Australian Real Estate Quarterly Review

Q4 2023

Westfield North Lakes, Brisbane

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Investment climate

Population growth a key theme

The much-anticipated slowdown in the Australian economy has been mild to date, with GDP growth easing to 2.1% per annum in Q2 2023. Growth is forecast to slow to 1.0% in Q2 2024.

There are signs of a bifurcation in the economy between households and businesses. In FY23, household consumption eased in the face of high interest rates and weak consumer sentiment. Accordingly, the value of retail sales grew by only 1.5% in the year to August and contracted in volume terms. Dwelling investment is bearing the brunt of monetary tightening, easing by 1.1% in FY23. By contrast, the business sector remains surprisingly resilient. Business confidence is subdued but not negative. Businesses are still hiring and business investment grew by 8.3% in FY23. The labour market remains relatively strong with the unemployment rate being low at 3.7%.

After peaking in December, Australia's headline monthly inflation rate slowed to 5.2% in August 2023. In line with the slowing, the Reserve Bank of Australia held the official cash rate steady at 4.1% in October. Despite this, the 10-year bond yield lifted to around 4.5%, indicating that markets may be anticipating a 'higher for longer' scenario for interest rates.

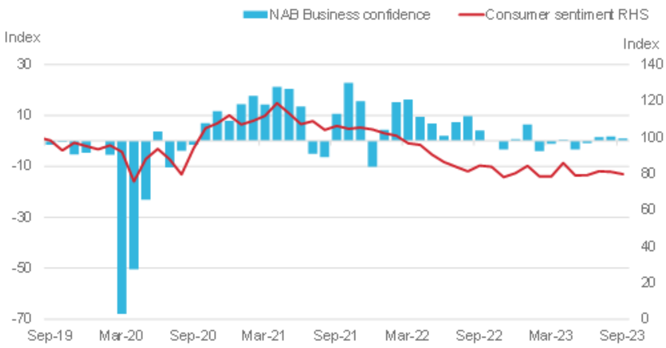
Demand for real assets is expected to be underpinned by strong population growth. Australia's population increased by 563,000 people in the year to Q1 2023 (+ 2.2%) the highest number in at least 40 years. The rise was driven by a surge in net permanent migration of 454,000 people, well above the pre-COVID average of 230,000. Longer term, population growth is forecast to grow by around 380,000 per annum (+ 1.4% p.a.). In rough terms, catering for this population increase is likely to require over two million square metres of industrial space, at least 150,000 new dwellings and enough retail space to support an extra $12 billion of spending every year.

Australian economic forecasts

	Jun-23	Jun-24	Jun-25
Real GDP %pa	2.1%	1.0%	2.7%
Employment %pa	3.2%	0.8%	1.9%
Unemployment %pa	3.6%	4.2%	4.4%
Business investment %pa	8.3%	2.4%	3.1%
Dwelling investment %pa	-1.1%	-4.6%	-1.7%
Population %pa	2.3%	1.9%	1.5%
Retail sales %pa	3.5%	1.5%	3.8%
CPI %pa	6.1%	3.4%	3.0%
Cash rate %	4.1%	4.1%	3.4%
10yr Bond %	4.0%	3.9%	3.2%

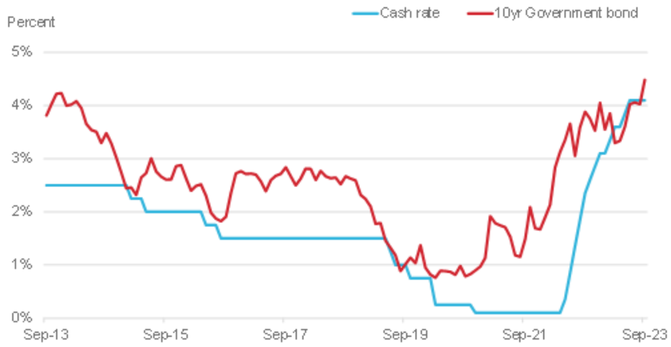
Source: Oxford Economics, September 2023

Consumer sentiment and business confidence



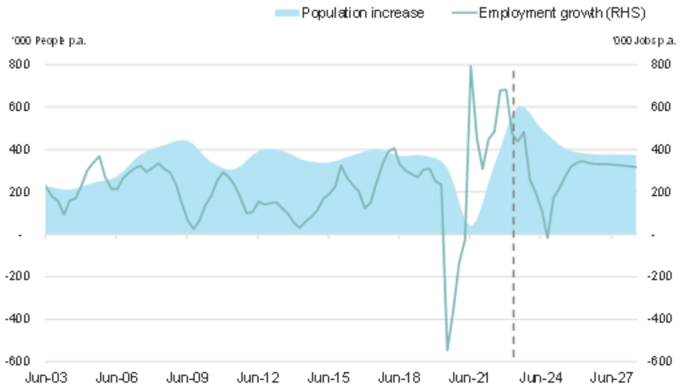
Source: NAB, Westpac

Official cash rates and 10-year bond yields



Source: NAB, Westpac

Population and employment growth forecasts



Source: Oxford Economics

Long-term view on pricing

Normalisation rather than quantum shift?

