dexus

Australian Real Estate Quarterly Review

Three thematics to define the year ahead

Q3 2018

In summary

Investment climate

Three thematics to define the year ahead

There are three main thematics which will define the year ahead. The first thematic is *broad based economic growth* supporting positive occupier demand for space across the office and industrial sectors in Australia.

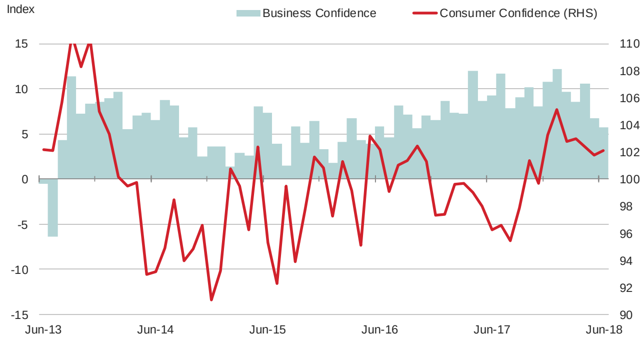
Within Australia, economic growth is rebalancing between the states with Queensland and WA forecast to catch up to Victoria and NSW over the next couple of years. While buoyed by infrastructure investment, Victoria and NSW will face some additional headwinds in FY19 and FY20 as weakening housing construction drags on employment growth.

Global growth is a positive influence on confidence (Figure 1), but on the downside, the probability of a global trade war has risen. If tariff levels were to escalate, a slowing of Chinese growth could impact Australia.

The second thematic is the *low and steady cost of capital* which continues to support investment demand for real estate. Transaction volumes remain relatively high and values are mostly firming. While investors should plan for risks to asset pricing as bond yields normalise over the medium term, the risk of a sharp rise anytime soon seems low given the economic headwinds described above. Official cash rates are expected to remain flat until late 2019. A steady cost of capital should continue to support investment demand in the short term. While the value cycle appears mature, it so far lacks a catalyst for change.

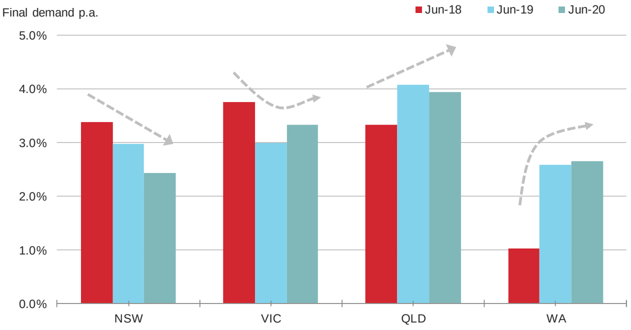
The third thematic is the *growth in e-commerce* which is providing double digit growth in deliveries and creating extra demand for warehousing space in the industrial sector. Conversely, conditions in the retail sector are subdued given modest household spending growth and pressure on retailer profitability.

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-18	Jun-19	Jun-20
Real GDP %pa	2.8%	2.8%	2.5%
Final demand %pa	2.7%	2.3%	2.5%
Employment %pa	2.5%	1.3%	1.3%
Goods imports %pa	6.2%	2.4%	2.2%
Retail sales %pa (real)	1.7%	2.8%	2.5%
CPI %pa	2.1%	2.2%	2.3%
90 Day bill %	2.1%	2.0%	2.5%
10yr Bond %	2.6%	3.0%	3.5%
AUD/USD	0.75	0.75	0.74

Source: Deloitte Access Economics base, Dexus adj. forecasts

Transactions

Domestic players active

Transaction activity has sustained its solid momentum following a record start to the year, with Q2 2018 volumes reaching over $7 billion.

While commercial real estate yields have tightened over the quarter, so have government bond yields, keeping the yield spread steady. The maintenance of reasonably wide spreads has supported investment activity to date in a maturing pricing cycle. Over time, pricing will be sensitive to a normalisation of interest rate yields, however such rises still seem some way off.

