Folkestone

"THIS TIME IT'S DIFFERENT
- *IS IT REALLY?"*

FOLKESTONE REAL ESTATE OUTLOOK

JULY 2015

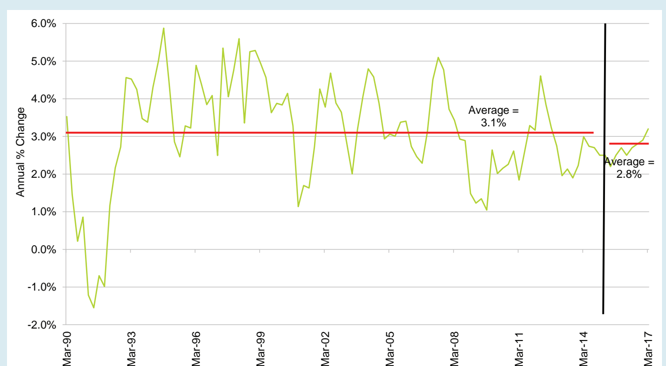
SUMMARY

- Australia's economic growth to remain below trend
- The wall of money chasing real estate assets, especially non-residential assets, will continue
- The biggest challenge for investors will be finding attractive investment opportunities in a competitive marketplace
- Both industrial and real estate related to social infrastructure to outperform
- Seniors living sector to offer significant investment opportunities
- The gap between yields on core and non-core assets will compress
- The wide divergence in performance of Australia's residential sub-markets to continue
- Momentum in the Sydney and Melbourne residential markets to slow but not crash
- The strong returns from A-REITs in FY15 unlikely to be repeated – returns to move back to long-term average
- Investors need to identify and quantify the risk in their real estate portfolios and focus on the underlying real estate fundamentals
- *"This time it's different"* does not abolish the real estate cycle

ECONOMIC

As we enter the second half of 2015, there is little to suggest any major sustained upswing in Australia's economic growth is likely to occur in the near term. The rotation from resources to other sectors has yet to gain full momentum, outside of the residential construction sector, and as a result, economic growth remains below trend (Figure 1).

Figure 1: Australian GDP Growth: 1990 - 2017



Source: ABS, Bloomberg

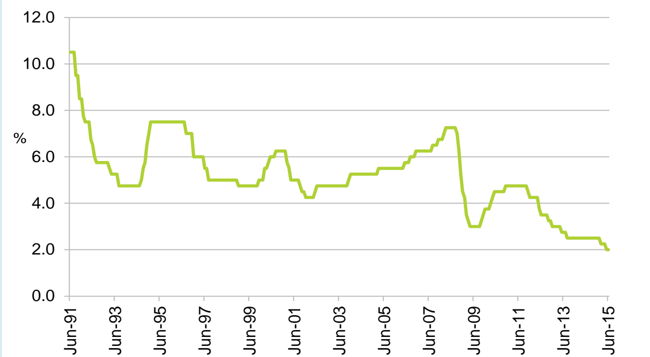
The Westpac Melbourne Institute Index of Consumer Sentiment fell again in July to 92.2 and has been below 100 (when pessimists outweigh optimists) in 15 of the past 17 months. Interestingly, the Index also tracks sentiment towards economic conditions over the next 12 months and this measure fell 10.5 per cent to 76.0 in July. In a signal that the housing market has run too hard, the "time to buy a home" Index dropped 15.4 per cent to 94.8 – the lowest Index level since June 2010.

In an effort to stimulate the economy, the RBA lowered the cash rate in May for a second time this year, to a record low of 2.0 per cent (Figure 2). Consumer confidence rallied following the rate cut with a better than expected Federal Government Budget

handed down in May, however like a few times in recent years, it has been short-lived.

THE ROTATION FROM RESOURCES TO OTHER SECTORS HAS YET TO GAIN FULL MOMENTUM

Figure 2: RBA Cash Rate: 1991 - 2015

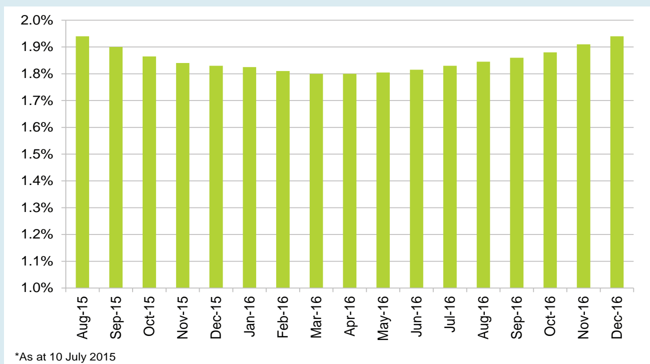


Source: RBA

Australia's leading economists remain split on whether the RBA will cut the cash rate again, although the futures market is expecting at least one further rate cut (Figure 3).

The July RBA board meeting left the door open for a further easing in monetary policy, although we expect rates to remain on hold for some months, as the RBA monitors the impact of the two rate cuts delivered earlier this year. The RBA acknowledges that Australia's economy continues to grow but *"….at a rate somewhat below its longer-term average" and therefore "in such circumstances, monetary policy needs to be accommodative"*[1].

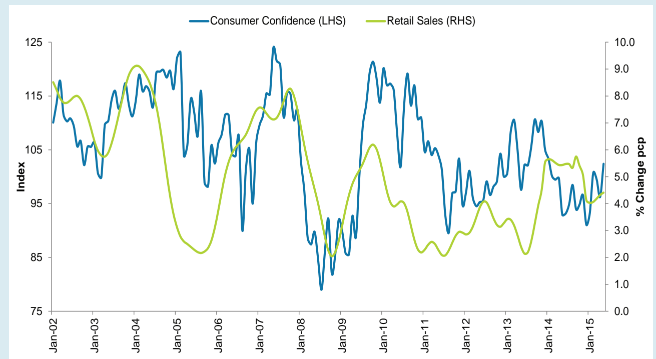
Figure 3: Cash Rate Expectations: 12 Months to December 2016



Source: The Yield Report

Consumer spending has improved but is still patchy. Retail sales rose by 0.3 per cent (seasonally adjusted) in May 2015 following a fall of 0.1 per cent in April and a rise of 0.2 per cent in March. Overall, retail spending is up 4.8 per cent for the year to May, a marked improvement on the 2.0 to 4.0 per cent growth rates recorded between 2010 and 2014, but still below the annual growth of 6.0 to 7.0 per cent recorded prior to the GFC. Anaemic wage growth, relatively high household debt and shaky consumer confidence continue to present headwinds for consumer spending (Figure 4). See page 9 for more detail on consumer spending and the implications for the retail sector.

Figure 4: Retail Sales and Consumer Confidence: 2002 - 2015

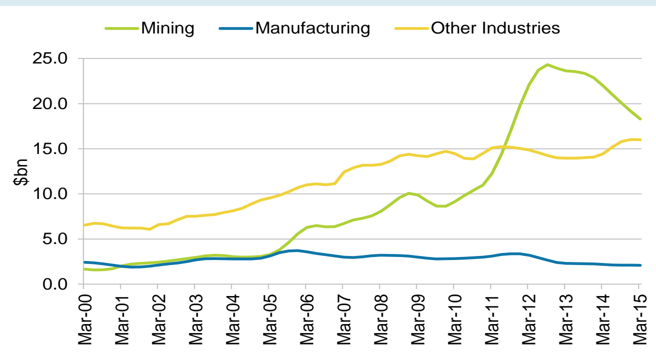


Source: ABS/Westpac

Business investment remains subdued with total new capital expenditure falling 2.3 per cent in the March 2015 quarter, with mining falling 4.4 per cent, manufacturing 0.9 per cent and other industries falling 0.1 per cent (Figure 5). The current recovery in non-mining investment is weaker than has been the case in the 1980's and 1990's recoveries. Despite low interest rates, businesses appear reluctant to commit to increased investment until there is a marked pick-up in the economy.

The RBA has therefore pushed timing of the recovery in non-mining business investment *"…out until later in 2016 on the basis that forward-looking indicators provide little, if any, evidence of a turning point before then"*[2].

Figure 5: Private New Capital Expenditure: 2000 - 2015



Source: ABS

1 *RBA - Monetary Policy Decision – 7 July 2015*

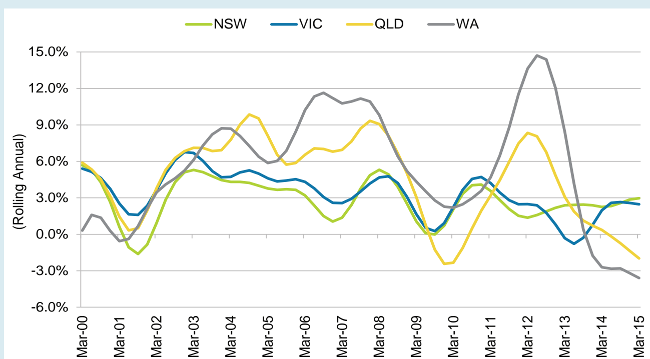
2 *RBA - Statement on Monetary Policy – May 2015*

Despite some slowing in employment growth over the three months to June 2015, the unemployment rate has remained at around 6.0 per cent which is lower than most forecasters had expected at this point in the cycle. NSW and WA have the lowest rates of unemployment at 5.8 per cent, but WA's rate has deteriorated significantly, up from 5.1 per cent in May. SA has also recorded a significant increase in the unemployment rate, up from 7.6 per cent in May to 8.2 per cent in June.

The outlook for employment is mixed. Significant job losses are still expected as the mining boom continues to unwind and the manufacturing sector continues to downsize, whilst employment in the service sector, especially IT, health and education pick up.

As has been the case for most of the past decade, Australia has had a multi-speed economy with wide divergence in performance across the States. After WA and QLD dominating since 2003, NSW and VIC have taken over as the best performing states (Figure 6) driven by a buoyant housing market and improved retail trade.

Figure 6: Gross State Demand: 2000 – 2015



Source: ABS

The mixed scorecard for the Australian economy, together with continued global uncertainty surrounding Europe and the slowdown in China's economy (Figure 7) and its stockmarket gyrations, will continue to weigh on sentiment, spending and business investment. Of particular importance will be the extent that this impacts activity in the non-mining sectors.

As a result, the Australian economy will continue to face challenges to move back to above trend for some time to come. According to Bloomberg's survey of 33 economists in June 2015, GDP growth is expected to average 2.5 per cent in 2015, 2.8 per cent in 2016 and 3.2 per cent in 2017 (Figure 1).

Figure 7: China – Annual GDP Growth: 2000 – 2014

Source: The World Bank

CAPITAL MARKETS

Global real estate is experiencing unprecedented levels of capital inflows. Global equity and bond valuations look stretched across most markets. At the same time volatility remains elevated around concerns of the fallout from events in Greece and China and the timing of US rate hikes. It is not surprising therefore, that sovereign wealth funds, pension funds (the global equivalent of our superannuation funds) and insurance companies are increasing their allocation to real estate.

