



Australian Real Estate Quarterly Review

Investors benefit from
extended cycle

Q2 2018

dexus

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Investment Climate

Investors benefit from extended cycle

The investment climate for real estate remains in a 'sweet spot' where positive occupier demand and a steady cost of capital continue to support investor returns. While the value cycle appears mature, it so far lacks a catalyst for change.

Business confidence and consumer sentiment are both above the average of the past three years (Figure 1) which bodes well for occupier demand in the office and industrial sectors in the short term. Job advertisements are up 12% indicating firms are hiring again.

Conditions in the household sector are relatively slow given low wages growth and high household debt levels. Hence the outlook for the retail and residential sectors is more subdued.

A key theme this year is the dampening effect of online retailing on sentiment towards shopping centres while the industrial sector benefits from growth in online fulfilment. Another thematic is the transfer of growth in office demand from large users to small users as service firms shift to more collaborative, outsourced modes of working.

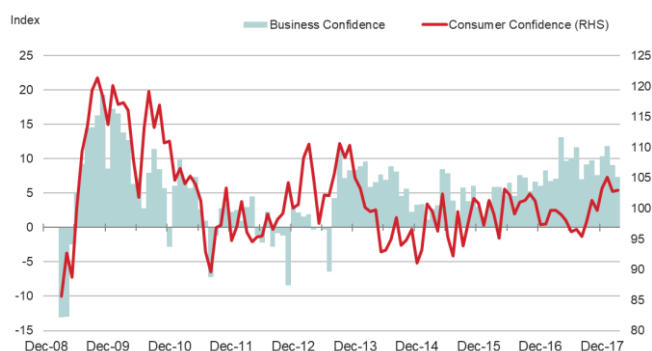
A further theme is a rebalancing of growth between the states. Mining investment is no longer a significant drag on growth in Queensland and WA.

Victoria and NSW are likely to continue to grow solidly, however the rate of growth could slow as existing infrastructure projects drive 'activity' more than 'growth'.

Key assumptions are:

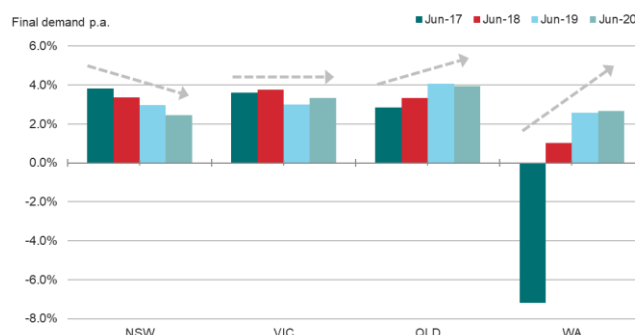
- A projected fall in housing construction will drag on growth more than many people think in FY19
- Modest inflation pressure should keep interest rates flat until mid 2019
- Capital markets are relatively stable, with bond yields and borrowing costs remaining at historically low levels
- Bond yields are expected to rise only slowly and mildly over the next two years with little influence on pricing while fundamentals stay good

Figure 1. Consumer and business confidence



Source: Westpac, NAB

Figure 2. Economic growth by state



Source: ABS

Table 1. Australian economic forecasts: Q2 2018

	Jun-17	Jun-18	Jun-19
Real GDP %pa*	2.0%	2.5%	2.8%
Final demand %pa	2.6%	2.4%	2.5%
Employment %pa	2.0%	2.6%	1.1%
Goods imports %pa	7.2%	2.0%	2.3%
Retail sales %pa (real)	2.5%	2.2%	3.1%
CPI %pa	1.9%	2.1%	2.2%
90 Day bill %*	1.7%	1.8%	2.0%
10yr Bond %	2.6%	2.6%	3.0%
AUD/USD*	0.77	0.77	0.74

Source: Deloitte Access Economics, *Dexus adjusted



Transactions

Volumes stay solid

Total transaction volumes were \$5.5 billion in the first quarter of 2018. While technically the highest first quarter volume on record, the number was inflated by the REST Industry Super purchase of a 33% stake in AMP's Quay Quarter for \$900m.