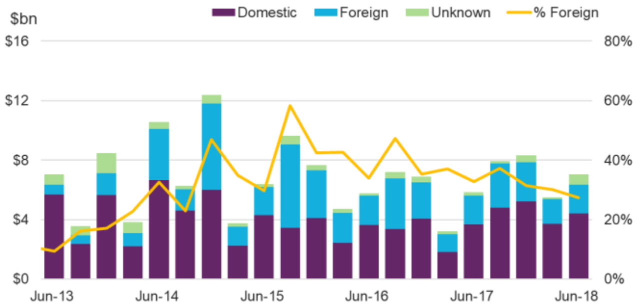
Foreign investment has eased from the high levels of a few years ago and domestic investors have been filling the void. The easing in foreign buyers is partially the result of capital restrictions in China and partly due to a lack of assets of a size and quality to appeal to foreign capital.

The most significant transaction for the quarter was the acqusition of Pacific Werribee and Pacific Epping shopping centres for $1 billion, setting the tone for retail deals in 2018. Both assets were highly contested and sit in high growth trade areas. While demand and pricing for well trading shopping centres remains strong, buyers are exercising caution in regard to mid-sized or regionally located retail investments. A larger than usual number of such centres have been put to market and some are taking a lengthy time to transact (e.g. Grand Plaza) or have been withdrawn from sale (e.g. Wollongong Central).

Mirvac's $856 million acquisition of a 50% interest in Westpac Place in Sydney on behalf of ISPT was the largest office transaction for the quarter. Other major office transactions included Charter Hall Core Plus Office Fund (CPOF) acquiring a 50% stake in the Allianz Centre, Sydney.

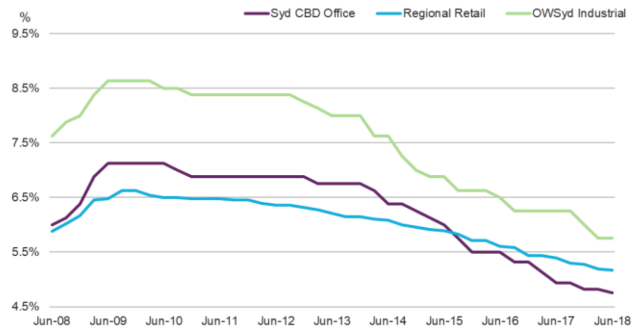
Private Macau-based player Loi Keong Kuong recently acquired the Tattersalls Building on 179 Elizabeth Street for $265 milliion, exemplifying a level of continuing foreign appetite for Australian assets.

Figure 3. Transaction volumes – quarterly



Source: JLL Research, Dexus Research Transaction Database

Figure 4. Average prime yield by sector



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

Table 2. Q2 2018 top transactions

Price ($m)	Asset/portfolio	Buyer
1,000	Pacific Werribee and Pacific Epping	QIC Global Real Estate
856	Westpac Place	ISPT
285	Allianz Centre	Charter Hall Core Plus Office Fund (CPOF)
265	Tattersalls Building	Loi Keong Kuong
255	55 Clarence Street	Zone Q
170	Revy Site – Building C	Google
146	Quay Connection	Greaton
125	Workzone West	Undisclosed
123	Pipe Networks House	Firmus Capital

Source: Dexus Research Transaction Database, JLL Research

Performance

Returns benefit from value gains

Despite market volatility and growing concerns about a global trade war (or perhaps because of these factors), demand for Australian commercial real estate has been robust.

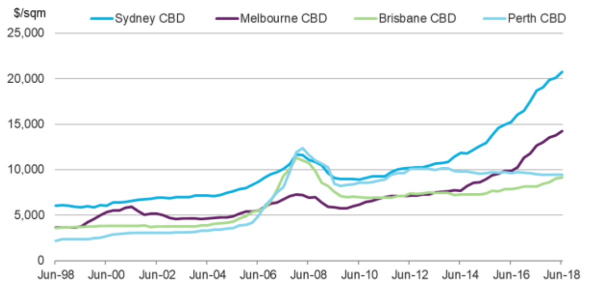
A-REITs have risen to the top of the asset class return table with a rolling 12-month return of 13.0%, closing the performance gap with the broader ASX200 Index. A-REIT pricing benefited from declining bond yields over the quarter, signalling a renewed focus on defensive assets. Asset values and transaction activity remained strong throughout FY18.

