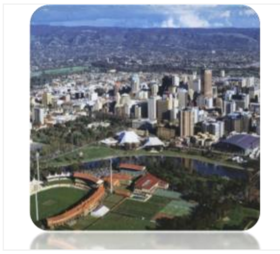
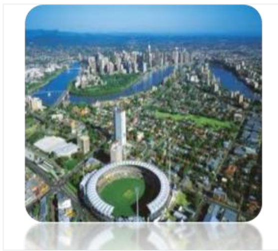
Australian Commercial Real Estate Market Focus





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 W-MI Consumer Sentiment Index fell in August by 2.3 to 103.6 but stayed in optimistic territory above 100. The Westpac Leading Index however was up after falling for two months rising to 0.55 % in July from -0.06% in June. The AiG PMI for August was also up by 4.7 points to 56.7 further into positive territory above 50. The Services PSI fell slightly in August by 1.4 points to 52.2 but still expanding. The Retail Trade sub-sector index rose 3.0 to 57.0 well into expansion. Retail sales for July were flat after a 0.4% lift in June.

At its September meeting the RBA Board once again left rates unchanged at the record low of 1.50% now passing two years at that level. The RBA's August Statement on Monetary Policy saw little change in their key forecasts with slightly above trend GDP of 3.25% (actual Q2 0.9%, yoy 3.4%) and unemployment of 5.25% by next year. Inflation however is set to remain at or below 2% for another year. The US Fed after raising rates in June left them unchanged in August but is widely expected to raise rates again later in the year. AUD/USD which had stayed higher than most economists had predicted this year has dropped 7.5% this year to the $0.72 range forecast by Westpac and could drop to $0.70 by early next year. Ten year Treasury bond rates in the US are still below 3.00% at 2.86%, but well above comparable Australian bond yields that are now down to 2.50%.

CoreLogic housing price statistics for August again showed a fall of 0.3% in Sydney and 0.6% in Melbourne. The quarterly figures tell the same story being down 1.2% and 2.0% respectively. Nationally the market weakened by 2.0% for the year, the fastest annual rate in 9 years. The "Softening" trend established last year continues in the Sydney and Melbourne markets which we continue to rate as Fair with further similar price movements expected. In this month's News and Views we are reviewing the results of the semi-annual MSCI index which has confirmed the continued improvement in Office and Industrial sectors with Sydney and Melbourne remaining out in front of the other capital cities but with Retail having lost considerable ground in Income Returns over the past year. Non-core sectors of Hotels and Health Care have dropped off considerably from recent highs.

There have been no further changes our July Quarterly Update when Melbourne and Sydney Residential fell to Fair from Good with their trends still Softening. We still rate four markets as Strong or Good and all are in Sydney and Melbourne. Adelaide and Perth have six ratings Weak and all trends are Stable. Brisbane has one Improving trend which is Industrial and Commercial that remains Weak but Stable. Retail is Fair and Stable except Adelaide which is Weak. Retailers continue to struggle despite Stable property prices as sales flat-line and income returns decline which justifies a very close watch.

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

Sources: ABS, ACCI, AiG, ABS, ANZ Research, ATO, CBA, CBRE, Colliers International, CoreLogic RP Data,Cushman & Wakefield, HTW, IMF, MSCI/IPD, JLL, Knight Frank, Melbourne Institute, OECD, PCA, RBA, RLB, Savills Research, Westpac Economics, World Bank

News and Views

- Our usual follow-up to the semi-annual Property Council of Australia (PCA) Office Market Report (OMR) is the MSCI All Property Index and its recent release shows a relatively steady rate of return of All Property at 11.7% compared to 11.9% of a year earlier and exactly the same as the 5 year average. The Total Return is evenly split between Capital Growth and Income Return. Individual sector returns vary quite widely both as compared to other sectors and returns of a year earlier. Amongst core sectors, Office has risen from 12.8% to 14.7% while Retail has fallen to 8.4% from 10.4% with the difference almost all in Income which has headed in the opposite direction by 2% opening up a substantial gap of 6.3% with Office as shown in Chart 1.

