

LEGAL INSIGHTS

# The road ahead for Australia's industrial and logistics sector

By Christine Miller, CBRE Head of Supply Chain Advisory & Nick Sparks Maddocks Partner

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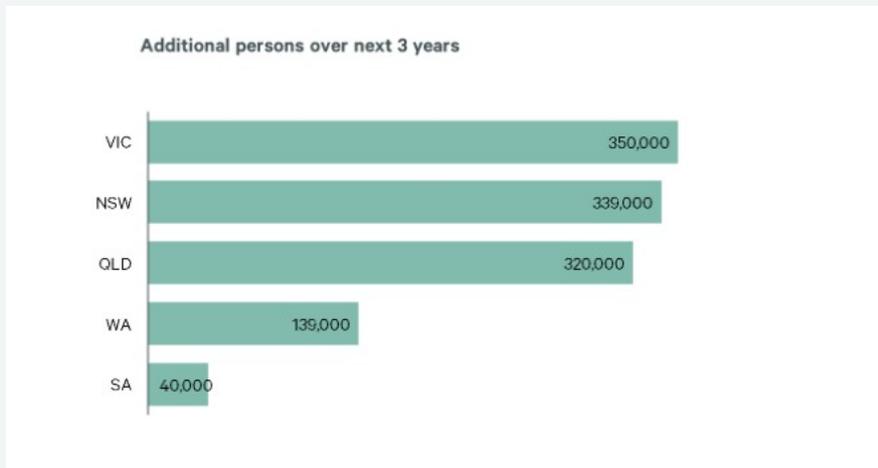
*Australia has the tightest Industrial & Logistics vacancy rate globally. What does that mean for the industrial and logistics sector and Australia's economic growth?*

Unpacking the current Industrial & Logistics property market requires a look at both demand and supply factors. There's a lot at play and the dynamic changes underway make understanding the future outlook challenging. [Christine Miller](#), Head of Supply Chain Advisory at CBRE and [Nick Sparks](#), partner in the Development team at Maddocks take a look at some of the key macro-economic and resulting legal issues below.

## Demand Factors

### Key macro-economic issues

Now that Australia is on the other side of the pandemic, population has returned to a growth story. A growing population puts increasing demand on the distribution network if only to simply fuel basic consumption. For example, daily supply chain food operations increase in volume as consumption volumes increase. This requires expanded space to operate those increased volumes. Melbourne is on track to be the largest city in Australia by 2029. The below graph shows the expected population growth.



Source: DAE, CBRE Research

CBRE's research team estimates that each additional person will require 4.3 sqms of Industrial & Logistics space to support their consumption. That's 5.4 million sqms nationally over the next 3 years. With average delivery to the market standing at 1.4 million per year – there's a notable gap forecasted which only increases the pressure on existing stock. While that can be good news for investors in terms of rent – that needs to be balanced with supply to keep the economy growing. At this point in time, Australia holds the lowest vacancy rate globally for Industrial & Logistics property. Nationally it's currently at 1.3%. This raises a concern in regards to ensuring Australia's growth story is not cut short by lack of space.

There has been plenty of chatter on eCommerce growth in recent years and undoubtedly it has grown at record levels. While that growth is starting to moderate, as a result of consumers enjoying being able to physically go to stores, the underlying story is the head room that exists for further growth. Australia's eCommerce rate as a percentage of total sales currently sits just under 15%. This is well under the rates in other similar demographics like the UK and America who sit at 30% and 22% respectively.

This indicates that regardless of how fast or slow the growth occurs, Australia is looking at

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continued growth in the role eCommerce plays in our total consumer spending. The flow on impact to the Industrial & Logistics sector comes from the need for increased operational space to process online orders. Typically, online order handling requires three times the space of a traditional retail store replenishment order. That's driven by the need to handle product at individual levels and the increased operational areas for order picking, packing and outbound distribution. The higher the eCommerce volumes the higher the demand for Industrial & Logistics space.

## Key legal issues

### Acquisitions

This continued demand, particularly for larger format product, creates challenges for developers seeking to acquire land to develop and meet that demand. In the current market where land supply is tightening, developers are needing to be more creative with their acquisition models and risk appetite, which is no mean feat in an environment of increasing interest rates and construction cost escalation.

As land supply tightens, fragmentation of landowners is becoming increasingly common, resulting in the need to deal with multiple landowners to piece together development parcels with sufficient critical mass. Maddocks are continuing to see developers utilise different acquisition models, including options, conditional contracts, and nomination deeds and development agreements, and this raises a number of issues to consider including:

- Making sure option periods and/or contract conditions provide sufficient time and flexibility to piece together a sufficient number of sites to create a bigger parcel if acquiring direct from landowners
- If a speculator has land under contract, and the acquisition model is a nomination play, understanding the duty and GST consequences arising on nomination is critical, as is understanding fully the terms and conditions of the underlying contract the speculator has with a landowner (for example, is there sufficient flexibility to access the land or undertake planning applications – often contracts between landowners and speculators can be light on detail)
- If considering a rezoning play, you'll need to fully understand how the wonderful Windfall Gains Tax (WGT) will apply and be modelled. Striking a commercial deal as to how this liability is factored into pricing is clearly critical. However, do not overlook ensuring that WGT is deferred for as long as possible to align with development revenue, as well as understanding how the valuation methodology will apply when the WGT is calculated.

