

# Improving outlook for Australian industrial property markets

## Property Market Review

5 November 2009

- Industrial property markets are susceptible to movements in economic activity and, as such, have been adversely affected by the recent global downturn. However, the unfolding recovery of the Australian economy and those of its key export partners will have a positive effect on demand for industrial real estate.
- In 2009 many new projects have been postponed. Despite the short construction timeframe for industrial property, the deferral of supply will stimulate rental growth once demand recovers in 2010, as there will still be a mismatch between demand and supply.
- We expect modest rental growth across the key Eastern Coast industrial markets during 2010 and a strong recovery in prime rentals in the period between 2011 and 2015. In the near term, we expect outperformance from those industrial markets where new supply is limited.
- Following a period characterised by subdued transactional activity and softening investment yields, investment activity in the sub-A\$30 million range has recently improved, heralding a return of investor confidence. Transactional activity in the institutional space (traditionally above A\$30 million) remains modest and is yet to recover. Looking ahead we will likely witness an increase in counter-cyclical investor interest as the sector is hovering around the trough of the property cycle.
- Increasing investor demand, coupled with improving credit conditions, is expected to result in widespread yield compression in the short term. Prime yields are expected to stabilise and slightly firm in early 2010, as rental growth is expected to be modest. We expect a wide-spread yield firming from 2011, once stronger rental growth returns.



## 1. Introduction

The industrial property sector, which is positively correlated with the real economy, has suffered in the recent global economic downturn, experiencing demand deterioration, supply deferral, rental contraction, a sharp fall in transactions and yield decompression.

However, demand is expected to recover in the short-term in line with a recovery in economic activity, whereas supply is projected to lag, providing an expected uplift to rental growth, particularly in the regions where supply additions will be smallest. Furthermore, recent yield stabilisation coupled with an increase in the investor activity heralds the return of investor confidence to this sector.

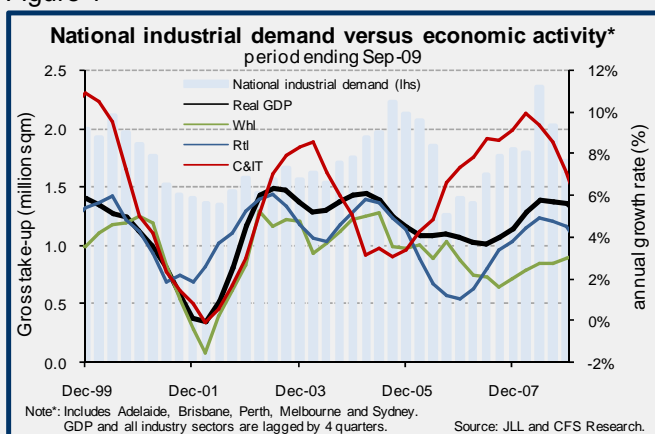
## 2. Space markets fundamentals

### Demand

In the 10 years to 2009, national demand for industrial space was solid, recording stable growth. Demand growth was driven by robust economic conditions, which was supportive for the main industrial-oriented tenants such as wholesale (Whl) and retail trade (Rtl) businesses, and transport and logistics.

Economic activity, measured by real GDP, is historically a main driver of demand. Real GDP has a strong positive relationship with tenant demand and leads demand by one year (Figure 1). Less cyclical tenants such as communications and information technology (C&IT) may temporarily diverge from the profile of real GDP when new technologies create a shift in demand.

Figure 1



Real interest rates are also a key driver of demand for industrial real estate, because of the strong inverse relationship with aggregate consumption and investment. The low and stable interest rate environment during the past seven years has also spurred demand by facilitating a tenant shift from leases to owner occupation of industrial space.

While we expect demand to remain subdued for the remainder of 2009, we expect regional outperformance in Perth, Brisbane and outer central west Sydney, where logistic facilities are leading a recovery in lease activity as they benefit from the impact of government stimulus on retail trade and inventory rebuilding.

