dexus

# Australian Real Estate Quarterly Review

Q4 2019

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

# Inside

# Investment climate

## Economy slower, interest rates lower

Australian growth moderated over the past year as housing construction weakened. Australia's Q2 2019 GDP growth rate was below average at 1.4% per annum and growth is forecast to be 1.8% in FY20.

Business confidence is below average given ongoing uncertainty about the US/China trade war and easing growth in the US, Japan, Europe and China (Figure 1).

The trade war has had little direct impact on the Australian economy to date with net exports remaining a positive contributor to growth. However, global uncertainty is influencing confidence (Figure 2).

Employment growth continues to run at a solid 2.6% per annum nationally with NSW and Victoria leading, however an easing back towards the average of 1.7% is likely in line with broader trends.

The growth outlook from FY21 should benefit from reductions in official cash rates and increased infrastructure investment as well as ongoing population growth (currently 1.6% per annum).

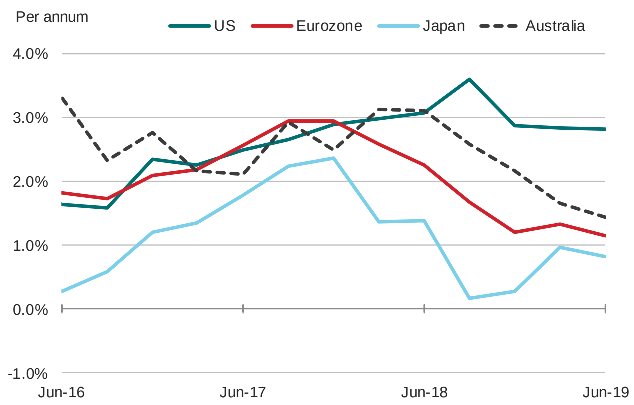
Financing costs are expected to remain low after three cuts to official interest rates. 10-year government bond yields (currently 1%) are forecast to remain below 2% for the foreseeable future, supporting investment demand for office, industrial and alternative sectors.

### Table 1: Australian economic forecasts: Q3 2019

| | Jun-19 | Jun-20 | Jun-21 |
|---|---|---|---|
| Real GDP %pa | 1.4% | 1.8% | 2.4% |
| Final demand %pa | 1.0% | 1.4% | 2.8% |
| Employment %pa | 2.9% | 1.8% | 1.6% |
| Goods imports %pa | -3.3% | 1.6% | 1.7% |
| Retail sales %pa (real) | 0.2% | 3.0% | 2.3% |
| CPI %pa | 1.6% | 1.5% | 1.8% |
| 90 Day bills % | 1.2% | 0.6% | 1.0% |
| 10yr Bond % | 1.3% | 0.9% | 1.2% |
| AUD/USD | 0.70 | 0.66 | 0.68 |

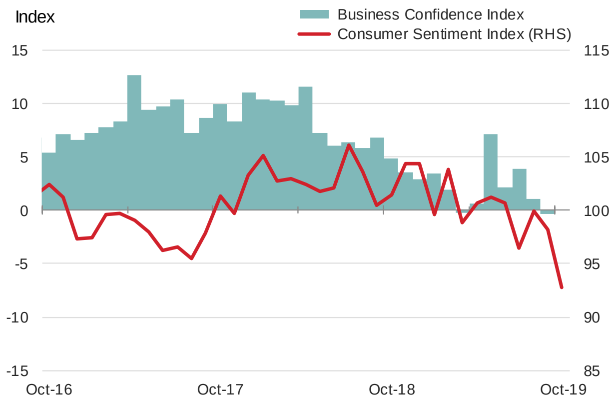
Source: Deloitte Access Economics base, Dexus adjusted forecasts

**Figure 1:** Global and Australian growth is slowing in the face of heightened uncertainty



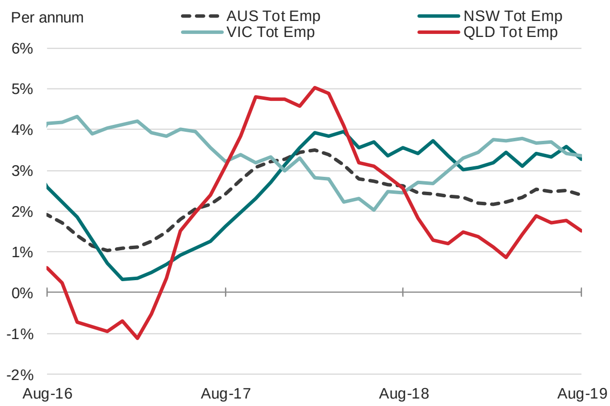

Source: Westpac-Melbourne Institute, NAB

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




Source: ABS

**Figure 3:** Employment growth still strong with NSW and Victoria above the national average




Source: ABS

# Transactions

## Higher yield spreads bode well for demand

The transaction market remains buoyant with Q3 volumes reaching $11.8bn, up 65% from the previous quarter. Office was the most active sector accounting for 74% of transactions in the year to date. In contrast, industrial and retail volumes were down 13% and 32% respectively from Q3 last year.

