

# AUSTRALIAN COMMERCIAL REAL ESTATE

FEBRUARY 2015



## KEY MESSAGES

- 8%-8.5% pa ungeared total return over the long term with potential for higher than average returns in the short term.
- Potential for increased volatility (up and down) over the base case returns depending on global interest rate movements.
- Portfolio construction models are starting to tilt towards defensive assets as property prices rise. This is giving signals to increase retail weightings and prune non-core assets irrespective of sector.
- Short term outperformance in Sydney and Melbourne expected.

We are set for a dynamic 3-4 years as real estate, like all asset classes, navigates through a raft of global economic and investment cross currents and challenges.

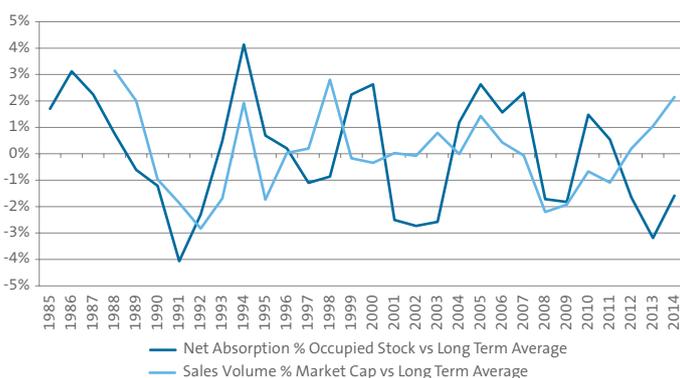
## IN OUR VIEW, THE SECTOR FACES FOUR KEY CHALLENGES IN THE SHORT TO MEDIUM TERM:

1. Scarcity of product for investment at a time of excess liquidity driven by the global chase for yield
2. Managing the medium term risk of prices rising beyond fundamentals, particularly if interest rates stay lower for longer
3. Navigating a reversal of the two speed economy, and
4. Accommodation demand patterns changing due to demographic shifts, globalisation, and technological disruption.

## EXCESS LIQUIDITY TO CONTINUE – HIGHER THAN EXPECTED RETURNS IN THE SHORT TERM

As we saw elsewhere in the world, investors in Australia flocked to commercial real estate in 2014 as the chase for yield intensified as interest rates fell. In fact, liquidity in Australia is currently in excess of the pre-GFC years as highlighted in figure 1 below. At the coal face, 2014 felt very much like 2006 except for the sluggishness in leasing markets.

Figure 1. The relationship between investor and tenant activity



Source: JLL Research, IPD, AMP Capital

From a macro perspective, the weight of money into real estate is understandable. Global bond yields remain near all-time lows and are well below the levels of potential economic growth. Part of this is due to monetary policy, part is due to risk perceptions, and part of it is due to the sluggish nature of the global recovery so far. Global bonds offer little value at current levels which is forcing defensive investors to search elsewhere for yield, real estate and infrastructure being a prime beneficiary.

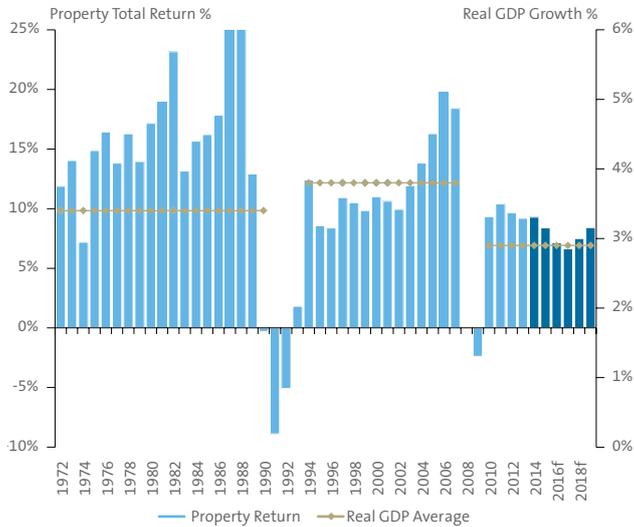
Looking forward, 2015 is expected to be a repeat of 2014 with inconsistent economic growth on the low side of long term averages, excess capacity in many economies, and non-conventional central bank monetary policy continuing. The IMF, World Bank, AMP Capital and many other economic commentators are in consensus that the global economic outlook is uninspiring with more risks than strength. Most expect it to improve in 2016 and 2017 but at this stage, 2015 looks more of the same. Australia too is looking like it will have one of its most challenging years in decades and further falls in interest rates are possible.

