AUSTRALIAN PROPERTY INSIGHTS

2020 VISION

The outlook for Australian commercial real estate investment markets in 2020

DECEMBER 2019

CUSHMAN & WAKEFIELD

2020 VISION

Key points

The most likely course for Australia in 2020 is moderate economic growth and a lower-for-longer interest rate environment (scenario 1). There remains a chance of a recession (scenario 2) with even smaller odds that growth will reaccelerate in 2020, reigniting inflation fears and pushing up interest rates and bond yields (scenario 3).

For Australian CRE investment this is likely to mean:

The capital growth cycle has likely peaked: Under scenarios 1 and 2 and a few variations within scenario 3, we have likely seen a cycle peak in capital growth for many Australian CRE markets.

Yields relatively stable: Yields should not move too much under scenario 1. There may some further compression in markets supported by structural change or with stronger fundamentals, but with sub-trend economic growth limiting business conditions, it may be a struggle to replicate the solid rental growth of recent years.

While significant compression is unlikely, under scenario 1 yield expansion should also be limited. Low interest rates, the ongoing hunt for yield and still positive economic growth ought to maintain demand for Australian CRE. The exceptions will be where market fundamentals are poor or if Australia falls into recession.

Strong transaction volume: Under scenario 1, transaction volumes should remain strong. Reduced growth opportunities may encourage owners to recycle capital, while still attractive yields are likely to maintain buyer interest.

Fundamental focus: With yield movement likely to be limited, unless there is a recession, individual property growth prospects and market fundamentals will move into sharper investor focus.

Overall, in two of the three scenarios, most Australian CRE markets should remain relatively good value and continue to attract solid interest from both local and overseas investors.

The outlook for Australian commercial real estate investment in 2020 and beyond

Australian Commercial Real Estate (CRE) transaction volumes are at record levels with strong demand from both local and international investors. However, the market is desynchronising with yields in some sectors and markets continuing to compress to record lows, while for others demand has fallen and yields are being challenged.

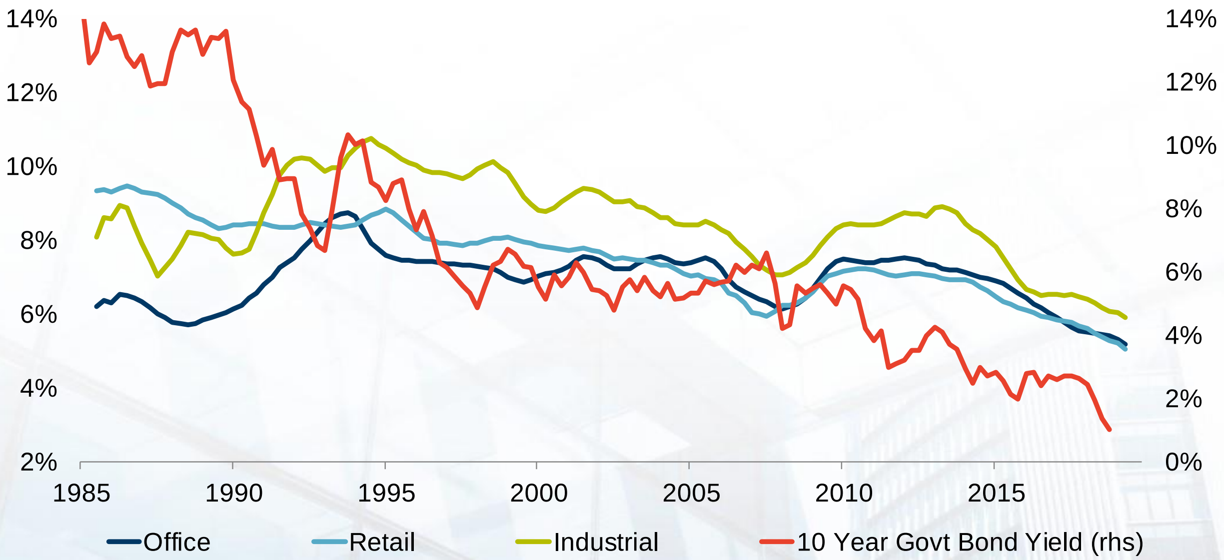
Does this signal the top of the cycle for the Australian CRE in 2020 and if so, how far might it decline?

