dexus

Australian Real Estate Quarterly Review

Q1 2019

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

Inside

Investment climate

Growth outlook faces headwinds

While the global economy grew at the reasonable pace of 3.8% in 2018, there is considerable uncertainty about whether that growth can be maintained - centred around the effect of interest rate rises on the US economy, the impact of the trade war on the Chinese economy and a slowing in Europe complicated by Brexit. While noting the risks, our assumption is for orderly moderation of growth in the US and China as the Federal Reserve reviews the pace of monetary tightening and progress is made on trade talks.

Recent data releases point to a moderating growth story for the Australian economy:

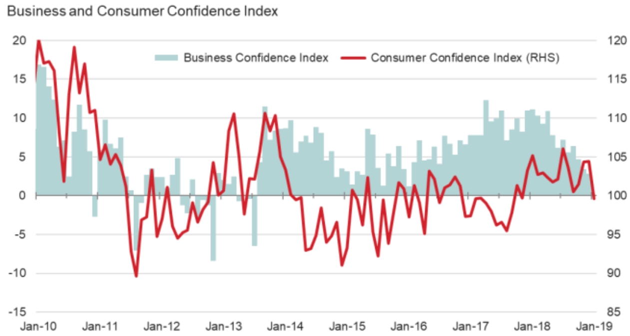
- Consumer confidence levels dipped and are now back in the pessimistic zone in January
- House prices declined further in the December quarter and building approvals have started falling. The correction in housing is expected to lead to a fall in investment and consumption, dragging on GDP by up to 0.9% p.a. over FY19/20
- Business conditions fell sharply in December with declines across most industries and states. We're hopeful the fall is more based on sentiment than reality, and expect business investment will remain supportive (albeit slowing)

The Australian economy is well positioned to handle the housing slowdown:

- The labour market still appears solid, with employment growing at 2.2% y/y and the unemployment rate is low at 5.0%
- Population growth is running at 1.5% p.a. and public spending on infrastructure is adding to growth

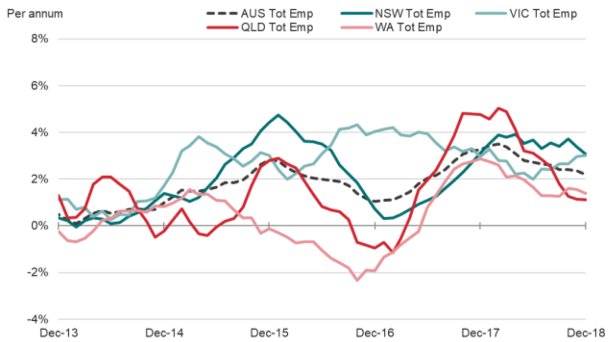
On balance, we expect Australian real GDP growth to moderate from 2.8% in FY18 to a below trend level of 2.0% y/y in FY19 and FY20. Our base case assumes two more rate cuts by the RBA, bringing the cash rate down to 1.0% by FY20. Interest rates are forecast to remain low for a considerable time.

Figure 1. Business and consumer confidence



Source: Westpac-Melbourne Institute, NAB

Figure 2. Employment growth



Source: ABS

Table 1. Australian economic forecasts: Q4 2018

	Jun-18	Jun-19	Jun-20
Real GDP %pa	2.8%	2.0%	2.0%
Final demand %pa	3.5%	1.5%	1.8%
Employment %pa	3.1%	2.0%	1.1%
Goods imports %pa	7.1%	0.0%	1.9%
Retail sales %pa (real)	2.6%	1.9%	2.0%
CPI %pa	2.0%	1.4%	1.8%
90 Day bill %	1.8%	1.8%	1.3%
10yr Bond %	2.7%	2.1%	2.0%
AUD/USD	0.77	0.65	0.60

Source: Deloitte Access Economics base, Dexus adjusted forecasts

Key themes for 2019

1. Risk aversion vs growth appetite

While our base case is for a moderation of growth rather than a sharp slowdown, investors clearly remain cautious about the risks. The prospect of heightened market volatility bodes well for capital flows into A-REITs, direct property and unlisted property funds as investors turn to defensives. Core CBD assets also stand to benefit. Australian property is well positioned in the event of a sudden demand shock. In Australia's largest office markets, Sydney and Melbourne, vacancy is at historic lows, making these markets well-placed to handle any moderation in occupier demand. Similarly, the pipeline of industrial supply is limited and demand will remain supported by ongoing e-commerce and supply chain management trends which are less dependent on the economic cycle.

