Australian Commercial Real Estate Markets – Q4 2022

SPOTLIGHT
Savills Research

Spotlight on 2023

The current playbook & Macro outlook ● Key Capital Market Impacts ● Trends to watch in 2023

The current playbook

A global downturn in 2023 looks more likely.

The global economic outlook has deteriorated markedly this year reflecting the impact of high inflation, which is eroding consumer purchasing power, and the associated rapid rise in interest rates, which is leading to a pronounced tightening in global financial conditions.

The IMF is predicting global GDP growth will slow from 3.2% in 2022 and 2.7% in 2023, with more than a third of the global economy set to contract this year or next.

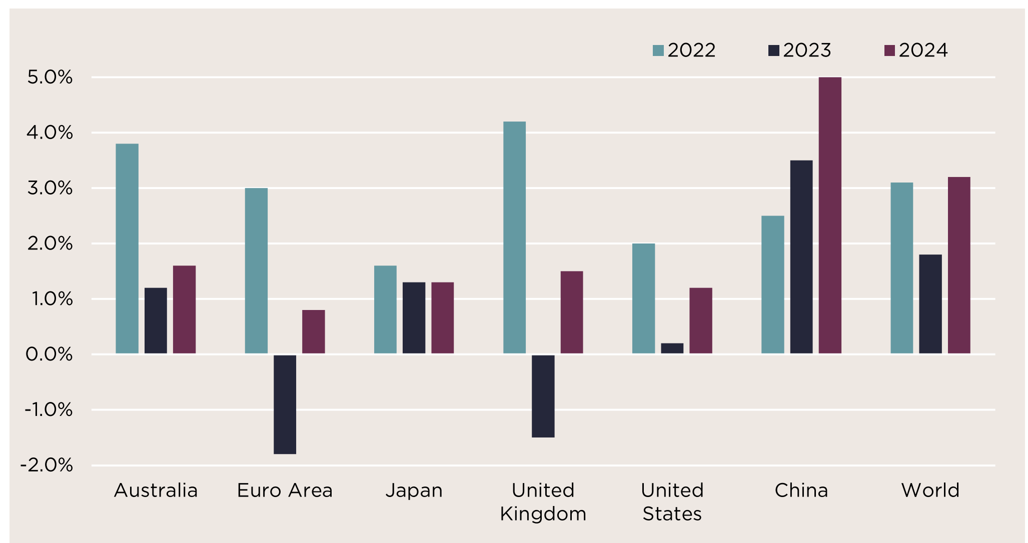
Meanwhile, Capital Economics is forecasting a sharper downturn, with global GDP growth slowing to 1.8% in 2023, the slowest growth rate in four decades outside of the GFC and COVID-19 pandemic. In this scenario, many advanced economies including the US, UK, and Euro area would enter recession, although the Australian economy is expected fair better than most and remain in expansionary territory.

These forecasts are supported by survey-based measures of economic activity such as purchasing managers indices (PMIs), which are strongly correlated with GDP growth, and point to most economies sliding into contractionary territory.

Forward looking indicators of these surveys such as forward orders, new export orders, and future output, are particularly weak, an ominous sign for future economic activity.

Australian GDP growth is forecast to slow from 3.8% in 2022 to a below-trend 1.2% in 2023. Economic acrivity is expected to strengthen thereafter, with GDP growing by 1.6% in 2024, and 2.0% in 2025, and 2.2% in 2026.

Global real GDP growth forecasts (%)



