Australian Real Estate Quarterly Review

Q3 2023

Quarter Quay Tower, Sydney

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Investment climate

Conditions challenging in short term

The Australian economy slowed mildly to 2.1% per annum growth in Q1 2023. There are signs of a bifurcation in the economy where the business sector remains relatively resilient, while households are feeling the effects of interest rises. On the business side, total employment grew by 3.4% in the year to May 2023 and business investment grew by 4.4% in the year to March. For households, which are more sensitive to mortgage rates, consumption growth slowed and dwelling investment contracted.

Amid these mixed economic signals, business confidence is easing in the face of weak consumer sentiment which points to a subdued outlook for real estate leasing in the year ahead. GDP growth is forecast to slow to 1.2% in Q4 2023.

After peaking in December, Australia's headline monthly inflation rate slowed to 5.8% in May 2023. The Reserve Bank of Australia held the official cash rate steady at 4.1% in July. Most commentators anticipate another one or two rises in cash rates will be necessary to control core inflation. The 10-year bond yield has lifted to around 4.2%.

It is anticipated that FY24 will be a challenging period as capital flows and market sentiment continue to be influenced by elevated interest rates and geopolitical risks. Such conditions are not uncommon and can create opportunities for capable well capitalised managers. A peaking of the interest rate cycle in the year ahead would be a positive signal for real asset markets.

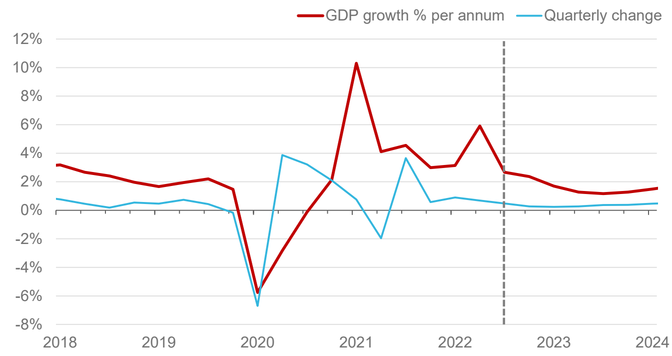
Longer term trends remain sound with demand for real assets to be underpinned by strong population growth and significant infrastructure investment. Population growth is forecast at 1.4% per annum over the next five years.

Australian economic forecasts

	Jun-23	Jun-24	Jun-25
Real GDP %pa	1.7%	1.5%	2.9%
Employment %pa	1.9%	1.2%	2.3%
Business investment %pa	3.7%	5.8%	5.0%
Dwelling investment %pa	1.5%	0.4%	-2.0%
Population %pa	1.6%	1.5%	1.4%
Retail sales %pa	3.6%	2.6%	3.5%
CPI %pa	6.5%	3.5%	2.5%
Cash rate %	4.1%	4.1%	3.6%
10yr Bond %	3.9%	3.6%	3.1%
AUD/USD	0.68	0.68	0.71

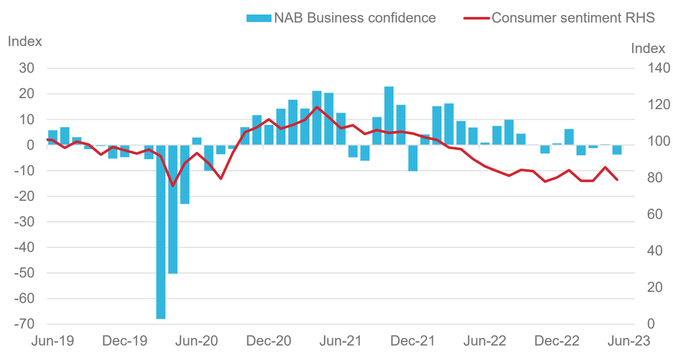
Source: Oxford Economics, June 2023

Australian economic growth



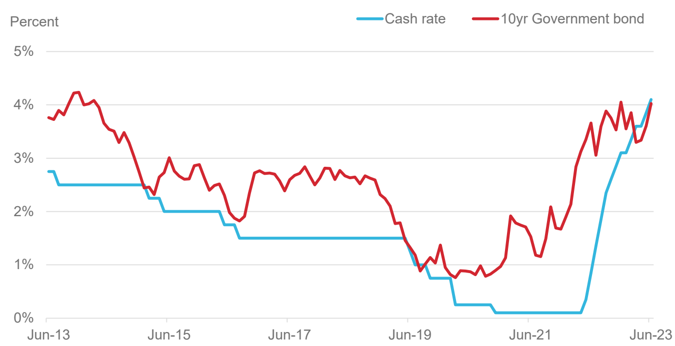
Source: Oxford Economics

Business confidence and consumer sentiment



Source: NAB, Westpac

Official cash rates and 10-year bond yields



Source: Bloomberg

Performance / transactions

Unlisted property returns ease

The high cost of capital is driving investors to re-evaluate pricing across all asset classes. Returns for unlisted property eased in Q2 2023. Income returns of circa 5% combined with growth in market rents are supporting total returns. Office funds returned -3.9% over the year, while industrial funds returned 6.4% due to strong rent growth which helped offset cap rate expansion. Unlisted retail returns were 1.1% in the year to June, protected somewhat from the current round of re-pricing by the cap rate expansion which had already occurred during COVID.

