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ANZ Australian Property Outlook

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Inside:

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Inside

Market Overview

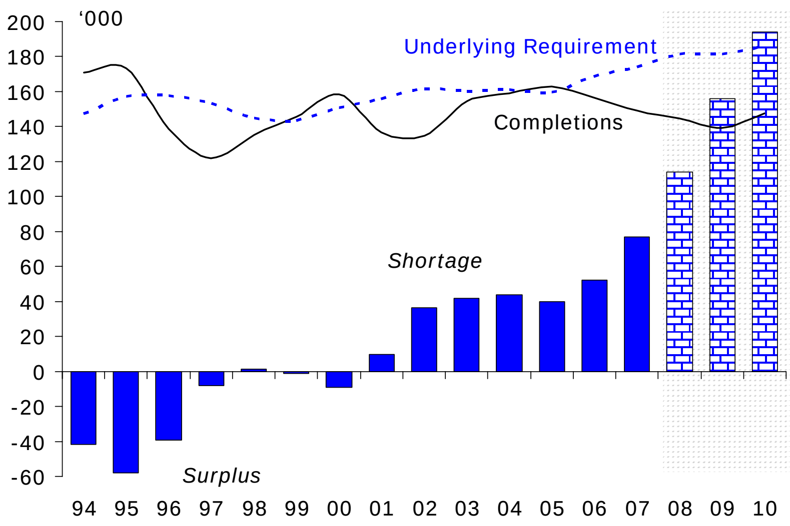
Property returns have accelerated, underpinned by buoyant economic growth and tightening market fundamentals. Despite a meltdown in US sub-prime mortgages and a crisis in global credit markets, the economic outlook remains supportive. Nonetheless, rising interest rates and a marked jump in risk aversion have heightened the risks facing the domestic property sector.

Residential Property

In risk-adjusted terms, residential property has delivered *vastly superior* returns to all other broad asset classes. Affordability conditions for new home-buyers and renters will deteriorate further unless *appropriate* policy action is taken. A dramatic tightening of the housing market will force already soaring house prices and rents sharply higher. By 2010 we project a *record* housing shortage of nearly 200,000 homes which risks becoming an intractable imbalance as renters and first-homebuyers become collateral damage in the Reserve Bank's ongoing war on inflation.

Housing crisis to worsen and become an intractable imbalance

Housing market balance: Australia



Sources: Australian Bureau of Statistics; Economics@ANZ

Commercial Property

CBD office markets continue to tighten with vacancy rates falling to a 17-year low of 4.8% in July 2007. While fundamentals will remain sound over 2008, hints of *oversupply* will start to emerge towards the end of the decade. Overall demand and supply conditions remain supportive for retail property. However, the global credit market dislocation will make further yield compression difficult. Limited new supply in most states coupled with growing demand should keep prospects for the tourist accommodation sector upbeat over the next few years.

Market Overview

Property markets are booming...

Property returns have accelerated, underpinned by buoyant economic growth and tightening market fundamentals. Total returns over the year to September were 20% in offices, 15.5% in retail, 13% in industrial and 14.3% in residential property. Yields have continued to firm and tightening availability is forcing both rents and capital values higher. Solid investment returns have underpinned a rebound in construction activity which has jumped to record levels, bolstered by a remarkable 24% increase in engineering construction, a 7.8% lift in non-residential building and a surprise 4.8% rise in residential activity. Surveyed expectations suggest private building and construction activity will continue to expand strongly and reach a record high of $82bn in 2008/09 (more than double the 2003/04 level). However, with all sectors likely to be firing, the availability of skilled labour will be an increasingly serious constraint on future growth and will place further upward pressure on costs.

...underpinned by a buoyant economy...

Despite deepening global pessimism following the meltdown in US sub-prime mortgages, the global economic outlook remains supportive. Asian growth has effectively decoupled from the US and the outlook for China in particular remains very strong. While the US has slowed sharply, we believe appropriate policy action will avert recession and global growth will remain well above trend at 4.8% in 2008 and 4.7% in 2009. Australia's prospects are much more closely linked with Asia where the growth outlook remains positive. Over the year to September, the Australian economy grew by a robust 4.3% buoyed by strong growth in household spending and solid gains in business investment. Total private sector demand expanded by a robust 6.2% over the year. A tightening labour market has driven strong gains in employment and wages and combined with further income tax cuts, has lifted household disposable income by a remarkable 10.4% over the year to September. Clearly, some households are being adversely impacted by rising interest rates but in aggregate, rising debt servicing costs have been more than offset by solid income gains.

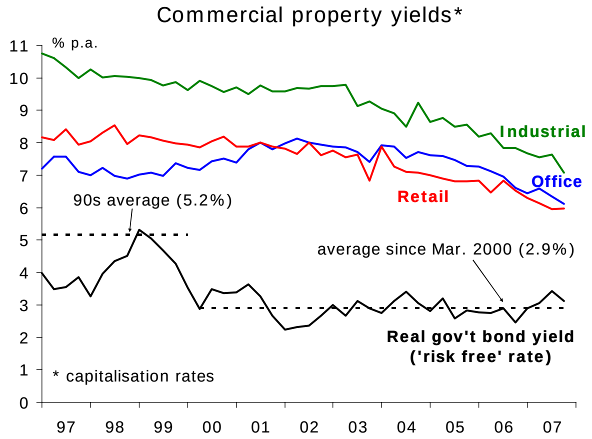
...but interest rates are rising...

However, inflation has accelerated and with economic growth forecast to remain well above trend in 2008 the risks for interest rates remain clearly to the upside. Solid domestic demand growth has pushed underlying inflation to the top of the Reserve Bank's 2-3% target band, forcing the Reserve Bank to lift official interest rates in August and November. Monetary policy has now been tightened on 10 occasions in this cycle lifting the official cash rate from a low of 4¼% in 2001 to 6¾% at present, its highest level since mid-1996. Above trend economic growth and a rapidly tightening labour market will maintain upward pressure on wages and inflation throughout 2008. The Reserve Bank is projecting underlying inflation to peak at (or above) 3.5% in the middle of 2008, which suggests further policy action *will* be required. We believe the Reserve Bank will be forced to lift official interest rates further in 2008 (in both February and May) taking the official cash rate to 7¼%.

...and credit crunch will test valuations

Commercial property yields have continued to firm despite rising borrowing costs. Reduced yields, at least in part, reflect a structural decline in the real 'risk free' benchmark as well as a tightening of underlying fundamentals.

