Positioning Commercial Property in the Australian Investment Market

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Abstract

Commercial property is an important investment asset class that can cover the four quadrants of the Australian investment market – debt/equity and private/public markets. On available data, the extent and composition of property within these sectors can be measured and compared to the wider Australian investment market. As at December 2004, the estimated size of the overall Australian investment market is AU$5.8 trillion of which Australian commercial property component represents AU$206 billion (4%). Of this amount the private commercial property sector comprises just over 55% and is distributed between debt AU$59 billion (28%) and equity AU$57 billion (27%) market. The publicly traded market (Listed Property Trusts) represents the largest component at AU$82 billion (40%).

In separating the equity, commercial property and securitised 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$122 trillion, and is apportioned equities (35%), debt securities (61%) and commercial property (4%). 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 3% of the global property market as there is a significant proportion of Australian investment grade property already owned by institutions.

Key words: Australian investment market, statistical analysis, commercial property

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In April 2005, *The Australian Financial Review* published a summary of research on the estimated size and ownership structure of the Australian property investment market (see Higgins 2005). There was a strong response to the article, with a high number of enquires and many requests for copies of the research report [1]. The level of interest by property and the wider investment industry highlighted the need for further information on commercial property as an investment class within the Australian capital market.

As the capital market places a value on the level of accessible information from competing asset classes, property is placed at a distinct disadvantage due to no central trading place, limited transactions and the unique characteristics of individual buildings. In saying this, property should not be considered as an isolated asset class in the capital market, as financial instruments exist which enable institutional investors to have an exposure to property in different shapes and forms. For example: institutional investors can buy and sell shares (units) in equity and debt vehicles which depend on underlying property asset returns.

[1] The Australian Financial Review article "Institutions running out of assets" - 21 April 05, created a lot of interest. The feedback on the article drawing one of the largest responses this year (Tina Perinotto, 9 November 05).

The Australian capital market structure and opportunities for institutional investors [2] 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:

(i) **Total stock**: represents all institutional grade property, whether owned by investors or owner occupiers, in the public or private sectors. This includes corporate owned property which forms part of an organisation's manufacturing operation.

(ii) **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 [3].

(iii) **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, however the underlying properties are counted as part of the total commercial property stock.

Adapted: Key and Law 2005

The three distinct measures can provide contrasting outcomes. For the purpose of this research, the focus is on the investment market which is available to institutional investors as at December 2004. Research on the performance of investment vehicles/assets and the Australian investable universe will be undertaken as part of future study.

In sourcing 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.

In addition, as the research focus is on the Australian institutional investment market, the main component of the private 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 private equity market.

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[2] As the focus is on institutional investment, the smaller non traditional asset classes (for example: art collections and antiques) are excluded, as they do not form part of most institutional portfolios.

[3] 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.

This paper examines the extent and composition of property within the Australian investment market. After a brief background, this research documents first the public markets and then the more difficult private markets. The combined public and private markets are matched up to form the domestic investment market. This is then compared with available data on key asset classes in the global investment market.

Background

As investment decisions inherently impact on the allocation of resources (land, labour and capital), 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. As investment opportunities become global, market depth is becoming an important part of the allocation process for major international funds [4]. This 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, 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, shares. Commonly, these 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. A range of property investment products operate within each sector and can offer a different risk and return profile, which can deliver diversification benefits. Figure 1 illustrates the four quadrant investment market and leading property asset classes that operate within each quadrant.

[4] Please see Key and Low (2005) for discussion on the allocation of capital in a fully diversified portfolio, under the Capital Asset Pricing model and Hudson-Wilson (2000), Watkins and Hartzell (2004) for a discussion on global property diversification benefits and approaches for institutional investors.

Figure 1

Four Quadrant Investment Market

	Public Markets	**Private Markets**
Equity Assets	**Shares** - *Listed Property Trusts*	**Private Entities** - *Direct Property* *- Unlisted Property*
Debt Assets	**Traded Debt Securities** - *Commercial Mortgage Backed Securities (CMBS)*	**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 the domestic Commercial Mortgage Backed Securities market is 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.

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 (2005) details currency transactions and deposits, which could be in either group. For the purpose of this research, it is considered the cash component in the publicly traded market sector.

The components of the publicly traded segments of the domestic investment market are exhibited in Table 1.

Table 1

Australian Publicly Traded Markets

Sector	Value AU$B	Sector Share %	Annualised sector growth for the last 5 years
Publicly Traded Equities	991	33%	8%
- Listed Property Trusts	*82*		21%
Publicly Traded Debt Securities			
- Short term debt securities	366	12%	8%
- Long term debt securities	634	21%	16%
Securitisation Vehicles	185	6%	28%
- Residential mortgages	*116*		26%
- Non residential mortgages	*9*		139%
- Others	*60*		26%
Currency and deposits	816	27%	11%
Total Publicly Traded	2,992	100%	11%

Source: ASX 2005, ABS 2005 and Standard and Poor's 2005

Table 1 shows that the publicly traded markets are close to AU$3 trillion with the traded debt securities and equities market being of similar size at just below AU$1 trillion. For the last 5 years the annualised growth of these key publicly traded debt markets range from a healthy 8% to 16% per year. The Listed Property Trust market did better, at 21% per year although this was eclipsed by the growth in securitisation debt vehicles. Specifically from a low base, the domestic non-residential mortgage market [5] developed at a prohibitive 139% per annum. These sophisticated financial instruments attract institutional investors as they can offer more liquidity than in the underlying markets.

