REIA

END OF FINANCIAL YEAR

Economic Outlook for Commercial Real Estate

July 2023

ACKNOWLEDGEMENT OF COUNTRY

REIA respectfully acknowledges the Traditional Owners of Country throughout Australia and recognises their continuing connection to land, water, and community. We pay our respect to them, their culture and their leaders, past, present and emerging.

DISCLAIMER

REIA is a federation of state and territory Real Estate Institutes. Formed in 1924, it represents the real estate industry in Australia at national and international levels.

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PRESIDENT'S FOREWORD

Dear valued stakeholders,

The close out to 2022-2023 has been a challenging one with uncertain investors, a challenging leasing market and lower transactions than usual.

REIA's Commercial Agency Engagement Program (Project CRE), a goal of ours in the same financial period, has committed to providing better information and insights to our family of commercial real estate practitioners across Australia.

It is my pleasure to launch this end-of-financial-year economic digest for commercial real estate agencies to help them, their clients and tenants navigate the next 12 months.

It consults with leading real estate economists and researchers to provide a forward view of the economic environment, inflation, interest rates, structural challenges over the short to long term and major trends that will impact the commercial sector moving forward.

REIA's forward research program for Project CRE will next focus on sustainability, supply and automation.
I encourage you to get involved with Project CRE, either direct to REIA or via your local Real Estate Institute.

Yours sincerely,

Hayden Groves
President
Real Estate Institute of Australia

ECONOMIC FACTORS SHAPING COMMERCIAL REAL ESTATE OVER 2023-2024

Interest Rates

High inflation and interest rates to the commercial property sector has been profound and this trend is set to continue over 2023-2024 unless inflation is controlled

Inflation

Inflation is predicted by the Australian Government and the RBA to come back into target range by 2025. However, services side inflation is proving to be harder to get back in to range, with increasing wages presenting an additional challenge against the inflation battle.

Occupancy

Occupancy across most asset classes has held up well, but the full impact of high interest rates will be realized over 2023-2024

Migration

Record migration is forecast over 2023-2024 which will shape both the house and office sector

Employment

Between February 2020 (the last 'regular' month before Covid-19 hit) and March 2023, almost 900,000 additional people are in employment in Australia with a continued tight labor market

Equilibrium Cash Rate

The question for 2023-2024 will be: Once inflation is under control, where will our equilibrium cash rate sit?

Contents

Part One:

The economic
outlook for
2023 – 2024

THE ECONOMIC OUTLOOK FOR 2023/24

As we head into the 2024 financial year, the global economic outlook is fraught with serious uncertainty.

Globally, Central Banks are in a concerted effort to get inflation back down to target levels, and almost all have tackled the problem head on with increases in local cash rates.

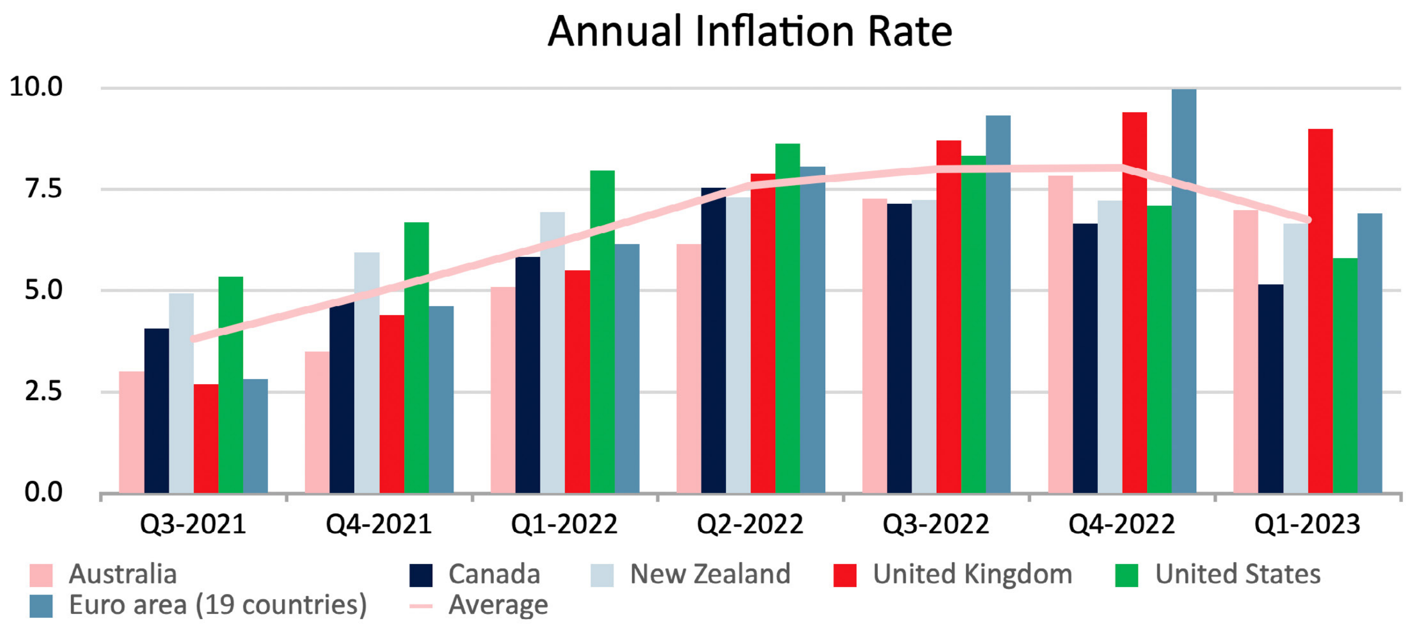
Australian commercial property industry is highly sensitive to movements in interest rates, both from a capital and occupancy perspective, making it more important than ever for investors, owners, occupiers and developers to understand the economic outlook.

