dexus

Australian Real Estate Quarterly Review

Q3 2021

One Farrer Place, Sydney.

Inside

Investment climate

What can we expect in FY22?

While the current lockdowns have injected an element of uncertainty into the outlook for FY22, there are reasons to be positive about the prospects for real estate. At this stage, the lockdowns appear likely to slow but not derail the broader economic recovery. Much depends on their duration. The year ahead is still expected to be a year of improving occupier demand for real estate in most sectors and markets. In addition, investment demand for quality real estate is likely to remain supported by low interest rates. Our key assumptions over the next 12 months are:

- Business confidence to be impacted by lockdowns, but bouncing back later in the year
- Export income will benefit from a strengthening global economy with the mining and agricultural industries benefiting
- Housing and infrastructure construction will positively contribute to growth
- Retail spending will benefit from low interest rates, rising house prices and accumulated savings
- The opening of international borders will be gradual, limiting international travel until FY23
- Short-term interest rates will remain low through FY22 however markets will begin to price in modest interest rate rises on a 2 to 3 year timeframe

The key themes for investors to consider in FY22 are:

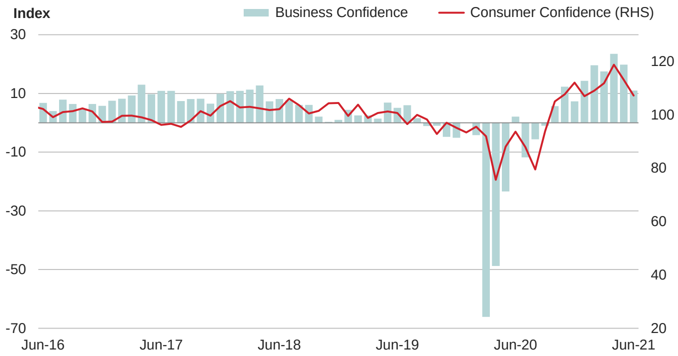
- Leasing markets should generally improve in all sectors, helped by positive business conditions
- Growth prospects in the industrial and healthcare sectors are better than for office and retail, where vacancy will take time to absorb
- A climate of improving occupier demand at a time of low interest rates is expected to be good for property values
- Yield spreads over 10 year bonds have narrowed for industrial, but remain wide for other sectors

Table 1. Australian economic forecasts

	Jun-21	Jun-22	Jun-23
Real GDP %pa	9.6%	2.9%	2.7%
Final demand %pa	11.7%	2.9%	2.4%
Employment %pa	8.1%	1.0%	1.1%
Goods imports %pa	14.8%	1.6%	2.2%
Retail sales %pa (real)	8.5%	0.7%	1.6%
CPI %pa	3.5%	1.8%	2.2%
90 day bill %	0.1%	0.1%	0.2%
10yr Bond %	1.6%	1.4%	1.4%
AUD/USD	0.77	0.76	0.74

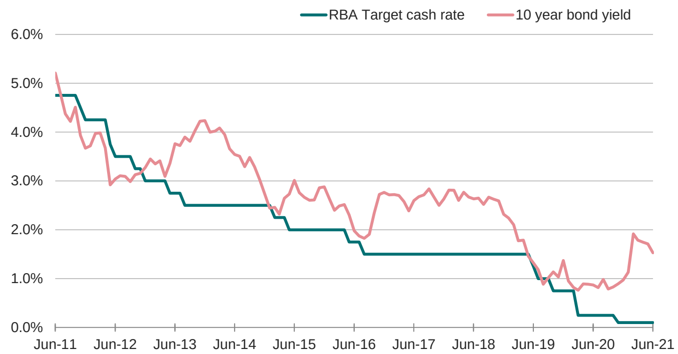
Source: Deloitte Access Economics, June 2021

Figure 1. Consumer sentiment and business confidence positive, but easing back to more normal levels



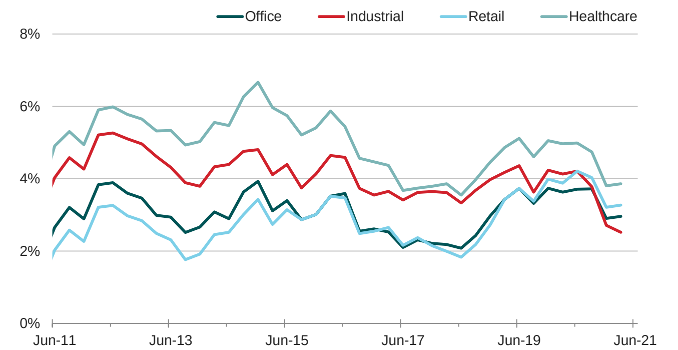
Source: Bloomberg, NAB, Westpac

Figure 2. Interest rates remain relatively low and supportive of real estate values



