Outlook for Australian Property Markets 2010-2012

Sydney

Update August 2010

Westpac
Australia's First Bank

Outlook for Australian Property Markets 2010-2012

Sydney Residential

Update August 2010

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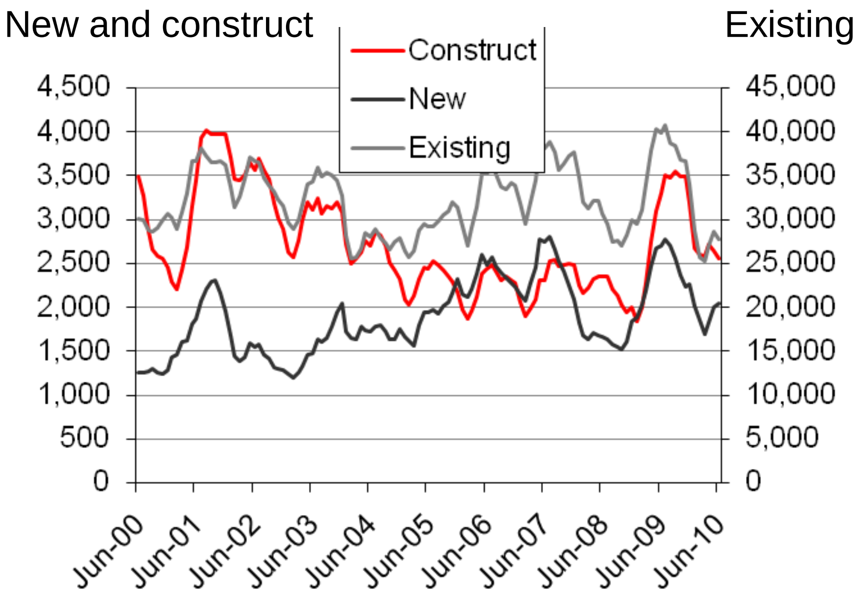
Demand far weaker than expected in 1H 2009, only finance to construct performed as forecast

Finance commitments to buy or construct new or to buy existing dwellings – NSW
3-month rolling totals



Source: ABS

Analysis: Westpac Property

- In February we forecast that continued increases in interest rates should ensure some hesitancy, but improving employment conditions should keep confidence and thus activity, at a reasonable level.
- While employment growth and confidence remained high until May, finance commitments fell back to 2008 lows for existing dwellings and just above that level for new homes. While finance to construct new dwellings also fell more than expected, levels have remained the highest since 2003.
- Interest rates have moved slightly faster than expected, rising to 4.50% by May, rather than September. However, the fear of how far would rates rise during the tightening phase appears to have dampened decisions.
- There were signs in Q2 of demand lifting again, despite the rate rises, although the lift was marginal. Lower than expected CPI, plus concerns around European sovereign debt refinancing have led to a recent change in view to no more rate rises until 2011. This plus expectations of continued job growth could lift demand in the latter period of 2010. Similarly State Govt incentives to buy new properties may help lift demand.

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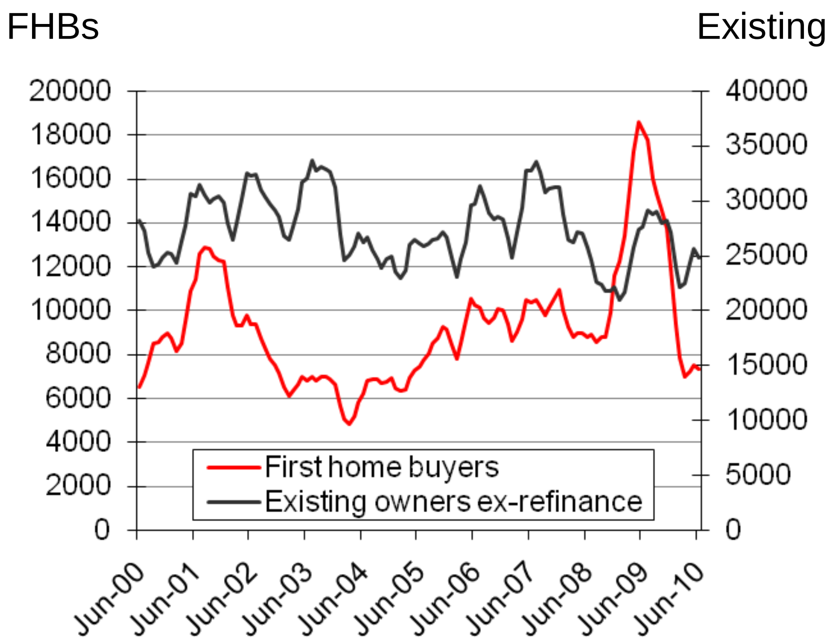
FHBs slow as expected, existing owners not as healthy. Activity to lift in 2H 2010

FHB vs. existing owners – NSW
3 –month rolling totals



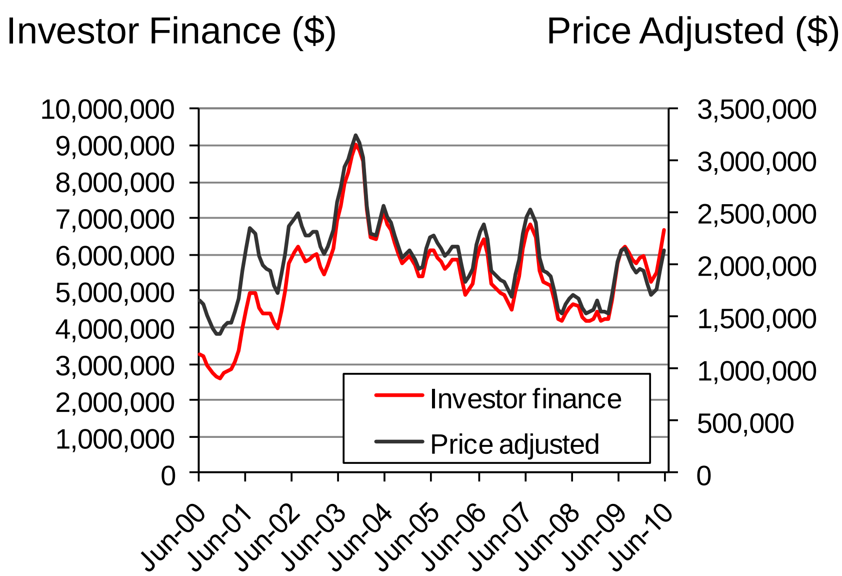
Source: ABS

Analysis: Westpac Property Markets

- As expected, first home buyers (FHB) slowed further into 1H 2010 and as with the previous downturn in 2002/3, fell below levels prior to the boost. Given that the boost would have pulled forward FHBs from 2010 and possibly 2011, this is not surprising. Signs that the FHBs had bottomed out emerged in 2Q 2010, although we do not expect this sector to grow significantly for some time.
- The surprise was demand from existing owners, which continued to fall into early 2010, before picking up gradually in the second quarter. Our expectations that strong job growth would help lift demand further did not eventuate, with rising interest rates outweighing the 34,500 new full time jobs created in NSW during 1H 2010.
- With an expectation of no further rate rises in 2010, continued but slower job growth should ensure the existing owner occupier market continues to pick up in 2H 2010.

