

# Property Market Review

18<sup>th</sup> February 2009

## An overview of Australian property sectors

- The fall-out of the global financial crisis (GFC) has negatively impacted the real economy. Economic activity has slowed sharply and the labour market is deteriorating. This, in turn, is impacting property space market conditions with demand weakening across most sectors. We expect an economic recovery to appear within 12 months due to strong fiscal and monetary stimulus.
- The office sector is seeing a decline in demand in line with slowing white-collar employment growth. Despite supply being relatively constrained, vacancy rates are set to rise steeply, although not to the levels seen in the early 1990's. As such, real rents are anticipated to fall over 2009. Markets are expected to reach the trough of the cycle over the next 12-18 months.
- The retail sector has moderated with growth in retail sales slowing sharply as consumers rein in spending due declining net wealth and concerns over income security. Spending growth should revert towards the longer-term average over 2009 due to monetary easing and fiscal stimulus.
- The outlook for the industrial sector is for further weakness in rental growth due to rising vacancies on the back of subdued demand and relatively strong supply cycle.
- The hotel sector continues to soften with slowing tourism and business demand as consumers cut back on discretionary spending and businesses undertake cost-cutting initiatives. As such, occupancy rates are now falling and growth in average room rates is slowing. Recovery is expected within 18 months.
- While the residential sector is set to broadly experience positive rental growth over the year, it will moderate from recent highs. The recent fiscal stimulus (including the boost to the First Home Owners Grant) and easing interest rates should support house prices, although the key downside risk remains the weak labour market.



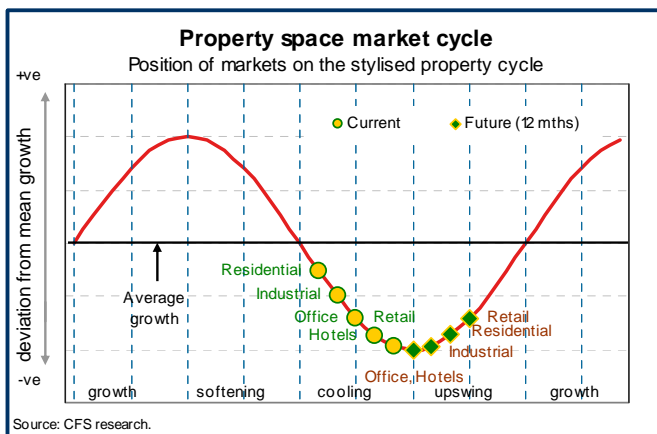
# 1. An overview of the property investment market

## Property space market overview

The generally favourable macroeconomic environment characterised by relatively low and stable interest rates, benign inflation and a solid labour market over the past five years to 2007 proved to be positive for space market fundamentals. This saw demand for space rise across property sectors, reflected in tightening vacancy rates and subsequently improving rentals.

With the negative fall-out from the global financial crisis (GFC) in 2008 now being felt by the real economy, both commercial and residential property markets have moved to the cooling phase of the cycle as shown in Figure 1. Generally, property markets are now characterised by sluggish or contracting demand, which is seeing vacancy rates move upwards and rental growth slow or turn negative. The 12 month outlook is for property sectors to be at their trough or early stages of upswing in the cycle.

Figure 1



The **office sector** is seeing a contraction in demand with a deteriorating white-collar employment growth. Despite the supply pipeline being relatively constrained in comparison to the previous downturn in the 1990's, vacancy rates are set to rise steeply as demand continues to contract and sublease space is relinquished to the market. As such, incentives are expected to rise and real rents should decline over 2009. Markets are anticipated to reach the trough of the cycle in about 12 months as economic conditions stabilise.

The **retail sector** is also moderating. Growth in retail sales has slowed sharply over the last six months as consumers rein in spending due to a decline in net wealth (from their negative investment returns) and

concerns over income security in a deteriorating labour market. Spending growth should revert towards the longer-term average over 2009 due to monetary easing and fiscal stimulus.