Inflation

The good news, inflation has almost certainly peaked both here and across the globe. Inflation was highest in both Q2 and Q3 2022, particularly in the Euro area and the United Kingdom, which are suffering from more extreme supply side issues than the rest of the world.

However, even in these markets, inflation is reducing. In Australia, the Q1 2023 inflation rate was 7.0 per cent, and while still too high, it is now firmly on the decline. Unfortunately, services inflation is still increasing, while goods inflation has definitively peaked.

Key inputs to services inflation, such as energy costs and rents, are immune to interest rate rises (indeed, rent inflation can get worse as interest rates move higher), so unfortunately it is likely that prices in these categories will continue to increase until the supply side pressures ease.



LONG TERM INTEREST RATES

Even as markets are quite certain inflation has peaked, long term interest rates remain high. In Australia, this is measured as the 10 year bond rate, and is typically used as a measure of the 'risk free' rate when analysing commercial property returns.

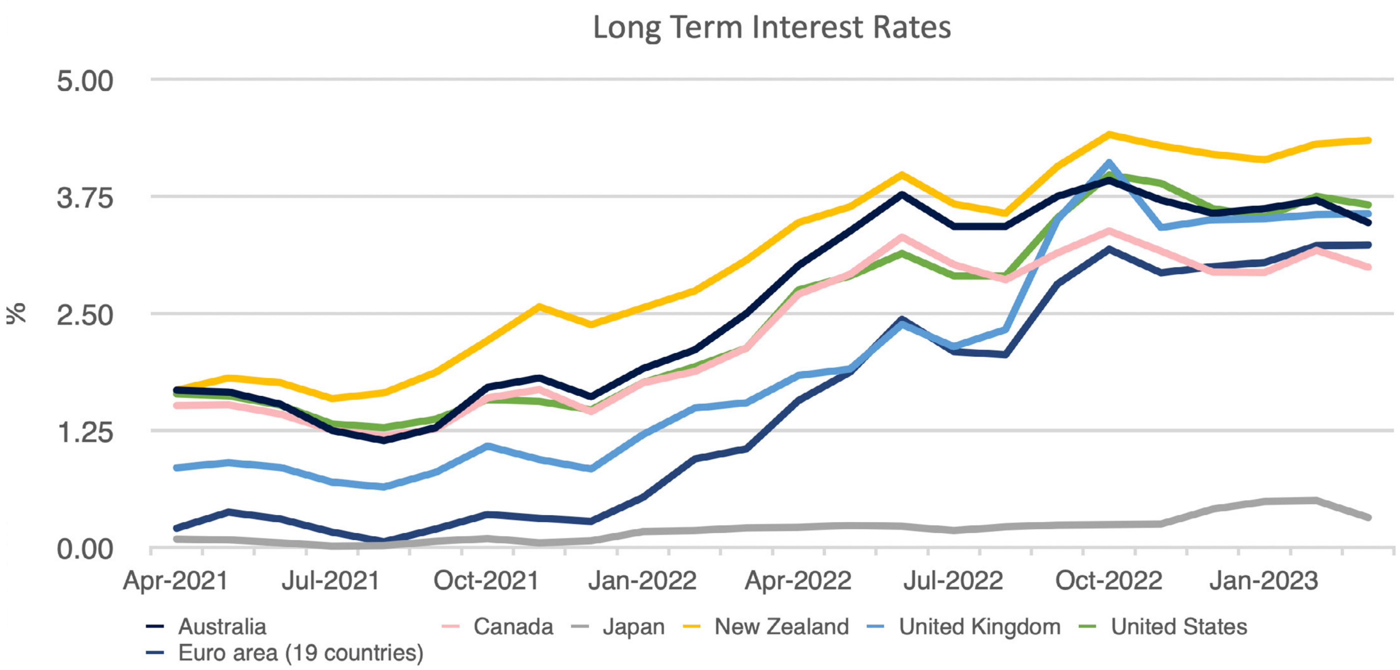
In April 2021, the 10 year bond rate in Australia was 1.68 per cent, which supported low commercial property yields. Now, the 10 year bond rate is 3.47 per cent. While this is down from a peak of 3.71 per cent in February 2023, there is no significant downward trend in long term interest rates globally. Markets remain unsure as to how long interest rates will need to remain restrictive in order to get inflation back down to target levels.

