RESEARCH

Knight Frank

SYDNEY
INDUSTRIAL MARKET BRIEF NOVEMBER 2015

Key Facts

Improving leasing activity at a time when vacancies are relatively tight has seen prime net face rents post annual growth of 2.1%.

Development activity is picking up, with 2016 supply forecast to increase by at least 25% compared to 2015.

Further cap rate compression of circa 55 bps has been recorded over 12 months to October.

Despite investment demand remaining at heightened levels, stand alone investment opportunities remain limited.

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A relatively tight leasing market and an outperforming state economy has resulted in improved rental growth. Coupled with further cap rate compression, this is boosting the appetite for developers to progress new projects.

Occupier Demand & Rents

The NSW economy is currently experiencing favourable economic conditions underpinned by strong growth in housing investment, above average retail expenditure, elevated infrastructure investment and a jobs market that has accounted for half of the new jobs created nationally over the past year. With interest rates forecast to remain low and the dollar expected to depreciate further, state economic growth is forecast to outpace the national average over the next two years.

These conditions are being conducive for positive leasing conditions across Sydney. During the third quarter of 2015 gross take-up (excl. D&C's) measured 175,389m², a rate 32% above the series average and the fifth successive period of above average take-up (for further details refer 'Sydney Industrial Vacancy Brief, Oct 2015').

This activity has been occurring at a time when vacant stock levels are relatively low, a factor that has been exacerbated in 2015 by, firstly, approximately 100,000m² of stock been withdrawn from the market due to hail damage in April; and secondly, a number of properties within Sydney's Inner Ring undergoing change of use redevelopment. These dynamics have resulted in prime annual rental growth in the 12 months to October 2015 measuring 2.1%, a rate double the average over the past five years. Average secondary rental growth has been less pronounced, averaging 1.5% over the same period. The bulk of this secondary growth has been recorded in the South and Inner Central West regions, where the residential conversion of older buildings has seen a number of displaced tenants competing for limited leasing options. It is also noted that some of the displaced tenant demand has translated into demand in western regions via 3PL requirements with tenants taking the opportunity to improve supply chain efficiencies by outsourcing logistics requirements.

Development & Land Values

Since 2009, new supply has been relatively benign in Sydney with gross completions tracking well below pre-GFC levels (refer

Figure 1). However, construction levels have picked up noticeably, with the development cycle set to experience an upswing in 2016, albeit well below the pre -GFC peaks. Knight Frank are currently tracking 554,449m² of new supply that is expected to complete in 2016, a 25% increase on the 2015 total. However with a number of projects actively seeking pre-commitments, the final tally will likely be higher given the sub-12 month lead times for projects where land is readily available for development.

Underpinning the increase has been a number of pre-lease deals in excess of 10,000m² (refer Table 2). However 2016 supply will also be boosted by speculative activity with approximately 188,000m² of speculative projects being tracked for expected completion. Developers of speculative product mostly comprise institutions, however, several large privates are starting to show an interest in following suit.

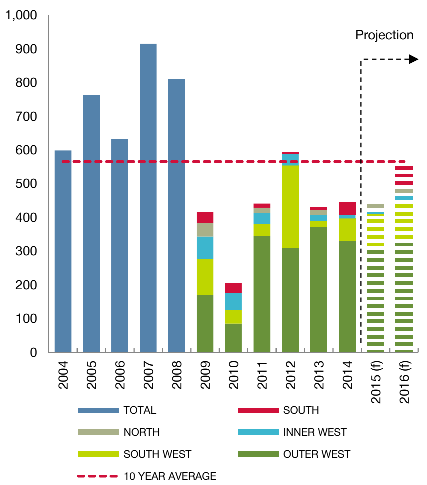
In addition to the relatively favourable improvement in tenant demand, there are several factors motivating this development trend. The substantial yield compression that has been recorded in investment markets has meant that developing new assets is representing a feasible alternative for many institutions to grow funds under management, as opposed to acquiring existing stock. Also, with the bulk of Western Sydney land supply unlikely to be readily developable within the next three years, current land owners with appropriately zoned land have an opportunity to be active players in the supply cycle when competition is broadly limited to a select group of land holders (for further details refer 'Western Sydney Land Insight, July 2015'). Adding further pressure to the demand for land are a number of turnkey briefs in the market, with low interest rates being supportive of owner occupation. The result of these factors has been further growth in average land values, which are estimated to have increased by between $25/m² and $50/m² over the past six months.

