dexus

Australian Real Estate Quarterly Review

Q2 2019

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

Inside

Investment Climate

What will moderating growth mean for property?

Recent data points to moderating growth for the Australian economy driven by a softening housing market and a downward revision to the global growth outlook. However, Australia's GDP growth will be higher than most other developed nations in the OECD despite easing from 3.1% in FY18 to 1.5% in FY19.

- Capital city house prices have declined 7.3% over the past year with further falls likely. Building approvals were down 21.7% in the year to Feb-19. Consumption growth is likely to slow due to the wealth effect from falling house prices
- Official cash rates during are expected to fall by 50 bps during FY20
- Business and consumer confidence levels have dipped in recent months with both back to mildly negative territory. It will be interesting to see if a clear result in the federal election on 18 May 2019 will help to reset confidence
- Significantly, business conditions are above average, and employment growth remains positive
- Supporting future GDP growth are positive net exports, growth in public spending and population growth

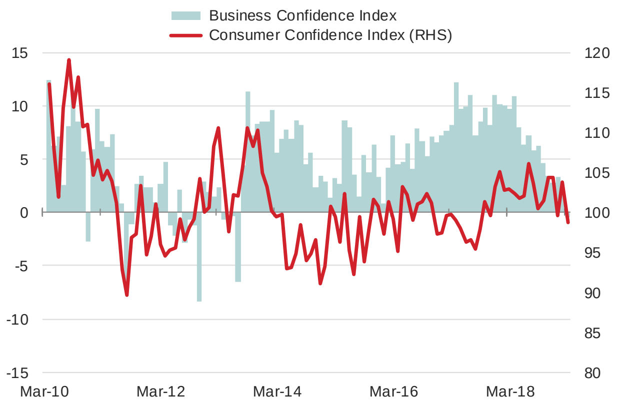
On balance, these trends are likely to lead to an easing of occupier demand across most markets and sectors, but not a significant contraction. If this assumption is right, the office and industrial sectors are reasonably well placed given falling levels of vacancy, a lack of short term oversupply and broad based investment demand. The retail sector will find conditions remain challenging.

Table 1: Australian economic forecasts: Q1 2019

	Jun-18	Jun-19	Jun-20
Real GDP %pa	3.1%	1.5%	2.0%
Final demand %pa	3.2%	1.2%	1.2%
Employment %pa	2.6%	2.0%	1.1%
Goods imports %pa	7.2%	2.1%	2.2%
Retail sales %pa (real)	2.4%	2.4%	2.9%
CPI %pa	2.2%	1.5%	1.7%
90 Day bills %	2.1%	1.7%	1.2%
10yr Bond %	2.6%	1.7%	1.7%
AUD/USD	0.74	0.69	0.66

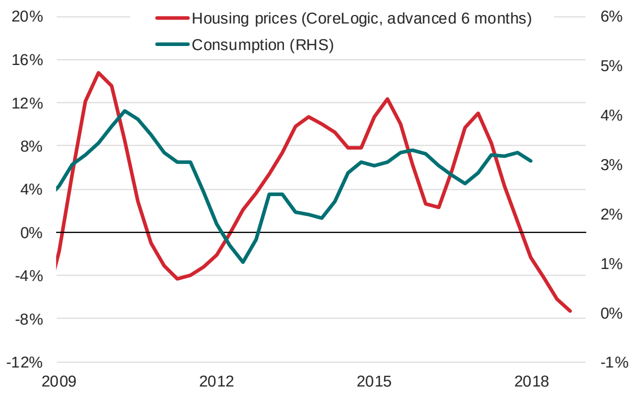
Source: Deloitte Access Economics base, Dexus adjusted forecasts

Figure 1: Confidence is fragile in the face of global risks and a domestic election



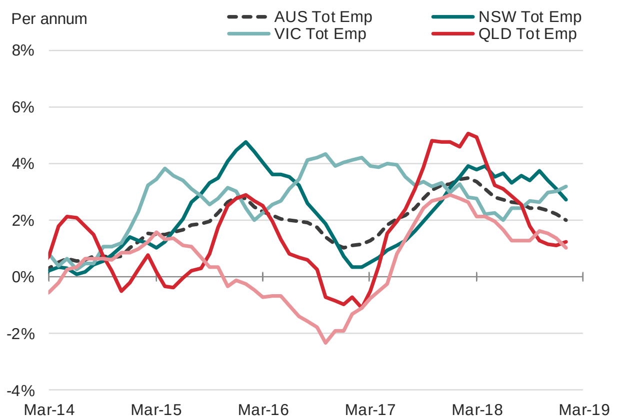
Source: Westpac-Melbourne Institute, NAB

Figure 2: House price falls likely to affect consumption, but low interest rates an advantage



Source: ABS

Figure 3: Employment growth still strong helped by positive business conditions



Source: ABS

Transactions

Sector cap rate trends now diverging

The trend of simultaneously tightening cap rates which has led to above average total returns across sectors has ended. Retail cap rates are now rising, office appear flat and industrial still tightening. This divergence leads to a different capital growth outlook for the sectors over the next year or two.