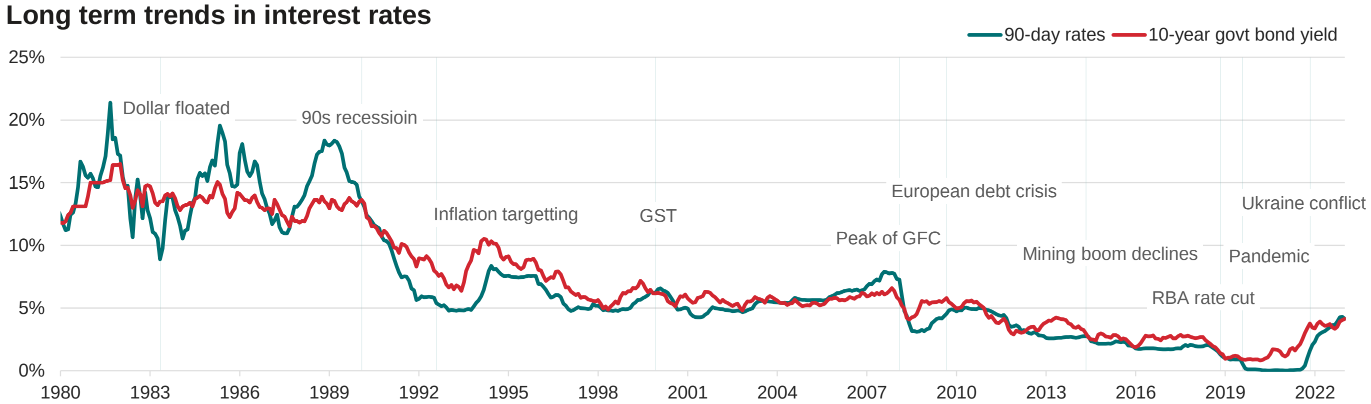
Periods of yield expansion can be disconcerting for investors and disruptive for lenders, buyers and sellers. However, they are a regular part of the property cycle. There is an argument that current trends represent a normalisation of yields more than a quantum shift. On this page we provide a long-term view of real estate yields to put the current cycle in context.

Real estate yields have broadly declined over a thirty-year period, consistent with a decline in bond yields. In 2020, the shock of COVID pushed bond yields to exceptionally low levels as authorities 'pump-primed' the global economy. Now that monetary policy is tightening, investors are lifting their required returns across asset classes, leading to a rise in real estate yields.

The top two charts show similar re-pricings have occurred during the recessions (1983 and 1992), the tech-wreck (2001) and GFC (2007).

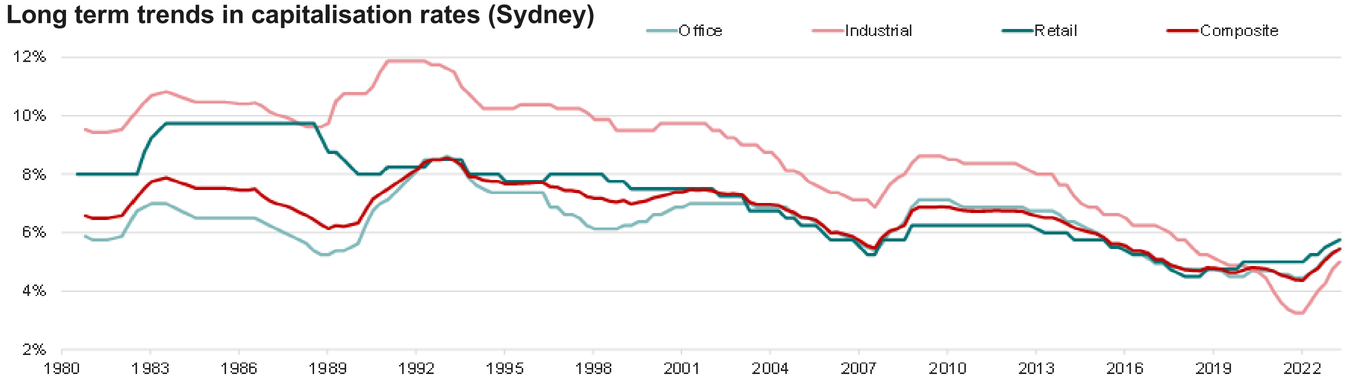
The bottom charts show that overall, the speed and magnitude of this cycle is broadly similar to past cycles, however, there are a few differences. While so far, office yields have matched past cycles, it will be interesting to see whether weaker sentiment affects the forward trend. Industrial yields have moved further and faster than in the past, but this is likely a function of how low they were during COVID (they have since only retraced to 2019 levels). Retail yield movements have been modest today reflecting previous expansion even prior to COVID.

Long term trends in interest rates



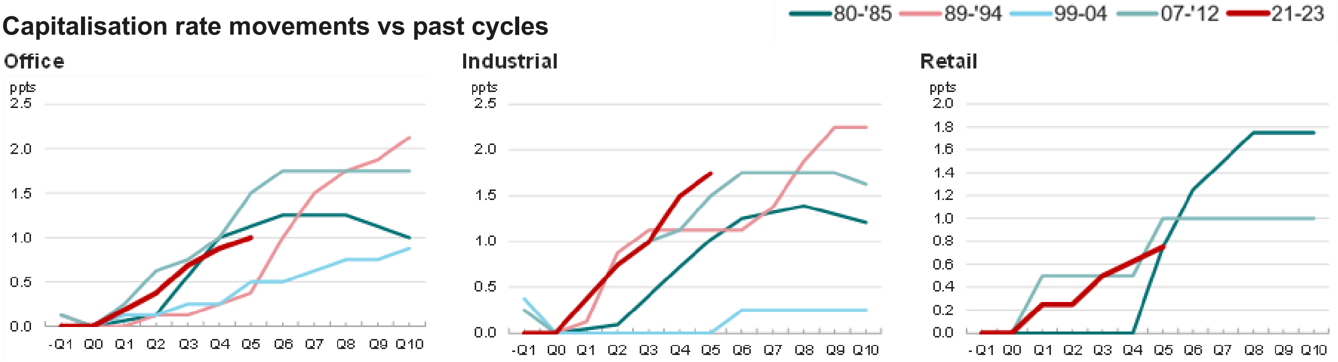
Source: Dexus Research, Bloomberg

Long term trends in capitalisation rates (Sydney)



Source: JLL Research, Dexus Research.

Capitalisation rate movements vs past cycles



Source: JLL Research, Dexus Research. Note for retail the 89-94 and 99-04 cycles are excluded as cap rates tightened.