The e-commerce thematic is becoming apparent in unlisted returns (Figure 6) with retail fund returns slipping relative to other sectors. Income growth has been subdued and capital growth appears to be tailing off, led by weaker performing shopping centres.

These headwinds are likely to continue to drag on retail sector performance in the mediumterm. On the flipside, incremental allocation of capital will favour the industrial and other sectors such as healthcare.

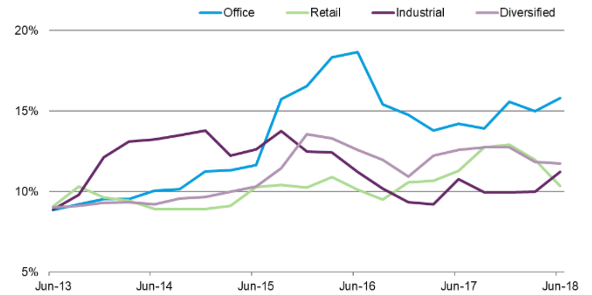
Capital values have continued to rise across core office markets as fundamentals remain sound and capitalisation rates tighten further to new historic lows.

Figure 5. Historical prime values



Source: JLL, Dexus Research

Figure 6. IPD Wholesale funds index returns



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

Table 3. Index returns to 30 June 2018

	Qtr. %	1 yr %p.a.	3 yr %p.a.	
A-REITs	10.0	13.0	9.7	S&P/ASX 200 A-REIT Accumulation Index
Australian shares	4.4	13.0	9.0	S&P/ASX 200 Accumulation Index
Unlisted property*	2.5	12.6	12.9	Mercer/IPD Aust. Unlisted Wholesale PFI*
Australian fixed interest	0.8	3.1	3.4	BACM0 Index
Australian cash	0.5	1.8	1.9	BAUBIL 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

Vacancy falls further in key markets

Office markets continue to perform well. Modest levels of supply in Sydney and Melbourne helped push vacancy rates lower to circa 4.5% and we expect further falls in the year ahead. The outlook for demand is positive in the short-term due to solid employment growth and positive business confidence. Net absorption of office space in Australia's CBD markets was around double the long-term average at 90,000sqm in the last quarter.

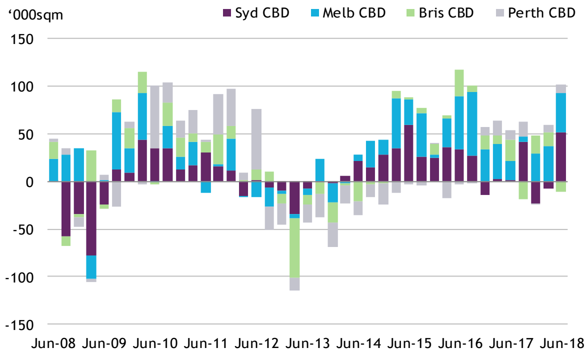
Sydney and Melbourne continued to lead other markets with strong net absorption of +51,000sqm and +41,800sqm, respectively in Q2 2018. Perth continued its recovery, recording positive net absorption of +8,681sqm, while the Brisbane CBD recorded negative net absorption of -10,462sqm in Q2 2018. The negative result for the Brisbane CBD was largely attributed to the relocation of Aurizon to Fortitude Valley (circa 19,000sqm), with the overall Brisbane market showing mild improvement.

Effective rents in Sydney and Melbourne are growing strongly at 12.5% and 12.8% per annum respectively. Perth and Brisbane are more subdued with effective rent growth of 2.8% and -0.9% per annum respectively. The outlook is for mild upward pressure on rents in the short term in Sydney and Melbourne, with growth declining on a two to three year timeframe as new supply materialises.

