Approaching a turning point?

Changing stages of growth in the Australian office cycle

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With Australia's gateway cities of Sydney and Melbourne now entering late stages of growth, is it time for a strategic rotation into the secondary cities of Brisbane and Perth?

Both the occupier and capital markets in Sydney and Melbourne's office sector have seen prolonged periods of growth. Rents have been rising for years and yields have been compressing almost simultaneously. Recent transactions suggest that investors are starting to look to Brisbane and Perth as cap rates in the gateway cities hit record lows. In this paper, we examine if the interest is justified.

Is it time for secondary cities to shine?

The past few years have seen Australia featuring strongly on investors' radars as the hunt for returns and growing amounts of capital start finding their way down under. Sydney is typically the first port of call, being the country's commercial center, while Melbourne follows as second in command. The office markets of both cities have been strong outperformers in APAC in recent years, but having already seen multi-year growth, is it now Brisbane and Perth's day in the sun?

First, the economy

The attention on Australia's two secondary cities of Brisbane and Perth follows increasing signs of an impending recovery there. On the economic front, the mining and resources-driven economy of Western Australia looks set for a turnaround after years of contraction following the collapse in commodity prices. While mining also makes up a significant portion of Queensland's economy, the eastern state has a more diversified base which helped it to recover more quickly than Western Australia.

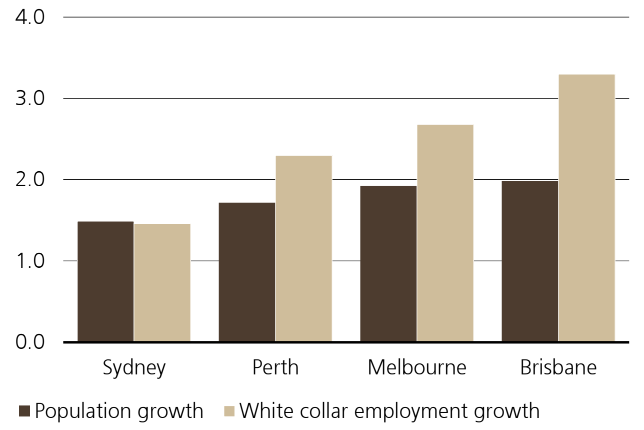
Going forward, Western Australia's capital city of Perth is expected to have the highest GDP growth rate among the four cities due to heavy investments into the resources sector. This extends beyond the traditional commodities of iron ore and oil & gas into new commodities such as lithium and uranium. GDP growth for Brisbane is projected to be the second highest, similarly with mining as a contributor to growth but more crucially, economic improvement will be supported by a broader range of industries including business services, finance and insurance and healthcare.

But a closer examination of the numbers is crucial to have a more nuanced understanding of the risks and volatility profile of each economy.

Perth's projected GDP growth will likely be overwhelmingly driven by the mining sector, which puts it at risk of a commodities downturn. Brisbane's growth, on the other hand, will be more broad-based, and similarly to Melbourne, both cities are expected to see strong population and white collar employment growth, which is supportive of office demand (Figure 1). From a volatility point of view, Perth has historically had greater swings in economic growth than the other three cities. This is testament to the risks that come with dependence on a singular growth driver (Figure 2).

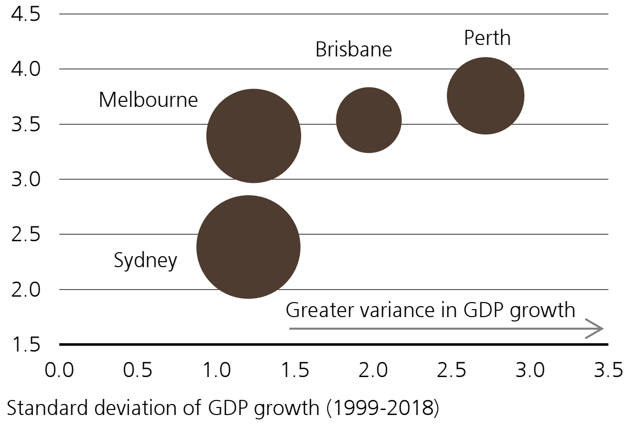
Size also matters, where for Sydney, having a GDP size that is more than twice that of Brisbane means that even a marginal 1% growth in GDP will amount to greater output than a 2% increase for Brisbane. In simplistic terms, the higher growth rates of Perth and Brisbane (which could be more cyclical in nature) would have to be weighed against the heft and relative stability of Sydney and Melbourne's economies.

Figure 1: Projected population and white collar employment growth, 2019-23 (% YoY, p.a.)