Source: Bloomberg

Figure 3. Yield spreads over 10 year bonds have narrowed for industrial, but remain wide for other sectors



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

Performance & transactions

Improving trend for unlisted property returns

Equity markets outperformed other asset classes in the past quarter. The ASX/S&P 200 A-REIT index continued to climb to back towards pre COVID-19 levels (up 10% in the past quarter) with a minor blip due to inflationary concerns (Figure 4). Banks continue to drive up the broader ASX/S&P 200 Index as investors price in increased volumes associated with housing loans.

Returns for unlisted property funds have turned the corner and are trending up. Industrial returns led the pack, with 26.5% pa, buoyed by strong capital gains from tightening yields. The retail sector posted a recovery back into positive territory with a 4.1% pa return in the year to June. An uplift in discretionary spending and the vaccine rollout bode well for returns going forward.

Office funds and Diversified funds returned 9.2% and 8.6% respectively in the year to June. While occupancy metrics have softened somewhat, investment demand has supported valuations. Improving occupier markets and low interest rates should be a positive influence over the next year or two.

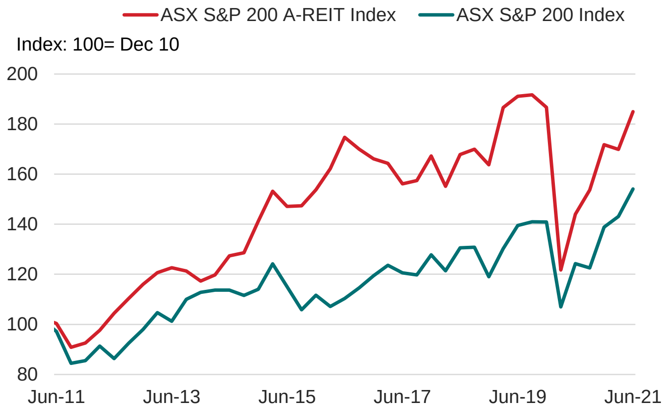
The transaction market activity has increased markedly since last year. Foreign buyers remain active, particularly for large core opportunities. Industrial transaction volumes outpaced the other sectors in the six months (Figure 5), heavily assisted by Blackstone's Milestone Portfolio sale to ESR. Other investors were active with Charter Hall deploying circa $630 million across multiple states. There has also been a mini-trend towards purchases of large format retail assets with industrial conversion potential. In healthcare, Dexus Healthcare Property Fund (DHPF) continued to grow its healthcare portfolio with the purchase of medical office suites at 399 Royal Parade Parkville, Victoria on an attractive yield.

Table 2. Index returns to June 2021

	Qtr.%	1 yr %p.a.	3 yr %p.a.
A-REITs[5]	10.0%	33.0%	1.6%
Australian shares[2]	8.3%	28.0%	5.7%
Unlisted property[4]	2.4%	8.6%	2.9%
Australian cash[3]	0%	-0.1%	0.3%
Australian fixed interest[1]	1.5%	-0.8%	1.1%

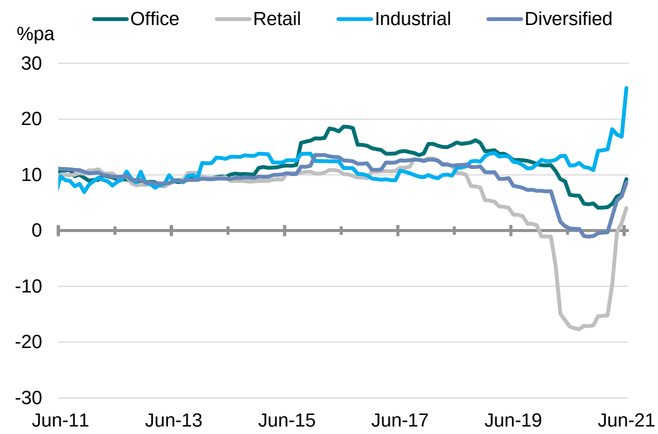
Source: [1]BACM0 Index, [2]S&P/ASX.200. Accumulation Index, [3]BAUBIL Index, [4]MSCI Mercer Australian Core Wholesale Monthly PFI (NAV Pre Fee) – Diversified (to June), [5]S&P/ASX.200.A-REIT Accumulation Index

