Australian Real Estate Quarterly Review

2017: Upside and downside risks finely balanced

Q1/2017

DEXUS
PROPERTY GROUP

In summary

Investment climate – Upside/downside risks finely balanced

The investment climate is characterised by a wider range of possible outcomes than usual. Allowing for divergent patterns of growth, the most likely outcome is continued positive leasing demand, but a slowing of capital gain.

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Investment climate

Upside/downside risks finely balanced

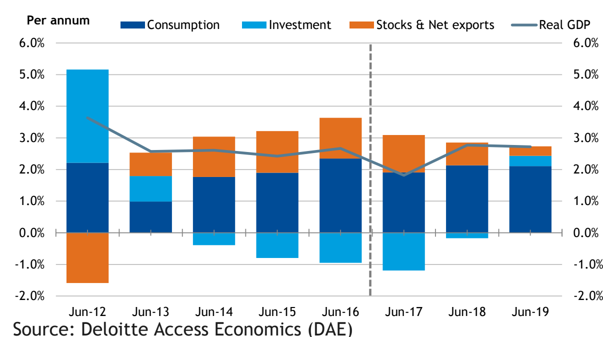
The investment climate is characterised by a wider range of possible outcomes than usual. Allowing for divergent patterns of growth, the most likely outcome is continued positive leasing demand, but a slowing of capital gain.

Baseline assumptions

Investors should hope for the upside, but plan for the downside. Key assumptions include:

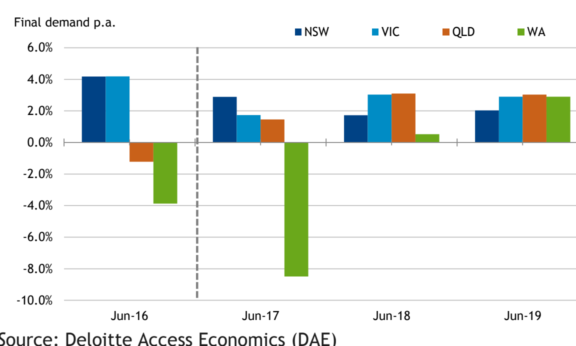
- The US economy will continue to strengthen through to FY19 regardless of any extra stimulus from Trump policy changes. US growth is expected to benefit the Asia Pacific region
- Rising US interest rate rises will lead both a strengthening of the US dollar and ongoing uncertainty in the pricing of assets globally
- China is assumed to maintain its current moderate growth profile but its continued reliance on debt-financed property investment is a risk
- The Australian economy is expected to grow only slowly, boosted by exports, but constrained by investment, particularly in mining and housing
- NSW and Victoria will outperform in the short term; but by FY19 growth will slow relative to the sunbelt states of QLD and WA
- NSW will become a victim of its own success with population growth easing as people migrate to more affordable regions
- Residential construction activity, particularly apartments, is expected to slow and could be a significant headwind for growth in FY18
- Employment growth is weakening from a high base and seems likely to weaken further by FY18 as subdued housing investment constrains full-time job creation

Figure 1. Australia – components of growth



Source: Deloitte Access Economics (DAE)

Figure 2. NSW and VIC leading state growth



Source: Deloitte Access Economics (DAE)

Table 1. Australian economic forecasts: Q4 2016

	Jun-16	Jun-17	Jun-18
Real GDP %pa	3.1%	1.7%	2.8%
Final demand %pa	1.6%	0.2%	2.4%
Employment %pa	1.9%	1.1%	1.3%
Goods imports %pa	-0.8%	1.9%	2.2%
Retail sales %pa (real)	2.2%	1.5%	3.2%
CPI %pa	1.1%	2.0%	2.2%
90 Day bill %*	1.9%	1.3%	1.6%
10yr Bond %	2.0%	2.8%	2.9%
AUD/USD	0.75	0.72	0.70

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

- Service sector activity will remain a growth driver for the economy led by education, health, IT and tourism. The public sector, professional services and finance will see more moderate growth while the mining, construction and retail sectors will lag
- Retail spending will be constrained in the short term by moderate confidence, weak wages growth and easing employment growth
- Official cash rates are expected to move mildly lower in 2017 and remain low in 2018
- Australian bond yields are expected to stablise at or near current levels and rise at a slower rate than in the US over the medium term, staying low by historical standards

