



November 2008

## Australia's Property Markets Fundamentally Sound

**There is a danger that the downturn in Australia's residential property markets predicted by a few noisy doomsayers could become a self-fulfilling prophecy. It is time for property owners, developers and investors to listen to more rational assessments based on supply and demand fundamentals, and not time to react in fear and panic.**

The media is thriving on a raft of contradictory opinion, some of it based on analysis of broadbrush figures such as debt levels and ratios of loan repayments to median prices. These figures can be misleading, ignoring market fundamentals.

It has already been said by leading commentators, including Tim Lawless of RP Data and Dr Frank Gelber of BIS Shrapnel: This is not America, there are no significant oversupplies in Australia's residential and commercial markets. On the contrary many residential markets have a shortfall of supply, exacerbated over recent years by rising costs and unrealistic expectations.

This is not to say that some localities and some market sectors will not

experience a downturn in activity and prices. There will be bargains to be had for those able to take advantage of the financial stress induced by the credit crisis. Some markets will experience oversupply conditions in the short to medium term.

### Property Fundamentals

This is a time to reflect on property investment fundamentals. These include:

- property should be viewed as a long-term investment (it is illiquid and has significant entry and exit costs); and
- property markets are cyclical, responding to economic cycles and especially to supply and demand conditions.

### *Advice for Home Buyers & Investors*

- *Do not be seduced by the first home buyers grant and low interest rates to take on a mortgage larger than you can service (make allowance for what if scenarios – for example what if your partner is no longer employed);*
- *Buy property to satisfy real needs – your family home, a lifestyle choice, an investment you can realistically afford. Don't be convinced to enter into a major purchase to minimise tax or to artificially structure your affairs, unless you yourself understand the risks. If someone is offering exceptionally high returns, this almost always comes at a higher risk;*
- *Be prepared to hold property for the long term – at least ten years, maybe longer to take advantage of the next cyclical upswing. Do not worry if prices fall in the meantime, as long as you can afford to hold. Now is probably not the best time to sell, when the market is crowded with properties as a result of those who fear the future or need to sell to satisfy margin calls and loan covenants; and*
- *Above all, do your own independent research, satisfy yourself that the property you are buying meets your real needs and obeys the other key rule of property investment: location, location, location.*

## An Economic Slowdown is Inevitable

The greatest risk to Australia's property markets, both commercial and residential, is a downturn in the real economy (as opposed to financial markets), leading to a significant rise in unemployment. Australia cannot escape some impact from the global recession.

The slowing of China's economic boom (possibly to 7% to 9% growth in GDP rather than 11% to 12% growth experienced over recent years), will inevitably lead to lower commodity prices. The sheer size of China's domestic economy will however ensure that over the medium to longer term, Australia will continue to supply coal, iron ore and other commodities.

The resources boom was never going to be sustainable at the peak level of demand and price growth that was being experienced last year. International competitors have increased supply to cater for demand from China and other emerging economies such as India.

