MaxCap
Investment Management

MAXCAP AUSTRALIAN INDUSTRIAL MARKET UPDATE

JANUARY 2021

AUSTRALIAN INDUSTRIAL UPDATE 2021

OVERVIEW

- The industrial and logistics sector has defied the ongoing economic challenges to outperform all traditional real estate sectors and is expected to remain as the sector of choice for investors post COVID-19.
- The significant interest in the sector saw over $1.8 billion in transactions recorded for the year to September 2020 from a range of domestic and foreign capital sources.
- MaxCap expects to see continued demand and growth across the industrial sector as impacts of COVID-19 are better understood and managed.
- Weight of capital looking to be invested in the sector is anticipated to remain heightened, although shortages in prime stock supports the growth in capital values.

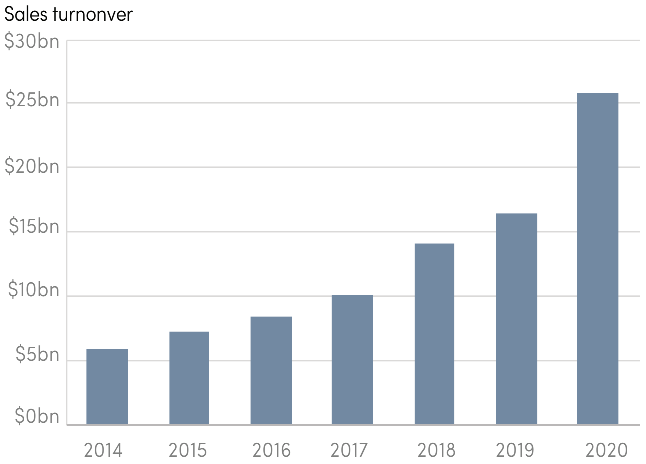
KEY INDUSTRIAL TRENDS

Online retail turnover has grown by 58% compared with the same period in 2019	Warehousing requirements grow as online retail drives further logistics needs	Valuations continue to grow, driven by the structural shift in online retail and strong capital demand for the sector

Industrial property is currently the most sought-after real estate asset class in Australia, underpinned by structural tailwinds which have supported resilience in the sector through the COVID-19 pandemic. In the 12 months to September 2020, the industrial sector provided a total return of 11.2%, above the 6.8% and -10.0% recorded for office and retail respectively over the same period (Graph 7).

The sector has remained relatively resilient during the COVID-19 pandemic period and there are several key trends and themes which have come to the forefront and are expected to continue shaping the sector in 2021 and beyond.

GRAPH 1: TOTAL ONLINE SALES TURNOVER (JAN TO OCT)



Source: ABS

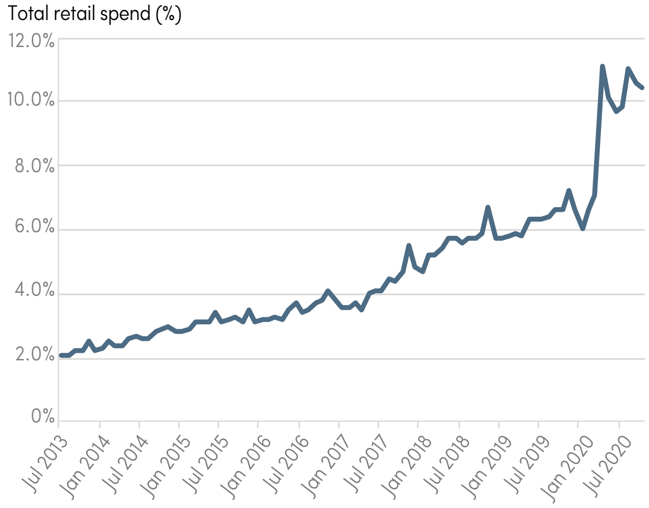
Online retail

Since the onset of the COVID-19 pandemic in Australia, according to Australia Post, more than 1 million new households have shopped online, with over 5.5 million households shopping online in November, up 28.2% when compared to 2019.

The rise in online retail purchases has contributed to online sales turnover for the nine months to October 2020 growing by 58% when compared to the same period in 2019 (Graph 1).

The large jump in online retail spending in 2020 highlights the change in consumers habits with online retail, which has been rapidly accelerating since the onset of the COVID-19 pandemic and associated restrictions on mobility across the country. The online penetration rate (online retail sales as a percentage of total retail spending) has rapidly increased during the pandemic from 6.3% in January 2020, to 10.4% in October 2020 (Graph 2).

