dexus

Australian Real Estate Quarterly Review

Positive year ahead for office markets
Q2 2017

In summary

Investment Climate

Expect the unexpected

Investment demand for commercial real estate remains strong, leading to solid capital gains. While pricing has pushed yields to record lows, a price correction still seems some way off given favourable supply/demand settings.

Looking forward, in most locations occupier demand is positive, there is a lack of over-building, and interest rates are reasonably low. The outlook will be guided by the following assumptions:

- The US economy will continue to strengthen through FY18 benefiting the Asia Pacific region
- The NSW and Victorian economies will outperform in the short term; but QLD is turning and should strengthen through 2017
- Residential construction activity, particularly apartments, is expected to slow and could be a significant headwind for growth in FY18
- Service sector activity will remain a growth driver for the economy led by education, health, IT and tourism.
- Retail spending will be constrained in the short term by moderate confidence, weak wages growth and slow employment growth
- Australian official cash rates are expected to remain flat and low in FY18

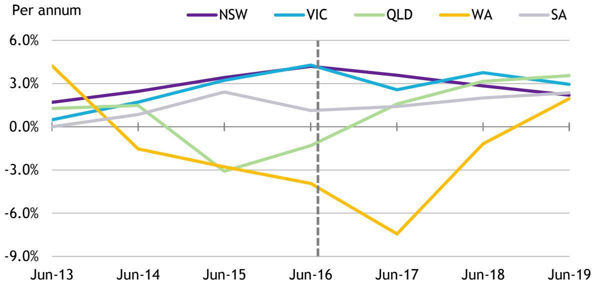
There are a number of risks worth noting, although none seem imminent. Global growth is firming, but so is global uncertainty. Brexit and the US election serve to amplify concerns about fragmentation of the European Union, trade protectionism and geopolitical risk. Rising US interest rate rises could lead to higher interest yields globally, but the Australian outlook is flatter.

For Australian real estate markets the most tangible risks going forward are:

- a sharper than expected correction in the domestic housing market in FY18
- a slowdown in China exacerbated by rising Chinese debt levels

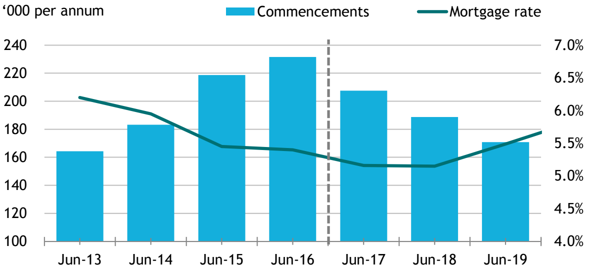
While the outlook appears positive in the short term it may be another year in which to expect the unexpected.

Figure 1. State economic growth



Source: Deloitte Access Economics (DAE)

Figure 2. Housing construction has peaked



Source: Deloitte Access Economics (DAE)

Table 1. Australian economic forecasts: Q2 2017

	Jun-17	Jun-18	Jun-19
Real GDP %pa	2.0%	2.8%	2.8%
Final demand %pa	1.3%	2.5%	2.5%
Employment %pa	1.0%	1.5%	1.4%
Goods imports %pa	2.0%	2.2%	2.1%
Retail sales %pa (real)	2.0%	2.5%	3.1%
CPI %pa	1.8%	2.2%	2.1%
90 Day bill %	1.85%	2.0%	2.4%
10yr Bond %	2.9%	2.9%	3.3%
AUD/USD	0.76	0.73	0.72

Source: Deloitte Access Economics (DAE), *DEXUS Research

Transactions

Lowest activity in five years

The first quarter of 2017 saw transaction activity ease considerably. While settlements are still pending, sharp pricing and limited stock for sale are constraining activity. The total transaction volume for the March quarter was $3.21 billion, with transactions still dominated by the office sector.

Private foreign investors were the most active during the quarter. However the 37% of purchases made by foreign investors is far below the highs of 57% just 12 months ago with less inflow from China. Domestically, unlisted property trusts and developers/private companies were the most active.