A key theme for office markets is growth in small office users as service firms shift to more collaborative, outsourced modes of working and the IT sector continues its mini-boom built on mobile applications, big data, fintech and social media.

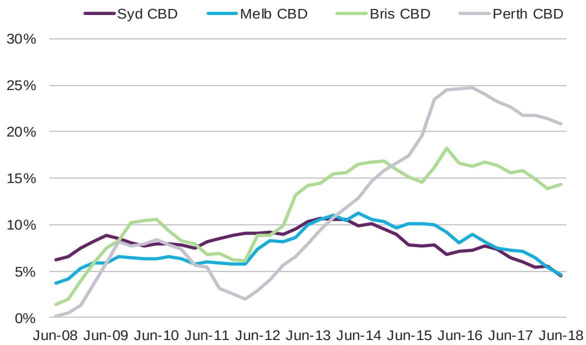
The rollout of flexible workspace offers continues with the opening of SuiteX by Dexus and new leases to Spaces and Hub Australia. WeWork also pre-committed to +10,000sqm at Daramu House in Barangaroo and announced its entry into the Brisbane market.

Figure 7. Quarterly net absorption by market



Source: JLL Research, Dexus Research

Figure 8. Vacancy by market



Source: JLL Research, Dexus Research

Table 4. Q2 2018 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth % p.a.
Parramatta	4.6%	14.5%	20.7%
Melbourne CBD	4.6%	8.5%	12.8%
Sydney CBD	4.5%	6.6%	12.5%
North Sydney	6.1%	4.7%	7.7%
Macquarie Park	6.2%	2.6%	6.3%
Canberra	13.4%	2.7%	3.9%
Brisbane CBD	14.4%	3.5%	-0.9%
Adelaide CBD	15.1%	1.6%	1.9%
Perth CBD	20.9%	0.1%	2.8%

Source: JLL Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney	**Sydney rebounds with strong positive net absorption.** After two quarters of negative net absorption, the Sydney office market bounced back, supporting the notion that the recent negative results were the result of limited space options, rather than a deterioration in underlying demand. The vacancy rate is a low 4.5% and is expected to fall further. Rental growth remains strong at +12.5% p.a. (prime gross effective) as incentives continue to fall. The majority of new supply is still not expected to hit until FY22-24, and the demand backdrop remains supportive. We expect above average rental growth over the next 1-2 years.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
North Sydney	**Vacancy rate continues to fall rapidly.** The North Sydney vacancy rate has fallen to 6.1% as the market faces withdrawal of stock for residential conversion. As a result, prime net effective rents are down to +7.7% over the year and net incentives down to 24%. Net absorption was +3,187sqm this quarter and we expect a positive demand outlook to continue as the market benefits from a strong NSW economy and overflow of demand from the Sydney CBD. Stronger demand will help support a further uplift in rental growth in the year ahead.	Vacancy ↓ Rents ↑ Incentives → Yields →
Macquarie Park	**Improvement in net absorption.** After net absorption dipped into negative territory last quarter it rebounded with +4,904sqm this quarter. Stock withdrawals for residential uses continue to play a part in the market, with the vacancy rate declining further to 6.2%. Prime net effective rents have grown strongly, up 6.3% over the year as net incentives fell to 23%. A relatively subdued immediate supply pipeline short term and a return to positive demand will support further rental growth in the year ahead.	Vacancy ↓ Rents ↑ Incentives → Yields →
Parramatta	**Continues to outperform.** Parramatta is well placed as vacancy remains very low at 4.6% (and 0.9% for prime stock) and there are no immediate supply risks. Rental growth is strong (+20.7% p.a. net effective) and incentives low for prime assets (18%). New supply will come online over the next 1-2 years including Parramatta Square, however, this stock is largely pre-committed and as such low vacancy and above average rental growth is likely to continue. There is more risk over the medium term with the exit of CBA and potential for a large amount of supply. How Parramatta performs over the mediumterm will be very much dependant on ability to attract tenants from outside the market.	Vacancy ↓ Rents ↑ Incentives → Yields →
Melbourne	**To benefit from strong economic growth.** Melbourne continues to benefit from strong economic fundamentals with net absorption of +41,858sqm for the quarter, and a sharp fall in vacancy to 4.6%. In line with improving vacancy, rental growth remains strong with prime net effective rents increasing by 12.8% over the year. While new supply will come online in the near term, the majority of new projects are pre-committed and solid demand will continue to keep pressure on vacancy and rents over the next 6-12 months.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Brisbane	**Still recovering but slowly.** Net absorption was -10,462sqm in the last quarter but this was largely attributed to the relocation of Aurizon to circa 19,000sqm at Fortitude Valley rather than a substantial weakening of demand. Overall the market has seen some improvement with net effective rent growth +1.0% in the last quarter, however incentives remain elevated (39% gross) as a result of high vacancy (14.4%) and speculative supply. Demand is projected to improve steadily over the next year or two which will support rental growth particularly in prime stock as a flight to quality absorbs prime space.	Vacancy ↓ Rents ↑ Incentives → Yields ↓
Perth	**Signs of continued improvement.** Perth continued a solid start to the year recording +8,681sqm of positive net absorption (Q2-2018) and vacancy rates declining further to 20.9%. Prime net effective rents have experienced mild growth of +2.8% while net incentives are stable at 48% net. Rental growth is expected to remain subdued in the short term, improving over the mediumterm as market conditions slowly recover in the absence of major new supply.	Vacancy → Rents ↑ Incentives ↓ Yields →
Canberra	**Office demand remains subdued.** Negative net absorption of 3,063sqm was recorded in Canberra as government tenants continued 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 5.7%) is helping to support rental growth in prime assets (+3.9% 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

