Knight Frank

NAVIGATING THE PATH TO PERFORMANCE

Outlook Report 2023

ONE

Inflation peak and greater certainty on rates outlook will restore liquidity by mid-2023

Compounding inflationary pressures have resulted in the sharpest tightening of financial conditions globally since at least 1994 and consequently, a rapid shift in the macrofinancial context underpinning property investment. As a result, property markets globally are going through a period of reduced liquidity on the path to price discovery. Higher rates are now embedded in expectations, but there remains significant uncertainty as to exactly how high they will reach and for what duration. The turning point for inflation, currently expected in early 2023, will provide greater clarity on the interest rate outlook and this is expected to restore confidence and liquidity by mid-2023.

TWO

Back to the future as yields rise to reflect the higher cost of funding, but the impact will be mild compared to past episodes

With bond yield and swap rates touching 10-year highs right along the maturity spectrum, the cost of debt has risen by over 200 basis points during 2022. On the basis that bond yields settle at around 3.5% over the next 12 months and rental growth is maintained, we expect to see a 50 basis point prime yield shift in the Sydney and Melbourne CBD office markets, and a 100 basis point rise in prime industrial markets, where yields are coming off a much lower base. To end Q3, we have already seen a 25-40 basis point rise in major office markets and a 50-75 basis point shift in industrial markets nationally. While significant, these forecast impacts are milder than in previous cycles, with sustained income growth helping to mitigate the impact of higher interest rates.

THREE

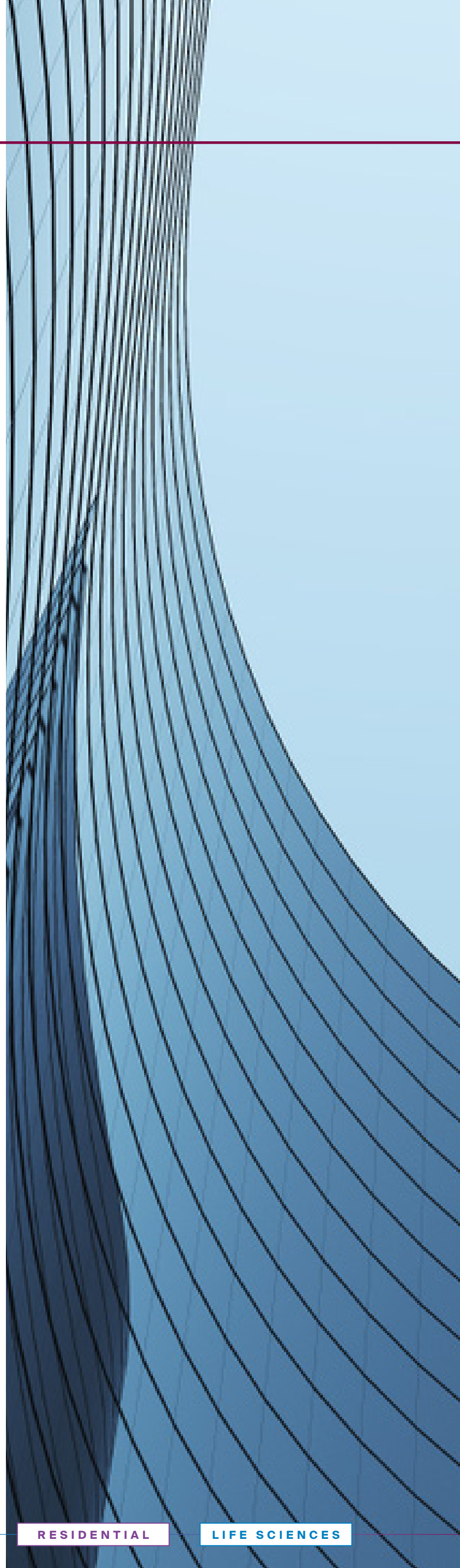
The new investment climate requires renewed focus on income growth

Over the past decade the market has seen significant yield compression across nearly all locations and property types, and so high investment returns could be achieved even in the absence of strong rental growth. In the current climate, however, the income growth equation has become more urgent. This will drive demand for emerging sectors such as life sciences. In traditional sectors, it will accentuate the evolution of new product types, such as multi-level logistics facilities and the next generation of office towers. It will also cast a spotlight on lease structures, and the ability to ratchet up rents relatively quickly in line with higher inflation. Finally, it will add to the focus on aligning with more demanding ESG criteria to safeguard long-term asset value.

FOUR

The rise of the experiential workplace will take place within grades and not just to premium assets

The term 'flight to quality' is as true as it is overused. However, it is a misconception to think that this means lower grades will inevitably suffer from limited demand. The preferred balance between cost, quality, specification and amenity will always differ across the gamut of occupiers and assets of all grades need to be optimised to remain competitive within their respective competitor set. Clever refurbishments will improve the performance of B grade buildings by capturing higher rents and reducing downtime, while no matter the grade of asset, a 'generic' or 'vanilla' property will struggle to compete with buildings consistently refreshing their offering.



FIVE

Tenants to shift into action on ESG

Knight Frank's (Y)our Space survey of over 400 global corporates observed a clear gap between ambition and action when it comes to the interplay between corporate targets and real estate decisions. Of those corporates surveyed, 40% had a net zero carbon target in place, but only 16% of those surveyed believed their commitment to net zero fundamentally changed the way they made real estate decisions. However, amidst rising energy costs and the growing focus on sustainability, we expect the gap between ambition and action to start to close in 2023. More occupiers are now bringing requirements to market with minimum sustainability requirements, and those headquartered in Europe or the UK will lead the way in putting greater weight on these issues when making their next lease commitment.

SIX

After expansion comes a period of supply chain optimisation to ensure efficiency and resilience

Across the East Coast, vacancy in industrial markets is at record lows. The shortage of space has come about as a consequence of structural change, which has required retailers and 3PLs to scale-up and has also shifted the goalposts for delivery time expectations and warehouse efficiency. While tenant demand is expected to remain robust, we anticipate the focus to shift to the strategic improvement and upgrading of the whole distribution network rather than rapid upscaling. Optimisation will encompass cost, location, design, operational and environmental considerations to maximise returns from significant recent investments in property and technology. The industrial portfolio of the future is expected to be more real-time tracked, physically distributed and flexible than ever before.

SEVEN

Structural undersupply in industrial markets will not be resolved until more developable land comes online

Undersupply in the Australian industrial market has previously been a short-lived event with relatively quick construction and planning timeframes – compared with office and retail assets – meaning imbalances are typically corrected within a year to 18 months. However, over the past two years, the strength of demand has overwhelmed the capacity of the supply-side to keep up. The market will welcome a record year for development completions in 2023, led by Brisbane and Melbourne, but this is still likely to be insufficient to restore a more normal balance between supply and demand, particularly in Sydney, with an equilibrium unlikely to be restored until a larger quantum of developable land comes online in 2024-25. With tight supply set to continue, we expect further rental uplift, but at a slower pace than the frenetic speed of 2022.

EIGHT

Rising investor demand for life sciences and healthcare assets

Investor interest in life sciences is growing rapidly as many have realised the sector's future potential and are now forming strategies to scale up their involvement. Given the limited existence of 'pure play' life sciences assets, investors are also screening for build-to-core opportunities, as well as prospects in adjacent sectors, with a broad focus spanning clinical research and production through to purpose-built healthcare infrastructure such as 'medi-hotels'. We expect to see a sustained depth of capital targeting the healthcare sector during 2023, and the current macro headwinds are likely to generate opportunities as some operators seek to offload non-core real estate assets to reinvest in their underlying business.

NINE

Availability of accurate data and understanding the right financial model will unlock development in new life sciences precincts

Australia has a shortage of high-quality, bespoke infrastructure to meet the needs of homegrown start-up ventures in clinical research and pharmaceutical industries. Despite a widespread desire on the part of investors to deploy capital into the sector, the specific needs of potential tenants have often been misunderstood. Key to bridging the gap and unlocking the development of new facilities is increasing the currently limited data on supply and demand, industry performance and occupational metrics such as typical lease terms and anticipated market rents. Over time, this will firm up market confidence by creating a better understanding of the sector and enable investors and developers to make firmer commitments to deliver the right stock in mixed-use precincts catering to the needs of tenants and the wider life sciences ecosystem.

TEN

Focus shifts from capital gains to rental return in residential markets

Residential property values are likely to ease further in 2023 across all capital city markets, although regional areas of Australia are still expected to experience positive annual growth. On the other hand, rental markets are experiencing severe supply shortages and rapid rental growth is expected to continue, with double-digit growth expected in 2023 for 11 of the 14 major residential markets across Australia. Sustained rental growth has allowed for much more attractive gross rental yields to emerge. This will continue in 2023 and higher yields will help restore investor demand and, over time, boost the currently subdued development pipeline.

ECONOMY & CAPITAL MARKETS

Back to the future

Inflation peak and greater certainty on rates outlook will restore liquidity by mid-2023

The global economic outlook is clouded by the highest inflation since at least the early 1990s, with cost of living pressures, the consequent tightening of financial conditions, the lingering effect of the pandemic and a de facto war in Europe all weighing on growth.

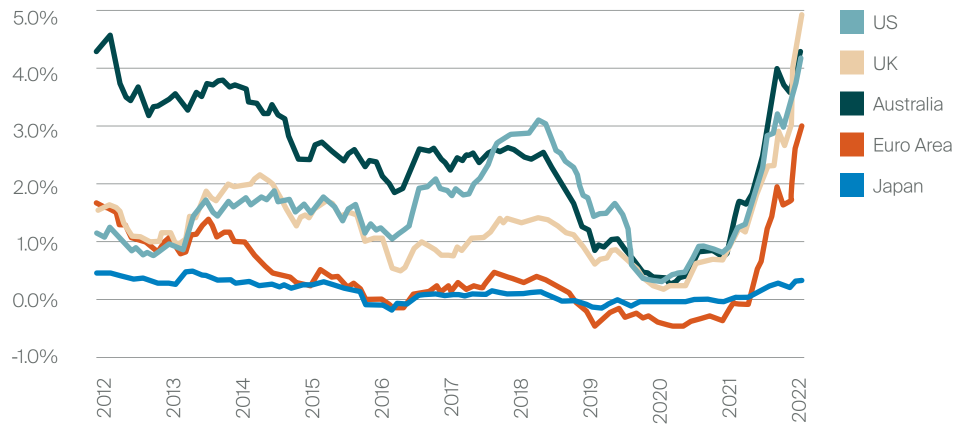
The rise in inflation can be viewed as the combined impact of several forces that have played out in sequence. It had its genesis in the shutdown of certain industries resulting in supply chain disruption during the pandemic, and this was then overlayed with the boost to consumer demand caused by fiscal stimulus packages in all major economies, and the switch in spending from services to goods. This phase is gradually abating, as evidenced by the falling cost of key global barometers including freight shipping rates and an easing in the shortage of semiconductors, which was a major cause of price pressures during the pandemic.

The next phase has centred on rising energy prices and this will keep inflation high in coming months even as supply chain pressures ease. The final, and more uncertain phase, will be the residual impact on inflation psychology and central banks will be keen to maintain stern rhetoric to ensure that this does not become embedded.

These compounding pressures have resulted in the sharpest tightening of financial conditions globally since at least 1994 and consequently, a rapid shift in the macrofinancial context underpinning property investment. Markets are going through a period of reduced liquidity as investors pause on the path to renewed price discovery, with Q3 investment volumes well down on last year across all major global markets including Australia.