Office and Industrial cap rates continued to compress over the quarter whilst retail remained flat, bringing sector yields closer together. Spreads are very tight between sectors, locations or grades of property. This implies some mispricing of risk at the riskier end of the spectrum.

Real estate yield spreads have widened sharply as a result of falls in the 10-year bond yield, which fell a further 40bps to just 1.0% in Q3 2019. Wider spreads, which make real estate pricing more attractive on a relative basis raise the prospect of even tighter cap rates and stronger valuations, particularly on quality assets with reasonable growth prospects.

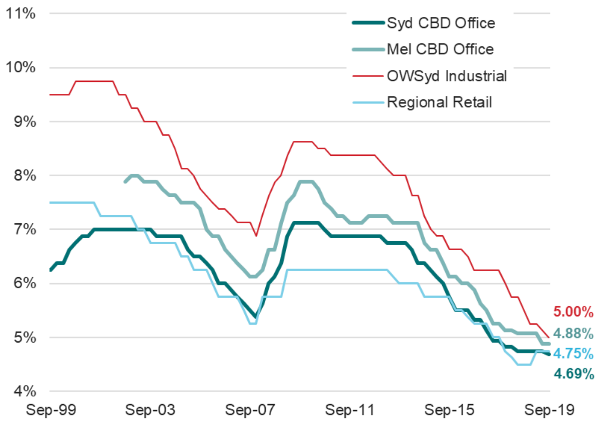
Foreign investors remain active, accounting for around 30% of transactions. The most significant transaction of the quarter was GIC's purchase of a 25.1% interest in the International Towers portfolio. Another notable transaction was ISPT's acquisition of a 25% interest in Liberty Place for $400m on a tight yield of 4.1% and a capital value of $26,900/sqm.

**Table 2:** Q3 2019 top transactions

| Price ($m) | Asset/portfolio | Buyer |
|---|---|---|
| 1,079 | International Towers (25.1%) | GIC |
| 920 | Chifley Tower (49.9%) | Charter Hall Core Plus Office Fund (25%)/ DVP Wholesale Fund (25%) |
| 830 | Telstra Centre | Charter Hall |
| 668 | Australian Unity Office Fund | Abacus Property Group (50%) / Charter Hall (50%) |
| 450 | Wynyard Place (25%) | AMP Capital |
| 398 | Darling Park Towers (25%) | GPT Wholesale Office Fund |
| 347 | Piccadilly Centre (50%) | Stockland |
| 340 | Glasshouse on the Mall (50%) | Oxford Properties |
| 300 | Northpoint (50%) | Early Light International Holdings |

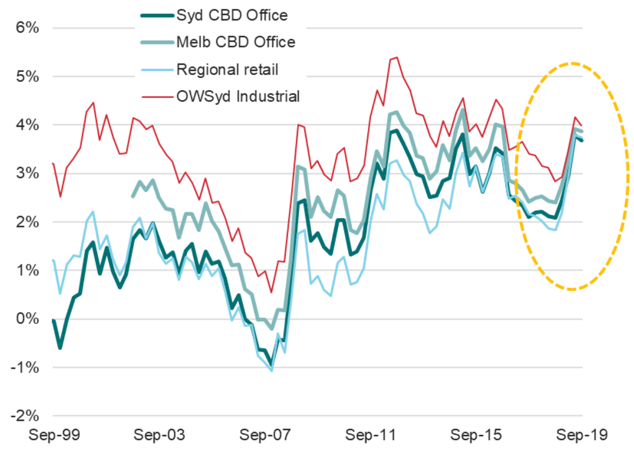
Source: Dexus Research Transaction Database, JLL Research

**Figure 4:** Cap rates continue to decline with sectors and quality grades converging



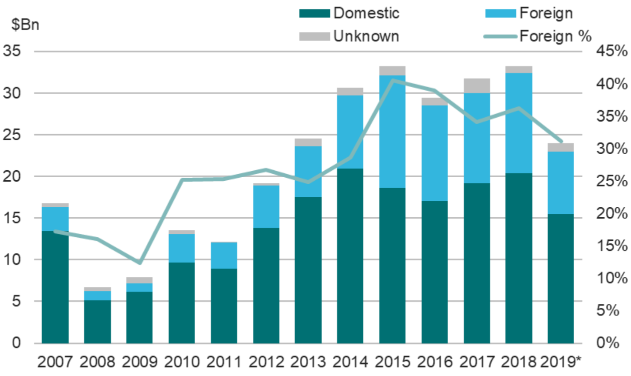

Source: JLL Research, Dexus Research Transaction Database

**Figure 5:** Yield spread to bonds will continue to impact investment demand and pricing




Source: JLL Research, Dexus Research

**Figure 6:** Foreign investors remain active in the Australian market




Source: JLL Research, Dexus Research
*YTD

## Performance

### A-REITs outperform despite a weak September

A-REITs outperformed other asset classes for the year to 30 September, delivering a +18.3% return, despite a weaker September quarter (Table 3). Having benefited from sharply falling bond yields for most of this year, A-REIT pricing reacted negatively to bond yields increasing from 0.9% to 1.2% in the month of September, before yields drifted back to 1.0% by month end (Figure 8).

