Bank of Melbourne

PROPERTY 2022:

The Outlook for Industrial and Logistics Commercial Real Estate

Bank of Melbourne Property Report | March 2022

Identifying a market opportunity for our Business customers.

DEMAND FOR INDUSTRIAL AND LOGISTICS REAL ESTATE IS RUNNING RED HOT AND HAS BEEN FOR SEVERAL YEARS.

There are several factors underpinning the sharp growth in demand, in particular, changes in the way we shop for goods and services. The pandemic has accelerated changes in consumer preferences, especially around online spending, in addition to spear-heading changes in Australian manufacturing. The upheaval from the pandemic has also led to disruptions to supply chains, which has flowed onto demand for industrial and logistics property.

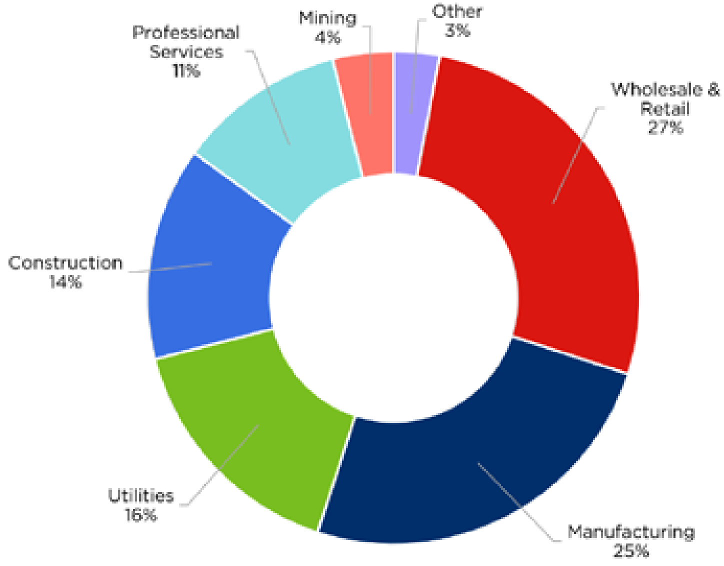
A greater need for social-distancing and less human interaction to manage potential pandemic outbreaks has resulted in greater use of automation. These changes are transforming the global logistics landscape. This will contribute to ongoing strong demand for industrial property over the next few years.

A lot of this demand has been driven by investors, especially offshore and major property institutional investors who have become increasingly involved in the sector in recent years. However, more recently, there is booming owner-occupier demand from businesses.

Internal Customer Data

Our customer portfolio data suggests there is a solid upturn underway in demand for financing from businesses to purchase their premises, especially among small-to-medium-sized businesses. This is in terms of both loan balances and loan volumes. It's concentrated in two key industries – wholesale & retail, and manufacturing.

INTERNAL NEW BUSINESS OWNER-OCCUPIER LOANS FOR INDUSTRIAL REAL ESTATE BY INDUSTRY (% OF BALANCES, YEAR TO JANUARY 2022)



Source: Westpac Internal Customer Portfolio Research

Leasing Take Up

Demand for warehouse space is running at historically high levels. The growth in e commerce and last-mile logistics (allowing shippers to get products to consumers faster) has been and will be a key driver of occupier demand for e-commerce industrial property in Australia. These trends are expected to help underpin strong take-up of warehousing space over the next few years.

Nearly 3.3 million square metres of industrial and logistics space was leased across the country in 2020, up 38% on the ten-year average. This is a record high, but has been surpassed, with over 4.7 million square metres leased in 2021.

4.7M SQUARE METRES OF INDUSTRIALS AND LOGISTICS SPACE LEASED ACROSS AUSTRALIA IN 2021, ~80% INCREASE ON 10-YEAR AVERAGE.

Drivers of Demand

1. Surge in online spending

The pandemic has underpinned dramatic changes in the way consumers shop. Health concerns and activity restrictions have driven consumers away from physical stores and towards online spending. Online shopping was growing for a number of years before the pandemic but has jumped sharply since COVID-19 hit our shores.

Online shopping has ramped up from under 7% of retail spending in Australia before the pandemic, to a record high of 14.7% in September 2021, before pulling back to 12.0% in January 2022.