Well positioned for growth

The industrial sector is in a growth phase with demand running ahead of supply. Demand is expected to remain solid in the year ahead given population growth and infrastructure investment are supporting economic activity. Sydney, Melbourne, and to a lesser extent Brisbane, are well placed to benefit.

E-commerce is emerging as a significant demand driver as online sales expand at double digit growth rates, and online retailers and fulfilment providers seek to increase scale. The launch of Amazon Prime is expected to act as a catalyst for low-cost express delivery, which requires significantly greater warehousing space in close proximity to customers. E-commerce is still in its early stages of development in Australia compared to overseas and hence there could be considerable future upside.

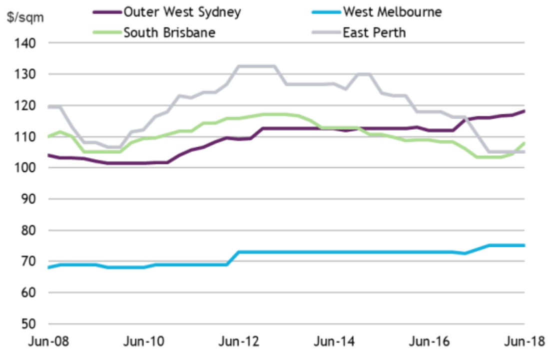
The outlook for rents is likely to remain positive, particularly in land constrained areas in Sydney and Melbourne. Conditions in Brisbane are projected to continue to improve in the short term as the economy rebounds, while Perth appears to have bottomed.

Demand for investment stock and development sites remains strong and highly competitive due to limited availabity of product and strong occupier demand. Land values have risen past previous peaks in key markets in Sydney and Melbourne (Figure 10).

