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Placing commercial property in the Australian capital market

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Placing commercial property in the Australian capital market

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Abstract

Like other developed countries, commercial property in Australia is an important investment asset class. On available data, the extent and composition of investment grade commercial property and associated property investment products can be measured and compared to the wider Australian investment market. As at December 2006, the estimated size of the Australian commercial property investment market is AU$449 billion of which Australian Institutions own approximately AU$178 billion (40%).

Due to illiquidity and high value thresholds there are several property investment products which allow investors exposure to local and overseas commercial property. The largest is public equity with Real Estate Investment Trusts AU$136 billion representing close to 10% of the Australian Stockmarket. Next is private equity comprising wholesale property trusts and property syndicates at a combined value of AU$ 69 billion. Debt securities offer an alterative return stream with the AU$71 billion whole commercial property mortgage sector and the emerging AU$12 billion traded debt securities sector.

In separating the equity, commercial property and publicly traded debt components, the size of the Australian investment market for these asset classes can be compared to the global equivalent. The total value of the global investment market is AU$152 trillion, and is apportioned equities AU$59 trillion (39%), debt securities AU$84 trillion (55%) and commercial property AU$9 trillion (6%). The Australian market share is 2% of the global investment market, although the percentages range across the different investment sub-markets. The Australian commercial property market accounts for 2.4% of the global property market as there is a significant proportion of Australian investment grade property already owned by institutions.

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1 Introduction

For investors, commercial property increasingly offers a wide range of exciting investment opportunities. Alongside a diverse range of property types, sourced locally and from overseas building stock, there are property investment instruments which even though linked long term to the security of the underlying property assets, can exhibit distinctively separate structures and investment attributes.

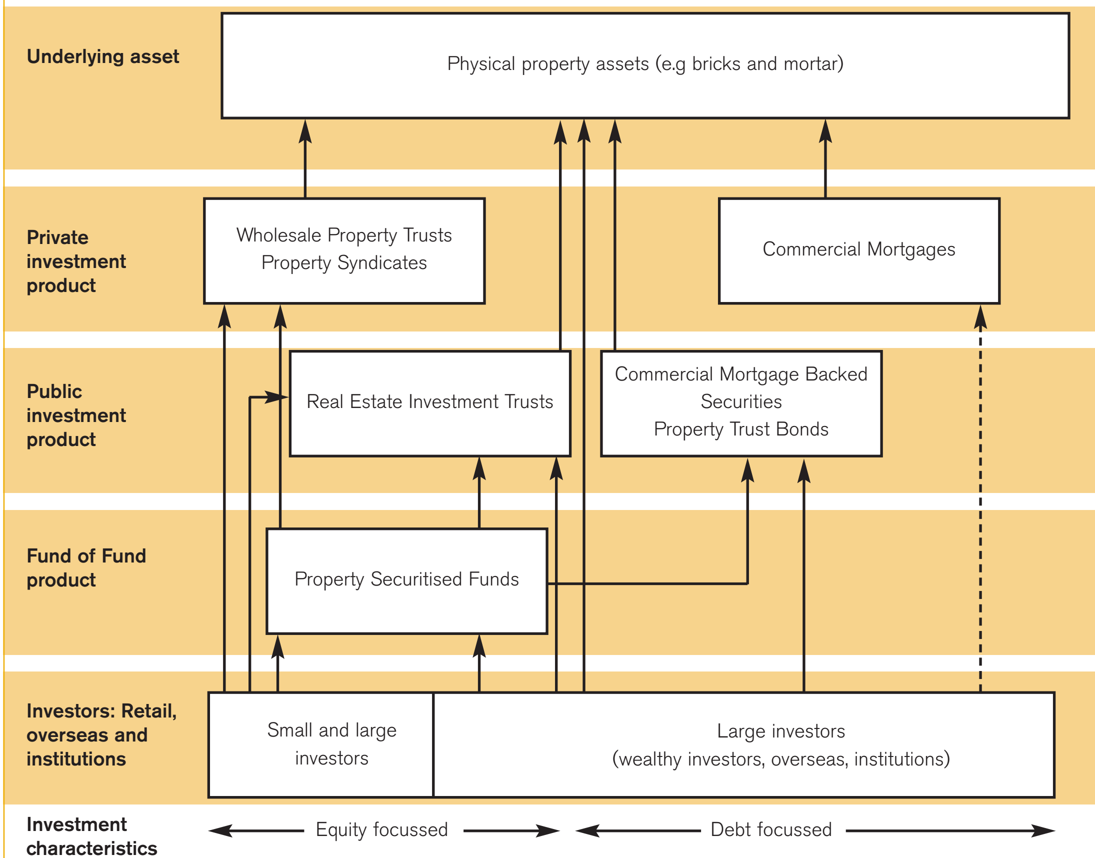
The capital market places a value on the level of accessible information. Compared to competing asset classes, underlying property as an asset class is placed at a distinct disadvantage due to:

