dexus

Australian Real Asset Review

Q1 2024

University of Melbourne student accommodation project

Inside

Investment climate

Population growth supports economy

While a slowing in the economy is a consideration for occupier activity in the short term, a forecast fall in interest rates in FY25 is expected to be a major positive for real asset valuation as investors factor in a lower cost of capital.

Australia's headline monthly inflation rate slowed to 4.3% in November 2023. The Reserve Bank of Australia lifted the official cash rate to 4.35% in December 2023 and the 10-year bond yield fell 50 basis points to 4.0% in the quarter, indicating that markets are anticipating that official cash rates are close to peaking and could begin falling in late 2024.

Of the real asset sectors, office, retail and industrial are likely to be more sensitive to economic conditions than some other real asset sectors such as healthcare, student accommodation and infrastructure.

The longer-term demand outlook for all the real asset sectors will be buoyed by population growth. Australia's population increased by 624,100 in the year to Q2 2023 (+2.4%) driven by a surge in net migration of around double the pre-COVID average.

The Australian economy slowed to 2.1% per annum in Q3 2023 as higher interest rates continued to impact consumption spending. GDP growth is forecast to slow to 1.0% in Q2 2024 but avoid recession.

Household consumption grew by just 1.0% over the year to Q3. Consumption was negative in per capita terms but the total value was held up by strong population growth of 2.2% per annum. Dwelling investment eased, reflecting the tightening of monetary policy.

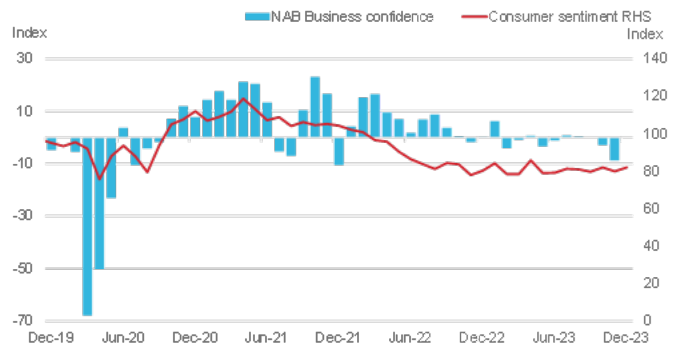
The business sector has remained surprisingly resilient despite a sharp weakening in confidence. Business investment grew 7.7% and the unemployment rate remains low at 3.8%.

Australian economic forecasts

	Jun-23	Jun-24	Jun-25
Real GDP %pa	2.0%	1.0%	2.4%
Employment %pa	3.4%	1.7%	1.6%
Unemployment %pa	3.6%	4.3%	4.4%
Business investment %pa	10.3%	2.8%	3.4%
Dwelling investment %pa	-0.2%	-2.8%	-1.6%
Population %pa	2.3%	1.9%	1.5%
Retail sales %pa	3.5%	1.5%	3.7%
CPI %pa	6.1%	3.7%	3.1%
Cash rate %	4.1%	4.4%	3.9%
10yr Bond %	4.0%	4.1%	3.8%

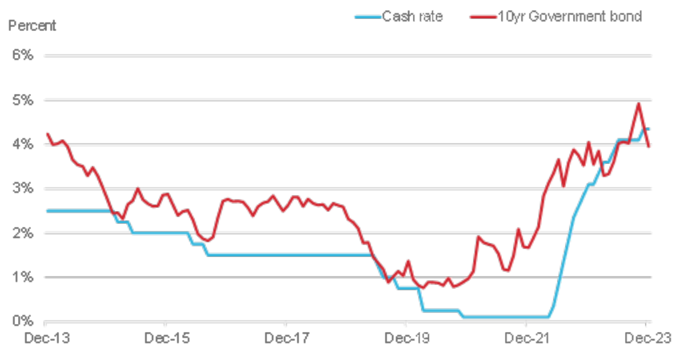
Source: Oxford Economics with Dexus adjustments, December 2023

Consumer sentiment and business confidence



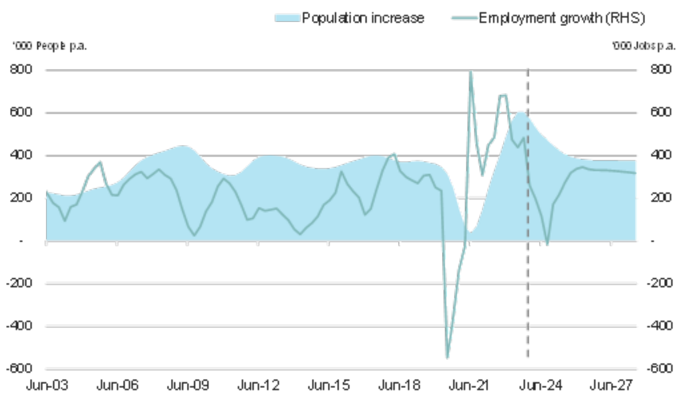
Source: NAB, Westpac

Official cash rates and 10-year bond yields



Source: NAB, Westpac

Population and employment growth forecasts



Source: Oxford Economics

Performance

Real asset cycle likely to turn in 2024

The past year was challenging for most asset classes with rising interest rates and global conflicts weighing on investor sentiment. However late in the year equity markets staged a comeback after a perceived maturation of the US cash rate cycle and a surge in bond prices.

Australian shares returned 8.4% through the fourth quarter and 12.4% per annum in 2023. AREITs experienced even stronger growth, returning 16.6% in the quarter and 17.6% over the year. The strong AREIT pricing can be partly attributed to a fall in bond yields of around 50 bps through the quarter. With the interest rate cycle expected to peak, further falls in bond yields should be positive for AREIT pricing in 2024.