Source: Oxford Economics, April 2019

Figure 2: Projected GDP vs. volatility, select cities projected GDP growth, 2019-23 (p.a., % YoY)

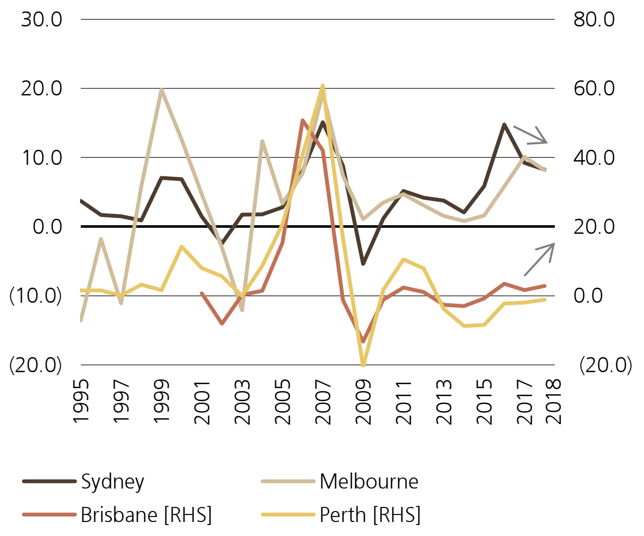


Source: Oxford Economics, April 2019. Note: Circles indicate size of GDP

Office: secondary cities are not necessarily counter cyclical
The office markets in Sydney and Melbourne have enjoyed positive growth in rents for the past ten years or so, although growth only started to accelerate strongly in 2015-16. With rents in these two cities at record highs and growth expected to taper off, Perth and Brisbane have been identified as counter-cyclical plays that may take over the reins in terms of rental growth from the former two gateway cities. While this looks to be the case in this current cycle, we think it is apt at this juncture to address the common thinking that Perth and Brisbane are necessarily always counter-cyclical plays against Sydney and Melbourne.

Figure 3 shows the change in net face rents for the four cities and it is worth noting that historically, rents have tended to move in tandem rather than in a counter-cyclical fashion, albeit to varying degrees[1]. Granted, the years during which rents in Perth and Brisbane were contracting saw rents expanding in Sydney and Melbourne, but improvements and deteriorations in rents took place during the same time periods across the four cities. This suggests that to some degree, overall office rents across Australia are *partially* driven by the common, macroeconomic environment – such as the commodities super cycle in the early-to-mid 2000's and the Global Financial Crisis (GFC) of 2007-08, which correspondingly saw rental growth rise and fall (Figure 3).

Figure 3: Change in net face rents (% YoY)



Source: CBRE ERIX, April 2019

[1] A similar relationship is found for rents across the four cities on a net effective basis, which accounts for incentives.

But macroeconomics cannot account for all of the rental movements. The other part of the equation, which is arguably just as, if not more influential when it comes to rental movements, is the real estate fundamentals – or simply, demand and supply.

Much of the performance in rents in Sydney and Melbourne has been related to supply – or rather, the lack thereof. Sydney is still in the midst of a very tight five years (three years of stock removals and two years of very limited completions), with the next spike in completions expected in 2021. Melbourne similarly saw two years of lower than historical average stock additions in 2015-16 and some stock removal in 2017, but the supply story is about to change with a large influx of completions expected in 2019 and 2020. This is almost welcome relief to a market which has seen strong appetite for space – data from CBRE shows that Melbourne has seen the highest amounts of net absorption of the four cities over the past 10 years at 72,000 square meters (sqm) per year, more than double than of Sydney (bearing in mind that this is in part due to the lack of new builds in Sydney).

Going forward, Melbourne is expected to remain the frontrunner in terms of demand for office space, but vacancy rates are still projected to rise on the back of new completions. Rental growth is thus expected to be moderated in the coming years. Sydney buys itself some time as the new supply cycle will kick in a few years later, but nevertheless, rents are in the late stages of growth.

