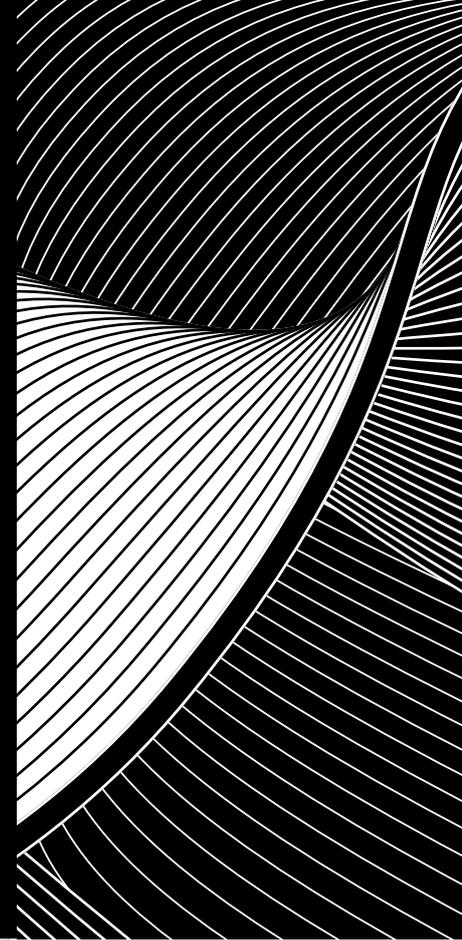


MACQUARIE ASSET MANAGEMENT

Pathways

Global real estate: Approaching the turn

February 2024



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For more information, or to speak to the author of this issue, David Roberts, please contact your Macquarie Asset Management Relationship Manager.

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Deglobalisation is the process of diminishing interdependence and integration between certain units around the world, typically nation-states.

The global financial crisis (GFC) refers to the period of extreme stress in global financial markets and banking systems between mid-2007 and early 2009.

Gross domestic product (GDP) is a measure of all goods and services produced by a nation in a year. It is a measure of economic activity.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

Net asset value (NAV) is the net value of an investment fund's assets less its liabilities, divided by the number of shares outstanding.

Net operating income (NOI) is a calculation used to analyse the profitability of income-generating real estate investments.

Recession is a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in

two successive quarters.

The yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year, and 30-year US Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. It is also used to predict changes in economic output and growth.

The **Consumer Price Index (CPI)** is a measure of inflation representing changes in prices of goods and services purchased for consumption by households.

The **Purchasing Managers' Index (PMI)** is an indicator of the economic health of the manufacturing sector. A PMI reading above 50% indicates that the manufacturing economy is generally expanding; below 50% indicates that it is generally contracting.

Index performance returns do not reflect any management fees, transaction costs or expenses.

Indices are unmanaged and one cannot invest directly in an index.

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Executive summary



Risk-free rates and the cost of capital lifted sharply in 2023, pressuring commercial property pricing and transactions across most markets. However, selective opportunities are now emerging in private markets, including in the logistics sector.



Different markets and sectors are moving at varying speeds. Nonetheless, firming investor sentiment, declining real bond yields and narrowing pricing gaps between public and private markets towards the end of 2023 – if maintained – should boost property transactions and liquidity as the year progresses. Higher capitalisation (cap) rates are creating better entry points for new investments, boosting unlevered expected returns from cyclical lows.



Unlike previous real estate cycles, jobs growth remained supportive of property revenues in 2023 across most sectors, with rising rents partially offsetting the negative impact of cap rate expansion on returns across most property types. The extent to which labour markets hold up will be the key swing factor in maintaining positive near-term demand and rising rents.



On the supply side, higher interest rates and construction costs alongside tighter lending standards are causing new development starts to fall back. This lower level of new supply may boost rental growth over the medium to longer term, supporting the recovery in property values.



Globally, we continue to see long-term thematics remaining in check and impacting demand for real estate and capital flows across markets and sectors, including the following:

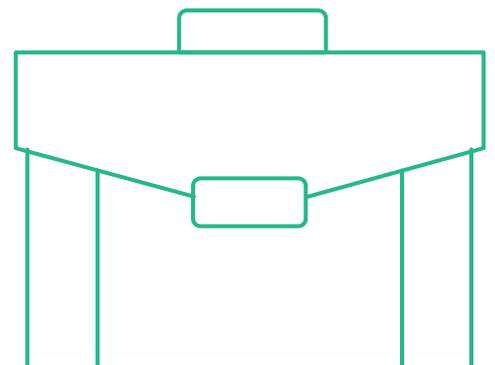
- Digitalisation/technology (logistics and data centres)
- Demographics (housing and adjacent sectors, such as self-storage)
- Deglobalisation (supply chains, manufacturing, and logistics)
- Decarbonisation/sustainability (premium offices and European housing)

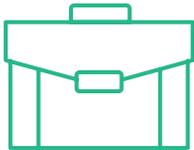


In this context we have a general investment preference for:

- Subsectors where demand-supply fundamentals exhibit resilience in the face of a slowing global macroeconomic environment, such as logistics and residential
- Discounted sectors facing temporary headwinds, such as US multifamily

Introduction: New opportunities are emerging in 2024



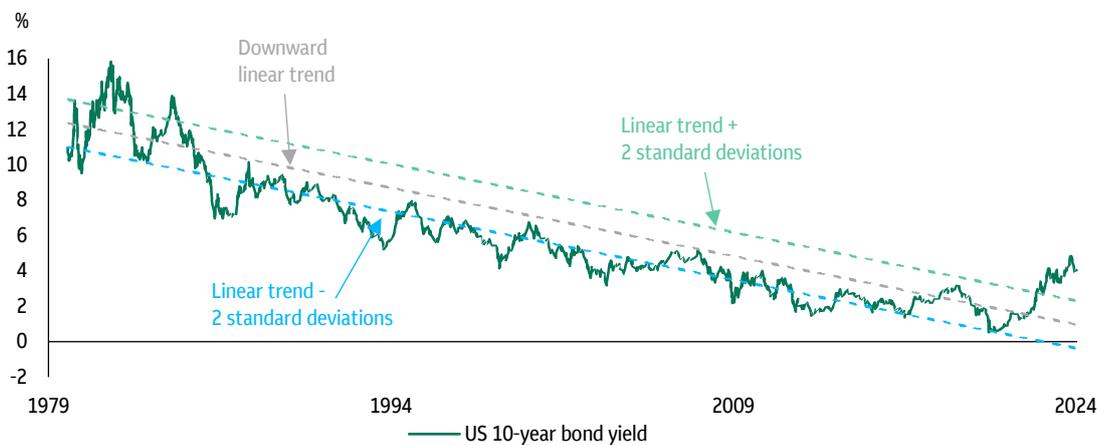


Heightened macro volatility spurred by high inflation and elevated geopolitical risks saw risk-free rates and the cost of capital lift sharply in 2023 (Figure 1), pressuring commercial property pricing and transactions across most markets and sectors. Following a challenging 24 months, selective opportunities in private markets are emerging as pricing adjusts, reflecting the tighter commercial property financing environment.

Different markets and sectors are moving at varying speeds, though, and valuations are generally lagging, with sales well below recent peaks and pre-COVID-19 averages.

Nonetheless, firming investor sentiment across asset classes, a pullback in real bond yields from the cyclical highs, and narrowing pricing gaps between public and private markets towards the end of 2023 – if maintained – should boost property transactions and liquidity as the year progresses. Any pivot towards looser monetary conditions – as implied by markets and expected by US Federal Reserve Board members – that helps lift global growth from expected 1H24 lows would aid the cyclical recovery in property pricing, transactions, and liquidity.

Figure 1. A higher cost of capital has impacted commercial property prices and liquidity

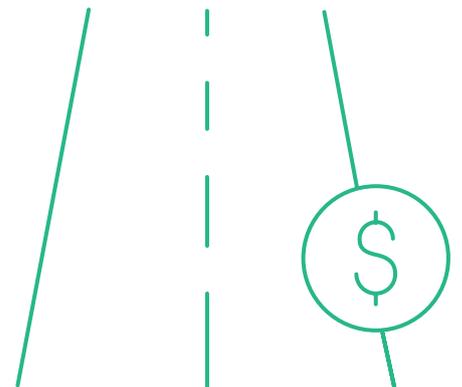


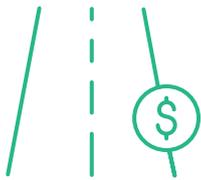
Source: Macrobond (January 2024).