In this environment, there is the likelihood interest rates could fall further if growth gets really weak and as the weight of defensive capital fleeing Europe and Japan chasing higher yield accelerates. This is already causing another downward push on bond yields and widening the yield spread to property. On paper, this is making property look more attractive, particularly for assets with certainty of income.

This is both good and bad. Firstly, it is good for liquidity in real estate and prices, however, like Bonds the weight of money will start to push pricing beyond fundamentals – this is a risk.

Thus the outlook for property returns in 2015 is looking stronger than our forecast in last year's house view. Our base case is for composite ungeared returns in the high single digits but if we see a substantial rise in leverage use once again (which is possible in this environment) or interest rates fall even further, then double digit returns are possible. Over the long term we still see 8%-8.5% return in Australian real estate.

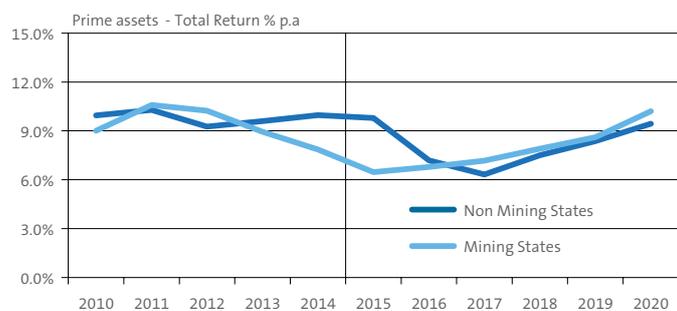
**Figure 2. Outlook for returns**



Source: AMP Capital/IPD/ABS/Access Economics

At a market level, we expect a wider spread of performance than experienced in 2014, reflecting the reversal of the two speed economy and chase for yield. Markets that are seeing very strong buying interest and improving fundamentals such as Sydney and Melbourne CBD office and high yielding markets such as industrial and neighbourhood retail are all likely to record double digit returns in 2015. However resource state markets are decelerating and there is the potential for values to fall in some sub-markets, particularly in the office sector. The divergence is highlighted figure 3.

**Figure 3. Commercial Real Estate Returns**



Non Mining = NSW, Victoria & ACT  
Mining = Queensland, Western Australia, South Australia

Source: IPD/AMP Capital

**BUT THE “CHASE FOR YIELD” IS SETTING THE MARKET UP FOR MEDIUM TERM VOLATILITY**

The inevitable rise in interest rates is one of the key medium-term thematic that real estate and indeed all asset classes will need to navigate.

On balance (as highlighted in figure 2), our base case outlook is that values will remain stable throughout the adjustment phase with earnings growth compensating for higher discount rates and lower leverage arbitrage excepting in the following sub sectors (where we believe asset values could fall):

- > Structurally low rental growth segments of the market such as industrial, bulky goods retail, and business parks where it is very hard to gain strong uplifts in rents to compensate
- > Second and third tier Sub regional Shopping Centres where structural headwinds will make it a challenge to hold occupancy rates in the long term, and
- > Secondary office and industrial assets in secondary or tertiary locations where there is no chance of residential conversion.

However, if interest rates stay “lower for longer” and the chase for yield gets amplified by higher leverage, yields are likely to surpass the lows of 2007 across the broader market. Under this scenario, double digit returns are possible at a market level in 2015 and possibly 2016, but the risk of a broader retracement in value is much higher, particularly in the office and industrial sectors, when the rate curve finally starts to rise.

While it is not our base case, lower interest rates may also be a sign of a recession which would normally cause values to fall. In any case, both scenarios suggest increased volatility in pricing is ahead.