Direct property delivered an annual return of +8.3% (PCA/MSCI Index, Jun-19), while unlisted property funds returned +7.0% (MSCI/Mercer Index, Sep-19) as capital gains continued to ease and returns were increasingly driven by income.

Sector returns continued to diverge across both listed and direct property markets. The retail sector has continued to lag in line with weaker fundamentals, while Sydney/Melbourne office (low vacancy) and industrial (ecommerce trade) have tended to outperform.

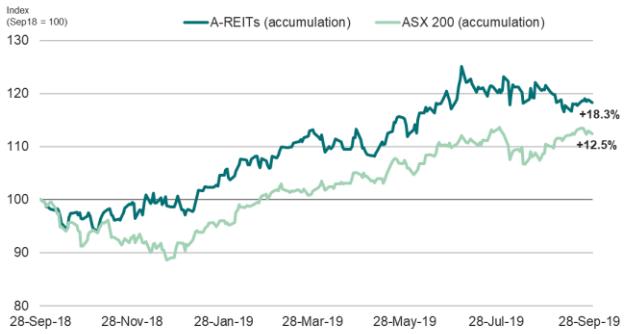
This divergence is most evident in the latest MSCI /Mercer Wholesale Funds index results (Figure 9). Retail returns (+1.2%pa) are being affected by negative capital returns driven by weaker income growth, rising incentives/capex and write downs in the values of poorer assets. Office (+12.5%) and industrial funds (+11.2%) continue to deliver double digit returns boosted by further cap rate compression and rising rents. Diversified fund returns (+7.3%) reflected their retail exposures.

**Table 3. Index returns to 30 September 2019**

| | Qtr.% | 1 yr %p.a. | 3 yr %p.a. | |
|---|---|---|---|---|
| A-REITs | 0.9 | 18.3 | 9.2 | S&P/ASX 200 A-REIT Accumulation Index |
| Australian shares | 2.4 | 12.5 | 11.9 | S&P/ASX 200 Accumulation Index |
| Australian fixed interest | 2.0 | 11.1 | 4.6 | BACM0 Index |
| Unlisted property* | 1.5 | 7.0 | 10.5 | MSCI Mercer Aust. Unlisted Wholesale PFI* |
| Australian cash | 0.3 | 1.7 | 1.8 | BAUBIL Index |

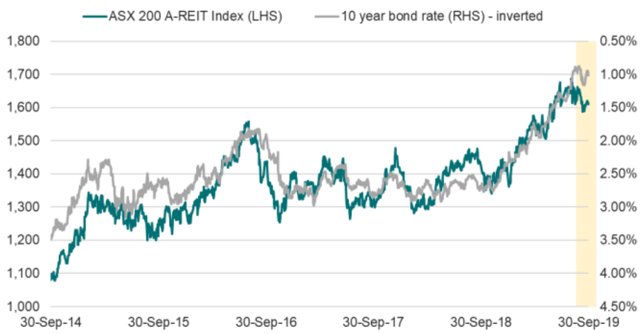
The indices are copyrighted by and proprietary to the relevant Source issuers: MSCI Mercer Aust. Core Wholesale Monthly PFI; Standard and Poor's Australian Securities Exchange Accumulation Index; Bloomberg/UBS Composite and Bank Bill Indices. *NAV Pre-Fee

**Figure 7:** A-REITs returned +18.3% over the year to September, outperforming the broader index



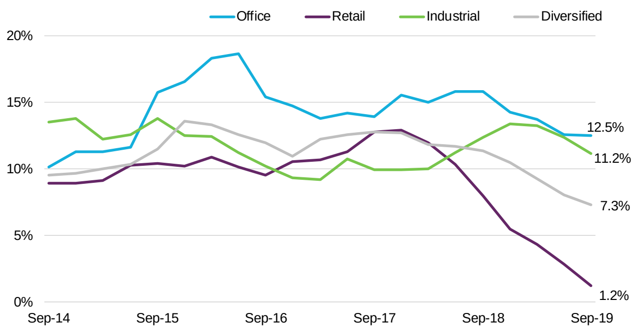

Source: IRESS, Dexus Research

**Figure 8:** A-REIT pricing reacted to recent trends in bond yields – which rose to 1.2% then dropped back to c1.0%




Source: IRESS, Dexus Research

**Figure 9:** Returns are easing for most unlisted funds with retail funds experiencing the greatest softening




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

# Office

## Office markets well placed given uncertainty

All CBD office markets nationally recorded positive net absorption in Q3 2019, with Sydney (9,632sqm) leading the other markets.

