dexus

Australian Real Estate Quarterly Review

Q1 2021

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

Inside

Investment climate

What can we expect in 2021?

The Australian economy is well positioned going into 2021 with fiscal stimulus translating to better than expected economic and employment data. While the pandemic risks are still significant, we expect 2021 to be a year when the investment climate turns more positive. Our key assumptions are:

- A vaccine roll-out in the first half of 2021 will help reduce the health risks of the pandemic but some mobility restrictions will still be required.
- The global economy will strengthen, but the recovery will be uneven. Australia and the Asia Pacific countries will lead the rest of the world.
- Australian economic growth is expected to improve, led by industries such as housing, finance, health and government. Other industries will lag.
- Interest rates will remain very low for an extended period, leading to a further fall in required returns.

The most likely thematics for investors to consider in 2021 are:

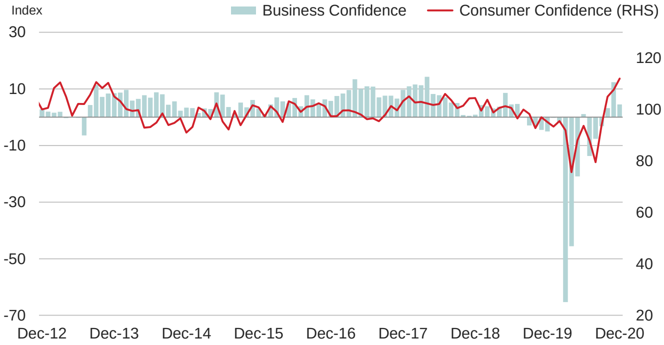
- Leasing markets should generally improve, helped by positive business and consumer confidence
- Occupier markets will strengthen but remain patchy, particularly for retail and office. There may be vacancy risk from delayed corporate insolvencies.
- Capital flows into property are likely to remain strong through 2021 given the low interest rate thematic. A wide yield spread in favour of property is expected to support investment demand.
- Investors are expected to shift from defensive to growth as their appetite for risk increases.
- Sentiment towards the property sectors will be variable with a strengthening demand for healthcare and other alternative sectors.

Table 1: Australian economic forecasts

	Jun-20	Jun-21	Jun-22
Real GDP %pa	-6.4%	8.7%	2.8%
Final demand %pa	-7.3%	11.3%	2.5%
Employment %pa	-5.7%	6.4%	1.0%
Goods imports %pa	-7.0%	3.4%	1.1%
Retail sales %pa (real)	-2.1%	6.3%	4.6%
CPI %pa	-0.3%	2.6%	1.1%
90 day bill %	0.1%	0.1%	0.1%
10yr Bond %	0.9%	0.9%	0.9%
AUD/USD	0.69	0.72	0.72

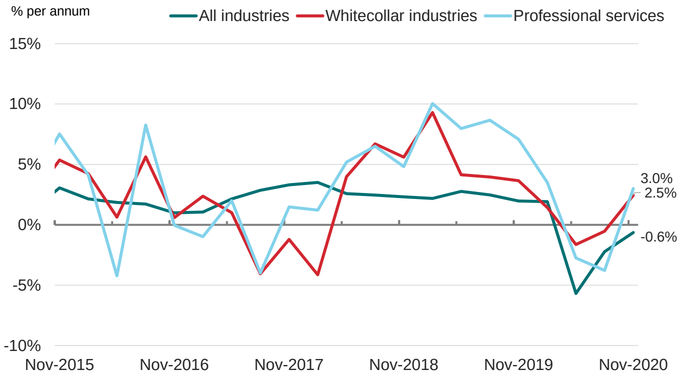
Source: Deloitte Access Economics, December 2020

Figure 1: Bounce in consumer sentiment and business confidence should help leasing markets



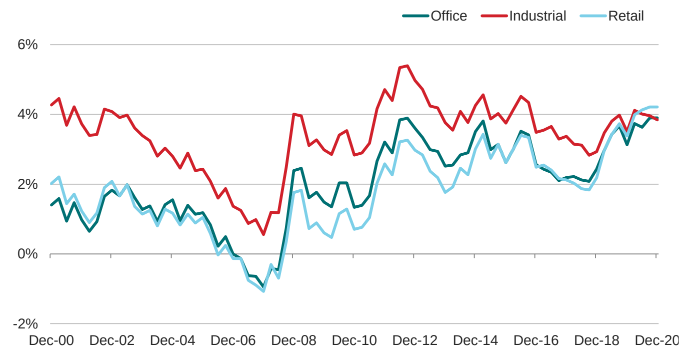
Source: Bloomberg, NAB, Westpac

Figure 2: Employment growth is improving with white collar employment back in positive territory