The proportion of foreign transactions remained stable at 30% in the March quarter. Within this total, Chinese inflows have declined due to capital restrictions in China and the gap has been filled by capital from other destinations. Australia is no longer seen as cheap compared to other global markets, nor is it expensive in yield terms. It also offers a degree of stability.

Other major office transactions included Australian Prime Property Fund Commercial (APPF) and First State Super each acquiring a 50% stake in Two Melbourne Quarter from Lendlease for \$275m each. Arcadia Wholesale Property Fund purchased ATO for \$176.0m. Another key sale was Blackstone's purchase of 1 York Street for \$204.1m.

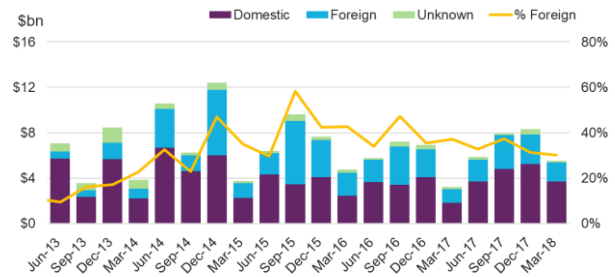
Key industrial transactions comprised two major portfolio sales; Allied Pinnacle sold their Portfolio to Qualitas Food Infrastructure Fund for \$400m and Cache Logistics Trust bought Blackstone's portfolio for \$178m.

Investment yields have continued tightening to historic lows. Even at lower yield levels, commercial real estate remains relatively attractive compared to bond yields for both domestic and foreign investors, and provides the additional promise of rental growth across most sectors and markets.

So far, bond yields have been relatively stable, however as the pricing cycle matures future movements in bond yields become more important. While bond yields are at similar levels now to where they were a year ago, rises of any significance would narrow the spread for real estate.

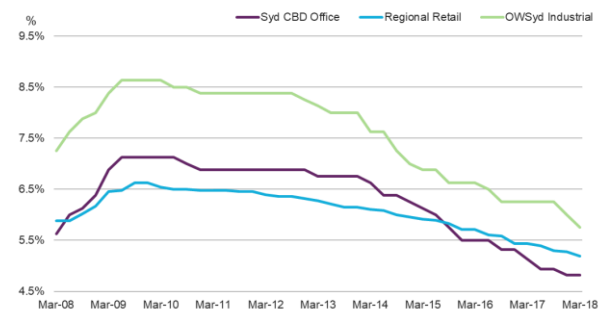
The other important metric is the outlook for rental growth. A reduction in growth prospects could quickly change price/yield expectations. The retail sector will be the one to watch in this regard.

Figure 3. Transaction volumes – quarterly



Source: JLL Research, Dexu Research Transaction Database

Figure 4. Average prime yield by sector



Source: JLL Research, Dexu Research. Includes portfolio sales.

Table 2. Q1 2018 top transactions

Price (\$m)	Asset/portfolio	Buyer
900.0	Quay Quarter	REST Industry Super (33%)
550.0	Two Melbourne Quarter	Australian Prime Property Fund Commercial (APPF) (50%) / First State Super (50%)
400.0	Allied Pinnacle Portfolio	Qualitas Food Infrastructure Fund
204.1	1 York Street	Blackstone
177.6	Blackstone Portfolio	Cache Logistics Trust
176.0	ATO	Arcadia Wholesale Property Fund
145.8	Quay Connection	Greaton
122.5	World Trade Centre	Zone O
106.5	Southgate Precint	Listed Property Trust

Source: Dexu Research Transaction Database, JLL Research



Performance

Returns driven by capital gain

Unlisted property rewarded investors with a higher return than equities or fixed interest over the year to March 2018, delivering a 12.7%.

Office funds provided the highest return with 15.0% for the year, followed by retail funds with 12.0%. Industrial and diversified funds also delivered double-digit returns.