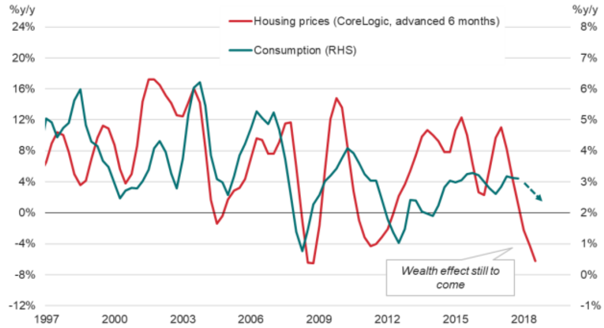
2. Householders holding back

Our base case view assumes house prices will fall nationally by 15%-20% (peak-to-trough) and building activity by 23%, bottoming in FY20. It's important to remember that housing markets are cyclical and subject to regular slowdowns. In addition, in the long run a correction will help to rebalance the economy in relation to affordability and household debt. The key is to manage the transition. Residential exposed A-REITs are likely to underperform, while a weaker consumption outlook will keep the pressure on the retail sector. Sectors such as office, industrial and healthcare will tend to outperform under these conditions. However, there is a risk that over time, consumption growth and a negative news cycle takes its toll on business investment.

3. Lower for longer interest rate outlook

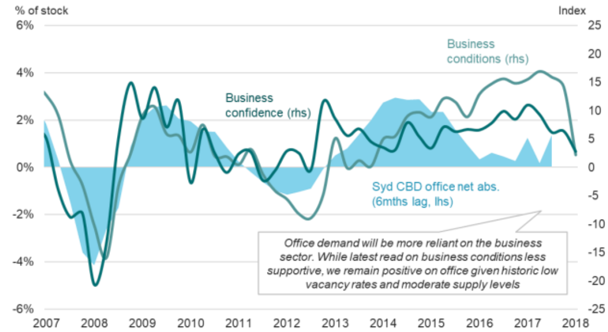
A slower growth scenario without inflation pressure will keep downward pressure on Australian interest rates and bond yields. With US rates appearing close to peaking, the risk of importing higher lending rates is moderating. We're factoring in the possibility of two more rate cuts by the RBA, bringing the cash rate down to 1.0% by FY20, and for Australian 10-year bond yields to drift down towards 2.0% (a big turnaround from last year's outlook). A steady cost of capital and low interest rate outlook will keep property yields looking relatively attractive and continue to support investment demand for direct and listed property in 2019.

Figure 3. Australian house prices vs consumption



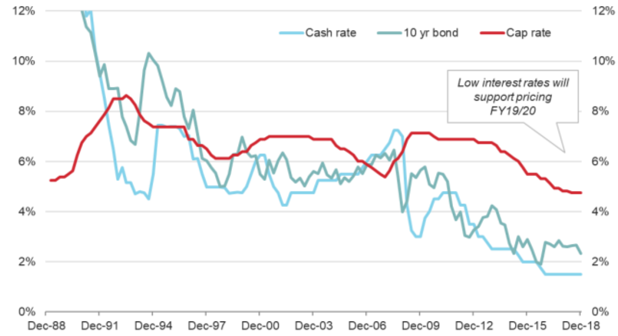
Source: ABS, CoreLogic, Dexus Research

Figure 4. Sydney office demand vs business conditions and confidence



Source: JLL Research, NAB, Dexus Research

Figure 5. Sydney CBD office cap rates vs interest yields



Source: RBA, Bloomberg, JLL Research, Dexus Research

Transactions

A record year for investment activity

Transaction volumes in 2018 were the highest on record, reaching a total of $31.4bn. Activity was driven by an increasing amount of Merger & Acquisition activity, confidence in Australia's main office markets and portfolio restructuring within the retail sector.

Oxford Property Group, a subsidiary of OMERS (one of Canada's largest pension plans), acquired Investa Office Fund's $3.4bn portfolio in December.

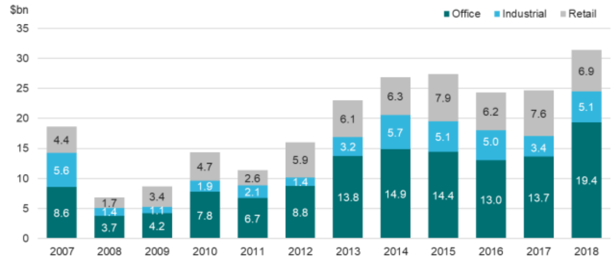
The IOF acquisition reflects the weight of foreign capital seeking exposure to Australian commercial real estate. Foreign investment volumes accounted for nearly 50% of volumes in Q4, being one of the largest on record. These transactions indicate that foreign investors continue to value Australian real estate even at lower yields due to its relative value compared to global markets, sound supply/demand fundamentals and the underlying growth drivers of population growth and infrastructure investment.

