Property Market Review

26th March 2009

Australian industrial property markets are set to worsen, reflecting a weak economy

- **Industrial property markets have a positive relationship with economic activity. With the negative fall-out from the global financial crisis (GFC) in 2008 now being felt by the real economy, industrial markets have moved to the cooling phase of the cycle. Signs of economic recovery are expected to appear in the next 12 months underpinned by expansionary fiscal and monetary policies.**
- **A large number of new buildings were completed in 2008. Our current estimates suggest that supply in 2009 should remain strong. However, the combination of the currently tight conditions in credit markets, the ongoing moderation in economic growth and the inability to secure pre-commitments are likely to force developers to shelve many projects.**
- **Deteriorating economic activity in industry sectors that tend to have a high use of industrial property space (such as wholesale retail) had a negative spill-over effect on demand for industrial property space. The expected further weakness in the economy over 2009 suggests sluggish demand for industrial property will persist into 2010.**
- **Rental growth eased in 2008. We anticipate further weakness in rental growth due to subdued demand and relatively strong supply conditions over the near term. However, where new supply is constrained, industrial markets are expected to outperform the other markets in the sector.**
- **Industrial investment yields softened rapidly in 2008. We expect yields to weaken further in 2009, with secondary assets experiencing greater yield expansion than prime grade assets. Transactional activity should remain subdued nationally in the near term due to deterioration in investment demand. However, some transaction activity is expected from deleveraging of institutional portfolios.**

Colonial First State Global Asset Management

1. Introduction

In recent years, space market fundamentals for industrial property have been positive, underpinned by favourable macroeconomic conditions. However, the GFC has had negative spill-over effects on the real economy, adversely impacting the industrial sector and industrial property markets. With regards to space markets, demand has started to soften and rental levels are contracting. On the investment front, transaction activity is slowing and yields are rising.

In this report, we provide an overview of the current state and short-term outlook for the industrial property sector in Australia, whilst also discussing demand and supply dynamics, land values, and rental activity. We also consider investment performance as reflected in transactional activity and pricing.

2. Space markets fundamentals

Demand

In five years to 2007, national demand for industrial property space was solid and growing steadily. During this period, the user profile of industrial space has seen a shift from lessee to owner occupier. Demand began to soften in 2008 driven by movements in real GDP (Gross Domestic Product) and interest rates.

Figure 1A highlights the close positive correlation between real GDP growth (lagged four quarters) and gross absorption. Notably, as economic activity has started to wane, so too has industrial demand. Furthermore, the correlation strengthens when we consider industrial-oriented sectors such as communication, information and technology (C&IT), wholesale trade, and retail trade. These industries recorded sluggish performance in 2008 (in line with the weakening economy). [The divergent growth profile for the C&IT industry reflects high demand for new technologies by businesses, households and farms.]

Another key driver of industrial demand is movements in real interest rates. The strong inverse relationship between real interest rates[1] (using index bonds as a proxy) and demand is highlighted in Figure 1B. The impact of real interest rates is twofold: on consumer demand and investments. Falling real interest rates generally support consumer spending and also foster investments (including industrial based sectors). These, in turn, have a positive impact on the level and nature (i.e. a shift towards owner occupier) of industrial demand.

[1] Nominal interest rate adjusted for the consumer price inflation expectations.

We expect industrial demand to remain sluggish in the near term with firms winding back new space requirements as economic activity continues to weaken and real interest rates edge up with falls in the consumer price inflation.

