

The return outlook for unlisted commercial property



Key points

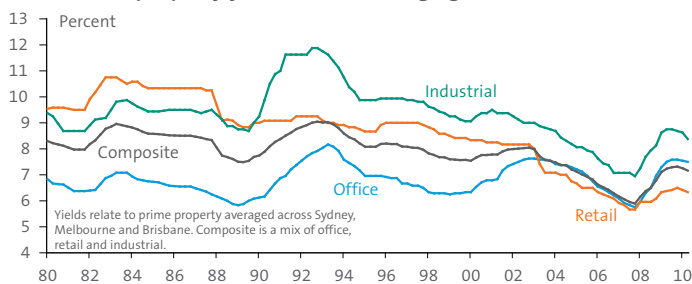
- Unlisted commercial property prices have started to grind higher after a 20% slump through 2008 and 2009.
- Expect a continuing but gradual recovery in returns going forward, on the back of attractive yields and constrained office supply, but only modest growth in space demand reflecting the somewhat mixed nature of the economic recovery. Returns from unlisted commercial property are likely to average around 9 to 10% p.a. over the next few years.

Commercial property starts to recover

Over the two years to December last year Australian commercial property values fell by around 20% as the global financial crisis (GFC) pushed up the cost and availability of debt, the slump in listed asset values in 2008 contributed to property selling to reduce unlisted property weights in superannuation funds, and an increase in the supply of property put downwards pressure on rents. As a result, from their low point in late 2007, average commercial property yields, or capitalisation rates, rose by around 1.4 percentage points (with each 0.25 percentage point rise corresponding to about a 4% capital loss).

This year though the pressure on yields has reversed resulting in modest capital growth for investors. Selling pressure has abated as borrowing rates have fallen and Australian real estate investment trusts (A-REITs) have recapitalised. The pressure on superannuation funds to rebalance away from property has faded and some have sought to take advantage of higher yields. And finally the demand/supply outlook for commercial property has improved along with the economic outlook.

Commercial property yields are declining again

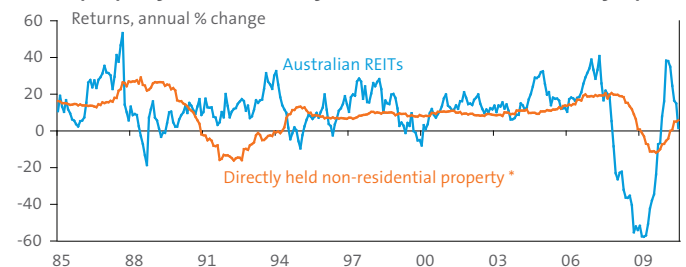


Source: AMP Capital Investors.

Expect the modest recovery to continue

There is good reason to expect the recovery in commercial property values to continue. Firstly, the rebound in A-REITs, which tend to lead direct property values, suggests there is more to go in the recovery in the latter. See the next chart.

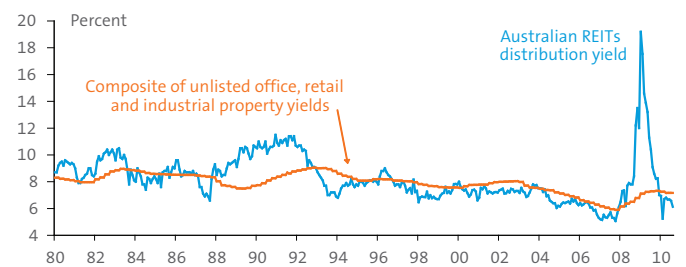
Listed property led on the way down & has led on the way up



* Direct property is AMP Capital Core Direct Property Fund and Mercer survey of unlisted property funds. REITs are real estate investment trusts. Source: Thomson Financial, Mercer Investment Consulting, AMP Capital Investors.

In fact, thanks to distribution cuts and the rebound in A-REIT values, unlisted commercial property now offers more attractive yields than A-REITs.

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

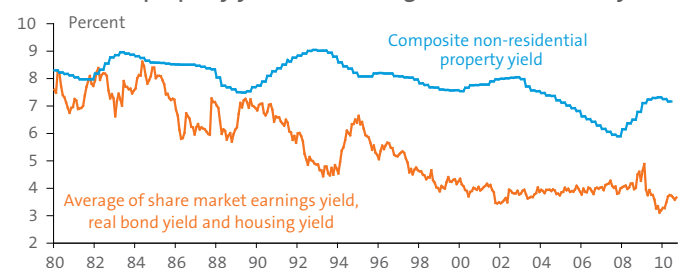


Source: Thomson Financial, AMP Capital Investors

Secondly, the yields available on Australian unlisted commercial property are now attractive compared to many 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.