Over the past year a tightening of industrial cap rates relative to office has reduced the yield advantage held by industrial to the lowest level on record at 50 basis points.

The retail cap rate tightening cycle has come to an end as Sydney regional retail yields expanded for the first time since 2009 by 25 basis points (Figure 4). Expansion was at the lower end of the quality range. Sydney sub-regional yields expanded by 50 basis points.

These yield trends are Agency estimates in the absence of much physical retail sales evidence. Valuation evidence is mixed, with the only REIT to report expansion in their weighted average cap rate being Stockland, moving from 5.8% to 5.9%.

While property yields are at historically low levels, the spread to the 10yr bond yield remains relatively wide which is supporting investment demand for property. For example, the office cap rate spread over bonds in Sydney CBD remains at historically wide levels at 280 basis points, mainly due to sharp falls in the bond rate in the past quarter.

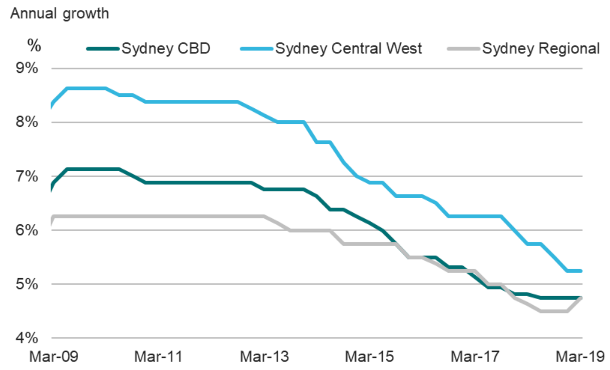
Transaction volumes were $3.7 billion in the first quarter of 2019, about average for this time of year. Foreign capital remained a sizeable proportion of total activity (approximately 30%) with the Hong Kong Monetary Authority (HKMA) purchasing Barangaroo International Tower 1 for $208m (10%).

Table 2: Q1 2019 top transactions

Price ($m)	Asset/portfolio	Buyer
800	MLC Centre	DXS (50%) / Dexus Wholesale Property Fund (DWPF) (50%)
342	Freshwater Place	GPT Wholesale Office Fund (GWOF)
314	595 Collins Street	Private
231	11 Talavera Road	Goodman Group
208	International Tower 1	HKMA
114	85 Spring Street	Proprium Capital Partners
103	Stockland Cleveland	Haben Number 8
97	113 Mary Street	ARA Asset Management
91	1 Eucalyptus Place	AMP Capital

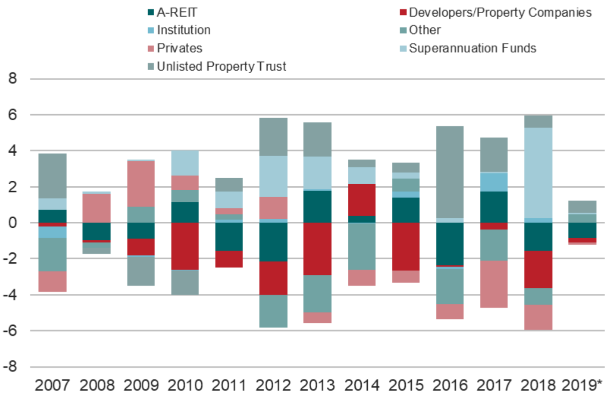
Source: Dexus Research Transaction Database, JLL Research

