Australian Real Estate Quarterly Review

Q3 2022

100 Mount Street, North Sydney

Inside

Investment climate

Headwinds from a shifting cost of capital

In FY22 the economy exhibited solid conditions for real estate including strong employment growth, improving population growth and above average retail sales growth. However, it is likely conditions will moderate over the next two years as rising interest rates constrain economic activity. On the occupier demand side, a decline in consumer confidence and a rise in the cost of living are the main risks. On the capital side, rising borrowing costs are leading to increased caution in the transaction market.

Our key assumptions are:

- Short-term interest rates will rise in FY23 to circa 2.5%. Long term yields are likely to be more stable, being already above 3.0%
- While consumer confidence is easing, business conditions remain positive
- Discretionary retail spending growth will ease from high levels as accumulated savings are deployed on the higher cost of living
- Employment trends are expected to remain positive, particularly in the professional services and health sectors
- Infrastructure projects and exports will contribute to economic growth; helping offset an easing in residential construction activity

The main themes to consider in FY23 are:

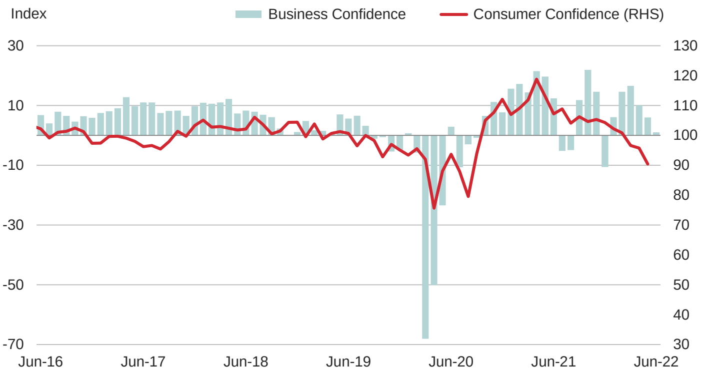
- Activity in the transaction market will remain slow in the short term as investors evaluate financial market risks, curbing vendor price expectations
- A lift in bond yields off abnormally low pandemic levels could lead to an upward revision to required returns for real estate
- Construction costs are likely to rise further over the next year increasing the risks of development and leading to postponement of some projects

Table 1. Australian economic forecasts

	Jun-22	Jun-23	Jun-24
Real GDP %pa	3.6%	2.5%	3.3%
Final demand %pa	4.5%	1.7%	3.0%
Employment %pa	2.2%	2.7%	2.1%
Goods imports %pa	6.1%	2.1%	2.5%
Retail sales %pa (real)	-1.2%	0.8%	1.7%
CPI %pa	6.1%	4.5%	3.0%
Cash rate %	1.4%	2.5%	2.5%
10yr Bond %	3.3%	3.5%	3.0%
AUD/USD	0.72	0.75	0.77

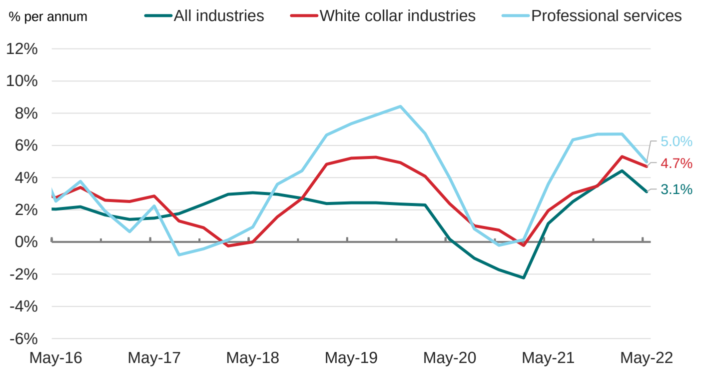
Source: Oxford Economics with Dexus Adjustments June 2022

Figure 1. Business conditions are relatively strong, however business and consumer confidence are on an easing trend



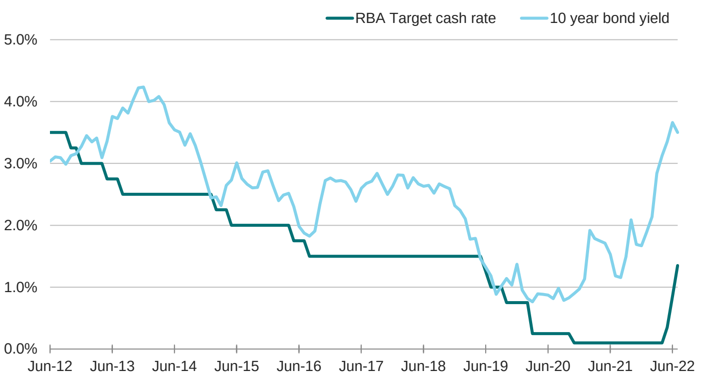
Source: Bloomberg, NAB, Westpac

Figure 2. Employment growth is strong particularly in white collar industries including professional services



Source: ABS

Figure 3. Short and long term interest rates increased sharply in Q2 2022 albeit long term yields have eased in July



Source: Bloomberg

Interest rate implications

How will interest rates affect pricing?

While valuations in Q2 2022 were generally firm, rising interest rates have fueled conjecture about real estate pricing going forward given a narrowing of yield spreads.

