Edition 30 – 30 October 2009
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AMP capital INVESTORS

Unlisted commercial property values nearing recovery

Key points

- Since peaking in late 2007, unlisted commercial property prices have fallen by around 20% as a result of the fallout from the global financial crisis.
- However, commercial property values appear to be at, or close to, a bottom as upward pressure on yields is fading and demand/supply fundamentals are improving.
- Just as share markets led commercial property returns on the way down they will likely do so on the way up. We therefore expect property values to start improving next year.

The plunge in commercial property values

The past 18 months have seen sharp falls in commercial property values. Since peaking in late 2007, commercial property values have fallen by around 20% on average - with 25% to 30% falls in office and industrial property and 10% to 15% falls in retail property. The driver of this slump has been the global financial crisis and the associated economic fallout. Specifically:

- The credit crunch increased the cost and reduced the availability of debt used to fund property purchases and holdings. This put pressure on existing owners to sell and led to reduced investor demand;
- Some diversified investors such as superannuation funds were put under pressure to sell unlisted property as their exposure rose in response to falls in share markets; and
- An increase in the supply of property space and reduced demand as the economy slowed put downward pressure on effective rents.

The result was downward pressure on unlisted commercial property values as investors demanded higher yields in order to invest. From their lows in late 2007, average commercial property yields have increased by around 1.4 percentage points (with each 0.25% rise in yield translating to a 4% loss in value).

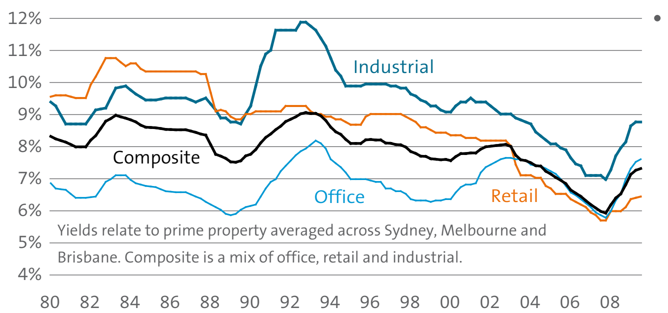
Values may be bottoming

However, there is now good reason to believe property values may be at or close to their low. As can be seen in the next chart, the rise in property yields appears to be slowing. This reflects a range of factors, in particular:

- Selling pressure is abating as the demand from lenders to reduce gearing is diminishing. This reflects improving credit markets, narrowing borrowing spreads and listed property trusts raising $19 billion in equity capital since the start of last year. Listed property trusts that were potential sellers last year are now potential buyers;

Commercial property yields may be at/close to topping

Source: AMP Capital Investors.



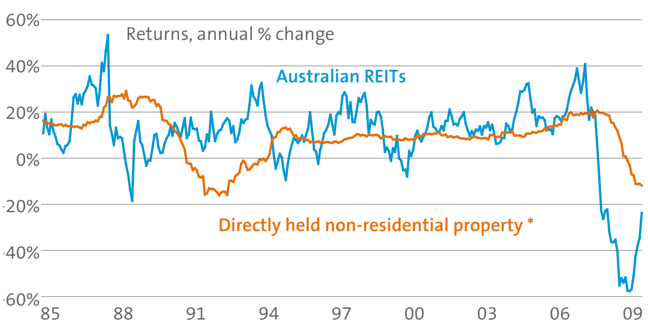
- Similarly, the pressure on diversified investors (such as superannuation funds) to rebalance and reduce their property exposures, which had become inflated by the slump in share markets, has reduced as property values have fallen and share markets have rallied;
- Property demand seems to be improving as investors seek to take advantage of higher property yields; and
- Demand for property space seems to be improving as supply is constrained. While demand for industrial space is still soft, the net absorption of office space moved into positive territory in the September quarter consistent with signs of economic recovery.

These considerations suggest that property valuations are likely to bottom in the current quarter.

Expect a recovery to commence next year

There are several reasons to expect a recovery in property values in 2010. **Just as last year's collapse in listed equities and property trusts led the slump in direct asset valuations, the rebound in listed assets points to a recovery in unlisted asset valuations through next year.** Thanks to their higher gearing and greater liquidity, Australian listed property trusts (A-REITs) dramatically overshot direct property on the upside during the 2004 to 2007 period and thus overshot on the way down during the bust. Contributing to this was their greater exposure to the US and Europe where the economic and property slump has been much deeper. In recent years they have been leading direct property by a year or so and are now pointing back up. Please refer to the next chart.

Listed property led on the way down and is leading on the way up

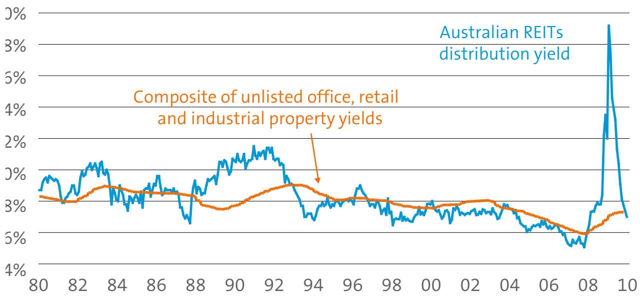


Direct property is the AMP Capital core direct property fund and the Mercer survey of unlisted property funds. REITs are real estate investment trusts.

