Australian Real Estate Quarterly Review

Corporate trends shaping take-up of office space

Q4/2016

DEXUS
PROPERTY GROUP

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Investment climate

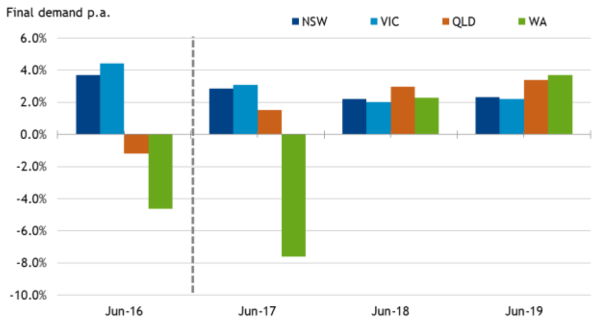
Growth outlook remains divergent

A concentration of growth in the NSW and VIC economies and in service industries will continue to support occupier demand and outperformance in the Sydney and Melbourne property markets in FY17.

Key assumptions affecting the near-term outlook include:

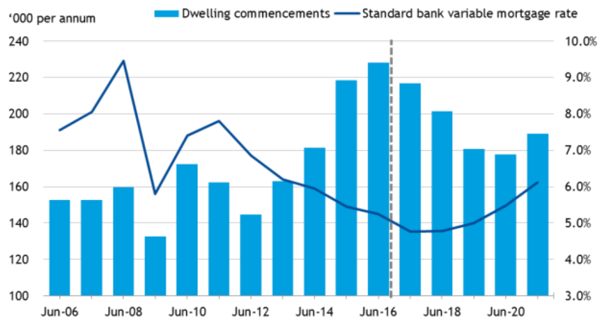
- NSW and Victoria will solidly outperform other states based on population growth and infrastructure spending (Figure 1). QLD is forecast to improve, while WA will continue to lag
- Official cash rate to remain unchanged over the next 6 months with a bias to move lower in 2017
- Residential construction activity is expected to slow and could be a key risk to growth (FY18-FY19) if it slows more sharply than forecast (Figure 2)
- Employment growth is positive, but the rate of growth is slowing with a continued shift from full time to part time jobs
- Service sector activity (such as education, health, IT, tourism and business) will remain a growth driver for the economy. Growth will be higher for small to medium businesses than large businesses
- The property markets of Sydney and Melbourne are forecast to show positive occupier demand over the next 12 months with mixed demand elsewhere
- Bond yields are expected to stablise at/near current levels and rise at a slower rate than in the US over the medium term, staying low by historical standards
- Property yields are expected to remain at low levels for a considerable time unless there is an external shock or disruption to capital flows

Figure 1. NSW and VIC lead the other states



Source: Deloitte Access Economics (DAE)

Figure 2. Dwelling commencements



Source: Deloitte Access Economics (DAE)

Table 1. Australian economic forecasts: Q3 2016

	Jun-16	Jun-17	Jun-18
Real GDP %pa	3.3%	2.6%	2.9%
Final demand %pa	1.2%	0.7%	2.4%
Employment %pa	1.9%	1.3%	1.4%
Imports %pa	-0.2%	1.9%	2.3%
Retail sales %pa (real)	1.9%	2.2%	3.2%
CPI %pa	1.0%	2.2%	2.2%
90 Day bill %	1.8%	1.4%	1.6%
10yr Bond %	2.0%	2.0%	2.2%
AUD/USD	0.74	0.75	0.72

Source: Deloitte Access Economics (DAE)

Corporate trends

Shaping take-up of office space

Office demand is being shaped by trends driving growth in Australia's service sector industries as well as changes in the way corporate tenants operate. The net result has been positive demand for office space, particularly from small users.

Background

There has been much focus over the years on how corporate tenants have been able to work more efficiently. But despite these trends office demand continues to grow. To understand why, it is important to consider how the operating environment is impacting the patterns of leasing demand by corporate tenants.