Most economists believe the global inflation spike will ease as supply chain issues alleviate over the next few years. In addition, amid fears of the official cash rate rising to 4.0%, it is worth noting that the average rise in the Australian cash rate during the last four tightening cycles has been just 2.25%. Nevertheless, the speed and magnitude of the movement in borrowing rates, including a rise in the 10 year bond yield to 3.5% in Q2 2022, has implications for confidence and investment markets. Market volatility has led to investors becoming more cautious and transaction volumes have slowed.

It is useful to consider pricing as a combination of two things; a) a structural lift in required returns off the abnormally low levels of the past two years and b) any cyclical shifts in risk premiums as a result of uncertainty. On this basis, there is a reasonable probability that real estate pricing will reset to some degree after a relatively strong run over the past two years.

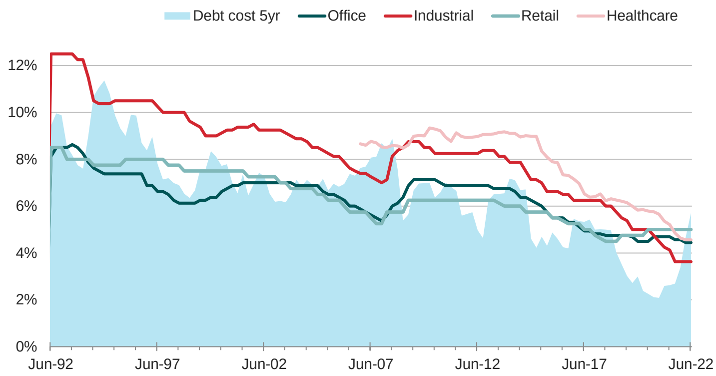
Real estate investors tend to look through volatile spot bond yield movements and base required returns on a 'look-through' basis reflecting a longer term investment horizon. For example, one scenario is that required returns could normalise consistent with an expected bond yield of circa 2.6%. While lower than the spot bond yield of 3.5%, this expected bond yield would be around 50bps higher than the yield implied by recent pricing.

In such a scenario, required returns would rise from current low levels. The amount would vary depending on asset type, quality and security of the income stream. Capitalisation rates can be expected to experience a more moderate change than required returns as investors factor additional inflation into their growth forecasts. Capitalisation rates will also be influenced by economic growth to the extent that it affects growth prospects.

Such periods of uncertainty are not uncommon in real estate, and they can create opportunities for capable, well capitalised managers. High quality assets tend to have more stable valuations than secondary or fringe assets. In addition, a period of uncertainty may unlock development sites that were previously unavailable.

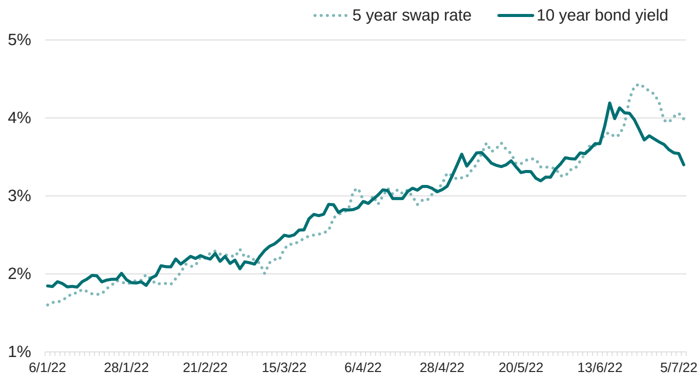
On a positive note, the Australian economy is running well compared to many others globally, which is attractive to foreign investors. Low gearing should limit the extent of forced selling.

Figure 4. A sharp increase in the cost of debt relative to prime property yields has led to a slowing of transaction volumes



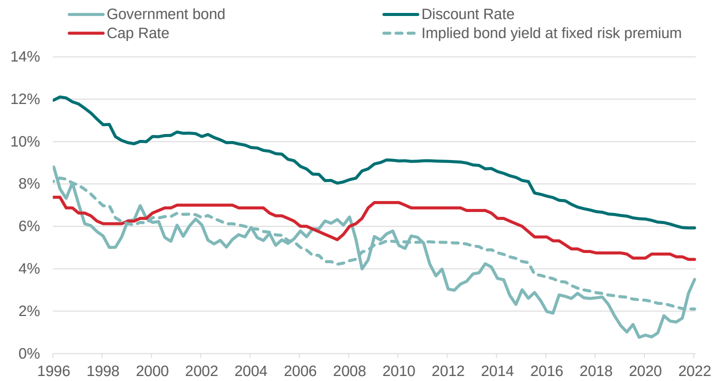
Source: Dexus Research, Bloomberg, JLL Research, MSCI

Figure 5. Action by the RBA appears to be calming financial markets with 5 and 10 year yields now trending down



Source: Iress

Figure 6. Sydney CBD discount rates (a proxy for required returns) have trended down over time



Source: Dexus Research, Bloomberg, JLL Research, MSCI

Performance and transactions

Unlisted real estate performing solidly so far

Unlisted funds have performed solidly in Q2 2022 with diversified funds returning 12.3% in the year to June 2022 (Figure 7). Industrial funds (23.2%) significantly outperformed other sectors, followed by office (11.9%). Retail was resilient with returns of 9.0% for the year, reflecting a slight firming of capital values. Overall performance is expected to soften in the next year as capital growth weakens in the face of higher interest rates and a slower transaction market.

The ASX 200 A-REIT Index (-12.3%) underperformed the ASX S&P 200 Index (-6.5%) in the year to Q2 2022 (Figure 8). The sell-off in A-REITs coincided with a sharp rise in 10 year bond yields. While yields are currently placing pressure on REIT valuations, any reduction in bond yields over time as inflation fears ease may benefit REIT pricing going forward.

