

RESEARCH

A map of Australia is centered on a dark blue background. The map is overlaid with a complex network of glowing lines in yellow, orange, and blue. These lines radiate from numerous points across the Australian continent and extend outwards, suggesting a global network or data flow. The lines are most dense around the major cities and coastal areas of Australia.

# AUSTRALIAN CAPITAL VIEW

OUTLOOK 2019

SHIFTING GEAR TO RENTAL GROWTH



# INTRODUCTION

Welcome to our inaugural report on the Australian capital markets outlook. The report provides an assessment of current investment market trends and our latest views on the outlook for the year ahead, covering the office, industrial, retail and alternatives sectors.

After a strong run of capital value growth and buoyant returns across the market in recent years, many investors are now asking whether the good news is already fully priced in, and whether the recent bout of equity market volatility presages a weaker year ahead for commercial investment. On the other hand, a robust labour market, tight supply and consequent rental growth momentum remain firmly in place in many markets.

These mixed signals set the scene for 2019. A forecast slowing in global growth may impact sentiment in some quarters, but recent experience suggests that demand is very resilient, and that Australian real estate will continue to benefit from rising allocations and the global search for yield.

## Top predictions for 2019

**Slower, but still solid economic growth:** Despite slower global growth, equity market volatility and geopolitical tensions, the Australian economy remains resilient. Growth is expected to slow but remain supportive of property investment, with sustained employment growth underpinning demand and absorption.

**Capital growth to decelerate, with rental growth key to prospects:** After five consecutive years of double digit total returns, as measured by the MSCI All Property Index, we expect returns to reduce to around 9% in 2019. Lower capital growth will drive this shift, down from 4.6% in 2018 to 3.6% in 2019 as broad based yield compression wanes. Increasingly, it will be rental growth, rather than yield compression, driving growth in total returns.

**Resilient demand, but tighter liquidity:** Demand for property will remain resilient, and rising allocations to real estate from the likes of global private equity and domestic super funds will ensure they maintain their appetite. However, lower capital growth will dampen the impetus to trade somewhat, resulting in slightly lower investment volumes in 2019.

**Window of opportunity still open in Sydney and Melbourne offices, but greater selectivity will be needed:** While the late cycle debate is nowhere more evident than in the Sydney and Melbourne office markets, tight occupational markets will underpin further rental growth and keep prime yields on a tight leash. In 2019, we expect the fastest growth to come in Melbourne, but Sydney is forecast to grow slightly faster over the next five years.

**Brisbane and Perth offices to benefit from effective rental growth:** Recent months have seen a decided improvement in leasing market sentiment. Face rents are now growing in Brisbane, and incentives will continue to creep down in Perth; this will prompt a reappraisal of risk and hence yield compression as the year goes on.

**Dollar depreciation to buoy high-end retail:** Headwinds for household spending and the ongoing impact of new technology will drive continued polarisation and under-performance relative to other sectors. Dominant shopping centres will prove resilient, while the substantial depreciation of the Australian dollar will benefit retailers exposed to tourism.

**Industrial portfolios at a premium:** The weight of demand continues to substantially outweigh available stock, to the point that investors accessing scale through portfolio acquisitions are prepared to pay a premium. This will continue in 2019 with investors exploring a variety of creative approaches to access the market.



**BEN BURSTON**  
Partner, Head of Research & Consulting



**CHRIS NAUGHTIN**  
Associate Director, Research

# GLOBAL MACRO THEMES

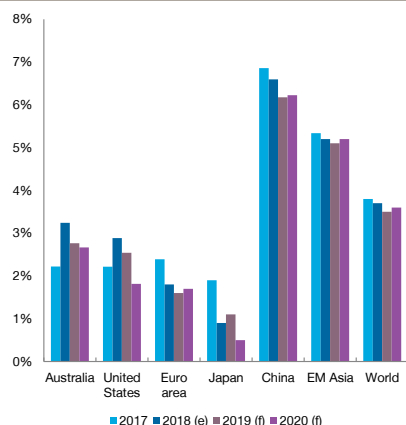
## Slowing global growth

The global economy slowed in the second half of 2018 and early 2019, mainly reflecting weaker growth in Europe and Asia. Downside risks to the economic outlook have increased, particularly US-China trade tensions, a stronger than anticipated slowdown in China, and uncertainty over Brexit.

The US economy grew at a strong pace in 2018, although growth is beginning to slow as the impact of fiscal stimulus wanes. Growth in Germany and Japan has slowed from the strong levels seen in 2017, with the slowdown in global trade weighing on the export sectors of both countries. In China, growth has slowed partly reflecting attempts by Chinese authorities to rein in rapid credit growth and manage financial stability risks.

