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The outlook for unlisted commercial property

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Key points

> Australian unlisted commercial property returns have been strong at around 9.5% pa over the last three years.

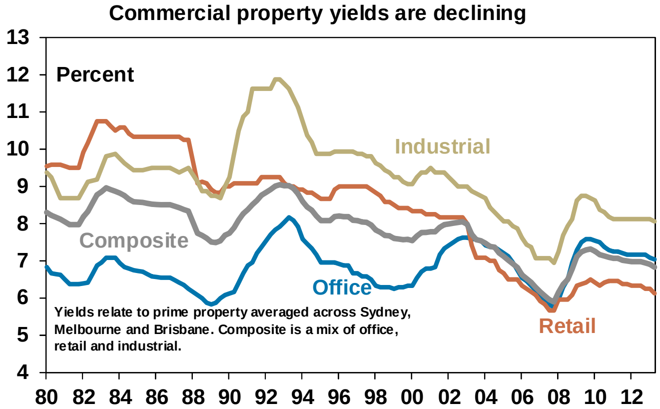
> Expect soft space demand against the back drop of a sluggish economy and rising space supply to see returns slow to around 7.5% over the year ahead.

> However, the attractive yields on offer from unlisted commercial property relative to other assets are likely to ensure that investor demand remains solid, plus with an improvement next year in Australian economic growth will likely drive an uptick in returns from 2014-15.

Solid returns from commercial property

The past three years have seen solid 9-10% pa returns from unlisted commercial property. This has been driven by a recovery from the GFC related slump of 2008 and 2009, moderate economic growth and more recently the desire for decent income bearing investments from investors that has pushed down investment yields across the board, but particularly for retail property. The decline in yields has been an important driver of returns as each 0.25% fall in yields translates roughly to a 4% capital gain.

Commercial property yields are declining



Source: AMP Capital

Reflecting the search for yield listed property, or Australian Real Estate Investment Trusts (A-REITs), have been even stronger with gains of around 17% over the last year and 11% pa over the last three years.

So where to from here? What does the mixed Australian economic outlook mean for property and has the decline in property yields run its course?

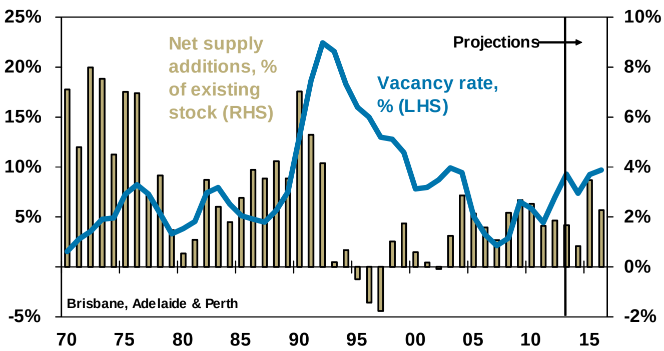
Space demand and supply

The biggest drag in the short term will be the soft Australian economy. While recession is expected to be avoided, economic growth is likely to remain sub-par at around 2 to 2.5% over the next six months or so and this is likely to push unemployment up to around 6.3% by mid next year. The soft economy will in turn mean subdued space demand into next year. Retail property is perhaps most vulnerable on this front, with retail property yields nearly back to pre GFC lows suggesting little return buffer.

However, economic growth, including retail sales, is likely to start picking up through next year as the benefit of lower interest rates, the fall in the $A, rising wealth levels, the benefits of increased housing construction and reduced consumer caution start to flow through to stronger demand. So growth in space demand should pick up from 2014-15.

Over the next few years, particularly around 2015 and 2016, the supply of office space is likely to increase (partly associated with Barangaroo in Sydney). As a result average office vacancy rates are likely to remain around 10% for the next few years acting as a negative for office rental growth.