The Dexus Office Demand Barometer, which measures leasing conditions, has eased in the past quarter, reflecting a softening in business confidence and job advertisements.

Australian office markets are well placed to handle a period of global uncertainty. Employment growth in NSW and Victoria remains well above average at 3.2% and 3.6% respectively.

Meanwhile, vacancy rates in both Sydney CBD and Melbourne CBD are well below the long-term average, at 4.6% and 3.7% respectively which provides a useful buffer.

Office markets on the East Coast are entering a period of generally higher supply which will test how quickly space, including backfill, can be absorbed. However, in Sydney CBD the supply pipeline is subdued with net supply forecast to add only 1.5% per annum to stock over the next three years compared to 3.1% per annum for Melbourne.

While market rental growth is tapering in some markets, the income passing through office buildings will be supported by high occupancy levels and lease structures with fixed reviews.

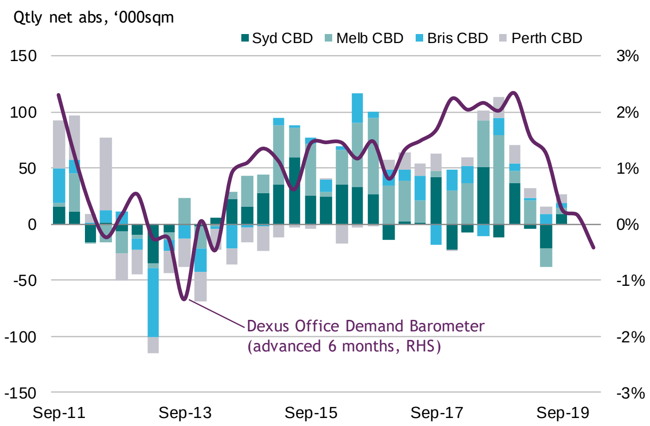
Longer term, investors in CBD office property will continue to benefit from the trend of urban density in Australia's capital cities which leads to a virtuous cycle of jobs growth and infrastructure investment. For example, over the past decade the rate of jobs growth in the inner areas of Sydney has been as much as a third higher than the state average.

**Table 4. Q3 2019 office snapshot**

| | Vacancy % | Prime net eff. rent growth % p.a. | Net Increase % of stock to FY22 |
|---|---|---|---|
| **Melbourne CBD** | 3.7% | 6.2% | 9.3% |
| **Parramatta** | 4.4% | 7.7% | 17.6% |
| **Sydney CBD** | 4.6% | 1.4% | 4.6% |
| **Macquarie Park** | 6.9% | 9.8% | 17.6% |
| **North Sydney** | 9.0% | 10.1% | 9.8% |
| **Canberra** | 10.6% | 1.2% | 4.9% |
| **Brisbane CBD** | 10.9% | 4.9% | 7.0% |
| **Adelaide CBD** | 13.5% | 6.7% | 4.6% |
| **Perth CBD** | 19.4% | 0.5% | 1.0% |

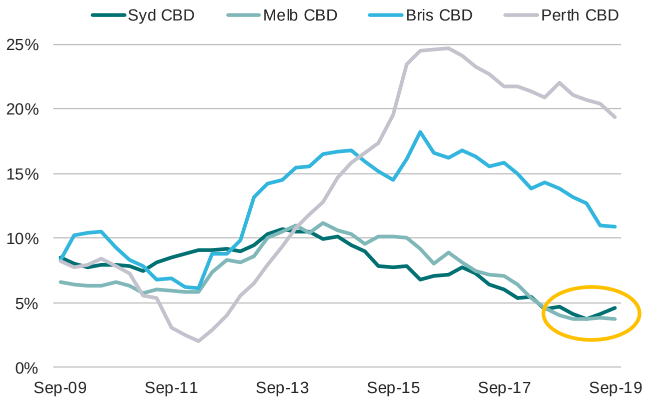
Source: JLL Research; *Projects under construction and plans approved

**Figure 10.** Leading indicators point to a moderation in office demand



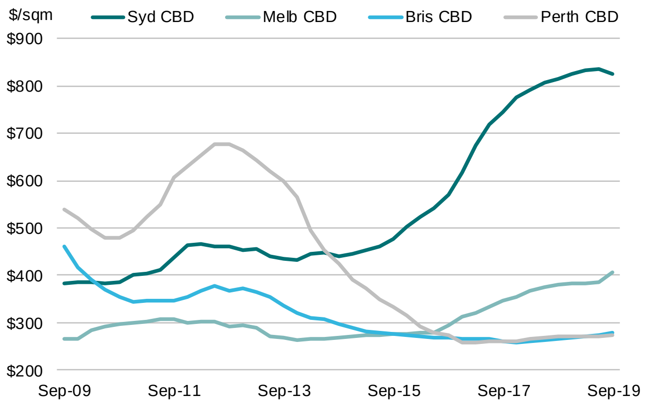

Source: JLL Research, Dexus Research. Dexus' Office Demand Barometer is a specialised model providing a leading indicator for office demand. Variables include: ANZ job advertisement series, US ISM Manufacturing Index, NAB Business Confidence Index, S&P/ASX 200 Index.