The upside scenario

The most likely upside scenarios are:

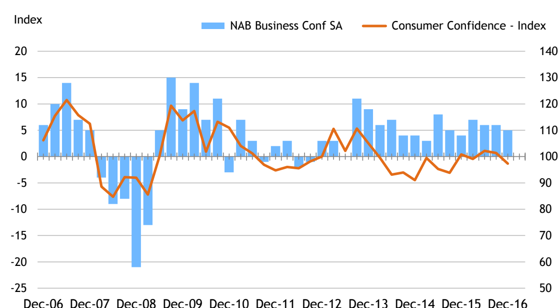
- US economic growth strengthens more quickly than expected, Chinese growth is sustained and Australia benefits from a resurgence in Asian middle class consumption
- The Queensland economy improves more quickly than expected

The downside scenario

At face value the downside scenario appears to have a 'higher impact' than the upside, particularly given the potential effect on asset pricing. It includes:

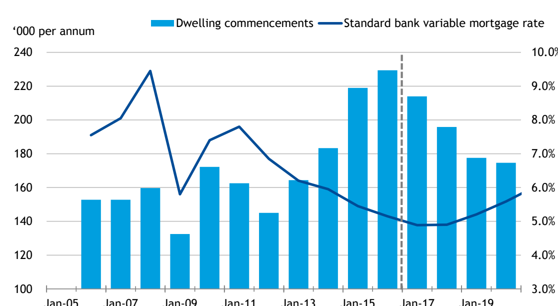
- A sharper than expected contraction in house prices and apartment construction triggered by a slump in confidence, legislative changes designed to increase affordability or a sharp lift in mortgage interest rates
- A slowdown in China associated with a financial crisis and attempts by authorities to curb capital outflows
- A trade war in the Asia Pacific as currency wars and concerns about competitiveness lead to higher tariffs and trade barriers by the US and China
- Geopolitical crises either in the Asia Pacific region or the European union

Figure 3. Confidence subdued



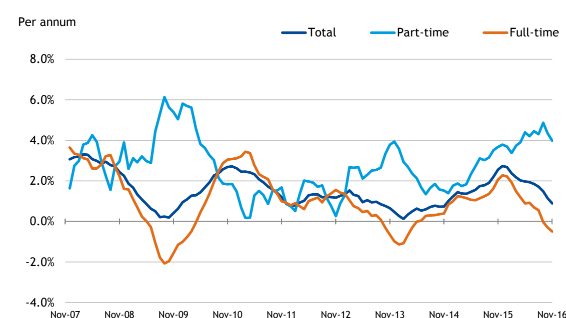
Source: Deloitte Access Economics (DAE)

Figure 4. Housing to drag on growth



Source: Deloitte Access Economics (DAE)

Figure 5. Employment growth easing



Source: ABS

Interest rates and real estate

Implications of rising yield expectations

The prospect of rising interest rates has implications for pricing of all high yielding investments including real estate. However it is important to keep recent trends in perspective.

How important are interest rates?

Historically, the relationship between interest rates and office yields has been weak and indirect (Figure 6) because rising interest rates are symptoms of a stronger economy. So it does not mean that real estate yields will simply follow interest rates up. However, given real estate yields are currently unusually low, it is reasonable to expect that real estate will be more sensitive in this cycle than usual.

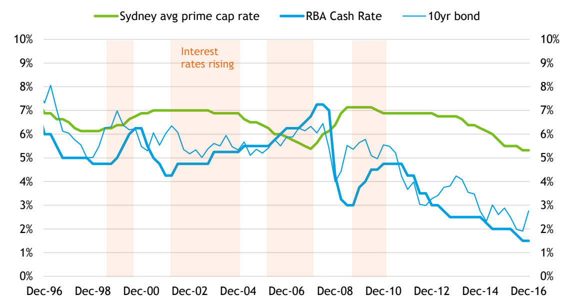
There are several mitigating factors which will help the Australian real estate market absorb initial rises in US rates:

- There is a wide spread between real estate yields and bond yields (Figure 6), which will provide a buffer
- Consensus forecasts are for Australian cash rates and bond yields to rise much less quickly than in the US (Figure 7)
- In the past, market fundamentals such as new supply and vacancy have had more influence on real estate yields than interest rates (Figure 8). Consequently it could be that expected movements in office vacancy rates have a large impact on pricing

So what will happen?