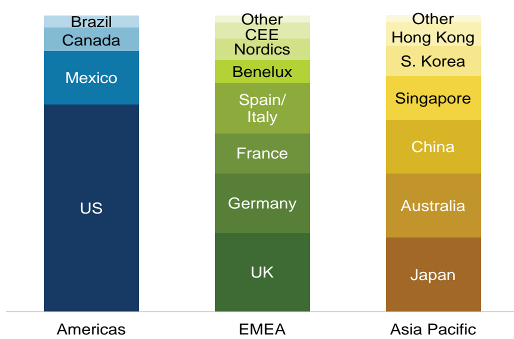
AUSTRALIA – A CAPITAL MAGNET

While the Australian non-residential real estate fundamentals (demand and rental growth) are still recovering post the GFC, capital values are being driven higher by an abundance of capital flowing into both residential and non-residential real estate from domestic and off-shore investors.

Australia is firmly a destination of choice for global real estate investors. Australian non-residential real estate yields are attractive relative to most other countries and the falling Australian dollar is also enhancing the case for allocating capital to Australia. Some of the largest global sovereign wealth funds and institutional investors from Europe, Asia (China and Singapore in particular), the Middle East and Canada have acquired Australian non-residential real estate assets in the past 12 months and we believe the wall of money chasing prime assets will continue (Figure 8). Sydney and Melbourne CBD office assets continue to be near the top of the shopping list (Figure 9), although retail, industrial and hotels are also being chased.

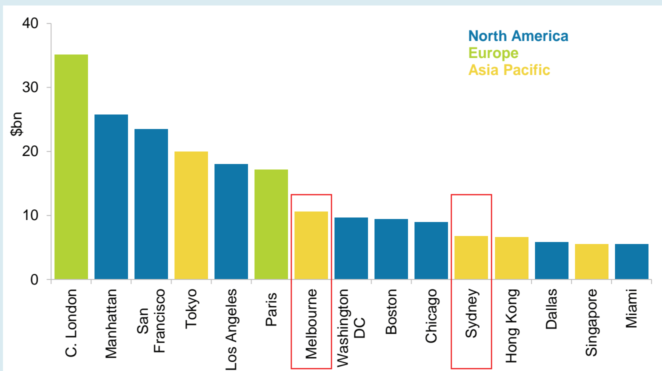
AUSTRALIA IS FIRMLY A DESTINATION OF CHOICE FOR GLOBAL REAL ESTATE INVESTORS

Figure 8: Investor Target Markets by Region: 2015



Source: DTZ

Figure 9: Investment in Major Global Cities: Q2 2014 – Q1 2015



Source: DTZ

Two high profile portfolio sales are currently underway. Morgan Stanley is exiting their investment in the Investa portfolio platform which is expected to sell for more than $9 billion. GIC, the Singaporean sovereign wealth fund, is disposing of their Sydney and Melbourne industrial portfolio which is expected to sell for more than $1 billion on a yield that is likely to set a new benchmark for industrial real estate in this country. We expect both portfolios to be well bid by global investors seeking scale in Australia.

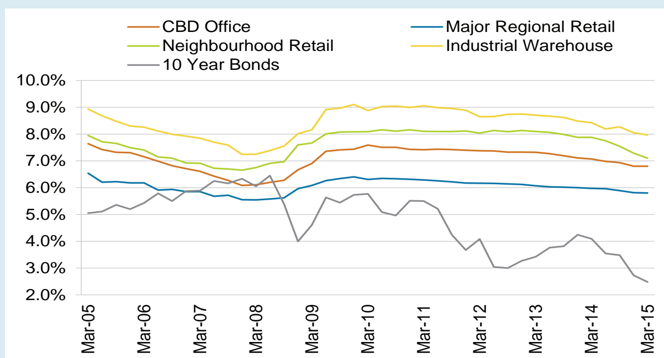
We are also witnessing an influx of Chinese developers chasing residential development sites in Sydney, Melbourne and to a lesser extent Brisbane. According to CBRE, 36 of the 116 inner city (within 5 kms of the CBD) assets sold across Sydney, Melbourne and Brisbane in the year to April 2015 were to Chinese investors. Knight Frank have identified that seven of the top 10 Chinese developers are now active in the Australian market and other Chinese developers are actively looking. The inflow of Chinese capital is pushing up land values to levels that local developers are increasingly finding it difficult to compete with.

CONTINUE TO CHASE YIELD OR MOVE UP THE RISK CURVE?

With the weight of money chasing prime core assets (office, retail and industrial), the pricing for these assets is not as attractive as it was in 2013 and 2014. In many cases, the easy money post the GFC has been made. Yield compression (when yields fall, values increase) has been driven by investors aggressively deploying capital rather than strong real estate fundamentals, which in turn is driving value increases (i.e. strong tenant demand underpinning income growth). In other words, the capital cycle is running ahead of the real estate cycle.

Real estate yields (cap rates) look attractive compared to bond yields, but the absolute levels are nearing record lows across most core sectors (Figure 10).

Figure 10: Real Estate Cap Rates vs 10 Year Bond Yields: 2005 - 2015



Source: MSCI IPD

Transaction volumes tapered off in the first half of 2015 (Figure 11) which was not due to any weakening in the availability of capital, but the limited availability of stock on the market. The biggest challenge for investors in the second half of 2015 and into 2016 will be sourcing attractive investment opportunities in a competitive marketplace.

Figure 11: Non-Residential Transaction Volumes by Sector: 2008 - 2015

Source: DTZ

THE BIGGEST CHALLENGE FOR INVESTORS IN THE SECOND HALF OF 2015 AND INTO 2016 WILL BE FINDING ATTRACTIVE INVESTMENT OPPORTUNITIES IN A COMPETITIVE MARKETPLACE

Commitments to new investments at this stage of the cycle will face greater headwinds than in recent years. Investors will need to anticipate the next cyclical downturn that will no doubt come in the next few years and ensure they do not over pay for assets that may not be able to deliver appropriate risk-adjusted returns when the cycle turns.

As noted earlier, the RBA is unlikely to raise the cash rate in the short term. However, investors need to be cognisant of movements in the long-end of the Australian yield curve (i.e. 10 year bonds). If bond yields start edging back up, either because markets anticipate the domestic economy recovering faster or as a result of global movements in bond yields, investors will need to be mindful of the impact on asset values.

Lack of investment opportunities for prime core assets and their low yield relative to historical averages is leading some investors to target:

- non-core assets – investors are increasingly being attracted to the higher yield and strong demographic prospects associated with real estate related social infrastructure (i.e. early learning, student housing, medical/health and seniors living);
- non-core markets - investment activity is now starting to focus on well performing secondary markets, with the Parramatta office market a good example; and
- higher risk-return strategies - value-add (letting vacant space, refurbishing or repositioning existing secondary buildings into core product) and opportunistic (developing assets to manufacture core product) to capture that extra return by taking advantage of the strong investor demand for core assets.

We believe there is merit in all three approaches; however, it's not for every investor. Experience, local knowledge and correct underwriting of risk are critical to success, particularly for the higher risk–return value-add and opportunistic strategies. We caution investors against blindly chasing these types of investments to eke out an extra few basis points of yield.

As more money flows into these strategies in the coming year, we would expect the yields on non-core and secondary assets to compress further and narrow the gap with prime core yields.

DEBT – THE BANKS ARE BACK

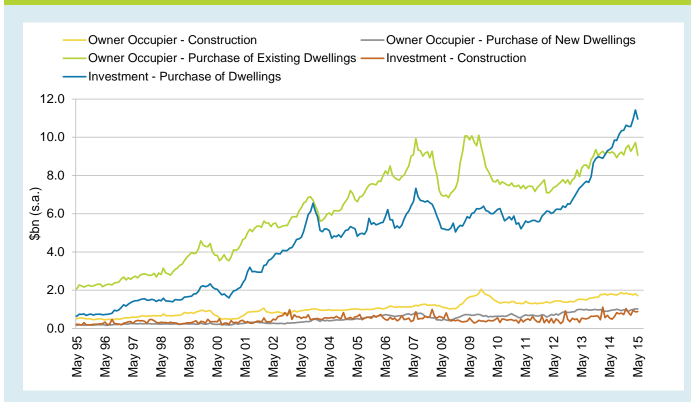
Debt availability for non-residential real estate has improved as competition between banks to lend capital has intensified. Credit standards have eased somewhat, especially for income producing real estate with moderate loan-to-value ratios. Development finance is available but the banks continue to be selective and are wanting significant pre-sales for residential development and tenant pre-commitments for non-residential development, and of course, recourse to the borrower.

COMPETITION BETWEEN BANKS TO LEND CAPITAL HAS INTENSIFIED

In the past 18 months, we have witnessed a number of non-bank lenders entering the market backed by both institutional and private capital. Not surprising, the non-bank lenders are focusing on higher risk lending where they can generate higher margins. Assets with vacancy, located in secondary markets or with higher loan to value ratios and developments are being actively funded by the non-bank lending sector.

Strong lending has fuelled the residential property market although there are signs that it is now tapering off (Figure 12). Housing finance (seasonally adjusted) fell 4.4 per cent in May 2015, following two consecutive months of solid growth in March and April. Finance was lower in June across both the investor (-3.2 per cent) and owner-occupier (-5.3 per cent) segments. Investors have been particularly active and have been the largest borrowers since March 2014.

Figure 12: Housing Finance by Type of Borrower: 1995 – 2015



Source: ABS

The Australian Prudential Regulation Authority (APRA) announcement in December 2014 of a crackdown on residential lending has taken a while to filter through the system but appears now to be having an impact. APRA, concerned about accelerating housing credit in an environment of historically low interest rates, high levels of household debt and strong competition in the housing market, announced they were looking to tighten home lending standards, particularly for investors. In particular, APRA warned the banks that it would look very closely at any lender where investment housing loans were growing faster than 10.0 per cent per annum. It also asked lenders to ensure that they were using an interest rate buffer at least two percentage points above current rates and a minimum interest rate floor of 7.0 per cent when testing whether a potential customer could afford to service their loan.

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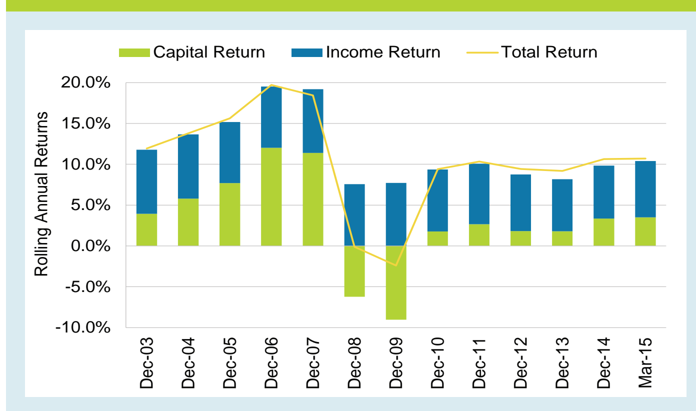
REAL ESTATE DELIVERS ATTRACTIVE RETURNS

In the year to March 2015, non-residential real estate as measured by the PCA/IPD Direct Property Index[3] generated a total return of 10.7 per cent underpinned by a healthy income return of 6.9 per cent. Non-residential real estate is now entering its sixth year of recovery. There has been a notable acceleration of capital returns in the past two years although not to levels recorded in the lead-up to the GFC (Figure 13).

