dexus

Australian Real Estate Quarterly Review

Q4 2021

One Farrer Place, Sydney

Inside

Investment climate

Pathway to recovery in FY22

Conditions for real estate are generally expected to improve over the next year. While lockdowns in NSW and Victoria caused a contraction in growth in Q3 2021, much of the lost ground is expected to be recovered over the remainder of FY22. Growth over the next year should be supported by high vaccination rates (expected to reach 80% nationally in early November) and the proposed easing of international travel restrictions.

Our key assumptions are:

- Consumer sentiment and business confidence remain resilient (Figure 1)
- Housing and infrastructure construction will positively contribute to growth, as stimulus measures are further reduced
- Employment trends are positive, albeit the data are somewhat skewed by absence of overseas workers (Figure 2)
- Retail spending will continue to benefit from low interest rates and accumulated savings
- Short-term interest rates will remain low throughout FY22, however markets will price in modestly higher long-term yields over the next 2 to 3 years

The key themes for investors to consider in FY22 are:

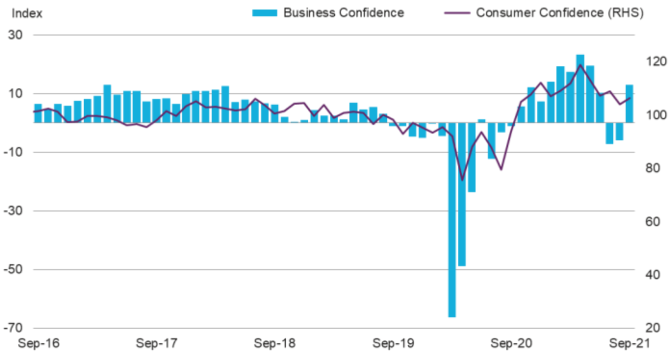
- Leasing markets are expected to improve in all sectors, helped by positive business conditions
- Improving occupier demand and low interest rates are usually good for property values
- Short-term growth prospects in the industrial and healthcare sectors are better than for office and retail, where vacancy will take time to absorb
- Capital flows into property are likely to remain solid given a reasonably wide yield spread over interest rates (Figure 3)
- The lower yield spread for industrial assets appears to reflect confidence on the growth outlook

Table 1. Australian economic forecasts

	Jun-21	Jun-22	Jun-23
Real GDP %pa	9.6%	2.7%	2.8%
Final demand %pa	12.2%	2.6%	2.7%
Employment %pa	8.1%	-0.2%	1.7%
Goods imports %pa	17.5%	1.7%	1.9%
Retail sales %pa (real)	9.2%	-0.1%	1.3%
CPI %pa	3.8%	1.6%	1.9%
90 Day bill %	0.3%	0.1%	0.2%
10yr Bond %	1.5%	1.1%	1.2%
AUD/USD	0.75	0.73	0.72

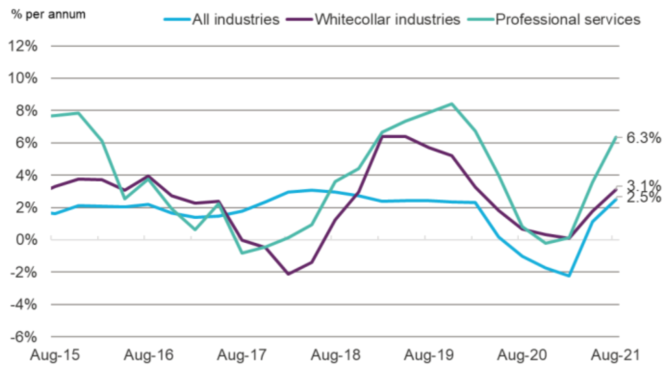
Source: Deloitte Access Economics, September 2021

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



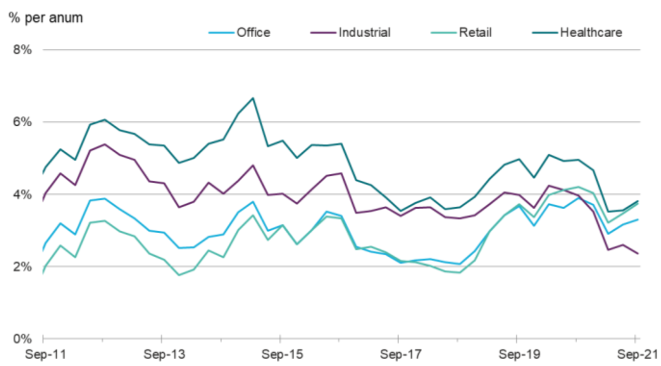
Source: Bloomberg, NAB, Westpac

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



Source: ABS

Figure 3. Investment demand for Australian property to remain strong given reasonably high yield spreads to 10 year bonds



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

State outlook

What can we expect post-pandemic?

