dexus

Australian Real Estate Quarterly Review

Q2 2020

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

Inside

Investment climate

Global and Australian slowdown likely

The COVID-19 crisis has generated significant uncertainty in relation to the economic outlook. As in other countries around the world, Australian economic growth is expected to slow with Deloitte forecasting a -5.2% contraction in GDP growth in 2020. However, the unprecedented nature of this event makes it hard to accurately predict the depth of the downturn and the timing of recovery.

The eventual rate of recovery will depend on infection rates and the speed with which social distancing measures and travel controls are relaxed. Infection rates now appear to be declining in Australia and many economists predict a recovery in growth in Q4 2020. Much will depend on the extent to which business closures and rising unemployment hinder confidence and consumption.

The outlook is improved by sizable fiscal stimulus packages amounting to 16.4% of GDP, designed to help businesses and workers. A reduction in the official cash rate to a record low of 0.25% by the Reserve Bank of Australia and an easing in the Australian dollar will provide further stimulus. Australia's ongoing infrastructure pipeline should also assist the growth outlook.

Real estate occupier markets are likely to feel the impacts of social distancing measures. A month into the crisis, an ABS survey shows that two-thirds of Australian businesses are experiencing reduced turnover. Small to medium businesses have been the hardest hit, with 41% of businesses with 20-199 employees temporarily reducing staff work hours.

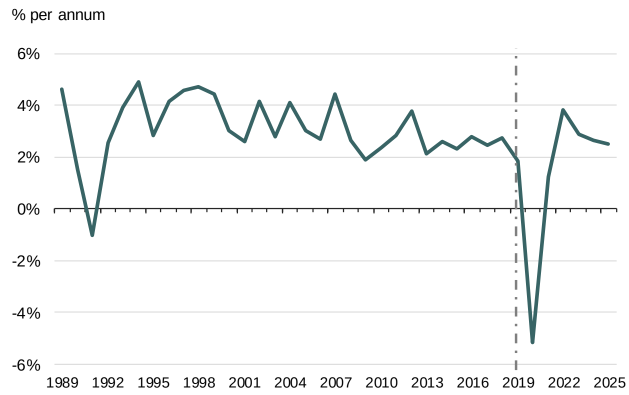
The outlook varies significantly between industries. Business stress is estimated to be highest in the socially interactive industries like retail trade, tourism and education. However, the outlook is significantly brighter for some other large industries such as professional services, mining, logistics and IT/telecommunications.

Table 1: Australian economic forecasts: Q1 2020

	Jun-20	Jun-21	Jun-22
Aus GDP (QoQ %)	-4.9%	1.8%	0.7%
Aus GDP (YoY %)	-3.7%	-0.7%	4.1%
Emp Gth (YoY %)	-6.4%	-0.3%	5.6%
Unemployment (%)	12.2%	8.1%	6.7%
Exports (YoY %)	-1.7%	1.0%	0.3%
Imports (YoY %)	1.5%	-0.3%	-0.4%
90 Day Rate (%)	0.3%	0.0%	0.4%
10yr Bond (%)	0.5%	0.5%	0.7%

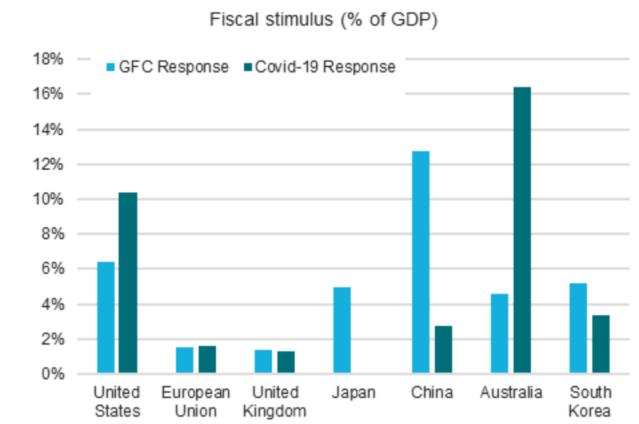
Source: Deloitte Access Economics base, Dexus adjusted forecasts

Figure 1: Australian GDP growth is forecast to slow over the next quarter or two, improving in 2021



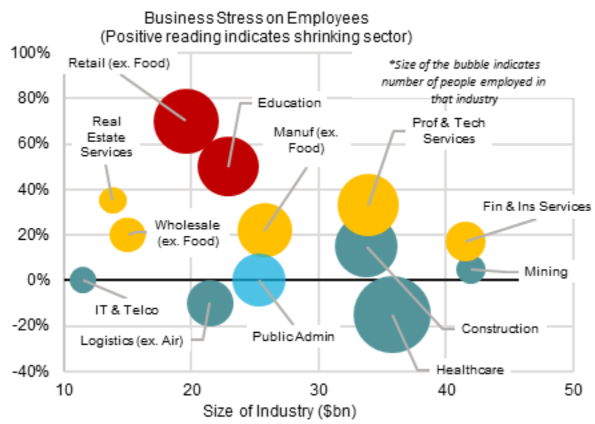
Source: DAE

Figure 2: Stimulus measures globally have been substantially higher than in previous crises



