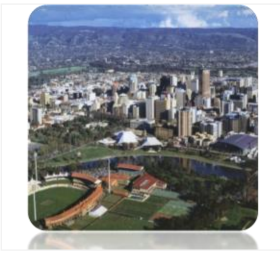
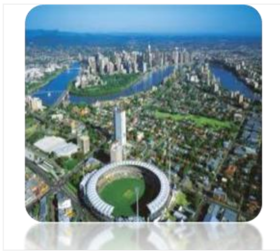
Thinktank

Leading Commercial Finance

October 2018

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 again in September by 3.1 to 100.5 just staying in optimistic territory above 100. The ACCI - Westpac Survey of Industrial trends however was up for the September quarter to 66.5 from 64.1 in June. The AiG PMI for September was up by 2.3 points to 59.0 marking two years of uninterrupted expansion above 50. The illion (D&B) Business Expectations survey for the fourth quarter also rose with sentiment amongst retailers finally lifting which is attributed to recent positive economic data.

At its October meeting the RBA Board once again left rates unchanged at the record low of 1.50% after more than two years at that level. Good economic data continues with GDP actual Q2 0.9%, yoy 3.4% and unemployment of 5.3%. Inflation however is set to remain at or below 2% for another year and this with soft housing markets appears to be the major brake on any chance of an increase in rates here in Australia. This is despite Standard & Poors removing the negative watch on Australia's sovereign debt rating right at the end of September. The US Fed as widely expected again raised rates at their September meeting and are still expected to do so again in December. AUD/USD has dropped considerably this year to the $0.72 range forecast by Westpac and could drop to $0.70 by the end of 2018 or early next year. 10 year Treasury bond rates in the US are now above 3.00% at 3.08%, but well above comparable Australian bond yields that are now at 2.68%.

CoreLogic housing price statistics for September again showed a fall in Sydney this time of 0.6% and 0.9% in Melbourne. The quarterly figures tell the same story being down 1.5% and 2.4% respectively and annually down 6.1% and 3.4%. Nationally the market weakened by 2.7% for the year, confirming a broad based downturn. 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 again reviewing the results of the semi-annual MSCI index as we did last month but taking a different view of some of their excellent data on investment returns and looking particularly at yields and capitalisation rates over the property cycle.

There have been no further changes in our market ratings or trends with Melbourne and Sydney Residential staying Fair but 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 in most locations.

	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,Cushaman & Wakefield, HTW, IMF, MSCI/IPD, JLL, Knight Frank, Melbourne Institute, OECD, PCA, RBA, RLB, Savills Research, Westpac Economics, World Bank

News and Views

- Last month we took a look at the MSCI All Property Index which follows the semi-annual PCA Office Market Report by a month. It gives us an opportunity to look at returns across all property sectors and locations after a focus on Office markets that comes with the OMR report. The MSCI review also looks at comparisons of investment returns in other non-property sectors consistent with MSCI's coverage of a large spectrum of investment vehicles together with the make-up and trends evident in those returns. That is what we will focus on this month together with the impact of tightening yields and capitalisation rates in each of the property sectors across the various Capital Cities we cover. What is clear is that Real Property is enjoying good average income returns matched by capital growth resulting from tightening yields and cap rate compression.

- The Total Return for Direct Real Estate as shown in Chart 1 is evenly split between Capital Growth and Income Return. Individual sector returns actually vary quite widely both as compared to other sectors and returns of a year earlier as well as by location. 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. The average however of 11.7% is just slightly down on 11.9% six months earlier and with much the same relationship to Equities which returned 13.9% compared to 13.8% in December 2017.

- As mentioned in last month's comments, the presentation 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 and this is shown in Chart 2. The range for All Property Types was about 2%, dropping from a post-crisis maximum of 7.5% to a current 5.5%. The first bar chart has an arrow on the left side showing the rise post-crisis and on the right side the much greater fall or tightening from the post-crisis maximum. 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. Returns on Bonds fell from 5.8% to 4.0%. Equities recorded a Dividend Yield of 4.5% compared to 4.1% six months ago. As noted above, Equities led Total Returns at 13.9% with strong Capital Gains with Direct Property at 11.7% and Listed Property trailing at 9.7%.

- Last month we looked at the MSCI breakdown of individual capitals which not surprisingly showed 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.

- In Retail 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. The June 18 cap rate shown on Chart 2 is the lowest of the sectors and like the others, well below the pre-crisis minimum. While not as wide as Healthcare, the three main sectors all show a very significant tightening and as in some of the examples cited above one has to be concerned about the outcome of any scenario that includes falling revenues and an expansion of cap rates.

