

## OCCASIONAL PAPER

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### investment strategy

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## CPI or Market Reviews?



### Key Points

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- The CPI measure of inflation is widely used throughout the commercial property industry even though it is a compilation of consumer items and nothing to do with commercial property whatsoever..
- There are several reasons for using CPI including historical, general acceptance, independence, capacity to pay and it meets investment objectives.
- However, in discussing investment objectives it is important to note the role CPI plays in tax, depreciation and within the portfolio context..
- If the investment objective is to provide a long-term hedge against inflation and the income of a property asset is CPI-based, can investment objectives be met? This paper shows market rents can outstrip CPI growth for all commercial property assets, but not all the time. This means an active management strategy is critical to maximising income returns..
- Commercial property is not a “set-and-forget” investment proposition. Property can be leveraged, it should be actively managed (leasing, capital expenditure, development and redevelopment) and it should be traded..
- This paper also looks at potential alternatives to the CPI.

## Introduction

The Consumer Price Index (CPI) measure of inflation is used extensively throughout the commercial property industry – often to determine rental increases. The purpose of this occasional paper is to examine why the CPI is used, to determine whether the CPI adequately meets objectives and whether there are alternatives. This paper will also examine the implications of using CPI for commercial property returns and investment management.

TABLE 1: CURRENT WEIGHTING PATTERN FOR THE CPI

Item	Percentage
Food	15.44
Alcohol and Tobacco	6.79
Clothing and Footwear	3.91
Housing	19.53
Household contents and services	9.61
Health	4.70
Transportation	13.11
Communication	3.31
Recreation	11.55
Education	2.73
Financial and Insurance Services	9.31
<b>All Groups</b>	<b>100.00</b>

Source: ABS 6430.0

## CPI defined

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The Consumer Price Index “provides a general measure of changes in prices of consumer goods and services purchased by Australian households.” An important point to note is the CPI is a **measure of changes in prices**. The CPI is not a measure of price levels. As an example, if fruit and vegetables had an index of 110 and meat had an index of 120 it does not mean meat is more expensive than fruit and vegetables but rather the price of meat has increased at twice the rate of the price of fruit and vegetables.

Another important point to note is the CPI is not a measure of purchasing power or of changes to the cost of living. The CPI is a measure of price inflation of a basket of consumable items.

The basket of items does not include “cost of living” items such as interest payments and various taxes and charges which are everyday “cost of living” expenses.

The Australian Bureau of Statistics produces a number of different price indexes including the Producer Price Index, Export & Import Price Indexes and Construction Cost indexes to name a few.

## Why CPI?

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From the information in Table 1 it can be clearly seen the CPI contains nothing in any way relating to commercial property. We are left asking ourselves: “Why do we use the CPI to determine so much of the income growth of commercial property?”

Several reasons spring to mind:

1. Historical reasons. “It’s the way we’ve always done it!” This does not look like a particularly good reason.
2. General acceptance. The concept and term “CPI” is commonly understood. Everybody dealing with commercial property leases understands and accepts the CPI from the tenant, to the solicitors, the leasing agent and the landlord.
3. Independence. The CPI is published by the Australian Bureau of Statistics. It is accurate, timely and reliable. Moreover, the CPI can be traced back to 1948 and as such is an indicator which is a known quantity. Everybody who uses the CPI has an expectation of its future amount based on their familiarity with the measure. The CPI is also an indicator which is widely forecast. It also comes with the following disclaimer:

“...it is important to carefully consider the range of available indexes and select the index which best meets the specific requirement. While the ABS can provide technical and statistical guidance, it does not provide advice on indexation practices and it cannot tell users which index they should use. These are matters for users to determine.”

4. Capacity to pay. The appropriateness of the use of the CPI also relates to tenants as much as to owners. The income growth of a tenant (ie. the revenue growth generated by a business) can be closely linked to CPI increases. The use of the CPI, therefore, is more palatable to a tenant especially when the tenant wants to contain and quantify costs going forward.

5. The use of the CPI meets investment objectives. This is where the discussion begins to get interesting. Most investors have very different objectives and constraints, yet so much of their rates of return must be similar due to the use of CPI to determine income growth.

