

Commercial property on track for \$25 billion in sales in 2015

At a glance

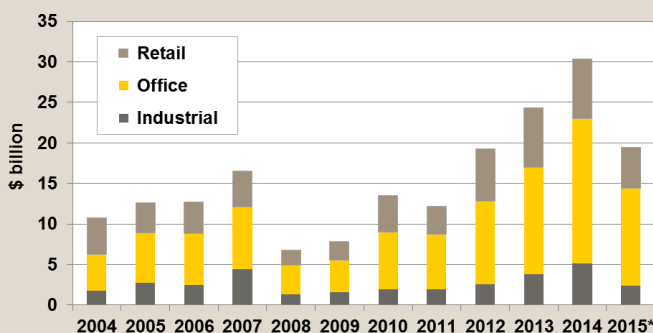
- Australian commercial property sales are on track to reach \$25 billion in 2015 — the third consecutive year above \$20 billion and 40 per cent above the 10 year average.
- Office property continues to be the most popular sector, with investors focusing on the large and fast-growing Sydney and Melbourne markets.
- New South Wales remains the country's commercial property hotspot, attracting 47 per cent of sales in the first three quarters of calendar 2015.
- A record 48 per cent of sales by volume have been to offshore investors.
- Landmark transactions in the \$200 million-plus price bracket have soared above long-term benchmarks, effectively driving the market and keeping average transaction volumes and prices high.

Sales set to pass \$20 billion for a record third year

Australian commercial property remains a highly sought-after investment, with sales on track to pass the \$20 billion mark for the third year running. As at 30 September 2015, around \$19.5 billion worth of office, retail and industrial property priced over \$5.0 million had already traded during the calendar year.

Although 8 per cent down from the same time last year, that total is already well above the 10-year average of \$15.0 billion. Sales are also on track to match or surpass the 2013 level of \$24.3 billion and be 40 per cent above the 10 year annual average.

Chart 1. Commercial property sales, 2004-2015



Sources: Real Estate Intelligence Service, JLL Research, Q2 2015, Commonwealth Bank Proprietary Data, September 2015, * 1 January to 30 September 2015

That's because the December quarter is traditionally the strongest period for commercial property, with 2015 looking set to follow that pattern. Almost \$5.0 billion of major assets and property portfolios have recently been placed on the market, enough to push total sales for the year close to \$25.0 billion.

The inherently high-yielding and stable income from commercial property is proving a magnet for investors at all levels during a period of instability and uncertainty in financial markets.

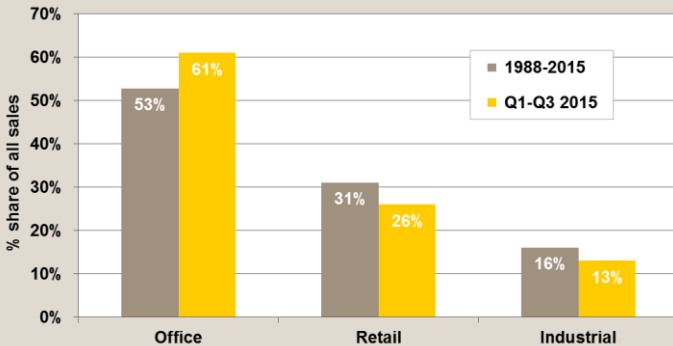
Office property more popular than ever

Since 1988, office buildings have accounted for 53 per cent of commercial property transactions by volume. In the calendar year to 30 September 2015, that proportion rose to 61 per cent (\$11.9 billion in transactions), confirming the enduring popularity of the office sector. For details of trading benchmarks, see Chart 2 on page 2.

One reason for this overwhelming popularity is simply the amount of quality stock available for purchase, boosted by recent construction activity in all capital cities, with new tenants committed to long leases and the potential for depreciation benefits. These assets have been especially attractive to institutional and offshore investors. A number of office portfolio transactions, including the Investa and Primewest portfolios, have also boosted sales numbers this year.