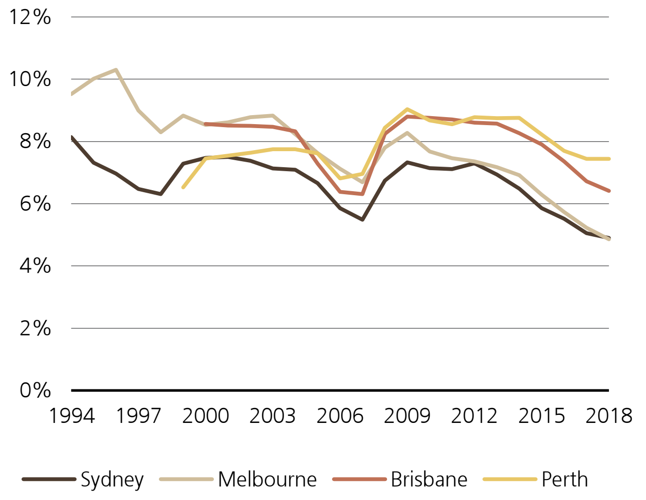
Perth and Brisbane: early stages of an office recovery
As mentioned earlier, the counter-cyclicality of Perth and Brisbane is only playing out over the last two years, as indicated by the arrows in Figure 3 – as rental growth starts moderating in Sydney and Melbourne, that for Brisbane and Perth are looking to improve.

It has been a long and hard slog out of a multi-year office downturn for Perth and Brisbane. Both cities saw an influx of new completions in 2012 but what did the markets in was the beginning of the end of the commodities super cycle and a subsequent collapse of the mining investment boom.

Commodity prices had begun to correct in 2012, and the subsequent years saw significant negative net absorption in the office market, led by resources firms giving up space which then spilled over into the overall business environment. Vacancy rates spiked from single digits to double digits, peaking at ~23% for Perth's CBD and 16% for Brisbane's CBD in 2016 and 2017 respectively. But with economic recoveries and stock withdrawals now taking place in both cities, and Perth in particular experiencing a dearth of new completions in the coming years, vacancy rates are now starting to trend downwards again with rents also expected to reverse their contractionary course.

Figure 4: CBD office yields (%)

	Sydney	Melbourne	Brisbane	Perth
2018 / 2009 ratio	67%	59%	73%	82%



Source: CBRE ERIX, April 2019

Is the price right?
Market recovery notwithstanding, investment decisions are seldom (if ever) purely driven by the rental cycle; acquisitions can be made even in a bad market – as long as the price is right.

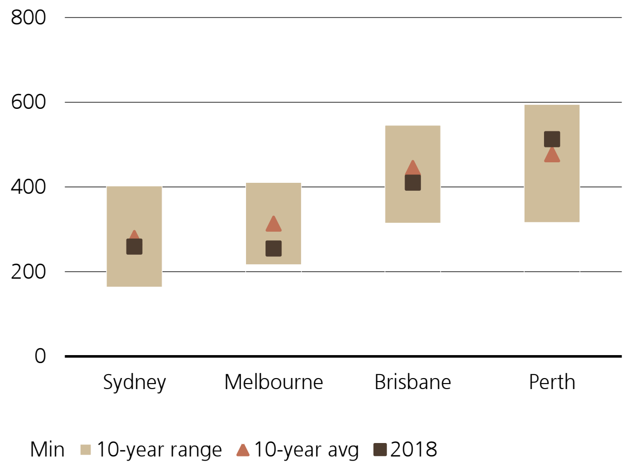
Determining the right price is where it gets tricky, especially against the broader backdrop of unprecedented amounts of liquidity and interest in real estate investments. Yields have been compressing as a result, but while they have sank to record lows for Sydney and Melbourne, that for Brisbane and Perth are close to but not yet at all-time lows. When compared to the previous peak in cap rates in 2009, yields in Brisbane and Perth have declined by a smaller extent than Sydney and Melbourne, as indicated by the 2018/2009 ratio (Figure 4).

From a yield spread perspective, however, there still seems to be some room for compression. The CBD office spread compared to the 10-year government bond yield is still not at the lowest point of the 10-year range (from 2009 to 2018) for the four cities, although they are below the 10-year averages for Sydney, Melbourne and Brisbane (Figure 5).

Perth appears to be at the most attractive pricing level from this perspective, given that it is the only city with a yield spread still above the 10-year average and that is closer to the high end of the 10-year range. Brisbane is also roughly in line with the 10-year average, which indicates that pricing levels have not gotten unduly carried away in Perth and Brisbane. With the Reserve Bank of Australia seemingly intent on an easing bias, there could still be room for some yield shift in the near-term. And, Perth and Brisbane would have more potential for capital appreciation relative to Sydney and Melbourne.