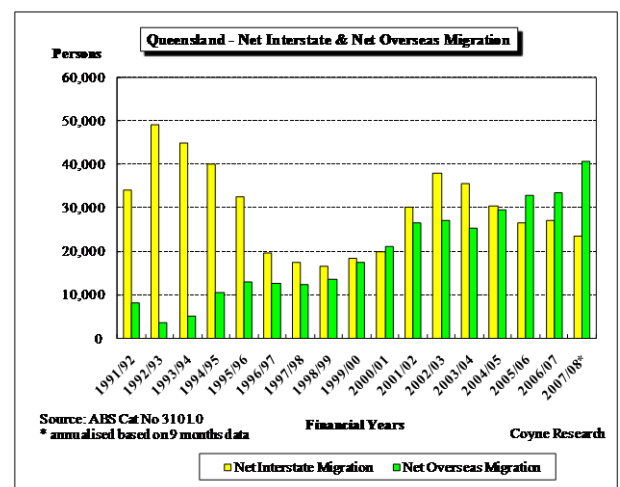
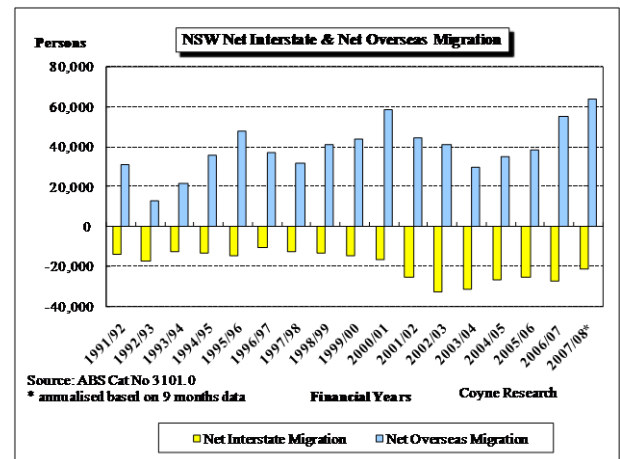
Economists have revised downwards the outlook for Australian economic growth over the next two years. For example, the National Australia Bank (NAB) is predicting GDP growth of 1.25% in calendar year 2009 and 2.0% in 2010, with unemployment expected to rise to 6% during 2009 (it was 4.1% in August 2008).

The economy is subject to contradictory influences, for example, the weaker Australian dollar is positive for exporters and will also discourage Australians from travelling overseas, and make our tourism destinations more appealing for both the domestic and overseas markets. However the lower Australian dollar will see the price of imported goods increase,

contributing to inflation and higher costs for business equipment.

## Residential Markets

The fundamental driver of demand for housing is population growth. During 2007/08 this reached new levels as a result of historically high net overseas migration (nationally around 200,000 persons), partly as a result of labour shortages.



It is considered that there will now be a return of net overseas migration to more sustainable levels, taking some of the pressure off housing prices, vacancy rates and rental growth.

The low vacancy rates of recent years were already experiencing some easing as people were encouraged by rising rents to become first home buyers. This trend will now accelerate as people take advantage of the increased

first home owners grant (FHOG) and falling interest rates.

The extent of the shift into home ownership from the rental market may not be as great as the Federal Government may have been hoping, for three reasons:

- rising unemployment and uncertainty about employment prospects will keep some out of the market;
- banks are likely to adopt more conservative lending practices, excluding some would-be purchasers; and
- Generation Y, with its “keeping my options open” approach to life may still prefer to rent or remain in the family home.

The reasoning behind the increase in the FHOG as a buffer to economic downturn appears to have been only partly thought through. ANZ Bank’s Chief Economist, Saul Eslake is critical of the \$14,000 FHOG for established housing, indicating that this has the potential to drive up prices, while contributing little economic stimulus or addressing the shortage of housing. Professor Tony Makin of Griffith University has also highlighted potential for the Federal Government stimulus to fuel imports of consumer goods.

The \$21,000 FHOG for new dwellings is also likely to have unintended adverse impacts, which should have been well understood from earlier years. It will bring forward demand into 2008/09 from 2009/10 and runs the risk of supporting unsustainably high prices for new housing. The \$14,000 FHOG of 2001 significantly contributed to the threefold increase in land prices observed across much of the Eastern Seaboard over the period to 2003.

Retreat from unsustainably high house prices has been difficult due to the upswing in commercial construction over recent years; rising construction costs; labour shortages exacerbated by the resources boom and ageing of the workforce; and introduction of Government infrastructure charges on the one hand and environmentally sustainable development (ESD) requirements on the other.



*Single storey housing at Macarthur Gardens in Campbelltown, Sydney: responding to the needs of smaller households for affordable housing*

Housing price falls of 30% to 40% predicted by pessimists are unwarranted, although median prices may possibly fall by up to 10% over the next 12 months. Some localities, where there is a rush of vendors seeking to dispose of properties, could however see more substantial falls.

The winners from the current FHOG initiative will be developers and builders who have affordable products ready to bring to the market now and over the next few months, as well as vendors of established housing in well regarded suburbs. Markets will also benefit from falling interest rates. Both NAB and Westpac predict the official cash rate will fall from 6.0% to 4.5% by mid 2009.