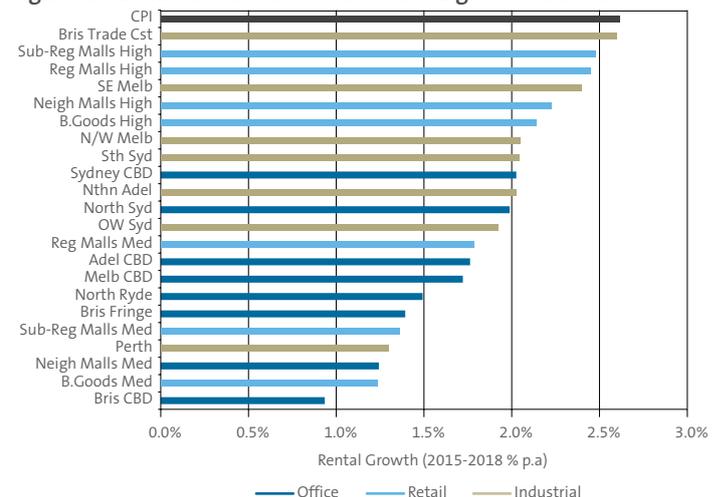
In terms of magnitude, time will tell on this. This is a risk that needs close monitoring.

At the moment, our quantitative models and experience tell us now is the time to start pruning assets which are replaceable, and making sure cashflows are as secure as possible with defensive portfolio construction. History has proven many times, that mispricing of risk and illiquidity tends to happen following periods of excess liquidity as we are currently witnessing.

**PROPERTY FUNDAMENTALS HELD BACK BY ONGOING CONSTRUCTION AND STRUCTURAL HEADWINDS**

While capital is in abundance, property fundamentals in all three asset classes are tracking sideways at best and are likely to do so until 2016/17 when the economy strengthens. Our short term rental growth forecasts are highlighted in figure 4. Strongest rental growth is expected in high growth retail malls and industrial markets, however in the historical context, the rates of growth are below average and struggling to match CPI. Office is being held back by high vacancy and on-going construction, while Retail is being affected by changes to the structural landscape of the sector.

**Figure 4. Fundamentals - Short term rental growth elusive**



Source: AMP Capital/Access Economics

At a macro level, while the next 12 months look weak, economic growth for Australia is forecast to be in a range between 2.8% - 3% pa over the next 5 years according to the IMF. The IMF is still forecasting Australia to be in the top third of the strongest performing advanced economies, but these growth rates are slightly weaker than the long term average. The key risk is a hard landing in China or another global shock. We expect China to eventually navigate its shadow banking issue, but the next 6-9 months look particularly weak.

Underneath that average, clearly the two speed economy is reversing, now to the benefit of Sydney and Melbourne. We expect these cities to continue to outperform resource states in the short term as economic growth is stimulated by low interest rates, housing and construction activity, and some improvement in business confidence.

The downturn in resource states has yet to bottom out and returns will be held back in 2015 and 2016 relative to the other states (highlighted in figure 3 earlier). Office markets are yet to see a peak in new construction and vacancy rates (see figure 5). Population growth is also likely to be less strong which could cause some short term issues for industrial and retail sectors.

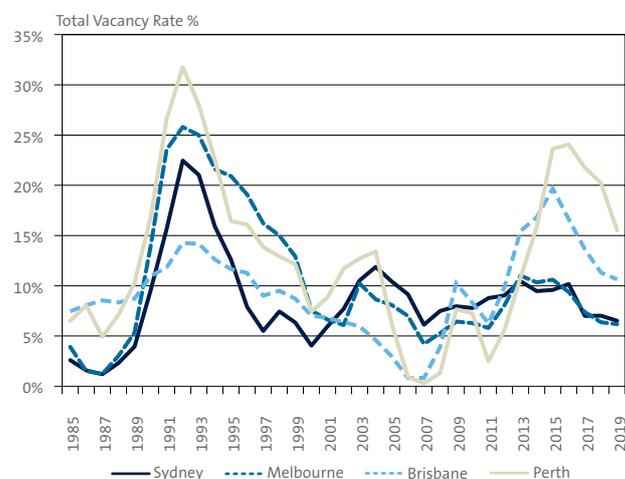
## OFFICE

In our last House View forecast, leading indicators (such as corporate profits) were pointing to an improvement in office demand in the non-mining states. This is now clearly happening. Both Sydney and Melbourne CBD markets have seen rates of net absorption in 2014 rise to/or above long term averages. Looking forward, this trend is going to continue given the solid profit growth announced by financial services companies and with the banking/financial services sector working past the structural adjustments to capital requirements and risk/compliance in the wake of the GFC.

