
dexus
Australian Real Estate Quarterly Review
Q4 2022
1 Bligh Street, Sydney

Inside

Investment climate

Australia's growth to ease from high levels

The Australian economy is expected to slow from above average pace over the next year as rising interest rates impact households. GDP growth is forecast to ease from 3.9% to 1.9% in FY23 before improving in FY24. While global risks appear to be on the downside, Australia seems well positioned with a GDP growth forecast well above the IMF average for advanced economies of 1.1% per annum. Improving population growth and high levels of infrastructure spending should help support growth.

Positive business confidence and conditions should provide some support for the labour market over the balance of 2022. Employment trends remain positive, with total employment growing by 3.3% in the year to August with strength in the finance, professional services and IT sectors. The unemployment rate remains low at 3.5%.

Private consumption has been strong, growing by 4.6% in FY22. However, weak consumer sentiment points to falls in house prices, an easing of housing construction and an end to the abnormally strong retail sales cycle in the year ahead.

The Reserve Bank of Australia lifted the official cash rate by 0.25% to 2.6% in October, slowing the pace of tightening. The 10-year bond yield has risen to 3.9% in October. Rising borrowing costs have led to increased caution in the transaction market.

The headline inflation rate was 5.1% in the June quarter and is forecast to peak at 7.2% in Q4 2022 before easing. Construction costs continue to rise.

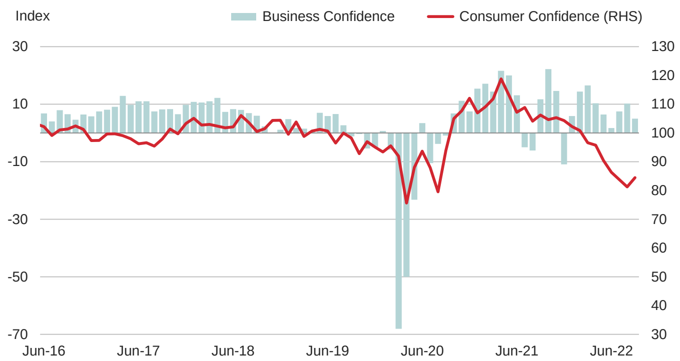
After spiking early in 2022, commodity prices have fallen by 17% since Q2 2022 reflecting global growth concerns. Strength in the US dollar has seen the Australian dollar weaken to USD 0.62 but remain relatively stable on a trade weighted basis.

Australian economic forecasts

	Jun-22	Jun-23	Jun-24
Real GDP %pa	3.6%	1.9%	3.0%
Final demand %pa	4.6%	1.5%	2.5%
Employment %pa	3.0%	2.3%	2.1%
Goods imports %pa	7.1%	3.9%	2.4%
Retail sales %pa (real)	2.3%	-0.8%	1.7%
CPI %pa	6.0%	6.5%	2.9%
Cash rate %	1.9%	3.1%	2.6%
10yr Bond %	3.7%	3.5%	3.0%
AUD/USD	0.69	0.70	0.72

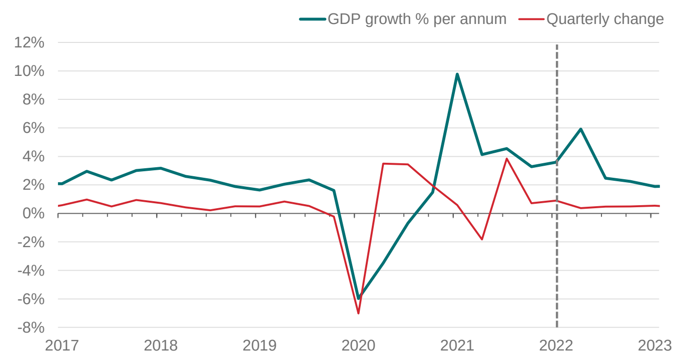
Source: Oxford Economics, September 2022

Business confidence and consumer sentiment



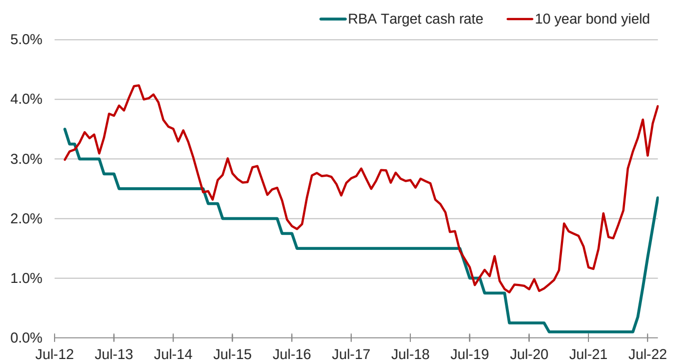
Source: NAB, Westpac

Australian GDP growth (annual and quarterly)



Source: Oxford Economics

Trends in official cash rates and 10 year bond yields



Source: Bloomberg

Performance and transactions

Asset returns experience volatility

Unlisted funds returns eased mildly in the year to September 2022, recording 11.9%. Industrial funds significantly outperformed the other sectors with 24.2% per annum, as significant rent growth helped offset a price softening. Office funds returned 11.5% and retail funds firmed slightly with returns of 9.2%. Returns are expected to ease across all sectors in the next six months as capital values weaken in the face of higher interest rates and a lift in cap rates. To date, cap rate softening has been offset to a degree by growth in market rents.

