# Australian Real Estate Quarterly Review

Q1 2020

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

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# Investment climate

## Economic growth down but not out

Australian GDP growth moderated over the past year and is forecast to remain below average at around 1.8% per annum in FY20 before improving FY21.

Australia's bushfire crisis is expected to have major environmental and social impacts. However, the overall economic impact is likely to be small with Goldman Sachs estimating a 0.3 basis points hit to growth in the short term followed by a boost to growth from rebuilding efforts. If there is a surprise in store it is most likely to be via a lull in tourism.

Rising house prices bode well for future construction levels, however, it will take until late FY21 and FY22 for the current slide in building commencements to turn around and for construction to contribute to growth.

The recent US/China trade deal should benefit business confidence, notwithstanding that some Australian agricultural exports could be affected by the terms of the deal.

Weak business and consumer point to generally subdued leasing conditions going forward. However, business conditions vary greatly by industry. Conditions in the finance and business services industries (big users of office space) are much more positive than conditions in the retail and wholesale trade industries.

Interest rates are expected to remain low for a considerable period. The official cash rate is 0.75%. The 10-year government bond yield (1.18%) is forecast to remain below 2% for the foreseeable future.

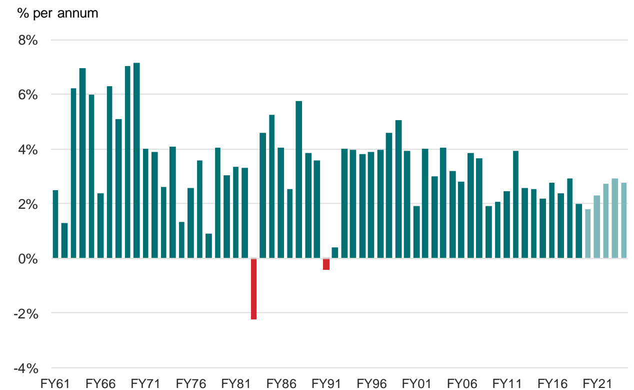
Australia's strong population growth will support demand for real estate going forward. The UN projects that over the next decade Australia's population growth of 1.5% p.a. will far exceed the average of the G20 (0.5%), the US (0.7%), the UK (0.5%) and China (0.2%).

**Table 1: Australian economic forecasts: Q4 2019**

| | Jun-19 | Jun-20 | Jun-21 |
|---|---|---|---|
| Real GDP %pa | 1.6% | 1.8% | 2.6% |
| Final demand %pa | 1.2% | 1.4% | 2.8% |
| Employment %pa | 2.8% | 2.0% | 1.7% |
| Goods imports %pa | -3.3% | 2.0% | 1.9% |
| Retail sales %pa (real) | 0.2% | 2.3% | 2.3% |
| CPI %pa | 1.6% | 1.8% | 2.0% |
| 90 Day bill % | 1.2% | 0.5% | 0.6% |
| 10yr Bond % | 1.3% | 1.0% | 1.1% |
| AUD/USD | 0.70 | 0.69 | 0.70 |

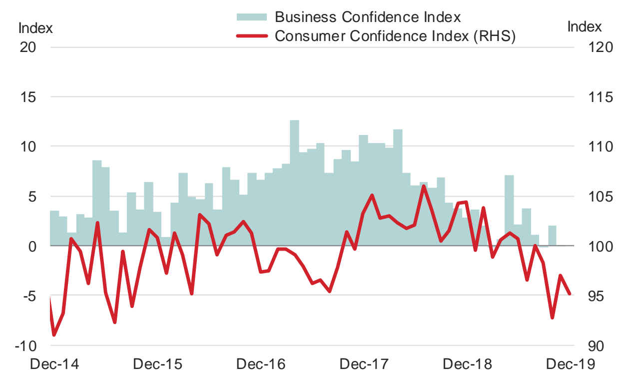
Source: Deloitte Access Economics base, Dexus adjusted forecasts

**Figure 1:** Modest growth outlook – slow in short term then improving in FY22



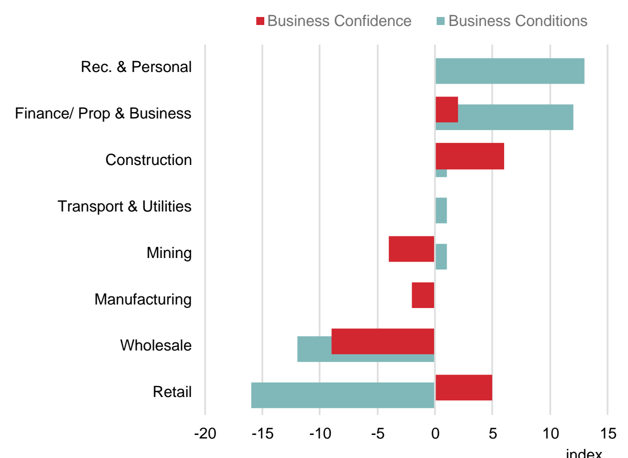

Source: Deloitte Access Economics

**Figure 2:** Uncertainty is influencing business and consumer confidence




Source: ABS

**Figure 3:** Business conditions stronger in business services than in retail/wholesale




Source: ABS

# Transactions

### Transaction volumes reach new highs

Transaction activity has sustained its positive momentum with 2019 volumes reaching a record high of $34 billion (Figure 4). Office continues to be the most active sector accounting for two thirds of total volumes.