Investor return gathers pace, a slower but steady pace of growth expected into 2H 2010

Investor Finance – NSW
3-month rolling totals



Source: ABS

Analysis: Westpac Property Markets

- In February we considered that "*with room to grow and considerations of an improving economy, particularly around job growth, we expect investor activity to continue to grow during 2010, despite rising interest rates".* This has occurred with three monthly moving totals for investor finance in May some 12% higher in nominal terms and 10% higher in price adjusted terms.
- Strong March and May figures have boosted recent data, but anecdotal evidence has suggested that investors are considering NSW property again.
- Part of the attraction may have been the strong price growth experienced in the past year and the attractive yields with an undersupply indicating further pressure on rents.
- Although we continue to expect a lift in investors over 2H 2010, the rate of growth may slow as prices stabilise.

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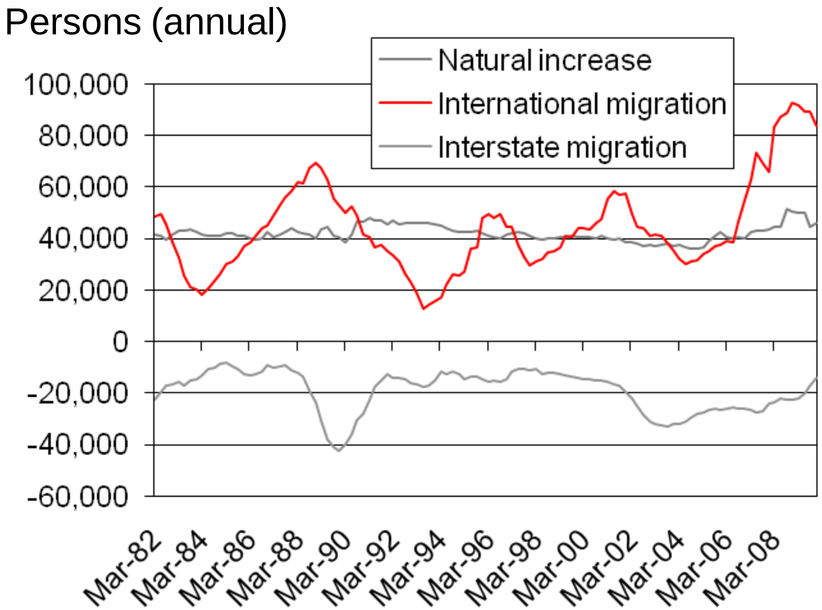
Population growth remains strong but as migrants slow, fewer leave interstate.

Population growth - NSW



Source: ABS

Analysis: Westpac Property Markets

- Our prediction of slowing international immigration appears to finally be eventuating, slowing to 39,000 people in 2H 2009 from almost 45,000 people in the previous two half years and 47,000 in 1H2008.
- However, as the gap between NSW median house prices and other States narrows, fewer people are leaving. In 2H 2009 a net 5,300 people moved interstate, the lowest half yearly total since 1997.
- Although slower than the record 27,000 in 2H 2008, natural increase has achieved growth in excess of 20,000 people in nearly all half years since 2005. The exception was 1H 2006.
- While the slowdown n international migrants is expected to continue as tighter immigration rules apply, the improving economy will continue to ensure that a high level of immigration is required. If the net loss interstate can remain low NSW population can continue to grow in excess of 100,000 per year.

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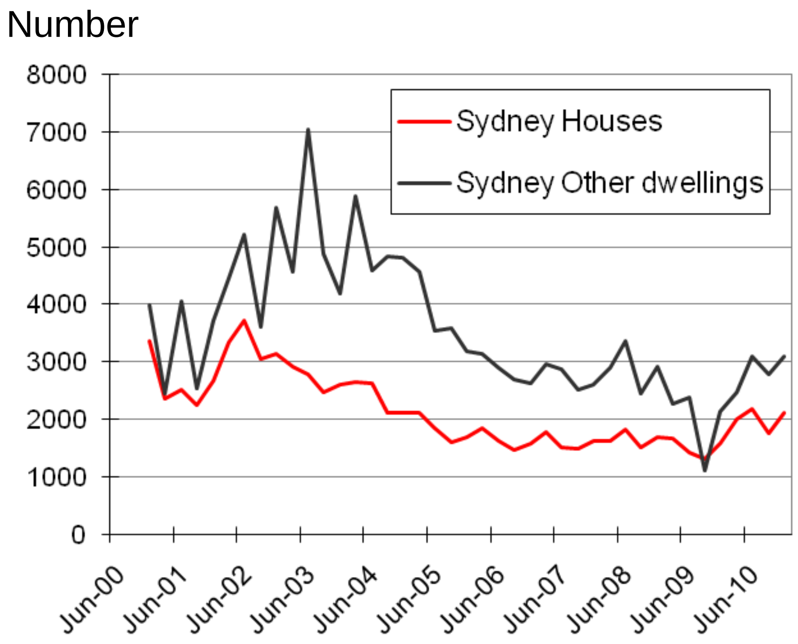
Dwelling approvals rise continues, but still around 10,000 short per annum

Dwelling Approvals – Sydney
Quarterly totals



Source: ABS

Analysis: Westpac Property

- The dearth of new development has been well publicised and despite an improvement in 1H 2010, dwelling approvals remain too low for the population growth, let alone any structural change in the demographics.
- In 1H 2009 some 9,700 dwellings were approved. This was similar to the previous six months and the highest since the mid 2000s.
- Once again units were the driving factor, and continues the trend of the past ten years.
- However, although the 12 monthly figure of 19,600 was the highest since 2005, it remains too low. Population growth in Sydney in the year to June 2009 was 85,400, around 71% of NSW population growth. Even allowing for slower population growth in 2010, over 80,000 people are likely to have moved to Sydney, generating a need of over 29,000 dwellings, before demolition and household change are taken into consideration.

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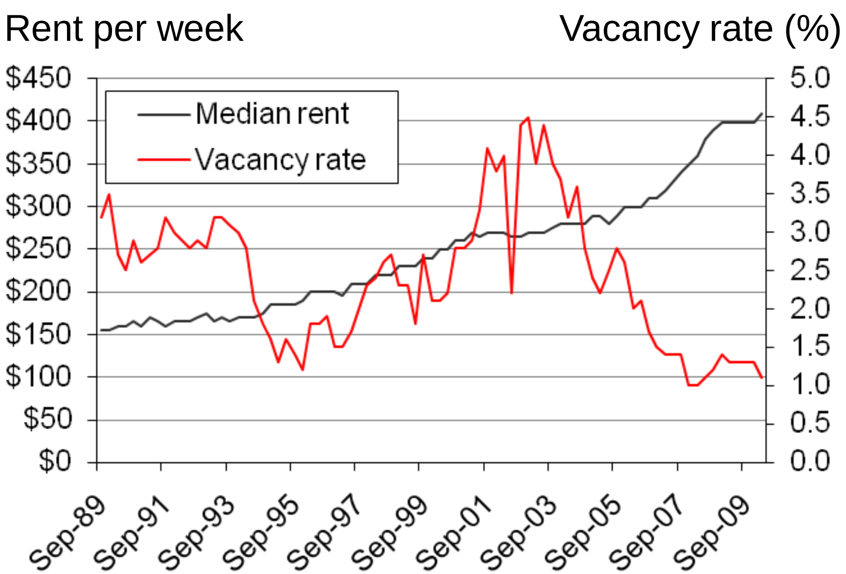
Rents rising as expected, vacancy low but affordability an issue.

