RESEARCH

SYDNEY

INDUSTRIAL MARKET BRIEF NOVEMBER 2014

Key Facts

Prime and secondary yields firmed at least 50bps over the past year with sales volumes at elevated levels

Land value appreciation has continued with all major regions above the 2009-2013 cyclical trough.

Leasing conditions relatively modest with prime net face rents posting annual growth of 1.1%.

Supply levels forecast to remain below the 10 year average in 2015 with new pre-leases relatively limited.

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Strong capital inflow continues to place downward pressure on yields for both prime and secondary stock. Development activity remains relatively modest, however land is being competitively sought where available.

Occupier Demand & Rents

Macro drivers for industrial tenancy demand such as retail spending and housing construction are starting to provide improving support to leasing activity in the Sydney market. September retail turnover data for NSW indicated the seventh consecutive month for yoy trend growth above 8.0%, while state dwelling commencements for FY14 were 16.2% higher compared with FY13.

However, at this stage of the cycle, these factors are yet to fully materialise into a robust pick-up in leasing activity. In the October quarter, Sydney industrial gross take-up (excl. D&C's) measured 166,398m² and, although being the first quarter of above average gross take-up since early 2013, this was notably boosted by some vacant possession sales to owner occupiers. Excluding this impact indicates that the underlying demand in the leasing market still remains somewhat inconsistent.

Tenants in the construction industry have underpinned a number of enquires, however enquiry from larger tenants in other sectors has been relatively subdued.

As a result, rental growth is yet to show a meaningful pickup with average Sydney prime net rents increasing 1.1% over the 12 months to October to $126/m². Incentives, have remained broadly stable over the past three years and average 10% for existing prime assets, although are slightly higher for pre-lease deals. However tenants are very particular with their requirements and as a result incentives can be lower for well located, well configured, highly functional assets.

Development & Land Values

Although development activity is yet to return to pre-GFC levels, there is considerable interest from both developers and owner occupiers in land opportunities, which has resulted in land values appreciating over the past 12 months after a sustained cyclical trough between 2009 and 2013. Major institutions such as Goodman, Mirvac, DEXUS and Stockland have all acquired large land parcels over the past 12 months, however appropriately zoned land parcels remain limited with any opportunities being well contested amongst buyers. This has resulted in both medium (1-5ha) and large (10ha+) sized lots appreciating by an average of 8.6% over the past year. There has also been strong demand from owner occupiers and developers, which has also seen land value appreciation for smaller sized lots, albeit with slightly softer growth of 3.8% over the past year.

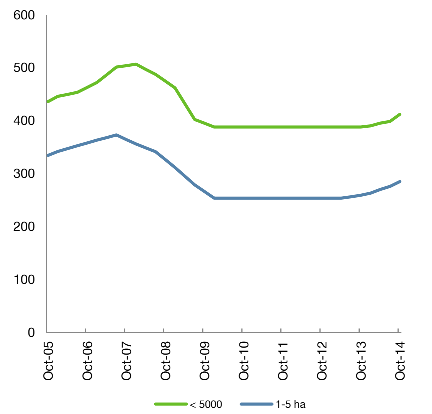
Land values in Inner Sydney Industrial markets are also being boosted by downward pressure on availability as a result of industrial rezoning to residential. Rezoning has, in many cases, changed the highest and best use to residential and mixed uses with demand for such opportunities substantial at present. This trend is also being underpinned by an unprecedented level of demand from developers looking for medium to high density infill development opportunities within Sydney's Inner Ring (broadly defined as within a 10-15km radius of the CBD), particularly near rail transport.

Gross supply of industrial projects (in excess of 5,000m²) is forecast to measure 412,015m² in 2014, which is 26% below the 10 year average. At this stage, 2015 supply is expected to remain in line with current levels. There is a reasonable amount of speculative supply anticipated for 2015 with 93,000m² either under construction or about to imminently commence. Pre-lease demand from larger tenants is currently relatively modest, which, in addition to a number of enquiries seeking existing buildings as opposed to new builds on the basis of cost savings, is likely to constrain any material increase in total supply volume in the year ahead. Approximately half of new pre-leases are currently stemming from developers moving tenants from existing buildings as opposed to lease deals satisfying new expansionary demand.