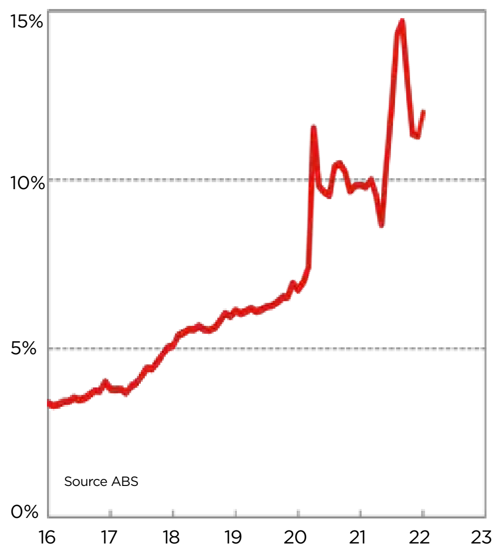
As a result, demand for parcel delivery has increased significantly. This has led to a large increase in demand for industrial property for the purposes of storage, distribution and fulfilment of goods. The growth of e-commerce has increased demand for distribution centres and warehouses, and as a result increasing inventory management also has the potential to drive the expansion of asset sizing.

While online shopping pulled back slightly as restrictions eased, we anticipate some of the changes in shopping habits are likely permanent, meaning that online spending is unlikely to shrink back to pre-pandemic levels. This, in turn, will continue to support demand for industrial property.

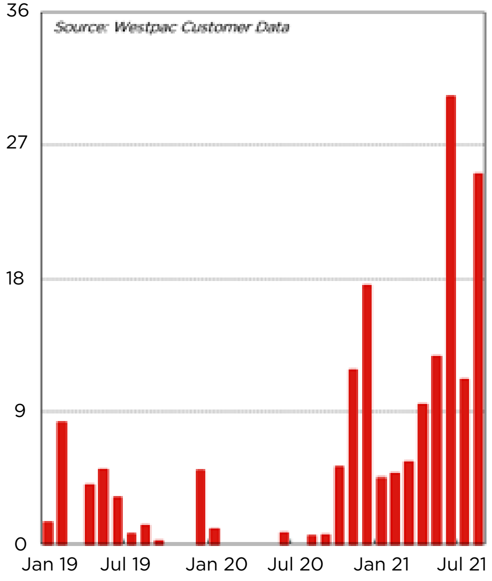
Notably, the global average for online spending as a share of all retailing is much higher and suggests the growth in Australian online spending will continue to accelerate.

As case numbers spiked following the spread of the Omicron variant, many consumers sought to reduce their movements to limit their chance of catching the virus. Case numbers are expected to continue to decline going forward. However, a potential for consumers to remain cautious will provide ongoing demand for online spending in the near term.

ONLINE SPENDING
(% SHARE OF TOTAL RETAIL SPENDING)



NEW BUSINESS OWNER - OCCUPIER LOANS FOR INDUSTRIAL REAL ESTATE



2. Shorter time to delivery

Another key contributor to demand for warehouse space is demand from consumers for shorter time to delivery.

In a product's journey from a warehouse shelf to the back of a truck, to a customer doorstep, the "last mile" of delivery is the final step of the process — the point at which the package finally arrives at the buyer's door. As consumers increasingly turn to e-commerce for their shopping needs, speedy fulfillment and distribution isn't just a "nice to have" — it's the expectation of every online shopping experience.

As a result, businesses are racing to develop new technologies and experimental supply chain models to increase parcel volume, expedite deliveries, and delight customers — all while trying to cut costs. Warehouse and logistics spaces that help improve time to delivery or "last-mile" delivery times are in greater demand.

These broadening expectations for faster delivery times have resulted in increased demand for distribution centres in areas that position inventory closer to the end consumer. It means properties located close to key transport nodes are typically more desirable to occupiers. Industrial assets located near residential areas are attractive to service this increasing demand for shorter delivery times.

In NSW, the state is moving towards a global metropolis of three productive, liveable and sustainable cities: Western parkland city, Central river city and Eastern harbour city. In the Western parkland city, the Western Sydney Airport will be the catalyst for an emerging aerotropolis and tourism gateway. It suggests these corridors could continue to have opportunities. Victoria is moving to developing nodes in areas like Box Hill.