AREITs staged a mild recovery over the quarter from a deeply discounted position, recording 3.4% in the quarter and 8.1% for the year. The recovery might have been greater except for the lift in bond yields in June which saw investors re-evaluate the yield on defensive assets. The sell-off in Australian 10 year bonds through May/June led to a weak quarter for fixed interest investments. Any peaking of the cash rate cycle in FY24 can be expected to lead to lower 10 year yields and a corresponding improvement in AREITs and defensive equities.

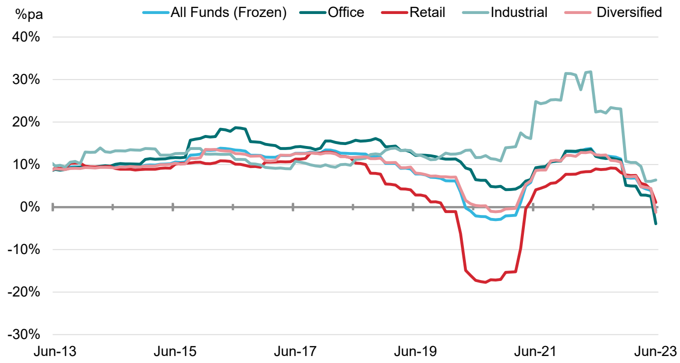
Transaction volumes have been at decade lows in both Q1 and Q2, as investors adjust to a higher cost of capital. The office sector saw the smallest volume of transactions. Despite the lack of volume in office transactions, the sale of larger assets such as 44 Market Street, Sydney increased the level of price discovery within the market, allowing investors to gain a better understanding of where values lie, which in the long run will improve confidence and liquidity in the transaction market. Investment demand is expected to pick up from early 2024 assuming when interest rates peak and investors can better predict their cost of capital.

Asset class performance Q2 2023

	Qtr. %	1 yr %p.a.	3 yr %p.a.
Australian shares[4]	1.0%	14.8%	11.1%
AREITs[6]	3.4%	8.1%	8.1%
Australian infrastructure[1]	-1.8%	4.0%	4.2%
Australian cash[3]	0.9%	2.9%	1.0%
Australian fixed interest[5]	-2.9%	1.2%	-3.5%
Unlisted property[2]	-2.7%	-0.8%	6.7%

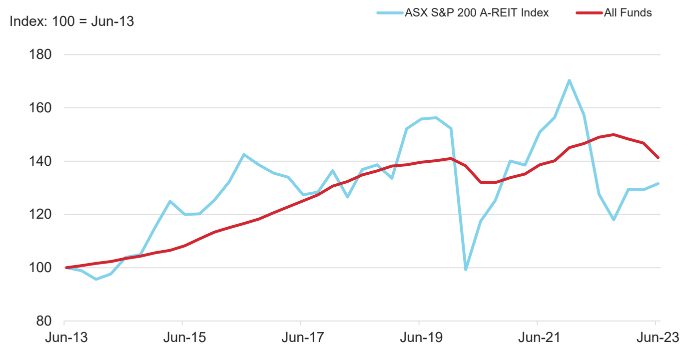
Source 1: MSCI Australia Infrastructure Index
Source 2: MSCI Mercer Australian Core Wholesale Monthly PFI
Source 3: Bloomberg BAUBIL Index
Source 4: Bloomberg BACM0 Index
Source 5: S&P/ASX 200 Accumulation Index
Source 6: S&P/ASX 200 A-REIT Accumulation Index

Unlisted wholesale fund returns



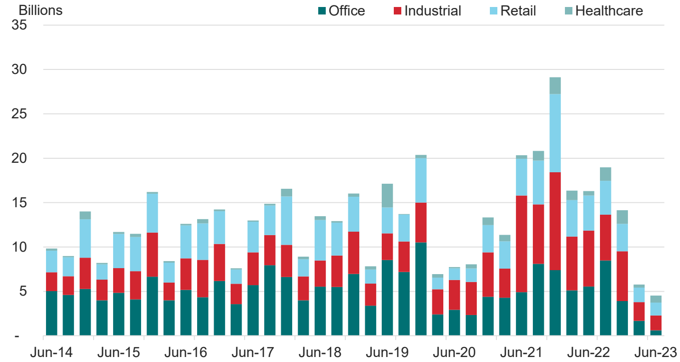
Source: MSCI/Mercer

Listed unit price and unlisted capital return indexes



Source: Bloomberg, MSCI

Transaction volumes – real estate



Source: Real Capital Analytics

Office

Diverging performance across CBDs

Flight-to-quality is a major theme for office markets as occupiers seek high quality centrally located offices with amenity that appeals to staff. Net absorption of premium space within the four major CBDs (Sydney, Melbourne, Perth and Brisbane, total positive 173,000 sqm) was much stronger over the past year than for all other grades (negative 89,000 sqm). The premium vacancy rates in Brisbane and Perth are down to 8.1% and 6.7% respectively.

A continued flight to quality was evident in superior rent growth for prime and premium space with growth in prime net effective rents (6.0% pa) exceeding secondary (0.7% pa) in Sydney CBD in FY23. In Sydney CBD there has also been a 'flight to core' with net absorption in the core of the CBD exceeding other precincts.

