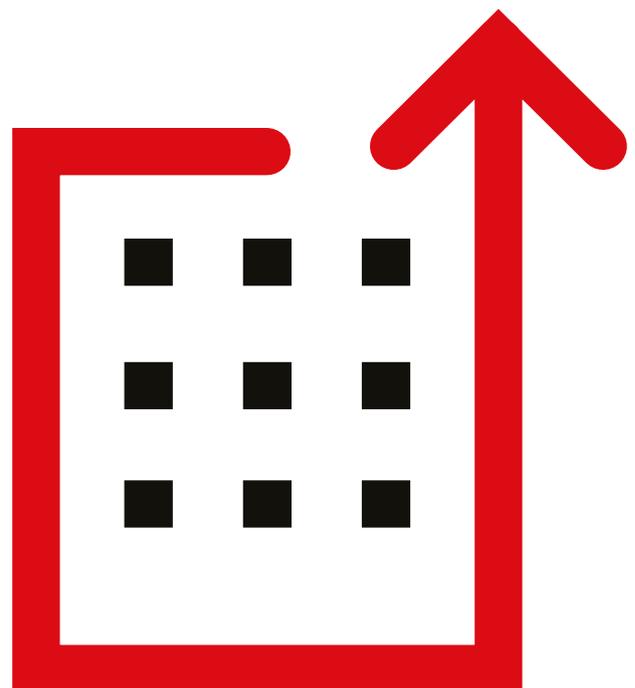


Research

Australia and New Zealand investment market themes for 2021



Hello

The Latin phrase *annus horribilis* best describes 2020. The policy response to mitigate the downside risk of the economic crisis stemming from the pandemic was unprecedented in Australia and New Zealand. As a result, Australia and New Zealand are now well placed for a sustained economic recovery in 2021.

We believe that six key idiosyncratic risk factors influence real asset selection – location, asset characteristics, covenant, WALE, capex requirements and rent profile relative to market. These factors are not weighted equally and are highly dependent on the macroeconomic environment.

In times of uncertainty, real estate investors gravitate towards investment opportunities with low risk profiles. As we moved through 2020, investment activity in the industrial & logistics sector remained firm, while multiple capital sources competed for office assets with long WALEs and convenience retail.

In this paper, we have considered the five key investment themes that will influence the Australia and New Zealand real estate investment markets. These factors will be at the forefront of shaping real estate investment strategies for 2021.

Andrew Ballantyne

Head of Research – Australia



Executive Summary

A sharp reduction in real estate transaction volumes: Australia and New Zealand are expected to experience a 50% decline in transaction volumes over 2020. Investor interest was concentrated on assets with income security – there was limited investment activity for core plus or value add strategies.

Global bond yield convergence has implications for asset pricing: Global bond yields have been converging over the past 30 years. While the convergence has partly been reflected in global real estate markets, the yield spread between Australia and New Zealand and other mature economies remains wide.

Cross-border investors will remain active participants: Australia and New Zealand are viewed as the model for the management of a health crisis. Over the next decade, Australia and New Zealand are projected to be two of the strongest performing mature economies, which will attract a diverse range of capital sources to investment opportunities.

Non-bank lenders have the potential to grow market share: We estimate the market share of non-bank lenders has the potential to grow to 30% of the real estate lending market. As a result, the investable universe for non-bank lenders would increase to AUD 111 billion in Australia and NZD 16 billion in New Zealand.

The rise of real estate alternatives: A number of real estate alternatives show no correlation or are negatively correlated to economic growth. The defensive nature of real estate alternatives ensures they play an important role in a diversified real estate portfolio.

ESG considerations will increase in relevance: ESG factors are becoming more important in the real estate sector. The environmental factor is especially relevant for real estate and a high proportion of listed Australian and New Zealand organisations have publicly stated they will move towards a carbon neutral footprint or have an objective to reduce carbon emissions.



The real estate investment market in 2020

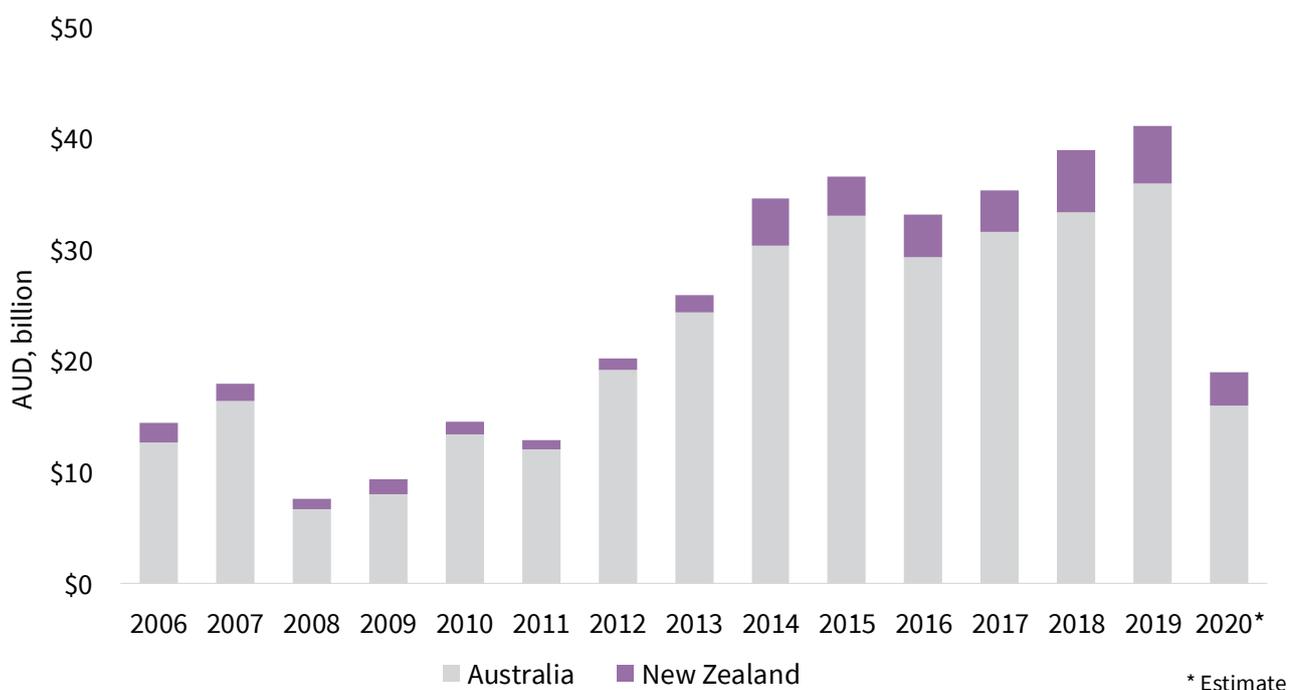
The Australian and New Zealand real estate investment markets started 2020 with high levels of liquidity, multiple capital sources seeking product across the risk spectrum and concerns about the availability of investment product. COVID-19 had a major impact across the world and derailed the real estate market momentum in 2020. We spent most of 2020 following the health crisis and attempting to understand the extent of the global economic recession, the potential recovery trajectory and the impact on real estate markets.