It is likely investment demand will remain strong in 2019. As we move forward into a period of global uncertainty, Australia's political and economic stability and the defensive nature of property investments will remain key strengths.

Yields (Figure 7) have remained flat over the past six months at 4.75% for office, whilst industrial saw 50 basis points of compression to 5.25%. The spread of industrial yields over office is now at the narrowest level on record, reflective of both a long running structural decline in industrial risk premiums and the current positive sentiment towards the sector and its growth prospects.

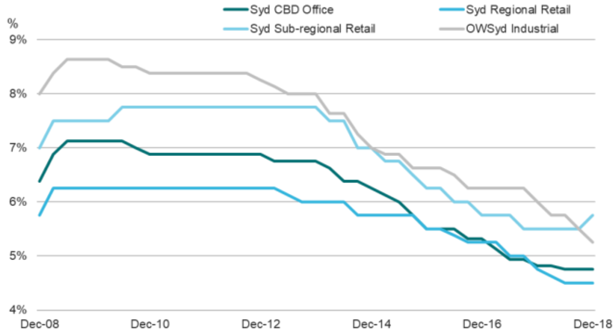
Pricing is a trend to watch for retail. Valuation evidence from some of the major players indicates that there has been expansion of cap rates on lower quality retail centres. Shopping Centre Australia's (SCA's) acquisition of Vicinity's portfolio for $573m reflected a 5.1% discount to book values - implying a 35 basis point cap rate expansion. Vicinity announced a small $37m revaluation loss on its portfolio, comprising a 4 to 15 basis point cap rate expansion on its regional, sub-regional and neighbourhood centres offset by valuation gains on its city retail and outlet centres. The transaction market for poorer centres is likely to remain weak in the year ahead as investors reposition portfolios.

Figure 6. Transaction volumes by sector



Source: JLL Research, Dexus Research Transaction Database

Figure 7. Average prime yield by sector



Source: JLL Research, Dexus Research

Table 2. Q4 2018 top transactions

Price ($m)	Asset/portfolio	Buyer
3350	Investa Office Fund	Oxford Properties
804	10 & 12 Shelley Street	Charter Hall
646	Hine Global REIT	Centuria Metropolitan REIT (50%) / Lederer Group (50%)
573	Vicinity to SCA Portfolio	SCA
420	Metcentre	Blackstone
275	61 Mary Street	Charter Hall Core Plus Office Fund (CPOF)
250	100 Skyring	Growthpoint Properties
182	Burwood One	Undisclosed
180	183-185 Clarence Street	TH Real Estate

Source: Dexus Research Transaction Database, JLL Research

Performance

Rise of the defensives

In a surprising turn of events, A-REITs made a last-minute comeback in the December quarter to outperform the broader Australian equity market in 2018 by +5.8% (Figure 8). Over the quarter, A-REIT pricing benefitted from declining bond yields and investors moving back into defensives on the back of heightened market volatility and a more cautious macro backdrop.

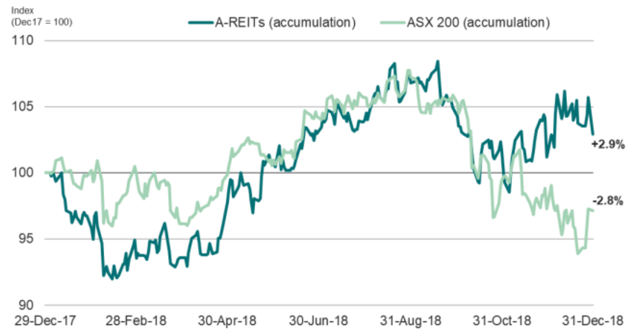
Performance in the direct property market remains robust with strong investor demand, especially for Sydney, Melbourne office and industrial assets. This saw direct property +11.1% (PCA/MSCI Index, Sep-18) and unlisted property funds +10.3% (MSCI/Mercer Index, Dec-18) lead listed property returns +2.9% over the year.

Sector returns continued to diverge across both listed and direct property markets. The residential and retail sectors lagged as fundamentals have deteriorated, while Sydney/Melbourne office (robust rental growth) and industrial (e-commerce trade) have outperformed. This is most evident in the latest MSCI/Mercer Wholesale Funds Index results, which clearly shows an increasing divergence between sectors (Figure 9). While industrial and office returns have been helped by rental growth, retail returns are being affected by weaker income growth, rising incentives/capex and write downs in values of poorer assets.

