dexus

Australian Real Estate Quarterly Review

Q3 2019

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

Inside

Investment Climate

Economic growth moderating

Australian growth is moderating as the housing market rebalances.

Employment growth continues to run at a solid 2.6% per annum but is forecast to ease given a fall in job advertisements.

The growth outlook should benefit from reductions in official cash rates and fiscal stimulus from tax rebates which are expected to support spending in FY20.

Business confidence is below average given ongoing, uncertainty about the US/China trade war, Brexit and a slowing in Japan, Europe and China.

On balance, these trends mean occupier demand is likely to soften in the year ahead. In this event, the office and industrial sectors are well positioned given falling levels of vacancy and a lack of oversupply. While spending should benefit from stimulus measures, conditions in the retail sector are likely to remain challenging overall in FY20.

The economy continues to benefit from structural growth drivers such as population growth of 1.6% and a substantial infrastructure pipeline. Australia's Q1 2019 GDP growth rate of 1.8% per annum is approximately equal to the average rate of growth across the OECD.

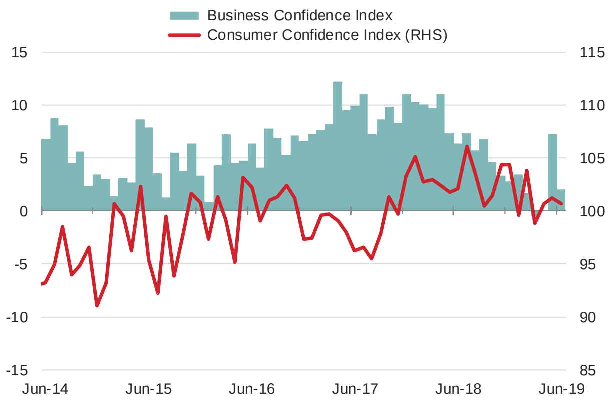
Financing costs are expected to remain low after two cuts to official interest rates. 10-year government bond yields are forecast to remain below 2% for the foreseeable future, supporting investment demand for office, industrial and alternative sectors.

Table 1: Australian economic forecasts: Q2 2019

	Jun-19	Jun-20	Jun-21
Real GDP %pa	1.6%	2.0%	2.3%
Final demand %pa	2.0%	1.6%	3.0%
Employment %pa	2.3%	1.7%	1.1%
Goods imports %pa	0.0%	-2.0%	0.0%
Retail sales %pa (real)	1.6%	2.0%	2.3%
CPI %pa	1.4%	1.5%	1.7%
90 Day bills %	1.8%	1.0%	1.0%
10yr Bond %	1.3%	1.5%	1.5%
AUD/USD	0.69	0.65	0.68

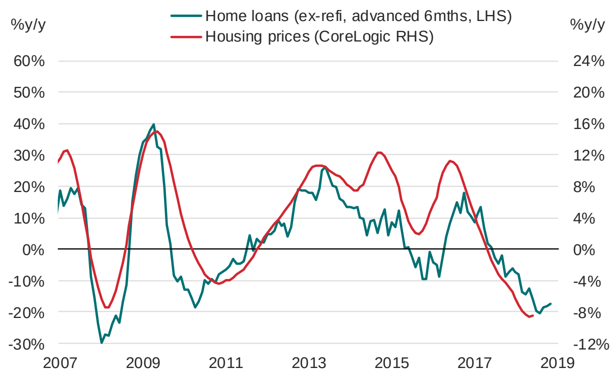
Source: Deloitte Access Economics base, Dexus adjusted forecasts

Figure 1: Confidence improved after the Federal election, but will it last?



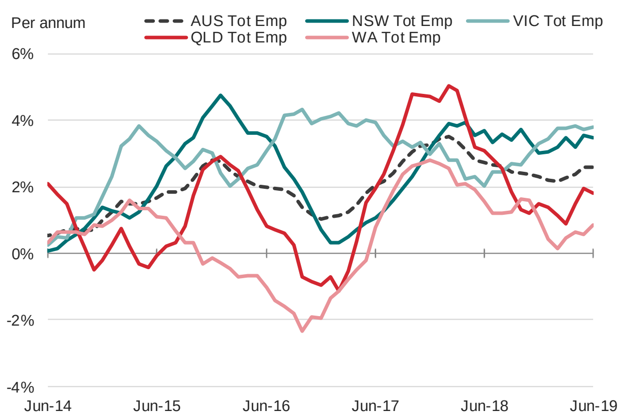
Source: Westpac-Melbourne Institute, NAB

Figure 2: House prices appear to be bottoming in Sydney following cuts to mortgage rates



Source: ABS

Figure 3: Employment growth still strong



Source: ABS

Transactions

Low interest rates support investment

Investment activity increased in the June quarter to $7billion, almost doubling volumes recorded in Q1 2019. Investment demand appears to be buoyed by sharp falls in bond yields (Figure 3). Australian government bond yields (10-year) have fallen to 1.4% which is half of where they were at this time last year.