Other dwellings median rental growth and vacancy - Sydney



Source: REIA

Analysis: Westpac Property

- Vacancy tightened in Q1 2010 to 1.1%, down from 1.3% of the previous year.
- Rental growth of $10 per week in Q1 2010 was the first increase in rents for five quarters and amounted to an increase of 2.5%. With continued under supply and a healthy level of population growth, rental growth should continue through 2010, particularly in the absence of any short term incentives to move into home ownership.
- However, affordability in terms of renting also needs to be monitored and at 27.4% in Q1 2010, it is one of the highest in the country. While affordability will remain an issue, continued low vacancy, and rising interest rates should result in rental growth rising over 2010 and into 2011.

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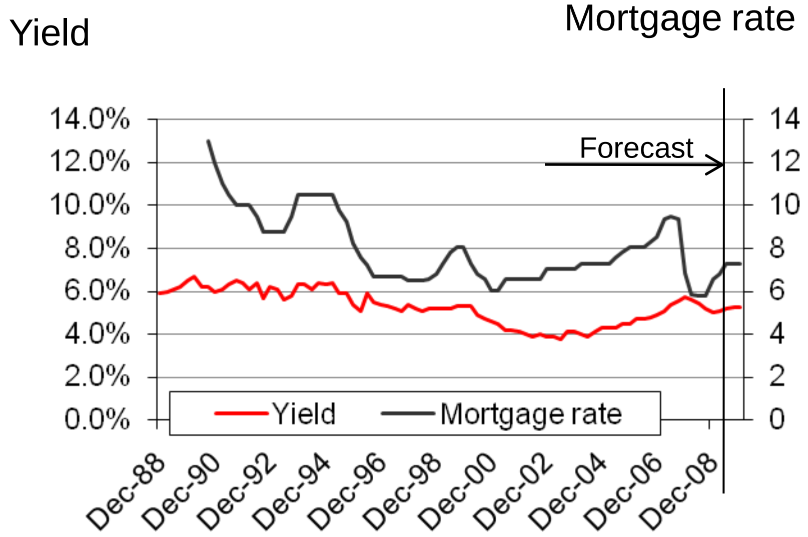
Yields stabilised in early 2010, as expected. Minor lifts expected.

Unit yields against mortgage rates - Sydney



- Gross yields for a two bedroom unit steadied at around 5.2% in March 2010. This was as expected.
- Rental growth re-commenced in Q1 as stated earlier and given the shortage of accommodation should continue through 2010. With limited price growth, further increases in yield are likely, although a significant jump is not expected.
- Affordability for both rents and prices should place a cap on how high yields may rise, although with vacancy down at 1.1% choice for tenants who may want to move is limited, which suggests the potential for upside for rents is high.

Source: REIA

Analysis: Westpac Property

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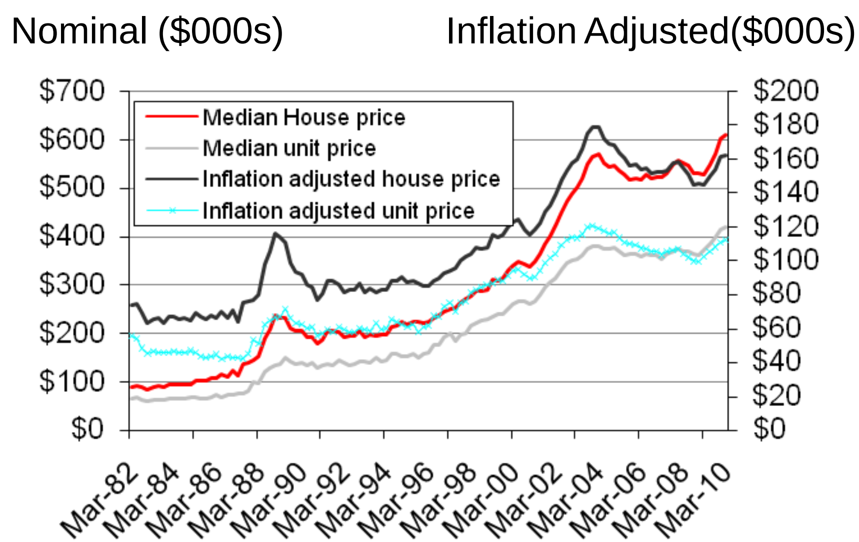
Sydney's median house and units prices following past trends

Median house and unit price –Sydney



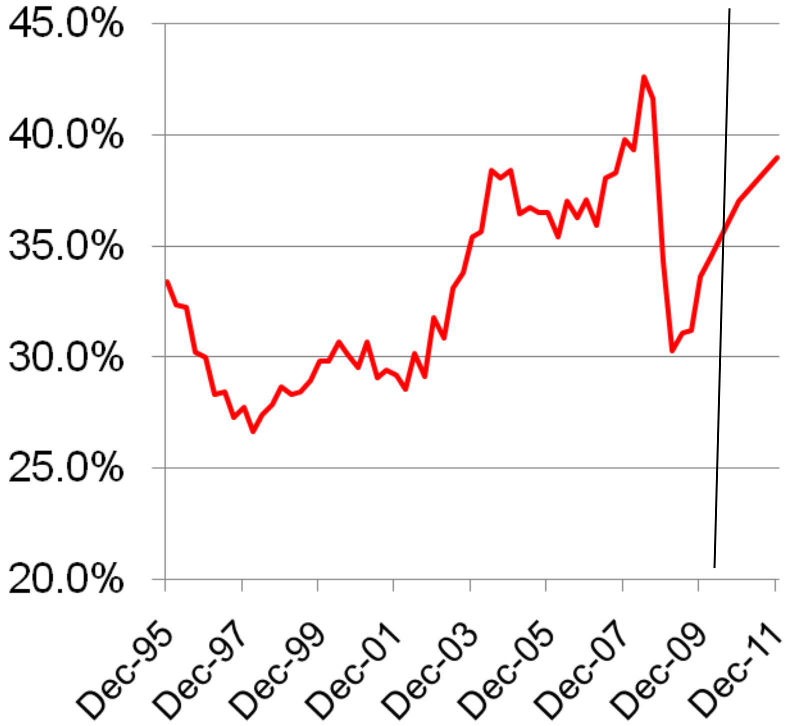
Source: REIA

Analysis: Westpac Poperty

- Price growth momentum continued into Q1 2010, although at a slower pace than expected. House prices rose by 1.4% in Q1 2010 while unit prices rose by 1.6%. However, over the twelve month period median prices have risen by 14% and 12% respectively. This has taken prices above the peak reached in 2004.
- ABS data suggests that house price growth has continued into Q2 at around 5%, with annual growth of just over 20% in Sydney. However, other providers of price data consider it has slowed further.
- In real or inflation adjusted terms Sydney continues to sit below 2004 levels, suggesting no real growth for six years. This is similar to trends in the early 1990s where real prices didn't reach previous peaks until seven to ten years later.
- With no further rate hikes expected in 2010 pressure may continue on prices until rates start to lift again in 2011.

Affordability to decrease as rates and prices rise, and should limit price growth

Home loan affordability % income to pay mortgage - NSW



Source: REIA

Analysis and forecasts: Westpac Property

- Not surprisingly affordability has been weakening as interest rates and prices (and thus loan size) increase. As at March 2010 some 34.5% of average household income was being used to service an average mortgage in NSW of just over $305,000. This is somewhere between the average 5 and 10 year proportions.
- With no further increases in interest rates expected in 2010 and improving economic conditions, pressure may shift back to house price growth. Should a further 6% be added to average loan size in the final three quarters of 2010 (the REIA survey showed loan size had actually fallen in Q1) the proportion of income servicing the loan would rise to 37%, allowing for around 5% growth in household income. In 2011 Westpac Economics believe that interest rates will rise again. No shift in loan size would lift the proportion to almost 38%, but a 4% rise in loan size would take it over 39%.

