dexus

Australian Real Estate Quarterly Review

Q4 2018

Gateway, Sydney, owned by Dexus Wholesale Property Fund.

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Investment Climate

Slow steady growth is good for demand

The global growth outlook remains supportive with US growth increasing and commodity prices remaining firm. However, global risks have increased given an acceleration of the trade war between the US and China, a lack of clarity around a Brexit outcome and volatility in share markets. The key issue for Australia is the continuance of Chinese and US growth in the face of trade pressures.

Domestically, the housing sector continues to slow with housing approvals falling by 6% over the past year and further declines ahead. Employment growth, while solid, is expected to slow mildly.

The outlook is for growth of the Australian economy to slow mildly. The upshot of this mix of trends is that occupier demand will remain positive without exceeding expectations.

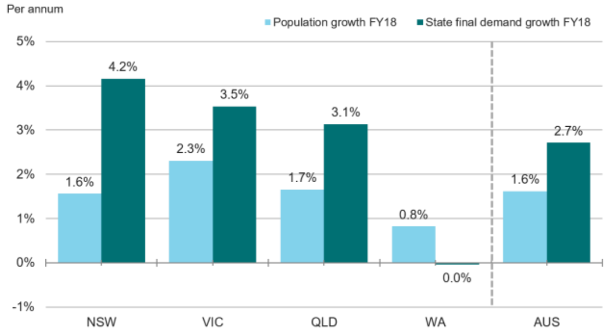
Within Australia, growth continues to rebalance between states, with WA gathering pace and Queensland forecast to overtake the NSW and Victorian economies as they ease off a high base.

The contraction in investment in housing appears likely to be largely offset by investment in infrastructure and non-residential construction. The NSW government has $87 billion of projects budgeted over the next four years, while Queensland has announced an infrastructure pipeline valued at $46 billion over the same period.

Population growth is another positive factor, with the Victorian economy currently benefiting from a growth boost of 0.7 percentage points per annum over the national average (Figure 1.). In this context, the political debate underway about appropriate immigration levels is extremely important.

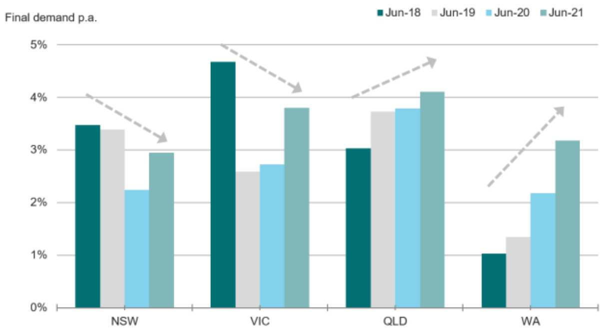
Australia is likely to avoid the rising interest rate cycle which is causing concern about future growth prospects and asset pricing in the US. The official cash rate in Australia is expected to remain flat until late 2019. While higher US bond rates may pull Australian bond rates up, the extent will be limited by the lack of inflation pressure here. A steady cost of capital should continue to support investment demand in the short term.

Figure 1. Population as a growth driver



Source: DAE

Figure 2. Forecast growth by state



Source: DAE

Table 1. Australian economic forecasts: Q3 2018

	Jun-18	Jun-19	Jun-20
Real GDP %pa	2.8%	2.8%	2.6%
Final demand %pa	2.7%	2.3%	2.5%
Employment %pa	2.5%	1.3%	1.3%
Goods imports %pa	6.2%	2.4%	2.2%
Retail sales %pa (real)	1.7%	2.8%	2.5%
CPI %pa	2.1%	2.2%	2.3%
90 Day bill %	2.1%	2.0%	2.5%
10yr Bond %	2.6%	2.9%	3.2%
AUD/USD	0.75	0.69	0.70

Source: Deloitte Access Economics base, Dexus adusted forecasts

Transactions

Superanuation funds becoming more active

Investment volumes remained steady in the September quarter at $6.6 billion despite purchases by foreign investors falling by more than 10% year-on-year to around 28% of purchases. Foreign interest in Australia appears solid, however volumes have been constrained by capital restrictions (China), lack of quality stock, a greater focus on M&A activity and competition from local buyers.