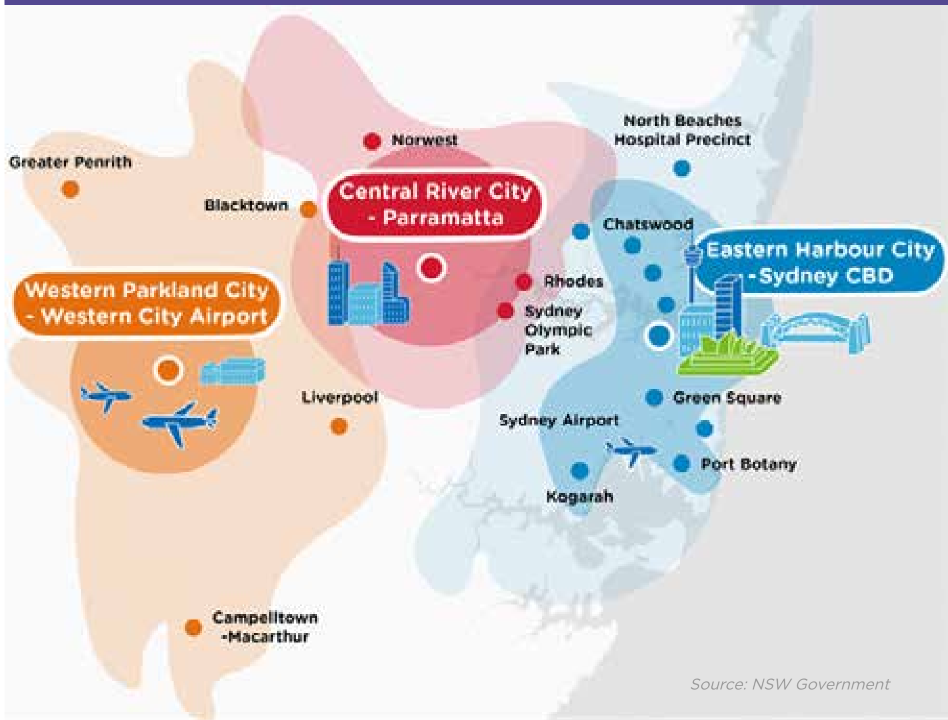
Infrastructure investment has been significant across Australia and especially in NSW and Victoria. These huge infrastructure projects will also help shape demand for industrial properties.

DEVELOPMENT OF NEW TECHNOLOGIES AND EXPERIMENTAL SUPPLY CHAIN MODELS TO

Increase Parcel Volume

Expedite Deliveries

Delight Customers



Source: NSW Government

3. Supply-chain disruptions

The pandemic-induced disruption of global supply chains has had a two-pronged impact on demand for industrial property.

First, supply chain disruptions – both offshore and interstate – mean more warehouse space is required to store goods. The volatility of supply chains means logistics occupiers will look to hold more stock to address supply chain risks, especially in Sydney and Melbourne. Plus, some businesses are being forced to hold more stock to accommodate bottlenecks.

Second, these disruptions coupled with trade tensions have pushed businesses to reassess the resilience of their networks. Some businesses are seeking to diversify their supply chains, boosting demand for industrial and logistics space in strategic locations closer to major markets.

Importantly for Australian manufacturers, some manufacturing has been brought back onshore, especially for vital goods and services. The government has noted medicine, personal protective equipment and fertilisers as points of focus. The boost to manufacturing will support demand for industrial property.

The Federal government is nurturing the revival of Australian manufacturing with its longer-term $1.5 billion Modern Manufacturing Strategy announced in 2020.

4. Accelerated technology adoption

The pandemic has also thrown up a need for less human contact, driving up demand for the automation of production facilities. As a result, manufacturing is undergoing a kind of renaissance.

These other technologies include the internet of things, cloud technology, blockchain, robotics, virtual and augmented reality, AI and additive manufacturing.

Demand for bigger warehouses from manufacturers – especially those in the food and pharmaceutical sectors – is growing.

The expansion in manufacturing will further underpin ongoing demand in industrial real estate. It will remain important to this sector. However, demand for industrial property has pivoted in recent years and has moved towards consumption-based industries, including retail trade, wholesale trade and the transport and logistics sectors. Indeed, Colliers data reveals in 2021 these sectors represented 73% of the total gross take-up volumes nationally. It compares to just over 50% a decade ago.