Office transaction volumes in Q2 2022 appear to be slowing as the cost of debt rises and financial market volatility continues (figure 9). There was a lift in the proportion of non-CBD transactions, particularly from domestic capital. Foreign interest remained subdued as a limited number of high quality CBD assets were transacted.

Industrial sector transactions fell when compared to the high levels observed throughout 2021. Despite this, H1 volumes were almost double the levels observed between 2017-2020. Strategic infill locations benefiting from ecommerce fulfilment continue to be a focus in Sydney and Melbourne. Notably, Adelaide has attracted growing interest this quarter, comprising almost 20% of total industrial transactions.

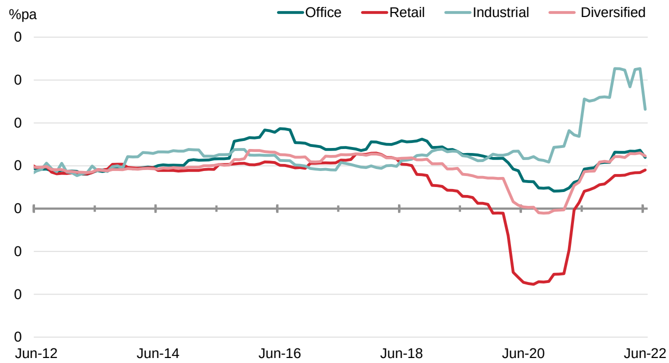
Retail transaction volumes are down from 2021 and more similar to those observed between 2018-2020. Sentiment remains weak overall, but is more positive for smaller supermarket based centres than for larger discretionary centres. Accordingly, pricing has tightened for the smaller centres. Larger centres now offer a more attractive yield and several of them have traded in recent times with demand driven by domestic investors focusing on a sustainable growth story and any mixed-use potential.

Table 2. Asset class performance to 30 June 2022

	Qtr.%	1 yr %p.a.	3 yr %p.a.
A-REITs[5]	-17.7	-12.3	-2.8
Australian shares[2]	-11.9	-6.5	-3.3
Unlisted property[4]	2.8	12.3	6.2
Australian cash[3]	0.1	0.1	0.3
Australian fixed interest[1]	-3.8%	-10.5	-2.6

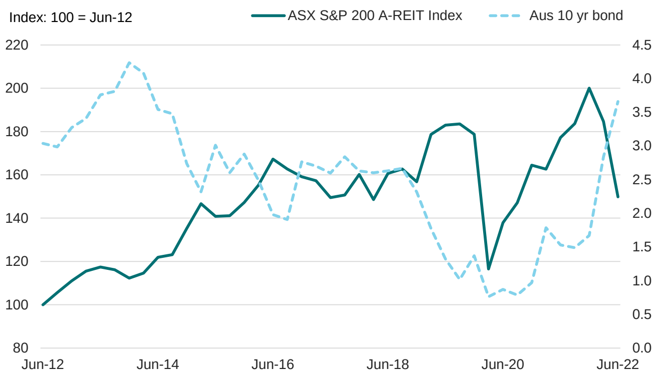
Source: [1]BACM0 Index, [2]S&P/ASX.200. Accumulation Index, [3]BAUBIL Index, [4]MSCI Mercer Australian Core Wholesale Monthly PFI (NAV Pre Fee) – All Funds, [5]S&P/ASX.200.A-REIT Accumulation Index

Figure 7. Unlisted property fund index returns have performed solidly over the past year, easing in Q2 2022



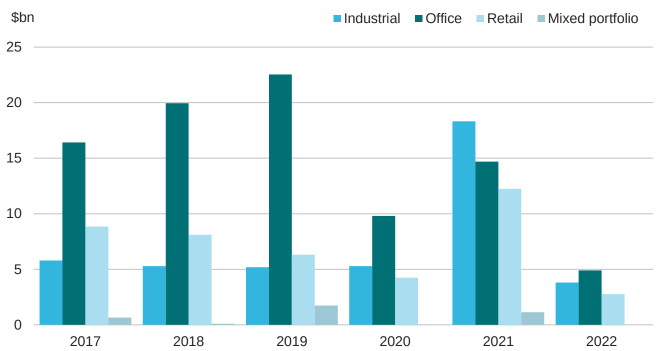
Source: Bloomberg, Dexus Research

Figure 8. The A-REIT index had a strong run over the past year, but lost ground in Q2 2022



Source: JLL Research, Dexus Research

Figure 9. Transaction market volumes remain subdued in 2022



Source: MSCI, Dexus Research

Office

Smaller occupiers driving office recovery

Most demand indicators are pointing in a positive direction. Business conditions surveys are positive, the labour market is expanding and job advertisements are at record highs. In addition, leasing enquiry levels improved in Q2 2022. Enquiries have been strongest in the professional services, finance and government sectors. While easing business confidence could become a factor for leasing markets over the next 12 months it has yet to influence inquiry levels.

After an encouraging start, net absorption was relatively modest in FY22. However, the aggregate data belies a pronounced expansion by smaller users (those with leases <1000sqm). For example, in Sydney CBD, small users absorbed 45,508sqm of space while larger users gave up 17,685sqm. Larger users were more likely to have had surplus space going into the pandemic and appear more focused on cost control coming out of it.

Physical occupancy rates have been recovering over the past six months and, although slowed down by cold, wet weather, are expected to improve further in the year ahead. Physical occupancy was recorded at 52% in Sydney and 41% in Melbourne.

