M3 PROPERTY

# VICTORIA MARKET SNAPSHOT

H2 2022

# CONTENTS



# INDUSTRIAL

“Occupier demand remains strong in Victoria's industrial sector. Rental rates are experiencing their strongest growth in decades, with effective rentals being boosted by both face rental increases and declining incentives. The key valuation question of 2023 will be if rental growth can continue to outstrip the easing of market yields."

MATT WEBB, DIRECTOR

# CURRENT STATE OF PLAY

- Rental growth continues to be strong with occupier demand outstripping supply and vacancy rates sitting at historic lows. Landlords are often delaying negotiations for upcoming lease renewals hoping to capture larger rental gains during mid to late 2023. While economic growth continues, the supply/demand imbalance is likely to continue to support rental growth.

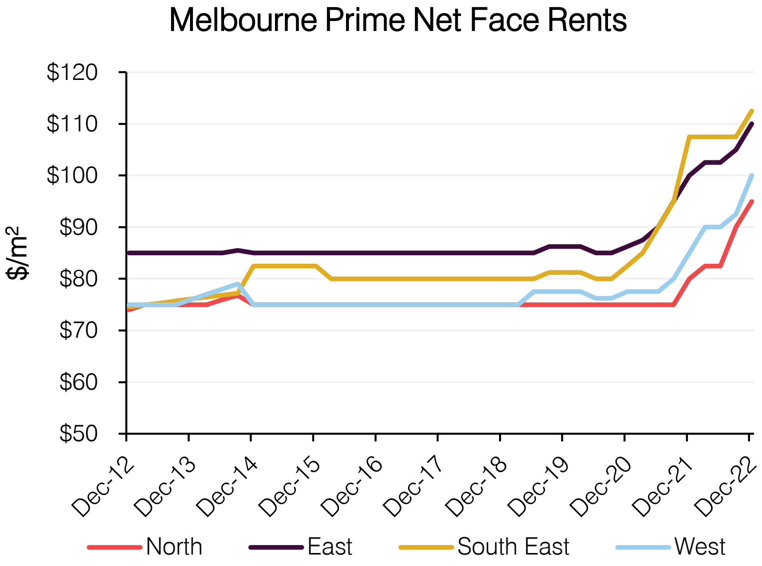
- High net worth individuals are becoming more active in the $10 to $30 million investment market as Real Estate Investment Trusts sit out the market due to their increasing cost of capital.

- Industrial development site sales across the Melbourne market totalled $1.08 billion (for sales over $5 million) in 2022, with institutional groups being the most active buyers in net terms (Source: RCA).

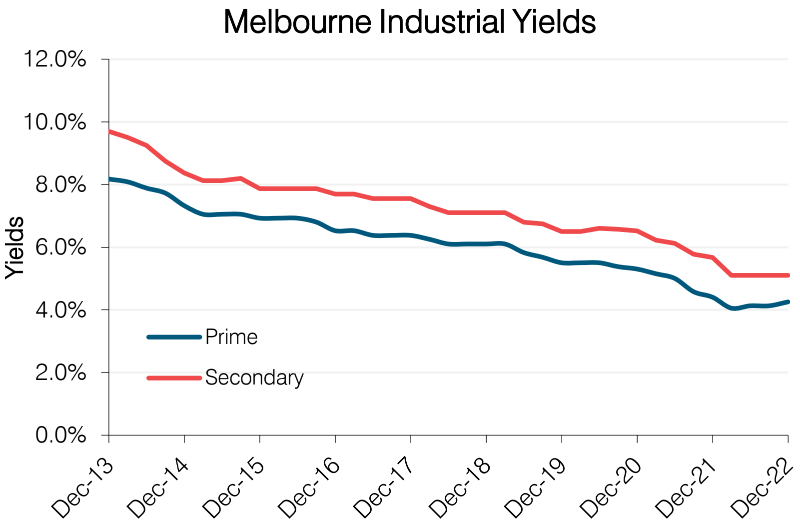
- Demand for larger land parcels (one hectare and greater) remains strong, being driven by larger occupiers and the trend towards consolidating multiple facilities.

- Improved infrastructure, land affordability relative to Sydney, a reduction of available sites in inner precincts, and ongoing residential development has seen an increasing prevalence of industrial land being marketed in outer areas.

- Early signs of the heat coming out of the sub five hectares land market were seen in the last quarter of 2022. The englobo land market, especially in the Western Corridor, continues to surprise on the upside.




Source: M3 Property

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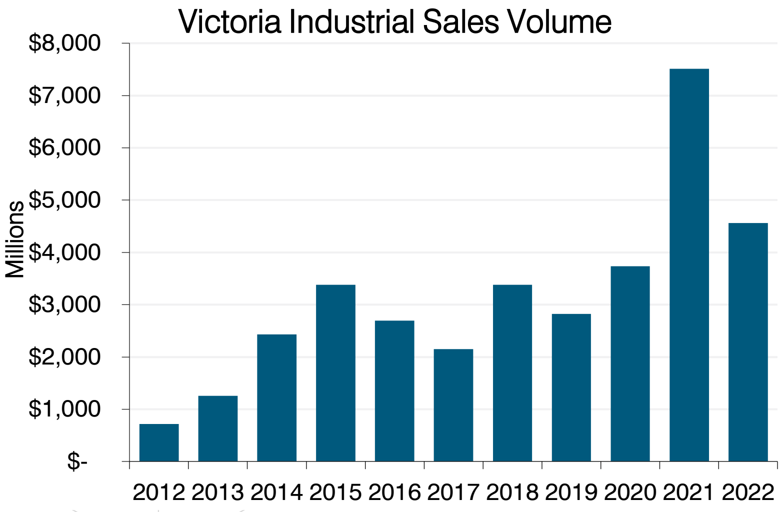



Source: Real Capital Analytics (RCA), M3 Property
Note: Sales over $5 million

## RENTAL MARKET

- Outside of the City Fringe, prime net face rents are currently ranging between $85 and $135 per square metre and secondary net face rents are ranging between $70 and $95 per square metre.
- Prime rents increased by circa 12.1% during 2022. Secondary rents also grew strongly over 2022. Precincts where land supply shortages are evident saw the strongest growth in rents over the year.
- Incentives for prime and secondary buildings declined over 2022.

