Australian Capital Markets - October 2023

MARKET IN MINUTES
Savills Research

Super Savers

Growing pool of capital

Growth in superannuation assets bodes well for commercial property investment

The rapid increase in interest rates since 2022 and the ongoing uncertainty over the outlook for inflation and interest rates have weighed heavily on investment activity both domestically and globally reflecting diverging buyer and seller expectations and higher funding costs. During the current lull in investment activity, it is easy to lose sight of the depth of liquidity in global capital markets that presents an ongoing source of demand for many assets including commercial real estate.

This article highlights the large and increasing pool of capital that superannuation funds are accumulating, and the potential for this growth to translate into a rising source of demand for commercial real estate assets, with profound implications for capital markets, particularly in sectors underpinned by structural tailwinds such as industrial and logistics, data centres, healthcare & life sciences, and multi-family residential/build-to-rent.

Australia has a large pool of superannuation savings, which totalled $3.54 trillion as at Q2 2023, equivalent to 140% of nominal GDP. According to the Thinking Ahead Institute's 2023 Global Pension Assets Study, Australia had the fifth largest pool of retirement assets globally in 2022 among the 22 markets it tracks behind the US, Japan, Canada, and the UK – relatively large compared to the size of the Australian economy, which is the 13th largest in the world in nominal US dollar terms.

The pool of superannuation savings will grow significantly over the next couple of decades. Total superannuation assets are expected to rise to between $9 trillion and $10.5 trillion by 2040 (around 185% of GDP), equivalent to 6%-7% average annual growth. This growth could translate into an additional $25bn-$30bn for investment in property per year, equivalent to over 40% of average annual commercial property investment in Australia over the past decade.

Growth in the pool of superannuation assets will be boosted strong population growth and increases to the Superannuation Guarantee rate.

Treasury estimates Australia's population grew by 2.0% in 2022–23, the strongest annual growth rate since 2008-09, underpinned by the largest increase in net overseas migration on record. Furthermore, Treasury is forecasting 1.7% growth in 2023–24, and average annual growth of 1.3% over the 10 years to 2033-34, a much higher growth rate than most advanced economies.

The Superannuation Guarantee rate is legislated to increase progressively in 0.5 percentage point increments each financial year up to 12% of an employee's gross salary by 1 July 2025. The most recent increase from 10.5% to 11% took effect on 1 July 2023, with further rises to 11.5% and 12.0% to take effect from July 2024 and July 2025 respectively.

Superannuation assets will grow strongly over next decade, boosted by population growth and increases to the Superannation Guarantee.

$3.5 trillion

Australia's total superannuation assets totalled $3.54 trillion as at Q2 2023.

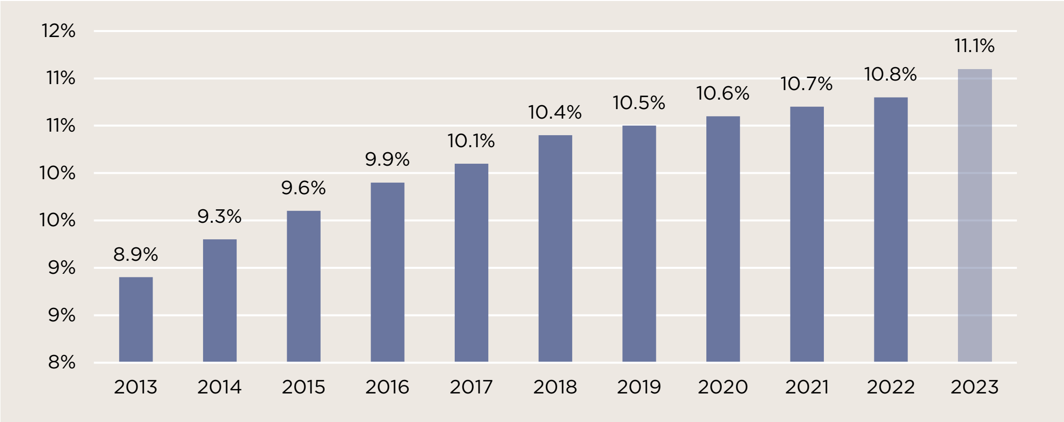
185% of GDP

Superannuation assets are expected to increase to 185% of GDP by 2040, up from 140% currently.