However, the current construction cycle is now drawing to a close. That should see a reduction in available stock in 2016, with trading likely to decline as a result.

Chart 2. Trading benchmarks



Sources: Real Estate Intelligence Service, JLL Research, Q2 2015, Commonwealth Bank Proprietary Data, September 2015,

Retail opportunities hard to find

Although retail property sales were up 6 per cent in the first three quarters of 2015, compared to the same period in 2014, they still represent just 26 per cent of total sales (\$5.0 billion), down from the long-term average of 31 per cent. In part, that reflects the fact retail property is tightly-held, with not a single regional shopping centre changing hands. (While the Adelaide Myer Centre sold for \$288 million in April, it is categorised as a CBD centre, not a regional centre.)

The most traded retail category this year has been the sub-regional centre (46 per cent of all retail property traded), popular with investors looking to add value through redevelopment or repositioning. Neighbourhood centres, the most accessible centres by price-point, have also been actively traded, with \$1.1 billion of sales to date (22 per cent of all retail property transacted).

The other notable category has been large format centres, representing 9 per cent of all retail property transactions.

This category has been buoyed by strong consumer spending on household goods, driven by strong residential housing construction and sales.

Industrial property set to boom

Despite the ongoing popularity of industrial property with a wide range of investors, trading volumes have fallen 20 per cent in the first three quarters of calendar year 2015, compared to the same period last year (\$2.4 billion). As a result, industrial property sales have made up just 12 per cent of trading, down from the long-term benchmark of 16 per cent.

Like retail property, industrial property is beginning to be tightly held by investors attracted by strong, stable long-term cash flows from quality tenants. Trading in the sector is increasingly influenced by the sale of large portfolios, such as the recent acquisition of the GIC/Frasers portfolio by Ascendas for over \$1.0 billion. However, with the pending sale of the Australian Industrial REIT and a JP Morgan portfolio of Sydney assets, industrial property is likely to feature prominently in a strong December 2015 quarter.

Sydney property in demand

The most notable feature of commercial property investments in 2015 has been the overwhelming popularity of New South Wales or, more particularly, Sydney. New South Wales has attracted around 47 per cent of commercial property investments this year, a disproportionate share for a state that represents 30 per cent of the country's economy.

The factors behind this popularity are the same as those driving Sydney's real estate market generally: strong employment and population growth, supported by government policies and infrastructure investment.

Focus on: Commercial property investment as a reflection of a changing economy

The end of the Australian resources investment boom has had a profound impact on short-term commercial property investment, with investors shifting their focus away from the resource-rich states, towards markets more exposed to traditional business services, particularly Melbourne and Sydney.

Federal government industry policy has contributed to this transition. It aims to restructure and grow the Australian economy by encouraging services-based export industries, including education, tourism and medical research. That has seen a number of educational institutions purchasing property to expand their operations — unusual in a market where owner-occupation is uncommon.

Recent examples include a \$90.0 million office purchase by the Australian Catholic University after a 53 per cent increase in student numbers over three years, and a \$13.0 million transaction by the Canadian-founded LCI Education Network for its Academy of Design Australia. While not yet a major trend, these examples are evidence of a general expansion in service-based industries as the Australian economy continues to restructure. As a result, office properties in particular are likely to remain in demand from organisations in these industries, either for purchase or lease.

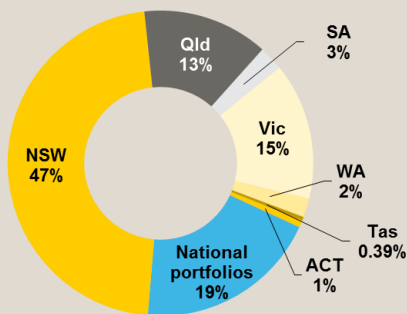
Over 70 per cent of Australia's full-time employment growth in the last 12 months has been in New South Wales, while population growth in Sydney is now running at more than 80,000 people a year. That has been supported by a housing construction boom and a renewed sense of purpose, as the government promotes its vision for Sydney as a centre for services-based exports in the post-mining boom economy.

