Accessing relative value across the public and private, debt and equity commercial real estate quadrants

Quarterly Market Update
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1.1 The Global and Australian Economies

Last quarter's downgrading of growth projections for Europe and the United States by the International Monetary Fund proved to be a good forecast of what were poor conditions in both geographic areas. The Eurozone crisis deepened as concerns focusing on the Greek sovereign debt problems spread right across the region and beyond with risk of a full blown global credit crisis a real possibility in the absence of credible action by the European Community. Despite some hopeful signs on the employment front with unemployment falling to 8.5% in November, its lowest level since February 2009, the US economy continues its weak growth trend. This together with political infighting during a Presidential election year is not producing any feelings of confidence in the markets that government has the answers needed to produce a real recovery. In its year end review, Westpac Economics has reduced its global growth projection from 3.2% to 2.8% for 2012. The 0.4% downward revision is explained by China 0.1%, India 0.1%, Europe 0.05%, Japan 0.05% and "other" 0.1%.

The domestic Australian economy grew by 1.0% during the third quarter of 2011. This followed growth of 1.4% in the second quarter after having contracted by 0.7% in the first quarter as a result of the flood affected start of the year. On the basis of expected growth of 1% in the fourth quarter, the full year forecast from the RBA is now 2.75%, down slightly from earlier projections. Westpac Economics has also lowered its forecast for domestic growth for 2012 to 3.0% from 3.5% with the first half of the year generating annualised growth of only 2.25% but growing more strongly in the second half of the year at 3.5% The most recent unemployment rate for November rose to 5.3% and consistent with weaker GDP growth in the first half of 2012, unemployment is now expected to increase in the first two quarters of the year through to mid-2012, when it is forecast to be at 5.7%. Weak business and consumer confidence is reflected by a variety of surveys, and suggests no likely pick-up in either manufacturing or retail activity. We discuss this further in later sections of this report. The CPI result for the September quarter was 0.6% and 3.5% yoy, however it was much lower for the core/underlying figure of 0.3% for the quarter and 2.5% yoy. The RBA now expects inflation to be 2.5% for the full year 2011 and a similar outcome is expected for 2012. This together with lower growth prospects and rising unemployment have provided the needed ingredients to trigger the interest rate reduction discussed below and the prospects of further cuts in the year to come.

1.2 Interest Rates

The fourth quarter of 2011 finally saw the much needed cut in the Cash Rate delivered by the Reserve Bank of Australia (RBA) at its Melbourne Cup Day board meeting in November and was then followed up by another in December. These two consecutive 25 basis point reductions in official rates reflected acceptance by the RBA that the Australian economy was in fact experiencing considerably slower growth than its economists had been expecting. Importantly inflation remained under control with no indications that it would emerge as a problem in the foreseeable future. This was all topped off by a genuine concern expressed by the RBA in its December statement that repercussions from the Eurozone debt crisis had the potential to adversely impact both the Asian and Australian economies.

The market's view is that this easing cycle of interest rates is going to last well into 2012 with a further 100 basis points now priced into the Cash Rate futures for June 2012 implying a quarter of one percentage point reduction at every RBA monthly board meeting starting in February 2012. Longer term Swap rates remain inverted to five years and virtually flat to ten years.

The statement by the RBA Governor which accompanied the December rate reduction highlighted the importance of the CPI figure in the board's thinking when emphasising "inflation is likely to be consistent with the 2-3 per cent target in 2012 and 2013" and "that the inflation outlook afforded scope for a modest reduction in the cash rate". In our view this does not read like the language preceding another full percentage point drop in rates over the next six months. With no meeting in January however there remains plenty of potential for weak retail sales over the Christmas period and an unresolved Eurozone debt crisis to keep the RBA on an easing bias.

1.3 Australian Real Estate Capital Outlook

The crisis in Europe worsened during the December quarter and whilst some commentators viewed this as the Global Financial Crisis (GFC) Part 2 we are of the view that what we are seeing is merely the result of companies and sovereigns "kicking the can down the road" and not facing up to the problems of the GFC earlier. As a result we expect tough trading conditions for the capital markets, including real estate capital markets, in Australia through 2012. The weaker European countries including Greece, Spain and Italy have been the main focus of capital markets during the quarter but we can't lose sight of the contagion effect on other seemingly stronger European nations such as Germany and especially France. Whilst the US market seems to be in slightly better shape the slow, protracted recovery in the US does not seem to provide any significant reassurance to the markets.

