Australian Real Asset Review

Q3 2024

Artwork: "Drawing from Gadigal" by Dennis Golding – 25 Martin Place, Sydney

Inside

Investment climate

Waiting for the interest rate cycle to turn

Australia's headline monthly inflation rate lifted slightly to 4.0% in May 2024 but remains well below the 5.5% recorded a year ago. The mild lift in inflation has increased the market's assessment of the probability of another rise in the cash rate in the short term, but much will depend on the more reliable quarterly inflation number to be released in July. Noting that the exact timing is uncertain, we retain our view, shared by many economists, that cash rates are at or near their peak for this cycle (currently 4.35%) and that they will decline through calendar year 2025.

The 10-year government bond yield has remained persistently above 4.0% over the past year, putting upward pressure on discount rates and required returns. Bond yields are expected to trade at 4.0%-4.5% in the short term before settling back to our estimated neutral levels of 3.5% in 2026.

A slowing in the economy is leading to subdued occupier activity in the short term. GDP growth is estimated to have slowed to circa 1.0% p.a. in June 2024. Consumer confidence remains low, constraining discretionary retail spending growth. The business sector has remained surprisingly resilient despite a sharp weakening in confidence with the NAB confidence index falling to -1 in June 2024. Infrastructure projects and exports are expected to contribute to economic growth in the year ahead helping offset an easing in residential construction activity. The labour market appears to be softening with the unemployment rate (currently 4.0%) expected to increase to 4.4% in Q4 2024.

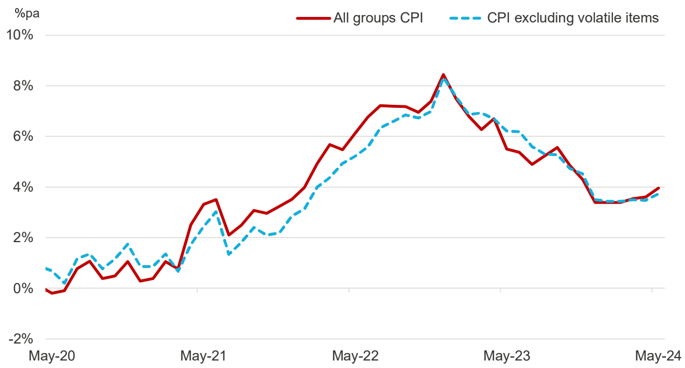
The demand outlook for the real asset sectors will be buoyed by population growth. Population growth has been running strongly (circa 2.2% p.a.), however the net migration surge has now begun to wane with population growth forecast to return to more normal growth rates of circa 1.5% p.a. in 2025. GDP growth is forecast to improve in FY25 to 2.4% p.a.

Australian economic forecasts

	Jun-24	Jun-25	Jun-26
Real GDP %p.a.	1.0%	2.8%	3.6%
Employment %p.a.	2.4%	1.9%	2.1%
Unemployment %	4.1%	4.4%	4.0%
Business investment %p.a.	3.1%	3.3%	4.2%
Dwelling investment %p.a.	-4.6%	-0.4%	6.4%
Population %p.a.	2.3%	1.5%	1.3%
Retail sales %p.a.	0.7%	3.3%	3.8%
CPI %p.a.	3.5%	2.7%	2.7%
Cash rate %	4.4%	3.9%	2.9%
10yr Bond %	4.3%	3.9%	3.6%

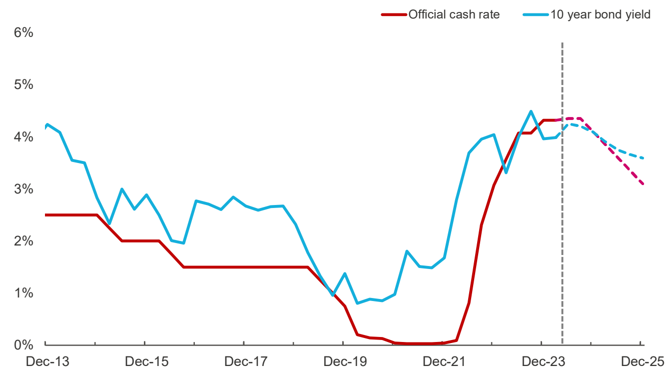
Source: Oxford Economics, July 2024

Australia's inflation rate (monthly)



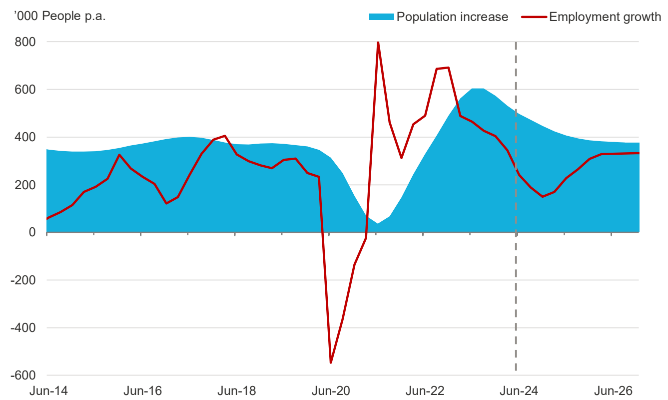
Source: ABS, Dexus Research

Australia's interest rate forecasts



Source: Bloomberg, Oxford Economics

Population and employment growth forecasts



Source: Oxford Economics

Market performance

Positive signs in the AREIT sector

The real asset transaction markets were subdued throughout FY24. Amid this general picture there were some positive signs such as the improvement in the Australian listed real estate index and relative outperformance of unlisted retail real estate funds.