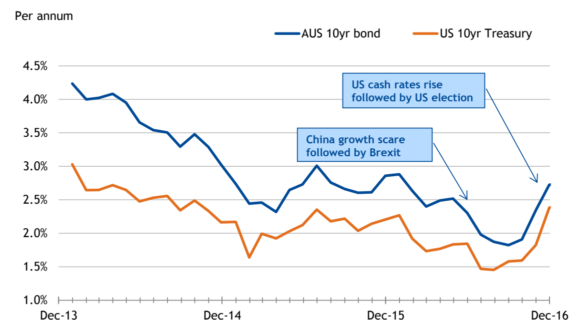
Higher yield expectations globally are expected to reduce cross border investment and limit further tightening of real estate yields in 2017. Investors should then be prepared for a medium term reversion in yields. In assessing how significant this could be, it is worth noting that the effect of a rising cost of capital seems relatively mild given the mitigating factors mentioned above. A more pronounced rise in yields would require a significant deterioration in the outlook for market fundamentals.

Figure 6. Interest rates and office yields



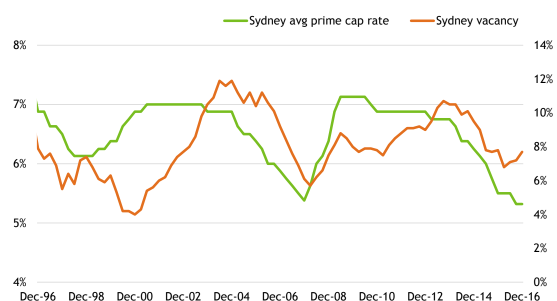
Source: Bloomberg, JLL Research

Figure 7. Bond yields lifted at end of last year



Source: Deloitte Access Economics (DAE)

Figure 8. Vacancy rate and Office yields



Source: JLL Research

Transactions

Lack of prime stock leads to easing activity

Transaction activity fell in the December quarter resulting in a total volume of sales of $24.5 billion in the 2016 calendar year. This trend mirrors a decline seen globally over the past 12 months.

The total transaction volume for the December quarter was $6.9 billion, with a significant portion ($650m) due to the second tranche of industrial properties purchased by Blackstone from Goodman. Overall, the fall in activity appears more linked to a lack of prime assets for sale rather than a withdrawal of investors.

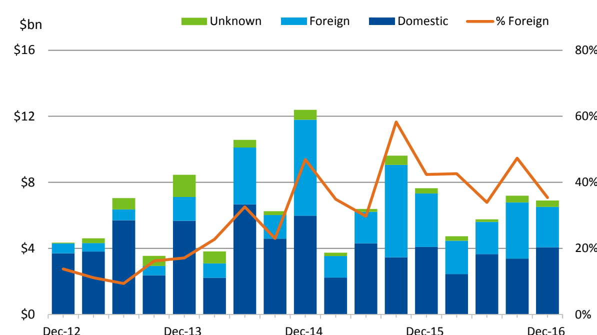
Foreign investment activity fell mildly to 35% from 47% in the December quarter, despite large acquisitions in all sectors. Domestically, unlisted property trusts and privates were the most active buyers with activity largely concentrated in the office sector.

Investment yields continued to tighten through 2016 reflecting solid demand, with prime office yields averaging around 5.5% for the Sydney and Melbourne CBDs. The recent sale of 111 Eagle St, Brisbane also achieved a reported yield of 5.5%.

Other major office transactions included the GPT Wholesale Office Fund purchase of the ANZ world headquarters on Queen St, Melbourne for $275m. AMP's Diversified and Wholesale fund each purchased a 50% share in 33 Alfred Street, Sydney for a total of $430m. A key sale was 39 Martin Place, which was purchased by Transport for NSW to be demolished for the construction of the Sydney metro and eventually redeveloped.