In this report Cushman & Wakefield Research reviews three scenarios and their potential impact on Australian CRE for investors to consider:

1. Lower-for-longer interest rates with moderate growth continues;
2. Australia slips into recession and bond yields fall; and
3. Growth reaccelerates and interest rates and bond yields increase.

Cushman & Wakefield Research views Scenario 1, lower-for-longer and ongoing moderate growth, as the most likely option. However, under all the scenarios, markets with solid growth potential are likely to continue to attract the most investor interest while markets with a more challenging growth outlook may struggle to maintain value.

FIGURE 1
AUSTRALIAN CRE INCOME RETURNS AND 10 YEAR GOVERNMENT BOND YIELD



Source: MSCI; RBA; Cushman & Wakefield

INTRODUCTION

Australian CRE markets have now experienced nearly 10 years of capital growth. The growth was likely driven by two main factors, a combination of:

The global hunt for yield or yield compression as interest rates and bond yields around the globe fell; and

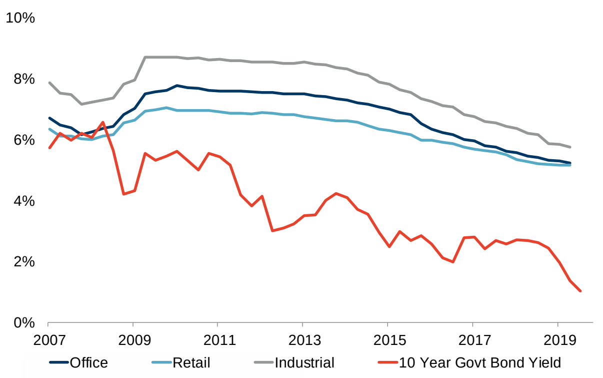
Above average rental growth from strong tenant demand and falling vacancy. This has been a result of either:

– Market fundamentals; or

– Structural change.

Future CRE capital growth will also be influenced by interest rate/bond yield movements and rental growth. In this report Cushman & Wakefield Research reviews three scenarios and how they might influence Australian CRE markets.

FIGURE 2
CRE CAP RATES AND 10 YEAR GOVT. BOND YIELD



Source: MSCI; RBA; Cushman & Wakefield

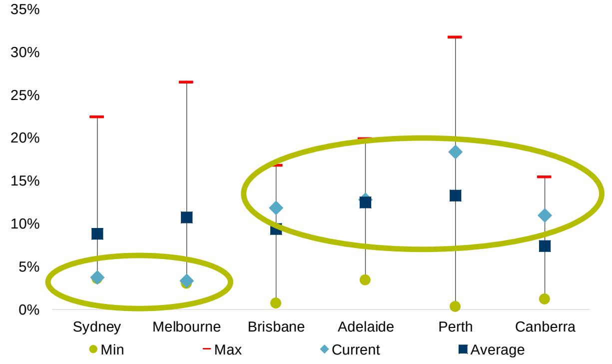
THE GLOBAL HUNT FOR YIELD

Australian CRE yields have fallen to record lows after a cycle peak in late 2009 (Figure 2). The compression has corresponded to declining interest rates and bond yields as a series of economic shocks, commencing with the Global Financial Crisis (GFC), has resulted in a succession of new lows for the Australian Cash Rate and bond yields. In some parts of the world interest rates and bond yields have gone negative. With limited or even negative returns from fixed interest investments, investors both local and global, sought the comparatively high yields offered by Australian CRE. However, the GFC and its aftermath generated relatively soft tenant demand conditions and limited rental growth for a number of years. This meant that capital gains were sometimes driven more by yield compression than rental growth, but in recent years growth is again becoming the dominant consideration.

