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DARROCH VALUATIONS
VALUERS & PROPERTY ADVISERS

Industrial Yields Up Over 1% on Last Year

➲Industrial Property Returns Now Similar to 2005 Results

"Yield De-Compression" has hit investment property in 2008

Industrial yields have softened further during the latter half of 2008, as uncertainty in world financial markets continues to impact on investor confidence. According to Darroch Valuation's latest *provisional* results, the median yield for Auckland industrial property increased to 8.4% during the second half of 2008. This is up 0.4% on the half year June result, when an 8.0% yield was recorded. One year ago the December 2007 yield was a competitive 7.30% for industrial property. The median yield has therefore softened by 110 basis points (1.1%) in just 12 months; easily the most dramatic annualised change since our sales analysis began in 1999 (see chart over). The Auckland result is significant in that the trend changes are usually a barometer for what is likely to occur nationwide in coming months.

Commercial property has been caught up in the global investment downturn with caution now more prevalent at investment level. Tougher access to funding, unsettled interest rates and uncertainty over tenant viability in an economic recession are major concerns for investors. Under these circumstances potential investors are seeking higher returns to compensate for perceived risk. All of this impact on yields and **"Yield De-Compression" has been in evidence this year.** The Auckland median industrial yield quickly rose 0.7% in the first half of this year and although the rate of softening has slowed a little, investment property continues to feel the impact of economic uncertainty. Given a subdued economic outlook, yield softening looks set to continue into 2009.

Darroch West Auckland manager Mike Bristow said; "The current investment market is a vastly different landscape from 18 to 24 months ago. Back in 2006-2007 vendors appeared to hold all the "cards", consistently achieving premium sale prices as a shortage of investment stock generated strong competition amongst buyers. Now with economic conditions tightening, buyers are much scarcer. Like the residential sector, market conditions have shifted away from vendors to purchasers. Many buyers are only willing to enter into negotiations on their terms".

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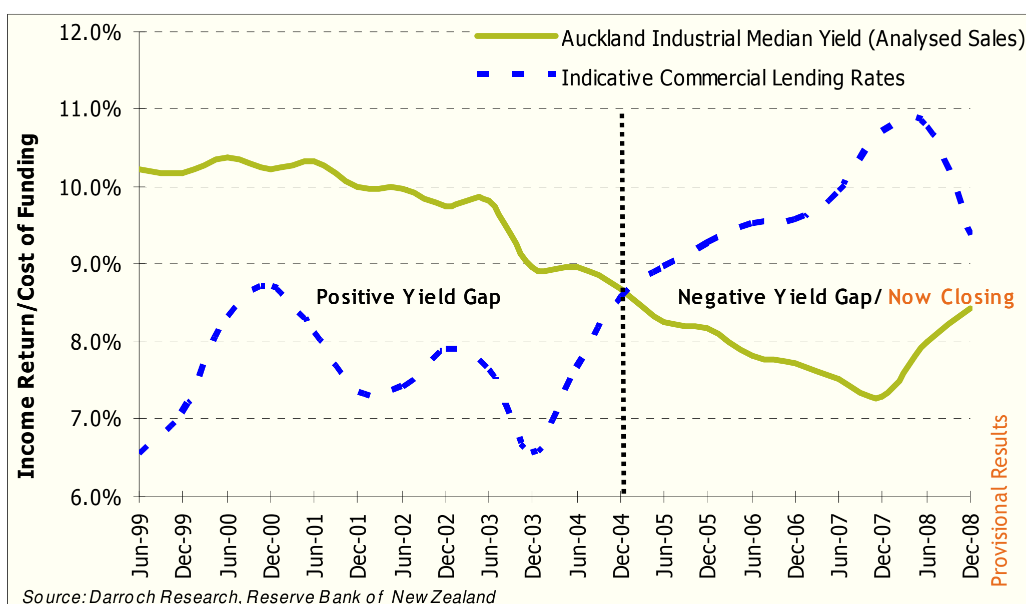
Mr Bristow also said; "We are seeing a number of property deals concluded at higher yields now, suggesting the market is factoring in risk much more strongly".

"It is difficult to calculate the full impact of this on industrial property values. Certainly some capital erosion is taking place. The last time industrial property attracted an 8.4% median yield was in early 2005. However, this does not necessarily mean that overall values have slid back three years because interim rental growth has helped to compensate for value loss. But it is a firm indication that capital values have receded over the past 12 months. The reality is that "yield compression" peaked last year. Investors who purchased around this time have probably incurred some value loss, particularly if rental growth has remained static", Mr Bristow said.