Closer to home, despite the continued positive story being told about the relative strength of the Chinese economy, there is also growing awareness of China's debt fuelled growth and the desire for the central government to manage a soft landing for their economy. This mixed message, together with the large pockets of weakness in the Australian domestic economy, is providing major hurdles for the capital markets to overcome. In recognition of the global and domestic uncertainty and lower economic growth expectations the RBA saw fit to reduce interest rates by 25bp in both November and December with the resulting cash rate now at 4.25%.

From a property market fundamentals perspective, Australian real estate prices and capitalisation rates have largely stabilised for premium quality core assets, however, we believe that slowing economic conditions will lead to a low rental growth environment putting more pricing pressure on secondary assets, development projects and impaired bank assets. This low forecast income growth when combined with the large volume of properties for sale (either officially or unofficially) means that it is expected to be some time before significant capital growth is achieved from institutional real estate assets.

The Australian commercial lending market is currently dominated by the big four major Australian banks. This is due to foreign banks largely withdrawing and the smaller banks having either been acquired by the big four, or dramatically scaling back their property lending activities on the back of a substantial rise in their commercial property loan impairments. Whilst the CMBS market did show some activity during 2010, there was only one new CMBS transaction in calendar 2011 being the ALE Property Group (ALE.ASX) $160 million CMBS issuance. Quadrant does not believe CMBS will be a significant source of real estate capital for the next few years and as such there is enhanced scope for new lenders (including institutional investors) to enter the market and provide an alternate capital source.

The banking sector has been largely focussed on the European crisis over the last quarter and whilst the four large Australian banks are not directly in the firing line, they remain concerned about the impact of contagion and general market volatility. Whilst the large domestic banks have assured the market that they currently have sufficient funding in place, we are of the view that the cost of wholesale funding is likely to be significantly higher when they do need to raise debt capital this year. This is likely to restrict Australian bank credit growth for at least the next 18 to 24 months as maturing historically cheap pre-GFC issued term debt is refinanced with more expensive longer-term debt. Recent covered bond issuance by the domestic banks is showing spreads (including currency swap costs) of 150bp for US issuance and 225bp for Euro issuance.

Overall, given the relative global strength of the Australian banks we believe that they should be able to meet their existing term debt refinancing obligations in the global capital markets, however, the price they pay will continue to increase in the near term and the availability of additional capital to fund credit growth will be severely constrained.

Accordingly, we believe that due to the relative scarcity of debt capital available in the property market, the coming 2 year period (at a minimum) will provide real estate debt investors an excellent opportunity to obtain relatively high, stable and secured income returns.

1.4 Listed Property Trusts

The Listed Property Trust Sector increased by 3.7% for the December quarter, however this gain was not enough to see the sector avoid recording its second consecutive yearly decline (-1.51% CY12). That said, the sector outperformed the broader market by 9.0% for CY12, reinforcing its strong defensive qualities amid the current global uncertainty that continues to place ongoing pressure on share markets.

The Centro amalgamation was a significant milestone during the December quarter, creating a new listed vehicle for investors after many years of uncertainty surrounding the future of the Group. Adding to this, the Group has also announced Steven Sewell, previously CEO of Charter Hall Retail Group as its new

CEO which is likely to be well received by the market. With a number of retailers such as Gerry Harvey, Billabong and JB Hi Fi to name just a few commenting on the increasingly difficult retail trading environment, the ongoing health of the retail sector will no doubt be one of the most closely watched themes by the market in 2012.

The approval by the Board of Charter Hall Office Fund (CQO.ASX) to take the vehicle private at a price of $2.49 for the Australian portfolio of assets was the other significant event to occur during the period, despite being at a slight discount to its NTA. This has led some in the market to speculate that 2012 may see more takeover offers should the sector continue to trade at a discount to NTA going forward. In our view we see this as unlikely.