The outlook for the **industrial sector** is for further weakness in rental growth due to rising vacancies on the back of weaker demand. Industrial markets that are expected to outperform the sector include South Sydney and Melbourne CBD fringe where new supply is constrained while less mature markets are likely to record negative rental growth.

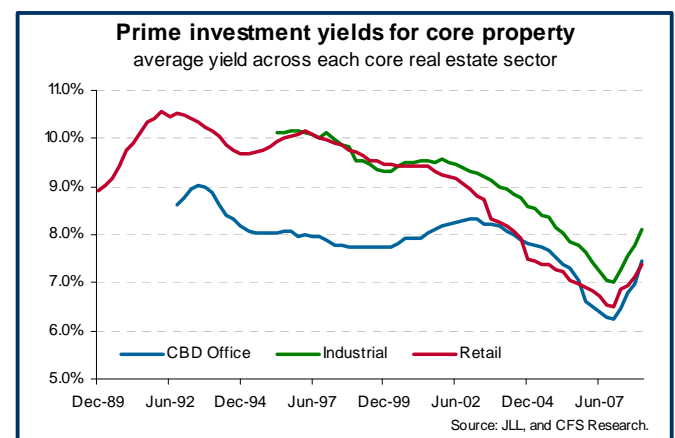
The **hotel sector** is weakening with both tourist and business demand for accommodation slowing as consumers cut back on discretionary spending and businesses implement cost-cutting measures. As such, occupancy rates have now passed their peak in the cycle and are falling. This is seeing growth in average room rates slow.

The **residential sector** is anticipated to experience positive rental growth across all capital cities. However, rental growth will moderate from recent highs in line with a slowing economy. While the fiscal stimulus package and easing monetary policy should provide support to housing sector (primarily at the lower price range of the market), the main downside risk factor is the extent and duration of the deteriorating labour market.

## Property investment market overview

The deterioration in both capital markets (which has seen a rise in the risk premium and cost of capital) and space market conditions has caused property investment yields to start softening. Figure 2 shows a rapid decompression in average core property yields over the last six months. Importantly, yield values vary markedly across geography and grade.

Figure 2



Yields will continue to soften over the next 12 months as asset de-leveraging continues which will see asset values move down due to rising discount rates, increased investor redemptions, and limited access to finance. Importantly, we expect that secondary assets will experience greater yield softening than prime grade assets<sup>1</sup>.

The remainder of this report provides an overview of the Australian office, retail, industrial, hotel and residential property sector markets. Discussion firstly centres on the macroeconomic environment as it is considered a key driver for property markets.

## 2. Economic environment

The transmission of the GFC from investment markets to the real economy started to emerge in 2H08. As shown in Figure 3, there has been a significant slowdown in economic activity across many global economies. Indeed, the United States, Japan and much of the European Union are already in recession, and China is also experiencing a sharp slowdown in activity. 2009 is shaping up to be one of the weakest years of global economic growth since the early 1990's. The International Monetary Fund (IMF) forecasts that global growth over 2009 will be 0.5% - significantly lower than the ten year global average of 3.9%. This is despite a raft of government stimuli via fiscal policy and monetary policy. While the IMF is forecasting a contraction in growth for Australia in 2009, consensus forecasts report growth to average 1.1%.

In Australia, the negative spill-over effects are already being felt with the labour market weakening. Since August 2008 the unemployment rate has been steadily rising from 4.1% to 4.8% in January 2009, while annual employment growth has eased to 1.0% - below its 10 year average of 2.2%. Leading indicators of future employment growth, such as the ANZ Job Advertisement series, project sharper declines as hiring intentions remain weak. CFS Research expects labour market weakness to persist throughout 2009 which will see the unemployment rate rise towards 6-7%.