The impact of service sector growth

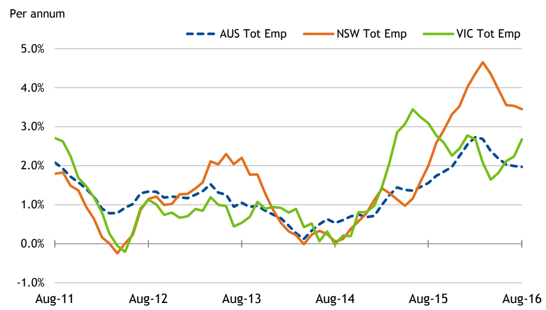
Service industries are growing rapidly in Australia helped by rising living standards and by exports of services like education, finance and tourism. The relatively strong growth of service industries compared with mining and manufacturing has created a two speed economy in Australia, with growth in NSW and Victoria far outstripping the rest of the country (Figure 3). Employment growth in NSW is double the long term average.

Figure 4 shows that the five industries forecast to grow the fastest over the next five years are all in the service sector. They include big office space users such as professional services, property services, education and other services.

Lease enquiry data for the past year shows significant inquiry from the education, health and construction industries. Enquiry has been supplemented by what is effectively a mini-boom in the IT sector.

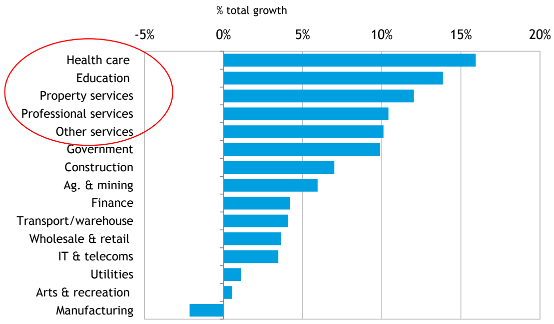
The big strategic theme is that office markets on the east coast of Australia should continue to do well in the short term. The effect of these big trends can be seen in almost every metric for Sydney and Melbourne including falling vacancy rates, rising rents and strong total returns.

Figure 3. Jobs growth in NSW and Victoria



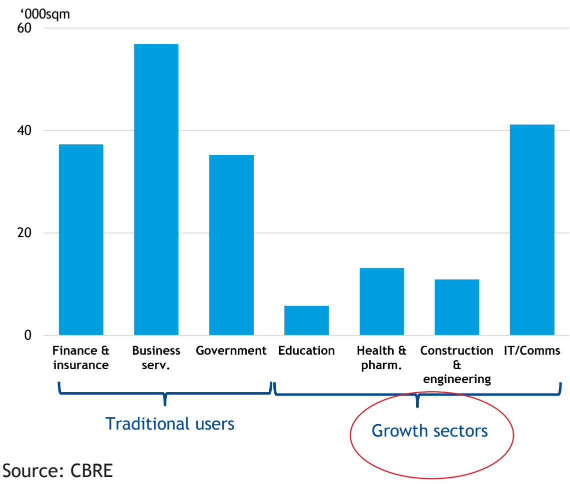
Source: Deloitte Access Economics (DAE)

Figure 4. Fastest growing industries - next 5 years



Source: Deloitte Access Economics (DAE)

Figure 5. Leasing enquiry by growth industries



Source: CBRE

The impact of corporate workplace trends

Corporate tenants are in a climate of rapid change which is transforming their space needs. Technology is enabling employees to work from a range of locations, yet demand for office space has been positive. We explore 'Why?'

Office markets are slow to experience change in work practices. Only 15-20% of leases expire in a given year to trigger a change of space use, and only a minority move to new space. Of these, not all occupiers adopt the same level of flexible working. Figure 7 confirms that large occupiers are much more likely to contract at the end of their lease than small occupiers. However, more expand at the end of their lease than contract.