Industrial transactions are down 27% since 2016 despite strong investment demand because stock remains tightly held as investors seek to grow their exposure. Unprecedented investment demand has reduced the spread between prime and secondary industrial assets to around 100 basis points compared to 200 basis points five years ago. The narrow spread points to the prospect of mispricing of risk in the secondary market.

Capitalisation rates have compressed a further 25 basis points in office and industrial over the past six months, hitting new historic lows of 4.50% and 4.88% respectively (Figure 5).

A-REITs were strong net buyers in 2019 (acquiring nearly $10 billion in assets) following an active year of equity raisings. ASX-listed REITs raised a total of $7.1 billion of fresh equity. Key issuers were CLW ($1.1 billion), DXS ($964 million), GPT ($867 million) and MGR ($796 million).

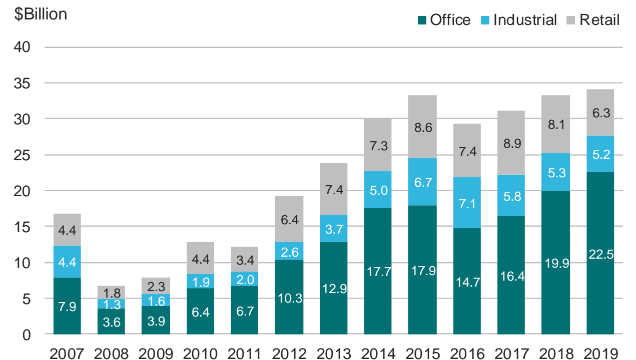
The most significant transaction of the quarter was Link REIT's purchase of 100 Market Street, the office part of the Westfield complex.

**Table 2:** Q4 2019 top transactions

| Price ($m) | Asset/portfolio | Buyer |
|---|---|---|
| 683 | 100 Market Street, Syd. | Link REIT |
| 670 | Westfield Marion | SPH REIT |
| 570 | Westfield Booragoon | Scentre Group |
| 425 | Australian Government Centre | AsheMorgan |
| 405 | Liberty Place | ISPT |
| 395 | Q&A Portfolio | Shayher Group |
| 350 | 118 Mount Street | CBRE Global Investment |
| 345 | National Cold Chain Logistics Portfolio | Lineage Logistics |
| 325 | Central Square | LaSalle Investment Management |

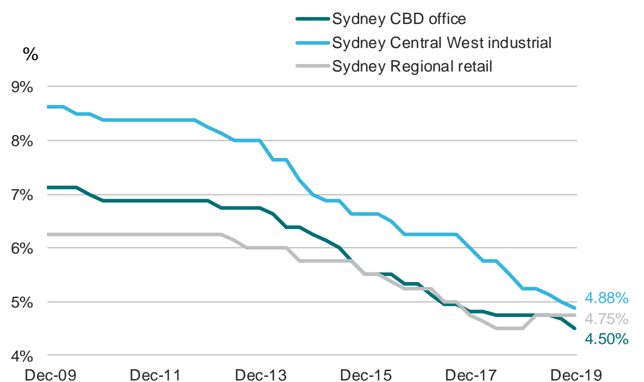
Source: Dexus Research Transaction Database, JLL Research

**Figure 4:** Transaction volumes reach record highs, led by the office market



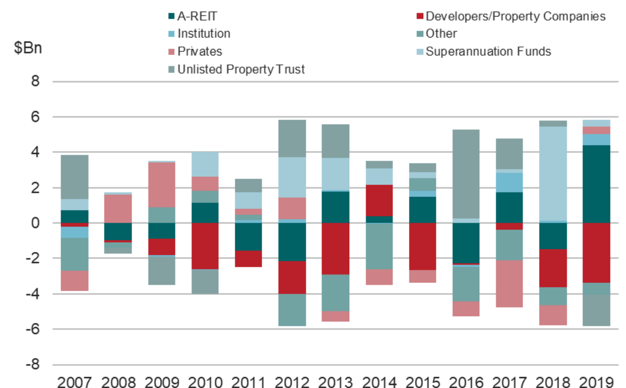

Source: JLL Research, Dexus Research Transaction Database
*YTD

**Figure 5:** Office and Industrial see further compression with retail yields flat to up




Source: JLL Research, Dexus Research

**Figure 6:** A-REITs are the largest net buyers off the back of capital raisings




Source: JLL Research, Dexus Research

# Performance

## Cap rates drive variation in returns

Equity markets performed well during the year with a 23.4% return. The strong performance was driven at the back end of 2019 through easing trade war tensions, Brexit optimism and the prospect of continued growth in the US economy as interest rates moderate.

A-REITs had a strong year, returning 19.4%, however the index weakened mildly in the last quarter due to a lift in 10 year bond yields which saw a mild sell off in defensive assets (Figure 7).

Returns for office and industrial unlisted property converged, recording 11.7% and 12.7% respectively in the year. Capital growth was mildly higher for industrial given greater cap rate compression (Figure 8).

Retail funds experienced a weaker total return (-1.1%) given a softening in cap rates and weaker operational metrics like vacancy and turnover growth. The slowdown in retail returns has dragged on performance of diversified funds.

