

# Property Market Review

4<sup>th</sup> March 2009

## Australian retail sector sluggish, underpinned by soft retail turnover

- **Retail dampened:** Consecutive interest rate rises, rising energy and food prices and the fall in the equity market over 1H08, compounded with the negative effects of the global financial crisis, had an adverse impact on retail sales and retail space market fundamentals over most of 2008.
- **Slower retail sales growth:** Growth in retail sales, a key demand indicator, has slowed as consumers rein in spending due to declining net wealth and concerns over income security. This is also reflected in a deterioration in consumer sentiment. Spending growth in 2009 is expected to be largely supported by the recent monetary easing and fiscal stimulus, although remain below trend. Beyond 2009, a pick-up in retail spending will be contingent on improvement in labour market conditions.
- **More supply coming:** A historically high amount of supply came on board in 2008. The supply pipeline is expected to remain strong in the near term due to projects currently underway. However, beyond 2010, financing constraints should see low levels of new supply nationally.
- **Increasing vacancies:** After a period of strong demand, vacancy rates have started increasing; although from a low base while varying across centre type. Rents are set to come under pressure in 2009 in line with weakening market conditions and tenants' inability to pay higher rents due to falling margins. Over the next 12 months retail property sectors are expected to approach the early stages of the upswing phase of the property cycle.
- **Yield decompression:** All major shopping centre types are experiencing rapid decompression in investment yields driven by deteriorating capital markets and space market conditions. In the near-term, we expect yields to continue to soften, with the greatest movement in Neighbourhood and Bulky goods centres.



# 1. Retail space markets

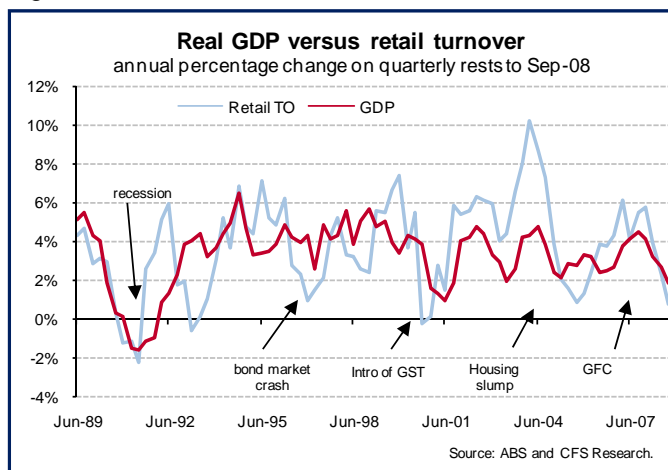
The negative effects from the global financial crisis have caused economic conditions in Australia to deteriorate over 2008. Economic growth has slowed rapidly, the labour market has softened, and both consumer and business sentiment have turned sluggish. Consequently, a cyclical slowdown in economic activity coupled with consecutive interest rate rises, rising energy and food prices, and the fall in the equity market (which occurred over 1H08) has had an adverse impact on retail sales, weakening retail space market fundamentals. Retail property markets are now characterised by contracting demand, rising vacancy rates and slowing rental growth.

## Demand and supply

A key indicator of retail demand is retail sales (or turnover). The close link between general economic activity and retail spending is highlighted in Figure 1. Notably, 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 currently due to uncertainty regarding job security) and wealth effects (in line with a large fall in asset markets) on consumers. Consequently, overall growth in consumer spending has been reduced with a marked change in the composition of consumer spending<sup>1</sup>.

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.

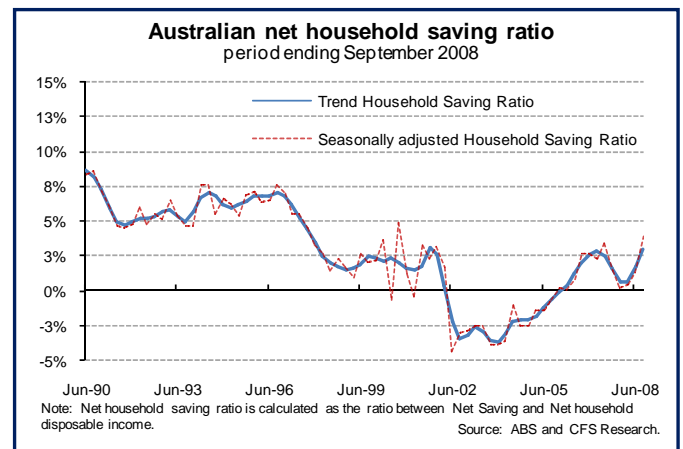
Figure 1



<sup>1</sup> Discretionary retail category and those linked to household markets were hit hard, but non-discretionary recorded positive growth.

