AUSTRALIAN INVESTORS ASSOCIATION

Investor Update

Monthly updates on investment issues for AIA members

November 2017

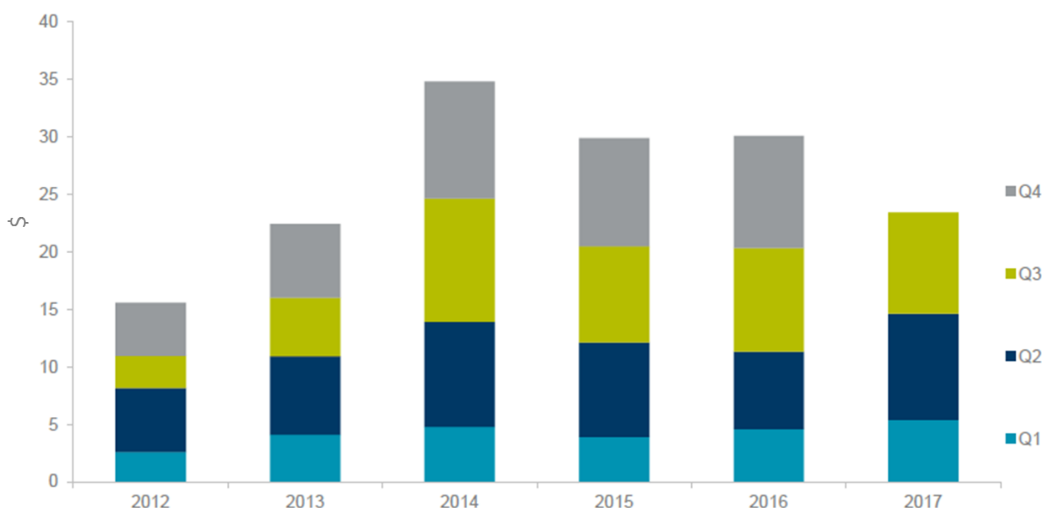
Non-Residential Property – Nearing the top of the cycle?

Adrian Harrington

The RBA's semi-annual Financial Stability Review (FSR) provides an assessment of the current condition of the financial system and potential risks to financial stability; an important health check on the Australian financial system.
Whilst the RBA has devoted significant time to the state of the residential market in the past few FSR's, the most recent FSR issued in mid-October put the spotlight on the non-residential property market. The RBA noted that they are closely monitoring conditions in non-residential property markets and also commented that "*conditions in commercial property markets vary significantly by state and property type*". The RBA specifically acknowledges that "*growth in commercial property prices in Sydney and Melbourne continue to exceed that in rents, and office vacancies are elevated in the cities with greater exposure to the mining sector, especially in Perth...*"

The RBA also noted that *"yields on commercial property in Australia remain high internationally"* and that is a key reason why the sector has been attracting both foreign and domestic investors. This is backed up by the latest transaction data from Cushman & Wakefield[1], which recorded $8.8 billion in sales in Q3 2017, taking the year to date total to $23.3 billion, well up on the $20.3 billion recorded at the same time last year. With a number of large assets currently on the market, Cushman & Wakefield expect the full year number to exceed $30bn for the fourth consecutive year and could go close to the peak of $35bn recorded in 2014.