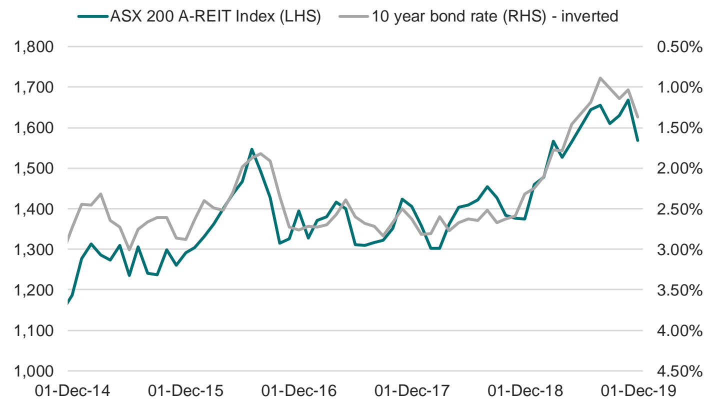
Strong returns in the industrial sector were driven by capital growth. While the average capital return was 6.5% for the year to September 2019, top quartile assets showed a capital return of 10.3% (Figure 9). There was significant variation in capital return for retail assets, with the lower quartile assets returning -3.1% whilst the top quartile returned 2.3%.

### Table 3. Index returns to 31 Dec 2019

| | Qtr.% | 1 yr %p.a. | 3 yr %p.a. | |
|---|---|---|---|---|
| Australian shares | 0.7 | 23.4 | 10.3 | S&P/ASX 200 Accumulation Index |
| A-REITs | -1.0 | 19.4 | 9.1 | S&P/ASX 200 A-REIT Accumulation Index |
| Australian fixed interest | -1.3 | 7.3 | 5.1 | BACM0 Index |
| Unlisted property* | 1.6 | 6.2 | 9.9 | Mercer/IPD Australia Monthly PFI Core Wholesale* |
| Australian cash | 0.2 | 1.5 | 1.7 | BAUBIL Index |

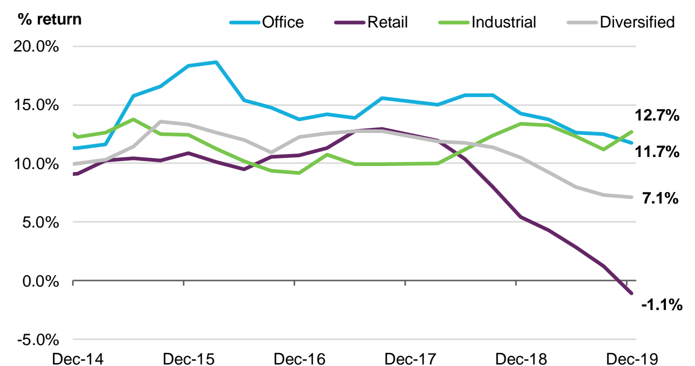
The indices are copyrighted by and proprietary to the relevant Source issuers: MSCI Mercer Aust. Core Wholesale Monthly PFI; Standard and Poor's Australian Securities Exchange Accumulation Index; Bloomberg/UBS Composite and Bank Bill Indices.
*NAV Pre-Fee

**Figure 7:** A-REIT pricing dips with a lift in 10 year bonds



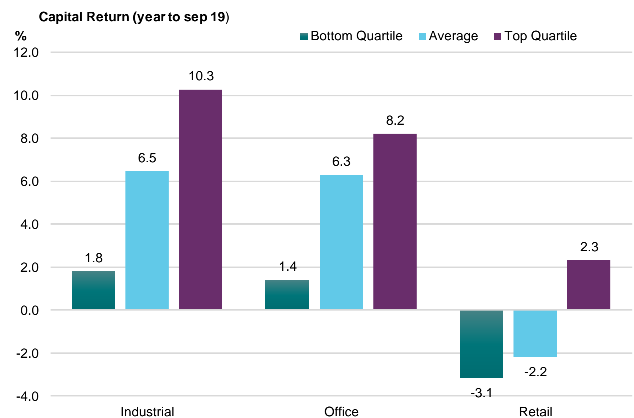

Source: IRESS, Dexus Research

**Figure 8:** Industrial cap rate compression edges out office returns, retail enters negatives




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

**Figure 9:** Strong capital growth in office and industrial sectors




Source: IPD/MSCI,Dexus Research

# Office

## Rent growth generally positive

Office markets nationally recorded positive rent growth in the 12 months to December 2019, with Melbourne CBD leading the charge (effective growth of 8.2%).

While weakness in the broader economy and a decline in job advertisements would seem to pose a risk for office demand, business conditions in office-using industries such as finance and professional services remain above the all-industry average, providing Australian office markets with a degree of resilience during this period of uncertainty.

Sydney CBD recorded negative net absorption of (37,700) sqm in the first half of FY20. This was almost entirely due to the decentralisation of several Government departments and consolidation by Telstra out of 231 Elizabeth Street. Not counting these moves, net absorption was close to zero reflecting a shortage of available prime space.

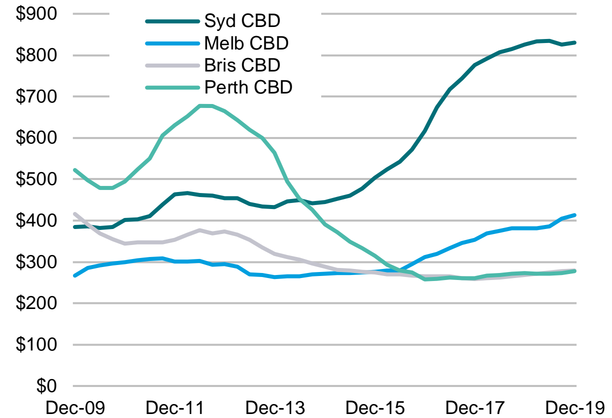
Australian office markets are well positioned. Vacancy rates are below average for Sydney (5.0%) and Melbourne (3.4%). While there is conjecture about increasing supply in these two markets, supply expected to complete in the three years to FY22 is well covered by average demand levels (Figure 12) hence we expect vacancy rates to remain below long-term averages for a considerable time. Over 90% of supply under construction in Melbourne is pre-committed. Brisbane faces a relatively greater challenge than Perth, which should benefit from a lull in new supply over the next three years. Proportionally, the largest increase in office supply will occur in Parramatta - albeit sizable pre-commitments will help shore up occupation of the new stock.