The office sector is expected to continue to experience elevated vacancy rates in the short term due to a slowing economy. Demand in Sydney and Melbourne has been characterised by continued leasing and expansion among small-medium firms, offset by consolidation among larger firms.

There is a marked divergence between the performance of office markets based on their exposure to mining. Office demand in the Brisbane and Perth CBDs has outpaced Sydney and Melbourne, with Brisbane currently boasting the lowest vacancy rate among the CBDs at 12.6%.

While business conditions remain positive, confidence is subdued. The labour market remains strong overall with an unemployment rate of 3.5% as of June 2023. Employment growth in white collar industries has flattened to 0.3% in the year to May 2023 with solid 5.9% growth in the professional services sector being offset by a mild contraction in the finance sector.

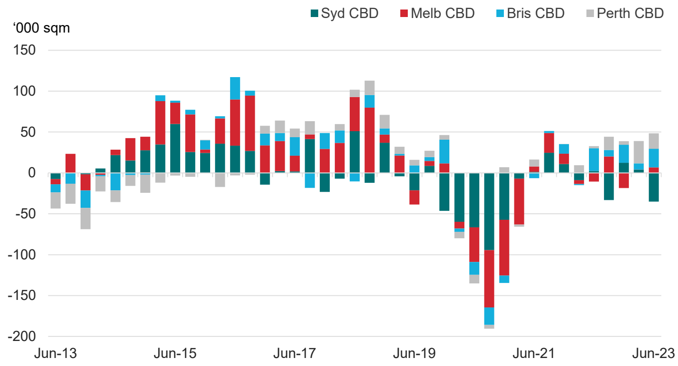
Cap rates continued to expand. Over the past year, cap rates are estimated to have increased by 50 bps to 88 bps for prime CBD offices.

Q2 2023 office snapshot

	Total Vacancy	Rent growth* (% p.a.)	Net supply FY24-26 (%pa)
Sydney CBD	14.4%	8.0%	1.1%
North Sydney	19.9%	5.5%	3.0%
Sydney Fringe	7.1%	10.1%	0.9%
Parramatta	23.5%	-0.3%	0.4%
SOP / Rhodes	22.7%	1.5%	0.0%
Melbourne CBD	16.2%	2.7%	1.5%
Brisbane CBD	12.6%	6.7%	1.5%
Perth CBD	18.5%	1.7%	1.9%

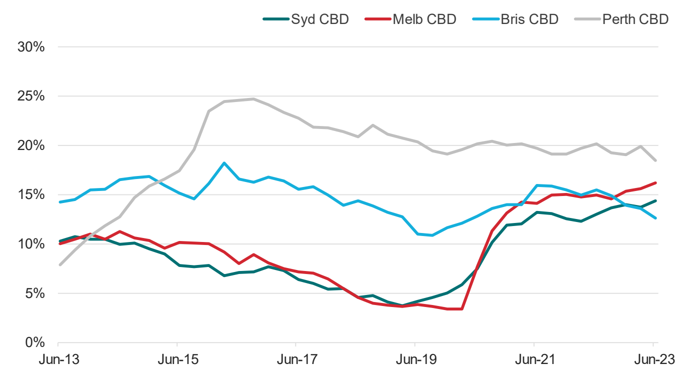
Source: JLL Research, Dexus *Net effective,

