



Worth Noting

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Worth Noting is the weekly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

Commercial Real Estate in Australia

Australia is an attractive place to do business in: the political landscape is stable, the operating environment is relatively transparent and laws are effectively enforced. Moreover, businesses in Australia have access to one of the most skilled and modern work forces in the world, in particular, in comparison to our immediate neighbours undertaking various degrees of modernization. We also have the advantage that Australia is located within what is touted by the World Bank to be the fastest growing region in the world (by GDP per capita) over the next 10 years.

There is also another reason why Australia is attractive to do business in. Besides the good supporting business infrastructure mentioned above, the relative costs of office accommodation are very low.

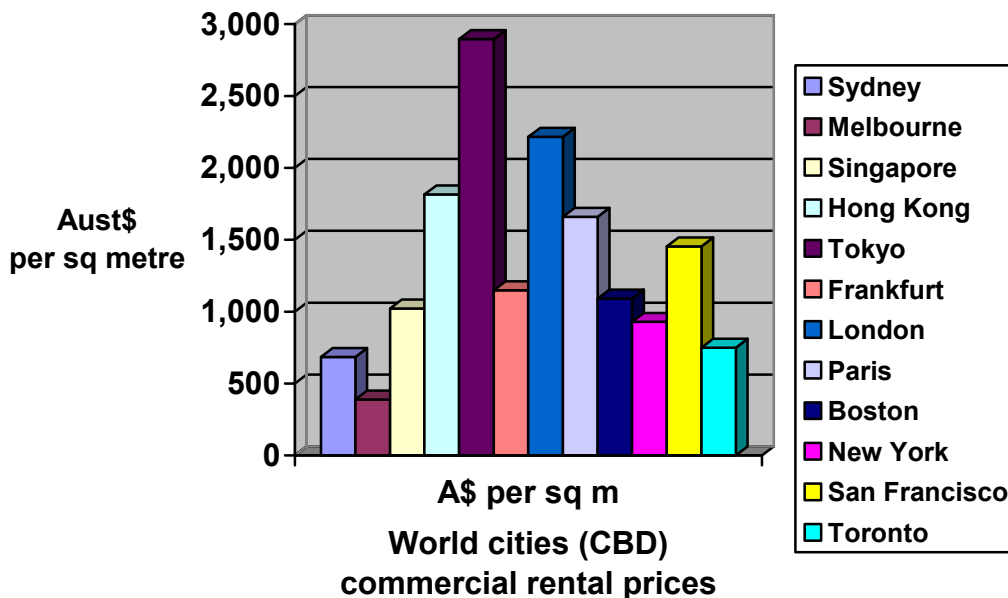
Our research suggests that prime Australian rental space compares very favourably to similar locations worldwide (i.e., in developed countries). This should contribute to Australia becoming an increasingly popular place for multi-nationals to establish themselves – in addition to the broader political, social and economic advantages. Moreover, it is worth noting the trends in commercial property rents in especially the main CBD areas of Sydney and Melbourne and the factors that drive those trends.

Australian & Global Comparisons

Despite our international outback image, we are one of the most urbanized countries in the world. Consequently, prime office locations are located in CBDs based in our major cities – Sydney and Melbourne, followed by Adelaide, Brisbane and Perth.

For the purpose of classification, we have adopted the Property Council of Australia grading system and distinguished between prime office space (generally those offices with a good outlook, with multi-zoned air-conditioning services, security card access and short waiting period for lifts) and secondary office space.

As mentioned, Australian rents are exceptionally cheap on pure dollar terms compared to other international cities.



Source: CB Richard Ellis Global Research & Consulting 2001

Australia also compares very favourably by another measure: the cost of commercial rental of office space taken up by a senior executive compared to the salary of the senior executive. This is a useful measure because it takes into account a significant cost of a business operating in that particular city (i.e.,

senior management salaries) and therefore provides an anchor point for global price comparisons.

Research has shown that in Sydney, the cost of prime commercial rental space taken up per person is 9% of the average senior management salary. In Melbourne, it is 5%; 6% in New York, 9% in Singapore, 11% in Hong Kong, 16% in Tokyo and 22% in London. (Axiss Australia) This obviously places Australia at a significant competitive advantage on pricing terms alone.

Demand for Prime Commercial Property

What drives current demand for prime commercial property in Australia?

In Sydney and Melbourne where over 70% of lease negotiations took place last year, finance and business services accounted for over 70% of the prime leases. Government departments were next, accounting for almost 18%.