- While Chart 1 also shows the evenness of Income Returns across the various sectors, the presentation by Bryan Reid of MSCI given at the report's release included an excellent comparison of historical cap rates for each core sector over the past 12 years since March 2006. The range for All Property Types was about 2%, dropping from a post-crisis maximum of 7.5% to a current 5.5%. Interestingly the pre-crisis minimum is shown as 6.40% so we have seen capitalisation rates fall 90 basis points from those levels. Retail is currently showing the lowest cap rate of 5.40% while Office is at 5.50% and Industrial is at 6.40%. The narrowest range across all measures is for Retail and these are also the lowest levels which should be interesting to test as Income Returns are squeezed. Chart 2 compares sector performance since the GFC in 2008 which was marked by the sharp decline in returns across all sectors with all property types recording negative returns until 2010. The recent upturn in Industrial is notable as compared to a steady downturn for Retail.

- Last month we looked at the PCA's Office Market Report with landlords forecasting vacancy in Australia's largest office space market, Sydney, will drop to "well below" 4% and a Melbourne's office market vacancy hit a 10-year low of 3.6%. The MSCI breakdown of individual capitals not surprisingly shows Total Returns for Sydney and Melbourne are way out in front at 17.6% and 14.2% respectively. All of the capitals show an even and steady Income Return from 5% to 7% but with very substantial differences in Capital Growth. Sydney is around 11% and Melbourne 8%. Brisbane's Total Return is shown as 9.5% and Perth has recovered to 8.4% after last year's 4.1% after moving from a negative Capital Growth of circa 3% to a small gain of 1.5%.

- A similar table was presented for the Industrial sector where Total Returns for all locations were 12.5%, up from 10.4% last year. While the variance between locations was not as wide as for Offices the familiar theme of Sydney and Melbourne leading the pack thanks to strong Capital Growth was repeated with Total Returns of 13.7% and 12.8% respectively. Brisbane trailed at 8.6% with Capital Growth of circa 2.4% while the rest of Australia enjoyed hardly any Capital Growth in a Total Return of 8.1%. This was up slightly from last year when the Total Return figure was 7.8% with a very slight negative Capital Growth no doubt driven by weak markets in Adelaide and Perth where oversupply and flat/weak local economies are just starting to turn around.

- The discussion on the Retail sector was focused on the returns from individual sub-sectors and the variance in performance against the full sector Total Return of 8.4% which was down from 10.4% last year and the lowest amongst the sectors reviewed. Large Format produced the best result of 10.7% but even that was 1% less than All Property. Regional Centres returned only 5.6% down from 9.4% with Capital Growth becoming slightly negative as compared to a gain of 3.4% last year. Especially interesting was a Capital Growth comparison of Super Regionals & Major Centres against Neighbourhood Centres. Cap rate compression has continued to support Super & Major performance but has fallen away for Neighbourhood. The Yield Impact of the former contributed twice the net Capital Growth with the Income Impact negative which is of concern.

- A comparative chart including Direct Real Estate, Listed Real Estate (A-REITs) and Equities was little changed in relative terms although the listed components both grew more. Income Return/Distribution Yield/Dividend Yield were all fairly close with the Real Estate sectors at 5.7% for Direct and 5.9% for Listed. This compared to 5.8% and 5.4% respectively six months ago. Returns on Bonds fell from 5.8% to 4.0%. Equities recoded a Dividend Yield of 4.5% compared to 4.1% six months ago. Equities led Total Returns at 13.9% with strong Capital Gains with Direct Property at 11.7% and Listed Property trailing at 9.7%.