Commercial property yields continue to firm



Source: IPD/PCA, Economics@ANZ

Nonetheless, rising interest rates and a marked jump in risk aversion following the US sub-prime mortgage meltdown have heightened the risks facing the property market. More recently, the collapse of Centro's share price has focussed market attention on gearing levels and stretched valuations in the listed property trust sector. While the fundamentals of the Australian commercial property market remain strong (supported by a robust economic environment), further yield compression in the current market environment seems unlikely. Moreover, the potential for overdevelopment in the CBD office markets of Melbourne, Brisbane and Perth could threaten capital values in the early part of the next decade. Housing affordability has already declined significantly and interest rate hikes in 2008 will drive a further deterioration. However, house prices will continue to be supported by household income gains and a dramatic tightening of the underlying housing demand/supply balance. Australia is facing a critical shortage of housing that could potentially become an intractable imbalance over the coming decade, forcing rents and house prices considerably higher.

Paul Braddick

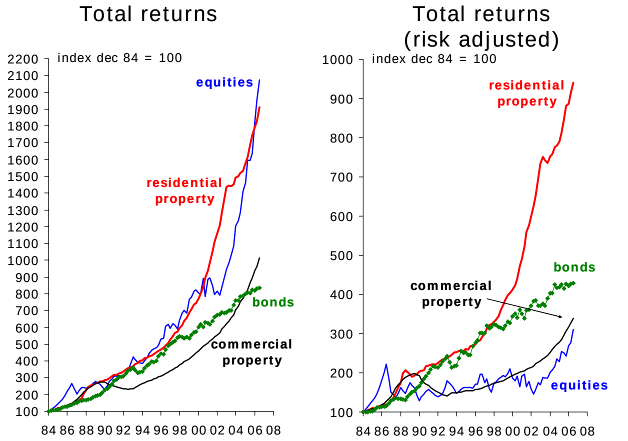
Residential Property

Safe as houses…

Much has been written about reduced yields on investor housing and house price 'bubbles' in recent years. However, as an asset class, housing has continued to deliver remarkably strong and relatively stable investment returns.

In raw terms, since 1984, residential property has enjoyed an extraordinary compound annual total return of 13.4%, only slightly below that of equities (13.8%) and far above both commercial property (10.3%) and bonds (9.4%). But in risk-adjusted terms[1], residential property has delivered *vastly superior* returns to all other broad asset classes.

Housing delivers superior returns



Source: IPD, ABS, Economics@ANZ

Returns on equities and commercial property have been significantly more volatile and hence face a far higher risk discount compared to both residential property and bonds. In fact over the past 23 years at the national level, house prices have *virtually never fallen* with the greatest annual falls being just -0.3% in the depths of the early 1990s recession and -0.9% in 1996. In contrast, Australian equities fell by 43% between September and December 1987, 15% in 1992, 17% in 1995 and 18% in 2003. In risk-adjusted terms since 1984, residential property returns have *more than tripled* those of equities and more than doubled those of commercial property and government bonds.

More recently, total returns on residential property have accelerated, underpinned by a sharp tightening in the housing demand/supply balance that is driving both rents and house prices sharply higher. Heightened uncertainty in global credit markets following the meltdown in US sub-prime mortgages has seen risk aversion rise sharply. Fears of recession in the US will continue to weigh on global equity markets and a 'flight to quality' will add to the weight of money that is driving residential (and other) property markets higher.

[1] Using a simple volatility adjustment

More fundamentally, a severe and potentially intractable shortage of housing will continue to drive house prices and rents sharply higher in the years ahead.

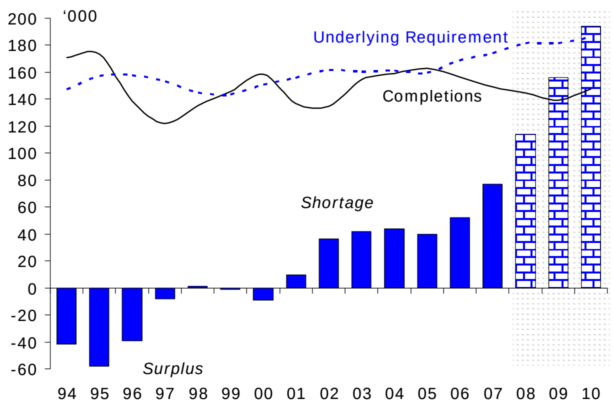
Houses are like bananas

Difficult affordability conditions for new home-buyers and renters will deteriorate significantly further unless *appropriate* policy action is taken. A dramatic tightening of the residential market is forcing up house prices and rents and difficult conditions for first-homebuyers are being exacerbated by rising interest rates. As a share of average after tax household income, repayments on a median priced home have risen from 22% in 1997 to 37% in September this year.

Remarkable growth in net international migration (178,000 over the year to June) and steady reductions in the number of people per household have boosted the underlying demand for housing to 185,000 in 2007-08, while rising interest rates and excessive infrastructure charges continue to delay the required recovery in home building. In fact, house completions are forecast to *decline* to just 140,000 over the coming two years. Consequently, by 2009-10 we project a *record* housing shortage of nearly 200,000 homes.

Housing shortage to reach record levels

Housing market balance: Australia



Sources: Australian Bureau of Statistics; Economics@ANZ

This is extremely bad news for both first-homebuyers and renters as houses are no different to bananas in that when there is a shortage, prices are likely to rise. However, *unlike* bananas, the necessary rebound in housing supply will be far more difficult to achieve and house prices are therefore unlikely to fall.

Historically, we have never experienced a major upturn in home building without a significant *fall* in interest rates. Despite falling vacancy rates and rising prices, developer sentiment remains very subdued and with the risks to interest rates remaining on the upside, we are unlikely to get anything like the required pick-up in residential development activity. And both renters and first-homebuyers will continue to be collateral damage in the Reserve Bank's ongoing war on inflation.

