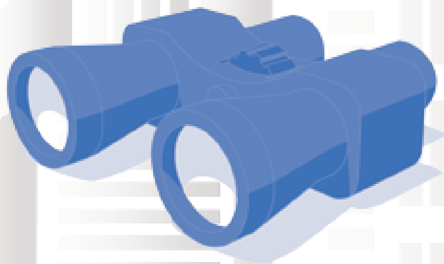
COMMERCIAL PROPERTY set for another positive year



Commercial property has performed strongly over the last few years. 2015 was no exception for the Australian Real Estate Investment Trust (AREIT) sector, with remarkable earnings growth, increasing asset values and decreasing debt costs. These factors, together with a continued low interest rate environment and steady economic backdrop set the path for another positive year for AREITs.

Despite global market volatility and rising interest rates in the United States, the domestic economy is likely to be relatively resilient through 2016 given the prevailing dovish monetary policy position (maintain low interest rates in order to stimulate growth), higher than anticipated employment levels and a depreciating Australian dollar.

In a low-growth macroeconomic setting, the AREIT sector is anticipated to perform favourably on account of its relative high earnings certainty and underlying growth profile. Indeed the "lower for longer" growth and interest rate environment should serve as a tailwind for the AREIT sector to deliver a steady total return through 2016.

As owners of prime grade assets, the AREIT sector is showing every sign that it is set to deliver sustainable risk adjusted returns over the next few years, further supported by steady economic fundamentals and a low interest rate environment.

Here we take a brief look at how the different sectors of the market are likely to perform this year.

Retail sector

Big spending, big brands and big rents

Retail is the largest sector in the AREIT market and is showing encouraging signs that it will deliver a strong performance in 2016.

Retail spending is an important gauge for the Retail sector. For the year ending December 2015, sales recorded growth of 4.7%[1] year-on-year.

Vacancy rates, another key indicator for the Retail sector (the larger shopping malls) across the nation are sitting at approximately 1% which is largely driven by demand from foreign retailers (Top Shop, H&M, Sephora, Uniglo and Apple are recent examples) for prime CBD retail space and quality regional centres. We expect this trend will continue to drive demand for space over the next 12 months.

Stronger retail sales and a line-up of big global brands wanting to expand into Australia gives us confidence that rents will rise, thereby underpinning its position as the most attractive sub-sector in Australian property markets.

Office sector

Sharp demand from buyers drives up valuations

The Office market in 2015 was punctuated by a highly active market of buyers and sellers. More than approximately $10.5 billion worth of office assets exchanged hands throughout 2015 with assets selling at or above book value in most instances. Demand for assets with long weighted average lease expiries (WALEs) and high occupancy levels attracted sharp demand from both local and offshore investors.

An influx of global technology companies (Google, Dropbox, Linkedin) who are establishing and expanding offices in prime CBD locations – particularly Sydney (the most important office market for AREITs) in order to attract the very best talent, has pushed occupancy levels (and rents) higher currently sitting at approximately 92%[2]. The equilibrium point (otherwise known as the "natural vacancy rate", where supply equals demand) for office markets is considered to be between 7-9%.

Whilst the mining downturn has depressed the Brisbane and Perth markets, these markets comprise only a relatively small component of the overall AREIT market; at approximately 15%. We expect the key Sydney and Melbourne markets (comprising approximately 80% of the AREIT sector) will continue to perform solidly in 2016. Occupancy rates and rents are set to slowly improve and strong offshore investor demand is tipped to continue.

Industrial sector

Increasing demand and low supply

Occupancy levels for the sector are currently sitting at approximately 95%. Increasing demand for logistics, data centres and online retail storage combined with a shortage of industrial space positions the sector for another strong year ahead. The sector will also continue to benefit from the residential boom with some industrial zoned land being converted to residential use therefore limiting supply in certain inner city industrial markets (particularly Melbourne and Sydney) which was a key driver behind rent growth in those markets. Uplift in value is material in these instances with some valuations expected to increase between 200 - 300% upon successful residential conversion.

Residential sector

Time for a cool down?

Residential housing boomed throughout 2015 - record levels of building approvals, new home starts and robust house price growth punctuated this highly active sector of the market. The historically low interest rate levels coupled with strong demand from both domestic and offshore buyers drove the values of dwellings up by 7.8%[3] on a national basis over the year.

Potential softening of the residential market over the short to medium term is likely to be influenced by new supply of dwellings as well as the influences from regulatory reform, particularly implementation of more stringent lender capital requirements and further monitoring of offshore purchaser activity.

The two largest AREIT residential property developers, Stockland (SGP) and Mirvac (MGR) performed moderately to December 2015, as signs of a potential cool down of the residential boom were reflected in the depressed share price of both stocks more recently. We remain cautious of this sub-sector of the property market and are cognisant that earnings from this component make up approximately 20% of total earnings for both MGR and SGP.

1 Australian Bureau of Statistics (ABS) data.
2 Jones Lang Lasalle (JLL) December 2015.
3 Research by RP Data released to the end of December 2015.