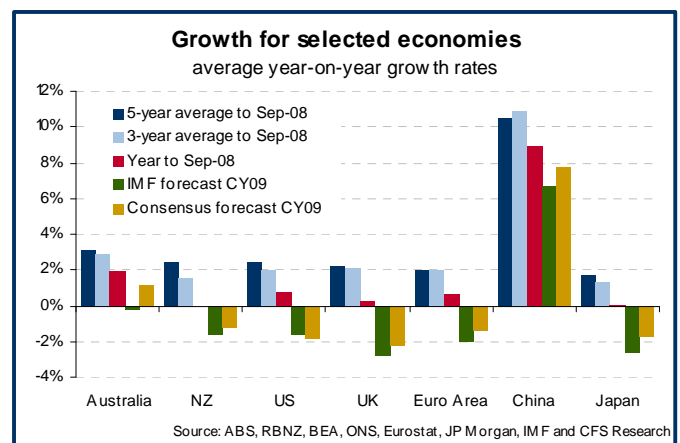
In an attempt to ease financial conditions and support aggregate demand, the Reserve Bank of Australia (RBA), in line with other central banks around the world, has aggressively cut the official cash rate (OCR) by 400 basis points since September 2008 to currently stand at 3.25%. Given the aggressive easing in monetary policy

in 2008, we expect a further moderate cut in the OCR by about 50bps over 2009.

With slowing domestic and global demand, inflationary expectations have abated. The CPI for December 2008 showed annual inflation had eased from 5% to 3.7%. The RBA expects underlying inflation to return to its target band by end of 2009<sup>2</sup>.

The Australian economy will continue to experience sluggish economic activity over 2009. The Federal government's fiscal stimulus package and the rapid easing of monetary policy should provide support to consumer spending, the residential housing market. In turn, this supports the broader domestic economy. Support is also expected from a rebound in China's economy in 2H09. However, downside risk depends on the extent and duration of the weakening labour market.

Figure 3



## 3. CBD office sector

The weakening real economy has resulted in employment slowing; particularly in white collar sectors. The office sector now faces the toughest conditions since the recession of the early 1990's. As such, growth in demand for office space has softened or turned negative across the majority of CBD markets.

This section provides an overview of the office sector. Particular attention is given to demand, supply, vacancy and rents.

### Demand

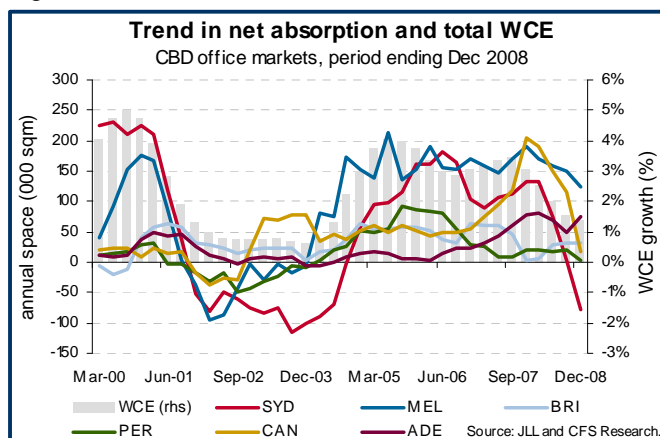
Figure 4 shows the close positive relationship between annual white collar employment (WCE) growth and annual net absorption. Notably, with the exception of Adelaide, office demand has slowed across all major CBD markets over calendar year 2008.

<sup>2</sup> Refer to Statement on Monetary Policy, February 2009.

<sup>1</sup> For a more detailed discussion refer to "The Pricing of the Australian Commercial Property Market: An Update," published in January 2009.

The Sydney CBD market, with large tenancy exposure to the financial and banking sector, has to date been the worst impacted by the global economic downturn. The negative net absorption of 72,000 square meters (sqm) recorded over 2008 reflects the scale back in WCE. The relatively strong demand in Melbourne of 109,000 sqm over 2008 was mainly due to tenants moving into pre-committed space. The decline in demand for Brisbane and Perth CBD markets reflects the downturn in the resources sector. The rapid slide in commodity prices has resulted in a number of planned expansions and mining operations being rendered postponed or cancelled. Also, the amount of space to be returned to the market from sub-lease is likely to be significant. For example, anecdotal evidence suggests reduced demand for space in Perth with Rio Tinto reportedly vacating 11,000 sqm of space in Perth in early 2009. Additionally, Telstra is also rumoured to be seeking to vacate and sublease 4,500 sqm in Perth in early 2009.