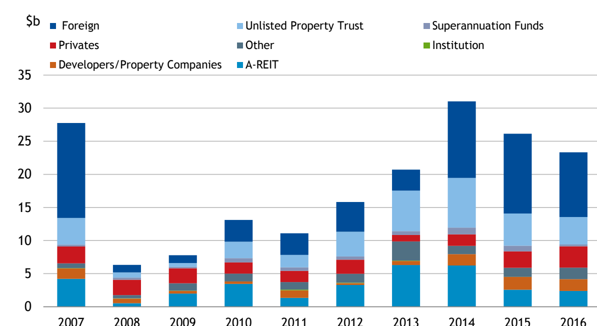
This quarter saw a number of major retail centres transacted including Westfield Woden ($335m, 50%) purchased by the Perron Group, the Casey Central Shopping Centre ($221m) purchased by M&G Real Estate Asia, St Collins Lane, Melbourne ($247m) purchased by JP Morgan Asset Management and Carillon City bought by DEXUS Wholesale Property Fund for $140m.

Figure 9. Transaction volumes - quarterly



Source: JLL Research, DEXUS Research Transaction Database

Figure 10. Gross transaction volume by buyer type



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

Table 2. Q4 2016 Top transactions

Price ($m)	Asset/portfolio	Buyer
650.0	Goodman Industrial Portfolio	Blackstone
335.0	Westfield Woden, ACT	Perron Group
332.0	39 Martin Place, Sydney (includes shopping circle)	Transport for NSW
284.2	111 Eagle St, Brisbane	GWOF
275.0	74-110 Queen St, Melbourne	GWOF
250.0	Collins St, Docklands	APPF
247.0	St Collins Lane, Melbourne	JP Morgan Asset Management
221.0	Casey Central Shopping Centre	M&G Real Estate Asia Pty Ltd
430.0	33 Alfred St, Sydney	AWOF/ADPF
169.0	55 Clarence St, Sydney	AEW Value Investors Asia II

Source: DEXUS Research Transaction Database, JLL Research

Performance

Property returns end on a weaker note

Both listed and unlisted property returns ended 2016 on a weaker note as the yield compression cycle tapered and value growth weakened. While returns are still above long term averages, capital growth is expected to soften in the year ahead

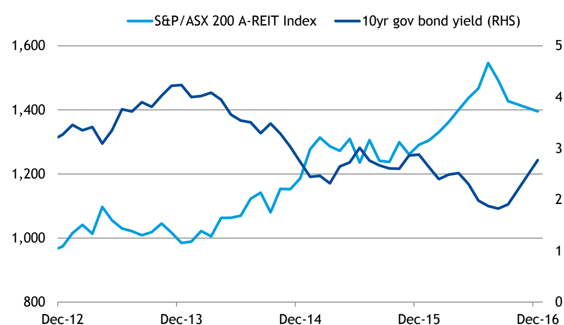
The share market continued to outperform in the December quarter, albeit at a slower pace. The A-REIT sector has outperformed on an annual and three year basis delivering 13.2% and 18.0% respectively, yet recorded only -0.7% for the quarter. The recent sell-off in bonds caused yields to rise on a range of other defensive assets including A-REITs, leading to a price correction. While above average growth in rental values should provide support, the sector will face challenges to deliver superior returns as cap rate compression eases and bond yields potentially rise further.

Unlisted property returns benefited from strong capital gains over the first half of 2016 producing double digit returns, however returns have eased since August as the rate of capital gain tapered. The cycle of cap rate compression, which fuelled past value gains appears to be coming to an end. The office sector continues to outperform the other sectors given the prospect of rental growth in some markets.

While performance in the share market has been strong, 2017 could see potential volatility in global conditions related to uncertainty about US interest rates, the implications of Trumps economic policies and possible strains in US/China relations. The equity market returned 11.8% for the year.