Figure 4: Regional retail yields expand for the first time since 2009



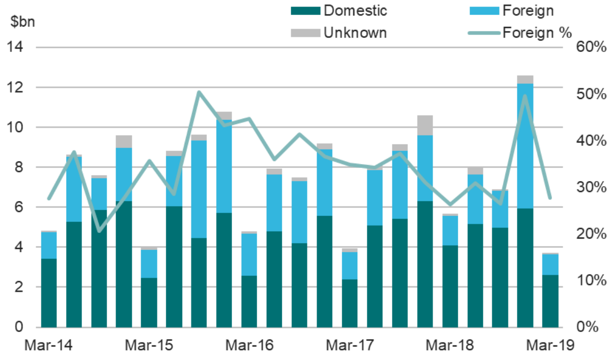
Source: JLL Research, Dexus Research

Figure 5: Unlisted funds and superannuation funds are the main net buyers



Source: JLL Research, Dexus Research Transaction Database
*YTD

Figure 6: Foreign investment volume remains elevated



Source: JLL Research, Dexus Research

Performance

A-REITs deliver the goods

A-REITs delivered a markedly strong quarter in March, easily outperforming the broader Australian equity market (Figure 7). A-REIT pricing continued to benefit over the quarter from falling bond yields (Figure 8) and investors moving back into defensives on the back of a more cautious macro backdrop.

Performance in the direct property market remains robust with strong investor demand, especially for Sydney, Melbourne office and industrial assets. This saw direct property deliver returns of +10.3% (PCA/MSCI Index, Dec-18) and unlisted property funds return +9.1% (MSCI/Mercer Index, Mar-19) over the year. We expect returns to trend lower in the year ahead as capital growth wanes and returns revert toward income.

Unpacking the headline numbers, returns are increasingly divergent at the sector level. The residential and retail sectors have lagged as fundamentals have deteriorated, while Sydney/Melbourne office (robust rent growth) and industrial (ecommerce trade) have outperformed.

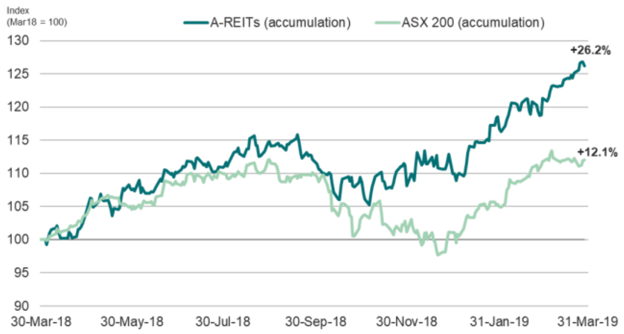
This divergence is evident in the latest MSCI/Mercer Wholesale Funds index results (Figure 9). Retail returns are being affected by weaker income growth, rising incentives/capex and write downs in the values of poorer assets. Office and industrial funds continue to deliver double digit returns boosted by further cap rate compression and rising rents. Diversified funds have been held back by their retail exposures.

Table 3. Index returns to 31 March 2019

	Qtr.%	1 yr %p.a.	3 yr %p.a.	
Unlisted property*	1.3	9.1	11.3	MSCI Mercer Aust. Unlisted Wholesale PFI*
Australian fixed interest	3.4	7.2	4.2	BACM0 Index
Australian cash	0.5	2.0	1.9	BAUBIL Index
A-REITs	14.8	26.2	9.9	S&P/ASX 200 A-REIT Accumulation Index
Australian shares	10.9	12.1	11.5	S&P/ASX 200 Accumulation Index

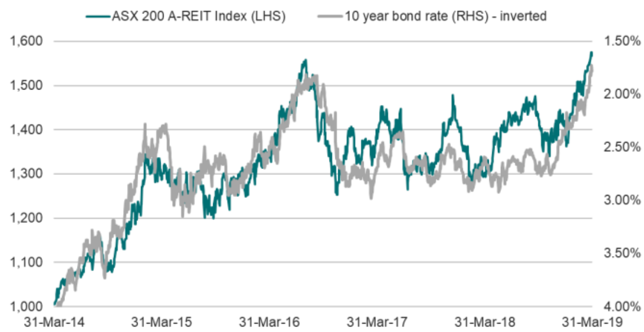
The indices are copyrighted by and proprietary to the relevant Source issuers: MSCI Mercer Aust. Core Wholesale Monthly PFI; Standard and Poor's Australian Securities Exchange Accumulation Index; Bloomberg/UBS Composite and Bank Bill Indices. *NAV Pre-Fee

Figure 7: A-REITs returned +26.2% in the year to March 2019, outperforming the broader market



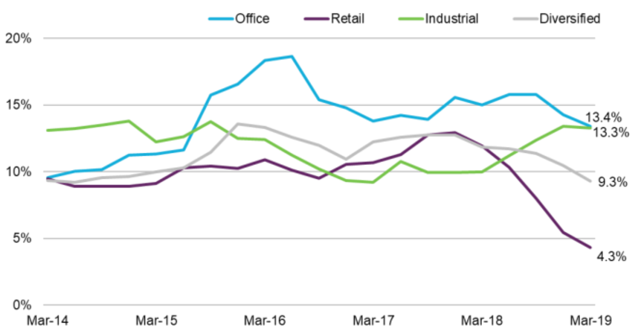
Source: IRESS, Dexus Research

Figure 8: A-REIT pricing is being supported by falling bond yields (down 33bps in March 2019**)**



