Charter Insight

The Current State of Play

Commercial Property Markets Melbourne

November 2018

charterkc.com.au

COMMERCIAL VALUATIONS

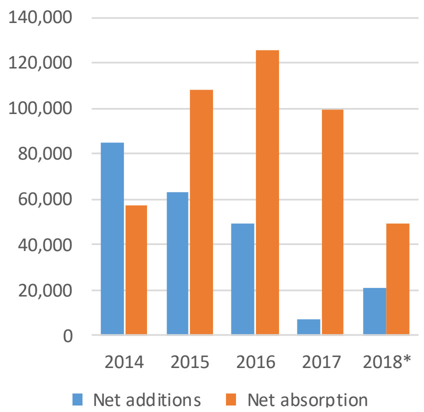
THE ECONOMY

Despite the cooling of house prices, Australia's economy continues to strengthen at above trend levels with solid job growth and unemployment declining, notwithstanding underemployment remaining an issue. Any resultant wage growth however, is likely to be offset in an environment of increased interest rates, whether by looming, moderate, incremental increases in the official cash rate by the Reserve Bank or continued independent increases by the major banks as they are exposed to increased costs of debt on the global market. As a result, consumer spending growth is likely to continue to be benign in the short term at least, providing a drag on our economic growth compared to other developed economies.

Victoria's economic conditions have been the strongest in the Country for an extended period, with key cyclical drivers supporting the diversified and largely non-mining economic base. Robust population growth, including overseas migration, continues to support Victorian economic growth, helping explain job growth and the absorption of strong residential and office development completions. It has also provided for substantial public investment in transport and social infrastructure as the Government looks to alleviate the pressures around such strong population growth. Having said that, receding housing prices suggest that residential construction supply has peaked, and is likely to plateau over the short term. Continued population growth however, should provide fundamental demand for housing in the long run. Commercial construction is anticipated to continue its robust fortunes of recent years, with a strong pipeline of both publicly funded building approvals around health and education in addition to a private sector providing mixed use developments around buoyant accommodation and offices sectors.

OFFICE

Figure 1: Central Melbourne Supply & Demand (sq.m.)



SOURCE - Charter Keck Cramer & Property Council of Aust
Central Melbourne includes CBD, Docklands & Southbank
*first six months of the year only

Melbourne's office markets have returned to a position of strength after several years in recovery mode. The office sector in Central Melbourne, supported by face rental growth and receding levels of rental incentives, is now successfully competing for sites previously intended for residential proposals, particularly as the apartment market comes off its peak. Strong underlying fundamentals in Melbourne on the back of population growth and the resultant expansionary jobs market for industry sectors requiring office accommodation have been reflected in substantial levels of positive net absorption recorded across the various markets in recent years. This is particularly the case around education and professional services supporting record level public infrastructure investment.

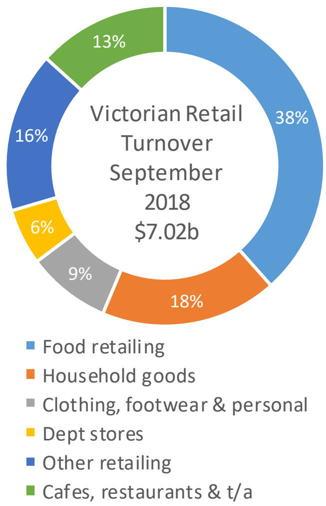
Despite a period of strong supply coming onto the market, a combination of elevated absorption rates of existing stock and high levels of precommitment to new stock being completed, has resulted in historically low vacancy rates in Central Melbourne in particular, but also in the established fringe and suburban markets. Recent policy changes targeting development controls in the CBD grid and Southbank, although well intentioned, are forcing some office development proposals beyond these boundaries and into new fringe markets that have the required sites.

Changing tenant requirements have also impacted positively on the office sector, with increased demand for co-working environments over shared accommodation an emerging trend, with both domestic and foreign providers expanding rapidly across the Melbourne CBD and fringe markets.

The Melbourne office market has recorded extensive purchaser interest from both domestic and international investors. The weight of capital seeking to invest in a limited supply of core office assets is placing continued downward pressure on yields and returns. This yield compression has been evident across all commercial property markets.