Against the backdrop of moderate but slowing growth, subdued inflation, and recent financial market volatility, central bank policy will remain accommodative for the foreseeable future. Monetary policy tightening is well advanced in the United States and the Federal Reserve has indicated it will patient in raising interest rates further. The European Central Bank ended asset purchases in 2018 but will not begin raising interest rates in the near-term, while the Bank of Japan is expected leave policy unchanged for some time.

FIGURE 1  
**Real GDP Growth**  
Per cent change



Source: IMF

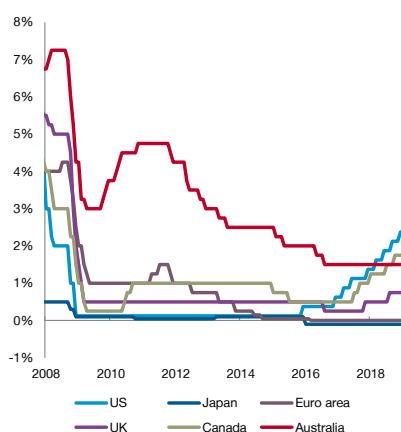
## Equity market volatility signals deteriorating investor sentiment

Equity prices declined significantly in the December quarter. Although equity markets have largely recovered in early 2019, concern over the impact of US-China trade tensions, and uncertainty over the pace of the slowdown in China and the flow on effects for global growth have the potential to further weigh on investor sentiment.

Despite the increased risks to outlook for the global economy and financial markets, we expect demand for commercial property assets will remain robust as strong leasing market conditions, particularly in Sydney and Melbourne, support income growth.

Commercial property assets remain an appealing investment option for institutional investors such as pension funds and fund managers. Commercial property assets deliver stable bond-like returns that are relatively attractive in a low interest rate environment. Commercial property assets are also attractive for investors looking to enhance diversification in investment portfolios given the relatively low correlation between returns to commercial property and other financial assets such as bonds and equities.

FIGURE 2  
**Central Bank Policy Rates**  
Per cent

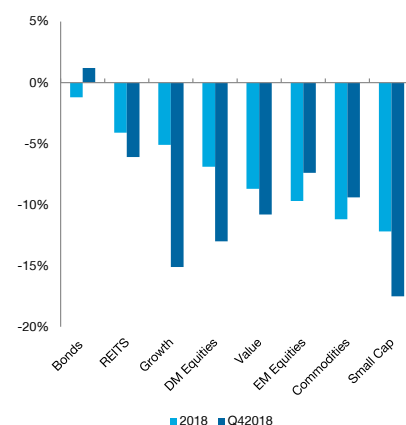


Source: RBA

## Market implications

- Global growth is slowing but is not expected to deteriorate sharply.
- Monetary policy will remain accommodative, keeping borrowing costs low.
- Investor demand for commercial property should remain resilient to deteriorating investor sentiment, supported by strong conditions in occupier markets.

FIGURE 3  
**Asset Class Returns**  
Total return in local currency, per cent change



Source: JP Morgan Asset Management

# DOMESTIC MACRO THEMES

## More balanced growth as resource states return to form

Growth across the states is becoming more synchronised. States such as Queensland and Western Australia with significant exposure to the resources sector are recovering as the downturn in mining investment stabilises. Meanwhile, the buoyant growth seen in New South Wales and Victoria in recent years is expected to moderate, driven by the downturn in housing construction and lower levels of migration.

Growth in Queensland accelerated sharply in FY2018 and is forecast to speed up further in FY2019 to be well above the national average. Activity is being supported by a recovery in trade-exposed sectors, particularly tourism and resources, following the depreciation of the Australian dollar in 2018.

Western Australia is also recovering but at a slower pace. After contracting in FY2017, the state returned to growth in FY2018 but remained significantly below the national average. Growth is expected to accelerate to around 4% in FY2019 and FY2020, supported by the ramp up in LNG production.

## Consumption headwinds to keep interest rates low in Australia

The RBA has identified household consumption as a key source of uncertainty for the economic outlook. Although wage growth has picked up a little as labour market conditions improve, it remains weak by historical standards and is expected to remain subdued as labour market slack diminishes only gradually.

Despite weak income growth, household consumption continues to be relatively stable. Indeed, growth in consumption has outpaced that of household disposable income as households save less. Looking ahead, this is not sustainable over the longer-term and weak income growth is likely to restrain household consumption. Falling housing prices, particularly in Sydney in Melbourne may also adversely affect household sentiment.