Source: IRESS, Dexus Research

Figure 9: Sector divergence is increasing with unlisted retail funds trailing the pack – returning only +4.3% pa



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

Office Markets

Running out of space

Vacancy rates declined across the key office markets in Q1 2019 with the amount of contiguous prime space becoming increasingly limited. Vacancy rates in the Sydney and Melbourne CBDs are now at 3.7%, the lowest level in around 30 years, while vacancy rates in Brisbane and Perth continue to fall.

The outlook hinges on the outlook for occupier demand. Employment growth remains positive, however in FY20 conditions are expected to ease due to slowing business confidence and an uncertain economic outlook which means occupier demand is likely to ease. Should this occur, Australia's main office markets are well-positioned given a degree of pent-up demand, low or falling vacancy rates and a lack of short term supply. In addition, an increase in the supply pipeline over the next few years is supported by solid levels of pre-commitment.

Against this backdrop, rent growth in Sydney and Melbourne is projected to taper in the year ahead as the cycle matures. In Sydney and Melbourne prime net effective rents were up +5.3% and +3.6% respectively for the year to March 2019 but the trend is clearly flattening. In Brisbane and Perth rents should continue to improve as markets recover, following net effective rent growth of +4.3% and +2.3%, respectively for the year to March 2019. The fact that Brisbane and Perth are at different points of their cycle than Sydney and Melbourne provides investors with useful diversification.

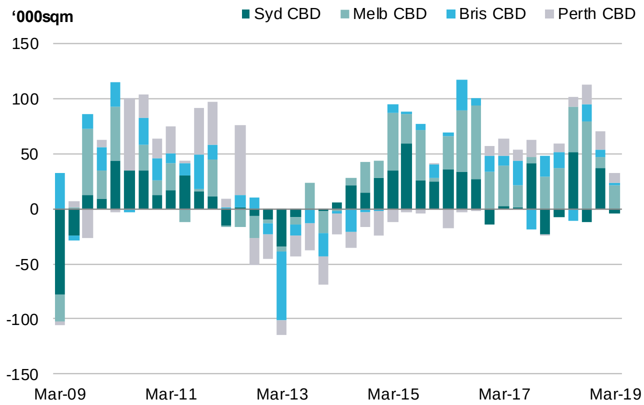
The Sydney metropolitan markets continue to perform well in terms of growth led by Parramatta with a record low vacancy rate of 3.5% and North Sydney with vacancy at 6.4%.

Table 4. Q1 2019 office snapshot

	Vacancy %	Prime net face rent growth % p.a.	Prime net eff. rent growth % p.a.
Parramatta	3.5%	6.7%	9.9%
North Sydney	6.4%	6.8%	9.3%
Macquarie Park	6.4%	5.6%	8.8%
Adelaide CBD	13.5%	2.9%	6.5%
Sydney CBD	3.7%	7.2%	5.3%
Brisbane CBD	12.7%	2.3%	4.3%
Melbourne CBD	3.7%	3.2%	3.6%
Perth CBD	20.7%	0.6%	2.3%
Canberra	10.9%	0.1%	0.2%