Source: ABS

Figure 3: Investment demand for Australian property to remain strong given high yields spread to Government bonds



Source: JLL Research, Bloomberg (note yields are for Sydney markets)

Performance & transactions

Variable performance through the pandemic

A-REIT pricing firmed in Q4 2020 in line with a lift in the broader equity market. The S&P200 is almost back to pre-COVID highs after a strong rebound in technology and retail stocks.

In the unlisted property market, the recent downward trend in office returns has begun to slow. Office funds returned 4% in the year to December 2020 and retail -15.3%. While both sectors should benefit from economic recovery in 2021, it will take longer for retail property values to turn the corner given weak investor sentiment.

The industrial sector continues to provide double digit returns at 13% in the year to December 2020 benefiting from a shift in weight of capital driving values. The industrial sector has been viewed as a relative safe haven with the strong positive ecommerce thematic.

Transaction volumes in 2020 were lower in all sectors compared to the previous year. Border closures and uncertainty about income levels and rent receipts limited the amount of stock actively traded, particularly larger assets. Foreign investors remained active during 2020, accounting for 40% of purchases by value.

Recent office sales included 225 George Street, Sydney, for $925m and 60 Miller Street, North-Sydney for $263m.

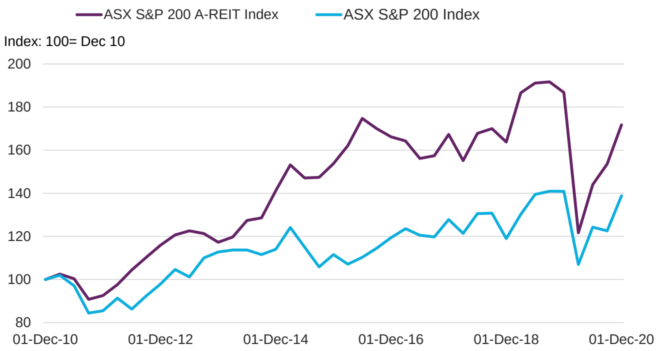
Industrial volumes were only mildly down on long-term averages, being helped by demand from foreign investors, domestic institutions and A-REITs. Larger sales included an Aldi distribution portfolio on a sale and lease back for $281m and a RAND logistics portfolio for $93m.

Table 2: Index returns to December 2020

	Qtr.%	1 yr %p.a.	3 yr %p.a.
Australian fixed interest[1]	0%	+4.0%	+5.0%
Australian shares[2]	+14%	+1.0%	+7.0%
Australian cash[3]	0%	0%	+1.0%
Unlisted property[4]	+2.7%	-0.4%	+2.2%
A-REITs[5]	+13%	-5.0%	+5.0%

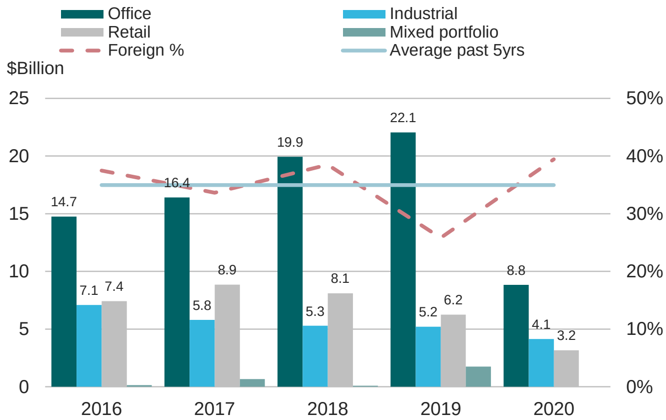
Source: [1]BACM0 Index, [2]S&P/ASX.200. Accumulation Index, [3]BAUBIL Index, [4]MSCI Mercer Australian Core Wholesale Monthly PFI (NAV Pre Fee) – Diversified, [5]S&P/ASX.200.A-REIT Accumulation Index

