

Pacific Region ViewPoint

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PROPERTY LENDING DRIES UP... WHILE YIELD BLOWS OUT

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SUMMARY Australian commercial property investment activity was down 60% in 2008 over the previous year. Lending for commercial property has fallen much more than that; roughly 80% off its peak in September 2007. The lack of debt in the investment markets has seen yield blow out substantially through 2008 and this trend continued in the first quarter of 2009, causing capital values to slide. The future of lending for real estate purchases is critical to not only the amount of activity in the investment markets, but also the direction and strength in pricing. In this ViewPoint, we look at the relationship of these two important factors.

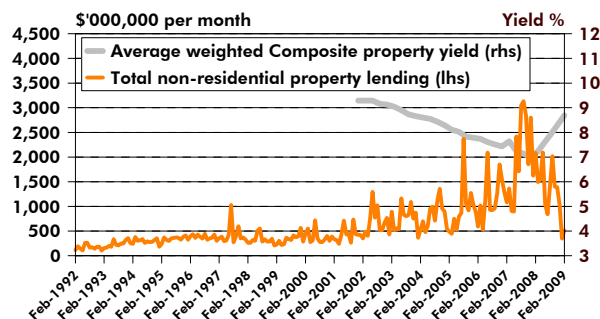
LENDING & PRICING: THE RELATIONSHIP

Some economists and analysts talk about debt as the lifeblood of the economy. Like circulation around the human body, if it drops too low, limbs go numb and eventually, gangrene sets in and organs and limbs may fail altogether!! Debt is certainly central to the property industry, for investment and development activity generally and for successful trading in larger assets in particular. The more buoyant investment activity is the more prices are likely to remain high and/or growing.

Data recently released by the Australian Bureau of Statistics graphically shows monthly fixed and revolving credit for the purchase of real property peaked at the highest level ever recorded in mid-2007. This retail lending has now fallen to levels not generally seen for seventeen years.

You can see the trend in Total non-residential lending in Chart 1 below. This is for the purchase of real office, retail, industrial, land and other property; it's fallen 84% from its peak in September 2007 and is still 21% below the long term average monthly lending level. Plotted against this trend is the average weighted composite yield for Australian commercial property. Despite the lack of historic data points in this composite yield series, the relationship to lending is clear. Yield started compressing at about the time lending started to trend up, in 2002. Then, when lending fell quite sharply in the third quarter of 2007, yield also started to soften. This 170 basis point softening in the composite commercial property yield since then, if applied as a cap rate, has removed about 15% from capital values.

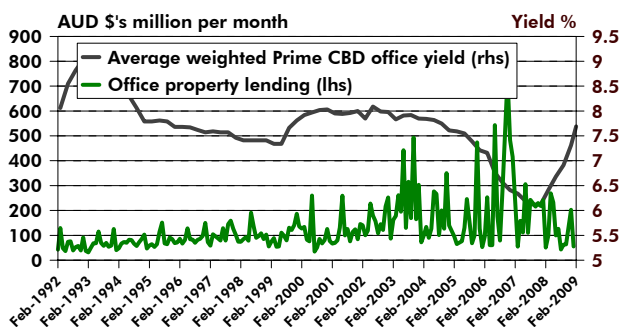
Chart 1: Commercial lending commitments, non-residential real property



Source: Australian Bureau of Statistics & CB Richard Ellis
Note: includes fixed loans & revolving credit

The ABS data series also drills down into lending for purchasing by property sector, including office, industrial and retail. Like Chart 1, you can see the lending versus the weighted average yield trend for CBD office prime properties in Chart 2.