Key themes this quarter include:

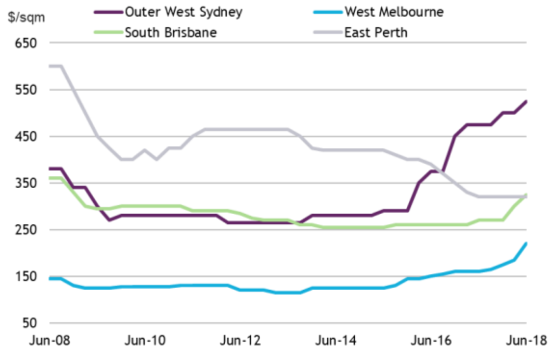
- Amazon launched 'Prime' in Australia, offering free two business day delivery to 90% of the Australian population
- Amazon made its first commitment to distribution/warehouse space in Sydney, leasing 42,570sqm of space at Centenary Distribution Centre, Moorebank
- Investment demand remains extremely strong, bouyed by the e-commerce thematic and firm/growing rents, pushing cap rates tighter in key markets in Sydney and Melbourne

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. Q2 2018 industrial snapshot

	Ave prime cap rate change from Q2 2017	Existing prime net face rental growth % p.a.
Outer West	-0.50	1.8
Southern Brisbane	0.00	4.3
East Perth	-0.12	-5.2
South Sydney	-0.50	6.8
West Melbourne	-0.25	1.7

Source: JLL Research, Dexus Research

Outer West Sydney

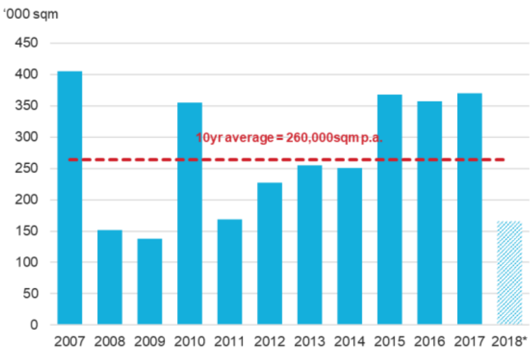
Demand remains strong in Outer West Sydney with above average take-up of 104,708sqm recorded in Q2 2018. Positive economic conditions are likely to support demand in the medium term.

Around 223,700sqm of supply was completed in H1 2018, with approximately 358,300sqm projected to be developed in 2018, above the 10 year average of 270,000sqm.

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

The largest lease deal in Q2 2018 was DHL (33,976sqm) at Oakdale South in Kemps Creek.

Figure 11. Outer West Sydney gross take-up



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

West Melbourne

West Melbourne recorded 119,195sqm of industrial take-up in Q2 2018. This follows a very strong 2017.

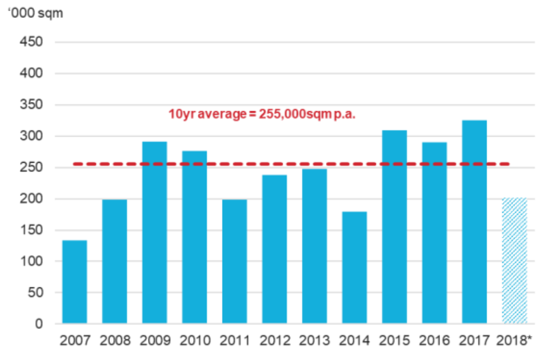
Demand is projected to remain above average as population growth continues and key infrastructure projects such as the West Tunnel project add further support to economic conditions.

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 over FY18.

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 120,000sqm was completed in H1 2018, with only 188,000sqm planned in 2018.

The largest lease deal in Q2 2018 was a pre-lease to Woolworths (32,600sqm) at Truganina.

Figure 12. West Melbourne gross take-up



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

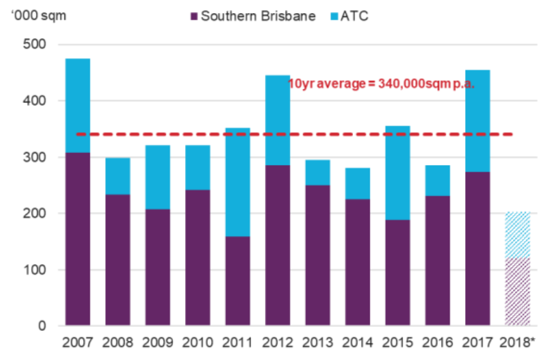
Brisbane

Demand in Brisbane is showing signs of improvement following above average take-up of almost 160,000sqm was recorded in Q2 2018. Improved economic conditions including employment growth and infrastructure investment points to a continued improvement in the year ahead after several years of weakness.