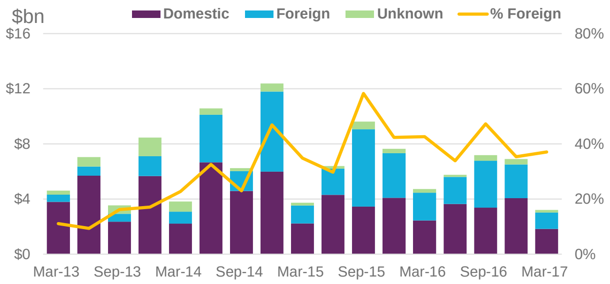
Major transactions for the quarter included the sale of the World Trade Centre in Melbourne to the Ouson Group for $267.5m on a reported yield of 6.5%. Eureka Real Asset purchased a 18,000sqm A grade tower at 505 St Pauls Terrace, Fortitude Valley for $205m, the first of two sold in the area, the second being K5 King Street for $140m. Anecdotally, 20 Bridge Street, Sydney has traded on a very tight yield.

Two key metropolitan sales in Sydney included Fujitsu House, North Sydney for $168m and the Everglade Campus at North Ryde for $120m.

Key industrial and retail transactions included the leasehold interest for the Woolworths Distribution Centre at Minchinbury, purchased by LOGOS for $161m with a WALE of 4.5 yrs and yield of 8.7% and the Canberra Outlet Centre in Fyshwick which sold for $67.5m to Deka Immobilien Real Estate Fund.

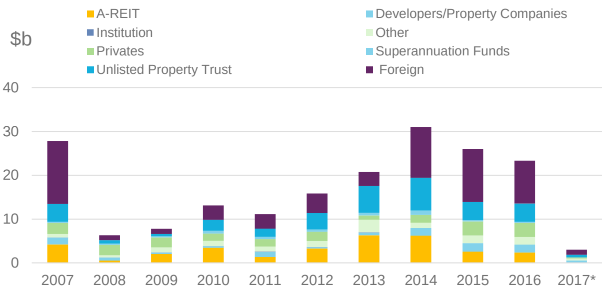
The March quarter saw Investment yields tighten in the Sydney and Melbourne CBDs to average 5.13% and 5.50% respectively. There appears to be a widening arbitrage with Brisbane and Perth CBD which remained relativeley cheaper at 6.50% and 7.00% respectively. Within the Sydney metropolitan markets yield compression ranged from 12bps to 50bps as investors sought opportunities in non-core markets. Yields are expected to stabilise in FY18.

Figure 3. Transaction volumes – quarterly



Source: JLL Research, DEXUS Research Transaction Database

Figure 4. Gross transaction volume by buyer type



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

Table 2. Q1 2017 Top transactions

Price ($m)	Asset/portfolio	Buyer
267.5	World Trade Centre, Melb.	Ouson Group
205.0	St Pauls Tce, Fortitude Valley	Eureka RA
168.0	Fujitsu House, North Sydney	Aqualand
161.0	Woolworths DC, Minchinbury	LOGOS
153.0	307 Queen St, Brisbane CBD	LaSalle Management
140.0	K5 King St, Fortitude Valley	Impact Investment
125.1	Grenfell Centre, Adelaide	Credit Suisse
120.0	Everglade Campus, Nth Ryde	Romeciti
88.9	333 Kent St, Sydney CBD	iProsperity
81.0	Elizabeth Plaza, North Sydney	Blackrock

Source: DEXUS Research Transaction Database, JLL Research

Performance

Equities outperform

Australian equities started the year strongly, outperforming the other asset classes, delivering a 4.8% return for the quarter and a solid 20.5% for the year. Global concerns remain centred on Trump's policies, the state of China's economy, the pending elections in Europe and the political tension with North Korea and Russia.

