RESEARCH

JUNE 2014

MELBOURNE INDUSTRIAL

Market Overview

HIGHLIGHTS

- Despite industrial vacancy being at its highest levels since January 2010 and the absorption of existing facilities over the quarter relatively benign, pre-lease activity continues to gain momentum as economic indicators improve.
- The new industrial supply pipeline is forecast to total 464,355m^2 over the course of 2014, a 5% jump compared to 2013, but 8% below the long term trend. The new development activity is boosted by an increase in prelease deals and owner-occupiers capitalising on low interest rates.
- The total value of industrial sales (>$10 million) across all regions in Melbourne over the 12 months to April 2014 was $978.8 million spread across 33 properties, a growth of 220% compared to the sales recorded a year earlier. Domestic institutions were the dominant purchaser class; unlisted funds and syndicates accounted for 46% followed by AREITs who acquired 30% of total industrial sales.

INDUSTRIAL OVERVIEW

Table 1
Melbourne Industrial Market Indicators as at April 2014

Precinct	Avg. Prime Rent		Avg. Secondary Rent		Core Market Yields (%)		Avg. Land Value <5,000m²		Avg. Land Value 1 – 5 ha	
	$/m² net	(%p.a)	$/m² net	(%p.a)	Prime	Secondary	$/m²	(% p.a)	$/m²	(% p.a)
City Fringe	130	0.0%	80	0.0%	7.25 – 7.75	8.25 – 9.50	800	9.6%	800	27.0%
North	75	0.0%	60	0.0%	8.00 – 8.75	9.25 – 10.25	230	0.0%	200	0.0%
East	85	0.0%	65	0.0%	8.00 – 8.75	9.00 – 10.75	300	0.0%	240	-4.0%
South East	80	0.0%	63	0.0%	7.50 – 8.25	9.25 – 10.75	215	2.4%	160	-11.1%
West	75	0.0%	65	0.0%	7.75 – 8.25	9.00 – 10.00	175	16.7%	124	3.1%
Melbourne Average*	**79**	**0.0%**	**63**	**0.0%**	**7.80 – 8.50**	**9.13 – 10.44**	**230**	**4.8%**	**181**	**-3.0%**

Source: Knight Frank * Excludes City Fringe
Prime: Asset with modern design, good condition & utility with an office component 10-30%. Located in an established industrial precinct with good access.
Secondary: Asset with an older design, in reasonable/poor condition, inferior to prime stock, with an office component between 10%-20%.
Core Market Yield: The percentage return/yield analysed when the assessed fully leased market income is divided by the adopted value/price which has been adjusted to account for property specific issues (ie rental reversions, rental downtime for imminent expiries, capital expenditure, current vacancy, incentives etc)

Economic Snapshot

The international outlook has improved over the past year, reflecting better conditions in most major developed economies. The International Monetary Fund predicts global growth will accelerate in 2014 and 2015.

The Australian economy is likely to grow below trend with Deloitte Access Economics forecasting growth of 2.7% in 2014/15, strengthening thereafter. A modest easing in GDP growth is likely as the national economy shifts from strong rises in mining investment toward higher exports and more broad-based drivers of domestic demand. Across the states, there is diversity in economic performance.

The Reserve Bank has indicated that a period of low interest rates is likely to continue as a means to stimulate non-mining sectors of the national economy. Low interest rates have already had some positive impact on property demand and forward indicators of housing construction, along with consumer spending. They are also likely to provide additional support to business investment.

While business confidence was positive toward the end of 2013, a more sustained improvement in the economic outlook and consumer spending will be necessary for businesses to confidently invest capital. Business investment is expected to make a modest recovery in 2014/15.

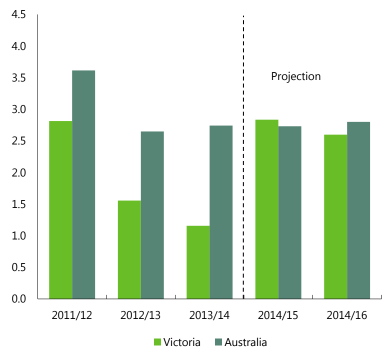
Labour market conditions are also expected to improve over coming years, following subdued conditions since 2011. The dynamic, flexible nature of Victoria's economy means the outlook will vary across industries. Recent announcements of future closures in the automotive manufacturing industry are part of a broader transition in the Victorian economy toward a more diverse, innovative economy, with strengths in the provision of services and the production and distribution of goods.

