

Property market review

An overview of Australian core commercial property sectors

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Executive summary

- The Australian economy, although slowing, remains solid driven by domestic demand and the resources boom. Price pressures have emerged as a problem and have motivated the RBA to tighten monetary policy twice so far in 2008. Nevertheless, the inflation figure of 4.5% for the year to June 2008 was higher than the market consensus estimate of 4.3%. The short-term outlook for further interest rate rises remains uncertain due to a lag between economic activity and inflation.
- Property investment, across all core sectors, has been adversely affected by the credit crisis. The increased cost of debt and a lack of interest from investors have resulted in yields softening and a decrease in transactional activity. Stock for sale is likely to increase throughout the remainder of 2008 as owners attempt to de-leverage.
- Demand within CBD office markets has turned sluggish due to heightened financial market volatility and a slowing domestic economy. While vacancy rates are set to rise, the overall impact on rents should be moderate due to low vacancy rates, which are currently well below their natural levels, and limited supply.
- The retail sector is also expected to moderate over the short-term with retail sales softening in 2008. Lower demand is likely to reduce the pace of rental growth, although growth is expected to remain positive.
- Rental growth is also slowing in most industrial markets while yields have started to soften. Of concern is the amount of supply coming online this year, much of which is uncommitted, and is thus likely to put additional downward pressure on rental growth.

1. Introduction

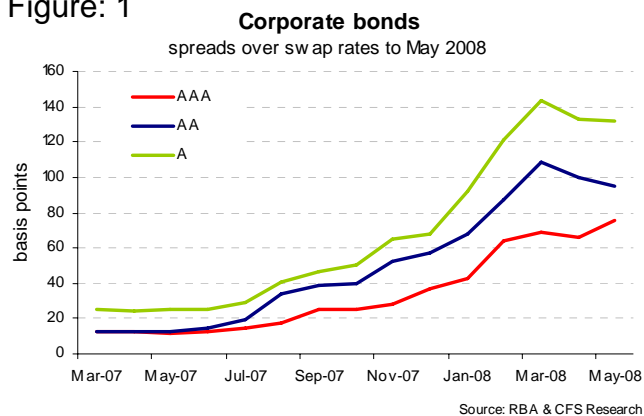
This report provides an overview of the Australian core commercial property sectors: office, retail and industrial as well as a commentary on the present state of the Australian economy. The report proceeds as follows: Section 2 provides a summary of the current macroeconomic issues, with a focus on the main drivers of the Australian property market. Section 3 gives an investment market overview, while Sections 4, 5 and 6 discuss the Australian office, retail and industrial property markets respectively. An outlook for the property sectors covered in this report is provided in Section 7.

2. Economic backdrop

The performance of direct property markets is, to a large extent, determined by the state of the economy. In this section we provide a brief summary of the pertinent economic conditions across Australia.

International financial/capital markets continue to factor in higher levels of risk resulting from the credit crunch. In Australia the lack of market confidence coupled with a deterioration of credit liquidity and building inflationary pressures has led to further increases in the cost of capital, a widening gap between corporate and government bonds and a continuation of the downward trend in the share market. Figure 1 presents corporate bond yield spreads.

Figure: 1



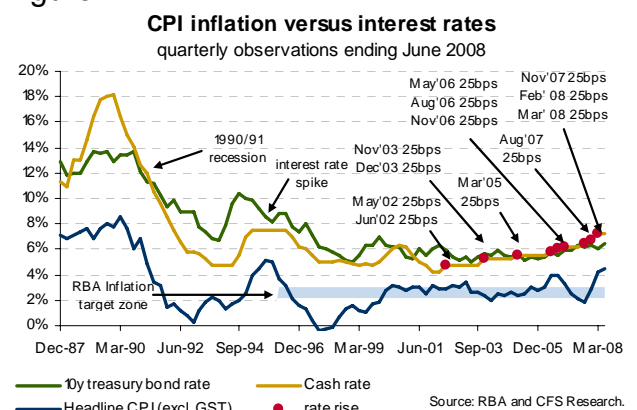
Australian Gross Domestic Product (GDP) grew by 3.6% over the year to March 2008, which is marginally greater than trend growth (3.5%). This has been driven by strong

domestic demand as well as the impact of the resources boom. Fears that the US economy will slow substantially and thereby adversely impact China's economic growth, and hence the demand for Australia's resources, have not yet eventuated to a material extent. Economic growth has, however, moderated relative to the year to December 2007 and it is expected to further slow to sub-trend levels in the short-term to medium-term.

