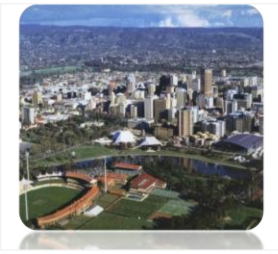
Thinktank

Leading Commercial Finance

December 2015

Australian Commercial Real Estate Market Focus



The following represents a monthly snapshot of how we see the commercial property markets across the country along with the near term outlook. For a more detailed commentary, please visit our website thinktank.net.au for our Quarterly Market Update.

The Westpac - MI Consumer Sentiment Index rose sharply again in November equalling the increase of 3.9 points in October. This brings the index to 101.7, its highest level since January 2014 and over the 100 level of optimism. The AiG-PMI for November also rose by 2.3 points to 52.5 for a fifth month above 50 which is the longest run of expansion since 2010. While much of this positive sentiment is attributed to the new Turnbull Government a surprisingly low unemployment rate for October of 5.9% down from 6.2% also contributed. Other economic statistics are not as strong and 2016 GDP growth rate forecasts continue to be downgraded most recently to 2.75% by Treasury. Third quarter GDP surprised slightly on the upside at 2.5% for the past year due to strong exports.

The December RBA Board meeting left the Cash Rate unchanged at 2.00% for a seventh straight month and sentiment as reflected in the futures markets has priced much less of a chance of a cut in rates in 2016. Most market economists continue to favour a wait and see approach being adopted by the RBA with a significant move downward in growth being required before another cut in rates. A further decline in commodity prices could be such an event but the RBA's November SoMP seems to favour a long period of low growth and low interests rates and Governor Stevens clearly reflected that in a major speech late in the month. Opinion is also less mixed on whether the US Fed will increase rates at its December FOMC meeting. An increase of 25 basis points is now expected on the 16th of December and forecasters see this as the start of similar quarterly increases through 2016 until rates have risen by 1%. It is difficult to see Australian rates falling in this environment although most expect the AUD to fall despite its recent rise to 73 cents.

We have not adjusted our Sydney and Melbourne Residential trends since reducing them to stable last month while leaving their ratings unchanged at Strong. Statistically, Sydney is certainly coming off "the boil" and auction clearance rates are a good measure of that. Prices of desirable property however are not falling and remain at elevated levels. In other sectors, retailers are signalling a better outlook for Christmas but some sub-groups remain troubled. Our News and Views section inside shows how strong commercial markets have been overall this past year but also how varied by sector and location.

We have left all of our ratings as they were with seven markets that are Strong or Good and five that remain Weak. Sydney and Melbourne Residential trends are Stable with Strong ratings. All of the rest of their sectors are Improving. This compares to Brisbane, Perth and Adelaide which have eleven ratings Weak and/or Deteriorating. Perth continues to be gloomy while Adelaide is trying to pick itself up with good efforts by the State Government to stimulate renewed interest and activity.

	Sydney		Melbourne		Adelaide		Brisbane (SEQ)		Perth	
Residential	Strong	Stable	Strong	Stable	Fair	Stable	Good	Improving	Fair	Deteriorating
Commercial	Good	Improving	Good	Improving	Weak	Deteriorating	Weak	Deteriorating	Weak	Deteriorating
Retail	Fair	Improving	Fair	Improving	Weak	Stable	Fair	Stable	Fair	Stable
Industrial	Good	Improving	Good	Improving	Fair	Deteriorating	Fair	Improving	Weak	Deteriorating

Sources: ABS, ACCI, AiG, ABS, ANZ Research, ATO, CBA, CBRE, Colliers International, CoreLogic RP Data, HTW, IMF, IPD, JLL, Knight Frank, Melbourne Institute, OECD, PCA, RBA, , Savills Research, Westpac Economics

News and Views

- The quarterly PCA/IPD Australia Property Index for 30 September 2015 produced by MSCI was released in late November and the annual returns highlighted commercial property's best year since 2008. As shown in Chart 1, the average of the total return for the 12 months to the end of September was 12 per cent based on a 6.9% income return and 4.8% capital return according to the index which covers $151 billion in assets. Robert Harley featured the report in an in depth article recently in the Australian Financial Review.

