dexus

Australian Real Estate Quarterly Review

Office markets to benefit from a surge in jobs growth
Q1 2018

In summary

Investment Climate

Job surge to boost demand

Over 400,000 full time jobs were created in Australia last year, the highest in 12 years and double the long term average. As Figure 1 shows, the big turnaround story was Queensland showing the strongest growth in the country, with NSW, Victoria and WA close behind.

Australia looks like becoming a 'one-speed' economy again as growth rebalances between the states. Mining investment is no longer a significant drag on growth and the Queensland and WA economies are beginning to respond.

NSW and Victoria continue to grow solidly due to population growth and infrastructure investment.

Business conditions are positive, helped by subdued wages costs, low financing costs and an improving global growth outlook. As a result, businesses are hiring again.

While softening housing construction is still the major risk to growth, the effects appear likely to be offset by improving business and public investment.

Service sector activity will remain a growth driver for the economy in 2018 led by education, health, and IT. The professional services and finance industries are growing solidly, but with a more subdued level of job creation. Agribusiness and tourism are also buoyant.

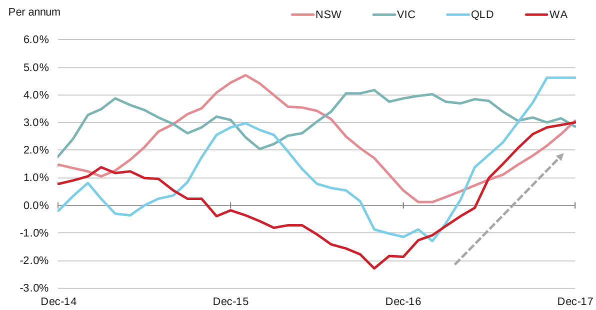
All of these trends will be positive for occupier demand in FY18 and FY19, particularly for the office and industrial sectors.

The strategic theme is that the office and industrial sectors will be relatively stronger than the retail and residential sectors in the year ahead.

Over time, retail spending should benefit from improved consumer sentiment and the prospect of stronger wages growth.

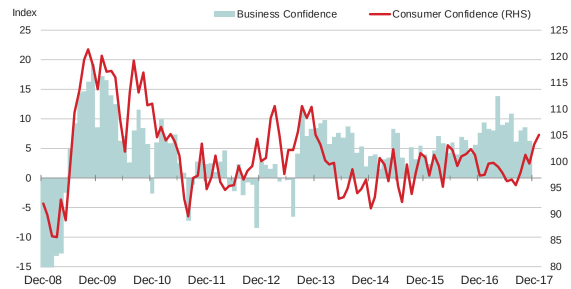
The improving global growth outlook is expected to lead to bond yields rising slowly towards more normalised levels in the medium term. However, weak inflation pressure should keep Australian official cash rates relatively flat over the next year, rising towards the end of FY19.

Figure 1. Jobs growth by state



Source: ABS

Figure 2. Consumer & business confidence



Source: Westpac, NAB

Table 1. Australian economic forecasts: Q1 2018

	Jun-17	Jun-18	Jun-19
Real GDP %pa	1.9%	2.7%	3.2%
Final demand %pa	2.4%	2.5%	2.8%
Employment %pa	2.0%	2.5%	1.4%
Goods imports %pa	7.2%	1.7%	2.1%
Retail sales %pa (real)	2.5%	2.6%	3.4%
CPI %pa	1.9%	1.9%	2.1%
90 Day bill %	1.7%	1.8%	2.2%
10yr Bond %	2.6%	2.5%	3.1%
AUD/USD	0.77	0.76	0.75

Source: Deloitte Access Economics

Transactions

Foreign buyers remain active

The fourth quarter of 2017 saw the highest transaction volume of the year, accounting for a third of all transactions during. Annual transaction activity was up 3% from $23.3bn in 2016.

Unlisted property trusts were the major domestic buyers for the third consecutive year in 2017, followed by A-REITs and privates.

Foreign transaction volumes stablised following Chinese capital restrictions. In the last quarter, 31.4% of transactions were from foreign sources, the lowest level since June 2015. That said, non-Chinese foreign buyers remained active indicating that they still see value in the Australian market relative to offshore jurisdictions.