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Outlook for Australian Property Markets 2010-2012

Sydney Offices

Update August 2010

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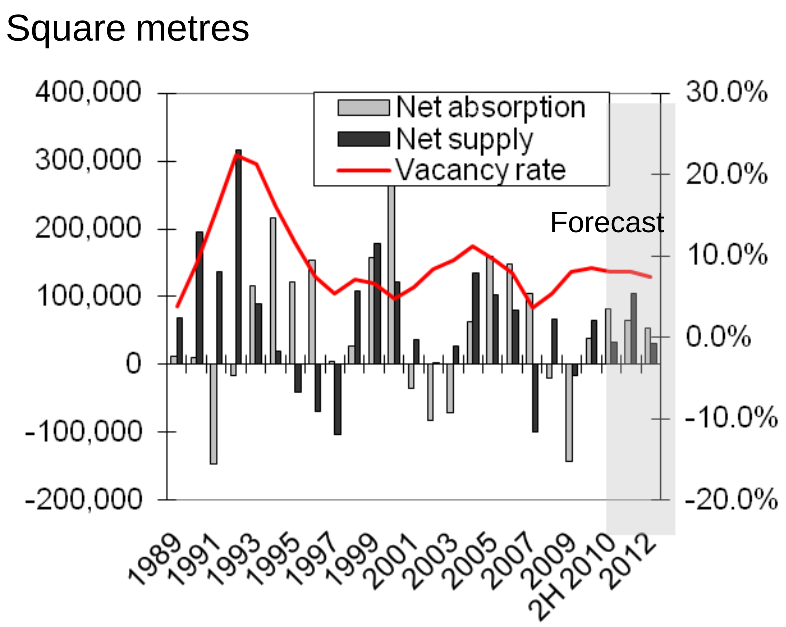
Sydney CBD office market vacancy lifted to 8.5%, gradual fall to 7.5% forecast by 2012

Net absorption, net supply and vacancy – Sydney CBD



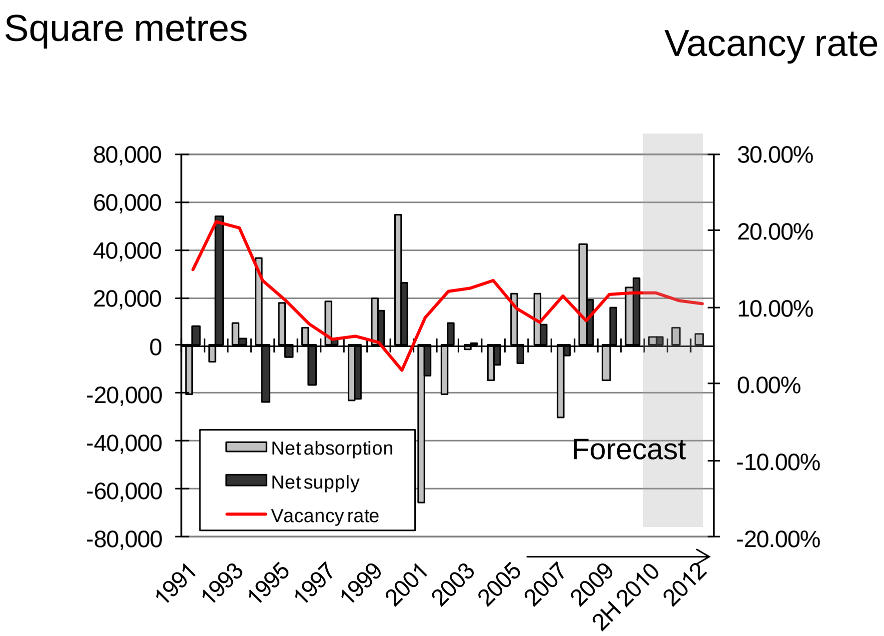
Source: Historical data: PCA OMR 7/2010

Forecasts: Westpac Property

- As forecast in February, net absorption returned to positive in 1H 2010, with 39,400 square metres recorded. Further improvements are expected over the forecast period. However, we only expect net absorption to return to around average, as the total occupied space lost was not as high as in previous downturns. The risk is that concerns over global economies and finance markets could delay some hiring in 2H 2010.
- Net supply was higher than expected with a low level of withdrawals. The pre-commitment of 163 Castlereagh has allowed this project to commence, although at present it is expected to complete in 2013. However, Sydney CBD has 3.5% of stock due for completion in 2.5 years.
- While demand is expected to remain positive, supply levels should keep vacancy around the 8% level to end 2011. This is slightly above the 7.6% long term average vacancy rate. In 2012 we forecast a fall to 7.5%.

North Sydney office market supply cycle complete, for now

Net absorption, net supply and vacancy – North Sydney



Source: Historical data: PCA Office market report July 2010

Forecasts: Westpac Property

- Net absorption posted a very strong 24,380 square metres in 1H 2010. Completion of the Ark project attracted tenants from the CBD and Chatswood.
- Vacancy was steady over 1H 2010 at 11.8%. This was a much better than expected in February, when we expected year end vacancy to reach 13% .
- With one small refurbishment under construction and further positive net absorption, vacancy should remain steady over the rest of the year.
- With no major projects under construction and positive net absorption forecast, vacancy should fall further than we considered at year start. Our revised vacancy is 10.4% by end 2012.
- There are a number of projects proposed for this market. However, completion date is not expected until at least 2014.

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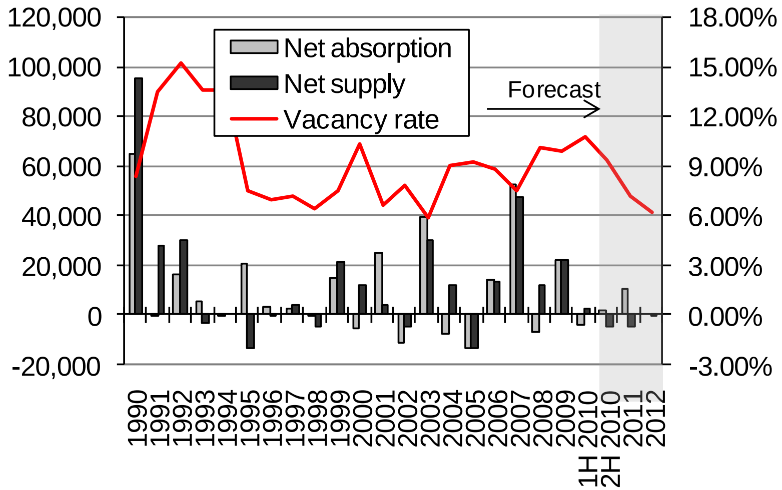
Parramatta’s office market surprises on the upside

Net absorption, net supply and vacancy – Parramatta

Square metres

Vacancy



Source: Historical data: PCA OMR July 2010

Forecasts: Westpac Property

- Net absorption was a negative 3,700 square metres in 1H 2010, one of the few markets to post negative net absorption over the period. It followed a stronger than expected result last year.
- Fortunately supply was also low and the impact on vacancy was a lift to 10.7%.
- Although there are a number of projects approved, none were underway by mid 2010 and expectations for future supply are low, short term at least.
- With economic conditions driving stronger net absorption over the remainder of the forecast period, limited supply should ensure vacancy falls over the next 2.5 years. Any new development is likely to require strong pre-commitment, which is likely to be from outside Parramatta.

