

Open partnerships
Open possibilities

Property Industry Outlook for 2008

April 2008

Is this the late 1980s revisited for property markets?

Much talk of Armageddon

- US in trouble plus Euro area and Japan slowing

Interest rates/funding costs have risen sharply

- Geared investors highly exposed

Investor sentiment has softened

- Residential auction clearance rates have slumped
- Weakened demand suggests commercial property yields could rise

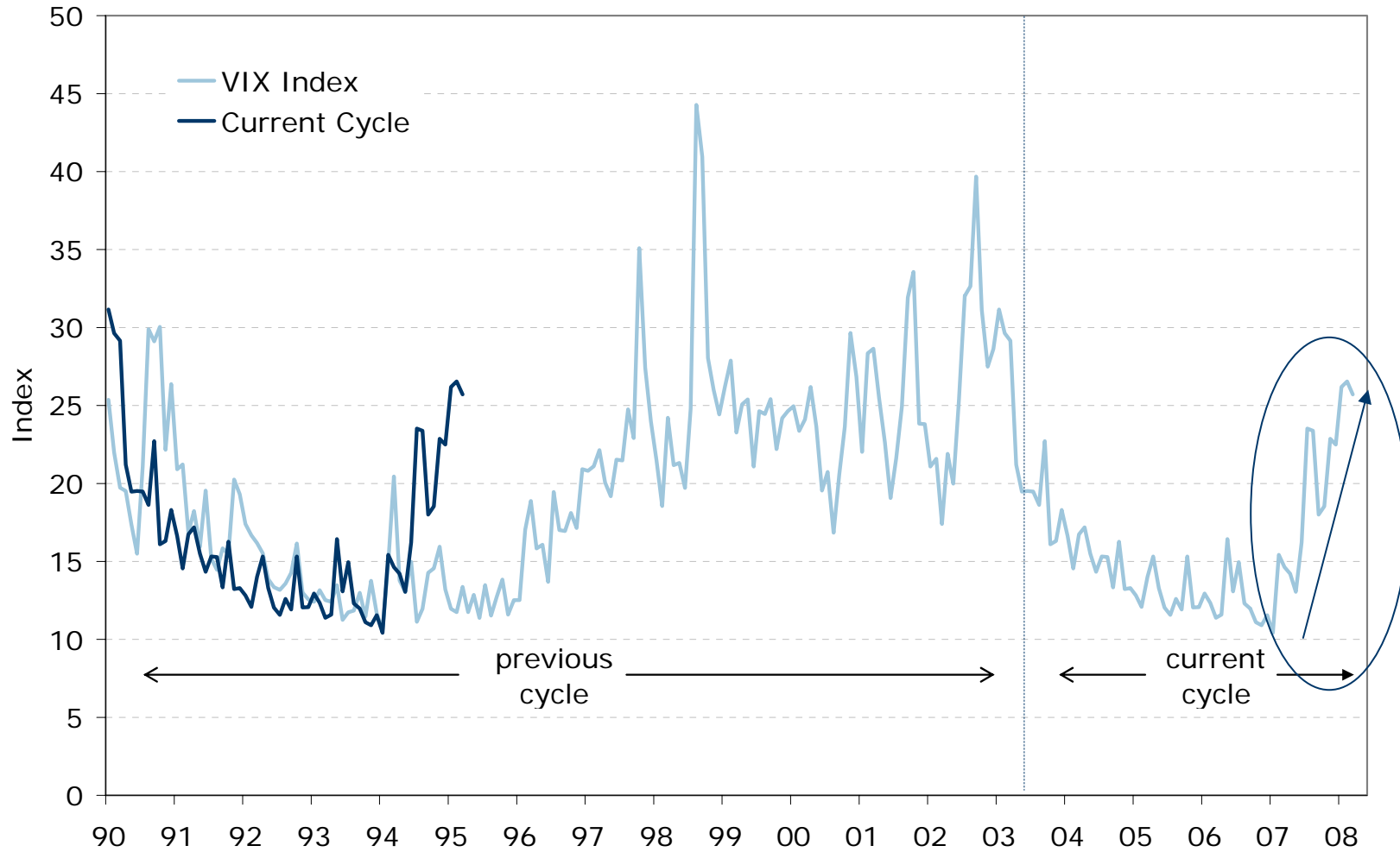
But, Australian economy remains broadly supportive

- Growth will be boosted by further (significant) gains in the terms of trade
- Labour market solid and unemployment at 33 year lows
- Corporate gearing very low cf 1980s

Property market fundamentals are *very* supportive

- Already *record* low res. vacancy rates will tighten further
- Office vacancies also very supportive in the near-term

We have shifted from a low volatility to a high volatility world in past 6 months



Sources: ANZ and Bloomberg
Relationship Banking • Corporate Finance • Markets • Working Capital

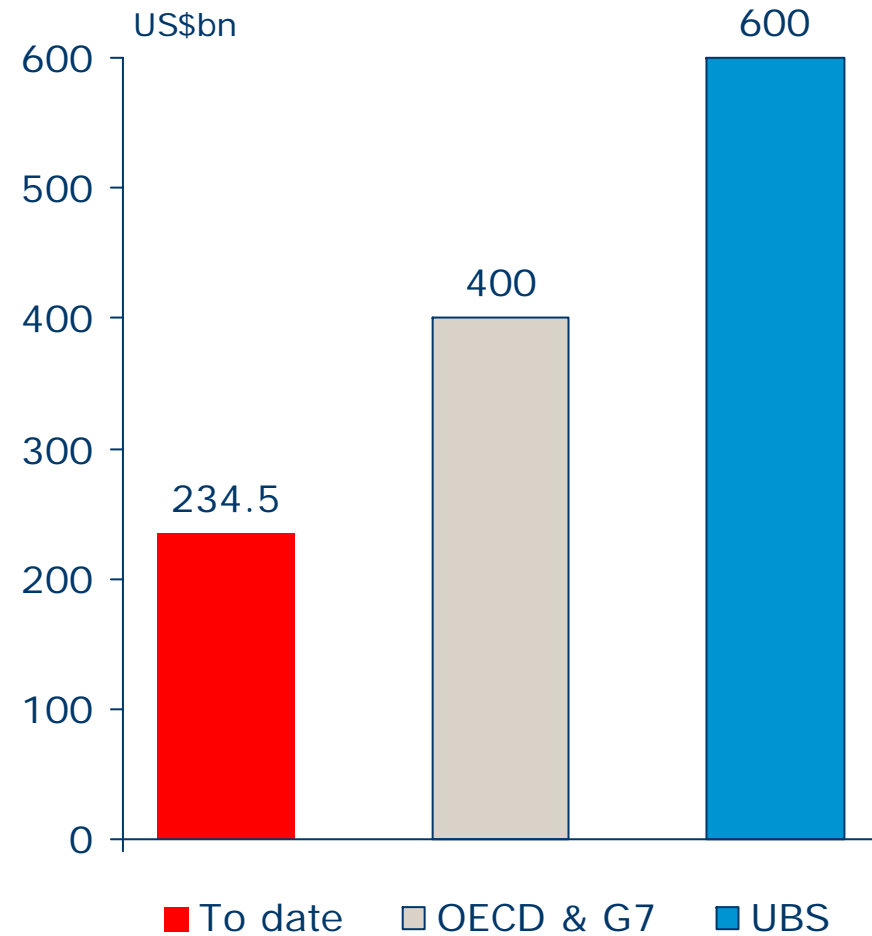


Declines in the value of mortgage-backed securities have led to substantial losses incurred by big global banks ⁴

Losses announced by major banks since mid-2007

Bank	Total (US\$ bn)
Merrill Lynch	25.1
Citigroup	23.9
UBS	38.0
HSBC	12.4
Morgan Stanley	11.7
IKB Deutsche	9.0
Bank of America	8.2
Credit Agricole	6.5
Washington Mutual	5.8
Credit Suisse	6.3
Wachovia	4.9
Canadian Imperial (CIBC)	4.0
Societe General	3.8
JP Morgan Chase	5.0
Mizuho Financial Group	3.4
Royal Bank of Scotland	3.2
TOTAL*	234.5

Losses (to date vs. *expected*)



Source: Bloomberg.

Swap spreads extended but have eased recently

Spread between swaps and government bonds



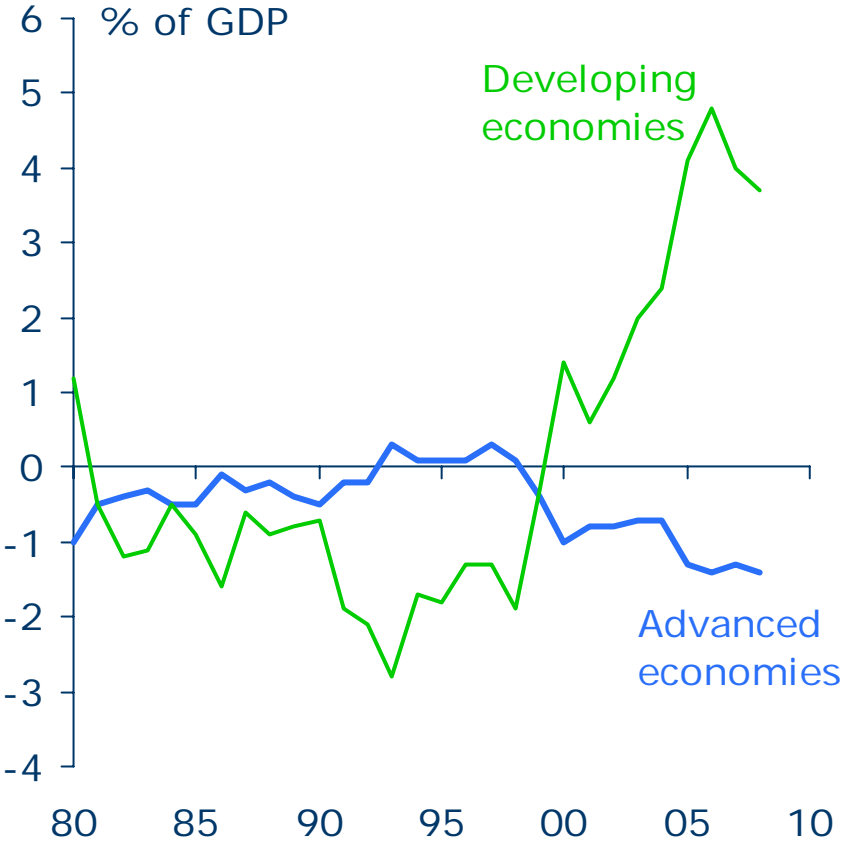
Source: Bloomberg and Economics@ANZ

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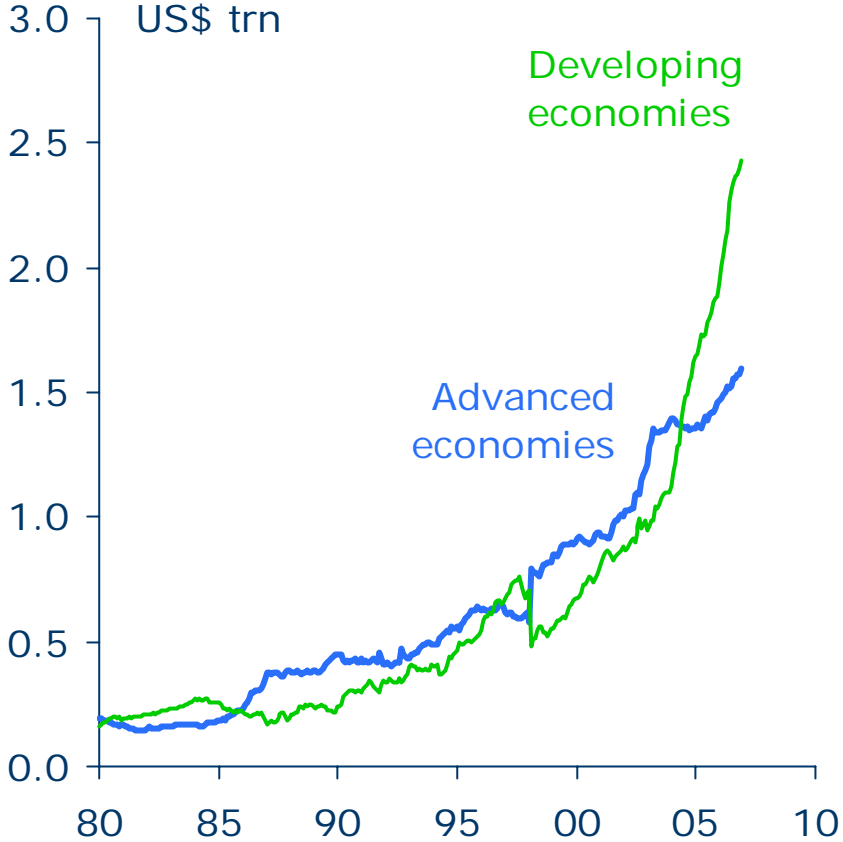


Developing countries well placed to withstand global financial upheavals

Current account balances



Foreign exchange reserves

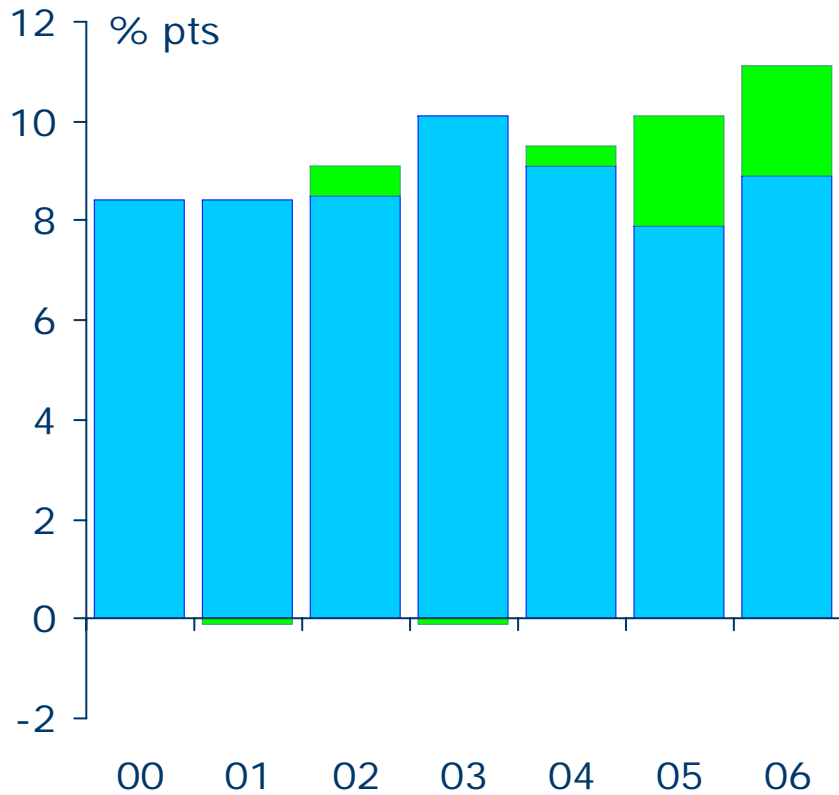


Sources: IMF; ANZ.

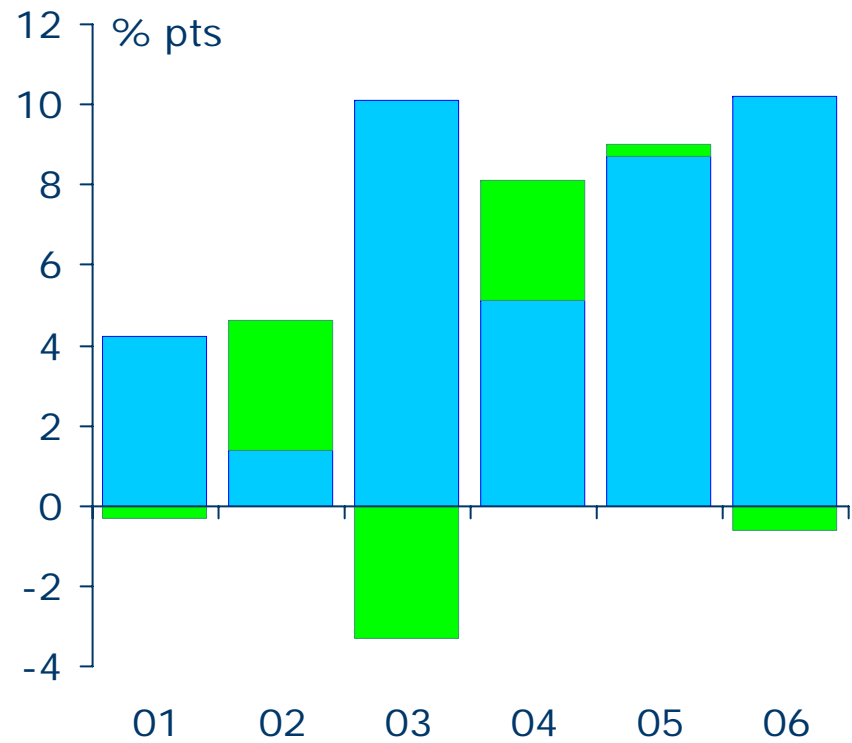


China's and India's growth has been predominantly driven by domestic demand, not by net exports

Contributions to China's real GDP growth



Contributions to India's real GDP growth



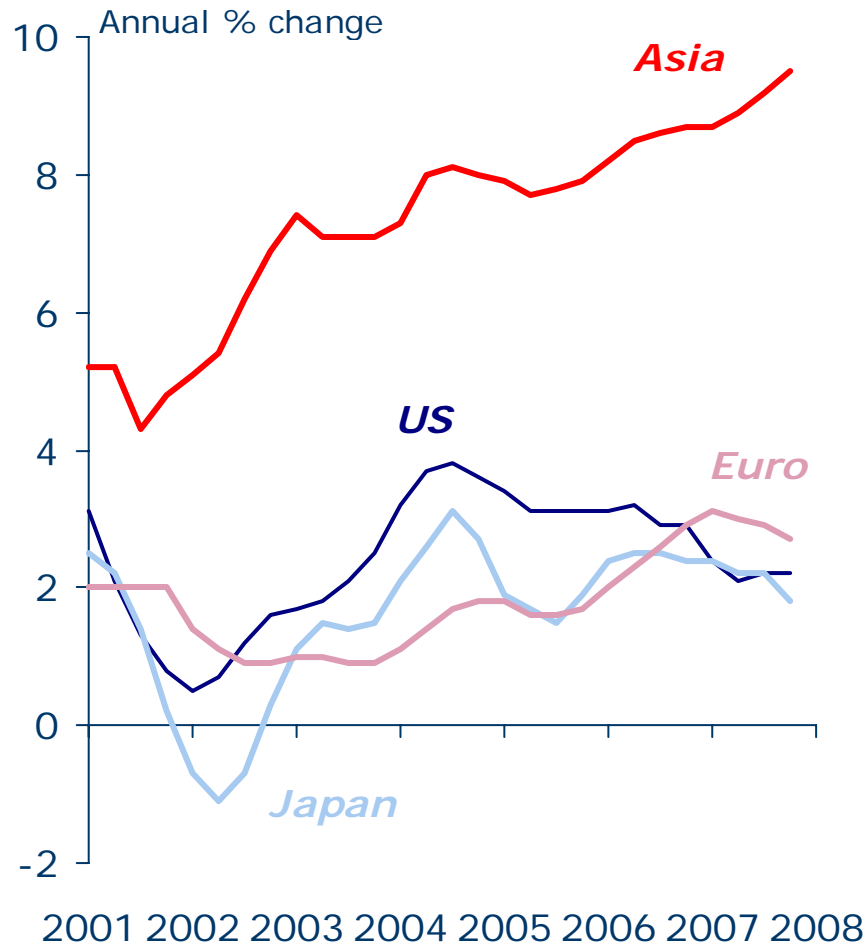
■ Domestic demand ■ Net exports

Source: China National Bureau of Statistics, CEIC.
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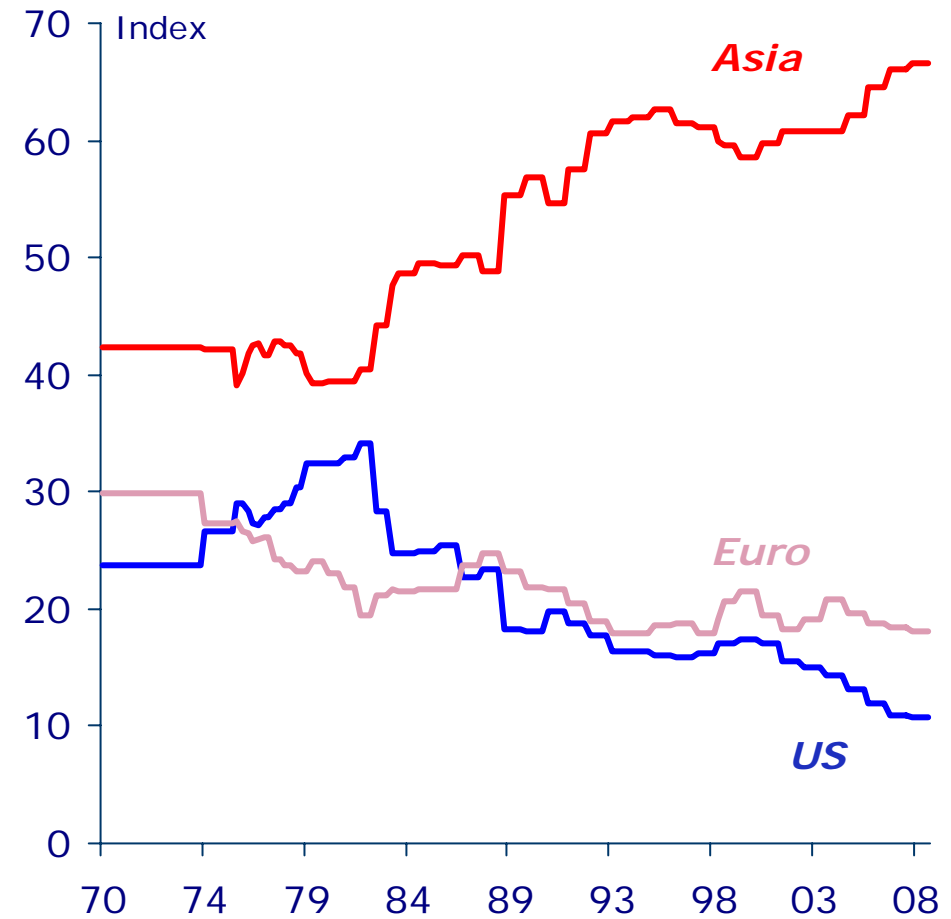