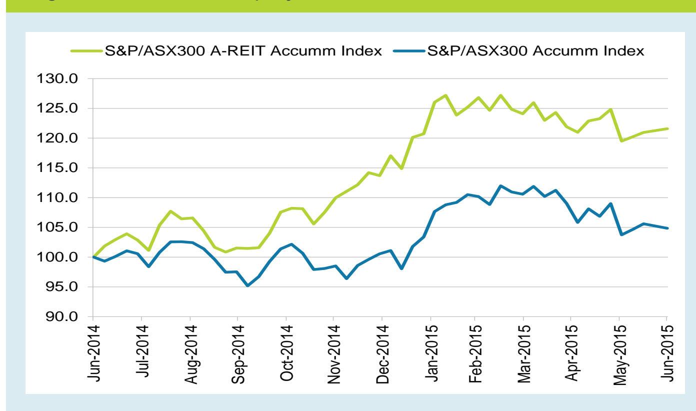
Figure 13: Non-Residential Total Returns: 2003 – 2015



Source: MSCI IPD

Our estimate of the total return from non-residential property for the year ending 30 June 2015[4] is 11.0 per cent which will show direct real estate outperforming equities (5.6 per cent) but significantly underperforming listed A-REITs which recorded another strong year of performance, with a total return of 20.2 per cent (Figure 14).

Figure 14: A-REIT vs Equity Performance: FY15



Source: IRESS

Industrial property has been the standout non-residential real estate performer over one and three years with a total return of 12.4 per cent for the year and 11.2 per cent p.a. for the three years to 31 March 2015 (Figure 15). The relative high yield (8.2 per cent in the past year) and the repositioning of the sector from manufacturing to high quality distribution centres leased to "blue-chip" tenants in the logistics and storage sectors is attracting significant investment into industrial property. The industrial sector is also benefiting from rising land values as the rezoning of inner city industrial land to residential gathers momentum, particularly in Sydney and Melbourne inner city areas.

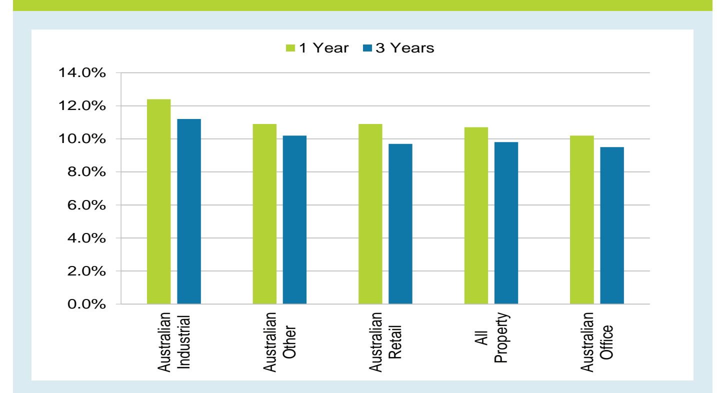
INDUSTRIAL PROPERTY HAS BEEN THE STANDOUT NON-RESIDENTIAL REAL ESTATE SECTOR

The next best-performing sectors in the year to 31 March 2015 were retail centres and other property (carparks, self-storage, medical centres, etc.), both with a total return of 10.9 per cent. The strong retail performance was driven by solid capital growth, the 4.1 per cent capital return was the highest of the major non-residential real estate sectors.

Other property or as we prefer to call them "alternate assets", performed well driven by an 8.0 per cent income return. Investors seeking yield have been attracted to this sector in part because of the higher yield relative to the core sectors (see page 13).

The office sector generated a total return of 10.2 per cent for the year. Despite the strong performance of Melbourne CBD office (13.5 per cent) and Sydney CBD office (11.1 per cent), the overall result was held back by the poor performance of Perth CBD (-1.9 per cent) and Brisbane CBD (-0.3 per cent) office markets.

Figure 15: Non-Residential Sector Returns: One and Three Years to March 2015



Source: MSCI IPD

3 *The Index measures the performance of more than 1,290 non-residential real estate assets with a combined value of $137 billion*

4 *The June quarter numbers are not released by MSCI IPD until mid August 2015*

OFFICE

Sydney and Melbourne continue to be the standout CBD markets. Both markets continue to benefit from the strong competition from investors for office assets and are also showing signs, unlike other CBD markets, that momentum in the occupier market is gathering pace. Demand is being driven by small and medium enterprises and by firms involved in industries such as IT, finance, business services, health, education and infrastructure.

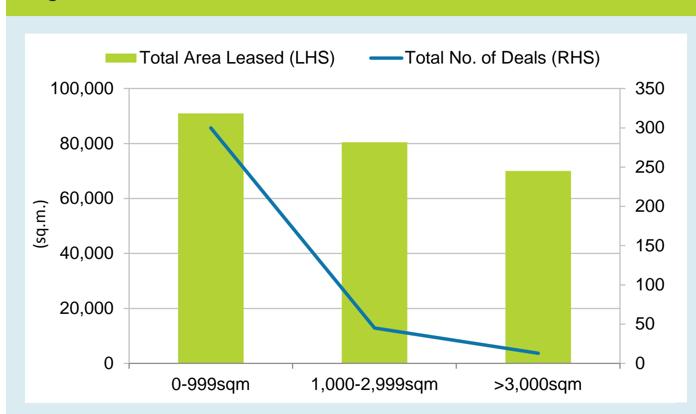
OFFICE LEASING ACTIVITY MIXED ACROSS MARKETS

According to Colliers International, leasing activity across Australian office markets is up 13.0 per cent in the first half of 2015 compared to the same period last year and the amount of space leased is up 22.0 per cent from 198,360 sq.m. to 241,551 sq.m.. Whilst the headline number looks good, not all markets are fairing as well. The Sydney CBD and metropolitan markets represented 47.0 per cent of the amount of space leased in the past six months, confirming the recovery in Sydney is underway.

SYDNEY AND MELBOURNE CONTINUE TO BE THE STANDOUT CBD MARKETS

Leasing activity across Australia in the past six months has been driven by smaller tenants with just over 90,000 sq.m. being taken up by tenants under 1,000 sq.m. compared to circa 70,000 sq.m. by tenants greater than 3,000 sq.m. (Figure 16).

Figure 16: Australian Office Demand: 6 Months to June 2015

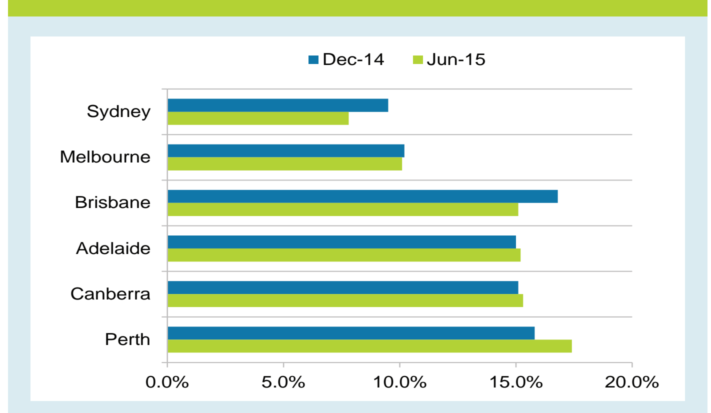


Source: Colliers International

The Sydney CBD vacancy rate fell from 9.5 per cent at December to 7.8 per cent at June 2015 - the only CBD market to record a single digit vacancy rate (Figure 17).

At the other end of the scale, the Perth CBD and Brisbane CBD markets are being impacted by the mining sector slowdown. Both markets recorded declines in capital value over the year of 1.9 per cent and 0.3 per cent respectively. We expect values in both these markets to fall further in the year ahead. Weak demand and further new supply will push the vacancy rate in both markets higher – above 15.0 per cent in Brisbane and more than 20 per cent in Perth – putting further downward pressure on rents and values.

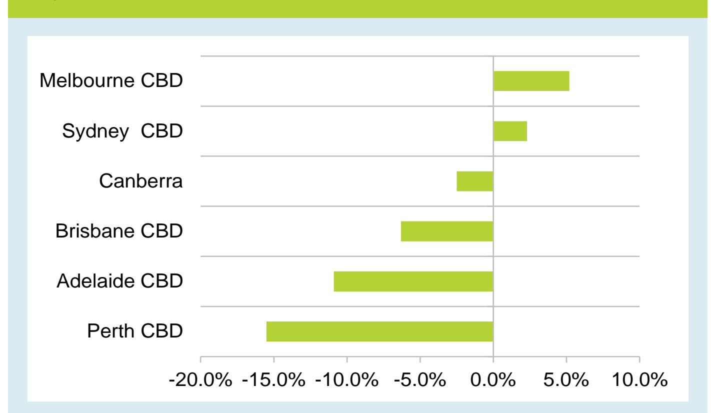
Figure 17: CBD Office Vacancy Rates: Dec 2014 - June 2015



Source: JLL

The divergent market conditions are also reflected in the rental growth outcomes of the major CBD office markets. Prime effective rents fell 15.5 per cent in Perth and 6.3 per cent in Brisbane in the year to June 2015. Melbourne CBD and Sydney CBD rents increased 5.2 per cent and 2.3 per cent respectively (Figure 18).

Figure 18: Prime Effective Rental Growth: Year to June 2015



Source: JLL

SUPPLY STILL AN ISSUE

New supply still remains an issue for most CBD markets and will temper the recovery in vacancy rates across most markets. The Sydney CBD office market has more than 400,000 sq.m., 266,000 sq.m. of which is due to the three office towers at Barangaroo, to come on line in the next two years. Although much of this space is pre-committed, it will lead to significant vacancy in the backfill space across the Premium and A Grade assets which is likely to see leasing incentives remain elevated for some time to come.

Brisbane CBD has more than 180,000 sq.m. to come on line in the next few years, Melbourne CBD has around 130,000 sq.m. and Perth has around 150,000 sq.m., whilst some of this space has been pre-committed, the uncommitted space will compete with the backfill vacancy, putting pressure on vacancy rates and rental growth.

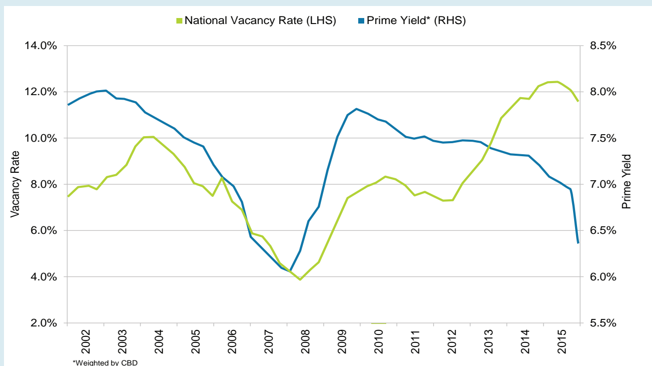
There is no doubt that stock withdrawn for refurbishment, redevelopment or conversion to alternative use such as

residential, which will be a feature of most CBD office markets in the next few years. Australia has an aging stock base and tenants want more adaptive, energy efficient space. Owners of older buildings will need to spend money refurbishing or redeveloping their buildings, or if they can, converting to residential. We have already seen Melbourne lead the way with residential living in our CBD's and Sydney and Brisbane are now following suit.

STOCK WITHDRAWAL FOR REFURBISHMENT, REDEVELOPMENT OR CONVERSION TO ALTERNATIVE USE SUCH AS RESIDENTIAL WILL BE A FEATURE OF MOST CBD OFFICE MARKETS

Looking ahead, the key question is whether there is enough momentum in the occupier market to justify current levels of pricing. Since 2012, the national vacancy rates and prime yields have diverged (Figure 19). If investors continue to chase office assets with the same vigour as they have in the past two years, the question going forward is whether values will run further ahead of real estate fundamentals.