Performance / transactions

Cost of capital weighing on transaction volumes

Unlisted property returns saw further weakening over the past quarter. Total returns for all funds were down -3.9% in the year to Q3 2023, industrial was more resilient at +4.8%, retail relatively flat at -0.2%, and office weaker at -8.6%. The weaker returns were largely the result of softening capital values with income returns relatively stable and positive at 4.5% on average.

Equity markets had a negative quarter with AREITs returning -2.9%. This is consistent with rising bond yields affecting the pricing of defensive assets. However, returns for AREITs over the full year were relatively healthy at 12.5%, off a low base.

It is worth viewing the current cycle in the context of long-term trends. Over the past 20 years, real estate and infrastructure have provided fairly consistent returns in the 5% to 15% per annum range, interspersed by short periods of revaluation. In 2009 the downturn was caused by the global financial crisis, while this time it is rising interest rates after COVID. Such periods of revaluation often provide good opportunities to enter the market. For example, investors who purchased real estate in Q4 2009 saw a 67% increase in asset values over the next decade. Unlisted infrastructure returns have compared well with real estate over the past 20 years.

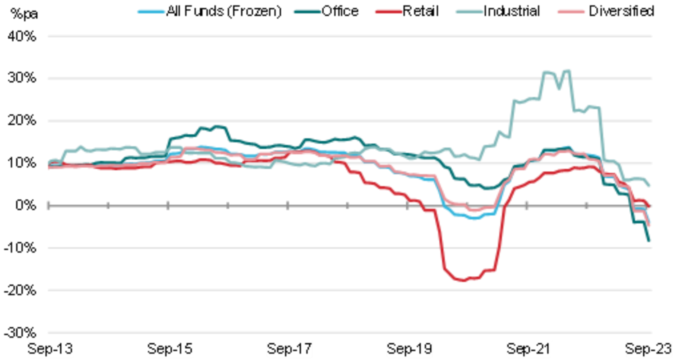
Transaction volumes in Q3 2023 dipped to the lowest level in more than a decade, reflecting caution by investors at a time of rising cost of capital. Anecdotal evidence points to a wider than usual gap between buyers and sellers. Office volumes have seen a sharp decrease compared to the same period last year. Liquidity in transaction markets is expected to improve from Q2 2024 assuming interest rates are seen to peak and a fall in 10-year yields allows investors to better gauge their cost of capital. By this time a softening in capital values should give investors greater confidence in achieving their required returns.

Asset class performance Q3 2023

	Qtr. %	1 yr %p.a.	3 yr %p.a.
Australian shares[4]	-0.8%	13.5%	11.0%
AREITs[6]	-2.9%	12.5%	4.7%
Australian infrastructure[1]	2.8%	10.4%	-10.3%
Australian cash[3]	1.1%	3.6%	1.4%
Australian fixed interest[5]	-0.3%	1.6%	-3.9%
Unlisted property[2]	-1.4%	-3.9%	-1.3%

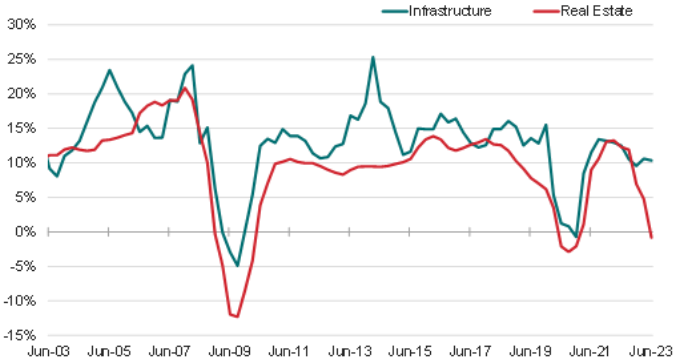
Source 1: MSCI Australian Infrastructure Index
Source 2: MSCI Mercer Australian Core Wholesale Monthly PFI
Source 3: Bloomberg BAUBIL Index
Source 5: Bloomberg BACM0 Index
Source 4: S&P/ASX 200 Accumulation Index
Source 6: S&P/ASX 200 A-REIT Accumulation Index

Unlisted wholesale fund returns by sector



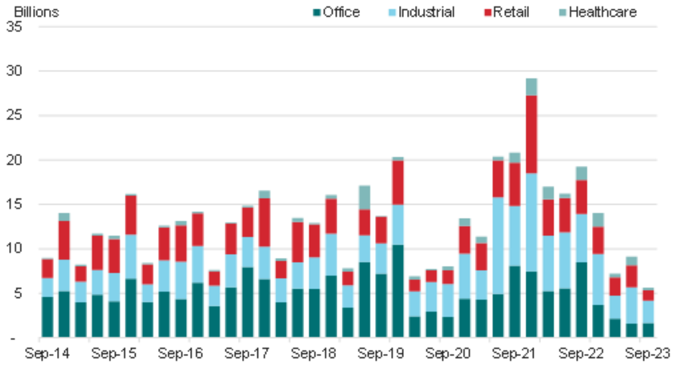
Source: MSCI/Mercer

Real assets returns over the long term



Source: MSCI/Mercer

Quarterly investment volumes – real estate



Source: Real Capital Analytics

Office

Mixed demand for office space

The third quarter of 2023 was mixed for the office sector with rent growth tapering. Brisbane and Perth CBDs saw positive net absorption, reflecting the continued strength in these markets. Sydney CBD saw its second successive quarter of negative net absorption (-25,000sqm). As this was largely driven by withdrawals, the impact on vacancy was modest. Melbourne CBD saw a decline in net absorption brought on largely by an increase in sublease space from the finance sector. The leasing market has been characterised by consolidations among larger firms and expansions among smaller firms. Vacancy rates declined in Brisbane and Perth and remained stable in Sydney and Melbourne.