Lower bond yields are likely to support demand for real assets with quality income streams.

Investor sentiment towards the industrial sector is at high levels, however investment demand for industrial assets remains partly unsatisfied due to the relatively low volume of stock available for sale. Retail sentiment is weak, and consequently the office sector appears to be benefiting from the increased demand for Australian real estate not satisfied by industrial.

Prime industrial cap rates tightened 12 basis points over the quarter, further reducing the spread to office and regional retail to a new historical low of 38 basis points.

The past quarter saw two of the largest office transactions in recent history in 80 Collins Street at a value of $1.48bn, 75% purchased by DXS and 25% by Dexus Wholesale Property Fund (DWPF) and the Scentre Group office portfolio at a value of $1.35bn purchased by Blackstone.

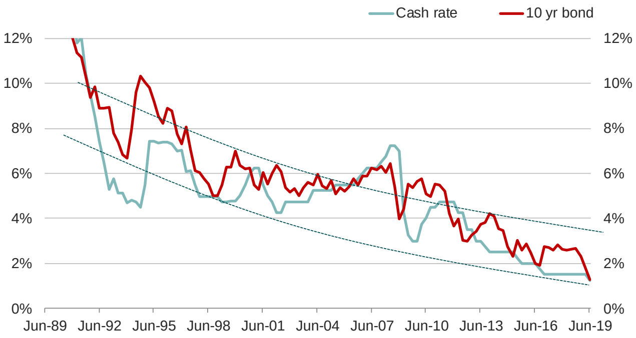
Foreign investment has been consistently strong over the past five years at over 30% of Australian transaction volumes.

Table 2: Q2 2019 top transactions

Price ($m)	Asset/portfolio	Buyer
1,520	Scentre Office Portfolio	Blackstone
1,476	80 Collins Street	DXS (75%) / Dexus Wholesale Property Fund (DWPF) (25%)
575	Westfield Burwood (50%)	Perron Group
325	10 & 20 Bond Street (50%)	Mirvac
274	AGL Centre	Mapletree Investment
225	Oxford Properties to Anton Capital Portfolio	Anton Capital
200	31 Queen Street	AEW Capital Management
192	Lion Building	Charter Hall PFA Diversified (PFA)
142	Rockdale Plaza	Charter Hall Retail REIT (CQR)

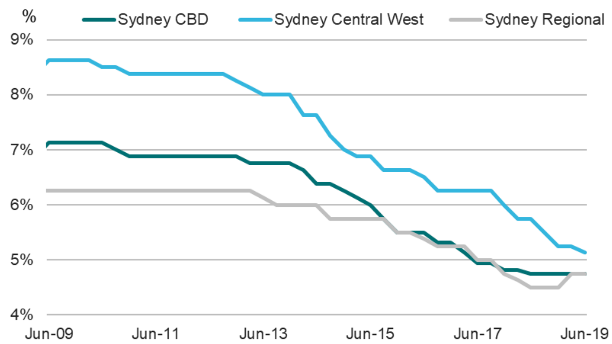
Source: Dexus Research Transaction Database, JLL Research

Figure 3: Low interest rates likely to support investment demand for income-producing assets



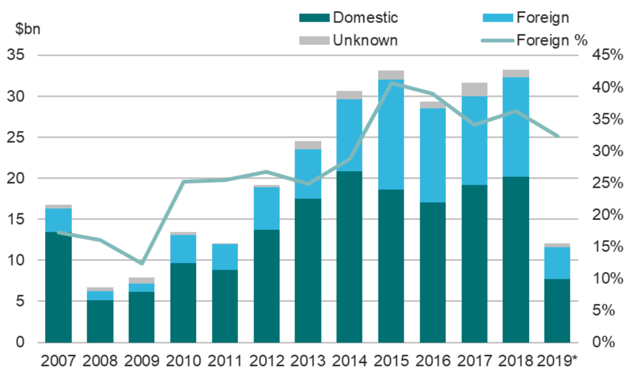
Source: JLL Research, Dexus Research Transaction Database
*YTD

Figure 4: Yield spread between sectors narrows to historical lows as industrial compresses further



Source: JLL Research, Dexus Research

Figure 5: Foreign investment volume remains elevated



Source: JLL Research, Dexus Research
*YTD

Performance

A-REITs outperform in FY19

A-REITs finished the financial year on top of the league table with a 19.3% return in FY19 - easily outperforming the broader Australian equity market (Figure 7). A-REIT pricing benefited from sharply falling bond yields in the second half of FY19 (Figure 8). Investors also moved back into defensive assets on the back of heightened market volatility and a more cautious global backdrop.