**Table 4. Q4 2019 office snapshot**

| | Vacancy % | Prime net eff. rent growth % p.a. | Net Increase % of stock to FY22 |
|---|---|---|---|
| **Melbourne CBD** | 3.40% | 8.20% | 9.7% |
| **Sydney CBD** | 5.00% | 0.40% | 4.5% |
| **Parramatta** | 5.40% | 6.50% | 17.6% |
| **Macquarie Park** | 5.90% | 7.30% | 17.6% |
| **North Sydney** | 8.30% | 7.80% | 9.8% |
| **Canberra** | 10.60% | 4.00% | 4.9% |
| **Brisbane CBD** | 11.70% | 4.30% | 7.0% |
| **Perth CBD** | 19.10% | 1.90% | 1.4% |

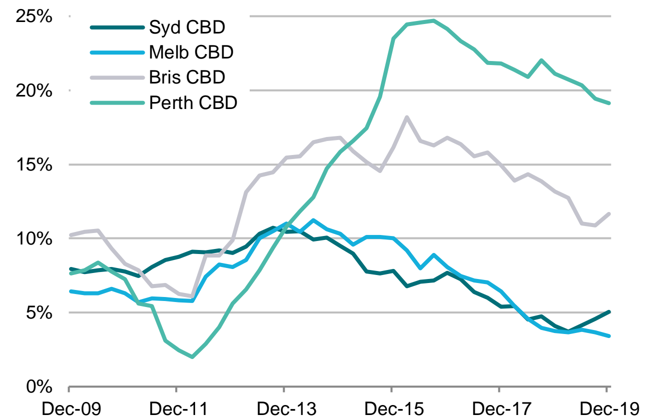
Source: JLL Research; *Projects under construction and plans approved

**Figure 10.** Rental growth most pronounced in Melbourne CBD



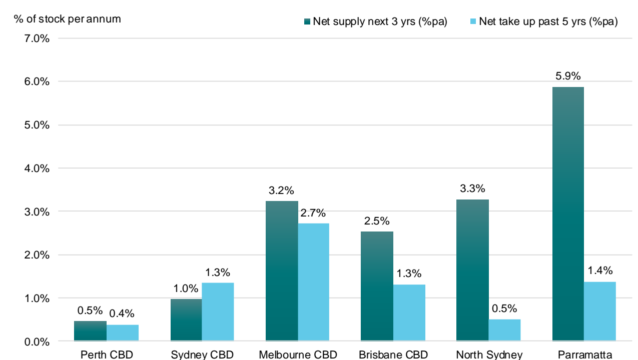

Source: JLL Research, Dexus Research.

