



Analysis

Retail property as an investment: return to the 1990's or the 2000's?

- National retail sales declines are yet to reach the lows of the 1990s recession or the early 2000s slowdown, due to aggressive fiscal and monetary policies.
- Growth in real retail rents has not matched real retail sales growth, with the exception of the period 2002 and 2007. Opportunity for real rents to grow at similar levels to real sales growth is high when economy recovers.
- Some compression of yields between 2003 and 2007 was warranted given rents grew at above average levels, however yields were pushed too low as risk was ignored.
- By measuring retail yields to the longer term historic risk premiums, current levels are acceptable although pressure on yields to rise will continue into 2009 as the downturn worsens.

Retail property as an investment has long been a favourite amongst many investors due to the expectation of low volatility in comparison to other commercial markets, particularly in times of economic downturns. In the early 1990s recession, retail capital values delivered growth of around 1% per annum on average while offices and industrials delivered double digit falls in value, according to IPD. However, recent data has suggested that retail assets may have been as prone to over pricing as other assets, with capital value declines occurring more aggressively in the current downturn in comparison to past downturns.

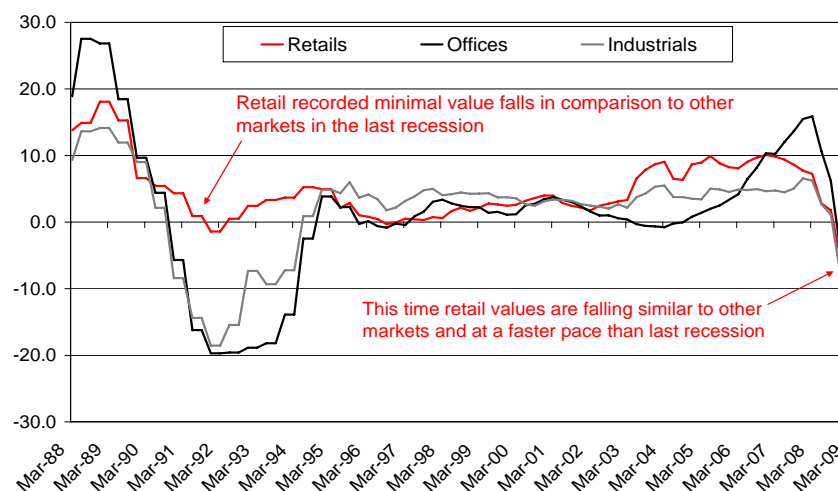
In the early 1990s recession retail capital values delivered positive growth while office and industrial delivered double digit value declines

This paper will attempt to address the question, whether or not retail assets were over-priced and if so, should yields revert back to early 1990s level or early 2000s level?

Retail capital value patterns in economic downturns – an overreaction or required repricing of retail assets?

As mentioned previously, retail property values were the least impacted of the property sectors in the last recession, falling marginally while other asset values plummeted. This may have been a significant factor for investor appetite towards retail as the perception around retail being relatively recession proof widened.

Graph 1: Annual % change in commercial capital values



Retail values entered a sustained period of above average growth from 2003 to 2008

Source: IPD/PCA; Analysis: Westpac Property

After stable value growth post the early 1990's recession, retail property entered a sustained period of above average value growth from mid 2003 to early 2008. During this period, retail property saw average annual capital value growth of 8.5% compared to industrial property's growth of 4.7% and office property's growth of 5.2%.

However, since early 2008 retail values have fallen in-line with other markets and by the largest annual amount since IPD began collecting data in 1985 (-6.9% as at Mar-09). The question is how much further will values fall and what do fundamentals suggest is an adequate yield?

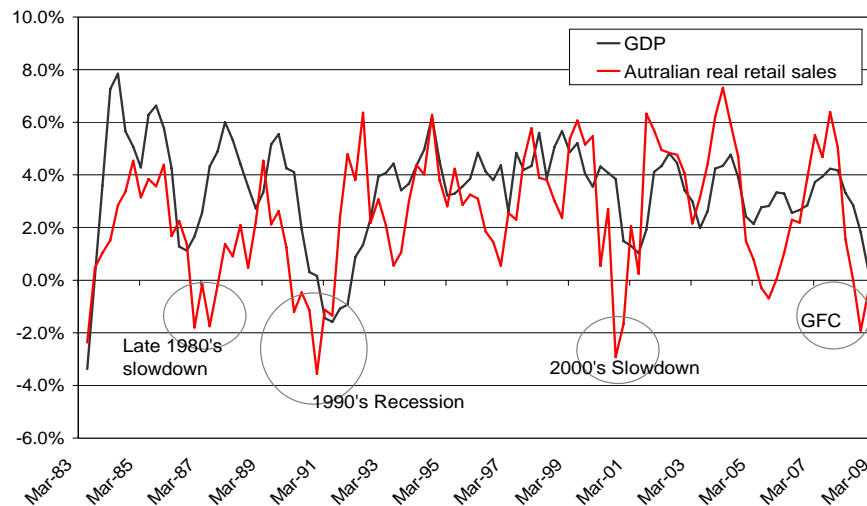
Historically, retail spending is pre-emptive of GDP by six to nine months

National real retail sales are yet to reach the lows of early 1990s recession and early 2000s slowdown

Economic trends and their impact on retail property fundamentals

On a national basis, retail spending is pre-emptive of GDP by six to nine months. This was particularly evident in the early 1990s recession and 2000 downturn and appears to be a lead indicator in the current downturn, as shown in graph 2 below.