Direct property delivered a return of +9.5% in the year to March (PCA/MSCI Investment Performance Index) as capital gains eased and returns were increasingly driven by income.

Unpacking the headline numbers, sector divergence remains a key theme. The residential and retail sectors have continued to lag in line with weaker fundamentals, while Sydney/Melbourne office (low vacancy) and industrial (ecommerce trade) have outperformed.

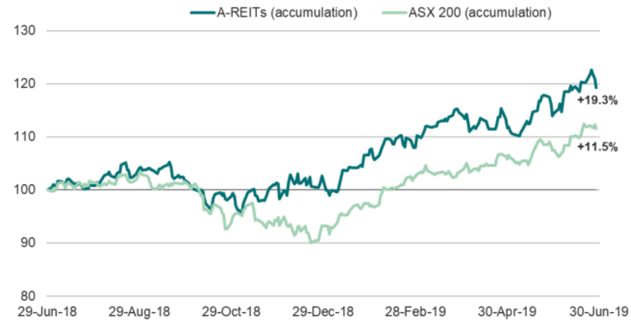
This divergence is evident in the latest Mercer/MSCI Australia Monthly Property Fund Index (Core Wholesale) which returned +7.8% FY19 (Figure 9). Retail returns are being affected by weaker income growth, rising capex and write downs in the values of poorer assets. Office and industrial funds continue to deliver double digit returns boosted by further cap rate compression and rising rents. Diversified funds remain held back by their retail exposures.

Table 3. Index returns to 30 June 2019

	Qtr.%	1 yr %p.a.	3 yr %p.a.	
A-REITs	4.1	19.3	8.1	S&P/ASX 200 A-REIT Accumulation Index
Australian shares	8.0	11.5	12.9	S&P/ASX 200 Accumulation Index
Australian fixed interest	3.1	9.6	4.2	BACM0 Index
Unlisted property*	1.7	7.8	11.0	Mercer/IPD Australia Monthly PFI Core Wholesale*
Australian cash	0.4	2.0	1.9	BAUBIL Index

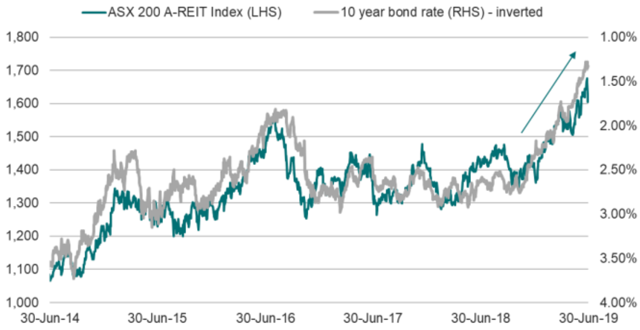
The indices are copyrighted by and proprietary to the relevant Source issuers: Mercer/IPD Australia Monthly Property Fund Index Core Wholesale; Standard and Poor's Australian Securities Exchange Accumulation Index; Bloomberg/UBS Composite and Bank Bill Indices. *NAV Pre-Fee

Figure 7: A-REITs returned +19.3% in FY19, outperforming the broader equity market



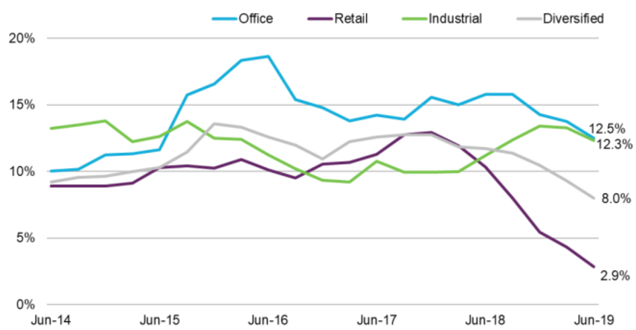
Source: IRESS, Dexus Research

Figure 8: A-REIT pricing is being supported by falling bond yields (down 100bps in the second half of FY19**)**



Source: IRESS, Dexus Research

Figure 9: Sector divergence is increasing with unlisted retail funds trailing the pack



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

Office Markets

Lead indicators moderating

A lack of available space contributed to Sydney and Melbourne recording negative net absorption this quarter (Figure 10) as businesses opted to consolidate and sublease excess space in a tight market.