Source: Reuters; Bloomberg; Dexus Research; *Calculated in USD at year end: 2008 for GFC and 2019 for Covid-19; Fiscal Stimulus as at 30/03/20

Figure 3: Business stress is not spread evenly, with some large industries able to recover more quickly than others



Source: ABS; Dexus Research

Transactions

Transaction data yet to show an impact

Transaction volumes and cap rate data for Q1 2020 are unlikely to reflect much impact of the COVID-19 crisis. Social distancing and mobility restrictions imposed in March slowed the rate of property inspections and anecdotally led to some withdrawal from and renegotiation of deals. However, with most deals already exchanged, any slowing of transaction volumes will manifest in Q2 2020.

Transaction volumes across all sectors were down on Q4 2019, but about the same as the same quarter last year.

Industrial volumes were similar to Q1 2019 levels as a result of continued strong foreign demand and onshore private buyers competing for stock. For example, a domestic private buyer purchased the vacant possession of a 40,000sqm distribution facility in West Melbourne for $55m.

Retail transaction volumes were up mildly on Q1 2019 levels, with private domestic buyers the most active, capitalising on softening yields. A private investor acquired sub-regional asset Armadale Shopping City for $110m.

Office transaction volumes were down 18% on the same quarter last year. Foreign interest has been relatively strong with Deka Immobilien acquiring Central Plaza Two in the Brisbane CBD for $380m at a tight equivalent yield of 5.13%.

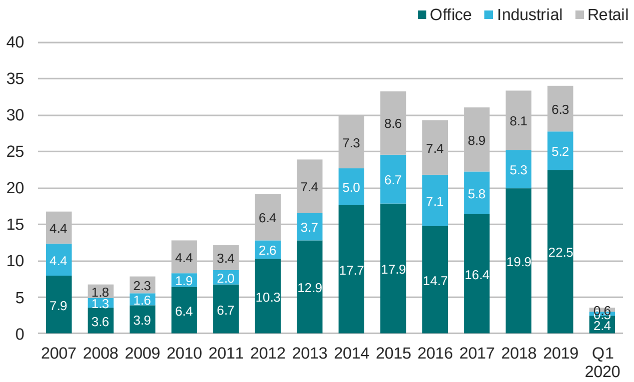
Cap rates in the Sydney office and central west industrial sectors flattened in Q1 2020 after rapid compression over the past year. They remain at historic lows of 4.88% and 4.50% respectively. According to JLL research, Sydney regional cap rates remained stable in the quarter with a rise in Sydney sub-regional assets by 25bps.

Table 2: Top transactions of Q1 2020

Price ($m)	Asset/portfolio	Buyer
440	Chevron HQ.	Invesco
380	Central Plaza Two	Deka Immobilien
328	200 Victoria Parade	ARA Asset Management/Quad-Real Property Group
270	59 Goulburn Street	Poly Group
160	100 Walker Street	Pro-invest Group
120	Tower 1, 475 Victoria Avenue	BlackRock
114	20 Berry Street	Holdmark Property Group
110	Armadale Shopping City	Nick DiMauro
102	East Sydney Private Hospital	Centennial Property Group

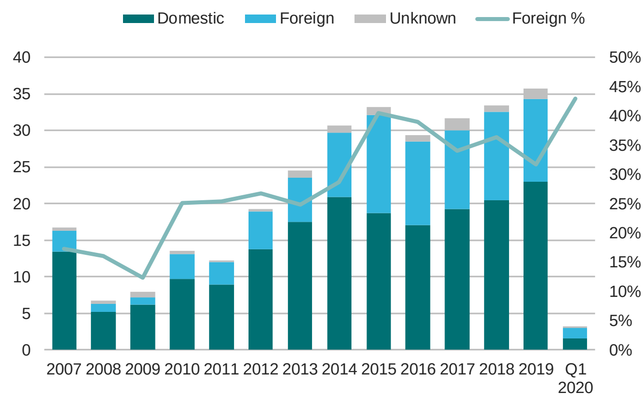
Source: Dexus Research Transaction Database, JLL

Figure 4: Transactions volumes in Q1 2020 were similar to levels for the same period last year



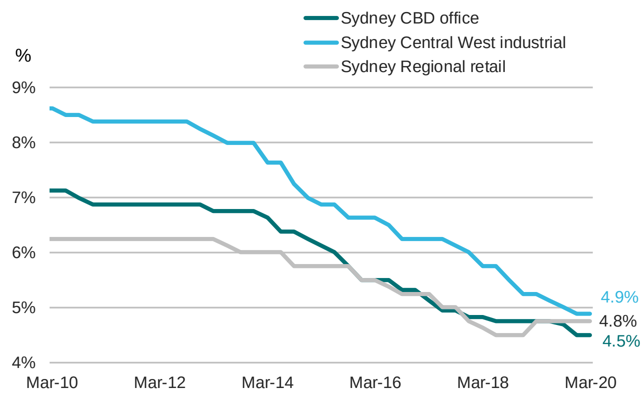
Source: JLL Research, Dexus Research Transaction Database