Unlisted property funds returned -4.4% in the quarter and -9.9% over the year. While performance for unlisted property was subdued, smart investors will note the improved performance of retail funds which outperformed the other real estate sectors at -2.0% in the year, followed by industrial funds at -4.9%. Retail portfolios are benefiting from relatively high yields and improving rents and occupancy. Office fund returns were the weakest at -15.9% over the year, due to significant declines in valuations of office buildings.

Listed real estate pricing retraced in Q2 2024 due to a lift in bond yields associated with the May inflation data. However, over the year AREITs benefited from the strength of broader equity markets. While Australian shares returned 7.8% in the year to Q2 2024, the AREIT index returned 24.6%. The extra rise in the AREIT index is an encouraging sign for real assets and signals greater confidence by investors in the underlying real estate markets.

Transaction volumes remained below average in Q2 2024 at $9.1 billion. In an otherwise lacklustre market, a feature was the increased flow of office transactions. Office transactions in Q2 2024 comprised 33% of the total, up from 17% in the prior year. Office buildings sold in the quarter included 55 Pitt Street Sydney, 5 Martin Place Sydney and 240 Queen Street Brisbane, with the buyers being a mix of institutional and foreign investors. While prices are lower than a year ago, the sales indicate that core buyers are coming back into the market, including Cbus at 5 Martin Place and Kepple REIT at 255 George Street.

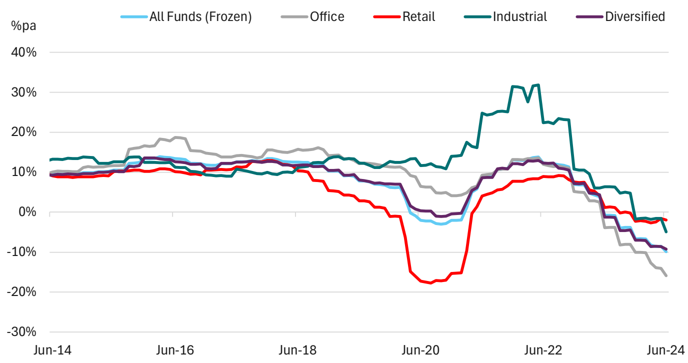
We anticipate a firming of transaction volumes in calendar 2025 as the interest rate cycle turns.

Asset class performance to June 2024

	Qtr. %	1 yr % p.a.	3 yr % p.a.
AREITs[1]	-5.6%	24.6%	5.7%
Australian shares[2]	-1.6%	7.8%	2.0%
Australian infrastructure[3]	1.6%	7.3%	9.7%
Australian cash[4]	1.1%	4.4%	2.4%
Australian fixed interest[5]	-0.8%	3.7%	-2.1%
Unlisted property[6]	-2.0%	-8.5%	2.6%

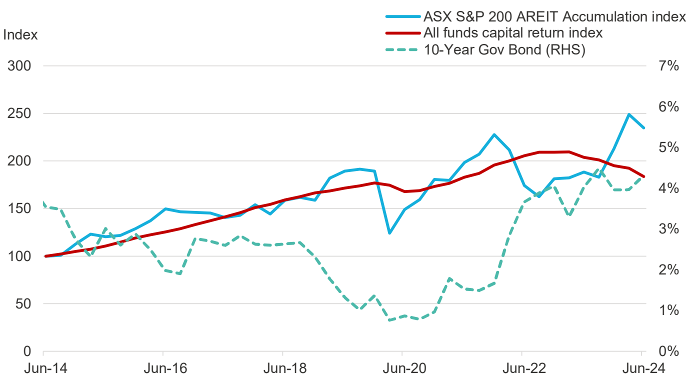
Source 1: S&P/ASX 200 A-REIT Accumulation Index
Source 2: S&P/ASX 200 Accumulation Index
Source 3: MSCI Australian Infrastructure Index (to Mar-24)
Source 4: Bloomberg BAUBIL Index
Source 5: Bloomberg BACM0 Index
Source 6: MSCI/Mercer Australian Core Wholesale Monthly PFI

Unlisted wholesale fund returns by sector



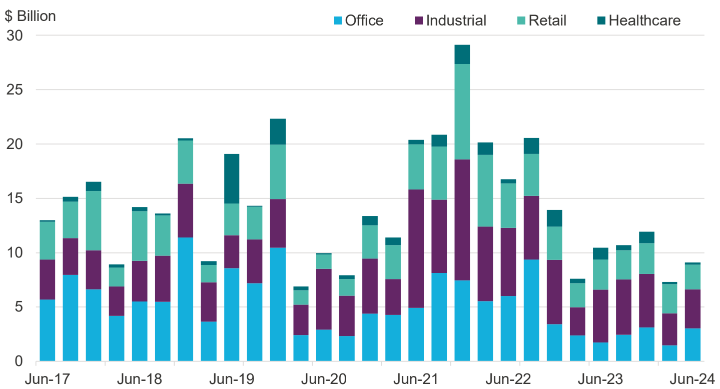
Source: MSCI, Dexus Research

AREIT price and unlisted capital return indexes



Source: Bloomberg, MSCI Core Wholesale Fund Capital Return Index

Quarterly investment volumes – real estate



Source: MSCI Real Assets

Infrastructure

Deals smaller but more frequent

The value of Australian infrastructure deals in H1 2024 of US$20.6bn was down 5.9% on the same period in 2023. However, the number of deals was up by around 22%, which may indicate that investors are finding smaller deals easier to get over the line. Volumes are being influenced by high interest rates, elevated listed equity markets and an unpredictable political environment from recent European and UK elections and the upcoming US election. A forecast decline in interest rates in calendar 2025 is expected to encourage deal flow, enhance valuations and provide more favourable debt terms to execute transactions.