Indeed, the RBA has been exceptionally clear that getting inflation back down to the target range of 2 to 3 per cent is their ultimate goal.

The impact of high inflation and interest rates to the commercial property sector has been profound.

According to global property group JLL, Q4 2022 global investment volumes were down 58% year on year, a massive decline on the all time high set in Q4 2021. Capitalisation rates, the annual return on rental income, have increased as commercial property is deemed more risky, and investors want a higher return. However, the rate of increase has been much slower than the rate of increase in 10 year bonds, suggesting that the risk metrics are not being accurately reflected in current yields.

According to Colliers, prime grade office yields increased by 30bps since the low point in early 2022. However, over the same time period, the Australian 10 year bond rate has increased by 196 bps. Unless there is some major drop to the 10 year bond rate, which seems unlikely while inflation remains elevated (even if falling), then capitalisation rates in the commercial property sector are almost certain to increase as we receive more transactional evidence over 2023.



WHERE TO FROM HERE FOR INTEREST RATES

Australia's latest inflation rate paints a mixed bag for future cash rate movements.

One the one hand, inflation is easing. This is most certainly a positive. However, there are certain key areas that have supply side impacts that are proving difficult to get under control. While interest rates cannot control inflation in these areas (namely, energy & rents), they are clearly working to get the demand side under control.

The latest March quarter CPI data showed that prices actually declined over the quarter in the clothing and footwear (-2.6%) and Furnishings, household equipment and services (-0.5%) categories.

Despite high inflation in the services sector, there is also the 'mortgage cliff' impact to consider.

We do know that the RBA considers our cash rate (at time of writing at 4.10%) to be in restrictive territory. On balance, it is more likely that the RBA will let the current policy settings sit a little longer, as this setting probably allow them the best chance to keep a lid on unemployment for the time being.

"We have seen economy slowing and inflation coming down, the RBA will be cautious about sentiment shifts with the international financing issues being raised albeit they will unlikely impact Australia."

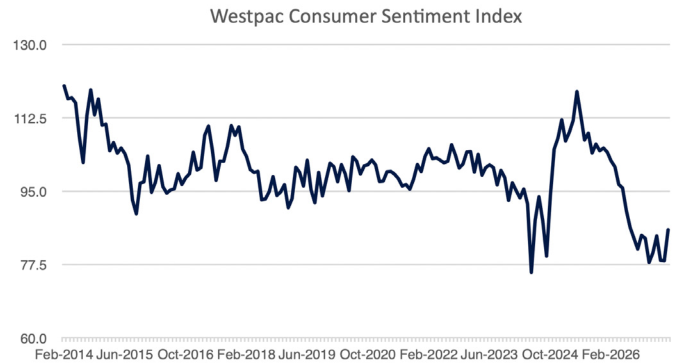
Vanessa Rader , Head of Research, Ray White Group

ECONOMIC IMPACTS ON OCCUPANCY

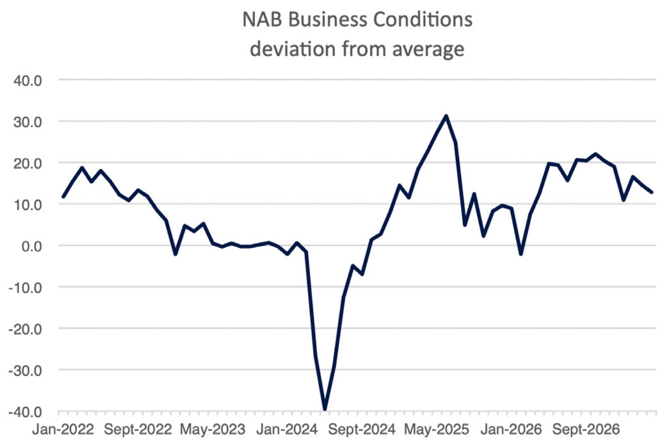
Thus far, occupancy across most asset classes has held up well, as the full impact of high interest rates has yet to be felt.