In 2018, the 207,000sqm of planned industrial supply is well below the 10 year average, providing scope for some upward pressure on rents.

The largest lease deal in Q2 2018 was a pre-lease to Mitre 10 (31,000sqm) in Berrinba.

Figure 13. South Brisbane and ATC gross take-up



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

Retail

Conditions remain challenging

Retail turnover growth increased 0.4% in the month of May 2018 based on ABS data, which was slightly above market expectations. The result was bouyed by a rebound in clothing and department stores, with weak-to-flat conditions reported across other categories.

Overall, pharmaceuticals (including cosmetics) and food catering continue to perform well, despite sales growth easing in May, with supermarkets leading the other anchor tenants.

Online retail sales continued to boom, up 17.2% over the 12 months to May, reaching $26.08bn or around 8.3% of the total retail market (NAB Online Retail Sales Index May 2018). The launch of 'eBay Plus' and 'Amazon Prime' this quarter is likely to further accelerate online penetration in Australia, as cost and convenience of online delivery improves.

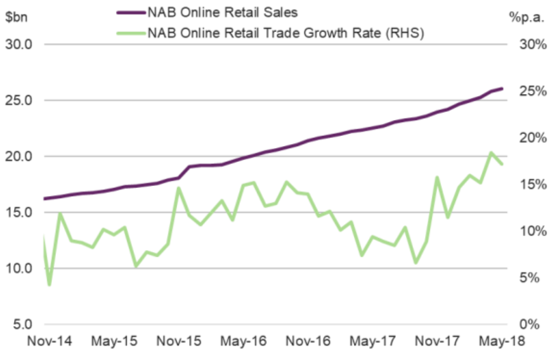
There may be some relief ahead as employment growth seeps through to wages and retail spending growth benefits from continued low interest rates. However, a softening housing market is likely to prevent spending growth from increasing too much.

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:

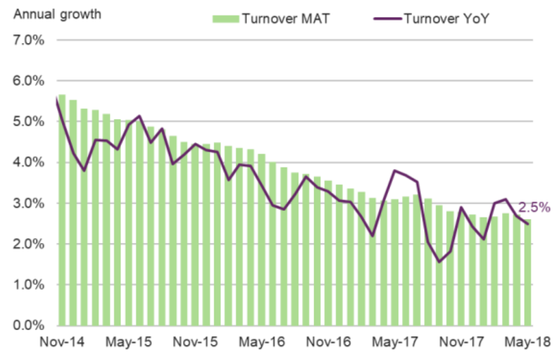
- eBay launched eBay Plus a subscription service, offering free delivery and returns on Plus items, in addition exclusive offers and deals to subscribers. Australia is only the second market in the world to be offered eBay Plus after Germany
- Amazon lauched its Prime subscription service, providing free delivery as well as access to exclusive sales with 'Prime Day' being held on 16 July
- Scentre Group acquired a 50% interest in Westfield Eastgardens for $720 million (4.25% cap rate), making it one of the biggest retail transactions this year. Despite the negative sector headwinds, high quality retail assets remain in strong demand

Figure 14. Online retail sales growth



Source: NAB Online Retail Sales Index, Dexus Research

Figure 15. Retail sales growth



Source: ABS, RBA, Dexus Research

Table 6. Q2 2018 retail snapshot

	Specialty rental growth % p.a.	Cap rate change from Q2 2017	State retail sales growth % p.a.
Sydney			3.0
Regional	0.13	-0.50	
Sub-regional	0.75	-0.25	
Neighbourhood	1.00	0.00	
Melbourne			4.3
Regional	0.50	-0.63	
Sub-regional	0.25	0.00	
Neighbourhood	0.50	-0.13	
SE QLD			1.2
Regional	0.00	-0.50	
Sub-regional	0.00	0.00	
Neighbourhood	0.00	-0.13	

Source: JLL Research, ABS, Dexus Research

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