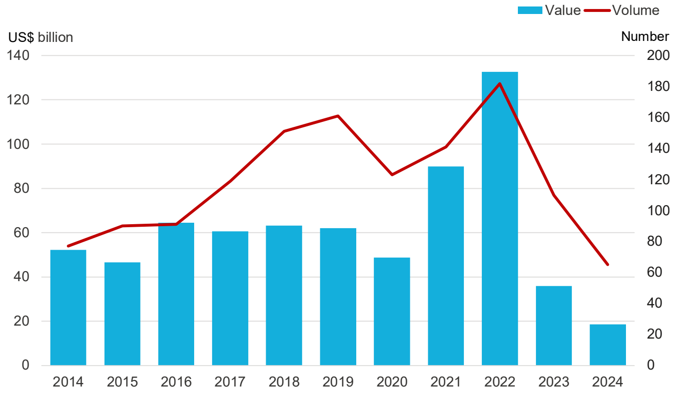
The Australian Government's 2024-25 budget underscored the Government's focus on investment in Australia's vital infrastructure in relation to energy, transport and housing. The government has committed to spending $16.5 billion on new and existing road and rail projects. Over $4.1 billion is allocated over seven years for 65 new priority infrastructure projects across Australia as part of a broader $120 billion ten-year infrastructure investment pipeline. An additional $1 billion is earmarked to support enabling infrastructure for housing, addressing housing shortages and supporting urban development. Regional airports will receive a $90 million boost to improve safety and enhance connectivity.

Further investments include $1.7 billion for the Future Made in Australia Innovation Fund to unlock private capital across new industries like green metals and low-carbon fuels, and $2.0 billion for the Hydrogen Head Start program to provide more certainty for the development of a large-scale renewable hydrogen industry.

Australian unlisted infrastructure funds returned a creditable 7.3% in the year to March 2024, outperforming listed infrastructure funds (-4.2%). While returns have eased in recent quarters, the sector has proved more resistant to the effects of interest rate rises than the unlisted real estate sectors. This could be due to several reasons such as the diversity of investments, the length of operating agreements, CPI linkages or frequency of external valuations.

Returns for unlisted infrastructure funds have not only been higher, but also more stable than listed funds. Over the past decade, the volatility of returns for the MSCI sample of unlisted funds was just 3.8% per annum compared to 11.5% per annum for listed infrastructure. However, listed funds offer a higher degree of liquidity than unlisted and a different opportunity set. In addition, it is worth noting that the performance of individual funds will vary from the combined indexes reported by MSCI for both unlisted and listed.

Australian infrastructure transaction volumes



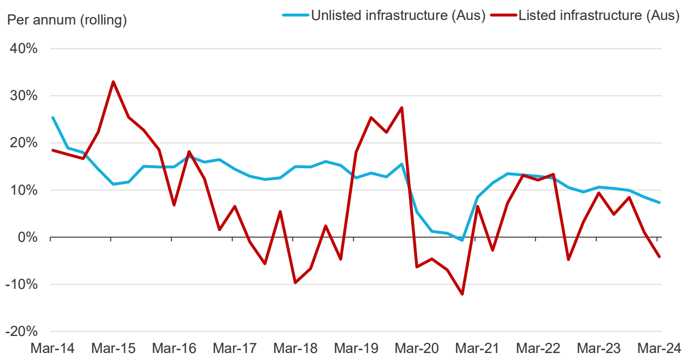
Source: Infralogic (closed transactions), *2024 includes Q1 and Q2

Major infrastructure transactions Q2 2024

Date	Asset	Buyer
Jun-24	Eco Resources	IWS
Jun-24	Ranui Generation Limited	SC Oscar
Jun-24	Ventura motors (97% stake)	Keppel Infrastructure Trust
Jun-24	Eastlink Motorway (19% stake)	Future Fund
Jun-24	Cobbora solar farm and battery	Pacific Partnership

Source: Infralogic, Dexus

Australian infrastructure returns by type



Source: MSCI Australia Quarterly Private, Infrastructure Fund Index, Australia Listed Infrastructure Index

Office

Mixed year for the office sector

Office demand is starting to build with a second consecutive quarter of positive net absorption in Sydney CBD. Brisbane CBD was the standout performer over the year with positive take-up, vacancy falling 2.3 ppts and net effective rental growth of 17.2%. These positive trends in Brisbane highlight the dominant role of cyclical demand factors as a cause of the current challenging conditions in office markets as opposed to the more subtle and drawn-out influence of flexible working practices.

Melbourne CBD's soft demand environment continued, with vacancy expanding 1.6 ppts through the quarter. Performance in Melbourne has diverged with core areas experiencing much lower vacancy. Vacancy in the Docklands precinct is 24.4% compared to 18.2% in the rest of the Melbourne CBD and 16.4% in the Eastern core.

Corporate tenants continue to actively shift to central locations and higher quality buildings. Net absorption of Premium space in Sydney CBD significantly outpaced the total market which saw -9,559 sqm overall.

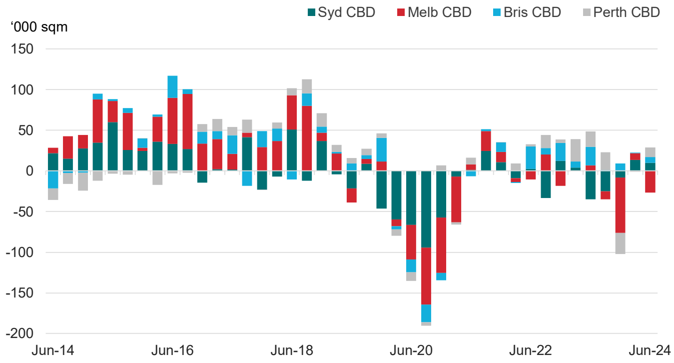
Notwithstanding the challenge of high vacancy rates in the short term, the seeds of recovery in office markets are already being sown. The supply pipeline has effectively dried up, with forecast in commencements for FY24-27 down 31% on the five-year average. Increasing construction costs and rising interest rates have put pressure on feasibilities, limiting project commencements. Since Q4 2019, the amount of stock forecast for Sydney CBD in 2027 has declined by approximately 200,000 sqm due to previously planned projects being postponed. For example, 383 LaTrobe Street, a 44,000 sqm office development has been shelved and is now expected to be developed into apartments. The pathway to recovery for office markets over the next 3-5 years will driven be demand benefiting from employment growth, falling supply levels and a tightening of vacancy rates.

