacancies relatively low).

In the short-term (next 3 years) we anticipate that all of the core sectors will have passed through the trough of the cycle and will be in either the late stages of the upswing (office and industrial markets) or early stages of the growth (retail market) phase of the cycle.

Key risks to this outlook include a significant slowdown in global economic growth (in line with a recession in the US) associated with the negative fall-out of the credit crisis. This is likely to hinder investment activity and recovery in space markets.

Figure: 3

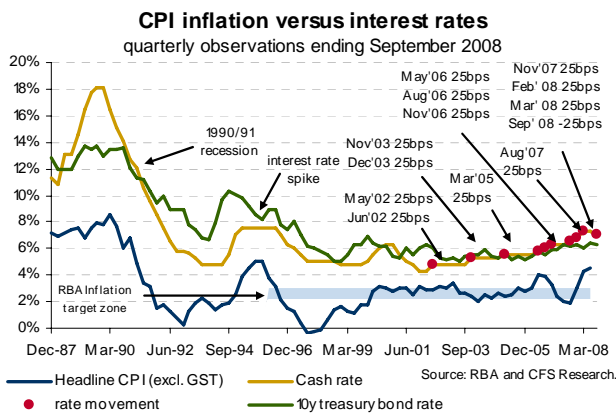


The risk-free rate

With regards to property investment, the risk-free rate is usually proxied by a government security with a long dated maturity (commonly the 5 or 10-year Treasury bond rate).

Figure 4 shows the evolution of the 90-day bank bill rate, the 10-year Treasury bond rate and Consumer Price Index (CPI) inflation since the late 1980s. The rates had pursued a downward trend between the late 1980s and the mid 1990s, followed by a period of relative stability until the early 2002. This latter period was marked with a benign inflationary climate.

Figure: 4



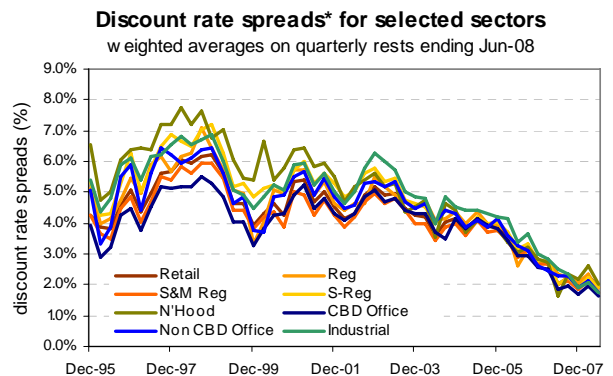
Currently, the official cash rate (OCR) stands at 7.0% after the RBA recently cut the rate by 25 basis points (bps). Although the inflationary pressures are expected to persist for the remainder of 2008 - the annual growth in the CPI to June 2008 was 4.5% - the RBA is expected to cut the OCR by at least another 25 bps before the end of 2008. Over the medium (3-5 years) to long-term, inflation is expected to return within the RBA's target

band of 2-3%. This should see the bond rate residing around 5.5-6%.

Movements in the risk-premium

As depicted in Figure 5, the period December 1997 to December 2007 was marked by a significant compression of risk premiums, both in the level as well as in variability across property sectors.

Figure: 5



The recent unfolding of the credit crisis, which continues to negatively impact liquidity, has resulted in a re-rating of risk across asset markets. As a consequence, risk premiums were pushed up in the first half of 2008.

The short-term outlook for key drivers of the property risk-premia is presented next.

- **Market depth:** liquidity levels in the market as well as the degree and timing of transactional information. In light of the recent credit crisis, both of these factors have been adversely affected and are likely to continue impacting the risk premium.
- **Asset quality:** over the last few years the buoyancy of investment markets has resulted in many new investment products being released into the market with pricing that underestimated risk. The credit crunch has resulted in a re-pricing of these assets but the question remains as to what extent the re-pricing has been completed. It is likely that we will continue to see flight to quality assets and a further re-pricing of risk to reflect fair value.
- **Risk to rental growth:** while the commercial property markets are currently placed in the softening or cooling phase of the property cycle, the looming downturn in global

growth and high interest rates pose additional threats to demand and, subsequently, rental growth.