Figure 4: A-REIT pricing benefited from a broad-based recovery in equity markets



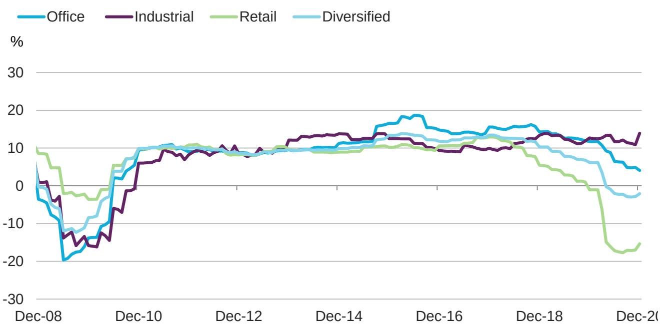
Source: Bloomberg, Dexus Research

Figure 5: Transaction volumes in 2020 fell in all sectors, with industrial property down the least



Source: JLL Research, Dexus Research

Figure 6: Industrial total return per annum at double digit levels through a time of relative uncertainty



Source: MSCI, Dexus Research

Office

Leading indicators improve sharply

After an uncertain year for office markets, an improvement in many of the key leading indicators signals a period of strengthening demand ahead. Business conditions recorded by the December 2020 NAB Business Survey were at the highest level since 2018. Professional job advertisements, an indicator of corporate hiring intentions, were up 31% on six months ago. Employment in white collar industries has grown by 2.5% over the past 12 months.

Vacancy rates have generally risen. A number of tenants have put surplus space on the market as a sublease, increasing the recorded vacancy rate. Sublease vacancy in the Sydney CBD stands at 3.3% of stock, however only part of it is competitive with prime space given the short tenure and quality of fit-out. The nature of sublease vacancy is that it can be quickly withdrawn if conditions improve. The total vacancy rates in Sydney and North-Sydney saw the largest gains past quarter, rising to 11.9% and 19.1% respectively.

Office building occupancy levels (the proportion of people actually in the office on a daily basis) remained below pre-COVID levels at the end of 2020, with Government guidelines, multinational sentiment and concerns about public transport the biggest deterrents. The risk of further clusters means it may take some time for work practices to move back towards pre-COVID levels.

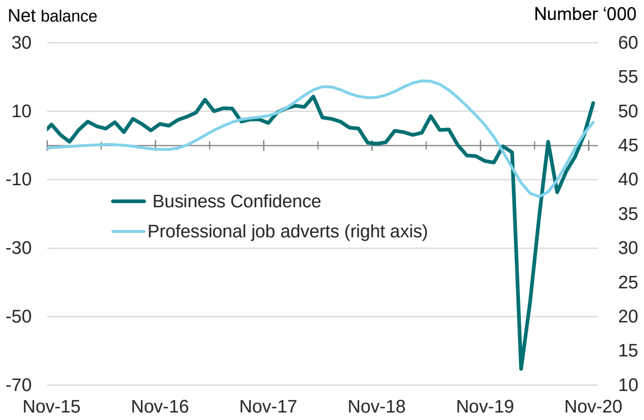
Face rents held relatively steady in Q4 2020. However, effective rents fell significantly on the back of increasing incentives. The growing availability of space and competition to maintain occupancy suggests incentives will remain elevated for a considerable time. The anticipated end of the Job Keeper subsidies in March 2021 will be keenly watched, with small to medium sized occupiers more likely to be affected.

Table 3. Q4 2020 office snapshot

	Total Vacancy	Rent growth* (% p.a.)	Net Increase in stock FY22**
Sydney CBD	11.9%	-15.1%	1.7%
North Sydney	19.1%	-7.4%	6.0%
Sydney Fringe	9.8%	-8.8%	N/A
Macquarie Park	11.2%	-4.8%	6.9%
Parramatta	10.9%	-19.0%	33.3%
SOP / Rhodes	22.2%	-6.7%	N/A
Melbourne CBD	13.2%	-7.8%	3.9%
Brisbane CBD	14.0%	-0.6%	8.7%
Perth CBD	20.0%	-3.1%	0.5%