Looking ahead, while not immune from global market conditions, the REIT sector should see some relative support from current levels, underpinned by their relatively attractive yield and sound cash flows. Also, the recent interest rate reductions, the increasing spread REITs are currently offering above bond yields and the sound balance sheets should help REITs withstand any future global shocks to some degree and are all positive for the sector. The sector will face some headwinds with an increasingly difficult global funding environment where the marginal cost of sourcing debt is likely to increase and deteriorating property market fundamentals are just some of the challenges confronting the sector in 2012, in our view. All this said, many of the REITs have a market credibility gap to bridge as evidenced by their discount to NTA. The market either does not believe the underlying asset values or doesn't believe management can deliver on their stated objectives.

1.5 Residential

The Australian housing market remains soft but has finally shown a small sign of a possible recovery with capital city house prices rising by 0.1% in November according to RP Data Rismark. Perth topped the capital cities with a yoy increase of 0.5% with Melbourne rising 0.2%. Brisbane fell 0.7% and Sydney's market was flat. For the year to date values for the capital cities have fallen by 3.7% on a seasonally adjusted basis with Brisbane and Melbourne down 7.0% and 5.6% respectively but Sydney off only 0.5%. While the uncertainty about interest rates has been resolved favorably consumer sentiment continues to be soft. Specific questions directed to housing such as in the Westpac Melbourne Institute survey show confidence levels still at low levels with the index tracking views on "time to buy a house" down 1.9% in December despite the RBA's cut of interest rates in two consecutive months.

The Australian Bureau of Statistics (ABS) reported in December that finance for Australian owner-occupied housing had risen by a modest 3.5% yoy to 31 October 2011 but when combined with a substantial fall in investor financing the total was down 0.7% compared to the previous year. Similar RBA data to the end of November shows a 5.7% increase for the year to date which was the slowest pace of growth since 1977. The ABS also reported dwelling approvals for October to be down 10.7% following an even larger fall in September of 14.2%. Not surprisingly the Australian Industry Group / Housing Industry Association Performance of Construction Index for December was 41.0 showing that activity has been in contraction since June 2010. A reading of 50 or above indicates expansion, while levels below 50 indicate contraction. The result for December was however slightly better than November's level; of 39.6 .

The ongoing issue of a "housing bubble" continues to be debated amid commentary concerning the sustainability of Australia's house prices. Affordability still appears to be the major issue but now that interest rates are falling this should improve and the expectation is that any recent increase in arrears will level off. Supply and demand factors still indicate that there is in fact a shortage of housing across the country. The more optimistic outlook on interest rates that has developed in the last quarter should see overall sentiment for the residential sector improve.

1.6 Office

The last national Property Council of Australia survey of office vacancy rates at mid-year indicated they had fallen to their lowest level in two years at 9.0%. This surprised a number of commentators who have taken a rather cautious view of the near term prospects of the sector. The contrast of Melbourne's 5.8% vacancy compared to Sydney's 9.3% is stark and even though more recent data from Colliers indicates a fall in Sydney vacancy to 8.9% we remain concerned about future leasing demand. The impact of the confidence in the resources industry is reflected in major reductions in vacancy rates in Perth and Brisbane during the course of the calendar year to 7.8% and 7.4% respectively. Adelaide vacancy remains fairly stable at 7.9% while Canberra continues to suffer oversupply at 13.3% and virtually no rental growth.

Rents in Melbourne have increased over 10.0% during the past year and could rise a further 20.0% in the next two years according to Jones Lang LaSalle. While new supply will come on stream during that period, particularly in the Docklands precinct, this is already 83% pre-leased. Over the past year Prime gross effective rents in Sydney have grown 6.6% and are forecast to rise a further 7.4% in the next 12 months. There has been little growth in secondary rents and with considerable space to be filled in the CBD as major tenants move to new developments, this is unlikely to change. Perth is also experiencing good rental growth with Prime net face rents averaging $700 - $850 / m2 and incentives for Prime grade space observed in a report from Knight Frank to be 0%-5.0%. High levels of pre-commitment for new developments and continued strength in the local resource based economy point to falling vacancy rates, particularly for prime properties. Perth yields also have room to contract in a falling interest rate environment.

