RESEARCH INSIGHT

SEPTEMBER 2011
CAP RATE ANALYSIS
POST AREIT REPORTING SEASON

Commercial Property Insight

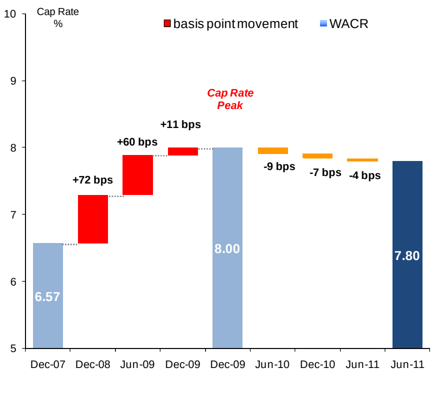
Knight Frank

Following the completion of the AREIT reporting season, the audited data reflects only a marginal firming in book value cap rates since the market trough (cap rate peak) in December 2009. The weighted average book value cap rate (WACR) of the major AREITs Australian commercial assets as at June 2011 sits at 7.67% for All Property (office, industrial and retail). This reflects a 15 basis point firming since the cap rate peak in December 2009 of 7.82%, after softening by 128 basis points (bps) between December 2007 and December 2009, hence remain 113 bps higher than the market peak (Dec 2007).

Office Sector

In the office sector, the WACR of the AREITs has firmed by a cumulative 20 bps over the past 18 months to 7.80% after softening on average by 143 bps from peak to trough, remaining 123 bps higher than the market peak in December 2007 (see Figure 1).

Figure 1
Australian Office Sector Book Values
Weighted Average Cap Rates for major AREITs

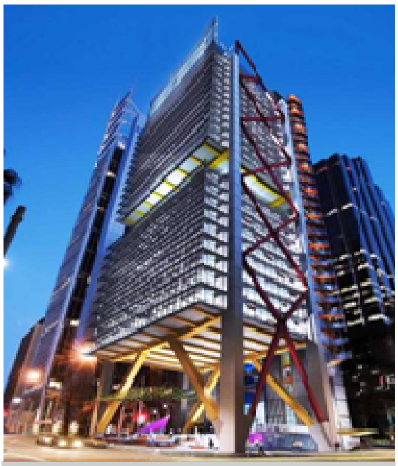


Source: Knight Frank, company reports

This is contrary to some of the commentary in the market of significant yield compression occurring over the past year, particularly for office assets. The market continues to be complicated by differences in purchaser profiles, with offshore purchasers dominating the market for "prime" assets, particularly in Sydney and Melbourne, although not actively pursuing "secondary" stock at present, which may continue to contribute to some inconsistency in yields in the short term.

When comparing the performance of the major CBD markets since the cap rate peak, there has been slight outperformance in Melbourne (with 30-40 bps tightening in average prime yields over the past 18 months driven by strong demand from off-shore groups) and to a lesser extent Sydney, with up to 25 bps of tightening occurring. That being said, the major weighting of office assets by geography is in NSW and VIC (circa 80% average weighting in the AREITs), hence much of this relative outperformance would be reflected in the 20 bps of firming in the WACR of office assets held by AREITs since Dec 09. Perth and Brisbane have recorded modest firming of prime yields, mainly via a tightening in the upper yield range.

With the macro drivers of the economy and capital market conditions relatively weak at present and occupier demand expected to remain somewhat constrained for the remainder of 2011, it would generally be anticipated that a short term stabilisation in yields would result. However, whilst these direct drivers may allude to minimal cap rate tightening in the near term, there remains the potential for the investment market/yields to run ahead of the fundamentals due predominately to off-shore demand, which



8 Chifley Square, Sydney CBD was an on-completion acquisition of a 50% interest by an offshore fund (K-REIT), transacting on a core market yield of 6.47%. The development is due for completion in August 2013, with the transaction subject to 5 years income support post completion.

has been well above the long term average trend in recent quarters.

This is especially the case in the Sydney CBD and Melbourne CBD markets, where recent benchmark sales have occurred, implying a degree of yield compression for “trophy” or newly constructed prime, passive assets. In Sydney, the recent “on-completion” sale of 8 Chifley Square (see accompanying image above) implied a 25 basis point tightening over the previous Sydney CBD benchmark sales that occurred in early 2010.