- It is easy to see from the blue income bar lines why commercial property is such a favourite of pension funds and other institutions with long dated liabilities with the consistency of returns over the past 10 years. While capital values have fluctuated widely, income has remained steady and as long as you had a long-term investment horizon and no immediate need to realise these assets, total returns eventually returned to the 15 year average return of 15.4%.

- MSCI's vice president, real estate, in Asia Pacific, said property investment cycle was in an upswing phase above the long-term average, of 10.4 per cent, for the third consecutive quarter. "The aggressive tightening in cap rates is being seen more broadly across the property market, spurred on by the lower cost of debt capital, and an unprecedented level of investment activity. Despite the tightening in cap rates, the spread between commercial real estate cap rates and the bond rates was still high and would continue to be favourable as long as interest rates remain relatively low in the short run.

- All the key sectors delivered in the year to September but with significant variations within the sectors as shown in Chart 1. Sydney and Melbourne were the stars of the office sector with total returns for the year of 14.7 per cent helped by strong capital growth. In Perth, where values are falling in the wake of the resources decline, the return was just 4.5 per cent. Within Sydney, it was the lower grades of central business district stock that shone, helped by the "stock withdrawals for residential conversion", and outside the CBD, Parramatta was the star with a total return of 16.3 per cent. The best performances in the retail sector came from the neighbourhood shopping centres (14.4 per cent) and the housing-boosted, large format retail centres (13.8 per cent) which were well ahead of the flagship super and major regional centres (8.6 per cent).

- A key question being asked however is like 2008, is this a market headed for a fall? MSCI executive director, Anthony De Francesco said the overall investment performance was likely to strengthen over the short term, underpinned by buoyant capital markets, and strong offshore appetite, which would deliver further cap rate compression. "A clear risk to the asset class remains the increasing disconnect between the strong capital market conditions against somewhat softer space market fundamentals."

- A recent article in the Sydney Morning Herald featured comments about the implications of Lang Walker, a veteran in the property development field, getting ready to sell his Collins Square project in Melbourne's Docklands. Walker now looks like taking advantage of mainly foreign buyers – from Canadian pension funds to Chinese billionaires - chasing prime CBD property in their global search for yield. Quoting RBA Assistant Governor Malcolm Edey, "The commercial property sector is again experiencing strong investor demand, ……however there are a number of signs of increasing risk."