Figure 19: CBD Vacancy Rates and Prime Yields: 2002 – 2015



Source: JLL

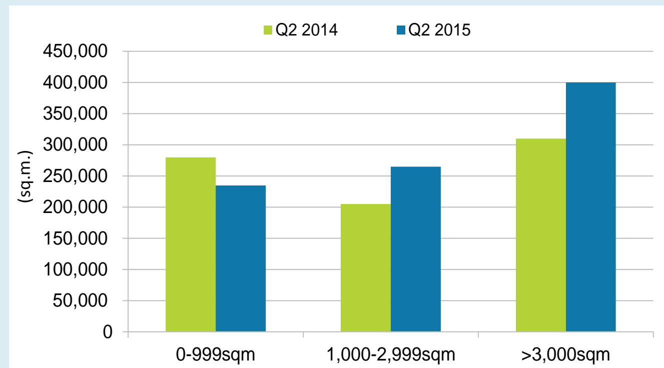
With below trend economic growth forecast in the next few years, we expect tenant demand to slowly improve across most office markets. The cost of securing tenants will remain high with elevated incentive levels leading to lacklustre effective rental growth.

THE COST OF SECURING TENANTS WILL REMAIN HIGH WITH ELEVATED INCENTIVE LEVELS LEADING TO LACKLUSTRE EFFECTIVE RENTAL GROWTH.

One positive for the market is that the Colliers International Office Demand Index is indicating larger tenants are now making more enquiries about new office accommodation which should be positive for leasing activity in the year ahead (Figure 20).

Whilst the focus from larger investors is on CBD office markets, one non-CBD office market drawing attention from both tenants and investors is the Parramatta office market. Parramatta has finally come of age with a revitalisation program underway underpinned by a concerted effort from government and industry to partner to bring new employment opportunities into the Parramatta market. It's not surprising that Parramatta was the best performing office market in the PCA/IPD Property Index in the year to March 2015, generating a total return of 15.0

Figure 20: Office Leasing Enquiries: Q2 2014 and Q2 2015



Source: Colliers International

per cent, supported by a 5.6 per cent increase in capital value.

Despite the opportunity for continued capital growth from yield compression, overall we remain cautious on the office sector. Sydney CBD looks good at the moment but the next wave of supply remains a threat which will only be tempered if the long list of mooted office buildings slated for conversion to residential development materialise. Across the other CBD markets, it will take some time before we see a material decline in vacancy and incentive levels, and therefore rental growth. We continue to look for office assets in suburban markets which are well located to transport and have quality tenant covenants.

RETAIL

The retail industry remains a very competitive environment. A number of cyclical and structural trends are at work contributing to a complicated outlook for the retail sector.

As a result, there continues to be a wide variance in performance between both retailers and individual retail centres.

A NUMBER OF CYCLICAL AND STRUCTURAL TRENDS ARE AT WORK CONTRIBUTING TO A COMPLICATED OUTLOOK FOR THE RETAIL SECTOR.

RETAIL SALES REBOUND BUT NOT ACROSS THE BOARD

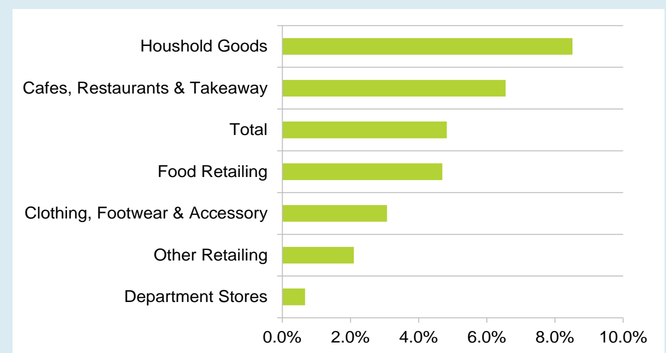
The latest retail trade figures from the ABS for the month of May 2015 show an increase of 0.3 per cent, taking the annual rate of growth to 4.8 per cent (seasonally adjusted) - this is down from the 5.5 per cent annual growth in November 2014 but is slightly above the 4.2 per cent annual growth recorded in the year to May 2014. Household goods are the stand-out performer growing 8.5 per cent in the year to May 2015 (Figure 21). Rising house prices in Sydney and Melbourne and the uplift in housing supply are flowing through to stronger demand for household goods such as furniture and white goods. In line with our growing desire to eat-out and drink more coffee, retail sales in cafes, restaurants and take-away food are up 6.5 per cent for the year.

Department store sales trends have declined significantly in recent years. Sales were down 1.37 per cent in May and up just 0.67 per cent for the year. The CEO of Myer in their half-year results announcement in March 2015 summed the woes of the department store sector quite succinctly *"At a macro level the challenges are well known, particularly the globalisation of retail which has brought new competitors to our shores. Digitalisation has both empowered the consumer and created new channels to market. Customers have changed the way they shop and their expectations of retailers have changed significantly. Some of the elements of the existing strategy represent solid fundamentals. However, overall it did not deliver a business model able to respond to this new retail environment and we have lost relevance with some customers".*[5]

As a result, we expect Myer and David Jones to continue to re-evaluate their footprint and close underperforming stores in the next few years which may actually be a positive for retail landlords who can remodel the space into smaller, more productive retail tenancies.

5 *Myer - First Half Results and Full Year 2015 Guidance - 19 March 2015*

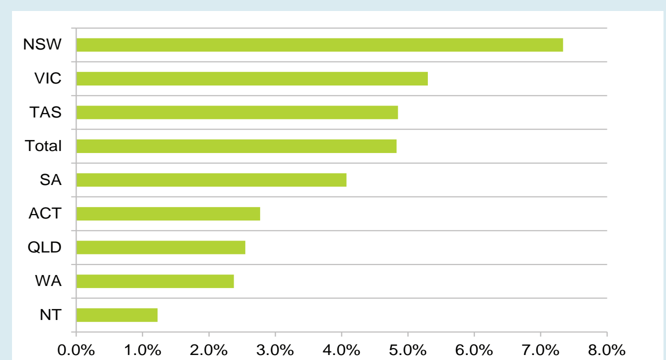
Figure 21: Retail Sales Growth by Type: May 2015



Source: ABS

Retail trade growth across the states is reflecting the macro economic picture with buoyant conditions in NSW and VIC, recording annual growth rates of 7.3 per cent and 5.3 per cent respectively in the year to May 2015 (Figure 22). The mining focused states of QLD, WA and the NT all underperformed, with annual retail sales growth of just 2.5 per cent, 2.4 per cent and 1.2 per cent respectively.

Figure 22: Retail Sales Growth by State: May 2015



Source: ABS

RETAIL CENTRE PERFORMANCE IMPROVING SLOWLY

While supply growth is modest in most major markets, net absorption of space is picking up, although vacancies remain elevated in selected parts of the retail market, especially older "tired" centres or centres in secondary locations. This has contributed to subdued rental growth across most retail centre formats. Landlords have become more flexible in their negotiations with tenants than they have been in years, as incentives continue to be a feature of the market, although there are signs that in the stronger markets of NSW and VIC, incentives are not as high as a year earlier. A number of the listed A-REITs who own retail centres noted in their June quarter updates that negative leasing spreads (the percentage by which rents on new leases are lower than rents on expiring leases) continue to reduce for new leases.

Retailers continue to be more selective about their store locations and are closing underperforming or poorly located

stores. At the same time, the influx of international retail brands continue to demand space in the best locations, typically in the larger destination regional retail centres. Retail landlords are having to adapt to both the structural and cyclical challenges facing the retail sector by continuing to refurbish and re-mix their tenants to grow market share within their catchment areas. Whilst this has been a feature of the retail market for decades, the continued evolution of retailing, the on-going threat from on-line retailing and the intense competition for tenants is taking this to a new level. The large regional shopping centres will continue in their transformation to destination centres, while the sub-regional centres which are anchored by discount department stores, will struggle to remain competitive, unless they operate as the dominant centre within their catchment area.

RETAILERS CONTINUE TO BE MORE SELECTIVE ABOUT THEIR STORE LOCATIONS AND ARE CLOSING UNDERPERFORMING OR POORLY LOCATED STORES

Retail centres focusing on convenience spending (i.e. food), more commonly known as neighbourhood centres, have performed well, generating a total return, according to the PCA/IPD Property Index, of 14.3 per cent in the year to March 2015 and 11.5 per cent per annum over three years. This segment of the retail sector has been popular with investors because of their focus on non-discretionary spending and the smaller lot size, which makes them attractive to private investors, syndicators and institutional investors.

Going forward, the increased competition amongst the supermarket operators (see on page 11 on The Rise of ALDI) and the threat of new operators such as LIDL, means that investors will need to focus more on the individual performance of the supermarket in each centre. We expect the variation in performance to widen depending on the supermarket operator, the size of the store, the demographics of the area and surrounding competition.

Large format retail properties (bulky goods centres) are back in vogue. Leasing conditions are improving with tenants wanting to expand their footprint on the back of strong growth in household goods retailing. The range of tenants being attracted to the large format centres is also expanding to include pet retailers, gyms, sporting goods retailers and even in some cases, where the planning has been relaxed, supermarkets.

Investor activity, both private and institutional, has also been strong with competition for quality large format retail centres intensifying. The standout segment has been free-standing hardware stores anchored by Bunnings or Masters which are now consistently trading on yields below 7.0 per cent. The Masters at Williams Landing in Melbourne was sold in April 2015 on a record yield of 6.0 per cent. We remain positive on the large format retail sector, although as is the case with all forms of retail, the individual characteristics of the centre are critical.

The key going forward as to which retail centres will perform and which won't, will very much depend upon the individual centre including:

1. is it a destination centre or the key convenience centre within its catchment;
2. does it have a more sophisticated feel and layout with well designed store frontages and public spaces;
3. does it offer an attractive mix of traditional retailers but also embrace non-traditional tenants and lifestyle and community uses such as cafes, children's play areas etc.; and
4. is it located in an area that has strong demographics that will foster customer traffic to the centre.

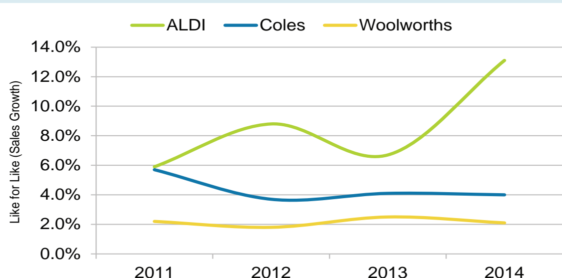
THE RISE OF ALDI

ALDI, who have been notoriously guarded about disclosing information on their business, has released some interesting information in a submission to the Senate Economics References Committee in July 2015[1] which relates to an inquiry into corporate tax avoidance and minimisation.

ALDI has established a network of 373 stores along Australia's eastern seaboard in QLD, NSW, ACT, and VIC and is moving into SA and WA with plans for as many as 120 new ALDI stores in these two states[1]. By utilising ALDI's unique business model - a limited range of high quality private label products (ALDI stocks an average of 1,350 lines of grocery products compared to 15,000 to 25,000 for a full service supermarket) and has a smaller store format which contains costs, ALDI provides Australian customers with grocery basket savings of 23 per cent to 50 per cent in comparison to its competitors based on the recent CHOICE survey published in June 2015[2].