Whilst we expect strong growth in the medium-term, economic drivers for each state will vary with Queensland and Western Australia (WA) seeing a significant acceleration (Figure 4). The medium term (5 year) drivers include:

- Victoria's outlook is for recovery from its large and long contractions in 2020. While population growth will make a positive contribution over the next five years, it is unlikely to match its pre-COVID heights
- The NSW economy will perform well but be constrained somewhat by a moderate population growth and affordability issues. Infrastructure investment will be a stable and reliable source of growth
- Queensland has seen a tightening labour market as it benefits from stronger net migration and population growth (Figure 5). The Olympic Games in 2032 will help drive an increase in investment.
- The ACT had an especially strong year in 2020 because COVID-19 had a smaller direct impact. Steady growth is forecast due to the reliable public service presence
- WA's growth is expected to with demand for its key exports – iron ore, still strong (recent price falls notwithstanding). Net migration is expected to be a driver of growth now that the tide is turning back to a positive inflow from the eastern states

Western Australia's outlook improving

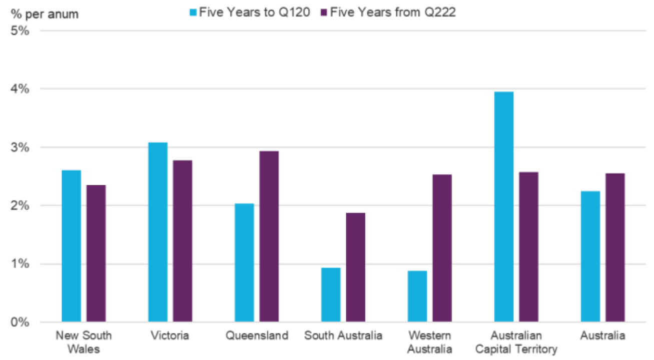
Over the past ten years since the construction phase of the mining boom, WA's economic output lagged the national average. This was partially driven by the capital-intensive (and labour non-intensive) nature of operational mines. Over the next few years, the resource sector will be a bigger driver of growth:

- Exploration investment has been increasing since June 2020 and is a leading indicator of real estate demand (Figure 6)
- As WA's existing mining assets depreciate, they will require further investment to maintain production
- There are some risks around China's stated plans to diversify its sources of iron ore and other commodities

WA's growth forecast is only partly dependent on mining. Growth in professional services, arts and recreation and education is expected to help balance WA's economy and make investment a more predictable and attractive proposition.

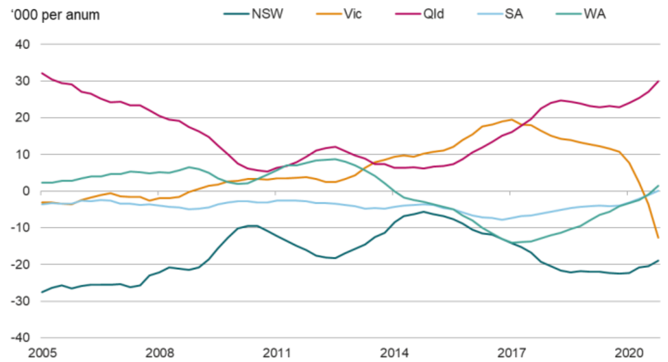
WA has been relatively unscathed by the pandemic, with very few COVID-19 cases and limited periods of lockdown.

Figure 4. Looking beyond the pandemic - long term growth in state output, excluding pandemic effects



Source: Deloitte Access Economics

Figure 5. Interstate net migration will be favouring WA and Queensland in the years ahead



Source: ABS

Figure 6. Mining exploration investment in WA has been increasing

Source: ABS

Performance and transactions

Markets perform well despite lockdowns

Over the past quarter the ASX 200 A-REIT index (+4.2%) and the ASX S&P 200 index (+1.7%) both lifted, despite Australia's two major states entering prolonged lockdown periods. Investor sentiment appears to be more positive this time with the vaccination roll-out reducing the "fear of the unknown", which affected markets last year. The outlook for the A-REIT index will depend on how the retail and office sectors respond to a post-pandemic environment.

Unlisted fund total returns firmed over the past quarter, recording 10.6% in the year to September. The industrial sector has led the rest, recording 26.0% in the year to date, driven by strong capital growth (20.5%). Unlisted office funds returned 10.6% in the year to September 2021. Despite uncertainty associated with the pandemic, investment demand for office assets kept office valuations relatively firm. The performance of unlisted retail funds (5.6%) is now improving after a weak 2020, where income returns were affected by rent collections and valuations softened. The improving retail performance helped diversified funds return 10.9% in the year.

Transaction markets are becoming more active after a subdued 2020, helped by a continued search for yield. The industrial market steamed ahead with $13bn of transactions in the year to date, surpassing the previous two full years combined. Deals in the past quarter included the Dexus/Dexus Industria REIT acquisition of Jandakot Airport for $1.3bn and the Dexus acquisition of the long WALE McPhee Super Core Logistics Portfolio for $186m across multiple states.

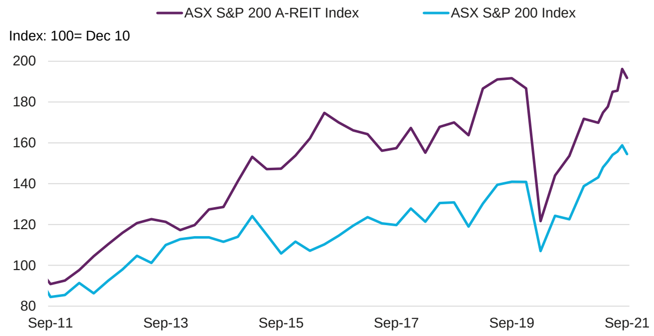
While the volume of office transactions remains below average, investment demand has, so far, supported valuations for high quality assets, perhaps due to resilience in face rents and attractive yields relative to borrowing costs. Dexus continued to recycle capital with the acquisition of Capital Square for $339m in the Perth CBD. International capital also continued its interest in Australian office assets with National Pension Service of Korea acquiring Melbourne Quarter Tower for $1.2bn in the Melbourne CBD.

