THINKING OUTSIDE THE BOX

COMMERCIAL **VS** RESIDENTIAL PROPERTY

Commercial property in Australia is worth a staggering $0.70 trillion (CoreLogic RP Data, December 2015). There are compelling reasons for investors to look beyond the residential home and broaden their investment portfolio to include commercial property.

Residential property dominates the news and is a favourite topic of choice for Australians. Skyrocketing prices, social concerns regarding affordability, speculation of a looming bust, the twelfth series of "The Block"… you would be forgiven for thinking that the only type of property is "residential", but its better looking, stable cousin might be worth considering.

Certain income vs uncertain growth

Whilst both types of property are founded on "bricks and mortar", the similarities largely end there. Commercial property is first and foremost considered a high yield, low growth investment. Residential property on the other hand is generally considered a low yielding and higher growth investment.

One of the most attractive features of residential investment property investing is the tax benefits gained due to negative gearing. However, the logic surrounding deliberately making a loss on your day-to-day cash flows in order to achieve a tax advantage is debatable. Investors should also be cognisant of the potential regulatory/policy risks concerning the future sustainability of negative gearing. Aside from the tax advantage, negative gearing increases an investor's reliance on the speculative capital gain component of the total return. This can be a risky strategy. The heavy reliance that residential property investors place on capital gain raises an interesting "income versus capital" debate.

Commercial property is an income investment, known for its higher yields and steadier long term capital growth. These high yields (which comprise the main component of the total return) are usually backed by commercial rent agreements which are generally locked in for multiple years. Most commercial leases have locked in rent reviews (generally meaning that the rent cannot drop) directly linked to CPI, fixed rates or market based reviews. These inbuilt reviews mean the relative benefit of property is even more pronounced in a period of elevated inflation and often referred to as "inflation proofing".

Conversely, residential property is generally considered a high growth and low yielding asset. "Punting" on potential growth returns from property is a strategy that has been proven over many years to be fraught with danger. The low initial yield that Australian residential property investors accept presumes an inversely high level of capital growth. Buy at the wrong time and your likely gain is even riskier.

	RESIDENTIAL PROPERTY	COMMERCIAL PROPERTY
Effective cash yield	2-4% pa[1]	Around 5.5 - 8.5% pa[2]
Capital growth	Highly variable.	Steady, low capital growth.
Property types	➢ Houses ➢ Apartments ➢ Flats ➢ Townhouses	➢ Office ➢ Retail ➢ Industrial ➢ Healthcare ➢ Retirement living ➢ Leisure parks ➢ Hotels
Leases	Short term (typically one year).	Long term (typically 5+ years).
Rental reviews	Upon lease renewal, determined by local market conditions.	Most lease contracts have locked in rent reviews directly linked to fixed rates or CPI.
Tenants	Individuals	Businesses, ASX listed corporations, multinationals and government bodies.
Legal protection	The Residential Tenancy Act tends to favour the tenant.	Balanced legislation between landlord and tenant. Commercial tenancy agreements are dealt with as business contracts and are negotiated at arm's length between the parties.
Property costs	The tenant is required to maintain good order. Costs are largely borne by the landlord.	Most leases will provide for outgoings to be paid by the tenant and typically include: council rates, water rates, land tax, insurance, strata levies and property management fees. Tenants are required to "make good" conditions factored into the lease. Majority of costs are borne by the tenant.

1 Core Logic RP Data Home Value Index. Effective cash yield takes into account deductions such as: agents fees, advertising, repairs and maintenance, vacancy on renewals, insurance, cleaning/damage.

2 APN forecasts February 2016.

Residential property is looking expensive

Australian residential property is currently looking expensive with national market price levels having increased approximately 32% since bottoming in May 2012 (HIA, November 2015). Whilst we do not subscribe to the view that says residential property prices will fall, we caution that a protracted period of low growth could ensue.

Our view has been supported most recently by the behaviour of multiple market indicators which suggest a moderation in capital values from this sector. Residential price growth has historically been led by various indicators, the most predictive of which have generally included sales volumes, building approvals, auction clearance rates and mortgage rates. A recent analysis of the aforementioned indicators suggests the rate of residential price growth nationally is more than likely to slow from current levels to a rate of between 0-5% (Citi Research, November 2015).