Victoria is well placed to take advantage of the national shift from mining investment toward more broad-based drivers of economic growth. According to Deloitte Access Economics, Victorian gross state product (GSP) is forecast to grow by 2.8% in 2014/15. This is part of a gradual return to trend growth as factors weighing (such as the exchange rate) on the economy ease.

Although still elevated, the exchange rate has moderated from the high levels experienced throughout 2011–2013. This is providing some benefit to exporters and local import competing businesses. The retail industry is also likely to benefit from the opportunity to offer more competitive prices compared with international alternatives.

Dwelling investment in 2014/15 is forecast to grow compared with 2013/14. Signs that dwelling investment will strengthen over the second half of 2014 include higher dwelling approvals, dwelling price growth, and strong population growth resulting in greater demand for new housing.

Figure 1
Vic & Australia Economic Growth
VIC GSP & Aust GDP % annual change



Source: Deloitte Access Economics

Industrial Overview

According to IPD, in the 12 months to March 2014, Melbourne industrial property posted a total return of 10.6% up from a total return of 9.8%. Although Melbourne industrial property recorded a slightly lower total return compared to Sydney industrial (11.7%) and Brisbane industrial property (11.2%); compared to other Victorian located property, industrial was the best performing property asset class. In Melbourne, industrial continued to outperform the office and retail markets, with total returns of Melbourne CBD office (9.9%), Victorian Retail (8.5%) in the 12 months to March. Within the Melbourne industrial market, Western and Northern located industrial property recorded a total return of 10.9%, outperforming City Fringe based properties (10.5%) and South Eastern located industrial property (9.9%) in the 12 months to March 2014.

Figure 2

Investment Performance Index

% Change (12 months to Mar 2014)

Source: IPD Australia

Despite increasing total return levels, largely through gains in capital values, industrial vacancy levels increased. Over the first quarter of 2014, the total amount of space available (>5,000m²) increased by 108,276m². The current vacancy level of 735,124m² across Melbourne's industrial space is now at its highest since January 2010 and 32% above the long term average of 559,099m². Compared to the levels recorded 12 months ago, the amount of available stock has increased by 324,616m².

By grade, as at April 2014, there was 339,694m² of available space within prime grade properties, accounting for 46% of total available stock. Available secondary space also tracked upwards to reach 395,430m². By precinct, the Western precinct has the greatest amount of available space with 307,385m² vacant space, accounting for 41% of space available for lease amongst all the regions.

Whilst take-up levels over the quarter were soft, the outlook is more promising with active enquiries from potential tenants for industrial space (>5,000m²) gaining momentum.

OCCUPIER DEMAND & RENTS

In the six months to April 2014, gross take up (excl. D&C's) for leases in excess of 5,000m^2 totalled 164,880m^2 within the Melbourne's industrial precincts. This level of absorption was 53,555m^2 lower than the level recorded during the previous six month period. Of the take-up in six months to April 2014, 60% was categorised as prime grade space covering nine buildings, six of which were still under construction but partially or wholly committed prior to their completion. Commitments to recently completed speculative properties include: Peter Stevens Motor Cycles (13,560m^2) at 9-31 Kimpton Way in Altona, and APL Warehousing (14,175m^2) at 76 Dunmore Drive in Truganina.

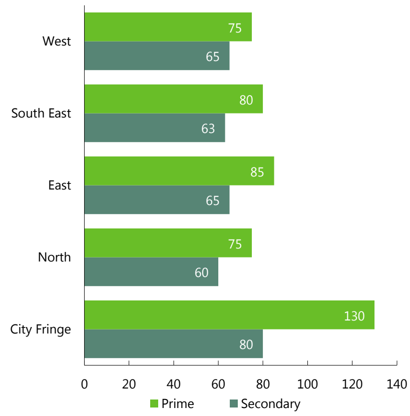
In addition to the gross absorption recorded in existing and speculative stock, pre-lease activity continues to gain momentum. In the six months to April 2014, tenants have pre-committed to 78,460m^2 purpose built facilities. Significant pre-lease commitments during past six months include Goodyear Tyres' pre-commitment to a 26,000m^2 purpose built warehouse at 18-20 Andretti Court in Truganina, and Montague Group's 20-year pre-lease deal for a cold storage facility (Stage 1- 16,960m^2) being built at 7-23 Dunmore Drive in Truganina. Montague Group's facility potentially also entails two further stages of development taking total warehouse space to 45,000m^2. In addition, Woolworths has pre-committed to a purpose built 25,000m^2 distribution centre at the Drystone Industrial Estate in Laverton North. Interestingly, Melbourne's Western precinct has dominated the pre-lease market over the past six months compared to the preceding half yearly period where South East accounted for the majority of pre-commitments.

