RESEARCH INSIGHT

MARCH 2013
CAP RATE ANALYSIS
POST AREIT REPORTING SEASON

Commercial Property Insight

Knight Frank

Following the completion of the AREIT reporting season, the audited data reflected only a very marginal firming in book value cap rates over the six months to December 2012, which contrasts with the relatively stronger firming that occurred in 2010 and the first half of 2011. The weighted average book value cap rate (WACR) of the major AREITs Australian commercial assets (office, industrial and retail) firmed by only 2 basis points (bps) over the past six months to sit at 7.68%. This reflects a 23 basis point firming over the past 3 years, however still remains 108 bps higher than the market peak in December 2007 (See Table 1).

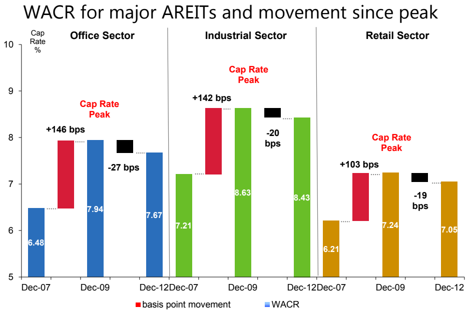
The underlying fundamentals of the property market may allude to minimal cap rate tightening in the near term. However, with the spread between real bonds and property yields being at historical highs, the cost of debt continuing to fall, select property yields remaining above their longer term average and most importantly the re-emergence of a much broader depth of buyer type, a re-pricing of commercial property is imminent.

We expect cap rates, especially in the office and industrial sectors, to firm by 25 basis points in 2013, predominately skewed towards prime assets.

Figure 1

Australian Property Sector Book Values

WACR for major AREITs and movement since peak



Source: Knight Frank, company reports

For AREITs, although the NTA gaps have narrowed significantly (now a premium in many cases) over the past six months and share prices have rallied (up 30%+ since July), the underlying property book values remain relatively unchanged. Whilst underlying income growth and re-leasing spreads have fallen (or turned negative for retail owners), the capital market drivers and recent competitive tension is already translating into firmer asset yields.

Recent benchmark CBD office sales that have occurred imply yield compression for "trophy" or newly constructed prime, passive assets, which has contributed to a widening spread between prime and secondary assets. The same is true for prime industrial assets, with recent benchmark deals confirming around a 25 basis point firming for well located, modern warehouses with long term leases in place. Strong demand for Regional shopping centres, especially from offshore groups and local super funds, has held these yields relatively firm, notwithstanding the pressure that currently exists in the sector.

There is real opportunity for investors to gain exposure to the global economic recovery – especially in China – and there is upside in buying ahead of the turning point of the underlying fundamentals that ultimately drive the property market ie. rents, vacancy rates.

Table 1

AREIT Sector Revaluations — Weighted Average Book Value Cap Rates

Sector	Dec 07	Dec 08	Dec 09	Dec 10	Dec 11	Jun 12	Dec 12	Bps Chg (past 6 months)	Cumulative Bps chg (past 3 years)	Bps higher than Dec 07 market peak
Major Retail Sector Avg*	5.62	5.98	6.32	6.25	6.23	**6.15**	**6.13**	**-2**	**-19**	**51**
Other Retail Sector Avg^	6.57	7.30	7.80	7.76	7.70	**7.62**	**7.59**	**-3**	**-21**	**102**
All Retail	6.21	6.80	7.24	7.20	7.15	**7.07**	**7.05**	**-2**	**-19**	**84**
Office Sector Avg	6.48	7.24	7.94	7.77	7.71	**7.68**	**7.67**	**-1**	**-27**	**119**
Industrial Sector Avg	7.21	7.78	8.63	8.51	8.48	**8.46**	**8.43**	**-3**	**-20**	**122**
Property Sector Avg	**6.60**	**7.25**	**7.91**	**7.79**	**7.75**	**7.70**	**7.68**	**-2**	**-23**	**108**

Source: Knight Frank, Company Reports

* Only tracks AREITs with exposure to Major shopping centres (mainly Regional Malls)

^AREITs with minimal exposure to Regional Malls, predominately Sub-Regional & Neighbourhood centres.

2013 will be the year of securing the right asset, funded out of pure equity or utilising historically low debt costs before the turning point, rather than wait for the market to become crowded with bidders once the recovery in prices is underway.