Figure 5: Levels of foreign investment continued to run solidly in early 2020



Source: JLL Research, Dexus Research

Figure 6: Office and industrial yields flatten, with retail rising



Source: JLL Research, Dexus Research

Performance

Flight to defensive assets and cash

Fixed interest investments, unlisted property and cash lead the performance table this quarter as investors adopted a more cautious stance.

After a solid run over the past five years the ASX200 A-REIT index turned down in March 2020 with a 39% decline in price as uncertainty about the impact of COVID-19 on tenancies and real estate markets weighed negatively on sentiment. Within the A-REIT sector, growth over the past five years was driven by the office and industrial sectors with retail A-REITs underperforming on the back of challenging retail trading conditions.

The 11-year bull market for 10 year bonds has continued, with falls in the official cash rate and quantitative easing contributing to a low bond yield of 0.76%. A divergence in the traditional relationship between A-REIT pricing and bond yields may indicate a degree of upside to A-REIT pricing once conditions improve.

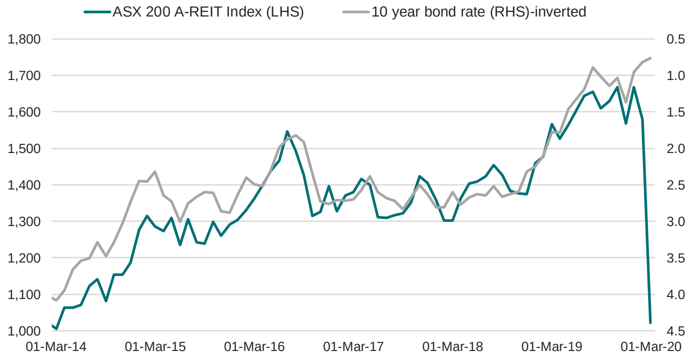
Unlisted returns were driven by the office (+11.7%pa) and industrial sectors (+12.5%pa). Industrial and office returns have been supported by capital growth generated by tightening yields and income growth. Retail funds continue to feel the squeeze on values of lower quality assets. Looking forward, the outlook for capital growth will be more subdued due to COVID-19 related risks on the income side.

Table 3. Index returns to February 2020

	Qtr.%	1 yr %p.a.	3 yr %p.a.	
Australian fixed interest	+3.0%	+6.8%	+5.7%	BACM0.Index
Unlisted property	+0.7%	+6.2%	9.8%	MSCI.Mercer.Aust. Unlisted Wholesale*
Australian cash	+0.3%	+1.2%	+1.7%	BAUBIL.Index
Australian shares	-23.1%	-14.4%	-0.6%	S&P/ASX.200. Accumulation Index
A-REITS	-34.4%	-31.7%	-5.1%	S&P/ASX.200.A-REIT. Accumulation Index

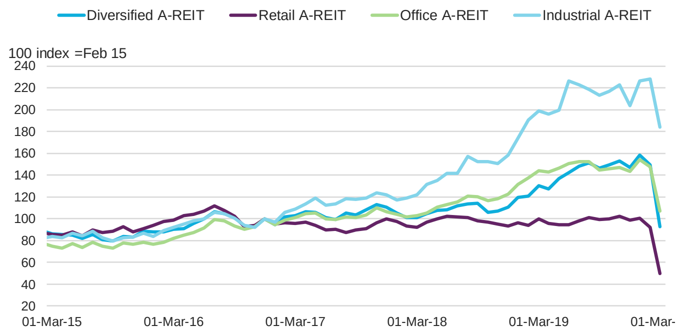
The indices are copyrighted by and proprietary to the relevant Source issuers: MSCI Mercer Aust. Core Wholesale Monthly PFI; Standard and Poor's Australian Securities Exchange Accumulation Index; Bloomberg/UBS Composite and Bank Bill Indices.
*NAV Pre-Fee