The A-REIT sector has been impacted by both equity market volatility and rising interest rates. The ASX 200 A-REIT Index (-24.6%) underperformed the ASX S&P 200 Index (-11.7%) in the year to Q3 2022. The sell-off in A-REITs coincided with a sharp rise in the 10 year bond yield which affected pricing of all defensive asset classes. At the same time, equity markets weakened in the face of growing concerns about global growth as the IMF and others adjusted US and European economic forecasts lower.

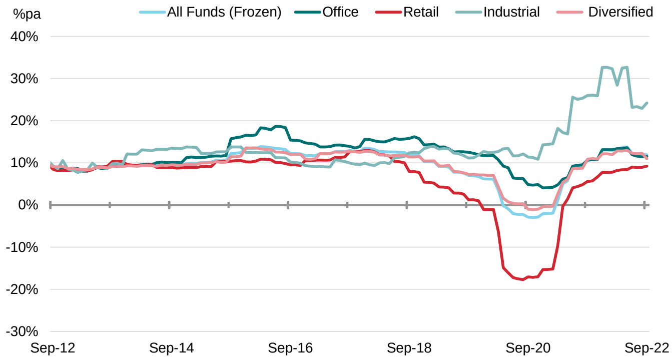
Real estate transaction activity has slowed over the past six months as buyers exercised caution in the face of volatile financial markets. There appears to be a gap between buyers and sellers due to the difficulty of assessing value in an environment of shifting cost of capital. The net effect according to JLL Research has been a lift in estimated prime market cap rates in Q3 2022 of 13-50 bps for prime office, industrial and retail. Any further price softening is likely to vary greatly between assets depending on quality, location and degree of leasing risk. Buyers are likely to favour higher quality, well located assets.

Asset class performance

	Qtr.%	1 yr %p.a.	3 yr %p.a.
Unlisted property[4]	1.8	11.9	6.3
Australian cash[3]	0.4	0.5	0.4
Australian infrastructure[6]	-10.8	-5.4	-2.3
Australian shares[2]	-0.4	-7.7	-2.7
Australian fixed interest[1]	-0.6	-11.4	-3.4
A-REITs[5]	-6.7	-21.5	-5.3

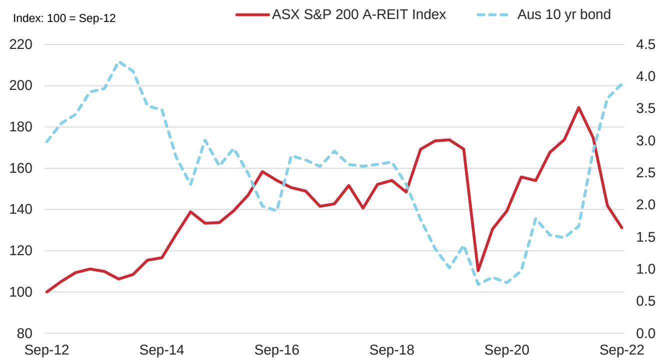
Sources: 1: Bloomberg BACM0 Index
Source 2.S&P/ASX.200 Accumulation Index
Source 3: Bloomberg BAUBIL Index
Source 4: MSCI Mercer Australian Core Wholesale Monthly PFI (AUD NAV Pre Fee) – All Funds to Sept. 2022),
Source 5: S&P/ASX.200.A-REIT Accumulation Index
Source 6: MSCI Australia Infrastructure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

Unlisted property returns by sector



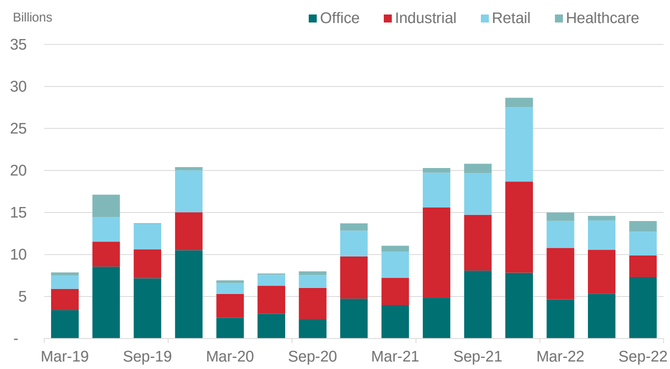
Source: MSCI, Dexus Research

A-REIT price index and 10 year bond yield



Source: Bloomberg

Australian transaction volumes by sector



Source: Real Capital Analytics

Office

Smaller occupiers lead take-up

So far this year, smaller occupiers have been responsible for the bulk of the take up in the sector. This has led to moderately positive net absorption, constrained somewhat by the larger users. Sydney recorded -33,000sqm absorption in Q3 2022, largely driven by Westpac vacating 16,000sqm at 275 Kent Street. Melbourne CBD recorded the largest quarter of net absorption in a year with 20,000sqm. Brisbane and Perth have both recorded consecutive quarters of positive net absorption.

Australian office markets are in varying stages of the supply cycle. Sydney and Brisbane are expecting relatively few office completions over the next 24 months. This should provide scope for a reduction in vacancy rates if demand is positive. Strong levels of new supply in Melbourne (174ksqm in FY23) will likely slow down the recovery in vacancy rates.