The fact that finance and business services dominate prime commercial space should not be surprising. In these industries, space required for stock is relatively low, investment lies largely in people, and prime locations allow businesses relatively easy access to a highly educated workforce.

Yet, what is perhaps more interesting is that a recent study by Colliers Jardine has found that multi-national organizations have been the most active participants in the Sydney CBD prime commercial market over the past three years, accounting for about 75% of the total available space. This supports the proposition that Australia is one of the more attractive places to do business around this region. In addition to the low risk political and operating environment mentioned earlier, the East Coast time zone (Sydney, Melbourne & Brisbane) covers the closing of the US market and the closing of the European market the following day with a local time zone that sees Australian markets open before regional counterparts in Singapore, Hong Kong and Tokyo.

The vast majority of the multi-nationals were broadly in the finance industry. As a result of surveys conducted on existing occupants, the factors that influenced decisions on where and what to rent were more a result of non-price factors (i.e., right location, lease period, quality of building and infrastructure) than price. This seems to make sense since over 80% of the lessees are 'mature' businesses who see prestigious office locations as a critical asset.

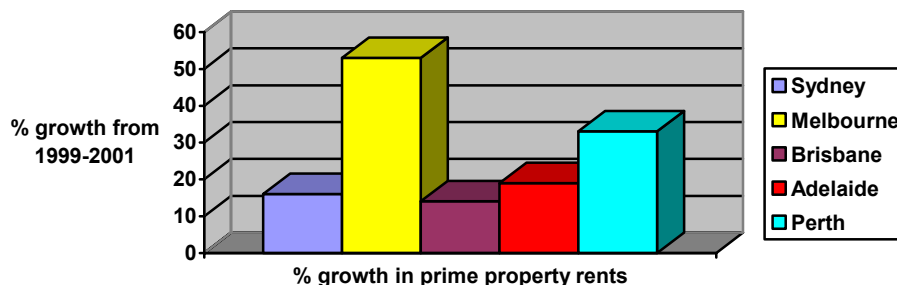
In fact, over 80% of lease space is taken up by 'mature' businesses having relocated or expanded rather than by new businesses entering the CBD for the first time.

Trends in Prime Commercial Property Leases

Predictably, Sydney and Melbourne (which together comprise about 70% of commercial office space) have the lowest vacancy rates in Australia. The Property Council of Australia states the 2001 vacancy rate as 4.8% and 6.2% respectively.

Yet, these statistics include both prime and secondary commercial property. When we consider only prime office locations, research suggests that vacancy rates fall to about 1-2% for each city.

This trend towards low vacancy rates in prime locations seems entrenched. However, fluctuations in rents have varied greatly across Australia.



Source: CB Richard Ellis Global Research & Consulting 2001; L21 Analysis

The figures above seem inexplicable when we compare the difference in rental increases between Sydney and Melbourne, especially when there is no readily discernable difference in the lease structure such as average lease terms etc.

One reason might lie in the fact that of recent prime CBD office buildings completed in 2000, 90% of them have been in Sydney. However, the vacancy rate for prime locations has not altered meaning that demand has closely followed supply in the Sydney CBD. Indeed, the absorption rate of prime office spaces in this period was the highest in a decade. Increasing the number of prime office spaces cannot account for the relatively sluggish Sydney rent price.

However, what is worth noting about the above statistic is that the numbers must be read against the background of the renegotiation of leases which is the only time when price enters the analysis.

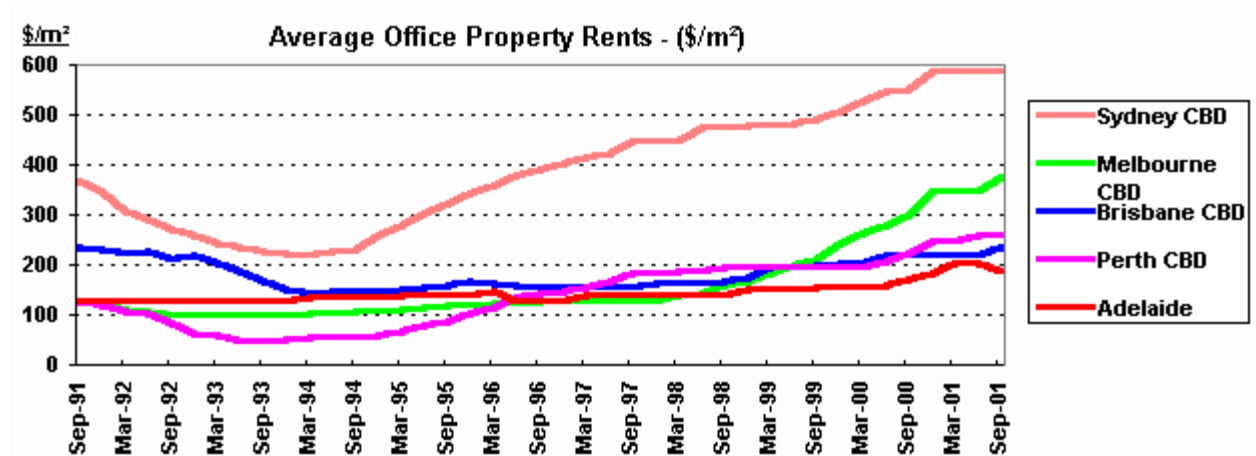
Just under 50% of leases in prime commercial locations are agreed to for a period of 6-12 years. About 25% are for a period less than 6 years and about 25% are for a period of more than 12 years. The average period is about 7 years.

