RESEARCH

SYDNEY
INDUSTRIAL MARKET BRIEF JUNE 2016

Key Facts

Improving tenant demand coupled with falling vacancies have resulted in prime net face rents increasing by 2.5% over the past year.

542,255m^2 of new supply is expected to be completed in 2016, representing an increase of 18% over 2015.

Speculative development is being developed primarily by institutions who have the ability to shift tenants within their portfolio.

Investor demand remains strong driving further cap rate compression for prime assets with long WALE.

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Positive economic conditions are translating into healthy growth in tenant demand and falling industrial vacancies. Investment activity remains strong driven by a continued quest for yield spread and income stability.

Occupier Demand & Rents

The NSW economy is going from strength to strength, underpinned by the positive growth in dwelling construction, retail sales and infrastructure investment. Consumer goods retailing is benefiting from the buoyant housing construction activity whilst the NSW Government is investing in a massive infrastructure investment program for Western Sydney, including upgrades to the M2, M4 and M5 and the construction of the WestConnex and NorthConnex.

These dynamics have translated into healthy tenant demand across Sydney, particularly from tenants with links to consumer goods and 3PL sectors. Over the first quarter of 2016, gross absorption (excl. D&C's) measured 190,337m^2, a rate 35% above the series average (for further details refer 'Sydney Industrial Vacancy Brief, April 2016'). Demand in the Outer West has accounted for the majority of the gross absorption over the quarter, registering 83,404m^2 (44% of total). This strong growth in the Outer West is driven by the availability of new stock and improvement in the transport network making it more cost efficient for tenants to relocate to the region.

On the back of improving tenant demand, vacancy stock levels (+5,000m^2) continued to decline, falling by 9,156m^2 (or 1.9%) in the recent quarter. As at April 2016, the vacancy level stood at 482,820m^2 across 53 buildings.

The falling vacancies saw prime rents increasing by 2.5% over the 12 months to April 2016, the strongest level over the last 10 years. In the secondary market, the conversion of older buildings to alternative uses has resulted in secondary stock experiencing even stronger rental growth than primary stock, measuring a 3.8% rise in the year to April 2016. Most of this growth occurred in the North, South and Inner West markets, where the withdrawal of stock is strong. The displaced tenants coming out of the sites earmarked for redevelopment will have to accept higher rents for the limited availabilities or be forced to relocate to the West and Outer West regions, in turn driving pent-up demand in those markets.

Development & Land Values

Sydney's industrial development activity continues to build momentum in the beginning of 2016 with the majority of new completions occurring in the Outer West precinct. Knight Frank is tracking a total of 542,255m^2 of new stock being completed in 2016, representing an increase of 18% over 2015. This is the strongest level of supply in the last four years, but still way below the pre-GFC levels.

Driving this strong supply pipeline is the buoyant pre-commitment market led by occupiers with large space requirements in excess of 10,000m^2 (Table 2). In addition, a number of developers have also triggered speculative developments. We are tracking a total of 86,977m^2 of speculative stock across six developments as at June 2016, all of which are under construction with no vacant completed speculative stock available, highlighting the strong demand for this type of product. Speculative development is dominated by institutional developers, who have the ability to shift existing tenants within their portfolio and minimise downtime.

As asset values continue to rise and yields compress further, a number of local institutions are finding it more feasible to grow organically by development rather than acquisition of existing assets. Equity is recycled from the sales of non-core assets, mainly in the South Sydney and Inner West markets, to fund new developments in the West and Outer West region.

This westward movement of capital is further supported by the availability of serviced land and improved transport network. The federal and NSW governments are funding a $3.6 billion road investment program for Western Sydney, which is expected to drive further tenant migration and investment into the region.

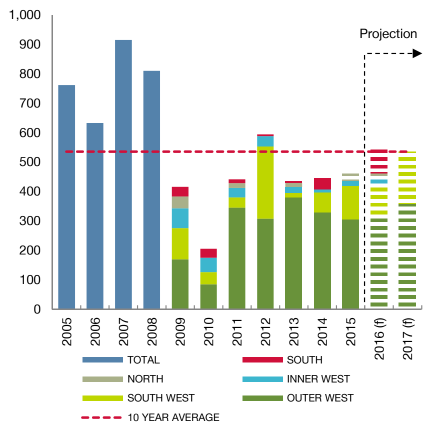
The uptick in demand for development sites has translated to an increase in land values over the last 12 months (Table 1), as developers continue to build up land bank to accommodate future projects. In April 2016, GPT acquired a five hectare industrial site on Eastern Creek Dr in Eastern Creek for $16.1 million, representing a rate of $322/m^2 (Table 3). GPT is looking to speculatively develop the site for a potential of 26,850m^2. It has also earmarked a 18,000m^2 development at 18-24 Abbott Road, Seven Hills, with speculative construction expected to commence in the coming months.