Higher rates are now embedded in expectations, but there remains significant uncertainty as to exactly how high they will reach and for what duration. As 2023 progresses we can expect clearer answers, with a turning point on inflation – currently expected in early 2023 – likely to coincide with greater clarity on the outlook for interest rates. While inflation will take time to subside, a shared understanding that the peak has been reached, even if there will remain divergent views on the outlook, will go a long way to restoring confidence and liquidity globally and in Australia.

5-YEAR SWAP RATES



Source: Knight Frank Research, Macrobond

GLOBAL INFLATION RATES HISTORIC & FORECAST

Source: Knight Frank Research, IMF

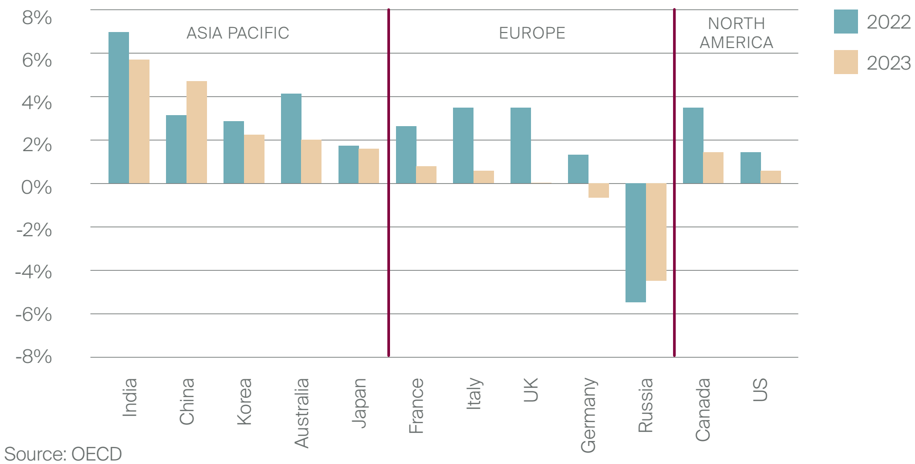
Australia will outperform amidst looming downturn and remain a global safe-haven for global investors

Given the pressures of higher rates and the outlook for growth to slow, it is easy to overlook the fact that, viewed through a global lens, Australia stands out as a beacon of relative calm. The domestic economy retains significant growth momentum heading into 2023, as reflected in the latest forecasts from the OECD and IMF. A key reason for this is our position as a major commodity exporter, which provides a substantial offset to the looming pressures on growth arising from the anticipated moderation in household spending.

In addition, our track record of stability and long-term growth has cemented our reputation as a safe-haven investment destination, as evidenced by our consistent standing as the sixth most actively traded investment market globally, behind only the US, UK, Germany, Japan and France – all much larger economies.

While not immune from global economic and market pressures, underlying demand for Australian real estate remains high with investors repeatedly nominating Australian cities as their top targets when executing an Asia Pacific investment strategy across multiple sectors, as highlighted by the annual ANREV survey on global investor intentions. This will help to mitigate against downside risks in the near term and underpin a resurgence in demand once conditions settle, especially when set against the backdrop of Australian dollar depreciation which will bolster demand from US and Singaporean investors.

GLOBAL ECONOMIC OUTLOOK GDP GROWTH FORECASTS



Source: OECD

MOST FAVOURED APAC CITY/SECTOR COMBINATIONS BY YEAR

	#1	#2	#3
2022	TOKYO BTR	SYDNEY INDUSTRIAL TOKYO INDUSTRIAL	SEOUL INDUSTRIAL
2021	SYDNEY INDUSTRIAL	MELBOURNE INDUSTRIAL	TOKYO BTR
2020	MELBOURNE OFFICE	SYDNEY OFFICE	TOKYO BTR
2019	MELBOURNE OFFICE	SYDNEY OFFICE	SYDNEY INDUSTRIAL
2018	SYDNEY OFFICE	MELBOURNE OFFICE	SYDNEY INDUSTRIAL
2017	SYDNEY OFFICE	MELBOURNE OFFICE	SYDNEY RETAIL

Source: ANREV Investor Intentions Survey 2022

Back to the future – yields rise to reflect the higher cost of funding, but the impact will be mild compared to past episodes

With benchmark interest rates touching 10-year highs right along the maturity spectrum, the cost of debt has risen by well over 200 basis points during 2022. Higher rates take effect across multiple channels, resulting in higher funding costs for leveraged buyers, higher hedging costs for overseas investors, and higher returns on alternative fixed income investments. The combination of these factors is now taking effect on property markets, although it is yet to fully play out.

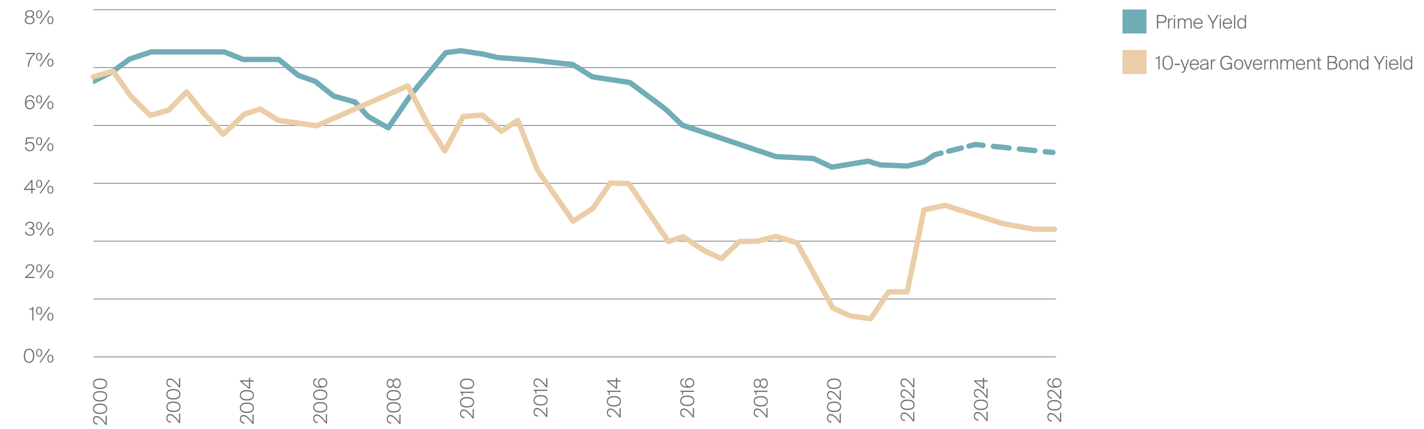
This begs the question as to how far yields will rise, which as ever, depends on multiple factors. In modelling the likely impact of the new environment, we consider the key factors with a demonstrated long-term relationship between property pricing, specifically the interest rates – as proxied by the 10-year bond yield – and the strength of rental growth.

On the basis that bond yields settle at around 3.5% over the next 12 months – much closer to historic averages than the very low rates of 2019-21 – and rental growth is maintained, we expect to see prime yields rise by 50 basis points on average in the Sydney and Melbourne CBD office markets. In industrial markets, where prime yields are much lower, we expect to see a 100 basis point rise. To end Q3, we have already seen a 25-40 basis point rise in major office markets and a 50-75 basis point shift in industrial markets. Part of the outward shift could well be clawed back in 2024-25 if central banks revert to rate cuts at that time, as widely anticipated.

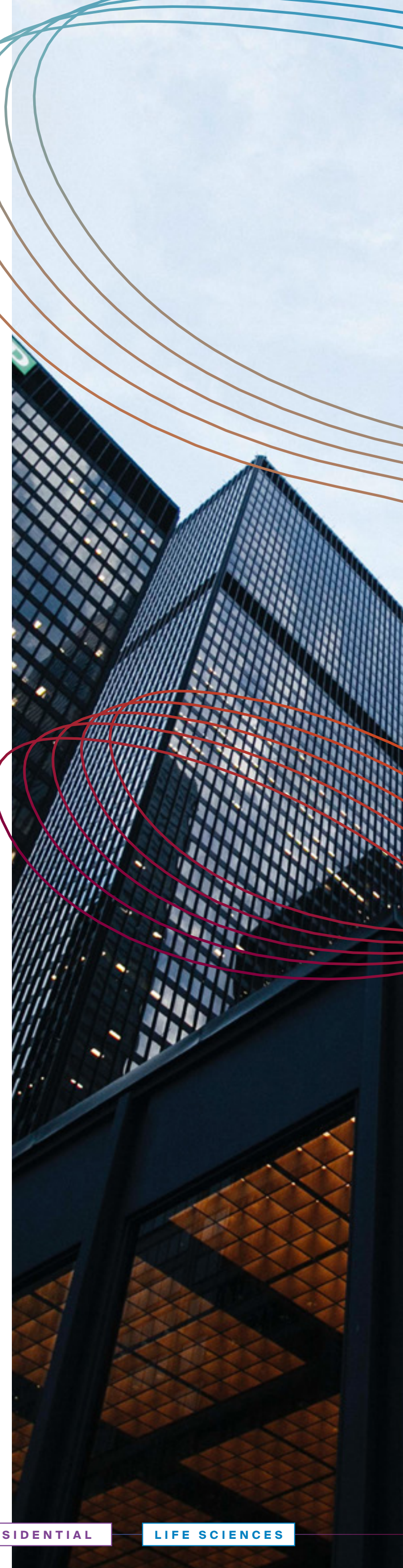
While higher yields detract from property values, the strength of rental growth is another key determinant, and this is acting to offset these macro headwinds. In industrial markets, in particular, surging rental growth is providing a powerful counterpoint to outward yield shifts, and to date this has been sufficient to offset them and allow capital values to continue to hold firm. In office markets as well, a return to rental growth has helped to support values, particularly for prime assets in major CBDs. At present, the current cycle appears different to past episodes including the GFC and early 1990s, which saw declining rents and greater exposure to accentuate the impact on property yields.

Related to this, it is important to note that the forecast average impact will not apply uniformly across all markets or all assets within a given market. Markets with a stronger rental growth outlook will tend to see less outward yield shift, while assets with inflation-linked income are also better placed to navigate the current environment. An additional consideration is scarcity; 'trophy' assets that are the exemplar schemes within a given market and infrequently traded are likely to see less yield shift. On the other hand, markets and assets that are perceived by investors to lack realistic prospects of rental and income growth in the near term may see a sharper yield adjustment.

FORECAST PRIME YIELD SYDNEY CBD OFFICES



Source: Knight Frank Research



The new investment climate requires renewed focus on income growth

The offsetting influence of rental performance is a reminder that total return as proxied by IRR is a more complete metric against which to gauge the impact of higher long-term interest rates – compared to an equivalent yield – in that it encapsulates the outlook for income growth as a key determinant of property value. With higher risk-free rates on offer to investors, required returns and hence target IRRs will rise, but this will have a divergent impact on yields depending on the income growth outlook.

As our yield modelling results clearly demonstrate, the relationship between property yields and bond yields is by no means one-to-one and is heavily moderated by the strength of rental growth. Assets with strong prospects of growth will require a smaller yield adjustment to maintain a given IRR, while assets with little prospect of growth will require a much larger yield shift.