However, vacancy rates are tracking sideways in both markets as the rise in demand is being counterbalanced by ongoing construction. In Sydney CBD there is almost 380,000sqm under construction (or about to start) dominated by the three towers at Barangaroo. In Melbourne, approximately 200,000sqm is underway. Even with older buildings being converted to residential, vacancy rates are expected to stay elevated until this supply completes. This means incentives will remain above average, holding back rental growth.

However, in the longer term, vacancy rates will start to fall and both markets are running out of cheap sites for development which provides scope for future rental growth, as construction will need to focus on more expensive sites in established areas of both CBDs.

Figure 5. Sydney and Melbourne to outperform



Source: JLL Research/AMP Capital

As highlighted above, the pain in resource states is not going to go away in the short term particularly now that the oil price has fallen which is undermining the energy/LNG sector on top of bulk commodities. Rents are falling in Perth and the secondary market in Brisbane and there is now pressure on values.

Excluding the resource states, returns in the short term are now looking stronger than the last House View but as discussed earlier, there is an increasing risk of volatility in the medium term. The strongest returns over the next 3-5 years are in markets with the most defensive fundamentals (and liquidity) such as Sydney and Melbourne CBDs along with some of the higher yielding markets such as Canberra.

Lastly, the next 5-10 years are going to be interesting for office markets as there are a number of thematic such as an ageing population, business margin pressure, the rise of virtual reality and activity based working which are all going to hold back potential net absorption rates. We have discussed these long term thematic in the past, suggesting portfolios be rebalanced towards CBD and inner city areas, upgrading assets to improve their destination appeal, and increasing exposure to cities where population growth is the strongest, such as Melbourne, Brisbane and Perth over the long term, when attractive cyclical opportunities exist.

Research completed by AMP Capital on the 'Workspace of the Future' suggests rates of growth may not be as strong as businesses adapt to shifting demographics, margin pressure, globalisation pressures, and improving technology. Thematic suggest the ageing demographic issues will fuel a skill shortage and business margin pressure is going to be best alleviated by outsourcing mid and back office functions, and substituting process with technology (including virtual reality workforces). Technology disruption is also going to fuel this. This is expected to see the bricks and mortar office workforce dominated by front of house staff over the long term. Anecdotally we can see this thematic already starting to happen. Providing a workplace solution that provides experiential destination appeal (for networking, business generation and work/life balance) is also going to be more beneficial as it will help to retain staff and tenants as cohorts become increasingly focused on Generations Y and Z.

## RETAIL

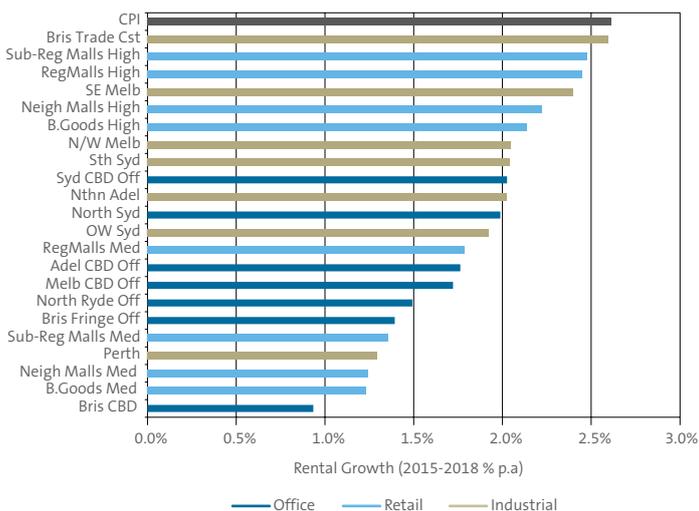
There has been no major change in our outlook for this sector since the last House View. Looking forward, all the cyclical and structural thematic suggest outperformance in this sector will polarise towards the dominant centres and the neighbourhood centres, particularly those in strong population and income growth areas over the medium to long term. Simply, these centres are expected to hold their occupancy rates best against the structural headwinds. Centres in low population growth areas with no ability to reposition or grow to capture market share are expected to feel the full force of the negative structural headwinds facing this sector. These second tier malls are expected to see weaker leasing demand and potentially higher vacancy rates which will undermine rents and values. This is expected to accelerate over the next 3-5 years as retailers start rationalising and closing stores as leases expire.

