MUTUAL TRUST

Wealth matters

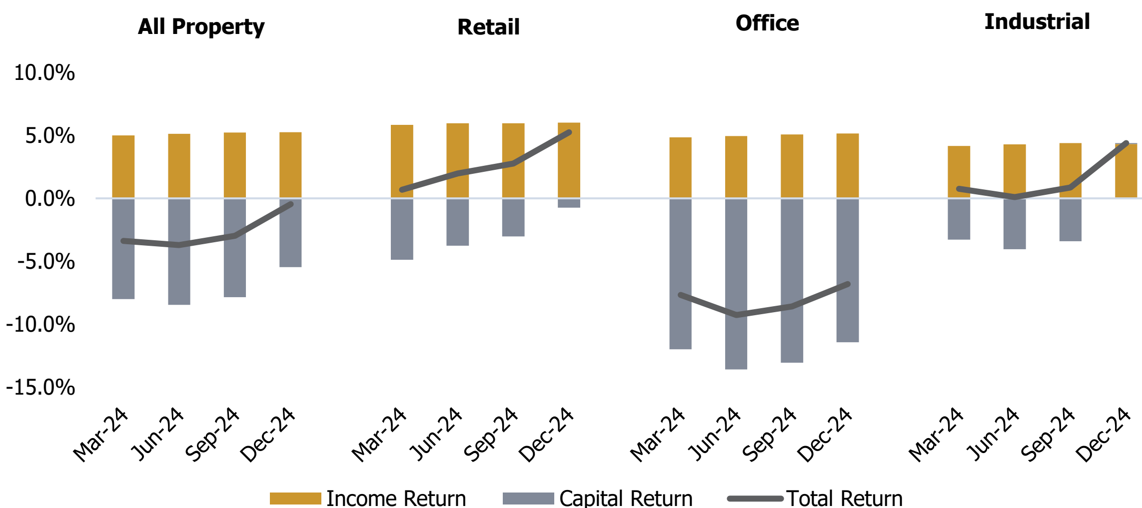
Brick by brick – capitalising on the commercial real estate recovery

> "Investors are acknowledging the value on offer in various sectors of Australia's real estate market. Pricing seems to have stabilised after a period of yield softening. Additionally, many existing assets are selling significantly below replacement cost, underscoring the value proposition."
>
> TOM BRODERICK, CBRE, AUSTRALIAN HEAD OF CAPITAL MARKETS RESEARCH, DECEMBER 2024

The outlook for the commercial property market in Australia has improved over the past twelve months. Asset values have stabilised and are expected to gradually increase as interest rate cuts by the Reserve Bank of Australia materialise. Attractive mispriced opportunities can be sourced if investors are willing to undertake detailed due diligence. However, substantial variance in fundamentals remain across different sectors and locations and not all investment opportunities will share in the expected recovery.

This Wealth matters article explores the evolving dynamics within Australia's commercial property sectors – office, industrial and retail. We showcase recent investments sourced and offered to Mutual Trust clients, highlighting their attractive characteristics as we aim to capitalise on the gradual recovery of the commercial property market. To deliver on these opportunities, Mutual Trust has identified and partnered with specialist investment managers with a proven track record of selecting, managing and adding value to properties over the long-term.

Commercial Property Returns



Stabilising asset values are providing select opportunities at attractive pricing

The latest data released by MSCI (to December 2024) showed stabilising asset prices across commercial property. However, there remains substantial variance across sectors, with the lingering effects of the pandemic continuing to impact fundamentals to various degrees. We believe long-term investors will benefit from opportunities to acquire assets at attractive pricing as recovery broadens.

While the office market faces challenges, it may provide the best opportunities

There are significant challenges in the office market, and the recovery across different locations will be highly variable in terms of speed and timing. Transaction activity is expected to increase over the next 12 to 18 months, and this sector may offer the best opportunities to buy high-quality assets at heavily discounted prices.

A demand-supply imbalance has severely impacted office fundamentals, despite a low unemployment rate and resilient economy. Market dynamics vary significantly across locations. According to JLL, Melbourne CBD and Sydney CBD vacancy rates are currently at 20% and 15% respectively, versus Brisbane CBD and Canberra CBD at 10% and 8%. Hobart has the lowest vacancy rate in the country at 3.6%, according to the Property Council of Australia. Major city fringe locations are the weakest markets, with Melbourne's St Kilda Road and Sydney's St Leonards reporting vacancy rates of around 30%. Sourcing assets in superior locations and understanding long-term supply-demand dynamics is critical.

