dexus

Australian Real Estate Quarterly Review

Q3 2020

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

Inside

Investment climate

Economic growth outlook remains uncertain

Overall, Australia is faring better than most other developed nations in controlling infection rates. A recent spike in cases in Victoria doesn't yet change this conclusion, but it is a reminder that the depth and duration of the impact of COVID on the economy and property markets remains uncertain. We maintain our view of a slow U-shaped growth profile with GDP growth relatively weak through early 2021 rather than the bounce predicted by some economists.

Labour markets remain challenged. The unemployment rate reported in May (7.1%) understates the weakness of labour markets as it is influenced by Job Keeper stimulus measures. A better measure is underemployment which is running at 13.1%. Underemployment, weak wages growth and high household debt levels are a further drag on growth. Population growth is expected to nearly halve over FY21 as international borders remain closed.

The stimulus measures applied to the economy in the form of Job Seeker and Job Keeper have been significant and it has been announced that these subsidies will extend in amended form until March 2021.

Positives for the economy are high levels of federal and state stimulus (more than 13.3% of GDP), ongoing levels of infrastructure investment and low interest rates. The official cash rate is 0.25% and expected to remain low for a considerable time. Consumer and business confidence are off the lows of April 2020.

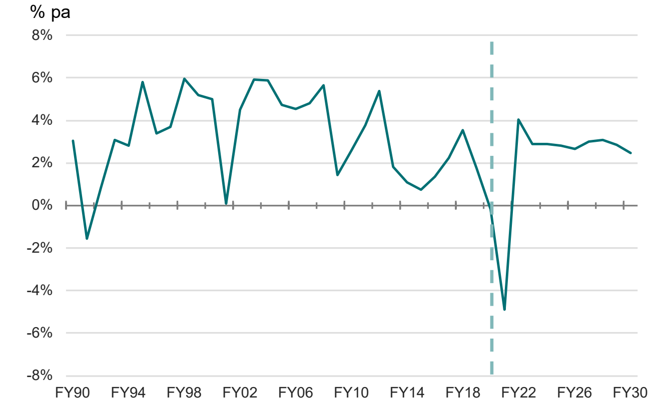
The industrial and healthcare sectors appear to have performed the best through the pandemic, followed by the office sector then retail. Occupier demand will be shaped by the differential impacts on revenue being observed across industries. So far, fewer professional services, finance and construction sector firms have reported revenue declines than firms in the retail and education sectors which bore the initial pandemic impact.

Table 1: Australian economic forecasts Q2 2020

	Jun-20	Jun-21	Jun-22
Aust. GDP (YoY %)	-0.6%	-0.1%	5.0%
Employment (YoY %)	0.2%	-1.3%	2.5%
Unemployment (%)	5.6%	8.2%	7.2%
Exports (YoY %)	0.3%	11.8%	4.3%
Imports (YoY %)	-1.1%	9.2%	2.3%
90 Day Rate (%)	0.3%	0.0%	0.0%
10yr Bond (%)	0.8%	0.5%	0.5%

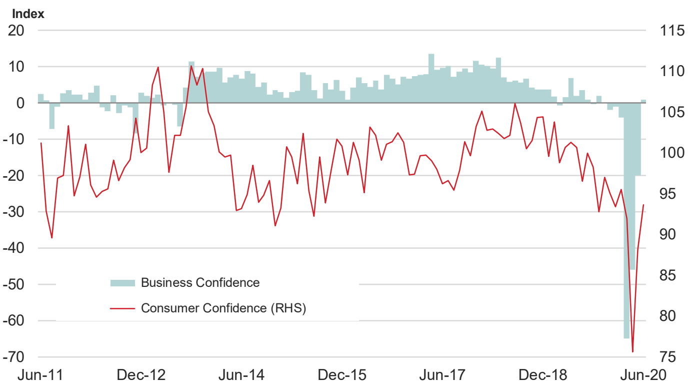
Source: Deloitte Access Economics

Figure 1: Australian GDP growth prospects have improved slightly but much depends on the re-infection rate



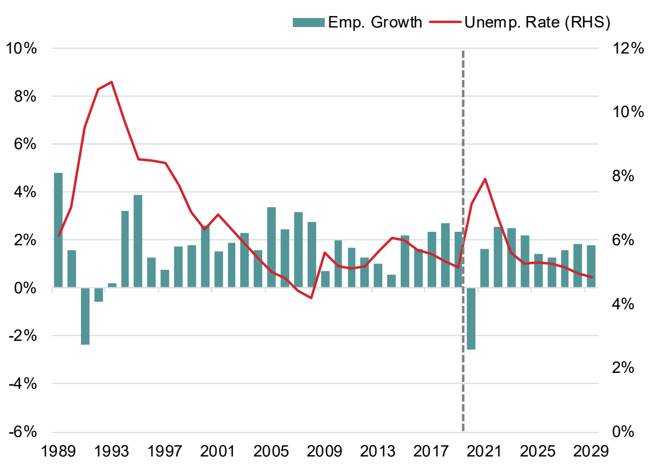
Source: DAE

Figure 2: Consumer and business confidence slowly trending up, though still below long-term averages