RENTAL GROWTH DRIVING VALUE

Vacancy rates in Sydney and Melbourne office markets have fallen to multidecade lows (Figure 3). The rates declining on solid demand from very strong business conditions combined with limited new supply and stock withdrawals. This helped drive above average rental growth. The compound annual growth rate over the five years to September 2019 for Prime Sydney CBD net effective rent a strong 10.0% and 11.3% for the Melbourne CBD.

FIGURE 3
AUSTRALIAN CBD OFFICE MARKET CURRENT AND HISTORIC VACANCY RANGE, 1990 TO JULY 2019



Source: PCA; Cushman & Wakefield

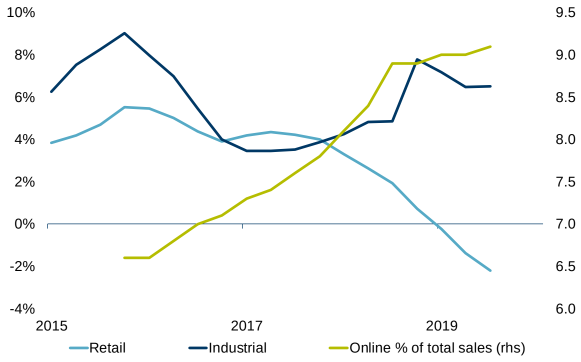
The vacancy rate for other capital cities' CBD office markets are above average and the markets 'tenant favourable'. As such, rental growth has been soft. However, vacancy has generally trended lower in recent years and rental growth is improving. Brisbane in particular achieving Prime net effective rental growth of 5.0% over the 12 months to September 2019, the strongest growth since 2013.

STRUCTURAL TAILWINDS

Structural change has also been a key driver of some Australian CRE markets. Changes to technology and demographics have hindered some retail markets but have also proven to be tailwinds for the transport and logistic sectors as distribution channels are streamlined to reduce costs. This has resulted in a push to develop larger, more automated warehouse facilities. Some new super prime facilities achieving yields approaching prime CBD office property.

In addition, changing demographics and residential encroachment have reduced the number of industrial properties and driven up land values for industrial property closer to city centres. At the same time demand for 'last-kilometre' logistic space has risen. As a result yields have continued to fall with, the yield range for South Sydney industrial property reported to be 4.00% to 5.50% as at September 2019.

FIGURE 3
RETAIL AND INDUSTRIAL CAPITAL GROWTH AND THE RISE IN ONLINE SALES



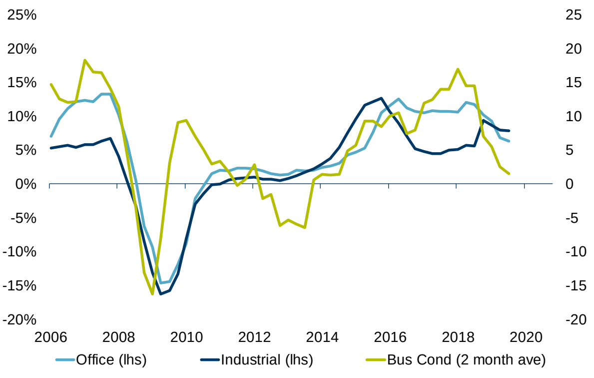
Source: MSCI; NAB; Cushman & Wakefield

MIXED CAPITAL GROWTH DRIVERS IN 2019

Australian economic growth slowed in 2019 on a combination of factors including the housing slowdown, the drought and falling business and consumer sentiment. This drove interest rates down to record lows. The Reserve Bank of Australia cutting the cash rate three times to 0.75% while the 10 year government bond yield fell from over 2.2% at the start of the year to a low of 0.89% in August. The softer economic growth dampened tenant demand, though the fall in bond yields widened the property-bond yield spread as per Figures 1 & 2.