Unlisted property returns saw negative movement through Q4 2023 and the wholesale fund benchmark return was -6.7% for the year to December 2023. Industrial property returns were strongest of the real estate sectors at -1.7%, followed by retail at -2.3%. Office returns were the weakest at -10.1% due to significant declines in valuations of office buildings over the year. Income returns were positive over the year at 4.5%.

Transaction markets for real assets can be expected to become more active as we move through 2024 given interest rates appear to be peaking and price discovery is well underway. Strong performance by the listed real estate market in Q4 2023 may be a lead indicator of the shift in attitude which might occur across the real asset spectrum as investors regain confidence.

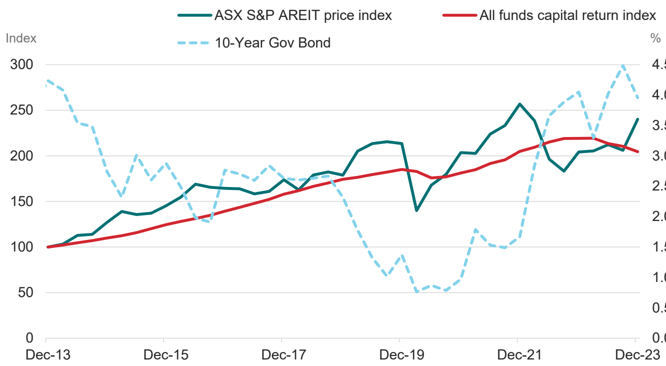
Real estate transaction volumes were significantly lower in 2023 than in the previous two years. Office transactions were the lowest seen in a decade, due in part to significant declines in asset valuations and hesitancy among investors given high levels of vacancy.

Asset class performance Q4 2023

	Qtr. %	1 yr %p.a.	3 yr %p.a.
AREITs[6]	16.6%	17.6%	5.7%
Australian shares[5]	8.4%	12.4%	9.2%
Australian infrastructure[1]	1.7%	9.9%	11.3%
Australian fixed interest[4]	3.8%	5.1%	-2.7%
Australian cash[3]	1.1%	3.9%	1.7%
Unlisted property[2]	-2.8%	-6.7%	4.1%

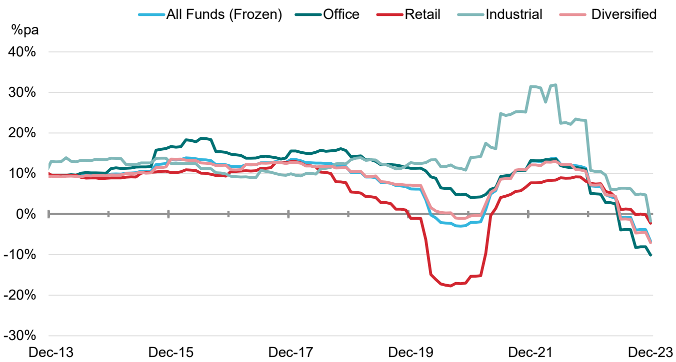
Source 1: MSCI Australian Infrastructure Index (Sep-23)
Source 2: MSCI/Mercer Australian Core Wholesale Monthly PFI (Dec-23)
Source 3: Bloomberg BAUBIL Index
Source 4: Bloomberg BACM0 Index
Source 5: S&P/ASX 200 Accumulation Index
Source 6: S&P/ASX 200 A-REIT Accumulation Index

AREIT price and unlisted real estate values



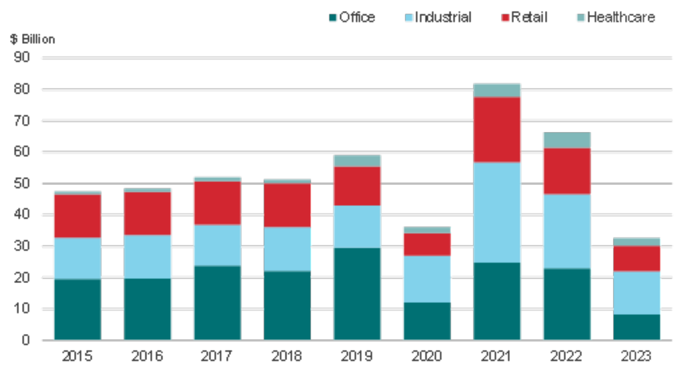
Source: Bloomberg, MSC Mercer Core Wholesale Property Fund capital return index

Unlisted real estate fund returns



Source: MSCI/Mercer

Quarterly transaction volumes – real estate



Source: Real Capital Analytics

Infrastructure

Deal flow has slowed but not stopped

Global M&A value across all sectors fell by 17% in 2023 to circa US$3.0 trillion, the lowest since 2013. Several contributing factors explain this decline, including high interest rates, a volatile global political landscape and general market sentiment. Global infrastructure deal value was similarly affected, declining by 23% to US$954bn in 2023. This trend was also apparent in Australia where total infrastructure deal value decreased from a record peak of US$132bn in 2022 to US$35bn in 2023. We anticipate a recovery in transaction volumes during 2024 assuming there is a stabilisation and moderation of the interest rate cycle.

The Australian Federal Government announced it was cutting funding for 50 transport projects worth A$6.5bn after finalising a review of its $120bn project pipeline. The move has come as construction costs have escalated. Over the medium to long term this may lead to opportunities for private capital to unlock value in tightly held key infrastructure assets. We have recently seen this play out in New Zealand where the government has expressed a need for private capital, resulting in an increased number of announced asset disposals to fund future public needs. These include Wellington City Council's consideration of a sale of all or part of its 34% stake in Wellington Airport, and The Bay of Plenty's Regional Council considering a 54.1% sale of Port of Tauranga.

