

Finding value from commercial property investment

Property Viewpoint

11 May 2010

- The Global Financial Crisis (GFC) sparked significant falls in property asset values, but fixed-interest yields have also risen, so does the commercial property sector offer any value now?
- To assess relative value, we argue that the appropriate measure is one which compares like with like.
- With nominal and real rates expected to rise and property investment yields anticipated to firm, the spread between the two will start to narrow. This suggests we can expect relative outperformance from property in the short- to medium-term.

As conditions across asset markets continue to normalise, it is worth considering the validity of various methods used for judging relative value. For example property investment yields are often compared to a risk-free alternative, such as a Commonwealth Government bond. Based on our research, we believe this standard practice compares yields from two different bases which distort any conclusions. However, when using a like for like measure, one which takes into account the effects of inflation, property offers good value by historical standards.

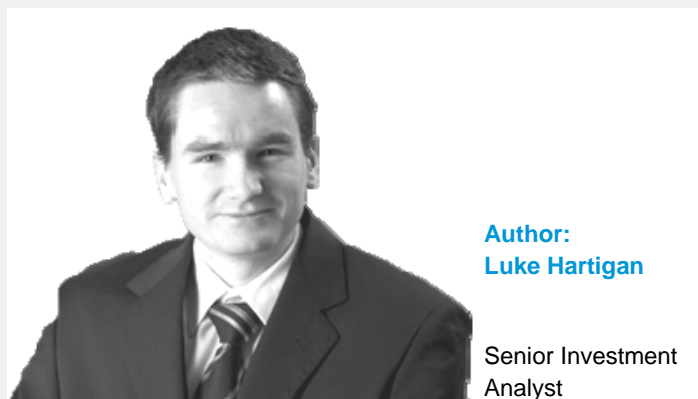
In the current environment of rising interest rates and tightening property investment yields, the question arises; what is property's relative value compared to a risk-free yield?

This assessment is usually based on comparing property investment yields¹ to the current yield on a 10-year Commonwealth Government bond. If the spread² between the two is positive, then the return on the property investment is deemed to be 'cheap' or to have 'positive carry.' Alternatively, if the yield differential is zero or negative, as was nearly the case in mid 2007, the investment is deemed to be expensive or to have 'zero or negative carry.'

The issue with the above analysis is that it compares two fundamentally different things. The current yield on a government bond is really a 'nominal' measure. In contrast, property investment yields are a 'real' statistic so a natural comparison cannot be drawn.

So what is the difference? Inflation has not been accounted for in a nominal figure, while a real figure considers the effects of inflation and reflects your actual purchasing power.

The real return on a nominal bond, which has a fixed face value, gets eroded over time due to inflation, whereas the two factors used to calculate a property investment yield (income and asset price) tend to change over time, at roughly the rate of inflation, due to rents tending to be linked to changes in the Consumer Price Index (CPI) and most buildings increasing in value with refurbishments and other capital improvements.



Author:
Luke Hartigan

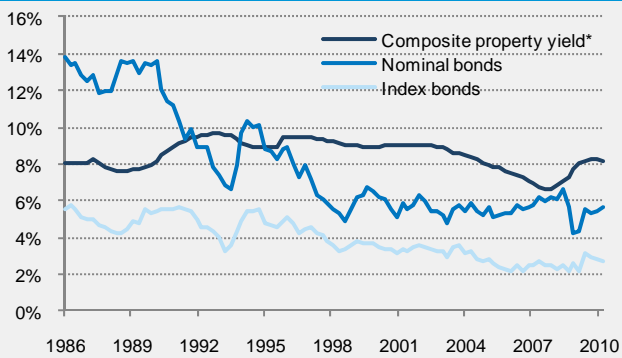
Senior Investment
Analyst

¹ Usually defined as the ratio of the total income from the property in year one to the property's purchase price.

² i.e., Property investment yield minus 10-year bond yield.

Hence, if we want to compare like with like using investment yields, then we need to compare them to a bond yield which also takes account of the effects of inflation. To do this we can use inflation-linked bonds (ILBs) which are bonds where the principal is indexed to changes in the rate of inflation (as measured by the CPI). Generally, an index bond yield will lie below a nominal bond yield when inflation is positive and above it when we have deflation (or falling prices). Figure 1 plots the investment yield for a composite average of the three core commercial property sectors (retail, office, and industrial) against the yield on nominal and inflation-adjusted (or index) bonds.