Chart 1: All Property Sector Returns –Twelve Months to June 2018

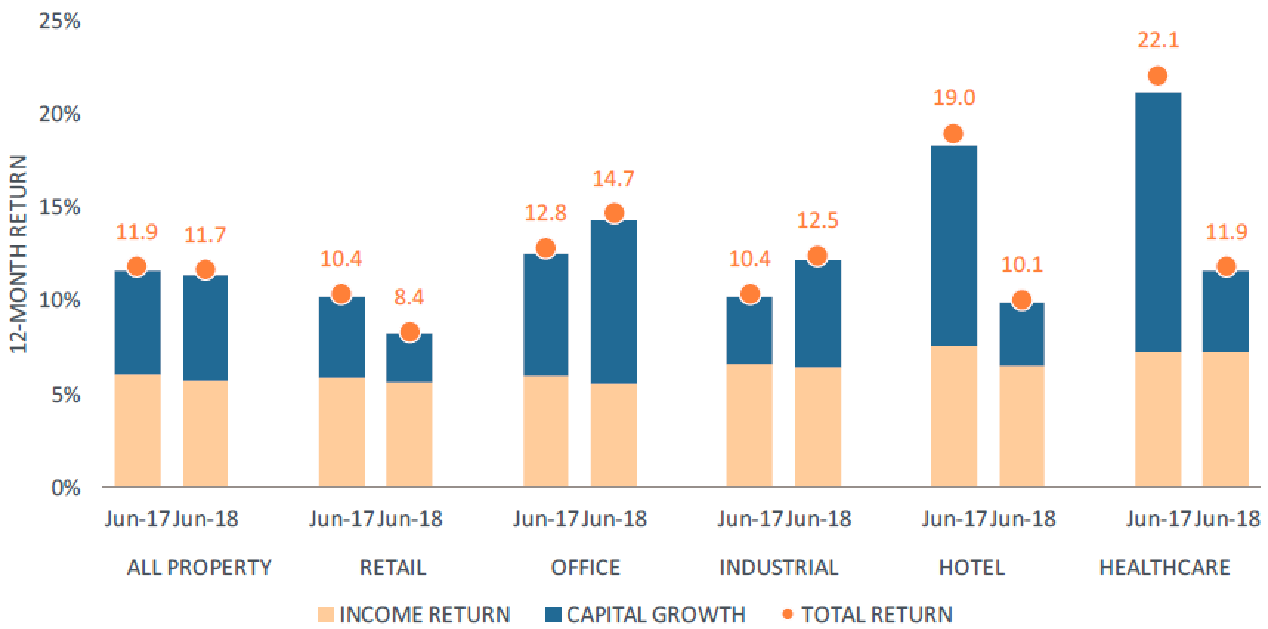
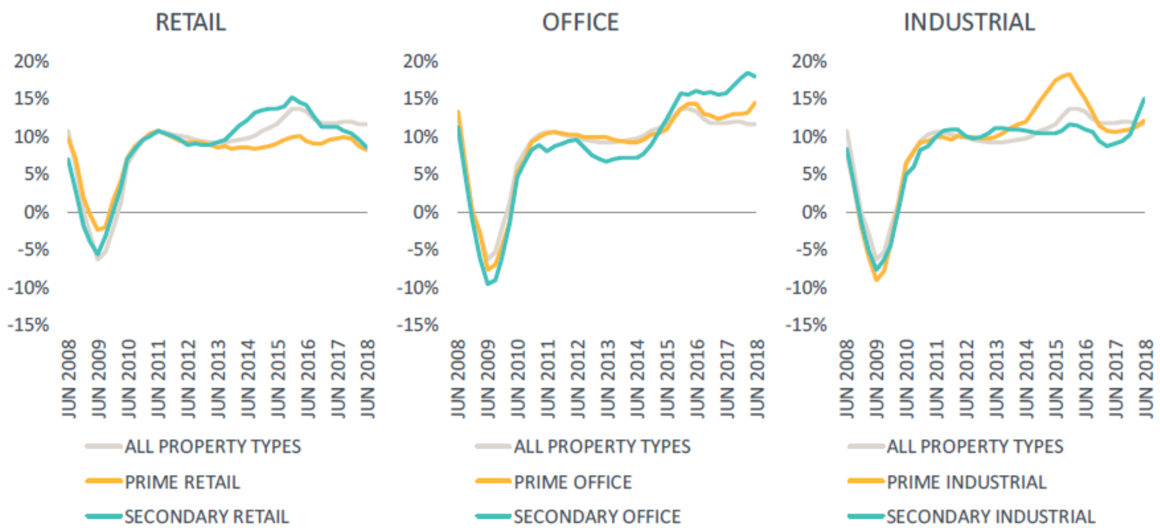


Chart 2: Core Sector Returns, June 2008 to June 2018



Source: MSCI Australian All Property Index Report

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