The labour market remains tight with the national unemployment rate of 4.2% as at June 2008. Employment growth, currently at 2.4% in June 2008, is hovering around the ten year average (2.2%). This is likely to moderate over the short-term with the unemployment rate likely to increase.

Inflationary pressures, fuelled by i) robust domestic demand, ii) supply constraints, and iii) soaring commodity prices, continue to be a major concern for the national economy. This was highlighted in the most recent Consumer Price Index (CPI) figure for June 2008, which showed an increase of 4.5% in year-on-year (yoy) terms, well above the Reserve Bank of Australia's (RBA) target band of 2-3%. To combat this, the RBA has increased the official cash rate (OCR) four times over the past 18 months, lifting the OCR from 6.5% to 7.25%. Figure 2 shows movements in the OCR and CPI since the late 1980's.

Figure: 2



Although it is anticipated that inflationary pressures will persist for the remainder of 2008 and that interest rates will stay comparatively high, the market appears to be divided on the possibility of another interest rate rise. The outlook for further interest rate rises remains uncertain in the short-term due to a lag between slowing economic activity

and easing inflation. The Reserve Bank of Australia (RBA) Governor Glenn Stevens has recently signalled that the RBA now places significant weight on “tighter” financial conditions.

3. Investment overview

The current investment climate for property has shifted significantly in recent times as a result of the global credit crunch which surfaced in August 2007 and its lingering after-effects on financial markets, both locally and overseas.

The impact of the credit crisis on property investment markets was first witnessed in the listed space where a number of Real Estate Investment Trusts (REITs) experienced difficulties in refinancing their debt in the face of rising funding costs. The most notable of these trusts was Centro.

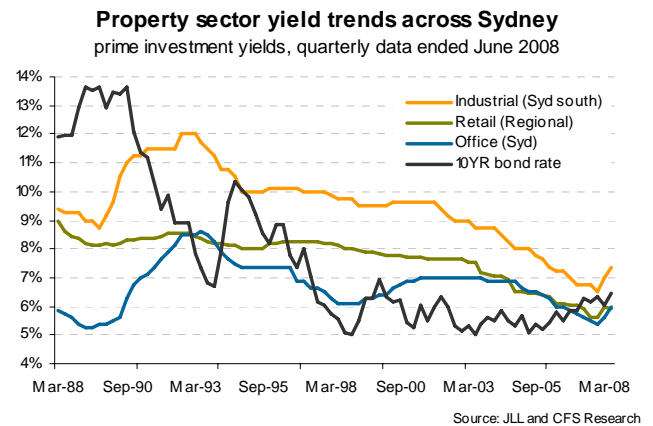
Yields and transactional activity

The period of yield compression which has driven capital returns over the last decade has come to an end. Recent market data from Jones Lang LaSalle (JLL) shows investment yields for the first and second quarter of 2008 softened across all sectors, throughout the majority of markets. Although space markets’ fundamentals remain generally favourable in most markets, it appears investor sentiment has deteriorated.

Figure 3 depicts yields for selected property markets in conjunction with the “risk free” ten year Commonwealth government bond rate. The period of yield compression across the commercial property sectors over the past ten years corresponds with a time of relatively low and stable interest rates. In contrast, the recent yield softening observed across sectors over the last two quarters, coincides with increases in interest rates, higher risk premia and reduced liquidity in wholesale credit markets.

Over the short term (next three years) property investment yields are likely to soften further across all property sectors.

