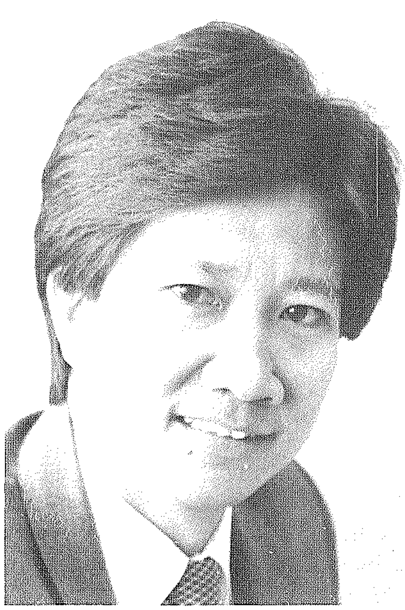
# UNSHAKEN TO THE FOUNDATIONS

## BRICKS AND MORTAR STAND FIRM



by N.H. SEEK

***Caution and prudence now govern property development decisions. But the commercial property outlook, despite the 1987 sharemarket crash, is favourable.***

Since the October stockmarket crash, attention has been focused on its likely impact on property. While the crash has had important effects, to which the market will adjust, there are strong underlying property trends which are unlikely to waver significantly. These trends are related to powerful forces of change occurring in a larger economic framework in which property is only one sector. This paper will briefly discuss these underlying trends and the post-crash prospects for property in the period to 1990.

Not all of the underlying trends are related to the bricks-and-mortar aspects of property and some are less visible than others: ▪ the property market is growing in complexity and sophistication; ▪ property and finance are becoming more integrated, particularly in the upper end of the market; and ▪ real-estate is becoming increasingly internationalised.

The underlying longer-term trend for more and better office space is expected to continue for two main reasons: ▪ the tertiary sector in the economy, which is the main generator of office employment, has expanded and will continue to expand faster than other sectors; and ▪ the average space being occupied per office worker has increased and will continue to increase to accommodate the demands for better working conditions and more space for office equipment.

Accompanying this growth in demand for office space is a market increasing in complexity and sophistication. Office space demands are becoming increasingly more diverse. Conventional office space in the city centre can no longer meet the needs of all businesses. For a number of years, particularly in Sydney and more recently in Melbourne, we have seen the decentralisation of office buildings.

Sydney city's share of office construction, in value terms, fell from more than 75 per cent in 1967-71 to about 40 per cent in 1982-86. In contrast, the outer suburbs in 1967-71 attracted only 10 per cent of the total office investment; by 1982-86 they accounted for 50 per cent of total office completions. The shift of office accommodation to the suburbs has not been as significant in Melbourne, but if recent leasings of suburban offices in the east and south-east regions are any indication, office suburbanisation in Melbourne has started in earnest. Perhaps the movement of the Coles Myer head office to Hawthorn is symbolic of the trend.

The tendency appears to be for businesses for which a central location is essential, such as banking and finance, to remain in the CBD as others disperse to the suburbs. This dispersion of office location is most visible in Sydney, where nearly 30 per cent of the space in the CBD is occupied by finance, investment

