



dexus

Australian Real Estate Quarterly Review

Q2 2023

Quarter Quay Tower, Sydney

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Investment climate

Inflation easing as Australia's economy slows

After lifting the official cash rate to 3.6% in March 2023 the Reserve Bank of Australia held it steady in April. There are now signs that interest rates are getting closer to peaking. Australia's headline inflation rate (monthly indicator) appears to have peaked and slowed from 8.4% in December 2022 to 6.8% in February 2023. While rents, energy bills and house prices are still inflationary, items like food, transport and accommodation are becoming less so.

A number of other trends are consistent with a market view that short rates are now close to their peak. The market bank bill swap rate forward curve has flattened and the 10-year bond yield has fallen to around 3.2% from a high of 4.0% in December.

The Australian economy slowed mildly in Q4 2022 to 0.5% for the quarter and 2.7% for the year. Private consumption growth slowed in the quarter and dwelling investment and business investment contracted, all signs that interest rates are beginning to bite. GDP growth is forecast to slow to 1.1% in Q4 2023.

Business confidence is easing in the face of weak consumer sentiment and points to a general slowing of business activity in the year ahead.

High construction costs will lead to a continued focus on risks and margins for development projects. However, construction cost growth is beginning to ease as timber and steel prices decline and supply chain costs subside.

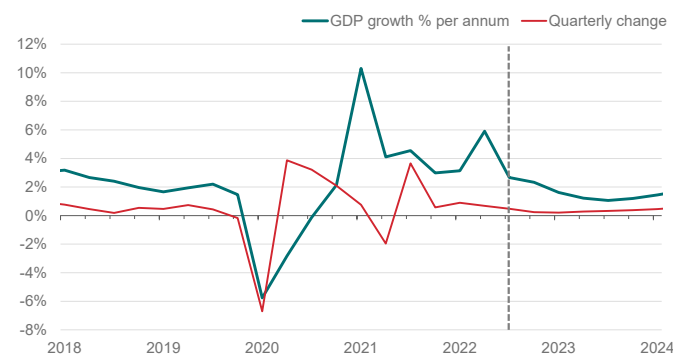
Transaction markets are likely to remain soft over the next six months but volumes are expected to pick up in 2024 as pricing resets. While the current phase is characterised by rising interest rates and risk, the next phase may well be one of flat to falling interest rates and growth. Occupier demand will be fuelled by Australia's strong population growth, forecast at 1.5% per annum over the next five years, the highest of any advanced economy.

Australian economic forecasts

	Jun-22	Jun-23	Jun-24
Real GDP %pa	3.1%	1.6%	1.5%
Employment %pa	3.3%	1.7%	2.0%
Business investment %pa	2.8%	3.3%	5.7%
Dwelling investment %pa	-5.1%	1.1%	0.3%
Population %pa	1.1%	1.7%	1.5%
Retail sales %pa	10.6%	3.6%	2.6%
CPI %pa	6.1%	6.5%	3.4%
Cash rate %	0.8%	3.9%	3.4%
10yr Bond %	3.7%	3.2%	3.0%
AUD/USD	0.71	0.68	0.69

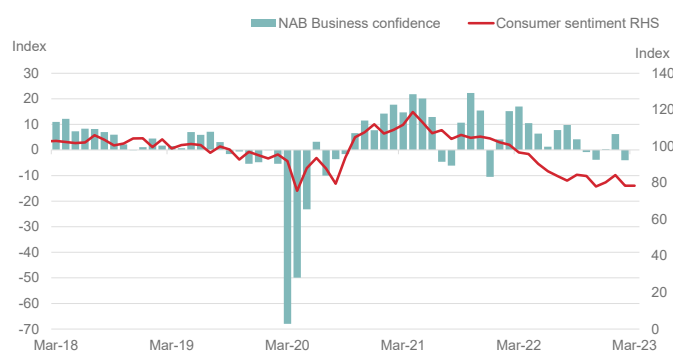
Source: Oxford Economics (with Dexus adjustment), March 2023

Australian economic growth



Source: Oxford Economics

Business confidence and consumer sentiment



Source: NAB, Westpac

Official cash rates and 10-year bond yields



Source: Bloomberg

The case for real assets

Why invest in real assets in 2023?

High interest rates have led to increased volatility in pricing across all asset classes. Understandably, investors are cautious about the outlook. However, there are reasons to maintain or increase exposure to real assets in the short term. It's more than just 'buy in gloom, sell in boom' argument. Quality real assets are by nature tightly held, so when the weight of capital returns, opportunities will become significantly harder to find.

It is in times of volatility that the qualities of real assets are most apparent. While financial assets can have value stripped away quickly (such as Twitter or Credit Suisse), real assets are physical assets that have an intrinsic worth due to their substance and purpose. The price of an airport or a hospital may change from year to year, but its underlying value to the community typically remains high, sometimes performing an essential service.

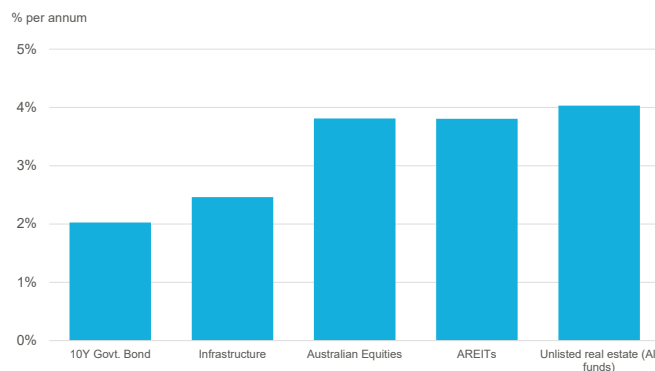
In the past, real estate has provided a high and steady level of income compared to other asset classes such as government bonds and Australian equities. Over the past three years, unlisted real estate funds provided a 4.0% per annum income return, ahead of other asset classes like government bonds (2.0%) and Australian equities (3.8%). The future growth in value of such assets is typically secured by leases and operating agreements.