Table 2. Index returns to September 2021

	Qtr.%	1 yr %p.a.	3 yr %p.a.
Australian fixed interest[1]	0.0	-0.5	4.1
Australian shares[2]	1.7	30.6	9.7
Australian cash[3]	0.0	0.0	0.8
Unlisted property[4]	1.3	10.6	4.8
A-REITs[5]	4.2	29.8	8.6

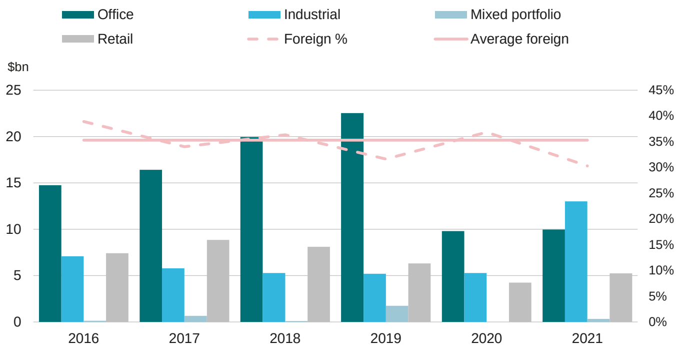
Source: [1]BACM0 Index, [2]S&P/ASX.200. Accumulation Index, [3]BAUBIL Index, [4]MSCI Mercer Australian Core Wholesale Monthly PFI (NAV Pre Fee) – All Funds, [5]S&P/ASX.200.A-REIT Accumulation Index

Figure 7. Listed markets fare better during this lockdown with REIT pricing back to pre-COVID levels



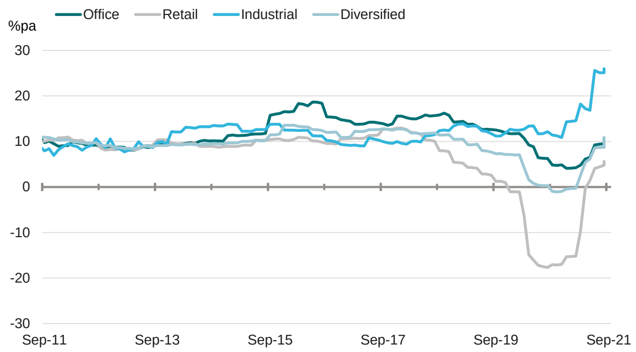
Source: Bloomberg, Dexus Research

Figure 8. Transaction markets are becoming more active, with industrial volumes surpassing the two previous years



Source: JLL Research, Dexus Research

Figure 9. Total returns improving, led by an extraordinary performance from industrial and a firming in retail



Source: MSCI, Dexus Research

Office

Vacancies stabilise as demand strengthens

Leasing activity across CBD office markets maintained momentum through recent lockdowns. Net absorption was positive in Sydney CBD and the Melbourne CBD in Q3 2021 recording 24,700 square metres and 24,070 square metres respectively, the highest since 2018 (Figure 10). The improving demand came on the back of expansions and centralisations into CBDs as well as a gradual reduction in sub-lease space.

There are signs white-collar businesses are confident and hiring again. After a dip at the beginning of the Delta lockdown (June), business confidence rebounded strongly in September to +13, the second highest reading on record. Similarly, professional job advertisements indicate sustained hiring intentions. White-collar industries continued to outperform other sectors, with payroll jobs 3.6% higher than pre-pandemic levels.

Vacancy rates across CBD markets have started to stabilise (Figure 12). Total vacancy fell marginally across all CBD markets except for Melbourne in Q3, with Perth recording the sharpest fall of 60bps.

While face rents have remained stable across office markets nationally, incentives have risen, leading to further falls in effective rents. Melbourne CBD recorded the sharpest fall in net effective rents in the September quarter (-3.8%), followed by Sydney CBD (-2.7%), Brisbane CBD (-1.7%) and North Sydney (-1.3%). Despite strong demand, there will need to be further falls in vacancy rates towards average levels before we see any material improvements in rents and incentives. Elevated supply levels in some markets are likely to delay the recovery path for rents.

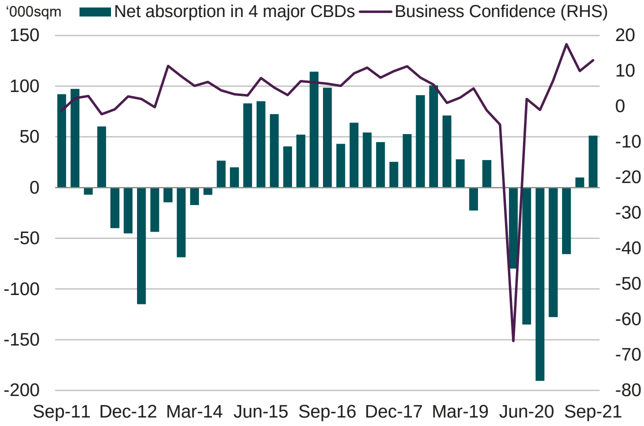
The vaccine roll-out will allow for a relaxation of mobility restrictions over the next few months, which should aid the return to office thematic. We need to be realistic about the pace at which workers return to CBDs given ongoing risks with infection rates, regulations on mask wearing, and the administrative difficulty of managing workforces.