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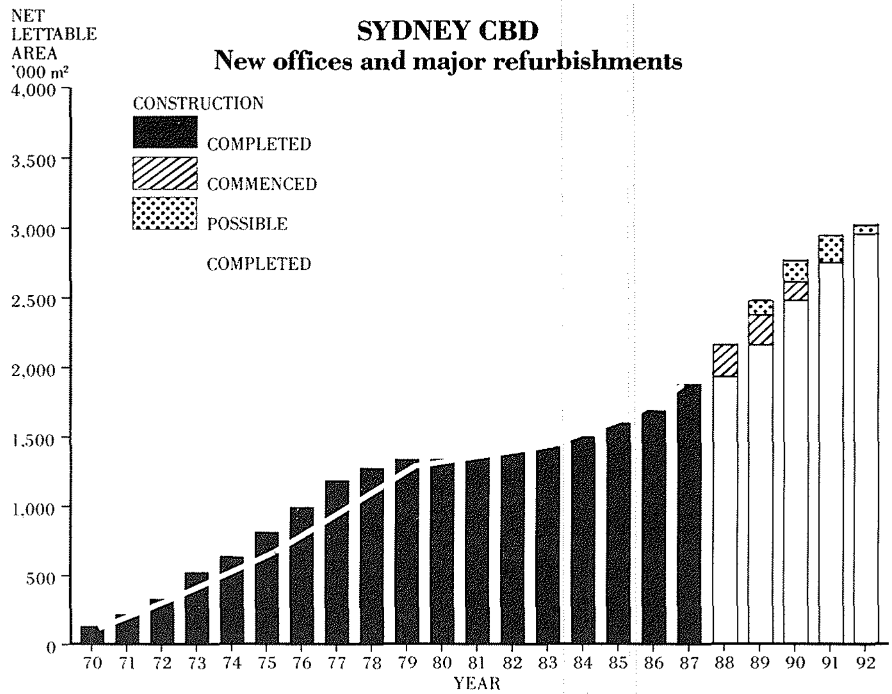
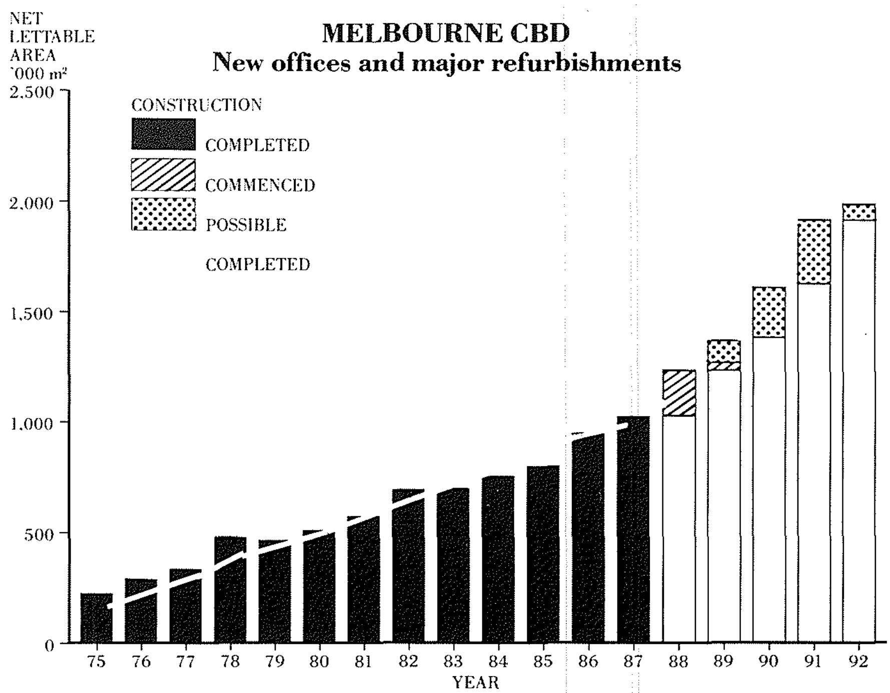
and insurance firms and another 30 per cent by the government sector. In contrast, in North Sydney, business services predominate, occupying 34 per cent of the total space compared with only 5 per cent in the CBD. Business services and the government sector are also highly represented in the suburban centres, accounting for about a third of the space occupied. Computer-related operations also have a decided preference for Sydney's North Shore. While this specialisation pattern is clearly most distinct in Sydney, it has been developing in other cities as well.

Technological changes and structural adjustments in the economy are affecting the way businesses are run and goods and services are produced. Businesses, in turn, demand accommodation tailored to their specific requirements, rather than conventional high-rise office space. In relatively recent years, developers have been responding to this demand from high-tech industries, as well as businesses which service these industries, by the construction of so-called office/business parks or high-tech developments. Such developments are attractive to industries which prefer to amalgamate office and production functions in one building and those with large data-processing workloads. Also, many finance businesses are relocating their back-office functions to suburban offices.

New developments in information and telecommunications technology have made the physical separation of activities possible. More important, it has given businesses more flexibility in their choice of where to house their activities, presumably to better financial effect. Recent surveys by Jones Lang Wootten suggests that accessibility to clients and customers is the main determinant in the choice of office location. Rent is an important factor but is quite far down in order of importance. The cost of accommodation is an important factor to all businesses, but there is little point in achieving cost savings by moving to cheaper accommodation, if the change adversely affects operations and consequently revenue.

