

REIV Commercial & Industrial Economic Forecast Lunch

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BIS Shrapnel

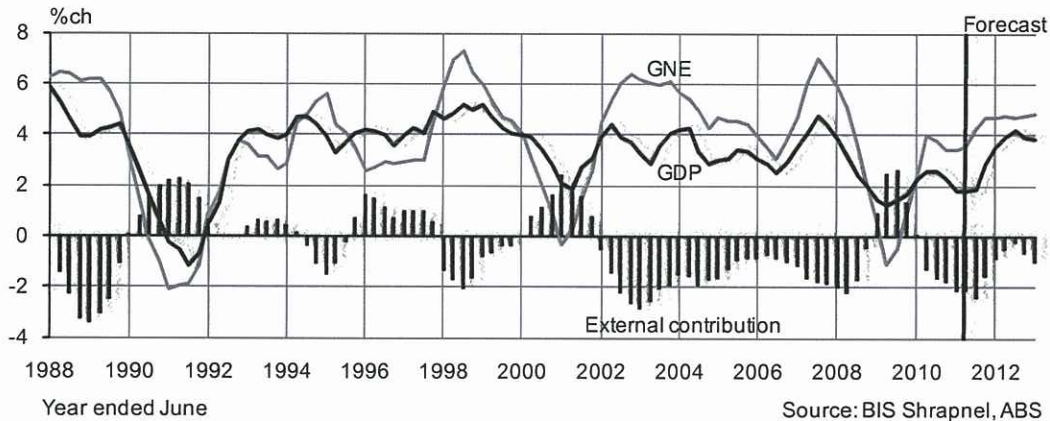


REIV Commercial
& Industrial

Australian economic outlook

- The economy hit a soft patch late last year just as the Reserve Bank last raised interest rates. This was compounded by the impact of floods and cyclone on mining and agricultural production and exports. As a result, consumer confidence has steadily weakened throughout 2011 and business investment in most sectors outside of mining remains subdued.
- Even so, we expect a strong rebound in June quarter GDP based on increased net exports, equipment investment, engineering (mainly resource-related) construction, a further rise in dwelling investment and stock rebuilding. Over the next two years, overall economic growth will strengthen, but the key drivers of growth will realise major differences between the performances of industry sectors.
- Over the second half of 2011 and into 2012, the key drivers of the recovery will be mining investment and increased mining production, with further increases in agricultural output also likely. The strengthening activity in these two sectors will then gradually broaden into the 'sheltered' domestic sectors which supply inputs and services. Another key driver of activity in the short term will be the re-building and repairing of infrastructure damaged by the floods and cyclones.

Basic economic indicators, moving annual totals



- However, there are factors which will act as a drag on growth. The high dollar is eroding the competitiveness of the export and import-competing sectors, with no relief in sight. The government is also cutting back spending to make way for the resources boom. The problem is that they have cut back before the recovery in non-mining and the broader economy has come through. Household and business caution is constraining growth now, with uncertainty about a range of issues, both political and economic effecting confidence. Fears of higher interest rates, the lingering GFC-related problems in Europe and the US and the exaggerated doom predictions from the losers in the carbon tax debate are the main concerns which will linger for a while yet.
- Eventually, however, confidence will return as these issues are resolved, and the mining boom broadens and 'trickles' down into the wider economy. Households and businesses will then lift spending and investment.

- Victoria has done well over the last decade, underpinned by strong investment and population growth, although the growth rate softened over the first half of 2011. Overall, we expect a solid performance in coming years. Although Victoria will not benefit directly from the major mining investment boom set to drive the national economy over the medium term, the state will nevertheless benefit indirectly from strengthening domestic demand and private investment.

Property market overview

- Last year, we were at the trough of the cycle. This year, the upswing has well and truly begun and Victoria is leading the charge. Confidence is high.
- In some office markets rents have risen sharply and yields have started to firm, driving price rises. However, conditions vary considerably across the cities, with Melbourne and Perth leading the way. Sydney and Brisbane will be the next cabs off the rank. Retail has started to pick up, though the weakness of retail sales is affecting consumer confidence. Despite the strength of household income growth, most consumers are choosing to build up a savings buffer rather than loosen their purse-strings. Industrial property, too, has started to pick up and strong business travel means that the hotel market is tight. In all of these sectors, the GFC curtailed construction so that, with demand recovering, leasing markets are tightening.
- On the investment side, excessive caution in both debt and equity markets is constraining demand for property. There are excellent opportunities for investment, but it seems that overseas investors are more willing to pick them up than domestic players.
- The next stage of the recovery in property markets will be driven by rising rents as leasing markets continue to tighten, with investors still largely sitting on the sidelines. Only when there have been several years of rental growth will we see the re-entry of a wider range of local investors in full force, in turn driving a further firming of yields and sharply higher prices.

