KPMG

The Australian Real Asset Economy

Market Update
May 2023

Key takeaways

Solid economic growth and the tight labour market are supporting occupational demand across the core commercial property sectors except for office property which is seeing softer demand.

Asset pricing dynamics have started to turn with capitalisation rates softening across the key property sectors. Discount rates have also reversed their downward trend and moving upwards.

Despite the rapid rate rises, the resilience of the Australian economy is likely to see it enter a cooling phase (rather than a recession) while other developed economies could see their economies contract over the next 6-12 months.

OFFICE SECTOR

Softer demand for space continues, as a large part of CBD workforces remain working from home and employment growth slows. A reversal in asset pricing dynamics has seen capitalisation rates soften further for low quality grade assets.

RETAIL SECTOR

Occupancy rates have been supported by the recent strength in retail demand. Investment return performance continues to be strongest for convenience and large format retail while softer for prime shopping centres.

INDUSTRIAL SECTOR

Demand is out-pacing available space in this sector. This is underpinned by e-commerce and disruptions to retail sales and delivery platforms. This is translating into higher rentals.

Executive summary

The Australian economy is now entering a softer growth phase as it confronts both domestic and global headwinds. Quarterly growth momentum in GDP stayed above trend in the December quarter, at 0.5% Q/Q, taking annual growth to 2.7%.

Solid economic growth and the tight labour market are supporting occupational demand across the commercial core property sectors except for office property which is already seeing softer demand. The short-term outlook is for leasing demand to soften across all three core sectors as the economy approaches the cooling phase of the business cycle.

Rising market interest rates are adversely affecting capital market conditions across most asset classes, including the commercial property sector. Asset pricing dynamics have started to turn with capitalisation rates softening across the key property sectors. Discount rates have also reversed their downward trend and moving upwards. As such, asset revaluations are likely to move down.

Investment performance for commercial property has started to moderate with total returns across the three core property sectors softening. This is largely attributable to narrowing capital returns as asset values retreat. We expect this to continue over the next 12 months. However, return profiles are likely to vary markedly across sub-sector markets given their intrinsic sub-market characteristics and drivers influencing space market conditions.

The construction industry is a significant part of the Australian economy. It currently represents 7.5% of the nation's economic activity and employs over 1.2 million people. The construction industry's growth profile is moderating and its market cycle has entered a softening phase. While there is still a significant pipeline of work to complete, new dwelling approvals have fallen sharply in the face of the end of the HomeBuilder package and rising mortgage rates. While the fall in actual activity is set to be softer than the drop in approvals, it is likely that activity will begin to contract in the near term.

Given the sector's size and its deep supply chains across the economy, the slowing in construction activity will have a material impact on the pace of economic growth. The extent of this downturn is contingent on the size and pace of future rate rises.

The sector also continues to face supply chain disruptions, elevated costs; rising borrowing costs and financial stress. And the long-term challenge of stagnant productivity has yet to be solved.

This report provides insights from KPMG Real Estate experts, Senior Economists and Real Investment Analytics.

Economic update

KEY ECONOMIC EVENTS FROM THE LAST QUARTER

- The Australian economy is now entering a softer growth phase as it confronts both domestic and global headwinds. Quarterly growth momentum in GDP stayed above trend in the December quarter, at 0.5% Q/Q, taking annual growth to 2.7%.
- The labour market remains resilient but is beginning to soften. Growth momentum in employment continues to soften since August 2022 with annual growth sitting at just above 3%. However, the unemployment rate continues to hold broadly steady, near historical lows, at 3.5%
- Retail demand has begun to soften over recent months, with moving annual turnover (MAT) growth slowing from 11.5% to 11.2% in February 2023. The decline in retail growth, -3.9% over the month of December 2022 and subsequently lower positive growth for the current year to date indicates that the higher interest rates are starting to impact household spending.
- Consumer inflation reached a peak of 7.8% in the December quarter 2022, the highest since 1990 but has moderated to 7.0% in March 2023. The cash rate was increased eleven times from 0.10% in May 2022 to currently sit at 3.85%. With the RBA returning to 'normal' cash rate increments, the pace of tightening has now slowed but is likely to continue its tightening bias until it brings inflationary pressures into check. However, due to the lagged flow-on effects of rising interest rates, the tightening cycle is expected to peak well ahead of inflation returning within its target zone.
- Despite the rapid rate rises, the resilience of the Australian economy is likely to see it enter a cooling phase (rather than a recession) while other developed economies could see their economies contract over the next 6-12 months.

WHAT THIS MEANS FOR REAL ASSETS

- Space market conditions: Currently, the solid economic growth and the tight labour market are supporting occupational demand across the commercial core property sectors except for office property which is already seeing softer demand. The short-term outlook is for leasing demand to soften across all three core sectors as the economy approaches the cooling phase of the business cycle.
- Capital market conditions: Rising market interest rates are adversely affecting capital market conditions across most asset classes, including the commercial property sector. Asset pricing dynamics have started to turn with capitalisation rates softening across the key property sectors. Discount rates have also reversed their downward trend and moving upwards. As such, asset revaluations are beginning to move down.
- Investment performance: Investment performance for commercial property has started to moderate with total returns across the three core property sectors softening. This is largely attributable to narrowing capital returns as asset values retreat. We expect this to continue over the next 12 months. However, return profiles are likely to vary markedly across sub-sector markets given their intrinsic sub-market characteristics and drivers influencing space market conditions.

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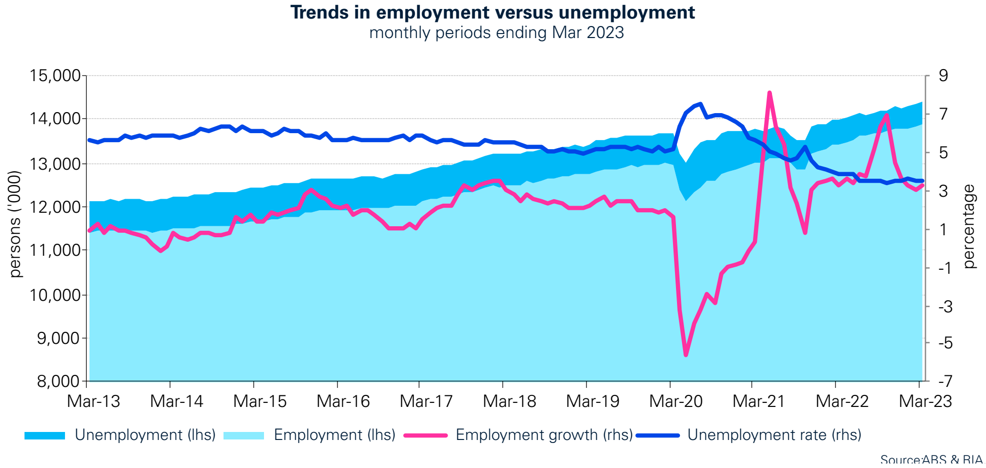
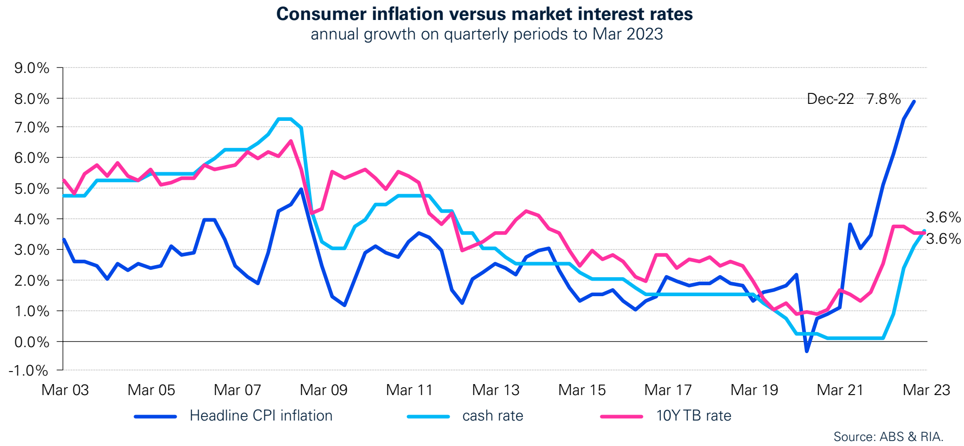
LABOUR MARKET REMAINS ROBUST

Over the last quarter national employment increased by 106,000 to 13.9 million persons employed as at Mar 2023; the unemployment rate remains near historical lows at 3.5%.



