dexus

Australian Real Estate Quarterly Review

Q1 2023

Inside

Page 1 Photo: Amazon, 103 Palm Springs Road, Ravenhall

Investment climate

Interest rates a risk for growth in 2023

The Australian economy showed surprising strength through 2022 with retail sales and employment growth both running above average. However, the economy is expected to slow in the year ahead as rising interest rates cool household consumption and investment.

The Reserve Bank of Australia lifted the official cash rate by 0.25% to 3.1% in December and further rises are anticipated in early 2023 to help curb inflation. Australia's headline inflation rate was 7.3% in November and has yet to show signs of peaking. The 10-year bond yield was around 3.7% in January 2023.

The year ahead is likely to be characterised by high interest rates and soft transaction markets. Business confidence is easing in the face of weak consumer sentiment and points to a general slowing of business activity in the year ahead.

While the office sector has enjoyed a strong labour market to date, global uncertainty could weigh on demand in 2023. The retail sector will likely see a fall in discretionary spending as cost-of-living pressures increase. However, the industrial sector should be resilient to retail sector trends given pent-up demand supporting pre-commitment levels. The alternative sectors like healthcare and student accommodation can be expected to perform relatively better than traditional sectors 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 expected to ease in FY24 as supply chain costs subside.

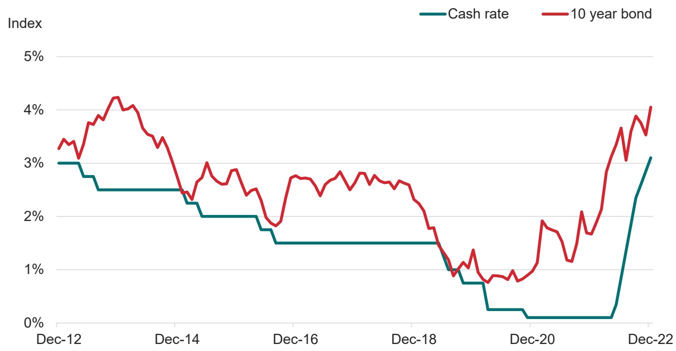
Amid this somewhat challenging picture, there are some positive takeaways for investors. Australia's longer term growth prospects will be supported by improving population growth and high levels of infrastructure spending. Private engineering investment is forecast to lift by 20% over the next three years. According to the IMF, Australia's GDP growth forecast for 2023 of 1.9% is well above the average for advanced economies of 1.1%.

Australian economic forecasts

	Jun-22	Jun-23	Jun-24
Real GDP %pa	3.2%	1.9%	1.8%
Final demand %pa	4.1%	1.8%	1.2%
Employment %pa	3.2%	2.2%	2.1%
Goods imports %pa	5.0%	3.5%	1.3%
Retail sales %pa	10.6%	4.0%	2.9%
CPI %pa	6.2%	6.8%	4.0%
Cash rate %	0.8%	3.6%	3.6%
10yr Bond %	3.7%	3.6%	3.2%
AUD/USD	0.71	0.67	0.69

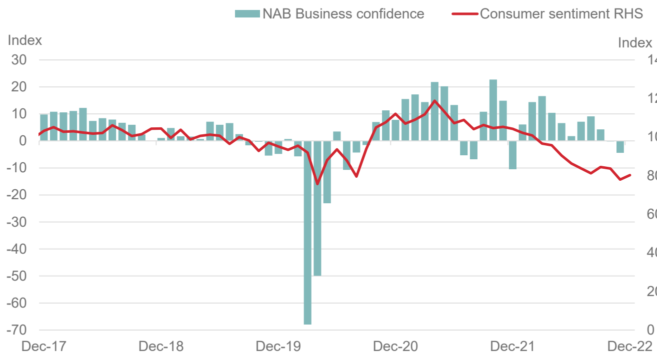
Source: Oxford Economics (with Dexus adjustment), December 2022

Trends in official cash rates and 10-year bond yields



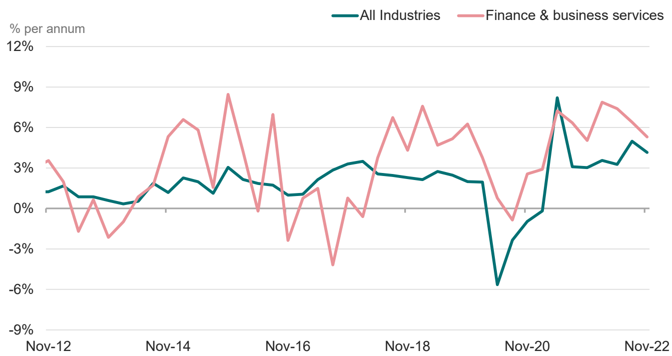
Source: Bloomberg

Business confidence and consumer sentiment



Source: NAB, Westpac

Employment growth by type



Source: ABS

Why quality matters

High quality assets expected to outperform

A key theme for investors in all real estate sectors in 2023 is the flight to quality. High quality assets are likely to outperform secondary or fringe over the next few years given both occupiers and investors are gravitating to higher quality buildings.

