Australian Collapse and Recovery ViewPoint

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COLLAPSE & RECOVERY USING VACANCY AS A TRIGGER POINT

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SUMMARY This report focuses on using office vacancy rates as a benchmark to track significant changes in the unemployment rate, net face rent and incentives.

INTRODUCTION

Movements in the total office vacancy rate acts as an important trigger to changes in other indicators. Changes in vacancy beyond a particular point, whether increasing or decreasing over a long time period, often coincides with, or triggers large changes in prime face rent and incentives in the main office markets in Australia.

The aim of this viewpoint is to locate these trigger points, and calculate by how much prime face rent and incentives change on average per year over two main phases of recovery and downturn. In addition, the amount of the increase and decrease in the total office vacancy and state unemployment rates are also estimated on a per year basis over both the recovery and collapsing trigger phases.

The recovery trigger phase identifies the range of vacancy rates which is associated with large rental price increases. The beginning of this phase is located by identifying that level of vacancy which leads to prime rental increases greater than $5/sq m over six monthly time intervals. The cut off or end of this recovery phase is located by finding where the vacancy level peaked.

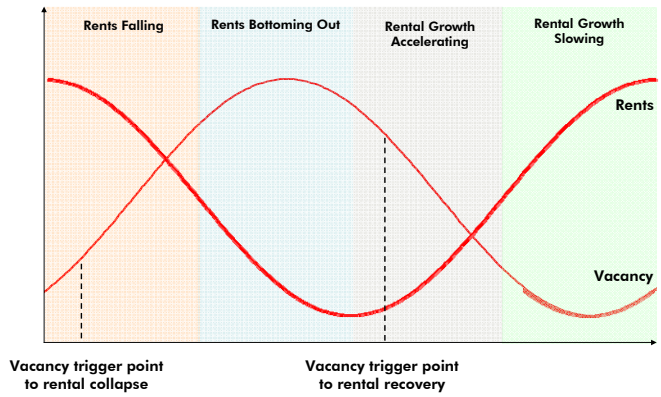
The collapsing trigger phase in contrast identifies that level of vacancy which leads to falls in rents of more than $5/sq m. The end of this collapsing phase is located at the vacancy rate trough. It must be stated at the outset that this study is not using the growth in real GDP or any other macro economic indicator to date the recovery or collapsing trigger points for rents and incentives. Using the office vacancy rate to determine these trigger points instead, is useful as this study develops internal benchmarks for charting collapse and recovery in office rents and incentives.

This study covers the 1990-2008 period and analyses the Sydney, Melbourne, Brisbane, Adelaide Core and Perth CBD office markets. Data is dated six monthly, from December to June from 1990 to 2008. Analysis on the Canberra Office market is not included as changes in the vacancy rate and rent are largely determined by the budget and election cycles.

VACANCY TRIGGER POINTS DURING RECOVERY AND COLLAPSE

When the vacancy rate starts to trend up or down, large changes in prime rents and incentives are not observed immediately. There is a time lag before substantial change in rents and incentives materialises. Most long

Figure 1. Stylised representation of vacancy recovery and down turn trigger phases



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term leasing arrangements are struck over five or ten years with upward only ratchet clauses written into the lease. Therefore, securing large changes in rent, beyond movements tied to annual market CPI based reviews, depends on significant change in underlying supply and demand fundamentals. Once these underlying fundamentals alters, and which is reflected in movements in the total office vacancy rate, rents and incentives are also driven to move. Figure 1 above shows a stylised example of vacancy recovery and collapsing trigger points. In practice, locating the trigger point is not easy. The presence of time lags implies that in some cases, rents are falling even when the vacancy rate starts to fall.

In the Sydney office market for example, the total vacancy rate started to trend downwards after reaching 22.4% in December 1992. Large increases in prime net face rent however were not observed until the office vacancy rate started to fall below 13.2% in Sept 1995. Consequently, this vacancy rate of 13.2% can potentially be dated as a 'recovery trigger point' for the Sydney office market for the early 1990's downturn.