The A-REIT sector delivered 6.0% return for the year, after recording -0.3% for the quarter. The recent sell-off in bonds caused yields to rise on a range of other defensive assets including A-REITs, leading to a price correction. Prices have since firmed and April will show a stronger performance. While growth in rental values should provide support, the sector will face challenges to deliver superior returns if cap rate compression eases and bond yields rise further.

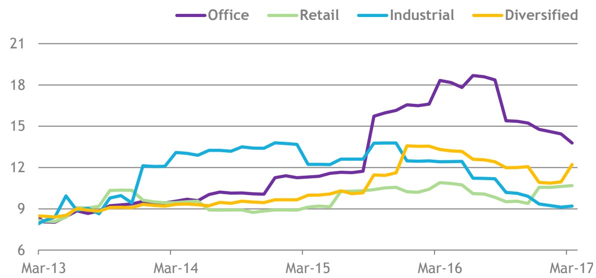
Unlisted property returns improved in the March quarter to 12.1%. While capital gains have been strong, they are now easing and should continue to ease as cap rates stabilise. The office sector outperformed in the quarter due to rental growth, followed by the retail sector. The total return for the industrial sector remains reliant on income returns as capital growth has slowed for the past six months.

Returns on fixed interest investments fell to 2.1% from 2.9% in the December quarter as bond yields increased and prices fell. The general consensus is for relatively slow rises in Australian bond yields over the next two years, which while mild, should have a dampening effect on asset value growth.

Figure 5. Unlisted returns Vs listed assets

Source: Bloomberg, DEXUS Research

Figure 6. Unlisted property returns by sector



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

Table 3. Index returns to 30 March 2017

	Qtr. %	1 yr %p.a.	3 yr %p.a.	
Australian shares	4.8	20.5	7.5	S&P/ASX 200 Accumulation
Unlisted property	2.1	12.1	12.0	Mercer/IPD Aust. Pooled Fund Index*
A-REITs	-0.3	6.0	16.7	S&P/ASX 200 Property Accumulation Index
Australian fixed interest	1.2	2.1	5.0	BACM0 Index
Australian cash	0.4	1.9	2.3	BAUBIL Index

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

Office markets

Positive year ahead

The office sector started 2017 strongly, with double digit rental growth in Sydney and Melbourne. With the next supply cycle several years off, the outlook appears buoyant over the next year or two.

Occupier demand turned positive in all four major CBDs in the first quarter of 2017 (Figure 7).

Leading indicators for demand are positive, pointing to further absorption of space in the year ahead. Employment growth is strong in Victoria, positive in New South Wales and Queensland, but weak in Western Australia. A positive read on the ANZ job ads series (+7.0% yoy) points to further job growth in the short-term. Positive business conditions and continued gains in equity markets, also bode well for office demand.

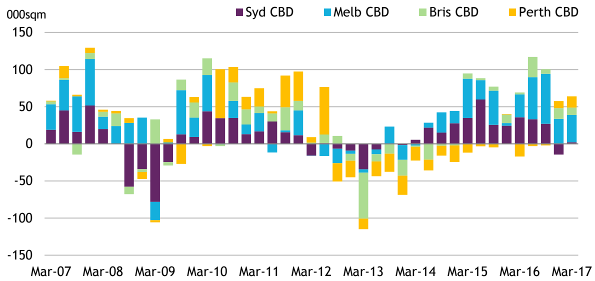
Sydney CBD recorded just over 28% growth in net effective rents over the past year, the fastest pace of growth in seven years. Most of the eastern seaboard office markets recorded solid increases with rents in Melbourne CBD firming by nearly 15%.

The gains are being driven by falling availability of office space. Vacancy rates have fallen below average in the Sydney and Melbourne CBDs. In contrast vacancy rates remain elevated in Brisbane and Perth so rental growth is subdued.

Looking forward, limited net supply in 2017-2018 for Melbourne and Sydney should lead to further rental growth in the short term. Brisbane is forecast to improve over 2017, with Perth remaining weak.

