CBRE

Intelligent Investment

2024

New Zealand Market Yield Outlook Update

Prime Commercial and Industrial Property

REPORT

CBRE RESEARCH
September 2024

Insights

- The Prime commercial and industrial property market is currently influenced by declining interest rates and weakening market rental growth. This is expected to continue in the next year or so. How this trend will influence property yields is a key question for yield forecasting.
- To enhance the forecasting outcomes during market turning points, CBRE Research has refined its market yield forecasting model through a closer analysis of cyclical turning points to predict yield movements in the next two years.
- 10-year bond rates have the closest long-term relationship to property yields across cycles. However, when examining the last two cyclical market turning points, it becomes evident that swap rates exhibit a stronger relationship with yields during these periods.
- CBRE's econometric analysis indicates yields respond to changes in interest rates with a delay of two quarters in the last three major market turning points. Our model also shows that compared to the historical average, yields are less sensitive to interest rate changes during a turning point. This means that a given rate of interest rate movement produces a lesser movement in yields at these points in the cycle.
- Nonetheless, recent and future anticipated interest rate decreases will result in declines in Prime commercial and industrial property yields. This will happen in the face of a challenging occupancy and rental environment.
- As interest rates stabilise in 2026 and market rental growth rebounds, yields will continue to firm, albeit at a more gradual pace. Rental growth will play a more important role in this process. Therefore, we forecast yields will firm by 30 bps to 6.50% by Q1 2025, and firm more gradually to 6.13% by the end of 2026.
- The margin between average prime commercial and industrial yields to swap rates is forecast to expand to 293 bps by the end of 2026, larger than recent margins which have been below 200 bps but 150 bps lower than the average post-GFC margin.
- Since late 2020 CBRE Research's market yield assessments have become somewhat disconnected from the average of adopted valuation cap rates observed in published book values of listed property portfolios and it is uncertain how our forecast market yield declines during 2025-2026 may flow through to actual portfolio values. Whilst market yields may firm by the forecast average of c.70 basis points to the end of 2026, the magnitude and timing of adopted valuation cap rates and resultant portfolio value improvements could be quite different.

Note: All references to CBRE's assessed and forecast property yields in this report are in relation to the average market yield of Prime Commercial and Industrial property.

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Interest rate trends and market yield implications

Medium/long-term wholesale interest rates have fallen significantly since early July as markets anticipated the RBNZ's monetary policy tightening cycle coming to an end. This was confirmed on 14 August with a 25 bps OCR cut to 5.25%. The RBNZ also indicated that there would be a series of OCR cuts during 2025 and 2026, leading to rates falling by 250 bps to 3.00% in this cycle. Due to the underlying weakness in the economy, there is potential for interest rates to go even lower.

These trends are bringing a renewed focus on the outlook for property yields, an area that CBRE Research explored extensively earlier this year in two published reports (New Zealand Interest rate outlook and its property yield implications, Cap Cate Drivers and Outlook Study) The latter report describes our detailed modelling of the variables that determine property yield movements and analyses how movements in these variables influence the property yields.

In this report, we further refine our model and explore how the variables that influence yields the most, being 2-year swap rates, 10-year bond rates, and rental growth, will manifest themselves. This is especially important as;

- 2-year swap rates have moved significantly (-100 bps since 1 July) more than 10-year bond rates (-30 bps since 1 July).
- lower interest rates could support firming yields, but the rental growth outlook is also softer due to more challenging economic and occupier conditions.

Figure 1: Recent Interest Rate Movements (1st July to 2nd September)

Source: RBNZ

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Refining CBRE's model for greater forecasting accuracy around cyclical turning points

In our June report, we developed a market yield forecasting model based principally on the long-term relationship between rental growth and 10-year bond rates. As shown in Figure 2, the model provides a statistically significant relationship over the past 30 years.