Figure 4. A-REIT pricing has benefited from a broad-based recovery in equity markets



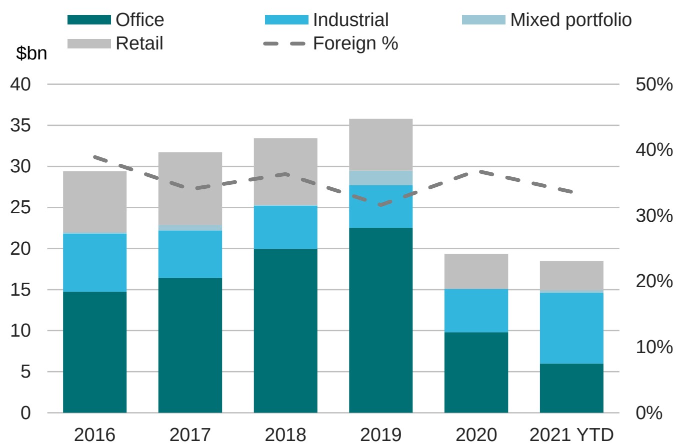
Source: Bloomberg, Dexus Research

Figure 5. Unlisted fund returns have turned the corner helped by an improvement in retail and a surge in industrial



Source: MSCI, Dexus Research

Figure 6. Transaction volumes increased since last year with Industrial transactions poised for a record year



Source: JLL Research, Dexus Research

Office

Office demand steadily improving

Against the challenging back-drop of the pandemic, office demand is steadily improving. Positive hiring intentions have led to strong white collar employment growth in the year to May 2021 in NSW (18.3%), Victoria (34.1%) and WA (17.3%). Lead indicators have been strong with business confidence and advertised jobs for professionals both running at high levels. The current NSW and Victorian lockdowns are expected to reduce confidence and leasing activity but not derail the recovery.

The recovery was apparent in leasing markets with positive net absorption across the major CBD office markets in the June quarter (see Figure 7). Demand has variously come from small tenants (<1000sqm), the IT industry, firms centralising into the CBDs and a flight to better quality space.

Vacancy in the Sydney CBD rose in the June quarter, due to the completion of several developments, which, while largely pre-committed, still had around 18% of space available. Positively, sub-lease space continued to fall. In the Melbourne CBD, while sub-lease vacancy rose further (to 3.9% of stock), quarterly net absorption was positive because of expansions and re-centralisations into the CBD. In Brisbane the completion of Midtown Centre (53% pre-committed) contributed to a rise in vacancy rates.

While face rents held steady, effective rents in CBD office markets fell further in the June quarter due to rising incentives. High vacancy is likely to keep rent growth subdued in the short term.

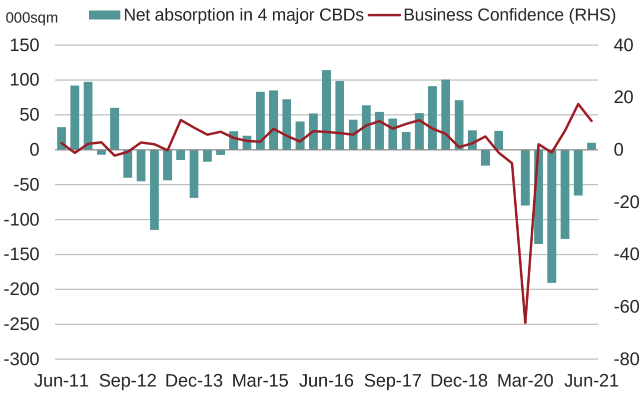
Investment demand for high quality Australian office assets remains strong, with AsiaPac investors now more optimistic about office demand than investors in other regions according to a CBRE report. Sentiment going forward will depend on both the economic cycle and on further resolution of questions about the pace of the vaccine rollout, the re-invigoration of CBDs and how different companies manage the space requirements of their workforces.

Table 3. Q2 2021 office snapshot

	Total Vacancy	Prime net eff. growth (% p.a.)	Net supply FY22 (% of stock*)
Sydney CBD	13.2%	-17.8%	2.5%
North Sydney	18.5%	-14.5%	1.4%
Sydney Fringe	9.2%	-1.0%	1.3%
Macquarie Park	13.2%	-4.0%	5.9%
Parramatta	15.4%	-20.7%	17.4%
SOP / Rhodes	24.3%	-6.4%	N/A
Melbourne CBD	14.1%	-7.5%	4.0%
Brisbane CBD	15.9%	-7.4%	2.6%
Perth CBD	19.7%	-3.3%	1.4%

