dexus

Australian Real Estate Quarterly Review

Growth cycle fuels strong unlisted property returns
Q3 2017

In summary

Investment Climate

Occupier demand improving

In a relatively subdued economy, positive business confidence and firming jobs growth bodes well for occupier demand over the next 12 months in the office, industrial and retail sectors.

Jobs growth in Australia has firmed over the past six months, with Victoria by far the strongest of the States. Queensland and WA have both turned the corner. Full time jobs growth is now gaining ground on part time which is a sign businesses are gaining confidence and are willing to hire permanent staff.

The Achilles heel of the economy remains the housing market which will likely slow over the next year or two. A slowdown in housing could affect consumer confidence which in turn could drag on business confidence in FY19 leading to a slowing of demand. This outlook makes for a flat outlook for official cash rates.

Key assumptions behind the outlook are:

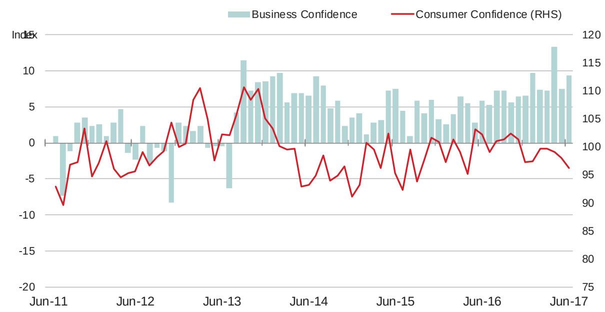
- The NSW and Victorian economies will outperform in the short term; but QLD is turning and should strengthen through FY18
- Residential construction activity, particularly apartments, is expected to slow and could be a significant headwind for growth in FY18 & FY19
- Service sector activity will remain a growth driver for the economy led by education, health, IT and tourism
- Retail spending will be constrained in the short term by weak consumer confidence and weak wages growth
- Australian official cash rates are expected to remain flat and low in FY18 and FY19

The pricing cycle for real estate is mature, yet a peak still seems some way off. The prospect of rising interest rates are an important theme for asset pricing globally. However, the pace of any such rises is likely to be slow. Signals from the US economy, while positive are still somewhat mixed and rises in US interest rates may be somewhat slower than generally expected. In addition, a flat interest rate outlook for Australia, combined with positive real estate fundamentals should help insulate real estate pricing.

Figure 1. Jobs growth now and six months ago

Source: ABS

Figure 2.Gap beween business and consumer confidence



Source: Bloomberg , Dexus Research

Table 1. Australian economic forecasts: Q3 2017

	Jun-17	Jun-18	Jun-19
Real GDP %pa	1.5%	2.8%	2.6%
Final demand %pa	0.9%	2.1%	2.3%
Employment %pa	2.0%	0.8%	0.9%
Goods imports %pa	8.1%	2.3%	2.1%
Retail sales %pa	1.6%	2.0%	3.6%
CPI %pa	2.0%	1.5%	2.1%
90 Day bill %	1.8%	1.7%	1.8%
10yr Bond %	2.4%	2.6%	2.6%
AUD/USD	0.75	0.72	0.71

Source: Dexus Research (Modified fr. Deloitte Access Economics)

Transactions

Yields remain firm

Transaction volumes firmed mildly from a subdued Q1 2017. A lack of investment stock continues to constrain sales volumes, despite solid investor demand and sharp pricing. The total transaction volume for the June quarter was $5.86bn, with transactions dominated by the office sector.

A-REITs and unlisted property trusts were active in Q2 2017 after a slow start to the year. Private foreign investors are also still participating, however, the share of purchases made by foreign investors continues to decrease, now down to 33% of transactions. This is a significant decline from 2015 when foreign purchasers accounted for over 50%. A pullback by Chinese purchasers has contributed to this decline, most likely due to tightened capital controls in China and the rising Australian dollar which makes Australian real estate appear more expensive to foreign buyers.