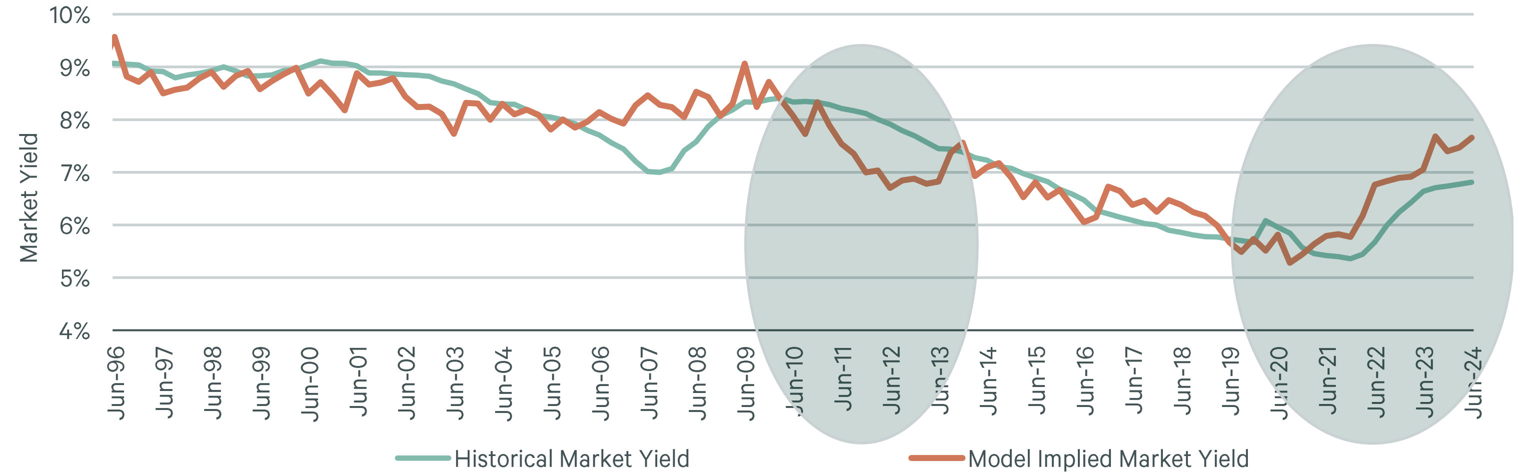
However, there are two notable periods (2010~2013 and 2020~YTD 2024) where the model's accuracy in predicting yields diminished. In both, the main difference between the model's predictions and the actual data is the speed of change around the market cyclical turning points. To address this issue, we have refined our approach by modelling these specific periods to better capture turning points.

Our refined forecast model includes two different coefficients for market turning points and the long-run average. Figure 3 shows how this change in the model enhances our forecasts, particularly for the last four years, which witnessed a sudden and significant change in interest rates.

Importantly, in predicting yield movements since 2020, the model replaces 10-year bond rates with 2-year swap rates, as the latter had a more substantial influence over this period. These findings are crucial for predicting yields in upcoming quarters, as 2-year swap rates have moved significantly recently (see Figure 1). Additionally, modelling the turning point indicates yields respond to changes in interest rates with a delay of two quarters.

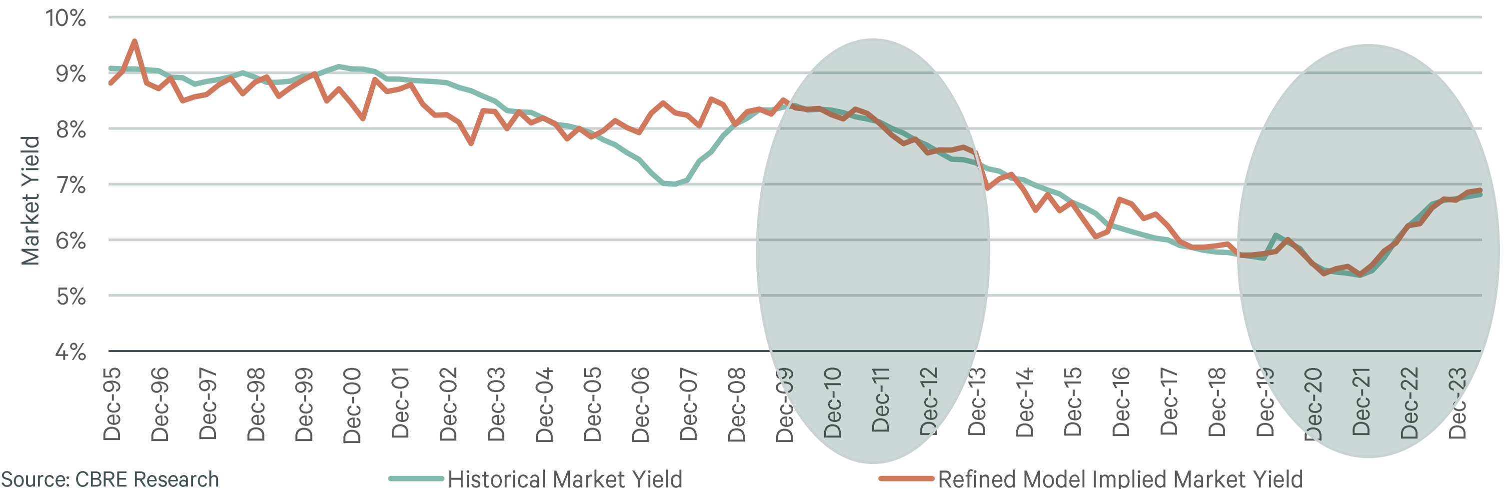
The additional insight is that whilst market rental growth prospects influence yields, interest rate movements trump the influence of potential rental growth. Interest rate's influence on yields is 2.6 times stronger than rental growth.