Figure 7: Uncertainty weighs on A-REIT pricing relative to bond pricing



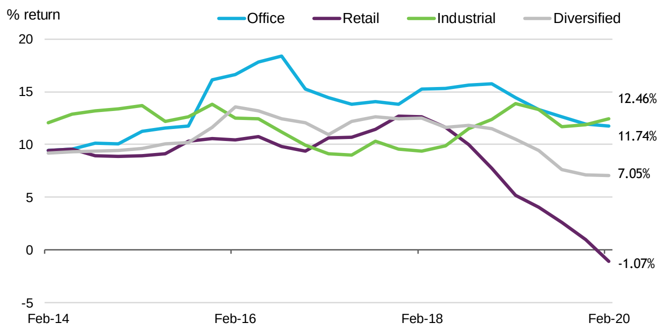
Source: IRESS, Dexus Research

Figure 8: Returns remain positive for industrial A-REITs



Source: UBS,Dexus Research

Figure 9: Listed office and industrial remain stable



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

Office

Indicators point to a more subdued outlook

Lead indicators point to a period of uncertainty in the office markets across Australia, with demand across the major CBD markets likely to be patchy in the short term. Business confidence fell to a record low in March. Similarly, growth in white collar job advertisements fell 8.2% nationally as falls on the East Coast more than offset gains in Perth, Canberra and Adelaide.

Office leasing enquiry levels have fallen and inspection rates have slowed as businesses exercise greater caution in decision making, particularly for small and medium enterprises (SMEs). If sustained, these trends will likely translate to more subdued demand from Q2 2020.

Sydney CBD and Melbourne CBD recorded below average net absorption in Q1 2020 at -59,800sqm and -8,200sqm respectively. In Sydney CBD, much of the movement was expected given planned consolidation and decentralisation by NSW Government departments.

Vacancy rates edged up in most office markets nationally in Q1 2020 with the exception of Melbourne CBD, where the total vacancy rate remained unchanged at just 3.4%. With below average vacancy rates, the Sydney and Melbourne office markets are well placed to weather a period of slower demand.

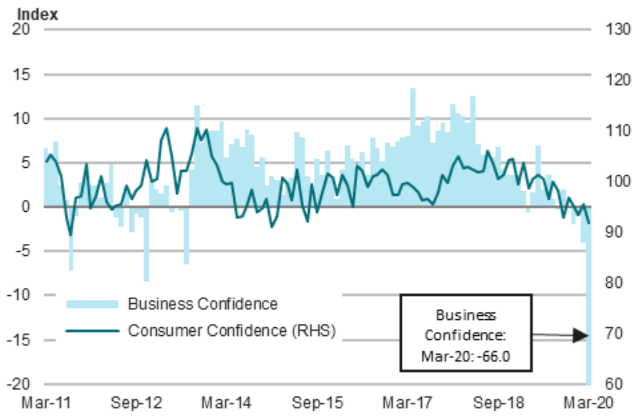
Positively for the office sector, businesses in Professional & Technical Services industry (traditionally a prominent occupier of office space) were the least likely to have been directly affected by COVID-19, with only 21% reporting negative impacts as a result of the virus according to a recent survey by the ABS.

Table 4. Q1 2020 office snapshot

	Vacancy %	Prime net eff. rent growth % p.a.	Net Increase % of stock to FY22*
Sydney CBD	5.8%	1.2%	3.5%
North Sydney	8.5%	6.0%	9.0%
Sydney Fringe	7.0%	-3.4%	-
Macquarie Park	8.3%	5.7%	17.6%
Parramatta	4.1%	6.1%	20.5%
SOP / Rhodes	18.7%	3.2%	-
Melbourne CBD	3.4%	8.7%	8.7%
Brisbane CBD	12.1%	6.0%	7.6%
Perth CBD	19.5%	2.9%	-0.5%

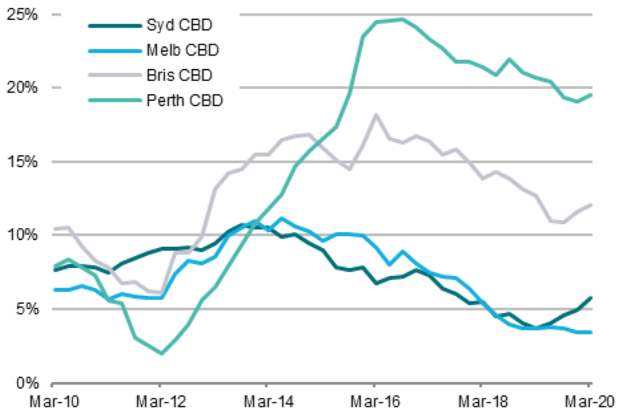
Source: JLL Research; *Projects under construction and plans approved

Figure 10. Business and consumer confidence fell sharply in March 2020



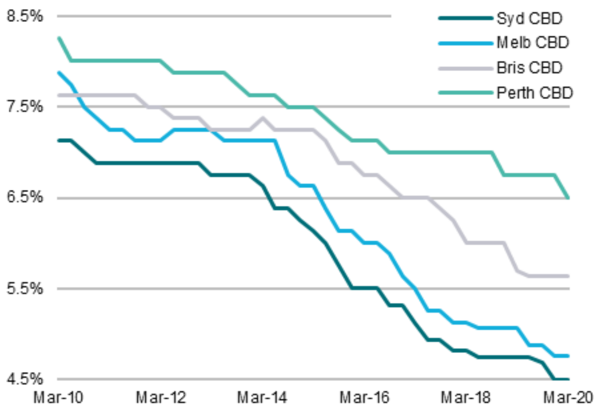
Source: JLL Research, Dexus Research.