Table 3. Q4 2021 office snapshot

	Total Vacancy	Rent growth* (% p.a.)	Net Increase in stock FY22**
Sydney CBD	13.0%	-9.7%	3.5%
North Sydney	17.5%	-13.4%	-
Sydney Fringe	10.3%	-3.0%	1.3%
Macquarie Park	12.5%	0.2%	-
Parramatta	12.8%	-9.0%	16.8%
Melbourne CBD	15.0%	-8.4%	3.2%
Brisbane CBD	15.8%	-6.9%	2.6%
Perth CBD	19.1%	0.8%	1.4%

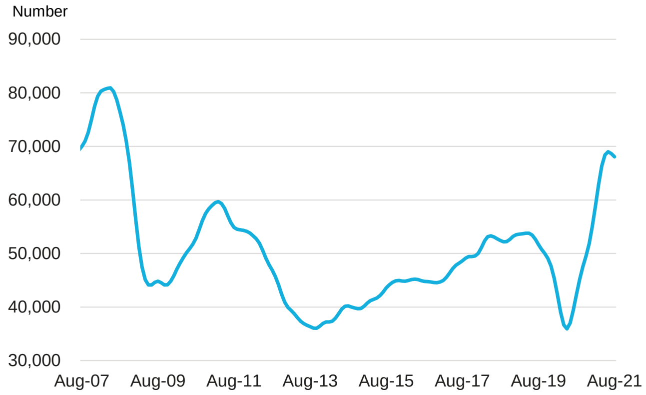
Source: JLL Research, Dexus *Net effective, **estimate as a % of stock,

Figure 10. CBD office net absorption continues its positive trend in line with business confidence



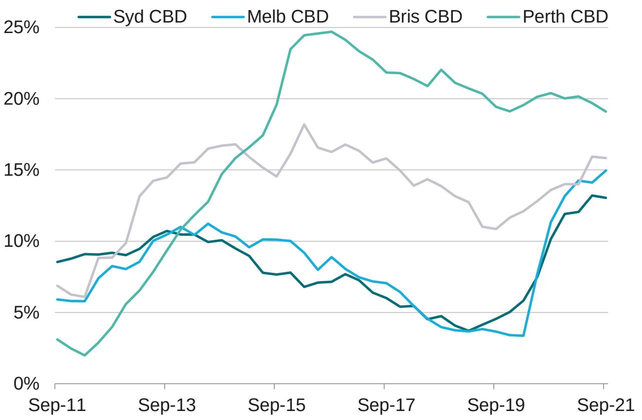
Source: JLL Research, ABS, Dexus Research.

Figure 11. Preliminary job ad numbers indicate a rebound in September after a brief dip in August



Source: ANZ

Figure 12. Vacancy rates are starting to stabilise in most CBD markets



Source: JLL Research, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney CBD	**Leasing activity remained strong during the lockdown, with sentiment improving in September**. Net absorption was recorded at 24,671 square metres in Q3 2021, the highest since December 2018, leading to the vacancy rate falling marginally to 13.0%, from 13.2% in June. Sub-lease vacancy fell 1.0 percentage points in the year to date, to 2.3%, as larger occupiers continued to withdraw previously offered sub-lease space. While net face rents rose 0.3% in Q3 2021, incentives rose from 33% to 34%, leading to prime net effective rents falling 2.7%. While leasing demand is positive, further falls in vacancy rates are needed before there will be a flow-on effect to rents. Average prime yields fell further in Q3 2021 by 12 basis points to 4.57%.	Vacancy → Rents → Incentives → Yields ↓
North Sydney	**Demand recovery evident, with vacancy rates falling across prime and secondary stock.** The total vacancy rate fell 1.0 ppts to 17.5% in Q3 2021. Prime grade vacancy rates continued to fall in the September quarter to 20.7%, while secondary vacancy rates fell marginally to 13.9%, after rising for the past 12 months. Quarterly net absorption was recorded at 9,727 square metres. Incentives rose by more than the neighbouring Sydney CBD, leading to effective rents falling 1.3% in Q3 2021. Investment yields remained flat in September.	Vacancy → Rents ↓ Incentives ↑ Yields ↓
Parramatta	**Positive net absorption led by pre-commitment activity**. Net absorption was recorded at 45,985 square metres in Q3 2021, led by the Department of Home Affairs consolidating to the one building at 101 George St. After effective rents fell significantly in FY21, rents have started to stabilise off the back of incentives remaining stable at 35%. In Q3 2021, prime net effective rents rose 0.5%. A plentiful development pipeline will keep rents and incentives at these levels for the foreseeable future, with 16.8% of total stock due for completion over the remainder of FY22. Investment yields fell 13 basis points in the September quarter.	Vacancy ↑ Rents ↓ Incentives ↑ Yields →
Melbourne CBD	**Elevated supply levels constrain improvements in vacancy rates**. While net absorption was recorded at 24,000 square metres in Q3 2021, vacancy rates rose further to 15.0% (from 14.1% the previous quarter). This was primarily due to the completion of 2two projects (405 Bourke Street and 1000 La Trobe Street), the latter of which was only 23% pre-committed. Sub-lease vacancy rates remained elevated, at 3.8% in Q3 2021. Incentives continued to rise to 37.8% in September, though face rents remained stable. Prime net effective rents recorded the largest fall (-3.6%) of all CBD markets nationally. Prime investment yields remained stable.	Vacancy ↑ Rents ↓ Incentives ↑ Yields →
Brisbane CBD	**Limited supply and stable demand see vacancy rates starting to fall**. The total vacancy rate fell to 15.8% in September, with quarterly net absorption recorded at 2,500 square metres, as a number of financial services firms contracted their presence in the Brisbane CBD. While face rents held steady, incentives rose to 42.0%, leading to effective rents falling 1.7% over Q3 2021. Prime investment yields remained stable.	Vacancy → Rents → Incentives → Yields ↓
Perth CBD	**Vacancy rates fall to 6-year lows**. The vacancy rate continued to fall to 19.1%, the lowest it has been since 2015, aided by strong leasing demand and the withdrawal of 905 Hay Street. Tenant demand was driven by both smaller tenants (<1,000 square metres) taking up space and some larger tenants expanding their footprint in the CBD. Incentives and face rents remained stable through the September quarter. Prime investment yields also remained stable, though the recent sale of Capital Square at an equivalent yield of 5.1% is likely to lead a rewriting of pricing in Perth.	Vacancy ↓ Rents → Incentives → Yields ↓