Real assets also provide a hedge against inflation. Analysis shows that infrastructure, real estate and healthcare have outperformed financial assets during periods of high inflation over the past 20 years. In some cases, the mechanism for this is very direct, with income linked to inflation by explicit clauses within leases.

Investor surveys typically nominate 'diversification' as one of the main reasons for investing in real assets. Real asset returns have a low correlation with the other assets classes held in a mixed portfolio (shown as blue in the bottom chart). A low correlation improves the chance that real assets perform differently to financial assets at times of volatility in financial markets, reducing overall portfolio risk.

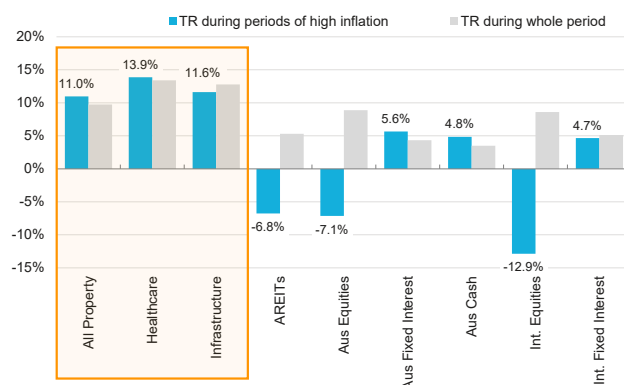
Regarding pricing, a discount to net tangible assets in the AREIT market has led to questions about the values of the underlying real estate. While values are adjusting, history has shown that the listed AREIT market tends to under-sell and oversell compared to the unlisted market because it is more sensitive to both interest rate movements and equity market volatility. Typically, when a wide discount gap closes, it is more due to listed pricing increasing than unlisted pricing easing.

Average income returns over the past 3 years



Source: Mercer/MSCI, Bloomberg, Dexis Research

Total returns over periods of elevated inflation



Source: MSCI, Bloomberg, Dexis Research, High inflation defined as greater than 3% per annum

Correlation of selected asset types

		Australian Fixed Interest	
		Australian Equities	Australian Fixed Interest
Real Assets	All Property	-0.09	-0.07
	Office	-0.14	0.10
	Retail	-0.06	-0.08
	Industrial	0.01	-0.15
	Healthcare	-0.01	0.01
	Infrastructure	0.28	-0.01
Financial Assets	Aus. Equities	1.00	0.05
	AREITs	0.81	0.27
	Aus. Fixed Interest	0.05	1.00
	Aus. Cash	0.04	0.46
	Int. Equities (hedged)	0.87	0.06
	Int. Fixed Interest	0.23	0.88

Source: MSCI, Bloomberg, Dexis Research

Performance / transactions

Asset performance faces choppy waters

Last quarter saw a watershed moment for bond markets which may have implications for asset pricing through 2023. Australian government bond yields fell from 4.0% in December to 3.3% in March. Consequently, fixed interest investments returned a strong 4.6% in the quarter ending the bear market that prevailed during 2022. With the economy likely to slow, defensive fixed interest investments seem likely to perform well as short rates peak and long yields fall further.

The outlook for equity markets is more mixed. While a peaking of the interest rate cycle would be positive, there are concerns about earnings growth in a slowing economy. While Australian equities returned 3.5% in the quarter, A-REITS remained stable at 0.5%. The impetus that falling bond yields would normally give A-REITS appears to be counteracted by concerns about occupier demand and underlying asset values.

Unlisted funds returns were subdued in the quarter at 0.4% with the annual return falling to 6.8%. Low transaction volumes and rising cap rates are weighing on capital values. Industrial funds performed the best of the unlisted real estate sectors returning 10.5% helped by strong rent growth. Retail funds, whose cap rates had already expanded during the pandemic returned 7.5% and office funds, which are perceived to be exposed to the economic cycle returned 4.9%.

Transaction activity in Q1 2023 was the lowest seen for a decade. An uncertain cost of capital has made buyers cautious leading to downward pressure on asset values. Transaction volumes are expected to remain subdued in the short term. Signals for an improvement in transaction volumes and values will be a clear peaking of short-term interest rates and an observable resetting of valuations. Capital is likely to return in a rush given Australia's population growth thematic.

Asset class performance

	Qtr. %	1 yr %p.a.	3 yr %p.a.
Australian infrastructure ²	6.1%	8.6%	8.6%
Unlisted property ¹	0.4%	6.8%	5.8%
Australian cash ³	0.8%	2.0%	0.7%
Australian fixed interest ⁵	4.6%	0.3%	-2.4%
Australian shares ⁴	3.5%	0.1%	16.5%
A-REITs ⁶	0.5%	-13.9%	13.6%