Our key predictions for 2019 include:

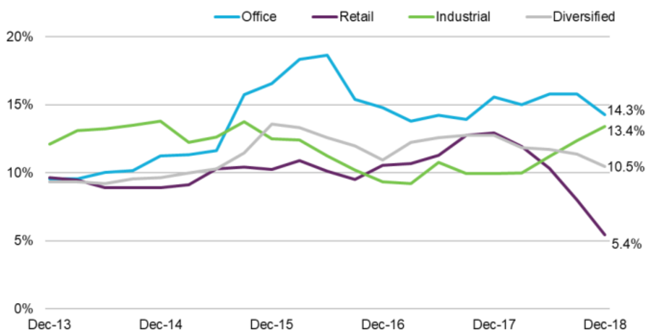
- Defensive investments will be on trend due to continued uncertainty
- A-REITs to outperform equities as Australian 10-year bond yields drift down towards c2.0% and volatility continues to plague equity markets
- Direct property and unlisted property funds will continue to outperform, but returns will move into single digits as capital growth starts to wane
- Industrial sector to outperform (boosted by cap rate compression and rising rents), followed by office.
- Retail is likely to underperform the other sectors at an index level, however, aggregate numbers will hide a growing divergence between better and poorer quality centres

Figure 8. Total returns: A-REITs vs ASX200



Source: IRESS, Dexus Research

Figure 9. IPD Wholesale funds index returns



Source: Mercer/IPD (NAV Pre-Fee), Dexus Research

Table 3. Index returns to 31 December 2018

	Qtr.%	1 yr %p.a.	3 yr %p.a.	
Unlisted property*	2.4	10.3	11.8	MSCI Mercer Aust. Unlisted Wholesale PFI*
Australian fixed interest	2.2	4.5	3.7	BACM0 Index
Australian cash	0.5	1.9	1.9	BAUBIL Index
A-REITs	-1.9	2.9	7.2	S&P/ASX 200 A-REIT Accumulation Index
Australian shares	-8.2	-2.8	6.7	S&P/ASX 200 Accumulation Index

The indices are copyrighted by and proprietary to the relevant Source issuers: MSCI Mercer Aust. Core Wholesale Monthly PFI; Standard and Poor's Australian Securities Exchange Accumulation Index; Bloomberg/UBS Composite and Bank Bill Indices. *NAV Pre-Fee

Office markets

Core CBD markets well positioned

Office markets continue to enjoy positive leasing conditions on the back of solid employment growth nationally (Figure 10). Looking forward we expect positive absorption to continue, however we have tempered our view, noting that business confidence has moderated in response to risks around the Australian and global economic outlook.

Australia's main office markets are well-positioned however these risks play out. Vacancy rates tightened during 2018 (Figure 11) and in most markets short-term supply is at modest levels with solid levels of pre-commitment.

The vacancy rate of 4.1% in Sydney CBD is the lowest it has been in 18 years and very little supply is due to be added in FY20. Sydney is experiencing an extended cycle with planned projects spread out over the period FY21-24. Anecdotal evidence is that a lack of available space is causing companies to squeeze into their existing accommodation, creating pent-up demand.

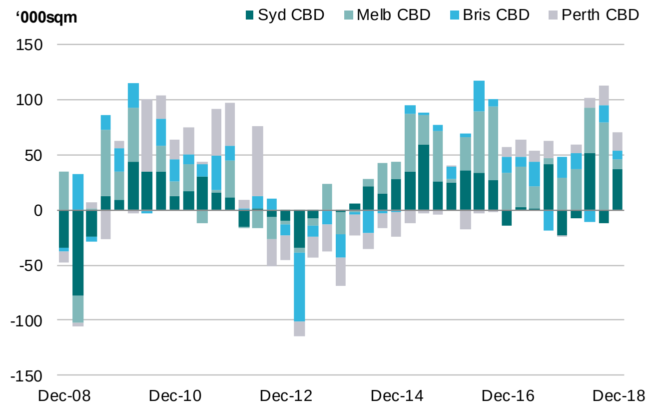
The vacancy rate in Melbourne CBD of 3.7% is at a 10-year low and demand for office space is benefitting from the strongest population growth in the country. The significant amount of supply currently under construction for FY20 delivery is likely to lead to a rise in vacancy, however the effect on the market will be muted by the low starting vacancy rate, the positive 167,000sqm of absorption in the year just gone and an 81% pre-commitment level.

Brisbane and Perth ended 2018 on a strong note recording falling vacancy rates on the back of broad-based service sector growth. A flight to quality has lead to prime vacancy in Perth and Brisbane falling well below total vacancy - to 16.0% and 7.2% respectively. In both markets planned supply in FY20-22 is below average.