Leading indicators such as job advertisements and business confidence have eased, causing a softening in the Dexus Office Demand Barometer in June 2019 (Figure 10). While net absorption is likely to be subdued in FY20 in Sydney CBD, strong infrastructure spending and employment growth of 2.6% per annum across NSW should provide support.

Australian office markets are well placed to handle a period of softer demand. Supply growth is still moderate overall, Melbourne being the exception, and vacancy rates are at historic lows for the largest office markets Sydney (4.1%) and Melbourne (3.8%).

Against this backdrop, we expect rent growth in Sydney and Melbourne to continue to moderate in FY20, after an extended period of double-digit growth. Prime net effective rents have already shown signs of tapering (Figure 12), up only +3.4% for Sydney in FY19 (vs +12.5% FY18) and +2.7% for Melbourne (vs +12.8% FY18).

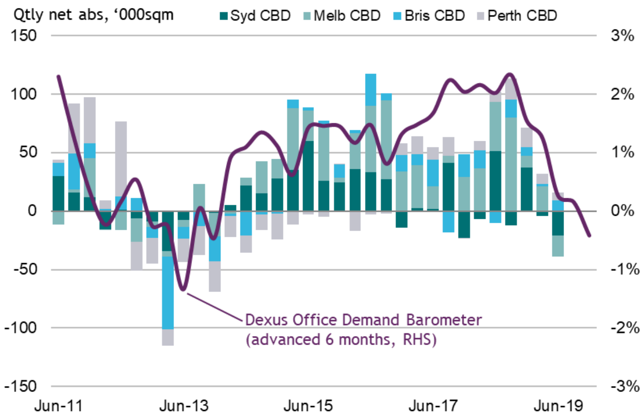
The Brisbane and Perth markets are in recovery phase with rising rents and falling vacancy rates. Net effective rents grew by +4.6% and +1.3% respectively for the year to June 2019. The fact that Brisbane and Perth are at different points in the cycle to Sydney and Melbourne provides investors with useful diversification.

Table 4. Q2 2019 office snapshot

	Vacancy %	Prime net face rent growth % p.a.	Prime net eff. rent growth % p.a.
Melbourne CBD	3.8%	2.2%	2.7%
Parramatta	4.0%	6.0%	8.6%
Sydney CBD	4.1%	6.0%	3.4%
Macquarie Park	7.2%	8.7%	11.9%
North Sydney	9.0%	7.0%	10.0%
Canberra	11.0%	0.0%	0.2%
Brisbane CBD	11.0%	1.6%	4.6%
Adelaide CBD	14.0%	2.5%	6.5%
Perth CBD	20.4%	0.5%	1.3%

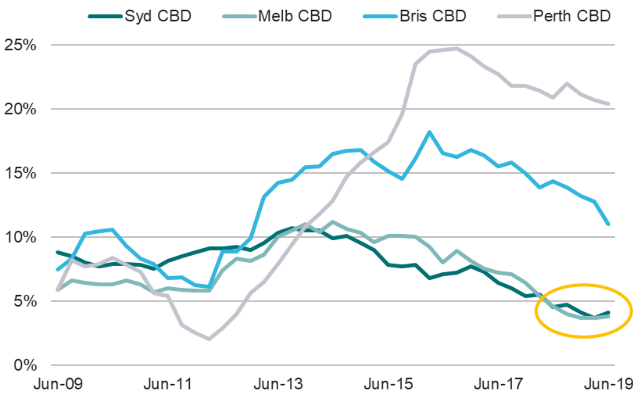
Source: JLL Research

Figure 10. Leading indicators point to a softening in office demand



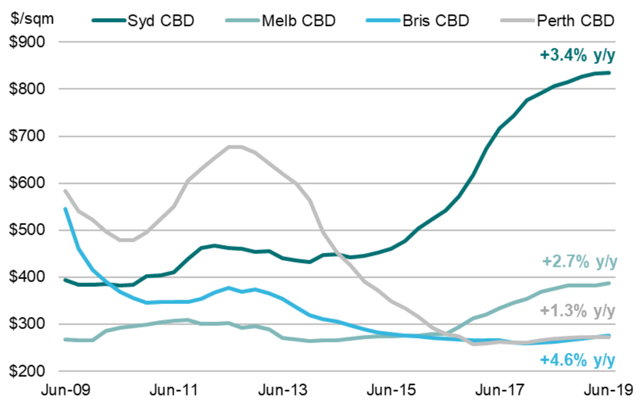
Source: JLL Research, Dexus Research. Dexus's Office Demand Barometer is a specialised model providing a leading indicator for office demand. Variables include: ANZ job advertisement series, US ISM Manufacturing Index, NAB Business Confidence Index, S&P/ASX 200 Index.