Quarterly net absorption by CBD market



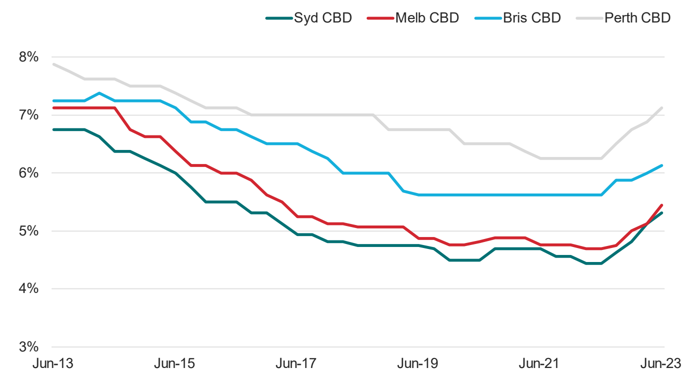
Source: JLL Research, Dexus Research

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	Rent performance strong despite increasing vacancy. Net absorption was negative for the year at -52,000 sqm. Demand is below the 10-year average of 1,000 sqm. While net absorption among small to medium tenants appears positive, a few large consolidations among banks and technology companies led to the negative overall take-up. Vacancy rates have increased by 1.3 ppts, currently standing at 14.4%. Incentives increased to 35% and prime gross rents grew by 4.5% over the year. Yields expanded 19bps over the quarter to 5.32%.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
North Sydney	High vacancy rates persist as a weakness. Net absorption was negative for the year at -26,000 sqm. This is below the 10-year average of -3,000 sqm. The negative absorption came partly from technology companies subleasing space and tenants centralise to the CBD. The vacancy rate increased by 2.8 ppts, with completion of 2-4 Blue Street and currently stands at 19.9%. Incentives have increased and prime gross rents grew 3.6% over the year. Yields expanded 25bps over the quarter to 5.5%.	Vacancy	↑
		Rents	→
		Incentives	↑
		Yields	↑
Parramatta	High vacancy rates will constrain the growth outlook, however, a tight supply pipeline may contain vacancy. Net absorption was negative for the year at -61,000 sqm driven by consolidations by the state government and companies in the finance sector. Vacancy rates have increased by 5.2 ppts, currently standing at 23.5%. Incentives increased to 45% and prime gross rents remained stable over the past year. Yields expanded 25bps over the quarter to 6.0%.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Melbourne CBD	Limited near-term supply to provide opportunity for occupancy to catch up. Net absorption was positive for the year at 9,000 sqm. This is below the 10-year average of 40,000 sqm. However, the positive result was driven by expansion among professional services, wealth management, ecommerce and government sectors. Vacancy rates have increased by 1.2 ppts, currently standing at 16.2%. Incentives increased to 40% and prime gross rents grew 1.3% over the year. Yields expanded 32bps over the quarter to 5.44%.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Brisbane CBD	Strong demand drives vacancy to post-pandemic low. Net absorption was positive for the year at 60,000 sqm. This is above the 10-year average of 4,000 sqm and largely driven by a wide range of same tenant moves and expansion with engineering firms contributing. Vacancy rates decreased by 2.8 ppts, currently standing at 12.6%. A decrease is expected in the coming year. Incentives reduced to 42% and prime gross rents grew 7.6% over the year. Yields expanded 13bps over the quarter to 6.13%.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑
Perth CBD	Increased demand and mining exploration offer potential for market improvement. Net absorption was positive for the year at 67,000 sqm. This is above the 10-year average of -11,000 sqm with demand supported by expansions in the mining sector and associated professional services. Vacancy rates decreased by 1.7 ppts, currently standing at 18.5%. A decrease is expected in the coming year. Incentives reduced to 48% and prime gross rents grew 0.6% over the year. Yields expanded 25bps over the quarter to 7.13%.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑

Industrial

Markets begin to normalise after a strong run

The fundamentals of the Australian industrial sector remain positive with rents growing and vacancy rates low. However, slowing consumption indicators point to a period of slower leasing demand ahead relative to the record levels achieved over the past two years. Retail turnover growth slowed in the year to May and slowing forward orders suggest retailers will pare back expansion plans in FY24, particularly those involved in discretionary categories. In an environment of moderating retail activity, industrial demand will remain supported by non-discretionary categories such as medical, supermarkets and materials supporting infrastructure investment. By location, demand has been relatively stronger in Brisbane and Perth than in the other cities, in line with firmer economic indicators.

Low market vacancy is providing support for rents. Net face rents in major markets lifted by between 12% and 32% in FY23. While industrial rents continued to rise during Q2 2023, the pace of growth is expected to ease towards more normal levels in the year ahead.

The longer-term demand trends remain positive, driven by ecommerce expansion and investment in more efficient supply chains. Population growth in Australia is among the highest of advanced economies. In a global context, characterised by tighter monetary policies, Australia's industrial market has fared well so far, showing generally stronger rent growth and a lower vacancy rates compared to many European and US markets.

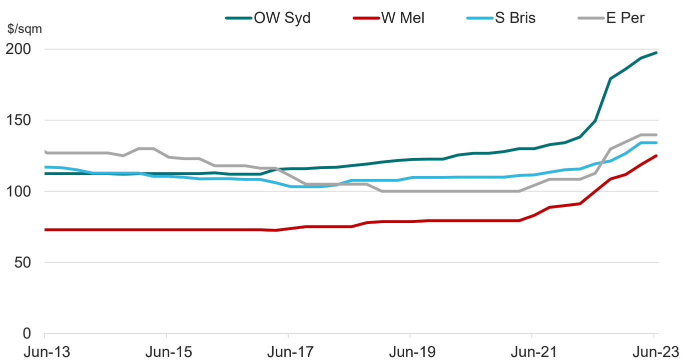
Transaction volumes were subdued in Q2 2023 as investors remained cautious about pricing in a rising interest rate environment. The industrial market saw $1.6bn in industrial transactions in the quarter, down by more than 50% on the historical run rate. Net acquisitions from foreign backed capital remain positive, accounting for a third of transactions in the calendar year to date. Cap rates lifted in the quarter, however valuation impacts were mild given strong rent growth. Land values have fallen by up to 12.5% depending on location.

Industrial snapshot

	Prime cap rate change from Q1 2023 (ppts)	Existing prime net face rental growth % p.a.
Outer West Sydney	+0.50	+32.0%
West Melbourne	+0.25	+25.0%
East Perth	+0.25	+23.9%
South Sydney	+0.25	+27.2%
Inner West Sydney	+0.25	+22.5%
Southern Brisbane	+0.13	+12.4%

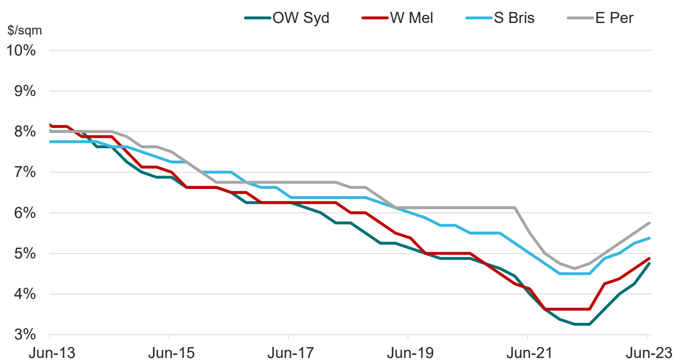
Source: JLL Research, Dexus Research (June 23)