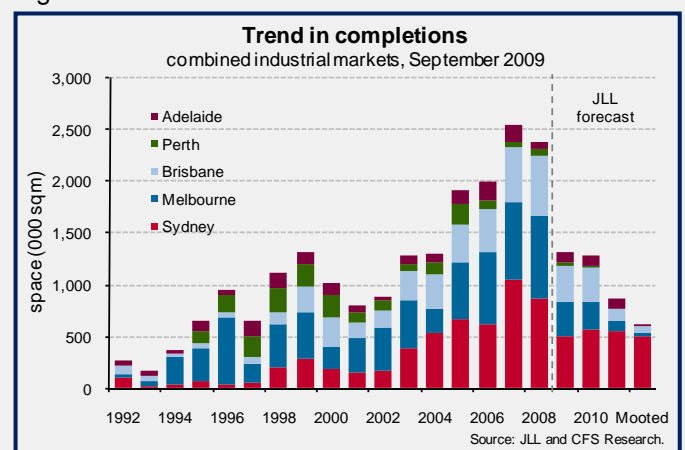
Moreover, in the short term, we expect aggregate demand for industrial space to strengthen in line with the expected economic recovery in 2010. We expect the restocking of inventories, which declined rapidly, to emerge in the near term on the back of stronger demand from industrial-oriented sectors. While the relatively strong Australian dollar will be a positive for the importers, supporting demand for logistics facilities, demand for manufacturing and other export focused sectors is expected to be relatively weak.

### Supply

An important feature of the industrial sector is that it's less vulnerable to oversupply versus other property sectors, reflecting short construction lead times and the flexible nature of supply from build-to-suit developments.

In the past five years, national supply has been historically strong, with completions (supply) exceeding gross take up (demand) at its peak in 2008. However, supply has fallen significantly in the recent economic downturn, easing the risk of oversupply in 2009/2010. The estimated supply for 2009 is 1.2 million sqm, down 50% year on year. In the current economic environment, tight credit conditions and difficulty in securing pre-commitments have significantly constrained the development pipeline, most notably along the east coast. Construction is showing signs of recovery in smaller markets such as Newcastle and Adelaide. This is in line with the improvement in domestic economic activity experienced in those regions in the September quarter; however, supply in other markets such as Perth and most notably Melbourne is still exhibiting a decreasing trend.

Figure 2



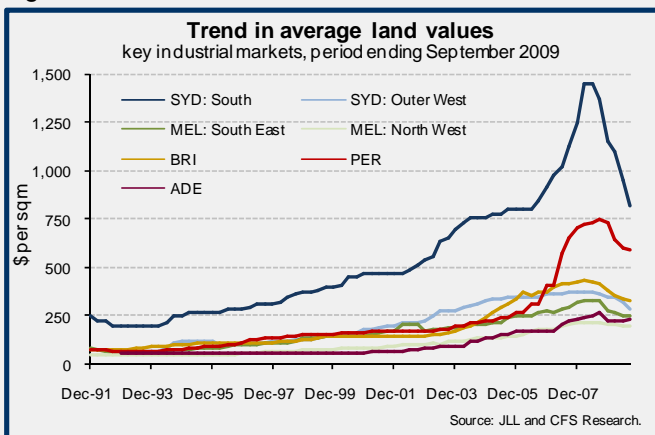
Supply is driven by construction costs. The cost of capital, such as interest rates, is a major component of construction costs. Costs of other factor inputs such as building materials and labour also affect supply. In the ten years to 2008, strong competition from mining, engineering, and export orientated sectors have led to rising real factor input costs. High factor input costs also serve to constrain supply. Currently, unfavourable credit conditions will continue to pressure supply for the remainder of 2009, limiting speculative developments and resulting in developers delaying planned projects.

## Land values

Land value is a key performance driver for industrial property. Over the past 10 years, growth in industrial land values have been supported by a strong economic climate, improved site access from infrastructure upgrades, and competition from other property sectors. Also, rezoning of land and construction of several major road projects has boosted industrial development activity and driven land values higher. However, this growth path was reversed due to the economic downturn in 2008 which caused a decline in supply and reduced competition from other sectors.