Over the next one to two years, vacancy rates are likely to return to equilibrium levels of around 3%, but

there will still be rental growth and pressure upon tenants. Not enough new construction has occurred, particularly in Sydney. The credit crunch and more conservative lending by banks going forward will ensure that oversupply conditions are unlikely to occur over the medium term in most localities. (Each market needs to be examined on its merits).

Investors should return to residential property in greater numbers, partly as a result of a flight from equities and lower returns from cash. It is not yet clear that they will return to New South Wales (NSW), where yields remain unsatisfactory for new dwellings and memories are still fresh of the ill-advised State Government Vendor Tax.

### Coastal and Retirement Properties

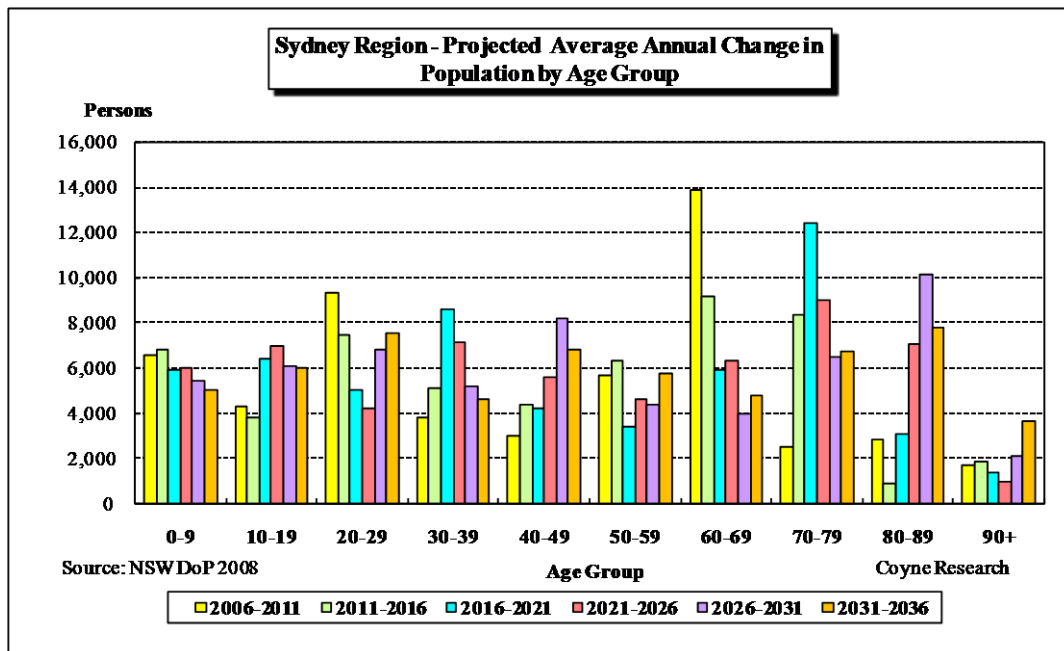
While much has been made of the impact of the loss of wealth in superannuation and the share markets, upon baby boomers about to retire, the demographic imperative of an ageing population will still play a major part

in the nature of future demand for residential and resort properties.

Losses in a superannuation fund or a share market investment are not crystallised unless the assets are sold. In many instances a more prudent approach is to hold, since the share market, like property, delivers its best returns over the long term.

While some baby boomers will extend their working lives, the choice to pursue part-time work was already factored in for many, who recognised some time ago that they had insufficient wealth to retire on schedule.

For many, retirement is not a choice, but an unpleasant necessity. The Commonwealth Bank's *Retire Ready* publication indicates 70% of retirees leave the workforce due to redundancy and ill health. Baby boomers will still retire in large numbers over the next decade (refer to graph), but their choice of a seachange property may be more modest.



The NSW Department of Planning has just released updated 2008 population projections. The above graph highlights the significant increases in older age groups projected for the Sydney region over coming decades.