Superannuation funds have filled the void, participating in $2.1 billion of transactions (Figure 3). Key purchases were Two Melbourne Quarter ($275 million) by First State Super, Westpac Place ($856 million) by ISPT and Quay Quarter ($900 million) by REST Industry Super. The Australian superannuation sector, which has grown by 12.1% p.a. over the past decade to be the fourth largest in the world, is likely to remain an important source of demand over the long term.

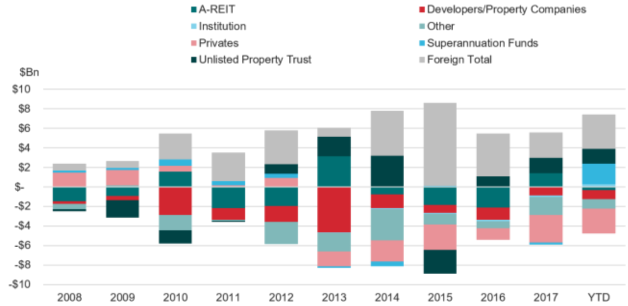
Average prime yields across sectors have continued to decline (Figure 4), with industrial sales transacting at increasingly low yields. Calibre in Eastern Creek was the largest single industrial asset transaction of the quarter, trading at an initial yield of 5.1%.

In the retail sector there has been a departure from the price tightening cycle of the past five years. Buyers are exercising caution regarding mid-sized or regionally located centres due to a perceived divergence in performance compared to better quality metro centres. Major owners are recycling capital within their portfolios leading to a significant amount of stock on the market.

Vicinity (VCX) divested eleven Sub regional and Neighbourhood shopping centres for A$631 million, reflecting a 5.1% discount to the June 2018 combined book values and a weighted average cap rate of 6.9%. This sale represents 11 of 14 of VCX's non-core asset disposal program, with the proceeds expected to be reinvested in the retail development pipeline as well as a share buyback.

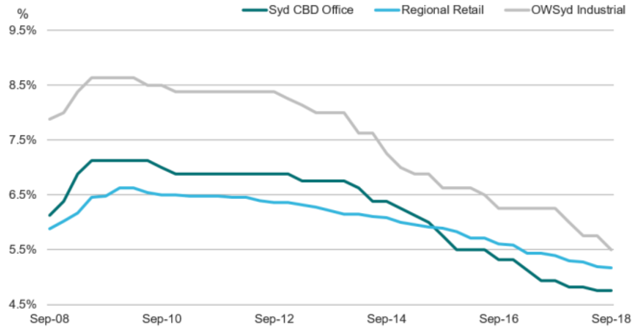
Demand and pricing for well-trading shopping centres remains strong with the largest transaction of the quarter being Scentre Group's purchase of a 50% stake in Westfield Eastgardens for $720 million.

Figure 3. Net buyers and sellers



Source: JLL Research, Dexus Research Transaction Database

Figure 4. Average prime yield by sector



Source: JLL Research, Dexus Research. Includes portfolio sales

Table 2. Q2 2018 top transactions

Price ($m)	Asset/portfolio	Buyer
720	Westfield Eastgardens	Scentre Group (50%)
500	Brookfield Property Partners	AMP Capital
418	80 Ann Street	M&G Real Estate (50%)
278	Eclipse Tower	GPT Group
252	53 Albert Street	JP Morgan A.M.
240	275 George Street	Daibiru Corporation
170	Homemaker City – Stge 1	Arkadia Capital Group
160	RBA Building	Dexus
131	Commercial & General	Straits Real Estate

Source: Dexus Research Transaction Database, JLL Research

Performance

M&A activity intensifies

Australian shares outperformed other asset classes for the year to 30 September, delivering a 14.0% return with A-REITs just behind. However, in early October, financial market volatility hindered returns with the VIX volatility index reaching heights last seen in February. Global jitters were driven by fears of higher interest rates and increasing trade tensions.

Unlisted property returned a credable 12.6% for the year with above average capital growth. Office values in Sydney and Melbourne have risen quickly as rent growth added to gains from cap rate tightening (Figure 5).