- no central trading place
- limited transactions
- illiquid with a high value threshold
- carries a significant concentration of risk
- unique characteristics of individual buildings
- low property related discloser/reporting requirements

In identifying the shortcomings, the underlying property asset should not be considered as an isolated asset class in the capital market, as financial instruments exist which enable investors to have an exposure to property in different shapes and forms.

For the Australian commercial property market, the various investment options for investors are shown in Figure 1.

Figure 1 Australian property investment market



Adapted: Geltner and Miller 2001

Figure 1 depicts the structure of the Australian property investment market, with the lines linking the underlying property assets at the top with the options for the small and large investors along the bottom. The key difference between small and large investors is that underlying property and debt focused investments have large indivisible units of investment, often above approximately AU$500,000. For the small investor, exposure to property can be across equity focused intermediate investment products. The property investment choices are as follows:

Private Investment Products: represents illiquid property investments where there is no central trading place. The investment horizon is normally long term.

- **Wholesale Property Trusts:** offers large investors a share in direct ownership managed by a third party. Generally major investors are represented on a supervisory (decision-making) board.
- **Property Syndicates:** focused at small investors offering low entry costs to a managed trust ranging from a single property asset to a major diversified property portfolio.
- **Commercial Mortgages:** this is the traditional debt financing arrangement and consists of whole non-transferable commercial mortgages held by a bank usually over a defined time period.

Public Investment Products: refers to investments that are easily traded over public exchanges and so provide a range of short to long term investment horizons.

- **Real Estate Investment Trusts:** (REITs): are tax transparent, open–ended property investment vehicles that primarily hold, manage and maintain properties for investment. REITs are liquid assets and are listed and traded on the Australian stock market. An alternative Australian name for REITs is Listed Property Trusts (LPTs).
- **Commercial Mortgage Backed Securities (CMBS):** are generally pass-though securities backed by a pool of first aligned mortgage loans secured over commercial properties.
- **Property Trust Bonds:** represent an unsecured claim against the property investment vehicle, rather than a claim against the underlying properties. The issuance of Property Trust Bonds generally obliges the property investment vehicle to adhere to specified covenants. These, like CMBS, are thinly traded on a secondary market.

In identifying the property investment products, they can be divided into four capital market categories according to whether they are traded on the public or private markets and if they are either equity or debt assets.