Real estate investors took time to pause in the March to July period as large parts of the Australian and New

Zealand economy were in lockdown. Offshore capital sources faced new challenges as international borders were closed and extended Foreign Investment Review Board (FIRB) time periods in Australia were additional barriers to investment.

We estimate transaction volumes will be a fraction below AUD 20 billion across Australia and New Zealand in 2020 (Figure 1) – well below the record level in 2019 (AUD 41.2 billion). While investors were nervous about under-writing assumptions, the lack of prime grade product available also impacted transaction volumes.

Figure 1: Australian & NZ commercial property market transaction volumes



Source: JLL Research

The price discovery journey was short in the industrial & logistics sector. The ALDI portfolio traded for AUD 648 million to Charter Hall / Allianz in June 2020 and highlighted the extent of investor demand for modern, long lease industrial & logistics assets underpinned by strong covenants. The depth of investor demand for industrial & logistics product was greater than the number of investment opportunities available, resulting in downward pressure on prime grade yields.

Our prime equivalent yield range for Sydney Outer Central West (4.50% to 5.00%), Melbourne West (4.50% to 5.00%) and Auckland (4.63% to 5.25%) all compressed through 2020.

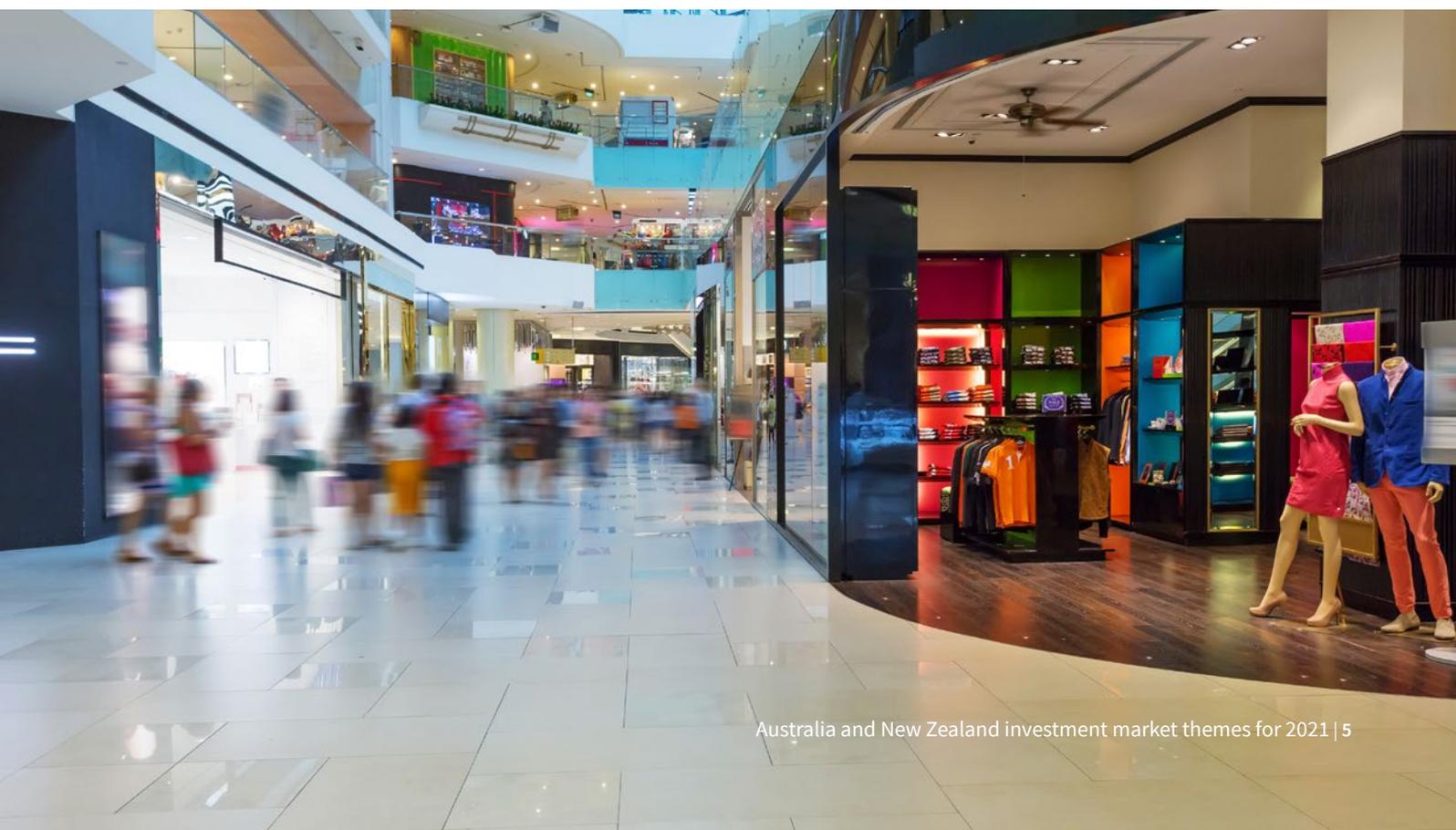
The long WALE thematic was replicated in the office sector with a number of benchmark transactions in Macquarie Park. AEW and Keppel Capital have exposure in CBD office markets and extended their mandates to include metropolitan office markets. Investors were more concerned with shorter WALE assets (typically less than three years), and we saw a widening in the bid-ask spread for these assets. The softening of office leasing market conditions and downward pressure on effective rents will test investor confidence in under-writing acquisitions with income risk. The Australian CBD office area-weighted average prime / secondary yield spread is currently 92 basis points, and we expect it will widen back towards the 10 year average spread of 120 basis points.

A dichotomy emerged in the retail investment market. The discretionary retail sector was facing a number of cyclical and structural challenges heading into 2020 and COVID-19 accelerated a number of those trends. Lockdown measures severely impacted foot traffic, while the mandatory code of conduct had a disproportionate impact on the retail sector and was a contributing factor to a sharp reduction in rent collection rates in Q2. Over the second half of 2020, foot traffic across shopping centres recovered and rent collection rates improved as retailers re-opened stores. The confluence of uncertainty led to larger discretionary

retail centres becoming illiquid, and we estimate regional shopping centre (-12.2%) and sub-regional shopping centre (-12.5%) asset values corrected in 2020.

The convenience and large format retail sub-sectors were resilient in 2020. The defensive characteristics of supermarket anchored shopping centres are supported by the inelastic nature of consumer spending on groceries. Investors gravitated towards neighbourhood shopping centre assets with a strong trade area, minimal capital expenditure requirements and limited supply risk. SE Queensland (5.50% to 8.50%) and Perth (5.75% to 7.75%) neighbourhood shopping centre yields were unchanged over 2020.

