

AUSTRALIAN
HORIZON



A New Cycle Dawns

Your guide to the future of the
Australian property market

2nd edition

2025

knightfrank.com.au/horizonreport



A woman with long blonde hair, wearing a red jacket and black pants, is walking away from the camera on a paved path. She is carrying a bag over her shoulder. The path is lined with trees displaying vibrant autumn foliage in shades of red, orange, and yellow. A black lamppost stands on the right side of the path. The background shows more trees and a building partially visible through the foliage.

The *Horizon Report* sets out our views on Australian real estate, taking you on a journey through the macro context underpinning investment performance, with specific insights across the office, industrial, retail and alternative sectors that shed light on the path to performance in 2025 and beyond.

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How we chose our cover



Looking ahead to 2025, we embarked on a creative journey to encapsulate the essence of the real estate market's transition to a new cycle. Our goal was to visually represent this transition, highlighting both resilience and renewal. The imagery needed to convey the gradual recovery taking shape, while also engaging our audience with a sense of optimism and intrigue.

Partnering once again with Studio Riz, we found inspiration in the natural cycle of a tree moving through the seasons. Influenced by the enchanting cherry blossoms of Toronto and the lush, iconic green tower of Sydney's One Central Park, they envisioned a cityscape interwoven with vibrant foliage, symbolising the market's evolution.

Using cutting-edge Generative AI, Studio Riz created a series of refined and captivating images featured throughout this document. The cover showcases a tower adorned with a spectrum of seasonal hues, perfectly encapsulating the theme of renewal. The tagline, *A New Cycle Dawns*, aligns seamlessly with our narrative, capturing the promise of a market poised for a brighter, more prosperous future.

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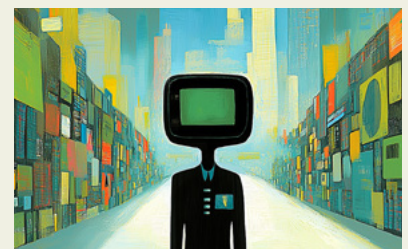
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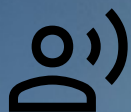
Key highlights

Based on our research here are the *Horizon* top 7 insights for 2025...



The level of neutral interest rates will underpin the strength of the cyclical recovery

The strength of the cyclical recovery will be guided by the extent of interest rate cuts once the RBA shifts stance to start easing policy. Investors will need to be tuned into the evolving debate on neutral rates and ensure their strategy is resilient to multiple scenarios for the level of long-term interest rates.



Ready to strike: investors poised to execute revised strategies after lengthy hiatus

After nearly three years with markets in a state of flux, many investors have reset their expectations and are ready to home in on their preferred investment opportunities. This will drive broader interest and higher liquidity across all asset classes in 2025.



A New Cycle Dawns: Australian property set to turn the corner to growth

Well-located core assets have now largely repriced and are poised to start the recovery in early 2025, with pricing, if not yet formal valuations, now at a cyclical low. Investors acquiring assets now will be well-placed to see strong returns in years to come, with core assets in Sydney to lead the way before the recovery extends to other cities.





Higher supply to lead to a divergence in industrial rent performance in 2025

Rising availability is expected to continue into 2025 with high levels of new supply still flowing into the market. New supply and exposure to sublease vacancy varies across the country and in 2025, we expect more divergence in rental performance between the markets more impacted by higher supply levels, such as Sydney's Outer West and West Melbourne, and less impacted markets such as South Sydney and East Melbourne.



Retail is back – strongest investor demand since 2015

Macro headwinds to the sector are now dissipating and centre performance is benefitting from extended efforts to enhance visitation and customer experience. Improving asset performance has been noticed by a broader range of investors and demand for retail assets in 2025 will be the strongest for at least a decade. With investor sentiment having shifted, a lack of available stock relative to the level of demand will tilt the balance toward a recovery in capital values.



High office vacancy rates obscure the looming lack of new supply

High vacancy rates in most markets and elevated incentives continue to point to the need for caution in bringing forward new office developments. However, this obscures the prospect of a tightening of supply at the top end of the market, particularly in Sydney and Brisbane, which will act to drive up the face rents on new developments and aid the Sydney market recovery.



Addressing the mid-market key to winning support for policy change to accelerate BTR

Linked to the debate on MIT treatment and potentially other policy changes needed to unlock BTR development is the perception of where it sits within the overall housing mix. The perceived success of schemes targeting the middle of the rental range – as opposed to the top end of the rental market – will be important to winning support from policymakers to adjust planning and taxation frameworks.



Economy

The search for R^* will underpin the property market outlook

10 More cash, more confidence

Economy to accelerate as real incomes return to growth

11 Slaying the dragon

Focus shifts to growth with rates likely to be cut in the first half of 2025

13 Finding the North Star for investors

How far will interest rates fall, and what are the implications for long-term interest rates?

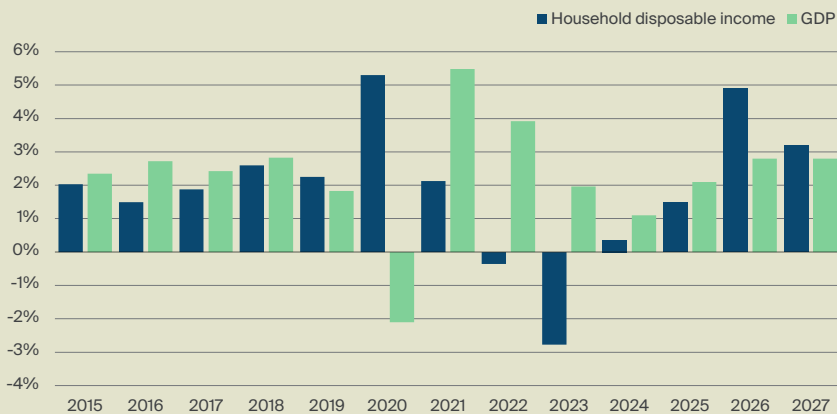
More cash, more confidence

Economy to accelerate as real incomes return to growth



Return to real income growth

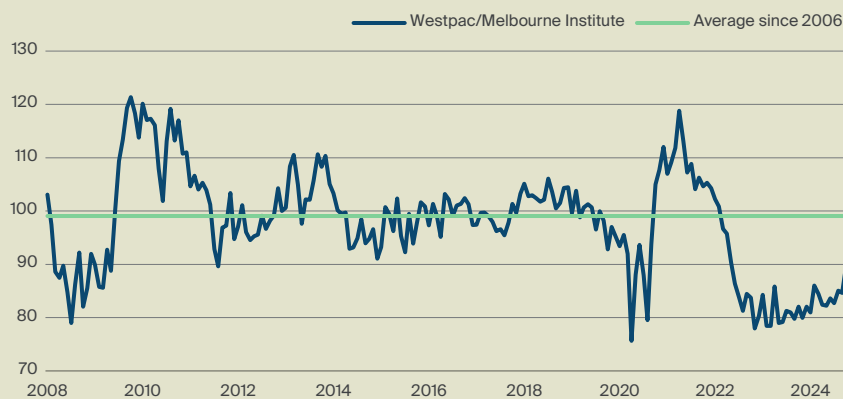
Total household real disposable income growth



Source: Knight Frank Research, Oxford Economics

Consumer confidence finally picking up

Confidence index, value above 100 signal optimism



Source: Knight Frank Research, Macrobond

So far, so good – or if not good then at least not as bad as feared. As we foreshadowed last year, the quest for a soft landing remains on track. Since early 2022, the global economy has endured a steep rise in interest rates and the Australian economy has withstood this relatively

well, and without falling off the Reserve Bank of Australia's (RBA) prescribed 'narrow path'.

Certainly, the pace of growth has slowed to a crawl, with consumers subjected to a severe and historically unusual contraction in disposable incomes owing to a painful

combination of high inflation, rising interest rates and a rising tax take. This has crimped spending and been the predominant driver of slow aggregate growth, with many households understandably feeling like they are experiencing a recession.

However, the consumer slowdown has not spilled over to weaken other parts of the economy to the extent feared, and strong population growth and an ongoing pipeline of infrastructure spending have helped to keep the aggregate growth figures in positive territory. Business investment has also picked up, again helping to offset consumer weakness.

While unsatisfying, this combination has nonetheless helped the economy to muddle through and avoid a sharp rise in unemployment.

Thankfully, as we look ahead to 2025, some relief is in prospect. The combination of solid wage growth and declining inflation has shifted real income growth back into positive territory in recent months, as reflected in improving sentiment indicators, and further improvements are expected in 2025 and 2026. In addition to this, tax cuts and a raft of cost-of-living measures from Federal and State governments will also aid the consumer and bolster disposable income across the economy, with lower interest rates also expected to take the pressure off.

As a result, after real disposable incomes declined by 2.8% in 2023, a gradual recovery is in store with growth of 1.5% forecast for 2025 rising to 4.9% in 2026. This will lead to a steady improvement in consumer spending and enable economic growth to accelerate more broadly, providing a supportive environment for property.

Slaying the dragon

Focus shifts to growth with rates likely to be cut in the first half of 2025

For some time, investors have been asking the same questions: how long will inflation persist; how high will interest rates rise; what will be the impact on growth; and, to what extent will asset values need to adjust?

After nearly three years, these remain important questions, but from a global perspective the degree of urgency has been dialled down as the answers are increasingly known and where uncertainty still persists, it has fallen back within a more normal range.

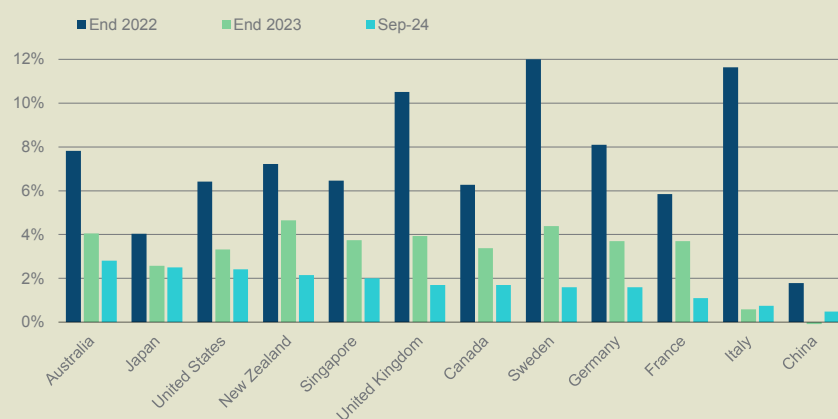
The initial genesis of the problem, high inflation, is now subsiding, albeit after a few bumps in the road. The headline rate of CPI inflation has now dropped to 2.4% in the United States, 1.7% in the euro area and to similar levels close to target in most major economies. In addition, measures of medium to long-term inflation expectations are contained and look to have fallen back to pre-pandemic levels, reducing the risk of lingering impacts on price and wage setting processes.

As a result, the focus of policy-makers is gradually shifting to safeguarding and promoting growth through reducing the degree of



Global inflation has eased significantly

Headline CPI rate y/y



Source: Knight Frank Research, Macrobond

restriction in monetary policy settings. Most major economies have now cut rates by 50 or more basis points (bps), with forward rate expectations pointing to further significant drops in 2025 to around 3.5% in the US, 4.0% in the UK and 2.0% in Europe.

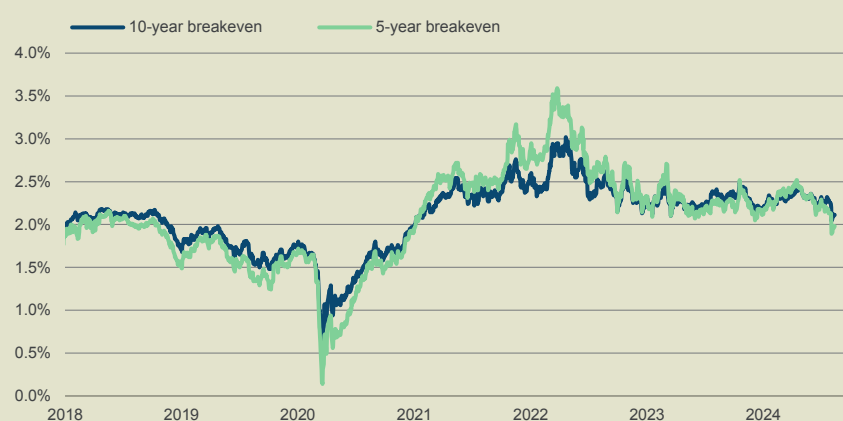
In Australia, progression on these key questions has been slower and while the headline rate has dropped below 3.0%, attention is still focussed on sticky inflation in service industries. This was once again reflected in the Q3 2024 data which contained a sharp contrast between persistently high inflation in service industries running at 4.6% and goods prices which fell in the quarter to be up only 1.4% annually. However, a deceleration trend is still intact with the rate of price growth on key items like rents and insurance falling from peak levels and the core measure falling to 3.5%.

With further progress expected in the Q4 2024 and Q1 2025 CPI readings, the market consensus is for the RBA to commence a rate cutting cycle in the first half of 2025, with rates significantly more likely to be lower than at the same level or higher this time next year.

For investors, the exact timing is less important than a clear direction of travel and after nearly three years of uncertainty, the prospect of policy easing will help to buoy sentiment in 2025.

US inflation expectations back to 2018 levels

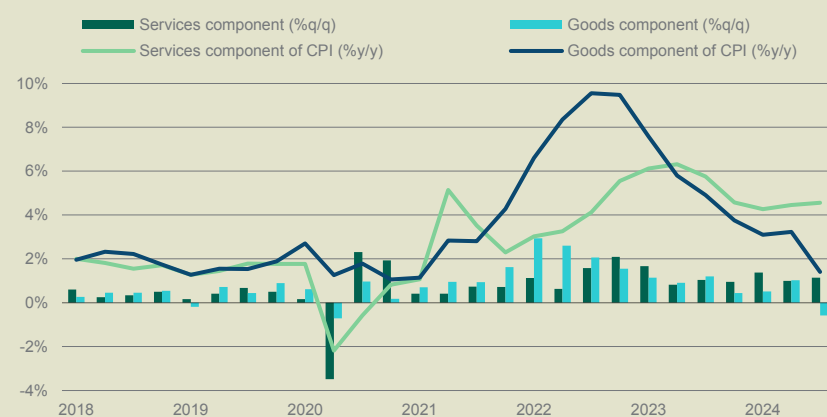
Per cent



Source: Knight Frank Research, Macrobond

Inflation in Australia taking longer to subside

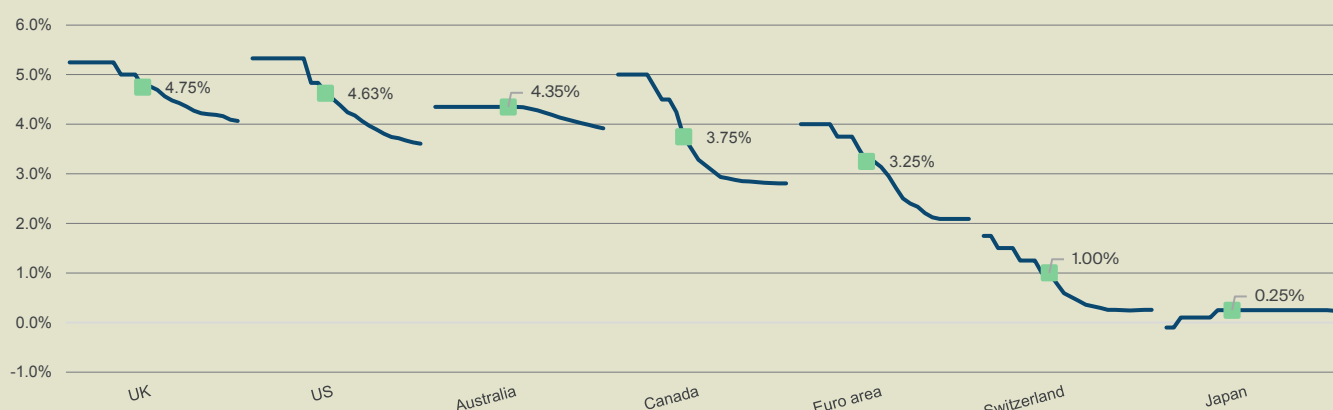
Annual and quarterly price growth



Source: Knight Frank Research

Global policy rates have turned the corner

Current policy rates and market expectations Jan 2024 - Dec 2025 (as at 8 November 2024, %)



Source: Knight Frank Research, Macrobond



Finding the North Star for investors

How far will interest rates fall, and what are the implications for long-term interest rates?

Beyond the immediate question of timing, is the more important one of how far rates will be cut when the RBA eventually shifts stance to start easing policy. This goes to the perennial question of level of the neutral interest rate, often dubbed R^* by economists and academics.

R^* can be thought of as an equilibrium interest rate that would allow for the economy to grow at a sustainable rate with inflation comfortably within the target band, when no shocks – favourable or unfavourable – are hitting the economy. That is, a rate that is neither expansionary nor contractionary, but somewhere in the middle.

The fact that the economy, both locally and globally, is always changing makes it very difficult to pinpoint exactly what this rate is, and those changes mean that it also changes over time. So, the concept is more theoretical than directly observable.

Economists spent much of the past decade explaining why interest rates had shifted down to very low levels, and there was a high degree of consensus that the neutral rate had also moved down substantially in most major economies around the world. However, the experience of the post-pandemic surge in inflation, higher budget deficits in the US, plus major economic changes including the advent of AI and the energy transition, have upended the consensus. Most forecasters now believe the neutral rate is higher than before at around 3.0% in nominal terms. This directly feeds through to forecasts for the cash rate in Australia, with the current consensus pointing to four or five rate cuts taking the cash rate to 3.1 – 3.35%.

At this level, it would be very similar to estimates in the US, where the current forward projections of most Federal Reserve Board members point to a policy rate in the range of 2.75 – 3.0%. It would also reflect a more modest rate cutting cycle than past episodes that have seen the RBA generally cut rates by 150-250 bps when shifting stance to support economic growth.

Importantly, this level of cash rate implies that long-term interest rates have limited scope to fall significantly from their current level. Most forecasts suggest that longer term rates, specifically the 10-year bond yield, are likely to drop only marginally to 3.5 – 4.0%, as the current level already reflects the expectation that the cash rate will be cut to circa 3.0% in the near term. This implies the reinstatement of a

meaningful gap between the cash rate and long-term yields given the reasonable expectation of a positive term premium and hence, an upward sloping yield curve to provide a higher return to investors in long-term bonds to compensate for the risk of changes in interest rates over investment horizon.