Developers seeking to cater to the younger retiree market would do well to remember that this is a discretionary market, with little sense of urgency. Very few people downsize from an established house unless they can sell it for their desired price, and few swap a house for an apartment or seachange property of equal value. There is strong motivation to free up capital that can fund the lifestyle today's retirees expect.

For the upper end of the coastal resort market, where the purchase is often additional to the family home, these are among the market sectors potentially most vulnerable to the financial turmoil. The same people may have had share portfolios affected by margin calls, and may need to sell. They may be employed in industries associated with financial markets and no longer be able to support the mortgage payments. For cashed-up buyers, this could be an opportunity to pick up bargains.

Another consideration with resort and coastal real estate is that it is sometimes driven to unsustainable heights by trends in fashion and outside influences such as offshore investment. Such influences make these markets more vulnerable to volatility. Investors in such properties want to be sure they have a genuine interest in the lifestyle on offer and can afford to hold for the longer term. Don't be taken in by promises of a quick capital gain.

Among the other trends observed in the retirement village and aged care markets are the following:

- increased acceptance of vertical living options among younger retirees who appreciate the convenience of compact apartments with luxury appointments and modern

connectivity, providing the freedom to travel;

- emergence of a product type seeking to bridge the gap between independent living units of self care villages and aged care facilities (high and low care beds). This appears to represent a new era of ageing in place, although the examples observed to date are attracting most interest from older retirees aged 78 years plus;



*The Tall Trees development at Rochedale South in Brisbane bridges the gap between retirement villages and aged care facilities.*

- ongoing concerns among retirees about the practice of charging deferred management fees or exit fees. Traditional retirement villages are experiencing strong competition from new concepts in manufactured home villages targeted to young retirees, which offer strong appeal because of the absence of exit fees; and
- evidence is mounting that despite undersupply conditions existing and projected for aged care facilities (high and low care beds), operators cannot sustain profitability in the face of rising costs, the absence of

accommodation bonds for high care places, fixed and regulated incomes and higher quality expectations among residents. Refer to Grant Thornton's survey of aged care providers ([www.grantthornton.com.au](http://www.grantthornton.com.au))

### **Commercial Markets**

The credit crunch has delivered a much needed correction/reality check to Australia's more buoyant commercial office and industrial markets. During 2007 record low vacancies led to unsustainable rental growth and the weight of money seeking investment grade property pushed yields to levels that did not make sense. In particular there was in some instances a merging of yields for prime and secondary properties, indicating unwise decisions were being made in the expectation of demand continuing at high levels.

Since late 2007 this situation has unwound with softer yields and a sharp decline in sales transactions as property trusts could no longer fund purchases through debt or equity. The dramatic fall from grace of the Centro Group was an early precursor of the funding crisis which has now affected numerous property and financial organisations in Australia, as the global financial contagion has spread since the collapse of Lehman Bros in September.

Brisbane and Perth have seen a higher number of commercial sales than other Australian cities over the past year. Purchasers have included private individual investors, developers, foreign buyers and a few cashed-up institutions.

Sovereign wealth funds and Government entities may also emerge to play a greater role in the markets. One example of this is Ipswich City Council's purchase for a reported \$45

million of Memo Corporation's Ipswich City Square in Ipswich CBD, a locality earmarked for development of a new transport hub by Queensland Government, in association with the decentralisation of part of its workforce from Brisbane CBD.