Source: Bloomberg; Dexus Research

Figure 3: Labour markets will take more time than the economy to recover



Source: ABS; Dexus Research

Transactions

Transaction volumes down

Transaction volumes have fallen as buyers and sellers wait to see how the market will handle the COVID uncertainty. The office sector has accounted for 60% of transaction volumes for the year to date.

Major recent office transactions were the purchase of 45 Clarence Street, Sydney for $530m by Singapore-based Peakstone Capital and the acquisition of a 50% interest in Rialto Towers, 525 Collins Street, Melbourne through a joint venture between Dexus and GIC for $644m.

Although overall transaction levels have eased foreign interest in Australian assets remains high with the proportion of foreign purchases sitting above the five year average in the first half of 2020. It appears that COVID-19 has not changed the attractive proposition of Australian real estate including the high yield, economic growth story and political stability. German multinational Allianz SE in conjunction with Charter Hall acquired an Aldi distribution portfolio for $648m on the basis of a sale and lease back at a yield of 4.76%. There have been a number of smaller retail transactions by domestic privates predominantly in QLD and NSW.

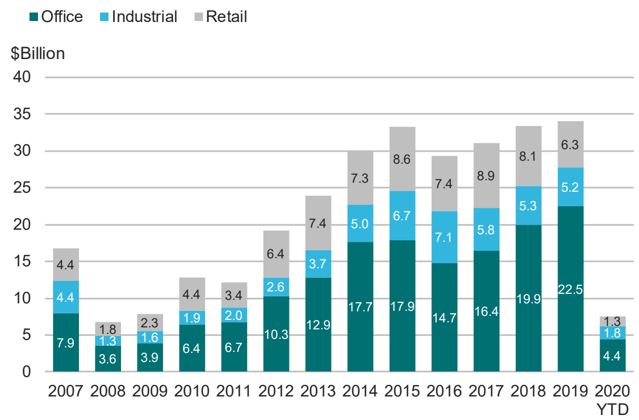
According to JLL Research, prime cap rates have remained relatively stable for many industrial and office markets despite the economic uncertainty. Because of the uncertainty, a gap is likely to open up between prime and secondary grade assets as investors demand a higher risk premium for poorer quality, fringe or short-WALE assets.

Table 2: Top transactions of Q2 2020

Price ($m)	Asset/portfolio	Buyer
648	Aldi Distribution Centre Portfolio	Allianz SE/Charter Hall Prime Industrial Fund
644	Rialto Towers (50%)	Dexus/GIC
530	45 Clarence Street	Peakstone
285	Mt Ommaney Shopping Centre	YFG Shopping Centres
136	120 Christie Street	Ausivale Pty Ltd
115	40-66 Lockwood Road	Charter Hall Group
88	Realside Adelaide Office Fund 2020	Realside
77	87-91 George Street	GPT Group
72	200 Victoria Street	Nippon Telegraph and Telephone Corporation

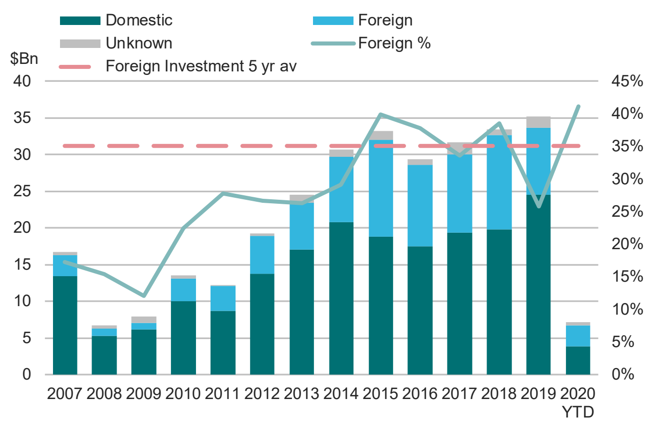
Source: Dexus Research Transaction Database, JLL Research