Source 1: MSCI Mercer Australian Core Wholesale Monthly PFI

Source 2: MSCI Australia Infrastructure Index

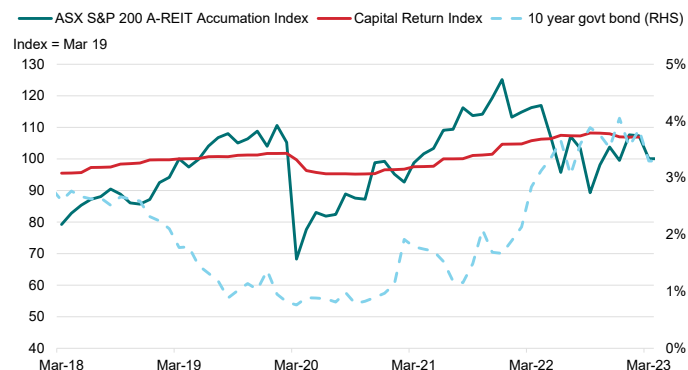
Source 3: Bloomberg BAUBIL Index

Source 4: S&P/ASX 200 Accumulation Index

Source 5: Bloomberg BACMO Index

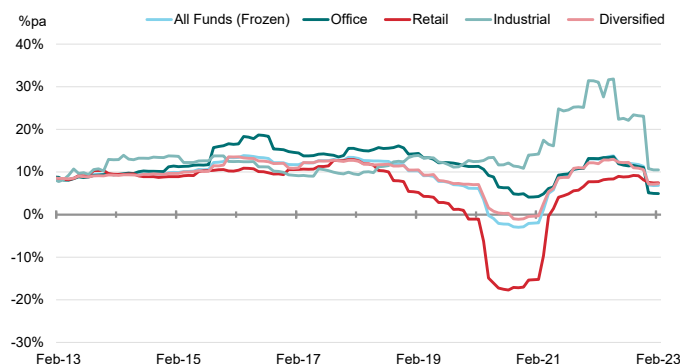
Source 6: S&P/ASX 200 A-REIT Accumulation Index

Unlisted and listed price/value movement



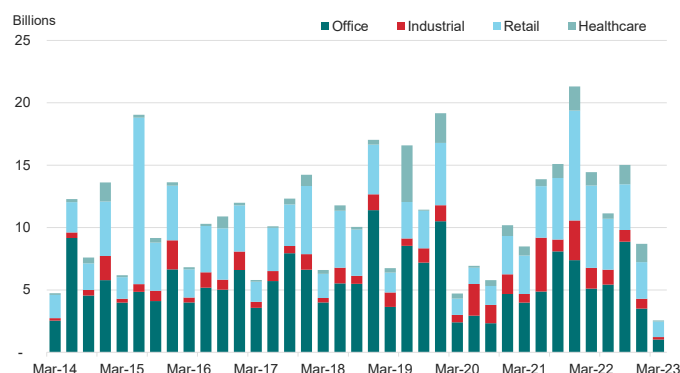
Source: Bloomberg, MSCI, Capital Returns to Feb-23

Unlisted property returns by sector



Source: MSCI

Australian transaction volumes by sector



Source: MSCI Real Assets

Office

Flight to quality a significant factor

Office demand has been positive in the Melbourne, Brisbane, and Perth markets over the past quarter, while Sydney saw a contraction. Perth recorded 27,000sqm of net absorption in Q1 2023, its strongest quarterly result since 2012, helped by buoyant conditions in the resources sector.

In Sydney CBD small to medium firms have been active in the leasing market, however a few large consolidations in the financial services sector have offset the smaller expansions. A trend towards centralisation, where suburban occupiers have taken CBD space, has supported demand.

Flight-to-quality remains a significant factor in the market, as higher quality buildings experience stronger demand. In Sydney, for instance, premium net absorption was up 60,000sqm in the year to Q1 2023, while the total market saw a decrease of 45,000sqm.

Office net face rents have risen despite elevated vacancy rates with Sydney CBD, North Sydney, Melbourne CBD, Brisbane CBD, and Perth CBD experiencing positive quarter-on-quarter growth.

Prime incentives have remained relatively stable, with mild increases in Sydney and Melbourne. According to JLL Research, average Sydney CBD incentives have inched up to 34.8% from 34.5% in Q1 2022. Conversely, Brisbane and Perth, benefiting from a better demand environment, are witnessing incentives compress slightly.

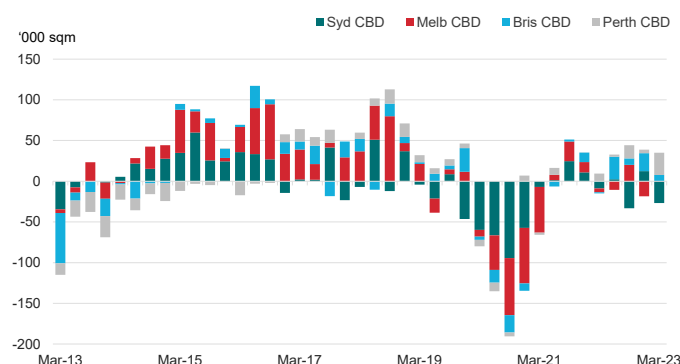
Looking towards the longer term, elevated construction costs are expected to support higher levels of rent and slow the development pipeline. However, this impact will likely take years to flow through to market rents.

Office snapshot

	Total Vacancy	Rent growth* (% p.a.)	Net supply FY23-25 (%pa)**
Sydney CBD	14.3%	6.3%	1.3%
North Sydney	17.2%	4.2%	3.0%
Sydney Fringe	7.6%	2.8%	0.5%
Parramatta	24.6%	-22.0%	0.7%
SOP / Rhodes	22.1%	-0.8%	0.0%
Melbourne CBD	15.6%	-1.0%	1.9%
Brisbane CBD	11.7%	2.5%	1.3%
Perth CBD	19.9%	1.5%	2.0%