For the office sector, the main drivers of the flight to quality are as follows:

- Australia's tight labour market means employers are competing for talent. Quality assets help companies attract and retain talented employees
- As hybrid working becomes more prevalent, employers are focusing more on improving the experience for workers who attend the office. Consequently, CBD locations are being favoured for their vibrancy and access to transport
- The definition of quality for office buildings has broadened to include more work-life balance elements. Office workers value being close to amenities such as public transport, restaurants, gyms and other services
- Quality buildings typically align better with occupiers' ESG objectives.
- Connectivity and modern and effective technologies within the office are also important factors for tenants moving into higher quality premises

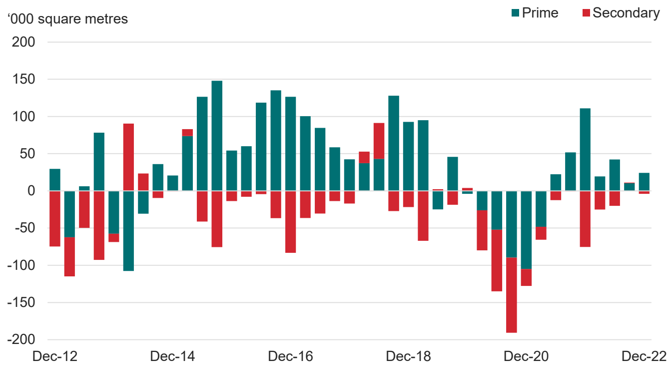
All these elements aid in tenant retention and help the financial performance of high-quality buildings. Take-up of prime office space has been far outstripping secondary. Through 2022 in Australia's four largest CBDs, prime buildings saw positive net absorption of 96,300 sqm, while secondary buildings experienced an outflow of 48,200 sqm.

The flight to quality has been reflected in investment returns. This is particularly true in periods when market vacancy is above average. Over the past 15 years, at times of high vacancy rates (above 8%) like at present, the average return for premium assets (7.2% per annum) exceeded those for secondary (5.9% per annum).

The benefits of quality also translate to a lower risk profile for premium investments. Over the past 15 years total returns for premium office buildings were substantially more stable than secondary (standard deviation 3.8% per annum a vs 5.1% per annum). Looking forward, a rising cost of capital is likely to amplify the risks in the secondary market given a narrow spread between secondary yields and premium.

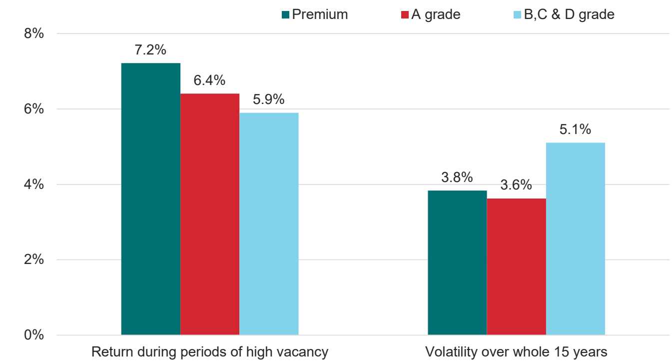
The flight to quality is occurring across office, retail and industrial investments and is expected to lead to higher quality portfolios outperforming in the year ahead.

Quarterly take up by building grade



Source: JLL Research, Dexus Research, data for Sydney CBD, Melbourne CBD, Brisbane and Perth

Office returns during periods of high vacancy by grade



Source: MSCI, analysis by Dexus Research

Performance / transactions

Returns affected by interest rate movements

Most asset classes experienced a volatile year in 2022 and generally weak returns.

The A-REIT sector saw an upturn in performance late in the year after a year of negative returns. The ASX 200 A-REIT accumulation index returned 11.5% in Q4 2022, compared to -20.5% over the full year. A-REITS were buoyed by a general lift in the equities market with the ASX S&P 200 accumulation Index returning 9.4% in the quarter.

A-REIT pricing has experienced greater volatility than unlisted pricing in recent years, being more affected by elevated interest rates and unstable share markets. The more consistent returns of unlisted funds were helped by their lower frequency of valuations. A-REIT pricing will continue to be sensitive to interest rate movements and having been sold off through 2022 as interest rates lifted, could experience a turnaround sometime in 2023 if interest rates or bond yields fall.

Unlisted fund returns remained solid through 2022 but eased significantly in the past month. Revaluation of assets during the December quarter led this decline. Higher cap rates are likely to weigh on capital values over the next six months resulting in a further decline in total returns. Industrial funds performed stronger than all other sectors at 10.8% in the year to Q4 2022, but also saw the greatest deceleration. Retail funds, saw a mild weakening returning 7.6% in 2022 and office funds returned 5.1%.

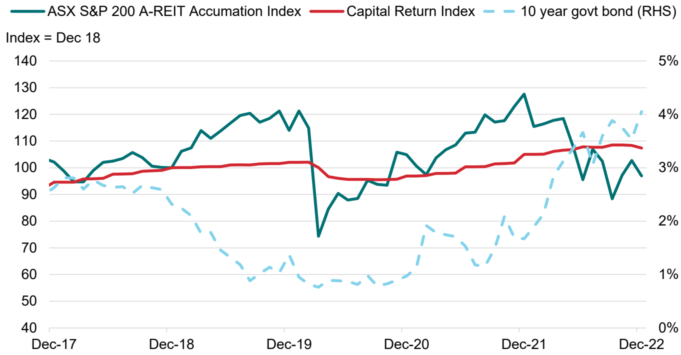
Transaction activity was relatively subdued in the latter half of 2022, constrained by cautious buyer sentiment and difficulty in assessing cost of capital. With interest rates likely to remain high in the next six months, investors are expected to remain generally cautious, constraining transaction volumes. In FY24 transaction markets could benefit from any stabilisation or reversal of the current high cost of capital.