Divergent views on the path of long-term rates have big implications for real estate

Academic economists are less sure that things will be seen to have changed to this degree, once the dust settles and the inflation surge is truly behind us. They point to the persistence of the long-term trends that dragged interest rates down in the 2010s, and that these forces have mostly carried on in the background, albeit obscured by the recent inflation surge.

Specifically, they refer to the role of demographics and the aging population in forcing households to save more; low productivity growth contributing to low economic growth and requiring lower interest rates to support major economies; the rise of China and other emerging market economies and their role in reducing the cost of traded goods; and, the related growth in demand for 'safe assets', particularly government securities in major economies such as the US.

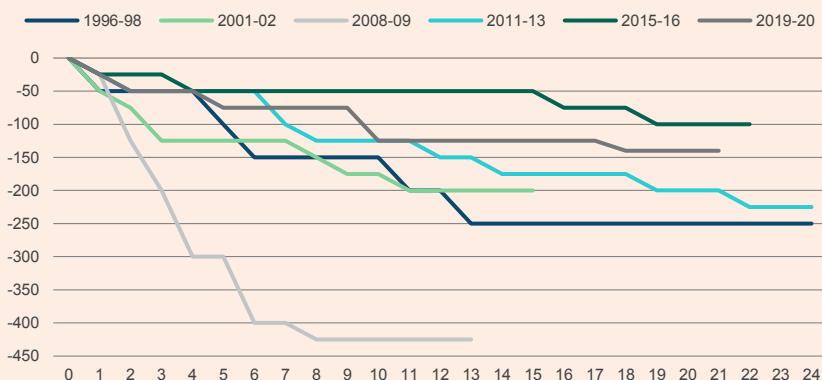
This line of thinking suggests R^* , and hence the cash rate may revert to a lower level, more like 2.5%, with long-term rates also commensurately lower and closer to 3.0% than 4.0%, similar to the levels prevailing in 2013-17 although not as low as in 2018-21.

Given the importance of the interest rate outlook for asset prices across multiple sectors globally, debate on the neutral rate will continue, with the answer not to be known in 2025. After a large drawdown in values a cyclical recovery is in the offing, but the strength of that recovery is still to be determined. Investors will need to be tuned into the debate on R^* and ensure their strategy is resilient to both scenarios.



Comparing RBA rate cut cycles

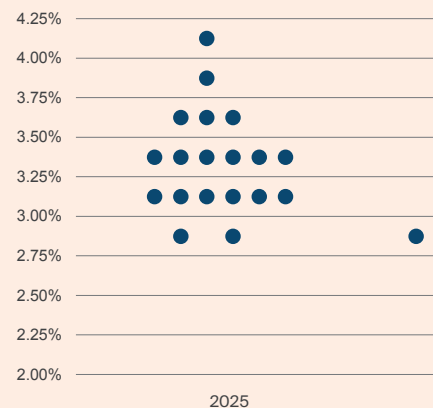
Number of basis points within two years from start of rate cuts



Source: Knight Frank Research, Macrobond

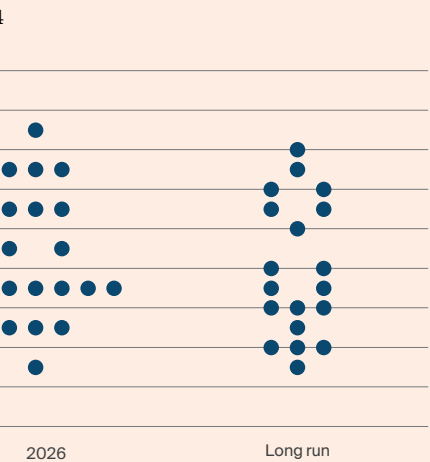
FOMC members assessment of appropriate rate

US Federal Reserve dot plot, September 2024





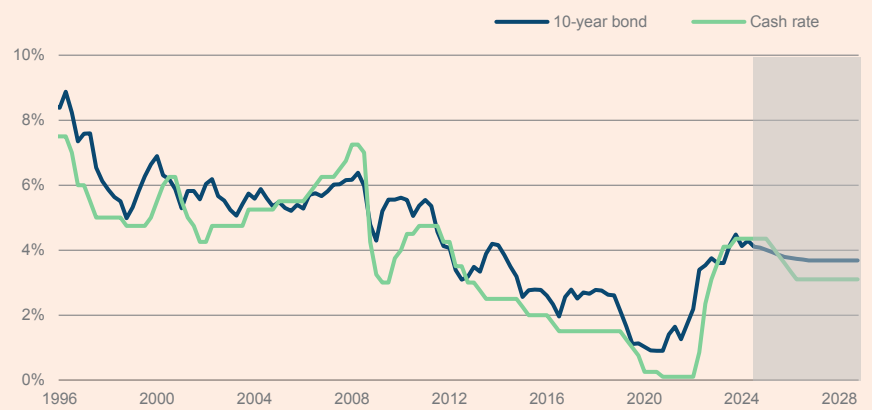
Appropriate policy rate



Source: Knight Frank Research, US Federal Reserve

Long-term rates may not fall much

Historic and forecast interest rates



Source: Knight Frank Research, Oxford Economics



Scenarios for the neutral rate

As experts debate where the neutral rate sits both in Australia and globally, two opposing views emerge – each with implications for the likely level of long-term interest rates and hence relative pricing in real estate markets.

Higher R*

~3.5%

Cash rate

3.5 – 4.5%

Long-term bond yields

"I don't think that it's likely that the neutral rate is as low as the Fed believes... We've had huge increases in wealth, vast changes in the budget deficit, in the level of the national debt. We've seen major new signs of increased investment in the green sector, in AI and in energy generation. So you take all those pressures downwards on savings, upwards on investment, and I think the neutral real rate has gone up."

LARRY SUMMERS
Former US Treasury Secretary

LOWER R*

~2.5%

Cash rate

2.5 – 3.5%

Long-term bond yields

"Equilibrium long-term real interest rates have risen recently according to market indicators. However, the main underlying factors that have pushed real interest rates down since the 1980s and 1990s – notably demographic shifts, lower productivity growth, corporate market power, and safe asset demand relative to supply – do not appear poised to reverse strongly enough to drive a big and durable rise in global real interest rates over the coming years."

MAURICE OBSTFELD
University of California, Berkeley and
former Chief Economist, IMF

Capital Markets

Window open for early cycle acquisitions with investors poised to execute revised strategies

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Have we hit the bottom yet?

Divergent downturn close to the trough



In response to higher interest rates, most property markets around the country have endured a downturn since early 2022. The degree of divergence in performance has been striking, however, and marks a sharp contrast with the experience of the GFC in 2008-09 when the market downturn was much shorter and more uniform.

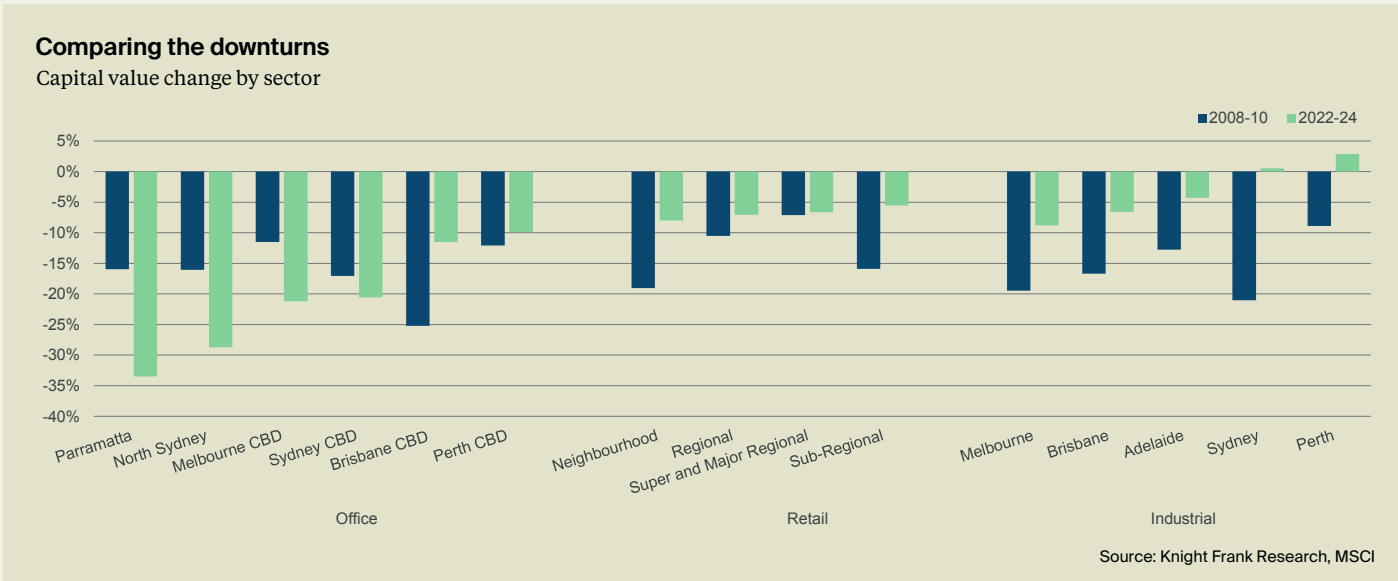
At that time, most cities and

sectors saw values fall by around 15%, with relatively little variation. However, this time the experience has been much more varied, with suburban office markets bearing the brunt of the correction with values falling by around 30% to date, more than CBD markets which have generally experienced declines closer to 20%. Retail assets have been more resilient, benefitting from population

growth and a lack of new supply in recent years that has helped to sustain income flows, while industrial assets have out-performed due to the strength of rental growth.

While all markets have been impacted by re-pricing and the need for higher income yields in the face of higher borrowing costs and strong returns on fixed income investments, the divergence speaks to influence of other factors, notably the changing perception of income security, shifts in the pattern of demand by location and grade, and the related outlook for rental growth.

These factors will continue to influence the market as we move first to stabilisation and then to recovery. The valuation cycle has at times lagged market sentiment and likely still has further to go in weaker segments such as suburban offices, where those other factors are still weighing on investor perception of value. But well-located core assets have now largely repriced and are poised to start the recovery in 2025, with pricing, if not formal valuations, now at a cyclical low.



Time to buy

Window now open for early cycle acquisitions as the market begins to thaw

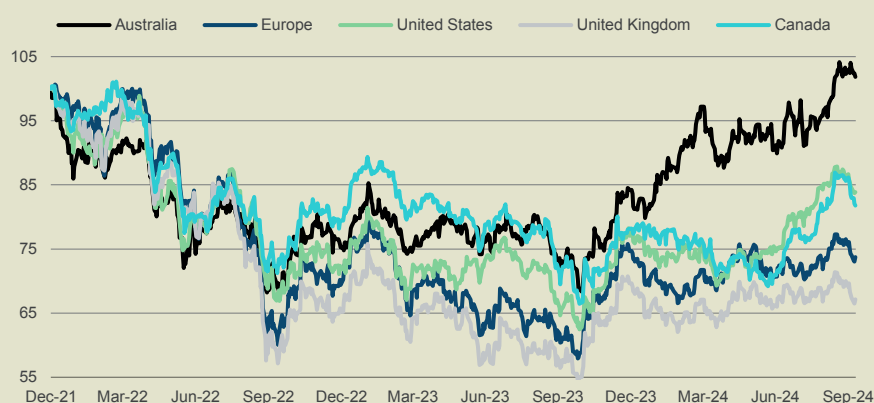
The central message of our *Horizons Report* last year was that 2024 would be a much better vintage for property investors, and that has certainly been the case. Investors acquiring assets now, after values have adjusted down, but not yet commenced the recovery, will be well-placed to see strong returns in years to come.

The optimal window to acquire assets will extend into 2025 and reflecting this, sentiment has improved markedly through the year across multiple dimensions. Improving consumer sentiment points to a pick-up in economic growth, while a much more favourable outlook for inflation and interest rates has buoyed investor sentiment as markets start to look ahead to cyclical recovery.

This improvement has been most noticeable in the faster-moving listed markets. Real estate equities around the world were first to feel the negative

Australia has led the public market recovery

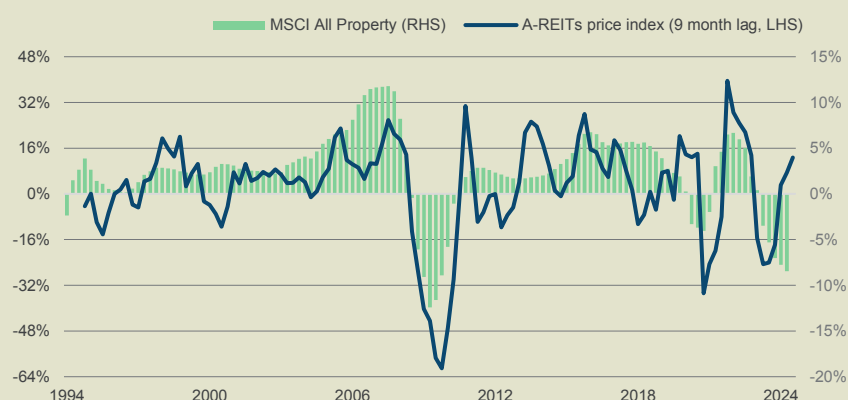
Global REIT price indices, 31 Dec 2021 = 100



Source: Knight Frank Research, Macrobond

Public markets a reliable leading indicator

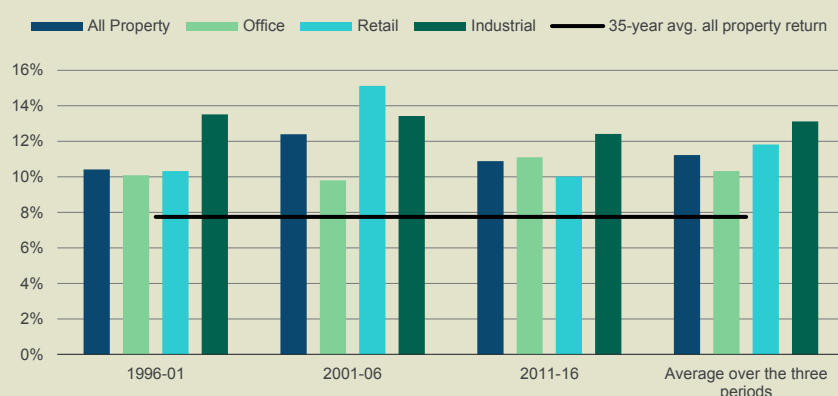
Annual price growth y/y



Source: Knight Frank Research, Macrobond

Rate cutting cycles have generated strong returns

5 -year avg. total return from the commencement of rate cuts



Source: Knight Frank Research, MSCI



impact of higher interest rate expectations in early 2022, well before declining asset valuations materialised a year or more later. The A-REIT price index fell by 25% in 2022 and bottomed out in October 2023 when long term interest rates peaked at close to 5%, similar to the experience on other major markets in the US and Europe that saw even larger falls.

Since then, however, listed markets have staged a strong recovery, with the broad A-REIT price index recouping those losses and back above the end-2021 level. This recovery has been significantly stronger in Australia, indicating that investors perceive a higher likelihood of strong market recovery locally.

In past cycles, significant shifts in the listed market have usually accurately foreshadowed shifts in valuation in the private market, and movements in the aggregate prices indices are highly correlated, allowing for a 6–12-month lag between moves in the public and private markets.

The recent recovery echoes our central thesis that core assets in the Australian market now represent good value for investors, with strong prospects for cyclical recovery and long-term growth. Acquiring assets at this time in the cycle, after a major decline in values and prior to a rate-cutting cycle, has invariably resulted in strong returns well above long-term averages.

A New Cycle Dawns

Sydney to lead the cyclical recovery, starting with industrial

As the market returns to growth, we expect core assets in Sydney to lead the way. As Australia's deepest and most liquid capital market and its most international city, investors are drawn to Sydney, with regional surveys of cross-border investors consistently highlighting it as a key target within the APAC region. In addition, many investors will be viewing the correction as an opportune time to acquire core Sydney assets with less competition.

Within Sydney, the industrial sector is likely to be quickest to return to growth. Industrial assets have largely been resilient over the past two years due to strong rental growth, but even as supply levels rise, most investors retain confidence in the long-term growth outlook and many are still seeking to deploy additional capital into the sector to boost its overall

weighting within portfolios. Bid-ask spreads have narrowed substantially, indicating there is broad consensus on asset values and paving the way to higher liquidity.

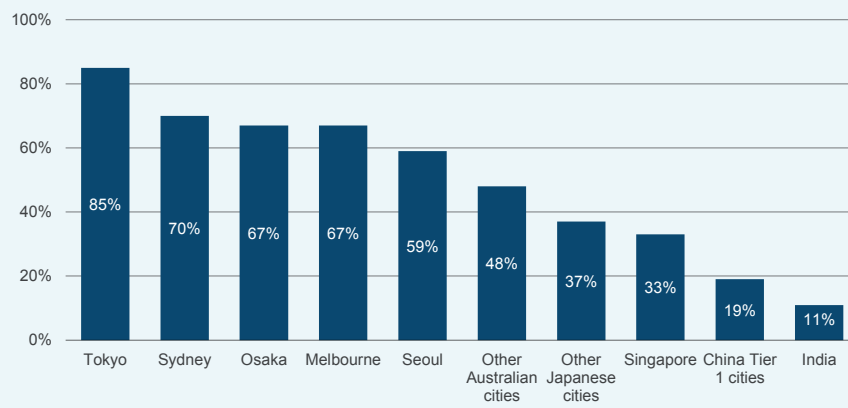
Offices are likely to follow, but there will be substantial variation by grade and location. Core CBD offices will be most sought after, reflecting the shifting pattern of tenant demand, while non-core CBD and suburban offices will take longer to recover, and the market will remain bifurcated at asset level.

Adopting the view that cash rate will settle at around 3.0% and long-term interest rates will settle in the 3.5-4.0% range, we forecast that prime yields will compress by 50-75 basis points during a cyclical recovery phase in 2025-27, with the industrial market expected to move more quickly, although the extent and timing of these moves remains dependent on the interest rate cycle.

As in past cycles, the recovery in Sydney will gradually extend to other cities, with Brisbane likely to be next in line to benefit from the strong economic growth of South East Queensland and lower supply levels compared to Melbourne.