Figure 4: Listed/unlisted property trusts favour office and industrial assets



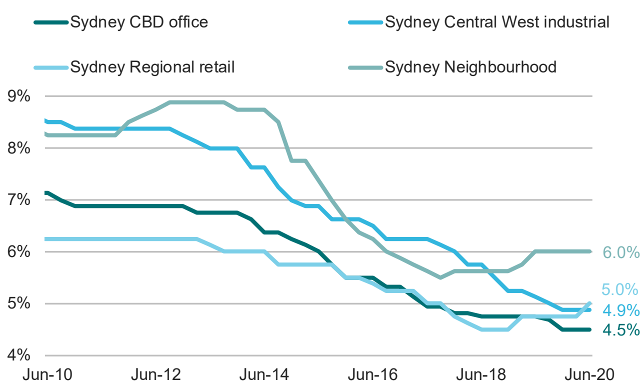
Source: JLL Research, Dexus Research Transaction Database

Figure 5: Foreign capital continues to be attracted to Australian investment



Source: JLL Research, Dexus Research

Figure 6: Regional centres feel the pinch of COVID-19



Source: JLL Research, Dexus Research

Performance

Investors may lower return expectations

The Reserve Bank of Australia has stated the official cash rates will remain low until there is significant progress towards full employment. In line with a low cash rate, 10-year bond yields are forecast to remain below 2% for a considerable time.

Investment demand for real estate is expected to be supported over the short to medium term by the wide spread of property yields over bond yields. In addition, a sustained period of low bond yields is likely to put further downward pressure on expected returns and discount rates to well below the current average of 6.4%, extending the 'lower for longer' thematic and providing some support for pricing.

A-REITs and Australian equities provided double digit returns over the quarter of +19.9% and +16.5% respectively, clawing back some of the ground lost earlier in the year. With a low bond yield, A-REIT yields have become more appealing. Despite this, pricing is far from restoring the previous relationship with 10-year bond yields (see chart). Australian equities have seen an improvement in line with investor confidence, predominately within the technology and healthcare sectors.

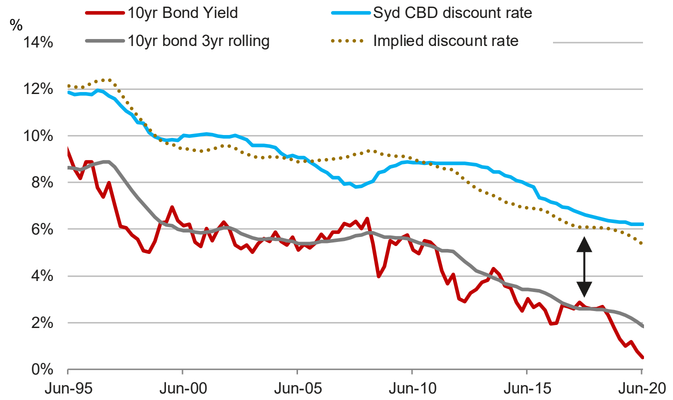
For unlisted funds, the industrial sector has performed better through the lockdown (+11.7% in the year to June 2020). The office sector has softened slightly (+6.4) as vacancies rise and the retail sector continues to weaken (-17.2%) in an environment of weak investor sentiment.

Table 3: Index returns to June 2020

	Qtr.%	1 yr %p.a.	3 yr %p.a.	
Australian fixed interest	+0.5%	+4.2%	+5.6%	BACM0.Index
Australian Cash	+0.1%	+0.8%	+1.5%	BAUBIL Index
Unlisted Property	+0.3%	-0.8%	+7.2%	MSCI Mercer Aust Unlisted Wholesale
Australian shares	+16.5%	-7.7%	5.2%	S&P/ASX.200. Accumulation Index
A-REITs	+19.9%	-21.3%	2.0%	S&P/ASX.200.A-REIT. Accumulation Index

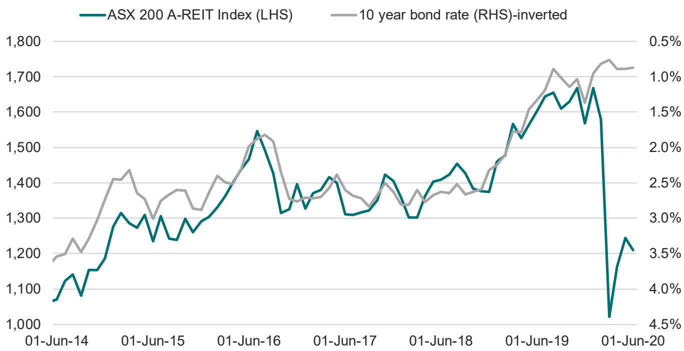
The indices are copyrighted by and proprietary to the relevant Source issuers: MSCI Mercer Aust. Core Wholesale Monthly PFI; Standard and Poor's Australian Securities Exchange Accumulation Index; Bloomberg/UBS Composite and Bank Bill Indices.
*NAV Pre-Fee