While consumer confidence has been near record lows for some time now, business conditions are faring much better. Unemployment remains near record lows, and while business confidence is falling, it is nowhere near the recessionary levels of consumer confidence.

Office vacancy rates have risen across the country, particularly in the Sydney and Melbourne CBDs, although this is mostly a result of a high level of office completions over the last 2 years.



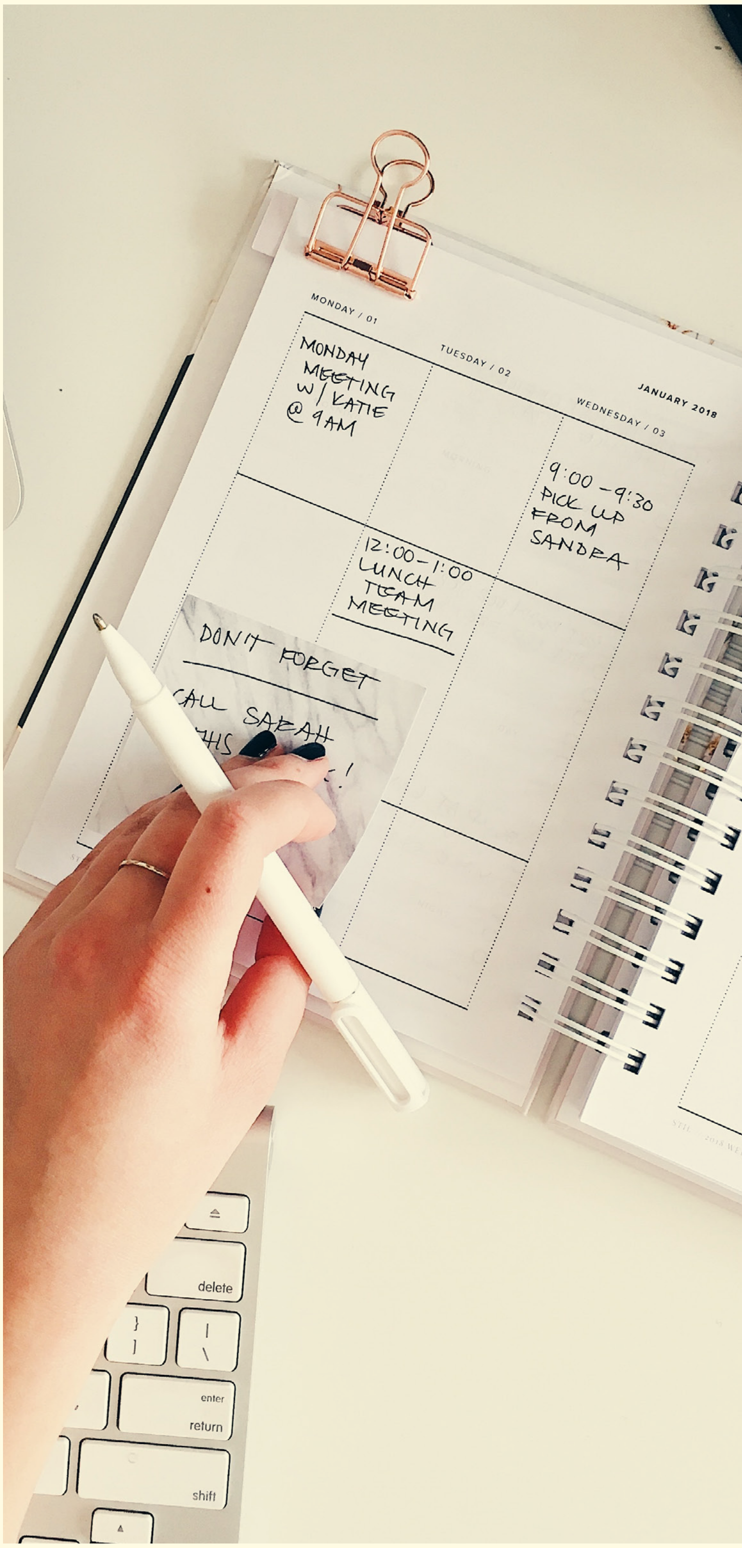
source: Westpac Consumer Confidence



source: NAB Business Conditions, RBA

Part Two:

Risks,
Disruptors
and Trends



SHORT TERM STRUCTURAL RISKS

The current economic climate, combined with the lingering societal effects of Covid-19, have created a set of economic challenges that will continue to impact the commercial property industry over the next year.