ALDI's growth highlights the competitive nature of the supermarket sector and the growing penetration of ALDI into the market. Figure 23 compares the like for like (LFL) sales growth for the food and liquor operations of Coles and Woolworths with ALDI and highlights clearly that ALDI's sales growth is running well ahead of its peers[3]. The improving rate of LFL sales growth is consistent with reports from Roy Morgan of ALDI's growing market share, up from 3.1 per cent in March 2006 to 11.6 per cent in March 2015 [4]. At the same time, Woolworths' market share has fallen from 40.3 per cent to 38.5 per cent and Coles' from 37.0 per cent to 31.8 per cent.

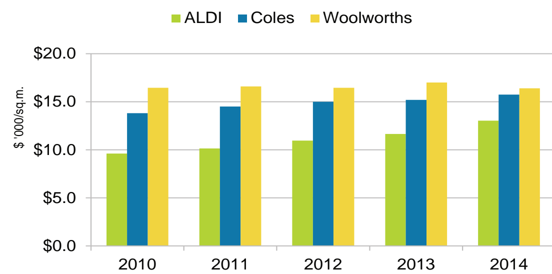
Figure 23: Retail Sector - Annual LFL Sales Growth: ALDI, Coles & Woolworths: 2011 - 2014



Source: Company reports and J. P. Morgan estimates. December year ends.

Figure 24 compares the sales per sq.m. for ALDI against Coles and Woolworths on a food and liquor basis. While surprisingly lower than Coles and Woolworths, ALDI's sales per sqm is growing strongly, as is Coles, while Woolworths is incurring falling sales per sq.m.. This is a key reason why Woolworths has been in the spotlight recently regarding its business strategy, high cost structures and poor sales momentum.

Figure 24: Retail Sector - ALDI, Coles Food & Liquor and Woolworths Food & Liquor Sales/sq.m.: 2010 - 2014



Source: Company reports and J. P. Morgan estimates. December year end

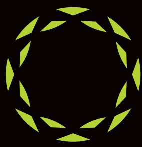
ALDI is currently embarking on a store expansion program and is seeking to use its scale to leverage the prices and quality of product and packaging from its suppliers and also include more brand products. As the product range improves, ALDI will be able to capture more affluent consumers to further enhance its marketshare.

Table 1: ALDI Sales Revenue and Productivity: 2010 - 2014

	2010	2011	2012	2013	2014
Sales revenue ($m)	3,139	3,523	4,163	4,998	6,000
Change (%)		12.2	18.2	20.1	20.0
Store numbers	251	267	292	331	354
LFL sales growth (%)		5.9	8.8	6.7	13.1
Sales/sq.m. ($)	9,620	10,150	10,967	11,615	13,038
Change (%)		5.5	8.0	5.9	12.2

Source: Company reports and J. P. Morgan estimates. December, year ends.

1. *ALDI - ALDI Submission to Senate Economics References Committee – 3 July 2015*
2. *CHOICE – Which Supermarket has the Cheapest Groceries? - June 2015*
3. *JP Morgan - Release of ALDI Australia Financials – Strong Sales and High PBT Margins Increase New Entrant Threat – 13 July 2015*
4. *Roy Morgan - The ALDI Effect: Australia's Changing Supermarket Scene – 22 June 2015*



Folkestone

INDUSTRIAL

Investor appetite for industrial assets remains elevated due to the tailwinds benefiting the sector - relatively high income yields compared to office and retail assets, the on-going evolution of the logistics sector, major transport infrastructure projects opening up new transport corridors and the gentrification of inner city industrial areas.

INDUSTRIAL YIELDS FIRM DRIVEN BY INVESTOR APPETITE

Industrial real estate has typically traded on a yield premium of between 100 and 200 basis points compared to office and retail assets, although the strong competition for industrial assets has seen this spread close, especially at the prime end.

Transaction activity in the industrial sector is heating up and we are seeing a growing bi-furcation in the industrial sector. Large scale distribution centres with long leases to blue chip tenants are now trading on yields between 6.5 per cent and 7.0 per cent – some 150 to 200 basis points lower than more traditional industrial assets and not much higher than prime office and retail assets. The recent sale by Goodman Australia Industrial Fund and Brickworks of the Coles Chilled Distribution Centre M7 Business Hub in Eastern Creek, NSW to Mapletree Logistics Trust, a Singaporean listed REIT for $235 million, on a yield estimated to be around 5.6 per cent has set a new benchmark for industrial property. The 55,395 sq.m. chilled distribution centre is leased to Coles until 2034.

Table 2 provides examples of other notable prime industrial transactions in the past year. All six featured transactions were on yields between 6.0 per cent and 7.0 per cent.

Table 2: Key Industrial Distribution Centre Sales: 2014 and 2015

Address	Price $m	Building Area sq.m.	Core Yield %	WALE	Vendor	Purchaser	Sale Date
36 Bernera Rd, Prestons	70.00	22,100	6.60	14.2	Vaughan	Logos (KWAP)	Oct 2014
133 Lenore Dr, Erskine Park	77.00	44,702	6.50	15.0	WH Soul Pattinson	Logos (KWAP)	Oct 2014
1 Griffin Cres, Brendale	73.80	50,300	6.40	15.0	WH Soul Pattinson	Logos (KWAP)	Oct 2014
2-12 Banfield Crt, Truganina	94.10	76,735	6.50	10.9	Goodman	Pramerica & Invesco	Nov 2014
16-28 Transport Dr, Somerton	22.30	21,279	7.00	14.0	Linfox (McPhee Distribution)	Cache Logistics Trust	Feb 2015
78-118 Cherry Ln, Laverton North	35.50	9,170	6.00	10.0	U/D	AIMS Property Securities Fund	May 2015

Source: Knight Frank

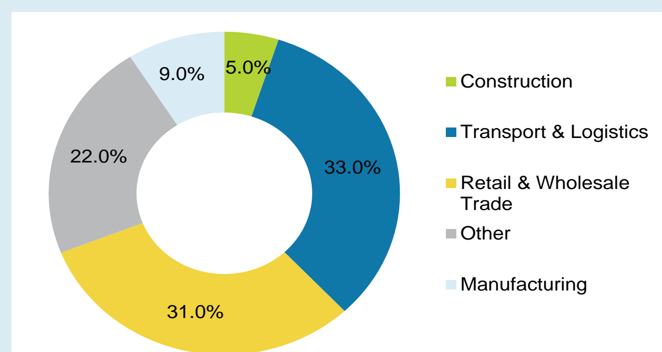
INDUSTRIAL TENANT DEMAND DRIVEN BY TRANSPORT AND LOGISTICS

The rise of e-commerce and the on-going evolution in the logistics and storage industry has intensified the demand for new, large warehouse and distribution centres. Supply chains are requiring logistics and transport groups to be more flexible and responsive which is driving a more strategic analysis of the location of facilities. The new wave of distribution centres are now typically more than 30,000 sq.m., have increased height to allow higher stacking, offer multiple docks and doors to facilitate ease of loading/unloading and cross-docking, and in some cases, have hi-tech automated warehousing systems inside the big-box.

THE RISE OF E-COMMERCE AND THE ON-GOING EVOLUTION IN THE LOGISTICS AND STORAGE INDUSTRY HAS INTENSIFIED THE DEMAND FOR NEW, LARGE WAREHOUSE AND DISTRIBUTION CENTRES

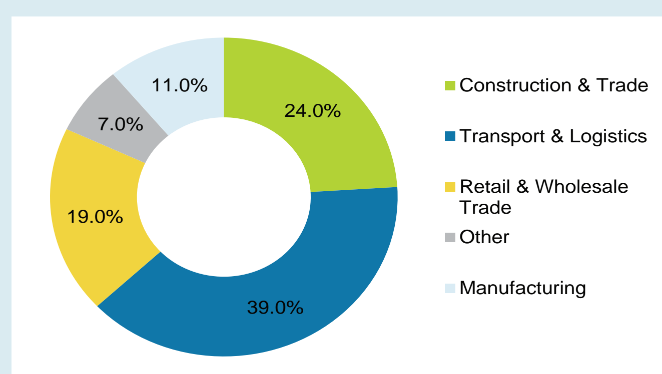
According to Colliers International, tenants in the transport and logistics sector have signed 39.0 per cent of all industrial leases across the country in the year to date, (Figure 26) which is up from 33.0 per cent in 2014 (Figure 25).

Figure 25: Industrial Leasing Activity by Type of User: 2014



Source: Colliers International

Figure 26: Industrial Leasing Activity by Type of User: 2015



Source: Colliers International

Major infrastructure projects (road and rail) are impacting distribution networks and will continue to stimulate new industrial development around the major transport nodes (i.e. Erskine Park and Eastern Creek in Sydney around the M7, M4 interchange and Truganina and Laverton North in Melbourne around the Western Ring Road).

Urban renewal is now becoming a theme in our major cities. Inner city industrial property in these areas are being rezoned for either commercial or residential re-development. The ASX listed Goodman Group (GMG) has been particularly active with more than $890 million of their urban renewal sites in Sydney now conditionally contracted for sale. We expect to see more investors accumulate land banks in these areas in anticipation of re-zoning to either develop themselves or on-sell to specialist commercial or residential developers.

One trend that has emerged in recent times and we believe will continue in the year ahead, is the sale and leaseback of premises by companies taking advantage of the strong appetite for industrial property to release capital from their balance sheets. In the past year, the Ingham's portfolio sold for more than $550 million to a range of buyers including Charter Hall and CorVal. Green Foods sold its major Brisbane facility to the 360 Capital Industrial Fund and McPhee Transport sold three warehouse and logistic facilities for more than $70 million to the Singapore based Cache Logistics Trust.

INVESTORS TO CONTINUE TO CHASE DISTRIBUTION CENTRES

International investors will continue to be active in the sector, especially targeting the large scale prime industrial distribution centres leased to the major transport and retail groups on long-term leases. As noted on page 4, the forthcoming sale of the GIC industrial portfolio, which is expected to sell for more than $1 billion on a yield well below 6.5 per cent, has received strong interest from international investors.

Domestic players will increasingly look to develop distribution centres to take advantage of the on-going demand for these prime assets. For those investors prepared to move-up the risk curve seeking opportunities to acquire modern assets that are well located, with shorter term leases that can be actively managed, it may provide better risk adjusted returns over the next phase of the cycle. These assets will trade on higher yields than the mega distribution centres, which typically have long-term leases and provide little opportunity to value-add.

ALTERNATE REAL ESTATE SECTORS

As yields on core real estate firm further, the search for yield in alternate real estate sectors is intensifying. In the past year, we have seen more capital allocated in both the listed and unlisted real estate markets to alternative assets such as real estate related social infrastructure – early learning, medical/health and seniors living. We have also seen childcare, health, self-storage and data centres make their presence felt in the listed market with the Folkestone Education Trust (FET), Generation Healthcare (GHC), Asia Pacific Data Centre Group (AJD) and National Self Storage (NSR) all listed on the ASX. In fact, in the June 2015 quarter, NSR was added to the S&P/ASX200 Index – a major milestone given this is the main benchmark used by fund managers.