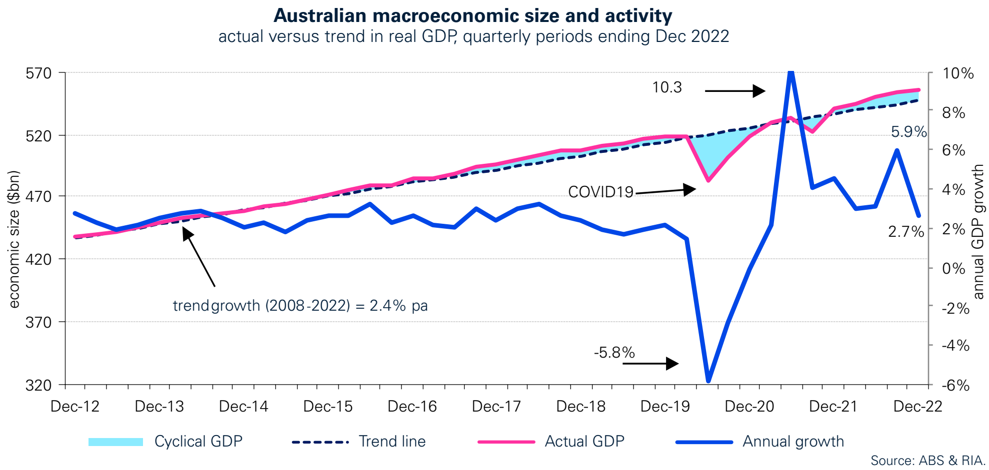
CONSUMER INFLATION HAS PEAKED

CPI inflation over the year to the Mar 2023 quarter was lower at 7.0% after peaking at 7.8% in December 2022. To reign in inflationary pressures, the RBA has embarked on monetary tightening; raising the cash rate eleven times since May 2022 to currently stand at 3.85%.



ECONOMIC GROWTH BEGINNING TO SOFTEN

Australia recorded significantly softer real GDP growth over the December 2022 quarter of 0.5% and annual growth at 2.7%. The slower growth was attributable to softer domestic activity offset by strong contribution from overseas trade. Notably, growth is starting to slow sharply as rising interest rates filter through the wider economy.



INFLATION RISK

- Entrenched consumer price inflation is likely to occur if wage rises are linked to consumer price index (CPI) increases.
- Relatively tight labour markets are likely to put upward pressure on wages due to a skilled labour shortage.
- Persistent supply-side constraints will continue to see elevated prices for raw materials.

FINANCIAL RISK

- A rapid rise in market interest rates caused by central banks undertaking aggressive monetary policy tightening to control inflationary expectations.
- Corrections in asset markets. Listed equity price indices are on a downward adjustment path to factor in higher interest rates and a lower growth scenario.
- A global recession caused by slower global trade and overly aggressive monetary tightening policies across multiple countries.
- The rising cost of government debt remains a challenge, while many countries are imposing discretionary fiscal policy to rein in budget deficits.
- Contagion risk due to financial stress for global banking sector, although Australian banks are adequately capitalised.

SUPPLY-CHAIN RISK

- Supply constraints due to supply and distribution bottlenecks as economies continue to normalise post-COVID and deal with relatively tight labour markets.
- Geo-political turmoil is likely to persist with the ongoing Ukraine-Russia conflict, which is causing disruptions to food and resource markets.

PANDEMIC RISK

- The world continues to face sporadic outbreaks of virulent mutations.
- Persistent COVID-19 outbreaks in China but government has now moved away from zero-COVID policy.

SHORT-TERM OUTLOOK (12 MONTHS)

- Economic growth to slow in the coming quarters.
- The labour market will remain tight but show some softening: employment growth will slow and unemployment is expected to edge upwards.
- Consumer demand will moderate with curbs to discretionary spending.
- Housing market activity to slow and house prices decline.
- CPI inflation to remain elevated against higher market interest rates.

MEDIUM-TERM OUTLOOK (3 YEARS)

- Economic growth will revert to trend, with a recovery in construction and discretionary sectors.
- The labour market will improve with employment strengthening and unemployment falling.
- Rebound in consumer demand with stronger moving annual total (MAT) growth.
- Housing sector will enter a recovery phase with rising house prices.
- CPI inflation to hover around the upper range of the RBA target zone and an end to rate rises.
- A rebound in the share market.

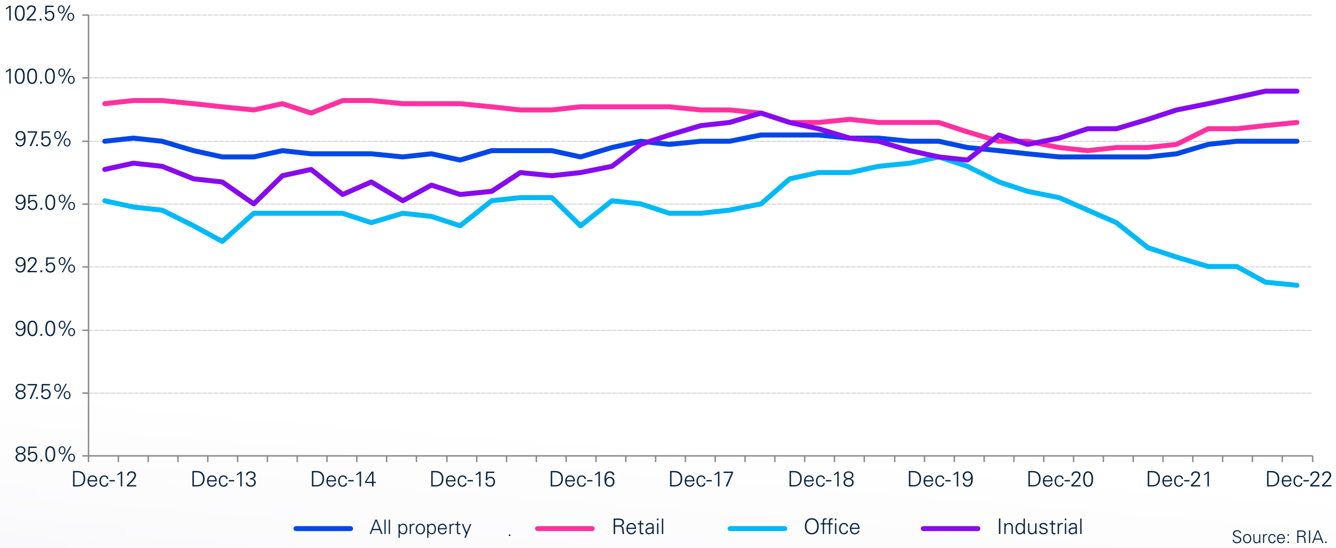
Commercial property: key themes

SPACE MARKET CONDITIONS ARE EVALUATED BY EXAMINING MOVEMENTS IN OCCUPANCY RATES.