Sales & Investment Activity

The weight of capital moving into Australian property has maintained its momentum in 2014 with high levels of capital inflow resulting in heightened transaction volumes and firming yields. There has been particularly strong interest from a number of local funds looking to increase scale with several portfolio sales providing such opportunity. Recent examples include the Altis and Valad portfolio sales to Mirvac and a combination of M&G Real Estate and Propertylink respectively. The relatively low cost of debt in addition to

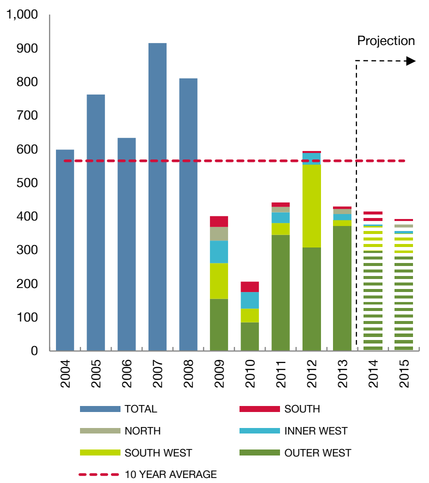
FIGURE 1
Sydney Industrial Land Values*
Avg. Value Serviced Lots ($/m²)



* Avg Outer West, Inner Central West and South West

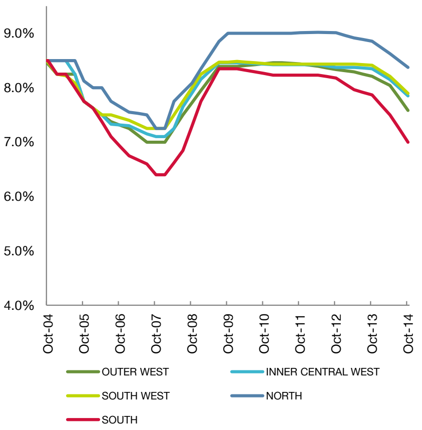
Source: Knight Frank

FIGURE 2
Sydney Industrial Development
Annual Gross Supply ('000 m², bldgs >5,000m²)



Source: Knight Frank

FIGURE 3
Average Prime Core Market Yields
Sydney Industrial Regions



Source: Knight Frank

TABLE 1
Sydney Industrial Market Indicators as at October 2014

Precinct	Avg Prime Rent		Avg Secondary Rent		Core Market Yields		Avg Land Values <5,000m²		Avg Land Values 1 - 5 ha	
	$/m² net	(%p.a)	$/m²	(%p.a)	Prime	Secondary	$/m²	(%p.a)	$/m²	(%p.a)
Outer West	104	0.5%	93	0.1%	7.00 - 8.00	8.25 - 9.25	359	2.6%	289	8.6%
Inner/Central West	119	1.1%	103	1.2%	7.25 - 8.00	8.50 - 9.25	525	3.2%	321	8.4%
South West	96	0.5%	82	0.0%	7.25 - 8.25	8.75 - 9.50	323	5.6%	234	8.8%
North	161	1.2%	135	1.0%	8.00 - 8.75	8.75 - 9.50	605	4.3%	500	7.5%
South	150	2.3%	126	1.3%	6.75 - 7.50	7.75 - 8.75	1,175	10.6%	913	12.3%
Sydney Average	**126**	**1.1%**	**108**	**0.7%**	**7.00 - 8.25**	**8.50 - 9.25**	**402***	**3.8%***	**281***	**8.6%***

Source: Knight Frank

*Average Outer West, Inner/Central West and South West
OW Outer West   SW South West   ICW Inner Central West   N North   S South

strong competition amongst lenders resulting in a narrowing of margins on corporate loans is expected to sustain demand from domestic groups.