While this has always been true, over the past decade the market has seen significant yield compression across nearly all locations and property types, and so high investment returns could be achieved even in the absence of strong rental growth. In the current climate, however, the growth equation has become more urgent, and we expect a renewed focus on achieving income growth to guide investor strategy and asset selection during 2023.

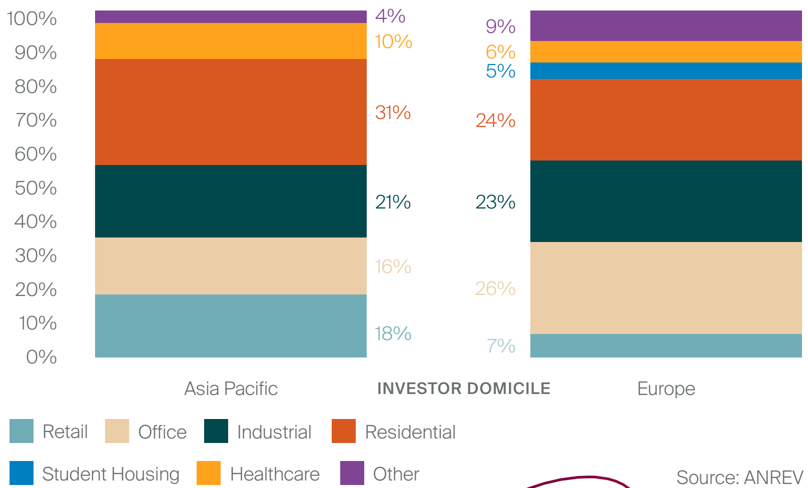
This search for growth will shape the outlook for 2023 across several dimensions. It will drive demand for emerging sectors such as life sciences and the wider healthcare space, where demographic and behavioural trends point to the need for more investable stock.

In traditional sectors, it will accentuate the evolution of new product types, such as multi-level logistics facilities in infill locations and the next generation of new office towers providing ultimate flexibility and heightened tenant experience and engagement.

It will also cast a spotlight on lease structures and the ability to ratchet up rents relatively quickly in line with higher inflation. This is a key thematic underpinning the rise of build-to-rent, which is keenly sought by global investors seeking to diversify.

Finally, it will add to the focus on aligning with more demanding ESG criteria to safeguard long-term asset value through maintaining access to the widest possible pool of tenants and investors over the next decade and beyond.

COMPOSITION OF PLANNED CAPITAL DEPLOYMENTS



Source: ANREV

Differential impact on prime and secondary assets as risk premia reasserts across all asset classes

While secondary property is often cast in one basket and labelled as having underperformed, over the past decade this has not been true. Secondary asset values have at least kept up with their prime counterparts and in some cases outperformed by a significant margin. Witness the average capital growth of Sydney office assets according to the MSCI benchmark – B, C and D graded assets have averaged 8.5% capital growth over the past decade while prime assets have averaged 5.9%.

Over this period, the low interest rate environment drove down secondary yields and tended to compress risk premia, while rental growth performance has not varied substantially. However, with interest rates rising, the price of risk is re-emerging across all asset classes. In government bond markets, we see this in the rise of the term premium – the part of a long-term yield attributable to the compensation required for committing to a fixed-income asset over a long period and thereby, subject to the risk that unexpected fluctuations in inflation and interest rates will erode the real return. We also see it in the recent widening of corporate bond spreads between higher and lower rated credit.

The clear lesson for property is that we should expect the price of risk to reassert through a widening of the average spread between prime and secondary, unwinding some of the compression seen in recent years.

TERM PREMIUM 10-YEAR BOND YIELD

Source: Australian Office of Financial Management

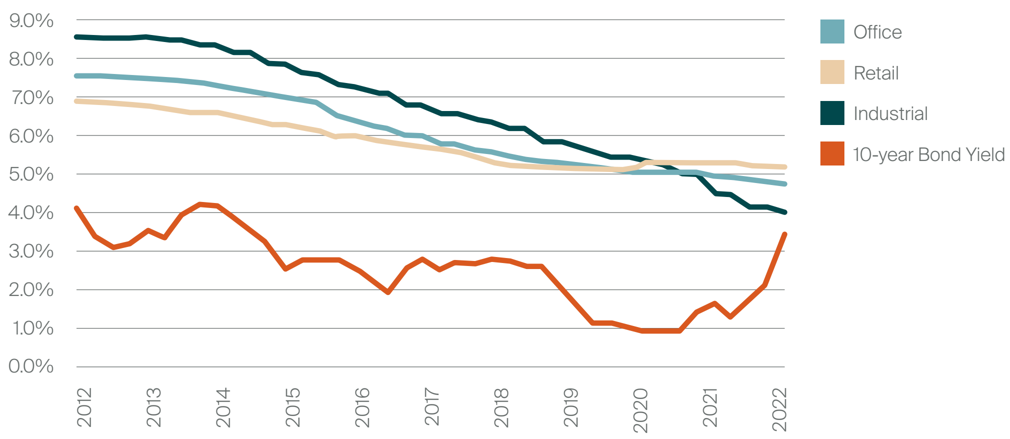
Sector divergence to contract as retail mounts a comeback

A historically wide divergence in performance has characterised the major sectors over the past five years, with retail assets suffering at the hands of the structural shift to online, while industrial assets have substantially outperformed for similar reasons. Total returns in industrial markets averaged 16.4% over the past five years, while retail averaged 2.3%.

The resulting shift in pricing means that industrial yields are now much lower than retail and embed the expectation of much stronger growth. To date, this has been borne out of the strength of rental performance, with industrial rents rising very rapidly over the past year and offsetting the impact of outward yield shift. However, the shifting environment is acting to change the dynamic, and retail is likely to be less exposed to outward yield shift given a much higher starting point. In addition, the strength of retail spending has been supportive, and amidst higher inflation the lease structure of retail assets is in many cases more amenable to translate higher inflation into income growth.

Both of these forces will act to narrow the wide divergence between the sectors. Instead, we expect asset quality to be a better guide to near term prospects across all sectors, with fewer investors likely to pursue a sector specific strategy to the exclusion of retail.

PROPERTY YIELDS & BOND YIELDS



Source: Knight Frank Research, MSCI

OFFICE

Rise of the experiential workplace

No one way street: diversity of response to workplace change

Nearly three years on from the onset of the pandemic and after much debate about the future of work and workplace, where have we landed? The initial gut reaction from many corporates was that new ways of working would see them shedding floorspace, but since then, it has become clear that assessing future workplace needs is complex and that there is no one-size-fits-all solution.

Globally and in Australia, we see a diverse response from occupiers, as anticipated in Knight Frank's global (Y)our Space publication. Some occupiers have been willing to embrace rapid change and have actively promoted remote working practices to their employee base. The tech sector has been at the vanguard here, with greater willingness to adopt remote working models. At the other end of the spectrum, a number of global corporates have firmed their stance to reinforce the primacy of the office. Most Australian corporates have expressed a willingness to embrace hybrid working but are wary of moving too quickly and are keen to ensure that culture and collaboration are not compromised.

The diversity of response and the preference for a longer-term evaluation of employee preferences and workspace needs implies that these shifts will take years to play out, allowing the market time to adapt. The resulting shift in the quantum of demand is likely to be less than was feared during the pandemic, and disruption is more likely to play out through shifts to the form and function of office space.

OFFICE	BLACKROCK	GOLDMAN SACHS	NETFLIX
OFFICE CENTRIC	SALESFORCE	CSL	CROWN RESORTS
HYBRID	WESTPAC	COMMONWEALTH BANK	CANVA
REMOTE CENTRIC	FACEBOOK	TELSTRA	ATLASSIAN
FULLY REMOTE	SLACK	TWITTER	SPOTIFY

Expectations increasing: experience is the new amenity

Occupier expectations of the workplace have continued to evolve as the desire to provide employees with a rounded experience grows. Occupiers increasingly expect a curated, ever-changing and hands-on approach from building owners to provide experiences and opportunities for building occupants. This ongoing program and relationship is very different from providing static space, no matter how well designed.

Landlords, particularly those who have substantial adjoining assets, will increasingly take a lead from major tech and innovation campuses by creating interconnected neighbourhoods or precincts that provide the opportunity for dining, entertainment, retail, education, networking, allied services and wellness. Scheduled events, drawcard venues and a sense of vibrancy that comes from being among likeminded people from not only within the same company or industry creates a sense of community. This is the new 'bump factor', not just within one business, but on a wider industry, interests and city level.

The shared space and aligned food and beverage offer for office assets is being extended through the evolution of co-working and 'club' tenants such as Soho House and 1880, which lease space and also provide curated services exclusively to building tenants and members.

Already retreating before the pandemic, the trend of a cavernous, silent, stone façade lobby is being replaced by the polar opposite – a more lively, vibrant and inviting space to mix, mingle and work. The ubiquitous lobby coffee shop is moving from the back corner to a central position and will be increasingly required to provide an all-day schedule from breakfast through to after work drinks. Dock72 in Brooklyn is a recent overseas example of an asset that has been heavily amenitised, partly to counteract its pioneering location, with a rooftop conference centre, podium level tenant lounge/meeting rooms, wellness centre and an outdoor terrace with basketball court curated by foundation building tenant, WeWork.

Experience is not just the responsibility of the landlord, and tenants are bringing similar ideas to their own space. An emerging trend is the demand for ultimate flexibility achieved through an adaptable workplace. This requires flexible fitouts which can be easily and quickly reconfigured as needed through the creation and breaking down of specific project spaces across the entire workplace as required. Treating some walls like furniture and allowing for such adaptation also has an environmental benefit of re-use rather than demolition if a layout no longer suits the tenant's needs. Recent examples include Mirvac's piloting of fully moveable desk layouts at its Sydney HQ and Macquarie's aspiration to employ flexible project-based layouts at 1 Elizabeth Street, Sydney.

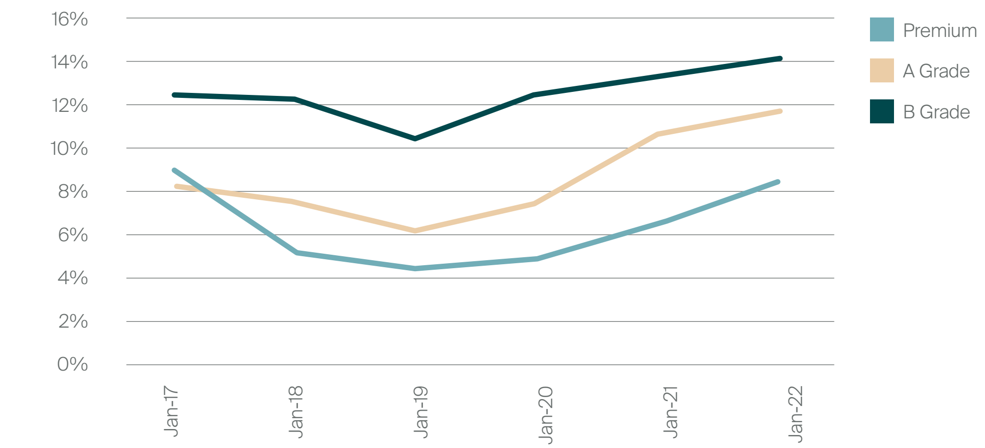
Flight to quality will take place within grades and not just to premium assets

The term 'flight to quality' is as true as it is overused. There is no doubt that tenants are seeking more from the space they rent to run their businesses efficiently and retain and attract staff. Upon relocation it is rare that a tenant will downgrade its location, building grade or fitout quality. This means innovation is always required to raise the bar and it is only natural that the best-in-class asset grade of premium has the greatest demand. Through the pandemic premium take-up remained strong, with its net absorption clearly outpacing all other markets.