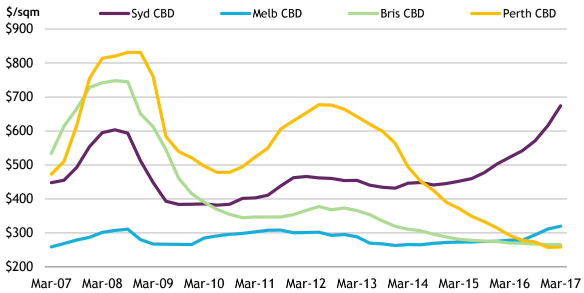
Office markets are historically cyclical. This period of strong rental growth and low yields is likely to encourage construction of new buildings, both in the CBD and in the metropolitan markets. The supply pipeline will take several years to develop with very little completing in FY18 and FY19, but an estimated 470,000 sqm completing by FY22. Depending on demand, this level of additions is likely to constrain rents from FY19 on, due to an increase in available space. So, while poised for a couple more years of strong growth the Sydney CBD market could experience softer market conditions in the FY20-23 period..

Figure 7. Quarterly net absorption by market



Source: JLL Research, DEXUS Research

Figure 8. Prime net effective rents by market



Source: JLL Research, DEXUS Research

Table 4. Q1 2017 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth
Parramatta	3.6%	5.0%	11.8%
Sydney CBD	7.3%	10.1%	28.9%
Melbourne CBD	7.5%	10.7%	14.8%
North Sydney	8.4%	8.2%	12.6%
Macquarie Park	9.6%	7.7%	15.0%
Canberra	11.7%	1.9%	2.9%
Brisbane CBD	16.4%	0.0%	-1.7%
Adelaide CBD	16.7%	-0.3%	-18.8%
Perth CBD	23.3%	-2.3%	-11.4%

Source: JLL Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney	Sydney continues to perform strongly with prime and secondary net effective rents increasing by +28.9%yr (9.4%qtr) and 44.5%yr (6.3%qtr) respectively. Below average vacancy of 7.3% is driving a fall in prime incentives to 22% (gross). Rising secondary rents are encouraging take-up of prime space. Given the constrained supply pipeline and a positive demand outlook, Sydney CBD is expected to continue to outperform over the next 12 months.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
North Sydney	North Sydney demand turned negative this quarter (-11,000sqm), which led to a one percentage point rise in vacancy to 8.4%. The negative demand read was more due to specific tenant moves than an underlying weakness in demand. Prime net effective rents increased by +12.6% over the year (+5.1% over the quarter), while incentives declined to 26% (net). With no new supply expected until FY19, and a continued positive demand outlook, vacancy is expected to tighten supporting a further uplift in rents.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Macquarie Park	Macquarie Park experienced a mildly negative quarter of net absorption (-870sqm), and saw vacancy rates rise to 9.6%. Despite the softening in demand prime net effective rents grew by +15.0% over the year (+7.0% over the quarter), and net incentives declined to 26% (net). A relatively subdued supply pipeline and an anticipated return to positive demand should continue to support rental growth over the next 12 months.	Vacancy ↓ Rents ↑ Incentives → Yields →
Parramatta	Parramatta experienced a further tightening in vacancy, down to 3.6% (total) and 0.4% (prime). Prime net effective rents increased by +11.8% over the year. Parramatta is expected to perform solidly over the next 12 months given limited availability of prime space. Supply risks will mount over the medium-term with the exit of CBA and development of Parramatta Square, however most new supply should be pre-committed and the market will benefit from government decentralisation.	Vacancy → Rents ↑ Incentives → Yields →
Melbourne	Melbourne is benefiting from strong economic fundamentals, recording the strongest net absorption of the CBD office markets (+36,800sqm over the quarter) and a fall in vacancy to 7.5%. In line with improving vacancy prime net effective rents increased by +14.8% over the year (+2.6% over the quarter), while incentives remained steady at 32% (net). Limited new supply and a solid demand outlook will see vacancy tighten and support further rental growth over the next 12 months.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Brisbane	The latest numbers support a recovery story for Brisbane over the next year or two with positive net absorption of +9,800sqm recorded for the quarter. Prime rents have remained weak, and incentives elevated (37% gross) as a result of high vacancy (16.4%). Prime rental growth is expected to improve over the medium-term, as vacancy levels move back towards the long run average with a flight to quality absorbing prime space.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Perth	The Perth market appears to be bottoming. Vacancy rates declined by 0.8 percentage points due to +15,200sqm of positive net absorption over the quarter. Prime net effective rents experienced mild growth of 0.6% over the quarter (-11.4% over the year) as net incentives declined by 40bps. Rental growth is expected to remain weak over the next 12 months, improving over the medium term as market conditions slowly recover in the absence of new supply.	Vacancy → Rents → Incentives → Yields →
Adelaide	Adelaide seems likely to stay in the slow lane for a while yet after experiencing another negative quarter of net absorption (-2,100sqm). Vacancy remained relatively steady at 16.7% due to withdrawals. Weak conditions saw prime net effective rents contract by -7.6% over the quarter (-18.8% over the year) as average incentives increased from 34% to 37% (gross). Rental growth is expected to remain weak over the next 12 months due to subdued demand growth.	Vacancy → Rents → Incentives → Yields →
Canberra	Canberra experienced negative net absorption in Q1-17 (-3,600sqm) however vacancy remained relatively steady at 11.7% due to stock withdrawn for alternate uses. Prime net effective rents increased by +1.6% over the quarter (+2.9% over the year) and incentives remained steady as prime vacancy rates tightened to 6.4%. A relatively benign supply pipeline and anticipated mild but positive demand should support an uplift in rents over the next 12 months.	Vacancy ↓ Rents ↑ Incentives → Yields →