The strong offshore demand that has been present for a number of years remains firm with the recent depreciation in the $AUD expected to sustain keen interest from offshore groups. After several years where the bulk of activity was via wholesale joint ventures, offshore funds are increasingly looking for direct investment opportunities, although local funds are providing strong competition for such opportunities. Recent purchases by offshore groups include Logos Property acquiring several new facilities with long dated WALE (c.15) on behalf of an offshore mandate on sub-7% yields demonstrating the market premium investors are prepared to pay for long term income streams.

Buildings with change of use potential, especially for residential, continue to be competitively sought and have resulted in an increased volume of older, secondary asset sales in inner city locations. There is also a growing trend for developers taking on planning risk in these transactions. While a large proportion of these have been located within suburbs in the South region undergoing urban renewal including Waterloo and Mascot, a number of opportunities are also emerging in the Inner Central West in suburbs such as Melrose Park. Such asset sales based on alternate use potential have traded at substantial premiums to metrics based on an ongoing industrial use.

Based on a five year WALE, average prime yields across Sydney are estimated to range between 7.00% and 8.25%. This range represents firming of approximately 80bps through the cycle thus far and now sees prime yields trading below their 10 year average. Market sentiment suggests

TABLE 2

Recent Leasing Activity Sydney

Address	Region	Net Rent $/m²	Area	Term (yrs)	Tenant	Date
Pre-lease						
West. Mwy, Eastern Ck	OW	Conf.	41,200	U/D	Techtronic Ind.	P/C
Kangaroo Ave, Eastern Ck	OW	Conf.	13,400	U/D	Fisher & Paykel	P/C
52 Quarry Rd, Erskine Pk	OW	Conf.	3,982	7	Premium Floors	P/C
38 Bernera Rd, Prestons	SW	Conf.	13,917	15	Inghams	P/C
Existing Leases						
2 Davis Rd Wetherill Park	OW	122g	10,274	5	Freight Specialists	Oct-14
90 Wetherill St, Silverwater	ICW	111	2,703	U/D	Kazoo Pet	Sep-14
230 Hoxt. Pk. Rd, Hoxton Pk	SW	105	6,533	7	ARB Corp	Aug-14
25 Frenchs Forest Rd, FF	N	211g	1,796	5	NDC Automation	Aug-14
1 Percival Rd, Smithfield	OW	125	4,992	10	Voith Turbo	Jul-14

Source: Knight Frank g refers gross U/D refers undisclosed FF refers Frenchs Forest

TABLE 3

Recent Land/Development Major Sales Activity Sydney

Address	Region	Price ($ mil)	Area (m²)	$/m² of area	Vendor	Purchaser	Sale Date
Richmond Rd, Marsden Park	OW	c.20.00	70,170	c.285	Marsden Park Dev.	Swire Cold Storage	Aug-14
Quarrywest at Greystanes	OW	50.50	256,400	197	Boral	DEXUS/Future Fund	Jun-14
Ingleburn Dist. Centre, Ingleburn#	SW	72.50	280,000	259#	Asciano	Stockland	Jun-14
2-28 McPherson St, Banksmeadow	S	33.10	93,000	356"	Orica	Goodman	Jun-14