The National Australia Bank's monthly Business Survey reported business conditions were near record high levels in 2017 and 2018 and this was associated with strong tenant demand and capital growth, particularly for the Sydney office market. However, in the weaker economic environment, conditions have deteriorated in 2019. Figure 4 indicating the fall in business conditions has been followed by slower capital growth.

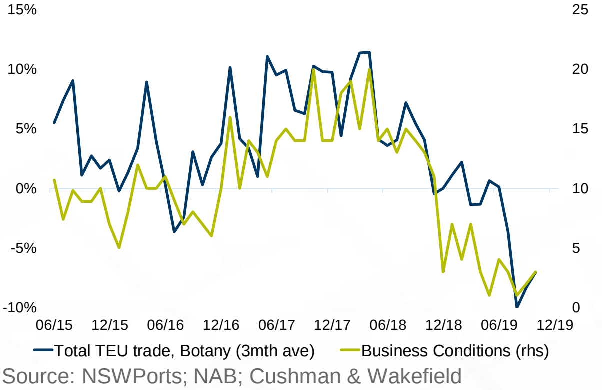
FIGURE 4
BUSINESS CONDITIONS AND SYDNEY INDUSTRIAL AND CBD OFFICE CAPITAL GROWTH



Source: MSCI; NAB; Cushman & Wakefield

While the tailwinds of structural change have insulated industrial property from the softer economy, as Figures 4 & 5 indicate, the sector is not immune from the cyclical slowdown. NSW Ports data on container volumes at Port Botany slowing significantly from 2017 and 2018 levels and anecdotal evidence suggesting tenant demand from small industrial space users has waned.

FIGURE 5
BUSINESS CONDITIONS AND CONTAINER MOVEMENTS



Source: NSWPorts; NAB; Cushman & Wakefield

WHERE TO FROM HERE?

Interest rate direction and market fundamentals will continue to be the key drives of future CRE capital growth. However, at present the outlook is mixed. Economic forecasters such as Deloitte Access Economics, Oxford Economics and Moody's Analytics predictions' for the Australian government long bond in 2020 range from around 0.55% to 1.25% and real GDP forecasts estimate growth to be around 2.25% to 2.50% in 2020. These indicate the view that interest rates will stay low and economic growth improve from 2019's level, but remain sub-trend.

THREE SCENARIOS

In 2016, Cushman & Wakefield Research introduced the Three Scenario approach, which reviewed a range of interest rate/bond yield and economic growth paths and their possible impact on Australian CRE. In this report we again review some potential paths of interest rates and growth for investors to consider:

1. Lower-for-longer interest rates with moderate growth continues;

2. Australia slips into recession and bond yield fall to new lows; and

3. Growth reaccelerates and interest rates and bond yields increase.

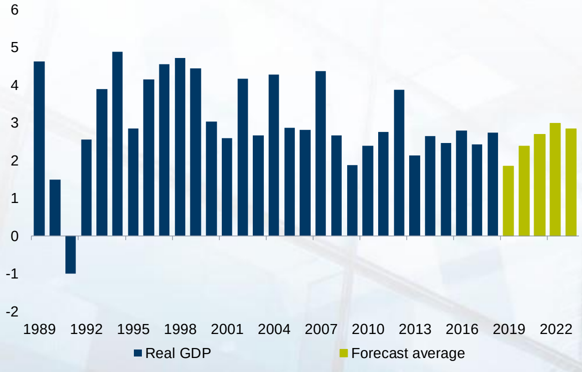
SCENARIO 1: LOWER-FOR-LONGER INTERST RATES WITH MODERATE GROWTH

In this scenario, interest rates and bond yields remain relatively stable, i.e. increasing or decreasing a little from current levels.