Major markets have seen modest rent growth, but incentives have also increased. Face rents have been growing across all CBD markets. Face rents are growing the fastest in Sydney CBD at 5.3% year-on-year. In Sydney, incentives increased from 21% in Q4 2019 to 34% in Q3 2022 representing 13ppts expansion. Prime Melbourne office has seen a 10ppts expansion in incentives for the same period. Incentives in Parramatta have risen substantially, driven by large levels of new supply, and resulting in a decrease in net effective rents of 18% year-on-year.

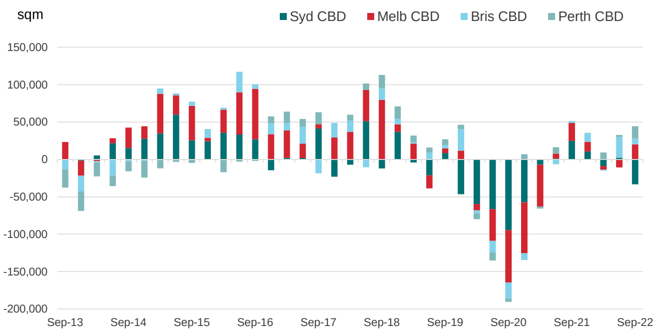
There have been early signs of cap rate expansion in response to an increasing cost of capital. While transaction evidence is still thin, JLL Research estimate cap rates increased by 20bps in Sydney CBD and 10bps in Melbourne CBD in Q3 2022. Further expansion is expected as transactions filter through.

Office snapshot Q3 2022

	Total Vacancy	Rent growth[1] (% p.a.)	Net Increase in stock[2]
Sydney CBD	13.7%	4.7%	0.2%
North Sydney	16.9%	1.6%	1.6%
Sydney Fringe	9.9%	0.7%	0.7%
Parramatta	21.9%	-18.2%	0.3%
SOP / Rhodes	19.5%	-8.3%	0.0%
Melbourne CBD	14.6%	-0.3%	1.8%
Brisbane CBD	14.9%	-1.1%	0.2%
Perth CBD	19.3%	0.1%	2.6%

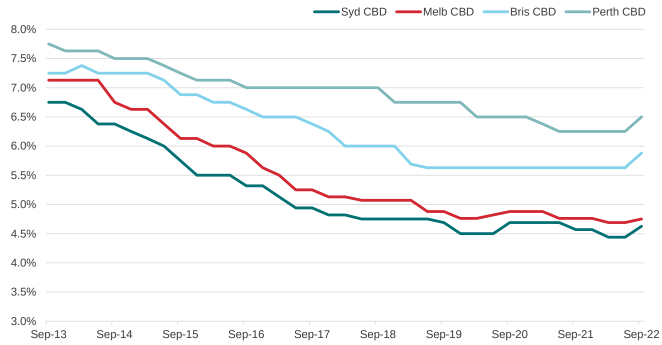
Source: JLL Research, Dexus Research [1] Net effective, [2] annualised FY22-FY24

Quarterly net absorption by CBD market



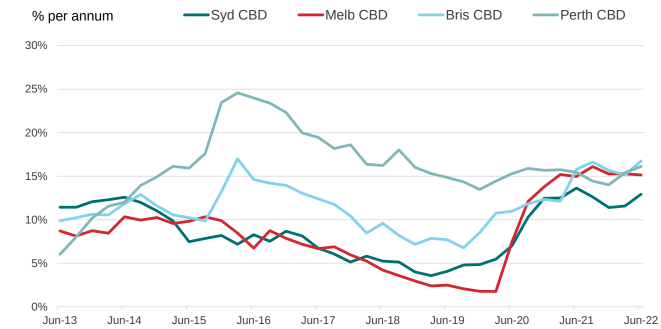
Source: JLL Research, Dexus Research.