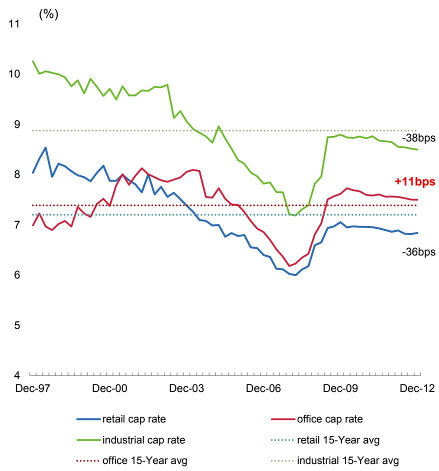
We expect the larger equity players – notably sovereign wealth funds and pension funds - to dominate the property investment landscape in 2013 and beyond. The investment market has structurally changed from a debt driven market to equity, demonstrated by the buoyant and increasingly cross-border investment activities of the Canadian and Asian sovereign wealth funds, as well as the large Australian Super Funds.

The ability to match long term, relatively stable income streams with long term liabilities make commercial real estate a strong fit for superannuation funds. With the allocation to property anticipated to rise further in 2013, there is significant scope for superannuation funds to boost exposure levels to real estate and they will create competitive pricing tension in 2013, especially for core, passive product.

Figure 2

Long term Average Cap Rates

Cap Rate vs 15-Year historical average by sector



Source: Knight Frank, IPD

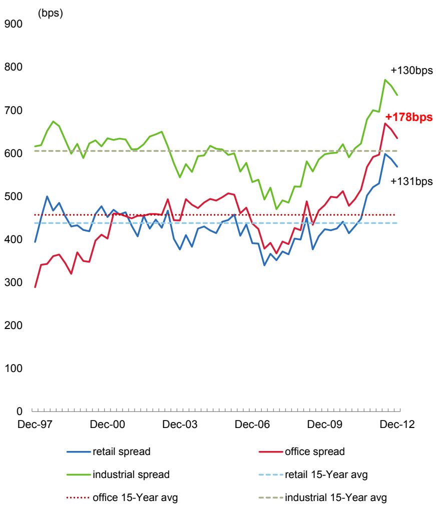
Our analysis of long term property sector cap rates and spreads to real bonds highlight that the office sector is best placed for yield compression on a relative basis, not taking into account the underlying fundamentals. Office cap rates remain 11 bps **above** their 15-year historical average, compared to retail and industrial sector cap rates being 36 bps and 38 bps respectively **below** their historical average (See Figure 2).

When analysing the spread to real bonds, the office sector is 178 bps above the 15-year average, compared to retail and industrial spreads of 131 bps and 130 bps respectively (See Figure 3).

Figure 3

Property Sector Risk Premiums

Cap Rate spread to real (indexed) 10 yr bonds



Source: Knight Frank, RBA, IPD

NB. 10 year indexed bond as at Dec 2012 was 1.15%

Although in isolation the spread data cannot be relied upon due to differences in geography, grade, quality, lease profile of specific assets and structural changes that have occurred in the AREIT sector, it does support stronger relative firming in office cap rates over the medium term.

Office Sector

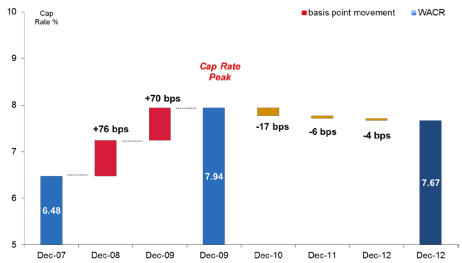
In the office sector, the WACR of the AREITs firmed by only 1 basis point over the past six months and firmed a cumulative 27 bps over the past 3 years to 7.67%, remaining 119 bps higher than the market peak in December 2007 (see Figure 4).

Overseas investors are once again trawling the market for predominately large, prime CBD assets, (although there is recent evidence that they are prepared to look at more Core Plus, value-add opportunities also). The return of the domestic listed groups to acquisition mode, assisted by their lower cost of capital, has allowed income accretive acquisitions. This competitive tension is a significant change to the investment landscape. Although we expect investment demand from offshore groups will continue to build in 2013, they will make up a smaller proportion of deals due to this stronger domestic demand.

Figure 4

Australian Office Sector Book Values

Weighted Average Cap Rates for major AREITs



Source: Knight Frank, company reports

The widening spread between prime and secondary yields has presented opportunistic buying and we expect syndicates, wholesale investors and private investors to increasingly seek high yielding secondary CBD (and suburban) assets as they represent good relative value. As prime yields firm further and the supply of core investments dissipate, investors will move up the risk curve, which in turn will drive a lagged firming in non-core asset yields.