Office snapshot

	Total Vacancy	Q2 Rent growth* (% p.a.)	Projected Net supply FY25-27 (%p.a.)
Sydney CBD	15.6%	-0.6%	1.5%
North Sydney	21.8%	-4.1%	2.0%
Sydney Fringe	12.3%	-1.1%	0.3%
Parramatta	24.7%	-8.4%	2.4%
SOP / Rhodes	22.6%	-5.8%	0.0%
Melbourne CBD	19.6%	-6.2%	1.3%
Brisbane CBD	10.3%	17.3%	1.2%
Perth CBD	15.9%	3.0%	1.8%

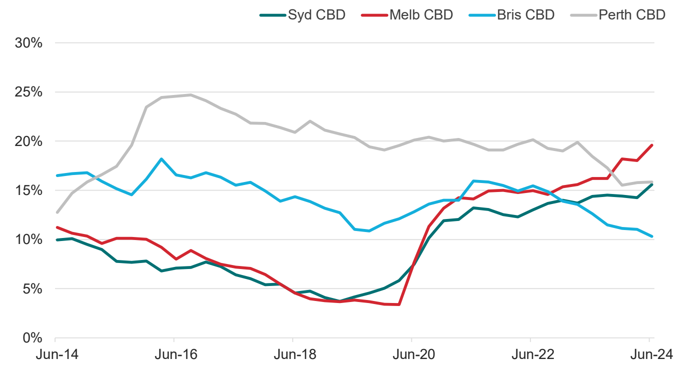
Source: JLL Research, Dexus, *Rent growth is net effective

Quarterly net absorption by CBD market



Source: JLL Research, Dexus Research

Vacancy rates by CBD market



Source: JLL Research

Office commencements

Source: Oxford Economics

Office market wrap

Market	Comments	Direction of trend for next 12 months	
Sydney CBD	The Sydney CBD office market showed positive net absorption for the second consecutive quarter, indicating growing demand for office space. The financial sector remains active, highlighted by the ASX's move to 39 Martin Place. The total vacancy rate has risen by 1.2ppts to 15.6%. Incentives increased to 35%, and yields expanded by 38 basis points to 6.25% this quarter.	Vacancy	↑
		Rents	→
		Incentives	↑
		Yields	↑
North Sydney	North Sydney's office market is facing challenges with mild demand and rising vacancy rates, now at 21.8%, partly due to competition from the CBD. The Victoria Cross development has struggled to secure precommitments, reflecting the difficulty in attracting tenants from outside the area. Net absorption was negative at -31,000 sqm. Despite stable prime face rents, incentives have increased 2.8ppts through the year to 39%.	Vacancy	↑
		Rents	→
		Incentives	↑
		Yields	↑
Parramatta	Parramatta's market has experienced weak demand throughout the year, especially in fringe areas, with few new tenants from outside the market. The area is characterised by a two-tiered market where new stock significantly outperforms older buildings. Net absorption was negative at -6,000 sqm for the year. Vacancy rates have risen by 1.3ppts to 24.7%, while incentives increased to 47%.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
Melbourne CBD	The Melbourne CBD market has seen a flight-to-quality, with higher quality and better-located properties outperforming, particularly in the Eastern Core, while vacancy rates have increased more in Docklands and the Western Core. Melbourne Quarter Tower was completed in Q2 2024 with several of the pre-leased tenants taking up less space in the new building than planned. Tenants are leveraging high incentives, which have risen to 43%, to upgrade their spaces. Vacancy rates have increased by 3.4ppts to 19.6%.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
Brisbane CBD	Brisbane CBD is the strongest capital city market in the country. Vacancy in the Brisbane CBD continues to decline, now at 10.3%, driven by strong demand. The CBD recorded 17.3% effective rental growth in FY24. Limited supply over the next five years expected to support continued growth. Incentives have decreased to 40%, while yields expanded by 50 basis points to 7% this quarter.	Vacancy	↓
		Rents	↑
		Incentives	↓
		Yields	↑
Perth CBD	Perth CBD has seen strong demand from mining and auxiliary industries. There remain increasing risks around the supply pipeline with Elizabeth Quay Four under construction. Net absorption was positive for the year at 7,000 sqm. While below the 10-year average of 10,000 sqm, this demand is outpacing new supply which will be minimal until Elizabeth Quay Four completes.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑

Industrial

Industrial growth now tapering

Industrial real estate has performed relatively well over the past two years with rents growing by 30-50% in major markets. Rent growth now appears to be slowing. Warehouse demand is moderating due to a subdued level of retail sales.

West Melbourne and South East Melbourne recorded 10.1% and 8.8% net face growth respectively in Q2 2024. Sydney markets were more subdued, with rents in the Outer West rising by just 0.7% in the quarter and 6.8% in the year. Gains in face rents came at the expense of higher incentives so in many markets including Melbourne, effective growth has been weaker than the headline rent would imply.

Take-up was generally subdued in H1 2024 compared to the same period in 2023. Inquiry levels have fallen, particularly for large warehouses. By industry, there are pockets of activity from non-discretionary retailers, but the ecommerce sector has gone quiet. Third party logistics providers have noticeably curtailed their leasing because the flow of contracts has diminished at a time when occupancy costs have risen. 3PL providers are responsible for much of the sublease space being offered to market.