The investment case for real estate alternatives firmed in 2020. We saw increased investor interest in data centres, private hospitals (and the broader healthcare sector), self-storage and the nascent Build-to-Rent sector. The long WALE thematic was prevalent in the real estate alternatives sector with the sale and leaseback of the Telstra data centre to the Centuria Industrial REIT for AUD 416.7 million, reflecting an initial yield of 4.19%. In the healthcare sector, Dexis acquired the Australian Bragg Centre in Adelaide for AUD 446.2 million and Charter Hall purchased the Mater corporate headquarters and healthcare training facilities in Newstead, Brisbane for AUD 122.5 million.



Five real estate investment market themes for 2021

The real estate investment market will provide a diverse range of opportunities across the risk spectrum in 2021. The official statistics will likely show that Australia and New Zealand both moved out of technical recession in the latter part of 2020.

Nevertheless, the economic recovery from the COVID-19 recession will be unpredictable and uneven. Deloitte Access Economics forecast the Australian economy will record GDP growth of 3.0% in 2021 and 3.9% in 2022. New Zealand is expected to be on a similar trajectory with economy rebounding to 4.3% in 2021 and 3.3% in 2022.

Figure 2: Australia and New Zealand, GDP Growth



Source: Deloitte Access Economics, JLL Research

The unpredictable and uncertain nature of the economic recovery will present a diverse range of opportunities and risk for real estate investors in 2021.

A number of themes will emerge in 2021, while others will become stronger and more relevant for real estate investors. In this paper, we will explore five themes for investors to watch in 2021:

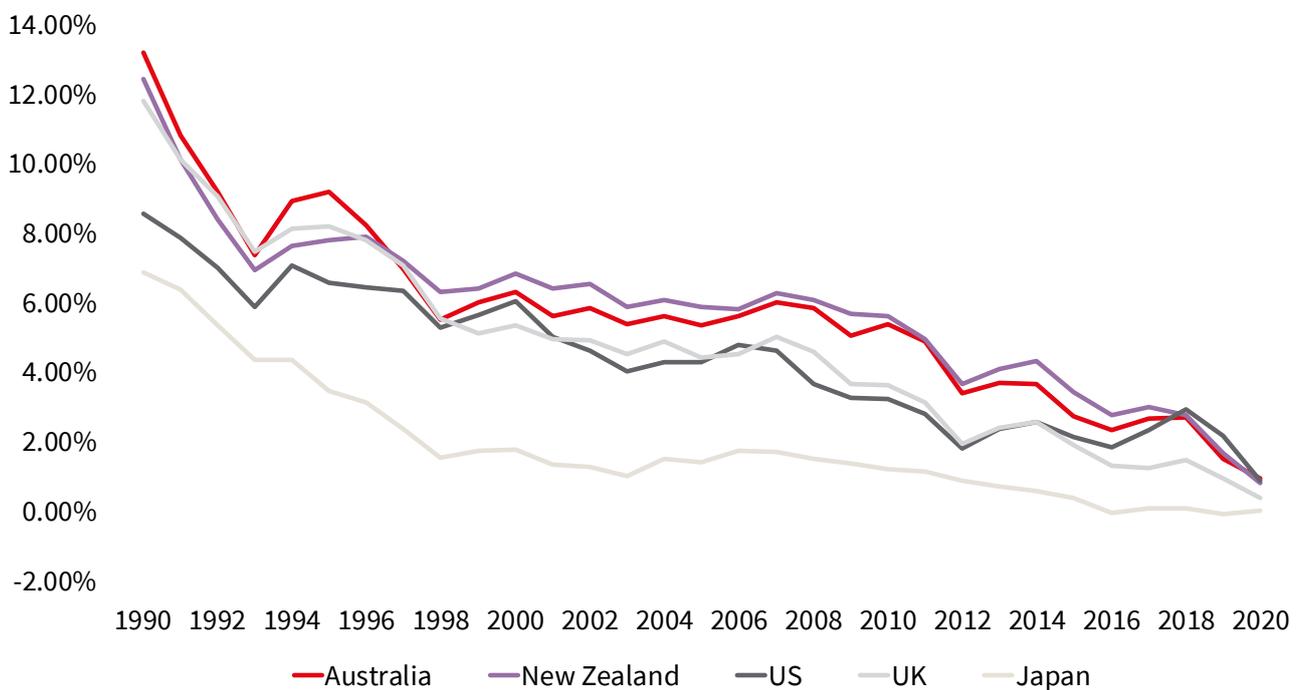


Bond yield convergence and the implications for real estate return expectations

Government bond yields have followed a downward trajectory over the past 30 years. Potential GDP has lowered for mature economies and Central Banks have been largely successful in managing inflation. Australia and New Zealand were historically viewed as higher growth / inflation economies with Government bond

yields above the US, UK and Japan in the 1990s, 2000s and the period through 2015. More recently, bond yields have converged across mature economies with important implications for asset pricing.

