THE OUTLOOK FOR DIRECT PROPERTY YIELDS

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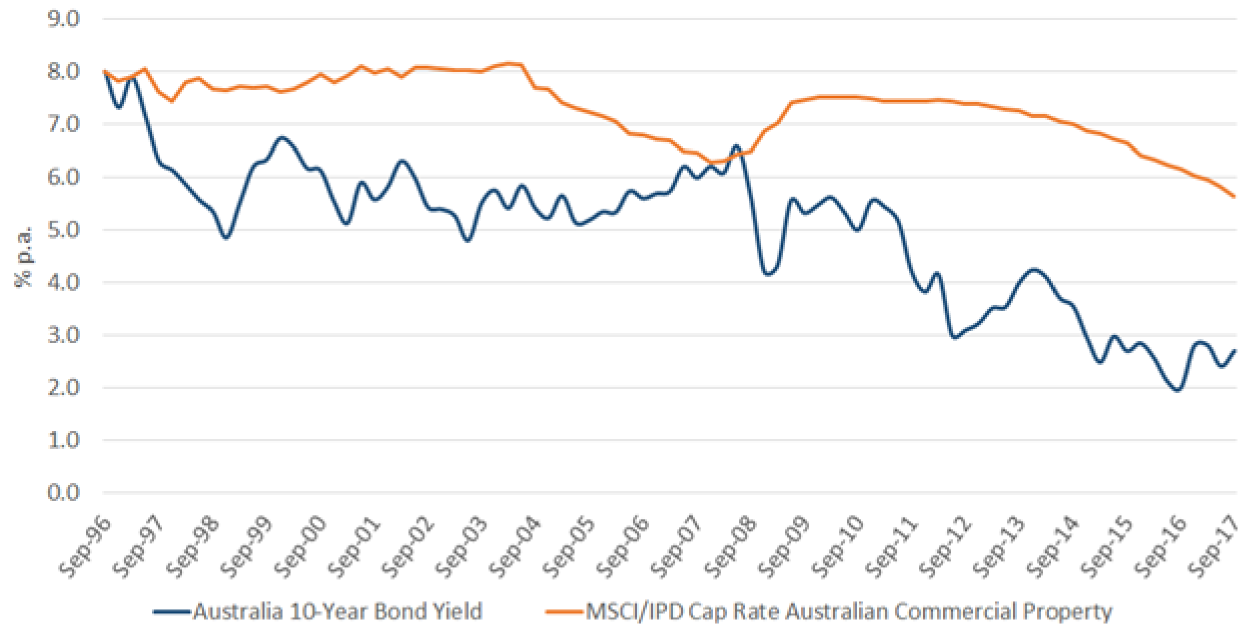
By guest contributor **Lev Driker**, ***Analyst***, Atchison Consultants

Australian direct property is an attractive investment asset class to hold in the current low interest rate environment, as it still offers relatively attractive yields. Low domestic interest rates and strong investor demand have placed downward pressure on capitalisation rates resulting in rising capital values. Some markets including Sydney and Melbourne have seen yields tighten considerably providing little room for further contraction. However, with improving economic conditions there is upward pressure on rents providing some room for capital growth.

Figure 1 compares the 10-year government bond yield with the market cap rate over 20 years to 30 September 2017.

Cap rate spreads, which can be used as a proxy for yield spreads, continue to remain wide and attractive relative to 10 year Government bond yields, with the spread currently sitting at around 3%.

Figure 1: 10 Year Government Bond Yields vs. Australian Commercial Property Capitalisation Rate