Vacancy rates have been reasonably stable over the past year. Office vacancy rates are likely to remain elevated during FY23, constraining rent growth.

Rising construction costs are an issue for the viability of planned new developments and any delay to major projects could help restore the supply/demand balance in the medium term.

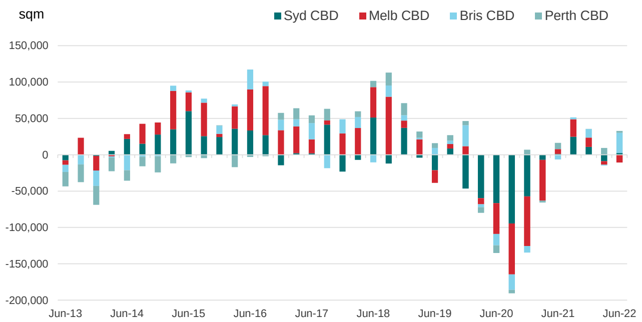
Rents have performed well over the past quarter. Sydney CBD prime net effective rents grew by 2.1% in Q2 2022, the fastest rate since Q4 2017. Brisbane net effective rents grew by 2.7%. Melbourne and Perth CBDs recorded 0.1% effective rental growth in the quarter.

Table 3. Office snapshot

	Total Vacancy	Rent growth* (% q/q)	Increase in stock in FY23**
Sydney CBD	13.0%	2.1%	0.8%
Melbourne CBD	15.0%	0.1%	3.3%
Brisbane CBD	15.4%	2.7%	-0.6%
Perth CBD	20.1%	0.1%	0.5%
Sydney Fringe	8.7%	0.7%	0.9%
North Sydney	17.1%	-0.2%	3.2%
Parramatta	18.3%	0.1%	0.6%

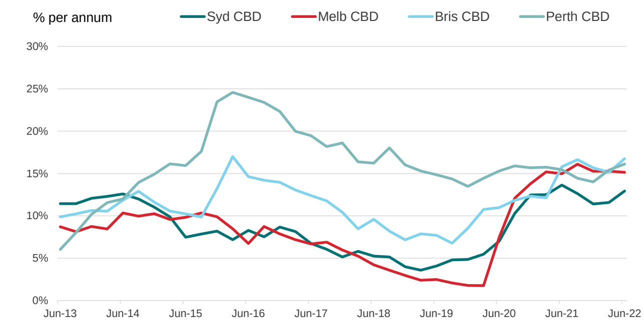
Source: JLL Research June 2022, *Net effective, ** as a % of stock

Figure 10. Net absorption was positive over the past year, but well below average



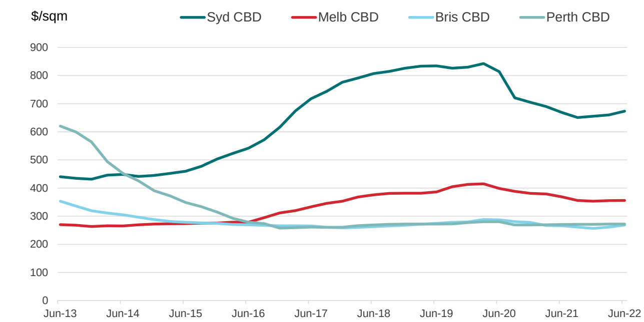
Source: JLL Research, Dexus Research.

Figure 11. Vacancy rates have been fairly stable over the past year, with some ups and downs each quarter



Source: JLL Research, Dexus Research

Figure 12. Effective rents have started to increase after dipping through the COVID-19 period



Source: JLL Research, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months
Sydney CBD	**The Sydney CBD market is slowly recovering after a pandemic slump.** Demand is driven mainly by smaller occupiers**.** Lead indicators have been generally positive, with strong business conditions, tight unemployment, and high levels of job advertisements. Key headwinds include lower consumer confidence and easing business confidence. Net absorption was positive for the year at 29,000, marginally outpacing supply. The vacancy rate fell slightly, currently at 13.0%. Incentives increased to 34% and prime gross face rents grew 1.3% over the year.	Vacancy → Rents ↑ Incentives ↓ Yields ↑
North Sydney	**Vacancy weighs on the market.** North Sydney is supported by the same positive economic fundamentals as the Sydney CBD. An influx of high-grade completions over the past few years has increased vacancy substantially. The supply pipeline is relatively strong with another 29,000sqm of completions expected in FY23. This market has been increasingly stratified, with stronger rental outcomes on the top of the market, whilst B-grade stock has seen rents fall. Net absorption was positive for the year at 9,000, outpacing supply.	Vacancy → Rents ↑ Incentives ↓ Yields ↑
Parramatta	**Vacancy rises due to new supply.** The Parramatta office market has grown substantially over the past few years, with a substantial level of completions in high-grade stock, particularly at Parramatta Square. Office vacancy has increased significantly, even amongst good-quality stock. The big question mark in this market is how quickly this stock will be absorbed. The market has been increasingly stratified, with stronger rental outcomes on the top of the market, whilst older buildings are harder to lease.	Vacancy ↑ Rents ↓ Incentives ↑ Yields ↑
Rhodes/Sydney Olympic Park	**Availability falls to sub 20%.** Net absorption was 7,250sqm in the June quarter, driven by Commonwealth Bank taking up 5,800sqm at 10 Dawn Fraser Avenue. As a result, vacancy has compressed to 18.1%, the lowest level since Q3 2019. There is now more certainty around the supply pipeline in Sydney Olympic Park, with developments associated with the Sydney Metro West unlikely to proceed this decade unless construction risks ease. Supply in Rhodes is limited to the development of Hewlett Packard HQ. Face rents remained stable over the year, and there was a marginal increase in incentives.	Vacancy → Rents → Incentives ↓ Yields ↑
Melbourne CBD	**Completions weigh on rental growth.** The Victorian economy has been performing well over the past year and is looking to grow solidly in FY23. The labour market is tight and interstate migration and population growth are expected to return. Tenant demand has been solid and broad-based. Whilst smaller occupiers have been more active recently, there is an increase in larger briefs, although these haven't been translated into activity yet. Net absorption was positive for the year at 21,000, although an increase in supply saw vacancy rise.	Vacancy ↓ Rents → Incentives ↓ Yields ↑
Brisbane CBD	**Office indicators positive.** Flight to quality has been a persistent trend in Brisbane, and Premium vacancy is significantly lower than the market average, driving rent growth in better buildings. Demand and occupier sentiment has been improving, particularly amongst Premium and better A-grade stock. There has also been an increase in interest in already fitted-out offices among lower A-grade stock and below. Brisbane led Australian CBDs in Q2 2022 with net absorption at ~28,000sqm over the quarter. Brisbane should benefit from positive interstate migration and the Olympics over the next decade.	Vacancy ↑ Rents → Incentives → Yields ↑
Perth CBD	**Improving conditions driving outlook.** Western Australia was Australia's best-performing economy throughout the pandemic. Lockdowns were limited and strong commodity prices continued to support demand. There have been signs of an increase in engineering investment, and this should translate into office demand. Net absorption was positive for the year at 12,000, albeit not keeping up with supply. The vacancy rate increased, currently at 20.1%. Incentives remained stable at 49% and prime gross face rents grew 0.4% over the year.	Vacancy ↓ Rents ↑ Incentives ↓ Yields ↑