Commercial Property

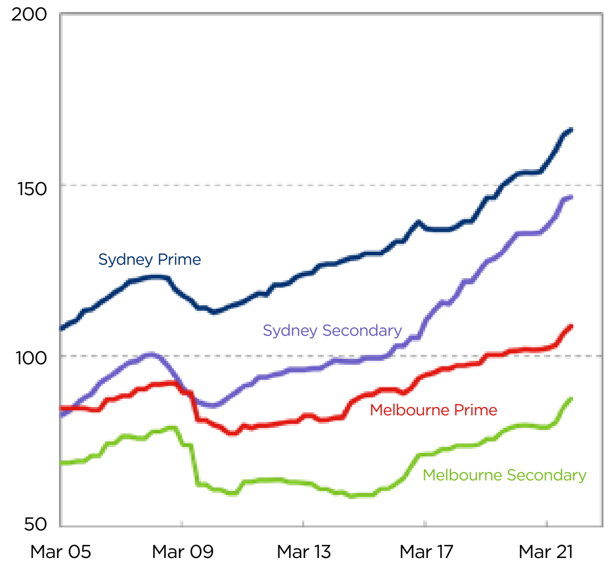
THE INDUSTRIAL MARKET HAS OUTPERFORMED OTHER COMMERCIAL PROPERTY MARKETS, INCLUDING OFFICE SPACE AND RETAIL.

Demand has been supported by the transport, postal and logistics industry, manufacturing, and warehousing. As a result, tenant take-up of industrial property in the year 2021 was almost 80% higher than its 10 year average. This trend has not slowed.

As investor competition for logistics and industrial assets has intensified, prices have risen significantly on the Eastern Seaboard, and yields have compressed. Industrial property yields have fallen dramatically and unusually are below that of office and retail prime property yields. Prime industrial yields in Sydney have fallen to a record low under 4%. Ten years ago, these yields were over 8%. Secondary industrial yields in Sydney have also fallen, so too have yields in other capital cities, although not as low as in the Sydney primary market.

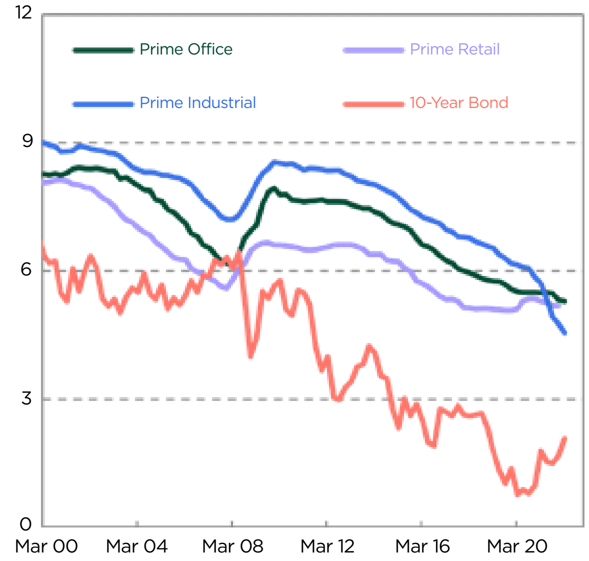
As the industrial sector has matured, there has also been a shift in investor composition towards institutional capital and portfolio transactions. These have accounted for a larger slice of the market in recent years, which has pushed up prices. The major funds and REITs are attracted to the sector's long term income streams. International investor demand has also been increasing as yields on Australian assets have generally been above those found in international markets.

AVERAGE INDUSTRIAL PROPERTY RENT ($ PER SQUARE METRE)



Source: Colliers

PROPERTY AND BOND YIELDS (AUSTRALIA-WIDE, %)



Source: Colliers, RBA, Westpac Property, St.George, Bloomberg

Outlook for Bond Yields

Australian long-term bond yields have been depressed due to the pandemic and large amounts of stimulus unleashed by the central bank, including bond-buying programs. But the Reserve Bank of Australia (RBA) scrapped its yield-curve control program in late 2021 and its bond-buying program for bond maturities of five to ten years in February.

Bond yields hit a bottom in March 2020 and mostly moved sideways until late 2020. Bond yields start lifting noticeably higher in late 2020, as the Australian economic recovery gathered momentum, although setbacks due to the Delta and Omicron waves did result in some temporary pull backs in yields.

The Australian 10-year bond yield is currently trading at around 2.15% (as at 3 March), which is down from the recent 38-month high of 2.30% on 23 February 2022. The invasion of Ukraine in late February led to a spike in demand for safe-haven assets, such as government bonds, and spurred a further lift in commodity prices. The situation in Ukraine is highly uncertain and fluid. There are some concerns a prolonged and broader conflict could hurt world growth whilst putting more upwards pressure on inflation.

Our core view remains one of strong economic growth this year and that the RBA will start raising the cash rate in August 2022 to tame inflationary pressures. We anticipate the Australian 10-year bond yield will move higher over this year towards 2.50%, but there is likely to be volatility with the geopolitical tensions. Against this background, investors are likely to still find industrial property appealing, with the gap between industrial property yields and 10-year bond yields to remain attractive.