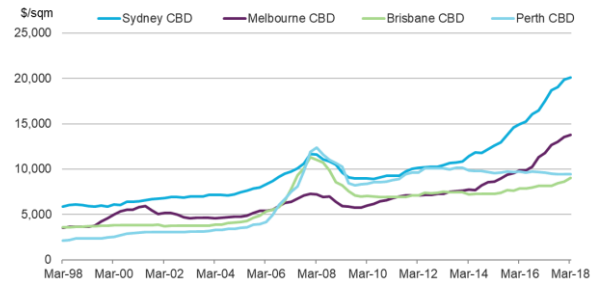
Capital gains (mainly in Sydney and Melbourne) continued to bolster office returns, as can be seen in Figure 5. A significant proportion of this capital growth has been from rental increases in these two markets.

As the cycle moves on over the next two years, and Sydney and Melbourne's rental cycle matures, the capital growth prospects for Perth and Brisbane will improve on a relative basis.

Despite a negative shift in sentiment toward the retail sector over the past 12 months, returns for unlisted retail funds remained in double digit territory.

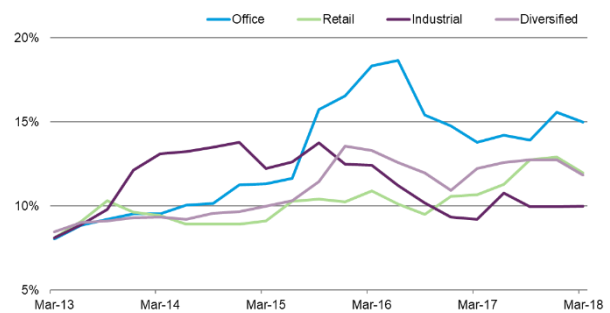
Bond yields have risen in early 2018, posing possible headwinds for A-REITS. Bond proxies such as property stocks tend to have a high negative correlation with Government bond yields. Central banks will likely continue tightening monetary policy around the world over the medium term, increasing bond yields and putting pressure on A-REIT pricing.

Figure 5. Historical prime values



Source: JLL, Dexs Research

Figure 6. IPD Wholesale funds index returns



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

Table 3. Index returns to 31 March 2018

	Qtr. %	1 yr %p.a.	3 yr %p.a.	
Unlisted property*	2.0	12.7	12.9	Mercer/IPD Aust. Unlisted Wholesale PFI*
Australian fixed interest	0.9	3.3	2.4	BACM0 Index
Australian shares	-3.9	2.5	3.8	S&P/ASX 200 Accumulation
Australian cash	0.4	1.7	2.0	BAUBIL Index
A-REITs	-6.4	-0.8	5.4	S&P/ASX 200 Property Accumulation Index

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

Office markets

Further growth ahead

The outlook for office markets remains positive in the short-term. The economic backdrop of positive employment growth and business confidence is supportive of office demand, while supply levels are low across most office markets. As a result vacancy rates are expected to tighten further leading to above average rental growth in a number of markets.

Melbourne continued to lead the office markets in occupier demand, recording +36,700sqm of net absorption for the quarter on the back of a powering Victorian economy and robust population growth. Brisbane and Perth continued their demand recovery into 2018 recording positive net absorption of +15,300sqm and +7,800sqm respectively in Q1 2018.

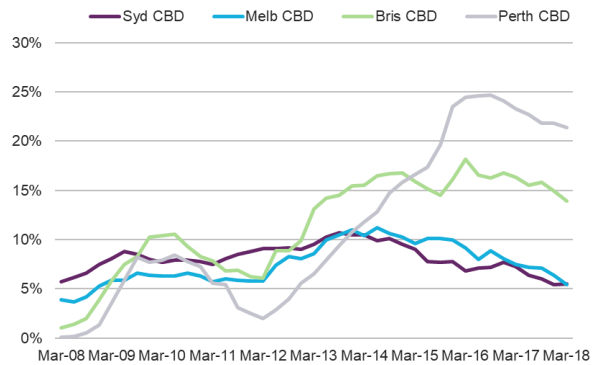
Vacancy levels across the major CBD markets continue to trend down (Figure 7), with Sydney and Melbourne now both sub six percent. It's not suprising that Sydney and Melbourne are delivering strong rental growth of 17.4% and 15.2% (Figure 8, Table 4). We expect these markets to deliver above average rental growth over the remainder of 2018 on the back of constrained supply (Sydney) and strong occupier demand (Melbourne).

Brisbane and Perth rents are still relatively flat as high vacancy remains. On the back of an improving outlook for the QLD and WA economies, we would expect improved conditions and a pick up in rental growth as incentives start to recede.