Figure 7: Low bond yields point to falling discount rates



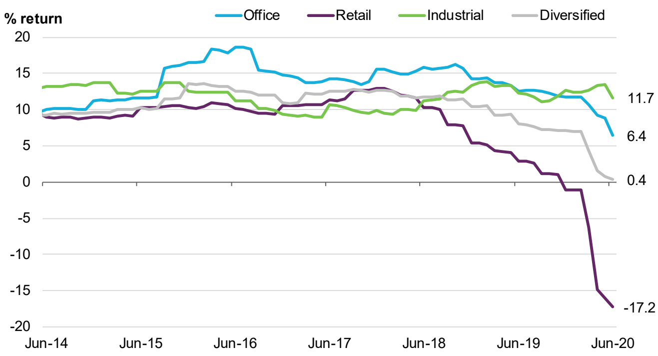
Source: Dexus Research, Deloitte Access Economics, RBA, JLL Research

Figure 8: A-REITs recover some of their previous losses



Source: IRESS, Dexus Research

Figure 9: Office and industrial funds outperform retail



Source: MSCI, Dexus Research

Office

Office markets feel the effects of slowdown

Australia's office markets face considerable headwinds in the short term. Leading indicators such as job advertisements and business confidence have declined. Net absorption weakened in the past quarter to be well down for the year in Sydney and Melbourne.

The demand outlook is clouded by a lull in decision-making by firms which currently have the majority of their workforce working from home and are still trying to gauge the pandemic's effects on their business before making decisions about head count and office requirements.

There was a significant rise in office vacancy rates, with the Sydney and Melbourne CBDs recording the biggest quarterly increase since the 1990's recession. Much of this was attributed to an increase in sub-lease space across the Education, IT, Finance and Professional Services industries. So far, a large part of the sublease space offered to market has been due to larger firms offloading excess space they were carrying prior to the pandemic rather than space vacated due to contraction.

The office sector is likely to experience further rises in vacancy in FY21 as additional supply is delivered to the market (see Table 4).

Net effective rents eased in the June quarter nationally (except in Perth and Canberra where they remained flat) on the back of rising incentives. Evidence from past downturns indicate there are likely to be further rises in incentives across the board as building owners try to preserve both occupancy and face rents.

Office markets are cyclical due to the sensitivity of demand to the economic cycle, so periods of negative net absorption are not unusual. Lease structures help protect income through these periods. Looking forward, the effects of the pandemic on white collar employment and the speed of the recovery of the economy will be critical for the outlook.

Table 4: Q2 2020 office snapshot

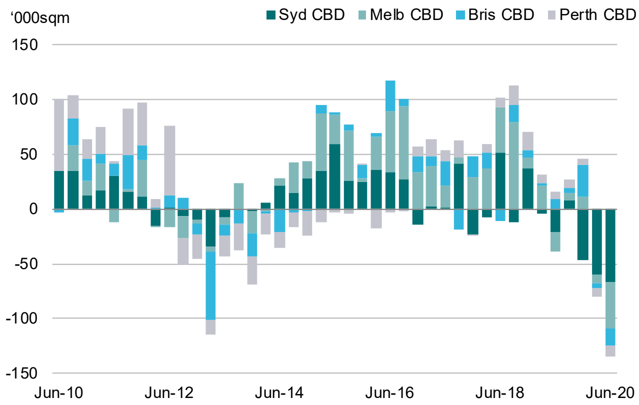
	Total Vacancy	Prime net eff. rent growth (% p.a.)	Net Increase in stock FY21 (% of stock*)
Sydney CBD	7.5%	-2.5%	3.0%
North Sydney	13.0%	3.6%	11.7%
Sydney Fringe	8.1%	-8.2%	N/A
Macquarie Park	7.1%	-0.9%	2.0%
Parramatta	9.7%	-3.5%	5.6%
SOP / Rhodes	18.6%	1.4%	N/A
Melbourne CBD	7.7%	3.3%	6.1%
Brisbane CBD	12.8%	4.4%	2.0%
Perth CBD	20.1%	2.9%	0.2%

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

Figure 10. Professional job advertisements are down 40% on the same time last year

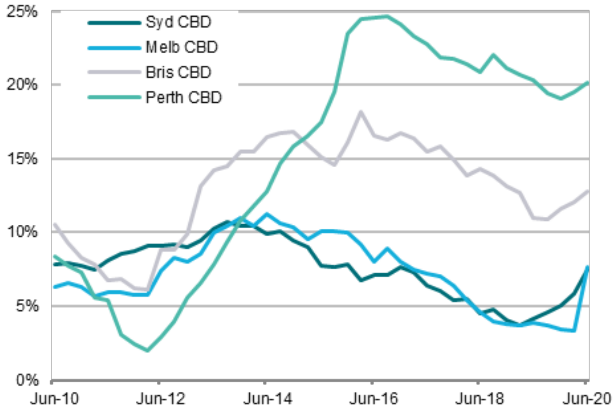
Source: JLL Research, Dexus Research.