Figure 11. Sydney and Melbourne well positioned with vacancy rates holding at ~4%



Source: JLL Research, Dexus Research

Figure 12. Rent growth tapering in Sydney and Melbourne as cycle matures. Green shoots in Perth.



Source: JLL Research, Dexus Research

Office Market Wrap

Market	Comments	Direction of trend for next 12 months	
Sydney	**Growth moderating.** Net absorption fell for a second consecutive quarter (-21,281sqm) as customers opted to consolidate and/or sublease excess space. Rent growth remained positive but is decelerating after a period of double digit growth (2017-2018). A significant pickup in demand seems unlikely for FY20 with business confidence low and job ads down. However, with the total vacancy rate at a tight 4.1% and limited short-term supply, Sydney is well placed to handle economic uncertainty.	Vacancy	↑
		Rents	↑
		Incentives	→
		Yields	↓
North Sydney	**Strong rent growth.** The North Sydney office market recorded positive net effective rent growth of 2.2% for the quarter and 10.0% for the year despite vacancy rates drifting higher to 9.0% as new supply outweighed an uplift in demand. Withdrawal of secondary stock for residential development and no new supply should drive vacancy lower in FY20 and support further rent growth.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↓
Macquarie Park	**Vacancy up as demand turns negative.** The vacancy rate increased to 7.2% as net absorption dipped back into negative territory this quarter (-5,300sqm). Prime net effective rents have been surprisingly resilient, up 4.4% for the quarter and 11.9% for the year. Demand is projected to remain mild, and with new supply largely pre-committed from outside the market, further rent growth in FY20 is expected albeit at a more subdued pace.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	↓
Parramatta	**Tight vacancy supporting rent growth.** Parramatta is expected to perform solidly in the short-term, with a low vacancy rate (4.0%) and pending new supply largely pre-committed by new entrants. A tight prime vacancy rate of 0.7% will continue to support rent growth for prime assets in FY20. There is medium-term supply risk due to backfill and a growing list of mooted projects. How Parramatta performs over the medium-to-long term will largely depend on its ability to continue to attract customers from outside the market.	Vacancy	↑
		Rents	↑
		Incentives	→
		Yields	↓
Melbourne	**Lowest vacancy rate in the country.** Vacancy remains extremely low at 3.8% despite Melbourne recording its first negative quarter of net absorption (-17,413sqm) in five years as tenants opted to consolidate and/or sublease excess space. Rent growth remains positive (2.7% y/y), but easing after a period of double digit growth. With vacancy expected to rise in FY20 due to above average supply, the prospect of strong rent growth s diminishing.	Vacancy	↑
		Rents	↑
		Incentives	→
		Yields	↓
Brisbane	**Steady recovery.** Improved economic conditions in Brisbane are flowing through to the office sector with positive net absorption over the past 12 months. While prime gross face rents continue to improve, incentives remain elevated (38-39% gross) as a result of high vacancy. Prime rent growth is expected to improve as vacancy levels move back towards the long run average with a flight to quality absorbing prime space. Prime vacancy is 7.7%. Growth is likely to be tempered by new supply with three major projects under construction.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	↓
Perth	**Vacancy continues to fall on improved demand.** The Perth vacancy rate fell further to 20.4% due to limited new supply and positive net absorption of +6,725sqm recorded in Q2 2019. Currently there is limited new supply planned over the next few years which should support the continued recovery. Prime net effective rents held steady in Q2 but are up 1.3% for the year. Effective rent growth is expected to improve in FY20 with scope for incentives to decline from current high levels.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	↓
Canberra	**Demand subdued in election year.** Canberra recorded another quarter of negative net absorption (-2,323sqm) keeping vacancy in double digit territory (12.4%). The modest availability of prime space (prime vacancy is currently 6.5%) is helping to support some mild rent growth in prime assets. Positive demand for prime assets should support an uplift in rents over the next 12 months.	Vacancy	→
		Rents	↑
		Incentives	→

Industrial

Australia's industrial revolution

The industrial sector is in the midst of a significant transformation which is changing the shape of occupier demand and attracting significant investment.

