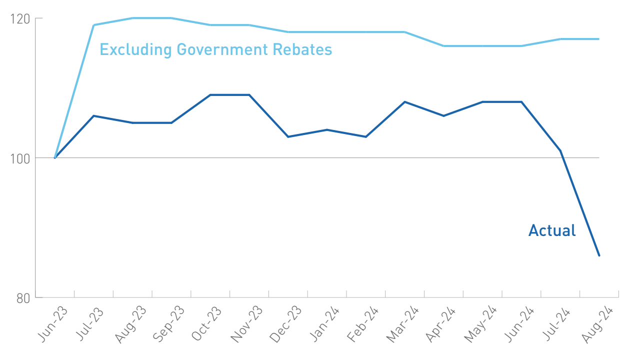
DIRECT PROPERTY UPDATE

SEPTEMBER 2024 QUARTER

Economy[1]

The trajectory of inflation – and consequently interest rates – remains top of mind for financial markets, businesses, and households alike. Year-on-year headline inflation of 2.7% was recorded in the month of August, a substantial fall from the 3.5% rise recorded in July and the first time the measure has sat within the RBA's target band of 2-3% since 2021. However, the sharp fall was in part due to Federal and State Government cost-of-living subsidies, namely electricity rebates. The RBA is "looking through" these temporary factors and instead focusing on underlying inflation, which continued to slow in August but was a more elevated 3.4% year-on-year (per the trimmed mean).

Electricity Price Index



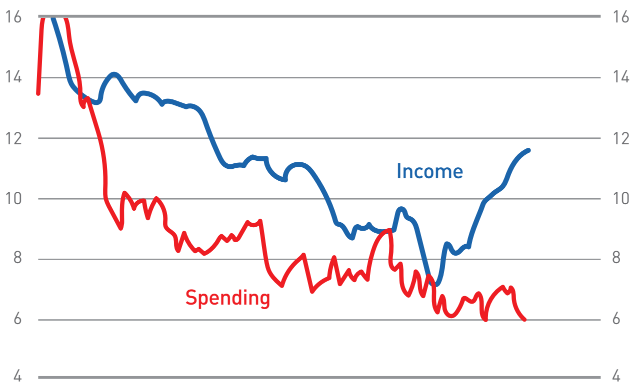
Source: ABS

The RBA has maintained its cautious stance, making it clear that its focus is on getting inflation sustainably within the target range. Any decisions to cut the official cash rate will be made with that objective top-of-mind. While some banks are still noting the possibility of a rate cut at one of the two remaining meetings this year, consensus points to the first cut occurring in February next year, with several cuts expected by December 2025. Lower interest rates should boost market confidence, stimulate transaction activity, and support property prices.

One of the key data points influencing the RBA's monetary policy decisions – besides inflation – is the strength of the labour market. Employment has proven resilient, with jobs growth of 47,500 recorded in August. Similarly, the unemployment rate remained at 4.2%, having only increased by +0.3% since the start of the year. While these and other metrics indicate a robust labour market, it is important to highlight that not all industries are experiencing the same conditions. One of the more obvious divergences exists between industries exposed to the business cycle and consumers (market industries), and non-market industries such as healthcare and education. Data released in September indicates non-market industries accounted for 89% of jobs created over the 12 months to June. This poses a challenge for the RBA, which would like to see some heat come out of the labour market overall, but whose blunt tool has more of an impact on the industries and sectors which have already slowed.

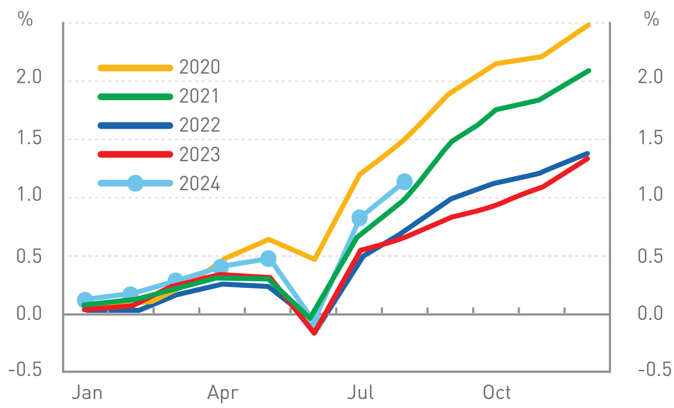
1. Data sourced from various ABS publications, except where otherwise specified