From an investor viewpoint, these alternate sectors typically have higher yields than the mainstream sectors of office, retail and industrial, although in the past 12 months the re-pricing of these sectors has seen the yield gap close and given the growing interest in the sector, we would expect this yield gap to close further in the year ahead.

THE DRIVERS OF DEMAND ARE STRONG

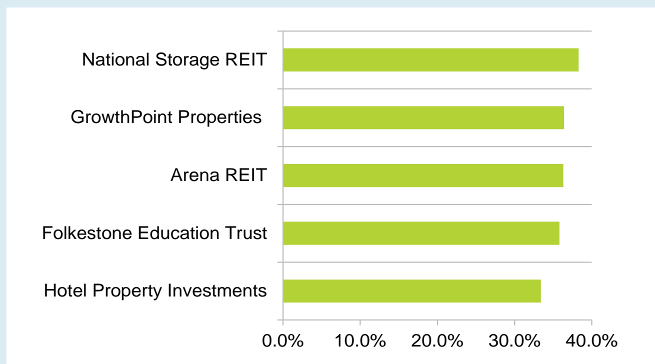
The drivers are clear. The population is both growing and aging, technology is driving change particularly in the health sector and operators of these businesses are increasingly recognising that in order to grow they need either to sell-off the real estate completely from their balance sheet to free up capital or partner with a real estate specialist who can provide the expertise to deliver and manage their real estate assets.

The benefits of investing in social infrastructure typically include longer leases than traditional real estate assets (often 10 years or more), net or triple net leases (whereby the operator/tenant pays outgoings and is responsible for repairs and maintenance), secure, often government backed cash flows and a lower relative volatility to other real estate and non-real estate assets. However, investors need to recognise that understanding the social infrastructure marketplace, operators, and the expectations of customers is critical to site and operator selection and ultimately, investment returns.

Although it is early days for the alternate sector, if the listed A-REITs are a guide, the performance is positive. Of the top five performing A-REITs in the year to June 2015, four are focused on the alternate sector (Figure 27).

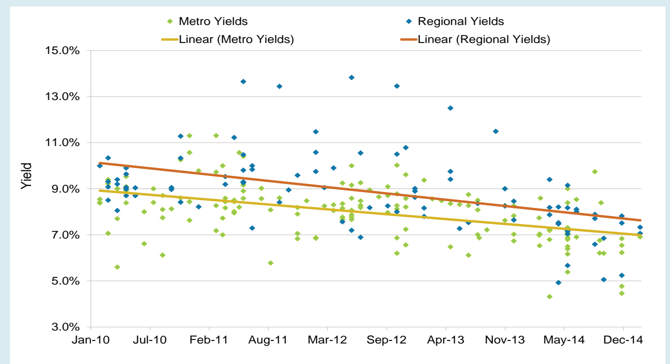
Whilst we are a long way from there yet, it should be acknowledged that there may simply not be enough acquisition opportunities to satisfy the demand for assets if these alternate real estate social infrastructure sectors go mainstream. The market is limited in terms of the number of potential assets in some sectors. Also, given they are often quite specialised, these assets can be less liquid than an office building or retail centre, potentially making it more difficult for the larger institutional investors to get scale. Also, like any sector, if the "hot money" starts chasing these assets, prices may rise too quickly, and yields fall, reducing their attractiveness relative to core assets.

Figure 27: Performance of the Top Five A-REITs: Year to June 2015



Source: IRESS

Figure 28: Early Learning Centre Sale Yields: 2010 – 2015



Source: Folkestone

Folkestone is the largest owner of early learning accommodation with more than 400 centres across Australia and New Zealand. We continue to like this sector given childcare is now seen as both a mechanism to support labour force participation, (particularly driven by the increase in female participation in the workforce) and an important form of early learning and education. We recognise that demand for centres from private investors, particularly SMSF's (with lot sizes ranging between $2 million and $7 million) is strong and this has driven yields lower (Figure 28). As a result, we believe the best opportunities will come from developing new centres within 15km of CBD's where there appears to be an under supply due to gentrification and people wanting to live both closer to the city, and in rapidly expanding growth areas.

The seniors living sector is expected to offer significant opportunities going forward. The seniors housing industry includes a wide range of facilities that provide varying levels of lifestyle support and health care services to residents. Facilities range from independent living (manufactured houses and retirement villages) that provide minimal or no special services for active retirees to specialised care facilities such as nursing homes that offer 24 hour assistance and medical care. Over the longer term, demand for seniors living should accelerate dramatically as the baby boomer generation reaches retirement age and life expectancies continue to increase. Also, the quality of assets in this sector ranges from very poor to very good, and not withstanding that the increased demand will require additional new facilities. A growing proportion of the existing retirement villages and aged care stock is tired and will become obsolete. This will create opportunities to develop new state of the art seniors living accommodation, or for facilities in the right location with a quality operator to be refurbished and repositioned in the market.

RESIDENTIAL

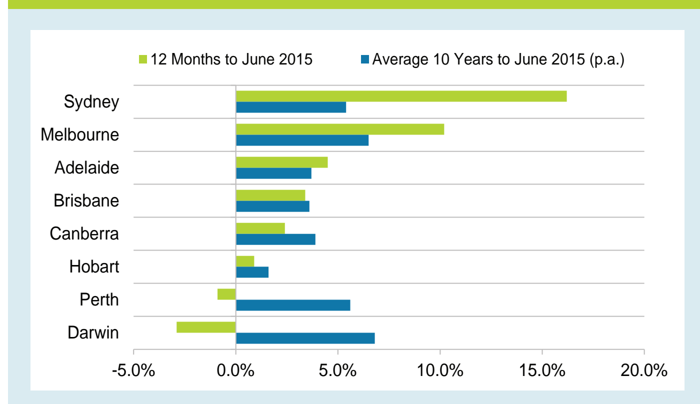
The housing sector has been in an upswing since 2012 with Sydney leading the way in this cycle.

However, there is wide divergence in the performance of dwelling prices across Australia. Sydney has recorded the highest growth over the year to June – up 16.2 per cent, followed by Melbourne (10.2 per cent) (Figure 29). Despite all the media commentary about a housing bubble, dwelling price growth outside of Sydney and Melbourne has been subdued. Brisbane, Canberra and Adelaide were up 3.4 per cent, 2.4 per cent and 4.5 per cent respectively, while values actually fell in Perth (-0.9 per cent) and Darwin (-2.9 per cent) in the part year. Brisbane, Canberra and Adelaide are being held back by softer economic conditions and low population growth while Perth and Darwin are being impacted by the mining sector downturn.

THERE IS WIDE DIVERGENCE IN THE PERFORMANCE OF DWELLING PRICES ACROSS AUSTRALIA

Whilst the spotlight continues to focus on the recent price increases in Sydney, it is worth noting that over the 10 years to June 2015, Sydney has recorded an average annual growth of 5.4 per cent, ranking it behind Melbourne (6.5 per cent) and Perth (5.6 per cent). It is also worth noting that the recent strong growth in the Sydney and Melbourne housing market has been driven by houses, up 17.8 per cent and 11.2 per cent respectively in the year to June 2015 compared to 9.5 per cent and 2.4 per cent respectively for apartments (units) - a factor we put down to the strong supply of apartments in both markets and investors focusing more on established housing (see page 16).

Figure 29: Dwelling Price Growth: One and 10 Years to June 2015



Source: CoreLogic RPData

We have argued in a previous report "Sydney Residential Market, Boom or Bust?" published in April 2015, that there are seven reasons other than just low interest rates why Sydney has outperformed in this cycle. These include:

1. price catch-up – as noted earlier Sydney's 10 year growth has not been extraordinary following the sustained period of underperformance in the mid 2000's;
2. fear of missing out (FOMO) – it is a natural human psychic to jump on the bandwagon when markets are running hot due to the FOMO;
3. demand – strong population growth into Sydney (despite Bob Carr's famous call that Sydney was closed) is fuelling demand for housing;
4. supply – we have not been building enough housing in Sydney to meet demand, due to a combination of factors, although Sydney's convoluted planning system can take much of the blame for significant delay in releasing land for development;
5. cost of land provision – the cost of providing basic raw land in Sydney is higher than in any other Australian city due to planning delays and high infrastructure charges;
6. fragmented land ownership and geographical constraints – both these limit Sydney's ability to deliver large tracts of land – Melbourne has a significant competitive advantage over Sydney in this instance; and
7. foreign investment – Sydney continues to be a key destination for foreign capital pouring into our residential market.

SUPPLY IS FINALLY RESPONDING TO DEMAND IN SOME MARKETS

After many years of under supply across most markets, housing supply is finally responding to demand with 182,455 dwellings completed across Australia in the year to March 2015 – the highest on record and 29,359 dwellings or 19.2 per cent higher than the previous 12 month period. The surge in completions was driven by a 29.5 per cent increase in the number of multi-unit dwellings completed in the year.

We expect the strong supply conditions to continue in the near term. In the year to May 2015, the number of residential buildings approved totalled 217,449 – a new record, while the number of commencements in the year to June exceeded 200,000 for the first time. Commencements continue to remain high with 53,900 dwellings commenced in the June quarter – the second highest on record.

One part of the residential sector where supply does not appear to be responding to demand is the land market. The latest data from the HIA-CoreLogic RPData Residential Land Report shows that capital city residential land sales in the March quarter fell for the third consecutive quarter, with sales declining by 7.7 per cent. Sales were down 21.8 per cent compared with the same period 12 months earlier (Figure 30).

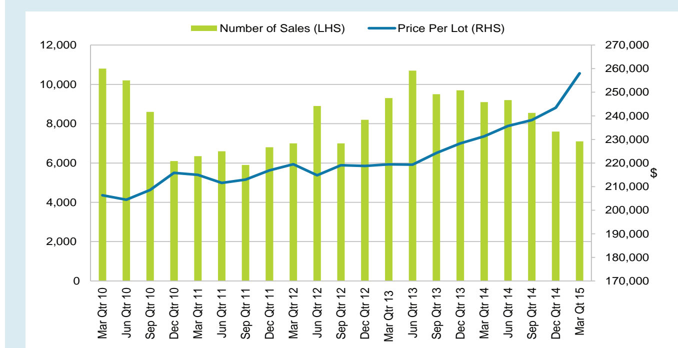
As a result of lower supply and stronger demand for capital city residential land, price growth has accelerated. During the March 2015 quarter, the median residential lot price increased by 6.0 per cent and was up 11.5 per cent in the year.

Sydney, not surprising, recorded a steep decline of 29.7 per cent in lot sales. Just 917 lots were sold in Sydney during the quarter, well behind Perth (2,188 lots), Melbourne (1,768 lots) and Brisbane (1,306 lots) and is almost 50 per cent lower than the record number of lots sold in December quarter 2013.

The median lot price in Sydney increased by 7.7 per cent in

the March quarter, and is up 23.7 per cent over the year, to $365,000. The median price for a residential lot in Sydney is now 64.4 per cent higher than in Melbourne ($222,000) and in Brisbane ($228,000). These numbers confirm that the recent announcement from the NSW Government to inject $400 million into the Housing Acceleration Fund to speed up the delivery of more housing and put downward pressure on house prices, will not be enough to address the issue. The government needs to urgently address delays in the planning system and the high cost of infrastructure delivery.