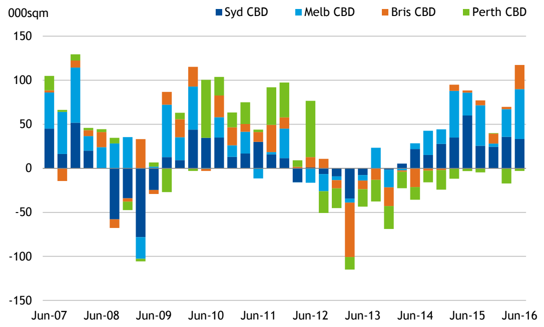
Growth in small space users is a significant trend that is evidenced in the numbers. Large companies are outsourcing functions to small companies. More than 70% of the net take-up in Sydney and Melbourne last year was from tenants seeking areas smaller than 1,000 square metres (Figure 8). Growth in the IT sector is boosting demand from small 'start-ups'. DEXUS has captured demand from small space occupiers through its 'small suites' strategy.

The rate of growth in part time jobs is about double that of full time jobs. More of the workforce is working independently or as subcontractors. As a result, we are seeing rapid expansion in serviced offices. According to Knight Frank there are 100 co-working offices in the Melbourne CBD and the number is growing rapidly.

At the same time companies are incorporating more meeting and collaborative space as they seek greater collaboration between staff and with other companies around them. Companies that cannot risk investing in under-utilised meeting space are increasingly accessing shared facilities.

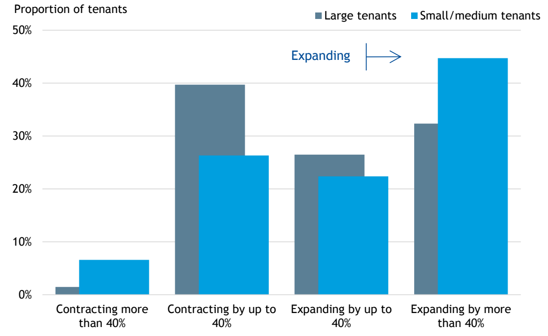
In summary, the big trends which are influencing space decisions for larger occupiers are also leading to rapid growth in other parts of the leasing market and contributing to continued positive demand for office space.

Figure 6. Rising CBD office demand



Source: RBA, DEXUS Research

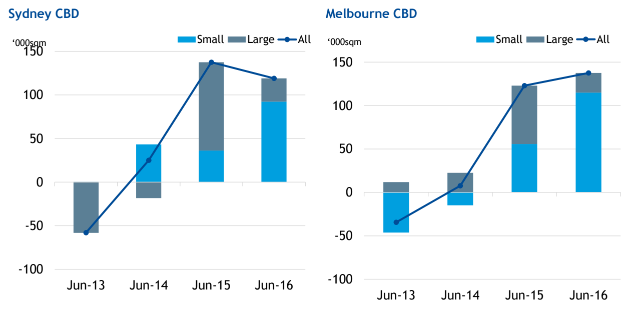
Figure 7. Expansion/contraction at end of lease



Note: Excludes consolidations from multiple tenancies

Source: Bloomberg, DEXUS Research

Figure 8. Increasing net take-up by small tenants



Source: Bloomberg, DEXUS Research

Transactions

Volumes are on an easing trend

Transaction volumes rose in the September quarter, however they were well below the same period last year. Foreign investors were active, comprising 47% of activity.

Total transaction volumes for the September quarter increased to $7.2 billion, partially due to the industrial portfolio sale from Goodman to Blackstone, however volumes were down on the prior year due to a lack of prime assets for sale.

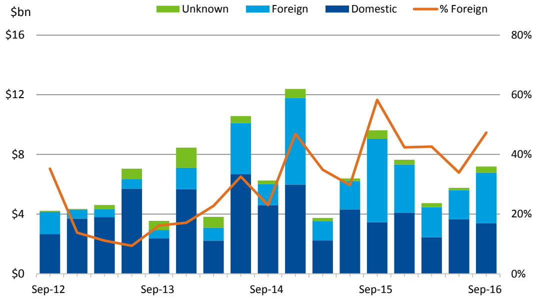
Major sales included the David Jones Market Street Store for $360 million, with CBus Super and Scentre Group each acquiring a 50% share. An ARA managed fund purchased the Southgate Complex in Melbourne ($439 million at 6.5% yield and reported IRR of 7.5%). Charter Hall Prime Retail Fund purchased the sub-regional centre, Campbelltown Mall for $197 million on a yield of 6%.