**Figure 11.** Sydney and Melbourne well positioned with vacancy rates at 4.6% and 3.7% respectively




Source: JLL Research, Dexus Research

**Figure 12.** Rental 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** | **Ongoing strength in demand for Sydney office assets.** Whilst economic conditions nationally moderated over the first half of 2019, Sydney continued to benefit from strong white-collar employment growth concentrated in the CBD and inner city. In addition, lower interest rates kept investor demand for Sydney CBD office assets buoyant, with nearly $7.5 billion of office assets being transacted in 2019. Vacancy rates increased 50bps over the September quarter to 4.6%, with the completion of 60 Martin Place, which has 20% available space. Net face rents grew 6.6% over the 12 months to Q3 2019. | Vacancy ↑<br>Rents →<br>Incentives ↑<br>Yields ↓ |
| **North Sydney** | **Strong rent growth.** Rising face rents in conjunction with falling incentives led to strong growth in effective rents, increasing 9.7% over the 12 months to September 2019. Sales of prominent North Sydney office buildings drove yields down a further 18 basis points over the past 12 months. Vacancy rates ticked up in the past quarter to 9.0%, as a result of tenant consolidations. The outlook for the North Sydney office market remains positive, with supporting infrastructure activity likely to aid in the ongoing revitalisation of the market. | Vacancy ↓<br>Rents ↑<br>Incentives →<br>Yields ↓ |
| **Macquarie Park** | **Vacancy rates remain low.** The total vacancy rate fell to 6.9% in Q3, though tenant relocation to North Sydney drove up vacancy rates across prime grade space. Rental growth remained a feature of the market, with gross face rents rising 7.6% over the past 12 months. Falling incentives over the same period saw more pronounced rental growth on an effective basis (8.4%). New supply in 2020 will likely place upwards pressure on vacancy rates in Macquarie Park over the short term, with circa 4.7% of stock under construction and due for completion in 2020. | Vacancy ↑<br>Rents ↑<br>Incentives →<br>Yields ↓ |
| **Parramatta** | **Lowest prime grade vacancy rate in the country.** Tenants consolidating space and relocating to other suburban office markets drove the total vacancy rate up in Q3 2019 to 4.4%. Whilst rental growth was lower than the double-digit growth of 18-24 months ago, net effective rents grew a healthy 7.7% over the 12 months to Sep-19, driven by growth in face rents. Investment demand for office assets remains strong from both domestic institutional and foreign investors. Supply side risks remain, with the upcoming development cycle likely to test the market's ability to absorb backfill space. | Vacancy ↑<br>Rents ↑<br>Incentives →<br>Yields ↓ |
| **Melbourne** | **Investor demand continues.** Strong economic and office market fundamentals in Melbourne continue to drive interest in the market from both investors and tenants alike. Investment yields fell 20 basis points over the past 12 months, with over $3.4 billion of office assets exchanging hands in the year to date. Vacancy remained at record low levels (3.7%). Annual net absorption is moderating at +19,831sqm recorded in September 2019, being well down on the previous year. With 10.0% of total due for completion over the next 18 months, we will likely see rising vacancy rates and normalised rental growth. | Vacancy ↑<br>Rents ↑<br>Incentives →<br>Yields ↓ |
| **Brisbane** | **Steady recovery.** Net absorption remained positive at +4,673sqm in Q3 2019 with expansions from coworking groups and healthy demand from government and mining tenants driving up leasing activity in the year to date. Vacancy rates have trended down since the start of 2016, with robust demand and no new supply leading to a fall to 10.9% in the current quarter. Net effective rents increased 4.9% over the past 12 months. However, the completion of 300 George St later this year (which is still largely available) will likely lead to a rise in vacancy rates. The current development cycle will likely keep incentives high, tempering rental growth. | Vacancy →<br>Rents ↑<br>Incentives →<br>Yields ↓ |
| **Perth** | **Vacancy continues to fall on improved demand.** The vacancy rate fell to a four year low of 19.4% in Q3 2019, with expansions by mining tenants resulting in positive net absorption of +7,709sqm in the current quarter. Rents remained stagnant, with no growth recorded in the past year. Incentives remain at elevated levels, though anecdotal evidence suggests they are falling across prime grade space. Whilst there are a number of proposed developments, greater caution from developers has meant that any new developments will likely be subject to significant pre-commitments. | Vacancy ↓<br>Rents ↑<br>Incentives ↓<br>Yields ↓ |
| **Canberra** | **Demand subdued in election year.** Canberra recorded postive net absorption of +3,777sqm in Q3 2019, though this was largely due to the withdrawal of Audit Office. Net leasing activity was flat over the current quarter, dominated by relocations. The noted withdrawal was also largely responsible for the fall in the vacancy rate to 10.6%. The modest availability of prime space (prime vacancy is currently 6.0%) should help to support some mild rental growth in prime assets in the short term. | Vacancy →<br>Rents ↑<br>Incentives → |