Employment is again arising as a negative issue with the October unemployment rate edging up to 5.3% and many indicators are that this trend will continue with a number of forecasts of industrial and business sentiment pointing to reduced hiring and slower growth. A particular area of concern remains the financial services sector and the potential impact on Sydney commercial property as the banks continue to cut costs in the face of slow loan growth and resulting flat revenues.

The improving outlook for rents has seen national CBD prime yields contract led by cap rate movements in Sydney CBD where prime core market yields currently lie across a band of 6.40% - 7.50% and in Melbourne CBD a range of 7.00% - 7.50%. The standout sale of the year was 259 George Street in Sydney that changed hands at $395 million, on a yield of 6.4%. Mirvac's sale of 50% of 8 Chifley Square was at 6.47% and both suggest a slight compression of yields compared to other earlier "trophy" asset sales. Notably both were to offshore buyers. In the last quarter, November saw the sale of Grocon's remaining 25% of 161 Castlereagh Street to ISPT for $197.5 million with an "on completion" yield of 6.5% and QIC buying out the remaining 50% of 52 Martin Place from Stockland for $$172.2 million at a 7.0% yield.

1.7 Retail

Indications of weakness in the retail sector that surfaced earlier in the year have intensified during the second half with a larger number of retailers speaking out about weak consumer sentiment. The December Consumer Sentiment results as measured by the Westpac – Melbourne Institute Index fell by 8.6% to 94.7, from November's 103.4 and below a neutral setting of 100. This weakness is somewhat surprising given the two consecutive reductions in interest rates by the RBA in November and December. It is however reflected in the ABS retail sales figures for November which were flat for the month after rising 0.2% in October. This is just a 3.1% increase for the year.

As noted in our last quarterly report, in spite of very challenging conditions for retail sales, the underlying retail property market has been holding up relatively well. Our concern is that with soft turnover growth the ability of some tenants to meet higher occupancy costs will come into question. CBD prime rents continue to be firm with large retail groups seeking premium locations. This is not so for other locations in secondary centres and bulky goods and we expect these rentals will lag. Retail yields were largely unchanged in the quarter ranging from 5.75% to 7.0% for Prime Regionals and should remain stable for any premium properties. However, yields have the potential to soften for secondary properties with weak fundamentals at 7.75% to 9.75%. The post-holiday period will certainly be especially challenging in our view with many national retailers reporting weak Christmas sales levels.

The big year-end story in the retail sector was of course the finalisation of the Centro restructuring and the resulting creation of a new retail A-REIT. With the naming of Steven Sewell of Charter Hall as the new CEO there will be great interest in the group's strategy going forward.

1.8 Industrial

The Australian Industry Group – PwC, Performance of Manufacturing Index (PMI), remained below the 50 point level in November, separating expansion from contraction, at 47.8. Eight of twelve sub-sectors recorded declines and of the ten components of the PMI, five were contracting. It is now five months since the index briefly moved into positive territory in June 2011.

Somewhat surprisingly, the outlook for transport and logistics continues to be firm presumably reflecting the satisfactory third quarter GDP growth of 1.0%. Industrial rents which were on the rise around the country have slowed to be steady in Sydney and Perth (which had been rising strongly) but continue to show smaller increases in Melbourne. Yields for Prime properties across all of these markets remain between 8% - 9% and for Secondary-grade 9% - 10%.

This past year saw a continuation of the recovery in the sector, which was one of the worst affected markets during the GFC, on the back of anticipated economic growth. The first quarter of 2011 saw the Goodman consortium buy the $2.5 billion ING Industrial Fund. However one of the year's major transactions, the $200 million purchase of Stockland's industrial portfolio by 360 Capital, failed to result in a successful float reflecting adverse/volatile equity market conditions.

1.9 Hotels and Tourism

The accommodation sector in Australia continues to perform well with Revenue Per Available Room (RevPAR) forecast by Deloitte in their November 2011 Australian Hotel Market Outlook, to grow to $94 for 2011, and to $101 in 2012. 2011 occupancy is expected to be 64.6% with an average room rate of $145 and in 2012, 65.2% occupancy and an average room rate of $154. This remains very much a story of two very different outcomes for city based hotels, which are recording excellent occupancy levels, while leisure destinations are fighting to maintain already low occupancy levels at the expense of room rates.