Figure 4



Net absorption for Canberra was 17,000 sqm for 2008; weak in comparison to the 206,000 sqm recorded over 2007. Adelaide is the only capital city currently bucking the trend of slowing demand with a robust 75,000 sqm absorbed over 2008. This strong demand was driven by expansion activity from a number of industries: government, defence, mining and education. However, despite a high level of pre-committed space in 2009, demand is expected to turn sluggish as commodity prices remain sluggish. For example, BHP is planning to shelve expansion plans at Olympic Dam in South Australia and also to reduce its workforce in Adelaide by at least 200 positions.

## Supply

Across CBD markets, the current construction pipeline is relatively moderate in comparison to the supply shock of the late 1980's. New net supply in 2009 is

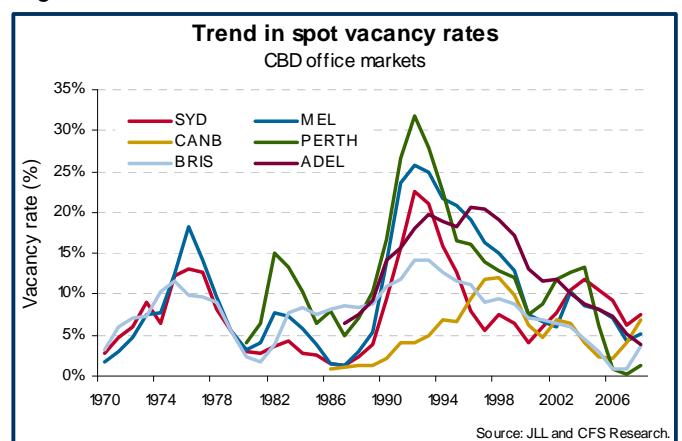
expected to be the largest since 1992 with completions concentrated in Brisbane, Melbourne and Canberra. However, while much of the current stock is pre-committed over the next two years, a number of proposed office developments across major CBDs have already been shelved due to increased funding costs, constraints on accessing funding, and the lack of pre-commitments.

## Vacancies and rents

With the exception of Adelaide, all major CBD markets recorded a rise in vacancies during the December quarter. This is highlighted in Figure 5 which shows trends in spot vacancy rates across selected markets. Notably, in contrast to their downward trend over the last 15 years, vacancy rates are now moving upwards. However, it is worth noting that they are way below the highs experienced in the early 1990's.

Over the December quarter 2008, Sydney's overall vacancy rate rose from 6.8% to 7.5%. This rise was recorded across all grades. Vacant sub-lease space is also rising; agents estimate the amount of sublease space available in January 2009 is close to 80,000 sqm, up from 20,000 sqm in July 2008. Of the 37 tenants subleasing space, 11 were from the financial sector. Perth's vacancy rate more than doubled to 1.5%, the first quarterly increase in vacancy since 2003. Brisbane's vacancy rate increased to 3.6% from 2.0% in the September quarter of 2008, primarily as a result of an increase in B-grade vacancy.

Figure 5



As a result of rising vacancy, the very strong positive rental growth seen in recent years across capital cities has slowed dramatically. Over 2009 real effective rental levels are expected to continue to fall. Face rents will outperform effective rents as incentives rise with rising vacancies.

## 4. Retail sector

The slowdown in the macroeconomy is also adversely impacting the retail sector, reflected in both household wealth and income.