Almost 80% of businesses aim to rent a space of less than 4,000 square metres (about 3 floors or less of the average building). This is where competition is intense.

Of just over 150 prime location leases negotiated in 2000, Melbourne accounted for almost 50% of them while Sydney accounted for about 25%. As a result, a higher proportion of leases in Melbourne reflect today's market rates – Sydney has a higher proportion of leases at prices set in earlier years.

However, this cannot alone account for the disparity in rent increases between Sydney and Melbourne. Clearly, there must be another variable that can serve as a better base for rental prediction since rental increases.

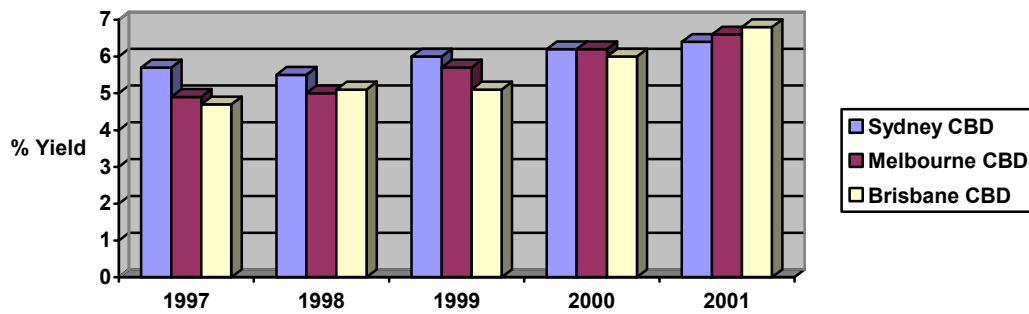
Melbourne started from a much lower base than Sydney – Sydney's price ramp-up in the mid-late 90s is startling.



Source: Property Council of Australia

Our research strongly suggests that the main variable in determining prime rental prices is the yield from the property. With about 70% of prime property owned by financial institutions or listed property trusts, yields will always be the key metric by which property value is judged.

Our analysis of yields from prime properties in Sydney, Melbourne and Brisbane over the past 5 years brings this out below.



Source: Property Council of Australia, L21 Analysis

The figures show that yields have shown a steady increase over the past 5 years. Yields in the period 1997-2001 in Sydney CBD have increased from 5.7% to 6.4%, in Melbourne from 4.9% to 6.6% and Brisbane from 4.7% to 6.8%.

It is worth noting that property trusts often make simplistic assumptions about the value of commercial property portfolios. Working backwards, portfolio managers make rental projections based on average market yields. This is flawed analysis, on our view: rent drives value, value does not drive rent. Rent is essentially an earnings stream, with value determined by usual DCF or P/E analysis.

A striking feature of the chart above is the extremely flat rental income of commercial property owners in capital cities outside Sydney and Melbourne (despite enjoying quite high yields). We see no reason for this trend to change. Globalisation favours the major cities – and particularly Sydney – disproportionately to the regional capitals. Global contracts are rarely won in Adelaide: limited growth opportunities exist outside the main centres.

Summary

This issue of Worth Noting makes the following points:

- Australia, and especially Sydney and Melbourne, will see continued demand for prime office space by particularly multi-national business and finance operations. Even though rents have risen, in comparative dollar terms, the most expensive CBDs of Sydney and Melbourne are still cheaper than comparative CBDs in the region such as Singapore
- Vacancy rates will remain low – at about 1-2% for the premium space. Most of the vacancies will be in secondary office locations
- Melbourne has enjoyed a substantial boom in office rents, driving up both capital value and yields
- Globalisation will continue to deliver disproportionately large rental increases to prime Sydney landlords