Melbourne office market

- Melbourne's office market decisively entered a cyclical upswing in 2010 and momentum continued through the first half of this year. Vacancy rates peaked in mid 2010 and have since declined, with our June estimate below 6%. Prime CBD rental growth was an impressive 14% (net effective) during 2010–11. Meanwhile, strong investment activity saw yields firm ahead of expectations to an average 7.2%, driving prime property values up by 20% from the cycle trough. Indeed, all the ground lost during the GFC-triggered downturn has been recovered. The B grade market is not far behind. Melbourne is first cab off the rank in the upswing amongst Australian office markets.
- The turnaround was aided by unusually strong employment growth—though net absorption failed to keep pace—and more subdued supply additions as the GFC's impact of stalling building commencements started to feed through to completions.
- The key to continued strength in the near term is the limited amount of new supply. Building commencements slumped in the wake of the GFC and we saw that feed through to completions in calendar 2010. Completions this year will be even lower, at less than 40,000 square metres in the CBD & Docklands.

- Having said that, commencement activity has rebounded strongly over the last 6 months or so. 12 months ago, the supply outlook was very constrained, whereas now there is already around 225,000 square metres of floorspace under construction in the CBD & Docklands (though very little in the suburban markets). The vast majority of this will be completed by June 2013. But, given the long lead time for new development, short term supply is locked in.
- With supply fixed, the short term performance of the Melbourne market will be driven by the strength of demand. Currently, employment growth is running at 3.7% p.a., easily outpacing the national average and probably unsustainable. Nevertheless, employment growth should remain solid over the next two years, driven by a strengthening economy. Whilst Victoria will not directly benefit from the minerals investment that will drive the Australian economy, it will benefit indirectly from strengthening domestic demand and private investment. We expect the structural positives of the state, such the ready availability of reasonably priced residential land and competitive office rents will continue to help underpin relatively strong office employment.
- Overall, near term prospects remain solid. The balance of demand and supply—despite the supply outlook being more aggressive than this time last year—should see vacancy rates fall further through to June 2013 in the CBD & Docklands. Tightening market conditions will drive strong effective rent rises, driving expectation of capital gain and firming yields which should drive solid price rises of the order of 80% from now to the forecast 2015 peak for prime CBD offices.

Forecast net effective rents and values, Melbourne

Year ended June	Net effective rents		Values	
	Prime	B grade	Prime	B grade
Next 2 years (2011e to 2013)	Current \$ (% ch)			
	34.9	34.2	41.8	40.7

e = estimate

Source: BIS Shrapnel

Retail property markets

- The retail property sector is daily grabbing the headlines with reports of weak consumer sentiment, subdued spending, the threat from online retailing, uncertainty over the carbon tax, retailer profit downgrades and even retailer failures.
- We agree that the retail sector is facing a number of challenges at present. Nonetheless, we have a broadly positive outlook. The main problem on the consumer spending side is confidence—willingness, not ability, to spend. Household incomes are growing at a solid pace, but people are choosing to build up their savings buffers rather than loosen their purse-strings. It's understandable when there are concerns about further rises in interest rates and in utilities bills, in particular. Not to mention flat to falling house prices and a nervous share market, which are making people feel less wealthy—and less disposed to spending. However, at some point households will realise that they are, in fact, well positioned financially, with good job security and prospects for wages growth.

- Meanwhile, thanks to the high \$A, retailer margins remain high, though the aggressive 'sales' season may make some inroads into margins.

Proportion of retail turnover by category

Year ended June	Food retailing	Department stores	Clothing and soft goods	Household goods	Other retailing	Cafes, restaurants & takeaway
	% of total					
1991	49.6	10.0	8.4	7.8	14.6	17.2
1996	47.3	9.3	7.3	9.8	14.2	17.2
2001	44.8	8.6	7.2	13.2	13.7	14.4
2006	40.5	8.4	7.9	17.6	13.0	12.8
2011e	38.9	7.7	8.3	18.4	14.0	12.7
<i>Forecasts</i>						
2016	37.7	7.7	8.3	19.8	14.2	12.3

e: estimate

Source: BIS Shrapnel, ABS data

- It's difficult to pinpoint the exact timing and trigger of the recovery in retail spending, but we expect it to become apparent through 2011–12 as the economic upswing broadens and gathers pace. The release of consumers' latent spending power will come as a welcome relief to retailers. Stronger activity in dwelling construction will add to retail demand, particularly as dwelling reach completion and the furnishing stage.
- But we flag the risk that retailers' ability to pay rental increases may be compromised by a fall in the \$A. The \$A is notoriously difficult to predict, and short to medium term indicators would suggest it will remain relatively strong. Our forecast is for continued strength for some years yet. But a collapse at some stage is not out of the question. This would put pressure on retailer profit margins, which have risen substantially over the last decade and have been a key driver behind retailers being able to absorb rental increases. Profitability—and ability to pay—could also be compromised if current consumer reluctance to spend continues well into 2011–12. Some retailer who are just hanging on may not survive a protracted period of falling sales.
- Another potential threat to shopping centre incomes is online shopping, at both domestic and overseas sites. The strong \$A is encouraging Australians to shop overseas, whilst domestic online sales are getting a boost from major retailers—finally—starting to take the medium seriously and offer consumers the opportunity to purchase online.
- We expect retail turnover to average over 3% annual growth over the next decade, translating to reasonably solid growth in retail rents and shopping centre incomes—despite the leakage online—keeping comfortably ahead of inflation.