**Figure 11.** Vacancy rates generally falling except for Sydney up from record lows




Source: JLL Research, Dexus Research

**Figure 12.** Upcoming office supply generally moderate in the context of past demand




Source: JLL Research, Dexus Research

# Office market wrap

| Market | Comments | Direction of trend for next 12 months | |
|---|---|---|---|
| Sydney | **Decentralisation of the NSW government leads to negative net absorption.** The total vacancy rate increased to 5.0%, with circa 23,000 sqm of space vacated in Q4 as a result of government decentralisations. In a generally subdued climate for business and consumer confidence nationally, and a shortage of prime space available office take-up has been subdued in Sydney CBD. However, in NSW, business confidence remains higher than the national average. Low interest rates have ensured investment appetite for Sydney CBD office assets remains strong and prime investment yields fell a further 25 basis points in 2019 to a record low of 4.5% | Vacancy | ↑ |
| | | Rents | → |
| | | Incentives | ↑ |
| | | Yields | ↓ |
| North Sydney | **Falling vacancy rates and pronounced rental growth still a feature.** Vacancy rates fell to 8.3%, with the permanent withdrawal of 168 Walker Street (conversion to residential). Prime gross face rents increased by 6.4% over 2019, with effective growth more pronounced at 7.9% as a result of falling incentives over the same period. Strong demand should help to support a further uplift in rents over 2020, though not at the same rate seen over the past few years. Prime yields compressed by 20 basis points in 2019 and are expected to fall further in the year ahead | Vacancy | ↓ |
| | | Rents | ↑ |
| | | Incentives | → |
| | | Yields | ↓ |
| Macquarie Park | **Annual face rental growth highest nationally.** The total vacancy rate fell a further 100 basis points in the December quarter to 5.9%. Net face rents grew by 7.5% over 2019, the highest growth rate recorded within office markets nationally. New supply in 2020 will likely place upwards pressure on vacancy rates in Macquarie Park over the short term, with circa 4.7% of stock under construction due for completion in 2020 and only one-third of the space currently pre-committed. | Vacancy | ↑ |
| | | Rents | ↑ |
| | | Incentives | → |
| | | Yields | ↓ |
| Parramatta | **Lowest prime grade vacancy rate in the country.** Total vacancy rates in Parramatta increased in Q4 2019 as the completion of 4 Parramatta Square saw the NSW Government vacating from a number of secondary locations (12,200 sqm total). Prime grade vacancy remains the lowest of any office market nationally (0.5%), however, secondary grade vacancy increased to 12.0% in December. While development of infrastructure projects should increase the tenant appeal of Parramatta, the market has yet to show it can attract head office tenants and become a viable alternative CBD. Prime investment yields fell 12 basis points to 5.57% in December 2019. | Vacancy | ↑ |
| | | Rents | ↑ |
| | | Incentives | → |
| | | Yields | ↓ |
| Melbourne | **Vacancy rates lowest on record and nationally.** The Melbourne CBD office market continues to see positive fundamentals, with prime gross face rents rising by 5.2% over the latter half of 2019. Relatively cheaper rents in Melbourne (compared to Sydney) provide the impetus for further tenant expansions in a state economy still doing well. Whilst annual net absorption of +21,517 sqm was well below the long-term average of 73,257 sqm, little available stock and tenant expansions saw vacancy rates falling further to a record low of 3.4%. While 2020 will see circa 330,000 of new supply delivered to the market, 92% of this space has been pre-committed. Prime yields fell a further 12 basis points in 2019 to 4.76%. | Vacancy | ↑ |
| | | Rents | ↑ |
| | | Incentives | → |
| | | Yields | ↓ |
| Brisbane | **Recovery on track with above average net absorption.** Improved economic conditions in Brisbane are flowing through to the office sector with annual net absorption of +44,947 sqm recorded in 2019, well above long-term averages. The vacancy rate increased to 11.7%, with the completion of the 300 George Street where 88% of space is still available. While prime gross face rents continue to improve, incentives (38-39% gross) remain elevated. With nearly half of the 125,000 sqm of supply currently under construction still available, the outlook for rental growth is subdued. Prime yields compressed by nearly 40bps over 2019. | Vacancy | → |
| | | Rents | ↑ |
| | | Incentives | → |
| | | Yields | ↓ |
| Perth | **Limited supply will support rental growth.** The steady recovery of the Perth market continues with annual net absorption of +28,939sqm recorded in 2019, steering vacancy rates lower to 19.1%. There was some upward pressure on face rents and downward pressure on incentives. Tenant movements are largely motivated by upcoming lease expiries, rather than any notable expansions, hence the rental market lacks tension. Recovery should continue in the absence of new supply, but it will take time. Prime yields remained stagnant during 2019. | Vacancy | ↓ |
| | | Rents | ↑ |
| | | Incentives | ↓ |
| | | Yields | ↓ |
| Canberra | **Above average rental growth recorded.** The re-election of the Coalition government brought stability back to Canberra's office market. Positive net absorption of 12,089 sqm in the six months to December 2019 was driven by a number of expansions by non-government tenants. In addition, there was notable rental growth on both a face and effective basis over the last two quarters of the year. Prime investment yields fell to 5.75% on the back of renewed interest from domestic institutional investors. | Vacancy | → |
| | | Rents | ↑ |
| | | Incentives | → |

# Spotlight - coworking

## Opportunity, challenge or risk?

The failure of the WeWork IPO last year has focused attention on the risks associated with the coworking sector. This article summarises the risks and opportunities.

Coworking has been a major part of office demand accounting for 18% of CBD office take up nationally over the past five years (Figure 13). While some have conjectured that a lull in coworking demand could reduce overall demand, the reality is that coworking is mostly accommodating demand that would otherwise be there from the underlying sources (e.g. IT, business services, finance etc).

The Coworking sector is growing its share of total office stock but at circa 3% of the Sydney and Melbourne CBD markets, remains at low levels by international standards. For example, several Asian cities have circa 4% coworking and Central London has circa 6%.

WeWork is the largest player, comprising 48% of coworking take-up over the past three years. Despite its rapid growth, WeWork still only accounts for 0.8% of total office stock nationally – which mitigates risks to the overall market.

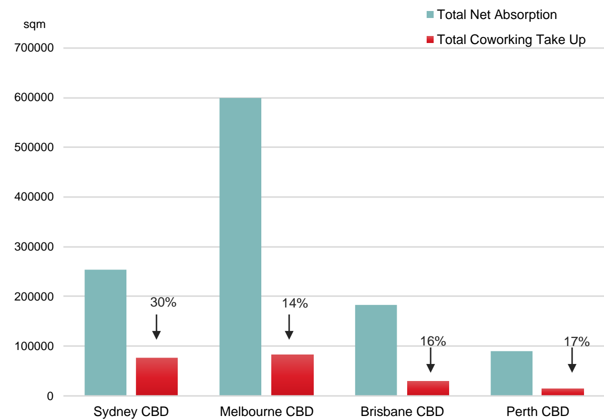
Coworking may compete with traditional office at the smaller end of the market, however it also attracts new business to CBD areas. Coworking complements traditional office space by allowing businesses to expand or contract on a short-term basis by acting as an incubator for traditional office space when occupiers outgrow their coworking space (Figure 15).

While it seems overall market risks are reasonably contained by the small size of the coworking sector, it is important that owners manage risks on building to building basis. WeWork's failed IPO highlights the risks of a business model which both relies on venture capital and fails to match short term revenue agreements and long-term cost obligations.

For these reasons owners are very focused on the credit risk of flexible operators, monitoring the extent of exposure to any one operator and containing their exposure in any one building.