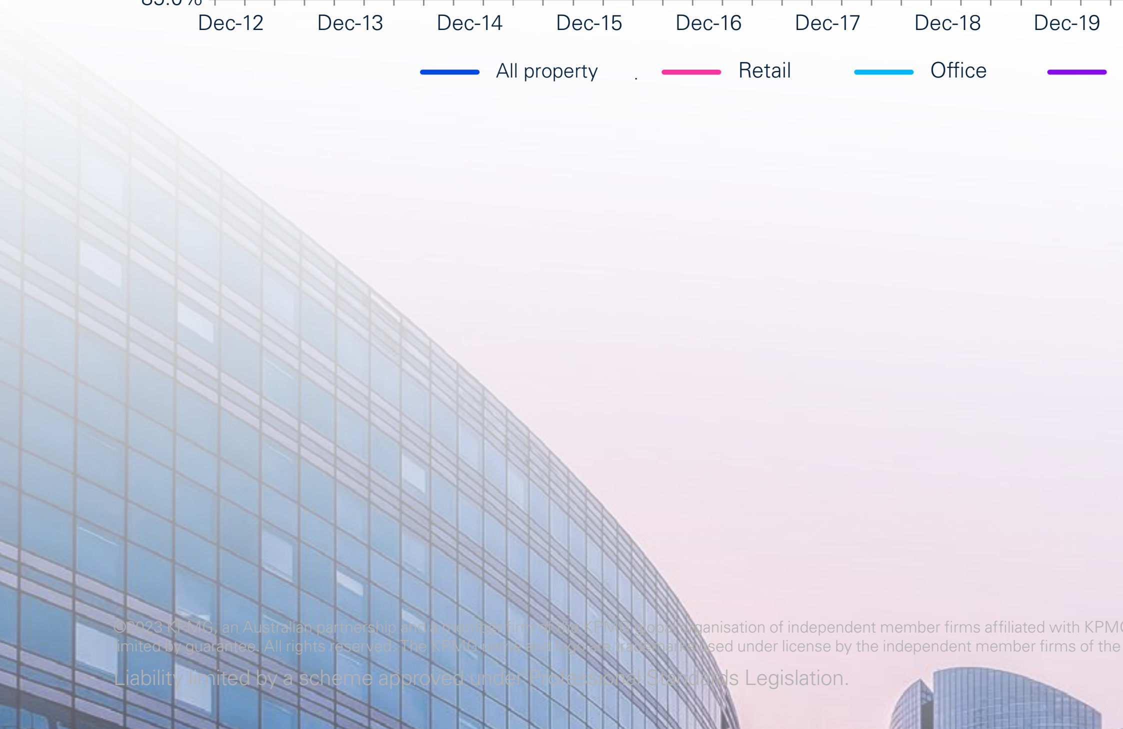
- Occupancy rate remained relatively tight at 97.5% for December 2022 for the combined three core commercial property sectors. This has been supported by solid occupational demand, underpinned by a strong labour market.
- While the occupancy rate remains steady for the overall commercial property market, it differs markedly across property sectors. Occupancy rates across industrial property, retail property and office property stood at 99.6%, 98.2% and 91.8% respectively.
- Over the last 12 months, movements in occupancy rates varied across property sectors. For industrial property occupancy rates remained very tight reflecting strong demand against limited supply. Retail property showed a mild improvement in occupancy, reflecting the stronger pick-up in retail demand. In contrast, office property experienced a mild softening occupancy rate due to softer net absorption.

Occupancy rate across poperty sectors

quarterly periods ending Dec 2022



Source: RIA.



Commercial property: key themes

ASSET PRICING DYNAMICS ARE EVALUATED BY EXAMINING MOVEMENTS IN PROPERTY CAPITALISATION RATES.

– Commercial Property capitalisation rates across core sectors have reached the end of the compression cycle in June 2022 where the average rate stood at 4.8%. Capitalisation rates across retail property, office property and industrial property stood at 5.1%, 4.8% and 4.1% respectively.

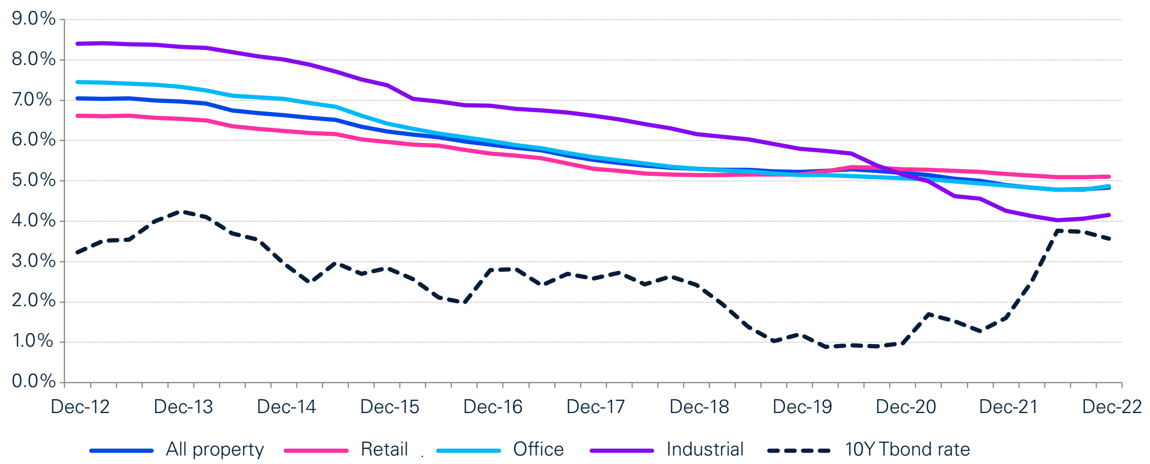
– Since June 2022, the average capitalisation rate has risen by around 10 basis points to sit at 4.9% in December 2022. The movement in capitalisation rates over the last six months varies across property sectors: retail property, office property and industrial property recorded softer rates of 5, 15 and 20 basis points respectively.

– The capitalisation rate-bond rate spread has also narrowed significantly. Over the last 12 months to December 2022, with tightening monetary policy, the 10-year Treasury bond rate has climbed sharply to sit at 3.6%. This represents a spread of only 60 basis points to industrial property.

– There remains a large differential between unit prices of publicly listed and private REITs. However, we note that this has begun to close with recent transactional evidence in the market realigning values.

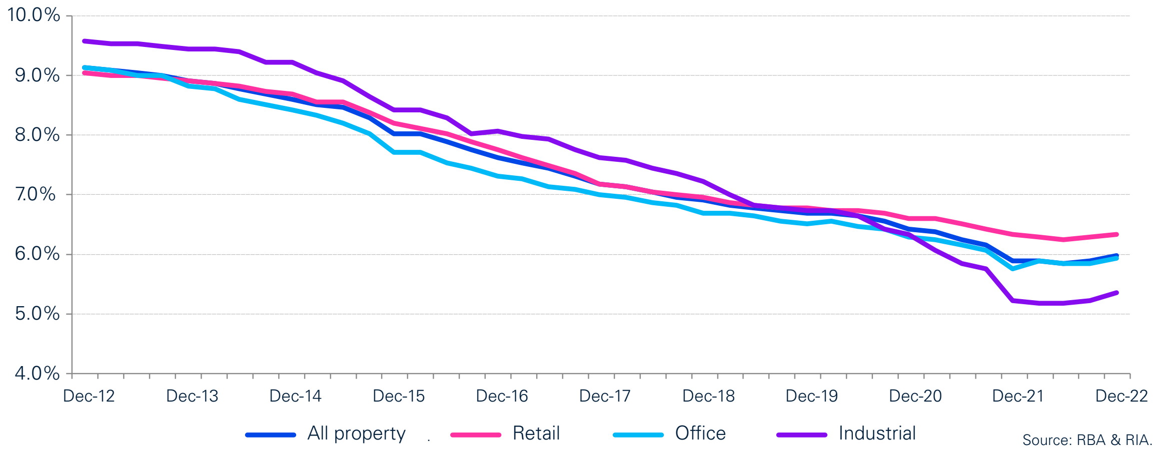
– Notably, there has been a corresponding movement in the discount rate over the same period, moving from 5.8% to 6.0%. Across property sector there, on average, a softening of 10 basis points for both retail property and office property and a 20 basis points movement for industrial property.