Asset Class Performance

	Qtr.%	1 yr %p.a.	3 yr %p.a.
Unlisted property[4]	-0.1	7.0	5.8
Australian infrastructure[6]	11.8	2.4	0.2
Australian cash[3]	0.7	1.3	0.5
Australian shares[2]	9.4	-1.1	5.5
Australian fixed interest[1]	0.4	-9.7	-2.9
A-REITs[5]	11.5	-20.5	-1.5

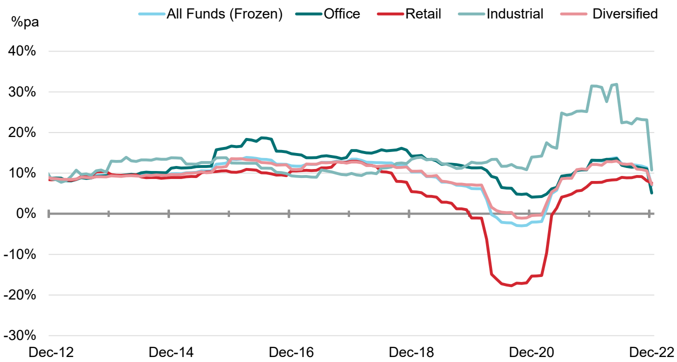
Sources: 1: Bloomberg BACM0 Index
Source 2.S&P/ASX.200 Accumulation Index
Source 3: Bloomberg BAUBIL Index
Source 4: MSCI Mercer Australian Core Wholesale Monthly PFI (AUD NAV Pre Fee – All Funds to Dec 2022)
Source 5: S&P/ASX.200.A-REIT Accumulation Index
Source 6: MSCI Australia Infrastructure Index (AUD)

Unlisted and listed price/value movement



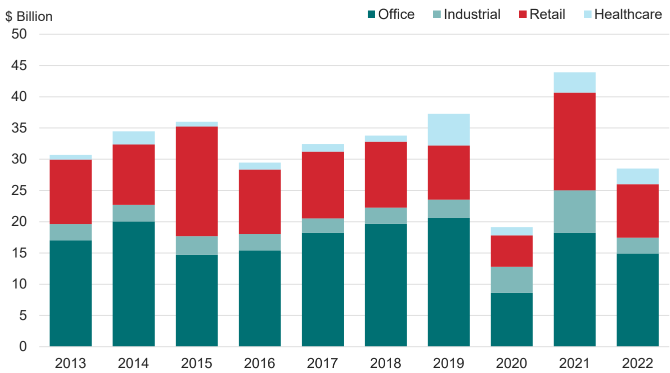
Source: MSCI, Bloomberg, Dexus Research

Unlisted property returns by sector



Source: MSCI/Mercer

Australian transaction volumes by sector



Source: MSCI Real Assets

Office

Demand variable across markets

A divergence is becoming apparent across markets. The more globally exposed office markets of Sydney and Melbourne have seen weaker net absorption than Brisbane and Perth which have been influenced more by local drivers such as the buoyant mining sector.

Vacancy rates ticked up in Melbourne and Sydney in Q2 2022 and down in Brisbane and Perth. Vacancy rates are likely to remain elevated over the next few years given the existing supply pipeline completes in a climate of subdued demand.

The supply pipeline is moderate across Australian CBDs. Sydney net supply is expected to grow 0.8% annually from FY-23 to FY-25, in-line with the 20-year average (0.7% yoy). Melbourne will see 2.0% stock growth annually over the next three years, below the 20-year annual average of 2.3%.

While rent growth is generally flat, there have been pockets of growth particularly in good locations and with high quality assets. Net absorption for prime offices has been outpacing secondary offices since Q2 2021 and vacancy rates are typically lower for higher grade buildings.

Net face rent growth has been supported by rising incentives. Incentives are likely to remain elevated over the near term. The signals for any future fall in incentives would be a drop-off in new supply coinciding with an improving economic outlook and, ultimately, falling vacancy.

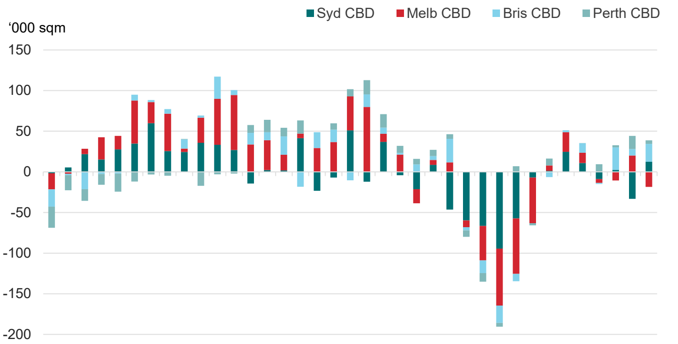
The office workforce is spending a larger share of its week working from home. However, it appears that most office workers still spend more than half their time in the office. Corporates are increasingly settling on a hybrid approach to working however, there are still few examples of what a modern hybrid office looks like design-wise. There was an increase in larger tenant moves during H2 2022 as tenants become increasingly confident of their longer-term needs.