Chart 1: Comparative Asset Class Returns –Twelve Months to June 2018

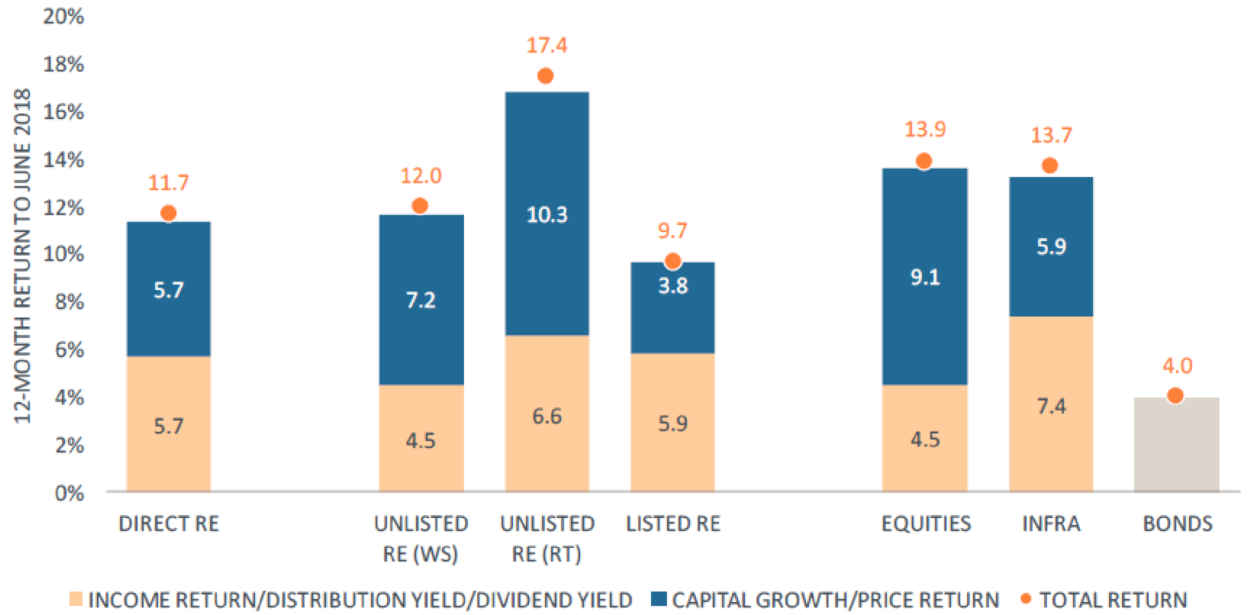
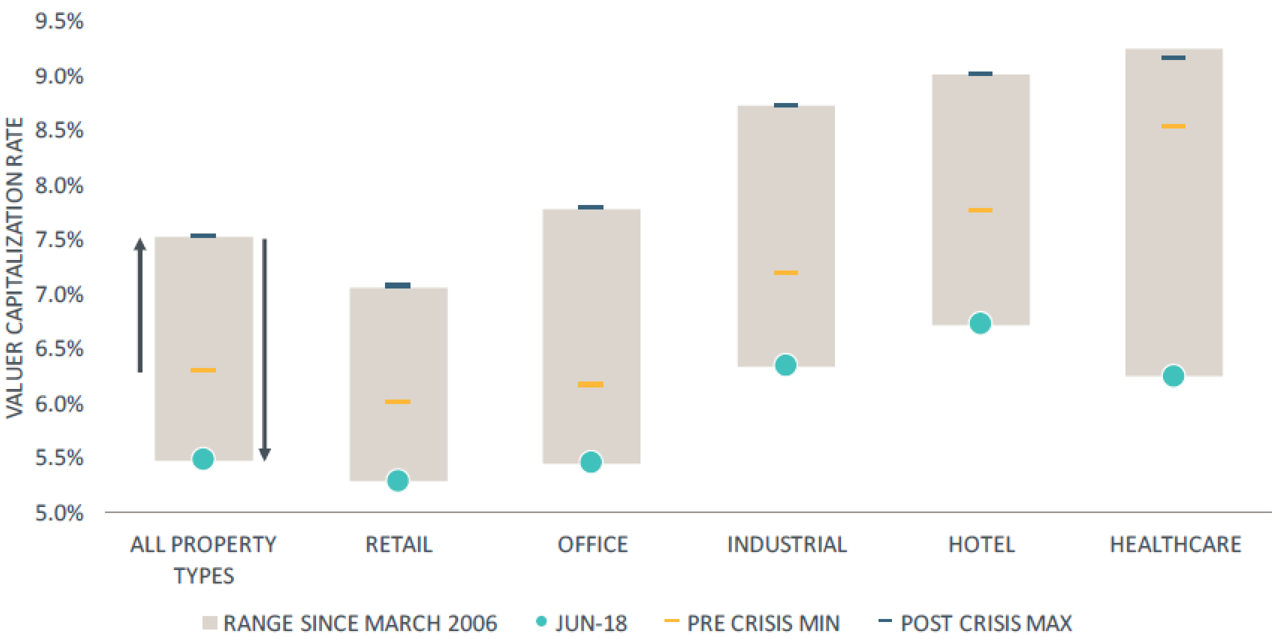


Chart 2: Capitalisation Rate Sector Movement, March 2006 - June 2018



Source: MSCI Australian All Property Index Report

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- Set and forget loan terms up to 30 years with no ongoing fees or annual reviews
- Self-Managed Superannuation Fund (SMSF) loans up to 75% LVR, and
- Loan options ranging from fully verified to self-certification of income.

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