Australia's economic future is closely tied to Asia

Global economic growth



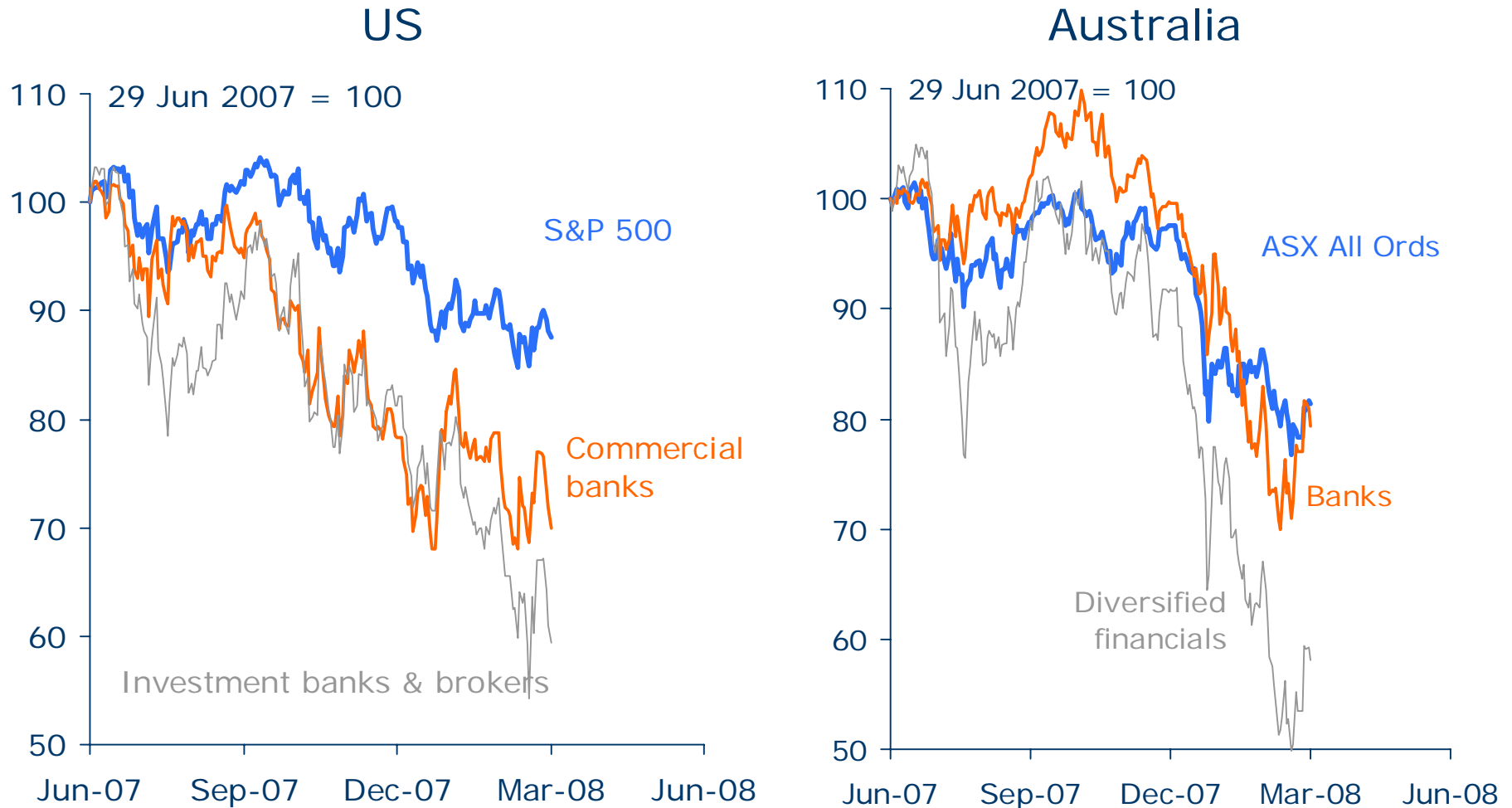
Australian two-way trade weights



Note: GDP is measured in US\$ at purchasing power parities. Source: IMF; Economics@ANZ.
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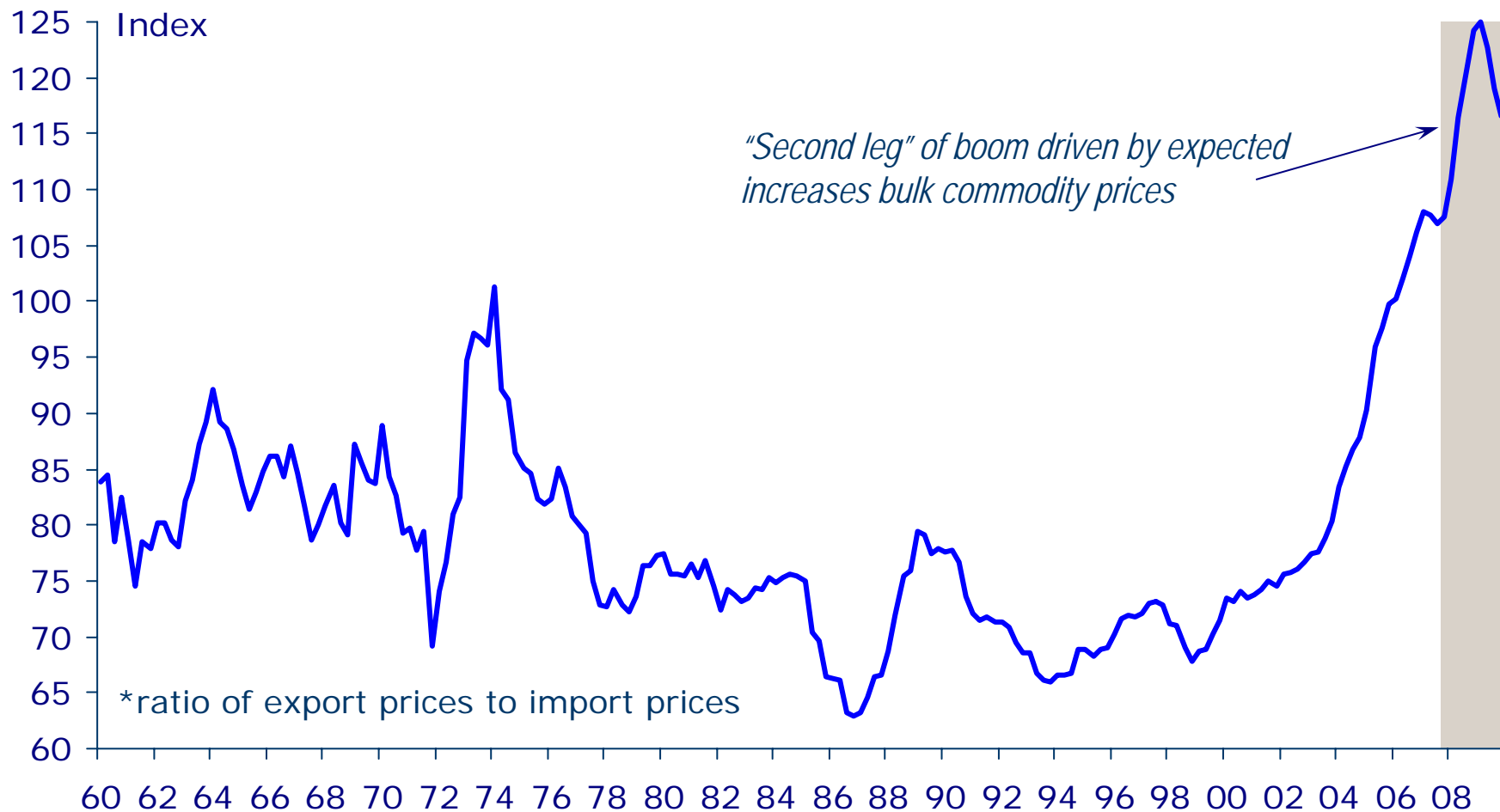
But no decoupling of equity markets so far



Source: Bloomberg

Rising bulk commodity prices will boost the terms of trade even higher in 2008

Terms of trade*

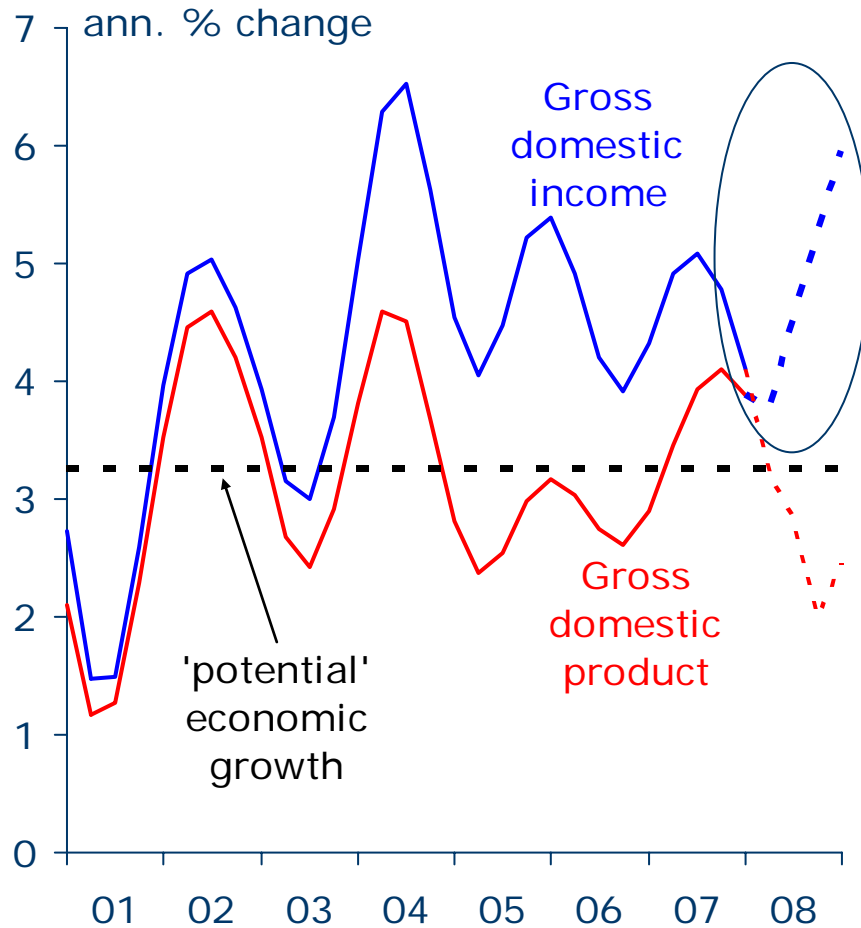


*ratio of export prices to import prices



Domestic growth accelerated in 2007, and the labour market continues to tighten

Economic growth



Labour market



Source: Australian Bureau of Statistics
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Australia faces a *critical shortage* of housing in the years ahead

Housing demand is booming

- Population growth is accelerating
- Declining persons per household (ageing)

But, supply remains constrained

- Rising interest rates/developer charges
- Building industry capacity?

And housing markets continue to tighten rapidly

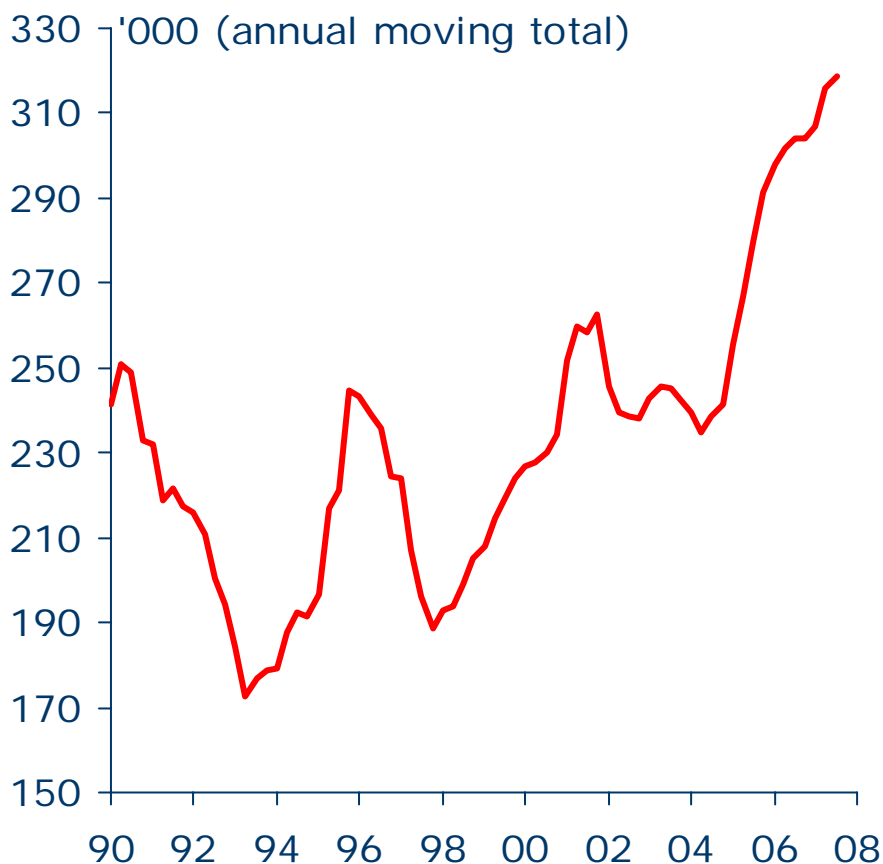
- Rental vacancies already well below long term averages...
- ...and supply is now *well* short of demand...
- ...driving vacancies lower & rents and prices higher

A critical housing shortage for next 5 years (if not 10)

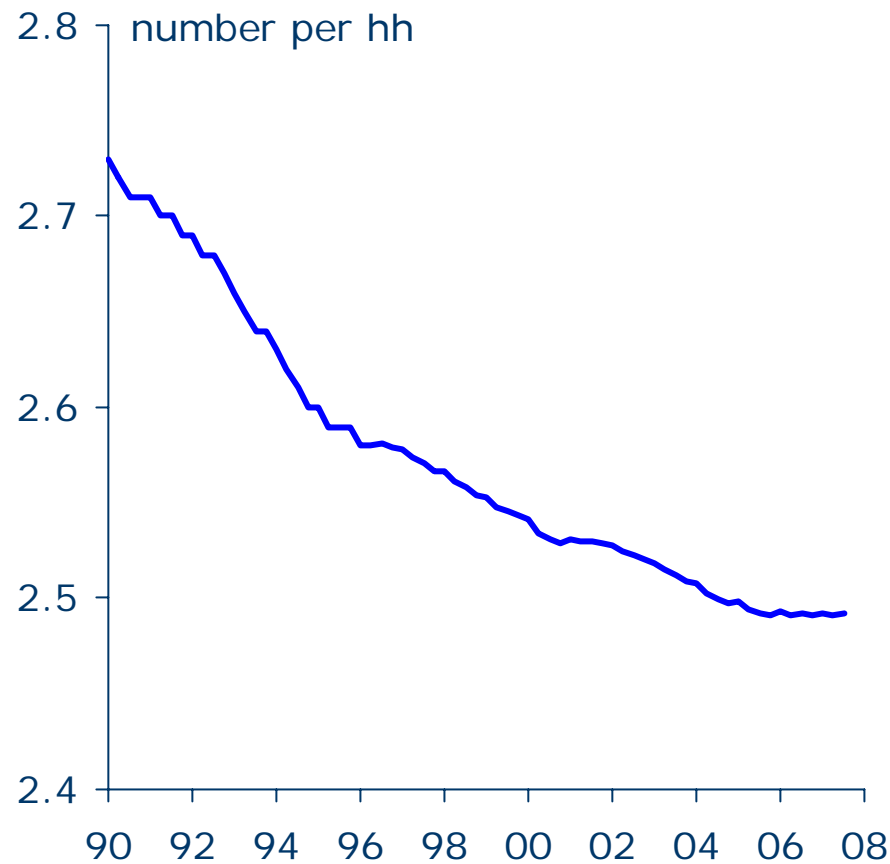
- Will continue to force rents and prices higher

Housing demand has accelerated boosted by rising population and fewer persons per household

Annual population gain



Persons per household

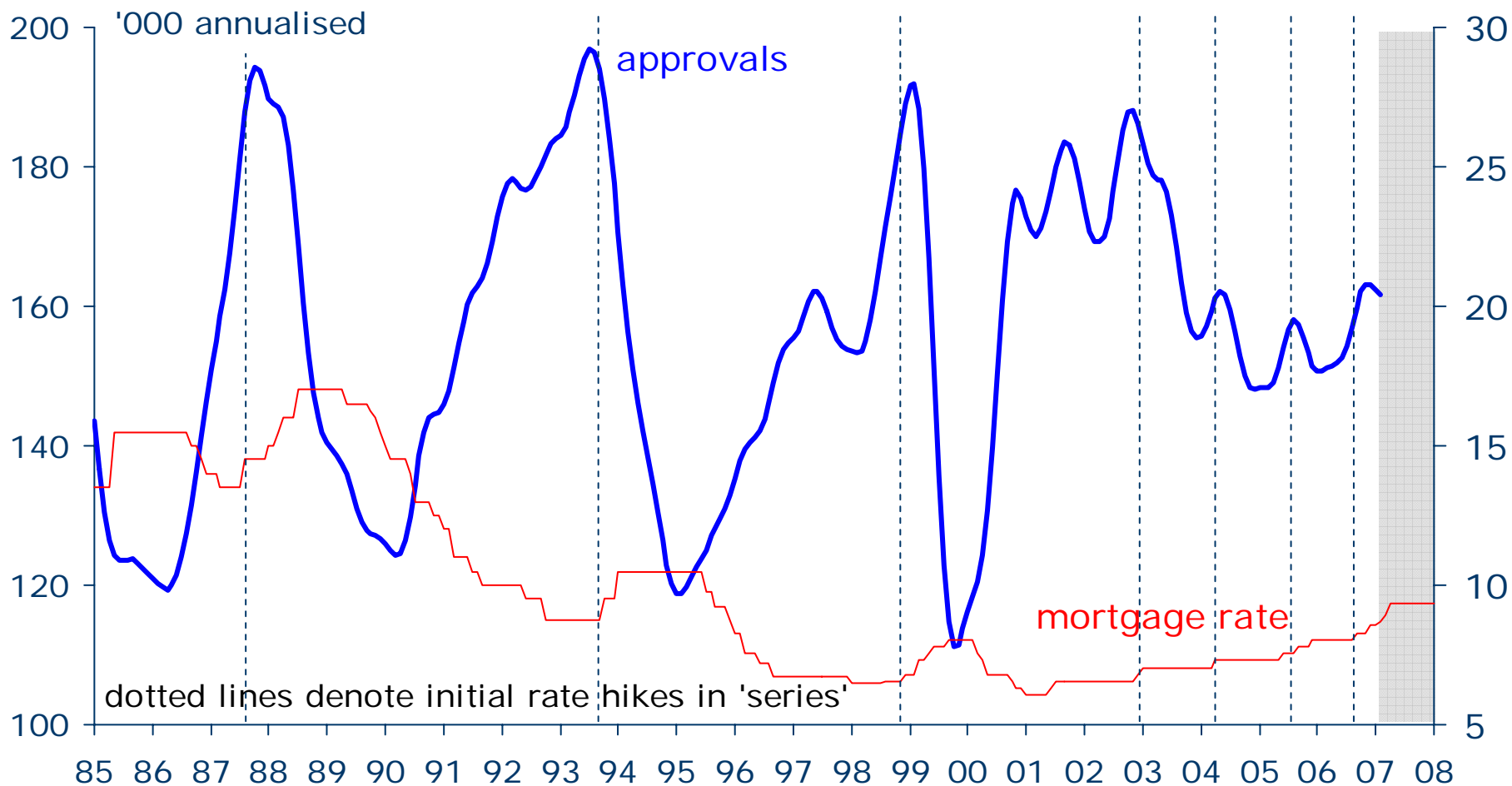


Sources: Australian Bureau of Statistics; Economics@ANZ.
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...while rising interest rates continue to stymie any building recovery...

Residential building approvals vs. interest rates

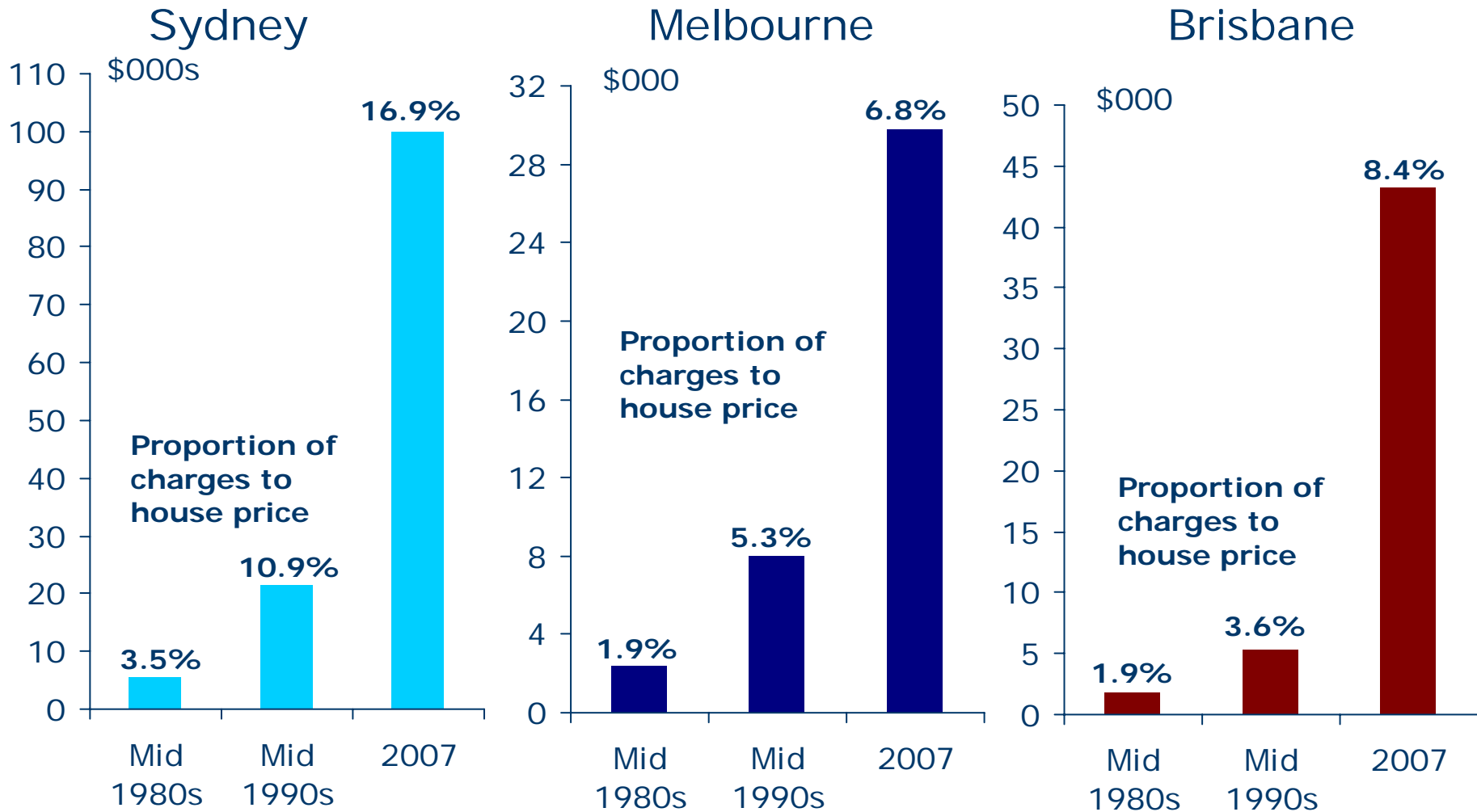


Sources: Australian Bureau of Statistics; RBA; Economics@ANZ
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...as do excessive developer charges

Primary charges for lot development

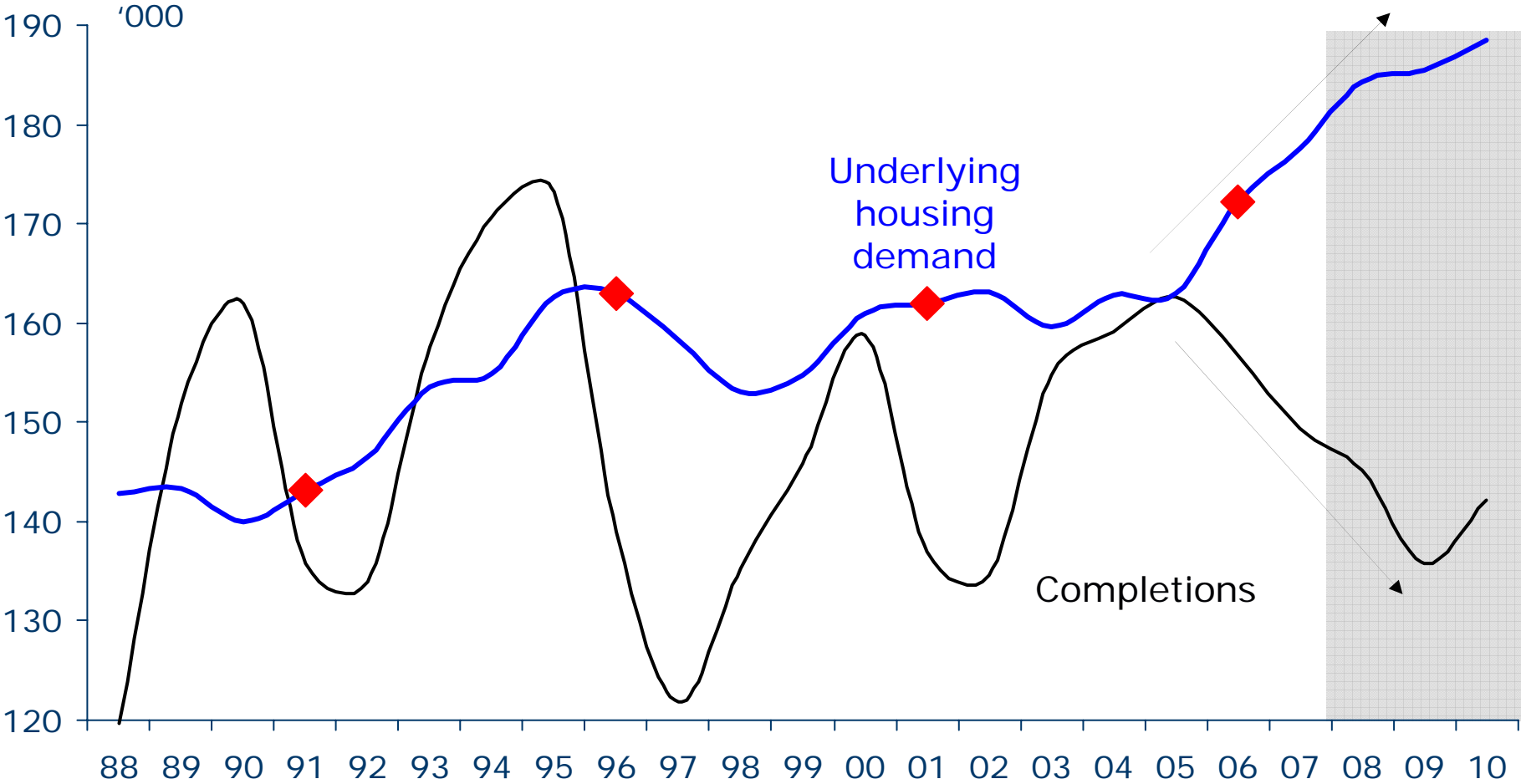


Source: HIA



Underlying housing demand is already outstripping new supply, and the gap is set to widen sharply...