Points of interest this quarter include:

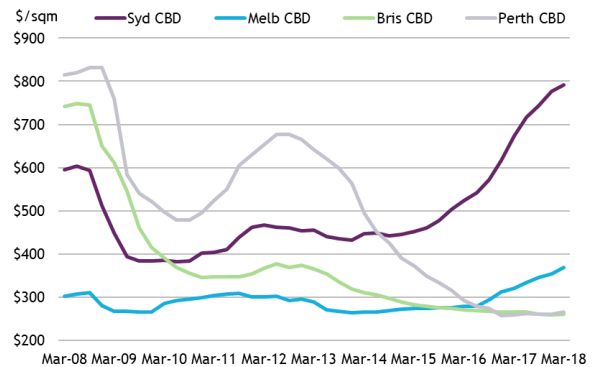
- Sydney CBD recorded another quarter of negative net absorption as government decentralisation and limited availability of space took their toll
- WeWork continues to expand its operations in the Sydney CBD, taking up +4,000sqm in the HCF Building and pre-committing +4,000sqm to York & George
- Investors appear to be taking advantage of countercyclical opportunities in Brisbane CBD with cap rates tightening by 25bps in contrast to other CBDs where cap rates remained flat. Perth could follow

Figure 7. Vacancy by market



Source: JLL Research, DEXUS Research

Figure 8. Net effective rents (\$/sqm) by market



Source: JLL Research, DEXUS Research

Table 4. Q1 2018 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth % p.a.
Parramatta	4.3%	14.4%	20.8%
Melbourne CBD	5.4%	9.1%	15.2%
Sydney CBD	5.5%	7.7%	17.4%
North Sydney	6.9%	4.5%	8.0%
Macquarie Park	6.9%	1.2%	4.9%
Canberra	13.2%	2.8%	3.5%
Brisbane CBD	13.9%	2.6%	-2.1%
Adelaide CBD	15.2%	0.5%	0.3%
Perth CBD	21.4%	-0.6%	2.7%

Source: JLL Research



Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney	With two consecutive quarters of negative net absorption are the good times over for Sydney CBD? We think not. The negative read is more a function of limited space options in the market, rather than a deterioration in underlying demand. The market is still benefiting from a withdrawal of stock and very low vacancy rates of 5.5%. Rental growth remains strong at +16.3% p.a. (prime gross effective) as incentives continue to fall. With major new supply still some years off (majority not expected to hit until FY22-24), and the demand backdrop remaining supportive, we continue to expect above average rental growth over the next 1-2 years.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	→
North Sydney	Lowest vacancy rate in a decade. North Sydney's vacancy rate is down to a 10 year low of 6.9% as the market benefits from a withdrawal of stock for residential conversion. Prime net effective rents have grown strongly as a result up +8.0% over the year with net incentives declining to 24%. Although net absorption was mildly negative this quarter, we expect a more positive demand outlook for 2018 as the North Sydney market benefits from a strong NSW economy and overflow of demand from the Sydney CBD. Stronger demand will help to support a further uplift in rents over the year ahead.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	→
Macquarie Park	Withdrawals offset a drop in demand. Despite net absorption dipping into negative territory this quarter, vacancy levels continued to decline to 6.9% as the market benefited from further withdrawal of stock for residential conversion. Prime net effective rents have grown strongly up 4.9% over the year as net incentives fell to 23.6%. A relatively subdued supply pipeline short-term and a return to positive demand is expected to support further rental growth in the year ahead.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	→
Parramatta	Look west for outperformance. Parramatta remains our pick for outperformance in the short-term, having one of the lowest total vacancy rates (4.3%) and no immediate supply risks. The tight prime vacancy (0.4%) is driving strong rental growth (+20.8% p.a. net effective) and low incentives (17.9%) for prime assets. With supply largely pre-committed over the next 1-2 years, we can expect low vacancy and above average rental growth to continue. The outlook is more uncertain over the medium-term with the exit of CBA and the potential for a large amount of supply to hit the market. How Parramatta performs over the medium-term will be very much dependent on its ability to attract tenants from outside the market.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	→
Melbourne	Melbourne - A growth story. Melbourne is benefiting from strong economic fundamentals, recording the strongest net absorption across the CBD office markets (+36,700sqm for the quarter), and a fall in vacancy to 5.5% (now on par with Sydney CBD). In line with improving vacancy, rental growth remains strong with prime net effective rents increasing by 15.2% over the year (largely driven by increases in face rents with incentives still elevated at 29% net). Limited new supply and a solid demand outlook will see vacancy tighten and support further rental growth over the next 6-12 months.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	→
Brisbane	Demand recovery continues. The latest numbers continue to support a recovery story for Brisbane over the next year or two with positive net absorption of +15,300sqm recorded for the first three months of 2018. While prime gross face rents have improved, growing 2.8% over the year, incentives remain elevated (38% gross) as a result of high vacancy (13.9%) and speculative supply. Prime rental growth is expected to improve over the medium-term, as vacancy levels move back towards the long-run average with a flight to quality absorbing prime space.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↓
Perth	On the long road to recovery. Perth started the year on a positive note recording +7,800sqm of positive net absorption (Q1-2018) and vacancy rates declining further to 21.4%. Prime net effective rents have experienced mild growth of +2.7% over the last 12 months as net incentives declined by -140bps to 48% net. Rental growth is expected to remain subdued short-term, improving over the medium-term as market conditions slowly recover in the absence of new supply.	Vacancy	→
		Rents	↑
		Incentives	↓
		Yields	↓
Canberra	Office demand remains subdued. Negative net absorption of -2,500sqm was recorded in Canberra as government tenants continue to consolidate space. The demand outlook is expected to remain subdued given Federal Government budget constraints, which will continue to weigh on public service job growth over the short- to medium-term. Limited availability of prime space (prime vacancy is currently 5.4%) is helping to support rental growth in prime assets (+3.6% p.a. net effective). Positive demand for prime assets should support an uplift in rents over the next 12 months.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	→