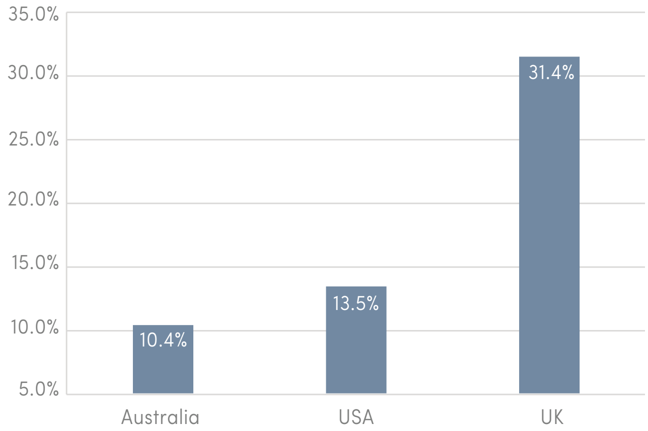
GRAPH 2: ONLINE RETAIL PENETRATION RATE



Source: ABS

The online retail penetration of other western countries suggests there remains scope for further growth in online retail with the UK seeing 31.4% of total retail sales made through online channels in November 2020 (Graph 3).

GRAPH 3: ONLINE RETAIL PENETRATION RATE



Source: ABS, U.S. Census Bureau, Office for National Statistics

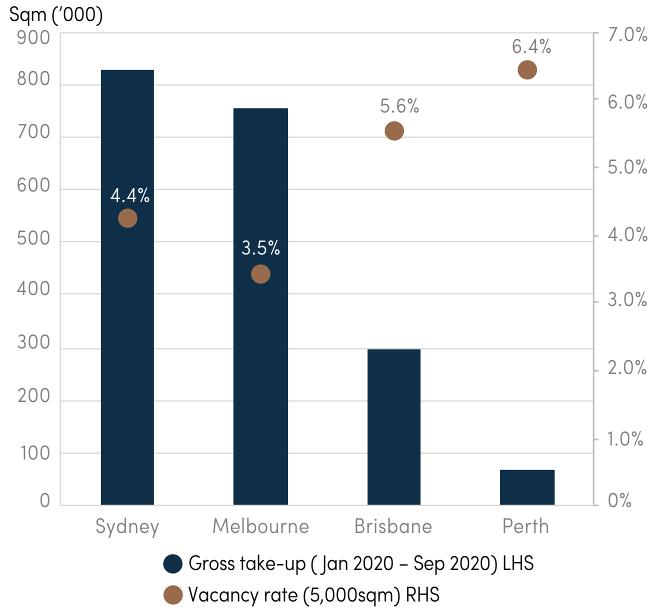
Expansion in warehousing and distribution

The shift to online retail spending has increased consumer demand for expedited delivery, driving tenant requirements for infill warehousing in key metropolitan areas.

Take-up of warehouse space by retailers surged to more than 800,000 square metres for the year to September 2020, 33% higher than the industrial space leased by retailers across the whole of 2019. The retail trade services sector accounted for 42% of all industrial space leased, more than double the long-term average of 19% between 2009 and 2019.

The additional requirement from retailers and logistics groups has seen the industrial vacancy rate on the eastern seaboard remain relatively low, especially in Melbourne where the vacancy rate is 3.0% (Graph 4), reflecting heightened demand from occupiers exposed to e-commerce.

GRAPH 4: OCCUPIER MARKET (SEP 2020)



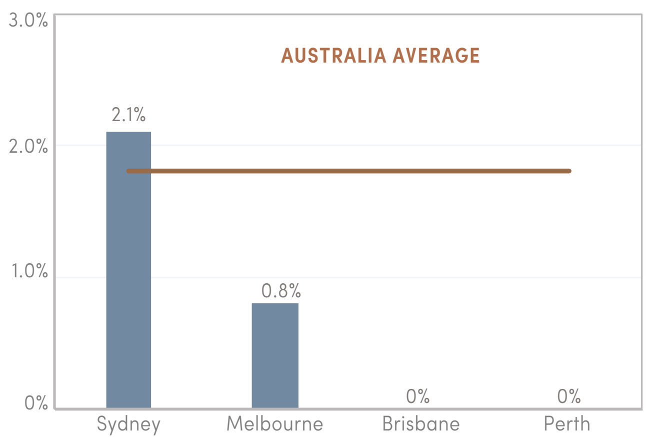
Source: JLL, Colliers

Rents

While industrial vacancy continues to compress, rents have remained relatively stable over 2020, with Melbourne and Sydney recording minor rental growth of 2.1% and 0.8% year-on-year respectively (Graph 5).