In the past, a normalisation of the US yield curve and bottoming out of global manufacturing Purchasing Managers' Indices (PMIs) followed by monetary easing would tend to trigger an upswing in the global economy. We are watching these leading indicators for signs of a sustained (seven-plus years) upswing in property pricing, transactions, and liquidity.

In terms of pricing adjustments, the industrial sector and alternative property types, such as student housing, single family rentals, health care, data centres, and life sciences, are likely to remain more resilient given stronger underlying demand drivers. Opportunities are emerging for investors to boost exposure in these sectors as managers look to sell stronger-performing assets to clear redemption queues, wind down closed-end funds, pay down debt, or recycle capital into higher-returning development strategies.

Fundamentals: Cap rates, cash flows, and demand-supply dynamics





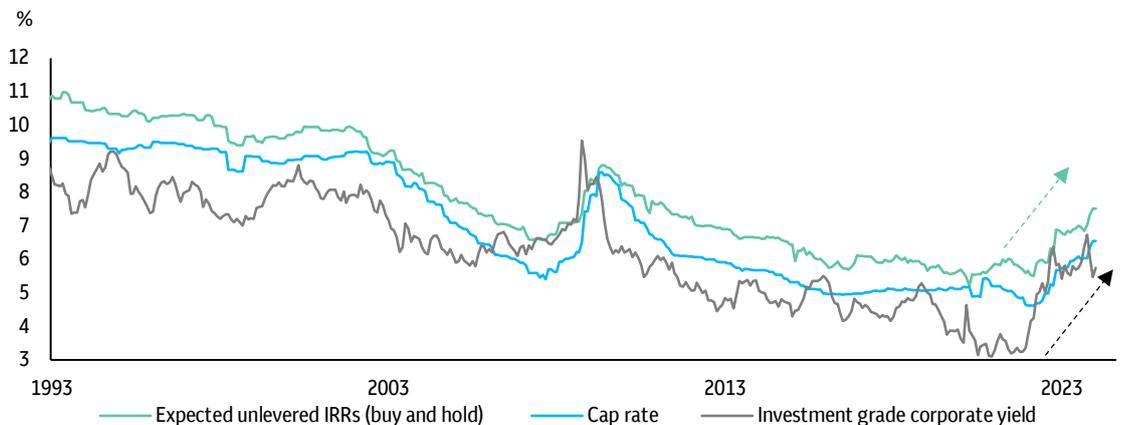
The higher cost of capital has pushed up cap rates, but ongoing jobs growth is supporting rental growth and cash flows. Deteriorating construction pipelines are further tightening medium-term demand-supply balances in some markets and sectors that are already taut due to demographics, challenged affordability, and tight credit conditions.

Cap rates and the cost of capital

Higher cap rates are creating better entry points for new investments and boosting unlevered expected returns from cyclical lows (Figure 2), including for those investors who are looking to increase their exposure or were simply priced out of the market. Cash buyers and investors with low leverage still have a distinct advantage in the current market given ongoing tight lending conditions, high financing costs, and constrained debt availability.

Activity from highly levered investors – as well as from investors with large exposure to weaker-performing property sectors, facing significant near-term refinancing issues or trading at large discounts to net asset value (NAV) in listed markets – is likely to remain subdued in the near term. This group is likely to remain on the sidelines until financing costs become accretive, bank credit conditions loosen significantly from current levels, and global growth accelerates.

Figure 2. US core real estate cap rates and expected returns have risen with the increase in interest rates

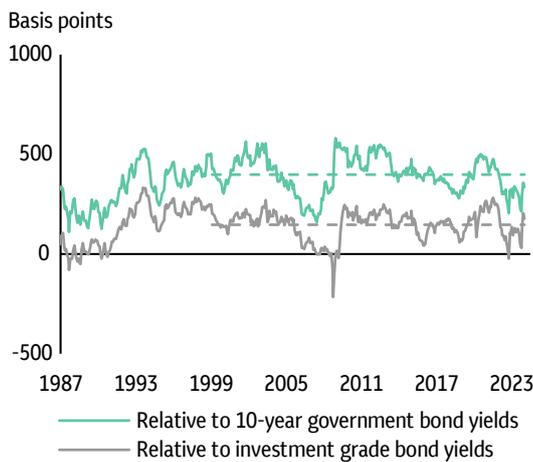


Sources: Green Street, Macrobond (January 2024).

With bonds rallying towards the end of 2023, expected total returns from real estate for buy-and-hold strategies appear to be approaching fair value against investment grade corporate bonds (Figure 2). This is helping to stabilise prices in leading markets, at least temporarily, and slow the rate of decline in lagging countries.

In the US, total return spreads to government bonds, which are currently around 350 basis points, remain below their 25-year average of 400 basis points (Figure 3), suggesting some caution is still warranted for core investments,

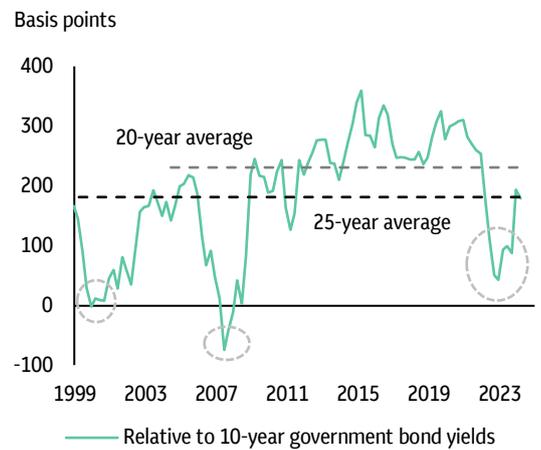
Figure 3. US real estate expected return spreads



Sources: Green Street, Macrobond, PMA (January 2024).

especially in those sectors with weaker fundamentals. In general, property valuations are likely to remain under pressure in the near term as they continue to adjust to marked-to-market prices and sentiment, particularly if the global macro environment softens in 1H24. In Europe, office yield spreads to government bonds are approaching their long-term averages following the dip in 2022, though investors could demand a higher risk premium relative to historical levels given some of the headwinds facing the office sector (Figure 4).

Figure 4. European prime office yield spreads

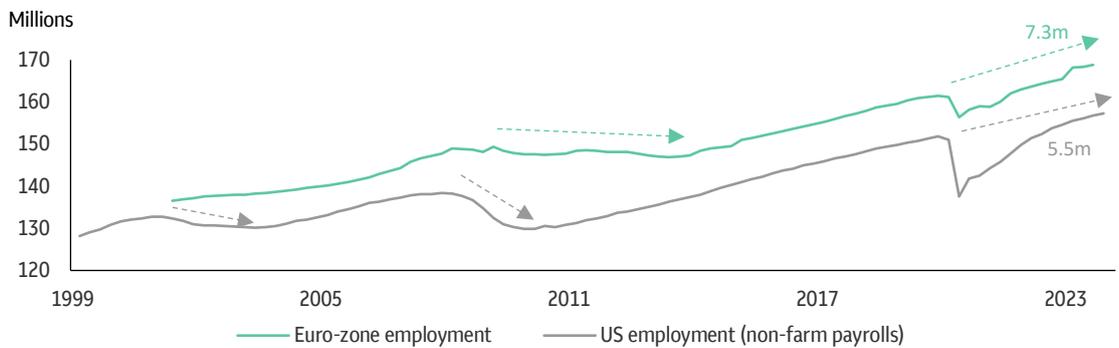


Jobs growth and cash flows

Beyond capital market volatility, jobs growth in developed markets remains generally supportive of property demand and cash flows, with rising rents partially offsetting the negative impact of cap rate expansion on capital values and total returns across most market and sector combinations. This is somewhat different from previous cycles, such as the early 1990s and global financial crisis (GFC) recessions – and to a lesser extent the dot-com correction, which mainly impacted the office market in tech cities – in which cash flows

came under pressure across many asset classes as rents and occupancies reset to lower levels reflecting weaker demand conditions. This is particularly the case in the US, where economic growth remained solid through the end of 2023, particularly compared with Europe and the UK, where gross domestic product (GDP) was flat or declining. Of course, timing could be the issue given the long and variable lags of monetary tightening on demand as households run down their savings, existing borrowers gradually roll over to higher rates, and new investors face much higher financing rates.

