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Commercial Property Downturn 'Beyond Tipping Point'

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Larry Schlesinger & Michael Bleby

The managing director of listed childcare centre landlord Arena REIT says the debt-fuelled binge by investors on commercial property means the odds of a downturn are now "well beyond the tipping point".

"Record low yields, new supply, generally high debt levels, increasing debt margins and investors are acting like the market never goes down," Arena REIT managing director Bryce Mitchelson told The Australian Financial Review.
"As a prudent investor, the best you can do is understand the odds and be prepared for the inevitable downturn ... if and when property prices drop 20 per cent, will/can you survive?

"Operating on high debt levels, given it's leverage effect, is very dangerous in a downturn ... it can wipe you completely out ... it's not a pleasant experience. The wealth destruction is horrendous and painful."

Mr Mitchelson's remarks follow a warning from professional property investor Alex Collins that a correction could be looming for commercial property because of the "insane prices" being paid by investors, which are driving down yields at the same as the cost of funds is going up.
Mr Collins and his father-in-law, Con Angelatos bought a supermarket in Maryborough, a regional Queensland town for $13 million on a 6 per cent yield.

'Incredibly strong run'

But he was aghast at the yields being achieved on some assets including a childcare centre in Vaucluse in Sydney's Eastern Suburbs, which sold on a record low 3.6 per cent yield and a strata retail property in St Kilda which sold on a 4 per cent return.

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"A lot of these properties have no growth built into their leases. There could be a crunch if funding dries up," Mr Collins said. Mr Mitchelson, who manages a 200-strong portfolio of childcare and healthcare assets, said the property market had had an "incredibly strong run since the GFC" supported by a host of factors including the market coming off a low base, declining interest rates and international investor interest.

"For those investors on that wave and putting 'risk on', the amount of wealth created over the past 8 years has been phenomenal.

"But it's not hard to see that the Australian property market is now late in the cycle. Like the age old truisms of 'death and taxes' smart investors truly appreciate that all investment markets work in cycles," he said.

Sentinel Property Group boss Warren Ebert told the AFR "the fundamentals have gone out the window".
"Prices have got silly. These investors maybe alright for a few years, but if interest rates go up what does that do to them?" Mr Ebert said.

Mr Ebert said for a lot of investors putting money into residential property and making a negative return, a 3 per cent return in commercial property looked attractive. "But a lot of them are misinformed."

"I'd rather take a 3.6 per cent return on a childcare centre in Vaucluse than 6 per cent yield in Maryborough," he said.

Nick Anagnostou, CEO of the country's biggest childcare centre owner, Folkestone Education Trust, said concerns about the commercial property market were valid.

"You might argue at the moment that generally commercial property is probably influenced by the temporarily cheap cost of debt and the chase for yield. Self-funded retirees can't find yield other than from commercial property," he said.

Private investors driving yields

But he said it was a different story for childcare centres, which he said was being "re-rated" because of the strong demand for childcare being driven by population growth and the increased participation by both parents in the workforce.

"I think this differentiates child care from other more discretionary type uses, especially retail.

"There's also the the underlying land value growth and future development potential underpinning childcare centres, which a typical retail investment doesn't have," Mr Anagnostou said.

Melbourne-based childcare industry veteran and chief executive of Veuve Property Group, Vin Harink, said the low yields in childcare were being driven by "private investors, particularly those with self-managed super funds" and applied to smaller properties in the $2 million to $5 million price bracket.

"Relative to interest rates, those yields are sustainable at the moment. If rates rise, those yields will rise.

"But when you get to larger centres, it's a different market. The nature of those investors is more commercial than the mum-and-dad super funds.

"Down the track, if you've got an 800-square-metre childcare centre site, that will potentially get snapped up by an apartment developer. When we go out looking for sites, we inevitably end up competition not with other childcare developers but with apartment developers," he said.

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