Figure 3: Mature economies 10 year Government bond rates

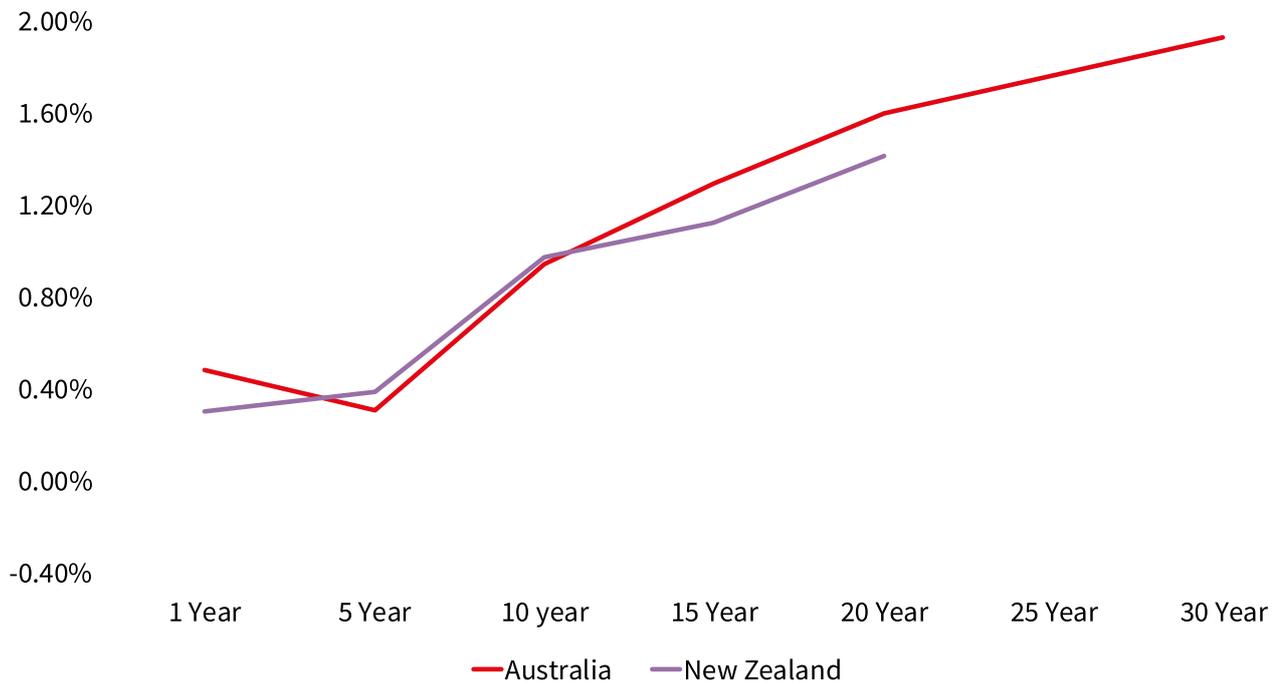


Source: JLL Research, Oxford Economics

In 2020, retail and to a lesser extent office sector valuations were negatively impacted by income risk and a reduction in short-term rental growth assumptions. However, real estate valuations are determined in relation to a risk-free rate, and the decline in the risk-free rate will normally pressure market risk premiums to compress. Over the long-term, we have observed a close relationship between property market discount rates and government bond yields. The correlation co-efficient in Australia is between 0.85 and 0.90.

Real estate is an illiquid asset class and core investors typically hold for periods of greater than five to seven years. We believe it is important to formulate a view on the potential movement of the risk-free rate over the investment horizon. The first phase of an assessment should be to review the yield curve – a curve which plots bond yields over differing maturities and provides an insight into future interest rate changes. While the yield curve in Australia and New Zealand has moved out post the Pfizer vaccine announcement, it remains relatively flat implying a low interest rate environment.

Figure 4: Australia and New Zealand yield curve



Source: JLL Research, World Government Bonds



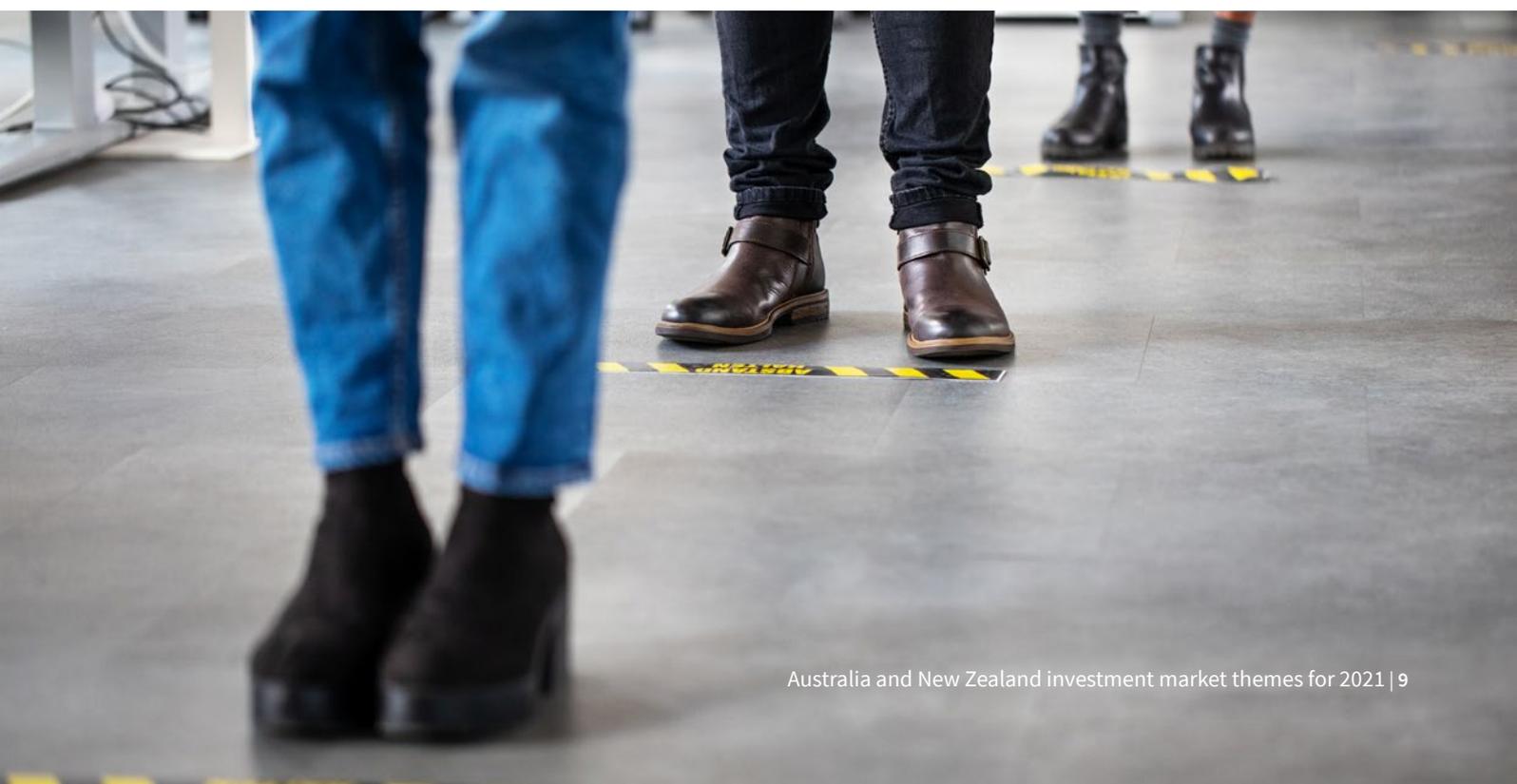
One of the legacies post COVID-19 is the expectation of an extension of the low interest rate environment. Deloitte Access Economics have shifted their medium-term bond yield outlook. The Australian Government 10 year bond rate is forecast to remain below 1.00% through 2024 and only move back to 1.78% by 2029. The same security in New Zealand is expected to follow the same trajectory, remaining below 1.00% through 2023.

Investors will form views on the appropriate risk-free rate and implied market risk premium for different sectors and geographies. A number of investors will be concerned that the unprecedented policy measures will be inflationary and interest rates will rise, while others believe the lower for longer thematic will remain prevalent over the next decade. We have constructed a cross-tabulation to highlight how sensitive real estate return expectations are to shifts in the risk-free and market risk premium (Figure 5).