The largest transaction was the sale of 50% of MLC Centre in Sydney's Martin Place to Dexus and Dexus Wholesale Property Fund (DWPF) for $722.6m, (each taking a 25% share). The next largest was Keppel REIT's purchase of the Victoria Police Headquarters on Spencer Street in Melbourne for $347.8m.

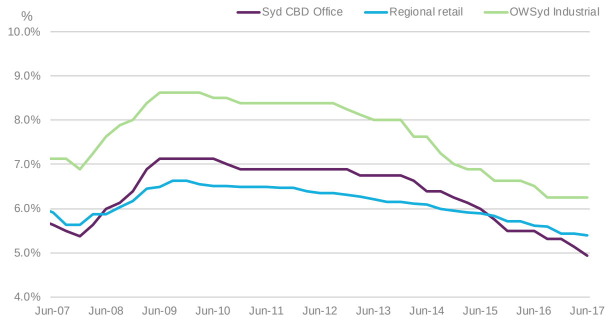
Two key metropolitan sales in Sydney included Gateway 241 at Mascot for $137.6m and the sale of 105 Phillip Street in Parramatta by Dexus to Charter Hall for $229m.

Key retail and industrial transactions included the sale of the bulky goods centre Home Hub at Castle Hill to Aventus Property Group for $336m (at an initial yield of 5.5%) and the Primo Foods portfolio to Charter Hall for $179.4m. Charter Hall also purchased Coca-Cola's distribution centre at Richlands in Brisbane for $156m.

There appears to be a widening arbitrage between Sydney and Melbourne (where investment yields tightened to 4.94% and 5.25% for CBD prime stock) and Brisbane and Perth (where investment yields were unchanged in the quarter at 6.50% and 7.00% respectively). Within the Sydney metropolitan markets yield compression ranged from 12bps to 38bps as investors sought opportunities in non-core markets.

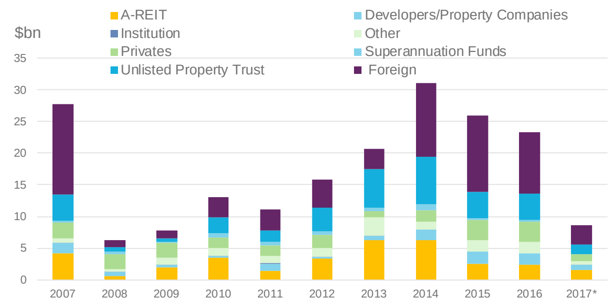
Yields were more stable in the industrial and retail sectors than in the office sector overall. Yields are broadly expected to stabilise in FY18.

Figure 3. Average prime yield by sector



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. Q2 2017 top transactions

Price ($m)	Asset/portfolio	Buyer
722.5	MLC Centre (50%)	Dexus/DWPF
347.8	Victoria Police HO	Keppel REIT
336.0	Home Hub, Castle Hill	Aventus
335.0	Exchange Centre, Sydney	Early Light Int.
327.5	100 Harris St, Pyrmont	Dexus
229.0	105 Phillip St, Parramatta	Charter Hall
203.5	Telstra Plaza, Sydney	ARA Australia
179.4	Primo Foods Portfolio	Charter Hall Group
174.5	Salamander SC	Charter Hall REIT
156.0	Coca-Cola Amatil DC	Charter Hall CPIF
138.0	Southern Cross Station	Morgan Stanley Real Estate
137.6	Gateway 241, Mascot	Fort Street Real Estate

Source: Dexus Research Transaction Database, JLL Research

Performance

Strong unlisted property returns

Unlisted property returns improved in the June quarter, delivering 12.0% for the year, second to equities on the asset class league table. Although income yields have generally tightened in recent years, capital growth has supported returns.

The office sector is outperforming the industrial and retail sectors helped by strong rental growth in Sydney and Melbourne and a continuation of very strong pricing. While growth in Sydney and Melbourne should continue for a while yet, diversified investors will benefit from a recovery in fundamentals in Brisbane and Perth over the next couple of years helping to smooth overall returns.

Going forward the gains in value from strong investment demand are likely to taper as investors weigh up how much they are prepared to pay for core assets after such a strong run in values.