Figure 1A

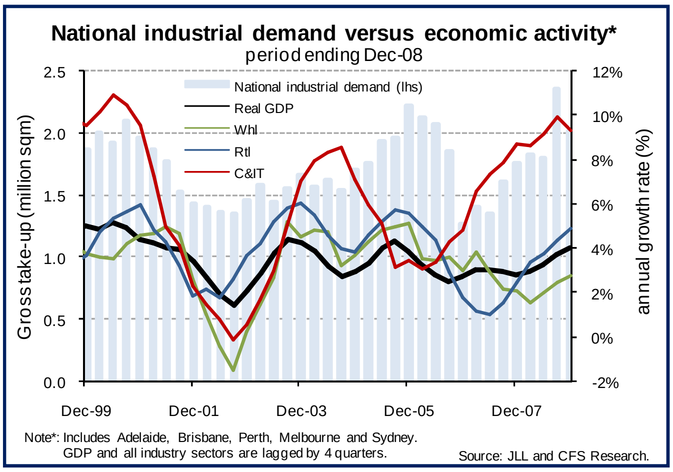
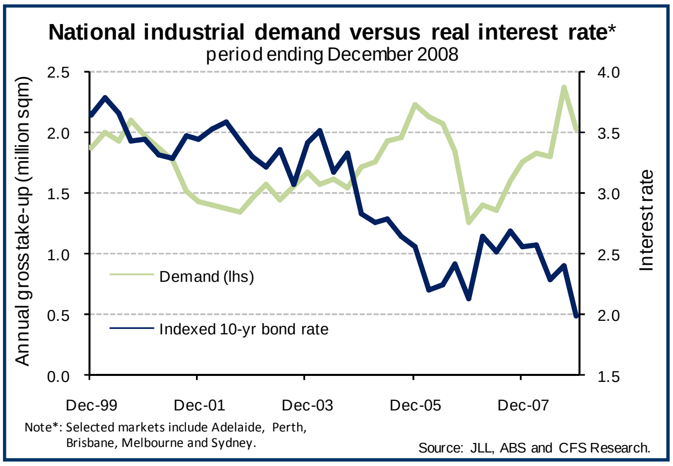


Figure 1B

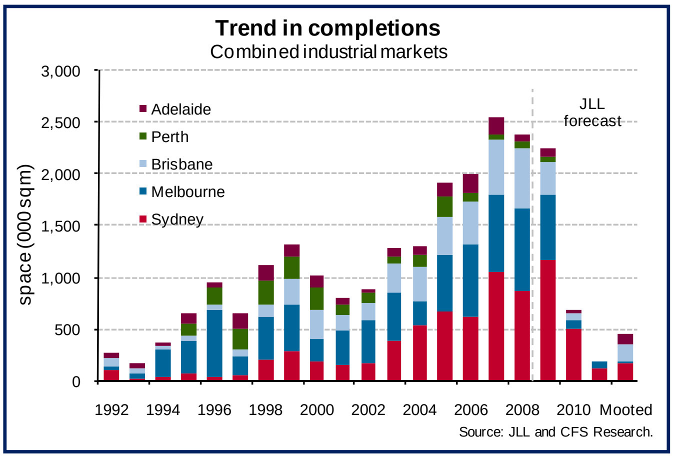


Supply

As shown in Figure 2, over the past four years new supply (gross completions) for industrial property was relatively strong. In 2008, a strong level of completions at 2.4 million square metres (sqm) came onto the market. Current estimates for 2009 suggest that new supply is also expected to be very strong (including approved projects) at about 2.2 million sqm. Around 80% of this space is expected to be delivered in Sydney (mainly the Central West market) and Melbourne (Northern and Western markets). Key drivers of supply include interest rates and construction costs.

Interest rates have a direct impact on development costs. Since industrial property has a relatively short lead-time for development, developers can respond promptly to changes in interest rates by either commencing or delaying projects. We expect that interest rates will remain low through the rest of 2009, with rates likely to start rising again in 2010 in line with anticipated stronger growth and rising inflationary pressures.