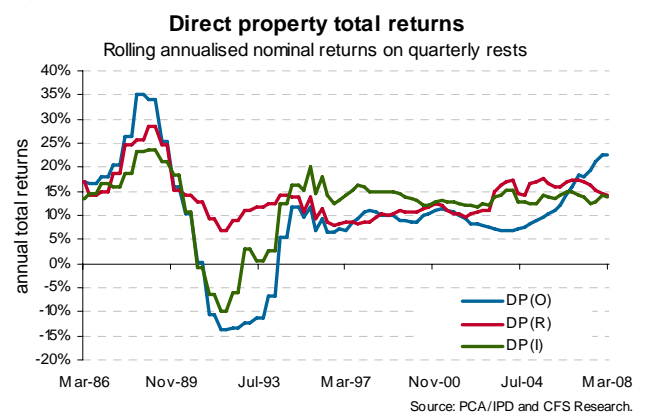
Figure: 3



Total returns

Figure 4 shows the historical total return performance of property across the office, retail, and industrial sectors. The office sector, which has underperformed the other sectors since the recovery of the property market in the mid-1990’s, has outperformed the industrial and retail sector over the past two years. This is the result of strong fundamentals in that sector. The office sector recorded a total return of 22.7% for the year ended March 2008. Total returns for retail and industrial property are solid at 14.0% and 13.8% respectively over the same period.

Figure: 4



Total returns are likely to ease over the short term but remain positive. Lower rates of capital growth will place downward pressure on total returns. Although space market fundamentals remain favourable for the moment they are likely to slow as the broader economy reverts to below trend growth. As such, active asset management will become critical in maximising returns.

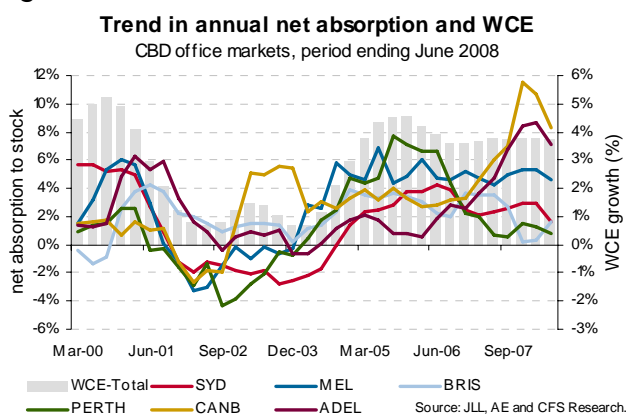
4. CBD office sector

The following provides an update of the main indicators of the Australian CBD office markets. Currently, the market is in a state of flux; amidst growing uncertainty arising from the ongoing crisis in the global credit and equity markets. Demand is slowing, or even contracting, across most CBD markets as a number of industries (especially finance and insurance) begin shelving expansionary plans and implement hiring freezes, while some are even commencing lay-offs.

Demand

The demand for office space, as measured by net absorption, is primarily driven by growth in white collar employment (WCE). Figure 5 shows the relationship between rolling annual WCE growth and the rolling annual net absorption as a share of total stock. As can be seen, demand has peaked across most markets.

Figure: 5



The solid performers over the first half of 2008 (H108) have been Melbourne (55,000 sqm) and Brisbane (30,000 sqm) which benefited from the completion of 333 Ann St, helping to release some pent-up demand in that market. Demand in Adelaide remains relatively solid (25,000 sqm). Perth was firm (6,000 sqm); aided by the return of two refurbished buildings back into the market.

Sydney (7,000 sqm) and Canberra (13,000 sqm) have both been relatively weak. Sydney's market is significantly exposed to the financial and insurance sectors, while Canberra has suffered as a result of cost cutting across federal government

departments as outlined in the May 2008 budget. The latest figures for June quarter 2008 show demand in Sydney has contracted for the first time in four years against the backdrop of continuing financial market turmoil. Net absorption for the period fell by 13,000sqm – of which around 7,000 sqm was from the financial and insurance sector. Canberra also saw a net release of space (2,000 sqm) into the market over the same period due to a pull back in demand from government and IT sectors.