As at April 2016, development land values in the Western Sydney region averaged around $452/m^2 for small sized lots (<5,000m^2) and $347/m^2 for medium-sized lots (1-5 hectares).

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)

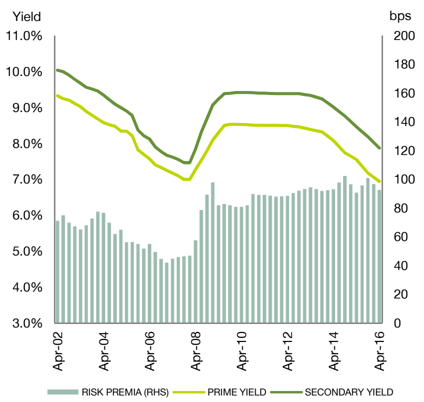
Source: Knight Frank Research

* Avg Outer West, Inner Central West and South West

FIGURE 3

Sydney Industrial Core Market Yields

Prime vs Secondary



Source: Knight Frank Research

TABLE 1

Sydney Industrial Market Indicators as at April 2016

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	109	2.1%	98	4.5%	6.50 - 6.75	7.50 - 8.00	417	12.6%	350	9.5%
Inner/Central West	124	2.8%	105	1.8%	6.75 - 7.25	7.50 - 8.50	566	4.6%	405	13.7%
South West	103	2.5%	84	3.1%	6.75 - 7.25	7.50 -8.50	372	14.5%	285	18.8%
North	166	2.3%	139	2.8%	7.00 - 8.50	7.75 -9.00	645	4.0%	525	5.0%
South	155	2.8%	134	6.6%	6.25 - 7.00	7.00 -7.75	1,375	8.9%	1,025	5.1%
Sydney Average	**131**	**2.5%**	**112**	**3.8%**	**6.65 - 7.35**	**7.45 - 8.35**	**452***	**9.6%***	**347***	**14.0%***

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%

Sales & Investment Activity

Investment demand for Sydney's industrial properties remains strong in the first half of 2016, driven by a continued quest for yield spread and income stability. Despite continued yield compression, industrial properties are still trading at relatively attractive core market yields (compared to other asset classes) of around 6.65% to 7.35% (based on 5 year WALE) as at April 2016. However, prime assets with over 10 year WALE may trade at around 5.75% to 6.25% yields. Secondary yields are ranging from 7.45% to 8.35%. This represents a spread of approximately 4.60% to 6.30% over the current 10 Year government bond yields.

The positive demand in South Sydney and Outer West persists with prime yields ranging from 6.25% to 7.00% and 6.50% to 6.75% respectively.

Offshore investors continue to set the pace in the market but local funds are following suit. In May 2016, Singapore-listed Mapletree announced the proposed acquisition (subject to FIRB's approval) of a portfolio of four properties from Altis for a total consideration of $85 million (See Table 3 for a breakdown). These properties are all located in the Western regions and are fully leased with an average WALE of 5.5 years as at 1 July 2016.

The four properties to be acquired by Mapletree were initially put on the market as part of a nine property portfolio by Altis Real Estate. The remaining assets (spreading across NSW, Victoria and Queensland) remain on the market after AMP decided to opt out of a potential deal with Altis to instead purchase JP Morgan's portfolio for $250 million. The AMP and JP Morgan deal represents local funds being more competitive for industrial portfolios for the first time in a few years.

TABLE 2

Recent Leasing Activity Sydney

Address	Region	Net Rent $/m²	Area	Term (yrs)	Tenant	Date
Pre-lease						
Horsley Drive Business Park	ICW	203	20,000	U/D	Martin Brower	P/C
Quarrywest, Greystanes	ICW	142	12,000	U/D	Toshiba	P/C
Eastern Creek Stage 5	OW	100	13,400	10	Fisher & Paykel	P/C
Eastern Creek Stage 5	OW	98	41,200	7	TTI Ryobi	P/C
Jurrajong Rd, Prestons	SW	107	15,000	7	Bracknells	P/C
7 Dursley Rd, Yennora	ICW	U/D	10,000	U/D	Kent Storage	P/C
78 Tyrone Pl, Erskine Park	W	242	6,600	15	Loscam Pallet	P/C
Existing Leases						
Greystanes	W	124	5,345	10	Gro-Mkt Logistics	Sep-16
647 GW Hwy, Eastern Creek	W	123	17,000	7	Blackmores	Jul-16
B/10-16 South St, Rydalmere	ICW	125	3,195	U/D	U/D	May-16
20 George Young St, Auburn	ICW	125	2,868	3	U/D	May-16
20 Slough Av, Silverwater	ICW	120	1,521	5	Inside Out Nutri.	May-16
222 Woodpark Rd, Smithfield	ICW	105	1,217	3	Flexonics	May-16