Preferred investment locations in the APAC region

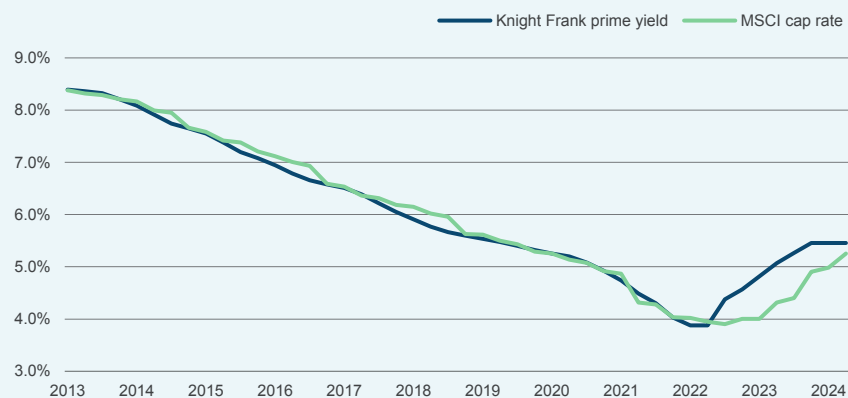
ANREV investment intentions survey of global investors 2024



Source: Knight Frank Research, ANREV

Bid-ask spread now narrowing

Sydney prime industrial - MSCI cap rate series vs prime yield series



Source: Knight Frank Research, MSCI

Sydney prime yield forecasts:

Cash Rates, Bond Yields, and Sector-Specific Projections (2019–2028)

	Cash Rate	Bond Yield (%)	Sydney CBD Offices	Sydney Industrial
2019	0.75	1.10	4.40	5.30
2020	0.10	0.90	4.50	4.90
2021	0.10	1.70	4.40	4.05
2022	3.10	3.75	4.75	4.60
2023	4.35	4.50	5.75	5.45
2024	4.35	4.00	6.05	5.45
2025	3.60	3.80	5.80	5.10
2026	3.10	3.70	5.60	4.85
2027	3.10	3.70	5.40	4.75
2028	3.10	3.70	5.40	4.75

Source: Oxford Economics, Knight Frank Research



Arrested development and structural change to drive the second wave of recovery and growth

Growth cycles typically feature both income growth and yield compression, although the sequencing and extent of these drivers differs depending on economic conditions. In the aftermath of the GFC, Australia benefitted from a period of high commodity prices and resulting strong growth and investment in mining and related industries. This strong growth kept interest rates higher than in other countries which experienced a swifter decline in interest rates, and as a result the cycle of yield compression took longer to commence.

This time around, forecasts for a swifter series of interest rate cuts

may see yields move down more quickly, although as noted earlier, the extent of the cyclical recovery remains in question.

The second wave will come from income growth and play out over a longer period, but the right ingredients are in place for long-term performance. Firstly, the steep rise in construction costs that has been emblematic of the high inflation environment has stifled construction activity across all sectors, thereby

tilting the supply-demand dynamic and contributing to rental growth both now and into the future.

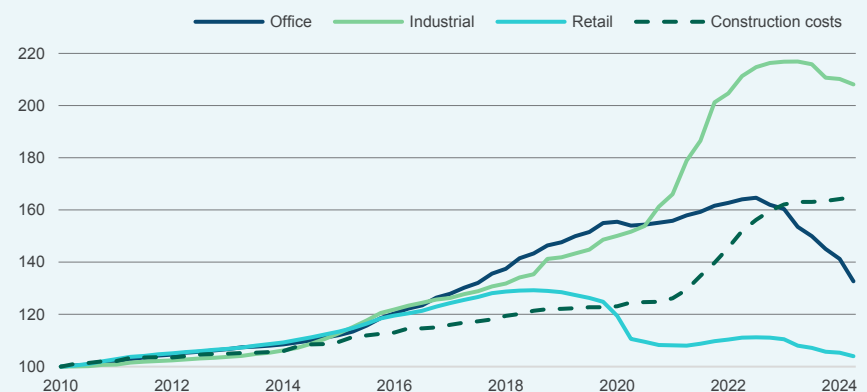
Indeed, given the fall in asset values, growth in construction costs has now outstripped the pace of asset value growth over the past decade, particularly in the retail and office sectors, meaning that asset values are often well below replacement cost which, limits the scope for large-scale supply additions. Instead, it is more likely we will see an extended period of subdued development activity, helping to underpin income growth for the foreseeable future.

On top of this, the backlog of demand arising from the population surge will open up new opportunities, particularly in the emerging living sectors and other alternative asset classes where there is likely to be more of a need for new development compared to office and retail.

Population growth is also shifting the geographic pattern of demand as governments respond with the roll-out of new infrastructure projects to improve connectivity and open up new markets. Among the centrepiece initiatives are Sydney's Metro and Western Sydney Airport, Melbourne's Metro Tunnel, Brisbane's Cross River Rail and Perth's Metronet. Each of these will act to generate new demand by opening up new opportunities for residential development and in some cases shifting the focus of commercial activity.

Construction costs have outpaced asset values

Average capital values vs construction costs, index, March 2010 = 100



Source: Knight Frank Research, ABS, MSCI

Secondary offices feel the pinch

The return of risk pricing in the Melbourne office market



We have recently seen a marked repricing in the market, as yields have come off their historic lows. This has primarily been seen as due to two main factors. Firstly, the rise in long-term interest rates, including expectations for the level of future rates. Secondly, the rise in vacancy and uncertainty over the strength of future demand, which casts doubt on security of income and leads to more subdued rental growth expectations over the forecast horizon.

Both of these factors, the level of interest rates and rental growth expectations (or their proxy), are important in explaining, modelling and forecasting yields. However, on top of these standard explanations of the general levels of yields, there is another issue that goes beyond any

specific property or market – risk. A risk premium is effectively the compensation investors require for taking risks, and one consequence of market volatility in recent years has been a rise in risk premia, as evidenced by a higher term premium in bond markets which compensates investors for the risk that interest rates may change over the life of a long-term bond. This had declined to less than nothing from 2019-22, partly due to perception that low interest rates were unlikely to change and partly due to quantitative easing. This environment has now ended, and risk now costs money. The yield premium has jumped nearly 150bps and now hovers around +100bps. This will have several impacts on commercial real estate.

ALL YIELDS ARE EQUAL, BUT SOME ARE MORE EQUAL THAN OTHERS

Within Melbourne CBD, and consequently within our basket measuring prime yields, there is a wide range of office assets varying in quality, specification, age, vacancy, likelihood of breaks in income and other factors. While all assets have been exposed to higher interest rates and a weaker market climate, the difference between the relative best and worst within the prime basket has increased markedly from 75bps to 175bps as risk is priced in more consciously to reflect that some assets present greater risk than others. If the risk premium continues to be elevated, then this increased spread will continue even as the

expected fall in prime yields comes about through 2025-26.

SECONDARY BUILDINGS ARE SECONDARY AND SHOULD BE PRICED AS SUCH

Similarly, the Melbourne CBD market had seen a marked decline in the spread between prime and secondary properties over the last few decades. In the 1990s the spread averaged around 400bps, reflecting high vacancy rates skewed to secondary buildings but this compressed to very low levels in 2017-22, when low vacancy rates and low interest rates engendered great confidence in the outlook for secondary assets.

Now, with the return of risk pricing, the spread between average prime and average secondary has risen to 93bps. Modelling by Knight Frank Research shows that this should move to around 140 bps with weakness in secondary pricing persisting even as the prime market starts to recover.

YIELD OUTLOOK

Melbourne yields are currently at 6.46% and are forecast to top out at 6.60% at the end of 2024. Whilst our forecasts are for prime yields to start falling in 2025 and head back below 6.0% in the medium term, this is just for prime yields on average. If risk continues to be priced in the market, then secondary yields are likely to remain under pressure and rise further in 2025, and then to have a more modest recovery compared to the prime market. In fact, we forecast them to remain over 200bps above their lows seen in 2022.

For the prime market we do not see yields returning to the low levels seen pre-Covid. However, within our 'average' prime forecast the expectation would be that the very best buildings would continue to outperform the average level and to a larger extent than in the recent past. Conversely, the weaker prime assets will struggle to get close to our forecast level.

Markets factoring in a higher risk premium

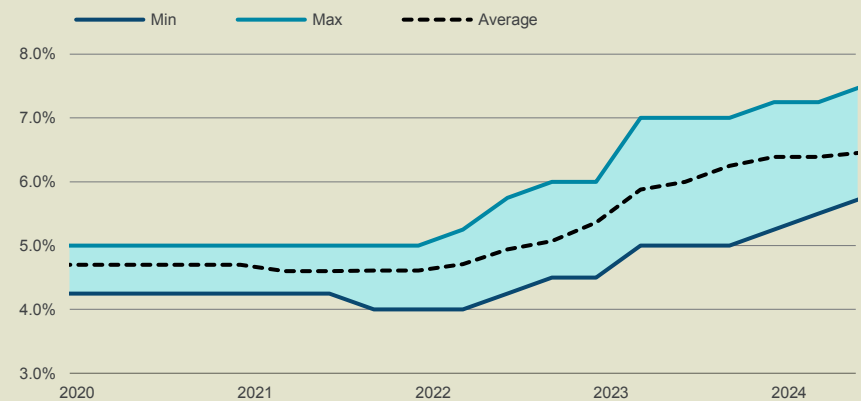
Term premium estimate for 10 year bond, per cent



Source: Knight Frank Research, AOFM

Widening prime yield range

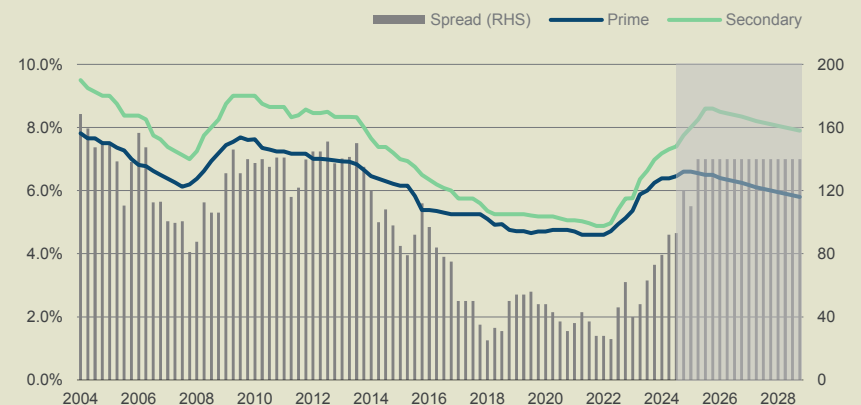
Melbourne CBD prime office yields



Source: Knight Frank Research

Widening spread between prime and secondary

Melbourne CBD office yields



Source: Knight Frank Research






Boosting portfolio resilience

Real estate to resume its role of stabilising long-term portfolio returns

With private markets now stabilising and listed markets amid a strong phase of growth, real estate is poised to re-assert its central role in multi-asset portfolios. Over the past two years, some institutional investors, including local superannuation managers and global pension funds, have sought to reweight to lower the proportion of real estate within their overall asset allocation strategy given the cyclical downturn, but as we look ahead, we consider that real estate will resume its role as a bond-equity hybrid acting to stabilise long-term returns.

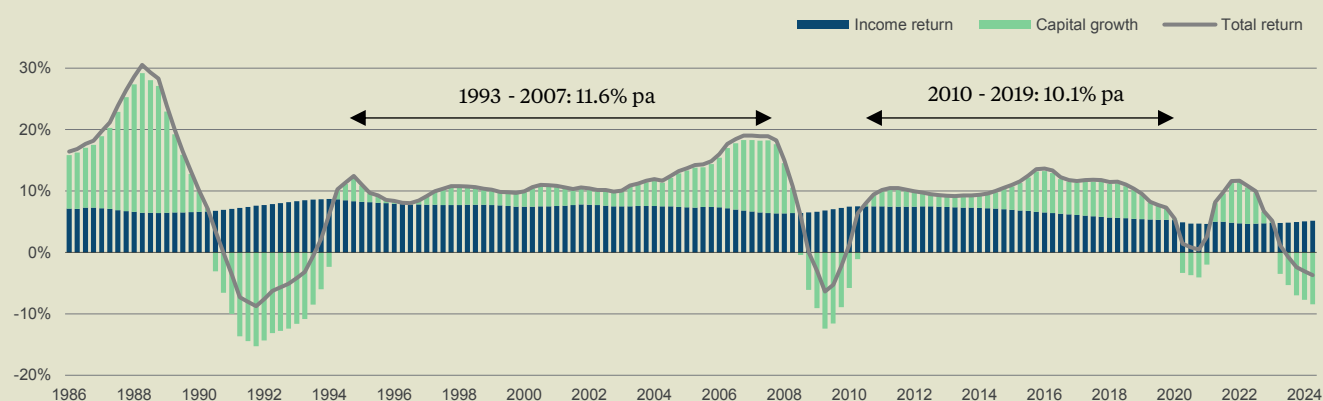
Real estate tends to experience long periods of growth, as evidenced by 15 consecutive years of strong returns from 1993-2007, and another 10 years in succession from 2010-2019. The current downturn is only the third such event in 40 years and once it ends, the sector is poised to resume its role as a critical component of institutional capital allocation – and with potential for a quicker and stronger recovery in Australia, global asset managers will be targeting our market.

Historic average total returns and volatility by broad asset class

	10-year	20-year	30-year	30-year standard deviation
 Real estate (MSCI All Property index)	7.3%	8.6%	9.1%	5.0%
 Equities (ASX 300 total return index)	8.0%	8.4%	9.1%	14.7%
 Fixed income (J.P. Morgan government bond index 7-10 years)	2.4%	4.8%	6.3%	10.1%

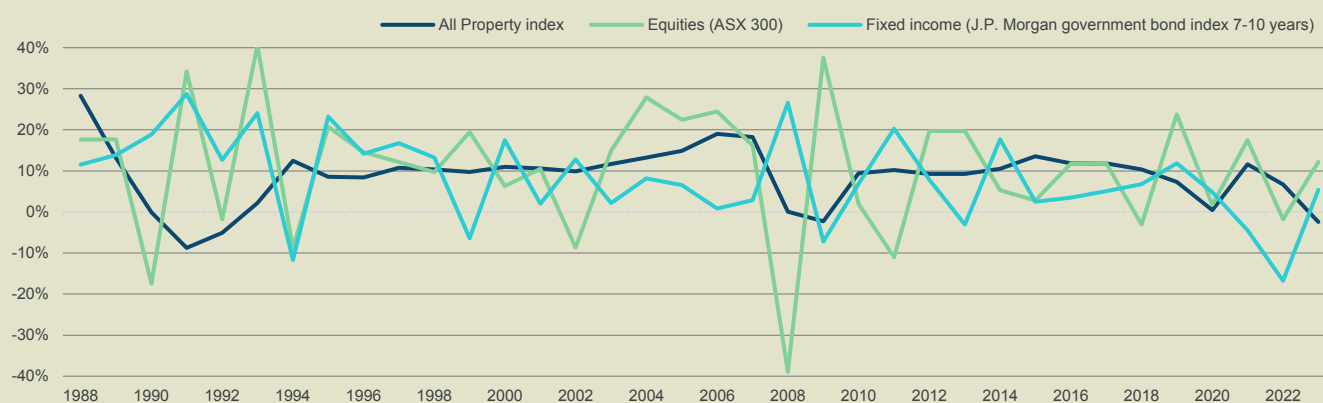
Long growth cycles have generated high returns

Historic direct property total returns - All Property average, y/y



A stabiliser in multi-asset portfolios: low volatility and strong average returns

Annual total returns in Australia by broad asset class



Ready to strike

Investors poised to execute revised strategies after lengthy hiatus

The divergent downturn described earlier speaks to a high degree of convulsion in property markets that has upended traditional norms and the perceived hierarchy of risk associated with different sectors, different locations and different types of investment.

Most obviously, prior to the pandemic, investors generally perceived low risk in the office sector and relatively little difference between the degree of income security in different locations. This resulted in relatively tight spreads between core CBD and non-core CBD locations, and between CBDs and wider suburban markets.

Retail assets have seen this convulsion play out over a longer period, as evidenced by the re-pricing of sub-regional shopping centres versus the strengthening of neighbourhood centres, as investors shifted their view of the relative growth outlook.

Meanwhile, the emergence of living sectors has opened new opportunities, but also the need to become familiar with new asset types and evolving planning frameworks.

Among the cities, there has been a similar reappraisal of the respective economic outlook, with Brisbane now viewed more favourably and Melbourne grappling with more uncertainty and the advent of new property taxes.

In this context, plus a wider macro environment of heightened uncertainty, it is not surprising that many investors have needed to take time to reappraise their strategy and hence their appetite for different sectors and locations.

After nearly three years in a state of flux, however, many groups have now reset their expectations and are ready to hone in on their preferred investment opportunities. Many are now comfortable with the balance between risk and return in the office market and are attracted by lower pricing, becoming increasingly ready to engage in upcoming campaigns.

Other groups are more focussed on living sectors and have taken time over the past two years to better understand the feasibility constraints and planning frameworks, and are now better placed to execute on new developments and form new partnerships.

Finally, retail markets are set to benefit from significantly higher demand as investors re-engage with the sector and seek to rebuild allocations. Many have been heartened by the relative resilience of the sector during a difficult period and a favourable outlook for income growth will attract more capital in 2025.



← Click/tap to view original report

Forecast review

Evaluating the accuracy of our 2024 Capital Market predictions

1

2024 WILL BE A BETTER VINTAGE FOR INVESTORS

While valuations may not have bottomed out yet, the stabilisation of prime yields in core markets reveals it is a much better time to get into the market, so we were right on this one.

2

WIDE DIVERGENCE IN YIELD IMPACT

This is undeniably true, as evidenced by the divergent performance in office markets between core and non-core locations.

3

PRIME SYDNEY OFFICE YIELDS TO PEAK IN 2024 AND FALL 50-75 BPS BY 2026

The jury is still out... let's see next year, although we think the pace of decline will be a little slower with long-term interest rates not expected to drop as much as was expected last year.

4

EXPANSION OF THE BTR PIPELINE

Progress in 2024 was much slower than expected, owing to challenges meeting feasibility thresholds, but we still think this will come through, albeit more gradually.

Office

Metro corridors redefining the geography of demand

31 Stay versus go?

Corporate conservatism will spotlight fitted space as companies prioritise financial prudence and workplace quality

32 Development drought

High vacancy rates obscure the looming lack of new supply

34 CBD revival

Metro corridors will reinforce the primacy of CBDs

36 ESG drives tenant demand in Adelaide

ESG considerations are not just a big city story

38 Achieving more with less

Key themes from the 2024 (Y)our Space Australian occupier survey

Stay versus go?