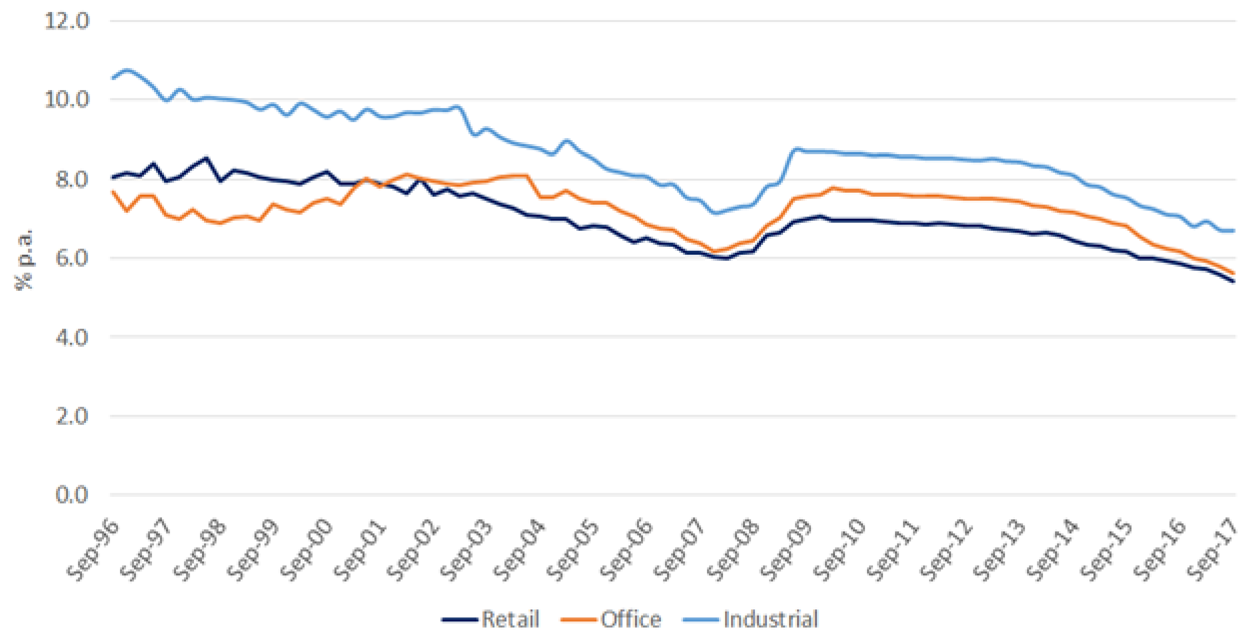
Source: RBA, MSCI

Major banks are increasing lending rates for commercial property borrowers. As the spread in yields narrows between property yields and debt interest rates, we expect this will have a moderating effect on investor demand for property. Capitalisation rates (yields) will flatten and possibly soften, leading to a stabilisation in capital values during the medium term (three to five year period).

We expect that growing tenant demand resulting from increased economic activity will lead to a flow-on effect of increased rental income. Sydney and Melbourne are already benefiting from strong economic fundamentals with falling incentives and increasing net effective rents. Brisbane is already showing positive signs of recovery.

Capitalisation rates (cap rates) are below their 10 year long term average of 7.0%. Rate falls still occurring in the office, retail and industrial sectors, which have been experiencing a noticeable downward trend since mid-2015. Falling capitalisation rates have been primarily driven by strong local and offshore investor demand looking for higher yielding defensive assets. However, investor demand from China has already begun to slow with capital controls restricting the level of investment seen in the previous couple of years.

Figure 2: Capitalisation Rates Retail, Office, Industrial

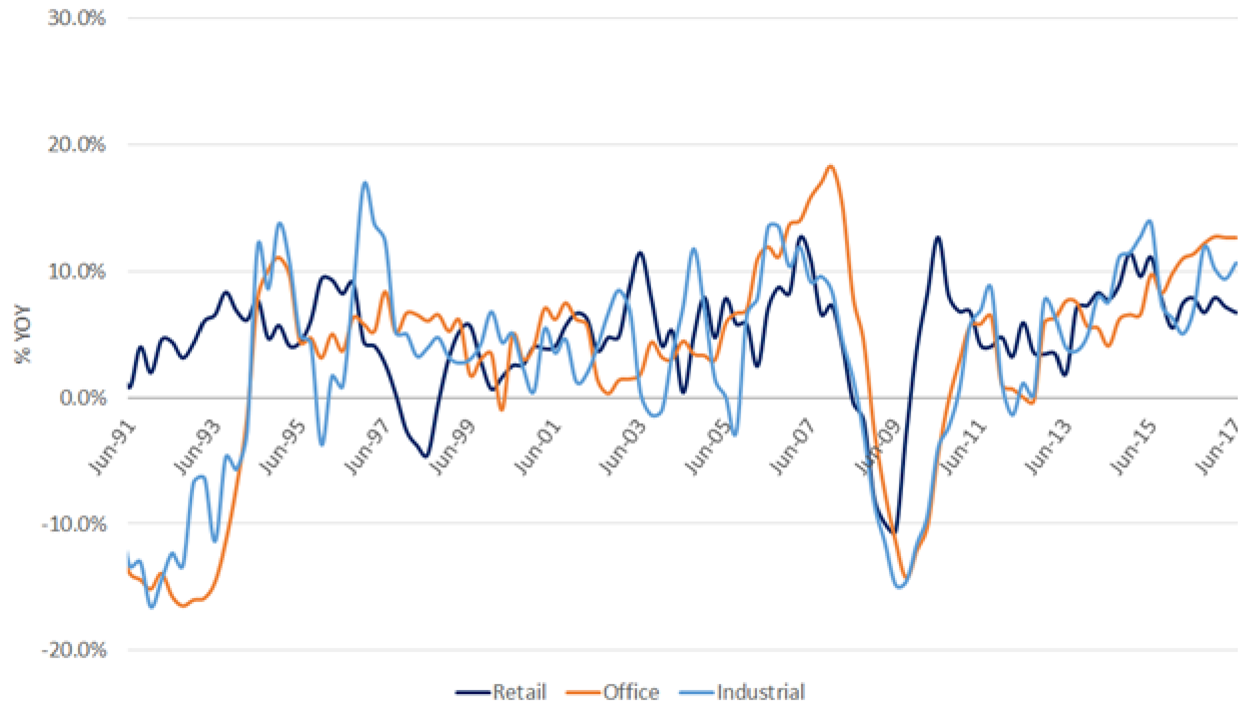


Source: MSCI

Figure 3 illustrates growth in the capital values of office, industrial and retail market over the last 25 years (to 30 September 2017).

Capital value growth rates for all property sectors are strong as cap rates have fallen.

Figure 3: Growth in Capital Values Retail, Office, Industrial



Our expectation over the next 12 months is for rents to grow fastest in NSW and Victoria across all three property sectors. Melbourne and Sydney CBD rental growth expectations of 4% and 3% respectively are of particular note for the office sector. Conversely, we remain neutral on Perth and Adelaide, where we expect rentals to stay relatively flat with high incentives. Yields are expected to be stay stable across Sydney,