Supply

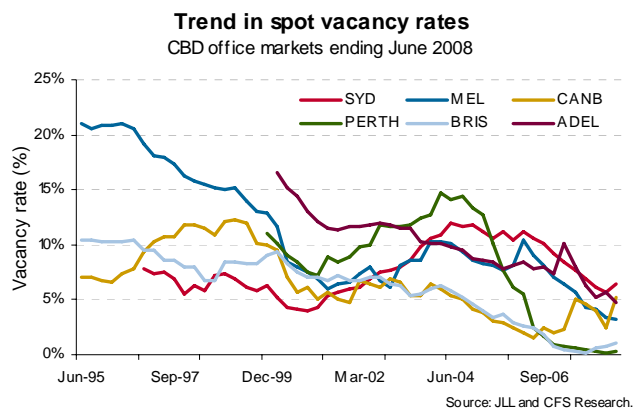
Net additions over H108 of new office space across the various CBD markets were relatively solid with a number of new buildings entering the market. Brisbane experienced a welcomed 40,300 sqm of new space; including the newly completed 333 Ann St. (16,500 sqm) and an additional 36,000 sqm of refurbished stock. Canberra saw an extra 36,400 sqm of space; comprised of eight new buildings. Of concern is that seven of these were speculative buildings which, at a time of waning demand, will likely experience difficulties in securing leases without offering substantial incentives.

Sydney (27,000 sqm) and Melbourne (22,000 sqm) each saw three new buildings enter the market. In Sydney these included; 61 and 68 York St. (2,300 and 13,500 sqm respectively) as well as 420 Pitt (1,800 sqm). Whereas, Melbourne saw 825 Bourke St. (9,000 sqm), 370 Docklands Rd (7,200 sqm) and the 6,000 sqm Life Lab located in Docklands. Adelaide also had a new building completed in City Central Tower 2 (11,900 sqm) while Perth had 5,000 sqm of refurbished stock re-enter the market.

Vacancies and rents

Figure 6A shows the historical movement in vacancy rates across the major office markets to June quarter 2008. The general trend of vacancy rates in all markets has been downward over recent years due to a combination of strong demand for office space as a result of solid economic conditions; coupled with relatively modest new additions to supply.

Figure: 6A



However, this trend stopped as of June quarter 2008 with the latest figures showing vacancy rates have risen in most markets with the exception of Melbourne (3.3%) and Adelaide (4.7%). This is illustrated in Table 1.

Sydney's vacancy rate rose to 6.5% with vacancy increasing in all grades with the exception of Premium and comes as a consequence of weaker demand. Notably, Canberra's vacancy rate more than doubled to 5.2%, primarily as a result of a significant rise in A-grade vacancy.

Table: 1

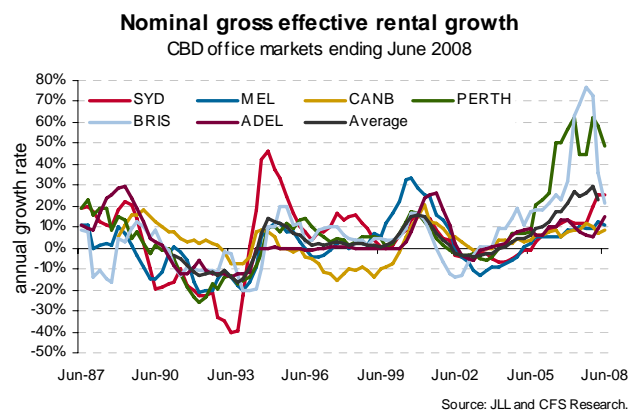
Average prime vacancy rates					
CBD office markets					
Market	Jun-08	Mar-08	Dec-07	Change to Jun-08	
	%	%	%	Qtrly	Annual
SYD	6.5%	5.7%	6.1%	0.8%	0.4%
MEL	3.3%	3.4%	4.1%	-0.2%	-0.8%
CANB	5.2%	2.4%	4.0%	2.8%	1.2%
BRIS	1.1%	0.8%	0.6%	0.4%	0.5%
PERT	0.2%	0.1%	0.3%	0.1%	-0.1%
ADEL	4.7%	5.7%	5.2%	-1.1%	-0.5%

Source: JLL and CFS Research.