Industrial

Growth drives uplift in land values

The outlook for industrial demand appears solid given that population growth and infrastructure investment are supporting economic activity. Sydney, Melbourne, and to a lesser extent Brisbane, are best placed to benefit.

E-commerce is emerging as a possible longer term demand driver as online sales expand at double digit growth rates, and online retailers and fulfilment providers seek to increase scale.

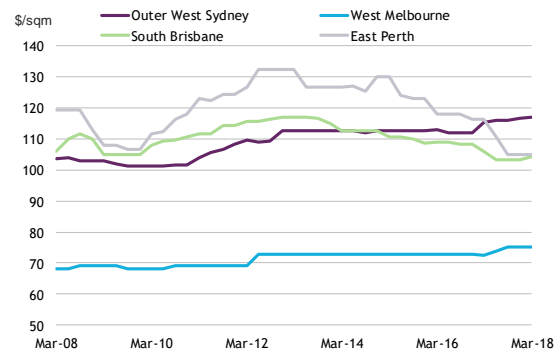
The outlook for rents is likely to remain positive, particularly in land constrained areas in Sydney and Melbourne, as demand runs a bit ahead of supply. Conditions in Brisbane are projected to improve in the short term as the economy rebounds, while Perth appears to have bottomed.

Solid demand from occupiers and a lift in rents has led to strong competition for development sites. Land values have risen past previous peaks in key markets in Sydney and Melbourne.

Key themes this quarter include:

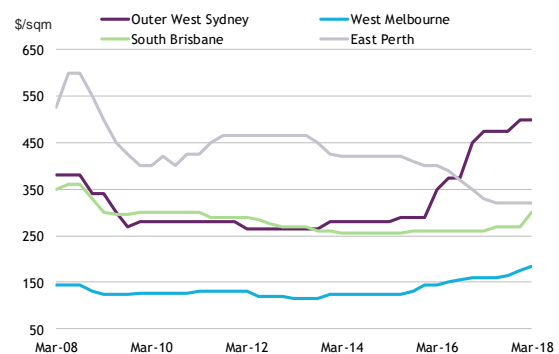
- Tenants, particularly retail and e-commerce operators, are investing heavily in automation within their facilities in search of efficiency gains, with a focus on sortation systems
- Amazon has rolled out their Fulfilment by Amazon (FBA) offering in Australia, providing third party partners with storage and logistics services
- Investment demand remains extremely strong, pushing cap rates tighter in key markets in Sydney in the last quarter