Source Savills Research using Capital Economics

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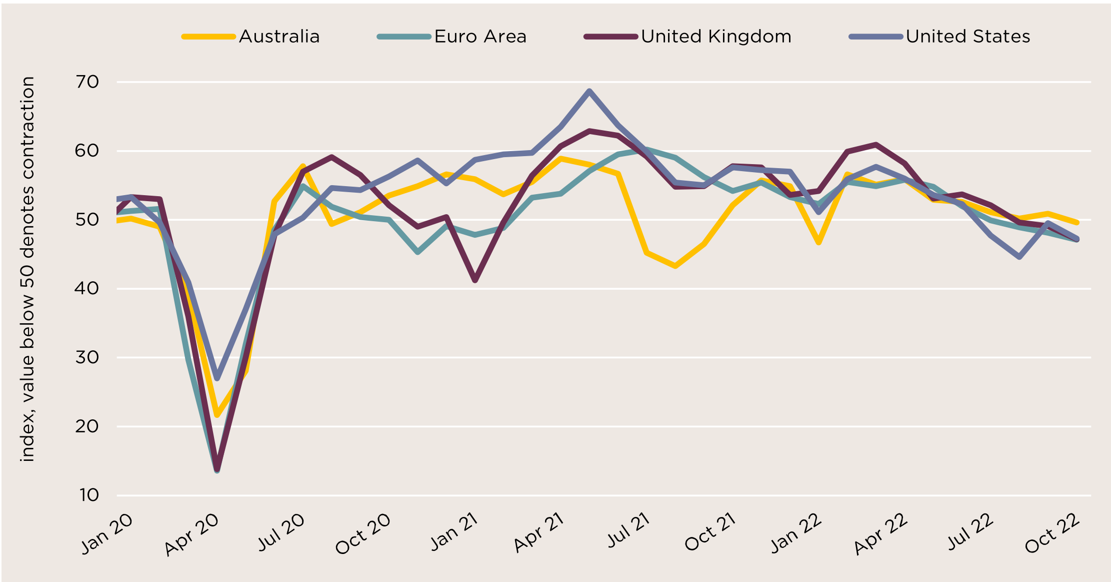
Katy Dean
Head of Research
Research & Consultancy
kadean@savills.com.au

Chris Naughtin
National Director,
Capital Markets, Research
chris.naughtin@savills.com.au

PMIs point to global slowdown



Source Savills Research / IHS Markit

The macro outlook

Will weaker global growth and moderating inflation to prompt central banks to cut interest rates in 2023?

INFLATION SET TO MODERATE

Weaker global economic conditions will see growth in inflation peak this year in many advanced economies and moderate in 2023 through a combination of weaker demand and easing supply constraints. Indeed, goods inflation has already moderated as demand-supply imbalances in goods markets unwind. However, services inflation is more sticky, and inflation will remain well above central bank targets next year. For example, the RBA is forecasting inflation will slow from a peak of 8% in Q4 this year to average 4.75% in 2023, and a little above the upper end of the RBA's target band at 3.25% in 2024.

CENTRAL BANKS COULD PIVOT

Expectations of a contraction in output in many advanced economies and an associated moderation in inflation has prompted some economists and financial market participants to speculate that the current monetary tightening cycle will soon come to an end. Current market pricing is consistent with interest rates peaking in the first half of 2023, with some central banks then beginning to cut interest rates in the second half of the year.

The timing of such a pivot to lower interest rates will differ among the central banks. The RBA and Bank of Canada have already slowed the pace of rate hikes. The Federal Reserve has also signalled the potential for a slowdown in the pace of tightening in December following four consecutive 75-basis-point increases. However, Fed Chair Jay Powell has said that the federal funds rate will peak at a higher level than previously expected. Meanwhile, more persistent inflation pressures in the Europe will likely restrict the ECB's ability to lower interest rates despite a relatively deep downturn.

WILL BOND YIELDS FALL?

After having risen sharply over 2022, government bond yields are set to fall next year as global growth slows, inflation eases, and investors anticipate eventual cuts in central bank policy rates. Materially lower bond yields would represent a significant change in the current market dynamics, with profound implications for investment markets across asset classes including property.

WEAKER GLOBAL GROWTH

The US dollar has appreciated sharply against most currencies this year reflecting the currency's safe haven status in the face of a deteriorating global outlook, and relatively high interest rates in the US. On the flipside, the Australian dollar has depreciated against the US dollar. Weaker global growth and lower prices for many of Australia's key commodity exports will continue to weigh on the Australian dollar in the near-term, although the US dollar might lose some momentum in anticipation of a Fed pivot to lower interest rates.