Figure 5: Real estate return expectations

Implied Risk Premium (bps)					
Risk Free Rate	200	250	300	350	400
1.00%	3.00%	3.50%	4.00%	4.50%	5.00%
1.50%	3.50%	4.00%	4.50%	5.00%	5.50%
2.00%	4.00%	4.50%	5.00%	5.50%	6.00%
2.50%	4.50%	5.00%	5.50%	6.00%	6.50%
3.00%	5.00%	5.50%	6.00%	6.50%	7.00%
3.50%	5.50%	6.00%	6.50%	7.00%	7.50%

Source: JLL Research



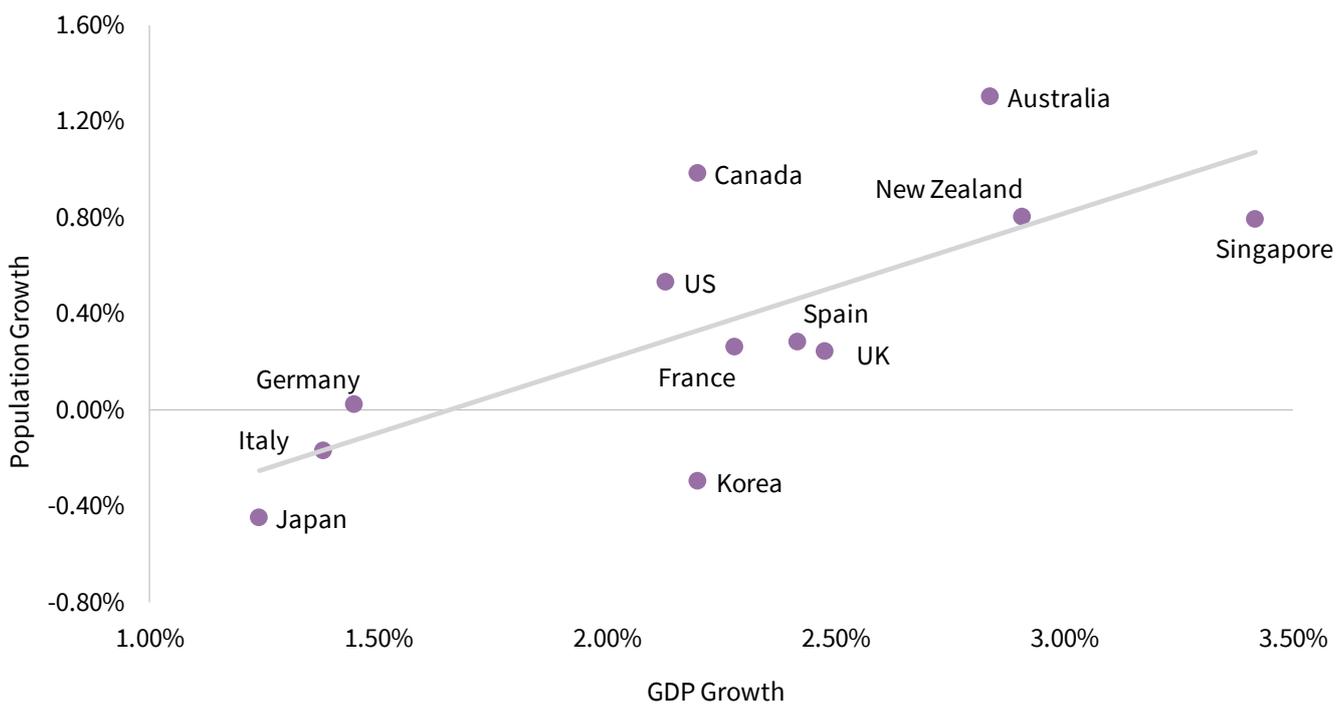
Cross-border investors views of Australia and New Zealand

Australia and New Zealand are attractive real estate investment destinations for offshore capital sources. The investment thesis is well-articulated in Australia and New Zealand. Investors are attracted to strong GDP growth, liveability attributes which support population growth, transparent real estate markets and importantly for core investors – low volatility of returns through the cycle.

We have benchmarked Australia and New Zealand against a number of mature economies – GDP outlook and population growth (Figure 6).

On the assessment of these macro variables, Australia and New Zealand are attractive relative to other mature economies. Furthermore, Australia (number 3) and New Zealand (number 6) are also ranked as two of the most transparent real estate markets in the world. The main limitation for offshore capital sources seeking to build a diversified portfolio of scale in Australia and New Zealand is the limited size of the investable universe.

Figure 6: Mature economies, GDP and population growth, 2020 to 2030



Source: JLL Research, Oxford Economics

We surveyed top investment leaders from 38 global and regional investors on how COVID-19 is impacting their strategic investment decision-making. One of the questions provided to investors was a view on their investment intentions for major Asia Pacific geographies

through 2021. The results for Australia were positive with 50% of investors planning to increase their exposure and only 7% looking to down-weight their real estate holdings in Australia.

Figure 7: Global real estate investors' geographical allocations (end 2021)

Country	Increase	Hold	Lower
 Australia	50%	43%	7%
 Hong Kong	4%	78%	18%
 India	18%	81%	1%
 Japan	56%	38%	6%
 Mainland China	51%	41%	8%
 Singapore	44%	52%	4%
 South Korea	44%	55%	1%
Southeast Asia (ex Singapore)	15%	77%	8%
Others	4%	89%	7%

Source: JLL Research

New Zealand has remained an attractive investment destination for cross-border capital sources in 2020. Australian based investors – Charter Hall and

Centuria – have expanded their holdings, while Logos, PAG and JP Morgan all made significant investments into the New Zealand real estate market.



The evolution of real estate debt capital markets

The domestic banking sector has been the primary source of debt finance for real estate investors in Australia and New Zealand. However, the domestic banking sector has become more risk averse and adopted more onerous lending criteria for the provision of real estate debt finance. Traditional lenders have concentrated their activities on lower risk property transactions with a more certain cash flow profile.

An opportunity has emerged for alternative lenders to become more active participants in the Australia and New Zealand commercial real estate lending market. Commercial real estate debt is providing lenders with comparatively stronger risk-adjusted returns compared with corporate bonds or equities. While a number of alternative debt investors take on greater risk than traditional banks, they can still target higher returns while sitting with the security of a first mortgage.

Debt market participants, as sources of capital, differentiate themselves based on their own risk or investment appetite. Lending on core assets was historically dominated by the domestic banking sector. We have seen a number of international commercial banks explore strategies to grow market share in this cohort of the lending market. Global pension / life funds are exploring core lending opportunities in Australia and New Zealand as they seek geographical diversification

in their commercial real estate debt exposure. Global pension / life funds have looked to differentiate their product offering by providing longer tenor (7 years+) than the domestic banking sector (2-5 years).

Non-bank lenders are particularly relevant to investors with assets that are considered transitional – short-term income issues, capital expenditure requirements or development opportunities. The expansion of these type of debt funds ensures that investors / developers now have access to a wider variety of alternative and increasingly attractive finance products.