CBA: Income vs Spending
(annual % change, smoothed)



Source: CBA

CBA: Additional Repayments
(YTD change in offset & redraws, % of housing credit)



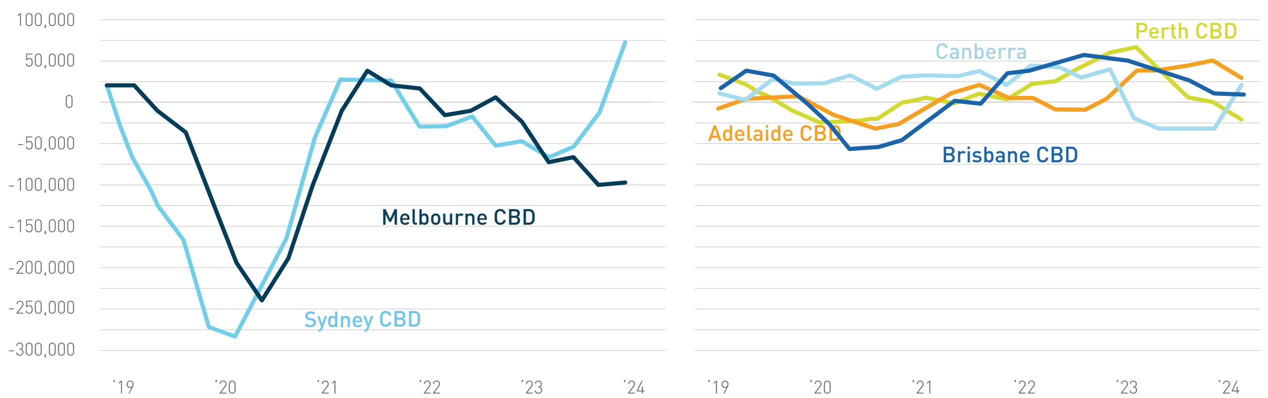
Source: CBA

Another important driver of the economy being closely watched is household consumption and how it responds to the stage 3 tax cuts which kicked in this quarter. While it's too early to get a firm read on consumers' response, initial indications suggest a greater propensity to save than spend. CommBank's analysis of their proprietary data shows while incomes have increased following the tax cuts, card spending has not seen a similar lift. Instead, consumers are saving the additional cash flow by boosting offset and redraw account balances. The CommBank data was broadly corroborated by the ABS Household Spending Indicator for August, which showed spending -0.5% lower than June levels. While the retail component of household consumption exceeded expectations in August (+3.1% YoY) and should be supported by the tax cuts, a sustained recovery may take some time (and rate cuts) to materialise.

Office

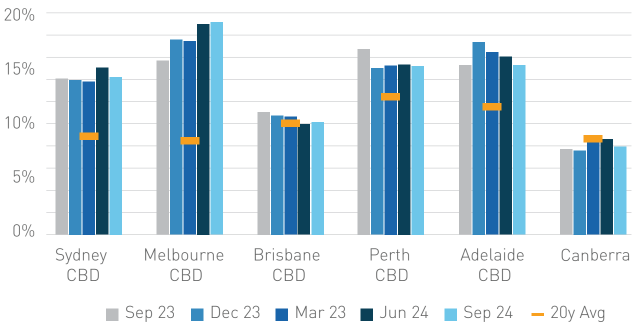
It was an improved quarter for office space fundamentals, but the headline figures continued to obscure varied performance across markets. Analysis of JLL Research data indicates over 90,000 square metres (sqm) of positive net absorption (demand) was recorded across the major CBD markets in aggregate, the strongest quarter since 3Q18. Most of the demand expansion was driven by Sydney CBD which recorded its strongest result since 2015, with support from Canberra and Adelaide CBD. Melbourne CBD was again the weakest performing market from a demand perspective, dragged into contraction by the western end of the city.