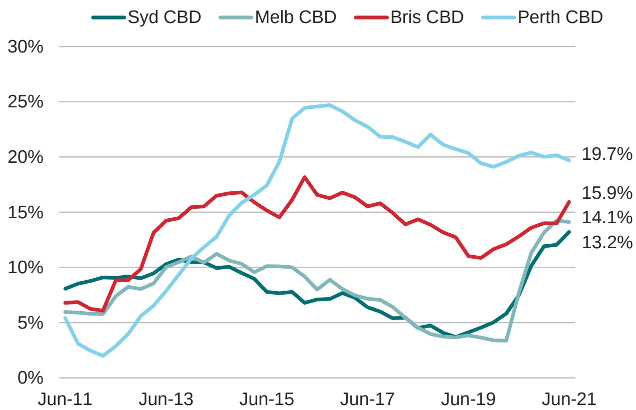
Source: JLL Research; *Projects under construction and plans approved;

Figure 7. Leading indicators point to improving conditions for leasing markets in the year ahead



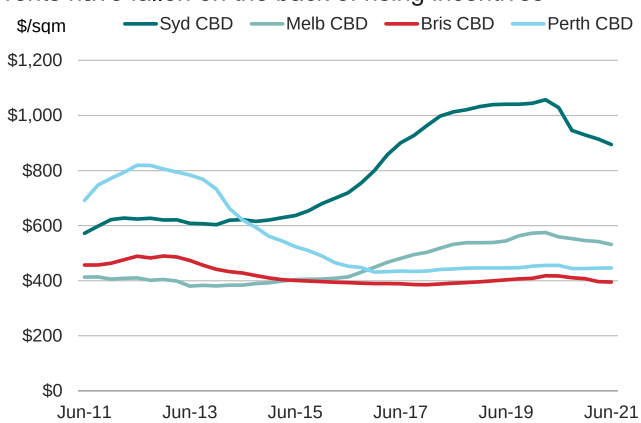
Source: JLL Research, Dexus Research

Figure 8. Vacancy rates remain elevated in the major office markets nationally



Source: JLL Research, Dexus Research

Figure 9. Face rents appear to be holding, but effective rents have fallen on the back of rising incentives



Source: JLL Research, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney CBD	**Lead indicators positive, with white-collar employment growth strongest on record**. Net absorption was recorded at positive 1,224 square metres in the Q2 2021. The vacancy to 13.2% in Q23. Positively, sub-lease space continued to fall from highs in Q4 2020. While prime net face rents rose 0.4% in Q2 2021, incentives also rose from 31% to 33%, leading to a fall in net effective rents of 3.0%. While leasing and demand metrics were turning more positive, the most recent lockdown will likely dampen sentiment and transaction activity for a month or two. Yields were stable in Q2 with a lack of office transactions.	Vacancy	↑
		Rents	↓
		Incentives	↑
		Yields	↑
North Sydney	**Prime grade stock performing well.** The total vacancy rate was recorded at 18.5%, down from highs recorded in Q4 2020. Although secondary vacancies rose, prime grade vacancies continued to fall in the June quarter. While prime face rents grew by 1.5% in Q2 2021, incentives rose further, matching the Sydney CBD at 33% and leading to further falls in prime net effective rents (-1.8%). Investment yields tightened 10 basis points in Q2 2021, with the sale of 74-76 Berry Street, showing positive demand for Australian commercial property from superannuation funds.	Vacancy	↑
		Rents	↓
		Incentives	↑
		Yields	↑
Macquarie Park	**Rising incentives lead to further falls in effective rents**. Quarterly net absorption was recorded at negative 10,000 square metres, as a number of tenants relocated out of the precinct and DXC Technology and Macquarie University put sub-lease space to market. The total vacancy rate rose by 1.3 percentage points to 13.2% in Q2 2021. Although face rents stayed flat, rising incentives led to further falls in effective rents (-3.6% in Q2 2021). A growing number of developments in the market are likely to keep rents in Macquarie Park competitive, as owners compete for a limited pool of possible pre-commitment tenants.	Vacancy	↑
		Rents	↓
		Incentives	↑
		Yields	→
Parramatta	**Supply leads to significant falls in effective rents**. Effective rents fell 10.9% in the June quarter, bringing the fall to 20.7% from the previous year. Incentives are now higher than the Sydney CBD at 35% which is a stark contrast to sub-20% incentives prior to the pandemic. A significant development pipeline will keep rents and incentives at these levels for the foreseeable future, with an amount of supply equal to 17.4% of total stock due for completion over the next 12 months alone. Investment yields fell 10 basis points in the June quarter.	Vacancy	↑
		Rents	↓
		Incentives	↑
		Yields	→
Melbourne CBD	**Demand improves as physical occupancy rates rise steadily**. While annual net absorption was recorded at -187,800 square metres in the year to June 2021, quarterly net absorption turned positive in June (6,575 square metres). Sub-lease space remains a concern, with 3.9% sub-lease vacancy recorded in Q2 2021, near record highs. There were several expansions from Financial Services and Government groups, with white-collar employment growth near record high levels. The vacancy rate was recorded at 14.1%, down 0.1% from the March quarter. Investment yields fell 10 basis points in Q2 2021, with a few sales transacting at passing yields between 4.2% and 4.3%.	Vacancy	↑
		Rents	↓
		Incentives	↑
		Yields	↑
Brisbane CBD	**Investor sentiment strong for Brisbane CBD office assets**. Although the Queensland economy has been relatively successful in the management of the COVID-19 pandemic, the Brisbane CBD office market has not been immune to demand shocks and rental falls. Net absorption was recorded at negative 6,400 square metres in Q2 2021, driven by a number of contractions and an increase in sub-lease space being offered. The vacancy rate rose in June to 15.9%, albeit prime vacancy is lower. Effective rents held steady in Q2-21 (-0.5%), though they were down 7.4% from Q2 2020. Despite this, office sales were strong in Brisbane CBD, with strong interest still evident from a range of investors.	Vacancy	↑
		Rents	↓
		Incentives	→
		Yields	→
Perth CBD	**Green shoots flower in Perth CBD, with increasing leasing activity**. The vacancy rate fell 50 basis points to 19.7% in June 2021, with healthy leasing demand and upcoming withdrawals of several buildings likely to edge this number lower. Quarterly net absorption was the strongest of all office markets nationally, recorded at 8,500 square metres in Q2 2021. Success in infection management and Perths distance from the rest of Australia has meant that occupancy rates are the highest of all major CBD markets. Investment yields fell 10 basis points in Q2 2021.	Vacancy	↓
		Rents	→
		Incentives	→
		Yields	→