Industrial vacancy rates continue to rise but below pre-COVID averages. The vacancy rate for most markets sits between 2% and 4%. Vacancies are anticipated to increase over the year due to weaker demand. Supply in 2024 is, for the most part, running at around average levels so it is demand which will determine the outlook for vacancy rates.

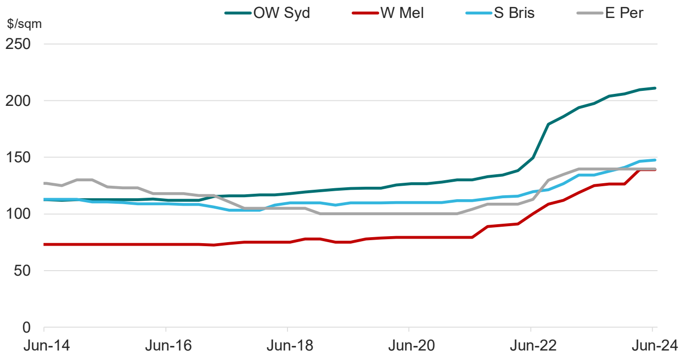
These factors are likely to keep developers cautious over the next year or two, especially for projects that have not yet started or have low precommitment rates. Rising replacement costs should help support rents in the medium to long term. While speculative supply has worked well in recent years, thanks to rising rents, developers are likely to focus more on pre-committed projects going forward.

Industrial snapshot

	Prime cap rate change from Q4 2023 (bps)	Existing prime net face growth % y-o-y
Outer West Sydney	32 bps	6.8%
West Melbourne	38 bps	11.0%
East Perth	0 bps	0.0%
South Sydney	13 bps	31.8%
Inner West Syndey	19 bps	10.7%
Southern Brisbane	13 bps	9.9%

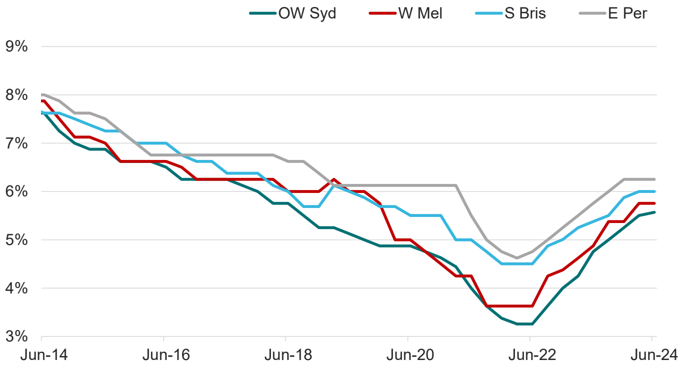
Source: JLL Research, Dexus Research

Prime rents by precinct



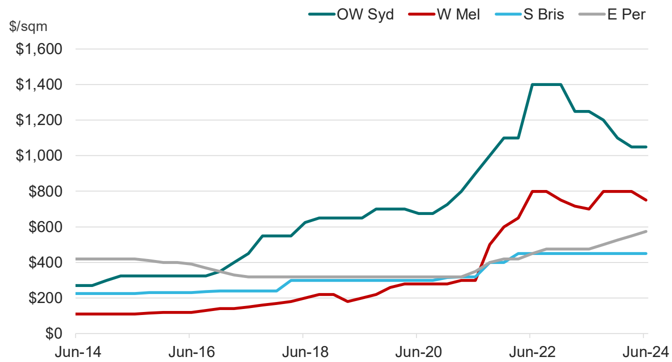
Source: JLL Research, Dexus Research

Prime yields by precinct



Source: JLL Research, 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

Take-up in Outer West Sydney was 348,000 sqm in FY24, well up on the previous year. Early in the year a large amount of this demand was driven by ecommerce and logistics tenants. Amazon committed to two sites in Outer West, taking up close to 91,000 sqm alongside Bevchain, a subsidiary of Linfox, who leased 33,000 sqm. In the last couple of quarters demand from logistics providers eased. Prime net face rents saw modest growth of 0.7% in the quarter and 6.9% for the year. Vacancy was reported as 4.4% (according to SA1 property).

West Melbourne

West Melbourne gross leasing eased in the year to Q2 2024 but remained above the 10-year average. Take-up was largely driven by manufacturing and logistics tenants including Mattel who sub-leased 31,000 sqm from DHL, and CEVA logistics, a 3PL tenant, who leased 24,140 sqm. Vacancy is reported as 3.8% by SA1 property, which is slightly higher than the past quarter. Prime net face rents have risen 10.1% in the past quarter and are sitting at $139/sqm, which is 11.2% higher than the previous year.

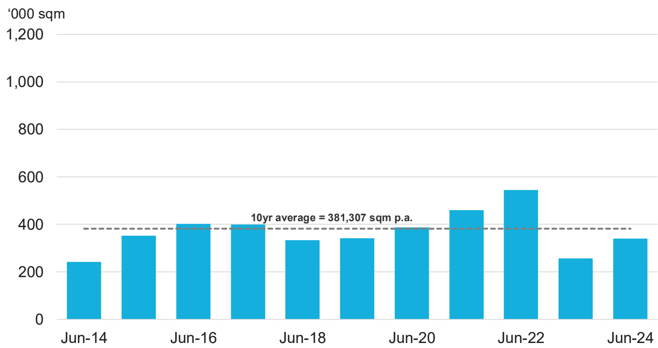
Brisbane (South & Australian Trade Coast)

Gross leasing in Brisbane in the twelve months to Q2 2024 was broadly in line with pre-pandemic levels, and the 10-year average. South Brisbane take-up slowed but remained close to the average. Take-up in South Brisbane was largely from wholesale tenants including Dixie Cummings and Furnix who specialise in furniture wholesale and leased a combined 21,442 sqm. Vacancy was reported at 3.6% for South Brisbane, which is one of the highest rates nationally, and 2.2% for the Trade Coast (according to SA1 Property). Net face prime rents grew 0.7% in South Brisbane and 5.2% in the Trade Coast in Q2 2024.