Cap rates across property sectors
quarterly periods ending Dec 2022



Source: RBA & RIA.

Discount rates across property sectors
quarterly periods ending Dec 2022



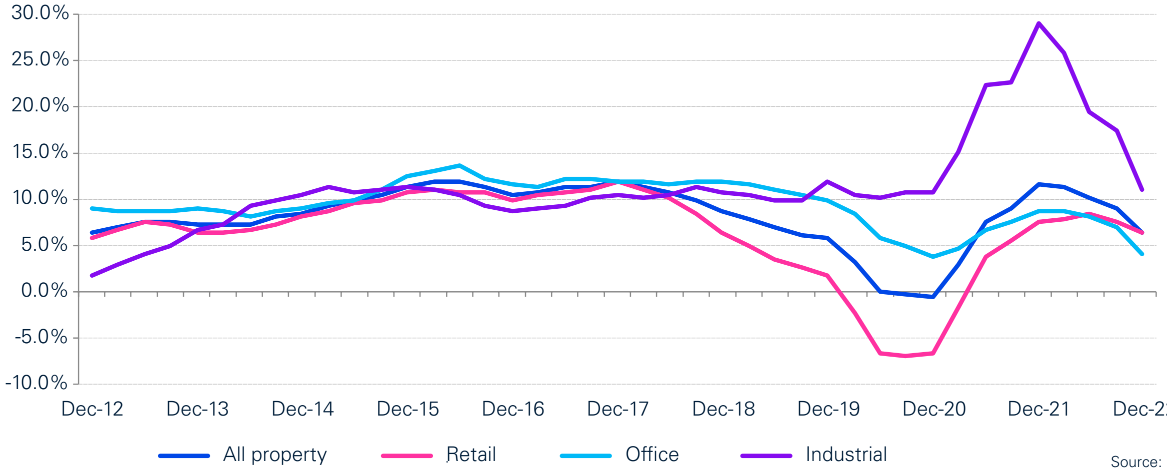
Source: RBA & RIA.

Commercial property: key themes

INVESTMENT PERFORMANCE IS EVALUATED BY EXAMINING PROPERTY TOTAL RETURNS.

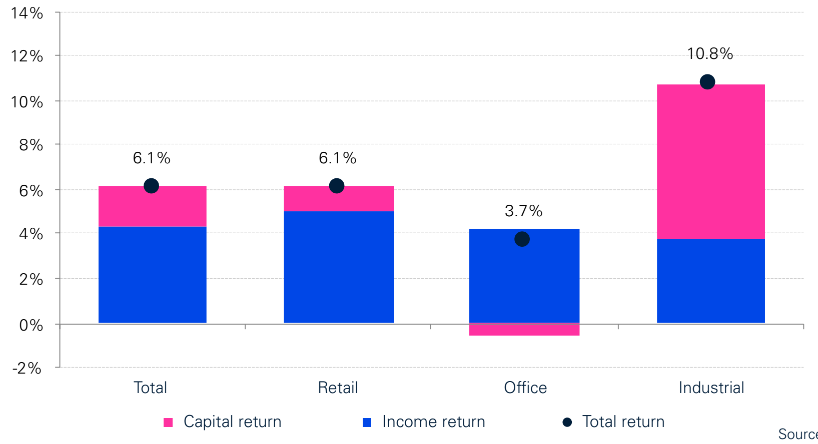
- Commercial property (ungeared) total returns continue to moderate across core property sectors. As at December 2022, the average 12 month return for all sectors stood at 6.1%, a decline of 2.7 percentage points over the quarter.
- Across key sectors, 12-month total returns to December 2022 delivered notable variations. Total returns across industrial property, retail property and office property were 10.8%, 6.1% and 3.7% respectively.
- While industrial property delivered a relative strong return it has moderated markedly from its peak of around 30% in December 2021. In contrast, both retail property and office property returns have posted significantly lower returns as they continue their softening path.
- There is a divergence in returns across property sectors that commenced around 2018. The fall-away in retail property returns commenced around the time there was a growing shift towards online retailing. The softening in office property returns commenced prior to the onset of COVID19, associated with weakening space market conditions.

Asset property returns across key sectors
rolling 1 year annualised returns, quarterly periods ending Dec 2022



Source: RIA.

Commercial property returns by sector
based on annualised return as at Dec 2022



Source: RIA.

Commercial property sector: Office property sector

SPACE MARKET CONDITIONS:

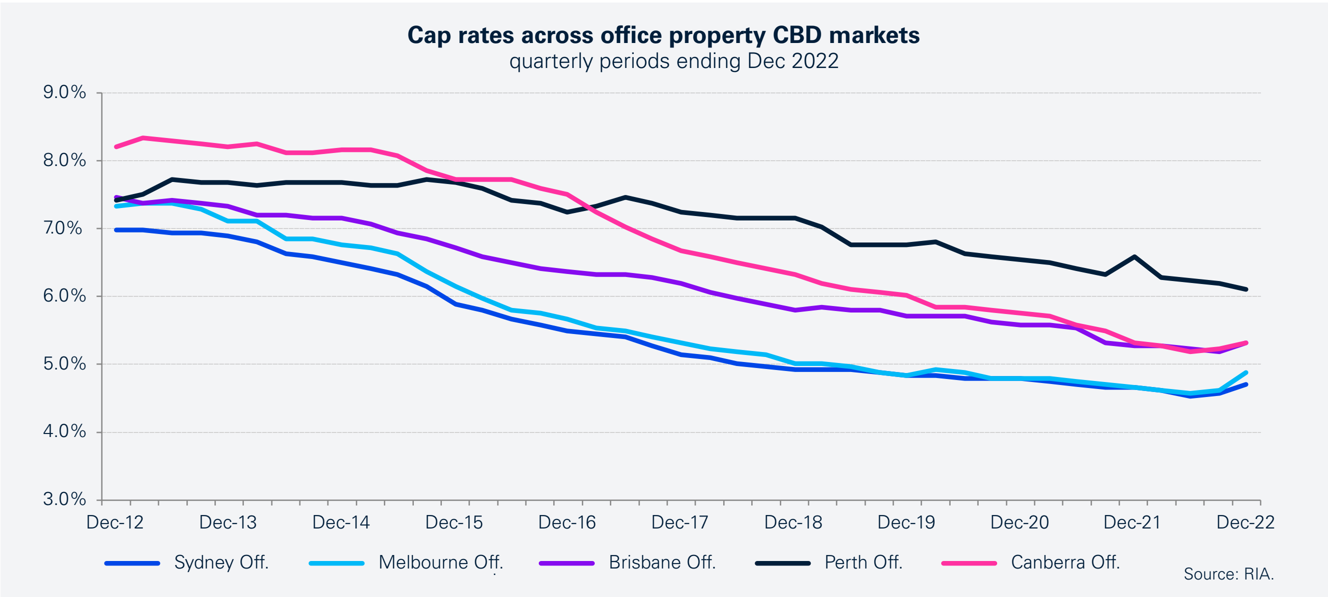
This sector will continue to experience weak demand for space, reflected in softening growth for white collar employment (WCE). This has seen occupancy rates soften across most CBD markets except for Canberra where occupancy rates have remained relatively high and steady during the post-COVOD period. Consequently, this has seen little growth in effective rentals.