Industrial

No sign of the industrial sector slowing

The industrial market has gone from strength-to-strength over the past quarter and is well on track for another strong year, notwithstanding recent lockdowns will affect confidence temporarily. The online growth story continues to have a profound effect on the Sydney and Melbourne markets with elevated levels of demand from food, furniture and fashion companies looking to establish or expand their online platforms. In the first six months of 2021 take-up from ecommerce-related retailers has been around 20% ahead of average 2020 levels and logistics companies have absorbed around 560,000 square metres of space in key locations in Sydney and Melbourne to service excess demand. Online penetration has increased to circa 13% of total retail sales.

Leasing metrics have significantly improved. Over the past year rent growth has been evident within the Inner West Sydney (+3.4%), Outer West Sydney (+2.6%), West Melbourne (+4.7%) and East Perth (+4.3%) markets whilst other locations have remained relatively steady. Incentives across Sydney and Melbourne markets have decreased in line with high levels of demand and record low levels of vacancy. In the East Perth market, incentives have nearly halved from prior levels.

Competition to deliver new product to the market continues to place upwards pressure on land values. In Outer West Sydney and West Melbourne markets values lifted by $100/sqm and $75/sqm respectively in the past quarter.

Investment demand continues to push yields tighter across all markets. Industrial transaction volumes far outpaced all other sectors at $8.6 billion for the year to date, influenced by the two Blackstone portfolio sales - Milestone for $3.8 billion and Kingdom II for $825 million. The portfolios comprising 65 assets across multiple states appear to have contributed to tightening yields. In the quarter, the main Sydney markets compressed an average of 40bps, Perth 63bps, Melbourne 13bps and Brisbane 25bps.

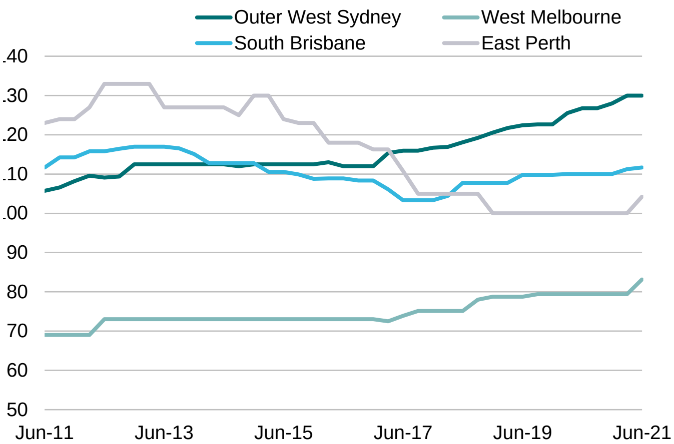
Appetite for cold storage remains strong with Charter Hall transacting a sale and lease back with PFD Food Services on a yield of 4.9% and another with food manufacturer Patties foods within Victoria at 4.4%.