Subdued wage growth and the associated muted inflationary pressures will provide the RBA scope to keep interest rates at record lows for a considerable period of time, thus providing a substantial silver lining for property investors, as a result of the consumption headwind.

## Market implications

- Stronger growth in Queensland and Western Australia will lead to improved office leasing market conditions, supporting income growth.
- Weak growth in household income poses a downside risk to growth in Australia.
- Solid employment growth should continue to underpin strong conditions in occupier markets.
- Record low interest rates in Australia will continue to support commercial property investment by keeping borrowing costs low.

FIGURE 4  
Real GDP and GSP Growth  
Financial year-end, per cent change



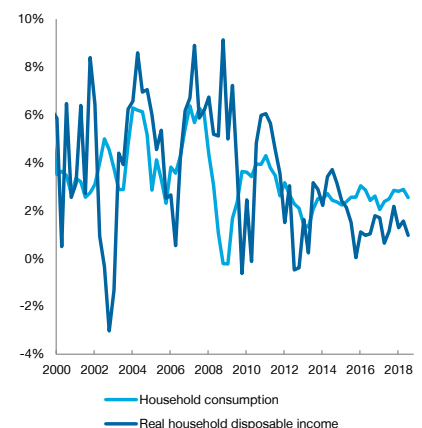
Source: BIS Oxford Economics

FIGURE 5  
Australian Dollar  
AUD/USD



Source: RBA

FIGURE 6  
Household Income and Consumption  
Per cent change (YoY)



Source: RBA

# INVESTMENT MARKET DYNAMICS

## Total returns to ease in 2019 as broad-based yield compression comes to an end

Yield compression has been ubiquitous in recent years as the rising tide of growing investor demand, accompanied by accommodative credit conditions, has seen yields on prime property across all sectors bid down to record lows.

In our view, the pace of yield compression and consequently capital value growth are likely to slow in 2019. And as a result, performance will become more varied and depend to a greater extent on rental growth and asset specifics. Skilled operators, focussed on assets with rental growth potential, will out-perform in this environment, as the market transitions to a new phase.

Slowing capital growth will weigh on total returns over the next few years. Total return for commercial property is forecast to decline from 10.3% in 2018 to around 9% in 2019 and 8% in 2020. Capital growth should slow from 4.6% in 2018 to 3.6% in 2019 and 2.8% in 2020, while growth in income is likely to slow slightly.

## 2019 to see more variability in performance by sector

Sector performance will become more variable in 2019 as capital value growth slows. After a period of significant capital growth, returns on office property will slow. However, strong demand and tight supply in Sydney and Melbourne, and improving leasing market conditions in Brisbane and Perth should support income growth. From the elevated levels seen in recent years, total return on office property is expected to slow from 13.7% in 2018 to 11.7% in 2019 and 10.3% in 2020 as capital growth moderates.

Industrial property should perform relatively well driven by strong demand for warehousing space partly reflecting the rapid growth of e-commerce. Total returns are forecast to slow from 14.8% in 2018 to around 13.4% in 2019 and 12.6% in 2020.

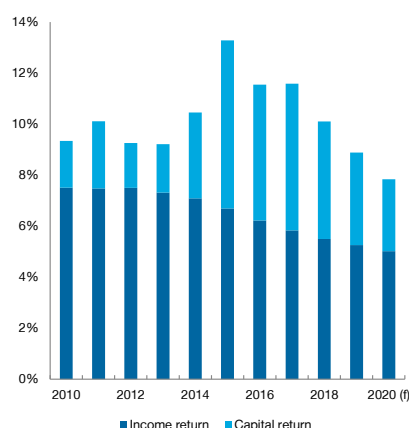
The retail sector will continue to struggle overall although with significant variation across the sector. Total returns will decline from 6% in 2018 to around 5% in 2019, and 4.2% in 2020 as capital value growth declines.

## Sustained demand to keep investment volumes high

Office and retail investment volumes hit a record highs in 2018, while investment in industrial property increased compared with 2017. Office investment was driven by Oxford Properties' \$4.3 billion acquisition of the Investa Office Fund portfolio, REST Super's purchase of a 33% stake in 50 Bridge Street (\$900 million), and Charter Hall's \$800 million acquisition of 10 and 12 Shelley Street. Super funds and fund managers continue to be a significant driver of investment activity, accounting for around 40% of office investment volumes in 2018.