## YIELDS

- Strong investor appetite and the spread between property yields and interest rates exerted downward pressure on yields during 2021 into the first quarter of 2022. Interest rate increases since the first quarter of 2022 have reduced demand from the institutional sector however private investors have become a stronger presence in the market.
- Prime assets are generally trading at yields between 4.00% and 5.00%, having softened over the second half of 2022. Secondary assets are trading between 4.50% and 6.00%, with the average secondary yield stable over much of 2022.

## INVESTMENT MARKET

- There was $4.56 billion worth of industrial properties transacted across Victoria in 2022, a 39% decrease from 2021 yet higher than pre-COVID-19 levels.
- Sales volumes were tracking above 2021 levels for the first five months of 2022, however, changes to the monetary policy resulted in a softening in investor demand in the second half of the year.
- Offshore investors were the largest buyers of industrial property in Melbourne between 2020 and 2022.

## OPPORTUNITIES AND CHALLENGES

- Despite concerns in the investment market due to inflationary pressures, recent transactions show land values continue to increase strongly. The market sees a persistent shortage of well-located industrial zoned land in the major markets of the southeast and western precincts.

- In the institutional space, purchasers have had to reprice due to increasing cost of capital, however, vendors have not yet adjusted to the new pricing levels. This has led to a significant fall in transaction levels from 2022. During 2023, the expectation is that more property in the $30 million plus price point will come to the market and a reevaluation of market yields may occur.

- Construction cost growth appears to have moderated. Cost certainty should help to increase supply; however, this will always be limited by a shortage of zoned land.

## OUTLOOK

- Occupier demand is expected to remain at strong levels over the coming six months with growth in e-commerce forecast to continue driving demand for warehouse and logistics space, solid public sector investment and continued demand for advanced (particularly food) manufacturing. However, as household discretionary incomes come under increasing pressure over the coming year, we expect to see logistics demand from retail groups reduce. In the near-term though, supply chain disturbances will continue to encourage retailers to keep larger inventories.

- In response to inflationary pressures, the Reserve Bank of Australia started a period of monetary policy tightening in May 2022. Inflation is forecast to remain high during the 2023 calendar year and the RBA has signaled that further rises to the official cash rate are likely over the short-term. Yields are forecast to show softening over the short- to medium-term.

| Property | Sale Date | Sale Price | Purchaser | GLA ($m^2$) | WALE (Income) | Initial Yield | GLA Analysis ($/$m^2$) |
|---|---|---|---|---|---|---|---|
| 152-158 South Gippsland Highway, Dandenong South | Dec-22 | $12,350,000 | Private Investor | 4,367 | 4.80 | 4.85 | $2,828 |
| 32-44 Rodeo Drive, Dandenong South | Dec-22 | $18,500,000 | Owner Occupier | 7,097 | - | - | $2,607 |
| 9 Quality Drive, Dandenong South | Nov-22 | $10,200,000 | Syndicate | 4,947 | 0.96 | 4.54 | $2,062 |
| 730-750 Springvale Road, Mulgrave | Oct-22 | $51,250,000 | Syndicate | 19,983 | 4.20 | 4.89 | $2,565 |
| 525 Mt Derrimut Road, Derrimut | Jul-22 | $47,100,000 | Fife Capital | 20,044 | 7.40 | 3.93 | $2,350 |

# RETAIL

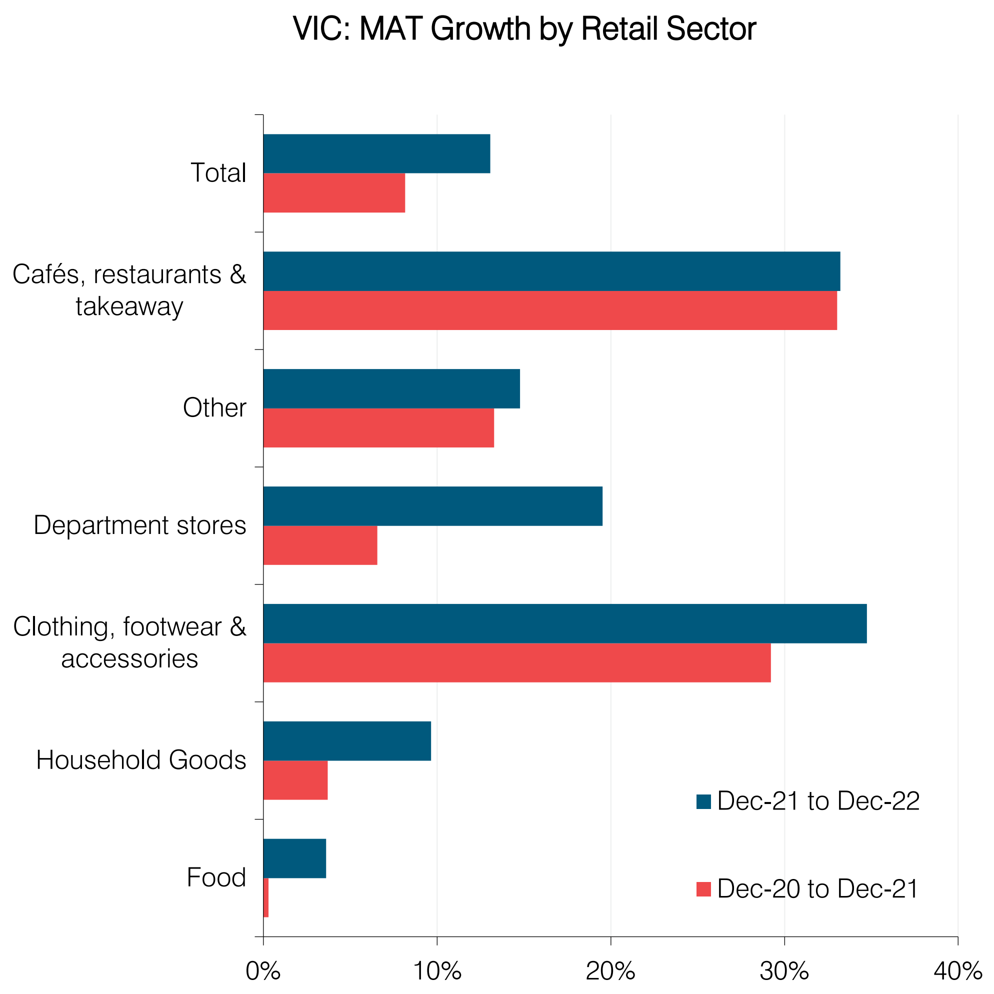
"After a subdued year of transactions during 2022, with the market unsettled during an increasing interest rate environment, purchaser and vendor expectations are expected to be more aligned in 2023.

