



Analysis

Commercial property: Over correction or fair value?

- With an historic average amounting to 76% of total returns, income is the main driver of total returns from commercial property.
- The recent correction appears to have stabilised yields to around long term averages, suggesting a move from over priced to fair value.
- Improving economic fundamentals and limited new supply should ensure income streams are secure, with the opportunity to value add as markets improve, adding to the base yield.

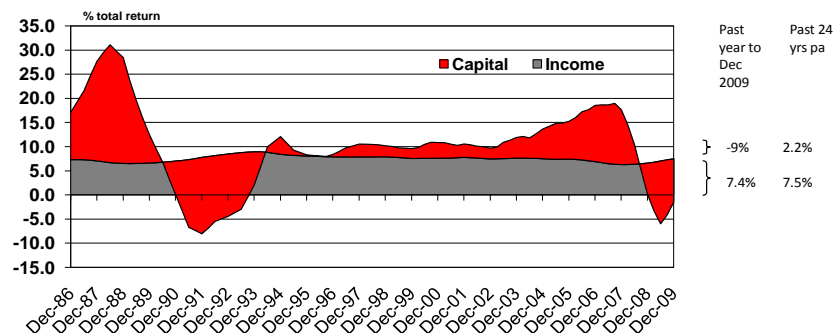
The outperformance of the Australian economy in the past year and expectations of continued, but controlled growth over at least the medium term should provide a sound base for the recovery of the commercial property market. Data from CB Richard Ellis research suggest that commercial property values fell on average by a range of between 12% for retail and 25% for industrial from the 2007 peak. As always there were examples of individual market values falling much further and individual properties further still. Westpac Property Markets continued to argue through the downturn that the falls in value would be limited by the fact that there was not the looming oversupply from over building, as in the 1990s, for most markets at least. Admittedly in the depths of late 2008 as the credit crunch hit its peak and financial institutions were failing, globally at least, we had our doubts, but fundamentals prevailed. Therefore as the Australian economy did outperform and things did not get as bad as some expected the question we pose is 'did the market overreact or was the correction from an overpriced situation?' In this paper we look to answer this question.

The correction in commercial property has seen values fall 12% to 25%

Why yield and not total return?

Chart 1: Total returns from commercial property

Historically income has accounted for 76% of total returns, with capital growth the most volatile



Source: IPD/PCA Investment performance Index Dec 2009

We are often questioned why we only use the equivalent yield against the 10 year bond as an indicator of market position, rather than total return. While we acknowledge that property investment is more than just the yield, our analysis compares income stream to income stream, to assess on a consistent risk premium basis where the market sits. As shown in chart 1, the capital growth part of total returns is volatile and attempting to include the future

Yield is largely the constant with capital values the variable in total returns.

capital growth would be subjective and open to bias. No investor would buy if they considered values would fall, but that's what happened in 2008 and 2009, following an exceptionally active market in 2006 and 2007. Few valuations would have factored this in to their estimated total return, yet market activity had driven yields to record lows in some instances. Shouldn't this have been a warning sign? Yes, but the consideration was that the yield alone should not be taken, with some suggesting it was different this time.

Yield, or income has been 76% of total return for past 24 years.

Yields are also the main driver of long term total return. Data from IPD has shown that around 76% of the long term (24 years, or 68% for 10 years) total return from commercial property investment comes from the income stream, the remainder being capital growth. It varies between asset classes; retail for example 64% of total return has come from income, while office and industrial are closer to 85% and 87% respectively.

Therefore, while we admit it's not perfect, comparing the largest and most constant part of total return against the income from a risk free asset provides a measure of where the market stands at a point of time. We accept that it should not be used in isolation as the indicator of market position. Other factors, such as expected vacancy, economic outlook, future income gains and estimated capital growth should also be considered. Similarly the level of the 10 year bond in relation to its own long term average and expected future movement needs to be analysed.

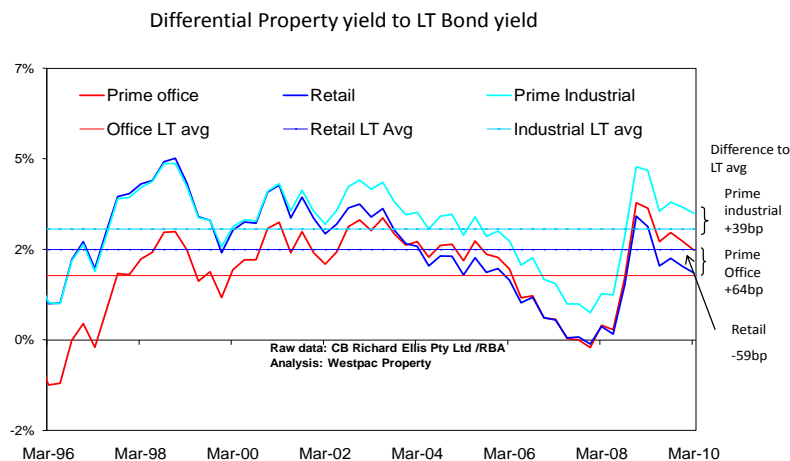
Over corrected or back to normal?