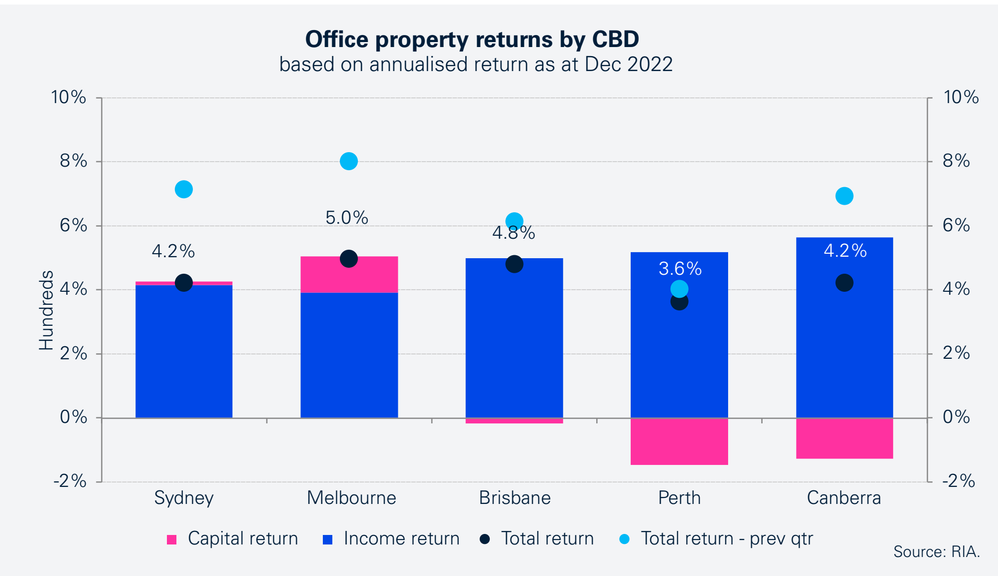
ASSET PRICING:

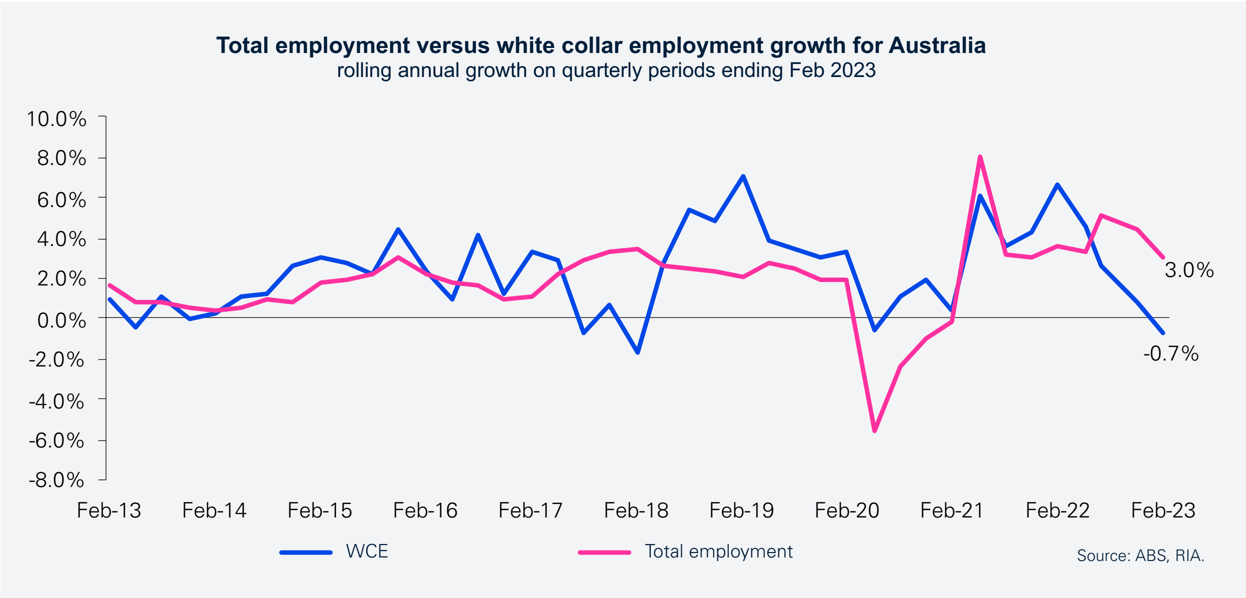
After experiencing a mild firming in capitalisation rates through 2021-22 they have now started to edge upwards. In the larger CBD markets of Sydney and Melbourne, capitalisation rates at 4.7 and 4.9% respectively have softened by 20 and 30 basis points respectively. Despite this, investors continue to seek high-quality office spaces which offer solid and robust income streams. Overall, we are now seeing capitalisation rates soften further across CBD markets, twith the softening being greater for low quality grade assets.

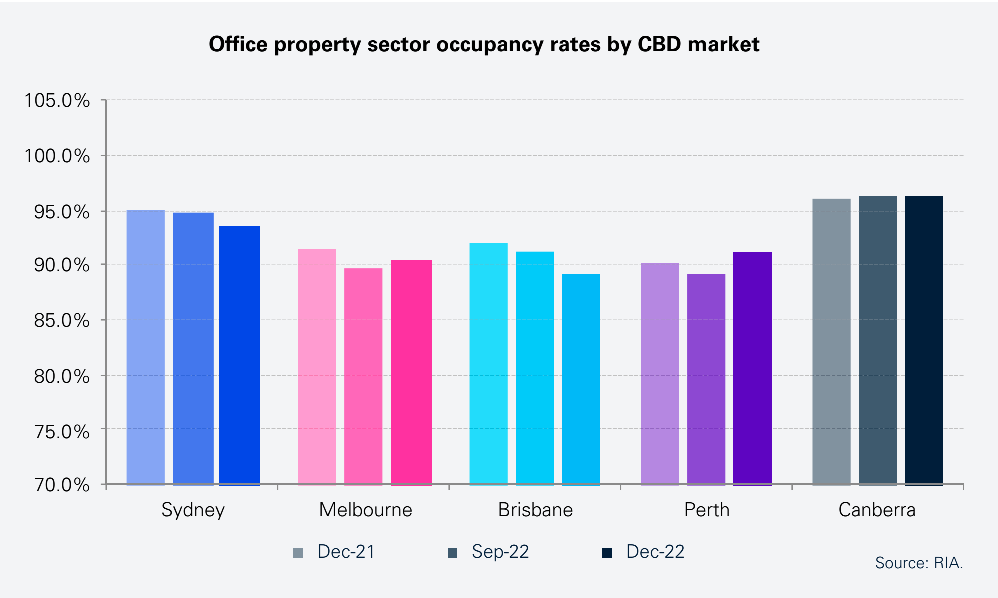
INVESTMENT PERFORMANCE:

Investment performance across CBD markets has softened further over the quarter, with total returns ranging between 3.6% and 5.0%. This was mainly attributable to softer capital returns for Sydney and Melbourne markets and declines in asset values for Brisbane, Perth and Canberra.