The other recent sale of 259 George Street, Sydney in July 2011 (7.0% initial; 6.4% core market yield) occurred after a direct approach from a private offshore fund and represented a 15.3% premium to the vendors 30 June 2011 book value. This could be perceived as a temporary outlier, however should further sales transact at this level on the back of the weight of off-shore capital seeking prime office assets in Australia, this could re-rate yields. It is important to also note that the initial yield of 7.0% was likely the major driver for the purchaser. Although the analysed core market yield reflects the risk of one of the major tenants exiting the building in mid 2012 (JP Morgan 8,060m²), there is positive rental reversion potential if demand and market rents continue to improve.

In Melbourne, the sale of 990 La Trobe Street, Docklands (Melb. Water Bldg.) announced back in late February (settling upon completion in early/mid 2012 - 6.8% initial; 7.1% core market yield) also alluded to a degree of firming for prime, passive assets in the Melbourne CBD on a like for like basis.

In addition to these sales, it has also been reported that a 50% share in QV1 in the Perth CBD is under due diligence for a price in the order of $310 million, reflecting an initial yield of circa 7.0%. The property is a landmark A-grade tower with a diversified tenancy profile, albeit dominated by a single tenant. These all tend to imply that yields for “trophy” or modern, prime, passive assets have firmed by around 25 bps over the past 6-12 months when compared on a like for like basis.

As yields take into account the expectations of future rental growth, with relatively strong effective growth anticipated in Sydney and Melbourne (and to a lesser extent Perth) from 2012 through to 2014, prime yields are expected to tighten in 2012 and 2013, with an average base case cumulative tightening of up to 50 bps over this period.

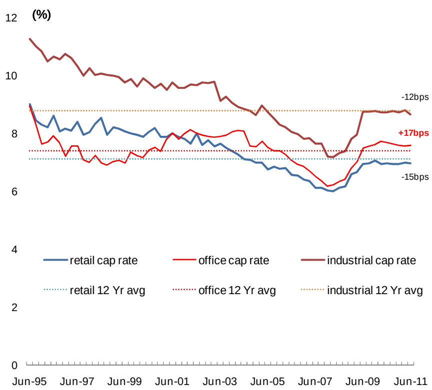
This is supported by two sets of long term historical data sets. Firstly, the current average office cap rate remains 17 bps **above** the 12 year historical average office cap rate compared to industrial and retail cap rates, which are currently 12 and 15 bps respectively **below** the 12 year historical average (see Figure 2). Although in isolation, this cannot be relied upon due to differences in geography, grade, quality and lease profile of specific assets, in addition to structural changes that have occurred in the AREIT sector over the years, it does support stronger relative firming in office cap rates over the medium term (of up to 30 bps).

Secondly, the historical relationship between All Property commercial yields and 10 year real (indexed) bonds is relatively closely correlated with a coefficient of positive 0.80 over the past 12 years compared with -0.08 with nominal bonds (which yields are often compared with in the market). The correlation is highest in the retail and industrial sectors, both with a coefficient of 0.86, whilst slightly lower in office at 0.62, however this increases to 0.75 when only looking at the data over the past 10 years. This can partly be explained by the relatively weak/volatile occupier market fundamentals between 1998-2002 where the correlation was actually negative, impacted by a raft of corporate collapses in Australia, the Asian financial crisis, September-11 and the demand shocks of the dot-com boom and bust. It is important to also note the structural re-rating of yields that was occurring in both the retail and industrial sectors, with yields in these sectors tracking the change in real bonds more closely over this period (See both Figure’s 2 & 3).

Figure 2

Long term Average Cap Rates

Current Cap Rate vs 12 Year historical by sector



Source: Knight Frank, IPD

The current Australian office cap rate is 63 bps **above** the 12 year average spread to 10 year real bonds, compared with only 35 and 32 bps for industrial and retail assets respectively (see Figure 3). At a macro level (not taking into account specific grades, locations and assets) this data points to the potential for a convergence between the office risk premium (spread to real bonds) and the retail/industrial risk premia of also up to 30 bps.