It is a misconception, however, to think that this means lower grades will inevitably suffer from limited demand. Not every tenant has the desire or ability to pay premium rents and their space requirements can be well supported by A or B grade – indeed, in contrast with widespread perception, A grade assets have actually seen a sharper increase in vacancy on average than B grade during the pandemic. The preferred balance between cost, quality, specification and amenity will always differ across the gamut of occupiers within an office market and a healthy market will have a wide range of options across different price points.

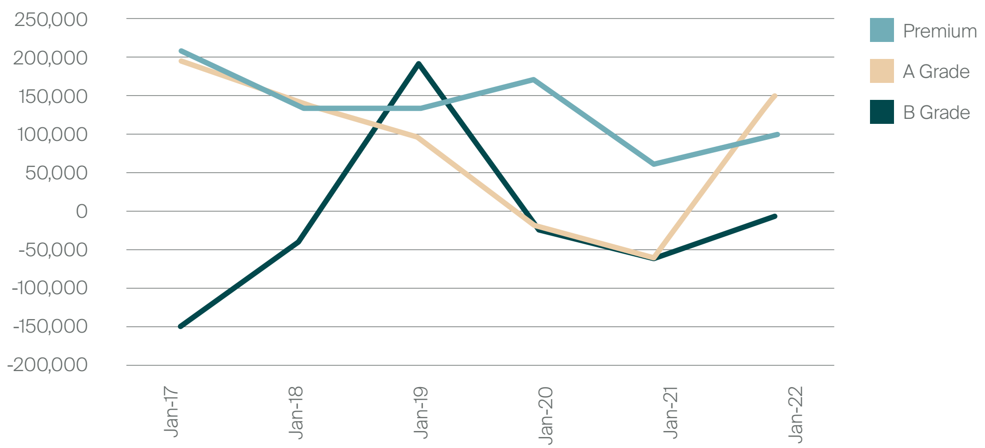
Assets of all grades, therefore, need to be cleverly optimised to remain competitive within their respective competitor set. Consistently, even through the pandemic, it has been shown that clever refurbishments have improved the performance of B grade buildings and provided sound return on investment by capturing higher rents and reducing downtime. No matter the grade of asset, a 'generic' or 'vanilla' property will struggle to compete with buildings consistently refreshing their offering and in this market, with elevated vacancy and numerous sub-lease options, asset performance will suffer.

AUSTRALIAN CBDS VACANCY RATE



Source: Knight Frank Research, PCA

AUSTRALIAN CBDS ANNUAL NET ABSORPTION



Source: Knight Frank Research, PCA

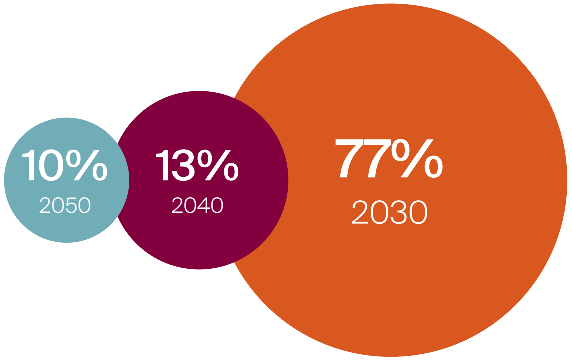
Tenants to shift into action on ESG

With the built environment making a substantial contribution to global carbon emissions, it seems only natural that corporate strategies to implement and adapt to net zero targets would include a clear focus on real estate utilisation allied to an analysis of how to drive down emissions at an operational level. However, Knight Frank's (Y)our Space survey of over 400 global corporates observed a clear gap between ambition and action when it comes to the interplay between corporate targets and real estate decisions.

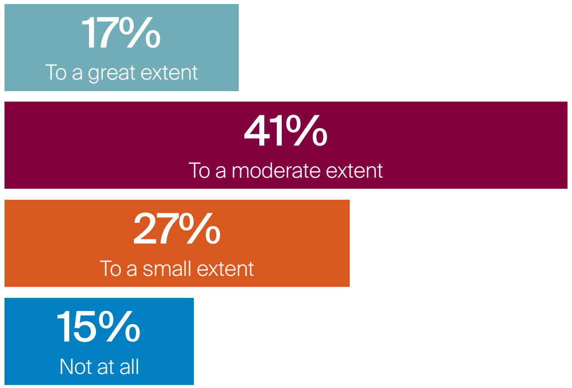
Of those corporates surveyed, 40% had a net zero carbon target in place and 77% of these had set an ambitious target date of 2030 – less than eight years from now. Only 16% of those surveyed believed their commitment to net zero fundamentally changed the way they made real estate decisions, while close to 60% had less than 10% of their global portfolios in accredited buildings. The disconnect between wider corporate sustainability concerns and future real estate strategy highlights how occupiers lag behind investors in their appreciation of the importance of the ESG challenge.

Amidst rising energy costs and the growing focus on sustainability, we expect the gap between ambition and action to further close in 2023. While occupiers have long included energy and sustainability minimum benchmarks in their requirements, these elements have not always been the key decision metrics, but this is beginning to change and those headquartered in Europe or the UK will lead the way in putting greater weight on these issues when making their next lease commitment.

Q DOES YOUR COMPANY HAVE A NET ZERO CARBON TARGET?



Q TO WHAT EXTENT DO YOU BELIEVE YOUR COMPANY'S COMMITMENT TO NET ZERO CARBON TARGETS WILL CHANGE YOUR REAL ESTATE CHOICES?



Source: Knight Frank Research

"Among businesses that espouse a positive ESG focus, there is a clear gap between ambition and action"

DR LEE ELLIOTT
Global Head of Occupier Research
Knight Frank

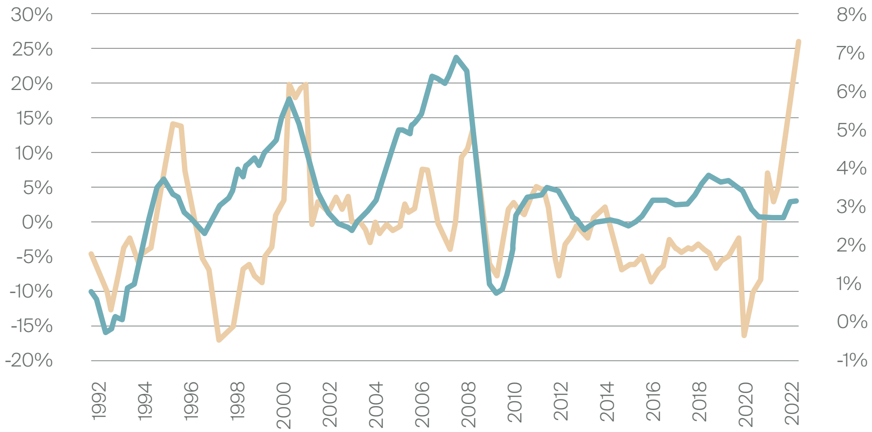
Will office rents respond to higher inflation?

It is often said that real estate fares well in an environment of high inflation. This view is underpinned by the belief that rents are closely correlated with inflation and hence, that they will keep pace as price pressures mount across the economy; but does historic experience reflect this?

Our analysis suggests that the answer to this is both yes and no. Rents are correlated to inflation to some degree, but the relationship is not particularly strong, with most markets showing a positive correlation between rental growth rates and CPI inflation of 0.2 - 0.5. However, more importantly, there is strong evidence that rents do keep pace with inflation over the long-term, and in most cases have grown much more strongly. Rents ultimately respond to the dynamics of demand and supply, but cost pressure across the economy have a bearing on both sides of the equation – clearly nominal rents must rise to keep real rents at the same level, while periods of high inflation tend to coincide with periods of strong demand and hence, rental growth.

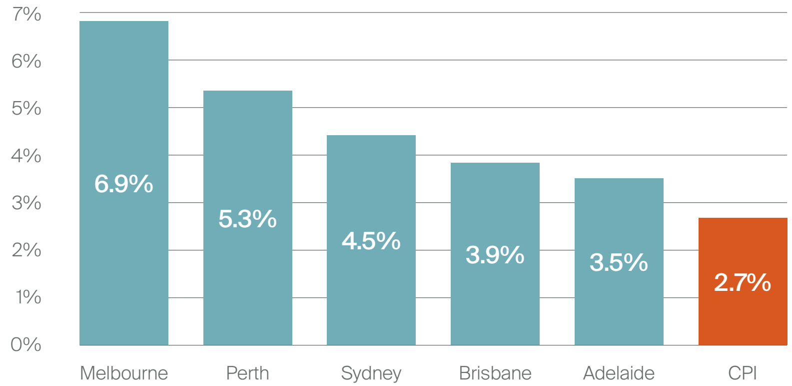
The timing of growth may not closely mirror the path of CPI, but the old adage that real estate acts as an inflation hedge remains true over the long-term.

OFFICE RENT GROWTH & CPI INFLATION



Source: Knight Frank Research, ABS

AVERAGE GROWTH OVER THE PAST 25 YEARS
PRIME OFFICE RENTS VS CPI INFLATION



Source: Knight Frank Research, ABS

INDUSTRIAL

Adapting to the supply crunch

As global supply chain issues begin to ease, with the container freight cost indexes back down to late 2020 levels, the industrial market in Australia is facing a different kind of supply issue: an acute shortage of space for near term or imminent occupation. This is forcing adaptation from both occupiers and developers as they seek to navigate unprecedented market conditions.

After expansion comes a period of optimisation to ensure efficiency and resilience

Across the East Coast, vacancy is at record lows. Much of the currently tracked 'available' space is still under construction with very limited existing stock available. As a result, lease deals are increasingly being negotiated 6-18 months in advance for existing space – an extended timeframe which use to be reserved for new construction.

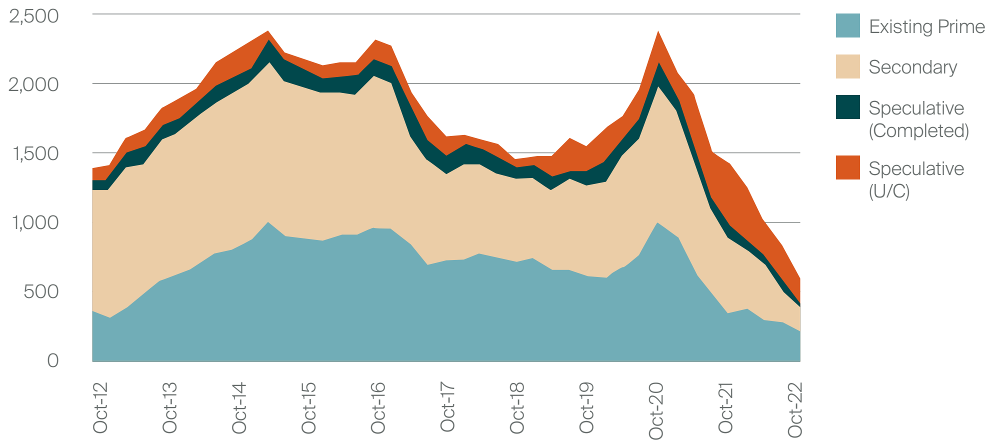
The shortage of space has come about as a consequence of structural change across the retail landscape which has required retailers and 3PLs to scale-up and has also shifted the goalposts for delivery time expectations and warehouse efficiency. This was well in train even before the pandemic, but as the supply chain ground to a halt in 2020, retail and wholesale traders also sought to scale up to mitigate risk through higher inventory levels.