Total employment versus white collar employment growth for Australia
rolling annual growth on quarterly periods ending Feb 2023
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
-4.0%
-6.0%
-8.0%
Feb-13
Feb-14
Feb-15
Feb-16
Feb-17
Feb-18
Feb-19
Feb-20
Feb-21
Feb-22
Feb-23
3.0%
-0.7%
WCE
Total employment
Source: ABS, RIA.


Office property sector occupancy rates by CBD market
105.0%
100.0%
95.0%
90.0%
85.0%
80.0%
75.0%
70.0%
Sydney
Melbourne
Brisbane
Perth
Canberra
Dec-21
Sep-22
Dec-22
Source: RIA.

Commercial property sector: Retail property sector

SPACE MARKET CONDITIONS:

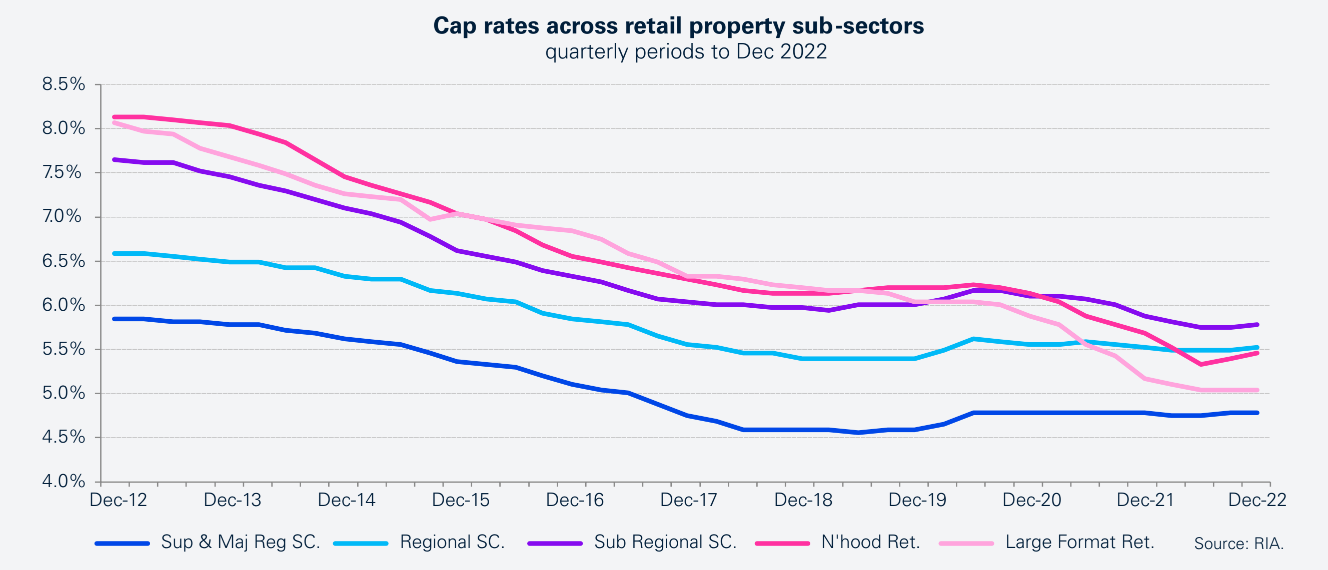
Conditions for retail property have been improving with the end to lockdown restrictions. This is reflected in stronger annual growth in retail turnover and MAT across both discretionary and non-discretionary items. This has resulted in higher occupancy rates recorded across the various sub-sectors. However, the decline in retail growth, -3.9% for the month of December 2022 and subsequently lower growth in the first two months of 2023 highlights that the higher interest rates are starting to adversely impact household spending.

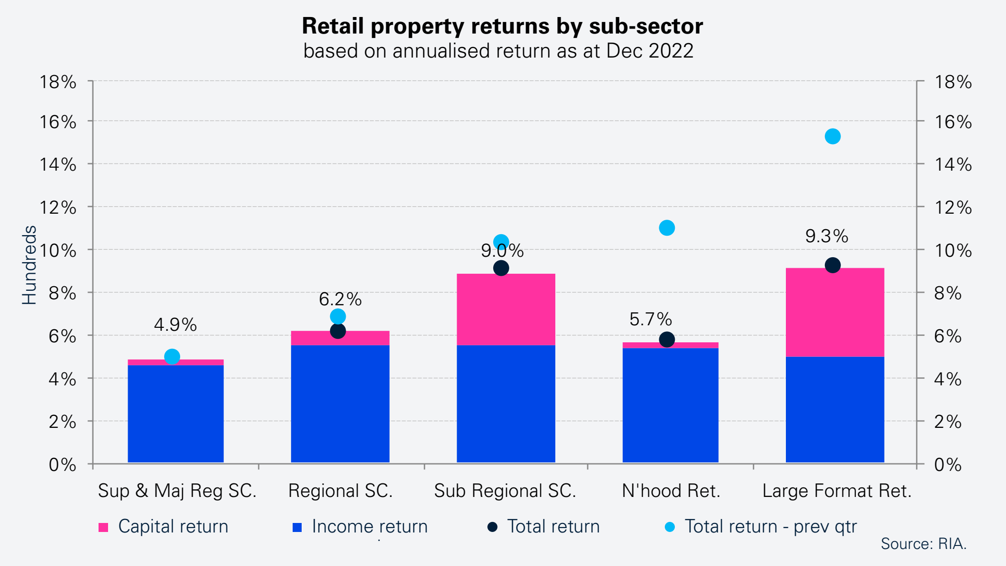
ASSET PRICING:

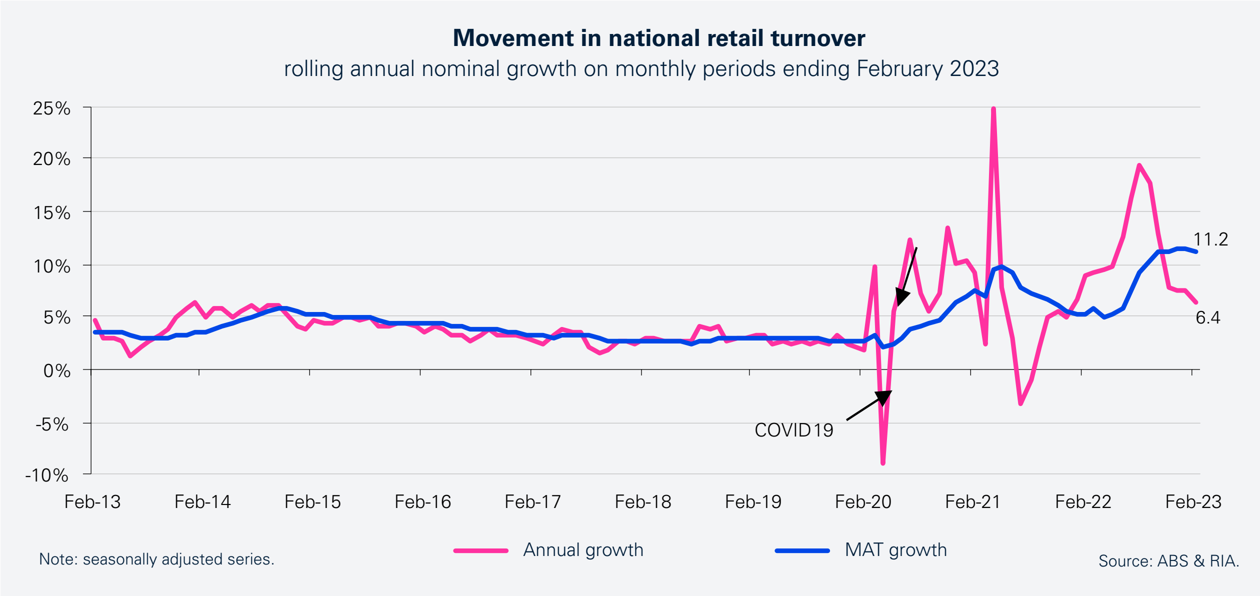
Capitalisation rates for retail property recorded a mild softening of 5 basis points over the last two quarters. Across retail sub-sector markets, prime shopping centres saw cap rates remain steady while neighbourhoods saw a softening of 10 basis points.