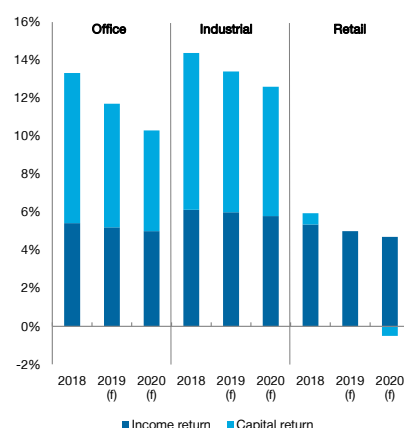
Investor demand for commercial property will continue to be robust in 2019 and 2020, although investment volumes should slow as investors find attractive opportunities harder to come by due to lower future capital growth after period of significant yield compression. Rising allocations to commercial property among super funds and the ongoing search for yield in a low interest rate environment will continue to support investment.

FIGURE 7  
Commercial Property Returns  
Total return, per cent change



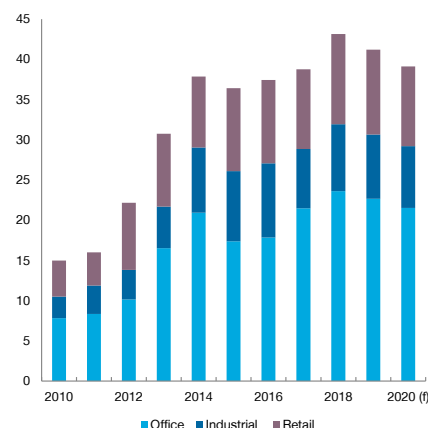
Source: MSCI

FIGURE 8  
Returns by Segment  
Total return, per cent change



Source: MSCI

FIGURE 9  
Investment Volumes  
\$ billion



Source: Knight Frank Research, RCA

# OFFICES: THEMES & PREDICTIONS

## Ongoing tight supply in Sydney and Melbourne mitigates downside risk

Yield compression has been ubiquitous in Sydney and Melbourne for several years. This has been the key driver of persistently strong investment returns, with 2018 marking five consecutive years of double digit returns in both markets. After such a sustained period of capital growth, many are now asking whether the good news is already fully priced in and questioning the sustainability of current yield levels.

However, persistently tight supply in the leasing market is likely to assuage these concerns during 2019. Yield compression may well come to an end, but with vacancy near record lows, at 4.6% in Sydney and 3.6% in Melbourne, and a thin development pipeline for 2019, the scene is set for further rental growth that will keep values well supported.

## Return to effective rental growth in Brisbane and Perth

After a protracted period of high vacancy, improving employment data and faster economic growth have fed through to improved leasing market sentiment in Brisbane and Perth. In

addition, Western Australia is now seeing the prospect of a return to exploration and investment activity in extractive industries, which has spurred improved confidence in the outlook. High vacancy disguises a rapidly tightening prime market. This is driving down incentive levels in Perth, causing a long awaited return to effective rental growth. Brisbane is also seeing growth starting to appear in the form of face rental uplift.

Improving sentiment is now driving increased investor interest, and we expect the relative value proposition and potential yield arbitrage will drive rising demand from both domestic and offshore groups.

## Forecast net face rental growth 2019-23

City	Face rental growth 2019-23
Sydney	23%
Melbourne	21%
Brisbane	14%
Perth	11%
Adelaide	11%

Our outlook for rental growth remains positive across all markets, with Sydney continuing to lead the way owing to structural undersupply that

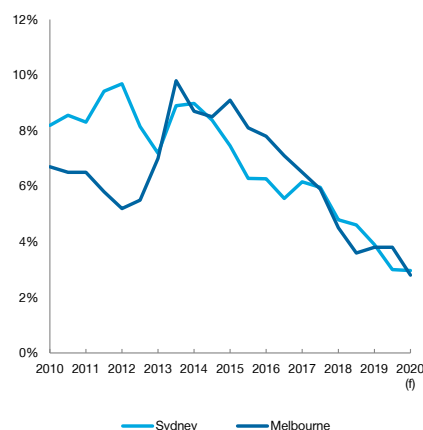
will persist over the forecast period. To alleviate cost pressures, Sydney requires a substantial injection of speculative new supply beyond the quantum projected over the next five years.

While rents in Melbourne are clearly more affordable, its supply pipeline is far more substantial. We expect Melbourne to see faster growth in 2019, but the pace will slow as more supply is delivered through 2020 and 2021. Brisbane is now seeing face rental growth and we expect this to be sustained, while Perth and Adelaide are likely to see effective growth coming through lower incentives in the first instance.