Industrial

Strong growth in the industrial sector

The Australian industrial sector continues to benefit from a period of strong demand, falling vacancy rates and robust development activity. Demand is very broad-based including medical supplies, supermarkets and groceries, agribusiness, materials supporting transport infrastructure and retailers investing in last mile fulfilment.

The outlook for leasing in FY23 is more subdued given the possibility that rises in interest rates will slow spending on retail goods. On a positive note, leasing activity is expected to be supported by a continued build-up of inventories from below trend levels and by retailers enacting long term plans to invest in multi-channel supply chains. Nevertheless, there are reasons to expect solid demand in the longer term. The Australian online retail market share (14%) lags the US (18%) so it will keep growing over the next few years albeit at a slower pace. In addition, over the next five years population growth is expected to increase at one of the fastest rates in the OECD. Rising transport costs are also influencing rents that users are willing to pay for certain locations. The fact that transport accounts for up to 50% of a tenant's costs while rent accounts for 5.0% reinforces the importance of having well located properties.

Development activity has accelerated yet is struggling to keep pace with demand. Over the past six months the national vacancy rate has fallen to 0.8% following strong levels of pre-leasing activity. Around 1.2 million sqm of supply is forecast this year however around 63% of this supply is already committed. Supply chain disruptions and land zonings look to influence the timing of future projects with vacancy remaining low in the short term.

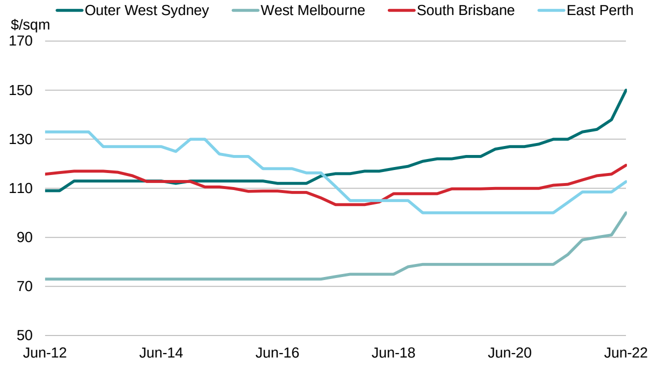
Strong demand and low vacancy rates are pushing up on rents with many markets experiencing double-digit rent growth over the past year. Developers should continue to be able to pass higher construction costs onto users in FY23. Going forward, land values will be sensitive to any rise in cap rates from cost of capital effects. Over the past six months the Sydney and Melbourne industrial markets experienced circa 30% growth in land values.

Table 4. Industrial snapshot

	Ave prime cap rate change in Q2 2022	Existing prime net face rental growth % p.a.
West Melbourne	-	+20.5%
East Perth	+0.13	+8.2%
South Sydney	-	+20.8%
Outer West Sydney	-	+15.4%
Southern Brisbane	-	+7.0%

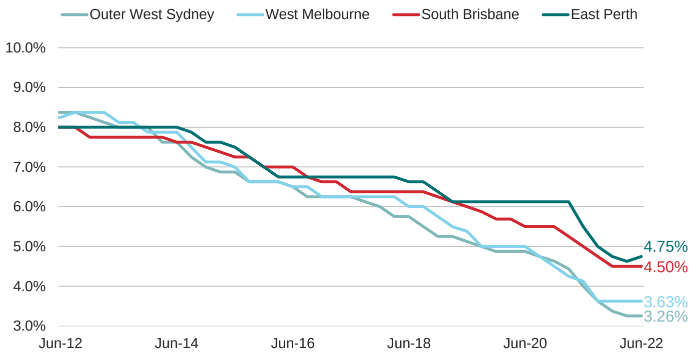
Source: JLL Research, Dexus Research (June 22), land values 2-5HA excl Perth (1HA)