A number of non-bank lenders are exploring the potential to increase their allocation to non-listed real estate debt. This will create competition in the Australia and New Zealand market and the potential for non-traditional lenders to grow market share. We have reviewed the commercial real estate investable universe for existing assets in Australia and New Zealand and assumed that 60% is equity funded and 40% debt financed. To understand the depth of opportunity for non-bank lenders, we reviewed a range of market share scenarios. If non-traditional lenders moved to a market share of 30%, that would imply a potential opportunity of AUD 111.30 billion in Australia and NZD 15.90 billion in New Zealand.

Figure 8: Non-bank lending universe

Market Share	Australia (AUD, billion)			New Zealand (NZD, billion)		
	30%	40%	50%	30%	40%	50%
20%	55.65	74.20	92.75	7.95	10.60	13.25
25%	69.56	92.75	115.94	9.94	13.25	16.56
30%	83.47	111.30	139.12	11.92	15.90	19.87
35%	97.39	129.85	162.31	13.91	18.55	23.18
40%	111.30	148.40	185.5	15.90	21.20	26.50

Source: JLL Research, PGIM

The rise of real estate investment alternatives

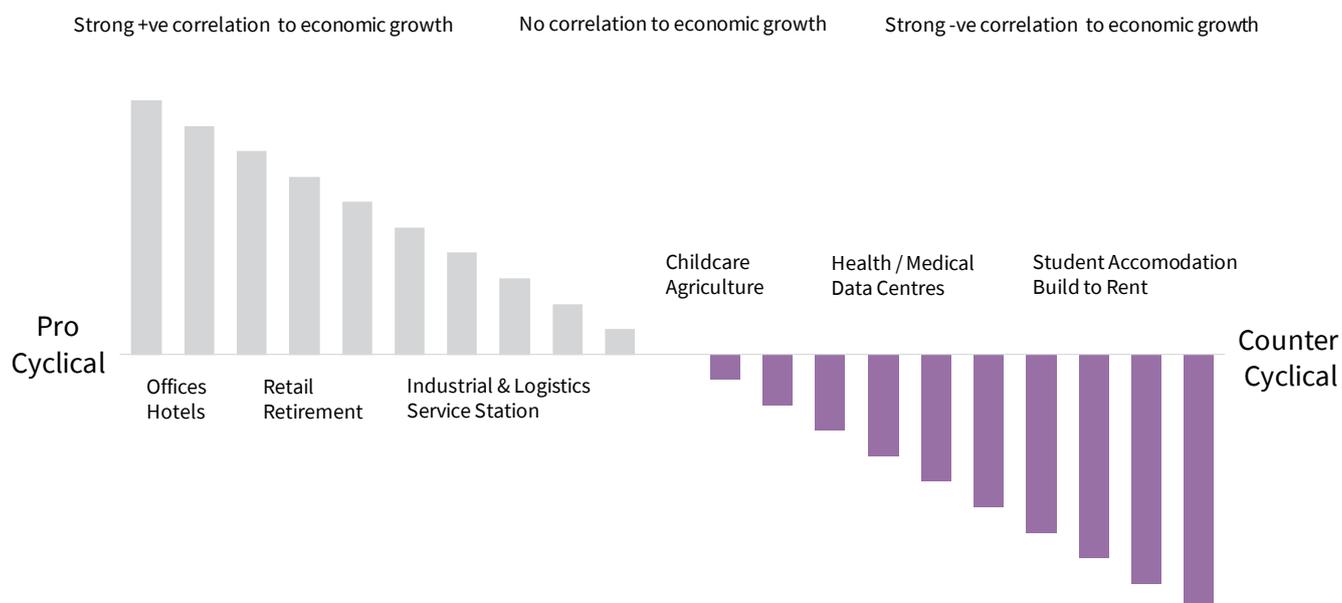
The real estate alternatives universe covers a diverse range of sectors. We have formed a definition that includes all sectors with the exception of the mainstream commercial real estate sectors of office, retail and industrial & logistics. The investment case for real estate alternatives is supported by long-term macroeconomic and demographic trends, the weight of capital seeking real assets and portfolio diversification benefits. Diversification is the cornerstone of modern portfolio theory and occurs between lowly or uncorrelated sectors or asset classes. The mainstream commercial property sectors have shown a high degree of correlation over the past 20 years. Furthermore, a number of real estate alternatives can be characterised as fundamental needs based services supporting the long-term demand environment for these sub-sectors.

Mainstream commercial property sectors are intrinsically linked to economic growth. In the office sector, white collar employment is highly sensitive to broader macroeconomic conditions.

The demand for office space fluctuates with changes in white collar employment. We have argued that real estate alternatives are less correlated with the broader economy (Figure 9). The resilience of most real estate alternatives sub-sectors was highlighted by high rent collection rates throughout COVID-19 and it has expanded the pool of investors seeking exposure to those sub-sectors.

There are a number of sectors where demand is not a function of economic factors (childcare, healthcare and data centres), so income streams are stable through the cycle. There are also some subsectors which display counter-cyclical characteristics. The propensity to buy a residential dwelling reduces in an economic downturn and part of the population gravitates towards rental accommodation supporting the underlying demand for Build-to-Rent properties.