A gap has widened between sectors in the Mercer/IPD Wholesale funds index (Figure 6). While industrial and office returns have been helped by rental growth, retail returns are being affected by weaker income growth and write downs in values of poorer assets.

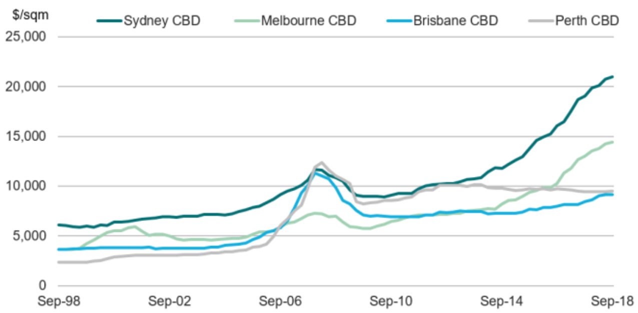
In the short term, expect more of the same with retail easing and diversified fund returns feeling the effect of the retail cycle. In the medium term, capital growth is likely to ease across all sectors as cap rate tightening tapers.

Mergers & Acquisitions (M&A) activity has increased driven by limited opportunities in direct property, global institutions reweighting exposure to industrial assets and Australia's attractive yields on a global scale. Rising global bond yields have also increased the arbitrage between direct and listed markets.

Oxford Properties appears to have prevailed in a $3.4 billion bid to take over Investa Office Fund (IOF) with a $5.60 per unit non-binding cash offer. The proposal represents a 1.4% premium to Blackstone's improved $5.52 per unit cash offer and at a 2.4% premium to IOF's Jun-18 NTA. Oxford has agreed to acquire a 19.9% interest in IOF from Investa Commercial Property Fund.

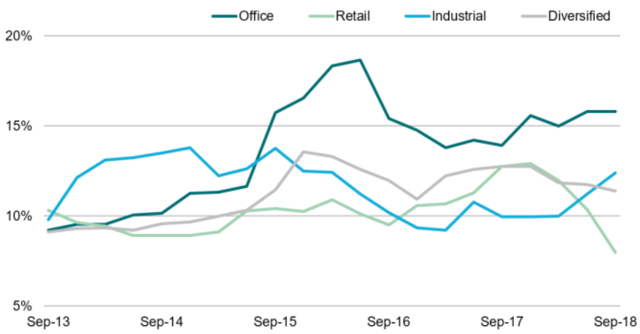
Further activity includes Propertylink giving approval to private equity-backed logistics fund ESR's $723 million buyout proposal and Centuria Metropolitan REIT (CMA) and the Leaderer Group entering into agreements to acquire $645 million of four suburban office assets from a subsidiary of Hines Global REIT.

Figure 5. Prime office values



Source: JLL, Dexus Research

Figure 6. IPD Wholesale funds index returns



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

Table 3. Index returns to 30 September 2018

	Qtr.%	1 yr %p.a.	3 yr %p.a.	
Australian shares	1.5	14.0	12.1	S&P/ASX 200 Accumulation Index
A-REITs	1.9	13.2	10.0	S&P/ASX 200 A-REIT Accumulation Index
Unlisted property*	2.9	12.6	12.9	Mercer/IPD Aust. Unlisted Wholesale PFI*
Australian fixed interest	0.5	3.7	1.9	BACM0 Index
Australian cash	0.5	1.9	1.9	BAUBIL Index

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

Office Markets

No sign of occupier demand slowing

Strong employment growth and positive business confidence continue to support demand across the major markets, with all markets except Sydney showing solid take-up in Q3 2018.

In Sydney CBD, while a lack of availability of large contiguous areas of office space is limiting absorption, office enquiry levels are up substantially since last year. Sydney recorded negative net absorption of -12,000sqm, largely attributed to the withdrawal of 66 King Street for refurbishment and smaller tenants leaving the market.

Melbourne continued its exceptionally strong run recording net absorption of +79,800sqm in Q3 2018, its strongest quarter in more than a decade. Brisbane bounced back following a subdued Q2 to record net absorption of +15,400sqm in Q3 2018. Perth continued its steady improvement recording +17,600sqm of net absorption. Strong business conditions are likely to support demand over the next year.