The most significant transaction of the quarter was the acquisition of Indooroopilly Shopping Centre by funds associated with AMP.

The next largest retail transaction was the 50% interest in Chatswood Chase, purchased by GIC for $562.3m. There were relatively few significant industrial transactions this quarter, despite Allied Pinnacle's portfolio sale to Qualitas for $204m.

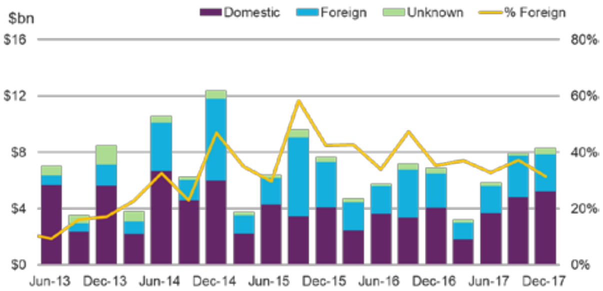
Two key metropolitan sales in Sydney were Telstra House for $342m to Charter Hall Direct Property Fund (CHDPF) and Blackstone's 1 Castlereagh Street to Early Light International for $218m at an undisclosed cap rate.

Investment yields have tightened in the Sydney and Melbourne CBDs to average 4.8% and 5.1% respectively. Brisbane and Perth continue to trade at a wider spread to Australia's largest cities. However, despite an apparent arbitrage, there has been relatively little transactional activity in these two markets.

The pricing cycle for real estate is mature. In the absence of an unforeseen capital market shock, cap rates are expected to remain low and investment demand strong over the next year.

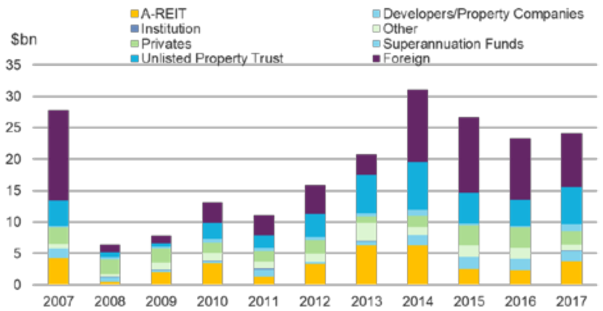
From here, trends in pricing are more likely to be driven by the fundamental growth outlook for markets (e.g., office supply/demand dynamics) rather than by interest rates or bond yields.

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. Q4 2017 top transactions

Price ($m)	Asset/portfolio	Buyer
800.0	Indooroopilly Shopping Centre	AMP Capital Diversified Property Fund (50%) / AMP Capital Shopping Centre Fund (50%)
562.3	Chatswood Chase	GIC
370.0	Santos Place	GIC
342.0	Telstra House	Charter Hall Direct Property Fund (CHDPF)
301.2	Queen Victoria Building	Vicinity Centres
300.0	Rockingham Centre	AMP Capital
289.3	Trust Capital Advisors Portfolio	PA Realty (MEC and CLSA Real Estate)
218.0	1 Castlereagh Street	Early Light International
204.0	Allied Pinnacle Portfolio	Qualitas Food Infrastructure

Source: Dexus Research Transaction Database, JLL Research

Performance

Office returns climb higher

A-REITs underperformed the broader Australian sharemarket by 6.1 percentage points in 2017, following three consecutive years of outperformance. However, A-REITs finished the year well, returning 7.6% in Q4 2017.

Performance going forward will be influenced by continued income growth and robust occupancy rates on the one hand, offset by a perceived maturing of the price cycle for underlying property and sentiment around structural changes in the retail sector on the other.

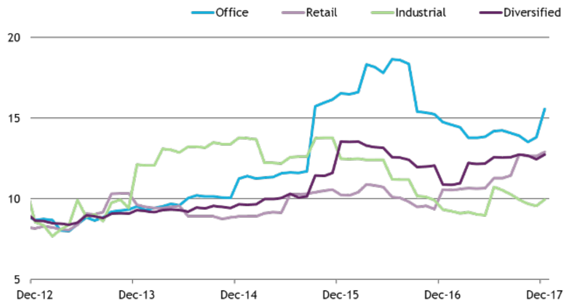
The prospect of rising bond yields could be another headwind for A-REITs. Figure 6 shows the sensitivity of A-REIT pricing to bond yield movements. Government bonds and bond proxies, such as property stocks, tend to be highly correlated. Any further tightening of monetary policy by central banks around the world over the next few years which leads to higher bond yields could influence pricing of high yielding defensive assets.

