Australian real estate market focus

September 2020

Thinktank..

The following represents a monthly snapshot of how we see the 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. This month we are featuring a special double edition of our News and Views to cover both the Property Council of Australia's Office Market Report (OMR) and MSCI's Australian Property Index.

The Westpac-MI Consumer Sentiment Index collapsed by 9.5% in August to 79.5 extending last month's fall as consumers reacted to the reimposition of restrictions. The AiG PMI Manufacturing Index fell by 4.2 points to 49.3 moving slightly into contraction below 50. The Services Index was also down 1.5 to 42.5 and the Construction Index was down 4.8 to 37.9 with falls in all sectors nationally but especially in Victoria while NSW was flat. AiG noted last month that the surveys in July had been completed ahead of the Victorian shutdown.

At its September meeting, the RBA Board held the Cash Rate at its record low of 0.25% as expected and once again confirmed its ongoing Quantitative Easing (QE) in maintaining 3 year Treasury yields at that same level of 0.25%. It did however add a comment that it was prepared to consider other stimulatory measures. This was completely understandable when the next day second quarter GDP figures showed a 7.0% decline and with unemployment at 7.4% and forecast to rise to 10% this year. The surprisingly positive data released were the Retail Sales for July which rose by a very strong 3.2%. The US Fed has said the same but in a statement coming from the August Jackson Hole meetings has said it will be flexible even in the face of rising inflation. 10 year US Treasuries were last traded at yields of 0.72% and AUS 10 year Gov't bonds at 0.98% both up slightly. Not surprisingly markets continue to expect interest rates to remain at these levels for some years to come. Since last month the AUD has broken through USD 0.73 and new forecasts are predicting a rise to USD 0.80.

CoreLogic housing prices for August as expected showed a fall for national dwelling of 0.5%, In Sydney, houses were down 0.5% and in Melbourne off 1.4%. Units were also down in both capitals, by 0.3% and 0.8% respectively. There is more ongoing comment on unit rents with Sydney down 4.2% from March to August and Melbourne 4.4%. We have continued our Fair rating and Softening trend for all capitals with Perth and Adelaide flat for housing values in August and unit rents actually rising in Perth for the last six months by 0.9%.

There have been no changes in our ratings and trends to those of last month. As we mentioned then, Retail which had already been struggling is now headed for even more difficult times ahead while Industrial continues to appear quite resilient. Office is still awaiting the response of businesses longer term to work from home attitudes but we are maintaining a Stable trend despite some ominous signs in various locations. We take a closer look at the Office sector in part one of our News and Views section which covers vacancy rates as reported by the PCA Office Market Report. Part two covers the MSCI Property Index review of all sectors and very graphically points out the stark differences being experienced between them.

	SYDNEY		**MELBOURNE**		**ADELAIDE**		**BRISBANE (SEO)**		**PERTH**	
Resi- Homes	Fair	Softening	Fair	Softening	Fair	Softening	Fair	Softening	Fair	Softening
Resi- Units	Fair	Softening	Fair	Softening	Fair	Softening	Fair	Softening	Fair	Softening
Office	Fair	Stable	Fair	Stable	Fair	Stable	Fair	Stable	Fair	Stable
Retail	Weak	Deteriorating	Weak	Deteriorating	Weak	Deteriorating	Weak	Deteriorating	Weak	Deteriorating
Industrial	Good	Stable	Good	Stable	Weak	Stable	Fair	Stable	Weak	Stable

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

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News and Views - Part One

- This month as part one of our two part special feature we are again focussing on the Office market with a close look at the PCA Office Market Report (OMR). As a result of the COVID-19 induced work-from-home wave that has swept most capital cities, workers and businesses will get used to working from home. As a result companies may reduce their office space requirements resulting in increased vacancy rates, lower face rents and higher incentives. There are many different views on this and the OMR has stimulated plenty of comment.

- As usual, release of the semi-annual OMR gets plenty of coverage in the Australian Financial Review. Nick Lenaghan edits the property section and included many interesting comments including differences with the JLL research issued last month. Nationally levels of vacancy rose from 8.3% to 9.5% in the OMR but the largest increases were seen in Sydney and Melbourne at 5.6% and 5.8% respectively. These were a lot lower than the JLL numbers which were 7.5% and 7.7% and the overall research was rather more negative from JLL. Nationally the difference wasn't as great with JLL coming in at 10.2% but forecasting as high as 12% next year in Melbourne. All capitals rose except for Canberra which fell marginally and Brisbane and Adelaide experienced increases of only 0.2% each. PCA CEO Ken Morrison said "Vacancy rates have increased over the past six months, but overall vacancies are still below the historic average." He also noted the uptick in sublease space is still relatively modest compared to previous downturns. In the early 1990s, when overbuilt markets were caught in a recession, sublease vacancy peaked at around 2.5% compared to the current level of 0.8%.