These are two-fold - a down trend in spending impact on smaller businesses and retail assets - and Australia's NetZero transition sparking a rapid refocus on Environment, Social and Governance issues.

"One of the main risks is the slowing economic environment, which could negatively impact businesses that are just starting to recover from the effects of COVID-19. This could affect the margins of smaller businesses and subsequently impact retail assets."

Mathew Tiller, Head of Research and Business Intelligence, LJ Hooker Group

"Higher interest rates and the rising cost of living are likely to contribute to decreased consumer spending on discretionary retail items this year. This is likely to increase vacancy risk in the retail sector, particularly for assets occupied by businesses operating in the discretionary retail space."

Anne Flaherty, Economist, REA Group

"ESG, this is a segment of the market making gaining traction and we are seeing property industry at the forefront and growing consulting, jobs and discussion when talking about commercial property."

Vanessa Rader, Head of Research, Ray White Group

LONG TERM STRUCTURAL DISRUPTERS

Office and retail spaces will continue to be fundamental but will change in nature.

When considering long term structural challenges, Mathew Tiller highlighted both the positive and negative challenges. 'One key trend is the continued advancements in technology and the increasing focus on employee well-being and work-life balance, which has resulted in more people working from home and a reduction in the number of working days. While this may have a negative impact on the occupancy levels of CBD office towers, it also presents an opportunity for office landlords that can adapt their assets and ensure their leases have the flexibility to benefit from this change.'

Anne Flaherty also pinpointed technology as one of the greatest disruptors to the office sector. 'Improvements in the ability of technology in connecting people could further reduce the need for office space.' She also highlighted the impact on another key commercial property sector, being CBD hotels. 'Similarly, this could reduce the need for business travel which poses a risk to hotel assets targeting business travelers.'

For the retail sector, long term structural changes in consumer shopping habits have been disrupting the sector for some time. The pandemic has only increased the speed of this change.

According to Anne Flaherty 'Retailers that don't embrace omnichannel are likely to struggle to compete against those that do. Consumers value viewing goods in person before purchasing, but increasingly are less likely to visit a store without first viewing a product online'.

The upshot? A shift in consumer behaviour towards online shopping, which is changing the way businesses use and design brick-and-mortar retail spaces. This trend is also driving significant demand for industrial space from retailers, as well as the transport and logistics industry.

Now that Australian consumers have had a good year of being able to visit shops unencumbered, as well as shop online, we can get a better idea of how consumers do prefer to shop independent of COVID-19 restrictions.

According to Australia Post's '2023 Inside Australian Online Shopping' report, Bricks and Clicks stores (that is, those with both an online and physical presence) enjoyed the most growth of all online retailers in the past year. Bricks and Clicks retailers recorded a collective 7 percentage point increase in share of online spend compared to 2019 (the last year before pandemic-influenced data), while Digital Native retailers recorded a 7-percentage point decline.