Prime yields by CBD market



Source: JLL Research, Dexus Research

Vacancy rates by CBD market



Source: JLL Research, Dexus Research

Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney CBD	**Occupier demand still slow to recover.** Net absorption declined for the year at -29,000sqm, not keeping up with supply. The vacancy rate increased, currently at 13.7%. Incentives increased to 34% and prime gross rents grew 3.8% over the year. Yields expanded 19bps over the quarter to 4.63%.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑
North Sydney	**Rent growth and declining vacancy, but incentives also increasing.** There has been almost no net absorption over the past year, with just a 150sqm increase in occupied stock. With withdrawals, net supply has been negative, driving the vacancy rate down, currently at 16.9%. Incentives increased to 37% and prime gross rents grew 1.6% over the year. Yields expanded 13bps over the quarter to 5.01%.	Vacancy	→
		Rents	↑
		Incentives	→
		Yields	↑
Sydney Olympic Park / Rhodes	**Limited activity over the past year**. Net absorption was positive for the year at 16,000, outpacing supply, driven by a 17,000sqm tenant move in Q4 2021. The vacancy rate fell, currently at 19.5%. Incentives increased to 36% and prime gross rents remained stable over the past year. Yields expanded 13bps over the quarter to 5.51%.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
Parramatta	**Elevated vacancy is putting pressure on effective rents**. Net absorption was positive for the year at 8,000sqm, not keeping up with supply. The vacancy rate increased, up 9%, currently at 21.9%. This has been driven by over 100,000sqm of net supply in FY22. Incentives increased to 42% and prime gross rents remained stable over the past year. Yields expanded 12bps over the quarter to 5.25%.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
Melbourne CBD	**Improving net absorption saw vacancy fall 42bps below peak in Q4 2021**. Net absorption was positive for the year at 17,000sqm, outpacing supply. The vacancy rate fell, currently at 14.6%. Incentives increased to 39% and prime gross rents remained stable over the past year. Yields expanded 6bps over the quarter to 4.75%.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
Brisbane CBD	**Positive sentiment in the market as demand improves**. Net absorption was positive for the year at 46,000sqm, outpacing supply, and the highest in any Australian market. The vacancy rate fell, currently at 14.9%. Incentives increased to 43% and prime gross rents grew 3.3% over the year. Yields expanded 25bps over the quarter to 5.88%.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑
Perth CBD	**Vacancy rates compress for premium stock.** Net absorption was positive for the year at 28,000sqm, outpacing supply. Perth is the only CBD office market to record three consecutive quarters of positive net absorption. The vacancy rate increased, currently at 19.3%. Incentives remained stable at 49% and prime gross rents grew 0.1% over the year. Yields expanded 25bps over the quarter to 6.5%.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑

Industrial

Rents grow while pricing softens

Industrial pricing began to reflect the pinch from a higher cost of capital in Q3 2022 as buyers adjusted their price expectations. The largest corrections were felt within the Sydney and Melbourne markets with average prime yields lifting by around 50bps. Moves were less pronounced in other markets, given wider spreads over bond yields.

Transaction volumes were subdued over the quarter at $2.5m sqm as buyers became more selective in their approach. Smaller private capital was focused towards the Brisbane market sub 10,000sqm, while larger institutional capital continued to favour the Sydney and Melbourne, particularly for land development opportunities. Land values remained steady over the quarter after a strong run, however they could come under pressure from rising cap rates in the year ahead.

Strong occupier demand and very low levels of vacancy continued to place upwards pressure on rents with double digit quarterly growth achieved in some markets, notably outer West Sydney, South West Sydney and Perth.

Occupier demand has remained robust despite increasing domestic cost pressures. Container delays have had a positive influence on demand as occupiers increased inventory levels to compensate. Although congestion in Chinese ports appears to be improving, signaled by increased container volumes, it is likely the backlog of demand will continue to impact wait times at sea.

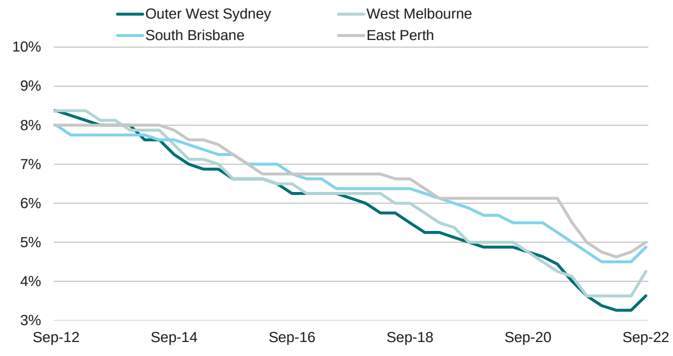
A reduction in shipping costs looks to somewhat alleviate supply chain pressures, however reliability remains a key concern. Shipping costs have declined by around 50% since Q1 2022 assisted by increased container production in China, capacity along key export routes and a softening in Chinese exports. While the cost reduction will have a positive effect across the broader supply chain, it is not expected to offset the imperative for businesses to minimise transport costs by locating around key logistics infrastructure.

Industrial snapshot Q3 2022

	Ave prime cap rate change from Q2 2022	Existing prime net face rental growth % p.a.
West Melbourne	+0.63	+22.2%
East Perth	+0.25	+19.6%
South Sydney	+0.38	+25.9%
Outer West Sydney	+0.38	+34.9%
Southern Brisbane	+0.38	+7.0%

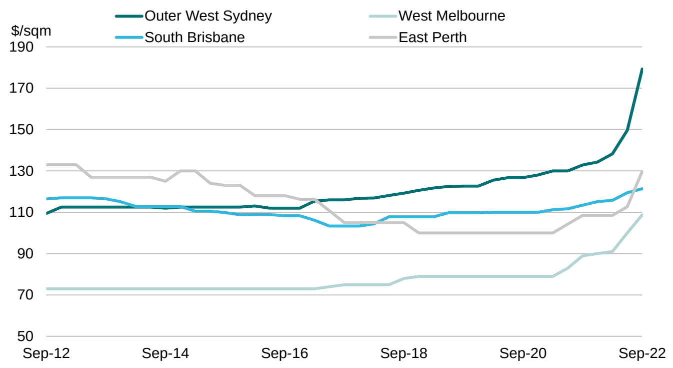
Source: JLL Research, Dexus Research (Sep 22)