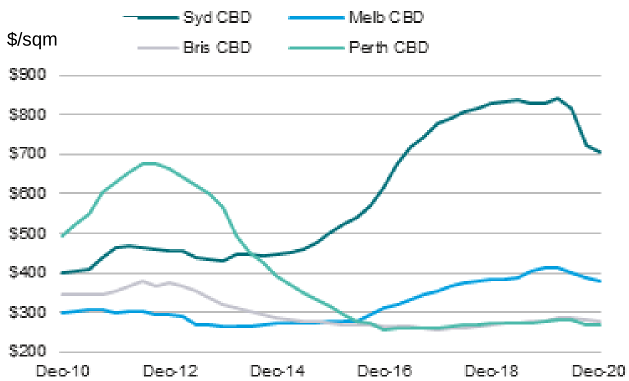
Source: JLL Research, Dexus *Net effective, **estimate as a % of stock,

Figure 7. Leading indicators point to improving conditions for leasing markets in the year ahead



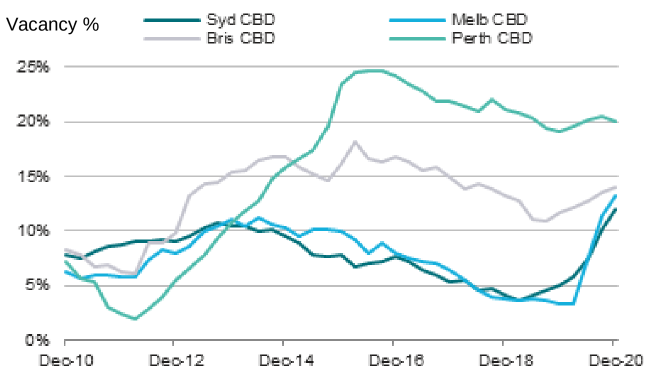
Source: JLL Research, Dexus Research.

Figure 8. Face rents appear to be holding, but effective rents fall on the back of rising incentives



Source: JLL Research, Dexus Research

Figure 9. Vacancy rates have lifted in the major office markets nationally



Source: JLL Research, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney CBD	The Sydney CBD is feeling the effects of the pandemic following a mid-year slump in economic activity and ongoing mobility restrictions. Sydney CBD's total vacancy rate rose further in the December quarter to 11.9%, as a number of occupiers handed back surplus space on a sublease basis. Annual net absorption was recorded at -278,000 square metres, the lowest yearly total on record. Face rents largely remained flat, however rising incentives led to net effective rents falling by 2.2% in the December quarter, bringing annual falls to 15.1%. Yields were stable in Q4 2020, albeit there was a lack of office transactions.	Vacancy ↑ Rents ↓ Incentives ↑ Yields ↑
North Sydney	North Sydney's vacancy rate lifted to 19.1% in Q4 2020, more than double the level in the previous year (8.5%) and considerably higher than the 10 year average. A sizeable supply pipeline expected to be delivered over the next 3 years (more than 20% of total stock) is likely to keep pressure on rents and incentives. While face rents held steady in 2020, competitive leasing deals saw a steep rise in incentives, leading to effective rents falling 9.3% in the past 6 months alone. Prime investment yields are estimated to have risen by 13 basis points over the latter half of 2020.	Vacancy ↑ Rents ↓ Incentives ↑ Yields ↑
Macquarie Park	Like other office markets, Macquarie Park is experiencing weaker conditions. Net absorption was recorded at 21,000 square metres over the past 6 months, though this was largely due to the withdrawal of the Macquarie Technology Centre (11-17 Khartoum Rd) in December. A number of relocations by smaller occupiers led to a rise in vacancy rates to 11.2%, up from 5.3% the year prior. Although face rents grew marginally, rising incentives led to further falls in effective rents (-4.8% in the year to Q4 2020).	Vacancy ↑ Rents ↓ Incentives ↑ Yields →
Parramatta	Parramatta is feeling the effects of new supply at a time of weak demand. Effective rents fell 19% in the year to December 2020, in line with sharply rising incentives. A flurry of development activity over the past 5 years has meant that the market now has a distinctly two-tiered market, with newly built stock likely to attract a sizable rent premium over existing lower quality stock. Vacancy rates rose sharply over 2020, with prime vacancy rates reaching 9.1% in December 2020, up from just 0.9% at the start of the year. Interest in Parramatta's office assets remained strong, with prime investment yields estimates to have contracted slightly by 7 basis points over the latter half of 2020.	Vacancy ↑ Rents ↓ Incentives ↑ Yields →
Melbourne CBD	Melbourne CBD has been impacted by the underperformance of the Victorian economy after two lockdowns in 2020. Annual net absorption in the Melbourne CBD was -189,000 square metres, with the vacancy rate rising to 13.2% in Q4 2020. While there is uncertainty about the level of tenant demand over the next 6 months, the leading indicators for Victoria are beginning to improve. Lockdowns have kept leasing volumes very low and rent falls over the past 6 months were less pronounced than expected, with net effective rents falling by 7.8% over the period. Incentives were estimated to have risen to 30% in Q4 2020.	Vacancy ↑ Rents ↓ Incentives ↑ Yields ↑
Brisbane CBD	The Brisbane CBD office market has weathered COVID-19 better than the southern states due to the relative performance of the Queensland economy and management of the pandemic. Over the 2020 calendar year, net absorption was recorded at -50,000 square metres, driven by a number of contractions and an increase in sublease space being offered. The vacancy rate rose to 14.0% in Q4 2020 and the upcoming supply pipeline likely to put further upward pressure on vacancy rates in 2021. net effective rents contracted 0.6% in 2020 on the back of rising incentives. Like other markets, a lack of transaction activity saw prime investment yields hold over 2020.	Vacancy ↑ Rents → Incentives → Yields ↑
Perth CBD	The Perth CBD market has been relatively insulated from COVID-19, with office occupancy levels consistently the highest of any CBD market nationally. Net absorption in Q4 2020 was +6,800 square metres as expansions and moves into the CBD by resources related groups surpassed a small number of occupiers offering sublease space. This helped to decrease the total vacancy rate by 0.1% to 20.0% in Q4 2020. Face and effective rents held steady. A considerable state budget surplus in conjunction with a strong resources sector and a limited supply pipeline offer green shoots for the long ailing market.	Vacancy ↓ Rents → Incentives → Yields →