Shopping centres that comprise large tracts of well-positioned land, with flexible zoning
and stabilised income, present owners and purchasers with opportunities to extract value."

SHAUN O'SULLIVAN, DIRECTOR

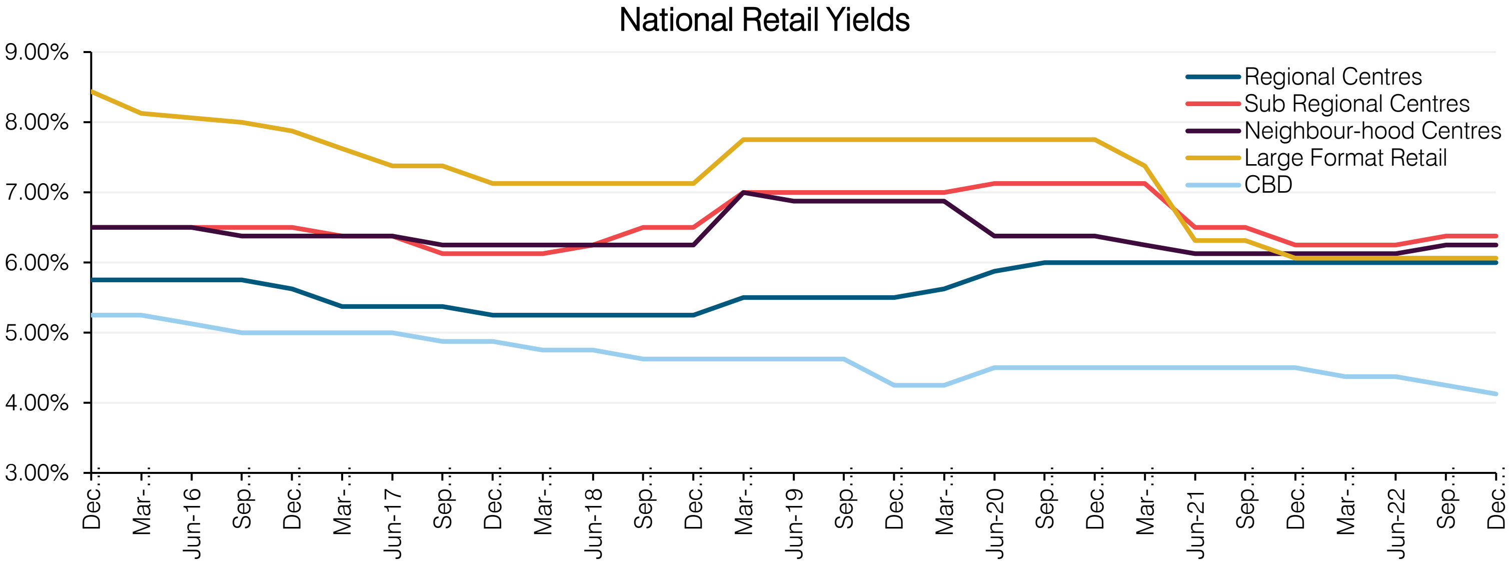
# CURRENT STATE OF PLAY

- Total retail spending growth in Victoria from the 2021 calendar year to the 2022 calendar year was 13.05%, up from 8.17% growth from 2020 to 2021.
- The strongest growth by retail category was recorded in Clothing, footwear, and accessories (34.74%) followed by Cafes, restaurants and takeaway (33.22%), coming off a low base from various periods of lockdown in 2020 and early 2021.
- Rental spreads (i.e., the difference between a tenants' new rent and their prior rent) have materially improved over the last 12 months for AREIT shopping centre owners.
- Growth in the online retail sector and the continuing expansion of online marketplaces has resulted in centre owners changing their tenancy mix. The pattern of rationalisation of fashion and growth of health and beauty, services, food-based retailing, and entertainment has been a trend over the past five years.
- CBD retailing has been strongly impacted by the pandemic due to office workers continuing to Work From Home (WFH) either part time or full time, reduced overseas student migration, and lower numbers of overseas visitors. However, pedestrian traffic volumes are recovering well in 2023 and market participants are reporting increased tenant demand, although rental levels are expected to remain below pre-COVID levels over the medium-term.




Source: ABS, M3 Property


Source: Real Capital Analytics (RCA), M3 Property
Note: Sales over $5 million




Source: M3 Property

## INVESTMENT MARKET

- Retail property sales in Victoria totalled $1.97 billion during 2022, decreasing from $3.0 billion in 2021. The number of properties transacted also decreased from 111 in 2021 to 87 in 2022.
- Privates were the largest buyer group during 2022, accounting for 59% of sales (by $ value). Offshore buyers were the next largest buyer group, with 27% of sales.

## TRANSACTIONS

- There were assets offered to the market and then withdrawn during 2022 with purchaser and vendor expectations not meeting in an uncertain economic environment.
- However, a number transactions were completed in late 2022 and further transactions are in the process of being completed in 2023 as vendor and purchaser expectations become more aligned.
- Transactions have reflected mixed results with some sales reflecting no yield softening and others indicating softening is occurring.