While benefiting indirectly from buoyant property fundmentals, returns for the listed A-REIT sector have been more volatile than for unlisted property. A-REITs delivered a -6.0% return for the year on average, after weakening over the past quarter.

A-REIT prices were impacted by a sell-off in bonds which caused investors to seek higher yields on a range of defensive assets.

The sell off in bonds came at a time of positive news about economic growth in the US, Europe and China which led to investors revising interest rate projections upwards. Accordingly, returns on fixed interest investments were subdued in the past quarter and year.

Australian equities ended the financial year on a weak note, but performed well enough in the early part of the year to deliver a return of 14.1% per annum, enough to top the table of asset returns (Table 3).

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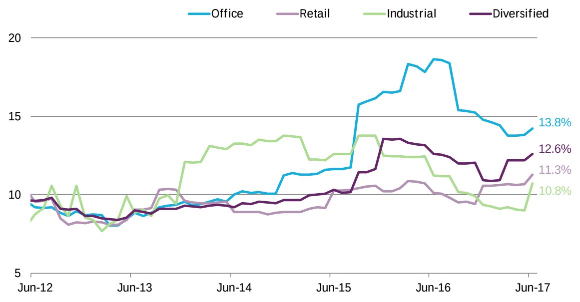
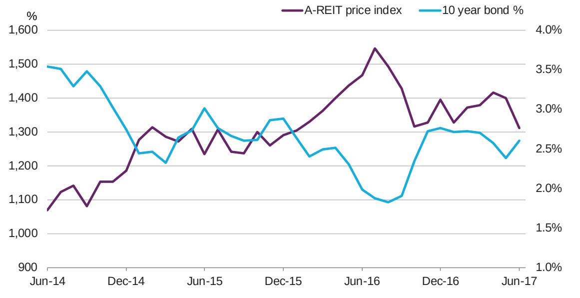
Figure 5. Unlisted property returns by sector



Source: Mercer/IPD (NAV pre fee)

Figure 6. A-REIT prices and bond yields



Source: Bloomberg, Dexus Research

Table 3. Index returns to 30 June 2017

	Qtr. %	1 yr %p.a.	3 yr %p.a.	
Australian shares	-1.6	14.1	6.6	S&P/ASX 200 Accumulation
Unlisted property*	2.9	12.0	11.6	Mercer/IPD Aust. Unlisted Wholesale PFI*
Australian cash	0.4	1.8	2.2	BAUBIL Index
Australian fixed interest	1.0	0.2	4.3	BACM0 Index
A-REITs	-3.4	-6.3	12.0	S&P/ASX 200 Property Accumulation 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

Positive outlook for FY18

Solid office demand is steadily absorbing the remaining pockets of available space across the nation's major office markets leading to falling vacancy rates. There is a pronounced flight to quality resulting in rapid take-up of prime space (Figure 7).

In Sydney CBD migration of tenants to A-grade and Premium space is being driven by withdrawals of older stock, while in other markets an abundance of prime space is making it cost-effective for tenants to upgrade.

While larger firms are seeking to consolidate their office space requirements using technology and more collaborative office designs, the overall growth in employment, particularly by smaller firms, continues to drive expansion in total office demand.

The outlook for rental growth in Sydney and Melbourne over the next two years is positive given below average vacancy and limited new supply.

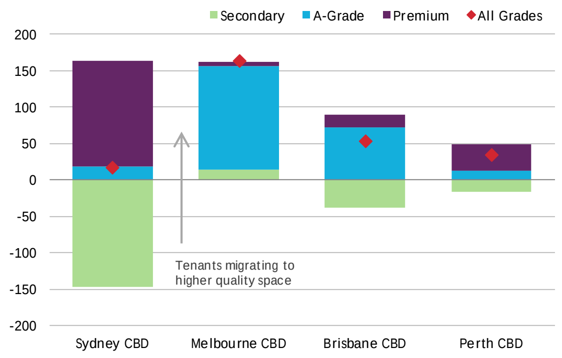
Brisbane is now clearly in recovery mode with vacancy declining and rents stable.