Industrial

Bounce back in confidence bodes well for rents

The industrial sector has proven to be very resilient over the past 12 months. While COVID-19 impacted supply chains, a rapid acceleration of ecommerce has led to a large amount of enquiry for additional space. Rapid growth has led to expansion by companies such as Amazon, Hello Fresh and Marley Spoon.

Transaction volumes remain robust at $4.1bn, although slightly down on the previous full year. There has been a strong appetite from both domestic and foreign institutions to purchase and develop property.

Sale and leaseback activity is expanding. Charter Hall transacted a sale and lease back with Australian Meat group for $87.1m in South East Melbourne, while Centuria completed a sale and lease back with Bidfood in Outer West Sydney for $73m.

ESR purchased a DA approved site in South Brisbane for $93m, while Stockland acquired two assets under construction within Leakes Road Business Park, West Melbourne for $60m due for commencement in July.

Strong investment demand is translating to improving land values. Over the past quarter land values increased by $50/sqm around Outer West Sydney and there was a $15/sqm rise in South Brisbane. Face rents have largely held flat in Q4 2020, but JLL recorded mild growth in Outer West Sydney (1%) and South East Melbourne (0.5%). In 2020 average incentives rose by up to 5 percentage points.

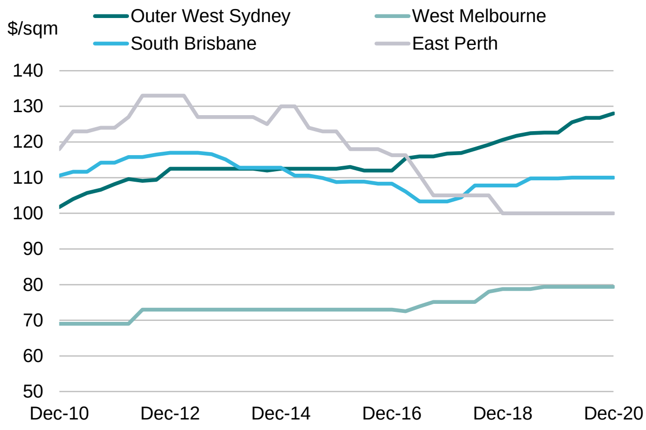
Business confidence is an important indicator for the leasing market. While weak confidence led to some delayed decision making in 2020, a recent bounce in confidence should strengthen inquiry levels in 2021.