Purchaser Profile
Darroch has previously commented on reduced market activity on the behalf of overseas investors during 2008 – particularly the listed property sector from Australia. At the moment property trusts are focused less on buying and more on reducing debt. Generally, most trusts are not highly geared but the double impact of higher refinancing costs and sliding capital values as well as fluctuating share prices, could threaten compliance with borrowing covenants. Risk management is prevalent at the moment and as market analysts rate trusts by debt level, it is paramount to get gearing levels down before the next portfolio revaluation is complete. In many respects trust are in a consolidating phase rather than a buying phase. This means that under-performing assets could be sold over the next 12 months.

Reduced activity from the listed sector is significant in that the market is trying to adjust and find the new level of returns for industrial property - in difficult financial conditions and now without key players setting benchmarks. The listed sector had played a major role in driving yields down, thanks largely to comparative advantages in funding. Prior to the market peak last year, most prime properties were readily snapped up by overseas foreign owned institutions, driving yields to new lows but this demand has quietened considerably.



The current situation is however drawing renewed interest from some sources. Well established Kiwi investors and counter-cyclical buyers are now showing market interest again in direct property. To some degree, Kiwi investors have been frozen out of the market for the past few years because of New Zealand's high interest rates. Commercial funding costs were often in excess of rental returns, indicating a "negative" yield gap (see above). Purchasing under such circumstances didn't make financial sense.

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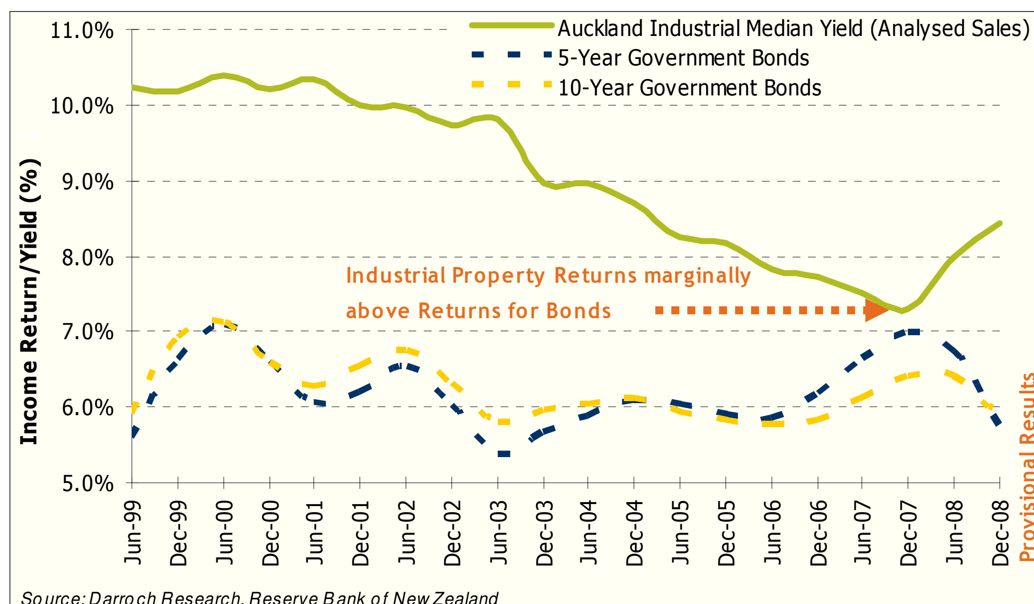
With interest/borrowing rates declining and yields rising, some Kiwi investors see opportunities on the horizon as the market moves towards a "positive" yield gap for the first time since 2004. For Kiwi investors borrowing locally, the negative yield gap for industrial property had widened to -3.5% in late 2007 meaning value growth was largely dependent on yields falling further and/or aggressive rental growth. Given the current economic outlook, prospects for the latter look somewhat subdued.

There is no doubt that the market is strongly factoring in risk. The "risk premium" for Auckland industrial property has widened considerably this year. In mid to late 2007, investors appeared to view property as almost risk-free, by purchasing at yields marginally above government bonds. It is noted however that competition from overseas investors was a driving force here. Investors have now adopted a stricter approach to risk/return. Lending institutions are partly driving this by initiating tighter lending rules, which require investors to have greater equity ratios. Reduced borrowing measurably limits the amount an investor can pay for a property. But the overwhelming fact is that economic uncertainty is at the forefront of investor's minds, and they are now seeking higher returns to compensate for risk.

Some equity analysts have been predicting yield expansion of up to 200 basis points (2%) from the market peak in 2007, and as each month passes, sales suggest we are moving in that direction.



Historically, the risk-free rate for industrial property had been approximately 3% to 4%. In 2000-2001 this began to narrow, and continued to do so over the following six years, whittling down to just 0.35% (against five year Government Bonds) at the height of market in late 2007. Now investors are looking for protection from market threats such as; reduced rental growth, and the prospect of yields rising further. Our analysis shows that the risk-premium has opened to around 2.5%, and is continuing to widen as the year comes to a close.

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