The large weight of money trying to find a home in a global environment with still historical low rates of interest means industrial property yields are likely to continue to compress or at least stabilise. Transactions, both domestic and offshore, totalled $16.3 billion in industrial assets in 2021, according to data from Cushman & Wakefield. This compares to totals of just over $5 billion in full calendar years 2018 and 2019.

Vacancy Rates

The vacancy rates in industrial property are low, reflecting a tight market. Nationally, the average vacancy rate had fallen from 5.0% at Q1 2020 to 2.7% at Q4 2021, due to tenant demand outpacing supply, despite the latter starting to lift recently. Vacancy rates by market in Q4 range from 1.9% in Sydney, 2.6% in Brisbane, 2.7% in Melbourne and 2.9% in Adelaide to 4.1% in Perth, according to Colliers Research.

Given the expectation for tenant demand and the consideration that a high proportion of future supply is already pre-committed, CBRE research expect vacancy rates to remain relatively low over the next 12 months despite an increase in speculative started construction.

Industrial Rents

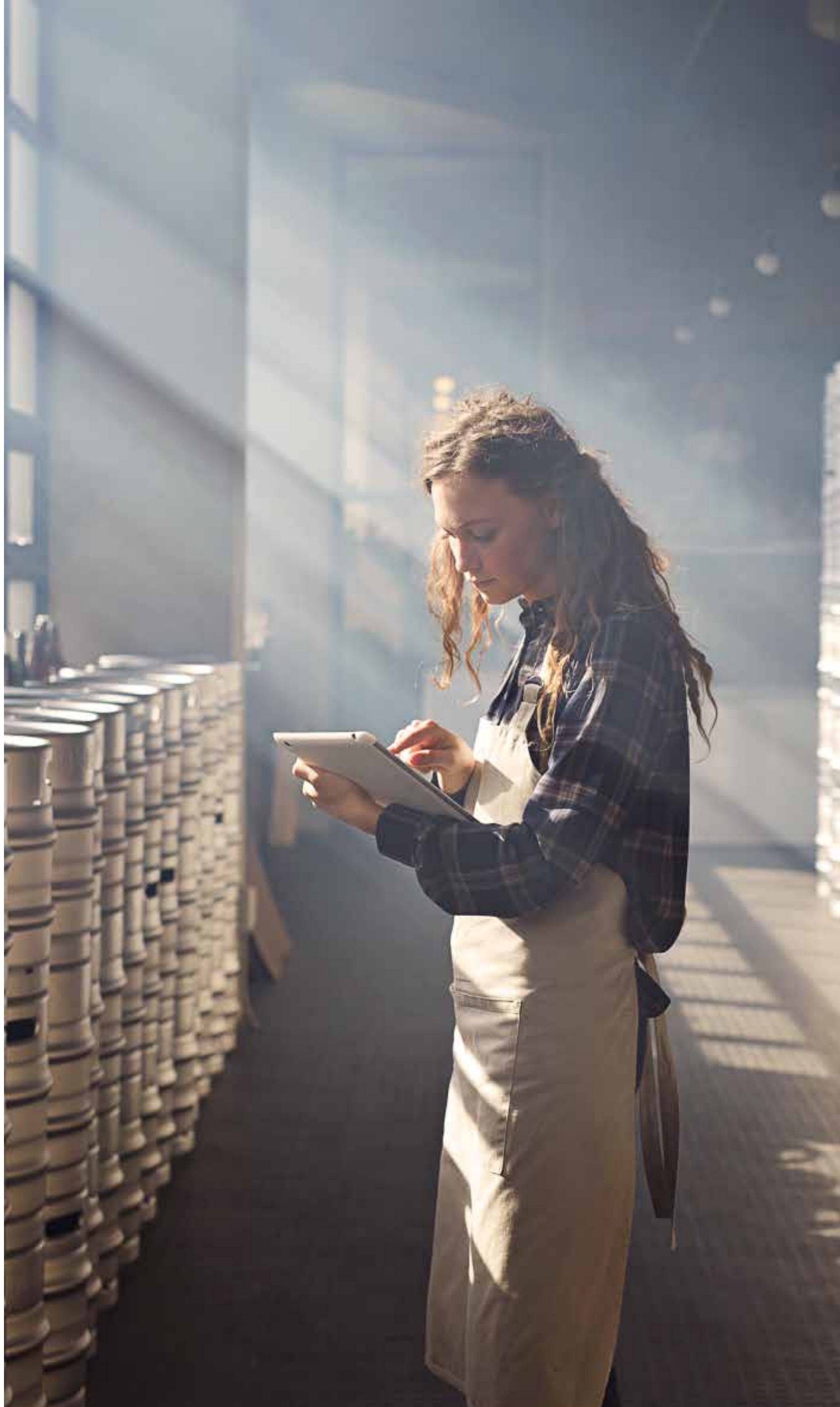
RENTS TRADITIONALLY HAVE SHOWN LITTLE GROWTH IN INDUSTRIAL PROPERTY, BUT THIS HAS SHIFTED IN RECENT YEARS, ESPECIALLY SINCE THE PANDEMIC HAS STRUCK.