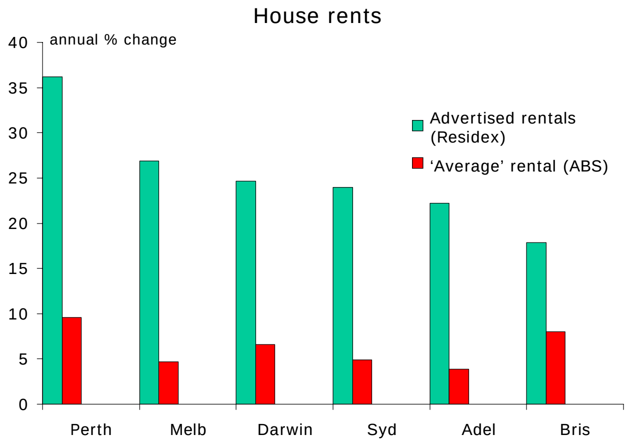
In addition, clear skill shortages in the building sector at present (in the midst of a *downturn*) raise serious questions over the *capacity* of the residential building industry to deliver the 200,000+ houses annually that would be required to redress the looming market imbalance. A critical housing shortage therefore risks becoming an intractable feature of the market for the next five years, if not the next decade.

To effectively tackle the broad housing affordability issue, policy action needs to be focused on increasing the *supply* of houses. This is important not only in outlying areas via 'greenfield' development, but throughout existing suburbs, by encouraging infill and medium density development. Ideally, specific policy initiatives should be aimed at the lower end of the rental market where problems of housing affordability are at their most critical. Scarce public sector resources must be directed to those most in need (predominantly low-income renters) rather than subsidising middle and higher income first home buyers. Labor's National Affordable Rental Incentive Scheme is a positive step. However, it will be insufficient to fully redress the widening gap between new housing supply and demand.

Rents will continue to soar

The chronic shortage of housing stock that is developing is reflected in plummeting rental vacancies. The rental vacancy rate has steadily declined to well below its long-term average in all capital cities. Indeed, the national rental vacancy rate is now at its lowest level on record, even pipping the previous low of 1.5% in 1982. Not surprisingly, rentals have started to accelerate with the ABS measure of *average* dwelling rents lifting 6% over the year to September 2007, its highest growth rate in 17 years.

Rents are already soaring...

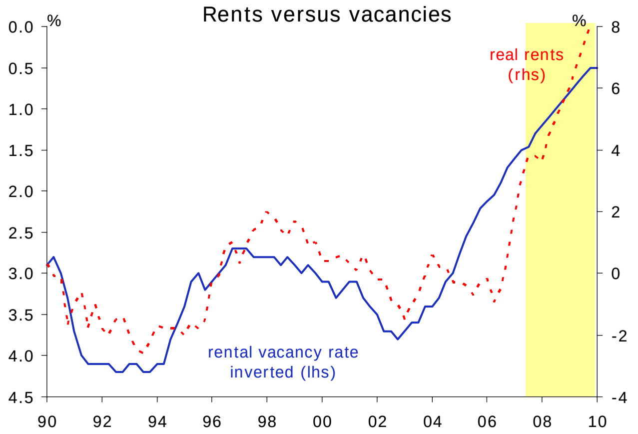


Sources: Residex, ABS, Economics@ANZ

Lags in rental adjustment can be quite long. Lease renewals are an obvious blockage but are unlikely alone to delay the adjustment of rentals by more than 6 months on average. Inertia and fear are also often cited as strong influences on the inaction of landlords to 're-price to market' although this has more to do with the highly fragmented structure of the residential investor market. These lags are much longer as a big chunk of the established rental market will only have sub-market rentals 'washed out' when the housing stock is turned over or tenants move.

To highlight the difference between average outcomes and the movement in *currently available* market rentals, we focus on a measure published by Residex that measures the growth in *advertised rentals* from one year to the next.[2] On this score, there is clear evidence that rentals momentum is already firing on all cylinders with rentals on "to let" properties jumping by between 18% in Brisbane to 35% in Perth over the past year. With vacancy rates set to break new records in the years ahead, this upward re-pricing of rentals will continue for a considerable time longer, eventually lifting the percentage of rental stock that is 'market-priced' and steadily being reflected more fully in the 'average' measure. Rents will therefore add significantly to inflationary pressures in coming years.

...and we've only just begun



Sources: Economics@ANZ; ABS, REIA

The rental boom is a clear reflection of the much needed recovery in dwelling construction. Whilst rental yields will struggle to firm if current momentum in house prices continues, it is the *total return* (capital and rental) that will grab the attention of the investor market. Here, we have already seen solid inroads, with the national total return up 14% over the year to September and Brisbane, Melbourne and Adelaide all achieving well over 20% total returns. Increased returns will provide an increasingly strong incentive for property investors and developers. However, rising interest rates and capacity constraints suggest the industry will continue to struggle to match underlying housing demand.

Paul Braddick & Ange Montalti

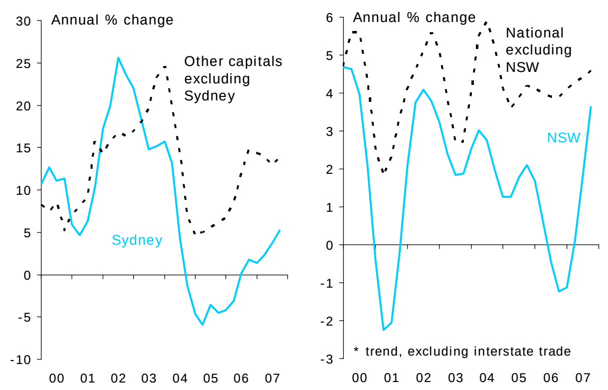
[2] These reflect changes in the asking rentals for properties that are 'to let'. They are stratified by size and location so the impact of compositional change on rentals is minimised.

New South Wales

After languishing for much of the past three years, Sydney house prices and the NSW economy are finally showing signs of life. While still lagging most other capitals, Sydney's median house price rose by between 5.2% (ABS) and 7.3% (Residex) over the year to September. Price growth remains patchy with softer conditions on the western fringe while inner and eastern suburbs have moved ahead strongly. The recovery has been buoyed by a marked tightening of housing market conditions with the vacancy rate falling to a 19-year low of 1.4% in September. In addition, the NSW economy has accelerated in 2007 and is now once more growing at a respectable pace.

NSW economy and house prices rebounding

Sydney house prices NSW gross state product*



Sources: ABS, Economics@ANZ

Despite this, residential development activity remains extremely depressed. NSW home building approvals have slumped to their lowest level on record and interest rate hikes in August and September along with expectations of further moves in 2008 suggest any recovery remains some way off.

Over the year to June, NSW lost a net 27,000 persons to the other states. However, this was more than offset by a sharp acceleration of net international migration which brought 55,000 people into NSW in 2006-07. The demand for housing therefore remains solid.