## Emerging urban fringe markets in focus

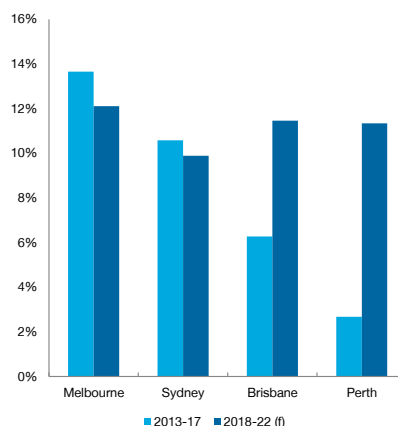
As the market transitions to rental growth as the key driver of returns, investor attention will increasingly focus on the emerging urban fringes of Sydney and Melbourne where the pace of growth is strongest at present. Markets such as Pymont, Surry Hills and Alexandria in Sydney, and in Richmond, Cremorne and Collingwood in Melbourne will benefit as tenants increasingly seek an alternative offering to the traditional CBD environment, with the added benefit of escaping escalating rental pressures in these supply constrained markets.

FIGURE 10  
Vacancy Rates  
Per cent of total stock



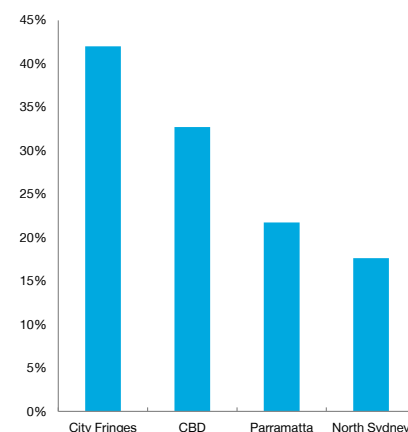
Source: PCA, Knight Frank Research

FIGURE 11  
Total Employment Growth  
Total over five year period



Source: Oxford Economics

FIGURE 12  
Rental Growth in Sydney markets  
Total over past two years—net effective basis



Source: Knight Frank Research



# INDUSTRIAL: THEMES & PREDICTIONS

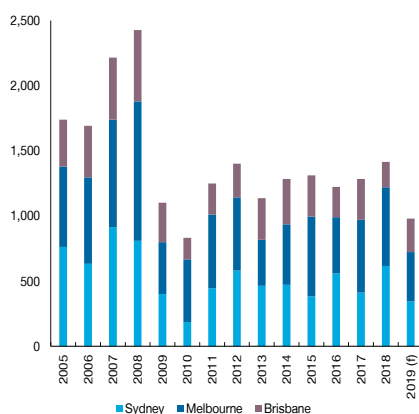
## Search for stock to drive strong demand for portfolios

Industrial assets continue to gain favour with institutional investors diversifying from office and retail assets, underpinned by the increasing sophistication of the sector. This evolution of both tenant quality and the industrial built form has arisen as supply chain management has matured, particularly over the past five years. Initially this was cost mitigation but more recently as a response to delivery time pressures of omni-channel retailing.

The increasing corporatisation of the logistics sector and widespread use of 3PL for both B2B and B2C fulfillment means there is now a large pool of national and international tenants occupying substantial, modern facilities – all highly desirable to institutional investors.

Despite the increasing size of major distribution facilities, lot size remains a stumbling block for core, largely offshore, investors with acquisition by portfolio the preferred method to gain scale. This has seen a premium paid for portfolios rather than a discount as is common in other asset classes. This high level demand for portfolios will remain strong in 2019 and spur the amalgamation and curation of balanced portfolios either for FUM or to on-sell for a premium.

FIGURE 13  
East Coast Industrial Supply  
'000sqm new construction by location



Source: Knight Frank Research/Cordells

## Investors exploring options to grow FUM beyond the development pipeline

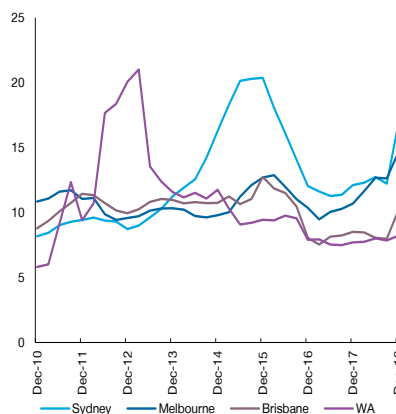
Larger domestic institutions have actively grown FUM via their development pipelines with development profits subsumed to the internal demand for investment product. With much of the immediate land supply held by a few such developers, alternative sources of investment are being actively sought to facilitate new entrants to the market.

Analysis of Real Capital Analytics data shows institutional investor penetration into the industrial market of c\$31billion out of an investment environment (\$15million+ assets) of c\$50billion—an ownership level of c62%, with the top 20 investors accounting for \$25billion.