Source: Thomson Financial, Mercer Investment Consulting, AMP Capital Investors.

While the surge in listed property trust yields led the rise in unlisted property yields last year, thanks to distribution cuts and a rebound in listed property trust valuations, they have now fallen back in line with unlisted yields. See the next chart. So whereas A-REITs were offering much better prospects than unlisted property at their low point in March this year, this is no longer the case and it is harder to distinguish between the two asset classes in terms of their return prospects, particularly on a five to ten year outlook.

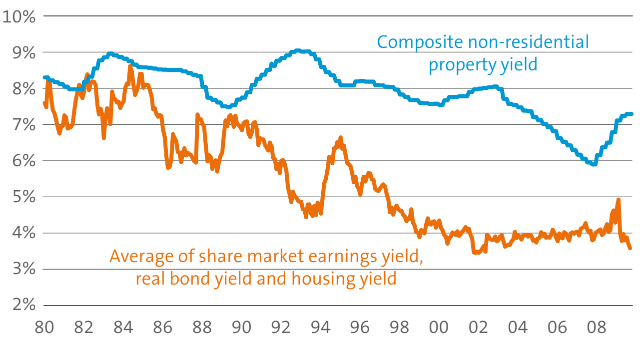
Australian listed property yields have fallen back to be in line with unlisted property yields



Source: Thomson Financial, AMP Capital Investors

Secondly, Australian unlisted property offers an attractive yield premium over other assets. The next chart shows a composite of office, retail and industrial property yields versus an average of government bond, equity and housing yields. The gap between commercial property yields and other yields has blown out, suggesting yields on commercial property are relatively attractive.

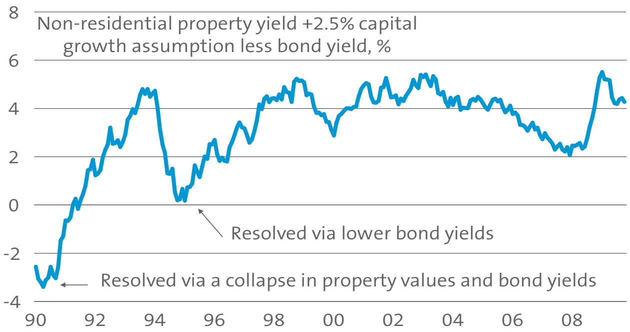
Commercial property yields are high relative to 'other yields'



Source: Thomson Financial, AMP Capital Investors

In particular the back-up in commercial property yields over the last two years, at the same time that government bond yields have fallen, has ensured the property risk premium has remained high. The next chart assumes constant property rental and capital growth of 2.5% per annum. This has been added to the composite non-residential property yield and the ten-year bond yield has been subtracted to show a property risk premium.

The property risk premium is high

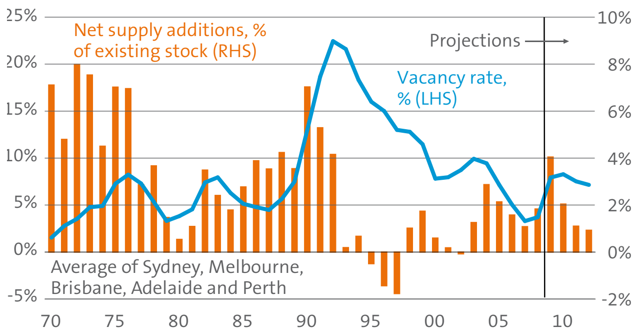


Source: Thomson Financial, AMP Capital Investors

The property risk premium is now relatively high and is likely to attract investors back into unlisted commercial property over time, particularly as bank and credit market lending spreads narrow further and the availability of finance for property improves in response to increased lender confidence in the property outlook.

Finally, the worst is probably over for property space supply and demand fundamentals and improvement is likely from next year. This is illustrated for office property where the supply of new space is likely to peak this year before declining in the years ahead. The improvement in economic confidence is also likely to lead to a continued improvement in office space absorption. This would suggest office vacancy rates are likely to start falling from next year – see the next chart – which in turn will be positive for rental growth. The office supply/demand situation is far better than was the case in the early 1990s when there was a massive supply of new office space just at the time the Australian economy had its worst post-war recession.

Average Australian CBD office vacancy rates and new supply



Source: AMP Capital Investors

Conclusion

Unlisted non-residential property values are at or close to the bottom. A gradual recovery is likely to begin next year in response to improved conditions in financial markets, the attractive longer-term return premium unlisted property is offering over other assets and the improving demand/supply outlook for property space.

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