# Industrial

## Occupier demand remains strong

Industrial take-up remains relatively strong after benefiting from solid economic growth over the past couple of years. Although slower economic growth and weaker consumer and business indicators point to a possible easing in take-up in the year ahead, it is yet to be reflected in the numbers.

Industrial has been insulated from a slowing in the consumption cycle by infrastructure investment, growth in online retailing and supply chain investment.

E-commerce has cemented itself as an established demand driver in Australia. As the proportion of online sales increases, so does the proportion of e-commerce occupiers. These occupiers require 2-3 times the floorspace to unpack boxes and cater for returns, hence driving incremental demand.

The Industrial sector continues to be one of the most sought-after sectors by investors looking to deploy capital. According to the UBS investor survey of 239 global investors/managers, 39% of respondents believe the listed industrial sector will outperform the other sectors.

Strong investment demand, coupled with limited land availability, has resulted in strong appreciation in land and capital values over the past three years. The growth run in land values now appears to be tapering in most areas, although in Outer West Sydney land values have edged higher to $675/sqm (1ha lots).

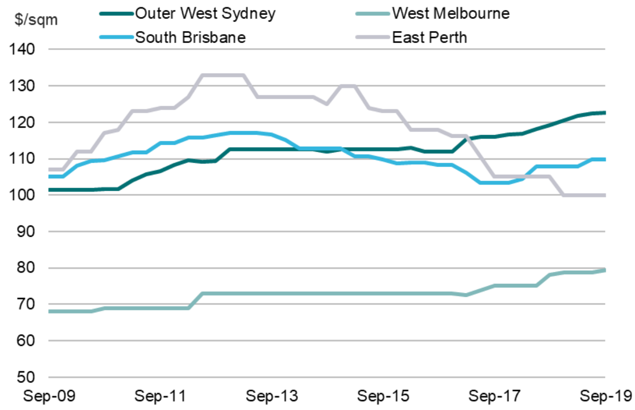
The outlook remains positive, particularly in land constrained precincts in Sydney and Melbourne. We foresee continued rental growth and some further capitalisation rate compression driven by a wider yield spread to Government bonds.

**Table 5. Q3 2019 industrial snapshot**

| | Ave prime cap rate change from Q3 2018 | Existing prime net face rental growth % p.a. |
|---|---|---|
| Outer West Sydney | -0.50 | 2.9 |
| Southern Brisbane | -0.50 | 1.9 |
| East Perth | -0.50 | -4.8 |
| South Sydney | -0.25 | 4.2 |
| West Melbourne | -1.00 | 1.8 |

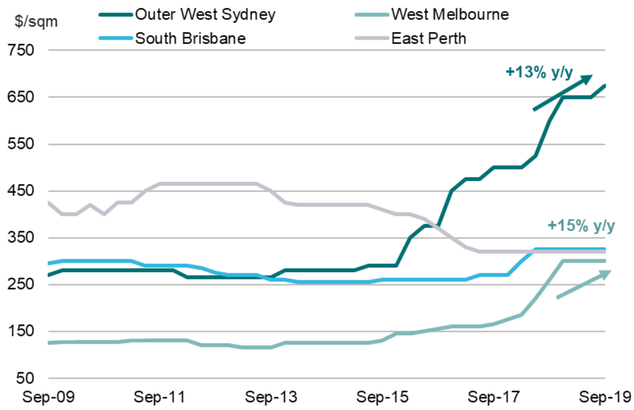
Source: JLL Research, Dexus Research

**Figure 13:** Prime rent growth continues in the east coast markets



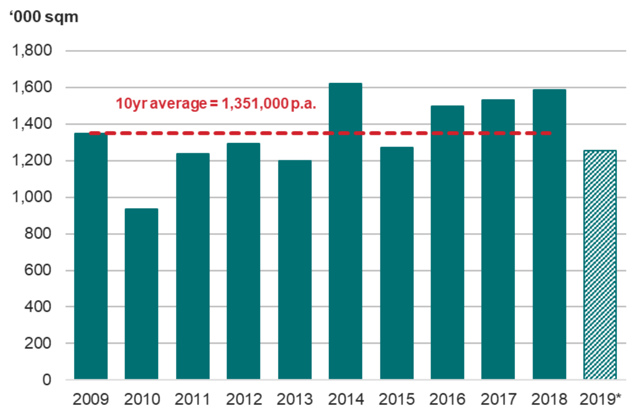

Source: JLL Research, Dexus Research

**Figure 14:** Land value growth flat over the quarter with a slight uptick in Outer West Sydney




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
*YTD

# Industrial

## Outer West Sydney

Take-up in Outer West Sydney is sitting at 271,000sqm on a rolling 12-month basis, just below the long-term average (Figure 16).

