At the gates of opportunity: buying below cost

By Christopher Davitt,
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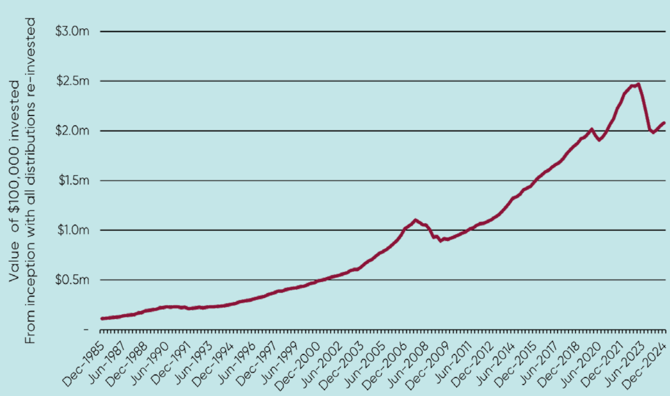
When it launched in 1985, the Dexus Wholesale Australian Property Fund (DWAPF) had a simple objective; to provide investors with reliable income and attractive long-term capital growth from a high quality commercial property portfolio.

Net of fees, the fund has delivered a total average annual return of 7.9% since launch, accompanied by the comfort of quarterly distributions, competitive fees and attractive liquidity. Thus far, it's fair to say that the original objective has been met.

Figure 1: Dexus Wholesale Australian Property Fund



That headline figure, however, hides a richer, more recent story that encapsulates a period of tumult. A period which has upended conventional wisdom and challenged investment managers to rally and adapt. Five years after we all first heard of 'Coronavirus 2019', it's worth taking stock of what's happened and how things might play out from here. We believe that time will show that the post-covid era can be divided into a series of phases: the first phase was dominated by the virus, lockdowns and new ways of working; the second phase was dominated by inflation, a sharp interest rate response and asset values repricing accordingly; and the third phase – well, that's what we're now positioning for.

The pandemic challenged commercial property at an elemental level. Governments mandated that tenants didn't need to pay rent and people must stay home, leaving offices and shopping centres largely empty between 2020 and 2021. The upheaval actually benefited industrial property and shopping centres bounced back. Flexible working and advancements in technology reduced the overall market demand for office space but workers have steadily been returning to the office - CBRE's 'return to work indicator' is now above 80% for most capital cities – and this step-change has now largely washed through the system.

By 2022, the medical emergency had stabilised but just as the things seemed to be getting back to normal, inflation spiked which pushed up interest rates, hitting commercial property prices hard.

So where does this leave the market?

On the one hand, operationally commercial property is performing well with high occupancy and low tenant arrears. Commercial property typically returns 7-8% through the cycle and income accounts for about 70% of the return so having the properties well leased with profitable tenants is essential. Shopping centres are benefiting from the lowest unemployment rate in 50 years and a 1.6 million post-covid surge in the Australia's population. Smaller centres have done particularly well. Especially if they are anchored by supermarkets and include a tenant mix that offers customers quality fresh food choices and a wide range of personal services that can't be delivered online. Industrial property has benefited from the acceleration of e-commerce, a business preference to avoid supply-chain disruption risks by holding more inventories and limited land releases in major capital cities.

In the office market, there has been a steady stream of corporate and government tenants insisting that workers return to the office in the interests of productivity and collaboration. Most recently by the NSW state government and the Commonwealth Bank. Five years on from lockdowns, businesses have generally adjusted their office space requirements to match their new way of working and similarly developers have throttled back the supply pipeline. Indeed, no new office buildings are due to be delivered to the Sydney CBD in all of 2026. Together, this has allowed most major Australian markets to rebalance to 'the new norm'. The other notable post-covid shift has been that new sectors – such as Life Sciences - have achieved heightened relevance to the economy and have come onto the investment radar of sophisticated property investors. The Dexus Wholesale Australian Property Fund has investments in each of these sectors and its current occupancy rate of 97% is indicative of the broader message: operationally, commercial property is doing well.

On the other hand, prices have come down from their 2022 highs. Over the same period, consumer inflation has risen by about 15% and construction inflation is up over 30% since the onset of the pandemic. This sets up an interesting conundrum where the cost of replacing assets is approximately 30-40% higher than current valuations. So far, it's the experienced private investors that have recognised this and been the first to act. 'Privates' were the leading buyer type of commercial property both here and offshore in 2023 and the trend looks set to continue in 2024. Landmark examples of this include Michael Bloomberg's $560 million upper east side office purchase in Manhattan; the real estate company of Amancio Ortega – the Spanish billionaire owner of Zara – buying in London's Fitzrovia for £81 million; and closer to home, mining magnate Gina Rinehart's acquisition of a $240 million office building in Brisbane. There is no compulsion for privates to buy – but they are famous for spotting value.

Herein lies the opportunity for financial advisers.

The Dexus Wholesale Australian Property Fund offers immediate access to a diversified portfolio of quality assets which are performing well. The properties have been selectively accumulated over decades and include gems such as 'Gasworks' which is a super-neighbourhood centre located amidst a forest of new apartments in the inner-city enclave of Newstead in Brisbane. The portfolio has recently been enhanced by the addition of five brand new logistics properties in Sydney and Brisbane which were all completed in the last 18 months; and it also includes The Mill in Sydney which is best known as the home of iconic hospitality brand The Grounds but also houses a certified 'P2' lab occupied by international Life Sciences group, AbCellera. Investors can buy a bite-sized share of the portfolio without paying any upfront stamp duty, buy spread or transaction costs. They are then paid a quarterly income distribution – which was 6.0% in the 12 months to September 2024[1] and are also entitled to all future capital gains.

But here's the thing: the Fund's unit price is independently determined by third-party valuers. Reflecting the broader market, these valuations are estimated to be well under the replacement cost of the portfolio. Real estate has a reputation as being a 'hedge against inflation'. This is largely due to the close, long-term relationship between values and the cost-to-build, but right now the gap is unusually large. If nothing gives, nothing will get built – developers won't start projects if the end product is worth less than the costs. So, the question is: are costs coming down 30-40% or will the gap be closed by a healthy uplift in values? Moreover, is now a good time to position your clients' portfolios the same way savvy billionaires around the world are positioning their own personal fortunes?

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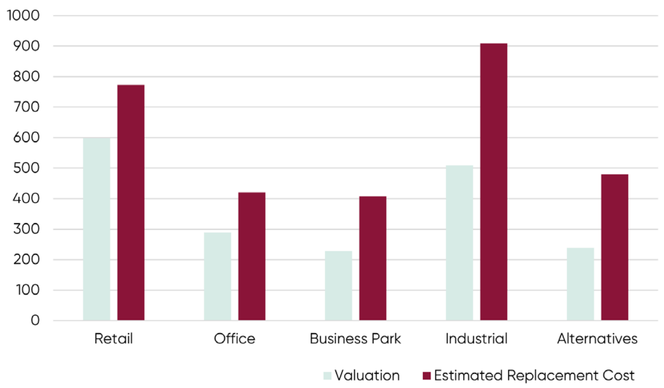
1. Past performance is not a reliable indicator of future performance

Figure 2: Fund valuations vs estimated replacement costs



Source: RLB, Dexus estimates

Invest in DWAPF

Dexus Wholesale Australian Property Fund (DWAPF) is an open-ended fund that aims to provide stable returns and long-term capital growth through investment in a diverse portfolio of quality Australian office, retail and industrial properties.

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