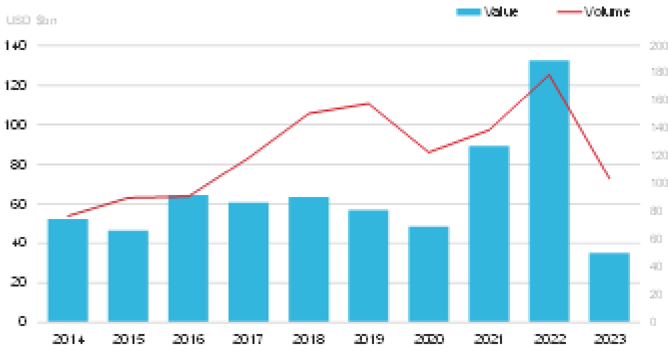
In the student accommodation sector, the number of foreign students approved to study in Australia has surged to the highest level in a decade with over half a million student visas approved in FY23. This increase comes at a time when the nation is experiencing a housing shortage and a deficit in student accommodation. Despite an estimated 8,000 rooms to be delivered over 2023-26, representing a 7% uplift to the current volume of rooms, supply is projected to fall short of meeting demand.

Performance of infrastructure has been relatively good to Q3 2023 with the Australian listed and unlisted infrastructure indexes returning 9.9% and 8.4% in the year to September 2023 respectively.

Key trends likely to drive the Australian infrastructure market in 2024 are:

- An undersupply of social infrastructure e.g. student housing, aged care, transport and healthcare
- Narrowing of the return gap between equity and credit investments leading to an increase in fundraising activity
- Resumption of sale processes that were on hold in 2023 due to a resetting of portfolio allocations and stabilisation of interest rates

Australian infrastructure transaction volumes



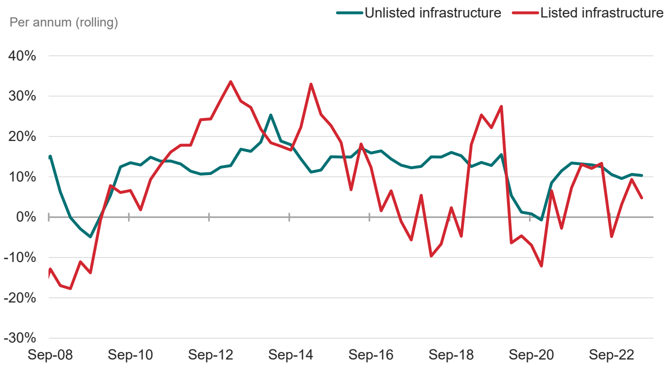
Source: Infralogic (closed transactions)

Major infrastructure transactions H2 2023

Date	Asset	Buyer	Value (A$'m)
Jun-23 to Dec-23[1]	Australia Pacific Airports Corporation (partial interest)	Dexus Wholesale Airports Fund	210
Jul-23	Enel Green Power Australia	Inpex	652
Aug-23	Alinta Energy Pilbara Assets	APA Group	1,700
Sep-23	Auckland Airport (7% interest)	Listed equity investors	~854
Oct-23	LMS Energy	Pacific Equity Partners	272
Dec-23	Lightsource BP Australia portfolio	BEJEI Australia	~1,800
Dec-23	Clarence Correctional Centre	Abrdn	907

Source: Infralogic, Dexus, [1]Acquired across three separate transactions from June to Dec 2023

Australian infrastructure total returns by type



Source: MSCI

Office

Mixed year for the office sector

It's been a year of mixed signals for the office sector with demand varying between cities and building grades. Demand in Brisbane and Perth appears stronger than Sydney and Melbourne reflecting strength in the mining sector.

Brisbane saw strong leasing demand driving vacancy down to 11.1% which is tighter than before the pandemic. Perth CBD also saw declining vacancy and incentives on the back of demand growth.

Sydney CBD saw weak net absorption through 2023 but was insulated from rising vacancy due to larger-than-expected withdrawals. 133 Liverpool Street and 39-41 York Street were withdrawn for conversion for other uses.

The large negative net absorption in Melbourne CBD of -71,000 sqm in Q4 2023 was almost entirely due to the long-planned Australia Post decentralisation combined with a large Telstra sublease. The latter is consistent with a trend of consolidation among large corporates offsetting expansion by smaller tenants. Corporates are adopting hybrid working models which typically embrace a combination of office-based work with a degree of flexibility.

A contraction in the forward supply pipeline will serve to protect existing stock from additional supply risk going forward and help support rent growth through the cycle. Rising construction costs, interest rates and vacancy have put pressure on the feasibility for uncommitted developments.

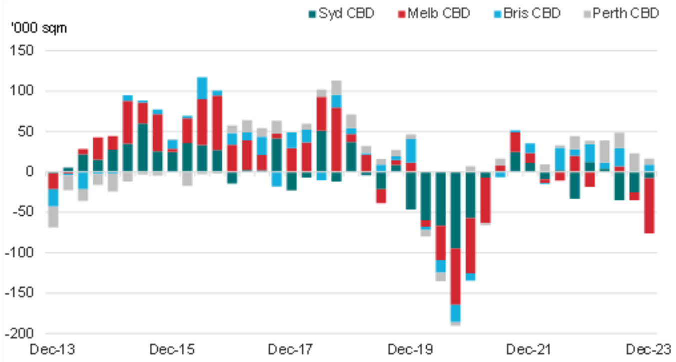
Asset selection and quality are key drivers of office performance. Higher quality buildings and central locations are showing stronger net absorption than the rest of the market. Consequently, vacancy is very unevenly spread. According to JLL Research only 10% of buildings account for around two thirds (66%) of the total vacancy in CBD buildings. Almost half of CBD buildings have no vacancy.

