

December 2008/January 2009

Retail Yields Rising As Well

➤ Risk Being Factored in More Strongly

Retail yields have continued to soften over the latter half of 2008 as uncertainty in world financial markets impacts on investment confidence.

According to Darroch Valuation's latest *provisional* results, the median yield for Auckland Retail property sales increased to 8.0% during the second half of 2008. This is up 0.40% on the half year June result when a 7.6% yield was recorded. One year ago the December 2007 yield was a very competitive 6.95% for retail property. The median yield has therefore softened by 105 basis points (almost 1.1%) in just 12 months; the most dramatic annualised change since our retail sales analysis began in 1999 (see chart over). The Auckland result is significant, as this region acts as a barometer for what is likely to occur nationally.



Yield "De-Compression" has impacted on investment property

Commercial property has been caught up in the global investment downturn with investors showing much more caution. Tougher access to funding, unsettled interest rates and uncertainty over tenant viability in an economic recession are of major concern for investors. Under these circumstances potential investors seek high returns in order to compensate for perceived risk. These factors impact on yields, with **"Yield De-Compression" being evident this year.** The Auckland median retail yield quickly rose 0.65% 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 the downturn in retail sales and a subdued economic outlook, yield softening looks set to continue into 2009.

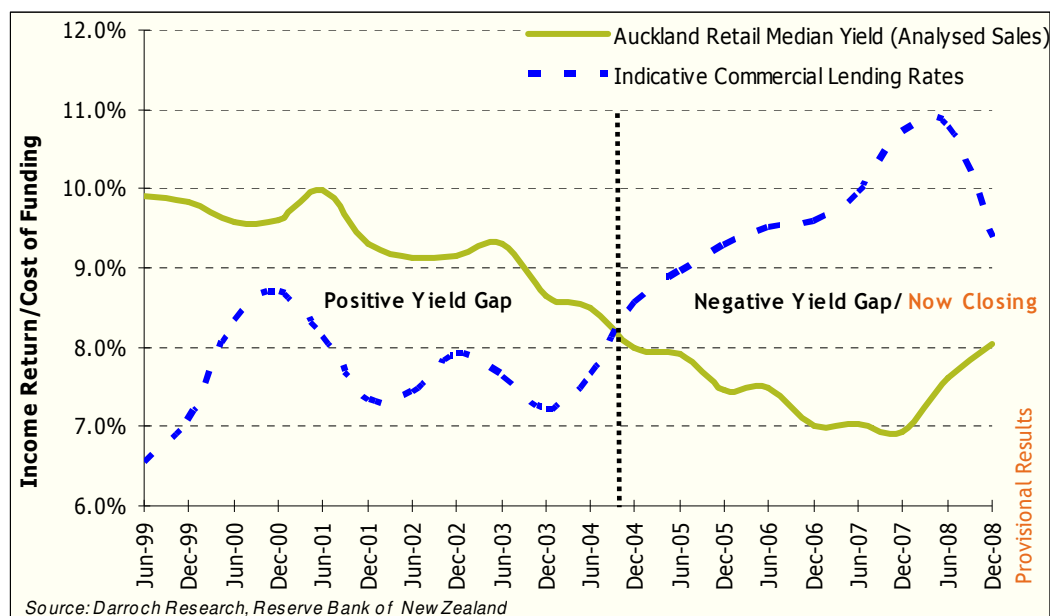
Darroch West Auckland manager Mike Bristow said; "The current investment market is a vastly different landscape from 18 to 24 months ago. Back in 2006-2007 vendors appeared to hold all the "cards", consistently achieving premium sale prices as a shortage of investment stock generated strong competition 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 says “We are seeing a number of property deals concluded at higher yields now, suggesting the market is factoring in risk much more strongly”.

“There are some challenges ahead for retail property. Retail spending is down, meaning some businesses may struggle to wear steep rental increases. At the same time some capital erosion is taking place. The last time Auckland retail property attracted an 8.05% median yield was in late 2004” said Mr Bristow.