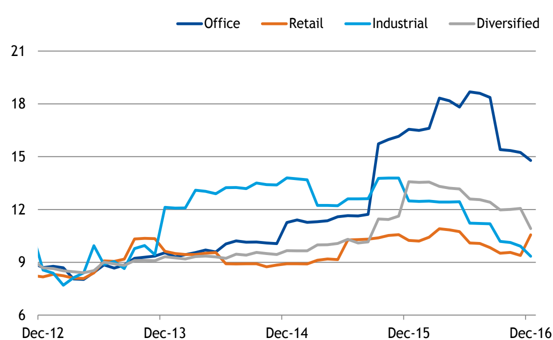
Returns on fixed interest investments fell to 2.9% for the year to December 2016 as bond yields increased and prices fell. The general consensus is for relatively slow rises in Australian bond yields over the next two years.

Figure 11. A-REIT prices vs Bond yields



Source: RBA, Bloomberg, DEXUS Research

Figure 12. Unlisted property returns by sector



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

Table 3. Index returns to 31 December 2016

	Qtr. %	1 yr %p.a.	3 yr %p.a.	
A-REITs	-0.7	13.2	18.0	S&P/ASX 200 Property Accumulation Index
Australian shares	5.2	11.8	6.6	S&P/ASX 200 Accumulation
Unlisted property	3.3	11.8	11.7	Mercer/IPD Aust. Pooled Fund Index*
Australian fixed interest	-2.9	2.9	5.1	BACM0 Index
Australian cash	0.4	2.1	2.4	BAUBIL Index

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

Office markets

Rents continue to surge, but for how long?

While the Sydney and Melbourne office markets are now in a strong growth phase, other markets are at or near the bottom of the rent cycle. This disparity will help smooth returns for diversified investors when the Sydney and Melbourne growth phase ends.

Sydney and Melbourne are experiencing strong effective rental growth, rising +22.5% and +13.0% over the year. This growth should continue in the short term based on robust fundamentals and strong state economies. Both cities are the dominant business centres for their region.

Limited net supply in 2017-2018 for Melbourne and Sydney will support a tightening in vacancy (with Sydney possibly falling to the lowest level in 16 years).

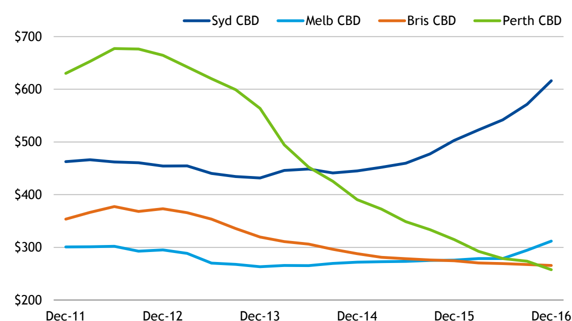
Office markets are historically cyclical and the natural progression is that rising rents will encourage more supply which will in turn constrain rents ahead of the supply completing. There are already signs of this process starting with the pipeline of identified new projects expanding in both cities (Figure 14).

It is worth considering the following mitigating factors in assessing the cyclical risks:

- It could be a considerable time before new supply impacts market fundamental given most of the new projects identified are timed to complete in FY21 or beyond
- The extent of any rise in vacancy in the outer years will depend on demand growth at the time (remember how strong demand smoothed the delivery of Barangaroo)
- Most projects are expected to proceed with substantial pre-commitment

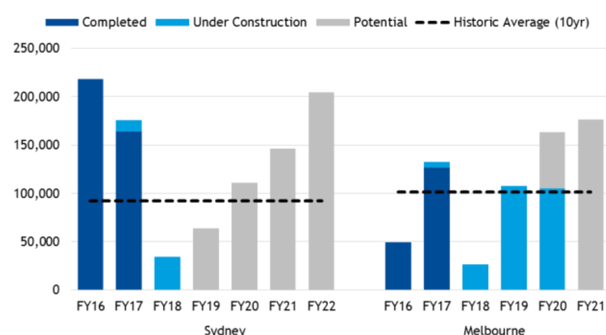
While the short term outlook is buoyant, the longer term outlook warrants conservative growth assumptions.

