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What is the future of commercial property investment post yield compression?

It has been fascinating and troubling in equal measure to watch the rapid decline of interest rates to near zero. We have played financial limbo to the bottom of the cycle, and now face the dual challenges of how to escape low rates without destroying the economy and the enormous inequality gap between those who own assets and have benefitted from interest rate reductions and those who do not.

Interest in Australia's commercial property sector has been consistently strong for the last 10 years with major overseas property investors continuing to make significant investments into CBD Sydney and Melbourne. As comfort levels have grown and competition forced yield expectations lower these investors broadened their mandates into different cities and different asset classes (Industrial and health in particular). This along with the steady reduction in interest rates have seen property yields approaching what were bank term deposit levels only 12 short years ago.

What is yield compression?

It is worth explaining yield compression before going to much further in this discussion. Yield compression is the re-rating of the price of an asset (priced off its net income earned) upwards due to a lower perceived risk of the asset failing to produce income or driven by an excess of demand over supply producing competitive tension for purchasing of the asset.

This analysis (like all in economics) assumes *ceteris paribus* (all other things remaining equal). All other things have not remained equal however and the property market has been repricing itself off a temporal reduction in variable costs (interest rates). This has been mischaracterised as yield "compressing" (getting lower) when in fact it is not what has been occurring.

What we have seen in the Australian commercial property market for the last 6 years has little to do with the repricing of risk. We have seen a variable cost (interest rate) fall below the yield level on most assets, meaning that debt becomes good, and more debt becomes better. This means that when interest rates return to mean levels (and they eventually will) the debt on these assets will rebound from being an incentive, to being a disincentive, and the predictable pattern of property sales will follow for the undercapitalised or for the institutions, a prolonged period of zero or negative returns for members ensues.

How do we know that some commercial property markets are overpriced?

What does all this look like in the cut and thrust of real-life property analysis? Amongst the myriad of examples we see day to day when reviewing commercial property deals we see two troubling trends time and time again. The examples below are by no means exhaustive but provide a clear picture of some of the risks in commercial property.

Incentives outsize rental paid in some asset classes

Property incentives are a normal part of the property market (within reason). They were initially a discount back to the tenant for providing a long lease commitment (3 months rent free on a 10-year lease for example).

They have morphed into something altogether more disturbing post the Global Financial Crisis in 2008. We now regularly see incentives (discounts) on certain commercial asset classes averaging 40 – 50% of the term of the lease. It is not uncommon to see a 5-year lease with two years rent free given. When the GFC hit in 2008 property owners were panicked at potential falls in the face value of rents (driven by lack of demand) and so offered increasing periods free of rental which property valuers blithely accepted as “incentives”.

The logic was that it was going to be temporary, as when demand picked up again, rents would return to normal levels, and hey presto problem solved.

Demand has not returned to “normal” and these incentives have remained as a semi-permanent feature of leasing. On the one hand we are saying that property prices are worth more as input costs have fallen and demand is high, yet the very metric we are using to measure that growth (rental) is based on offering an overstated sale price trimmed by a hefty discount to make it palatable.

Clearly that makes no sense. If it did Apple would be offering iPhone 12’s at $5,000 per handset but selling at $2,300 after incentives were considered.

Rentals below the real-life cost of asset provision and construction

In asset classes such as industrial, tenants take enormous facilities at relatively inexpensive rents. The bulk of these leasing deals are done on new, design and construct facilities which are state of the art.

This can see tenants occupying a brand new 6000m2 facility for as little as $400,000 per year. There is an important dimension to consider as the rental the tenant can pay is directly related to the business’s ability to fund it. The reciprocal implication is that a tenant who needs a brand new 6,000m2 industrial facility is only able to pay a maximum of $400,000 for it and keep their business profitable.

This is a disturbing situation and one which confronts every developer on a design and construct contract. The rentals required by industrial tenants only support the build cost of the facility when you have an era of tiny yields. Risk mitigation means a sale price for the facility must be locked in upon completion of construction.

It shows that the one component keeping the industrial sector moving is artificially cheap rentals from artificially low yields and if there is an adjustment upwards there could be swathes of industrial tenants unable to afford new rents.

How do you find value at this end of the property cycle?

When we don’t get a property at Aviator Capital because we have been outbid we don’t refer to it as missing out. Quite the opposite. Not paying over full value for an asset is considered a good thing. It does limit areas of investment for our funds, but we don't like future surprises for our investors.

Remember that the one item that has not changed in the last 100 years of property investment is that money is made when you purchase an asset, not when you sell it.

Where are we seeing value in commercial property and what areas are we avoiding? We certainly pay attention to the types and amounts of incentives offered, particularly on suburban office assets, and despite the long WALE's we usually have little interest in industrial assets.

Aviator Capital has been looking regionally for some time, and curiously one of the likely permanent outcomes from COVID19 will be a renewed focus on living regionally. We think this trend is likely to continue for some time and supports the regional investment thesis.

We are also very microeconomic in our thinking. We don't get carried away with sector and market trends (a rare benefit of not having significant institutional funding). We like businesses and tenants that we understand, doing things that we see having a degree of entrenchment. Smaller assets are only as good as the businesses that occupy them, and that remains an important metric for us.

We are also looking in areas which have been previously oversold. Strategically located retail assets with good covenants will remain important for years to come.

Increasing or earlier exposure to development assets through fund through mechanisms. We are actively engaging with quality developers to review asset pipelines to look to get early access to quality product. This remains one of the core competencies for a property investment business to retain. There are a core of quality businesses looking to (and capable of paying for) upgrading their facilities every 5 – 10 years. It is this approach that provides the bulk of the business for most large listed developers.

Value adding to existing assets. Creativity always has a value beyond just being a manager of assets. This has been one of the central ways to improve asset values during times of steady or rising interest rates. It will remain relevant for years to come, especially as technology and population factors change the use loads on the built environment.

Ends of cycles are inflection points

"There is nothing to fear but fear itself" **Franklin D. Roosevelt**

Inflection points in market are not things to fear, but things to be coveted as they are significant opportunities to make money. They without exception reward those who are conservatively geared at the point of inflection and punish those who are heavily geared or holding assets that are not producing income.

This inflection point will be different to the last few crises on which we have kicked the can down the road. There is no more monetary accommodation available through interest rate adjustment and so being on the wrong side of the gearing equation could be ugly.

Remember that the day after the announcement of a crisis there is a lingering fear of what's next but our basic human desires continue undiminished. The desire to eat, to work, to holiday, to interact with friends can't be replaced by technology.

We see caution being the rule of the day but opportunities will continue to arise unabated even during current times of uncertainty.