Graph 2: Annual change in GDP v. Real retail sales



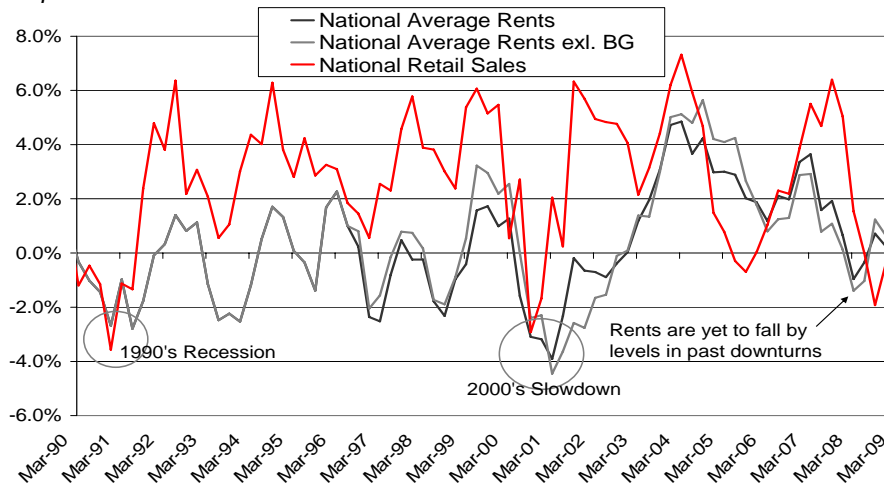
Source: ABS; Analysis: Westpac Property

In real terms, national retail sale declines are yet to reach the lows of the 1990s recession or the early 2000s slowdown and have actually improved in the first quarter of 2009. This is due to aggressive fiscal and monetary policies implemented from late 2008. This is expected to be short lived as unemployment rises into 2010 and real retail sales growth slows closer to 0.5%, as the economy contracts in 2009.

Retail sales and their relationship with retail property income – where to from here?

Logic suggests that with slower retail sales growth, slower retail rental growth should follow. Analysis of past trends is illustrated in graph 3 below.ⁱ

Graph 3: National retail real net effective rents v. Real retail sales



Source: CBRE, ABS; Analysis: Westpac Property

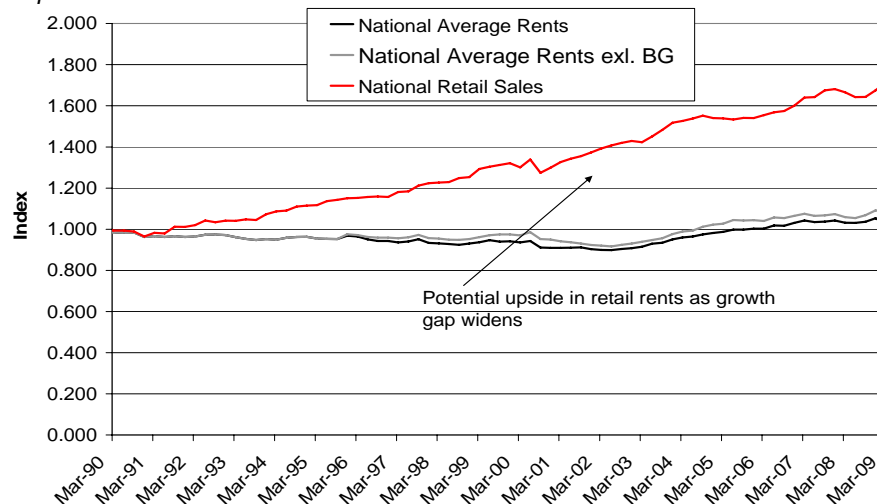
Average long term retail rental growth has not matched long term retail sales growth, except in the period between 2002 and 2007

Pressure on rents to fall significantly in the current downturn should be low

With the exception of the period 2002-2007, growth in real retail rents has not matched real retail sales growth, as illustrated in graph 4 overleaf. In fact looking at long term average trends since 1989, growth in real retail sales has been 2.7% per annum, compared with growth of only 0.4% for real retail rents.