## YIELDS

- Retail yields generally continue to look attractive relative to the alternative investment classes of office and industrial.
- Over 2022 and into 2023, transactions have been limited to below $300m. There has not been any recent transactions in Victoria above that point.
- There has been limited stock of Bunnings Warehouses and Coles and Woolworths supermarkets offered to the market and as such, purchaser investment hurdles for these asset classes are yet to be strongly tested.

## OPPORTUNITIES AND CHALLENGES

- Rental levels within shopping centres have largely been reset over recent years, leading to more stable income profiles.
- Shopping centres sit on large tracts of land with flexible zoning provisions, allowing for a variety of mixed uses to be introduced, supporting the retail component and extracting further value for the owner. Many shopping centres are adding co-working tenants, childcare, serviced apartments and other non-traditional retail uses.
- The role of shopping centres in assisting with last mile logistics also provides opportunities.
- Under-performing anchor tenants are seen as a key income risk by potential purchasers, being mindful that while a vacant anchor tenancy can provide re-positioning opportunities, it creates income uncertainty and re-purposing is capital intensive.

## OUTLOOK

- Tenant leasing demand has increased over the last six months, supporting improved leasing conditions.
- There was a pricing gap between vendor and purchaser expectations for assets offered to the market in 2022. We expect that gap to narrow in 2023 leading to more transactions.

| Property | Sale Date | Sale Price | Purchaser | GLA ($m^2$) | WALE (Income) | Initial Yield | GLA Analysis ($/m²) |
|---|---|---|---|---|---|---|---|
| Forrest Hill Shopping Centre, VIC | Dec-22 | $256,000,000 | Haben | 63,581 | 3.94 | 7.73% | $4,026 |
| Chirnside Park Lifestyle Centre, VIC | Dec-22 | $50,400,000 | IOOF | 11,082 | 7.72 | 5.26% | $4,548 |
| Sunshine Marketplace, VIC | Oct-22 | $66,000,000 (50%) | Aware/Altis | 34,153 | 4.10 | 6.40% | $3,865 (100%) |
| Arena Shopping Centre, VIC | Nov-22 | $50,000,000 | Private | 8,148 | 6.72 | 5.19% | $6,136 |

# CBD OFFICE

“In  response to inflationary pressures, the RBA started a period of monetary policy tightening in May 2022. The RBA has signalled that further rises to the official cash rate are likely over the short term. Melbourne office yields softened at the end of 2022 and are expected to soften further over 2023. Yield movement in calendar year 2023 to date shows 50 to 100 basis points, however transactions have been minimal."

GARY LONGDEN, DIRECTOR

# CURRENT STATE OF PLAY

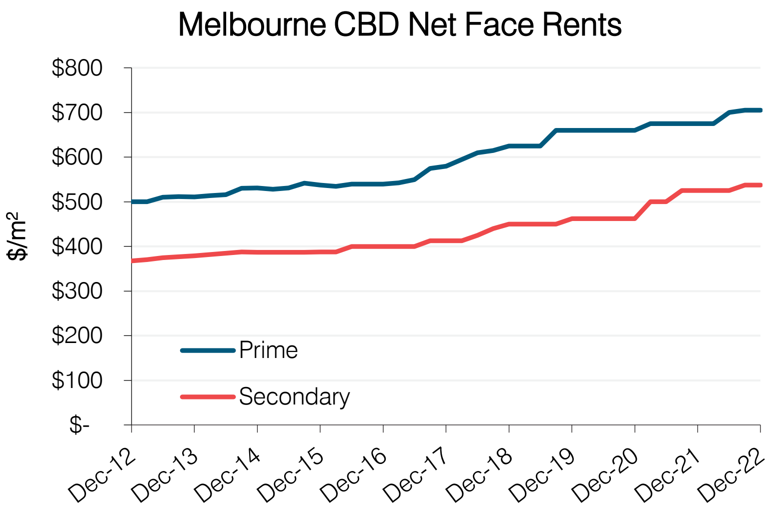
- According to the Property Council of Australia (PCA), there was 5,128,231 square metres of office space in the Melbourne CBD as of January 2023, an increase of 96,448 square metres from January 2022. The Western Core remains the largest precinct, accounting for 33% of total CBD stock, followed by Docklands (24%).

- The total vacancy rate for Melbourne's CBD office market increased from 11.9% in January 2022 to 13.8% in January 2023, with increases experienced in both the prime and secondary markets. Vacancy has increased due to both new supply added to the market, as well as negative / subdued net absorption, over the past four years.

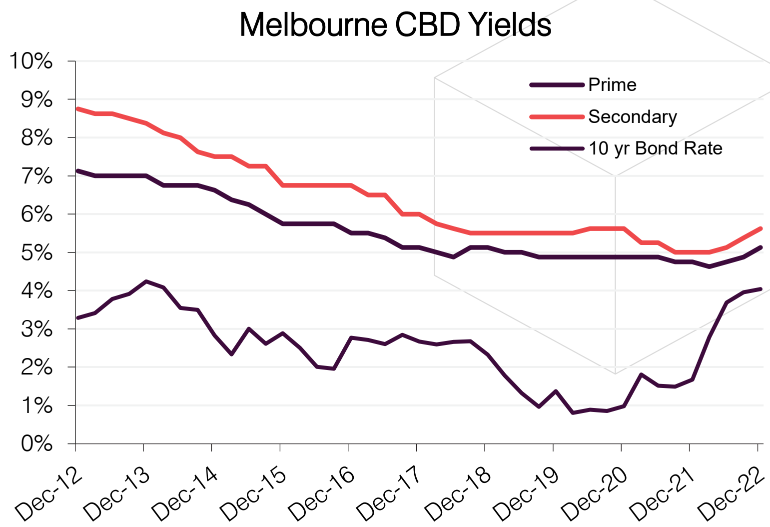
- Over the past five years, there has been an average of 89,500 square metres of new supply added to the market every six months. Accounting for withdrawals, net supply additions averaged 61,950 square metres every six months. There is currently circa 206,000 square metres of stock under construction in the CBD and an additional 62,000 square metres undergoing site works. Adding DA approved and submitted developments, the total supply pipeline for the Melbourne CBD is circa 658,000 square metres, however, not all projects that are approved will proceed to development.