Figure 9. Average existing prime industrial rents



Source: JLL Research, Dexus Research

Figure 10. Average industrial land values (1ha)



Source: JLL Research, Dexus Research

Table 5. Q1 2018 industrial snapshot

	Ave prime cap rate change from Q1 2017	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.50	1.3
Southern Brisbane	-0.25	-1.6
East Perth	0.00	-9.7
South Sydney	-0.38	7.9
West Melbourne	0.00	3.6

Source: JLL Research, Dexus Research



Outer West Sydney

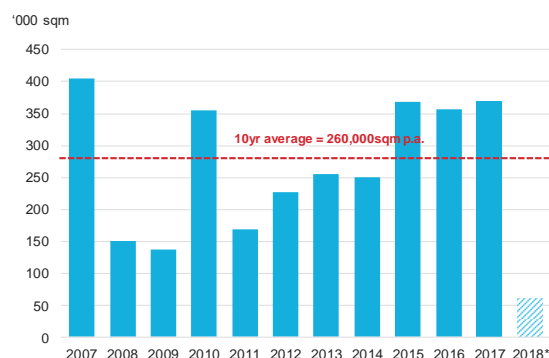
Demand remains strong in Outer West Sydney with around 60,580sqm of take-up recorded in Q1 2018. Positive economic conditions are likely to support demand in the medium term.

Around 109,000sqm of supply was completed in Q1 2018, with approximately 321,500sqm projected to be developed in 2018, above the 10 year average of 270,000sqm.

Rental growth is likely to remain solid in the short term as demand runs ahead of supply, supported by the solid economic outlook.

The largest lease deal in Q1 2018 was Pet Circle (20,950sqm) at Calibre in Eastern Creek.

Figure 11. Outer West Sydney gross take-up



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

West Melbourne

West Melbourne recorded a solid 82,359sqm of industrial take-up in Q1 2018. This follows a very strong 2017.

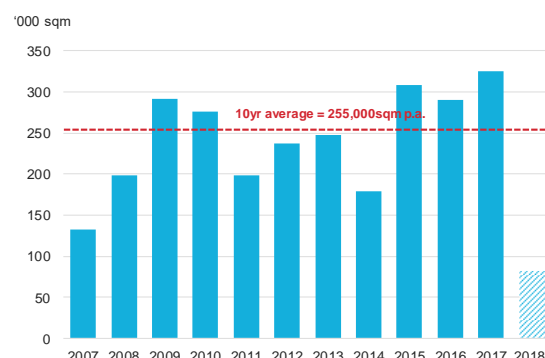
Demand is projected to remain solid as population growth remains strong and key infrastructure projects such as the West Tunnel project add further support to economic conditions.

There is a relatively limited amount of land that is currently zoned and serviced in West Melbourne, and as such, there has been upward pressure on rents, which has continued in Q1 2018.

The outlook is for continued mild levels of rental growth in the short term as a relatively limited supply pipeline is projected in 2018. Approximately 66,700sqm was completed in Q1 2018, with only 198,000sqm planned in 2018.

The largest lease deal in Q1 2018 was a pre-lease to Hickory Group (21,733sqm) at Laverton. Dexus also secured Winit (21,030sqm) at Truganina.

Figure 12. West Melbourne gross take-up



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

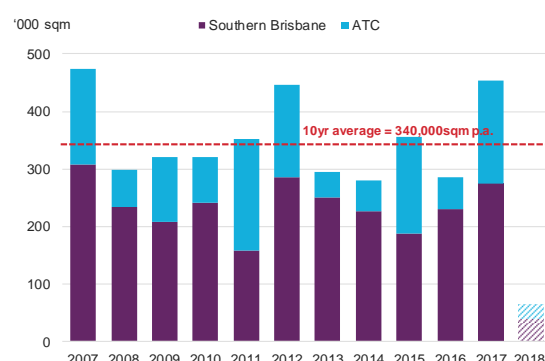
Brisbane

Almost 80,000sqm of industrial take-up was recorded in Brisbane in Q1 2018. Industrial demand in Brisbane remains patchy, however, improved economic conditions (including employment growth and infrastructure investment) points to an improvement in the year ahead after several years of weakness.