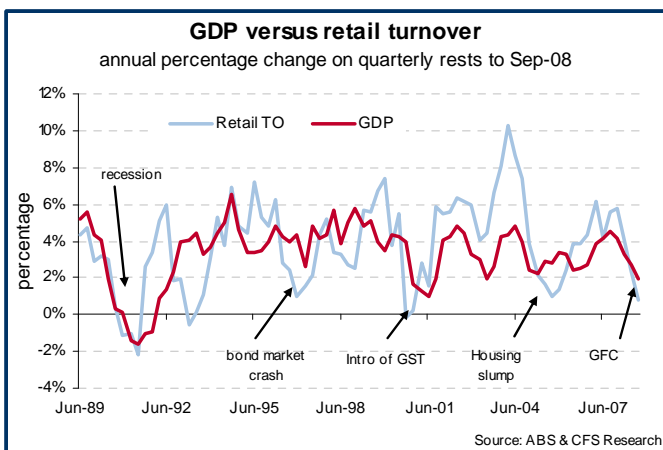
This section provides an overview of the retail sector. Discussion focuses on demand indicators (such as retail turnover and consumer sentiment) and rents.

### Retail turnover

A key indicator of retail demand is retail sales or turnover. The close link between the general economy and retail activity is highlighted in Figure 6. The recent deterioration in economic activity has resulted in a rapid slowdown in retail turnover growth. This reflects both adverse income effects (due to increasing prices for housing, petrol and food items and uncertainty regarding job security) and wealth effects (in line with a large fall in asset markets) on household consumers.

This market downturn varies from previous downturns. The slowdown in 2004-05 coincided with a downturn in the housing market and its impact on household wealth. The recession of the early 1990's resulted in a double-dip in retail sales, due firstly to high interest rates and then a deteriorating labour market.

Figure 6



Recent support for household incomes has come from the Federal government's one-off cash payment to retirees and lower incomes in December 2008, falling petrol prices and lower interest rates. The government's cash payment has had a significant impact with retail sales jumping 3.8% over the month. This follows increases of 0.4% in November and 1.0% in October 2008.

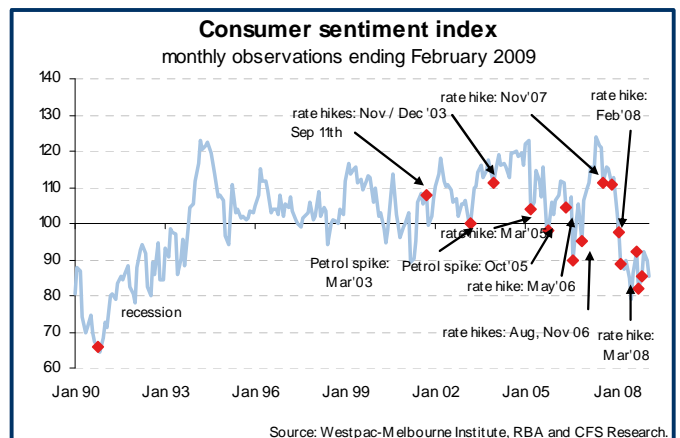
### Consumer sentiment

Another key indicator gauging conditions in the retail sector is the consumer sentiment index. A historical time series of the index is shown in Figure 7. Index values above 100 indicate relatively favourable retail conditions whereas values below 100 indicate the opposite.

The index has recorded a significant fall since mid 2008 reaching the lowest score of 79.0 since 1992. This was due to successive interest rate rises, rising energy and food prices, as well as the fall in the share market. The recent index scores suggest some stabilisation in the index, partially reflecting the December fiscal stimulus. However, the low scores highlight that consumers are nervous about the short-term outlook.

Rising unemployment and lower wage expectations over 2009 will keep consumer sentiment low. Importantly, sentiment is likely to recover when signs of recovery in the labour market are prevalent.

Figure 7



### Rents

In conjunction with softening retail demand, growth in retail rents has started to weaken.

Regional centres (particularly those focused on non-discretionary items) are expected to relatively outperform other retail sub-sectors as consumers reduce discretionary spending. Sales turnover in sub-regional centres, which are generally anchored by a discount department store, will also show a degree of resilience due to consumers substituting department store goods with those from discount department stores. Neighbourhood centres face greater downside risk to income streams due to a greater threat of tenancy bankruptcy. Bulky goods will also come under pressure from reduced consumer demand on discretionary items.