Consequently, new housing supply is now falling well short of underlying housing demand and looks likely to do so for a number of years. Our projections suggest a *critical* and rapidly expanding shortage of housing in Sydney will provide significant support to house prices and rents and foreshadow a further deterioration in housing affordability in the medium term.

Tightened conditions have already seen rents accelerate with growth of 4.9% over the year to September in established rents (ABS), but a far more dramatic 24% jump in advertised rentals (Residex). With vacancies set to push even further below record low levels in the year ahead, ongoing rapid rental growth appears inevitable.

Victoria

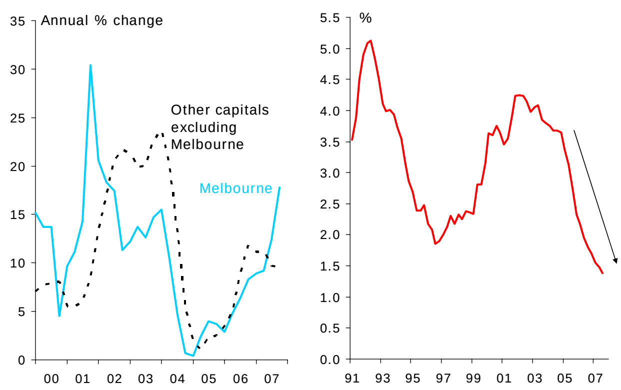
The Victorian housing market is booming with prices, sales volumes and clearance rates all up significantly on 2006. Home sales have outstripped all other capitals and Melbourne's median house price surged by a remarkable 17.8% over the year to September (ABS). Prices accelerated sharply in the June and September quarters and despite interest rate hikes in August and November, demand remains strong (particularly in inner suburbs) and sales volumes and clearance rates have stayed at high levels. The best performing suburbs included Toorak, Camberwell and Elwood (all recording annual price gains above 20%) while gains in outer suburban areas have generally been more subdued.

The boom has been underpinned by tightening fundamentals with new home building falling well short of housing demand and underlying fundamentals will tighten further in the years ahead. However, a slowing of state economic activity and further interest rate hikes could see house price momentum moderate in 2008.

The residential vacancy rate fell to a 25-year low of 1.4% in September and tightening rental availability has driven rents sharply higher with advertised rents up a whopping 27% over the year to September (Residex). Like Sydney (albeit less dramatically), the Melbourne housing market balance will continue to tighten and there is little relief in prospect for embattled renters.

Melbourne housing is booming

Melbourne house prices Melbourne vacancy rate



Sources: ABS, Economics@ANZ

Buoyant economic conditions and a tightening labour market have supported solid gains in household incomes and attracted increasing numbers of international migrants. Further gains in net migration will maintain population growth and underlying housing demand at high levels in the years ahead. On the supply side, new dwelling approvals have rebounded strongly in the past six months. However, rising interest rates again threaten to snuff out the burgeoning recovery and the housing demand/supply balance and housing affordability will continue to deteriorate.

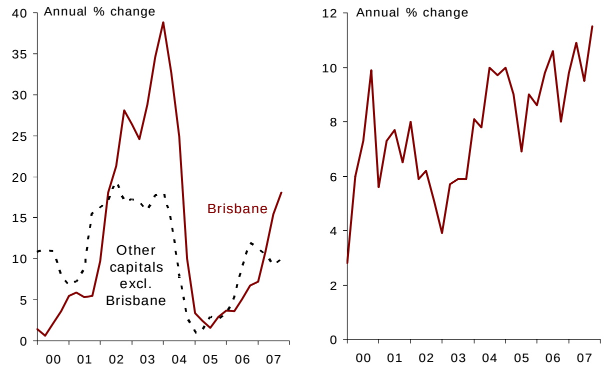
Queensland

The Brisbane property market is also booming, underpinned by a rampant state economy. Queensland continues to reap the benefits of the commodity boom and a buoyant labour market has boosted household incomes by a remarkable 11.5% over the year to September. A marked jump in infrastructure spending, solid investment intentions and healthy household cash flow suggest economic conditions will remain very supportive in 2008.

House prices accelerated in 2007 and were up an impressive 18% over the year to September. Price growth has been supported by tightening market fundamentals and a continued influx of cashed up interstate economic refugees. Sales growth has continued to expand strongly and, like Sydney and Melbourne, inner suburbs have outperformed.

Buoyant economy is driving up house prices

Brisbane house prices — Household disposable income, Qld



Sources: ABS, Economics@ANZ

Rental markets have continued to tighten and advertised rents are up a solid 18% over the year to September.

In stark contrast to other states, Queensland's home building industry is performing strongly. Residential building approvals have risen sharply since early 2006 and are currently at a 13-year high.

Nonetheless, dwelling supply is still falling short of underlying housing demand and the market is expected to tighten further in 2008 increasing upward pressures on house prices and rents.

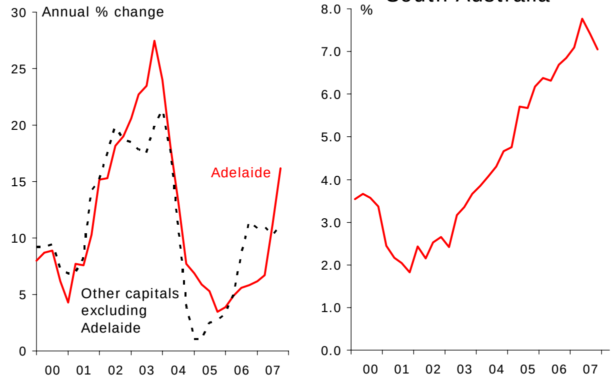
South Australia

The Adelaide housing market has performed remarkably strongly in recent years despite a languishing state economy.

South Australia's gross state product growth slumped to just 0.8% in 2006-07 (by far the weakest of all the states and territories). Weakening relative employment opportunities saw South Australia experience a net interstate population exodus of 3,500 in the year. Fortunately, this has been more than offset by a growing influx of international migrants. South Australia's share of international migration has risen sharply since 2001 lifting the (net) number of migrants from a low of 2,500 in 2002, to 13,200 in 2006/07. This has provided a significant boost to underlying housing demand which is now running above new supply and is driving an ongoing tightening of market conditions.