While tenant demand is expected to remain robust, there are signs emerging locally and globally that the rapid upscaling of industrial footprints driven by ecommerce, particularly from 3PLs and retailers, will start slow as the step-change to grow scale starts to moderate. Instead, the focus will shift to strategic improvement and upgrading of the whole distribution network.

Optimisation will encompass cost, location, design, operational and environmental considerations to maximise returns from significant investments in property and technology. This is likely to see major players continue to vacate older buildings and focus on more efficient facilities which are designed for automated warehouse systems and can maintain higher sustainability ratings. Efficiency of the warehouse, stock control and transport costs will all come under greater focus as cost cutting returns to the fore to sustain margins in a tougher economic environment. At the same time, the need to document carbon emissions as well as reduce transport cost and time parameters will see location continue to be a driving force in efficiency and environmental considerations, further boosting brownfield development and existing asset refurbishment in inner and middle ring locations.

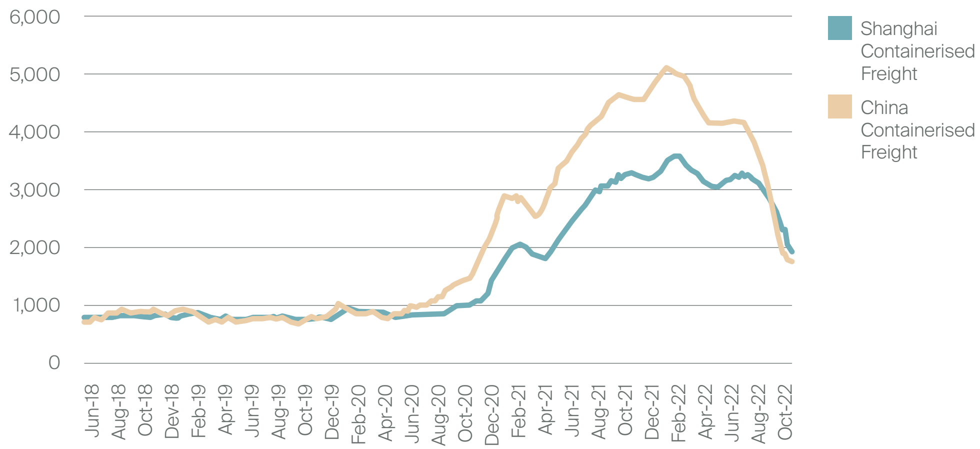
Greater weight is also being given to factors of business resilience like the exposure of the asset or road and rail network to potential flooding or fire, and exposure of assets to damage from natural disasters such as hail and wind. These questions are being asked not only for the portfolio of assets occupied, but also those of suppliers. There is the potential to move to a more distributed network of warehouses and suppliers so that adverse events within one region or company will not cause national chaos. The industrial portfolio of the future is expected to be more real-time tracked, physically distributed and flexible than ever before.

EASTERN SEABOARD VACANCY



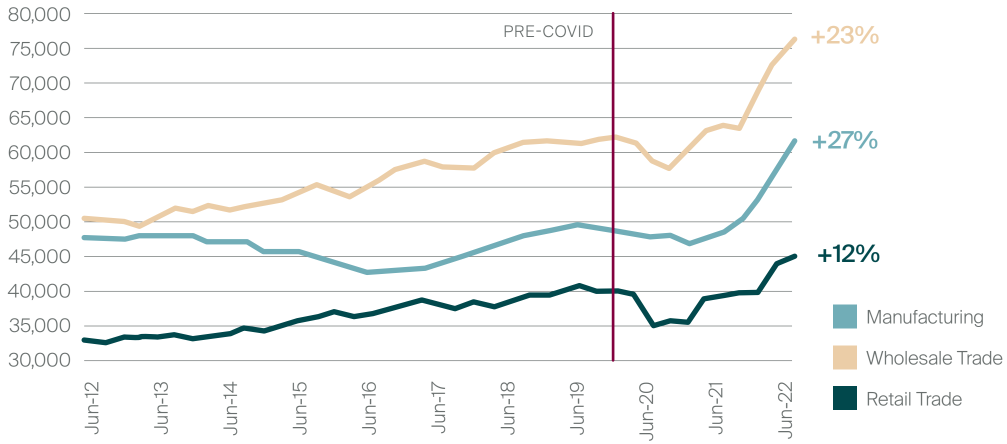
Source: Knight Frank Research

FREIGHT COSTS MODERATING
SHANGHAI SHIPPING EXCHANGE INDEX (RMB)



Source: Knight Frank Research, Macrobond

AUSTRALIAN INVENTORIES
$ BILLION, CURRENT PRICES, SEASONALLY ADJUSTED



Source: Knight Frank Research, ABS

Tenants will turn back to owner-occupation as one means to avert leasing risk

As industrial yields contracted from 2020, many owner-occupiers took advantage of market conditions and sold on leasebacks to free up capital. At the same time, potential owner-occupiers were frequently outbid on vacant properties by large investors voracious in their appetite for value-add and moving into smaller scale assets than ever before. This resulted in a shift away from owner-occupation for middle and upper tier business owners.

Now, however, amidst tight supply conditions, some occupiers may be motivated to reverse course. Rents are growing rapidly and with competition high, landlords are frequently able to select from a number of competing offers for the same tenancy. Large international and ASX listed tenants are naturally favoured in this process, which has left smaller businesses at real risk of being without business premises – which is business limiting if not terminal.

Also, with owners keen to access reversionary rents in a rising market for inner and middle ring assets, the lease terms offered may only be 2-3 years. All these factors have made security of tenure front of mind for industrial business owners and we expect to see more tenants reverting back to owner-occupation.

With asset values remaining high in spite of yield widening, the cost to gain security of tenure remains high, but opportunities to purchase short WALE assets and those with vacant possession will attract more interest from tenants in 2023 as they seek to mitigate the risk of not being able to secure space through conventional leasing.

Improve the efficiency of industrial land use through multi-level development

Multi-level industrial emerged long ago in the land locked markets of Singapore and Hong Kong before expanding to China and Europe. As an indication of its prevalence globally, Goodman Group reports that 57% of its current construction pipeline is within multi-level industrial assets ($7.7 billion of $13.6 billion) with significant increases in Europe, particularly on brownfield sites.

Despite this, it remains unchartered territory in Australia, with planning regulations and the underlying value of the land both significant constraints. However, with the industrial market expanding and suffering from severe supply shortages, the economics are increasingly pointing in the direction of multi-level as a new product type that will inevitably enter the market.

Firstly, the supply of industrial land has become a thorny issue across the major Australian markets, with limited ready-to-build land triggering significant price rises as tenant demand surged. Over the past five years price of lots 1-5 hectares have more than doubled in Sydney (+110%), Melbourne (+127%) and Adelaide (+115%) with strong growth also in Brisbane (+85%) and Perth (+46%). This escalation points to the need to better utilise existing industrial land, particularly in sought after inner fringe locations, including through allowing higher floor space ratios.

Secondly, recent rental growth is also acting to make schemes more viable, particularly in South Sydney. As a result, several developers are actively pursuing multi-level, with Goodman, Charter Hall, Logos, ESR and Hale Capital all having proposals in the precinct. With land values double its nearest rival of Inner Melbourne, South Sydney will inevitably lead the way, but provided early schemes generate acceptance from both developers tenants, it could extend to outer Sydney precincts and eventually other cities. Indeed, Logos has included one multi-level building in its five building proposal at Huntingwood in Sydney's Outer South West.

Multi-level industrial assets are expected to be an adjunct to primary facilities for the larger logistics players, with high turnover last mile warehouse and delivery more suited to an inner ring location. The inherently lower racking heights (~7m) and higher proportion of columns make multi-level warehouses more suitable for a lower number of higher turnover stock items rather than extensive stock control systems. Building efficiency is gained through the second warehouse level, but must be balanced by the extensive driveway and ramp areas and requires a far higher site coverage allowance to be feasible. In Australia the schemes are expected to be in the 2-4 level range and cater for medium sized tenancies of sub-7,000 sqm in a multi-tenanted facility.

LAND VALUE GROWTH BY PRECINCT

Source: Knight Frank Research

Supply response is not automatic given current constraints

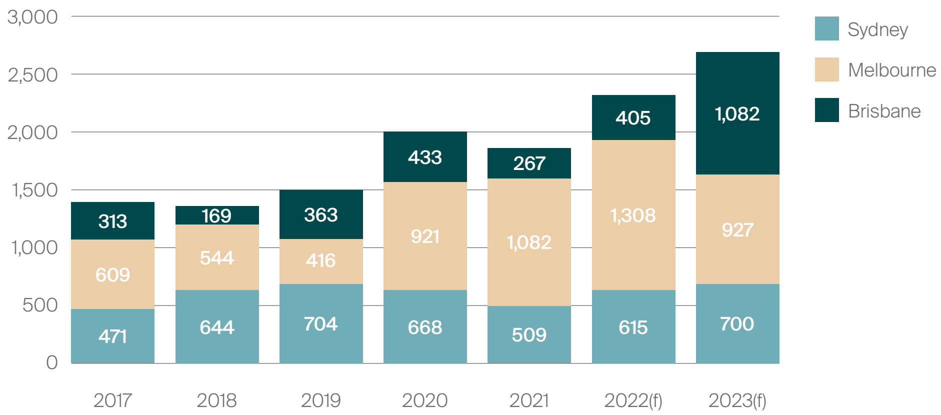
Undersupply in the Australian industrial market has previously been a short-lived event with relatively quick construction and planning timeframes compared with office and retail assets – meaning imbalances are typically corrected within a year to 18 months.

However, over the past two years, the strength of demand has overwhelmed the capacity of the supply-side to keep up, and in spite of historically high levels of development, the supply shortages have persisted. More recently, new pressures have tempered the ability of supply to ramp up. Land price and construction cost increases, coupled with softening yields, have placed greater pressure on development feasibility which has slowed the progression of projects in the short term. In addition, weather delays have also been pervasive in 2022, and in many cases led to the deferral of speculative projects into 2023.

Melbourne responded more quickly to the demand cycle with delivery of a record 1.3 million square metres expected this year. Brisbane is set to deliver its record high in 2023 with ~1 million square metres. The outlier remains Sydney, where slow planning processes and a shortage of zoned and serviced land continue to limit the quantum of industrial land for development. While there remains substantial capacity to expand supply in Sydney's Outer West and South West, the ability to satiate demand on the ground now is limited with Kemp's Creek potentially not coming online until 2025. This has the potential to divert demand to other locations such as Melbourne or Brisbane as occupier are unable to grow their footprint in Sydney as needed.

Looking ahead, the market will welcome a record year for development completions in 2023, led by Brisbane and Melbourne. While this will be welcomed by tenants, it is still likely to be insufficient to restore a more normal balance between supply and demand, particularly in Sydney, with an equilibrium unlikely to be restored until a larger quantum of developable land comes online in 2024-25.