Industrial capitalisation rates by precinct



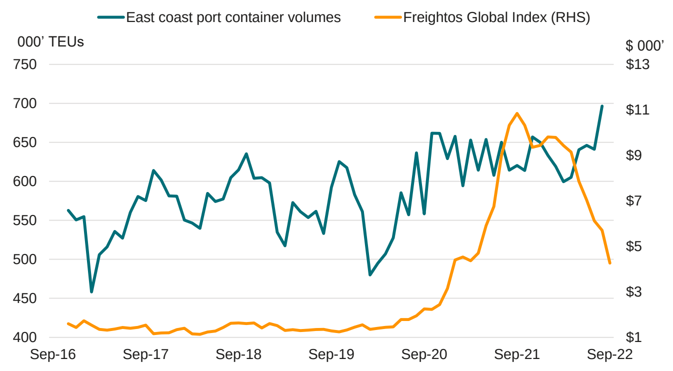
Source: JLL Research, Dexus Research

Industrial rents by precinct



Source: Real Capital Analytics (Excludes industrial R&D), Dexus Research

Shipping costs and container volumes



Source: Monthly Trade Reports (Port Botany, Port of Brisbane, Port Melbourne), Bloomberg, Dexus Research

Industrial by region

Outer West Sydney

Leasing volumes in the outer West Sydney market were subdued over the quarter, reflecting a lack of available short-term supply. Although the outer west has experienced record levels of completions (640,000sqm) year to date, most of this has been pre-committed, leaving tenants scrambling for space. With the bulk of Kemps Creek supply more than 12 months away and a third already committed, surrounding markets have begun to benefit, particularly the Inner west and North West. Logistics companies continue to reconfigure supply chains to leverage the Moorebank Intermodal. Mainfreight pre-leased 55,000sqm at Moorebank Logistics Park and a smaller 8,000sqm facility at Keylink Estate, Minto.

West Melbourne

The West Melbourne market continued to attract the majority of the city's demand (287,000sqm) over the quarter, however there continues to be growing interest in the North. The availability of serviced land benefited Dexus's Horizon Estate over the quarter. The estate accounted for nearly 50% of the market's demand including national retailers; Nike (61,000sqm) and Lululemon (22,000sqm). Supply chain delays have placed greater emphasis on location diversification. Techtonic industries pre-leased a record 74,000sqm in Melbourne Airport Business Park, their second facility of this scale in two years following the Yards Estate, Sydney.

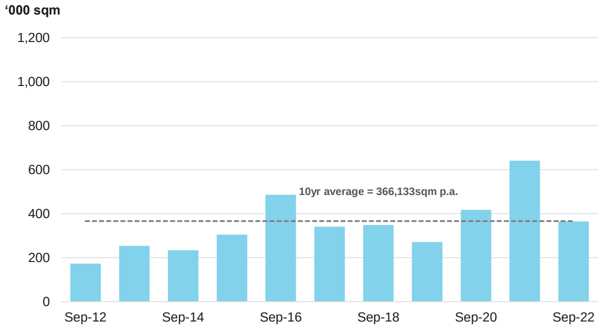
Brisbane (South and Australian Trade Coast)

Leasing volumes were subdued in the South market after a strong prior quarter, while Trade Coast leasing volumes continued to benefit from strong agriculture export volumes (up 20% yoy), which saw 10,000sqm leased by Rain Agribusiness, Pinkenba. The future BNE Auto Mall also continued to draw interest to the precinct with two automotive industries taking up space in proximity. The majority of leasing deals within the South were sub 10,000sqm filling the remaining spaces of completed projects.

Perth (East and South)

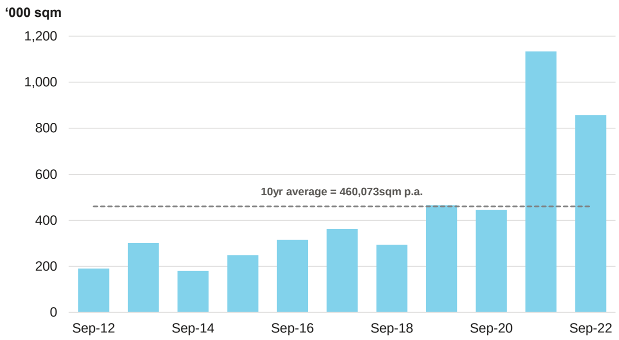
Demand across the East and South markets climbed over quarter (113,000sqm) following growth in the state's retail and mining sectors. Shorter delivery times and increasing road freight costs (8% yoy) continued to drive local demand for space. Office Works leased 15,000sqm at Perth Airport and JB Hi-Fi leased 12,000sqm at Roe Highway Logistics Park. Proximity to airports remain crucial for time sensitive freight. The outlook for Perth remains positive with mining exploration at record highs and rising iron ore production (Rio Tinto). Space requirements and rent growth are likely to benefit from the mining industry.

Outer West Sydney gross take-up (FY)



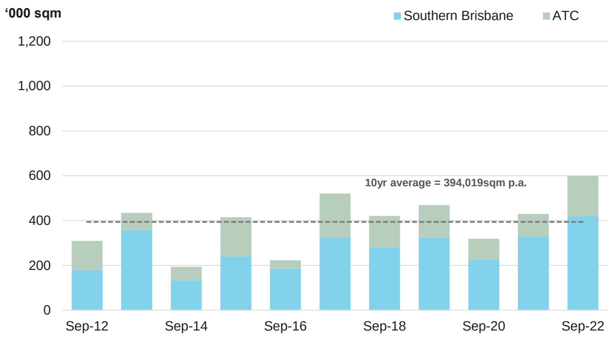
Source: JLL Research (gross take-up), Dexus Research.

