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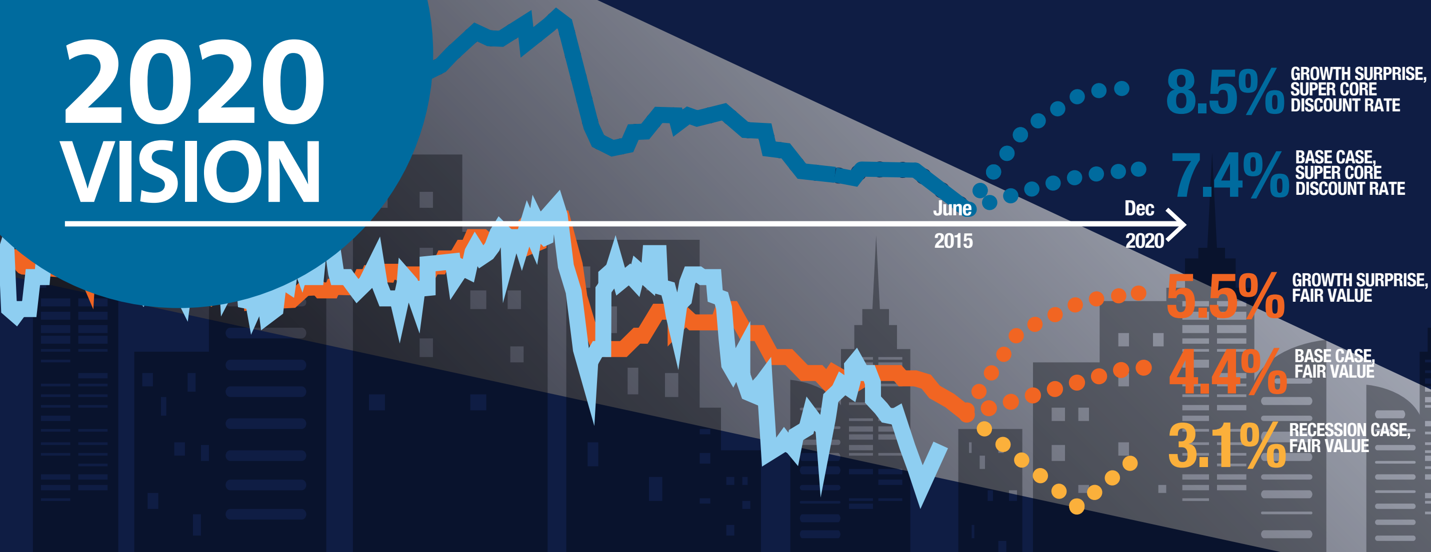

COMMERCIAL PROPERTY: WHERE'S THE RENT GROWTH?

The next three to four years look fascinating, as real estate and indeed all investment classes navigate a raft of global economic and investment cross currents and challenges. In this article, we delve into the fact that Australia is towards the bottom end of the economic growth and inflationary cycle as the economy struggles to move away from mining and the slowdown in China materialises.

KEY POINTS

- Outlook for GDP, inflation, interest rates will be "lower for longer".
- Discount rate is likely to need to lift later in the decade.
- A rapid rise in the yield curve and structural headwinds will have a negative impact on property values.
- Now is the time to capitalise on the weight of money and position assets for the volatility and structural headwinds in the medium.

INSIGHTS.IDEAS.OUTCOMES.