While we expect this divergence, the prospects of a strong uplift in rents in better quality malls is also not realistic in the short term unless centres are extensively repositioned and expanded and capture a sizeable uplift in market share. Consumer sentiment is still patchy and retailers are slowly adjusting their business models to the new challenges resulting in lower overall demand for space from domestic retailers.

Research indicates that you need to be at the head of the development pipeline to grow market share and generate additional investment performance, hence AMP Capital's pro-active approach on shopping centre expansions, most recently evident in the completion of Macquarie Centre, Sydney and Ocean Keys, Perth developments.

In terms of passive assets, rental growth is expected to struggle to match CPI over the next 3 years (highlighted in figure 6) unless shopping centres are expanded substantially and capture market share. Second tier centres are expected to see further falls in rents in the short term, and their average face rental growth is among the weakest in the sector at the moment.

Figure 6. Fundamentals - Short term rental growth elusive



Source: AMP Capital/Access Economics

## INDUSTRIAL

Since 2010, our House View has advocated increasing weighting to industrial (which has proven highly beneficial to returns) but with real rental growth elusive, prime assets are getting closer to the top of the cycle as capitalisation rates move under 7%. In fact, JLL Research report prime yield in parts of Sydney surpassed the 2007 highs in late 2014. Secondary asset pricing is also moving in the same direction albeit with a lag. While there is still some run left in prices in 2015 (and possibly 2016), portfolio construction models are less likely to include the addition of prime industrial because of the risk of re-pricing in the medium term once the global yield curve has escalated.

While we expect industrial rents will grow closest to their long term average in the years ahead, growth is still flat/negative in real terms. Strongest rental growth is expected in Brisbane where there is a shortage of mid-size and large warehouses but an oversupply of small units (which have become less in demand as population growth drives up volumes of goods, requiring larger facilities for businesses). Similar growth is expected in Sydney and Melbourne around the 2% pa mark over the next 5 years.

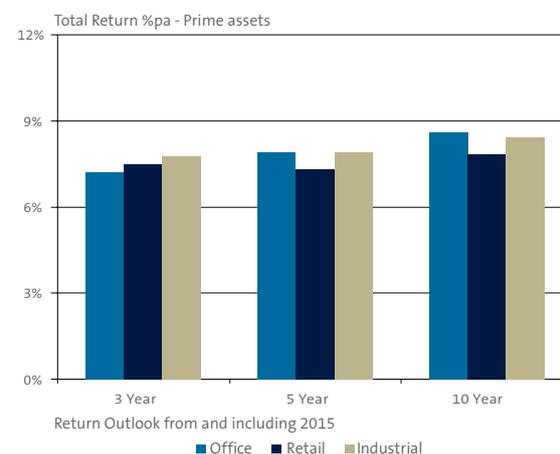
While there are a lot of structural thematic (such as the online retail story) that are very positive for the sector, the investment gain is not likely to be fully felt as it will still be hard to drive up rents until land banks are eroded and land supply reduced. This is at least 1-2 cycles into the future, subject to governments not rezoning significant tracts of new employment land in our major cities.

In that regard, since the last House View, the Federal Government has committed to building Badgerys Creek Airport in Western Sydney. The infrastructure built to support the airport is also expected to unlock 4,600Ha of new employment land between the airport and Eastern Creek/Erskine Park, earmarked by the NSW Government as part of the Broader Western Sydney Employment Area structure plan. To put that into context, it is almost two thirds the size of the employment land base in Western Melbourne and double the size of the Brisbane Tradecoast. Our view is that this will attract businesses next decade and potentially undermine rents in the more expensive parts of Sydney, given the trends observed in Melbourne during the 1990s when the Western Ring Road opened up vast tracts of land. This is an "over the horizon" factor to consider with Sydney portfolio construction moving forward.