Q4 2022 office snapshot

	Total Vacancy	Rent growth* (% p.a.)	Net supply FY23-25 (%pa)**
Sydney CBD	14.0%	4.7%	0.2%
North Sydney	17.6%	3.1%	1.6%
Sydney Fringe	8.6%	-0.9%	0.7%
Parramatta	22.6%	-19.5%	0.3%
SOP / Rhodes	21.7%	-9.0%	0.0%
Melbourne CBD	15.4%	0.1%	1.8%
Brisbane CBD	13.9%	2.5%	0.2%
Perth CBD	19.0%	0.4%	2.6%

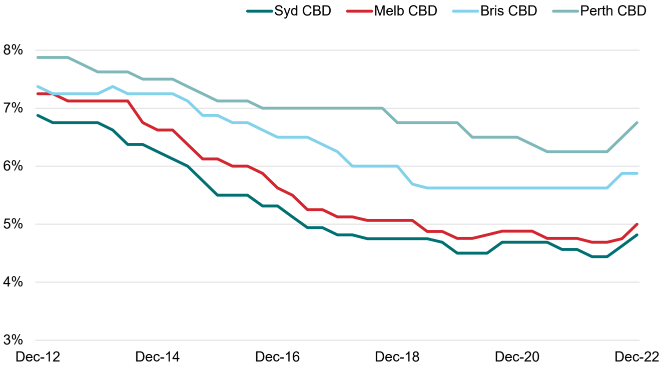
Source: JLL Research, Dexus *Net effective, **per annum FY23-FY25

Quarterly net absorption by CBD market



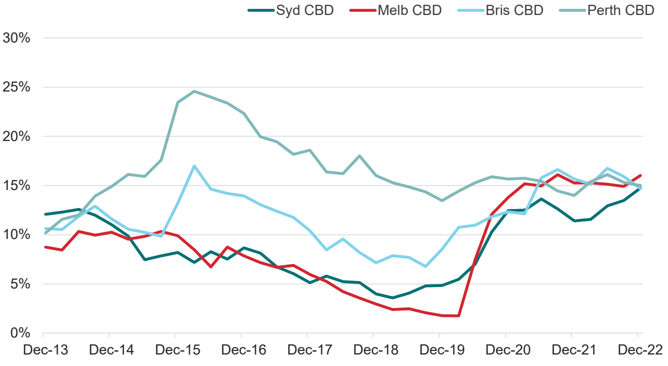
Source: JLL, Dexus Research

Prime yields by CBD market



Source: JLL, Dexus Research

Vacancy rates by CBD market



Source: JLL, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney CBD	Rental growth has surprised in Sydney CBD. Net absorption was negative for the year at -27,000, not keeping up with supply. The vacancy rate has increased 1.5% over the past year. It is currently 14.0%. Incentives increased to 35% and prime gross rents grew 3.8% over the year. Yields expanded 19bps over the quarter to 4.82%.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	↑
North Sydney	Withdrawals have helped limit rising vacancy in North Sydney. Net absorption was negative for the year at -19,000, not keeping up with supply. The vacancy rate has increased by 0.3% over the past year. It is currently 17.6%. Incentives increased to 37% and prime gross rents grew 2.9% over the year. Yields expanded 19bps over the quarter to 5.19%.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	↑
Parramatta	High levels of vacancy and a large supply pipeline has been impacting the Parramatta CBD. Most of this supply is now delivered. Net absorption was negative for the year at -68,000, not keeping up with supply. The vacancy rate has increased 10.5% over the past year. It is currently 22.6%. Incentives increased to 43% and prime gross rents remained stable over the past year. Yields expanded 25bps over the quarter to 5.5%.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Melbourne CBD	New supply has been limiting rental growth. Net absorption was negative for the year at -14,000, not keeping up with supply. The vacancy rate has increased 0.4% over the past year. It is currently 15.4%. Incentives increased to 39% and prime gross rents grew 1.2% over the year. Yields expanded 25bps over the quarter to 5%.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Brisbane CBD	Brisbane CBD vacancy is now the tightest among Australian big four CBDs. Net absorption was positive for the year at 56,000, outpacing supply. The vacancy rate has decreased 1.6% over the past year. It is currently 13.9%. Incentives remained stable, currently at 43% and prime gross rents grew 5.7% over the year. Yields were steady over the quarter, at 5.88%.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑
Perth CBD	Perth CBD has seen tightening vacancy and modest rent growth. Net absorption was positive for the year at 33,000, not keeping up with supply. The vacancy rate has remained stable. It is currently 19.0%. Incentives fell to 49% and prime gross rents grew 0.3% over the year. Yields expanded 25bps over the quarter to 6.75%.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑

Industrial

A balancing act for the industrial sector

The industrial sector is well positioned for another strong year of rent growth. While the macroeconomic environment is uncertain, vacancy is tight, supply is constrained and customer demand remains solid across the markets. Rent growth is expected to continue to mitigate the effect of rising cap rates on valuations in the year ahead.

Increases in the cost of debt over the past 12 months has influenced price expectations. Cap rates in the industrial sector have seen the largest correction across all sectors, softening between 30-75bps in 2022. The Sydney and Melbourne markets have experienced the greatest movement in cap rates, however, they also boasted the strongest rent growth nationally at 20-30% yoy, helping preserve valuations.

Supply increased yet vacancy tightened in 2022 indicating that take-up continues to outpace supply. National industrial completions finished the calendar year at 2.5 million sqm, nearly double the historical average. Key completions include Amazon and Coles automated distribution centers at Oakdale West, Outer West Sydney and Myer at Horizon Estate, West Melbourne. With the bulk of completions being pre-leased developments, the additional supply had negligible effect on national vacancy rates which tightened further to circa 0.6. Development costs will continue to put upward pressure on asking rents while land values appear to have topped out across key industrial markets and may see downward pressure.