- According to the PCA's Office Occupancy Survey, occupancy in the Melbourne CBD remains below its pre-COVID-19 level at 57% during November 2022.

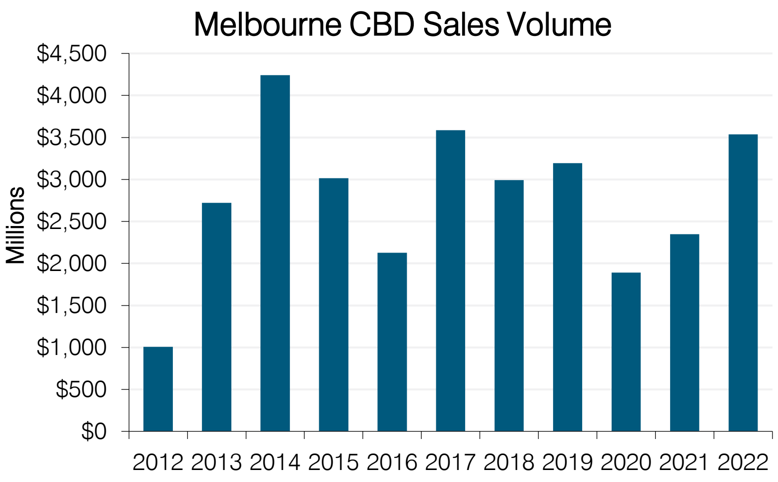
- Investor demand at previously compressed yields has significantly reduced. Currently vendors are reluctant to reduce asking prices and selling periods are extended.




Source: M3 Property




Source: M3 Property




Source: Real Capital Analytics (RCA), M3 Property
Note: Sales over $5 million

## RENTAL MARKET

- Melbourne CBD prime and secondary net face rents increased over the year to December 2022.
- Prime net face rents increased by 4.4% in 2022 to range between $575 and $835 per square metre as of the December quarter 2022. Prime incentives ranged between 33% and 42% during the quarter.
- Secondary net face rents ranged between $475 and $600 per square metre as of the December quarter 2022, increasing by 2.4% over the year. Secondary incentives are generally ranging between 30% and 40%.

## YIELDS

- During the December quarter 2022, yields ranged between 4.75% and 5.50% for prime buildings and 5.25% and 6.00% for secondary buildings.
- Prime and secondary yields softened over the second half of last year following the RBA's first increase to the official cash rate in May. Prime yields are estimated to have softened by circa 40 basis points over 2022 and secondary yields are forecast to have softened by circa 100 basis points.

## INVESTMENT MARKET

- Sales activity in the Melbourne CBD office market averaged $2.79 billion per annum over the five years to 2022.
- There was $3.5 billion of office properties transacted during 2022, which is positively skewed by the transaction of Southern Cross Towers ($2.05 billion), being the first premium grade asset to transaction since April 2020. Offshore buyers generally account for the largest share of sales (by total value transacted) in most years.

## OPPORTUNITIES AND CHALLENGES

- The high vacancy rate in the Melbourne CBD market continues to make conditions favourable to occupiers. Occupiers are showing preference for high quality, newly constructed buildings, being critical of the level of amenity and end-of-trip facilities. Occupiers are also increasingly considering the building's NABERS, Green Star and WELL ratings.

- Office occupancy rates remain substantially lower than they were prior to the pandemic. In recognition of the changing work habits of employees (including more employees working from home), occupiers are seeking tenancies with numerous collaboration areas and breakout spaces as well as leases that allow for expansion and contraction of space during the lease term.

## OUTLOOK

- There is circa 206,000 square metres of supply under construction in the Melbourne CBD. The increased cost of construction as well as rising interest rates have potential to push some development timeframes out.

- The medium-term outlook for white-collar employment in Melbourne is positive with BIS Oxford Economics forecasting an additional 81,000 persons to be employed in white collar employing industries in Melbourne over the five years to June 2027. Occupier demand in the CBD market is expected to strengthen in 2023.

- Effective rents are forecast to rise modestly over the 2023 financial year due to the forecast increase in face rents and incentives being relatively stable over this period. Effective rental growth is expected to strengthen considerably as incentives reduce in the second half of the decade.

- In response to inflationary pressures, the RBA started a period of monetary policy tightening in May 2022. The RBA has signalled that further rises to the official cash rate are likely over the short-term. Melbourne office yields softened at the end of 2022 and are expected to soften further over 2023.

# RESIDENTIAL

"The residential market is expected to remain subdued for the majority of 2023, with market stabilisation anticipated late 2023. Following further softening in prices through 2023, we are forecasting growth returning to the market from early 2024 as the cash rate stabilises and market confidence begins to return. Affordability and supply remain a key issue, which is putting pressure on the rental market. This is resulting in increased rental rates, with investors expected to return to the market supporting future apartment construction and supply."

LUANA KENNY, MANAGING DIRECTOR

# CURRENT STATE OF PLAY

- Residential vacancy rates are returning to pre-COVID-19 levels since increasing significantly during 2020 and 2021. The low vacancy rate is putting pressure on supply, with this to support a recovery in the built form market.