Figure 11. Vacancy rates edged higher in most markets other than Melbourne



Source: JLL Research, Dexus Research

Figure 12. Office yields relatively stable in March with a mild compression for Perth



Source: JLL Research, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney	**Easing tenant enquiries and further decentralisation weighs on net absorption.** Vacancy rates rose 2.1% over the 12 months to March 2020 to 5.8%, though well below the 20-year average of 7.8%. Annual net absorption was recorded at -118,800sqm, which was largely due to relocations outside of the CBD and consolidation of space. The Sydney CBD recorded a 1.7% increase in net face rents in the March quarter, bringing the annual growth rate to 4.9%. Yields remained stable in Q1-2020 due to a lack of office transactions and growing caution by investors.	Vacancy ↑ Rents ↓ Incentives ↑ Yields →
North Sydney	**Rental growth remained a feature of the market.** After falling marginally last quarter, vacancy rates rose to 8.5%. Net absorption was recorded at 3,500sqm over the year to Q1 2020. Prime net face rents increased by 4.1% over the same annual period, with effective growth more pronounced at 6.0%. Prime yields compressed further, with the sale of prominent North Sydney assets 100 Walker Street and 20 Berry Street.	Vacancy ↑ Rents ↓ Incentives ↑ Yields →
Macquarie Park	**Annual net absorption in line with long-term trends.** Total annual net absorption was largely as a result of Transport NSW moving from multiple locations around Sydney to Macquarie Park. The total vacancy rate rose to 8.3%, as a result of the completion of The Glasshouse (45-61 Waterloo Road) which was not fully pre-committed. Net face rents grew by 6.5% over the 12 months to Q1 2020, though growth on an effective basis was more muted as a result of rising incentives. New supply in 2020 will likely place further pressure on vacancy rates in Macquarie Park.	Vacancy ↑ Rents → Incentives → Yields →
Parramatta	**Annual face rental growth highest nationally. The t**otal vacancy rate in Parramatta fell 1.3% in Q1 2020, due to the withdrawal of 11,000sqm of stock in the quarter. This helped to bring the secondary vacancy rate down to 3.7% from 12.0% last quarter. The vacancy rate will likely fall further with withdrawals associated with infrastructure projects planned over 2020. Low vacancy and a level of precommitment may help insulate the Parramatta market in the face of the COVID-19 crisis. Yields fell by 10 basis points in the March quarter to 5.5% after the 50% sale of the Octagon (110 George Street).	Vacancy ↓ Rents ↑ Incentives → Yields ↓
Melbourne	**Vacancy rates hold steady in Q1-20.** The Melbourne CBD recorded net absorption of -8,200sqm in Q1 2020, with a number of tenants contracting. After strong rental growth during 2019, the first quarter of 2020 saw rental growth plateau. Net face and effective rents grew by 0.9% and 0.5% respectively in the quarter. Whilst much of the new supply has been largely pre-committed, backfill space will likely put upward pressure on vacancy rates over the short term, particularly as tenant enquiries weakened as a result of the COVID-19 crisis. Prime investment yields held steady in Q1 2020.	Vacancy ↑ Rents → Incentives ↑ Yields →
Brisbane	**Contractions largely offset by expansions.** Annual net absorption has been above the long-term average, with expansions by a number of firms in the IT & Telecommunications industry. The vacancy rate increased 50 basis points in Q1 2020 to 12.1%. Despite elevated incentives, face rents recorded growth of 2.8% in the quarter. The outlook for rent growth is benign in the Brisbane CBD office market, with sticky incentives likely to be an ongoing feature of the market. Prime yields were flat at 5.6% in Q1 2020, although the sale of 66 Eagle Street represented the tightest equivalent yield recorded in the Brisbane CBD market (5.13%).	Vacancy ↑ Rents → Incentives → Yields →
Perth	**Government consolidation weighs on net absorption.** Vacancy rates rose to 19.5% in Q1 2020 as a result of the WA Government consolidating its operations, vacating 11,000sqm of CBD space. In a sign that the office market is continuing to recover, Perth CBD was one of only two office markets nationally to record growth in job advertisements for white-collar workers. With a muted supply pipeline, Perth is in a reasonable position to weather the COVID-19 crisis with potential for rent growth in the short to medium-term. Prime yields fell 30 basis points in Q1 2020, driven by Invesco's acquisition of a 50% stake in Brookfield's Chevron HQ.	Vacancy ↓ Rents ↑ Incentives ↓ Yields ↓
Canberra	**Largest quarterly drop in vacancy rates nationally.** Expansion by the ABS led to the largest net absorption figure recorded in nearly two years. Expectations of increased requirements by the Commonwealth of Australia in the short term, will likely flow through to additional office demand. Positive net absorption of 22,300sqm in Q1 2020 was also driven by a number of expansions by non-government tenants.	Vacancy → Rents ↑ Incentives →

Industrial

Market underpinned by essential spending

Leasing activity was quite robust in the first quarter across the eastern seaboard markets, however uncertainty about the short term economic outlook saw enquiry levels slow sharply towards the end of March as businesses deferred decision making.