Top 4

Takeaways on the macro outlook

1 Inflation set moderate but remain well above target levels. The RBA is forecasting inflation will slow from a peak of 8% in Q4 this year to average 4.75% in 2023, and a little above the upper end of the RBA's target band at 3.25% in 2024.

2 Central banks to pivot and cut interest rates in 2023? Current market pricing is consistent with interest rates peaking in the first half of 2023.

3 Will bond yields fall as investors anticipate interest rate cuts? After having risen sharply over 2022, government bond yields are set to fall next year as global growth slows, inflation eases, and investors anticipate eventual cuts in central bank policy rates.

4 Weaker global growth will re-enforce US dollar strength in the near-term. Weaker global growth and lower prices for many of Australia's key commodity exports will continue to weigh on the Australian dollar in the near-term, although the US dollar might lose some momentum in anticipation of a Fed pivot to lower interest rates.

Key capital markets impacts

Relatively strong growth outlook and competitive exchange rate: Australia's enduring appeal as an investment destination.

The sharp rise in interest rates and greater uncertainty around the outlook have led to a **period of price discovery**. The Bid-Ask spread between purchaser and vendor has widened, which has limited deal activity. Some investors will continue to wait for the impact of higher interest rates to wash through valuations.

Low leverage among major investors means higher interest rates pose limited systemic risks to the commercial property sector. Globally, REIT balance sheets are in good shape, with leverage at low levels historically. The average debt to assets ratio is around 35%, much lower than the GFC peak of around 60-65%, creating a large buffer against the impact of rising interest rates.

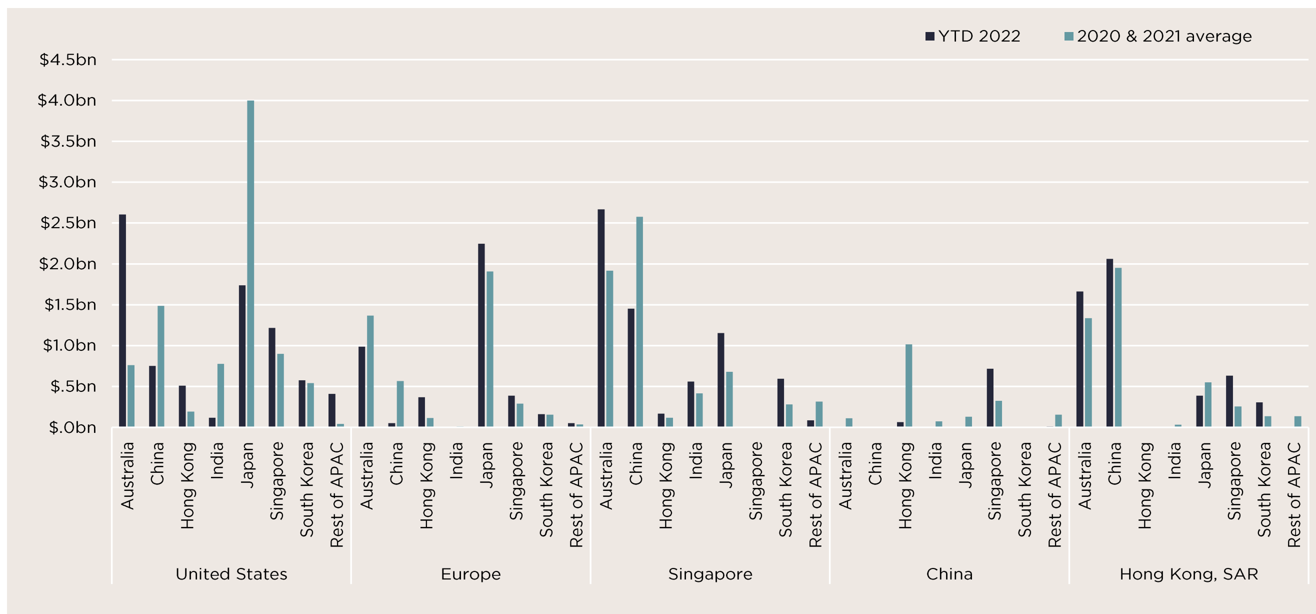
Falling bond yields in 2023 will **ease the pressure on property yields** with the potential to limit further widening. However, movements in yields could diverge significantly by individual asset depending on sector, quality, location, and lease length.