Table 1 below presents the vacancy benchmarks for recovery trigger points for each of the CBD office markets. All office markets had two different trigger points for recovery. In Brisbane CBD Office for example, stronger rental recovery and drop in prime incentives was witnessed after Sept 1997 once the vacancy level went below 8.6%. The second time stronger rental recovery and incentives fall was witnessed was in Sept 2004 once the vacancy rate fell below 7.0%.

Some interesting patterns emerge in relation to the vacancy recovery trigger points. The benchmark vacancy rate for rental price recovery and prime incentives fall is lower over the post 2004 period compared to the 1996-2003 period for all markets except for Perth CBD.

Since most office markets emerged from the 1991 recession with a record amount of new supply, totalling 2, 044,676 sq m in Australian CBD office markets over 1990-94, the ensuing pick-up in demand in the Australian economy from 1992 onwards meant that all office markets were accelerating from a vacancy rate that was coming down from an extremely high base. With the exception of Brisbane CBD, rental price recovery and incentives decline in all markets as shown in Table 1 started from vacancy rates ranging between 10.5% and 14.2% in the 1996-2003 period.

Table 1. Vacancy recovery trigger points

Office	Trigger period	Trigger vacancy rate	Trigger period	Trigger vacancy rate	Average rental upswing time after vacancy recovery (yrs)
Sydney	Sep-96	10.5%	Sep-05	10.2%	3.3
Melbourne	Dec-98	14.2%	Dec-05	8.3%	2.5
Brisbane	Sep-97	8.6%	Sep-04	7.0%	1.8
Adelaide Core	Dec-03	11.7%	Sep-07	8.2%	1.8
Perth	Dec-97	12.6%	Sep-04	13.9	3.5

In Perth CBD, the presence of a larger net supply increase over the 12 months to September 2004 (53,595 sq m), the trigger point in the second upturn, compared to the corresponding 12 month period to December 1997 (-38,804 sq m), the trigger point in the first upturn, meant that rental price acceleration in September 2004 was coming off a larger vacancy rate benchmark of 13.9% than December 1997 (12.6%). It is interesting to note that in Brisbane CBD, only 65,966 sq m of new stock entered the market over 1990-93 and thus its vacancy trigger point of 8.6% was relatively lower than in the other states.

The average recovery time summarises the average period of rental recovery once the vacancy rate reaches the trigger point for each of the markets in the study over the 1990-2008 period. Recall again, vacancy recovery covers those periods where the prime net face rental increase exceeds $5/sq m over six monthly periods. Results from Table 1

indicate that both the Sydney and Perth CBD markets remain in an upswing after recovery for a longer period of time. The recovery in Melbourne (2.5 years), Brisbane and Adelaide Core (1.8) are relatively shorter. It is tempting to conclude that based on these statistics, it may be more attractive to own and lease office buildings in Sydney and Perth than the remainder of the states because recovery lasts longer. Of critical importance however is the average magnitude of the prime net face rental price increase over this period. These magnitudes are presented in the main results section below.

Table 2. Vacancy recovery trigger points

Office	Trigger period	Trigger vacancy rate	Trigger period	Trigger vacancy Rate	Average rental fall time after vacancy collapse (yrs)
Sydney	Dec-90	9.0%	Sep-01	5.0%	2.8
Melbourne	Sep-90	7.4%	Sep-02	6.7%	2.3
Brisbane	Sep-90	9.1%	Sep-01	6.4%	1.8
Adelaide Core	Sep-90	10.7%	Dec-06	6.6%	2.3
Perth	Sep-90	14.6%	Sep-02	9.0%	2.3

Table 2 above presents the benchmark vacancy rates which lead to a large collapse in prime net face rental values. These figures suggest that for most markets, once the vacancy starts to trend upwards consistently past the 6.5% level for the post 2000 periods, large falls in prime net face rental values usually follow. In Sydney and Perth, the vacancy trigger levels for collapse are at 5% and 9% respectively. In both markets, the increase in vacancy beyond these benchmarks were quite large because both markets combined experienced net supply additions of 165,250 sq m over the 2001-05 periods.