- Chart 2 shows the higher levels of vacancy experienced by secondary offices across every capital city surveyed. Charter Hall, which manages one of the largest office portfolios in the country, is building a slew of next generation towers around the country. Managing director David Harrison pointed out that rising vacancy will hit backfill space first, as major tenants move into pre-committed space in larger buildings. "In every cycle I have experienced over 33 years, backfill B and low A grade building suffer from new supply as a 'flight to quality' sees corporate and government tenants move to modern space." The most extreme difference is seen in Perth but this is certainly not just COVID-19 related. Secondary office space has suffered far higher vacancy there for some time as new office towers filled up and older buildings were left struggling for tenants hitting over 25%.

- Below we show the long-term trends for Office vacancy here in Australia. There is no missing the impact of the property downturn of the early 1990s followed by the gradual recovery through the rest of the decade. As we wrote last month, no doubt the short term impact will be considerable but investors and developers still appear confident in the future. Our example last month of a 42 story Office tower in North Sydney above the new Metro Station is backed up by another this month with further details of the Brookfield Place in Sydney (the renamed Wynyard Place) with Hub Australia joining anchor tenants NAB and Allianz. At the same time Cromwell and partner Blackrock announced plans for a third office tower in their Chatswood project. The question still remains as to how long lasting the effects of COVID-19 will be; Goldman Sachs last month predicted vacancy rates of 13% in both the Sydney and Melbourne CBDs and only time will tell if their view is right.