Figure 2: Actual Historical and Model Implied Average Prime Commercial and Industrial Market Yields– Original Model (10-yr Bond Rate and Rent Growth)



Source: CBRE Research

Figure 3: Actual Historical and Model Implied Average Prime Commercial and Industrial Market Yields – Refined Model (2-yr Swap Rate Around Turning Points and Rent Growth)



Source: CBRE Research

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The outlook for interest rates, rents and property yields

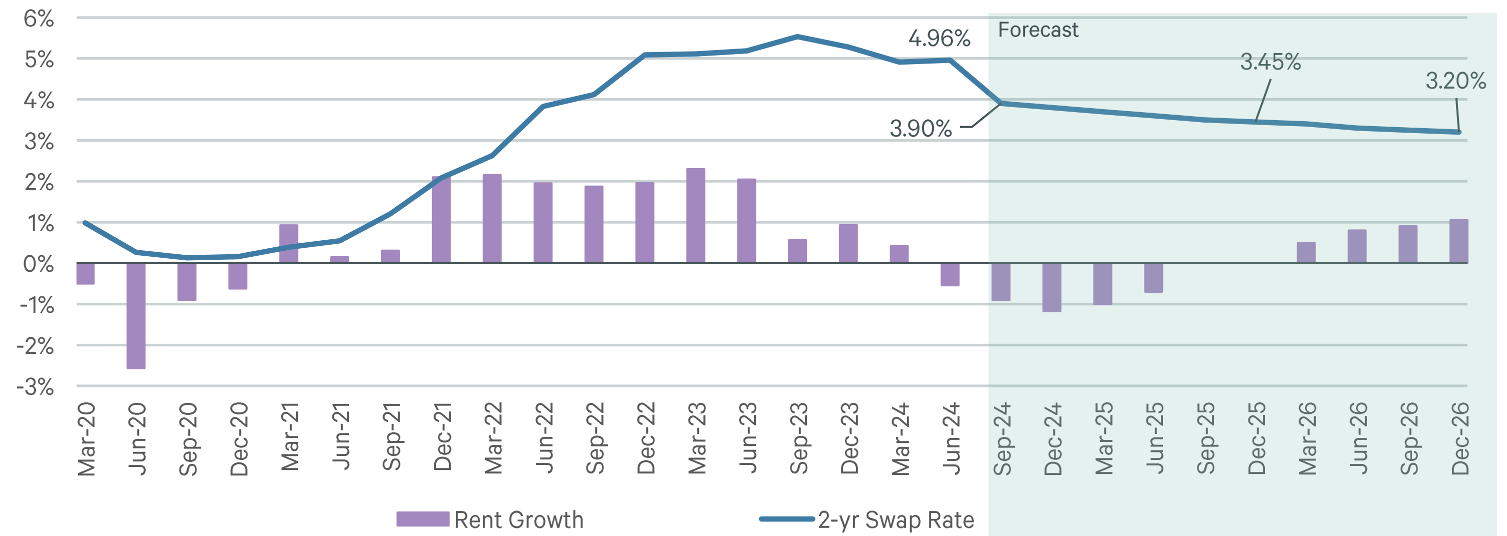
Figure 5 shows the refined model's prediction for yield movements to the end of 2026 based on 2-year swap rates and rental growth. As shown in Figure 4, swap rates are expected to remain at around 3.90% in Q3 and then firm gradually to 3.20% by the end of 2026. Rents are forecast to decrease by 3.7% from Q3 2024 to Q2 2025, but then will rebound reaching +3.3% in 2026.