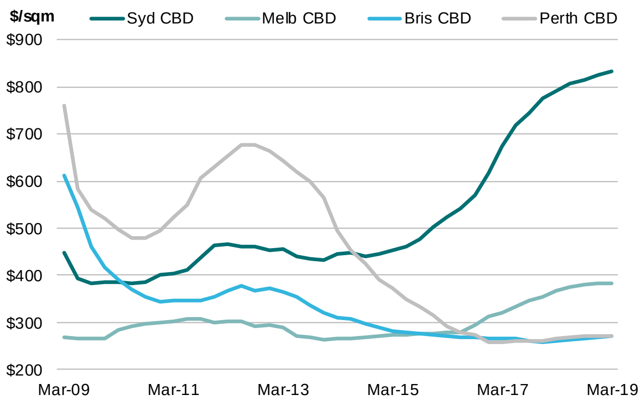
Source: JLL Research

Figure 10. CBD net absorption remains positive in aggregate for the main markets



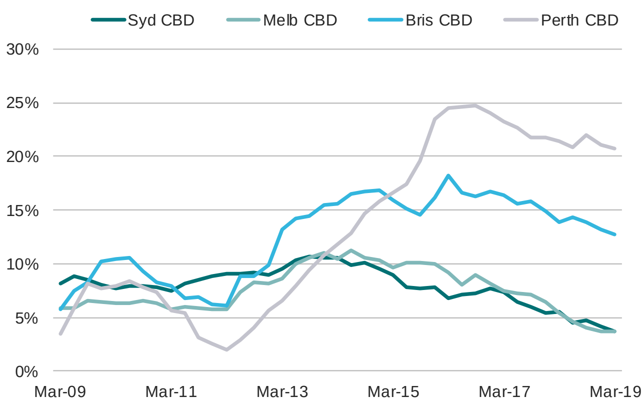
Source: JLL Research, Dexus Research

Figure 11. Rent growth tapering in Sydney and Melbourne as the cycle matures



Source: JLL Research, Dexus Research

Figure 12. Vacancy rates continue to fall leaving limited areas of contiguous space



Source: JLL Research, Dexus Research

Office Market Wrap

Market	Comments	Direction of trend for next 12 months
Sydney	**Lowest vacancy rate in three decades.** The Sydney CBD vacancy rate fell to 3.7%, the lowest level in around 30 years, supporting continued rent growth. Net absorption fell in Q1 with -4,100sqm recorded, however this was largely attributed to secondary space withdrawals. The rent cycle is approaching a peak with growth tapering and incentives stabilising. The majority of new supply is still not expected to complete until FY22-24 and as such, the market is well placed for a period of softer demand.	Vacancy ↓ Rents ↑ Incentives → Yields →
North Sydney	**Strong rent growth.** The North Sydney office market recorded positive net absorption of +16,855sqm in Q1 2019, supporting positive net effective rent growth of 3.9% for the quarter and 9.3% for the year. The vacancy rate decreased to 6.4%. The outlook for demand is positive as the market benefits from tightening supply across the Sydney region which should help support further rent growth in the near term.	Vacancy → Rents ↑ Incentives → Yields →
Macquarie Park	**Demand improves slightly.** Demand improved in Q1, recording positive net absorption of +4,059sqm. The vacancy rate reduced further to 6.4% and prime effective rents have improved with a fall in incentives along with increased face rents. Demand is projected to remain mild, and with a relatively subdued supply pipeline over FY19 there is likely to be some upward pressure on rents.	Vacancy → Rents ↑ Incentives → Yields →
Parramatta	**Lowest vacancy rate in the country.** The vacancy rate in Parramatta decreased further to 3.5% in Q1 2019. Rent growth has slowed but remains strong, up +9.9% p.a. (net effective) driven by face rents. There is medium-term supply risk due to backfill and mooted projects, however the next stages of Parramatta Square are largely pre-committed from outside the market and new projects will require pre-commitment. How Parramatta performs over the medium-term will depend on its ability to attract tenants from outside the market.	Vacancy → Rents ↑ Incentives → Yields →
Melbourne	**Strong demand continues.** Melbourne vacancy remains extremely low at 3.7% following another positive net absorption figure in Q1 2019 (+21,923sqm). Additional supply is due to complete over the coming years and the vacancy rate is likely to increase from FY20, reducing rent growth. The majority of new projects are largely pre-committed and the market is well placed to absorb the new supply. Rent growth remains positive (+3.6% net effective for the year to Mar-19) but is easing.	Vacancy → Rents ↑ Incentives → Yields →
Brisbane	**Steady recovery.** Net absorption remained positive at +2,085sqm in Q1 2019 and with limited new supply this pushed the vacancy rate lower to 12.7%. Prime vacancy is 7.9%. Net effective rent growth improved further (+4.3%p.a.) as face rents increased. Incentives are likely to remain elevated in the near term. Demand is projected to improve steadily over the next year or two, particularly for prime stock which is benefiting from a flight to quality. However, growth is likely to be tempered by new supply.	Vacancy ↓ Rents ↑ Incentives → Yields ↓
Perth	**Vacancy continues to fall on improved demand.** The Perth vacancy rate fell further to 20.7% due to limited new supply and positive net absorption of +8,728sqm recorded in Q1 2019. Currently, there is limited new supply planned over the next few years which should support the continued recovery. Prime net effective rents held steady in Q1 but experienced further growth (+2.3%p.a.). Rent growth is expected to improve with scope for incentives to decline from current high levels.	Vacancy ↓ Rents ↑ Incentives ↓ Yields ↓
Canberra	**Demand subdued in election year.** Canberra recorded negative net absorption of -1,497sqm in Q1 2019 attributed in part, to a 'wait and see' approach by tenants in an election year. The vacancy rate remains stable at 10.9%, with rents also largely stable compared to 12 months ago. The modest availability of prime space (prime vacancy is currently 6.4%) should help to support some mild rent growth in prime assets in the short term.	Vacancy → Rents ↑ Incentives → Yields →

Industrial

Demand, rents and land values remain strong

After a period of relative buoyancy, weaker consumer and business indicators point to the prospect of slower demand in FY20. However, there has been little sign of a moderation in take-up to date.