While the likelihood of falling rents is high during the current recession, the pressure on rents to fall significantly should be low, given that rental growth has not matched sales over the past 20 years. However, the potential for a resumption of rental growth close to sales growth, as occurred between 2002 and 2007, is reasonably high once the recession ends.

Graph 4: Indexed real retail rents v real sales



Source: CBRE, ABS; Analysis: Westpac Property

Inflation adjusted rents are likely to fall into 2010 as retail sales slump, however above average rental growth beyond 2011 is possible

So where to from here for retail rents? As mentioned, despite recent strength in monthly retail sales growth, Westpac Economics forecasts real retail sales to slump in the second half of 2009, posting growth of just 0.5% for the year. This makes it difficult to justify any growth in retail rents in the short term, resulting in a fall in real retail rents into 2010.

Beyond 2010 Westpac Economics expects retail spending will revert back to around average annual growth levels of just under 3%. Given the possible under pricing of retail rents since 1989, it would not be unreasonable to expect real retail rents to follow a similar pattern to those since 2003, at around 90% of retail sales growth. This would suggest 2.7% annual real growth in retail rents.

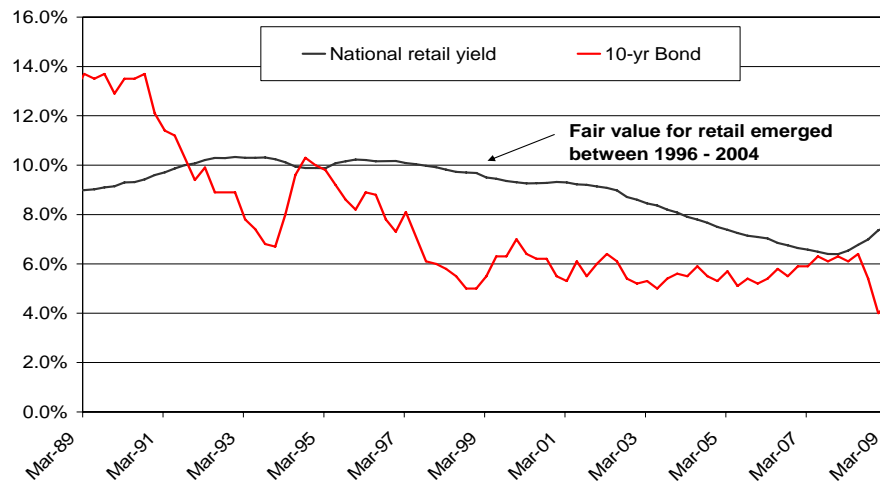
Retail yields – are current levels acceptable?

National retail yields currently average 7.5%, which is still some way below the 8.0% average for the past ten years. This has many expecting yields have to rise further. However, there are other points to consider:

Retail yields are currently 50bps below their 10-year average, suggesting yields may rise further

- As at Q1 2009 retail yields were some 310bps above the 10 year bond rate, well above the 10-year average premium of 230bps. By this measure yields could be considered to be at acceptable levels.
- The problem is that the 10-year bond rate at Q1 2009 was only 4.4%, which is also well below its 10-year average of 5.7%. Should the higher 10-year bond average of 5.7% be used, current retail yields would need to rise by 50bps if the historic risk premium is to be met.
- Is the 10-year average risk premium of 230bps too high? In the period between 2005 and 2007, the risk premium narrowed to average 150bps when real rental growth was 2.9% per annum. If future rental growth, post recession, is closer to sales growth, a risk premium of around 150bps maybe more acceptable. If so current yields even against a 10-year bond at 5.7% would be acceptable.
- The long term (1988-2009) risk premium averages 140bps.

Graph 4: Averaged national retail yield v. Risk-free rate



Source: RBA, CBRE; Analysis: Westpac Property

However based on historic risk premiums, current retail yields appear acceptable

Some yield compression was warranted in the last boom, however yields were driven too low

Conclusion

Some compression of retail yields between 2003 and 2007 was warranted given the fundamentals of above average rental growth during the period. However, investment risk was ignored to some extent, as is common in boom times, pushing retail yields down too low by the end of 2007.

It is of Westpac Property's consideration that the historic risk premium of 230bps for retail can be lowered, should rental growth be at similar levels to retail sales. A long-term risk premium of around 140bps would not appear out of line if such rental growth occurred. This would suggest that current yields are acceptable, even if the 10 year bond rose to longer term averages. However, as the economy moves into recession and retail rents fall, annual returns will be driven solely by the yield. It is likely therefore that pressure on yields to rise continues into 2009, as the recession worsens. On recovery, as retail sales return closer to a 3% real level, a firming of yields back to today's levels could occur, so long as rental growth remains close to sales growth.

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ⁱ National real retail rents exclude CBD retail. Analysis includes a comparison in average retail rents including and excluding bulky goods (BG).