Growth in retail rents is expected to remain weak over 2009, although supported by the second fiscal stimulus

announced by the government in February. Despite many retail leases having inflation-indexed or fixed rental increases, centre owners will have to wind back their expectations for rental increases.

## 5. Industrial sector

Industrial markets have also entered the cooling phase of the property market cycle. Weakening economic conditions, in particular in the export and import, manufacturing and wholesale sectors are negatively impacting on the demand for industrial property. Rental growth is slowing rapidly in most markets while yields have been softening for three consecutive quarters.

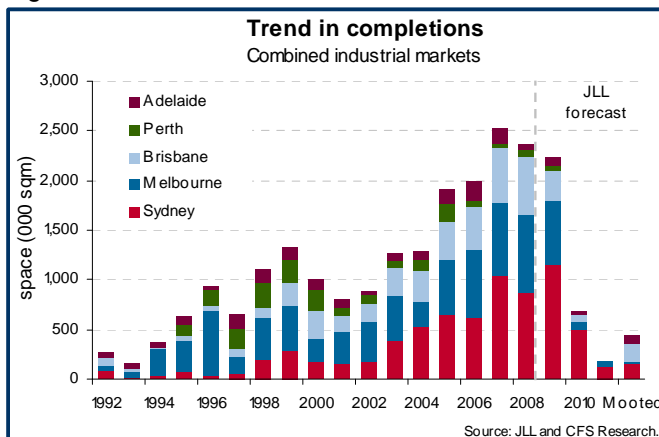
This section discusses supply and demand conditions as well as rental movements across industrial property markets.

### Supply

The trend new supply (gross completions) for industrial property split by major city is shown in Figure 8. Over 2008, a strong level of completions at 1.8 million sqm came onto the market. Current estimates suggest that supply over 2009 is also expected to be very strong with about 2.0 million sqm entering the market. However, the combination of the currently tight conditions in credit markets, the on-going moderation in economic growth and the inability to secure pre-commitments, is likely to force developers to shelve plans for many projects.

It is expected that some industrial markets, particularly those less mature, such as the Central and North-West markets of Sydney and the South-East and West markets of Melbourne, will be in a state of oversupply by the end of this year.

Figure 8



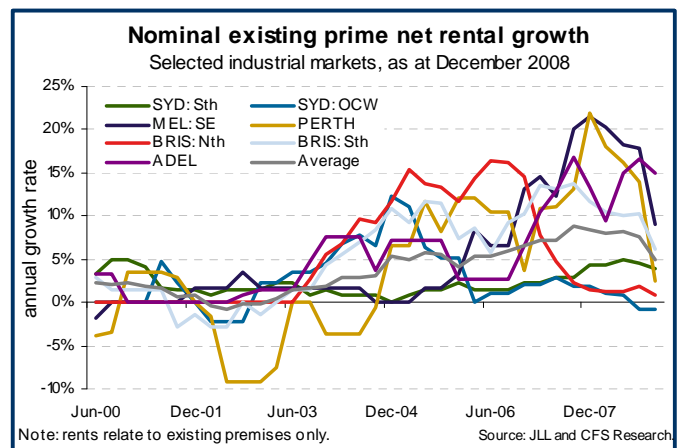
### Demand

The fall in business confidence over 2008 suggests that demand for industrial property over 2009 will be sluggish. Firms are tightly monitoring and reducing costs in light of weaker macro-economic conditions. This is likely to see tenants cut back on new space requirements as expansionary projects are placed on hold.

### Rents

Figure 9 shows rents for a variety of industrial markets across Australia. Since 2003, most markets have experienced strong rental growth. This was due to rising land values, rising construction costs, and demand generally outstripping supply. However, over 2008 rental growth has started to ease. The weaker macroeconomic environment and oversupply of industrial space will result in negative real rental growth over 2009 in most markets. Tenancy expiries in 2009 will also see leases renegotiated at lower rents.