Figure 5. US and Euro-zone employment levels



Source: Macrobond (January 2024).

Rental growth momentum is decelerating as we head into 2024 but remains positive, especially in asset classes boosted by structural drivers related to demographics (housing and health care), digitalisation (data centres and premium offices), and deglobalisation (supply chains and logistics). In the background, the flight-to-quality space – particularly evident in the office sector – in part reflects ongoing decarbonisation efforts of many investors and occupiers as they look to hit their net zero targets.

The extent to which labour markets hold up this year will be the key swing factor in maintaining positive near-term

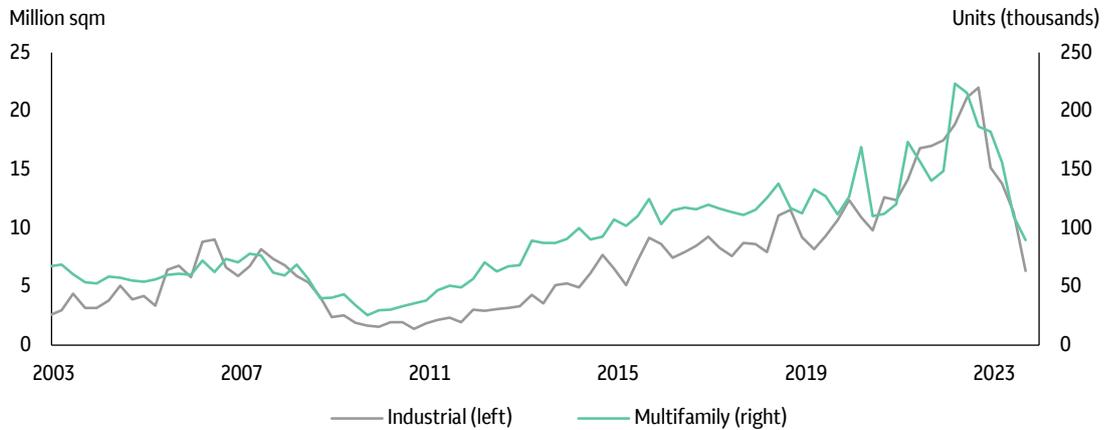
demand throughout 2024. A sharp rise in unemployment would impact rents and cash flows, particularly in the core sectors. But on the flip side, any material global growth slowdown would also see risk-free rates fall back further from current levels, assuming past relationships continue to hold, as markets begin to price in more rate cuts, though lending margins could rise somewhat with deteriorating credit conditions. This adjustment would be brought forward if general investor sentiment sours sharply and rates are cut aggressively to boost demand in a global recessionary scenario.

Demand and supply fundamentals: A tightening medium-term supply picture

On the supply side, the combined impact of higher interest rates and elevated construction costs alongside tighter debt financing standards and higher exit cap rate assumptions is becoming evident as new developments fall back in many markets. Leading indicators

for activity, such as commercial property construction starts and housing permits, were down sharply across sectors in 2H23 compared with prior year levels (Figure 6). Similar trends are playing out across markets to varying degrees, with some of the sharpest slowdowns occurring in those sectors that have seen the most significant capital inflows in recent years, such as US logistics, US multifamily, and German residential.

Figure 6. US construction starts fell sharply in 2H23

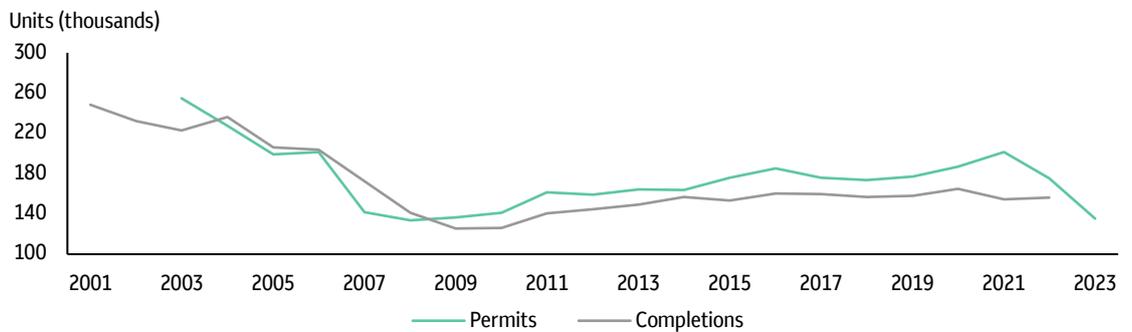


Source: CoStar (January 2024).

While less construction will be a headwind for economic activity and jobs in 2024, the impact on future demand-supply dynamics in real estate may be underestimated when the global macroeconomic cycle picks up, given the long lags associated with delivering new space to the market. In fact, the pullback in supply is likely to provide a boost for rental growth and cash flows over the medium to longer term, supporting the recovery in property values, particularly if demand remains resilient or accelerates coming out of this cycle.

It is worth differentiating between sectors and regions here. Development cycles for logistics are notably shorter than for most other asset classes and can be adjusted more quickly to reflect demand conditions, as is currently taking place in the US market. In the housing sector, planning and permitting regimes differ across markets and according to existing density and local authorities' appetite for development. Europe's tight and patchy planning regime is likely to slow the recovery in completions as the development cycle turns, despite strong demand fundamentals, creating ongoing rental and occupancy tensions over the long term.

Figure 7.
The German construction pipeline has also pulled back

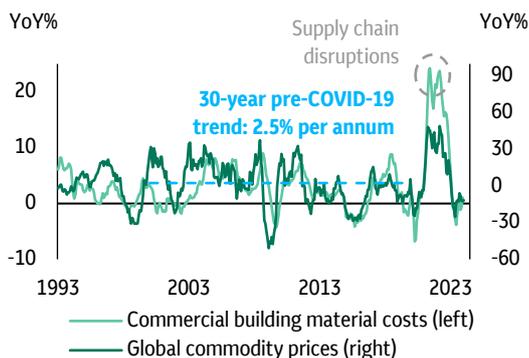


Source: Macrobond (January 2024).

The sharp rise in construction costs (due to higher material input costs and wages) relative to historical averages has been one of the drivers behind the pullback in development activity in commercial property. Even in sectors with stronger fundamentals, such as logistics, it has been difficult to recoup these higher costs via higher tenant rents as the demand cycle normalises, thereby impacting returns and starts. In weaker office markets, valuations have fallen below replacement costs, which not only affects development feasibility but also fuels the case for refurbishments and repositioning opportunities.

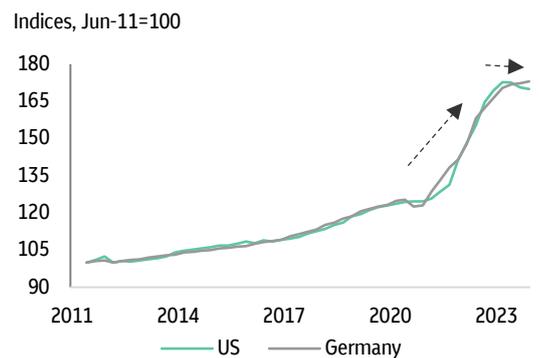
With the prices of many raw materials falling from mid-2023 levels, cost inflation has normalised (Figures 8 and 9) aided by increasing contractor availability as pipelines dry up and builders compete for a reduced amount of work, though overall construction prices are unlikely to reset to prior levels anytime soon, consistent with previous cycles where costs remain sticky. This suggests that we will need to see a sustained period of rental growth before construction activity lifts sharply again, aided by any normalisation in construction financing and valuation stability.