Perth (East & South)

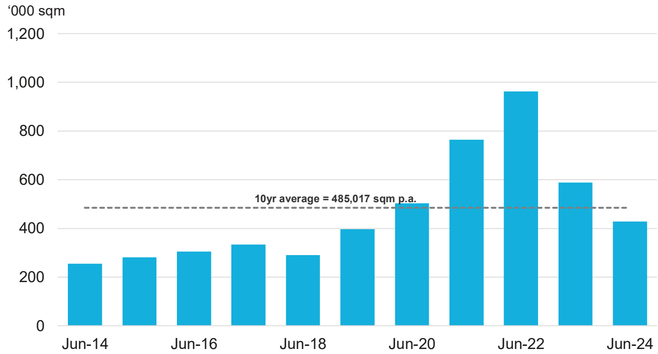
Perth saw an unexpectedly large amount of gross take-up in the twelve months to Q2 2024, well above the take-up levels of the past eight years. A large proportion of this was driven by demand in East Perth, which saw more than the 10-year average gross demand alone. Wabtec, a transport equipment manufacturer, and Lindsay, a road transport tenant, both pre-leased 10,000 sqm respectively in East Perth. Net prime face rents in East Perth are sitting at $140/sqm, with no rental growth over the 12 months. South Perth, however, saw a lift in rents over the quarter with 1.7% growth, the first rise in over a year.

Outer West Sydney gross take-up



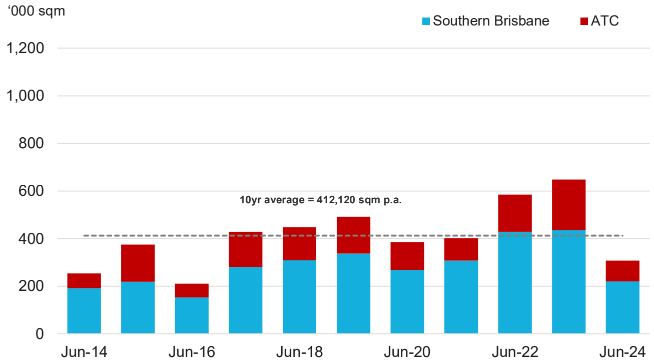
Source: JLL Research, Dexus Research.

West Melbourne gross take-up



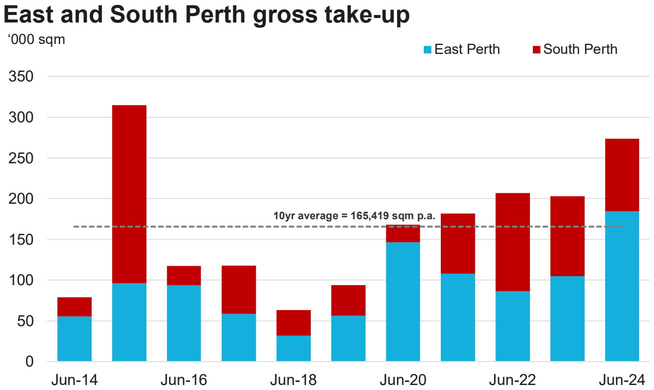
Source: JLL Research, Dexus Research

South Brisbane and ATC gross take-up



Source: JLL Research, Dexus Research

East and South Perth gross take-up



Source: JLL Research. Dexus Research

Retail indicators

Sales growth to improve through FY25

Retail turnover in Australia grew by a sluggish 1.7% in the year to May 2024, well below the 10-year average.

Cost of living pressures impacted consumer spending over the past year. Discretionary spending remains weak particularly in electronics and department stores. Non-discretionary spending has been relatively better with pharmaceuticals and supermarkets having an outsized impact on the headline growth.

The headline sales number quoted above is buoyed by strong population growth to some extent. When this is stripped out, retail sales per capita are estimated to have declined over the past year but turned up in May. The headline monthly increase in May of 0.6% was well above expectations.

We expect an improvement in sales growth over the next year with the annual rate rising to 3.5% per annum by Q2 2025. This improvement will be driven off a base effect from the current low level of sales, solid rises in after-tax wages and population growth.

Australia boasts one of the tightest labour markets in the OECD with positive real wage growth of 0.5%. Population growth and a rebound in international tourist numbers have been a source of strength for retail. City retail and high catchment areas have enjoyed the increase in foot traffic with a plateauing of vacancies and a sizeable lift in turnover.

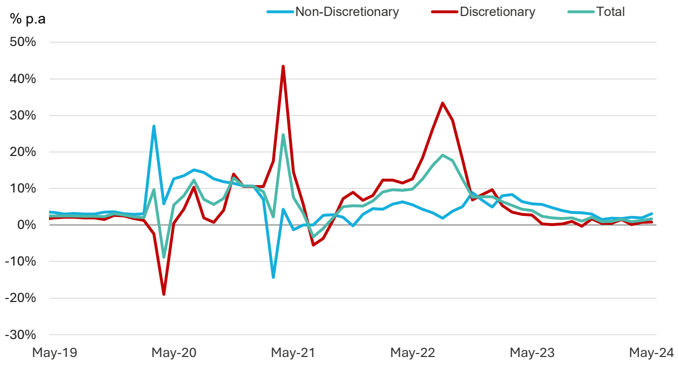
Ecommerce sales are also resuming their growth path after flatlining over the past year. Online spending grew by 7.5% in the year to May 2024. Retailers have been leaning more heavily on omnichannel distribution with physical stores being a core strategy to enhance customer experience.