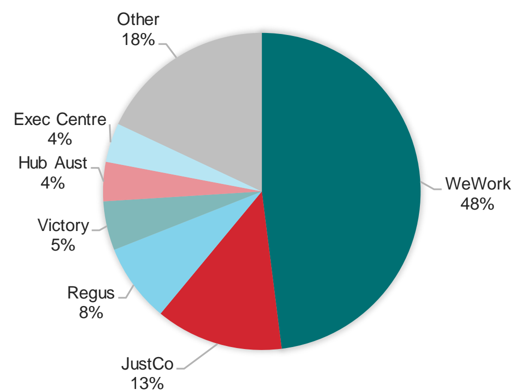
In the event of a sharp economic downturn, coworking space is likely to be more sensitive to vacancy than traditional office space due to its discretionary nature. However, the broader trend driving its growth – a customer need for greater flexibility – is not going away. So, despite inevitable bumps in the road, the sector is likely to continue on its long-term growth trajectory over the next decade.

**Figure 13:** Office demand in the form of coworking has comprised 18% of total take-up over the past 5 years



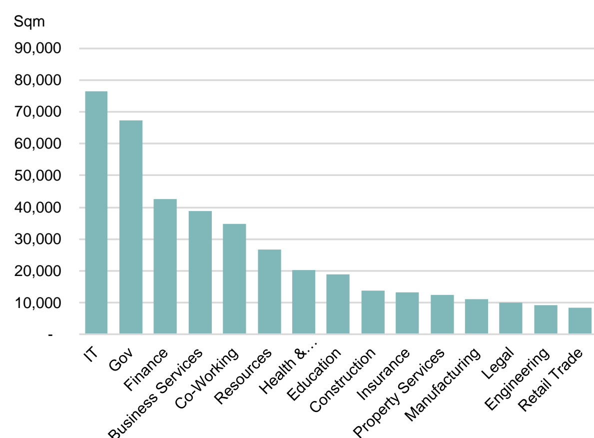

Source: ABS, JLL Research, Dexus Research

**Figure 14:** WeWork expanding by more than other operators with almost half the take-up from 2016-19




Source: Morgan Stanley Research, Dexus Research

**Figure 15:** Coworking behind business services and finance in terms of area leased (year to Q3 2019)




Source: Colliers, Dexus Research

# Industrial

## Unprecedented investment demand

Occupier activity continues to stay elevated on a national basis, bolstered by ongoing structural tailwinds such as ecommerce and outsourcing of logistics. A broad-based economic slowdown across the states is yet to have a material impact on leasing demand, although it is a possibility if business confidence eases.

Industrial metrics continue to move positively. Land values have risen strongly and investment demand has pushed up values for industrial investments. Prime rents continue to grow in the major east coast markets, although a competitive market for pre-leased product has constrained the level of growth achieved.

Demand has outpaced supply creating a lack of available space in the Sydney market. Consequently Sydney (473,000sqm) experienced much less take-up than Melbourne (842,000sqm). Favourable demographics and major infrastructure projects have bolstered demand in Melbourne.

A trend towards Investment in warehouse fit-outs is a lengthening the average tenure of industrial occupiers with longer tenant covenants making new developments increasingly competitive.

The 25-75 basis points tightening of cap rates over the past year has led to a significant appreciation in land values. Despite the push up in land values, developers have been taking advantage of higher values for built product to offer very competitive rents to secure customers. This dynamic has constrained rental growth.

Buoyant conditions have encouraged increasing levels of speculative development, particularly in Melbourne. While speculative projects have typically been leasing up quickly, their presence could add volatility to rents in the event of a disruption in demand.

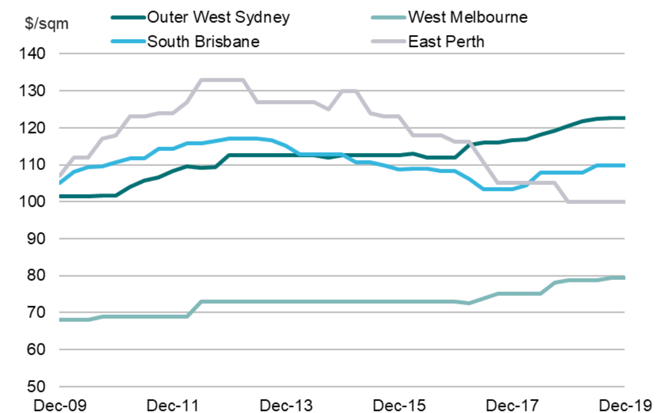
On-market opportunities have a significant depth of institutional buyers. In addition, institutional capital raisings for industrial strategies have been oversubscribed in recent years, highlighting the unprecedented strength of investment demand.