One way to gauge the strength of consumer demand is by examining the Household saving ratio (HSR) as it is inversely correlated with consumer spending. As Figure 2 highlights, after more than a decade of trending down with a period of dissaving, the HSR started trending upwards. The period of negative HSR is associated with relatively low unemployment, rising household net worth, relatively low interest rates, strong consumer confidence and generally favourable economic conditions. However, a recent rise in the HSR is signalling household balance sheet de-leveraging and a change in households' spending attitude, which will likely constrain retail turnover growth.

Figure 2

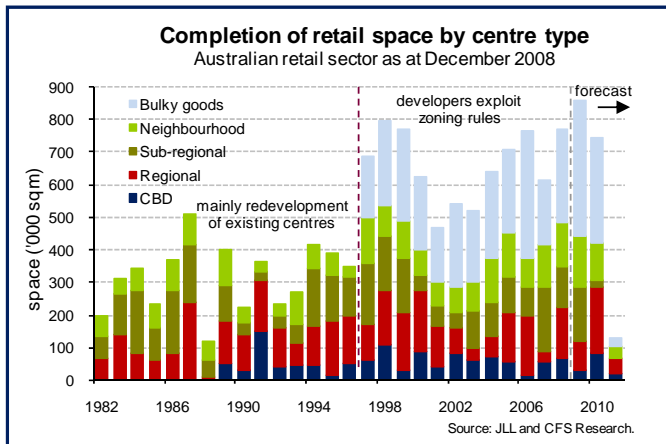


Conversely, support for household incomes has come from the Federal government's one-off cash payment to retirees and lower income earners in December 2008, falling petrol prices, significantly reduced interest rates and tax cuts. The government's cash payment has had a significant impact with retail sales jumping 3.8% over the month. This follows increases of 0.4% in November and 1.0% in October 2008. We expect spending growth to revert towards the longer-term average over 2009 due to monetary easing and the second fiscal stimulus announced by the government in February 2009.

A historically strong amount of supply entered markets over 2008, as shown in Figure 3. Total retail completions were 767,548 sqm, of which one half was completed over Q408 - well above the ten-year average of 640,944 sqm per annum. Strong levels of completions were recorded in the Melbourne market (312,008 sqm), followed by South-East Queensland (148,666 sqm). Bulky goods centres accounted for 37% of total completions in 2008. A large share of the supply pipeline (around 800,000 sqm) is still under construction and is expected to arrive onto the market during 2009. However, new supply projects are expected to be restricted after 2010 as an increase in funding costs and constraints on accessing credit, have scaled back

or delayed new supply across markets/categories.

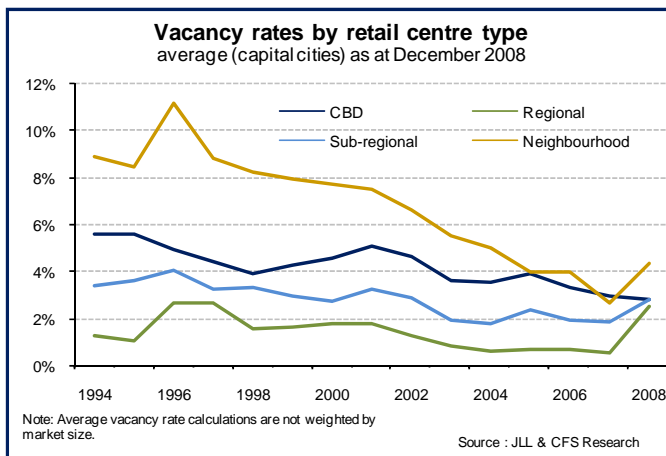
Figure 3



**Vacancies**

A period characterised by strong demand saw vacancy rates trend down. However, they have recently started rising although remain relatively low (Figure 4), varying widely across retail centres categories. As at Q408, total vacancy rates ranged from a high of 4.3% for Neighbourhood centres to a low of 2.5% for Regional centres. Vacancy rates are expected to increase across all categories in the short term due to strong supply coming on line, in a weak demand environment.

Figure 4



**Rents**

Retail rental growth has started to weaken in line with softening in retail demand. Face rents have come under pressure as tenants experience tough spending conditions.<sup>2</sup> Thus, the dominance of the landlord has

<sup>2</sup> Despite tenants efforts to support retail sales via squeezing their margins, additional pressure is coming from a low Australian dollar.

dissipated and the re-introduction of incentives is occurring as landlords start fighting to keep occupancy levels high.