Flight to quality, is a key theme in the office sector, with ‘flight to core’ and ‘flight to CBD’ themes emerging. Tenants are moving from lower-grade spaces to higher-quality office stock, centralising from outside the CBD and taking up space in core CBD locations. Examples of these trends include:

- Net absorption is higher for premium stock in each of the CBD markets than any other grade
- Vacancy in non-CBD markets North Sydney and Parramatta has risen markedly compared to that of the CBD
- The Sydney CBD core has the lowest vacancy among the CBD precincts and saw 60,000sqm of net absorption over the past year while all other precincts saw declines

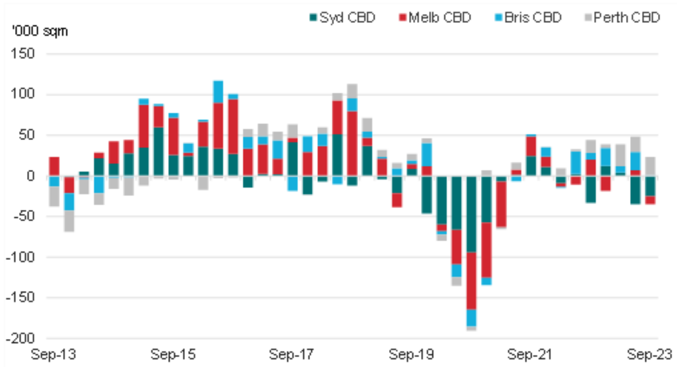
Rising cap rates and higher construction costs have put pressure on development feasibilities, limiting potential supply in the medium term. The supply pipeline in Sydney for FY24-26 is slightly above average, but pre-commitments are strong. Melbourne saw significant completions over the past few years but has a much more benign development pipeline going forward.

Q3 2023 office snapshot

	Total Vacancy	Rent growth* (% p.a.)	Net supply FY24-26 (%pa)
Sydney CBD	14.5%	3.6%	0.9%
North Sydney	20.8%	1.8%	2.5%
Sydney Fringe	8.9%	3.1%	1.1%
Parramatta	25.0%	-15.6%	0.8%
SOP / Rhodes	22.6%	-4.3%	0.0%
Melbourne CBD	16.2%	-3.4%	1.7%
Brisbane CBD	11.5%	17.1%	1.5%
Perth CBD	17.3%	3.6%	1.4%

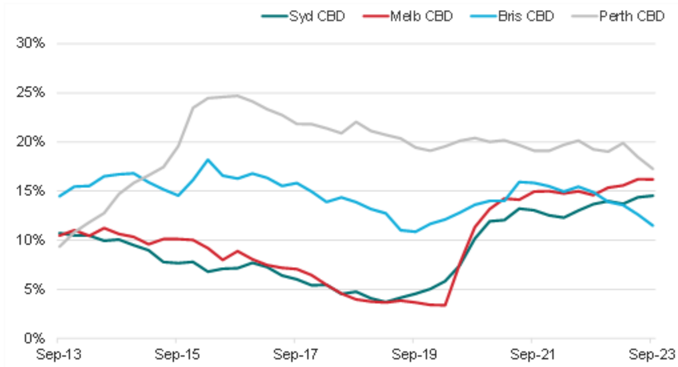
Source: JLL Research, Dexus
*Net effective

Quarterly net absorption by CBD market



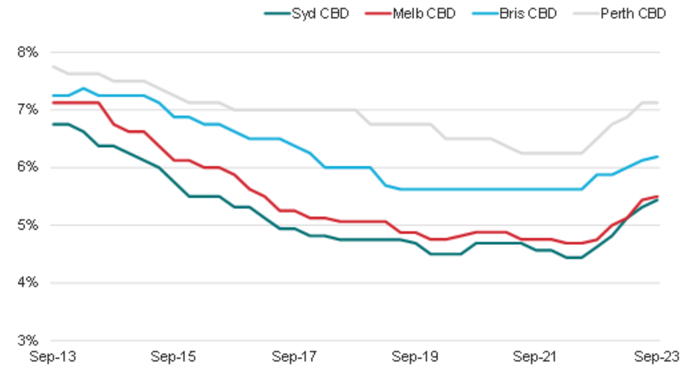
Source: JLL Research, Dexus Research

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	Sydney CBD witnessed another quarter of negative net absorption mainly due to withdrawals, resulting in only a modest increase in vacancy rates. The demand is notably stronger in the core areas compared to surrounds, with premium net absorption remaining positive. With no major completions in FY24, there is an opportunity for the market to stabilise. Demand has been characterised by expansions by smaller tenants offset by large consolidations in the financial sector. Net absorption was negative in the past year at -44,000sqm.	Vacancy	→
		Rents	→
		Incentives	↑
		Yields	↑
North Sydney	North Sydney is experiencing above-trend vacancy. The Victoria Cross over station development projected for 2025 will put pressure on the leasing market, particularly with availability still high in the CBD. Net absorption was negative for the year at -21,000sqm.	Vacancy	↑
		Rents	→
		Incentives	↑
		Yields	↑
Parramatta	There is a weak demand and a rising vacancy rate in Parramatta, especially in the fringe areas. The core has performed marginally better, but there remain limited examples of attracted new tenants from outside the market. Parramatta is a two-tiered market with new stock leasing up and vacancy shifting to older buildings. Negative net absorption (-33,000sqm) over the past year has been mainly due to government and finance sector consolidations.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Melbourne CBD	Large financial tenants have made sublease spaces available in Melbourne CBD. New supply is meeting a quiet leasing market, keeping vacancy stubbornly elevated. The supply pipeline is below trend over the next three years providing some opportunity for vacancy falls. Net absorption was negative for the year at -21,000sqm.	Vacancy	→
		Rents	→
		Incentives	→
		Yields	↑
Brisbane CBD	Brisbane CBD is showing strong employment growth, which is fueling a fast-leasing market, indicating a healthy demand for office space. Drivers in population, tourism, infrastructure, and commodities point towards continued demand growth. Premium vacancy in particular has tightened, providing scope for further rent growth. Net absorption was positive for the year at 53,000sqm.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑
Perth CBD	Perth CBD exhibits strong employment growth with a notably tight vacancy rate in premium spaces, reflecting an improving office market. Limited new supply should see vacancy continue to compress. Net absorption was positive for the year at 73,000sqm, the strongest result in 11 years.	Vacancy	↓
		Rents	↑
		Incentives	→
		Yields	↑

