



REIV Commercial & Industrial Economic Forecast Luncheon

REIV

Commercial
& Industrial

Dr. Frank Gelber

BIS Shrapnel

Australian Economic Outlook

- The Australian economy is emerging from what turned out to be a relatively mild downturn. The much-feared recession never eventuated, and unemployment peaked at a benign 5.8 per cent. The fiscal stimulus package, together with a quick pick-up in growth in China, helped to achieve this outcome.
- We're now well into the recovery.
- Employment growth is strengthening. Delays in pushing through the construction component of the stimulus package are sustaining public sector investment. And private residential building is picking up.
- The outlook for next year is for further improvement. Private sector building activity is expected to turn around as public sector investment plateaus. Business profits should continue to firm, underpinning solid employment growth. Consumer spending will gain momentum.
- Nonetheless, sovereign debt fears in Europe and concerns about US and Chinese growth are unsettling business and consumer confidence and could prove to be a drag on growth.
- Victoria has done well over the last decade, underpinned by strong investment and population growth. Overall, we expect a solid performance in coming years, though state final demand and employment growth may ease next year from the surprisingly strong growth of 2009–10 due to declines in public investment and private sector non-dwelling building and engineering construction.

Property Market Overview

- This time last year, rents and property values were falling. There was a large amount of property for sale, but investors—with the exception of private investors—were thin on the ground. They were either unable to enter the market, due to their debt problems, or unwilling to do so, waiting for the market to bottom out. There was considerable uncertainty about the economic outlook and its impact on both user demand for property and on investor confidence and capacity to buy.
- Twelve months on, most property markets have troughed. The key exceptions are the Brisbane and Perth office markets, together with some secondary sectors. In the main, occupier demand has picked up and tentative rental growth is in evidence—usually in the form of reduced leasing incentives rather than growth in face rents. In the retail sector, occupier demand is being boosted—though in a small way initially—by overseas retailers entering the Australian market for the first time.
- On the investment side, the major A-REITs have recapitalised and are poised to re-enter the market. Super funds are also becoming more active, and look set to become involved in innovative funding arrangements. Private investors continue to seek out opportunities. With prices still below replacement cost, it remains a good time to buy.
- As investor sentiment continues to grow—bolstered by recovering leasing markets—yields should start to firm. Indeed, this is already apparent in some markets. However, we do not expect a rapid rebound in yields back to December 2007 levels. Far from it. In the retail and industrial sectors, we estimate that yields overshot thanks to the strong (debt-fuelled) funds flow associated with the financial engineering boom in the period leading up to the GFC. Meanwhile, although office market yields did not appear to overshoot, it will be several years at earliest before yields regain boom-time levels.
- The pace of recovery varies from one property sector to another, and from city to city. The office and industrial markets show the greatest geographic discrepancies. The Melbourne CBD office market will be first cab off the rank in the recovery. Thanks to robust employment growth, relatively low vacancy rates and little new supply underway, its prospects seem bright. Developers are dusting off projects—albeit it may be premature to do so. Some other cities will see vacancy rates rise further before they start to fall, delaying the commencement of new development activity.
- Furthermore, many smaller listed and unlisted funds and syndicates continue to face debt problems and may yet be forced to sell properties. Quite how great is the extent of the problem is difficult to estimate, but it could slow the pace of recovery in secondary markets.

