RESEARCH

MELBOURNE INDUSTRIAL

MARKET OVERVIEW JULY 2018

HIGHLIGHTS

Pre-lease activity reached an all-time high in 2017 as the flight to purpose-built facilities continues. Nevertheless, demand for cost-effective existing stock has pushed up face and effective rents.

The shortage of industrial land has placed upward pressure on land values and has also made way for new industrial land outside of the metropolitan area.

Despite the scarcity of investment opportunities, investors in the industrial sector remained active, causing further yield compression in both prime and secondary markets.

MARKET DRIVERS

Population Growth
Aust: 1.6%   VIC: 2.3%
ABS Dec 16 to Dec 17

Economic Growth
Aust: 2.0%   VIC: 3.3%
ABS 2016-17

Retail Trade
Aust: 2.5%   VIC: 4.2%
ABS May 17 v May 18

Engineering Construction
Aust: 13.7%   VIC: 48.7%
ABS Mar 17 v Mar 18

Infrastructure Spending
VIC State Budget 2018/19: $13.7 bil

JANE WONG
Research Analyst

ECONOMY & DEMAND

A healthy economy and the rise of E-commerce has strengthened tenant demand in Melbourne’s industrial market.

Victoria’s economy boosts Melbourne’s industrial market performance

A number of positive economic indicators have played a key role in Melbourne’s industrial market performance over the course of 2017 and 2018 to date. To demonstrate, Victoria’s population growth is currently the strongest in the nation, with an increase of 143,000 people in the 12 months to December 2017; interest rates have remained at 1.50% since August 2016; and Victoria’s total employment grew by 2.1% in the 12 months to May 2018.

Strong population growth reaffirms the importance of infrastructure investment for job creation and economic growth. At present, the government is investing in $55.1 billion worth of infrastructure projects across Victoria, the largest valued at $16.5 billion (the North East Link). Of these projects, the $1.28 billion CityLink Tulla Widening is expected to complete in 2018.

Altogether, these projects will create a positive impact for Melbourne’s industrial market in the long term, with most, if not all projects improving road connectivity and reducing congestion across all industrial precincts.

Industry 4.0 changing the industrial landscape

Short for the fourth industrial revolution, Industry 4.0 refers to the creation of ‘smart factories’—factories with improved automation, machine-to-machine communication and machine-to-human communication, all thanks to technology. This has had a direct impact on the industrial market, with tenants changing their requirements to capitalise on the industrial market’s increasing capability and landlords adapting to such needs.

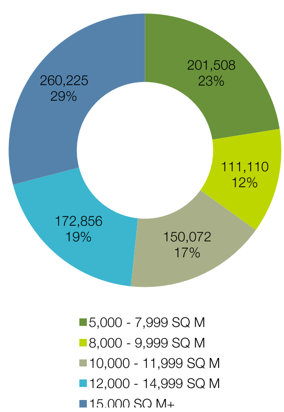
E-commerce and Manufacturing sectors lift demand for industrial space

Quarterly take-up levels (5,000 sq m+) have remained above the historical average since the second half of 2016, with leasing activity for existing and speculative stock totalling 804,445 sq m in the 12 months to July 2018 .

The E-commerce sector has heavily influenced take-up levels over the past year, having grown exponentially as consumers access the internet more regularly and choose to shop online more often in today’s digital age. Australia Post reports that Australians spent $21.3 billion in online shopping in 2017, an 18.7% increase from the year before.

Demand from the Manufacturing sector has also grown in recent months after a sustained period of relatively low activity in 2017, headlined by the closure of major car manufacturers across Victoria. The growth was led by improvements in new orders, exports and employment.

FIGURE 1
Melbourne Industrial Take-Up
% of total area leased by size bracket—12 months to July 2018
Exc D&C commitments



Source: Knight Frank Research

VACANCY & RENTS

Limited vacancy additions causes vacancy to fall

Melbourne's industrial vacant space (5,000 sq m+) currently totals 720,193 sq m, having declined by 6.6% over Q2 2018. Take-up levels over the quarter were relatively similar compared with that of the previous quarter, indicating that the fall in vacancy over Q2 2018 was driven by limited vacancy additions.