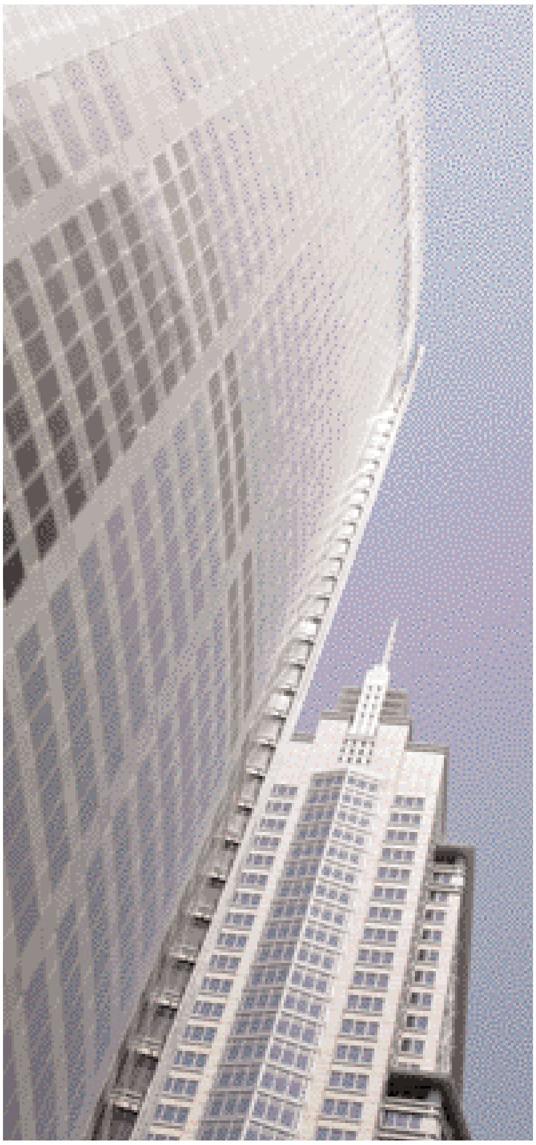
Fund of Fund Products: accompanying the main property investment products, fund of funds products offer an efficient structure for investors to gain access to a wide range of investment products. The investment horizon depends to an extent on the liquidity of the underlying investments.

- **Property Securitised Funds:** are designed to provide investors with exposure to a range of public and private property investment vehicles. Investment managers research and select funds and have access to specialist property funds that might otherwise be unavailable to investors.

In detailing the property opportunities available to investors, the sourcing of property and capital market information, definitions and coverage do vary between data providers and in some instances samples are representative of the total population. In acknowledging these limitations, commercial property can be compared with other major components of the domestic investment market. For the purpose of this research, the focus is on total stock and the investment market which is available to investors as at December 2006.

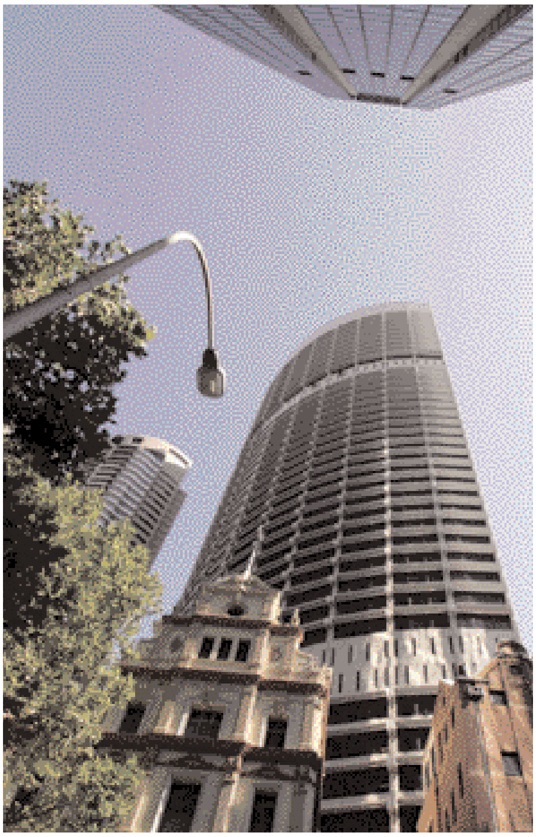
As the research focus is on the Australian investment market, the main component of the equity and debt market, household residential property has been separated and omitted as there are limited opportunities for institutions to invest in residential properties in the public equity market.

This research is structured so to examine firstly the size of the total Australian property investment market and that owned by institutions. Secondly, comparisons are then made with the global investment market (including property). On measuring the overall Australian property market, the third section looks at the value of the property investment products with a comparison to the equivalent capital market sectors. A conclusion details the key points of this study.



2 Literature review

Investment decisions inherently impact on the allocation of resources (land, labour and capital), so it is therefore critical as part of the decision making process to have exceedingly good market knowledge. More often, there is a contrast across the asset classes as to the type and level of information; specifically well documented is risk, return and liquidity information to commonly less known market size (Higgins 2005).