Corporate conservatism will spotlight fitted space as companies prioritise financial prudence and workplace quality



As we highlighted in last year's report, real estate decisions have become more complex across multiple dimensions since the pandemic. Business transformation, workstyle experimentation and new technologies continue to influence

real estate strategy and occupiers are adapting to change on several fronts. Most of these changes ultimately put a higher premium on the quality of the workplace experience, motivating many tenants to upgrade. This has been reflected in the superior leasing

performance of prime assets in the best locations.

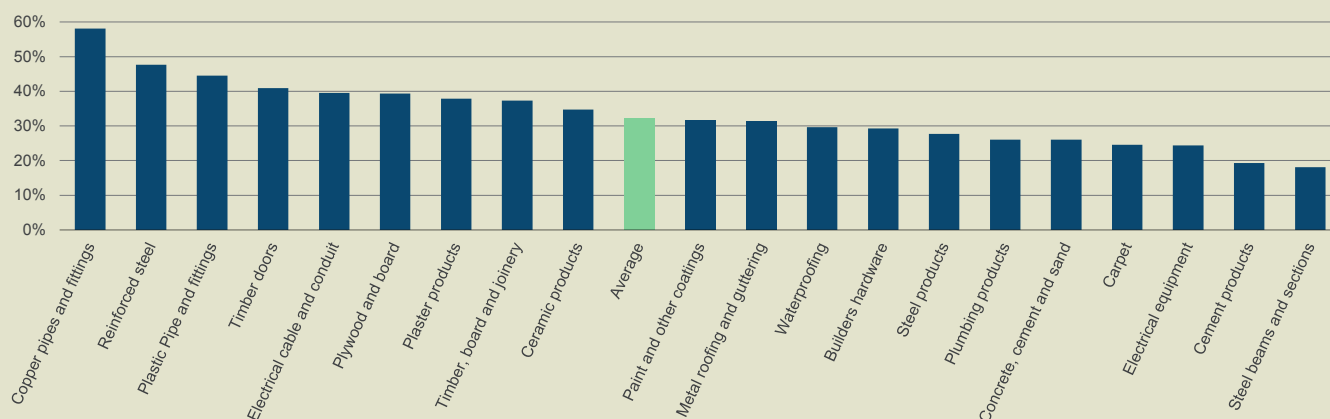
At the same time, the business climate has been cautious throughout 2024, with corporates wary of the potential for weak consumer spending to weigh on the economy and drag on growth prospects. In addition, higher construction costs and higher incentives have shifted the financial metrics driving the stay versus go decision. A high level of incentives can still be obtained on lease renewals, making staying put more attractive, while steep rises in material and construction costs have driven up the cost of new fit-outs. Also, some owners are limiting the extent to which incentives can be taken as up-front capital contributions versus rent abatement, which also tends to reduce the appeal of moving.

As a result, in the near term we expect a higher-than-normal proportion of tenants opt to stay put, and many that opt to move will be seeking good quality fitted space that can be adapted to suit a new user with relatively little cost.

By late 2025, however, we expect more tenants will be opting to move once again, as confidence picks up off the back of an improving economy and the prospect of a tightening supply dynamic starts to influence decisions, motivating more tenants to move to secure better quality space ahead of time.

Steep rise in construction costs since 2020

ABS producer price index growth, Q4 2020 - Q2 2024



Source: Knight Frank Research, ABS

Development drought

High vacancy rates obscure the looming lack of new supply



High vacancy rates in most markets and elevated incentives continue to point to the need for caution in bringing forward new developments, and at the aggregate level, many markets appear over-supplied. However, this obscures the prospect of a tightening of supply at the top end of the market, owing to a slowdown in new development while many more tenants still need to adapt and upgrade their workplace experience.

Looking beyond the limited number of schemes currently under construction, the office market is facing several years of limited new supply as developers find it difficult to meet feasibility thresholds. High construction prices and elevated funding costs continue to weigh on development decisions. In addition, the market downturn has in many cases upended the balance between total costs and achievable sale values.

The slowdown in commencements is now clearly impacting the pipeline and will start to influence tenant decisions in 2025 as they perceive the risk of a shortage of prime space later in the decade, especially in Sydney and Brisbane. This will bring tenants to market earlier, particularly those with larger requirements, and act to drive up the face rents on new developments since this will be the only way to counter other pressures on feasibility.

Sydney to see a new supply drought in 2025-26

2024 saw a large influx of new supply arising from over-station developments (OSD) at Martin Place, Parkline Place and Victoria Cross in North Sydney. Beyond the OSD developments, however, the market will enter a period of virtually no new supply until 2027, with the refurbished 33 Alfred Street the only major scheme to be delivered in 2025. Three

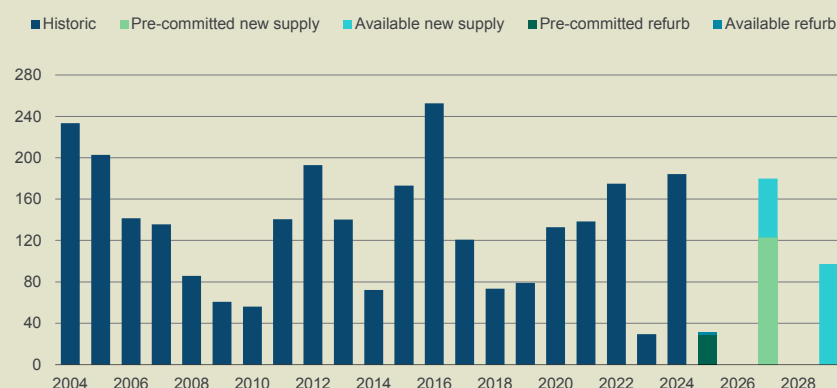
major developments have recently commenced construction: Atlassian Central (75,000 sqm) at the future tech central precinct; Charter Hall's 2 Chifley South (42,000 sqm); and, Mirvac's 55 Pitt Street (62,800 sqm). All have achieved strong levels of pre-commitment already and with no other new-build options before 2029, prospective tenants seeking Premium Grade options will have limited choice.

Tight supply in Brisbane to persist

In contrast to Sydney, Brisbane will see a significant quantum of prime stock delivered in 2025 including the fully pre-committed 205 North Quay (43,700 sqm), the 62% pre-committed 360 Queen Street (46,700 sqm) and refurbishments at 70 Eagle Street (11,476 sqm) and 140 Elizabeth Street (9,908 sqm). Beyond 2025, however, no major schemes will be forthcoming in 2026 and 2027, with the next major development not due until Waterfront Brisbane North is delivered in 2028. Total vacancy is forecast to increase with the new supply in 2025, but then fall to a low point of circa 8% in early 2028.

Thin development pipeline in Sydney

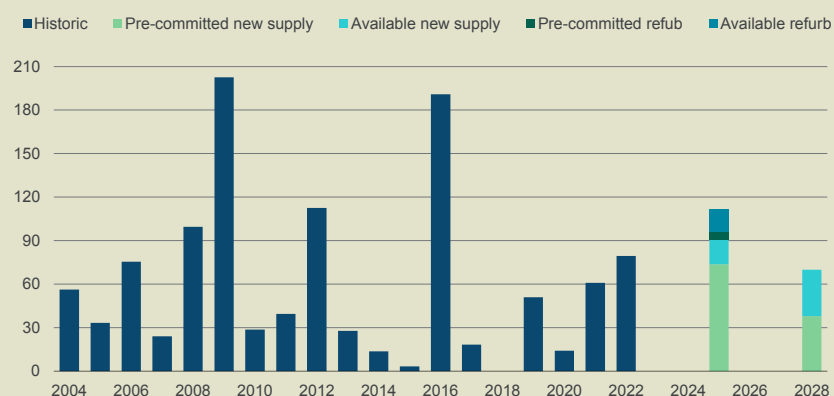
Sydney CBD development pipeline, thousands sqm



Source: Knight Frank Research

Thin development pipeline in Brisbane

Brisbane CBD development pipeline, thousands sqm



Source: Knight Frank Research, PCA



CBD revival

Metro corridors will reinforce the primacy of CBDs

In the context of current office market dynamics whereby the CBD markets are generally out-performing suburban centres, new rail lines in Sydney, Melbourne and Brisbane are likely to reinforce the primacy of CBDs, while also creating opportunity in fringe markets along the newly redefined transport corridors.

By speeding up connectivity to the central core, they reinforce the strength of the CBD as the predominant business cluster within each city, widen the pool of talent that can be accessed through a central location and reduce one of the motivations for tenants to locate elsewhere. New stations also tend to act as focal points for new development, thereby creating more opportunity for businesses to cluster around newly activated precincts.



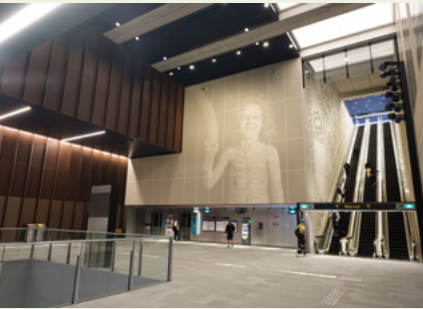
Sydney CBD footfall almost back to 2019 levels

Average daily trips to Sydney CBD for all modes of public transport



Source: Knight Frank Research, Transport NSW

East Coast Metro Corridors



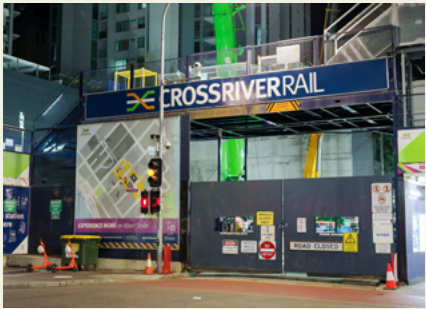
SYDNEY METRO

The advent of Sydney Metro marks a step change in the quality and speed of Sydney’s mass-transit rail network, setting a new benchmark for the standard of public transport within Australia. The Metro provides much faster transit between Chatswood on the North Shore and Sydenham in the south-west. The project has already helped to boost footfall in the CBD, which was up by 17% y/y in Q3 and is now getting close to the peak levels set in 2019.



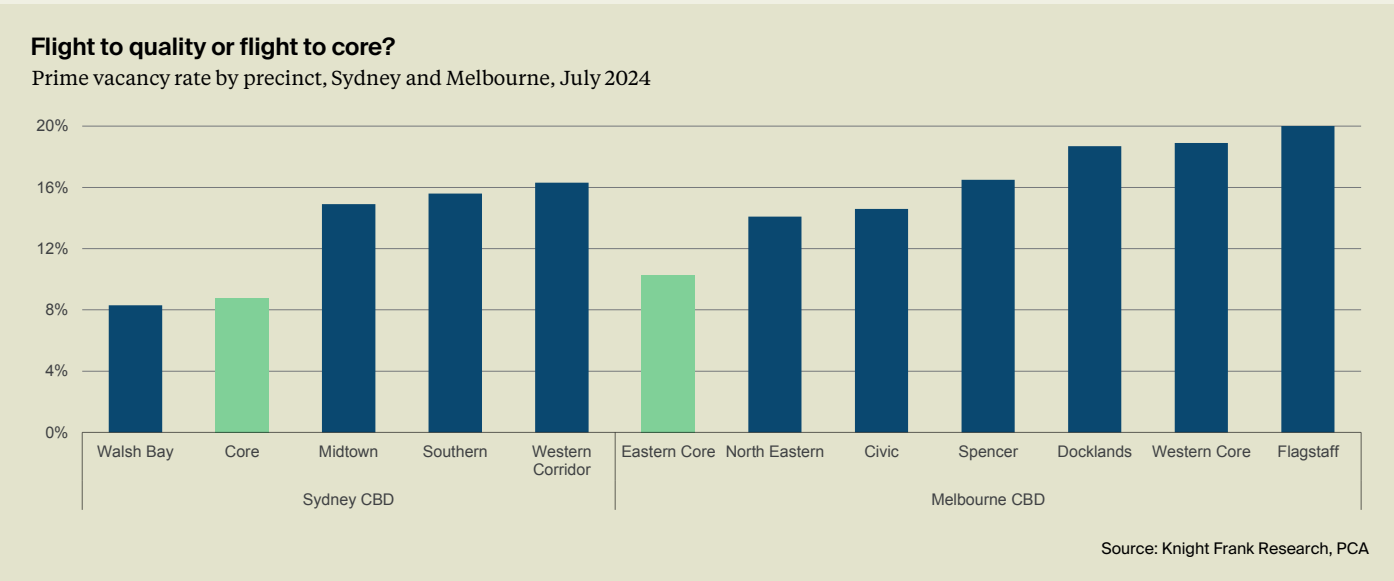
MELBOURNE METRO TUNNEL

In 2025, Melbourne is also set to benefit from a new rail line servicing the CBD and adjacent markets, in the form of the Metro Tunnel project with five new underground stations at Town Hall, State Library, Anzac, Arden and Parkville. The project will create an end-to-end rail line from the north-west of the city to the south-east, provide substantial additional capacity and take pressure off the city loop. Passengers will be able to travel across the city from Anzac Station on St Kilda Road to Arden Station in North Melbourne in 11 minutes.



BRISBANE CROSS RIVER RAIL

Meanwhile, the construction phase of Brisbane’s Cross River Rail project is set to complete in 2025, although services are not scheduled to commence until 2026. The project provides a second rail line running across the Brisbane River directly through and under the CBD, increasing capacity and removing the current bottleneck whereby all trains need to run over a single river crossing. Four new underground stations, including at Albert Street and Roma Street, will immediately speed up travel times to the CBD and change pedestrian patterns through the mid-CBD region, while additional capacity at the core of the network will be created allowing for further improvements to rail connectivity across South East Queensland from the Gold Coast through to the Sunshine Coast.



ESG drives tenant demand in Adelaide

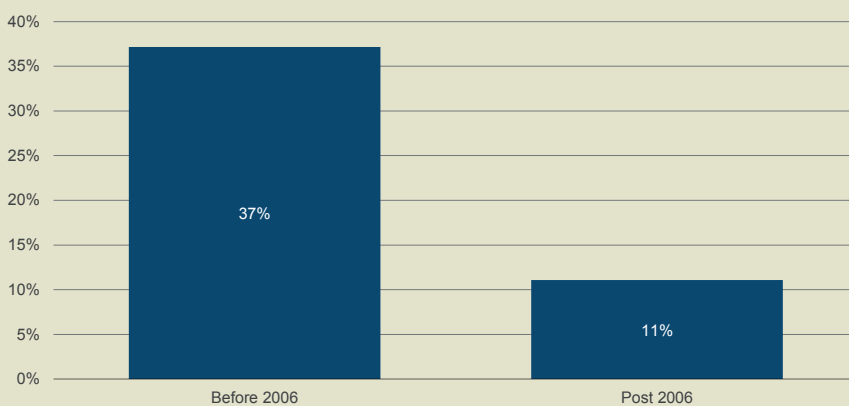
ESG considerations are not just a big city story

Divergent trends within the A Grade market in Adelaide highlight that ESG is not just impacting on tenant demand in the largest cities. Following a flurry of new builds and refurbishments within the CBD, the A Grade vacancy rate has jumped from 11.9% to 21.9% over the past two years. However, newer buildings with high levels of environmental accreditation are still faring relatively well, as evidenced by the much lower vacancy rate for office stock completed after 2006 (11.6%), while older A Grade assets are experiencing much higher vacancy (37.2%).

There has clearly been a significant move from tenants to more highly accredited buildings and this is where the momentum will remain going forward, providing much more secure income in a market facing elevated supply levels. For example, the Royal Automobile Association (RAA) signed a lease earlier this year to move to 150 Grenfell Street, which aims to be a 6-star NABERS, fully electric building. RAA's CEO specifically stated that the building 'is seeking to become South Australia's first upfront carbon neutral certified office building – reflecting RAA's commitment to reduce its environmental impact and maximise sustainability.' Looking ahead, the Federal government's desire for highly accredited assets will continue to pose a challenge for the market given that there are relatively few assets with a 5+ star NABERS rating.

Newer and more highly credentialed buildings in demand

Adelaide prime vacancy rate by age of stock, July 2024



Source: Knight Frank Research, PCA





← Click/tap to view original report

Forecast review

Evaluating the accuracy of our 2024 Office predictions

1

STRONG OUTLOOK FOR BRISBANE AND PERTH

We were right on this – Brisbane and Perth have led the way in terms of rental performance with net effective growth of 16.4% and 12.9% respectively over the past year.

2

CORE CBD OUTPERFORMANCE WOULD SPREAD TO NEIGHBOURING PRECINCTS

This has occurred in Sydney, with Barangaroo and Midtown now performing broadly in line with the Core market. In Melbourne, the Western Core has stabilised, but performance is still strongest in the Eastern Core.

3

PRESSURES ON FEASIBILITY WOULD SLOW DEVELOPMENT STARTS

This has occurred with the multiple schemes being delayed. The impact on rents will take longer to play out.



Achieving more with less

Key themes from the 2024 (Y)our Space Australian occupier survey

OCCUPIERS SEEKING TO UPGRADE WITHIN A BUDGET

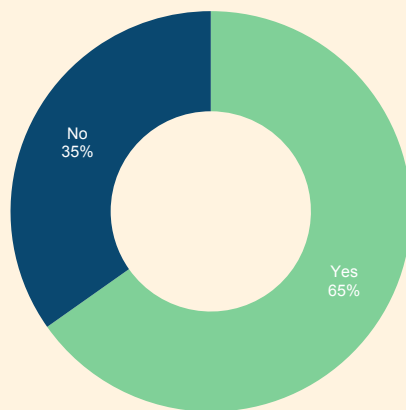
Our latest survey of Australian occupiers reveals that many continue to grapple with how best to adapt their workplace settings to suit evolving business needs and workstyle preferences. In a complex

environment for decision making, the results reflect increased focus on cost effectiveness, with real estate options viewed through the lens of needing to provide the optimal workplace experience, while also providing excellent value for the investment outlay.