With weakening demand and rising vacancies, the extraordinary rental growth seen in the recent past is likely to have come to an end. This is most evident in the Brisbane market where gross effective rents grew by only 0.8% over June quarter 2008 and 2.6% over H108 compared to 46% over H107. Similarly, Perth's rental growth was also much slower over H108 (7.4%) compared to H107 (17.2%). Sydney was relatively solid over H108 (7.3%); however, most of this growth occurred during March quarter 2008. Melbourne (4.9%) and Canberra (2.6%) over H108 were stable. In contrast, Adelaide recorded strong growth of 11% over H108 compared to only 1.9% in H107. Figure 6B shows the historical time

series for the annual change in nominal gross effective rents.

Figure: 6B



Outlook summary

Over the last six months the short-term outlook for the Australian CBD office market has deteriorated as a consequence of heightened financial market volatility and a slowing domestic economy. However this cycle is unlike previous downturns, as the current supply pipeline is limited. The current climate is likely to make a number of potential projects unfeasible, thereby limiting the potential supply.

However, the prospects for demand are concerning. If demand continues to weaken due to a contraction in WCE growth, then even with a relatively limited supply pipeline, vacancy rates will no doubt rise. Any increase in vacancies will negatively impact rental growth, although current vacancy rates are at such low levels that any rise is likely to see vacancies approach what is considered a natural rate. As such, rental growth is likely to moderate to rates below those witnessed in recent times.

5. Retail sector

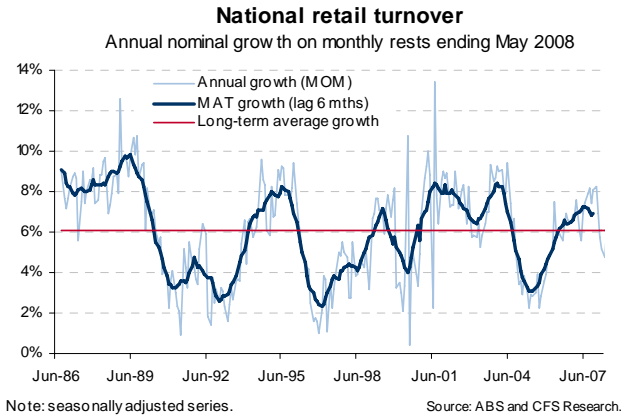
The following provides an overview of the key indicators of the Australian retail markets. Each indicator is discussed in turn, followed by a summary outlook on the market.

Retail turnover and consumer sentiment

Growth in retail turnover has showed clear signs of slowing since the end of last year, as illustrated in Figure 7.

Evidence suggests that consumers are succumbing to the burden of higher housing, petrol and food prices, and accordingly, reducing spending on discretionary items.

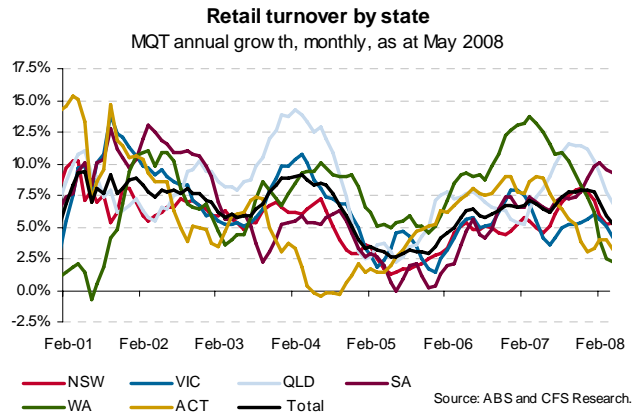
Figure: 7



Retail turnover by state

As illustrated in Figure 9, the slowdown in retail turnover growth has occurred across all states. The boom states of Western Australia (WA) and Queensland (QLD) have both experienced the biggest softening in retail turnover growth. WA has slowed from a peak of 13.7% yoy growth in March 2007 to 2.9% yoy growth in May 2008. QLD has eased by a lesser extent, from a peak of 11.6% yoy in September 2007 to 6.3% yoy as of May 2008.