International migration boosts house prices

Adelaide house prices — O/S Migration share South Australia



Sources: ABS, Economics@ANZ

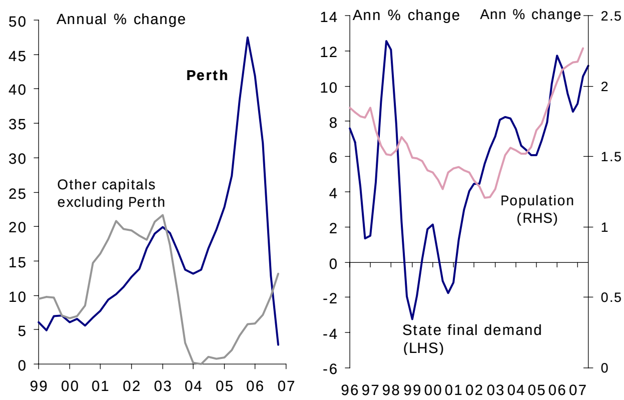
House prices rose by 16.2% over the year to September buoyed by a tightening housing demand/supply balance that is reflected in the lowest rental vacancy rate of all the state capitals (1.1%). The tightness in the rental market has pushed up advertised rents by 22% over the year to September and with rental vacancies forecast to reach record lows in the years ahead strong upward pressure on rents will be maintained.

Western Australia

General economic conditions in Western Australian remain the strongest in the country. However the housing market has temporarily come off the boil. The commodities boom is still providing significant economic momentum and real gross state product expanded by a massive 6¼ in 2006/07, while real gross state income grew at a remarkable 12%. This strong economic environment will maintain a floor under the WA property market and despite widespread doomsday commentary will avert a significant correction.

Strong growth continues to attract people

Perth house prices — Final demand & population



Sources: ABS, Economics@ANZ

House price growth slowed to just 2.8% through the year to September, yet this was not entirely unexpected given the close to 50% annual growth in prices seen last year. In the wake of recent interest rate hikes, combined with a doubling of median house prices since late-2003, affordability has clearly become an issue and this will continue to cap prices in coming quarters.

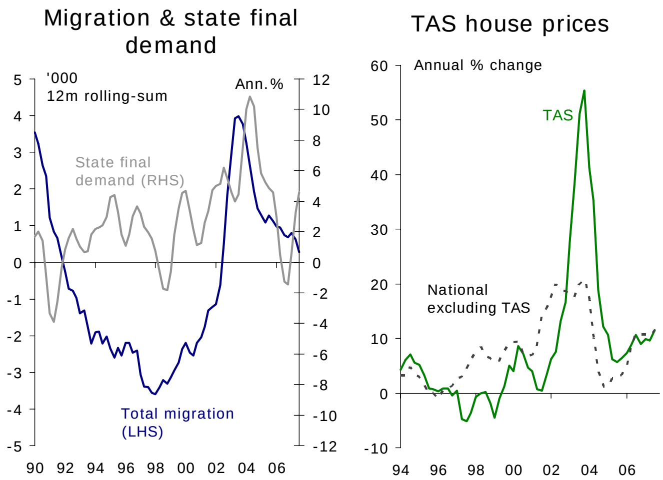
But the underlying fundamentals of the market remain supportive and should see robust house price growth return towards the end of 2008. The local economy strengthened in the September quarter with annual state final demand growth just shy of 12% and household incomes have been rising rapidly, prompting population growth to accelerate to 2¼% in the year to June.

Despite this, housing approvals and commencements have continued to fall from the peaks reached in late 2005 as interest rates have climbed. Consequently, demand for housing will remain robust in what will continue to be a tight market. With affordability putting home purchase out of the reach of many, rental vacancy rates have fallen to 20-year lows. Ongoing tightness in the rental market has seen rents skyrocket with increases in advertised rents in excess of 35% in the year to September (Residex). A chronic shortage of housing going forward combined with strong economic growth will provide continued support for house prices and rents in coming years.

Tasmania

The Tasmanian economy may have turned the corner after GSP growth slowed to 2.1% in 2006-07. State final demand posted 4.5% growth (trend) in the year to the September quarter, boosted by a strong showing by the manufacturing sector, after contracting in late 2006. Job prospects have also improved with employment growth building to just below 3% in the year to November. These signs of recovery should be enough to maintain positive inward migration levels and underpin housing demand.

Recovering economy underpins housing market



Sources: ABS, Economics@ANZ

New housing commencements and approvals have been maintained at solid levels, despite interest rate hikes. The number of housing finance approvals actually increased in October, bucking the trend that saw falls across all other states except NSW in the month. The tightness of the residential market in Tasmania is reflected in house prices rising by 11.6% in the year to September, keeping pace with price growth around the country. Further, residential vacancy rates remain remarkably stable near long-term historical lows of around 2%. Consequently, median established and advertised rents have risen by around 5% in the year.

Northern Territory

The commodities boom has ensured solid economic and population growth in the Northern Territory over the past three years. Gross state product has averaged growth over 5% p.a. since 2004-05 with employment growth averaging 5½% p.a. over the same period. Strong economic prospects have attracted significant inward overseas migration that has driven average annual population growth of over 2% since mid-2005.

As a result, the residential market has remained tight and house prices have boomed, with growth exceeding that of other capital cities for some time. This growth has doubled median house prices over the past 5 years and combined with interest rate hikes has led to a significant deterioration of housing affordability which has moderated house price inflation in recent quarters. However, ongoing economic growth and a limited capacity to significantly add to the housing stock will see the market remain tight for the foreseeable future.

Australian Capital Territory

The ACT was the third fastest growing state or territory, expanding by 5.0% in 2006-07, an exceptional pace of growth for a non-resource region. This performance was driven by a strong government administration & defence sectors and underpinned by solid population growth. However, more recent data suggests the economy is coming off the boil with state final demand experiencing its largest quarterly contraction in over ten years, falling 1.9% in the September quarter. Employment growth has also stalled with the number of employed reduced by 0.5% in the year to November. However, with the trend unemployment rate at 2.6% and disposable incomes growing at a healthy rate the residential market should be well supported going forward.

House prices rose 11.2% in the year to the September quarter implying that median house prices in the nation's capital were $460,000, significantly higher than the national average and second only to prices in Sydney. Yet these relatively high prices may not deter those in the residential market with affordability still at manageable levels due high disposable incomes. Repayments on the average mortgage are only 24.9% of disposable income in Canberra much lower than the national average of 36.9%. This may give prices some further upside in coming quarter. With housing demand expected to stay solid, vacancy rates, currently just below 2%, are expected to narrow. Consequently, it is anticipated rental growth will accelerate, from the already solid 15% rise seen in the year to September.