In addition to the pre-lease activity, the Western region accounted for the majority of gross take up of existing vacant accommodation with 124,674m^2 absorbed over the past six months. In comparison, the North absorbed 19,797m^2 of vacant space during past six months, outperforming the South East (14,134m^2) and City Fringe (6,275m^2) industrial precincts.

During the past six months, analysis of leasing activity of premises greater than 5,000m^2 revealed that occupiers from the Retail trade, Transport & logistics and Motor Vehicle Retailing industries drove demand. Tenants from the Retail trade based occupiers accounted for 35% of the total industrial space leased followed by the Motor Vehicle Retailing sector (30%) and Transport and logistics sector (22%).

Melbourne's average rents (excl. City Fringe) remained steady in the past six months at \$79/m^2 for the prime grade options and \$63/m^2 for the secondary grade options. Whilst take up levels have been below the historical average since mid-2011, rents have remained somewhat stable over this period. Rental levels have been maintained as landlords have been flexible with lease terms for tenants who remain cautious in entering long term commitments.

Figure 3
Melbourne Industrial Rents
\$/m^2 net market rent by precinct - April 2014



Source: Knight Frank

Table 2
Major Industrial Leasing Transactions Melbourne Region

Address	Region	Net Rent (\$/m^2)	Area (m^2)	Term (yrs)	Lease Type	Tenant	Date
7-23 Dunmore Drv, Truganina	W	U/D	16,960	20	Pre-com	Montague Group	Q4-14
76 Dunmore Drv, Truganina	W	73	14,175	5	Speculative	APL Warehousing	Q2-14
9-31 Kimpton Way, Altona	W	75	13,560	10	Speculative	Peter Stevens Motorcycles	Q1-14
1651-1657 Centre Rd, Springvale	SE	82	10,987	7	Renewal	Mainfreight Distribution	Q1-14
50 Parkwest Drv, Derrimut	W	60	16,020	3	New	IPS Logistics	Q1-14
2/54 -58 Boundary Rd,Braeside	SE	65	7,700	U/D	New	Perroplas Australia	Q1-14
18-20 Andretti Crt, Truganina	W	73	26,000	10	Pre-com	Goodyear Tyres	Q4-13
31-55 Carter Way, Dandenong South	SE	U/D	10,426	12	Pre-com	Kumho Tyres	Q4-13
25-27 Olive Grove, Keysborough	SE	75	5,208	U/D	New	QEP Australia	Q4-13
25 Briggs Drv, Derrimut	W	91	14,917	2	New	Austrans Container	Q4-13
1 Westpark Drv, Derrimut	W	75	7,600	2	New	Goodyear Tyres	Q4-13

Source: Knight Frank SE South East, W West, E East, CF City Fringe U/D refers undisclosed

DEVELOPMENT & LAND VALUES

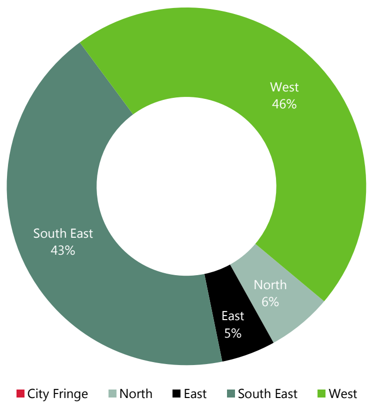
Over 2014, 464,355m² of new gross supply (>5,000m²) is forecast for completion across Melbourne's industrial regions, a jump of 5% over the year 2013 but still 8% below the 10-year average. The increase in new development is a reflection of uplift in business confidence levels during the past year, which was pessimistic according NAB's business survey 12 months prior.