RETAIL

Figure 2: Victorian Retail Trade by Category



SOURCE - ABS (Cat. 8501) Seasonally adjusted

Retail sales growth has been subdued at below-historical levels, but importantly remains positive. The value of retail sales has been improving both across states and categories of spending, and employment growth has picked up. When combined with flat retail prices, this is expected to support solid growth in the volume of retail sales, mostly because of robust population growth. Employment growth is also expected to continue which ordinarily would support household incomes and non-discretionary spend however the threat of increases in mortgage interest rates and a cooling of the residential market in general has put paid to any significant increases.

Household budgets are already under increased pressures associated with major banks increasing mortgage rates independently of any Reserve Bank movement in the official cash rate, and higher electricity and petrol pricing.

Competitive pressures remain, particularly on discount department stores and apparel traders following the arrival of international tenants in Australia. Leasing demand, especially from fashion tenants, has suffered from several retailers entering administration over the last couple of years. For owners and managers there is a shift towards more experiential retailing, focusing on food & beverage, dining and entertainment facilities. This trend has been reflected in many of the redevelopments having taken place in the larger shopping centres in Melbourne. The leasing market generally however, remains a significant challenge.

Retail property remains a tightly held asset class, with premiums continually paid for ownership opportunities. Smaller centres and supermarket based centres as well as large format retail centres (leased to prime tenants) are generally attracting the strongest investment interest domestically and from offshore. Retail strips have generally had less investor interest due to higher vacancy rates and limited rental growth, however interest does remain for retail assets with development upside.

INDUSTRIAL

Melbourne's industrial market has a diversity of occupants, reflective of the broad Victorian economic base, and remains the largest of all Australia's capital cities in terms of land stock and built floorspace. Melbourne's industrial market is central to Australia's manufacturing industry which, although diminishing in significance to the national economy, is still a large driver of industrial markets. Melbourne also plays a primary role as the largest distribution centre for the country and accounts for approximately 40% of Australia's shipping container activity. The sector is supported by high quality transport infrastructure.

The industrial property market continues to evolve and mature through increased integration with e-commerce and warehousing and logistics. The evolution is necessary due to the ongoing contraction of the Victorian manufacturing industry as a percentage of the State's total economy, however Melbourne remains the Country's manufacturing capital.

As with other asset classes, Prime grade assets across industrial markets are also experiencing offshore investor demand as international institutions chase a scarce number of investment-grade assets across global property markets. The scarcity of industrial investment-grade assets with long lease expiries is a likely limiting factor for continued high levels of investment and sales volumes. Demand however is expected to remain high over the short term.

The depreciation of the Australian Dollar coupled with historical low interest rates is expected to prolong the high levels of purchaser demand from both local and offshore investors as well as owner occupiers.

For more information on this insight or the commercial property market more broadly, please contact:

Chris Holroyd
NATIONAL EXECUTIVE DIRECTOR - VALUATIONS (CBD)
E chris.holroyd@charterkc.com.au
T +61 (0) 3 8102 8805
M +61 (0) 410 505 624

Bernard Cussen
NATIONAL EXECUTIVE DIRECTOR - VALUATIONS (RETAIL)
E bernard.cussen@charterkc.com.au
T +61 (0) 3 8102 8818
M +61 (0) 419 139 279

Sam Lipshut
DIRECTOR - VALUATIONS (OFFICE)
E sam.lipshut@charterkc.com.au
T +61 (0) 3 8102 8860
M +61 (0) 409 504 588

Anthony Witton
DIRECTOR - VALUATIONS (INDUSTRIAL)
E anthony.witton@charterkc.com.au
T +61 (0) 3 8102 8927
M +61 (0) 401 213 458

Glenn Lampard
DIRECTOR - VALUATIONS (STRATEGIC RESEARCH)
E glenn.lampard@charterkc.com.au
T +61 (0) 3 8102 8928
M +61 (0) 419 008 742

Charter Keck Cramer is a leading provider of evidence-based property insights. We provide accurate and timely market intelligence and industry insights that are rigorous, considered and forward-looking. Recent examples of properties that Charter Commercial Valuations have provided advice on include:

101-107 York Street, South Melbourne.

Mortgage valuation for settlement purposes of a $49M office investment.

McDonalds' Highlands Shopping Centre Craigieburn.

Acquisition advice resulting in a successful transaction.

Thomastown Portfolio.

Valuation assessment of an industrial portfolio comprising 64 properties.