Figure 13. All major markets record strong rent growth with West Melbourne up 20% in the year



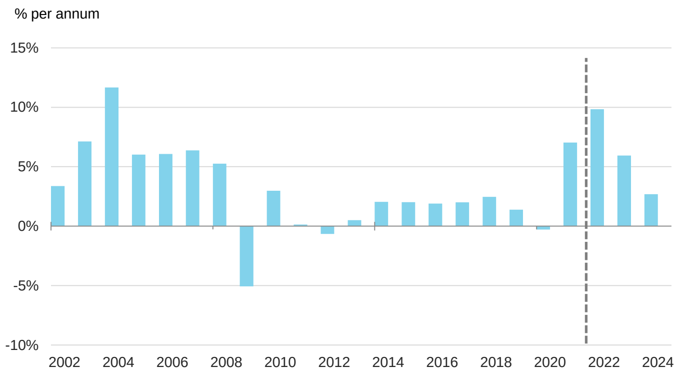
Source: JLL Research, Dexus Research

Figure 14. Reported industrial yields remained steady for the second consecutive quarter



Source: JLL Research, Dexus Research

Figure 15. Construction cost growth looks likely to remain elevated in 2022 and 2023



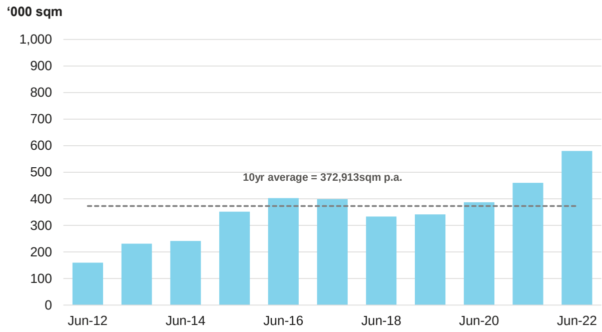
Source: Oxford economics

Industrial by region

Outer West Sydney

Sydney's quarterly leasing volumes are reflective of the tightest vacancy rate nationally. Take-up levels in the Outer West Sydney market finished the quarter at 46,200sqm, well below the prior quarter and this time last year. This can be at least partly attributed to the low vacancy rate of just 0.3%. The majority of supply forecast to be delivered in 2022 has already been completed across multiple projects including Amazon and Coles at Oakdale West. For the second half of the year there is around 180,000sqm under construction, 80% of which is already committed.

Figure 16. Outer West Sydney gross take-up

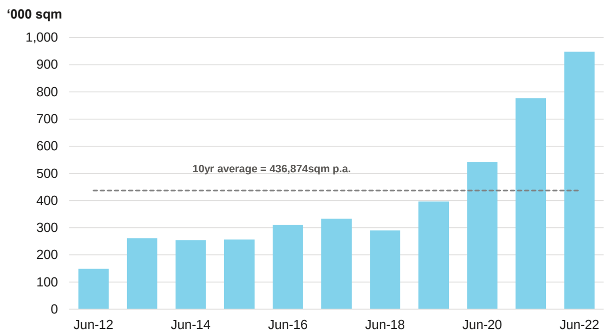


Source: JLL Research (gross take-up), Dexus Research.

West Melbourne

Melbourne demand and rent growth is the highest nationally. Over the quarter, West Melbourne absorbed 217,000sqm broadly in line with the prior quarter, accounting for 60% of Melbourne demand over the past six months. Ecommerce related take-up continues to be concentrated in the West with Officeworks leasing 20,000sqm in ISPT's Port Link Logistics Estate for $85/sqm. Transport and logistics companies continue to compete for space with Gilders Transport leasing 7,400sqm in Truganina for $98/sqm. Agents suggest that the West has experienced 20.5% rent growth year-on-year and incentives are declining.

Figure 17. West Melbourne gross take-up

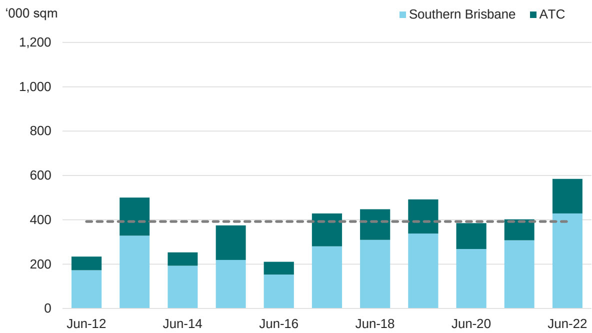


Source: JLL Research (gross take-up), Dexus Research

Brisbane (South & Australian Trade Coast)

Leasing momentum in the Brisbane market picked up over the past quarter with around 245,000sqm absorbed between the South and Trade Coast. The South has absorbed 71% of Brisbane's demand over the past six months which saw the vacancy rate fall from 3.3% to 1.7%. Major leasing commitments include Bunnings occupying 20,000sqm at Crestmead logistics estate. Historically, leasing volumes in the Trade Coast have been influenced by a lack of prime grade supply. Over the past quarter, the Trade Coast experienced a record level of quarterly demand attributable to VISY pre-leasing 46,000sqm within Dexus's Crossbank estate.