Industrial

Market tapers after a strong run

The Australian industrial market continues to normalise after an abnormally buoyant period during the pandemic when retail sales grew by around double the average pace. National gross leasing volumes eased in Q3 2023 as businesses exercised a level of caution about weakening growth in retail sales. Slowing forward orders are leading to a focus on inventory management, suggesting a further re-calibration of space requirements in the year ahead. There has been a degree of subleasing over the quarter, particularly in the Sydney market.

Industrial vacancy increased marginally across the Sydney and Brisbane markets to 1.4% and 2.2%. While an increase in vacancy is seen as a negative for growth prospects, this figure is still very low on a global scale compared to key US industrial markets, such as Inland Empire at 3.3% and New Jersey at 6.1%. These trends can be thought of as a cyclical adjustment amid a positive longer-term thematic for industrial. The looming wave of population growth driven by overseas arrivals will underpin future space requirements.

Rents continued to grow in many major markets in the quarter, although the pace of growth is tapering. Over the past two years, growth in rents has been driven by low vacancy and higher development costs. These drivers are now easing with some extra vacancy appearing in the market and land values falling. Consequently, the slowing growth is most evident in outer markets of Sydney, Melbourne and Brisbane. Inner markets appear to be a more resilient, with supply constraints benefiting lease renewal discussions. Total occupancy costs will be a key consideration for tenants so rents in the more affordable locations, such as North Melbourne and Brisbane, may benefit.

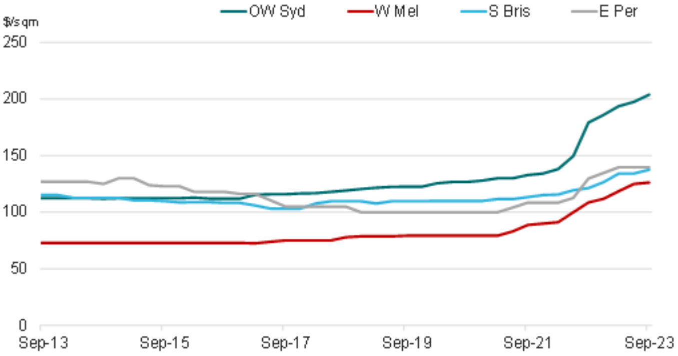
Investor sentiment for industrial property remains positive albeit transaction volumes are affected by uncertainty around the stability of capitalisation rates and cost of debt. Over the past year, net acquisitions have been largely driven by REIT investors who appear to back a strong growth outlook for the sector.

Industrial snapshot

	Prime cap rate change from Q2 2023 (ppts)	Existing prime net face rental growth % p.a.
Outer West Sydney	0.25	13.7%
West Melbourne	0.50	16.1%
East Perth	0.25	7.7%
South Sydney	0.25	27.4%
Inner West Sydney	0.25	19.5%
Southern Brisbane	0.13	13.4%

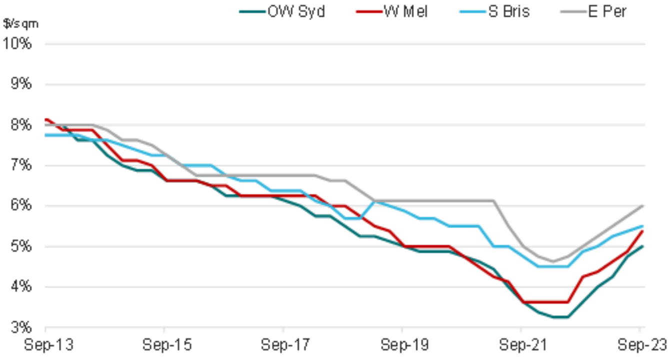
Source: JLL Research, Dexus Research (June 2023)

Industrial rents by precinct



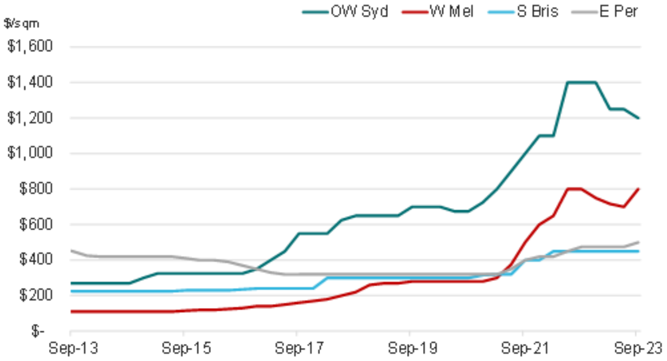
Source: JLL Research (average prime), Dexus Research

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 Peth = 1HA, Dexus Research

Industrial by region

Outer West Sydney

Gross leasing volumes in the Outer West Sydney market are trending broadly in line with pre-COVID levels, with 300,000sqm leased in the year to Q3 2023. Over the quarter most of the leasing activity came from transport and logistics industries concentrated within Eastern Creek. While rental evidence suggests a wide variance in achieved rents, average prime net rent face growth increased marginally by 3.2% over the quarter. Vacancy for the Outer West precinct increased above 1%. While incentives appear to be stable for the most part, increased supply could apply some upward pressure.