The yield premium to 10 year bond was above average in Q1 2010 for office and industrial

Using the comparison of property yield and 10 year bond rate, as at March 2010 commercial property appears to be around fair value. The premium for both prime industrial and prime office yields, as shown in chart 2 overleaf, are above the longer term (15 year) average premium to the 10 year bond rate; prime office by some 64 basis points and prime industrial by 39 basis points. Not a significant difference but positive nonetheless. Retail remains below the average premium by some 59 basis points. Taking secondary offices, the premium above the average is a higher 99 basis points, while secondary industrial is only 11 basis points above the average. A breakdown of retail categories reveals bulky goods, at 14 basis points over and regional shopping centres at 19 basis points under long term average are best placed.

Chart 2 suggests that the market over corrected from being over valued for most of 2007, to under valued in 2008. It had subsequently moved closer to average by March 2010. However, the December 2008 10 year bond rate was way below average at 4% and economic conditions at that time exceptionally pessimistic, confirming that using this measure in isolation or without knowledge of the factors of input would not be correct. At the March 2010 5.6% level the risk free rate is closer to average and a better measure. Analysis of this chart suggests the market has moved from a position of over value to fair value, but has not over corrected, or rather property isn't under valued.

Chart 2: Premium commercial property yields are above risk free
Office and industrial property is above the average premium to risk free

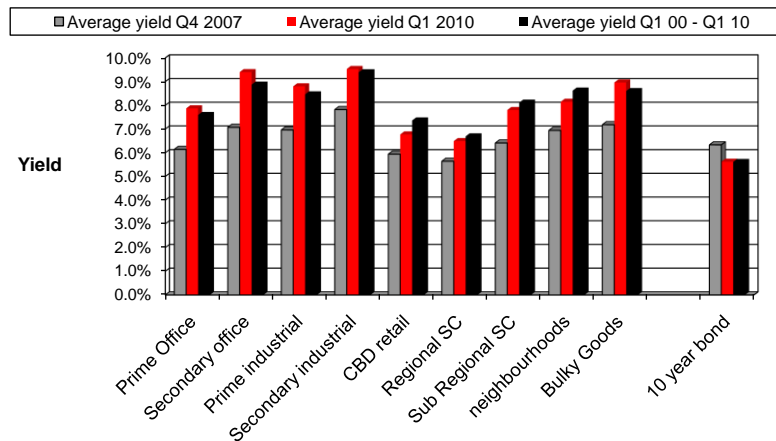


Yields close to 10 year averages

Another measure of where the property market sits would be how the current yield sits against its own average, ignoring alternative investments. Again while far more favourable than a couple of years ago, there is nothing to suggest commercial property is under or even overvalued. Admittedly offices and industrial are above the average, but not by much, while retail is only just below in most instances. This again suggests that the markets do not appear to have over corrected, but were overpriced in 2007.

Chart 3: Average commercial property yields

Markets now stabilising around 10 year average yields



Source: CB Richard Ellis, analysis Westpac Property

Over correction or fair value?

The indicators used above suggest that commercial property is essentially fair value and hasn't over corrected. With improving economic fundamentals and a limited level of new supply, in most markets, the position of yields either against long term averages or the risk free rate should be seen as favourable as the market fundamentals should also start to improve. With 76% of the total return from commercial property historically coming from the income, a position of average in potentially improving fundamentals should be seen as a positive with regards of being able to generate some value add over the future.

Contact: Frank Allen
Fallen@westpac.com.au

The information in this Analysis is general in nature and should not be relied upon as a substitute for professional advice. While every effort has been taken to ensure that the assumptions and information on which any forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by risks and uncertainties. All opinions, statements and forecasts expressed in this bulletin are based on information from sources that Westpac believes to be authentic. Westpac does not warrant the completeness or accuracy of information it has used to prepare this Update. Westpac accepts no liability arising from the use of information contained in this Update. The information in this Update is current as at 7th May 2010. Westpac Banking Corporation ABN 33 007 457 141