Chart 1: Total Property Returns – September 2005 to September 2015

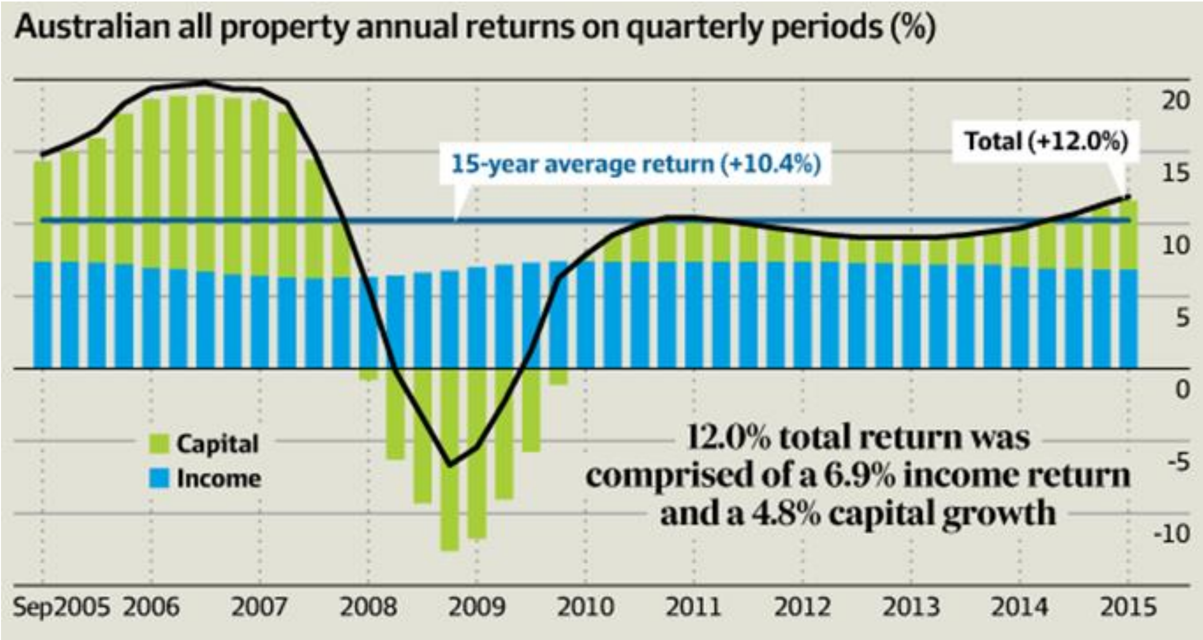
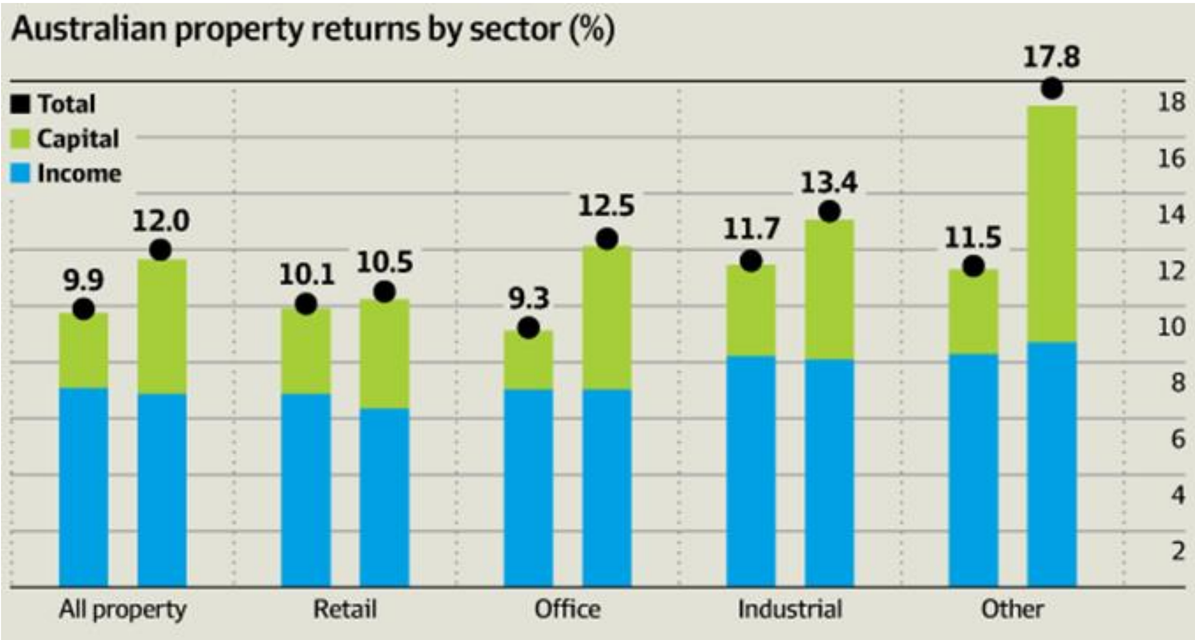


Chart 2: Property Sector Returns – September 2014 and September 2015



Source: AFR, MSCI

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- Self-Managed Superannuation Fund (SMSF) loans up to 75% LVR, and
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