With tenants opting for well located, modern facilities, prime vacancy fell to its lowest in four years. Prime grade stock accounted for 61% of total take-up in the 12 months to July 2018.

New supply levels to fall in 2018

Given the growing demand for industrial space, gross new supply (5,000 sq m+) in 2017 totalled 547,850 sq m, a 27% increase from the previous year. The West delivered the bulk of new supply (42%), the largest completion being Target's purpose-built distribution centre (63,000 sq m) at Drystone Industrial Estate, Truganina.

Looking forward, gross new supply in 2018 is anticipated to fall back to below-historical average levels, influenced by industrial land supply decreasing across metropolitan Melbourne. 449,999 sq m of new supply is expected to be supplied in 2018, 53% of which has reached completion, comprising mostly of pre-leased facilities in the West.

Strong tenant demand triggers rental uplift

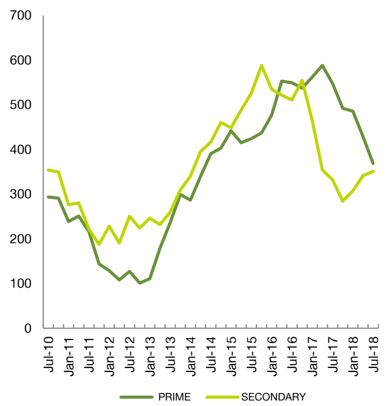
Strong leasing activity saw average prime net face rents (excluding the City Fringe) increase by 5% in the 12 months to July 2018, now $83/sq m. Prime incentives currently average 16.1%, down from 25% a year ago, bringing average prime effective rents to $68/sq m (12.5% y-o-y growth). In the secondary market, average net face rents rose by a modest 9.7%, now $68/ sq m, although incentives fell marginally, bringing average secondary effective rents to $58/ sq m (12% y-o-y growth).

With tenant demand showing no signs of slowing down, the supply and demand imbalance will see rents steadily increase in the short-term.

Rents, Incentives & Outlook

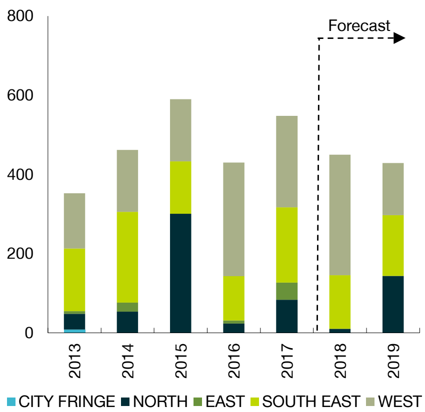
Prime	$83/sq m 5.0% gth y-o-y 16.1% incentive	↗
Secondary	$68/sq m 9.7% gth y-o-y 14.8% incentive	↗

FIGURE 2
Melbourne Industrial Vacancy
'000 sq m prime v secondary available space



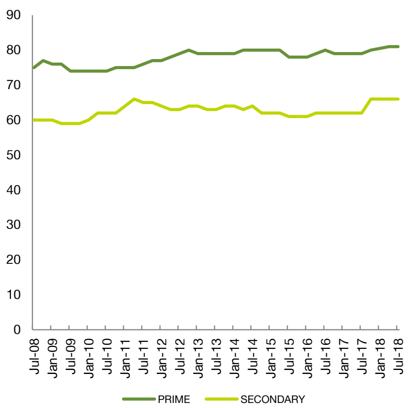
Source: Knight Frank Research

FIGURE 3
Melbourne Industrial New Supply
'000 sq m gross new industrial construction



Source: Knight Frank Research/Cordell Connect

FIGURE 4
Melbourne Industrial Rents
Net face rents by grade ($/sq m) exc City Fringe