Declining market interest rates could also help to facilitate a rebound in investment through reduced funding costs, and lower future returns on alternative fixed income investments.

Australia's relatively strong economic growth outlook and high yields compared to many major markets, coupled with the weaker Australian dollar, make **Australia an attractive destination for offshore investors.** Australia has been at the top of the list in terms of cross-border investment within the APAC region over the past couple years and this trend is expected to continue.

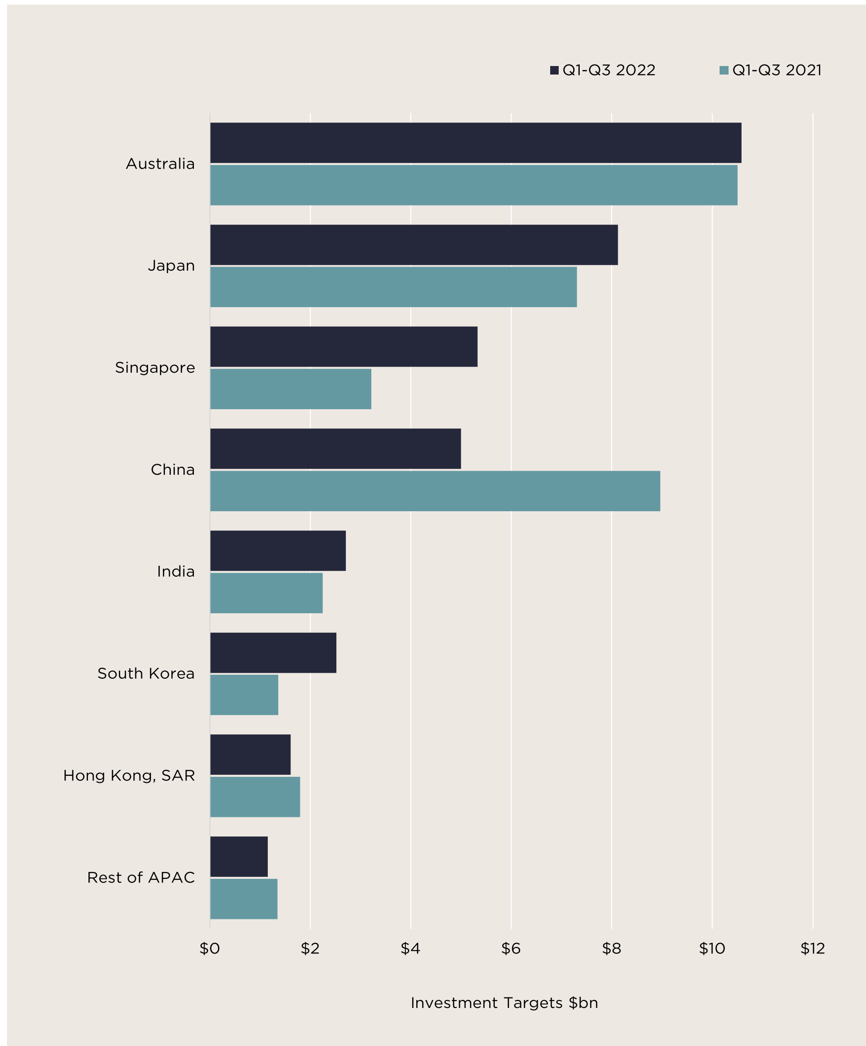
US and Singaporean investors have played a key role in cross-border investment, accounting for 60% of offshore investment volume in the September quarter and 54% over the year to September 2022. The appreciation of the US dollar and the Singaporean dollar against the domestic currency have helped to increase the appeal of the Australian market, and we expect US and Singaporean investors to remain highly active in 2023.