Apart from Brisbane where demand was broad based in the first quarter, leasing activity in the other major cities were dominated by three main groups – transport and logistics companies, online retailers, and physical retailers. This activity pre-dated the COVID-19 crisis and reflected structural changes in the supply chain and retail model already underway before the lockdown.

While the outlook for demand is looking more subdued, there are pockets of strength, such as firms in the essential goods, pharmaceutical supplies, medical equipment and online retail sectors which were all seeking additional warehouse space at the end of March. Ecommerce sales in non-discretionary categories also benefited. A sharp rise in grocery sales caused by social distancing rules and hoarding saw some of the supermarkets seeking temporary space in an environment where vacancies were low after a buoyant three years.

Rent growth was recorded in some regions of Sydney, and in Brisbane's Trade Coast in Q1 2020. However, the lull in enquiry points to pockets of weakness in rent ahead. There have been reports of requests for rent relief under the Commercial Tenancy Code of Conduct.

After significant falls in 2019, cap rates were stable this quarter in line with the general uncertainty.

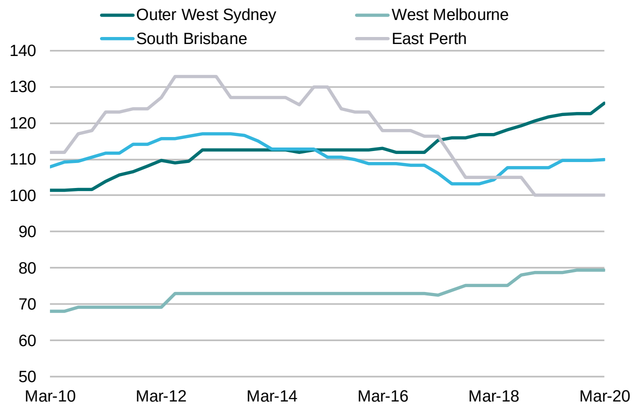
Industrial property markets are expected to be relatively resilient given market vacancy is relatively low and the risk of over-supply will be mitigated by the responsiveness of supply to adjusting levels of demand. The long- term growth drivers for the Australian industrial market remain intact with continued expansion in ecommerce and infrastructure investment.

Table 5. Q1 2020 industrial snapshot

	Ave prime cap rate change from Q4 2019	Existing prime net face rental growth % p.a.
Outer West Sydney	No change	3.1%
Southern Brisbane	No change	2.1%
East Perth	No change	0.0%
South Sydney	No change	4.1%
West Melbourne	No change	0.0%

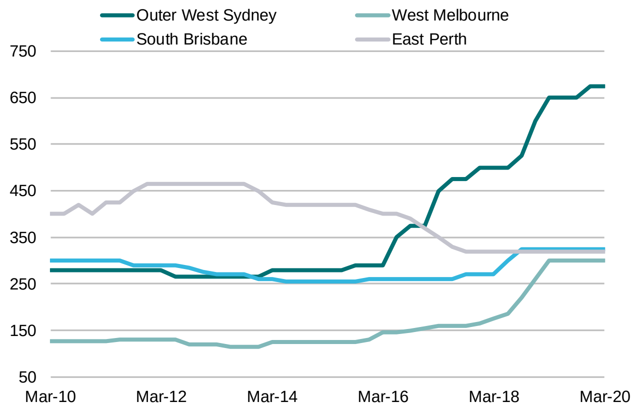
Source: JLL Research, Dexus Research

Figure 9: Prime rents continue to grow mildly in the east coast markets



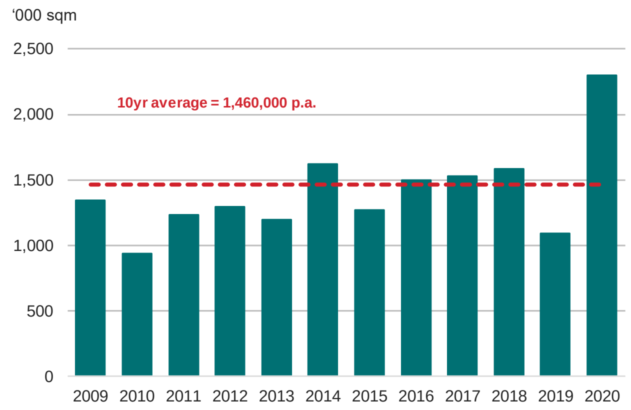
Source: JLL Research, Dexus Research

Figure 10: Land value growth flat over the quarter with a slight uptick in Outer West Sydney



Source: JLL Research, Dexus Research

Figure 11: Industrial supply will rise across the Australian capital cities this year



Source: JLL Research, Dexus Research

Industrial by region

Outer West Sydney

Low vacancies and modest availability of serviced land have been an issue in this region for a while, limiting take-up and construction levels last year.