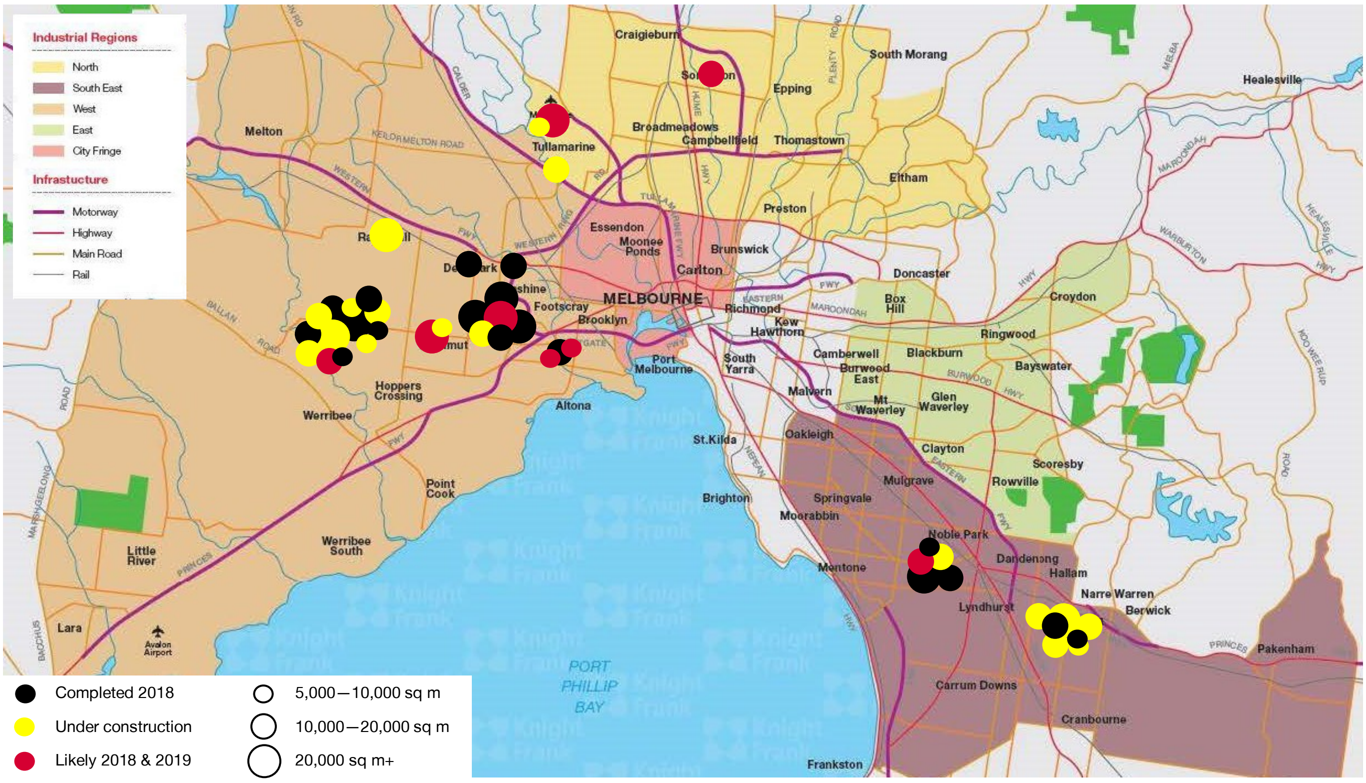
Source: Knight Frank Research

TABLE 1
Recent Leasing Activity Melbourne

Address	Region	Net Rent $/sq m	Area	Term (yrs)	Tenant	Date
24-32 Stanley Dr, Somerton	N	82.50	14,251	5	Regent RV	Q2-18
West Park Industrial Estate, Truganina*	W	U/D	23,199	U/D	CEVA Logistics	Q2-18
The Key Industrial Estate, Keysborough*	SE	90.00	7,357	5	GH Cabinets	Q1-18
M2 Industry Park, Dandenong South^	SE	U/D	18,000	10	Dulux	Q4-17
27-43 Toll Dr, Altona North	W	79.50	16,299	3	Storage Material Handling Group	Q3-17

CF City Fringe N North E East SE South East W West *Speculative ^Pre-lease
Source: Knight Frank Research

DEVELOPMENT & LAND VALUES



Land values rise in response to land shortage and yield compression

Strong tenant demand, the ongoing rezoning of existing industrial land for mixed-use/residential-use and the delayed time of getting new industrial land onto the market have presented the industrial market with an underlying problem: a lack of development-ready sites.