Once the vacancy rate starts to trend upwards to the point where it triggers a rental price falls that exceeds $5/sq m, the period of average collapse was greater in Sydney CBD (2.8 years) than all the other states in the study.

A comparison with the average recovery and collapse times suggests that Adelaide Core CBD is the only office market where rental price falls take slightly longer than rental price recovery. In all other markets, the vacancy recovery period exceeds the vacancy collapse period. For example, in Sydney CBD, the average rental recovery upswing occurs for 3.3 years once the vacancy rate shifts past its trigger points of 10.5% and 10.2% in September 1996 and September 2005 respectively. In contrast, the average rental fall occurs for 2.8 years once the vacancy starts to trend upwards past its collapsing trigger points. This suggests that its is worthwhile to lease office buildings across the main CBD markets.

RESULTS: COLLAPSING TRIGGER POINT

Most office markets that experienced large vacancy rate increases also witnessed greater increases in their respective state unemployment rates.

Figure 2. Vacancy and unemployment rate increases beyond the collapsing trigger point

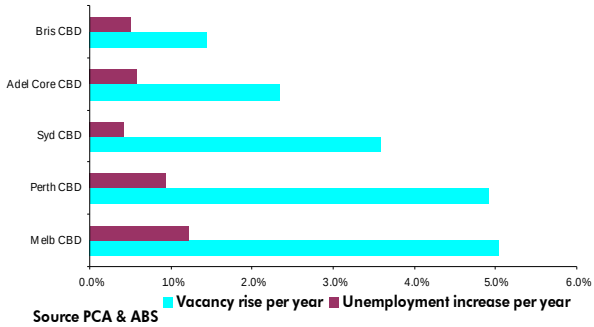
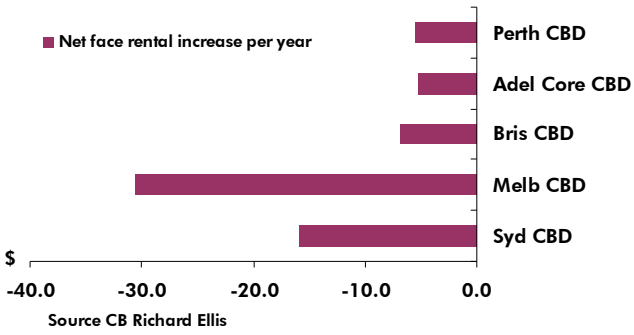


Figure 2 above shows that the Melbourne CBD (5.0%) observed the largest vacancy increase on average per year beyond its 'trigger' point, followed by Perth CBD (4.9), Sydney CBD (3.6%), Adelaide Core CBD (2.3%) and Brisbane CBD (1.4%). The corresponding values of the increase in the unemployment rate beyond this trigger point for each of the respective states were: Victoria (1.2%), WA (0.9%), NSW (0.4%), Adelaide Core (0.6%) and Brisbane CBD (0.5%).

With such large increases observed in the total vacancy rate beyond the trigger point for Melbourne, Perth and Sydney CBD's in particular, it is logical to expect a bigger fall in prime net face rent for each of these capital cities and/or a large increase in prime incentives. Figures 3 and 4 reveal that this supposition is true but in different proportions depending on the state. The corresponding fall in prime net face rental values beyond the trigger point was certainly large for Sydney CBD ($15.9/sq m for 2.8 years) and Melbourne CBD ($30.6/sq m for 2.3 years).

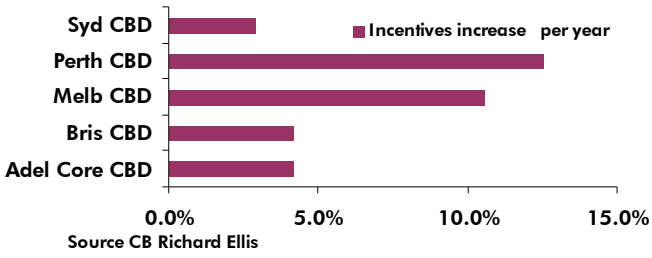
Figure 3: Prime net face rental falls beyond the collapsing trigger point



Source CB Richard Ellis

As Figure 4 reveals below, however the result was different for Perth CBD where incentives did the work. Landlords in Perth were most likely to increase prime incentives on average per year by 12.6% for 2.3 years than decrease the prime net face rental value (-$5.6/ sq m for 2.3 years).