Q4 2023 office snapshot

	Total Vacancy	Rent growth* (% p.a.)	Net supply FY24-26 (%pa)
Sydney CBD	14.4%	3.5%	0.9%
North Sydney	21.4%	1.8%	2.4%
Sydney Fringe	10.4%	4.0%	0.7%
Parramatta	24.2%	-15.6%	0.8%
SOP / Rhodes	22.1%	-2.8%	2.9%
Melbourne CBD	18.2%	-5.4%	1.7%
Brisbane CBD	11.1%	17.0%	1.2%
Perth CBD	17.3%	3.8%	1.0%

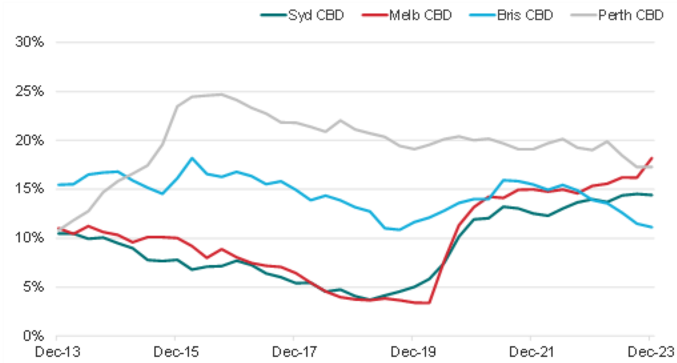
Source: JLL Research, Dexus
*Net effective

Quarterly net absorption by CBD market



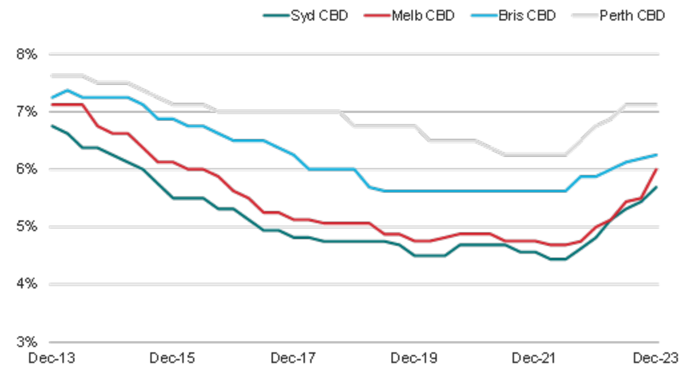
Source: JLL Research, Dexus Research

Vacancy rates by CBD market



Source: JLL Research

Prime yields by CBD market



Source: JLL Research

Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney CBD	An increase in withdrawals for a change of use has helped insulate the CBD from a year of negative net absorption but consolidation of tenancies remains a challenge for the market. Demand has been characterised by expansions by smaller tenants offset by large consolidations. Net absorption was negative for the year at -64,000 sqm with the main consolidations being WeWork, IRESS and the NSW Department of Corrective Services. The vacancy rate is 14.4% in Q4 2023.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
North Sydney	Vacancy expanded in North Sydney in 2023. The Victoria Cross over station development projected for completion in 2025 will put further pressure on the leasing market, particularly with availability still high in the CBD. Net absorption was negative for the year at -31,000 sqm. Falling net absorption was driven by MLC vacating 27,000sqm in Q4.	Vacancy	↑
		Rents	→
		Incentives	↑
		Yields	↑
Parramatta	Parramatta has seen weak demand in 2023, particularly in fringe areas. There remain limited examples of attracted new tenants from outside the market. Parramatta is a two-tiered market with new stock leasing up and vacancy shifting to older buildings. Net absorption was negative for the year at -19,000 sqm. The net absorption decline was driven by the Department of Education vacating 7,800sqm and Link Market Services vacating 6,000sqm.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
Melbourne CBD	Flight-to-quality and core has seen higher quality and better located stock outperform with vacancy shifting towards Docklands and the Western Core. Tenants are taking advantage of high incentives to upgrade their spaces. Net absorption was negative for the year at -71,000 sqm. This is below the 10-year average of 41,000 sqm. The large negative absorption for Melbourne was driven by the long-planned Australia Post decentralisation and a large Telstra sublease. Vacancy lifted to 18.2%.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
Brisbane CBD	Strong office demand, and high levels of enquiry point to an improving outlook in the Brisbane CBD. Net absorption was positive for the year at 41,000 sqm. This is above the 10-year average of 18,000 sqm. Prime vacancy was sub 10% at 9.8%, significantly lower than secondary at 13.0%.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	↑
Perth CBD	Perth CBD has seen strong demand from mining and auxiliary industries. There remain increasing risks around the supply pipeline with Elizabeth Quay Four under construction. Net absorption was positive for the year at 75,000 sqm. Premium vacancy in Perth is reasonably tight at 10.9% compared to the market average of 17.3%.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑

Industrial

Growth to taper through 2024

Demand for industrial space normalised during 2023. While gross leasing activity from retail and ecommerce tenants has declined from its peak in 2021, it is still broadly in line with long-term averages. The moderation in demand is attributable to a lower level of leasing activity in the discretionary retail segments, while demand from the non-discretionary segments of food, groceries and pharmaceuticals is much more stable. On a positive note, any easing of the interest rate cycle will support retail spending in the year ahead, as will population growth.

Vacancy shifted upwards over the past six months but remains well below global averages. Sydney and Perth remain the tightest markets, being below 2%. In Sydney, availability is being limited by supply constraints in the West, yet sub-leasing is becoming more evident due to the decline in retail volumes. Vacancy is well below pre-COVID levels suggesting that the market has not yet achieved equilibrium. Vacancy in Brisbane lifted further than Sydney due to record levels of supply.