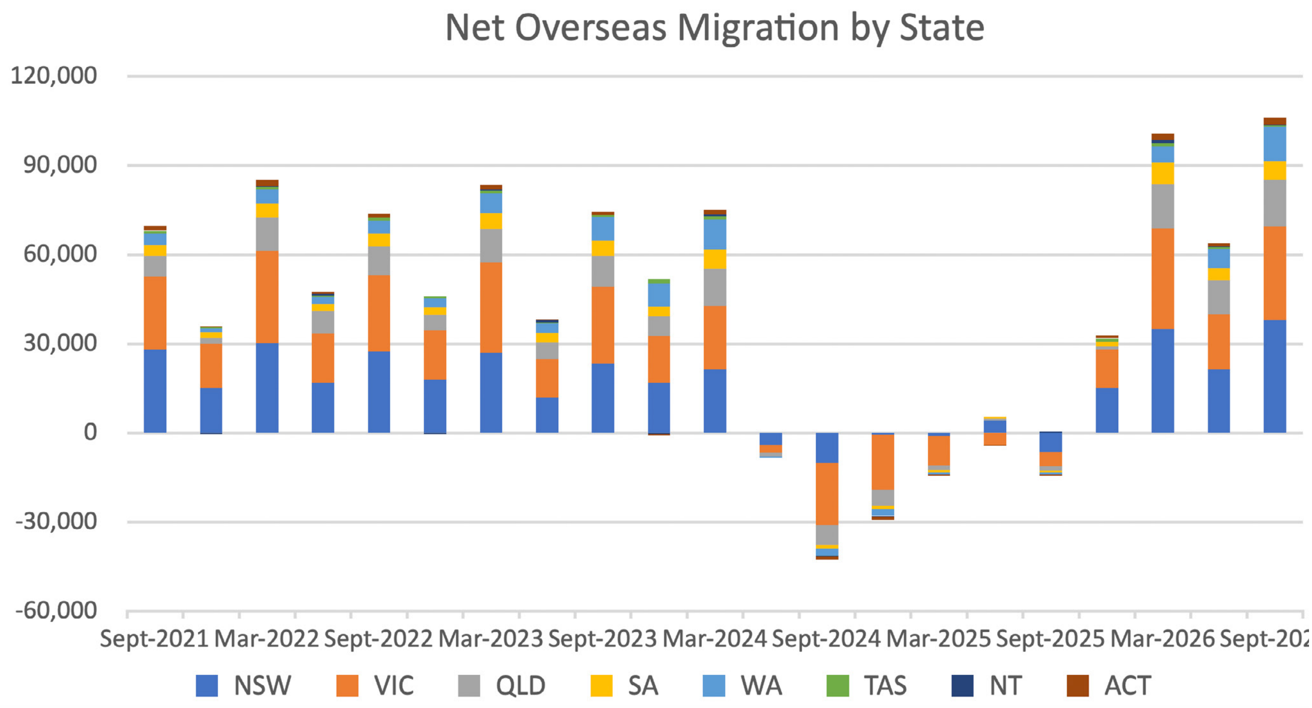
There will be a continued emphasis of physical retail spaces, despite consumers still buying many goods online.

MAJOR TRENDS
MIGRATION

One key driver of demand for commercial real estate that is extremely positive is overseas migration. This has bounced back very strongly since the re-opening of borders, and probably more strongly than most anticipated.

Both the March and September 2022 quarters were record years for net overseas migration, which is extraordinary given how strong migration was prior to the pandemic.

One key driver of demand for commercial real estate that is extremely positive is overseas migration. This has bounced back very strongly since the re-opening of borders, and probably more strongly than most anticipated.



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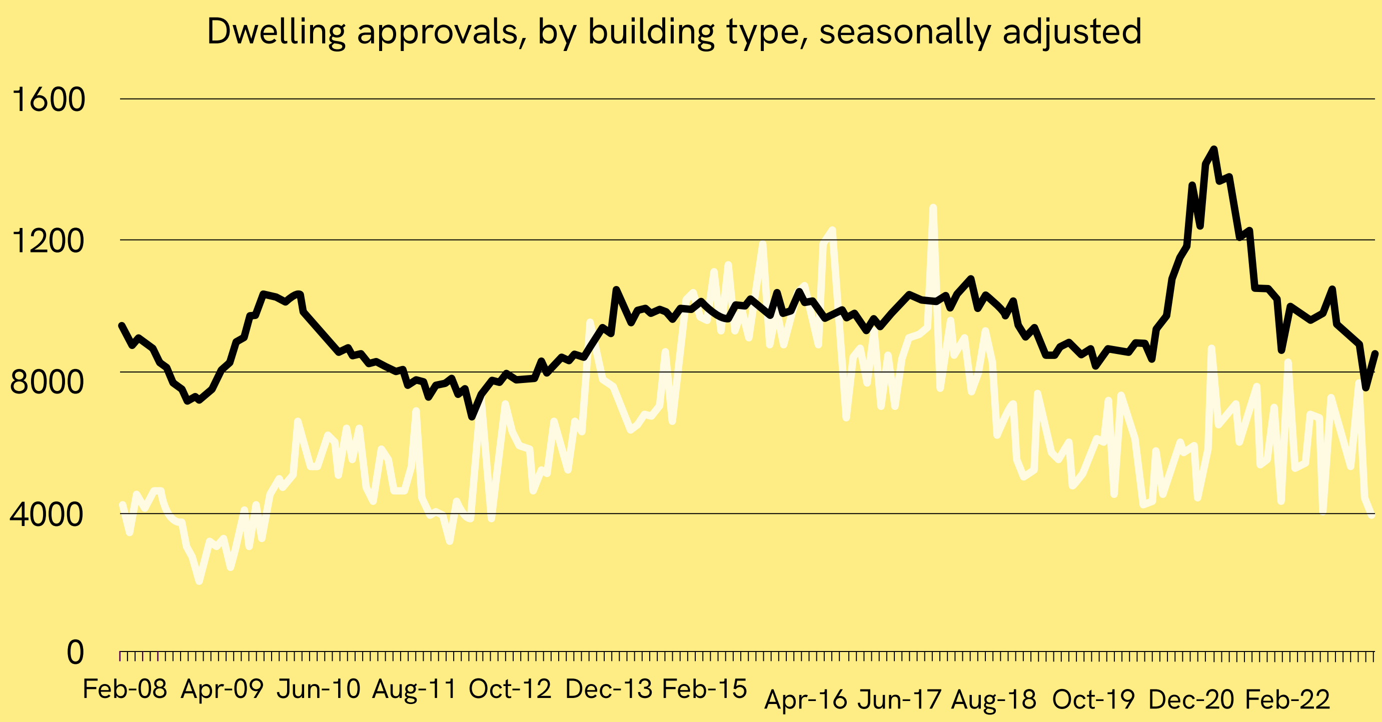