Private Markets

Various private markets form the remainder of the domestic investment market. The structure of these private markets is considerably more complex to the publicly traded markets although the ABS (2005) values unlisted shares [6] at AU$949 billion. This can represent an estimate measure of the private equity market and would appear to exclude household (residential property) interests.

[5] In addition to the growth in the domestic securitised non residential mortgage market, major Listed Property Trusts do source securitised debt funding offshore.

[6] 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.

Apart from the ABS (2005) 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 Low 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$26 billion) and development/residential properties (AU$7 billion) recorded in the PIR (2004) *Australian Property Fund Industry Survey*. In acknowledging data limitations, the findings in Table 2 can highlight the Australian property ownership structure and allow comparisons to the total stock of Australian investment grade commercial property.

Table 2

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	67	43	64%
Retail Investment Market	64	58	91%
Industrial Investment Market	39	15	38%
Sub Total	**170**	**116**	**68%**
Non Core Property Sector	184	8	4%
Totals	**354**	**124**	**35%**

Source: Higgins 2005

Table 2 outlines the size and the degree of institutional ownership of the Australian property investment market. The institutional AU$116 billion exposure to the core property sector is apportioned; office 37%, retail 50% and industrial 13%. The proportion of the retail market owned by institutions is a high 91% and would suggest that growth opportunities may centre more on redevelopment opportunities or retail transactions between institutions. Alternatively, as institutional investors own 38% 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. Table 3 shows the different property investment vehicles and the associated value of the underlying Australian properties.

Table 3

Australian Commercial Property: Comparing Public versus Private Markets

	Institutionally Owned Property Total Value AU$B	% of Total
Public Market		
Listed Property Trusts	75	61%
Private Market	49	39%
Direct Property Funds [7]	*40*	*32%*
Property Syndicate	*9*	*7%*
Totals	**124**	**100%**

Source: PIR 2004 and author

Table 3 illustrates the ownership profile of the Australian investment grade property market with the well documented publicly traded market (Listed Property Trusts) owning AU$75 billion of Australian investment grade property. This compares in the unlisted/private market which is formed by the less documented, institutional based AU$40 billion Direct Property Funds and the retail investment focused AU$9 billion Property Syndicate market.

Limited discloser restricts information in the private debt market. The ABS (2005) reports on loans and placements outstanding which can be detailed [8] as the outstanding loan liability outside the publicly traded market. As at December 2004, loans and placements outstanding is AU$1,730 billion with households borrowing the largest proportion at AU$826 billion. To match the private equity market, household borrowings [9] have been deducted to record an outstanding amount of AU$904 billion.

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

[8] 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.

[9] The major proportion of household borrowing (AU$639 billion) is for residential property purchases (ASB 2005).

This can be compared to survey data collected by APRA (2005) on outstanding commercial property market debt held by Australian banks. Please see Table 4.

Table 4

Commercial Property Debt Market – Australian Banks

	Total Value AU$B	% of Total
Core Property Sector		
Office	22	26%
Retail	17	20%
Industrial	8	10%
Sub Total	47	
Land development/other residential	24	29%
Other (inc Tourism)	12	15%
Totals	**83**	**100%**

Source: APRA 2005

Table 4 details Australian banks' outstanding debt across commercial property sectors. The banks AU$47 billion exposure to the core property sector is apportioned; office 47%, retail 36% and industrial 17%. 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.

Combined Public and Private Markets

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 part of the aggregates data. Figure 2 details the Australian investment market composition.