Unlisted property returns also ended the year on a positive note, remaining at the top of the asset class return table with an annual return of 13.5%.

Office remains the best performing sector with strong fundamentals, widening re-leasing spreads, and a subdued supply pipeline in the short term. However, as the pricing cycle matures, total returns are expected to ease over the next two years with capitalisation rates flattening, leading to a softening in capital growth.

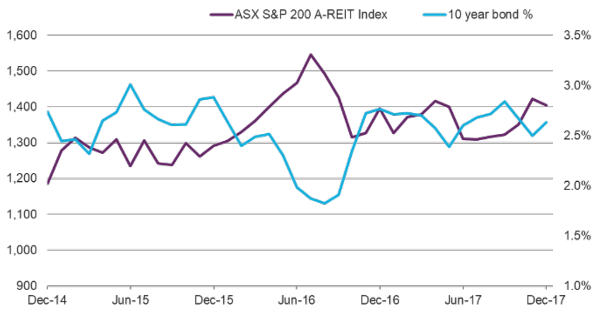
Australian equities have continued to underperform global markets despite a commendable 11.8% return in the year to December 2017. Persistent structural issues plague the market, such as a dearth of technology stocks that have driven growth internationally. The Australian sharemarket's high weighting to banking and retail stocks has also held back performance.

Figure 5. Unlisted property returns by sector



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

Figure 6. A-REIT prices vs Bond yields



Source: RBA, Bloomberg, Dexus Research

Table 3. Index returns to 31 December 2017

	Qtr. %	1 yr %p.a.	3 yr %p.a.	
Unlisted property*	3.7	13.5	12.9	Mercer/IPD Aust. Unlisted Wholesale PFI*
Australian shares	7.6	11.8	8.6	S&P/ASX 200 Accumulation
A-REITs	7.9	5.7	11.0	S&P/ASX 200 Property Accumulation Index
Australian fixed interest	1.4	3.7	3.1	BACM0 Index
Australian cash	0.4	1.7	2.1	BAUBIL Index

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

Office markets

Strong performance to continue in 2018

The eastern seaboard office markets experienced a stellar year in 2017. Effective rents grew by double digits across most markets (Table 4) with Sydney and Parramatta CBDs leading the charge, up +26% and +25% respectively for prime assets. Both markets are expected to perform strongly in 2018 as they continue to benefit from low vacancy and positive demand supported by infrastucture investment.

Melbourne continued to lead the office markets in terms of occupier demand, recording +91,100sqm in net absorption for the year on the back of a powering Victorian economy and robust population growth. Brisbane and Perth also proved they were on the mend, recording very strong net absorption of +33,200sqm and +41,800sqm respectively in 2017.

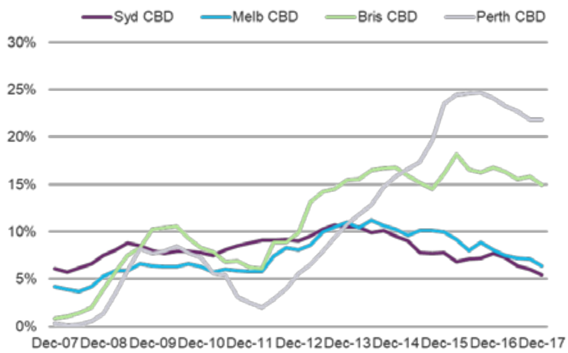
Vacancy levels declined across the major CBD markets (Figure 7), with vacancy levels below the longterm average. Sydney and Melbourne delivered strong rental growth in 2017 (Figure 8). Brisbane and Perth rents were relatively flat as high vacancy remained an issue.

We remain positive on the outlook for office markets in the year ahead as they continue to benefit from growth in the service sector and minimal supply.