West Melbourne gross take-up (FY)



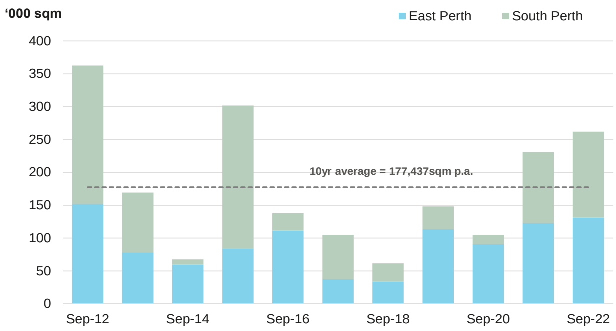
Source: JLL Research (gross take-up), Dexus Research

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

Mixed signals in the retail sector

Retail sales growth has been strong according to the ABS with moving annual turnover (MAT) growing by 7.5% in the year to July 2022 (16.5% year-on-year). Driving this was discretionary spending with the MAT for cafes and clothing categories growing by 12.4% and 13.9% respectively. Growth has been buoyed by elevated inflation and is coming off a low base from the lockdown period 12 months ago. Domestic sales have also been supported by low levels of overseas travel through the pandemic.

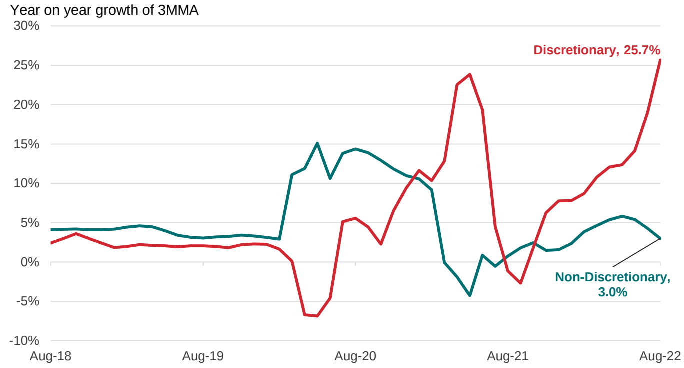
The catchup in discretionary spending will benefit large centres with a high proportion of specialty clothing and dining tenants. Food and grocery retail has been strong in recent times. However, this category traditionally sees moderate, stable growth and appears to be reverting to trend with implications for smaller supermarket based centres. Household goods sales have been strong, but are likely to ease in the near-term given a forecast weakening in housing construction.

Strong retail sales growth and rising population growth are positive signs for the retail sector. However, recent economic developments such as the increase in inflation and interest rates have had a significant impact on consumer sentiment. In addition, cost of living pressures and a decline in real wages have put pressure on household budgets.

Declining sentiment has had limited impact on sales growth given the tight labour market, and a drawdown on household savings. Looking ahead, the pressures on household budgets are expected to slow the pace of sales growth, particularly for the discretionary categories.

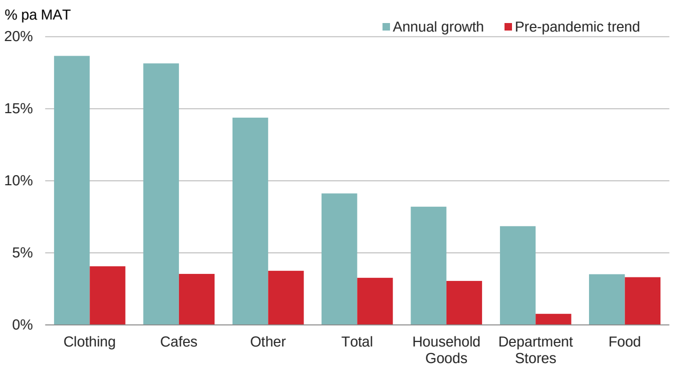
Overseas migration is improving and will be a positive influence in the medium term. Population growth in Australia ticked up to 0.9% per annum in Q1 2022, with nearly 100,000 people arriving over the year. The Federal government has raised the cap on permanent arrivals and fast-tracked visa applications. Population growth is expected to rise back towards its pre-COVID trend to 1.5% per annum in 2023. New South Wales and Victoria are expected to benefit most from overseas arrivals, while interstate migration is likely to benefit Queensland and Western Australia.

Discretionary vs. non-discretionary retail spending



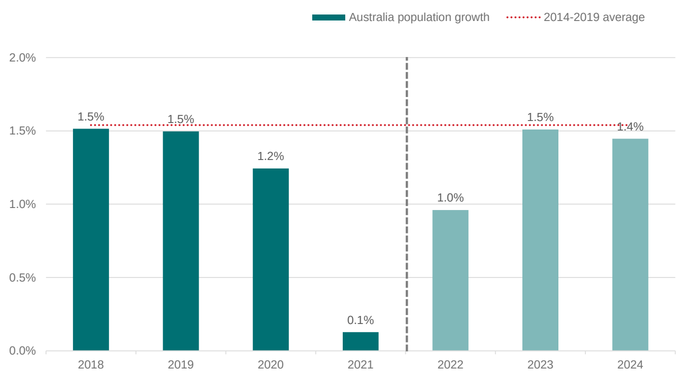
Source: ABS, Dexus Research

Retail sales by category



Source: ABS, Dexus Research

Australian population growth forecast



Source: Oxford Economics, Dexus Research.