Figure 11. Net absorption weakening sharply in line with weak business confidence



Source: JLL Research, Dexus Research

Figure 12. Vacancy rates lifted in major office markets nationally



Source: JLL Research, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney CBD	**Negative net absorption is pushing the vacancy rate up, ending the market's long growth run.** Vacancy rates rose 3.3% over the 12 months to June 2020 to 7.5%, the highest since the completion of Barangaroo in 2016. Annual net absorption was recorded at -164,000 square metres. A number of larger occupiers handed back space leading to an increase in sub-lease space. While face rents remained largely flat, rising incentives led effective rents down 1.5% in the first half of 2020. Given a lack of office transactions JLL Research kept their official yield numbers stable in Q2-20, but uncertainty could impact pricing of assets with leasing risk in the year ahead.	Vacancy ↑ Rents ↓ Incentives ↑ Yields ↑
North Sydney	**The vacancy rate lifted to 13.0%, well above the 10-yr average of 9.4%.** The completion of 73 Miller Street's refurbishment, which was still 60% available in conjunction with a number of professional services and manufacturing occupiers consolidating saw annual net absorption recorded at -34,125 square metres in June 2020. The outlook for North Sydney is particularly subdued given that new supply equivalent to 9.7% of total stock is expected to complete over the next six months. While rents grew on both a face and effective basis in FY20, effective rents are expected to weaken over the next 12 months as incentives rise.	Vacancy ↑ Rents ↓ Incentives ↑ Yields ↑
Parramatta	**Effective rents ease for the first time in a decade.** The vacancy rate rose sharply in June 2020, with the CBA's exit from the market more than offsetting NAB's relocation to 3 Parramatta Square. Tenants moving into completed developments over the past 12 months saw annual net absorption being the highest nationally, recorded at 41,860 square metres. A sharp rise in prime incentives over Q2-20 (up 5.5 percentage points on Q1-20) saw net effective rents fall 8.2% in the June quarter. A strong supply pipeline will likely moderate rents further, with nearly 30% of total stock due to be added to the market over the next 2.5 years around 60% of which is still available.	Vacancy ↑ Rents ↓ Incentives ↑ Yields →
Melbourne CBD	**Vacancy rates rise by their highest quarterly increase on record.** Annual net absorption was recorded at -32,800 square metres in FY20, with vacancy rates rising from a record low of 3.4% in March 2020 to 7.7% in June. Amid demand shocks due to the COVID-19 crisis, the 3.4% of total stock that is due for completion over the next six months alone, is likely to put further upward pressure on the vacancy rate in the short term. The strong presence of education tenants in the market have left it vulnerable to macroeconomic shocks and a faltering international student intake.	Vacancy ↑ Rents ↓ Incentives ↑ Yields ↑
Brisbane CBD	**Weak outlook for rent growth.** Net absorption in the June quarter was -15,700 square metres driven by an increase in sub-lease space being offered by a number of Finance and Professional Services firms. The vacancy rate rose to 12.8% in the June quarter, up 1.8% on the year prior. Average market yields were recorded as flat on little transaction evidence after the sale of trophy asset Central Plaza Two (66 Eagle Street) at an equivalent yield of 5.13% in February. With nearly half of the 125,000 square metres of supply currently under construction still available, the outlook for rental growth is subdued.	Vacancy ↑ Rents → Incentives → Yields ↑
Perth CBD	**Net absorption was negative in the June quarter due to Chevron's vacancy.** Vacancy rates rose 58 basis points over the June quarter to 20.1% as a result Chevron's 10-year project space concluding and the whole building being vacated, as well as St George Bank offering 3,000 square metres of sub-lease space. Rents and incentives stayed flat over Q2-20, with the rental outlook benign in line with the economic outlook. While prime yields compressed 25 basis points from the start of the year, investor interest in the market remains limited, with a misalignment in buyer and seller expectations likely to lead to a stalemate on transactions over the short term.	Vacancy ↓ Rents → Incentives → Yields →

Industrial

Industrial performing better than expected

Demand has been driven by defensive occupiers including food and beverage retailers, e-commerce groups, transport/logistics providers, data centres, cold storage and pharmaceuticals. Other businesses have tended to place their leasing decisions on hold due to the ongoing uncertainty.

With social distancing measures in full swing and the closure of non-essential business, many consumers turned to e-commerce channels. Online sales increased by approximately 50% in the year to May 2020 (NAB) taking online's share of the total market to 10.3%.