The commercial property market has indeed become more complex, with a greater degree of market segmentation. Sub-markets are emerging to cater for different sets of office requirements. The net result is that office users have a greater variety of choices to satisfy their needs and ability




to pay, and this trend will continue.

The funding of real-estate investments has become more varied and creative. Many innovations are aimed at reducing the effective cost of finance and maximising tax benefits. One particularly popular scheme which is undergoing further development is the transformation of bricks and mortar into tradeable financial units, as in property trusts. The growth in the property trust industry is certainly a phenomenon of the 1980s. Property trusts as a group hold about 20 per cent of the total urban non-residental property investment in Australia. Their combined property assets increased by about 22 per cent to nearly $5 billion between 1985 and 1986. The success of the industry is evidence of the trend towards the fusion of property and finance.

Property trusts have continued to adapt to the changing tax and investment environments and to grow in sophistication. Recently, the concept of unitisation for single-property vehicles has received widespread acceptance in the investment community. Unitisation provides a vehicle to channel long-term equity funds for development and investment in "mega" projects. While Australia and the UK are working towards securitising equity through unitisation, in the US significiant development has been made in securitising debts through mortgage-backed securities.

However, the traditional real-estate business will probably never be replaced. Most property transactions, which involve smaller properties, will continue to be funded and traded in the conventional ways.

The parochial and localised nature of real-estate markets is slowly breaking down. Major investors now look to the whole world for investment opportunities to diversify their investment portfolios, taking account of differing economic and political risks. Large pools of funds amassed by cash-rich nations, such as Japan and the newly industrialising countries, are being recycled globally. Some of these funds find their way into property across national boundaries.

Unlike previous waves of foreign investment which tended to be dominated by British interests, Australia has now been exposed to worldwide investors including the Japanese, South-East Asians, New Zealanders and Europeans. Certainly, the recent relaxation of foreign investment restrictions has made Australia more attractive but, more important, it has the necessary prerequisites for foreign investment — long-term political and economic stability and prosperity. In 1986/87, the real-estate sector accounted for about 30 per cent of the total expected foreign investment in Australia. The Japanese and New Zealanders formed the two largest groups of investors in real-estate. Foreign investment in real-estate between 1985/86 and 1986/87 increased by slightly more than 100 per cent. Australia has clearly been a beneficiary of the globalisation of real-estate and is expected to continue to attract some of these international investment funds. However, it should be noted that Australian investors are also caught up in this globalisation process and have been investing in overseas real-estate.

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The prospects for property following the October stockmarket debacle depend largely on the performance of the Australian economy. To date, the property market has adjusted well, which is not surprising given the unexpectedly good performance of the Australian economy, and, for that matter, the world economy. However, it is difficult to predict whether the crash represents a temporary loss of confidence or will lead to a major worldwide recession. If the economy plunges into a recession, property as well as other economic sectors will be adversely affected.

If, however, the post-crash performance of the overall economy is any guide, it appears that only activities related to the securities industry will bear the full brunt of the crash. Given this scenario, the prospects for property are generally positive in the medium-to-long term, although they may not all be directly related to the crash.

As expected a short period of inactivity followed the crash as decision-makers held back from making commitments while re-assessing the position. Since the crash there have been very few significant casualties in the property industry; nor was there much forced or panic selling. Listed property trusts and property companies suffered the same fate as equities, although the severity of the falling prices for property trusts is considerably smaller.

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The market has now moved into a period of cautious optimism and decisions to proceed with investments are being made more frequently and with greater confidence.

The crash has also removed the pressure on fund managers to compete on the basis of short-term performance, which had led to a bias towards equities. With the stock market moving into what seems like a prolonged bearish cycle, there is likely to be a reversal to a more conservative investment philosophy among institutional investors, favouring more stable and predictable long-term investment alternatives such as fixed-interest instruments and property. We will continue to see more funds being diverted from equities to their property portfolios.

Contraction of employment in the securities and related industries can be expected to affect future demand for office space. However, the impact may not be as severe as generally believed if other economic sectors remain relatively insulated from the crash.

The finance-related sector, which includes the securities industry, accounts for less than a quarter of the occupied space in the CBD. Any decline in demand for space is therefore restricted to a small section of the total. Also, historically, the quantity of leased office space is less sensitive to changes in economic conditions than is the level of office employment. In other words, should there be a downturn in the economy there are unlikely to be massive sub-lettings.