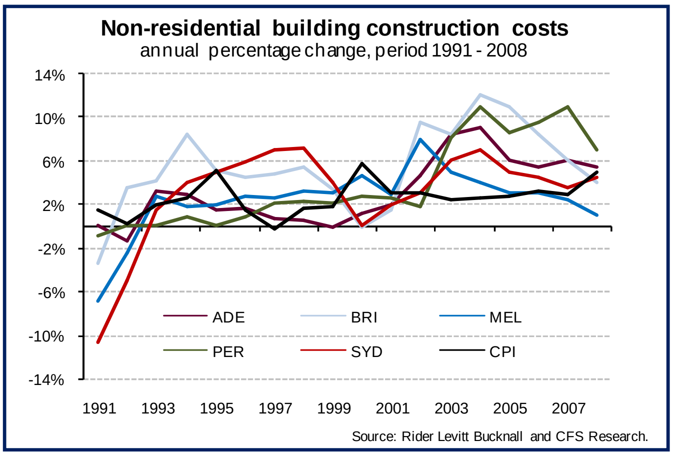
Figure 2



Building construction costs are a large part of the property development cost. Building construction costs include the costs of building materials and labour (or factor inputs). Over recent years, the rise in building construction costs relatively outpaced CPI growth (refer to Figure 3) due to: i) the engineering construction sector (via major infrastructure projects such as road, rail etc.); ii) an interstate labour migration to the booming mining industry; iii) strong competition for factor inputs from residential and other property sectors; and iv) increased international competition for raw materials. However, in 2008 the slowdown in economic activity resulted in a decline in construction costs growth, particularly in Perth (-4.0%) and Brisbane (-1.9%). For the remainder of 2009, we expect the construction cost growth to decline as competition for factor inputs deteriorate due to the following reasons: i) reduced output by building materials suppliers; ii) a moderation in labour costs; iii) moderate inflation; and iv) a construction halt nationally due to the GFC (as demand remains weak).

We forecast that the combination of currently tight credit market conditions, on-going moderation in economic growth and the inability to secure pre-commitments[2] will likely force developers to shelve plans for many projects throughout the remainder of the year, in spite of supportive interest rates and construction costs. However, the less mature industrial markets, 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.

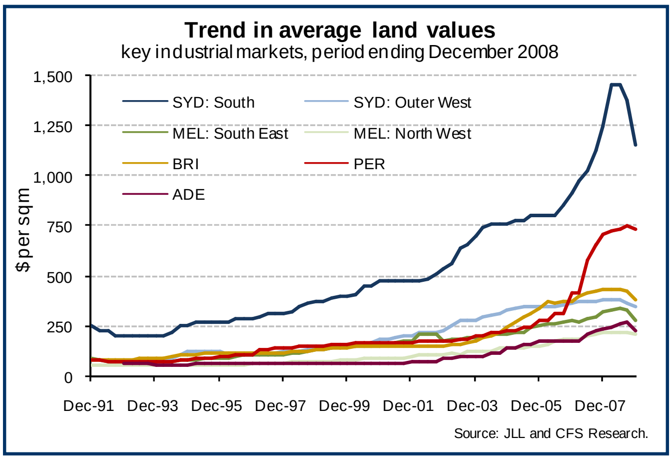
Figure: 3



Land values

Land values have been a key driver of performance across industrial property markets. Land values have been rising over time (refer to Figure 4), particularly since 2000 underpinned by a number of factors: i) solid demand for sites and space; ii) a lack of available space; iii) improvements in site access (mainly via improved road infrastructure); and iv) competition from other property sectors (mainly residential) and other commercial users of land.

Figure 4



However, the economic slowdown (compounded by a cooling residential market) resulted in easing growth in land values. The biggest decline in land values in 2008 was recorded in Melbourne markets (Scoresby -17.5% and Oakleigh -16.7%) and Sydney (Arndell Park -16.7%). In the short term we expect further declines in land values due to delays of development projects and

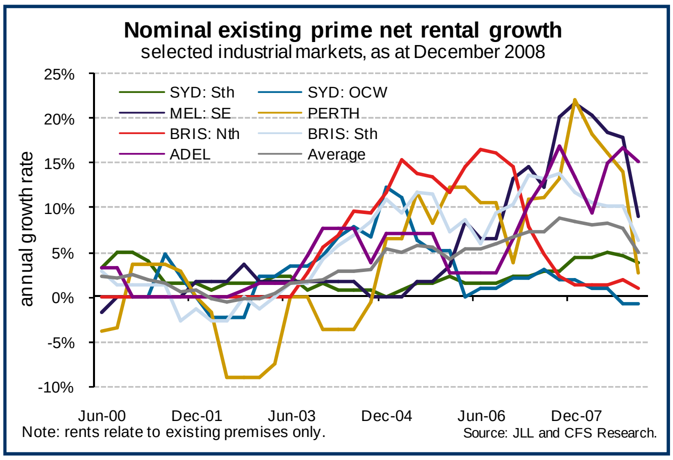
[2] For example, in Q408, the total of Melbourne's supply projects that were either approved or submitted for approval was 314,300 sqm, of which just 13.5% is pre-committed.

a decline in lending for industrial property. We expect lending for industrial property to remain constrained in the near term due to lenders' reluctance to support the sector (due to the expected decline in valuations).