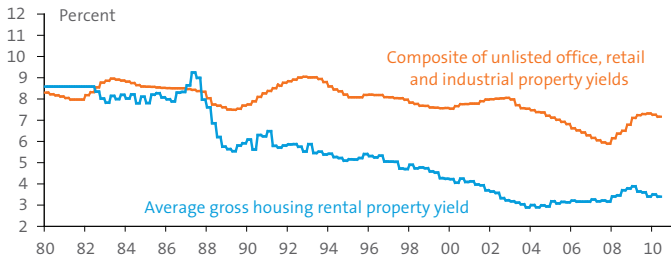
Commercial property yields remain high relative to "other yields"



Source: Thomson Financial, AMP Capital Investors

This is particularly noticeable when compared to residential rental property, as can be seen in the next chart. In the 1980s the rental yield on housing and commercial property was similar, but today commercial property has a rental yield which is far higher. In fact, over the last few years the average commercial property yield has risen to around 7.2% whereas the gross rental yield on housing has actually fallen to 3.4%. With Australian residential property over-valued on most measures, this suggests that office, retail or industrial property is far more attractive for investors than housing as it is less dependent on capital growth going forward and less at risk of a correction.

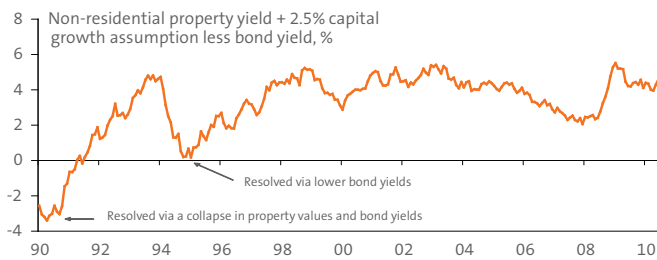
Australian commercial property yields are very high compared to the yield available on housing



Source: REIA, AMP Capital Investors

The relatively high level of commercial property yields at the same time that government bond yields have fallen, has ensured that the property risk premium has remained high. The next chart assumes constant property rental and capital growth of 2.5% p.a. This has been added to the composite non-residential property yield to give a guide to potential total returns and the 10-year bond yield has been subtracted to show a property risk premium.

The property risk premium is still high



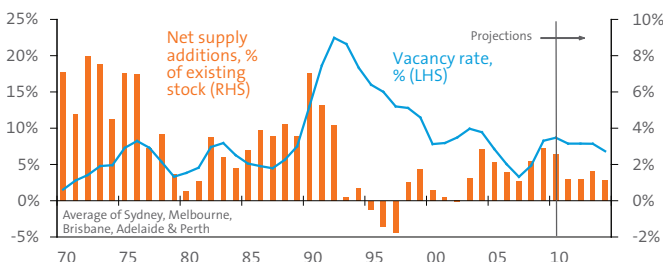
Source: Thomson Financial, AMP Capital Investors

The property risk premium remains relatively high and is likely to attract investors back into unlisted commercial property over time, particularly as bank and credit market lending spreads narrow further and the availability of finance for property improves in response to increased lender confidence in the property outlook.

Finally, the worst is probably over for property space supply and demand fundamentals, and a gradual improvement is likely.

New CBD office supply is in the process of peaking and this combined with an increase in space absorption on the back of the improving economy suggests that CBD office vacancy rates have likely peaked and will trend down over the next few years. This is very different to the early 1990s, as shown in the next chart.

CBD office vacancy rates and new supply peaking



Source: AMP Capital Investors

The retail property construction cycle has been relatively subdued although constrained retail sales going forward, in response to more cautious consumer attitudes towards debt and higher interest rates, will likely ensure only modest growth in retail capital values.

Industrial property supply is one area where growth is likely over the next few years.

Concluding comments

The recovery in unlisted commercial property is expected to continue, reflecting attractive income yields compared to other assets, an attractive risk premium over government bonds and a generally favourable supply outlook for office and retail property space. However, constrained financial conditions compared to the pre-GFC period and constrained growth in space demand, reflecting the mixed nature of the economic recovery, suggest that total returns will be constrained. As a result, we expect commercial property returns of around 9 to 10% p.a. over the next few years.

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