Finding opportunities in Australian property

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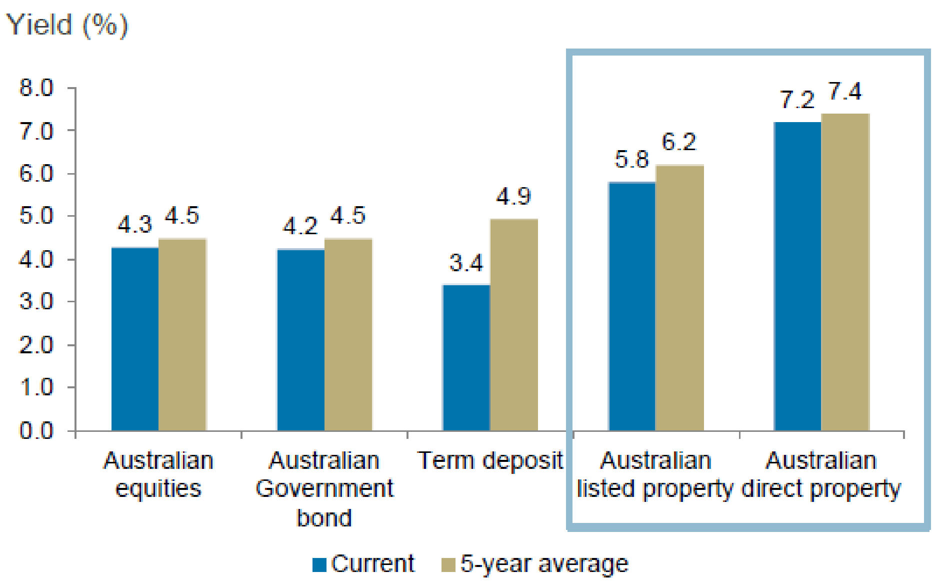
The hunt for income is as relentless as ever. In the current environment of low interest rates and bond yields, Australian property is forecast to continue to provide strong, reliable income streams for investors. In this article, we highlight the income opportunities available in Australian property and provide insights into how the asset class is performing.

Australian property can provide a strong and sustainable income

The appeal of Australian property has been built on the stability of the income it provides. Although capital values can rise and fall, the yields from rents have proven to be extremely consistent. The stability of these income streams is a reflection of the rental agreements of the underlying assets. These are generally signed on a long-term basis, so the cash flow of rental income is 'locked in' for a predetermined period.



Source: Bloomberg, IRESS, Reserve Bank of Australia, IPD Australia Quarterly Digest as at 31 March 2014. Australian listed property: S&P ASX 200 A-REIT Accumulation Index AUD, Australian direct property: IPD Australia Index Australian Equities: S&P/ASX 200 Index, Australian Government bond: Australian 10 year Government Bond, Term deposit: Australian 1-year term deposit rate. Past performance is not indicative of future performance

Australian property remains attractive to investors looking for income

A large proportion (around 75%) of the total return from Australian property is from income. Over the next ten years, we believe that both prime direct property and Australian listed property will deliver robust income returns.

What are some key investment trends?

Sydney leads non-mining states

In Sydney, office leasing enquiries are slowly improving, house prices are rising, and consumer confidence has strengthened which raises the prospects for a pick-up in retail spending in the near future. Looking forward, we expect this trend will strengthen and extend to other markets that were held back during the mining boom such as Melbourne and South-East Queensland. Resource states are now expected to underperform as their pricing adjusts to a lower growth outlook and vacancies rise, particularly in the office sector.

Flight to quality will intensify

While we expect better momentum in Sydney and Melbourne, we expect Australian businesses to remain focused on cost containment and restructuring until strong economic growth returns. As companies look to centralise, consolidate and/or streamline processes to drive profits, we see opportunities emerging in:

- CBD prime office buildings
- Dominant shopping centres
- Retail warehousing
- Undeveloped industrial areas capable of developing large warehouses
- Storage facilities
- Technology centres

In a constrained economic environment, we believe that older, less well-located office and industrial buildings, and non-dominant shopping centres will struggle to hold occupancy rates which will undermine income returns.

Sector performance and outlook

The industry sectors within Australian property include residential, retail, office and industrial. Each sector offers different property types, locations, lease lengths and tenants, and may perform well at different stages of the property cycle.

Residential:

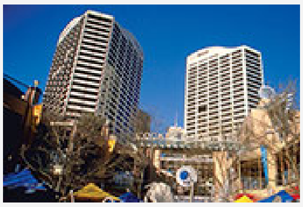
The housing story keeps improving on the back of lower interest rates and foreign investment. Housing approval rates are up and capital-city auction clearance rates remain elevated despite high-profile company closures and job losses. Strong capital into the sector should translate into further price increases, which should support capital appreciation and grow future earnings over the long term. Stocks that have benefited from improvements in the Australian residential market are Mirvac Group, Stockland Group and Australand Property Group.

Retail:

We see the retail sector slowly improving as the wealth effect of higher house prices combined with a higher equity market should lead to a gradual improvement in retail sales. As a result, the 'high growth' neighbourhood shopping centres are now showing the highest total return outlook mostly because of the higher yield on offer.

Office:

This sector is now forecast to be the worst performer over the next three years because of additional construction of new buildings. Sydney and Melbourne are expected to show the strongest performance over the next 3-5 years as the flight to quality and centralisation trends strengthen. There is strong demand for prime Australian office properties from major offshore investors. Therefore, capital values should be well supported despite the recent uptick in vacancy levels.



Industrial:

The industrial sector is expected to perform well over the next 3-5 years because of the high yield, but our pricing models suggest that long-term leased prime assets are becoming slightly overpriced. Better income opportunities are available in functional, well-located, short-term lease assets close to ports, major infrastructure nodes and central metropolitan areas in Sydney, Melbourne and Brisbane.

Top three investing tips

The Global Financial Crisis has taught us the importance of remaining focused on long-term investment outcomes. Three tips for investing in Australian property include:

1. Ensure you conduct some research into a fund's track record and stick to fund managers with an established reputation and sound history.

2. Check that the gearing levels are not too high. Some property funds may borrow capital to increase potential returns, a technique called gearing which can magnify both returns and losses.

3. Understand the underlying risks of the types of investments the fund holds. Be mindful that funds investing in a single asset carry more risk than those that invest in a portfolio of properties. Also be wary of properties with complex business models where there is a cross collateralisation of debt.

Final thoughts

The high yield of Australian property makes it an attractive investment proposition, and interest from foreigners, particularly Chinese investors, is expected to continue.

In tougher economic times, retention of tenants is critical for preservation of income and distributions to investors. This is where experienced management is important in identifying or managing quality properties in order to attract a diverse spread of lower credit risk tenants as opposed to secondary properties with higher risk tenants.

Interested in investing?

There are various ways to invest in Australian property besides buying an apartment, shopfront, office unit or warehouse; or outlaying a large amount of money. You can gain some exposure by investing in Australian real estate investment trusts (A-REITs) which are listed on public markets. For direct exposure, you can invest through unlisted funds or syndicates.

For more information on the ways to invest, download our Understanding real estate booklet.

About the authors

Mark Ferguson joined AMP Capital in September 2005 and was appointed to the position of Head of Australian Listed Real Estate in March 2006. He is based in AMP Capital's Sydney office and heads up the team responsible for the analysis of property securities in Australia.

Christopher Davitt is the Fund Manager for AMP Capital's Wholesale Australian Property Fund. Joining AMP Capital in March 2010, Christopher was previously a Vice President at MGPA based in London.