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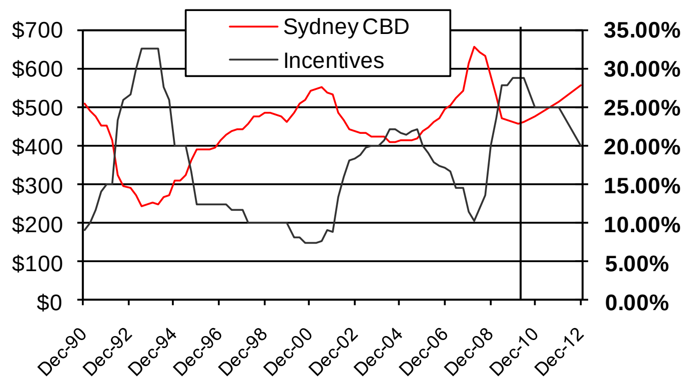
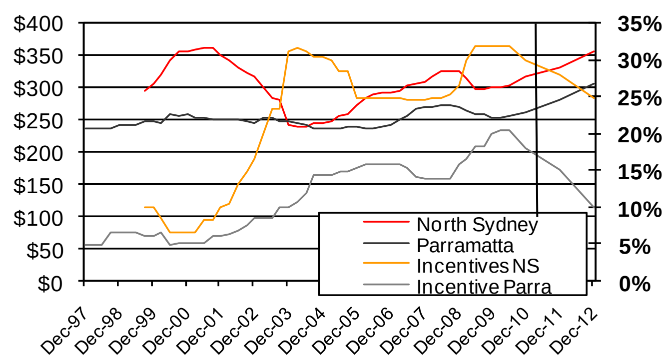
Incentives largely stable in 1H, low prime vacancy to help reduce further

Sydney CBD – net effective rents



North Sydney and Parramatta



Source: Historic CB Richard Ellis,

Forecast Westpac Property

- Prime CBD incentives remained unchanged in1H 2010 at 29% and as such net effective rents were also stable. In February we expected incentives to fall mostly in 2H 2010 as vacancy fell. Despite slightly higher vacancy than expected, we continue to forecast a fall in incentives to 25% by year end, but then unchanged until 2012, when lower vacancy should push them down to 20%. This should lead to prime net effective rents increasing in 2011 and 2012 by over 8% each year.
- In both North Sydney prime net effective rents rose by around 2% in the half year. Stronger than expected take up in North Sydney should ensure vacancy doesn't reach the high we forecast in February and prime vacancy will remain below the market average. As such our rental growth forecast has been revised upwards, averaging 6.5% per annum by 2012, as incentives fall towards 25%. Although Parramatta vacancy rose, prime vacancy is under 3%. Our forecast from February therefore is unchanged.

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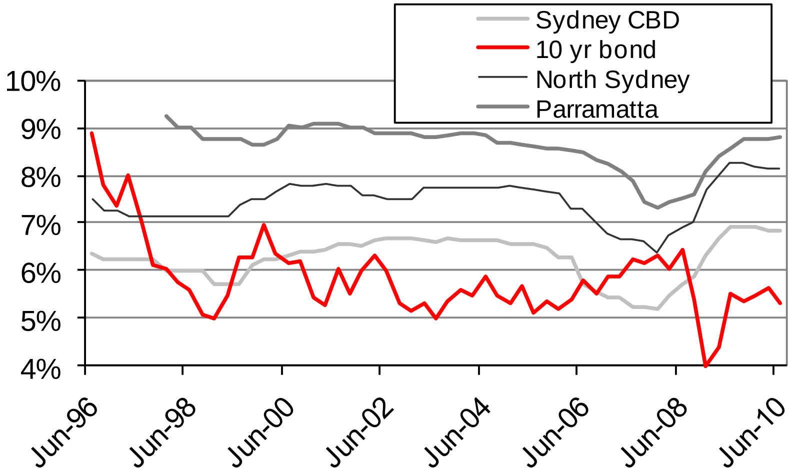
Minor firming evident in yields, earlier than expected.

Prime indicative office yields – Sydney markets

Yield



Source: CB Richard Ellis historic data to June 2010

RBA bond data

- In February we considered that improving market conditions and confidence would lead to yields firming in the CBD and Parramatta, but not until 2H 2010. However, prime yields have firmed marginally (up to 10 basis points) in 1H 2010 in the CBD and North Sydney, but risen marginally in Parramatta. Interestingly secondary CBD office properties have firmed most, by 50 basis points since Q3 2009.
- All three markets have prime yields above their 10 year averages by around 50 basis points, while secondary yields in North Sydney are 87 basis points above average. However, CBD secondary office yields are close to average. The premium to 10 year bond rate is also above average in all markets.
- With expectation of rental growth, yields should firm towards the average over the next eighteen months.

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Outlook for Australian Property Markets 2010-2012

Sydney Retail

Update August 2010

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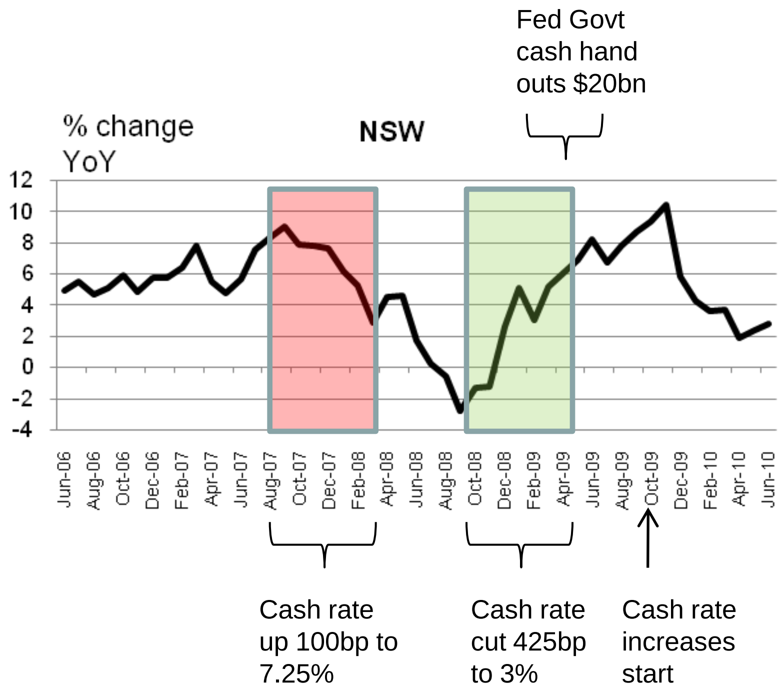
Retail sales slow further than expected, but moving back to above average in 2011

Retail sales growth - NSW



Source : ABS

- The sensitivity of the NSW economy to interest rate movements is evident in the graph opposite. Despite interest rates still below average, the rise of 150 basis points since October 2009 has led to year on year (YOY) retail sales growth slowing to 2% in April 2010, from almost 10% in November 2009.
- However, the 2009 growth was achieved within an environment of falling interest rates and government cash handouts.
- Access Economics forecast NSW retail sales to rise by almost 3.0% in 2H 2010, which would provide a YoY growth of around 3.2% by year end. Although well below the 5.1% average since 2000, it would have been achieved in the absence of stimulus. Access Economics anticipate above average growth in 2011 of 5.8%, but expect a slowdown in 2012 to under 3%.

