Australian CBD office property value: Trends and outlook

Property viewpoint

January 2012

Do Australia's major CBD office property markets represent good value?

The CFSGAM Property Research team has identified a quantitative four point system to determine the relative value of Australia's CBD office property markets:

1. Where are the key measures of value and yields now placed relative to history?
2. How do yields compare to a risk-free alternative?
3. On a total return basis, adjusted for risk, how does CBD office property compare to a risk-free alternative?
4. What do the key drivers of valuation suggest for the future direction of yields?

Key findings include:

- Despite volatile financial markets, prime CBD office property yields have been stable to firm over the past 12 months, with yields moderately below their highs during the recent global financial crisis (GFC).
- Most prime CBD office yield/index bond yield spreads are well above their historical average, indicating excellent value on this measure.
- On a total return basis, relative to a risk-free rate plus a risk premium, most CBD markets also indicate good value.
- Key drivers of office property valuations are expected to allow moderate yield compression over the next few years, unless there is a significant external shock such as another global financial crisis.

Outlook

- With CBD office markets representing relatively good value on a range of measures, and expected movements in key drivers looking favourable, CBD office yields can be expected to compress and values rise over the next two to three years.
- On this basis out of the analysed CBD office markets, Sydney, Perth and Melbourne have the largest potential for yield compression.

1. Commercial property yields stable to firm amid solid transaction activity

The GFC resulted in Australian commercial property markets and values deteriorating, with CBD office yields rising sharply from their lows in 2007 to peak in 2009 (Table 1).

Despite continued global economic uncertainty, prime equivalent yields in most markets have since stabilised. Solid transaction activity amid continued demand from domestic and overseas investors resulted in yields firming on average in Australia's largest CBDs over the period between Q4:2010 and Q4:2011.

Table 1:CBD prime equivalent yield (bps)

Office Markets	Mkt Peak to Trough*	Post GFC	Past 12 month	Current Yield* %
Sydney	175	-26	0	6.88
Melbourne	175	-75	-25	7.13
Brisbane	200	-25	-12	7.50
Perth	200	-50	0	8.00
Adelaide	200	-38	13	8.63
Canberra	138	12	13	8.25

* CBD Prime Equivalent Yields
Source: Jones Lang LaSalle, CFSGAM Research

Melbourne posted the largest yield compression over the 12-month period (-25bps) followed by Brisbane (12bps). Yields remained unchanged in Sydney and Perth, while Adelaide and Canberra were the only market to experience yield expansion (+13bps).

2. Yields spreads

Table 2:CBD office property bond yield spread (bps)

CBD Markets	Q4 2011	Avg.*	Deviation	Value Indicator***
Sydney	647	297	350	**P**
Melbourne	672	275	397	**P**
Brisbane	709	357	352	**P**
Perth	759	427	333	**P**
Adelaide	822	511	311	**P**
Canberra	784	508	276	**P**
National **	703	355	348	**P**

* 20 year average property bond yield spread ** Weighted Average
***Value indicator: P = positive (>150); S = stable (>0); N = negative (<0)
Source: Jones Lang LaSalle, CFSGAM Research

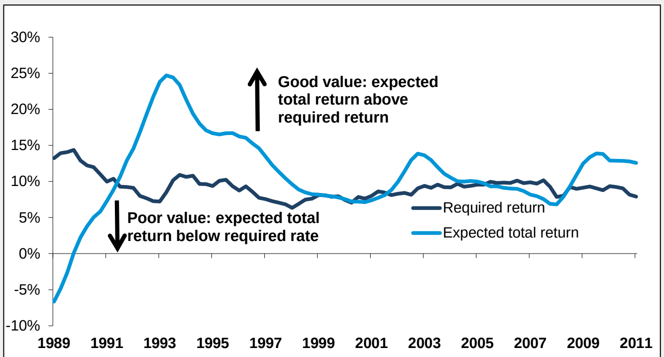
Based on the current spread between property yields and the indexed bond rate ('risk-free rate'), prime-grade assets remain above the historical average, suggesting, on this measure, markets are good value.

Heightened investor risk aversion in Q4:2011 has pushed the inflation adjusted risk-free rate below 1.00%. This may have exaggerated the relative value of prime-grade CBD office assets. However, after allowing for the recent fall in the risk-free rate, spreads remain well above their historic averages.

