Industry Focus

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Commercial property yields woo investors

Strong conditions in the commercial property sector and forecast future growth are setting the scene for developments in 2014

WORDS: CAMERON COOPER

High yields and low interest rates are an alluring mix for investors—and they are likely to ensure the attraction to commercial property remains strong next year.

With offshore investors already netting relatively high returns in the Australian sector compared with many foreign markets, domestic investors are now also joining in. Yields were achieving about 6 per cent in 2007 and have since escalated by about 250 basis points, making them too tempting to ignore for many offshore investor syndicates, smaller investors and funds packaging up self-managed super funds.

David Rees, Regional Director and Head of Research at Jones Lang LaSalle, expects strong demand for commercial assets from offshore and domestic investors to continue next year, although "the mix of investors may change somewhat".

"We don't see any slackening in offshore demand for assets and we don't see any slackening in domestic demand," he says.

Rees says one of the big questions in 2014 will be what happens to yield spreads, some of which have been at historically wide levels in recent months. For example, the gap between CBD and many non-CBD properties, regional and neighbouring shopping centres, and prime-grade and secondary grade industrial facilities has been significant.

"Is this the new norm that we have to get used to … or is it an unusual anomaly and we'll start to see yields tighten?" Rees asks.

He believes market confidence will be one of the key factors that determine the answer. Higher confidence will see investors "willing to move up the risk curve to take advantage of high yields". Rees believes the wide spreads provide an opportunity to reposition second-grade assets through means such as changing the tenancy mix or investing in the asset itself.

"You can sometimes turn a second-grade asset into a prime-grade asset," says Rees. "The market's going to reward you because of the wide spread. I think we'll see investors nibbling away at that [in] the next 12 months."

Focus on quality

Cameron Greenwood, Westpac Property Risk Manager for Victoria and Tasmania, says investors will be carefully assessing yield spreads and investment criteria over the next 12 months and beyond.

"Asset quality, strength of tenant, length of [rental] tenure and growth in income remain the key aspects for investors these days," he says. "The reality [though] is that the criteria for appetite in that local market are different for each asset class."

Greenwood adds that, while finding properties that tick all those boxes is tough, investors are identifying some appealing propositions in the sector.

"If you can get 7 per cent from a neighbourhood shopping centre and your head tenant is a listed major, that's pretty attractive."

For industrial property in Melbourne, Rees says prime yields are firming to about 7.5 per cent to 8.5 per cent compared with 9.5 per cent to 10.5 per cent for secondary yields.

"That will make the gap between prime and secondary yields tighten up," he says. "As those prime assets become less affordable the market says, 'I've still got to buy something so let's look at the secondary asset,' and you'll see a lot more weight of money going on to that asset class."

Bullish buyers

Appetite in the Melbourne CBD market remains strong, with investors acquiring $1.29 billion in office assets over the first half of 2013, according to commercial real estate services firm CBRE.

Greenwood says offshore investors, in particular, are eyeing redevelopment opportunities in the Melbourne CBD. If the assets have a steady income, it is a bonus, "but at the end of the day the potential of the site is what is attractive to them".

He says domestic investors are also becoming more active on the back of low interest rates and lending competition.

Nationally, Rees says yields for shopping centres, office and industrial sites are attractive relative to bonds and other assets. However, the overall picture for office markets has been blurred courtesy of impacts such as subleasing growing in Sydney, the mining sector slowing in Perth and public sector rationalisation in Brisbane. While leasing demand in office markets has been "fairly subdued" across the country, Rees says the market showed signs of stabilising during the September quarter.

"We don't see a strong recovery in demand, but we have seen a lot of the shake-out … The saving grace is that in many markets the supply pipeline is relatively slim as well."

Positive future

As 2014 looms, Greenwood says that "everything hovers around confidence". With banks keen to lend and interest rates and unemployment likely to stay low, he believes the signs are solid for the sector.

"Everything appears to be in a position, which will maintain that confidence and as long as confidence can be maintained then property markets should continue to hold and grow."

Rees expects the other emerging trend in the next 12 months to be the growth of funds under management in Australia.

"We're going to find ourselves again talking about scarcity of domestic assets and there are a number of responses to that," he says. "If you can't buy the assets you want then you can either go up the risk curve or you can go to new asset classes such as student housing, or you can go offshore, or instead of getting equity exposure you can start looking at debt … I think we'll see people looking at all of those alternatives increasingly over the next 12 months."