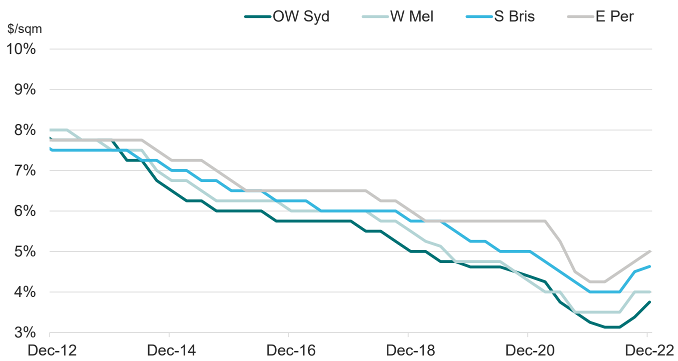
Population growth looks to assist consumption in the years ahead despite other indicators suggesting a slowdown. While a lower spend per person is possible, a return of population growth will somewhat support inventory levels. National gross leasing finished the 2022 calendar year at 3.2 million sqm (the second highest on record) after 2021. Demand is broad-based including medical supplies, supermarkets, materials supporting transport infrastructure, ecommerce and retailers investing in last mile fulfilment. Onshoring of manufacturing will likely continue following the global supply chain uncertainty of the pandemic. Warehouse demand is being supported by growing inventory levels as firms adopt a 'just in case' business model as a long term thematic.

Industrial Snapshot

	Prime cap rate change from Q3 2022 (ppts)	Existing prime net face rental growth % p.a.
West Melbourne	+0.12	+24.3%
East Perth	+0.25	+24.2%
South Sydney	+0.37	+23.1%
Outer West Sydney	+0.37	+38.6%
Southern Brisbane	+0.13	+10.0%

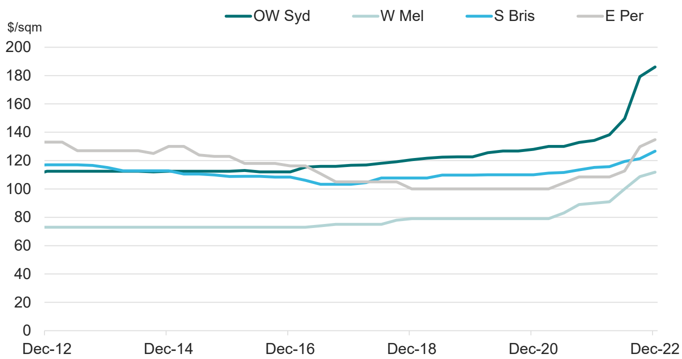
Source: JLL Research, Dexus Research (Dec 22)

Industrial capitalisation rates by precinct



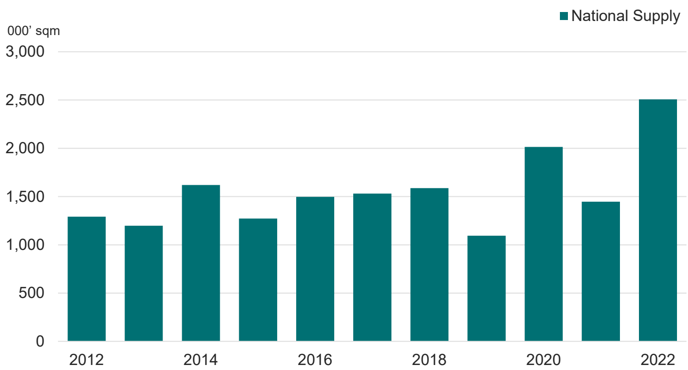
Source: JLL Research, Dexus Research

Industrial rents by precinct



Source: JLL Research, Dexus Research

Record levels of completed supply



Source: JLL Research, Dexus Research

Industrial by region

Outer West Sydney

The Outer West Sydney market experienced the strongest level of completions nationally over the calendar year at 765,000sqm. The high levels of completions were a direct result of record leasing in 2021. The bulk of completions were concentrated within Goodman's Oakdale West and South Estates. Gross leasing volumes for the year reflected delays in Kemps Creek master-planning, with take-up only a third of the prior year. Outer West Sydney continues to boast the strongest rent growth nationally (+38.6% yoy) which is likely to continue with vacancy the tightest nationally and globally at 0.2%.

West Melbourne

Gross leasing volumes in West Melbourne finished the calendar year at 820,000sqm, marginally below the prior record year. West Melbourne continues to be a hotspot for ecommerce leasing accounting for 53% of national demand. Victorian markets are capturing strong rent growth given low vacancy and a lack of immediately developable land in some areas. Vacancy appears to have stabilised at 1.1% due to material delays and tenants being less inclined to take secondary space. North Melbourne continues to benefit from overflow demand experiencing a record level of leasing over the calendar year. Vacancy in the north has significantly declined and is now on par with the west.

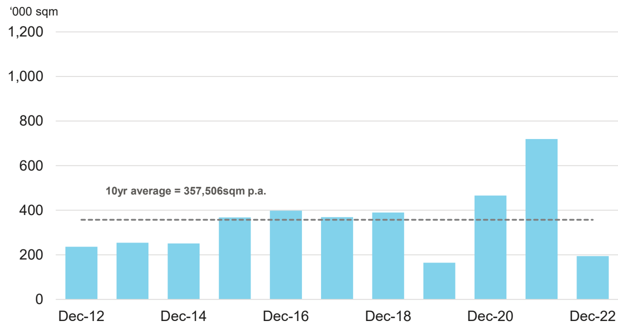
Brisbane (South & Australian Trade Coast)

Brisbane's Southern and Trade Coast markets both enjoyed record levels of gross leasing over the calendar year, totalling 788,000sqm. The Brisbane market experienced the largest decline in vacancy across all cities from 1.4% to 0.5%. This was attributable to strong existing market leasing within the South/M1 corridor, towards the back half of the year. Both the Southern and Trade Coast markets recorded the strongest quarterly growth nationally now at double digits year on year. While incentives have improved and effective rent growth may be possible over the next 12 months, higher levels of speculative developments could constrain growth prospects longer term.