Table 4. Industrial snapshot

	Ave prime cap rate change Q2 2021	Existing prime net face rental growth % p.a.
Outer West Sydney	-44bps	2.6%
Southern Brisbane	-25bps	1.5%
East Perth	-63bps	4.3%
South Sydney	-38bps	-0.6%
West Melbourne	-13bps	4.7%

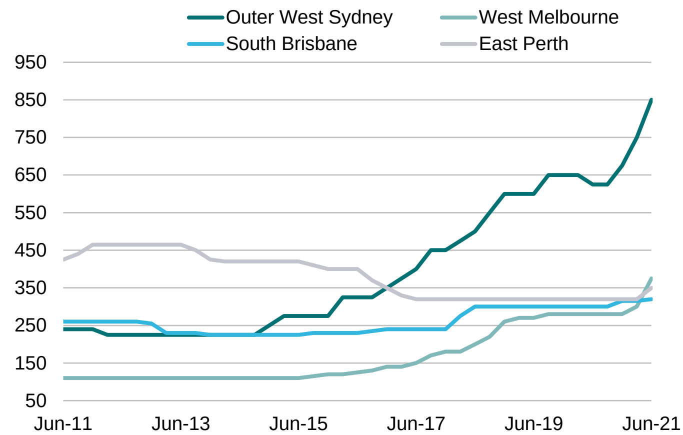
Source: JLL Research, Dexus Research (June 2021), land values 2-5HA exl Perth (1HA)

Figure 10. Industrial rents rising in major markets with Perth now recovering from a post mining boom slump



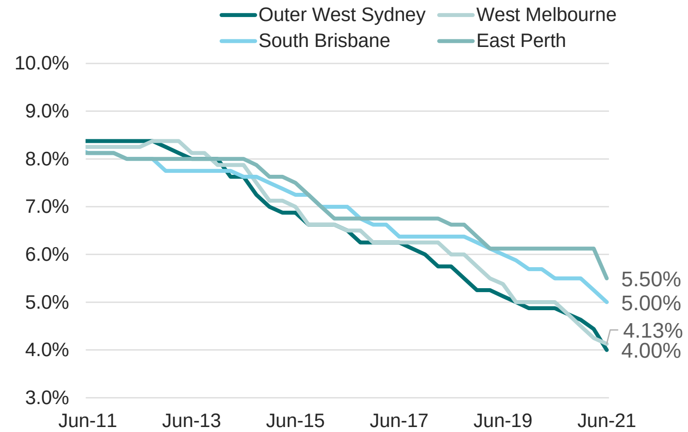
Source: JLL Research, Dexus Research

Figure 11. Land values continue to climb, particularly in the favoured markets of Sydney and Melbourne



Source: JLL Research, Dexus Research

Figure 12. Cap rates continue to tighten across all states with Sydney prime assets down to 4.0% on average



Source: JLL Research, Dexus Research

Industrial by region

Outer West Sydney

Take-up levels remain elevated in Q2 2021 taking the total for the year to June 2021 to 460,000sqm, well above average.

Warehousing/Logistics companies were the most active over the quarter, accounting for 62% of take-up. ACF Port Logistics leased a 16,000sqm in Eastern Creek whilst UPS pre-committed to a purpose built cold storage facility within Horsley Logistics Park.

The majority of leasing activity from retailers was concentrated within the Moorebank precinct as businesses who rely heavily on large containerised freight look to take up space in close proximity to the Moorebank Intermodal Terminal. Catch.com a pureplay online retailer, committed to a 40,000sqm design and construct distribution facility within Moorebank Distribution Centre.

West Melbourne

West Melbourne take-up levels have maintained their extraordinary strength. The past two quarters have seen 576,000sqm of space taken up, leading to the strongest 12 months ever recorded for West Melbourne by a large margin.

Almost a third of take-up recorded over the quarter was from companies designated as 'Manufacturers' (albeit much of their space is actually warehousing). The ecommerce thematic remains strong. eStore Logistics, an ecommerce warehousing and fulfilment company, has been quite active in the West Melbourne market pre-leasing 17,600sqm at Dexus's industrial estate in Ravenhall and a further 11,000sqm within Derrimut.