It should also be noted that the tertiary sector of our economy has grown substantially in relative as well as absolute terms, and now has the capacity to absorb more office space. The Australian GNP increased in real terms by more than one third between 1977/78 and 1986/87, and the service sector, which is the main user of office space, enjoyed a disproportionate share of this increase. In addition, according to research by JLW the average amount of space per worker has continued to increase.

There is indeed a danger of an oversupply developing in both Sydney and Melbourne in the next two to three years, but the problem lies more in the supply side of the equation. Caught in the euphoria of a strong bullish equities market and indications of a strong pent-up demand reflected by abnormally low vacancies rates of between one and two per cent in the past few years, the office construction cycle had moved into a sharp upswing.

While the crash has not stopped this upturn in its tracks, it has brought back caution and prudence in property development decisions. Decisions are more likely to be based on achievable final demand for the development and not just on ever-increasing capital gains, the net result of which is the postponement and shelving of marginal projects.

The quantity of new office space in the next few years will almost certainly be significantly smaller than was expected before the crash.

Based on the above assumptions, we are able to construct three scenarios with respect to vacancy rates for 1987 to 1990 for both Sydney and Melbourne. Our forecast takes into consideration the current very high levels of precommitments in both Sydney and Melbourne of approximately 110,000 square metres in Sydney and 90,000 square metres in Melbourne. Vacancy rates are expected to become progressively higher over the next three years. Our worst scenario indicates that vacancy rates will increase from 2.5 per cent in 1988 to 9.5 per cent in 1990 for Melbourne and 2.5 per cent to 10 per cent for Sydney. The more likely scenario for Melbourne and Sydney is 7.5 per cent and 8 per cent respectively. What the vacancy statistics suggest is that, while there is some cause for caution, there will not be collapse of the property market as suggested by some commentators. If one compares with a more mature market like Manhattan, 7 to 8 per cent is considered normal vacancy. Most real-estate practitioners in Australia would see 5 per cent as an indication of a healthy market allowing for frictional movements; ie, the market would be close to equilibrium. If anything, the market is moving towards a healthier and more normal state, erring perhaps on the side of a moderate surplus.

Property commentators tend to draw on the experience of the commercial property market in the 1970s to make predictions for the rest of the 1980s, but the circumstances in the 1980s are quite different. Indeed, for three to four years in the 1970s, property values for Sydney fell by more than 10 per cent a year in real terms, but it should be noted that this was a period of stagflation with very high vacancy rates peaking at about 18 per cent. Under such a combination of negative factors, property yields edged upward, resulting in a real decline in property values, but even during this period nominal prime rental levels held constant.

The scenario for the rest of the 1980s is probably the reverse: relatively low inflation rate, liquidity in the system with expected declining interest rates and probable vacancy at half that of the 1970s. Also, real economic growth of 2 to 3 per cent is expected. In view of the relatively positive economic outlook in the next few years and the number of factors discussed above, at worst, values and rents will plateau in general as vacancies rise to a peak in 1990, assuming no additional growth in absorption. Realistically, downward resistance to values and rents is more likely for these reasons:

- diversion of more funds by institutions from equities to property;
- a more mature property investment market, which has increased in size and in depth, to provide greater cushion to sudden changes in the property market;
- continuous interest by foreign investors in Australian real estate; and
- a reduction in expected supply, resulting from the delaying and shelving of marginal development projects.

It is important to note that, while we are looking at a three-year horizon, property should really be evaluated on a longer-term basis. Property has a proven record of being a very good long-term performer.

For example, the average total return of prime CBD office properties in five major Australian cities from 1979 to 1987 is approximately 24 per cent a year.

Sydney and Melbourne were consistently the best performers for a number of years but all cities show steady long-term growth. It is interesting to note that while Adelaide has been the worst performer in terms of total returns, it tends to be negatively related to other cities and therefore is an ideal place to invest in for purposes of diversifying risks in a property portfolio.

Barring any major economic debacle, the prospects for property in the next three years should be reasonably favourable.

While there is a danger of an oversupply of office space developing in some cities, current evidence suggests a healthy market with higher vacancy rates than in the past few years, and slower growth in rents and prices ☐

**PRIME CBD OFFICE YIELDS** (1978-1987)