

# Property Market Review

24<sup>th</sup> February 2009

## Australian office CBD markets in cyclical downturn

- The negative effects of the global financial crisis (GFC) have impacted the Australian real economy and weakening the labour market. This, in turn, has adversely impacted office space market fundamentals (particularly demand). We expect economic recovery to appear within 12 months due to strong fiscal and monetary stimuli.
- Almost all major CBD markets have seen a rapid decline in demand over 2H08 due to a slowdown in white-collar employment growth (WCE). Consequently, a rise in sub-lease and backfill space has placed additional downward pressure on demand. In the short term, we anticipate a further deterioration in demand across all markets.
- A solid amount of supply entered markets over 2008. In the near-term supply is expected to remain strong due to a solid project pipeline. However, a lack of pre-commitments beyond 2009 and financing constraints should see new supply moderate nationally.
- Space market tightening has now reversed with vacancy rates increasing across all markets. However, they are not expected to reach the levels seen in the early 1990's. Subsequently, increases in vacancy rates have caused incentives to rise, leading to a fall in effective rents. Rents are set to fall over 2009 in line with market weakening. We expect markets to reach the trough of the cycle over the next 12-18 months.
- With deteriorating capital markets and space market conditions, all major CBD markets are experiencing rapid decompression in property investment yields. Over the near-term, we anticipate yields to further soften in line with asset de-leveraging, resulting in a further decline in asset values.



## 1. Space market fundamentals

Space market conditions for Australian office markets have deteriorated rapidly over 2008. The negative effects of the GFC have impacted the real economy, causing a deterioration in the labour market (including WCE). This, in turn, has adversely impacted office space markets nationally (particularly demand). Sectors which were hardest hit were the Finance and Insurance (F&I) and the resource sectors. Moreover, a cyclical downturn in economic activity coupled with weaker demand and financing difficulties has scaled back or stalled new supply. Consequently, deteriorating leasing market activity has led to a rise in vacancies, and the resulting increase in incentives is causing a decline in rental growth. However, it is worth mentioning that not all markets have been uniformly affected, with some being relatively more resilient.

### Demand and Supply

WCE is a key driver of demand for office space. Figure 1 shows a positive relationship between annual WCE growth and annual net absorption. WCE has significantly declined over 2H08, negatively impacting demand. Consequently, softening demand was recorded across the majority of major CBD markets, apart from Adelaide (ADE)<sup>1</sup>. Sydney (SYD) recorded negative net absorption of 72K sqm - of which 65% was in prime grade. Furthermore, there has been a noticeable rise in both sub-lease and backfill space due to companies' consolidation/contraction activities which is placing additional downward pressure on net absorption.

Another important factor in assessing demand profiles is the composition of WCE. SYD, a market with large occupancy exposure to the F&I sector (29.6%), has been the worst hit by the GFC, recording the largest decline in net absorption. Cyclical softness, as a result of diminished external demand for resources, has had a negative flow-on effect for demand in Perth (PER) and Brisbane (BRI). Two markets which experienced relatively strong demand were Melbourne (MEL) and Adelaide (ADE). MEL's strong demand, despite its second highest exposure to the F&I nationally (19%), was mainly due to movements into pre-committed space negotiated in a better macro-economic environment. ADE is the only capital city opposing the trend of slowing demand with the strongest demand (74K sqm) recorded nationally over 2008 relative to the size of market (1.24m sqm).

In 2009, demand is expected to remain sluggish nationally. Markets with high exposure to the F&I sector (SYD and MEL) are expected to be the most vulnerable,

however, MEL should perform better due to its thin rental spread across grades which attracts tenants into the CBD – this is dissimilar to SYD. Resource driven markets should experience further softening in demand due to a continued decline in external commodity demand. In 2010 demand is expected to show signs of recovery in line with a pick-up in external demand (due to a comeback of longer term structural themes) as well as foreseen stabilisation of the domestic economy. However, the government sector should, to some extent, provide support to the markets in which it is a provider of WCE such as Canberra (CAN), ADE and BRI.