## Investment objectives

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### TAX

The tax situation of individuals is markedly different to those of companies which is different again to superannuation funds and this alone would create vastly differing rates of return. The vehicle in which you house your investments will have a large bearing on your returns. Taxation, whilst not the "be all and end all" of the investment decision, is an important factor in the investment process. How does tax affect the investment decision? As an example, an asset purchased prior to September 1985 for the purpose of profit is not subject to capital gains tax (except in a complying superannuation fund). The capital gain on assets purchased between September 1985 and September 1999 is subject to indexation. For assets purchased from 21 September 1999 onwards the capital gain is a flat unindexed rate which varies depending on the type of investment vehicle. Those investors who purchased an asset between September 1985 and September 1999 have the option of choosing indexation or the flat unindexed rate. Those investors who purchased an asset after September 1999 and have held the asset for twelve months or more apply their top marginal rate to half the capital gain.

It seems safe to assume all investors require, as a minimum, a rate of return equal to the risk free rate of return (6.25% for 10-year bonds as an example) plus an additional amount to account for the risk undertaken (say 3.75% for commercial property). It follows, if the average capitalisation rate for prime commercial property is 7%, then investors require 3% per annum capital growth to meet their risk adjusted total return of 10%.

The income tax rate of a high income private investor is 47% (plus medicare), for a company – 30% and a superannuation fund – 15%. Assuming the asset is held for more than 12 months the Capital Gains Tax (CGT) is applied as outlined above.

When indexation existed, the tax rate payable affected the investment decision by altering the rate of return needed to break even as follows:

$$\frac{\text{Inflation}}{1 - (\text{Tax Rate} - \text{Inflation})}$$

From September 1999, indexation ceased and the flat rates of CGT now apply. This has served to skew the preference of certain types of investors towards either capital growth OR income generation depending on the way it is taxed.

If we were to take a commercial property with a capitalisation rate of 7.5% and CPI income growth of say 3% per annum (no capex, no debt, no depreciation) then the annualised 10 year return on every dollar invested is as follows:

**TABLE 2: COMMERCIAL PROPERTY RETURNS FOR DIFFERENT TAX RATES**

	Gross return of asset	Individual	% of gross	Company	% of gross	Super'n fund	% of gross
Capital	2.9%	2.2%	76%	2.0%	70%	2.6%	90%
Income	8.6%	4.4%	51%	6.0%	70%	7.3%	85%
Total	11.5%	6.6%	57%	8.0%	70%	9.9%	86%

Source: Savills Research

Taxation substantially skews income and capital returns. The bias is large enough to warrant the adoption of different investment vehicles and a bias in favor of capital returns as opposed to income returns. Investors of all types should require income growth substantially higher than CPI in order to generate stronger capital growth.

## DEPRECIATION

Depreciation benefits are another important factor – commercial buildings constructed after 20 July, 1982 provide the investor with certain tax concessions namely building, plant and equipment depreciation.

## PORTFOLIO CONTEXT

It is widely believed commercial property in a portfolio context can play many parts:

- (a) CPI inflationary hedge
- (b) Smooth returns and reduce volatility
- (c) Match liabilities more perfectly

There are a great many papers written on the attributes of property within a portfolio and it is not my intention to go over the ground here, but rather investigate the use and appropriateness of the CPI measure of inflation in commercial property investment. So, let us look at this in more detail.

## Does CPI work?

If investment yields remain relatively stable over time (which it appears they do) then market rental growth needs to equal or exceed CPI inflation in order for commercial property to be regarded as a hedge against inflation.

**TABLE 3: QUARTERLY CPI AND CBD OFFICE GRADE A RENTAL GROWTH**

	NSW	VIC	QLD	SA	WA
Quarterly periods observed	150	137	91	147	131
State CPI	1.50	1.49	0.96	1.53	1.41
A Grade Rent	4.82	2.87	3.35	2.57	12.80

Source: Savills Research

Growth in Grade A CBD office property market rents has outstripped inflation in all mainland CBD office property markets in Australia over the last 35 years. However, there have been periods where market rental growth has outstripped inflation and periods where inflation has substantially outstripped market rental growth however, on balance, over time CBD office property has effectively hedged inflation. In the period 1978 to 1988 rental growth tripled the rate of inflation. The period from 1994 to the present has seen rental growth in Melbourne and Sydney outstrip inflation by seven times in Sydney and an extraordinary sixteen times in Melbourne. (See Figures 1 and 2).