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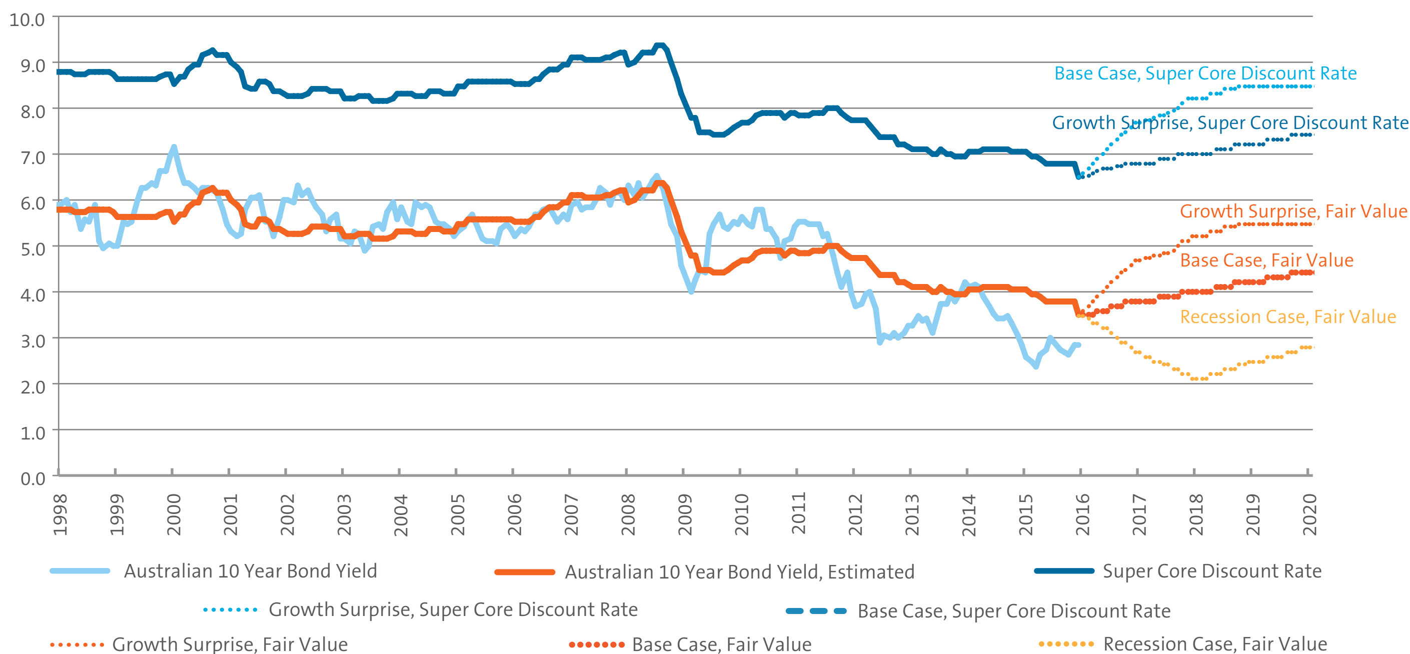
At the moment, Australia is towards the bottom end of the economic growth and inflationary cycle as the economy struggles to move away from mining and the slowdown in China materialises.

As highlighted in Figure 1, AMP Capital's investment strategy team has developed a statistical model for Australian 10-year bond yields, which we use as a starting point to assess appropriate discount rates for real estate. The model is an amalgam of real policy interest rates; that is, the cash rate less the Reserve Bank of Australia's (RBA) Consumer Price Index (CPI) target, real Gross Domestic Product (GDP) growth and implied inflation expectations. In the short term there is space for rates to fall if economic conditions and inflationary expectations deteriorate, but as the economy slowly starts to build momentum over the latter years of the decade, interest rates and discount rates will slowly have to rise as growth and inflation returns.

Figure 1: Outlook for GDP, inflation, interest rates "lower for longer"



Source: AMP Capital, RBA

DISCOUNT RATE LIFT-OFF

Our model is suggesting the discount rate is likely to need to lift later in the decade more towards the 7.5-8% circa range as growth and inflation return. Two key points here:

1. Discount rates of 9% for core real estate are a thing of the past unless there is a recession and the risk premium rises as we saw during the financial crisis. Discount rates are likely to remain at least 100bps below that long term average. Given the lower for longer outlook for economic growth and inflation, the model suggests 10-year bond yields are likely to 'normalise' around the 4.5-5% range vs 5.5-6% range historically;
2. With prices rising towards peak levels, future capital values will be increasingly sensitive to how much earnings growth can be derived from the asset to meet a higher required rate-of-return hurdle later in the decade (when bond yields rise). If this is unachievable, then capitalisation rates and values will have to adjust. This will likely mean capital losses for those assets that cannot capture enough growth.

AMP Capital's Investment Strategy team model is implying that interest rates and growth will stay 'lower for longer", but ten year bond yields could still rise towards the 4.5-5% range later in the decade (the growth assumptions behind that estimate are highlighted in Figure 1).

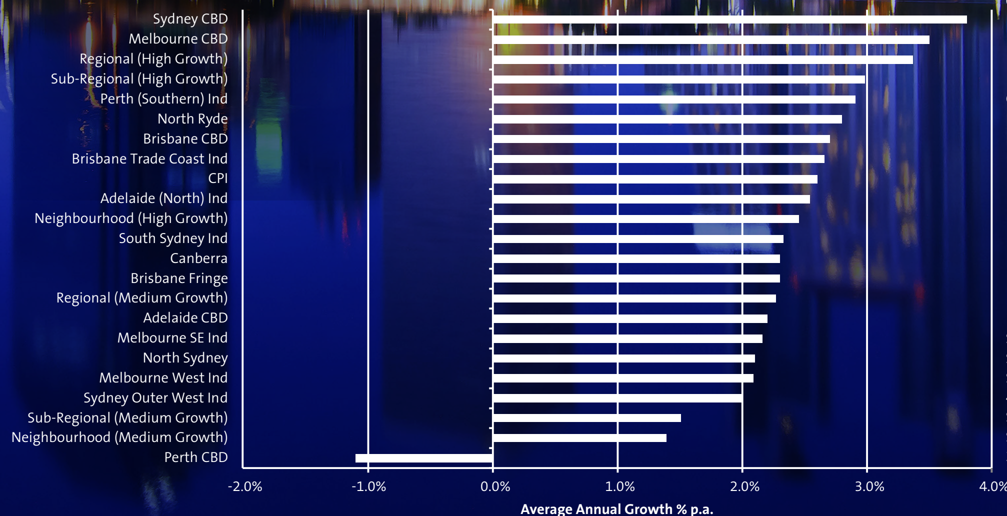
Our analysis reveals there will not be a uniform impact when the interest rate curve shifts. At a sub-market and asset level, it will depend on where values are priced relative to the level of earnings growth for that market or asset and how accretive debt is to the yield at the point in time.