Melbourne Office Market

- Melbourne's office market is recovering after a cyclical downturn through 2008 and 2009. On the face of it, Melbourne escaped the GFC and its side-effects relatively mildly. Prime CBD net effective rents fell by 12 per cent and prime CBD values fell by 22 per cent (with the secondary market slightly more severely affected in both cases). By contrast, most other CBD markets suffered much greater losses.
- However, Melbourne did not escape as lightly as these figures suggest. Vacancy rates more than doubled from 20 year lows—from just 3 per cent in the CBD to 6.6 per cent (at December 2009), and from 4.1 to 8.5 per cent across the broader metropolitan area. This occurred thanks to a downturn in demand at the same time as a major supply cycle was drawing to a close. And though rents fell mildly, they were coming off a relatively low base—in real terms, Melbourne's rents had never recovered from the 30 per cent fall over the period 2002 to 2005 before the GFC hit. And investment yields in Melbourne blew out by a similar amount as those in Sydney and Canberra, for example.
- As the economy recovers, and with it leasing demand and investor confidence, Melbourne's office market should make up all the lost ground and more, quite possibly much more.
- Melbourne has already enjoyed a strong bounce-back in employment growth. All the losses incurred in 2008 had already been clawed back by mid 2009. The pace of growth is phenomenal. In the year to June 2010, Victoria posted a 4.4 per cent gain, outpacing every other state and territory bar Western Australia. The Melbourne metropolitan area has been performing even more strongly than the state, recording 5.5 per cent employment growth in the year to May 2010 (latest data available).
- Anecdotal evidence supports stronger tenant demand. Tenants are seemingly expecting rents to rise and are keen to do deals. Moreover, larger tenants are cognisant of the shortage of large contiguous accommodation options. Several major pre-commitment deals have been announced in recent months, notably the ATO, Melbourne Water and the NAB in Docklands and Origin Energy in the 'traditional' CBD.
- We don't anticipate that employment growth will be sustained at the pace of recent months, but it should remain solid off the back of a strengthening economy. Net absorption is forecast to be solid this year, both as (pre-committed) tenants move into buildings completed over the last 12 months or so, and as the generalised upturn in tenant demand benefits established buildings. Delays in tenant decisions and physical moves could sustain solid net absorption through 2011, but by 2012 we expect net absorption to be constrained by lack of space options. The reason for this is essentially the near-absence of new construction.
- The development cycle that has just drawn to a close has added over 2 million square metres of new and refurbished office floorspace. After allowing for stock withdrawals, this equates to an increase in stock of almost 30 per cent. The cycle ended abruptly—and prematurely—thanks to the intervention of the GFC and associated domestic credit squeeze. New commencement activity plummeted post-2007. Completions only remained robust until this year because those projects had been started pre-GFC.

- Over the next two years, we will see the effects of the collapse in building commencements. Very little will be completed. In the CBD, most major buildings take at least two years to construct. That's why we can be confident that supply additions will be very muted.
- With solid demand and little new supply, vacancy rates are likely to contract. We estimate the CBD vacancy rate will be below 4 per cent by June 2012. In turn, this will send rents sharply higher. Meanwhile, investor confidence has already been partially restored, and is likely to strengthen further in the light of the forthcoming strength of the leasing market and rental growth. Yields should firm, boosting capital values.

Forecast rents, values, IRRs, Melbourne

	<i>Net effective rents</i>		<i>Values</i>		<i>IRRs</i>	
	<i>Prime</i>	<i>B grade</i>	<i>Prime</i>	<i>B grade</i>	<i>Prime</i>	<i>B grade</i>
Peak to trough (2008 to 2009)	-12.4	-14.3	-21.6	-26.3	-4.3	-6.6
Next 5 years (2010e to 2015)	97.6	113.0	123.7	144.8	24.1	27.0
Next 10 years (2010e to 2020)	72.5	78.5	68.8	69.8	14.0	15.6
Peak to trough (2008 to 2009/10)	-15.5	-18.4	-24.5	-29.0	-6.6	-8.9
Next 5 years (2010e to 2015)	54.9	62.7	66.7	83.7	20.9	23.7
Next 10 years (2010e to 2020)	33.0	40.8	29.2	38.5	11.1	12.7

e = estimate

Note 1: Rent and value cycles differ slightly in their peak/trough dates. Growth rates are presented over the relevant cycle for each market. IRRs are calculated over the values cycle, year ending June

Note 2: The date of trough/peak can be December rather than June

Source: BIS Shrapnel

- How long this favourable scenario will endure is dependent on the resumption of new supply. Although a few major pre-commitments will kick-start new buildings in Docklands, we do not believe that a major development wave will commence until rents and values have risen substantially, to replacement cost levels. This is likely to be two years off at least. Hence, allowing for the delay in construction, market conditions could remain tight until mid-decade. If so, this would generate continued gains in rents and values.
- However, at some stage development activity is likely to gather pace to the extent that it once more outpaces demand. Although we do not expect to see this in the short to medium term, it is vital to closely monitor the market for signs of aggressive development.

Retail Property Markets

- The retail property sector has faced challenging conditions over the last couple of years. Now, a recovery appears to be underway. Certainly, investment activity has picked up and yields have stabilised—with signs of firming in some cities/centre types. Development projects are also being dusted off again after being put on hold in the wake of the GFC.
- The major question-mark over the recovery lies in the area of consumer spending. This has been on a roller-coaster ride over the last two to three years. In 2008, consumers became more cautious as the global turmoil created expectations of a recession in Australia whilst interest rates were still high. In response to the federal stimulus package and a rapid series of cuts by the Reserve Bank, consumers started to loosen the purse-strings in 2009. But this year, on the back of a reversal in interest rate policy and fears of double-dip recession in the US and the impact of the European sovereign debt crisis, consumer confidence has slumped. Retail turnover appears to have weakened. However, in our view this is more illusory than real, as comparisons are being made with the stimulus-boosted results of last year.
- Looking ahead, as economic growth strengthens so too will consumer spending. No major economic setbacks are envisaged before the end of the decade at the earliest. This should underpin solid growth in retail rents and shopping centre incomes.
- 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. 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.
- Another potential threat to shopping centre incomes is online shopping, which appears to be re-emerging as a competitive threat after a phantom first appearance a decade ago.
- On the investment side, retail yields softened through 2008 and 2009, though by less than we had expected. There may have been a re-rating of retail yields 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 few years.
- Therefore, even though retail property may enjoy reasonably solid income growth, we do not forecast the stellar capital returns that boosted total returns in the 2003 to 2007 period. Retail property is expected to be a solid, rather than spectacular, performer. The focus has returned to the nuts and bolts of the business of running a shopping centre.