West Melbourne

West Melbourne gross leasing volumes were softer over Q3 2023. This was heavily influenced by a lack of immediately available stock, following a period of elevated pre-leasing. Despite lower volumes, the vacancy rate in the West declined marginally. Across the broader Melbourne market there was a resurgence of demand from ecommerce-related retailers, despite a fall in ecommerce sales. Three quarters of this was concentrated in the South- East precinct. Lack of deal evidence saw lower growth in net face rents. Asking rents are now sitting between $125-130/sqm (for 3,000sqm+).

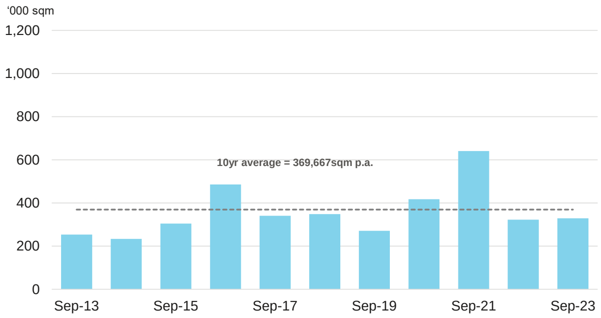
Brisbane (South & Australian Trade Coast)

Southern and Trade Coast gross leasing volumes are trending broadly in line with the past couple of quarters. A combined 300,000sqm has been absorbed year to Q3 2023, with volumes supported by higher than historical leasing in the Trade Coast. Leasing demand was generally driven by smaller Transport and logistics requirements sub-10,000sqm in the South. The Trade Coast saw a large pre-lease from government backed Powerlink of 45,000sqm at $176/sqm. The Trade Coast also saw the strongest growth in rents nationally over the quarter. The South precinct saw a lift in vacancy, however the figure is still below 2%.

Perth (East & South)

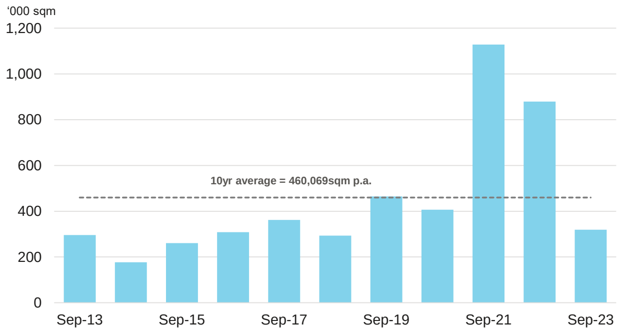
Gross leasing volumes across the South and East Perth markets were strong, with 82,000sqm absorbed over the quarter. Pre-leasing activity increased in the East, particularly driven from smaller transport and logistics requirements (sub 10,000sqm). Market vacancy in the East precinct is now above 1% whereas the South remains more constrained at 0.4%. Net face rental growth remained fairly flat over the quarter. Investors are becoming increasingly interested in land given the lack of immediately developable supply. Land values have now increased around 11% year on year in the South which is likely to place upwards pressure on economic rents. Incentives remain steady sub 10%.

Outer West Sydney gross take-up



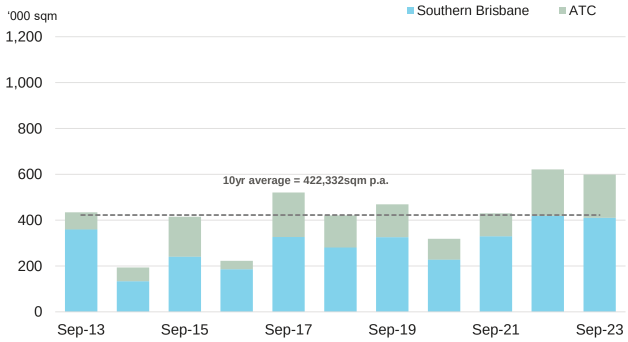
Source: JLL Research (gross take-up), Dexus Research.

West Melbourne gross take-up



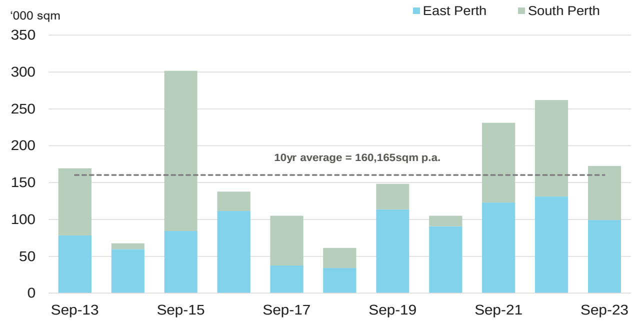
Source: JLL Research (gross take-up), Dexus Research

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

Sales growth tapering from high levels

Retail annual turnover grew by 1.5% in the year to August 2023, a much slower rate than the 19.3% recorded this time last year. Discretionary spending has been weaker than non-discretionary in the past couple of quarters. High mortgage interest repayments are taking precedence in the budgets of many households, causing them to focus on essentials.

Through the past thirty years, growth in retail volumes has consistently been positive, with only few periods of decline. The recent interest rate cycle has helped buck the trend with volumes contracting over the past quarter. As the bottom chart shows the contraction in volumes is as much due to sales returning from the abnormally high levels of COVID as with interest rate pressures. In fact, monthly retail sales figures remain elevated when benchmarked against pre-pandemic volumes, underscoring the strong performance of the retail sector through the pandemic and the stickiness of recent sales trends. Concurrently, a surge in net overseas migration has bolstered retail demand, helping to offset per capita declines in spending.

Online retail spending declined by 0.1% in the year to August. This restrained growth can again be attributed to the high base achieved during COVID as well as shifts in retail strategies with an emphasis on enhancing profitability. The strategy shift has led to a focus on click and collect rather than delivery, increased delivery charges, more restrictive return policies, and reduced marketing spend.