Retail businesses with pre-existing e-commerce channels have enjoyed accelerated levels of growth over the past few years resulting in companies looking to expand their footprint or seek more efficient premises. Retailers, particularly in the non-discretionary sector have accounted for 30% of industrial take-up over the past six months. Large retailers including Coles have signed pre-lease agreements in Outer West Sydney and West Melbourne while large online retailer Amazon signed pre-leases in Outer West Sydney and Brisbane's Trade Coast.

National import volumes have fallen sharply, partly due to cross border trade disruptions. While demand for goods at a retail level has remained relatively solid, the lull in imports have meant inventories have run down to a degree.

Prime face rents have been relatively stable in the past quarter with rents up mildly on a year ago. There are reports of incentives rising to help protect face rents. Land values appear to have flattened across all states, although transaction volumes have been thin.

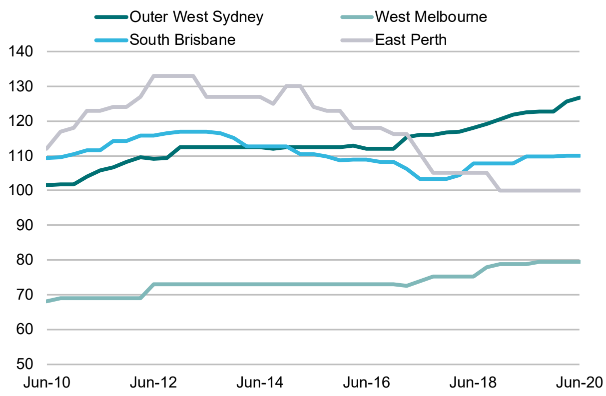
Construction remains relatively strong on the back of a continuing level of pre-commitment, much of it negotiated pre-COVID. There is significant level of speculative development still to be leased, however the overall market vacancy rate is relatively low.

Table 5: Q2 2020 industrial snapshot

	Ave prime cap rate change from Q1 2020	Existing prime net face rental growth % p.a.
Outer West Sydney	No change	3.5%
Southern Brisbane	-0.2%	0.2%
East Perth	No change	No change
South Sydney	No change	3.3%
West Melbourne	No change	0.8%

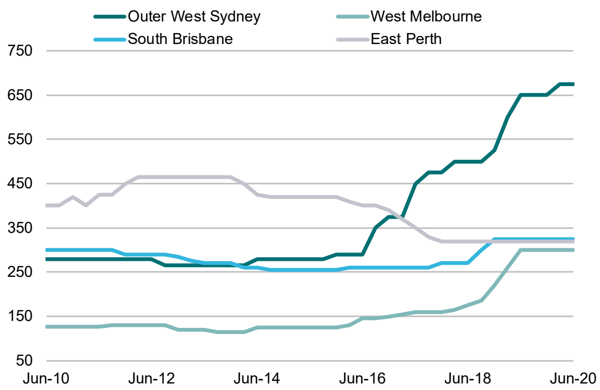
Source: JLL Research, Dexus Research

Figure 9: Industrial face rents remained relatively stable in the June quarter



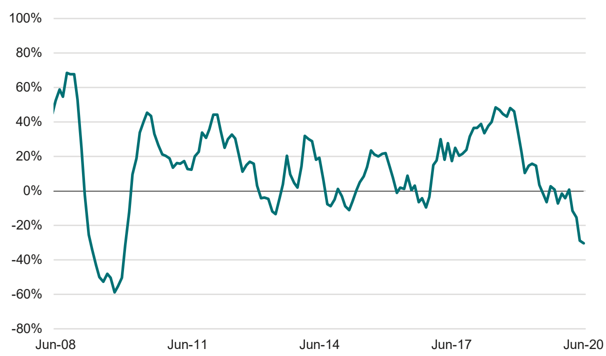
Source: JLL Research, Dexus Research

Figure 10: Land values remained flat, ending the run of strong increases



Source: JLL Research, Dexus Research

Figure 11: Australian import volumes contracting, partly due to supply chain disruptions



Source: ABS, Dexus Research

Industrial by region

Outer West Sydney

Despite overall inquiry declining, pre-committed take-up within Outer West Sydney has continued to rise, with FY20 being the second highest year for take-up levels in the past 10 years at c390,000sqm. This figure includes a 191,000sqm pre-commitment by Amazon for a fully automated facility at Kemps Creek.

Outer West Sydney has been favoured by tenants involved in retail trade and ecommerce accounting for 90% of gross take-up including food retailers Coles and Marley Spoon signing pre-commitments in Wetherill Park.

Outer West Sydney recorded rent growth of c3.5% in the year, although face rents stabilised in the last quarter and incentives are reported to have risen mildly.