Melbourne's Industrial Property Markets

- Demand for industrial property in Melbourne is recovering after the GFC triggered downturn in the Australian economy during 2008–09. Economic growth at both a national and Victorian level was underpinned by government stimulus packages in 2009–10. Indeed, with the state government ramping up stimulus spending faster than other states, Victoria has been one of the better performing state economies. Activity in the state's distribution, transport and wholesale trade sectors is also slowly improving in line with the economy, with imports picking up from trough levels and being distributed locally and interstate.
- Our industrial demand indices show almost all the excess capacity created during the downturn has been absorbed, particularly in warehousing, with businesses restocking in anticipation of future demand. Strengthening demand is also translating to the leasing market with agents reporting leasing volumes across Melbourne in calendar 2009 almost double that of 2008. And demand has remained solid through 2010 to date.
- On the supply side, industrial construction in Melbourne has collapsed, with work done for factories and warehouses at its lowest level in 14 years. The latest data available to March shows the value of metropolitan work done sitting at about \$600 million, less than half the \$1.3 billion reached at the early 2007 peak. The collapse has been more pronounced for factories which—at just over \$100 million in MAT terms—have reached their lowest level in more than 30 years.
- 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. That said, we have seen a few major pre-commitment deals negotiated in recent times at what we understand to be above existing market rents—just not too many. The biggest deals include Kmart's 76,000 square metre distribution centre in Laverton North and Cadbury's 27,000 square metre pre-commitment in Dandenong.
- The combination of rising demand and little supply means that vacancies amongst prime industrial buildings have fallen appreciably over the last 12 months. However, despite a demand and supply imbalance, there are still sufficient options available for most occupants. As a result, prime net stated rents have remained fairly stable over the last 12 months. The secondary markets have been hit harder, with face rents falling between 2 and 7 per cent over the year to June 2010 (depending on the region).
- In the investment markets, the period of yield softening is now over. The major A-REITs have recapitalised, removing the imperative to sell assets and reduce gearing. Indeed, a number of A-REITs have become active again in the industrial market, acquiring englobo land or kick starting (limited) development activity. Nevertheless, some of the smaller funds (both listed and unlisted) who have not been able to attract fresh equity remain under pressure from their financiers. Overall, over the last 12 months, sales values and volumes have picked up appreciably, with private investors the most active.
- The collapse in supply has also had an impact on industrial land values, although prices appear to be have stabilised and are even starting to rise again. Since the peak in 2008, the average price of 2,000 to 5,000 square metre serviced lots has fallen by between 5 and 22 per cent. However, these falls have only taken prices back to 2007 levels.

- In the short term we expect the national economic recovery to continue, but domestic and overseas drivers will take time to flow through to demand for industrial space. Even so, the Victorian economy is set for a period of solid growth. Continued relatively strong population growth—via an increased share of high net overseas migration and only a small net interstate outflow—will underpin housing construction, consumer demand, infrastructure construction and the business investment required to support increased employment and demand for goods and services.
- Nevertheless, we expect the strength of annual realised demand (net absorption) will be lower than between 2004 and 2007, as upgrading amongst tenants, which drove the previous construction boom, is unlikely to recover to earlier levels.
- Prime industrial yields have started to firm again and currently average about 8.5 per cent, close to the long term equilibrium. Given our view that the firming of yields evident during the upswing and boom to 2007 was driven by a debt-fuelled flow of funds, we do not expect to see the same over-reaction in yields this decade. Rather, we expect yields will cycle around the current longer term average.
- That means that rents will need to rise appreciably from here, or land values fall, for new development to get underway. Land values are not expected to fall much further from here, but nor will there be too much upwards pressure. Given that Melbourne has no real shortage of zoned industrial land and much of what is available is controlled by the A-REITs/major developers, competition to develop is likely to intensify in the short term, keeping a lid on land price growth.