The biggest decline in land values in 12 months to September 2009 was in Sydney (South Sydney, -40%; Outer North West, -35%) and Perth (Canning Vale and Bibra Lake, -33%).

Figure 3



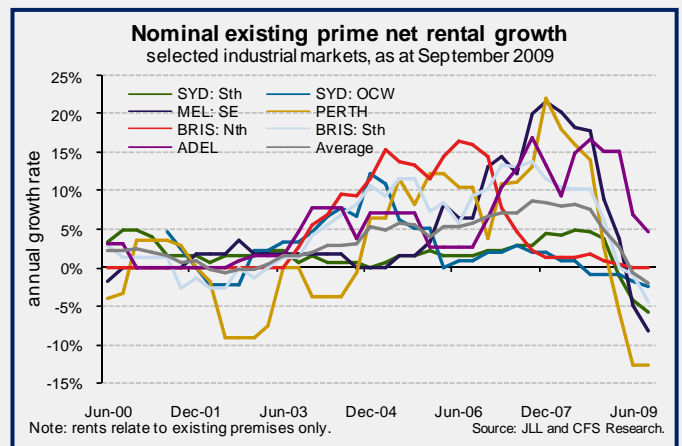
In the short term, we expect a slight decline in valuations to continue; however, at varying degrees across markets. The resulting delay in planned developments and decrease in lending to industrial developers will continue to pressure land values. We expect upside potential for land values as demand recovers ahead of supply in line with the economy, positively boosting rents.

## Rents

Rental growth increased solidly in the five years to 2007, in line with demand. However, decreasing demand and a backlog of supply entering the market since 2008 caused a contraction in rental growth nationally.

In the current economic climate, we expect the contraction of rental growth to reverse as demand recovers against a limited supply pipeline. In the September quarter 2009, rental growth plateaued in Newcastle, Brisbane and South Adelaide, while inner west and east Adelaide have recorded a positive rental growth of 2.8% quarter on quarter (qoq).

Figure 4



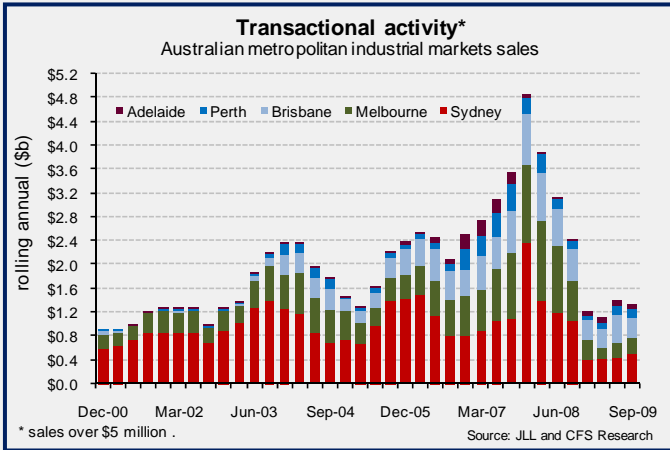
In the short term, the trend towards positive real rental growth will be supported by an expected economic recovery in 2010. Overall, we predict a modest rental growth across the key Eastern Coast industrial markets during 2010. A strong recovery in prime rentals is anticipated in the period between 2011 and 2015 in line with stronger economic activity and a lack of new supply. However, the recovery will vary across markets, with the fastest correction expected in the markets which recorded the most pronounced fall in rents such as South Sydney, Perth, Melbourne's South East and Southern Brisbane.

## 3. Investment performance

The investment climate for industrial property has shifted significantly in recent times as a result of the global economic downturn. National industrial property transactions fell in the 12 months to 30 September 2009, with Melbourne (-60%) and Sydney (-52%) markets experiencing the largest decline in transaction sales. In contrast, the Adelaide market was relatively resilient, underpinned by ongoing project expansion activity in the defence and mining sectors and infrastructure improvements.