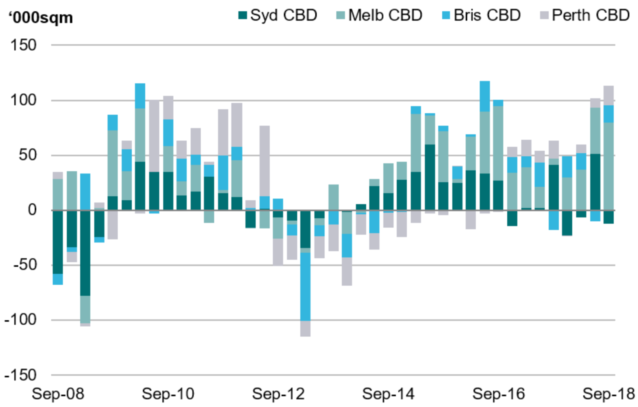
Supply levels remain modest across most major markets, putting downward pressure on vacancy rates. Melbourne's CBD office vacancy rate of 4.0% is the lowest in 30 years, while Sydney CBD it is the lowest for 18 years. In Perth the vacancy rate increased to 22.0%, largely due to backfill associated with Woodside's move into the recently completed Capital Square. Vacancy rates are likely to reduce further in the major markets over the year ahead.

Effective rents in Sydney and Melbourne continue to grow but the rate is easing off a high base. Perth and Brisbane have begun to improve mildly. The outlook is for mild rent growth to continue in the near term before new supply comes online in the medium term.

The NSW Government and Atlassian made an announcement this quarter about the desire to create an innovation hub between Central and Eveleigh, with plans for creation of 10,000 new jobs by 2036. The NSW Government has also recently approved plans to progress to Stage 2 of the Unsolicited Proposals (USP) process for Dexus and Frasers Property Australia to redevelop the Henry Deane Plaza and Lee Street within the Central precinct.

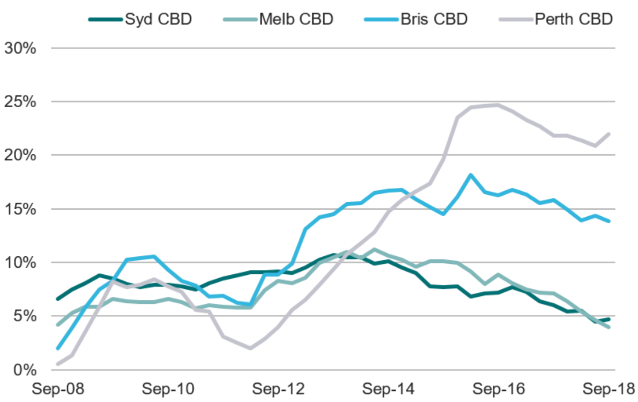
WeWork once again was active in leasing activity in Sydney and Melbourne, committing to almost 8,500sqm at York&George and 161 Castlereagh Street in Sydney, and over 5,000sqm at 222 Exhibition Street in Melbourne.

Figure 7. Quarterly net absorption by market



Source: JLL Research, Dexus Research

Figure 8. Vacancy by market



Source: JLL Research, Dexus Research

Table 4. Q3 2018 office snapshot

	Vacancy %	Prime net face rental growth % p.a.	Prime net eff. rental growth % p.a.
Parramatta	4.7%	16.3%	22.2%
Melbourne CBD	4.0%	6.9%	10.3%
Sydney CBD	4.7%	5.8%	9.6%
North Sydney	7.4%	4.2%	6.6%
Macquarie Park	7.5%	3.5%	7.4%
Canberra	11.6%	2.9%	3.4%
Brisbane CBD	13.9%	2.7%	1.8%
Adelaide CBD	13.7%	2.1%	2.9%
Perth CBD	22.0%	1.1%	4.1%