Chart 2: Commercial lending commitments, real office property

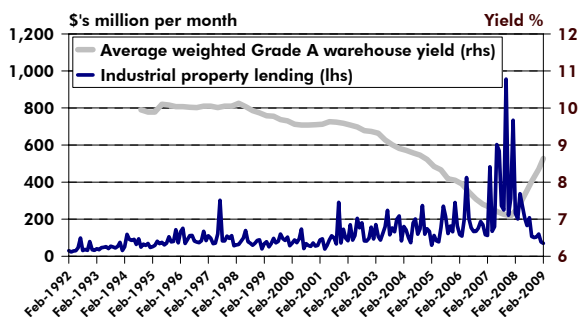


Source: Australian Bureau of Statistics & CB Richard Ellis
Note: includes fixed loans & revolving credit

Lending in this sector is now 52% below the monthly average recorded since 1992 and 92% lower than the peak in November 2006. The average weighted Australian yield for Prime CBD offices has blown out 157 basis points since the fourth quarter of 2008, to now be quoted at 7.69%. This has removed 18% from implied capital values.

The industrial sector shows the clearest inverse relationship between lending and pricing of any sector. The trend is shown in Chart 3 below. What's notable is just how far average industrial yields compressed in the last cycle; from 10.0% in 1992 to 7.0% in 2007. At the peak of the market, some industrial properties transacted at prices representing a much lower yield than this average.

Chart 3: Commercial lending commitments, real industrial property



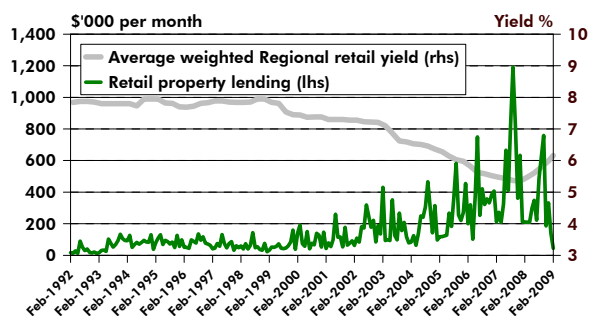
Source: Australian Bureau of Statistics & CB Richard Ellis
Note: includes fixed loans & revolving credit

Monthly lending in the industrial property sector is now 43% below the long term average and 93% down from the peak in October 2007. This peak lending month was in the same quarter as the tightest yields we recorded in the last cycle. Weighted average Australian yield for Grade A Warehouse properties has softened 155 basis points to date and removed 18% from implied capital values.

Finally, the retail sector was the beneficiary of the highest levels of lending in the last cycle, as can be seen in Chart 4, reaching a peak of \$1.2 billion in September 2007. It's perhaps not surprising then that monthly lending for the purchase of retail property has fallen more than for any other sector. Lending is now down 72% from the long term monthly level and 96% down from the peak, which, like the Industrial sector, was reached in September 2007.

Meanwhile, the average weighted implied yield for Regional Shopping Centres has softened 81 basis points to now be quoted at 6.16%.

Chart 4: Commercial lending commitments, real retail property



Source: Australian Bureau of Statistics & CB Richard Ellis
Note: includes fixed loans & revolving credit

WHERE TO FROM HERE?

Although the relationship shown in these charts might suggest it, simply opening the taps of bank lending (even if the banks were ready and able to do so) won't by itself restore activity and pricing in the direct property markets.

The story, though, is a very different one for assets under \$30 million compared to those at the institutional level. Although patchy, there are still active buyers and sellers in the sub-\$30 million bracket of properties. The limited lending which is occurring is probably at this end of the market. (We estimate at least 40% of all purchases are currently to private interests). We think this part of the market will continue at current levels of activity and gradually pick up as pricing continues to adjust in the short term.

The big issue for the future really lies at the institutional end of the direct property markets. This is where banks are concerned institutions address current balance sheets to re-capitalise in the face of falling values, before lending for any further acquisitions would be contemplated.

Given the current slow rate of adjustment in property values, it could take the rest of this year before the outlook for property balance sheets is clear enough to consider a return to acquisition activity, supported by bank lending.

Whichever way you look at it, the cost and availability of lending is likely to remain a constraint on domestic investment activity and a major cause of weakness in pricing for many months yet.

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