ASSET outlook

RENTAL GROWTH SHOULD ENSURE ONGOING GOOD RETURNS FOR KEY COMMERCIAL ASSET CLASSES IN NEW ZEALAND THROUGH 2023 AND BEYOND.

FIGURES RELEASED BY GLOBAL investment data company MSCI in December 2022 clearly show the long-term strength of some commercial property asset classes over the past 10 years. While volatile economic conditions have led to softer returns in recent months, Bayleys commercial market experts are confident predicted strong rental growth, particularly in industrial and bulk retail, should shore up future total returns.

The MSCI figures show the retail sector as the top-performing sector for the three months ending in December 2022, driven largely by the growth of the large-format retail sector.

Large-format or "bulk" retail recorded a 5.5 percent income return in the last calendar quarter of 2022, and a total return of 4.8 percent, according to the MSCI figures. That places it ahead of industrial with 4.1 percent income return for the quarter, and a total return of 2.9 percent.

Bayleys national director commercial and industrial, Ryan Johnson says the bulk retail sector has been less impacted by widespread drops in capital growth, which is why it has nudged industrial out of top spot in asset class performance.

"Long leases and the overall performance of large-format anchors like supermarkets and hardware stores, even through this inflationary period, have meant bulk retail hasn't seen the same softening of capital growth as other asset classes," Johnson says.

Over the long term, both industrial and bulk retail have proven themselves as strong performers. The MSCI figures show the industrial sector recording total annualised returns of 13.5 percent over 10 years, and 14.5 percent over five. Bulk retail has been close behind with total annualised returns of 11.5 percent over both five and 10 years.

While annualised total returns over the last calendar year were notably lower, Johnson says key market fundamentals are likely to keep fuelling rental growth for the foreseeable future, giving investors' confidence to ride out a challenging period.

"If you look at industrial, for example, it has consistently been the best performing asset class. The 10-year MSCI figures show capital returns at 6.9 percent and income at 6.3 percent," Johnson says.

"What that shows, is a really nice balance between capital growth and income. What is forecast now is for that income to remain strong, driven by rental growth. While totals for the sector might be flatter, as capital rates soften, that ongoing rental growth will ensure the sector delivers good returns in the short term."

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BAYLEYS NATIONAL DIRECTOR COMMERCIAL AND INDUSTRIAL, RYAN JOHNSON

RENTAL GROWTH

Bayleys experts across both the large-format retail and industrial asset classes are confident market fundamentals will continue to drive rental growth.

Bayleys national director industrial and logistics, Scott Campbell says strong rental growth over the past six to 12 months in the industrial sector has been driven by strong occupier demand coupled with increasing construction and land costs.

"That rental growth has been a big driver of good total returns for industrial investors. That was supported for some time by compressed yields," Campbell says.

He expects the trend for industrial rental catch up to continue as supply tightens and demand increases further in the short to medium term.

"There has been a slowdown in speculative development of new industrial sites in recent years because of pandemic disruption and uncertainty, so we will have some catching up to do to meet demand as immigration regains momentum."

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There is also strong demand driven by an increasing flight to quality as occupiers look for cubic capacity and prime locations near arterial routes and key infrastructure, Campbell says, adding that the signs are there that industrial returns will remain strong.

"There are some nerves out there over interest rates, the OCR and other economic indicators. Values are moving around but by mid-year we can expect things to have settled down a bit.

"The advice is to talk to your real estate broker, your occupiers and your bank to see where you can shore up your portfolio. There will also be opportunities for good buying in the next six to 12 months as others strengthen their balance sheets."

Bayleys national director retail, Chris Beasleigh says that the rental growth forecast is similar in bulk retail as demand outstrips supply, and developers seek to cover construction costs.

He adds that those fundamentals don't look likely to change in the near future.

"Demand for bulk retail is still high. Any time a vacancy comes up there is intense competition which pushes rentals up," he says.

"To make developments feasible, owners are having to set rents at a certain rate to cover higher costs of construction and land, so that is also driving good total returns."

Similar to the industrial sector, what has changed for investors is yields.

"Yields have dropped away. So while there is still plenty of demand and we are still seeing big transactions taking place, the yield is not what it would have been a few months ago," Beasleigh says.

He's confident rental growth will take the sting out of market changes in the short term for bulk retail which is maintaining its strength as an asset class, following a post-pandemic growth surge.

"There has been a global shift to bulk retail, it hasn't just been in New Zealand. It's a very strong sector as more retailers recognise the efficiencies offered by large format, compared to the operating expenses of being in a shopping centre," Beasleigh says.

He adds that yields, and the continuing high cost of construction, have also slowed the rate of new large-format retail developments, creating a further tightening of supply and adding to the increase in rental income.

"Yields tend to track interest rates so if we start to see a decrease in rates in about a year, yields should move with that. Hopefully, we are almost at the interest rate peak, it will just depend on how slowly it starts to come back down.

"The advice is to make the most of rental growth which should distil some of the impact of the change in yields."

ONE TO WATCH

While bulk retail remains the star performer of the retail sector, Johnson is optimistic the commercial property sector as a whole has strong fundamentals and should bounce back well, once economic volatility cools down.

The December MSCI data shows the primary retail sector returning 6.9 percent income over the last quarter in 2022, against -7.5 percent capital growth to record a total return of -1.2 percent. Over the past 10 years, the sector has earned annualised total returns of 7.6 percent.

"Neighbourhood retail centres, well-located high street retail and regional shopping centres with large land areas have all held up well in terms of income and monthly average turnover," he says. "Returns are starting to look more attractive for some of those well-located large area shopping centres."

CBD OFFICE

While the MSCI data combined with ongoing rental growth tells a story of ongoing good returns for bulk retail and industrial, the numbers are more challenging for the CBD office sector, Johnson says.

"Office has always been a really strong performer, but it has been impacted through that cap rate softening period," he says.

MSCI figures for the last calendar quarter of 2022 show CBD office recording income of 5.3 percent, against capital growth of -4.9 percent for a total return of 0.2 percent.

"We're still seeing a strong flight to quality in the CBD office sector, supported by robust supply from developments started in the past two years.

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BAYLEYS NATIONAL DIRECTOR RETAIL, CHRIS BEASLEIGH

"That supply could be more constrained going forward due to construction costs and the softening cap rates across prime and secondary, which are more pronounced in the secondary sector," Johnson says.

TOWARD 2024

The overall outlook for the remainder of 2023, is more of the same, Johnson says.

"When we are looking at figures again at the end of this year, I would expect to see that total returns have flattened more, and there will have been further softening in capital growth.

"Whilst the Reserve Bank is more cautious, financial markets are certainly pricing in a predicted drop in the lending rates by the end of the year. In that environment the advice for investors is to actively manage the assets they have to navigate through this year," he says.

But while Johnson expects all asset classes to go through a little more pain over the next six to nine months, there is still opportunity to be had in the market.

"I think the market is seeing through the volatility of the next few months and into next year. Real estate is a defensive asset class so, from an inflationary perspective, there is a natural hedge, and there is significantly more value now in commercial real estate than there has been over the past three years.

"There is also a wave of private wealth, ultra-high net wealth capital out there looking to acquire assets in 2023. That's a global trend but we're also seeing this play out in New Zealand."