Retail performance

Returns on an improving trend

Supermarket-anchored centres performed well over the year to Q2 2022, with a total return of 14.5% per annum. The larger regional and super regional centres returned 9.8% and 6.2% per annum respectively. The returns of larger centres are on an improving trend helped by tenancy mixes skewed to the faster growing discretionary retail categories and increased spending on restaurants, services and entertainment. City retail was hardest hit during the pandemic and the recovery remains constrained by the slow return of office workers to the city and reduced number of tourists.

Shopping centre vacancy rates remained elevated after rising during the pandemic. While the worst affects of lockdowns have passed, it will take time for retailers to resume expansion plans and re-populate centres. Of the categories, leasing activity in the apparel segment remains weak, while food and services are more active.

According to JLL Research, specialty rents were steady-to-up across all centre types in Q3 2022, particularly in neighbourhood shopping centres where Sydney specialty rents grew by 0.25% in the quarter. There is significant variation between centres.

Investor sentiment appears to be improving given transaction volumes for the retail sector are above the levels of 2019 and 2020 in the year to date. Volumes are a little below the levels seen in 2021 where several large shopping centres changed hands after COVID-19 restrictions lifted.

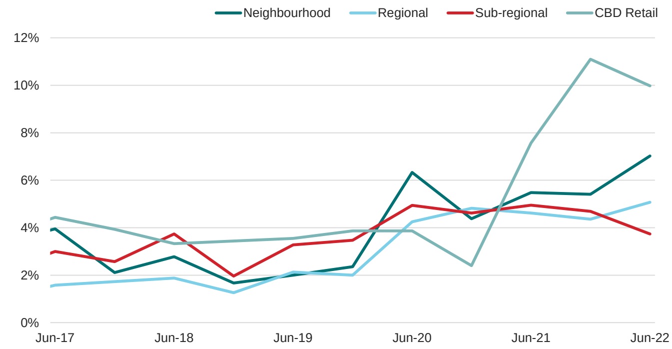
Like the other property sectors, retail pricing softened mildly in the face of rising bond yields in Q3 2022. Neighbourhood centre yields lifted more than larger centres, reflecting an unwinding of the more significant tightening they experienced over the last three years. The yields of larger centres may prove more stable than for smaller centres given spreads are more in line with the long-term average.

Retail snapshot Q3 2022

	Specialty rent growth % q-o-q.	Cap rate chge from Q2 (bps)
Sydney		
Regional	0.10%	25
Sub-regional	0.10%	13
Neighbourhood	0.25%	38
Melbourne		
Regional	0.05%	13
Sub-regional	0.05%	25
Neighbourhood	0.30%	50
SE QLD		
Regional	0.05%	0
Sub-regional	0.05%	0
Neighbourhood	0.25%	25

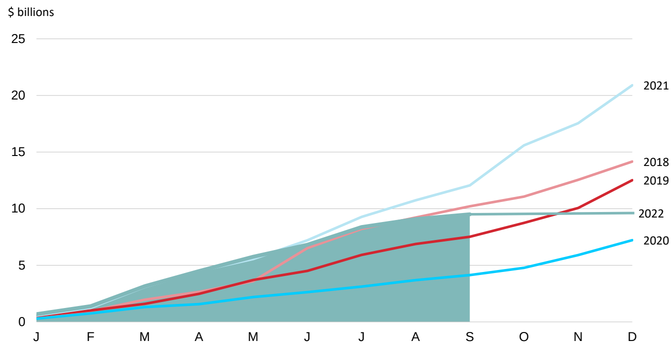
Source: JLL Research, Dexus Research

Shopping centre vacancy rates



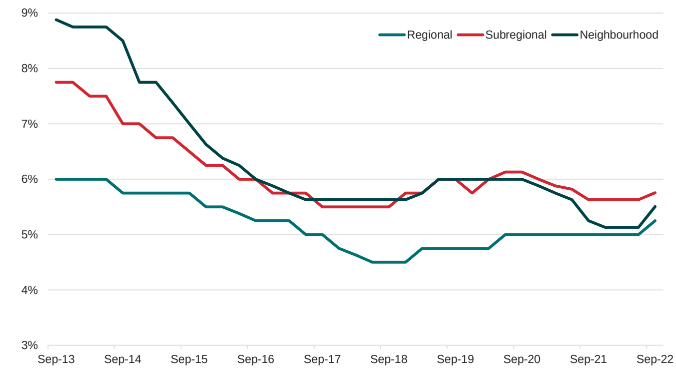
Source: JLL Research, Dexus Research

Retail transaction volumes



Source: Real Capital Analytics

Sydney shopping centre yield movements



Source: JLL Research, Dexus Research

Healthcare

Health a major focus for governments

Healthcare sector returns remained robust over the quarter with strong demand for hospital assets. State government funding looks to support growth in infrastructure and workforce over the longer term.