Figure 1: Investment yield vs. real and nominal bonds
Quarterly rests to March 2010



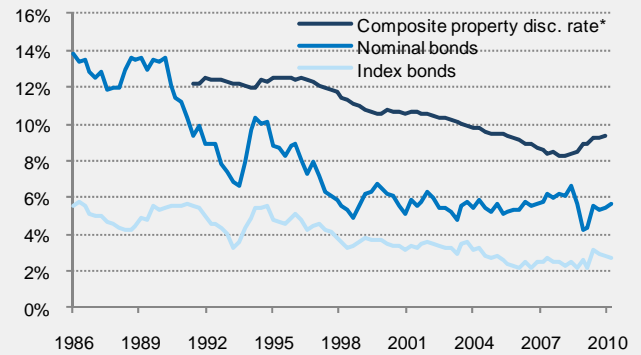
* Retail, office, and industrial sectors Source: RBA, JLL & CFS Research

There have been periods in the past where the yield on a nominal 10-year government bond was above that of a property investment yield, such as between 1986 to mid 1992, and a brief period in late 1995. So a property yield near to or below a risk-free rate is not of itself unusual or a cause of concern because they are measuring different things. At the same time, the spread between the *real* bond rate and property investment yields has remained positive and fairly constant; averaging 460 basis points (bps), across the time period we have data for. What is interesting to note here is that, by this measure, property investment did not really move into expensive territory unlike what is implied by using a nominal bond yield.

Nevertheless, the market for nominal 10-year Commonwealth Government bonds is relatively more liquid than the ILB market and is also a better indicator of the potential costs of property acquisitions via debt funding. In this case a better comparison is to use property discount rates as used in Discounted Cash-Flow (DCF) modelling. Discount rates include a growth factor for rents over the period considered and this factor tends to approximate inflation over the long term due to the way rents are usually linked to CPI.

Figure 2 highlights historical discount rates for the composite average for property compared to the yield on nominal and index bonds

Figure 2: Discount rate vs. real and nominal bond yields
Quarterly rests to March 2010

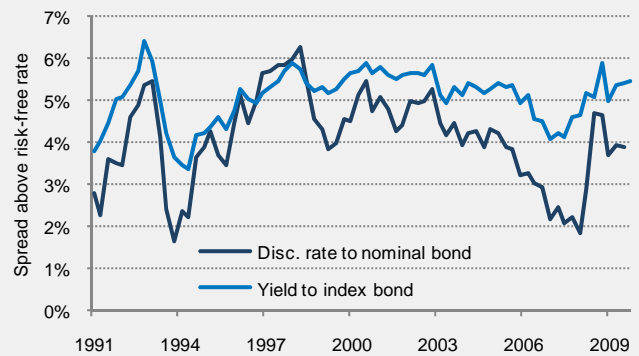


* Retail, office, and industrial sectors Source: RBA, IPD & CFS Research

Again we observe a healthy positive spread between the discount rate on commercial property and the yield on nominal bonds for the period for which data is available. The differential has averaged around 410 bps but got as tight as 180 bps in mid 2008, before heading back to the historical average as a result of the GFC.

Observing both of these spreads (or risk premia) across time can shed light on the question of the relative value of property investment to a risk-free comparable (Figure 3). Over long time periods these two measures should be broadly similar with any short-term deviations due to differences in rental growth and inflation expectations.

Figure 3: Comparing measures of property risk premia
Quarterly rests to March 2010



Source: RBA, IPD, JLL & CFS Research

These two measures of risk premia have a tendency to revert back to their long-run averages over time, indicating that property investment markets appear to have some natural long-term 'equilibrium' spread over the comparable risk-free alternative towards which market participants will gravitate.

So with nominal and real rates expected to rise and property investment yields anticipated to firm, the spread between the two will start to narrow. This suggests we can expect relative outperformance from property in the short- to medium-term.

For further information

John Sears	Head of Research	+61 2 9303 3598	jsears@colonialfirststate.com.au
Luke Hartigan	Senior Investment Analyst	+61 2 9303 2625	lhartigan@colonialfirststate.com.au
Dejan Radanovic	Investment Analyst	+61 2 9303 6429	dradanovic@colonialfirststate.com.au
Ritesh Prasad	Investment Analyst - Infrastructure	+61 2 9303 7195	rprasad@colonialfirststate.com.au
Mary Culjak	Research Assistant	+61 2 9303 3518	mculjak@colonialfirststate.com.au

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