Australian Office Vacancy – 1990 to 2020

OFFICE MARKET REPORT

PROPERTY COUNCIL of Australia

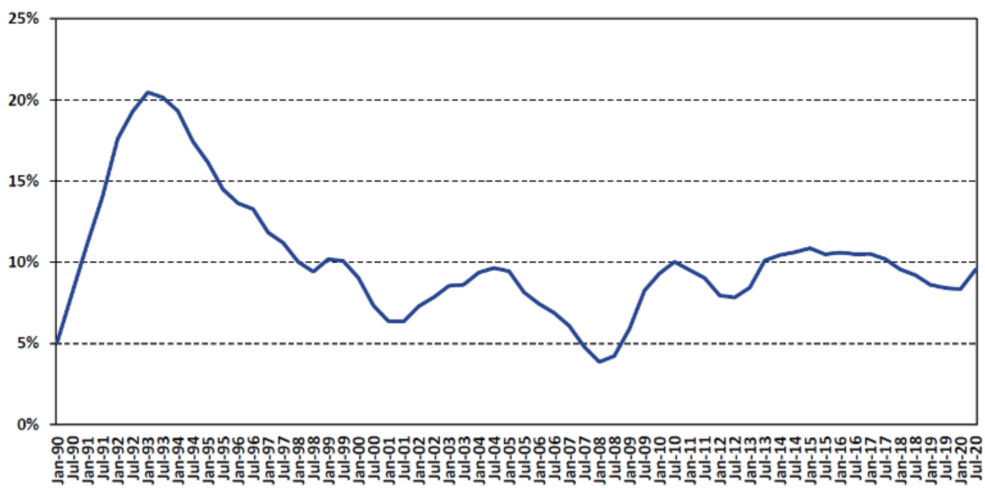


Chart 1: CBD Vacancy Change – Six Months to July 2020

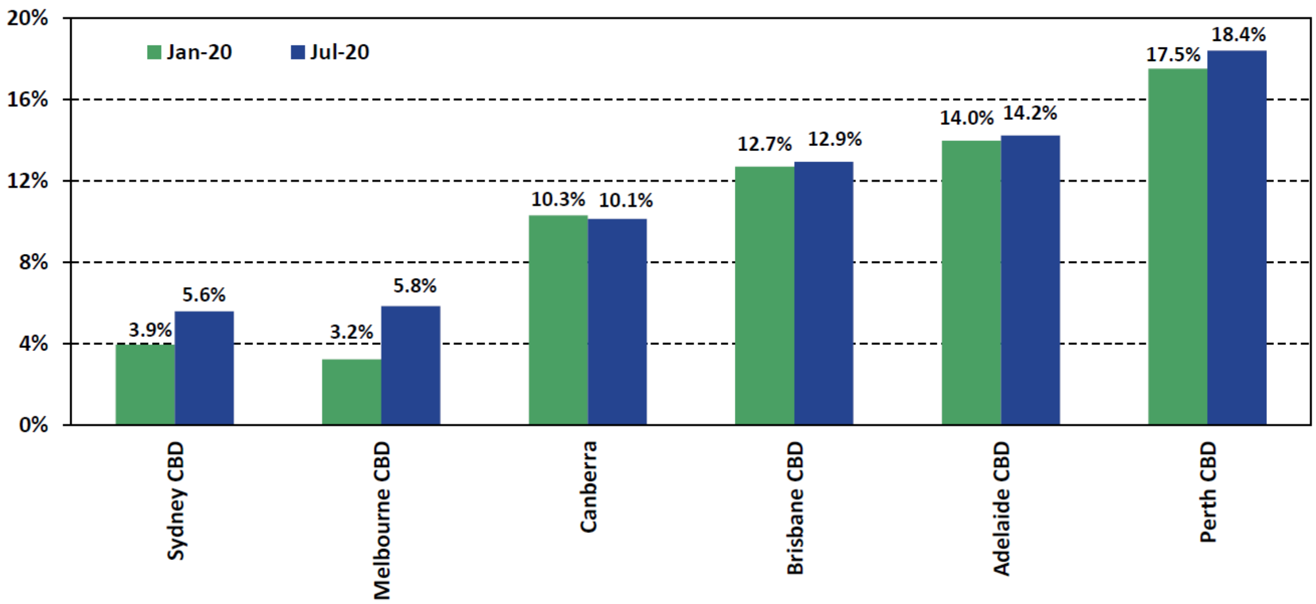
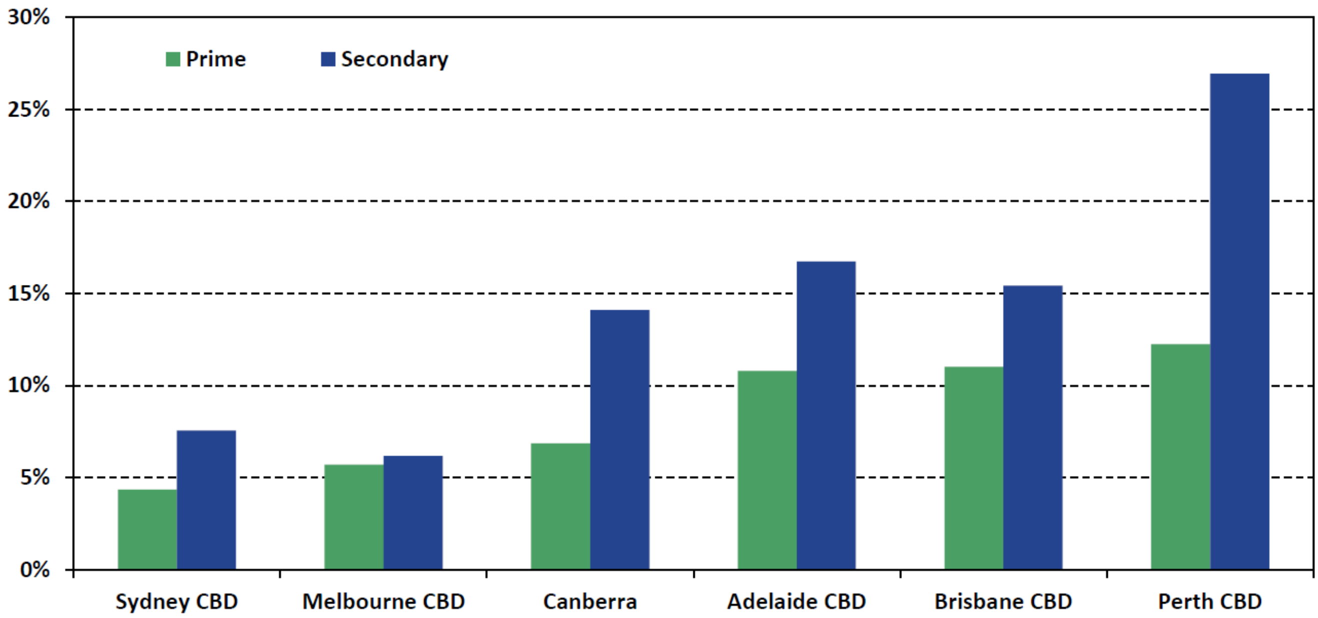