Commercial property is attractively priced

In contrast to the residential market, our valuation analysis confirms that AREITs are not overvalued and are in fact attractively priced. A key metric utilised in our AREIT valuation process includes analysis of a trust's Net Asset Value (NAV). This methodology essentially involves a mark-to-market assessment of the trust's net assets having consideration to the most recent drivers of value for the vehicle's physical real estate assets and associated intangibles. Our assessment of NAVs across the AREIT sector suggests the market is currently trading at a discount of around 5.2%[3], suggesting material upside potential.

The historically low interest rate environment continues to support the stable high yield nature of AREITs and the sector's relative popularity with investors as the search for risk-adjusted yield continues. Low interest rates are a key driver of investor preparedness to bid up the market. Private clients who invest directly in the market compare the yield they can achieve in fixed interest investments (2.5%-3.0%) with the yield in AREITs (most currently yielding in the range of 5.5%-8.5%). Institutional investors often utilise the 10 year bond as the risk free rate in the discounted cash flow valuation process. With the bond trading within the historically low band of 2.5-3.0% throughout 2015, it is little wonder that many valuations support the sector's current pricing.

3 As at 29 February 2016, APN forecast.

Accessing commercial property

In reality, very few investors have the financial capacity or specialist knowledge needed to acquire multi-million dollar property assets. Nor do most investors have the expertise or time required to intensely manage the property – such as completing capital improvements, rent review negotiations, tenant relations, repairs and maintenance, accounting, legal compliance and ultimately execute a disposal. All property assets need to be continuously and actively managed in order to maximise rental income and value.

Why AREITs?

1 Dedicated management and expertise

Managed by teams of dedicated professional investment managers who are highly skilled at managing property and property related investments, AREITs and property securities funds allow investors to purchase an interest in a diversified and professionally managed portfolio of real estate. Investors have comfort from the knowledge that their investment is being managed by full-time property specialists whose sole job is to maximise the return on your investment (both in terms of rental income and capital appreciation).

Residential investment property owners often engage the services of a real estate agent to assist with the buying/selling and management of residential property, however, considerable commitment and time is required to successfully manage a property – dwellings flood, walls and foundations crack and there's no guarantee that tenants will reliably pay rent or treat the property with respect. These issues are ultimately the owner's responsibility.

2 Liquidity

REITs or liquid property securities funds offer the benefit of liquidity and the ability to increase an investment even in very small parcels (typically the minimum additional investment size or regular investment plans are $500-$1,000). By comparison, you can't sell a bedroom in a residential investment property, nor can you purchase a kitchen. An investment in residential property is lumpy. It's all or nothing.

3 Diversification

The risk of "putting all your eggs in one basket" by buying a single asset is significant. The concentration risk that exists with a single residential investment (one asset, one tenant, one location) compares unfavourably with the diversification benefits of a well-managed real estate securities fund. Multiple REITs holding numerous assets, in varied locations, each with a multitude of tenants obviously offers far superior diversification.

4 Income security

The income security due to the quality of commercial property tenants provides additional comfort for landlords (and investors). Tenants of REITs are normally very strong businesses, supporting their ability to pay the rent and often include ASX 100 listed companies, multinational corporations and Government bodies.

Income. Diversification. Liquidity.

Over the long term, the greatest virtue of commercial property, as an asset class, is to provide **sustainable and growing income**. Underlying capital growth will follow properties with good income streams. The all-important lease covenant is what gives commercial property its unique characteristic. Even if underlying property values drop, rental income is still received.

Different investment classes obviously offer different attributes including style of income, capital growth and risk. However, the inescapable conclusion is that a well-managed REIT portfolio offers superior diversification, lower ongoing costs and greater liquidity than the alternative direct residential property investment. Not only is the risk/reward trade-off superior (due to the lower reliance on capital growth versus security of the rental income stream), but the liquidity and diversification in addition to the lower ongoing costs makes an AREIT investment far more attractive than a residential property investment.