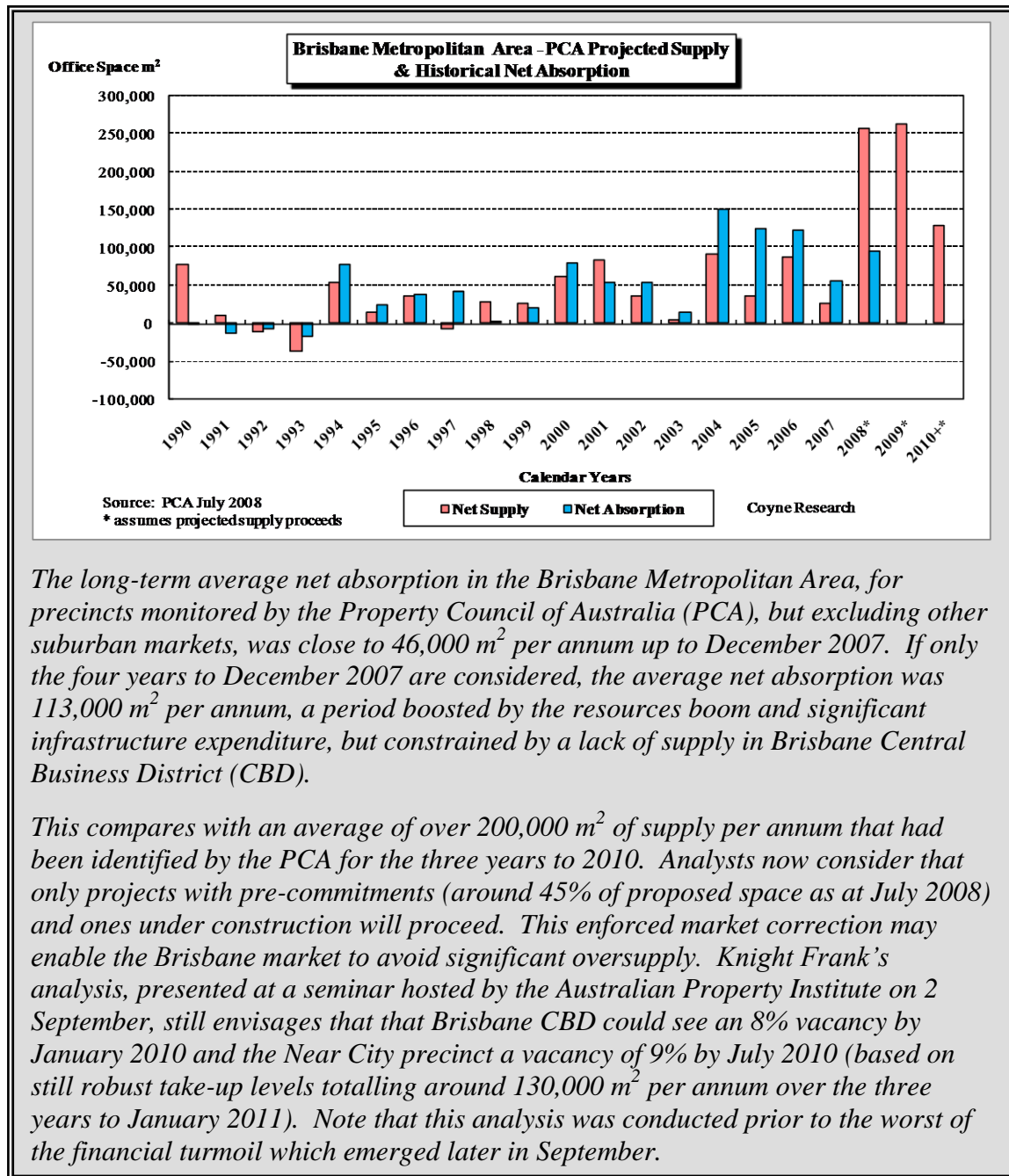
As at mid 2008, yields had risen by 50 to 100 basis points, but under the current situation, with a glut of properties on the market, they may increase by a further 50 to 200 basis points, as vendors determined to effect a sale may need to accept lower prices.

In fact many of the properties on offer are unlikely to sell, given the credit shortage and the gap in perceptions regarding the correct value between vendors and purchasers. There is also the fact that many properties are on the market to satisfy financiers' requirements related to loan covenants, not because the vendors are genuine sellers.

Over the next few months as stability returns to the financial markets, credit should become more readily available and normal trading and development will gradually occur.

In the meantime, the development plans of many are on hold or abandoned, which will enable markets such as Brisbane to avoid or at least postpone the significant oversupply that was threatening for commercial office markets. There is a fundamental disconnect between the problems affecting the investment property markets and the underlying leasing markets, which generally remain sound.