Based on these swap rate and rent growth forecasts, yields are anticipated to firm in Q1 2025 by an average of circa 30 bps and continue this firming process at a slower pace thereafter. This pattern is consistent with previous cyclical turning points where yields followed 2-year swap rates with an overall delay of two quarters and were less sensitive to 10-year bond rates, and substantial interest rate movements had a more material impact on yields than the rental growth outlook. At the same time, as we discussed in our previous report, there isn't a direct 1 to 1 relationship between interest rate and yield movements. Our analysis shows that a 100 bps decrease in swap rates during a cyclical turning point, such as the one we are currently experiencing, only results in circa 30 bps yield firming.

In 2026, interest rates will remain relatively stable compared to the recent fluctuations, with some gradual firming still expected. In contrast, the leasing market is expected to begin recovering and rental growth will contribute to yield firming in 2026, although this firming will be less robust than 2025 which will be primarily driven by the more substantial interest rate firming.

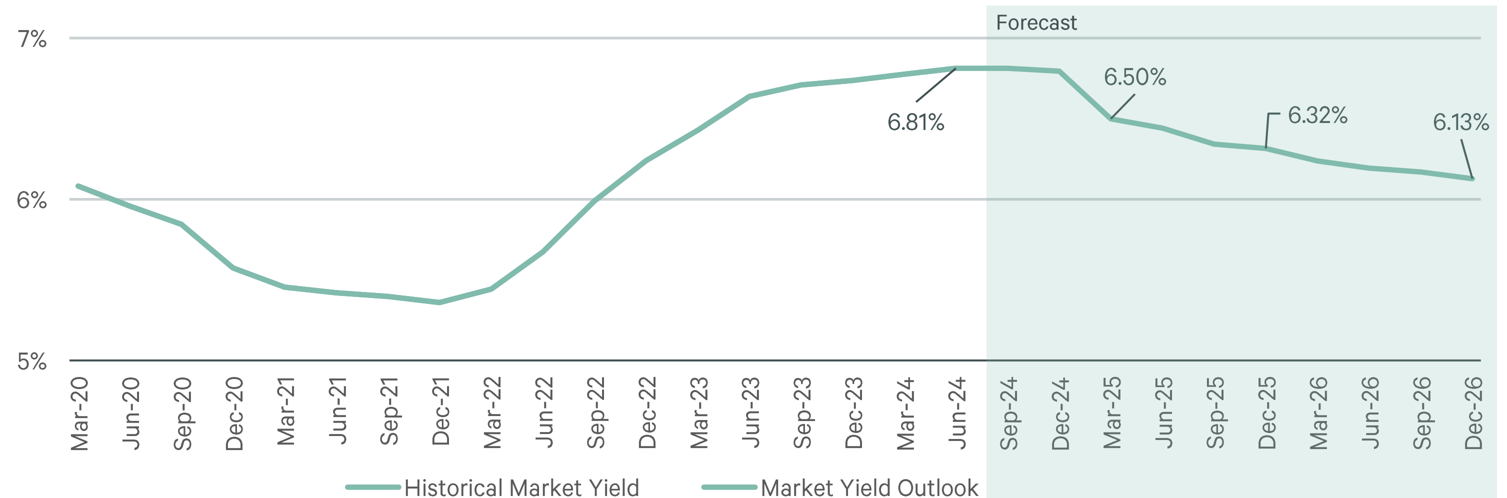
Investment market liquidity is not a variable in our model, but RBNZ data shows that commercial lending is starting to pick up. In addition, only 1% (and starting to reduce) of commercial property loans are nonperforming, suggesting that the risk to yields from highly motivated vendors under selling pressure is low.