Figure 4. Prime incentive increases beyond the collapsing trigger point.



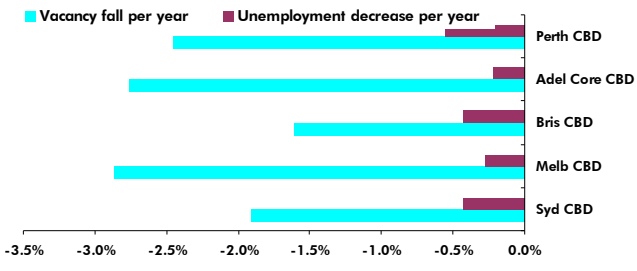
Source CB Richard Ellis

In Sydney incentives increased by relatively less than Perth at 2.9% per year for 2.8 years. Note that the lack of data availability for prime incentives in the Sydney CBD office in the pre 2000 period implies that the average incentives increase was much smaller than in practice. As the Sydney CBD is a boutique market, landlords would prefer to keep face rental growth decline to a minimum and change incentives instead. In Melbourne, the prime incentive increased by 10.6% on average per yea over 2.3 years. The decrease in prime net face rent and increases in the prime incentive in Brisbane CBD ($6.9/sq m per year & 4.2% per year over 1.8 years respectively) and Adelaide Core CBD ($5.2/sq m & 4.2% per year over 2.3 years) were relatively more moderate than in Melbourne.

RESULTS: VACANCY RECOVERY TRIGGER POINT

In the recovery phase, the decline in the total vacancy rate for most states was not as fast as the corresponding increase in vacancy during a slump phase. Both Brisbane and Adelaide Core CBD were notable exceptions, where the recovery in vacancy rate was quicker than the increase in the collapsing phase. Figure 5 below indicates that during a recovery phase, the vacancy rate falls were greater in Melbourne CBD (-2.9%), Adelaide Core CBD (-2.8%) and Perth CBD (-2.5%). The vacancy rate decline was correspondingly much smaller in Brisbane (-1.6%) and Sydney CBD (-1.9%).

Figure 5. Vacancy unemployment rates fall beyond the recovery trigger point.



Source PCA & ABS

The fact that the vacancy rate, once it starts to fall, does not fall as quickly beyond its trigger point for most states is due to the lack of availability of quality space. This suggests that perhaps, additional increases in the supply pipeline may not

be materialising quickly enough to accommodate potentially greater increases in demand once the office markets are in full recovery mode. For example, if one compares the 1991-93 period when an economic recession coincided with a supply wave across most markets to the trade boom period from 2005 to 2008 in WA and QLD, net supply additions were relatively lower over the 2005-08 period. The vacancy rate fell considerably more in the recovery phase after the 1991 recession than it did during the recovery phase in the 2005-08 boom period. Consequently, even though the recovery vacancy trigger level was lower in Brisbane over September 2004 (7.0%) than in September 1997 (8.6%), recovery from a relatively lower vacancy rate does not necessarily imply better conditions are prevailing as it is likely that tenants may not be faced with quality leasing choice.

The most interesting fact is that prime net face rental increases were greatest once the office markets moved into full recovery mode. The fact that rents responded quickly during the recovery phase provides a very strong argument for why owning office property is a very good investment. It produces a very good income stream during an upturn; any income loss during a downturn is not as severe as the corresponding gain during the vacancy recovery phases.