Chart 2: CBD Vacancy Rate – Prime vs Secondary – July 2020



Source: Property Council of Australia

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News and Views – Part Two

- The recent release of the MSCI All Property Index shows Total Return falling to 1.4%. Nick Lenaghan property editor of the Australian Financial Review wrote about the index results and noted the following comments: "It (the index) paints a picture of what we all know: the top-performing sectors are Industrial and Office, and then at the bottom, regional shopping malls are shockers," David Harrison, managing director of listed fund manager Charter Hall, told the AFR. "The continued moderation in Retail funds represents an acceleration of a trend playing out pre-COVID-19 and current markets continue to challenge operating models and investor appetite," Mitchell McCallum, MSCI's executive director, said. He also commented on future expectations as follows: "The removal of JobKeeper and the rise of the second wave continues to threaten any recovery in Retail. In addition, the impacts to Office (property) remain unclear, with subdued demand offset by increased space requirements leaving the market speculating at the overall impact."

- Chart 1 on the opposite page shows quarterly returns over the past year for All Property and key sectors. The differences are quite graphic and clearly illustrate the impact of what is happening as described in the article. Retail has been delivering negative Capital Growth each quarter for the past year and has finally dragged All Property there as well in the latest quarter. While COVID-19 added to the negative situation in Retail it was really the story in Office which had been doing very well until the latest quarter. Industrial has maintained its strong and steady performance with fairly even Income Returns and Capital Growth producing double digit Total Returns. This steadiness is also reflected in comparisons of current Industrial returns of 11.0% to those achieved over the past 3 years of 11.1% and for five years of 10.8%.

- Chart 2 looks at separate sector returns by capital city and nationally for the 12 months to June 2020. Industrial leads nationally followed by Office with Retail dragging down All Property returns close to negative. Sydney was the best performer with Adelaide and Perth both in negative territory overall. The extent to which sector returns were so similar in most locations is reflected in our own Ratings and Trends shown on the front page with little variance from city to city. This is quite a recent situation when in the past it was much more common to see very different situations based on local economies or industry concentration.

- In a similar fashion to the graph shown on page two of the PCA Vacancy Rate over 30 years, the one below shows the MSCI Australian Property Returns over a slightly longer period of 35 years. The cyclical trends are clear and even though it takes into account all property sectors, the downturns experienced reflect the same impact as in the Vacancy Rate graph but appearing as the inverse in terms of the shape of the curve. Slight timing differences may well indicate the forward looking nature of Capital Growth while Income Return has been extraordinarily stable for the 35 years but can be seen to be trending down slightly right now. What had often supported diversified real property portfolios in the past has been the different cycles for different sectors so Office and Retail have often trended in different directions. Whether that is the case or not on this occasion is very important.

Rolling 12 Month Total Return, Dec 1985 to June 2020

The PCA/MSCI Australia Annual Property Index

Results as of 2Q 20 – All Assets

MSCI

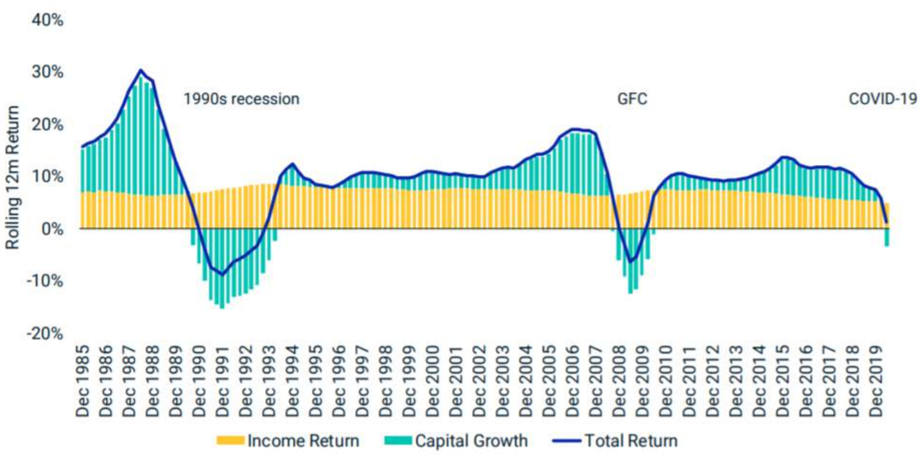

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Chart 1: All Property & Sector Quarterly Returns to June 2020