EASTERN SEABOARD INDUSTRIAL SUPPLY
000 SQM



Source: Knight Frank Research

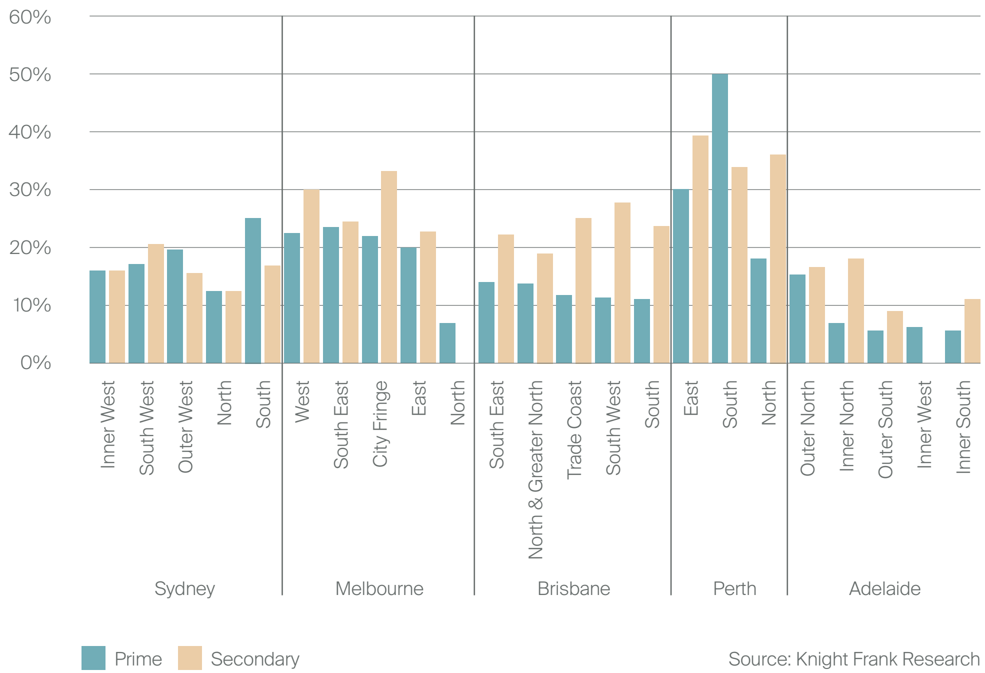
Where next for industrial rents?

The tight leasing market and limited existing space has seen surging rental growth across all markets, with the strongest growth over the past year recorded in Perth where the market has been propelled by a resurgence in demand from mining companies, particularly in the south.

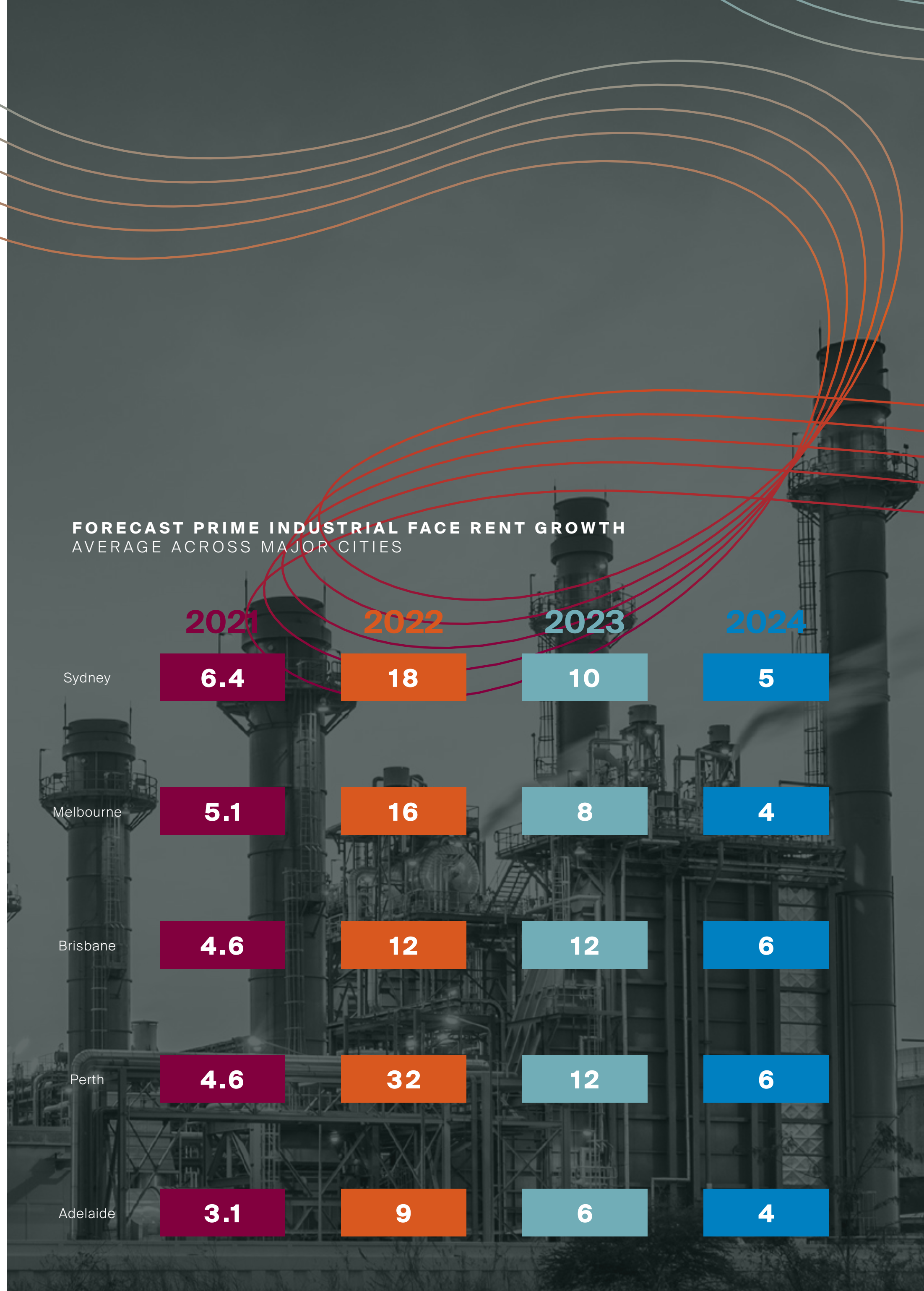
Prime and secondary rents have converged with tenants very much price-takers across all forms of industrial space. There is less than a fifth of the amount of secondary vacancy now compared with two years ago and while the headlines may be focussed on the top-line rents being achieved in new pre-lease agreements, the change to the secondary market rental landscape is also having a large business impact. Secondary rents now average 77-89% of the prime rent value across Australian markets, compared with a range of 66%-86% two years ago.

With tight supply set to continue, we expect further rental uplift, but at a slower pace than the frenetic speed of 2022.

RENT GROWTH BY PRECINCT ANNUAL GROWTH TO Q3 2022



Source: Knight Frank Research



FORECAST PRIME INDUSTRIAL FACE RENT GROWTH
AVERAGE ACROSS MAJOR CITIES

	2021	2022	2023	2024
Sydney	6.4	18	10	5
Melbourne	5.1	16	8	4
Brisbane	4.6	12	12	6
Perth	4.6	32	12	6
Adelaide	3.1	9	6	4

RESIDENTIAL

Focus shifts to rental return

Displacement of tenants to intensify

One in three Australian homes were rented at the time of the 2021 Census. Across this rental pool, supply and demand balance tends to be achieved at around 3% residential vacancy. Over the past five years, vacancy has averaged 2.7% in Australian capital cities, and 1.7% throughout regional Australia.

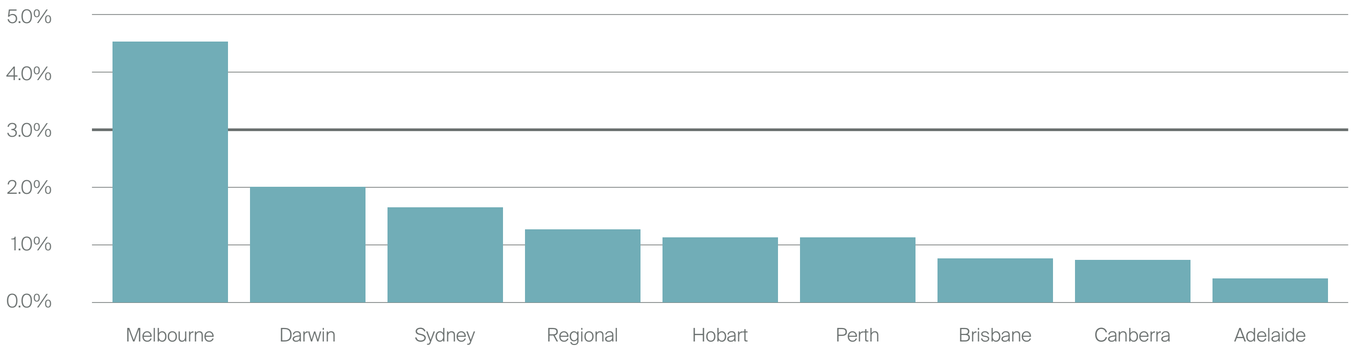
By mid-2022, however, vacancy had contracted to a very lean 2.1% in capital cities, and 1.2% in the regions. This is the lowest vacancy rate for capital cities since 2010, whilst regional Australia saw only a modest rise from the 0.9% record low in March 2021.

The supply crunch has come about for a number of reasons. Firstly, sustained population growth, up by 4.6% over the past five years, has continued to add to demand and been augmented by a gradual rise in the proportion of households renting. Secondly, new dwelling construction has fallen by 17.8% over the past five years, after the high completions of 2017-18 gave way to much lower levels. Thirdly, strong price rises during the pandemic saw many investors take the opportunity to sell their rental properties, while recent severe weather events have also taken homes offline and removed from rental pools across the country.

The combined impact of these forces has been to severely restrict the supply of rental accommodation and place significant upward pressure on rents. As the cost of living pressures continue to rise, we will see some households get bigger with current tenants moving back home, and tenants who upsized during the pandemic absorbing increasing rents by taking on a housemate or two. A shortage of listed homes has also forced many to seek offsite storage solutions for their belongings until their ideal abode becomes available for rent, sale, or their renovations or new home constructions are complete. As a result, it is also becoming increasingly competitive to secure storage space.

The supply shortage will be difficult to resolve and rental displacement is likely to intensify over the coming years as Australia once more welcomes permanent migration, with over 90% of the 195,000 places going to skilled migrants and over a quarter targeted for regional areas.

RESIDENTIAL RENTAL VACANCY



Source: Knight Frank Research, REIA

Slim pickings of new apartments for investors

Apartments are the more affordable option for home ownership when compared to standalone houses across Australian cities. In most instances, increasing distance from the central business district (CBD) attracts a lower relative listing price for apartments, although the challenge remains of limited higher density product being built along the greater city growth corridors in some of our larger cities.

Developers have been encouraged in recent times to build larger lateral apartments to meet the growing demand for owner-occupier 'rightsize' buyers, defined as those downsizing to luxury apartment living without compromising on expansive living areas once enjoyed in the large family home.

This trend has acted to shift the composition of supply and reduced the availability of affordable opportunities in the current construction pipeline of new apartments for investors and for many first time buyers hoping to exit the rental market and buy a home whilst price growth is subdued.

