

# 2011: Real Estate Outlook

INSIGHTS

February 2011

2011 has kicked-off with a mixed-bag of economic news that will set the scene for the performance of residential and non-residential real estate markets throughout the rest of the year.

A number of key indicators remain subdued – consumer sentiment, retail sales, and house prices. At the same time, unemployment is reaching historical lows and mining investment continues to create capacity issues for the economy. Short-term, the floods and cyclones that hit Australia over the summer break will impact economic growth at least for the next two quarters. Consensus GDP forecasts for the year ahead are between 2.5% and 3.75% – a reasonably large range and reflects the wide divergence in views on the outlook for 2011.

The recovery in the commercial real estate sector will continue but is unlikely to shoot the lights out. In the year to December 2010, unlisted wholesale property funds, as measured by the Mercer/IPD Australian Pooled Property Fund Index, recorded a total return of 9.5% and we'd expect a similar return this year. (Table1)

Table 1: Total Returns to December 2010

Returns %	3 months	12 months	2 years	3 years
Direct Property (i)	2.6	9.5	-0.2	-0.5
A-REITs (ii)	-1.4	-0.5	3.6	-20.9

While cap rates for prime non-residential real estate are likely to firm by a further 25-50bps, we still see non-residential returns being driven by the income side of the equation, with active management the key to increasing income and hence growth in total returns.

According to the Property Council of Australia's latest office market audit, the Australian CBD office market is improving with the national vacancy rate falling to 9.5% in January 2011<sup>1</sup>, the first decline since the GFC took hold three years ago. All CBD markets, except Hobart and Adelaide, recorded a net take-up in office space. The two key CBD office markets – Sydney and Melbourne recorded vacancy rates of 8.2% and 6.3% respectively. Off the back of this rising demand, rents are set to improve in 2011. Sydney and Melbourne will continue to be the markets most investors will focus on but Perth with its significant exposure to the resource sector may surprise on the upside in 2011.

On the retail front, it is likely to be a tough year especially for larger retail centres which are highly dependent on discretionary spending. As the RBA pointed out in their Statement of Monetary Policy in February, *"The household sector has continued to exhibit considerable caution in its spending....nominal retail sales remain*

1. Property Council of Australia – Office Market Report – February 2011

weak and retailers report that consumers continue to very value-conscious.”<sup>2</sup> This was backed-up by Myer’s latest trading update with the CEO saying “We, like other discretionary retailers, have observed a consumer that is more cautious to spend and has a tendency to save.”<sup>3</sup> Also, with the high Australian dollar and internet shopping becoming more popular, retail expenditure is increasingly leaking off-shore. We continue to favour neighbourhood and smaller sub-regional retail centres that focus on non-discretionary spending.

The A-REIT sector continues to trade at a discount to NTA and whilst significant progress was made on repairing balance sheets and getting back to basics - a greater focus on improving income streams and concentrating on domestic exposures – the A-REIT sector finished 2010 with a total return of just 1.2%. The market will look to increases in earnings growth from A-REITs to close the gap in NTA, although M&A activity and share-buy backs could be a catalyst in the short-term. (Figure 1)

Figure 1: A-REIT Prices and Discounts to NTA



Source: AFR<sup>4</sup>

Liquidity is returning to the direct markets, with a number of large transactions completed in the December quarter.

Table 2: Completed Transactions: December 2010

Asset	Vendor	Purchaser	Price	Yield
Melbourne Office Portfolio	Grollo	Commonwealth Property Office Fund	\$581m	7.6%
Doncaster Shopping Centre (25% interest)	LaSalle	ISPT	\$350m	5.7%
Brisbane Square	Westscheme	Telstra Super/Charter Hall Fund	\$300m	7.7%
Industrial Portfolio	Colonial Direct Property Fund	Dexus Wholesale Property Fund	\$232m	9.0%

2. Reserve Bank of Australia – Statement on Monetary Policy – February 2011  
 3. Myer Holdings – Update on Trading and FY2011 Outlook – 7 February 2011  
 4. Australian Financial Review – REITs: Bridging the Gap a Focus for Investors – 5 February 2011

Prime non-residential real estate will continue to be attractive to large wholesale funds, superannuation funds and off-shore investors. Many super funds now have built up significant cash and are looking for long-term investments. As the Chief Executive of the \$18bn REST super fund recently said in relation to their purchase of a \$240m office tower in the Dockland “we look for good-quality investments such as commercial office property, because it provides strong levels of cashflow and a degree of inflation protection”.<sup>5</sup> The A-REITs have by and large remained out of the market but as the gap between their share prices and NTA close, they will become active buyers of real estate again.

Debt availability and margins have improved from the dark days of the GFC, but unfortunately for many developers banks continue to rationalise debt and this will continue to put a drag on new development. Furthermore, the disparity between markets rents and the rent required to underpin new construction will continue to be a hurdle to kick-start the next wave of construction.

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We believe in the non-residential space, the best up-side will come from buying smaller assets in good locations, that are either too large for private owners who have difficulty getting access to finance, or are too small for institutions who are focused on chasing larger prime assets. Many of these assets have significant upside potential from repositioning through active management.

On the residential front, we expect price growth to be subdued in 2011. The market clearly peaked in May 2010 after a stellar run. Sentiment and affordability will be the main drag on the sectors performance in 2011.

According to RP Data-Rismark, Australian capital city residential prices increased by 0.2% in December. However, there was divergence across the major cities. Prices in Melbourne (0.4%mom, +8.4%yoy) and Sydney (1.0% mom, 6.6%yoy) increased while prices in Perth (-0.9%mom, -2.3%yoy) and Brisbane (-0.1%mom, -1.0%) were lower.<sup>6</sup>

Sentiment toward the housing sector took a hit in the second half of the year as the RBA’s fourth interest hike in November, which was topped up by a fifth via the banks, increased the cost of finance and put further pressure on housing affordability.

The rental market remains buoyant with low vacancy rates as first home buyers decide to rent rather than buy. The national vacancy rate at December 2010 was just 2.2% - with Canberra recording the lowest rate of just 0.9% and Melbourne the highest at 3.6%.<sup>7</sup> One worrying sign is that the number of first home-buyers in the market has weakened. In November 2010, first home-buyers accounted for just 15.6% of purchasers compared to a record 28.5% in May 2009.

Taking a longer-term view, we still like the residential sector. Supply remains constrained and we are not building enough accommodation to meet overall demand. Low unemployment, solid wages growth and reasonable high net overseas migration should underpin longer-term demand.<sup>8</sup>

5. Investors Chasing Big-City Office Towers – Australian Financial Review – 3 February 2011

6. RP Data – Rismark Home Value Index Media Release – 31 January 2011

7. SQM Research – National Vacancy Rate – December 2010 – 23 January 2011

8. ABS – Housing Finance , Australia November 2010 – published 12 January 2011

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