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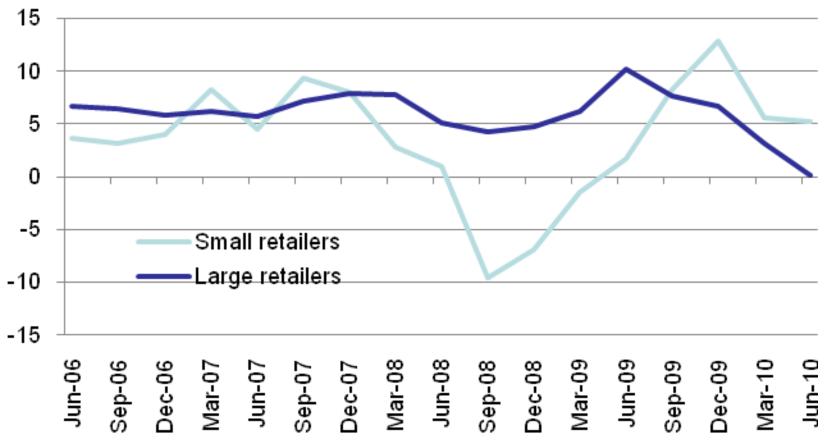
Surprising lift in smaller retailer turnover

Small vs. large retailer's sales growth - NSW

YoY growth (%)

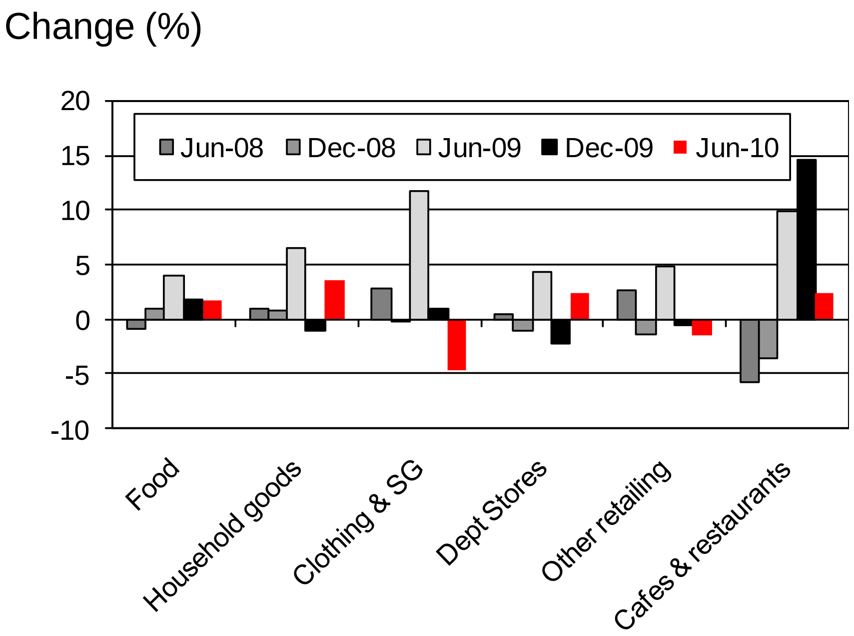


- Data from the ABS provides a breakdown of retail sales by type of retailer. The larger, national retailers are fully enumerated, while the far more numerous smaller retailers are based on samples.
- The trend identified in February of a slower growth rate for larger retailers continued over 1H 2010. ABS data suggests that sales have been flat over the past year for the larger retailer. Surprisingly the smaller retailer has held up relatively well, growing by an above inflation 5%.
- Given the weak retail sales overall for NSW, it is surprising that smaller retailers are holding up better than the large given the ability of larger retailers to advertise and discount.

Source: Access Economics

All sectors slow in 1H 2010

Half yearly change in retail spending by sector - NSW



Source: ABS

- Analysis of retail spending by category highlights areas where retailers may be struggling. Most sectors have shown a slowdown in growth. The exceptions being Department stores and Household goods retailing.
- The stand out sector from previous time periods, cafes & restaurants showed a significant slowdown to 2.3% for the six months to June. As this followed strong growth of 15% in the six months to December 2009, slower growth is not surprising. However, analysis shows that cafes and restaurant spending slowed by 2.4% over the half year
- The weakest sectors include other retailing and clothing. The Food sector's sluggish performance was once again due to specialised food products, which fell 7% in 1H 2010.

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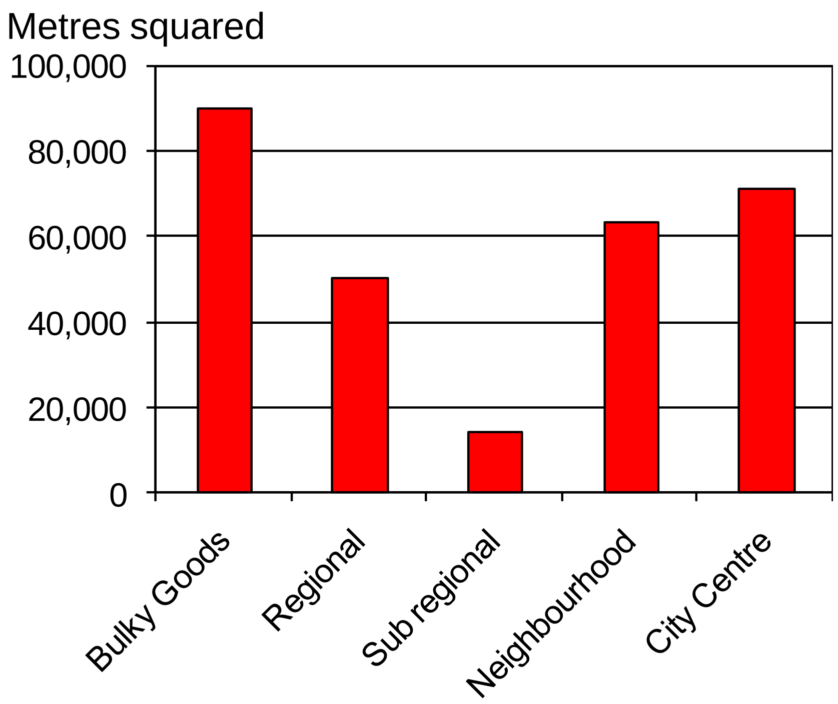
Expansion of larger centres continues

Future retail supply - NSW



- Retail supply under construction in NSW totalled some 288,000m^2 at July 2010, a similar level to the beginning of the year. However, the majority of the space under construction is outside of Sydney, with only 139,050 square metres underway there.
- The small amount of new supply in Sydney is largely provided by the redevelopment of the Centrepoint city centre shopping centre by Westfield.
- It is noted however, that a high level of new supply is underway in the Newcastle area, with the Charlestown Square expansion and Kotara Bulky Goods centre accounting for almost 70,000 square metres.