Housing market balance: Australia

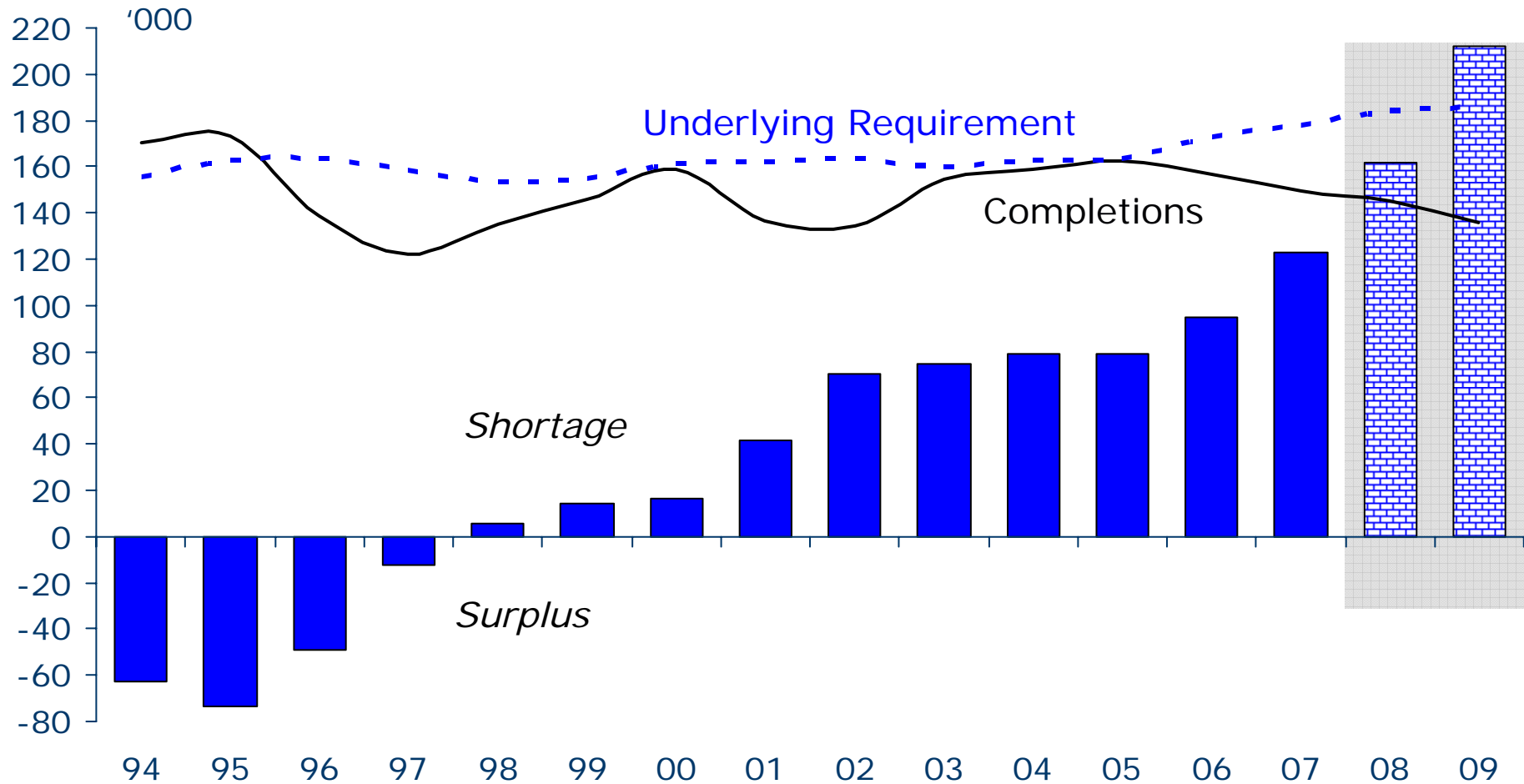


Sources: Australian Bureau of Statistics; Economics@ANZ
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...and pent-up housing demand will rise to record (and *potentially intractable*) levels

Housing market balance: Australia

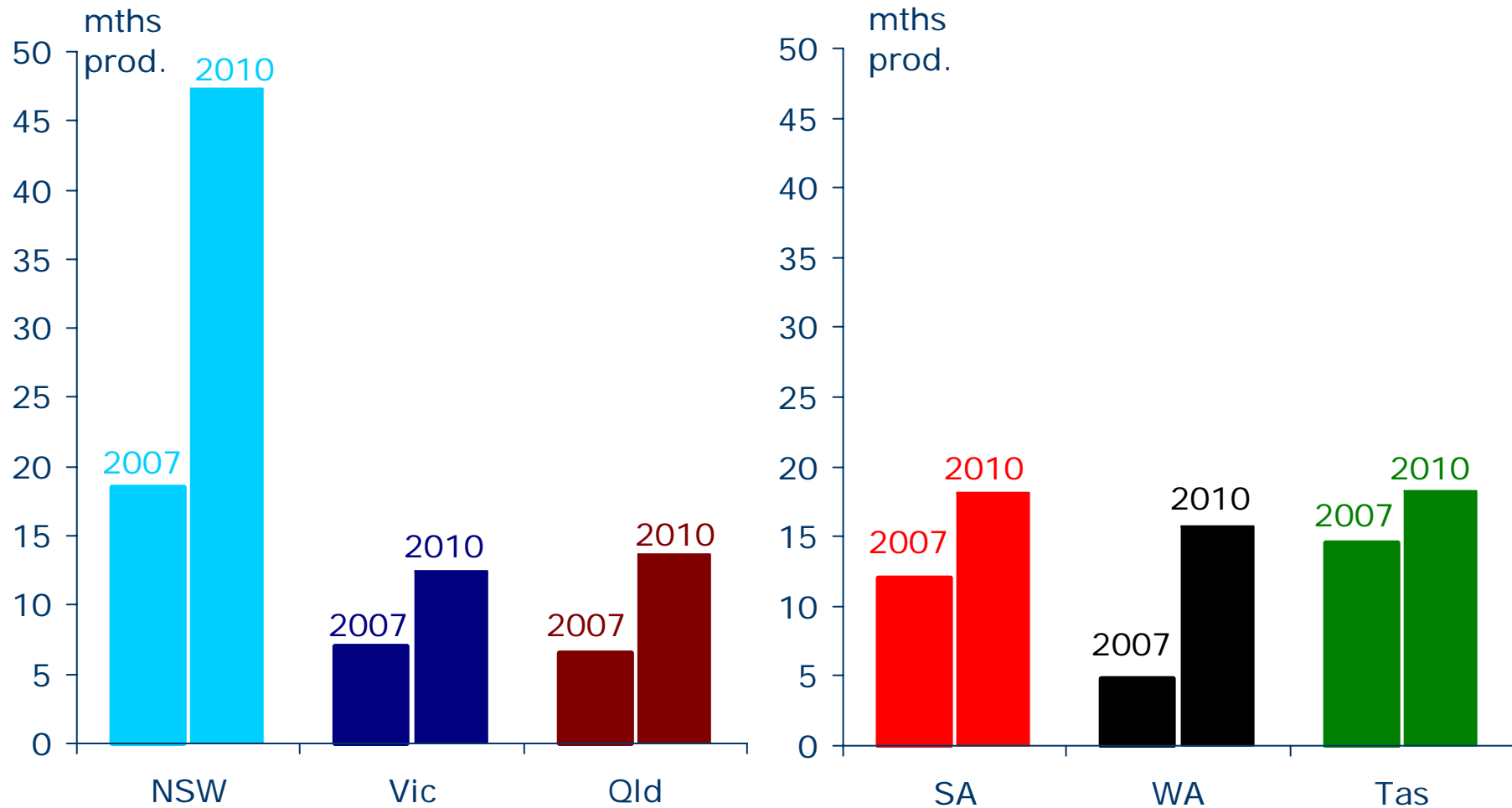


Sources: Australian Bureau of Statistics; Economics@ANZ



...in all states, but particularly in New South Wales

Pent-up housing demand by state



Sources: Australian Bureau of Statistics; Economics@ANZ

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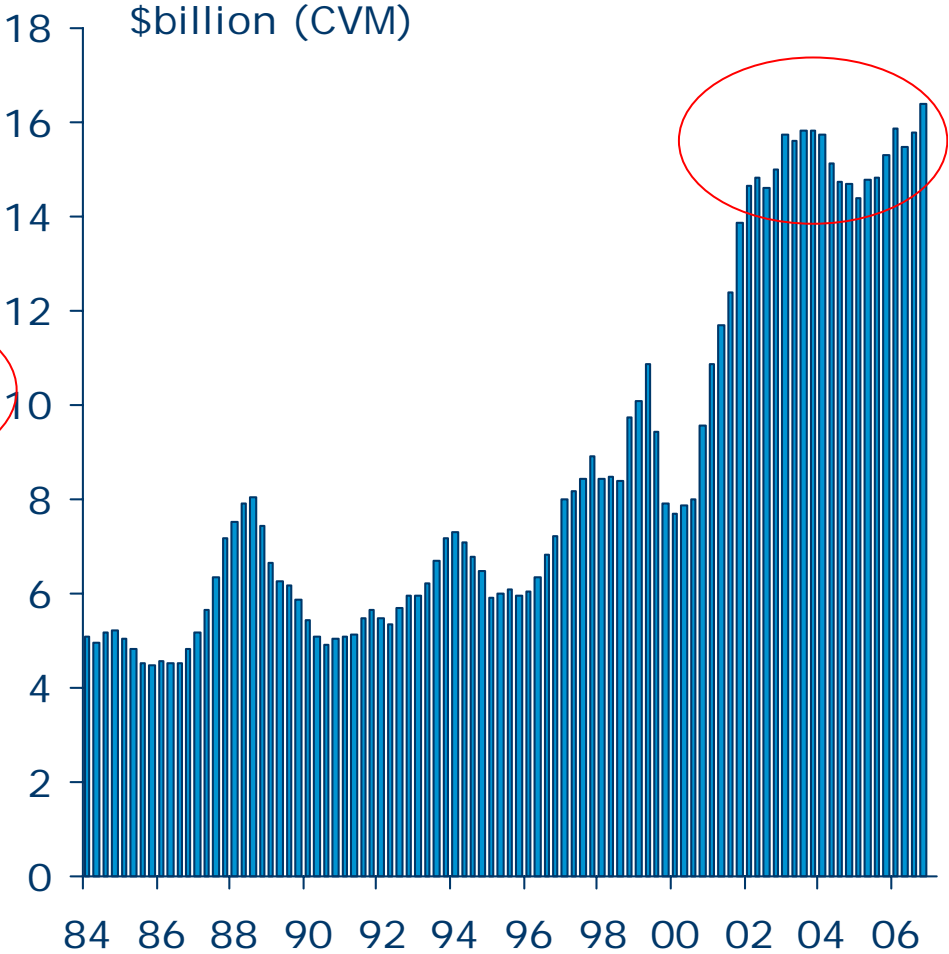


Moreover, capacity constraints may prevent building industry delivering the required stock

Australia



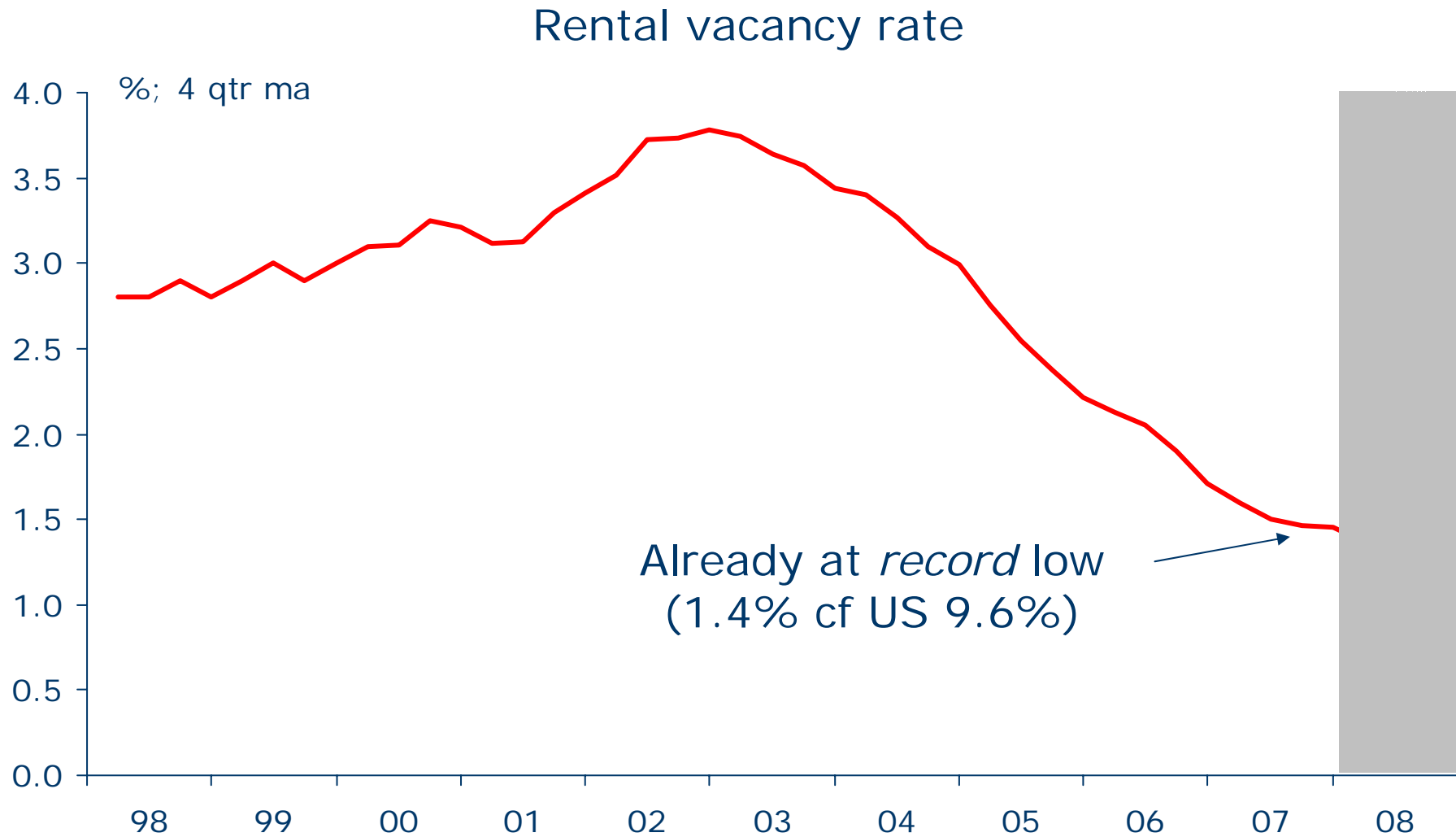
Work yet to be done



Source: ABS
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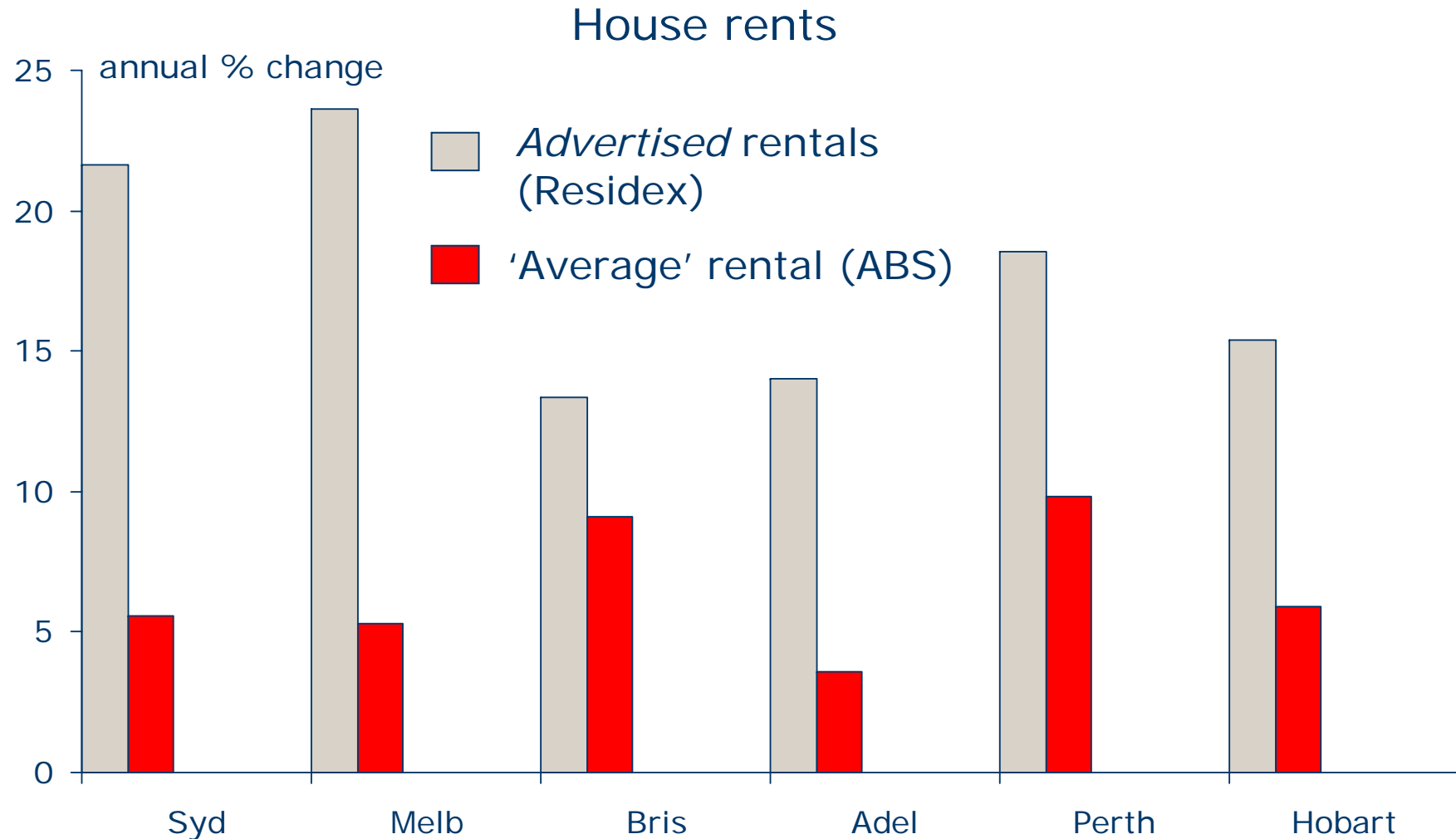


The tightening is reflected in sharp falls in rental vacancy rates²⁰
rates...



