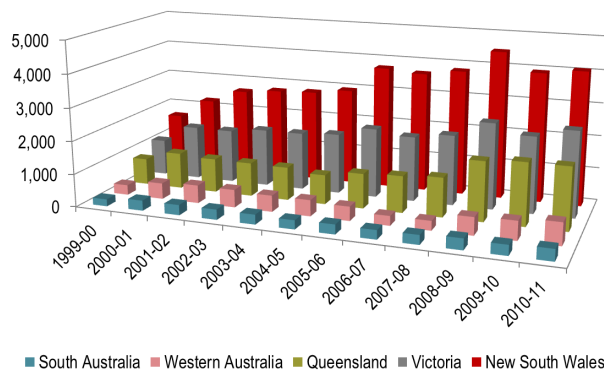


## Clearing the deck for the market upturn

The Global Financial Crisis (GFC) is usually dated from late-2007. On this metric, 2012 is potentially the fifth successive year of financial stress and investor uncertainty. However, as Figure 1 shows, some types of financial stress predate the onset of the GFC. Nationally, the number of insolvencies has been on a rising trend since around 2000, particularly in New South Wales and Victoria. Evidently, therefore the GFC is only one (though an important) contributor to the current cycle of distressed real estate asset sales.

Secondary and non-CBD real estate markets are influenced by many of the same macro-economic drivers that dictate prime markets. But availability of finance, buyer profiles and trends in vacancy rates can lead to sharp differences in market timing and investment performance across different sectors of real estate markets. The performance of these markets will be particularly important through 2012 as bankers and investors move to clear their portfolios of under-performing and troubled assets.

**Figure 1: Number of Insolvencies by State**



Source: ASIC, Jones Lang LaSalle Research

**Real estate backdrop:** Prime grade non-residential asset values fell by between 20% and 25% from their peak in Q4/2007 and the cyclical trough, around the end of 2009. During 2011 early signs of an upturn in capital values emerged. The recovery in capital values is expected to continue over the next few years (Figure 3).

Moving into 2012 the underpinnings of the property market are:

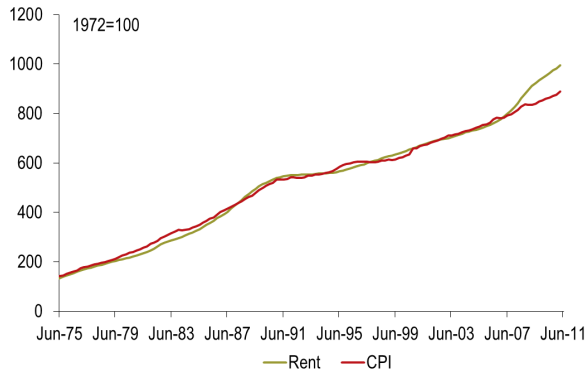
- Demand for space, which remains reasonably robust, driven by sustained growth in wages and employment and subdued growth in retail spending. Population growth remains robust, though the pace has slowed from a 40-year high of 1.9% p.a. in 2008;
- Capital market confidence, which is fragile, driven by a contraction in credit markets, widening of credit spreads and a sharp reduction in the alternative sources of capital, as illustrated by Table 1. In addition, lenders are clearly imposing more onerous hurdles on lending decisions;
- Subdued activity in the residential sector, where trends are diverse and location specific. As Figure 2 shows, nationally, rents are outpacing inflation for the first time in thirty years. Residential accommodation is in short supply, revealed by trends in rents and vacancy data as well as dwelling completion statistics across most markets. But in some markets (Melbourne inner city and the Gold Coast, for example) localised over-supply is reflected in slower apartment rental growth, an overhang of unsold stock and declining values. Mortgage stress is evident on some locations (Western Sydney, for example) although even in this sub-market the proportion of housing loan arrears is running below 1%.

**Table 1: Contraction in Debt Finance Alternatives**

	2008	2011
1st tier banks	4	4
2nd tier banks	14	6
Commercial securitised	2	0
1st tier mortgage fund	8	2
2nd tier mortgage fund	22	7
Foreign banks	13	4
<b>TOTAL</b>	<b>63</b>	<b>23</b>

Source: Jones Lang LaSalle Research, Balmain Funds Management

**Figure 2: Average National Residential Rents and Inflation**



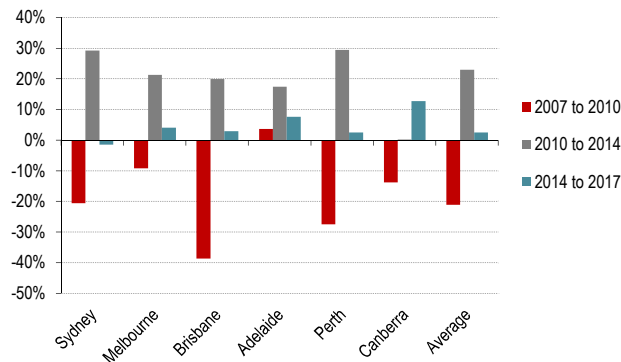
Source: Jones Lang LaSalle Research

**Investor activity and sentiment:** Investor sentiment in the prime grade commercial sector (> AUD 5 million) is reflected in relatively high levels of transaction activity and, in particular, a high level of participation by offshore investors. In the year to end-November transactions of AUD 9.44 billion were reported, of which a record 27% of transactions were to offshore buyers.