Source: JLL Research

Office Market Wrap

Market	Comments	Direction of trend for next 12 months
Sydney	**Limited stock availability restricting absorption**. The Sydney office market recorded negative net absorption in Q3 2018 as a lack of large, contiguous space options impacted activity despite solid levels of enquiry. The vacancy rate increased slightly to 4.7% but is expected to fall further. Rental growth remains strong at +10.1% p.a. (prime gross effective) as incentives continue to fall. The majority of new supply is still not expected to come online until FY22-24 and the demand backdrop remains supportive. The pace of rent growth is tapering and we forecast another two years of rent growth in this cycle.	Vacancy ↓ Rents ↑ Incentives ↓ Yields →
North Sydney	**Rent growth continues**. The North Sydney office market recorded positive net effective rent growth of 6.6% for the year, despite negative net absorption of -10,993sqm in Q3 2018. The vacancy rate increased to 7.4%. The outlook for demand is positive as the market benefits from a strong NSW economy and overflow of demand from the Sydney CBD. Stronger demand will help support further rental growth in the year ahead.	Vacancy ↓ Rents ↑ Incentives → Yields →
Macquarie Park	**Net absorption eases in Q3 2018**. After recording positive net absorption in Q2, net absorption was negative -9,438sqm in Q3 2018. As a result, the vacancy rate increased to 7.5%. However, prime net effective rents remain solid, growing 7.4% over the past year, as face growth increased. A relatively subdued supply pipeline short term should support further rental growth in the year ahead.	Vacancy ↓ Rents ↑ Incentives → Yields →
Parramatta	**Continues to outperform**. The vacancy rate in Parramatta remains very low at 4.7% (1.4% for prime stock). Rents are up +22.2% p.a. (net effective) and incentives have reduced further for prime assets to 17%. Rent growth is projected to remain positive in the short term as new supply such as Parramatta Square, is largely pre-committed. There is risk over the medium term with the exit of CBA and potential for a large amount of supply. How Parramatta performs will depend on its ability to attract tenants from outside the market.	Vacancy ↓ Rents ↑ Incentives → Yields →
Melbourne	**Strongest quarterly net absorption in over 10 years**. Melbourne recorded its strongest quarterly net absorption figure in more than a decade at +79,800sqm as the market continued to benefit from strong economic fundamentals. The vacancy rate also fell further and is now at 4.0%. Rental growth is strong with prime net effective rents increasing by 10.3% over the year. While new supply will come online in the near term, the majority of new projects are pre-committed and strong demand will continue to keep pressure on vacancy and rents over the next 6-12 months.	Vacancy → Rents ↑ Incentives ↓ Yields →
Brisbane	**Steady recovery**. After recording negative net absorption last quarter, net absorption rebounded to +15,400sqm in Q3 2018, largely supported by mid-sized occupiers. The vacancy rate reduced slightly to 13.9%, and net effective rent growth improved further (+1.8%p.a). Incentives are likely to remain elevated in the near term while the vacancy rate is still high. Demand is projected to continue to improve over the next year or two which will support rental growth, particularly for prime stock supported by a flight to quality.	Vacancy ↓ Rents ↑ Incentives → Yields ↓
Perth	**Market improves on steady demand**. Perth continued to rebound recording +17,600sqm of positive net absorption in Q3 2018. The vacancy rate increased to 22.0% as Woodside's new headquarters at Capital Square completed and their backfill space became available. Prime net effective rents have experienced further growth of +4.1%p.a. while market net incentives are stable at 48%. Rental growth is expected improve mildly as market conditions slowly recover in the absence of major new supply.	Vacancy → Rents ↑ Incentives ↓ Yields →
Canberra	**Office demand improves**. Canberra recorded positive net absorption of +35,700sqm in Q3 2018, which was the first positive recording this year, supported by expansion of the Department of Home Affairs. The demand outlook is expected to remain mild given Federal Government budget constraints. Limited availability of prime space (prime vacancy is currently 6.2%) is helping to support rental growth for prime assets (+3.4% p.a. net effective). Positive demand for prime assets should support an uplift in rents over the next 12 months.	Vacancy → Rents ↑ Incentives → Yields →

Industrial

Demand, rents and land values rising

The industrial sector remains in a growth phase. Demand is continuing to strengthen, leveraged to growth in metropolitan Sydney and Melbourne due to solid population growth and infrastructure investment, supplemented by double digit growth in e-commerce.