The moderate growth expectation is based on the previously mentioned economic forecasters who suggest real GDP growth should average 2.7% pa over the four years from December 2019 to December 2023 (Figure 6).

Under this scenario, the CRE-bond yield spread would remain relatively high and Australian CRE should continue to enjoy solid investment demand. For example, the average Prime Sydney CBD office market yield, arguably one of Australia's most expensive CRE markets, is currently around 4.6%, with a relatively large premium of around 350 basis points (bps) to the 10 year government bond yield. Bond yields would need to increase significantly (or property yields decline) before they were higher than property yields

FIGURE 6
AUSTRALIAN REAL GDP, ANNUAL AVERAGE GROWTH



Source: Deloitte Access Economics, Oxford Economics, Moody's Analytics; ABS; Cushman & Wakefield

SCENARIO 2: AUSTRALIA SLIPS INTO RECESSION AND BOND YIELDS FALL

As the housing market recovers and trade talks wax and wane, an Australian recession seems a lower probability than a few months ago. However, economic forecasters generally suggest risks are skewed to the downside. A recent survey from Oxford Economics[1] noted the chances of a global recession in 2020 were 1 in 5, though 71% of respondents were of the view that risks are weighted to the downside. Just 12% suggested stronger growth was more likely.

While a global recession is not required for an Australian recession, global events are usually seen as the key risks. Factors which could push Australia into recession include a full blown global trade war, a global financial crisis, a US recession, a sharp slowing of Chinese growth or a hard Brexit. Local risk factors include a worsening of the drought or a deepening of the slump in consumer spending accompanied by lower business investment

TABLE 1
EQUITY MARKET CORRECTIONS, RECESSIONS AND CRE CAPITAL GAINS

Peak Month[2]	Trough Month[2]	ASX/S&P 200	Real GDP Growth	Change in 10yr Bond	Office Capital Gain	Retail Capital Gain	Industrial Capital Gain
Jun 82[3]	Jun 83	+28%	-3%	-1.7%	NA	NA	NA
Sep 87	Dec 90	-43%	+3%	-0.4%	+26%	+26%	+11%
Dec 89[4]	Dec 93	+31%	-1%	-6.2%	-47%	+7%	-32%
Dec 93	Dec 94	-12%	+5%	+3.4%	+3%	+5%	+6%
Dec 01	Mar 03	-16%	+4%	-0.6%	-1%	+8%	+3%
Sep 07	Mar 09	-46%	+3%	-1.7%	-3%	-4%	-7%
Mar 11	Sep 11	-17%	+3%	-1.2%	+1%	+1%	+1%

Source: MSCI/IPD; ABS; S&P Indices; Cushman & Wakefield

Australia's last two recessions were in 1982/83 and 1991, over 28 years ago. While CRE return data for 1982/83 is not available, MSCI data for the 1991 recession show that over the 12 months to December 1991, the All Property capital return index fell by 8.8%. However, the economic downturn was accompanied by a supply wave in some CBD office markets that resulted in the vacancy moving up from single digits into the mid to high 20s. The impact on CRE returns lasted until the end of 1993. Office capital returns were down by nearly 50%, with industrial returns also suffering from the recession. Retail property held up surprisingly well, supported at the time by the relatively small size of the shopping centre market and a low floor space to population ratio (Table 1).

[1] Oxford Economics, *Research Briefing, Global Risk Survey*, 5 Nov 2019
[2] Month ASX/S&P 200 peaked and troughed (month end data used).
[3] Quarter GDP peaked and troughed.
[4] Quarter office markets peaked and troughed.

Cap rates are not available for the 1991/93 CRE crash, but MSCI's income return series provides a good proxy. The data show that from the CRE market peak in December 1989 to December 1993, the office income return rose by 270 basis points to 8.7% and the industrial by 190 basis points to 10.0%. The retail income return remained steady at 8.4%.