Source: CB Richard Ellis

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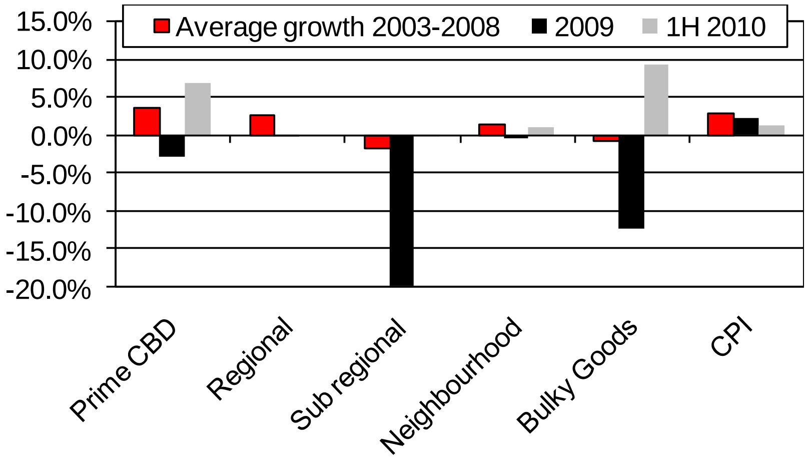
Rental growth mixed in 1H 2010, limited upside expected

Rental growth - Sydney

Annual growth rate



- Net effective rental trends are not following fundamentals. Despite the weak retailing market, rents have lifted in 1H 2010 for prime CBD and bulky goods centres. While the CBD may be a reflection of the shortage of space as new development is underway in the Pitt Street Mall, the Bulky Goods result appears strange. An explanation may be a correction from 12% fall in 2009.
- However, despite the improving expectations around retail sales for the next eighteen months NSW and limited new supply, we continue to expect limited rental growth in most centres. We expect the consumer to remain cautious and looking for discounted goods. This should impact on the ability of retailers to pay significantly higher rents

Source: CB Richard Ellis

Analysis: Westpac Property

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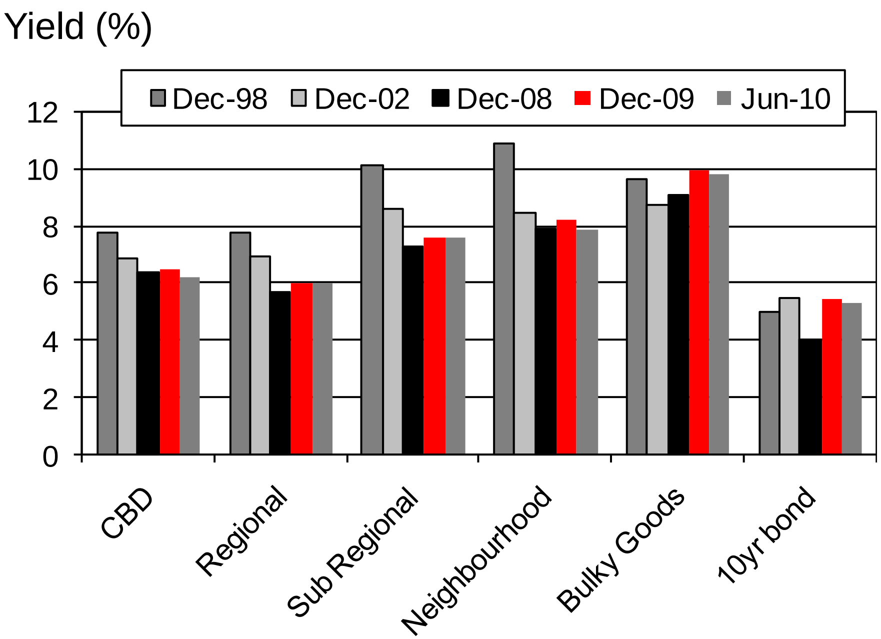
Yields continue to stabilise

Indicative retail yield in Sydney and 10 year bond rate



Source: Raw data CB Richard Ellis and RBA

Analysis: Westpac Property

- The stabilisation of retail yields indentified in Q4 2009, continued into 1H 2010. This is despite yields largely remaining below 10 year average and below average premiums to the risk free rate.
- However, in terms of investor activity, retail has continued to attract interest, with close to $2 billion in sales, nationally, in 1H 2010.
- Although limited rental growth is expected over the forecast period, investor pressure on the favoured retail sector may well push yields down. However, the uncertainty around global economies and the impact on confidence in Australia, may delay yield firming to 2011, rather than our expectations from February of 2H 2010.

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Outlook for Australian Property Markets 2010-2012

Sydney Industrial

Update August 2010

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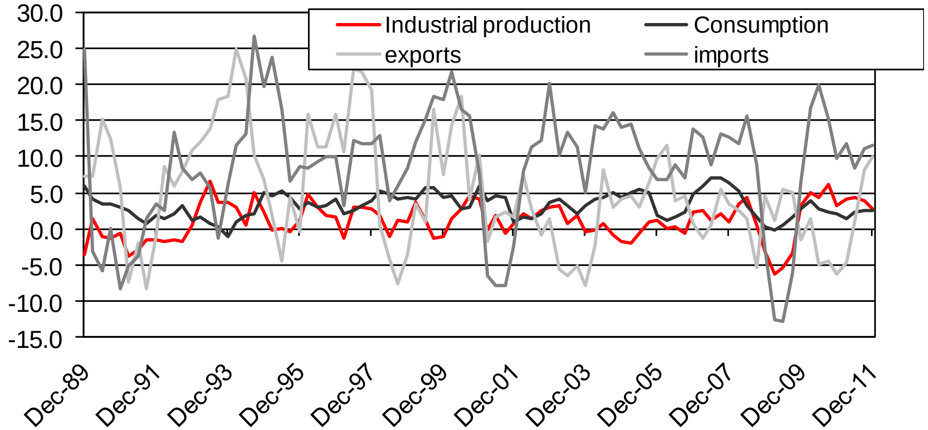
Improving economic outlook for NSW to help drive a steady lift in tenant demand

Industrial demand drivers- NSW

YoY change (%)



Source: Access Economics

- Once again, expectations for the NSW economy are for a lift in the major drivers of industrial demand.
- Industrial production is expected to recover from the downturn in 2009, posting 3% growth in 2010 and 4% in 2011. However, flat production levels are expected in 2012.
- Consumption is likely to be the driver of the above growth with underlying economic fundamentals driving stronger growth in 2H 2010 and 2011.
- While the strong Australia dollar will help imports, the demand from a growing Asia is expected to drive exports.
- Although growth is expected, steady rather than a surge in tenant demand is forecast for the market.

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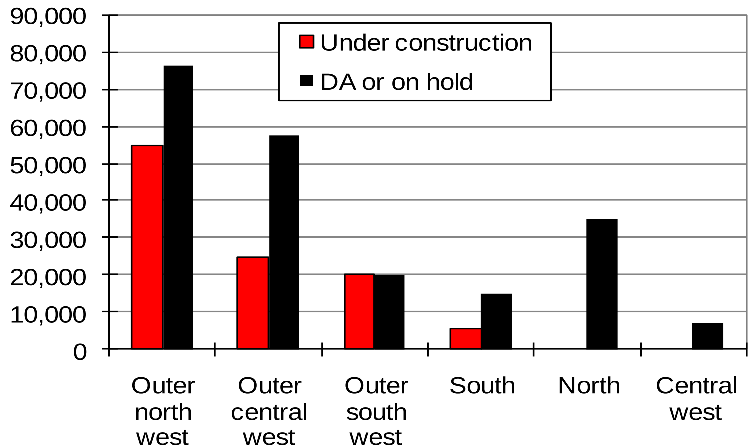
Supply moving too low

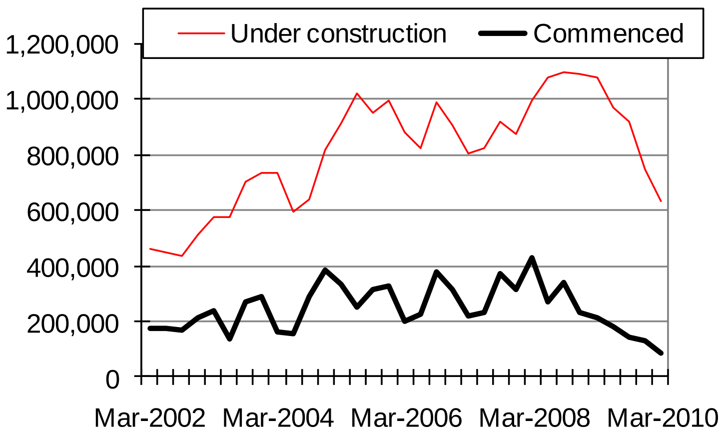
Industrial supply over 5,000m² - Sydney

Square metres

Source: CBRE Research



$000 Industrial construction value - NSW



Source: ABS

- New industrial supply under construction continued to slow into 2010. In projects sized over 5,000 square metres some 105,000 square metres was under construction in May 2010. This is down from 189,000 square metres in November 2009 and 473,000 square metres a year earlier.

