



Size matters - Sydney's office market shrinks while Melbourne booms

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In the last decade, Melbourne, Sydney, Brisbane and Perth have become home to an additional 3 million people¹. The rate of growth is unlikely to abate, either. Infrastructure Australia estimates population growth of 11.8 million people over the next three decades, much of it focused on Sydney and Melbourne, the country's two largest office markets.

This is good news for commercial property investors. Both markets continue to strengthen, albeit for different reasons.

Let's start with Sydney, where the CBD vacancy rate has fallen from its 2013 peak of 10.5% to just 5.5% as at 31 March 2018².

There are two reasons for this. First, a booming population and greater tourism is increasing demand for accommodation, resulting in the conversion of old office blocks into hotels and apartments. The second is Sydney's Metro project in which the State Government is acquiring and demolishing buildings to make way for new railway stations.

Combined, this has had an astonishing impact on the Sydney office market. Over the past two years a total of 246,000 square metres of office space was been withdrawn from Sydney's CBD - the equivalent of five large office buildings.

Melbourne's CBD office market has also enjoyed a fall in its vacancy rate, from 11% at the 2013 peak to 5.4% at 31 March 2018, but for very different reasons.

In Melbourne, net absorption - an industry term that refers to the difference between space vacated by tenants and total space leased - has gone through the roof. Over the last two years, net absorption was 280,000 square metres, more than 2.5 times the Sydney market over the same period.

This extraordinary demand for central office space is a result of "recentralisation" of tenants into the CBD from suburban markets and the growth of existing CBD tenants. In comparison to the more expensive Sydney CBD, Melbourne's remains affordable even to suburban tenants.

This is great for the outlook for rental growth in Melbourne office buildings, although the trend has been evident for years. Melbourne's net absorption rate has averaged around 71,000 square metres a year for the last decade but in Sydney it has only been around 29,000 square metres.

The likely result is that in the not too distant future Melbourne's office market will pip Sydney's as the biggest in the land.

Since reliable records began in the 1970s, Sydney has been the larger office market (as measured by square metres). At its 2002 peak, Sydney's CBD office market was

37% larger than Melbourne's. However, the structural shifts in demand now mean that Sydney is only 6% larger. This is a demand shift of major proportions with implications for investors and asset allocators alike. With tenants voting with their feet, investors are sure to follow.

APN has long held the view that the Melbourne office market is more attractive than reflected in some AREIT's asset allocations. Over the years, APN has voiced these concerns to property owners. The data is now unequivocal. Melbourne's office market has traditionally been under-represented in AREIT portfolios but, in all likelihood that will soon change. And that will support values in the medium term.

Finally, it is the great benefit of the deeply diversified and liquid nature of the AREIT sector that allows investors (like APN) to invest based on local market views as described here in. Accordingly, the active management style employed in the APN AREIT Fund has been able to invest more into Melbourne office than would be the case in a passive (or index) style strategy. These investments have helped us successfully deliver on our key objectives of relatively high income and lower risk.

1 <http://www.news.com.au/technology/environment/is-australia-prepared-for-an-exploding-population-influx/news-story/3a5b3ef230ae618b0612fbd27a276e6c>

2 APN uses data from Jones Lang Lasalle to analyse property markets, providing data back to 1970. This service in our view is (arguably) the most comprehensive data set on retail, office and industrial property in Australia. It provides us with the data that assists us in interpreting markets and predicting their future.

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