Supply chains are becoming more complex as retailers adopt omnichannel business models and seek to deliver merchandise to shops, collection points or direct to consumers homes. There is a growing emphasis on speed of delivery with consumers expecting two-day, one-day or even same-day delivery. Firms are increasingly valuing proximity to the consumer over distance from supplier to save time and cost. The net result is an increasing focus on inner city and motorway-adjacent sites.

The technology to manage inventory is improving rapidly. Firms are using customer data and interconnected control systems to track and manage inventory. Advancements in automation and robotics are capable of providing large increases in productivity within warehouses. Going forward, the rate of automation is likely to increase due to competition from fully automated online players like Amazon and Alibaba.

Delivering products 'last mile' from the warehouse direct to the consumer is an expensive part of the supply chain. Transport costs comprise around 50% of an average supply chain, and of this one third to one half is last mile delivery. Given rents are only 5% of costs on average, firms are responsive to property solutions which deliver transport costs savings.

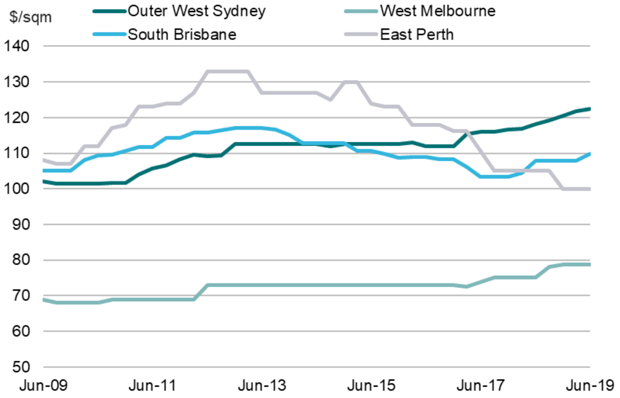
These trends are plain to see in the example of major footwear retailer, Accent group, a major footwear retailer, whose corporate vision is 'focusing on speed to consumer'. It has opened a state-of-the-art automated facility at Prestons in Sydney and a purpose-built digital hub of excellence in Melbourne.

Table 5. Q2 2019 industrial snapshot

	Ave prime cap rate change from Q2 2018	Existing prime net face rent growth % p.a.
South Sydney	-0.50	5.0
West Melbourne	-0.62	4.8
Outer West Sydney	-0.62	3.7
Southern Brisbane	-0.38	1.9
East Perth	-0.50	-4.8

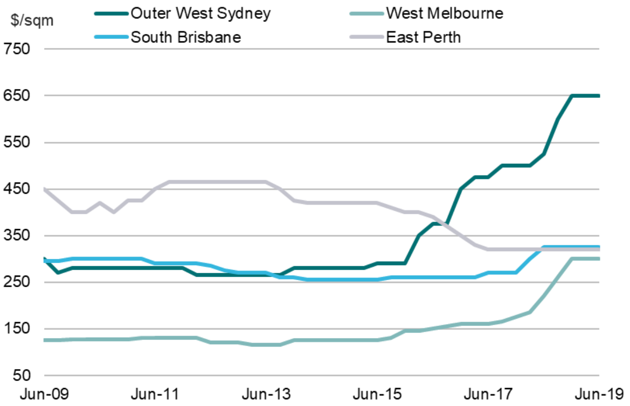
Source: JLL Research, Dexus Research

Figure 13: Prime rent growth continued in Sydney, ticked up in Brisbane, and remained flat in other markets



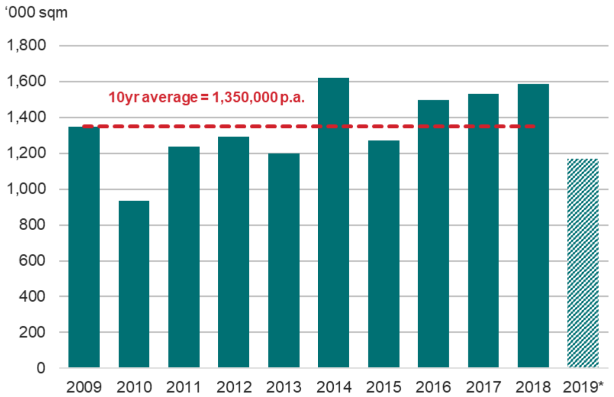
Source: JLL Research, Dexus Research

Figure 14: Land value growth appears to be tapering after strong gains



Source: JLL Research, Dexus Research

Figure 15: Industrial supply has fallen below the 10-year average across Australian capital cities



Source: JLL Research, Dexus Research

Industrial

Outer West Sydney

Demand in Outer West Sydney is above the long-term average for the fifth year in a row with 342,000sqm of take-up recorded in FY19.