Figure 2

Australian Investment Market – AU$5.8 Trillion

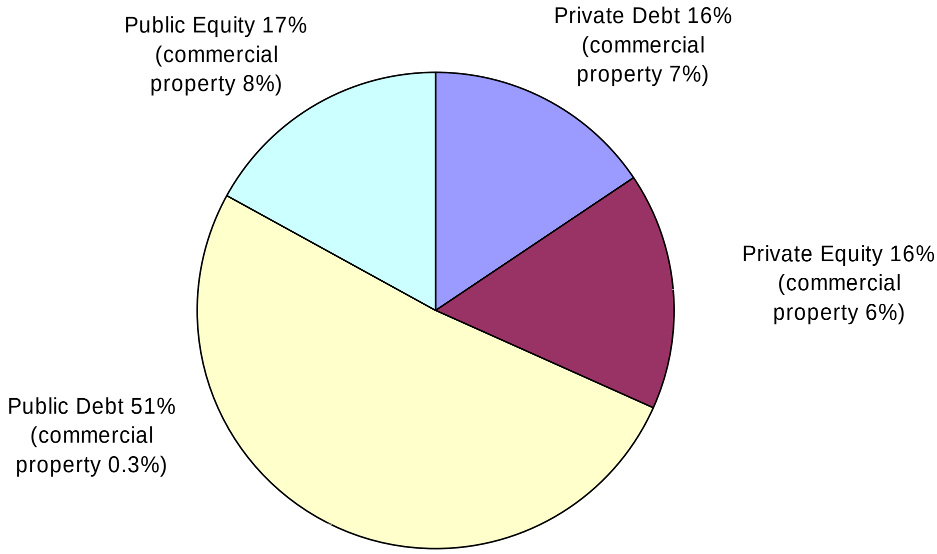

Figure 2 illustrates the components of the AU$5.8 trillion Australian investment market and the relative magnitude of commercial real estate assets in each section. The public debt market accounts for over 50% of the Australian investment market with short and long term debt securities comprising the major share. In Australia, these are primarily issued by banks and other financial corporations (RBA 2005).

The total commercial property component of AU$206 billion, represents close to 4% of the Australian investment market. The private sector commercial property market comprises just over 55% and distributed approximately between the debt AU$59 billion [10] (28%) and equity AU$57 billion (27%) market. The publicly traded market (Listed Property Trusts) represents the largest component at AU$82 billion (40%).

Global 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. Table 5 measures the global property market, as in the North American, European and Asian continents as well as the Australian property market [11].

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

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

Table 5

Global Commercial Property Market [12]

	Commercial Property Market (AU$ Trillion)	Institutionally Owned Property (AU$ Trillion)	% of Commercial Property Held for Investment
US and Canada	6.2	2.3	37%
Europe	5.6	1.1	20%
Asia	4.5	0.9	21%
- Australia	*0.32*	*0.15*	47%
Total	16.3	4.4	27%

Source: UBS 2005

Table 5 shows the size of the global commercial property market and that held for investment purposes by institutions. According to UBS (2005), when compared to overseas markets, institutions own a significant proportion (47%) of the Australian property market. This in part can be attributed to the developed Listed Property Trust market, resourced quality commercial properties and the impact from the introduction of compulsory superannuation.

In providing information on the global property market, similar can be sourced on 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).

Table 6 illustrates the global investment markets across the equity, debt and institutionally owned commercial property market.

[12] UBS figures are based on their estimated composition of the global commercial property market and that which is institutionally owned. The UBS institutionally owned Australian commercial property market data varies to the authors sourced (PIR 2004) survey data.

Table 6

Global Investment Market

	AU$ Trillions	% of Total	
Equity Market			**% of Equity Market**
US and Canada	20.7	17%	48%
Europe	12.1	10%	28%
Asia	6.9	6%	16%
- Australia	*1.0*	*0.8%*	*2.3%*
Emerging Markets	3.6	3%	8%
Total Equity	43.3	35%	100%
Debt Securities - International and Domestic			**% of Debt Market**
US and Canada	30.0	25%	40%
Europe	25.2	21%	34%
Asia	12.5	10%	17%
- Australia	*0.8*	*0.7%*	*1.1%*
Offshore Centres & Int Org.	1.8	1%	2%
Developing Markets	4.8	4%	7%
Total Debt	74.3	61%	100%
Commercial Property (Institutionally owned)			**% of Property Market**
US and Canada	2.3	2%	53%
Europe	1.1	1%	25%
Asia	0.9	1%	21%
- Australia	*0.2*	*0.1%*	*3.4%*
Total Property	4.4	4%	100%
Total Investment Market	121.9	100%	

Source: Standard and Poor's 2005, BIS 2005, UBS 2005

The total value of the global investment market is AU$122 trillion, and is apportioned equities (35%), debt securities (61%) and commercial property (4%). 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.

In accounting for 61% 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$35.8 trillion represents 48% of the global debt market.

The Australian market share is AU$1.9 trillion, being 2% of the overall global investment market, although the percentages range across the investment sub markets. The commercial property market accounts for 3% of the global property market and is relatively high due to the significant proportion of Australian investment grade property already owned by institutions.

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 and market coverage 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 2004, the estimated size of the Australian investment market is AU$5.8 trillion of which Australian commercial property component represents AU$206 billion (approximately 4%). The private equity and debt market for property comprises just over 55%, being nearly equally distributed with the publicly traded market (Listed Property Trusts) representing the largest component at 40%.

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$122 trillion, and is apportioned equities (35%), debt securities (61%) and commercial property (4%). The comparable Australian market share is AU$1.9 trillion and represents 2% of the global investment market. The percentage ranges across the different investment sub-markets with the commercial property sector accounting for 3% 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.

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