Over the past three years, we have witnessed a substantial adjustment in workplace strategy, with 65% of respondents reporting they have changed the mix of space in their workplace. The changes made vary widely, with no one-size-fits-all approach, but many occupiers have

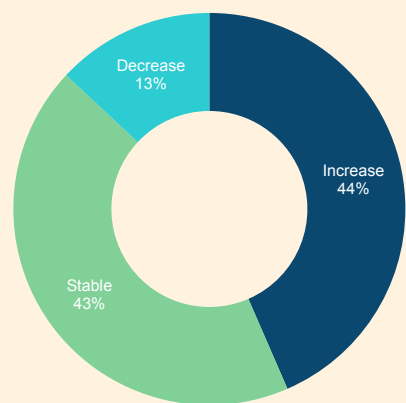


Over the past three years have you changed the mix of space in your workplace?



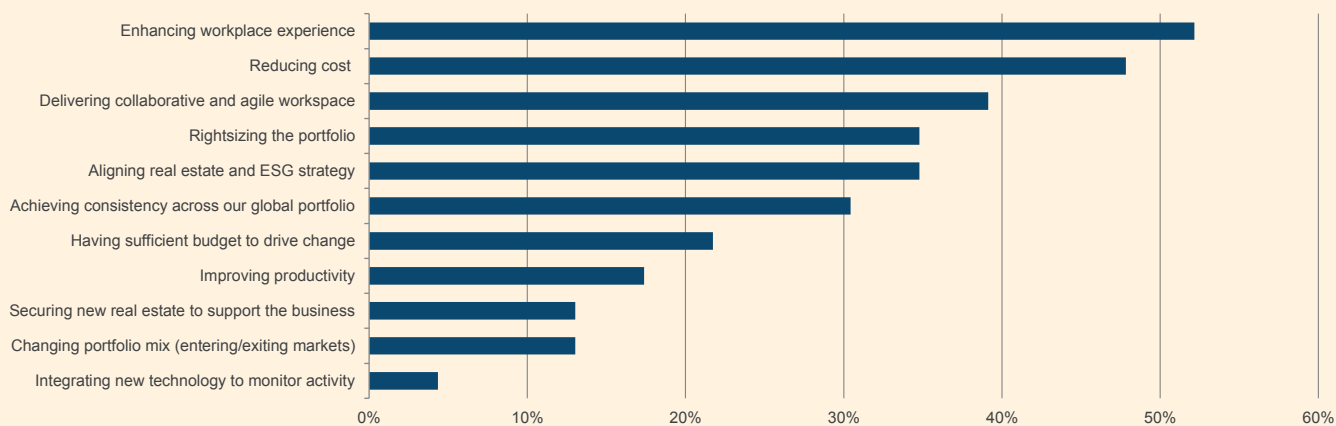
Source: Knight Frank Research

Over the next three years how do you expect your average office occupancy to change?



Source: Knight Frank Research

What will be the key challenges to delivering real estate strategy over the next three years?



Source: Knight Frank Research

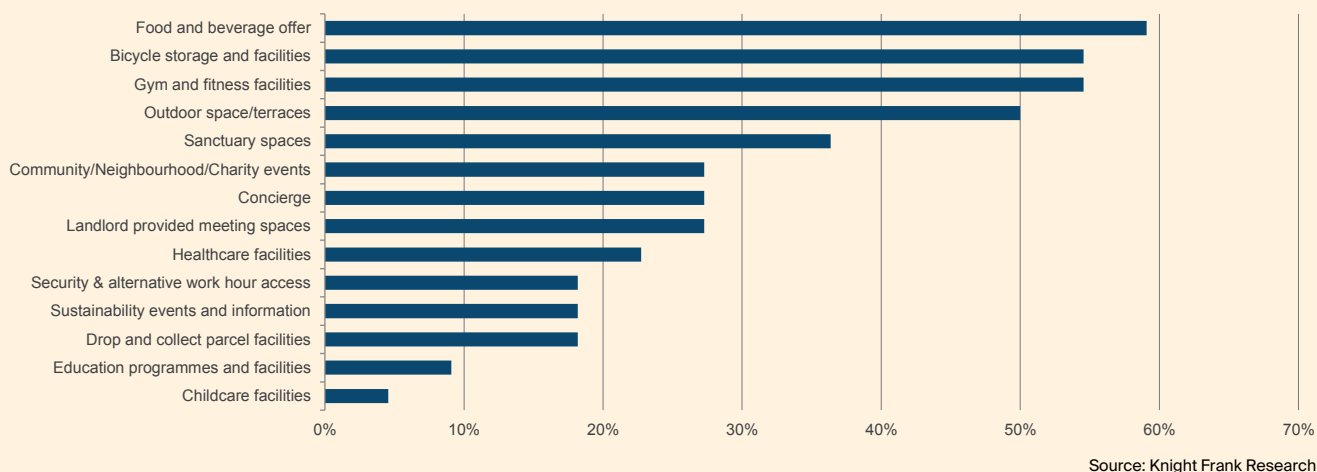
opted to designate more of their space for informal collaboration and increase the number of meeting rooms. There has also been a concerted push to enhance the quality of client spaces and audio-visual technology to boost the capability of meeting rooms and event and training spaces.

Looking ahead, occupiers expect to see overall occupancy numbers continue to tick up, with 43% of respondents expecting occupancy to increase, while only 13% expect to see a decline. In turn, this continues to ramp up expectations of the quality of the workplace experience, which emerges as the top-ranking consideration when respondents are asked about their major challenges

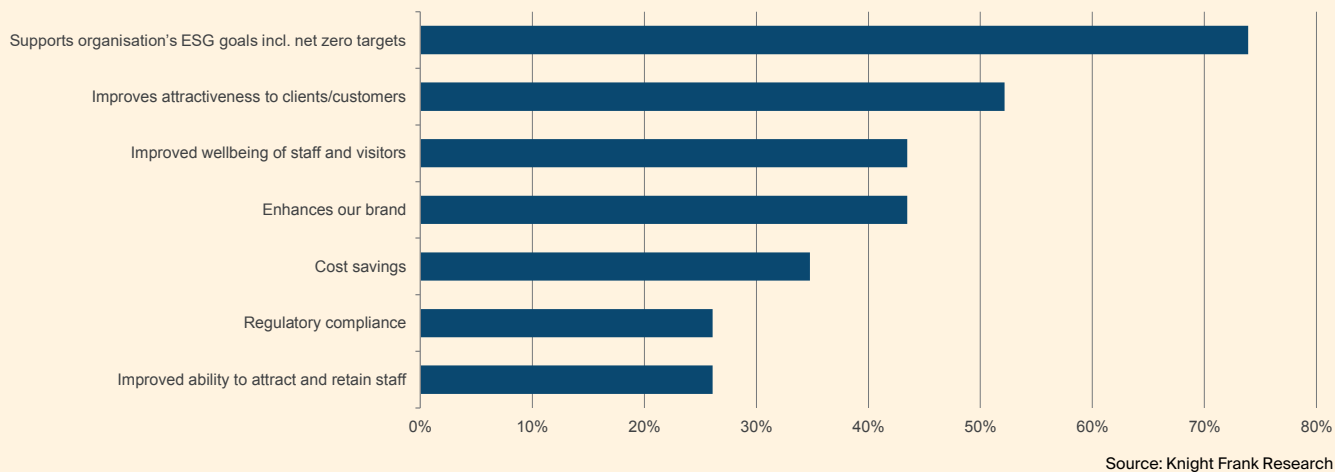
over the next three years. Alongside it, however, is the spectre of cost reduction, which ranked second – up from fourth two years ago – and was cited by nearly 50% of respondents as a major strategic consideration, no doubt reflecting cautious sentiment and a sluggish economy over the past 12 months.

There is a clear tension between these two overarching objectives, as in most cases a substantial improvement in workplace experience will not be achieved without additional investment. As noted earlier, in the short-term we expect cautious sentiment to win out but by the second half of 2025, the enduring pressure to upgrade will see a pick-up in deal flow.

What services will staff demand from their buildings over the next three years?



What do you regard as the benefits of occupying buildings with sustainability accreditations?



Industrial

Performance will be more divergent across cities and sub-markets during 2025

42 Rising imports to bolster tenant demand
Improving import volumes point to demand stabilising in 2025

44 Strong supply response rebalancing the market
Vacancy likely to rise further into 2025, driven by rising supply rather than weaker demand

46 The development adjustment
New supply wave will begin to abate in 2025

47 Paved with gold
Industrial land values continue to defy gravity

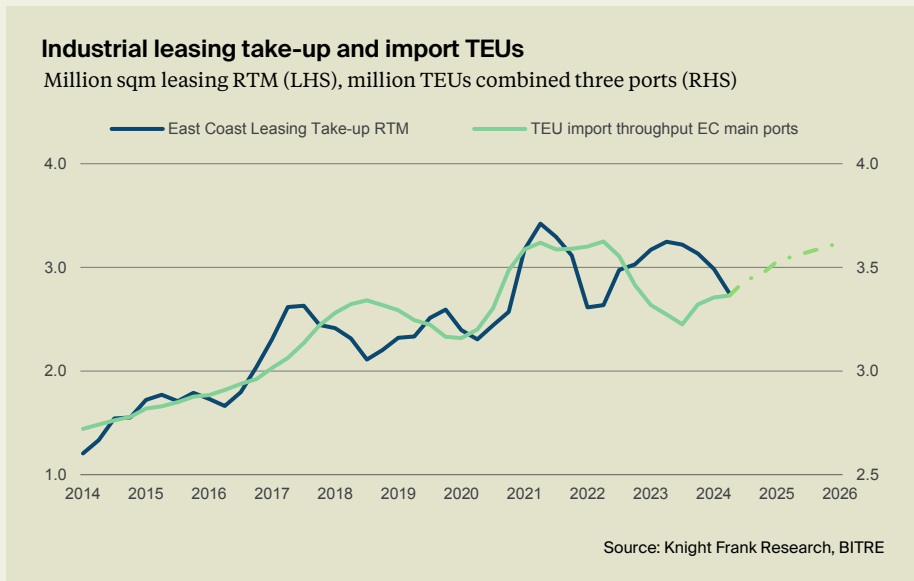
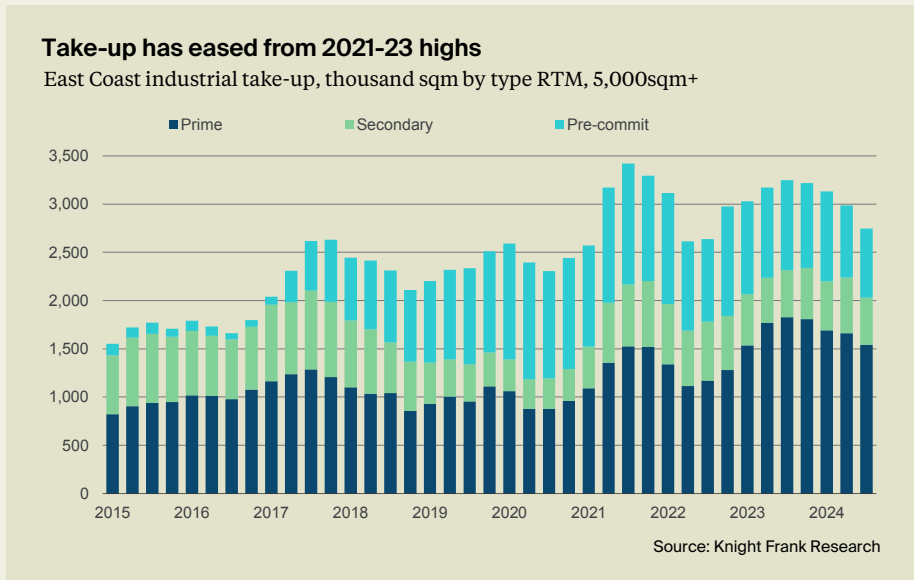
48 Rental precinct shake-up
Divergence in rent performance to deepen

50 From back-up plan to new asset class
The rise of hardstand investment

52 Melbourne's new investment frontier
Growth of Melbourne stock in the West and North highlights opportunity for multiple investment strategies

Rising imports to bolster tenant demand

Improving import volumes point to demand stabilising in 2025





After an extended period of high demand from 2021-23, the sentiment surrounding tenant demand shifted markedly from late 2023, in response to the slowing economy and the knock-on impact of weakening household spending. The moderation in demand is also partly a consequence of the buoyant activity in 2021-23 which partly reflected a bringing forward of plans for relocation and expansion from major retailers and 3PLs that would normally have played out over a longer period.

Across the East Coast, rolling annual leasing take-up is sitting at 2.75 million square metres to end Q3 2024, almost 20% below the peak of 3.42 million square metres recorded through mid-2021, although it remains higher than 2020 levels and 13% above the 10-year average. Demand is still robust for smaller units of space, particularly in infill locations, but the strength of demand for large units of space, particularly 10,000+ sqm, has moderated with tenants taking a more measured approach.

As we move through 2025, we expect demand to stabilise as economic growth and retail spending picks up. This will lead to a related acceleration in import volumes which have already started to recover. Import TEU volumes have long been seen as an indicator for industrial space demand and have recently returned to growth. This is expected to continue in 2025 as consumer spending picks up, with Oxford Economics forecasting further growth over the medium term. This is a simple measure which directly feeds through to a critical component of total industrial demand creation, and the broad peaks and troughs broadly align with the direction of total demand and industrial activity. Stevedore and port expansion is always a strong leading indicator of greater industrial space demand and leasing activity.

Strong supply response rebalancing the market

Vacancy likely to rise further into 2025, driven by rising supply rather than weaker demand



Industrial availability across the East Coast has lifted since the extreme lows of early 2023 as greater balance returns to the tenant-landlord relationship. This trend is expected to continue into 2025 with the strong supply response still flowing into the market.

Our latest vacancy data reveals that 40% of availability is from speculatively constructed assets, many in the early stage of construction. The strong pre-commitment market has also seen modern assets returned to the leasing market as backfill when tenants

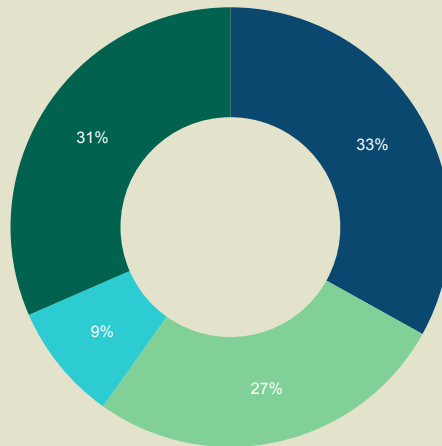
relocate into their new facilities.

Looking more deeply into the Sydney and Brisbane vacancy changes during 2024, to date the dominant cause of vacancy creation (51%) has been new space – arising from speculative completions and backfill due to tenants moving

Available space - October 2024

Sydney, Melbourne & Brisbane

- Existing Prime
- Secondary
- Speculative (Completed)
- Speculative (U/C)

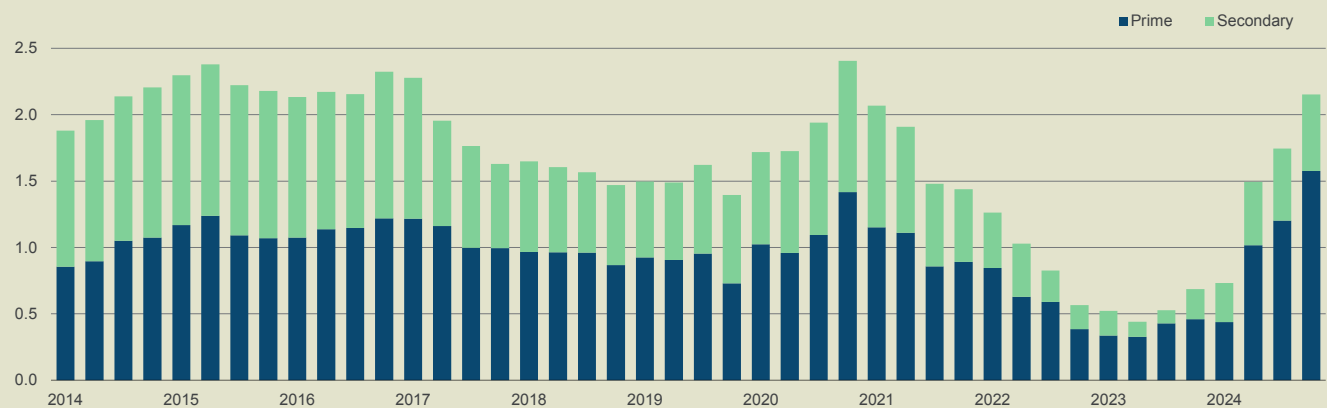


Source: Knight Frank Research

into new accommodation. This has been particularly apparent in the Brisbane market. Meanwhile, Sydney has experienced more instances of contraction and sub-lease vacancy. Some of this contraction space is a delayed response to the extremely tight supply conditions in 2021-23, when some businesses chose to lease assets that were too large due to a lack of alternative options, and now that space is coming back to the market as sub-lease availability. This process still has some way to run and we expect to see more sub-lease, assignment and short term deals as this excess space is absorbed.

Vacancy has normalised

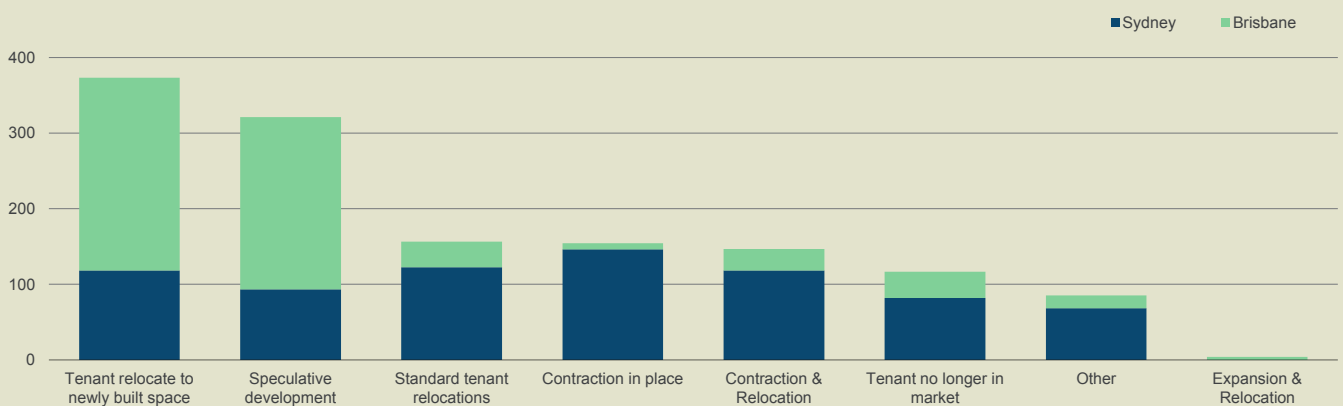
Eastern seaboard vacancy by grade, million sqm, 5,000sqm+



Source: Knight Frank Research

Reasons for new industrial vacancy - Sydney & Brisbane

Thousand sqm by location and type, 2024 year to date



Source: Knight Frank Research

The development adjustment

New supply wave will begin to abate in 2025

Although industrial is one of the fastest sectors able to deliver a newly constructed building to the market, there was still a delay in ramping up new industrial supply in response to the acceleration of demand in 2021. The pace of this delivery was also

predicated on deep institutional landholding pipelines and strong investor appetite outweighing construction cost elevation to fast-track feasibility and capital release for these projects.