Industrial rents by precinct



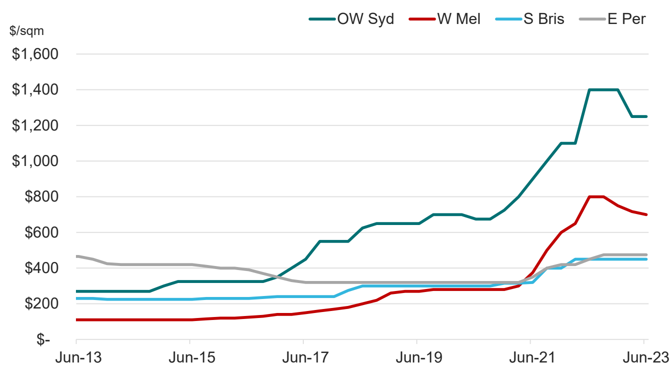
Source: JLL Research (average prime), Dexus Research

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 Perth = 1HA, Dexus Research

Industrial by region

Outer West Sydney

Gross leasing volumes in the Outer West Sydney market improved in the second quarter of 2023 with 176,037 sqm absorbed. Most of the leasing activity came from transport and logistics industries around Eastern Creek/Erskine Park. DHL extended their lease at Dexus's 51 Eastern Creek Drive a zero incentive, reflective of the tightest market vacancy of 0.1% for product 5,000sqm+. Net face rents increased moderately at 1.9% over the quarter. Flight to quality will benefit rents in the market as new product becomes available in the year ahead.

West Melbourne

West Melbourne gross leasing volumes rebounded last quarter with 111,652sqm absorbed, attributable to an uptick in pre-lease activity. Leasing demand came from food retailers and transport/logistics industries (3PL). Vacancy in the West marginally increased during the quarter to 1.4%, concentrated in secondary grade stock. Net face rents increased by 5.3% however development incentives continue to hover around 15%-20% dependent on size. Land values have declined by 12.5% in the past year.

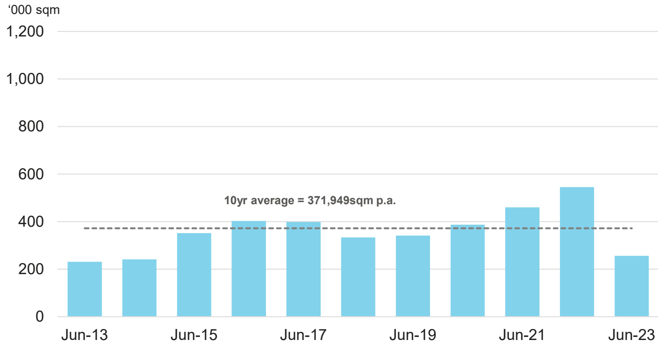
Brisbane (South & Australian Trade Coast)

Southern and Trade Coast gross leasing volumes were marginally above the prior quarter with 122,000sqm absorbed. Leasing volumes in the South were from a range of industries including retailing (food & furniture), professional services and government entities. Larger leasing deals within the Trade Coast consisted of Russell Transport and Daikin Australia. Strong leasing activity over the past 6 months has seen the Southern market vacancy sink to the lowest in Brisbane at 0.3%. Trade Coast vacancy is marginally higher at 1.1%, though this is a smaller market with higher concentration in secondary stock. Net face rents remained flat over the quarter and may be pressured in the year ahead given the substantial development pipeline.

Perth (East & South)

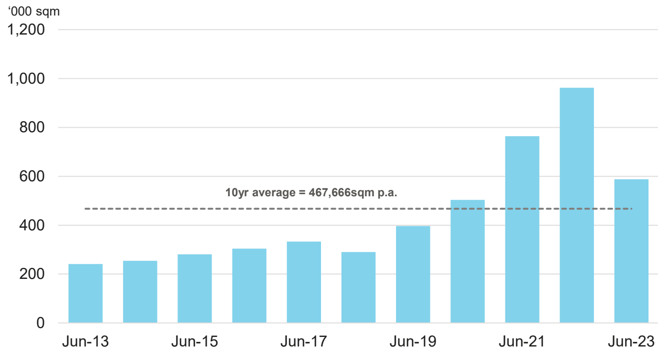
Gross leasing volumes in South Perth were well above the previous quarter at 37,800sqm while the East remained flat after strong prior quarters. Demand came from retailers, construction and heavily vehicle services. Jandakot Airport continues to benefit from co-location, with food retailer Hello Fresh committing to 16,000sqm joining the likes of Marley Spoon. Western Australia is forecast to benefit from strong population growth in the year ahead, which will warrant further demand from food related industries. Net face rent growth remained flat over the quarter, despite the Perth market vacancy being the second lowest nationally at 0.6%. Speculative developments are likely to rise to take advantage of positive demand.