Rents

Since 2003, most industrial property markets have experienced strong rental growth due to rising land values, rising construction costs, and demand generally outstripping supply. However, a deterioration in demand and strong supply conditions resulted in a rise in vacancy rates and incentives in 2008. Consequently, rental growth has eased in 2008, as seen in Figure 5.

Figure 5

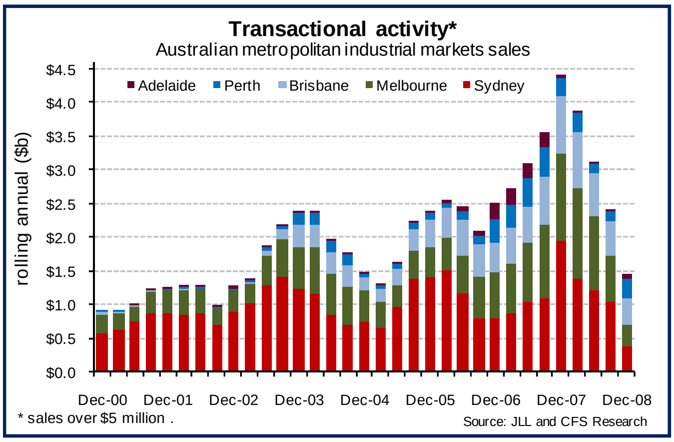


We expect a weaker macroeconomic environment and oversupply of industrial space to cause negative real rental growth in most markets during 2009, particularly in less mature markets. However, industrial markets which are expected to relatively outperform the sector as a whole include South Sydney and the Melbourne CBD fringe where new supply is constrained. Moreover, we expect tenancies which expire in 2009 to result in leases renegotiated at lower rents.

3. Investment performance

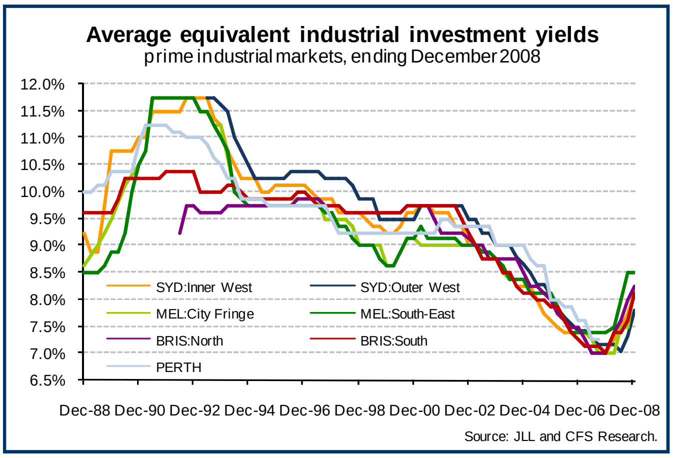
In 2008, national industrial property transactions recorded the largest contraction since 2000, as highlighted in Figure 6A. Sydney and Melbourne markets witnessed a decline in transaction sales by 81% and 75%, respectively. In contrast, the Adelaide (+65%) market was supported by ongoing project expansion activity in the defence and mining sectors and infrastructure improvements. We expect transaction activity to remain subdued in 2009 due to a deterioration in investor demand and a pricing mismatch between vendors and purchasers. However, some transaction activity is expected from the deleveraging of institutional portfolios across both listed and unlisted markets.

Figure 6A



A deterioration in capital markets and space market conditions has resulted in a rapid decompression in industrial yields in 2008, as seen in Figure 6B. Importantly, the pace of softening varies across regional markets and grades. On average, the Melbourne West market experienced the greatest yield softening in secondary and prime grade. We expect yields to soften further in 2009. Secondary assets should experience greater yield softening than prime grade assets, due to tenants' flight to quality assets and the deleveraging of institutional portfolios.

Figure 6B



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	Investment 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		Institutional Account Management	
Tony McFadyen	+61 2 9303 2699	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		