MaxCap expects rental growth to pick-up in 2021, bolstered by the normalisation of economic activity and continued demand from tenants requiring additional space, further increasing industrial valuations.

GRAPH 5: YEAR-ON-YEAR CHANGE IN RENTS (SEP 2020)



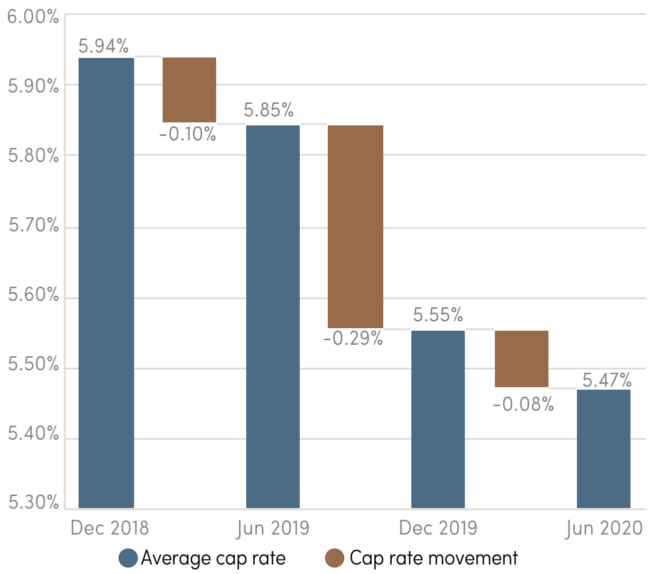
Source: CBRE

Valuations

The accelerated growth of these underlying market fundamentals is continuing to drive tenant demand, supporting favourable growth forecasts for rents, tenant covenants and lease terms, driving increases in valuations due to both improved income and capitalisation rate (cap rate) assumptions. Evidenced by Centuria Industrial REIT (ASX: CIP) December 2020 preliminary valuations, as independent valuations increased by 6.3% from prior book values.

The FY2020 A-REIT reporting period highlighted the strength of the industrial sector, with average industrial cap rates compressing by 8bps over the six months to June 2020, following larger compressions over previous periods (Graph 6). This contrasts with office cap rates which compressed by 3bps and retail cap rates increasing by 18bps.

GRAPH 6: AUSTRALIAN REIT INDUSTRIAL CAP RATE ANALYSIS

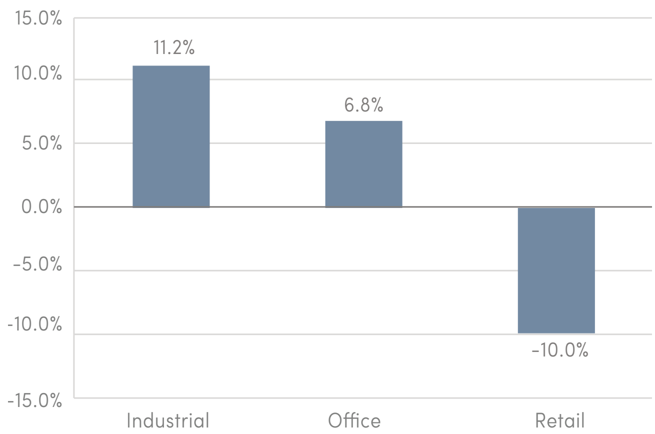


Source: Company filings, MaxCap Research

Transaction evidence

The strong market fundamentals of the industrial sector have strengthened investor demand as they look to deploy increased capital to the sector. Industrial is currently the best performing real estate asset class in Australia (Graph 7).