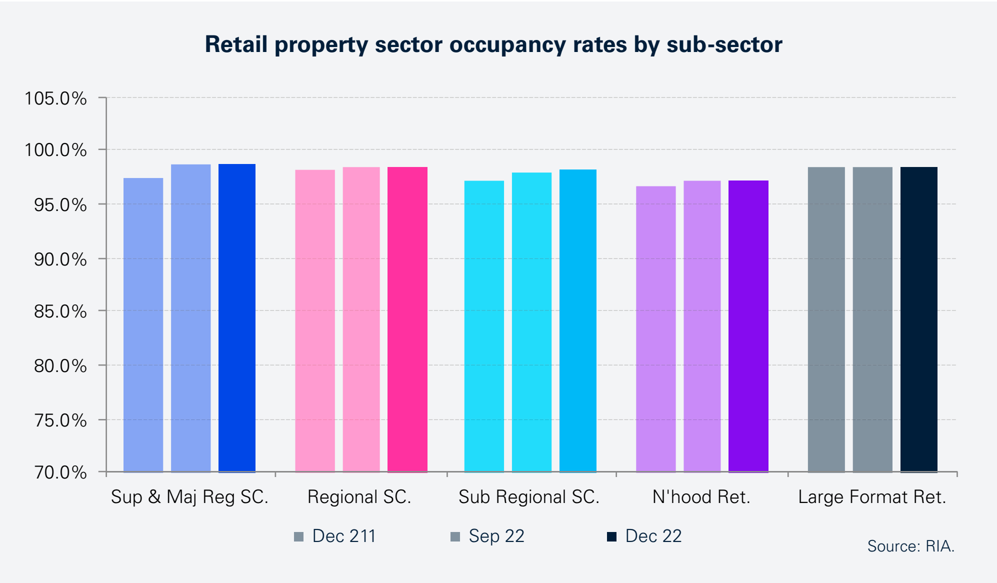
INVESTMENT PERFORMANCE:

Investment performance has moderated for retail property over the quarter. Across retail sub-sector markets total returns range between 4.9% and 9.3%. This was mainly attributable to softer capital returns, reflecting the slower growth in asset valuations. Total returns continue to be strongest for large format retail, while relatively softer for prime shopping centres.






Movement in national retail turnover
rolling annual nominal growth on monthly periods ending February 2023
25%
20%
15%
10%
5%
0%
-5%
-10%
Feb-13
Feb-14
Feb-15
Feb-16
Feb-17
Feb-18
Feb-19
Feb-20
Feb-21
Feb-22
Feb-23
11.2
6.4
COVID 19
Note: seasonally adjusted series.
Annual growth
MAT growth
Source: ABS & RIA.


Retail property sector occupancy rates by sub-sector
105.0%
100.0%
95.0%
90.0%
85.0%
80.0%
75.0%
70.0%
Sup & Maj Reg SC.
Regional SC.
Sub Regional SC.
N'hood Ret.
Large Format Ret.
Dec 211
Sep 22
Dec 22
Source: RIA.

Commercial property sector: Industrial property sector

SPACE MARKET CONDITIONS:

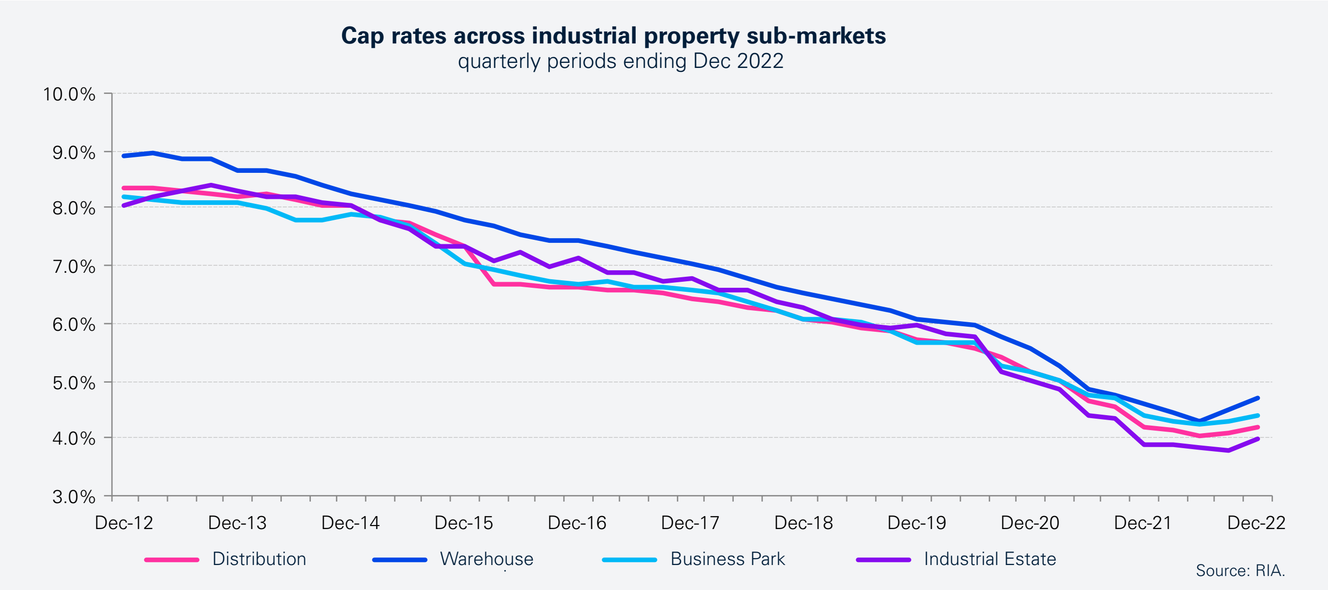
There are favourable space market fundamentals with demand out-pacing available space in this sector. Strong demand is underpinned by e-commerce and disruptions to retail sales and delivery platforms. This has seen occupancy rates close to 100% across all sub-sector markets. This is translating into higher rentals.