West Melbourne

In West Melbourne, take-up levels have been well above the long-term average with the past two quarters adding 300,000sqm. Take-up has been driven by organic growth, particularly in non-discretionary retail and transport services including Coles and DHL acquiring a total of 70,000sqm of space on a pre-lease basis. A proportion of the 3PL take-up is believed to be associated with ecommerce contracts.

Vacancy levels have risen over the past six months due to a high level of pre-committed development with tenant movement leaving backfill in older stock. Incentives are reported to have by around 5 percentage points on average.

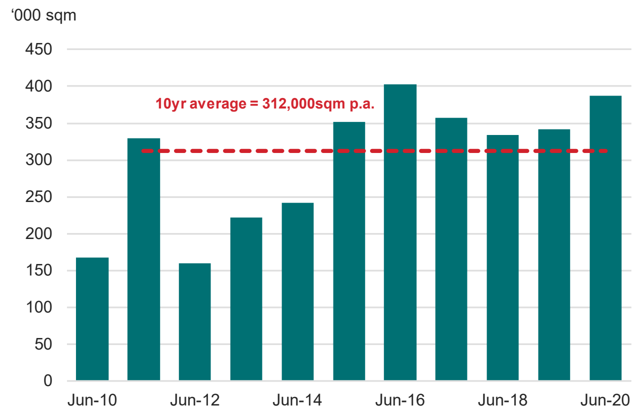
Brisbane

The Australian Trade Coast (ATC) and South Brisbane have recorded take-up of 195,000sqm.

Over the past quarter transport and warehousing industries have been active within South Brisbane accounting for an additional 20,000sqm of take-up. The Trade Coast has gained major e-commerce player Amazon which is expected to attract further retailers and wholesalers to the area.

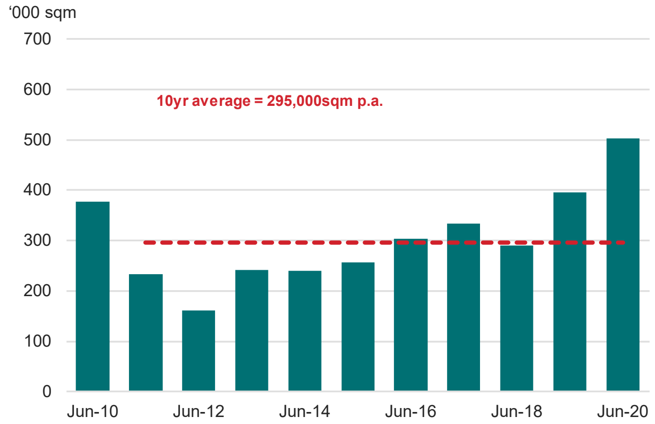
Brisbane prime and secondary face rents remained stable in the quarter with incentives pushing up mildly, particularly in smaller units.

Figure 12: Outer West Sydney gross take-up



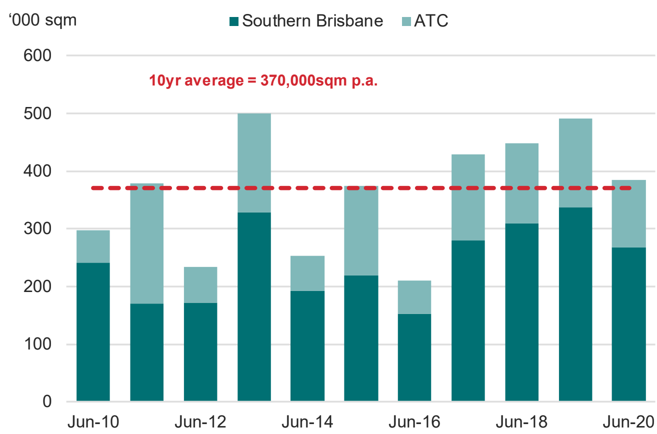
Source: JLL Research (gross take-up), Dexus Research.

Figure 13: West Melbourne gross take-up



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

Figure 14: South Brisbane and ATC gross take-up



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

Retail

A year of extreme ups and downs for retailers

The year 2020 has been one of unprecedented highs and lows for retailers. Retail spending grew by 16.9% in May after contracting 17.7% in April, as fiscal stimulus and a gradual easing of social distancing measures saw more Australians return to the shops. The greatest volatility was in discretionary retailing, particularly Clothing & Footwear which surged 129% in May after falling by 54% in April.

The share of online retailing has grown at a much faster rate than pre-COVID-19. While online sales contracted slightly in May, the annual growth was still the second highest on record at 50% per annum.

Nationally, Queensland was the strongest performing state over the past three months, faring relatively better in terms of infections. In Victoria the outlook for retail spending has deteriorated after the state entered another lockdown for a six week period.