This focus on Sydney has seen other states and capitals fall behind their usual investment benchmarks. With just 15 per cent of sales to date, Victoria is trading well below its 25 per cent historical average, although Melbourne is also likely to account for a large portion of national portfolio sales (representing another 19 per cent of transactions). Certainly demand for commercial property is high in Melbourne because, like Sydney, the economic fundamentals are favourable.

Despite an economy in transition from a heavy mining influence, Queensland has attracted significant investor interest, with 13 per cent of sales, mostly in Brisbane. Investors have been active at the extremes of the risk spectrum, buying both high quality property (such as the Waterfront Place office building in Brisbane) and near-empty office buildings, in anticipation of an eventual recovery.

Trading outside these three major east coast markets has been very light. In the first three quarters of 2015, just 2 per cent of single-asset trading activity has been in Western Australia, as mining investment loses its hold as a key driver of property activity. Similar forces have seen South Australia's share of transactions by value fall to 3 per cent, while Canberra's share to date is just 1 per cent. Investors will need to see a clear path to economic recovery before weighing more heavily into these markets.

Chart 3. Commercial property sales, Q1-Q3 2015



Source: Real Estate Intelligence Service, JLL Research, Q2 2015, Commonwealth Bank Proprietary Data, September 2015

International sales surge as local institutions step back

Sales to international buyers have surged during 2015, accounting for a record 48 per cent of sales by volume. Demand has come from a variety of sources, including Chinese and Middle Eastern sovereign wealth funds, Singaporean fund managers, and publicly listed property companies and banks from Germany and Switzerland. There is also a healthy level of interest and activity from offshore high net worth private investors at lower-to-mid price points.

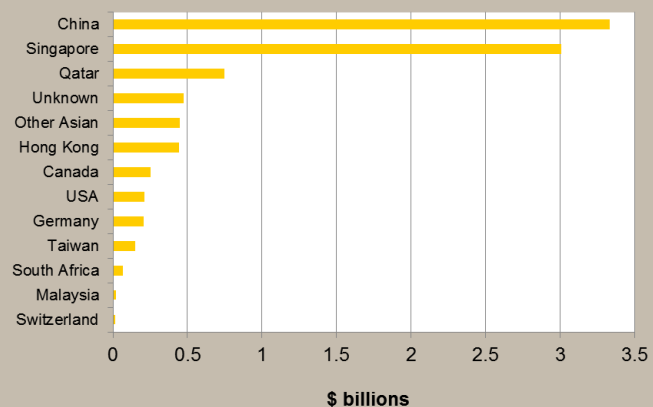
Acquisitions from international sovereign wealth funds jumped from zero in the first three quarters of 2014, to \$3.2 billion during the same period in 2015 as shown in Chart 5. This group has been the third largest investor group to date. Offshore private investors and syndicates have also increased their exposure in 2015, including a wide range of small to mid-sized entities.

In contrast, some of the largest Australian commercial property owners have reduced acquisitions significantly in 2015, including superannuation funds (with purchases down 79 per cent) and A-REITs (down 65 per cent).

As competition drives prices higher, it seems many of these traditional buyers are adopting a disciplined approach to purchases, waiting for the market to cool before stepping back in.

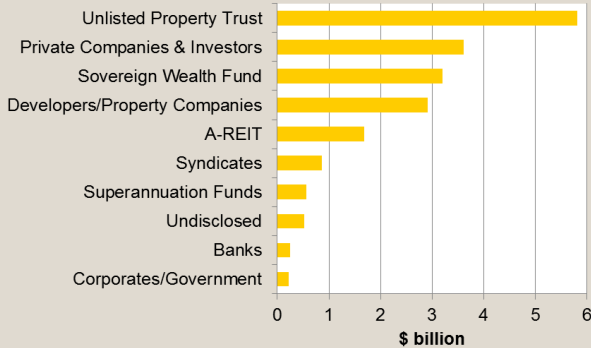
Nonetheless, the most active group of purchasers remains the broadly-defined unlisted property trust category, which includes privately-funded trusts (typically equity-driven) and super funds, followed by private companies and direct investors.

