

Interest Rates vs. Property Yields – What is the outlook for 2010?

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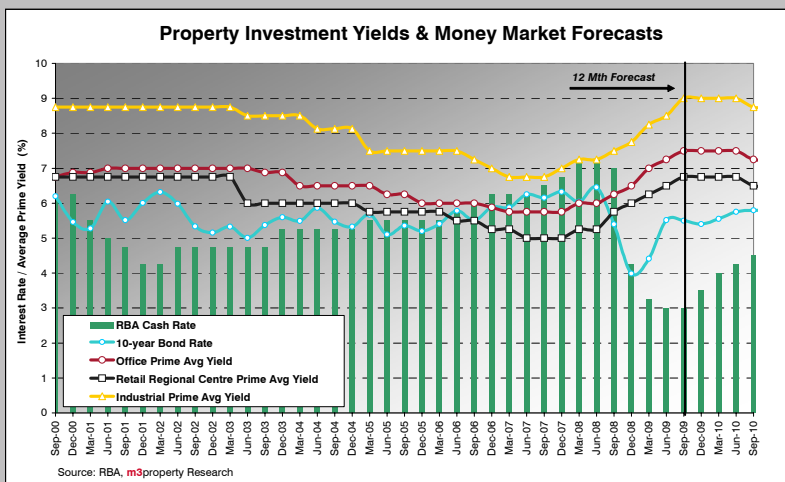
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Following the announcement of the RBA's decision to increase interest rates on October 6, financial markets have forecast a second upward move on Melbourne Cup Day as a near certainty. This is a reasonable assumption given the RBA's historic interest rate decisions usually include at least two consecutive rises. However, of more importance to the commercial property sector is whether this rise (and further anticipated rises over the coming months) will relieve the upward pressure on property investment yields after the onset of the global financial crisis?

Regarding the relationship between interest rates and yields, it could be expected that yields will increase as interest rates move upwards to maintain property's competitive parity as an investment class. History shows the relationship between interest rates and yields has recorded no distinct trend. The chart below highlights yields are now above their long term average. Was property somewhat overvalued in 2007 – or has an 'over-correction' transpired in 2009? Based on this fact, 2010 is the year to invest in commercial property due to favourable higher yields (which will be at or near the bottom of the cycle). So, if interest rates won't necessarily influence the direction of yields, what will in 2010?

In the case of commercial property, the performance of yields are closely tied to vacancy (or the expectation of impending vacancy as per the national office markets), although there are some exceptions. For example, industrial property's performance over the last decade has been influenced by the change in buyer profile. Between 2005 and 2007 the industrial sector became increasingly favoured by institutional purchasers leading to a strong compression of yields (sub-7% was recorded in several investment sales).



Looking forward, the expected impact of October's cash rate rise (and subsequent short term future rises) on commercial property will likely see the gap between yields and interest rates narrow. Yields are forecast to reach a 'ceiling' in 2010 and the cash rate is likely to continue rising from its 'emergency' setting to a more neutral level. The investment climate will still remain a challenge for purchasers, particularly those seeking funding despite an improvement in credit spreads. The higher cost of capital will continue to be a major consideration of acquisitions.

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What is the outlook for non-residential property markets in 2010? Will the increase in corporate confidence translate to a sustained improvement in property fundamentals?

OFFICE MARKETS

The national office supply pipeline is shrinking as the construction cycle nears the end and the scarcity of development finance limits new project starts. This is despite the recent increase in tenant requirements above 5,000 square metres as corporates move from a consolidation/contraction phase (late 2008/early 2009) hoping for a sustained improvement in business conditions (late 2009/early 2010). The low supply outlook has become an important buffer that will ensure vacancies do not reach the heights of the 1990s recession. The July release of CBD office vacancy data by the Property Council of Australia showed a national rate of 7.3%, which is still below the long term historical average of 10.5% (and a peak of 21% in January 1993). Effective rental growth is expected to remain under pressure in 2010 due to the higher incentive levels on offer (highest – Brisbane, Perth, Sydney/lowest – Melbourne, Adelaide).

RETAIL MARKETS

Should interest rates undergo a rapid rise over the next six months, it is likely that retail turnover growth will be below the longer term trend. Sub-Regional and Neighbourhood shopping centres (including stand-alone supermarkets) will remain highly contested by private investors and syndicates. Larger Regional shopping centres have failed to transact over 2008-09 with the view that landlords (essentially the AREITs) have become more reluctant to sell their 'trophy' assets (as well as the absence of purchasers above \$100M). While property returns are to a large extent not expected to increase as a result of current tightening in monetary policy by the RBA, the expectation of improving demand and property's own success as an investment class will prevail. Yields have increased considerably since September 2007, with the market returning to a level of risk pricing which is more consistent with longer term averages. In such a marketplace, there is a growing pool of investors who are looking to acquire shopping centres (both on and offshore), while purchasers and vendors appear more realistic about current market value. This should underpin stronger acquisition activity in 2010.

INDUSTRIAL MARKETS

The sector tends to follow the state of the economy more closely, hence why industrial property has been a poor performer (when compared to other property asset classes) in regards to the stronger yield adjustment and lower sales activity for much of 2009. The short term positive economic outlook will strengthen the sector with anecdotal evidence suggesting buyer interest in prime grade industrial assets is growing. Rents and land values continue to be challenged, but there are signs that prime grade yield easing may have run its course.

OVERVIEW

There is growing evidence that the domestic economy is stabilising. The recovery is expected to witness some volatility in that government stimulus is ending, credit markets are improving (albeit slowly) and building approvals are still weak. The investment climate will remain a challenge in 2010, particularly after the global financial crisis caused such a sudden and rapid softening of yields impacted by deteriorating capital markets. Yields may soften further due to rising discount rates and limited access to funding, not necessarily because of higher interest rates and the cost of capital.

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