The Perth market has bottomed. After four years of contraction, demand has finally turned positive and the vacancy rate has declined off last year's peak.

The cyclical nature of office markets means that we cannot expect the strong run of Sydney and Melbourne to continue indefinitely. Over the medium term supply risks are expected to mount as strong rental growth encourages new development. With the potential of c450,000sqm of new stock completing in Melbourne CBD FY19-21 and c330,000sqm in Sydney CBD FY20-22, rental growth is likely to slow from FY19 onwards.

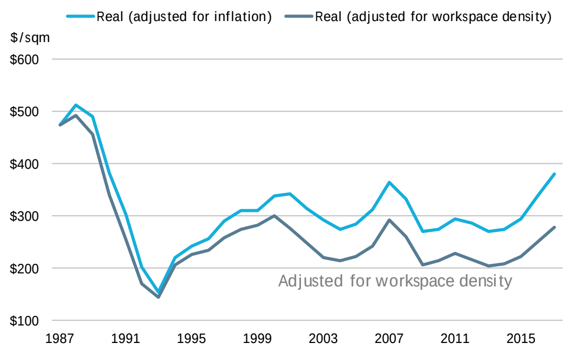
Strong growth in the Sydney CBD has raised questions about rental affordability for tenants. However, recent rises have largely been a catch-up from very low levels post GFC. Average nominal growth over the past 10 years has been just 4.3% per annum. In addition, analysis by JLL Research provides an interesting long term perspective. Figure 8 shows the average prime rent on a dollar per metre basis when adjusted for inflation and for the fact that companies have increased the density of their workforce (number of staff per square metre) over time. On this measure, current rents are not out of line with past ranges and there appears to be room for further growth.

Figure 7. Net absorption by grade FY17



Source: JLL Research, Dexus Research

Figure 8. Long term perspective on Sydney CBD rents



Source: JLL Research (using prime gross effective rents)

Table 4. Q2 2017 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth
Parramatta	3.6%	6.2%	13.8%
Sydney CBD	6.4%	10.9%	32.4%
Melbourne CBD	7.1%	13.4%	19.6%
North Sydney	8.6%	8.3%	13.6%
Macquarie Park	10.9%	6.4%	13.6%
Canberra	11.8%	2.5%	3.3%
Brisbane CBD	15.5%	0.3%	-1.5%
Adelaide CBD	16.0%	0.2%	-18.2%
Perth CBD	22.7%	-2.0%	-6.3%

Source: JLL Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney	Sydney continues to perform strongly. With below average vacancy of 6.4%, prime and secondary net effective rents are increasing by +32%yr and 39%yr respectively. Rising secondary rents and withdrawals are encouraging take-up of prime space with c160,000sqm of net absorption recorded for the year. With supply tapering, vacancy is expected to decline in the year ahead leading to a strong outlook for rents in the year ahead.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
North Sydney	North Sydney demand remained negative this quarter (-2,000sqm), which led to vacancy trending higher to 8.6%. The negative take-up is more due to specific tenant moves than an underlying weakness in demand. Prime net effective rents increased by +13.6% over the year (+1.9% over the quarter), while net incentives declined to 25%. With no new supply expected until FY19 vacancy is expected to tighten supporting a further uplift in rents.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Macquarie Park	Over the past 6 months softening demand has seen vacancy rates rise by 2.2 percentage points to 10.9%. Despite the softening in demand, prime net effective rents grew by 7.2% over the last 6 months (13.6% over the year), and net incentives declined to 26%. 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 is expected to perform solidly in the short term, having one of the lowest total vacancy rates (3.6%) and no immediate supply risks. A very tight prime vacancy (0.4%) should continue to support further rental growth and low incentives for prime assets. 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 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 (+163,000sqm over the year), and a fall in vacancy to 7.1%. In line with improving vacancy, prime net effective rents have increased by 19.6% over the year, and incentives have remained steady at 31% (net). Limited new supply and a solid demand outlook will see vacancy tighten supporting further rental growth over the next 12 months.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Brisbane	The Brisbane CBD market is clearly in recovery mode after experiencing the highest level of net take-up in five years in FY17. After peaking at 18.2% in early 2016 the total market vacancy rate is down to 15.5% with A Grade vacancy just 11.0%. Despite improving fundamentals, prime rents still remain weak and incentives elevated (37% gross). With no major new completions anticipated until FY19 the market is expected to continue to improve, leading to rents rising from a low base.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
Perth	The Perth market appears to have bottomed. Demand expanded by just over 33,000sqm in FY17 after four consecutive years of contraction. After peaking at 24.7% last year the vacancy rate has fallen to 22.7%, helping effective rents to stabilise. The market is poised for a recovery, however it will take time and depend on the performance of the economy.	Vacancy → Rents ↑ Incentives ↓ Yields →
Adelaide	Conditions in the Adelaide CBD market remain challenging with South Australian economic conditions providing little support for office demand. Vacancy is elevated at 16.0% and incentives have continued to trend upwards to currently average 37% (gross). Rental growth is expected to remain weak over the short-medium term due to subdued demand growth and heightened 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-medium term. Limited availability of prime space (prime vacancy is currently 6.0%) is helping to support moderate rental growth in prime assets. 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