With limited core CBD assets available for sale, there were a number of office assets purchased in metropolitan or fringe locations e.g. Toorak Road, Hawthorn, New South Head Road, Edgecliff and Coward Street, Mascot.

Foreign investment activity increased this quarter, comprising the majority of larger acquisitions in the office and industrial sectors. Domestically, Privates and A-REITS were the most active, with A-REIT activity largely concentrated in the retail sector including SCA acquiring a number of centres.

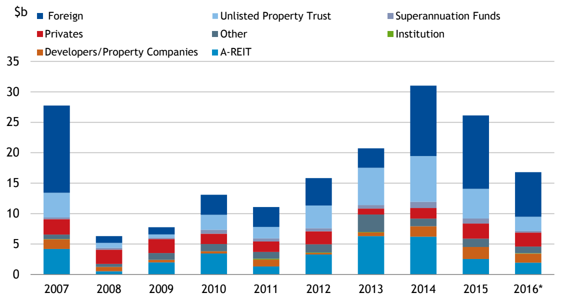
Investment yields continued to tighten over the past six months with prime assets in the Sydney and Melbourne CBDs trading below 5.5%, while Brisbane and Perth assets trading slightly higher. Values continue to firm in most sectors and markets.

Figure 9. Transaction volumes - quarterly



Source: JLL Research, DEXUS Research Transaction Database

Figure 10. Gross transaction volume by buyer type



Source: JLL Research, DEXUS Research* Includes portfolio sales.
*YTD

Table 2. Q3 2016 Top transactions

Price ($m)	Asset/portfolio	Buyer
640.0	Goodman Industrial Portfolio	Blackstone
439.0	40-60 City Rd, Southbank	ARA Asset Management
360.0	David Jones, Market St, Sydney	CBus/Scentre
286.0	Twenty8 Freshwater Place, Southbank	GWOF/Frasers
197.0	Campbelltown Mall, NSW	CHPRF
194.2	40 City Rd, Southbank	ARA Asset Management
174.4	Denison Diversified Property Fund	Propertylink (PEP)
170.0	114 William St, Melbourne	N/A
160.0	210 & 220 George St, Sydney	Poly Group
157.0	380 La Trobe Street, Melbourne	Wharf Investments

Source: DEXUS Research Transaction Database, JLL Research

Performance

Property returns appear to taper

The equity market was a strong performer in the September quarter. The A-REIT sector, while producing a solid return on an annual basis, eased in the quarter, driven by a sell off in bonds. Unlisted returns also tapered.

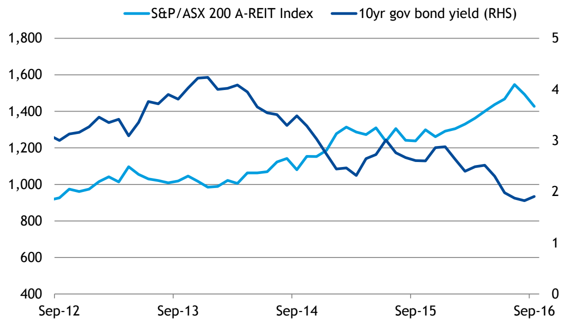
The equity market returned 5.1% for the September quarter. While performance was strong, over the next few months the sector faces potential volatility created by global conditions including a possible increase in US interest rates and the US Election.

The A-REIT sector has outperformed on an annual and three year basis delivering 20.8% and 17.7% respectively. However, the recent sell-off in bonds has caused yields to rise on a range of other defensive assets including A-REITs, leading to a price correction. The sector has been trading at a high premium to NTA, which may have contributed to investors being sensitive to pricing metrics.

Unlisted property returns have benefited from strong capital gains over the past 18 months, however returns eased in August as the rate of capital gain tapered. Moving forward, the office sector seems likely to outperform the other sectors given the prospect of growth in some markets.