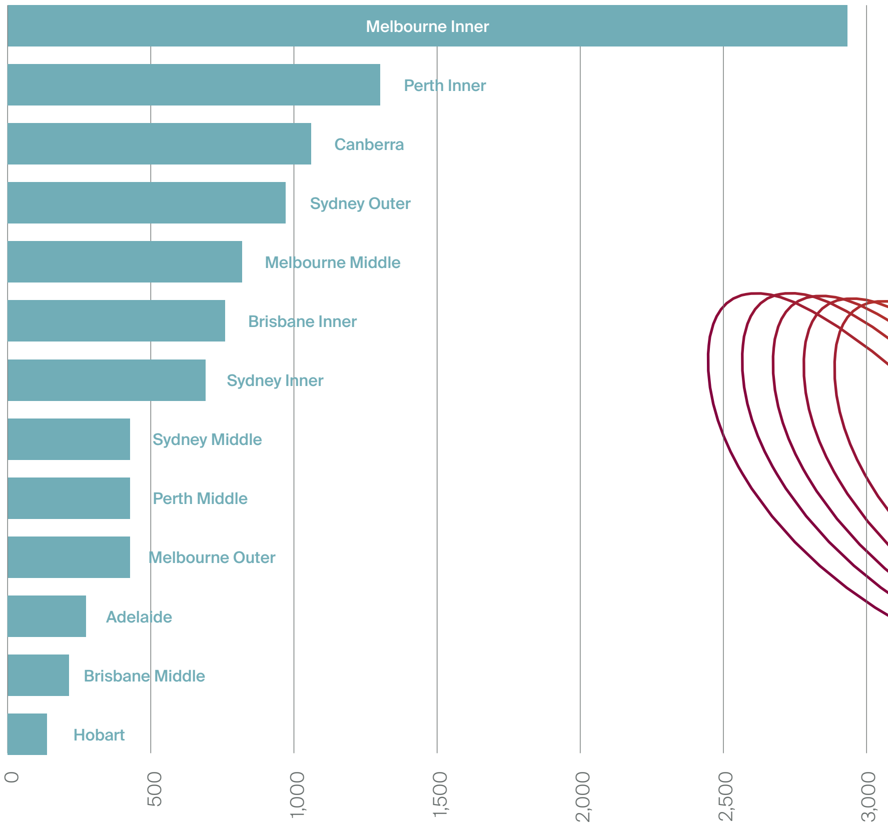
Across the construction pipeline of larger Australian capital cities broken down by rings from the CBD, it is evident that the pipeline for 2023 is relatively subdued, with 56% less new apartments being built in 2023 when compared against the 5-year average.

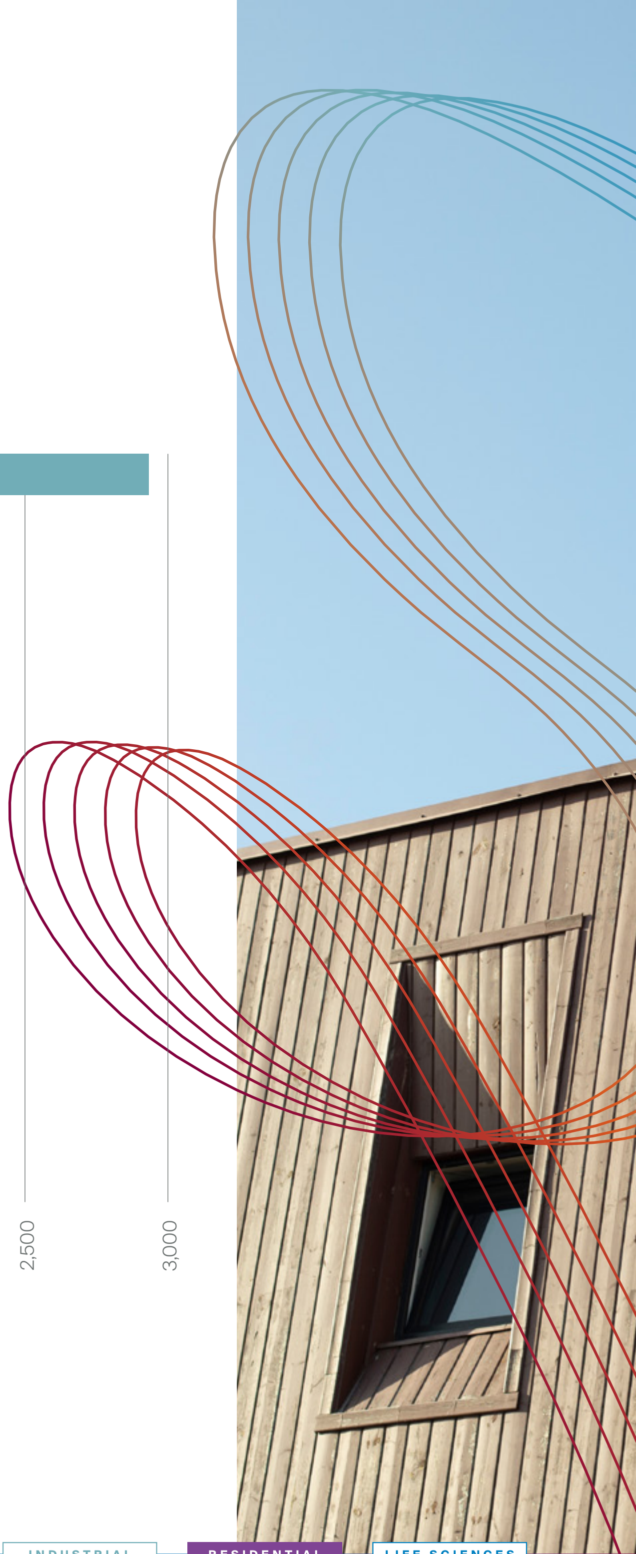
The inner suburbs of Melbourne will see the highest number of new apartments built in 2023, double the tally of the next region being the inner suburbs of Perth. With a larger pipeline, Melbourne has the greatest opportunity to potentially ease vacancy tensions, and it remains Australia's only capital city with a technical oversupply of rental properties despite still recording rental growth. In addition to a robust pipeline for inner Melbourne, the pipeline for its middle suburbs is also significant, while there will be fewer completions in the outer rim.

Other observations for 2023 include the solid new apartment pipeline expected for Canberra, while in contrast with Melbourne, the majority of Sydney's new attached homes will come online in the outer suburbs.

NEW APARTMENT DELIVERY FORECAST FOR 2023

Source: Knight Frank Research





Focus shifts from capital gains to rental return

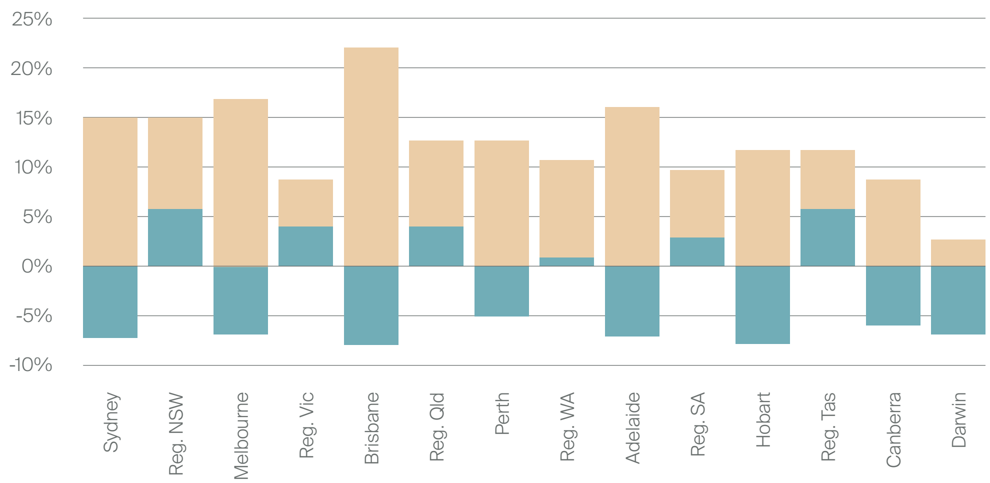
Heading into the global pandemic, the residential market was faced with uncertainty and uncharted direction. In hindsight, substantial government stimulus, rapidly rising household savings and historically low interest rates made it inevitable that significant growth in property values would follow.

Since the pandemic, Australian residential values have grown by 20%. Although since March 2022, values have fallen by 4.6% as the cash rate has shifted substantially higher to tackle elevated inflation, providing a catalyst for the market to ease towards a more sustainable level of annual growth over the coming years.

Capital values are likely to ease further in 2023 across all capital city markets, although regional areas of Australia are still expected to experience positive annual growth. Current expectations are for the RBA to resume cutting the cash rate in 2024, and this should see every capital city back on track with a positive capital growth trajectory as population growth returns to pre-pandemic levels and new residential stock remains in short supply.

On the other hand, rental growth is expected to endure double-digit growth in 2023 for 11 of the 14 major residential markets across Australia. Whilst the focus has come off capital value growth, sustained rental growth has allowed for more attractive gross rental yields to emerge, moving up 11 bps to 3.71% in the past two quarters. Off the back of strong rental growth, the gross rental yield for Sydney residential homes rose the most of all cities over this period, up by 29 bps to now trend north of 3.00%. With further rental growth expected, rental yields for investors will continue to shift up over the 12 months and this will help restore investor demand and, over time, boost the development pipeline.

RESIDENTIAL GROWTH FORECAST FOR 2023



Source: Knight Frank Research

L I F E
S C I E N C E S

Transitioning from discovery to commercialisation

The Australian life sciences sector continues to mature steadily against a backdrop of an ageing population, personalised treatments, technological advancements, future food transitions, and other agri-tech and marine technologies. The spotlight on our limited sovereign capability during the pandemic is one of several stimulants driving growth and ambition. Australia punches above its weight in terms of life sciences discoveries, but more needs to be done to bridge the gap to commercialisation.

Real estate has a key role to play to help navigate the transition to successfully commercialise Australia's research capability

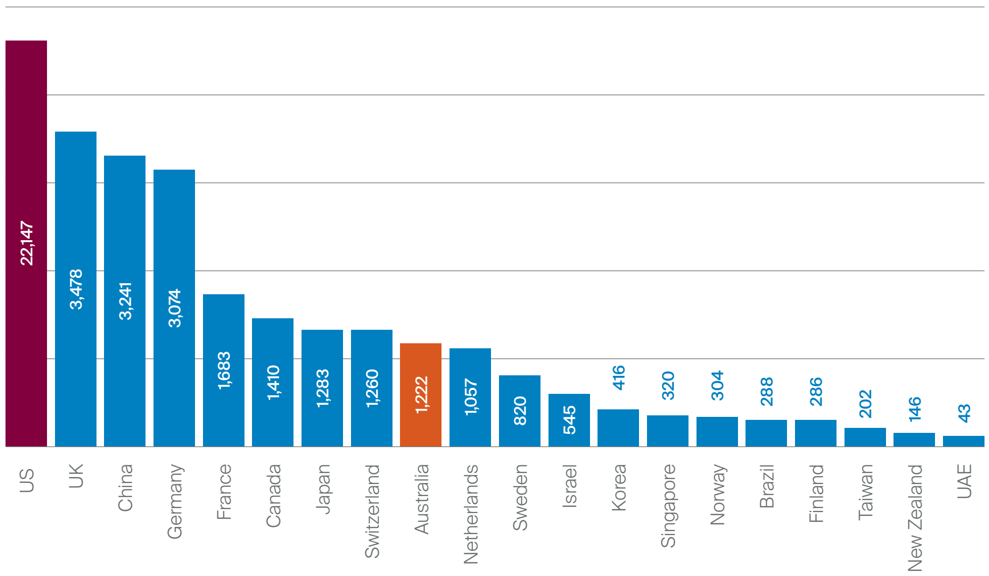
Australia's life sciences sector continues to expand rapidly, with 43% growth in the number of organisations identified as part of the sector since 2019[1], reflecting a steady maturing of the field as we solidify our track record on the world stage. Victoria and NSW remain the nation's key hubs, representing a combined 73% of our capability, with NSW experiencing 51% growth in workforce population since 2019, followed by Victoria (34%) and Queensland (18%). Our skilled capability and successes in the research and discovery phase across a broad spectrum of disciplines – not only encompassing human science, but also plant and animal science – has piqued increasing interest among real estate investors, with widespread expectations that the Australian life sciences sector is ripe for expansion.

