

Adelaide Collapse and Recovery

Viewpoint

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1 October 2009



ADELAIDE POSITIONED WELL FOR RECOVERY

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SUMMARY Adelaide is unlikely to reach the vacancy trigger point where rents begin to fall during the current downturn. This positions Adelaide for a quick recovery in the office market, but could lead to future supply constraints.

INTRODUCTION

Movements in office vacancy rates are an important trigger for changes in supply and rents and large movements in vacancy can trigger large changes in prime face rents and incentives. This Viewpoint by CB Richard Ellis investigates the vacancy trigger for rents to change by more than \$5/sq m. This was investigated from data since 1990 which allowed the analysis of two economic cycles in the Adelaide office market.

ADELAIDE RENTS & INCENTIVES

According to the Ex ante Sharpe ratio Adelaide Prime CBD office is the most stable of all other office markets nationally on an annual basis. Adelaide Prime CBD office also offers the best returns per unit of risk nationally. Adelaide has experienced sustained gross face rental growth since March 2003. Gross face rents have grown by 48.5% over this period. There have been several periods in this time where no growth in rents was recorded, but conversely there were no falls in rents over this period either.

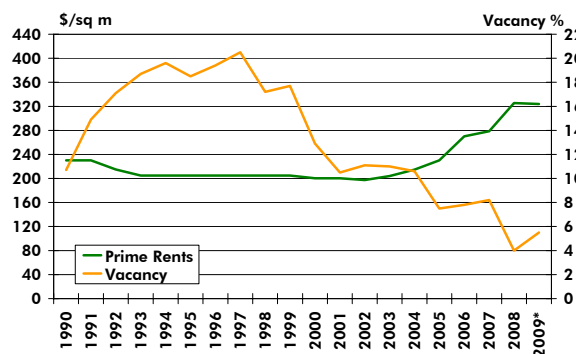
When looking at periods when rents fell there was only one significant period. During 1992 & 1993 rents fell by as much as \$30/sq m which equated to 13.0% fall in rents, with this correction occurring over three quarters. After this initial fall, rents remained relatively stable from June 1993 until the recovery in March 2003. It was not until vacancy reached 11.7% that rents began to grow again.

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It appears that incentives seem to be the tool landlords used to entice tenants over this time. There was a sustained period of incentives at 25% being offered by landlords from 1992 to 2000. Incentives began to fall in 2000, but this was not translated into effective rental growth until 2003.

As we are now in a period of increasing vacancy will the Adelaide office market reach the collapsing trigger point causing rents to fall? According to our forecasts it is very unlikely, but not impossible. Based on the last economic cycle the Adelaide market needs to reach a vacancy rate of 8.0% before a significant slow down in rental growth is experienced. There are two factors which may contribute to increasing vacancy to this level, a contraction of current demand and new supply coming to the market without a pre-committed tenant.

Rents and vacancy



Source: CB Richard Ellis and Property Council of Australia (July 2009)

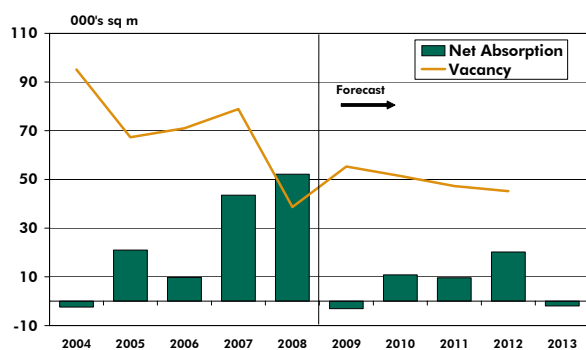
The previous construction cycle was relatively conservative and driven by tenants demand for new office space. New buildings added to supply over the past few years have had more than 50% occupancy on completion and typically it was around 70-80%.

NEW SUPPLY

Currently in the pipeline are several new developments which will add a further 46,500 sq m of space to the Adelaide CBD office market by the end of 2009 of which approximately 20,000 sq m has a pre-committed tenant. If all else in the market remains the same, this new supply will increase vacancy to 6.2% in the Adelaide CBD. Looking forward there are no major projects which are due to complete during 2010 and at this stage there is only the SA police building (18,000 sq m) to complete in 2011. As this is a fully pre committed building this will have limited impact on vacancy. In the current financial climate it is unlikely Adelaide will see any major speculative developments due to the difficulty in funding this type of project, Therefore new supply is more likely to be driven by major tenants pre-committing to buildings.

There was a significant increase in the amount of sublease space available in the July 2009 survey with 11,807 sq m available. To increase vacancy to the trigger point of 8.0% an additional 25,000 sq m of space would need to become available either through a direct or sublease arrangement. Given the current market conditions however it is highly unlikely that this amount of additional space will become available in the Adelaide CBD office market.

Net Absorption and vacancy



Source: Property Council of Australia & CB Richard Ellis (July 2009)

Adelaide experienced very strong demand for office space through 2007 and 2008. It is therefore unsurprising given the current economic conditions that net absorption was negative in the first half 2009. This was mainly due to contraction in business activity and were a result of firms reducing costs and therefore office space requirements which made sublease space available. Although demand has slowed in the last six months it is predicted when Adelaide economy recovers so will the demand for office space.

SUMMARY

In summary the Adelaide office market is positioned really well to weather the current economic downturn. The Adelaide office market has been the most stable office market over the last 17 years and offers the best returns based on unit of risk. This places Adelaide as one of the best performing office markets nationally. Although the vacancy rate is expected to increase slightly is very unlikely to reach the trigger point where there would be substantial revisions in rents. There is also very limited new supply forecast for the next two to three years which is likely to drive the vacancy rate lower and place further upward pressure on rents. Given all of this, the Adelaide market is likely to recover quickly from the current downturn. This leads to the another question, given the timeframe for new developments – is Adelaide going to face a shortage of supply in the not to distant future?

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