10.8%

Institutional investor target allocation to real estate in 2022, up c.200bps over the past decade.

Weighted average target allocation to real estate
Per cent of assets under management



Source Savills Research / Hodes Weill & Associates

Rising allocations to property

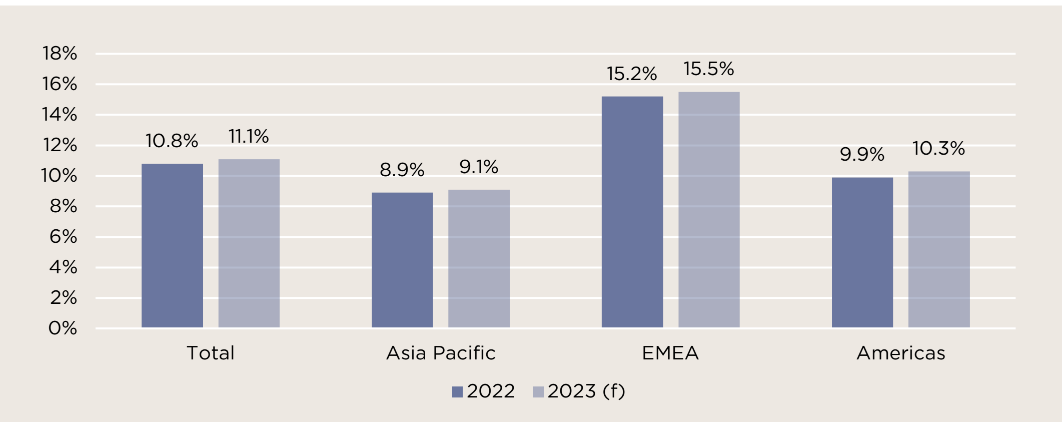
The growth in superannuation assets will translate into more liquidity in capital markets across equities, bonds, and real assets. In addition, rising target allocations to property among institutional investors globally will further drive commercial property investment and enhance liquidity.

According to the Hodes Weill & Associates and Cornell University 2022 Institutional Real Estate Allocations Monitor, average target allocations among the 173 institutional investors in 34 countries it tracks have on average risen by around 200 basis points over the past decade to 10.8% of assets under management. These institutions expect to increase allocations to real estate by a further 30 basis points to 11.1% in 2023.

In the Asia-Pacific region, institutional investors also plan to increase their allocation to property, with an average target of 9.1% in 2023 compared to 8.9% currently.

Even a seemingly marginal increase in asset allocation translates into a potentially large increase in the dollar value of investment. For example, Hodes Weill & Associates estimate a 10-basis point increase in allocation to real estate assets globally could potentially translate into between US$80bn and US$120bn of additional investment, equivalent to 7%-11% of annual average global commercial property investment volume over the past decade.

Weighted average target allocation to real estate
By location of institution, per cent of assets under management