Chart 4. Source of offshore purchasers by sales volume, Q1-Q3 2015



Source: Real Estate Intelligence Service, JLL Research, Q2 2015; Commonwealth Bank Proprietary Data, September 2015

Chart 5. Commercial property sales by purchaser type, Q1-Q3 2015



Source: Real Estate Intelligence Service, JLL Research, Q2 2015, Commonwealth Bank Proprietary Data, September 2015

The biggest deals drive the market

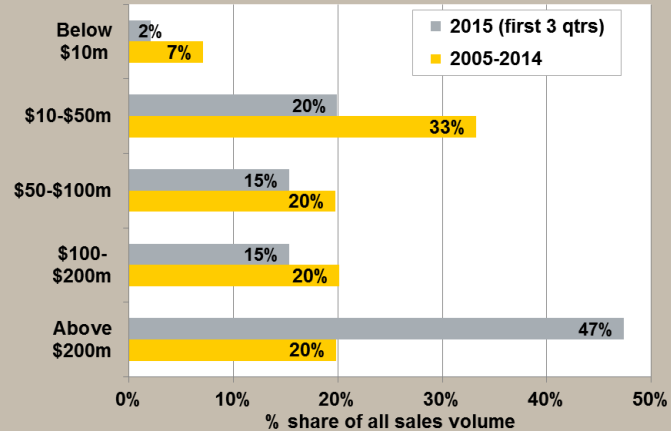
In 2015, 47 per cent of all transactions have been above \$200 million, well above the 10 year average of 20 per cent. But while other price brackets have fallen below long-term averages as a proportion of total sales, it's important to remember the absolute level of trading activity remains very high.

Unsurprisingly, the \$200 million plus bracket is dominated by institutional property investors. On the sell side, domestic REIT's, wholesale funds, corporations, governments, offshore institutions and even private groups are actively selling large assets or portfolios at what many see as the high point in the pricing cycle.

On the buy side, groups with sufficient capital to purchase \$200 million plus assets at high prices are increasingly likely to come from offshore. These groups seek high-yielding assets with reliable long-term income streams in a transparent business environment. Offshore sources of capital are deep, with many yet to fully engage in Australia.

For example, Asian insurance companies are widely seen as the next wave of offshore institutional investors. They may well make their presence felt in the last quarter of 2015, when the \$5.0 billion of commercial real estate presently on the market is set to transact.

Chart 6. Share of sales by price bracket



Source: Real Estate Intelligence Service, JLL Research, Q2 2015; Commonwealth Bank Proprietary Data, September 2015

What does it mean for investors?

Commercial property markets are running hot, with high turnover and high prices. Yet property is also a high-yield investment compared to other asset classes. Its stable investment performance is likely to continue attracting investors in a period of volatility in other financial markets.

These factors are likely to see strong trading activity in the December 2015 quarter, with institutional vendors bringing almost \$5.0 billion in commercial properties to market. That could see buyers push prices up to, and potentially beyond, previous peaks.

However, there is a limit to the number of very large assets available to drive ongoing trading volumes. Following record trading levels from 2013–15, it's likely that limit will soon be met. That makes it probable sales volumes will decline in 2016 as the pricing cycle peaks. But while the Global Financial Crisis brought a rapid decline in activity at the end of the last price cycle in 2008, there are no similar catalysts on the horizon today. Instead, the market is likely to gradually return to more typical annual trading over the next 2–3 years.

For buyers with no immediate need to invest, that suggests there may potentially be benefits in waiting for the market to cool. But for those who have recently made purchases, it's time to develop strong asset management plans to make the most of the next property cycle.

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