A reading on sentiment in secondary market sectors is available in a survey of 276 high net worth commercial property borrowers conducted in October 2011 by Balmain Funds, one of Australia's larger commercial fund managers.

The Balmain survey reveals that respondents expect investment returns to stabilise but they are not about to engage in aggressive investment behaviour. Nevertheless one third of respondents reported that they are prepared to consider new investment purchases or property development.

**Figure 3: Changes in Prime Office Market Capital Values**

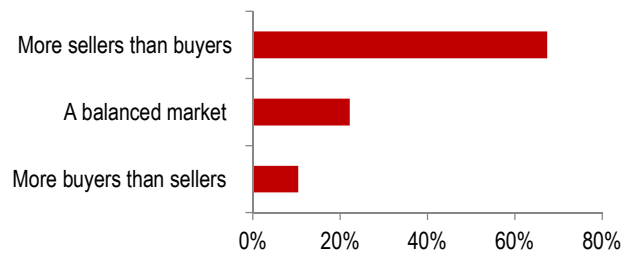


Source: ABS, Jones Lang LaSalle Research

While most respondents to the Balmain survey expect the market to be dominated by sellers, in fact, the gap between those survey respondents planning to invest and those planning to divest is relatively narrow (26% vs 29%). By a small margin, the majority of respondents expect investment returns to be lower in 2012 than in 2011. Activity is expected to be strongest in the residential sector.

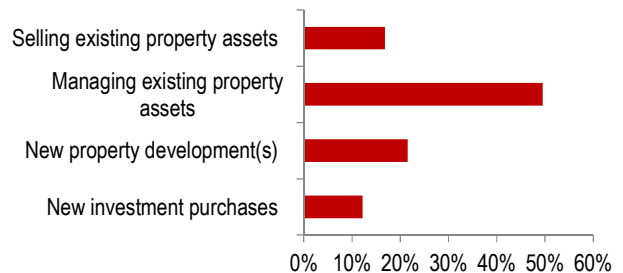
Key survey findings are set out in the charts below.

**What market conditions do you expect over the next 12 months?**



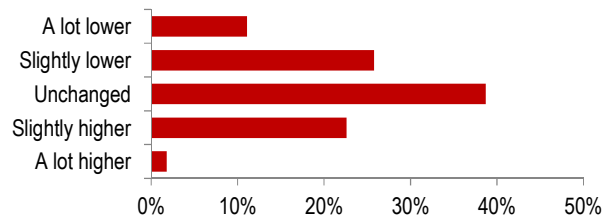
Source: Jones Lang LaSalle, Balmain

**What are you likely to be focussed on?**

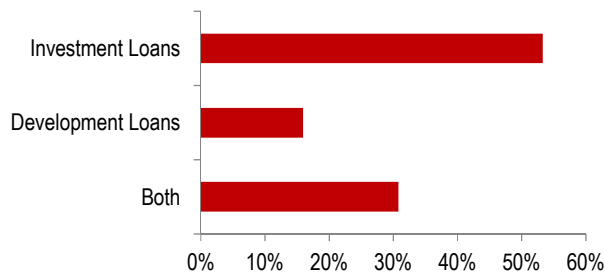


Source: Jones Lang LaSalle, Balmain

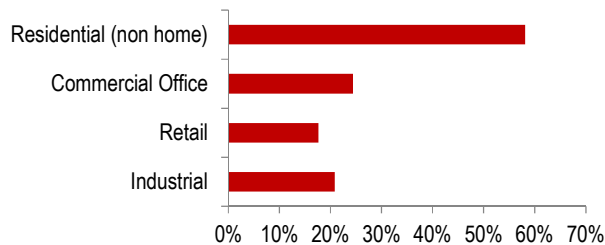
**Over the next 12 months, how do you expect your commercial property market returns (income + capital) to compare to the preceding 12 months?**



Source: Jones Lang LaSalle, Balmain

**Commercial property borrowings include:**

Source: Jones Lang LaSalle, Balmain

**In which sector will any new activity (buying or selling) principally be:**

Source: Jones Lang LaSalle, Balmain

**Secondary Market Overview and Value:** A robust economy remains the major underpinning of real estate markets. Demand for space – retail, office and industrial – is positively related to economic growth. Demand for residential accommodation is positively related to population growth, household formation and wages growth. All these factors remain relatively positive.

Commercial real estate values, however, remain attractive against many long-term benchmarks. Yields are relatively high by historical and international standards. As Table 2 shows, yield spreads in non-CBD office markets monitored by Jones Lang LaSalle are uniformly wider than the ten-year average, which suggests that these assets are “cheap” by historical norms.