Sources: Economics@ANZ; REIA

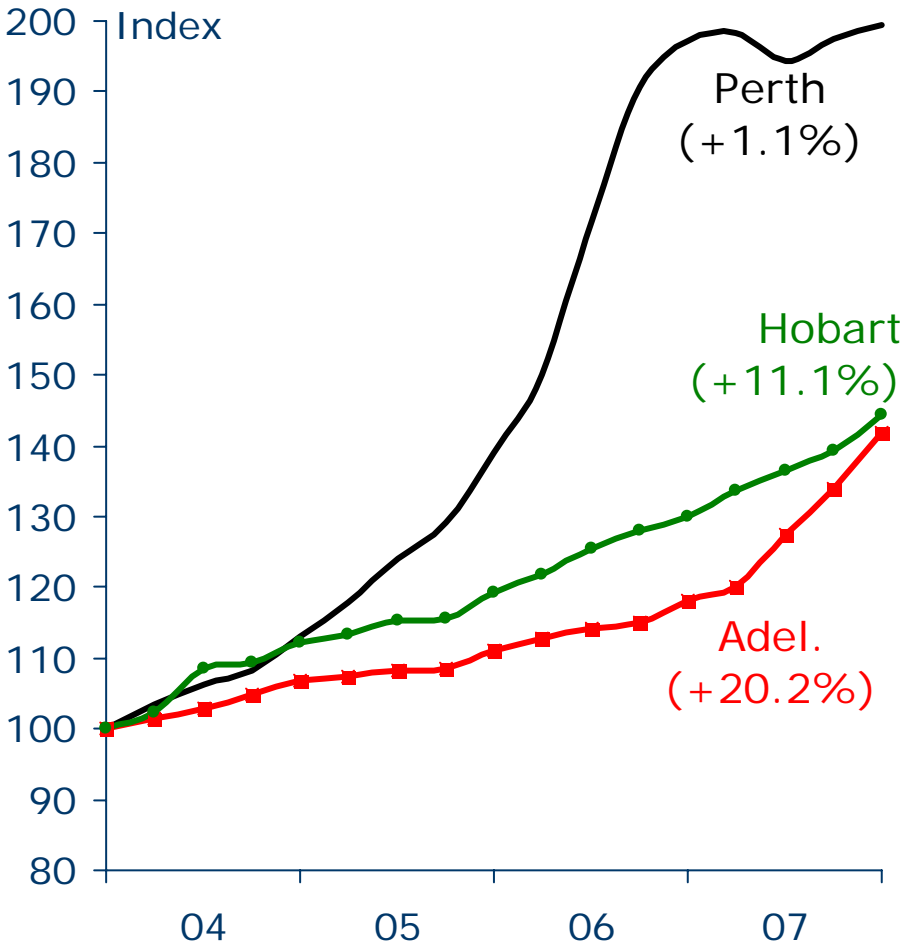
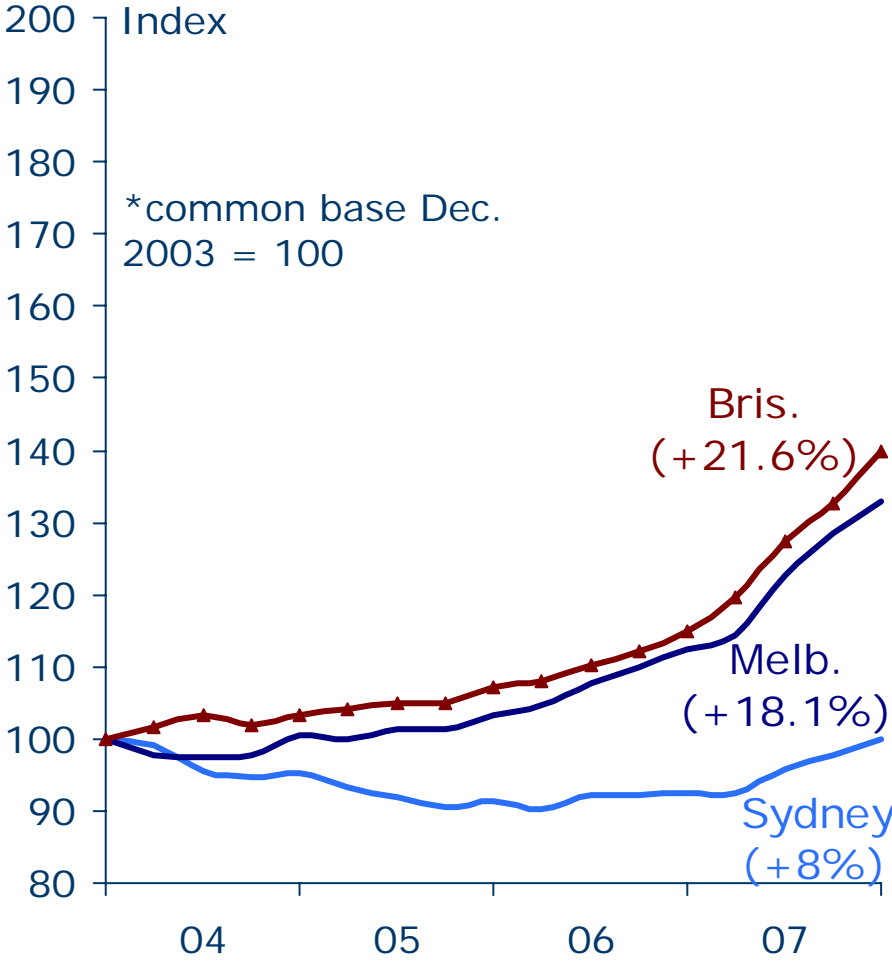
Moreover, 'advertised' rents are already surging (way in excess of ABS 'average")... ²¹



Sources: Residex, ABS, Economics@ANZ

Capital city house prices have been remarkably buoyant - even Sydney has improved ²²

House prices*

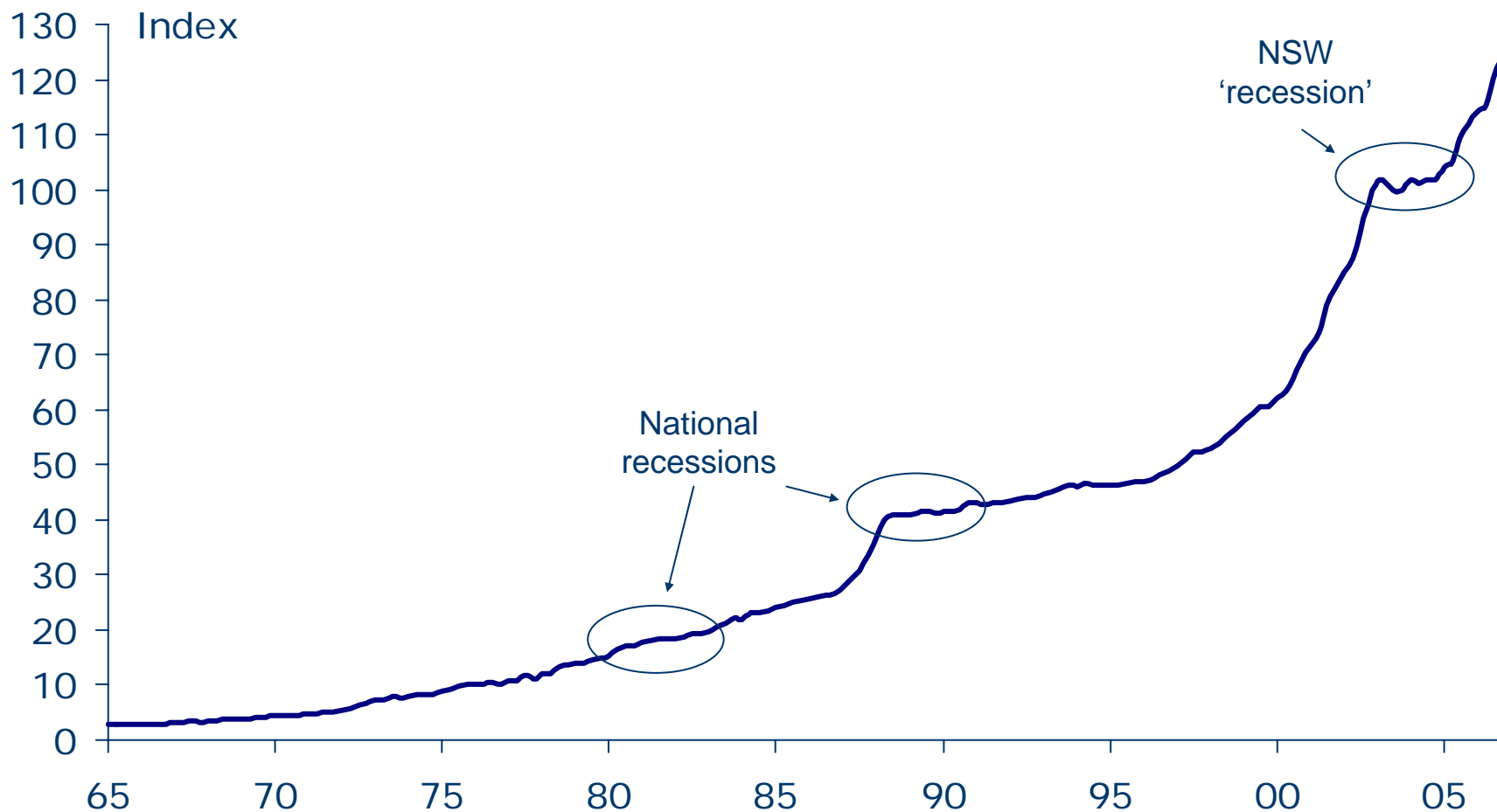


Sources: ABS, Economics@ANZ



Note: aggregate house prices have virtually never fallen
– even in deep economic recessions

ABS House price index



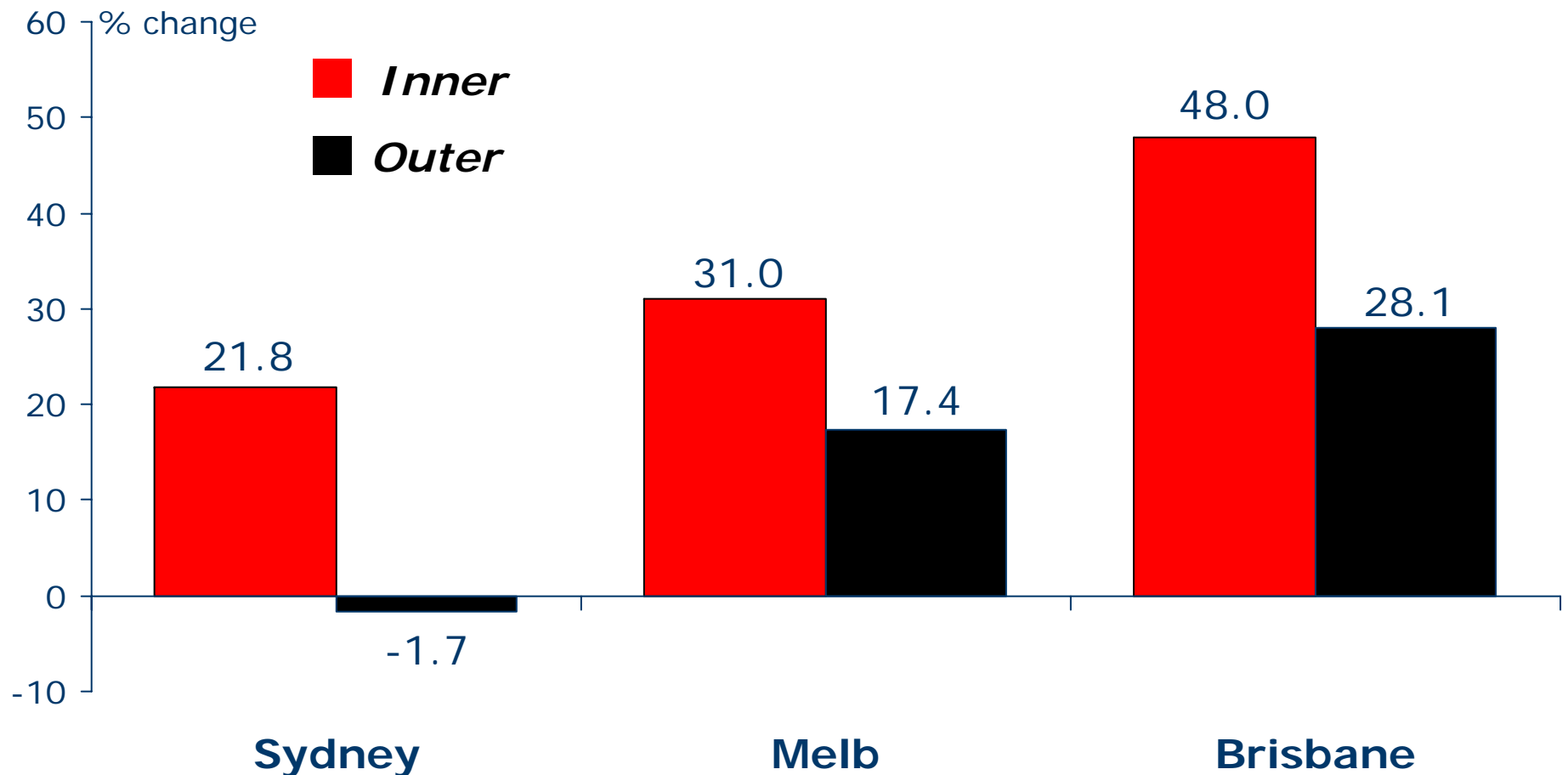
Sources: ABS, Economics@ANZ

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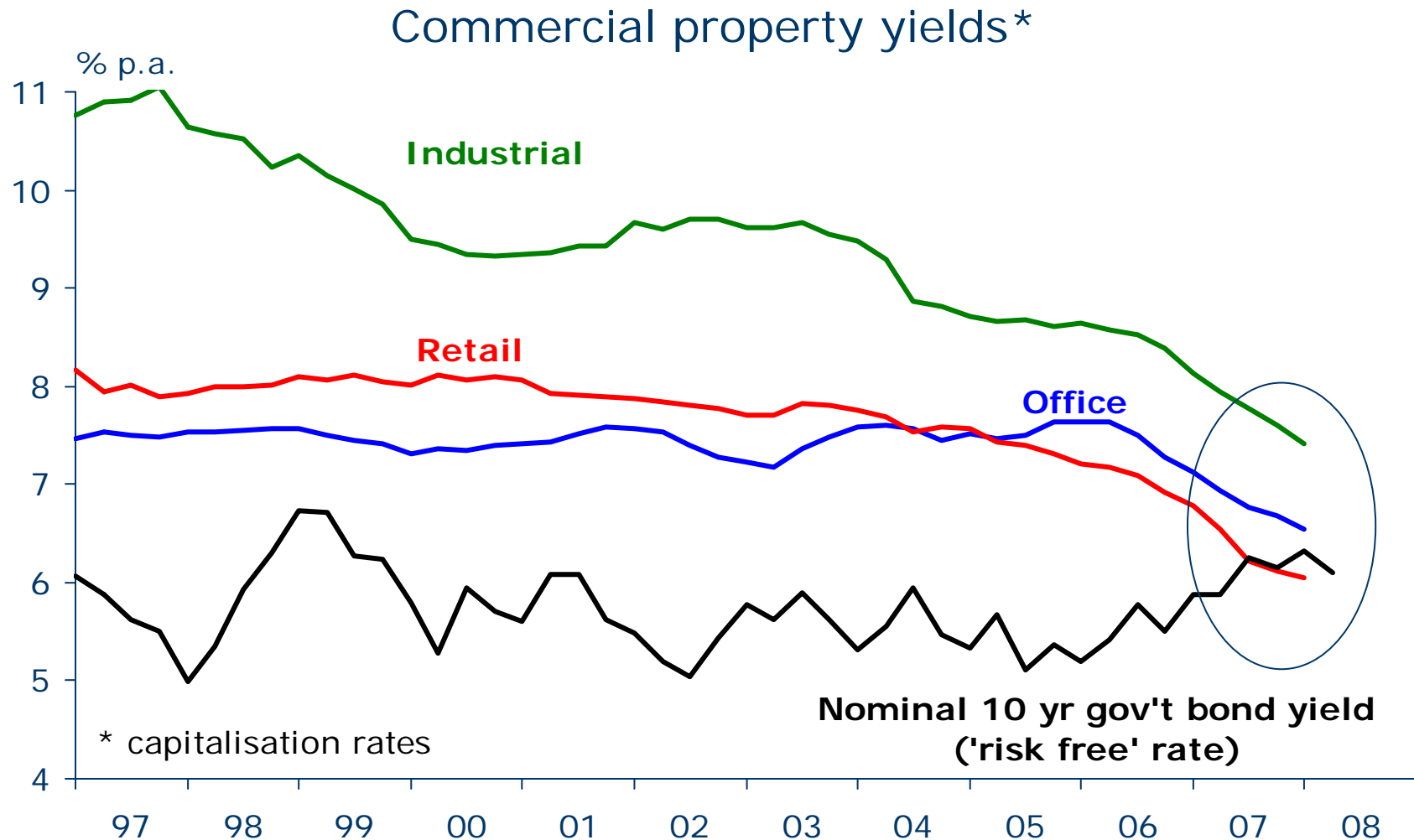
House price relativities between inner-city locations and outer-areas continue to widen ²⁴

% growth in house prices between 2004 and 2007



Sources: Residex, Economics@ANZ

Have commercial property yields fallen too far?

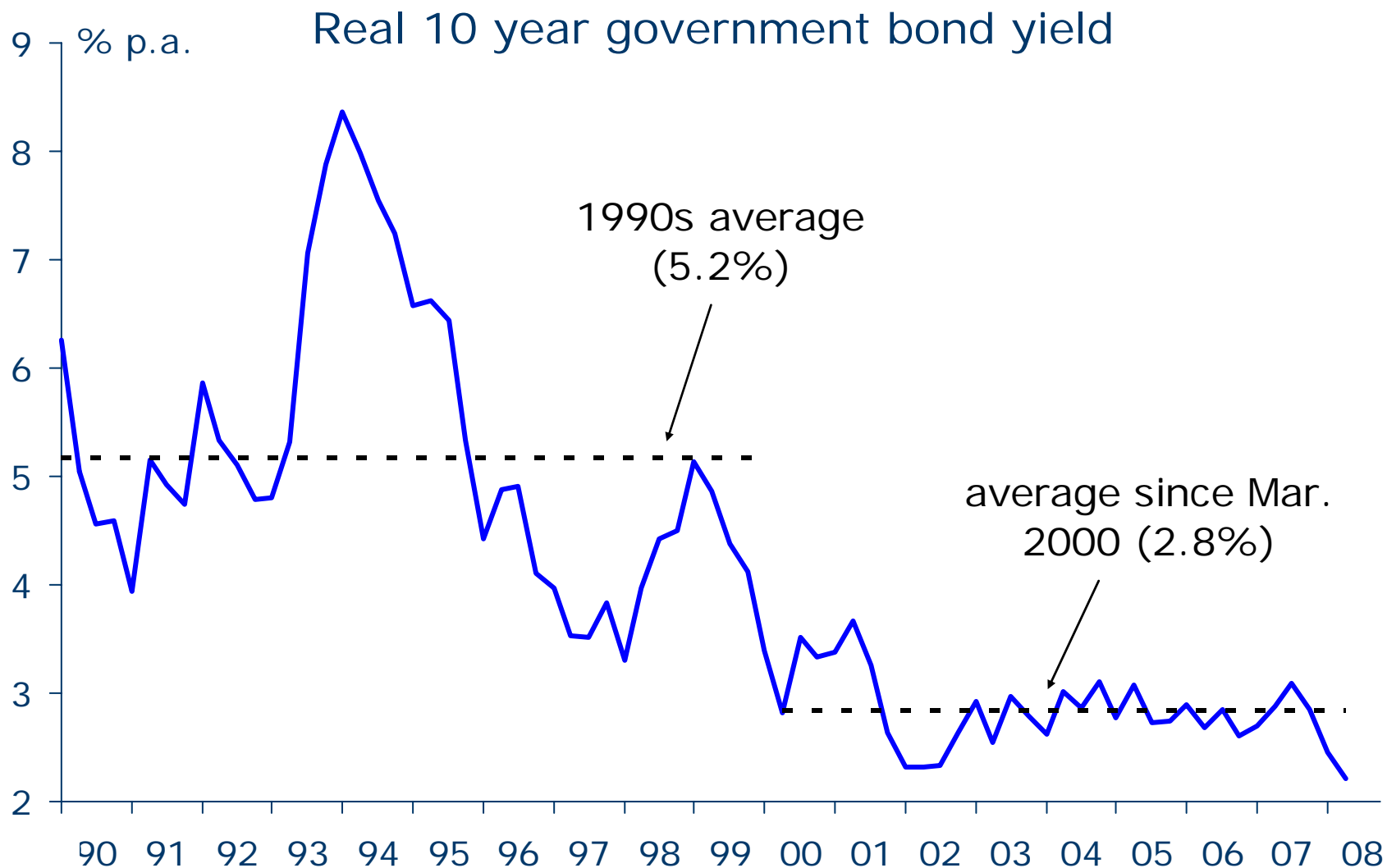


Source: IPD/PCA, Economics@ANZ

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We have witnessed a *structural* lowering of the *real* risk free benchmark in the past decade...

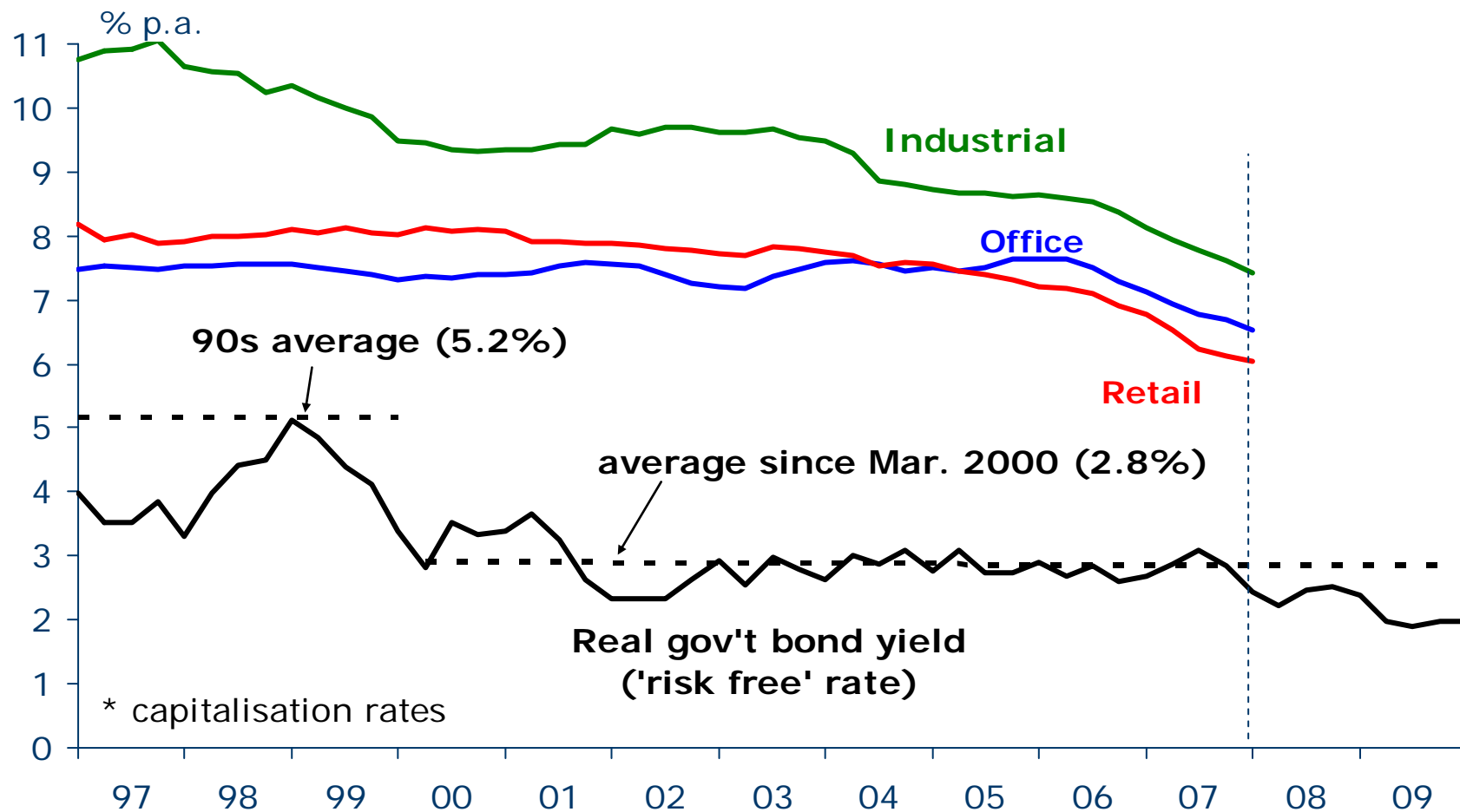


Source: RBA, ABS, Economics@ANZ
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...and falls in commercial property yields have been broadly in line with the decline in the 'risk free' benchmark