Source: ABS

MAJOR TRENDS
MIGRATION

While the housing sector has typically not been viewed as a commercial property sector, this is changing with the emergence of the Build to Rent (BTR) commercial property investment category.

The next two years will provide enormous opportunity for this sector to meet the challenges of providing additional housing stock where tenants are demanding it.

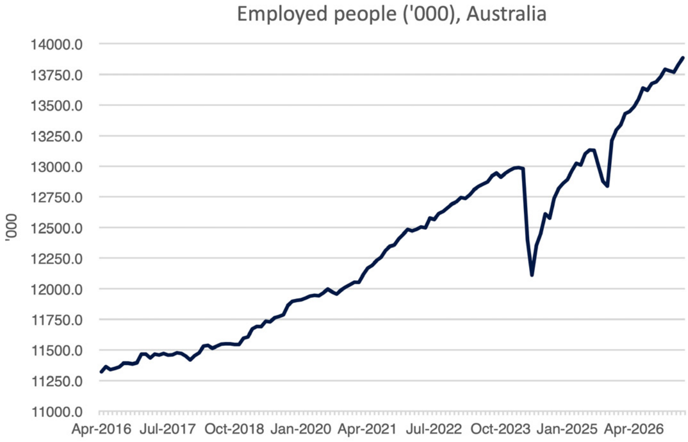
EMPLOYMENT

There has long been a strong correlation between overall employment levels, and demand for commercial office space.

Through this monetary policy tightening cycle, the employment market has remained strong, and unemployment low.

Even if higher interest rates start to have a negative impact on the unemployment rate, we are likely to still see growth in overall employment, simply due to strong migration.

Higher employment is a positive not just for the office sector, but also retail and industrial sectors as it sustains retail trade. Since November 2021, Australia has recorded a massive