Industrial

Sydney markets leading

Following two years of strong demand, the strength of the Sydney industrial market is starting to flow through to rental growth, with signs of rent growth in all key precincts.

Melbourne is the next best performing market, followed by Brisbane which continues to show modest signs of improvement. Perth remains subdued.

The outlook is for industrial activity to remain solid nationally, supported by infrastructure investment and population growth.

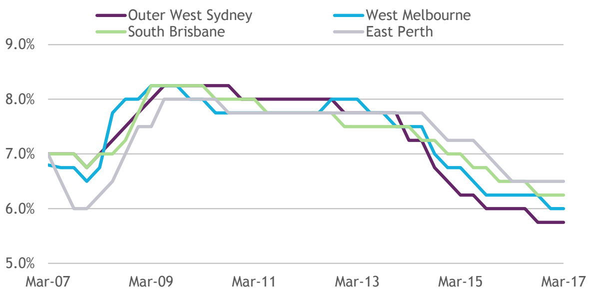
A shortage of investment stock, combined with relatively easy access to capital is supporting development conditions. Industrial supply across the capital cities is projected to be above average at over 1.7m sqm in 2017, following a solid 2016. The development pipeline will generally be led by institutions.

The strongest rental growth will continue in land constrained markets in Sydney, while, in other markets the solid supply pipeline is likely to constrain growth.

The key themes for this quarter include:

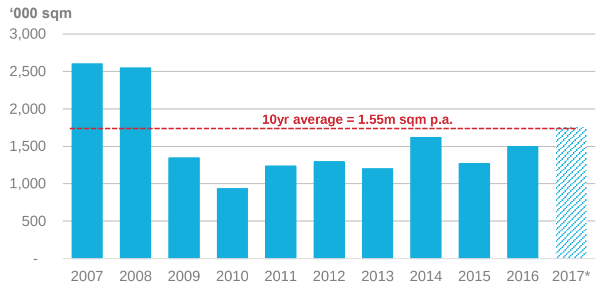
- Amazon has confirmed it is looking for a distribution centre as part of their impending entry into the Australian market. Western Sydney has been identified as one possible location for a facility of around 100,000sqm
- Major occupiers, particularly retailers, continue to invest in automation and supply chain efficiencies (i.e. The Iconic and Country Road), with a focus on 'just-in-time' delivery
- Land values continue to increase across the Eastern states due to strong demand and limited land availability
- Moorebank Logistics Park, the site of the Moorebank Intermodal Terminal in South-west Sydney, commenced construction in early April with rail operations expected to begin late 2018.