All of the above, coupled with rising capital values on the back of yields compressing, have resulted in an increase in land values, with overall land values (excluding the City Fringe) for small-sized lots (<5,000 sq m) growing by 61% in the 12 months to July 2018, and by 49% in medium-sized lots (1-5 ha). Growth was the most prominent in the South East and North.

Looking ahead, land values are expected to continue rising on account of diminishing land supply and strong development activity. In fact, users have begun venturing beyond metropolitan Melbourne to fulfill their facility needs, with MAB delivering large turnkey developments for Dulux and D'Orsogna in Merrifield Business Park, Mickleham, and Bertocchi Smallgoods expanding its operations into regional Victoria within the next year.

D&C activity remains competitive

Driving the strong tenant demand in 2017 has been the buoyant design & construct (D&C) market, totalling a series high of 336,606 sq m, and absorbing much of available serviced land. In 2018, D&C levels are forecast to total 202,856 sq m, with 52% already completed and 11% currently under construction. The Manufacturing sector is set to account for the majority of new D&C facilities (completed and currently under construction) at 46%.

Land Values & Outlook

<5,000 sq m	$391/sq m 61% gth y-o-y
1-5 ha	$261/sq m 49% gth y-o-y

TABLE 2
Recent Land/Development Sales Activity Melbourne

Address	Region	Price $ mil	Area (sq m)	$/sq m	Purchaser	Sale Date
285 Palmers Rd, Truganina	W	28.00	275,000	102	LOGOS Property	Jul-18
442-540 Doherty's Rd, Truganina	W	55.35	580,000	95	Charter Hall	Apr-18
13-36 Doherty's Rd, Laverton North	W	19.00	230,000	83	Time & Place Commercial	Mar-18
16 Bate Dr, Braeside	SE	19.00	230,000	83	Frasers Property	Feb-18

CF City Fringe N North E East SE South East W West
Source: Knight Frank Research

INVESTMENT ACTIVITY & YIELDS

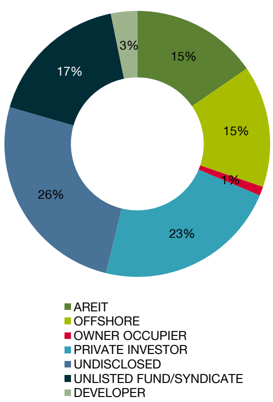
Current Yields & Outlook

Prime	6.15% - 6.85% -38 bps 12 mths	
Secondary	6.80% - 7.80% -93 bps 12 mths	

Sales volumes fall as less stock gets offered

Over the 12 months to July 2018, sales volumes ($10 million+) totalled $1.1 billion across 44 transactions in Melbourne's industrial market. This compares with $1.7 billion across 65 transactions over the 12 months prior.

FIGURE 5
Melbourne Industrial Sales ($10 mil+)
By purchaser type—12 months to July 2018



Source: Knight Frank Research

The lower sales volumes levels over the 12 months to July 2018 had more to do with a lack of available stock rather than a lack of investor appetite, as investors hold on to their assets in anticipation for more asset recycling opportunities.

Growing confidence in private investors

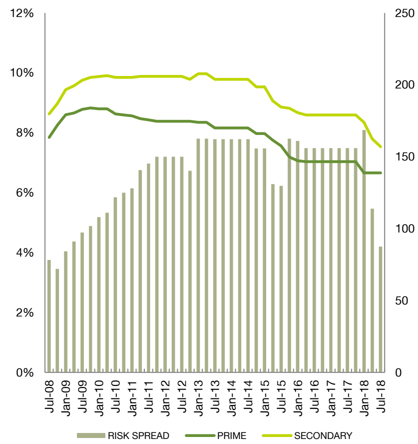
Heightened demand for industrial space and significant investment in Victoria's infrastructure have seen private investors increase their exposure in the industrial sector over the 12 months to July 2018, accounting for the majority of sales volumes by purchaser type (disregarding undisclosed purchasers) over the period at 23%.

Transactions made by private investors were characterised by properties with secure tenancies and medium- to long-term development upside. The largest transaction was Harry Stamoulis' acquisition of the Woolworths Distribution Centre at 522-550 Wellington Road, Mulgrave for $90.75 million on a 5.18% initial yield.