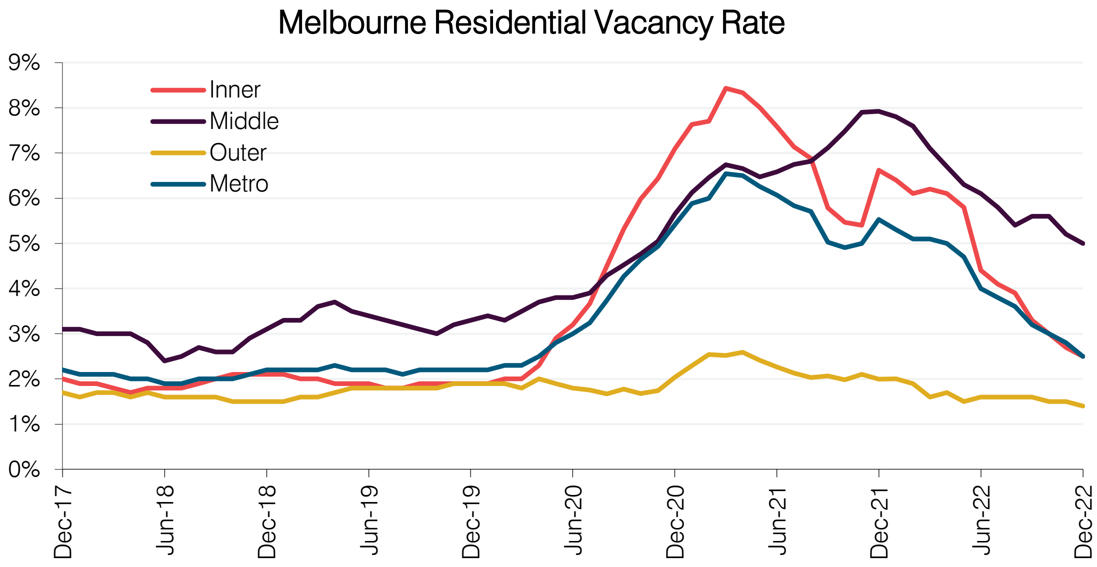
- Property prices in Melbourne have increased significantly over the past two years with Inner Melbourne house prices being the highest average. Following the strong growth, prices are expected to further soften in some parts of the market.

- Outer Melbourne has experienced the strongest price growth in the last three years (16%), followed by the Metropolitan area (13%).

- Inner Melbourne experienced the most significant reduction in vacancy over the year to December 2022, changing from 6.6% in December 2021 to 2.5% in December 2022.

- Dwelling approvals over the year to December 2022 dropped by 22% from the previous year.

- The median price of houses in the Melbourne Metropolitan declined by 14.0% over the year to December 2022. The strongest decline over the year was seen in the Middle market. Across the Metropolitan market, the median house price remains 9.4% higher than it was at the start of the pandemic.




Source: REIV, M3 Property

# OPPORTUNITIES AND CHALLENGES

- Population growth is expected to improve which will assist the residential market recovery from 2024, with pricing expected to stabilise. As a result of the slowdown in population through 2020 and 2021, this will in part impact the market through 2023 and 2024. The impact of low population rates will in part be offset by reduced housing supply coming to the market.

- As a result of increased construction costs and labour shortage, supply to the market has been impacted. With population forecasts positive and increased net and overseas migration, this will result in an undersupply in the market. The government has estimated 1,000,000 homes will be required, with the market expected to fall well short of this demand. Construction costs are showing signs of easing, and this will in turn assist to bring new supply to the market. As investors start to return to the market, there will be increased demand for apartment projects, with this market expected to see increased activity in the latter part of 2023/early 2024.

- The residential land market has softened, with sale rates more than halving in some areas and lot pricing stabilising following significant price growth in this market. The market is expected to remain challenged over the course of 2023, however, whilst we remain cautious, it will be underpinned by a lack of land availability in the growth areas.

# OUTLOOK

- Whilst the market is expected to remain subdued through 2023, the overall economic fundamentals will continue to underpin a recovery, as we start to see improved market conditions in 2024, albeit we do not expect to see growth return to the levels experienced in 2020 and 2021.
- Incentives and rebates are now being offered in the market, particularly the land market, as demand declines with borrowing capacity reduced, and we expect this to continue through 2023.
- We expect the demand for townhouses to remain consistent, with townhouse development increasing in the growth areas as affordability remains a focus particularly in a more challenging market. The townhouse market will present opportunities within middle and outer ring suburbs, with larger sites having recently transacted.

| Property | Sale Date | Sale Price | Purchaser | Site/Developable Area | Permit | Site/Developable Area Analysis |
|---|---|---|---|---|---|---|
| 191-193 Bayswater Road, Bayswater North | October 2022 | $8,000,000 | Local Developer | 12,238m² | Nil | $654/m² |
| 1075-1095 High Street, Armadale | September 2022 & January 2023 | $30,000,000 | Local Developer | 2,020m² | Part | $14,778/m² |
| 1 Abrehart Road, Pakeham | August 2022 | ~$60,000,000 | AVID | 30.73ha gross (23.60ha dev) | Nil | $1,880,898/ha (gross) $2,449,153/ha (dev) |