Figure 1

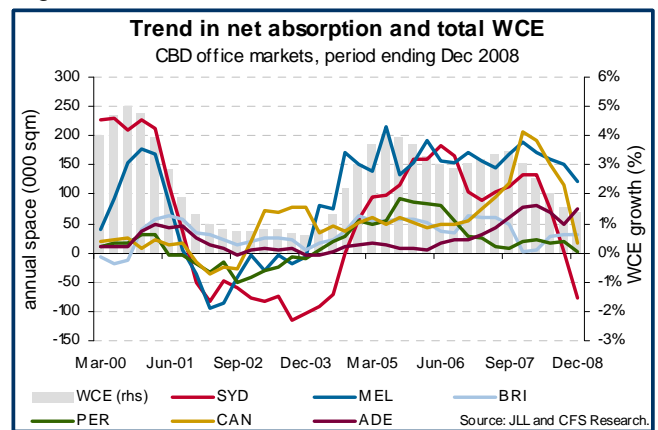
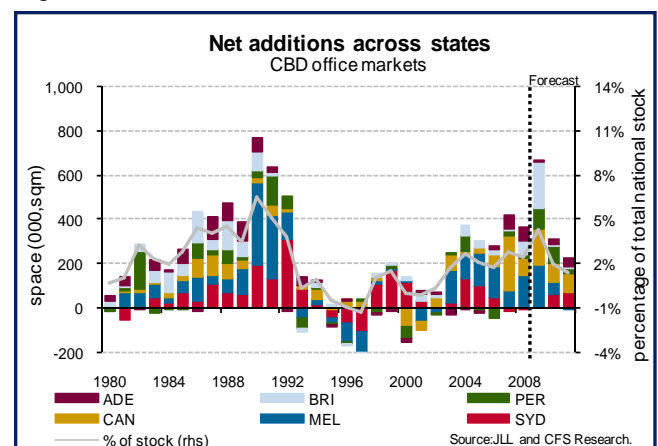


Figure 2



Across all CBD markets, the current construction pipeline is relatively moderate compared with the supply shock of the late 1980's. New net supply in 2009 is expected to be the largest since the 1990s with completions concentrated in BRI, MEL, PER and CAN, as seen in Figure 2. While a significant share of these projects is pre-committed in MEL and BRI, they have an issue with a significant amount of upcoming backfill space. In the short term, SYD will likely experience

<sup>1</sup> ADE was underpinned by expansionary activity from state government (including defence) and mining.

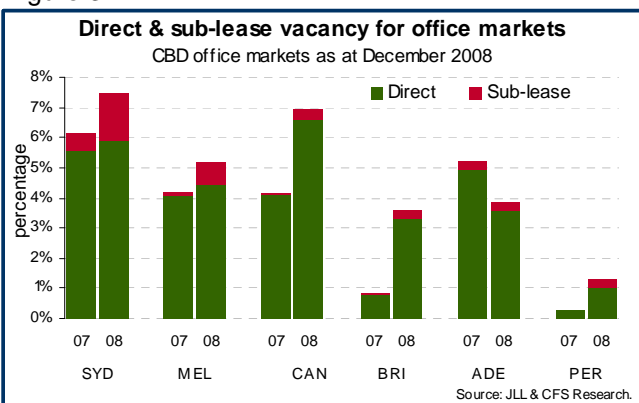
relatively subdued supply<sup>2</sup> while PER and CAN<sup>3</sup> an over-supply. However, while much of the stock is pre-committed over 2009, there is a lack of pre-commitments afterwards. This, combined with an increase in funding costs and constraints on accessing credit, has scaled back or delayed new supply across major CBDs. An expected recovery in macro-economic conditions during 2010 should see signs of recovery in building.