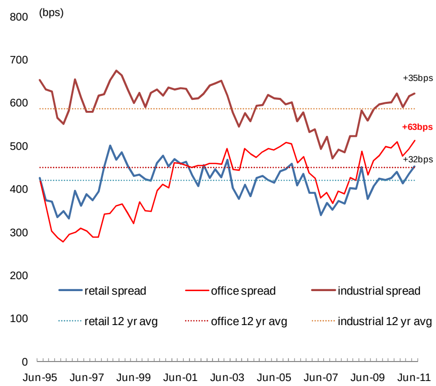
Notwithstanding this, we don’t expect yields to test similar benchmarks to the last market peak where excess liquidity and credit assisted the various off-shore and local wholesale funds in building their portfolios at a rapid clip. There is the potential for greater firming than the base case scenario if:

- the macro environment improves more strongly and quicker than anticipated (leading to stronger effective rental growth than anticipated), and/or
- if other capital market influences surprise on the positive side (eg. interest rates remain on hold for an extended period, debt markets and liquidity continue to improve etc).

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 June 2011 was 2.45%

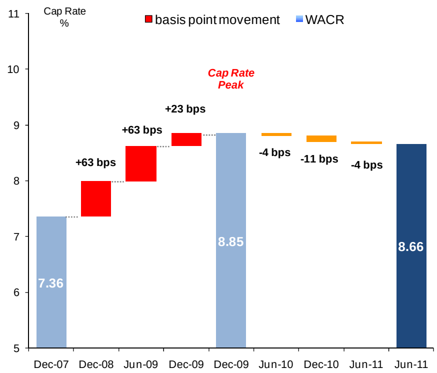
Some secondary and suburban asset yields have the potential to remain soft as the depth of purchasers is thin relative to prime, passive assets and investors generally price in slightly higher risk. This has presented opportunistic buying and we expect syndicates, wholesale investors and private investors to increasingly seek high yielding secondary CBD and/or suburban assets as they represent good relative value.

This will be supported in many suburban locations where tight vacancies and a limited supply pipeline will provide comfort to investors and financiers. Suburbs such as Hawthorn, Burwood East and Box Hill in Melbourne have all recorded tightening vacancies over the past year, whilst major Sydney suburban hubs such as Parramatta, Homebush, Rhodes, Mascot and the City Fringe have minimal prime tenant options. In Brisbane, the Near City prime vacancy rate also sits below 5% as at July 2011.

Industrial Sector

In the industrial sector, the WACR of the AREITs has firmed by a cumulative 19 bps over the past 18 months to 8.66% after softening on average by 149 bps from peak to trough, remaining 130 bps higher than the market peak in December 2007 (see Figure 4).

Figure 4
Australian Industrial Sector Book Values
Weighted Average Cap Rates for major AREITs



Source: Knight Frank, company reports

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 (the only pure AREIT industrial owner left), 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 AREIT owned assets (grading) in the industrial sector continue to 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.

Secondary industrial assets will remain generally soft over the coming 12-24 months, as occupiers continue to seek modern, well located properties. There will be pockets of stress, which will be exacerbated by the recent and ongoing weakness in the manufacturing sector, with many of the older style facilities located in the traditional inner industrial precincts likely to be vacated over the medium term. However, in recent times tenant retention has actually been on the increase in secondary assets, albeit on shorter term leases, amidst the uncertain economic environment. Owners have been flexible on asking rentals, terms and incentives to move the secondary stock, benefitting from the short-term cashflow that is generated, whilst occupiers are able to postpone their expansion or relocation plans until the growth of their business becomes clearer.

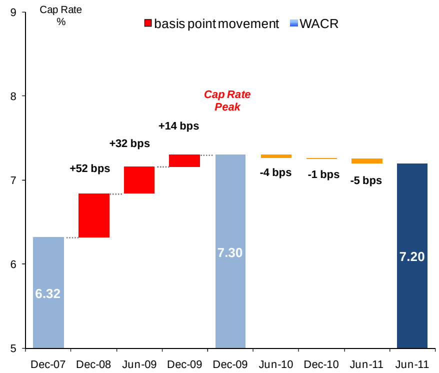
Once pre-lease activity picks up again and the development pipeline is ignited, this will drive the secondary vacancy higher. This is likely to widen the yield gap between prime and secondary assets, albeit there are now some very good opportunistic buys in the value add space, with secondary yields of 9.50% plus the norm not the exception.