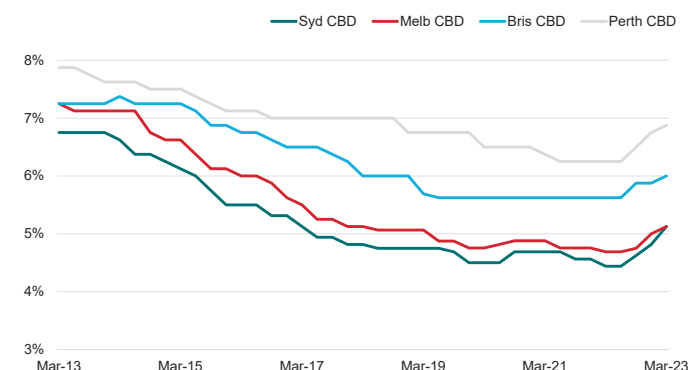
Source: JLL Research, March 2023, Dexu *Net effective, **per annum FY23-FY25

Quarterly net absorption by CBD market



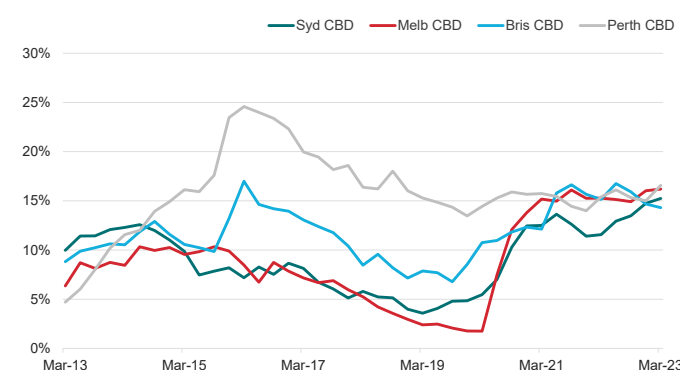
Source: JLL Research

Prime yields by CBD market



Source: JLL Research

Vacancy rates by CBD market



Source: JLL Research

Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney CBD	Rent performance surprisingly strong despite elevated vacancy. Net absorption was negative for 12 months at -45,000, not keeping up with supply. The vacancy rate has gone up 2.0 percentage points over the past year. It is currently 14.3%. Incentives increased to 35% and prime gross rents grew 5.2% over the year. Yields expanded 31bps over the quarter to 5.13%. Supply in Sydney CBD over the next 3 years FY24-26 is expected to be 1.1% vs a 0.7% per annum long term average.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
North Sydney	High vacancy rates persist, despite some signs of improvement. Net absorption was positive for the 12 months at 2,000, outpacing supply. The vacancy rate has gone down by 0.2 percentage points over the past year. It is currently 17.2%. Incentives increased to 37% and prime gross rents grew 3.6% over the year. Yields expanded 6bps over the quarter to 5.25%. The vacancy rate is expected to remain relatively high in the medium term with the expected completion of the Victoria Cross over station development in FY25.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Parramatta	High vacancy rates limit the rent growth outlook; however, a tight supply pipeline may contain vacancy going forward now that Parramatta Square has completed. Net absorption was negative for the 12 months at -60,000, not keeping up with supply. The vacancy rate has gone up by 9.4 percentage points over the past year. It is currently 24.6%. Incentives increased to 44% and prime gross rents remained stable over the past year. Yields expanded 25bps over the quarter to 5.75%.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Melbourne CBD	Vacancy has plateaued and the CBD has a contained supply pipeline in the near term. Net absorption was negative for the 12 months at -9,000, not keeping up with supply. The vacancy rate has gone up by 0.8 percentage points over the past year. It is currently 15.6%. Incentives increased to 40% and prime gross rents grew 0.7% over the year. Yields expanded 12bps over the quarter to 5.13%. Supply in Melbourne CBD over the next 3 years FY24-26 is expected to be 1.5% vs a 2.3% long term average.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	↑
Brisbane CBD	Stronger demand tied to commodities contributes to a more positive market situation. Net absorption was positive for the 12 months at 65,000, outpacing supply and well above average. The vacancy rate has gone down by 1.4 percentage points over the past year. It is currently 13.6%. Incentives remained stable, currently at 43% and prime gross rents grew 6.1% over the year. Yields expanded 13bps over the quarter to 6%. The premium vacancy rate in Brisbane has tightened to 7.6%.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	↑
Perth CBD	Increased demand and mining exploration offer potential for market improvement. Net absorption was positive for the 12 months at 50,000, not keeping up with supply. The vacancy rate has gone up by 0.2 percentage points over the past year. It is currently 19.9%. Incentives fell to 48% and prime gross rents grew 1.0% over the year. Yields expanded 13bps over the quarter to 6.88%. The premium vacancy rate in Perth CBD has tightened to just 14.0%.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	↑



Industrial

Growth story attracting foreign investment

The industrial market continued to perform strongly in Q1 2023. Record low vacancy continues to lead to significant rent growth.

Rent growth is mitigating valuation risks. In the past quarter average prime cap rates softened a further 25bps across the board with the rise since last June being 60 to 90 basis points. While capital values have eased, key industrial markets have now achieved between 20-30% growth in rents over the past 9 months which has been vital for preserving valuations. Land values in Outer West Sydney and West Melbourne declined 10%, with inner markets proving more resilient.

Conditions may slow if weakening business sentiment influences space requirements. In this event, furniture and clothing categories will be more susceptible to fluctuations in discretionary spend while supermarket and beverage will be more resilient. Lack of available space poses some challenges for companies looking to expand, however a potential increase in subleasing opportunities may provide short term refuge in the year ahead.