Figure 9



## 6. Hotel sector

The hotel sector has performed remarkably well over recent years due to a culmination of limited new supply and robust economic conditions. As with the core commercial sectors; the slowdown in domestic and global economic activity is also adversely impacting the accommodation market. As such, the sector is also in the cooling phase of the cycle with occupancy rates now softening.

This section provides an overview of the hotel sector. Discussion focuses on demand, occupancy rates and revenue per available room (RevPAR).

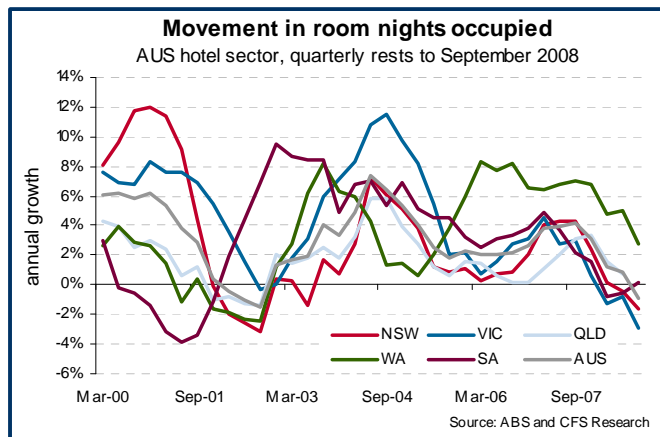
## Room nights occupied

Hotel demand is measured by room nights occupied (RNO). Due to the global economic slowdown, corporate and leisure (inbound tourism) demand for hotel rooms has slowed or is contracting across the nation. This is highlighted in Figure 10 which shows that growth in RNO in all states is trending down and turned negative for major states towards the end of 2008.

This is likely to be the state of market conditions over 2009 due to weaker demand on the back of reduced discretionary spending from consumers and lower corporate (travel and conference) spending with cost cutting measures underway.

On an annual basis, inbound tourist arrivals contracted over 2008, the first contraction since 2001, undoubtedly a result of many of our major tourist markets falling into economic recession over last year. Tourism Research Australia forecasts that 2009 inbound tourist arrivals will again be negative despite the support provided by a lower Australian dollar and fuel costs.

Figure 10

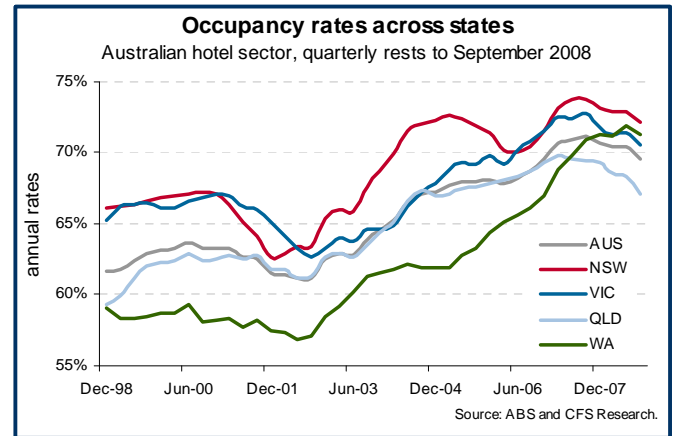


## Occupancy rate

Up until recently space market fundamentals for hotel markets was relatively tight, reflected in rising occupancy rates. However, the fall away in demand is seeing occupancy rates soften as shown in Figure 11.

The limited supply pipeline for hotels nationally, with the exception of the Melbourne CBD which has a moderate supply pipeline in the short term, should buffer the softening in occupancy rates. Over 2009 occupancy rates are expected to weaken further with subdued demand. A pickup in global economic conditions in 2010 should see occupancy rates stabilise.