Net absorption YoY (sqm)



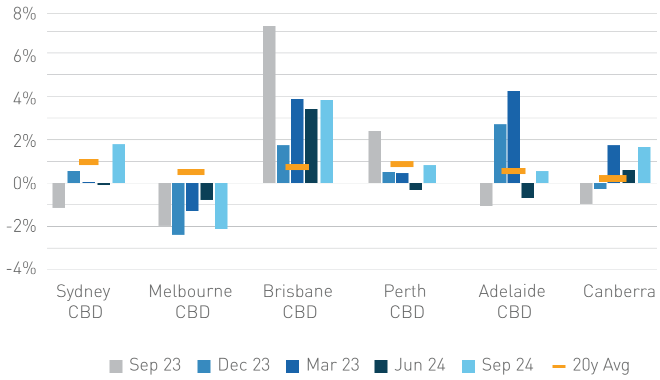
Source: JLL (Sep-24); Cromwell

Total Vacancy Rate



Source: JLL (Sep-24); Cromwell

Prime net effective rental growth (QoQ)



Sources: JLL (Sep-24); Cromwell

With limited new supply completed over the quarter and the demand side of the equation proving solid, the national CBD vacancy rate improved from 15.4% to 15.1%. Every market except Melbourne CBD and Brisbane CBD saw vacancy decline, with Sydney CBD (-0.9%) the standout due to its strong quarter of demand. Canberra and Brisbane CBD remained the tightest markets – their vacancy rates are in line with or tighter than the long-term average.

The pace of prime net face rent growth (+1.3%) improved over the quarter, taking national CBD annual growth to +4.7% (from +3.9% last quarter). Reflecting its favourable supply-demand conditions, Brisbane CBD was again the standout market recording growth of +2.8% (QoQ). Pleasingly, there were also material improvements in face rental growth for Canberra and Sydney CBD, with Canberra delivering its strongest quarterly result since 2012. Incentives were relatively unchanged with the exception of Melbourne CBD, which worsened. This resulted in positive net effective rental growth outcomes, particularly in Sydney CBD which recorded its strongest quarter of effective growth since 2017.

While transaction activity slowed in dollar terms compared to last quarter ($2.1b vs $2.7b), the number of deals done increased. It was the absence of any 'mega' deals which dragged the volume figure, with the largest transaction this quarter – Billbergia's estimated $500m acquisition of Han's Group's Sydney Pitt St development site – dwarfed by last quarter's 55 Pitt St stake selldown. The Melbourne and Sydney CBDs were the most active markets comprising 71% of dollar volume, well above their average share over the last ten years of less than 50%. Across the major CBD markets, average prime yields were largely unchanged with only Sydney CBD seeing a negligible softening. This was only the second quarter since market pricing peaked approximately two years ago where national CBD yields expanded by less than 15bps.

Retail

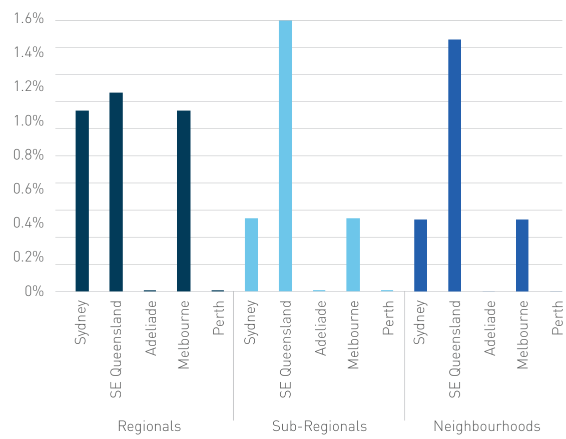
It was a very strong quarter for retail with the core sectors (Regionals/Sub-Regionals/Neighbourhoods) recording weighted net rent growth of +0.7% compared to June. This was the best quarterly result since 2010, in aggregate and for each sub-sector. Regional centres stood tallest delivering growth of +0.9% (QoQ), but the outcomes across Sub-Regionals and Neighbourhoods were also healthy.

> If rates are held steady, the labour market continues to soften, and disinflation resumes its downwards trend, we should see further improvement in capital market liquidity and property transaction activity.

From a market perspective it was the East Coast which outperformed. South-East Queensland recorded the strongest core retail growth for the second consecutive quarter, with growth in every sub-sector exceeding +1.0% and the convenience end of the centre type spectrum (Sub-Regionals and Neighbourhoods) performing particularly well. Sydney and Melbourne also recorded solid growth while Adelaide and Perth were unchanged across the board. Rental growth has been supported by a lack of supply, with stock growth running well below population growth over the last two years.