Outer West Sydney gross take-up



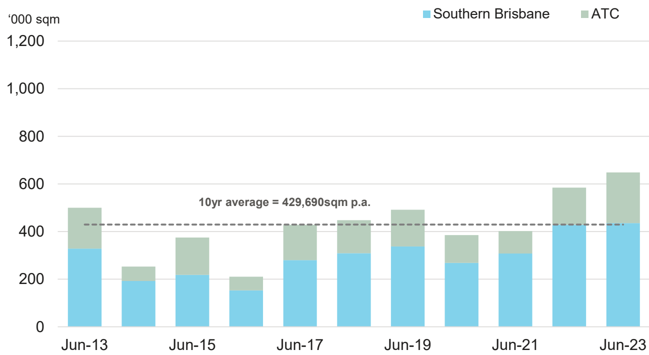
Source: JLL Research (gross take-up), Dexus Research.

West Melbourne gross take-up



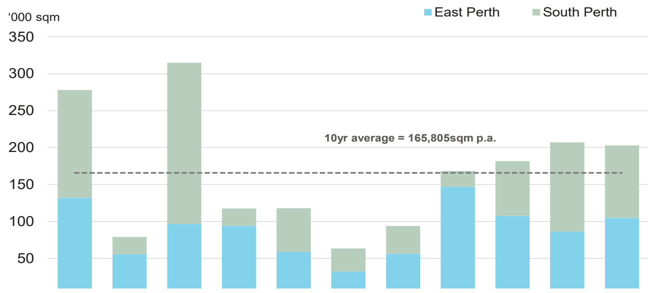
Source: JLL Research (gross take-up), Dexus Research

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

Retail sector adapts to interest rates

Retail turnover grew by 4.2% in the year to May, a slower rate than prevailed last year. Discretionary spending has been weaker than non-discretionary in the past couple of quarters. With the cash rate at a decade high, mortgage repayments are taking precedence in the budgets of many households, causing them to focus on essentials.

The changes in consumer behaviour are reflected in the main retail spending categories. The focus on essentials means that the pharmaceuticals, cosmetics and supermarket categories were among the stronger categories in the year to May. However, spending growth for discretionary items is easing. Department stores and the clothing and footwear categories both slowed over the quarter, while household goods saw an outright contraction.

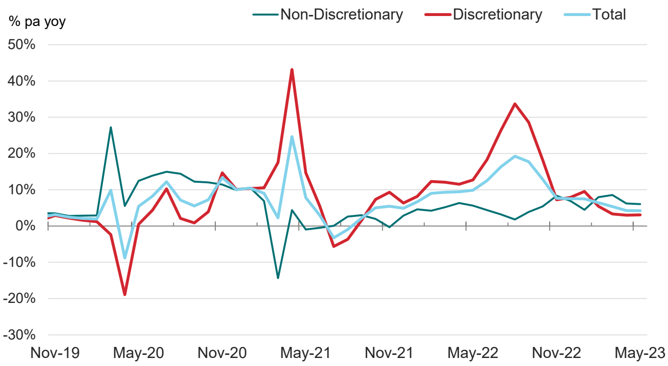
Cafes, restaurants, and takeaway food surprised on the upside and this category now makes up 34% of discretionary spending compared to 31% in May 2022. The growth in spending on cafes, restaurants, and takeaway food can be attributed variously to an increase in tourism, price inflation and the resilience of higher income earners and baby boomers in the face of higher interest rates.

The rise in headline value of sales (helped by price inflation) belies a contraction in the volume of sales over the past two quarters, which means fewer goods leaving stores and warehouses. Inventories vary across categories, however a general lift in unsold inventory levels is expected to encourage major retailers to discount to clear stock. Retailers are also investing in expanded click-and-collect services as these reduce the 'last mile' transport costs associated with home delivery of online purchases. Over time, expansion in click-and-collect should benefit foot traffic in shopping centres.

Looking forward the rate of growth in spending is likely wane further in Q3 2023 as energy prices rise in July and a proportion of fixed term mortgages roll onto a variable rate. The personal savings ratio has declined back to pre-pandemic levels, reducing the buffer households have to sustain spending. However, in dollar terms deposits remain at high levels implying there is still some buffer, particularly in areas with a low proportion of 'mortgage belt' borrowers.

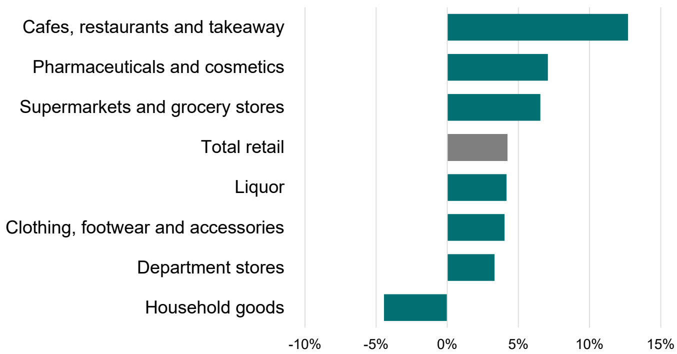
There are positives which could lead to an improvement in sales growth through 2024. These include a forecast peaking and possible decline in interest rates, a generally low unemployment rate, rising wages and growth in both tourist arrivals and permanent migration.