Table 4. Industrial snapshot

	Ave prime cap rate change from Q3 2020	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.12	4.36%
Southern Brisbane	No Change	0.20%
East Perth	No change	No change
South Sydney	-0.12	2.28%
West Melbourne	-0.25	No change

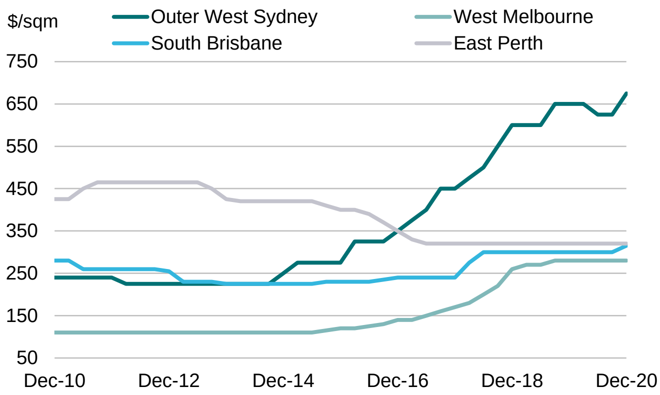
Source: JLL Research, Dexus Research (Dec 2020), land values 2-5HA exl Perth (1HA)

Figure 10: Slight lift in Outer West Sydney rents



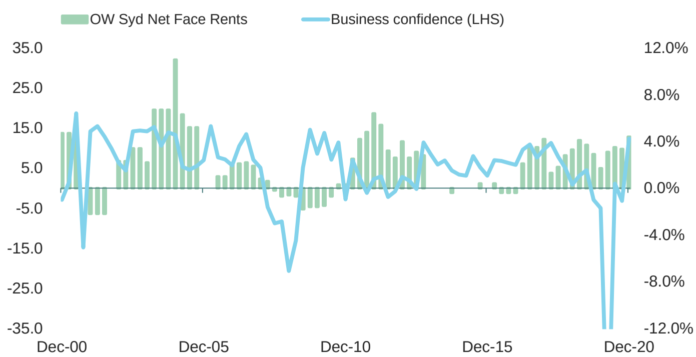
Source: JLL Research, Dexus Research

Figure 11: Investment demand driving land values



Source: JLL Research, Dexus Research

Figure 12: Recovery in business confidence bodes well for rent growth



Source: JLL Research, ABS

Industrial by region

Outer West Sydney

Take-up levels for 2020 calendar year finished well above the long-term average at 465,900sqm. Levels were significantly buoyed by the Q2 2020 Amazon deal which accounted for 41% of take-up.

Deals for Q4 2020 demonstrated the need for more space by transport and logistics businesses. AFCS Port Logistics moved into 19,874sqm at Eastern Creek while Wilmot Transport took up 12,302sqm at Erskine Park.

Face rents grew mildly over the past six months, supported by solid take-up and higher incentives.

West Melbourne

West Melbourne has experienced a turnaround since the beginning of the year with supply chain issues causing 3PLs to forego space to the market, only for it to be absorbed from excess demand fuelled by ecommerce growth.

Take-up for full year is far beyond long-term averages and above the prior year at 522,000sqm. Building on the ecommerce thematic, Amazon pre-leased 37,000sqm at Dexus facility, 11-167 Palm Springs Road, Ravenhall. Pureplay online retailer Hello Fresh has taken up space at the 25,550sqm spec facility at the same location to accommodate its expansion, following the rapid growth in online food retailing.

Incentives and rents have remained flat in West Melbourne with cap rates tightening by 25bps.