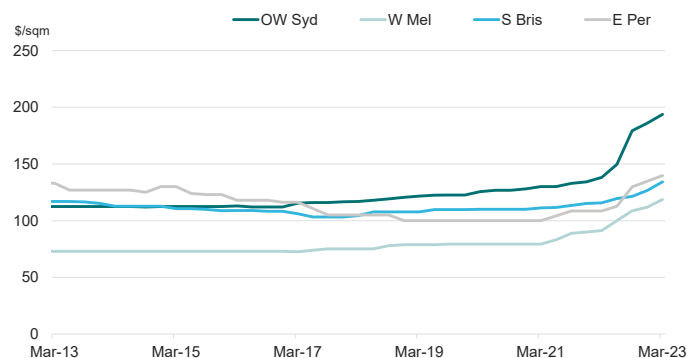
Tight vacancy and a strong rental growth outlook continues to attract capital to the Australian industrial market. However, investors are becoming more selective in their choice of product due to tightening capital markets. Transaction volumes eased over the quarter with around \$1 billion of investment recorded in the industrial sector. Short WALE and value add opportunities were more keenly sought after, as a means of capturing short term rent growth. Foreign backed capital remained strong with acquisitions significantly outweighing disposals. The bulk of transactions were concentrated in the Western Sydney market including; 2 Glendenning Road, Glendenning for \$181m (Amazon Corporate Services) and 8 Williamson Road, Ingleburn for \$125.7m (Mapletree Logistics Trust).

Industrial snapshot

	Prime cap rate change from Q4 2022 (ppts)	Existing prime net face rental growth % p.a.
Outer West Sydney	+0.25	+40.2%
West Melbourne	+0.25	+30.1%
East Perth	+0.25	+28.8%
South Sydney	+0.25	+22.2%
Inner West Sydney	+0.25	+21.7%
Southern Brisbane	+0.25	+15.9%

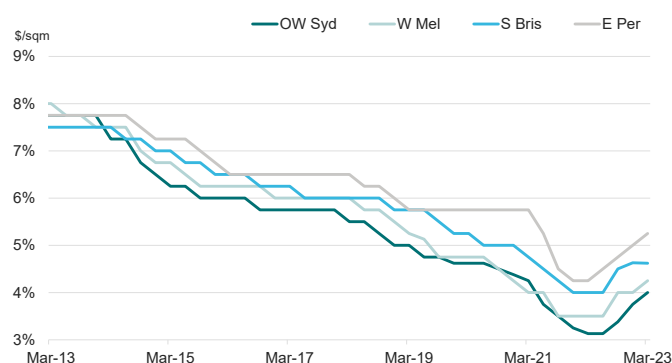
Source: JLL Research, Dexis Research (March 23)

Industrial rents by precinct



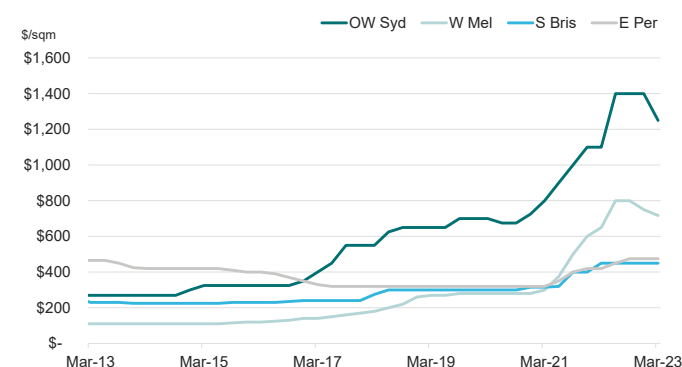
Source: JLL Research (average prime), Dexis Research

Industrial cap rates by precinct



Source: JLL Research (average prime), Dexis Research

Industrial land values by precinct



Source: JLL Research 2-5HA land values *East Perth = 1HA, Dexis Research

Industrial by region

Outer West Sydney

Gross leasing volumes in the Outer West Sydney market improved over the first quarter of 2023 with 45,000sqm absorbed. Deals consisted primarily of existing market leasing within the Wetherill Park/ Greystanes catchments from transport/logistics companies. Woolworths was the primary occupier for completed supply in the broader Sydney market with a 35,000sqm distribution centre in the Outer West and a 20,000sqm automated fulfilment centre in the Inner West. Significant Infrastructure investment into Western Sydney will continue to see a re-calibration of ecommerce supply chains.

West Melbourne

Gross leasing in West Melbourne cooled off over the quarter with 53,000sqm absorbed. Demand came from a broad range of industries including transport/logistics, manufacturing and utilities. Leasing volumes in the South East were the strongest following increased levels of supply, primarily in Dandenong South. Completed supply in the West consisted of 14,000sqm for Daikin Air Conditions in Gateway Logistics Hub and 20,000sqm for Officeworks in Port Link Logistics Estate. Availability of supply in the West is likely to be constrained in the year ahead.

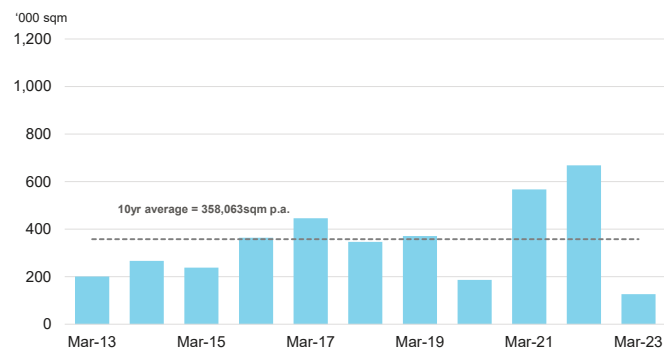
Brisbane (South & Australian Trade Coast)

Gross leasing within the Southern and Trade Coast markets cooled over the quarter with 91,000sqm absorbed, following a record prior quarter. Transport/Logistics was a primary driver of demand in the South with players including TFMXpress and SendAble acquiring an additional 6,000sqm each to suit their expansion plans. The Trade Coast saw continued interest with Slime Darby Motors and BSR Group taking up space in two new facilities within the Airport precinct. Higher levels of speculative development are expected in the year ahead.