Major capital flows routes ($bn)



Source Savills Research / MSCI Real Capital Analytics

Cross-border investment targets in the Asia Pacific region ($bn)



Source Savills Research / MSCI Real Capital Analytics

DOWNSTREAM IMPACTS

The deteriorating economic outlook will increase the appeal of sectors with long-term structural tailwinds that are less correlated with the economic cycle like industrial and logistics (which will be boosted by near-shoring), data centres, healthcare, and build-to-rent.

More countercyclical investment: equity capital (or capital with low leverage), such as sovereign wealth funds and pension funds, will play a greater role in driving investment. There is also growing interest from owner-occupiers in sale and leaseback deals to unlock capital.

Flight to quality: Investors will seek out well-located, premium assets in safe haven markets that are well-tenanted with relatively long WALEs to reduce exposure to leasing risk.

"Central banks to pivot in 2023 as global slowdown gains momentum."

> "There will be an increase in countercyclical investment. Equity capital (or low leveraged buyers), such as domestic privates, sovereign wealth and pension funds, will play a greater role in driving investment."

Trends to watch in 2023

Investment capital will chase assets with the strongest underlying demand fundamentals to take advantage of favourable tailwinds.

Greater demand for long-term secure income stream assets. Global assets under management (AUM) amount to more than USD $123 trillion (Deloitte 2021). Reflecting the increasing allocation to property from institutional, private equity, and sovereign wealth funds, this is almost double the volume in 2016. This suggests that there will be increased pressure to make higher returns to match the increase in global allocations, particularly from pension funds. This may lead to greater demand for long-term secure income stream assets such as industrial/logistics, BTR/multi-family and core office.

Search for positive reversionary potential to gain momentum. New building development has struggled to keep pace with demand and vacancy rates have reached record lows, sending industrial rental growth rates in most markets into unprecedented territory. As yields expand, this rental growth will play an important role in helping to cushion the impact on values. There will be increased appetite for prime quality industrial assets in good locations with shorter lease terms from investors seeking reversionary upside that is linked to both inflationary pressures and current rental growth performance to drive total returns from income growth.

Rotation towards core assets and out of non-core assets. The current disconnect between buyer and seller expectations is expected to ease as the interest rate outlook becomes clearer, which will facilitate a pick-up in investment activity. Major institutional investors are also expected to reposition their portfolios towards core assets that are less exposed to leasing risk which will further boost market turnover.

Investment capital will chase assets with the strongest underlying demand fundamentals, specifically industrial/logistics, core office / prime grade quality, and alternative/emerging asset classes (BTR/multi-family, student accommodation) to take advantage of tailwinds from higher migration and travel recovery.

> "Bond yields could fall in 2023 as financial markets anticipate central bank interest rate cuts."

The Top 5

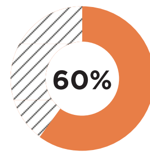
1. **Investment capital will chase assets with the strongest underlying demand fundamentals,** specifically industrial/ logistics, core office / prime grade quality, and alternative/emerging asset classes (BTR/multi-family, student accommodation) to take advantage of tailwinds from higher migration and travel recovery.

2. **Rotation towards core assets and out of non-core assets.** The current disconnect between buyer and seller expectations is expected to ease as the interest rate outlook becomes clearer, which will facilitate a pick-up in investment activity.

3. **Occupiers and investors are demanding green credentials.** There will be an increase in ESG initiatives as part of investment strategies across all asset classes, with landlords adopting green building certifications, along with energy efficiency upgrades, and investment as part of their strategies.

4. **Migration boost will continue to contribute to underlying domestic demand for tourism.** Investors will be keen to capitalise on the hotels and pubs recovery as travel patterns normalise.

5. **Retailers that sustained growth during the pandemic will fuel future demand.** This presents downstream benefits for industrial/logistics, as well as office for engineering or project planning space, and alternatives.



US and Singaporean investors have played a key role in cross-border investment, accounting for 60% of offshore investment volume in the September quarter.