However, increased transactional activity in the past six months, notably in Sydney and Melbourne, indicates the return of investor confidence towards the market. The most active investors in 2009 were property syndicates and private investors in the sub A\$30 million bracket while the market above A\$30 million, which is traditionally the playground of institutional investors, remains almost inactive.

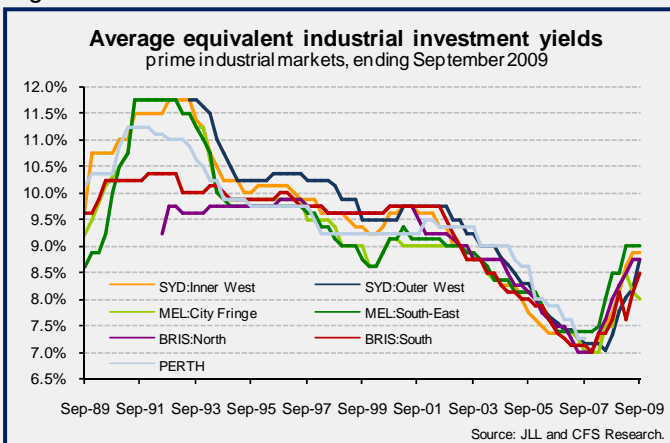
Figure 7



Deterioration in capital markets and space market conditions resulted in a rapid decompression in industrial yields since 2008, varying across regional markets and grades. However, yields across many markets have stabilised during the September 2009 quarter, and in some cases firmed, indicating a turning point for the sector has possibly been reached.

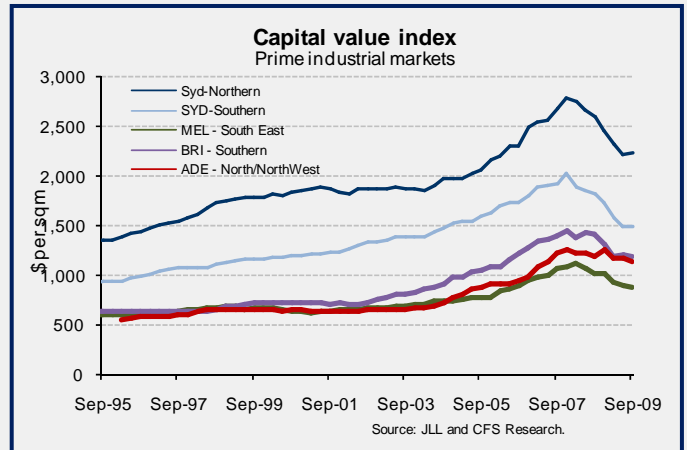
Prime yields on average softened by 5 basis points (bps) over the September quarter 2009 and 65 bps over the year to 30 September 2009. The strongest softening in yields occurred in the Sydney (70 bps) and Adelaide (75 bps) markets over 2009 to currently reside at 8.4% and 8.2% respectively. Average yields remain tightest in Perth, at 8.3%. Currently, average industrial yields range from 8.0% to 9.8%.

Figure 8



As shown in Figure 9, the softening in industrial yields reflected declines in capital values. After more than 12 years of trending upwards capital values have fallen. Over the 12 months to 30 September 2009, industrial property in Southern Sydney has been the weakest performer, reporting 18.2% reduction in capital values. This was followed by Southern Brisbane, South-East Melbourne and Northern Sydney, with growth rates of -15.6%, -13.7%, -14.5%, respectively.

Figure 9



Yield forecasts are dependent upon space market and capital market fundamentals, with the latter driven by interest rates and investor demand. Despite the Reserve Bank having started the process of returning monetary policy to a more normal setting, CFS Property Research expects the cash rate to remain below the 20-years average of 6.33% over the next few years, which, coupled with a pick-up in investor demand, is expected to place downward pressure on yields. This will likely increase counter-cyclical investor interest as the sector is hovering around the trough of the property cycle.

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