Figure 13. Prime net effective rents



Source: JLL Research, DEXUS Research

Figure 14. Sydney and Melbourne potential gross supply



Source: JLL Research, DEXUS Research

Table 4. Q4 2016 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth % p.a.
Parramatta	4.2%	1.0%	4.1%
North Sydney	7.3%	7.3%	10.4%
Sydney CBD	7.7%	9.5%	22.5%
Melbourne CBD	8.1%	8.9%	13.0%
Macquarie Park	8.7%	3.7%	7.5%
Canberra	11.7%	2.3%	3.0%
Adelaide CBD	16.9%	0.3%	-11.5%
Brisbane CBD	17.2%	0.7%	-3.2%
Perth CBD	24.1%	-1.7%	-18.2%

Source: JLL Research, DEXUS Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney	Sydney continues to perform strongly with prime and secondary net effective rents increasing by +22.5%yr (7.8%qtr) and 42.0%yr (11.3%qtr) respectively, and below average vacancy of 7.7%. Net absorption declined in the quarter, impacted by Barangaroo Tower 1 related tenant contractions, however for the year (+82,000sqm) remains above the long-run average. Given the constrained supply pipeline, an uptick in withdrawals, and a positive demand outlook, Sydney CBD is expected to continue to outperform over the next 12 months.	Vacancy ⇩ Rents ⇧ Incentives ⇩ Yields ⇨
North Sydney	North Sydney recorded positive net absorption (c+10,200sqm in Q4-16) and further tightening in vacancy as rates dropped to 7.3% from 8.6% last quarter. In line with tightening vacancy prime net effective rents increased by +10.4% over the year (+3.9% over the quarter), while incentives remained relatively steady. With no new supply expected until FY19, and a continued positive demand outlook, vacancy should continue to tighten supporting a further uplift in rents.	Vacancy ⇩ Rents ⇧ Incentives ⇩ Yields ⇨
Macquarie Park	Macquarie Park experienced a positive quarter of net absorption (c+2,300sqm), and a slight decrease in vacancy to 8.7%. In line with improving vacancy prime net effective rents grew by +7.5% over the year (+1.3% over the quarter), and net incentives fell slightly to 28%. Demand is expected to remain positive and combined with a relatively subdued supply pipeline should continue to support rental growth over the next 12 months.	Vacancy ⇩ Rents ⇧ Incentives ⇨ Yields ⇨
Parramatta	Parramatta experienced a further tightening in vacancy as rates dropped to 4.2% (total) and 0.5% (prime). Prime gross effective rents increased by +3.0% over the year as incentives dropped slightly to 25%. Parramatta is expected to perform solidly over the next 12 months given limited availability of prime space. Supply risks to 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 continue to benefit from government departments decentralisation.	Vacancy ⇨ Rents ⇧ Incentives ⇩ Yields ⇨
Melbourne	Melbourne recorded the strongest net absorption across the CBD office markets, and saw vacancy tighten to 8.1%. After an extended period of limited rental growth and rising incentives, prime net effective rents picked up this quarter growing +5.9% over the quarter (+13.0% over the year). Limited new supply and a solid demand outlook will see vacancy tighten and support further rental growth over the next 12 months.	Vacancy ⇩ Rents ⇧ Incentives ⇩ Yields ⇨
Brisbane	The demand recovery in Brisbane continued with positive net absorption of c+5,400sqm for the quarter. Vacancy rates increased slightly to 17.2% due to the completion of 1 William Street, which increased backfill space. Prime gross rents have remained weak, and incentives elevated as a result of the high vacancy. Prime rental growth is expected to improve over the medium-term, as vacancy levels move back towards the long run average with a flight to quality absorbing prime space.	Vacancy ⇩ Rents ⇧ Incentives ⇩ Yields ⇨
Perth	Perth recorded a positive quarter of net absorption (c+9,500sqm), benefiting from higher commodity (iron ore) prices. However elevated vacancy rates (24.1%) continue to place significant pressure on rents with prime incentives rising to 50% (net), and prime net effective rents declining -18.2% over the year. Rental growth is expected to remain weak over the next 12 months, improving over the medium term as market conditions slowly recover in the absence of new supply.	Vacancy ⇨ Rents ⇨ Incentives ⇨ Yields ⇨
Adelaide	Adelaide experienced a negative quarter of net absorption and a rise in vacancy levels to 16.9%. Weak conditions saw prime gross effective rents contract by -4.3% over the quarter (-7.4% over the year) as average incentives increased from 32% to 34%. Rental growth is expected to remain weak over the next 12 months due to subdued demand growth.	Vacancy ⇨ Rents ⇨ Incentives ⇨ Yields ⇨
Canberra	A positive quarter of net absorption (+14,900sqm) and -30,700sqm of withdrawals saw vacancy rates tighten in Canberra to 11.7% (down -1.3ppts). Despite this, rental growth was limited and incentives remained steady at 20% for the prime market. 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 markets