Our key predictions for 2018 include:

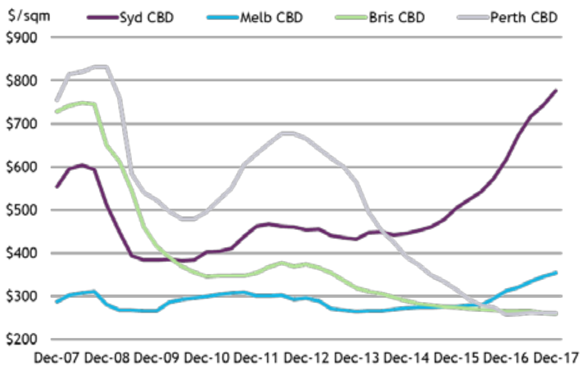
- Sydney markets (especially the CBD, Parramatta and North Sydney) to outperform with strong rental growth benefiting from a robust NSW economy and minimal supply
- Melbourne will continue to record the strongest take-up in 2018 helped by population growth of 2.7%pa. While supply is expected to ramp up from FY19+, strong demand should continue to support rental growth over the next 6-12 months
- Brisbane and Perth will see a return to rental growth (albeit mild) in 2018 due to improving state economies, positive demand and falling vacancy rates

Figure 7. Vacancy by market



Source: JLL Research, DEXUS Research

Figure 8. Net effective rents ($/sqm) by market



Source: JLL Research, DEXUS Research

Table 4. Q4 2017 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth % p.a.
Parramatta	3.9%	16.1%	25.0%
Sydney CBD	5.4%	9.6%	26.0%
Melbourne CBD	6.4%	9.5%	13.4%
North Sydney	7.6%	7.3%	11.9%
Macquarie Park	7.8%	4.5%	10.4%
Canberra	13.3%	3.4%	5.3%
Brisbane CBD	15.0%	2.5%	-2.7%
Adelaide CBD	15.1%	0.3%	-7.4%
Perth CBD	21.8%	-1.3%	1.3%

Source: JLL Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney	Sydney is expected to outperform in the shortterm driven by growth in the service sector and minimal supply. With below average vacancy of 5.4%, prime and secondary gross effective rents have risen +20.5% and +13.3% over the year. Rising secondary rents and withdrawals are driving strong take-up of prime space with c104,200sqm of net absorption recorded in 2017. A constrained supply pipeline and expectations of falling vacancy will continue to support strong rental growth in 2018.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
North Sydney	Despite subdued demand and vacancy remaining relatively steady in North Sydney, prime net effective rents grew by 11.9% over the year with net incentives declining to 25%. A more positive demand outlook is expected for 2018 as the market benefits from a strong NSW economy and overflow of demand from the CBD. Stronger demand should help to support a further uplift in rents over the year ahead.	Vacancy ↓ Rents ↑ Incentives → Yields →
Macquarie Park	Stronger demand and withdrawal of stock for residential conversion has seen vacancy rates fall below average to 7.8%. Prime net effective rents have grown strongly up 10.4% over the year as net incentives fell to 24%. A relatively subdued supply pipeline and positive demand is expected to support further rental growth in the year ahead.	Vacancy ↓ Rents ↑ Incentives → Yields →
Parramatta	Parramatta is expected to perform solidly in the shortterm, having one of the lowest total vacancy rates (3.9%) and no immediate supply risks. The tight prime vacancy (0.4%) will continue to support rental growth and low incentives for prime assets. Supply risks will mount over the mediumterm with the exit of CBA and development of Parramatta Square; however most new supply should be largely pre-committed and the market will benefit from government decentralisation and significant infrastructure investment.	Vacancy → Rents ↑ Incentives → Yields →
Melbourne	Melbourne is benefiting from strong economic fundamentals, recording the strongest net absorption across the CBD office markets, and a fall in vacancy to 6.4%. In line with improving vacancy, prime net effective rents have increased by 14.4% over the year (largely driven by increases in Face rents). Limited new supply and a solid demand outlook will see vacancy tighten and support further rental growth over the next 6-12 months.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Brisbane	The latest numbers continue to support a recovery story for Brisbane over the next year or two with positive net absorption of +33,208sqm recorded for the year. While prime gross face rents have improved, growing 2.5% over the year, incentives remain elevated (38% gross) as a result of high vacancy and speculative supply. Prime rental growth is expected to improve over the mediumterm, 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 on the mend. Demand has improved with net absorption of +41,781sqm recorded for the year and vacancy rates have declined by -2.3 percentage points. Prime net effective rents have experienced mild growth of +1.3% over the last 12 months as net incentives declined by -80bps. Rental growth is expected to remain subdued shortterm, improving over the mediumterm as market conditions slowly recover in the absence of new supply.	Vacancy → Rents ↑ Incentives ↓ Yields →
Adelaide	Conditions in the Adelaide market appear to be improving with net absorption of +20,850sqm recorded for the year and vacancy trending lower. Prime incentives have remained stable at 37% (gross) while face rents have increased slightly. Rental growth is expected to remain subdued over the short to medium term as the market works through elevated vacancy.	Vacancy ↓ Rents → Incentives ↓ Yields →
Canberra	The demand outlook remains subdued given Federal Government budget constraints, which will continue to weigh on public service job growth over the short to medium term. Limited availability of prime space (prime vacancy is currently 5.6%) is helping to support rental growth in prime assets. Positive demand for prime assets should support an uplift in rents over the next 12 months.	Vacancy ↓ Rents ↑ Incentives → Yields →