Sales & Investment Activity

There remains strong investment demand from buyers looking to allocate capital to Sydney industrial assets, a trend that has seen further cap rate compression recorded in 2015. Based on five year WALEs, prime core market yields have firmed by 55bps in the 12 months to October 2015 to range on average from 6.75% to 7.75%. Secondary yields have firmed by a similar degree over the past year to range on average between 8.00% and 8.75%. This range indicates a spread of 100 bps between prime and secondary, a risk premium that has shown no material signs of narrowing through the compression cycle thus far.

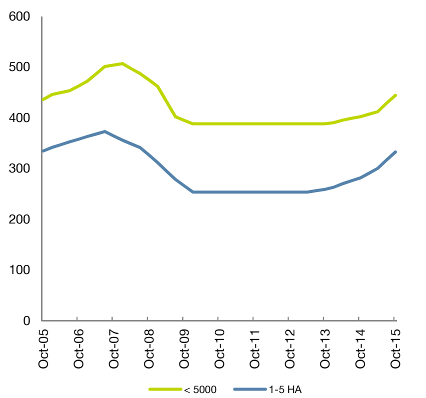
However, super prime assets with long

FIGURE 1
Sydney Industrial Development
Annual Gross Supply ('000 m², bldgs >5,000m²)



Source: Knight Frank Research

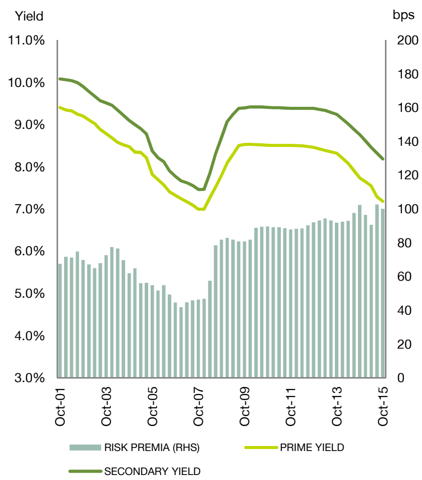
FIGURE 2
Sydney Industrial Land Values*
Avg. Value Serviced Lots ($/m²)



* Avg Outer West, Inner Central West and South West

Source: Knight Frank Research

FIGURE 3
Sydney Industrial Core Market Yields
Prime vs Secondary



Source: Knight Frank Research

TABLE 1
Sydney Industrial Market Indicators as at October 2015

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	108	2.4%	94	1.1%	6.75 - 7.50	7.75 - 8.25	417	16.1%	345	19.4%
Inner/Central West	123	3.2%	105	1.8%	6.75 - 7.50	8.00 - 8.50	566	7.9%	394	22.6%
South West	100	2.1%	82	0.0%	7.00 - 7.75	8.00 - 8.75	350	8.4%	285	21.8%
North	163	1.0%	135	0.0%	7.50 - 8.50	8.50 - 9.00	645	6.6%	510	2.0%
South	153	1.9%	132	4.6%	6.25 - 7.00	7.25 - 8.00	1,325	12.8%	1,000	9.6%
Sydney Average	**129**	**2.1%**	**109**	**1.5%**	**6.75 - 7.75**	**8.00 - 8.75**	**444***	**10.8%***	**333***	**21.2%***