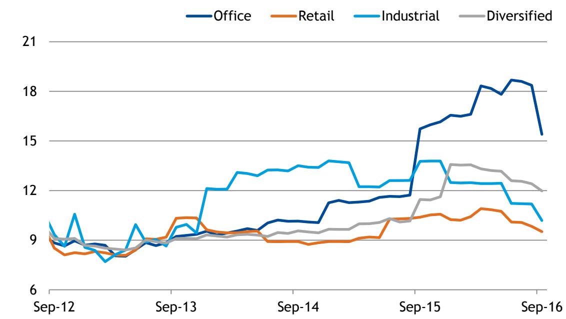
Returns on fixed interest investments fell to 5.7% for the year to September 2016 as bond yields increased. While consensus projections are for relatively slow and modest rises in Australian bond yields over the next three years, asset pricing is such that markets can be expected to react with volatility to any news that appears to signal a lift in bond yields.

Figure 11. A-REIT vs Bond returns



Source: RBA, Bloomberg, DEXUS Research

Figure 12. Unlisted property returns by sector



Source: Mercer/IPD, DEXUS Research, NAV pre fee

Table 3. Index returns to 30 September 2016

	Qtr. %	1 yr %p.a.	3 yr %p.a.	
A-REITs	-1.9	20.8	17.7	S&P/ASX 200 Property Accumulation Index
Australian shares	5.1	13.2	6.0	S&P/ASX 200 Accumulation
Unlisted property	2.7	12.2	11.3	Mercer/IPD Aust. Pooled Fund Index*
Australian fixed interest	0.9	5.7	6.2	BACM0 Index
Australian cash	0.5	2.2	2.4	BAUBIL Index

*NAV Pre-fee

Office markets

East coast markets performing strongly

Strong occupier demand across the east coast office markets and the expectation of tightening vacancy is leading to a surge in rents in a number of locations. This is consistent with our long-held view of east coast office markets outperforming in FY17.

Occupier demand continues to track in line with our expectations. Occupier demand in Sydney and Melbourne is strong. Brisbane demand is positive but subdued, while Perth experienced another negative quarter.

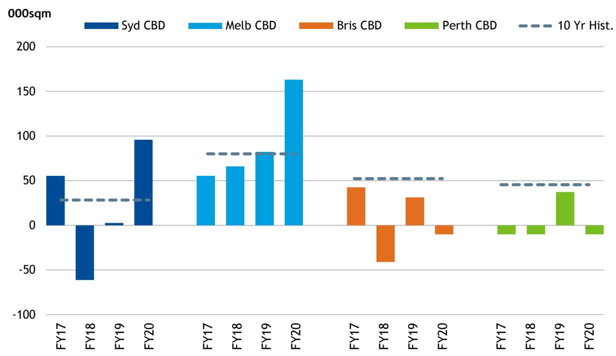
Lead indicators for demand remain positive, pointing to further absorption of space in the year ahead. Positive business conditions and confidence, and recent gains in equity markets, bode well for future office demand. Employment growth in NSW and VIC is positive, and the ANZ job ads series, although slowing to +3.7% in annual growth, remains positive, pointing to further job growth albeit at a more moderate pace.

On the supply side, most markets are now close to, or have passed, the peak of this supply cycle. A constrained supply pipeline, combined with an increase in withdrawals, is expected to lead to a tightening in vacancy for Sydney and Melbourne over the next three years.

As foreshadowed in previous editions of the Australian Real Estate Quarterly Review, with expectations of tightening vacancy, rents have surged across the east coast markets. Sydney is particularly strong. Prime and secondary net effective rents have risen +19.7% p.a. and +37.4% p.a. as incentives dropped -4.2ppts (prime) and -6.7ppts (secondary). Similarly, Melbourne recorded above trend growth with prime net effective rents rising +7.1% p.a.

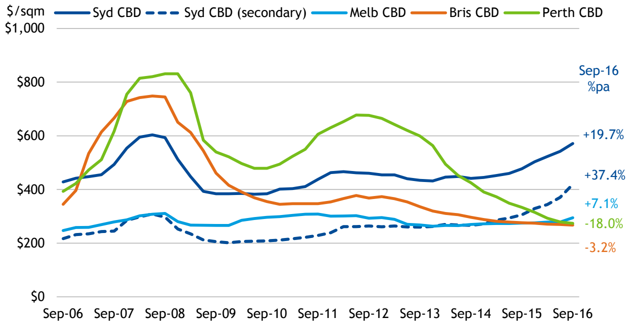
Overall our outlook remains unchanged. We expect Sydney and Melbourne to continue to outperform with vacancy falling below 4% (Sydney) and 6.5% (Melbourne) by FY19, and a significant uplift in rents to continue. Brisbane is forecast to improve over FY17 and FY18, with Perth remaining weak.