3. Total return spreads

Despite its usefulness as a benchmark, the property-bond yield spread does not make provisions for future rental growth or capital gain. This can be achieved by a 'total return spread' (TRS). The TRS compares the expected total return, yield plus forecast rental growth, to a risk-free rate plus a hurdle.

Figure 1: Sydney CBD total return spreads



Required return = 5 yr average property - bond yield spread + bond yield
Expected total return = yield + expected rental growth
Sources: Jones Lang LaSalle & CFS GAM Research

As an investment hurdle rate, or 'required risk premium', we use the five-year average spread between property yields and the real bond rate.

With a positive outlook for rental growth, the Sydney CBD provides the highest TRS (see Figure 1). On this basis, Sydney should provide the highest potential for yield compression and capital value appreciation, followed by Perth and Melbourne (see Table 3).

Table 3: CBD office risk premium analysis (%)

Office Markets	Expected Total Return Range* Lower	Expected Total Return Range* Upper	Required Return**	Total Return Spread Range Lower	Total Return Spread Range Upper	Value Indicator ***
Sydney	10.75	12.25	8.00	2.75	4.25	P
Melbourne	10.25	11.75	8.50	1.75	3.25	P
Brisbane	10.00	11.50	8.50	1.50	3.00	S-P
Perth	11.25	12.75	9.00	2.00	3.50	P
Adelaide	9.50	11.00	9.50	0.00	1.50	S
Canberra	7.50	6.00	9.00	-1.50	-3.00	N

* 5 Year CAGR Effective Rental Growth Forecast + Current Yield
** 5 Year Avg Property Bond Yield Spread + Risk Free Rate
***Value indicator: P = positive (> 1.5%); S = stable (> 0%); N = negative (<0%)
Source: Jones Lang LaSalle, CFSGAM Research

The risk premium analysis for Canberra indicates that the market could trade below fair value, due to the outlook for rental growth being limited, as well as historically higher required returns.

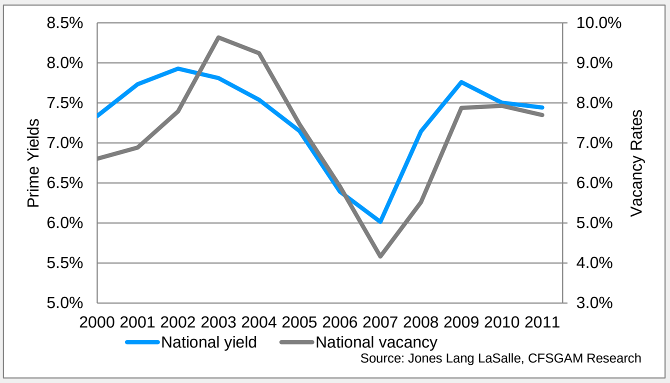
4. Yield drivers

TRS analysis provides a rough value indicator that allows us to compare individual property markets on a relative basis with regard to historic required returns. However, it does not tell us to what extent property yields are likely to move.

Changes in property yields are driven by both the outlook for the physical market as well as capital market forces. In this regard we continue our analysis by looking into the potential drivers of commercial property yields.

Vacancy rates
Vacancy rates represent the balance between supply and demand and provide a summary measure of the space market. In periods of weak demand or excess supply, vacancy rates tend to rise and vice versa, putting downward or upward pressure on current and future rental growth. Changes in rental growth affect the cash flow of a property and its value. Therefore, an increase in vacancy rates generally leads to softening office investment yields. Figure 2 illustrates the positive relationship of yields and vacancy rates.

Figure 2: National CBD prime office yields and vacancy rate

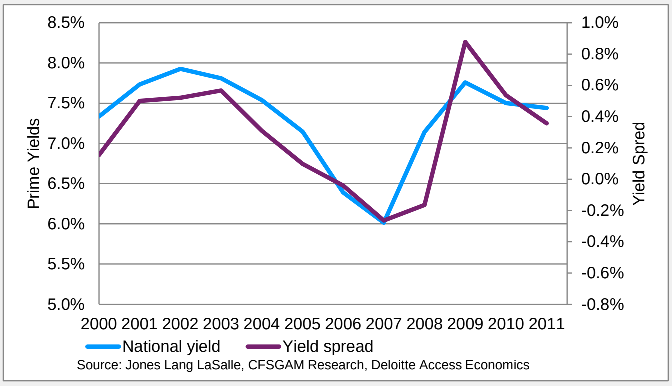


Source: Jones Lang LaSalle, CFSGAM Research

Interest rate spreads
The level of interest rates conveys information on a number of factors including current and expected economic growth, inflation expectations and investors' risk appetite. While both long and short rates can provide information, the spread between the long and short rates, or the yield curve, has a strong correlation with office property yields (Figure 3). In this analysis we have used 10-year less three-year bond yields.