Recent Improved Major Sales Activity Sydney

Address	Region	Price $ mil	Bldg Area m²	Passing Yield (%)	WALE (yrs)	Vendor	Purchaser	Sale Date
Portfolio Sale†	NSW/SA	224.10	86,579	7.0	8.0	Altis	Mirvac	Nov-14
Portfolio Sale*	NSW/Qld	137.90	113,102	N/A	N/A	Valad	M&G Real Estate & PAIP	Oct-14
133 Lenore Dr, Erskine Park≈	OW	U/D≈	44,702	c.6.5ˇ	c.15.0	W. H Soul Pattinson	Logos Property‡	Oct-14
2 Dursley Rd, Yennora	OW	46.00	52,548	4.5»	8.4	Scheinberg	Charter Hall (CLP)	Sep-14
52 Quarry Rd, Erskine Park	OW	13.3	8,067	7.8	7.0	Fife	Australian Industrial REIT	Sep-14
36 Bernera Rd, Prestons	SW	c.70.00	22,100	c.6.6	14.2	Vaughan Constructions	Logos Property‡	Oct-14
50 Airds Rd, Minto	SW	21.6	33,452	9.3	3.8	JSKM Pty Ltd	PAIP	Jul-14
406 Marion St, Condell Park	SW	9.75	10,377	8.2	15.0	Albury Prop. Holdings	CorVal	Jun-14
300 Coward St, Mascot	S	22.50	10,420	6.4	8.0	Bricktop	Private	Oct-14
68 Anzac St, Chullora	ICW	15.75	20,000	7.2	9.7	Scheinberg	Pipeclay Lawson	Oct-14
40 Carrington Rd, Castle Hill	NW	20.00	13,359	9.0ˇ	4.9	Leda Holdings	Private	Aug-14
44 Wharf Rd, Melrose Park	ICW	95.00	71,243	Conf.	Conf.	Reckitt Benkiser	Payce Consolidated	Jun-14

Source: Knight Frank

includes 6,700m² lettable area and 221,680 vehicle storage area with WALE 7.9 years. Residual 5.1ha available for immediate development.

" unadjusted for unusable portion of land ‡ on behalf of Kumpulan Wang Persaraan (KWAP) PAIP refers Propertylink Australian Industrial Partnership

† Five asset portfolio including four in NSW, namely 39 Herbert St, St Leonards, 34-38 Anzac Ave, Smeaton Grange, 39 Britton St, Smithfield and 8 Brabham Dr, Huntingwood with the fifth asset located in South Australia ˇ reported yield CLP refers Core Logistics Partnership

* includes two core assets (one in NSW, namely 9-10 John Morphett Dr, Erskine Park) leased to Bluestar Logistics acquired by M&G Real Estate for $85.2m with residual four assets (2 each NSW, namely 164-166 Newton Rd, Wetherill Park and 144-156 McCredie St, Smithfield and Qld) acquired by PAIP for $52.7m

≈ Part of two asset portfolio sale acquired for c.$150m with other asset located in Brendale, Qld » Passing rent at 2010 and subject to an objection process

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firming in excess of this amount and with capital inflows likely to remain strong, further compression is anticipated. Across the regions, the South has led the firming cycle for prime assets, with approximately 125bps of tightening recorded since 2010. The sale of 300 Coward Street, Mascot on a passing yield of 6.4% (eight year WALE) is indicative of the level of firming in the region.

For assets with longer lease profiles of between 10 and 15 years, compression has been greater and such assets will trade below the aforementioned average range. Recent acquisitions in Erskine Park and Prestons have evidenced yields in the mid-6’s for new facilities in the West with circa 15 year WALE.

Yield firming for secondary grade assets has become more entrenched over the past 12 months with cumulative firming at this stage of the cycle of 65bps such that average core yields range from 8.50% to 9.25%. This yield range is broadly inline with the 10 year average.

Outlook

There continues to be a relatively deep pool of unsatisfied capital from both domestic and offshore groups looking for industrial buying opportunities. This is expected to underpin a continuation of heightened sales volumes with further yield firming anticipated. While passive assets are strongly bid where available, urban renewal is anticipated to see further inner city secondary asset sales.

With leasing demand still inconsistent and vacant prime stock levels having increased over the past few years, it is likely that rental growth will remain soft over the coming year. However with business conditions in NSW now the highest in the country (NAB September business survey), a modest improvement in leasing activity can be expected into 2015.

Definitions:
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 with 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 vacancies, incentives etc).

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