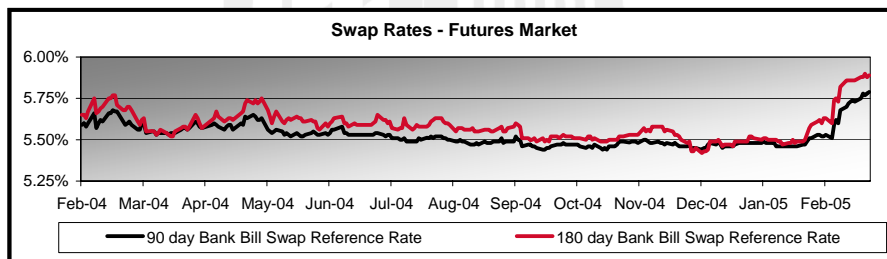


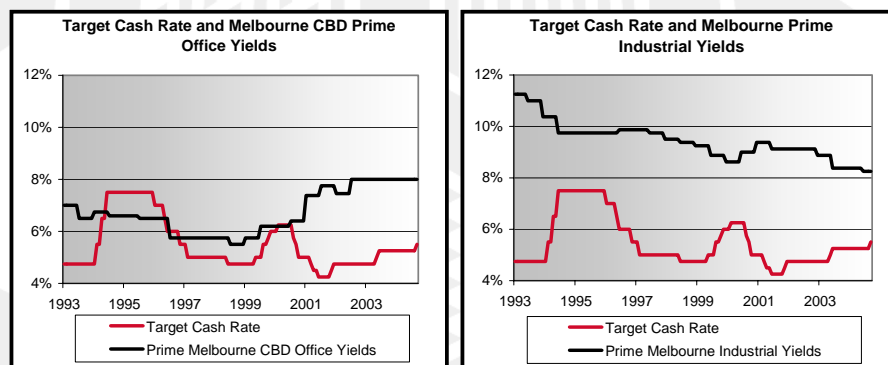
Following the announcement of the RBAs widely anticipated decision to increase interest rates on March 2, the financial markets have already begun guessing on when the RBA will make its second move upwards; a reasonable assumption, as generally the RBA interest rate decisions move in two's. However, of more importance to the property sector is whether this, and any further, increase in interest rates will relieve the recent downward pressure on yields across all sectors.

Following the release of the RBA's Statement on Monetary Policy in early February, markets and commentators have been increasingly confident of a rate rise. In the week before the announcement, the likelihood of a rate rise in March was firming as a certainty. The market also expects a move again by the RBA in the next three months, as the following chart of swap rates on the futures market shows.



Source: ANZ; Commonwealth; AFR; m3property

Regarding the relationship between interest rates and property yields, it could be expected that yields should increase as interest rates move upwards, to maintain property's competitive parity as an investment class. However, the relationship between interest rates and property yields in the Melbourne Prime CBD Office Market and, in particular, the Melbourne Prime Industrial Market over the past 10 years shows very little relationship at all. This contributes to property playing an important 'hedging' or diversification role in terms of an overall investment portfolio.



Source: Reserve Bank of Australia; m3property

So, if not interest rates, what is driving yields? In the case of commercial property, the performance in terms of yields is more closely tied to the vacancy rate (or the expectation of vacancies) within the relevant market, although the relationship is not particularly strong. In the case of industrial property, however, its performance over the past ten years is more based on the profile of the market: the industrial sector has become increasingly favoured by Institutions, which has changed the buyer profile of assets, leading to a compression of yields. Industrial property trusts have become increasingly prominent, while industrial property has also been allocated a greater weighting in property portfolios overall, up from 4.6% to 8.1% over the past 10 years, according to the PCA.

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m3 Dimensions

Interest Rates Are Up, but What About Yields?

Continued

Turning to the expected impact of last week's interest rate rise on four major property sectors it appears likely that yields in these markets will continue to diverge. In prime non-residential sectors no impact is expected, as strong demand for a limited amount of available stock is likely to keep downward pressure on yields. However, for residential property and lower-end non-residential property, the negative impact on demand from a higher cost of capital could be expected to see a slight softening in prices.

Commercial: Despite the relative underperformance of office property, the commercial sector remains in favour with investors. This favourable view will improve further, as record low unemployment has substantially increased demand for space, and in the case of Melbourne has led to lower forecast peaks in the vacancy rate in the current construction cycle. Despite the fact that competition for tenants is keeping lease incentives high, a lack of quality stock available for sale and improving office market fundamentals overall will lead to yields remaining firm, and possibly falling, in the short term.

Industrial: Competition between trusts to fill their significant land banks with design and construct projects for pre-committed tenants remains fierce, keeping pressure on rents and yields, at least in the short term. The relatively strong returns in the sector are also likely to keep demand high. However, at the lower end of the market rents could be expected to improve, as owner occupying becomes a less attractive option than it has been in the past. This could see yields in the lower bracket soften, as competition for property eases slightly.

Residential: The two interest rate rises at the end of 2003 had a dampening impact on activity in the major capital city markets of Australia, however the market has stabilised at a reasonably strong level. Ongoing population growth and an easing of construction levels will slowly lower the vacancy level, while higher interest rates will further deter investors and owner-occupiers from entering the market, leading to an expected softening in prices but only in the medium term.

Retail: Increased interest rates are likely to further slow domestic economic activity, and therefore further slow retail turnover growth. While yields for Institutional-grade property and supermarkets should remain largely unaffected, there could be some softening of yields for smaller retail investments, as the fundamentals of the sector deteriorate slightly and the cost of capital for smaller investors' increase.

While yields are to a large extent not expected to be impacted as a result of the current tightening in monetary policy by the RBA, this is largely due to the expectation of continuing strong demand, a result of property's own success as an investment class. Property is well regarded as an investment vehicle, for small investors who appreciate its tangible aspects and favourable treatment under taxation laws, and large investors attracted by its relative stability of cash flow and capital return. In particular, irrespective of wider economic performance, the on-going growth in superannuation funds will provide an on-going source of demand for investment grade property.

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