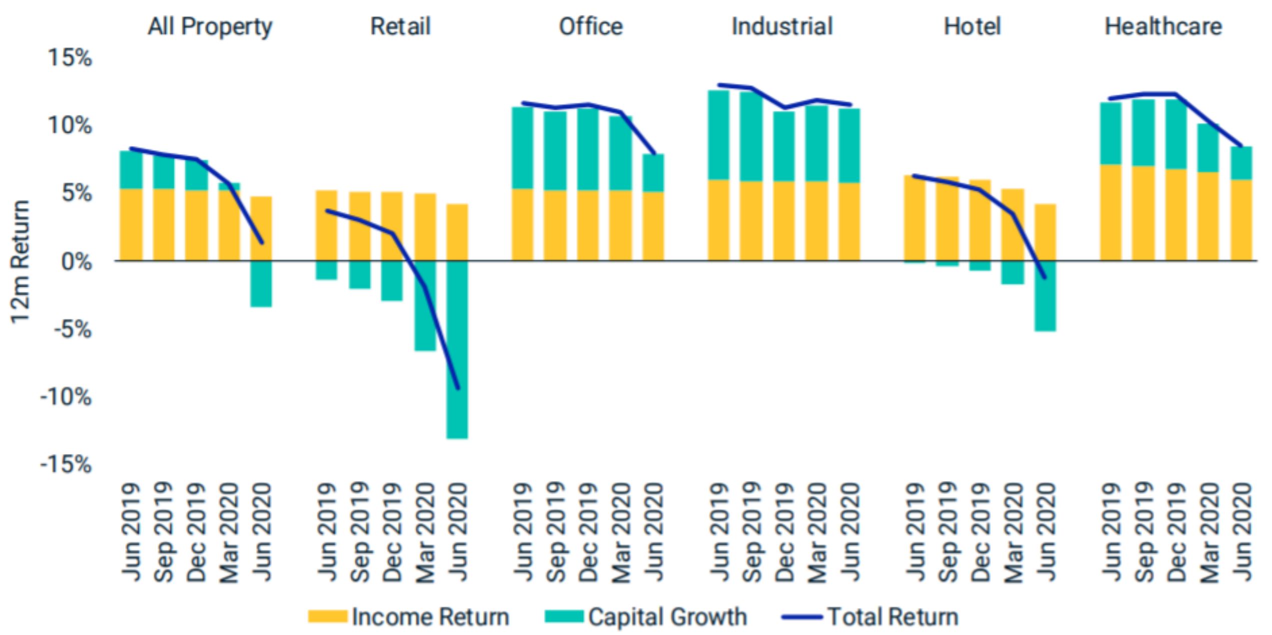

Chart 2: Sector Returns, National and by Capital City – 12 Months to June 2020

Source: MSCI

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Business relationships and loan inquiries

Heather Noonan
Regional Sales Executive
VIC, TAS, SA
M: 0435 960 646
E: hnoonan@thinktank.net.au

Tony Zaccari
Senior Relationship Manager
VIC/SA
M: 0403 758 514
E: tzaccari@thinktank.net.au

Dev De
Senior Relationship Manager VIC
M: 0466 576 338
E: sde@thinktank.net.au

Cath Ryan
Regional Sales Executive
NSW, ACT, WA
M: 0433 862 944
E: cryan@thinktank.net.au

Ranei Alam
Senior Relationship Manager NSW
T: (02) 8669 5502
M: 0434 609 240
E: ralam@thinktank.net.au

Paul Burns
Senior Relationship Manager NSW
T: (02) 8669 5510
M: 0434 609 241
E: pburns@thinktank.net.au

Claire Byrne
Relationship Manager NSW
T: (02) 8669 5522
M: 0414 235 478
E: cbyrne@thinktank.net.au

Robyn Hadlow
Business Development Manager
NSW/ACT
M: 0406 857 708
E: rhadlow@thinktank.net.au

Adam Hutcheson
State Sales Executive QLD/WA/NT
T: (07) 3117 3787
M: 0434 609 239
E: ahutcheson@thinktank.net.au

Bob Whetton
Business Operations Manager QLD
T: (07) 3117 3787
M: 0413 241 316
E: bwhetton@thinktank.net.au

Kat Gasparovic
Relationship Manager QLD
T: (07) 3117 3787
M: 0405 815 287
E: kgasparovic@thinktank.net.au

Alex Turnbull
Marketing Manager
M: 0400 599 535
E: aturnbull@thinktank.net.au

For additional information, please contact

Publications & Market Update
Per Amundsen
Company Secretary
T: (02) 8669 5515
M: 0417 064 252
E: pamundsen@thinktank.net.au

Partnerships & Distribution
Peter Vala
GM Partnerships & Distribution
T: (02) 8669 5512
M: 0468 989 555
E: pvala@thinktank.net.au

Investor Relations
Lauren Ryan
BDM – Investments
T: (02) 8669 5532
M: 0401 974 839
E: lryan@thinktank.net.au

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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; and
- Loan serviceability options ranging from fully verified to self-certification of income.