Perth (East & South)

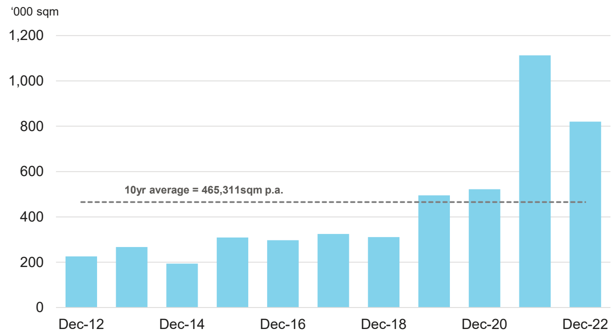
Gross leasing volumes in Perth's East and South remained robust over the 2022 calendar year totalling 260,000sqm, marginally below the record levels of 2021. There has been very little development activity recorded over the year which saw vacancy in Perth fall to 0.4% (second lowest nationally). Rents increased 24.2% year on year following increased enquiry from 3PL, ecommerce and food industries. With around 50% of supply for 2023 committed, it is likely there will be increased speculative development activity in the year ahead.

Outer West Sydney gross take-up (FY)



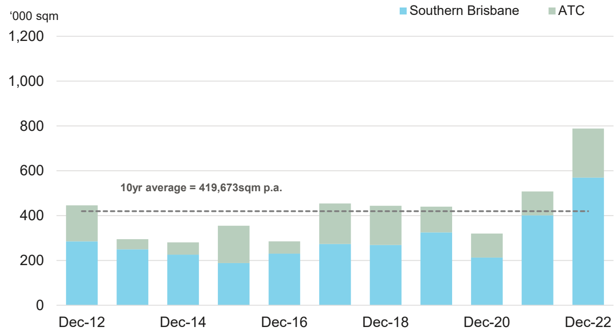
Source: JLL Research (gross take-up), Dexus Research.

West Melbourne gross take-up (FY)



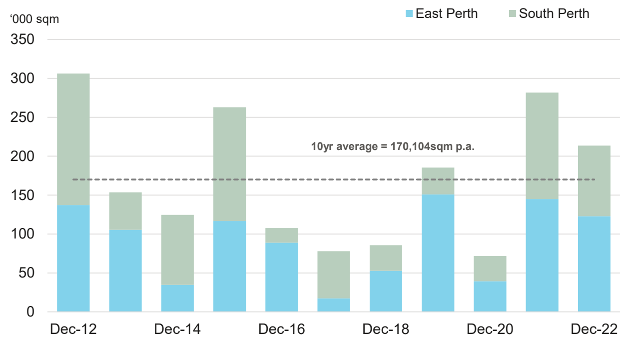
Source: JLL Research (gross take-up), Dexus Research

South Brisbane and ATC gross take-up (FY)



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

East and South Perth gross take-up (FY)



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

Retail indicators

Retail sales resist interest rate pressures

Retail sales have been growing rapidly, increasing by 11.2% on a moving annual turnover basis in the year to November 2022. Growth has been driven by spending on clothing and cafes, both of which have grown by 25.4% over the past year. Grocery sales grew at a slower rate of 4.6% per annum. Retail sales were boosted in November by strong spending during Black Friday and Cyber Monday and reports suggest that Christmas spending was also strong. Inflation will have played a role in this growth, as prices for goods and services have risen over the past year.

The strong growth in discretionary spending is particularly good for shopping centres with a higher proportion of discretionary tenants, such as regional and subregional centres.

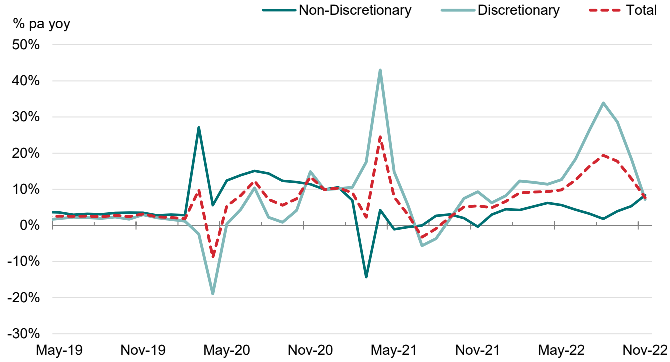
Retail sales growth is expected to slow sharply in H1 2023 as cost-of-living pressures mount and household savings decline. In addition, higher interest rates will increase mortgage costs. The slowdown is expected to be mainly in discretionary categories. Non-discretionary retail such as supermarkets and pharmacies will be more resilient.

Ecommerce spending grew rapidly during the pandemic. However, in the past year, ecommerce spending has slowed, restrictions have eased, and in-person shopping is recovering well. On a moving annual basis, in-store sales have grown 11.5%, while online sales have grown a more modest 7.3%.

In the long term, ecommerce's share of retail trade will continue to grow. However, shopping centres will still have an important role in the online component of retail sales. A significant share of this growing ecommerce spend will be fulfilled in-store, either by post or click-and-collect. In addition, shopping centres will continue to adapt in response to consumer preferences and technology, including expanding the range of uses on-site.