Recent office investment example: Canberra CBD, ACT

Through one of our trusted investment managers, Mutual Trust clients recently co-invested in an A-grade commercial office building in the heart of Canberra's CBD, primarily leased to government-backed tenants. The purchase metrics were highly attractive. The property was secured on a 9% initial passing yield and a significant discount to replacement cost.

Unlocking the asset's full potential involves implementing a comprehensive ESG strategy by the manager, including full electrification and net zero certification for the building. We believe the sustainable elements of the strategy will help retain and attract additional government and corporate tenants. Moreover, the limited supply of existing office buildings with strong sustainability credentials in Canberra's CBD is a supportive factor.

The addition of new supply, following the completion of pre-COVID projects over the past two years, has coincided with weak demand from tenants who have reduced their space requirements to match the shift to a hybrid working model. While this dynamic has impacted most markets, it's been particularly severe in Melbourne. It is unlikely that office attendance will return to pre-COVID levels, despite pressure by some companies to force staff back to the office five days a week.

Encouragingly, the most recent data from CBRE showed average occupancy has improved, reaching 74.5% of pre-COVID levels in 2024 (up from 71% in 2023). Recent ABS data also showed a very gradual reduction in the percentage of employed people who worked from home, indicating the trend towards returning to the office is heading in the right direction.

An additional challenge for asset owners is the inability to fund essential capital works. Refurbishing floor space and amenities to higher standards and upgrading the sustainability credentials of buildings is becoming essential to attract and retain higher quality tenants. However, capacity to fund these works can be limited in instances where higher vacancy and higher cost of debt have impacted cash flows and stretched loan-to-value ratios (LVRs) limit balance sheet capacity.

Given the challenging market conditions and the significant increase in construction costs, it is unsurprising that the new supply pipeline is forecast to be materially lower than in the past few years. This slowdown in new projects will help rebalance the demand-supply equation over time, which will help reduce vacancy and drive rental growth.

Retail – benefiting from positive tailwinds

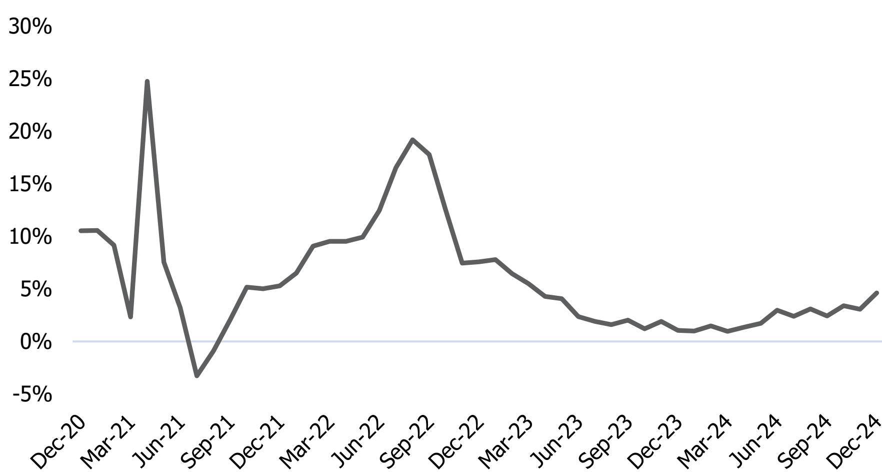
Positive tailwinds, coupled with constrained new supply, should support the occupancy and rental growth of well-located and well-managed assets within the retail sector, while generating attractive returns for investors. Shopping centres, especially large assets, are more complex and require specialist skills to unlock value and maximise returns. Selecting a partner with a proven track record of active management is critical to ensuring success.

Shopping centres were in the doldrums for years before COVID. Oversupply, growth in online retailing and subdued economic and real wage growth were all factors plaguing the sector for a prolonged period. Consequently, the impact on valuations from COVID was less severe, given the sector had partially ‘taken its medicine’ before the downturn.

Following a huge surge in spending in the two years following the end of lockdowns, retail sales growth moderated in 2023 and early 2024, with the cumulative impact of higher interest rates, depletion of excess savings and higher inflation weighing on household spending. Nonetheless, spending has remained robust and improved over the second half of 2024. Meanwhile, online sales as a percentage of total retail sales has also stabilised at around 11% to 12% (ABS).

We expect retail sales growth to be modest but positive going forward, with population growth, easing inflationary pressures and lower interest rates supporting consumer spending.