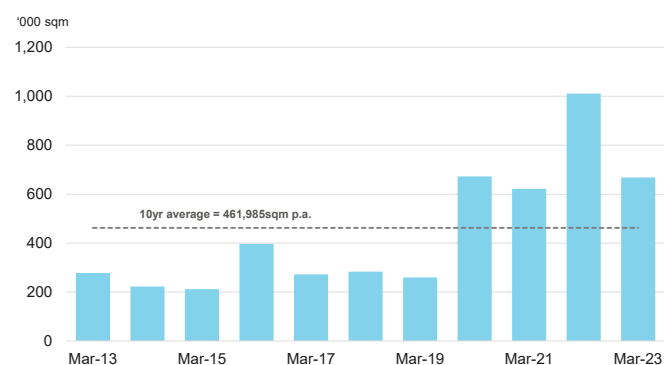
Perth (East & South)

East and South Perth gross leasing volumes were marginally below the prior quarter at 21,000, reflective of tight market vacancy. The largest leasing deal recorded was Austrans who committed to 14,000sqm in Kewdale Distribution Centre, completing their national distribution expansion. The bulk of supply due to be completed in 2023 is within Roe Highway Logistics Park, however majority is pre-committed by the likes of Mainfreight and JB-HI-FI. Demand for the Perth market will continue to be supported by increased investment into mining exploration and strong population growth.

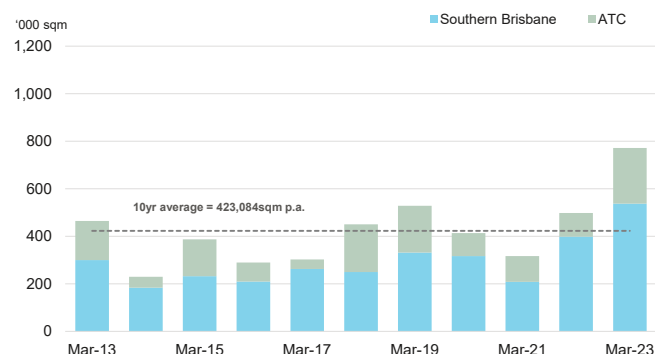
Outer West Sydney gross take-up



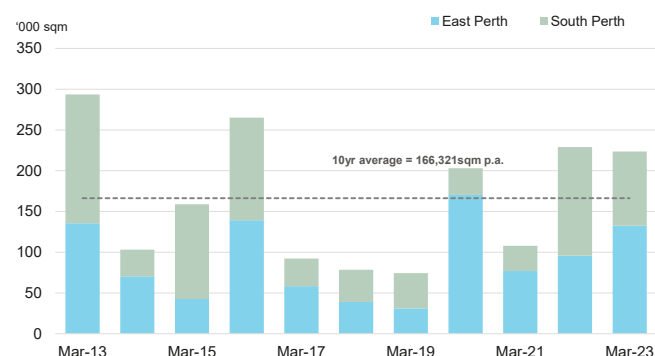
West Melbourne gross take-up



South Brisbane and ATC gross take-up



East and South Perth gross take-up



Retail indicators

Retail sector adapts to interest rate pressures

In a high inflation environment, it has become increasingly important to distinguish between nominal and real retail sales. Nominal sales growth has been particularly strong at 9.3% in the year to December 2022, helped by rising prices, while real retail sales growth, a measure of volume, has been slower at 1.8% in the year. Real sales growth is forecast to turn negative in 2023.

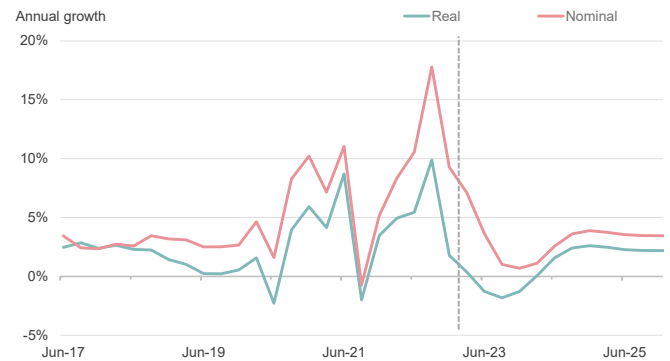
In terms of retail sales performance, cafes, clothing, and department stores have experienced significant annual nominal sales growth relative to the pre-pandemic trend, with total sales growth also showing a marked increase on an Moving annual basis. However, household goods and food sales growth have remained closer to their pre-pandemic trends. Clothing sales and household good sales have slowed over the past three months, down 6.7% and 6.9% respectively.

Ecommerce sales growth, which spiked during the pandemic, has now plateaued, growing by 0.6% month on month in the year to January 2023. Although long-term ecommerce growth is expected to outpace in-store sales, shopping centres still play an important role in the online component of retail sales. A significant share of ecommerce spending will be fulfilled in-store, either by post or click-and-collect. The 'buy online, pick up in store' market is expected to increase to reach over \$700 billion by 2027, growing by nearly 20% annually. Shopping centres will continue to adapt in response to consumer preferences and technology, including expanding the range of uses on-site. In addition, retailers are increasingly focusing on enhancing customer experiences and leveraging technology to offer seamless online-to-offline shopping journeys.

Migration has turned positive and is poised to drive sales growth and foot traffic in the retail sector. Visitor arrivals are on track to reach their pre-pandemic levels in the second half of 2023, contributing to increased foot traffic and retail sales, particularly in tourist-centric areas. This resurgence in migration is expected to have a positive impact on the retail market as a whole, providing much-needed support amidst the challenges of rising interest rates and inflation.