Source: Knight Frank Research

† reflects average rents for existing buildings. Pre-lease rents average above these indicative rates.
* Average Outer West, Inner/Central West and South West
^ Core yields assume five year WALE. Prime assets with 10+ year WALE trading 5.75% - 6.25%
OW Outer West SW South West ICW Inner Central West N North S South

dated WALE or portfolio offerings continue to trade at a material premium to these ranges. This trend was evident with Singaporean group Ascendas Real Estate Investment Trust acquiring the GIC and Frasers Group portfolio for $1,013 billion. Setting a new record for the largest single industrial transaction in Australia, the sale comprised 26 logistics properties spread across four states, amounting to 630,946m² of GFA. The sale reflected a passing yield of 6.4% with a WALE of 5.7 years, however the core market yield was closer to 6.0% given that numerous assets within the portfolio are leased above market rents. It is understood that a number of separate parties made bids in excess of $1 billion, evidence of the depth of capital looking for quality, core industrial assets. The largest single asset to trade in 2015 has been the sale of the Coles Distribution Centre in Eastern Creek in June. The asset, which benefitted from a 19 year WALE, traded for $253 million to offshore group Mapletree Logistics and reflected a core market yield of 5.77%.

As a result of the firming market, particularly amongst prime assets, the propensity of investors to look further up the risk curve has become more entrenched with a number of local groups actively pursuing assets with leasing risk. Examples include Stockland, who acquired 23 Wonderland Crescent, Eastern Creek with a sub-one year WALE with intensions to refurbish and re-lease in 2016. The group recently enjoyed success with a similar strategy at Botany, where they acquired 2-8 Baker St with a 1.5 year WALE before extended the tenant's lease (SMEG) by seven years.

Although a number of assets have continued to trade to residential developers in the second half of 2015 (eg.

TABLE 2

Recent Leasing Activity Sydney

Address	Region	Net Rent $/m²	Area	Term (yrs)	Tenant	Date
Pre-lease						
Eastern Creek Business Park	OW	Conf.	24,500	10	DB Schenker	P/C
ILC, Enfield	ICW	Conf.	c.20,000	U/D	Swift Transport	P/C
Horsley Drive Business Park	OW	Conf.	18,559	U/D	Martin Brower	P/C
290 Kurrajong Rd, Prestons	SW	Conf.	15,340	7	Bracknells	P/C
Quarrywest, Greystanes	OW	Conf.	12,400	U/D	Toshiba	P/C
Keylink South Industrial Estate	SW	Conf.	12,260	10	Joy Global	P/C
Existing Leases						
15-16 Ormsby Pl, Wetherill Pk	OW	105	4,421	5	Normet Asia	Nov-15
2 Davis Rd Wetherill Park	OW	102.5	5,988»	5.5	Stora Enzo	Oct-15
22 Frank St, Wetherill Park	OW	95	13,500	8	Border Express	Sep-15
178 Power St, Glendenning	OW	120	7,277	7	Hy-Clor Australia	Sep-15
2 Holker St, Silverwater	ICW	154g	3,502	7	Anixter	Sep-15
1-15 Kellet Cl, Erskine Park	OW	115	14,797	5	BevChain	Jul-15
809 Botany Road, Rosebery	S	160	1,076	5	Amzen	Jul-15

TABLE 3

Recent Land/Development Major Sales Activity Sydney

Address	Region	Price ($ mil)	Area (m²)	$/m² of Area	Vendor	Purchaser	Sale Date
34 Yarrunga Street, Prestons	SW	50.00	200,000	c.250	Private	Logos Property	Oct-15
402 Hoxton Park Rd, Prestons^	SW	13.76^	44,300	311	AHG^	Charter Hall (CPIF)	Aug-15
290 Kurrajong Rd, Prestons	SW	38.99	c.150,000	c.260	Private	Charter Hall (CPIF)	Jun-15
8 Abbott Rd, Seven Hills	OW	U/D	76,940	U/D	Nuplex	Private	Jun-15
449 Victoria St, Wetherill Park	OW	4.65	12,250	380‡	Private	Private	May-15

