

# Research insight

July 2007

Yields on Retail Property – “Be Alert, Don’t be Alarmed”

Investor interest for leased retail properties has been strong for an extended period and now appearing to be further strengthening as evidenced by the more frequent media reporting of **sub-4% yields** (particularly for properties in traditional retail strips). The frequency of transactions at such low yields would have been unimaginable as recently as 2 years ago.

Just as the Federal Government implored the community to “be alert, don’t be alarmed” about the potential for terrorism threats, investors should similarly **be alert** to the changed investment environment relating to retail property but **not alarmed** because there are sound reasons for such low yields given improvements in underlying fundamentals of this segment. Furthermore, and perhaps more importantly, additional considerations (previously unrecognised / ignored) have emerged that underpin and justify the higher prices being observed. Despite the continuing importance of rental income from retail property there has been a clear weakening of the traditional relationship between income and value as purchasers consider other factors, particularly redevelopment potential, when determining their price and hence the yield they are prepared to accept.

Whilst there has been a clear trend towards an acceptance of lower yields for retail property, as observed for other asset classes, the sub-4% yield headlines however can also often be misleading and need to be correctly interpreted. The reported initial sale yield typically does not fully reflect the maintainable investment performance and nor, as a result, the appropriate property value based on the traditional capitalisation of income valuation approach.

Prospective investors should be aware - for a range of reasons - that yields can be deceptively high or low. Depending upon investors’ risk tolerance, these deviations may indicate either additional risk or opportunity or a need for additional caution or an excellent investment opportunity.

#### Some Reasons for Low Yields

- Rental increase to a realistic level (in accordance with lease rent review provisions) that will improve the yield shortly after purchase;
- Property may have a special value to a purchaser such as an intending owner occupier when tenant vacates; tenant may be purchasing to protect goodwill; or property purchased by adjoining owner for consolidation in anticipation of redevelopment;
- Rental may be well below a fair market rental with medium term prospects for strong income recovery;
- Combination of extremely strong lessee and long term lease making for very secure cashflow;
- Property may have potential other than income, for example additional land, notional development “air rights”, prime location providing redevelopment prospects, refurbishment or subdivision potential.

#### Some 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 property 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. This is likely to become more of an issue with the introduction of the Retail Leases Act 2003, and the fact that Land Tax is not recoverable from the lessee, including if an option period is exercised.

Initial yields or yields on sale price can fluctuate wildly and should rarely be accepted at “face value” when assessing comparable properties. Charter therefore advises those Clients involved in the preliminary assessment of property values to be careful to fully qualify yields, rental values and redevelopment potential before drawing a conclusion about fair market value. A simple capitalisation approach without proper analysis can often lead to the wrong result. Be informed about these issues and therefore be wary not to be misled, and if uncertain be sure by referring your concerns to our office.

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