Yields tighten on investor demand

The appeal of industrial properties to investors, combined with the limited stock on offer, has resulted in prime yields compressing by 38 basis points in the 12 months to July 2018 to currently range between 6.15% and 6.85%.

FIGURE 6
Melbourne Industrial Yields
% core market yield (LHS) & bps premia (RHS)



Source: Knight Frank Research

Secondary yields compressed over the same period as well, although to a higher extent, given higher investment activity levels in the secondary market. Compressing by 93 basis points, secondary yields currently range between 6.80% and 7.80%.

The risk spread between the two markets now sits at 88 points, the tightest it has been in 11 years.

With local and offshore investors still looking to expand their foothold in the performing industrial market, it is likely that yields will experience further tightening.

TABLE 4
Recent Improved Sales Activity Melbourne

Address	Region	Price $ mil	Bldg Area (sq m)	Core Mkt Yield (%)	WALE (yrs)	Vendor	Purchaser	Sale Date
169 Australis Dr, West Park Industrial Estate, Derrimut	W	34.00	30,993	6.84	3.0	Abacus	Ascendas REIT	Jun-18
6 Albert St, Preston	N	30.10	20,531	6.25	2.7	Centuria Industrial REIT	U/D	Jun-18
36-42 Hydrive Cl, Dandenong South	SE	19.45	14,635	6.22	U/D	LOGOS Property	Investec	Apr-18
86-102 Whiteside Rd, Clayton South	E	15.50	8,000	4.44*	U/D	Virtus Property Group	Local developer	Mar-18
121-139 Dohertys Rd, Altona North^	W	38.15	30,388	6.25	6.6	Dexus	APPF Industrial	Jan-18

Source: Knight Frank Research CF City Fringe N North E East SE South East W West * Initial yield U/D Undisclosed ^ Myer Distribution Centre

PRECINCT HIGHLIGHTS

City Fringe

Vacancy

Prime:	N/A*
Secondary:	14,000 sq m

Land

<5,000 sq m:	N/A
1-5 ha:	N/A

Rents

Prime:	$120/sq m
Secondary:	$100/sq m

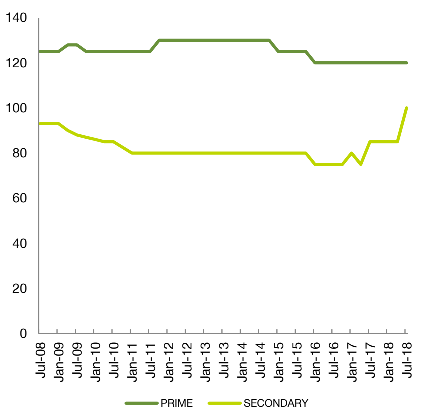
Yields

Prime:	5.50% - 6.25%
Secondary:	6.00% - 6.75%

*No vacancy

- The ongoing lack of available 5,000 sq m+ space is seeing tenants being pushed out to other precincts to have their requirements fulfilled.
- Strata units are being sold more frequently in the City Fringe.
- The City Fringe remains an important industrial precinct, given its close proximity to Port of Melbourne and the West Gate Bridge.

FIGURE 7
City Fringe Industrial Rents
Net face rents by grade ($/sq m)



Source: Knight Frank Research

North

Vacancy

Prime:	55,443 sq m
Secondary:	46,846 sq m

Land

<5,000 sq m:	$400/sq m
1-5 ha:	$300/sq m

Rents

Prime:	$83/sq m
Secondary:	$72/sq m

Yields

Prime:	6.50% - 7.00%
Secondary:	6.75% - 7.75%

- The North accounted for 43% of take-up in Q2 2018, stemming from the Transport, Postal & Warehousing, Manufacturing and Retail Trade sectors.
- Vacancy additions were a result of previous 5,000-6,000 sq m users expanding and relocating within the North.
- Majority of industrial land sales have been concentrated in Epping.

"The Food Manufacturing sector has been fast-growing in Melbourne's northern growth corridor in the City of Hume and the City of Whittlesea."