The major CBD markets recorded solid effective rent growth over the past year (Table 4). We forecast further growth in Sydney and Melbourne over the next year, however the rate of growth is tapering. Perth and Brisbane have continued to improve mildly.

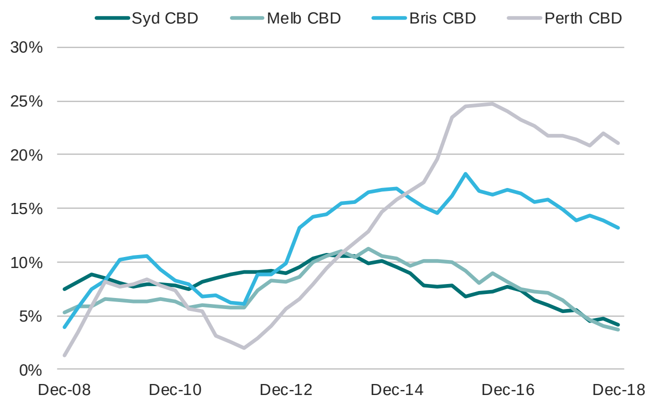
Centralisation of tenants, valuing the amenity of the CBD, remains a key theme in core markets. Examples of moves back into the CBD from a fringe or metro market location included IBM and Pfizer (Sydney), Civil Aviation Safety Authority (Brisbane) and P&N Bank (Perth).

Figure 10. Quarterly net absorption by market



Source: JLL Research, Dexus Research

Figure 11. Vacancy by market



Source: JLL Research, Dexus Research

Table 4. Q4 2018 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth % p.a.
Parramatta	3.9%	8.4%	13.1%
Macquarie Park	7.0%	5.0%	8.9%
Melbourne CBD	3.7%	5.2%	8.0%
North Sydney	8.6%	4.4%	6.8%
Sydney CBD	4.1%	6.4%	6.4%
Perth CBD	21.1%	1.1%	4.3%
Adelaide CBD	13.7%	2.2%	4.2%
Brisbane CBD	13.2%	2.4%	3.7%
Canberra	10.9%	0.4%	-0.1%

Source: JLL Research

Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney	**Approaching inflection point.** Net absorption remained solid in Q4 with 36,926sqm recorded, ending a strong 2018, however demand indicators are showing signs of moderating. The market is well-placed to weather uncertainty with the majority of new supply still not expected to hit until FY22-24. The vacancy rate reduced further in Q4 to 4.1% and is projected to fall further, supporting rents in the year ahead. Incentives appear to be stabilising.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	→
North Sydney	**Rent growth continues.** The North Sydney office market recorded positive net effective rent growth of 2.4% for the quarter and 6.8% for the year, despite negative net absorption of -19,990sqm in Q4 2018, due to some large moves out of the market. The vacancy rate increased to 8.6%. The outlook for demand is positive as the market benefits from a strong NSW economy and overflow of demand from the Sydney CBD, which should help support a further uplift in rental growth in the year ahead.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	→
Macquarie Park	**Demand eases further.** Demand slowed further in Macquarie Park in Q4, recording negative net absorption of -6,201sqm for Q4 2018. Stock withdrawals have kept the vacancy rate low at around 7.0% and prime effective rents have improved with a fall in incentives along with increased face rents. Demand is projected to be mild, and with a relatively subdued supply pipeline over FY19 there is likely to be some upward pressure on rents.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	→
Parramatta	**Continues to outperform.** The vacancy rate in Parramatta decreased further to 3.9% in Q4 2018 and there is limited supply risk in the short term. Rental growth has slowed but remains strong up +13.1% p.a. (net effective) and incentives have reduced further for prime assets to below 17%. There is medium term supply risk due to backfill and mooted projects, however the next stages of Parramatta Square are largely pre-committed from outside the market and new projects will require pre-commitment. How Parramatta performs over the medium-term will depend on its ability to attract tenants from outside the market.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	→
Melbourne	**Vacancy reaches historical low.** Melbourne vacancy hit 3.7% in Q4 2018 following very strong net absorption in 2018 (almost +170,000sqm) despite new supply coming online. Additional supply is due to complete over the coming years and as such, the vacancy rate is likely to increase in the medium-term, however the majority of new projects are pre-committed and continued solid demand will support market conditions. Rental growth is strong with prime net effective rents increasing by 8.0% over the year.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	→
Brisbane	**Steady recovery.** Net absorption remained positive at +7,389sqm in Q4 2018, largely supported by mid-sized occupiers. While the total vacancy rate reduced slightly to 13.2%, prime vacancy is just 7.2%. Accordingly, prime net effective rent growth improved further (+3.7%p.a) as face rents increased. Demand is projected to improve steadily over the next year or two, particularly for prime stock with a flight to quality. However, growth may be tempered by the three projects under construction.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↓
Perth	**The Perth market is expected to continue to recover aided by a three-year lull in supply from FY20-22.** Perth recorded +16,628sqm of positive net absorption in Q4 2018. The vacancy rate fell to 21.1% following a jump in Q3 due to backfill from Woodside's move to Capital Square. Prime vacancy is just 16% due to a flight to quality. Prime net effective rents have experienced further growth (+4.3%p.a.). Rental growth is expected to improve with scope for incentives to decline from current high levels.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	↓
Canberra	**Office demand improving.** Canberra recorded positive net absorption of +16,833sqm in Q4 2018. The vacancy rate has declined to 10.9% as a result. Despite limited rent growth in the past 12 months the modest availability of prime space (prime vacancy is currently 6.2%) should help to support some mild rental growth in prime assets in the short term.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	→