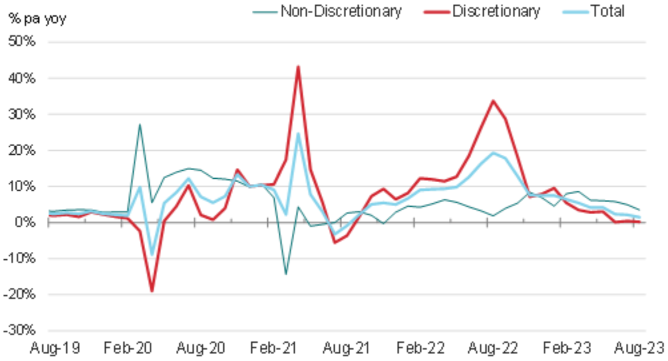
In the year to August, turnover growth in food and cafes improved to 3.5% and 8.0% respectively. Dragging on growth has been household goods, declining by 6.6%. Household goods are the only category to be declining over the past year on a moving annual turnover (MAT) basis.

Retail sales growth by category

	m-o-m	y-o-y	MAT
Cafes	0.7%	8.0%	19.5%
Clothing	1.3%	1.4%	10.3%
Department Stores	0.4%	-0.6%	9.5%
Food	-0.3%	3.5%	6.0%
Other	0.7%	0.1%	2.9%
Household Goods	-0.4%	-6.6%	-1.8%
Total	**0.2%**	**1.5%**	**6.4%**

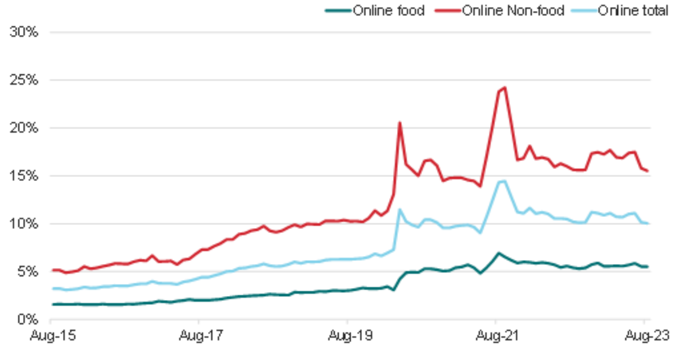
Source: ABS, Dexus Research

Discretionary vs non-discretionary spending



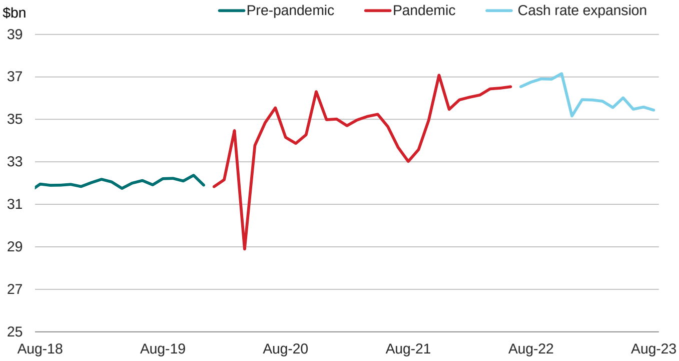
Source: ABS, Dexus Research

Online retail spending as share of total trade



Source: ABS, Dexus Research

Monthly sales volumes through recent shocks



Source: ABS, Dexus Research

Retail performance

Improving vacancies and occupancy costs

Rents across all centre types grew modestly in the year to Q3 2023, although Sydney regional shopping centre rents declined on an annual basis. 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.

Shopping centre vacancy continues to decline. City retail vacancies stabilised but remain elevated. Steadily growing tourism and returning office workers should help improve occupancy.

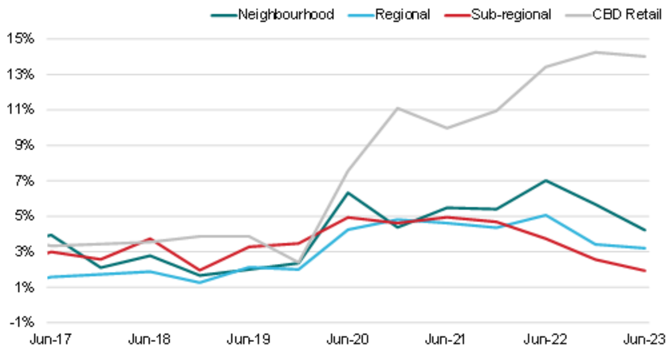
Retail yields have continued to expand over the quarter. Sydney regional and sub-regional shopping centre yields have risen between by 50bps year on year with neighbourhood yields rising by 63bps. While higher rates are influencing pricing, the quantum is less than pre-covid movements. Moving forward, cap rate rises for the retail sector are expected to be more modest than for the office and industrial sectors.

Retail snapshot

	Specialty rent growth % q-o-q.	Cap rate change from Q2(bps)
Sydney		
Regional	0.1%	12 bps
Sub-regional	0.2%	25 bps
Neighbourhood	0.2%	13 bps
Melbourne		
Regional	0.2%	12 bps
Sub-regional	0.2%	0 bps
Neighbourhood	0.3%	0 bps
SE QLD		
Regional	0.1%	50 bps
Sub-regional	0.3%	0 bps
Neighbourhood	0.3%	0 bps