Assuming consumption growth does slow across the economy, the industrial sector won't be immune, but it will be insulated to a degree by the ongoing structural tailwinds of infrastructure projects and supply chain investment particularly in the ecommerce sector.

The supply chain investment and consolidation trend favours investment in new well-located stock. Stock obsolescence will become increasingly prevalent as customers require more advanced building technology to facilitate the efficiency of their logistics operation.

Demand is running slightly ahead of supply, leading to upward pressure on rents and land values. Land value rises have been further exacerbated by strong investment demand which has developers competing for sites. Investment demand has put downward pressure on yields, narrowing industrial's historical yield spread over office.

Land values in Sydney and Melbourne markets have experienced significant year on year growth of 30% and 62%, respectively. While the unusual strength of investment demand means further land value growth is likely, the rate of growth is likely to flatten given the difficulty of providing viable developments at current values.

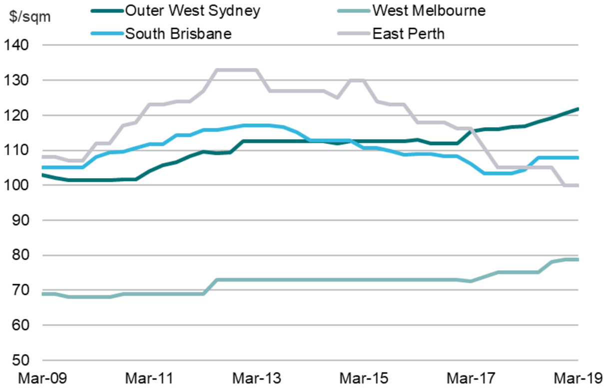
The greatest challenge for investors going forward will be gaining scale within the sector given strong competition for stock.

Table 5. Q1 2019 industrial snapshot

	Ave prime cap rate change from Q1 2018	Existing prime net face rent growth % p.a.
Outer West Sydney	-0.50	4.1
Southern Brisbane	-0.25	3.2
East Perth	-0.62	-4.8
South Sydney	-0.62	5.8
West Melbourne	-0.75	4.8

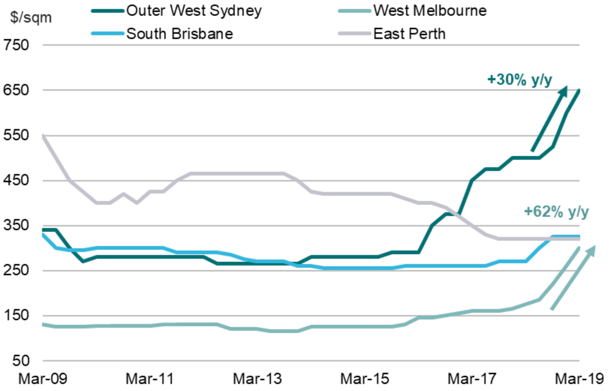
Source: JLL Research, Dexus Research

Figure 13: Prime industrial rent growth continued in Sydney while remaining flat in other markets



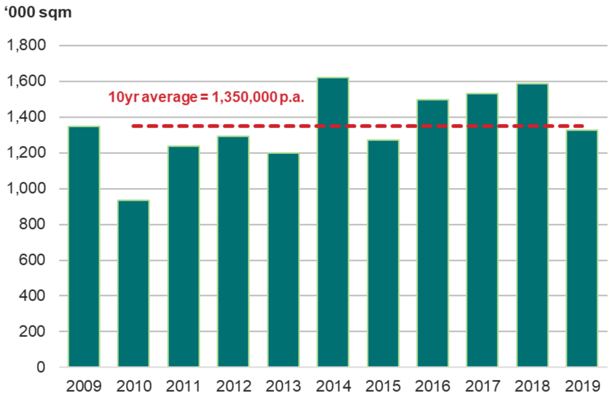
Source: JLL Research, Dexus Research

Figure 14: Average industrial land values (1ha) exhibit strong year-on-year growth



Source: JLL Research, Dexus Research

Figure 15: Industrial supply has fallen below the 10-year average across Australian capital cities



Source: JLL Research, Dexus Research

Industrial

Outer West Sydney

Demand remains robust in Outer West Sydney with take-up c371,000sqm recorded in the year to March 2019. Occupier inquiry is coming from retailers particularly in the ecommerce sector.