Industrial Sector

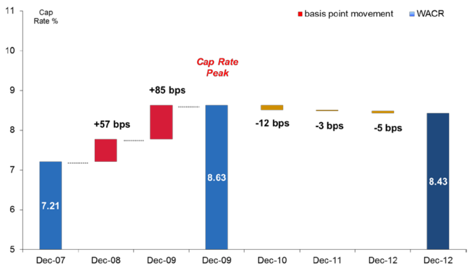
In the industrial sector, the WACR of the AREITs firmed by 3 bps over the past six months and has firmed by a cumulative 20 bps over the past 3 years to 8.43%, remaining 122 bps higher than the market peak in December 2007 (see Figure 5).

The industrial sector is going through a structural change with the likes of Stockland (AREIT) and various wholesale funds such as AMP and Colonial divesting their secondary industrial assets and reweighting their portfolios to other sectors. At the same time, groups such as Goodman, GPT, DEXUS and Australand are focusing even more attention on the sector via acquisition and growing their development pipelines. Over the medium term, this will see the quality of industrial assets improve, as secondary assets are recycled, in effect replaced over time with prime grade speculative and design & construct assets. This will drive relative yield compression as the quality of the average portfolios improve.

Figure 5

Australian Industrial Sector Book Values

Weighted Average Cap Rates for major AREITs



Source: Knight Frank, company reports

Pre-lease activity is picking up again, driven by limited prime stock and larger emerging enquiry, which will stimulate the development pipeline further, in turn driving the secondary vacancy higher. This is likely to widen the yield gap between prime and secondary assets, albeit there are now some very good opportunistic buys in the Core Plus space, with secondary yields of 9.50% plus the norm, not the exception.

The logistics sector continues to benefit from the strong $AUD making imports attractive and the increase in online retailing is fuelling demand for distribution centres and warehouses, with fulfilment stores also likely to increase in demand. Even with some "leakage" of retail spending overseas which Australian retailers are railing against, is a positive influence for industrial/logistics courier operators.

Even if the $AUD does revert back to mean over the next few years, the larger industrial players are well positioned to capture the demand that will come from transport and logistics groups, select large occupiers and of course the major retailers.

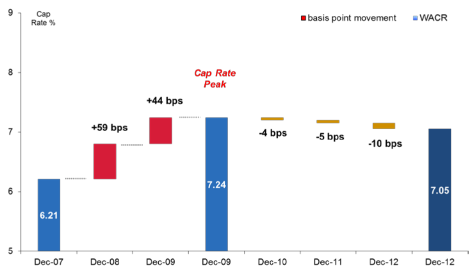
Retail Sector

In the retail sector, average AREIT cap rates firmed by 2 bps over the past six months and have firmed by a cumulative 19 bps over the past 3 years to 7.05%, remaining 84 bps higher than the market peak in December 2007 (See Figure 6). When isolating the WACR of the major three listed owners of Regional/Sub-Regional assets (Westfield, CFX and GPT), "Major Mall" cap rates have firmed a cumulative 19bps to 6.13% after softening on average by only 70 bps peak to trough.

Figure 6

Australian Retail Sector Book Values

Weighted Average Cap Rates for major AREITs



Source: Knight Frank, company reports

NB. data relates to the "All Retail" segment

The retail sector will always be well sought after due to the diversification benefits and relatively lower volatility it provides. When measuring capital growth and total return profiles, the sector has historically been the least volatile. The long term historical average volatility for the Retail sector on a 5 year rolling basis is 1.9 compared with 2.9 for All Property (IPD). Due to this, the major listed retail landlords, large wholesale funds and select superannuation/sovereign funds will continue to inject capital into the sector for selective acquisitions and development/expansion opportunities that arise.

There is the potential for many landlords with retail expertise and focus to see this point in the cycle as a counter-cyclical opportunity to acquire or upgrade/expand centres to capture a potential upturn in trading performance from mid-2013.

Neighbourhood centres have been heavily traded in 2012, with many investors attracted to the higher yields attainable, the relatively strong growth and lower volatility experienced in the food based retailing segment. We expect this will continue over 2013 until discretionary spending picks up.

Conclusion/Outlook

Balance sheet repair has been successful with average gearing levels of the AREITs falling significantly since late 2007. Margins for debt refinancing have also narrowed, down on average from 450 bps above the relevant reference rate (eg. 3/5 year swaps) in mid-2009 to around 200 bps currently. After focusing on cost containment and supporting earnings last year, AREITs have become increasingly acquisitive, with competitive pricing tension now strong, particularly for core assets.

We expect cap rates, especially in the office and industrial sectors, to firm by 25 basis points in 2013, predominately skewed towards prime assets. *The office sector is best placed for firmer cap rates on a relative basis.* We expect the risk premium (spread to real bonds) for office assets to converge with the retail/industrial risk premia over the medium term; as well as a firming of the average office cap rate to below the long term average (as is currently the case for retail and industrial yields).

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