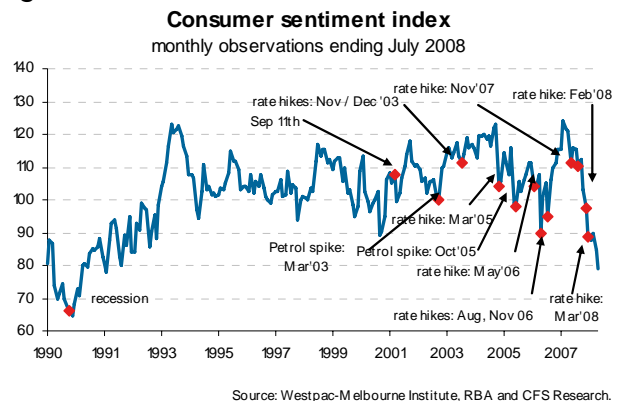
Figure: 9



Consumer confidence, as measured by the monthly Westpac-Melbourne Institute index, passed a peak in the cycle in May 2007 (123.9). Figure 8 depicts the recent steep decline in consumer confidence.

Confidence reached its lowest point in July 2008 (79.0) in sixteen years. Due primarily to the impact of four successive interest rate rises coupled with rising energy prices and food prices. Generally a figure below 100 signifies that consumers are relatively pessimistic and it is likely the measure will remain in this region for the remainder of 2008 and early 2009.

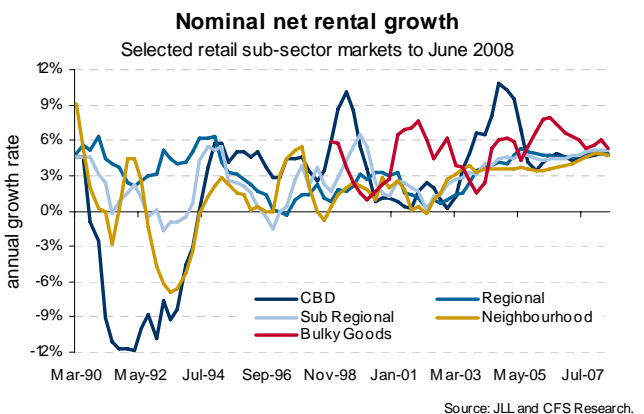
Figure: 8



Rents

Slowing retail turnover growth has resulted in some, though limited at this stage, downward pressure on rental growth. Nominal net rental growth by retail sub-sector is shown in Figure 10. Rental growth has been positive across a majority of retail sub sectors since the mid-1990's, supported by relatively low vacancy rates across most retail centres. Notably, across the sub-sectors, annual rental growth was around 5% to June 2008.

Figure: 10



However, this is expected to weaken due to slowing retail turnover. Generally, centre owners will not be able to demand higher rents in a weakening economic environment, resulting in slower rental growth. Threats to this outlook include the possibility of further interest rate rises, continued increases in the prices of petrol and food and, perhaps most significantly, an ongoing softening in the labour market.

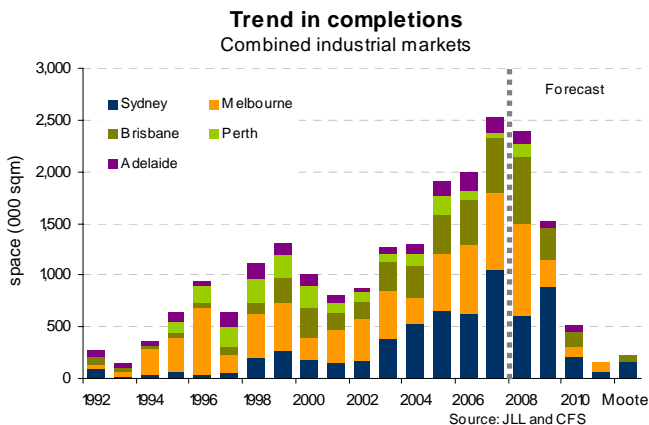
6. Industrial sector

The following provides an overview of the key indicators of the Australian industrial markets. Each indicator is discussed in turn, followed by a summary outlook on the market.

Demand and supply

Demand for industrial property has been strong over the last few years. This has resulted in record completions of new industrial space. New supply of industrial property is shown in Figure 11, broken down by state. Take up of industrial space has been particularly strong in the resource rich states of WA and QLD, while the VIC and NSW industrial markets have seen a surge in supply due to improved infrastructure provision and land rezoning.