# SPECIAL INTEREST - SPECIALIST DISABILITY ACCOMMODATION

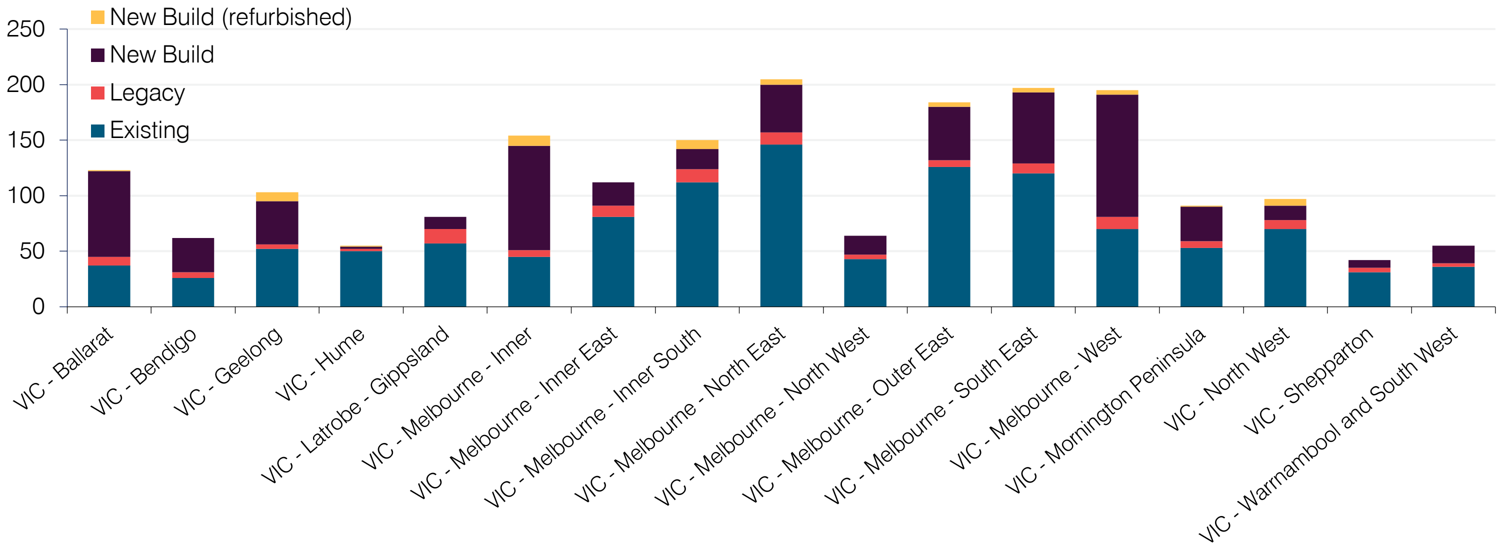
“The Specialist Disability Accommodation (SDA) investment market is continuing to mature, with a growing development pipeline, increased operator sophistication, and proven stable returns providing investors with an attractive capital allocation alternative."

LAILA BURNET, DIRECTOR

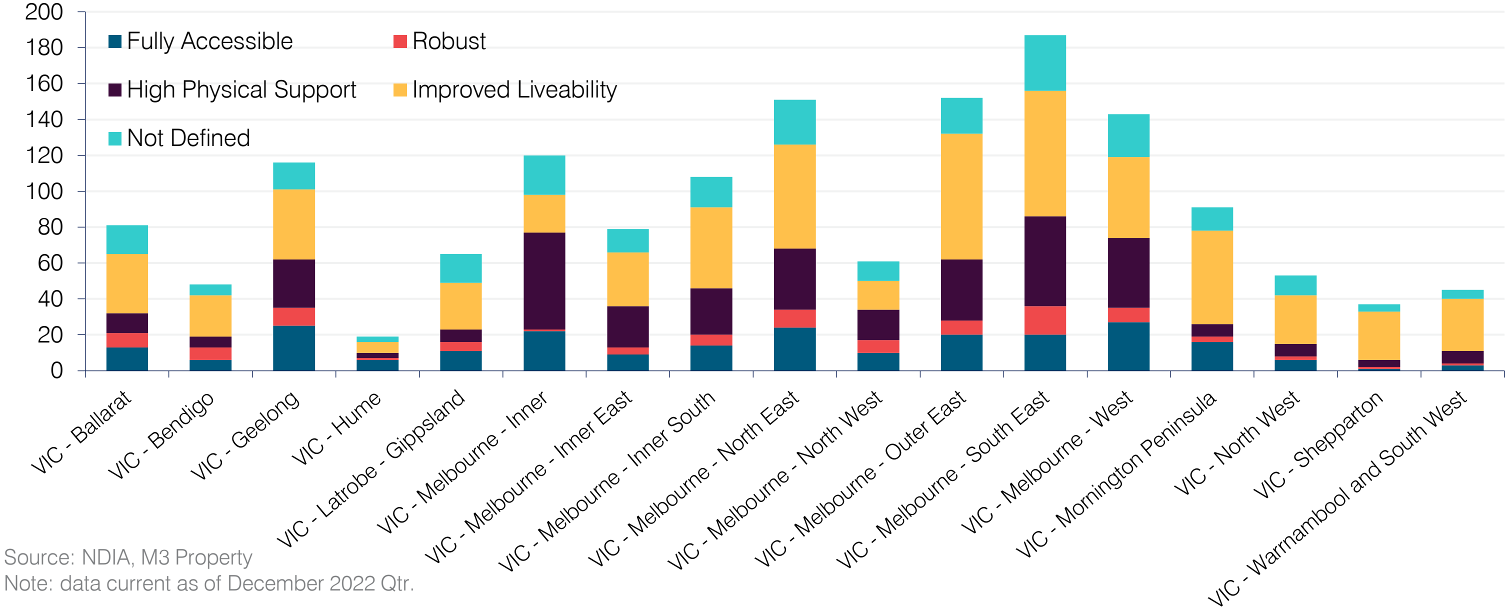
# CURRENT STATE OF PLAY

- The NDIS has an annual recurrent budget of $700 million (indexed over the next 20 years) for SDA. This budget is aimed at incentivising investment into the market and the development of new SDA dwellings.
- Currently, national funding for SDA is circa 48% of the total allocated $700 million per annum. In Victoria, there is currently $90 million allocated on a recurring annual basis.
- There is currently 6,560 SDA participants in Victoria. The number of NDIS participants with SDA funding has grown by an average of 232 participants per quarter since the September 2018 quarter.
- Whilst the SDA market is growing as an attractive investment option due to its high return potential and long-term government backing through the NDIA, we note that there remains a lack of understanding of some of the complexities involved in SDA dwellings and there are many unsophisticated developers operating in this space.