GRAPH 7: PROPERTY RETURNS BY ASSET CLASS (12-MONTHS TO SEPTEMBER 2020)

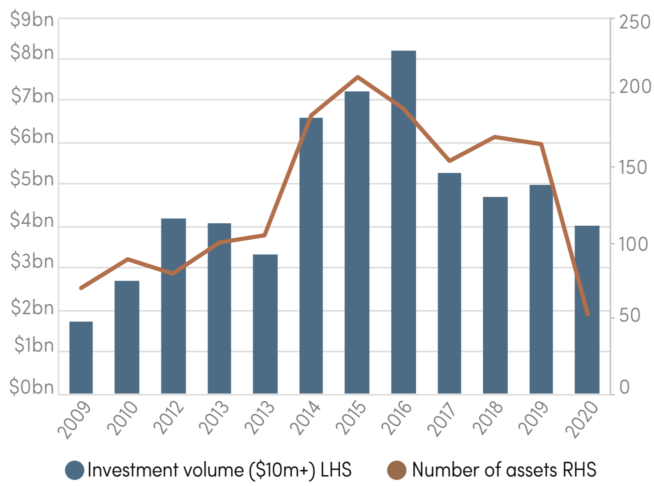


Source: Property Council / MSCI All Property Index Digest

As industrial owners continue to hold industrial assets, transaction volumes have fallen significantly since the 2016 peak, although the average transaction price increased from $43m to $75m (Graph 8).

MaxCap assesses that there remains a significant weight of capital looking to be deployed with demand expected to continue exceeding the limited supply of well-located prime industrial assets, driving future valuation uplift and price growth.

GRAPH 8: INDUSTRIAL AND LOGISTICS CAPITAL TRANSACTIONS



Source: Colliers

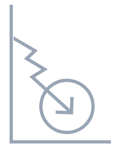
Market disruption

Whilst these strong market fundamentals are likely to continue to drive the sector forward in the short to medium term, it is critical that we continually assess longer term disruption and evolutionary change that the industrial and logistics sector may face, and strive to ensure our investments can adapt and evolve accordingly. As an example, future disruption may be driven by supply chain efficiencies and technological advancement in areas such as multi-level warehousing and automation, which is already prevalent in other parts of the world where land supply is significantly constrained. As technology advances at a rapid pace, the role and function of industrial land and infrastructure will also need to evolve with it. MaxCap is continuing to monitor these advancements that may impact the sector in the long term which will also facilitate the identification of market dislocations and investment strategy.

OUTLOOK

Industrial sector outlook remains positive, underpinned by tailwinds of e-commerce and government funded infrastructure investment

Weight of capital seeking industrial opportunities with limited prime stock available



Further downward pressure on yields, particularly for prime industrial assets along Australia's eastern seaboard

The impacts of the COVID-19 pandemic are still playing out across the Australian economy and property markets, however, the industrial property sector remains resilient despite the ongoing economic headwinds. This has been driven by structural factors, such as the rise of e-commerce, which existed before the pandemic, and has been accelerated through the crisis by an increased demand for online fulfilment services and a need to fundamentally re-think supply chains. MaxCap believes that many of the changes in consumer behaviour and logistics infrastructure brought about by the pandemic will be long-lasting, supporting ongoing demand for industrial property.

State and Federal governments have announced approximately $120 billion in government funded infrastructure spending over the next three years across Victoria, NSW, QLD and WA (Infrastructure Partnerships Australia) to support the growing industrial sector and to stimulate economic growth. This spending will enable industrial assets to benefit from greater efficiencies by improved access to population centres and transport routes, which are key to the growth and evolution of the industrial sector.

As demand drivers continue to support occupier demand for industrial property, it has become the sector of choice for investors seeking stable income returns with strong covenants. Colliers estimates the mismatch of demand and supply to be $26 billion, which is 6.5 times the transaction volume in the first nine months of 2020 (January to September), highlighting the shortage of prime investment opportunities.

Given the re-weighting of investor portfolios and positive industrial tailwinds, MaxCap expects that cap rates will continue to compress driving increases in capital values and supporting the growth in underlying industrial land values.

NATIONAL SNAPSHOT

MELBOURNE

Despite recent COVID-19 related lockdowns, occupier sentiment remains positive across the Melbourne market, contributing to the continued fall in vacancy to 3.0% and stability in rents at $91 per sqm. This has led to a reduction in yields to 5.25% and an increase in land values to $419 per sqm as the requirement for industrial space continues to grow.