The yield curve quantifies the complex relationship between long and short rates and reflects monetary policy, current and expected economic conditions, and risk aversion.

Figure 3: National CBD prime office yields and yield curve

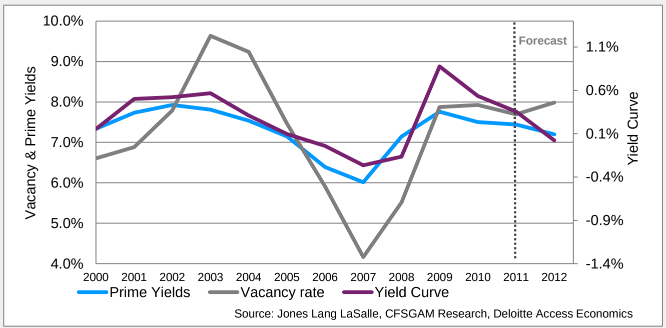


Property yields trended lower between 2003 and 2007, driven by relatively cheap and plentiful debt, low yields on alternative risk-free assets and relatively low risk aversion. Over this period, short-term rates gradually rose as economic conditions strengthened and the RBA tightened monetary policy. This caused the yield curve to contract. The stronger economic conditions also supported the rental growth outlook for property. This trend came to an abrupt end with the GFC. The Reserve Bank of Australia (RBA) aggressively lowered short-term rates while the availability of debt fell and risk aversion soared, causing the yield curve to rapidly widen. Limited credit and a poor outlook resulted in property transaction volumes plummeting and CBD office property yields increasing. Since peaking during the GFC in 2009, office yields have stabilised supported by improved economic conditions, a thawing in credit markets and an increase in investors' risk appetite.

The outlook for commercial property yields

Based on CFSGAM Property Research forecasts for vacancy rates as well as the Deloitte Access Economics forecast for interest rates, CFSGAM Property Research has developed a quantitative property yield forecasting model. With small variations, the model provides a market by market outlook on average prime yield movements.

Figure: 4 National CBD prime yield development and outlook



Despite favourable economic conditions in most markets, increased supply in Brisbane and Canberra is likely to lead to a marginal rise in the national vacancy rate in 2012, while Deloitte Access Economics (Q3/2011) is predicting a further tightening in interest rate spreads.

Based on the projections for vacancy rates and the yield curve, a further tightening in investment yields is anticipated across most Australian CBD office markets.

Table 4: Outlook for CBD office property values Q4 2011- Q4 2012

	Sydney	Melbourne	Brisbane	Perth	Adelaide
Outlook*	P	S-P	S	S-P	S-P

*Potential for Yield Compression in percentage points:
P = positive (>25bps); S = stable (25<> 0); N = negative (<0)
Source: CFSGAM Research

On an individual market basis, the Sydney CBD is currently the market with the highest potential for prime equivalent yield compression over the next year.

Conclusion

Australian prime CBD office property currently appears good value when compared to risk-free alternatives on both a yield spread and total return basis. Unless the current sovereign debt issues abroad lead to a GFC Mark II, solid valuations combined with an anticipated improvement in space market fundamentals and economic conditions should support a modest tightening in prime equivalent yields. There are variations across markets, based on the four point analysis system outline above, Sydney, Perth and Melbourne have the largest potential for yield compression of the analysed markets.

Table 5: CBD office value indicator and outlook summary

Office Markets	Bond-Yield Spread	T. Return Spread	Forecast Model
Sydney	P	P	P
Melbourne	P	P	S-P
Perth	P	P	S-P
Brisbane	P	S-P	S
Adelaide	P	S	S-P
Canberra	P	N	na

Source: CFSGAM Research

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