The sub-markets and assets that are best placed to cope with a rise in discount rates later in the decade are those markets towards the top end of Figure 2 on the next page. These markets have the **strongest rental growth** prospects over the next five years. Other assets that are likely to be resilient are those seeing a rise in underlying land values (because of factors such as gentrification) or stronger occupier demand due to shifting thematics.

However, in our view there is a high probability of a negative impact on values in the following instances:

- If there is a **rapid rise** in the **yield curve**, some of the higher yielding, lower rental growth sectors such as industrial, business parks, and bulk retail will be impacted. This is because these types of assets cannot gain a large uplift in rents due to structural impediments (such as abundant land supply or lack of rent differential to new buildings) to offset higher required rates of return and lower leverage uplift.
- Assets where there are **structural headwinds** emerging that will undermine earnings growth compared to historical benchmarks (such as second and third tier retail malls).

Figure 2: Where's the rent growth?
5 year (2016-2020) face rent growth % per annum



CAUSE
Residential conversions causing greater fall in vacancy rates
Residential conversions causing greater fall in vacancy rates
Population growth and rising market share
Population Growth and rising market share
Constrained land supply (but falling rents in 2015/16)
Densification (New LEP)
Population Growth rising off back of housing affordability
Population Growth/Inland Rail

Sunset Market – Inner/Mid suburbs residential long term
Sunset market – residential long term
Substantial land bank & aggressive development market
4,200ha of new employment land around Badgerys Creek Airport
Structural rise in vacancies based on thematic research
Structural rise in vacancies based on thematic research
25% Vacancy Rate

Source: AMP Capital

As mentioned at the outset, the dynamics of the global economic environment and consequent challenges make for uncertain times for real estate and indeed all asset classes. In the short term, the chase for yield is a positive trend but is pushing prices ahead of rental growth, which could cause a risk for low rental growth assets when interest rates rise. On balance, our quantitative models are confirming our observations that the market is approaching the **top of the pricing cycle** and **now is the time** to capitalise on the weight of money and position funds and assets for the volatility and structural headwinds in the medium term. These are the following strategies we are enacting to manage this medium term risks.

Firstly, while the chase for yield is still in place, we are **selling second-tier assets**. These assets include those where value-add can no longer be extracted, or those assets that will not comfortably ride the next part of the cycle because of either cyclical timing, or structural changes, such as industrial and second/third tier discretionary sub-regional shopping centres.

Secondly we are **recycling this capital back** into improving the experiential 24/7 appeal of core assets to ensure they can ride both this adjustment in pricing and long term thematic changes ahead e.g. our clients' regional shopping centre portfolio, and the Quay Quarter Sydney project.

Thirdly, we are being circumspect on acquisitions and asset pricing at this point in the cycle. This means still maintaining a strategy of **acquiring super prime assets** or those that are going to benefit in the medium term from shifting thematics such as gentrification and technology disruption; but disregarding those assets that are unlikely to be able to generate sufficient returns later in the decade.

Fourthly, portfolio construction models are clearly picking up the **risk of cap rate adjustment** and value loss/stagnation potential later in the decade. At the moment, the models are reducing exposure to industrial and being more biased to high growth retail (circa 60%) and office (circa 40%). Looking forward through the cycle, the optimal portfolio is progressively tilting towards high growth retail assets the lower cap rates go given this asset types proven defensive characteristics during periods of weakness. Our medium term portfolio construction bias is thus to high growth retail assets.

IN SUMMARY

- Balancing short term pricing against lagging fundamentals and an asset's ability to capture growth in earnings is challenging
- The discount rate is likely to need to lift to the 7.5-8% circa range as growth and inflation return over the next decade.
- Against low interest rates and growth, the 10 year bond yields could still rise towards the 4.5-5% range later in the decade.
- The chase for yield is a positive trend but is pushing prices ahead of rental growth; this could lead to low rental growth assets when interest rates rise.
- The market is approaching the top of the pricing cycle. We are managing medium-term risks by selling second-tier assets; recycling capital back into core assets and being circumspect on acquisitions at this point in the cycle.
- From a portfolio management perspective, we are reducing exposure to the industrial sector and being more biased to high growth retail and office sectors.

INSIGHTS.IDEAS.OUTCOMES.

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