Figure 8.
US construction cost inflation has normalised

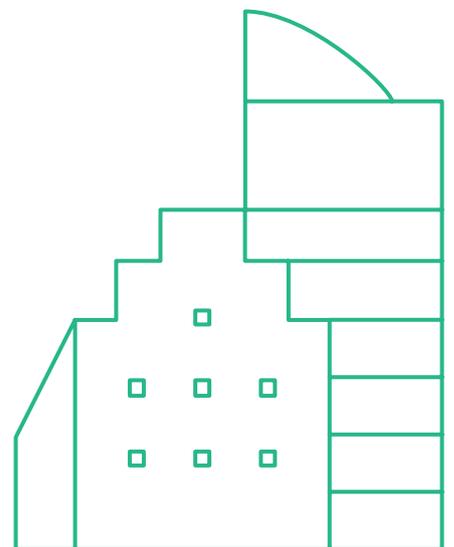


Sources: Bloomberg, Macrobond (January 2024).

Figure 9.
Construction cost indices appear to have peaked



Regional positioning and sector opportunities: Widening divergences





Different regions and sectors have different exposures and underlying drivers, but COVID-19 has widened divergences, accelerated some already-existing trends, and disrupted historical relationships.

Regional positioning: UK and Europe are weak, while the Asia-Pacific region is holding up well

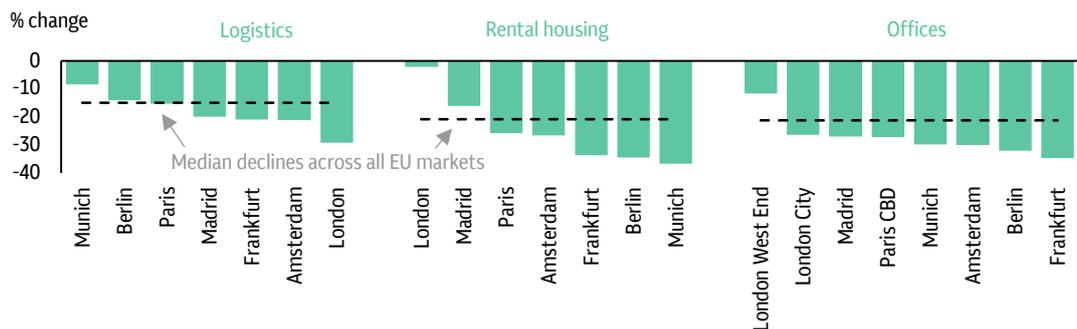
On a global basis, the UK has corrected more quickly during this cycle, reflecting the forward-looking approach of valuers and higher liquidity of the London market. The US has followed with cap rates and lending volumes impacted by a sharp credit tightening and a general repricing of debt, though there is considerable variation across sectors and cities, reflecting local supply-and-demand fundamentals. Our view is that the UK and US markets are likely to emerge first when global growth accelerates.

We are already starting to see investors without significant legacy exposures and portfolio issues beginning to take advantage of the better pricing metrics available today.

Europe’s adjustment is catching up, with pricing now 15% lower than mid-2022 peaks for prime logistics, 20% lower for rental housing, and 20% to 25% lower for prime offices, according to PMA (Figure 10). Secondary valuations are likely to have seen bigger declines. This is presenting better entry points for new investments and repositioning opportunities for Grade B buildings in good locations as values reset below replacement costs, particularly for those that are less reliant on debt markets to boost returns.

With cap rates moving out throughout 2023, we are now at a point where debt is marginally accretive across many European Union (EU) markets and sectors, usually providing some positive spreads to expected total returns while taking some away from cash-on-cash (CoC) yields. Another potential downside risk to future income growth is the fact that inexperienced players entering the market now often do so at a significantly lower cost base compared with current owners and in turn may be willing to accept lower rents – taking some momentum away from the market.

Figure 10. Estimate peak to 3Q23 declines in European capital values by sector



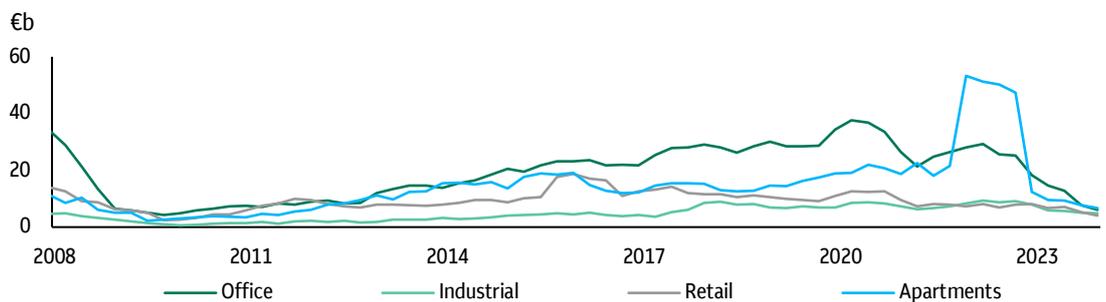
Source: PMA (January 2024).

Further visibility that 10-year bond yields have stabilised alongside credit and lending spreads may also support any cyclical recovery across the US and Europe, with property typically benchmarked against local risk-free rates plus a risk premium. Historical data from Green Street over the past 25 years show that the excess return that investors typically require to hold core stabilised assets is around 400 basis points, with variation across sectors. This equates to prime cap rates stabilising at around 200 basis points over local government 10-year bond yields, with rents growing at 2% per annum. Stronger growth assumptions would imply tighter cap rates and vice versa. There is a caveat here: any premiums over local bond yields reflect investors' perceived risk, and for those asset classes with weaker fundamentals and an uncertain outlook (secondary retail and non-core offices) it may be noticeably higher going forward. On the other hand, for those sectors with strong fundamentals that have matured as an

institutional asset class, this spread is likely to be tighter than historical averages.

In local currency terms, Germany's commercial real estate transaction volumes dropped by 56% in 2023 (Figure 11) compared with the prior year's decline of 63% (in German A cities), according to preliminary data from Real Capital Analytics (RCA). While there are differences across sectors, with logistics (down 40% year over year (YoY)) and apartments (down 47% YoY) holding up better than offices (down 66% YoY), the fact is that the market slowed to levels last seen in the aftermath of the GFC and improved only slightly during the normally active fourth quarter. Although prime net yields have expanded by 175 basis points since the peak for offices and 115 basis points for logistics, and average net yields for apartments by 60-85 basis points, according to the latest PMA data, this has not been enough to increase investment volumes.

Figure 11. Germany's commercial real estate transactions have fallen sharply



Sources: RCA, MSCI (January 2024).

While the rapid increase in interest rates has been the main driver of the weak performance of German real estate during the past 12 months or more, a contracting economy and the news regarding the Signa project development insolvencies are certainly not helping investor sentiment either. Moreover, as calculated by CBRE, Germany will face the most commercial real estate debt refinancing requirements in Europe during the next four years. Based on current valuations and interest rates, one-third of this debt, or €77 billion, cannot be refinanced due to the decreased capital values and tighter lending conditions (lower loan-to-value ratios). Falling interest rates, as well as potential short extensions agreed by the lenders, would obviously ease the situation for investors looking to refinance, but we can still expect to see distressed sales caused by the debt financing gap.

Opportunities may therefore emerge in Germany for investors with “dry powder” during the next few years. We believe the sectors with the most potential now are apartments and logistics, both of which offer 3% annual rental growth during the next five years, according to PMA, driven by their more favourable leasing fundamentals relative to offices and retail.

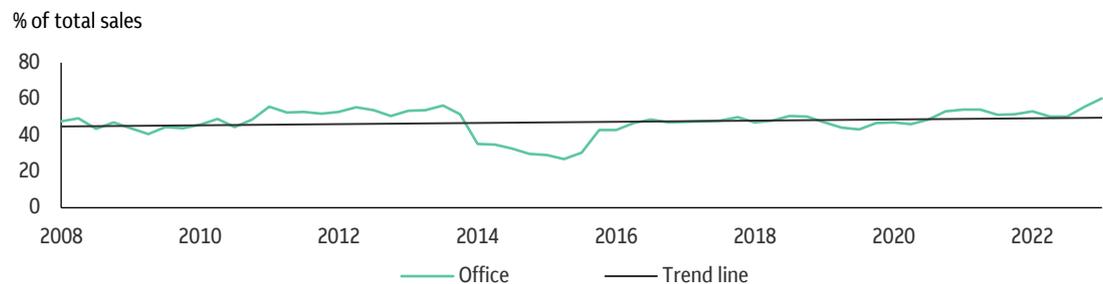
In terms of pricing and demand, Asia ex China property has fared better during this cycle compared with other regions and previous downswings. For example, unlike other developed markets, Japan’s capital values continued to increase in 2023, reflecting a combination of steady fundamentals, improving business conditions, and accommodative debt markets.