Figure 18. South Brisbane and ATC gross take-up

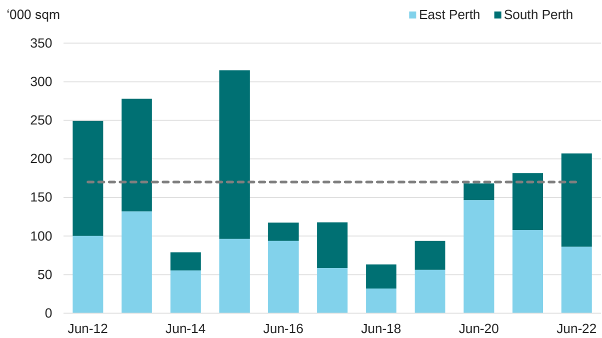


Source: JLL Research (gross take-up), Dexus Research

Perth (East & South)

Perth's economy continues to benefit from record high commodity prices and significant interstate migration which bode well for the year ahead. Over the past quarter, around 60,000sqm was absorbed between the East and South, driven by logistics, mining and retailers. The lower levels of take-up coincide with a lack of prime grade supply against a total market vacancy pushing sub 1.0%. Jandakot Airport continues to provide opportunity and scale for retailers looking to establish a national footprint, with Marley Spoon pre-leasing 14,000sqm. Rents grew another 3.9% in the East and 9.3% in the South while incentives remain steady.

Figure 19. East and South Perth gross take-up



Source: JLL Research (gross take-up), Dexus Research

Retail

Retail sales growth likely to slow

Sales growth in the sector has continued to exceed expectations, growing by 10.3% in the year to May 2022. Growth was driven by discretionary categories such as clothing, cafes and restaurants, helping the performance of larger shopping centres (Figure 19). Going forward, the retail sector is facing potential headwinds from rising interest rates and cost of living pressures which could see sales growth slow from high levels.

The housing market looks like it may weigh on retail sales growth in FY23. The residential property market is slowing as credit conditions tighten. In addition, household goods comprise a large proportion of retail sales. The combination of falling house prices and increased mortgage repayments is likely to impact spending, especially for household goods and discretionary items (Figure 20).

Cost of living pressures are also a headwind, albeit to a lesser extent than mortgage rates. As figure 21 shows, petrol prices and energy costs combined account for about half of the impact of mortgage rates on the household budget. On a positive note, a high level of household savings, amounting to around $225 billion above normal levels is likely to act as a buffer, supporting the retail sector in FY23, but not preventing a slowdown from current strong levels.

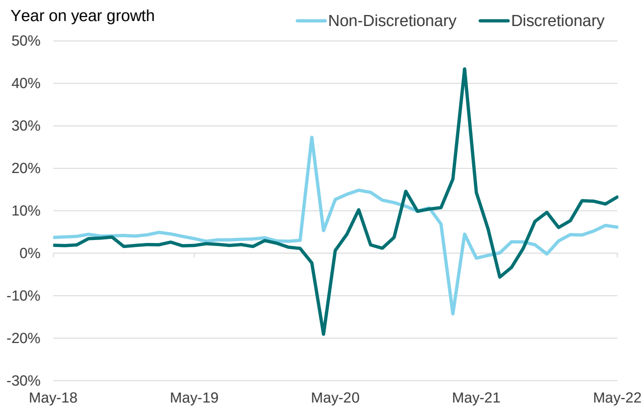
Overall, shopping centre performance is improving slowly, with regional, sub-regional and neighbourhood rents stabilising somewhat relative to this time last year. Limited planned supply should aid the recovery in rent growth. City retail remains challenged however, FY23 should be more positive as office workers and tourists return.

Table 5. Retail snapshot

	Specialty rent growth % p.a.	Cap rate change from Q1 (ppts)	State sales growth % p.a.
Sydney			9.6%
Regional	1.8%	-	
Sub-regional	-0.4%	-	
Neighbourhood	0.4%	-	
Melbourne			10.8%
Regional	-1.5%	-	
Sub-regional	0.3%	-	
Neighbourhood	-1.4%	0.12	
SE QLD			10.9%
Regional	-0.7%	-	
Sub-regional	0.1%	-0.25	
Neighbourhood	0.3%	-	

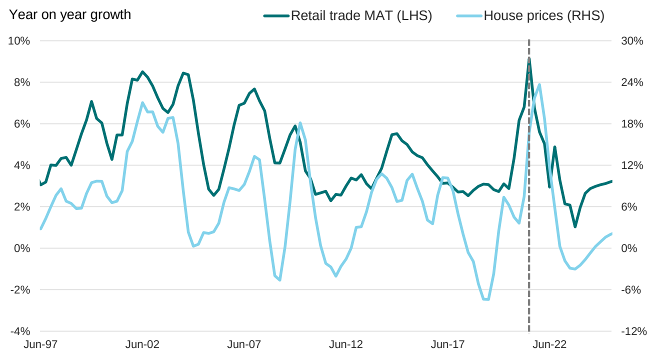
Source: JLL Research, Dexus Research (June 2022)

Figure 19. Discretionary retail spending has outpaced non-discretionary spending since Oct-21.