Recent Improved Major Sales Activity Sydney

Address	Region	Price $ mil	Bldg Area (m²)	Passing Yield (%)	WALE (yrs)	Vendor	Purchaser	Sale Date
57-65 Templar Rd, Erskine Park	OW	50.0	30,115	Conf.	Conf.	DEXUS	M&G	Oct-15
24 Wellington St, Waterloo	S	12.00	2,868	n/a	VP	Private	Owner Occupier	Oct-15
12 Birmingham Ave, Villawood	ICW	7.50	6,591	6.5	Conf.	Private	Owner Occupier	Oct-15
National Portfolio Sale*	n/a	1,013.0	630,946	6.40	5.9	GIC/Frasers Property	Ascendas	Sep-15
23 Wonderland Dr, Eastern Ck	OW	34.00	23,081	7.70	sub 1.0	McDonald Bros	Stockland	Sep-15
1 Worth St, Chullora	OW	45.00	37,600†	n/a	VP	Fairfax Media	Charter Hall (CPIF)	Aug-15
2 Costello Pl, Seven Hills	OW	14.87	11,116	7.85	3.3	DEXUS (DWPF)	Propertylink (PAIP II)	Aug-15
Coles Dist Centre, Eastern Ck	OW	253.00	55,389	5.76	19.0	GMG/Brickworks JV	Mapletree Logistics	Jun-15
National Portfolio Sale#	n/a	103.30	115,646	c.10.0	c.3.0	Equity Commonwealth	Propertylink (PAIP)	Jun-15
66 Glendenning Rd, Glendenn.	OW	19.17	16,461	7.66	4.3	Austral Refrigeration	Investec	May-15

Source: Knight Frank Research

ILC refers Intermodal Logistics Centre   P/C refers practical completion   » additional hardstand area of 9,000m² at $30/m² also leased   g refers gross rent
^ Subject to a 15 year pre-lease to AHG (Automotive Holdings Group)   ‡ includes approx. 2,000m² unusable land   U/D refers undisclosed
* Comprises 26 prime logistics properties located in Sydney, Melbourne and Brisbane. Sydney component comprises 9 assets totalling 198,129m², which accounts for 38% of portfolio income. Yield is pre-transaction costs.   † located on a 10.3ha site
# Comprises eight industrial properties across Sydney, Brisbane, Melbourne and Perth. Sydney assets comprise 16 Rodborough Rd, Frenchs Forest (8,410m²), 22 Rodborough Rd, Frenchs Forest (4,035m²) and 44 Mandarin St, Villawood (22,229m²)
PAIP refers Propertylink Australian Industrial Partnership

15 & 19 Berry St, Granville, $65.0m; 38-42 Wharf Rd, Melrose Park, $144.5m; and 154 O'Riordan St, Mascot, $32.0m), there is some evidence that buyers are becoming more selective in buying opportunities. Compared with a year ago, there is less propensity to take on planning risk (unless the property offers substantial scale), while a number of offshore developers now require that a site provide adequate holding income in order to be held as development inventory.

Outlook

The positive outlook for the NSW economy is expected to sustain positive leasing conditions into 2016. While current vacant stock levels are relatively tight, rental growth in the next two years is likely to remain relatively modest at circa 1.0% to 1.5% per annum for the Western Sydney regions (compared to 0.9%pa over the past 5 years). This reflects both pre-lease competition and forthcoming speculative supply, in addition to cap rate compression reducing the economic rents for some developers (notwithstanding some counterbalancing impact from increasing land values). Despite the general migration of tenants west, slightly higher rental growth is forecast for the South and Inner Central West markets of 1.5% to 2.0% given declining stock due to rezoning. There are a number of tenants who still need to be located in these middle ring markets such as those wanting to be close to consumers or, in the case of the South, users storing high turnover goods near the airport.

The relatively deep pool of unsatisfied capital will continue to maintain the high level of demand for investment opportunities in 2016. While this will maintain a tightening bias on yields, it is anticipated that the rate of compression may start to level out, particularly at the prime end of the market where yields have reached the levels experienced during the previous market peak in 2007.

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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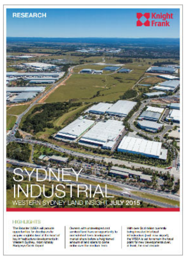

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