Capital flows into Japan’s property market have remained positive, with investors looking for steady yield and potential diversification against other developed markets, particularly in the logistics and residential sectors. Japan benefits from being one of only a handful of markets

with sufficient size and liquidity for global investors looking to boost their Asia-Pacific allocations. The presence of strong local banks, tight lending margins, and the dominance of private investors are combining to support pricing in Singapore compared with other gateway cities, although high-end residential has softened with the doubling of stamp duty for foreign buyers from late April 2023.

From a global standpoint, South Korea’s office market remains a standout performer (Figure 12), supported by a combination of tight vacancy, low prevalence of work-from-home, and limited new construction in recent years. Unlike other markets, capital continues to gravitate towards Seoul’s office market, with the sector garnering 60% of investment volumes in 2023. Similar trends are evident across Asian cities where high density and smaller living spaces minimise the impact of the hybrid working practices that landlords are grappling with in Western markets.

Figure 12. Transactional activity - South Korea



Sources: RCA, MSCI (January 2024).

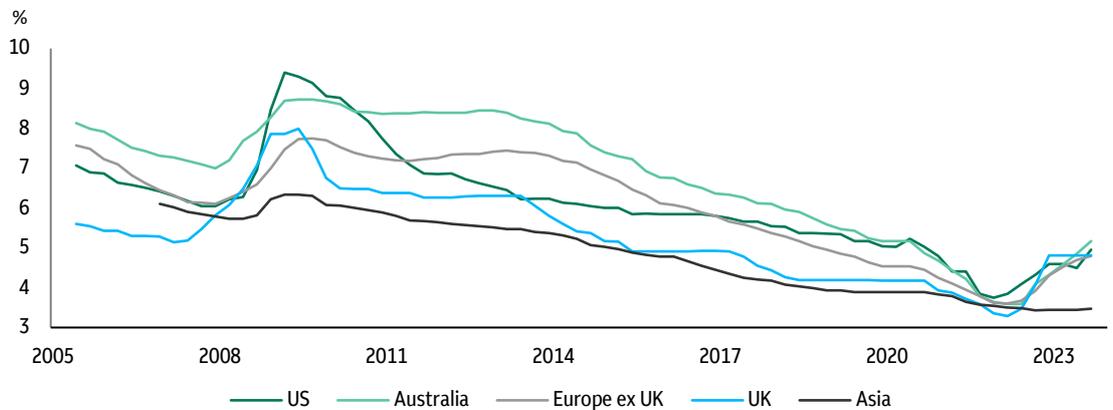
Elsewhere in the region, Australia’s commercial property adjustment is lagging, consistent with previous cycles. Although transactions have followed similar trends seen in other markets, with preliminary sales down more than 50% in 2H23 relative to levels in 2022, pricing is holding up better, particularly in the rental housing sector. The combination of lower leverage in commercial property and strong local banks that continue to provide liquidity, alongside accelerating population growth, is dampening pricing declines compared with global peers.

Sectors: Logistics and rental housing preferred

The logistics sector is likely to remain one of the more liquid asset classes in 2024, providing exit routes for investors repositioning portfolios or raising cash. Recent capital market volatility is creating better entry points for investors seeking to build exposure to the asset class, with US nationwide cap rates at 5% and 50-100 basis points higher at today's stabilised

market rents, having moved from cyclical lows of 3.5%, according to Green Street. Similar trends have been observed in the UK, where net initial yields have expanded to 5% from mid-2021 lows of 3.5%, and in Europe, where yields are now at 4.8%, according to data from PMA (Figure 13). Similar expansions have been seen across other developed markets, outside of Japan where cap rates continued to firm in 2023, boosting valuations.

Figure 13. Industrial cap rates by country

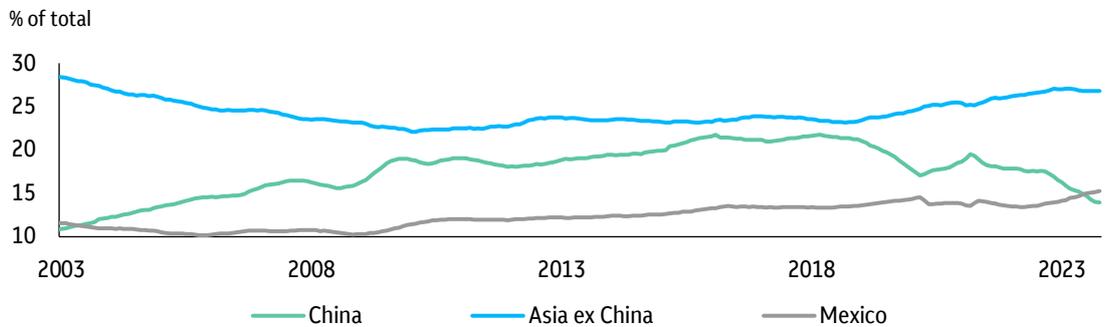


Sources: Green Street, JLL, PMA (January 2024).

Refinancing and redemption events are also triggering sales of industrial facilities, despite their solid fundamentals. The turnaround from the tight pricing and low cap rates of the COVID-19 period is providing good opportunities for new investment into a sector that is still seeing healthy net operating income (NOI) growth relative to other core sectors, although demand and rental growth are normalising with slower jobs growth. With many investors underweight logistics exposure in recent years, exacerbated by strong price performance, the current capital market volatility provides an opportunity for those seeking to rebalance.

Changing consumer behaviour and rising online sales are not the only factors driving the current demand for logistics space. Businesses are increasingly facing up to the risks that geopolitical tensions pose to their supply chains and operations. At the same time, the pandemic exposed the limitations of just-in-time production and holding a limited amount of inventory for a given level of sales, and now businesses around the world are diversifying supply chains and onshoring manufacturing. These shifts are increasing the demand for warehousing and logistics facilities, particularly in strategic locations.

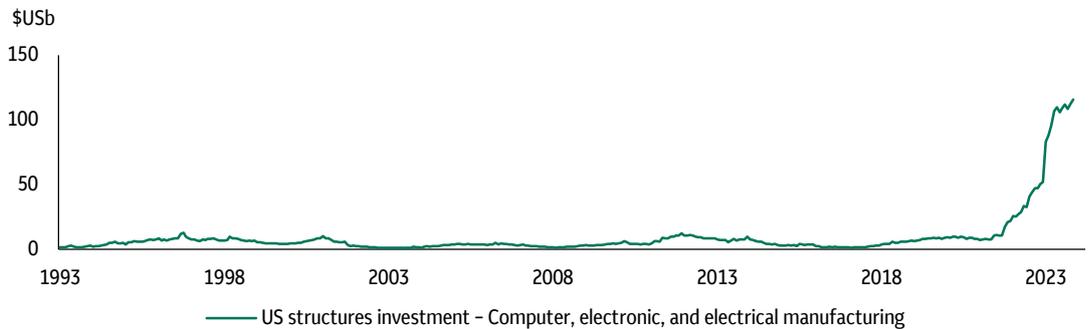
Figure 14.
US goods imports by country



Source: US Census Bureau (January 2024).

These trends are particularly evident in the US, where government subsidies from the Inflation Reduction Act and the CHIPS and Science Act are driving a surge in investment in electric vehicles, batteries, and semiconductors (Figure 15), boosting manufacturing construction, particularly in the Sun Belt states. This gradual retooling of Western supply chains alongside near-shoring and shifting trade patterns, supported by governments and corporates seeking to diversify their supply chains, will be an important driver of growth in logistics over the coming years. Key market beneficiaries are likely to be parts of the US and Mexico and low-cost manufacturing producers in Southeast Asia and Central and Eastern Europe.

Figure 15.
US investment



Source: Macrobond (January 2024).