Figure 9: Indicative cyclicity of real estate income streams



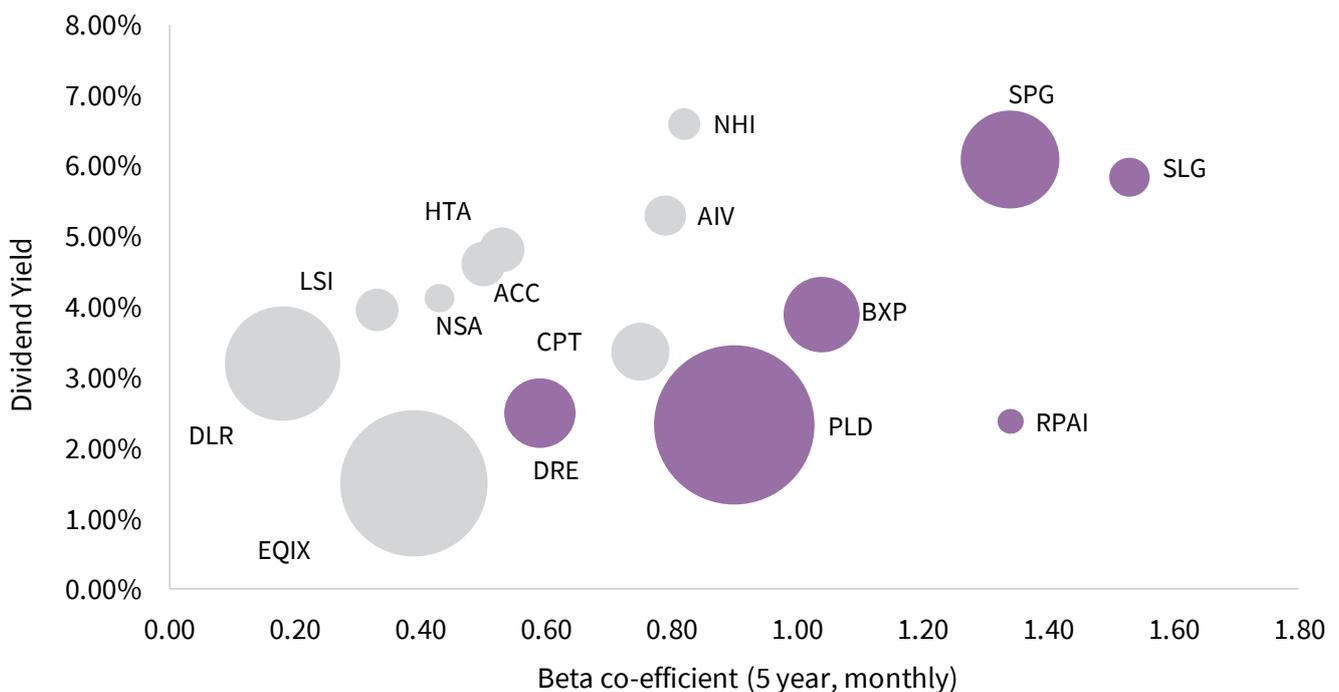
Source: JLL Research

The lowly correlated nature of real estate alternatives to economic conditions makes them less correlated to the broader market than the office and retail sectors. One of the challenges in demonstrating the lowly correlated nature of real estate alternatives in Australia and New Zealand is the limited scale of the investable universe, the lack of investment performance indices and a finite number of listed vehicles specialising in real estate alternatives.

To demonstrate the low volatility of real estate alternatives we have assessed a number of US REITs – a sector covering 219 vehicles with a market capitalisation of USD 1,328.8 billion at the end of 2019.

The scale and depth of the US REIT sector is shown by a number of vehicles specialising in the ownership and management of healthcare, self-storage, student accommodation multi-family and data centre assets. We have looked at a range of specialised vehicles (Figure 10) focusing on the beta co-efficient as the measure to assess the volatility of an individual REIT compared to the systematic risk of the broader market. While the beta co-efficient is calculated against the broader equity market, we have observed that the beta co-efficient for real estate alternatives is lower than REITs focusing on the office, retail and industrial & logistics sectors.

Figure 10: US REITs beta co-efficient, dividend yield and market capitalisation*



* The size of the bubble is the market capitalisation

Note: Mainstream commercial property sectors in purple and real estate alternatives in grey

Source: JLL Research, Yahoo Finance

A number of early adopters have already invested into the Australia and New Zealand real estate alternatives sectors. The resilience of most of these sub-sectors through COVID-19 has strengthened the investment

thesis, and we expect to see a more diverse range of capital sources explore established assets and development opportunities in 2021.

ESG considerations will increase in relevance

Environmental, Social and Corporate Governance (ESG) refers to the three central factors in measuring the sustainability and societal impact of an investment. ESG factors are becoming more significant in the real estate sector as they quantify the sustainability of non-financial impacts of investments and are viewed to have a positive influence on long-term return and risk profiles. We believe that the COVID-19 pandemic has led to a sharper focus on ESG criteria and investment.

Real estate investors are becoming more socially aware in investment decision-making and considering the social and societal implications of each investment opportunity pursued. Investment managers are also implementing corporate governance programs to create a strong corporate culture which leads to the highest standards of integrity, responsibility and propriety. A breach of corporate governance standards can negatively impact the reputation of a real estate manager and the ability to raise capital for future funds.

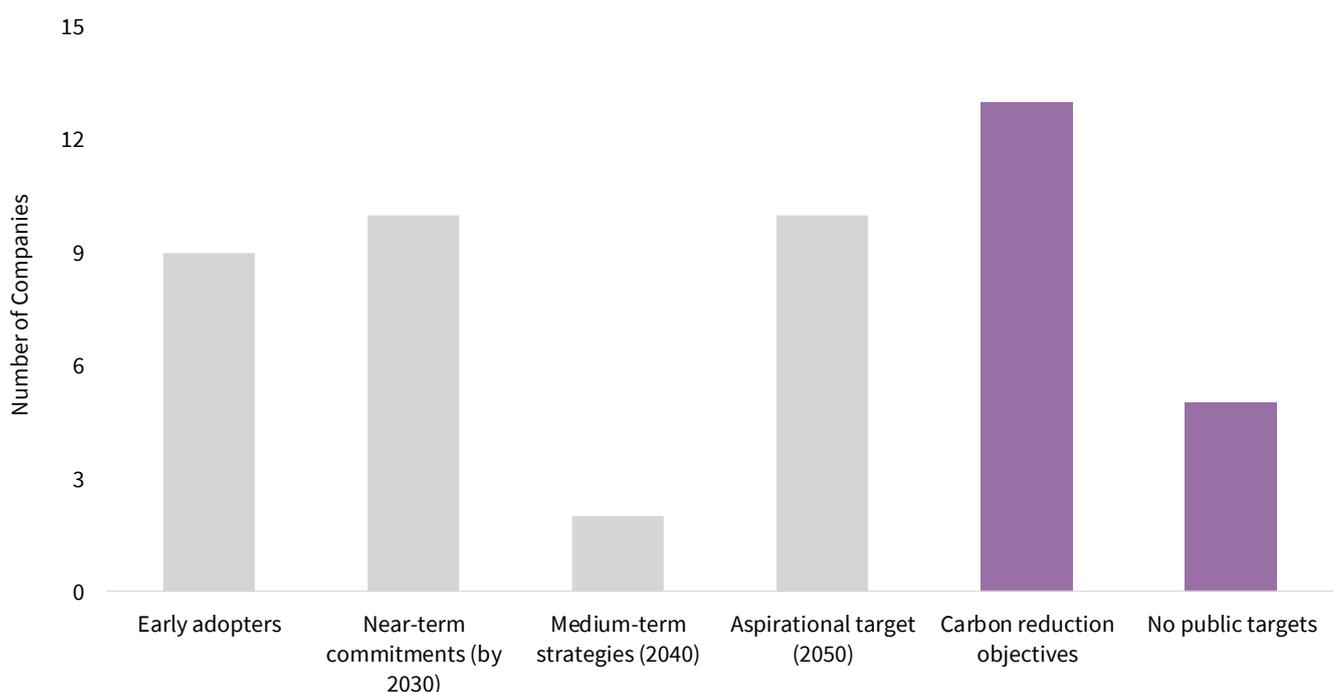
The most visible element of ESG in the real estate sector is environmental considerations. The real estate industry is estimated to account for 30% to 40% of global carbon emissions and a number of real estate investors have made public statements about minimising their carbon

footprint. The GRESB benchmark has seen coverage grow through COVID-19 and now covers 1,229 portfolios encompassing more than USD 4.8 trillion in assets under management. The real estate sector has become more customer-centric with institutional owners seeking to provide a solution for major occupiers of commercial real estate to support their journey towards a carbon neutral future.