Commercial property yields*

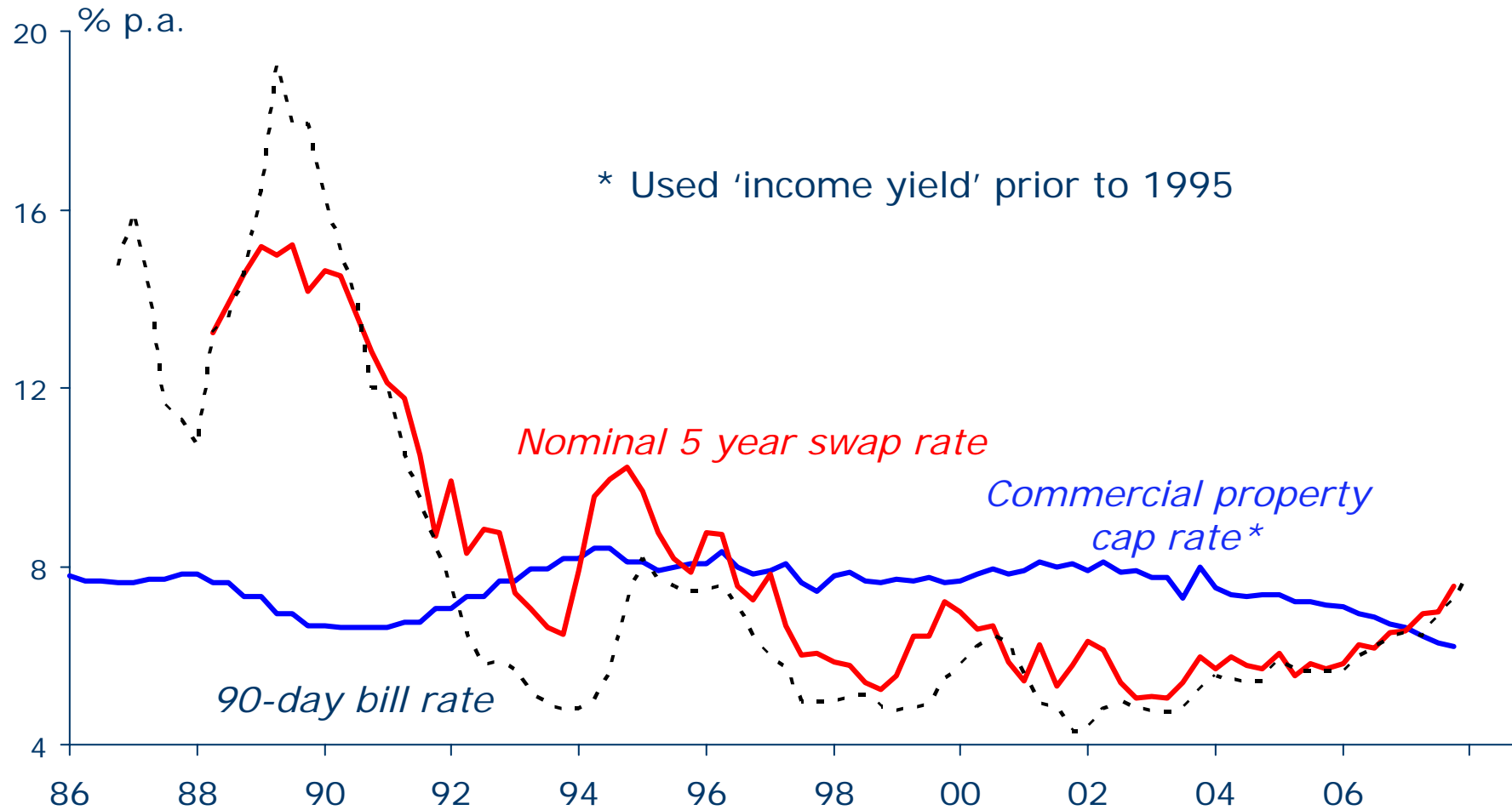


Source: IPD/PCA, Economics@ANZ



Nominal funding costs up while cap rates firming

Australian commercial property yields vs funding costs

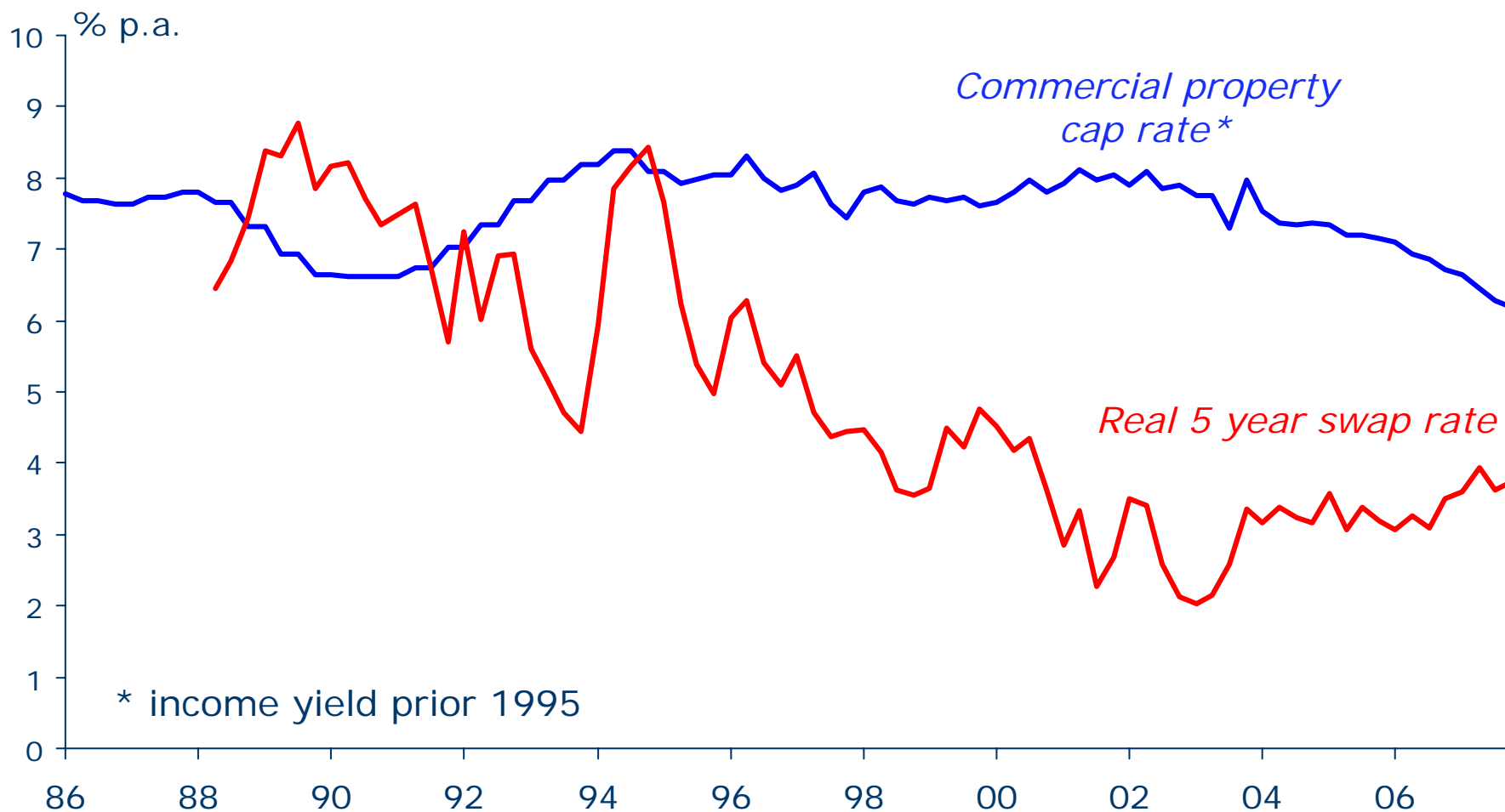


Source: Property Council/IPD, RBA, ABS, Economics@ANZ
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...but in real terms rise in cost of LT funds has been less dramatic and are still well below early 1990s levels

Australian commercial property yields vs funding costs

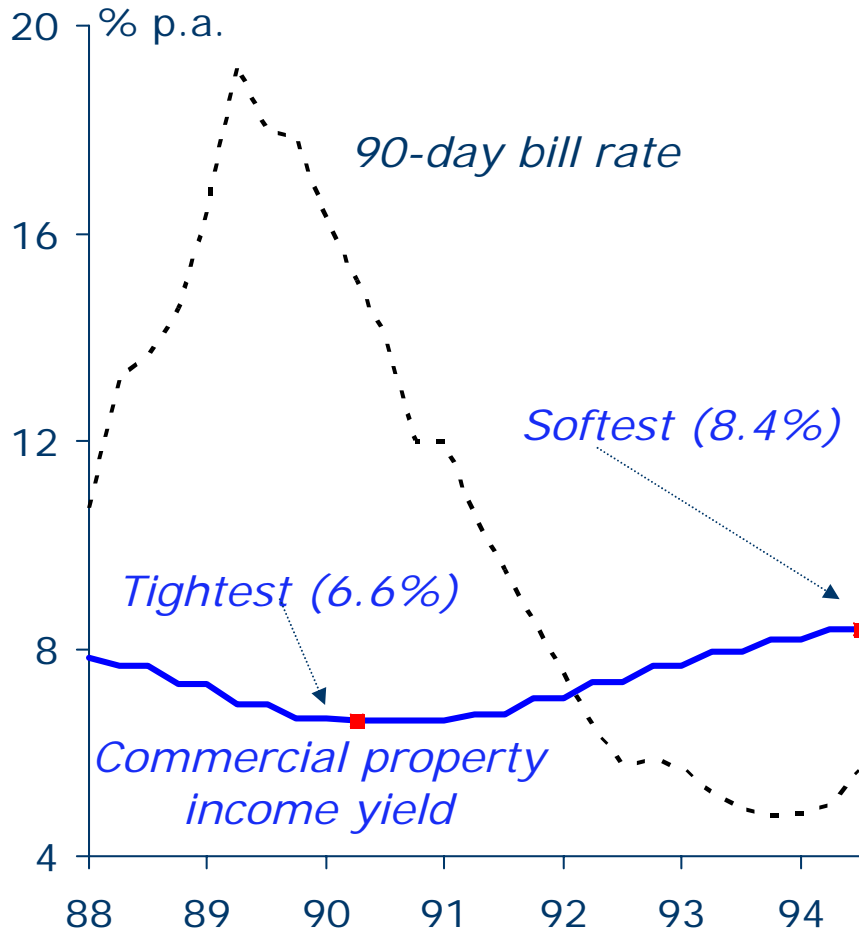


* income yield prior 1995

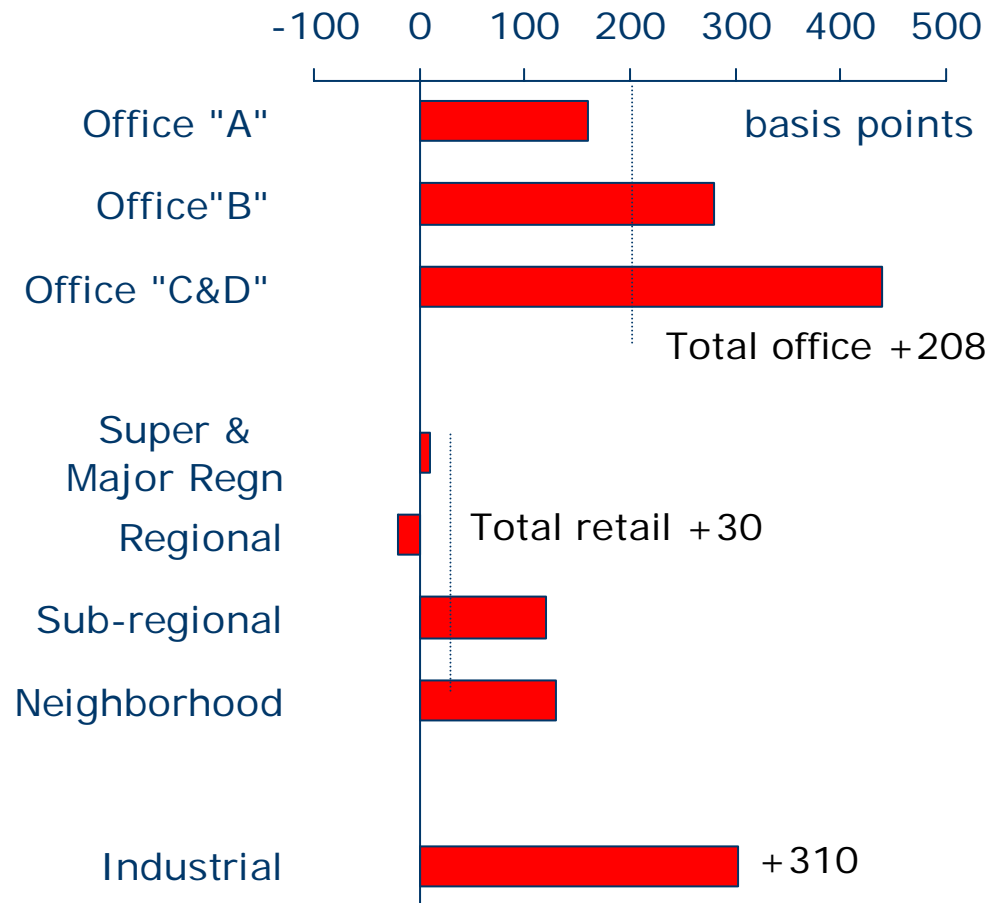


Recession, higher gearing and much higher interest rates (than now) saw income yields blow out 180bp

Composite income yield



Income yield change between 1990 and 1994



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

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Softening in yields expected but will be tempered by positive economic and market fundamentals

There is plenty of underlying support for cap rates

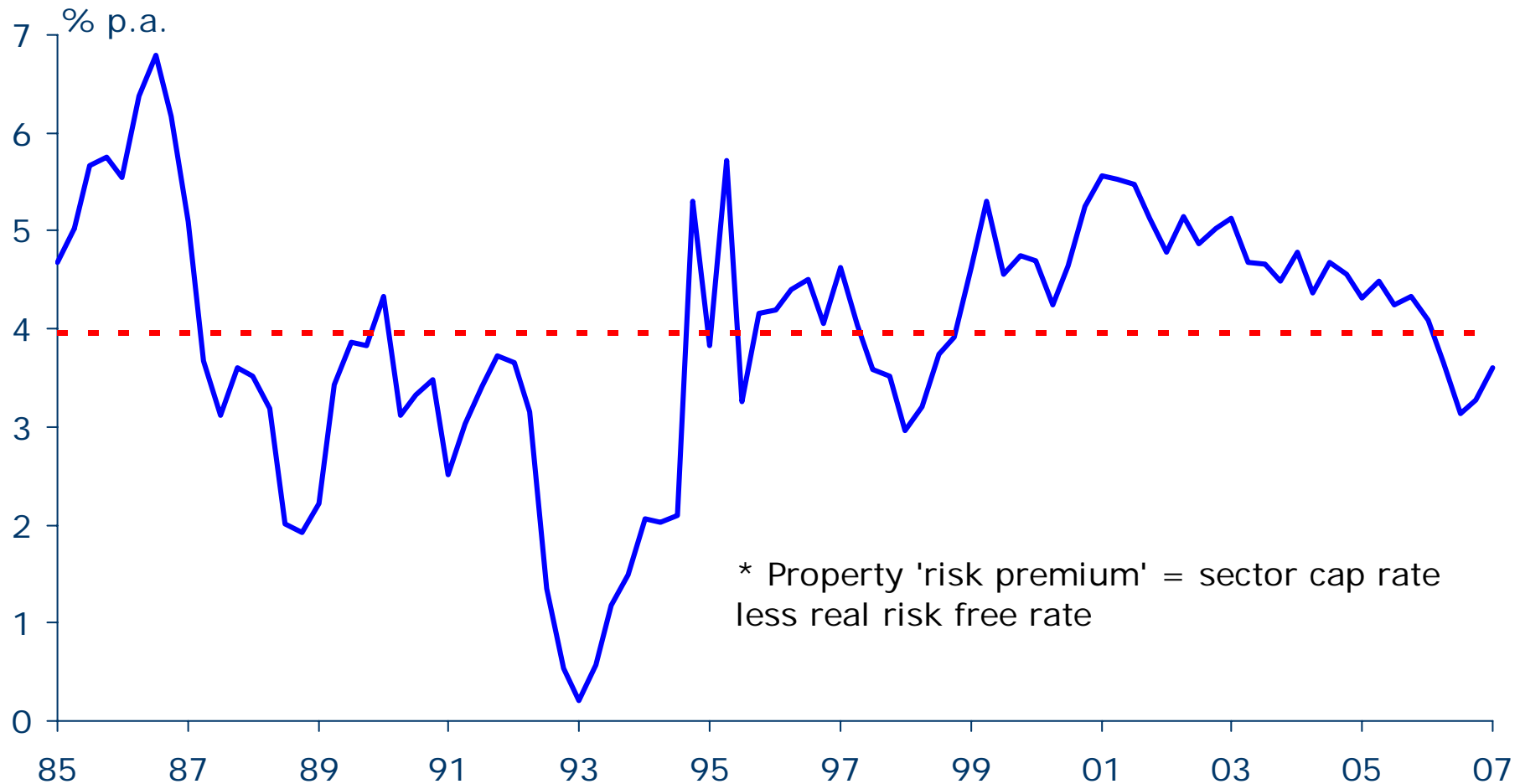
- Economy and labour market growth expected to remain healthy
- Property risk premium valuation tool suggests values are around where they should be given long-term real risk-free rate. Office markets are in a relatively more favourable position (PRP still above long-term average).
- Sound underlying property asset market fundamentals. Apart from tight demand/supply balance, quality of rental flow is underpinned by solid business conditions and retail spending.

Despite the solid underpinnings, scope for some softening in yields

- Rise in cost of funding has reduced attractiveness of geared investments. Rise in real terms however, has been measured and pales into insignificance compared to late-1980s experience
- Some 'stressed' sales likely (LPTs) but will not be deep enough to set new benchmarks for broader market, particularly prime quality buildings.
- Expect 10-25bp for prime and 25bp to 50bp for secondary over next 6-18 months. Positive rental growth over this period minimises price declines.

Retail 'property risk premium' has moved below it's long-term benchmark

Australian retail 'property risk premium'*

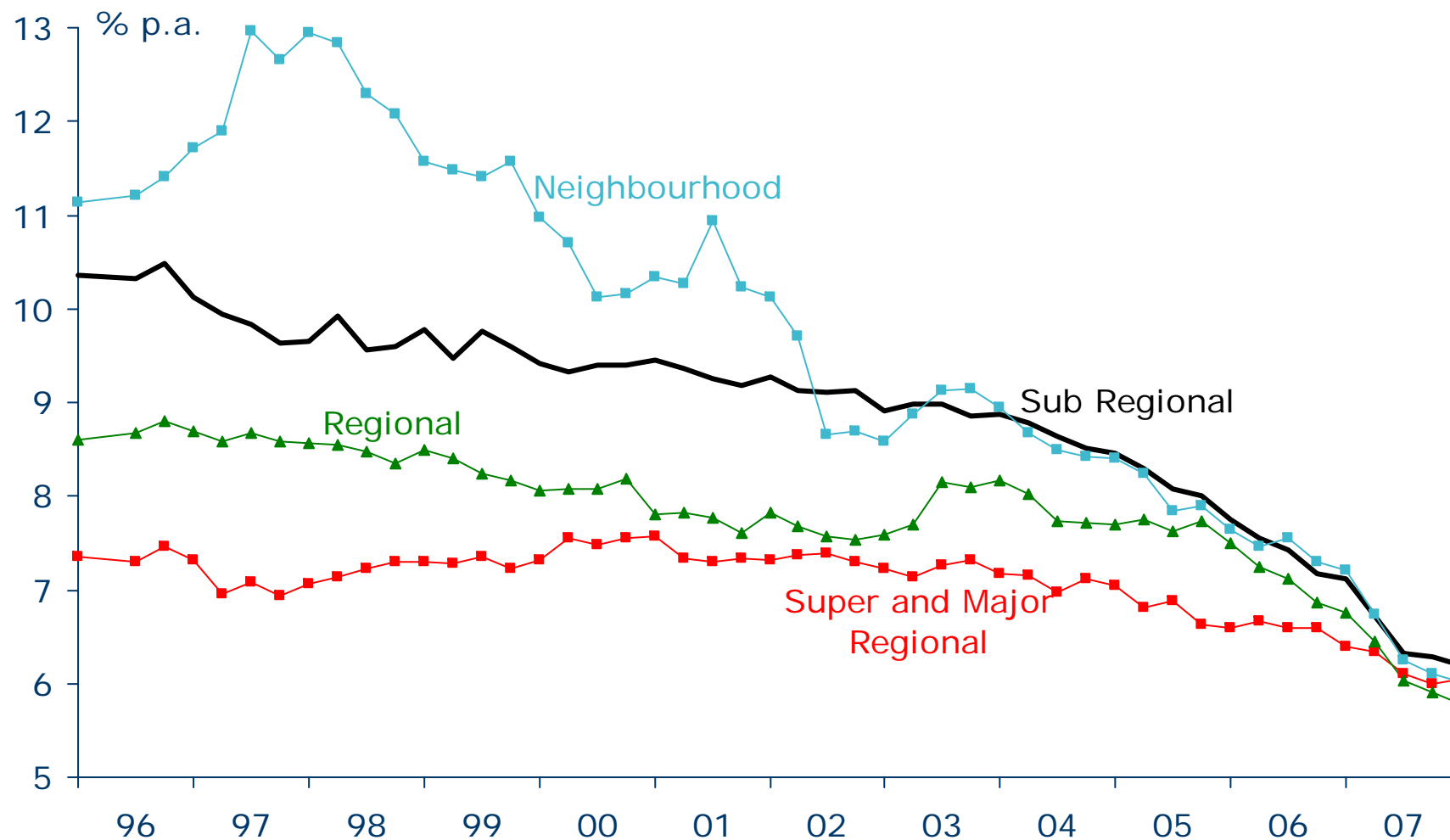


Source: Property Council, Economics@ANZ
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Retail yield compression has been most marked at the smaller end of the market