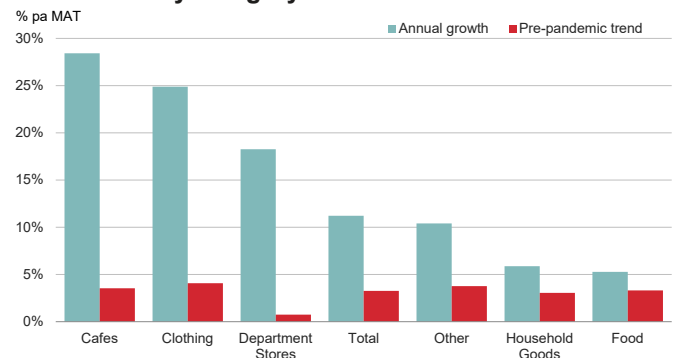
The retail sector is likely face some headwinds through 2023 as interest rate and cost of living pressures begin to bite.

Nominal and real retail sales growth



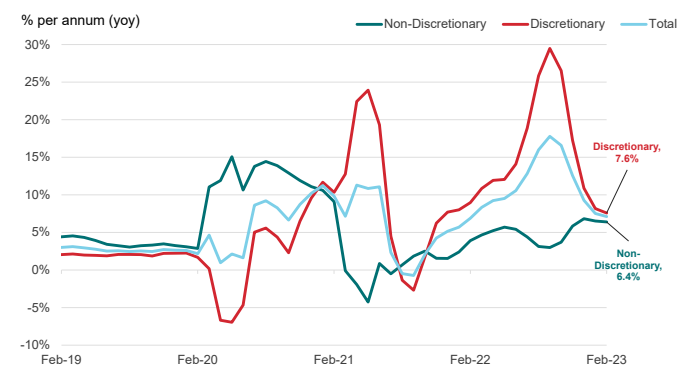
Source: Oxford Economics

Retail sales by category – MAT basis



Source: ABS

Discretionary and non-discretionary retail sales growth



Source: ABS, Dexus Research

Retail performance

What can we expect in 2023?

Shopping centre specialty vacancy rates, which had been on the rise during the pandemic, have been tightening. After peaking in Q2 2022 at 5.1%, Sydney regional shopping centres saw vacancies decrease to 3.4% in Q4 2022. Furthermore, vacancy rates in Brisbane for regional, subregional, and neighbourhood centres are now lower than pre-pandemic levels, suggesting a solid recovery across the shopping centre spectrum.

City retail sales have also picked up driven by increased CBD visitation from office workers, tourists and students. As this trend continues vacancy rates are expected to fall, albeit rents are likely to remain weak in the short term.

During the pandemic, shopping centres experienced a rent reset as owners and retailers renegotiated leases and rents to adapt to the changing market conditions. This strategic approach allowed owners to maintain occupancy while helping retailers stay viable. With releasing spreads now in line with 2019 trends and occupancy costs lower than five years ago, rent growth prospects are improving.

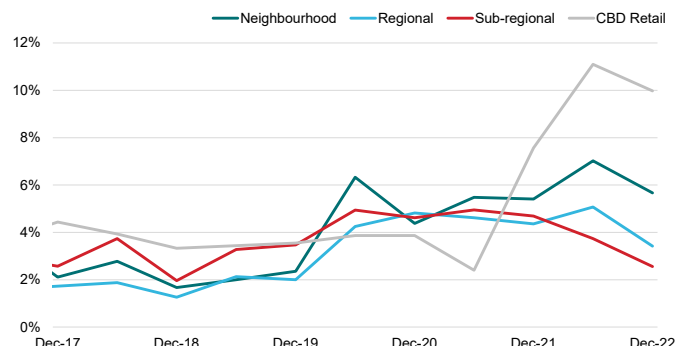
Like other sectors, the retail sector remains susceptible to broader economic factors, such as an increasing cost of capital. Sydney regional shopping centre yields have increased by 50 basis points since Q2 2022. On a positive note, given the retail sector did not face the same yield tightening as other sectors during the pre-pandemic period, it may experience a milder value cycle going forward.

Australian retail performance

	Specialty rent growth % q-o-q.	Cap rate change from Q4 (ppts)
Sydney		
Regional	-0.5%	25
Sub-regional	1.0%	12
Neighbourhood	1.0%	25
Melbourne		
Regional	-0.5%	12
Sub-regional	1.0%	25
Neighbourhood	1.0%	50
SE QLD		
Regional	0.0%	0
Sub-regional	0.3%	0
Neighbourhood	0.3%	0