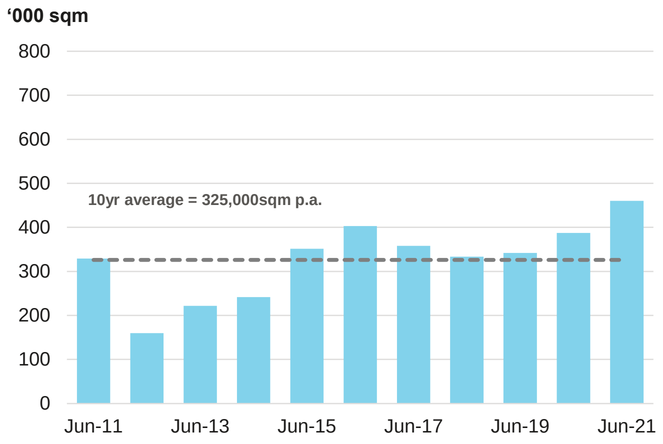
Brisbane

The South Brisbane market has reported its strongest quarter since 2017 with 138,000sqm of take up. The Trade coast was broadly in line with average levels. The increase in activity from the South has pushed the total take-up for the year June 2021 slightly above the average.

The uplift in leasing volumes was attributable to multi-channel retailer Winning Appliances pre-leasing 45,000sqm within Wacol.

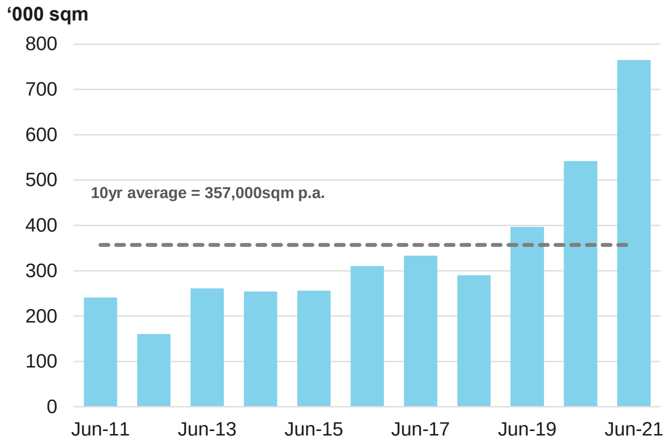
Transport and Logistics also continues to be a major part of the Southern market with Chep, Bevchain and Specialised Logistics Australia all taking up space. Leasing activity around the Trade coast was associated with smaller tenancies associated with motor vehicle parts retailing and construction.

Figure 13. Outer West Sydney gross take-up



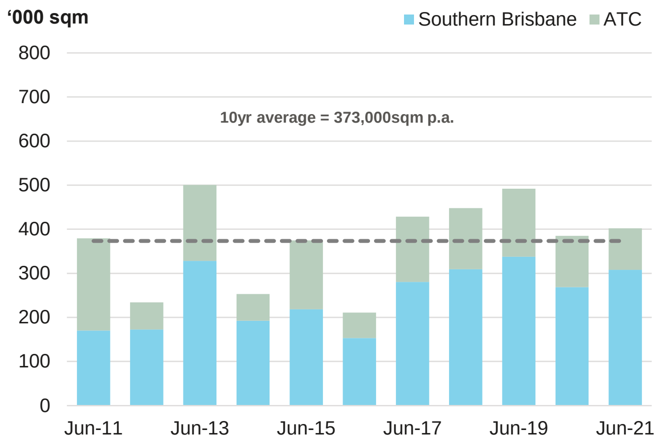
Source: JLL Research (gross take-up), Dexus Research

Figure 14. West Melbourne gross take-up



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

Figure 15. South Brisbane and ATC gross take-up



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

Retail

Sales growth reverting to more normal patterns

Activity in the retail sector received a boost during 2020 as shown in Figure 16, with online sales and total sales both running ahead of average.

Growth rates are now converging back to more normal levels. While total retail turnover rose by 7.7% in the year to May 2021 this high growth rate reflects the low base last May as Australia's lockdown commenced. The more modest monthly growth rate of 0.4% indicates a return to more normal trading conditions, albeit the short term outlook in NSW and Victoria has been clouded by recent lockdowns. After peaking at over 60% per annum growth last year, online sales growth appears to be returning to the 10% to 15% per annum, considered normal prior to the pandemic.