TABLE 3

Recent Land/Development Major Sales Activity Sydney

Address	Region	Price ($ mil)	Area (m²)	$/m² of Area	Vendor	Purchaser	Sale Date
Eastern Creek Dr, Eastern Creek	OW	16.10	50,000	322	Jacfin	GPT	Apr-16
16 Bernera Rd, Prestons	SW	5.60	19,800	282	Alex Chignone	Private	Feb-16
34 Yarrunga St, Prestons	SW	48.00	20,000	250	Private	LOGOS	Oct-15

Recent Improved Major Sales Activity Sydney

Address	Region	Price $ mil	Bldg Area (m²)	Passing Yield (%)	WALE (yrs)	Vendor	Purchaser	Sale Date
JP Morgan Portfolio*	W & SW	250.00	147,496	6.50	U/D	JP Morgan	AMP Capital	Jun-16
53 Britton St, Smithfield^	W	27.80	13,484	7.35	6.0	Altis	Mapletree	May-16
405-407 Victoria St, Wetherill Park^	W	17.70	11,028	7.56	4.2	Altis	Mapletree	May-16
3 Distillers Pl, Huntingwood^	W	15.20	8,963	7.35	5.1	Altis	Mapletree	May-16
114 Kurrajong Ave, Mount Druitt^	W	24.30	18,137	7.26	7.1	Altis	Mapletree	May-16
309-396 Marion St, Condell Park	SW	5.30	4,000	U/D	U/D	Private	Private	Mar-16
15 Onion Rd, Lane Cove West+	N	21.00	9,838	6.70	U/D	U/D	Intrasia Oxley RE	Feb-16
6 Inglis Rd, Ingleburn	SW	8.55	6,922	7.40	U/D	S&S Holding	Fife	Feb-16
337-381 Victoria St, Wetherill Park	W	6.80	5,472	U/D	U/D	Private	Private	Feb-16
6-20 Clunies Ross St, Pemulwuy	W	76.60	38,549	7.02	5.9	Deka	Ascendas	Dec-15

Source: Knight Frank Research

* Assets include; 52 Huntingwood Drive, Huntingwood, 32 Sargents Road, Minchinbury, 64 Biloela Street, Villawood, 52 Lisbon Street, Fairfield,104 Vanessa Street, Kingsgrove and 32 Bessemer Street, Blacktown.

^ part of a 4 property portfolio sold by Altis Real Estate Equity Partnership (AREEP) II Fund

+ mortgagee in possession sale

OW Outer West SW South West ICW Inner Central West N North S South

g refers gross U/D refers undisclosed

Outlook

The positive economic and retail conditions in NSW are expected to support further improvement in tenant demand in the consumer goods and 3PL sectors. As vacancy levels tighten, we expect to see rental growth to sustain over the medium term. However, the projected supply pipeline will put a lid on this growth over the long term. Overall, we expect rental growth to track slightly above the CPI rate of around 2.5% to 3.5% per annum over the next two years, but growth will vary across the different precincts.

The migration of tenants from the South and Inner West markets to the Western precincts is expected to intensify over the next 24 months as the buildings recently sold for residential conversion start to vacate for construction. This will see slightly stronger rental growth for the South and Inner Central West markets compared to the rest.

Over the next 12 months, investor appetite for income stability is expected to put further pressure on the yields of prime assets with long WALE. However we maintain a view that compression will level out in the medium term as yields are at historical lows and more local institutions are engaging in development, which in turn will increase supply. Prime assets with 5 year WALE are expected to trade at around 6.5% to 7.5% yield but those with 10+ year WALE could potentially be trading at circa 6.0% and below.

Liquidity this year is expected to come from portfolio sales, at least two of which are expected to be completed this year. The strong appetite for Australian industrial properties by Asian and international fund managers is insuring that there is no shortage of suitors, but volumes are expected to slow down.

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 specific issues (ie rental reversions, rental downtime for imminent expiries, capital expenditure, current vacancies, incentives etc).

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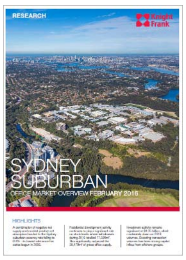

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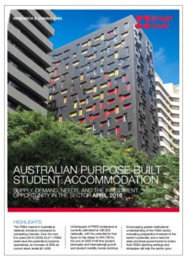

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