MELBOURNE	NET FACE RENT ($/SQM)	YIELD (%)	CAPITAL VALUE ($/SQM)	LAND VALUE ($/SQM)
September 2020	$91	5.25%	$1,733	$419
Change (March 2020)	⟷	↓	↑	↑

Source: Colliers

SYDNEY

Strong leasing activity, particularly in Sydney's Outer West (headlined by the 200,000 sqm pre-commitment by Amazon) has placed downward pressure on Sydney's vacancy rate which has fallen to 4.4%. While rents ($129 per sqm) and land values ($760 per sqm) have remained relatively stable since Q1 2020, yields have continued to compress to 4.66% as a by-product of the limited purchasing opportunities for industrial assets.

SYDNEY	NET FACE RENT ($/SQM)	YIELD (%)	CAPITAL VALUE ($/SQM)	LAND VALUE ($/SQM)
September 2020	$129	4.66%	$2,732	$760
Change (March 2020)	⟷	↓	⟷	⟷

Source: Colliers

BRISBANE

Rents and land values have remained stable since Q1 2020 whilst yields, as evident across all Australian key markets, compressed to 5.69%. The South and South West precincts have become the fastest growing industrial markets in Greater Brisbane and with the growth in values are expected to outpace other areas of Brisbane.

BRISBANE	NET FACE RENT ($/SQM)	YIELD (%)	CAPITAL VALUE ($/SQM)	LAND VALUE ($/SQM)
September 2020	$110	5.69%	$1,949	$321
Change (March 2020)	⟷	↓	↑	⟷

Source: Colliers

PERTH

The relative success of Western Australia in containing the coronavirus has allowed operations to quickly return to greater normality. Demand from transport and logistics tenants has strengthened through the pandemic, contributing to the rise in rents to $82 per sqm and compression in yields to 6.65%, growing the capital value for industrial assets.

PERTH	NET FACE RENT ($/SQM)	YIELD (%)	CAPITAL VALUE ($/SQM)	LAND VALUE ($/SQM)
September 2020	$82	6.65%	$1,229	$422
Change (March 2020)	↑	↓	↑	↓

Source: Colliers

INVESTMENT OPPORTUNITIES

Equity opportunities to participate in a niche development strategy, capitalising on growing demand for industrial assets

Carefully selected, experienced partners and sponsors continue to perform

MaxCap continues to apply robust risk management strategies for investments

Demand for Industrial CRE Debt

As demand from investors and developers continues to grow for industrial opportunities, commercial real estate (CRE) debt solutions are expected to play an important role in the activation of industrial projects.

MaxCap considers industrial land financing as a key product offering in the MaxCap portfolio that is set to grow as traditional bank lenders increasingly focus on prime institutional assets and hold an over-cautious view on the typical low, manageable risk of unpermitted industrial land sites. Opportunities to provide construction finance for industrial developments have historically been limited due to developments being funded on balance sheet by well capitalised institutional developers. However, with more private developers now participating in the sector, MaxCap is already seeing an increase in the volume of opportunities to provide funding for the construction of non-institutional and more speculative developments as they rise.

We note there has been little to no deterioration to credit risk due diligence or controls over this period, reflecting the positive fundamentals of the sector and relative robustness of industrial and logistics assets and their underlying land values.

Notwithstanding these results, given the broader global economic context, we are very focused on the valuation of the underlying asset; the location of the site; transport links and access to established population; site conditions, in particular ground contaminants; and the sponsor's financial capability and covenant. We are also highly cognisant of future disruption and evolution in the sector and continue to monitor this on a global scale.

Key risks and mitigants

- **Market risk**

  Industrial markets have remained relatively robust through COVID-19, with compression in industrial yields and transaction evidence supporting industrial as the sector of choice for investors.

  MaxCap expects values for industrial to continue to be well supported with near and medium term growth in values due to the positive tailwinds experienced in the sector.

  As the supply of well-located industrial land dries up, there will be increased pressure placed on the quality of existing assets which will likely culminate in greater tenant movement and increased redevelopment of sites.

- **Delivery risk**

  MaxCap anticipates that the delivery of industrial supply will remain strong, backed by record level of industrial lease take up.

  MaxCap expects that the delivery risk for industrial assets will be minimised as elevated occupier activity supports leasing assumptions while the continued return to normality following the easing of COVID-19 related restrictions should allow developments to progress to program.

- **Settlement risk**

  Due to the typical buyer profile for industrial assets typically being sophisticated, well capitalised institutional investors, settlement risk is expected to be relatively minimal.

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