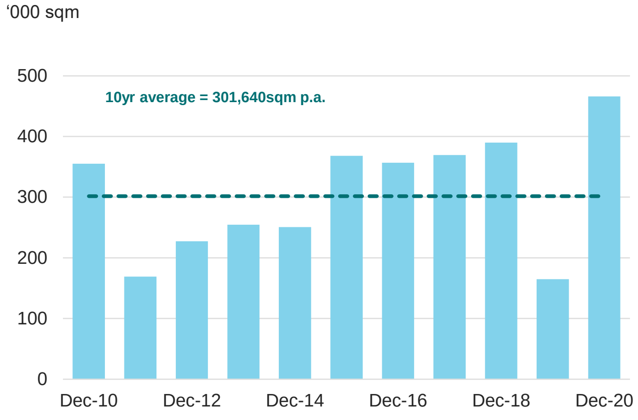
Brisbane

The Brisbane markets have seen take up levels for the full year slightly below average at 213,200sqm for South Brisbane and 106,800sqm for the Trade Coast.

Traditionally the Brisbane market is heavily concentrated in logistics and manufacturing tenancies. Although Brisbane lags other states in ecommerce take-up, it has gained traction in 2020 with Amazon acquiring space on the Trade Coast. In Q4 2020 we saw homeware retailers Mocka Products lease 5,420sqm in Pinkenba on the Trade Coast and James Lane move into 9,900sqm at Richlands, South Brisbane.

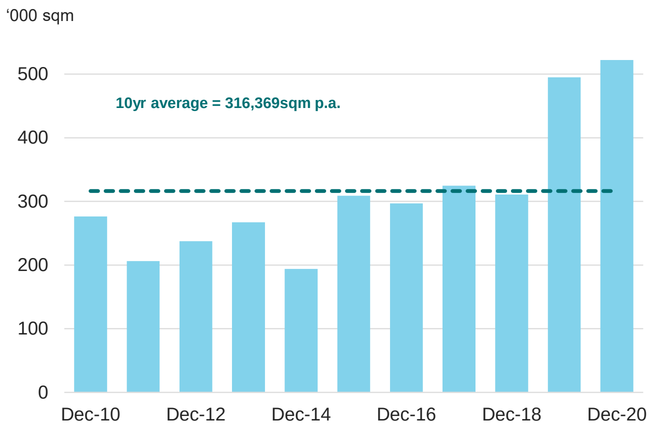
Trade Coast rents have increased by 1.4% over the year however incentives also rose 4.5 percentage points.

Figure 13: Outer West Sydney gross take-up



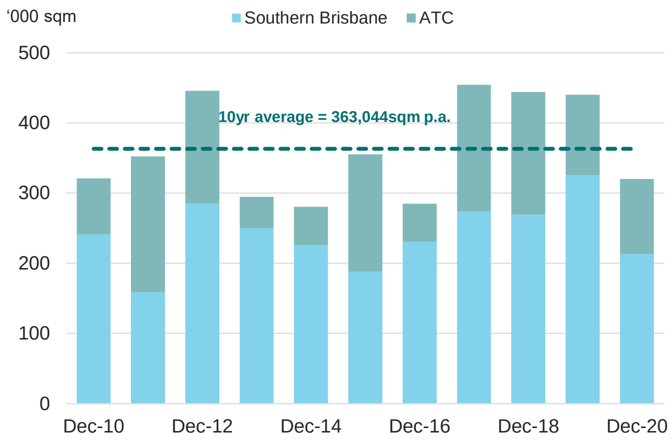
Source: JLL Research (gross take-up), Dexus Research.

Figure 14: West Melbourne gross take-up



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

Figure 15: South Brisbane and ATC gross take-up



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

Retail

Retail sector benefits from stimulus

The retail sector has experienced many highs and lows over the past year. Retail turnover grew by 13.1% in the year to November 2020, driven by continued strong growth in non-discretionary spending as well as a rebound in discretionary spending following the Victorian lockdown. Spending in shopping centres has been supported by government stimulus as well as a smaller diversion of household budgets to travel.

A trend to shopping locally has seen smaller supermarket and discount department store anchored centres outperform the larger regional centres with a higher proportion of discretionary specialty shops. City retail outlets have been particularly weak given the reduced number of office workers in the CBD. Market rents in regional centres and city centres have weakened accordingly.

Online retail sales have received a significant boost over the past year. According to the ABS, online sales were up 71.5% in the year to November 2020 compared to a 9.8% increase the year before. The majority (67%) of online sales occur via multi-channel retailers (who own both physical and online stores). The combination of strong online growth and stimulus spending has meant increased profits for some retailers such as JB HiFi, Wesfarmers, Accent Group and Premier Investments.