Figure 4: Historic and Forecast Average Prime Commercial and Industrial Rent Growth and 2-yr Swap Rate



Source: RBNZ, CBRE Research

Figure 5: Historic and Forecast Average Prime Commercial and Industrial Market Yield



Source: CBRE Research

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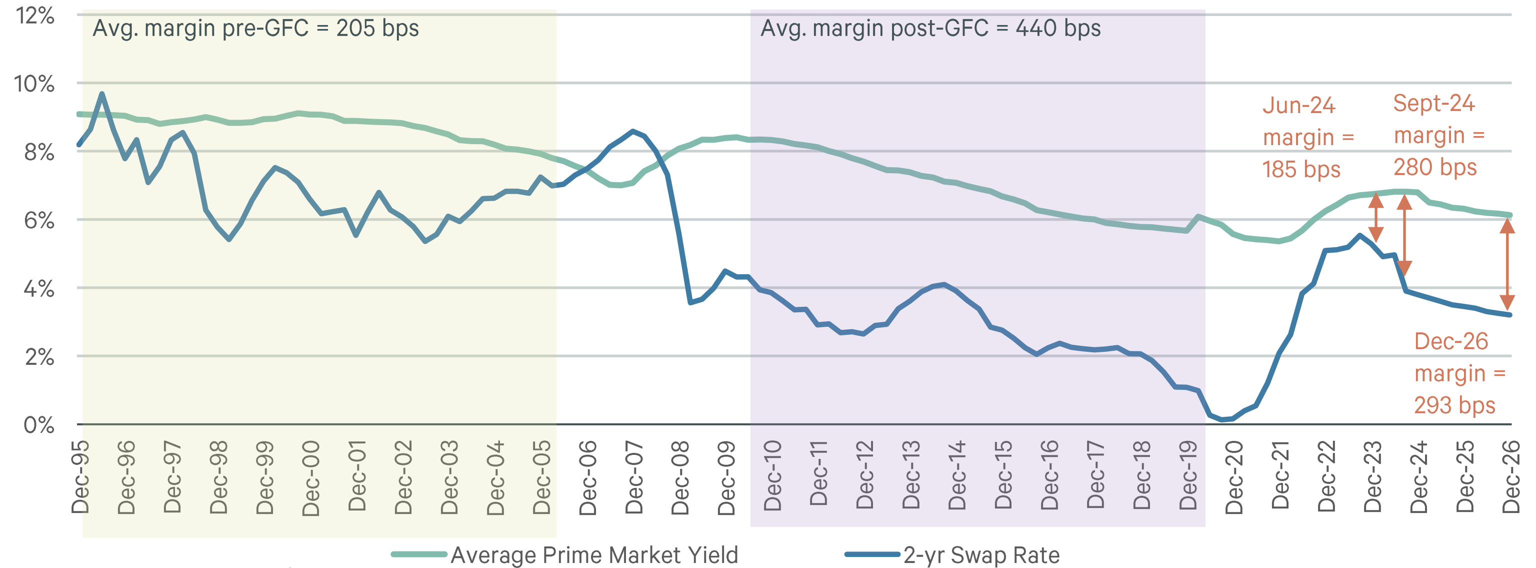
Property yield to interest rate margins vs CBRE's yield model forecasts

The industry's standard approach to gauging the appropriate level of property yield is to consider their relative historic margins to interest rates. Our yield forecast model takes a different (we think better) approach, but we consider it useful to compare historic interest rate to yield margins and what these imply for the future, as well as how they compare to our model's forecast.

Looking at historic yield to interest rate margins, an obvious questions is what period is the most reliable indicator of what these margins should be? Figure 6 shows that in the pre-GFC period the average margin was 205 bps. In the post-GFC pre-Covid period, this margin averaged 440 bps. This compares to a margin of 185 bps in June this year, that with the recent movements in 2-year swap rates widened to 280 bps in September. Based on which period one picks, it can be argued that yields should fall substantially, or not at all, in response to recent and expected forthcoming interest rate falls.