**Table 2: Non-CBD Office Market Yield Spreads**

Market	Prime Equivalent Yields		Spread (bp)
	Current (%)	10-Year Average (%)	
North Sydney	7.00-8.50	7.50	25
Parramatta	7.75-8.75	8.20	5
St Leonards	8.00-8.50	8.00	25
Chatswood	8.75-9.50	8.30	85
Macquarie Park	7.50-8.50	7.90	10
Sydney Fringe*	7.50-8.50	7.85	15
Melbourne Fringe	7.75-8.75	8.05	20
Melbourne SE	8.00-9.00	8.20	30
Brisbane Fringe	7.75-9.00	8.35	5
West Perth	8.00-8.75	8.30	10

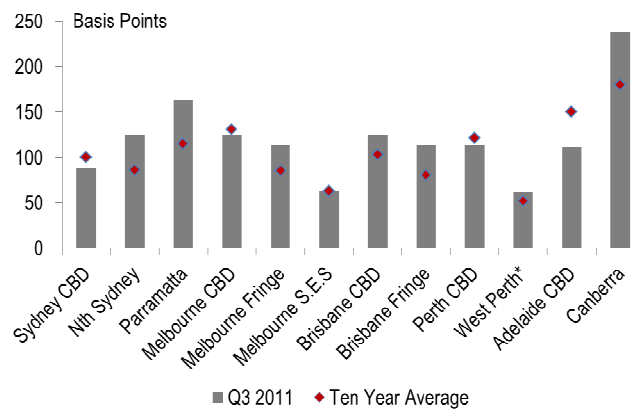
\* Indicates the time series is less than 10 years

Source: Jones Lang LaSalle Research

As further evidence of the strength of secondary markets, vacancy rates in non-CBD office markets are falling sharply. Non-CBD office vacancy in Q3/2011 was 8.1% compared with 7.4% for CBD office markets. Despite the slightly higher average vacancy rate, prime gross effective rents across non-CBD markets tracked by Jones Lang LaSalle Research rose by 6.9% in the year to Q3/2011, closely matching the 7.0% growth in CBD markets (weighted by market size).

It is tempting, but incorrect, to describe a two-tier market for commercial assets, consisting of institutional grade assets trading at a premium and secondary grade assets at a discount. The situation is more complex. After the initial impact of the GFC in 2008 and 2009, private investors were the first to emerge, picking up smaller income generating assets on relatively high yields. As a result, in several markets secondary yields tightened through 2010 ahead of prime yields in the first phase of the market recovery.

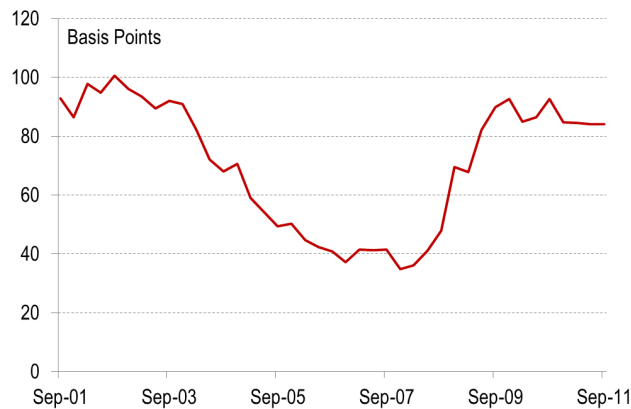
Figure 4 shows the yield spread between prime and secondary grade assets across a range of office markets in comparison with the ten-year average. Significantly, secondary yields remain relatively high across most non-CBD markets, suggesting scope for compression in these markets as vacancy rates tighten.

**Figure 4: Office Market Yield Spreads (Prime to Secondary)**

\* Indicates the time series is less than 10 years

Source: Jones Lang LaSalle Research

Capital growth in secondary grade industrial markets is also suggested by Figure 5, which shows that on a national basis, secondary yields are close to an eight-year high of around 80 basis points relative to prime industrial yields.

**Figure 5: Industrial Market Yield Spread (Prime-Secondary)**

Source: Jones Lang LaSalle Research

**In summary:** We expect that returns will stabilise, development activity will remain subdued but investment activity will gather pace as confidence recovers during 2012. Access to finance will continue to be a threshold constraint on investment and development activity, particularly in smaller markets and secondary grade assets where long-term tenant pre-commitments are difficult to lock in. Against this backdrop, however, the economy will continue to expand, supporting increased demand for retail, industrial and office space.

The current programs of asset sales by banks and other financiers, as well as portfolio realignment by institutional fund managers and A-REITs represents a recognition that markets are stabilising and that values in many cases have been recalibrated. Portfolio managers are preparing for the next phase of the market recovery. That is why current market activity can be described as clearing the decks, a far more productive activity than shifting the deckchairs.

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