Industrial

Industrial indicators gather even more pace

The industrial market has continued its strong run in the second half of 2021. The lockdown of the nation's two largest cities, Sydney and Melbourne, placed extra demand on the logistics sector, with a further circa 450,000 square metres absorbed nationally. Online sales surged ahead to record 31% growth over the quarter. The logistics sector remains the biggest category in terms of leasing, accounting for approximately 35% of national take-up in the year to date.

Competition by companies seeking to lease prime, well-located assets, combined with record low vacancy, continued to drive rents. The West Melbourne market surged with rents growing by 6.8% over the September quarter for a gain of 11.8% in the past year. Outer West Sydney experienced a robust 2.2% in the quarter for an annual gain of 4.8%. Sydney's inner markets also saw strong growth. After languishing for several years, Perth is beginning to follow the trends evident on the east coast, with East Perth recording its second consecutive quarter of rent growth (4.1%) taking the year-on-year growth to a staggering 8.5%. Rents remain at a 23% discount the peaks of 2012, reflecting significant upside.

Investment demand remains very strong. Domestic appetite from major players to purchase and develop product appears to be pricing out smaller players. Over the past quarter, average prime yields have significantly compressed in Outer West Sydney and West Melbourne to well below 4%, on the back of circa $900 million worth of investment in both markets. With improving leasing fundamentals, Perth has appeared on the radar of many players looking for an attractive yield play. Large investments by Dexus/Dexus Industria REIT at Jandakot Airport and Charter Hall in the north have tightened the yield spread between the Perth and Brisbane market to c25 basis points.

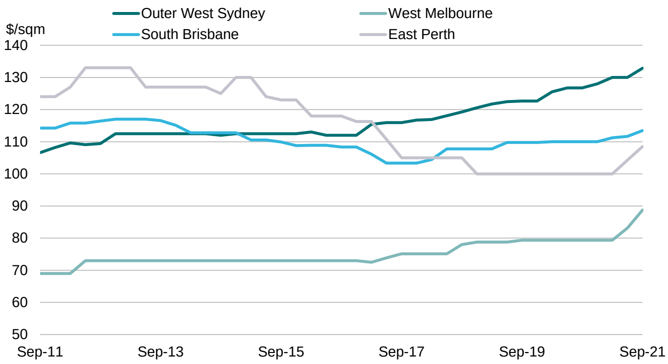
Land values continue to benefit from a combination of the weight of capital by developers and diminishing supply of large sites. The Outer West Sydney market has hit $1,000/sqm (2-5 ha), while West Melbourne boasted the strongest growth of all markets adding a further $125/sqm onto its price tag to $500/sqm (2-5ha), a gain of 67% over the year.

Table 4. Industrial snapshot

	Ave prime cap rate change from Q2 2021	Existing prime net face rental growth % p.a.
West Melbourne	-0.50	+11.8%
East Perth	-0.50	+8.5%
Outer West Sydney	-0.38	+4.8%
Southern Brisbane	-0.25	+3.1%
South Sydney	-0.38	+2.9%

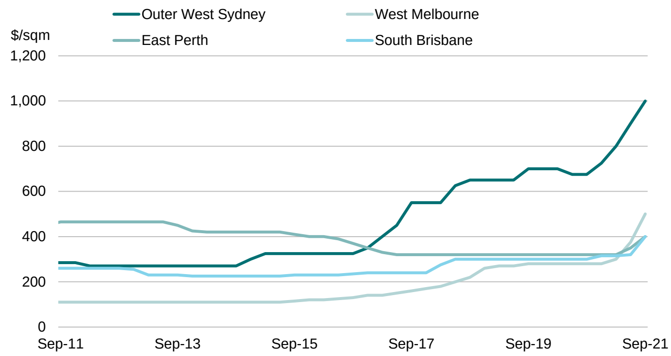
Source: JLL Research, Dexus Research (Sep 21), land values 2-5HA exl Perth (1HA)

Figure 13. Rents continue to rise in most markets, with Melbourne and Perth standing out