The size of the individual property investment markets can be determined although, like alternative asset classes in the Australian capital market, measuring the market size is difficult due to the following:

- limited disclosure on corporate assets and private investment products.
- investment products can overlap and invest in more the one investment product (for example: Fund of Funds).
- investment products can comprise different levels of equity and debt.

To overcome these issues, market size and opportunities for investors can be examined at three distinct levels. This is best illustrated by studying a specific asset class. For example, measures of the Australian investment grade commercial property market can be considered as follows: *(Adapted: Key and Law 2005)*

- Total stock: represents all institutional grade property, whether owned by investors or owner occupiers and in the public or private sectors. This includes corporate owned property which forms part of an organisation's manufacturing operation.
- Investment market: consists of all investment vehicles/assets that are available to investors in the public or private sector that have property as the core underlying constituent[1].
- Investable universe: is the total value of all institutional grade assets with all overlaps removed. Double counting can occur when assets are included in more than one investment asset class. For example: Listed Property Trusts are part of the publicly traded equity market, but the underlying properties are counted as part of the total commercial property stock.

[1]For the purposes of this research, managed funds, fund of funds (property securitised funds) and derivates, are omitted as their value simply captures the value of the equities or debt obligations they own or have the right to own in the future.

The three distinct measures can provide contrasting outcomes. For the purpose of this research, the focus is on the total stock and the investment market.

As investment opportunities become global, market depth is becoming an important part of the allocation process for major international funds (Key and Law 2005, and Hudson-Wilson 2000). This historically places the property investment community at a distinct disadvantage with their attention on local property market knowledge compared to the better informed and more transparent alternative asset classes, like the public equity and debt markets.

In acknowledging that value can be added from the unique physical attributes of property (Ling and Archer 2005), the capital market perspective is focused essentially on pricing the future cash flow and associated risk levels. This then allows property assets to be compared to and compete with other forms of capital market assets, for example, public equity (shares).

Commonly, these capital market assets which include property can be divided into four categories according to whether they are traded on the public or private markets and if they are either equity or debt assets (Geltner and Miller 2001).

The property investment products identified in Figure 1 operate within the four categories and can offer a different risk and return profile and so deliver diversification benefits. The four quadrant investment market and leading property asset classes that operate within each quadrant are illustrated in Figure 2.

Figure 2 Four Quadrant investment market and associated property investment products

	Public Markets	Private Markets
Equity Assets	**Shares** - Real Estate Investment Trusts	**Private Entities** - Unlisted Property (Wholesale Property Trusts and Property Syndicates)
Debt Assets	**Traded Debt Securities** - Commercial Mortgage Backed Securities - Property Trust Bonds	**Bank Loans** - Whole Commercial Property Mortgages

Adapted: *Geltner and Miller 2001*

Property investment strategy based on the four quadrants investment market can improve a portfolio's risk and return profile (Hudson-Wilson and Guenther 1995). In the Australian property investment market, this concept is untried as the private debt market appears to operate separately to the other three markets and traded debt securities (Commercial Mortgage Backed Securities and Property Trust Bonds) are still a relatively new property asset class.

In identifying a diagrammatic framework for the Australian investment market, the total value of the public portion is relatively straightforward. As in most public traded markets, the value of each security is known, as public trading provides constant pricing information and the number of shares (units) is a matter of public record.

On the other hand, as Miles and Tolleson (1997, p12) points out,

"…estimating the aggregated value of non-securitised or private market investment is most difficult. This results from the fragmented, non-standardised and complex nature of trading in these instruments. In addition, there is not much incentive to publicise transactions details as this can provide a competitive advantage to the owners and their representatives."

Consequently, the available estimates of the total value of many private market asset classes come from market surveys carried out by service data providers where classification and market coverage may vary.

"Property investment strategy based on the four quadrants investment market can improve a portfolio's risk and return profile"

3 Australian Property Investment Market

Various private markets form the domestic investment market. The structure of these private markets is considerably more complex than the publicly traded markets although the ABS (2007a) values unlisted shares[2] at AU$1,156 billion. This can represent an estimate measure of the private equity market and would appear to exclude household (residential property) interests.