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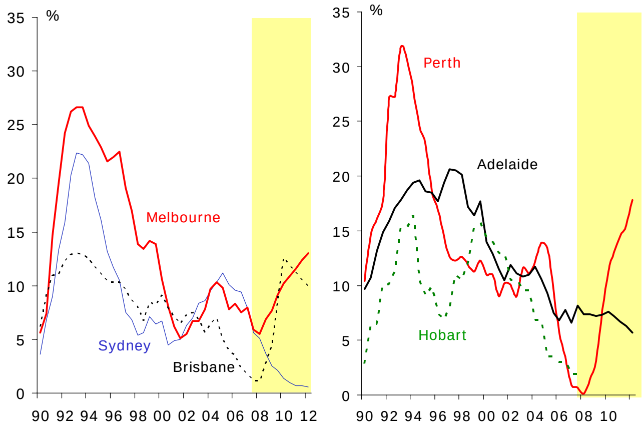
Office Property

Office markets are tightening

CBD office markets continue to tighten with vacancy rates falling sharply from 10.2% in July 2004 to a 17-year low of 4.8% in July 2007[3]. Further tightening is expected as labour market strength keeps absorption at healthy levels and new capacity lags underlying space requirements. The vacancy rate for 'average of 5 CBD' centres is projected to bottom at around 4% by year's end. From there, we expect a gradual easing in overall conditions as the supply side response gathers momentum. While fundamentals will remain sound over 2008, *hints* of oversupply will start to emerge in later years. Those centres that temper supply growth in the out-years should sustain a healthy development and price cycle. While the pipeline of committed projects is likely to be absorbed quite easily, the weight of supply driven by acute shortages in some centres is likely to overwhelm demand conditions.

Office market has tightened

CBD office vacancy rates

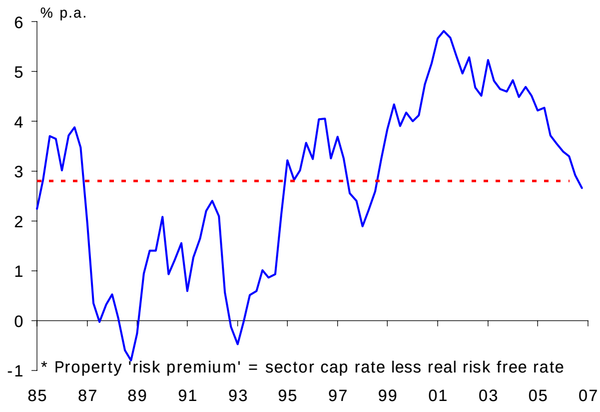


Sources: Property Council of Australia, Economics@ANZ

Not surprisingly, tighter conditions to date have driven office values and rentals higher (up 10% and 13%) respectively over the year to September 2007[4]. Yield compression has continued and is being consolidated by further lowering of capitalisation rates over this period. A resilient economy, profitable business sector and a relatively steady risk-free rate are providing justification for further yield compression to below historical benchmarks. Volatility in credit markets, liquidity constraints and the flow-on impact these conditions have had on some players in the listed property sector will unsettle investors. Some of this greater risk profile could transfer to the *real* property sector, limiting further yield compression. Entities with highly-geared exposures will however, more than likely face tougher pricing conditions than the underlying assets themselves. At this stage, we do not expect these events to inhibit rental and capital growth both of which are being underpinned by strong fundamentals.

Office premium near long term benchmark

Australian office 'property risk premium'*



* Property 'risk premium' = sector cap rate less real risk free rate

Source: Property Council/IPD, RBA, ABS, Economics@ANZ

Despite having a relatively weak economic backdrop, the **Sydney CBD** office market offers a relatively secure medium-term outlook. A measured supply pipeline (partly a reflection of a reluctant development sector and partly available site limitations) will avert any weakening in market fundamentals. Indeed, further tightening is expected over the next 4 years. This is likely to underpin rents and values over this whole period. Fundamentals in the **Melbourne CBD** market are also sound but a robust economy, the eager rollout of Docklands projects and generally less constraints on CBD development is threatening to create a pipeline of activity that will weaken fundamentals to uncomfortable levels by the turn of the decade. In the meantime, solid absorption levels and strong investor demand will maintain rental and capital values growth. **Perth and Brisbane CBD markets** are both experiencing acute shortages of office space, with vacancy rates falling to record lows in mid-2007 (0.1% and 1.1% respectively). A sluggish supply response suggests very tight conditions will persist over 2008. However, the boom mentality pervading these growth economies presents a serious risk for these two office markets. With *committed* developments likely to be well absorbed in a growing economy, *mooted* development presents a considerable threat to underlying fundamentals. With expectations for these two economies remaining favourable, a 'sanity check' on future supply is unlikely to be forthcoming. The implication is a roller-coaster ride that will threaten rentals and capital values into the next decade. The **Adelaide** office market had been in a tightening phase since 1997 with vacancy rates in the "core" precinct falling from over 20% to 6.6% in January 2007. The tightening phase has reversed in 2007 with a temporary supply boost easing conditions. A fairly measured supply response from here, however, and continued trend absorption levels should avert a weakening in fundamentals over the medium-term.

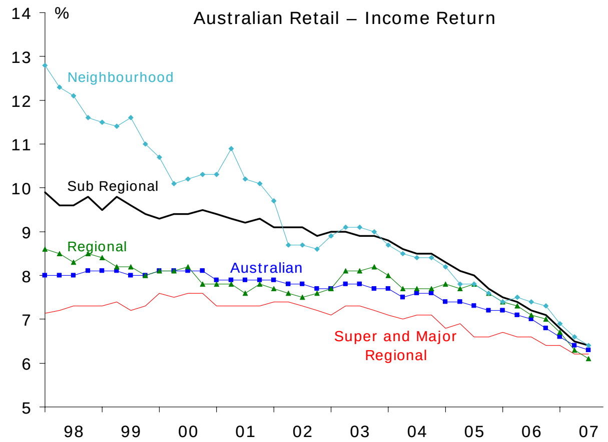
Ange Montalti

[3] Office Market Report, Property Council of Australia
[4] IPD

Retail Property

Overall demand and supply conditions remain supportive for the retail property sector. Strong investment demand for retail assets has seen yields firm with the breakdown by type of retail showing a more significant decline in some segments over recent years. One could argue that there is further scope for an even lower benchmark premium than the long term average of around 4% given the above-trend outlook for retail turnover. However, continued financial market volatility and increased cost of funding, which has already been felt in the listed property sector, could make further yield compression difficult if the current dislocation in global credit markets persists.