Strong tenant demand and rising construction costs are putting upward pressure on rents in parts of Sydney and Melbourne, especially in supply constrained (inner-city) markets (Figure 9, Table 5).

Conditions in Brisbane are projected to continue to improve over the short term as the economy rebounds and infrastructure investment improves, while Perth appears to have bottomed.

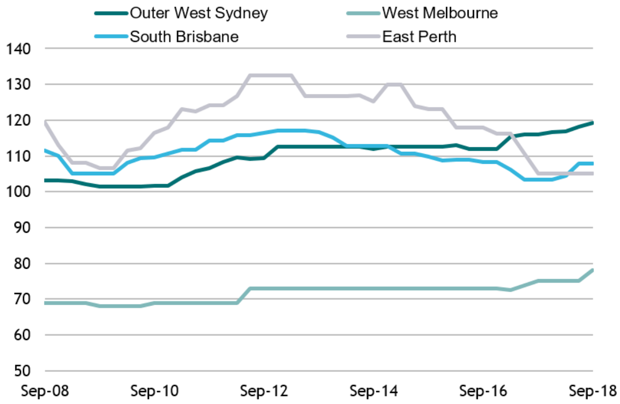
Further rental growth is expected over the next few years supported by positive economic conditions; limited land supply; stock withdrawal for alternative uses; and significant infrastructure investment. E-commerce is expanding rapidly and is likely to significantly add to demand over the medium to long term.

This positive outlook for industrial is supporting strong investor sentiment and heightened interest in industrial assets.

Demand for investment stock and development sites has remained strong and highly competitive as a result. Combined with limited availability of product, land values have risen past previous peaks in key markets in Sydney and Melbourne as developers seek to maintain their pipelines (Figure 10), and yields have been pushed lower (Table 5).

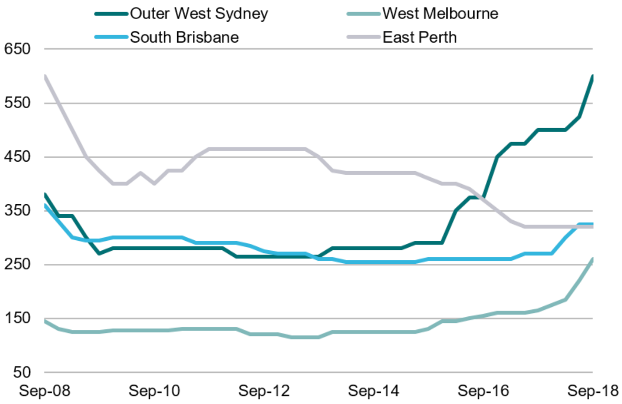
While the trend to higher land values is well underway in Sydney and Melbourne, Brisbane is now also moving and likely to rise further in the year ahead.

Figure 9. Average existing prime industrial rents



Source: JLL Research, Dexus Research

Figure 10. Average industrial land values (1ha)



Source: JLL Research, Dexus Research

Table 5. Q3 2018 industrial snapshot

	Ave prime cap rate change from Q2 2017	Existing prime net face rental growth % p.a.
Outer West Sydney	-0.75	2.8
Southern Brisbane	-0.75	7.3
East Perth	-0.25	3.8
South Sydney	0.00	4.3
West Melbourne	-0.12	0.0

Source: JLL Research, Dexus Research

Industrial

Outer West Sydney

Demand remains robust in Outer West Sydney with above average take-up of 91,400sqm recorded in Q3 2018. Positive economic conditions are likely to support demand in the medium term.

Supply completions have been strong with approximately 271,700sqm of stock added Year to Date (in line with the 10 year average of 270,000sqm) and a further 86,700sqm of stock projected to complete in Q4 2018.

Rental growth is likely to remain positive in the short term with demand expected to outpace supply, supported by the solid NSW economic outlook.

The largest lease deal in Q3 2018 was a pre-lease to ACFS (21,700sqm) at Eastern Creek.