Retail Sector

In the retail sector ("All Retail" segment), average AREIT cap rates have firmed by a cumulative 10 bps over the past 18 months to 7.20% after softening on average by 98 bps from peak to trough, remaining 88 bps higher than the market peak in December 2007 (see Figure 5). When isolating the WACR of the major three listed owners of Regional/Sub-Regional assets (Westfield, CFX and GPT), "mall" cap rates have firmed a cumulative 9bps to 6.23% after softening on average by only 70 bps peak to trough. The owners of predominantly Neighbourhood and Bulky Goods assets with minimal exposure to Sub-Regional's fall into the "other Retail" category, where cap rates have firmed 10 bps to 7.79% after softening on average by 115 bps peak to trough.

The outperformance in the retail sector through the cycle is two-fold. Firstly, 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 1.8 compared with 2.8 for All Property (IPD). Hence in the recent correction to values, Retail was far and away the best performing sector, as the risk premium increased much less than in the wider market as investors perceived the sector as a relative safe haven. Secondly, the macro drivers of the office and industrial sectors were much more dire, especially at the height of the downturn. White collar employment was taking a hit, the economy was seemingly slipping into recession and global demand contracted significantly, which compared against a backdrop of stimulus-led activity in the retail sector.

Figure 5
Australian Retail Sector Book Values
Weighted Average Cap Rates for major AREITs



Source: Knight Frank, company reports
*data relates to the "All Retail" segment

However, this outperformance has also driven a relatively smaller firming in cap rates since the market trough in the Retail sector. Once the general market fundamentals and economy improved, there has been greater firming in the sectors that were re-priced the most, namely office and industrial.

More recently, sentiment in the retail sector has fallen and on a relative basis, it is now arguably the least preferred commercial sector when looking at the potential for capital and/or total return expectations over the next 12-24 months. This has led to relatively modest tightening in cap rates, which is expected to continue over the next 12 months, with office and industrial cap rates likely to firm at a greater rate over this period. However the retail sector will always be well sought after due to the diversification benefits and relatively lower volatility it provides. The major listed retail landlords, large wholesale funds and select super funds will continue to inject capital into the sector for both 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 the upturn in trading performance from mid 2012.

Conclusion/Outlook

Balance sheet repair has been successful with average gearing levels of the AREITs falling significantly since late 2007, to now sit around the longer term average level of 30% (JP Morgan) which gives many of the larger groups a strong platform to grow from.

Greater competitive pressures have emerged in the market with liquidity improving and margins for debt refinancing narrowing, down on average from 450 bps above the relevant reference rate (eg. 3/5 year swaps) in mid 2009 to sub 200 bps currently. If there is a further reduction in reference rates and/or margins, this will assist in bringing the cost of debt down for the AREIT sector, which bodes well for competition in the direct market. However much depends upon the global financial markets and money market liquidity as any major increase in risk aversion or banking instability surrounding the ongoing sovereign debt issues, may see interbank lending spreads increase as they did back in 2008/09.

The major focus this reporting season has been the recycling of capital from asset sales into either growing development pipelines or instigating share buy-backs. These have and will likely continue to be funded by non-core asset sales, not drawing down debt. Apart from the trend toward buy-backs, the listed trusts will focus on the higher returns acheivable in the development sector and/or targeted, strategic acqusitions. The super funds and off-shore groups will continue to target prime, passive assets whilst the unlisted funds/syndicates and select private investors chase higher yielding secondary assets and increasingly look towards opportunities in the suburban and industrial markets. The predominately food based Neighbourhood centres have also been heavily traded in 2011, with many investors attracted to the higher yields attainable and the relatively strong growth and lower volatility experienced in the food based retailing segment. We expect this will continue over the next year.

Although we expect limited potential for significant tightening to direct commercial property yields over the next 6-12 months, 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). This is supported by long term historical data and will be driven by the underlying fundamentals and macro drivers of the relevant sectors.

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