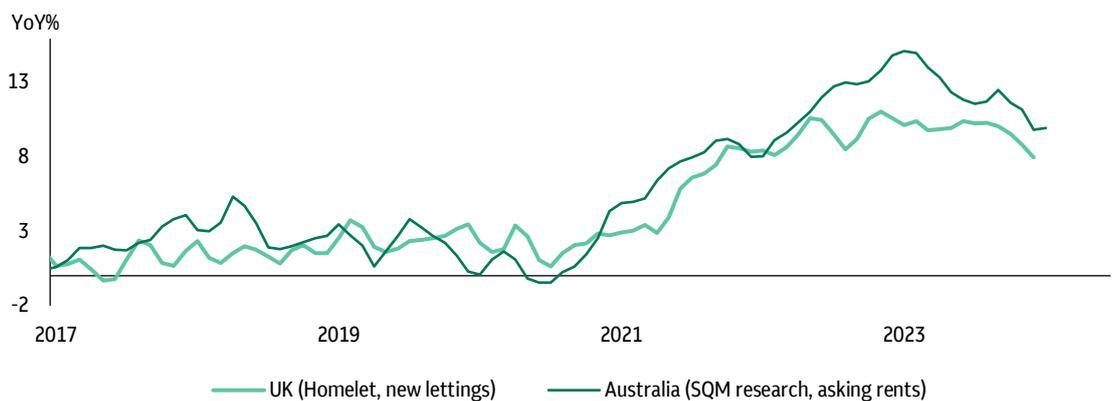
Globally, rental housing demand is set to remain solid over the medium term, creating opportunities for investors that are looking to boost their “living” sector exposure, though near-term drivers and growth patterns differ somewhat across markets. On the development front, new supply is likely to remain constrained for the next 12-18 months if construction costs and financing rates remain elevated, alongside higher exit cap rate assumptions in Europe and the US, which are impacting development returns.

Sticky demand and falling supply should support rents and occupancy rates over the medium term. Demographic shifts and affordability constraints are also creating subsector opportunities such as larger apartments and single-family rentals for millennials (those born between 1981 and 1994), affordable housing products for key workers (e.g. US manufactured homes), and amenity-rich residential communities for retiring downsizers (e.g. Australia’s land-lease communities sector).

The combination of high migration from overseas, demographics, elevated mortgage rates, and stretched affordability for purchase

continue to support strong rental demand across markets, including the UK and Australia’s build-to-rent (BTR) sectors (Figure 16). Market rental growth is set to remain solid this year given ongoing tight vacancy rates and the pullback in supply, with broader Consumer Price Index (CPI) rental measures gradually catching up as leases reset in line with the market. Generally, ongoing strong rental growth and occupancy assumptions continue to support pricing relative to other sectors and markets. Longer term, rents are expected to grow in line with wages as affordability issues cap growth, helping to minimise any further regulatory scrutiny.

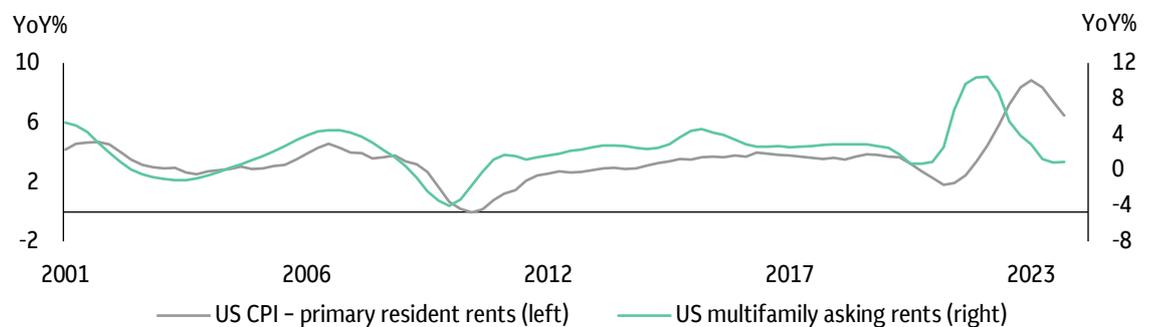
Figure 16. Australia and UK private housing rents



Source: Macrobond (January 2024).

In other markets, elevated US multifamily supply growth – particularly at the higher end – is set to cap near-term asking rents, with vacancies remaining above average at least at a national level, though there is significant variation across individual cities and submarkets reflecting local drivers. Higher cap rates and stabilising demand are creating better entry points for those investors who are looking to boost their exposure or were simply priced out of the market during the pandemic. A sharp pullback in multifamily starts into 2024 should provide some relief to vacancy rates over the medium term as the current pipeline is absorbed.

Figure 17.
US multifamily rental growth is normalising



Sources: Bloomberg, CoStar (January 2024).

In Europe, market rents are picking up although regulated in-place rents are likely to lag as indexation pass-through is slow and revenues are falling short of expenses (at least temporarily) with cap rates expanding as a result. This is creating better entry points for new investors along with less new supply to compete with over the medium term. A longer-term trend for Europe’s housing sector is likely to arise from the EU’s Energy Performance of Buildings Directive (EPBD), which reached final agreement in 2023. According to the EPBD, the EU aims to reduce emissions by at least 60% in the building sector by 2030 compared with 2015 levels and to achieve climate neutrality by 2050. In addition to potential energy renovation needs, housing landlords may also be impacted by the EU’s plan to ensure there are safeguards for tenants, such as through rent support or caps on rent increases, which may also affect near- to longer-term supply.

Polarisation remains a key theme in office markets, with occupiers focused on high-quality, amenity-rich buildings in locations with good transport linkages. These buildings tend to command significant and rising rent premiums, which is helping to buttress the capital decline of the broader office sector.

Newly developed and redeveloped offices in the right locations are likely to continue to gain the attention of tenants given their strong environmental, social, and governance (ESG) credentials and layouts suitable to the use of technology in the workplace, alongside the broader digitalisation trends of business operations. Demographics is also an underappreciated driver in office investment strategies, as millennials become the dominant age group in labour markets, driving corporate fit-out strategies, location preferences, and post-pandemic work-life practices.

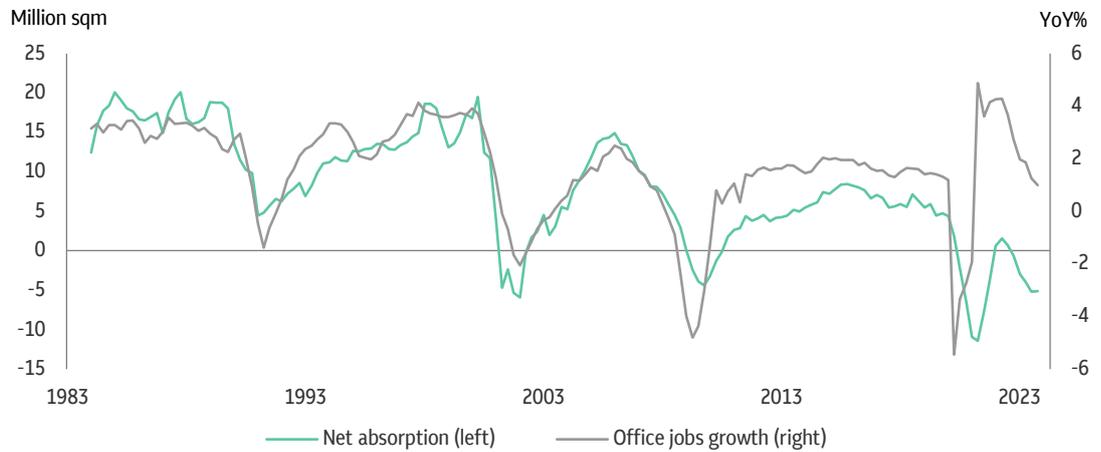
European regulatory overlay is also likely to aid the prime office story over the coming decade as older assets are withdrawn and tenants “right-size” their spacing requirements by focusing on the best buildings. This dynamic is already playing out in the central London market where mixed-use property submarkets and high-quality buildings near transport linkages are achieving the highest rents and occupancy rates, creating opportunities to reposition older buildings in good locations. Similar shifts are taking place across many developed markets where office landlords are competing with worker commute times and daily expenses.