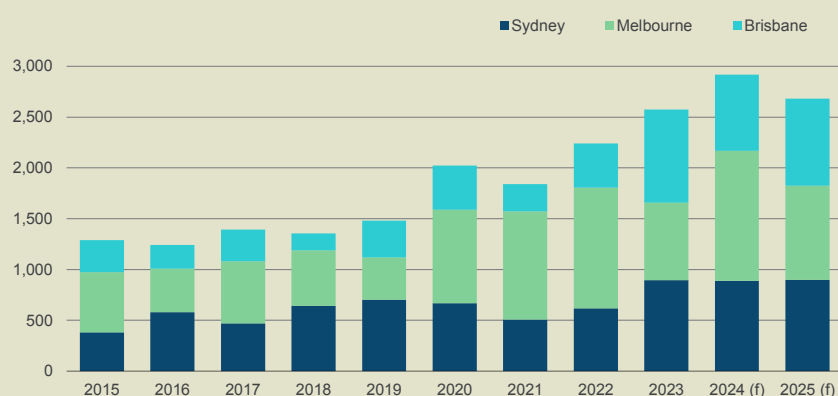
Reflecting this lagged escalation

in new supply levels, 2024 has been a record year for East Coast industrial completions with just under 3 million square metres expected to be delivered by year end (5,000sqm+). Over half of this is pre-committed space (58%) but speculative new supply will still make up 36% of the total, reflecting over one million sqm of new supply.

Looking ahead, total new supply is expected to drop back from this high-point with the 2025 total currently expected to be 8% lower at 2.7 million square metres. With construction of 800,000 sqm already underway for 2025 completion the year will again start strongly, however the release of capital for speculative developments is expected to moderate as capital constraints take a toll on development activity. We are already seeing this with planned schemes being pushed out to 2026 in response to shifting market conditions.

Supply pipeline moderating from high levels

Total completions, thousand sqm 2015 – 2025 (f)



Source: Knight Frank Research





Paved with gold

Industrial land values continue to defy gravity






Land values have continued to hold up despite rising construction costs and pressure on asset values. The scarcity of readily developable land means this is likely to continue in 2025, even though the development market is softening. Strong owner occupier demand, appetite for small land parcels from private investors plus institutional owners in for the long haul have combined to keep resale values robust, while there have been very few distressed sales of industrial land.

As evidenced in Western Sydney over the past four years, the presence of industrially zoned land is only part of the delivery and value equation. Without essential services the ability to capture tenant demand remains elusive. This is particularly the case as greater tenant scrutiny and conservatism comes in tandem with new pre-commitment decisions.

As such, zoned and serviced land values are expected to continue to hold firm and potentially return to growth in 2025 with developers looking through the current slowing in development and maintaining their long-term appetite for the sector.

Land Values (site 1-5ha \$/sqm change)



	Sydney	Melbourne Ex Fringe	Brisbane	Perth	Adelaide
10 Year	280%	282%	164%	56%	155%
5 Year	61%	70%	103%	74%	165%
2 Year	0%	1%	22%	22%	37%
1 Year	0%	2%	16%	16%	17%
2025	 Flat → Low	 Flat → Low	 Mid → High	 Low → Mid	 Mid → High

Rental precinct shake-up

Divergence in rent performance to deepen

Prime net rental growth continued through 2024 led by the smaller markets of Adelaide, Perth and Brisbane. Incentives are continuing to creep back into the market, firstly increasing for pre-commitment and speculative product and now extending further into the market. Incentives now average 12% in Sydney and Brisbane and 16% in Melbourne.

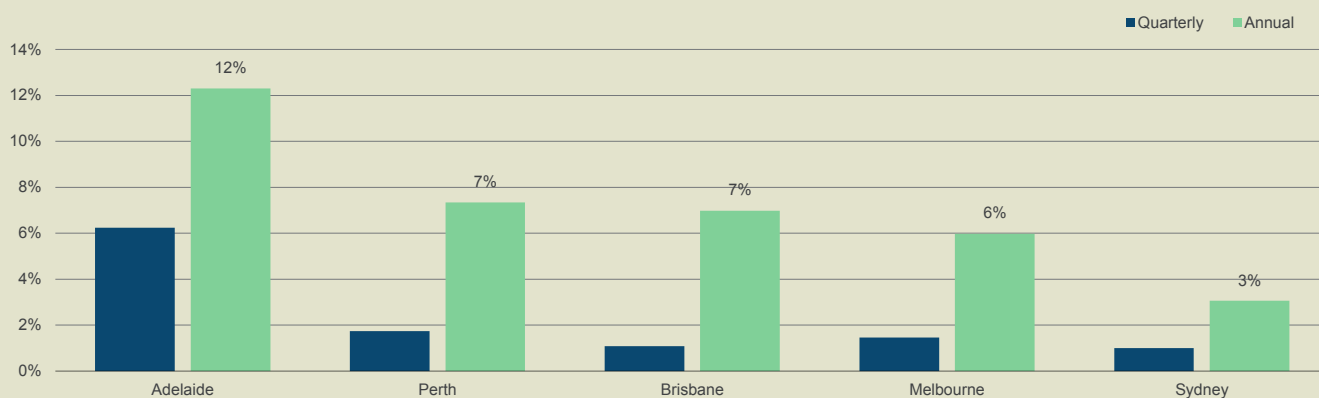
Within the larger markets there are still precincts which are seeing strong growth but there is greater variation emerging between the precincts depending on what exactly is available and the level of competition for tenants. In Melbourne growth is strongest in the established East and South East precincts where there is less supply able to be delivered, while in Sydney the growth is led by the tightly held South Sydney market.

This localisation of rental performance is expected to continue into 2025 and potentially deepen for precincts with similar product becoming available at similar timeframes. Market disruption from sub-lease and contraction space will also have an impact on rents and occupancy, diverting demand into shorter term spaces, but this will not be universal across the cities or sub-markets.



Rents have continued to grow

Prime rent growth y/y - average in major capital cities to Q3 2024



Source: Knight Frank Research

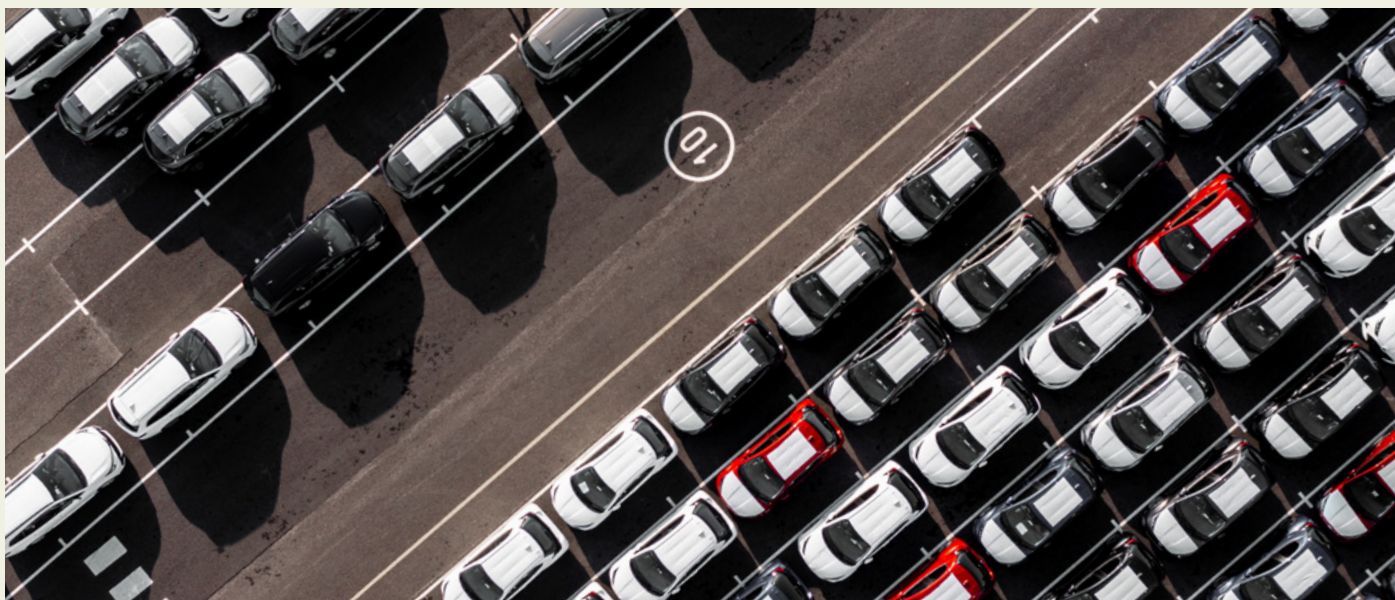


Vacancy is not evenly spread

Vacant space by precinct on the East Coast, Q3 2024, thousand sqm



Source: Knight Frank Research



From back-up plan to new asset class

The rise of hardstand investment

Hardstand, or Industrial Outdoor Storage (IOS), is in the midst of increasing sophistication and investor demand. Long central to the movement of container freight and new car delivery, the shift to just-in-case inventory and supply chain resilience has seen demand overflow out of the traditional port and intermodal adjacent locations and into more traditional industrial precincts.

Additionally, demand for outdoor storage has broadened with growing last-mile delivery fleet parking (and EV charging) requirements, recycling and waste management facilities, staging and storage for major construction and infrastructure projects, vehicle and heavy equipment sales/rental and even the increasingly ubiquitous pickle ball courts all competing for similar sites. The construction surge of the past two to three years has also absorbed a number of hardstand sites, leading to greater competition for this type of space and a change from casual or handshake agreements to more formal and longer leases to secure tenure by occupiers.

IOS has traditionally been the saviour of land impacted by powerlines, easements, flood exposure, challenging geotechnical conditions or as a back-up plan while a site

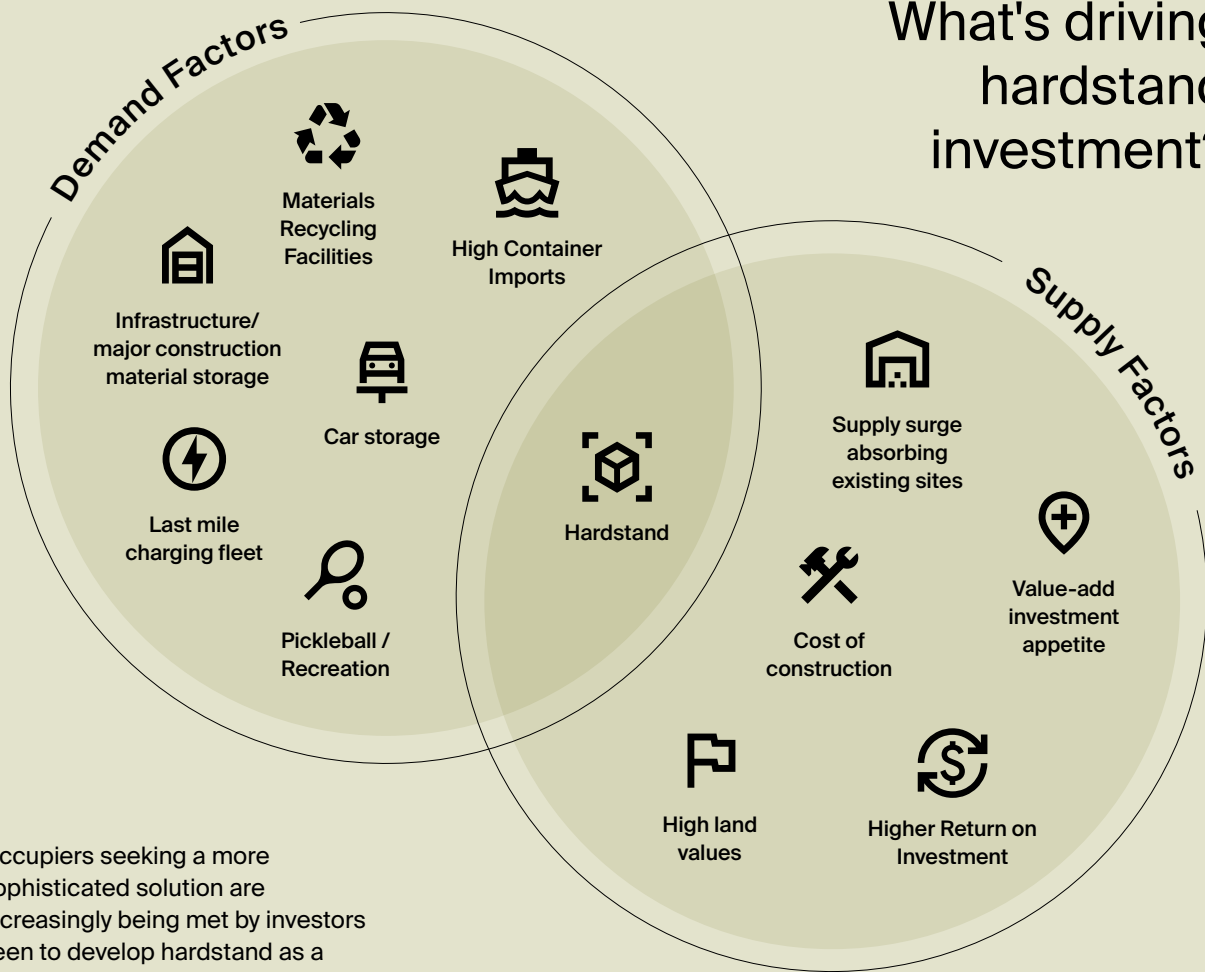
is being prepared for development. However, as occupiers have become more sophisticated in their needs and willing to take on longer lease terms and amortise more landlord improvements, the standard and expectations for this type of space has shifted.

Container rated hardstand, multiple crossovers, security fencing and CCTV, power, water and internet, industrial and preferably 24/7 zoning with B-double access to arterial roads are all considered to be central elements to IOS. Additionally, for car storage in NSW and Qld hail netting is also frequently used. These more sophisticated improvements are becoming more permanent than in the past and are taking IOS out of the 'short-term back-up plan' style of investment and attracting institutional investors keen to secure the relatively higher yields available for this space.

IOS has been a recognised asset class in the US for some time and investor demand has been building in other markets, becoming in focus in Australia as the higher cost of debt since 2022 has seen investors seeking higher yielding assets. Soaring construction costs and easing tenant demand for warehouse space has made development feasibility on new prime warehouse space more difficult. To date, although concrete costs have also had a large impact on the cost of IOS, the demand for this limited space has seen tenants accepting rents fully reflective of the cost of improvements.

As the Australian investment market moves through the next stage of maturity, with strong offshore ownership now in place, IOS will continue to appeal to value-add investors with relatively high ongoing income yield (relative to investment) and greater institutional ownership over larger, potentially multi-user sites as they tap into economies of scale, rather than fragmented ownership. Investors will see the exit strategy to take advantage of increasing land values and changing zoning to release the land value in a 5-10 year timeframe.

What's driving hardstand investment?



Construction costs and achievable rents for hardstand in Melbourne (\$/sqm)

Type of Hardstand	Construction cost (Q3 2023)	Construction cost (Q3 2024)	Achievable Rent (Q3 2023)	Achievable Rent (Q3 2024)
Crushed Rock / Bitumen	\$125	\$125	\$25-35	\$40-50
Concrete (Heavy Duty)	\$200-250	\$200-250	\$40-50	\$45-55
120 Tonne Container Rated Concrete	\$400-500	\$400-500	\$60-65	\$75-80

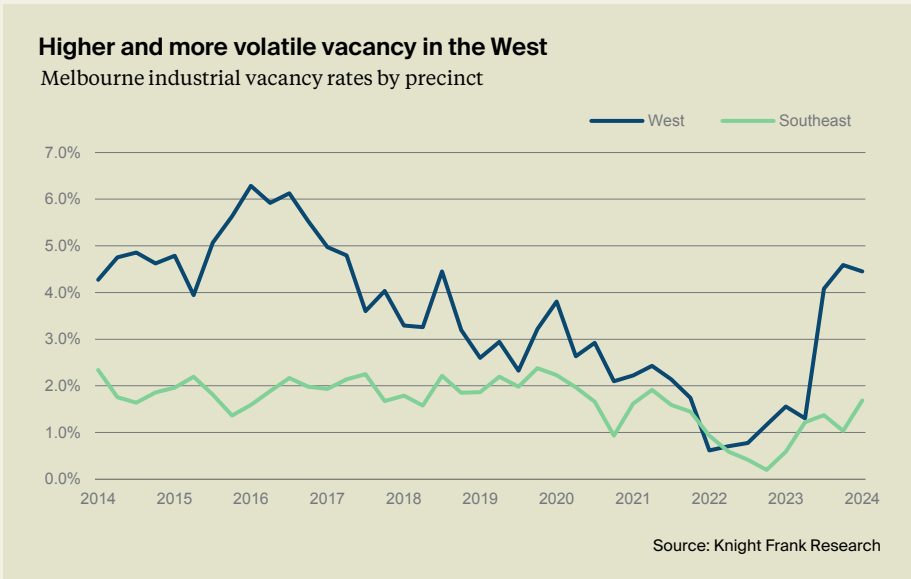
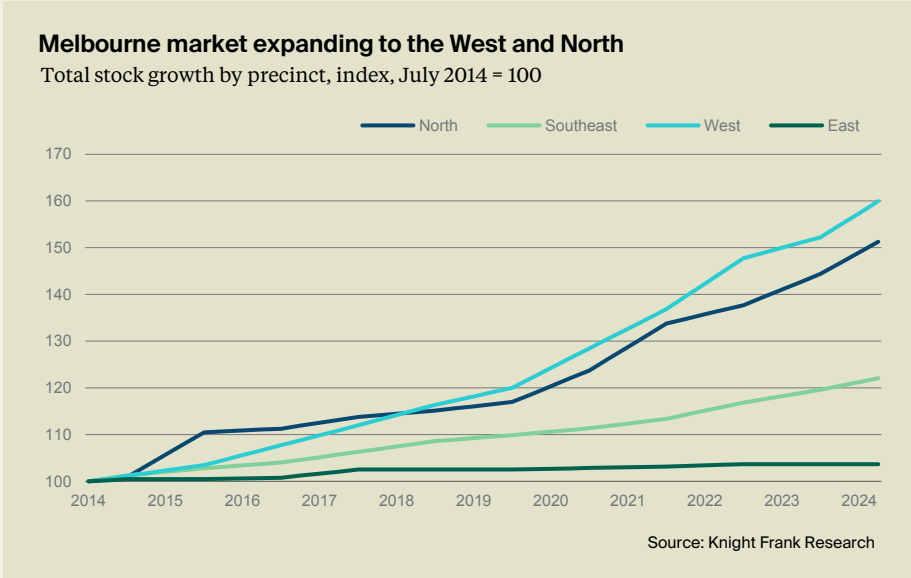
Melbourne's new investment frontier

Growth of Melbourne stock in the West and North highlights opportunity for multiple investment strategies

The industrial sector is often seen as a development heavy division of the commercial real estate market. Whilst this is true in many cases, a mature, standing investment environment also exists and can happily co-exist, as is the case in Melbourne.