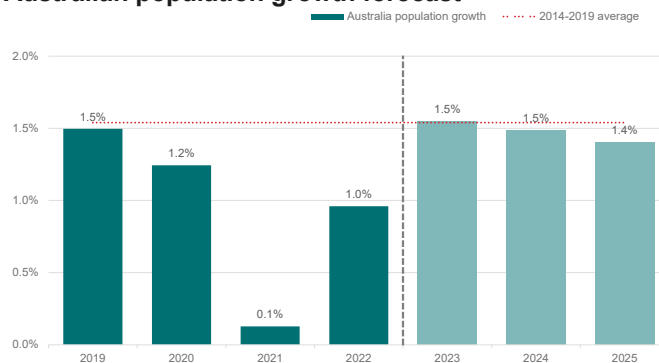
Source: JLL Research, Dexus Research

Shopping centre vacancy rate



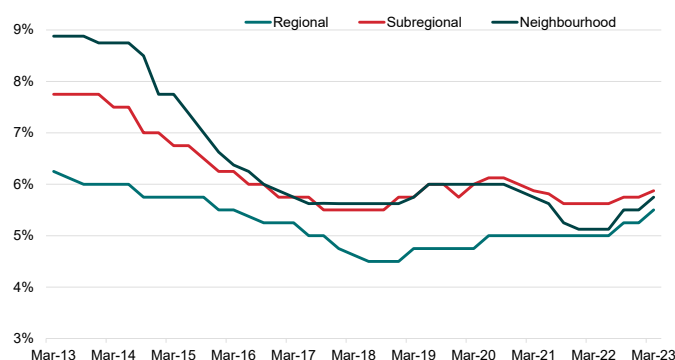
Source: JLL, Dexus Research *Sydney

Australian population growth forecast



Source: Oxford economics

Shopping centre yields



Source: JLL Research, Dexus Research

Healthcare

Spotlight on the private healthcare sector

The private health insurance (PHI) system is an integral part of the healthcare system because it reduces dependency on public services and provides for a more sustainable level of care. While there are risks to the outlook for the private health sector, several positive trends should support industry growth.

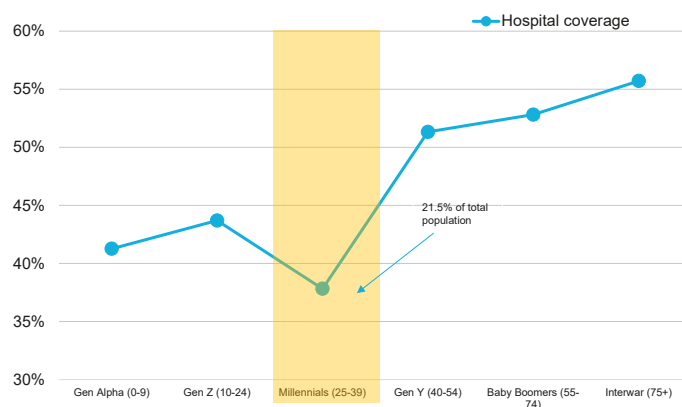
Private health funds are a key driver of revenue in private hospitals. Private health insurance funds contribute around \$18bn per annum to the private sector with half feeding directly into private hospitals. Uptake of PHI has improved with 45.1% of Australia's population holding a level of hospital cover, up from 44.2% two years ago.

Levels of PHI are weaker amongst millennials (37.8%) who are the largest portion of Australia's population. Affordability of cover is a concern. Major private health insurance providers are expected to increase their premiums by an industry average of 2.3% after a year of little to no increase which will leave millennials more financially exposed. Fortunately, over the past couple of years private health reforms have been introduced to stimulate take-up of private cover. Firstly, in 2019 an aged based discount of up to 10% for persons under the age of 41 was introduced. This was followed in 2021 by an increase in the age of dependents in family cover from 24yrs to 31yrs, allowing individuals to stay on family cover longer. In 2022 it was announced that the Medicare levy surcharge will be extended a further two years incentivising take-up of cover before the age of 30yrs. It is expected that these reforms will have a positive impact on the rate of PHI uptake.

Government reforms also look to strengthen the private hospital sector. Historically, private health insurance premiums have increased at double the rate of CPI, heavily influenced by Australia's contracts on prosthesis and medical devices which are 20-40% higher than other nations. Over the next two years the federal government in conjunction with the IHACPA will look to review and re-group items to reduce surgical costs. In addition, the federal government is reviewing the PHI rebate model over the next three years, which should see the rebate benefit improve.

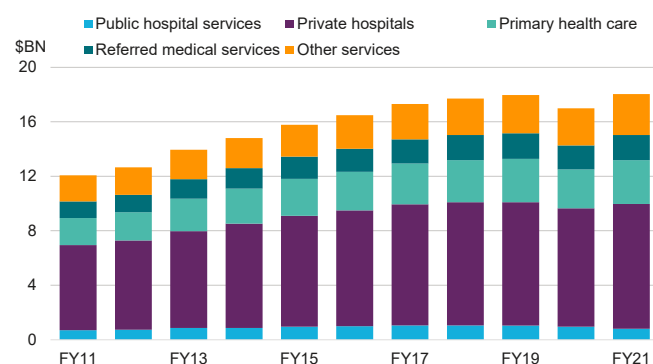
At a state level, the NSW labor government will begin drafting the scope for a royal commission into the state's healthcare services to tackle the elective surgery wait list, workforce pay and budget allocation. A key focus is the registered nurse workforce, with the turnover rate in a steady incline over the past three years. The NSW labor government has promised that wages will be increased with an improvement in conditions.

PHI up-take by generation



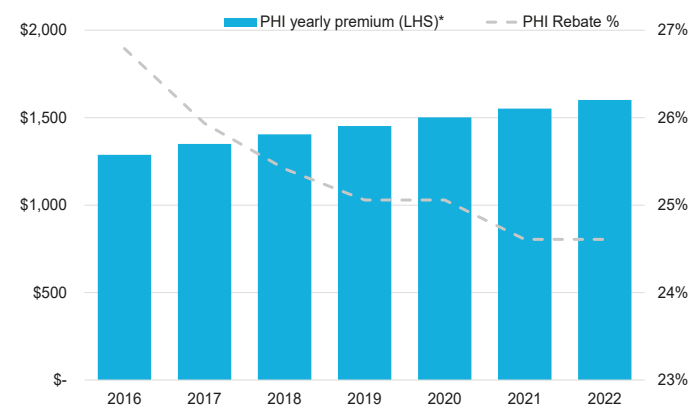
Source: APRA Quarterly private health insurance membership and coverage Dec 2022, ABS

Private health insurance investment by area



Source: AIHW Health expenditure in Australia 2020-21

Growth in PHI vs PHI rebate



Source: Australia government department of health and aged care 2023, Medibank Bronze Plus Progress and Essential Extras cover*



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