West Melbourne

Take-up rates in West Melbourne eased in Q3 2018 to 48,900sqm following a very strong first half of the year. Demand is projected to improve as population growth continues and key infrastructure projects such as the West Tunnel project add further support to economic conditions.

There is a relatively limited amount of land that is currently zoned and serviced in West Melbourne, and as a result, there has been upward pressure on rents over the last 12 months.

The outlook is for continued mild levels of rental growth in the short term as below average levels of supply is projected over the next 1-2 years.

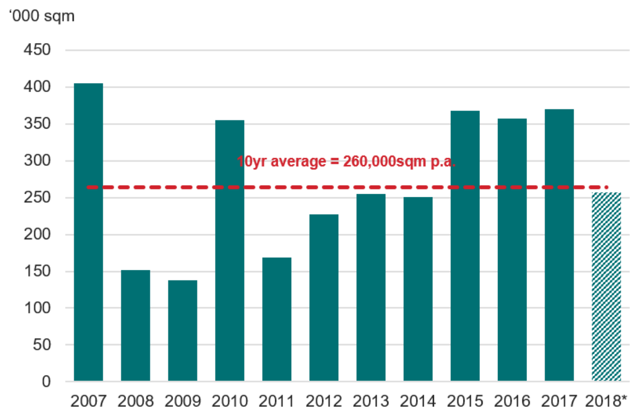
The largest lease deal in Q3 2018 was by Visy, pre-commiting to a 42,770sqm design and construct project in Truganina.

Brisbane

Take-up in Brisbane increased further in Q3 2018, with approximately 177,000sqm recorded. Improved economic conditions including employment growth and infrastructure investment points to a continued improvement in the year ahead after several years of weakness.

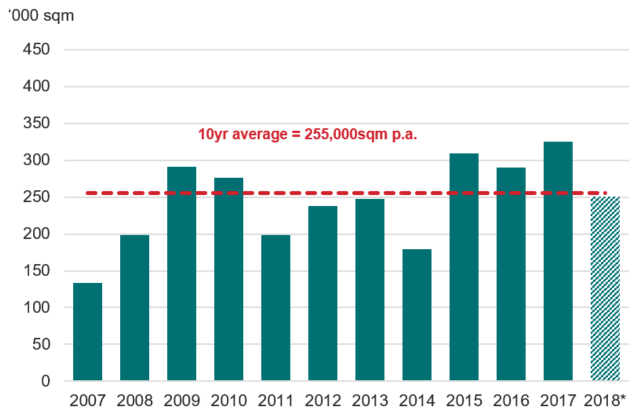
In 2018, the 250,000sqm of planned industrial supply is well below the 10 year average (320,000sqm), providing scope for some upward pressure on rents.

Figure 11. Outer West Sydney gross take-up



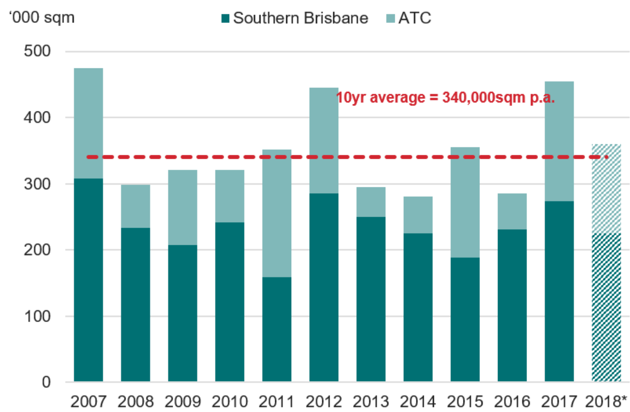
Source: JLL Research (gross take-up), Dexus Research. *Jan-18 to Sep-18

Figure 12. West Melbourne gross take-up



Source: JLL Research (gross take-up), Dexus Research. *Jan-18-Sep-18

Figure 13. South Brisbane and ATC gross take-up



Source: JLL Research (gross take-up), Dexus Research. *Jan-18-Sep-18

Retail

Conditions challenging

Turnover growth has improved mildly in recent months, but conditions remain challenging within the retail sector. Retail turnover growth increased 0.3% in the month of August 2018 based on ABS data, which was slightly above market expectations. The annual pace is now tracking at 3.8% year on year.