A major milestone will be hit in 2025. The Southeast, which has historically been the largest provider of industrial space in Melbourne will lose its crown to the West. This will highlight the shift in the historical positioning of Melbourne's industrial base to the West and North.

Whilst the West and North have expanded rapidly, the very mature East is built out and with little available land it cannot expand. The Outer Southeast is still expanding, but the Inner Southeast faces the same issue as the Eastern precinct. Consequently, in the last 10 years total stock in the West has grown by 60% with the North not far behind. The East has barely added any space and the Southeast is somewhere in between.



One of the consequences of this is that there is much greater instability in the rapidly growing markets. Vacancy rates are both higher on average and more volatile. Developments in the Southeast and particularly the few in the East are much more likely to be pre-committed for example. However, during the recent boom years, the vacancy rate dropped most in the West as new tenants flocked to where they knew there would be space.

The different precincts highlight the contrasting investment styles on offer. The Eastern precinct offers solid standing investments underpinned by tight supply. Rental growth expectations are generally higher in the constrained East, often based around lease renewals of established tenants. Hence, whilst we are expecting rental growth of 2-4% on average in Melbourne industrial in 2025, as the markets are experiencing a period of slower growth, we are expecting to see 5-6% in the East and 0-2% in the West. Similarly, incentives will be under more pressure in the West than the East/Inner Southeast.



← Click/tap to view original report

Forecast review

Evaluating the accuracy of our 2024 Industrial predictions

- 1 RENTAL GROWTH SET TO CONTINUE**
Rental growth continued across all cities, however performance was more divergent than we anticipated with the smaller markets outperforming expectations, while Sydney and Melbourne underperformed.
- 2 INDUSTRIAL DEVELOPMENT WILL REMAIN ELEVATED**
We were right on this – construction and new construction starts continued to grow and 2024 is now expected to be a peak year for new supply.
- 3 INDUSTRIAL IRRS TO BE SUPPORTED BY WEIGHT OF MONEY SEEKING INDUSTRIAL ASSETS**
Industrial yields stabilised quickly with the risk premium for this asset class settling below that of office assets.





Environment, Social & Governance

Action replaces ambition

56 Race to Net Zero

As the 2030 target looms, regulatory pressure and skills shortages pose major challenges



BY JENINE CRANSTON, PARTNER, HEAD OF ESG

Race to Net Zero

As the 2030 target looms, regulatory pressure and skills shortages pose major challenges

Buildings need to be optimised for operational net zero

Investors at all levels, and especially owners of secondary grade assets, are seeking to decarbonise their portfolios, including via electrification. As regulation, mandatory reporting and changing stakeholder (capital, occupier and employee) expectations become further embedded in the sector, we are seeing investors across all grades now actively tackling programmes to reduce the operational carbon emissions of their portfolios. Demand for decarbonisation pathways and general sustainability reviews is growing strongly as 2030 – a popular net zero target date amongst property managers and investors – is now only 66 months away. In a highly competitive construction and building labour market, the industry has legitimate concerns about being able to access the design and construction skills, materials and trades necessary to effect these upgrades, as well as manage their associated costs.

Data central to mandatory reporting

A recent snap poll of Knight Frank's clients identified that access to quality data was the biggest challenge to achieving a net zero portfolio (65%). The Federal Government recently delayed the introduction of mandatory sustainability reporting by six months to commence in January 2025, which has come as a relief to many owners grappling with the issue of data collection and capacity to deal with reporting and are using the time extension wisely to prepare.

Nature has entered the conversation

The topic of nature-related risks and biodiversity was a real focus at the Green Building Council of Australia's (GBCA) Transform Conference, and we predict sustained momentum in this area reflecting nature's incredible role in combatting climate change. However, the Federal Government recently signalled its openness to compromise on nature safeguards in its budget, prompting the Australian Land Conservation Alliance (ALCA) to state that 'the accelerating loss of our unique biodiversity and ecosystems will also have far-reaching consequences for the economy and society unless urgently addressed'.

In the meantime, investors with the means and motivation are actively building nature roadmaps for their organisation. The GPT Group, for example, is looking carefully at nature withdrawals and investments in nature to create a 'net positive' nature outcome. These considerations are site-specific but also extend into the supply chain and consideration of how the organisation's suppliers and purchases impact nature.



The lion's share of emissions is expected to shift to embodied carbon

Embodied carbon was another key subject at this year's GBCA Transform Conference and is fast becoming a reality with the introduction of a NABERS embodied carbon tool and the NSW Government's Sustainable Buildings State Environmental Planning Policies (SEPP) introduced in October 2023. Investors, developers and occupiers are now grappling with measuring, designing and sourcing low embodied carbon fit-outs, refurbishments and buildings, at a time when reduction of operational carbon is an increasing priority in the sector.

Returning resources to re-use with a circular economy approach is also part of the hard but necessary work required to conserve resources in our resource-hungry industry. New skills and talent in this area will be required to tackle circular and sustainable design and demolition. In the UK this has been dubbed a 'retrofit revolution' with 58% of investors surveyed by Knight Frank targeting poor ESG-performing assets to upgrade, recognising a growing market distinction between 'the best' and 'the rest'.

Climate resilience

Insurance premiums are rising rapidly as climate-related natural disasters and weather events become more common in Australia. By 2060, Deloitte Access Economics forecast the costs of natural disasters in Australia to reach \$94 billion, representing a 29% increase relative to a baseline low emissions scenario. Over the next 40 years the different trajectories will lead to a \$125 billion difference in cumulative cost in present value. Even if a low emission scenario is achieved, the cost of natural disasters is forecast

to be \$1.2 trillion in cumulative costs over the next 40 years.

In addition, the Insurance Council of Australia have observed the heightened risk of flooding, noting that approximately 230,000 properties in Australia face a one-in-20 risk of a catastrophic flood each year. We see physical climate risk assessments as essential to inform owners about their climate risk and as an input ahead of any strategic upgrades and associated capital spend.

Built environment plays a pivotal role in the health and wellbeing agenda

Despite the continued impetus and urgency associated with energy efficiency and environmental factors, wellbeing and the 'S' aspects of ESG are gaining prominence in the minds of investors, operators and occupiers. The February launch of the joint GBCA and Hassell report – Social Value in the Built Environment – signalled the industry's commitment to setting, measuring and managing the social impact of the built environment. However, it is apparent that Australia still has some way to go when compared to its UK and European counterparts.

Over recent years, great progress has been made in defining targets for Australia's built environment sector to achieve net zero emissions, demonstrate climate resilience and create positive environmental impact. The momentum is now building to establish an equally robust, industry-wide framework around the social impact of our work. There is much to learn from global best practice, but an industry-wide local framework is still in development. We expect this conversation to progress in 2025, with owners increasingly seeking guidance in the assessment and creation of social strategies for their assets.



Retail

Strongest investor
demand since 2015

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A brighter outlook for retail sales

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Leasing spreads and MAT
demonstrate resilience

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2025 to see the strongest investor
demand since 2015



Growth back on the menu

A brighter outlook for retail sales

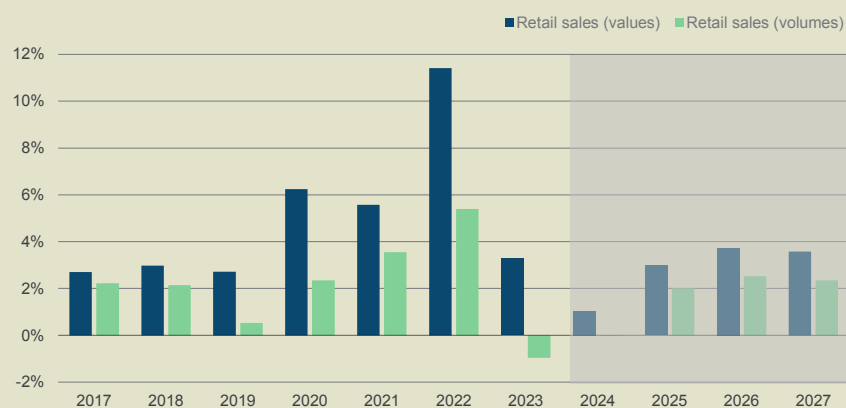
Given the contraction in real incomes during 2022-24 and the sustained pressure of higher interest rates on the consumer, retail sales momentum has inevitably been slow over the past two years. In nominal terms, total sales were up by a below-trend 2.0% over the year to June, while sales volumes have contracted marginally, down 0.6% over the year, reflecting weakness in most discretionary categories.

However, the outlook for retail sales is improving as some of the pressures on household budgets start to ease. The combination of wage growth and declining inflation is gradually enabling a transition to growth in real incomes, while income tax cuts and a raft of cost-of-living measures from State and Federal governments will also aid the consumer and bolster disposable income. Strong population growth is also playing a part in boosting aggregate spending capacity.

The most recent monthly data has shown early signs of improvement, with improving sales momentum in August. This is expected to continue into 2025, and by the end of the year retail sales growth is expected to be back to trend, at 3.0% y/y in nominal terms and by 2.0% in volume terms, which should provide a boost to discretionary spending on items that have lagged, such as household goods and clothing.

Improving retail sales outlook

Historic and forecast retail sales growth



Source: Knight Frank Research, Oxford Economics



Major centres have been resilient

Leasing spreads and MAT demonstrate resilience

Despite a challenging economic backdrop, retail owners have reported a steady improvement in leasing spreads, with a broad-based return to growth in FY 2024. In 2021 and 2022 lease spread data had bifurcated with stronger performance in neighbourhood centres dominated by non-discretionary tenants, but now growth has returned across all asset types. Operators of major shopping centres – such as Vicinity and Scentre Group – returned to growth, reporting 3.0% and 3.1% respectively, while operators of smaller neighbourhood assets such as HomeCo (5.9%) reported a continuation of solid growth.

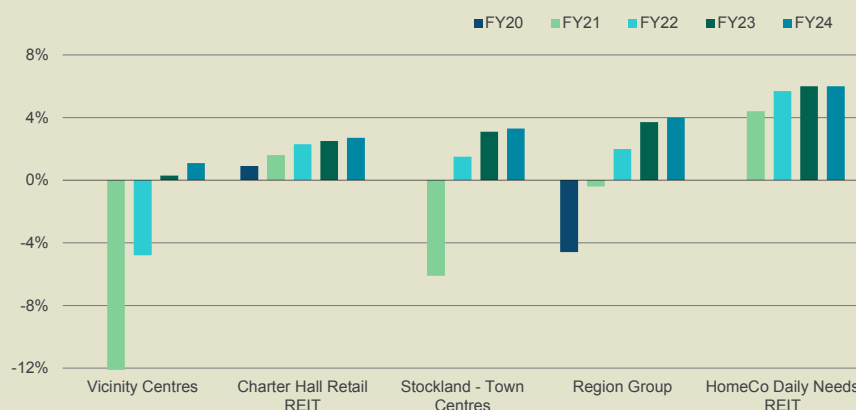
In addition, major shopping centres have withstood the aggregate retail slowdown and increased their share of overall spend, thereby experiencing resilient growth in

MAT over the past year. Most major centres experienced MAT growth of 4-6% supported by strong population growth and the gradual restoration of centre visitation after the disruption

caused by the pandemic. Aggregate visitation levels are moving back toward 2019 levels and this is translating to renewed interest from retailers in striking new leases.

Leasing spreads have steadily improved

Annual change as reported by financial year



Source: Knight Frank Research, Company reports

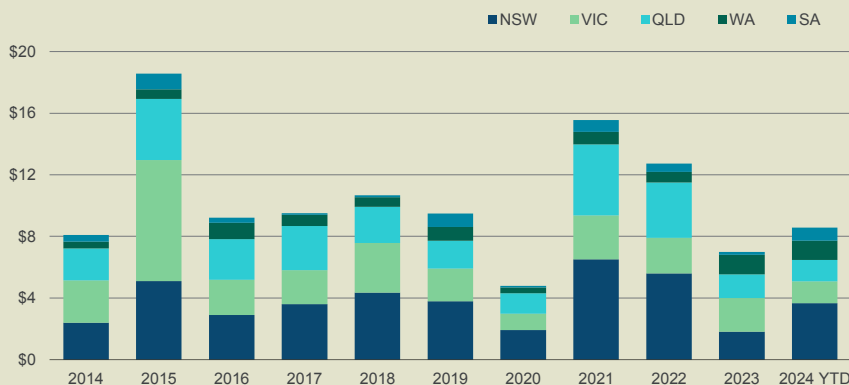
Retail reclaims the spotlight

2025 to see the strongest investor demand since 2015



Retail investment volumes on the rise

Investment volumes by state (AUD billions)



Source: Knight Frank Research, RCA

In the face of significant headwinds for the consumer, a backdrop of persistent underperformance since 2015 and uncertainty over whether the accelerated growth of e-commerce would continue post-pandemic, investors have understandably been cautious about the outlook for retail property in recent years. Cross-border investors have for the most part preferred to focus on other sectors, while major domestic owners have focussed on enhancing the performance of existing centres rather than expanding their holdings

through new development.

But after an extended period of caution and consolidation, the outlook for the sector is now much brighter, with several of these macro headwinds now dissipating and centre performance benefitting from those extended efforts to enhance visitation and customer experience. It is striking that in a period of weak retail spending, performance metrics have shown resilience and a return to growth and this augurs well for continued improvement as the economy returns to trend growth.

On top of this, high population growth without commensurate additional supply has bolstered the strength of the catchment for dominant shopping centres and also boosted demand for neighbourhood centres focussed on non-discretionary spending. Meanwhile, growth in online sales penetration has slowed to a gradual creep and is no longer perceived as an immediate threat to performance.

As a result, the outlook for the sector has shifted decisively and we consider that investor demand will be the strongest since 2015 when sector-wide transaction volumes hit a record high of \$19.2 billion. Improving performance has been noticed by a broader range of investors, with core funds that have avoided the sector for several years now renewing their appetite, and new retail funds set to be launched in 2025. Many current active buyers are acquiring retail assets for the first time.

With investor sentiment much more positive, the challenge now shifts to the supply side, with a lack of available stock relative to the level of demand. This will tilt the balance toward a recovery in capital values in 2025 as retail looks set to reclaim its traditional role at the heart of cross-sector portfolios.

Alternatives

Will the dam wall break?
Offshore capital awaiting
MIT reform

64 BTR sector heats up

Core capital ready to bridge the gap between ambition and action

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As AI demand surges - power access, investment shifts, and Melbourne's rapid rise drive unprecedented opportunities for Australian real estate



BTR sector heats up

Core capital ready to bridge the gap between ambition and action

Build-to-Rent (BTR) apartment completions reached a record high in 2024, with 4,349 apartments expected to be completed nationally, as the sector continues to expand. Looking ahead, 2025 is likely to see a higher total of close to 6,000 apartments based on schemes currently under construction, although the potential for delay means we may see a more modest increase.

On the face of it, this is a rapid expansion and a significant step up from much lower levels of apartment completions in 2023, but it is still less than many developers were projecting a year ago, due to well-documented challenges in the form of elevated construction costs, labour shortages and high funding costs.

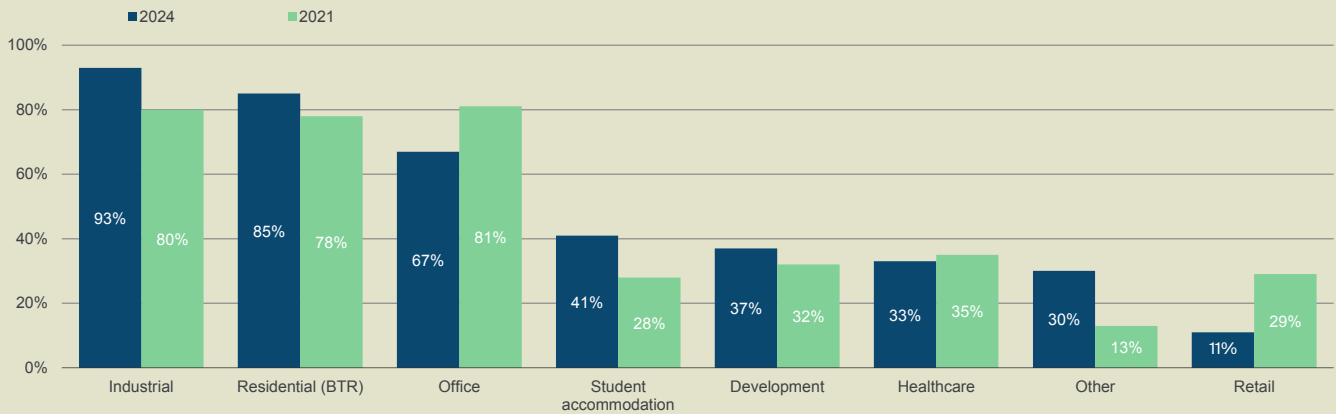
Slower progress points to a gap between ambition and action, given

that living sectors are consistently cited as among the most desirable form of investment for major domestic and cross-border groups. Feasibility hurdles have been difficult to navigate, notwithstanding the long-term desire to ramp up allocations to residential and the existence of chronic supply shortages in the rental market that document the need for alternative forms of new supply that target the rental market more directly than traditional build-to-sell product.