Figure 9. Upper prime industrial cap rates



Source: JLL Research, DEXUS Research

Figure 10. Capital city industrial supply pipeline



Source: JLL Research, DEXUS Research

Table 5. Q4 2016 industrial snapshot

	Ave prime cap rate change from Q1 2016	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.38	2.1
Southern Brisbane	-0.38	-2.6
East Perth	0.00	-1.4
South Sydney	-0.75	9.1
West Melbourne	-0.38	-0.7

Source: JLL Research, DEXUS Research

Outer West Sydney

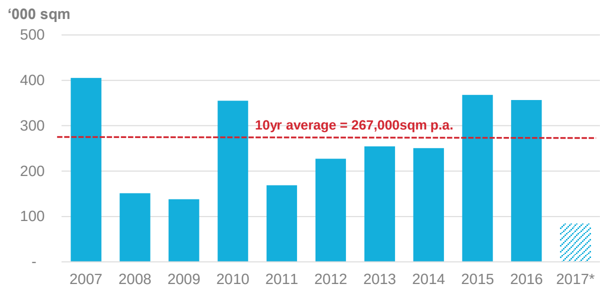
Outer West Sydney continued its strong performance with over 80,000sqm of take-up recorded in Q1 2017. Demand is projected to remain solid in the medium term, benefitting from economic conditions.

While there are a significant number of projects in the pipeline, the amount of supply currently planned to come online in 2017 is around 220,000sqm, below the average of 290,000sqm.

Outer Western Sydney is likely to experience mild levels of rental growth in the year ahead.

The largest lease deal in Q1 2017 was Costco committing to a 35,700sqm warehouse as part of a D&C deal at Oakdale South.

Figure 11. Outer West Sydney gross take-up



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

West Melbourne

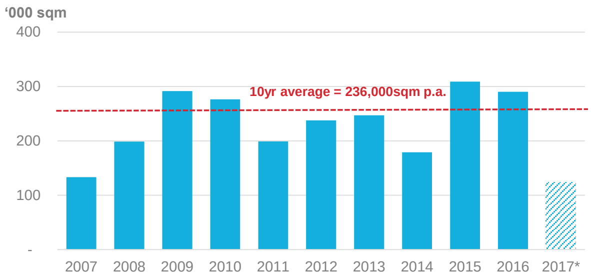
West Melbourne recorded more than 120,000sqm of take-up in Q1 2017, accounting for the majority of take-up in Melbourne over this period. Demand is expected to remain positive in the medium term due to strong levels of population growth.

A substantial 360,000sqm of supply could potentially come online in West Melbourne in 2017, well above the 10 year average of 220,000sqm. Some 120,000sqm has already been completed.

West Melbourne is a key market for tenants, however, the large provision of zoned land is likely to constrain rents.

The largest lease deal in Q1 2017 was a pre-lease deal to Isuzu Australia (21,685sqm) at the Dexus Industrial Estate at Laverton North.

Figure 12. West Melbourne gross take-up



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

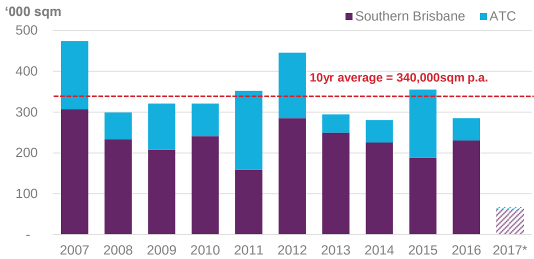
Brisbane

Take-up in Brisbane totalled almost 70,000sqm in Q1 2017, suggesting the market may be turning.