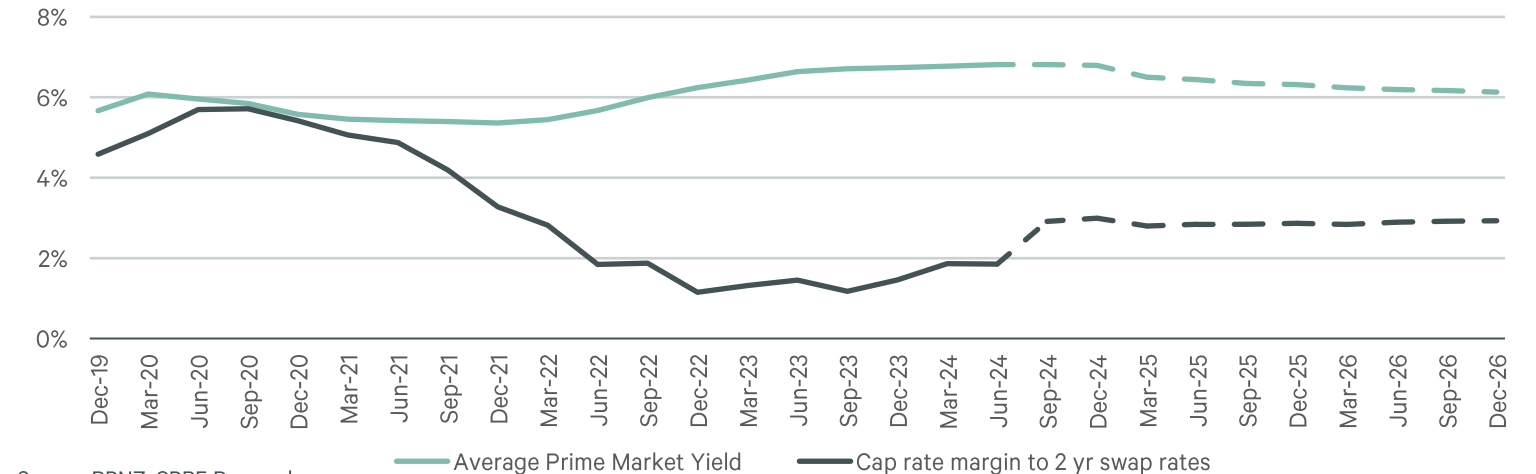
Our model suggests that the c110 bps decline in 2-year swap rates in H2 this year will produce a c30bps decline in average Prime commercial and industrial property yields during Q1 next year. Subsequently, the further 60 bps decline forecast for swap rates would produce a 26 bps decline in yields from Q2 2025 to Q4 2026. However, the positive impact of improving occupier market conditions and subsequent rental growth improves yield firming to 37 bps during this period. From a yield to swap rate margin perspective this means that the current 280 bps margin will largely be maintained/expanded slightly over the next two years.

Figure 6: 2 yr Swap Rates and Average Prime Commercial and Industrial Property Market Yields



Source: RBNZ, CBRE Research

Figure 7: Average Prime Commercial and Industrial Property Market Yield Margins to Interest Rates



Source: RBNZ, CBRE Research

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CBRE research assessed market yields vs published valuation cap rates and share price implied cap rates