Discretionary vs non-discretionary spending



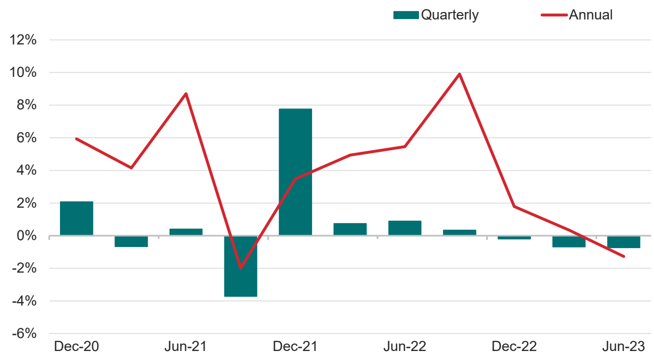
Source: ABS

Spending by retail category*



Source: ABS, *Year to May 2023

Volume of retail sales



Source: ABS

Retail performance

What can we expect in FY24?

The tightening of shopping centre vacancy rates seen since mid-pandemic in 2020 appears to have picked back up. Vacancy rates in Sydney centres are trending towards average ranging from 1.9% for sub-regionals to 4.2% for neighbourhoods. South-East Queensland also saw this trend with specialty vacancy in neighbourhood centres falling to 3.1% in Q2 2023. City retail vacancies stabilised and steadily improving numbers of tourists and office workers should help things in recover in 2024. Average vacancy numbers hide a large difference between centres where top-quartile assets have much lower vacancy levels than the average.

Shopping centre rents broadly improved through FY23. Occupancy costs (ratio of rent to turnover) for some key specialty categories including clothing are now below the pre-COVID average, indicating an improving value equation for retailers with implications for future growth.

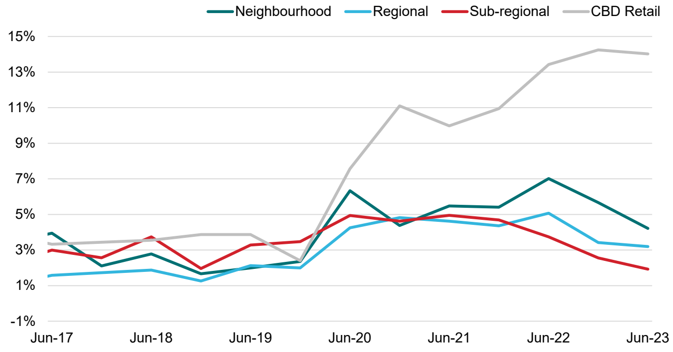
Yields are estimated to have moved up in the quarter, albeit transaction evidence was thin. Sydney regional and sub-regional shopping centre yields are estimated to have risen by 40 bps to 70 bps over the year with neighbourhood yields rising by 80 bps to 90 bps unwinding some of the price tightening they experienced during COVID. Going forward, cap rate rises for the retail sector are expected to be more modest than for some other major sectors given a higher starting point.

Australian retail performance

	Specialty rent growth % q-o-q.	Cap rate change from Q1 (bps)
Sydney		
Regional	0.1%	50 bps
Sub-regional	0.2%	25 bps
Neighbourhood	0.2%	50 bps
Melbourne		
Regional	0.2%	0 bps
Sub-regional	0.2%	0 bps
Neighbourhood	0.3%	25 bps
SE QLD		
Regional	0.2%	25 bps
Sub-regional	0.2%	25 bps
Neighbourhood	-1.3%	25 bps

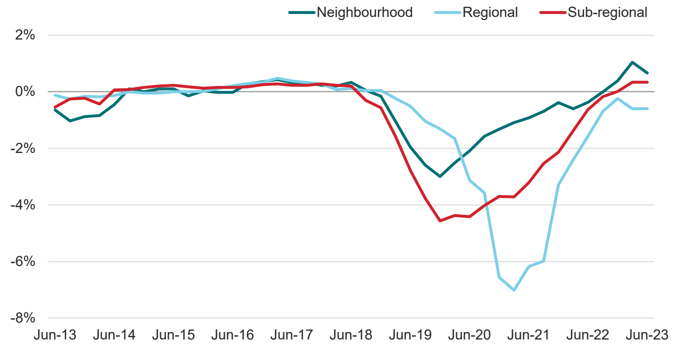
Source: JLL Research, Dexus Research

Shopping centre vacancy rate



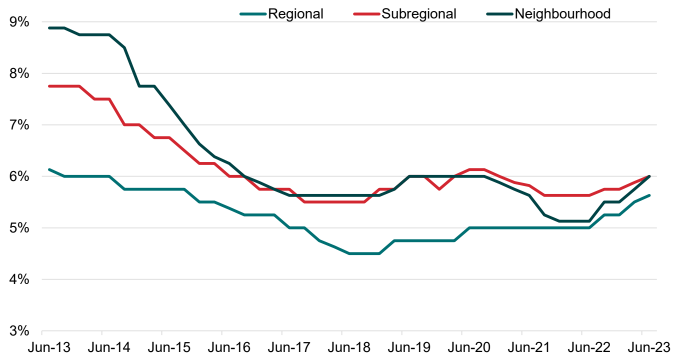
Source: JLL Research *Sydney

Retail rent growth by centre type



Source: JLL Research

Shopping centre yields



Source: JLL Research, Dexus Research

Healthcare

Spotlight on the primary healthcare sector

The Australian healthcare system is regarded as one of the best in the world. In a recent study across OECD nations, Australia ranked first for healthcare equity/outcomes and third for overall performance.