Industrial

Sydney leading the charge

Occupier demand is running just ahead of supply in Sydney and Melbourne, leading to pockets of rental growth. In 2017, Sydney recorded almost 920,000sqm of industrial take-up, the highest level in more than 10 years and 60% more than the 10 year average. Tenant demand remained solid in Melbourne.

Industrial conditions appear to be improving in Brisbane after 2017 recorded the highest level of take-up in five years, supported by several large pre-lease and owner-occupier deals. Demand in Perth remained subdued.

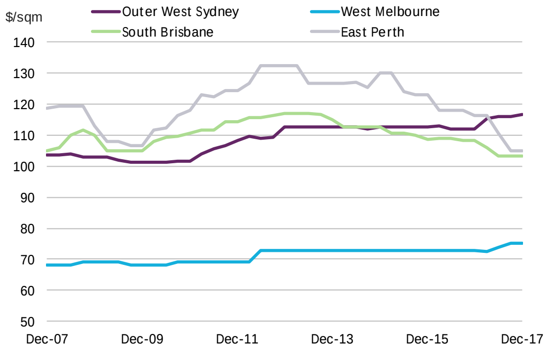
Solid population growth and large infrastructure pipelines will support industrial conditions in the Eastern states over the next couple of years.

2017 also saw key industrial markets in Sydney and Melbourne record rental growth for the first time in several years on the back of favourable conditions. These markets are likely to continue to witness upward pressure on rents in the near term, particularly in land constrained areas in the inner city.

Industrial supply is projected to remain in-line with the 10 year average in 2018; as institutions continue to build new stock despite increasingly limited serviced land supply in some core markets.

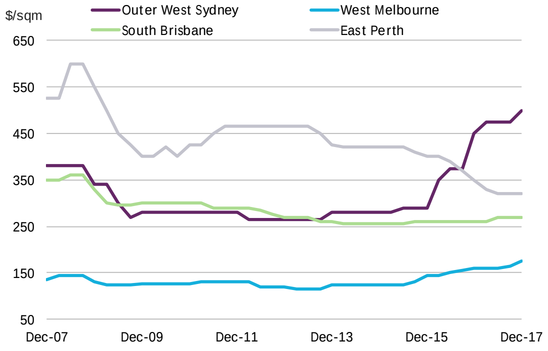
Demand for investment stock and development sites remains strong and highly competitive due to limited availability of product, driving up prices for all asset types and industrial land. Land values have lifted by 11% in Outer West Sydney over the past year.

Figure 9. Average existing prime industrial rents



Source: JLL Research, Dexus Research

Figure 10. Average industrial land values (1ha)



Source: JLL Research, Dexus Research.