Supply completions were relatively subdued in Sydney over the quarter, with 44,500sqm recorded in the Outer West.

Land availability is limited in the short term. As such, rental growth is likely to remain strong with demand continuing to outpace supply of serviced land.

The largest lease deal of the quarter was TTI (Techtronic Industries) who leased a 15,600sqm speculatively developed distribution centre at Eastern Creek prior to completion.

## West Melbourne

Demand in West Melbourne is at all-time highs with 465,000sqm of take-up recorded over the last 12 months, 64% above the long-term average.

Market dynamics are expected to remain favourable in the short to medium term with limited land supply, structural tailwinds and a growing pool of labour and suppliers. Victorian economic growth is above the historical average.

During the quarter eStore pre-committed to the 26,000sqm warehouse located in Dexus' Foundation Estate with construction expected to be completed mid-2020. This deal is an example of how e-commerce occupiers are boosting total demand.

## Brisbane

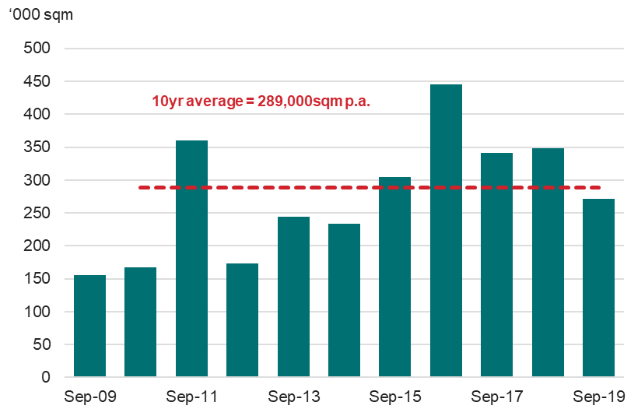
Take-up in the Australian Trade Coast (ATC) and Southern Brisbane was 469,000sqm, exceeding the 10-year annual average of 365,000sqm.

Southern rents remained unchanged over the quarter and the ATC recorded slight negative growth (0.7%). However, these movements are quite asset specific and not necessarily indicative of market movements. ATC rental growth remains positive on an annual basis.

The biggest deal of the quarter was Coles pre-leasing 65,000sqm within Goodman's Redbank facility, which is due for completion mid-2022.

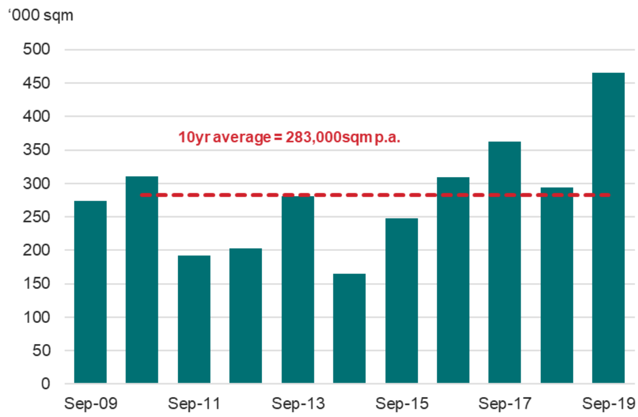
Changes to land tax legislation by the Queensland Government may have implications for investment volumes going forward. Developers remain reluctant to build speculatively without pre-commitments.

**Figure 16:** Outer West Sydney gross take-up



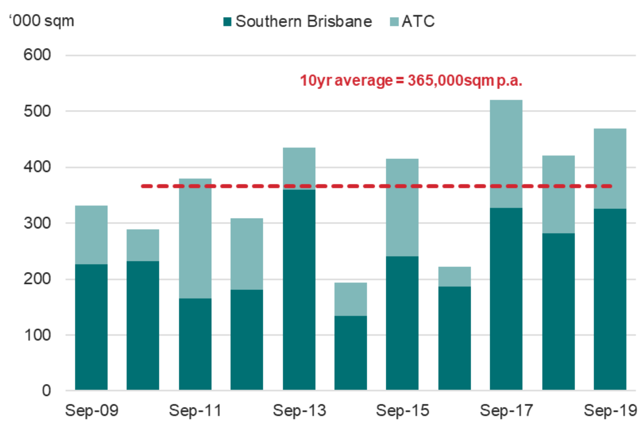

Source: JLL Research (gross take-up), Dexus Research.