In addition to the boost in the pre-lease market, owner-occupiers have also been active. Capitalising on the low interest rate environment, owner occupiers have also expanded their operations as demonstrated by Australia Post who are constructing a further 15,500m² to their existing facility at 133-169 Fairbarn Road in Ardeer.

As at April 2014, there were six speculative projects (>5,000m²) under construction in the West and South East regions, two of which were reaching practical completion. In addition, the East saw the addition of 12,817m² through the speculative development at Lots 8&9 Henderson Road in Rowville. According to Knight Frank analysis, speculative development in excess of 5,000m² has fallen in the past six months from 160,152m² as at September 2013 to 116,528m² as at April 2014.

Continuing the trend of 2013, the majority of new supply is located in the South East and Western regions which together account for 89% of Melbourne's 2014 total development pipeline forecast. While the bulk of the new supply are distribution centres, a significant portion of these are refrigerated logistic facilities. In 2014 alone, refrigerated facilities that are scheduled for completion include: Swire Cold Storage (18,000m²), Paramount Liquor (14,434m²), Colonial Farm (10,000m²) and Montague Group (16,960m²).

Figure 4
Melbourne Region Industrial Supply
% of supply under construction 2014



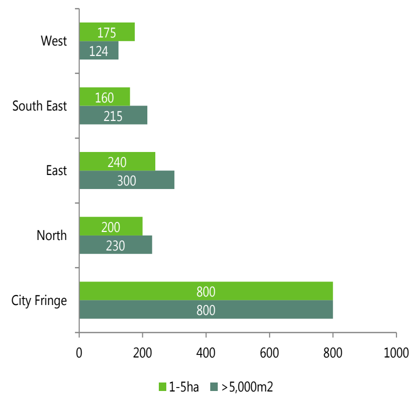
Source: Knight Frank

Limited by the Fishermans Bend Urban Renewal Project, within the City Fringe precinct there are no industrial developments in excess of 5,000m² forecast to be completed in 2014. The renewal project will result in 248 hectares of industrial land rezoned to Capital City zone incorporating commercial, residential and retail over the course of the next 5 to 10 years.

Although the rezoning of Fishermans Bend has stifled new development, land values within the City Fringe precinct (particularly Port Melbourne) have increased significantly over the past 12 months. With residential development offering the higher and better use, increasingly City Fringe sites are purchased for redevelopment, as demonstrated by Little Projects' purchase of 85 Lorimer Street, Port Melbourne who have proposed 1,500 apartments to be built on the 8,800m² site.

Elsewhere, across Melbourne's industrial regions, over the 12 months to April 2014, average land values for small land parcels (< 5,000m²) across Melbourne (excl. City Fringe) climbed by 4.8% to reach $230/m², brought about by a shortage of appropriately zoned land parcels offered for sale.

Figure 5
Melbourne Industrial Land Values
$/m² value of land by precinct – April 2014



Source: Knight Frank

Table 3
Major Land / Development Sales Activity Melbourne Region

Address	Region	Price ($ m)	Area (m²)	$/m² of site area	Vendor	Purchaser	Date
Cnr Hammond Rd & Rodeo Drv, Dandenong	SE	15.00*	90,000	167	Undisclosed	Vaughan Constructions	Q1-14
85 Lorimer St, Port Melbourne	CF	18.50	8,800	2,102	Undisclosed	Little Projects	Q1-14

Source: Knight Frank *Estimated

SALES & INVESTMENT YIELDS

Knight Frank analysis reveals that industrial sales (>$10 million) across Melbourne's industrial precincts during the 12 months to April 2014 totalled $978.8 million across 33 properties, increasing by 220% from the $305.5 million transacted in the preceding 12 months.

In the past 12 months, the Western precinct remained the focal point of investment activity with more than 40% of all Melbourne industrial transactions occurring in the region (by value and number). Investment levels within the West were also raised as a result of major asset transactions. Six assets priced above $30 million were sold in the region as investors sought assets with long term leases and blue chip covenants. In contrast, in the preceding 12 months there were just three transactions above $30 million.