Retail yields converge



Sources: IPD/PCA, Economics@ANZ

Above-trend economic growth and relatively healthy consumption prospects in the coming year bode well for the retail property sector. While expectations of further interest rate rises and high oil prices could put a dent on discretionary spending, pre-election promises in the form of further tax cuts, rising wages, low unemployment and asset wealth gains are likely to support growth in consumer spending. Nominal retail turnover is forecast to expand by an average of 6% per year over 2008 and 2009, slightly slower than the 7.1% estimated for 2007 but remaining higher than the 15-year average. In volume terms, retail sales are forecast to rise by an average 3½% pa during the same period, compared with 4½% in 2007.

Building approvals data reflect a strong momentum in retail construction activity in the months ahead. For the first ten months of 2007, approvals were up 33% compared with the same period in 2006. Estimates indicate that there is close to 1mn sqm of new supply under construction or with planning approval and scheduled for completion in 2008. This is up almost 50% from 2007. Bulky goods stores are expected to dominate new floor space. In addition, the trend towards mega-regional centres will see further expansion and refurbishment of regional shopping centres.

Across the states, **Western Australia** has been the best performer in terms of retail sales turnover, posting growth of 11.3% between January-October 2007 compared with the same period in 2006, eclipsing the national average of 7%. The mining boom is expected to continue to bolster consumption growth in WA and fuel retail tenant demand. According to a recent Property Council/Lease Equity Retail development survey, gross lettable area for retail developments will rise by 210,000 sqm by 2011. This should help to alleviate pressure from firm tenant demand.

Despite additional supply coming into the CBD market, strong demand in **Victoria** is expected to keep CBD vacancy rates low and limit downside pressure on rents. Significant developments underway include bulky goods centres in Chadstone and Mentone, completion of the second stage of Waterfront City, redevelopment of a shopping centre in Somerville, the $100 mn mixed-use development in Camberwell and expansion of Westfield's Bay City in Geelong.

Retail sales growth in **Queensland** has been robust, expanding by 9.2%, in annual terms, in the first ten months of this year. A strong economy and rising household incomes are likely to underpin retail spending and tenant demand. A strong pipeline of bulky goods is coming on stream with the majority in regional and sub-regional areas, capitalising on strong population growth. Other major projects include the $100 mn Robina Town Centre stage 1 expansion, Bundaberg Central Plaza and Brisbane's Mt Ommaney shopping centre extensions.

Building approvals show an upturn in activity ahead in **New South Wales**. Several retail projects in the pipeline include the Top Ryde shopping centre redevelopment, Glenrose Shopping centre and Stocklands Merrylands Mall. Retail spending conditions are improving, supported by stronger employment gains and income growth. The retail sector has recorded a relatively healthy annual total return averaging 16.4% for the first three quarters of 2007, supported by low vacancy rates and strong investor demand.

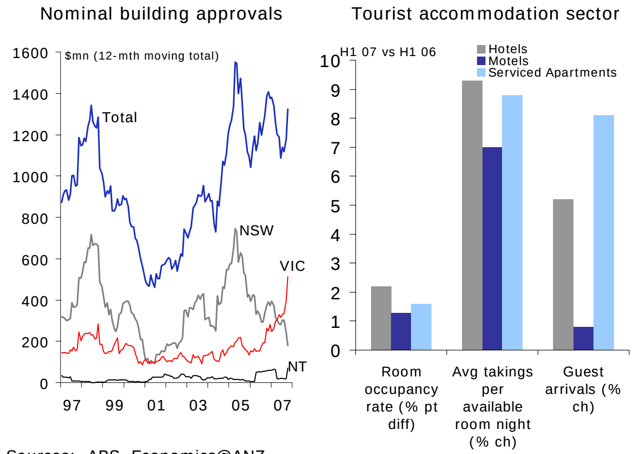
Shop building approvals in **South Australia** have only ticked up slightly. Activity has largely featured the refurbishment of neighbourhood centres and construction of bulky goods stores to support new residential developments. Projects underway include the 60,000 sqm retail bulky goods space in Gepps cross and Hallett Cove shopping centre extensions. Although retail sales have picked up strongly this year, rising to above-trend rates, new supply coming on stream could limit the pace of rental growth.

Jasmine Robinson

Tourist accommodation

Limited new supply in most states coupled with growing demand should keep prospects for the tourist accommodation sector upbeat over the next few years. Medium term projections are for overseas visitor arrivals to grow by an average rate of 5% per year over the next five years according to the Tourism Forecasting Committee. This is much stronger than the average recorded over the past two years of 2.2% pa. Despite the strength of the Australian dollar, increasing wealth gains in the Middle East and Asia, particularly India and China, as well as the expansion of airline capacity are likely to drive this expansion in visitor numbers. On the supply side, accelerating land and construction costs will continue to weigh on expansion plans but building approvals data show some upturn in activity and suggest that Victoria and the Northern Territory are expected to see a significant amount of building activity in this sector over the next year. However, new supply is likely to be absorbed by demand from both international and domestic travellers.

Positive outlook for tourist accommodation



Sources: ABS, Economics@ANZ

Given the long lead time in the construction and/or redevelopment of tourist accommodation, the outlook is for further increases in room rates as occupancy rates tighten. Recent data indicate that the tourist accommodation sector continues to chalk up new highs with marked increases in room rates recorded for most states in the first half of this year. The average occupancy rate for hotels, serviced apartments and motels & guesthouses reached 64.3% in the first half of 2007, the highest rate on record. Further yield compression can be expected as rising occupancy and room rates coupled with limited new supply attract increasing interest in the market.

The tourist accommodation segment in **Victoria** remains vibrant with additions to supply in the next 3-5 years expected to be comfortably absorbed. Demand is expected to gain momentum in coming years, bolstered by the completion of the 5000-seat convention centre in 2009. Developments underway or in the pipeline include the $50mn makeover of the Rialto hotel, redevelopment of Crown and the construction of the Hilton Hotel in the convention centre site. Hotel construction is also planned for the Docklands. Occupancy rates in the hotel and serviced apartment segments have remained firm and were up 1.1ppt and 2.9ppt in H1 2007 from a year ago to 72.4% and 74.1% respectively. This has supported a further increase in room rates.