Speculative developments, accounting for around 35-60% of new supply, will become more competitive within the Sydney and Melbourne markets over the next 18 months. Slowing growth in rents, rising vacancy and longer letting up periods are eroding the edge speculative developments previously had. Consequently, development strategies will pivot towards pre-commitments and longer leases in the year ahead.

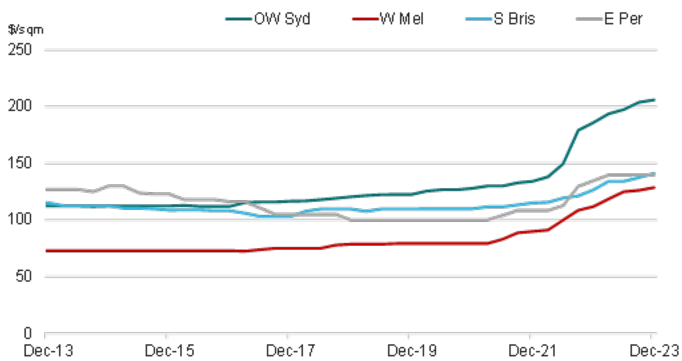
While rent growth is tapering after a strong run, rents are expected to continue to be supported by supply constraints driven by planning issues and high construction costs. Developers with a lower land cost base will arguably fare better in the year ahead as they can offer more competitive rents. Land values have declined 10-20% from their peak. Inner markets appear to be more resilient given marginally stronger rent growth

Industrial snapshot

	Prime cap rate change from Q3 2023 (ppts)	Existing prime net face rental growth % p.a.
Outer West Sydney	0.25	10.8%
West Melbourne	0.25	15.1%
East Perth	0.25	3.7%
South Sydney	0.25	37.4%
Inner West Sydney	0.25	20.8%
Southern Brisbane	0.38	11.4%

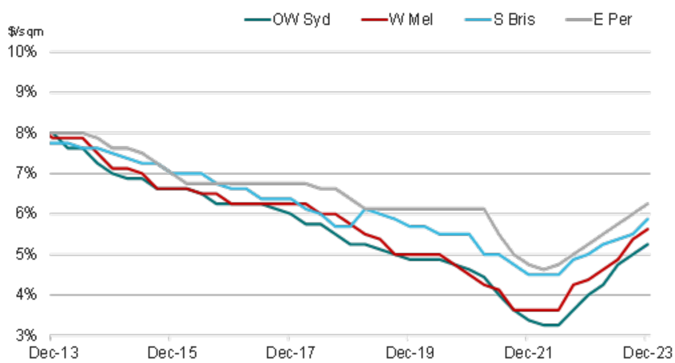
Source: JLL Research, Dexus Research (data Q4 2023)

Industrial rents by precinct



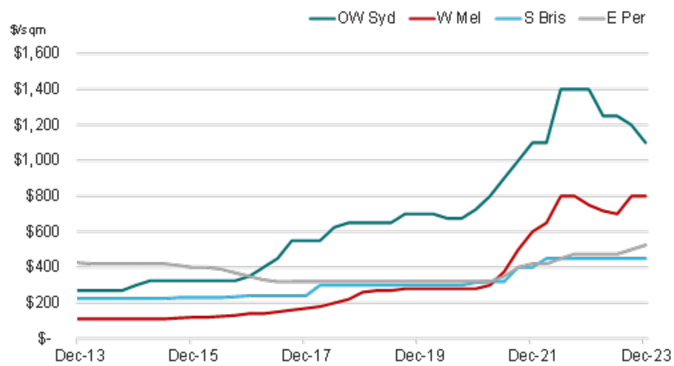
Source: JLL Research (average prime), Dexus Research

Industrial cap rates by precinct



Source: JLL Research (average prime), Dexus Research

Industrial land values by precinct



Source: JLL Research 2-5HA land values *East Peth = 1HA, Dexus Research

Industrial by region

Outer West Sydney

Outer West Sydney gross leasing volumes finished the calendar year broadly in line with the prior year at 685,000sqm. Leasing activity moderated over the second half of the year, with most leasing existing leases/renewals. While rental evidence suggests a wide spread between achieved rents, average prime net face growth slowed to 1.1% (3,000sqm+) over the quarter. Incentives have begun to increase signaling challenging conditions. Supply delays continue to constrain vacancy to less than 2%.

West Melbourne

West Melbourne gross leasing volumes finished the calendar year significantly below the prior two years, with 300,000sqm leased. Leasing activity has been influenced by a lack of immediately available stock. Around 230,000sqm of new supply was delivered to the market in 2023, half of the prior two years. This has seen the vacancy rate in the West Melbourne market hover around 2% for the past 6 months. Despite the favourable market conditions, growth in net face rents slowed to 2.0% (3,000sqm+) over the quarter. Incentives have begun to increase.

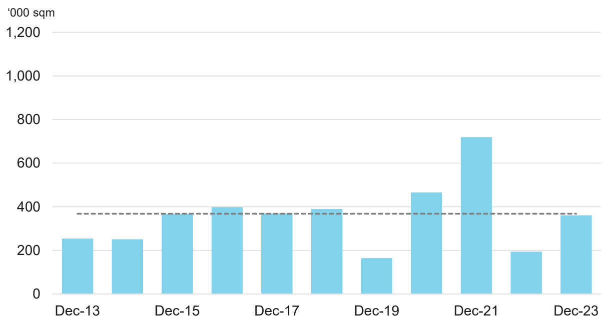
Brisbane (South & Australian Trade Coast)

Southern Brisbane leasing volumes eased with 265,000sqm leased over the calendar year. Despite a record level of completed supply, leasing volumes were only half that of the prior year. The vacancy rate in the southern market is now the highest in Brisbane, edging closer to mid-2%. The Trade coast on the other hand saw a more positive picture with leasing activity elevated at 143,000sqm over the calendar year. Leasing volumes were influenced by a handful of larger than average pre-commitments around 20,000sqm. Vacancy in the Trade Coast remains the tightest within the Brisbane market, leading to a more favourable outlook for net face rent growth than in the South where incentives may need to rise to hold face rents steady.