**Table 5. Q4 2019 industrial snapshot**

| | Ave prime cap rate change from Q3 2018 | Existing prime net face rental growth % p.a. |
|---|---|---|
| Outer West Sydney | -0.38 | 1.7% |
| Southern Brisbane | -0.56 | 1.9% |
| East Perth | -0.25 | 0.0% |
| South Sydney | -0.13 | 4.4% |
| West Melbourne | -0.75 | 0.8% |

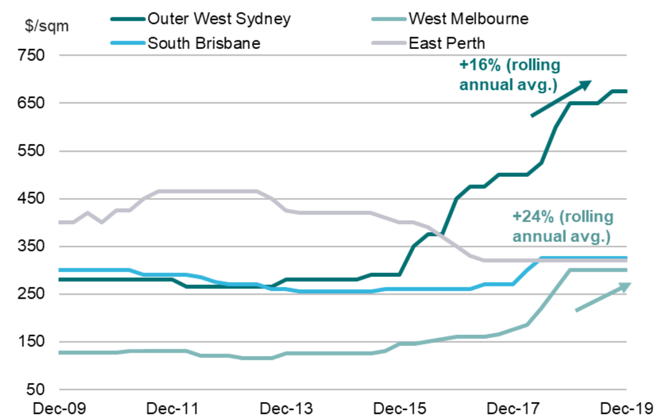
Source: JLL Research, Dexus Research

**Figure 16:** Prime rents continue to grow mildly in the east coast markets



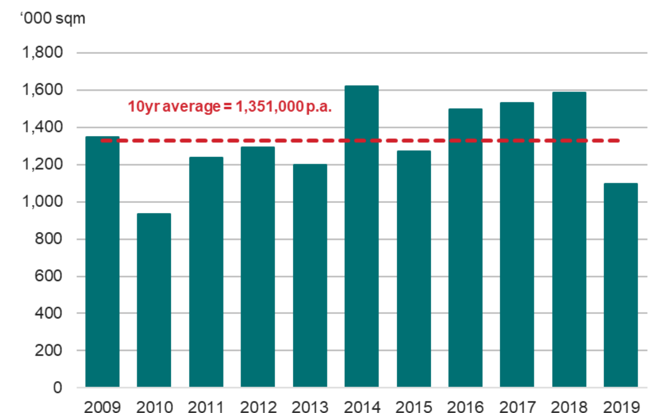

Source: JLL Research, Dexus Research

**Figure 17:** Land value growth flat over the quarter with a slight uptick in Outer West Sydney




Source: JLL Research, Dexus Research

**Figure 18:** Industrial supply has fallen below the 10-year average across Australian capital cities




Source: JLL Research, Dexus Research

## Industrial

### Outer West Sydney

Take-up in Outer West Sydney has eased to 165,000sqm on a rolling 12-month basis, significantly below the 10-year average (Figure 19).

Leasing activity was subdued this quarter due to a lack of available stock. Wetherill Park had the strongest leasing volumes over the quarter with deals to Sunrise Medical (14,920sqm) and Freight Assist (5,100sqm).

In line with take-up, the supply pipeline for 2020 appears subdued following a couple years of heightened development activity, while it appears a short-term scarcity of serviced land is the main issue the trend is also consistent with weaker business confidence.

### West Melbourne

Melbourne had its strongest year of demand since the GFC with 842,000sqm recorded across all sub-markets, with ~60% coming from the West.

West Melbourne's estimated 2020 supply pipeline of 427,000sqm is well above the average of 287,000sqm with 50% being built speculatively. While this supply is high, it comes off the back of a record year of take-up and the market can be expected to benefit from a lack of new supply in South East Melbourne.

The most significant leasing deal of the quarter was Scalzo Foods taking up 35,300sqm at the Horizon Estate in Ravenhall, highlighting the importance of the growing food and grocery retail sector.

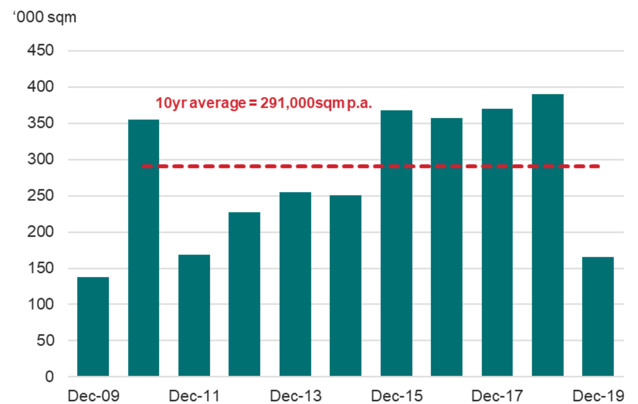
### Brisbane

An improvement in economic conditions in Brisbane is being reflected in leasing activity. Take-up in the Australian Trade Coast (ATC) and Southern Brisbane was 440,000sqm, exceeding the long-term average for three years in a row. TCK Alliance was the largest deal of the quarter, taking up 10,500sqm in Berrinba.

Although take-up has remained elevated, rental growth has been subdued due to the availability of stock. Over the past six months the ATC has recorded negative growth (0.7%) due to a more competitive stance by the Port of Brisbane. However, numerous suburbs have experienced growth despite a lack of growth at the market level.

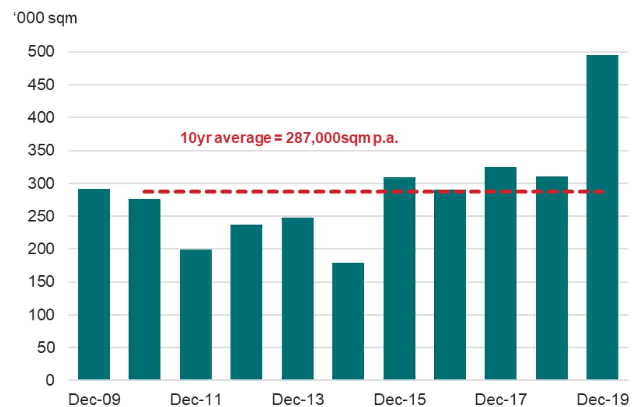
Speculative development is lower in Brisbane (35%) than Melbourne and Sydney and such projects are taking around four months to lease after practical completion on average.