Industrial

In the midst of a strong growth phase

The latest data supports our view that the industrial sector is in the midst of a strong growth phase. While demand may ease a little with the economic cycle, it remains leveraged due to solid population growth and infrastructure investment in Sydney and Melbourne, supplemented by double digit growth in e-commerce and continued supply chain investment.

Strong tenant demand and rising development costs are putting upward pressure on rents in parts of Sydney and Melbourne, especially in supply-constrained (inner-city) markets (Figure 12, Table 5).

Further rental growth is expected over the next few years, especially in Sydney and Melbourne markets, helped by limited land supply and stock withdrawal for alternative uses.

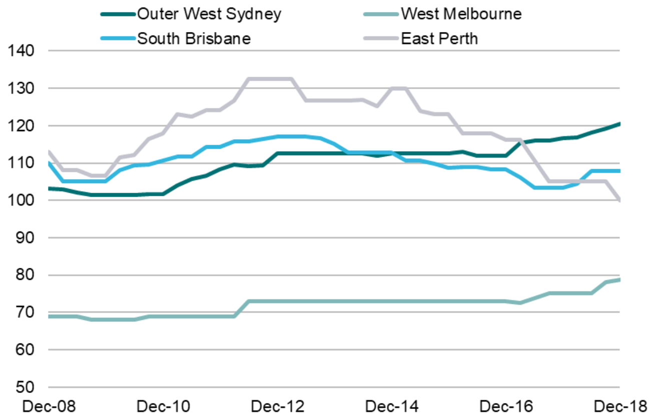
Conditions in Brisbane are projected to continue to improve over the short-term as the economy rebounds and infrastructure investment improves, while Perth is still feeling the pain with the latest data suggesting rents have dropped -4.8% in Q4-2018.

This positive outlook for industrial is supporting strong investor sentiment and heightened interest in industrial assets. With limited buying opportunities, yields have continued to compress across most industrial markets, falling 25-50 basis points over the past six months. Given the good rental growth prospects for the sector and positive investment demand, we expect yields to tighten further.

Key events this quarter:

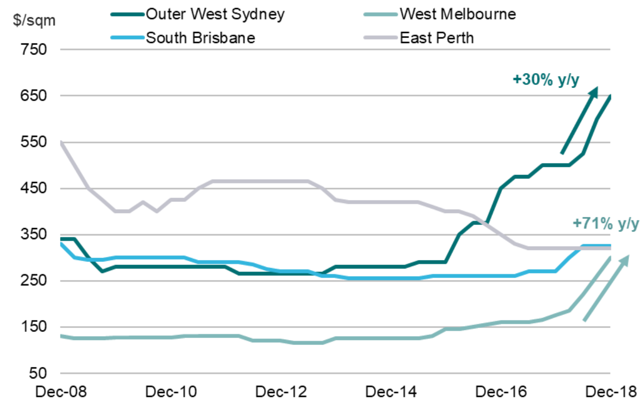
- In an event which could be seen as symbolic of the e-commerce trend, Goodman Group overtook Scentre Group to become the largest most capitalised player in the Australian listed property sector (24th Jan 2019)
- As evidence of the rising importance of automation, Coles entered into agreements for the development of two new automated distribution centres at Redbank in south-west Brisbane and Kemps Creek in western Sydney (24th Jan 2019)
- Dexus announced the establishment of the Dexus Australian Logistics Trust (DALT) in partnership with GIC seeded with $1.4bn of core logistics properties from the Dexus balance sheet and a further $138m of development land (30th Nov 2018)