Apart from the ABS (2007a) figure, the value of individual classes of assets is estimated using methodology and data sources appropriate for that particular asset class. For example, investment grade commercial property is one of the largest components of the private investment market. Estimates of the commercial property investment universe depend on the approach, with a top-down analysis based on a nation's economic activity (see Liang and Gordon 2003) to a more expensive in-depth bottom-up study (see Key and Law 2005, for the UK property market) which comprised extensive information on ownership structures and a value for a range of different building stock.

For Australia, Higgins (2005) selected three separate models that appeared to come together, based on overseas benchmarks, to provide a robust estimate of the Australian property investment market. To arrive at a value of institutionally owned property, the research itemised and omitted both the overseas owned properties (AU$71 billion) and development/residential properties (AU$14 billion) recorded in the PIR (2007) Australian Property Fund Industry Survey. In acknowledging data limitations, the findings in Figure 3 can highlight the Australian property ownership structure and allow comparisons to the total stock of Australian investment grade commercial property.

Figure 3 Summary of the Australian Property Investment Market

	Property Investment Market Size Total Value AU$B	Institutionally Owned Property Total Value AU$B	Market Coverage by Institutional Investors
Core Property Sector			
Office Investment Market	92	64	70%
Retail Investment Market	87	83	95%
Industrial Investment Market	52	20	39%
Sub Total	**232**	**167**	**72%**
Non Core Property Sector	217	11	5%
Totals	**449**	**178**	**40%**

[2] Unlisted shares are sourced from the ABS quarterly survey of public unit trusts. As this is a survey of investment value, ABS advises that the information should be viewed with caution.

Figure 3 outlines the size and the degree of institutional ownership of the Australian property investment market. The institutional AU$167 billion exposure to the core property sector is apportioned; office 38%, retail 50% and industrial 12%. The proportion of the retail market owned by institutions is a high 95% and would suggest that growth opportunities may centre more on redevelopment opportunities or retail transactions between institutions. Alternatively, as institutional investors own 39% of the industrial property market, a major source of future industrial property investment would be from non-institutional investors, for example: corporate owned property.

Furthermore, institutionally owned Australian properties are spread across property investment vehicles in the public and private markets. This will offer investors a different risk/return profile, as publicly listed property trusts are affected more by the stockmarket than the private market property vehicles, which are driven by underlying property fundamentals.

Figure 4 shows the different property investment vehicles and the associated value of the underlying Australian properties. It illustrates the ownership profile of the Australian investment grade property market with the well documented publicly traded market (Real Estate Investment Trusts) owning AU$98 billion of Australian investment grade property. This compares with the unlisted/private market which is formed by the less documented, institutional based AU$59 billion Direct Property Funds and the retail investment focused AU$21 billion Property Syndicate market.

Figure 4 Australian Commercial Property: Comparing Public versus Private Markets

	Institutionally Owned Property Total Value AU$B	% of Total
Public Market		
Listed Property Trusts	98	55%
Public Market	80	45%
Direct Property Funds[3]	*59*	*33%*
Property Syndicate	*21*	*12%*
Totals	**178**	**100%**

Source: PIR 2007 and author

[3] Direct property funds include the PIR classification of unlisted property trusts and wholesale property funds.

> “...institutionally owned Australian properties are spread across property investment vehicles in the public and private markets”

4 Global Property Investment Market

Investors often look at the overseas markets to assess opportunities and to compare market size. An estimate of the investment grade global property market can be based on a nation's economic activity (see Liang and Gordon 2003). This can be compared with data collected on property that is held for investment purposes by institutions. Figure 5 measures the global property market, as in the North American, European and Asian continents as well as the Australian property market[4].

Figure 5 shows the size of the global commercial property market and that held for investment purposes by institutions. When compared to overseas markets, institutions own a significant proportion (49%) of the Australian property market. This in part can be attributed to the developed Real Estate Investment Trust market with sourced quality commercial properties and the impact from the introduction of compulsory superannuation.