**Figure 19:** Outer West Sydney gross take-up



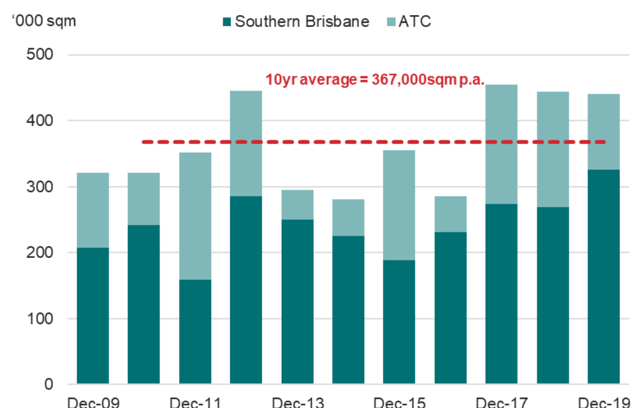

Source: JLL Research (gross take-up), Dexus Research.

**Figure 20:** West Melbourne gross take-up




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

**Figure 21:** South Brisbane and ATC gross take-up




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

# Retail

## Retail conditions still challenging

The Australian retail sector continues to muddle through in an environment of subdued spending growth. Centre performance remains variable with a large gap in performance between best and worst performers. While hard to generalise, city retail, dominant regionals and good convenience centres have tended to outperform the average.

Retail turnover lifted by 3.2% in the year to November (2.7% on an MAT basis) buoyed by strong performance from food and groceries, cosmetics and pharmaceuticals. Retailers experienced a strong month in November 2019 with 0.9% growth for the month - at least part of which can be attributed to strong 'Black Friday' sales.

Clothing and footwear sales recorded a creditable 3.6% MAT growth over the year. The improvement in the clothing category will be welcome given its ongoing competitiveness. While some commentators have blamed online retailing for Harris Scarfe, Jeanswest and fashion chain Bardot entering administration in recent months, the reality is that management of changing fashion trends and rising costs were the main factors.

Queensland saw MAT growth above the national average at 4.5% (Figure 23). On the other hand, growth is significantly lower within New South Wales and Victoria compared to the previous year, dragged down by a weak housing sector.

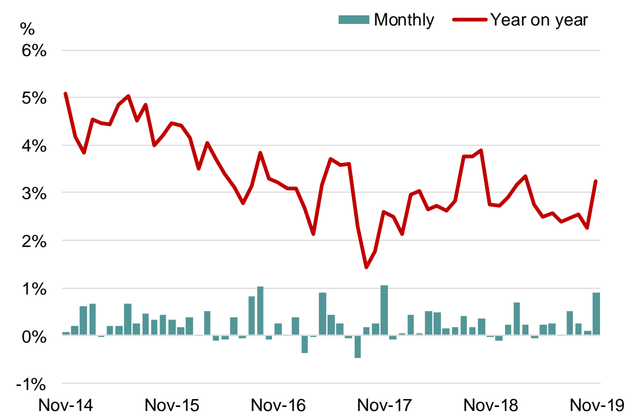
Looking forward, conditions are expected to improve only slowly. While rising house prices and growing employment are positives, consumer sentiment and rising living costs continue to constrain spending growth.

**Table 6. Q4 2019 retail snapshot**

| | Specialty rent growth % p.a. | Cap rate change from Q4 2018 | State retail sales growth % p.a. |
|---|---|---|---|
| **Sydney** | | | 1.5 |
| Regional | -0.6 | 0.25 | |
| Sub-regional | -0.7 | 0.00 | |
| Neighbourhood | -0.8 | 0.37 | |
| **Melbourne** | | | 3.5 |
| Regional | -0.7 | 0.25 | |
| Sub-regional | -4.4 | 0.13 | |
| Neighbourhood | 0.5 | 0.13 | |
| **SE QLD** | | | 4.5 |
| Regional | 0.0 | 0.25 | |
| Sub-regional | -6.3 | 0.00 | |
| Neighbourhood | -0.1 | 0.13 | |

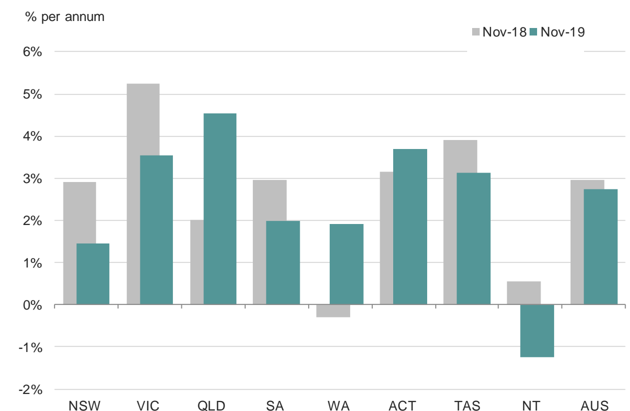
Source: JLL Research, ABS, Dexus Research

**Figure 22.** Retail turnover growth appeared to receive a boost in late 2019




Source: ABS, Dexus Research

**Figure 23.** QLD the standout within a flat retail outlook with NSW and Victoria easing




Source: ABS, Dexus Research

**Figure 24.** Supermarkets and pharmaceuticals underpin growth while household goods drag

Source: ABS, Dexus Research

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