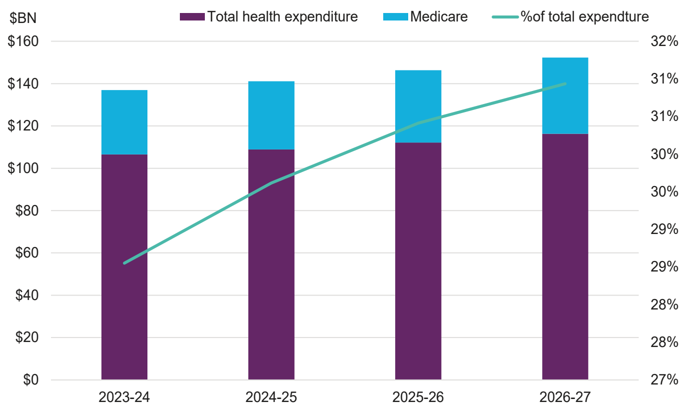
The Medicare system is the pillar of Australia's public healthcare system. The Australian government spends around a third of the total healthcare budget on Medicare subsidies to keep out-of-pocket costs low. Low out-of-pocket costs assist general practitioner clinics and medical centres to maintain patient volumes.

Over the past 15 years, poor indexation of the Medicare rebate against inflation has led many operators to run at 'thin' margins, particularly those that utilise bulk billing. In recent times, a significant rise in operational costs (utilities, consumables, and insurances) has led to a rapid decline in the national bulk billing rate. With practitioners pushing increased costs onto patients, average out-of-pocket costs are now above the Medicare rebate for the first time.

Cost pressures appear to be more prominent within the primary healthcare sector (general practitioner clinics and medical centres) rather than the secondary healthcare sector (which includes specialists). While they both rely on the Medicare funding model, bulk billing is less common amongst secondary services (e.g. imaging, diagnostics, oncology). Structurally, bulk billed specialist fees (generally consulting) are more than double that of a general practitioner, which provides more of a buffer to rising operational costs. In addition, Medicare safety nets are in place for higher acuity patients, assisting affordability.

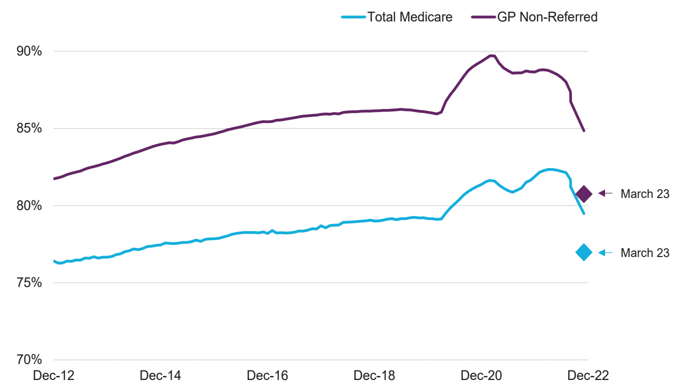
The Australian Government is committed to strengthening Medicare with a key focus on the primary healthcare sector. Medicare is forecast to become a larger part of healthcare expenditure over the next three years. The 2023-24 Federal Budget has announced numerous initiatives to improve the national bulk billing rate. Incentive payments of $20.65 (city) and $39.65 (rural) per consultation will be provided to general practitioners who bulk bill 'vulnerable patients'- including children under 16, pensioners and commonwealth concession card holders. Rebates have also been increased for consultations which take up to 60 minutes to reflect a fee-for-fee improvement. Lastly, the Medicare rebate is forecast to increase by 4% in FY24 which will somewhat assist gap payments.

Medicare as a proportion of total healthcare expenditure



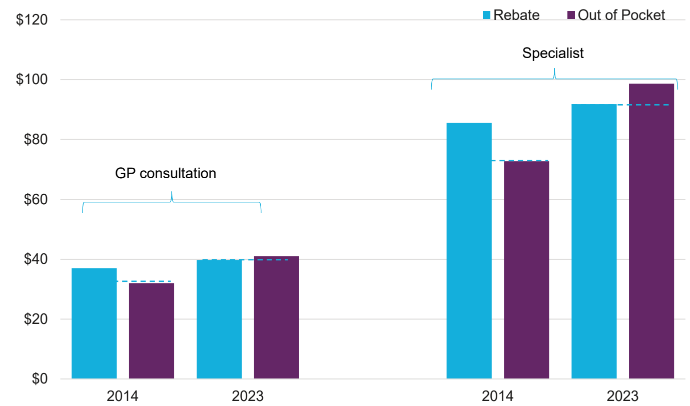
Source: Federal Budget Paper 2023-24 paper 1 pg 210 & 211

National bulk billing rate (rolling 12 months)



Source: Medicare annual statistics rolling annual Jul 2010-Dec 2022, Medicare annual statistics year to date July to March 2022-23

Out of pocket costs vs Medicare rebate (2014 vs 2023)



Source: Medicare Benefits Schedule Book Nov 2014 pg 123 item 104 & pg 118 item 23

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