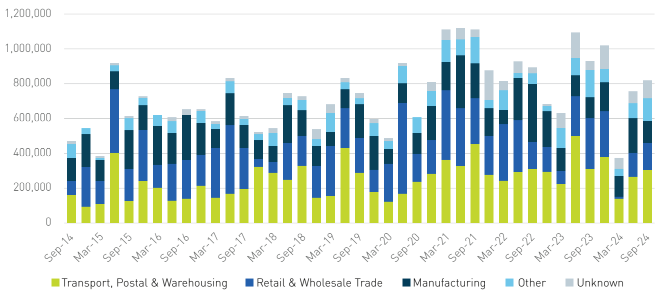
Transaction activity continued to improve, with September dollar volumes totalling $1.9b and exceeding the $1.8b recorded last quarter. The total was buoyed by Vicinity's $420m acquisition of the Future Fund's 50% stake in Lakeside Joondalup – a major shopping centre in Perth – in what was the largest deal in a year. Two other Regionals also changed hands in Perth during the quarter, resulting in the highest transaction volume on record for Western Australia. Yields were largely unchanged except for Sydney Neighbourhoods, which recorded 12.5bps of compression. This represents the second quarter of no movement for most centre types and markets, potentially signalling retail asset pricing is starting to stabilise.

Net Rent QoQ Change (excl. Canberra)



Sources: JLL (Sep-24); Cromwell

Gross occupier take-up by industry (sqm)



Sources: JLL (Sep-24); Cromwell

Industrial

Occupier take-up (gross demand) increased on last quarter to total nearly 820k sqm, which is in line with the quarterly average of the past five years. Multiple industries recorded weaker take-up with Manufacturing and Construction (a notably volatile industry) being the main drags. These industries were more than offset by solid growth across Transport & Warehousing, Wholesale Trade, and various smaller tenant industries. The major driver of improved take-up was Brisbane, which recorded its strongest quarter since last year. Adelaide and Perth also recorded solid growth while Sydney and Melbourne were relative drags.

Rental growth remains above the long-term average despite a weakening of demand relative to supply. The quarterly pace of rental growth slowed across the East Coast but improved in Perth and Adelaide. Perth recorded a sharp acceleration across all three of its precincts, while Adelaide was the top performing market over the quarter, led by rents in the Outer South growing by more than 6%. Melbourne prime rents were unchanged across the board, while Brisbane and Sydney outcomes were mixed – precincts that outperformed in the previous quarter slowed, while those which underperformed saw an acceleration this quarter. Incentives increased in Brisbane, Perth and most Sydney precincts, impacting effective rental growth.

Delivery of supply moderated compared to last quarter but remained elevated versus historical averages, with nearly 750k sqm of new stock completed over the three months to September. Melbourne recorded very little supply after a record level of completions last quarter, outpacing only the much smaller markets of Perth and Adelaide.

Supply continues to be concentrated in a small number of precincts, with a single Sydney precinct (Outer Central West) accounting for more than half of new supply over the quarter. There are currently over 2 million sqm of floorspace under construction and largely due for completion in 2024 and 2025. While extended delivery schedules and solid pre-commitment levels are helping prevent a surge of unleased supply from entering the market, the elevated pipeline of projects will likely continue to push the vacancy rate upwards and dampen the pace of rental growth.

It was a solid quarter of transaction activity with dollar volumes totalling $2.1b. While Sydney activity fell after three consecutive $1b+ quarters, Melbourne recorded its strongest quarter in history. The result was underpinned by the $600m acquisition of the Austrak Business Park in Melbourne's north, which Aware Super and Barings jointly secured. Yields across every Perth precinct expanded by 25bps, the only movement recorded over the quarter.

Outlook

Global issues are expected to dominate the headlines over the coming quarter. From an economic perspective, escalating conflict in the Middle East may put upwards pressure on oil prices and hence headline inflation. However, the potential impact on underlying inflation is less clear. While consumers would notice some pain at the bowser, higher fuel prices could dampen demand across the economy more broadly. As Australia's largest export market, the impact of economic stimulus in China will also be closely watched. Announcements to date appear unlikely to move the needle significantly, but there is scope for additional policies to be delivered. Finally, the outcome of the election and key data prints (jobs and CPI) in the US could materially shift interest rate expectations and financial conditions in Australia.