Figure 1: Total Non-Residential Property Investment Activity: 2012 – 2017



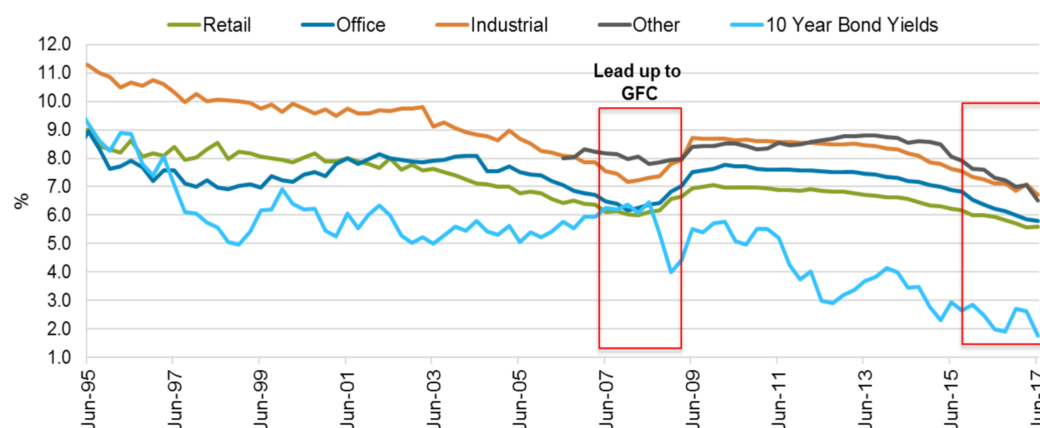
Source: Cushman & Wakefield

[1] Cushman and Wakefield – Australian Investment Marketbeat – September 2017

In a low interest rate environment, it is tempting to gear up non-residential property to generate higher returns on equity. Yet, we believe now is not the time to be pushing leverage (gearing) levels too high. As the RBA quite rightly points out, if there is a *"marked increase in global long-term interest rates, highly leveraged investors close to the maximum LVR covenants on bank debt could become vulnerable to breaching loan covenants."* In such an environment, highly leveraged investors face two choices, either provide additional equity to reduce the LVR below the maximum covenant or secondly, sell the asset, which may not be desirable if there are other forced sellers in the market.
As we approach the end of 2017, and almost 10 years since the GFC, it is timely that the RBA sends a warning shot across the bow. No one has a perfect crystal ball of what lies ahead, but it's a timely reminder for market participants to pause and take stock of where we are in the cycle.

As the Property Council/IPD Property Index highlights, yields across all the major non-residential property sectors are at, or close to record lows (Figure 2).

Figure 2: Non-Residential Property Yields: 1995 – 2017



Source: MSCI/PCA

The one defining difference between now and 2007 is the yield gap between non-residential property and 10 year bonds. Back in 2007, the spread was negative. In other words, the yield from owning a 10 year bond was higher than the yield from owning a non-residential property. At June 2017, the yield gap is positive, with non-residential property yields 200-300 basis points higher than the 10 year bond yield.

The issue now confronting investors is, can property yields go even lower (property values go higher) and the yield gap close, or alternatively, will bond yields go up and the gap closes? We believe we are entering the closing stages of the property yield compression cycle. Therefore, the strong increases in property values over the past few years will moderate, but remain positive.

At the same time, we believe interest rates should remain low and capital will continue to search for opportunities across the real estate sectors. In such an environment, the challenge is to avoid simply taking greater risk in the search for higher returns.

Looking ahead, we still like the office and hotel sectors in Sydney and Melbourne. Demand remains strong from office tenants and hotel guests while the underlying economies of both cities remains in a healthy state.

The other sectors on our radar centre around property related social infrastructure - childcare, seniors living and medical/health. The demographic drivers (workforce participation and population growth for childcare and an ageing population for seniors living and medical/health) and a shortage of quality accommodation in all three sectors bode well for considering these types of property sectors as a legitimate part of an investment portfolio.

The one sector we remain cautious on is retail. The retail sector is being buffeted by both structural and cyclical headwinds. The arrival of international retailers in recent years has reshaped the retail landscape – Zara, H&M and Uniqlo to name a few. At the same time, local retailers such as Dick Smith, Payless Shoes and Rhodes & Beckett have disappeared.

Amazon's imminent arrival is sending shock waves through the retail community despite bullish responses from the likes of Gerry Harvey – "*Amazon in Australia, it is not going to be as easy as the US … Most of the retailers there rolled over but they won't here*."[2] Yet the newly anointed CEO of Wesfamers, Rob Scott, has been a little more conciliatory - *"we have been expecting this for a long time. We have a healthy sense of paranoia. We are not complacent around the competitive risks."*[3]

The tough retail environment was certainly front and centre in the recent September quarter updates from a number of the ASX listed real estate investment trusts (A-REITs) exposed to retail property. Retail sales growth was lower or at best flat, relative to June 2017 levels - GPT (+1.8% vs. +3.4%), Stockland (+0.3% vs. ~0%), and Vicinity (+0.2% vs. +0.4%).

Ultimately, as we enter the next phase of the property cycle, investors will need to be disciplined in the implementation of their property investment strategy. Now is not the time to stretch on price or overcommit to debt. At the same time, investors (or their managers if investing via unlisted property funds or listed A-REITs) will need to focus on active asset management of the underlying property; the next few years will be about driving income growth rather than relying on yield compression and financial engineering (i.e. higher gearing) to deliver higher returns.

Adrian Harrington, Head of Funds Management at Folkestone

This publication has been prepared as information without consideration of any reader's specific investment objectives, personal financial situation or needs. No reader should rely upon the information and/or recommendations contained in these publications. Readers should, before acting on any information contained herein, consider the appropriateness of the information, having regard to their objectives, financial situation and needs.
The AIA believes that the material contained in these publications is based on the information from sources that are considered reliable and is accurate when issued. However, the AIA does not warrant its accuracy or reliability. All views and information expressed by the AIA, its officers, agents, representatives, and employees are for the purposes of discussion only.

Australian Investors Association Ltd
PO Box 1208
Oxenford QLD 4210
Tel 1300 555 061
Fax 07 5573 7319
Email aia@investors.asn.au
Web www.investors.asn.au

[2] http://www.news.com.au/finance/business/retail/gerry-harvey-says-amazon-will-face-a-tougher-battle-in-australia/news-story/3b4f6ddbb0ad91d8647586ccd7594165

[3] http://www.smh.com.au/business/retail/wesfarmers-secret-amazon-response-team-20170420-gvokyy.html