**TABLE 4: QUARTERLY CPI AND INDUSTRIAL RENTAL GROWTH**

	NSW	VIC	QLD	SA	WA
Quarterly periods observed	131	131	78	127	102
State CPI	1.38	1.39	0.80	1.35	1.05
Industrial Rent	3.40	4.57	0.93	2.87	2.54

Source: Savills Research

Growth in the level of prime inner-city industrial property market rents has generally outstripped growth of CPI inflation in the eastern seaboard property markets in Australia over the last 33 years. There have been periods where market rental growth has outstripped inflation and periods where inflation has substantially outstripped market rental growth. However, on balance, over time industrial property has effectively hedged inflation.

**TABLE 5: QUARTERLY CPI AND SHOPPING CENTRE INCOME GROWTH**

	Regional	Sub-Regional	Neighbourhood	Bulky Goods
Quarterly periods observed	87	87	87	52
National CPI	0.91	0.91	0.91	0.69
Centre Income	2.61	4.12	2.53	2.03

Source: Savills Research

Growth in Regional shopping centre income has kept pace with inflation in almost all mainland metropolitan areas in Australia over the last 22 years. There have been periods where centre income growth has outstripped inflation and periods where inflation has substantially outstripped centre income growth. However, on balance, over time Regional shopping centres have effectively hedged inflation.

## Enhancing returns

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Having arrived at the figures in Tables 3, 4 and 5 we should pause to reflect on the fact, over the periods analysed, commercial property rents have struggled to keep pace with inflation. If commercial property income is a function of market rent reviews and CPI-based rent reviews, then over time the property loses money. The tenants are not paying for the depreciation of the plant and equipment they use and the building in which they reside. If we take into account the following facts:

- building income is a function of market and CPI rent reviews;
- the building and its plant and equipment are depreciating; and
- the owner of the building has to pay tax on income and capital returns;

then, on our numbers, commercial property, *prima facie*, loses money regardless of the location and regardless of the asset class. We also know intuitively this is not entirely true. It may be true sometimes, but not all of the time.

1. Property can be geared. Commercial property can be geared to as much as 70%, which changes the return on equity ratio into a much healthier looking number. Of course, the purists will then tell us that we are no longer investing in property with its inherent risks and rewards but rather debt and its inherent risks and rewards.

2. Property can be actively managed. Properties can and do enjoy better returns within a marketplace because they are well managed. Retail properties, particularly enclosed shopping centres, are a classic example as are high rise CBD office towers.

3. Property can be traded. The old adage “buy low, sell high” has been replaced with the new adage “it’s not *timing* the market, *it’s time in* the market.” This may be true of the equities market where a large proportion of the gains are made on a handful of days but it is not true of commercial property markets. We need only have reference to Figures 1 and 2, which illustrate the long-term cyclical nature of property returns.

4. Property can be developed, re-furbished and redeveloped. Extensions, the adoption of new technology, a new façade, lobby, lifts, air conditioning – the regeneration and enhancement of old buildings not only extends their useful life in a cost effective manner, but can reap excellent returns on investment.

The point is commercial property must be actively managed. There must be a balance between debt and equity in order to enhance return on equity. First class management of property should ensure an appropriate mixture of tenants, lease expiries and lease structures, below average vacancies and letting up periods and a passing income within five percent of market income.

Property can, and should, be traded. Commercial property markets, relative to other asset classes, do go through periods of under-performance. This is also true of the sub-classes of commercial property. The same can be said for geographical differences. Timing is everything.

Of course, commercial property is now the only asset which can truly match fund liabilities. A superannuation or life insurance fund may have an average liability of 35 years. Because you cannot buy 35 year bonds and you cannot bank on the cashflow of companies for more than a decade these days, it would seem the only dependable asset which has a life of 35 years plus is commercial property.