- Our expectations in February were for a pick up in construction starts during the year. Tenant nervousness to pre-commit has ensured this hasn't occurred, but we continue to believe levels will pick up during 2H 2010 and into 2011.

- There are some 212,000 square metres with a DA and on hold as at May, which could boost development into 2H 2010.

- The chart on the value of construction (warehouses, factories and other industrial) reflects just how far the NSW market has slowed, with under $100 million of new starts in the March 2010 quarter .

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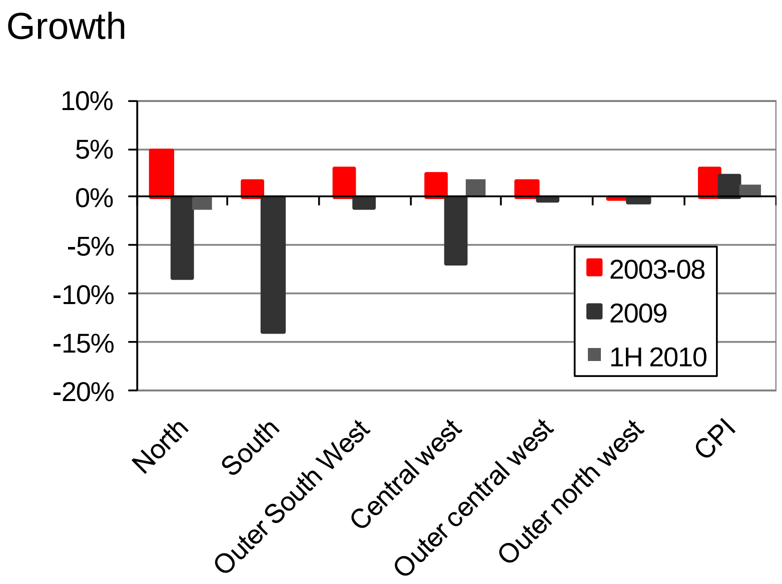
Little rental growth in 1H 2010, potential for growth in 2011

Annual Industrial rental growth - Sydney



- Historically, industrial property has under performed inflation over medium term time spans. The declines in net effective rents during 2009 will have an impact on medium term analysis.
- However, as indicated earlier, the fundamentals of the market are beginning to improve. New supply is low and an improving economy should help lift tenant demand. Pressure on rents, or rather incentives, is therefore likely in 2011.
- There was little evidence of rental growth in 1H 2010 and caution likely into 2H 2010 around global rather than local events could well result in limited growth over 2H 2010 as well. However, as confidence grows around an expanding local economy, rental growth should emerge in 2011.

Source: CBRE research and ABS

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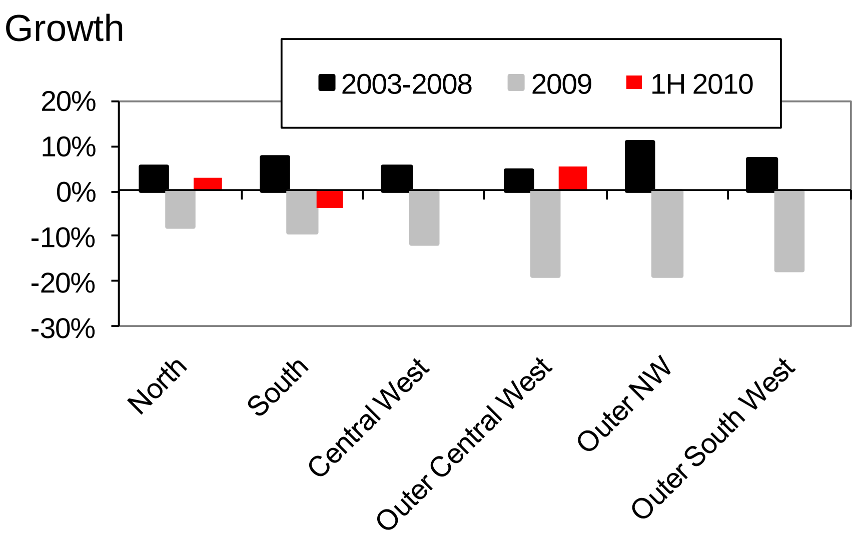
Land values largely stable

Annual growth in industrial land values - Sydney 0.25 Ha serviced sites

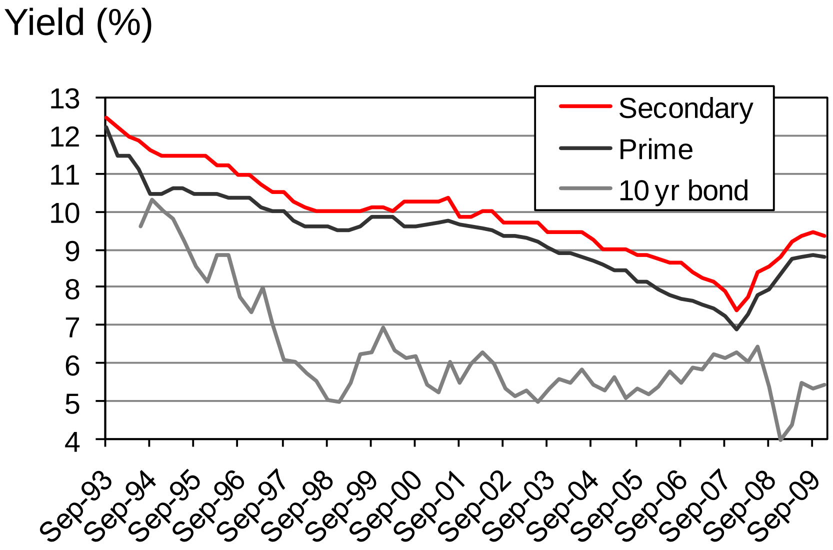


Source: CBRE research

- The decline in industrial land values generally stopped in 1H 2010. Land values were stable in all but South Sydney, North Sydney and the Central west. South Sydney was the only market to record a fall in value of almost 3%. North Sydney values rose by almost 3% and Central west by 5.4%, according to CB Richard Ellis.
- Our expectations in February were for stable land values through the year and we maintain this forecast for 2H 2010. Although supply under construction is low, the amount of potential projects is high and the need for new industrial land short term is likely to be low. However, a correction in values of up to 30% since the peak should ensure little further downside.

Industrial yields stable in 1H 2010

Industrial yields - Sydney



Source: CB Richard Ellis/RBA

- As expected Sydney's industrial yields were largely stable during the first half of the year. There were signs of minor firming, surprisingly for secondary properties rather than prime.
- Both prime and secondary yields are slightly above their ten year average. Prime yields are 4 basis points above the average, while secondary are 18 basis points.
- However, at around 9% and in an improving outlook, yields appear attractive. Caution from investors has seen little activity over 1H 2010. While we considered in February that yields may start to firm in 2H 2010, the continued caution suggests this may be premature and we have moved our forecast for yields to firm back to 2011.

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