The tourist accommodation market in **New South Wales** is enjoying one of its strongest gains in occupancy and room rates. The outlook is for further improvement given a positive forecast for visitor arrivals with Sydney remaining a key capital city destination, a strong events calendar and solid domestic corporate demand. Further investments in the hotel sector include the construction of the five-star Pullman hotel and budget Formule 1 in Olympic Park, and developments in King Street Wharf and East Darling Harbour.

Performance across **Queensland** is likely to be mixed. Despite an increase in supply, hotel occupancy rates in Brisbane are running at above 75%. Demand from both overseas and domestic leisure travellers is expected to stay strong, keeping upward pressure on room rates. Corporate demand is also forecast to stay firm given the healthy outlook for the resources sector. Gold Coast tourist accommodation also fared well with average takings per room night available up 10% in H1 2007 compared with the same period in 2006 but new supply could temper the pace of growth. Occupancy and revenue data for Cairns, however, is likely to remain weak, reflecting the declining trend in the number of Japanese visitors.

An upturn in domestic visitor arrivals is expected to keep revenue and occupancy indicators in **South Australia** firm over the coming year. Domestic corporate travel, in particular, is likely to pick up as SA benefits from the resources boom and a strong regional events calendar underpins leisure travel. Building approvals data suggest some softening of activity over the next year after the surge in approvals in 2006.

Although **Western Australia** is among the top performing markets, no significant expansion of room supply is in the pipeline. This could be due to prohibitive land and construction costs as well as developer focus on the robust residential market. Developments underway include the Barrack Square Hotel and Fraser Suites serviced apartments. The booming resources sector will continue to underpin growth in demand for tourist accommodation. Room rates are, therefore, likely to increase at a solid pace as occupancy levels head higher.

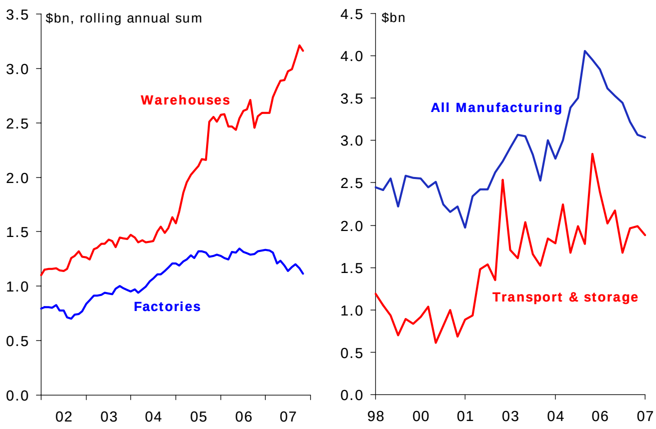
Jasmine Robinson

Industrial property

The relatively soft performance of the manufacturing sector in recent years has seen a significant divergence in the two largest sub-sectors of industrial property; manufacturing/factories and warehousing/logistics/storage. This divergence is manifested in a prolonged contraction in the value of factory building approvals. Low cost manufactured imports from emerging economies in Asia have worn away at the domestic sector and the manufacturing sector continues along a trend of long term decline. Despite modest growth in manufacturing production in recent quarters, as a proportion of the total economy, manufacturing reached its lowest ever point at 9.9% in September. The diminishing significance of manufacturing is being reflected in a reduction of demand for additional factory space with the value of approvals contracting over the past 12-18 months.

The divergence of factories and warehouses

Value of non-res approvals Capital expenditure

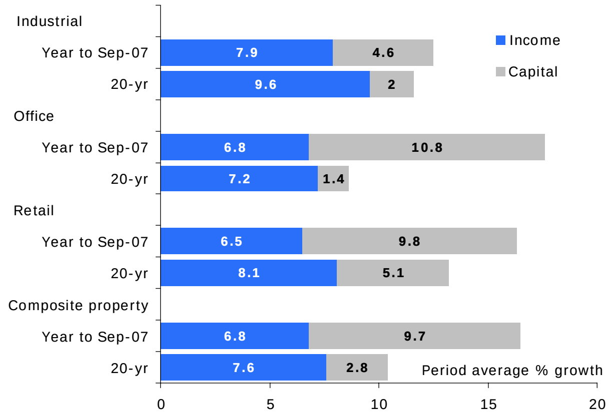


Source: ABS, Economics@ANZ

In contrast, demand for warehouse space is booming. This is being met by increases in supply with building approvals for warehouses accelerating significantly in recent years. This has been supported by investment in infrastructure projects facilitating the expansion of warehousing/storage and logistics. Improvements in infrastructure have allowed for the emergence of new industrial zones that have taken advantage of population growth corridors in major capital cities. The development of new industrial land has contributed to significant increases in capital expenditure by storage and transport companies throughout the past 5 years. The strength of the Australian dollar throughout 2007 has also facilitated the shift from factories to warehouses. Import growth has remained solid and import penetration has remained relatively high at 35% of sales. This has benefited importers, storage and distributors alike. The overall steady growth of industrial building approvals is seemingly satisfying current levels of demand with capital growth remaining relatively subdued, averaging around 4½%p.a. over the past 12-months. Consequently, industrial property capital returns have under-performed the office and retail sectors which have been running at just over and just under 10% p.a. respectively over the same period.

Industrial yields remain at a premium

Income and capital returns by sector



Sources: IPD/PCA, Economics@ANZ

Relatively subdued capital growth in the past decade has allowed rental yields to remain at a premium to other commercial property sectors. However, solid increases in land values may serve to support additional capital growth in the industrial sector, further adding to the recent trend of yield compression. Land values are anticipated to continue to rise, especially on prime sites in high growth corridors where demand continues to be strong. However, overall supply to the market should remain robust and will most likely cap any significant acceleration of growth in capital returns. Within the sector, overall returns have been strongest in warehousing and distribution averaging 14½p.a. and 13½p.a. this year respectively. High-tech and unit estates have fallen off this pace with 12.2%p.a and 11.6%p.a. growth respectively.

NSW – building approvals are being pushed higher by warehouses offsetting the continued decline of factories. This is supported by strong demand for imports despite weaker than average economic activity more generally. This strong supply will dampen rental growth, yet solid capital growth should be enough to keep the attention of institutional investors to support the market.

VIC – The value of building approvals are rising, again driven by warehousing approval which are by far the highest in the country. This supply will be shored up by ongoing infrastructure investment, gradually making land available. Yet, in the meantime increased land values and construction cost will add to rental yields.

QLD – The strength of economic growth continues to bolster approval levels. This supply will make some in-roads into strong demand. Yields will remain amongst the strongest in the country.

Dr Alex Joiner

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