Perth (East & South)

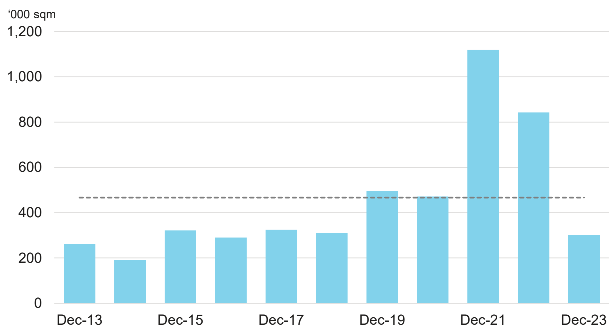
Gross leasing volumes in the Perth markets finished the calendar year elevated compared to long term averages with 190,000sqm absorbed. Figures were heavily buoyed by larger leasing deals in the East around Perth Airport. Vacancy trended up in both the South and East precinct, however the average remains below 2%. Vacancy in the South was influenced by a handful of larger available buildings. Net face rents have been steady in the Perth market over 2023.

Outer West Sydney gross take-up



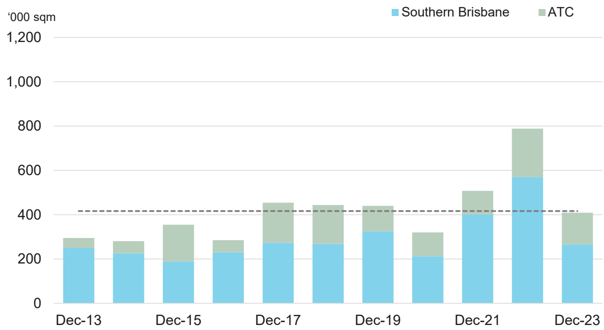
Source: JLL Research (gross take-up), Dexus Research.

West Melbourne gross take-up



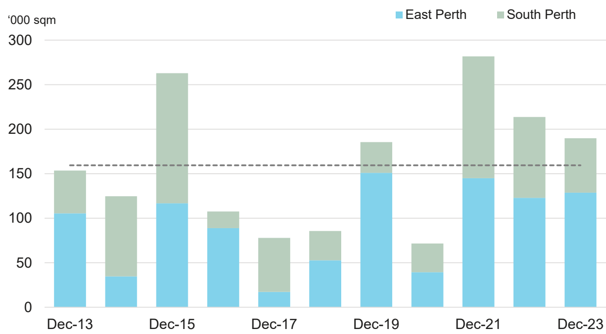
Source: JLL Research (gross take-up), Dexus Research

South Brisbane and ATC gross take-up



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

East and South Perth gross take-up



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

Retail indicators

Interest rates weighing on retail sales

Retail turnover grew by 2.2% in the year to November 2023, a slower rate than the 7.6% that prevailed this time last year.

Cost of living pressures are weighing on consumers' purchasing power. With the cash rate at a decade high, mortgage interest repayments are taking precedence in the budgets of many households and, causing them to focus on essentials and is limiting spending. While this will be a drag on per capita retail sales, aggregate sales have been supported by Australia's large overseas migration program.

Discretionary spending growth is weaker than non-discretionary but remains positive. Household goods sales growth was positive after a contractionary year. November sales were stronger than expected due to Black Friday sales and anecdotal reports indicate the Christmas/Boxing Day trading period was up on last year. Non-discretionary spending growth (mainly food) eased mildly to 2.9% per annum.

Longer-term retail sales growth will be supported by high population growth driven by overseas migration. Population growth is forecast to grow by around 380,000 per annum. Total retail sales growth should increase as per capita spending growth returns to more normal levels.

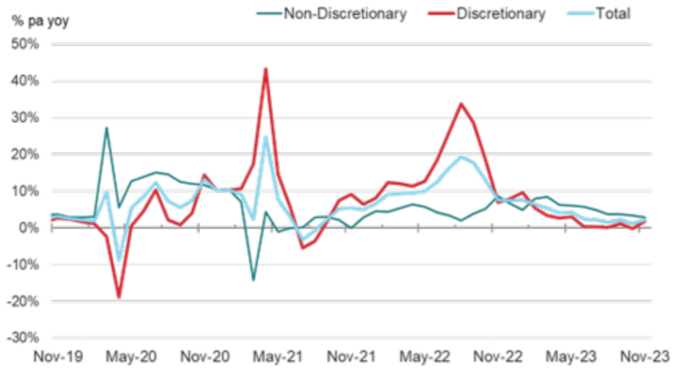
Despite commentary about declining retail sales, the ecommerce share of retail sales has been steady since 2021, after falling from pandemic-induced highs. The spike in Nov-2023 was due to the increased prominence of Black Friday sales. Shopping centres will continue to have an important role in the online component of retail sales, responsible for the bulk of retailer turnover, and having a role in online fulfilment. Shopping centres will continue to adapt in response to consumer preferences and technology, including expanding the range of uses on site.