However, there has been considerable movement underneath the surface. The travails of the past two years have to some degree filtered out those groups with the capacity and appetite to proceed in the current climate – albeit more slowly than envisaged two years ago – versus those

Preferred sectors for investment in 2024 vs 2021

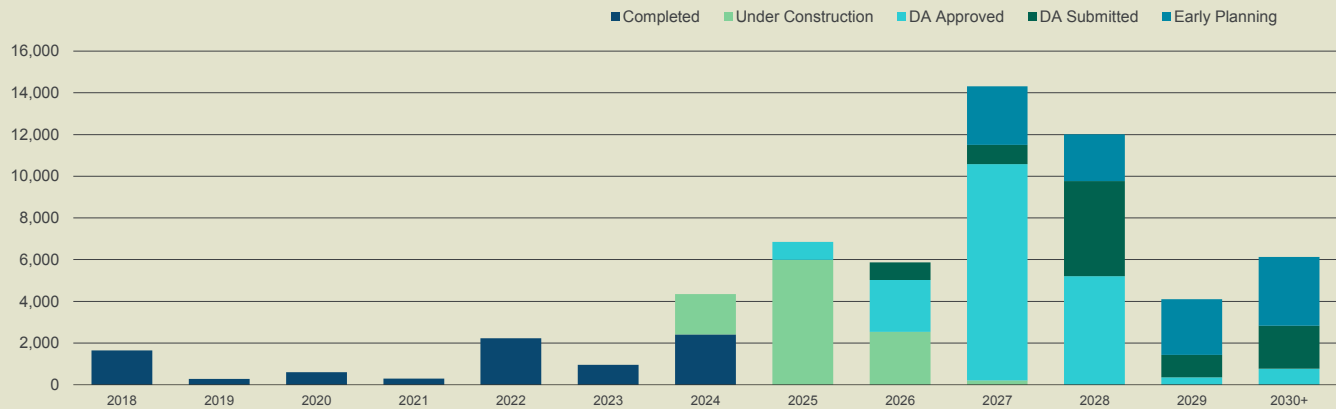
ANREV survey of global investors in the APAC region - proportion of respondents targeting each sector



Source: Knight Frank Research, ANREV

Ramping up despite the headwinds

Australian BTR pipeline - number of apartments each year by planning status



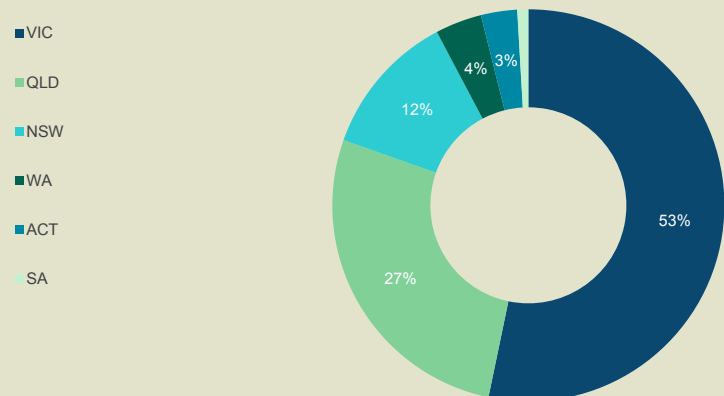
Source: Knight Frank Research

for whom planned developments will not meet projected return expectations unless the macro environment becomes more favourable.

This means that in 2025, activity will be led by core offshore investors with both a lower cost of capital and specialist expertise in living sectors, including major European investors such as PGGM, Bouwinvest and APG and major Canadian investors such as Ontario Teachers' Pension Plan. For these groups, living sectors are at the heart of their long-term strategy and their global expertise means they are better placed to satisfy more challenging feasibility criteria which new entrants will be unable to navigate.

Victoria and Queensland leading the way

BTR apartments under construction or DA approved, % of national total



Source: Knight Frank Research



Affordability stalemate

MIT reform a potential game changer, but affordable housing provisions a double-edged sword

Ahead of the 2023 Budget, the Federal government announced it would provide incentives to increase the supply of housing, with two measures directly geared to support investment in BTR. Firstly, reducing the withholding tax rate for eligible fund payments from Managed Investment Trusts (MIT) attributable to BTR developments from 30% to 15%, and secondly, by increasing the capital works tax deduction depreciation rate for eligible developments from 2.5% to 4% per year.

The measures are currently held up in the Senate and a successful resolution has the potential to significantly accelerate BTR development activity, with EY modelling estimating that an additional 100,000 apartments would be developed – relative to a baseline estimate of 50,000 assuming no policy change – if the MIT rate was changed to 15% with no mandatory requirement for affordable housing.

One of the sticking points is whether eligible developments should include mandatory affordable housing, and if so, under what terms. While no one would question the need for more affordable housing supply, the terms under which a mandatory component is required in BTR developments have the potential to reduce the positive impact of the tax change in triggering new supply, with the Property Council noting that the requirement to provide 10 per cent of dwellings as affordable tenancies in BTR projects ‘must be balanced with tax settings that will still promote and not deter investment’.

The debate speaks to the difficulty in attempting to advance multiple policy objectives at once. MIT reform would send an important signal to global investors, not only by making more projects viable in the short term, but also by signalling acceptance of the role for BTR in housing mix in the long-term, thereby providing assurance that policy will remain supportive.



Transforming housing policy

Addressing the mid-market key to widening awareness of the benefits of BTR

Linked to the debate on MIT treatment is the perception of where it sits within the overall housing mix. If BTR is perceived to be exclusively a premium product rather than targeting the mainstream rental market more directly, this reduces the likelihood that policymakers at all levels will adjust planning and taxation frameworks to encourage a faster roll-out.

The expected completion of around 6,000 apartments next year will be a welcome addition to overall supply, but still pales in comparison with the shortfall of dwelling completions relative to household formation nationally – estimated by the National Housing Supply and Affordability Council to be 71,000 in 2022-23 and 30,000 in 2023-24. BTR clearly has the potential to deliver supply at a faster rate, but the perceived success of schemes targeting the middle of the rental range will be important in widening awareness and understanding of the BTR model and winning broad community support for policy changes aimed at accelerating development.

On this point, we think that tight supply and affordability constraints, on top of the escalation in apartment rents over the past three years, favour the roll-out of more schemes targeting average mid-market rents with a less elaborate amenity offering, as opposed to premium product seeking higher rents. We also expect to see greater focus from both active capital and BTR developers on smaller schemes of 200 to 300 apartments to help with speed to market, limit construction risk, minimise leasing risk and drive the performance of the asset.

Co-living has a role to play here too and should be viewed as a dwelling type that can contribute to the delivery of housing, while broadening the product mix with a distinct offering at relatively affordable rents.



Healthcare REITs to return to buyers' circle

Divestment cycle close to ending

Institutional investment in Australia's healthcare and life sciences sectors has gathered significant momentum in recent years, driven initially by domestic investors seeking defensive assets, and now sees strong market participation by regional and global sector specialists and their capital partners.

Healthcare and health-related expenditure accounted for over \$241 billion in 2021-22 in Australia [AIHW], which represents approximately 10.5% of GDP, with an estimated 73% of this provided by the Commonwealth and State Governments. The significance of this expenditure to healthcare real estate in Australia cannot be understated, and when considered in tandem with the fact that 23% of the population will be over 65 years old by 2062, provides strong support for investment across all subsets of the sector.

Despite these demographic tailwinds, however, the sector

has not been immune from the wider market pressures exerted by higher funding costs and a more challenging environment for capital raising. A number of established healthcare REITs have been undertaking a portfolio maturation process, divesting management-intensive, yet less-specialised non-core medical office buildings and primary care assets and seeking to redeploy into core-style class 9a facilities. This has created the opportunity for new-to-sector capital, led by syndicators and private investors, to enter the market, which has typically been tightly held amongst a smaller concentration of investors.

This process is yet to fully play out, but as we move into 2025 we are seeing specialist managers tentatively return to the buyers circle. This mirrors the improvement in sentiment emerging across global markets as greater future interest rate and debt cost certainty flows through.

Delinking OpCo from PropCo

The opportunity to evolve Residential Aged Care Investment

As investors embrace the living sectors thematic, Australia's senior living sector is experiencing strong demand, with the growth in the over-65 population cohort outpacing the supply of new accommodation across the spectrum of land lease communities (LLC), retirement village (RV) and residential aged-care (RAC) sectors. Affordability is becoming critical and as such the market is attempting to respond with more supply. LLCs in particular are generating significant institutional interest adding to increasing M&A activity occurring across all areas of the senior living sector.

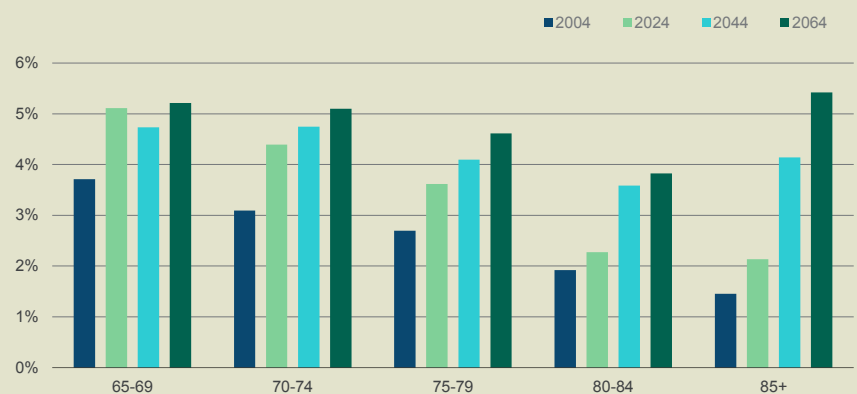
Institutional investors, including large superannuation funds, identify the opportunity for exposure to RAC's, however most super funds have typically been either unwilling or prohibited from directly exposing themselves to the operating and reputational risks which comes with the combined OpCo and PropCo structure typical in our market.

The recent introduction of Australian National Aged Care Classification model (AN-ACC) for tariff setting and improved funding to the RAC sector has improved operator margins, with many now looking to reactivate their development pipelines. Many institutional investors are also seeing this improvement and are seeking opportunities to partner with operators on a traditional Landlord / Tenant structure as is typical in global markets such as the UK, Europe and US.



Population aging will persist

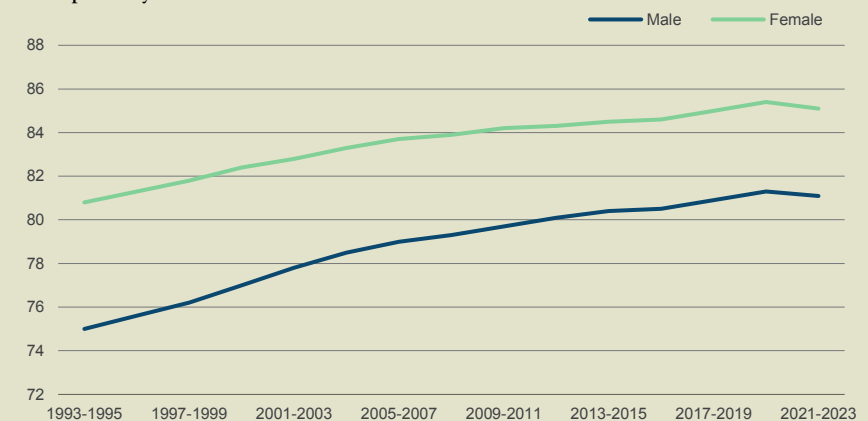
Proportion of the population by age range (historic and projected)



Source: Knight Frank Research, ABS

Life expectancy has risen significantly

Life expectancy at birth



Source: Knight Frank Research, ABS

Australia's data centre gold rush

As AI demand surges - power access, investment shifts, and Melbourne's rapid rise drive unprecedented opportunities for Australian real estate

The data centre sector in Australia has undergone a seismic shift in the last five years, underpinned by the rapid expansion of cloud computing and AI. This transformation is reshaping the real estate landscape, creating new opportunities for investors and landowners in Australia. Here are three key trends that we think will shape the next five years.

Power takes centre stage as Australia looks to become the APAC AI Hub

The traditional focus on location is being reconsidered by the lack of viable power connections in the traditional data centre clusters. Data centre operators are now prioritising access to abundant, cost-effective, and preferably renewable energy sources. This shift is particularly crucial as AI deployments start to happen in Australia, which demand unprecedented levels of computing power. These deployments can be located further away from existing data centre clusters, most of which are highly constrained from a land and power perspective. Proximity to high voltage infrastructure and the ability to scale power capacity at speed and at cost are now paramount considerations in site selection, unlocking previously disregarded locations.

Australia is well positioned to capture much of the AI demand across the APAC region given the availability of land, access to renewables power and relative cost on a

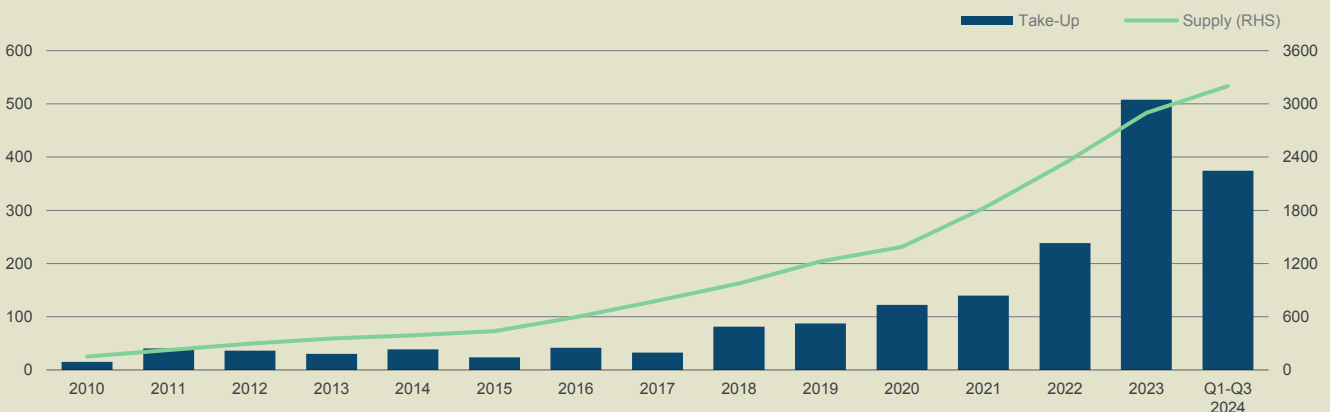
national basis. Also crucial is Australia's stable political climate and strong legal framework which provides a safe and reliable environment for hosting critical AI and cloud infrastructure for the region. This is crucial for global AI companies and governments seeking to avoid geopolitical risks given the sensitivity of the data and the scale of investment required to develop the facilities.

Capital constraints adjusting the investor pool

With 200MW (Megawatt) campuses now becoming commonplace in Australia, the investor pool is necessarily changing as to construct campuses of this size requires capital commitments in the region of \$3 billion. Very few investors have the ability to compete at this scale. As a result, the pool of potential operators has shrunk with only those backed by very large investors, such as sovereign wealth funds or global private equity groups, are able to tender for large hyperscale Cloud and AI contracts. Additionally, the capital constraints that some operators are facing serves to highlight the value proposition offered by major industrial turned data centre developers such as ESR and Goodman. Their access to aggressive capital willing to build data centres on a speculative basis, firm banking, strong

Take-up of data centre capacity rising exponentially

Annual take-up and total supply of data centre capacity across the APAC region



Source: Knight Frank Research, DC Byte



relationships with local authorities and monumental land banks across Australia and wider APAC put them in a strong position to capitalise on the industry tailwinds.

Melbourne coming of age

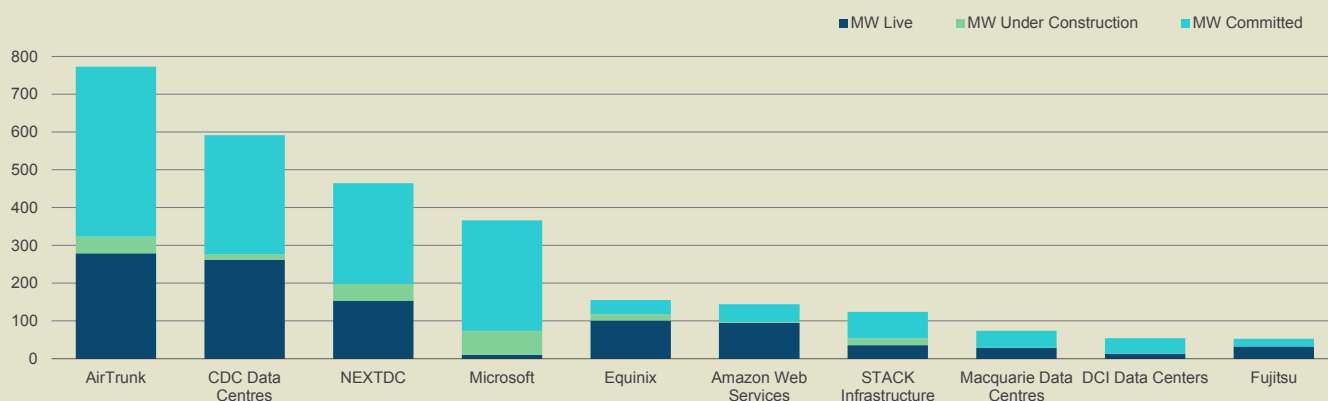
Melbourne is emerging as a highly attractive data centre market alongside Sydney due to its greater availability of affordable land and power capacity, particularly in Western Melbourne, where energy supply is less constrained. In 2024, 1GW of capacity has been added to the market by the likes of Air Trunk, CDC, Next DC, Vantage and Microsoft. This follows the global trend of secondary cities in key data centre hubs attracting interest as historic centres become

crowded and complicated. We are witnessing this play out internationally at great scale with the likes of London/Manchester, Frankfurt/Berlin and North Virginia/Phoenix.

Melbourne benefits from a streamlined planning process and strong government support, with the Victorian government offering incentives like tax breaks and grants to attract data centre operators. Additionally, Melbourne's growing role in fibre connectivity, supported by new subsea cables back to APAC, enhances its appeal as a regional hub alongside its ability to offer disaster recovery capacity from Sydney. Currently Melbourne has a total IT capacity including pipeline of circa 1.5GW vs Sydney's 3.7GW. We expect the gap to narrow as local and regional players look to increase their exposure to the Melbourne market.

IT power leaderboard

Total capacity of top ten data centre providers across the APAC region (megawatts)



Source: Knight Frank Research, DC Byte



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