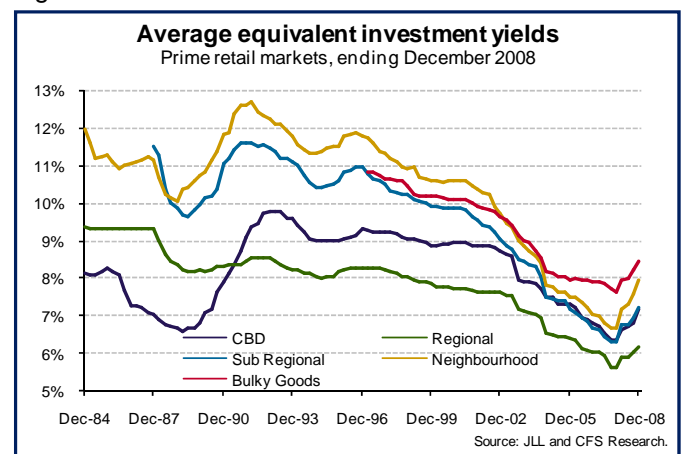
Regional centres, particularly those focused on non-discretionary items, are expected to relatively outperform other retail sub-sectors as consumers reduce discretionary spending. Sales turnover in sub-regional centres, which are generally anchored by a discount department store, will also show a degree 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. Consequently, the largest rise in incentives is expected in the Neighbourhood and Bulky goods retail centres.

Growth in retail rents is expected to remain weak over 2009, although supported by the second fiscal stimulus. Despite many retail leases having inflation-indexed or fixed rental increases, centre owners will have to wind back their expectations for rental increases.

**2. Investment Performance**

After a decade of yield firming and the yield spread narrowing between retail categories (due to a fall in the risk premium), the deterioration in both capital markets and space market conditions has caused a rapid decompression in average investment yields (Figure 5) across retail centre types. Importantly, the yield spread has widened across grades, to reflect varying asset quality. In the near term, yields are set to soften further. We expect that yield softening will be greater in Neighbourhood and Bulky goods centres than in Regional centres. This trend should reverse once market conditions improve over the short term (3 year period).

Figure 5



**CFS Research has a global reach and the expertise to tailor research to your needs.****Contact details**

Anthony De Francesco	Head of Research	+61 2 9303 3598
Dejan Radanovic	Property Analyst	+61 2 9303 6429
Mary Culjak	Research Assistant	+61 2 9303 3518

**For further information****cfsinstitutional@colonialfirststate.com.au****Head of Business Development, Australia and New Zealand**

Tony McFadyen +61 2 9303 2699

**Institutional Account Management**

Jeremy Edmonds +61 2 9303 2695

Daniel Bristow +61 2 9303 6311

**Institutional Business Development**

Peter Weldon +61 2 9303 6860

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Liz Krajewski +61 2 9303 2927

Helen Squadrito +61 2 9303 6142

Nadene Moore +61 3 8628 5615

Hugh O'Neill +61 2 9303 6116

Simon Good +61 3 8628 5681

Lucas Rooney +61 7 3328 5875

**DISCLAIMER**

Product Disclosure Statements (PDS) and Information Memoranda (IM) for the funds issued by Colonial First State Investments Limited ABN 98 002 348 352, Commonwealth Managed Investments Limited ABN 33 084 098 180, and CFS Managed Property Limited ABN 13 006 464 428 (collectively CFS) are available from Colonial First State Global Asset Management. Investors should consider the relevant PDS or IM before making an investment decision. Past performance should not be taken as an indication of future performance.

No part of this material may be reproduced or transmitted in any form or by any means without the prior written consent of CFS. This material contains or is based upon information that we believe to be accurate and reliable. While every effort has been made to ensure its accuracy we cannot offer any warranty that it contains no factual errors. We would like to be told of any such errors in order to correct them.

This material has been prepared for the general information of clients and professional associates of CFS. You should not rely on the contents. To the fullest extent allowed by law, CFS excludes all liability (whether arising in contract, from negligence or otherwise) in respect of all and each part of the material, including without limitation, any errors or omissions.

This material is intended only to provide a summary of the subject matter covered. It does not purport to be comprehensive or to render specific advice. It is not an offer document, and does not constitute a recommendation of any securities offered by CFS. No person should act on the basis of any matter contained in this material without obtaining specific professional advice.

Colonial First State Global Asset Management is the consolidated asset management division of the Commonwealth Bank of Australia ABN 48 123 123 124.

Copyright © CFS 2009

All rights reserved.