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



Price Banding

Despite an overall 8.0% median yield for retail property, yields remain sensitive to price banding. Lower priced property is more likely to attract a more competitive yield. In the Darroch analysis, sales of retail property in the under-\$1 million category generated a yield closer to 7.7%, whereas the median yield for sales above this threshold was 8.3%. This is not unusual for the retail property sector. The reduced capital sums required for smaller scale property means the market is naturally open to a wider pool of buyers, including local investors and new individual players from overseas. Larger scale property is more expensive and perceived risk at this time is greater.

Darroch has previously commented on reduced market activity on the behalf of overseas investors in 2008 – particularly the listed property sector from Australia. At present, property trusts are focused on reducing debt, rather than on buying. Reduced activity from the listed sector is significant because the market is trying to adjust to find the new returns for larger scale retail property. This is happening alongside difficult financial conditions without key players setting benchmarks. The listed sector had played a major role in driving yields down, due largely to comparative advantages in funding. Prime properties were readily snapped up by foreign owned institutions, driving yields to record lows but this demand has now quietened considerably.

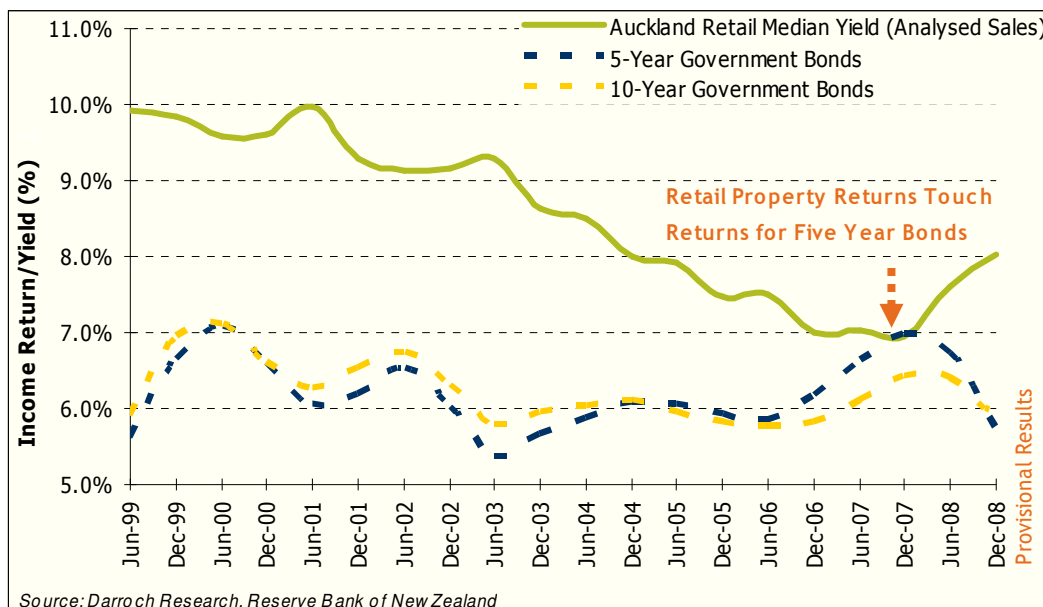
The current situation is however drawing renewed interest from some sources.

Established Kiwi investors and counter-cyclical buyers are now showing market interest again. 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.

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 retail property had widened to -3.8% 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 subdued.

There is no doubt that the market is fiercely reacting to risk at present. The "risk premium" for Auckland retail property has widened considerably this year. In mid to late 2007, investors appeared to view property as almost "risk free" by purchasing at yields similar to government bonds. It is however noted that competition from foreign investors was probably a driving force here. As Government bonds are sometimes referred to as a "risk free" rate, this investment behaviour represented an unprecedented situation.

Now investors have 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. The overwhelming influence is that economic uncertainty is at the forefront of investor's minds, and they are now seeking higher returns to compensate for risk.



Historically, the risk free rate for Auckland retail property has been approximately 3% to 3.5%. In 2000-2001 this started to narrow, and continue to do so over the following six years, whittling down to virtually 0% (against five year Government Bonds) at the height of market in late 2007. Now investors are looking for protection from market threats like reduced rental growth and the prospects of yields rising further. Our analysis shows that the risk premium has opened to around 2.20%, and is continuing to widen as the year comes to a close.