Positively activity rose in the March quarter, JLL Research reported over 60,000sqm of leasing and pre-commitment activity, a rise of almost 50% on Q1 2019 activity levels. Activity was predominantly being driven by online retailers, manufacturers and transport companies, as well as the relocation of tenants from inner city urban renewal areas.

The recent lift in demand caused rents to rise around 2.5% in the quarter for both prime and secondary space according to JLL Research. Pre-lease rents rose even more, up almost 4%.

As per the national trend, enquiries slowed sharply in March.

West Melbourne

This region has experienced above average take-up levels in the past 12 months, and continued the trend in Q1 with almost 170,000sqm of leases and pre-commitments recorded by JLL Research.

The lift in leasing activity has lessened the risk of excessive vacancies caused by speculative development, which at times were accounting for almost half of the space under construction in 2019. There is now almost 430,000sqm under construction according to JLL, of which almost 80% is committed. The high supply in West Melbourne at least partly compensates for below average supply in the South East.

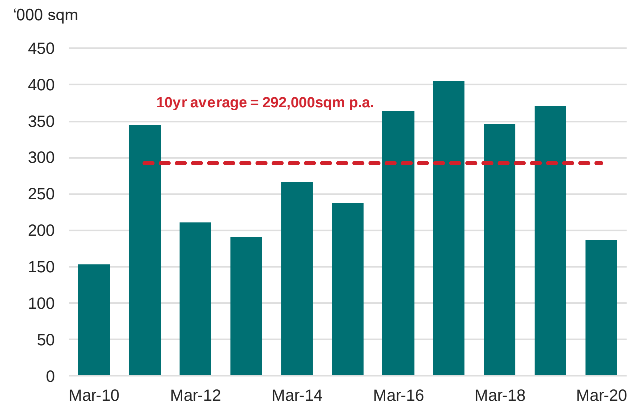
Brisbane

The Australian Trade Coast (ATC) and South Brisbane recorded above average levels of tenant demand in Q1 2020 despite a slow March. Demand was broad based and consistent with an improving Queensland economy.

Looking forward however, there are signs of weaker momentum ahead as all states cope with delays to decision-making caused by the crisis. Construction is strong with over 400,000sqm underway, but less than half has been pre-leased. This suggests vacancies may rise with some risk to rent growth.

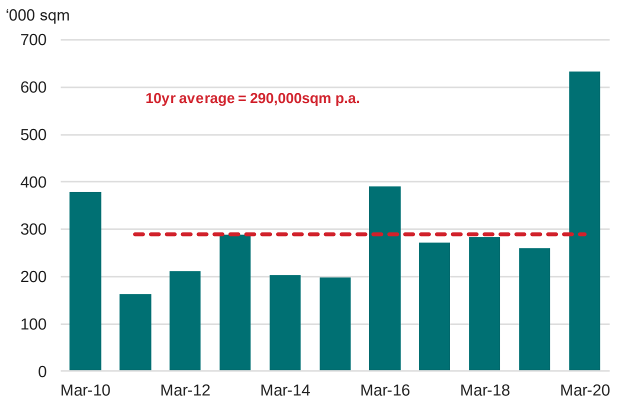
The ATC saw rent and land value growth in Q1 2020 according to JLL Research, but the southern industrial areas have been stable.

Figure 12: Outer West Sydney gross take-up



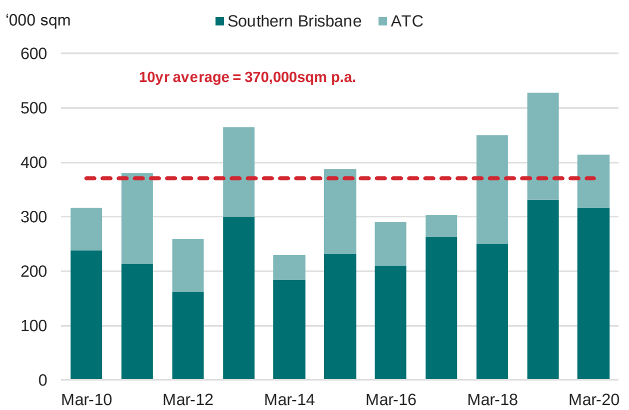
Source: JLL Research (gross take-up), Dexus Research.

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

Retail sector faces significant adjustment

Retail turnover grew by 2.5% over the year to February 2020. ABS retail sales data paints a picture of steady food and non-discretionary spending, but patchy discretionary sales growth. This trend widened in March as consumer behavior shifted as the COVID-19 took hold.