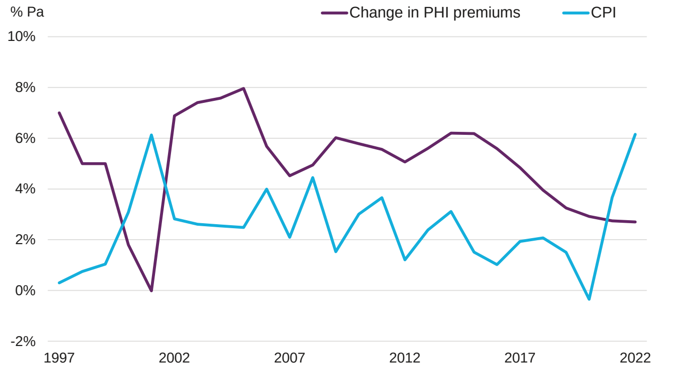
Australia's healthcare system is a major focal point for federal and state governments which will continue to create attractive investment opportunities. The NSW FY23 budget looks to focus on "life sciences" including $253m allocated towards PPE equipment, $287m towards COVID-19 testing clinics and $270m over four years towards biomedicine and biopharmaceutical facilities. The VIC FY23 budget allocated funds to building a new mental health wellbeing system which includes assets such as mental health hospitals.

Over the past two years there has been a significant increase in the take-up of private health insurance, which is a positive for the healthcare system. According to the latest figures, around 55% of Australians have a level of "general" cover which is an increase of 2.6% per annum from the lows of June 2020. Trends show that more consumers are opting for combined general and hospital cover which has had a positive influence on the level of hospital cover. However, most of the growth in hospital cover has been driven by persons over 75 years+ following COVID-19 "age of risk" concerns.

Affordability may become an issue for PHI uptake going forward. Historically, private health insurance premiums have increased double the rate of CPI, which constrained uptake, particularly for "Millennials". According to recent data, only a third hold hospital cover yet account for 21.5% of the population. During 2021, the federal government passed legislation to freeze the rise in premiums, in order to alleviate stress on the public system, however this is set to end in the coming months. With the cost of living at record highs, it will be interesting to see how premium levels affect future PHI levels.

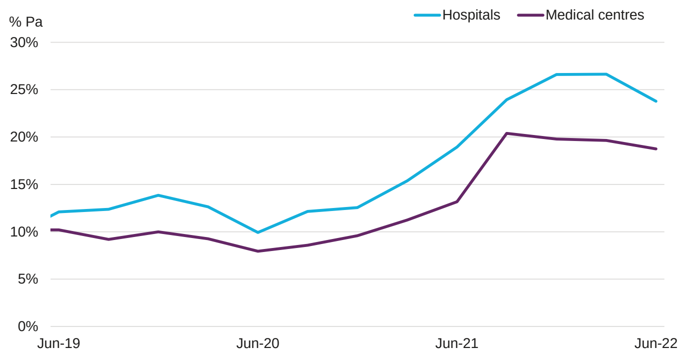
Over the past 12 months healthcare returns have been heavily buoyed by double digit capital returns, which have seen valuation cap rates fall to 4.5% (and even lower in the transaction market). Hospitals have displayed stronger total returns through the pandemic (peaking at 27%), with medical centres perceived to be more sensitive to economic conditions. Investors are generally attracted to hospitals given their scale, tenant investment and longer leases. Over the quarter Healthscope sold Peninsula private Hospital (acute surgical and rehabilitation hospital) in Brisbane for $47.6m on the condition of a sale and lease back to Norwest Healthcare Properties.

Private health insurance premiums and inflation



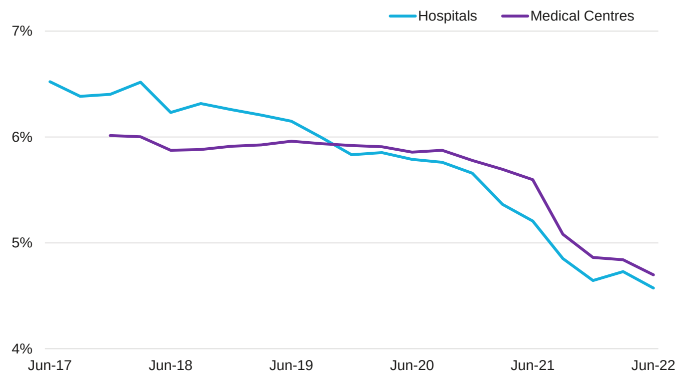
Source: Department of health, Oxford economics, Dexus Research

Total returns by sub-sector



Source: MSCI, Dexus Research

Capitalisation rates for healthcare assets



Source: MSCI, Dexus Research

Dexus Research

Peter Studley
Head of Research
d: +61 2 9017 1345
e: Peter.Studley@dexus.com

James Melville
Research Manager
d: +61 2 9017 1181
e: James.Melville@dexus.com

Matthew Persson
Senior Research Analyst
d: +61 2 9080 4950
e: Matthew.Persson@dexus.com

Disclaimer

dexus

dexus.com

Responsible Entity
Dexus Funds Management Limited
ABN 24 060 920 783
Australian Financial Services License Holder
(License Number 238163)

Registered Office
Level 25, 264 George Street
Sydney NSW 2000
Australia
PO Box R1822
Royal Exchange NSW 1225
Australia