Online food sales (up 72.5% in the year) are only a small portion of total food sales so there is considerable growth potential in this category.

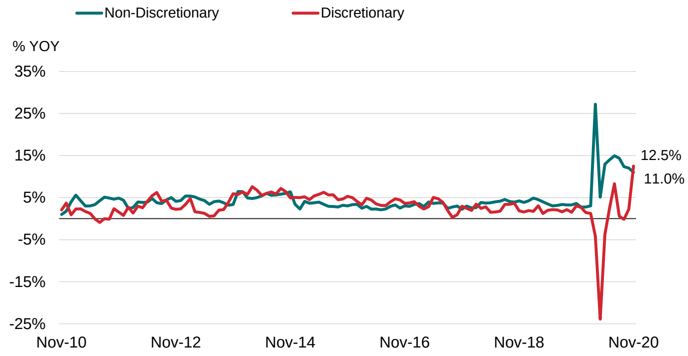
While improving profitability has been a positive, not all retailers have benefited. Vacancy rates in shopping centres have risen on average in a weak leasing environment, with cafes and restaurants under pressure due to social distancing requirements.

Table 5. Retail snapshot

	Specialty rent growth % p.a.	Cap rate chge from Q3 2020	State sales growth % p.a.
Sydney			
Regional	-3.0%	No change	
Sub-regional	-0.5%	-13bps	5.2%
Neighbourhood	+0.2%	-13bps	
Melbourne			
Regional	-5.0%	+13bps	
Sub-regional	-1.0%	No change	0.0%
Neighbourhood	-0.5%	No change	
SE QLD			
Regional	-2.0%	No change	
Sub-regional	+0.2%	No change	9.6%
Neighbourhood	+0.2%	-13bps	

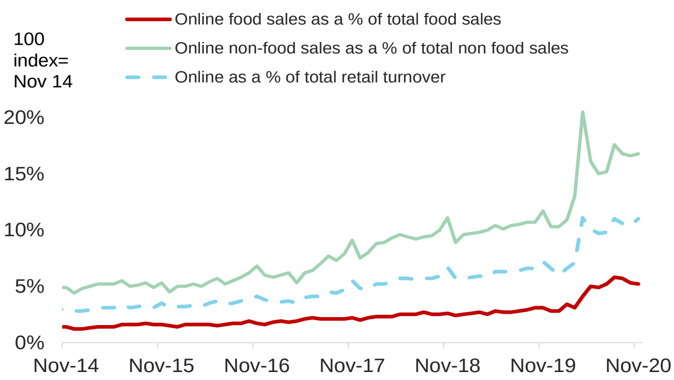
Source: JLL Research, Dexus Research (December 2020)

Figure 16. Discretionary turnover beginning to recover while non-discretionary remains strong



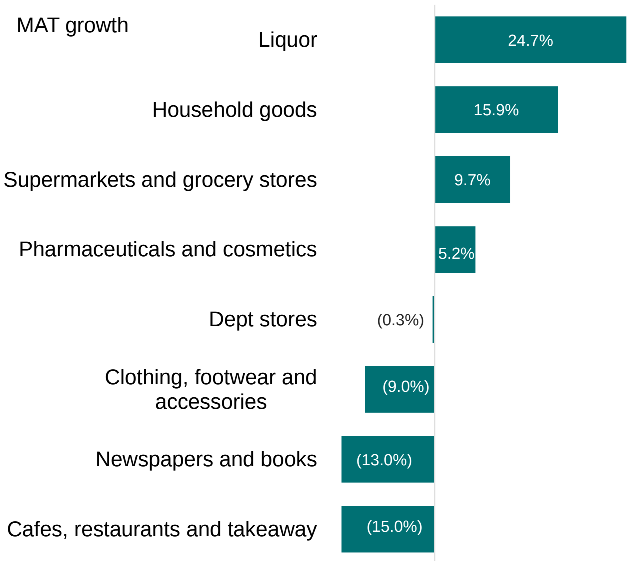
Source: ABS, Dexus Research

Figure 17. Online retailing shows significant growth with food retailing having room to grow market share



Source: ABS, Dexus Research

Figure 18. Divergence between category growth



Source: ABS, 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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