The retail sector is at the forefront of measures taken to control COVID-19 in Australia with social isolation, restrictions on non-essential retailing and reduced tourist flows impacting trade. However, essential services retailers like supermarkets, fresh food, medical services, pharmacies and liquor are all experiencing strong sales growth as people advance-buy. With their greater reliance on discretionary spending, larger centres are being impacted more than smaller convenience based centres.

Sales growth for discretionary categories has weakened sharply over the past month. Foot traffic has declined following government trading restrictions on discretionary retailers. Positively, there are early signs consumers are getting bored in the home and are starting to increase their discretionary spending online, with the major retailers reporting significant online sales growth in early April.

A number of retailers are requesting rental assistance, particularly in discretionary categories like apparel, jewellery, cafes, restaurants, and non-essential services.

Longer term it is likely that the current situation will increase the adoption of online retail. We note that majority of online sales are by retailers that also have a physical presence.

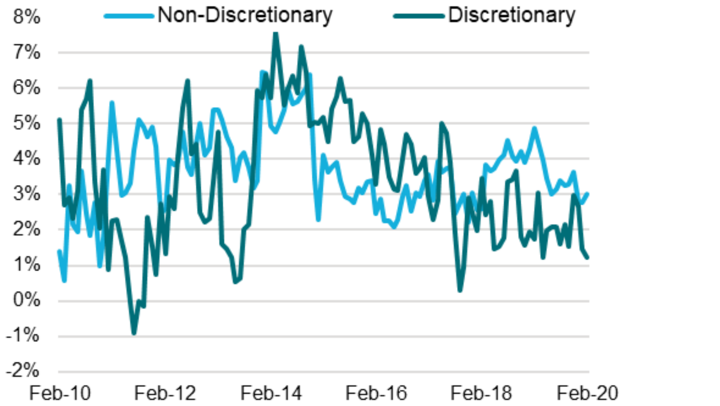
There is a wide gap in capital return between the best and worst centres as shown by the MSCI data in Figure 21.

Table 6. Q1 2020 retail snapshot

	Specialty rent growth % p.a.	Cap rate change from Q4 2019	State retail sales growth % p.a.
Sydney			0.8
Regional	-1.0	No change	
Sub-regional	-1.4	+0.25	
Neighbourhood	-1.1	No change	
Melbourne			3.1
Regional	-1.0	No change	
Sub-regional	-5.1	No change	
Neighbourhood	-0.9	No change	
SE QLD			4.9
Regional	-1.2	No change	
Sub-regional	-6.7	No change	
Neighbourhood	0	No change	

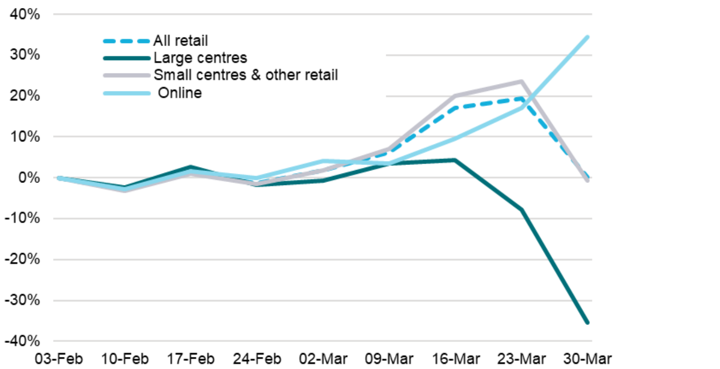
Source: JLL Research, ABS, Dexus Research

Figure 19. Discretionary spending growth has been decelerating since 2015 and will be further impacted by COVID-19



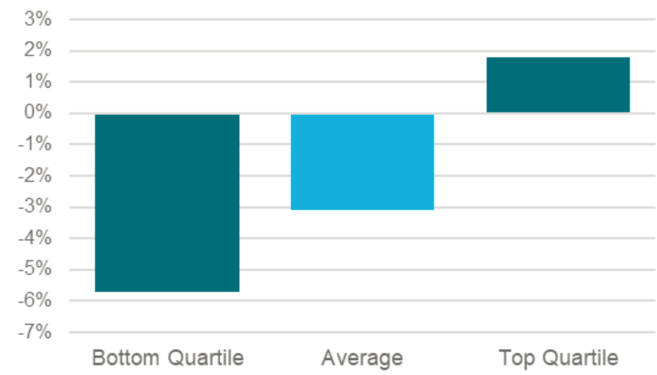
Source: ABS, Dexus Research

Figure 20. National total retail spend index, by channel (retail wallet only) during the COVID-19 crisis – February/March 2020



Source: Quantium. Analysis based on electronic spend (not incl. cash or buy now pay later), Week ending on date indicated. I.e. 03-Feb includes spending from 6 preceding days. Dexus Research

Figure 21. Widening spread in performance between the best and worst centres – capital return trends over the past year



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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