

Research insight

July 2007

Non-residential property yields: How low can they go?

Non-residential property yields in Melbourne (and for that matter Australia) have been defying market expectations and are continuing to fall. At the lower end of the market, private investors continue to bid up values for securely leased smaller properties in retail strips, city fringe office precincts and prime grade industrial suburbs. At the top end, cashed-up institutions and funds are competing for a diminishing pool of high value assets to park in trusts for long term income streams. With \$1.2 trillion of superannuation already under management in Australia, it is unlikely that pressure for investment real estate both locally and offshore is about to ease any time soon. Superannuation has provided additional national savings of about \$65 billion in 2006 alone but it is estimated around 10% of this is invested into property.

Charter's assessment about the prospects for yields in Melbourne is that even with the upside potential to interest rates, medium term economic conditions remain favourable and a correction in prime grade investment property values is unlikely. The sheer weight of funds will continue to place pressure on yields to at least plateau if not fall further. Non-residential property in Melbourne has been recording stronger growth in rentals reflecting the underlying supply and demand conditions that investors are willing to accept at such low yields. It is for this reason that purchaser demand has consequently pushed up the value of property faster than rental returns resulting in the strengthening of yields.

The "how low can they go?" question continues to draw much debate. Whilst there are varying opinions, it is still worth noting that Australian non-residential property yields are typically above those of similar-grade global property. As an example, prime grade office buildings in Europe on triple net leases have been selling at substantially lower yields, closer to 4% on average. In Australia, although on perhaps shorter lease terms when compared to overseas, prime grade buildings are averaging around 7%. So to answer that question – "much lower".

Further pressure is also coming from private equity, both local and offshore, emerging over the last few years. A recent announcement was Morgan Stanley agreeing to buy Investa Property Group for \$4.7 billion. Looking forward, the weight of funds is exhausting supplies of investment grade property locally.

Research by Charter indicates that recent sales activity shows evidence of aggressive yields being paid by large investors on the proviso of stronger future returns coming via rental growth. With robust economic fundamentals in place this seems logical, however, there do remain concerns. The main issue relates to secondary grade properties which have rather untraditionally experienced significant yield tightening to the extent that they aren't too far away from prime grade properties. In Melbourne, prime grade average office building yields have fallen around 75 to 100 basis points between 1995 and 2007. Secondary grade offices have fallen a staggering 250 to 275 basis points. In light of this yield spread, there is a real concern for correction of secondary grade stock once this very long property cycle finally begins to show signs of slow down.

Economic fundamentals are improving with unemployment likely to remain close to the 'natural' rate over the medium term. Leading economists forecast interest rate increases of up to 50 basis points by the end of 2008 and in the absence of any major global economic correction, provide limited impetus to reduce the appetite for property investment. The attractive returns relative to other investment asset classes will continue to provoke strong private and institutional interest.

In conclusion, there is definitely further potential for non-residential property yields to fall further and to forecast this compression would be pure speculation. The point of this Research Insight is to highlight the comparison to larger more mature overseas property market yields for similar properties being substantially lower.

Frank Sorgiovanni
Senior Property Analyst – Commercial
Strategic Research

Charter Keck Cramer offers detailed and customised briefings by engagement. To find out more about the firm's full range of services including Corporate Real Estate, Private Equity, Strategic Research, Urban Economics & Policy, Valuations, Quantity Surveying & Tax Depreciation and Development & Project Management contact:

Melbourne – Telephone 03 9642 5000

Level 4, 473 Bourke Street Melbourne VIC 3000

frank.sorgiovanni@charterkc.com.au

Visit the Charter Keck Cramer web site @ www.charterkc.com.au for further information.

This report has been carefully prepared by Charter Keck Cramer – Melbourne. This report is not intended to be comprehensive or render advice and neither Charter Keck Cramer nor any persons involved in the preparation of this report accepts any form of liability for its contents. The information contained herein should not be relied upon to replace professional advice on specific matters. This report is Copyright and cannot be reproduced without written permission of Charter Keck Cramer.