Investors will get more selective. The market may see a greater divergence between asset classes, with increased demand for top locations, top quality assets in office, industrial and retail versus less interest in secondary locations and assets in the near term, thus flight to quality! Demand for 'green' will intensify, driven by growing ESG commitments and competition for talent. ESG will also be an important focus for asset managers, particularly the use of big data and analytics to realise the green premium.

Multi-speed office leasing market. Occupier requirements for prime grade office, and low supply in core locations will sustain current demand but there may be a softening of incentives in peripheral locations to attract/retain tenants. Expect to see increased flight to quality across asset type (core), higher building quality (premium, high quality A grade, highly green-rated) as well as flight to location with well-located, notably CBD or gateway locations front of mind for occupiers.

Slower economic growth may increase leasing risk in some markets, exacerbating pandemic headwinds. This will result in some businesses taking more time to figure out how much space they need and where they should be located. However, most markets have already repositioned after the downturn in 2020 and the sector is not expected to experience a downward shift in demand, just a short period of inertia, with the rise in enquiry to fuel pent-up demand on recovery.

Occupiers and investors are demanding green credentials. There will be an increase in ESG initiatives as part of investment strategies across all asset classes, with landlords adopting green building certifications, along with energy efficiency upgrades, and investment as part of their strategies. The green agenda has also become a priority for corporate occupiers who want to meet their own net zero commitments and have strategies to achieve their targets under the pressure of public demand and employee expectations. Green certified and energy efficient assets are more sustainable and require capital expenditure to comply with existing and upcoming regulation (reducing obsolescence risk!). They can be easier to rent out and more liquid to sell, retaining their value even in periods of weaker market conditions.

Has industrial and logistics been oversold? On the supply side it is hard to see industrial vacancy rising dramatically through over development which should continue to mean there is competitive tension for stock. This will continue to push industrial rents in both prime and secondary markets in the short term. However, industrial land prices are increasing, and materials and labour have been in short supply so building costs are going up and the development cycle will become more elongated in the short term. Vacancy averages less than 1.0% in many markets, well below the standard needed to allow existing stock to churn, and this is keeping intense pressure on new development take-up rates. This suggests substantial rental growth will continue.

Supply chain disruption - are we out of the woods? While the effect of e-commerce growth is still playing out, there has been evidence of some improvements in the supply chain, including a decline in the cost of shipping, container availability and easing of port congestion. The drop in the prices of some commodities, suggests that shortages are starting to ease, while an increase in industrial production suggests manufacturers are better positioned to meet demand levels. Warehouse industrial demand may slow as inventories are managed down but record low vacancy will remain as available stock is in short supply.

10.8% Australian office market premium grade net absorption since H1 2020. Per cent of premium office stock.

Retailers that sustained growth during the pandemic will fuel future demand. Online retail spending has declined from its pandemic peak but is not likely to revert to its pre-pandemic levels. The share of online spending of total retail remains elevated, at just over 10%, nearly double its share from five years ago but spending in store is also up due to jobs growth and high household saving rates. This presents downstream benefits for industrial/ logistics, as well as office for engineering or project planning space, and alternatives such as data centres due to increase technology and data storage requirements. Shopping centres and CBD retail have a chance to regain some of the market share as demographic tailwinds present key repositioning opportunities for investors. There are significant cyclical challenges, but the pandemic accelerated many of the structural changes, including the withdrawal or closure of some retailers. A rise in retail investment is anticipated in 2023, with opportunistic plays becoming an increasingly important target for investors.

As datacentre demand intensifies, so does competition. Competing demand from data centres for sites in some markets, particularly urban infill locations could begin to price out traditional industrial/ logistics users and other mixed-use occupiers. Similarly, with the increase in cyber crime and an increase in the appetite and need for data storage, cloud computing and connectivity, as well as business continuity, more firms will employ processes to mitigate the risks. There will be greater reliance on data centres, either traditional offsite servers or micro-data centres.

Pent-up demand increases pub deal activity. Pubs have experienced a record investment sales period, post the initial Covid-19 shutdown period in early to mid-2020. The resurgence in demand from investors will see pub assets remain sought after, particularly pubs with sustainable and consistent earnings or those that have undergone renovations to attract patrons. However, the increased legislative pressure on gaming could cause a recalibration of expected yields and therefore sale prices.

