

Property Research Note

16th January 2009

The pricing of the Australian commercial property market: an update

- **Recent developments**
 - The credit crisis has negatively impacted listed and unlisted property investments.
 - So far, direct property returns have not experienced the significant re-pricing seen in the listed market; with returns moderating to 8.2% over the year to November 2008 compared with -53% in the AREIT sector.
- **Short-term outlook**
 - Additional weakness in direct property returns due to: deteriorating space market fundamentals, slowing economic growth and a softening in investment yields.
 - Secondary grade assets will see the greatest decline in returns, whereas good quality (core) assets with secure income streams should be relatively better placed.
 - Investors will generally focus on defensive products with exposure to core assets.
- **Risks**
 - Forced sales in a thin market to address vendor liquidity issues will see prices initially overshoot on the downside.
 - A prolonged and severe downturn in global economic growth as a result of the negative fall-out of the credit crisis.
 - Investors should avoid highly geared investments with poor quality assets with insecure income streams and wrapped in opaque financial structures.



1. Introduction

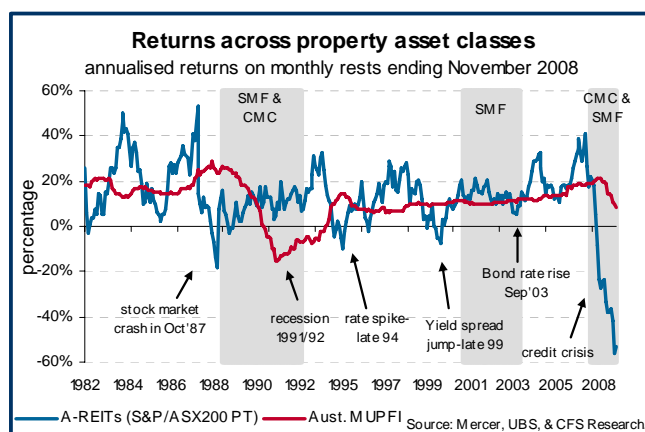
The performance of all aspects of property investment has deteriorated since August 2007 - especially the listed property sector, mainly as a result of the global credit crisis and a re-focus on risk and the move towards the de-leveraging of balance sheets. The freezing of credit markets and the flow-on effects across broader financial markets led to a re-rating of investment risk across all asset classes. This situation, coupled with what appears to be the threat of a prolonged global economic downturn, has led to a deterioration in the outlook for Australian commercial property space market fundamentals (SMFs), predominantly on the demand side.

Question to ask is: How severely will increasingly negative market conditions impact the outlook on pricing of commercial property? This note aims to address this question and outline a number of key factors pertinent to the medium-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) and the Mercer unlisted wholesale core property funds index (MUPFI) over the period from January 1982 to November 2008.

Figure 1



The shaded bars highlight periods where the property market was characterised by adverse conditions in either the capital markets (CMCs) or space markets fundamentals (SMFs).

The period prior to 1994/95 coincides with a period that saw adverse SMFs such as excess supply conditions

and a contracting economy, as well as unfavourable CMCs characterised by relatively high interest rates.

At the start of the 2000's, the property market experienced weak SMFs due to subdued demand conditions as a result of the unwinding of the tech 'bubble' coupled with the terrorist attacks in the US. However, investment returns remained relatively solid due to favourable CMC, on the back of strong inflows of capital from investors keen to get exposure to property.

The present state of the property market is different and bears more resemblance to the period between 1989 and 1992 - deteriorating CMC (due to the credit crisis) and weakening SMF (as a result of a weakening global economy).

The first impact from the credit crisis was felt in the listed property sector (A-REITs). Total returns for A-REIT sector have fallen by over 53% during the year to November 2008. As yet, this has not been replicated in the unlisted property sector, which so far has been relatively moderately affected by current market conditions, recording an annual total return of 8.2% over the same period. However, growth has weakened noticeably compared to this time last year, where total returns grew by 20.4%.

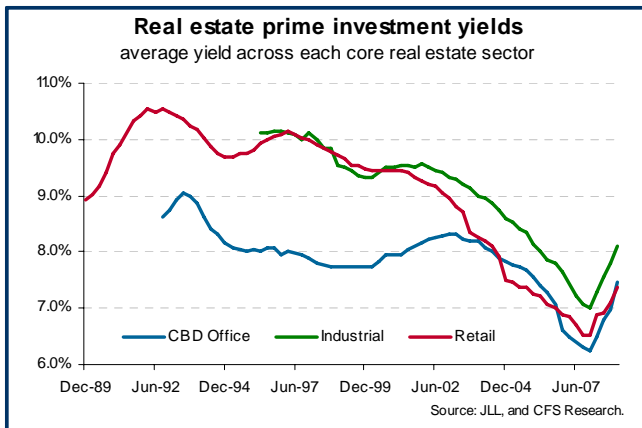
Total returns in the unlisted sector are expected to show a continued weakening growth profile. This is due to falls in capital returns, with more and more appraisal-based valuations starting to incorporate the rising risk premia, increased cost of credit, as well as an expected softening in rental growth. However, they are not anticipated to fall to the same extent as the listed sector. This is due to the listed sector being penalised for a number of growth orientated strategies undertaken in recent years such as increased off-shore exposure, greater use of gearing and the stapling of fund management or development arms to the property trust - all of which have increased the sector's embedded risk profile.