Supply completions slowed with only 50,000sqm completed in Q1 2019 after 175,000sqm was completed in the previous quarter. However, the annual pipeline remains solid for the Sydney industrial market, just under the 10-year annual average.

The largest lease deal in Q1 2019 was Coco Republic taking 12,000sqm in Greystanes.

West Melbourne

West Melbourne recorded around 260,000sqm of industrial take-up over the year, in line with the 10-year average.

Demand is projected to remain solid in the long term supported by structural tailwinds, strong Victorian population growth, and key infrastructure projects such as the West Tunnel.

Limited availability of serviced land in West Melbourne has resulted in upward pressure on rents and capital values over 2018.

The most significant deal of the quarter was Arlec Australia pre-leasing 31,000sqm in Maker Place, Truganina.

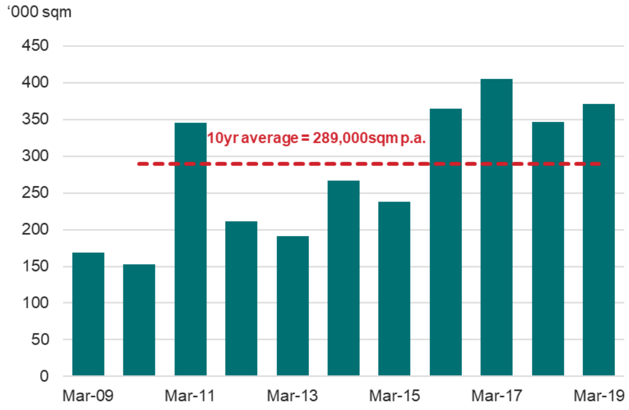
Brisbane

Take-up in Brisbane increased further in Q1 2019, with the 144,000sqm recorded being well above average. Improved economic conditions including employment growth and infrastructure investment points to a more positive outlook in the year ahead after several years of weakness.

Nine projects totalling 145,000sqm are currently under construction. Developers are reluctant to build speculatively in this market and are continuing to seek pre-commitments.

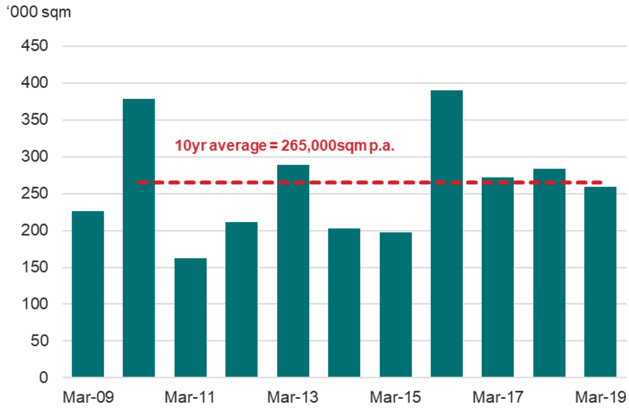
The biggest deal of the quarter was 46,000sqm to Woolworths Group in Acacia Ridge.

Figure 16: Outer West Sydney take-up remains elevated above the 10-year average



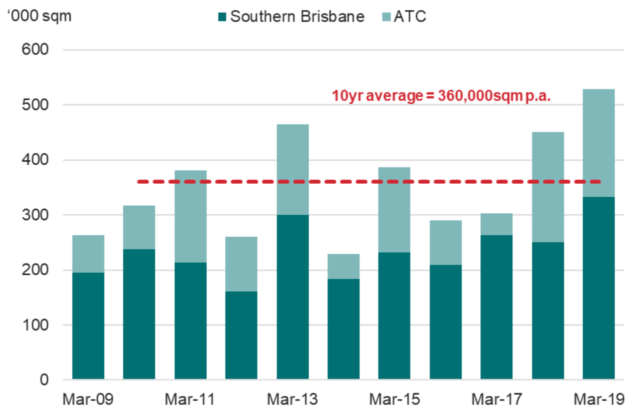
Source: JLL Research (gross take-up), Dexus Research.

Figure 17: West Melbourne take-up remains in line with 10-year average



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

Figure 18: South Brisbane and ATC take-up well above average after several years of weakness



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

Retail

Some relief, but conditions remain challenging

The outlook for the retail sector remains challenged due to the slowing housing market, weak wages growth and high levels of household debt. However, the sector is getting positive support from solid employment growth.

