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HOW LOW CAN YOU GO?

Scope for further yield compression within retail assets

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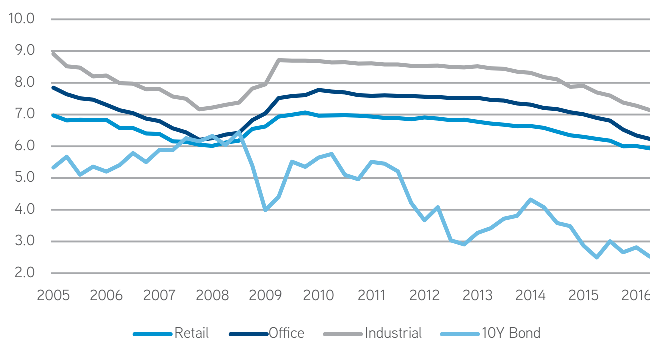
Against a backdrop of low interest rates and benign global inflation, commercial property investors continue to be attracted to higher yielding asset classes. However given the amount of yield compression that has already occurred, investors are no doubt asking how much further this cycle can run. We argue that high yields on offer within the Regional retail asset class are theoretical in nature and will compress once more transactional activity occurs.

It's no secret that investors have benefitted from the substantial amount of yield compression in the commercial property sector (see Chart 1). Low interest rates and the hunt for yield have been key catalysts here, but investors are now contemplating how much room there is for further compression.

Chart 1: Commercial property cap rates vs risk free rates



Source: IPD

Looking at the spread between retail sector yields and risk free rates (10 year government bonds), we can observe that current spreads as at 3Q16 are far higher than what they have averaged over the past 20 years (Table 1). This is because even as retail asset yields sharpen, bond yields have fallen at a greater rate, maintaining a wide spread between the two. In this vein, we suspect there is room for retail property yields to compress further, approaching their long term historical averages.

Table 1: Difference between current asset class spread and 20 year average spreads (at 3Q16)

	CBD	REG	SUB REG	N HOOD	LFR
Sydney	1.71%	1.50%	0.42%	0.26%	0.68%
Melbourne	1.35%	1.61%	0.51%	0.03%	1.79%
Brisbane	1.28%	1.24%	0.53%	0.16%	1.06%
Perth	0.37%	1.53%	0.13%	0.31%	0.82%
Adelaide	0.51%	1.75%	1.48%	0.93%	1.38%

Source: Colliers Edge

So where can yields compress the most? Table 2 suggests the highest potential for yield compression lies within CBD and Regional retail assets, while there is less room in the Sub Regional and Neighbourhood classes.

Table 2: Forecast yield compression from 3Q16 to 4Q19

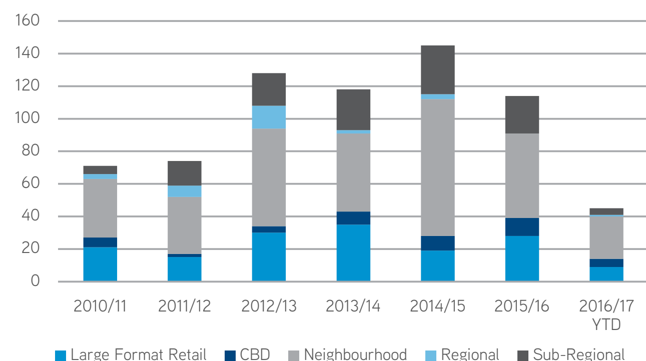
	CBD	REG	SUB REG	N HOOD	LFR
Sydney	2.52%	2.31%	1.23%	0.89%	1.49%
Melbourne	2.16%	2.42%	1.32%	0.68%	2.60%
Brisbane	2.47%	2.05%	1.63%	0.97%	1.87%
Perth	1.18%	2.34%	0.94%	1.12%	1.63%
Adelaide	1.32%	2.56%	2.38%	1.74%	2.19%

Source: Colliers Edge

But if these asset classes are offering the highest yields, why aren't investors driving up prices (and simultaneously driving down yields)? The reason comes down to stock availability. While investors would love to acquire a major Regional centre, these assets come to market infrequently. In fact a true Regional centre hasn't traded since early FY15. Conversely, Sub Regional and Neighbourhood centres are far more common and therefore trade more frequently, providing investors with a more efficient vehicle to access the commercial property market. In this respect, we can see how the high volumes

of transactional activity (Chart 2) have brought yields much closer to historical spreads allowing less scope for further compression.

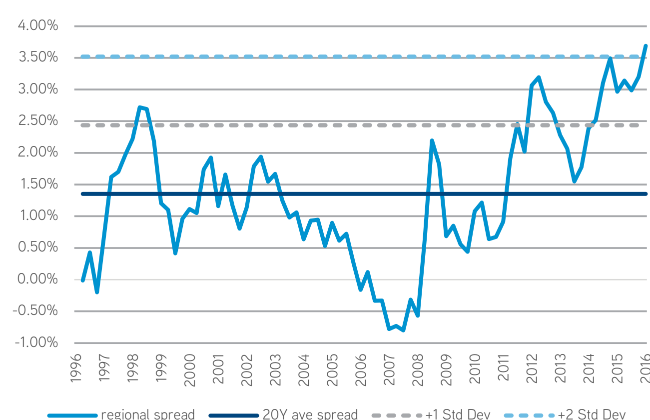
Chart 2: Frequency of retail asset sales



Source: Colliers Edge

Therefore with an absence of transactional activity, the pricing within the Regional asset class is largely theoretical, which explains why spreads in this asset class are so high. In fact according to Colliers Edge data, Regional asset spreads are now two standard deviations away from historical long term averages as at 3Q17 (Chart 3).

Chart 3: Australian Regional centre yield spread



Source: Colliers Edge

As such it's logical to assume that the trading of Regional assets should reprice the market closer to where historical spreads deem these shopping centres should be, which in our view is between 124 and 175 bps lower than where current yields are sitting.

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