Figure: 11



The current high interest rate environment is likely to force developers to revise their plans for industrial projects, due to higher funding costs and moderating economic growth. In this respect developers of industrial property hold

an advantage over developers of other property classes in that they can react more quickly to changes in demand and interest rates as a result of the relatively shorter lead times in construction.

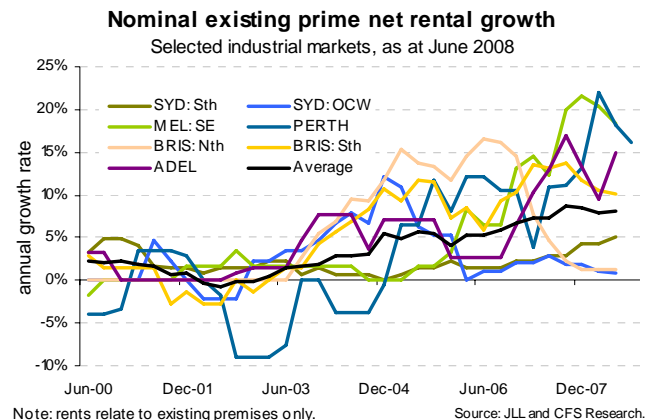
2007 was a bumper year of industrial completions with around 2.5 million sqm of completions; while 2008 is projected to bear another 2.4 million sqm across the nation.

It is likely that some industrial markets, particularly those less established, will be in a state of oversupply by the end of this year. Established markets, such as Sydney South, where new supply is constrained due to a lack of development sites, are better positioned to withstand the oversupply. However, as developers are able to swiftly withhold projects it is likely the oversupply will not last long.

Rents

Figure 12 shows industrial rents for the major metropolitan markets of Australia. Industrial rents have experienced strong growth in most markets since 2003. Recent data suggests that the period of strong rental growth appears to have passed the peak in some markets, as rental growth has moderated in most markets over the past three quarters.

Figure: 12



It is likely that rental growth for industrial assets will slow further as a large number of projects are due to be completed in 2008, in conjunction with a weaker macroeconomic environment.

Outlook summary

Industrial markets appear to have entered the softening phase of the property market cycle. Rental growth is slowing in most markets while yields have started to soften. Of concern is the amount of supply coming online this year, much of which is uncommitted.

Over the short-term we expect further weakness in rental growth, with the possibility that less established markets will record negative rental growth for a short period. Vacancy and incentives will also rise as demand softens. The sectors of the market that will outperform over the short term are likely to be prime assets in core, established industrial markets.

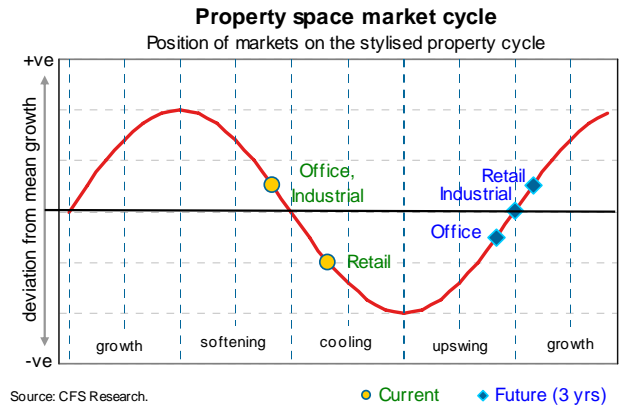
7. Sector outlook

Figure 13 is a stylised property cycle showing the current and short-term outlook positions for the three property sectors.

All of the core sectors have passed the peak in the cycle and are now positioned in either the softening (office and industrial markets) or cooling (retail market) phase of the cycle. These phases are typically characterised by

the following events: investment yields soften, rental growth slows, new supply peaks, vacancy begins rising and net absorption slows.

Figure: 13



In the short term we anticipate that all of the core sectors will have passed through the trough of the cycle and will be in either the late stages of the upswing (office and industrial markets) or early stages of the growth (retail market). This is dependant on confidence being returned to credit and equity markets.

8. Research Team

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