Figure 13. Projected net supply by market



Source: JLL Research, DEXUS Research

Figure 14. Prime net effective rents ($/sqm)



Source: JLL Research, DEXUS Research

Table 4. Q3 2016 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth % p.a.
Parramatta	4.3	1.0	3.6
Sydney	7.2	8.0	19.7
North Sydney	8.6	7.9	9.6
Melbourne	8.9	5.3	7.1
Macquarie Park	9.0	3.2	7.5
Canberra	13.0	2.1	3.6
Adelaide	16.1	0.3	-4.1
Brisbane	16.3	0.6	-3.2
Perth	24.7	-3.2	-18.0

Source: JLL Research, DEXUS Research

Industrial markets

Supply chain efficiencies driving demand

Large retailers and transport and logistics occupiers are supporting industrial demand, taking advantage of the competitive pre-commitment market to improve and consolidate their supply chains.

Occupier demand varies widely between states with Sydney and Melbourne solid, Brisbane improving and Perth remaining weak.

The manufacture of core stock is a primary focus for many institutions, particularly in Sydney and Melbourne, due to the solid pre-lease demand in these markets and the strong values that can be achieved for fully leased buildings.

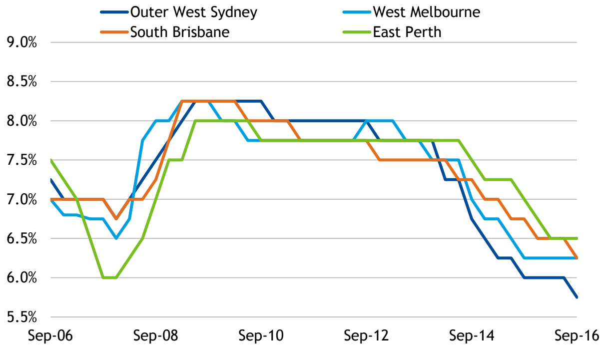
The industrial supply pipeline will be solid in 2016, in line with the 10 year average, however 2017 is likely to be more subdued following a reduction in planned projects in Brisbane and Perth.

Consequently, rents are likely to remain relatively subdued and stable in the short term as the pre-commitment market remains competitive. Land constrained markets are the best placed for rental growth in the future.

The key themes for this quarter include:

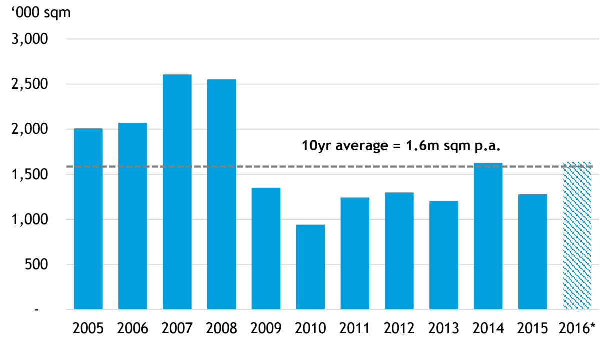
- Demand for assets with a long WALE remains strong, however prime investment stock is limited as owners hold income producing properties
- The closure of the Ford plants in Geelong and Broadmeadows (VIC) could result in these large industrial sites being released to the market in the coming years after site remediation. Holden and Toyota are expected to close in 2017
- The privatisation of Australian ports has continued with The Port of Melbourne sold on a 50 year lease to Lonsdale Consortium (consisting of QIC, Future Fund and Global Infrastructure Partners) for $9.7bn

Figure 15. Upper prime industrial cap rates



Source: JLL Research, DEXUS Research

Figure 16. Capital city industrial supply pipeline



*2016 is projected supply
Source: JLL Research, DEXUS Research.

