July/August 2008

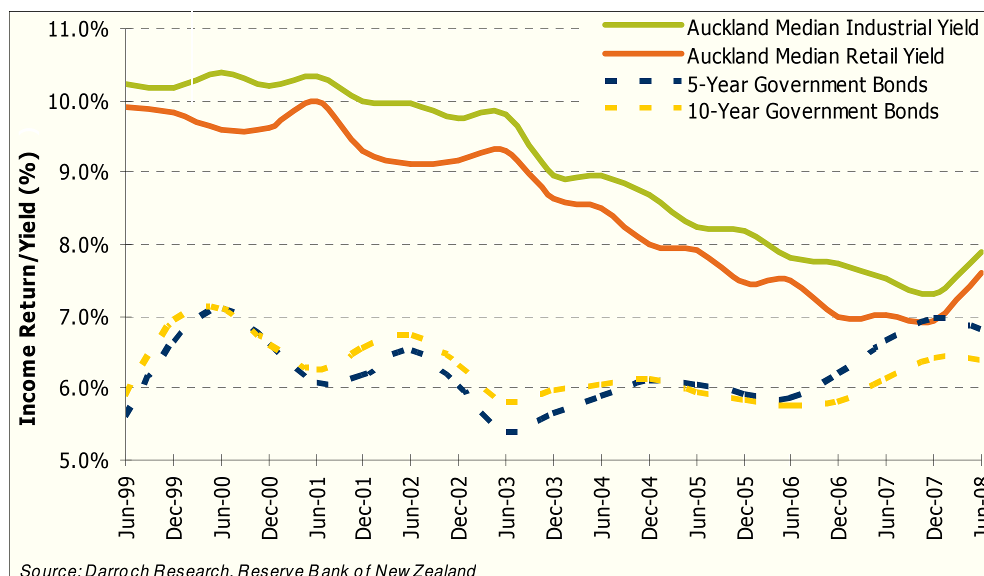
darroch

Industrial Yields Do U-Turn

➲ Capital Losses on the Books

Weaker confidence and general uncertainty in investment circles is impacting on commercial property yields. For the first time in six years investment yields have changed direction and are now moving up, not down. According to Darroch Research's provisional results, the median yield for Auckland retail property for the first six months of 2008 is now 7.6%. This is up a dramatic 0.65% points on the second half of 2007 when a 6.95% yield was then recorded. A similar pattern emerged for industrial property – recording an overall median yield of 7.9% for the first half of 2008. The preceding six month industrial result for December 2007 had been 7.3%. Both results point to a yield increase of at least half-a-percent. The Auckland result is significant in that it is usually a barometer for what is likely to happen across the rest of the country. It also reinforces general sentiment that market conditions have changed dramatically from last year.

Prior to 2008 the market had become accustomed to constant yield compression and dwindling income returns. Between 2002 and 2007, both retail and industrial yields fell on average a quarter of a percent at each six-month interval. But now there has been a vigorous about turn. The 2008 yield rise is the largest points change recorded since our analysis commenced. It verifies that demand for investment property has softened. There is uncertainty in this market at present and buyers are now much more discerning about investment stock. Some secondary properties are being overlooked and it is possible that even the strength of prime stock will be tested over the remaining year. Rising yields have repercussions on investment value.



Source: Darroch Research, Reserve Bank of New Zealand

Reproduction of material: No part of this article may be reprinted or quoted without the expressed permission of Darroch Valuations. Consent must be obtained in writing and is given on the basis that any reproduced material must be sourced wholly to Darroch Valuations

While media attention is preoccupied with predicting residential house price movements, real price changes are currently occurring in commercial property markets. Investors are now reluctant to pay a premium to secure commercial property. The reality is that vendors have had to readjust their price expectations owing to fewer investors in the market. Darroch Auckland Manager, John Darroch explains "Twelve months ago the vendor was in the driving seat with several suitors in chase. But now in the aftermath of the credit crunch and tighter lending rules, investors are increasingly harder to find."
A combination of factors is dampening demand for commercial property. We touch on some of these below;

Current economic factors are impacting. Retail yields in particular appear very responsive to economic trends. Lower discretionary spending is currently in practice as cost of living factors like mortgage interest rates and petrol and food prices bite, with retail businesses usually the first to feel this. Darroch's investment portfolio specialist, Mark McNamara, believes that lower retail spending is definitely having an impact. He says "Prudent investors feel that a sustained drop in sales turnover could hamper the ability of some tenants to wear steady rental increases – particularly businesses dealing in non-essential items. Given some uncertainty over rent prospects, investors are building this risk into the capitalisation rate or yield".

Our analysed transactions also show international investors have been less active of late. Listed property vehicles (LPT's) particularly from Australia, have been very strong players in the New Zealand market since 2001. They often hold competitive advantage over Kiwi investors. Borrowings could be financed offshore where interest rates are lower, meaning higher prices/lower yields could be paid. But in the aftermath of the global credit crunch, world interest rates have risen. In Australia, the OCR has risen 1% in the past year making investment in NZ commercial property less attractive. Add in the fact that the NZ Dollar has weakened against the AUD in 2008, and there has been a foreign exchange risk for our neighbours as well. Many buyers are now in trouble themselves and some like Centro are looking at exit strategies.

Clearly, the "risk premium" for commercial property has started to widen. Up until late 2007 many investors viewed property as almost "risk free" by purchasing at yields marginally above government bonds. Now investors are adopting a stricter approach to risk/return. Lending institutions are also complying by initiating tighter lending rules. Investors are now required to have greater equity ratios, as lenders look to reduce their risk exposure. Second tier and mezzanine lenders are also being squeezed owing to higher cost of funds. In part, reduced borrowing levels effectively limit the amount an investor can pay for an investment property. Developers will be affected the most, meaning supply of new product to the market will slow.

Reproduction of material: No part of this article may be reprinted or quoted without the expressed permission of Darroch Valuations. Consent must be obtained in writing and is given on the basis that any reproduced material must be sourced wholly to Darroch Valuations

Impact on Market Value

The softening in yields has repercussions on market value for property owners. What may be seen as a small yield rise of say 0.5% or 0.6% has significant impact on the value of a building. As an example, a property with a rent roll of $150,000 per annum which previously had a market yield of 7.3% would have generated market value of $2,055,000. A revised 7.9% yield would derive a lower market value of $1,900,000 – effectively loss in capital value of close to $155,000 or 7.6%.

Potential Impact of Rising Yields on Commercial Property Values							
Example #1 Industrial Property							
Net Rent	$150,000 pa	@	7.30%	$2,054,795			
		@	7.90%	$1,898,734			
				-$156,060	or	7.6%	Loss in Market Value
Investor would require the equivalent of a				8.2%	rental increase to recoup loss		
Example #2 Retail Property							
Net Rent	$75,000 pa	@	6.95%	$1,079,137			
		@	7.60%	$986,842			
				-$92,295	or	8.6%	Loss in Market Value
Investor would require the equivalent of a				9.4%	rental increase to recoup loss		

Source: Darroch Valuations

Faced with this scenario, a prudent investor would need to achieve an 8.2% increase in rental in order to get the property's value back to where it was prior to the yield rise. This appears optimistic considering current annual rental growth parameters for Auckland property lie in the 2% to 5% band. The level of catch up required would compound again if yields soften further. Moreover in the case of retail property, the slowdown in retail trade could see owners accept low rental increases to keep tenants ticking over.

Reproduction of material: No part of this article may be reprinted or quoted without the expressed permission of Darroch Valuations. Consent must be obtained in writing and is given on the basis that any reproduced material must be sourced wholly to Darroch Valuations