Retail sales growth by category

	m-o-m	y-o-y	MAT
Cafes	0.4%	4.4%	12.1%
Clothing	2.7%	-0.1%	3.5%
Department Stores	4.2%	3.3%	4.2%
Food	0.4%	2.9%	5.3%
Other	1.1%	1.3%	1.1%
Household Goods	7.5%	0.5%	-3.5%
Total	**2.0%**	**2.2%**	**3.8%**

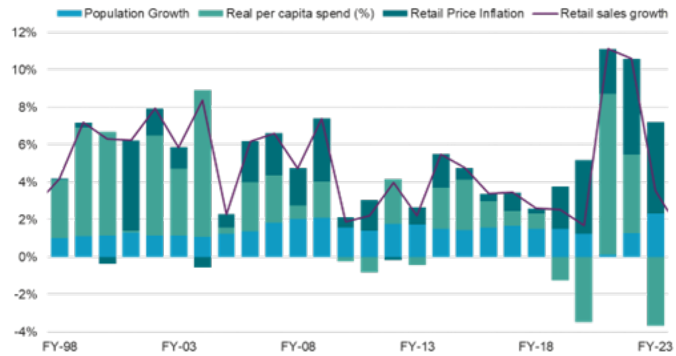
Source: ABS, Dexus Research

Discretionary vs non-discretionary spending



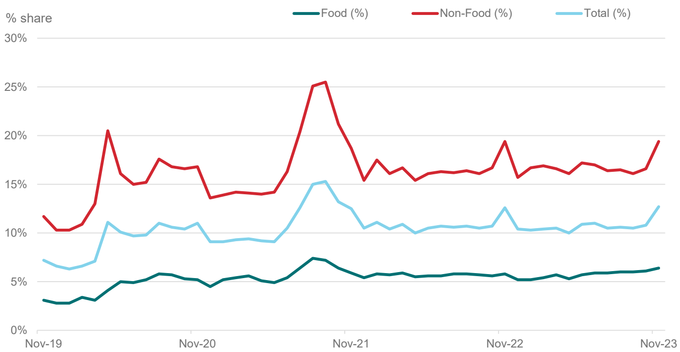
Source: ABS, Dexus Research

Online retail spending as share of total trade



Source: ABS, Dexus Research

Ecommerce share of retail sales by type



Source: ABS, Dexus Research

Retail performance

Lower vacancy and higher yields

Retail fundamentals have shown steady improvement since the pandemic with a recovery in foot traffic driving improvements in rents and occupancy.

Vacancies have fallen significantly since the pandemic across the main enclosed shopping centre types. City retail vacancies remain high but have plateaued, except Melbourne CBD which is outperforming other CBDs. The return of international tourism has helped drive foot traffic in CBDs which is now approaching pre-pandemic trends.

Rents have generally strengthened over the past couple of years. Neighbourhood and sub-regional rents improved faster than regional and super regional centres. Occupancy costs (ratio of rent to turnover) for key specialty categories including clothing are well below the pre-COVID average, indicating an improving value equation for retailers which should have positive implications for future growth. However, in the short term the outlook for rent growth will depend on sales growth which varies by centre and is generally moderating.

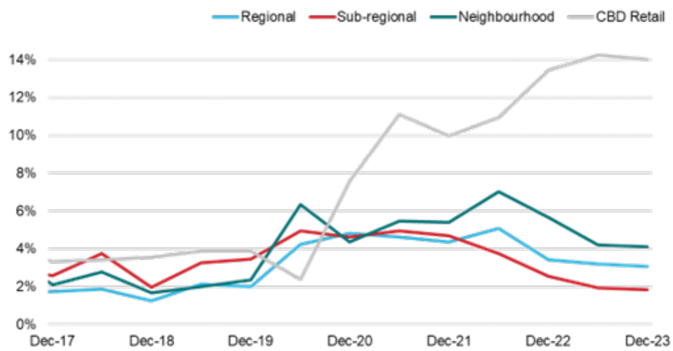
Rising yields are improving the value equation for investors. Sydney regional and sub-regional shopping centre yields rose by 50bps over the year with neighbourhood yields rising by 75bps. We expect that cap rate rises for the retail sector will be more modest than for the office and industrial sectors through the remainder of this cycle.

Retail performance snapshot

	Specialty rent growth % q-o-q.	Cap rate change from Q2(bps)
Sydney		
Regional	-0.8%	50 bps
Sub-regional	0.8%	50 bps
Neighbourhood	0.8%	75 bps
Melbourne		
Regional	-0.9%	37 bps
Sub-regional	0.8%	25 bps
Neighbourhood	0.9%	37 bps
SE QLD		
Regional	-0.3%	75 bps
Sub-regional	0.0%	75 bps
Neighbourhood	-1.6%	25 bps