Figure 30: Residential Land Sales and Medium Lot Values - Capital Cities: 2010 - 2015



Source: HIA, CoreLogic RPData

We expect the overall level of supply across Australia to taper off in 2016 due to:

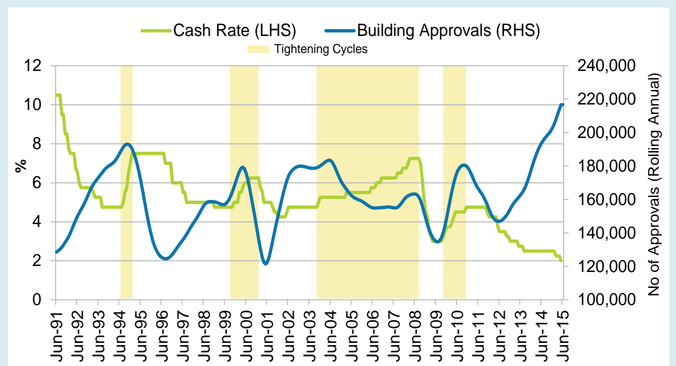
1. pent up demand in the system reducing due to the recent surge in supply;
2. concerns of an oversupply in selected apartment markets will put a brake on commencements in those markets;
3. affordability is beginning to bite;
4. supply bottlenecks in some residential land markets will restrict supply;and
5. the impact of macro-prudential controls introduced by APRA (see page 5) will reduce the number of borrowers.

Also, the residential sector is highly correlated to monetary policy - both when rates rise and when they fall (Figure 31). Therefore, residential construction activity in 2016 and 2017 will in part be dependant on the next moves in monetary policy by the RBA.

WE EXPECT THE OVERALL LEVEL OF SUPPLY ACROSS AUSTRALIA TO TAPER OFF IN 2016

The risks of oversupply are most evident in the inner Melbourne and inner Brisbane and the South Sydney apartment markets. In all three precincts, the supply pipeline remains elevated, with an increasing number of the apartments being pre-sold to foreign investors, in particular the Chinese.

Figure 31: Building Approvals and Monetary Policy: 1991 - 2015

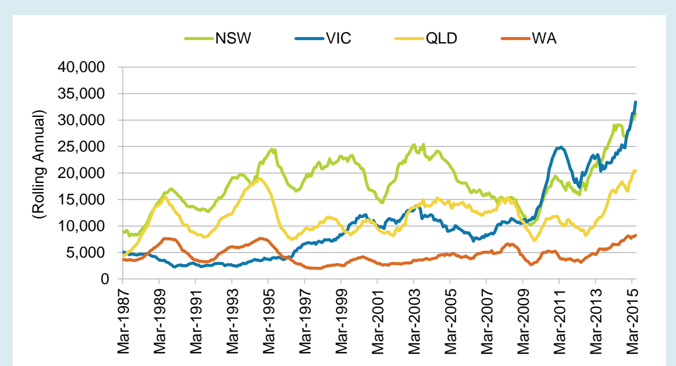


Source: ABS and RBA

APARTMENTS NOW A KEY PART OF THE MARKET

Multi-unit dwellings (mainly apartments) accounted for a record 47.0 per cent of total dwelling commencements in the year to May 2015, up from 30.0 per cent in the mid 2000's. Multi-unit dwelling approvals have risen strongly in most major cities in recent years with Melbourne and Sydney the standouts (Figure 32).

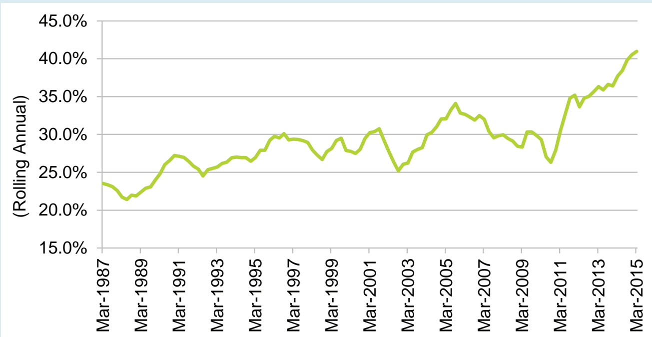
Figure 32: Multi-Unit Dwelling Approvals – by State: 1987 - 2015



Source: ABS

In the year to March 2015, 74,793 multi-unit dwellings were completed – 41.0 per cent of total completions. This is the largest contribution of multi-unit dwellings to total completions on record (Figure 33).

Figure 33: Multi-Unit Dwellings as % of Total Dwelling Completions: 1986 - 2015



Source: ABS

Apartments are now a key part of the market due to:

1. lifestyle changes - people are more accepting of apartment living and want to live closer to work and entertainment;
2. demographic changes - more people are downsizing given the ageing population and the number of single households is increasing;
3. affordability - apartments are cheaper. The median apartment price in Sydney is 28 per cent lower than a house and in Melbourne they are 22 per cent cheaper; and
4. planning changes - state and local governments are recognising the need for higher density living, particularly around transport and employment nodes to accommodate the growing population.

INVESTORS DRIVE THE MARKET

Investors have been driving the market. However, whilst there has been a lot of attention on apartment sales and off the plan purchases, investors are still overwhelmingly preferring to purchase existing properties rather than new properties. Investment housing finance commitments for the construction of new dwellings was $0.88 billion in May 2015 compared to $10.6 billion for established dwellings.

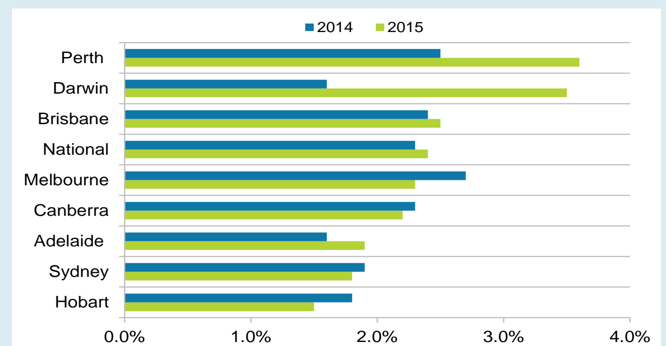
INVESTORS ARE STILL OVERWHELMINGLY PREFERRING TO PURCHASE EXISTING PROPERTIES

The RBA has raised its concerns about the level of investor activity warning that *"heightened investor demand can amplify the housing price cycle, especially when it involves the use of leverage, and so increases the risk that prices later fall significantly"*.[6]

INVESTMENT STOCK – HOLDING UP

Despite record supply and heightened investor activity, vacancy rates have yet to blow out with the exception of Perth and Darwin (Figure 34). Sydney recorded the second lowest vacancy rate at June 2015 – just 1.8 per cent. It is worth pointing out that the hidden vacancy rate is probably higher than what is reported given more people are now renting directly via the internet and avoiding agents.

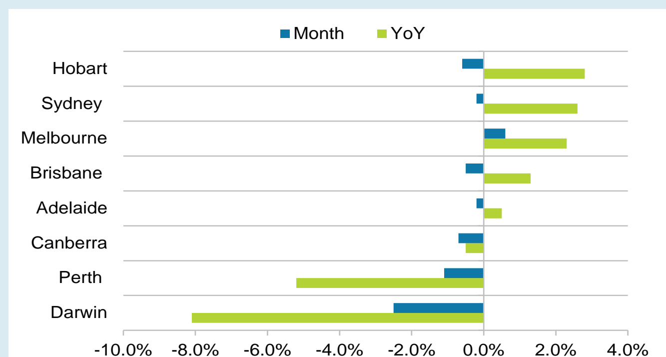
Figure 34: Residential Vacancy Rates: 2014 and 2015



Source: SQM Research

Rental growth remains subdued across most markets, again with the exception of Perth and Darwin where rents fell in the year to June 2015 (Figure 35). Hobart and Sydney recorded the largest increase in rents over the past year – up 2.8 per cent and 2.6 per cent respectively.

Figure 35: Residential Rents: 2014 and 2015



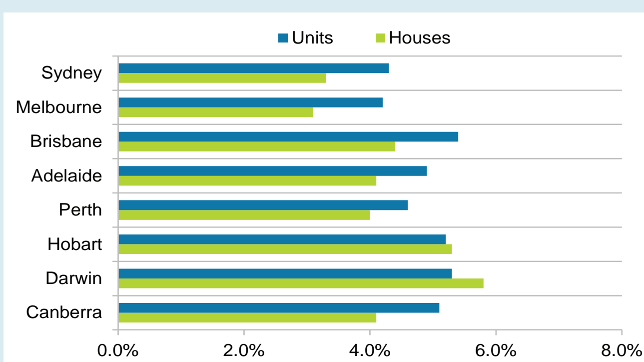
Source: CoreLogic RPData

RESIDENTIAL YIELDS – HEADING SOUTH

Residential property returns have been more about capital growth than income. According to CoreLogic RP Data, the average gross rental housing yield across Australia was 3.5 per cent at June – the equal lowest on record (Figure 36). For units, the average gross yield was 4.4 per cent, the lowest yield since 2010 and just above the record low of 4.3 per cent recorded in 2007. Melbourne recorded the lowest yield for both housing and units – 3.1 per cent and 4.2 per cent respectively. Across most markets, values have been growing faster than rental income.

6 *RBA - Financial Stability Report – March 2015*

Figure 36: Gross Rental Yields – Houses and Units: June 2015



Source: CoreLogic RPData

TOP OF THE CYCLE – ARE WE THERE YET?

We are approaching the top of the residential real estate cycle – does this mean a major downturn is around the corner? No, we don't think so. The momentum in the Sydney and Melbourne residential markets is set to slow as affordability constraints, weaker rental yields and tighter lending conditions start to impact. The fundamentals still remain positive with low interest rates and population growth. We expect national dwelling prices to rise between 6.0 to 8.0 per cent over FY16, just below the rates of the previous two years, and for "the heat" to come out of the Sydney market, with high single digit increase expected in the year ahead.

THE MOMENTUM IN THE SYDNEY AND MELBOURNE RESIDENTIAL MARKETS IS SET TO SLOW

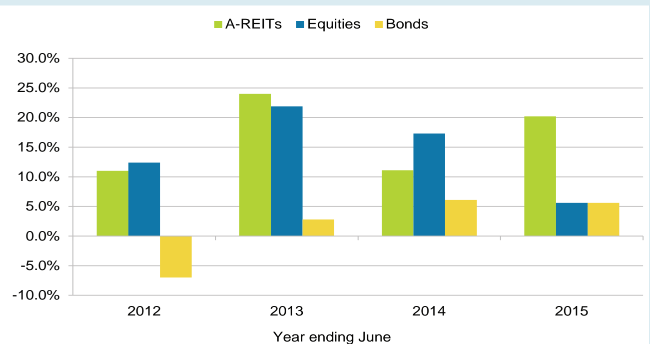
However, in assessing the market, we need to remember that residential comprises a myriad of sub-markets geographically, price point and type (houses vs apartments). Therefore, in assessing where to invest, investors need to understand the specific drivers of these submarkets. Our preference in the coming 12 months, is residential land and housing in Melbourne, Sydney and Brisbane, and apartments in Sydney around major transport nodes and residential in mixed use developments. The markets we would look to avoid are the inner Melbourne, inner Brisbane and the South Sydney apartment markets where supply remains elevated. Also the Perth residential market which will continue to feel the brunt of slowdown in the resource sector in the year ahead, putting further pressure on prices.