However, life sciences is still a relatively misunderstood asset class in Australia. With a lens on research and discovery, Australia is a global contender by comparison of industry metrics and performance, ranking as a top 10 worldwide contributor to life sciences research off the back of our leading universities[2]. Despite this strength in discovery, however, Australia is yet to fully capitalise on the commercial opportunity, which is evidenced by a high proportion of start-ups leaving to commercialise their businesses offshore. This is typically to locations across the US and Europe where they benefit from greater access to venture capital, readily available and fit-for-purpose infrastructure, skilled staff and like-minded collaborators, as well as more attractive tax incentives.

To generate greater momentum on our own shores and build upon the strong underlying research foundation already established, better quality infrastructure is needed, and within this the property industry has a key role to play to help facilitate commercialisation.

LIFE SCIENCES RESEARCH - NUMBER OF ARTICLES IN ACCREDITED JOURNALS BY COUNTRY

Source: Nature, 2022 Life Sciences Index, Austrade



1. AusBiotech (2022). Australian Biotechnology Sector Snapshot 2022. https://www.ausbiotech.org/documents/item/707
2. Austrade (2022). Austrade Benchmark Report 2022. https://www.austrade.gov.au/benchmark-report/innovation-skills

Developer hesitancy will be overcome by increased availability of accurate data and understanding of the right curation model to bridge the gap between tenant and investor expectations

There is growing demand for bespoke built assets to accommodate the life sciences sector. It is generally accepted by leading industry groups that the ecosystem is dominated by up to 80% start-up and SME entities. Of these, approximately 70% are pre-clinal and 80% are pre-revenue. Whilst these numbers appear daunting, they represent abundant latent demand, as we know they scale-up exponentially when they have the right environment and pipeline to thrive. For example, San Diego – the third largest life sciences market in the US – has more developments in speculative construction (3.7 million sqm) than already in existence (2 million sqm), a recurring theme in most emerging and established markets[3]. To put this in context, the Brisbane CBD office market is only 2.3 million sqm.

Australia has a critical and growing shortage of bespoke acceleration and scale-up infrastructure to meet the needs of homegrown start-up ventures and retain them onshore. Despite a widespread desire on the part of investors to deploy capital into the sector, the specific needs of potential tenants have often been misunderstood; perhaps due to the relatively smaller scale of the Australian market compared to overseas.

In general, developers prefer to minimise leasing risk by pre-committing life sciences-built assets with a large established tenant. However, this is less likely in Australia where the target market is largely comprised of smaller companies in their infancy. As a result, there is widespread hesitancy to invest as the financial and operating model required is less understood. Life sciences requires a curated model of master planning, development and scale-up of spin-out companies, and established global life sciences giants will only ever be attracted based on success and growth of local start-ups.

In overseas markets, it is common to have a blended model where more established life science tenants pay higher than comprable office market rent and effectively cross-subsidise fledgling start-ups who co-locate with these more established businesses and pay lower rents. This arrangement is beneficial for all, with larger businesses keen to co-locate with start-ups to benefit from new research, while start-ups are keen to leverage off the scale of larger companies. This is the likely path forward in Australia and developers who can offer low-cost space to start-ups will rate high on accommodation search lists and reap the benefits of encouraging a sustainable ecosystem. This 'incubator arrangement' enables fledging businesses to scale up, become more attractive to venture capitalists, and convert into commercial enterprises.

Key to bridging the gap and unlocking investment is increasing the amount of supply and demand data, industry performance, and occupational metrics such as growth projections, sub-sector data, typical lease terms, and anticipated market rents. Over time, this will firm up market confidence by creating a better understanding of the sector and enable investors and developers to make firmer commitments to deliver the right stock and facilitate the sector's growth.

3. https://therealdeal-com.cdn.ampproject.org/c/s/therealdeal.com/la/2022/11/04/irvine-company-to-build-life-science-complex-next-to-uc-campus/amp/

The precinct model will continue to underpin majority of sector growth, but must be complemented by a new governance model with less government operational involvement

Given the nature of life sciences and its adjacent uses, it is likely that new investment into the sector will occur within the framework of innovation precincts that enable partnerships with a cross-section of complementary disciplines including academia, research, advanced manufacturing, contract development and manufacturing organisations (CDMOs), and conventional office tenants. While Australia already has numerous successful health and life sciences precincts, these tend to be governement led.

Whilst trending toward commercialisation, these precincts are still heavily discovery led – and the precinct partners are also greatly reliant on government grants for operational and capital subsidies. This model is unsustainable in the long run, given the growing gap in demand that will need to be filled by private investors. Land tenure also becomes a significant challenge for potential incoming infrastructure investors, as some governments and universities are reluctant to sell or transact land in a manner that aligns with a market financial model.

Furthermore, operational governance that provides fast growing companies a means to continuously expand in-situ is critical to efficient research and in some cases, impacts compliance of the product (TGA or FDA). The need for precincts with a common governance framework akin to life sciences parks in the US or UK is becoming increasingly evident. This approach has a number of wider benefits including collective visioning, marketing, operations, and sharing common infrastructure needs.

Airports will emerge as alternative locations for life sciences and innovation hubs

Urban innovation precincts tend to dominate the sector given need to attract a creative workforce close to amenity and lifestyle.

Across Australia, outer suburban precincts have emerged with various levels of success, and increasingly regional towns such as Townsville (QLD) and Pinjarra (WA) are also entering the mix with tropical disease and food innovation specialisations.

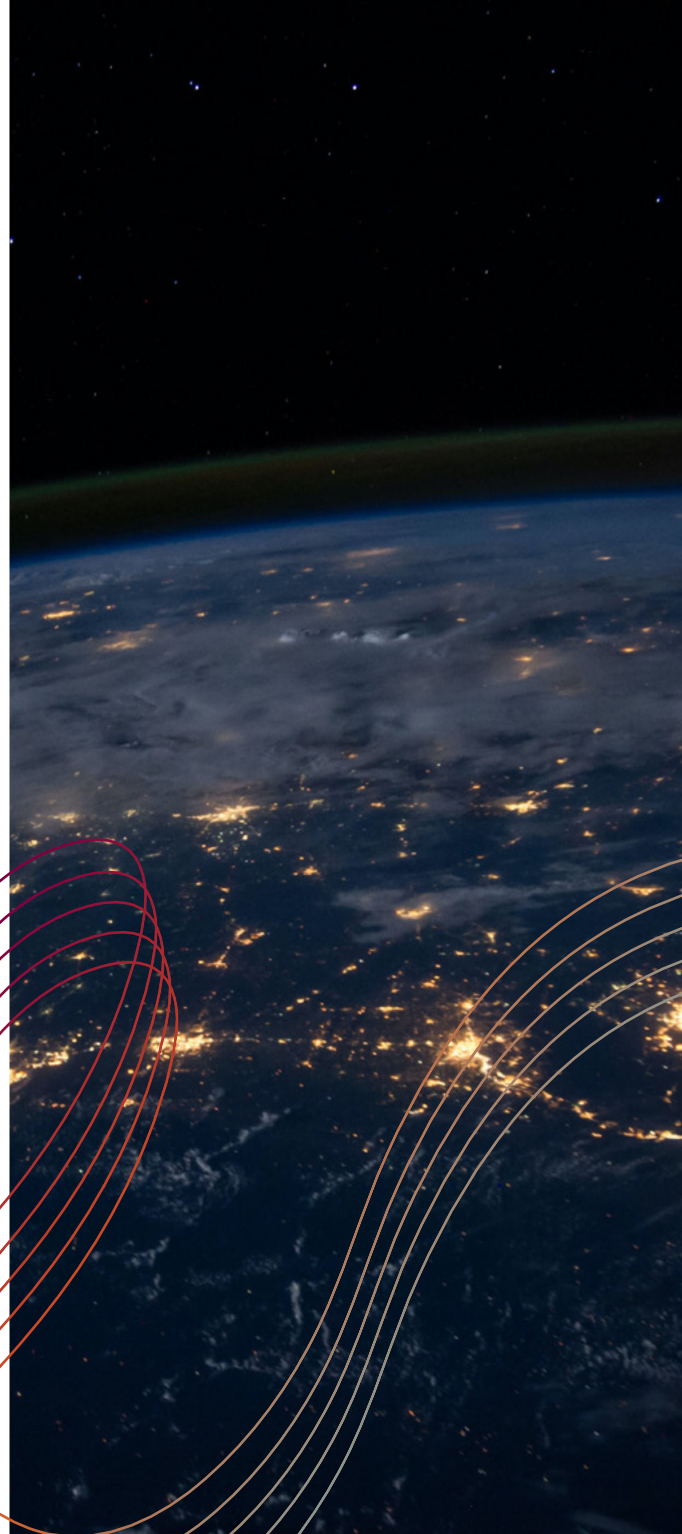
Of the potential locations for new precincts, we predict airports to emerge as an alternative base for life sciences and innovation hubs. Airports offer a raft of opportunities, including transit connectivity, cheap land, increasing mix-use assets, product logistics and alignment of land use that may have otherwise been redundant. This is starting to emerge at locations such as Melbourne Airport (CSL), Western Sydney Aerotropolis, and the Sunshine Coast Airport with the recent approval of its Turbine Precinct development.

Meanwhile, established precincts overseas have been criticised for some of the negative effects they bring to urban locations. The high income, skilled workforce these precincts attract create a wave of gentrification and displacement to the detriment of egalitarian socioeconomic mix, as can be seen in the US at Kendall Square (Boston) or University City (Philadelphia)[4]. Airports counter this trend by attracting populations and ancillary amenities that create new places to live and work, with a further benefit being the agglomeration effect that counters typical sprawl in developed cities.

Resilient and rising investor demand for life sciences and adjacent assets

Life sciences is still a relatively small asset class for real estate investors, with limited large-scale institutional grade stock. However, interest is growing rapidly as many investors have realised the sector's future potential and are now forming strategies – or broadening the scope of their existing social infrastructure strategies – with a view to scale up their involvement. Given the limited existence of 'pure play' life sciences assets, investors are screening for build-to-core opportunities, as well as prospects in adjacent sectors, with a broad focus spanning clinical research, production, or variations of these disciplines housed within assets of interest.

The current macro headwinds are likely to generate further interest in alternative sectors linked to a strong underlying growth story, and we expect to see a sustained depth of both venture and institutional capital targeting the life sciences sector throughout 2023.



4. https://www.timeshighereducation.com/blog/universities-must-address-downsides-innovation-districts

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