**Vacancies and rents**

After a protracted period of firming, vacancy rates have increased across all markets. The national vacancy rate currently stands at 5.5% (4.2% in 2007), although still below the early 1990's peaks. With the exception of ADE which experienced a minor increase in vacancy, all major CBD markets recorded a significant rise in vacancy rates over Q408. The main contributors to this rise were an increase in both new vacant space and sublease space (Figure 3).

In the short term, most markets are set to experience double-digit vacancy rates (low teens) due to further deterioration in demand. A recovery in the economy and the expected pick-up in demand (over 2010) combined with limited supply should lead to a gradual firming in vacancy rates. However, markets with a strong supply pipeline and low pre-commitments will likely experience a period of prolonged high vacancy rates.

Figure 3

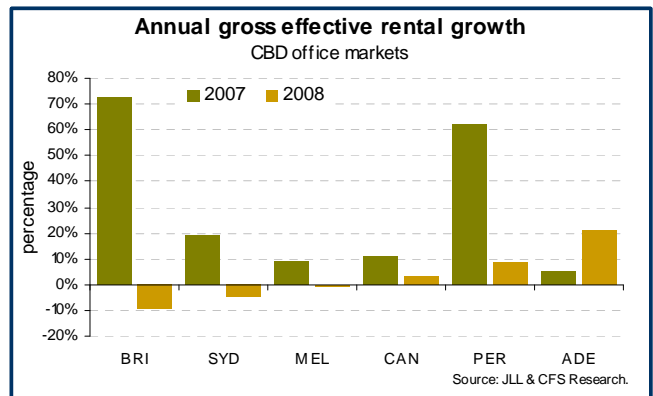


All major CBD markets, with the exception of ADE, have recorded falling effective rental growth in the period 2007-2008, as seen in Figure 4. Falling effective rents were caused by the re-introduction of, or a sharp rise in, incentives due to rapid deterioration in market sentiment. In the near term, tenants will dominate the

<sup>2</sup> Due to problems with pre-commitments, development finance and site limitations.  
<sup>3</sup> Strong supply over the short term in weak demand environment. CAN should be supported by the Federal Government spending.

market, as landlords will battle to keep occupancy levels high. We anticipate a further decline in effective rental levels over 2009.

Figure 4



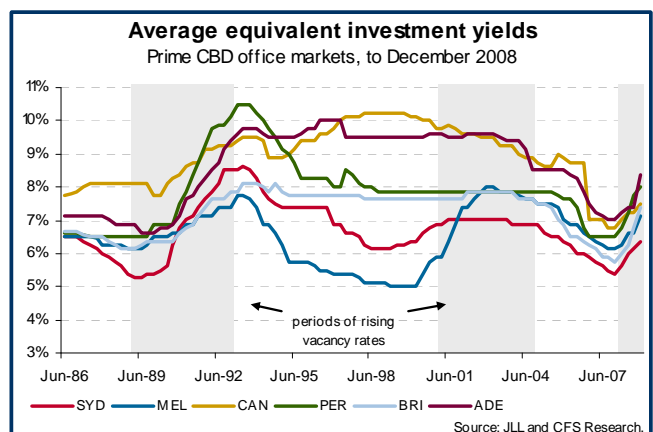
**2. Investment market**

**Yields**

The investment market nationwide remained dormant over 2008, with a limited number of transactions recorded.

The deterioration in both capital markets and space market conditions has caused a rapid softening in property investment yields over 2H08 (Figure 5), negatively impacting capital values. Despite a softening in yields, ADE experienced positive capital values due to robust rental growth.

Figure 5



In 2009 yields are expected to soften as asset de-leveraging continues, causing a further decline in asset values (10%-20%). This is due to rising discount rates, increased investor redemptions and restricted financing accessibility. We expect that yield softening will be greater in secondary grade assets than in prime. This trend should be reversed once market conditions improve in the short term, rental growth recovers and vacancy rates start firming.

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