### Is industrial still retail?

With the ongoing evolution of the industrial market to deal with eCommerce, the recent case of *Eastcombe Pty Ltd v Fagersta Steels Pty Ltd* [2022] VCAT is a timely reminder to consider whether industrial leases can become retail leases, and therefore subject to the *Retail Leases Act 2003 (Vic)(RLA)*.

Many will remember the *Cold Storage* case (*CB Cold Storage Pty Ltd v IMCC Group Pty Ltd* [2017] VSC) and the various appeals a number of years ago. That suite of cases reminded many in the industry that some industrial leases can be retail leases in Victoria, and therefore be subject to the RLA. Some of the key provisions of the RLA include the regulation of outgoing (land tax is not recoverable), market rent reviews (they can go up or down) and tenant assignments (a tenant has greater flexibility to assign a lease) amongst other matters.

The result of the *Cold Storage* cases was that most services would be captured as retail activities under the RLA, as most services that are paid for are not able to be passed on (e.g. the cold storage services CB Cold Storage provided to its business customers who were the ultimate consumer of those services). Whether the sale of goods will be captured as retail activities under the RLA is a slightly different analysis, and depends largely on what the consumer intends to do with the goods purchased – if they are to be sold on in an unaltered state then it might be they are not classified as retail for the purposes of the RLA.

Since the *Cold Storage* suite of cases, there have been a number of cases testing grey areas associated with components of the original cases. The general trend has been to start to wind back the outcome of the *Cold Storage* case. For example, warehouses that stored and shipped goods direct to consumers to fulfil online orders were held not to be retail (*Bulk Powders Pty Ltd v Seicon* [2018] VCAT and *A.G. & F Italiano Pty Ltd v Rovigo Pty Ltd* [2020] VCAT).

Most recently in the case of *Eastcome Pty Ltd v Fagersta Steels Pty Ltd* [2022], VCAT held that as the warehouse premises in question were not open to the public, and as it was not clear if the ultimate consumer test was satisfied, the lease was not a retail lease for the purposes of the RLA. The tenant's attempt to withhold payment of \$136,000 in outgoing, on the basis that the lease was retail lease for the purposes of the RLA, failed.

The *Eastcombe* case acts as a reminder to developers to consider a tenant's use and be alive to drafting their leases appropriately to navigate any unwanted retail leasing disputes.

## Supply Factors

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### Key Macro-economic Issues

There are green shoots appearing that supply chains are starting to stabilise and that large scale disruption has subsided. Ocean freight rates have declined 45% from the recent peak but still are more than double what they were pre-pandemic. China continues to face factory shut-downs as a result of the zero-covid policy. Travel is back however not fully to pre-pandemic levels on all routes which means air freight capacity is not fully back.

Businesses are wanting to trim excess inventory but may not be able to go as fast as they want in this area due to the lingering supply chain factors. Higher inventory holdings need space and the disruption factors have taught us that if the inventory is not in stock it can't be sold, and in order not to risk lost sales – higher inventory is the simple answer. This is starting to change but will take some time.

With vacancy tight and rental rates increasing, it's a good time for investors to deliver increased capacity to the market. However, the recent escalation in construction costs and tight land supply has restricted the market's response to the demand.

### Key Legal Issues

#### Pre-Leasing

Winning the commercial battle to secure a tenant is far from easy in the current market, and there are a number of key issues for a developer to manage in pre-leasing and an environment of construction costs uncertainty, supply concerns and interest rate volatility:

- Signing up the agreement for lease close to signing up the building contract is more important than ever to minimise pass through gaps between documents
- Scope works well, early and if possible interrogate design with the tenant to minimise surprises
- Obtain comfort around supply and availability of key materials for the build to minimise delay to practical completion and rent commencement
- Tenant fit out – another one to watch for delays in equipment and to ensure that does not delay rent commencement
- For projects with some conditionality in the agreement for lease, for example around planning, that might result in surprises affecting build costs consider:
  1. conditions precedent for developers to exit, such as planning conditions being too onerous or, if relevant, finance terms being unacceptable; and/or
  2. where possible provisional costs being allocated to certain items, and a regime to perhaps pass on all, or share, cost escalations.

#### Skills, material shortages and cost escalation in construction

A hot topic at the moment that many developers are grappling with. The Maddocks Construction team recently undertook a survey of clients to better understand how the construction industry is:

- managing the extreme cost escalation challenges
- mitigating risks posed by issues associated with COVID-19 and recent major global events and their impact on the global supply chain
- adapting to deal with these unprecedented pressures on projects.

See here for the report following that survey for trends, insights and recommendations:

[Construction Pulse 2022 report: Managing uncertainty – how Australia's property and construction industry is dealing with skills and material shortages and cost escalation](#)

## Summary

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There is clearly a lot for developers to grapple with in the current market in order to navigate volatile macro-economic conditions and appropriately manage legal risk in their industrial projects. Fundamental to all of this is, more than ever, a preparedness to be flexible and consider multiple solutions to unlock deals, along with keeping up to date with relevant information to inform those solutions.

# Looking for more information on Australia's industrial and logistics sector?

Feel free to contact Christine Miller and Nick Sparks

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