Commercial property values after the credit crunch

**Oliver’s insights**

**Key points**

- The credit crunch is pushing up yields on unlisted office, retail and industrial property.
- However, the downside in Australian unlisted commercial property values is likely to be limited by relatively good demand/supply fundamentals and more conservative pricing than has been evident overseas.
- But, expect unlisted commercial property returns to slow substantially. Shares, including LPTs, are likely to provide better returns over the next year or so.

**Introduction**

Last year saw direct (or unlisted) commercial property funds – office, retail & industrial – return around 21%. By contrast Australian listed property trusts (LPTs) lost 8.4%, their worst calendar return ever. In fact, from their high in February last year to their low last month, LPTs fell 41% in value in response to the impact of the global credit crunch.

**Reasons for concern**

Returns from directly held office, retail and industrial property in Australia accelerated over the last few years on the back of strong growth in rents (reflecting tightening underlying supply and demand conditions) and investors being prepared to buy buildings on lower yields (ie the ratio of annual rents to property values).
The previous chart shows a composite of office, retail & industrial yields versus an average of bond, equity and housing yields. In the 1980s the two lines were close, but a large gap arose which only in recent years started to close. Secondly, while Australian bond yields rose in the last two years, directly held non-residential property still offers a satisfactory risk premium over bonds. The next chart assumes constant property rental and capital growth of 2.5% pa. This has been added to the composite non-residential property yield and the 10-year bond yield has been subtracted to show a property risk premium.

The property risk premium is down, but above previous lows

| Source: Thomson Financial, Jones Lang LaSalle, AMP Capital Investors |

While the excess return expected from commercial property over bonds has declined, it is far more attractive than prior to the early 1990s slump in property values.

Secondly, while there is some evidence that LPTs lead direct property, LPTs are very volatile. As evident in the next chart, movements in LPT distribution yields have been far more extreme than the yields on offer for unlisted commercial property. This has seen LPT share prices trade wildly around the value of their underlying buildings. In fact, LPT’s 5.1% yields a year ago saw them trading at a greater than 20% premium to the underlying value of the properties they represent. It’s also likely that currently reported distribution yields for LPTs of around 7.5% based on historic distributions will exaggerate actual yields as some trusts have cancelled or cut distributions to reduce debt.

LPT yields are very volatile versus direct property yields

| Source: Jones Lang LaSalle, AMP Capital Investors |

So while the rise in LPT yields suggests upwards pressure on unlisted commercial property yields, their recent rise is likely to exaggerate the actual pressure. The low rental yields on residential property suggest that it is particularly vulnerable – but that is a separate story.

Third, space demand/supply fundamentals are good versus the early 1990s. For example, the supply of new office space is running below the levels that created big trouble in the early 1990s. The next chart shows net new CBD office space supply (with projections based on current construction & approvals data) against the vacancy rate. There doesn’t appear to be a general office overbuilding problem, unlike in the early 1990s. While finance sector employment will slow in Sydney it has modest new supply in prospect. By contrast, Perth & Brisbane, which are seeing the strongest supply pick-up, are underpinned by the resources boom. And compared to the situation in 1990 we are less into the office construction cycle now so there is more scope for projects to be shelved. So, absent a severe recession, a re-run of the 1990s surge in vacancies seems unlikely. CBD office vacancy rates are now very low at an average 3-4% & while rising office supply points to an increase in the next few years it will probably only be to around 6-8%, well below the 20% plus of the early 90s.

Concluding comments

The credit crunch and concerns about the economic outlook will likely put further upwards pressure on yields for commercial property. Lower quality property where yields have fallen the most and selling pressure is greatest, mortgage belt shopping centres vulnerable to reduced retail sales and Melbourne office property where new construction may not be matched by space demand are most vulnerable. However, barring a recession or end to the resources boom, both of which are unlikely, the rise in yields & the impact on property values is likely to be limited by reasonable valuations for direct property and good demand/supply fundamentals driving solid rental growth. However, returns will be well down on the 20% returns of last year. Due to their higher yields and the fact they are now trading at a 15% discount to property valuations, listed property trusts offer better returns on a 12 month view.

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