Rents traditionally have shown little growth in industrial property, but this has shifted in recent years, especially since the pandemic has struck. In 2021, rents grew by 8% in Sydney prime industrial property.

However, in specific areas rents have risen faster. South Sydney prime industrial rents have risen by 16% in 2021 and 11% per annum since 2018. Part of the reason has been a reduction in the amount of industrial space in inner-city locations as some industrial buildings and sites have been converted to residential premises. This has driven up the price of the remaining industrial land, which in turn has flowed through to higher rents. For example, while Sydney industrial land values have risen 204% over the past five years, South Sydney industrial land values have risen by almost 300%. Melbourne's western suburbs have seen rises averaging 175% over the same period compared with a city-wide average of 148%.

The closer a business needs to be to the inner city, the higher the rent. Taking Sydney as an example, the gross effective rental for a prime 5,000 sqm warehouse in either North or South Sydney would cost around $275 per square metre, compared with $140 per square metre in the South West or $155 per square metre in the Western markets.

With limited opportunity to build in the inner-city areas, expectations are that these rental differentials will only widen. Colliers Research forecast South Sydney prime face rents to rise by around 4.3% per annum over the next three years, while they have projected South Western Sydney markets to rise by 3.1% per annum.



Supply

Supply has responded to the strong demand, with over 2.1 million square metres of industrial space being completed in 2021. This was the largest increase in supply since 2007 and is well above the 10-year average. 2022 is also expected to be a strong year, with over 2.6 million square metres of supply expected to be added.

As demand is expected to remain strong going forward, this increase in supply is unlikely to place much downward pressure on prices or rents.

Investment Markets

As mentioned previously, industrial property has become increasingly attractive to investors in recent years. This has driven yields to record lows and driven prices up significantly for all types of industrial property. The highest increases have been in Sydney and Melbourne, and not only for the prime stock. Secondary industrial values, or values for older properties, in Sydney rose, on average, by 39% in the 2021 calendar year, with the highest rises in the Southern markets at 45%. In Melbourne the growth was 53%, with Western suburb industrial values rising almost 69% over the year, while Brisbane and Adelaide values surged, on average, by 42% and 41%, respectively. Rises in values for secondary industrial properties in Perth (up almost 18%) were more subdued, but still quite impressive and attracting attention.

The level of investor attention and the expectations of continued tenant demand, suggests that values are unlikely to correct over the short term. Colliers expect capital values to continue rising to 2024.

Outlook for Monetary Policy and the Australian Economy

ECONOMIC GROWTH IN AUSTRALIA OVER THE YEAR AHEAD WILL BE SUPPORTED BY ROBUST HOUSEHOLD BALANCE SHEETS, CONTINUED FISCAL STIMULUS, CONSUMER SPENDING AND A STRONG LABOUR MARKET.

We are expecting economic output to step up again this year and anticipate annual GDP growth in 2022 will be well above the long-run average around 2.5%. International borders have begun to gradually reopen, which should lead to a steady improvement in population growth via immigration and student arrivals. This will support demand for consumer goods, and in turn, will support demand for industrial real estate to warehouse and distribute these goods.

We expect the emergence of the Omicron variant earlier this year only temporarily slowed the recovery. High-frequency economic data suggests the recovery has now resumed.

The Reserve Bank has progressed towards its inflation and employment goals much faster than it expected, laying the groundwork for rate hikes to commence later this year. Inflation is now above the mid-point of the 2–3% target band and the unemployment rate has fallen to 4.2% – its lowest level since 2008. We expect wages and inflation will pick up further over the year and have forecast the unemployment rate to fall below 4.0%. The Reserve Bank has emphasised it is prepared to be “patient” before lifting the cash rate. But this patience will likely soon wear thin.

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