

YOUR GUIDE TO

AUSTRALIAN
PROPERTY
INVESTMENT

YIELD AND CHOICE

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Amongst investors, the most frequent enquiries are about guidelines for portfolio investment, an understanding of yield, and in the non-residential sector, an understanding of the differences between retail and industrial. The following thoughts may be helpful to a better understanding of these issues.



Portfolio Guidelines

It seems to be accepted that in a balanced portfolio property should play a significant role, and typically, weighting of between 30% and 40% is usual. Depending on the size of fund, the variety of property can vary but for those of a size to include multiple holdings, the essential guidelines may be summarised as follows:

- To complement alternative categories of investment and to broaden exposure and resilience to the economy through incorporation of a capital growth base weighted across selected property sectors;
- To provide secure, long term, regular net cash flows of predictable and acceptable growth;
- To target property categories, lessees and long lease terms which minimise management and capital contributions;
- Through regular review to rationalise and re-invest selectively to maintain a high level of saleability for all properties;
- To minimise vulnerability & administration of portfolio by ensuring matrix of well spread timing for key events such as rental reviews, lease expirations and acquisitions or disposals.

Whilst it may be more relevant to larger funds, it is important to recognise that to ensure the fundamental goals as set out above, the development

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of a strategy for pro-active management is necessary, and which may involve as key issues the following components:

- To quantify the determinants of initial capital allocation, projected annual funds availability and capital reversion requirements, particularly "make good" issues;
- Adopt a view about the economy noting next likely cyclical extreme, lead time, inflationary factors, monetary policy and exchange rate;
- Determine property sector eligibility and FIRB requirements;
- Adopt mix of property sectors by value/percentage from eligibility groups;
- Review existing properties based on adopted criteria;
- Set program for acquisition/disposal targets as necessary to reflect criteria.

Yields - Be Informed, Aware and Careful

Investor interest for leased retail and industrial property always creates discussion amongst investors about the movement and acceptability of property yields or income returns. Although there is a general understanding of property yields, they can still be misleading as so often initial yield or return may not accurately reflect the maintainable investment performance and therefore appropriate purchase price or value. Prospective investors should be aware that yields can be deceptively high indicating an element of risk and need for caution or alternatively can be deceptively low often indicating an excellent investment opportunity. To assist in an understanding as to why yields may be high or low the following explanation guide is provided.

Reasons For High Yields

- Short term lease with risk of vacancy leading to discounted price.
- Rental higher than fair market value foreshadowing likely fall in rental in short term.
- Highly specialised property with limited rental market.
- Old or economically obsolescent building warranting redevelopment and approaching land value only.
- Perceived weakness about lessee's financial strength and ability to maintain lease obligations.
- Property may be inappropriately zoned or affected by other adverse planning issues.
- Rental quoted may be gross rental rather than net rental.
- Lease may not have "minimum clause", allowing rental fall at reviews.
- Misunderstanding about impact of Retail Tenancies Act.

Reasons For Low Yields

- Rental may increase to full market and thus yield will improve shortly after purchase.
- Property may have special value to purchaser such as intending owner/occupier when tenant vacates, tenant may be purchasing to protect goodwill, or property purchased by developer for consolidation.
- Rental may be well below market rental with medium term prospects for strong income recovery.
- Combination of extremely strong lessee and long term lease making for very secure investment.
- Property may have potential other than income, for example additional land, key location to redevelopment project, refurbishment or subdivisional potential.

Initial yields or yields on sale price can fluctuate wildly and should rarely be accepted at "face value" as a guide when assessing comparable properties. A simple capitalisation approach without proper analysis can often lead to the wrong result.

Investment Decision - Industrial Or Retail

The categories, industrial and retail are very different forms of investment and to assist prospective investors, the key aspects of each may be summarised as follows:

Retail

The majority of value relates to the land, often as much as 85% of purchase price with only a small portion relating to improvements. Land and location therefore are the strengths of retail investments and obsolescence is usually of little concern as most premises can be routinely modified, usually at little expense and invariably at the lessee's cost.

Positions of high pedestrian flow ensure increase of tenancy and consistency of income flow other than during the most severe recessionary periods. Compared with the advantages of negligible obsolescence and maintenance of income, the detraction however relates to the strength of lessee, which often tend to be small concerns with no great financial strength and usually only committing to relatively short term leases.

Recent surveys evidence retail yields in prime strip inner urban centres to have firmed to 4% - 5% with the prospects for further growth likely to come from increases in rental, rather than a further firming of yields. Well located "secondary centres" which may benefit from an increase in medium density residential development can be particularly attractive.

Industrial

Compared with retail the typical industrial investment involves a far greater proportion of funds invested into the building component, often representing more than half the total investment. Obsolescence is therefore a risk, the land and location alone not being sufficient to guarantee long term serviceability if the improvements do become outdated. Industrial properties however do offer the opportunity, in the relatively lower price range, to access major organisations as lessees, many of Australia's top companies and international groups found as lessees, and usually for attractive terms up to 10 years.

For prime, contemporary design, recently constructed industrial premises let for 10 years or a balance of lease up to seven years, yields have firmed to 8% - 9% and over the next 2 - 3 years, capital growth is expected both from increases in rental and further tightening of yields, unlike retail, where most growth will only come from increases in rental.

Summary

In summary, retail offers reliability due to little obsolescence and strong locational factors but generally weaker tenancies whereas industrial offers strong tenancies but higher risk physical characteristics. On balance, the negligible obsolescence factor associated with retail compared with the faster depreciation for industrial, means that investors require their investment in industrial to be amortised more quickly, for which reason prime industrial properties are purchased at higher yields. Correspondingly the rate of depreciation with industrial usually results in slower capital growth than for retail holdings.

The comparison becomes one of balance between income return, capital growth and perceived risk for which reason any investor's criteria should include a pro-active strategy involving intended holding period, envisaged timing of re-sale and a full appreciation of the timing of lease expiration and likely prospects for renewal.

Remember - Note of Caution

Whilst diversification into non-residential sectors such as Retail and Industrial may have appeal, many investors make this move too early. You should remember, that Residential real estate is by any measure, the lowest risk category, and the most liquid, and over many years, has afforded many investors excellent returns through capital growth and income. Perhaps not fitting everybody's investment profile, but as a generalisation, any Portfolio, should in my opinion, excluding the family home, be anchored around a residential core, to a value in the range \$10.0M - \$15.0M, before contemplation is seriously given to diversification away from the residential sector.