ASSET PRICING:

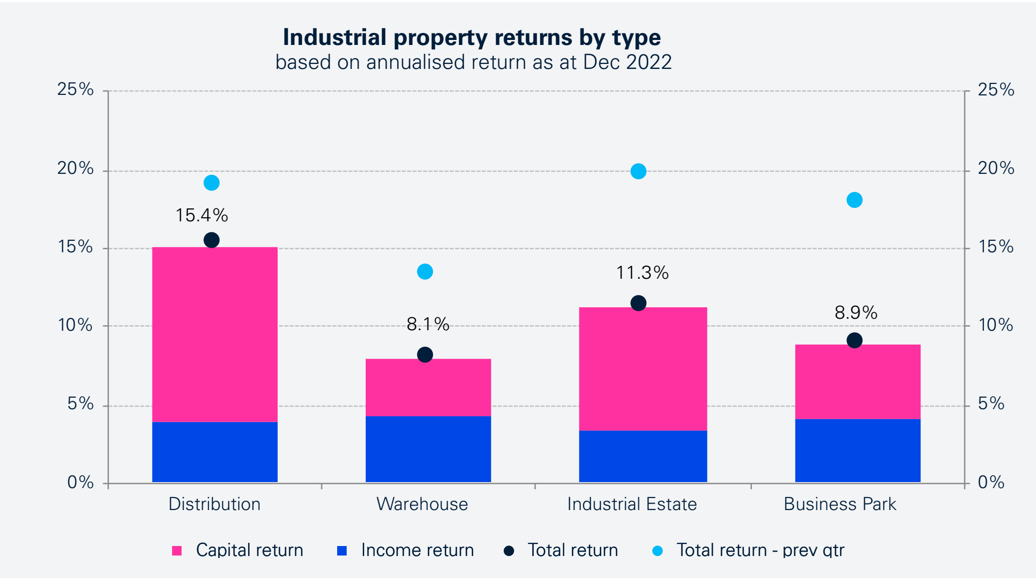
After experiencing a relatively steep firming in capitalisation rates through 2021-22 they have now started to edge upwards. On average, capitalisation rates have softened by 20 basis points over the last two quarters. Average capitalisation rates remain relatively tight across the sub-sectors, ranging between 4.0% - 4.7%.

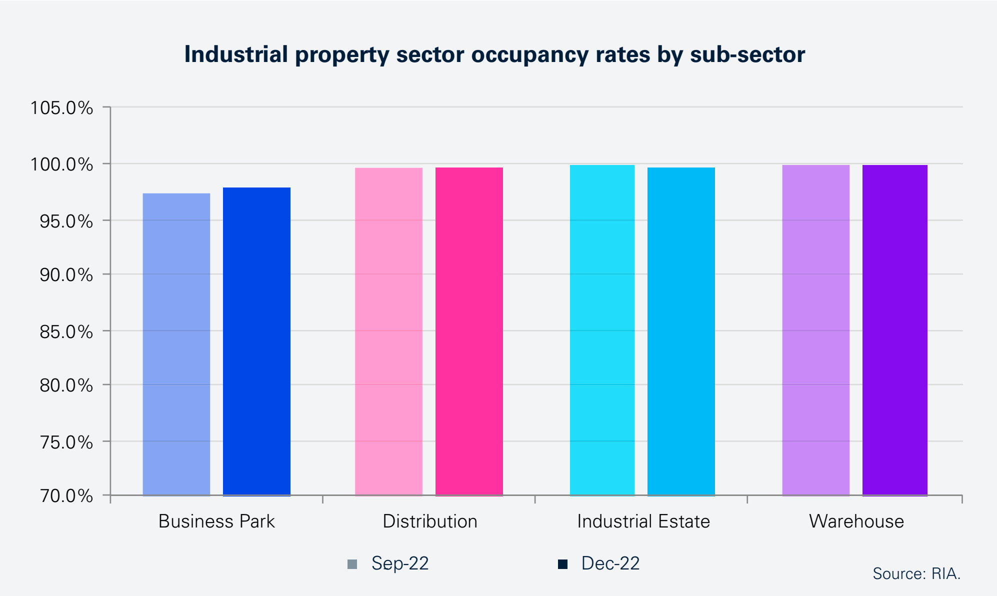
INVESTMENT PERFORMANCE:

Investment performance for industrial property has moderated further over the quarter and is significantly softer than the strong returns reported between December 2021 and March 2022. Across industrial product type, total returns ranged widely between 8.1% and 15.4%. This was mainly attributable to softer capital returns, reflecting the slower growth in asset valuations.



Source: RIA.




Industrial property sector occupancy rates by sub-sector
105.0%
100.0%
95.0%
90.0%
85.0%
80.0%
75.0%
70.0%
Business Park
Distribution
Industrial Estate
Warehouse
Sep-22
Dec-22
Source: RIA.

Recent banking events around the globe look to stir uncertainty in the construction industry in Australia

The building and construction industry has been facing various challenges recently and we are now experiencing a period of significant economic uncertainty, as seen with a number of recent high profile insolvencies in the sector and anxiety around the world has mounted over the stability of the banking sector.

RECENT BANKING EVENTS

The current condition in the global banking system can have a significant negative impact on sentiment in the real estate and construction sector. Commercial property development and investment often require large amounts of financing and for projects with longer timeframes. Given the current financial difficulties, financial institutions, and even macroprudential regulators may become more cautious and tighten their lending standards, potentially leading to a reduction in liquidity in the market, and tighter access to financing especially for smaller borrowers.

In addition to reduced liquidity, the current banking sector turmoil may also lead to an increase in funding costs for the property sector as a whole. As banks become more risk-averse, they require higher interest rates and stricter lending terms. This will make it more expensive for developers and investors to obtain the necessary funding, reducing their profit margins and slowing down activity in the sector.

Overall, the authorities in the US and in Europe have shown confidence a larger contagion risk following the recent banking events to the broader financial system is unlikely by injecting liquidity to the banking system. Furthermore, the Australian financial system is well-capitalised and highly liquid. Australia's banks are required by APRA to satisfy capital and liquidity standards that are considered to be among the most robust in the international financial system. However, the current banking instability is likely to have a negative impact on sentiment in the commercial property sector. The exact extent of this impact will depend on a range of factors, including the severity and the duration of the crisis, the availability of alternative sources of financing, the stance of monetary policy, and the overall strength of the economy.

CONSTRUCTION INDUSTRY

The Australian real estate sector still has a strong pipeline of work to be done which will support the construction activity in the near term. However the factors that previously supported home construction are unwinding; interest rates have risen from record lows to their highest rate since 2013, the HomeBuilder subsidy has now ended, house prices have fallen, and the household saving rate has returned to around its pre-virus level. Dwelling approvals (new activity into the pipeline) have now slumped, particularly in Victoria.

We forecast new dwellings investment to decline during 2023, as the backlog is cleared and new activity falls back. But by 2024 we expect the RBA to begin cutting rates again, which will support a renewed rise in house prices and residential construction activity. Despite the positive increases predicted for longer term demand, we expect that construction sector risks and challenges will prevail for the next 12 to 18 months, including:

- Intense competition, which drive down margins in order to secure revenue at the expense of the bottom line;
- Supply chain issues delaying projects and increasing input costs;
- Skilled trades and labour shortages causing project delays and impacting feasibility;
- Working capital pressures and cashflow timings for construction contracts; and
- Prevalence of fixed-price construction contracts, resulting in the absorption of increases to input costs, putting further pressure on already slim margins.

Developers and other stakeholders exposed to the construction sector need to be cognisant of these challenges as the failure of a builder or critical sub-contractor can impact value significantly on a real estate project, in particular in delays to a project, and absorbing the increase in costs to ensure the project is completed. In order to navigate the increased risks and optimise the success of projects, developers, financiers and suppliers now more than ever, need to:

– Undertake appropriate due diligence to assess the feasibility of future and ongoing projects, including quality of build, timing for commencement and completion, and importantly local buyer demand and financial capacity;

– Independently review the financial position and suitability of their current builder/s, any potential new builder (particularly in the event of the predecessor builder collapsing) and major sub-contractors;

– Continue to focus on cost control, monitoring of costs in real time and be agile with contracting arrangements in order to manage the potential movement in constructions costs;

– Maintain regular and transparent dialogue with lenders, investors and other stakeholders as to any changes to forecast liquidity requirements, performance and project delivery timeframes;

– Expect to share risks between developer and builder in order to support the solvency of builder and successful completion of projects.

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