Supply chain dynamics drive demand

Following a subdued start, the second half of 2016 saw tenant demand improve, supported by retail and transport occupiers optimising their East Coast distribution networks.

Sydney and Melbourne continue to perform well, while Brisbane is improving following a solid second half of 2016. However, Perth remains subdued.

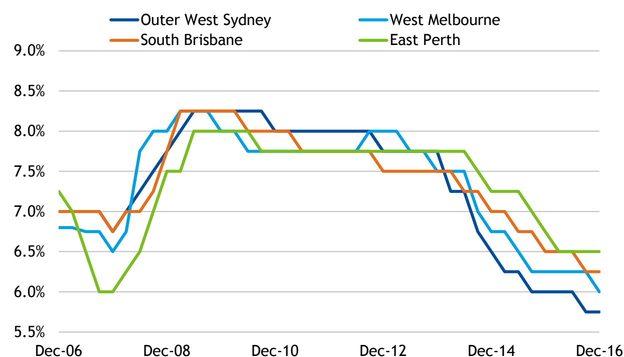
Around 1.5m sqm of new industrial supply was recorded in 2016, slightly below the 10 year average. Supply in 2017 is likely to be above average as institutions take advantage of easy access to capital to manufacture core stock at competitive rents. Owners of older properties (older than say 20 years) will need good retention strategies.

Rents are likely to remain relatively subdued and stable in the short term as the pre-commitment market remains competitive. Land constrained markets are the best placed for rental growth in the future.

The key themes for this quarter include:

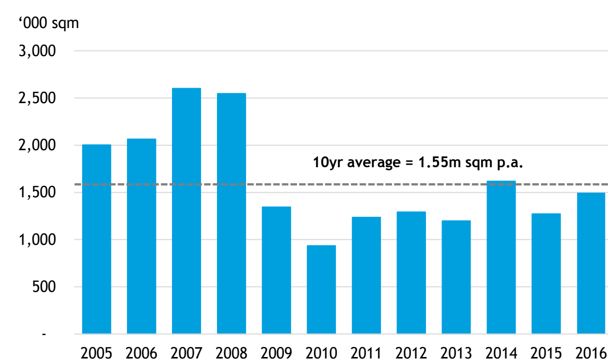
- Limited investment stock is resulting in a competitive transaction market and stronger demand for risker assets at a time when retention risks are rising for older stock
- Limited land availability and strong demand in key markets is putting upward pressure on land values, particularly in Sydney and Melbourne
- The progression of major road infrastructure projects (North East Link - Melbourne and M12 – Sydney) has positive implications for surrounding industrial precincts
- The development of Badgery's Creek Airport in outer west Sydney progressed further in December with the Federal Government's approval of the Airplan Plan. The airport is planned to complete Stage 1 by 2025.

Figure 15. Upper prime industrial cap rates



Source: JLL Research, DEXUS Research

Figure 16. Capital city industrial supply pipeline



Source: JLL Research, DEXUS Research

Table 5. Q4 2016 industrial snapshot

	Ave prime cap rate change from Q4 2015	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.38	-0.4
Southern Brisbane	-0.38	-0.4
East Perth	-0.25	-5.4
South Sydney	-0.63	8.1
West Melbourne	-0.38	0.0

Source: JLL Research, DEXUS Research

Retail

'Placemaking' is the future of retail

In order to combat the online challenges, successful retail precincts are becoming places which provide a unique customer experience; where people want to visit, interact and shop.