A significant portion of the investment universe therefore remains available for institutional acquisition. The pool may be reduced by functional obsolescence in some older, privately held assets. Nevertheless, the acquisition and repositioning of properties to form balanced portfolios will be an avenue to increase FUM.

Additionally, with syndicators active while other market participants were more tentative in 2011-2013 there will be assets rolling out of syndications, potentially available for incorporation into portfolios.

FIGURE 14  
Australian Industrial Returns  
Per cent rolling annual total return by location



Source: MSCI

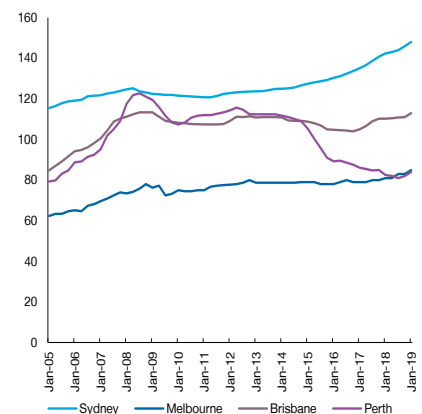
## Positive rental growth to spur greater speculative development

The sustained period of lower industrial construction post-GFC has combined with steadily improving tenant demand to drive vacancy to 5.5 year lows across the East Coast. As a result rental growth has been well in evidence across both the Sydney and Melbourne markets with 4.1% and 4.3% y-o-y increases to net face rents respectively to January 2019. Brisbane rents grew by 2.5% as the market balance began to return to landlords, while Perth rents increased by 1.7%.

This has, and will continue to, spur greater speculative development rather than developers holding out for a pre-commitment. The immediacy of demand and potential to maximize rental levels from speculative construction has seen it increase to 40% of building activity in the East Coast in 2018, up from 29% in 2017.

This is now starting to grow construction with Sydney recording a 10 year high in 2018. Tenant acceptance of higher rents and the expectation that rental growth is entrenched in Sydney and Melbourne, building in Brisbane, and emerging in Perth, underpins the sector's attractiveness to investors as market attention turns from capital growth to rental growth.

FIGURE 15  
Industrial Rents  
\$/sqm net face rent



Source: Knight Frank Research

# RETAIL: THEMES & PREDICTIONS

## Retail under pressure

The outlook for retail is generally weaker than other sectors as it grapples with structural changes such as the shift to online shopping and changes in consumer spending patterns. Persistently weak wage growth and falling housing prices also pose downside risks to household consumption.

## Polarisation in performance to continue

While the retail backdrop is challenging, conditions within retail segments vary significantly, reflecting changing consumer patterns. As a share of the total, retail trade in the food, and cafes & restaurants segments has increased by a little over 2.5 percentage points each since 2000. By contrast, share of total retail sales accounted for by department stores has declined by 3.8 percentage points over the same period, while the shares for household goods, and clothing & footwear has fallen by a little over half a percentage point each.

Consistent with changing consumer preferences, there has been considerable divergence in the performance of retail assets in recent years. Capital growth has been stronger at large regional shopping centres compared with mid-sized and smaller

centres and neighbourhood retail. MSCI's "other" retail segment, which includes higher quality and specialty retail in the major city centres has significantly out-performed the broader sector in recent years.

Retail will come under further pressure over the next few years. Yields on retail property in Australia remain low. By contrast, yields in some major economies such as the United Kingdom have widened significantly. The shift to online retail is relatively well advanced in the UK with online trade accounting for around 20% of total retail sales compared with a little under 10% in Australia. Online retail has considerable scope to grow further in Australia and presents an ongoing headwind to the retail property sector. To adapt to this trend, retailers are increasingly combining online and in-store shopping by providing "click-and-collect" services, providing customers with the convenience of online shopping while encouraging impulse purchases at the physical store.

In this environment, yields on retail property will likely widen, particularly for mid-sized and smaller regional shopping centres. However, specialty retailers and retail spaces that focus on enhancing customer experience still have the potential to outperform.

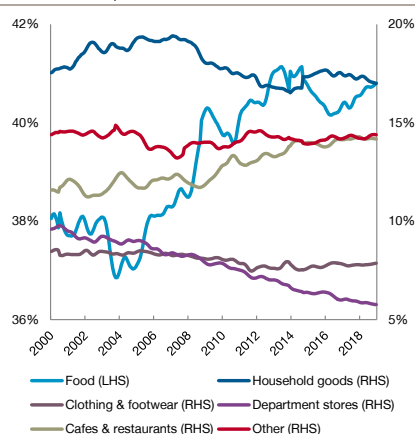
## Focus on consumer experience

A key trend emerging in response to the headwinds facing the retail sector is an increasing focus on consumer experience and lifestyle retailing within shopping centres. Diversifying tenant mix by incorporating services such as gyms, medical centres and entertainment has the potential to improve customer experience. Integrating technological innovation from artificial intelligence to augmented reality into the traditional retail experience will also become increasingly prevalent as retailers try to find new ways of attracting consumers.