In providing information on the global property market, similar information can be sourced on the global equity market and the key elements that form the global debt market (publicly traded short and long term debt securities). These three components of equity, debt and property form the core portfolio allocation for managed funds (Watkins and Hartzell 2004).

Figure 6 illustrates in Australian dollars the global investment markets across the equity, debt and institutionally owned commercial property market. The global investment market size in US dollars is shown in the Appendix.

The total value of the global investment market is AU$151 trillion, and is apportioned equities AU$59 trillion (39%), debt securities AU$84 trillion (55%) and commercial property AU$9 trillion (6%). The allocation by regions illustrates the role of the US in the global investment market with approximately 40% overall market coverage. As a result, the US plays a unique role as the global capital hub and as a conduit of capital.

Figure 5 Global Commercial Property Market

	Commercial Property Market (AU$ Trillion)	Institutionally Owned Property (AU$ Trillion)	% of Commercial Property Held for Investment
US and Canada	7.7	4.3	55%
Europe	8.6	3.0	35%
Asia	4.7	1.8	38%
- *Australia*	*0.4*	*0.2**	49%
Totals	**21.1**	**9.1**	**43%**

* = RREEF 2007 figure

Adapted: Author synthesis estimates of various sources

[4] Continents outside the three main global property markets have been omitted due to low levels of investment grade property.

In accounting for 55% of the global investment market, debt securities do vary both geographically and on the role and contribution of government and private debt facilitators (McKinsey Global Institute 2005). Foremost, are the Japan and US domestic debt markets as, when combined, the AU$35 trillion represents 42% of the global debt market.

The Australian market share is AU$2.5 trillion, being just below 2% of the overall global investment market, although the percentages range across the investment sub markets. The commercial property market accounts for 2.4% of the global property market and is relatively high due to the significant proportion of Australian investment grade property already owned by institutions.

Figure 6 Global Investment Market

	AU$ Trillions	% of Total	
Equity Market			**% of Equity Market**
US and Canada	23.9	16%	41%
Europe	17.3	11%	29%
Asia	13.0	9%	22%
- Australia	*1.3*	*0.8%*	*2.2%*
Emerging Markets	4.7	3%	8%
Total Equity	58.9	39%	100%
Debt Securities - International and Domestic			**% of Debt Market**
US and Canada	34.4	23%	41%
Europe	29.3	19%	35%
Asia	12.2	8%	15%
- Australia	*1.0*	*0.7%*	*1.2%*
Offshore Centres & Int Org.	2.3	1%	3%
Developing Markets	6.0	4%	7%
Total Debt	84.0	55%	100%
Commercial Property (Institutionally owned)			**% of Property Market**
US and Canada	4.3	3%	47%
Europe	3.0	2%	33%
Asia	1.8	1%	19%
- Australia	*0.2*	*0.1%*	*2.4%*
Total Property	9.1	6%	100%
Total Investment Market	152.0	100%	

Source: Standard and Poor's 2007, BIS 2007, various (property)

5 Australian Property Investment Products

The four quadrants of the Australian capital market are defined to include public equity, public debt, private equity and private debt. The following details information on the structure and size of these individual markets alongside the associated Australian commercial property products in each quadrant.

Public Markets

The disclosure requirements in the publicly traded markets lead to detailed information, although in some instances the line between an investment and the use for household consumption is unclear. For example, ABS (2007a) details currency transactions and deposits, which could be in either group. For the purpose of this research, it is considered to be the cash component in the publicly traded market sector.

The components of the publicly traded segments of the domestic investment market are exhibited in Figure 7.

Figure 7 shows that the publicly traded markets are approximately AU$4 trillion with the traded debt securities and equities market being of similar size at just above AU$1.3 trillion. For the last 2 years, the annualised growth of these key publicly traded debt markets range from a healthy 13% to 20% per year. The Real Estate Investment Trust market did better, at 33% annual growth. This in part was driven by overseas property purchases which now represents $65 billion (46%) of commercial properties owned by REITs.