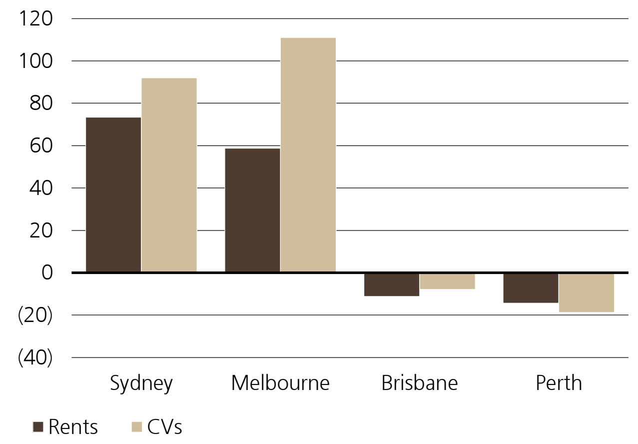
Indeed, the way capital values behaved has almost been dichotomized between the gateway cities and the secondary cities. All four cities saw capital values peak in 2007 before the GFC hit, but the correction for Sydney and Melbourne lasted for only two years. As of 2018, capital values in both cities are roughly double that of their 2007 peaks. Capital values in Brisbane and Perth, on the other hand, have not even reverted back to levels attained more than 10 years ago. Therein lies the risk in terms of market resilience, but opportunists would see that the opportunity comes precisely because of depressed capital values, whereas the run-up in prices for Melbourne and Sydney have already exceeded the increase in rents (Figure 6). If the office markets in Perth and Brisbane are at the start of a rental recovery, this should also be supportive of improvements in capital values.

Figure 5: CBD office yield spread (vs. 10-yr bond yield; bps)



Source: CBRE ERIX; PMA, April 2019

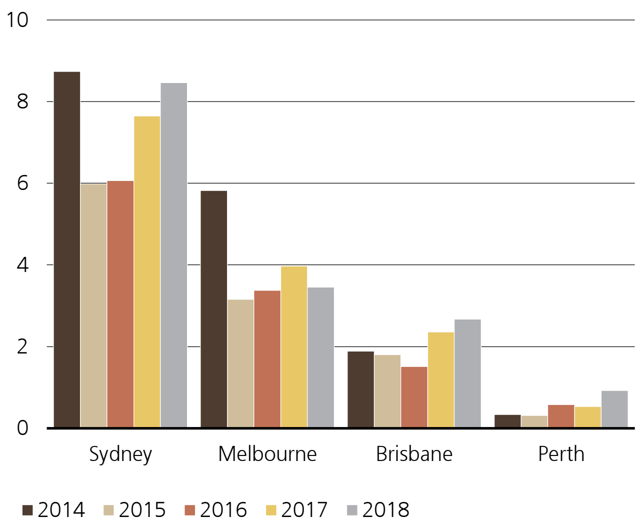
Figure 6: CBD office rents and capital values, 2018 vs. 2007 (% change)



Source: CBRE ERIX, April 2019

Fund flows
However, what could be a real impediment to investors is the lack of liquidity and thus exit options for the secondary cities, particularly for Perth. Even though total office transaction volumes in Perth jumped more than 70% YoY in 2018, total transactions in Sydney are still nine times that of Perth (Figure 7). This makes things tricky from an exit perspective and might lead to lengthened hold periods, which investors need to be mindful of.

Figure 7: Office transaction volume (USD billion)



Source: RCA, April 2019

Conclusion
Growing interest into Australia's secondary cities of Perth and Brisbane are well justified given the macroeconomic and office rental recovery story, as well as the positive yield spread and relative lack of cap rate compression. This indicates that there is greater potential for capital values to appreciate. All things considered, Brisbane's macro story has more legs to stand on than Perth given the strong population growth expected as well as the diversified economic growth drivers, although Perth appears more attractive from a yield and capital value perspective.

Despite the positive macro outlook, the lack of depth and liquidity in both markets still place them higher up the risk spectrum. Corrections in Brisbane and Perth were steeper and lasted longer than that of Sydney and Melbourne. Brisbane and Perth look attractive from a cyclical perspective but in all likelihood, these two cities are more suitable for investors with a greater risk tolerance with the ability to ride through cycles. Sydney and Melbourne, though in late stages of the cycle, will still be attractive to investors looking for a more stable risk profile.

This does not mean that investors with a lower risk tolerance cannot invest in Australia's secondary cities and vice versa; combination strategies can also exist, such as investing in stable, Grade A assets in the secondary cities as a hedge against uncertainty. Or, investing in under-rented Grade B assets in gateway cities in a bid for potentially higher returns. In a crowded investor environment, asset selection and micro-market analysis have become increasingly important with blanket strategies hard to prescribe. Rather, it is a case of *caveat emptor*, with due considerations given to the risks involved when underwriting deals in these cities.

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