## Tourism boom supporting CBD and luxury retail

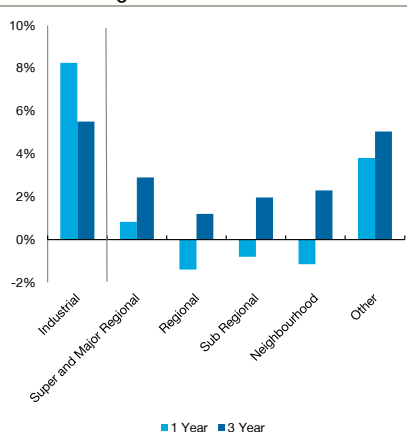
The tourism boom in Australia is supporting the retail sector, contributing to the relatively strong performance of luxury and higher-quality retail in the major city centres. The number of short-term arrivals in Australia and net tourism-related receipts are at record highs. The depreciation of the Australian dollar over 2018 and the increasing number of direct flight routes are expected to continue to support tourism, with positive flow-on effects to the retail sector. Over the longer-term, the rapid increase in economic development and household wealth across the Asian region will provide an ongoing tailwind to the tourism and retail sectors.

FIGURE 16  
Retail Trade by Segment  
Share of total, trend



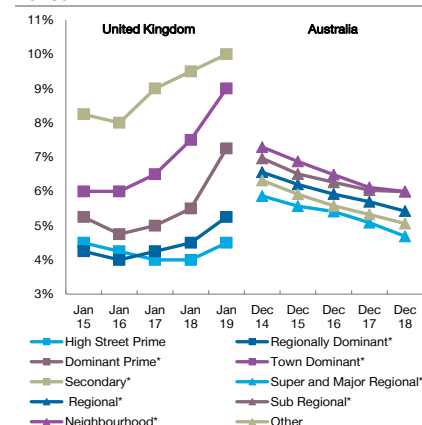
Source: ABS

FIGURE 17  
Capital Growth by Segment  
Per cent change



Source: MSCI

FIGURE 18  
Retail Property Yields  
Per cent



\* Shopping centres

Source: Knight Frank Research, MSCI



# ALTERNATIVES

## PBSA: from uncertainty to destiny

Hidden deep within the Treasury's 330 page 2018/19 Mid-Year Economic and Fiscal Outlook it was made clear that the maturing student housing sector is to be classed as "commercial residential" real estate and not subject to an increased tax. Prior to the announcement the Federal government released draft plans to tax foreign investment in the sector at double the usual rate of 30%. Development of the PBSA sector is fostering growth in international students within Australia, and the importance of international students to the economy contributed to the government's decision.

The waves of development and flows of investment that the sector has seen over the past five years have been piloted by foreign capital. Significant growth of 105,000 full time overseas higher education student enrolments since 2012, and by 36,000 over the 2017, continues to support the investment thesis into Australia's student housing sector. The surprise prospect of a doubling of the tax rate for foreign investors triggered anxiety, as local operators feared the tightening of the overseas liquidity tap. Since 2014, foreign capital from North America, Europe, the Middle East and Asia has spearheaded the development of over 25,000 new purpose built, predominantly direct let, student beds across Australia. That same capital is

funding the delivery of a further 10,000 PBSA beds across Australia's four most active capital cities within the next two years. Renewed certainty around the MIT legislation will provide greater clarity for investors looking to fund the ongoing delivery of PBSA.

## Domestic capital to favour University partnerships

Domestic capital, through infrastructure funds, has emerged as favouring income strip or concession style arrangements, and not direct let operators. One of the largest placements of capital during 2018 saw AMP Capital, through its AMP Capital Diversified Infrastructure Trust (ADIT) enter into a \$300 million, 40-year student residences contract with the University of Melbourne. The long-term arrangement comprises a total of 954 beds across two facilities being refurbished and constructed at the University's Parkville campus. The concession includes the responsibility for facilities management services whereas the University retains operational responsibility.

We foresee further expansion in this space as universities seek additional sources of funding to develop their campuses. We expect domestic capital to dominate these transactions as they are viewed as less risky and place long term money which suits superannuation fund mandates.