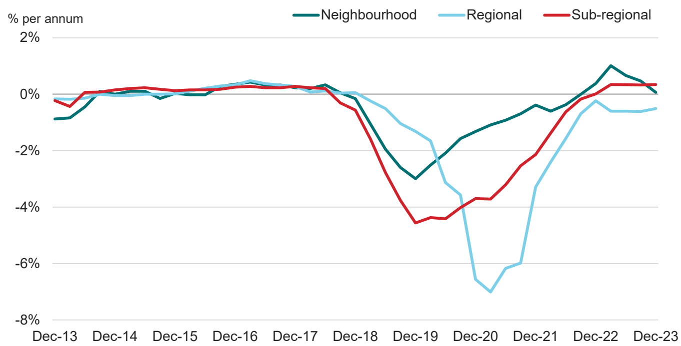
Source: JLL Research, Dexus Research

Shopping centre vacancy rates



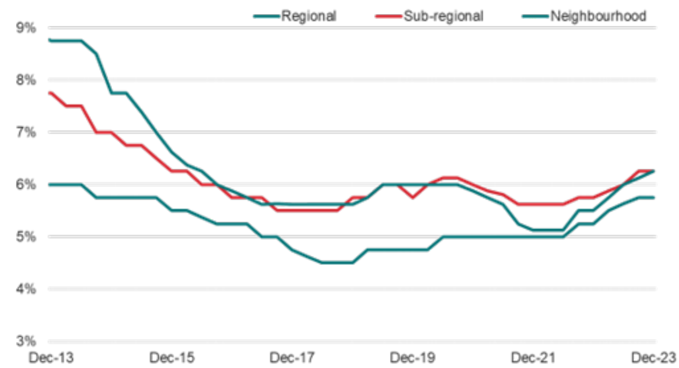
Source: JLL Research

Shopping centre specialty rent growth



Source: JLL Research

Capitalisation rates by centre type



Source: JLL Research

Healthcare

Capacity needs will create opportunity

The healthcare sector saw reasonable investor sentiment and capital allocation over past year despite an uncertain broader investment climate. Looking ahead to the medium and longer term, the opportunity set for investment is likely to expand rapidly given the sector will require a significant lift in capacity to service a growing and aging population.

Increasing private health insurance (PHI) coverage bodes well for demand for private services in the clinical, day hospital and overnight hospital sub sectors. National PHI coverage rates continue to rise and now represent 45.2% of the population. Up-take of hospital cover increased by 274,896 people over the 12 months to September 2023. Growth in the number of people insured has been highest in Western Australia and Queensland.

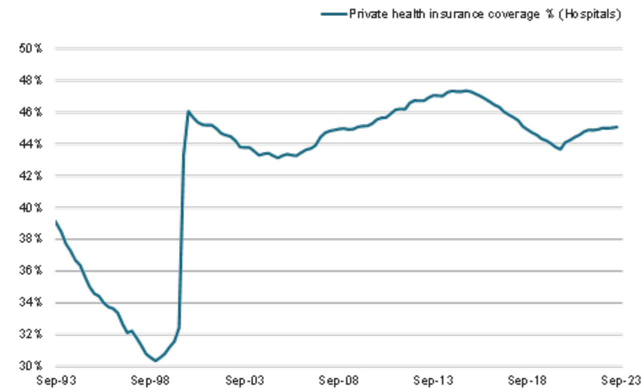
A projected increase in Australia's population by an additional 3.9 million people over the next decade is set to stimulate significant and development opportunities in specific subsectors in order to maintain current bed-per-head ratios. We estimate population growth will lead to extra demand equivalent to 137 public acute hospitals, 113 private acute hospitals and 62-day hospitals over the decade. General practitioner attendances are also expected to increase by around 70% over the next decade reflecting increased service requirements.

Australia's ageing demographic will warrant additional resources. People over the age of 65yrs are more frequent users of the healthcare system and are expected to become a larger portion of the population over the next decade. It is estimated that around 2.9 million people over the age of 65yrs will be living with multiple chronic conditions by 2033. This will see increased demand for specialist and hospital services.

A shift towards defensive assets continues to benefit the healthcare sector. Investment demand for health assets fared better compared to other traditional property sectors. Around $2.5 billion was transacted over the year to December 2023 a proportionally larger volume than the traditional property sectors.

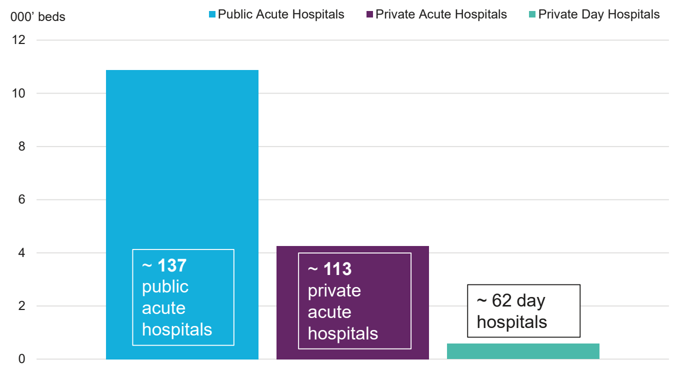
Like all other real estate sectors healthcare is feeling the impact of higher interest rates on pricing. Capital returns dipped into negative territory while income returns remained relatively steady, leading to a total return of 0.3% in the year to Q3 2023. While a phase of price discovery is inevitable in the short term, we anticipate a relatively quick recovery once the interest rate cycle turns. The underlying sentiment for healthcare remains very positive due to the diversification benefits and long-term growth thematic.

Private health insurance coverage



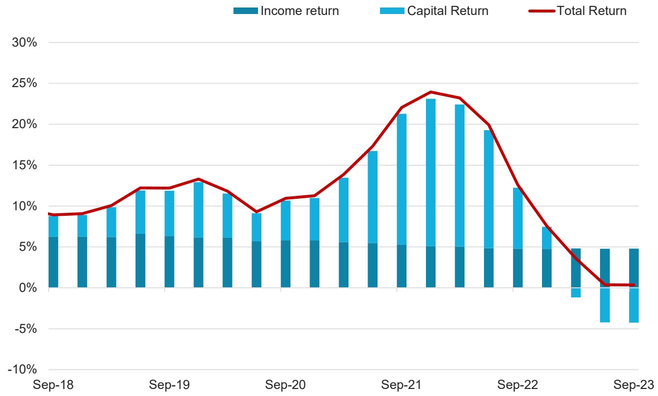
Source: APRA Quarterly Private Health Insurance Membership Trends Sep 2023

Increased capacity and service requirements



Source: Hospital Resource Tables 2021-22, Private hospital resources ABS

Healthcare total returns



Source: MSCI, unlisted, asset level returns

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