Migration boost will continue to contribute to underlying domestic demand for tourism. More traditional hotel investors remain active seeking value add opportunities. The recovery in trading fundamentals has been strong, especially in Brisbane and Adelaide, easing any potential debt serviceability issues. Some sellers are preparing to divest as yields will be applied to earning performance. There are record ADR levels being achieved, with operators using the pandemic period as an opportunity to reset rates. Room rates may level out or fall in 2023 but occupancy is expected to continue to trend upwards in compensation.

Will there be a market rebalance in accommodation options? Long-term rentals are less volatile and with state governments introducing new limits on the number of days in which hosts can rent out their properties, along with registration requirements, there is upside for the hotel economy, as well as the residential sector. The return of overseas migrants, students and tourists, both through permanent migration and increased short-term caps, is being supported by low unemployment, in turn increasing the demand for homes, particularly, multi-family apartments.

Is investment in Student Accommodation counter cyclical? There will be continued strong investor interest in student accommodation as an asset class, driven by the strong bounce back in international students, occupancy, and outperformance in rental growth during 2022. As student numbers continue to rebound, particularly international students who often maintain higher budgets and are less familiar with local housing, and supply remains constrained, there will be strong demand for investment into purpose-built student accommodation.

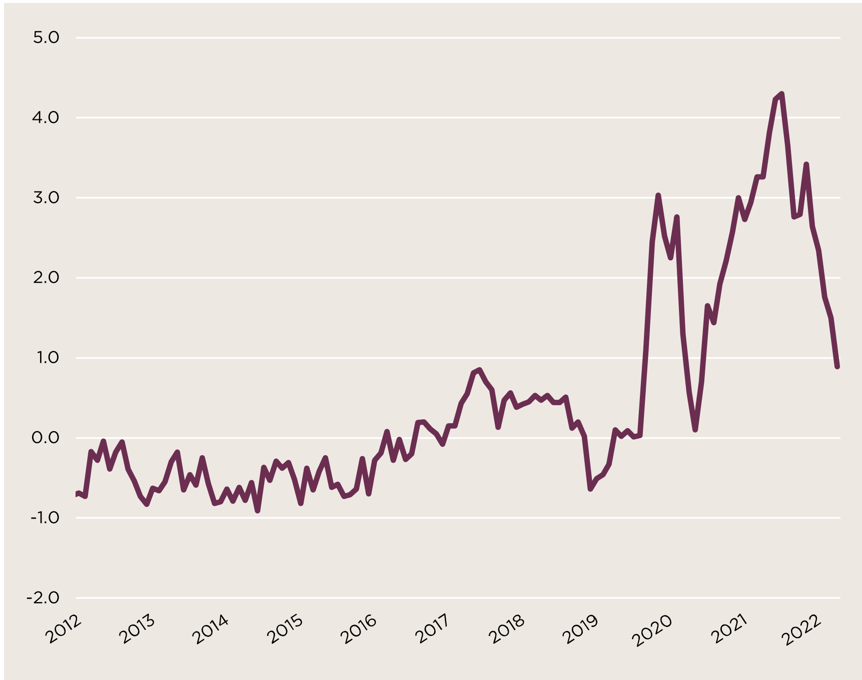
Build-to-Rent to offer some shelter as a hedge against inflation. The number of investors targeting Australian Build-to-Rent (BTR) sector will continue to grow, with the yield stability of the sector reinforcing how investors are attracted to the sector for the long-term income streams it generates. Rents have quickly recovered post lockdowns and the declining availability of rental product is fuelling future demand. With projections for the formation of smaller households to continue, and immigration increasing, record low vacancy rates are forecast to remain lower for longer.

11.2%

Online retail average share of total retail (11.2%) since 2021 has increased from an average of 4.2% in 2017.