The industrial supply pipeline for Brisbane is projected to increase to almost 400,000sqm in 2017, well above the 10 year average of 335,000 sqm. A number of projects are under construction in both South Brisbane and the Australian Trade Coast (ATC), with many supported by pre-lease deals.

The largest lease in Q1 2017 was a pre-lease deal to Beaulieu Carpets (23,051sqm) at Yatala.

Figure 13. South Brisbane and ATC gross take-up



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

Retail

Competitive pressures

Domestic retailers are faced with a tough competitive environment due to competition with new international bricks and mortar stores, continued growth in online retailing and patchy, albeit positive sales growth.

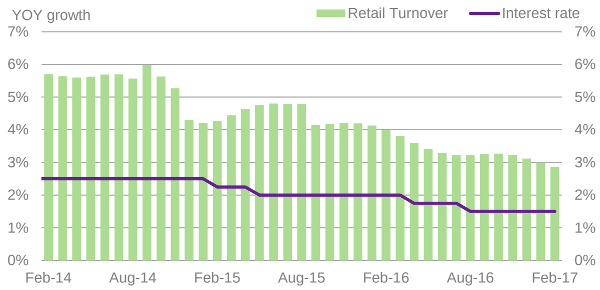
Retail turnover growth eased to 2.9% in the year to February 2017 based on ABS data. Growth was solid in non-discretionary categories, led by supermarkets. Non-discretionary spending has now overtaken discretionary spending growth over the last 12 months. This is good news for supermarket based centres but may reflect a growing caution among consumers.

Household spending is being challenged by weak wages growth and the prospect of an easing housing market. However, solid population growth and low interest rates should continue to provide some underlying support to retail sales.

Key themes this quarter include:

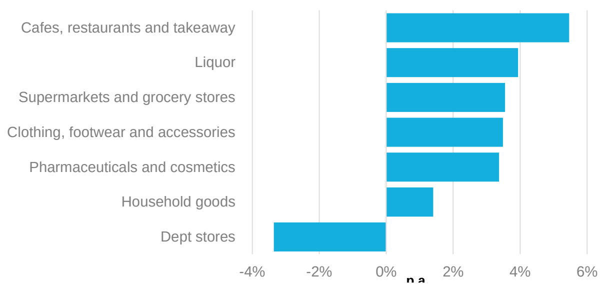
- Amazon has confirmed plans to enter the Australian market in the near term, with their full suite of products likely to roll out progressively starting with Amazon Marketplace and Amazon Prime
- Myer has acquired the Marcs and David Lawrence brands after they entered into administration with store and staff requirements still under review
- The rebranding of former Trade Secret stores to TK Maxx has commenced and will continue over the coming months with new stores to follow
- The first Legoland Discovery Centre in the southern hemisphere has opened at Chadstone Shopping Centre (VIC). Up to four more Legoland's may open in Australia in the future
- The largest shopping centres continue to grow with recent expansions to Chadstone (VIC), Westfield Chermside and Grand Central (QLD).

Figure 14. Retail sales growth and cash rate



Source: ABS, DEXUS Research

Figure 15. Retail growth by category



Source: ABS, RBA, DEXUS Research

Table 6. Q1 2017 retail snapshot

	Specialty growth % p.a.	Cap rate change (%)	State retail sales growth % p.a.
Sydney			3.2
Regional	0.50	-0.38	
Sub-regional	1.13	-0.75	
Neighbourhood	1.00	-0.63	
Melbourne			3.6
Regional	1.37	-0.38	
Sub-regional	0.63	-0.50	
Neighbourhood	1.38	-1.13	
South East QLD			3.2
Regional	0.00	-0.25	
Sub-regional	0.00	-0.88	
Neighbourhood	0.00	-0.63	

Source: JLL Research, ABS, DEXUS Research

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