Table 5. Q4 2017 industrial snapshot

	Ave prime cap rate change from Q4 2016	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.25	4.2
Southern Brisbane	-0.25	-4.6
East Perth	0.00	-9.7
South Sydney	-0.25	6.8
West Melbourne	0.00	2.9

Source: JLL Research, Dexus Research

Outer West Sydney

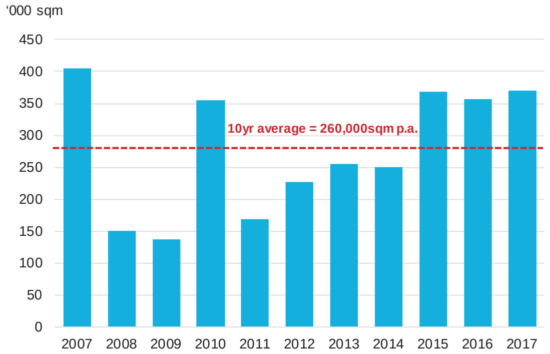
2017 was a record year for industrial take-up in Outer West Sydney, with some 370,000sqm recorded, well above the 10 year average and the highest level since 2007. Demand is projected to remain solid in the medium term, benefitting from positive economic conditions.

Supply in 2017 was below the 10 year average and the reduced supply, combined with strong tenant demand, helped to drive rental growth in the Outer West. Supply is projected to bounce back in 2018 with around 384,000sqm of industrial stock likely to be developed, significantly above the 10 year average of 290,000sqm.

Rental growth is likely to continue in the short term but at a more subdued rate, taking into account the supply pipeline.

The largest lease deal in Q4 2017 was Miele pre-committing to a 17,000sqm warehouse at Calibre in Eastern Creek.

Figure 11. Outer West Sydney gross take-up



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

West Melbourne

West Melbourne recorded 43,000sqm of industrial take-up in Q4 2017, leading to 325,000sqm of take-up in 2017, substantially higher than the 10 year average of 255,000sqm.

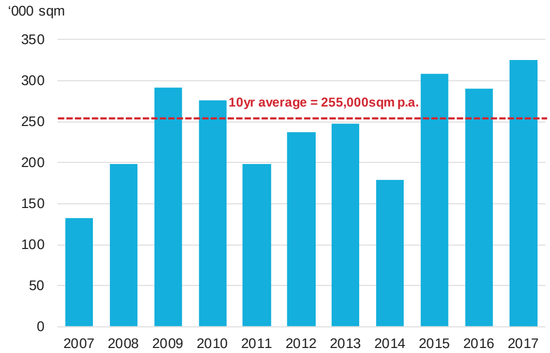
The Victorian economy is projected to remain strong over the medium term and as such, industrial demand in West Melbourne is likely to remain solid.

2017 saw industrial rents in West Melbourne increase slightly. It is likely that some mild upward pressure on rents will continue in the short term.

Around 230,000sqm of industrial stock is projected to be developed in 2018, in-line with the 10 year average but below the 360,000sqm completed in 2017. Reflecting the provision of cleared, zoned land in West Melbourne, the supply figure may increase as new developments are announced.

The largest lease deal in Q4 2017 was a pre-lease to CTI Logistics (15,000sqm) at Truganina.

Figure 12. West Melbourne gross take-up



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

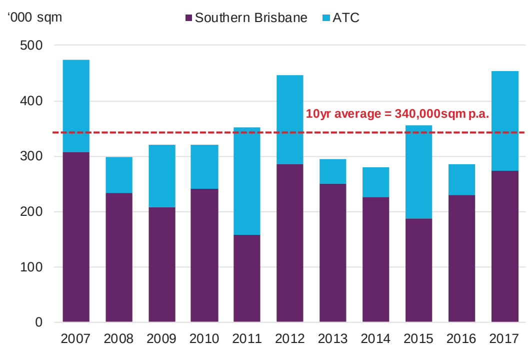
Brisbane

Total take-up in Brisbane reached almost 480,000sqm in 2017, the highest level since 2012 and suggesting industrial conditions are improving.

The industrial supply pipeline for Brisbane is currently projected at 160,000sqm in 2018, well below the 10 year average and the 340,000sqm completed in 2017. The reduced supply pipeline may help to support rents in Brisbane in the short term.