## PORTFOLIO CONSTRUCTION MODELS STARTING TO MOVE AWAY FROM GROWTH TO A STABILITY BIAS

Our base case forecasts (see figure 7) suggest there is very little difference in performance likely at a sector level over the 3, 5 and 10 year view. However, volatility of returns is rising (up and down) and if interest rates stay "lower for longer", there is the risk of higher volatility in office and industrial and small retail centres over the 3 and 5 year horizon (up and down) over this base case.

Figure 7. Similar return outlook across sectors



Source: AMP Capital

Portfolio construction models are therefore starting to shift away from growth to stability of return as there is the increasing risk of volatility on the downside over the next 5 years.

Under the base case returns, the models are shifting away from office/industrial back towards the long term optimal portfolio (50-60% retail, 30-40% office, 5-10% industrial). Under the "lower interest rates for longer scenario", models are tilting very long to defensive, scarce assets such as regional retail centres, similar to portfolio construction for managing a recession. This is an important point.

The conclusion from this analysis is that investors should clearly be looking to improve the defensive qualities of their portfolios in the current environment. The modelling clearly suggests raising allocations to retail and down-weight industrial. Current pricing points suggest pruning assets where no additional value add is available and being very circumspect on new acquisitions at this point in the cycle.

At a sub-market level, there hasn't been much change in the key portfolio construction signals since the last House View:

**RETAIL** – Focus only on dominant assets or those in population growth areas. These are best placed to hold occupancy rates against the structural headwinds facing the sector.

**OFFICE** – Tapping into the reversal of the two speed economy and focusing portfolios on CBD/Inner City markets (with opportunity to upgrade lifestyle amenity) is the key to delivering returns in this sector based on thematic “workplace of the future” and market cycle forecasts. Optimisation models suggest Sydney/Melbourne bias supplemented by secure high yield (any market). Brisbane should be added once prices fall.

**INDUSTRIAL** – as highlighted above, reduced weighting recommended. Best now to wait until interest rates rise to buy into this sector. The window to buy well located secondary assets has now closed and yields have compressed in the past 6-9 months.

**NON-CORE MARKETS AND SECONDARY MARKETS** while they look good on paper, there is still tenancy risk as the economy is sluggish and most are liquidity traps except neighbourhood retail, port area industrial, and George/Collins Street CBD office. We urge care with asset pricing. Investors are underestimating the impact on occupancy rates from some of the cyclical and structural thematics.

## CONCLUSION – INVESTMENT STRATEGY

As mentioned at the outset, the dynamics of the global economic environment and consequent challenges make for uncertain times for real estate and indeed all asset classes.

On balance, our quantitative models are confirming our observations that the market is getting closer to the top of the cycle and now is the time to capitalise on the weight of money and position funds and assets for the volatility and structural headwinds in the medium term.

The following are the key strategies AMP Capital-managed funds are employing based on the House View:

- While there is likely to be further gains in prices in 2015, current pricing points suggest selling replaceable assets where no additional value add is available while capital is in abundance, and being very circumspect on new acquisitions at this point in the cycle. Accelerate this if prices rise well beyond fundamentals and returns are being delivered increasingly via leverage.
- Portfolio construction models are moving back towards the long term optimal portfolio. This means we are now getting signals to increase weighting to retail and start down-weighting cyclical performing assets. If prices rise excessively in 2015, then portfolio construction models are biasing further to retail, particularly the most defensive asset types (ie. regional shopping centres).
- The reversal of the two speed economy means there will be outperformance in Sydney and Melbourne over the next couple of years and poor performance in resource states. Thus, a short/medium term bias to Sydney and Melbourne will reward.
- On the thematics, all of the research suggests to focus on population growth areas/cities, dominant assets and core locations and deepen the destination and experiential feel of assets to attract customers and staff. This will help offset flatter or declining accommodation demand over the long term.

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