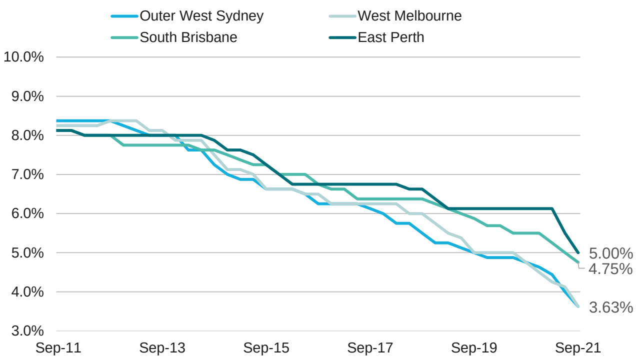
Source: JLL Research, Dexus Research

Figure 14. Competition by developers continues to drive up land values, particularly in West Melbourne



Source: JLL Research, Dexus Research

Figure 15. Prime yields continue to tighten overall with Perth's spread to Brisbane narrowing markedly



Source: JLL Research, Dexus Research

Industrial by region

Outer West Sydney

The Outer West Sydney market had another strong quarter with 230,000sqm leased. Total take-up for the year to September was an unprecedented 2.5 times the past average rate of take-up.

Around 75,000sqm of transport and logistics space has been leased in the Eastern Creek and Erskine Park areas in Q3 2021. These deals included CEVA Logistics and Cameron's Transport with circa 20,000-25,000sqm requirements.

The major developers in the Kemps Creek region appear to be burning through their land holdings faster than previously anticipated following strong pre-leasing activity. McPhee Distribution Services pre-committed to 72,000sqm at the newly acquired Dexus site at 113-153 Aldington Road, while Woolworths has taken up 35,000sqm at Goodman's Oakdale West Industrial Estate. The strong level of demand saw incentives decrease around two percentage points.

West Melbourne

West Melbourne continues to be the preferred market in Victoria, with demand in the year to September, running nearly four times the past average rate. Since the start of 2021, an astonishing 960,000sqm has been leased. The high level of dmand has triggered more speculative developments, with the proportion rising to around 50% of supply under construction.

The retail sector continues to be a major source of logistics demand. National multi-channel retailers, Myer and Mitre 10, have pre-committed to Dexus's Horizon 3023 estate, absorbing a combined 110,000sqm, joining Amazon and Hello Fresh. The pure-play online space also continues to grow with international retailer Costway leasing circa 20,000sqm in Truganina to accommodate its Australian expansion.

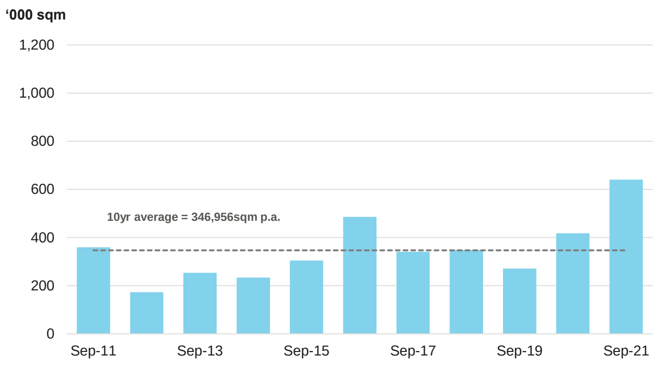
Brisbane

While positive, conditions in Brisbane are a little more subdued than in Sydney and Melbourne. Take-up volumes over the Southern and Trade Coast markets were broadly in line with average levels at around 75,000sqm.

The Brisbane market looks to be benefiting from a growing interest in logistics space from the retail sector. Since the start of the year, around 130,000sqm of space has been leased by retailers which accounts for 33% of demand, heavily concentrated in the Southern precinct. A big name in the online food sector, Youfoodz, has pre-committed to a production facility in Berrinba Logistics Hub.

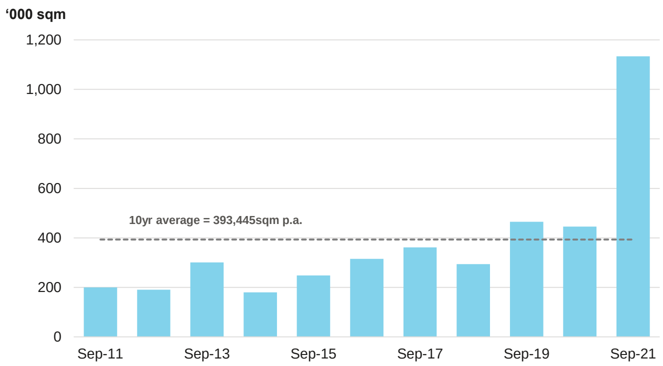
Rents in Southern Brisbane have grown 3.1% over the year however, a growing amount of speculative development may put some upward pressure on incentives unless demand picks up significantly.

Figure 16. Outer West Sydney gross take-up



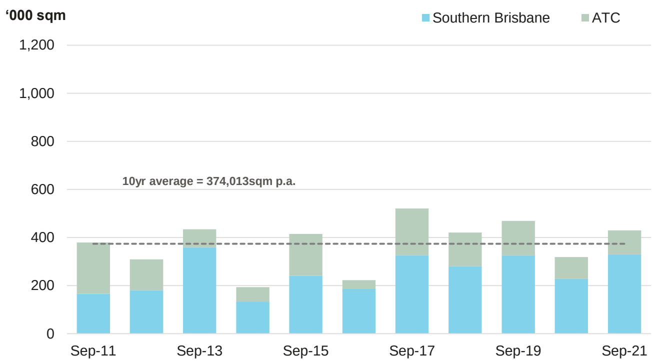
Source: JLL Research (gross take-up), Dexus Research.