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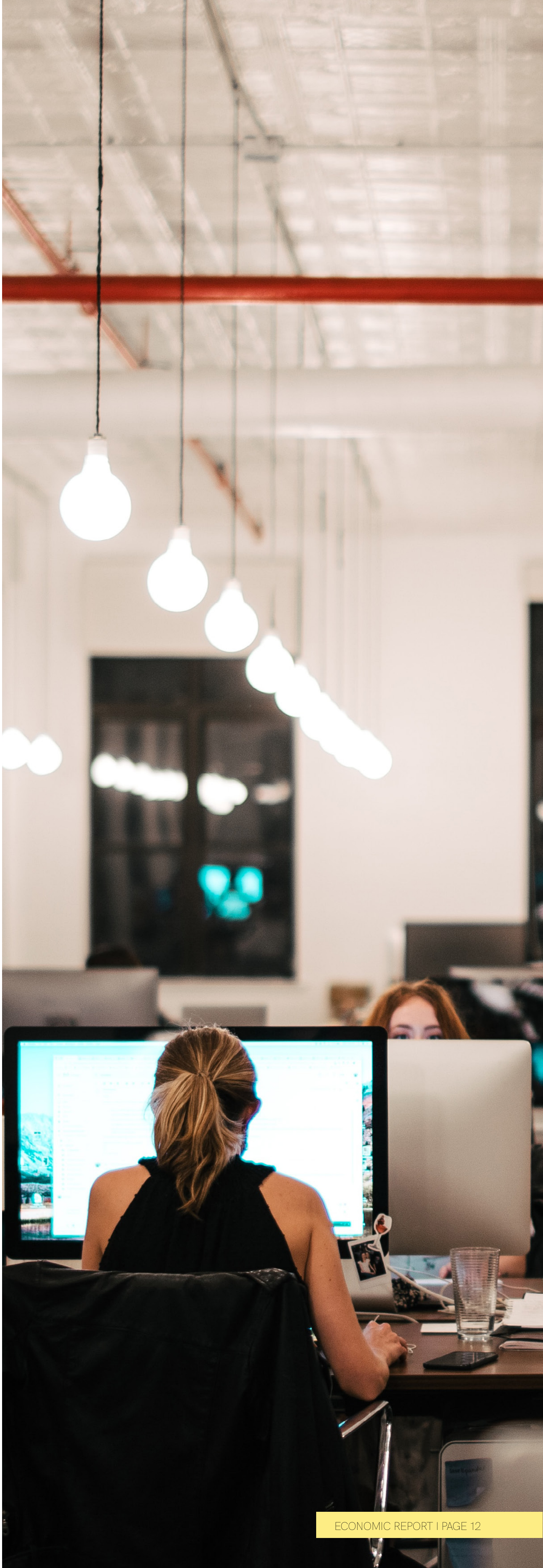


EQUILIBRIUM CASH RATES

Finally, a major long term economic impact to consider is just where interest rates are likely to settle to once inflation is under control.

Clearly, a 0.2 per cent cash rate is far too low to remain in the long term, and this setting was all about inducing demand. When asked what the long term or 'equilibrium' cash rate might be, Matthew Tiller says 'As the economic climate shifts, maintaining inflation within the 2-3% band and achieving full employment may require an equilibrium cash rate target of 2.75% to 3.25%. This projection exceeds pre-pandemic levels and reflects the structural changes in the economy since then'.

This response highlights why it is so important to consider structural changes when thinking about economic settings in the future. Further, Mathew points out a higher equilibrium cash rate may put pressure on highly leveraged properties in the short term. In the medium term, higher interest rates may lead investors to seek higher yielding assets, potentially leading to adjustments in the low yields of some Australian commercial assets'.

CONCLUSION

We look forward to providing continued industry insights and data as part of our REIA Commercial Agency Engagement Program (Project CRE).

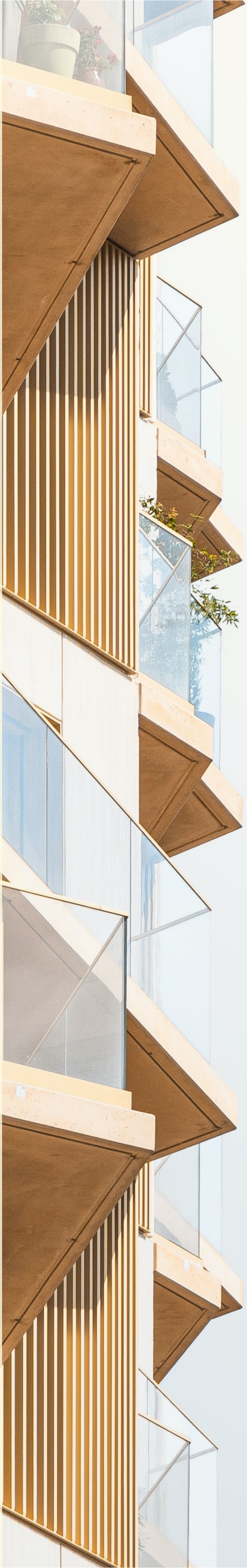
The commercial property sector is undergoing significant structural changes, where the challenges of implementation need to be balanced with the opportunities this presents.

The Australian market is one of the most innovative in the world, and we are here to help the industry work its way through these opportunities and continue to showcase to the world the latest in commercial property capability.

REPORT METHODOLOGY

In order to get a variety of perspectives on the Australian economic outlook and what it means for commercial property, we have interviewed some of Australia's leading subject matter experts. We thank the people below for their contributions:

- Vanessa Rader, Head of Research, Ray White Group
- Mathew Tiller, Head of Research & Head of Business Intelligence, LJ Hooker
- Anne Flaherty, Economist, REA Group

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