This dynamic has been playing out in Tokyo for decades, as office rents fall off sharply for buildings located farther from train stations.

The flight-to-quality theme is also evident in the US, where overall demand trends remain negative on a global basis (Figure 18) given that office attendance rates are much lower than European and Asian peers. Occupiers are also increasing scrutiny of space utilisation, using lease expiries to adjust their spacing requirements to meet peak-day attendance.

In this environment, demand has held up relatively well at a small number of new and premium offices that are able to create unique employee experiences, which is consistent with demand trends in other developed markets. The slight nuance in the US is that CBD location is less important than in Europe and the Asia-Pacific region, given the prevalence of working from home and the stronger performance of suburban submarkets.

Figure 18. The relation between US office-based jobs growth and nationwide office demand has broken down



Sources: CoStar, Macrobond (January 2024).

CoStar reports that five-star properties and new offices in the US – particularly those completed within the past two to three years – have seen consistently positive net absorption since early 2020, with levels comparable to 2011-2019 averages (Figure 19). By comparison, demand for lower-quality buildings and older properties has suffered significantly, including those assets that are just 5-10 years old and are coming to the end of their first leasing cycle. In an environment of slowing jobs growth and ongoing structural headwinds, these trends are likely to become more entrenched.

With construction activity (and therefore the addition of new premium stock) moderating, and existing supply at the top end of the market remaining tight, any pickup in demand going forward is likely to trickle down to the higher end of the four-star property tier. Given persistent pricing dislocation in this part of the market, this might create selective market entry opportunities over the coming years as the relationship between jobs growth and demand stabilises.

Figure 19. Premium US office leasing demand is holding up well relative to lower quality space



Source: CoStar (January 2024).

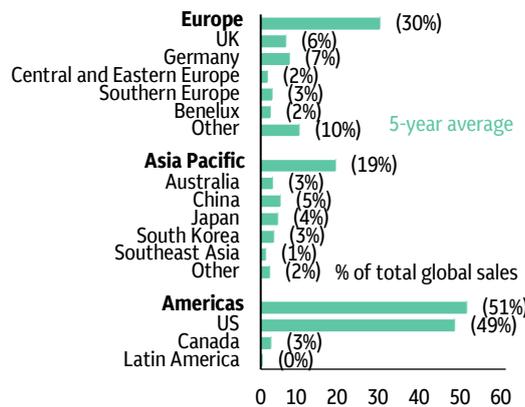
Transaction volumes, debt levels, and the economic cycle





Over the past five years, global transactional activity of existing stabilised properties has been split between North America (51%), Europe (30%), and Asia Pacific (19%) (Figure 20), although Asia’s share would be higher if sales of land were accounted for given the region’s much higher development activity in catering to its faster-growing cities and economies.

Figure 20. Annual transactions by market (2019-2023)

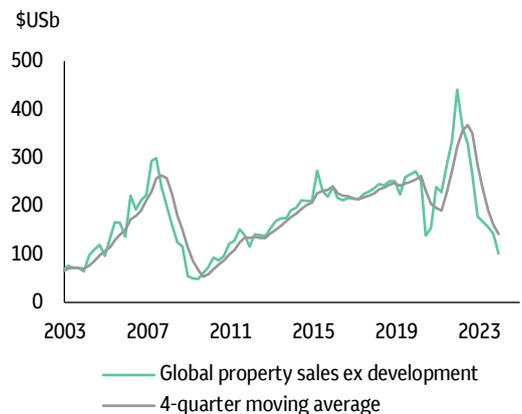


Sources: RCA, MSCI (January 2024).

Overall, all regions have seen sizeable declines in sales relative to pre-COVID-19 levels (2017-2019) with the Asia-Pacific region holding up better (transactions down 29%) and Europe faring relatively worse (down 57%). In addition to Japan, liquidity has held up better in smaller markets that are less open to cross-border capital and dominated by either local institutional investors, such as Canada, or a combination of private local investors and developers, such as in South Korea and Southeast Asia.

Following a surge in transactions during the pandemic, global property sales were down 50% in 2023 compared with 2022 levels (Figure 21) and down 40% relative to pre-COVID-19 averages (2017-2019). Transactions were down sharply across most markets and sectors, with the obvious exception being Japan, where nationwide volumes were in line with pre-COVID-19 averages in local currency. Unlike previous years, the bounce in global year-end transactions failed to materialise in the final quarter of 2023, with activity only back to late-2010 levels after seasonal adjustments.

Figure 21. Global property sales



The weak performance of Europe is likely to be driven by a combination of factors, including weaker macroeconomic sentiment, overall lower leverage, the presence of real estate investment trusts (REITs)/retail funds (which may be under less pressure on the sell side, with less distress, fewer discounts, fewer deals coming to market), and a greater reliance on cross-border investments (which remain relatively subdued). The latter accounted for 48% of annual volume in Europe over the past five years compared with 17% in the Asia-Pacific region and 12% in the US, according to data from RCA.

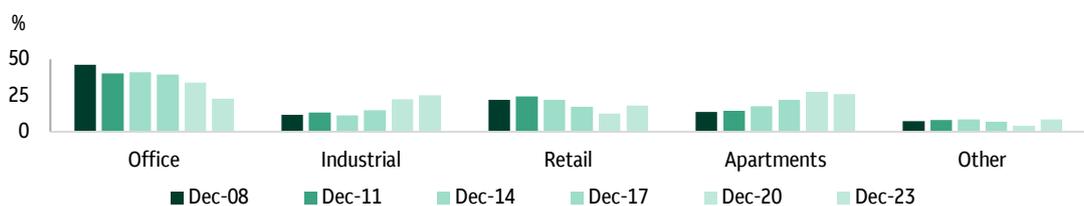
Figure 22. 2023 transactions versus pre-COVID-19 (2017-2019) averages



Sources: RCA, MSCI (January 2024).

By sector, long-term investment shifts remain in place with capital continuing to gravitate towards industrial and living exposure at the expense of offices and retail. These themes have generally played out at a country level as well, though there are some important exceptions, particularly in the Asia-Pacific region where demand for office exposure remains healthier compared with Europe and the US, reflecting solid demand fundamentals and less structural headwinds from working from home.

Figure 23. Global transaction activity by sector (% of total by sector)



Sources: Bloomberg, RCA, MSCI (January 2024).

Although retail investment activity has fallen off sharply in absolute terms in 2023, in relative terms it appears that the sector has broadly stabilised, reflecting a combination of better entry points for new capital following an extended period in which pricing has now adjusted to an environment of rising online sales and pandemic-induced shutdowns. Fundamentals appear to be improving, at least in certain segments, such as grocery-anchored assets, convenience retail, selective big-box retail assets (large format retail in Australia and out-of-town retail in the UK) and high-quality shopping centres. Most of the buyers in this space are family offices, high-net-worth individuals, and pooled retail investors that have been less exposed to the valuation adjustments in the sector over the past five years, with institutional capital selling down their exposure.

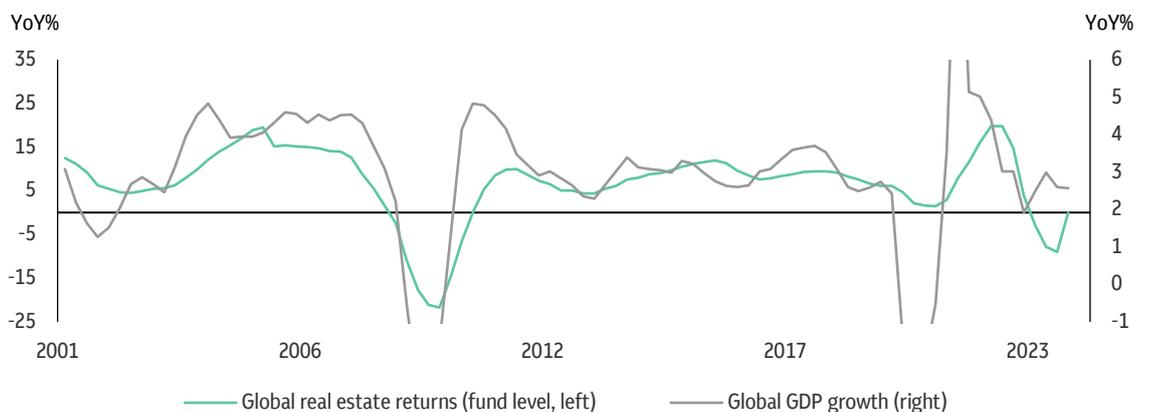
The sharp pullback in retail development activity over the past 10-15 years has also helped as occupiers focus their leasing activity and expansionary plans on existing centres and high street pitches. A similar trend is likely

to occur in the office sector as construction activity comes under pressure given lower margins and increased risk of leasing speculative space.