Figure 7 Australian Publicly Traded Markets

Sector	Value AU$B	Sector Share %	Annualised sector growth for the last 2 years
Publicly Traded Equities	1,390	34%	20%
- *Real Estate Investment Trusts*	136		33%
Publicly Traded Debt Securities			
- Short term debt securities	461	11%	13%
- Long term debt securities	886	22%	20%
Securitisation Vehicles	236	6%	14%
Residential mortgages	155		17%
- *Non residential mortgages*	12		18%
- Others	69		8%
Currency and deposits	1,076	27%	16%
Total Publicly Traded	4,049	100%	18%

Source: ASX 2007, ABS 2007 and Standard and Poor's 2007

Private Markets

The structure of the private market is considerably more complex than the publicly traded markets. The ABS (2007a) values unlisted shares at AU$1,156 billion. The unlisted property sector is covered by private property investment products represented by Wholesale Property Trusts and Property Syndicates. The size of theses markets are detailed in Figure 8.

Figure 8 outlines the size of the unlisted property investment market. In part the growth in wholesale property trusts is due to major REITs setting up wholesale property trusts with properties that they have under management. Likewise property syndicate growth has been affected by property syndicators restructuring their portfolio of syndicates into REITs.

Limited disclosure restricts information in the private debt market. The ABS (2007a) reports on loans and placements outstanding which can be detailed[5] as the outstanding loan liability outside the publicly traded market. As at December 2006, loans and placements outstanding are AU$1,730 billion with household borrowing the largest proportion at AU$826 billion. To match the private equity market, household borrowings[6] have been deducted to record an outstanding amount of AU$904 billion. This can be compared to survey data collected by APRA (2007) on outstanding commercial property market debt held by Australian banks (Figure 9).

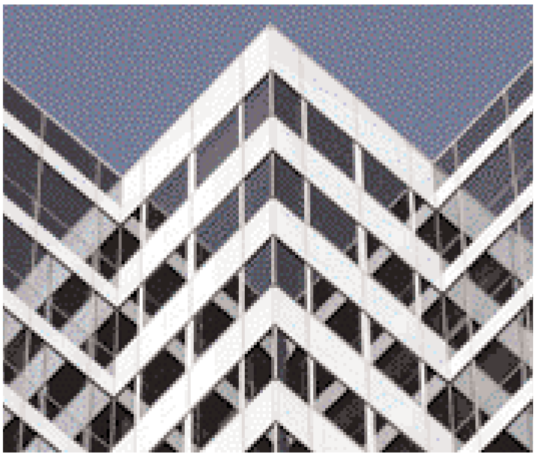


Figure 8 Summary of the Private (Unlisted) Property Investment Market

	Total Value AU$B	% of Total
Wholesale Property Trusts	56	81
Property Syndicates	13	19
Totals	**69**	**100%**

Source: PIR 2007 and author

[5] ABS explanatory notes detail "loans" as borrowings which are not evidenced by the issue of debt securities, and are not usually traded. Also "placements" are customers' account balances with entities not regarded as deposit-taking institutions.

[6] The major proportion of household borrowing (AU$639 billion) is for residential property purchases (ASB 2007b).

Figure 9 Commercial Property Debt Market – Australian Banks

	Total Value AU$B	% of Total
Core Property Sector		
Office	25	26%
Retail	19	19%
Industrial	11	11%
Sub Total	**55**	
Land development/other residential	29	29%
Other (inc Tourism)	16	16%
Totals	**99**	**100%**

Source: APRA 2007

Figure 9 details Australian banks' outstanding debt across commercial property sectors. The banks' AU$55 billion exposure to the core property sector is apportioned as follows; office 45%, retail 35% and industrial 20%. This is different to the allocation by the institutions to the core property sector and would suggest debt funding arrangements vary across property sectors depending on the ownership structure of the property investment vehicles and the underlying performance profile of the building asset/ property portfolio.

The four quadrants of the public and private, debt and equity markets can be joined together to provide an overview of the Australian investment market. Likewise, the commercial property component of each quadrant can be shown as an amount and percentage of the respective investment quadrant. Figure 10 details the Australian investment market composition.