Interest rate expectations will remain a key influence on the performance of commercial property. We believe rate cuts will contribute to improved market confidence, support a stabilisation of pricing, and stimulate transaction activity. Other countries such as the US, Canada, New Zealand, and several across Europe, have already started lowering rates. Australia's inflation cycle took hold around six months later than peer markets, and rate cuts are also expected to commence a bit later. A consensus is starting to form across economists, with February being pencilled in for the first rate cut by three of the four major banks. However, it is important to note that the precise timing is uncertain and will be data dependent.

How did the Cromwell Direct Property Fund fare this quarter?

In late August, Cromwell Direct Property Fund completed the sale of 433 Boundary Street, Spring Hill, at a 3.8% premium to its most recent external valuation of $40.0 million. The net proceeds from the sale were used to repay debt, reducing the fund's gearing.

In September, Cromwell Funds Management revalued approximately 28% of the fund's portfolio, resulting in an overall decrease in value of 2.2%. As at 30 September 2024, the portfolio is valued at $554.6 million, with a weighted average capitalisation rate of 7.24%. Despite continued strong growth in rents and increased tenant demand, recent sales evidence has contributed to further cap rate expansion. Major sales in the Brisbane CBD this quarter include the William Buck Centre at 120 Edward Street, and 116 Adelaide Street.

Despite this, the outlook for both Brisbane's CBD and fringe office markets remains positive. Market commentary suggests that while there will likely be some further downward pressure on valuations through the remainder of 2024, yields are finally nearing the bottom of the cycle.

Additionally, new interest rate hedging has been executed this quarter to provide certainty around the fund's largest cost – its interest expense. The fund is now 58% hedged, with a weighted average hedge term of 2.4 years. Variations in interest expense can have a material impact on operating earnings, so minimising the downside risk associated with those movements through the use of interest rate derivatives helps maintain the fund's ability to consistently deliver monthly distributions to investors.

Altitude Corporate Centre, Mascot NSW

Portfolio updates for the quarter

Cromwell's Projects Team remains hard at work on major capex updates, including the finalisation of lift modernisation at Creek Street. This work involves upgrading the equipment and controls for the building's eight lifts. The team is also in the procurement stage for installing a new heating plant at Creek Street.

At the O'Riordan Street asset in Mascot, a new bracketing system is being installed to secure the car park façade panels, with the project currently in the engineering design and development phase. Additionally, the team is progressing with the design for the lobby and end-of-trip facilities, which enhance the tenant experience and support lease renewals.

At the Flinders Street asset in Townsville, Cromwell continues investigations with engineers into some remediation works on the wet wall. This proactive effort aims to address issues with the shoring wall construction and prevent potential water infiltration. Due to limited access for repairs, this is a complex project, with testing underway to guide the next steps.

CromwellConnect, the new tenant platform, has been successfully rolled out and has been incredibly well received by tenants at Creek Street. The online platform and mobile app allow tenants to stay updated on the latest building news, book meeting rooms, join health and wellbeing sessions, and access local retail offers.

Annual tenant engagement surveys have been completed, with results expected later this month. The information will be included in our annual ESG report, which is also set to be released by the end of the month.

Encouragingly, data from the fund's Altitude Corporate Centre in Mascot shows an 18% reduction in base building electricity consumption over July and August this year, while our Flinders Street property in Townsville saw a 14% reduction. These results are thanks to the newly installed solar infrastructure.

The fund's portfolio currently stands at 95% occupancy, with a weighted average lease expiry of 3.7 years. However, there are leasing deals currently under Heads of Agreement – the stage where terms have been agreed but lease documentation is not yet executed. Accounting for the largest of these agreements – a new seven-year deal across more than 2,100sqm at Queen Street, Brisbane – occupancy improves to 97%.

Across the eight-asset portfolio, there is now only three floors available for lease – one each at Creek and Queen Streets in Brisbane, and one at Grenfell Street in Adelaide.

Read more about the Cromwell Direct Property Fund: **www.cromwell.com.au/dpf**.