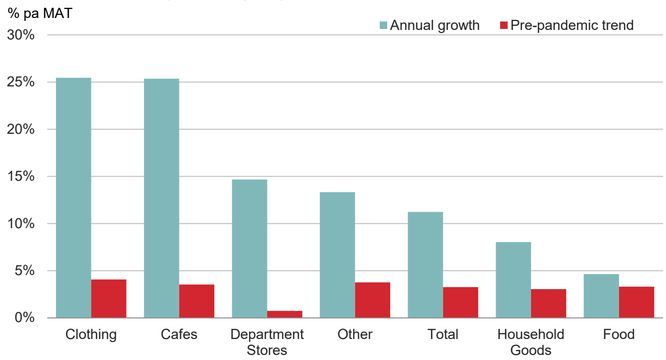
Population dynamics are also likely to support the Australian retail sector in the future. The return of short-term international travel should help drive stronger foot traffic, particularly in tourist-centric areas such as central business districts and coastal areas. Additionally, international long-term migration is accelerating from pandemic-lows which will help to drive higher retail spending in the long term.

Discretionary vs. non-discretionary retail spending



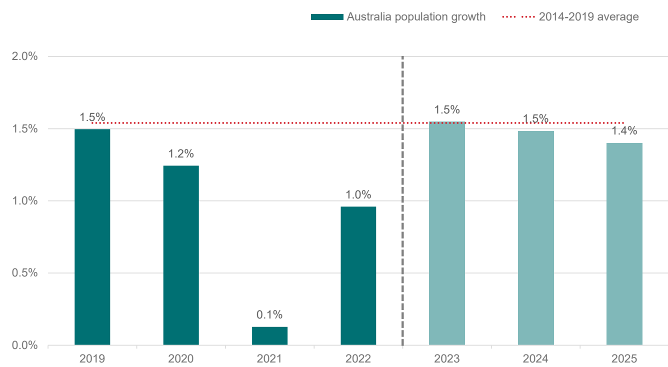
Source: ABS, Dexus Research

Retail sales by category – MAT basis



Source: ABS

Australian population growth forecast



Source: Oxford economics

Retail performance

Retail boost benefiting shopping centres

Shopping centre specialty vacancy rates have begun to tighten after increasing through the pandemic. Sydney regional shopping centres saw vacancies peak at 5.1% but fall to 3.4% in Q4 2022. Vacancy in Brisbane is lower now than it was before the pandemic for Regional, Subregional and Neighbourhood centres.

City retail vacancies remain very high at 10%, with the recovery held back by a slow return of office workers and tourists to the cities. An expected rise in tourist arrivals in 2023 should help city retailers.

During the pandemic, shopping centres saw a reset in rents as owners and retailers renegotiated leases and rents to adapt to pandemic conditions. This reset has allowed owners to preserve occupancy, while also helping retailers stay viable. The outlook for rents is now improving. Specialty rents were steady in Sydney but grew in both Melbourne and Brisbane in Q4 2022.

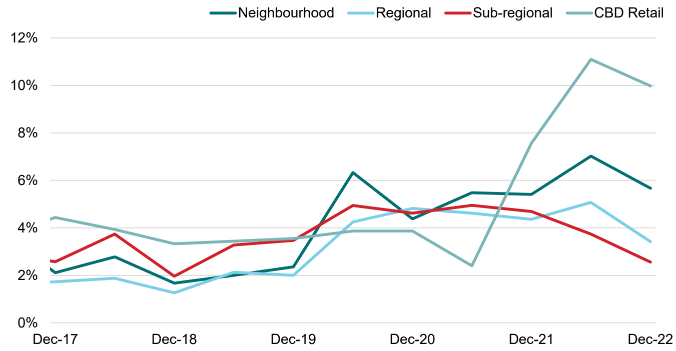
There are clear headwinds in the economic outlook. Bond yields have risen, and economic growth is projected to slow. Since Q2 2022, Sydney regional shopping centre yields have expanded 25bps. Subregional and neighbourhood yields have expanded 12.5 and 37.5 bps respectively. There are reasons to believe retail valuations will be more resilient than many other real estate sectors in the year ahead. While cap rates are expected to lift further in response to rising interest rates, the previous rent and pricing reset in the retail sector will help protect market valuations to other sectors which experienced a more pronounced tightening.

Australian economic forecasts

	Specialty rent growth % q-o-q.	Cap rate change from Q3 (ppts)
Sydney		
Regional	0.0%	0.0
Sub-regional	0.0%	0.0
Neighbourhood	0.0%	0.0
Melbourne		
Regional	0.2%	0.0
Sub-regional	1.1%	0.0
Neighbourhood	3.7%	+0.13
SE QLD		
Regional	0.1%	0.0
Sub-regional	0.2%	0.0
Neighbourhood	0.2%	+0.25

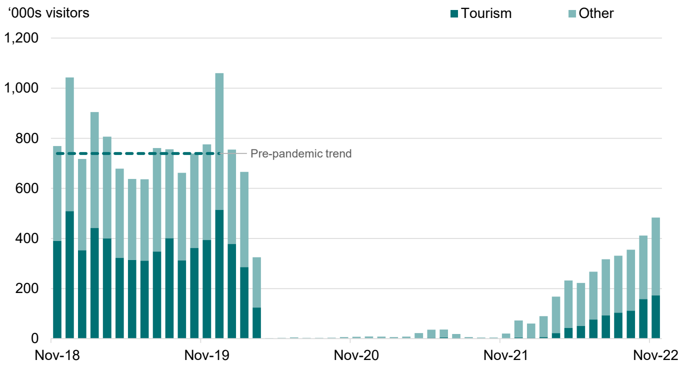
Source: JLL Research, Dexus Research

Shopping centre vacancy rates



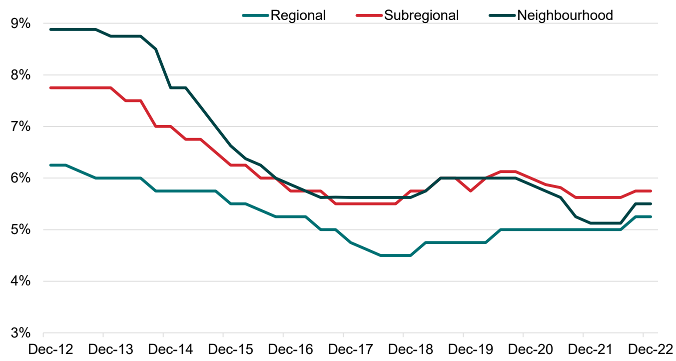
Source: JLL, Dexus Research *Sydney

Australian short-term arrivals



Source: ABS

Shopping centre yields



Source: JLL Research, Dexus Research

Healthcare

Learnings from the COVID period

There are some important learnings from the past couple of years, such as the resilience of the healthcare real estate sector in the face of a volatile global environment.