Figure 12. Average existing prime industrial rents



Source: JLL Research, Dexus Research

Figure 13. Average industrial land values (1ha)



Source: JLL Research, Dexus Research

Table 5. Q4 2018 industrial snapshot

	Ave prime cap rate change from Q4 2017	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.75	3.3
Southern Brisbane	-0.13	4.3
East Perth	-0.37	-4.8
South Sydney	-0.87	6.0
West Melbourne	-0.50	4.8

Source: JLL Research, Dexus Research

Industrial

Outer West Sydney

Demand remains robust in Outer West Sydney with above average take-up of c389,900sqm recorded in 2018 – marking the strongest levels of take-up post GFC. Positive economic conditions and rising demand from e-commerce-related tenants are likely to support demand in the medium to longer term.

Supply completions have been strong with approximately 447,300sqm of stock added in 2018, nearly double the 10 year average of 262,900sqm. Current projections suggest supply has peaked and should trend down over 2019.

Rental growth is likely to remain positive in the short-term with demand expected to outpace supply.

The largest lease deal in Q4 2018 was a pre-lease to Snacks Brands Australia (30,255sqm) at Erskine Park.

West Melbourne

Take-up rates in West Melbourne picked up in Q4 2018 with approximately 60,300sqm recorded. Demand is projected to improve as population growth continues and key infrastructure projects such as the West Tunnel project add further support to economic conditions.

There is a relatively limited amount of land that is currently zoned and serviced in West Melbourne, and as a result, there has been upward pressure on rents, up 4.8% over the last six months (JLL Research).

The outlook is for continued rental growth in the short term as below average levels of supply is projected over the next 1-2 years.

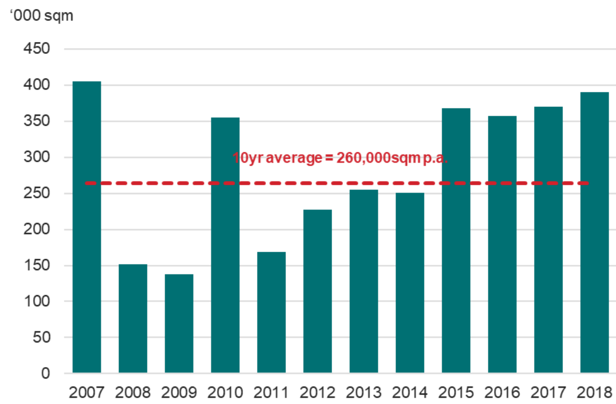
The largest lease deal in Q4 2018 was by Arrow Logistics (29,000sqm) in Altona.

Brisbane

Take-up in Brisbane increased further in Q4 2018, with approximately 97,700sqm recorded. Improved economic conditions including employment growth and infrastructure investment points to a more positive outlook in the year ahead after several years of weakness.

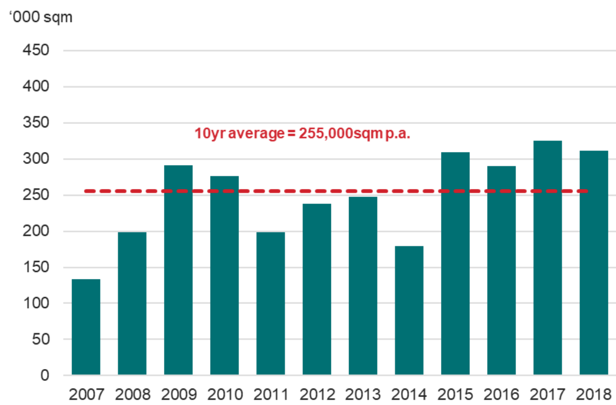
Supply completions in 2018 were manageable and well below the long term average of 280,000sqm, with approximately 207,000sqm added to stock, providing scope for some upward pressure on rents.

Figure 14. Outer West Sydney gross take-up



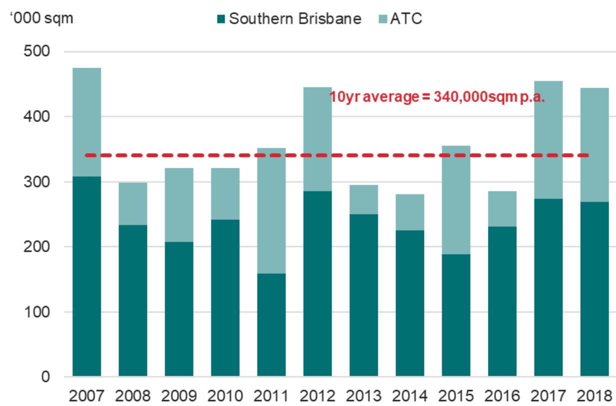
Source: JLL Research (gross take-up), Dexus Research.