- On the investment and development side, activity in the retail sector has picked up markedly from post-GFC lows. Market players are seemingly shrugging off, or seeing beyond, the current weakness in retail spending. Development activity, in terms of commencements of retail projects, has bounced back sharply. The value of retail transactions soared through 2010 and investor interest remains keen this year. Retail yields have stabilised at a lower level than we originally expected—they have been re-rated in the light of the relatively low volatility of income returns. We expect yields to firm in the short to medium term, though not back to December 2007 levels. Without the debt-fuelled investment boom in the lead up to 2007, there is no over-riding factor to drive yields sharply lower. On the contrary, higher (forecast) 10 year bond rates will exert upwards pressure on yields over the next couple of years.
- Overall, with moderate centre income growth and little firming of yields, we do not forecast the stellar capital returns that boosted total returns in the 2003 to 2007 period. Beyond the near term challenges, retail property is expected to be a solid, rather than spectacular, performer.

Melbourne's industrial property markets

- Underlying demand for industrial property in Melbourne appears to have weakened this year, in line with the softening national and Victorian economies. Nonetheless, demand remains solid, with Victoria one of the better performing states. Economic growth in Victoria is being held back by weak household spending, the winding back of government stimulus spending and the high \$A (hitting trade-exposed sectors, such as manufacturing). However, parts of the state economy are benefitting from servicing interstate minerals investment and rising imports (boosted by the high exchange rate) which need to be stored and distributed.
- We estimate that the strength of demand has absorbed excess capacity created during the downturn, particularly in warehouses, with new demand growth fuelling net absorption in the leasing markets. Agents report occupier take-up has been solid over the year to date, but has not matched the level of activity of the same period last year. Nevertheless, vacancy rates amongst prime stock (particularly larger than 5,000 square metres) are low.
- On the supply side, industrial development work done has recovered moderately since the 2009–10 trough, but the recovery in activity has been sporadic, reflecting the commencement of a handful of large warehouse/distribution projects. Even so, the value of work done remains some 37% below the 2006–07 peak level. Approvals data gives a good indication of work about to commence. The latest data to March 2011 shows annual metropolitan-wide factory approvals running at extremely low levels of \$185 million with warehouses at \$470 million. Almost half of the warehouse approvals were captured by the western region, with 35% in the south-east.
- New industrial supply is constrained because construction remains broadly unfeasible at current market rents, yields and land values, with pre-commitment rents well above rents for existing prime space in most of the regions. However, low land values in the west in particular means the gap is very narrow here.

- Despite the constraints, a number of pre-committed projects are currently under construction, with low vacancies (and rising rents) encouraging limited speculative development. The biggest pre-committed projects under way include the 43,000 square metre Pacific Brands Distribution Centre at Trugania, Trimas Corporation's 25,000 square metre warehouse at Keysborough and Toll's 17,000 square metre facility at Altona.
- The combination of sustained demand and limited supply means has pushed down vacancies amongst prime properties, encouraging rental growth across all regions but particularly in the south-east and the west. Average face rents in these two regions have increased by between 3 and 5% over the last 12 months. The secondary markets have also benefitted from the tightening prime markets, with rents rising between 0 to 5%.
- In the investment markets the value and volume of activity in the Melbourne industrial market has recovered steadily over the last two years but is still well below level reached at the peak in 2007. The pool of buyers was quite broad over the last 12 months but private investors were the most dominant. Amongst institutional grade industrial property, activity was boosted by a number of portfolio sales, which also increased the dominance of Goodman and Dexus. Whilst the funding constraints on the major industrial and diversified A-REITS have eased, there are still many smaller players who remain under pressure to sell to reduce gearing.
- At June 2011, prime industrial remain steady at around 8 to 8.5% or close to the long term equilibrium.
- Over the next one to two years, we expect overall economic growth will strengthen both nationally and in Victoria, but not until the current uncertainty about the political and economic environment eases. The key drivers to the recovery will be mining investment and production, with a further boost from agriculture likely. The strengthening of these sectors will trickle down to the wider economy which should benefit Victoria as it services domestic demand. Amongst the key industrial sectors, manufacturing should grow moderately with strong growth in the mining related sectors, partially offset by the high \$A weakening export and import competing sectors and weak housing construction. This will lead to moderate demand for new factories.
- We expect growth in wholesale trade to pick up as retail sales recover and growth accelerates in equipment investment, construction and farm output. This will run in tandem with a pick-up in transport and storage sectors as consumer spending and machinery and equipment investment strengthens. Brightening prospects in these sectors should provide sustained demand for Melbourne warehouses over the next few years.