Retail sales growth by category (May 2024)

	m-o-m	y-o-y	MAT
Cafes	-0.1%	0.9%	4.2%
Clothing	1.6%	-0.2%	0.4%
Department Stores	-0.9%	-1.7%	0.3%
Food	0.7%	3.1%	3.0%
Other	0.5%	3.8%	3.0%
Household Goods	1.1%	0.1%	-2.9%
Total	**0.6%**	**1.7%**	**1.6%**
Online Sales	-2.4%	5.0%	3.8%

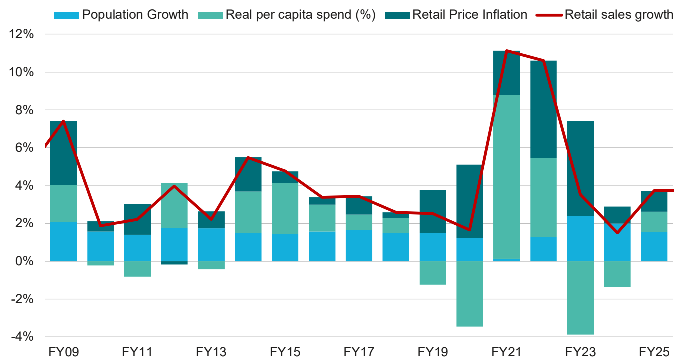
Source: ABS, Dexus Research

Discretionary vs non-discretionary spending growth



Source: ABS, Dexus Research

Components of retail sales



Source: Oxford Economics, Dexus Research

Level of ecommerce sales

Source: ABS, Dexus Research

Retail performance

Retail investment looking more compelling

The retail sector appears to have reached a significant inflexion point after a challenging period over the past five years.

Shopping centre fundamentals are generally positive. Vacancies across shopping centre types have held relatively steady despite the weak sales environment. Melbourne and Sydney have seen a small uptick in vacancy while vacancy has declined in Adelaide and Perth. Lower occupancy costs than before the pandemic will help preserve occupancy levels and provide room for future growth in shopping centre rents. Rents are responding, as evidenced by both Vicinity and Scentre Group reporting positive releasing spreads of ~3%.

A lack of new shopping centre supply is another positive, particularly given population growth is adding to aggregate demand. The supply of enclosed shopping centre space projected over the next two years is around 53% of the 20-year average. Supply of shopping centre space is being held back by construction costs and planning constraints.

The retail sector is looking compelling on a relative value basis. Yield expansion has been milder than the other main real estate sectors and total returns for retail funds in FY24 of 0.7% p.a. exceeded the 'All funds' index of –3.4% p.a.

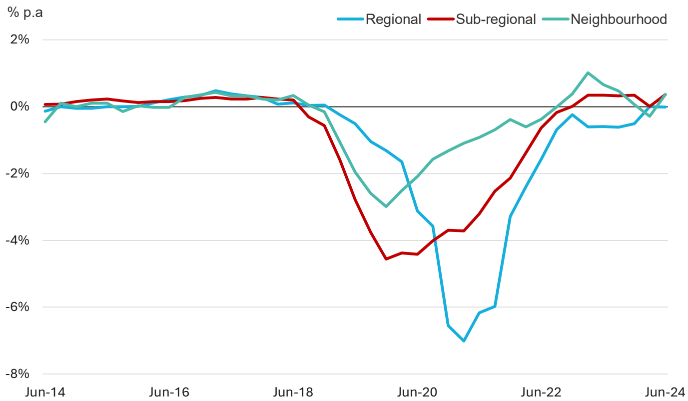
It appears investors are waking up to the positive story. Over the past year, the discount to net asset value for listed retail REITs in Australia has narrowed from 13% to 3%, indicating greater confidence in the future stability of these asset values over office and diversified AREITs.

Retail performance snapshot

	Q2 Specialty rent growth % y-o-y.	Cap rate change y-o-y (bps)
Sydney		
Regional	0.0%	13
Sub-regional	0.0%	25
Neighbourhood	0.0%	25
Melbourne		
Regional	0.0%	13
Sub-regional	0.1%	0
Neighbourhood	0.0%	0
SE QLD		
Regional	0.0%	50
Sub-regional	1.8%	25
Neighbourhood	1.8%	25

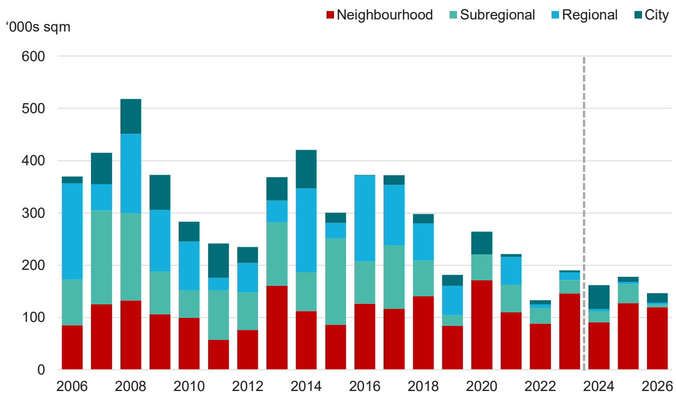
Source: JLL Research, Dexus Research

Shopping centre rent growth



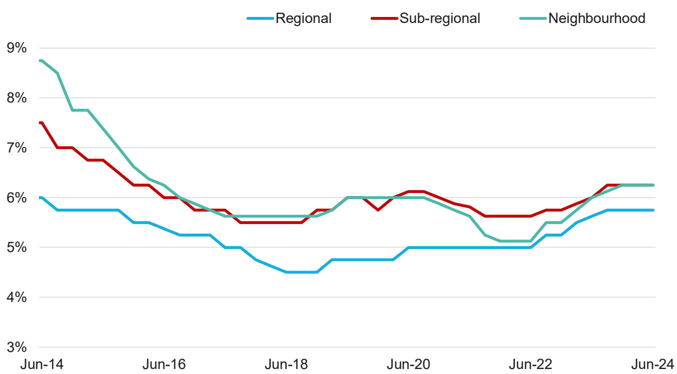
Source: JLL Research, Dexus Research

Australian enclosed shopping centre supply



Source: JLL Research

Yields by centre type



Source: JLL Research, Dexus Research

Healthcare

Short-term pressures amid positive trends

Australia's healthcare system rates highly in global comparisons on metrics like health spending per capita and hospital beds per head of population. Health is forecast to have the fastest output growth of any Australian industry over the next five years.