Australian Retail by Size - Yield

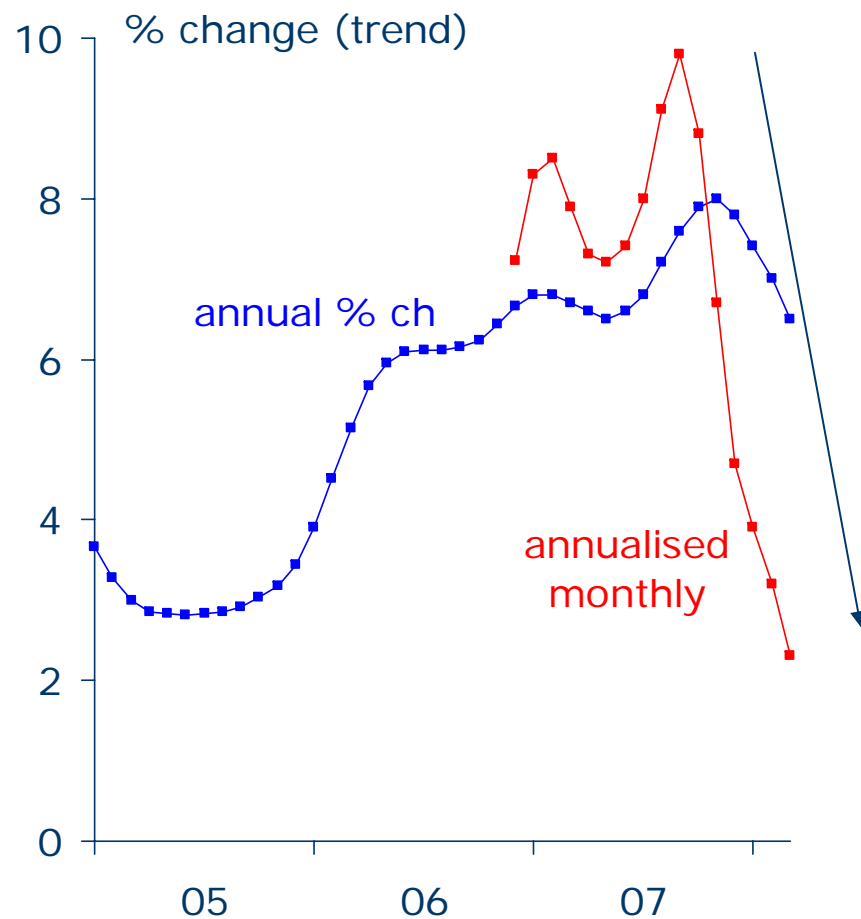


Source: Property Council, Economics@ANZ
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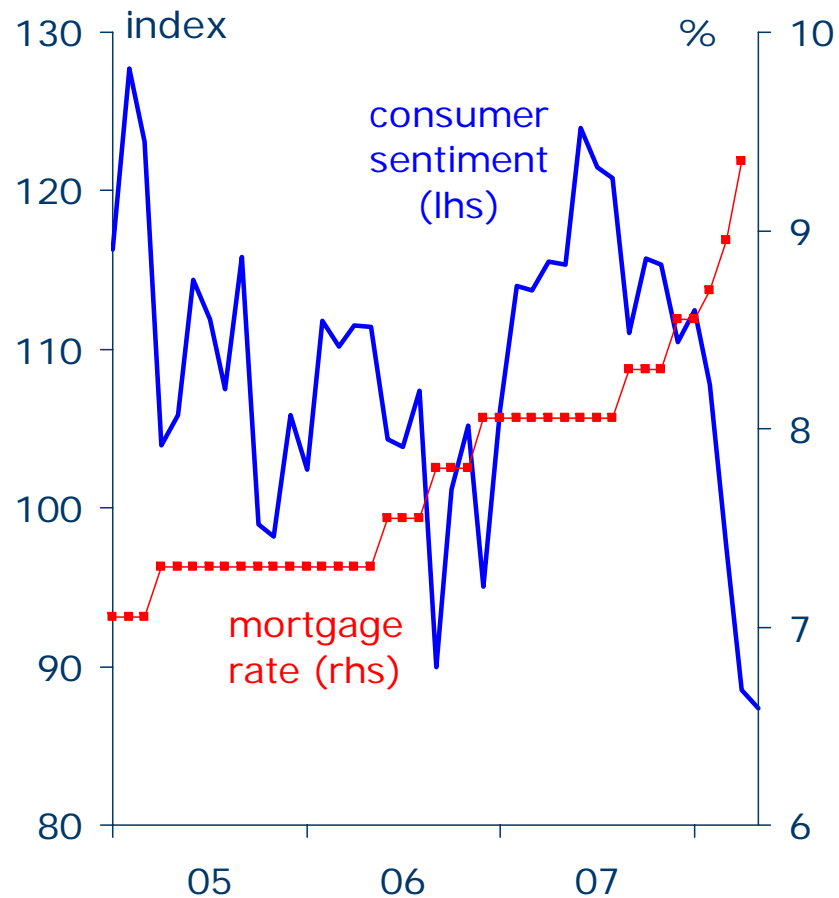


There are early signs that retail sales are softening as interest rates rise and sentiment softens

Retail sales

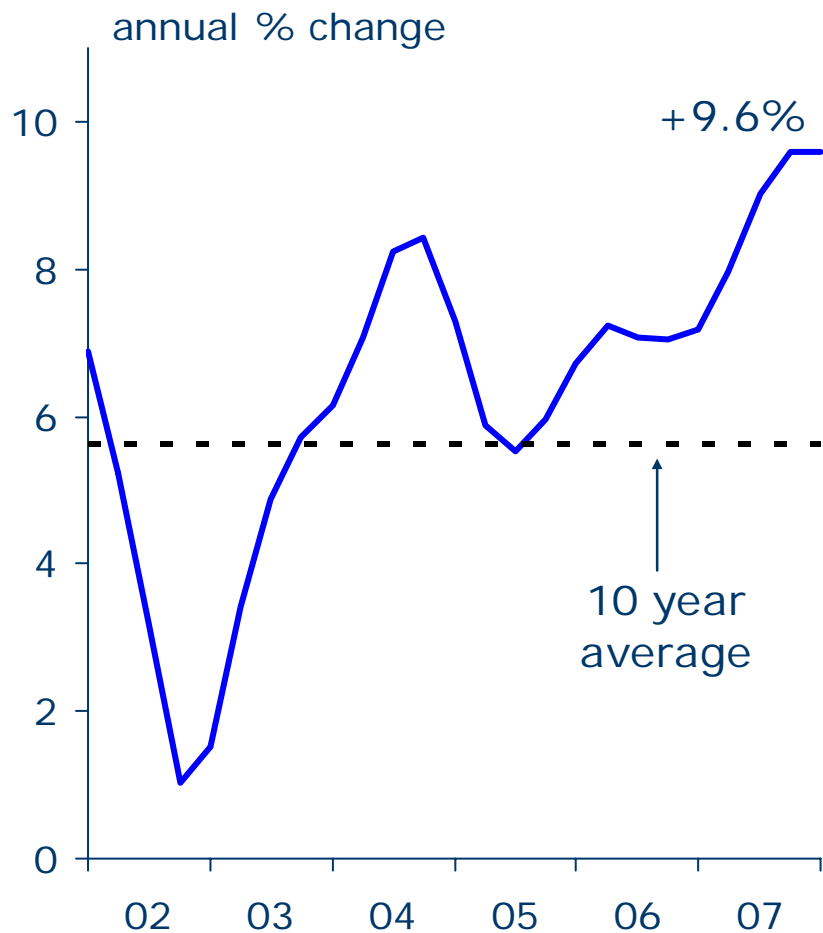


Consumer sentiment & interest rates

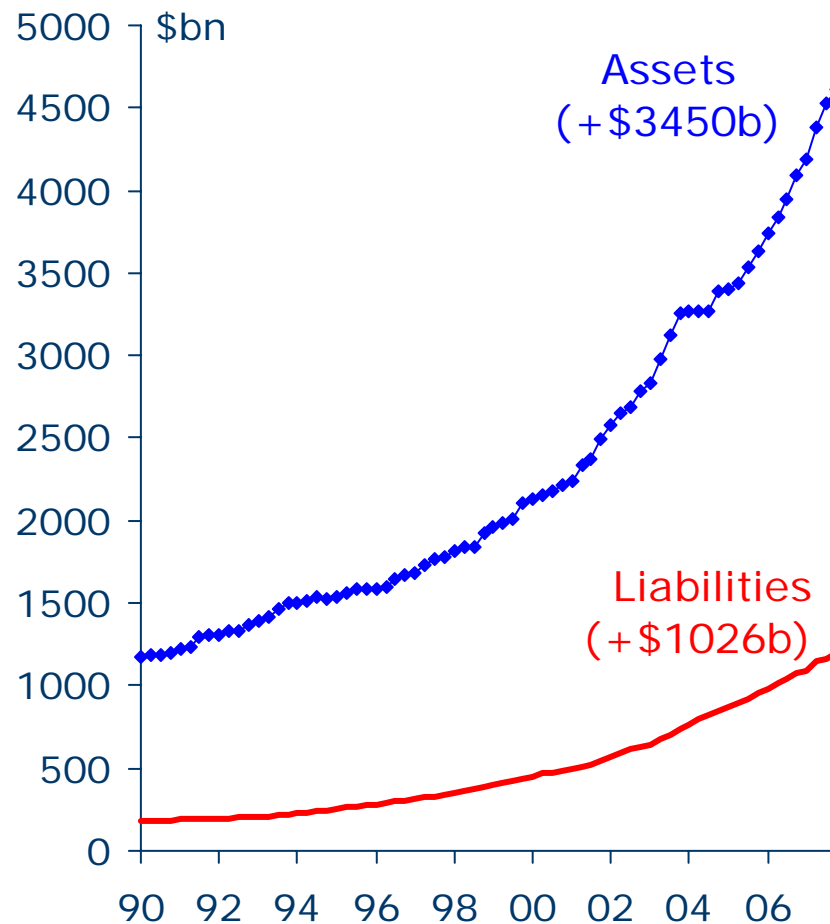


But despite widespread doomsday commentary, the household sector remains *very well placed*

HH disposable income



HH balance sheet

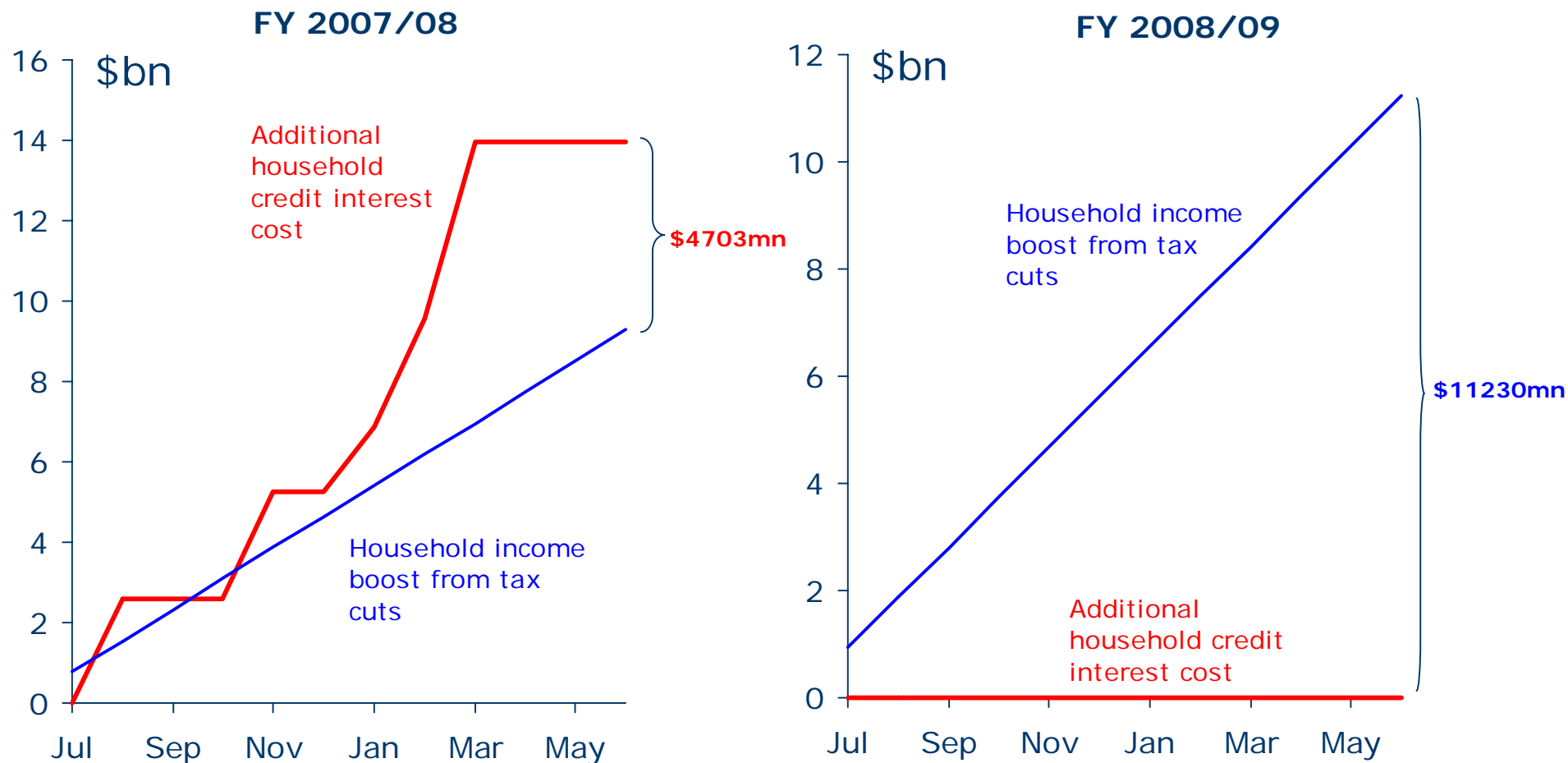


Source: ABS



And although hikes will be restrictive in 2007/08 these will be more than offset in 2008/09

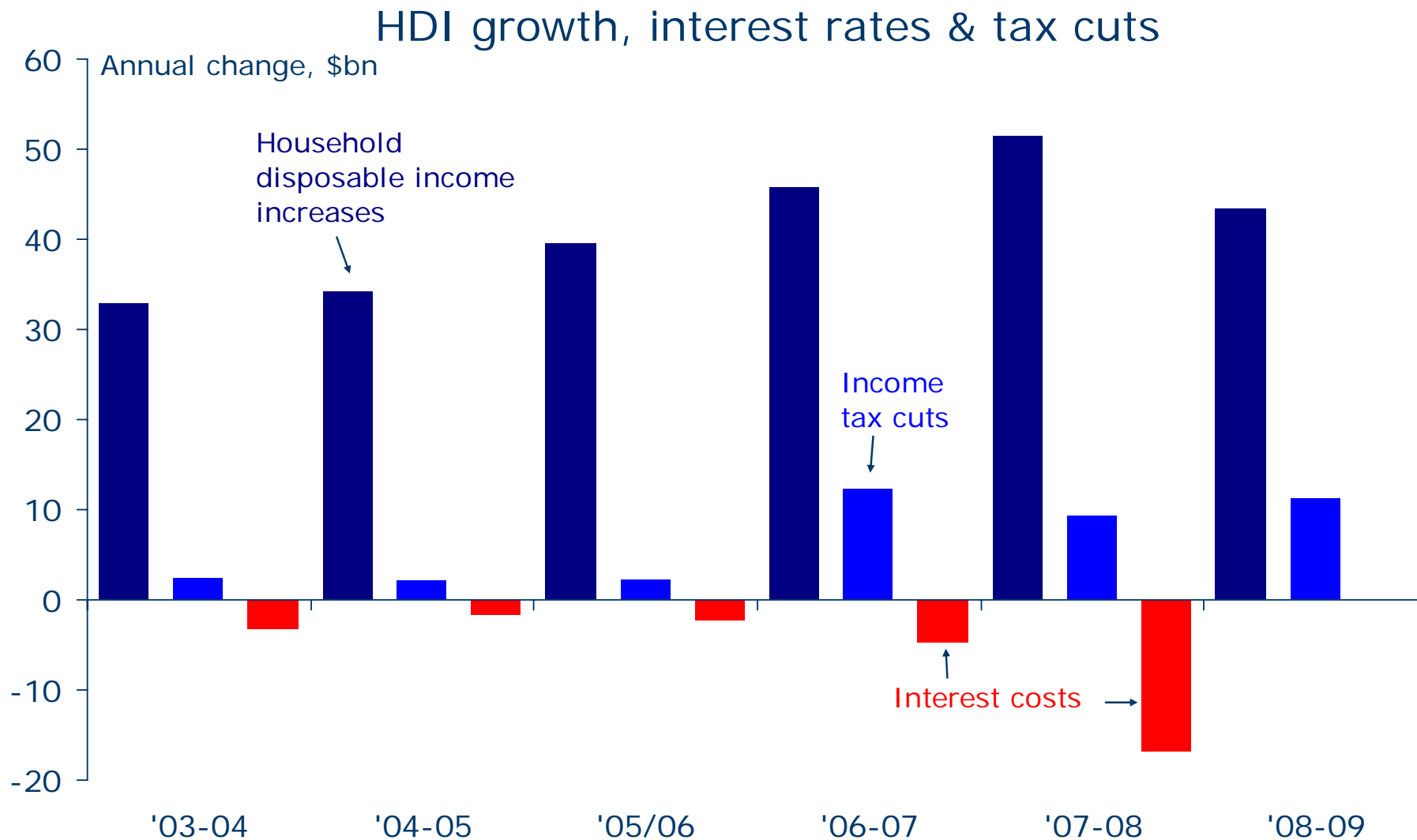
Interest rates versus tax cuts



Sources: Australian Bureau of Statistics; Economics@ANZ.
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However, household disposable income growth has easily offset the monetary tightening

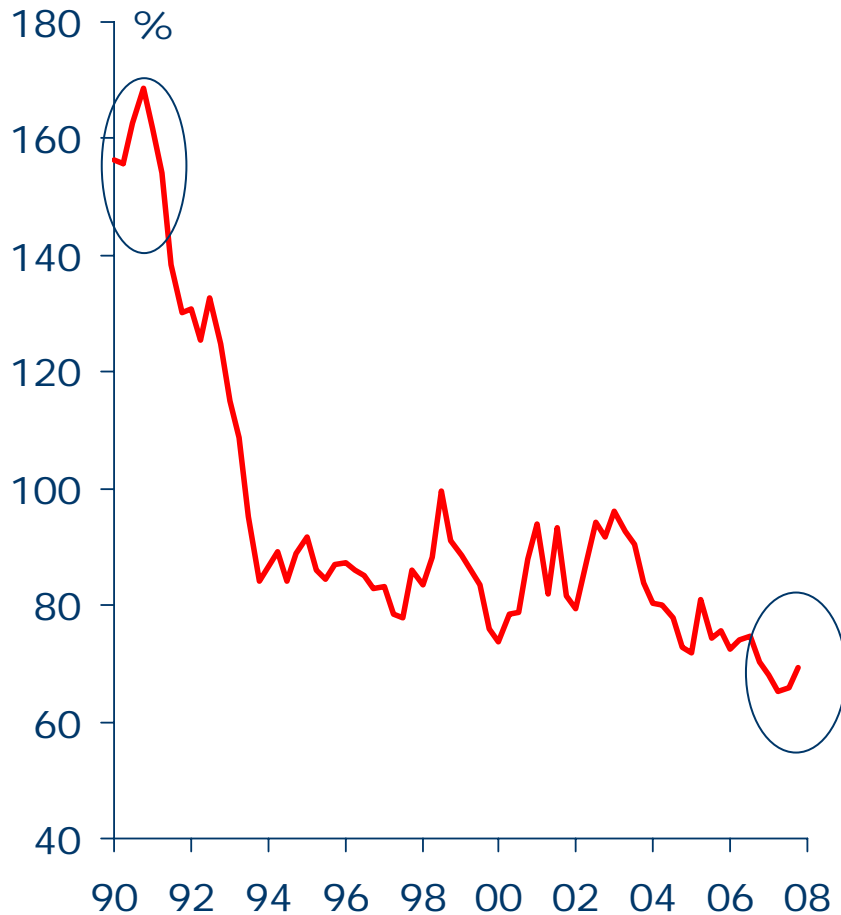


Sources: Australian Bureau of Statistics, RBA and Economics@ANZ
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Moreover, corporate balance sheets are far better shape than the late 1980s

Corporate Gearing Ratio

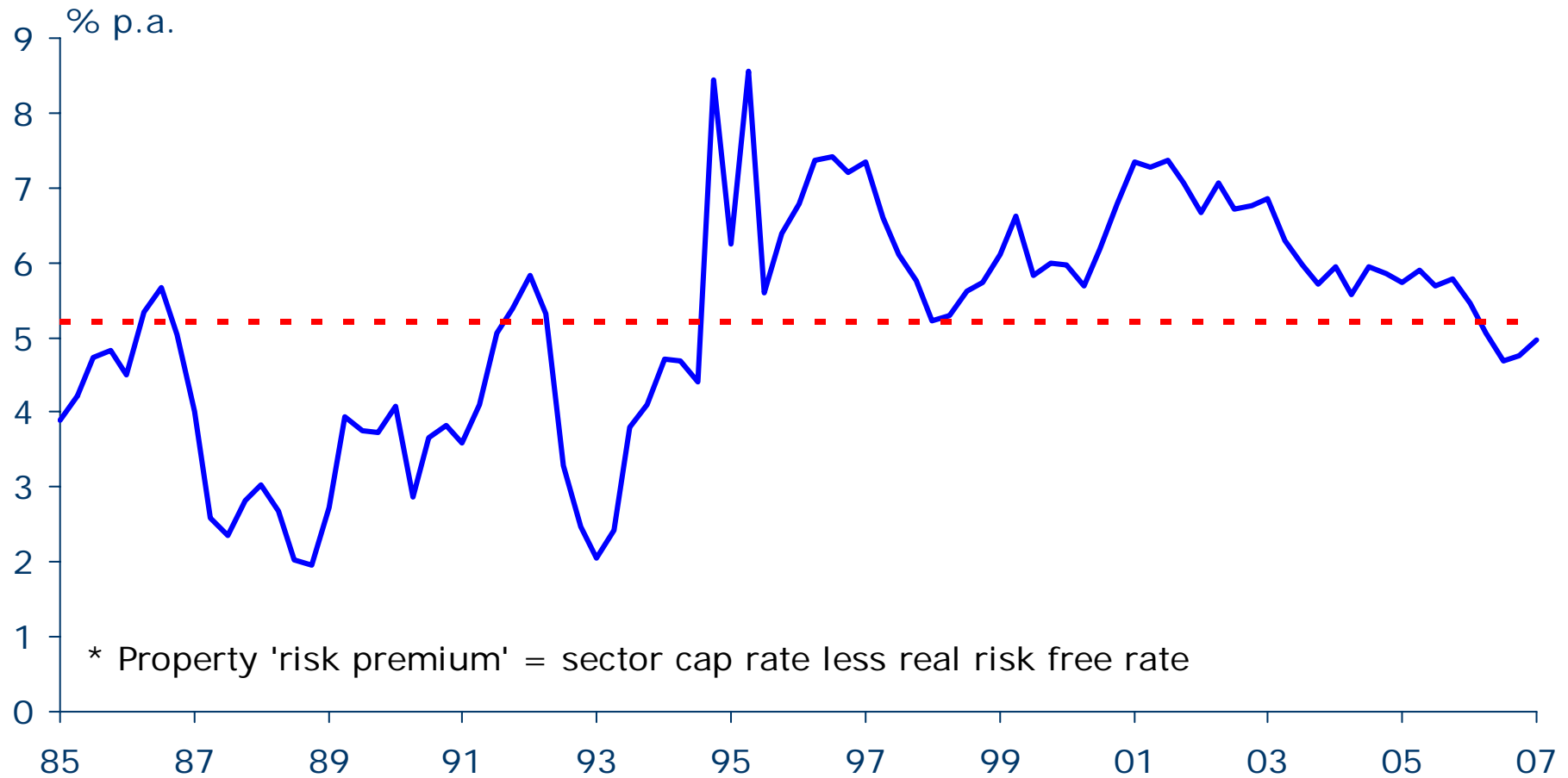


Corporate interest cover



Industrial property near 'fair' value

Australian industrial 'property risk premium'*

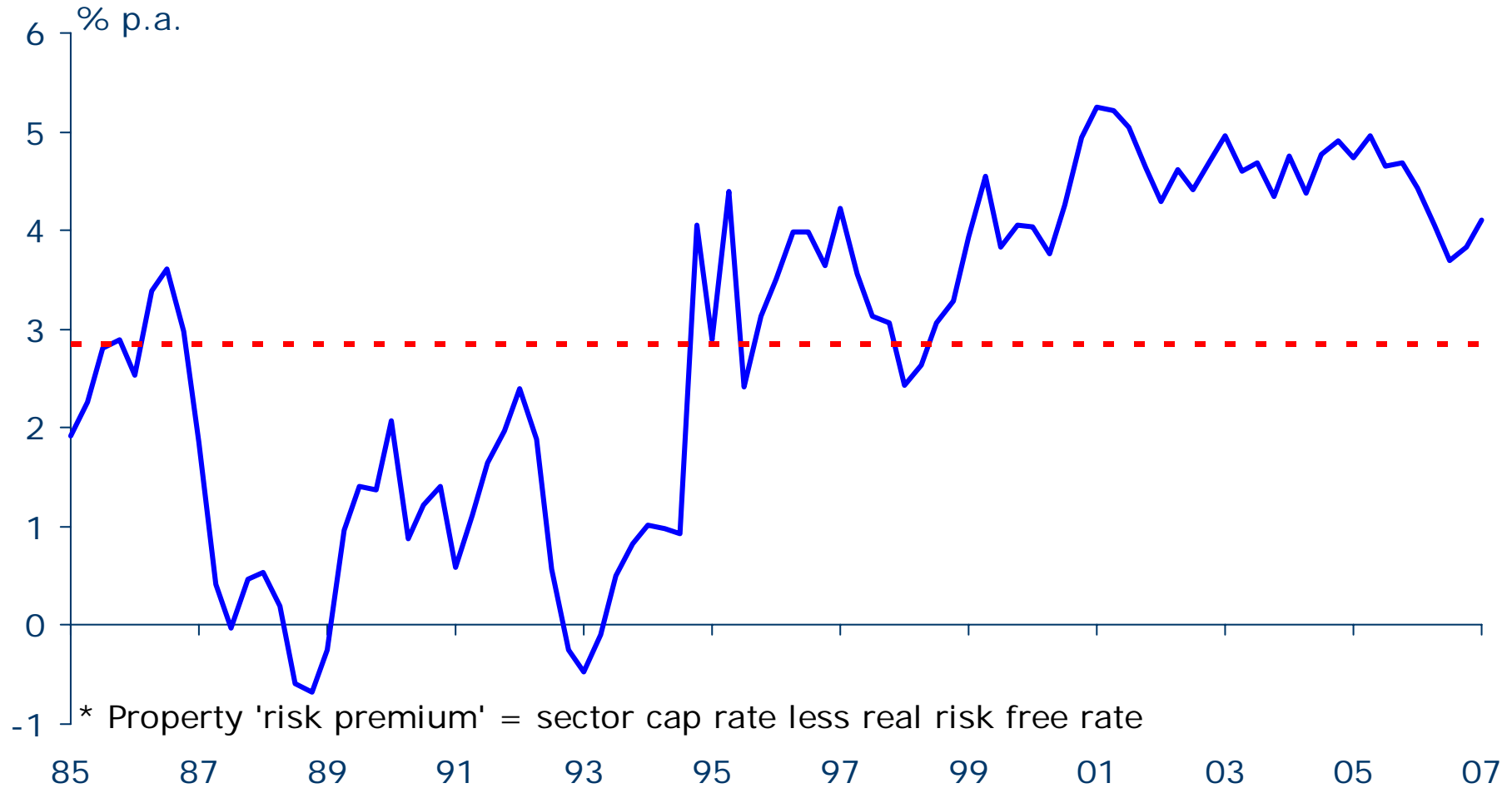


Source: Property Council/IPD, RBA, ABS, Economics@ANZ
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...but office property remains well placed