Rents have seen upward pressure as demand continues to run ahead of serviced land supply.

There is continued evidence of occupiers investing in their supply chains with Coco Republic leasing a further 12,000sqm in Greystanes to assist in improving logistics.

The level of speculative development has increased to around 40% and while it is currently leasing up quickly, it bears watching as a potential risk to future growth.

The largest lease deal in Q2 2019 was a private occupier taking 25,000sqm in Lidcombe.

West Melbourne

West Melbourne has experienced record take-up with 397,000sqm leased in FY19. Demand in Q2 2019 itself was 256,000sqm, just below the long-term average, predominately driven by storage and logistics industries.

Zoned and serviced land remains limited resulting in the timing of several short-term projects being delayed. While good for rent growth in the short term, delayed projects may subdue it in the medium term.

The most significant deal of the quarter was Amart Furniture leasing nearly 50,000sqm in Truganina.

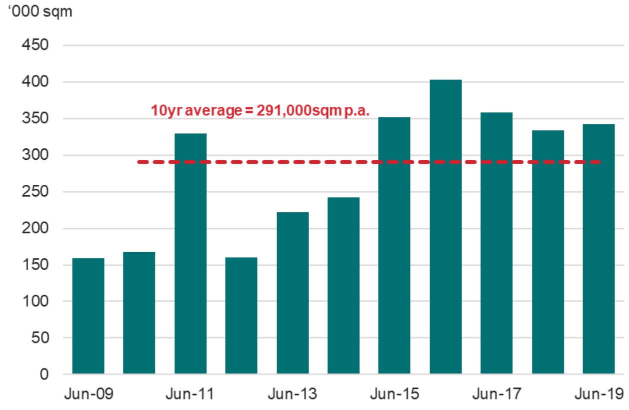
Brisbane

Tenant demand in Brisbane was relatively strong over the quarter with 120,000sqm of take-up recorded, reducing vacancy to the lowest level in six years.

Pre-lease rents have increased 4.5% over the past six months, driven by major occupiers looking for quality buildings as large prime options diminish.

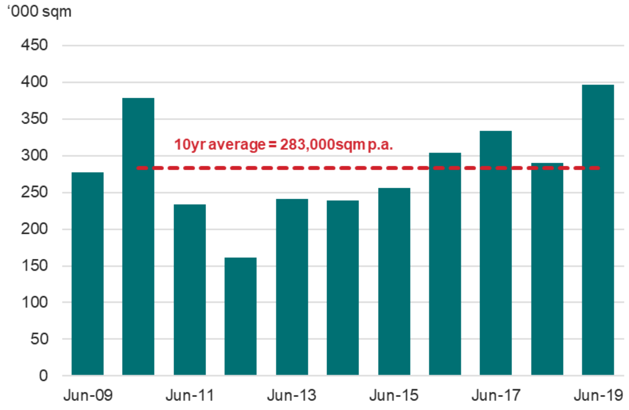
The supply pipeline is in-line with long-term average with 280,000sqm projects expected to complete across Brisbane in 2019. Developers are reluctant to build speculatively without pre-commitments as the average time to lease speculative space is four months post practical completion.

Figure 16: Outer West Sydney take-up remains elevated above the 10-year average



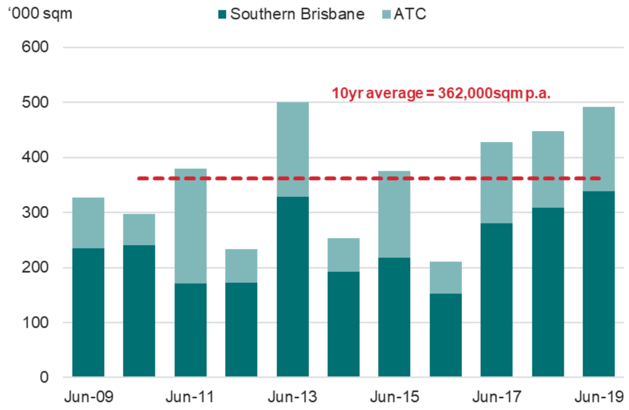
Source: JLL Research (gross take-up), Dexus Research.