CBD office vacancy rates to remain around 10%



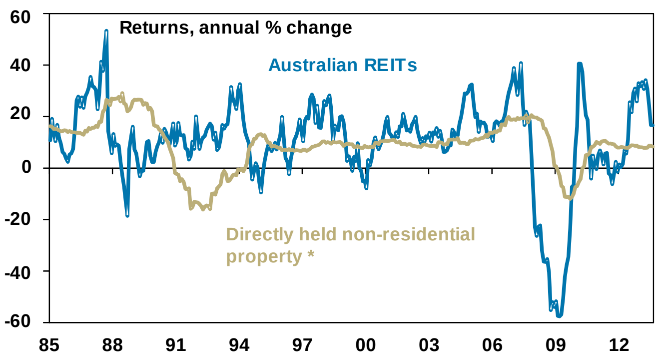
Source: AMP Capital

Rising supply at a time of sluggish demand is also likely to be a drag on industrial and retail property rents and returns in the short term.

A-REITs lead

While the near term space demand and rental growth outlook is subdued, the strength in A-REITs is a positive sign for unlisted commercial property. While A-REITs are far more volatile, they tend to provide a good lead for unlisted commercial property. This can be seen in the next chart.

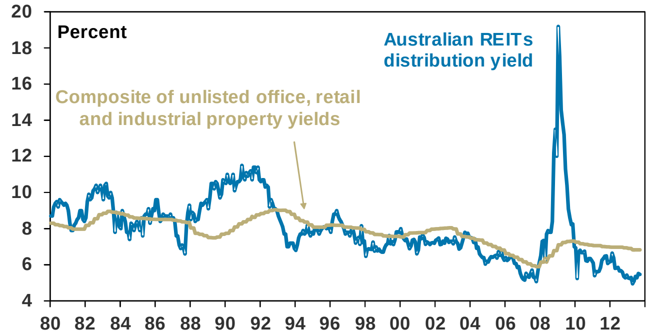
Strong listed property returns are a positive sign



* Direct property is AMP Capital core direct property fund. Source: Bloomberg, AMP Capital

The search for yield by investors has seen A-REITs come back into favour pushing their yields down and boosting their returns. This augurs well for unlisted commercial property returns ahead. Unlisted commercial property continues to offer more attractive yields than A-REITs.

Australian unlisted commercial property yields are well above those available from A-REITs

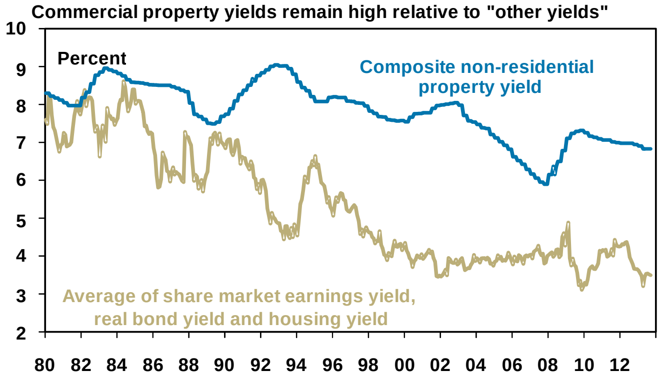


Source: Bloomberg, AMP Capital

Downwards pressure on yields

While the yields available on Australian unlisted commercial property have declined over the last three years, they remain attractive relative to most other assets. The next chart shows a composite of office, retail and industrial property yields versus an average of government bond, equity and housing yields. The gap between commercial property yields and other yields remains wide suggesting yields on commercial property are relatively attractive.