Table 5. Q3 2016 industrial snapshot

	Ave prime cap rate change from Q3 2015	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.38	-0.4
Southern Brisbane	-0.50	-1.4
East Perth	-0.50	-4.1
South Sydney	-0.50	5.8
West Melbourne	-0.13	0.0

Source: JLL Research, DEXUS Research

Retail

Experience-based retailing to drive growth

Retail sales growth has eased further at the expense of traditional major anchor tenants. Consumers continue to limit spending on traditional retail goods in favour of retail services and dining/entertainment experiences.

Retail turnover growth eased to 2.6% for the year to August 2016. NSW and VIC continue to lead other states but QLD has been improving, having now recorded four consecutive months of increased growth. WA is weak with mildly negative growth over the year.

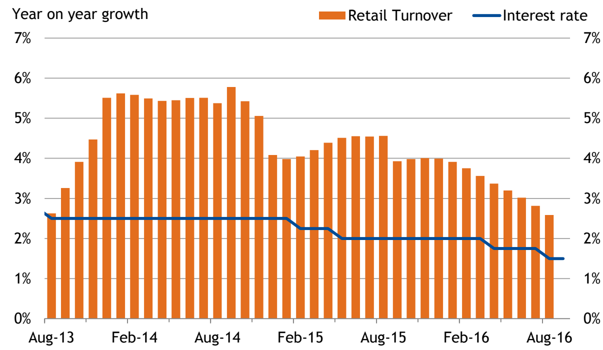
At a category level, 'clothing, footwear and accessories' and 'cafés, restaurants and takeaway' are currently the best performers. 'Household goods' growth has eased and 'department store' sales are contracting.

There is significant development activity particularly in regional centres, as owners seek to expand their entertainment/leisure precincts to cater to new consumer preferences. The evolution of shopping centres is continuing to shift the balance from traditional anchor tenants, e.g. department stores to mini-majors/specialties.

Key themes this quarter include:

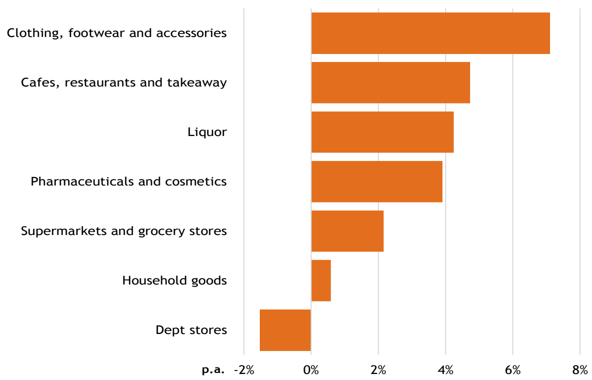
- Consumer confidence has remained steady in the last few months
- Several retailers have announced expansion plans including Costco, Harris Scarfe (13 stores with a focus on NSW) and David Jones' high-end food offer (commencing with Market Street, Sydney)
- The UK department store Debenhams has announced their first Australian store will be at St Collins Lane, Melbourne in September 2017
- Consolidation of major retailers is increasing with JB Hi-Fi acquiring The Good Guys, Home Consortium purchasing Masters and Steinhoff's planned takeover of Fantastic Holdings
- As part of its restructure, Woolworths has announced a review of existing and planned stores, with 30 stores targeted for closure

Figure 20. Retail sales growth and cash rate



Source: ABS, RBA, DEXUS Research

Figure 21. Retail growth by category (YOY)



Source: ABS (August 2016), DEXUS Research

Table 6. Q3 2016 retail snapshot

	Specialty rent growth since Q3 2015 % p.a.	Ave cap rate change from Q3 2015 (%)	YOY state retail turnover (Aug 16) % p.a.
Sydney			3.1
Regional	0.00	-0.50	
Sub-regional	0.63	-0.50	
Neighbourhood	1.00	-1.00	
Melbourne			3.9
Regional	1.38	-0.25	
Sub-regional	0.38	-0.38	
Neighbourhood	0.63	-0.63	
South East QLD			2.4
Regional	0.05	-0.25	
Sub-regional	0.00	-0.25	
Neighbourhood	0.00	-0.25	

Source: JLL Research, ABS, DEXUS Research

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