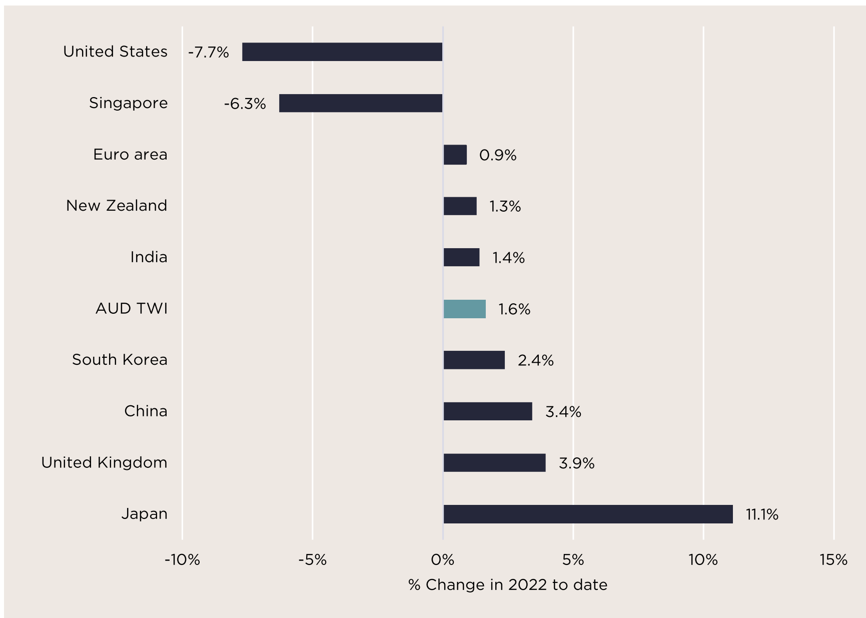
(Savills Research / ABS)

Global Supply Chain Pressure Index (Std dev from average value)



Source Savills Research using Federal Reserve Bank of New York, Global Supply Chain Pressure Index, https://www.newyorkfed.org/research/gscpi.html.
**index integrates transportation cost data and manufacturing indicators to provide a gauge of global supply chain conditions (includes Baltic Dry Index, Harpex, Airfreight cost indices, PMI surveys)

AUD against major trading partners (% change in 2022 to date)



Source Savills Research using Macrobond (Nov-22)

CAN NEAR-SHORING SOLVE SUPPLY CHAIN RESILIENCE?

According to Savills Impacts[1], the pandemic has demonstrated that a complex and dispersed supply chain can be disrupted, while the Russian invasion of Ukraine may, in the words of the IMF, "fundamentally alter the economic and geopolitical order" over the longer term. Reconnecting with domestic and regional supply chains is looking more attractive.

At the same time, disruptions to ports, airports and shipping drove a sharp rise in the cost of moving goods around the world. Prior to Covid-19, it cost $1,500 to ship a single container from China to the West Coast of the US; in September 2021 this rose tenfold to $15,000. Additionally, with the backlog of vessels at the port, total transit times quadrupled in some cases.

This upheaval has led to increased demand for supply chain resilience, rather than minimising costs and frictions. Resilience can be built into supply chains in three ways: a shift from just-in-time to just-in-case inventory management, the nearshoring or reshoring of manufacturing closer to the final point of retail, and an increase in transparency and monitoring to boost flexibility.

In Australia, nearshoring / onshoring trends in industrial will continue to gain momentum, particularly in high traffic areas.

More businesses will be looking closer to home to shore up supply chains and where not practical to onshore, will increasingly look to nearshore by choosing suppliers from nearby regions to tighten supply chain coordination and reduce shipping costs.

The government grants to establish or scale up manufacturing capability will also assist in driving demand. Low vacancy in industrial and a sustained low unemployment outlook will see regional areas compete to fulfil some of this demand.

Source Savills Research / Savills Impacts by Savills World Research
[1] https://www.savills.com/impacts/market-trends/can-nearshoring-solve-supply-chain-resilience.html

Savills Research
For more information about this report, please contact us

Research & Consultancy

Katy Dean
Head of Research
+61 2 8215 6079
kadean@savills.com.au

Chris Naughtin
National Director
+61 2 8215 8832
chris.naughtin@savills.com.au

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