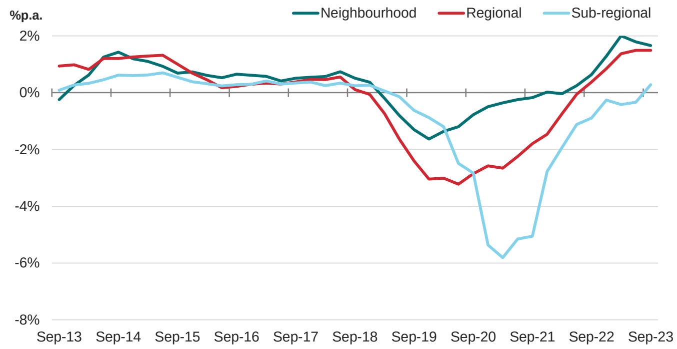
Source: JLL Research, Dexus Research

Shopping centre vacancy rates



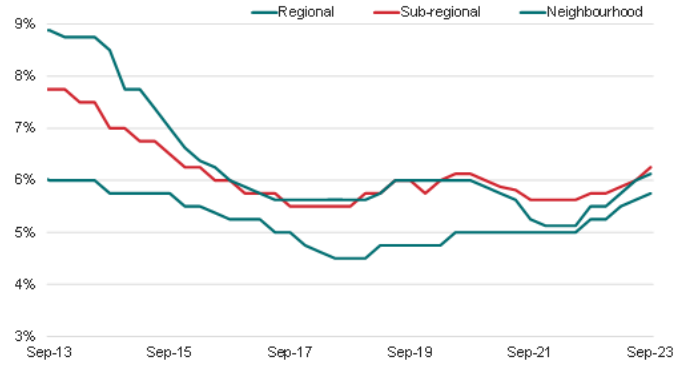
Source: JLL Research

Shopping centre rent growth



Source: JLL Research

Shopping centre capitalisation rates



Source: JLL Research

Healthcare

Healthcare resilient in weak economy

The overall healthcare environment has been resilient in the face of the economic slowdown with some positive demand indicators. Private health insurance up-take of hospital cover increased by 270,160 people over the 12 months to June 2023. This saw national coverage rates lift from 44.9% to 45.1%. More than half of this growth came from people aged 25-44 and 75yrs+.The industry is further set to benefit from an increase in premiums over the next quarter which see increased investment into the private sector.

Utilisation of Medicare funded services increased over the 12 months to June 2023. The strongest growth in number of services came from Optometry (10% yoy) followed by Imaging/diagnostics (4% yoy), and Radiotherapy (4% yoy). Each of these services support long term health conditions, backed by government funding.

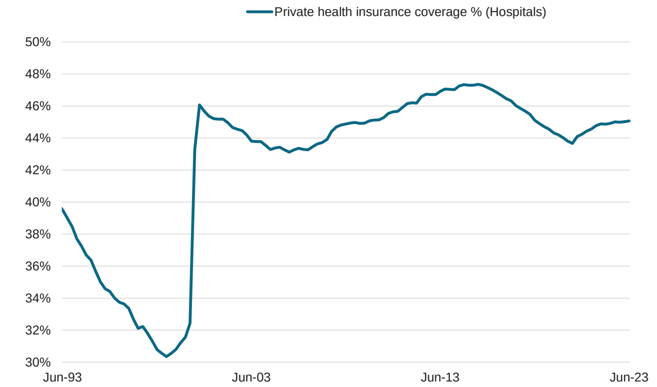
Despite the sectors fundamentals being largely positive, a higher inflation environment has led to cost pressures for some operators. Cost pressures are more prominent amongst primary healthcare operators with secondary and tertiary much less exposed. General Practitioners have attempted to pass on these costs to patients, however this has led to 12% decline in the number visits in the 12 months to June 2023. Projected growth in population will somewhat offset this decline in volumes.

Investors are generally protected from these operational trends, by leases which typically mandate fixed, or CPI linked increases, providing a stable income/growth profile. The most likely outcome of these short term operational pressures is a trend towards the consolidation of smaller or poorer performing healthcare operators.

A shift towards defensive assets continues to benefit the healthcare sector. Investment demand for health assets has remained robust compared to other traditional property sectors. Around $1.6 billion of healthcare transactions occurred over the year to September 2023, just shy of average full year volumes. Like all other real estate sectors, healthcare is feeling the impact of higher interest rates on pricing, with some pressure on valuations. However, this is a phase of price discovery at a time when underlying sentiment for healthcare remains very positive.

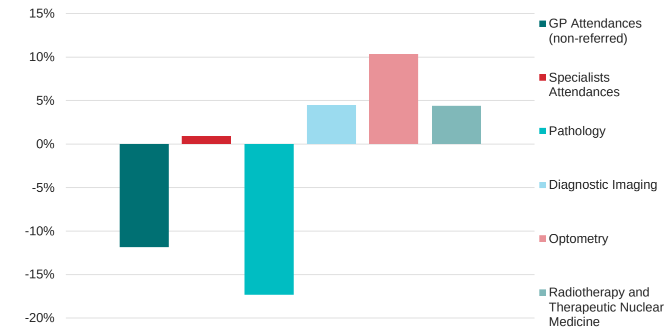
The sector is poised to attract an increased capital allocation over the next few years as price expectations become clearer, due to its non-discretionary nature, diversification benefits and long-term growth thematic. Valuations are expected to benefit from funds being allocated away from some of the larger more traditional real estate sectors.

Private health insurance coverage



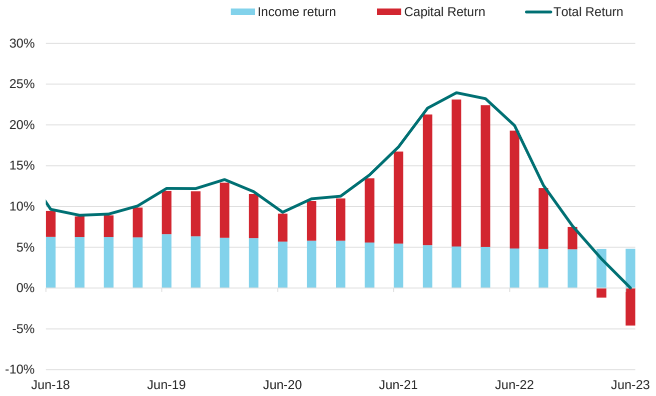
Source: APRA Quarterly Private Health Insurance Membership Trends June 2023

Growth in Medicare services (rolling annual)



Source: Medicare annual statistics rolling 12 months July 2009 to June 2023

Healthcare returns



Source: MSCI

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