Market transparency: it is often argued that the A-REIT sector has a high degree of transparency. This is supported by in-depth market research and regulation. In recent times, however, transparency in the sector has come under review with some trusts disclosing exposure to opaque financial structures.

Investor demand considerations

Another key factor influencing pricing is the strength of investor demand. This can be gauged in terms of capital flows into the sector and product offering.

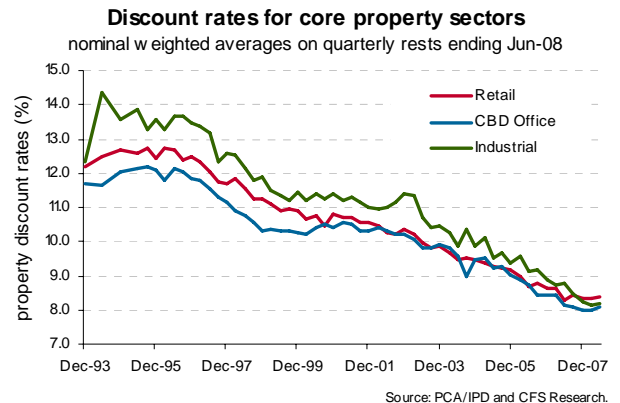
The Australian property sector has experienced an increasing stream of capital flows over the last decade, largely attributable to growing superannuation funds. The proportion of total property allocation to managed investment funds stood at around 12% by the end of 2007. However, with the recent sharp downturn in the stock market and A-REITs, anecdotal evidence suggests that allocations to direct property are currently overweight. This, when considered in isolation of other factors, would suggest a downturn in investor demand for direct property. However, given the current market turmoil and exceptionally high levels of volatility across all asset classes, market participants in search of steady income streams are likely to be attracted to direct property.

5. Return performance: outlook

The favourable investment conditions of early 2000 to mid-2007 coupled with a declining risk-free rate and falling risk-premia for property as an investment class resulted in a downward trend in discount rates. A key feature of this trend was the compression of discount rate spreads both across sectors and within sub-sectors. For instance, the sector spread has narrowed from about 2.5% in 1995 to the present figure of around 0.5%. This is highlighted in Figure 6, which shows

weighted-average movements in discount rates.

Figure: 6



However, in line with a softening in property yields (as shown in Figure 2), discount rates are softening, reflecting: i) increased cost of debt (due to difficulty in sourcing finance and rising interest rates) and ii) an upward revision of the risk-premia. This latter point reflects: i) a lack of market depth (i.e., lack of liquidity and transactional activity); ii) a review of risk across asset quality; iii) reassessment of risk to earnings growth; and iv) a review of market transparency across investment trusts.

Discount rates (across both core and non-core sectors) are set to soften over the short-term (next 12-18months) to sit between 8.5%-11.5%, depending on sector and asset quality.

Movements in discount rates are expected to diverge across sector. The retail sector is likely to see firmer rates compared to the office and industrial sectors due to relatively low cyclicality of its rental stream.

Across asset quality, discount rates are set to soften for lower quality assets where income streams are under threat. Discount rates in these secondary assets could range between 10-12%. In contrast, yields on good quality (core) assets with secure income streams are likely to show mild rises with discount rates below 10%.

Overall, direct property investment is expected to see a mild erosion in capital return for quality assets. This supported by a limited rotation of capital out of unlisted property due to investors viewing this current crisis as cyclical.

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For further information about this report or our research capabilities, contact our Head of Research, Dr Anthony De Francesco or his assistant Mary Bonello.

Contact details

Anthony De Francesco	Head of Research	+61 2 9303 3598
Mary Bonello	Research Assistant	+61 2 9303 3518

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