While the Western precinct accounted for the majority of sales, the largest sale in the 12 months to April 2014 was recorded in the North, with Charter Hall's unlisted fund Core Logistics Partnership purchasing of Somerton Logistics Centre in Somerton for $121 million.

Having witnessed an influx of offshore capital into Melbourne's industrial market last year; in the 12 months to April 2014, domestic institutions re-emerged as the largest purchaser of industrial assets. Together, unlisted funds and syndicates acquired 46% of all purchases by value followed by AREIT's (30%) and super funds (17%). Of the unlisted funds, Charter Hall's unlisted fund Core Logistics Partnership has been very active, acquiring six assets including: Saintly Drive, Truganina ($41.7 million), Frederick Road, Brooklyn ($39.08 million), Wellington Rd, Mulgrave ($62.00 million) and Woolworths' under construction distribution centre in Laverton North ($70 million).

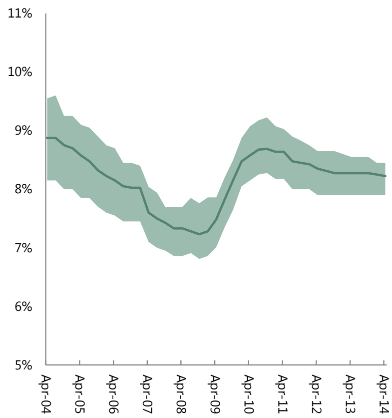
Impacted by the increased allocation to real estate from institutional investors, private investors found investment opportunities scarce, accounting for 4% of all industrial transactions in the 12 months to April 2014.

Capitalising on the unsatisfied investment appetite seeking core assets, developers and owner occupiers have emerged as the main source of divestments. Developers were the most prominent vendor of Melbourne industrial assets, accounting for 44% of all sales. Montague Group's (Qanstruct) and Woolworths' (Citius) both still under construction demonstrate the trend of pre-lease / D&C deals delivering investment opportunities.

In addition, owner occupiers were also active vendors, as demonstrated by Core Logistics Partnership's purchase of a Peters' ice cream facility with a 20-year leaseback arrangement in place.

As a result of this strong investor demand, over the 12 months to April 2014, average prime industrial yields contracted by 19 basis points and now range between 7.80% and 8.50%. However for assets with longer lease profiles, several recent transactions show a greater compression of yields; as demonstrated by ISPT's purchase of Murray Goulburn's facility (6.75% core market yield) which was sold with a 20-year lease in place.

Figure 6
Melbourne Industrial Prime Yields
Core Market Yield Range & Median -2004 to 2014



Source: Knight Frank

Table 4
Major Improved Sales Activity Melbourne Region

Address	Region	Price ($ m)	Bldg Area (m^2)	Core Mkt Yield (%)	Vendor	Purchaser	Date
99-103 William Angliss Drv, Laverton North	W	19.85	8,871	8.50%*	Blackstar Investments	Growthpoint	Q2-14
49 Temple Drv, Thomastown	N	13.00	13,428	9.00%*	Primewest Management	Australian Industrial REIT	Q2-14
324-332 Frankston-Dandenong Rd, Dandenong	SE	24.60	28,316	9.40%	Primewest Management	Australian Industrial REIT	Q1-14
7-23 Dunmore Drv, Truganina	W	48.00	45,960	8.00%	Qanstruct	Corval Partners	Q1-14
254-294 Wellington Rd, Mulgrave	E	62.00	20,000	7.50%	Australasian Food Group	Core Logistics Partnership (Charter Hall)	Q1-14
Lots 2 & 5 Frederick Rd, Brooklyn	W	39.08	104,342	8.96%*	Cromwell Property Group	Core Logistics Partnership (Charter Hall)	Q4-13
85 William Angliss Drv, Laverton North	W	92.60	60,310	6.75%	Murray Goulburn	ISPT Core Fund	Q4-13

Source: Knight Frank
* Initial yield

OUTLOOK

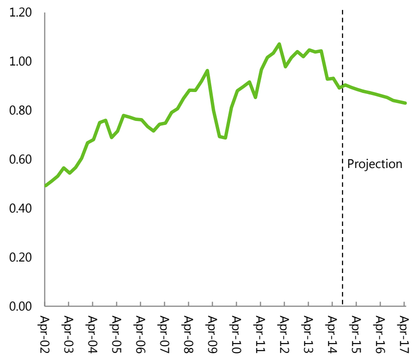
Low interest rates, improved business confidence and an improved global outlook are expected to drive economic growth in the near term. The Victorian Government forecasts state economic growth to increase by 2.5% in 2014-15, while the unemployment rate is expected to remain stable at 6.25%, before gradually easing to 5.5% over the medium term.