**Figure 17:** West Melbourne gross take-up




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

**Figure 18:** South Brisbane and ATC gross take-up




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

## Retail

### Domestic retailers dominate online traffic

Australia's retail turnover growth was 2.9% per annum on a moving annual basis in the year to August 2019.

Expectations of stronger discretionary spending as a result of stimulatory tax rebates and ongoing cuts to mortgage rates have yet to materialise, with Australians growing more cautious about their economic futures. Whilst overall discretionary retail spending remained muted (particularly across Department Stores and Household Goods), there was an uptick in spending on clothing, footwear and accessories in August.

Looking forward, despite record low mortgage servicing costs, we expect retail turnover growth to remain muted until there is an increase in wages growth and a pickup in consumer sentiment. Saying this, a pickup in activity in the residential property market could have a positive effect on Household Goods retailing over the next couple of years. Although a renewal in new home construction is still at least 12 months away, greater transaction activity in freestanding houses with more renovations and alterations could lead to increased spending on Hardware & Garden retailing.

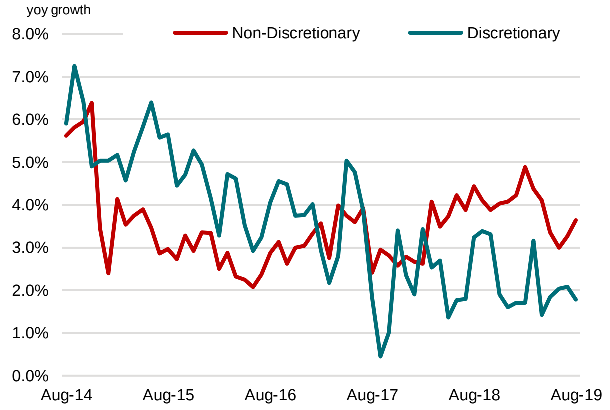
After negative growth in online retail sales in June and July, August saw a return to strong growth. This was attributed to domestic players including omnichannel retailers, which are growing significantly faster than their international competitors. Domestic retailers are becoming creative in adapting to the retail environment, with Bunnings launching its online marketplace, MarketLink, which offers more product than is available in its physical stores. Whilst deliveries of sausage sandwiches are still not on the cards, there is optimism that Bunnings' entry will have a positive effect on growth in total domestic retail turnover and the economy at large.

**Table 6. Q3 2019 retail snapshot**

| | Specialty rent growth % p.a. | Cap rate change from Q3 2019 | State retail sales growth % p.a. |
|---|---|---|---|
| **Sydney** | | | 1.6 |
| Regional | -0.09 | 0.25 | |
| Sub-regional | -0.02 | 0.50 | |
| Neighbourhood | -0.02 | 0.38 | |
| **Melbourne** | | | 4.5 |
| Regional | -0.03 | 0.13 | |
| Sub-regional | -1.74 | 0.13 | |
| Neighbourhood | 0.51 | 0.13 | |
| **SE QLD** | | | 4.3 |
| Regional | 0.22 | 0.25 | |
| Sub-regional | -3.55 | 0.00 | |
| Neighbourhood | 0.31 | 0.25 | |

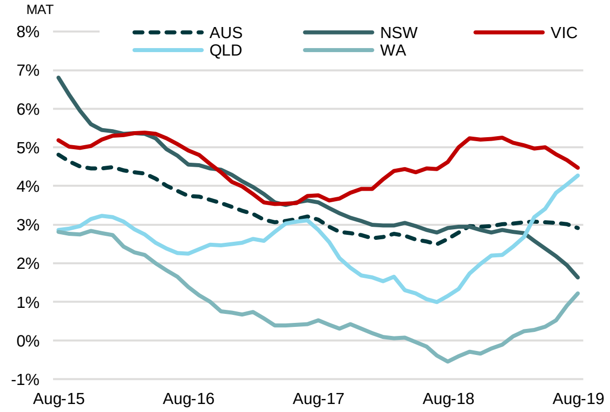
Source: JLL Research, ABS, Dexus Research

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



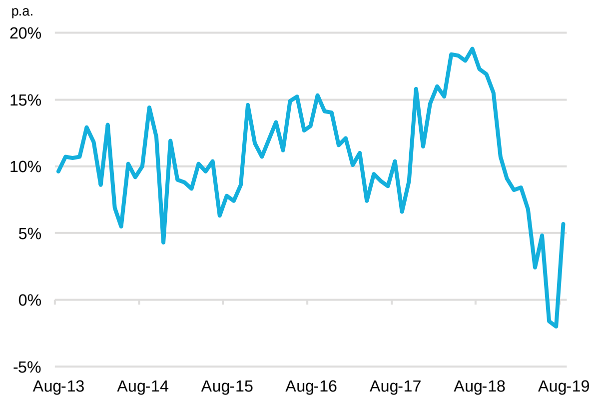

Source: ABS, Dexus Research

**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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