Signs of growth

After years of subdued rental growth, solid levels of industrial take-up, combined with limited land supply are supporting some mild rental growth in a number of Sydney markets.

Melbourne is also following Sydney's lead with some mild rental growth being recorded following strong take-up in the first half of 2017. Brisbane saw improved take-up in the ATC but rents remain under pressure. Conditions in Perth are subdued.

Major infrastructure projects currently planned or underway, along with continued population growth, provide a positive outlook for industrial activity.

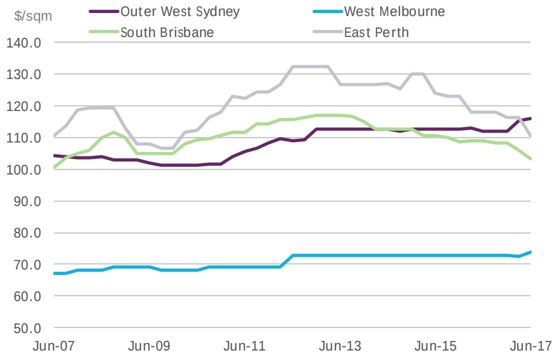
Industrial supply across the capital cities is on track to be in line with the 10 year average in 2017, primarily supported by institutions looking to develop investment grade stock.

The pre-commitment market remains competitive as institutions jostle to secure tenants for their developments, however, the availability of zoned and serviced industrial land is becoming more limited.

Key points of interest this quarter include:

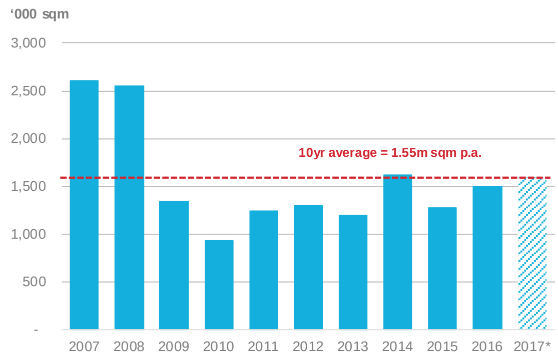
- Retail, wholesale and logistics providers continued to account for the majority of industrial demand as they seek to improve their supply chains
- Land values continued to increase overall in the Eastern states, led by Sydney and Port Melbourne
- In the May Federal Budget, the government outlined a commitment to spend over $70bn on transport infrastructure in the coming years which is likely to benefit the industrial sector. Projects include the Inland Freight Rail project - a dedicated high productivity rail freight corridor running from Melbourne to Brisbane and a commitment to build the Western Sydney Airport at Badgerys Creek, with works planned to commence late 2018