Shopping centres have not been able to capitalise on all of the growth in spending in the past year given a proportion was in the household goods category which is dominated by standalone and bulky goods premises. Last year it was the smaller convenience centres anchored by supermarkets which performed well as people kept spending on essential items.

This year, the outlook for performance of larger shopping centres should improve, benefitting from a 14.5% jump in discretionary spending in the year to May 2021. Sales growth, particularly for discretionary goods and services, is expected to remain positive in the year ahead, buoyed by high consumer confidence, an improving jobs market, low interest rates and above average levels of household savings.

City retail remains challenged as companies continue to navigate their return to CBD locations and tourism is constrained by border closures.

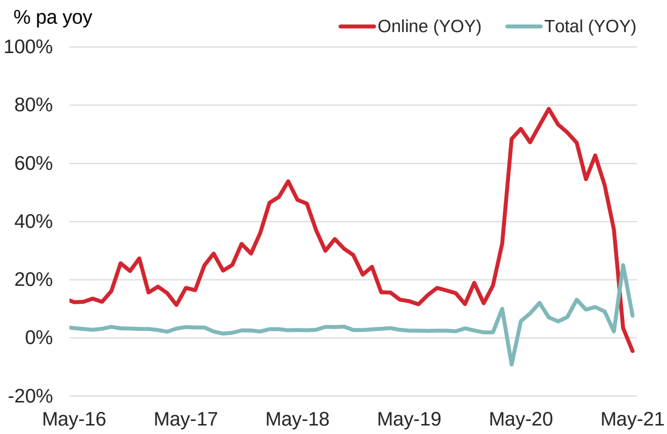
We will continue to see a gap in performance of shopping centres depending on their trade area and level of competition.

Table 5. Retail snapshot

	Specialty rent growth % p.a.	Cap rate change Q2 bps	State sales growth % p.a.
Sydney			
Regional	-5.4%	0.0	
Sub-regional	-2.0%	-6.0	10.7%
Neighbourhood	-0.2%	-12.5	
Melbourne			
Regional	-7.6%	0.0	
Sub-regional	-3.2%	0.0	3.7%
Neighbourhood	-1.7%	-25.0	
SE QLD			
Regional	-4.7%	0.0	
Sub-regional	-0.1%	0.0	12.3%
Neighbourhood	1.3%	0.0	

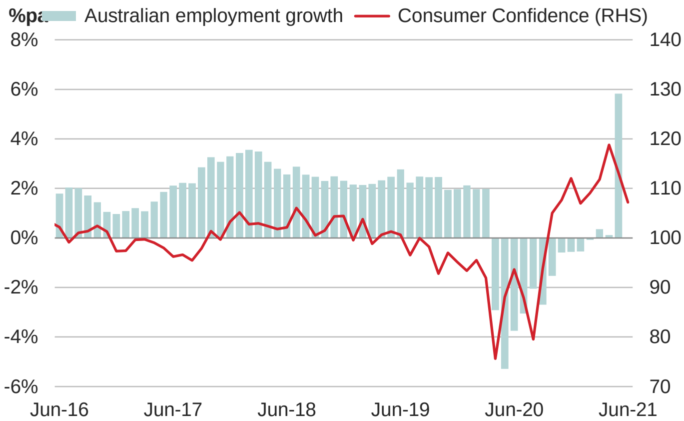
Source: JLL Research, Dexus Research (Q2 2020)

Figure 16. After a turbulent period last year retail turnover growth appears to be reverting to a more sustainable rate



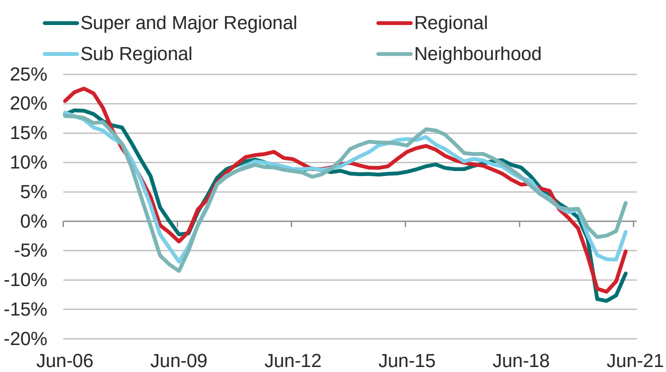
Source: ABS, Dexus Research

Figure 17. High consumer confidence and jobs growth should benefit discretionary spending



Source: ABS, Dexus Research

Figure 18. Retail total returns look to be improving, Neighborhood back to positive territory



Source: MSCI, Dexus Research.

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