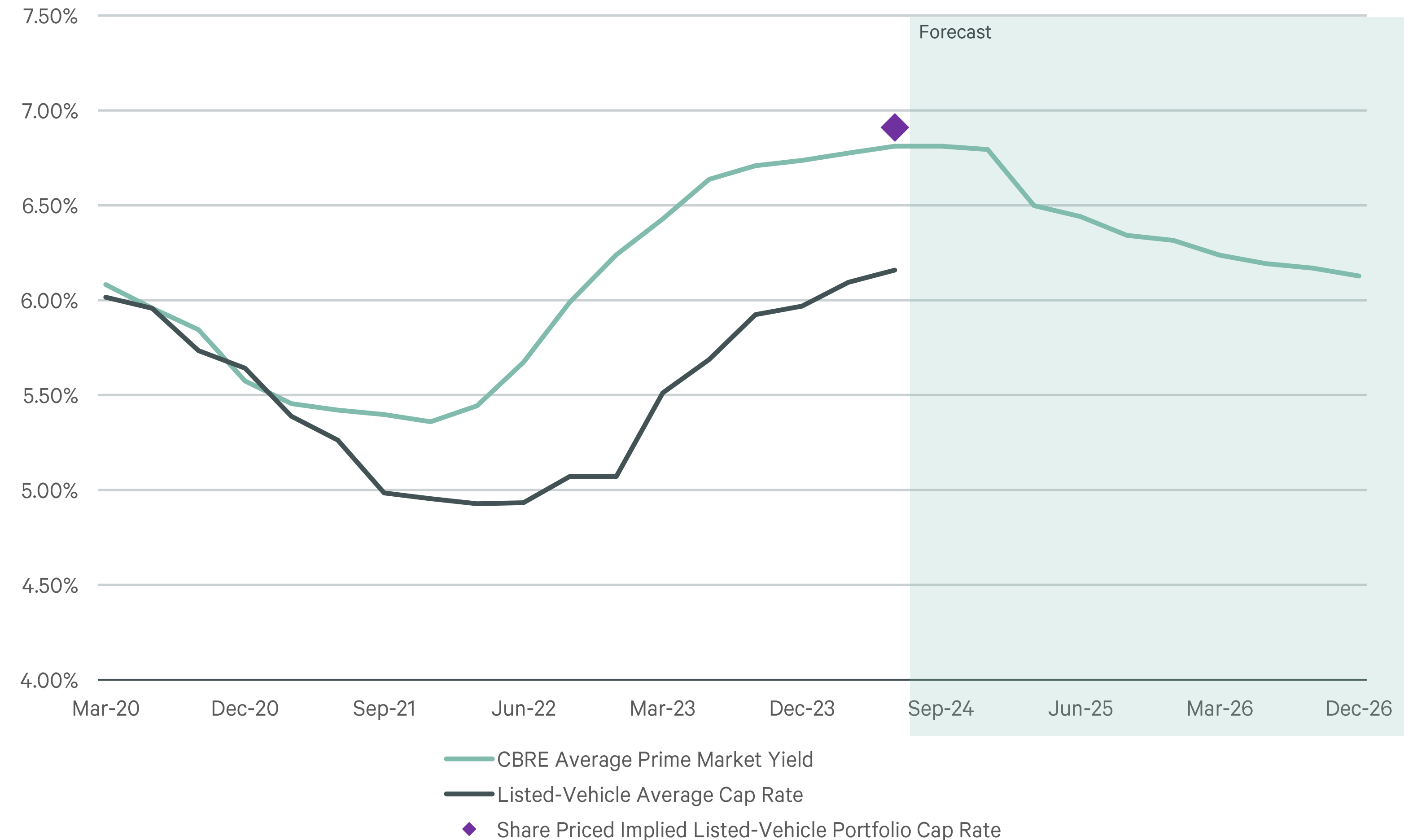
CBRE Research's quoted market yields are based on quarterly assessments that consider transactional evidence but also focus on in-house capital market interactions with buyers and purchasers and available bidding statistics. These provide more nuanced insight into market pricing beyond transactions, and their importance becomes greater in periods of low transaction volumes. Interestingly, the share price implied average yield of listed portfolios has sat quite close to (10 bps above) CBRE market assessments.

As shown in Figure 8, our methodological approach shows that since 2020 our market yield assessments have become somewhat disconnected from the average of adopted valuation cap rates observed in published book values for listed property portfolio's. CBRE's assessed market yields firmed less than average adopted valuation cap rates in 2021, started increasing in early 2022, about nine months before shown in published valuations, and increased at a higher rate to date (145 bps vs 123 bps). However, valuations have started to close the gap in recent quarters.

There could be various reasons behind the disconnect between CBRE Research and adopted market valuation cap rate assessments such as variations in the composition of listed property portfolios compared to CBRE Research's basket of buildings and methodology differences.

The important point in the context of our market yield forecasts is the anticipation of how the declines in market yields during 2025-2026 may flow through to actual portfolio values. Given the current gap, whilst market yields may firm by the forecast average of c.70 basis points to the end of 2026, the magnitude and timing of adopted valuation cap rates and resultant portfolio value improvements could be quite different.

Figure 8: CBRE Market Yield vs Listed-Vehicle Portfolio Cap Rate and Share Priced Implied Listed-Vehicle Portfolio Cap Rate



Source: CBRE, Forsyth Barr analysis of share price implied cap rates and listed vehicle average cap rates

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