Australian office 'property risk premium'*

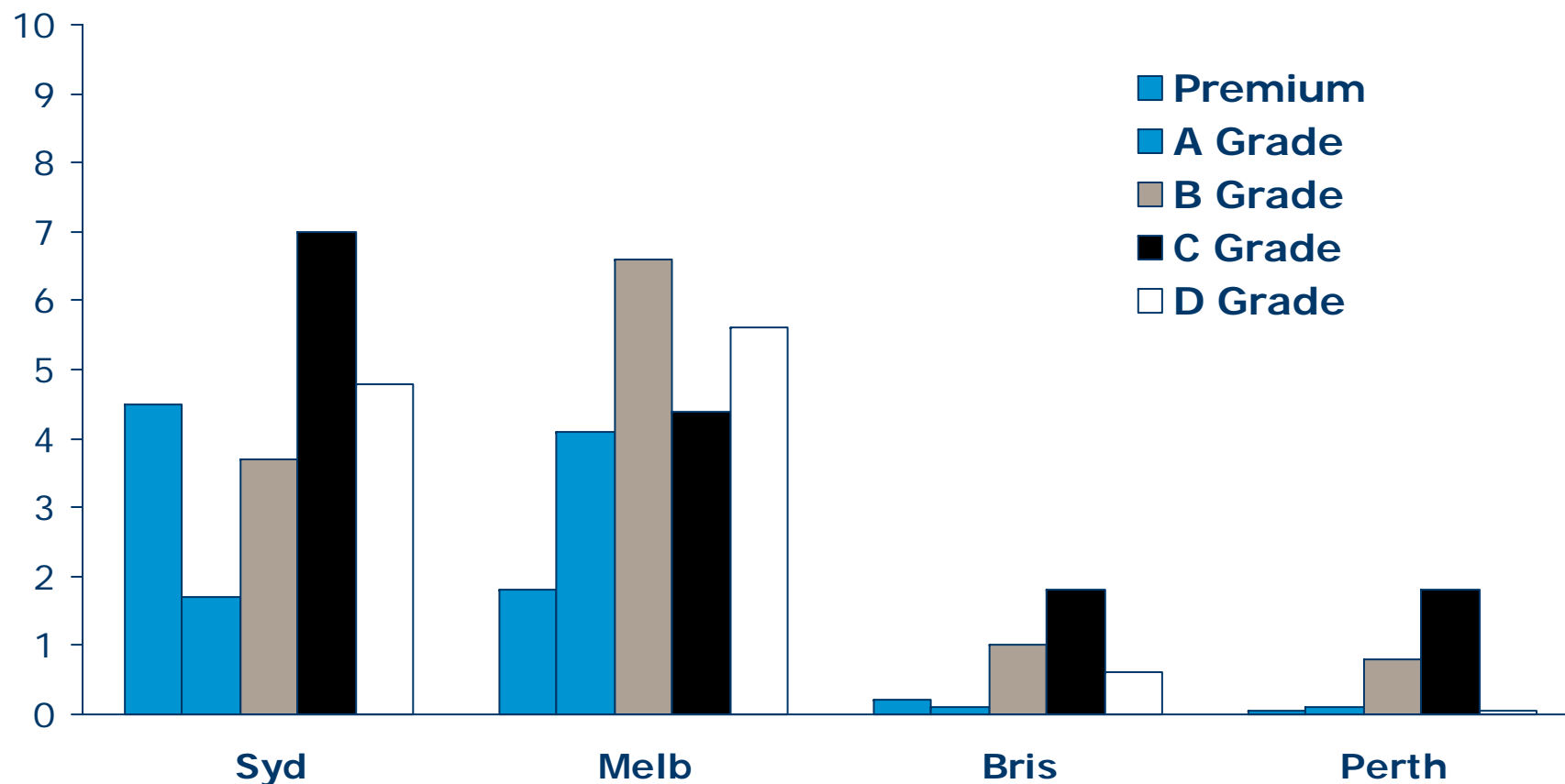


Source: Property Council/IPD, RBA, ABS, Economics@ANZ
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CBD office market fundamentals generally tight across quality grades, especially in 'resource' capitals

CBD Office vacancy rates

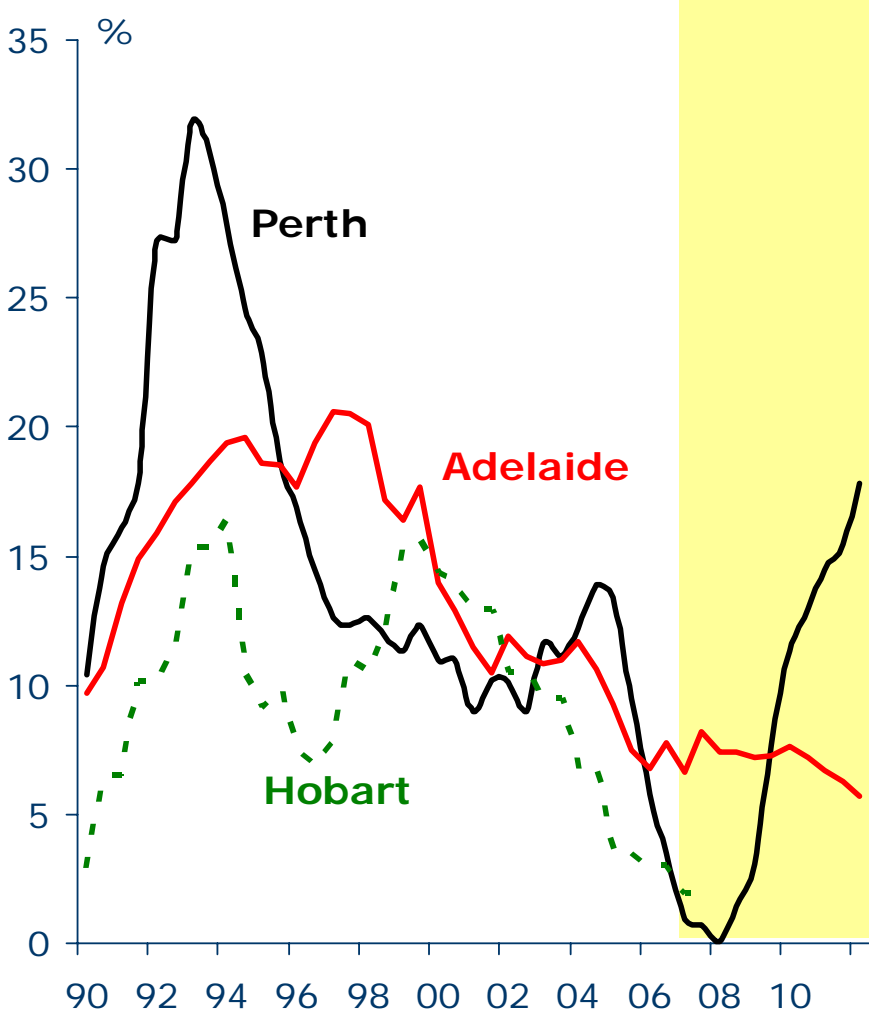
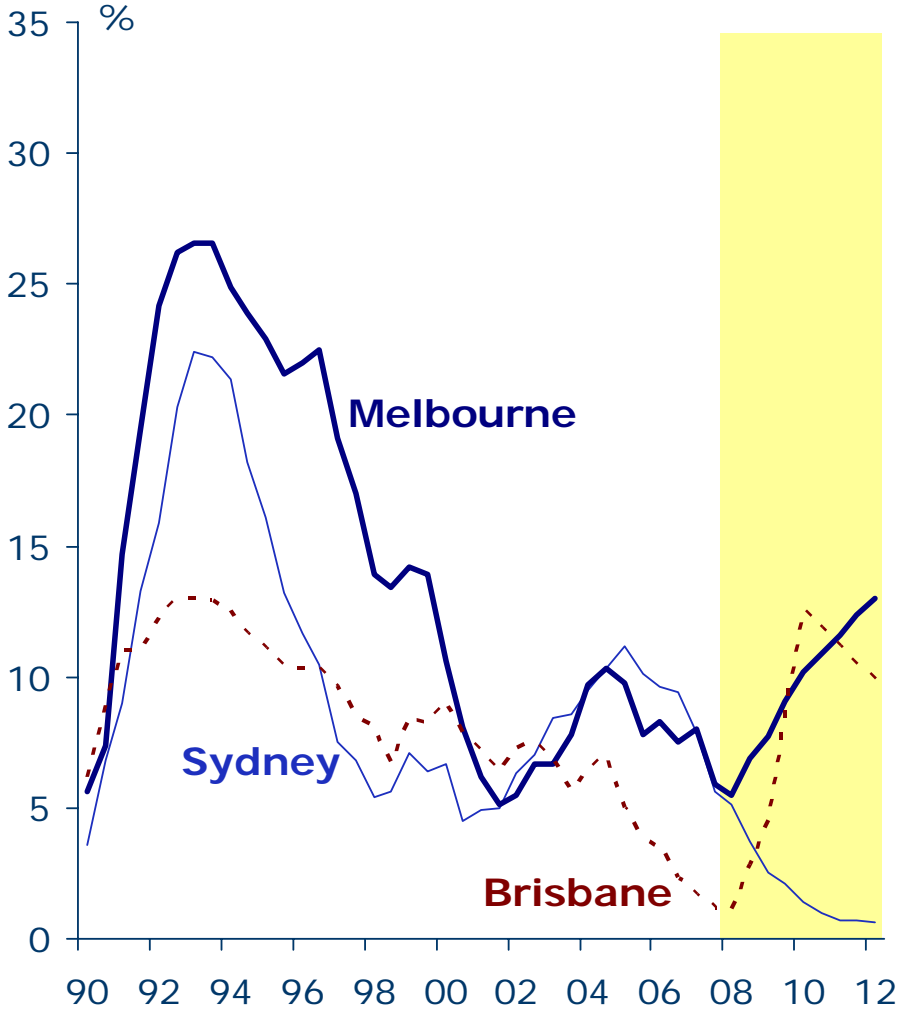


Source: Property Council of Australia, office market report
Relationship Banking • Corporate Finance • Markets • Working Capital



Office market to remain tight over 2008 and 2009 but fundamentals will weaken at turn of decade

CBD Office vacancy rates



Summary: risks *have* risen but solid economic and property market fundamentals provide some insurance

Armageddon 'bandwagon' is gaining passengers

- Bearish sentiment building in US, finance sector and equity markets

But some perspective required

- Heightened risks, but Australian fundamentals still strong
- Funding remains a *pricing* issue

Australian prospects still tied to Asia

- Asian outlook, particularly China, remains solid
- Commodity prices and terms of trade still rising strongly
- Domestic growth slowing – but far from recession

Property market fundamentals are *very* supportive

- Heading for a critical (and intractable) shortage of housing
- Commercial property very well placed cf late 80s

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LPT sector is sound but it needs to adapt to more risk averse environment

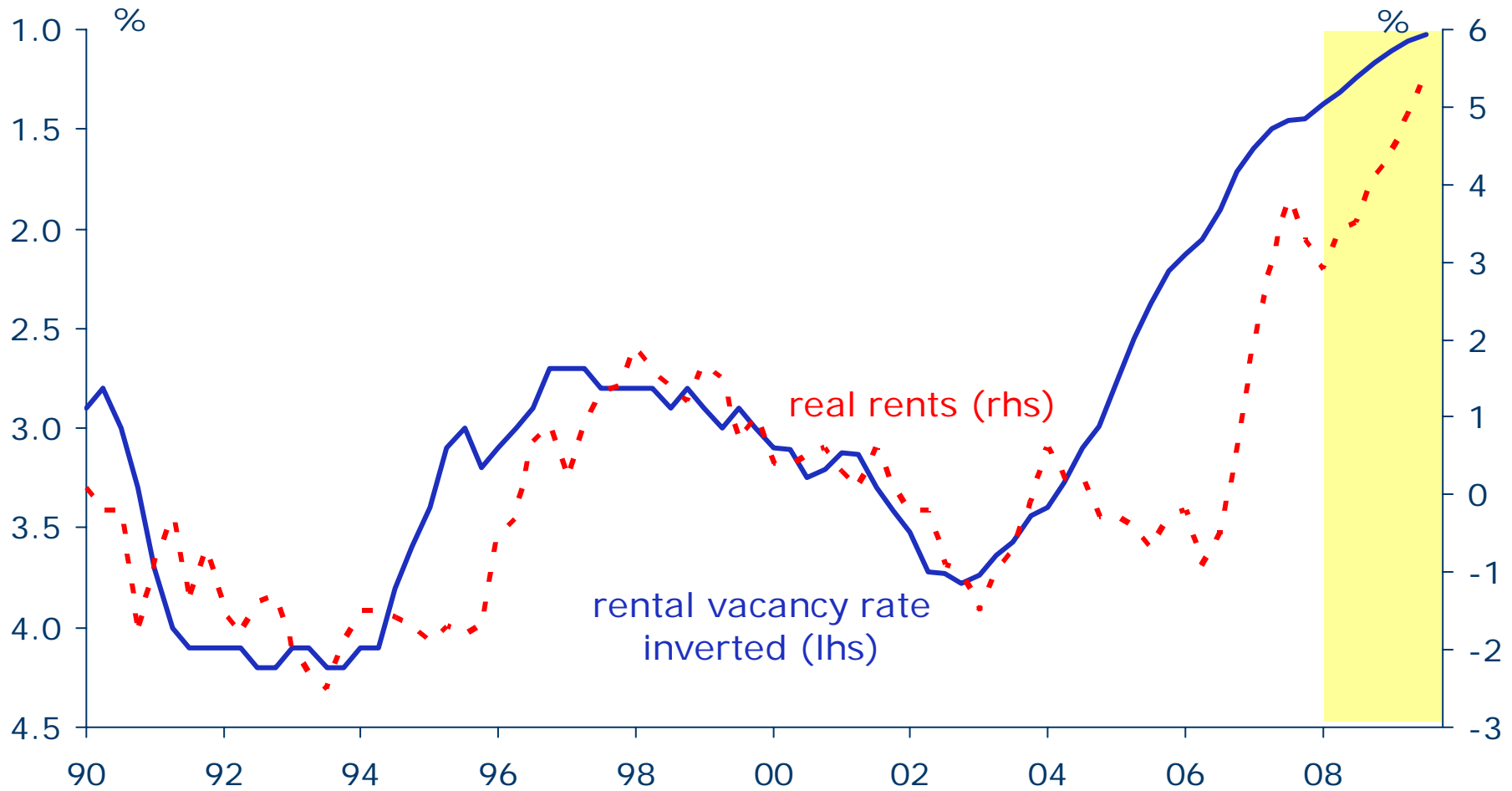
Summary

- Listed Property Trust sector taken a hit since the Centro “incident”
- Attention has shifted to gearing levels, liquidity levels and fund structures.
- Unsettled financial market has stalled issuance, likely to create pent-up demand for funds for expansion over next year or so.
- Underlying property asset market fundamentals remain sound. Quality of rental flow is underpinned by solid business conditions and retail spending. Any ‘stressed’ sales are likely to be minimal and offshore.
- Trusts will be consolidating balance sheets (deferring development, raising equity e.g. rights issues), creating more balance sheet and fund structure transparency. Its all about perceptions.
- Urgency of adapting to new environment varies within the sector depend upon refinancing requirements in 2008 and condition of balance sheet.
- Short-term funding costs to rise but this is second order issue compared to securing rollover of existing debt.
- Opportunity for bank (on-balance sheet) finance to this sector

Source: PIR, UBS reports and Economics@ANZ

...which is already forcing rents sharply higher

Rental vacancy rate vs. real rents

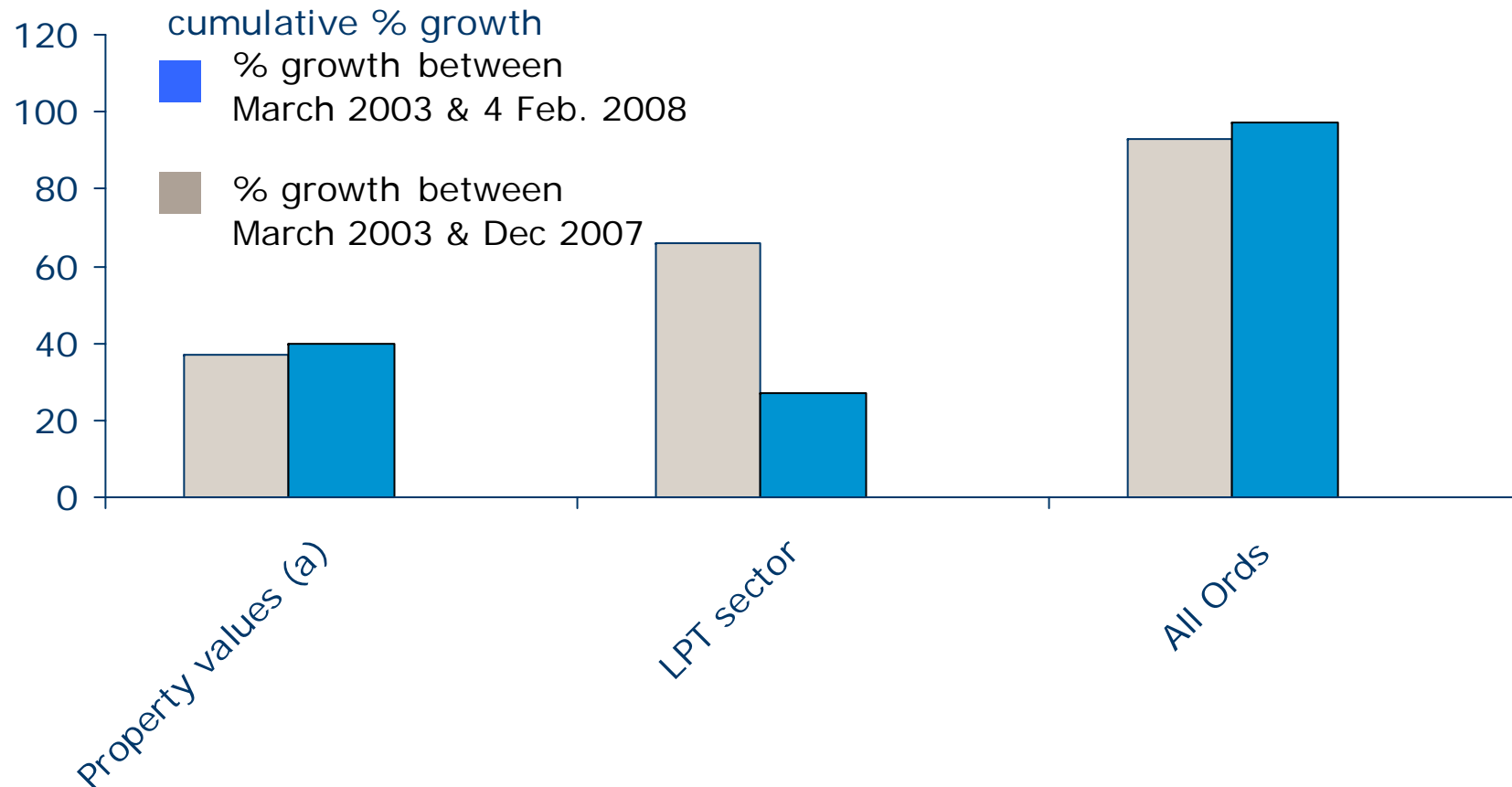


Sources: Economics@ANZ; ABS, REIA



Correction in LPT sector market value has been substantial

Market performance



(a) Estimated December 2007 and March quarters 2008

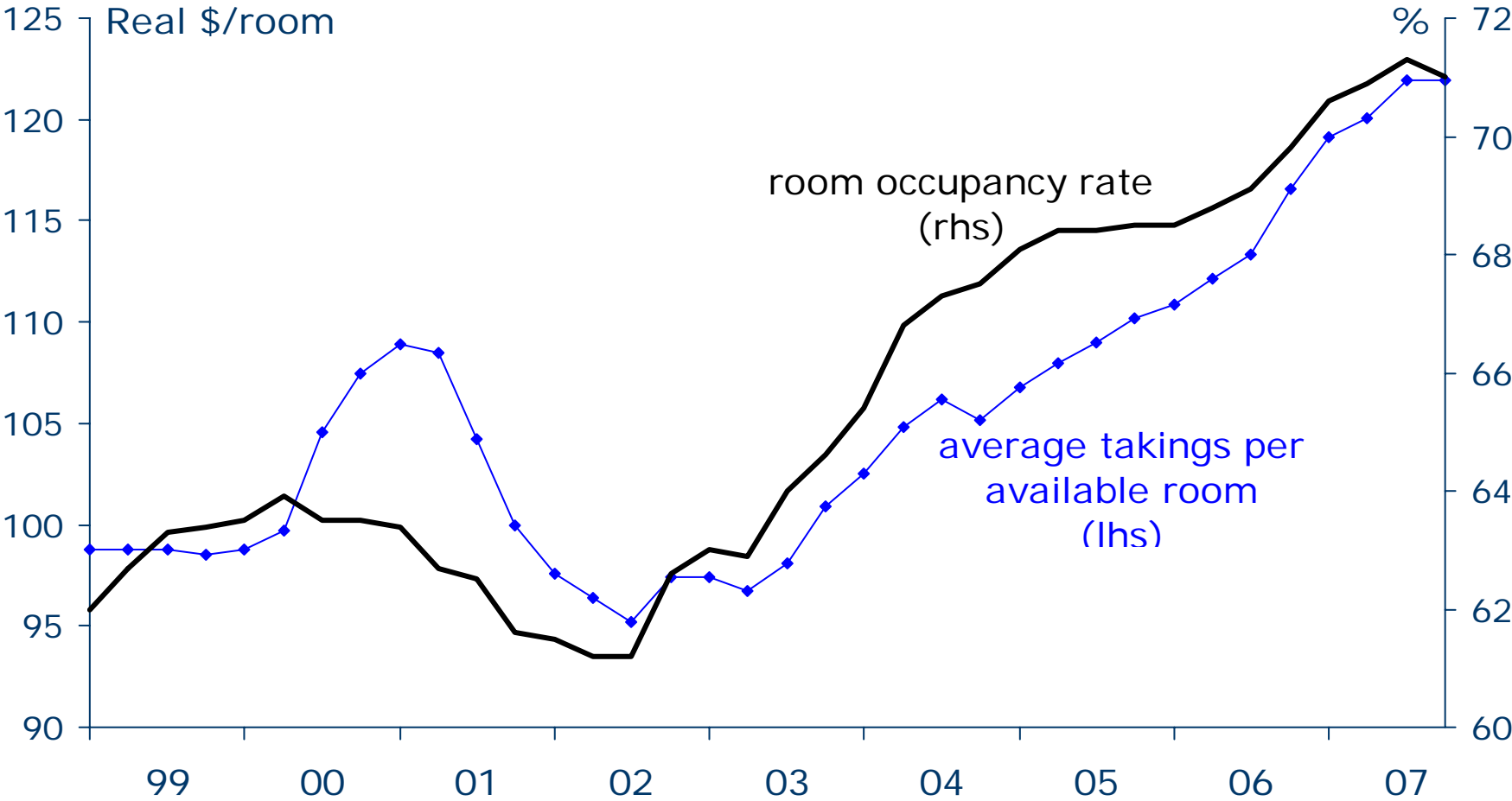
Source: IPD, ASX and Economics@ANZ

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Tightening room availability has boosted average hotel room takings