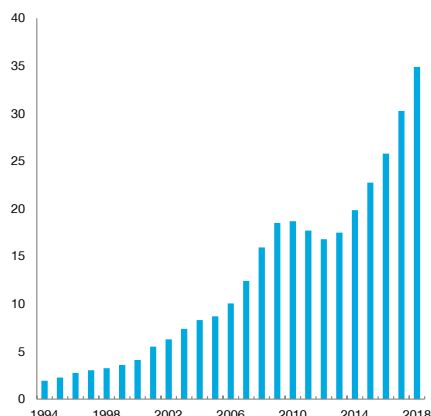
## Build-to-Rent at scale remains a distant utopia

The fledgling Build-to-Rent (BTR) sector remains without clear legislation and direction. Widely regarded as a sensible decision to recognise PBSA as commercial residential housing, BTR has not had such luck. Foreign investment into this sector is subject to the 30% concessional tax rate, contributing to the assets' lack of financial viability.

The number of households living in a rented dwelling across Australia has increased by over one million during the past 25 years, implying demand for BTR product. The growth in rented dwellings has accelerated over the past five years, with the 2016 ABS Census recording a compound increase of 52,770 new rented dwellings per year since 2011, outstripping the formation of owner occupied households.

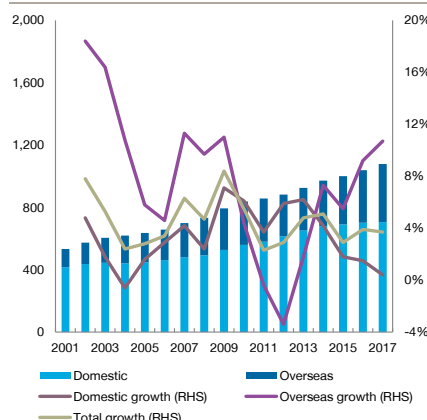
Growth in the number of rented dwellings and increasing residential property prices has seen the value of the Australian rental sector soar by \$770 billion over the past five years. The total value of Australian residential dwellings is estimated to be \$6.9 trillion, broadly valuing rental housing at \$2.1 trillion. If the BTR sector does eventuate, and progresses at the speed observed in the UK, whereby 1% of total rental supply becomes BTR stock, the Australian BTR sector easily could be worth \$21 billion within the next decade.

FIGURE 19  
International Students' Contribution to the Economy



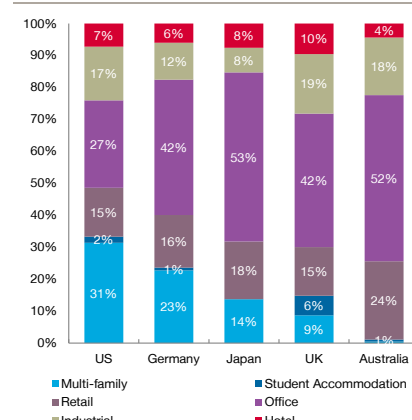
Source: Knight Frank Research, ABS

FIGURE 20  
Higher Education Student Enrolments  
Full-time students



Source: Knight Frank Research, Department of Education and Training

FIGURE 21  
Investment Volume by Segment  
Share of total volume in 2017 and 2018



Source: RCA

## RESEARCH

### Ben Burston

Head of Research & Consulting  
+61 2 9036 6756  
[Ben.Burston@au.knightfrank.com](mailto:Ben.Burston@au.knightfrank.com)

### Jennelle Wilson

Partner, Queensland Research  
+61 7 3246 8830  
[Jennelle.Wilson@au.knightfrank.com](mailto:Jennelle.Wilson@au.knightfrank.com)

### Chris Naughtin

Associate Director, Research  
+61 2 9036 6794  
[Chris.Naughtin@au.knightfrank.com](mailto:Chris.Naughtin@au.knightfrank.com)

## CAPITAL MARKETS

### Ben Schubert

Joint Head of Institutional Sales, Australia  
+61 2 9036 6870  
[Ben.Schubert@au.knightfrank.com](mailto:Ben.Schubert@au.knightfrank.com)

### Paul Roberts

Joint Head of Institutional Sales, Australia  
+61 2 9036 6872  
[Paul.Roberts@au.knightfrank.com](mailto:Paul.Roberts@au.knightfrank.com)

### Paul Henley

Head of Commercial Sales  
+61 3 9604 4760  
[Paul.Henley@au.knightfrank.com](mailto:Paul.Henley@au.knightfrank.com)

### Dominic Ong

Head of Asian Markets  
+61 2 9036 6747  
[Dominic.Ong@au.knightfrank.com](mailto:Dominic.Ong@au.knightfrank.com)

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