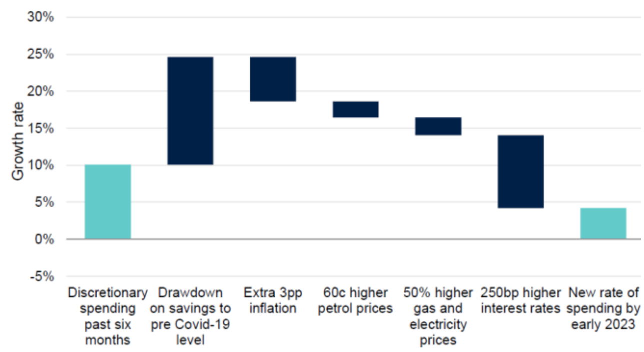
Source: ABS, Dexus Research

Figure 20. A downturn in house prices is a negative signal for retail spending



Source: Oxford Economics, Dexus Research

Figure 21. Accumulated savings are likely to be a significant buffer for households in FY23



Source: ABS, MST Marquee

Healthcare

Healthcare operations should prove resilient

The healthcare sector appears well placed to handle an uncertain investment climate. Whilst rising interest rates are likely to impact consumer spending patterns, spending on healthcare is expected to continue to grow due to its non-discretionary nature.

Healthcare operators are still experiencing pressures from COVID-19 via staffing challenges, cost pressures and elevated infection rates. Medical practices impacted by social distancing during the pandemic should benefit from more normal consultation levels going forward. On a positive note, waiting times for elective surgery remain elevated after COVID-19 restrictions and the backlog of surgeries represents a source of demand in the year ahead. If anything, longer waiting times for public hospitals may encourage the uptake of private health insurance as a way of speeding up the treatment process.

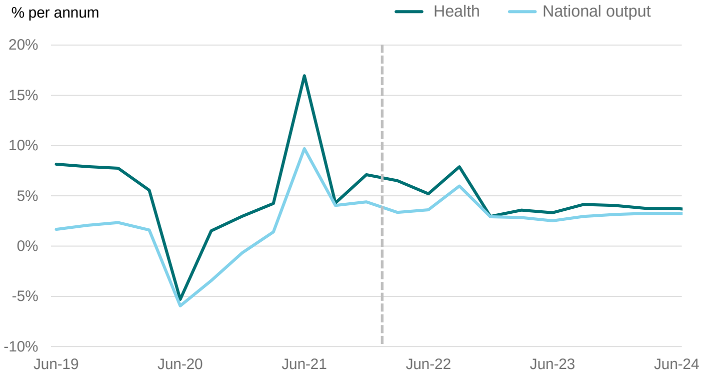
Overall, private health insurance (PHI) uptake has increased over the past year (from 45.8% to 46.3% as at March 2022). However, within this positive trend there remains a divide between younger and older persons' uptake of private health insurance, as younger Australians are increasingly forgoing hospital treatment cover. Over the long-term, if this trend is to persist, there will be a greater strain on the delivery of public hospital care, with approximately 40% of total hospital separations in Australia provided by the private sector.

The recent change of Federal Government appears generally favourable for the healthcare sector. The most significant commitment is the promise of $1 billion over the next four years in primary care reform which will improve patient access to GP-led multidisciplinary team care, including nursing and allied health and after-hours care and better management of complex conditions. The Medicare Benefits Schedule will receive additional funding to deliver best practice therapies.

The FY22 Federal Budget contained additional funding for aged care including increasing the number and skills of aged care workers, adding registered nurse coverage in aged care facilities and support for a wage rise for aged care workers, to help address the issue of staff shortages in the sector. The budget also additional funding for mental health.

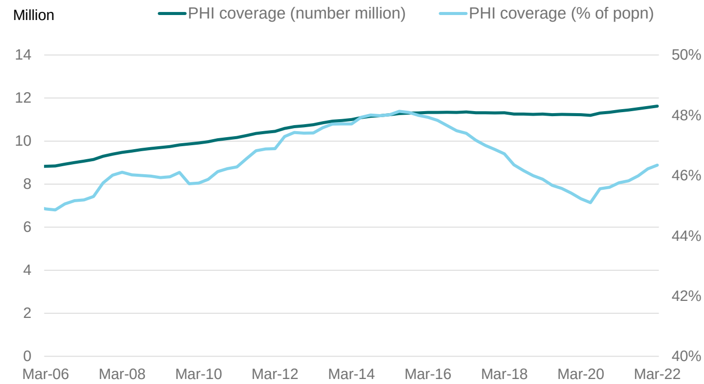
Total returns have been very solid over the past year, however they are expected to normalise in the year ahead as cap rate compression diminishes in a higher interest rate environment. Investors continue to demonstrate interest in healthcare and alternative asset classes. Demand for healthcare services will continue to benefit from ageing demographics, longer life expectancy and population growth.

Figure 22. Healthcare output has been resilient through the pandemic and should continue to outpace the national average



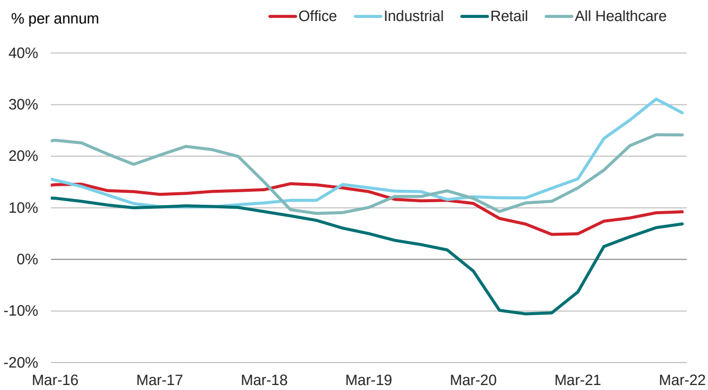
Source: MSCI, Dexus Research

Figure 23. Private health insurance coverage has increased over the past year as a proportion of population



Source: APRA

Figure 24. Total returns have been running strongly, but should normalise in the year ahead due to less cap rate compression



Source: MSCI, Dexus Research

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