3. Movement in capitalisation rates

Figure 2 shows historical trends in average prime equivalent yields for the office, retail and industrial sector markets. Note the period of yield compression (i.e., trending down) over the past decade has turned around with recent data showing yields weakening across the three sectors - largely triggered by the global credit crisis. This softening is based on appraisal assessment as a result of a lack of significant transactional sales evidence. Yields are ranging between 7.4% and 8.1% compared to 6.3% to 7.0% less than 12 months ago.

The main reasons yields firmed as much as they did include: i) solid underlying economic conditions; ii) cyclical favourable space market fundamentals (healthy rental growth and falling vacancy rates); iii) strong investor demand for real estate investment. This latter point was underpinned by both a re-rating of risk (investor expectations of risk is down weighted against traditional asset classes); and the weight of capital phenomena (supported by the compulsory superannuation levy).

Figure 2



The recent period of rising yields, marked by the interplay of the ongoing 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 predominately 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 historical spread in the risk-premium across asset grade; as such there will be greater softening in yields for secondary grade than prime assets.

4. Outlook for property investment pricing

Following the intensification of the credit crisis over the second half of 2008, the outlook for commercial property pricing metrics (cap rates, rental growth and discount rates) have all deteriorated.

Discount rates are set to increase over the short-term (next 12-18 months). This will be the result of a

combination of factors including: i) weaker expected rental growth, a rising risk premia coupled with subdued investor demand for commercial property. One positive will be the fall in the risk-free rate as a consequence of the Reserve Bank’s aggressive cutting of the cash rate over the four months to December 2008 with additional cuts expected during 2009.

This will be across both core and non-core sectors. Discount rates are expected to sit between 8.5%-11.0%, depending on sector and asset quality. This illustrated in Figures 3A for Australian office property and 3B for Australian retail property.

Figure 3A

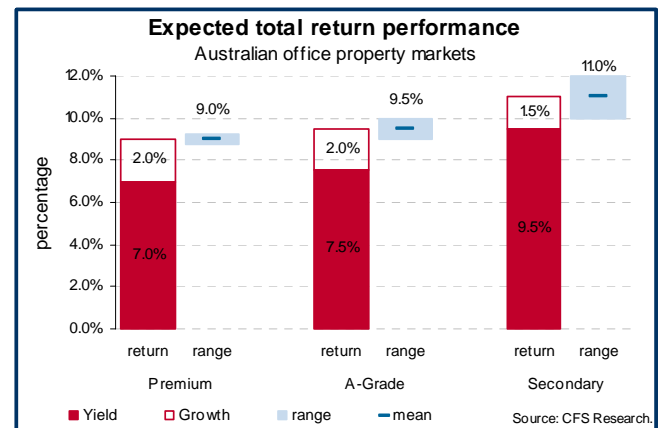
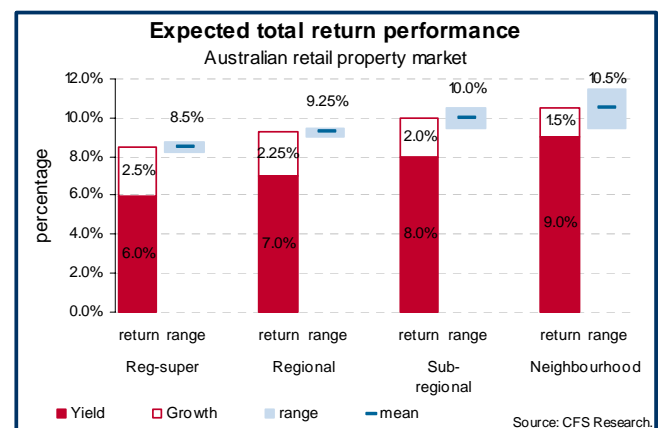


Figure 3B



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 cyclical 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%.

An important consideration for the outlook will involve the next phase of the credit crisis. The first phase focused on the re-rating of risk across all asset classes. The next phase involves the de-leveraging of balance sheets which could see a number of forced sales of property. If there are a sufficient number of sales which transpire, then these sales will service as market evidence even if that realised market price is below fair value. As such, there is a risk that prices could over shoot on the downside in the short term.

However, we expect pricing to firm (moderately) over the medium term (2-3 years). This will be driven by investors re-entering the commercial property market to take advantage of these temporarily low values coupled with improving capital markets and strengthening space markets. Nevertheless, property value metrics are not likely to return to pre-credit crisis levels, which could be considered abnormal pricing by historical standards.

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Contact details

Anthony De Francesco	Head of Research	+612 9303 3598
Mary Bonello	Research Assistant	+612 9303 3518

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