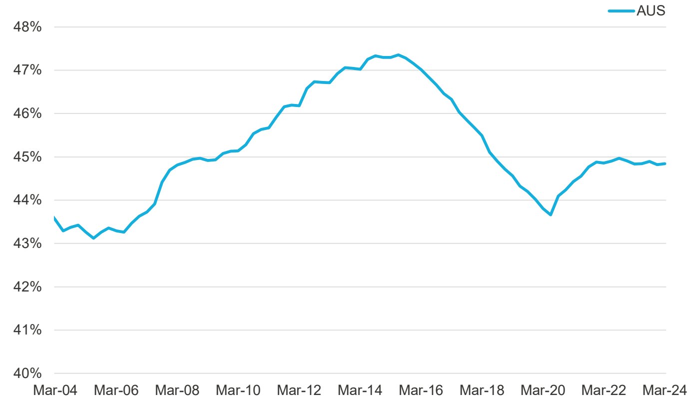
Like many industries, healthcare has experienced pressures related to rising costs and staff shortages which has put pressure on margins, particularly for private hospitals. In healthcare, the issue is that costs have been rising faster than either the growth in private health insurance or Medicare. Health insurance premiums, regulated by the Australian Government, are expected to rise by circa 3% in 2024. On a positive note, steady private health insurance (PHI) coverage rates should help support demand for clinical, day hospital and overnight hospital services. In the year to Q1 2024, 293,108 people took up hospital cover with coverage rates remaining steady at 45% of the population.

Australia's ageing population is a significant driver of demand for hospital and clinical services. Over the past 30 years, the life expectancy of Australians has increased from 74 to 83 years. In the next 50 years, the proportion of individuals aged 65 and over is projected to rise from 17% to 25%. The increasing number of older adults will heighten the demand for healthcare services, particularly as those over 65 experience much higher rates of long-term health conditions. According to the latest national health survey, 94% of individuals aged 65 or older have two or more long-term health issues. Positively for the private sector, the uptake of private health insurance (hospital cover) significantly increases with age, with 50% of those aged 65 and over possessing some level of cover.

General practitioners' costs have increased faster than Medicare indexation. As a result, GPs have reduced bulk billing rates and increased out of pocket charges, effectively passing costs onto their patients. Gross billing charges increased by 9% to $355 per hour in 2023.

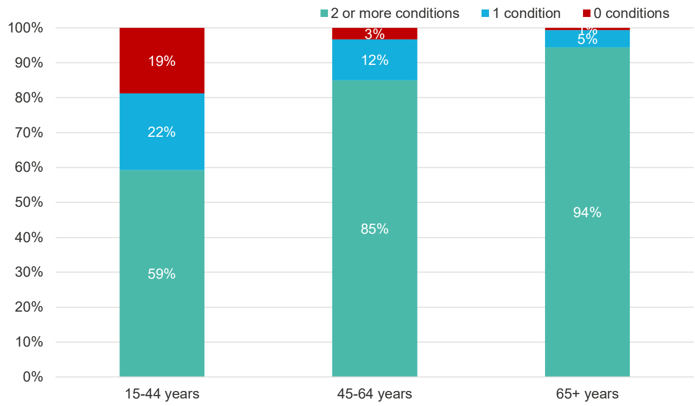
The healthcare investment sector is experiencing a milder re-pricing than the broader real estate market. According to MSCI, the average valuation capitalisation rate for hospitals lifted by 0.6 ppts in Q1 2024 to 5.1% in Q2 2022 compared to a 0.7 ppts average rise for all property types. While high bond yields look like putting further pressure on pricing in the next couple of quarters, market expectations that interest rates could fall through calendar 2025 bodes well for transaction volumes and valuations over the next 18 months.

Private hospital insurance coverage (National %)



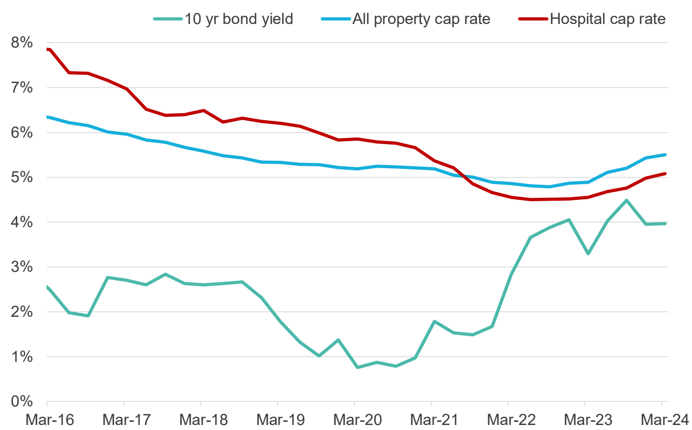
Source: APRA, Dexus Research

Long-term health conditions by age (% of respondents)



Source: ABS, Dexus Research

Trends in valuation metrics



Source: MSCI Real Assets, Dexus Research

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