Turnover growth in convenience based centres has benefitted from people's preference to shop locally. Supermarkets and DDS's continue to perform well. Conversely, turnover growth in larger shopping centres has been constrained by greater reliance on discretionary categories like fashion, restaurants and entertainment. City retail remains weak, held back by the absence of office workers, tourists and university students.

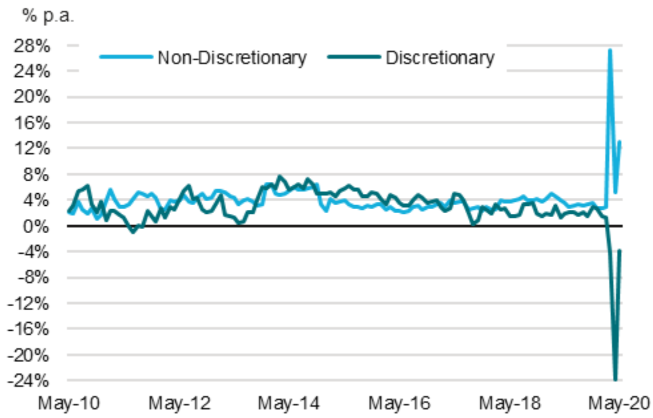
The outlook for FY21 is for further volatility in retail sales numbers and continued out-performance by non-discretionary categories such as food and online retailing. Overall sales growth is likely to be held back by high rates of unemployment and weak wages growth.

Table 6: Q2 2020 retail snapshot

	Specialty rent growth % p.a.	Cap rate change from Q1 2020	State retail sales growth % p.a.
Sydney			
Regional	-1.5%	0.25bps	
Sub-regional	-2.5%	0.13bps	0.5%
Neighbourhood	-1.4%	No change	
Melbourne			
Regional	-1.6%	0.25bps	
Sub-regional	-5.0%	12.5bps	1.8%
Neighbourhood	-1.2%	No change	
SE QLD			
Regional	-5.8%	No change	
Sub-regional	-7.5%	No change	5.1%
Neighbourhood	0.0%	No change	

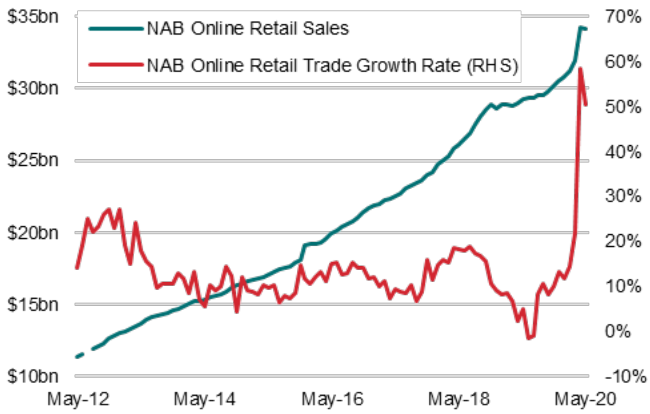
Source: JLL Research, ABS, Dexus Research

Figure 19. The COVID-19 lockdown saw a large dispersion between non-discretionary and discretionary categories



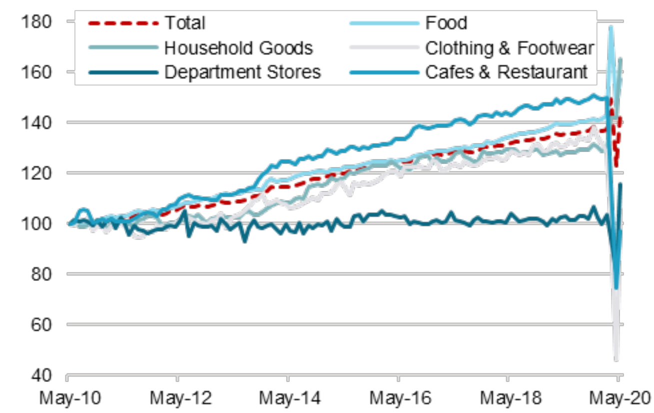
Source: ABS, Dexus Research

Figure 20. Despite contracting slightly in the month of May-20, online sales grew by 50% over the year



Source: ABS, Dexus Research

Figure 21. Indexed growth indicates that food retailing has been the best performing category over the past decade



Source: MSCI, Dexus Research

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This report was prepared during the disruption caused by the outbreak of COVID-19 and the resultant deterioration in business conditions. It is apparent that there are implications from the outbreak for the global and domestic economy, volatility in equity markets, liquidity in credit markets and impact on the appetite for and pricing of real estate assets which are uncertain and unquantifiable at this time. This report should be read and considered in light of that uncertainty.

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