Figure 9. Average existing prime industrial rents



Source: JLL Research, Dexus Research

Figure 10. Capital city industrial supply pipeline



Source: JLL Research, Dexus Research

Table 5. Q2 2017 industrial snapshot

	Ave prime cap rate change from Q2 2016	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.25	3.5
Southern Brisbane	-0.62	-5.1
East Perth	0.00	-6.1
South Sydney	-0.88	7.5
West Melbourne	-0.25	1.2

Source: JLL Research, Dexus Research

Outer West Sydney

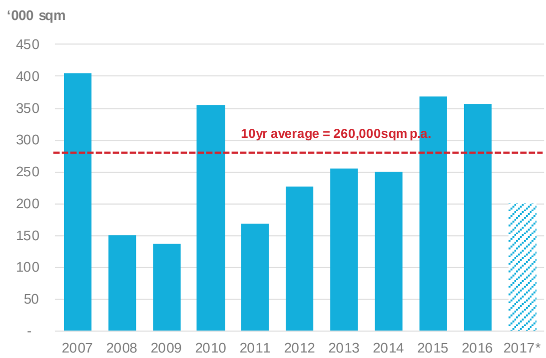
Outer West Sydney recorded over 117,000sqm of take-up in Q2 2017 extending the strong result from Q1 2017. Demand is projected to remain solid in the medium term, benefitting from positive economic conditions.

The provision of serviced, zoned land in the Outer West is limited and 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.

Consequently, Outer Western Sydney is likely to experience further upward pressure on rents in the year ahead.

The largest lease deal in Q2 2017 was Sheldon and Hammond committing to a 30,000sqm warehouse at Calibre Estate in Eastern Creek.

Figure 11. Outer West Sydney gross take-up



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

West Melbourne

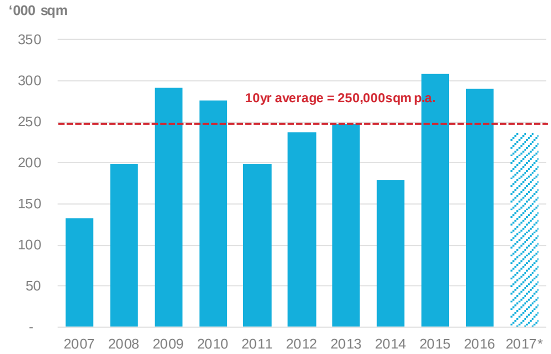
West Melbourne recorded more than 110,000sqm of take-up in Q2 2017. Take-up in the first six months of 2017 is almost in-line with the 10 year annual average. Demand is expected to remain positive in the medium term due to strong levels of population growth.

Almost 380,000sqm of supply could potentially come online in West Melbourne in 2017, well above the 10 year average of 220,000sqm. Around 320,000sqm is under construction or already complete.

West Melbourne is a key market for tenants, however, the large provision of zoned land is likely to constrain rents. That said, the provision of available land has declined recently with the rezoning of land at Tarneit Plains to residental.

The largest lease deal in Q2 2017 was a pre-lease deal to CEVA Logistics (37,000sqm) at West Park Industrial Estate.

Figure 12. West Melbourne gross take-up



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

Brisbane

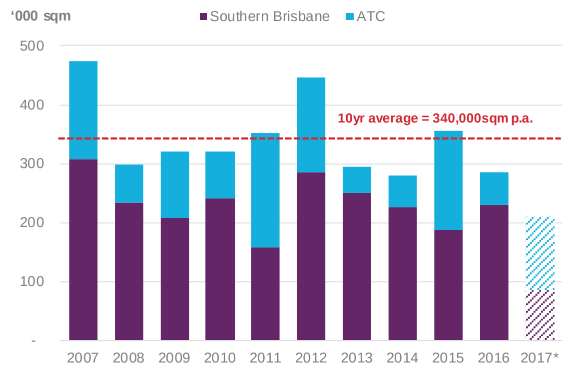
Take-up in Brisbane increased further in Q2 2017, with some 140,000sqm recorded. The majority of activity was in the ATC.

Mild improvement in industrial conditions is expected over the medium term.