Figure 15. West Melbourne gross take-up



Source: JLL Research (gross take-up), Dexus Research.

Figure 16. South Brisbane and ATC gross take-up



Source: JLL Research (gross take-up), Dexus Research.

Retail

Conditions to remain subdued in 2019

The outlook for the retail sector remains challenging. On the positive side, employment growth is above 2%, the unemployment rate is low at around 5% and mortgage rates, despite inching up, are relatively stable. Turnover growth is on a firming trend.

On the negative side, consumer confidence has eased and the slowing housing market is likely to dampen consumer spending over the next 18 months (see Figure 17).

Turnover growth improved slightly in the second half of 2018, increasing by 0.4% in the month of November 2018 based on ABS data, which was slightly above market expectations (and likely reflected impacts from online events such as Click Frenzy and Black Friday). The annual pace is now tracking at 2.8% year-on-year.

By industry, apparel and household goods had a strong month while pharmaceuticals, cosmetics and food categories continued to perform well.

Supermarkets still lead other anchor tenants and we expect non-discretionary categories to perform better than discretionary in the months ahead.

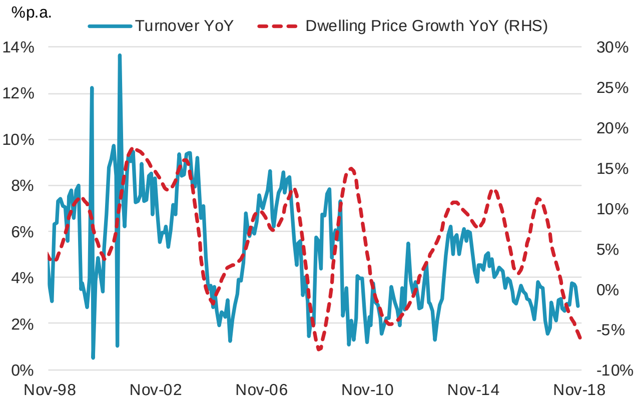
Online retail sales continue to increase with growth of 10.7%p.a. to November and comprising a share around 9.0% of spending at traditional bricks and mortar retailers (NAB Online Retail Sales Index November 2018).

The outlook is for specialty rent growth to remain subdued in the short to medium term. After a period of negative re-leasing spreads, occupancy cost ratios are now declining, indicating that rents are steadily re-basing and becoming more affordable for retailers.

Key events this quarter include:

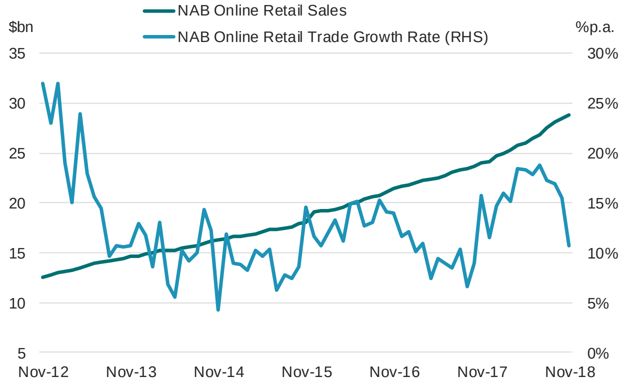
- Coles pushed further into convenience, announcing a trial partnership with Uber Eats to deliver 'ready to eat' range of products
- Ed Harry has been placed into administration while Crabtree & Evelyn have announced they will wind down the Australian business with only an online presence
- Coles and Woolworths have both recently rolled out smaller, high-end concept stores, offering organic 'market' style offerings at Coles Local in Surrey Hills (VIC) and Woolworths with 'The Kitchen' at Double Bay (NSW).

Figure 17. Retail sales growth vs house prices



Source: ABS, CoreLogic, Dexus Research

Figure 18. Online retail sales growth



Source: NAB Online Retail Sales Index, Dexus Research

Table 6. Q4 2018 retail snapshot

	Specialty rental growth % p.a.	Cap rate change from Q4 2017	State retail sales growth % p.a.
Sydney			2.9
Regional	0.17	-0.25	
Sub-regional	0.68	0.25	
Neighbourhood	0.93	0.00	
Melbourne			5.2
Regional	0.71	-0.38	
Sub-regional	0.38	0.00	
Neighbourhood	1.20	-0.13	
SE QLD			2.0
Regional	0.18	-0.13	
Sub-regional	-0.23	0.00	
Neighbourhood	0.39	0.38	

Source: JLL Research, ABS, Dexus Research

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