Figure 17: West Melbourne recorded its strongest quarter of take-up in Q2 2019



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

Figure 18: South Brisbane and ATC take-up well above average after several years of weakness



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

Retail

Retailers embrace omni-channel

Australian retail turnover growth remains positive at around 3.1% per annum on a moving annual basis.

Consistent with subdued sentiment, consumers are focused on non-discretionary spending (mainly food and groceries). Discretionary spending is weaker particularly in the department store and household goods categories.

Going forward, spending should benefit from the stimulatory effect of recent cuts in bank mortgage rates and Federal tax rebates. A recent report by UBS estimated that tax rebates could add up to 1.1 percentage points to the per annum growth in retail turnover in the latter months of 2019 – mainly in discretionary categories.

Online retail spending growth has slowed to 4.8% per annum, probably aligned with the slowdown in discretionary spending.

Profit results from listed retailers showed some improvement this year as expanding online sales increasingly compensated for subdued physical store sales.

A recent survey by Quantium provided an insight into the role of physical stores in shopping centres by finding that 60% of online sales captured by domestic retailers were by players with an omni-channel (physical) presence.

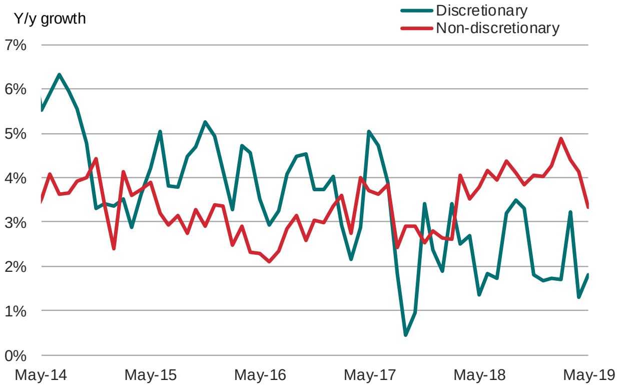
We also note a global trend whereby previously pure-play online retailers, are opening physical stores.

Table 6. Q2 2019 retail snapshot

	Specialty rent growth % p.a.	Cap rate change from Q1 2018	State retail sales growth % p.a.
Sydney			2.4
Regional	0.20	0.25	
Sub-regional	0.00	0.50	
Neighbourhood	0.20	0.37	
Melbourne			5.0
Regional	0.00	0.00	
Sub-regional	-1.30	0.00	
Neighbourhood	0.04	0.13	
SE QLD			3.4
Regional	-0.01	0.13	
Sub-regional	-3.90	0.13	
Neighbourhood	0.10	0.38	

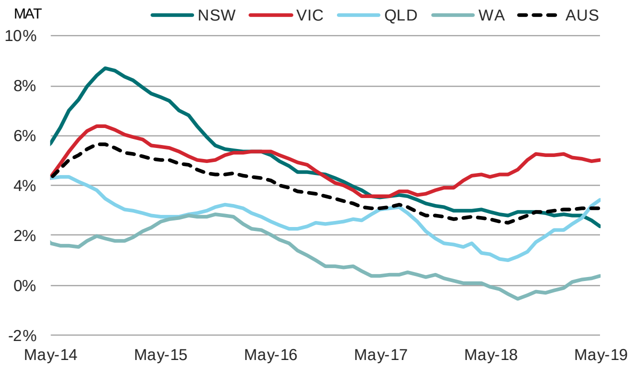
Source: JLL Research, ABS, Dexus Research

Figure 19. Non-discretionary (food) sales growing faster than discretionary



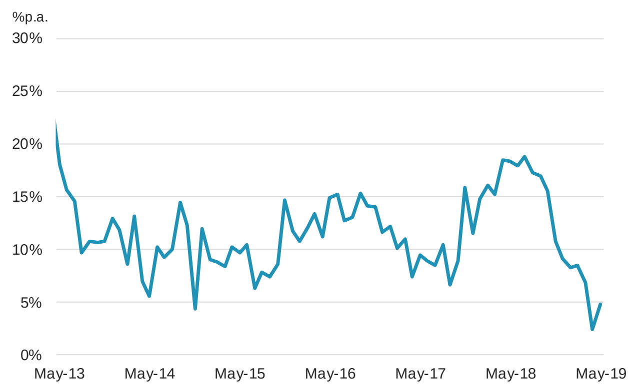
Source: ABS, Dexus Research

Figure 20. Victoria leading in retail sales with Queensland improving



Source: ABS, Dexus Research

Figure 21. Online retail sales growth data has paused but should resume double digit levels



Source: NAB Online Retail Sales Index, Dexus Research

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