In 2018, the 155,000sqm of planned industrial supply is well below the 10 year average, providing scope for some mild upward pressure on rents.

The largest lease deal in Q1 2018 was Steelforce (16,000sqm) at Port West Estate in Lytton.

Figure 13. South Brisbane and ATC gross take-up



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



Retail

Will turnover growth improve?

Retail turnover growth jumped 0.6% in the month of February 2018 based on ABS data, almost double market projections. The result was buoyed by an increase in discretionary spending, with household goods, apparel and department stores showing improvement.

Overall, pharmaceuticals (including cosmetics) and food catering continue to perform well, with supermarkets leading other anchor tenants.

Online retail sales reached \$25bn or around 8% of the total retail market (NAB Online Retail Sales Index).

While online retailing has been absorbing 0.5% to 1.0% per annum of total sales for several years, the cyclical decline in overall turnover growth to just 2.7% p.a. on a moving annual basis (ABS) exposed physical store retailers to extra margin pressure as physical store growth dropped to 1.7% to 2.2% on average. The apparel category was particularly hard hit because price discounting further reduced turnover growth.

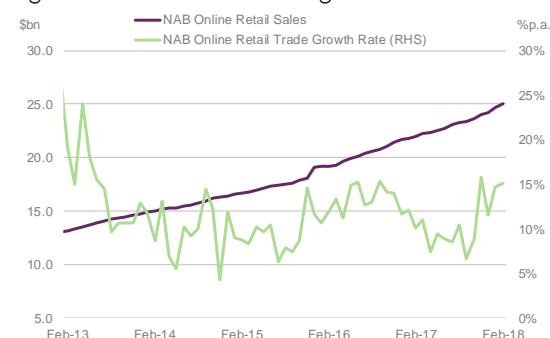
There may be some relief ahead as strong employment growth trickles through to wages growth and retail spending growth benefits from continued low interest rates. Additionally, some mild inflationary pressure may benefit the food category.

The outlook for rents is subdued in the short to medium term, reflecting high occupancy costs and poor retail margins.

Key themes this quarter include:

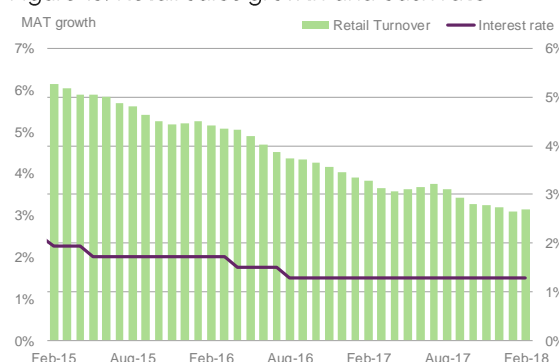
- Wesfarmers announced a proposed demerger of Coles, planned for FY19 subject to unitholder and other approvals
- Amazon is likely to rollout its 'Prime' subscription service, providing free delivery as well as access to online content
- Myer is under pressure following the CEO's resignation in February and a number of disappointing financial results
- The rollout of German discount grocer Kaufland is gathering pace with the group securing sites in SA and VIC

Figure 14. Online retail sales growth



Source: NAB Online Retail Sales Index, Dexus Research

Figure 15. Retail sales growth and cash rate



Source: ABS, RBA, Dexus Research

Table 6. Q1 2018 retail snapshot

	Specialty rental growth % p.a.	Cap rate change from Q1 2017	State retail sales growth % p.a.
Sydney			3.0
Regional	0.12	-0.63	
Sub-regional	0.63	-0.25	
Neighbourhood	1.00	-0.13	
Melbourne			4.2
Regional	0.25	-0.63	
Sub-regional	0.25	0.00	
Neighbourhood	0.25	0.00	
SE QLD			1.5
Regional	0.00	-0.50	
Sub-regional	0.00	0.00	
Neighbourhood	0.00	-0.25	

Source: JLL Research, ABS, Dexus Research



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