Figure 10 Australian Investment Market – AU$6.1 Trillion

	Public Markets	Private Markets
Equity Assets	**Shares (AU$1,390 billion)** - Listed Property Trusts (AU$136billion – 9.78%)	**Private Entities (AU$1,156 billion)** - Unlisted Property (AU$69billion – 5.96%)
Debt Assets	**Traded Debt Securities (AU$2,659billion)** -Commercial Mortgage Backed Securities and Property Trust Bonds (AU$12billion – 0.45%)	**Bank Loans (AU$904 billion)** Loans (AU$904billion) - Whole Commercial Property Mortgages (AU$71billion – 7.85%)

Adapted: Geltner and Miller 2001

Figure 10 illustrates the components of the AU$6.1 trillion Australian investment market and the relative magnitude of commercial real estate assets in each section. The public debt market accounts for 44% of the Australian investment market with short and long term debt securities comprising the major share. In Australia, these are primarily issued by banks and other financial corporations (RBA 2007).

The total commercial property component of AU$288 billion represents close to 5% of the Australian investment market. The private sector commercial property market comprises approximately 49% and is distributed approximately between the debt - AU$71 billion[7] (25%) and equity - AU$69 billion (24%) markets. The publicly traded market (Listed Property Trusts) represents the largest component at AU$136 billion (47%).

[7] Commercial property debt included core property and other (tourism) sector.

6 Conclusion

There are major benefits in knowing the extent and composition of property within the Australian investment market. Opportunities for institutional investment can be identified alongside market coverage which is a key component in the allocation of capital in a fully diversified portfolio.

Competing investment classes including property can be examined in four categories, according to whether the assets are traded on the public or private markets and if they are either equity or debt assets. As at December 2006, the estimated size of the Australian investment market is AU$6.1 trillion of which Australian commercial property component represents AU$288 billion (approximately 5%). The private equity and debt market for property comprises approximately 49%, being nearly equally distributed with the publicly traded market (Real Estate Investment Trusts) representing the largest component at 47%.

In separating the equity, property and securitised debt components, the size of the Australian investment market for these assets can be compared to the global equivalent. The total value of the global investment market is AU$152 trillion, and is apportioned equities (39%), debt securities (55%) and commercial property (6%). The comparable Australian market share is AU$2.5 trillion and represents just below 2% of the global investment market. The percentage ranges across the different investment sub-markets with the commercial property sector accounting for 2.4% of the global property market. This is relatively high and is due to the significant proportion of Australian investment grade property owned by institutions.

In identifying the composition and size of the various Australian investment markets, further research is needed to explore the issue of double counting between asset classes. Once overlaps are removed, the total value for the Australian investable universe can be determined. The more knowledge gained about the commercial property position and investment opportunities in the Australian capital market, the more attractive property will be to prospective institutional investors.

“The more knowledge gained about the commercial property position and investment opportunities in the Australian capital market, the more attractive property will be to prospective institutional investors”

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Appendix

Global Investment Market in US Dollars

	US$ Trillions	% of Total	
Equity Market			**% of Equity Market**
US and Canada	18.9	16%	41%
Europe	13.7	11%	29%
Asia	10.3	9%	22%
- Australia	*1.0*	*0.5%*	*2.2%*
Emerging Market	3.7	3%	8%
Total Equity	46.6	39%	100%
Debt Securities - International and Domestic			**% of Debt Market**
US and Canada	27.2	23%	41%
Europe	23.2	19%	35%
Asia	9.6	8%	15%
- Australia	*0.8*	*0.1%*	*1.2%*
Offshore Centres & Int Org.	1.8	1%	3%
Developing Market	4.7	4%	7%
Total Debt	66.5	55%	100%
Commercial Property (Institutionally owned)			**% of Property Market**
US and Canada	3.4	3%	47%
Europe	2.4	2%	33%
Asia	1.4	1%	19%
- Australia	*0.2*	*0.1%*	*2.4%*
Total Real Estate	7.2	6%	100%
Total Investable Universe	120.3	100%	

Source: Standard and Poor's 2007, BIS 2007, various (property)

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