Source Savills Research / Hodes Weill & Associates

Changing allocations within property

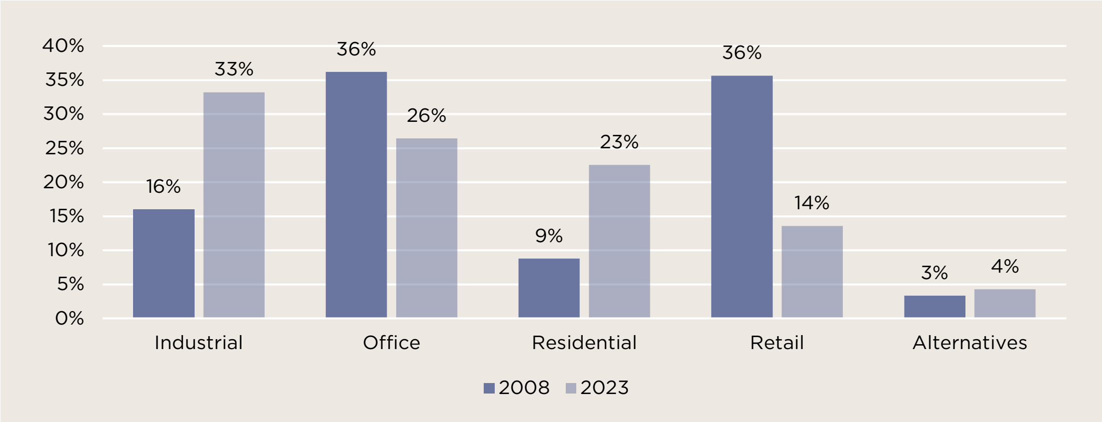
In tandem with rising investment in real estate, investors are increasing shifting their allocations within the sector towards industrial & logistics and multi-family residential. The share of industrial & logistics property by asset value in the MSCI Global Property Fund Index roughly doubled from 16% in Q1 2008 to 33% in Q1 2023. This reflects both the relatively strong capital value growth of industrial assets in many markets globally in recent years and investors increasing exposure to the sector.

Similarly, the residential sector's share of total asset value has increased markedly over the same period, rising from 9% in Q1 2008 to 23% in Q1 2023 reflecting the rapid growth in the multi-family/BTR sector.

By contrast, office and retail assets have become less prominent in the index over the same period. The share of office assets in the total index declined from 36% in Q1 2008 to 26% in Q1 2023, while the retail sector's share fell from 36% to 14% over the same period, reflecting a combination of declining capital values relative to pre-GFC (Q1 2008) levels as well as an overall shift away from both sectors.

A similar trend is evident in the Australian index, with a rising industrial share.

MSCI Global Property Fund Index weights by property sector
Per cent share of asset value



Source Savills Research / MSCI Real Capital Analytics

Implications for commercial property investment

Strong demand for commercial property assets
The ever-increasing in pool of savings from pension funds in Australia and overseas combined with rising allocations to real estate will bolster demand for commercial property assets and provide an ongoing source of liquidity. Investors with little to no leverage such as pension funds are in a unique position to increase investment, being relatively unaffected by higher debt costs.

Underscoring this potential, the world's largest pension fund, Japan Government Pension Fund, has recently committed $500 million to Blackstone's Real Estate X fund – this fund is c.$30.4 billion and 7% of the fund will be allocated to Australia (c.$2.1 billion).

Industrial and alternatives assets set to benefit the most
Investors are likely to seek out assets that will benefit from structural tailwinds such as industrial and alternatives.

- Strong population growth in Australia and constrained housing supply are likely to support the development of the multi-family/BTR sector, while population growth, increasing e-commerce penetration, and a reassessment of supply chains (including the potential for onshoring or near-shoring and a shift to just-in case inventory management) will continue to underpin occupier demand in the industrial and logistics sector.
- These tailwinds are prompting some of Australia's largest super funds such as AustralianSuper and Australian Retirement Trust to restructure their property portfolios to shift towards industrial & logistics and alternative assets. For example, AustralianSuper has invested $2.5 billion in Vantage Data Centres, a major developer of data centres in Europe and the United States.
- By contrast, structural headwinds for the office sector will weigh on relative demand for office assets, particularly for secondary and less well-located assets. However, high quality and well-located office assets with relatively low leasing risk will continue to have appeal for institutional investors looking to invest at scale.

Investor demand to support long-term asset performance
The rapid rise in interest rates and debt costs has led to higher yields and placed capital values under pressure. While the market has yet to fully adjust to the higher interest rate environment, stronger investor demand over the medium to long-term will support renewed yield compression and capital value growth, boosting investment returns over a longer-term horizon.

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