Hotel occupancy rates vs. average takings

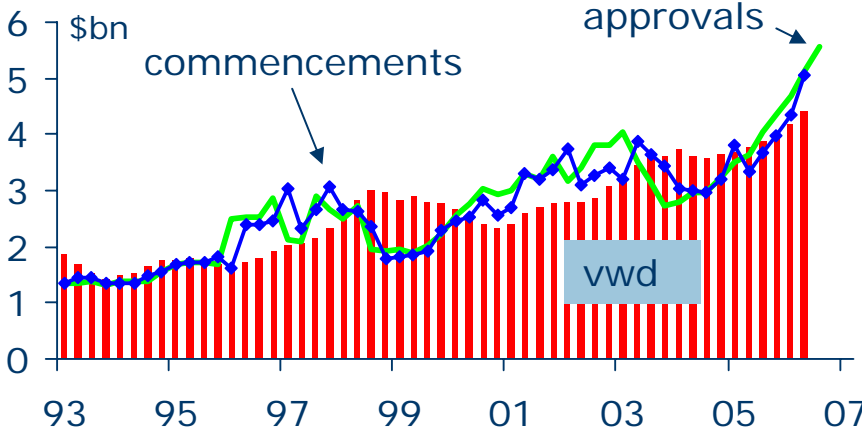


Sources: ABS, Economics@ANZ

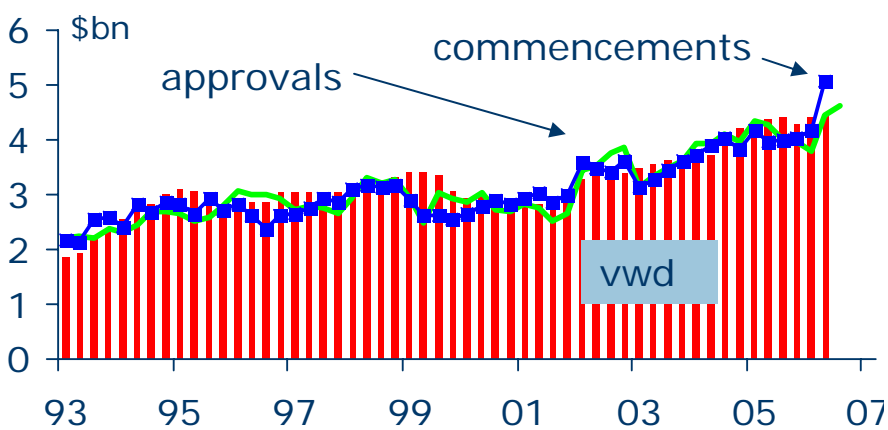


Office and retail building strengthening while hotels soften

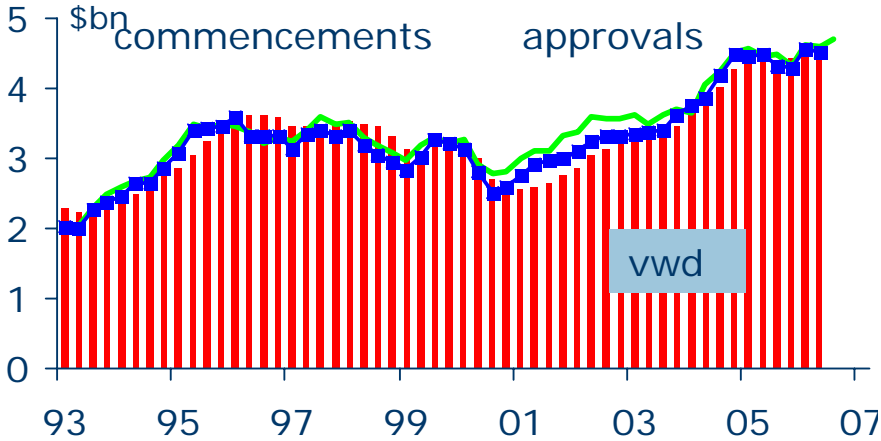
Office



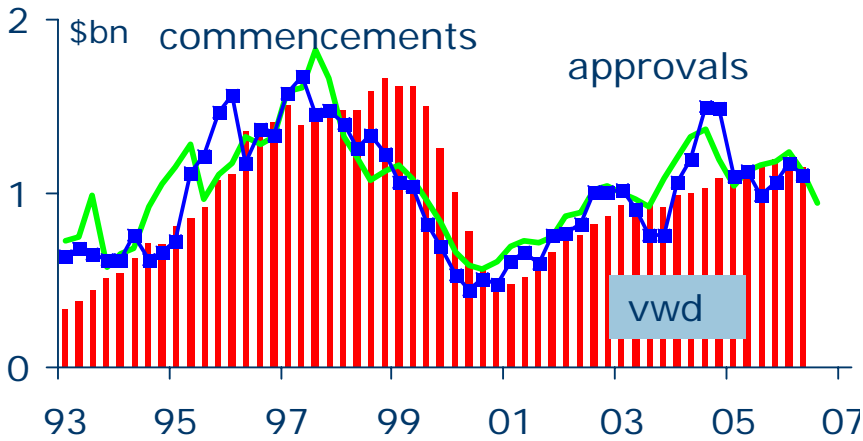
Retail



Industrial

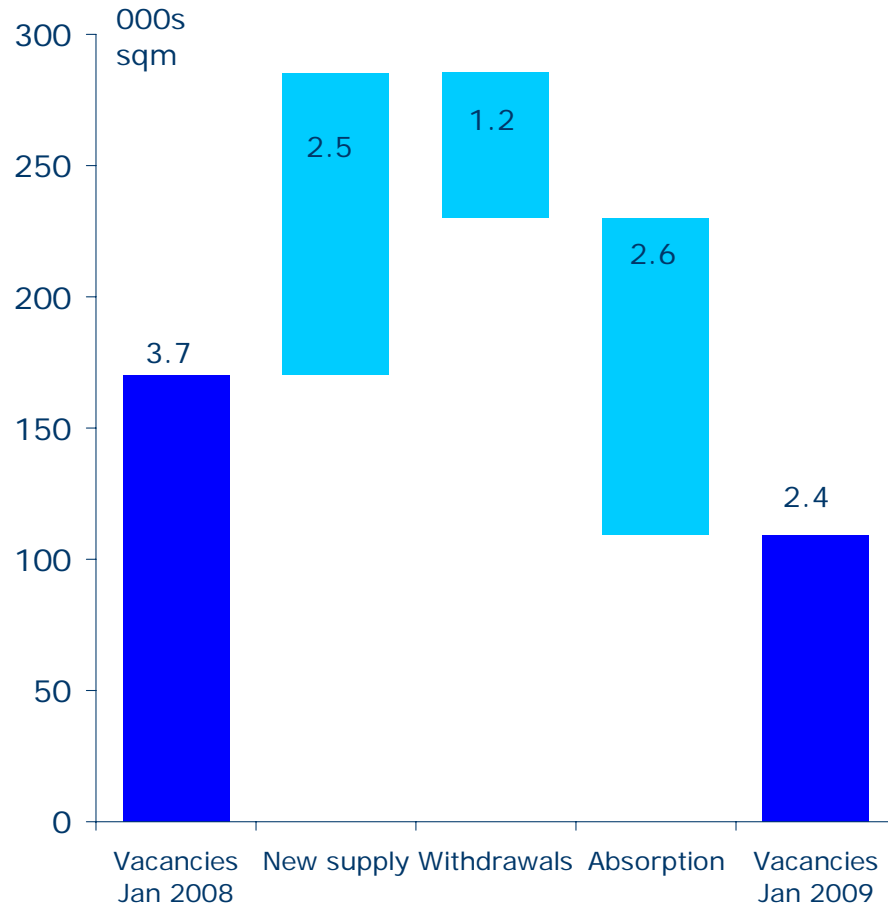


Hotels

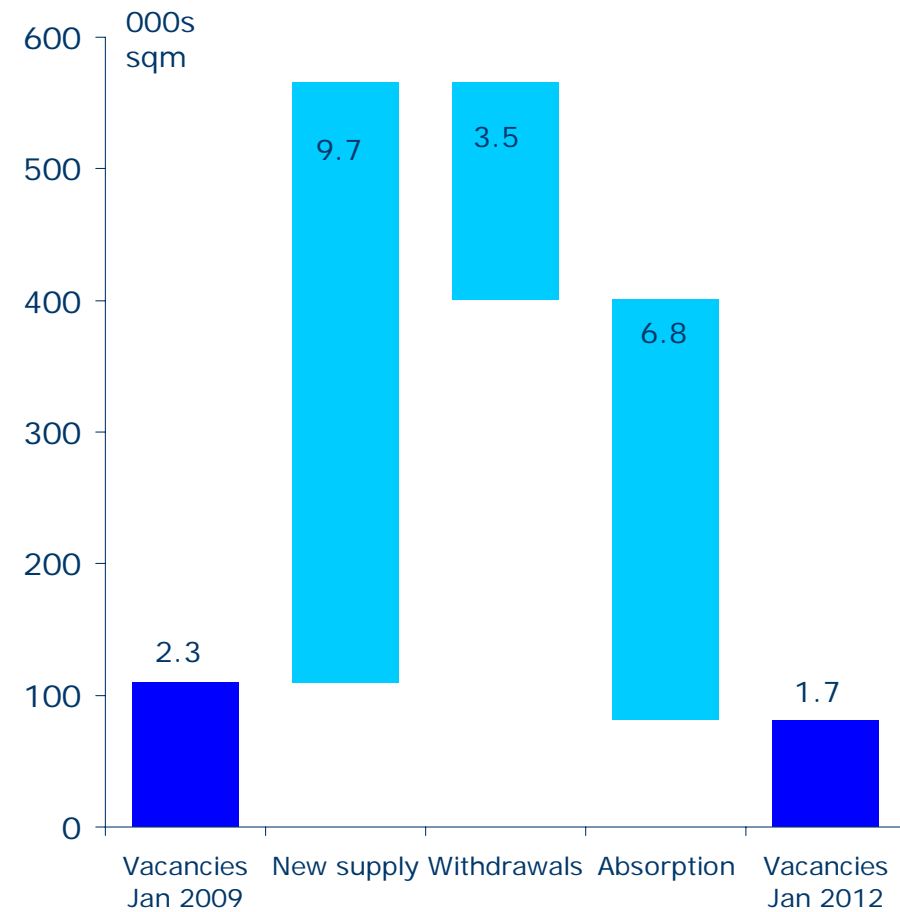


Sydney CBD office market fundamentals protected over medium-term

Contributions to change in Sydney CBD vacancy rate, Jan-08 to Jan-09



Contributions to change in Sydney CBD vacancy rate, Jan-09 to Jan-12

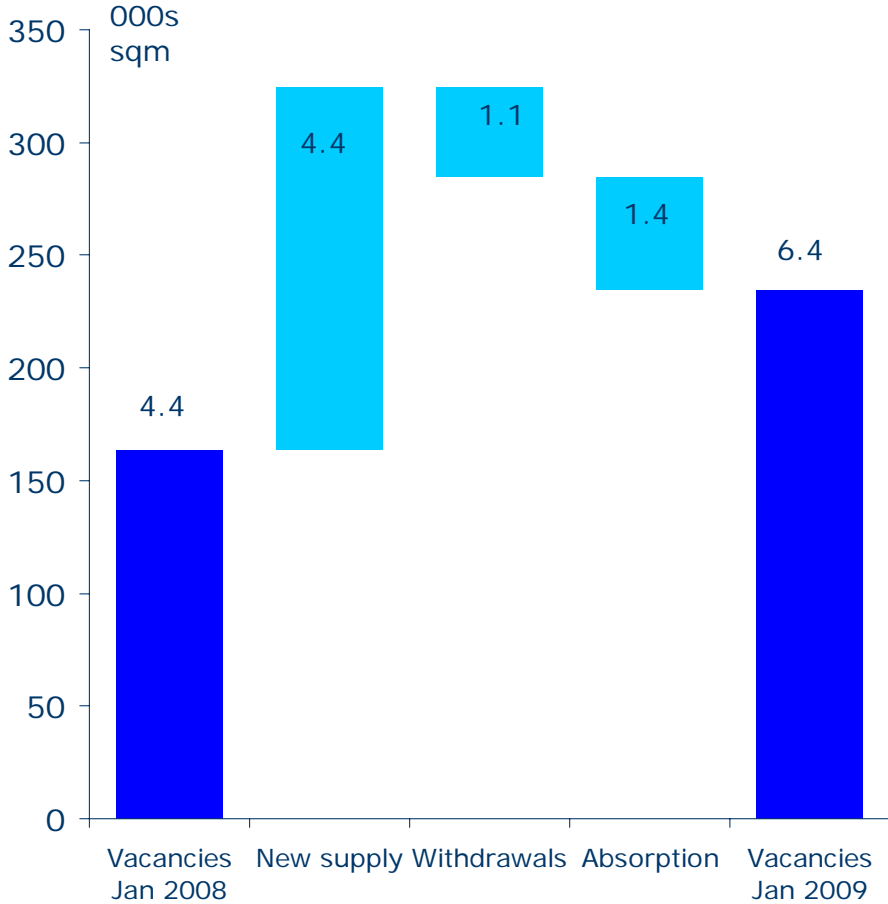


Sources: PCA, ABS, Economics@ANZ

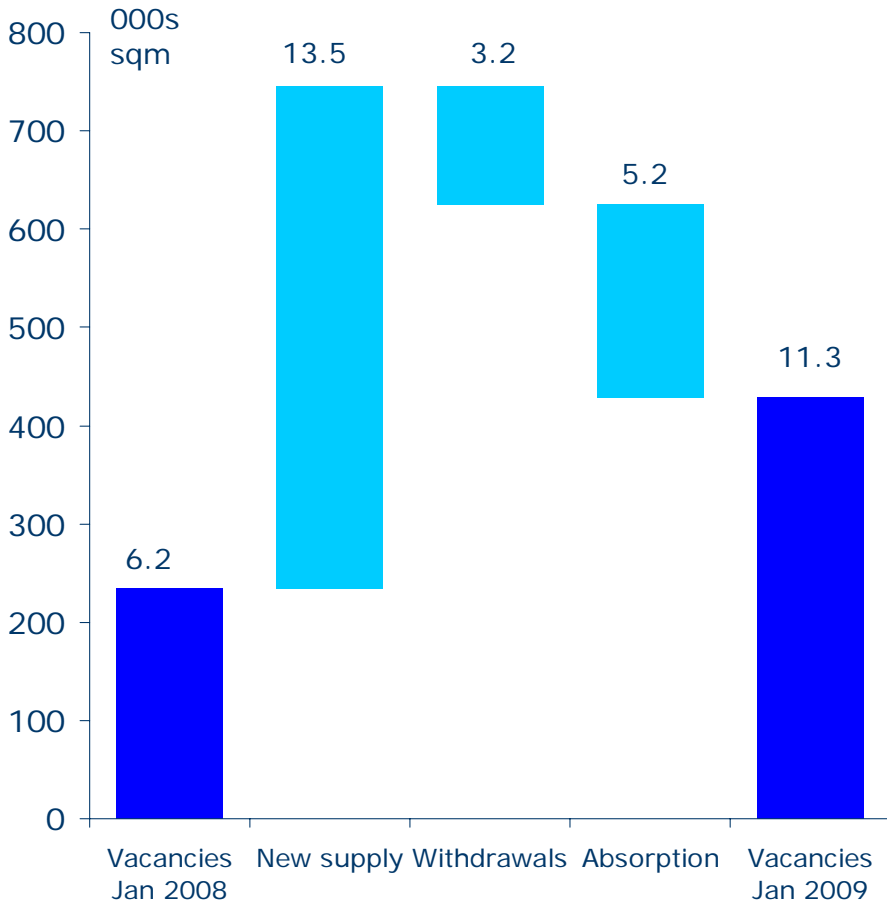


Strong supply lines to weaken fundamentals in Melbourne CBD office market by turn of decade

Contributions to change in Melbourne CBD vacancy rate, Jan-08 to Jan-09



Contributions to change in Melbourne CBD vacancy rate, Jan-09 to Jan-12

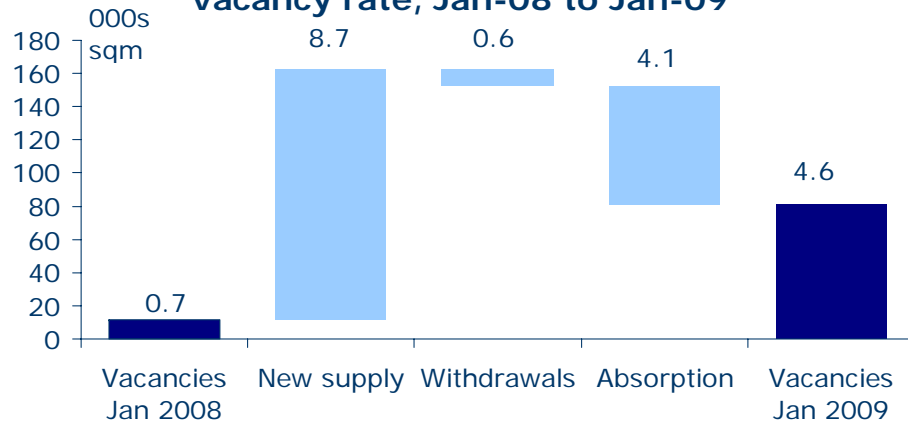


Sources: PCA, ABS, Economics@ANZ

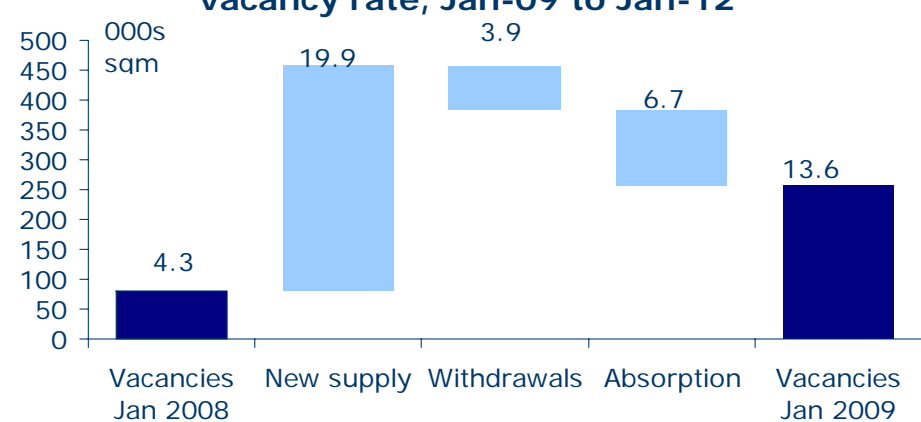


Resources boom drives office construction boom to alleviate chronic shortage. Trouble to emerge later.

Contributions to change in Brisbane CBD vacancy rate, Jan-08 to Jan-09



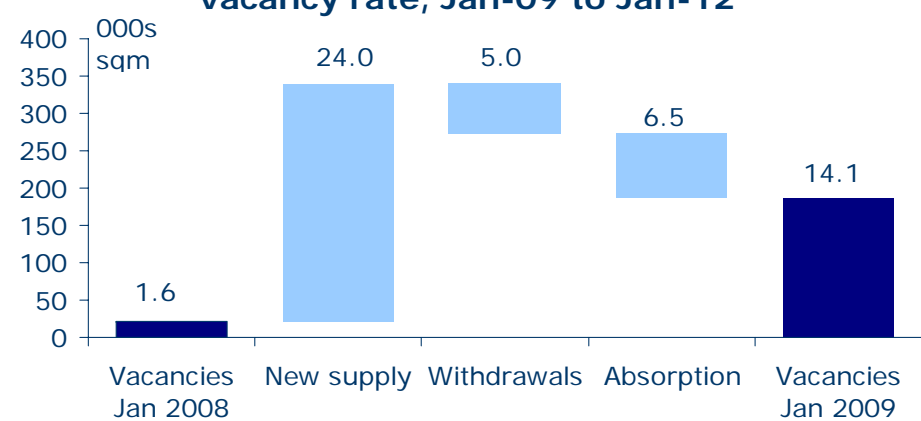
Contributions to change in Brisbane CBD vacancy rate, Jan-09 to Jan-12



Contributions to change in Perth CBD vacancy rate, Jan-08 to Jan-09



Contributions to change in Perth CBD vacancy rate, Jan-09 to Jan-12



Sources: PCA, ABS, Economics@ANZ