Nevertheless there is evidence that the strength of tenant demand of 2007 has weakened as the credit crunch adversely affects expansion plans, reduces confidence and results in actual job losses.



The long-term average net absorption in the Brisbane Metropolitan Area, for precincts monitored by the Property Council of Australia (PCA), but excluding other suburban markets, was close to 46,000 m<sup>2</sup> per annum up to December 2007. If only the four years to December 2007 are considered, the average net absorption was 113,000 m<sup>2</sup> per annum, a period boosted by the resources boom and significant infrastructure expenditure, but constrained by a lack of supply in Brisbane Central Business District (CBD).

This compares with an average of over 200,000 m<sup>2</sup> of supply per annum that had been identified by the PCA for the three years to 2010. Analysts now consider that only projects with pre-commitments (around 45% of proposed space as at July 2008) and ones under construction will proceed. This enforced market correction may enable the Brisbane market to avoid significant oversupply. Knight Frank's analysis, presented at a seminar hosted by the Australian Property Institute on 2 September, still envisages that that Brisbane CBD could see an 8% vacancy by January 2010 and the Near City precinct a vacancy of 9% by July 2010 (based on still robust take-up levels totalling around 130,000 m<sup>2</sup> per annum over the three years to January 2011). Note that this analysis was conducted prior to the worst of the financial turmoil which emerged later in September.

Cities such as Sydney, where demand for office space is more dependent upon the financial sector, will be more adversely affected by a contraction of tenant demand.

However even in Brisbane and Perth where vacancies are so low, incentives are now set to re-emerge as developers of new space compete with existing landlords (particularly given the impact of recent events on tenants).

Nevertheless real tenant demand does exist in these cities, with Government, resource companies and other institutions sometimes occupying fragmented space in multiple buildings.

The lack of significant additional construction should enable softer markets to absorb the space that will still be completed over the next two to three years, extending the period of demand/supply equilibrium.

## **Industrial Markets**

Demand for industrial property usually responds to underlying economic conditions, so a downturn may be anticipated over the short to medium term. There has also been considerable new construction over recent years, indicating that this market sector has peaked.

At Property Investment Research's Property Funds Industry Forum held recently in Coolumb, Patersons' Equities Analyst - Property, Jonathan Kriska warned that even if Australia avoids a technical recession, Victoria and NSW are likely to experience recessionary conditions.

These states account for a significant share of Australia's industrial property assets, so there is perhaps greater concern for these markets than for states where the resources boom may run on for some time (even if commodities prices fall).

In Perth, the confluence of a number of fortunate factors has enabled the State Government's development agency, Landcorp, to create a leading marine industry estate at Henderson, half-way between Fremantle and Kwinana, noted for its heavy manufacturing. The Australian Marine Complex has a site of 255 hectares fronting the deepwater harbour at Cockburn Sound.

Demand for the Common User Facility, with its fabrication hall, wharves and 40 hectares of laydown area, has come from the mining industry, offshore oil industry, boat building and the Royal Australian Navy, which has half of its fleet based at nearby Garden Island.

The capacity to deliver world-class construction technology has been supported by an established shipbuilding industry, specialisation in aluminium handling and Perth's structural steel industry.

While the success of Landcorp's venture has been driven by factors peculiar to Western Australia's strategic advantage, the State Government's role in facilitating the estate presents an object lesson to other State Governments in fostering industry which benefits the regional economy.

Among the significant trends observed in industrial markets over many years is the important role of infrastructure in stimulating demand for industrial premises. Recently new motorway systems have stimulated construction of large distribution centres, for example along the M7 in Sydney and at Dandenong near the new Eastlink Motorway in Melbourne.

Seventeen years of economic growth have resulted in a significant increase in container trade through Australian ports. Some cities are now experiencing severe congestion (for example around Port Botany in Sydney), so that Government is supporting creation of inland intermodal terminals. At the same time, Government is committed to raising the share of containers carried by rail (currently in the 10% to 20% range).

These inland intermodal terminals are expected to generate considerable future demand from industrial occupants.

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