The prime net face rent increased strongly (Figure 6) on average in Melbourne ($50.3/sq m per year over 2.5 years) relatively to Sydney CBD ($27.6/sq m per year over 3.3 years) and Adelaide Core CBD ($22.8/sq m per year over 1.8 years). Magnitudes in Perth CBD ($74.9/sq m over 3.5 years) and Brisbane CBD ($69.4/sq m over 1.8 years) were higher than the rest of the states due to the presence of the mining boom and rising terms of trade over the 2005-08 period. If this period is removed from the analysis, the average increase per year was $13.8/sq m in Brisbane CBD spread over five and a half years and $20/sq m in Perth CBD spread over six years within the 1990-2008 sample period. Both set of statistics for Perth and Brisbane CBD provide an interesting benchmark on how much rental increase pressure rises once the resources sector starts to really take off.

Prime incentives fell during the recovery phase. As Figure 7 indicates, incentives fell quicker in Brisbane CBD (-4.0% on average per year over 1.8 years), than Perth CBD (-3.9% per year over 3.5 years), followed by Melbourne CBD (-3.3% per year over 2.5 years), and Sydney CBD (-1.4% per year over 3.3 years). In Adelaide Core CBD, incentives increased by 1.3% on average per year for 1.8 years. This seems counter-intuitive, as one would expect falling vacancy and rising rent to be associated with falling incentives.

Figure 6. Prime net face rents increase significantly beyond the recovery trigger point.

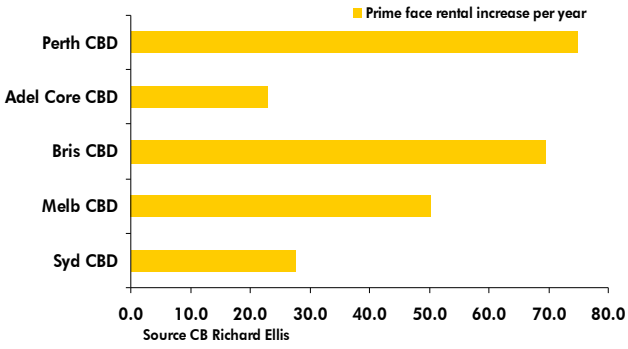
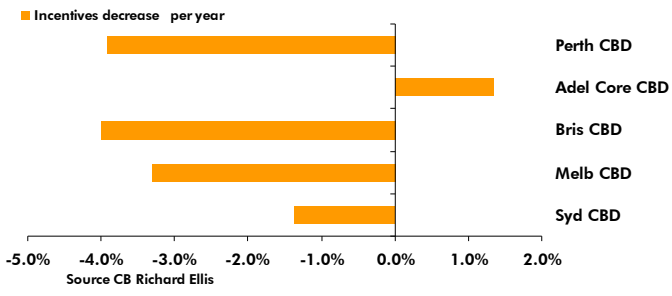


Figure 7. Prime incentives fall slightly beyond the recovery trigger point



This anomaly is due to the impact of future supply which was already under construction and being actively marketed during the period from June 2005 onwards in Adelaide Core. Incentives generally become relatively more important during periods when the office markets are deteriorating than in periods of recovery.

The increase in incentives on average per year over the collapsing phase is greater than the corresponding fall in incentives during a recovery phase in all office markets, with incentives usually rising prior to face rental changes in a collapsing phase.

CONCLUSIONS

With indications suggesting that the Australian economy has dodged an important bullet by avoiding a prolonged recession, the overall outlook for the office markets over the next 12 to 24 months seems more optimistic. Focus is now likely on recovery in the office markets from mid 2010. In particular, CB Richard Ellis is suggesting that, based on past history, rental price recovery is greater than rental price falls. With the average prime net face rent increasing by between $22.8/sq m to $74.9/sq m per year during office market recoveries lasting between 1.8 to 3.5 years across the major CBD office markets, this viewpoint strongly recommends that office building ownership is a very stable form of investment as it provides solid income streams based on historical evidence over the 1990-2008 period.

Importantly, from a forecasting perspective, falling vacancy rates do not imply that rental recovery is immediate. Once rental recovery does occur, the gains in rent over each year is quite large for most markets so that over time, these gains wipe out any rental losses encountered in a vacancy collapsing phase.

I am grateful to Kate Gray, who provided me with the idea for this topic during our interaction in the forecasting round. Jennifer Beard also provided valuable insight into some of the explanations behind the results

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