Figure 17. West Melbourne gross take-up



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

Figure 18. South Brisbane and ATC gross take-up



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

Retail

Spending patterns still disrupted

Lockdowns in NSW and Victoria have caused disruptions in spending patterns with retail turnover declining 13.9% and 5.7% respectively in the quarter to August. Sales in the states which avoided lockdown fared better, growing 0.3%. Despite the recent weakness, retail sales increased 7.1% nationally over the past year in moving annual terms.

The volatile period was characterised by the temporary closure of non-essential stores. As a result, discretionary spending weakened with food and household goods performing well (Figures 19 & 20). Discretionary spending should surge again as Sydney and Melbourne emerge from lockdowns towards the Christmas period.

Shopping centres have not been able to capitalise on all the growth in spending in the past year. Much of the growth in the household goods category was in standalone and bulky goods premises. Smaller centres anchored by supermarkets have performed best, given their reliance on non-discretionary spending. While large regional centres have borne the brunt of the pandemic (Figure 21) conditions should improve markedly over the next year as spending reverts to more normal patterns.

Looking ahead, sales growth should be supported by government stimulus, expansionary monetary policy, employment growth and an enlarged pool of household savings.

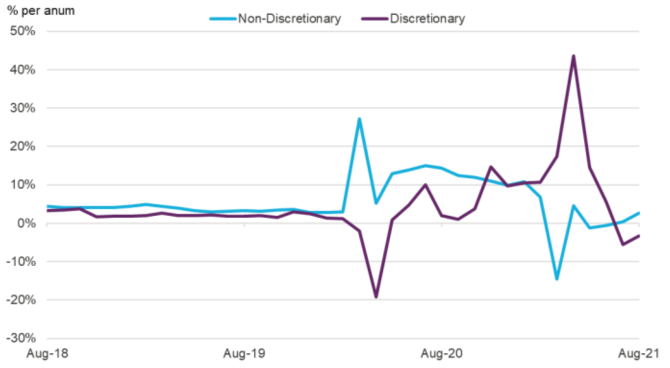
City retail remains challenged given the pandemic's effects on CBD locations and the number of store closures. Subdued conditions seem likely to continue over the next few months as it will take time for office workers to return to the 70%-80% of capacity prior to the latest lockdowns. However, 2022 should be a year of upside from a low base as office workers, tourists and university students slowly return.

Table 5. Retail snapshot

	Specialty rent growth % p.a.	Cap rate chge from Q3 (ppts)	State sales growth % p.a.
Sydney			6.3%
Regional	-6.9%	-	
Sub-regional	-2.1%	-0.50	
Neighbourhood	-1.1%	-0.75	
Melbourne			5.4%
Regional	-9.3%	0.12	
Sub-regional	-3.1%	-0.12	
Neighbourhood	-2.5%	-0.52	
SE QLD			8.7%
Regional	-3.8%	-	
Sub-regional	-1.2%	-	
Neighbourhood	+1.2%	-0.63	

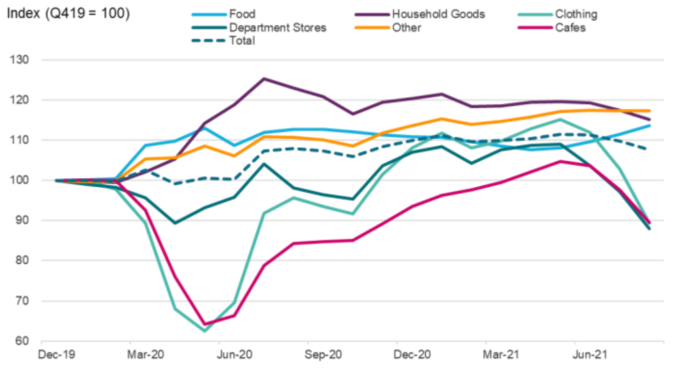
Source: JLL Research, Dexus Research (September 2021)

Figure 19. While non-discretionary spending remains positive, discretionary turnover should begin to recover



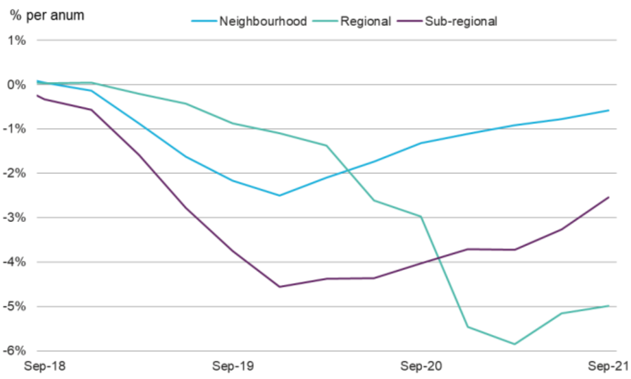
Source: ABS, Dexus Research

Figure 20. Retail trade has been volatile throughout the pandemic, particularly in discretionary categories



Source: ABS, Dexus Research

Figure 21. Market rents have been more resilient on average in neighbourhood centres than larger centres



Source: JLL, Dexus Research.

Healthcare

Demand for healthcare assets remains strong

Investor interest in healthcare real estate has continued to firm as the sector proves resilient to cyclical economic movements, offering defensive income streams. The institutionalisation of the sector has continued as both listed and unlisted institutional investors have increased their exposure. There has also been a notable increase in merger and acquisition activity and portfolio acquisitions, as demand outstrips investment opportunities.