There were no pre-lease deals in Brisbane in Q4 2017, with the largest lease being to Toll (20,000sqm) at Acacia Ridge.

Figure 13. South Brisbane and ATC gross take-up



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

Retail

Will consumers come to the rescue?

Consumers appear to be shrugging off a range of headwinds such as weak wages growth and a softening housing market. Consumer sentiment has risen over the past few months to reach its highest level in four years in January. The key question is 'will it be sustained?'.

Retail turnover growth remains below trend on an annual basis at 2.8% per annum. While the retail environment remains challenging, the retail sector appears to have benefitted from improving sentiment.

Retail turnover growth jumped a record 1.2% in the month of November 2017 based on ABS data, well above the typical average for that time of year. The results was helped by sales of new electronics such as the release of the iPhone 8 and iPhone X as well as discounting events like Black Friday.

At a category level, food catering continues to perform well, along with pharmaceuticals and cosmetics, while department stores are still contracting.

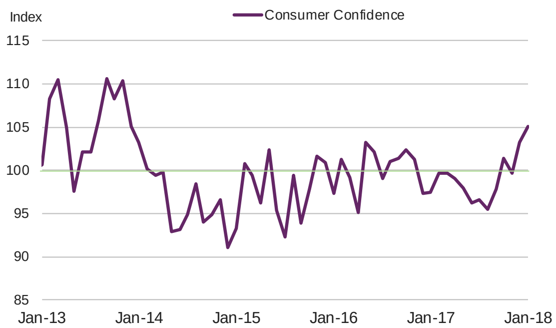
The outlook is for mild improvement in retail sales in the medium term as solid jobs growth flows through to wages and an improvement in household incomes.

The outlook for rents is relatively flat in the short to medium term given slow sales growth and high occupancy costs.

Key topics this quarter include:

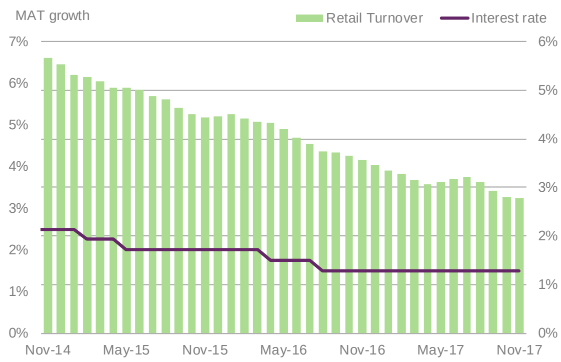
- Amazon officially commenced trading in Australia in December following a soft opening in late November; Amazon will continue its steady rollout in the coming years
- Landlords should expect some negative re-leasing spreads for physical retail stores in the near term as retailers adjust business models to compete with international and online retailers
- The latest physical retailers to face difficulties include Oroton, which was recently placed into administration; while Specialty Fashion Group (Millers, Katies, Rivers, City Chic) and Mountain Designs have both announced plans to close some of their physical stores

Figure 14. Consumer confidence



Source: Westpac, Dexus Research

Figure 15. Retail sales growth and cash rate



Source: ABS, RBA, Dexus Research

Table 6. Q4 2017 retail snapshot

	Specialty rental growth % p.a.	Cap rate change from Q4 2016	State retail sales growth % p.a.
Sydney			3.2
Regional	0.63	-0.50	
Sub-regional	0.88	-0.25	
Neighbourhood	1.00	-0.25	
Melbourne			3.8
Regional	0.25	-0.25	
Sub-regional	0.12	-0.25	
Neighbourhood	0.37	0.00	
SE QLD			1.9
Regional	0.00	-0.50	
Sub-regional	0.00	0.00	
Neighbourhood	0.00	-0.50	

Source: JLL Research, ABS, Dexus Research

Dexus Research

Peter Studley
Head of Research
d: +61 2 9017 1345
e: peter.studley@dexus.com

Kimberley Slow
Research Manager
d: +61 2 9017 1287
e: kimberley.slow@dexus.com

Lee Cikuts
Research Manager
d: +61 2 9017 1268
e: lee.cikuts@dexus.com

Karl Sarich
Research Associate
d: +61 2 9017 1299
e: karl.sarich@dexus.com