If Australia does slip into recession it is likely interest rates and bonds yields will decline further. This could be supportive of CRE investment demand in two ways. Firstly, depending on the relative level of local rates with overseas rates, it could improve the hedging benefit for overseas investors while lower bond yields could aid investment demand as the global hunt for yield continues.

However, as interest rates and bond yields are already at or near record lows, there is limited scope for further declines and any benefit to investment demand may be more than offset by the potential for a deterioration in occupier demand and the associated drop in property income. In the periods where office markets experienced negative capital gains (1993, 2003 and 2009), the national unemployment rate rose by 4.9%, -0.7% and 1.5% while the vacancy rate in the Sydney CBD rose by 17.8%, 2.3% and 4.1% respectively. The larger capital declines associated with the bigger jumps in unemployment and vacancy. Interestingly, major stock market and CRE corrections were generally only linked when vacancy also rose.

In summary, while there may be some benefit to CRE markets from lower interest rates and bond yields, the extent unemployment rises and occupier demand falls, will determine how CRE markets fair in an economic slowdown.

SCENARIO 3: GROWTH REACCELERATES, INTEREST RATES AND BOND YIELDS RISE

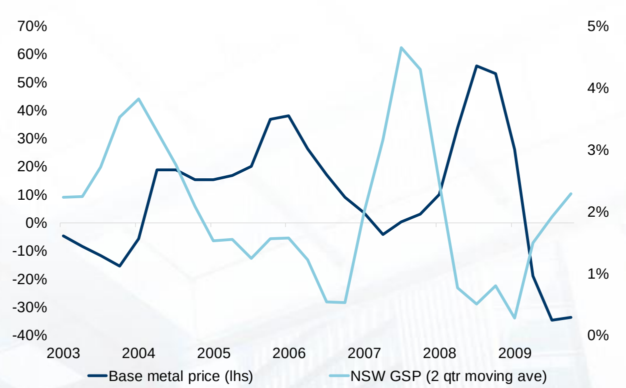
This scenario assumes Australian and global growth reaccelerate and inflation worries lift bond yields. A relatively low probability scenario but possible. Stronger economic growth should support occupier demand and Australian CRE. However, depending on the rate and distribution of the growth a number of outcomes are possible including:

Stronger commodity price growth supporting tenant demand in resource driven states such as Western Australia and Queensland.

If the Australian 10 year government bond yield was to increase by more than 350 bps and remain near or above that level, Australian CRE could be viewed as relatively expensive. However, this would require an increase in bond yields not seen since the 1994 bond market selloff. As Table 1 indicates, a bond market selloff is not necessarily negative for CRE.

Improving economic growth is usually positive for tenant demand, however, a potential downside impact might be a rise in interest rates, and potentially the exchange rate, as a result of stronger commodity markets. This may lead to a slowing in housing and business activity in service sector led states such as New South Wales (NSW) and Victoria. Figure 7 highlights the generally negative relationship between NSW economic growth and base metal price growth.

FIGURE 7
BASE METAL PRICE AND NSW GROSS STATE PRODUCT,



Source: RBA; Deloitte Access Economics; Cushman & Wakefield

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Summary

Scenario 1, moderate growth with lower-for-longer interest rates, is our preferred option for 2020, though there remains a chance of a recession with even smaller odds that growth will reaccelerate in 2020, reigniting inflation fears and pushing up interest rates and bond yields.

So what is this likely to mean for Australian CRE investment in 2020?

Capital growth cycle has likely peaked: Under scenarios 1 and 2 and a few variations within scenario 3, we have likely seen a cycle peak in capital growth for many Australian CRE markets.