Australian prime CBD markets again recorded excellent results with Sydney leading the way on 86.0% occupancy and an average room rate of $190. RevPAR of $163 was up 8.6% on last year. Melbourne's occupancy rate is only slightly behind Sydney at 80.0% with an average room rate of $181 for 2011. Perth has also experienced high occupancy levels at 84.5% and an average room rate of $174 in 2011 but with occupancies at record levels for that city and little new development, average room rates are expected to climb to $204 in 2012 driving RevPAR growth of 18.6%.

Unfortunately occupancy levels in resort areas remain around 60.0% with only a little improvement during school holiday periods as domestic operators compete with offshore destinations that continue to be helped by the high Australia dollar. Notwithstanding a recent correction to parity, the continued strength of the Australian dollar encourages offshore travel and limits in bound tourists so the heavy discounting we have seen will doubtless continue. The Gold Coast which has struggled at 65.9% occupancy and an average room rate of $133 faces the added burden of 820 new rooms with the opening of three new 5 star hotels being the Oracle managed by Peppers, the Hilton and Soul which will be a Sea Temple operation. As a result no improvement is seen for 2012 and the same can be said for the Cairns, Palm Cove, Port Douglas which could do no better than 57.3% occupancy and a Room Rate of $117 in 2011. A report by the RBA in its December 2011 Quarterly Bulletin on Australia's Tourism Industry emphasises the weakness in the traditional leisure market and the need for it to reorient to growing markets such as China.

We still expect little or no supply growth as there is still a strong gap between valuation and construction costs and funding for hotel development is practically non-existent. The big story for the fourth quarter was Mirvac Group's sale of most of its hotel assets to the Accor making it Australia's biggest operator by far in terms of rooms under management at 29,000 rooms in 210 hotels ahead of Mantra at 16,268 rooms in 110 hotels. Expansion through acquisition remains the preferred option for overseas operators when looking at the Australian market.

1.10 "QREA" - Market Focus

Since the end of the First Quarter of 2011 we had been quite pessimistic about the health of the Australian economy despite the strong resources sector. Gradually through the period leading to the end of the year this weakness is becoming evident as the Euro-crisis and the weak US economy are now being recognised as pulling back global growth. Even with emerging Asia and China balancing this, they too are slowing from their prior growth rates and the Reserve Bank of Australia finally acted in November and December by lowering the Cash Rate by 25 basis points in consecutive monthly board meetings.

The Euro-zone sovereign debt crisis has dominated the markets globally and is likely to remain the centre of attention well into the New Year. The Australian economy has been partially insulated from European and North American weakness due to the growth of the Chinese economy and the continued profitability of the resources sector and its associated capital spending. However weaknesses in other parts of the economy continue and are increasingly evident. This has put more pressure on the need to resolve the resulting dilemma presented to both fiscal and monetary policy and these actions can be expected to continue to be very important through early 2012.

Our assessment of the state of various property markets across Australia remains little changed from our last report having downgraded a number of sectors earlier in the year. Last quarter we shifted Sydney Commercial to “Fair” from “Good”. This quarter we have upgraded Perth Commercial from “Fair” to “Good” resulting in 5 of 20 markets showing a current status of “Good”. Three are in the Hotels and Tourism sector benefitting from high occupancy levels in capital city CBD locations but with weakness persisting in resort areas. Apart from these same three Hotel and Tourism sectors only three additional markets are seen as having improving trends. They all are benefitting from the impact of resources investment in Queensland and Western Australia. We have chosen not to make any other changes this quarter relying somewhat on what we expect to be the benefits of lower interest rates on most sectors including residential which has suffered so much from negative sentiment over the past year.

	Sydney	Melbourne	Queensland	Perth
Residential	Weak →	Weak →	Weak →	Weak →
Commercial	Fair →	Good →	Fair ↑	Good ↑
Retail	Weak →	Weak →	Weak →	Fair →
Industrial	Fair →	Fair →	Fair →	Fair ↑
Hotels and Tourism	Good ↑	Good ↑	Fair →	Good ↑

Source: Quadrant Real Estate Advisors LLC

Sources and References

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