If construction levels continue at levels similar to 2015, residential vacancy rates should rise and rents fall which will be good for rental affordability but not for investors.

A-REITS

A-REITs generated a total return of 20.2 per cent[7] in the year to June 2015, outperforming equities[8] and bonds[9], which both returned 5.6 per cent (Figure 37). This is the second time in three years that A-REITs have been the best performing of the three asset classes.

Figure 37: A-REITs vs Equities and Bonds – Total Returns: 2012 - 2015

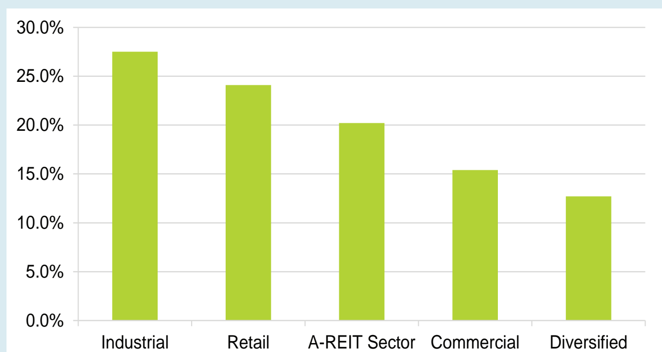


Source: S&P,UBS

Despite the headwinds in the second half of FY15 from rising bond yields and heightened market volatility over concerns about Greece and China, A-REITs actually performed stronger in FY15 than FY14, when they generated a total return of 11.1 per cent.

Notwithstanding the sector's strong performance, there was a marked variation in the performance across the various A-REIT sub-sectors (Figure 38) and individual A-REITs (Figure 39) during the year.

Figure 38: A-REIT Sector - Total Returns: Year Ending 30 June 2015



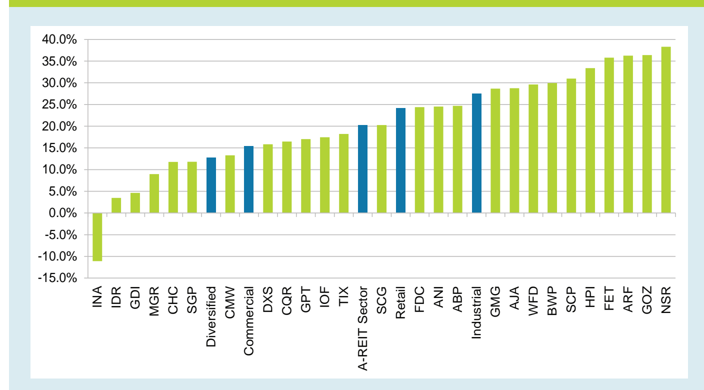
Source: S&P, UBS

The best performing sector was industrial at 27.4 per cent and the worst performing sector was diversified at 12.7 per cent. National Storage REIT (NSR) was the best performing A-REIT with a return of 38.3 per cent while Ingenia Communities was the worst performing A-REIT at negative 11.1 per cent. The variation

7 S&P/ASX 300 A-REIT Accumulation Index
8 S&P/ASX 300 Accumulation Index
9 UBS Composite Bond Index

in performance at both the sub-sector and individual trust level reinforces our belief that there is definitely a case for active management of A-REIT securities funds.

Figure 39: A-REITs Total Return: Year Ending 30 June 2015

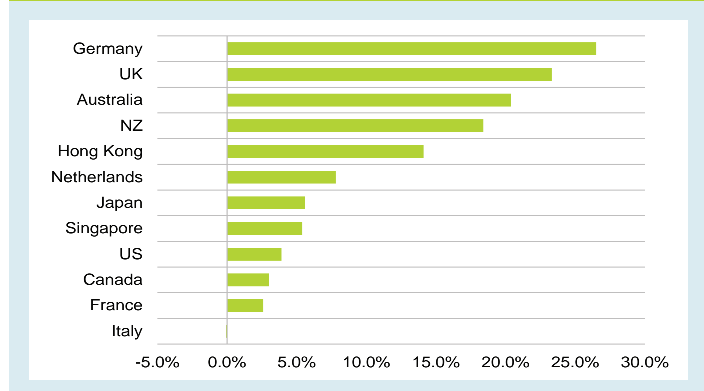


Source: S&P, UBS

GLOBAL PERFORMANCE – AUSTRALIA TAKES BRONZE

A-REITs were the third best performing global REIT market in FY15, beaten only by Germany (+26.5%) and UK (+20.9%), and significantly outperforming Japan (+5.6%), Singapore (+5.4%) and the US (+3.9%) (Figure 40).

Figure 40: Global REITs - Performance: Year Ending 30 June 2015



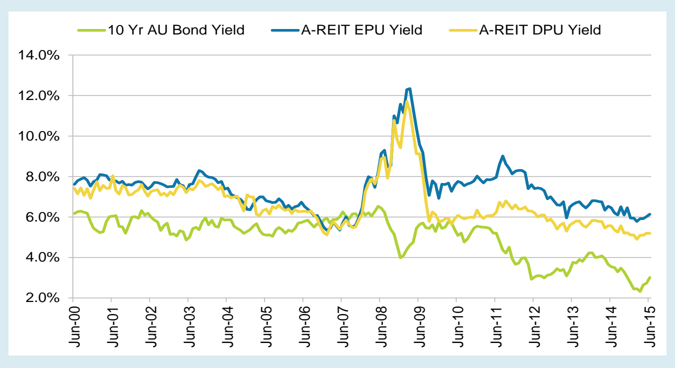
Source: Bloomberg, J.P.Morgan

The A-REIT sector is currently trading at a FY16 estimated distribution yield of 5.2 per cent (Ex WFD), representing a 320 basis points premium to cash and a 225 basis points premium to 10 year bonds (Figure 41).

A-REIT OUTLOOK – STRONG RETURNS OF FY15 UNLIKELY TO BE REPEATED

The A-REIT sector's strong performance in recent years has been primarily driven by declining bond yields rather than strong growth in earnings. Whilst as noted in our analysis of the various direct real estate sectors, we expect market conditions

Figure 41: A-REIT Sector EPS and DPS Yields vs. 10 Year Bonds Yields: 2000-2015



Source: Bloomberg, J.P.Morgan

to improve, albeit slowly. The performance of the A-REIT sector in the next 12 months will continue to be driven by the whims of the bond market and flows into the sector from equity funds and hedge funds who often park money in the sector short-term, rather than any significant earnings growth from the A-REITs.

Any material change in expectations around increases in bond yields or general equity market uncertainty could see a short-term sell-off like it did in April 2013. As a result, volatility in the A-REIT sector will be a feature in the year head.

Having said that, the majority of the A-REIT's balance sheets are in good shape (sector look through gearing currently stands at a reasonable 32.0 per cent), pay-out ratios are not pushing the upper limits and the likelihood of significant capital being raised is low. The lessons learnt from the GFC are seemingly being adhered to. Management appears reluctant, despite the low cost of debt to increase gearing, and with the exception of Cromwell's recent move into Europe through the acquisition of Valad Europe, have not been tempted to head back off-shore. Management are also focused on extracting value from their domestic portfolios through active management of existing assets, taking advantage of the strong appetite for real estate by selling underperforming assets and selectively acquiring new assets.

The upcoming reporting period is likely to deliver higher NTA's for A-REITs as a result of cap-rate compression (which leads to higher values) on the back of increased demand from offshore and local investors for quality assets.

We expect A-REITs to deliver a total return of between 8.0 per cent and 10.0 per cent in the year ahead – a respectable return in the current low interest rate environment, but well down on the above average returns recorded in recent years.

We continue to favour those A-REITs with exposure to industrial and social infrastructure sectors, and those securities with quality management and relative attractive yields, that have the ability based on active management of their portfolios, to drive earnings growth. We believe yield will continue to remain relevant as an investment attribute in the year ahead.

Folkestone

OUTLOOK

"This Time It's Different – Is It Really?" We don't think so. This time it's different does not abolish the real estate cycle.

Whilst the drivers of this cycle may be different from the late 1980's and the 2006/2007 real estate run-ups, the real estate cycle is alive and well. If there is one lesson we can take from previous periods of exuberance, when capital flows (either debt and/or equity) override real estate fundamentals, it can end in tears for some. While we still appear some way off from a real estate correction, we need to be cognisant that with capital market volatility expected to continue in the coming 12 months, capital flows to real estate will continue as investors seek yield in the current low interest rate environment.

Whilst interest rates are an important consideration in the purchase of real estate, they are not the only consideration. It is imperative therefore, that investors identify and quantify the risk in their real estate portfolios. On the risk front, we caution on two aspects.

Firstly, the weight of capital expected to continue to flow into real estate in the coming year could lead to overheating in some sectors and sub-markets.

Real estate, whether listed or unlisted, is a total return proposition and the current focus on chasing yield may not entirely compensate investors for loss of capital down the track if conditions change or yields soften. Investors therefore need to focus on the underlying real estate fundamentals. Factors such as the supply and demand dynamics of the market, strength of lease covenants, duration of the leases, rent review mechanisms and relevance of buildings to cater for tenant needs going forward, remain fundamental to the assessment of risk. Answers to these will be critical in the investment decision at this point in the cycle, to either buy or sell assets into a market where capital continues to be hungry for yield.

Secondly, investors need to exercise caution that acquisitions make sense on a through-the-cycle basis and that capital structures remain relevant despite the temptation, to take advantage of the availability of debt and "gear up". Relying on higher leverage to boost the performance of a real estate asset in a low yield environment may come at a cost, which too often doesn't materialise until it is too late. Conservative gearing levels and structures provide a buffer when (not if) the market changes.

Investors should continue to assess how various interest rate scenarios may impact the performance of assets going forward. Although we expect the cash rate to stay lower for longer, investors need to keep an eye on the long-end of the yield curve, as it is the long-term bond rate (not the cash rate), that real estate investors use as the yardstick for comparing the spread with real estate yields. Any rise in long bonds over the next two years is likely to be modest or even delayed if the Australian economy weakens further. However, the recent sell-off in global bonds (including Australian bonds) in response to comments made by the US Federal Reserve Chair Janet Yellen, served as a timely reminder of continuing volatility in global capital markets and how intertwined our markets are.

Looking forward, we remain focused on the east coast markets for both residential and non-residential investment opportunities. At the sub-market level, we are cautious on a number of submarkets such as the inner Melbourne and inner Brisbane apartment markets, the South Sydney apartment market and the Perth and Brisbane CBD office markets.

Our approach to the next few years, is very much focused on looking at specific investment opportunities and trying to identify those that for various reasons may be mispriced or we see an opportunity that others haven't assessed to add value. We will also look for opportunities where we can manufacture core product rather than relying on entering a competitive tender process to acquire assets on market.

Finally, we remain positive on the opportunities in the real estate related social infrastructure space, especially early learning and seniors living. The demographic tailwinds are compelling. Also most social infrastructure sectors have an undersupply of quality assets which provides opportunities for real estate specialists to either manufacture new product or refurbish and reposition older stock, as most operators don't have the skill set to execute on the real estate.

One thing that should remain a priority for all investors is to have a well-diversified investment portfolio. Bought well, both residential and non-residential real estate have a key role to play in a mixed asset portfolio.

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