Marco Sandrin
Director

East

Vacancy

Prime:	9,260 sq m
Secondary:	124,425 sq m

Land

<5,000 sq m:	N/A
1-5 ha:	N/A

Rents

Prime:	$82/sq m
Secondary:	$63/sq m

Yields

Prime:	6.25% - 7.00%
Secondary:	7.00% - 8.25%

- The East is the most constrained precinct for land availability, with no further land supply additions anticipated over the forthcoming years.
- Investment activity in the past 12 months was spread across the entire precinct, with transactions taking place in Blackburn, Mount Waverley, Croydon South and Scoresby, among some.

Address:	1314 Ferntree Gully Road, Scoresby
Price:	$16.20 million
Sale Date:	May 2018
Vendor:	Owner occupier
Purchaser:	Ascendas REIT
Yield:	VP
Comment:	The property has strong underlying land value

South East

Vacancy

Prime:	78,828 sq m
Secondary:	81,076 sq m

Land

<5,000 sq m:	$600/sq m
1-5 ha:	$250/sq m

Rents

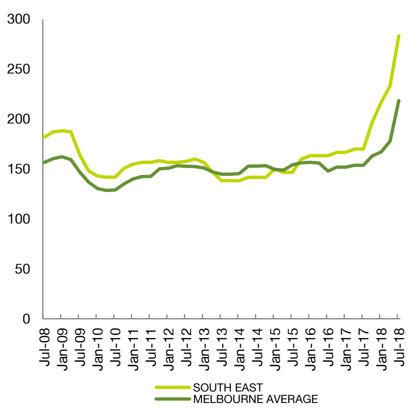
Prime:	$86/sq m
Secondary:	$64/sq m

Yields

Prime:	6.25% - 7.00%
Secondary:	7.00% - 8.25%

- Leasing activity over Q2 2018 was dominated by the Wholesale Trade sector.
- Similar to the East, land availability in the South East is expected to be tightly held, one reason for the significant uplift in land values.
- The South East remains an attractive location for owner occupiers.

FIGURE 8
South East Industrial Land Values
$/sq m v Melbourne average



Source: Knight Frank Research

West

Vacancy

Prime:	225,451 sq m
Secondary:	84,864 sq m

Land

<5,000 sq m:	$308/sq m
1-5 ha:	$228/sq m

Rents

Prime:	$82/sq m
Secondary:	$73/sq m

Yields

Prime:	6.25% - 7.00%
Secondary:	7.25% - 8.00%

- Gross new supply in 2018 is anticipated to total 304,217 sq m, 32% higher than what was delivered in 2017.
- Land sales activity has been robust, with more than 100 ha of industrial land sold since the start of 2018.
- The Victorian government has identified the West as having the greatest capacity to support industrial land expansion in the long-term.

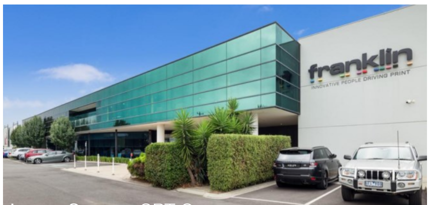


Image Source: GPT Group

Address:	25-33 Fourth Avenue, Sunshine
Price:	$74.00 million
Sale Date:	February 2018
Vendor:	The Taylor family
Purchaser:	GPT Group
Yield:	6.02% core market
Comment:	Four buildings, fully occupied by IVE Group

Definitions:
Core Market Yield: The percentage return/yield analysed when the assessed fully leased net market income is divided by the adopted value/price which has been adjusted to account for property specific issues (i.e. rental reversions, rental downtime for imminent expiries, capital expenditure, current vacancies, incentives, etc).
Prime Grade: Asset with modern design, good condition & utility with an office component 10-30%. Located in an established industrial precinct with good access.
Secondary Grade: Asset with an older design, in reasonable/poor condition, inferior to prime stock, with an office component between 10-20%.
WALE: Weighted Average Lease Expiry.
Vacancy Methodology:
This analysis collects and tabulates data detailing vacancies (5,000 sq m+) within industrial properties across all of the Melbourne Industrial Property Market. The buildings are categorised into 1) Existing Buildings – existing buildings for lease. 2) Speculative Buildings – buildings for lease which have been speculatively constructed and although have reached practical completion, still remain vacant. 3) Spec. Under Construction – buildings for lease which are being speculatively constructed and will be available for occupation within 12 months.

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