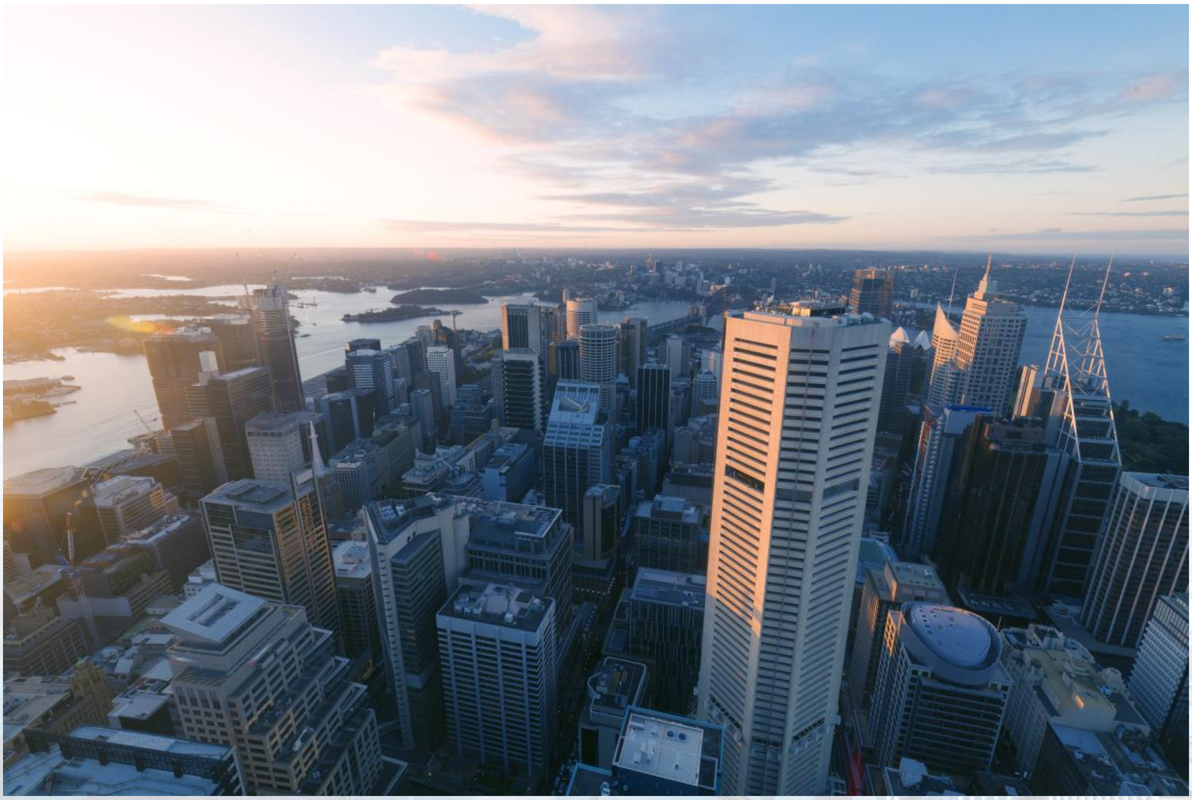
Yields relatively stable: Yields should not move too much under scenario 1. There may some further compression in markets supported by structural change or with stronger fundamentals, but with sub-trend economic growth limiting business conditions, it may be a struggle to replicate the solid rental growth of recent years.

While significant yield compression is unlikely, expansion under scenario 1 should also be limited. Low interest rates, the ongoing hunt for yield and still positive economic growth ought to maintain demand for Australian CRE. The exceptions will be where market fundamentals are poor or if Australia falls into recession.

Strong transaction volume: Under scenario 1, transaction volumes should remain strong. Reduced growth opportunities may encourage some owners to recycle capital, while still attractive yields are likely to maintain buyer interest.

Fundamental focus: Since the GFC, most CRE markets have benefited from yield compression driven by the global hunt for yield. With interest rates unlikely to move much lower, unless there is a recession, individual property growth prospects and market fundamentals will move into sharper investor focus.

Overall, unless there is a recession, most Australian CRE markets should remain relatively good value and continue to attract solid interest from both local and overseas investors



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