The economic cycle, transactions, and returns

Looking at historical relationships, real estate returns and transactions have corrected well ahead of the usual macro drivers such as global GDP growth (Figures 24 and 25), which remained resilient last year and surprised on the upside compared with consensus expectations at the beginning of 2023. Positively, this suggests that any acceleration in global growth in 2H24 and into 2025 could boost prices and transactions more swiftly than expected, with fundamentals and supply conditions in decent shape, aside from the US and secondary offices. Elevated amounts of dry powder targeting the sector may aid the recovery, particularly if financing costs adjust in line with market expectations.

Figure 24. Global property returns and global GDP are correlated

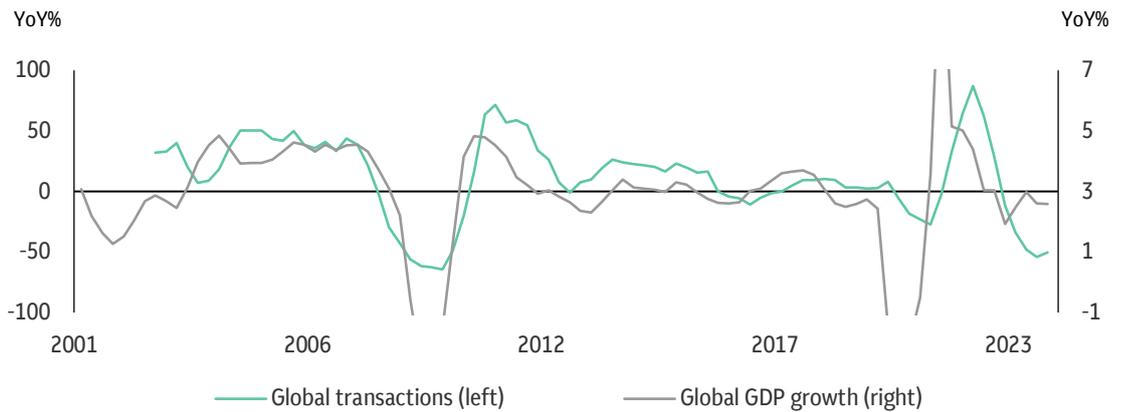


Sources: Asian Association for Investors in Non-Listed Real Estate Vehicles (ANREV), European Association for Investors in Non-Listed Real Estate Vehicles (INREV), National Council of Real Estate Investment Fiduciaries (NCREIF), Oxford Economics (January 2024).

On the flip side, the widening divergence between property returns and global GDP partly reflects the lack of pricing discovery during COVID-19 and subsequent material increase in liquidity that found its way into the asset class during 2020 and 2021. This helped to establish new valuation benchmarks across

property types, allowing investors to reset their property portfolios to much higher prices and lower cap rates. In the current market, many properties that traded during the pandemic would sell at discounts to their original purchase prices if they were sold today.

Figure 25. Global GDP growth also drives global transaction volumes



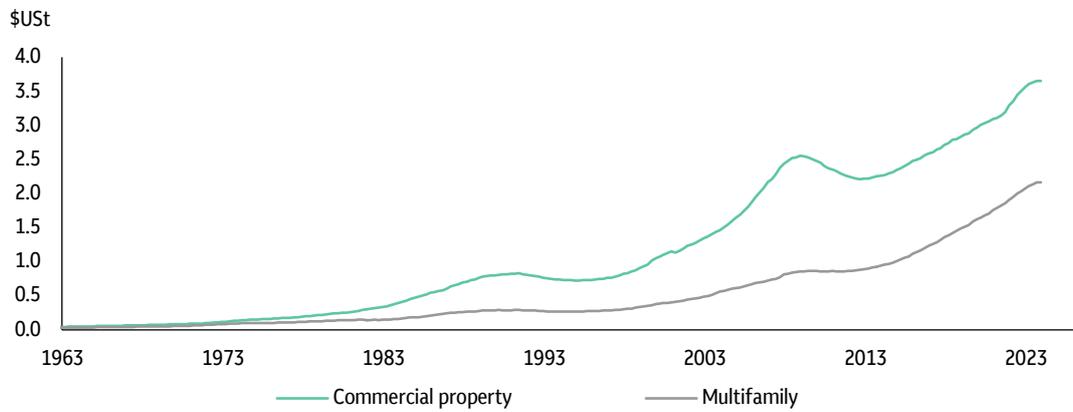
Sources: Oxford Economics, RCA, MSCI (January 2024).

Investors that can continue to service their loans have been reluctant to sell at today's prices, aided by lenient lenders that have been happy to kick the can down the road until pricing and liquidity conditions improve. However, in some instances, levered investors have walked away from their properties where the rental income no longer covers the interest, and the valuation has fallen well below the underlying loan. This has been most obvious in the secondary office market, followed by retail and hotel sectors given valuation pressure and demand sensitivity to the economic cycle.

Commercial property debt cycle: Benign relative to previous cycles

Despite pockets of rising stress in selective markets and sectors, overall commercial property leverage appears more manageable for regulators and central banks than in previous cycles, at least when outstanding loans are scaled as a percentage of the nominal economy. In the US, total outstanding commercial property debt tracked by the Fed in its quarterly financial accounts has grown by 5.0% per year over the past decade while home mortgages have grown at 3.3% per year over the same period. But as a percentage of nominal GDP, the total amount of loans has fallen from a peak of 17% in 2009 to 13% in September 2023. Similar trends have been seen in other countries.

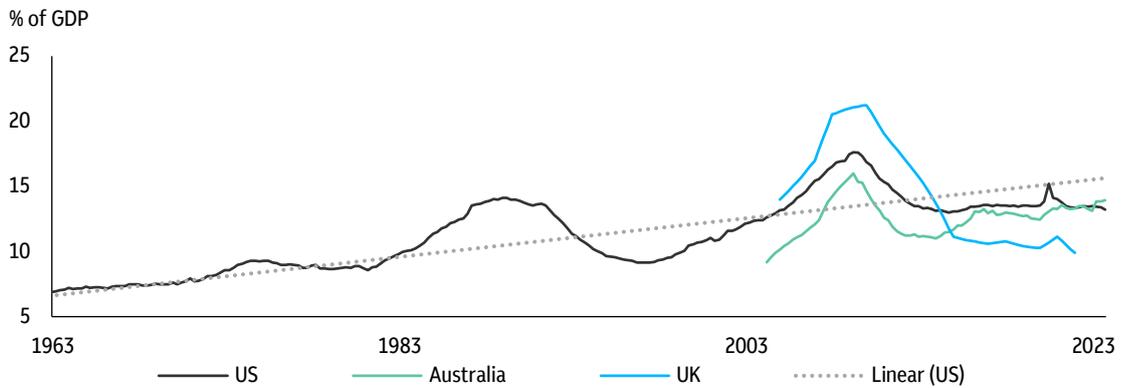
Figure 26.
Strong absolute growth in loans secured against commercial property



Source: Bloomberg (January 2024).

In Australia, the same ratio has fallen from a peak of 16% to 14% of GDP, and in the UK the adjustment has been even more pronounced given significant regulatory pressure on high street banks. Nonetheless, given materially higher borrowing costs, lower loan-to-value ratios, and lower valuations, opportunities are emerging as owners are forced to sell or chip in more equity at refinancing events.

Figure 27.
Commercial property loans as a percentage of GDP over the long run



Sources: APRA, Bloomberg, Macrobond (January 2024).

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For more information, or to speak to the author of this issue, David Roberts, please contact your Macquarie Asset Management Relationship Manager.