Overall, pharmaceuticals, cosmetics and food catering continue to perform well, with supermarkets leading the other anchor tenants on strong food sales growth.

Online retail sales continued to boom, up 17.2% over the 12 months to August, reaching $27.8 billion or around 8.8% of spending at traditional bricks and mortar retailers (NAB Online Retail Sales Index August 2018). Online sales growth should continue to grow at double digit pace with the emergence of faster delivery services (such as Amazon Prime and Ebay Plus) placing continued pressure on bricks and mortar retailers.

There may be some relief ahead as employment growth seeps through to wages and retail spending growth benefits from continued low interest rates. However, a softening housing market, mortgage rate increases and rising petrol prices are likely to keep consumer spending constrained.

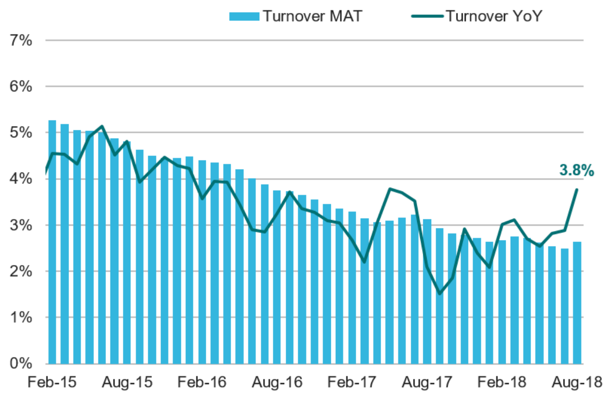
The outlook for rents is subdued in the short to medium term, reflecting high occupancy costs and poor retail margins.

Centre performance varies – bottom quartile centres are experiencing higher incentives and negative leasing spreads, while top quartile centres are maintaining metrics. The best performing Australian retail centres are in growing catchments with a focus on convenience, food, entertainment, leisure and services.

Key events this quarter include:

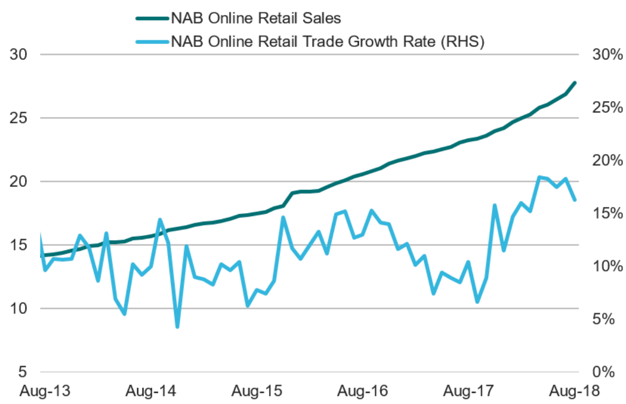
- Amazon Australia continued its expansion into new categories, adding automotive and pet supplies last month, and more recently, food and beverages to its range
- Online retailer Catch opened the doors to its first bricks-and-mortar pop-up store at Chadstone Shopping Centre in a former Toys 'R' Us store
- Max Brenner's Australian business went into voluntary administration, citing rising costs and sluggish retail trade

Figure 14. Online retail sales growth



Source: ABS, RBA, Dexus Research

Figure 15. Retail sales growth



Source: NAB Online Retail Sales Index, Dexus Research

Table 6. Q3 2018 retail snapshot

	Specialty rental growth % p.a.	Cap rate change from Q2 2017	State retail sales growth % p.a.
Sydney			2.9
Regional	0.15	-0.50	
Sub-regional	0.75	0.00	
Neighbourhood	1.12	0.00	
Melbourne			4.6
Regional	0.70	-0.38	
Sub-regional	0.57	0.00	
Neighbourhood	1.09	-0.13	
SE QLD			1.2
Regional	0.17	-0.50	
Sub-regional	-0.25	0.00	
Neighbourhood	0.35	-0.13	

Source: JLL Research, ABS, Dexus Research

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