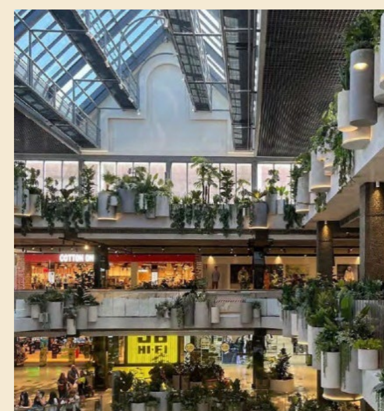
In terms of retail property fundamentals, recent data from JLL indicates the average national vacancy rate has generally been stable at around 5% and rental growth has been mildly positive. Although data varies by location and retail sub-sectors, it is significantly more consistent and robust than the office sector.



Source: ABS

Recent retail investment example: Greater Sydney, NSW

Within retail, our most recent co-investment was a major regional shopping centre (and ancillary land parcel) located in one of the largest and fastest growing local government areas by population in NSW. It is the dominant shopping centre in the total trade area. Income is predominantly secured by non-discretionary tenants, providing defensive elements. In addition, upside optionality is attached to the ancillary land parcel adjacent to the shopping centre, which the manager will seek to secure development approval for residential accommodation during the term of ownership.



The property was secured ‘off market’ at a significant discount to replacement cost. The manager is a specialist retail property investor with a long track record of successfully optimising shopping centre performance and results for investors.

Industrial – while structural tailwinds are intact, there are variances across sub-markets

Structural tailwinds supporting the industrial sector remain intact. However rental growth is likely to moderate further and vacancy rates are expected to increase in the near-term. We anticipate greater variance across sub-markets. We prefer exposure to well-located infill markets (densely populated urban locations), particularly mid-market assets, with potential to enhance returns through active management.

In contrast to office and retail sectors, industrial property benefited enormously from COVID. Structural tailwinds from online retailing growth accelerated as lockdowns forced shoppers to move online. Strong demand from e-commerce (and more conservative inventory management), coupled with a lack of supply, led to historically low vacancy and double-digit rental growth in 2022 and 2023. While rental growth moderated in 2024, it remains well above long-term averages. This growth has partially offset the impact of rising capitalisation rates (softer valuations), providing asset owners with a smoother ride through the downturn.

Recent data showed increasing vacancy rates, although still well below long-term averages. Some locations have seen a rise in speculative development. However, over the long-term, new supply is constrained by construction costs, availability of land in suitable locations and long lead times required for planning permits. Specialised manufacturing related to the renewable energy sector is another source of demand for industrial space, as detailed in the Savills report *"Is manufacturing making a comeback?"*.

Recent industrial investment example:

Within industrial, our most recent investment was in a diversified portfolio of industrial assets in and around suburban/ metropolitan areas of Australia's main cities.

We favour existing industrial assets with smaller lot sizes in land-constrained urban locations with ease of access to major population and consumer hubs – benefiting from the rising demand for last mile logistics. This is in contrast to "big box" warehouse assets out in the periphery of Australia, with an abundance of surrounding developable land, which we believe may place constraints on long-term growth potential.

The Fund's primary objective is to invest in A and B-Grade industrial assets in land-constrained, urban infill locations, for conversion and aggregation to create a core institutional-grade portfolio over time.

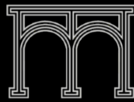
Brick by brick – constructing a direct property allocation within a portfolio

> "Population growth, infrastructure spending and higher costs limiting new construction will underpin demand for well-located space over the long-term in Australia."
>
> HEMANT GOVAN, MUTUAL TRUST, HEAD OF RESEARCH AND PORTFOLIO MANAGEMENT

For over a decade, Mutual Trust has built trusted partnerships with specialist investment managers who have a proven track record of selecting, managing and adding value to direct property investments over the long-term. Our preference is for Australian commercial property in central locations with high quality attributes where longer-term trends are supportive for demand. We favour assets purchased at a discount, often below replacement cost, with value-add potential (those with potential for income growth through refurbishment works and leasing and tenancy remixing). Assets with strong sustainability credentials (or a strategy to improve) are of increasing importance as an avenue to attract and retain tenants.

Within our portfolio allocation to direct property, we blend more defensive exposures (such as healthcare assets), with higher returning opportunities across office, retail and industrial sectors. Our portfolios are well diversified regionally, with recent investments made in NSW, ACT and Tasmania.

Please call or email your Mutual Trust Advisor if you have any questions, or for more details regarding Mutual Trust's direct property approach.



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