## Alternatives

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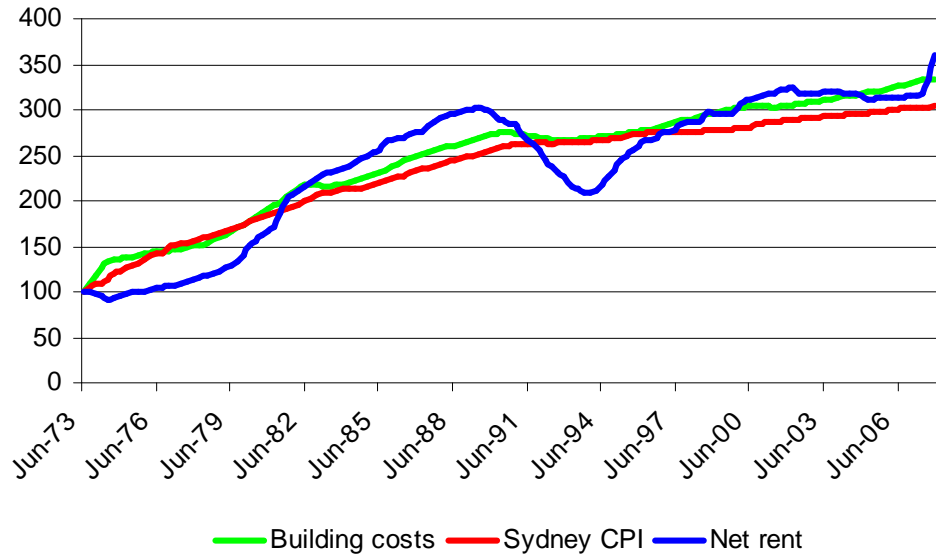
Is there an alternative to CPI? The short answer is no. Even if there were an alternative to CPI what would it achieve? If there is no link between the cashflow of a tenant and the index provided then there is little point in using it. Try creating an index to be used in a 15-year lease with no guarantee the organisation creating the index will still be in business in 15-years time. If we are to use a new index then how do we get general acceptance when there is no history? Business cannot and will not sign to an unknown quantity. We must also ask "What is the purpose of rent reviews, be they CPI, market or fixed escalations?" If the purpose is to receive a return on construction, then over what period of time should we hope to receive the return? Should it be 10 years, 20 years or 30 years?

We could use some sort of construction cost index but the difference between CPI and the index is so small. (See Figures 1 and 2).

# CPI or Market Reviews?

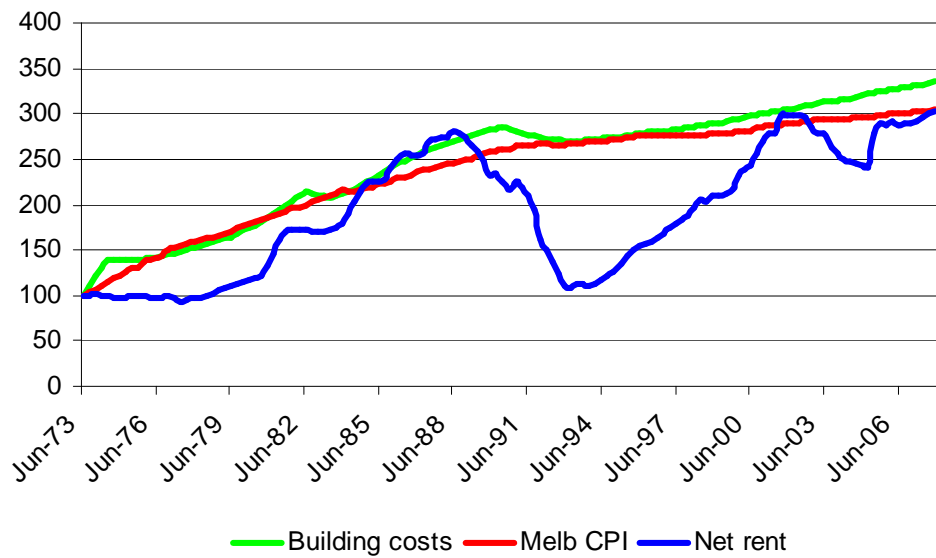


Figure 1: New South Wales CBD Office



Source: Savills Research, ABS, Rawlinsons

Figure 2: Victoria CBD Office



Source: Savills Research, ABS, Rawlinsons

## Conclusion

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The Consumer Price Index measure of inflation is used extensively throughout the commercial property industry to determine rental increases due to its general acceptance, its independence and the capacity to pay on the part of tenants. It is doubtful the use of the CPI can meet the objectives of all investors given different tax rates and the fact, over the long term, commercial property income returns barely keep pace with CPI inflation. This implies commercial property, in general, is not a passive investment but an investment which must be actively managed. Commercial property returns must be enhanced through the use of debt, tenant mix, lease expiry risk, trading, development and refurbishment.

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