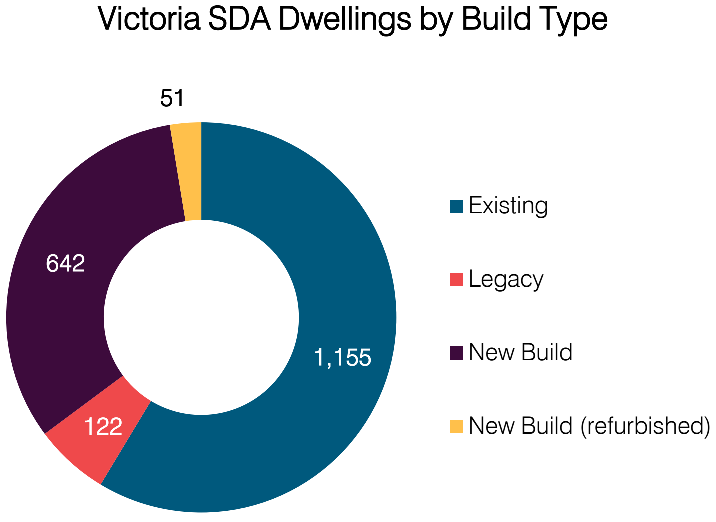
Victoria Enrolled SDA Dwellings by Type




Victoria Participants Seeking SDA Dwelling by Design Category




Source: NDIA, M3 Property
Note: data current as of December 2022 Qtr.

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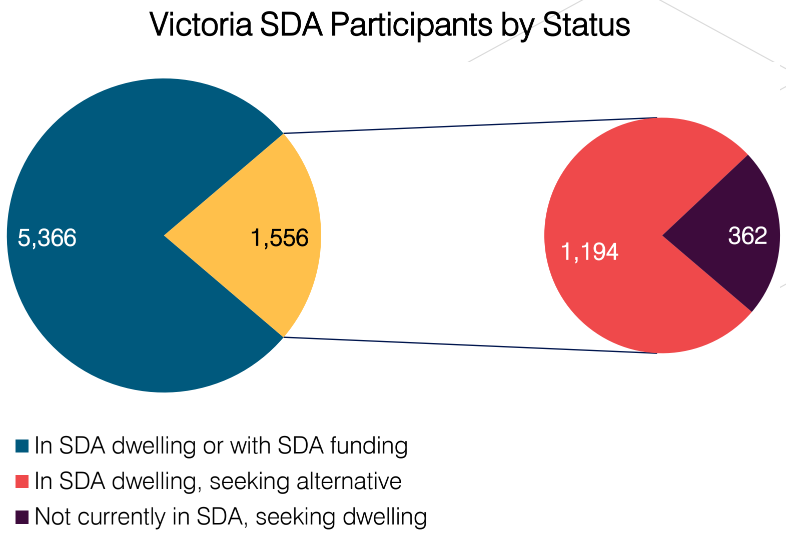


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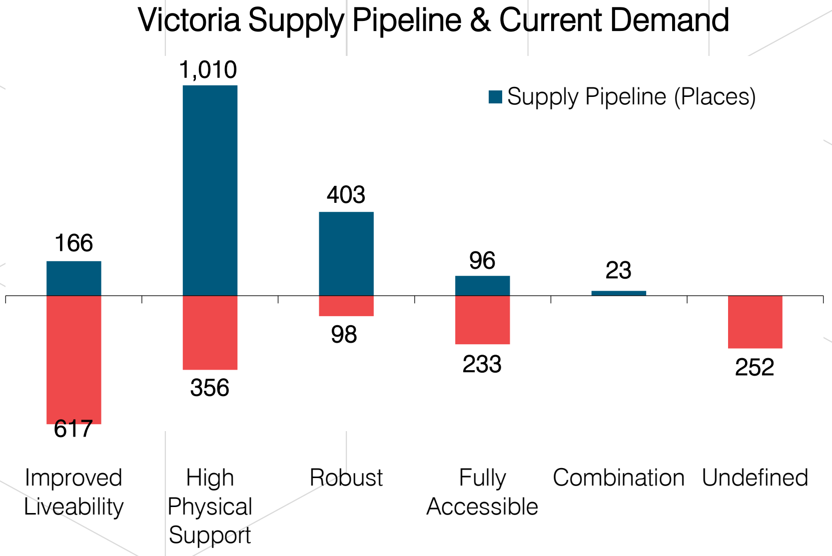


Source: NDIA, M3 Property
Note: data current as of December 2022 Qtr.

## CURRENT DWELLING COMPOSITION

- There are 1,970 SDA dwellings in Victoria, providing an estimated 6,207 places.
- Close to two thirds of SDA dwellings in SDA are ‘Existing’ or ‘Legacy’ dwellings and it is likely that a substantial number of these dwellings are not suited for participant needs.

## CURRENT PARTICIPANT DEMAND

- There is current demand for 1,556 SDA places. This includes 1,194 persons already in SDA yet seeking an alternative dwelling as well as 362 persons not currently in SDA but seeking a dwelling.
- As the market matures, we are seeing an increasing number of participants within SDA dwellings looking for alternative accommodation. This is being driven by increased awareness of SDA, including awareness of the new Design Standard, as well as new supply being developed that might be more suited to a participant’s needs.

## SUPPLY PIPELINE

- Victoria has a development pipeline of 1,698 places.
- Most places in the future supply pipeline are High Physical Support and Robust dwellings, despite demand being strongest for Improved Liveability dwellings.

# OPPORTUNITIES AND CHALLENGES

- As SDA awareness increases and the market matures, it is likely that a substantial proportion of existing and legacy stock will not be suited for participant needs. This can be seen from the 1,194 participants (18.2%) in SDA dwellings but seeking an alternative dwelling.

- Assuming 1.8 places per dwelling, an additional 2,052 dwellings are required within Victoria to replace the current existing / legacy stock.

- New residential building activity has been slowed by labour and supply shortages which have fed through to significant rises in the cost of construction over the past 12 months. The increase in construction costs have put pressure on project feasibilities of some developments and this is likely to continue over the near term. Specifically, there is reduced inner metropolitan development being proposed in comparison to outer metropolitan or regional areas, with high underlying land values prohibiting project feasibility. This is likely to result in reduced supply levels over the medium to long term, with a review of the Price Guide necessary to incentivise further development to meet current and projected demand levels.

# OUTLOOK

- A review of SDA pricing was announced in August 2022, evaluating the impact of current SDA prices on supply and demand. The review intends to set new SDA prices to encourage investment in areas most required over the coming five years. Outcomes of the SDA price review will be implemented 1 July 2023 with final decisions to be released in May 2023.

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