We undertook a review of the S&P/ASX 50 to understand their policies towards a low carbon future. Almost 20% (nine companies) have already achieved their goal to become carbon neutral. A further 22 organisations have pledged to become carbon neutral by 2050 – we have termed these companies as near-term commitments, medium-term strategies or aspirational targets. Thirteen listed companies have not made the full carbon neutral commitment, but have publicly stated they will reduce carbon emissions. Only five of the S&P/ASX 50 have not provided guidance on their carbon footprint plans.

New Zealand has moved beyond the carbon neutral ambitions of most countries with legislation passed in 2019 that commits to making the country carbon neutral by 2050.

Figure 11: S&P/ASX 50 carbon neutral / carbon emissions reduction pledges



We believe that organisations will gravitate towards assets with strong sustainability attributes. This creates a potential pool of pre-commitment tenants for developers and an opportunity for investors to refurbish / reposition existing assets. The sustainability journey starts with developers seeking to source building materials within a specific radius and ensuring that

a high proportion of waste is diverted from landfill and composted or recycled. In the office, retail and industrial & logistics sector we are seeing the adoption of solar panels and wind turbines to generate energy. Furthermore, rainwater harvesting is becoming more prevalent in the industrial & logistics sector for use in toilets and exterior water taps.



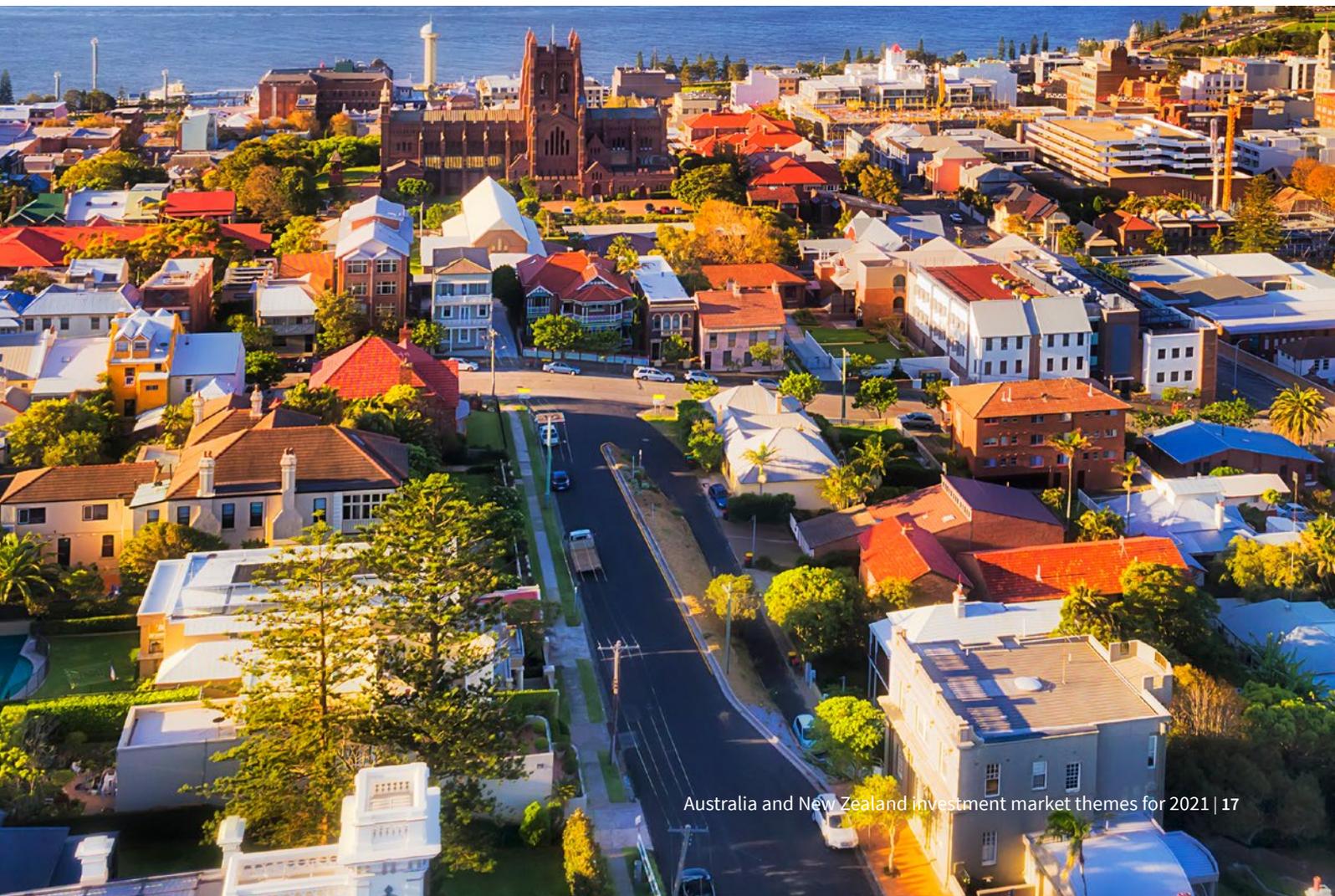
Outlook

Australia and New Zealand are on the economic recovery path with GDP forecast to rebound in 2021 and 2022. Policy measures will be supportive with both the Commonwealth of Australia and New Zealand Government outlining plans to support employment growth and commit funding to a range of infrastructure initiatives, while monetary policy will remain at very accommodative levels. Greater confidence in the economic growth trajectory will lead to an improvement in office and retail leasing enquiry and activity. However, leasing markets will remain challenging and vacancy pressures in some geographies will exert downward pressure on effective rents. The industrial & logistics leasing market will continue to remain healthy with the expansion of e-commerce operators, 3PLs and organisations related to the healthcare sector.

The first potential vaccine announcement on the 9th November had a positive impact on equity markets. Listed investor confidence in COVID-19 exposed sectors (office, retail and hotels) led to a strong rally in unit

prices for those vehicles and a significant narrowing of the discount to NTA. We expect this confidence to flow through to direct real estate investors. While the share market rally may reduce the motivation for some A-REITs to be motivated vendors, we believe that portfolio re-weighting will remain a relevant theme for A-REITs and unlisted funds in 2021.

Offshore capital sources will be an active buyer cohort in 2021. Australia and New Zealand are beneficiaries of two major investment themes – higher allocations to real assets and a portfolio re-weighting towards Asia Pacific. The expectation that Asia Pacific economies will recover more quickly than western countries is an additional ingredient to the investment thesis. The likelihood that international borders will remain closed in the first half of 2021 will present a barrier to investment. However, a number of offshore capital sources have Australian based investment professionals or strong relationships with local managers and are able to overcome the barrier of physical inspection.





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