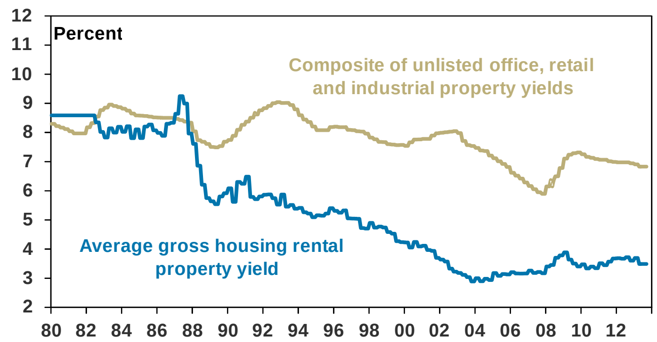
Commercial property yields remain high relative to "other yields"



Source: REIA, Bloomberg, AMP Capital

This is particularly noticeable compared to residential rental property, as can be seen in the next chart. In the 1980s the rental yield on residential and commercial property was similar, but today commercial property has a rental yield which is far higher, ie just below 7% for commercial property compared to around 3.5% for residential property. With Australian residential property over-valued on most measures – albeit less than it was – this suggests that office, retail or industrial property is far more attractive for investors than housing on a medium term horizon as it is less dependent on capital growth going forward and less at risk of a correction, when say interest rates start rising again.

Australian commercial property yields are very high compared to the yield available on housing

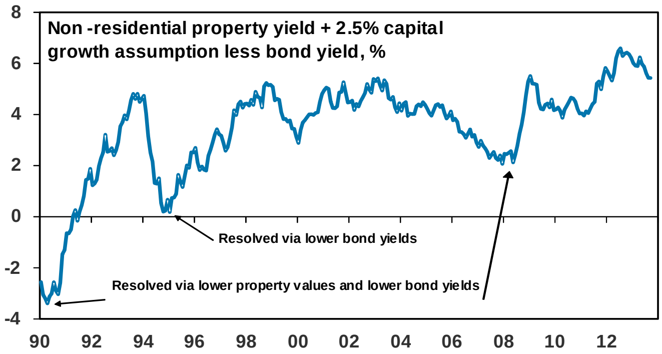


Source: REIA, AMP Capital

Apart from soft near term demand and rising supply, the biggest concern regarding commercial property is probably that bond yields back up sharply as global growth improves. In fact bond yields have already backed up this year – with the 10 year government bond yield in Australia rising from 3.3% at the start of the year to 3.9% currently.

However, despite the back up in government bond yields the risk premium offered by commercial property over bonds remains well above average. The next chart shows a proxy for this. It assumes that rental and capital growth will average 2.5% pa over time (ie, in line with average inflation) and adds this to the average non-residential property yield to give a guide to potential total returns. The 10 year bond yield has been subtracted to show a property risk premium. It can be seen that even though it has fallen slightly recently it still remains at levels that are well above its historical average.

The property risk premium is still high



Source: REIA, Bloomberg, AMP Capital

The bottom line is that while rising bond yields on the back of recovering global growth may act as a bit of a constraint, the huge yield advantage commercial property offers over government bonds and other yield bearing assets like residential property suggests that investor demand is likely to remain strong. In fact this is a key message from surveys of global institutional investors.

It's worth noting commercial property has been a beneficiary of investor flows during periods of rising bond yields in the past. This happened during the bond crash of 1994 and the more gradual backup in bond yields that occurred prior to 2007 as investors simply switched out of bonds into assets like commercial property that offered higher yields. Property only became vulnerable in 1990 and 2007 when the property risk premium in the previous chart had fallen to far less attractive levels than is currently the case.

Return outlook

The net result of these conflicting forces is that while soft demand and rising supply may result in average unlisted commercial property returns slowing to around 7.5% over the year ahead, they are likely to remain solid on the back of investor demand for the relatively attractive yields commercial property offers. Returns are likely to pick up from 2014-15 if economic growth improves as expected.

Within unlisted commercial property the main opportunities are likely to be in industrial property reflecting its relatively attractive yields and quality retail property in strong population corridors. Retail property in low growth areas is vulnerable and office property is likely to underperform thanks to rising supply and subdued office space demand.

A-REITS having outperformed over the last few years are likely to perform in line or even lag unlisted property going forward. Distribution yields have fallen to 5.5% as they have benefitted the most from falling bond yields.

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