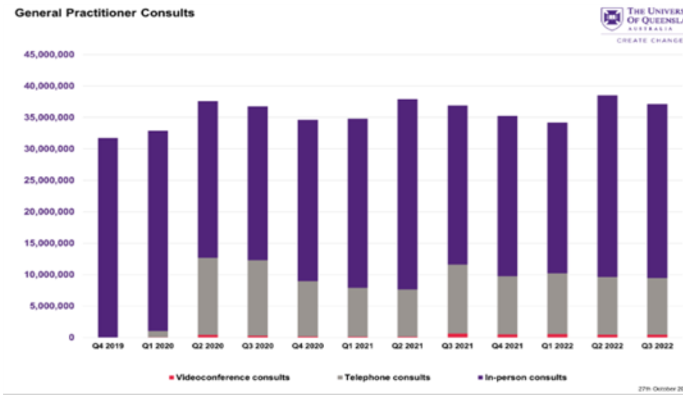
In primary care, COVID-induced inflation is likely to lead to rising up-front costs for patients. An increase in the rebate for General Practitioner consultations of 1.6% in In July 2022 gave little respite in the context of rising costs, notably utilities (+20%) and medical consumables (+6.5%). General Practitioners have been left with little choice but to push the higher costs onto patients with average out of pocket costs now sitting above the Medicare rebate. With national bulk billing rates on the decline, volumes may be impacted in the year ahead.

In relation to telehealth, the use of online/telephone consultations were expanded in 2020 to reduce community transmission (chart 1). However, the use of telehealth has since stabilised or even declined, showing that one size does not fit all. General Practitioners and mental health professionals have maintained a higher adoption of online/virtual consultations (25-30%), than specialists, which have fallen back to 14%. What telehealth means for space requirements is yet to be determined, however for now it is likely more of a complementary service than a risk.

The importance of life-sciences has become more apparent. As COVID-19 ran rampant across Australia, the government and private non-for-profit sectors turned to a reliance on health research and development (R&D). Health R&D accounted the largest portion of total R&D expenditure (chart 2) with investment into diagnostics, vaccines and therapeutics. The Pandemic reinforced the importance of the health R&D sector, with the federal government set to invest heavily over the next four years, including the Biomedical Translation Fund ($3.7bn) and Medical Research Future Fund ($2.6bn). This investment looks provide opportunity to create hospital/ university linked laboratories or biomedical precincts.

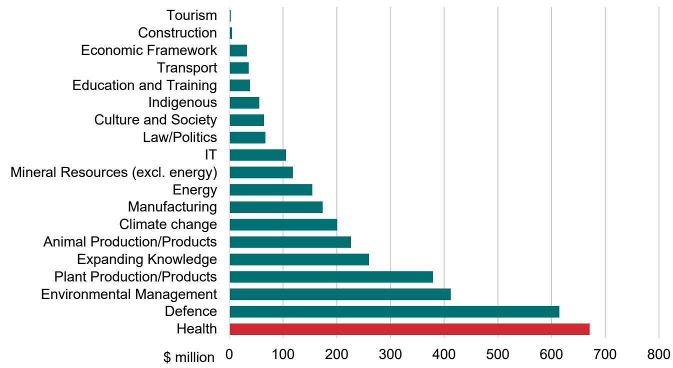
In the hospital sector, there remains significant pent-up demand for elective surgeries (chart 3). Over the first two years of the pandemic 'non-urgent' elective surgery volumes fell with resources and capacity reserved for containing the outbreak of COVID-19. Post pandemic backlogs continue to extend wait times (up 40%) with volumes below pre-pandemic levels. Specialist services including EN&T, Ophthalmology and Orthopaedics have reported 10-15% of patients waiting more than a year. In the year ahead, the pre-existing trend towards day hospitals will likely accelerate, benefiting from overflow demand.

Telehealth consultations have stabilised



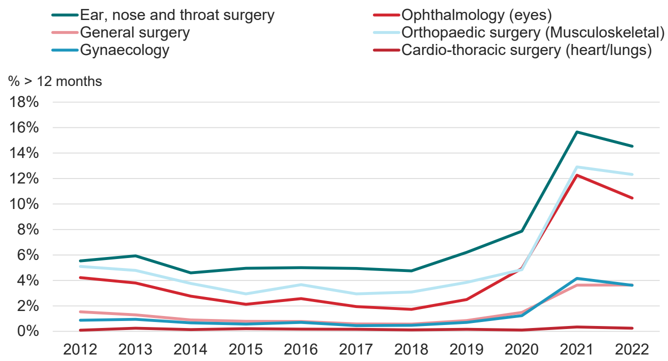
Source: University of Queensland

High levels of investment in life-sciences research



Source: ABS

Wait times indicate pent-up demand for elective surgery



Source: AIHW

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