Uncertainty about inflation and the current economic environment has investors chasing the embedded income growth that comes with healthcare real estate, inherently tied to the longer WALEs and exposure to tenants providing essential services. Over the past 15 years, the healthcare sector has offered attractive risk-adjusted returns (Figure 22).

The strong structural thematics of healthcare (such as a rapidly ageing population and increasing healthcare spending) will likely continue to attract investors to the sector. Investors' hurdle rates appear to be falling as they recognise strength of cash flows and acknowledge healthcare's place as the largest 'alternative' real estate sector. The low correlation of returns between healthcare and traditional sectors like office and retail, provides investors with diversification benefits at a portfolio level.

This flurry of investor interest and increased demand, combined with a reduction of required returns has driven yields down, making the transaction market more competitive. Additionally, in the current low interest rate environment, the low cost of debt is still a big driver for yield compression.There is evidence of healthcare assets being transacted at yields comparable with prime office and industrial assets. Indeed, recent acquisitions by Centuria have been transacted at yields of 4.1% (Perth Clinic, 21-29 Havelock Street) and 4.5% (Sunbury Medical Centre).

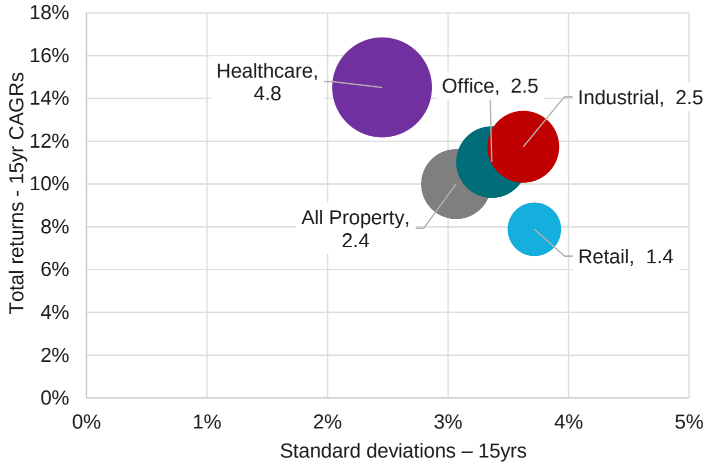
There is also increasing interest from foreign investors, which will add further pressure to yields. In October, New Zealand listed Vital Healthcare (controlled by Canadian NorthWest Healthcare) transacted on Tennyson Centre in Adelaide at a yield of 4.7%.

Table 6. Correlation of returns to other sectors

	Retail	Office	Industrial
Office	0.71		
Industrial	0.42	0.80	
Healthcare	**0.09**	**0.11**	**0.18**

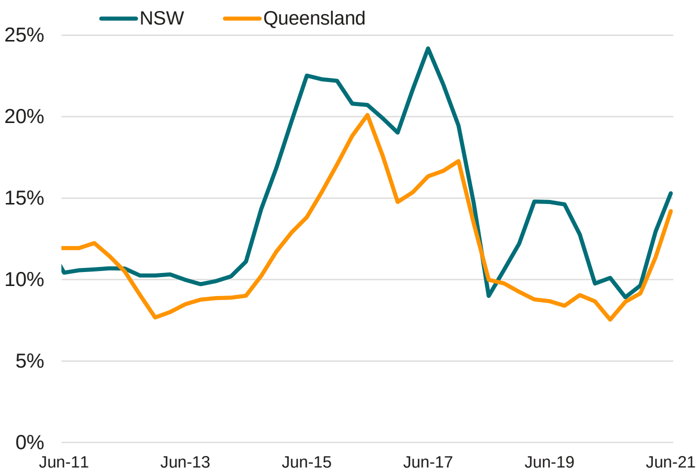
Source: MSCI, Dexus Research

Figure 22. Healthcare has the most attractive risk-adjusted returns, with lower risk tied to longer WALE assets



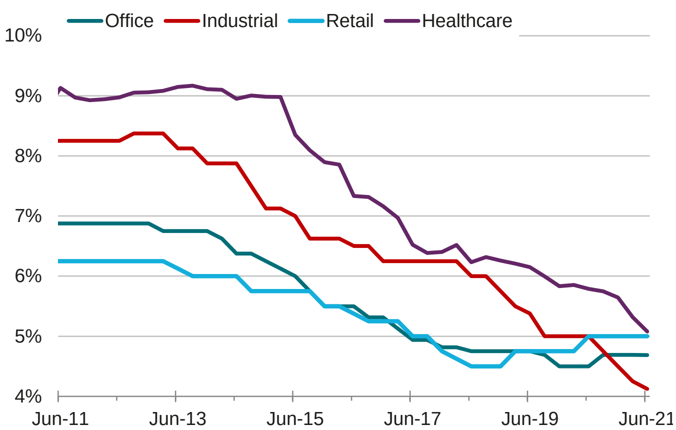
Source: MSCI, Dexus Research (Size of the bubble pertains to the Sharpe ratio)

Figure 23. Healthcare returns remain strong and show a reasonably similar profile across states



Source: MSCI, Dexus Research

Figure 24. Yields in the healthcare sector are compressing closer to the traditional property sectors



Source: MSCI, Dexus Research

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