Retail sales growth stabilised recently but will continue to face headwinds such as subdued consumer confidence and wages growth. The housing market is also a potential headwind should it weaken. Retail turnover growth reached 3.4% for the year to November 2016. NSW and VIC remain solid, QLD is stable while WA remains weak. Speciality rent growth will remain subdued.

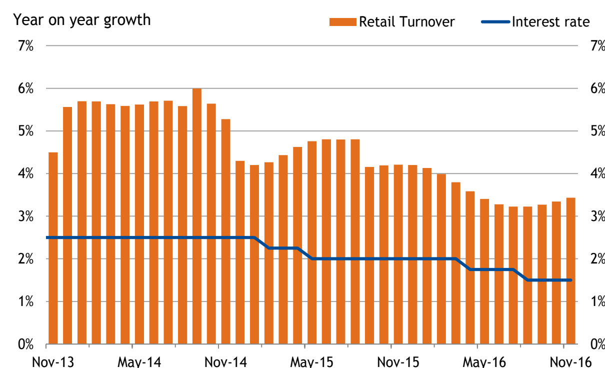
'Cafés, restaurants and takeaway' and 'clothing, footwear and accessories' are currently the best performing categories, while 'department store' sales continue to contract.

Development activity remains concentrated at regional centres, as owners seek to expand their entertainment and leisure precincts and attract new international retailers.

Key themes this quarter include:

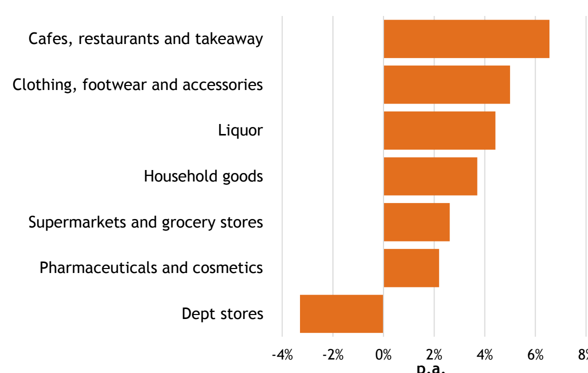
- Amazon is rumoured to soon be establishing its physical presence in Australia following the registration of more than 250 trademarks
- David Jones is progressing the rollout of smaller boutique stores (1,400-1,500sqm) following the opening of Barangaroo (Sydney) and plans now lodged for Fortitude Valley (Brisbane)
- Woolworths has sold its fuel business to BP, ending the Woolworths/Caltex arrangement; a new convenience store partnership is likely to commence at some 200 BP service stations
- The prevalence of mobile devices being used in online transactions is increasing rapidly, with eBay Australia reporting that 2.3 items were sold per second on mobile devices in 2016
- International retailers likely to open stores in Australia in 2017 include luxury brands by LVMH, Richemont and Kering, along with mid-tier retailers such as J.Crew and Banana Republic.

Figure 20. Retail sales growth and cash rate



Source: ABS, RBA, DEXUS Research

Figure 21. Retail growth by category



Source: ABS (November 2016), DEXUS Research

Table 6. Q4 2016 retail snapshot

	Specialty rent growth since Q4 2015 % p.a.	Ave cap rate change from Q4 2015 (%)	YOY state retail turnover (Nov 16) % p.a.
Sydney			4.0
Regional	0.00	-0.25	
Sub-regional	0.88	-0.50	
Neighbourhood	1.00	-0.75	
Melbourne			4.3
Regional	1.63	-0.38	
Sub-regional	0.50	-0.50	
Neighbourhood	1.00	-1.13	
South East QLD			4.3
Regional	0.00	-0.25	
Sub-regional	0.00	-0.50	
Neighbourhood	0.00	-0.50	

Source: JLL Research, ABS, DEXUS Research

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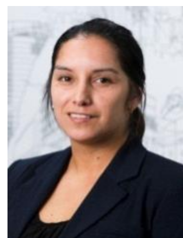

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