Figure 11



## Revenue per available room

Over recent years RevPAR growth has been fuelled by robust economic conditions and consequently tightening market conditions. More recently, growth in RevPAR is also slowing in line with falling occupancy rates and softening average room rates. Over 2009 and into 2010, growth in RevPAR is expected to remain sluggish as demand conditions remain generally soft, although offset by a relatively tight national supply pipeline.

## 7. Residential sector

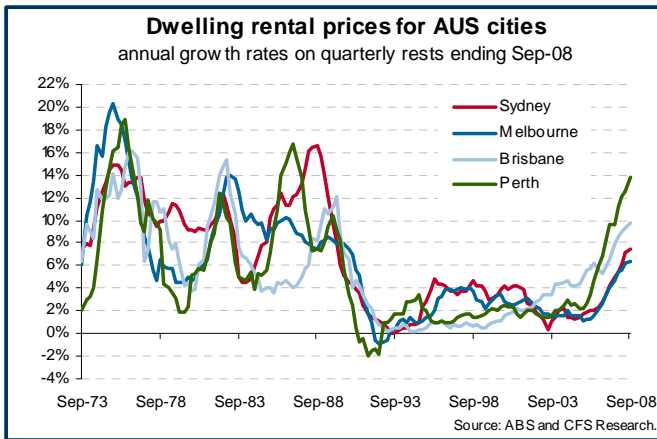
As with the commercial property markets, the residential property market is also showing signs of weakness. Until mid-2008 the national residential market was generally buoyant, although activity differed across states. The resource rich cities of Perth and Brisbane have recorded very strong capital growth since 2005 while Sydney's growth profile was moderate. With a slowdown in the macroeconomy, housing markets have begun to cool, reflected in subdued approvals and falling house prices.

## Vacancy and rents

Since 2000, a national shortage in residential housing has seen an ongoing decline in residential vacancy rates across major capital cities. The shortage reflects strong demand conditions, fuelled by strong immigration and limited new supply due in part to prohibitive development costs.

With rental vacancy rates falling towards 2%, from 2005 onwards rental growth accelerated rapidly, as shown in Figure 12.

Figure 12



Perth and Brisbane recorded the strongest growth in rents due to solid demand caused by healthy inter-state migration and favourable labour market conditions, spurred on by the resources boom. Over the short-term, while rentals will be supported by undersupply conditions, rental growth is expected to moderate in line with a slowing in macroeconomic activity.

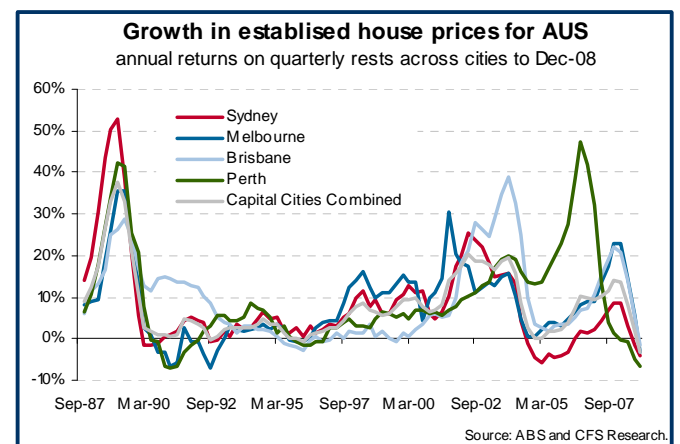
### House prices

The latest ABS established house price index for all Australian capital cities recorded a decrease of 3.3% over the year to December 2008. Falls in house prices was reflected across all major capital cities as shown in Figure 13.

Over the course of 2009 movements in house prices are set to diverge across price segments. The lower price-end market is likely to experience some upward price pressures spurred on by greater buying activity on the back of the Federal government’s boost to the first home owners grant in October 2008. Such a scheme is also set to provide some support to residential construction and consequently broader spending. On the flip side, premium suburbs are set to experience a fall in the median house price, stemming from forced sales on the back on wealth destruction and job losses.

Perth and Brisbane are likely to experience the largest falls in house prices as they correct with a cooling in the resource cycle.

Figure 13



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