The industrial supply pipeline for Brisbane is projected to increase to around 380,000sqm in 2017, well above the 10 year average of 335,000 sqm. It is understood that the majority of these projects are supported by pre-lease deals. Currently only 130,000sqm has been completed.

The largest lease in Q2 2017 (excluding owner-occupiers) was to Chemist Warehouse (25,836sqm) at Eagle Farm.

Figure 13. South Brisbane and ATC gross take-up



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

Retail

Survival of the fittest

The outlook for retail sales growth is mixed and subdued, with low interest rates providing underlying support on the one hand, and weak wages growth is constraining household spending on the other.

Retailers are facing strong competitive pressures from international and online retailers. While online retailing is gaining share at about the expected rate with current market share around 7.3% of total sales it is just one of the issues facing retailers. A combination of broader pressures, including rising costs, is exposing retailers whose business models aren't optimal (eg. Dick Smith, Pumpkin Patch). Many retailers are adapting and responding to the current climate (e.g. Kmart, Cotton On).

Shopping centre owners are responding to online retailing by increasing the food, leisure and entertainment component in their tenant mix to offer a better experience.

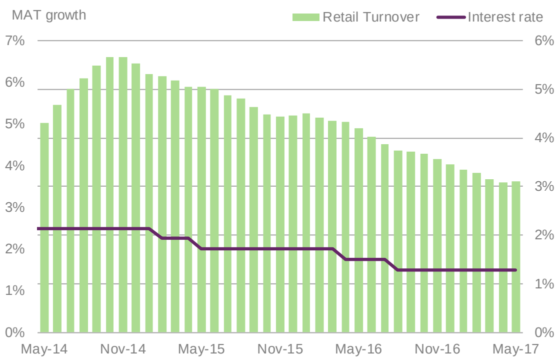
Amazon's entry to the market has received extensive publicity and while there is no doubt that Amazon will increase competition, its ultimate impact will depend on the speed and extent of the roll-out. Initially it seems likely that Amazon will have a bigger impact on existing online operators than on physical stores..

Retail turnover growth increased to 3.1% for the year to May 2017 based on ABS data. Growth was solid in non-discretionary categories, led by supermarkets, however, discretionary spending rebounded from growth in household goods and clothing.

Key points of interest this quarter include:

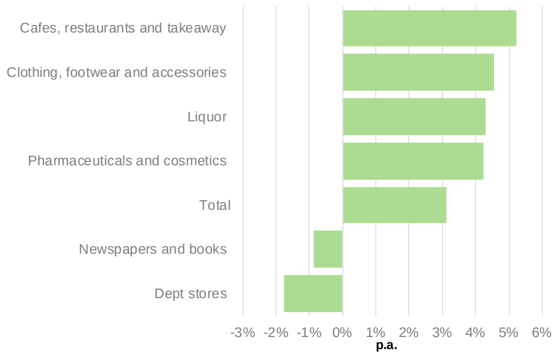
- The Federal Parliament has passed legislation that will close the $1,000 GST Low Value Threshold loop-hole on goods purchased from overseas from July 2018
- JD Sports has now opened stores at Melbourne Central (VIC), Westfield Parramatta (NSW) and is opening at Miranda (NSW)
- Decathlon will open its first store in Tempe (NSW) later this year and has plans for around 100 stores nationwide
- David Jones has announced it will open its first gourmet food offering at Westfield's Bondi Junciton in August, this will be followed by others.

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. Q2 2017 retail snapshot

	Specialty growth % p.a.	Cap rate change (%)	State retail sales growth % p.a.
Sydney			3.5
Regional	0.50	-0.38	
Sub-regional	1.13	-0.25	
Neighbourhood	1.00	-0.63	
Melbourne			3.6
Regional	0.88	-0.12	
Sub-regional	0.50	-0.75	
Neighbourhood	1.13	-1.00	
South East QLD			3.0
Regional	0.00	-0.25	
Sub-regional	0.00	-0.25	
Neighbourhood	0.00	-0.63	

Source: JLL Research, ABS, Dexus Research

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