In addition, the softening of the $AUD over the medium-term is likely to benefit Australian industrial production and resources exports. A lower $AUD is anticipated to reduce consumer interest in imported goods, boost the Victorian export market and continue to promote domestic produce, driving demand for warehousing and logistics. The building take-up in 6 months to April 2014 comprised 53% of tenancies committed by Transport, Postal & Logistics users and Retail Trade tenants, signifying the importance of these sectors on Melbourne's industrial market.

With the Victorian Government forecasting consistent budget surpluses over the next four years, while maintaining a triple-A credit rating, as part of the 2014/15 State budget $27 billion of new infrastructure projects have been announced. In order to fund some of the Government's infrastructure program, the Government will enter into a medium-term lease over the Port of Melbourne's operations. The proceeds of the Port of Melbourne lease will be invested in new productive economic infrastructure including the Melbourne Rail Link and the East West Link.

In addition, the Victorian Government's Freight & Logistics Plan released in August 2013 outlays several initiatives for creating an efficient Metropolitan Intermodal Freight Distribution Network. To-date initiatives have seen commitments made for expansion of Port of Hastings and East-West road link, which will further enhance Victoria's position as the national leader in freight and logistics.

Figure 7
Units of $USD per $AUD
2002 – 2017



Source: RBA/Deloitte Access Economics

With tenants remaining cautious, demand for space in the Melbourne industrial market has been relatively soft since 2011. In the six months to April) take up levels (above 5,000m^2) totalled 164,800m^2 to be 9% down on the preceding six months. Although take up levels in the past six months were 40% below the historical average, the outlook is more promising with increasing confidence leading to higher pre-lease activity and tenant enquiries.

Driven by speculative construction and backfill options, prime space vacancy is at its highest levels since January 2010. However, prime vacancy levels are likely to ease in the medium term with developers deferring to undertake new speculative development until the current absorption levels rise. In contrast, secondary grade vacancy levels are expected to rise further with tenants increasingly looking to upgrade or expand into prime grade industrial accommodation. Highlighting the tenants' preference for better quality industrial space was reflected in 60% of the take-up in six months to April 2014, was categorised as prime grade space.

The rising levels of vacant available space have impacted rents, with rental growth relatively static over the past two years. Going forward, prime grade rents are anticipated to remain stable while secondary grade rents to face increased pressure as a result of the increasing secondary vacancy levels.

New supply within the Melbourne industrial market remains constrained, with 2013 marking the lowest annual level since 2000. While new construction is forecast to pick up in 2014, annual new supply will remain below the historical average in the medium term with 464,355m^2 scheduled for completion in 2014. As a result of the current higher vacancy levels, speculative development is anticipated to slow further but is offset by increasing pre-lease activity. It is expected that the West will account for 46% of new supply in 2014, boosted by the completion of several cold storage facilities which include: Swire Cold Storage (18,000m^2) and Paramount Liquor (14,434m^2).

In stark contrast to the muted tenant demand, strong investment appetite from all buyer groups resulted in transactional levels this year increasing by 220% from last year. Given Melbourne's high quality infrastructure and availability of funds, investors seek to increase their exposure to the industrial market; transactional activity is likely to remain buoyant for the remainder of 2014.

As a result of the imbalance between available modern assets with long leases to blue-chip tenants and growing investor demand, forward funding and also lease-back investment opportunities are likely to remain actively sought after.

Since 2012, the majority of yield compression for industrial assets stemmed from the tightening of prime, core assets with long leases. However, given the limited opportunities to secure prime assets, evidence of compression in secondary assets has also emerged as investors move up the risk curve.

Although the yield gap between prime and secondary industrial property is forecast to continue to narrow; the rate of compression in secondary assets is anticipated to slow over 2014, with only modest rental growth forecast in secondary assets in the short term.

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