According to the ABS data, turnover growth rebounded in February 2019, increasing by 0.8%, significantly higher than market expectations and maintaining a moving annual turnover growth rate of 3.0%. The results indicate increased volatility in spending over the Christmas period, likely attributed to changing customer behaviour due to online events such as Click Frenzy etc. Despite volatility in the monthly series, retail turnover growth over the past four-month period is largely in line with the average.

On the back of significant changes to the online series (including merging SME and Corporate sales), the NAB Online Retail Sales Index for February 2019 showed mild growth of 0.5% for the year to February 2019, representing $28.9 billion or around 9.0% of spending at traditional bricks and mortar retailers.

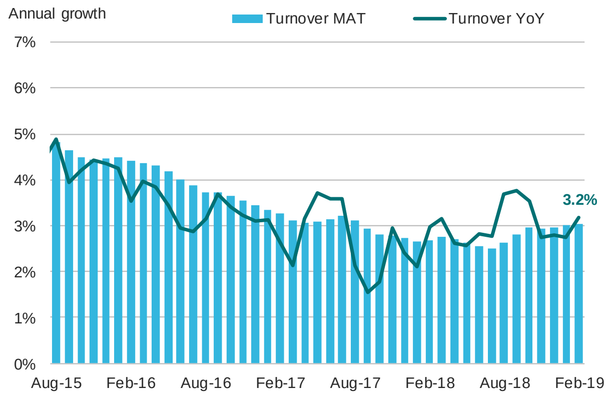
Online sales are projected to continue to grow quickly at 12.5%p.a. over the next 10 years. The total retail market (including online sales) is projected to growth at 3.7%p.a. over the same period. Retailers are experiencing significant margin pressure, and in many cases their long-term success will depend on their ability to transition to an effective omni-channel business model.

Table 6. Q1 2019 retail snapshot

	Specialty rent growth % p.a.	Cap rate change from Q1 2018	State retail sales growth % p.a.
Sydney			2.8
Regional	0.20	0.13	
Sub-regional	0.50	0.25	
Neighbourhood	0.76	0.13	
Melbourne			5.1
Regional	0.46	0.00	
Sub-regional	0.34	0.00	
Neighbourhood	0.94	-0.13	
SE QLD			2.4
Regional	0.22	-0.13	
Sub-regional	-1.50	0.00	
Neighbourhood	0.45	0.50	

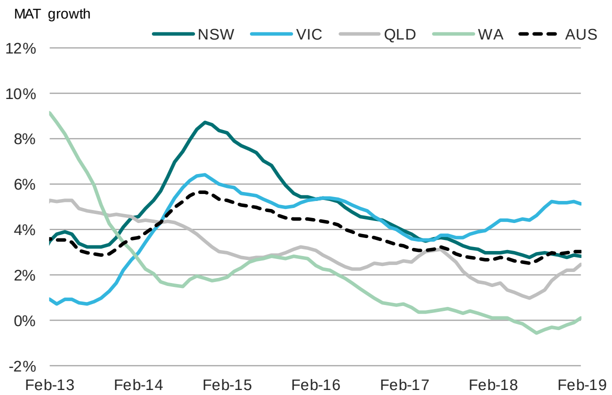
Source: JLL Research, ABS, Dexus Research

Figure 19. Retail sales growth has improved mildly but faces headwinds in FY20



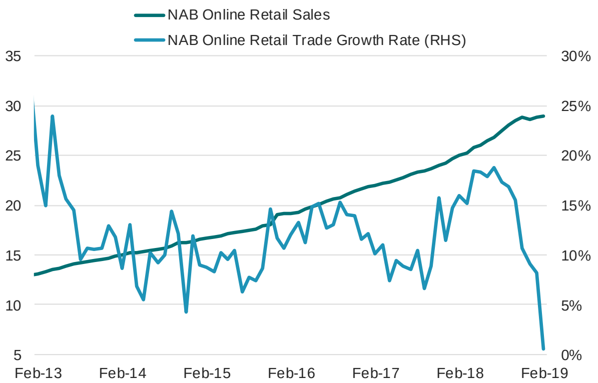
Source: ABS, Dexus Research

Figure 20. Retail sales growth varies by State with Victoria and NSW leading



Source: ABS, Dexus Research

Figure 21. Online retail sales growth data has paused but should resume double digit levels



Source: NAB Online Retail Sales Index, Dexus Research

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